

WEEK OF OCTOBER 23, 2006—FED HOLDS RATES STEADY

Since the Federal Reserve's Open Market Committee held short-term rates steady last Wednesday, a debate has been raging on the meaning of the phrase, "moderate pace", that was part of its press release.

"Economic growth has slowed over the course of the year, partly reflecting a cooling of the housing market," the FOMC statement said. "Going forward, the economy seems likely to expand at a moderate pace."

"Nonetheless, the Committee judges that some inflation risks remain," was the caveat. "The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

So does this mean Fed Governors think the economy is slowing and no more rate action is necessary, until and unless inflation picks up? Or, that the slowdown has not yet happened, so further rate hikes might be necessary?

In fact, market interest rates have been falling—particularly on the long end of the curve—and the Treasury yield curve has become even more inverted. I.e., short-term rates are being held up by the Fed's inaction, so costing banks valuable profits, since they must borrow at short-term rates and lend at longer-term rates.

The yield curve is inverted because bond traders see that inflation has been falling of late. The wholesale PPI and retail CPI indexes for Sept. fell 1.3 and 0.5 percent, respectively, because of falling energy prices. The Fed policy of holding short-term rates high could therefore be overly restrictive, and an attempt to shrink the money supply (I.e., higher rates cause less borrowing, hence money in circulation.). This means that they would be in a position to drop rates if inflation remains benign and housing continues its slump through the end of the year.

Inflation hawks maintain that the lull is only temporary, on the other hand. Third quarter GDP growth may be only 1.6 percent, but signs point to a housing market that is bottoming out rather than continuing to slide, incomes are growing at a 10 percent rate through Q2, and the jobless rate is still at 4.6 percent.

With both new and existing-home sales slower, however, it remains to be seen if the housing market continues its decline, and that will probably be the Fed's deciding factor whether to hold rates or begin to cut them in 2007.

PPI/CPI—The Sept. inflation decline was attributed to a drop of 7.2 percent in overall energy prices and 13.5 percent fall in gas prices. But the core rates did not decline, hence the Fed's concern that some inflation risks remain. Core inflation does show signs of decline with the CPI core rate 2.7 percent in the past 3 months, vs. 3.8 percent in the prior 3 months. And the headline CPI rate is up just 2.1 percent over 12 months, vs. a 3.8 percent gain through August.

EXISTING-HOME SALES—Sept. sales showed a 2 percent annual decline, the sixth in a row, and the national median sales price also fell 2 percent to \$220,000. There was also a slight decline in absolute numbers on the market, but a 7.3-month supply remained due to the declining sales rate. This could mean a bottoming out of declining sales, especially if inventories continue to decline.

NEW-HOME SALES—Much more positive news was the uptick of 5.3 percent in new-home sales. The national median price fell 10 percent to \$217,000, however, the lowest price in 2 years, according to CBS Marketwatch. This means builders are cutting their prices in a bid to reduce inventories.

The U. of Michigan's October sentiment survey also upticked slightly because of lower gas prices. This is a much more transitory index, but inflation expectations over the next 5 years did fall to 3.1 percent. This is heartening to Fed officials, who place more importance on such expectations for consumers buying habits. I.e., research has shown that consumers tend to save more (and spend less) if inflation does not seem a problem.

This is all fuel for the predictions of a Fed continuing to hold rates steady and moderate growth next year. But if both longer-term bond rates continue to decline—the latest rally has brought 10-year TBond yields down to 4.6 percent—and the housing market doesn't stabilize, then the Fed will have to begin to lower short-term rates sooner rather than later. Next week we will discuss some major economists' even more dire predictions for next year.