The Federal Reserve Board

Meeting of the Federal Open Market Committee
August 7, 2007 Presentation Materials -- Text Version

Presentation Materials (PDF)

Pages 117 to 136 of the Transcript

Appendix 1: Materials used by Mr. Dudley

Class II FOMC - Restricted FR

Page 1

Top panel
(1)

Title: Subprime 60+ Delinquency Rate by Vintage
Series: ABX 06.01, 06.02, 07.01, 07.02, and average 2000-2005 ARMs
Horizon: Loan Age from 4 to 24 months
Description: The ABX 07.02 vintage has been experiencing a sharper increase in 60+ day delinquencies earlier in the vintage as compared to past ABX vintages.

Source: Merrill Lynch, Intex

Middle panel
(2)

Title: ABX BBB- Spread by Vintage
Series: ABX BBB- 06.01, 06.02, and 07.01 vintages
Horizon: January 1, 2007 - August 3, 2007
Description: Spreads on ABX BBB- 06.01, 06.02, and 07.01 vintages have widened over the inter-meeting period.

Source: JP Morgan

Bottom panel
(3)

Title: ABX Spreads for ABX 07-01 by Rating
Series: ABX 07.01 AAA, AA, A, BBB, and BBB- tranches
Horizon: January 1, 2007 - August 3, 2007
Description: The spreads of all tranches of the ABX 07.01 vintage widened over the inter-meeting period.

Source: JP Morgan

Page 2

Top panel
(4)

Title: U.S. Corporate Debt Spreads Widen
Series: High-Yield and Investment Grade option adjusted spreads
Horizon: January 1, 2007 - August 3, 2007
Description: High-yield and investment grade option adjusted spreads have widened since the beginning of June 2007.

Source: Bloomberg

Middle panel
(5)

Title: Global Credit Default Swap Spreads Widen
Series: High-Yield On-the Run CDX, ITRAXX Crossover Series 7, and LCDX Spreads
Horizon: January 1, 2007 - August 3, 2007
Description: Since mid-June, spreads on high-yield CDX, ITRAXX, and LCDX have widened sharply.

Source: Bloomberg

Bottom panel
(6)

Title: U.S. Corporate Default Rates Near Lows
Series: Corporate Default Rates for all U.S. Corporations and U.S Speculative Grade Corporations
Horizon: January 1970 - July 2007
Description: Despite declining credit conditions, U.S. corporate default rates are near historical lows.

Source: Moody's

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Top panel
(7)

Title: 2007 Earning Expectations are Rising
Series: S&P 500 Bottom-Up Equity Analyst Estimates
Horizon: January 1, 2007 - July 27, 2007
Description: Bottom-up S&P 2007 earnings estimates have been increasing since the beginning of May 2007.

Source: Thompson Financial

Middle panel
(8) A Typical Capital Structure for a Cash CLO

Class	*Size (%)*	*Rating*

Class	*Size (%)*	*Rating*
Class A	68	AAA
Class B	7	AA
Class C	7	A
Class D	5	BBB
Class E	4	BB
Equity	9	NR

Source: Barclays Capital

Bottom panel
(9)

Title: CLO and CDO Issuance Declines
Series: CLO and CDO Issuance Volume by Month
Horizon: July 2006 - July 2007*
Description: As demand for CLOs and CDOs has declined due to recent credit problems, issuance of these securities has also declined.

* Only includes issuance until late July Return to text

Source: Lehman Brothers and Merrill Lynch

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Top panel
(10)

Title: U.S. Equity Markets Decline Sharply
Series: S&P 500 index, Nasdaq index, and Russell 2000 index
Horizon: January 1, 2007 - August 3, 2007
Description: With recent credit conditions, U.S. equity markets have declined sharply.

Source: Bloomberg

Middle panel
(11)

Title: CDS Spreads Widen
Series: Average CDS Spreads for Mortgage Insurers, Financial Guarantors, Large Commercial Banks, and Broker Dealers
Horizon: January 1, 2005 - August 3, 2007
Description: Average CDS spreads on Mortgage Insurers, Financial Guarantors, Large Commercial Banks, and Broker Dealers widen sharply as conditions in the mortgage market continue to deteriorate.

