



## Confronting Higher Inflation and Fed Rate Cuts

- **Fed's committed** to offsetting the negative effects of a contracting U.S. housing market and a terribly stressed credit environment by being accommodative.
- **Uncertainty has intensified** and has become increasingly evident by declines in consumer and business confidence. Unprecedented gains in cash balances and further declines in short-term Treasury yields reflect a continued flight-to-quality.
- **Inflation pressures surge** as the Fed's commitment to lower interest rates puts downward pressure on the U.S. dollar, pushing commodity prices and import costs higher.
- **The U.S. yield curve is steeper** and short-term rate declines are adding relief to the banking system. February witnessed intermittent upward pressures on long-term rates.
- **The cumulative effects of Fed easing and fiscal stimulus** may increase business and consumer spending in the second half of 2008.

### Situation for U.S. interest rates is temporary, but how temporary is the question

The outlook for U.S. Treasury yields and swap rates is unusually conflicted with the current realities of economic weakness and difficult credit conditions facing off against a growing inflation problem. The Federal Reserve has cut rates aggressively and has spoken at length recently about heading off an economic recession with additional rate cuts while risking the potential for higher inflation. Although the Fed sees "downside" risks to its economic outlook and is betting on inflation risks moderating due to weakening growth dynamics, the U.S. Central Bank's own GDP forecasts point to a 2008 real (inflation adjusted) growth scenario of 1.3% to 2.0%. The Fed's forecast does not reflect an actual U.S. recession materializing – an outcome likely necessary to bring about a realistic moderating inflation scenario. Considering that U.S. real GDP increased at a 2.5% rate in 2007 and 2.6% in 2006, the Fed's most recent 2008 growth forecast might not be meaningful enough to curb demand to the level needed to reduce U.S. inflation pressures.

### Inflation

The latest U.S. headline inflation data (January) showed an annual CPI of 4.3%, PPI at 7.4% (highest in 26 years) and an import price index of 13.7% (highest on record, 25 years of data). U.S. Treasury yields and swap rates, out to 5-year maturities, have been below these 3 inflation measures so far this year, reflecting a negative "real" interest rate environment. Further Fed rate cuts combined with any additional increases in inflation in the months ahead would make the negative "real" interest rate gap even wider. Historically, periods of negative "real" interest rates have only been temporary. Ultimately, either inflation falls or interest rates rise to realign the relationship between inflation and interest rates. Ultimately, investors require a positive return, to the inflation rate, on risk-free Treasuries. Forward looking inflation risks appear significant with crude oil prices reaching a record high in March while many other commodity prices are near record highs and U.S. dollar weakness continues.

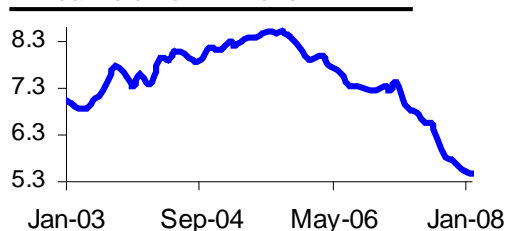
## Reversing accommodative policy might take some time

In the event U.S. inflation pressures do not recede, easier monetary policy and lower short-term rates must be viewed as increasingly temporary and unsustainable. To this point, the Fed is preparing the market for such a possibility. The minutes from the Jan 29-30 FOMC meeting (released Feb 20) said some members noted, "When prospects for growth had improved, a reversal of a portion of the recent easing actions, possibly even a rapid reversal, might be appropriate."

Although a number of senior Fed officials have made similar references in recent weeks, the FOMC's commitment to providing monetary accommodation should not be dismissed - conditions in the credit markets remain very stressed and the U.S. housing market is still deteriorating. N.Y. Fed President Timothy Geithner said today "If turbulent financial conditions and the associated downside risks to growth persist, monetary policy may have to remain accommodative for some time."

### Combined new & existing U.S. home sales

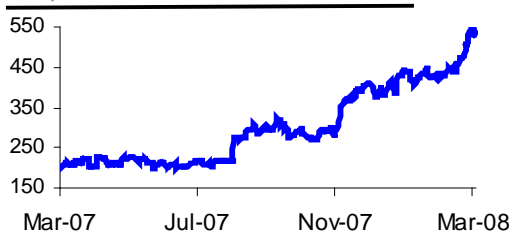
Annual Volume in Millions



Data source: Bloomberg

### Stressed credit markets

BB industrial bond spread - 10 yr  
in bps



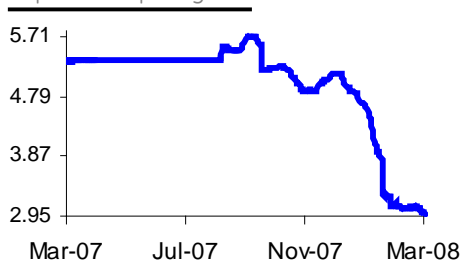
Data source: Bloomberg

## Market summary

As of today, 3-month U.S. LIBOR has fallen to 2.99000%; it's lowest level in this rate cycle, benefiting from the Fed's cumulative 225 bps of rate cuts since mid-September. With additional Fed rate cuts expected, further declines in LIBOR are expected. In the event U.S. inflation pressures do not moderate as the Fed anticipates, upcoming LIBOR declines should be viewed as temporary and unsustainable. In Ben Bernanke's testimony before Congress last week, the Fed Chairman said "The further increases in the prices of energy and other commodities in recent weeks, together with the latest data on consumer prices, suggest slightly greater upside risks to the projections of both overall and core inflation." Since the Chairman's Feb 27 testimony, energy and commodity prices have continued to climb.

### 3-month U.S. LIBOR

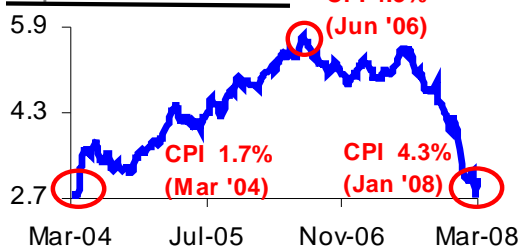
in percent - past year



Data source: Bloomberg

### 3-year U.S. swap rate

in percent



Data source: Bloomberg



## What it means for corporate borrowers

By the end of February, 2 to 3-year U.S. swap rates had declined for 8 straight months to their lowest levels in nearly 4 years. Lower short-term rates combined with increasing inflation pressures increase the likelihood of a steeper yield curve where relative hedging costs might rise relative to LIBOR. Rates have risen slightly so far in March.

- As of March 6, customers can swap to a U.S. fixed rate approximately flat to 3-month LIBOR for a 3-year term.
- Customers can enter into a 3-year no-cost collar on 3m LIBOR, with a cap of 4.00% and a floor of 2.25% providing rate protection above 4.00% and a downside benefit to 2.25% to incorporate the potential for further Fed rate cuts.

Current pricing for the above solutions is indicative and subject to change with market conditions.

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