Tea Leaf

...weekly since 1976

Your guide to understanding today's economy and financial markets

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Right Move…Right Time

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The Federal Reserve's somewhat surprising one-half percent cut in its most important tool—the federal funds rate—on Tuesday, September 18 was the right move delivered at a critical time. Stock markets around the world loved the aggressive Fed action, with the Dow recording its best two-week rise since 2004. We currently expect another cut, most likely one-quarter percent, all dressed up on Halloween.

The surprising element of the rate cut (from 5.25% to 4.75%) was its magnitude, rather than a cut in general. The chart below was included in our *Tea Leaf* of August 22, entitled "Fed Clatter." We noted at that time, "The graph indicates our current best guess of a 0.50% cut on September 18, followed by a further 0.25% cut on Halloween (October 31). We would currently suggest a federal funds rate of 4.50% at the end of the year."

The consensus view at that time expected a 0.25% cut, with many forecasters suggesting the Fed would do nothing at all. As stock prices rose and global credit tensions diminished in recent weeks, however, we did see a rising chance of a 0.25% move…the first of perhaps three such moves prior to year-end.

Of lesser importance on September 18 was the Fed's similar one-half percent cut in its discount rate. This rate, largely irrelevant since passage of the Monetary Control Act of 1980, was cut from 5.75% to 5.25%. The Fed had cut this rust covered and antiquated interest rate on August 17 by one-half percent…a largely symbolic move…while keeping its powder dry for a later change in the federal funds rate.

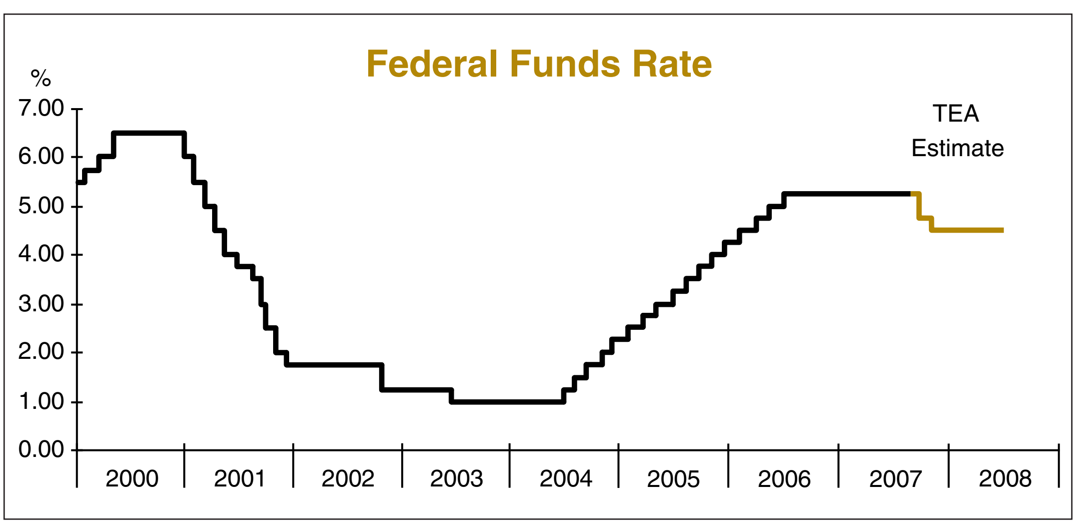
As expected, the Fed acknowledged in the accompanying statement on September 18 its continuing concern regarding inflation…that IS its primary job. To the comfort of investors around the globe, the Fed also acknowledged that housing pressures and credit crisis concerns had become more serious than previously expected. The Fed also noted that additional rate cuts could be provided "as needed to foster…sustainable economic growth."

While most financial-types greeted the bold Fed move, critics accused the Fed of trying to "bail out" lenders and investors who got too caught up in greed-driven housing speculation and private equity deals of recent years…

…you can't please everyone

Our View

The Fed was responding to legitimate and serious challenges to U.S. economic growth and global credit market viability. Recent data on the American economy has been of concern, including the weak August employment report and alarming housing data. Recent inflation news was also very market friendly (although even higher oil prices will soon unwind recent progress).



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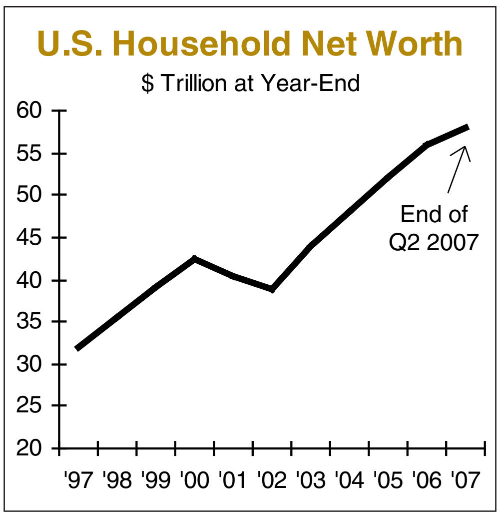
Global financial markets have faced severe dislocations and occasional "freeze ups," concerns addressed by major foreign central banks. The national media's focus on all things negative has only heightened market and investor emotions.

We remain strong believers in the Fed's inflation-fighting credibility. We also respect the fact that unusual times can warrant unusual monetary moves…

…this is one of those times

$57,860,000,000,000

The Federal Reserve releases a quarterly calculation entitled the Flow of Funds Accounts of the United States. This study estimates the value of all household assets, including homes, financial institution deposits, stocks, mutual funds, pensions, and equity in businesses. This combined value is then rubbed against all household liabilities, including home mortgage debt, home equity loans, other consumer debts, and unpaid life insurance premiums. The net difference represents the combined net worth of the American household.



U.S. household net worth at June 30, 2007 was $57.86 trillion, the highest total on record. It was up 2.1% ($1.2 trillion) from the prior quarter and the 19th consecutive quarter where a new record was set. The $57.86 trillion net worth total was 43% higher than at the end of 2001 and more than three times the total in 1988.

The total had declined in 2001 and 2002 from the prior $43.6 trillion peak in 2000's first quarter. The meltdown of the stock market during those years (especially the NASDAQ) had hurt many investors, particularly those who were the most aggressive. The big unknown in future quarters will be to what extent home prices remain under pressure.

New record highs have been driven by two primary factors. The first has been the sharp rise in home values across the country of the past few years. Home equity now represents roughly 40 percent of net worth, near the highest percentage on record. The second has been the strong rebound of the American stock market of recent years.

Nearly 70 percent of American families now own their homes and have, in most cases, enjoyed sizable increases in their home values in recent years. The Office of Federal Housing Enterprise Oversight noted in June 2007 that the average existing American home value rose roughly 50 percent over the prior five years.

Even as home price gains slowed sharply, or even declined, in various coastal, Southwestern, and Upper Midwest markets in 2006 and 2007, home values across many American communities continued to rise. Most forecasters expect overall prices to decline slightly in 2007, with a return to stable and slightly rising home values in 2008 and 2009, respectively.

An estimated 50 percent of American families now own stocks, a sharp rise from prior periods. Many now own stocks through their participation in employer-provided 401(k) programs. Solid gains in stock values of the past few years have sharply boosted the value of equity portfolios for millions of investors and retirees.

Median net worth (half of families with more, half with less) was slightly in excess of $100,000. The *average* family had a net worth near $500,000. This latter figure, however, overstates the typical family's net worth as significant wealth is concentrated among the richest households.

"TEA"sers

EVER WONDER…

…why the man who invests all your money is called a broker?

…why the time of day with the slowest traffic is called rush hour?

…why the sun lightens our hair, but darkens our skin?

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