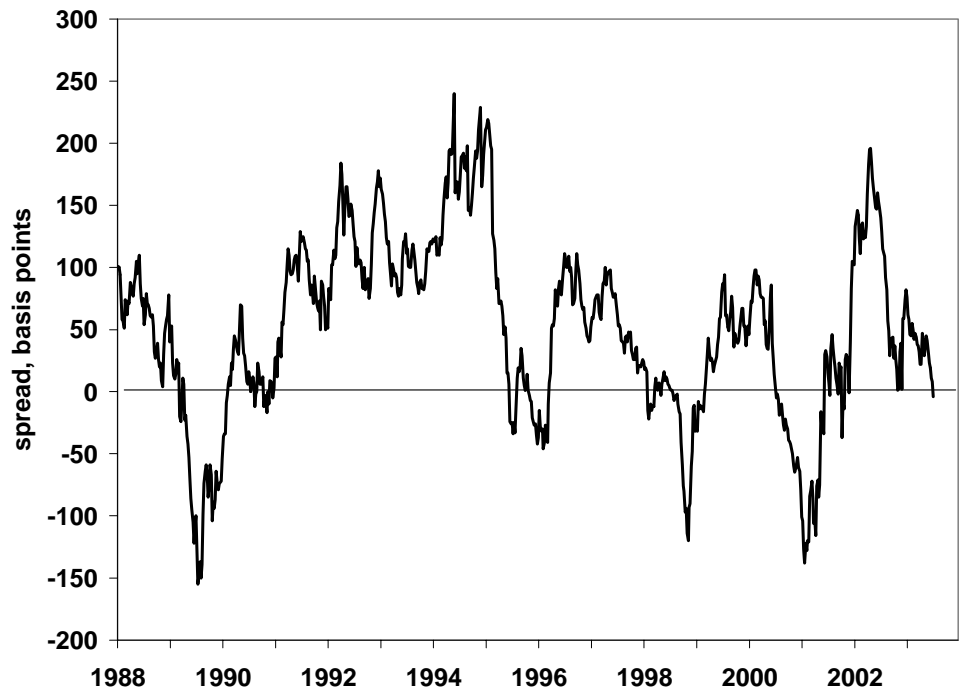


Markets Price in Rate Cut After Greenspan

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Fed Chairman Alan Greenspan's comments while participating via satellite in an international monetary conference have dramatically boosted market-based probabilities of a further cut in interest rates at the June 24-25 meeting of the Federal Open Market Committee (FOMC). Before Greenspan's appearance, July fed funds futures put the probability of a quarter-point rate cut at the June FOMC meeting at 58%. In the wake of his comments, the implied probability has risen to 90%, while the yield on the two-year Treasury note has moved below the fed funds rate target, which has proven to be a good predictor of Fed easing in the past. While Greenspan said little that was new, the emphasis on the need for a "wider firebreak" against deflation and the greater inclination to take out "insurance against economic weakness," suggest that the debate at the June FOMC meeting is likely to be a vigorous one. Our position at this point is that a rate cut is more likely than we previously thought—although we think any action is still contingent on the upcoming economic data for May being weak. On that front, both the May manufacturing and nonmanufacturing ISM (Institute for Supply Management) reports were stronger than expected. Moreover, the continued equity market rally is a growing market-based signal of acceleration ahead for the economy. For now, we will hold to the view that the more likely outcome is that the Fed will keep rates steady in June. However, we recognize that Greenspan has opened the door wider to a rate cut.

Spread of the Two-Year Treasury over the Fed Funds Rate Target

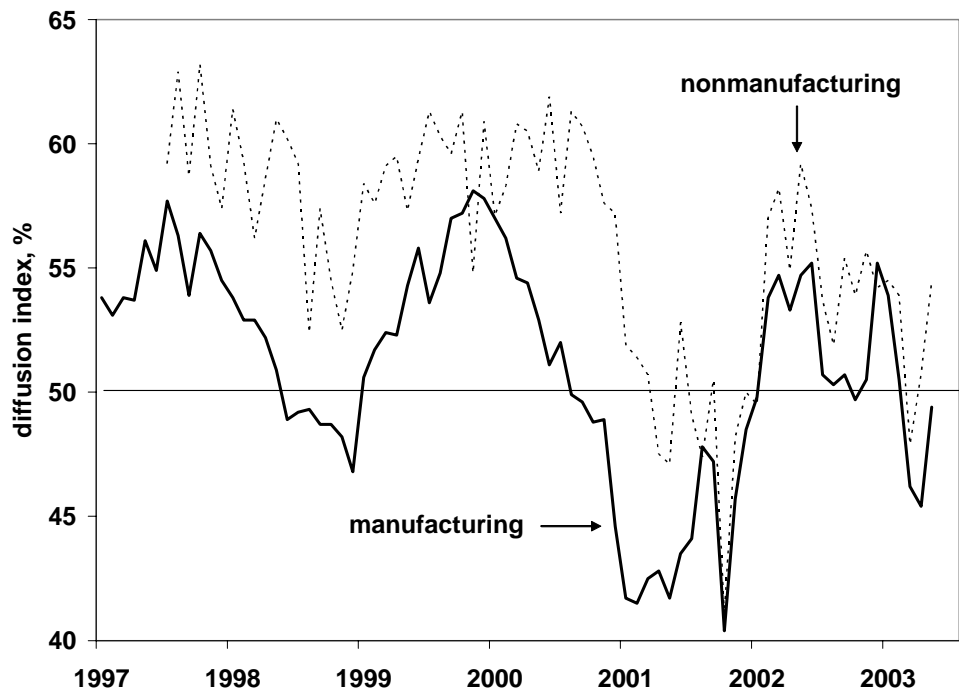


Source: Federal Reserve Board.

