Equity Research

Global

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Global
Strategy

January 8, 2002

Fed Watcher

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-Briefly-

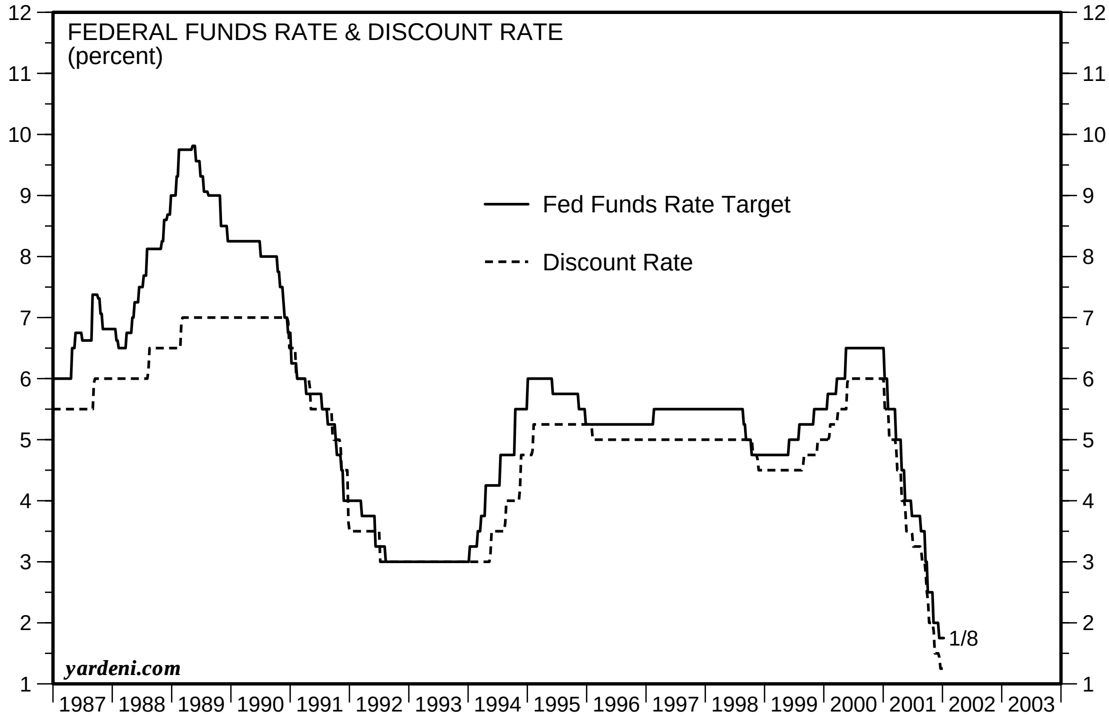
The Federal Open Market Committee decided to lower its target for the federal funds rate by 25 basis points to 1-3/4 percent on December 11 (Exhibit 12). In a related action, the Board of Governors approved a 25 basis point reduction in the discount rate to 1-1/4 percent. The Fed issued a statement emphasizing the deteriorating economic conditions: “Economic activity remains soft, with underlying inflation likely to edge lower from relatively modest levels. To be sure, weakness in demand shows signs of abating, but those signs are preliminary and tentative. The Committee continues to believe that, against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future. Although the necessary reallocation of resources to enhance security may restrain advances in productivity for a time, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate.”

Against that backdrop, the Fed will likely ease further in January. The Fed Funds Rate Models shown in Exhibits 1-10 mostly confirm this assessment. The federal funds rate is highly correlated with the yearly percent change in nominal GDP which is slowing (Exhibit 2). Nominal GDP growth slowed to 2.9% in the third quarter from the second quarter’s 3.5% annual rate. It is on track to slow even further during the fourth quarter, consistent with our forecast of additional Fed easing.

The yearly change in the federal funds rate (in basis points) is highly correlated with both the capacity utilization rate and the NAPM Price Index (Exhibits 9 and 10). The utilization rate fell to 74.7% in November. The NAPM index peaked in March of last year at 78.5 and has fallen to 34.7 in December.

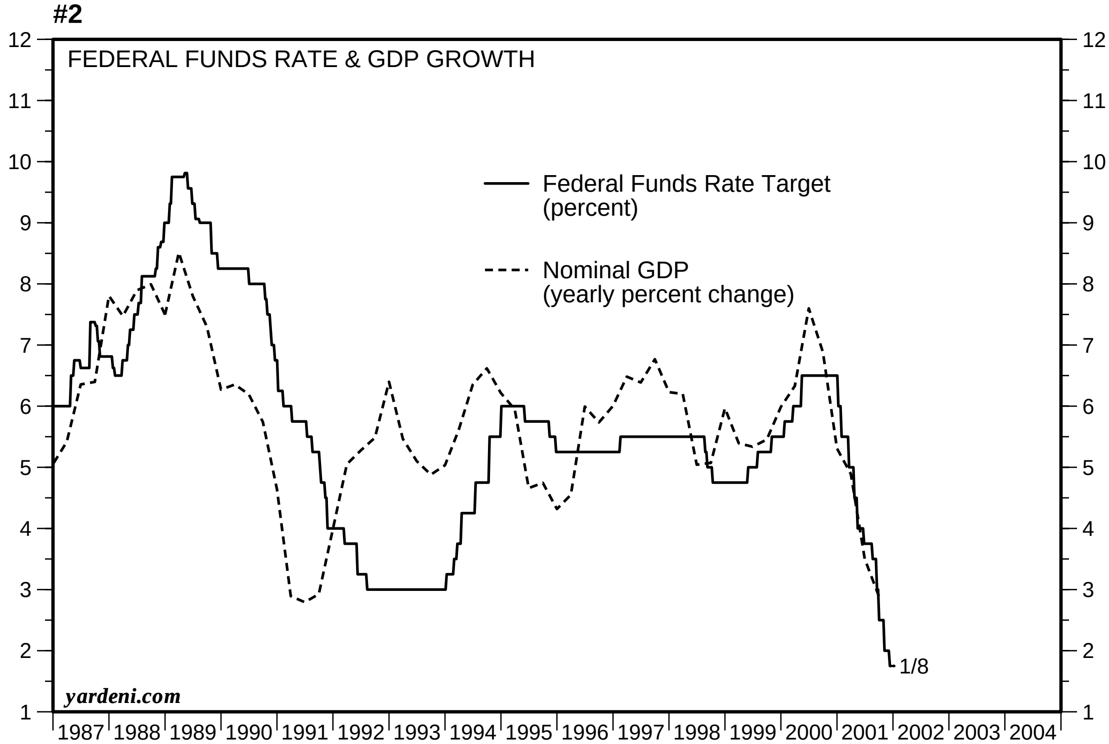
- Fed Funds Rate Models -

#1



Fed policy is very cyclical.

