

DAILY GLOBAL
COMMENTARY

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul L. Kasriel
plk1@ntrs.com

Why The Fed Might Want To Take A Breather After Tuesday's Hike

March 27, 2006

The drama on Tuesday around 2:15 pm EST won't be that the Fed raised the funds rate by 25 basis points for the fifteenth consecutive time to 4-3/4%. If there is any drama, it will lie in the accompanying announcement as it relates to the upcoming May 10 monetary policy decision. The announcement is likely to be anticlimactic inasmuch as I suspect that the FOMC really does not know what it is going to do with the funds rate on May 10 – leave it at 4-3/4% or bump it up to 5%. If I am correct about the Fed's uncertainty, then the FOMC is likely to communicate that both options are on the table – pause at 4-3/4% or forge ahead to 5%. As of last Friday, the betting in the fed funds futures market was that there was about a 74% probability that the FOMC would move the funds rate to 5% at the May 10 meeting. I put the odds considerably lower for the following reasons.

A move to 4.75% on the fed funds rate would put it well above its long-run relationship to core PCE inflation. In January, the year-over-year change in the core PCE price index was 1.8%. Based on the 0.1% month-to-month increase in the February core CPI and other factors, the February year-over-year change in the core PCE price index is expected to be up only 1.7%. Let's split the difference and say that the March year-over-year change in the core PCE price index turns out to be 1.75%. A 4.75% fed funds rate, then, would represent a 300 basis point spread over core PCE inflation. The median spread from January 1960 through January 2006 is 2.49%. Thus, a move to 4.75% on the fed funds rate puts the spread over core inflation well above its long-run relationship. And bear in mind what Bernanke hypothesized to the Economic Club of New York on March 20: **“About a year ago, I offered the thesis that a "global saving glut"--an excess, at historically normal real interest rates, of desired global saving over desired global investment--was contributing to the decline in interest rates ... So long as these factors persist, global equilibrium interest rates (and, consequently, the neutral policy rate) will be lower than they otherwise would be.”** If Bernanke thinks that there is some risk that the neutral policy rate is lower than it would otherwise be, why would he want to continue to push the real fed funds rate above some long-term average?

From the January 31 FOMC minutes: **“In some areas, home price appreciation reportedly had slowed noticeably, highlighting the risks to aggregate demand of a pullback in the housing sector. For instance, the effects of a leveling out of housing wealth on the saving rate were difficult to predict, but, in the view of some, potentially sizable.”** And from Bernanke's prepared remarks to Congress in February: **“Some cooling of the housing market is to be expected and would not be inconsistent with continued solid growth of overall economic activity. However, given the substantial gains in house prices and the high levels of home construction activity over the past several years, prices and construction could decelerate more rapidly than currently seems likely. Slower growth in home equity, in turn, might lead households to boost their saving and trim their spending relative to current income by more than is now anticipated.”** So, the Fed's economic

downside-risk concerns relate to the housing market. Housing affordability is at its lowest level since 1991. New home sales have fallen in five of the past seven months. On a year-over-year basis, new home sales in February were down 15.6%. At the same time, new homes for sale were up 24%. New home prices have fallen for four consecutive months and are down 2.9% vs. year-ago. Existing home sales have fallen in six of the past eight months and are a fraction under unchanged vs. year-ago. Existing home prices are down in six of the past eight months. I think any reasonable observer would characterize these statistics as “some cooling of the housing market.” If the Fed keeps pushing up short-term interest rates, what is the greatest risk for the housing market – toward freezing or heating up again?

Also from the January 31 FOMC minutes: **“Rising debt service costs, owing in part to the repricing of variable-rate mortgages, were also mentioned as possibly restraining the discretionary spending of consumers.”** In 2005, the households devoted a record 13.71% of their after-tax income to servicing their debt. This was a 54 basis point increase over 2004 and the largest basis point increase since 1995 (up 62 basis points). Merrill Lynch’s David Rosenberg has estimated that approximately \$2-1/2 trillion of household debt (21% of outstanding household liabilities) will reprice in 2006. If the Fed is worried about rising debt service costs slowing consumer spending, why would it keep operating in a way to guarantee that those debt service costs keep rising?

