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THE VIEWPOINT

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Conventional wisdom would indicate that when the Federal Reserve (Fed) is raising the federal funds rate (The short-term interest rate used by the Fed to guide monetary policy.) the economy is growing and inflation may be ready to rear its ugly head. One might also expect to see long-term rates move up in a parallel fashion. This has not happened. In the last year the Fed has raised the federal funds rate by $\frac{1}{4}$ % on 9 occasions ($2\frac{1}{4}$ %) yet long-term interest rates are going down. This has led many to worry about whether the Fed has gone too far and a recession may be around the corner.

The 20 year interest rate graph below shows that the federal funds rate (FEDFU) and the 10 year Treasury (T10) have moved in the same direction most of the time. The only exceptions are around recessionary periods. During the past two recessions the Fed lowered the federal funds rate to help stimulate the economy. Then as the economy picked up, they raised the federal funds rate in increments until it was close to the 10 year treasury yield.

So, what can you infer from recent interest rate action? First, the Fed feels the economy is on good footing or else they wouldn't be raising rates. One of the ways the Fed keeps inflation under control is by raising the federal funds rate to slow the economy. If the Fed felt the

economy was not moving forward they would be lowering rates to stimulate the economy.

Second, the bond market feels the economy and inflation will grow more slowly in the 2000's than it did in the 1990's, otherwise; interest rates would be higher than they are today. The market sets rates based on how they predict other assets will perform. If the economy was growing as fast as it did in the 90's, rates would be higher. This means that the expected return on assets will be less in the next 10 years than in the past.

And last but not least, Marshall & Sullivan will continue to purchase short-term bonds (3-5 year) for our balanced portfolios. With the yield curve flattening out we can buy a 5 year bond and capture 95% of the yield of a 30 year bond. Normally you would have to buy a bond between 10 to 20 years out to receive a yield that close to a long-term bond.

When the economy starts to grow at a faster pace, long-term interest rates will go higher. Until then, expect long-term rates to remain low and the Fed to stop raising rates soon.

Greg Robinson CFA, President
greg@msinvest.com