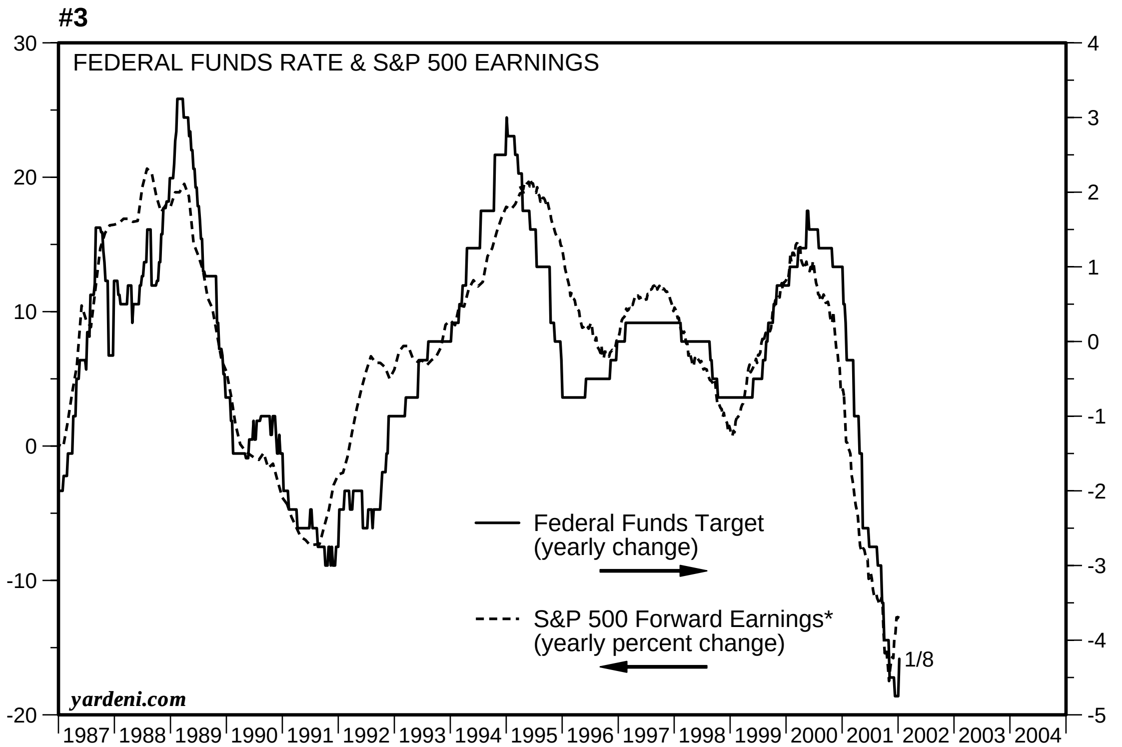
#2



Federal funds rate is highly correlated with year-over-year growth in nominal GDP. The fit has been especially tight over the past year.

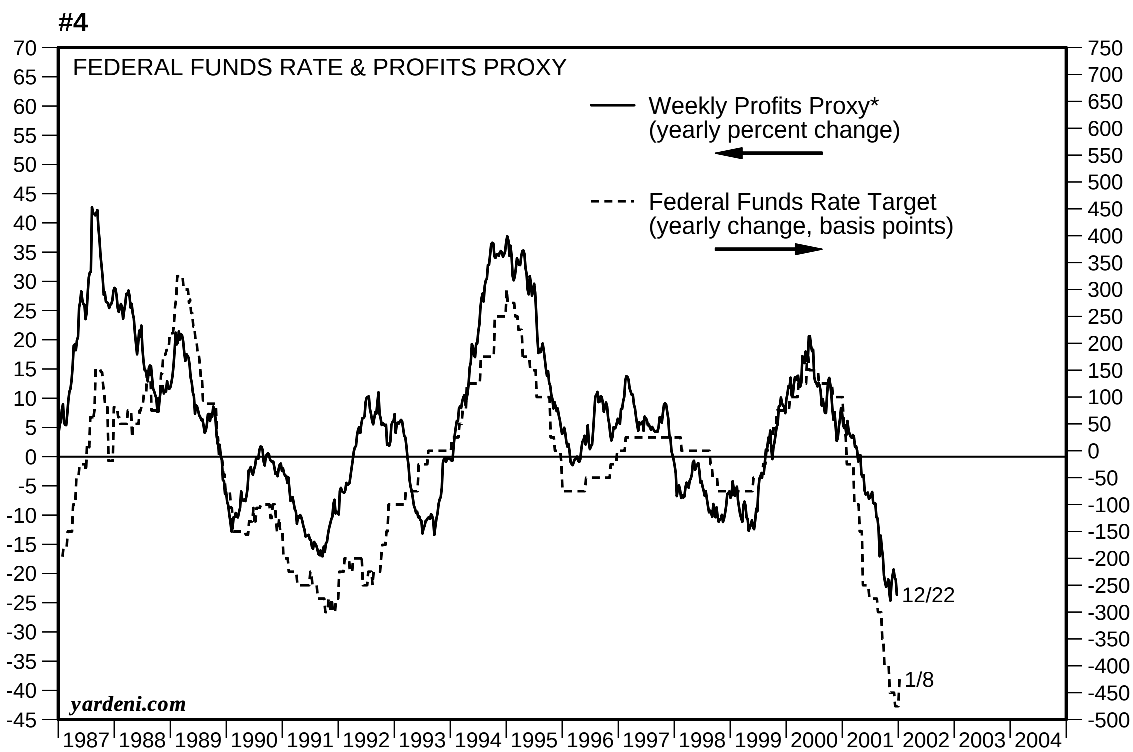
- Fed Funds Rate Models -

Fed policy is very highly correlated with corporate earnings expectations.



