

# US WEEKLY ECONOMIC UPDATE



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# US Economic and Investment Perspectives

## Fed Rate Cuts Prompt Fast Gains, Long-Term Risks

The dramatic cut in interest rates by the Federal Open Market Committee this week provided quick pain relief to troubled financial markets. Still, it could take months before we know whether the decision is a panacea for the financial markets and the economy.

The Fed's main goal was to boost investor confidence by improving liquidity in segments of the debt markets after weeks of fear and uncertainty. Reactions of the dollar and potential changes in inflation are less pressing for policymakers, but these factors will ultimately determine whether the quest for sustainable growth succeeds.

While a reduction in the Fed's two official interest rates was widely expected, the scope of the cut exceeded expectations of most analysts and investors. The Federal Open Market Committee voted unanimously to reduce the target on fed funds (loans between banks) by 50 basis points to 4.75%, and the target on the discount rate (loans between the Fed and banks) by 50 basis points to 5.25%. It was the largest combined cut in both official lending rates since November 2002.

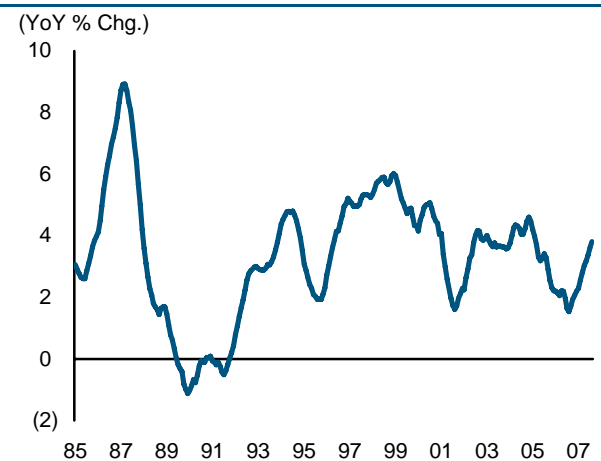
Federal Reserve Chairman Ben S. Bernanke was intent on proving that he will stand by his word. In late August, the FOMC said it "stands ready to provide liquidity and promote the orderly functioning of markets" and "to limit the adverse effects on the economy on the broader economy" from the turmoil in the credit markets.

Additional support for what appears to be a preemptive move can also be found in a recent staff research paper entitled "Housing and the Monetary Transmission Mechanism," drafted by Federal Reserve Governor Fredric S. Mishkin. The paper found that "under certain conditions the housing sector can be a source of financial instability" and

policymakers must act swiftly and boldly to prevent that instability from spreading.

Some gains from the rate cuts should be seen soon, particularly in sentiment surveys and the financial markets. Liquidity is slowly returning across the credit markets. Moreover, official rate cuts almost always trigger stronger liquidity flows in the ensuing months, so we expect the "growth signal" from our proprietary liquidity index to get even stronger (**Display 1**). Even before the rate cuts, overall liquidity flows posted the strongest gains in two years, signaling that better growth prospects should begin to surface within six to nine months.

**Display 1: Liquidity Flows Poised to Improve Further After Rate Cuts**  
Liquidity Growth (Index)



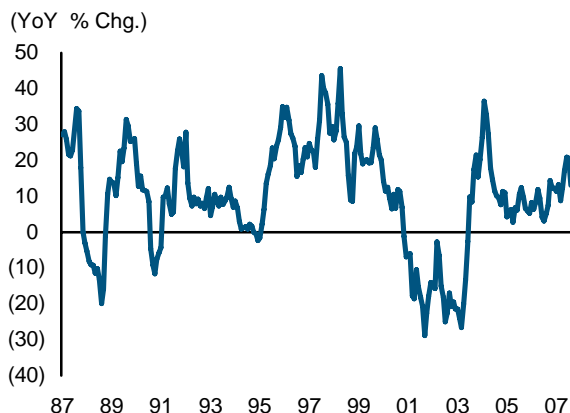
12-month moving average. Liquidity is a measure of real money growth, growth in business and consumer credit, and growth in short-term liquid assets.

