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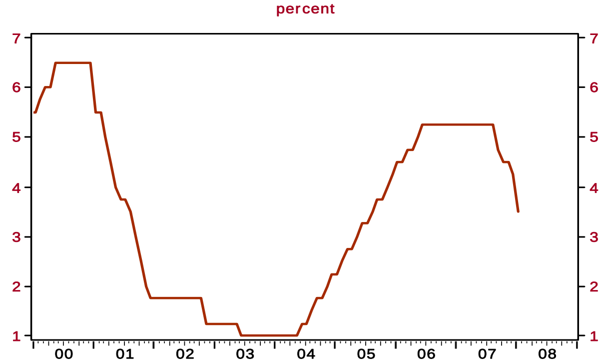
Economic Commentary

Fed Makes Emergency Rate Cut

Early this morning, as an emergency action, the Federal Reserve cut both the federal funds rate and discount rate by 75 bps. The funds rate is now 3.50%; the discount rate is now 4.00%. This is the first inter-meeting change in rates since September 17, 2001.

The next scheduled Fed meeting is on January 30th. Unless the stock market is up sharply between now and then, maybe even if it is, rates will be cut again. The Fed is no longer treating the situation like the 1987 stock market crash or the freezing of credit market conditions in 1998. In those situations, the Fed cut by no more than 75 basis points. The Fed is increasingly treating the current situation like the economic slowdown and recession of 2001.

We do not believe the economic outlook is nearly as bleak as the Fed believes and remain very concerned about inflation. That said, the Fed clearly does not share our view.



The statement accompanying today's action was bearish about the economy and lacked the usual level of concern about inflation. The statement referred to "increasing downside risk to growth," a tightening of credit for businesses and households, and "some softening in labor markets." Notable by its absence was the sentence from the December statement that the rate reductions so far "should help promote moderate growth over time."

This means the Fed is much more concerned today, than it was last month, that rates are still not low enough to get the economy back to moderate growth.

The Fed also substantially altered its language on the inflation outlook. Two important parts of the December statement were removed: (1) a reference to energy and commodity prices potentially generating upward inflation pressure and (2) an assertion that "some inflation risks remain." In other words, any fears the Fed has about inflation are now firmly on the back-burner.

In addition, the Fed substantially altered its description of the balance of economic risks. It opened with an unusually short and direct sentence: "Appreciable downside risks to growth remain." The Fed then asserted it will act "in a timely manner" to deal with financial risks and other developments.

In December, the Fed said it would act "as needed." This change demonstrates a sense of urgency. Perhaps most telling was the complete removal of the reference to "price stability" as one of the Fed's goals.

This is not just a bias toward easing. It's an engraved invitation to more rate cuts.

Interestingly, William Poole, president of the Federal Reserve Bank of St. Louis, dissented against the rate cut saying that he would rather wait until the regular meeting. Poole has typically been a hawkish member who worries about the Fed's mandate to keep prices stable over time.

Text of the Federal Reserve's Statement:

The Federal Open Market Committee has decided to lower its target for the federal funds rate 75 basis points to 3-1/2 percent.

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The Committee took this action in view of a weakening of the economic outlook and increasing downside risks to growth. While strains in short-term funding markets have eased somewhat, broader financial market conditions have continued to deteriorate and credit has tightened further for some businesses and households. Moreover, incoming information indicates a deepening of the housing contraction as well as some softening in labor markets.

The Committee expects inflation to moderate in coming quarters, but it will be necessary to continue to monitor inflation developments carefully.

Appreciable downside risks to growth remain. The Committee will continue to assess the effects of financial and other developments on economic prospects and will act in a timely manner as needed to address those risks.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; Timothy F. Geithner, Vice Chairman; Charles L. Evans; Thomas M. Hoenig; Donald L. Kohn; Randall S. Kroszner; Eric S. Rosengren; and Kevin M. Warsh.

Voting against was William Poole, who did not believe that current conditions justified policy action before the regularly scheduled meeting next week. Absent and not voting was Frederic S. Mishkin.

In a related action, the Board of Governors approved a 75-basis-point decrease in the discount rate to 4 percent. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of Chicago and Minneapolis.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Senior Economist*