* 52-week forward consensus expected operating earnings per share. Monthly through March 1994, weekly after.
Source: Thomson Financial

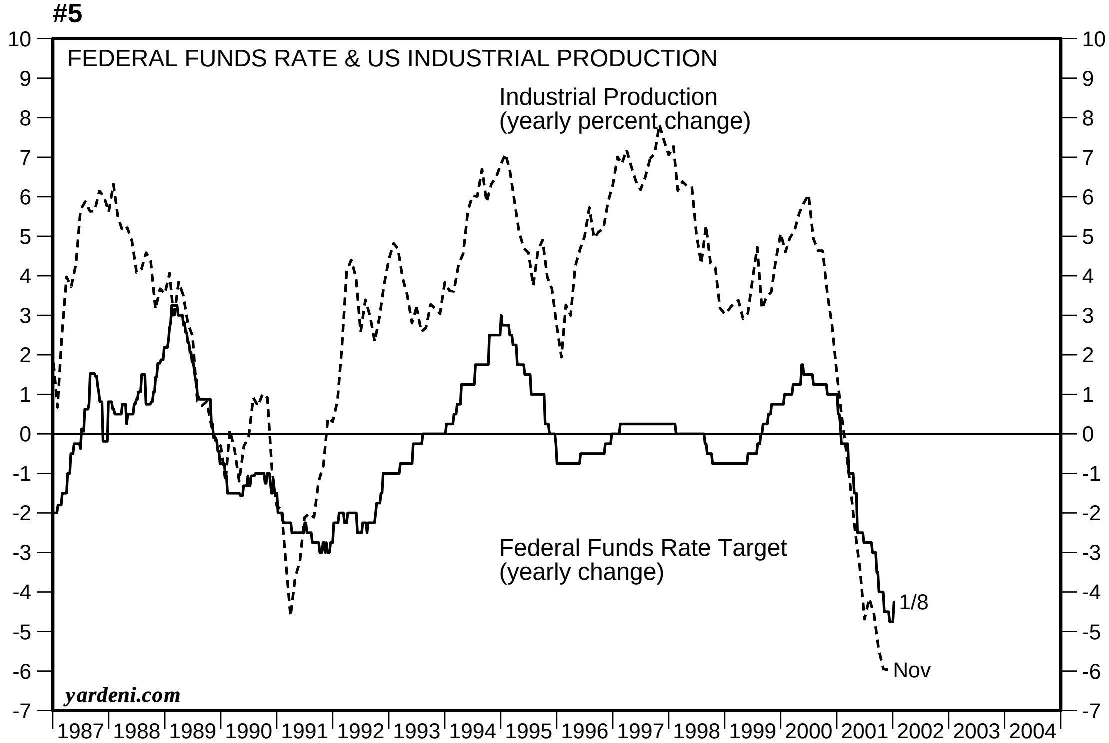
Yearly change in federal funds rate target is highly correlated with our Weekly Profits Proxy.



* Business Week's industrial production index multiplied by CRB raw industrials spot price index.