Source: Markit

Top panel
(12) Correlation of Daily Price/Yield Changes

July 9, 2007 - August 2, 2007
Blue boxes denote correlations greater than 0.50 or less than -0.50

Variables	2YR Yield	10YR Yield	S&P	USD/JPY	Swap Spreads	VIX	CDX IG	Merrill-HY
2YR Yield								
10YR Yield	0.95							
S&P	0.75	0.69						
USD/JPY	0.85	0.86	0.74					
Swap Spreads	-0.82	-0.70	-0.84	-0.72				
VIX	-0.72	-0.70	-0.89	-0.72	0.79			
CDX IG	0.43	0.31	0.69	0.48	-0.63	-0.65		
Merrill-HY	-0.85	-0.75	-0.74	-0.74	0.82	0.71	-0.40	

Source: Bloomberg and JP Morgan

Middle panel
(13) Correlation of Daily Price/Yield Changes

February 27, 2007 - March 20, 2007
Blue boxes denote correlations greater than 0.50 or less than -0.50

Variables	2YR Yield	10YR Yield	S&P	USD/JPY	Swap Spreads	VIX	CDX IG	Merrill-HY
2YR Yield								
10YR Yield	0.97							
S&P	0.84	0.76						
USD/JPY	0.90	0.84	0.88					
Swap Spreads	-0.68	-0.62	-0.77	-0.68				
VIX	-0.86	-0.79	-0.97	-0.84	0.79			
CDX IG	0.81	0.74	0.89	0.88	-0.71	-0.91		
Merrill-HY	-0.88	-0.81	-0.82	-0.85	0.70	0.81	-0.78	

Source: Bloomberg and JP Morgan

Bottom panel
(14) Correlation of Daily Price/Yield Changes

March 21, 2007 - July 6, 2007
Blue boxes denote correlations greater than 0.50 or less than -0.50

Variables	2YR	10YR	S&P	USD/JPY	Swap	VIX	CDX IG	Merrill-HY

	Yield	Yield			Spreads			
2YR Yield								
10YR Yield	0.85							
S&P	-0.04	-0.23						
USD/JPY	0.33	0.19	0.34					
Swap Spreads	0.30	0.48	-0.43	-0.07				
VIX	0.01	0.14	-0.81	-0.27	0.44			
CDX IG	-0.10	-0.16	0.57	0.14	-0.37	-0.46		
Merrill-HY	-0.60	-0.62	0.01	-0.36	-0.08	-0.02	-0.12	

Source: Bloomberg and JP Morgan

Page 6

Top panel
(15)

Title: Implied Volatility Has Increased in Recent Weeks
Series: MOVE index, VIX index, SMOVE 1-Month index, 1-Month Euro-Dollar Volatility index, and 1-Month Dollar-Yen Volatility index
Horizon: January 1, 2007 - August 3, 2007
Description: During the inter-meeting period, implied volatility across asset classes has increased in recent weeks except for the Euro-dollar currency pair.

Source: Bloomberg

Middle panel
(16)

Title: Eurodollar Futures Curve Shifts Lower
Series: Eurodollar futures curve as of 5/8/2007, 6/27/2007, and 8/3/2007
Horizon: May 8, 2007 - August 3, 2007
Description: As of 8/3/2007, Eurodollar futures contracts show that there are increased expectations for a rate cut by the end of 2008 similar to expectations before the May FOMC meeting.

Source: Bloomberg

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Top panel
(17)

Title: Distribution of Expected Policy Target Among Primary Dealers Prior to June 28 FOMC Meeting
Series: Dealer expectations for policy target rate by quarter, average forecast for policy target by

quarter, and market rate for policy expectation by quarter as of 6/18/2007
Horizon: Q3 2007 - Q4 2008
Description: There is more dispersion regarding where dealers expect the policy rate to be in Q4 2008. Dealers on average expect lower rates than what is currently priced into Eurodollar futures.

Source: Dealer Policy Survey

Middle panel
(18)

Title: Distribution of Expected Policy Target Among Primary Dealers Prior to August 7 FOMC Meeting
Series: Dealer expectations for policy target rate by quarter, average forecast for policy target by quarter, and market rate for policy expectation by quarter as of 6/18/2007
Horizon: Q3 2007 - Q4 2008
Description: Compared to the June policy survey, there is less dispersion of policy rate expectation for Q4 2008. Dealers on average expect higher rates than what is currently priced into Eurodollar futures.

