



SPECIAL COMMENTARY

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FOMC October Meeting – 50 Basis Point Ease

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Recession, Lower Inflation, Financial Workout Drives Fed Policy

Today the Federal Reserve lowered its target for the federal funds rate by 50 basis points to 1.00 percent, the lowest rate in more than four years. Monetary policy continues to adjust to an environment of economic recession, lower inflation expectations and the imbalance of asset valuations. While talk of recession and credit dislocations are not new, lower gas prices, along with the dip in broader consumer prices, opened the door to the Federal Reserve to respond to economic weakness by lowering the federal funds target rate.

Growth: Credit, Housing & Energy Weigh on the Economy – Lower Inflation Supports Case for a Cut in Rates

Unfortunately, the domestic private economy remains in recession as weak growth in real disposable income for consumers and lowered profits for non-financial companies dictate a lack of spending power for consumer and investment goods. The Fed highlighted a decline in consumer expenditures, and employment losses in recent months suggest little forward momentum in the domestic economy (Figure 1). The recent dip in gas prices and the broader CPI support the case for ease (Figure 2).

Figure 1

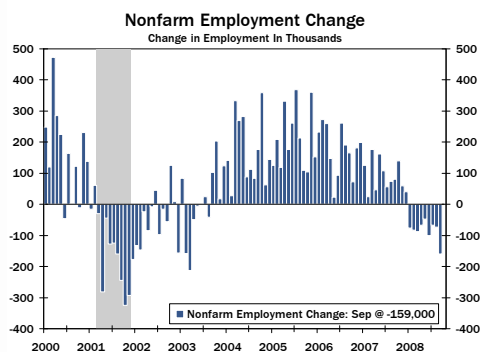
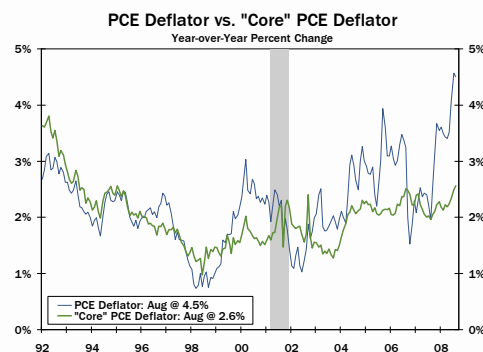


