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WEEK OF JUNE 6, 2005—TOO MUCH, TOO FAST?

Is the Federal Reserve tightening too much, too fast—i.e., not giving the markets enough time to digest its rate hikes? The 10-year benchmark Treasury yield has fallen below 4 percent, 80 basis points (0.8 percent) less than one year ago, even as Greenspan & Co. continue to raise short-term rates, not an encouraging sign for continuing growth. The Fed's hikes to date have resulted in a 6 percent Prime Rate, with predictions of at least one more quarter percent hike at their June 30 meeting.

But, since the new Dallas Federal Reserve President Richard Fisher, a democrat and former Treasury official, hinted that we might be in the eighth inning of the Fed's credit tightening cycle with June the ninth inning, economists have begun to question the Fed's wisdom of continuing to raise their interest rates at this time.

Foremost is the problem of a flattening Treasury yield curve, with the 30-year Treasury bond now yielding just 4.19 percent—where the 10-year Treasury was one week ago—while 3-month bills yield 3 percent (same as the fed funds overnight rate). Because long-term rates have been falling as short-term rates rose, banks are being squeezed. They borrow short-term to lend longer term, so when the interest gap between what they borrow and lend narrows—the meaning of a flatter yield curve—so do their profits.

Should short-term rates climb higher than long-term interest rates, banks would have to stop lending altogether with dire consequences for real estate, particularly. Homeowners took out more than $700 billion in equity last year from refinancings, for example, and they tend to spend most of it. Then Harvard's Joint Center for Housing Studies says that 40 percent of all construction spending was by home and rental property owners in 2003, accounting for more than 2 percent of that year's economic activity.

Chairman Greenspan says he is still puzzled by the conundrum of falling long-term bond rates, yet in a recent satellite speech to the Beijing International Monetary Conference, he maintains that in fact interest rates have moved lower "virtually everywhere…Even in emerging economies, whose history has been too often market by inflationary imbalances and unstable exchange rates, access to longer-term finance has improved."

He then proceeded to debunk the current theories of why such rates are falling while the Fed tightens credit. He says it cannot just be foreign bank purchases of U.S. Treasuries, since rates are falling elsewhere as well, or lower inflation because of globalization, or even economic weakness down the road. On the contrary, Greenspan maintains that "periodic signs of buoyancy in some areas of the global economy have not arrested the fall in rates."

Are Greenspan and his Fed Governors being just a bit disingenuous? Just how "buoyant" is the U.S. economy is a subject of debate. The jobs market is till sluggish, for example, and is creating half the jobs of the last recovery cycle in 1991. They must know that continuing to push up short-term interest rates will put the squeeze on bank profits, hence banks' lending activities. Is this therefore Greenspan's way of manipulating bank lending practices, and so letting the air out of any real estate bubble? If that is the case, then he will be affecting much more than real estate activity. So many other segments of our economy—such as construction, insurance and bank lending—depend on real estate for their livelihood.

A weakening May jobs picture did in fact cause bond yields to decline further in the U.S. So even during 'buoyant' times, any sign of economic weakness has a direct effect on U.S. interest rates, at least. The 78,000 new nonfarm payroll jobs were more than 100,000 below anyone's predictions, and 10-year bond yields immediately fell to 3.82 percent on the news. This means markets are concerned about slower growth ahead. Both the ISM manufacturing and service sector activity indexes for May also declined. But Q1 labor productivity rose, as did personal incomes and construction spending.

UNEMPLOYMENT RATE—May's jobless rate did fall to 5.1 percent, which Barron's Gene Epstein asserts is close to full employment. But the jobless rate is taken from the Household survey, which includes the self-employed. Employment in that sector increased 376,000, while 360,000 more entered the labor force. So more are beginning to look for work again, but that doesn't mean they will find salaried jobs, the meaning of the payroll numbers. They might have to work for themselves.

ISM SURVEYS—The Institute of Supply Management's May surveys showed slower growth. Manufacturing's index fell almost 2 points to 51.4, while service sector activity fell 3.2 points to 58.5. Manufacturing employment, exports, new orders and prices all declined, signaling that more manufacturing is being done overseas. The service sector was much healthier, with new export orders and order backlogs increasing at a faster rate. But all were concerned that continued Fed rate hikes could dampen their businesses.

PRODUCTIVITY—Labor's output per hour was revised upward to a 2.9 percent annual growth rate. This was goods news, though labor's so-called unit costs are surging, meaning that a major component of inflation is increasing. Labor costs are a combination of salaries and benefits. Higher labor costs also mean that employers could cut back on hiring more workers.

The financial markets do not like uncertainty, and the gist of Greenspan's remarks of late are that such conundrums as declining worldwide interest rates are still puzzling to him. "The economic and financial world is changing in ways that we still do not fully comprehend," said Dr. Greenspan in his satellite remarks. "Policymakers accordingly cannot always count on an ability to anticipate potentially adverse developments sufficiently in advance to effectively address them."

If that is the case, then why not err on the side of greater accommodation, rather than further credit tightening? If we are looking at a possible economic precipice, while globalization is opening new markets at a dizzying pace, then a little inflation is needed to prime the pumps.

'Chindia'—China and India—is much in the news, because their combined 2 billion plus consumers will soon by sucking up much of the world's supply of everything. Most of U.S. inflation is fed by higher energy prices, which is a consequence of the weaker dollar (since we import most of our energy needs), which is a consequence of our twin trade and budget deficits. Debt always cheapens a currency. That is our problem to fix, while the rest of the world benefits.