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MONTHLY

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WHEN WILL CASH RATES RISE ?

Introduction

Most investors are acutely aware that cash rates are extraordinarily low. Bank deposits and money market mutual funds are effectively earning zero while 3-month certificates of deposit (CDs) offer rates that are unlikely to keep up with inflation. As a result, many savers and risk-averse investors are frustrated and asking the question, *when will cash rates rise?* A recent (October 17, 2009) cover story from Barron's titled "C'mon Ben" called for the Federal Reserve to raise rates immediately. The article states, "With the crisis clearly past, the Fed ought to boost short-term rates to a more normal 2%." As a contrast, many market participants believe that the economy is weak and fear a "double dip" recession. They would argue that zero interest rates are still appropriate and should persist until there is more evidence of a sustained economic recovery. In this *Monthly*, we provide background on cash rates and examine how a widely followed model that describes Fed policy can be a useful guide in determining the future path of cash rates.

Background

Investors hold cash in many forms – checking and savings accounts, short-term CDs, money market mutual funds, T-bills, etc. Although these investments have some unique features, their interest rates tend to follow each other very closely.

The most commonly used indicator for cash rates is the London Interbank Offered Rate (LIBOR). It represents the rate at which high quality banks are willing to lend to each other. We believe that LIBOR is heavily influenced by the Fed Funds rate which is set directly by the Federal Reserve in its implementation of monetary policy. Figure 1 shows the tight

(Continued on page 2)

CURRENT TOPIC

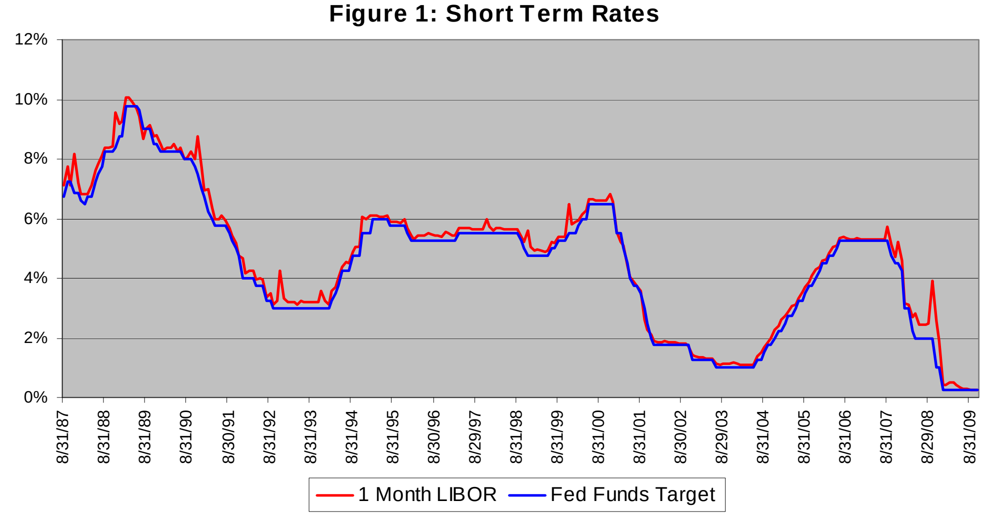
When will Cash Rates Rise?

- *Introduction*
- *Background*
- *The Fed*
- *The Taylor Rule*
- *Conclusion*

Strategy

- *We made no strategy changes during the month of October*
- *Portfolio strategies remain overweight developed equity markets and credit*

Figure 1: Short Term Rates



Sources: Federal Reserve, Bloomberg

"LIBOR IS HEAVILY INFLUENCED BY THE FED FUNDS RATE, WHICH IS SET DIRECTLY BY THE FEDERAL RESERVE"

WHEN WILL CASH RATES RISE ? - CONT'D

relationship between LIBOR and the Fed Funds rate.

From an investors point of view, cash rates usually provided a rate of return that is modestly higher than inflation. Over the last 20 years, LIBOR has average 4.75% while the consumer price index (CPI) has averaged around 2.9%. There are times, such as the recent past, where cash rates have been lower than observed inflation.

The Fed

Since the Fed Funds rate has such a profound effect on cash rates, it is important to understand how the Fed will conduct monetary policy in order to estimate the future return on cash investments. As mentioned earlier, the Fed uses the Fed Funds rate to conduct monetary policy. This is because borrowing rates have a direct effect on economic activity. In general, lower rates stimulate the economy by enticing individuals to borrow or redeem low-yielding cash investments for consumption of goods and services or to invest in long-term assets. Likewise, lower cash rates encourage companies to borrow money or reduce cash on their balance sheets to finance business expansion. Higher rates have the opposite effect, generally decreasing the incentive for investment and consumption.

