Fed Watch

The Federal Open Market Committee (FOMC), while huddling twice in the fourth quarter, opted to run out the clock and hold the federal funds target rate at 5-1/4 percent. At its October meeting, the Fed indicated that economic growth had slowed, partly as a result of a softer housing market. In terms of their outlook, they noted that the economy seemed likely to expand at a moderate pace and that core inflation, while elevated, seemed likely to be restrained over time.

In contrast, minutes from the December 12th meeting revealed that several members noted a more pronounced weakness in recent economic indicators. Their bias toward moderate growth appeared to falter as they seemed more concerned that the downside risks to GDP growth in the near term had increased. In addition, Fed members felt the need to reclassify their commentary regarding the "cooling" in the single family housing market as "substantial." True to form, all of the policy members agreed that the preeminent risk lies in their inflation forecast, as they remain concerned that price pressures will not moderate as much as desired.

In spite of some deflationary signals, i.e. the breakdown in several commodities, the Fed remains concerned about the overall level of inflation. In particular, they are fearful that the tight labor market and recent pickup in wages will cause inflationary expectations to rise. Historically however, wage gains and the current level of unemployment have traditionally been poor tools to measure future inflationary movements. Wage strength may be more an indicator of past economic strength than a predictor of future muscle as they are traditionally the last measure to show improvement during an expansion. For example, during 2000 the unemployment rate bottomed at 3.80% while hourly earnings peaked a few months later at 4.30%.

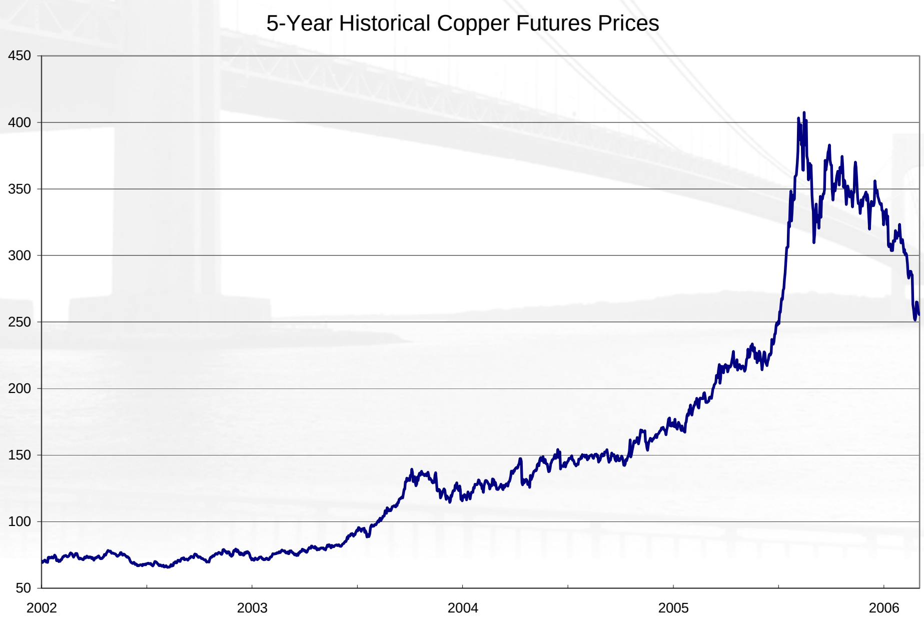
For reasons highlighted in our 2007 Fixed Income Market Outlook we embrace the view that as the early months unfold it should become evident that the Fed will need to get back on the field, and "move the chains" to address a slowdown in economic activity.

Have the basic laws of gravity miraculously changed?

