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May 30, 2006

Monday Morning Outlook

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-31 / 9:00 am	May Chicago PMI	56.4	57.0		57.2
6-1 / 7:30 am	Q1 Productivity: Revised	+4.0%	+3.8%		+3.2%
	Q1 Unit Labor Costs	+1.9%	+2.0%		+2.5%
	Initial Unemployment Claims	320K	305K		329K
9:00 am	Apr Construction Spending	0.0%	+0.1%		+0.9%
	May ISM Index	55.6	56.5		57.3
Sometime During	May Domestic Auto Sales	5.6M	5.7M		5.6M
the Day	May Domestic Light Truck Sales	7.2M	7.1M		7.2M
6-2 / 7:30 am	May Non-Farm Payrolls	+170K	+205K		+138K
	May Unemployment Rate	4.7%	4.6%		4.7%
	May Average Hourly Earnings	+0.3%	+0.3%		+0.5%
	May Weekly Hours	33.9	33.9		33.9
9:00 am	Apr Factory Orders	-1.9%	-2.2%		+4.1%

Nominal GDP, the Fed and Nirvana

Ask anyone what the Federal Reserve controls and you will most likely get an answer having to do with interest rates. And while most people should be forgiven for believing this, they would be dead wrong. The Fed has direct control over only one thing – money.

By using open market operations, the Fed can add or subtract reserves from the US banking system at will. When it adds reserves the federal funds rate falls. When it subtracts reserves, money becomes less plentiful, and the federal funds rate rises.

While 99% of the stories carried in the business press focus on these changes in interest rates when talking about the Fed, it is not the rates that matter, but the money. The growth rate of the money supply determines the growth rate of nominal GDP, or total spending.

The idea is simple really and is described by "The Quantity Theory of Money." This equation (MV=PQ) is attributed to Irving Fisher. The equation says Money x Velocity = Price x Quantity.

More succinctly, the change in the money supply and the change in how fast that money is spent will equal the change in total spending. If the Fed increases the money supply by 6% (and velocity does not change), then nominal GDP (real growth plus inflation) will grow by 6%. The faster the money supply grows, the faster total spending grows – assuming constant velocity.

In the 1930s, the Fed allowed the money supply to contract. This incredibly damaging mistake caused nominal GDP to decline. The US experienced deflation and falling real output at the same time. In the 1970s, the Fed created too much money. Between 1978 and 1981, nominal GDP grew at an annual average rate of 10.9% - real GDP averaged 1.8%, while inflation averaged 8.9%.

Understanding this is the key to understanding Fed policy. It shows exactly how accommodative Fed policy has been in the past few years. During the deflationary years of 2001 and 2002, nominal GDP grew just 3.3%. But in the past three years, nominal GDP has grown at an annual average of 6.8% - the fastest three-year growth rate since 1990.

Moreover, our models indicate that to be "neutral," the federal funds rate should be within 1% or less of the growth rate of nominal GDP. A "neutral federal fund rate" is when money supply and money demand are in balance – when nominal growth is stable.

In other words, if the Fed had hiked rates faster in 2004 and 2005, nominal GDP would have stabilized at a slower rate and the Fed would already be at neutral. Instead, the measured pace of Fed rate hikes left the Fed "behind the curve." Our models suggest that today's 5% rate is roughly 100 basis points below a true neutral rate. The longer it takes the Fed to hike rates to 6%, the faster nominal GDP will grow and the higher the neutral rate will become.

While conventional wisdom suggests that the Fed will pause soon, we suspect that this is just wishful thinking by many who felt the Fed would stop hiking months ago. While 16 consecutive rate hikes have created a great deal of consternation for those who view the Fed only in terms of interest rates, monetary policy is not yet tight. The more accurate description is that policy is just "less loose." If the Fed can lift rates to 6% by autumn, our models would judge this as monetary policy nirvana.

Week of June 5, 2006

Date/Time (CDT)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-5 / 9:00 am	May ISM Non Mfg Index	61.8	62.0		63.0
6-9 / 7:30 am	May Import Prices	+0.5%	+0.8%		+2.1%
	May Export Prices	+0.3%	+0.3%		+0.5%
	Apr Trade Balance	-$64.7B	-$64.0B		-$62.0B

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