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Highlights

- The Federal Open Market Committee (FOMC) reduced the federal funds rate by 0.50% to 3.0%.
- The Fed retained its explicit easing bias, noting that "downside risks to growth remain".
- I see the Fed cutting another 0.50% by June to bring the federal funds rate to 2.50% by mid-year.

The Fed Meets Market Expectations

The Federal Open Market Committee (FOMC) cut the benchmark federal funds rate by another 0.50% to 3.00% today. The vote was 9 to 1 in favor of the rate cut with Dallas Fed President Richard Fisher voting for no change at this meeting. The reduction, which came on the heels of the Fed's surprise decision to slash the overnight lending rate by 0.75% last Tuesday, was widely anticipated by investors. In its statement, the Fed acknowledged that "downside risks to economic growth remain" and that the FOMC "will act in timely manner, as needed, to address those risks."

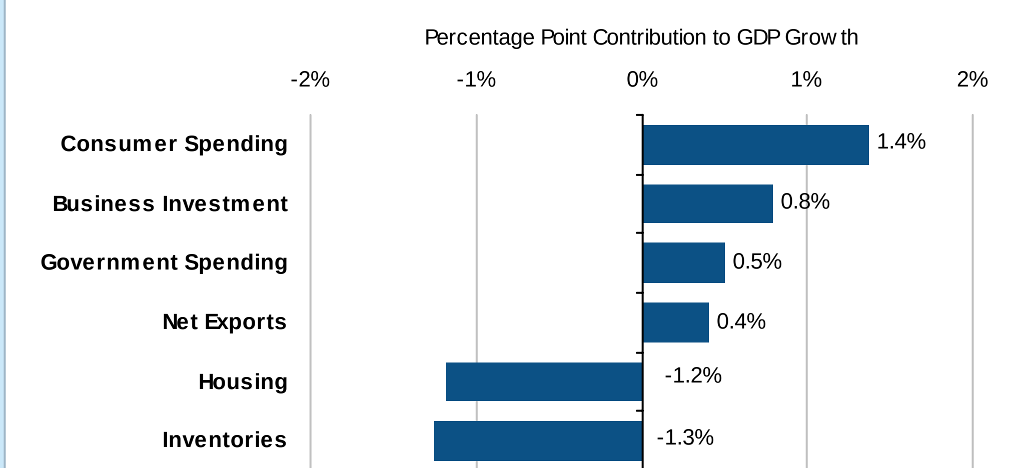
Those downside risks were quite apparent in this morning's report on US real gross domestic product (GDP). The US economy stalled in the aftermath of the August credit crunch with real GDP increasing at an annual rate of just 0.6% in the fourth quarter. Much of the weakness continued to be concentrated in the housing sector with residential construction declining at an annual rate of nearly 24%—the largest such decline since 1981! While some of the fourth quarter weakness was undoubtedly payback for a very strong third quarter in which real GDP increased at an annual rate of almost 5%, we are seeing increasing spill over effects of the downturn in housing in more timely economic indicators. Specifically, real retail sales turned negative at the end of last year and the unemployment rate has risen from a cyclical low of 4.4% in March 2007 to 5% at year end. Such a rise has never occurred outside of a recession. As a result, I currently see the Fed cutting short-term interest rates to 2.50% by June.

January Employment Could Be the Last Hurrah for the Bulls

That said, this Friday's payroll number may be a last hurrah for those who are bullish on the US economy before the economic data take a turn for the worse as we head into February and March. Today's ADP report suggests that nonfarm payrolls may have rebounded by 100,000 in January and the unemployment rate may have dipped back below 5% for the month. However, the longer-term trends in the labor market demonstrate clear softening with the six-month moving average slowing from a gain of 180,000 at the beginning of 2007 to less than 90,000 jobs at the end of the year.

We have experienced several bouts of extreme optimism followed by extreme pessimism since February 2007 when the first shoe dropped in the subprime mortgage market. Since then, the stock market relief rallies have become shorter-lived and if the economic data were to turn down in a meaningful way in the next few months, we could see a final capitulation by the bulls. But, as we mentioned last week, even if we have a recession, it would not be the end of the world. Indeed, the average recession has lasted only 10 months over the past six decades. More importantly, according to Standard & Poor's, the stock market has

Contribution to Real GDP Growth By Component - 2007 4Q Real Growth = 0.6%



Source: Commerce Department