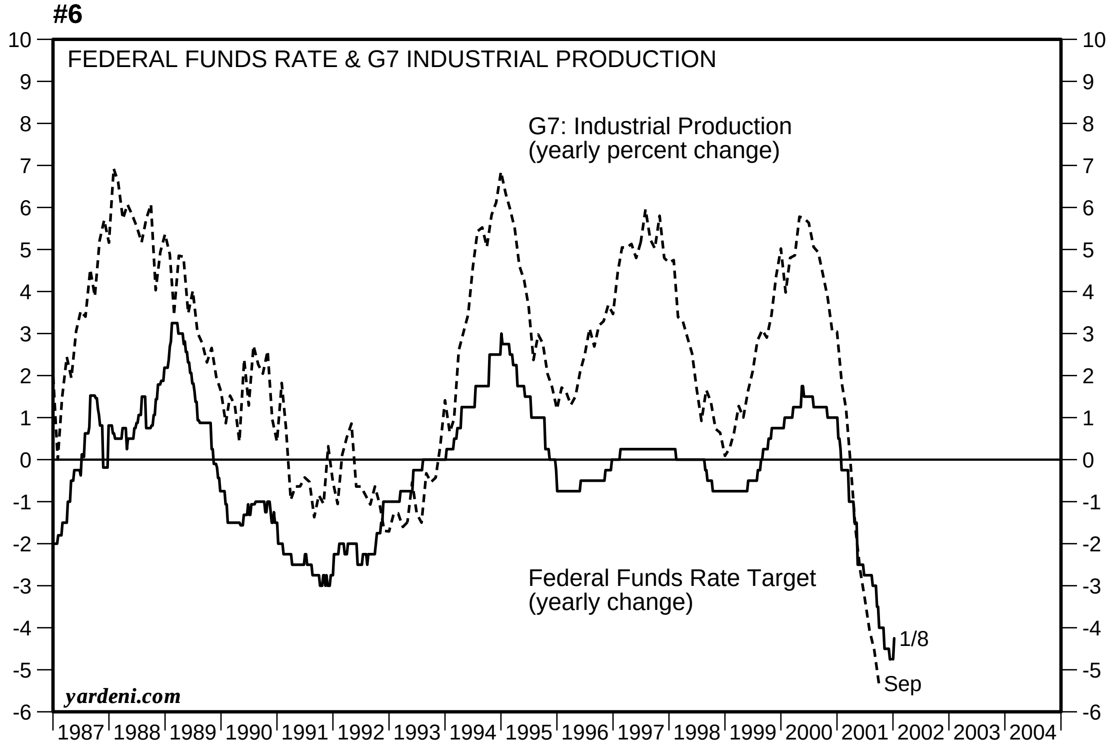
- Fed Funds Rate Models -

#5



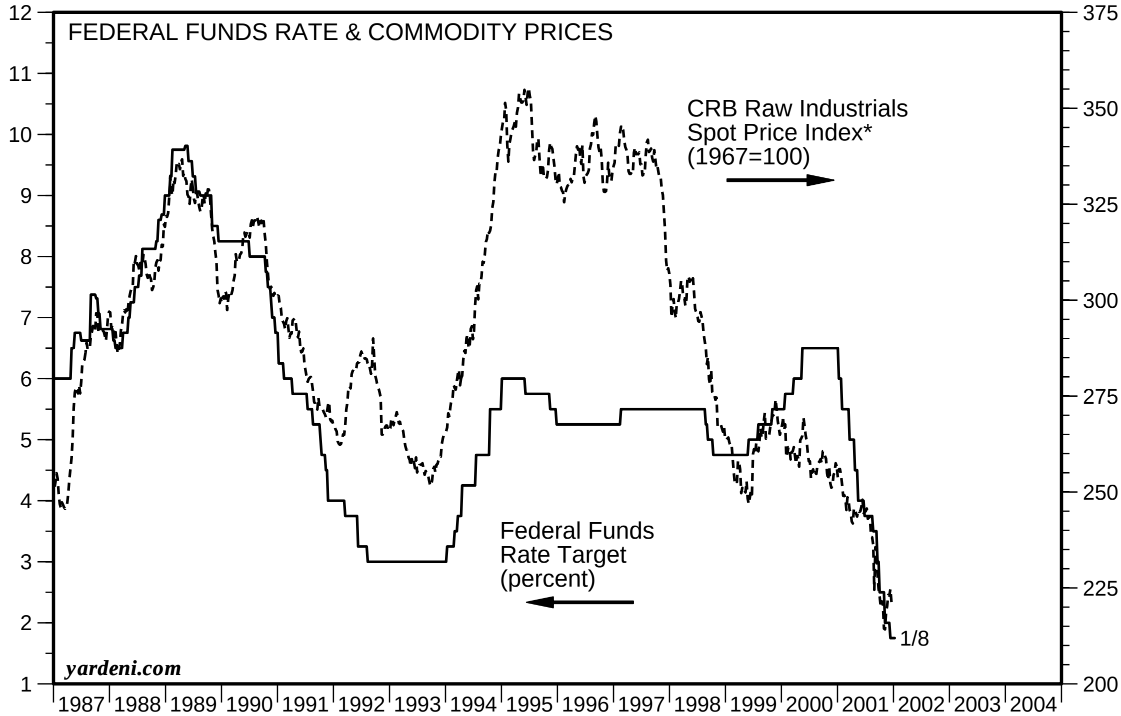
Fed policy is influenced by both domestic and global production cycle.

#6



- Fed Funds Rate Models -

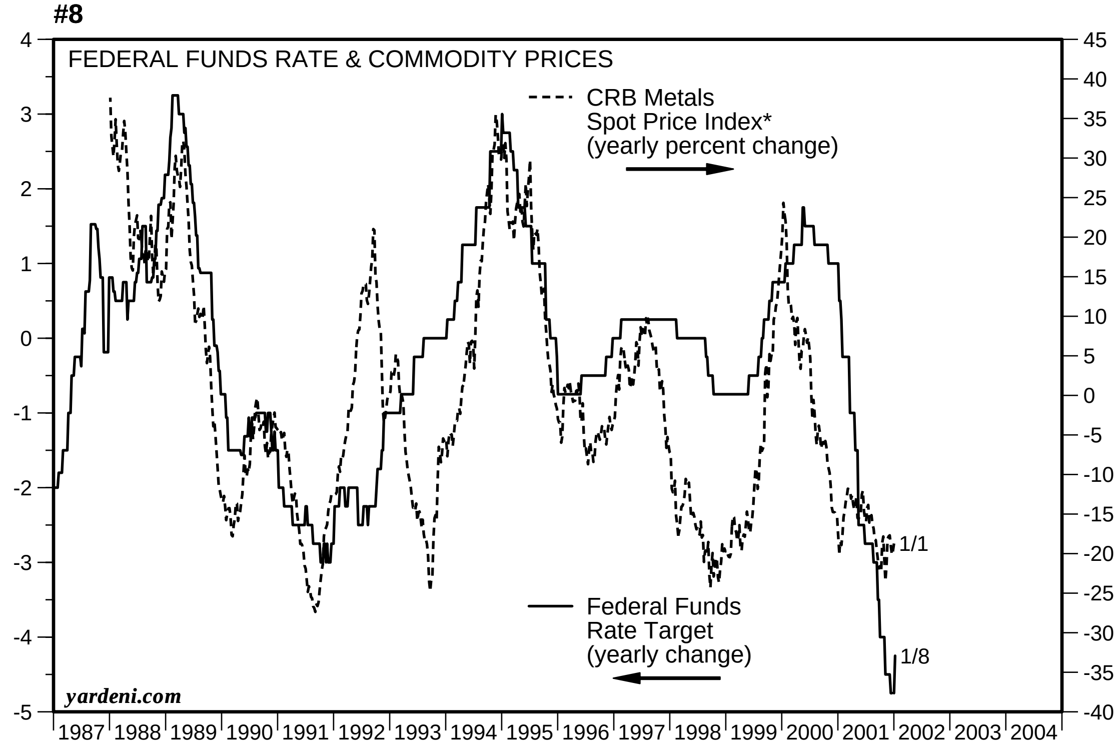
#7



* Includes copper scrap, lead scrap, steel, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, tallow.

Fed policy is strongly influenced by industrial commodity prices.