Well, of course, one reason it might keep pushing up debt service costs would be to fight rising inflation. Is inflation rising? Let’s assume that the consensus forecast for the February month-to-month change in the PCE price index is right – up 0.1% all items, up 0.1% for core items. This would put the year-over-year change for the all-items PCE price index up 2.9%, which is down from January’s 3.1% and down from the cyclical peak of 3.8% set back in September 2005. So, the overall rate of consumer inflation is trending lower as energy prices level off. The Fed frets about the pass-through of energy prices. Is there much evidence of that? If the consensus is right, as mentioned earlier, the year-over-year change in the core PCE price index in February will be 1.7%, down from 1.8% in January and down from its cyclical peak of 2.3% in November 2004. Keep in mind inflation is a *lagging* economic process. So, if core inflation *already is trending lower*, chances are it will continue to do so.

Labor expenses account for about two-thirds of total production costs in the U.S. Any sign that inflationary pressures are bubbling up from this source? When controlling for the kinds of jobs being created (e.g. health-care professionals vs. health-care non-professionals), the partial answer is “no.” The Employment Cost Index (ECI) for private sector employees, which includes total compensation but adjusts for the kinds of jobs being created, on a year-over-year basis was up only 3.0% in Q4:2005 – down from 3.8% in Q4:2004. Looking at this ECI on a Q4/Q4 basis, you would have to go back to the 2.6% in Q4:1995 to find a change less than the 3.0% in Q4:2005.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

What about inflation *expectations*? As of Friday, the market's CPI expectations over the next ten years was 2.47% -- down from 2.53% at the time of the January 31 FOMC meeting and down from 2.52% at the time of the June 30, 2004 FOMC meeting. By the way, the price of a barrel of crude oil on June 30, 2004, the day the FOMC embarked on its measured tightening campaign, was almost \$27 a barrel cheaper than it was last Friday. Yet, inflation expectations are marginally lower.

I don't know what *leading* indicators the FOMC puts any faith in, but based on past performance, it could do worse than putting some faith in the Conference Board's LEI index. Based on the January-February average, the year-over-year change in the LEI in Q1:2005 is 1.8%. This is down from a cyclical peak growth of 9.0% in Q1:2004. Chances are that if the FOMC keeps pushing up the fed funds rate, LEI growth will keep falling. Gosh, it sure would be embarrassing to the new Fed chairman if he nudged the economy into a recession with inflation trending lower and the LEI having given him a clear "pause" signal at 4-3/4%.

James Pressler
jap10@ntrs.com

Japan: Is It Still Okay to be Optimistic?

