

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

Thursday, June 12, 2008

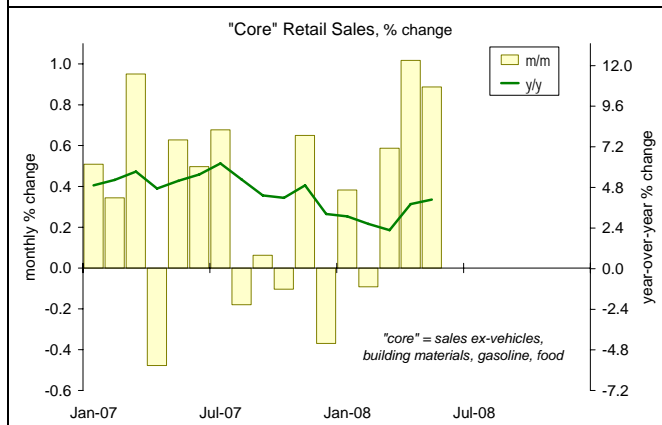
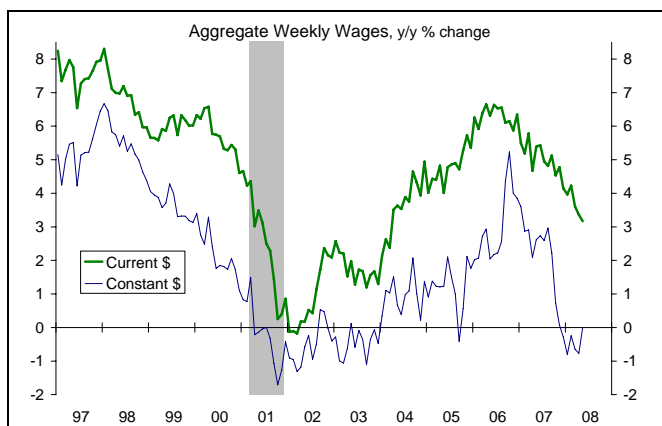
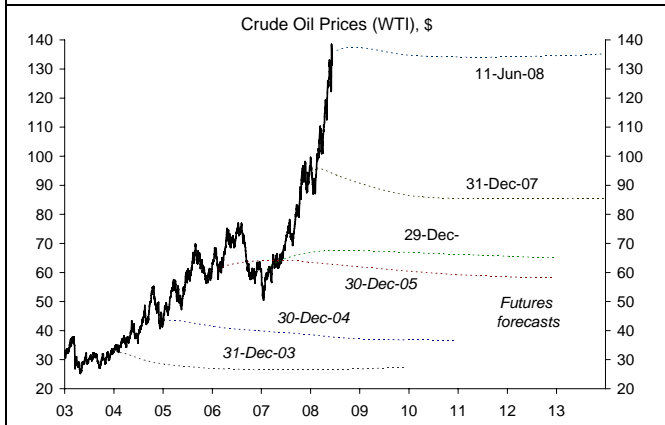
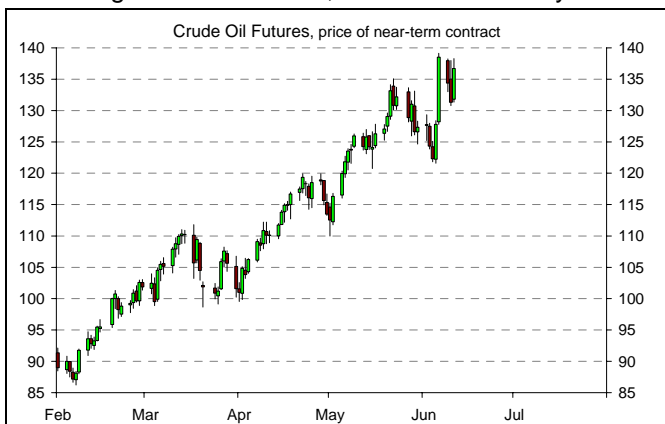
A Shift In The Fed's Focus

- *Federal Reserve policymakers, along with foreign central bank officials, have expressed greater concerns about inflation, stressing the importance of keeping inflation expectations contained. Rather than "slamming on the brakes," central bank rate hikes would essentially "take the foot off the accelerator."*
- *Readings on the health of the consumer have been conflicting. Anecdotal evidence suggests a serious squeeze on household budgets from higher food and energy costs. However, retail sales results have been relatively strong, apparently aided by tax rebates.*
- *The price of oil remains a major wildcard in the economic outlook. A stabilization of food & energy prices should help to moderate headline inflation and improve consumer purchasing power into 2009.*

Crude oil prices have risen sharply in the last four months. The reason for the increase is unclear. Some blame speculators, but while speculation appears to have had an impact on the day-to-day volatility, it could not keep prices elevated indefinitely. The global supply and demand fundamentals have been a dominant factor, but conditions are not that much different than four months ago. If it's a bubble, it should eventually correct.

