SKIPPING STONES

by Steve Brown

A month ago you couldn't throw a stone without hitting an economist predicting the FOMC was probably done raising interest rates. Now, with a spike in inflationary data and comments from Bernanke that he finds such signs "unwelcome," everyone is convinced the battle against the inflation beast will continue to rage. As things stand now, it would be easier to find a cold drink of water in Hades than an economist saying the FOMC will not raise rates at the June meeting. In fact, 100% of Wall Street Primary Dealer economists say Fed Funds will be boosted to 5.25% in just 7 short days. Interestingly, as of the last survey taken just a few days ago, about 1 in 4 economists expect the FRB to increase rates in August to 5.50% and about 1 in 6 look for a hike to 5.75% at the September meeting. What is even more interesting is that way out on the fringes; there are even a couple of more aggressive economists, who expect the Fed Funds rate to reach a whopping 6.00% by the end of the year (which would push the Prime rate to 9.00%). The good thing about economic forecasting, however, is that there are rarely any repercussions for economists who change their opinion. As we try to digest a 9% Prime rate, let's step back a minute and see whether the Futures markets are in synch with the pundits. While we have said over and over that the illiquidity of the Fed Funds Futures markets can cause aberrations (and that Eurodollar Futures are much better), we use it here as a discussion thread. What is interesting with the Fed Funds Futures calculation is that it currently implies the probability of 25bp increase on August 8 of 78%, assuming a 25bp increase on June 29. For the June meeting, on the other hand, there is currently a 94% chance of 25bp increase and an 8% chance of a 50bp increase. We will all have to wait to see which one is right, but suffice it to say we certainly hope the end of this cycle is near. Even bankers that believe higher rates are finally starting to impact the economy and that the FRB will stop in June will still have to suffer through a 100bp to 150bp squeeze on funding costs as past rate hikes snake their way through the system. Should June (or August) mark the last rate hike, it is only a matter of time before headlines begin to spout expectations for an impending recession. History tells us the FRB will overshoot the mark and that from 6 to 12 months after the last rate increase, they will be forced to start cutting. Given a peak in interest rates of probably 5.50% to 5.75%, that means the end of 2007 will likely see short rates back down around 4.50%. Conventional wisdom holds that the 2Y Treasury yield normally will exceed Fed Funds futures by about a quarter-point when inflation is stable. With the 2Y yield hovering about 20bp over current Fed Funds rates, the data tells us investors believe the FRB will be successful at defeating inflation. As economists walk along the edge of the interest rate pond looking for good skipping stones, it will be interesting to see which ones gather up 2 more and which will pick up 3. We'll keep you informed.

BANK NEWS

Selling

SunTrust Banks has sold its 19% stake in Nuestra Tarjeta Servicios (GA) for an undisclosed sum to other investors. Nuestra is a joint venture targeting unbanked people in the Latino community.

Potential Acquisitions

Mitsubishi UFJ Financial Group, the world's largest bank by assets, said that it is considering commercial and retail bank acquisitions in the U.S. The bank, which already owns 63% of UnionBanCal is looking to increase its presence in the U.S.

Confidence

A survey by the National Association of Home Builders finds confidence reached its lowest level in nearly 11Y this past month.

Risk Guidance

The FDIC has issued guidance on "country risk" for financial institutions. The guidance includes such things as contracts with foreign-based, 3rd party service providers for technology and data processing. The guidance reiterates that financial institutions should complete thorough due diligence, write contracts to protect their interests and continually monitor the condition of each provider and the country in which it is located.

State Taxes

State tax collections have rebounded from a downturn in 2005 and saw solid growth in the 1st Qtr of 2006.

High-Net-Worth

About 3mm people are estimated to have at lease $1mm in assets, not including personal residence. This makes North America home to the highest number of high-net-worth individuals.

Outbound Emails

A recent survey finds 1-in-5 emails sent in the U.S. carries content with legal, financial, or regulatory risk. In the U.S. some 23% of firms admit confidential business information has been sent out through their servers.