

Fed Policy Monitor — November 2007

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The next Federal Open Market Committee (FOMC) meeting is December 11th and the big question leading up to the session is, “Will they or won’t they ease?”

At its last meeting, the FOMC lowered the Fed Funds Rate 25 basis points (0.25%) to 4.5%. That decision appears to have been a close call. The committee’s statement suggested that it felt that it had eased enough and that growth would slow but pick up speed later next year. The FOMC remained concerned about inflation and viewed the balance of risks as neutral.

Since the last meeting, the financial markets have expressed strong disagreement with the Fed’s contention that there has been enough easing. Stocks are down sharply, led to the downside by the

financial sector. Treasury yields across the curve have fallen as investors have flocked to safe haven assets. Credit spreads have also widened, reflecting ongoing problems in the credit market.

We believe the Fed should listen to the markets. If it is concerned about avoiding a high risk (even if it is a low probability) outcome, then the Fed should ease, preferably more than expected. While our analysis suggests current fears are greater than the reality and the markets are overreacting, there is a risk that these fears could become self-fulfilling.

With core inflation coming in lower than expected since the last meeting, the Fed’s concern about inflation may have eased. Given its forecast of slower growth, the Fed may decide to take out more insurance and lower rates. It can always remove the ease if the credit markets

settle down and the growth outlook becomes clearer.

The Fed Funds Future is discounting a 25 basis point (0.25%) cut at the next meeting and another 25 basis point (0.25%) cut over the next three months. The bond and stock markets are acting like the Fed is on the verge of a policy mistake. Comments from some Fed governors about having done enough have been unsettling to financial markets. Based on the indicators we monitor (shown below), it is our opinion that the Fed should ease.

FEDERAL FUNDS RATE VALUATION MEASURES	RULE OF THUMB	CURRENT	BIAS
Federal Funds Rate (FFR)		4.50%	ease
Real Federal Funds Rate	neutral= 2.2%	2.60%	ease
Taylor Rule	(2% core Personal Consumption Deflator + 2% real yield + output gap)	3.4%	ease
FFR vs. Nominal Gross Domestic Product (NGDP)	convergence over time	NGDP=4.6%	neutral
Federal Funds Futures	3 month forward rate	4.00%	ease
INFLATION INDICATORS			
Personal Consumption Deflator	direction and level	2.4%/down	ease
Core Personal Consumption Deflator	direction and level	1.8%/down	ease
Breakeven Inflation -10-Year Treasury Inflation	direction and level	2.4%/down	ease
Reserves/Money	direction and level	falling/low	ease

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Market Commentary

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FINANCIAL MARKET INDICATORS

10-Year Treasury Bond Yield	direction and level	4.0%/down	ease
T-Bill Yield (6-month rate)	6 Mo. Rate >Federal Funds Rate	3.4%/down	ease
Yield Curve	inverted, stop tightening	-.50%	ease
Credit Spread	rising = ease	rising	ease
S&P 500 year-over-year (y-y) % change	negative y-y, stop tightening	+3.7%	neutral/ease
Forward Earnings (12 month)	y-y % change forward earnings per share < 10%	7.5%	ease
Oil Price	above/below year ago	+58%	tighten

ECONOMIC INDICATORS

	RULE OF THUMB	CURRENT	BIAS
Unemployment Claims	rising = ease	small increase	neutral
Employment Growth	direction and level	1.2%/slowing	ease
Commodity Research Bureau (CRB) Spot Metals (y-y)	rising = tighten	falling	ease
Institute of Supply Management (ISM) Composite	<55 ease	50.9	ease
ISM Price	<60 ease	63	neutral
ISM Price + Production	<60 ease	56	ease
Housing Starts (y-y % change)	below zero	-21%	ease
Existing Home Price	below 5%	-5.1%	ease
Resource Utilization	capacity + employment rate > 88	89	tighten
Financial Crisis	Fed eases in crisis	subprime	ease

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

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