

April 29, 2005

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FEDERAL RESERVE AND INTEREST RATES: CONUNDRUM, CONSTERNATION, OR CONFUSION

The Recession of 2001, yet again...

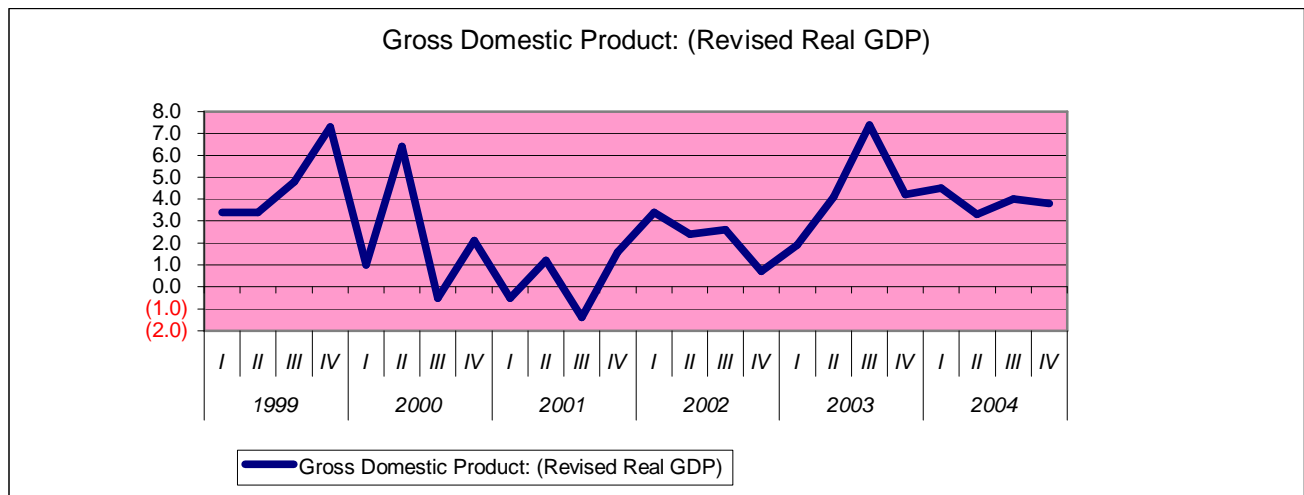
There is a widely held belief that the economy began to slow down and entered into a recession in the second quarter of 2001. The NBER (National Bureau of Economic Research <http://www.nber.org/cycles/recessions.html>), an economic organization has asserted as much. Looking at the following schedule and accompanying graph, you might find a different interpretation. It is our contention that the slowdown actually occurred in first quarter of 2000 after a fourth quarter of 1999 sizzling real growth of 7.3% annualized; the economy destabilized and the result was a plunge in GDP...

What Recession? The ongoing debate as to when/if there indeed was a recession at all

(Webster's Dictionary) **RECESSION** : A period during which economic activity, as measured by gross domestic product, declines for at least two quarters in a row in a specific country. If the decline is severe and long, such as greater than ten percent, it

Bureau of Economic Analysis (BEA)
Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product
[Percent] Seasonally adjusted at annual rates
Today is: 4/16/05 Last Revised on March 30, 2005 Next Release Date April 28, 2005

	1999				2000				2001				2002				2003				2004			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Gross Domestic Product: (Revised Real GDP)	3.4	3.4	4.8	7.3	1.0	6.4	(0.5)	2.1	(0.5)	1.2	(1.4)	1.6	3.4	2.4	2.6	0.7	1.9	4.1	7.4	4.2	4.5	3.3	4.0	3.8



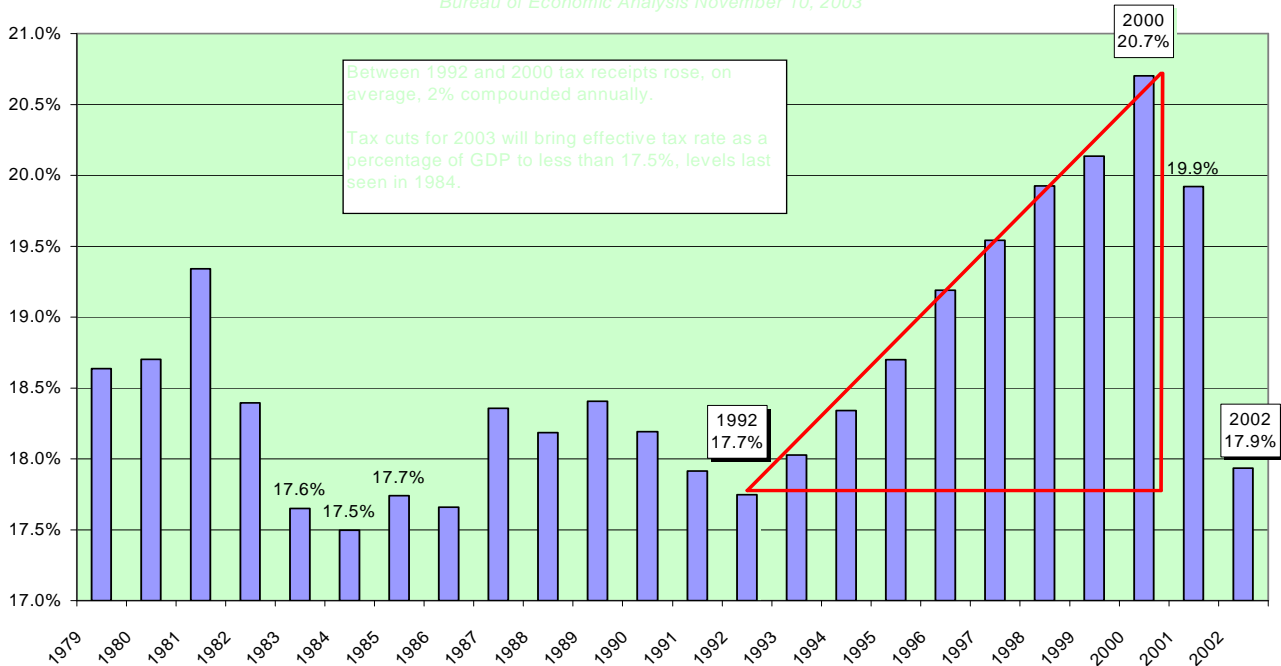
NBER: "According to the chronology, the most recent peak occurred in March 2001, ending a record-long expansion that began in 1991. The most recent trough occurred in November 2001, inaugurating an expansion."

