Interest Rates - Next Step ... Up?

After cutting the fed funds rate by 325 basis points since last September, the Federal Reserve is signalling that rate cuts could be at an end. The financial markets seem to agree, and have now shifted to an outlook for higher rates, in the future, albeit not the immediate future. Despite the shift in consensus, we believe that short-term rates could go slightly lower in the near future, while long-term rates should go somewhat higher.

The Fed has gotten very creative with trying to boost credit market liquidity, while trying to minimize rate cuts. But we believe that persistent economic weakness will renew pressure on the Fed to cut short-term rates, while heightened inflation worries will cause long-term rates to rise.

Recent Trends

After rebounding from the mid-March financial market panic, interest rates have maintained an upward trend in the last several weeks. Since the peak of market panic in mid-March, short-term interest rates have risen 100 basis points and long-term interest rates have risen 60 basis points, including a 40 basis point increase in short-term rates and a 20 basis point increase in long-term rates since the end of April.

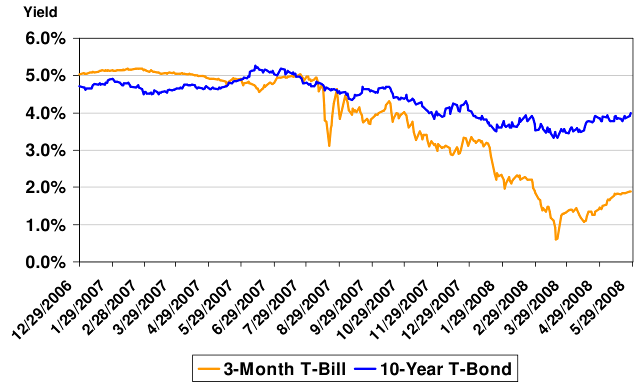
LIBOR spreads have continued to recover, but remain noticeably wider than normal. After reaching above 200 basis points in December 2007, the spread between 3-Month LIBOR and the 3-Month T-Bill seemed to recover in early 2008, shrinking to 80 basis points in mid-February. The spread widened significantly during the mid-March financial panic, briefly reaching 200 basis points again. Since then, the spread has contracted substantially, but is hovering around 80 basis points, as compared to a 40 basis point spread before the onset of the credit crunch in mid-2007.

The Fed

The Fed has been trying to steer the market away from expectations for further cuts, and towards a greater focus on inflation. In just the past two weeks, Fed Chairman Bernanke, Vice Chairman Kohn and Governor Warsh have all highlighted the risk of higher inflation, while contemplating a stronger economy by 2009. Minutes from the FOMC's April meeting further suggest that the Fed is finished with rate cuts, at least for now.

Nevertheless, the economy has been weakened by the housing market downturn and the corresponding increased pessimism among consumers. While economists debate whether we are actually in a recession, it is clear that the economy has slowed - with GDP growth at a near

Treasury Yields
During 2007-2008



Source: Federal Reserve

Recent Interest Rates and Inflation

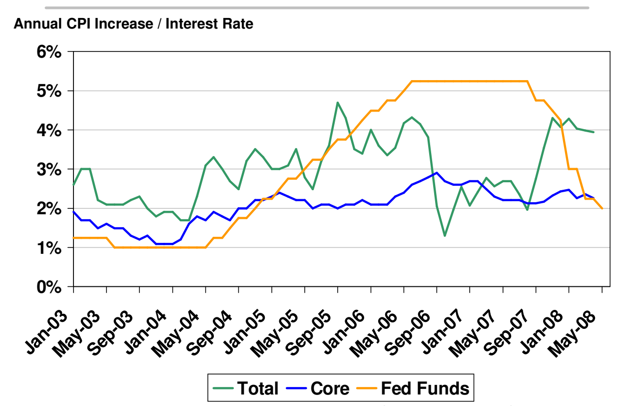
	Interest Rates 3-Mo T-Bill	Interest Rates 10-Yr T-Bond Nominal	Interest Rates 10-Yr T-Bond Real	Inflation 1-Year	Inflation Long-term**
2003	1.0%	4.0%	2.1%	2.3%	2.0%
2004	1.4%	4.3%	1.9%	2.7%	2.4%
2005	3.2%	4.3%	1.8%	3.4%	2.5%
2006	4.9%	4.8%	2.3%	3.2%	2.5%
2007	4.5%	4.6%	2.3%	2.9%	2.3%
2008*	1.9%	3.7%	1.4%	4.1%	2.3%
May-28	1.9%	4.0%	1.5%	3.9%	2.5%

* Year-to-date average.

