EAGLE STAR

Market Comment

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Surprise US Interest Rate Cut of 0.5%, No Change in Europe

Yesterday evening the US Federal Reserve cut its key fed funds interest rate by 0.5% to 1.25%. This is the lowest level of US interest rates since 1961.

While a rate cut was widely expected, the size of the reduction surprised analysts who had been anticipating a 0.25% cut. The Fed statement explained that:

"....an accommodative stance of monetary policy, coupled with still-robust underlying growth in productivity, is providing important ongoing support to economic activity. However, incoming economic data have tended to confirm that greater uncertainty, in part attributable to heightened geopolitical risks, is certainly inhibiting spending, production and employment. Inflation and inflation expectations remain well contained. "

The Fed statement also emphasised that its policy stance is now neutral, meaning that it considers yesterday's cut to be sufficient to kick-start the economy again and prevent a double dip recession.

Analysts generally view the move as beneficial for the economy and for equities, although short term difficulties such as a weak US business background, the high valuation of the US market, and policy towards Iraq are more likely to dominate sentiment. The cut could also move the dollar lower relative to the euro and other currencies.

Today, the UK monetary authority and the European Central Bank decided to leave interest rates unchanged. In the case of the UK, the high level of house price inflation was a deterrent to making a move. In the Eurozone, while the ECB's rhetoric has softened in recent months, the lack of movement this month was in line with earlier forecasts, but some commentators had anticipated a move given the large cut by the Fed overnight. A reduction at the ECB's next meeting in December remains a distinct possibility.