By historical definition, since we did not have at least two consecutive quarters of real negative growth, **we did not have a recession**. The infamous second quarter of 2001 was positive in the first estimation, later revised downward and finally, the last revision for that quarter was positive yet again. Again, the rules, according to the NBER have been changed: from as much as we can tell, a recession is based on a vote; a board reviews whether or not they deem a recession has in fact occurred.

The year 1999 ended with a fourth quarter real positive growth of 7.3%. That growth rate had fallen to a negative growth rate of 0.5% by the third quarter of 2000. If a recession was to be designated, the beginning of it should have been dated as the first quarter of 2000 and surely no later the second or third quarter of 2000. To say it began in 2001 first quarter makes all such future designations highly subjective and suspect.

Fiscal Factor – Taxes

Tax Receipts as a Percentage of (Nominal) GDP
 Data extracted from Department of Commerce:
 Bureau of Economic Analysis November 10, 2003



The year 2000 marked the 8th consecutive year of rising tax revenues, partly caused by periodic tax rate increases. By 1999, \$111 billion surplus in the Federal government’s general account occurred as well as a rising surplus in the Social Security budget. The U.S. Trade Deficit had reached a very high level of \$260 billion by 1999. Despite the self-kudos by Federal officials pointing to the “achievement” of a budget surplus beginning in 1998, one has to remember that budgetary deficits still stimulate economic activity, while surpluses actually depress, regardless of the political merit or popularity.

Yes! Budgetary surpluses still depress the level of economic activity.

Taxes by government reduces

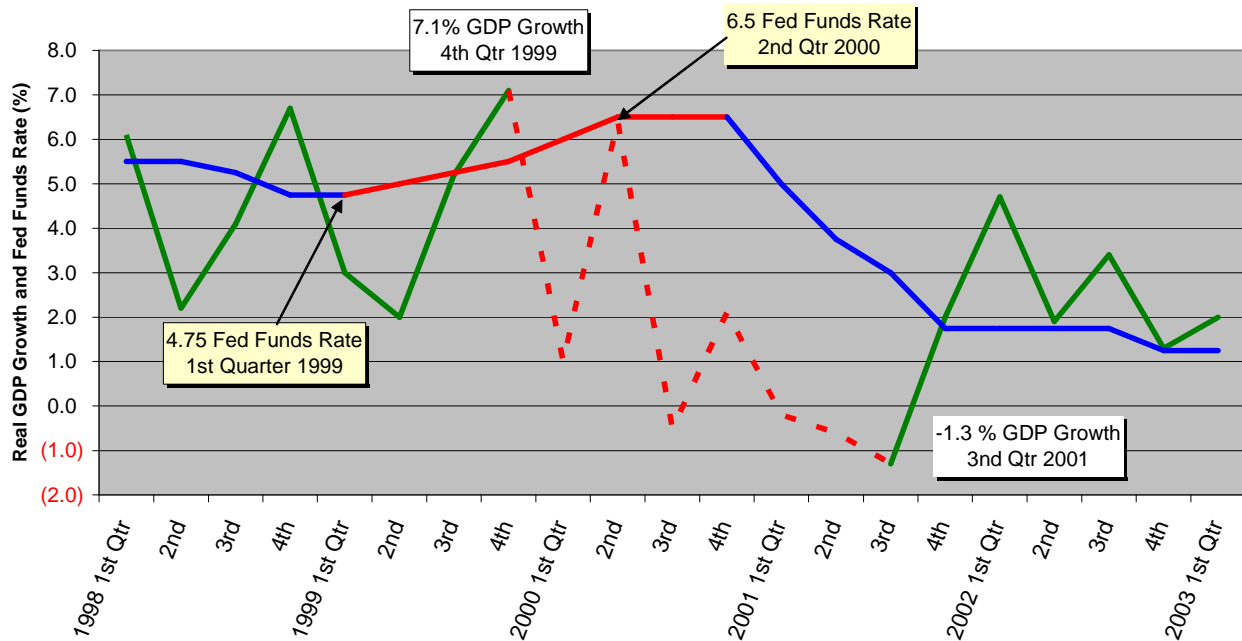
Here comes the Fed...

