

Fed Watch

With their inflation-fighting credentials on the line, Bernanke and company left the Federal Funds target rate unchanged during the August 8th meeting for the first time since June 2004. The decision to snap the string of seventeen straight rate hikes was based on the Fed's belief that inflation would recede over time brought on by a slowing of economic activity. Bernanke was quickly heralded for his decision as the next series of reports showed a slowdown in growth for the first time since he took the Central Bank's reins back in February. In particular, single family housing permits, starts, sales, and home prices all continued to erode. Wholesale prices also began to fall unexpectedly and reports of slowing sales from Home Depot Inc. and Wal-Mart Stores Inc. provided evidence which supported the Fed's forecast for a downshift in economic expansion. Once again, at the September meeting, the FOMC refrained from changing the level of the Federal Funds target rate. Being sidelined again, many market participants believed that it was now a "slam dunk" that the Fed's hiking cycle was complete. Recently however, this thought process has quickly unraveled as many Federal Reserve members have been on the tape warning about the upside risk to inflation. The minutes released from the September meeting further clarify this concern. "Members continued to see a substantial risk that inflation would not decline as anticipated." This has the fixed income markets troubled as these inflation fears are coinciding with Bernanke's acknowledgement that the housing sector is in a "substantial correction" that could lop off 1% from the growth rate in the second half of this year and continue to be a drag on U.S. growth in 2007 as well.

Ben in a Box

Are there crosscurrents presenting yet another conundrum for the Fed? Just as FOMC members had few good options in 2003 when they were concerned about deflation, here too their alternatives are looking sparse as they attempt to deal with a higher than desired level of inflation. Collapsing energy prices and falling longer term maturity bond yields have removed some of the restrictive forces that were facing consumers. In fact, the latest series of retail sales data provided evidence that consumer spending patterns have bounced off the bottom.

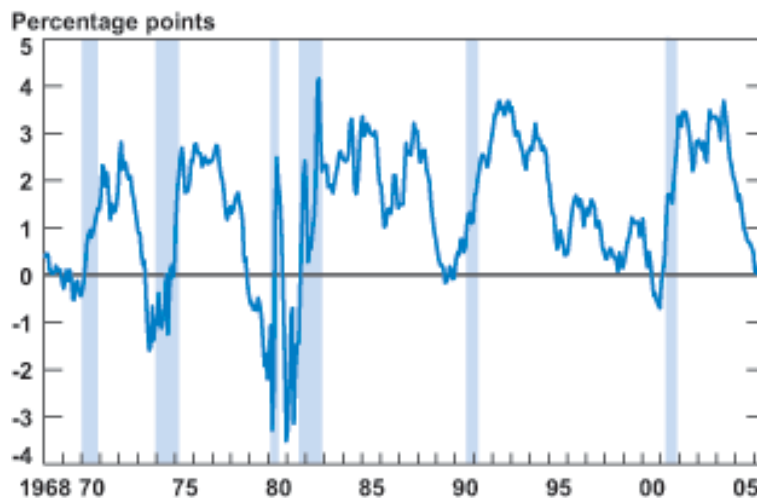
The recent bounce in consumer behavior has the Fed concerned since they would like to give the elevated Fed Funds rate time to work to further constrain growth and ease inflationary pressures. At the same time however, the bond market is taking the other side of the trade (ten-year yields plunged from peak to trough by 71 basis points in approximately two months), and has provided a stimulative mechanism for individuals. The "box" or quandary could in fact be self-created. The more hawkish the Fed speak or their actions are, the more pronounced the inversion of the yield curve tends to become as short term rates remain high and long term bond yields stay at levels that are below the FOMC target rate. Since the Fed can only manipulate short term rates, it is bond investors who are pushing long rates lower

as they appear to be taking comfort from a Fed that is fighting inflation and perhaps also speculating that their actions may tip the economy into a recession.

Inverted Yield Curve and Single Family Housing

According to a study conducted by the Federal Reserve Bank of New York, an inverted yield curve can be used as a proxy to determine the probability of a recession twelve months out. They concluded that each time since 1968 that the yield differential between three-month Treasury rates and ten-year notes was negative, a recession followed over the next twelve months. Currently the yield spread stands at (-14) basis points.

3 Month Treasury Bill / 10 Year Treasury Yield Spread



Source: New York Federal Reserve Bank

As mentioned in previous reports, we continue to believe that the signal that the yield curve is sending is one that shouldn't be quickly dismissed. In fact, it is quite conceivable that there is a link between a weak housing sector and the skewed shape of the yield curve. Since 2002, the housing market has been the primary engine propelling domestic growth. With this engine shutting down, it is not a stretch to believe that the massive debt that has been built up to support these inflated home values may become problem loans. While it is true that consumer spending has held up quite well in the face of extraordinary headwinds, the days of mortgage equity withdrawals have come to a close for many individuals. The removal of this source of spendable cash from the system should carry broad economic consequences as it was pivotal in spurring the economic recovery from the 2001-2002 recession. Although some economists and investors dismiss the housing bubble as a sector event and not of global concern, we remain skeptical. To us, just as these professionals who called the "dot-com" bust an isolated incident that won't spill over to the entire economy were wrong, here too they may be in denial until a sharp economic downturn occurs.

Municipal Bond Overview

The familiar pattern of weak price performance in the first half of the year followed by robust performance in the second half has emerged yet again. As we anticipated, the municipal bond market regained its footing with twenty-year municipal bond yields approaching 5%. Tax-exempt bonds scored strong performance as measured by the Lehman Bros. Municipal Bond Index, which rebounded by 3.41% during the third quarter. Helping to fuel the municipal rally was significant yield declines in the Treasury bond market, with ten-year Treasury note yields falling by 51 basis points to stand at a 4.63% on September 30th. Favorable supply-to-demand dynamics have also provided a favorable tail wind to the tax-exempt market as new issuance declined by 15.6% through September from the same period last year.

In terms of the yield curve, the trend toward a flatter slope continued during the period. For example, thirty-year municipal bonds now offer a 72 basis point pick up compared to two-year tax-exempt notes; 20 basis points flatter than the spread at the end of the second quarter. As discussed above, this is in sharp contrast to the Treasury bond market where investors are only receiving an 8 basis point advantage by investing in 30-year bonds versus 2-year maturing debt.

Strategy

During the quarter we sought the opportunity to enhance our holdings in longer-dated premium coupon callable bonds that were eligible to be advance-refunded. Typically, once a bond is advance-refunded, the security increases in value as the final maturity date becomes the first call date, thus shortening the effective time period until the bond is redeemed. Timing is important because as is often the case, when interest rates are rising, existing bond owners ask potential buyers to pay a lower price for the refunding option compared to times when rates are low and continuing to fall. These transactions should begin to pay dividends as a portion of our clients' holdings should increase in value due to the issuers' desire to lower their borrowing costs and refund their higher coupon debt.