

WEEK OF JUNE 13, 2005—WHAT CONUNDRUM?

“Among the biggest surprises of the past year has been the pronounced decline in long-term interest rates on U.S. Treasury securities despite a 2-percentage-point increase in the federal funds rate. This is clearly without recent precedent.”

--Alan Greenspan, June 9, 2005—

The simplest answer to Chairman Greenspan's interest rate conundrum is that the Federal Reserve no longer controls the world's money supply. And the amount of money in circulation has a direct effect on inflation and interest rates. The Fed has been attempting since last June to slow money growth by raising the fed funds rate, but longer-term securities have fallen 0.8 percent during that time, as we mentioned in last week's column. This is in order to control consumer spending and hence inflation.

The Fed had a greater influence over currency flows when the dollar was the world's main currency, but no longer. The euro and Japanese yen have been accounting for much of world trade, and it is possible that China's yuan could also become a world currency, if its currency is allowed to float against the dollar in the next 12-18 months.

The rest of the world now has an excess of money, brought on in part by our trade imbalance. We buy more of their goods than they buy from us—something like \$1 billion more per week! And the Fed hasn't yet appreciably influenced the trade imbalance, so it cannot control what foreigners and their central banks do with their (formerly our) money. That has meant investing in U.S. securities—to date in government and corporate bonds, and mortgage-backed securities—which keep medium and longer-term fixed mortgage rates at historic lows.

Has the Fed slowed spending with their interest rate hikes? Not really, because most consumers—whose spending accounts for 80 percent of our economy—can get around having to borrow on their credit cards. They are borrowing against their homes with a vengeance. But higher energy prices have been cutting into consumers' pocket books, especially for the middle and lower classes. And so the higher energy prices, in effect, are doing the job the Fed cannot do.

Meanwhile, inflation seems to be lessening. Both wholesale and retail prices actually declined in May. This is probably because said oil prices “have diminished U.S. purchasing power”, said Dr. Greenspan in his most recent testimony. “The alternating bouts of rising and falling oil prices have doubtless been a significant contributor to the periods of deceleration and acceleration of U.S. economic activity over the past year.”

The Greenspan testimony before the joint economic committee also dashed hopes of an early pause in rate hikes, when he stated that “the soft readings on the economy observed in the early spring were not presaging a more-serious slowdown in the pace of activity.” Bond rates proceeded to rise on his testimony, as it seemed to imply that the Fed was not yet ready to take an interest rate break.

WHOLESALE & RETAIL INFLATION—The (wholesale) Producer Price Index fell 0.6 percent and Consumer Price Index 0.1 percent in May. Prices fell across the board, but energy prices dropped the most. Retail gas prices were down 4.4 percent. The PPI has risen 3.5 percent over the past year, and CPI 2.8 percent, down from their April readings.

RETAIL SALES—May sales fell 0.5 percent, 0.9 percent in department stores and 1.6 percent at motor vehicle and parts dealers. Sales were down everywhere except health and personal care stores, which increased 0.8 percent.

INITIAL JOBLESS CLAIMS—This important indicator of unemployment showed an increase of 1,000 claims to 333,000 per week. It therefore looks like we will be lucky to maintain our current unemployment rate of 5.1 percent.

The third quarter Manpower Employment Outlook Survey also is giving us a possible picture of a flat future for hiring. Manpower surveys 16,000 U.S. companies on their quarterly hiring plans, and its outlook is little changed from the previous five quarters reports CBS Marketwatch. This could mean several things, but mainly that employers are just as cautious about hiring new workers. Only public agencies and new housing construction showed steady jobs growth.

There is a tug-of-war going on between Federal Reserve Policy and the financial markets. But it is the markets that reflect the true state of the economy, and the Fed can do little about it. The Fed Governors seem to be tilting at the inflation windmill with no signs of inflation. The \$56 per barrel crude oil price is doing the heavy lifting for the Fed in tempering consumer spending, which has been noted by the markets, as well as Greenspan.

Inflation does not seem to be a problem and GDP growth is still robust. We again have a ‘goldilocks’ economy; not too hot or too cold. International interest rates are also falling. So what can the Federal Reserve do? We believe that the Fed continues to raise their rates in order to have some ammunition for future emergencies that it may see on the horizon, such as a plunging dollar and/or recession next year.

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