The Collapse of the Economy 2000-2001

Interest Rate Hikes (Fed Funds) from 4.75%
in 1st Quarter 1999 to 6.5% in 2nd Quarter 2000

GDP Data from Bureau of Economic Analysis (Retroactive Adjustments in Dec. 2003)

Fed Funds Data from Federal Reserve Board



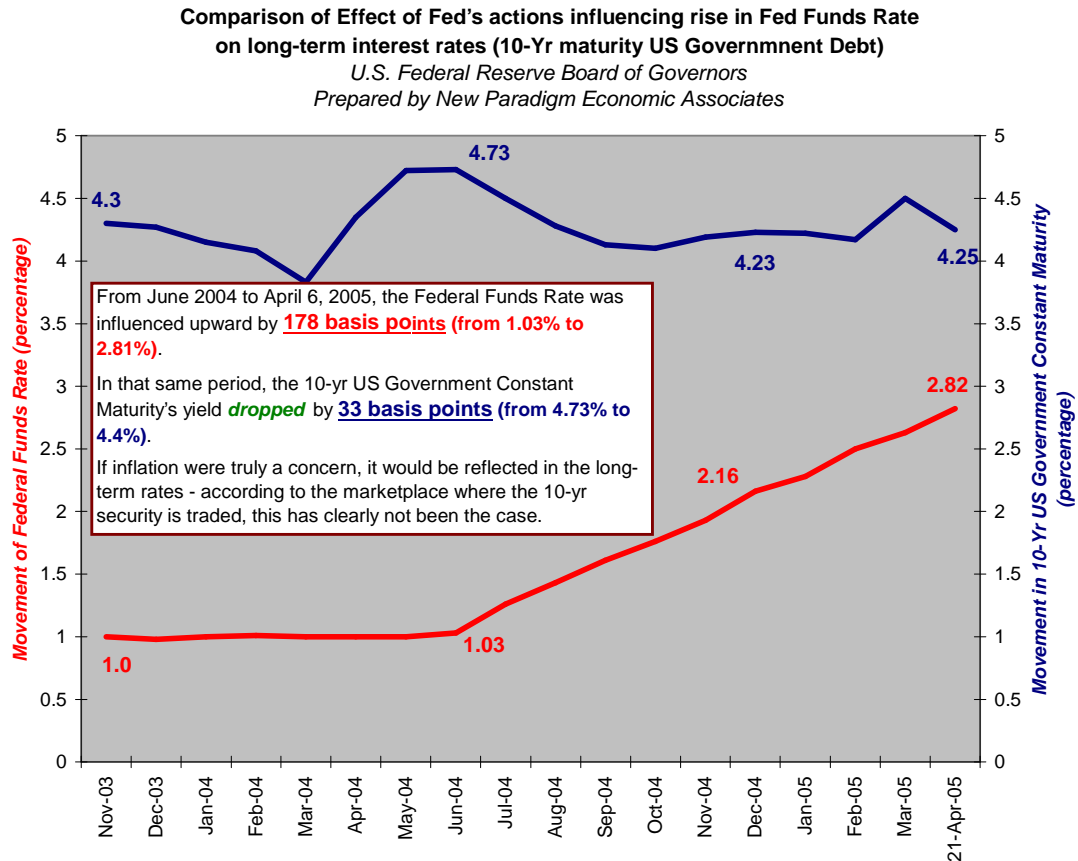
By 2000, the U.S. was experiencing a lethal combination of a large Federal Government budget surplus, a growing Social Security System surplus and a huge trade deficit. This was a time bomb waiting to explode. While this combination was sufficient in itself to bring down a rapidly growing economy, 7.3% real annualized growth in the fourth quarter of 1999, the Fed, appearing blissfully ignorant of these conditions, was the spark to blow apart the rapidly growing economy. Paranoid about the possibility of a return to significant inflation, it began a period of restrictive monetary policy by influencing interest rates upward. The collapse began in the first quarter of 2000, rebounded slightly in the second quarter of that year, but then turned negative by quarter three of 2000.

The record is absolutely clear...

Perhaps the Fed was a victim of its past where preoccupation with fighting unemployment led them to ignore the persistent rise of the inflation rate and its explosive acceleration in the late 1970s as it approached 20% at an annualized rate.

That was nearly 20 years before the fiasco of ill-advised monetary and fiscal policies leading to the collapse of 2000. The inflation of the late 1970s was real. There was no such evidence of inflation in 1999.

Beginning in 2004, the Fed once again began to force short-term interest rates upward. From about a 1% overnight Fed funds rate to about 2.75% April of 2005.



Focusing more narrowly on the Fed's actions

First, some background...

The Expectations Theory of the Term Structure of Interest Rates, widely held by analysts, argues that the relationship of interest rates of varying maturities (the graph of which is the yield curve) is determined by the markets expectations of short-term rates over the coming relative period. For example, the 10-year rate is the geometric average of the expected short-term rates over the coming ten years.

Since the Fed operates primarily in the short-term end of the market by buying and selling short-term securities, it is not certain of the

impact of these open market operations on the longer term rates. Their apparent frustrations (a.k.a. conundrum) appears to be the decline of longer term rates (e.g., 10-year government bond rates) even though they have forced up short-term Federal funds rates by 150 basis points. What this means is that the market has formed expectations of the coming ten years of short-term rates to cause the longer term rates to be lower than the Fed wanted them to be...

In one sense, the market could be convinced that the Fed's current policy will cause either an elimination of inflation, or perhaps, the beginning of deflation, or even a recession in the ensuing years. In the other sense, that means longer term rates will have smaller inflation premiums embedded in them or that a weakened economy will result in lower real interest rates.

The market is of the belief that short-term interest rates are going to rise less in the future than the Fed believes. Recall that in the Expectations Theory, actual long-term rates are the geometric average of the expected short-term rates for that time period.

It is clear that the Fed does not control expectations of future short-term interest rates. Some possibilities are that the Fed has set off fears of a softening economy, or that the public believes that any remaining inflation will be eliminated, if not outright deflation occurring. An alternative to the Fed's fear of inflation could be that they want short-term rates higher in order to give them some room to maneuver should the economy actually soften (providing them an opportunity to lower interest rates should the need arise).

