

## DAILY GLOBAL COMMENTARY

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### Tracking the Success of the Discount Rate Cut August 22, 2007

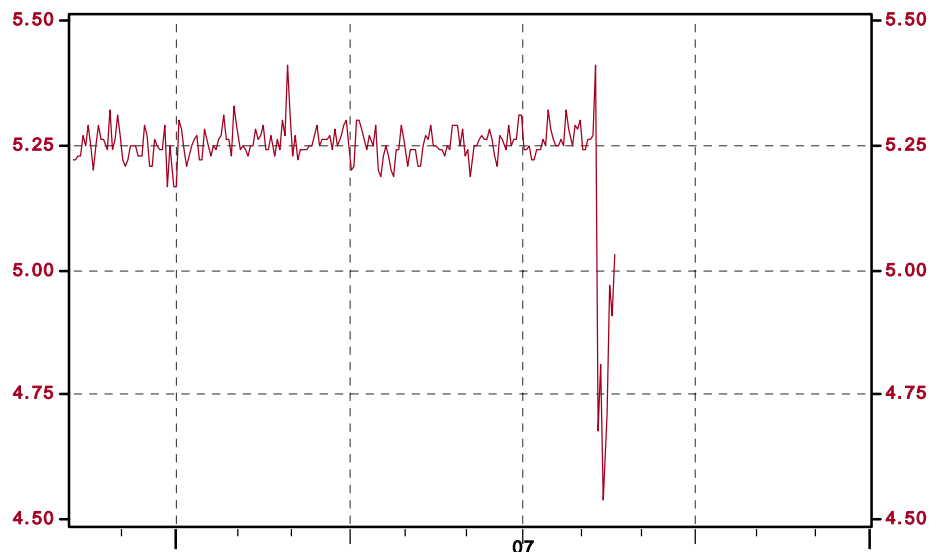
It is the fourth market day after the Fed implemented a cut in the discount rate to control the current financial market crisis. The Fed and other central banks continue to inject large amounts of funds to ensure liquidity of markets. The Fed's rhetoric indicates that although it recognizes the possibility of a significant downturn in economic activity, it has opted to choose an innovative method to stem the liquidity crisis. On August 21, the Fed lowered the fee to borrow Treasury securities, yet another measure to ease constraints in the marketplace. Senator Dodd's remarks after meeting with Chairman Bernanke reassured markets about the Fed's willingness to act as needed to prevent any damage to the economy. In sum, the Fed has responded to market turmoil, soothing comments by officials have been made, and the world is watching as global markets respond.

The effective federal funds rate is a good starting point to begin assessing market response to the August 17 cut in the discount rate. The federal funds market was marked with suspicion when banks were unwilling to lend to each other at close to the target fed funds rate. Fed intervention has held this rate below the target rate of 5.25% since August 17. The federal funds rate was 4.54% on August 14, traded higher at 4.91% on August 17, closed at 4.89% on August 21. The federal funds rate tumbled to 4.50% late today, implying that the Fed continues to provide liquidity in excess of what is consistent with the target rate.

Chart 1

#### Federal Funds [Effective] Rate

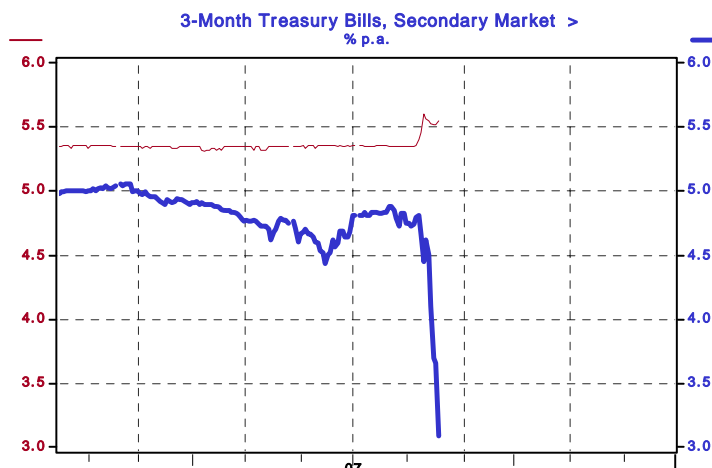
% p. a.



Source: Federal Reserve Board /Haver Analytics

Other market spreads allow us to track the success of the latest Fed move to restore liquidity in markets. The spread between 3-month Eurodollars and the 3-month U. S. Treasury bill widened significantly in recent days (see chart 2, data end on 8/20). Noticeable narrowing is taking place, with the 3-month Treasury bill trading at 3.60%, up from a low of 3.08% on August 20. This spread has narrowed to 190 bps (5.50% less 3.60%) today from the widest spread of 247 basis points on August 20 but still higher than the 187 bps spread seen on August 17.

