

## 1<sup>st</sup> Quarter 2011 Economic Commentary

Government coups, sovereign bailouts, natural disasters of historic proportions, threat of nuclear meltdown – no it's not the latest script for a Hollywood disaster movie. This is a snapshot of the events that moved the world and the financial markets during the first quarter of 2011. These “Black Swan” events added uncertainty to the global economic outlook and overshadowed some positive developments in the fledgling US economic recovery.

The US economy appears to be gradually transitioning from a stimulus-driven recovery to a consumption-driven expansion. Strength in both the manufacturing and service industries led to stronger job growth and a drop in the unemployment rate during the quarter. Business and consumer spending also picked up as confidence in the recovery increased. Housing, however, remained depressed, held down by the glut of foreclosed homes on the market and weak demand. In addition, there is concern that mounting gasoline and grocery bills will erode consumer confidence and cause consumer spending to retrench. So while the economic recovery appears to be self-sustaining, some headwinds remain.

Despite historic headlines and rising commodity prices during the quarter, the overall impact on the U.S. interest rate market was not significant. In the end, although market volatility was high, interest rates rose only slightly along the yield curve. Most recently, short-end rates have come under pressure as a result of a change in the FDIC's deposit insurance fee assessment. Under the new scheme, which went into effect April 1, the FDIC will assess fees based on a bank's total assets (less equity) instead of its deposit base. This makes balance sheets expensive for FDIC insured institutions and limits their arbitrage opportunity of taking money in the overnight market and leaving it in the Fed to earn interest on excess reserves. As a result, the effective fed funds rate dropped, pushing overnight repo rates to single digits and causing short-term spreads to compress. Given that the official target range for the fed funds rate remains 0 to 0.25%, it is unlikely that this plunge in overnight rates will raise concern from Fed policy makers.

Rising commodity prices have caught the attention of the Fed and a battle between hawks and doves is starting to brew. While FOMC members agreed that recent increases in commodity prices would result in only a “transitory” increase in headline inflation, officials are split over the future path of monetary policy. A few of the more hawkish members are leaning toward reducing accommodation this year to get ahead of the curve on inflation. Dallas Fed President Richard Fisher stated that the Fed is near a “tipping point” and must now use discipline to normalize operations in a timely way to quell emerging inflationary pressures. Other members, including Chairman Bernanke, believe that inflation pressures remained subdued and economic conditions such as elevated unemployment and the depressed housing market may warrant exceptional policy accommodation beyond 2011. The increased rhetoric from both sides is setting the stage for contentious debate at the next FOMC meeting. Who will prevail, the hawks or the doves? Either way, it appears that the focus has shifted from is further accommodation necessary to when and how will accommodation be removed. Stay tuned...