Source: AllianceBernstein

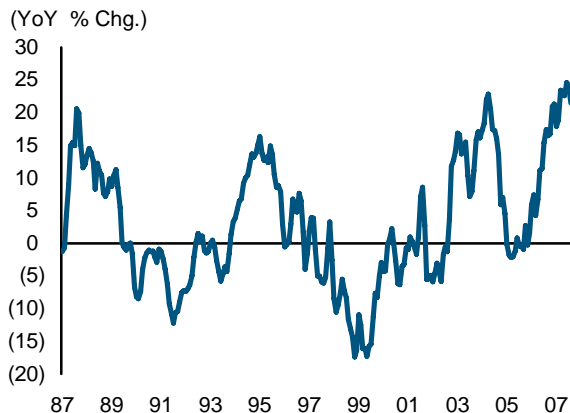
However, it is also important to see improvement in other financial indicators such as stock prices, real money growth and the Treasury yield curve as they often are harbingers of positive changes in the real economy. Although it's still far too early to assess the full impact from this week's rate cut, the equity market rally and other changes in these financial variables has been encouraging.

## Display 2: An Unusual Backdrop for Rate Cuts Growth of Stock and Commodity Prices

### S&P 500



### Commodity Prices (Index)



Source: Commodity Research Bureau, Standard & Poor's and Haver Analytics

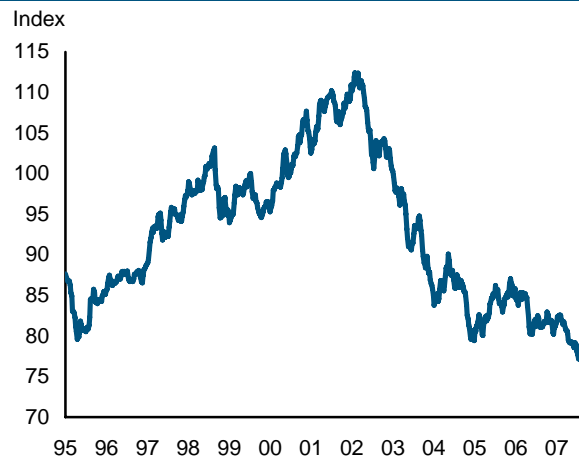
In the longer term, the sizeable reduction in policy rates carries some risks. First, it is unprecedented for the FOMC to lower official rates amid rising equity prices and commodity prices (**Display 2**), which reflect growth prospects and future inflation pressures respectively. The Fed's dual mandate of safeguarding maximum growth (i.e. full employment) and price stability would appear to warrant caution, as injecting additional liquidity could eventually lead to imbalances that would destabilize the tradeoff between growth and prices. Paradoxically, even though policymakers cut rates, they reiterated their concern about inflation.

Second, even though the mortgage and commercial paper windows have been closed for a select group of borrowers, overall bank credit growth has remained relatively strong. This indicates that the general economy was not being starved or denied

credit. Thus, while an easier money policy probably won't quickly arrest the credit crunch in the mortgage and commercial paper markets, it could trigger more borrowing and other imbalances in other parts of the economy or the financial markets.

Third, monetary policy has played a key role in rebalancing global growth over the past year or so. Tightening financial conditions and restraining domestic demand has helped the US stabilize and reduce its non-oil trade imbalance. However, a huge trade imbalance remains in place and an easier monetary policy runs the risk of stopping or reversing the progress to date by encouraging domestic demand. After the rate cuts, the US dollar fell against all major currencies as investors sensed that the US trade deficit and its financing needs may be on the rise again (**Display 3**).

## Display 3: Dollar Drops After Rate Cut Trade-Weighted Dollar vs. Major Currencies



Source: Federal Reserve Board and Haver Analytics

But all of these concerns are not the top priority to policymakers today. Their primary objective is to ensure secure and sustainable economic growth. We agree that in the short run, the Fed's decision will allow markets to function orderly, help restore confidence and stabilize the economy. However, investors should not forget that policymakers are still concerned about inflation risks. Ongoing declines in the dollar and rising commodity prices increase the risk of those fears becoming a reality.

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