**MAY BUSINESS
SENTIMENT BOUNCE**

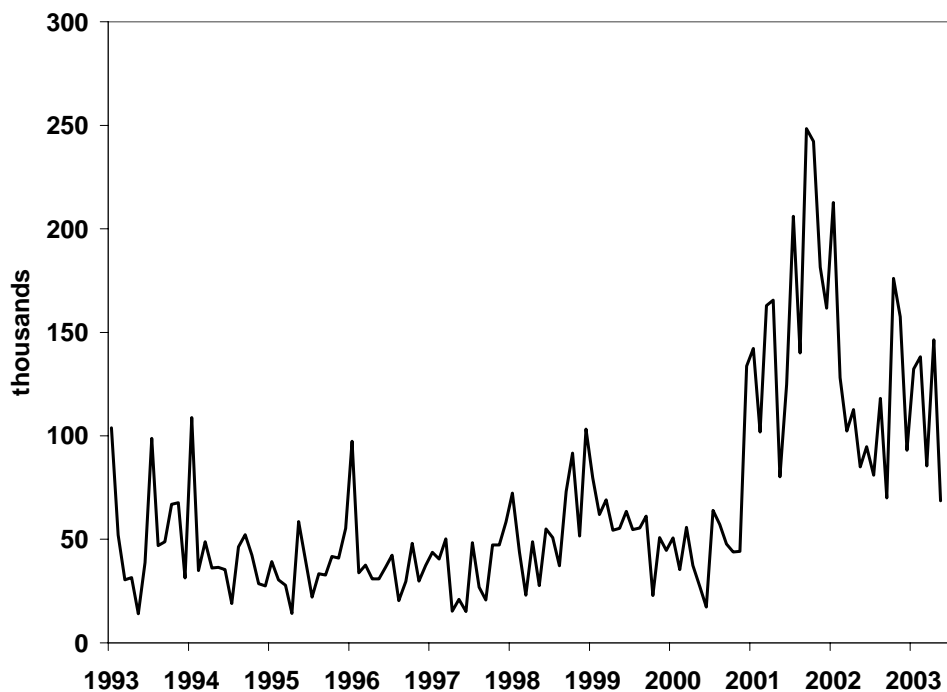
While Greenspan repeated his view that growth would pick up in the second half of the year, he said that the data for May suggested the economy had only “stabilized” following weakness in March and April. We are encouraged by the data for May thus far, especially on business related indicators. The manufacturing ISM index rose four points, to 49.4 in May, while in the same month nonmanufacturing ISM increased 3.8 points, to 54.5. Notably, the leading components in the report exhibited greater strength than the overall indexes, as manufacturing new orders increased 6.7 points, to 51.9, while nonmanufacturing orders rose 4.1 points, to 54.7. Order backlogs, which rose 3.5 points, to 51.0 for manufacturing, and five points, also to 51.0 for nonmanufacturing, also suggest improving activity levels ahead. We judge both of these reports as indicating that business confidence improved in May, which we see as an essential precondition for a pickup in capital spending and hiring. Consumer confidence measures have also pointed to improving confidence levels, with the University of Michigan’s consumer sentiment index rising 6.1 points, to 92.1 in May (the highest reading since June 2002), following an 8.4 point increase in April. The Conference Board’s consumer confidence measure tells a similar story, rising 2.8 points in May, to 83.8, following a 19.6 point increase in April. The surveys, however, underscore that employment remains the weakest link in the recovery chain, as the ISM manufacturing employment index edged up to only 43.0 in May, from 41.4 in April, while the nonmanufacturing index increased only 0.5 points, to 48.7. The consumer confidence report showed an increase of 3.2 percentage points in May in the number of respondents seeing jobs as hard to get. The four-week average of unemployment claims at 427,000 in late May also suggests a weak labor market, and we look for a decline of 40,000 in nonfarm payrolls in the month and an increase in the unemployment rate to 6.1%. However, the Challenger survey of mass layoff announcements fell sharply in May, to 68,600—the lowest level since November 2000—possibly indicating an improvement in net job creation ahead.

Manufacturing and Nonmanufacturing ISMs



Source: Institute for Supply Management.

Challenger Mass Layoff Announcements



Source: Challenger, Gray & Christmas.

