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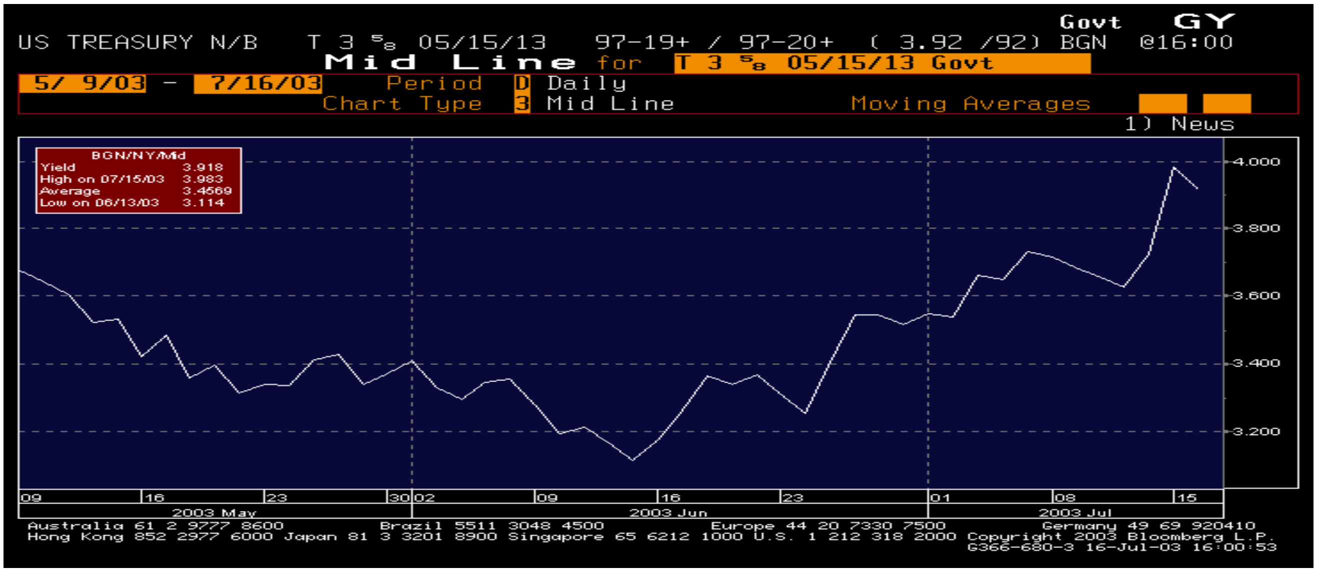
So, what does the Chairman really think…and what will the Fed do?

Session two of "Humphrey-Hawkins" for midyear 2003 is now history. The Senate Banking Committee produced a sober and sedate dialogue in contrast to the House. Judging by the behavior of the Bond Market, it



US 10 Year Yields 5/09/03-7/16/03

appears that both Greenspan and the Bond Junkies "got it." A picture of yields on 6/16/03 is given below with

<HELP> for explanation. N127 Index C15

HISTORICAL YIELD CURVE PAGE 2 OF 2

DATE RANGE 6/16/03 7/14/03 MTY RANGE 3M 30Y

	6/16/03	7/14/03	CHANGE
3 MONTH	0.856	0.886	0.0306
6 MONTH	0.858	0.950	0.0923
2 YEAR	1.153	1.336	0.1831
3 YEAR	1.401	1.677	0.2760
5 YEAR	2.113	2.545	0.4321
10 YEAR	3.172	3.724	0.5524
30 YEAR	4.232	4.769	0.5378

Pre-Hearing Yield's and Changes 6/16/03 –07/14/03

the changes computed to 7/14/03 before the first day of testimony.

