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Research

Bernanke Provides Continuity and More Transparency

Federal Reserve Board Chairman Ben Bernanke's first meeting of the Federal Open Market Committee (FOMC) seemed to go off without a hitch. The FOMC hiked interest rates for the 15th consecutive time (to 4.75%), and released a somewhat more transparent statement that signaled a least one, and possibly more, rate hikes are on the way.

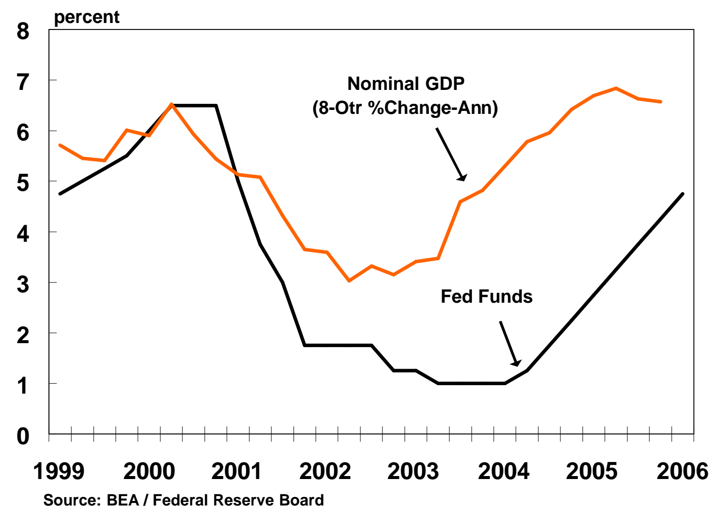
The market response was interesting. The decline in both stock and bond prices following the FOMC announcement suggests that investors were expecting some sign that the Fed was winding down its tightening campaign. But, a slightly more transparent statement made it clear that this was not the case. The first paragraph provided a very understandable explanation of what the Fed sees, forecasts, and does not know. Here it is verbatim:

"The slowing of the growth of real GDP in the fourth quarter of 2005 seems largely to have reflected temporary or special factors. Economic growth has rebounded strongly in the current quarter but appears likely to moderate to a more sustainable pace. As yet, the run-up in the prices of energy and other commodities appears to have had only a modest effect on core inflation, ongoing productivity gains have helped to hold the growth of unit labor costs in check, and inflation expectations remain contained. Still, possible increases in resource utilization, in combination with the elevated prices of energy and other commodities, have the potential to add to inflation pressures."

The Fed expects the economy to slow, respects the power of productivity to contain inflation, but still thinks there is potential for inflation to increase. This economic environment is not a recipe for an end to rate hikes. And the Fed added that "some further policy firming may be needed." The Bernanke Fed has maintained a clear continuity with the Greenspan Fed, and at the same time become slightly more transparent.

We believe that the negative response from the bond market was warranted. The Fed is highly likely to lift rates to 5% at its next meeting on May 10th, and 10-year Treasury yields are likely to move above 5% by that time. The negative response from the stock market, however, was not warranted. There are no signs yet that Fed tightening has cut off liquidity.

Commercial and industrial loans have grown at a 15.3% annualized rate in the past three months, monetary base growth is accelerating, and real interest rates remain historically low. In the past few years, the stock market has temporarily fallen at signs of further Fed rate hikes, but subsequently rebounded. Any pullback due to fear of the Fed should be viewed as a buying opportunity.



Our models continue to suggest that a neutral federal funds rate is near 5.5%. While the Fed may pause before it gets to this level, eventually this rate will be reached. As the chart nearby shows, the funds rate is still significantly below the eight-quarter annualized change in nominal GDP. We will not worry that the Fed has gone too far until the funds rate moves to within 50 basis points of nominal GDP growth. As a result, we remain bullish on the economy and equities, and believe that the Fed will reach a neutral rate within the next twelve months without causing a recession.

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