GREENSPAN'S WORDS

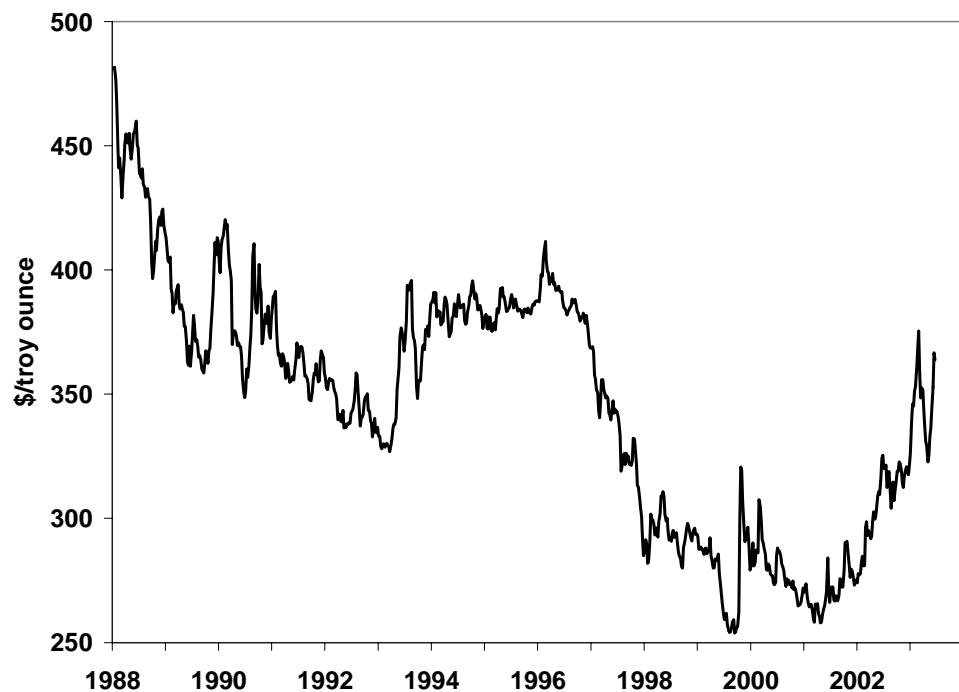
We think that the fixed income and futures markets may have read a little too much into Greenspan's recent comments. On the economy, Greenspan said, "the acceleration has not yet begun, although obviously the marked moves in the stock markets in recent weeks and especially in the credit markets [are] suggestive of a fairly marked turnaround." Once again, he also counseled patience in evaluating the post-Iraq war economy, saying, "it is too early to get any real fix on the American economy in the period ahead." Nonetheless, Greenspan suggested that there were limits to his patience, and he appeared to distance himself slightly from the forecasts of a marked pickup in real GDP growth in the third quarter, qualifying consensus forecasts with the comment, "in order to get anywhere close to the type of increases that economists are forecasting . . . the monthly data—indeed the weekly data—have got to start moving in a positive direction fairly quickly." His comments on deflation, however, appeared to be the ones that set the bond market on fire. He said, "the issue we are concerned about is not the issue of deflation in the sense of falling prices per se, but the issue of corrosive deflation, that is a deflation that essentially feeds on itself, creates falling asset prices, which in turn brings down levels of economic activity." Greenspan said the lack of experience with deflation suggests that "we're far more unclear on the issue of deflation, and as a consequence, we need a wider firebreak . . . so we lean over backwards to make certain that we contain deflationary forces." He did not suggest, however, that the Fed assessment of the chances of such a deflation had increased, saying, "the actual data do not at this stage indicate that the probabilities of deflation are anything significant or anything that we must be immediately concerned about." Nonetheless, there was a whiff of an insurance motivation for a further rate cut when he said, "the chances of inflation reemerging in the near future are quite small . . . what happens if we attack deflation and indeed inflation is the problem? We have concluded . . . that inflation was not something of significance for the Federal Reserve to be concerned about." He went on to say, "which means that

we would be far more inclined, as we have been over the last couple of years, to be taking out insurance against economic weakness . . . the reason why you're hearing a good deal about the deflation issue is that we perceive that as a low probability but the cost of addressing it is very small indeed."

WE DON'T SEE THE DEFLATION RISK

While we accept everything that Greenspan says on the problem of deflation, we think the risks of a "corrosive" deflation are extremely small, and we do not see the need for further rate cuts. Consider, for example, that the S&P 500 has risen over 23% from its lows of mid-March. Note that the median price of a home resale has risen 6.8% over the 12 months to May 2003. Remember that the dollar has fallen 24% against the euro over the last year, while the price of gold has risen 11%. None of these price moves are remotely deflationary, and we are somewhat concerned that the Fed could feed these moves with additional monetary easing, which would add to the eventual problem of withdrawing the easing moves as economic growth accelerates in 2004. We would prefer to see the European Central Bank cut rates aggressively and the Bank of Japan take bold actions to ease policy along the lines suggested by Fed Governor Ben Bernanke, rather than see the Fed cut rates again. Moreover, the tax cut that the President signed into law last week should have a significant stimulus effect in the second half of the year and into 2004. However, it appears that action by the Fed to cut rates is likely to depend on the upcoming data releases. We will be watching them closely. Stay tuned.

Price of Gold



Source: Haver Analytics.