

# INVESTMENT UPDATE

There was an interesting (some would say “exhausting”) piece that hit our desks the other day from the good folks at Deutsche Bank, contrasting the operations of the US Federal Reserve with its two major global counterparts, the European Central Bank (ECB) and the Bank of Japan (BOJ). We thought we might share with you some of their conclusions, and put the “G3” central banks’ respective functions into the context of both the current markets and prospects for the next few quarters.

Collectively, these three central banks directly control, through their influence on their countries’ monetary policies, almost 2/3 of global GDP. In terms of history, the ECB is the new kid on the block, having been formed in 1998 as a result of the Maastricht Treaty that bound together the main economies of continental Europe into a single currency and monetary policy (it should be noted that the UK is not a member of the 13-nation European Economic and Monetary Union, nor are Switzerland, Norway, Denmark or Sweden). The BOJ has been around since 1882, but its operations were completely revamped in 1997, under The Bank of Japan Law, which gave it some degree of independence from the Japanese government. The Fed was established by the Federal Reserve Act of 1913, and began operations in 1914. While the Fed has never had full independence from the US Government, it is perhaps the most autonomous of the three; unlike the other two, the Fed is free to pursue monetary policy with little regard to political concerns.

All three have, as a primary objective, the responsibility to maintain “price stability”—and all practice inflation targeting, some more explicitly than others. Surprisingly, the Deutsche Bank study found that the Fed, which does not identify official inflation targets (see our *Investment Update* from November, 2006), and despite its dual mandate to control inflation and promote economic growth, in fact more strictly follows an inflation-targeting practice than either the ECB or the BOJ. The Fed, for all its foot shuffling on the issue of inflation targeting, pays strict attention to the level and direction of inflation in setting policy, while the other two have been known to look past problematic inflation conditions in order to address other factors, such as asset values and monetary aggregates.

In fact, the ECB uses what they call a “two pillar” strategy in setting monetary policy. In carrying over much of the old German Bundesbank’s (the de-facto predecessor to the ECB) practices, the ECB examines both the economic environment to set an inflation target, and also looks at investor’s behavior when examining the demand for money.

This differs not only from the way the Fed operates but is also inconsistent with classical monetarism, which dictates only that the money supply be tightly regulated, not that policy makers try to figure out what the demand for money is by looking at the financial markets. The result is that the ECB is far more likely to make policy decisions based on perceived imbalances in European asset values.

Meanwhile the Bank of Japan follows a strategy close to that of the ECB, with both short (one- to two-year horizon) and longer-term considerations determining the setting of monetary policy. In effect, the first set of analyses are very similar to those of the Fed, while examination of long horizon factors is similar to the ECB’s in that they study asset prices and capital markets when setting monetary policy.

In terms of their decision-making style, the Fed, at least since the Alan Greenspan era, works to avoid dissention and tries to achieve monetary policy decisions by consensus; there is the occasional dissenting vote, but more than one dissenting vote is extremely rare. The BOJ is quite different, as 55% of the decisions since the BOJ law was enacted in 1997 have had at least one dissenting vote. Like the Fed, the ECB has a strong President (currently Frenchman Jean-Claude Trichet) who seeks consensus among the five other members of the ECB’s Executive Board. Even though they’ve been around less than ten years, in this short period there have been few dissents among the six EBC Board members.

Perhaps the most interesting finding in this study, which became obvious only when using quantitative tools to examine these central banks’ policies, is that actions taken by the Fed influence the other two, while the converse is not true. In other words, the ECB and BOJ, in setting monetary policy, deviate from what would be expected of them by looking just at the macro environment. When Deutsche Bank constructed models to explain past moves by the BOJ and (especially) the ECB, adding Fed policy as a variable significantly improved the explanatory power of the model. Clearly, the Fed’s monetary policy decisions have a wide impact on the global economy and therefore on other central banks’ policies.

Which brings us up to the present. We’ve seen, over the past few weeks, fairly dramatic moves in the term structure of US interest rates (and those overseas as well) despite no real change in the US macro outlook. While US growth looks to have firmed just a bit over the past month or two (especially in the industrial sector), the US housing market has yet to hit bottom and the inflation rate has been trending down; on balance, these factors should have led to little change in in-



terest rates. Instead, as the next chart shows, the US Treasury yield curve has been transformed from its “Nike swoosh” to a more normal, upward slope. Three, five- and ten-year Treasury yields have risen by approximately fifty basis points (0.50%) since the end of the first quarter, with little fundamental change in the outlook.