The New Economic Paradigm Its Increasing Relevance and answer to Greenspan's Conundrum

There are a couple of problems in the Fed's monetary policy, both in 1998 – 2000 and currently in 2004 – 2005. What the Fed fails to understand is that in an environment of significant competition, demand-pull inflation is much less likely to occur than in the past. What the Fed seems to be unable to fathom is that inflationary pressures occurring today are coming primarily from the oil industry, or a cost-push variety of inflationary pressure. The Fed has never successfully tamed cost-push inflation (witness the two oil shocks in the 1970s) without a dramatic decline in the economy and large collateral effects – as seen in the engineered collapse of the economy

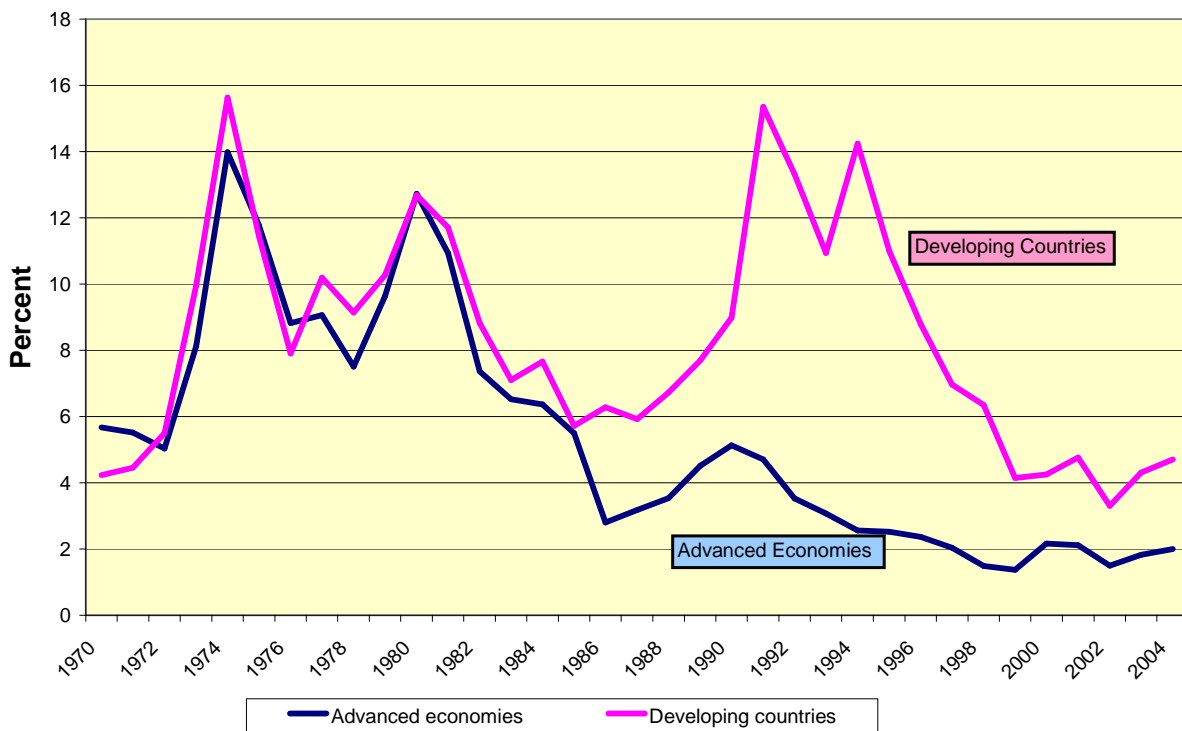
in 1980 – 1982. What the Fed needs is to humbly admit that the cost-push inflationary pressures we are now experiencing, while increasingly dampened at the retail level, can be best addressed by the Anti-Trust Division of the Justice Department. In the meantime, sub-par profits are accelerating structural unemployment.

As another indicator of those evolutionary, but dramatic changes in the increasingly competitive U.S. markets, note the changes that have also been occurring on the international front. Increasing competition in the world, as well as domestically in the U.S. has brought together the behavior of commodity prices facing both the developing and advanced countries.

