



RICHMOND CAPITAL MANAGEMENT
Experience, Knowledge, Service

First Quarter 2008

Interest Rate Trends

Quarterly Newsletter

The technical definition of recession is two consecutive quarters of negative GDP. While fourth quarter GDP was still modestly positive, a slowdown in the U.S. economy is obviously underway. Kicked off by the housing weakness of 2007 and followed by the credit crunch of 2008, our economy is now going through a period of contraction. This slowdown is a natural response to the expansion that gathered momentum over the past five years as excess liquidity first fueled growth and then speculation.

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
Lehman Aggregate	2.17%	7.67%	5.48%
Lehman Govt/Credit	2.53%	8.35%	5.55%
Lehman Int. Govt/Credit	3.00%	8.88%	5.66%

Source: Lehman Brothers

As of March 31, 2008

Economic Indicators

➤ On March 27th, final **GDP** was reported for the 4th quarter of 2007 at 0.6%. This level represented a steep drop from the 4.9% GDP growth of the 3rd quarter.

Treasury Market Yields		
	3/31/08	12/31/07
2 Year	1.58%	3.05%
5 Year	2.44%	3.44%
10 Year	3.41%	4.02%
30 Year	4.29%	4.45%

➤ **Durable Goods** orders recently surprised to the downside. The March release (February data) fell -1.7% on the heels of a 4.7% decline in the prior month. The declines were spread across many sectors and are expected to continue as business pulls back.

➤ The S&P/Case Shiller Home Price Index release came in at -10.5% (year over year) in late March. This Index is a representative measure of housing prices nationwide.

➤ The housing slump has been a large contributor to weakness in **consumer confidence**. The Michigan Survey reading was reported at 69.5 at the end of March. Meanwhile the Conference Board Survey was last at 64.5. Both indicators have declined sharply in the first quarter.

➤ The **jobs market** remains weak. Non-Farm Payroll data from early February showed a contraction of 70,000 jobs. This series has been in decline for four months now and has been in negative territory for 2 months. The Unemployment rate is 4.9% (as of February).

Commodities		
	3/31/08	12/31/07
Oil (\$ bal)	\$101.58	\$95.98
Gold (\$/oz.)	\$921.50	\$838.00
CRB Index	386.89	358.71

Spread Product (Spread to 10 Yr. Treasury)		
	3/31/08	12/31/07
10 Yr. "A" Corp	+2.30%	+1.76%
GNMA Current Coupon	+1.63%	+1.32%
10 Yr. "AA" Municipal	+0.42%	-0.30%

Inflation

The **Core PCE Deflator** has moderated at 2.0% which is within the Federal Reserve's tolerance level as of March of 2008. **Consumer Price Index (CPI)**, on the other hand, remains elevated at 4.0% YOY due to higher fuel prices, in particular gasoline and natural gas. **Core CPI**, the inflation measure which strips out the volatile food and energy prices, has also moderated at 2.3% YOY.

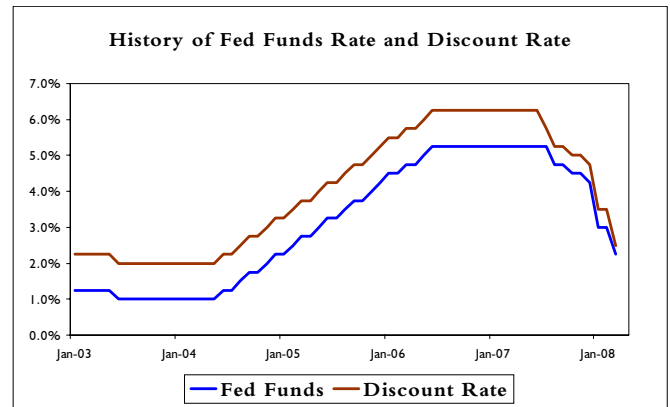
The Federal Reserve

With core inflation data moderating, the **Federal Reserve** has become aggressive in fighting a slowing domestic economy. At an unscheduled meeting on January 22, 2008 the Federal Open Market Committee (FOMC) lowered the Federal Funds rate by 0.75% to 3.5%. With the credit market showing distress signs, the FOMC lowered short term rates two more times in the quarter to 2.25%. The Fed also took several unusual actions of lowering the discount rate to 2.5% and opening the discount window to non-banks (see article on back page).

Liquidity at a Premium

The Federal Reserve has been actively lowering short term rates, dropping the Fed Funds level 3% from 5.25% to 2.25% over the past six months. In cycles past, easing rates in response to an economic slowdown has been the textbook formula to create an economic rebound. Normally, such a precipitous drop in the Fed Funds level would encourage banks and lending institutions to lower their lending rates and thus increase liquidity in the marketplace. **Recently, however, financial institutions have actually been tightening their lending standards and, although the Fed is lowering short term rates, borrowing rates for some consumers and some businesses have actually increased.** Clearly, this time around, the cycle has been different and the textbook formula was apparently not the solution.

What's different about this cycle? The sub-prime mortgage crisis is the obvious answer. Write-downs of bad loans forced many large banks and brokerage firms to raise additional capital to shore up weakened balance sheets. During the first quarter of 2008, the losses and write-downs became so widespread that investors wondered how many losses were still yet to be announced. Confidence among financial institutions was shaken, they pulled back from lending, and several over-leveraged players (most notably Bear Stearns) were forced to the brink of bankruptcy. **In response to the tightened liquidity and the realization that lowering short term rates would not resolve the problem, the Federal Reserve was forced to look at other options.**



Source: Federal Reserve

On March 11, the Federal Reserve created the \$200 billion Term Securities Lending Facility (TSLF), which allowed for term auctions of Treasuries in exchange for mortgage-backed and agency collateral. The auction was designed to allow financial institutions to exchange less liquid mortgage-backed bonds with more easily traded U.S. Treasuries on a temporary basis. With the more liquid Treasury collateral, those institutions could then borrow at lower interest rates. One week later, the Fed followed up with the announcement of the Primary Dealer Credit Facility (PDCF), which allowed primary securities dealers to directly borrow cash for up to 60 days. This was the first time that the Fed had allowed primary dealers access to overnight funding since 1932. In addition, the Federal Reserve expanded the type of collateral that would be permitted to include certain corporate bonds, municipal securities, and mortgage-backed securities. Finally, the Fed lowered the discount rate to 2.5% at the last FOMC meeting. This rate is now just 0.25% higher than the Fed Funds target (prior to September 2007, the discount rate was a full one percent higher) and should help to encourage borrowing. Already, several primary dealers have accessed the discount window, with large dealers like Goldman Sachs and Lehman Brothers noting the attractive interest rate levels available.

Chairman Ben Bernanke appears willing to look beyond textbook formulas to find solutions in a troubled marketplace. The Federal Reserve's controversial role in engineering the purchase of embattled Bear Stearns by JP Morgan further demonstrates that willingness. **Ultimately, the success of the Fed's actions will be measured when financial institutions once again lend to one another freely, interest rates to consumers and businesses fall, and consumer and business confidence is restored.**