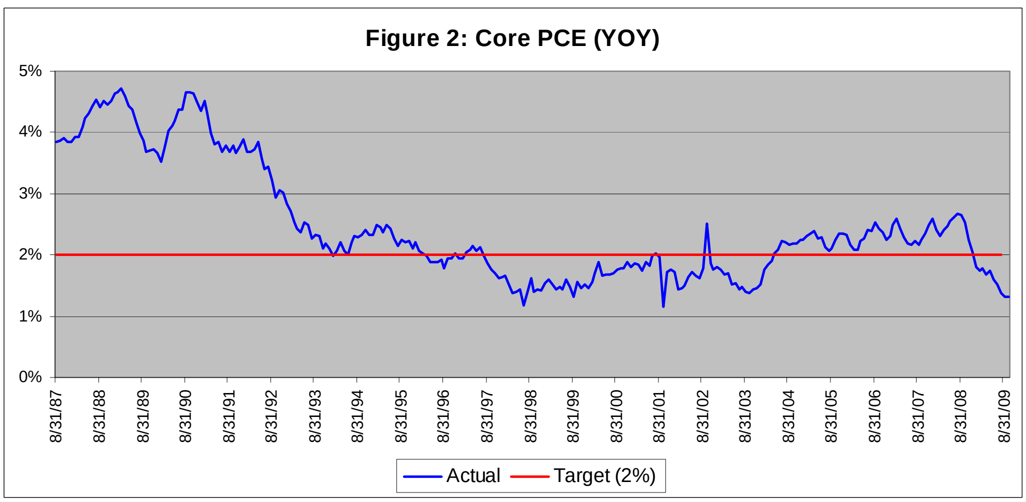
In an effort to promote transparency and market efficiency, the Fed provides investors with insight into the factors they view as important to their monetary policy objectives of maximum employment and price stability. Although financial markets attract attention in times of crisis, the bulk of the Fed's communications revolve around the condition of the US economy. As a result, it is our view that anticipating changes in the Fed Funds rate requires an understanding of how the Fed formulates policy based on economic fundamentals.

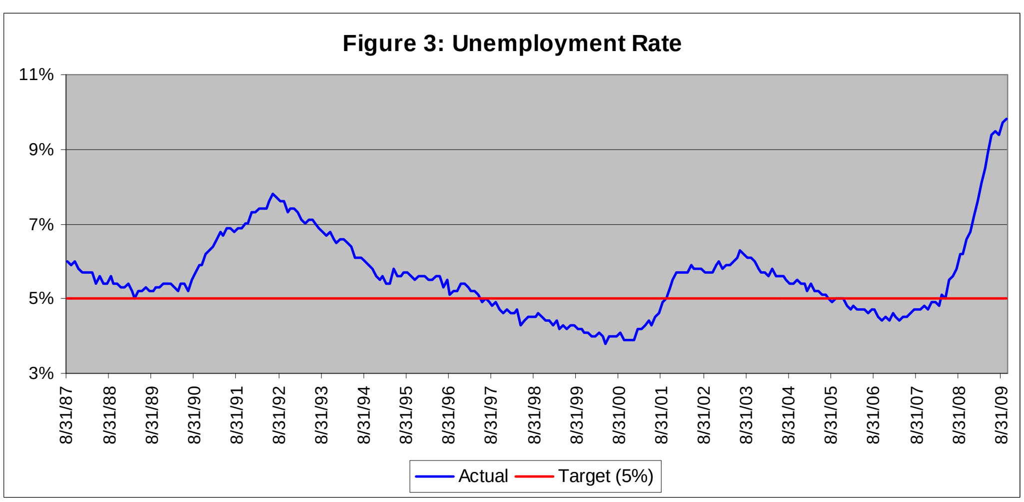
The Taylor Rule

In 1993 John Taylor, a respected economist and expert on monetary policy, proposed a relatively simple and widely accepted model to help guide policy makers at the Fed in setting the Fed Funds rate. The model is based on the idea that the Fed should set rates based on the rate of inflation and the amount of economic slack relative to predetermined targets. This model is known as the Taylor Rule. The model has done a good job of historically explaining Fed

(Continued on page 3)

"THE CURRENT STATE OF CORE PCE AND THE UNEMPLOYMENT RATE RELATIVE TO THEIR RESPECTIVE TARGETS EXPLAIN WHY WE BELIEVE THAT NEAR-ZERO RATES ARE APPROPRIATE"





Sources: Bloomberg, Stairway Partners Note: Target rates are specified by Stairway Partners

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.

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policy. This should come as no surprise because the model inputs reflect the before-mentioned policy objectives. Because of its practical nature and high explanatory power, many research efforts, including our own, have created versions of the model to better understand cash rates.