Consumer Prices --- Inflation

Real Commodity Prices

(Source) International Monetary Fund: April 2005



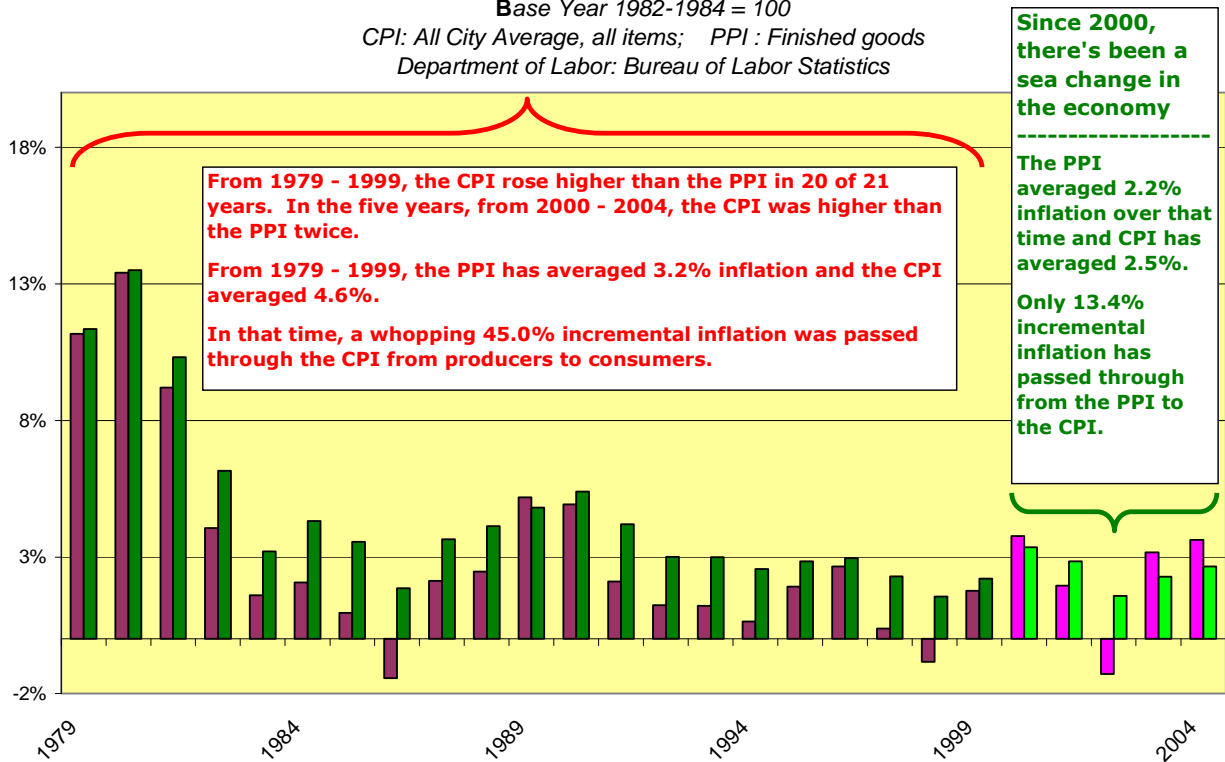
For the past five years, as contrasted with previous data, the Consumer Price Index CPI no longer reflects the Producer Price Index pressures. The CPI has been rising less than the PPI in three of the last five years. Remember also, that the CPI includes services at the retail level have in previous years, been the main source of inflation.

Even with these included, the CPI is reflecting less inflation than the PPI. This is in stark contrast to what has typically been the case in the past.

Growing Relevance (Evidence) of the New Paradigm
Less Inflation being passed on to the Consumer

Base Year 1982-1984 = 100

CPI: All City Average, all items; PPI : Finished goods
 Department of Labor: Bureau of Labor Statistics



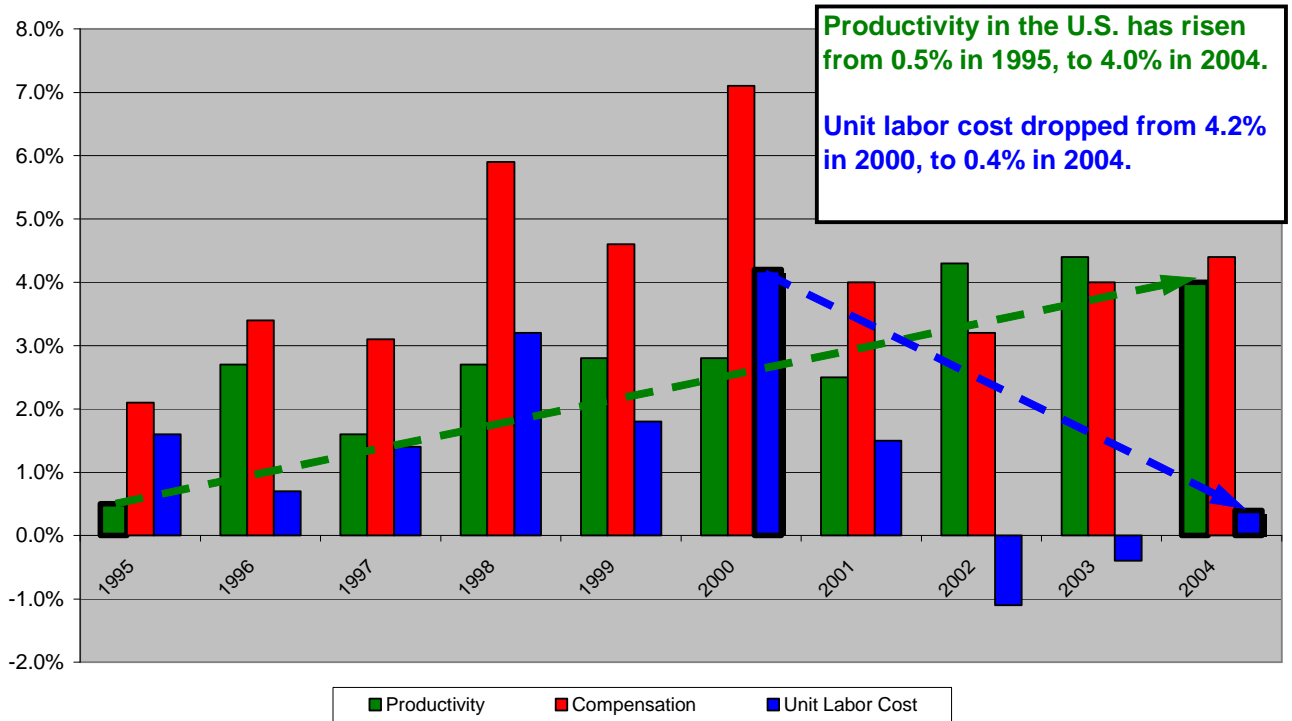
Another one of Greenspan’s so-called conundrums, or areas of concern is productivity. The data increasingly shows more rapid rates of growth in productivity, especially in areas where competition has been forcing restructuring. The restructuring, whether through outsourcing, automation, etc., results in higher output per worker. The increases in productivity offset increases in compensation – as a result, the figures on unit labor cost have been trending down for the past five years. In this newsletter, we have pointed out several instances showing that “The New Paradigm” is in fact evolving through increasing competition and in an ever-widening pattern of markets. While there has been a major increase in oil costs as seen in oil prices and in imported oil price statistics, much of the cost pressures – including oil prices, have been substantially muted at the consumer price level because of the inability to pass those costs on in the form of higher prices. This is all

consistent with the increasingly growing and diffused pressure of competition.

