

Economic Research – Scott J. Brown, Ph.D.

Friday, March 9, 2007

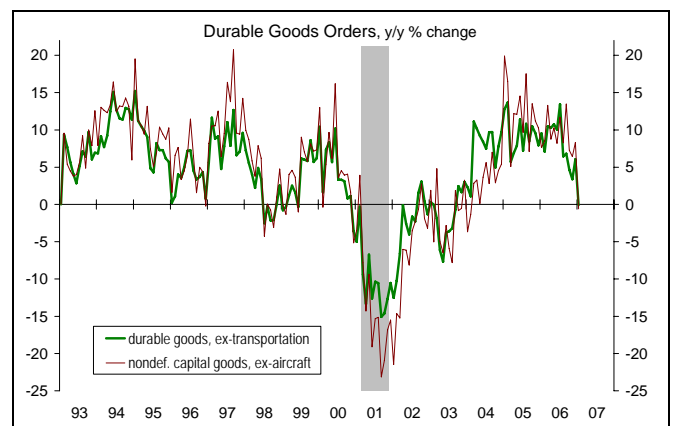
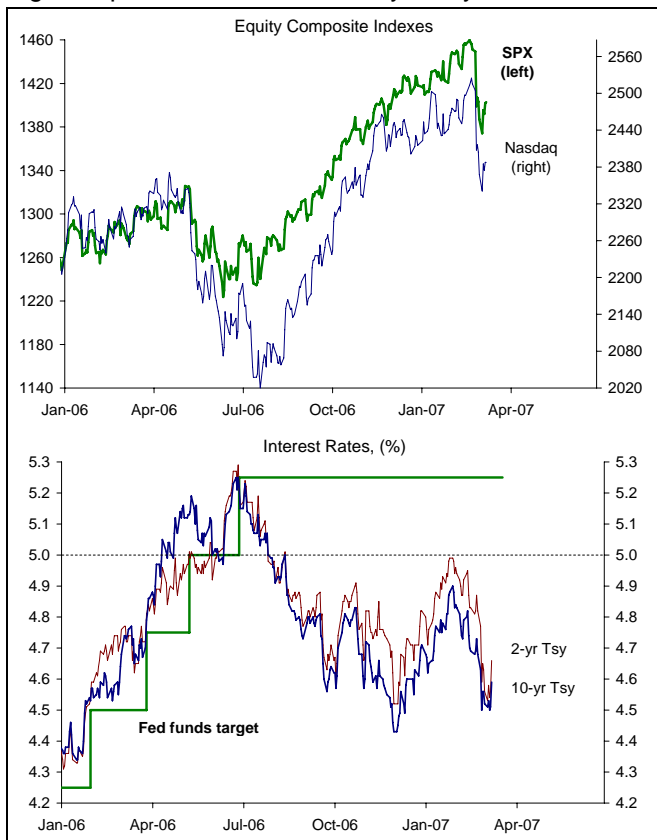
Misplaced Worries

- *Global concerns appeared to be a factor behind the recent stock market correction, but worries appear largely misplaced or overemphasized.*
- *Economic data have continued to suggest mixed but moderate growth. However, weak business spending and slower productivity growth bear watching.*
- *Fed officials are likely to still see higher inflation as “the predominant risk,” but monetary policy is likely to be unchanged over the next several months.*

A sharp drop in China’s stock market appeared to be a catalyst sending U.S. equities lower in February. In addition, fears about disruptions to the global funding of the U.S. trade deficit intensified on rumors of a more rapid unwinding of the yen-carry trade. Market fears weren’t entirely global. Renewed worries about the U.S. economy were also a factor, as the financial market began to price in a Fed rate cut by mid-year.

The yen-carry trade (borrowing cheaply in yen and investing for higher returns abroad) is thought to have been a significant force in global liquidity in the last several years. A year ago, the Bank of Japan signaled that short-term interest rates would be raised gradually, signaling the beginning of the end of the yen-carry trade. However, the pace has been almost glacial (the BOJ hiked in July and February). The biggest risk for the yen-carry trade is not interest rates, but exchange rates (although interest rates do affect exchange rates). A significant rally in the yen can quickly make these trades unprofitable. However, the Japanese authorities are unlikely to let the yen move too fast too soon.

