

## Fed Policy Monitor — April 2007

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### The Fed is on Hold

Most Federal Funds Rate (FFR) valuation measures suggest monetary policy is right on target, although some indicators (such as the 2.8% real Fed Funds Rate) are a bit on the snug side. Since the FFR and the nominal GDP (NGDP) growth rate tend to converge over time, a FFR of 5.25% and a NDGP growth rate of 5.6% indicate the current Federal Funds Rate is

probably just about right. The Fed currently views inflation and economic risks as balanced. Outside of energy, inflation is contained and, with growth moderating, a neutral stance seems appropriate. In the short term, headline inflation may rise due to higher energy prices; however, the Fed is well aware of energy's impact on inflation and will probably look past it. Given the problems in the housing sector and the subprime mortgage

market, the Fed is likely to move cautiously before tightening further. If the housing problems escalate, the Fed has indicated a willingness to ease. For now, the Fed is on hold. The FFR is likely to stay at its current level for some time. If we are right in our forecast for stronger economic growth later this year, the central bank's next move could be to tighten, but we don't think that will happen for a while.

FEDERAL FUNDS RATE VALUATION MEASURES	RULE OF THUMB	CURRENT	BIAS
Fed Funds Rate		5.25%	
Real Federal Funds Rate	neutral = 2.4% using core PCE	2.80%	ease
Taylor Rule	(2% core Personal Consumption Deflator+2% real yield + output gap)	3.60%	ease
Federal Funds Rate and Nominal Gross Domestic Product (NGDP)	Convergence over time	NGDP=5.6%	neutral
Federal Funds Futures Rate	3 month forward	5.23%	neutral
<b>INFLATION INDICATORS</b>			
Personal Consumption Deflator	direction and level	3.50%	tighten
Core Personal Consumption Deflator	direction and level	2.40%	neutral
Breakeven Inflation -10-Year Treasury Inflation	direction and level	2.50%	neutral
Protected Bond Yield			
Unit Labor Costs	direction and level	2.10%	neutral
Reserves/Money	direction and level	falling	neutral
<b>FINANCIAL MARKET INDICATORS</b>			
10-Year Treasury Bond Yield	direction and level	4.75% rising	neutral-
T-Bill Yield (6-month rate)	6 Mo. Rate >Federal Funds Rate	5.08%	neutral
Yield Curve	Inverted, stop tightening	-28 bp inverted	neutral
Credit Spread	low and rising, stop tightening	low, rising	neutral
S&P 500 year-over-year (y-y) % change	negative y-y, stop tightening	+10%	neutral
Forward Earnings	y-y % change forward earnings per share > 10%	+7%	neutral
Oil Price	above/below year ago	-4%	ease

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# Market Commentary

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<b>ECONOMIC INDICATORS</b>	<b>RULE OF THUMB</b>	<b>CURRENT</b>	<b>BIAS</b>
Unemployment Claims	rising = ease	low and stable	neutral
Employment Growth	level and direction	1.80%/	neutral
		slowing	
Commodity Research Bureau (CRB) Industrial Spot Metals	high and stable, ease/ low and rising, tighten	high	tighten?
Institute of Supply Management (ISM) Composite	<55 ease	51	ease
ISM Price	>60 tighten	65	tighten
ISM Price + Production	<60 ease	60	neutral
Housing Starts	y-y % change below zero	-28.5	ease
Existing Home Price	below 5%	-2.0%	ease
Resource Utilization	capacity + employment rate > 87 and rising, tighten	88 and falling	neutral
Global Resource Utilization		ample	neutral
Crisis	Fed eases in crisis	subprime?	ease

Sources: Bailard Research, Oak Associates, Bloomberg, Ned Davis Research

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