

## FED STICKING TO VERY LOW RATE POLICY

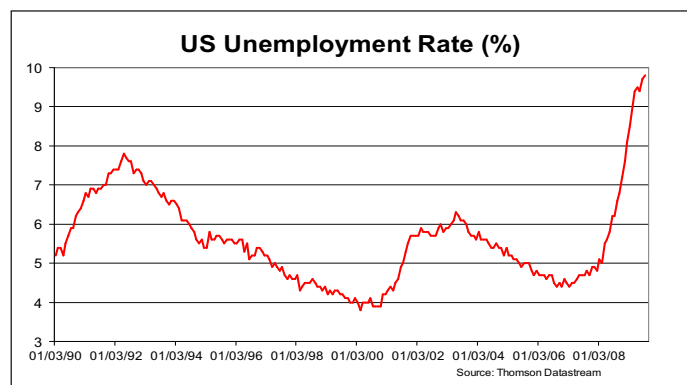
**As expected, the US Federal Reserve kept its key interest rate, the Fed funds rate, in a target range of 0 to 0.25 per cent at the conclusion of its FOMC policy meeting yesterday.** The Fed has kept rates at this historically low level since last December. In its post meeting statement, the Fed again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

The key question in the run up to the FOMC meeting was whether or not there would be a change in **the key phrase "extended period"**, which is interpreted as meaning that the Fed is nowhere near raising interest rates. The fact that the FOMC stuck with this wording is significant given that it has just been reported that the US emerged from recession in Q3, with a 3.5% annualised rise in GDP in the quarter, leading to much speculation about when the Fed might begin to hike rates.

During the summer, markets were pricing in the possibility of a hike in rates before year end. This talk has since abated and now **markets do not see the first rate increase until next June.** However, the December 2010 futures contract is trading some 100bps above the December 2009 contract, indicating that **the market expects a significant amount of policy tightening later next year. We are doubtful about such tightening and, indeed, the FOMC statement still struck a very cautious note about economic prospects,** though acknowledging that economic activity has continued to pick up.

Perhaps crucially, **the Fed gave some indication of the factors that will determine its exit strategy from current stimulatory policies, highlighting low resource utilisation, subdued inflation trends and stable inflation expectations as reasons to keep rates low for an extended period.**

There is substantial resource slack especially in the labour market, where wage growth has slowed sharply. **We feel that the very high level of unemployment will be a major impediment to Fed rate hikes next year.** The unemployment rate looks set to rise to 10% or above. Although the recession has come to an end, the pace of recovery is expected to prove subdued, with below trend growth anticipated for 2010. Thus, unemployment is set to remain very high next year.



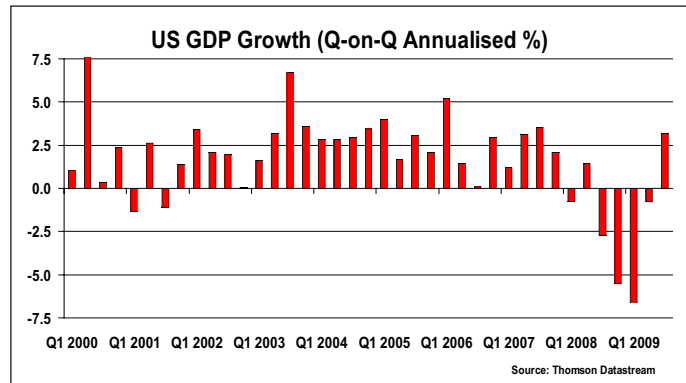
Meanwhile, the decision to reduce, to \$175 billion from \$200bn previously, the level of agency debt purchases was stated as due to the technical constraint of lack of available debt. However, the move may also help to signal that any removal of quantitative easing will be cautious and gradual. Indeed, overall, there was nothing in the Fed statement to indicate that it is considering an exit strategy anytime soon from its very accommodative policy stance. **We maintain the view that the Fed will not start hiking rates until late in 2010 at the earliest.**

## Economic Recovery Expected To Be Subdued

**The US recession which began at the end of 2007 finally ended in Q3 2009, with the economy expanding by 3.5% annualised.** Consumer spending rose by 3.4% in the quarter, while housing investment surged by 23.4%. Federal government spending increased by 7.9% and exports were up by 14.7%. A slowdown in the pace of inventory liquidation boosted the GDP growth rate by 1%.

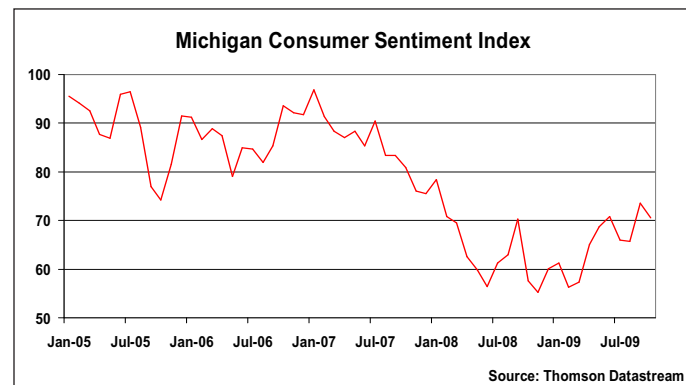
Leading indicators continue to rise with the manufacturing ISM moving well above the key 50 level in October and the services ISM staying above 50. The leading indicators index is also rising strongly. All the indications are that the economy is on a recovery path.

It has proved a long and deep recession, with GDP declining by almost 4% in the year to Q2 2009 alone. Meanwhile, the unemployment rate has soared from under 5% to close on 10%. Normally, one would expect a very strong rebound in activity after such a severe recession, especially given the extent of policy easing, both monetary and fiscal. **However, the US economy is facing many headwinds, suggesting that the pace of recovery will be relatively modest.**



**Although GDP did grow by 3.5% annualised in Q3 and may well rise by a further 3% in Q4, much of the growth is due to the Federal government stimulus package, as well as a slowdown in the pace of destocking.** The 'cash for clunkers' car scheme, tax credit for first time home buyers, tax cuts plus aid to state and local government all boosted GDP in Q3. Without these, growth would have been close to zero in the quarter - the 'cash for clunkers' scheme alone accounted for 1.6% of the 3.5% rise in GDP. Indeed, consumer spending fell by 0.6% in September as the car scrappage scheme ended. Meanwhile, the tax credit for first time home buyers is due to end this month, unless it is extended by Congress.

**The concern is that growth will weaken again as the impact of the fiscal stimulus package abates** given that the economy still faces very strong headwinds. Consumer sentiment remains very depressed at recessionary levels. Household balance sheets are weighed down by heavy debts and pressures on disposable income, with the focus very much on rebuilding savings. Meantime, the scale of job losses is still high and unemployment is expected to continue moving upwards into 2010.



Meanwhile, credit availability is still very constrained. There are large overhangs of unused industrial capacity and vacant homes. Given all these headwinds, the recovery in activity is likely to prove subdued in 2010. GDP is expected to rise by 2% or less next year, i.e below trend growth. This suggests that **inflationary pressures will remain well contained.** Indeed, the core CPI rate and core PCE price deflator, which both currently stand at 1.3%, are likely to fall further. The Fed, then, is facing an environment of a relatively weak upturn in economic activity, high and rising unemployment and very weak inflationary pressures. **It all suggests that a hike in US rates is unlikely until late 2010 at the earliest.**