

1% again: market conditions warrant aggressive response

Back to basics

Despite an alphabet soup of programs designed to restart financial markets, many markets remain closed for business. With equity, credit and money markets seizing up and the real economy showing signs of weakening sharply, we have moved up our Fed rate cut call to the end of the month (although we would not rule out an inter-meeting cut). We have also added an additional 50 basis point ease in December. This takes our forecast for the Fed funds target to 1.00% by year end. We see this easing as necessary just to offset the contractionary effects from the tightening in financial markets over the past month. Whether the Fed stops at 1% depends on the state of the economy and market functioning come 2009. Additionally, we cannot rule out more aggressive use of alternative measures that may cause the Fed to ignore the target rate for some period. Inflation and inflation expectations are likely to recede in coming quarters, judging by the rapid turndown in commodity prices and growing slack in the economy.

Treasury rally, persistently high LIBOR

Between our expected rate cuts, a persistent flight-to-quality bid for Treasuries, a weak economy and a sharp decline in inflation pressures we expect Treasury yields to continue to fall sharply with 2-year yields moving below 1.00% early next year and 10-year yields dropping below 3.00% in the first half of 2009. By this time, we expect to be experiencing our third quarter of negative growth and anticipate headline inflation will have decelerated to just 2.5%. Moreover, we would expect banks to take advantage of a steeper yield curve by buying longer-dated Treasury securities as a means of recapitalizing their balance sheets – like they did during the credit crunch of the early 1990s. Despite our forecast of Fed rate cuts, we expect counterparty risk aversion to remain high and for the 3-month LIBOR rate to remain quite high relative to historic norms. Simply put, nothing the Fed has done has had a positive impact on the inter-bank market – a fact that was highlighted by their recent decision to dramatically expand the TAF (Term Auction Facility), supplanting the inter-bank market over year-end.

With a twist?

Checking against Chairman Bernanke's playbook for dealing with deflation we see that in 2002 he noted that the Fed could 1) target long-term yields, 2) purchase Agency debt, 3) offer direct loans to banks using a wide range of collateral, 4) purchase foreign bonds and municipals and, as a last resort, 5) use foreign exchange rates. Given that he has done numbers 2 and 3 and that 5 would not seem to be helpful in the current environment, it is important to consider the possibility that the Fed might choose to explore, as he put it, "A more direct method, which I personally prefer, would be for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt."



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Table 1: Interest rate forecast table

(% EOP)	1Q08	2Q08	3Q08	4Q08	Q109	Q209	Q309	Q409
<i>Fed Funds</i>	2.25	2.00	2.00	1.00	1.00	1.00	1.00	1.00
<i>3-Month T-Bill</i>	1.38	1.74	0.91	0.50	0.60	0.60	0.70	0.85
<i>3-Month LIBOR</i>	2.95	2.78	4.05	3.00	2.75	2.50	2.00	2.00
2-Year T-Note	1.62	2.62	1.96	1.35	0.95	0.95	1.00	1.00
5-Year T-Note	2.46	3.33	2.98	2.60	2.25	2.00	2.00	2.00
10-Year T-Note	3.45	3.97	3.83	3.35	3.00	2.90	2.90	2.90
30-Year T-Bond	4.30	4.53	4.31	4.10	3.80	3.55	3.60	3.60

Shaded regions represent Merrill Lynch forecast.

Source: Merrill Lynch

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