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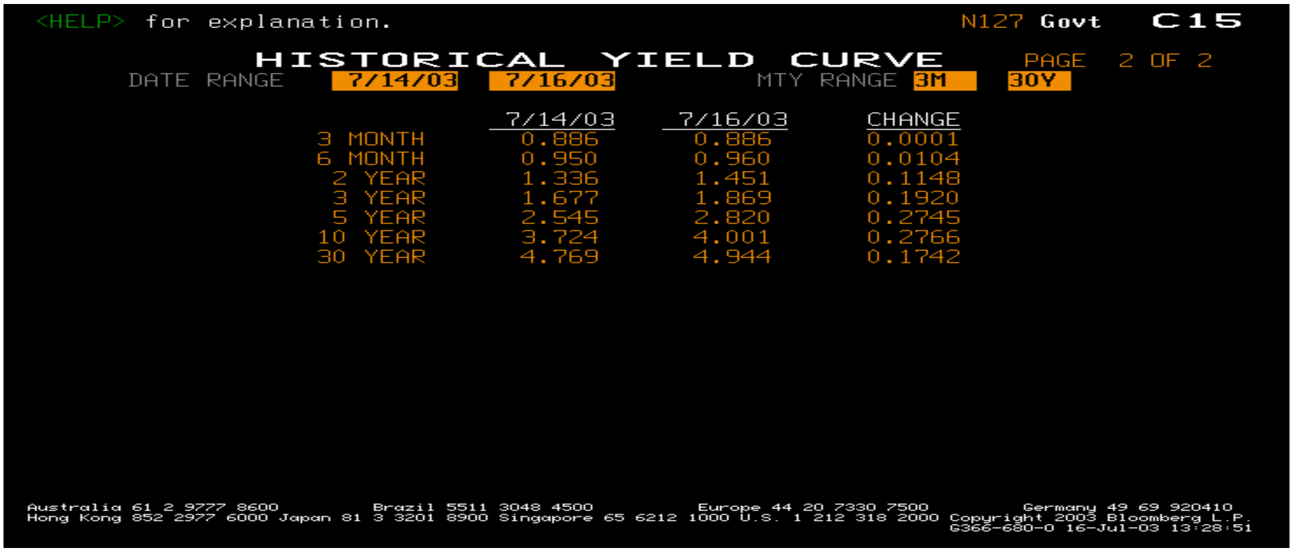
<HELP> for explanation. N127 Govt C15

HISTORICAL YIELD CURVE PAGE 2 OF 2

DATE RANGE 7/14/03 7/16/03 MTY RANGE 3M 30Y

	7/14/03	7/16/03	CHANGE
3 MONTH	0.886	0.886	0.0001
6 MONTH	0.950	0.960	0.0104
2 YEAR	1.336	1.451	0.1148
3 YEAR	1.677	1.869	0.1920
5 YEAR	2.545	2.820	0.2745
10 YEAR	3.724	4.001	0.2766
30 YEAR	4.769	4.944	0.1742

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2003 Bloomberg L.P.
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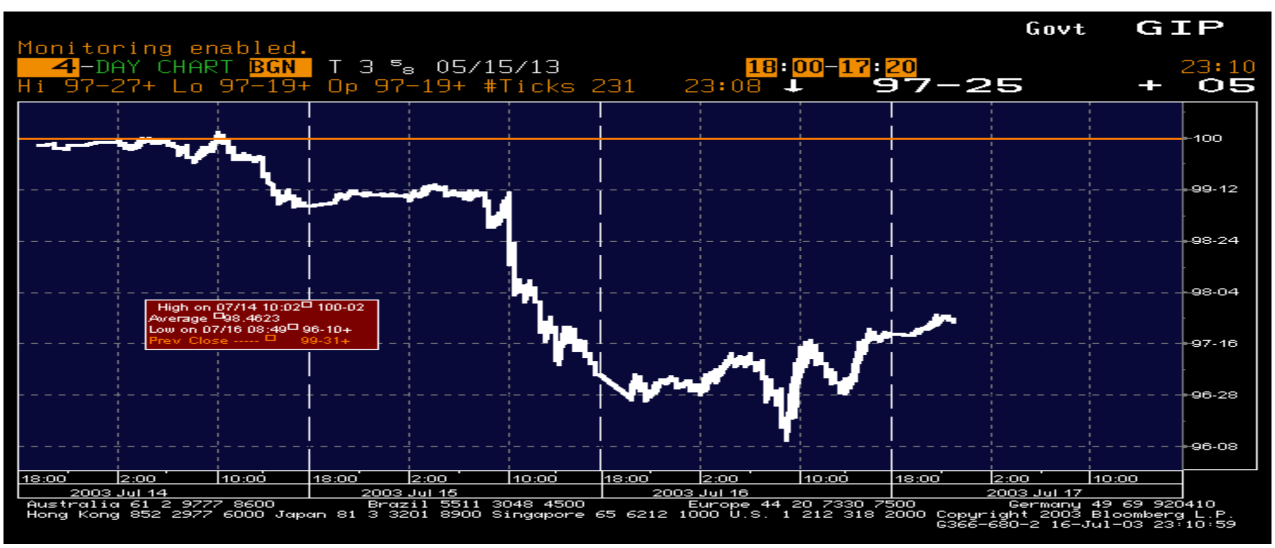
Yield Fireworks 07/16/03 (1:28 p.m.)

