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•**The Economy:** *The Federal Reserve fears the third risk*
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The Economy

On October 31, 2007, the Federal Reserve concluded its two-day meeting by cutting the Fed Funds rate by another 25 basis points to 4.5%. The move was expected, but the sell-off by the bond market on that day indicated that the accompanying statement, with its comment on the balance of risks, was a disappointment. The statement concluded: "The Committee judges that, after this action, the upside risks to inflation roughly balance the downside risks to growth…" For the first time during this interest rate cycle, the Fed has stated that monetary policy has brought the economy to where the risk of slower growth (which would require easing policy) is equal to the risk of higher inflation (which would require tightening). With this language and with the 75 basis points it has cut since the summer, the market concluded that the Fed believes it may be done easing for now.

In addition to the new language on the balance of risks, however, the Fed cited a third risk that could affect policy—the possibility that financial market conditions could damage the economy and potentially tip the balance of risks. "Today's action," the FOMC statement reads, "combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time."

Let's talk about these "disruptions." Besides the fact that they can wreak serious damage on the economy, we believe that one of the reasons the Fed Chairman and governors are so worried about them is that they don't quite understand them. Crack open an economics textbook and you won't find a chapter on the economic effects of illiquidity, or the downside of securitization, or home price depreciation. What is a central banker to do when the economic and financial landscape is dominated by unintended consequences? How does any manager set policy when there is no visibility on the future? This is Lewis & Clark territory for the Fed and, clearly, in July it had no inkling of what lay ahead in August. (To be fair, many financial markets participants were also caught unprepared.) The October 31 issue of the *Wall Street Journal* recounted in substantial detail how the Fed reacted during the period from August 9 until it cut the discount rate on August 17. It was not only a study in effective crisis management, it was a primer on how central bankers get a crash course in advanced financial markets dynamics. The story featured the heavy involvement during that period by Fed Governor Kevin Warsh, a 37-year old former investment banker with little economics training but whose brief experience and contacts on Wall Street were suddenly very valuable. The feedback mechanism that worked through Warsh and other channels over the past 12 weeks were (and likely continue to be) integral to the Fed's decisions.

By now, the August "disruptions" have been well-documented: Spreads gapped between LIBOR and Fed Funds, T-bills rallied massively, the asset-backed commercial paper (ABCP) market dried up, liquidity evaporated for all but the most pristine credits, various players in the fixed income markets—both in the US and abroad—suffered collapse or near-collapse. The Fed, and other central banks, took steps to address the situation, including liquidity injections and cutting rates. Their efforts have borne some fruit and conditions have become less severe, but they certainly are not back to where they were before August. For example, while Fed Funds have dropped 75 basis points since July, 1-month LIBOR has only dropped about 63 basis points. 3-month T-bill yields are still 90 basis points through Fed Funds. Jumbo prime mortgage rates are still 100 basis points higher than conforming rates. ABCP outstandings continue to decline, although at a slower rate. Financing terms for non-Agency MBS are still tight.

