

Fed Policy Monitor — February 2008

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The next Federal Open Market Committee meeting is March 18th. Given the recent deterioration in many indicators, the Fed is likely to move between meetings to reduce rates.

The Fed cut the Fed Funds rate 125 bp (1.25%) in January as concerns about economic growth and credit market conditions increased. These concerns remain firmly in place, and the financial markets are suggesting the central bank needs to cut further. T-bill rates are approaching 2%, ten-year U.S. Treasury

bond yields are at 3.5%, the three month Fed Funds Rate Future has fallen to 2.%, stock prices and housing prices are falling, and credit spreads are widening. From a valuation perspective, at 3.0%, the Fed Funds rate is too low relative to underlying inflation. However, the key issue for the Fed is restoring confidence. If it is concerned about avoiding a high risk (albeit low probability) outcome, the Fed should listen to the market and ease. Currently fears appear to be greater than the reality. Although we believe the markets are

overreacting, there is a risk that today's fears could become self-fulfilling.

Any concern that the Fed has about inflation should be eased, as core inflation remains well contained and falling oil prices should bring the headline inflation rate down. Once the financial markets stabilize and begin to reverse, the Fed will be able to stop easing; however, we aren't there yet. After confidence is restored, the Fed can move aggressively in raising rates to address inflation concerns.

| FEDERAL FUNDS RATE VALUATION MEASURES | RULE OF THUMB | CURRENT | BIAS |
|---|--|---------------------|---------|
| Federal Funds Rate (FFR) | | 3.0% | ease |
| Real Federal Funds Rate | neutral= 2.0% | 0.9% | tighten |
| Taylor Rule | (2% core Personal Consumption Deflator + 2% real yield + output gap) | 3.6% | tighten |
| Real FFR vs. Potential Real Gross Domestic Product (RGDP) | convergence over time | Potential RGDP=2.8% | ease |
| FFR vs. Nominal Gross Domestic Product (NGDP) | convergence over time | NGDP=5.1% | tighten |
| INFLATION INDICATORS | | | |
| Personal Consumption Deflator | direction and level | 3.5%/rising | tighten |
| Core Personal Consumption Deflator | direction and level | 2.2%/stable | ease |
| Breakeven Inflation -10-Year Treasury Inflation | direction and level | 2.2%/down | ease |
| Bank Willingness to Lend | falling = ease | falling sharply | ease |
| Oil Price | above/below year ago | +51% | tighten |

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Market Commentary

continued from front

| FINANCIAL MARKET INDICATORS | RULE OF THUMB | CURRENT | BIAS |
|---|---|----------------|-------------|
| 10-Year Treasury Bond Yield | direction and level | 3.6%/down | ease |
| T-Bill Yield (6-month rate) | 6 Mo. Rate >Federal Funds Rate | 2.1%/down | ease |
| Federal Funds Futures | 3-month forward rate | 2.4% | ease |
| Yield Curve | inverted, stop tightening | steepening | neutral |
| Credit Spread | rising = ease | rising | ease |
| S&P 500 year-over-year (y-y) % change | negative y-y, stop tightening | -7.0% | ease |
| Forward Earnings (12 month) | y-y % change forward earnings per share < 10% | 7.0% | ease |
| Commodity Research Bureau (CRB) Spot Metals (y-y) | rising = tighten | falling | ease |
| ECONOMIC INDICATORS | | | |
| Unemployment Claims | rising = ease | low/small rise | neutral |
| Employment Growth | direction and level | 0.7%/slowing | ease |
| Institute of Supply Management (ISM) Composite | <55 ease | 50.7 | ease |
| ISM Non-manufacturing | <55 ease | 41.9% | ease |
| Housing Starts (y-y % change) | below zero | -38% | ease |
| Existing Home Price | below 5% | -6.0% | ease |
| Resource Utilization | capacity + employment rate > 88 | 88 | neutral |
| Financial Crisis | Fed eases in crisis | subprime | ease |

Sources: Bailard Research, Yardeni Research, Ned Davis Research.

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