The Fed’s tone becomes even more dovish

ACCORDING TO THE FEDERAL RESERVE (Fed)

• The Committee will maintain the target range for the federal
funds rate at 0 to 1/4 percent.
• The pace of recovery in output and employment has slowed
in recent months. The pace of economic recovery is likely to
be more modest in the near term than had been anticipated.
• Measures of underlying inflation have trended lower in recent
quarters and, with substantial resource slack continuing to
restrain cost pressures and longer-term inflation expectations
stable, inflation is likely to be subdued for some time.
• To help support the economic recovery in a context of price
stability, the Committee will keep constant the Federal
Reserve’s holdings of securities at their current level by
reinvesting principal payments from agency debt and agency
mortgage-backed securities in longer-term Treasury
securities.
• The Committee continues to anticipate that economic
conditions are likely to warrant exceptionally low levels of
the federal funds rate for an extended period. Kansas City
Fed President Thomas Hoenig continues to oppose this
statement and the reinvesting of maturing securities.

COMMENTS

The Fed responded to the markets’ expectations by signalling
that it wanted to maintain its support for the American
economy’s recovery. Given that the financial strains
stemming from the problems in the euro zone have eased, it
dropped the statement that “financial conditions have become
less supportive of economic growth.” Despite this, it is
showing more concern about the American economy,
deeming that the recovery will be more modest in the near
term.

Signs that the American economy is flagging convinced the
Fed that it was too early to cut back on its support measures.
It therefore announced that it would maintain its holdings of
long-term securities by reinvesting amounts from maturing
securities into Treasuries. The value of the Fed’s security
holdings will remain around US$2,054B until further notice.
The proportion of federal securities in this amount will
gradually increase as agency securities (including mortgage-
backed securities) mature. In taking this action, the Fed is
not expanding its quantitative measures, but it is preventing
them from unwinding automatically, which would have
prompted some firming in monetary conditions.

The latest economic statistics have confirmed that the
American economy’s growth moderated last spring, as
quarterly annualized real GDP growth went from 3.7% in
the first quarter of 2010 to 2.4% in the second quarter. Even
if we exclude the census effect, the job market has also been
slowing substantially in the last few months. Although
everything points to moderating growth in the second half
of the year, it is still too early, in our opinion, to anticipate a
comeback of the recession. The leading indexes are still well
above levels that signal economic contraction and the
composition of the national accounts for the second quarter
shows an impressive surge by business investment and
imports, reflecting some vitality in U.S. domestic demand.
The high jobless rate and moderate economic growth will
substantially subdue inflation pressures, but, in our opinion,
the fears of Japanese-style deflation that some analysts are
expressing are exaggerated.

Implications: The Fed is showing more concern about the
American economy’s problems. For now, it does not seem
to be anticipating a double-dip recession or deflation, but
has opted to make a symbolic gesture to reassure the markets.
If the situation were to become really critical, the Fed will
not hesitate to take more aggressive action. Today’s statement
also signals that the key rate will stay at this low level for a
long time.

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EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE

“Information received since the Federal Open Market Committee met in June indicates that the pace of recovery in output and employment has slowed in recent months. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls. Housing starts remain at a depressed level. Bank lending has continued to contract. Nonetheless, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be more modest in the near term than had been anticipated [...] Measures of underlying inflation have trended lower in recent quarters and, with substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time [...] The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period [...] To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve’s holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities [...] The Committee will continue to roll over the Federal Reserve’s holdings of Treasury securities as they mature [...] The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability [...].”

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<tr>
<th>Date</th>
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| July 2010  |                        |          |       |
| 1          | Bank of Sweden          | +25 b.p. | 0.50 |
| 6          | Reserve Bank of Australia | s.q.  | 4.50 |
| 8          | European Central Bank   | s.q.     | 1.00 |
| 8          | Bank of England         | s.q.     | 0.50 |
| 14         | Bank of Japan           | s.q.     | 0.10 |
| 16         | Bank of Mexico          | s.q.     | 4.50 |
| 20         | Bank of Canada          | +25 b.p. | 0.75 |
| 21         | Bank of Brazil          | +50 b.p. | 10.75|
| 28         | Reserve Bank of New Zealand | +25 b.p. | 3.00 |

| August 2010|                        |          |       |
| 3          | Reserve Bank of Australia | s.q.  | 4.50 |
| 5          | European Central Bank   | s.q.     | 1.00 |
| 5          | Bank of England         | s.q.     | 0.50 |
| 9          | Bank of Japan           | s.q.     | 0.10 |
| 10         | Federal Reserve         | s.q.     | 0.00 / 0.25 |

s.q.: status quo; b.p.: basis points
Source: Desjardins, Economic Studies