Source: Dealer Policy Survey

Bottom panel
(19)

Title: Probability Distribution on Eurodollar Futures Contract
Series: Probability Distribution on Eurodollar Futures Contract as of 6/29/2007 and 8/3/2007
Horizon: June 29, 2007 - August 3, 2007
Description: Since the June FOMC meeting, the probability of policy rate increase has declined significantly.

Source: CME Option

APPENDIX: Reference Exhibits

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Top panel
(20)

Title: Treasury Yield Curve Shifts Lower and Steepens
Series: Constant maturity Treasury yield curve as of 5/8/2007, 6/27/2007, and 8/3/2007
Horizon: May 8, 2007 - August 8, 2007
Description: The Treasury yield curve has shifted lower and steepened since the last FOMC meetings.

Source: Bloomberg

Middle panel
(21)

Title: 10-Year Treasury Inflation Protected and Nominal Treasury Yields
Series: 10-Year Nominal Treasury yield and 10-Year inflation protected Treasury yield
Horizon: January 1, 2007 - August 3, 2007

Description: Both nominal and inflation protected Treasury yields have declined since the last FOMC meeting.

Source: Bloomberg

Bottom panel
(22)

Title: TIPS Inflation Compensation: 5-10 Year Horizon
Series: 5-10 Year Horizon TIPS inflation compensation
Horizon: June 1, 2006 - August 3, 2007
Description: TIPS inflation compensation over a 5-10 year horizon has decreased since mid-June.

Source: Federal Reserve Board

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Top panel
(23)

Title: Dollar Weakens
Series: Yen vs. USD, Euro vs. USD
Horizon: January 1, 2007 - August 3, 2007
Description: Since mid-June the U.S. dollar has softened against the Euro and Japanese Yen.

Source: Bloomberg

Middle panel
(24)

Title: September 2008 Eurodollar, Euribor, and Euroyen Interest Rate Futures Contracts
Series: Eurodollar-Euribor and Eurodollar-Euroyen Contract Spreads
Horizon: January 1, 2007 - August 3, 2007
Description: Spread between September 2008 Eurodollar-Euribor and Eurodollar-Euroyen contracts have narrowed since the June FOMC meeting.

Source: Bloomberg

Bottom panel
(25)

Title: Trade-Weighted Dollar Weakens
Series: Trade-Weighted Dollar Indices: USTW$ and DXY index
Horizon: January 1, 2000 - August 3, 2007
Description: Since the beginning of 2000, the U.S. dollar has weakened against other currencies.

Source: Bloomberg

Appendix 2: Materials used by Mr. Madigan

Material for **FOMC Briefing on Trial-Run Projections**
Brian Madigan

August 7, 2007

Class I FOMC - Restricted Controlled (FR)

Exhibit 1
August Trial Run Projections

Top panel
Central Tendencies

		2007:H2	2007 [1]	2008	2009
1.	GDP Growth	**2.0 to 2.7**	**2.0 to 2.3**	**2.2 to 2.7**	**2.4 to 2.7**
2.	(June)		2.2 to 2.5	2.5 to 2.8	2.6 to 3.0
3.	Unemployment Rate (Q4)	**4.6 to 4.7**		**4.6 to 4.8**	**4.7 to 5.0**
4.	(June)	4.6 to 4.7		4.7 to 4.8	4.7 to 5.0
5.	Core PCE Inflation	**1.9 to 2.1**	**1.9 to 2.0**	**1.8 to 2.0**	**1.6 to 1.9**
6.	(June)		2.0 to 2.2	1.8 to 2.0	1.6 to 2.0
7.	Total PCE Inflation	**2.0 to 2.9**	**3.0 to 3.4**	**1.8 to 2.1**	**1.6 to 2.0**

[1] August figures for 2007 are averages of published data for 2007: H1 and central tendency of projections. Return to table