Productivity, Compensation and Unit Labor Costs

1995 - 2004

Department of Labor
Extracted April 29, 2005



It must be stressed that the rise in import prices, dominated by oil, underscores the argument that this is not generalized inflation, but rather coming primarily from one source – energy.

Again, most of the current inflationary pressures are coming from the energy sector. The price of imported oil has risen by 36% from April 2004 to March 2005.

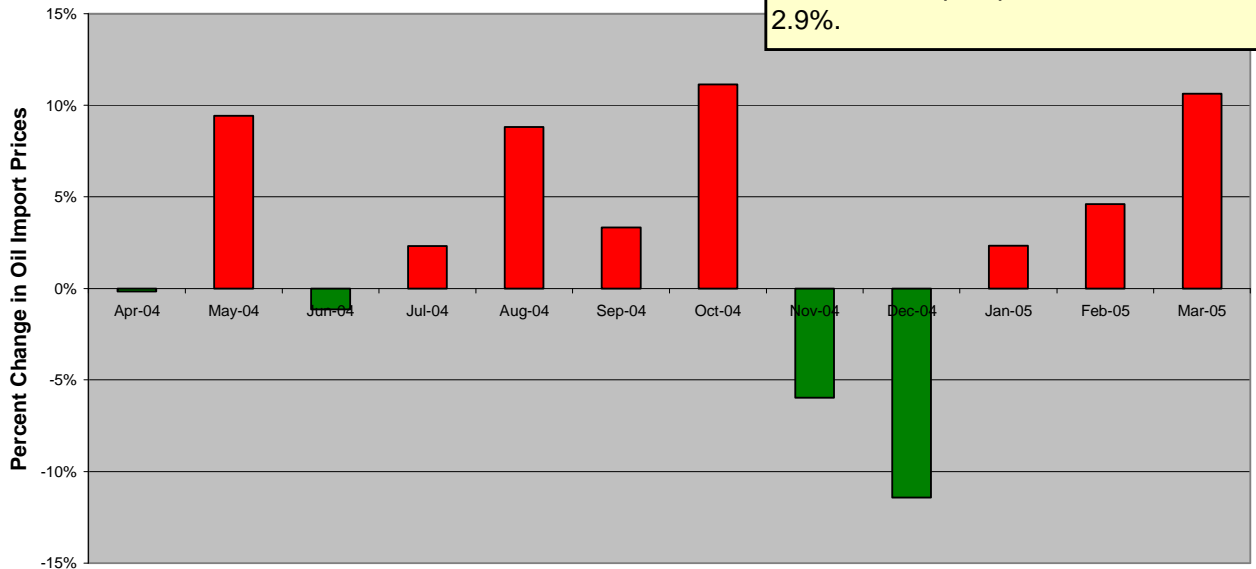
Percent changes in import and export price indexes:

Petroleum and Petroleum Products

U.S. Bureau of Labor Statistics

Extracted 4-27-2005

The overall Imports increased by 7.1%, from April 2004 through March 2005, while energy increased by 36.1%. Without oil, import prices increased 2.9%.



Bear in mind that we consume around 20 million barrels of oil per day and of that amount, we import well over half...but we'll speak to that in the next issue.

Finally...

The Fed should realize that the traditional monetary policies used to combat demand-pull inflation cause extreme collateral damage to the economy, including a slow-down because inflation is coming from the aggregate supply side (cost-push) in the form an oil shock.

When, oh when, will the Fed understand this distinction?

Current Statistics (4-29-2005)

The Employment Picture



Unemployment Rate ({5.2% Jan}...{5.4% Feb})...**{5.2% Mar}**

Total nonfarm payroll employment increased by 110,000 in March, and the unemployment rate declined to 5.2 percent, the Bureau of Labor Statistics of the U.S. Department of Labor reported today. Several industries added jobs over the month, including construction, mining, health care, and wholesale trade.

Industry Payroll Employment (Establishment Survey Data)

Total nonfarm payroll employment increased by 110,000 in March to 132.9 million, seasonally adjusted. Industries with over-the-month job gains included construction, mining, health care, and wholesale trade. Payroll employment has risen by 2.1 million over the year and by 3.1 million since its most recent trough in May 2003.

Unemployment (Household Survey Data)

Both the number of unemployed persons, 7.7 million, and the unemployment rate, 5.2 percent, decreased in March. The jobless rate was down from 5.7 percent a year earlier.

News Release - <http://bls.gov/news.release/empsit.nr0.htm>



Jobless Claims
(4-wk rolling average: **338,750 Apr-9**, to **331,000 Apr-16**, to **323,000 Apr-23**)

In the week ending April 23, the advance figure for seasonally adjusted initial claims was 320,000, an increase of 21,000 from the previous week's revised figure of 299,000. The 4-week moving average was 323,000, a decrease of 8,000 from the previous week's revised average of 331,000.

For 2001, the average weekly initial jobless claims were running around 405,000; thus far, in 2005, the average has been in the 330,000 range.

