

FED SAYS THAT RATES TO REMAIN LOW FOR AN EXTENDED PERIOD

As expected, the US Federal Reserve kept its key interest rate, the Fed funds rate, in a target range of 0 to 0.25 per cent at the conclusion of its FOMC policy meeting yesterday. The Fed has kept rates at this historically low level since last December. In its post meeting statement, the Fed again reiterated that **weak economic conditions are likely to warrant continuing exceptionally low levels of the Fed funds rate for an extended period.**

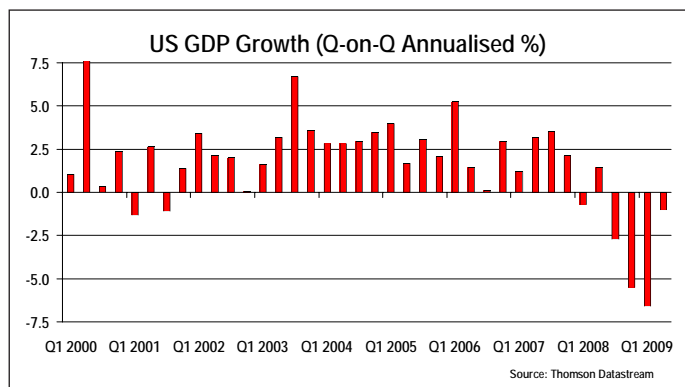
With official interest rates close to zero per cent, the Fed's focus shifted earlier this year to quantitative easing measures to stimulate the economy and support the functioning of financial markets. These involve large scale purchases of agency debt, mortgage backed securities and Treasuries. Not surprisingly, given the signs of an improving economy, the Fed did not announce any expansion of these measures. **Indeed, it decided to gradually slow the purchasing of \$300bn of long dated Treasuries, which will now not be completed until the end of October instead of next month.**

As evidence mounts that the US recession may soon be over, particularly following last week's better than expected July non-farm payrolls numbers as well as the only modest fall in GDP in Q2, there has been speculation that the Fed will begin to hike rates by early next year. Indeed, last week the **Fed funds futures contracts were discounting a 96% chance of a January rate hike. The tone of the Fed statement, though, struck a fine balance between curbing this rate hike speculation and quashing the growing optimism about economic prospects.**

The Fed statement was somewhat more upbeat than previously in its assessment of the economy, saying that economic activity is levelling out. **It is still cautious, though, about economic prospects.**

While showing signs of improvement, economic activity is still likely to remain weak for a time, with continuing high unemployment, sluggish income growth, lower housing wealth and tight credit. The Fed, meanwhile, expects inflation to remain subdued, given the very substantial resource slack, especially in the labour market where wage growth has slowed sharply.

Overall, then, there was nothing in the Fed statement to indicate that it is considering an exit strategy from its current very accommodative policy stance. **Although the recession may be coming to an end, the pace of recovery is likely to prove very subdued. Combined with the large amount of spare capacity, particularly very high unemployment, these conditions are likely to warrant a very low Fed funds rate for an extended period. We maintain the view that the Fed will not starting hikes rates until well into 2010.**



RECESSION APPEARS TO BE NEARING AN END

The official view is that the US recession started in December 2007. However, it is only since last autumn, following the collapse of Lehmans, that it morphed into a very deep downturn in activity. More recently, there is increasing evidence that the worst of the downturn could well be over. GDP contracted by just 1.0% annualised in Q2 this year, following the very sharp 6.4% and 5.4% contractions in Q1 2009 and Q4 2008, respectively. Furthermore, the extent of inventory liquidation in Q2 (which took 0.8% of GDP growth in the quarter) points to a restocking boost in the second half of the year.

Further signs that the recession is easing are provided by the ISM indices. Both the manufacturing and services ISMs have been on a rising trend for a number of months now, though the services index dropped back slightly in July. While the manufacturing index, in particular, is approaching the key 50 level, both indices, though, are still at levels consistent with contracting activity.

The latest Fed Beige Book survey, which covers the period up to July 20, also shows that while the economy remains weak, the pace of decline has moderated or at worst stabilised, albeit at low levels. In regard to the housing market, housing permits, starts and sales all picked up in June. However, the Beige Book notes that, while the residential sector is improving, most districts still report that the market remains weak. Elsewhere, the industrial sector continues to suffer, with manufacturing output falling by a further 0.6% in June. Consumer confidence, though, has picked up significantly from its lows.

Nowhere has the weakness of the economy been more evident than in the labour market. Here too, though, there has been a distinct slowing in the rate of decline. Non-farm payrolls fell by 247,000 in July, the smallest number of monthly job losses since August last year. The unemployment rate, meanwhile, appears to have stabilised, at least for now, at around the 9.5% level.

There is no doubt that US policy is very expansionary, with a massive fiscal stimulus, zero official interest rates, significant quantitative easing and a weak currency, so the improving data are not unexpected. **However, the economy is still facing very significant headwinds.** Household balance sheets are weighed down by heavy debts and pressures on disposable income, with the focus very much on rebuilding savings. Credit availability is still constrained. The renewed rise in oil prices crimps spending power even further. Meantime, the scale of job losses is still high and global demand remains weak. Overall, the economic environment remains very challenging.

Thus, while the pick up in leading indicators, expansionary policy stance and need to restock suggest that there should be a return to growth in the US economy in the second half of this year, the pace of recovery is likely to prove subdued. There are also doubts about whether a pick up will prove sustained. Combined with the large amount of spare capacity in the economy, particularly very high unemployment, it suggests that Fed rates are going to remain very low until well into 2010.