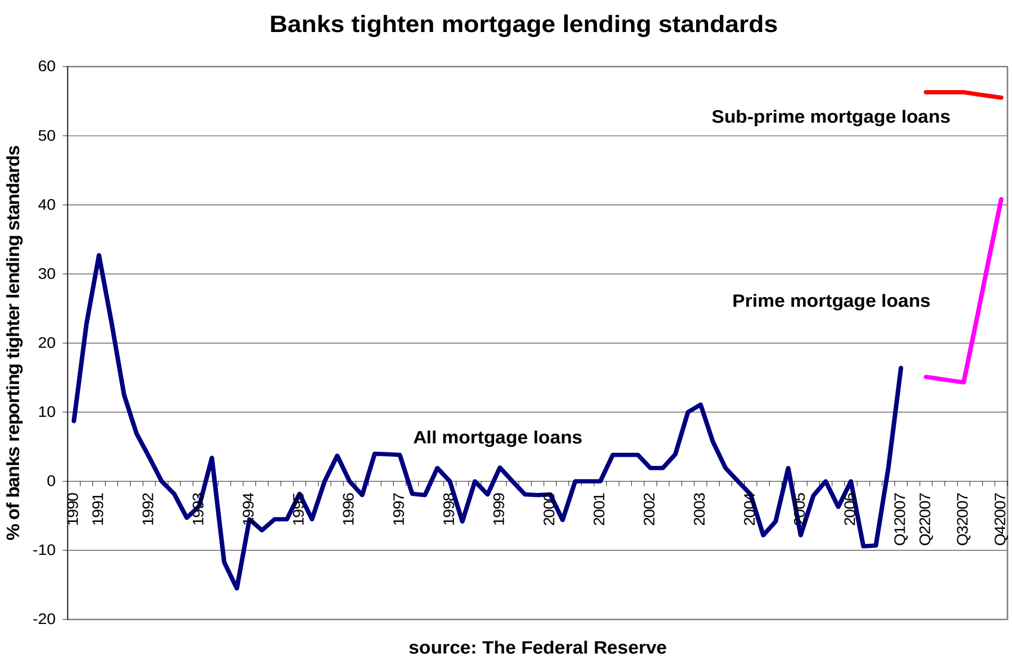
Today, the Fed still has little visibility, but at least it is on guard. Judging from the minutes of the September 18 FOMC meeting the Fed seems to understand that this third risk could weigh heavily on the economy going forward. Pardon the length of this extended quote, but it encapsulates current conditions and, given the source, is quite remarkable for its level of understanding:

> "Given the unusual nature of the current financial shock, [FOMC meeting] participants regarded the outlook for economic activity as characterized by particularly high uncertainty, with the risks to growth skewed to the downside. Some participants cited concerns that a weaker economy could lead to a further tightening of financial conditions, which in turn could reinforce the economic slowdown… Given existing commitments to customers and the increased resistance of investors to purchasing some securitized products, banks might need to take a large volume of assets onto their balance sheets over coming weeks, including leveraged loans, asset-backed commercial paper, and some types of mortgages. Banks' concerns about the implications of rapid growth in their balance sheets for their capital ratios and for their liquidity, as well as the recent deterioration in various term funding markets,

might well lead banks to tighten the availability of credit to households and firms. Tighter credit conditions were likely to weigh particularly on residential investment and to a lesser extent on other components of aggregate demand in coming quarters. Meeting participants also noted that financial market conditions, while seeming to have improved somewhat in the most recent days, were still fragile and that further adverse credit market developments could well increase the downside risks to the economy. Even after market volatility subsided and the recent strains eased, risk spreads probably would be wider and credit terms tighter than they had been a few months ago. Although these developments would likely be consistent with longer-term financial stability, they were likely to exert some restraint on aggregate demand."

In short, banks are worried, credit availability for borrowers is tightening, and the economy is at risk. The crisis that began in August has abated for now, but it has not passed. We would characterize the current environment as one of uneasy calm, not too dissimilar to being in the eye of a hurricane. The eye, however, may be passing. The market may have been disappointed on October 31 by the lack of direction on future monetary policy, but that momentary doubt has been replaced by a reinforcement of all the risks that lay before us. Retail sales have continued to come in weak with several retailers guiding lower. Target Corp., for one, the second-largest US discount chain, cut its full year profit forecast. The ISM manufacturing index came in at the lowest total in 7 months. Core PCE has been within the Fed's comfort zone for four straight months, indicating inflation is not an issue. The housing market continues to fall like a knife. Just as seriously, credit concerns over the condition of financial institutions have been renewed, as writedowns continue to hit the headlines. Most notably, Merrill Lynch almost doubled its previous estimate when it announced $8.4 billion in writedowns, and Citigroup also warned of large writedowns. S&P, Moody's and Fitch have stepped up their downgrade activity, which may exacerbate the stress for financial institutions exposed to structured products. Market participants (and, no doubt, regulators) are attempting to size their exposure to, among other things, CDO tranches including retained subordinate pieces, and the amount of assets that are being valued according to so-called Level 3 rules (in which values are marked to an internal model rather than market prices or third-party pricing). The numbers are large, and we believe a feature of the other side of the storm will be the identification of capital adequacy issues.