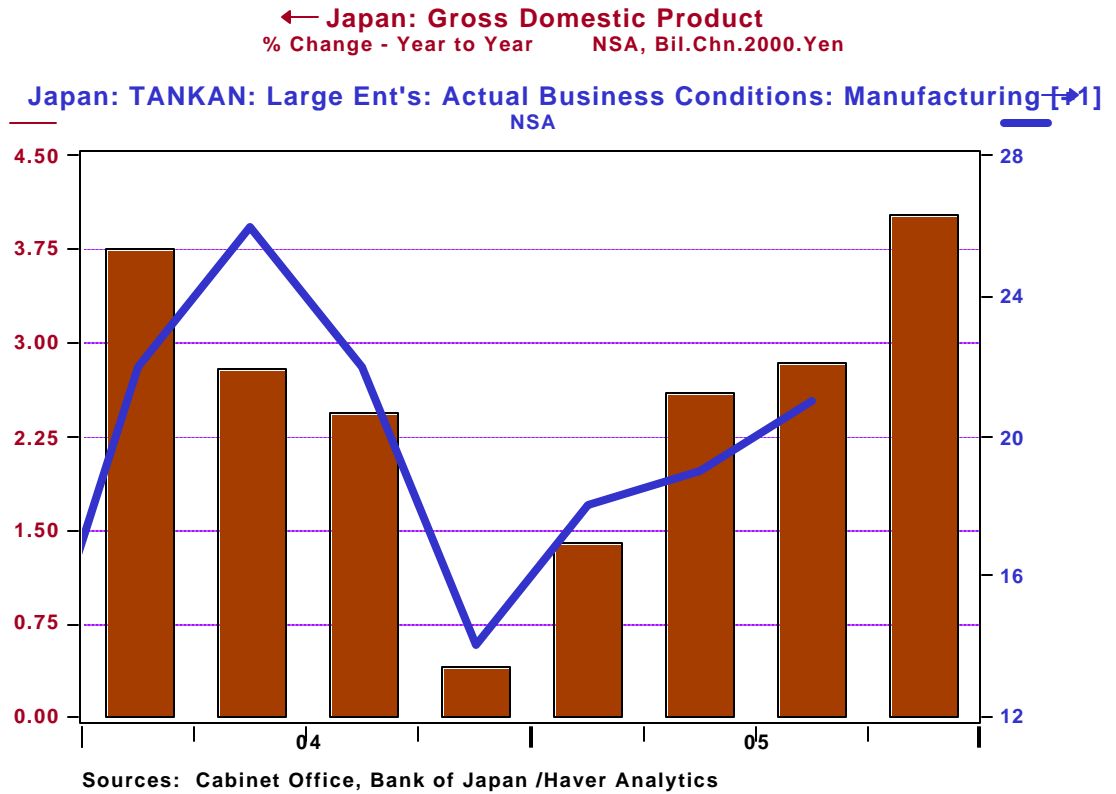
Confidence in Japan's resurgence built slowly throughout last year as economic growth broadened and accelerated, consumer prices stabilized and PM Junichiro Koizumi's reform agenda was pushed forward. This year, anxious Tokyo markets fared well in the run-up to the Bank of Japan's (BoJ's) first change of monetary policy in four years (see *Daily Global Comment, March 8, 2006* – [Bank of Japan to Take First Step in the Journey of One-Thousand Miles](#)) and seem confident that monetary policy will be managed responsibly in the months to come. Now it's time for the next stage in the long trip back to normalcy – fiscal adjustment. Will corporate Japan and its many consumers handle this change just as well?

In Q1 1997, the government decided to implement some fiscal austerity under the belief that the economy had pulled out of its seven-year slump, announcing a two percentage-point increase to the sales tax, effective at the beginning of fiscal 1997 (April-March). Consumers did not take the change well – to put it mildly – and Japan soon fell back into recession. This time around, Koizumi's administration has outlined measures to wind back the budget deficit, forecast in excess of 7% of GDP for the fiscal year ending this week. These adjustments include a 3% reduction in government expenditure and a gradual unwinding of income tax cuts implemented nine years ago. If this fiscal tightening works as planned, it would be a significant first step toward achieving the long-term goal of a balanced budget by 2015. If this calculated risk falls short, however, it could be a 1997 redux.

Next Monday the month starts off with the release of the Q1 Tankan survey of business conditions, which should be a very good indicator of how well corporate Japan is digesting the policy changes. The Tankan figure of actual conditions for large manufacturing enterprises is

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

usually a good proxy for the previous quarter's y-o-y GDP figure, which means that the Q1 Tankan should post a significant rise come Monday – perhaps to a reading of 25.



What will be key in the Tankan release is any deviation of the headline figure from the expectations suggested by the GDP figures. If corporate Japan believes that the announced fiscal adjustment will be a beneficial change from the status quo, such optimism will be reflected in an above-consensus reading. However, if the BoJ and/or Koizumi have made the survey participants a little edgy, this will weigh heavily on the April Tankan release (the Tankan survey was administered in mid-March, shortly after these changes were introduced).

For those who cannot wait for a week for the answer, the March Shoko Chukin index for Small Business Sentiment is due for release on March 30. Any surprise movements in this barometer could be seen as foreshadowing for Monday's Tankan release, and Tokyo markets would have ample time to adjust accordingly. We, however, remain cautiously optimistic that there will be no big surprises in the run-up to the Tankan's release on April 3rd.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.