Economic Commentary

October 31, 2005

Fed Meets Again, … Rates Rise Again

The U.S. Federal Reserve is meeting again tomorrow and is fully expected to raise rates by a quarter of a percentage point to 4.0%, the 12th consecutive increase in the target for the fed funds rate. With one more meeting left for 2005 on December 13th and one more chaired by Alan Greenspan, the outgoing Chairman on January 31, 2006, the Fed is expected to raise the key policy rate to –at least 4.5% by the end of January and probably to between 5.0% and 5.5% by the middle of next year.

The arithmetic for this forecast is fairly clear. The U.S. economy continues to grow at an above average rate –the preliminary estimate output growth for the third quarter came out at 3.8% last Friday- while headline consumer inflation has jumped to a year-over-year annual rate of 4.7% in September. With the US output gap closing quickly and inflation expectations rising, the biggest threat to the US economy has become inflation, not unemployment. The Federal Reserve like any central bank has an obligation to deal with the prospect of higher inflation by tightening the growth in the money supply and raising interest rates. After a prolonged period of easy money the Fed and Alan Greenspan in particular whose term is ending in three months is on course to return the monetary policy settings back to neutral, which most economists believe is around the 4.5% level.

Whether there will be a need to raise them further is too early to tell, but one can make a strong case that they will. Although I believe that the US economy is heading for recession some time next year and I have pointed out repeatedly the reasons why in my previous commentaries, the Fed has to respond to the actual data and as long as the actual data show that the economy is growing and inflation is rising they have no choice but to react with further tightening. The 3.8% preliminary reading issued by the Commerce Department for third quarter growth has cheered the market and calmed the fears of an impending slowdown, the result of rising interest rates, the impact of the two hurricanes, the crash in consumer confidence and the overextended US consumer have not shown up in the data, at least not yet. The 3.8% reading is a rear view mirror of what happened in the economy during the June to September period and is not a leading indicator of future economic activity. Sooner or later the structural imbalances and consumer fatigue will set in. The longer it does, the more the Fed will keep raising interest rates and the longer it keeps raising interest rates the higher the probability that an economic slowdown will occur.

Last week President Bush announced Greenspan's replacement as Chair of the Federal Reserve, Mr. Ben Bernanke. As is always the case with a new boss, he has to establish his credibility in the marketplace and in a central bank's case that means showing his willingness and ability to be tough on inflation. Once he does he can afford to lower rates without being dubbed a softy. Since Ben Bernanke will be assuming the helm on February 1st, 2006, one should expect that he is more likely to raise rates than to hold them steady. Thus, I expect short-term rates to keep on rising through Spring and early Summer until the market feels the sting and starts clamoring for the Fed to stop. Given the structural imbalances of the US economy, and the time lag with which monetary policy operates, the risk is that the US Fed will over-tighten rates and precipitate a recession.

With ten-year US bond yields peaking at 4.57% last week, up from 4.32% in March, a move in the target for the fed funds rate above the 4.5% mark implies either an inverted yield curve which has proven to be an accurate predictor of recessions in the past or a drop in bond prices and a corresponding jump in long rates to the 5.0% – 5.5% range. The longer the US economy keeps growing, the higher the price of oil and allied energy prices will remain, the higher oil prices remain the higher the inflation rate will be, the higher the inflation threat the more vulnerable bond prices will be to a correction and/or the higher the Fed will have to raise money rates. Either way the best of the economic expansion is behind us and we are heading for more trying times. A soft landing, if the new Fed Chairman can engineer it, seems the "best case" scenario right now. But the risk of a hard landing remains.

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