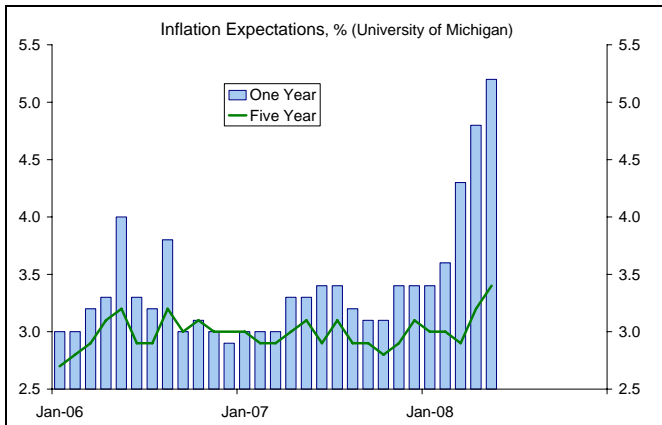
The futures market suggests a stabilization in oil prices in the months ahead. However, while futures contracts represent the market's best guess, they do not have a good record in forecasting the path of oil prices.

Wage growth has slowed in recent months as the labor market has softened. The unemployment rate jumped to 5.5% in May (vs. 5.0% in April), with much of that increase likely due to seasonal adjustment difficulties (there were sharply higher unemployment rates for teenagers and young adults). However, most labor market indicators suggest a general softening in job growth. Higher food and energy costs have led to a flattening in inflation-adjusted income growth, the main fuel source for consumer spending growth.



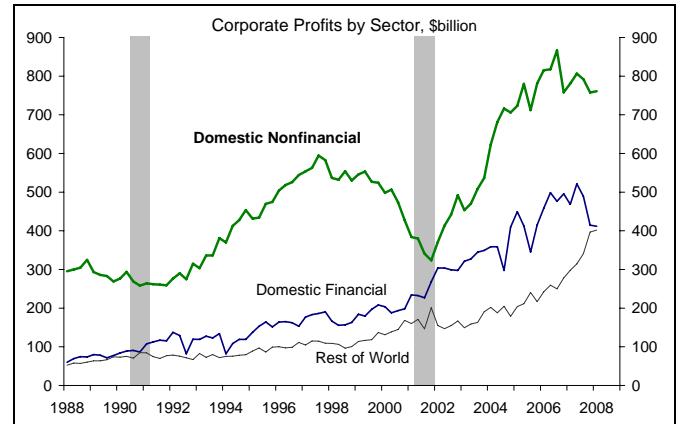
Retail sales were better than expected in May, which may be taken as evidence that tax rebates are being spent. However, March and April retail sales figures were revised higher and the Treasury Department did not begin issuing tax rebates until late April. Through early June, 66.6 million rebates were distributed, averaging \$854 each. Surveys suggest that most of the tax rebates will be saved or used to pay down debt. Some will be used to pay higher food and energy bills. However, enough will be spent to offset the drag from higher gasoline prices – at least in the short term.

Federal Reserve policymakers, as well as foreign central bank officials, have expressed greater concern about inflation in recent weeks. Low inflation expectations are a necessary condition for maintaining low inflation. Some measures of inflation expectations (such as those included in consumer surveys) have been rising. Seeing their inflation-fighting credibility beginning to fade, the Fed and other central banks seek to re-anchor inflation expectations. This is likely to require only a modest increase, not a campaign of rate hikes. However, a move is likely to come sooner than one would have thought possible just a month ago. A slow economy should help contain inflation pressures and we still have not seen evidence that inflation pressures are becoming rooted in the labor market (which would be a much bigger problem for the Fed).



Can the Fed raise rates amid sub-par economic growth and with the unemployment rate trending higher? Sure. Looking at the drag from the housing correction and the troubles in the credit markets, the Fed was justified in cutting rates aggressively in January and March. However, the rise in oil prices, while a drag on growth, is a serious threat to the inflation outlook. A small hike in rates should help get inflation expectations down without unsettling the economy too much.