Middle panel
Ranges

		2007:H2	2007 [1]	2008	2009
1.	GDP Growth	**1.8 to 3.0**	**1.9 to 2.5**	**1.9 to 2.8**	**2.0 to 3.1**
2.	(June)		2.0 to 2.7	2.5 to 3.0	2.0 to 3.1
3.	Unemployment Rate (Q4)	**4.5 to 4.8**		**4.5 to 4.9**	**4.4 to 5.2**
4.	(June)	4.6 to 4.8		4.5 to 5.0	4.4 to 5.1
5.	Core PCE Inflation	**1.9 to 2.2**	**1.9 to 2.1**	**1.7 to 2.1**	**1.5 to 2.0**
6.	(June)		1.9 to 2.2	1.7 to 2.1	1.5 to 2.0
7.	Total PCE Inflation	**1.9 to 3.1**	**2.9 to 3.5**	**1.7 to 2.4**	**1.5 to 2.2**

[1] August figures for 2007 are averages of published data for 2007: H1 and central tendency of projections. Return to table

Bottom panel
Appropriate Path of Federal Funds Differs From Greenbook?

YES	NO
5	12

Exhibit 2
Uncertainty and Risks

Top panels
Real GDP

Top-left panel
Uncertainty

Number of participants

	Lower	Broadly similar	Higher
June	1	13	2
August	0	11	6

Top-right panel
Risk Weighting

Number of participants

	Downside	Balanced	Upside
June	4	12	0
August	7	10	0

Middle panels
Core PCE Inflation

Middle-left panel
Uncertainty

Number of participants

	Lower	Broadly similar	Higher
June	2	14	0
August	1	14	2

Middle-right panel
Risk Weighting

Number of participants

	Downside	Balanced	Upside
June	0	9	7
August	0	11	6

Bottom panels
Total PCE Inflation

Bottom-left panel
Uncertainty

Number of participants

	Lower	Broadly similar	Higher
August	1	12	4

Bottom-right panel
Risk Weighting

Number of participants

	Downside	Balanced	Upside
August	0	9	8

Appendix 3: Materials used by Mr. Madigan

Material for **FOMC Briefing on Monetary Policy Alternatives**
Brian Madigan
August 7, 2007

Class I FOMC - Restricted Controlled (FR)

Exhibit 1
Recent Financial Market Developments

Top panel

- Credit market conditions have deteriorated sharply
- Actual and implied volatilities have jumped
- Market participants much more cautious about credit exposures
- Originations of nonprime and jumbo mortgages and leveraged loans down steeply
- Secondary market for nonagency mortgage securities illiquid
- Increased focus on risks in asset-backed commercial paper market
- Large increases in CDS spreads for some institutions
- A few financial institutions experiencing funding difficulties
- But core financial markets generally functioning well

Exhibit 2
Monetary Policy Alternatives

Top panels
Alternative A: 25 bp easing, balanced risks

Top-left panel
Rationale

- Increased risk of weakness in aggregate demand
  - Tighter credit conditions

- Recent soft spending indicators
- More optimistic than staff about potential growth
- More optimistic than staff about NAIRU
- Subdued inflation readings

Top-right panel
Equilibrium real rates*

A line chart shows the real federal funds rate and the ranges of model-based point estimates of its equilibrium value, along with 70 and 90 percent confidence intervals since 1990. The Greenbook-consistent equilibrium real federal funds rate is also shown, going back only to 1997. The actual real federal funds rate declined in the early 1990s, rose to around 4 percent in the mid 1990s and then fell sharply in 2001 and reached a trough of -1 percent in 2004. The actual real federal funds rate has climbed back to to 3.3 percent today. It now lies above the range of model-based estimates of its equilibrium value (1.8 to 2.4 percent), though still within the 70 percent confidence interval (0.8 to 3.8 percent). The actual real federal funds rate and Greenbook-consistent measure are now identical.

* Explanatory notes are provided in appendix A of the Bluebook. Return to text

Bottom panels
Alternative C: 25 bp firming, upside risks to inflation predominant

Bottom-left panel
Rationale

- Concur with Greenbook forecast
  - See at most modest restraint from financial developments
- But dissatisfied with the inflation outcome
- And concerned about risk that inflation could be higher

Bottom-right panel
Optimal Policy: \pi^*=1.5%

Three line charts. The first shows the optimal monetary policy simulation for the federal funds rate with a long-run inflation target of 1-1/2 percent. The other two show the corresponding values of the unemployment rate and core PCE inflation rate, respectively. In all cases, the trajectories are shown for the current and previous Bluebooks, from 2007 through 2012. The trajectories in the current and previous Bluebooks are close. The federal funds rate rises to about 6 percent next year, before falling to below 4 percent at the end of 2012. The unemployment rate rises over the next three years to 5.2 percent and then flattens out at that level. Core PCE inflation, which dropped at the start of this year, falls very slowly to 1.6 percent at the end of 2012.

