

MONTHLY

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SHORT-TERM INTEREST RATES

CURRENT TOPIC

Short-Term Interest Rates

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STRATEGY

- No changes were made to strategy
- We remain underweight equity, high yield and emerging debt across portfolios

Introduction

Because interest rates are the price of borrowing and lending, they can have significant effects on economic activity. There is an array of interest rates at which borrowing and lending occurs, depending on the length and the credit quality of the borrowing.

With the recent market turmoil and the Federal Reserve's (the Fed) reductions in the discount and fed funds rates, short-term interest rates have been in the news. This *Monthly* will present an overview of the most commonly cited short-term interest rates. Figure 1 de-

scribes the four different interest rates that we discuss in this piece.

Fed-Determined Rates

The target *fed funds* rate is set by the Federal Reserve's Open Market Committee (FOMC). Through open market operations, the New York Federal Reserve ensures that the actual level of the fed funds rate is consistent with the intentions of the FOMC. Typical open market activities involve injecting or withdrawing money from the banking system through repurchase agreements or outright purchases and sales of government securities.

The Fed specifically manages the fed funds rate to meet its mandate: maximum employment, stable prices, and moderate long-term interest rates. Although the Fed sets the fed funds rate, changes to it typically produce similar changes in market-determined short-term interest rates. Figure 2 shows how closely together these interest rates have moved over time. In addition, Fed policy, as expressed in the setting of the fed funds rate, can also bring changes in areas well beyond short-term money markets. This includes longer-term bonds, credit spreads, equity prices

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Figure 1: Short-Term Interest Rates

Name	Description
Fed Funds	Set by the Federal Reserve, the federal funds interest rate is the rate banks charge each other to borrow cash overnight.
Discount Rate	Also set by the Fed, the discount rate is the interest rate charged to banks and other depository institutions for borrowing funds directly from the Federal Reserve's discount window.
LIBOR	London InterBank Offered Rate - this reference rate is set in the market daily and represents the interest rate at which high-quality banks lend to each other in London in the wholesale money market. LIBOR is widely used as a reference in a number of borrowing and lending instruments.
US Treasury Bills	Short-term obligations issued by the US government that represent the highest liquidity and credit quality. Yields on short-term US Treasuries are determined by the market and used as a reference in setting rates on adjustable rate mortgage loans and other borrowings.

SHORT-TERM INTEREST RATES - CONT'D

(Continued from page 1)

and foreign exchange rates. For example, as witnessed recently, the reduction in the fed funds rate from 5¼% to 4¾% produced a significant run-up in stock prices.

The Fed also sets the *discount rate*, the rate charged to financial institutions for short-term borrowings from the Federal Reserve's discount window. The purpose of the discount window is to provide liquidity to banks that are otherwise unable to borrow needed funds from other banks. Discount window borrowing is typically collateralized and short-term - usually overnight or a few days, but recently extended when the Fed addressed the recent credit crunch. Currently, the discount rate is set 0.5% (half a percentage point) above the fed funds rate. This higher rate does in fact impose a small penalty

for institutions that need to access this borrowing facility.

Market Rates

LIBOR (London Interbank Offered Rate) is set daily among large high-quality banks and represents the rate at which they are willing to lend to each other. More importantly, LIBOR acts as a reference interest rate to numerous financial instruments in the U.S. and around the world, with maturities lasting from overnight to as long as one year. Many business and consumer adjustable rate borrowings are set relative to the level of LIBOR. If LIBOR moves higher for example, then borrowing costs for these types of loans also move higher. As shown in Figure 2, the 1-month LIBOR rate closely tracks the fed funds rate and normally trades at a slightly higher level.

Short-term Treasuries, such

as T-bills, represent the lowest risk and highest liquidity in the debt markets. Like other short-term rates, yields on Treasuries are highly correlated with the fed funds rate (Figure 2). T-bills normally carry a lower yield than the fed funds rate because they are backed by the full faith and credit of the US government. In our last *Monthly* (September 2007), we showed that during the recent credit crunch, investors greatly preferred T-bills to other short-term instruments, driving this liquidity and quality spread abnormally wide.