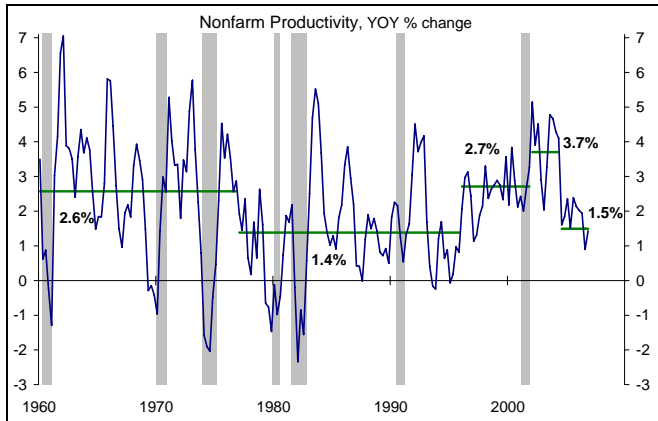
In the U.S., investors continue to worry about an “overburdened” consumer, a negative savings rate, a more substantial housing market correction, and problems in subprime lending. However, consumer fundamentals remain in good shape, with robust growth in jobs and wage income. Debt service burdens remain generally manageable. The negative savings rate is largely an artifact of its construction (savings is calculated as the residual of income less taxes and consumer spending). Capital gains do not count as income, but are spent – making the personal savings rate appear low (yet, admittedly, there is substantial evidence that many households do not save enough). Housing is showing some signs of stabilization, although there appears to be more downside ahead for residential homebuilding. Subprime lending woes are a devastating concern for subprime lenders (what a surprise, huh?) and those holding these mortgages. However, the rest of the mortgage market is in fine shape.



The Chinese market rose sharply over the last year – so a retreat isn’t much of a surprise. Even still, capital controls should limit the contagion across markets. Among other efforts, Chinese authorities have raised bank reserve requirement ratios to reduce “excessive” borrowing and slow the economy down. However, the goal is to achieve 8% to 10% growth (vs. 11%+).

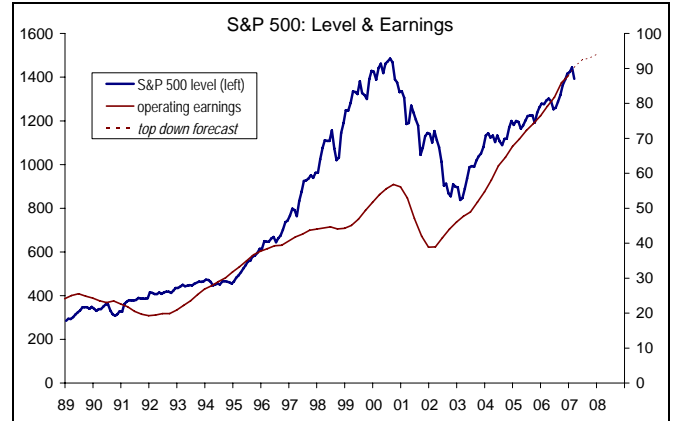
While the consumer continues to carry the weight, business fixed investment has generally stalled (mixed, but relatively weak on average). Poor weather may have been a factor in January, but the underlying trends in new orders and production were already softening in late 2006. The weakness in business spending is likely to be transitory, eventually recovering as consumer spending growth continues. However, a more pronounced or prolonged slowing can’t be ruled out.

Revised productivity figures show a decreased trend in output per worker in over the last several quarters. These data are notoriously fickle (when you start multiplying and dividing statistical estimates, the uncertainty expands greatly). Still, the data correspond to what we're seeing in the economy – slower economic growth overall, but relatively good job growth.



Fed officials have remained confident that the slowdown in productivity growth is temporary. However, if they are wrong, and productivity growth remains slow, there will be important economic implications. Productivity is critical for a number of reasons. One is that it is the only way to achieve improvement in the standard of living of the typical worker over time. In addition, productivity helps offset labor cost pressures. Compensation (wages and salaries plus benefits) have accelerated in recent quarters. If productivity growth remained strong, the labor expense per unit of output would not be much of a concern. However, slower productivity growth implies larger increases in unit labor costs. Over the last several years, a larger share of national income has gone to profits and a smaller share to labor. Now, the pendulum has begun to swing the other way. That's good for the consumer in the short-term, but bad for corporate profit growth.