News Release - <http://www.dol.gov/opa/media/press/eta/ui/current.htm>



GDP (1st Quarter 2005 Real GDP: 3.1%)

Real gross domestic product -- the output of goods and services produced by labor and property located in the United States -- increased at an **annual rate of 3.1 percent in the first quarter of 2005**, according to advance estimates released by the Bureau of Economic Analysis. In the fourth quarter, real GDP increased 3.8 percent.). It marked the 14th consecutive quarter of economic expansion.

The major contributors to the increase in real GDP in the first quarter were:

Personal Consumption Expenditures (PCE) 2.45%
 (Durable Goods 0.0% (Motor Vehicles and parts -0.42%); Nondurable Goods 0.98%; Services 1.46% change from 4th Quarter)

Gross private domestic investment. 2.03%
 (Fixed Investment 0.82%; Change in Private Inventories 1.21%)

Net Exports (Exports – Imports): -1.49%
 Exports contributed 0.69% while Imports negatively impacted the total by -2.19%

Government Spending (Government consumption expenditures and gross investment): 0.1%
 Federal increasing 0.04% and State and Local up 0.06%

News Release - <http://bea.gov/bea/newsrelarchive/2005/gdp105a.htm>

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Leading Indicators

According to figures released by the Conference Board on Thursday, April 21, 2005, "The leading index declined in March following a small increase in February. The leading index has been essentially flat since October 2004 following a small decline over the previous five months. In addition, there have been more weaknesses than strengths among the components of the leading index in recent months." The Conference Board announced today that the U.S. leading index decreased 0.4 percent, the coincident index increased 0.2 percent and the lagging index decreased 0.1 percent in March.

Next release – Thursday, May 19 at 10:00 AM ET

News Release - http://www.conference-board.org/economics/bci/pressRelease_output.cfm?cid=1



Construction (put in place)

The most recent data from the Census Bureau shows rising levels of construction put in place. The U.S. Census Bureau of the Department of Commerce announced today that construction spending during February 2005 was estimated at a **seasonally adjusted annual rate** of \$1,047.3 billion, 0.4 percent ($\pm 1.6\%$)* above the revised January estimate of \$1,043.6 billion.

The February figure is 10.0 percent ($\pm 2.2\%$) above the February 2004 estimate of \$952.2 billion.

Next release – March 2005 data will be released on May 2, 2005 at 10:00 A.M. EDT.

News Release - <http://www.census.gov/const/C30/release.pdf>



New Housing Starts

The most recent joint U.S. Census Bureau and U.S. Department of Housing and Urban Development data available show a drop off in new housing starts. Housing starts in March 2005 were 1,837,000, down 17.6% at a **seasonally adjusted annual rate** from February's revised level and down 8.2% from March 2004. Permits were 2,023,000, down 4% from last month but up 0.2% from one year ago.

Next release (for April) – May 17, 2005 at 8:30 A.M. EDT.

News Release - <http://www.census.gov/indicator/www/newresconst.pdf>



New Residential Sales

According to the U.S. Census Bureau and U.S. Department of Housing and Urban Development, sales of new homes (one-family houses) in March were 1,431,000, up 12.2% from last month and up 12.7% from one year ago (on a seasonally adjusted annualized basis). This rate is above the revised February 2005 figure of 1,275,000 units and the March 2004 of 1,270,000.

Next release (for April) – May 25, 2005 at 10:00 A.M. EDT.

News Release - <http://www.census.gov/const/newressales.pdf>



Durable Goods

The most recent report from the Commerce Department, Census Bureau shows that **New Orders** for manufactured durable goods in March decreased \$5.6 billion or 2.8 percent to \$194.0 billion, the U.S. Census Bureau announced today. This followed a 0.2 percent February decrease.

Shipments of manufactured durable goods in March, down two consecutive months, decreased \$0.3 billion or 0.2 percent to \$204.0 billion. This followed a 1.8 percent February decrease.

Unfilled orders of manufactured goods in March, down two of the last three months, decreased \$2.7 billion or 0.5 percent to \$551.9 billion. This followed a 0.5 percent February increase.

Meanwhile, **Inventories** of manufactured durable goods in March, up sixteen consecutive months, increased \$1.2 billion or 0.4 percent to \$291.0 billion. This followed a 0.7 percent February increase.

Capital Goods Industries (March):

Defense, new orders increased \$0.4 billion or 5.2% to \$7.3 billion; shipments decreased \$0.2 billion or 1.9% to \$8.2 billion; unfilled orders decreased \$0.9 billion or 0.6% to \$144.5 billion; inventories decreased by \$0.3 billion or 1.6% to \$19.7 billion.

Nondefense new orders decreased by \$4.3 billion or 6.2% to \$64.5 billion; shipments increased by \$0.1 billion or 0.1% to \$66.7 billion; unfilled orders decreased \$1.2 billion or 0.5% to \$248.4 billion; and inventories increased \$0.4 billion or 0.4% to \$113.6 billion.

As ever, durable goods measure continues to be a volatile indicator but the trends have been positive (looking over the past several months).

Next release (for April) – May 25,2005 at 8:30 A.M. EDT.

News Release - <http://www.census.gov/indicator/www/m3/>



Current Account Balance (Trade Balance)

The Current Account Balance consists of the Trade Balance (Net Exports (Exports less Imports) of Goods and Services), the Income Balance (Income Receipts and Income Payments), and net Unilateral Current Transfers. The Department of Commerce publishes the Current Account Balance data on quarterly basis.