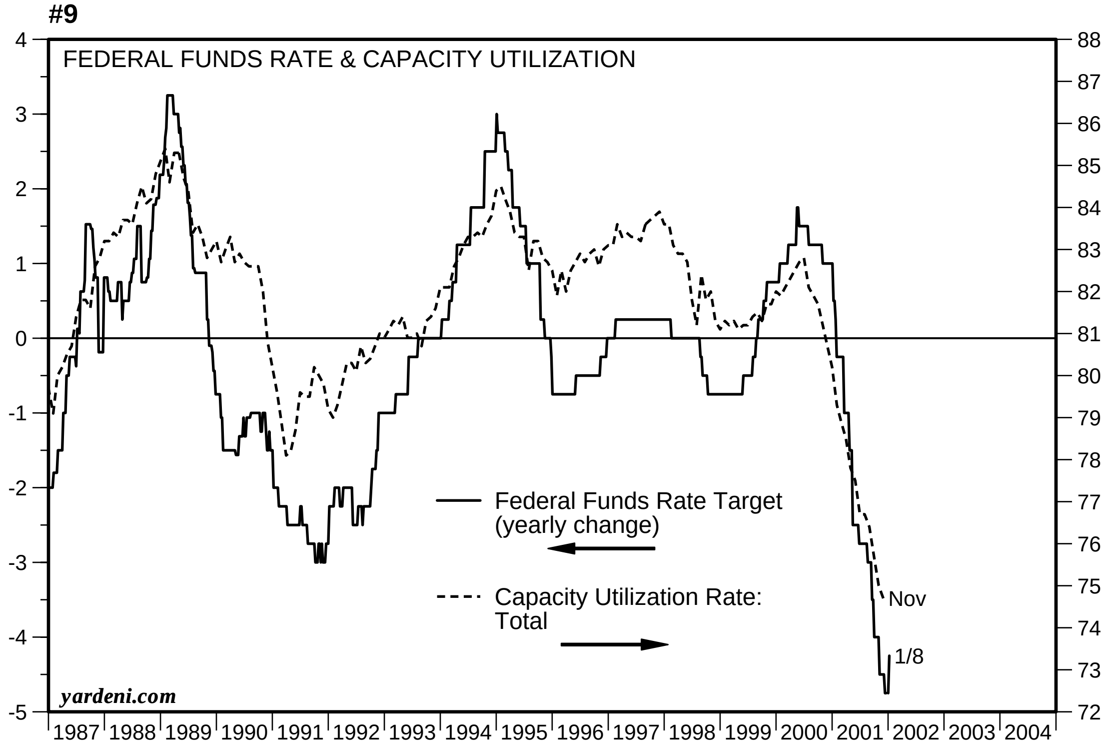
#8



* Includes copper scrap, lead scrap, steel scrap, tin and zinc.

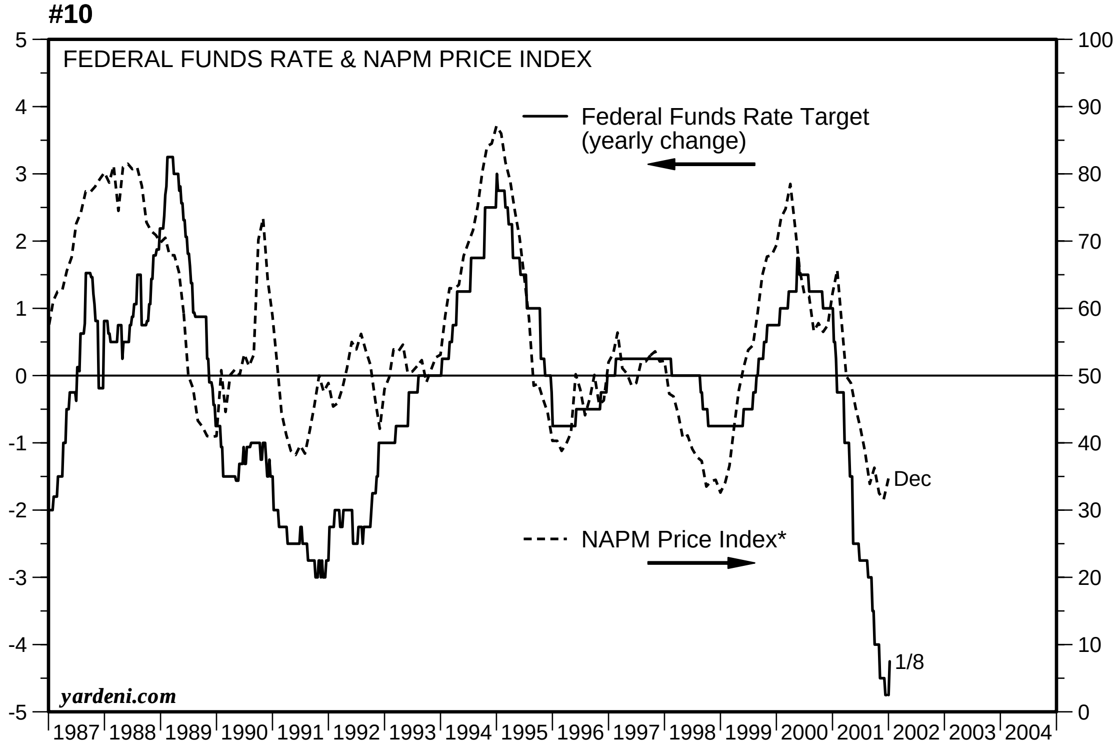
- Fed Funds Rate Models -

#9



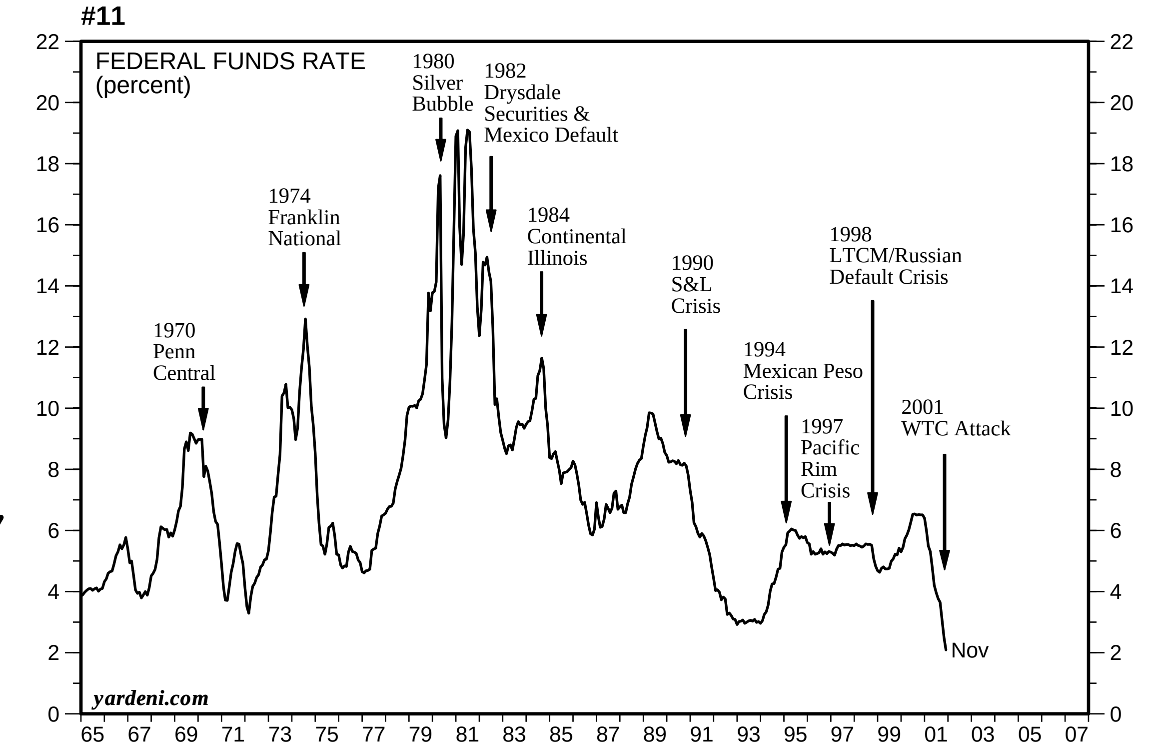
The year-over-year change in the federal funds rate is very highly correlated with both the capacity utilization rate and the NAPM price index.

