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Payden & Rygel Economic**Research**

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Highlights

- Fed cut both the federal funds rate and discount rate by 25 basis points to 4.25% and 4.75%, respectively.
- Investors were disappointed by the Fed's failure to adopt an easing bias and the 25 basis point cut in the discount rate (versus the expected 50 basis points).
- We believe that tighter credit conditions and the housing market downturn will force further Fed easing.

Fed's Decision Generates Little Holiday Cheer

The Federal Open Market Committee (FOMC) reduced the federal funds rate by 25 basis points to 4.25% today noting that deterioration in financial market conditions has increased the uncertainty about the economic outlook. However, the central bank disappointed investors by a) not adopting a formal easing bias with regard to future monetary policy and b) choosing a 25 basis point cut in the discount rate instead of 50. Consequently, the stock market sold off and Treasuries rallied. The S&P 500 stock index tumbled 2.5% on the session to 1,477 while the yield on the 10-year Treasury note rallied from 4.14% to 3.97% after the Fed announcement.

Investors and Fed Out of Synch

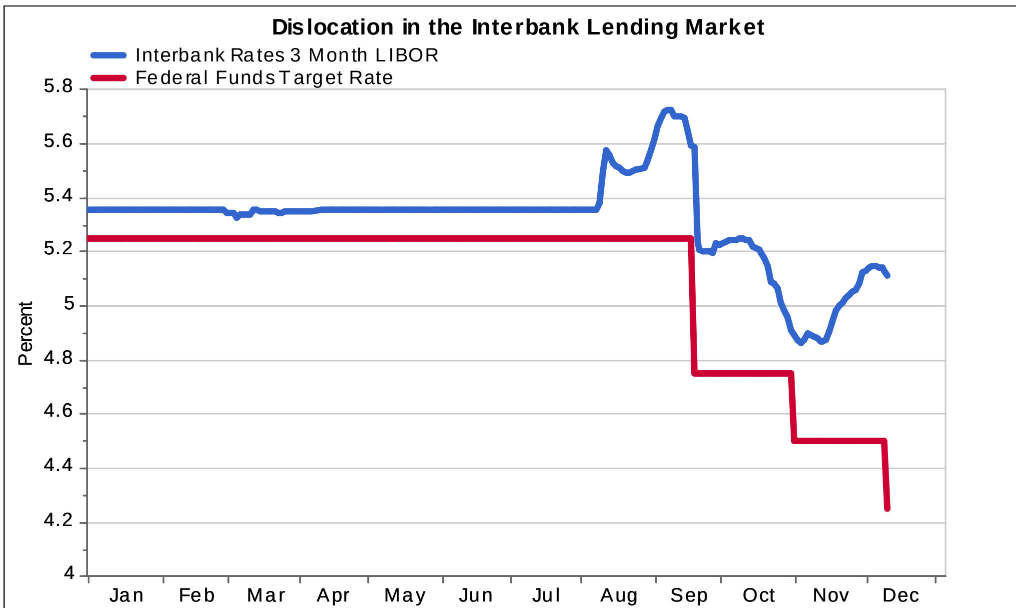
Ahead of today's Fed meeting, investors bet the Fed would change its risk assessment to recognize that downside risks to economic growth outweighed upside risks to inflation and open the door to further rate cuts. This would have marked an important policy shift from the October 31 meeting when the Fed characterized the risks to growth and inflation as roughly balanced.

Instead, policymakers dropped the risk assessment altogether. This may have been a compromise between FOMC hawks (who wanted to keep the neutral policy bias) and doves (who wanted an easing bias). Unfortunately, from the market's perspective, it appears weak, especially in light of expectations that fourth quarter economic growth has stalled.

The second disappointment was the 25 basis point cut in the discount rate rather than the 50 basis points investors expected. The discount rate is the rate at which banks borrow directly from the central bank. Recent speeches by Fed Chairman Ben Bernanke and Vice Chairman Don Kohn seemed to suggest that the Fed would seek to make the discount window a more attractive option to ease pressures in the interbank lending markets. The interbank market, which is the place where banks borrow and lend to one another, has been broken since last August as banks remain wary of counterparty risk. As shown below, problems persist in the interbank market.

Is the Fed Behind the Curve?

While it may be premature to say that the Fed is behind the curve, today's decision did little to assuage concerns. This may be due to disagreement on the FOMC. For example, we know that Boston Fed President Rosengren wanted a 50 basis point cut in the fed funds rate. Looking ahead, whether the Fed adopts a formal easing bias or not, we believe that tighter credit conditions along with the downturn in the housing market will force further Fed easing.



Sources: Reuters, Federal Reserve