



**ABOUT
BILL SULLIVAN**

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

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JVB FINANCIAL

Weekly Commentary by Bill Sullivan, JVB Chief Economist

February 22, 2010

FOMC on cruise control

The quarter point hike in the Discount Rate last week was indeed a technical adjustment that contains little significance for the outlook for monetary policy. If anything, the Federal Open Market Committee (FOMC) continues to receive input that suggests the key Fed funds target can be kept in the current range of zero to 25 basis points for an extended period, a development that could act as an anchor for the overall Treasury yield curve in the months to come.

The potential for a stable approach to interest rate targeting is a by-product of several considerations. Conceivably, the most important influence on the FOMC's decision-making process is their outlook for the U.S. labor market, which Chairman Bernanke will reiterate later this week on Capitol Hill. As detailed in the minutes of the January policy meeting, most members expect the nationwide unemployment rate to finish the current calendar year at 9.5% to 9.7%. This projection is slightly more pessimistic than last November when the Committee outlined a forecast that pegged the jobless rate as low as 9.3% during the fourth quarter. The latest outlook basically implies that the employment picture will stagnate for the balance of 2010, given the fact that the jobless rate was already at 9.7% in January. Against the backdrop of a historically large volume of slack in the labor force, it is extremely doubtful that the Committee would be willing to actively restrict credit conditions in this environment.

At a minimum, for the Membership to consider a higher funds target, the unemployment rate would have to fall well under the levels that are now projected for later in the year. The Fed would probably also want to avoid any movement toward restraint while the Congress is actively debating financial reform legislation that could eventually affect the central bank's status as a regulatory body.

Another important factor in the FOMC's approach to calibrating monetary policy are the ongoing changes in the cost of living for most households. For sure, recent price trends are very supportive of the Committee leaving their Fed funds target on hold for a lengthy interval. In particular, the latest data point toward a highly competitive retail setting in which some sectors are experiencing a modicum of deflation. This consideration is clearly evident when tracking the core rate of inflation as measured by the Consumer Price Index. Over the last twelve months, prices for all items excluding food and energy have climbed 1.6%. However, during the last half year, the core measure has registered an increase of just 0.8% while over the three months ending January the annualized change is zero, pointing towards a progressive diminution in price pressures. The downturn in prices not only reflects the general weakness in housing, especially for rents, but discounting is widespread in such areas as recreation, personal care and apparel. Given the downward trajectory to core

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inflation – and the genuine prospect this pattern will persist – it is quite apparent that the Fed has substantial leeway to maintain a highly accommodative stance.

It should also be noted that the downward bias to core inflation could be intensified if the dollar were to register substantial improvements from current readings on world foreign exchange markets. In particular, the sovereign debt situation in Europe may be troublesome enough to encourage a return flow of funds to dollar denominated instruments, especially U.S. Treasury debt. The appreciation in the greenback would of course place another downward bias to core inflation as the price of imported goods would tend to move lower. Moreover, a firmer dollar would act as a headwind on the export sector of the economy as domestically produced goods would eventually become less competitive on the global marketplace. Clearly, if the Committee were to tighten policy any time soon, the dollar could surge which would only augment the trend toward deflation and lost export business.

An additional factor that the FOMC must consider is how its policy approach affects the mortgage markets. Specifically, there is no evidence to suggest that housing is poised for a self-sustaining recovery process. Any gains over recent quarters have largely been a function of Government support programs. With the homebuyer tax credits likely to expire in the next few months, a huge prop for housing will be removed. If mortgage borrowing costs were allowed to surge through the critical spring buying season, the housing

sector could experience a major reversal and could become an outright drag on the economy once again. This situation may already be underway as intermediate Treasury yields have moved up by at least fifty basis points in the last quarter, pushing mortgage rates higher, accordingly. The added expense of borrowing will of course reduce housing affordability and could create the conditions for a renewed bout of weakness in this sector, especially as the Fed's own program to purchase mortgage-related securities comes to an end in March. Any hint that the Committee would be willing to raise the funds target would only exacerbate the current upward bias toward higher costing housing credit. Effectively, to avoid another pullback in housing, the FOMC must be very clear in its upcoming communications that policy is on hold and the funds target will remain at historically low levels for a lengthy period. If fixed income investors have assurance that the Federal funds rate will be maintained, there may be a greater willingness to extend on the yield curve and lock in the tremendous positive carry that now exists between long - term Treasury debt and the cost of short- term borrowing. Eventually, these purchases could help moderate rate pressures or even allow yields to move lower, which would be a definite plus for housing. ■

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February 22, 2010*

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