** Long-term inflation as implied by the spread between nominal and real 10-Yr T-Bond rates.

Sources: Federal Reserve, Bureau of Labor Statistics, Bloomberg, Foresight Analytics

Inflation Since 2003
Total and Core CPI vs. Fed Funds Rate



Sources: Bureau of Labor Statistics, Federal Reserve standstill, 4 consecutive months of job losses, a decline in real retail sales year-to-date, and lingering worries about creditworthiness throughout most sectors of the economy, including between lenders themselves.

The severity and duration of the economic downturn is key. As shown in the neighboring chart, the last three economic cycles have shown a progression towards shallower, but more prolonged declines. In the early 1980s, job losses reached -3.1%, but had surpassed the previous peak by 28 months after the downturn began. The early 1990s recession caused a much shallower fall (-1.5% from the peak), but it took 32 months before the job level surpassed the prior peak. The early 2000s recession was also relatively shallow (-2.0% decline from peak to trough), but it took much longer — 48 months — for the recovery.

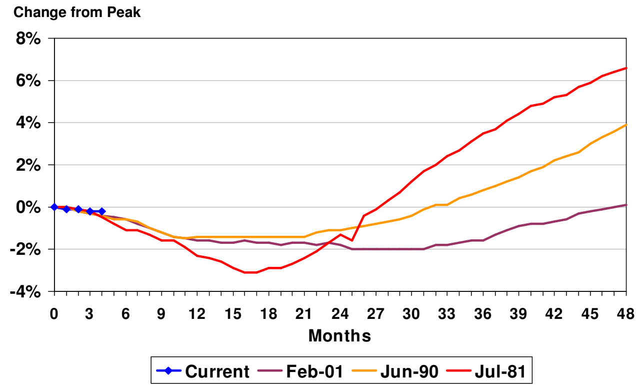
So far, this downturn is proving even slighter than the previous three downturns. Jobs have only declined by 0.2% since the peak four months ago, while jobs had declined by 0.4% to 0.5% in the three previous cycles. With structural issues, such as an aging workforce, and the removal of two recent engines of economic growth, namely the housing and finance sectors, it could be a quite a while before positive growth resumes. Furthermore, the Fed will likely be particularly hawkish on interest rates to forestall a recurrence of the two bubbles we have experienced in the last decade. Instead, the Fed is pinning its hopes for restoring liquidy to credit markets on the alternatives it has developed, such as the Term Auction Facility, the Term Securities Lending Facility and the Primary Dealer Credit Facility, all of which are intended to shore up commercial and investment banks' balance sheets by swapping out risky, illiquid assets for non-risky, liquid assets. Initial indications are that these alternatives are helping, but they do not yet appear to have spurred lenders to expand their lending activities.

The Bond Market

The bond market has caught inflation jitters. Bond market expectations for long-term inflation have risen noticeably in the last two weeks. After hovering around 2.3% for several weeks, they are now in the 2.4% to 2.5% range. The 10-Year T-Bond yield has similarly risen to almost 4.0%, up from 3.8% in late April.

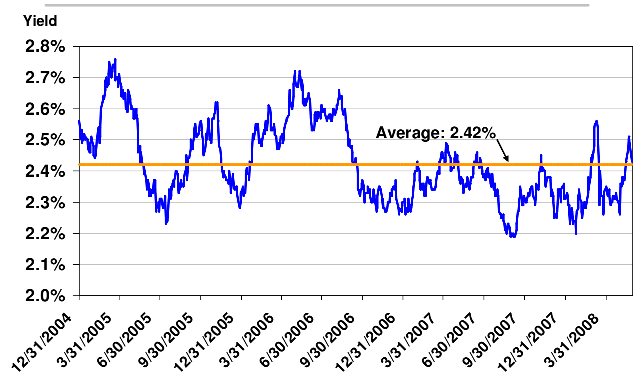
While nominal rates and inflation expectations have risen, real rates have fallen slightly in the last few weeks, with the 10-Year TIPS rate dropping from 1.6% at the end of April to 1.4% to 1.5% currently. Fixed income investors have bid up the price (and yields down) of TIPS (Treasury Inflation-Protected Securities), based on heightened worries about future inflation.