Bond traders crushed the market yesterday and early today fearing the Greenspan "put" had been pulled when **unorthodox measures** (code for trading in maturities beyond the overnight money market) got a cold shoulder and Greenspan focused on the recovery soon to happen! The dramatic crush of bond prices yesterday was offset to some extent this morning and bond prices have retraced from their maximum losses yesterday morning as Greenspan cane to understand that the way he framed his testimony and Q&A on Tuesday (7.15) had "spooked" the bond market. He went out of his way today trying to walk both sides of the street in effect claiming that the Put had not been pulled but he saw no likelihood it would have to be used. ('Yes, we will use these measures if necessary. But, they are probably not going to be used because the economy seems about ready to accelerate.' 'That will raise yields, won't it? Not right away because we are going to anchor the Fed Funds rate and besides, we think many of the forecasts from Wall Street for the QIII are overly optimistic.')



10 year Prices 7/14-7/16 (late p.m.)

As can be seen from the "four day" chart above, the maximum damage occurred just before Greenspan began his Senate testimony, clearly aware that his remarks from the prior day had disturbed bond traders. Parenthetically, the Monetary Report lowered GDP growth numbers again from the February projections. Trying to "correct" the market's reaction to his remarks on Tuesday suggests a return of a much-criticized Central Banking practice, i.e. making statements to influence the direction of a market. Presumably, that is not what transparency is all about. Greenspan's critics will have a field day with the Greenspan jawbone today.

By the end of the bond day, some traders had stepped in and bought the 5's and 10's probably asking themselves, 'just how much has really changed?' Their behavior suggests not a lot! Nonetheless, the yield curve has moved since the close on July 14th and Greenspan's two day thrust and parry with the Congress provided for significant gyrations. Did it really alter the path that yields may take over the next few months? Maybe not!

<HELP> for explanation. N161 Govt C15

HISTORICAL YIELD CURVE PAGE 2 OF 2

DATE RANGE 7/14/03 7/16/03 MTY RANGE 3M 30Y

	7/14/03	7/16/03	CHANGE
3 MONTH	0.886	0.893	0.0065
6 MONTH	0.950	0.956	0.0063
2 YEAR	1.336	1.418	0.0825
3 YEAR	1.677	1.806	0.1294
5 YEAR	2.545	2.725	0.1803
10 YEAR	3.724	3.898	0.1745
30 YEAR	4.769	4.876	0.1069

Yield Curve Changes at 3:22 PM 07 16 03

The resiliency of the market was demonstrated by the retracement. Ten year yields fell back to 3.898 from somewhere over 4.083 in post 07/16/03 trading. (See the chart below). Most of the damage was done in the 3-10 year segment of the curve, undoubtedly related to hedging arising out of the mortgage market. The central issue is Why and What is implied going forward after the Greenspan fireworks.

Looking at the bond market since early May, it seems that some of the 'smart money' (who could see that yields had dropped about as low as might be expected, baring the small probability that a true deflationary episode would occur), began edging out of the very pricey midsection of the curve. Even at the long end, there was some back up in yields, but the change in the 30-year, resulting from the hearings, was significantly less.

