



Quarterly Economic Report – 2nd Quarter 2006

A Crossroads of Confidence

A key aspect for all markets is confidence. When market participants see inconsistency and uncertainty confidence wanes and volatility increases. Currently, we have global confusion as economic leaders settle into their roles and geo-political forces collide. We appear to be moving from a period when one central banker - Alan Greenspan - was dominant and held the global pivotal role to a period of multiple international officials. Unfortunately, these multiple voices are flapping in the economic winds. Add this to seven missile tests in Korea and continuing hostilities in Iraq, Iran and Afghanistan and it is no wonder the markets are roiling.

When investors lack confidence it tends to make them avoid risk (creating the safe harbor effect) but makes them demand additional compensation which has resulted in higher rates throughout the quarter worldwide. Based on his academic writing and confirmation testimony Ben Bernanke was expected to keep a strong focus on low inflation. But, an early testimony gaff (to the JEC 4/18) raised hopes for a pause even if inflation was not in check. Reversing that in June his comments were hawkish again but the FOMC language after the hike turned more moderate once more. The stance for Bernanke and the FOMC has been difficult to determine. On the April statements the Dow soared 195 points with a slowing in sight. Three weeks later when Bernanke spoke of hikes again the Dow fell 142 points. One more time (6/5) Bernanke spoke of "unwelcome inflation" and the Dow dropped 199 points. Confusion at the Fed alone is estimated to have raised world bond yields 20 bps.

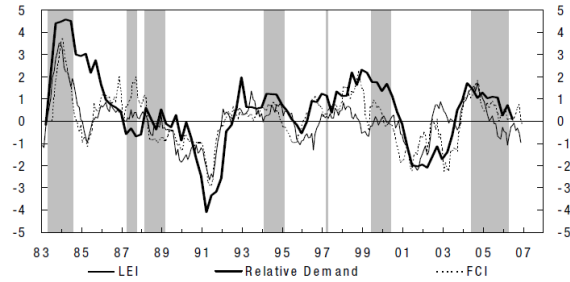
Bernanke is not alone in the gaff department which adds to global confusion. In Japan, after strong no action statements regarding their low rates, BOJ Governor Toshiko Fukui reversed himself stating a need to adjust from 0% "without delay". That dropped the US dollar 1% against the yen and hit Japanese bonds hard. Later that day he said he was "misinterpreted" and markets reversed. On the other side of the globe, the ECB President Trichet attempted to dispel uncertainty on whether the ECB would raise rates 50 bps after their last three hikes of 25 bps. His comments sent the euro up one-half cent against the dollar. The next day he whipsawed the markets by affirming his strong stance on inflation! The ECU Group in London thinks the indecision has added 20 bps to the 10 year and the Royal Bank of Scotland estimates the same is due to Bernanke's uncertainty.

These gyrations are critical to the US because of relative global rates but also for the dollar's value and its impact on trade. **The dollar** is significantly undervalued against the Asian currencies contributing to the US trade imbalance. This will undoubtedly be a major focus for the new US Treasury Secretary.

Besides the dollar, another area hard hit by the confusion is **commodities**. As risks rise, investors move to hard assets. Coincident to the May-June Fed-speak confusion the CRB (commodities index) of 19 commodities fell 7.7% and futures over the same period had a swing of 80%. It is no wonder that with the confusion, Fed hikes had to continue in June to keep expectations and confidence in check. In order to clear away some of that confusion it is necessary to look at the fundamental conditions to see how this "data dependent" Fed may react as conditions change.

The Fed has definitely become less hawkish the past two quarters as the economy slowly cools and inflation stays somewhat hidden. The awareness will not cool however because inflation is present and its uncertainty unsettling. Energy has soared but import and consumer prices are stable. In the past quarter key inflation prices have risen 3% - significantly above the Fed's 1-2% comfort zone. There is little choice for the FOMC but to continue the fight and err on the side of restraint.

Figure 1. Financial Conditions Index and Leading Economic Indicators (Deviation From Trend) vs. Growth in Aggregate Demand Relative to Trend, 1983-May 06



Note: Shaded regions denote periods of Fed tightening.
Sources: Citigroup, Conference Board, and Bureau of Economic Analysis.

year.

The consumer gains or sustains their wealth from (1) income growth, (2) the wealth effect, and (3) the ability to borrow. Income growth is mixed. We have had three soft jobs reports but the jobs confidence reports are optimistic and the unemployment rate suggests full employment at 4.6%. There has also been growth in hourly earnings averaging 3.9% and hiring is broad-based in manufacturing, retail and service industries. Business is having trouble finding good people so they are paying people more. The ISM report on banks, builders and retail has slipped to 57 from 60 but a reading above 50 indicates expansion.

The wealth effect gained during the housing boom remains. Although activity and prices have dropped on new houses the appraisals have not which continues the wealth effect. The borrowing ability of consumers has been troubling because we have seen a tremendous drop in the savings rate (wages minus outlays). However, the savings rate figure is flawed in that capital gains (and decreases in mortgage payments) are not counted as income but they are spent which makes the savings rate look worse than it may be.



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Another factor in the cooling effect is the budget position which is better than expected. There has been a \$40 billion improvement from last year and estimates have the deficit at \$260 billion by year end mostly on increased tax revenue.

Inflation is not cooling. The historically high energy prices are working their way into the core prices charged producers and consumers. Trucking firms to UPS have increased prices. Railroads have upped their fees. Manufacturers are using resources hit by the commodity price increases. Wage pressures are increasing not on the hiring side but on higher wages. The US dollar's loss of value with major trading partners has lowered import prices which induces consumers to pay more. Even with three months of increases to 2.4% inflation appears moderate but the rate of increase is large compared to 1.6% in all of 2005.

With inflation present but some deceleration in the economy the Fed can afford to be less hawkish. They can not afford to become doves. Inflation is a laggard and it could well still explode on the scene. The Fed has to also guard against a hint of *stagflation* which will add to market uncertainty. Stagflation however needs three factors: slow growth, high inflation and low employment. Two out of three factors are not enough.

Certainly in the next quarter the FOMC will remain data dependent but if the trends of a cooling economy continue we may hear more talk of a pause - unless inflation increases dramatically. The uncertainty continues.