Our modified Taylor Rule model keeps the framework of the original model intact, but changes the specification to utilize more stable economic indicators and account for behavioral biases observed in past easing and tightening cycles. Figure 4 shows that historically our model has done an excellent job of tracking the historical Fed Funds rate - explaining 96% of its movement.

To produce this result, the model uses the Fed's preferred inflation measure, the Personal Consumption Expenditure Index excluding food and energy (Core PCE). Figure 2 shows Core PCE through time relative to our specified Fed target of 2%. To measure economic slack, the model utilizes the Unemployment Rate and Capacity Utilization Rate. Figure 3 shows the Unemployment Rate through time against a 5% target, which we believe is consistent with the Fed's mandate of full employment.

The current state of Core PCE and the Unemployment Rate relative to their respective targets explain why we believe that near-zero cash rates are currently appropriate. Furthermore, we believe a sustained and significant reduction in economic slack accompanied by an increase in the rate of inflation will need to occur before the Fed will raise rates.

Figure 4, in the area to the right of the dotted line, shows our estimated path of Fed Funds (red line) relative to the market implied level (green line). As you can see, the market is anticipating an increase in Fed Funds during the course of 2010. Despite our view that the economy is in recovery, our model does not predict an increase in Fed Funds until 2011.

Conclusion

Many investors are frustrated with the current level of cash rates and hope for higher returns in the near future. There are market observers who believe that it would be appropriate for the Fed to raise rates now. We believe the economy is not yet strong enough for the Fed to make this move. Our analysis concludes that, even with a sustained economic recovery, cash rates are likely to stay low for an extended period of time.

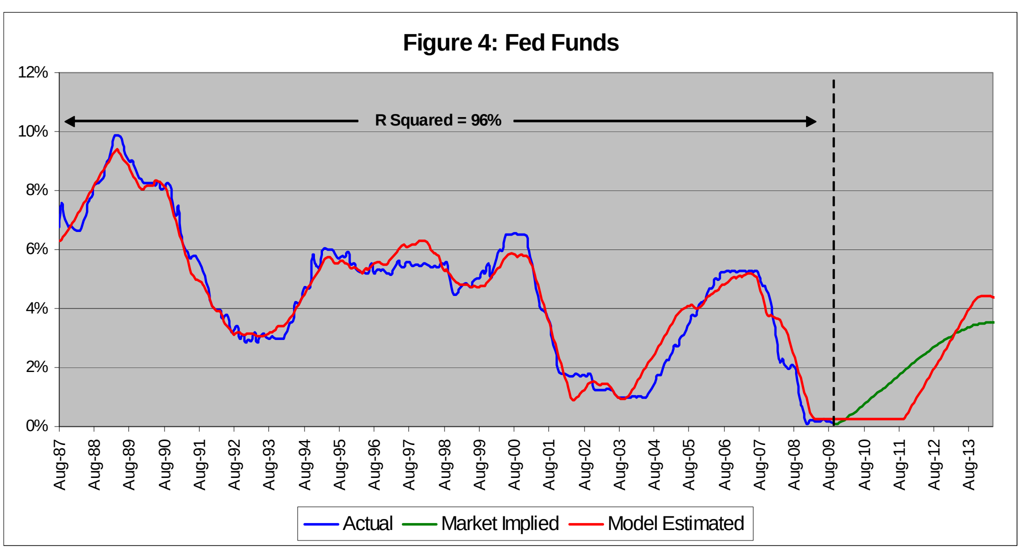

Figure 4: Fed Funds

> "Despite our view that the economy is in recovery, our model does not predict an increase in Fed Funds until 2011"

Sources: Federal Reserve, Bloomberg, Stairway Partners Note: Market Implied based on Overnight Index Swaps

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	18.4%	5.8%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive despite recent rally
Eurozone	22.3%	5.8%		
Japan	15.7%	4.4%		
UK	17.2%	32.3%		
Emerging	5.2%	10.3%	neutral	Asset class is close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors are more attractive
2-Year	0.7%	2.8%		
5-Year	0.7%	3.6%		
10-Year	1.2%	4.3%		
30-Year	0.9%	4.8%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly overpriced
2-Year	0.9%	2.2%		
5-Year	1.2%	2.8%		
10-Year	2.6%	3.5%		
30-Year	8.6%	4.5%		
US High Yield	2.2%	4.3%	over	Sector is close to fair value
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.2%	4.1%		
Japan 10-Year	-0.1%	1.9%		
UK 10-Year	1.3%	4.5%		
Emerging Markets Debt	2.7%	4.6%	under	Other asset classes offer better value
Cash	2.6%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-9.2%	13.2%	-8.0%	Euro is overpriced
Japanese yen	-3.4%	12.4%	-3.5%	Yen is moderately overpriced
UK pound	-1.4%	15.8%	-0.1%	Pound is near fair value

Notes: **As of: October 30, 2009**

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.