

Fed Policy Monitor — September 2007

Arthur A. Micheletti, CFA

Chief Economist and
Investment Strategist

SEPTEMBER 5, 2007

Fed Likely to Cut 25 bp; 50 bp Possible!

The Fed is likely to reduce interest rates at its next Federal Open Market Committee meeting on September 18, 2007. The key questions are not whether the Fed will lower rates but by how much and when. It is possible that the central bank will act before its September meeting. Chairman Bernanke made it clear during his recent speech at Jackson Hole that, while the Fed will not bail out specula-

tors, it will seek to ease systemic risk and keep liquidity flowing. During periods of financial crisis, the Fed usually responds by lowering interest rates. With market interest rates falling and credit spreads widening sharply, the bond market is telling the Fed to ease. Over the past twenty years, the Fed has tended to follow signals from the bond market. The Fed Funds Future is also pricing in lower interest rates: the three-month forward contract is discounting almost 75 basis points

(0.75%) of rate cuts between now and year end. When the Fed changes direction, it can move aggressively and often maintains its new monetary policy for some time. We believe the central bank is shifting to an easing bias, which tends to be positive for financial markets. Even without the ongoing subprime problem, with inflation and economic activity slowing, valuation measures suggest that Fed policy has become too tight.

FEDERAL FUNDS RATE VALUATION MEASURES	RULE OF THUMB	CURRENT	BIAS
Federal Funds Rate (FFR)		5.25%	
Real Federal Funds Rate	neutral= 2.2%	3.0%	ease
Taylor Rule	(2% core Personal Consumption Deflator + 2% real yield + output gap)	3.1%	ease
FFR vs. Nominal Gross Domestic Product (NGDP)	convergence over time	NGDP=4.6%	ease
Federal Funds Futures	3 month forward rate	4.55%	ease
INFLATION INDICATORS			
Personal Consumption Deflator	direction and level	2.1%/down	ease
Core Personal Consumption Deflator	direction and level	1.9%/down	ease
Breakeven Inflation -10-Year Treasury Inflation	direction and level	2.2%/down	ease
Protected Bond Yield			
Reserves/Money	direction and level	falling/low	ease
FINANCIAL MARKET INDICATORS			
10-Year Treasury Bond Yield	direction and level	4.6%/down	ease
T-Bill Yield (6-month rate)	6 Mo. Rate >Federal Funds Rate	4.3%/down	ease
Yield Curve	inverted, stop tightening	+31%	neutral
Credit Spread	rising = ease	rising	ease
S&P 500 year-over-year (y-y) % change	negative y-y, stop tightening	+14%	neutral
Forward Earnings (12 month)	y-y % change forward earnings per share > 10%	+11%	neutral
Oil Price	above/below year ago	+10%	tighten

continued on back

Market Commentary

continued from front

ECONOMIC INDICATORS	RULE OF THUMB	CURRENT	BIAS
Unemployment Claims	rising = ease	low and stable	neutral
Employment Growth	direction and level	1.4%/slowing	ease
Commodity Research Bureau (CRB) Spot Metals (y-y)	rising = tighten	stable	neutral
Institute of Supply Management (ISM) Composite	<55 ease	52.9	ease
ISM Price	>60 ease	65	neutral
ISM Price + Production	<60 ease	60	neutral
Housing Starts (y-y % change)	below zero	-21%	ease
Existing Home Price	below 5%	-2.0%	ease
Resource Utilization	capacity + employment rate > 88	89	tighten
Global Resource Utilization Financial Crisis	Fed eases in crisis	subprime	ease

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

DISCLAIMER

This piece has been distributed for informational purposes only and is not a recommendation of, or an offer to sell or a solicitation of an offer to buy, any particular security, strategy or investment product. This piece does not take into account the particular investment objectives, financial situations or needs of individual clients. This piece contains the current opinions of the author and such opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Bailard will not offer investment advice in any jurisdiction where it is prohibited from doing so.

© 2007 BAILARD, INC. FOSTER CITY, CALIFORNIA



For more information, please call 800.BAILARD (800.224.5273) or visit www.bailard.com.

Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404