

December Liquidity Market Update

Economic statistics released during the month were mostly stronger than expected with nonfarm payrolls, retail sales, industrial production and housing permits leading the way. This was reiterated in the Federal Reserve statement released mid-month which stated, "Information received since the Federal Open Market Committee (FOMC) met in November suggests that economic activity has continued to pick up and that the deterioration in the labor market is abating. The housing sector has shown some signs of improvement over recent months." Despite this positive tone, the FOMC not only kept its target rate between 0 to 25 basis points, but maintained the phrase, "likely to warrant exceptionally low level of the federal funds rate for an extended period." Fed observers will be paying careful attention to the FOMC's wording in future releases as they consider the possibility of future rate hikes.

Year end dictated much of the movement in the cash marketplace. The typical quarter-end pressure increased slightly at year end with 1- and 3-month LIBOR rates dropping slightly and 6-month LIBOR pushing down 5 basis points. The bigger change took place in the Treasury marketplace with 2-year note yields rising from 0.67% to 1.14% during the month due to the lack of supply at year end.

Despite the positive indicators mentioned, we believe that current economic conditions will prevent the Fed from hiking its federal funds target at least through the second quarter of 2010. Meanwhile, it appears that the Fed is beginning to take other steps that may affect rates. Earlier this month, the Fed formally announced a proposal for the creation of a term deposit facility to help drain reserves from the banking system. This mechanism would offer interest-bearing deposits to eligible institutions through an auction. The Fed also began testing its reverse repurchase agreement process. Both of these actions could cause rates to increase slightly, ahead of any formal rate hikes.

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