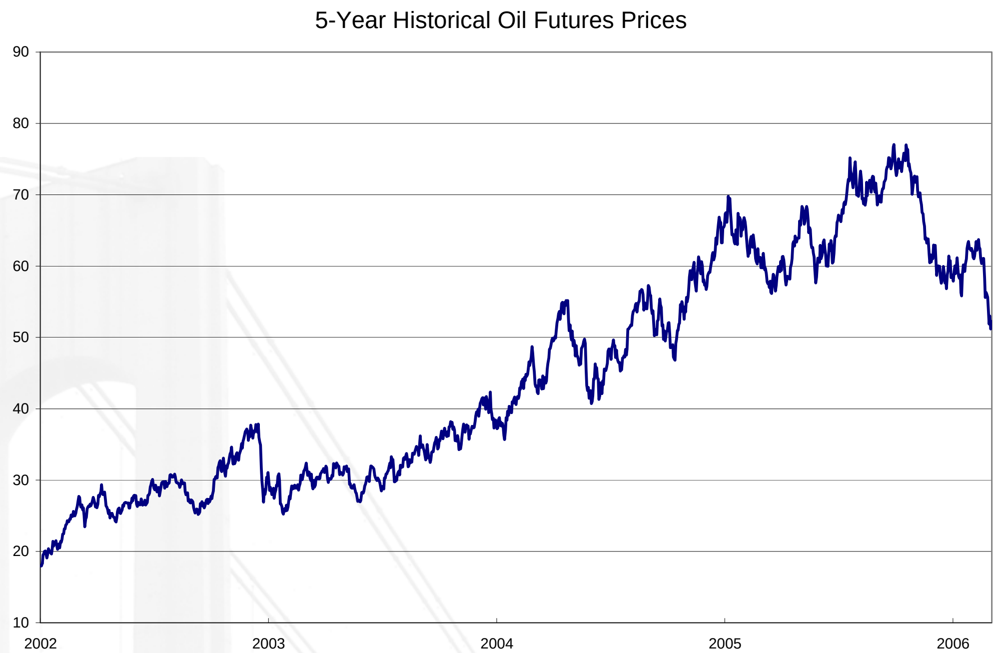
Although we have previously discussed the implications of the "housing bubble" on economic growth and resultant Fed policy, some recent developments obligate us to return to the topic. There are growing discussions in the media that the market for newly constructed single family homes is "bottoming" and showing some signs of revival. There are two points to make here. The first is that new home sales make up approximately 15% of the housing market and yet it draws a disproportionate share of the press coverage. To our way of thinking it is the health of the secondary home sector (comprising about 85% of the housing market) which holds the key to a "bottoming" forecast. Secondly, we can all debate whether the reported 2 1/2 % of price decline in year-over-year secondary home prices is a large enough correction to the parabolic move in home appreciation witnessed over the last seven years (please see chart below for a comparison of the latest housing boom compared to historical norms). However, what should be indisputable is that a lack of affordability is the underlying cause of the housing slowdown.

One thing appears painfully clear. The cost to own a single family home remains unaffordable to the remaining 30% of the population who didn't join the masses and acquire a home at cheaper prices. Achieving a 70% home ownership rate is a noteworthy milestone. However, this too comes at a price. As individuals offer their home up for sale who will provide the bid? Although it is possible to put a "bottom" in with home affordability at a 14 year low, it is not a sound wager to make.

Traditionally when a commodity or investment makes a parabolic move to the upside, it is followed by a bust. You only need to add the word "eventually." Copper and Oil highlight this concept as shown by the charts below. As oil prices pierced $75 a barrel in the summer of 2006 many pundits were forecasting $100 a barrel as their next target. Their premise rested on a razor thin supply-to-demand equation, continued double digit growth in emerging economies such as India and China, and an escalation in Middle Eastern tension. As is usually the case: right premise, wrong price. At the time of this writing, oil futures are down roughly 34% since July 2006 breaching $51 a barrel. While some stand by and look in amazement we look at it as an inevitable outcome of a parabolic move.

