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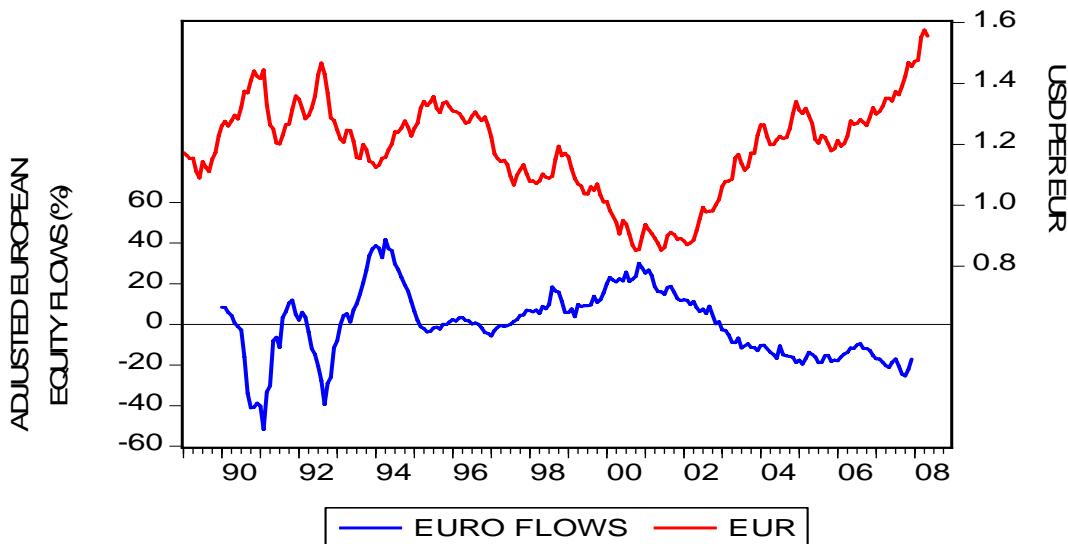
On the horns of a dilemma

- Federal Reserve policy makers face a very difficult situation. On the one hand, financial system problems and the collapse in home prices have hurt households. For example, for the first time in five years, household net wealth has declined compared to the prior year. The unemployment rate for May jumped to 5.5% from 5.0%. Consumer sentiment is at its lowest level in 28 years. These issues tend to weigh on consumption and depress economic growth, as consumers feel less affluent. Such conditions would likely call for lower interest rates. At the same time, commodity prices are reaching historic highs. Inflation concerns are increasing, which would normally prompt the Federal Reserve to raise rates.
- Thus, the Federal Reserve rests on the 'horns of a dilemma'. If they make additional rate cuts to support a weak economy, they run the risk of sparking inflation. If they raise rates to contain inflation, there is a risk that the economy, which we believe is probably in a mild recession at this point, could suffer a more profound growth decline. In the last two deep recessions, the 1974-75 and the 1981-82 periods, the policy makers increased rates during the downturn, exacerbating the weakness.
- Federal Reserve policy makers, seeing their precarious situation, have opted to try and employ multiple tools to deal with divergent problems...to 'split' the horns of the dilemma. To support the economy, in addition to a series of rate cuts over the past several months, Fed policy makers have created new credit facilities to provide liquidity to the beleaguered financial system. To address growing inflation worries, policy makers have employed "jawboning", talking about how current inflation levels will prompt tighter monetary policy at some point in the future. This "talk" has led to announcement effects; the mere discussion of tighter policy has led to rising interest rates.
- It appears that the next policy tool to contain inflation is a stronger dollar. In a speech given June 3, 2008, in Barcelona, Spain, Federal Reserve Chairman Bernanke mentioned the dollar's weakness was an unwelcome development, as a softer greenback tended to boost import prices (which rose 17.8% last month, a new record). In the U.S., monetary policy is the purview of the Federal Reserve but exchange rate policy rests with the Treasury Department. It is unusual for Federal Reserve officials to discuss exchange rates; we view this break in protocol as an important policy signal.
- If the dollar can rise, it would tend to weaken import prices. With European policy makers worried about the growth dampening effect of the strong euro on their economies, we expect a G-8 effort to boost the dollar. Not only should that help contain inflation, it should allow the Federal Reserve to delay a rate increase. A stronger dollar should also encourage foreign investment into the United States, which should support our equity markets. This is the topic of the chart of the week.

Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.

Chart of the Week:

THE EURO AND EUROPEAN EQUITY PARTICIPATION



For illustrative purposes only. This does not reflect the performance of any specific investment. Past performance is no guarantee of future results

Sources: Treasury Dept., Federal Reserve, Haver Analytics, Wachovia Securities

The upper line on the chart shows the euro/U.S. dollar exchange rate; it measures how many dollars it takes to purchase one euro. The lower line on the chart measures European participation in U.S. equity markets, adjusted for the level of the S&P 500. A positive reading indicates that European equity participation is higher than the general performance of the equity markets would dictate, and visa versa. The lower line and the upper line have tended to move inversely to each other, suggesting that European participation in U.S. equity markets declines when the dollar is weak, and increases when the dollar is strong. As shown in the above chart, the current reading on European equity flows suggests Europeans are 20% underinvested in the United States. If the dollar's rally continues, we would expect increasing European participation in U.S. equities which should be a supportive factor for domestic equities.

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