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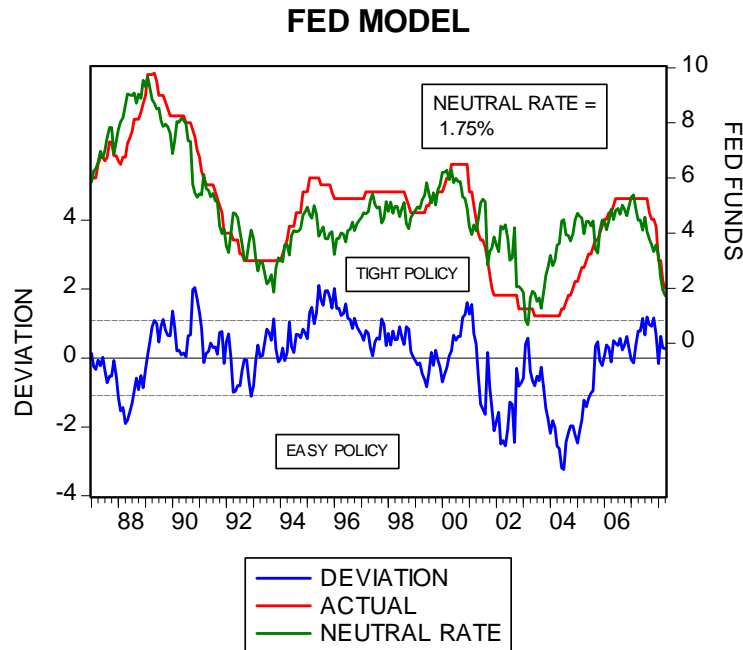
Bill O'Grady, Chief Investment Strategist

Is the easing cycle over?

- Last week, the Federal Open Market Committee (FOMC) announced a quarter-percent reduction in the fed funds rate, to a target of 2.0%. The rate cut was widely expected. However, the key issue analysts and investors were watching for was the direction of future policy. Is this easing cycle coming to an end?
- The market consensus indicates that, at least, the FOMC is taking a pause on future rate cuts. The fed funds futures market is suggesting the most likely outcome is steady rates throughout the summer. Although these estimates can change, the current expectation is that the FOMC has done enough to support the economy.
- There are a number of reasons to believe the FOMC has sufficiently reduced rates. The "real" fed funds rate, the rate less the yearly change in CPI, is below zero, at -1.38%. From 1980 until 2002, this rate was generally positive, with a period of near zero rates in the early 1990s. Negative real rates suggest a very accommodative policy; from August 2002 until May 2005, real fed funds were negative. This long period of accommodative policy has been blamed for the real estate bubble. The weak dollar and the rise in commodity prices are, at least in part, due to easy monetary policy. Thus, avoiding a repeat of another asset bubble would likely be favored by the Federal Reserve. We note that in the last two meetings, when the FOMC cut rates, two regional Federal Reserve presidents, Richard Fisher of the Dallas bank and Charles Plosser of the Philadelphia bank, voted against the reduction, preferring steady policy. This suggests internal opposition to further rate reductions.
- If this is the end of the easing cycle, we would expect the dollar to rally and commodity prices to falter. Since the mid-1970s, the inverse correlation between the dollar and the Commodity Research Bureau (CRB) index has been a rather modest 27%. However, since 1995, the inverse correlation has lifted to 78%. Thus, continued dollar strength will likely lead to a cyclical decline in commodity prices in our view.
- In general, the end of easing is supportive for equities. According to Ned Davis Research, since 1954, 126 days after the last easing, the Dow Jones Industrials rise, on average, by 8.2%. The same data source suggests that, since 1980, technology tends to perform best over the same time period.
- The key question, of course, is whether or not the FOMC is finished cutting rates. We examine this issue below in the Chart of the Week.

Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.

Chart of the Week:



*For illustrative purposes only. This does not reflect the performance of any specific investment.
Past performance is no guarantee of future results*

Sources: Commerce Dept., Conference Board, Federal Reserve, Wachovia Securities

This chart shows a fed funds target model that uses what historically has been the FOMC's favorite inflation indicator, the yearly change in the core personal consumption deflator and consumer confidence from the Conference Board. We believe consumer confidence gives a good fit because the Federal Reserve, despite its official independence, has that independence at the good graces of Congress. Ignoring adverse consumer confidence could make the Fed appear insensitive.

The lower line on the chart shows the deviation from the model's estimation of a neutral policy rate. A neutral policy rate is one in which policy is neither tight nor easy. The current estimation of a neutral fed funds rate is 1.75%, a bit below the current target of 2.00%. The model suggests the FOMC is modestly tight.

In easing cycles, the above model shows that the deviation from the neutral policy rate usually declines below one standard error, as shown on the chart by the parallel lines surrounding the deviation line. This decline can happen in three ways: rate cuts, steady policy with rising inflation and/or rising consumer confidence. Standard error measures deviation; in general, in a normal distribution, a point will deviate from forecast within one standard error 66% of the time. Often, the wider a data point deviates from forecast, the more unusual the situation.

Although core inflation in this measure is at 2.1% and may move higher in the coming months, consumer confidence is very depressed. Consumers are being hit with higher fuel and food costs, relatively high unemployment and a stagnant housing sector. After the 1990-91 recession, which is similar to the current one, confidence didn't rise to pre-recession levels for nearly four years. This model, coupled with market signals from the fed fund futures, suggests that the way the FOMC will create an easier policy is by keeping rates persistently steady, allowing improved consumer confidence and an uptick in inflation to effectively ease policy. Although another cut in rates cannot be completely ruled out, a pause is reasonable and we would not expect any rate action until next autumn at the earliest.

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