Higher labor costs could be passed along in the form of higher consumer prices, but firms still appear to have generally limited success in raising prices. Profit margins are wide, which will provide some cushion against inflation, but only if firms absorb higher labor costs. Even with the recent correction, stock market valuations appear relatively rich. A flattening, or perhaps even a decline, in corporate profits is a threat to the outlook for later this year or in early 2008.



The Fed is aware of upside and downside risks to growth, but officials still see a potential increase in inflation as the biggest worry. As such, contrary to market hopes of a rate cut in the next few months, Fed policymakers should retain a small tightening bias – and short-term interest rates are likely to remain unchanged well into the second half of the year.

For the most part, people worry about things that they shouldn't worry about, and don't worry about the things that they should worry about. The risks to the economy have not changed over the last few weeks. However, the perception of risk has changed. The housing market and subprime problems will not lead to a recession. Global fears have been overplayed recently, but there's still some small risk of a dramatic adjustment in global imbalances. For the overall economy, the profit outlook will be most critical in the months ahead.

	4Q05	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2004	2005	2006	2007
GDP (↓ contributions)	1.8	5.6	2.6	2.0	2.2	2.4	2.7	3.0	3.1	3.9	3.2	3.3	2.5
consumer durables	-1.1	1.5	0.0	0.5	0.4	0.5	0.3	0.3	0.3	0.5	0.5	0.4	0.4
nondurables & services	1.6	1.9	1.8	1.5	2.5	1.9	1.7	1.7	1.7	2.2	2.0	1.8	1.9
bus. fixed investment	0.5	1.4	0.5	1.0	-0.3	0.3	0.6	0.6	0.7	0.6	0.7	0.7	0.4
residential investment	-0.1	0.0	-0.7	-1.2	-1.2	-0.6	-0.4	-0.2	-0.1	0.5	0.5	-0.3	-0.7
government	-0.2	0.9	0.2	0.3	0.6	0.2	0.2	0.2	0.2	0.4	0.2	0.4	0.3
Domestic Final Sales	0.7	5.4	1.6	2.0	2.0	2.4	2.4	2.6	2.8	4.2	3.8	3.1	2.3
exports	1.0	1.4	0.7	0.7	1.1	0.7	0.7	0.7	0.7	0.9	0.7	0.9	0.8
imports	-2.0	-1.5	-0.2	-0.9	0.4	-0.5	-0.5	-0.5	-0.5	-1.5	-0.9	-1.0	-0.4
Final Sales	-0.3	5.6	2.1	1.9	3.6	2.6	2.5	2.8	3.0	3.5	3.5	3.1	2.7
ch. in bus. inventories	2.1	0.0	0.4	0.1	-1.4	-0.2	0.2	0.2	0.2	0.4	-0.3	0.2	-0.2
Unemployment, %	5.0	4.7	4.7	4.7	4.5	4.5	4.5	4.5	4.5	5.5	5.1	4.6	4.5
NF Payrolls, monthly, th.	220	252	124	202	177	120	115	120	125	175	212	189	120
Consumer Price Index	-1.6	3.7	5.7	0.6	0.2	2.6	2.4	2.0	2.2	3.3	3.5	2.6	2.3
excl. food & energy	3.0	2.6	3.4	2.7	1.6	2.3	2.1	2.1	2.1	2.2	2.2	2.6	2.2
PCE Price Index (q/q)	2.9	2.0	4.0	2.4	-0.9	2.5	2.2	2.1	2.0	2.6	2.9	2.8	1.8
excl. food & energy	2.5	2.1	2.7	2.2	1.9	2.1	2.0	1.9	1.9	2.0	2.1	2.2	2.0
Fed Funds Rate, %	3.98	4.46	4.91	5.25	5.25	5.25	5.25	5.25	5.25	1.35	3.21	4.96	5.25
3-month T-Bill, (bnd-eq.)	3.9	4.5	4.8	5.0	5.0	5.1	5.0	5.0	5.0	1.4	3.2	4.9	5.1
2-year Treasury Note	4.4	4.6	5.0	4.9	4.7	4.8	4.7	4.8	4.9	2.4	3.9	4.8	4.8
10-year Treasury Note	4.5	4.6	5.1	4.9	4.6	4.7	4.8	4.9	5.0	4.3	4.3	4.8	4.9