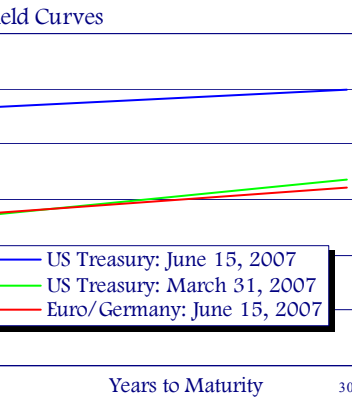
But here’s the deal: In the modern world economy, the US bond market is subject to demand that ebbs and flows based on global demand, not just what’s happening here at home. This is particularly true in the US Treasury market, where more than half of the outstanding supply of bonds is held by foreign investors (including foreign central banks). So when we look around at the world (especially at Europe and Japan) we get a much different picture than what we’re seeing here at home.

Continental Europe, over the past couple of years, has had a much slower growth rate than the US; the ECB has pursued a stimulative monetary policy to try to turn this around and boost growth. That policy is now changing, as Euroland GDP came in at 3.5% for fourth quarter of ’06 before backing off slightly to 2.4% in the first quarter. Yet both of these figures easily outpaced the US’ first quarter GDP which was a feeble 0.6%. In contrast to expectations here in the US, the ECB is not nearly done with raising short rates, and while European yields have risen, as the chart above demonstrates, they are still far below those here in the US. What’s more, even though European interest rates have risen more than their US counterparts over the past few months, their collective economies are expected to grow at a faster rate over the next couple of quarters than ours, while it’s looking increasingly likely that the Fed will remain on hold—implying that we should expect a further convergence of interest rates between the US and Euroland.

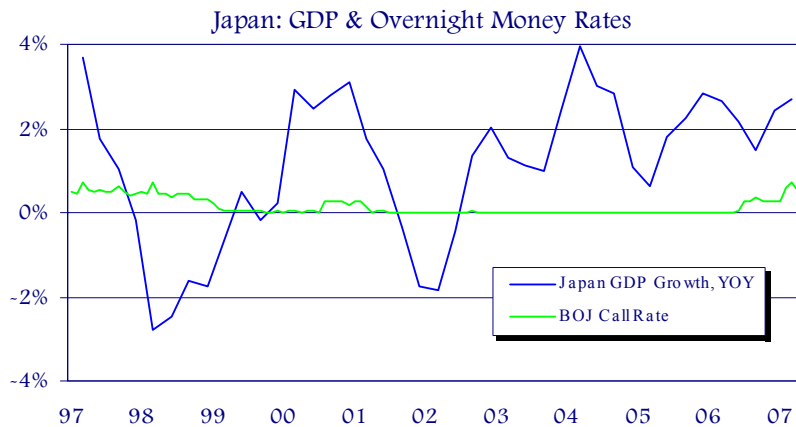
Meanwhile, the Bank of Japan has been raising their overnight lending rate (the “BOJ call rate”), in response to what

finally appears, after a protracted period of anemic growth, a fairly strong economic outlook. As the bottom chart shows, Japanese GDP grew at a 2.7% annual rate in the first quarter, and the outlook is guardedly optimistic. At 0.5%, the BOJ call rate stands at its highest rate since 1998, and the rest of the Japanese yield curve has ratcheted up as well, with ten year government yields approaching 2%. While these rates still look remarkably low, it should be kept in mind that Japan suffers from massive structural impediments, including an aging population that acts as a permanent drag on economic growth.

Not only is demand for US bonds faltering with the shrinking of the US yield advantage, but higher short rates in Japan, and a weakening US dollar has had a big impact on the “yen carry trade.” Hedge funds, in particular, have made easy money for years by borrowing



yen at ultra-low overnight rates and investing the proceeds in higher-yielding intermediate-maturity US bonds. With the US economy stumbling, relative to our main trading partners, the dollar is weakening—the exact opposite of



what a leveraged investor who is long dollars/short yen wants to happen. Combined with rising short Japanese rates, the economics of this trade have been going south for months now. Many of those that haven’t bailed completely are seeking a more stable currency, selling their US bonds and replacing them with Euro-denominated bonds, despite the fact that it means sacrificing some yield. The net result is just more erosion of demand for US bonds.

Ultimately, the recent spike in rates here in the US will finish the job the Fed started two years ago in cooling off a too-hot economy propelled by the lowest interest rates in a generation. With the potential for US growth to quickly resume due to a combination of strong overseas growth and a weak dollar, and the expected bottoming of our housing market, hopes for a Fed easing have been shelved for now. And since a rise in longer-term rates is far more effective than a similar hike in short rates, we expect the Fed to be on hold for the foreseeable future.

