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WHAT DO THE FED'S RECENT RATE CUTS MEAN TO THE ECONOMY AND INVESTMENTS?

Prior to the September 18th rate cuts, the economy had been slowing on average for about two years. As measured by the year-over-year percent change of inflation-adjusted (or "real") gross domestic product (GDP), the U.S. economy was growing about 4% in mid 2005, but only just over 2% in the middle of this year. That slowing was principally the result of the progressive tightening of the Fed's monetary policy stance that began in June 2004, at which point the Fed funds rate was just 1%. During the subsequent two years after the tightening first began, the Fed more than quintupled its target for the Fed funds rate, eventually raising it to 5.25% in June 2006. And, after that time, up to the recent cut, the Fed held its rate target steady at the 5.25% level, maintaining its now tighter policy for over one year. All of this renewed monetary stringency cut into the economy's vigor, eventually cutting (as mentioned earlier) economic momentum in half. Year over year, real GDP growth went from a 4% pace in 2005 to 2% recently.

So, will the economy show better growth now that the Fed has started to loosen monetary policy again? The answer to that is: probably, but not too soon and not too vigorously. The primary reason for that is that monetary policy changes, whether ease or tightening, only work with a delay. Easing today will not be felt by the economy immediately, but rather months after that ease. In addition, the magnitude of any easing move matters. If the Fed doesn't ease beyond



the 50 basis point cut of September 18th, we will likely experience modest or, more likely, little improvement in the economy's growth path. Only if the Fed follows its recent ease with additional cuts over an extended period would the economy's growth trajectory get a significant lift. But, given that the economy was still showing decent (albeit slower) growth before the September 18th cut and financial markets now look calmer, the prospects for extended, aggressive Fed ease going forward look small. Indeed, if the economy were to improve significantly, with the unemployment rate still uncomfortably low (4.6% currently), the Fed could reverse policy, eventually taking back all or more of the ease recently put in place. As mentioned in last week's Market Monitor, there is ample historic precedent for this. The crux of all this is that absent an additional period of substantial Fed easing, the fundamental growth path for the economy is not likely to improve much from here, namely, remain at or below trend growth.

As a result, the uncertainty surrounding the future course of monetary policy makes it hard to get a handle as to where financial markets will be going. Certainly, the financial markets have performed much better since the Fed cut interest rates last month. The Dow Industrials stock index has rebounded from its August low, now closing in on its prior peak. The liquidity in the asset-backed, fixed-income markets has improved substantially, but still has some way to go before "normalizing". And, the Treasury yield curve flattened a bit (although still positively sloped), as yields at the short end of the maturity spectrum rose more than those at long maturities.

These better investment results may prove fleeting with limited upside from here. Without aggressive Fed easing, U.S. economic growth is likely to remain less than robust and inflation is likely to continue to moderate. This means that the current deceleration we are seeing in corporate profits could very well remain in place. As a result, equity markets may find it difficult to rally beyond current levels unless the Fed decides to ease substantially from here. On the other hand, corporate and mortgage-backed, fixed-income securities may benefit from a slow growth, lower inflation economy and from a gradual "renormalization" of liquidity conditions in the market place. If the Fed, however, becomes aggressive in easing, fixed-income markets could suffer as a stronger economy leads to a ratcheting up of investor inflation expectations. So, the bottom line

here hinges on how aggressive the Fed is in easing going forward. If the Fed eases aggressively, equity returns will likely outstrip fixed-income market returns. Instead, if they choose to maintain their current position or even resume tightening, there is a good chance that fixed-income market returns will outstrip those of equity markets in general.

What does this mean to investors? Those who invest across a wide range of asset classes could do reasonably well regardless of what the Fed does from here. Although the returns on a diversified portfolio will likely not be as high as those of a portfolio investing in a single asset class that benefited from Fed action or inaction, the returns in its portfolio are likely to be reasonable and less volatile than a single asset class portfolio. With a diversified portfolio, sub-par returns tend to be offset (at least in part) by higher returns on other asset classes in the portfolio. This also applies to the volatility of the portfolio, since the asset class returns are not perfectly, positively correlated. For example, if the Fed were to ease aggressively from here, equity returns would likely increase while fixed income securities could post much smaller or even negative returns. The net result would be a portfolio return somewhere between the equity return and the fixed income return. In this and other cases, a well diversified investment portfolio would have a return somewhere between that of an asset class benefiting from a Fed policy change (equities in the example above) and the asset class whose returns decreased (fixed income) due to the Fed's policy change.

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