SISR Strategic International Securities Research Inc.
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Economics & Stocks

Philip L. Miller – 646-415-9141
Chief Strategist
pmiller@sisecurities.com

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Banking, Housing, and Federal Reserve Policy: Fed Unlikely to Lower Interest Rates

Summary:

The Federal Open Market Committee decided on October 31, 2007 to lower the federal funds rate 25 basis points to 4 ½ percent from 4 ¾ percent. This is the second consecutive meeting where the open market committee lowered the interest rate after NOT altering the interest rate in nearly one and a half years. **The Federal Reserve we believe will not change rates going forward for an extended period unless the conditions become extreme and it becomes essential.**

The federal Open Market Committee made the following statement on October 31th when they lowered the fed funds rate stating that: "Today's action combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time." (October 31, 2007). The prior statement on September 18th read that: "Developments in financial markets since the Committee's last regular meeting have increased the uncertainty surrounding the economic outlook. The Committee will continue to assess the effects of these and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth" (September 18, 2007). The difference in statements appears clear. In September the fed believed that there was "increased uncertainty surrounding the economic outlook," whereas in October they contended that: "Today's action, combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy." **We believe that the fed was indicating that it does not anticipate having to lower rates in the near future.**

We further believe that the Bernanke Fed is significantly less likely to use the fed funds rate than have any of the prior fed chairmen. This review will elaborate the proposition that the Bernanke fed has a different preference function with respect to the two dominant tools available to them. We will show that the Bernanke fed has a preference for using money flows or M2 as the means for micromanaging the economy, as opposed altering the fed funds rate more often, as has been the historical pattern. **If this contention is correct, that the preference function by the fed has changed, then this in itself is**

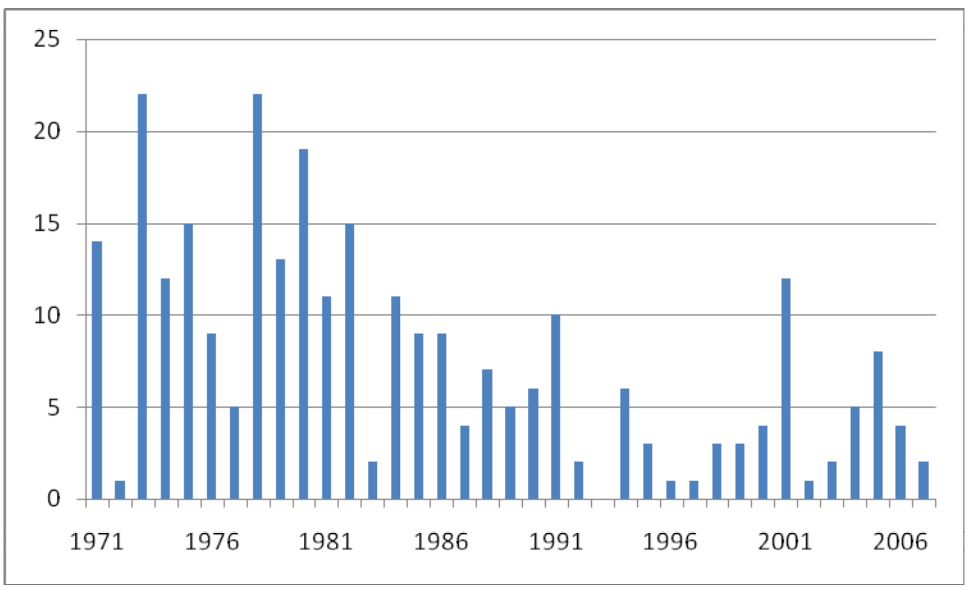
further evidence that the fed funds will not be changed rates at the next Fed meeting, or anytime in the near future.

I. Using Money Supply as the Primary Economic Management Instrument and Not the Fed Funds Rate

A. Bernanke has made Fewer Federal Funds Rate Changes than any of the Prior Fed Chairman

From 1971 through 2007 the Federal Reserve Open Market Committee on average has changed the fed funds rate 7.5 times per year. In Figure I we show the number of changes in the fed funds rate by the fed in each year from 1971 through 2007. In 2006 there were just 4 changes and only 3 since Bernanke took over as chairman in February 2006, with these changes occurring as a way to keep continuity with the Greenspan fed. So far in 2007 there have been only 2 changes. **We believe that Bernanke has a bias of using money supply over altering the fed funds rate.**

Figure I: Number of Rate Changes by the Federal Reserve per Year from 1971 through 2007



Source: Federal Reserve Board; SISR

On January 31, 2006 we initiated a series of reports on the "Bernanke effect," **arguing that Bernanke would be different than Greenspan in that he would use money supply as a key instrument for controlling the economy and not the fed funds rate**, unless absolutely necessary (NYGS *Significant Events: The Bernanke Effect)*. Our reasoning was that by keeping the fed funds rate stable it would make the banking industry more stable by reducing uncertainty in the financial markets, and enabling the maximization of growth in contrast to inflation, the mandate of the fed.