Like LIBOR, short-term Treasury yields are also used as reference rates in the setting of adjustable rate loans. As an example, the 1-year Constant Maturity Treasury (CMT) is a popular index used for setting interest rates on adjustable rate mortgages.

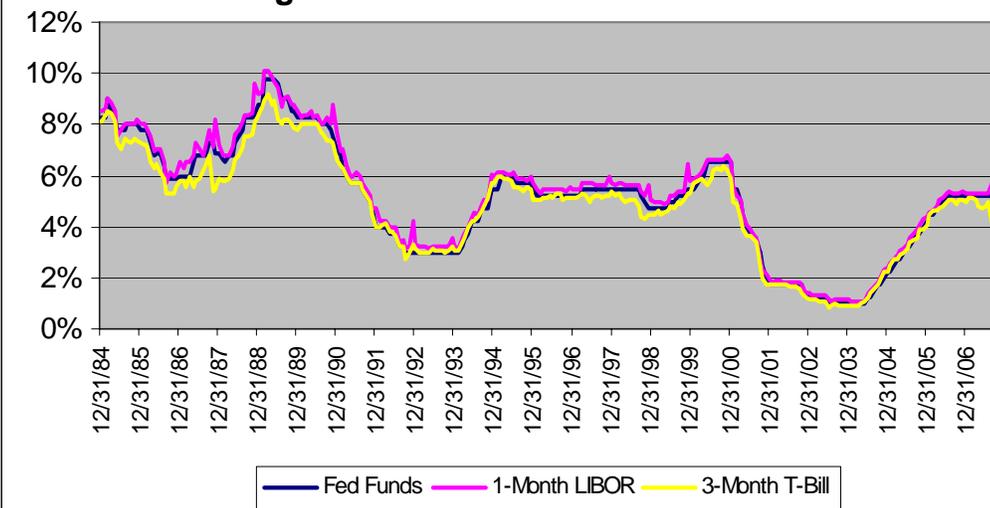
Cash Rate

At Stairway Partners, we often refer to the short-term interest rate as the cash rate. As a benchmark for client portfolios, we use the 1-month LIBOR rate because of its high quality and acceptance as a short-term borrowing and lending benchmark. We prefer not to use the 1-month T-bill because, although it is risk free, only the government can borrow at that level.

The cash rate can be thought of as having two components: a real rate of return and compensation for inflation. The real rate of return from cash should provide modest compensation over inflation. In our view, this real rate should normally be around 2%. A real cash rate that differs substantially from this level might provide information about Fed policy or the health

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Figure 2: Short-Term Interest Rates



“YIELDS ON SHORT-TERM RATES ARE HIGHLY CORRELATED”

“DURING THE RECENT CREDIT CRUNCH, INVESTORS GREATLY PREFERRED T-BILLS TO OTHER SHORT-TERM INSTRUMENTS”

Sources: Federal Reserve, Bloomberg

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

of the economy.

Fed Policy

Figure 3 shows the long-run behavior of the real fed funds rate – fed funds less inflation. Through much of the '70s, real rates were negative as the Federal Reserve kept short-term interest rates below inflation. This accommodative monetary policy reinforced the inflationary effects of the OPEC supply shock. It was not until the late '70s, and the appointment of Paul Volcker as Fed Chairman, that the Fed regained control over inflation. This was accomplished through aggressive interest

rate hikes that brought real rates into significantly positive territory.

We believe that the Fed is fully aware of past mistakes and is clear on their mandate to control inflation.

Recent Fed Move

As we saw earlier, short-term rates are highly correlated with each other. As also mentioned, by targeting the fed funds rate, the Fed has significant control over short-term borrowing costs. The recent 50 basis point reduction in the fed funds and discount rates has produced substantial relief and optimism among investors.

Our view is that this move was not prompted, as some have suggested, by a Fed desire to inflate financial assets. We believe this move was instead a result of a reappraisal of the risks of a slowing economy weighed against the potential for inflation to accelerate.

