



SPECIAL COMMENTARY

January 28, 2009

FOMC January Meeting: Exploring New Territory

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Two Objectives Still Dominate: Both Still Elusive

For the Federal Open Market Committee (FOMC), the two objectives of financial stability and economic recovery remain the intermediate-term policy targets. Yet, both targets are a distance away from being reached. The longer-term goal is, of course, price stability with sustainable real economic growth. To promote financial stability the FOMC retained its 0 to 25 basis point target range for the federal funds rate. In addition, the Fed is committing to a continued expansion of its balance sheet to support financial markets. The Fed will continue with its outright purchases of GSE debt and Agency mortgage backed securities. Monetary policy continues to adjust to an environment of economic recession, lower inflation expectations and the imbalance of asset valuations.

Inflation and Growth: Both Below Desired Levels

In a rare comment, the FOMC cited that they see “some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.” Such a comment supports the FOMC’s suggestion that “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.” There certainly is no incentive from the inflation data for the Fed to alter its ultra easy policy. For inflation, the FOMC continues to emphasize an intermediate term (2010-2011) range around the 1.5 percent number.

Meanwhile, the outlook for industrial production, housing and employment remains disappointing. The domestic private economy remains in recession as weak growth in real disposable income for consumers and lower profits for non-financial companies dictate a lack of spending power for consumer and investment goods. The deterioration in labor market conditions (Figure 1) continues along with declines in consumer spending and business investment.

Credit Markets; Liquidity Improvement at the Short-end

Over the last year we have witnessed the destruction of credit market liquidity and now we face the difficult task of increasing trust and liquidity in the marketplace. In its statement, the FOMC suggested that “the focus of the Committee’s policy is to support the functioning of financial markets and stimulate the economy.” Financial markets have witnessed some very modest improvement in credit spreads, but the search for that new equilibrium between risk and reward remains in progress. Meanwhile, the TED spread, an indicator of stress in money markets, which had

widened to over 400 basis points, has now retreated by over 300 basis points (Figure 2). Commercial paper issuance has increased especially for maturities over 81 days. The market and the economy remain constrained by ill-defined risk horizons. This process of seeking a new risk/reward balance will take time and suggests continued Fed easing and credit aversion in the private market.

Figure 1

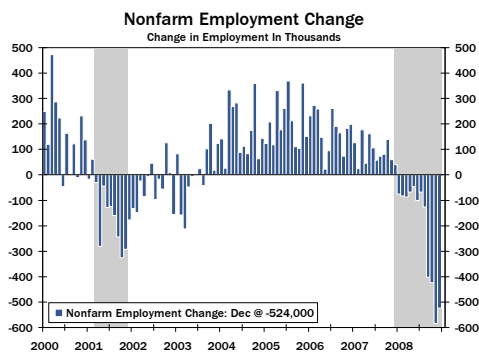
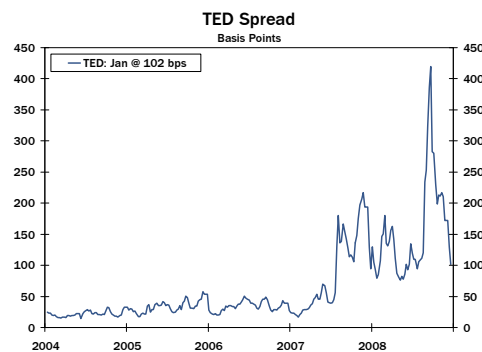


Figure 2



Source: U.S. Department of Labor, Federal Reserve and Wachovia

The FOMC emphasized that the size of the Fed balance sheet will remain “at a high level.” The Fed is expected to continue to purchase agency debt and mortgage-backed securities as well as “prepared to purchase longer-term Treasury securities if evolving circumstances indicate such transactions would be particularly effective...” This is effectively an attempt to bring down mortgage rates directly, as well as influence Treasury rates at the long end of the curve.

But Still Uncertainty for the Long-end and for Private Credits

In response to the weakness in the economy and credit issues, the Fed has lowered the real fed funds rate to levels below that of the entire post 1992 period. However, both the price and the availability of credit to the high grade and high yield bond markets have assumed a very different tone from earlier in this decade. While the Fed will supply whatever power is necessary to rev-up the economic engine, so far such easy liquidity has not brought in corporate credit spreads (Figure 4). Moreover, the rapid expansion of the balance sheet and negative real interest rates at the short end have raised fears that inflation will rise and that sub-three percent ten-year Treasury yields provide no inflation protection. As a result we have seen in recent weeks that ten year rates have drifted upward.

In the short run, Fed easing is a plus. Over the longer run, however, a long period of easy monetary policy may generate more problems down the road with a combination of higher inflation premiums and a weaker dollar to boot. Higher long-term rates are the likely outcome.

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