#10

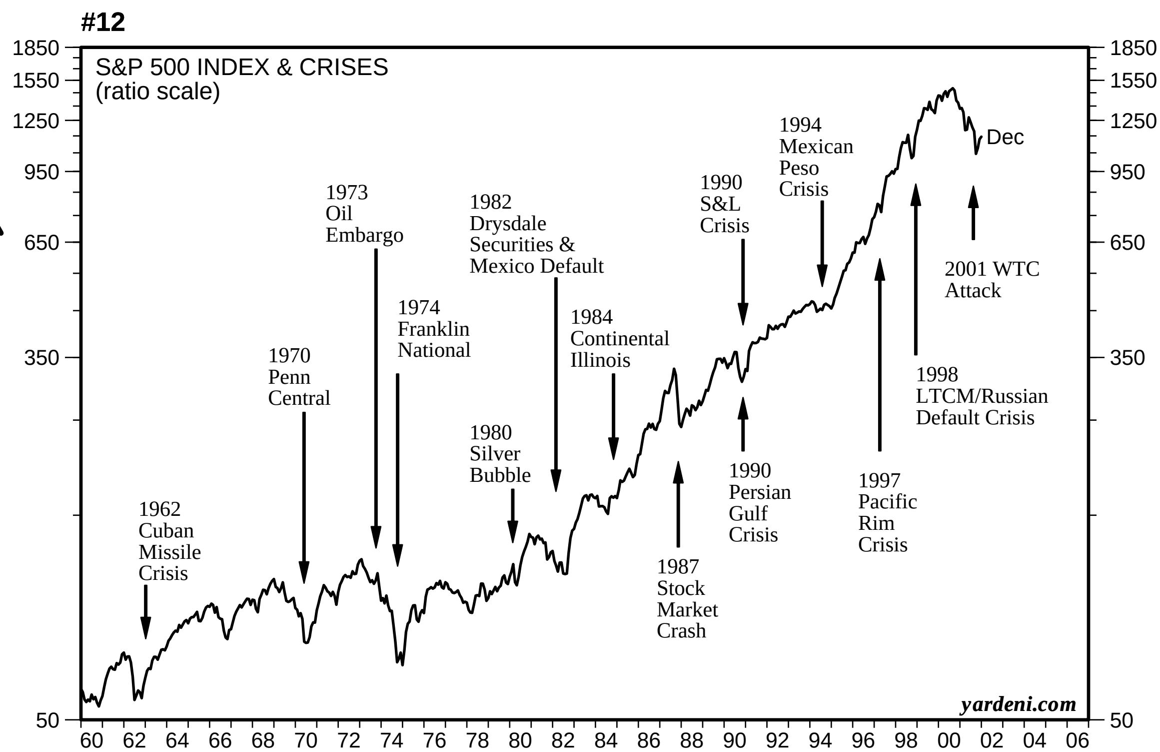


* National Association of Purchasing Management.

- Fed Easing Cycles -



Fed always responds to financial crisis by easing, providing a lift for the economy and stock prices.



- Policy Chronology -

#13: Chronology of Federal Reserve Policy Changes Since 1987

				Date of Change	Days Since Previous Change	Change In Fed Funds	New Rate Levels Fed Funds	Discount
Tightening:	Duration (in months)	9	**1987**	Jan 2	134	13	6	n/c
	Number of moves:	7		Apr 30	118	50	6 1/2	n/c
	Cumul. change in fed funds:	144		May 20	21	25	6 3/4	n/c
				Jul 2	43	-13	6 5/8	n/c
				Sep 3	63	25	6 7/8	n/c
				Sep 4	1	50	7 3/8	6
				Oct 8	34	-6	7 5/16	n/c
Easing:	Duration (in months)	4		Oct 19	11	-25	7 1/16	n/c
	Number of moves:	4		Nov 4	16	-25	6 13/16	n/c
	Cumul. change in fed funds:	-81	**1988**	Jan 28	85	-19	6 5/8	n/c
				Feb 11	14	-13	6 1/2	n/c
Tightening:	Duration (in months)	14		Mar 30	48	25	6 3/4	n/c
	Number of moves:	15		May 9	40	25	7	n/c
	Cumul. change in fed funds:	331		May 25	16	25	7 1/4	n/c
				Jun 22	28	25	7 1/2	n/c
				Jul 19	27	19	7 11/16	n/c
				Aug 8	20	6	7 3/4	n/c
				Aug 9	1	38	8 1/8	6 1/2
				Nov 10	93	13	8 1/4	n/c
				Nov 22	12	13	8 3/8	n/c
				Dec 15	23	31	8 11/16	n/c
			1989	Jan 5	21	31	9	n/c
				Feb 9	35	31	9 5/16	n/c
				Feb 23	14	25	9 9/16	n/c
				Feb 24	1	19	9 3/4	7
				May 17	82	6	9 13/16	n/c
Easing:	Duration (in months)	40		Jun 6	20	-25	9 9/16	n/c
	Number of moves	24		Jul 7	31	-25	9 5/16	n/c
	Cumul. change in fed funds:	-681		Jul 27	20	-25	9 1/16	n/c
				Aug 22	26	-6	9	n/c
				Nov 6	76	-50	8 1/2	n/c
				Dec 20	44	-25	8 1/4	n/c
			1990	Jul 13	205	-25	8	n/c
				Oct 29	108	-25	7 3/4	n/c
				Nov 16	18	-25	7 1/2	n/c
				Dec 7	21	-25	7 1/4	n/c
				Dec 18	11	-25	7	6 1/2
			1991	Jan 8	21	-25	6 3/4	n/c
				Feb 1	24	-50	6 1/4	6
				Mar 8	35	-25	6	n/c
				Apr 30	53	-25	5 3/4	5 1/2
				Aug 6	98	-25	5 1/2	n/c
				Sep 13	38	-25	5 1/4	5
				Oct 30	47	-25	5	n/c
				Nov 6	7	-25	4 3/4	4 1/2
				Dec 6	30	-25	4 1/2	n/c
				Dec 20	14	-50	4	3 1/2
			1992	Apr 9	111	-25	3 3/4	n/c
				Jul 2	84	-50	3 1/4	3
				Sep 4	64	-25	3	n/c
			1993	(None)				n/c

