

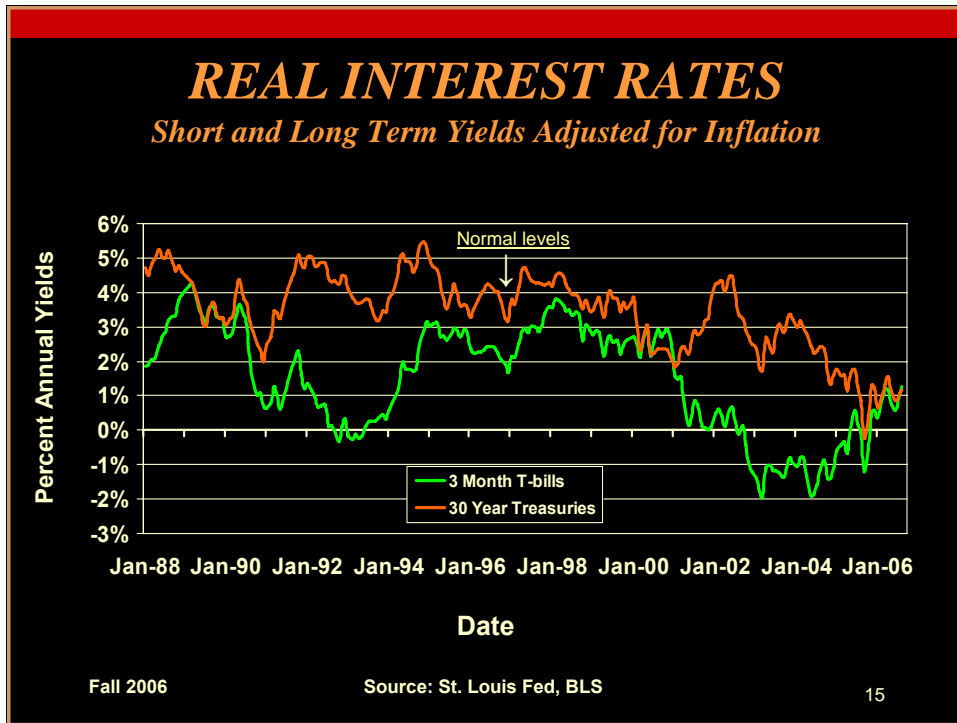


***DID THE FED
OVERSHOOT
THE MARK?***

Fall 2006

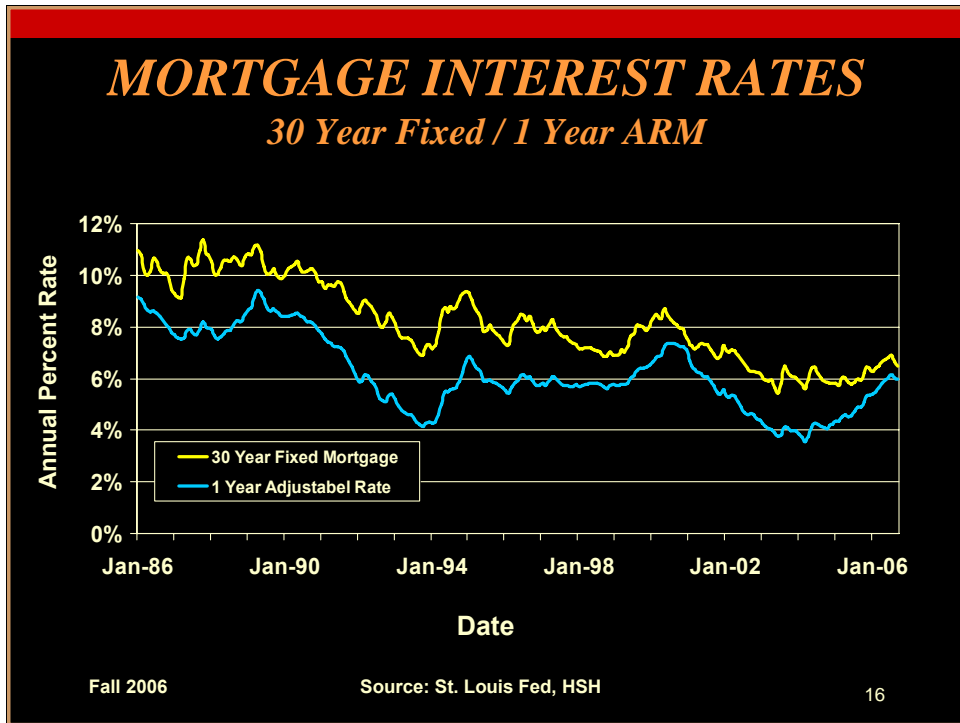
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There has been some talk on Wall Street that the FED will lower interest rates next year. I suggested that possibility during May's symposium and still feel that it remains a possibility. But, it's helpful to understand what might have prompted such a move. Has the FED really overshot the mark, requiring them to back off a bit as they did in late 1995?



Well, if you look at today's real interest rates, they are certainly not high. Both short and long-term real rates are hovering today around 1.0 percent. During normal periods of sustainable economic expansion, one would expect to see real short-term rates of about 2% and long-term rates of about 3%.

The most surprising interest rate story over the past 12 months has been the fact that while short-term rates have been increasing sharply, long-term real rates have fallen. The long bond market is behaving as though a recession is imminent. If that doesn't happen, and I believe it won't, there will be a bond market correction within the next 12 months.



Of course, the flattening of the yield curve has had interesting implications to the mortgage market. Despite the FED's push to raise short-term interest rates, traditional fixed 30 year mortgage rates have barely inched up. This is crucial right now for the health and well being of the housing market. Marginal home buyers entering the market over the past 4 years with ARMs are feeling the pinch right now, but fully qualified home buyers locking in today's low fixed rates are still finding housing relatively affordable, especially in markets such as Houston's that have not over-inflated.

DIFFERENCE IN MONETARY POLICY TODAY

THE FED IS GETTING HELP

1. International Unrest
2. Energy Price Spike
3. Housing Market Correction

THE FED WILL LIKELY BACK OFF NEXT YEAR

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So if interest rates are not that high, what's all the talk about the FED needing to lower interest rates next year? Were these normal times, current interest rates would, if anything, be somewhat low. But these aren't normal times. Just as the FED got help in cooling the economy at the start of this decade from the stock market crash, 911 and the corporate scandals of 2002, the FED has been getting help this year from the continued worry over international unrest and terrorism, from high energy prices, and from the now unfolding housing market correction. The bottom line is that because of these external forces threatening the economy, they simply don't need to raise rates nearly as high as they did during the less threatening mid-1990s.