Figure 2

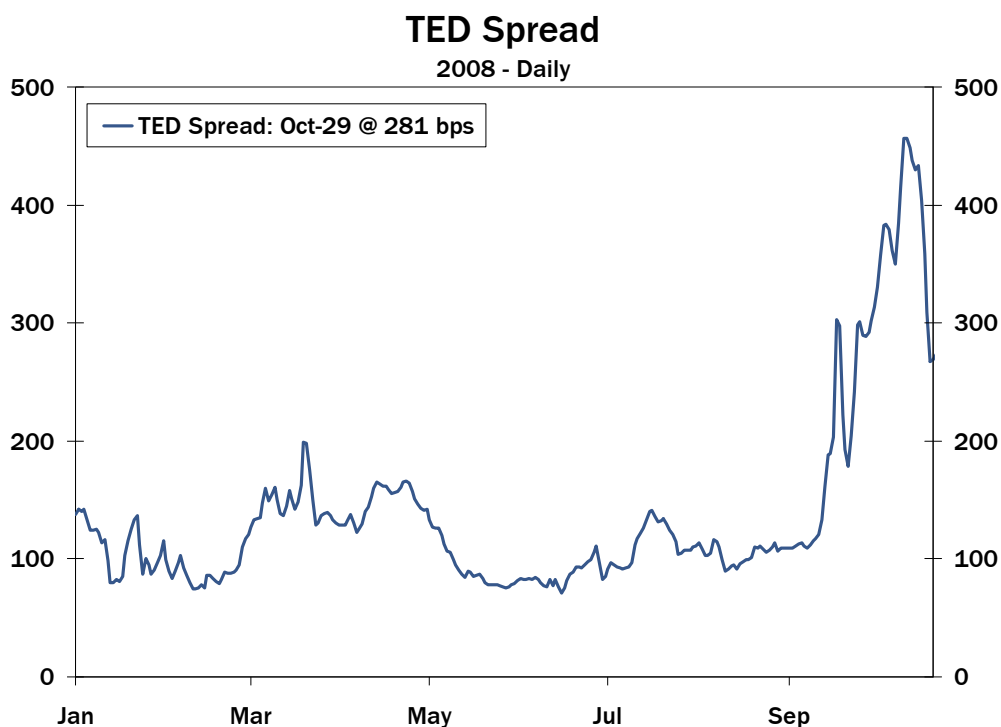


Source: U.S. Department of Commerce, U.S. Department of Labor and Wachovia

Credit Markets: Peak Risk Aversion Past but Improvement Slow

In its statement, the Federal Open Market Committee suggested that recent policy actions should help over time to improve credit conditions. Financial markets have evidenced some very modest improvement in credit spreads, but the search for that new equilibrium between risk and reward remains in progress. For example, 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. Meanwhile, the TED spread widened to over 400 basis points and has now retreated below 300 basis points (Figure 3). Commercial paper issuance has increased especially for commercial paper maturities over 81 days. The market and the economy remain constrained by the paradox of lemons—make more lemonade. This process will take time and supports continued Fed easing at the short end of the curve and credit aversion in the private market.

Figure 3

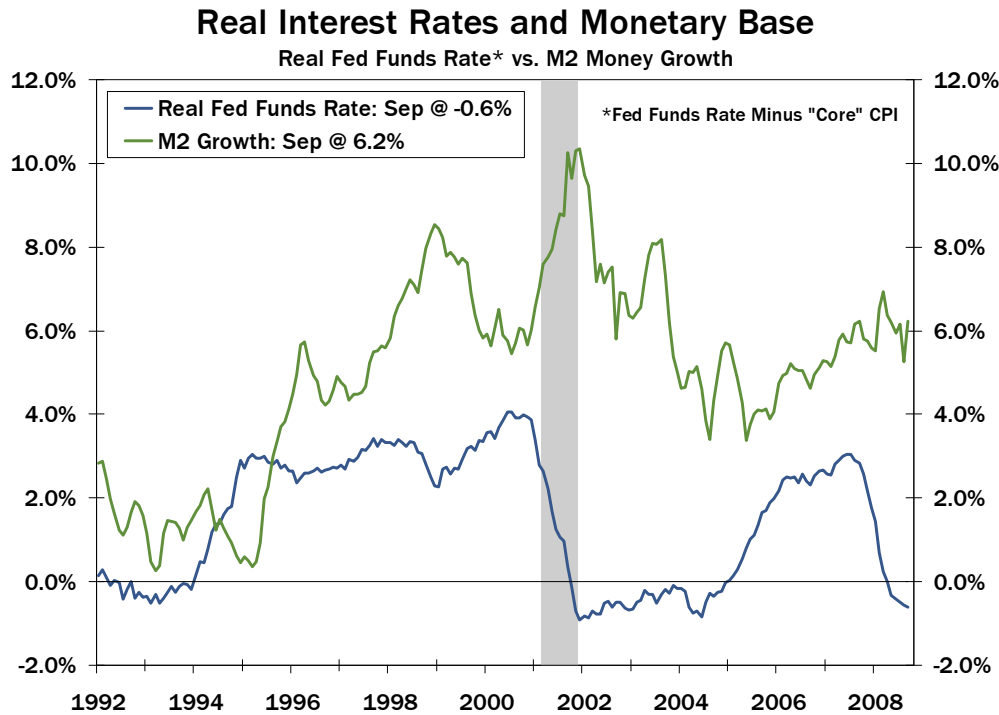


Source: Federal Reserve Board and Wachovia

Real Fed Funds Returns to Lows of 2002-2004

In response to the weakness in the economy and credit issues, the Fed has lowered the real fed funds rate to negative levels reminiscent of the 2002-2004 period (Figure 4). However, the legacy of criticism of that period of easy policy suggests the Federal Reserve will be very cautious in repeating the sustained period of a low nominal funds rate experience. In part, this low nominal rate period has been blamed for the housing boom/bust. Yet, looking ahead, slow growth and credit issues will offset the low funds rate for a while such that recovery in the economy will be slow in coming. There simply is no easy out for the financial markets, the economy or policy makers. The great American financial work-out continues.

Figure 4



Source: Federal Reserve Board and Wachovia

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