



## Quarterly Economic Report – 2<sup>nd</sup> Quarter 2005

*Confusion Reigns!*

If there has been a common thread throughout the markets this quarter it has been confusion. With any number of moving parts and a global span of forces, historical relationships and reactions to fundamental issues appear to have changed or at least shifted temporarily.

Of one thing we can be sure, the US economy may slow at some time, but, certainly not as soon as some people expected. It is growing and that growth is affecting everything including the very important strength of the dollar and long term rates. The growth and rates balance is a fragile one being monitored carefully by the Fed. Will firms achieve pricing power or will oil and increasing employment costs start to diminish profits? Will the current account deficit take down the economy or continue despite its unsustainable levels? Will Mr. Greenspan's "frothy" view of housing fizzle slowly or bust? (Did you ever notice how froth on beer is composed of thousand of little bubbles?)

For credit investors, we are two rate hikes and two bad employment reports away from a flat yield curve! The long end of the market is dancing to a new drummer and instead of heeding the warning of the short-end (to increasing inflation) it has dropped 75 basis points since June 2004 and the beginning of the tightening cycle.

This quarter – as has been since June 2004 – the rate news revolves around the Fed's steady actions. The FOMC has raised short term rates nine times from 1.0% to 3.25% and their current choice of words fails to signal any end in sight. By keeping the words "accommodative" and "measured pace" they are clearly staying on a path to 4.0 or 4.5% rates by year-end. (Next meeting is August 9<sup>th</sup>) The FOMC continues to argue that the "pressures of inflation have picked up in recent months and pricing power is more evident". Though inflation may appear benign, income and demand trends continue to pose a legitimate threat. Household income is advancing strongly which makes families less sensitive to higher prices – even gasoline! Despite the choppy markets and data being released, aggregate demand is strong added to by stimulative monetary policy and a very liquid financial situation. Inflation is not expected to appear full grown on stage. Moderate global growth – particularly in Europe – may limit the scope and magnitude of inflation, but it is there. As employment grows, household incomes will likely continue and consumers will spend at an already well-established rate. Even if core inflation remains well behaved it is likely that oil prices will siphon some measure of growth from the economy.

In a typical economic cycle, during such a mid-to-late expansion phase, growth eats into capacity and generates noticeable inflation, so the Fed raises rates to slow the inflationary spiral. This time the cycle appears to be different for a number of reasons and in reaction to a number of global forces. In fact, while the Fed continues to raise rates to lessen liquidity, banks are gleefully continuing to ease terms and standards on loans. (Two-thirds of mortgage loans in California are now interest only!)

Growth is evident. This is the 8<sup>th</sup> consecutive quarter growth has been above 3.0% - the longest cycle in 20 years. Consumer confidence is at a 3 year high. Home sales continue to soar accelerating economic growth from service industries to home improvement stores. GDP is growing at a 3.8% annual rate. Personal income is rising at an annual 11.5%. Wages and salaries are up (+7.2% YOY), disposable income is up (+5.5% YOY), and the PCE price inflator is relatively docile at 2.2% YOY. Housing starts have topped 2 million units for 15 consecutive months and show no sign of slowing. All this growth with no evident or pinching inflation is keeping the "bond bulls" buying and keeping rates in the 4.0% to 4.5% range.

The Fed's moves over the past year should have had a chilling – or at least cooling - effect on long term rates. However, rates stay stubbornly and amazingly low. Our US rates are relatively high however in comparison to global alternatives. Global low rates would traditionally suggest slow growth prospects around the world. Normally a looming flat or inverted curve has been associated with slowdowns in which investors get pessimistic. It is not reflected here. Some of that traditional motivation may come if oil stays over \$60 a barrel. Global GDP is projected to slow to 3.2% from 2003's 3.9% however few economists see a real slowdown. Why then are the rates so low?

Usually with a flat curve financial conditions are tight but instead they are currently stimulative. Also, inflation would normally be high but we have fallen from 9% in the early 1990s to 2.7% currently. The low inflation reflects monetary

changes in emerging economies along with declining trade barriers. These together have created a more flexible supply chain removing a barrier to trade and reduced price pressures. It also may reflect a surprising decline in the impact of commodities such as oil. In addition, there is now greater capital mobility globally illustrated by the consolidation of the euro. These factors significantly reduce the *risk premium* which would normally push rates higher. These are also factors which will not change. Another current factor is the investment pattern. The normal high savings rate in Asia is down because of depressed economies and redirection of funds into capital enterprises. Central banks are holding dollars but threatening a reduction in their holdings.

On a relative basis the US rates are high so investors are still directed into our credit markets. The EU has not raised rates in two years (2%) in hopes of generating growth. The rejection of the EU constitution by France and the Netherlands this quarter was acrimonious at best and decreased investor interest in the area. Japan is staggering. (China requires dollars and US trade but is an economic maverick deserving of its own paper.) This has led to a continuing, high non-domestic demand for US obligations. Central banks continue to buy but at a slower rate. The EU defeat added strength to the dollar which has risen 10% this year. The increased dollar value increases the value of US obligations which creates a double-edged sword.

If central banks continue to buy our obligations our US growth can continue. If they stop, the US consumer has to also stop and the economy may falter. Global confidence in the dollar and our obligations rests on our economy and its ability to grow. If monetary policy tips the US economy to a hard landing and confidence drops, the dollar could take a plunge with multiple ripple effects stopping our growth, inflating our trade imbalance and jeopardizing global recovery based on the all-consuming American public.

The Fed has to engineer a soft landing or at least a comfortable slowing of the economy and along with that also raise the longer rates slowly. (Remembering that the Fed has no direct control of longer rates.) A major or rapid reactive correction in the long end of the curve will choke off economic growth, will raise doubts of our economic underpinnings, and will rapidly decrease the value of the dollar which will rapidly raise the current account deficit.

Greenspan has only six more months to effect the changes he wants. (And any unnecessary furor over his successor could add destructive volatility to the mix.) He has had to add much more liquidity to the economy than desired for Y2K and 9/11 and has created a situation that will difficult to slow, especially given little global growth.

So what are the major risks to this delicate balance? Monetary policy will be a more delicate balance than normal. The FOMC's monetary policy is clear. It will continue to drive up short term rates to fight inflation but it is having little or no effect on the bond bulls. They are ignoring the prospects of inflation. A little assistance may come from the reintroduction of the 30-year Treasury note in October. Although the note issuance itself will be small it could reverse the supply and demand balance created partially with its elimination in October of 2001 (to keep the economy humming after 9/11). Another major risk is the housing market and this is why Greenspan has spent so much time referencing it in recent remarks. Without a doubt housing has been the major stimulus for several years. Housing transactions now top \$2 trillion a year, double the rate two years ago and four times the 1995 rate. Housing is now half of the value of retail sales on the national GDP versus only one-quarter in 1995. If housing slows too quickly – or stops – with higher rates, it could stop the economy and the dollar and run the account deficit to unsustainable levels which will dry up global confidence in our economy and drive rates even further effectively stopping growth. If inflationary pressures start to appear and long term investors slowly drive rates higher, the move may be slow enough to affect that soft landing Greenspan wants as his swan song.

As a result, the US credit markets have an interesting year ahead. As the third quarter ends we should have a clearer view of longer term rates and the direction of the curve. Until then we have to assume that shorter rates will continue to rise, but, at some point, we will have to be nimble enough to move out the curve and lock in longer rates from an inverting curve if necessary at some point. Only time and the variable strength of the global factors at work will start to clear up the confusion that has been reigning for the first two quarters of this year.