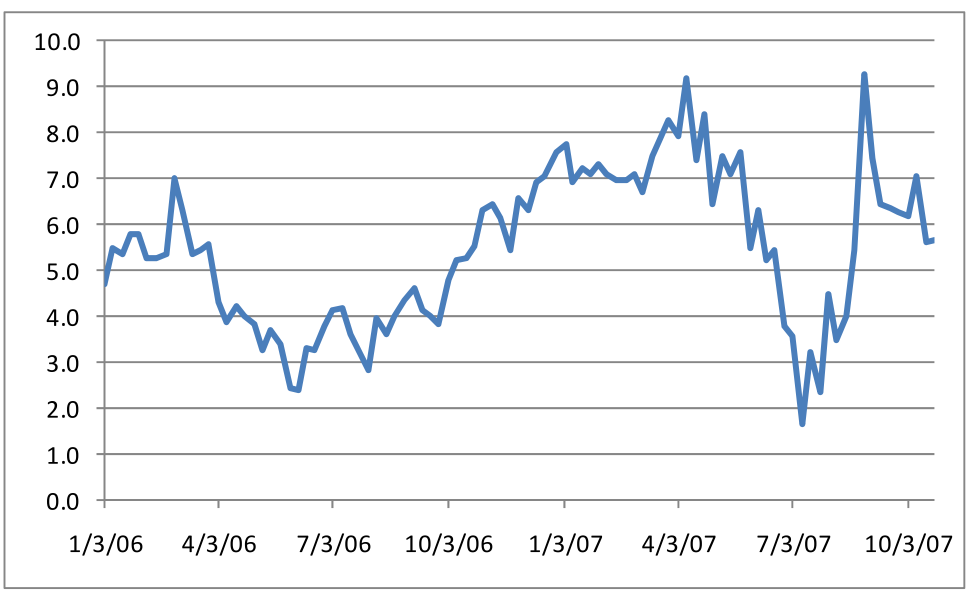
On July 2, 2007 we followed up our thesis that the Federal Reserve would act only when it felt it was imperative, and highlighting the fact that interest rates have not been changed in over one year (SISR, *Money Supply and Federal Reserve Policy*). **The significance for present purposes is that if our thesis is correct then it is unlikely that the fed will lower rates in the near future, unless this subprime problems spirals out of control.** We continue to believe in our Bernanke thesis that Chairman Bernanke is much more resistant to alter interest rates believing that in the long run this policy will help to stabilize the housing market as well as help to maximize growth, while controlling inflation. Section B will go further in elaborating our hypothesis that money supply has been the vehicle that Bernanke has employed. We will conclude in explaining why we believe this to be the case, and the advantages of such a policy.

B. Bernanke using Money Supply as his principle Micro Management Tool

When Bernanke became the chairmanship of the Federal Reserve Board on February 1, 2006, the Federal Reserve continued the Greenspan program of raising rates to preserve continuity with the past and not to destabilize or create uncertainty in the financial markets. They raised interest rates 3 more times, at each of the open market committee meetings, until August 8 2006 when it took no action on rates. From the March 28th 2006 meeting, Bernanke's first as chairman, through the June 29th 2006 meeting there were constant reference to inflation. In March the statement said: "As yet, the run up in the prices of energy and other commodities appear to have had only a modest effect on core inflation." In May they used the same language, but in June they changed their inference by saying: "Readings on core inflation have been elevated in recent months."

From the fed statements we observe a clear concern with commodity inflation from the beginning of the year until August of 2006. Following traditional monetary theory, the way to reduce inflation is to contact money supply, which is exactly what the fed did from February 2006 until August 2006. Figure II presents the three month rate of change annualized in M2 from January 2006 through October 2007.

Figure II: Three Month Change in M2 Annualized Jan 2006 to Oct 2007



Source: Federal Reserve Board; SISR

Beginning in August of 2006, as seen in Figure II money supply again began to increase. The fed signaling this increase in M2 with the following statement in August: "Economic growth has moderated from its quite strong pace earlier this year…inflation pressures seem likely to moderate over time." Following our thesis from early 2006 we projected that the fed would increase money supply as much as possible to attempt to maximize growth if there was no inflation, again following traditional monetary policy. In August 2006 the fed decided not to increase rate but began an 8 month period of accelerated monetary growth. The Fed used basically the same statement until their January 31, 2007 meeting when they indicated that: "Recent indicators have suggested somewhat firmer economic growth…and reading on core inflation have improved modestly in recent months. Their program was working and the financial markets were soaring.