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10 year yields (7/14-7/16 late pm)

During the hearings, there was significant displays of distemper by some of the Congresspersons, largely focused on the fact that employment has definitely lagged (as might be expected) and the residual discomfort by Democrats over the perceived beneficiaries of the latest tax cut ("fat cats"). In addition, there is the politically inspired and deliberate misunderstanding by certain Congresspersons over the process of comparative advantage and the clear preference for protectionism by some (e.g. Sanders). Jobs do move as the opportunities to produce various manufactured goods in countries with lower costs are revealed, but normally, more jobs are created. This recession, however, has not produced the new jobs and a job-protection attack is highly evocative. More heat than light, perhaps, but that is what the Congress frequently exhibits. In a normal business cycle, the job-shedding process is aggravated and in the upturn phase, more jobs are typically created. This cycle has been different, at least to date. The Democrats repeatedly cited the fact that during the three years of this Administration, net job creation has been negative while GDP has grown (except for a single quarter during the period). By any standards, however, this has been a mild recession, and it has been an even milder recovery! The losers are the former manufacturing jobholders.

Some Committee members think they get considerable mileage by making the Fed responsible for the change in the composition of employment that results from globalization. Those are cheap shots that can be supported by a myopic knowledge of economics on the part of the TV audience. Real economic myopia is more likely to reside with the Congresspersons. While their understanding of economics is limited, their understanding of public relations is not. Politicians have to be good at something and politics is what they are good at. The actual audience, largely financial market participants, is probably much more professional and will to dismiss these criticisms. But a good sound bite draws the economic paparazzi that who thrive on 'populist journalism' and populist economics.

For market participants, the meaty parts of Greenspan's remarks centered on **(a) the likelihood that the economy had already begun its recovery process, notwithstanding the continuing series of shocks in**

the early part of the year and (b) continued de-emphasis of the likelihood that a true deflation will appear with the consequent need for the Fed to apply unorthodox methods to transmit more monetary stimulus. That blunts the **put** (or effectively raises its strike price). Hence, the sell off.

If Greenspan is right, however, and the economy is on the way to recovery, the curve is likely to steepen further as real demand creeps into the economy and credit needs associated with expanded business appear.

In our view, this is where the real problem ahead will lie. Why? Greenspan repeatedly emphasized the unwillingness of the FOMC to pull up the short end of the curve until the recovery is well established (self-sustaining). Since both tax cut-induced spending and monetary stimulus tend to have cumulative effects stretching over many months, the possibility of a true 'overshoot' on the upside exists. The Bond Vigilantes will be riding the fences to locate the first whiff of any inflationary pressure.

Greenspan's view that the Fed will have ample time before it begins to tighten hinges on his belief that there will be a more than an ample warning period before any inflationary momentum appears. But, as he also pointed out, there is considerable monetary stimulus in other parts of the world and a likelihood of further fiscal stimulus, even in the European Union. The bond market thrives on ferreting out surprises not yet imagined, and the Fed's ability to forecast (necessary for this pre-emption strategy to work) has been put to the test over this cycle. Assertion is not proof, no matter how large the halo!

The Congress is focused on two major issues: unemployment (and job loss, which may be a different kind of issue since it relates to fixity of labor skills in particular constituencies) and the implications of a growing imbalance between Congressional wishes to expand benefits and the continuation of the current tax structure (post tax cuts) that undermines their ability to grant such benefits. The relative lack of stridency at the Senate hearing were punctuated by frequent overtures from the Democratic Senators for Greenspan to reiterate his stand on the dangers of large budget deficits stretching into the future. Senator Bennett (R-Utah) drew a very careful comparison between the problems now arising in Germany (with its very high benefit structure and rigid labor market) and the U.S. with its rising health care costs, but flexible labor market. Inflation down the road is a future point of collision when resolution of budget conflicts will be required. A second problem to be solved is matching the continual cries from constituents for the Government to provide virtually unlimited access to unlimited health care and the need to pay for such a benefit. Even Greenspan cannot provide a simple solution to that conflict, and he does not believe that GDP increases will be sufficient to generate the needed tax revenue without changes in tax rates or tax coverage. The Democrats (and some Republicans) in Congress know that and repeatedly welcomed Greenspan into the ring. He floats around that ring like Muhammad Ali in his prime.