- Policy Chronology -

#13: Chronology of Federal Reserve Policy Changes Since 1987 (cont.)

				Date of Change	Days Since Previous Change	Change In Fed Funds	New Rate Levels Fed Funds	New Rate Levels Discount
Tightening:	Duration (in months)	12	**1994**	Feb 4	518	25	3 1/4	n/c
	Number of moves:	7		Mar 22	46	25	3 1/2	n/c
	Cumul. change in fed funds:	300		Apr 18	27	25	3 3/4	n/c
				May 17	29	50	4 1/4	3 1/2
				Aug 16	91	50	4 3/4	4
				Nov 15	91	75	5 1/2	4 3/4
			1995	Feb 1	78	50	6	5 1/4
Easing:	Duration (in months)	7		Jul 6	155	-25	5 3/4	n/c
	Number of moves:	3		Dec 19	166	-25	5 1/2	n/c
	Cumul. change in fed funds:	-75	**1996**	Jan 31	43	-25	5 1/4	5
Tightening:	Duration (in months)	13	**1997**	Mar 25	419	25	5 1/2	n/c
	Number of moves:	1						
	Cumul. change in fed funds:	25						
Easing:	Duration (in months)	2	**1998**	Sep 29	553	-25	5 1/4	5
	Number of moves:	3		Oct 15	16	-25	5	4 3/4
	Cumul. change in fed funds:	-75		Nov 17	33	-25	4 3/4	4 1/2
Tightening:	Duration (in months)	9	**1999**	Jun 30	225	25	5	n/c
	Number of moves:	6		Aug 24	55	25	5 1/4	4 3/4
	Cumul. change in fed funds:	175		Nov 16	84	25	5 1/2	5
			2000	Feb 2	78	25	5 3/4	5 1/4
				Mar 21	48	25	6	5 1/2
				May 16	56	50	6.5	6
Easing:	Duration (in months)	11	**2001**	Jan 3	231	-50	6	5 1/2
	Number of moves:	11		Jan 31	28	-50	5 1/2	5
	Cumul. change in fed funds:	-475		Mar 20	48	-50	5	4 1/2
				Apr 18	29	-50	4 1/2	4
				May 15	26	-50	4	3 1/2
				Jun 27	43	-25	3 3/4	3 1/4
				Aug 21	39	-25	3 1/2	3
				Sep 17	27	-50	3	2 1/2
				Oct 2	15	-50	2 1/2	2
				Nov 6	35	-50	2	1 1/2
				Dec 11	35	-25	1 3/4	1 1/4

#14: FOMC Meetings and Members

Upcoming FOMC Meetings	Members of the Board of Governors	Federal Reserve Bank Presidents
Jan 29, 2002	Alan Greenspan - *Chair*	Cathy E. Minehan - *Boston*
Mar 19, 2002	William J. McDonough - Vice Chair	William J. McDonough - *New York*
May 07, 2002	Roger W. Ferguson, Jr.	Edward G. Boehne - *Philadelphia*
Jun 25, 2002	Edward W. Kelly, Jr.	Jerry L. Jordan - *Cleveland*
Aug 13, 2002	Laurence H. Meyer	J. Alfred Broaddus, Jr. - *Richmond*
Sep 24, 2002	Edward M. Gramlich	Jack Guynn - *Atlanta*
Nov 06, 2002	*Vacancy*	Michael H. Moskow - *Chicago*
Dec 10, 2002		William Poole - *St. Louis*
		Gary H. Stern - *Minneapolis*
		Thomas M. Hoenig - *Kansas City*
		Robert T. Parry - *San Francisco*

- Directives -

#15: Federal Reserve Monetary Policy Directives

December 11, 2001. The Federal Open Market Committee decided today to lower its target for the federal funds rate by 25 basis points to 1-3/4 percent. In a related action, the Board of Governors approved a 25 basis point reduction in the discount rate to 1-1/4 percent. Economic activity remains soft, with underlying inflation likely to edge lower from relatively modest levels. To be sure, weakness in demand shows signs of abating, but those signs are preliminary and tentative. The Committee continues to believe that, against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future. Although the necessary reallocation of resources to enhance security may restrain advances in productivity for a time, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate.

November 6, 2001. The Federal Open Market Committee decided today to lower its target for the federal funds rate by 50 basis points to 2 percent. In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 1-1/2 percent. Heightened uncertainty and concerns about a deterioration in business conditions both here and abroad are damping economic activity. For the foreseeable future, then, the Committee continues to believe that, against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness. Although the necessary reallocation of resources to enhance security may restrain advances in productivity for a time, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate.

October 2, 2001. The Federal Open Market Committee decided today to lower its target for the federal funds rate by 50 basis points to 2-1/2 percent. In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 2 percent. The terrorist attacks have significantly heightened uncertainty in an economy that was already weak. Business and household spending as a consequence are being further damped. Nonetheless, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate. The Committee continues to believe that, against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

September 17, 2001. The Federal Open Market Committee decided today to lower its target for the federal funds rate by 50 basis points to 3 percent. In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 2-1/2 percent. The Federal Reserve will continue to supply unusually large volumes of liquidity to the financial markets, as needed, until more normal market functioning is restored. As a consequence, the FOMC recognizes that the actual federal funds rate may be below its target on occasion in these unusual circumstances. Even before the tragic events of last week, employment, production, and business spending remained weak, and last week's events have the potential to dampen spending further. Nonetheless, the long-term prospects for productivity growth and the economy remain favorable and should become evident once the unusual forces restraining demand abate. For the foreseeable future, the Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness.

