

## Market Insights with Bill Knapp of MainStay Investments

\*\*\*

March 20, 2008

### **The Fed's Aggressive Actions—Too Little, Too Late?**

This week the Fed mollified, but did not tranquilize, wary investors with a 75 basis point rate cut and by opening new lending facilities to its primary dealers. The Fed's tougher language on inflation is fair warning to commodities speculators and provoked the commodity price elevator to lurch quickly down a few floors—testing the fortitude of recent-to-board momentum chasing riders.

The Fed was busy in the last week—cutting the Fed Funds rate three quarters a percent Tuesday, in two moves cutting the Discount Rate one percent (thereby narrowing the spread to Fed Funds), offering to lend Treasuries for Mortgage Backed Securities to its primary dealers and opening the Discount Window to these primary dealers.

The Fed's aggressive and timely actions appear to have assuaged the mortgage backed securities market as spreads versus treasuries have collapsed a full percentage point from recent record levels.

A potentially more economically important testament to the Fed's success is a decline in mortgage rates back to levels seen before the recent market disruption. Lower rates will benefit would-be buyers in the downtrodden housing market and should encourage a pick up in refinancing.

The Fed statement accompanying its recent rate cut offered a more balanced assessment of risk facing the US economy. While acknowledging “the outlook for economic growth has weakened further,” the statement also contained much stronger language regarding the Fed's concern over current inflation levels.

The Fed noted “Inflation has been elevated, and some indicators of inflation expectations have risen.” This inflation concern is the principal reason the fed disappointed market expectations of a one percent cut in rates. A one percent cut may not have even been seriously discussed as two Fed Board members voted against the enacted cut—feeling it was too high.

Commodity speculators were given a shot across the bow as the Fed “projected leveling-out of energy and commodity prices.” Since the Fed action on Tuesday, most commodity prices have tumbled around 10%. Oil is back at a \$100 per barrel and gold has sunk more than \$100 per ounce from recent record prices.

These hefty commodity price declines may be self re-enforcing as long investors may have to liquidate positions as they face margin calls for the first time in recent history.

Novice entrants to these markets may head for the exits as well—now that their initial investment may be underwater.

Economic data has taken a back seat to market and Fed action this week. One important release was Thursday's new Claims for Unemployment for the Labor Department. New claims for the week ending March 15 scooted up 22,000 to 378,000. The four-week moving average rose 6,000 to 365,000.

The labor market is clearly showing signs of weakening, but not necessarily distress just yet. The harmonizing of lower mortgage rates, lower food and energy prices and the coming tax rebates should reverse the downtrend in labor and the broader economy.

### **Looking Ahead...**

The coming week is relatively quiet with respect to economic releases—Existing Homes' Sales come Monday, Consumer Confidence Tuesday, and New Homes' Sales and Durable Goods are reported Thursday. Look to next Thursday's unemployment report for signs of further labor market deterioration or steadiness.

***William Knapp, PhD, is a managing director at New York Life Investment Management's Equity Investor's Group and serves as the investment strategist for MainStay Investments.***

***Previously, he served as chief investment officer of Personal Financial Services at the Northern Trust Company in Chicago, Illinois where he oversaw strategic asset allocation and was responsible for investment policy for the private client business.***

***Prior to Northern Trust, he was head of global investment strategy at Citigroup Asset Management/Citigroup Private Bank and oversaw Citigroup's flagship global asset allocation products.***

***Dr. Knapp received his PhD in Economics from the University of Wisconsin – Madison.***

***To arrange an interview with Dr. Knapp, please contact Allison Scott at 212-576-4517.***

If you prefer not to receive future Market Insights, please reply to this email with "UNSUBSCRIBE" in the header.

Bill Knapp's economics publications are distributed by New York Life Investment Management LLC (NYLIM). The information and opinions herein are for general information use only. NYLIM does not guarantee their accuracy or completeness, nor does NYLIM assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice.