



Economic Commentary - 2nd Quarter 2003

Carpet Bombing the Economy

In the second quarter of the year the staggering economy began to convince even the nay-sayers of its potential by showing signs of recovery and growth. That should not be a surprise to observers considering the veritable economic and administrative *carpet bombing* directed at the economy.

On June 25th, the Federal Open Markets Committee of the Federal Reserve cut the federal funds rate for the thirteenth time in two years bringing the overnight rate to 1% - a level not seen in 44 years. The statement from the Committee was balanced but noted a concern regarding deflation which Chairman Greenspan had mentioned as a potential threat for several weeks. The Committee did however state that they saw definite growth in the economy. This rate cut was to assure that the growth was sustainable. The limited cut (of 25 basis points) and the FOMC's view of growth has almost convinced the market that the cuts are complete.

The Fed's war has three fronts which makes their job especially difficult. They are trying to "reflate" the economy, keep inflation under control when it does "reflate", and keep the consumer liquid so that spending continues. With this latest cut, most economists surveyed forecast sustainable growth by at least the fourth quarter. The reason is that economists know that stimulus works. With three tax cuts in three years and the lowest interest rates in two generations the economy will grow. Now it is critical that employers believe in that growth potential. Business has seen three years of below-average growth and is reticent to hire and increase capital spending. That reticence is keeping job growth at a bare minimum.

In June, the jobless rate (which is a survey of households) jumped unexpectedly to 6.4% from 6.1% in May. This is the highest unemployment rate in nine years (since April 1994). And, although this is not necessarily bad it does mean that 30,000 jobs have evaporated at least temporarily. Increased productivity throughout industry and services has allowed management to cut costs while also cutting jobs. Against this rate however, the services component of the labor economy grew for the third straight month and the ISM (Institute of Supply Management) non-manufacturing index climbed to 60.6 which is the highest since September 2000.

The jobless rate is a lagging indicator however. A leading indicator gives another side of the picture. There has been real growth in the temporary help area especially in service industries (which include banks and governments and not just McDonalds). In June the index showed an increase of 38,000 jobs after a 44,000 rise in May. This shows business' reliance on temporary workers until the growth in the economy is clear and sustainable. That may take a few more months if we also look at the workweek. The hours in the workweek have stayed at a low near 37.7 hours for four of the last five months. The demand for more workers hours must increase to push business to hire permanent workers. The growth in the service area however can not be denied since it represents over 85% of the economy currently.

Business may also be forced to increase their payrolls and capital spending soon regardless of their reticence. The level of new orders and the backlog of orders have been growing steadily.

The worker has also seen incomes grow in the form of average hourly earnings (up .2%). The fractional growth is not awe-inspiring but will help keep maintain spending power. With stock prices down, low borrowing rates, and \$330 billion in tax cuts the consumer should be able to buoy the service and retail industries for a few more months. Such growth should be sufficient to achieve growth estimates of 3.5% for the second quarter and around 3.7% for the fourth quarter. A rate above 3.25% is seen as a portent for sustainable growth.

One area in which some economists see potential threats to the recover is housing. The “bubble-ologists” have been worrying since early 2003 that housing construction and sales will slow. Surely, at some point housing refinancings and new growth must moderate but there are a few conditions that point to a continuation of housing interest for several more months. For example, there is ample affordability in the system to maintain this movement. The affordability index at 144 is at a 30 year high. That means that median income families have 144% of the income required to afford their homes. They will not be liquidating their biggest investment for lack of funds. In addition, housing is not as liquid as stock and therefore does not represent a reasonable or quick trade for liquidity purposes. Housing too is more than just an investment. It is part of our psyche, where we raise our kids and find solace. For these reasons it does not appear that the housing industry has serious cracks threatening its foundation.

The one crack that may affect some home-owners is the level of mortgage debt. The percent of mortgage debt has naturally increased with the housing bubble created by low rates. This can have a serious detrimental affect if the underlying property does not appreciate over time. However, unlike the 1980’s the newer standards for lending and building have saved the bankers and housing brokers this time around from making the same credit mistakes.

Another bubble that directly affects governmental portfolios is the bond bubble. If inflation does ignite and growth is recognized as sustainable across most sectors of the economy, the bond bubble will burst or at least start to seriously leak. The effect will undoubtedly be seen first in the intermediate and longer sectors as we have already seen. It may take a few months longer in the very short end of the curve – from three months to one year. One reason for the delay is the consumers use of money funds. In 2003, money market funds have lost only 5.5% (or \$130 billion) of their assets (according to Imoney.net) because the consumer wants – and feels safer with liquid funds. This could be the result of fear for liquidity or it could be a result of the general consensus that rates are going up. From the move we have already seen in fixed income rates and in the stock market from only 5.5% of the funds moving it is clear that when investors withdraw from the money market funds in larger numbers it will represent a major move for short term funds – probably in a very short time period.

The result from the carpet bombing, positive assault on the economy does appear to be working. The timetable remains a question, but, if the signs are correct we may have only until the end of the third quarter see significantly higher rates even in the short end of the curve.