Another concern voiced by the Fed minutes is the availability of credit. The timely release of the Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices reveals that banks are indeed tightening credit. The graph below shows that residential mortgage loans are even harder to get. Business loans are also harder to get, as more lenders report tightening credit standards. When the loan officers were asked why they were less likely to lend, the two dominant answers were "less favorable or more uncertain economic outlook" and "decreased liquidity in the secondary market for these loans." If the Fed wants to alleviate the credit crunch through monetary policy, lending officers are telling them they have some more wood to chop.



* Through Q12007, the Fed asked about all residential mortgage loans, but since then it has asked about prime and sub-prime loans. We would argue that this is the tightest lending standards have ever been since 1990, because in 1991, the last peak, virtually all loans were prime.

The Mortgage Market

Prepayment speeds fell 19% for September (October reporting period). The main culprits of this dramatic decrease in speeds are day count, seasonality, a deteriorating housing market and tighter underwriting standards. The aggregate speed on the 30-year Fannie Mae universe is now roughly 7.4 CPR, representing the third consecutive month that aggregate speeds for this product are below 10 CPR, which have not been seen since the mid-1990s. Looking ahead, the rally in the 10-year Treasury since the beginning of October, as well as the increase in business days, may accelerate prepayment speeds, however the onset of the holiday season typically brings an annual trough in prepayments.

There has been a rising crescendo of demand for agency hybrid ARMs since the beginning of this year, particularly in premium ARMs, thanks to their prepayment speeds being at historic lows as well as their inclusion in both the Lehman U.S. Aggregate and the Lehman MBS Index. Also contributing to the attractiveness of this sector is that the well-publicized and feared first "reset" on ARMs is relatively insignificant for Agency ARMs compared to non-agency ARM products. Despite their numerous positive attributes, agency hybrid ARMs are still not without their negatives. Principal among them are the liquidity crunch in the current mortgage market and the absence of a liquid TBA, or forward purchase, market, both of which have made originators less enthusiastic about originating them.

The Markets

In October, short and long rates fell, while stocks rose. The dollar continued to weaken, helping oil and gold rise.

	10/31/2007	9/30/2007	10/31/2006	MOM % change	YOY % change
Fed Funds	4.50%	4.75%	5.25%	-5.3%	-14.3%
2-year US Treasury	3.949%	3.988%	4.697%	-1.0%	-15.9%
10-year US Treasury	4.473%	4.588%	4.600%	-2.5%	-2.8%
10-year JGB	1.610%	1.685%	1.720%	-4.5%	-6.4%
10-year euro	4.239%	4.329%	3.741%	-2.1%	13.3%
10-year UK Gilt	4.928%	5.011%	4.511%	-1.7%	9.2%
10-year Canada Treasury	4.307%	4.344%	4.026%	-0.9%	7.0%
30 yr conventional mortgage	6.07%	6.25%	6.21%	-2.8%	-2.2%
Dollar Index	76.48	77.72	85.32	-1.6%	-10.4%
Japanese Yen	115.18	114.80	116.71	0.3%	-1.3%
S&P 500	1549.38	1526.75	1377.94	1.5%	12.4%
Nasdaq Composite	2859.12	2701.50	2366.71	5.8%	20.8%
Gold $/oz (nearby contract)	$795.30	$742.80	$606.80	7.1%	31.1%
Oil $/bbl (nearby contract)	$94.53	$81.66	$58.73	15.8%	61.0%
MBA Refi Index (month end)	2249.0	1950.4	1709.2	15.3%	31.6%

Source: Bloomberg; Japanese Yen quote is the London feed

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