

HOW A FED INTEREST-RATE CUT MAY BACKFIRE



October 30, 2007 -- THE last time the Federal Reserve cut borrowing costs, the interest rate on home mortgages went up.

Huh!

I'll say it again.

When the Fed attempted to rescue the housing industry in August by cutting its funds rate and reducing the discount rate for the second time in a month, the financial markets became spooked and punished mortgage seekers.

According to BankRate.com, the average rate on an adjustable rate mortgage went up from 6.53 percent right before the latest round of Fed rate cuts to 6.64 percent soon afterwards.

The Fed, as you've probably heard, is meeting today and tomorrow to discuss whether another rate cut is warranted.

And there will probably be a cut, although the Fed likely will try to discourage speculation about more monetary easing in the future.

Make no mistake, lower borrowing costs would help an economy that is struggling more than Washington's economic numbers would have you believe.

With housing suffering through a serious recession and speculation on Wall Street driving the price of oil to record levels, the economy is in enough jeopardy to not only make rate cuts inevitable but also urgently needed.

But there's a problem that nobody wants to talk about.

A reduction in borrowing costs," explains **Greg McBride**, senior financial analyst at BankRate.com, "doesn't necessarily have a direct effect on mortgage rates."

In fact, a move by the Fed could hurt the housing industry.

"Last month," McBride adds, "when (the Fed) cut rates, adjustable rate mortgages went up."

And people who couldn't afford houses - so-called subprime borrowers - took out mortgages that adjust.

I've already told you my idea for helping the housing market - loosen the rules that now mostly prohibit people from investing trillions in retirement money in real estate.

As I've been explaining in this column for a long time, the interest rate solution being pursued by the Fed - as McBride explained in a telephone interview - could backfire.

Here's why.

Urgently needed foreign capital will flee the dollar and interest rates will rise if the financial markets think the Fed has lost sight of its main role - controlling inflation. And with all commodities - not just oil - rising rapidly, that day could soon come.

Interest rates - including mortgages - have fallen in the past few weeks as it becomes quite evident that the economy is slowing and as investors seek the relative safety of government bonds.

The 10-year government note is now at 4.38 percent; it was 4.66 percent in mid-August.

And the thinly traded 30-year government bond - whose maturity aligns most closely with fixed mortgages - is down to 4.68 percent. It had been 4.96 percent in August, but is only a little lower than its September level.

Even mortgages have relented to economic reality.

Now, Wall Street is clamoring for another rate cut.

But this could be a case of "be careful what you ask for."

Foreign investors, apparently concerned, sold a record \$69 billion worth of American stocks and bonds in August.

If that trend continues, Washington's bonds could go begging for buyers and interest rates would have to rise to lure foreigners back.

That's what makes this week's decision so difficult. There is ample reason for a rate cut, but it still might be the wrong move.

Here are just some of the reasons rates should be trimmed.

- * Most Wall Street firms are smothering in bad investments, including foolish gambles on home loan securities. A compliant Fed is their salvation.
- * Expectations are that existing home sales this year will fall to a five-year low. If the cost of mortgages actually goes down, a rate cut is beneficial. But there are no guarantees.
- * There are signs that housing prices are falling in most markets.
- * There's also evidence that the housing problem is spreading to the rest of the economy.

Retailers are anticipating poor Christmas sales; trucking and rail companies say freight shipments are down and automakers - as always - are reeling.

- * Also, orders for long-lasting durable goods declined unexpectedly last month.
- * Corporate earnings - despite the occasional favorable surprise like Goldman Sachs, Microsoft and Google - are weak.

Despite the severe drop-off in company earnings, Wall Street is taking the glass-is-a-quarter full approach to the economic environment.

It believes that bad news is good news - because it will force the Fed to act.

Here's how the situation shakes out going into this week's meeting.

If the Fed cuts interest rates it could risk losing control over monetary policy with borrowing costs rising against its will. This would be a catastrophe.

But if it doesn't cut rates - or issues a disappointing statement with a cut - then the stock market could go into a deep funk. This would merely be a disaster. Tough call.

