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Will They or Won't They?

October 8, 2007
Weekly Market Beat

Now that the Fed has relieved some of the pressure on the credit markets due to the sub-prime mortgage induced seizure in credit availability, the obvious question for the financial markets is "What's Next?"

Since the Federal Reserve's September 18th decision to cut the Federal funds rate by a surprising 50 basis points, along with another drop in the discount rate, three-month Treasury bill rates fell from 4.0% to 3.88%, two-year Treasury note yields increased by 10 basis points and 10 year bond yields rose by 20 basis points. The yield curve, as mentioned last week, has steepened suggesting investors' expectations of future inflation have gotten worse. Gold prices have risen above their multi-year high established last year, and industrial commodity prices have had another run higher. At the same time, stocks, especially inflation beneficiaries such as energy, materials, and technology, have led the stock market higher.

Yield spreads between asset-backed commercial paper and financial commercial paper have dropped by 65 basis points, and yield differences between junk bonds and U.S. Treasuries have fallen by 75 basis points. There has been a noticeable loosening in credit availability, though the sub-prime mortgage market itself is still moribund. The basic money supply (cash, checking deposits and money market funds) accelerated to 12% annualized growth suggesting rising liquidity to support economic activity and higher financial asset prices.

All of this suggests that the Fed is probably going to refrain from lowering the Federal funds rate at its next meeting on October 31st. Several Fed officials have been talking publicly since the September 18th cut in the Fed funds rate, and though they have been cautious in their assessment of the economy, the Fed-heads see economic activity continuing on a moderate growth path. Some of them have noted that they are monitoring the credit markets closely for signs that conditions could tighten the availability of credit. However, if one considers last Friday's stronger than expected September employment report, the large upward revision to the August report, and the jump in inflation expectations since the last rate cut, it is possible that the Fed may be on hold for now.

We do not view this as the end of the rate cutting cycle, however. Despite last week's stronger employment report, the annual rate of job growth is declining, along with the growth rate of retail sales. Auto sales are falling, and home prices are sinking. Housing permits are at a two-decade low, and the repricing of adjustable rate mortgages, 20% of which are sub-prime, haven't reached their peak yet. That will not occur until mid-2008. So there is still a lot of wood to cut before the economy can shake off the effects of the housing bust. We expect declining home prices to be a drag on household spending and consumer confidence for some time to come.

As mentioned earlier, the stock market's reaction to all of this has been a sharp rally that actually got underway in mid-August as the scent of a Federal Reserve policy change began to be picked up by the markets. The upward move accelerated after the September 18th policy change with the Dow Jones Industrial Average ahead by 5% since then. It is possible, however, that market reaction could be more negative over the next few weeks if the market senses that the September policy change was a "one and done" decision. In our view that is not likely, but a correction would certainly give laggard investors a chance to position themselves for the next leg up.



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We will be taking the next two weeks off to recharge our batteries. The next **Weekly Market Beat will appear on October 29th.*

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