Exhibit 3

Alternative B: Unchanged policy stance, upside risks to inflation predominant

Top-left panel
Rationale

- Staff forecast seen as best modal projection and an acceptable outcome
- Consistent with staff forecast and \pi^*=2
- Consistent with Committee's past behavior

    - Outcome-based rule
    - Forecast-based rule
- Viewed as a suitable weighting of risks to growth and inflation

Top-right panel
Optimal Policy: \pi^*=2%

Three line charts. The first shows the optimal monetary policy simulation for the federal funds rate with a long-run inflation target of 2 percent. The other two show the corresponding values of the unemployment rate and core PCE inflation rate, respectively. In all cases, the trajectories are shown for the current and previous Bluebooks, from 2007 through 2012. The trajectories in the current and previous Bluebooks are close. The federal funds rate remains flat for the next two years, before falling to a bit above 4 percent at the end of 2012. The unemployment rate rises gradually to 5.1 percent. Core PCE inflation, which dropped at the start of this year, remains around its target value of 2 percent through the end of 2012.

Bottom panel
Statement language (revised)

The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5-1/4 percent.

Economic growth was moderate during the first half of the year. Financial markets have been volatile in recent weeks, credit conditions have become tighter for some households and businesses, and the housing correction is ongoing. Nevertheless, the economy seems likely to continue to expand at a moderate pace over coming quarters, supported by solid growth in employment and incomes and a robust global economy.

Readings on core inflation have been relatively subdued in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures.

Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the outlook for both inflation and economic growth, as implied by incoming information.

Table 1:
Alternative Language for the August 2007 FOMC Announcement

Revised: August 6, 2007
[Note: In Appendix 3, Table 1, strong emphasis (bold) has been added to indicate red text in the original document.]

	June FOMC	Alternative A	Alternative B	Alternative C
Policy Decision	1. The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5¼ percent.	The Federal Open Market Committee decided today to lower its target for the federal funds rate 25 basis points to 5 percent.	The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5¼ percent.	The Federal Open Market Committee decided today to raise its target for the federal funds rate 25 basis points to 5½ percent.
Rationale	2. Economic growth appears to have been moderate during the first half of this year,	Overall economic activity seems likely to continue to expand at a moderate pace	Economic growth was moderate during the first half of **the** year. **Financial**	Economic growth picked up in the second quarter. The economy seems likely to

	June FOMC	Alternative A	Alternative B	Alternative C
	despite the ongoing adjustment in the housing sector. The economy seems likely to continue to expand at a moderate pace over coming quarters.	over coming quarters. However, increased weakness in the housing sector, along with reduced availability and higher cost of credit to some households and businesses, has raised the risk that economic activity might grow less than anticipated.	**markets have been volatile in recent weeks**, credit conditions have become tighter for some households and businesses, **and the housing correction is ongoing. Nevertheless**, the economy seems likely to continue to expand at a moderate pace over coming quarters, **supported by solid growth in employment and incomes and a robust global economy.**	expand at a moderate pace over coming quarters despite the ongoing adjustment in the housing sector.
	3. Readings on core inflation have improved modestly in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures.	Readings on core inflation have been relatively subdued in recent months and core inflation is expected to be moderate over coming quarters. However, the high level of resource utilization has the potential to sustain inflation pressures.	Readings on core inflation have been relatively subdued in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures.	Readings on core inflation have been relatively subdued in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Overall inflation has been elevated, boosted by increases in the prices of energy and other commodities. The high level of resource utilization has the potential to sustain inflation pressures.
Assessment of Risk	4. In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.	After this action, the Committee judges that the downside risk to economic growth is roughly balanced by the upside risk to inflation. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.	**Although the downside risks to growth have increased somewhat**, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the outlook for both inflation and economic growth, as implied by incoming information.	Even after this action, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

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