

## WEEKLY MARKET MONITOR SEPTEMBER 24, 2007

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### WHAT'S UP WITH THE FED?

For the first time since June 2006, the Fed decided to change interest rates. More precisely, it decided to lower its target on the Fed funds rate (the overnight interest rate for banks lending and borrowing reserves) by one half of a percentage point (50 basis points) to 4.75%. However, the rate cut was effectively only about a 25 basis point cut from the average 5.02% funds rate that prevailed in the market during August. Nonetheless, prior to last week's move, the Fed funds rate target had been unchanged at 5.25% for about 15 months. In its press release announcing the change, the Fed asserted that while there was still the risk that inflation would again rise to unacceptable levels, there was now also the risk that economic growth would slow more than desired. With this new risk profile, they felt that some monetary ease was appropriate at this time. The financial market response to the Fed's cuts was mixed: the stock market started to rise again, while the prices of Treasury bonds fell (presumably from fears that a stronger economy might re-ignite inflation) causing yields to rise. Why the change in risk profile? Why do the prospects for the economy look dimmer? The primary reason for thinking that economic growth may drop to undesirable rates revolves around the financial turmoil that has flowed from the melt down of the sub-prime residential mortgage market (mortgages made to persons with poor credit histories or other factors making them higher-risk borrowers).



Defaults, delinquencies, and foreclosures have all soared in that market. Consequently, trading has largely dried up in financial instruments (mortgage-backed bonds, asset-backed commercial paper) related to the sub-prime mortgage market, something that has widely been heralded in the press. And in the midst of this drying up, holders of this paper had little idea of the current value of their sub-prime holdings, introducing risk into the value of their balance sheets and capital positions. As a result, major financial players (banks, brokerage houses) have become highly risk-averse with respect to sub-prime paper, contributing further to the freeze in sub-prime land. Furthermore, with lending at a stand-still in the sub-prime arena, we have also seen a generalized tightening of residential mortgage lending standards, although most dramatically in the non-prime areas. In addition, lenders are also worried that defaults and foreclosures will spike upwards as remaining non-prime mortgages see their interest rates rise substantially in coming months due to the resetting of their rates to current higher market rates.

Due to the distress in the sub-prime market, financial markets in August saw a sharp rise in volatility. As a result of this higher volatility and risk, prices of high-yield (below investment grade) corporate debt fell significantly, causing yields on such instruments to rise significantly versus similar maturity Treasury securities. Or, in other words, high-yield spreads ballooned out, although far less than witnessed in 2002. In this same environment of heightened risk, we also saw stock markets fall in August from the higher levels seen near mid-year, but only by about 10%, far less than in other equity market "corrections". Even Treasury debt markets saw a marked step-up in volatility. The Treasury yield curve switched from being negatively sloped (inverted) to being positively sloped. This resulted primarily from investors, in their flight from more risky assets, piling into the safety of liquid, short-dated Treasury securities, thereby driving down the yields on such securities. In short, distress in the sub-prime market resulted in increased financial market volatility and a repricing of risk across many financial asset classes in August.

Of course, the Fed saw what was happening in August, especially the turmoil in financial markets and the resulting beating asset prices were taking during a period of heightened risk. At first, they simply monitored the situation and reiterated that higher inflation still remained

their principal policy concern. However, around the middle of August they started to act to calm financial markets. First, they announced that they were injecting liquidity into financial markets through a variety of means to mitigate liquidity constraints (some very acute) that were now all so evident in financial markets. They took this action in concert with other central banks around the globe, including the European Central Bank which actually injected considerably more liquidity into the markets than the Fed.

But these actions proved insufficient to stem the rising tide of distress in asset markets. As a result, on August 17th the Fed took another action to calm financial markets: it lowered the interest rate (known as the Fed discount rate) by 50 basis points charged to banks (and other authorized entities) who borrow directly from the Fed (through what is called the "discount" window). And, in that announcement, it also dropped any mention of higher inflation being its primary policy concern. The omission of the "inflation" risk language hinted at the possibility of a near-term interest cut.

So, when last Tuesday (September 18th) eventually rolled around, most financial market participants were expecting an interest rate cut from the Fed, although only half of the 50 basis points actually served up by the Fed that day. Moreover, the Fed's press release which announced the cut still included higher inflation as policy risk, but that risk, at least for now, outweighed by the downside risk to economic growth coming from recent financial market liquidity constraints and volatility. Hence, the Fed felt it prudent to cut interest rates at this time to take out some insurance against the possibility of a significantly weaker economy, even though evidence of a substantially weaker economy is not yet visible.

What will the Fed likely do from here? As usual, it all depends on how the economic data unfolds. If signs of the economic faltering become increasingly clear, the Fed may indeed cut interest rates further. However, if calm returns to financial markets and the economy shows few signs of weakness, the Fed will probably not cut further beyond the 50 basis points it already put in place last week. And, if economic growth actually picks up and financial market volatility lessens, there is a strong possibility that the Fed may actually raise rates, taking back the 50 basis point of ease installed last week or raise rates even more. This last possibility would mean that from the Fed's perspective the downside risk to

the economy would have been displaced by a heightened concern that inflation would move higher. Furthermore, this last scenario has strong historic precedent: the Fed has renewed its tightening posture just a few months after an ease was put in place during periods of financial market distress (for example, in the wake of the 1987 stock market crash and the LTCM liquidity crisis). In each of those cases, the Fed started to tighten again once concerns about the faltering economy were displaced by worries that improved economic growth would push inflation higher.

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