Bottom Line: The Fed (or at the least, Greenspan) views the signs of recovery optimistically, but it has cut its estimates for growth for SH2003 and 2004. It has pre-committed to leaving short rates alone until the recovery is well established. It will use unorthodox monetary policy, if required, but it sees little likelihood that such measures will be required. The curve must steepen despite even the not-so subtle suasions of the Chairman. The Bond Vigilantes, however, on now on alert and there is a much deeper skepticism over Greenspan's ability to bring all of this off without a hitch.

What's Left Out: A careful reading of both the Chairman's remarks and the Report itself makes clear that since the early part of this year, the Fed's models (or its consensus judgment) has been too optimistic regarding growth. There have been many reasons adduced for the poor forecasts and poorer performance. Now, war uncertainties have been replaced by the still yet to be explained lagging investment expenditures. How the crease between household consumption and poor job growth will be negotiated while waiting for a substantial increase in capital investment is a conjecture at best. Despite increasingly complex political uncertainties, financial markets have become much easier. The calmness of Greenspan's presentation hides the conflicts at the FOMC that must surely be there now. When the minutes of the latest FOMC meeting is available a clearer pattern of these differences over the economy's course may emerge. Only a brave soul would argue that harmony prevails at the FOMC. Victory has many fathers and Defeat is an orphan. Stay tuned!

As an example of these errant forecasts, if the Fed really believed its White Paper on Japan, it would have cut the Fed Funds rate earlier. After all, the staff study emphasized getting to the battlefront on time and with all of the heavy artillery. In late 2000, the FOMC could not get it together and waited until January to initiate the first of three 50 basis point cuts. That suggests that the Fed models were much too rosy in 2001. In 2003, in our view, there was more fumbling and the result were many speeches on deflation but few rate cuts. Besides forecasting issues, there are policy presentation issues that remain unresolved. In its attempt to change the form of communication, the Fed has still not made clear how the two targets, (Output Gap) and (Inflation Gap), are weighed in its deliberations. Further, in the awkward (and remote?) circumstance that unorthodox monetary policy would have to be used, the Fed has not really clarified how it would communicate under such circumstances. Senator Sarbanes asked if we would need a whole new set of Fedwatchers if unorthodox policies came into being, to which question the Chairman simply referred to the availability of the Fed's balance sheet (made available weekly) which he claimed would be sufficient to tell the market what the Fed was doing. The market would still have to understand how the Fed viewed various measures of quantitative easing, but that was a subtlety that escaped the Committee today.

In our view, two issues have been left open. If in fact the recovery takes place on the Fed's schedule, it is unclear how and when it will communicate its need to be changing monetary policy and it has yet to make clear how it will resist the normal Central Bank impulse to make sure inflation does not arise. It has not said in public what we know in private. The Fed will have to overshoot. Fearing that, our view is that Time-inconsistency will come to haunt us yet. The Fed has much to resolve within its own confines and much to transmit to the markets. The Fat Lady has yet to sing.

Our Fed Forecast: Unless some startling developments take place in the job market and evidence of a very solid expansion in business investment shows up in the next few weeks, the pressure for a further rate cut will grow. Right now, the market is predicting that nothing more will be done at the Fed. We think that not all of the cards have been counted, and the Fed may yet act. If that were not a real possibility, the Chairman would not have spent some of his precious ammunition on disabusing the mutual fund industry of the notion that the 1% Rubicon on the Fed Funds rate could not be crossed. The pithy legal wisdom that 'hard cases make bad law' may yet apply. This is a very different cycle than those of the past, and new territory is encountered each day. Further steepening of the yield curve is possible at the short end. It won't be over until it's over!