The fed funds rate of 4.75% is, in our view, indicative of a policy that is close to neutral, neither accommodative nor restrictive.

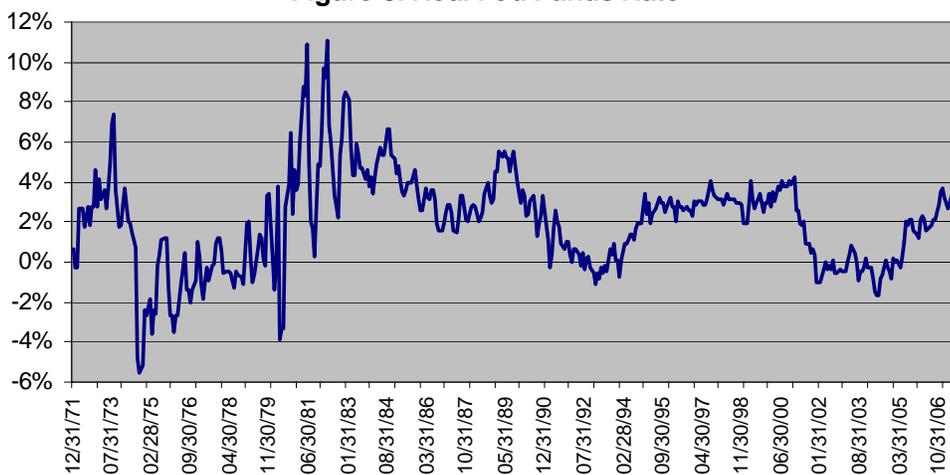
Conclusion

Over time, short-term interest rates are highly correlated to one another. The Federal Reserve, by setting the fed

funds rate, exhibits significant control over the short end of the yield curve. This in turn affects interest rates on a wide range of financial instruments.

The Fed, in determining monetary policy, must fulfill its congressional mandate of maximum employment and stable prices. Regardless of market opinion, we do not think this recent move by the Fed is an attempt to bail out unsuccessful risk takers. Although it provoked a significant positive reaction in the equity markets, we believe that the move was a response to the risk of a slowing economy.

Figure 3: Real Fed Funds Rate



Sources: Federal Reserve, Bureau of Labor Statistics, Stairway Partners

Note: The real Fed Funds rate is calculated as the yield on targeted fed funds minus core CPI inflation.

“THROUGH MUCH OF THE '70S, REAL RATES WERE NEGATIVE AS THE FEDERAL RESERVE KEPT SHORT-TERM INTEREST RATES BELOW INFLATION”

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities				
US	3.2%	8.4%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	2.2%	7.9%		
Japan	-6.7%	4.7%		
UK	6.6%	9.1%		
Emerging	-7.5%	11.4%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector is slightly expensive, particularly at longest maturities
2-Year	4.0%	4.3%		
5-Year	4.0%	4.6%		
10-Year	3.8%	4.9%		
30-Year	3.5%	5.2%		
US Municipal Bonds			neutral	Yields are attractive relative to risk
2-Year	3.5%	3.4%		
5-Year	3.7%	3.6%		
10-Year	4.1%	3.8%		
30-Year	6.7%	4.3%		
US High Yield	5.7%	6.8%	under	Despite widening, spreads over US Treasuries remain tight
Non-US Government Bonds			under	Yields in some markets too low, especially at longer maturities
Euro 10-Year	3.7%	4.7%		
Japan 10-Year	0.5%	2.0%		
UK 10-Year	4.4%	5.2%		
Emerging Markets Debt	3.2%	7.1%	under	Spreads over US Treasuries remain too tight
Cash	4.6%	---	over	Allocation comes from overpriced asset classes
Currencies				
	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-6.9%	-4.7%	-3.2%	Euro is somewhat expensive
Japanese yen	4.7%	-2.0%	5.1%	Yen is slightly attractive
UK pound	-7.1%	-0.5%	-2.7%	Pound is somewhat expensive

Notes:
As of: 9/30/2007

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.

The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).

The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.

Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.

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