At the next meeting on March 21, 2007, however, they said that: "Recent readings on core inflation have been somewhat elevated … and in these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected," indicating that they would begin to rain in M2 growth. From Figure II we find that in early April, M2 growth had hit its high and was beginning to slow. They continued this statement for the May 9, 2007 meeting, all the while not altering interest rates but making various alterations in the rate of money growth. The market was still in rally mode and there was significant liquidity in the system.

At the June 28, 2007 meeting they stated that: "Reading on core inflation have improved modestly in recent months … economic growth appears to have been moderate during this first half of this year, despite the ongoing adjustment in the housing sector." With core inflation moderating and continuing adjustments in the housing sector the fed as seen in Figure II began to increase money supply again. However this time they may have contracted too much liquidity from the market in the prior three months leading to the volatility in the markets. As the economy slowed they felt they needed to increase liquidity and began to increase M2 at a fairly rapid rate to make these adjustments.

On August 7, 2007 the fed indicated the possible need to increase liquidity with the following statement: "Financial markets have been volatile in recent weeks, credit conditions have become tighter for some household and business, and the housing correction is ongoing… readings on core inflation have improved modestly in recent months." The increase in M2 was clear from the statement that now they needed to micromanage the economy for growth and not inflation, implying M2 growth or monetary expansion.

On September 18, 2007 for the first time in nearly one and a half years the fed finally lowered interest rates by 50 basis points. They stated that: "Developments in financial markets since the Committee's last regular meeting have increased the uncertainty surrounding the economic outlook," indicating here that they are real concerned and have decided for the first time in a long while to lower rates. They were already increasing M2 but felt a greater need to take more drastic action, given the volatility in the financial markets. They also said that: "Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time." Since July the fed has been radically increasing M2 again following traditional monetary policy.

At the last meeting October 31, 2007 the fed lowered rates again by 25 basis point to 4 ½ % stating that: "today's action, combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time." **We believe that the fed in indicating that they will not be lowering rates in the near future, and will continue to deal with this issue through the expansion of M2, the primary tool that they have been using since Bernanke became Chairman.**

II. Implications of the Federal Reserve Policy

Based on the belief that Bernanke will continue to use money stocks or M2 as opposed to the fed funds rate for micromanagement of the economy, we believe that the fed is attempting to indicate that they will not be lowering rates in the near future. In addition they will strive to balance growth with inflation through the expansion and contraction of M2, the primary tool that they have been using since Bernanke became Chairman, and not alter if not essential the fed funds rate.

It appears clear from the above review that the Open Market Committee, as chaired by Bernanke is less likely than prior Federal Reserve Chairman to use the fed funds rate as the primary tool for micromanagement of the economy. The logic we believe is quite simple; if the interest rate is kept constant it reduces a great deal of uncertainty in the financial markets, particularly in the long run.

1. By keeping interest rates constant for extended period of time it reduces uncertainty in the financial markets. This impacts banking, foreign exchange, housing, and in fact the value of all assets, because changes in the interest rate affects the long run expected returns. By keeping interest rates stable it reduces the speculation regarding changes in rates and as a consequence reduces the risk on long term expected returns on assets. In housing in particular with respect to variable rates it reduces the volatility in variable rate mortgages, as well as reducing price fluctuation in the housing market based on the future interest rate, which are factored into the true value of a particular house, just like any other asset.

2. By keeping the interest rate stable, the entire banking sector should also benefit because it reduces any form of uncertainty. It reduces loan uncertainty, particularly with variable rates with respect to the lender being able to pay off loans if rates increase, the economy slows and the cost of their loans become more expensive. This stabilizes the lenders cost basis for this loan.

3. Additionally for the banking sector, if rates are stable, it should impact the dollar relative to other currencies less severely because it would reduce interest rate risk for forward international transactions. If all countries worked together on reducing rate volatility, which is Bernanke's goal, even currency rates would be less voidable, and would respond more to export balances than to interest rate fluctuations.

The U.S. economy is still adjusting to the housing correction; however, if our expectations are correct with respect to the policies of the Bernanke Fed, we believe the long run impact will be positive, and there will be fewer rate changes during the Bernanke tenure as chairman of the fed.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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