CAPITAL MARKETS PERSPECTIVES

Weekly Market Review

Week ended **February 19th**

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For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, financial advisor and portfolio manager.

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Federal Reserve's "Exit Strategy" Proceeds with Discount Rate Hike

The U.S. Federal Reserve took a key step toward unwinding its emergency economic support policies last week by raising the discount rate—the rate at which banks borrow from the central government—by 25 basis points (bps) to 75bps.The Fed's main policy tool, the Fed Funds Rate (the rate at which banks lend overnight to each other) remained unchanged at 25 basis points. The spread between the two rates is still only half its historical norm of about 100bps, indicating further tightening of the discount rate is likely.

Raising the discount rate serves in part to reinstate the stigma previously associated with borrowing at the discount window. Prior to the 2008–2009 financial crisis, banks would only seek funding at the discount window as a last resort, since doing so could appear to be a sign of desperation. To help unfreeze lending during the crisis, however, the Fed sharply lowered the discount rate and actively encouraged financial institutions to use the tool to regain their financial footing.

The Fed's move last week was not a major surprise; during Congressional testimony two weeks ago, Chairman Ben Bernanke had telegraphed that such a hike was on its way—without specifying exactly when it might happen. In response to the move, the U.S. dollar rallied nonetheless, and futures on the S&P 500 Index initially declined but equities eventually rallied on Friday. International stocks lagged for the week as they have for much of 2010.

Moving toward normalization

We view the Fed's move as a healthy step toward normalizing monetary policy. It is a sign that the moment of greatest weakness in the economic crisis has clearly passed. The U.S. economy is now firmly in the recovery phase, and several factors suggest that the recovery will continue, including:

- The need for today's leaner, more efficient companies to rebuild inventories, which should eventually translate into hiring
- Pent-up demand for increased capital expenditures, which, it should be noted, is strongly correlated (~84%) to employment
- Government spending

Ongoing U.S. structural problems

Though government spending continues to help support the U.S. economy, concerns about long-term structural economic problems, especially public-sector borrowing, remain widespread. Naturally, the debate over spending continued to rage as the one-year anniversary of the $787 billion American Recovery and Reinvestment Act of 2009 came and went last week.

Government spending continues to help support the economy, and we believe that concerns over public-sector borrowing are most relevant to the next phase of the recovery—the expansionary phase. We suspect that the ongoing recovery will not give way to the "next great expansion," in part because of high debt levels. A modest expansion is more likely.

With the longer term economic outlook still tenuous, the Fed is moving cautiously and giving ample warning to markets as it gradually unwinds its emergency support mechanisms. Caution is certainly warranted in order not to remove the "punch bowl" of low interest rates too soon, choking off the recovery. Fortunately, the latest inflation reports indicate that the Fed has little to fear in taking its time and working deliberately. The **consumer price index** (CPI), a measure of inflation at the consumer level, rose 0.2% overall in January, but high fuel prices were to blame. Excluding the volatile food and energy categories, the CPI fell 0.1%.

With no inflation pressures on the immediate horizon, we don't view raising the discount rate as an indication that a Fed Funds Rate hike is due any time soon. "Reflating" an economy, it turns out, can be very difficult. Just look at Japan, which has basically stagnated for the last two decades. (I should note, however, that last week Japan reported stronger-than-expected growth of 4.6% in the fourth quarter of 2009—a welcome "green shoot," perhaps.)

Foreign "exit strategies" continue apace

Overseas, we've already seen a number of countries begin to enact their own "exit strategies," particularly among major commodity producers and emerging markets. China, in particular, has been tapping the economic brakes recently, upping the reserve requirements of its major banks twice in the last month and a half to try to restrain lending.

China continues to grow at a very fast pace, potentially putting inflation pressure on the world's most populous nation. In working to cool off the economy now, the Chinese authorities are trying to set the country up for strong, sustainable growth well into 2011 and 2012.

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