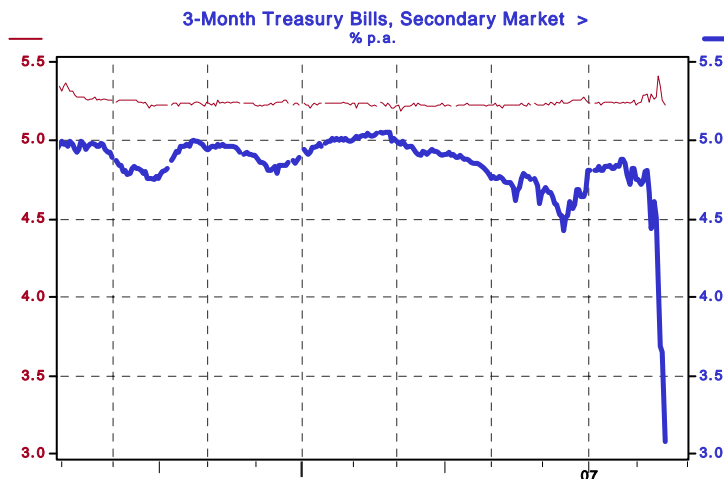
Chart 2  
 < 3-Month Eurodollar Deposits (London Bid) % p.a.



Source: Federal Reserve Board /Haver Analytics

The spread between 3-month commercial paper and the 3-month U.S. Treasury bills grew by a significant measure with the widest spread on August 20. The spread in this sector has now improved from 215 bps on August 20 (5.23%-3.08% = 215 bps) to 175 bps as of this writing (5.35% -3.60%=175 bps), which is higher than the 161 bps spread on August 17.

Chart 3  
 < 3-Month Financial Commercial Paper % per annum



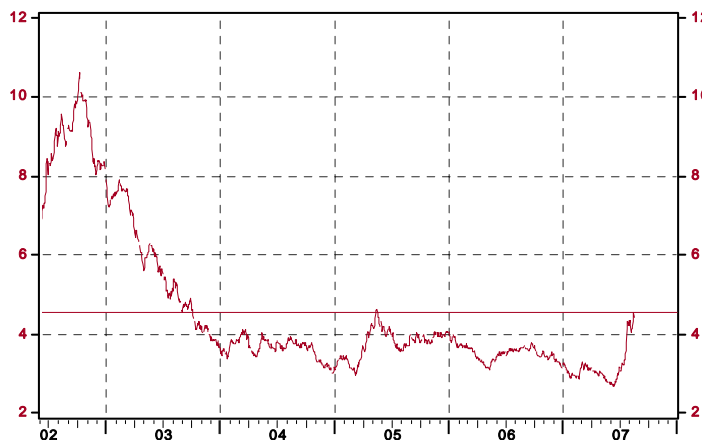
Source: Federal Reserve Board /Haver Analytics

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In the high yield market, the spread between the yield on junk bonds and the 10-year U.S. Treasury note yield was 455 bps on August 16, which declined to 444 bps on August 20. The 455 bps spread is the largest since May 2005 (see chart 4).

Chart 4

Merrill Lynch Corporate High Yield Master II less 10-yr. Treasury note yield  
percent



Equity markets in the U.S. have rallied, with the S&P 500 trading at 1464 near the close today, up from a low of 1406.70 on August 15. The dollar is trading around \$1.35 per euro and \$1.98 per pound compared with recent highs of \$1.38 and \$2.06, respectively as of July 24.

Remedies for financial market turmoil are hard to swallow, the resolution of the crisis is slow, and it seldom ends on a clean note. The final grade for handling the current crisis can be given only in the months or years ahead. On the fourth day, the financial storm appears to be calming down in the expected direction and given the Fed time to sort it out but spreads have to narrow sufficiently more to declare that the worst is over.

Table 1 Market Spreads Being Watched (basis points)

	7/17/07	8/17/07	8/22/07	High 2007	Low 2007
3-month Eurodollar less 3-month U.S. Treasury bill	54	187	190	<b>247.00</b> 8/20/2007	<b>30.00</b> 2/20/2007
3-month Commercial Paper less 3-month U.S Treasury bill	43	161	175	<b>215.00</b> 8/20/2007	<b>17.00</b> 2/22/2007
Merrill Lynch 10-month U.S. Treasury note	320	442	444 (8/20/07)	<b>454.60</b> 8/16/07	<b>266.90</b> 6/12/07

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