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FIRST Trust ADVISORS L.P.

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Economic Commentary

Pause Talk Déjà vu

All eyes were on Federal Reserve Board Chairman, Ben Bernanke, as he delivered part deux of his semiannual report on monetary policy to the House Financial Services Committee.

The semiannual report includes testimony from the Chairman, a longer written report on the economy and monetary policy, a Fed forecast, and some Q&A. Other than the Q&A, the rest of the report is a compilation of the views of the Fed Board and its regional banks. The views of Governors, regional bank presidents, staff, boards of directors, and advisory committee members are all included in one form or another. However, the Washington-based staff clearly has the most influence on the entire process.

On a whole, the testimony sounded no new themes. The Fed is still in the "data dependency" mode. However, it appears that the Fed staff is more convinced than ever that past tightening is beginning to bite into the economy.

The "central tendency" of all the Fed's forecasts puts real GDP growth between 3.25% and 3.5% in 2006, and nominal GDP growth in the 6.0% to 6.25% range. Working out the math shows that the Fed staff expects real GDP to grow 2.5% or less in the second half of 2006, while overall inflation will fall below 2.5%.

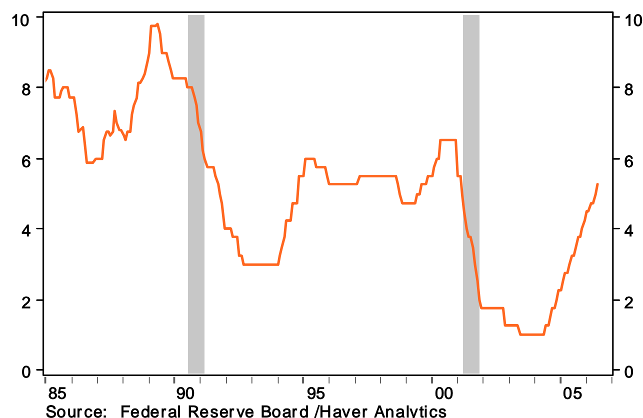
This is a very bearish forecast for economic growth and a very optimistic forecast for inflation. For example, it is below the average forecast of Wall Street Journal survey participants who see second half real GDP growth of 2.9% and consumer price inflation of 3.1%. While the Fed expects nominal GDP growth to slow to less than 5.0% in the second-half, the WSJ survey shows an expectation of roughly 6.0%.

This is very important. The Fed staff and most of the financial press, have underestimated the strength of the economy for many years. In addition, the market has expected the Fed to go "one and done" for at least the past 1 ½ years. In June 2005, Dallas Fed President Richard Fisher said the Fed was in "the eighth inning" of rate hikes. The market went nuts. Since then the Fed has hiked interest rates nine times.

While the past does not determine the future, we believe that the renewed hope for a "pause" or "halt" in rate hikes is unlikely to be satiated. Chairman Bernanke told Senator Bunning yesterday that "if we had stopped raising rates at 4.75% or 4.5%, I think there would be a lot of concern in the market, in the economy, about inflation at this point."

Certainly, the Fed wants to pause. And, it appears that the market wants the Fed to pause too. But we continue to believe that the best policy for the US economy and financial markets is for the Fed to reach neutral. Bernanke is absolutely right – if the Fed stops too soon, inflation will be worse. Our models show that a neutral interest rate is roughly 1% below the 2-year average growth rate of nominal GDP. In the past two years, nominal GDP has increased 6.7%. This would put the neutral fed funds rate at roughly 6%.

As long as the Fed holds the federal funds rate below neutral, the economy is highly unlikely to slow down significantly. It is not the total number of rate hikes or the pace of those hikes than matters for the economy (except in extreme circumstances); it is the level of the federal funds rate relative to nominal GDP which we use as an indicator of monetary policy. As a result, we believe that the Fed is not yet tight, just less loose.



