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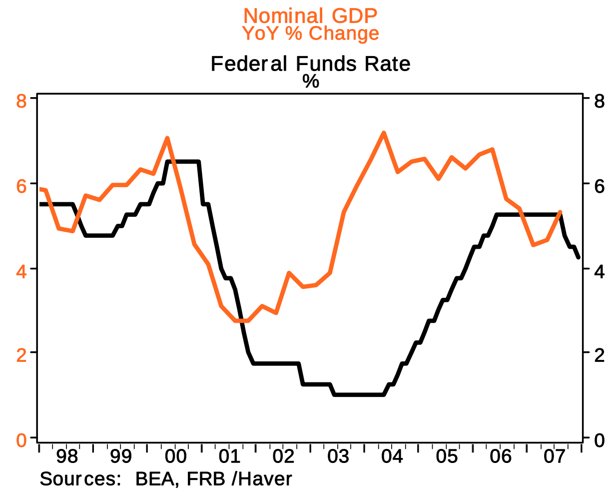
Dec 20, 2007

Economic Commentary

Non-Housing GDP Signals Loose Money

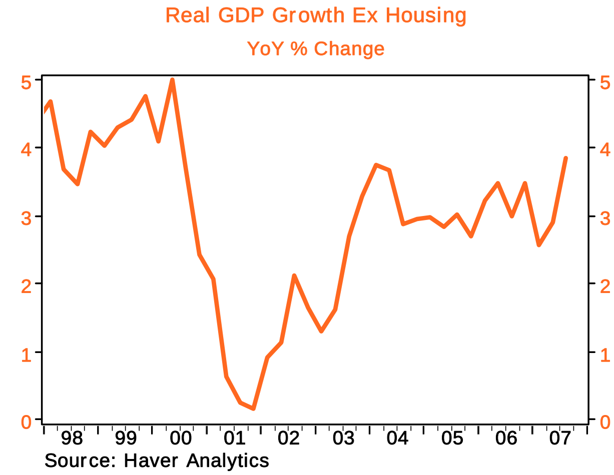
Our model for judging the stance of Federal Reserve policy is heavily dependent on the link between the federal funds rate and growth in nominal Gross Domestic Product (real GDP plus inflation). Nominal GDP is a measure of top-line revenue growth, or overall purchasing power.

A neutral funds rate is roughly 50 basis points below nominal GDP growth. A loose policy occurs when the Fed holds the federal funds rate significantly below that level, while a tight policy is signaled by a federal funds rate at or above nominal GDP growth.

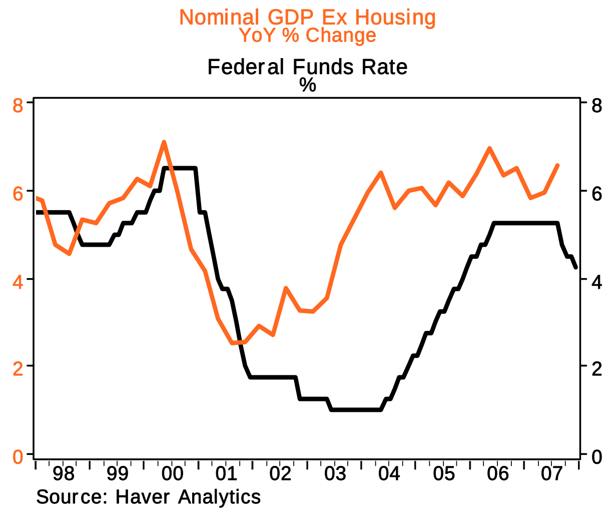


This model shows clearly how easy monetary policy was between 2002 and 2005. The funds rate was well below nominal GDP; gold, oil and other commodity prices rose sharply, while the dollar fell. In other words, loose monetary policy increased inflationary pressures. This model also makes it appear that the Fed became tight in late 2006 - early 2007, and has now become loose again.

However, the current business cycle has been greatly affected by a boom and bust in the housing market that was created by easy money and lax credit standards. Excluding housing, the economy has shown no significant signs of slowing. In fact, real GDP has grown at a 3.8% annual rate in the past year, the fastest pace since 2000, when the dot.com boom and Y2K-related spending was boosting growth.



As a result, a monetary policy designed to help the housing market is too easy for the non-housing economy. After excluding housing, nominal GDP has accelerated in the past year, while the Fed has been cutting rates.



The bottom line: Federal Reserve policy is much easier than conventional wisdom suggests. The 95% of the economy that is outside the housing market is booming, and an interest rate policy designed for the housing market will be much more inflationary than many believe.

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