

WEEKLY MARKET MONITOR MARCH 26, 2007

BRETT HAMMOND
CHIEF INVESTMENT
STRATEGIST

LEO KAMP
CHIEF ECONOMIST

DOUGLAS FORE
DIRECTOR OF PORTFOLIO
ANALYTICS

MORE OF THE SAME FROM THE FED, BUT...WITH A TWIST

Last week, the Federal Reserve Board (the Fed) left short-term interest rates alone and markets rallied. Today we will discuss TIAA-CREF's views on this scenario and will address the following:

- The recent monetary policy announcement from the Fed
- What was different about that announcement compared to those in the recent past
- The reasons the Fed changed its monetary policy stance a bit to hint toward possible easing later this year
- Why we think it is likely the Fed will ease in the second half of the year
- The immediate reaction of U.S. financial markets to the Fed's announcement

The Fed's recent decision to keep its short-term interest rate target steady at 5.25% extends the same interest rate stance that has been in place since the Fed last raised rates in June 2006. So, with respect to the interest rate they target, the Fed again took another pass at doing anything this time, the same as the previous five meetings.



However, there is a change this time from what we saw in the press releases following the five previous meetings. In the past, they talked only about further “firming” (interest rate increase) moves that would depend on how the pace of economic activity and inflation evolve in subsequent months. This time they talked about “additional adjustments” rather than further “firming.” That changed wording presents a more symmetrical posture regarding future monetary policy actions. More specifically, with that emphasis change, the Fed signaled that they may, depending on circumstances, ease (lower interest rates) or tighten (raise interest rates) in the future. This obviously is a change from the wording of recent past press releases.

Why did the Fed open the door to possible future easing? Well, basically because economic growth has come in softer than expected in recent months. In January, the Fed characterized growth as “somewhat firmer,” whereas last week they noted that the recent growth picture is “mixed,” meaning some economic indicators remain firm while others point to softer growth. This is especially true regarding housing, which was described in January as showing “signs of stabilization,” but last week as still undergoing further (downward) adjustment. All of this means that the Fed now sees a greater risk of the economy being softer than it previously thought. Hence, the “twist” in the Fed’s wording last week to allow for a possible ease in interest rates as well as a tightening.

If the economy looks softer, why then is the Fed still implying that raising interest rates further is a possibility? The answer here rests with their view that there is still a risk that inflation could move higher. They point to recent elevated “core” inflation readings (those excluding food and energy price movements) to buttress their view of a still-present inflation risk. In addition, although not explicitly mentioned by the Fed last week, there have been significant recent rises in both food and energy prices, which may ultimately percolate through to wages and final product prices. They also worry about inflation not moderating as they expect—their principal concern. So all in all, despite recent softness in economic activity, the Fed is not yet convinced that the risk of inflation remaining higher than desired or moving higher has diminished enough for them to abandon possible future tightening moves.

Nevertheless, it has long been our view that some easing by the Fed was likely in the second half of 2007. That view was predicated on our forecast showing significantly below-trend growth for much of the year, leading to a higher unemployment rate and moderation in inflation. The problems in mortgage lending, particularly in the sub-prime segment, were anticipated by us as a drag on housing and the economy for much of the year, but the apparent magnitude of those problems currently was underestimated. So, there is probably some additional downside risk to our forecast for economic growth and inflation this year. This, in turn, means that there is now an even greater possibility of Fed easing later this year.

In any event, financial markets reacted positively following the Fed’s announcement of the “twist” in their policy stance. By eliminating their previous exclusive bias toward tightening in favor of a more balanced approach, including the possibility of some ease down the road, financial markets saw a greater prospect for lower interest rates and a somewhat better economy down the road. For equities, a better economy probably improved earnings growth in the future, on top of a possible expansion of price-earnings multiples with lower interest rates. And for fixed-income products, the prospects are obvious: prices on fixed-income products rise as market interest rates fall. So, following the Fed’s announcement last week, the markets focused on what possible lower interest rates could mean to financial asset prices in the not-too-distant future. Rather than devoting much attention to the slower growth and lower inflation that we might experience before any Fed easing, the markets apparently looked through those factors and focused on what lower interest rates could mean to financial asset pricing in the future.

Of course, changes in expectations are principal sources of volatility in financial markets. So, when the Fed changes a position, even to a small extent, as occurred last week, it is not unusual for financial markets to take notice, and even react strongly. Certainly, last week’s rally in financial markets following the Fed’s announcement is one example of this scenario. Other examples abound, including the interest cuts we saw in 1998 during the Long-Term Capital Management crisis and in early 2001 when the Fed eased aggressively to minimize the magnitude of a developing recession.

In sum, the Fed shifted last week towards a more balanced monetary policy stance, suggesting some scope for lowering interest rates in the future, not just the possibility of hiking them as they had indicated at earlier meetings. This change arose from a perceived greater risk of a softer-than-expected economy continuing, and, with that, inflation moderating to more than expected. Nonetheless, the Fed was not yet ready to move to an exclusive bias towards easing, still seeing some risk of higher inflation on the horizon. Given our slower-than-consensus view for the economy this year, we expect that the Fed will likely ease a bit later in the year.

TIAA-CREF is a national financial services organization and the leading provider of retirement services in the academic, research, medical and cultural fields with over \$400 billion in combined assets under management (12/31/06). Further information can be found at www.tiaa-cref.org.

Market Monitor is prepared by TIAA-CREF Asset Management and represents the views of TIAA-CREF's Investment Strategy and Client Solutions Group. These views may change in response to changing economic and market conditions. Past performance is not indicative of future results. The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate.

TIAA-CREF Asset Management is a division of Teachers Advisors, Inc., a registered investment advisor and wholly owned subsidiary of Teachers Insurance and Annuity Association (TIAA). TIAA-CREF® personnel in its investment management area provide investment advice and portfolio management services through the following entities: Teachers Advisors, Inc., TIAA-CREF Investment Management, LLC, and Teachers Insurance and Annuity Association® (TIAA®). TIAA-CREF Individual & Institutional Services, LLC, and Teachers Personal Investors Services, Inc., distribute securities, members, NASD. TIAA, TIAA-CREF, Teachers Insurance and Annuity Association, TIAA-CREF Asset Management and FINANCIAL SERVICES FOR THE GREATER GOOD are registered trademarks of Teachers Insurance and Annuity Association.

Brett Hammond, Leo Kamp and Douglas Fore are available to comment on economic data. If you wish to speak with them, please contact Chad Peterson, Media Relations, 212-916-4808 or email cpeterson@tiaa-cref.org.

C38358