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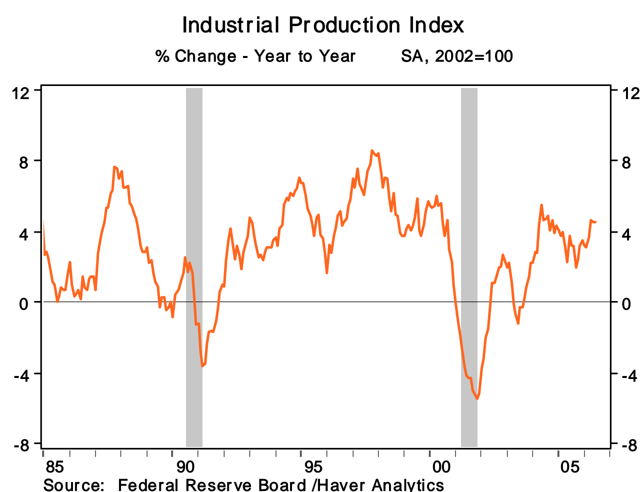
Of course, nominal GDP could slow. But sharp shifts in nominal GDP growth from 7% to 5%, as the Fed staff has forecasted for the second half of this year, are very rare. They typically are caused by excessive tightening in Fed policy. There is no sign of this yet in the economy. Commercial and industrial loans and other measures of liquidity do not indicate tight money.

While many pundits are focused on slowing consumer spending and housing, historically, it is business investment, durable goods orders and industrial production that are much better leading indicators. In the recession of 2001, consumption did not decline in any quarter, but business investment and industrial production fell sharply.

In June, industrial production increased by 0.8%, while durable goods orders are strong and the backlog of durable goods orders is up 15% so far this year. Moreover, productivity and profits are booming



Our models suggest that current weakness in the housing market is just a pull-back to more normal levels of activity as interest rates return to justifiable levels. Even after sharp declines, the housing industry is operating at historically high levels. Moreover, one month of decline in retail sales is not overly concerning. During the 55 months of this recovery, retail sales have fallen 18 times. With initial unemployment claims remaining between 300,000 and 330,000 during recent months, it is also difficult to believe that the labor market is weakening.

In the end, the Fed may be forecasting a slowdown in the economy, but it is unlikely to happen. This is not all that surprising. With tax rates low, the supply-side of the economy remains resilient. Moreover, monetary policy is not tight. As a result, our forecast continues to suggest 3.5% to 4.0% real GDP growth for the remainder of this year with inflation in the same range. This will keep nominal GDP growth at 7%, or above.

With nominal GDP possibly accelerating, it is hard to imagine the Fed pausing in its rate hikes. We expect the Fed to hike in August and continue to believe that it will reach 6% before the end of 2006. If the Fed does pause, it will return to hiking rates later in the year because the economy will not slow. Either way, if the markets are really expecting that interest rates have topped out, they are likely to be disappointed.

There has been hope among many supply-side oriented economists that Chairman Bernanke would push the Fed to at least look at more market-based indicators of the monetary policy, such as gold, other commodity prices and the dollar. But these hopes have been dashed in the past two days.

The entire Fed outlook is based on a demand-side, Phillips Curve view of the world. The Fed is still thumbing its collective nose at the power of these market-based indicators. We find this amazing. In the late 1990s and early 2000, commodity prices were weak and the dollar was strong. These markets forecasted the deflationary pressures which became evident in 2001-02. In recent years, rising commodity prices and a falling dollar gave advanced warning that inflation would be a problem.

As long as the Fed ignores these signals, mistakes in monetary policy will be made. Right now, these markets are signaling that the Fed has more work to do.

While the markets yesterday seemed to like the idea that a pause may by in the works, as Chairman Bernanke said, “the literature suggests that stock markets don’t do well in periods of high inflation.” We could not agree more. The Fed cannot create wealth by printing more money. The Fed’s number one goal should be to keep inflation low and stable. We believe that the best way to do this is to pay attention to market-based indicators not a low-probability forecast emanating from Fed staff models.

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