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Market Facts

Second Comparative Assessment Of August 5th FOMC Meeting

By Howard L. Simons (847) 304-1511

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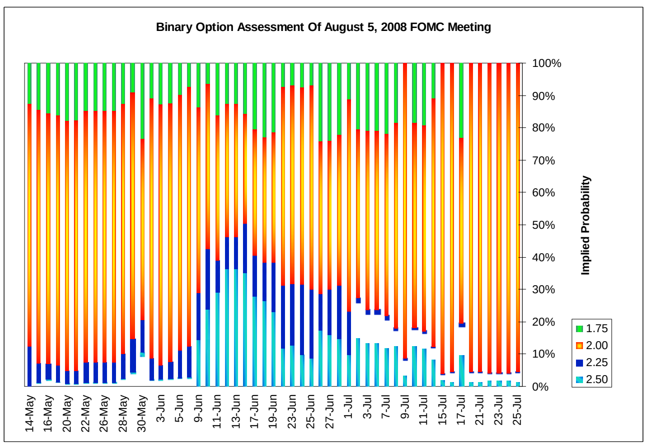
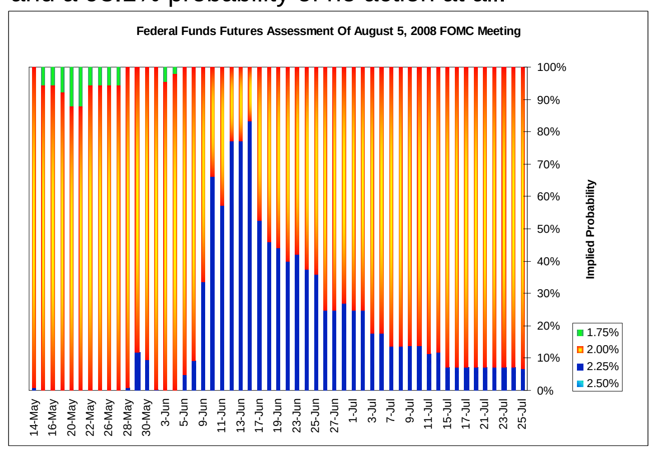
The binary options market (left-hand chart) now is pricing in a 3.2% probability of a 25 bp rate hike, a 1.4% probability of a 50 bp rate hike and a 95.4% probability of no action at all.



The federal funds futures market (right-hand chart), which settles to the average effective rate and not the target rate, continues what has been a binary outcome. Here there is a 6.95% probability of a 25 bp rate hike and a 93.1% probability of no action at all.



Conclusion

Good traders learn eventually not having a position is a position. In a market where risk levels are elevated and there is a natural and unavoidable exposure, this can be the riskiest position of all.

This is where we find ourselves as we approach the one-year anniversary of the August 2007 FOMC meeting whose carefully scrutinized statement assured us the credit crisis was contained, no rate cuts would be forthcoming and no moral hazards would be created by bailing out wayward banks.

The European Central Bank caved first. On August 9, 2007, it injected €94.8 billion into the banking system to backstop BNP Paribas investment funds. The Federal Reserve cut rates 50 basis points before the stock market's opening on August 17, 2007, and the cycle of central banks and finance ministries undertaking extraordinary actions continues to this day.

We asked rhetorically in our most recent entry in this series whether the Federal Reserve had a clear policy and some sense of the outcomes likely to result from those policies. The answer is "No" to both questions.

If so – and we challenge anyone to prove us wrong – the prospect of no action is unsettling. For the Federal Reserve to remain "on hold" because no actions are indicated is one thing; for the Federal Reserve to remain on hold because they are lurching from one crisis to the next without a plan and need to satisfy their conflicting mandates is another thing altogether.

They will remain on hold because they fear whatever action they undertake will be wrong. It is quite simply human nature and an observation of behavioral finance mistakes of omission are preferable to mistakes of commission. They are not.

We arrived at this point as the logical and inevitable result of Congress placing the Federal Reserve out of the bounds of normal political accountability in 1913. An extra-political body unable to satisfy the increasingly impossible demands placed upon it has no place in either a democratic republic or, for that matter, in a monotheistic culture.

Cato ended every address to the Roman senate, "*Ceterum censeo Carthaginem esse delendam*" (Furthermore, it is my opinion Carthage must be destroyed). What would he say about modern central banking?

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511
Fax (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599
James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Ryan Malo rmalo@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 606-1872
Fritz Handler fritz.handler@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595

e-mail inforequest@arborresearch.com
http://www.arborresearch.com

Domestic - For more information about Arbor Research & Trading and its services:

New York Sales Office

The Chrysler Building, 405 Lexington Ave
New York, NY 10174
Edward T. McElwreath ed.mcelwreath@arborresearch.com
Phone (212) 867-5326 Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office

4 Broadgate, 2nd Floor, Room 57
London England EC2M 2QY
Phone 44-207-965-4784 Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com

European Sales

James L. Perry james.perry@arborresearch.com
Phone (847) 756-3510 Fax (847) 304-1595
Rich Kleinbauer rich.kleinbauer@arborresearch.com
Phone (41) 22 363-9229

Far East Sales

Robert Reynolds robert.reynolds@arborresearch.com
Phone (847) 756-3680 Fax (435) 647-3073