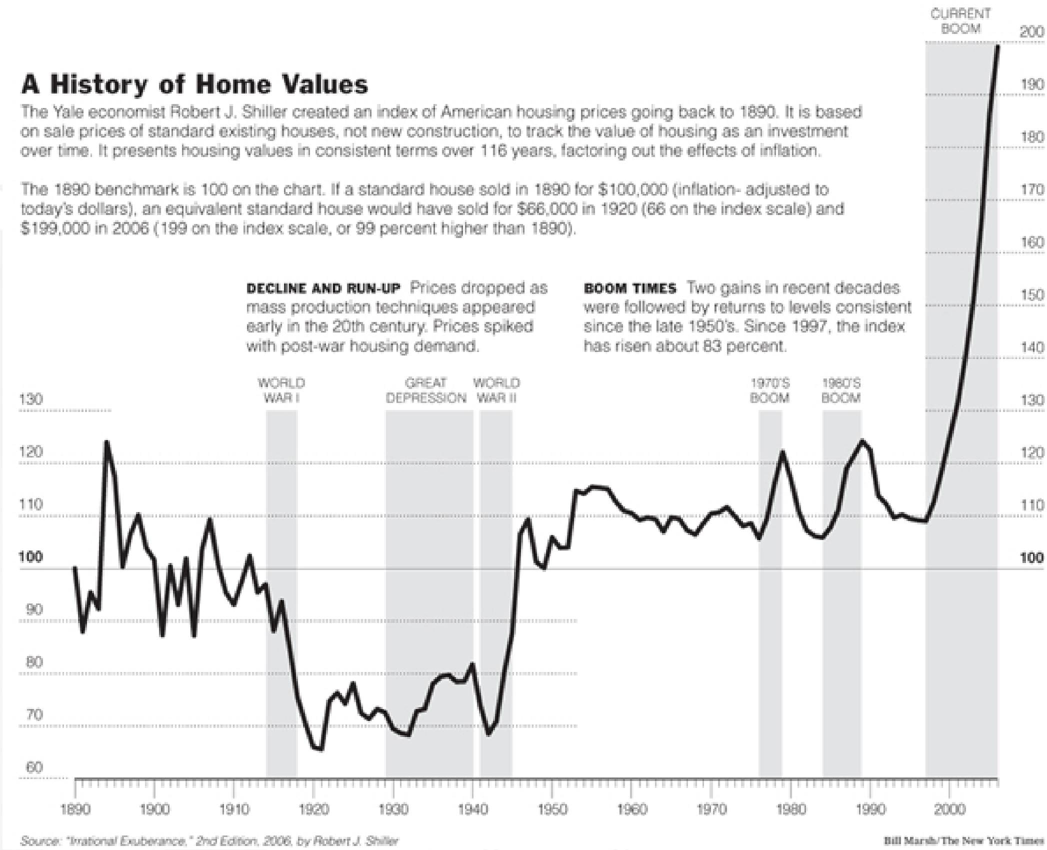


Source: Bloomberg, LP



Source: Bloomberg, LP

Maybe housing will surprise us and it will be different this time, but we strongly believe that no product is exempt from the type of price action discussed above. The boom in housing witnessed over the last 7 years should not unwind with just a “dip” in price. If it did, this could be one of the first “bottoms” put in so close to the top. For a history of home values, please see the chart below. We feel a more protracted and deeper decline is in store with negative implications for the overall economy. Finally, irrespective of the fact that many assets trade over the counter or on an exchange, housing is just another market example where a reversion to the mean is inevitable.



Municentric view

Demand, Demand and yes more Demand

The fourth quarter of 2006 saw municipal new issuance surge by 19.4% over levels recorded a year ago. Despite the flood of new issuance, the volume for the year still fell short of last year's pace by 6.1%. Notwithstanding the heavy supply of the final quarter, the marketplace absorbed the flow as demand continued to heat up. In particular investors were flush with cash as roughly $75 billion of bonds were called during the period. Tender Option Bond investors (leveraged participants) were also active during the period as they sought to take advantage of the relative steepness of the municipal yield curve versus Treasury's.

On the back of this strong demand, the total rate of return scored in the Municipal Bond Market bested Treasury market returns. Using the Lehman indices as a proxy, the Municipal Bond Market was up 111 basis points compared to a 72 basis point increase in the Treasury bond market, even without considering the tax benefits accruing to municipal bond holders.

Contributing to the overall tax-exempt markets solid performance was the continued strong returns registered by the lower rated investment grade category. In fact, with investors “reaching” for yield the term high yield is now a misnomer. The sector should be classified as incremental yield since the basis point differential between lower-rated bonds and “AAA”-rated securities is approaching the lowest levels seen over the last 14 years. This is yet another sign of the growing complacency among investors as they seem to be taking on greater risks for smaller potential rewards.

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***Lehman Brothers Municipal Bond Index, is a broad-based total return index comprising investment grade, fixed-rate, and tax-exempt issues, with a remaining maturity of at least one year, including state and local general obligation, revenue, insured, and pre-refunded bonds that are selected from issues larger than $75 million dated since January 1990. Investors cannot directly purchase an index. The returns of the index are shown for comparative purposes. When comparing the investment returns of the manager to the index, you should know the manager does not necessarily hold the same securities that comprise the index, the index may not reflect the asset allocation and portfolio characteristics of accounts managed by the manager and that the index is unmanaged.