Job Losses
Current vs. Previous Cycles



Sources: Bureau of Labor Statistics, Foresight Analytics

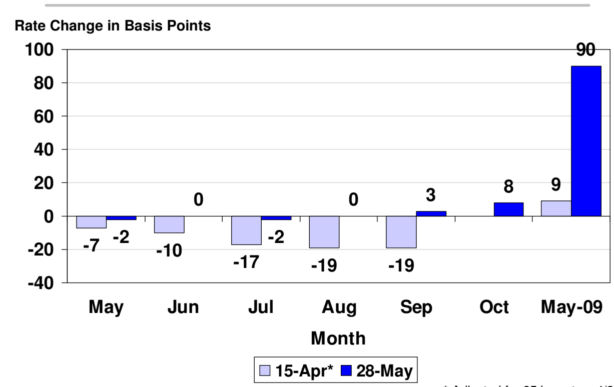
Long-Term Inflation Expectations*
Since 12/31/2004



* Spread between nominal and real 10-year T-Bond rates.

Source: Federal Reserve, Foresight Analytics

Market Expectations for Rate Cut / Increase
Implied by Futures Prices



* Adjusted for 25 bp cut on 4/30/08

Sources: TradingCharts.com, Foresight Analytics

Despite the increase, we believe that long-term rates are a little low. Real rates, at around 1.5%, are noticeably lower than the 2.5% average in mid-2007 and nearly 2.0% average in late 2007. Furthermore, despite the recent rise, inflation expectations seem low, when considering that overall inflation is running at close to 4%. The futures markets have made an about-face in the last month, changing from an outlook for further rate cuts to an expectation of future rate hikes. Current futures prices imply a market expectation for a markedly higher fed funds rate by next Spring (see chart on previous page).

Outlook

The Fed will strive to maintain the current 2.0% fed funds rate, even in the face of more economic and financial turbulence. However, we believe that as the economy weakens further, there will be renewed calls for the Fed to cut interest rates, perhaps by the August or September Fed Open Market Committee meetings. We have incorporated a 25 basis point cut in into our forecasts.

Inflation is unlikely to be tamed in the near term, so inflation expectations should rise further. Real interest rates (ie, the TIPS rate) are currently on the low side, so a combination of an increase in the real interest rate and inflation expectations will result in higher 10-Year T-Bond rates. Our outlook is for rates to rise to the 4.0% to 4.2% range.

One major factor in the outlook is how successful the Fed is at restoring liquidity to the credit markets. If the Fed believes that its alternative approaches to providing liquidity to commercial and investment banks are working, it will be emboldened to hold fast on the fed funds rate. The Fed would probably like to actually increase rates to stave off inflation, but that action appears unlikely in the near term, at least.

We assign a 55% probability of occurrence to our base case scenario.

Interest Rate Outlook
Next 6 to 12 Months

Scenario	3-Mo T-Bill	10-Yr T-Bond	Likelihood
Base	1.75%	4.1 to 4.3%	55%
Alt. 1	1.25%	3.2 to 3.4%	30%
Alt. 2	3.00%	4.5 to 4.7%	15%

Source: Foresight Analytics

Alternate scenarios include:

- Alternate 1: the economy erodes more rapidly, prompting the Fed to cut interest rates by another 75 basis points. Inflation worries ease temporarily, creating room for the 10-Year T-Bond yield to fall to the 3.2% to 3.5% range. We assign a 30% chance of occurring to this scenario.
- Alternate 2: the economy strengthens and inflation accelerates. The Fed sharply raises rates by 100 basis points. The bond market prices in higher inflation expectations, pushing the 10-Year T-Bond yield sharply higher to 4.5% to 4.7%. We assign this scenario a 15% probability of occuring.

Implications

Rates for adjustable rate borrowers are likely close to their lows. Short-term rates will probably go slightly lower, but not enough to warrant waiting for lower rates. The slight exception would be for LIBOR-based borrowers: spreads have been higher than their historic norms, so while LIBOR spreads have tightened significantly in the last month, there is still some room for improvement if and when bank liquidity improves.

Long-term fixed-rate borrowers could face higher rates in the near future. With inflation fears rising, benchmark Treasury yields are likely to go higher, increasing borrowing costs. Credit spreads have tightened somewhat in recent weeks, but until liquidity returns (including to the CMBS market), lenders are likely to have the upper hand in setting rates.

The near-term impacts of higher inflation are likely to be negative for real estate. Operating costs and borrowing costs will go higher, while rental income stagnates. Longer-term, however, higher inflation should ultimately translate into higher rents, and with a general avoidance of overbuilding in the commercial sector in this cycle, landlords will be in a better position when the economy recovers and demand picks up.

For more information, contact:

Matt Anderson m.anderson@foresightanalytics.com
Partner

Susan Persin s.persin@foresightanalytics.com
Partner

Tel: (510) 893-1760
Web: http://www.foresightanalytics.com