In collaboration with the Treasury, Fed Chairman Bernanke also expressed concerns about the dollar and its role in the inflation process. The implication is that the Fed could raise rates to keep the dollar from weakening further. The softer dollar has contributed to the increase in global commodity prices, including oil, but is not the sole reason for these increases (for example, the price of oil is rising sharply in other currencies too). The softer dollar has aided U.S. export growth and lifted foreign earnings of U.S. stocks (which were also helped by strong global growth).



Higher input costs are likely to pressure corporate earnings growth in the near term. Firms are having somewhat more success in passing higher costs along (another reason for the Fed to work against inflation expectations). Profit pressures are likely to lead to a further deterioration in labor market conditions in the near term (which will keep consumer spending at a sub-par pace into the third quarter).

An unusually high level of uncertainty surrounds the current economic outlook. The housing correction could intensify. Credit conditions, which have been improving, could deteriorate. Oil prices could move toward \$150 per barrel – or \$100. While downside risks remain, a gradual economic recovery is likely into early 2009.

	2007	3Q07	4Q07	1Q08	2008	3Q08	4Q08	1Q09	2Q09	3Q09	2007	2008	2009
GDP (↓ contributions)	3.8	4.9	0.6	0.9	1.2	1.0	1.6	2.1	2.4	2.6	2.2	1.6	2.0
consumer durables	0.1	0.4	0.2	-0.5	-0.3	0.1	0.2	0.2	0.2	0.2	0.4	-0.1	0.2
nondurables & services	0.9	1.7	1.4	1.2	1.3	1.1	1.1	1.3	1.4	1.5	1.7	1.3	1.3
bus. fixed investment	1.1	1.0	0.6	0.0	-0.2	-0.3	-0.2	0.1	0.2	0.3	0.5	0.2	0.0
residential investment	-0.6	-1.1	-1.3	-1.2	-0.6	-0.4	-0.2	-0.1	0.0	0.1	-1.0	-0.9	-0.1
government	0.8	0.7	0.4	0.4	0.1	0.2	0.3	0.2	0.2	0.2	0.4	0.4	0.2
Domestic Final Sales	2.2	2.5	1.3	-0.1	0.3	0.8	1.1	1.7	2.0	2.2	1.9	0.9	1.5
exports	0.9	2.1	0.8	0.3	0.6	0.5	0.5	0.5	0.5	0.6	0.9	0.7	0.5
imports	0.6	-0.7	0.2	0.5	0.6	0.3	-0.1	-0.3	-0.4	-0.4	-0.3	0.3	-0.2
Final Sales	3.6	4.0	2.4	0.7	1.6	1.6	1.5	1.9	2.1	2.3	2.5	1.9	1.9
ch. in bus. inventories	0.2	0.9	-1.8	0.2	-0.4	-0.6	0.0	0.2	0.3	0.3	-0.3	-0.3	0.1
Unemployment, %	4.5	4.7	4.8	4.9	5.3	5.7	5.9	6.0	6.1	6.1	4.6	5.5	6.1
NF Payrolls, monthly, th.	105	71	80	-82	-50	-40	40	60	90	105	91	-33	91
Consumer Price Index	4.3	2.5	6.2	3.1	3.5	2.2	2.3	2.3	2.3	2.3	4.1	2.8	2.3
excl. food & energy	2.3	2.5	2.6	2.0	1.8	2.1	2.1	2.1	2.1	2.1	2.4	2.0	2.1
PCE Price Index (q/q)	4.3	1.8	3.9	3.5	3.2	2.4	2.1	2.1	2.1	2.1	2.6	3.1	2.2
excl. food & energy	1.4	2.0	2.5	2.1	1.9	2.0	1.9	1.9	1.9	1.9	2.1	2.1	1.9
Fed Funds Rate, %	5.25	5.09	4.49	3.18	2.11	2.15	2.44	2.72	3.19	3.50	5.02	2.47	3.23
3-month T-Bill, (bnd-eq.)	4.9	4.4	3.5	2.1	1.7	2.2	2.5	2.8	3.2	3.4	4.5	2.1	3.2
2-year Treasury Note	4.8	4.4	3.5	2.0	2.5	3.1	3.8	4.1	4.4	4.5	4.4	2.9	4.4
10-year Treasury Note	4.8	4.7	4.3	3.7	3.9	4.5	4.8	5.0	5.1	5.2	4.6	4.2	5.1