Tea Leaf

…weekly since 1976

Your guide to understanding today's economy and financial markets

July 4, 2007

view previous issues

370 Days…and Counting

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

It has now been slightly more than one year since the Federal Reserve last changed monetary policy. On June 29, 2006, the Fed pushed its key short-term interest rate target—that of the federal funds rate—from 5.00% to 5.25%.

The federal funds rate is the interest rate at which financial institutions, primarily commercial banks, lend excess funds to other commercial banks on an overnight unsecured basis. The federal funds rate is arguably the most important of ALL short-term interest rates, and the rate that other short-term rates, such as the prime lending rate, are largely based upon.

Such a move then followed the 17th consecutive meeting of the Fed's Open Market Committee (the FOMC, which meets roughly every 45 days) wherein a 0.25% interest rate hike was enacted. The cumulative impact of 17 consecutive 0.25% tightening moves (was there a pattern here?) was to take the Fed's target rate from the 1.00% level in effect from June 2003 to June 2004 to the 5.25% level now in effect for more than a year…

…the best guess today suggests that at year-end 2007 we will talk about a federal funds rate that has not changed for 18 months. Financial markets have, however, in recent days priced in about a one-in-five chance that the Fed could trim its key rate by 0.25%, perhaps on December 11, 2007.

Most Recent Meeting

The FOMC held a regularly scheduled two-day meeting last week. As widely expected, the Fed made no change to the 5.25% federal funds rate at that meeting.

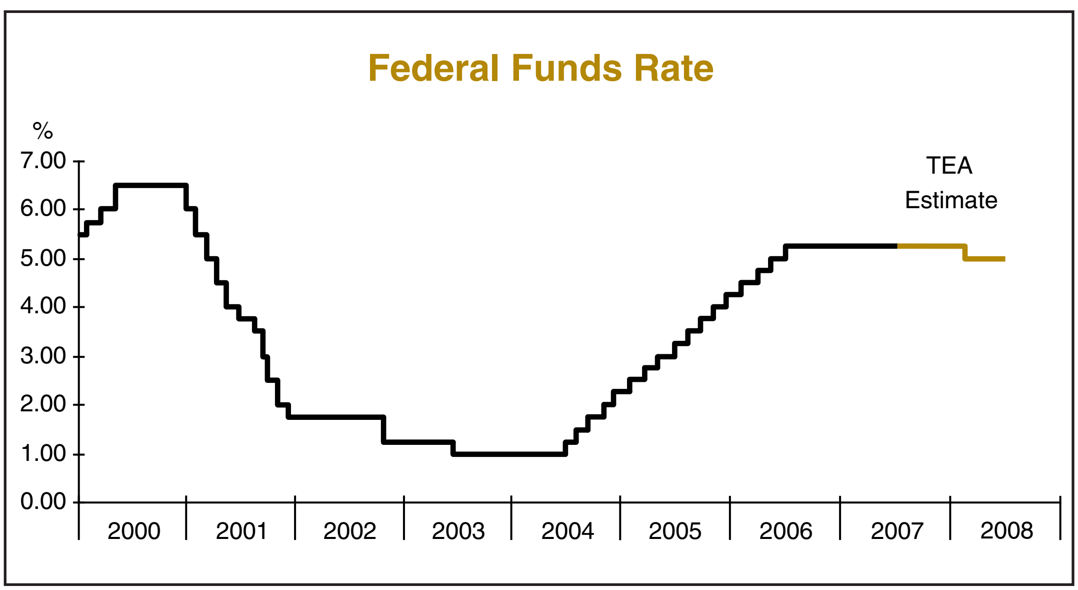
At the same time, however, financial markets were extremely interested in the accompanying "Fed statement"… which can many times provide clues as to the Fed's monetary policy intent in coming months.

Fed Chair Ben Bernanke

Here is the statement in its entirety…

The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5-1/4%.

Economic growth appears to have been moderate during the first half of this year, despite the ongoing adjustment in the housing sector. The economy seems likely to continue to expand at a moderate pace over coming quarters.



THREDGOLD ECONOMIC ASSOCIATES

The TEA Company
A Professional Speaking and Economic Consulting Company
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
801-614-0403
www.thredgold.com

> Readings on core inflation have improved modestly in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures.
>
> In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Interpreting "FedSpeak"

Significant efforts are made by economists and financial market players to determine just what the FOMC is saying in regard to future monetary policy. While such attention to detail may seem somewhat overdone, bear in mind that the Federal Reserve arguably has a greater impact on the average American consumer than does the Administration or the Congress.

After considerable examination and dissection, financial market players generally determined that the Fed is still seriously concerned about inflation pressures (that's what they are paid to do), even as the Fed's preferred inflation measures have moderated…

Note: the Fed's preferred measure of consumer inflation (the core personal consumption expenditures index, core PCE, which excludes food and energy costs) declined to a 1.9% rate over the most recent 12-month period, the first time it has been within the Fed's desired 1.0%-2.0% range in three years. Such increases had been in the 2.0%-2.8% range since 2004.

At the same time, the Fed sees the current economic expansion continuing at a reasonable pace over the balance of the year, as do most economists…

Note: the first quarter's revised 0.7% real (inflation adjusted) annual growth pace—the weakest quarterly growth pace in four years—likely gave way to a more acceptable 3.0%-3.8% growth pace during the April to June quarter just ended. We continue to expect a real annualized growth pace of 2.5%-3.0% over the next 12 months.

Mortgage Rates

The easiest way to develop a rough idea as to the level of 30-year fixed-rate mortgages around the country is to take the current yield (or return) on 10-year U.S. Treasury Notes and add 1.60%. The Treasury yield had been in a relatively tight range of 4.40% to 5.00% over the past nine months, corresponding to a 6.00% to 6.60% range on 30-year fixed rate mortgages.

U.S. Treasury Note yields rose sharply in June's first two weeks, with the 10-Year Treasury yield reaching 5.33% on June 13, a five-year high. Such a yield corresponded to roughly 6.90% to 6.95% 30-year fixed-rate mortgages at that time.

Long-term U.S. interest rates had moved sharply higher during June's first two weeks in response to additional evidence that the U.S. economy was rebounding impressively from the first quarter's pathetic growth pace. Such evidence largely ended hopes at that time that the Fed might trim its key rate later this year.

The upward move in long-term U.S. interest rates during June 1-15 was also tied to further evidence that the global economy was practically booming. Such a development led to various interest rate hikes by numerous central banks around the globe, tied to keeping inflation pressures under control.

Such long-term interest rates have eased over the past two weeks. The more market friendly core PCE data, combined with investor concern about Wall Street giant Bear Stearns' sub-prime mortgage hedge fund woes, led bond prices higher…bond yields lower…in recent days. The 10-year U.S. Treasury Note yield hovered around 5.00% Monday and Tuesday (4.99% close on Monday, 5.04% close on Tuesday), suggesting 30-year fixed-rate mortgages back near a 6.60% level.

Jeff

"TEA"ser

Apple's iPhone…
The good news?
A cool, sleek, glitzy product

The bad news?
Dealing with AT&T

THREDGOLD
ECONOMIC
ASSOCIATES

The *Tea Leaf* is delivered weekly as a link to a PDF file.

To receive the *Tea Leaf* free via email, email your name, email address and "subscribe Tea Leaf" to subscriptions@thredgold.com
or
fill out the form at **www.thredgold.com**

Thredgold Economic Associates
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
www.thredgold.com

Graphics and layout by Kendall Oliphant
Research assistance from Shawn Thredgold