August 21, 2001. The Federal Open Market Committee at its meeting today decided to lower its target for the federal funds rate by 25 basis points to 3-1/2 percent. In a related action, the Board of Governors approved a 25 basis point reduction in the discount rate to 3 percent. Today's action by the FOMC brings the decline in the target federal funds rate since the beginning of the year to 300 basis points. Household demand has been sustained, but business profits and capital spending continue to weaken and growth abroad is slowing, weighing on the U.S. economy. The associated easing of pressures on labor and product markets is expected to keep inflation contained. Although long-term prospects for productivity growth and the economy remain favorable, the Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

#15: Federal Reserve Monetary Policy Directives (cont.)

June 27, 2001. The Federal Open Market Committee at its meeting today decided to lower its target for the federal funds rate by 25 basis points to 3-3/4 percent. In a related action, the Board of Governors approved a 25 basis point reduction in the discount rate to 3-1/4 percent. Today's action by the FOMC brings the decline in the target federal funds rate since the beginning of the year to 275 basis points. The patterns evident in recent months--declining profitability and business capital spending, weak expansion of consumption, and slowing growth abroad--continue to weigh on the economy. The associated easing of pressures on labor and product markets are expected to keep inflation contained. Although continuing favorable trends bolster long-term prospects for productivity growth and the economy, the Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

May 15, 2001. The Federal Open Market Committee at its meeting today decided to lower its target for the federal funds rate by 50 basis points to 4 percent. In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 3-1/2 percent. A significant reduction in excess inventories seems well advanced. Consumption and housing expenditures have held up reasonably well, though activity in these areas has flattened recently. Investment in capital equipment, however, has continued to decline. The erosion in current and prospective profitability, in combination with considerable uncertainty about the business outlook, seems likely to hold down capital spending going forward. This potential restraint, together with the possible effects of earlier reductions in equity wealth on consumption and the risk of slower growth abroad, continues to weigh on the economy. With pressures on labor and product markets easing, inflation is expected to remain contained. Although measured productivity growth stalled in the first quarter, the impressive underlying rate of increase that developed in recent years appears to be largely intact, supporting longer-term prospects. The Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

April 18, 2001. The Federal Open Market Committee decided today to lower its target for the federal funds rate by 50 basis points to 4-1/2 percent. In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 4 percent. The FOMC has reviewed prospects for the economy in light of the information that has become available since its March meeting. A significant reduction in excess inventories seems well advanced. Consumption and housing expenditures have held up reasonably well, though activity in these areas has flattened recently. Although measured productivity probably weakened in the first quarter, the impressive underlying rate of increase that developed in recent years appears to be largely intact. Nonetheless, capital investment has continued to soften and the persistent erosion in current and expected profitability, in combination with rising uncertainty about the business outlook, seems poised to dampen capital spending going forward. This potential restraint, together with the possible effects of earlier reductions in equity wealth on consumption and the risk of slower growth abroad, threatens to keep the pace of economic activity unacceptably weak. As a consequence, the Committee agreed that an adjustment in the stance of policy is warranted during this extended intermeeting period. The Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

March 20, 2001. The Federal Open Market Committee at its meeting today decided to lower its target for the federal funds rate by 50 basis points to 5 percent. In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 4-1/2 percent. Persistent pressures on profit margins are restraining investment spending and, through declines in equity wealth, consumption. The associated backup in inventories has induced a rapid response in manufacturing output and, with spending having firmed a bit since last year, inventory adjustment appears to be well underway. Although current developments do not appear to have materially diminished the prospects for long-term growth in productivity, excess productive capacity has emerged recently. The possibility that this excess could continue for some time and the potential for weakness in global economic conditions suggest substantial risks that demand and production could remain soft. In these circumstances, when the economic situation could be evolving rapidly, the Federal Reserve will need to monitor developments closely. The Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

For a complete history, see
http://www.yardeni.com/fomc.asp

#16: Fed's Economic Forecasts

Monetary Policy Report	Consumer Prices*		GDP*		Unemployment**	
	Forecast	*Actual*	*Forecast*	*Actual*	*Forecast*	*Actual*
	1996		**1996**		**1996**	
Jul 96	3.00 - 3.25	3.1	2.50 - 2.75	4.1	5.50	5.3
	1997		**1997**		**1997**	
Jul 96	2.75 - 3.00		1.75 - 2.25		5.50 - 5.75	
Feb 97	2.75 - 3.00		2.00 - 2.25		5.25 - 5.50	
Jul 97	2.25 - 2.50	1.9	3.00 - 3.25	4.1	4.75 - 5.00	4.7
	1998		**1998**		**1998**	
Jul 97	2.50 - 3.00		2.00 - 2.50		4.75 - 5.00	
Feb 98	1.75 - 2.25		2.00 - 2.75		4.75	
Jul 98	1.75 - 2.00	1.5	3.00 - 3.25	4.7	4.25 - 4.50	4.4
	1999		**1999**		**1999**	
Jul 98	2.00 - 2.50		2.00 - 2.50		4.50 - 4.75	
Feb 99	2.00 - 2.50		2.50 - 3.00		4.25 - 4.50	
Jul 99	2.25 - 2.50	2.6	3.50 - 3.75	4.6	4.00 - 4.25	4.1
	2000		**2000**		**2000**	
Jul 99	2.00 - 2.50		2.50 - 3.00		4.25 - 4.50	
Feb 00	1.75 - 2.00		3.50 - 3.75		4.00 - 4.25	
Jul 00	2.50 - 2.75	2.4	4.00 - 4.50	3.5	About 4.00	4.0
	2001		**2001**		**2001**	
Jul 00	2.00 - 2.50		3.25 - 3.75		4.00 - 4.25	
Feb 01	1.75 - 2.25		2.00 - 2.50		About 4.50	
Jul 01	2.00 - 2.50		1.25 - 2.00		4.75 - 5.00	
	2002		**2002**		**2002**	
Jul 01	1.75 - 2.50		3.00 - 3.25		4.75 - 5.25	

* Fourth quarter-to-fourth quarter percent change. As of February 2000, the Federal Reserve is using the Personal Consumption Deflator, rather than the CPI, to forecast inflation.

** Fourth quarter average.

Source: *yardeni.com*

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