The U.S. Current Account Balance 2003 – \$530.7 billion

The U.S. Current Account Balance 2004 – \$665.9 billion

The U.S. Trade Balance 2003 – \$496.5 billion

The U.S. Trade Balance 2004 – \$617.1 billion

As reported by the Commerce Department, the trade deficit in February 2005 stood at \$61.0 billion, increasing by \$2.5 billion from the \$58.5 billion (revised) reported for January 2005. February exports were at \$100.5 billion up slightly

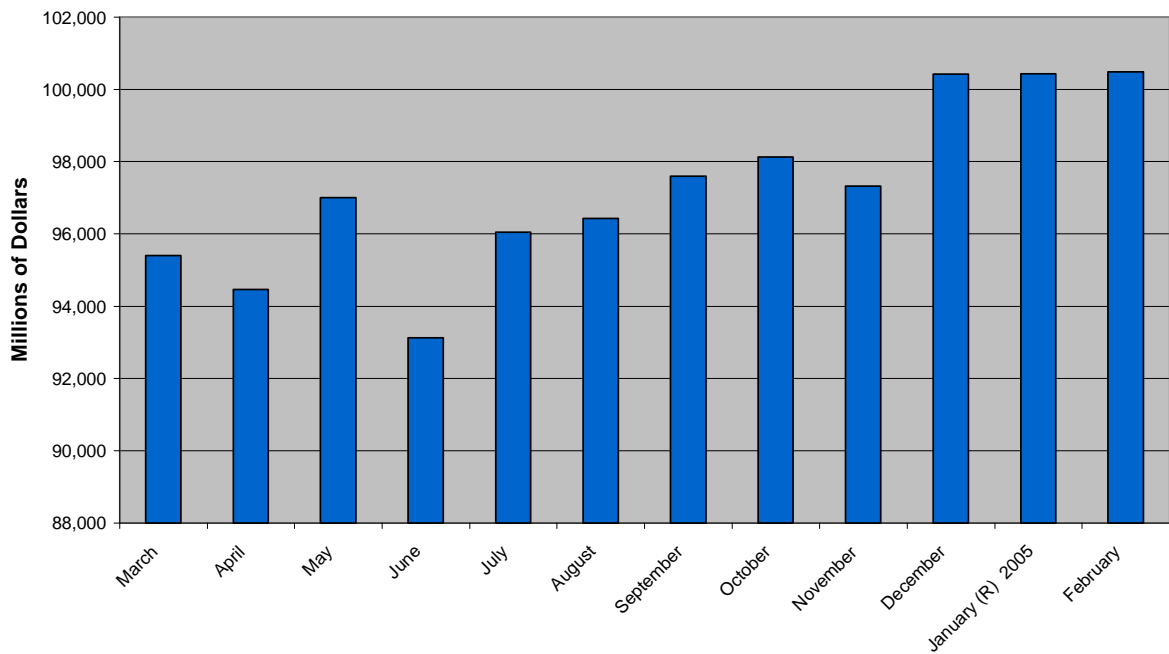
from \$100.4 billion revised figure for January. Imports were at \$161.5 billion, up \$2.6 billion from the revised \$158.9 billion reported for January.

Next release (for March) – May 11,2005 at 8:30 A.M. EDT.

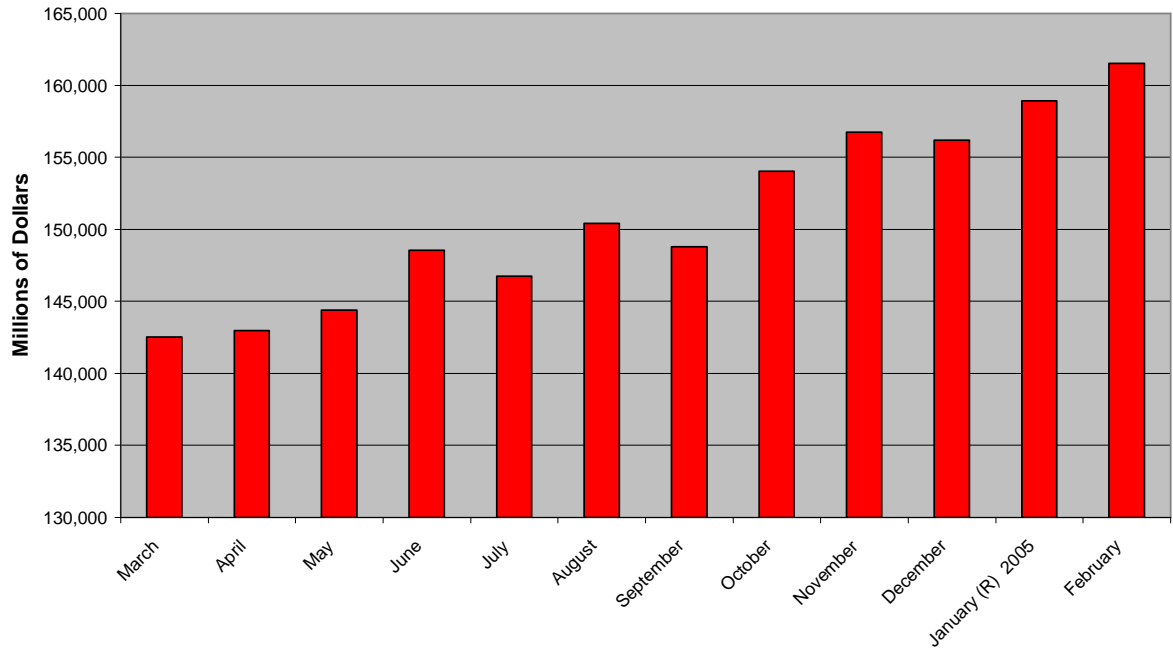
News Release - <http://bea.gov/bea/newsrelarchive/2005/trad0205.htm>

The Good (Exports Mar 2004 - Feb 2005)

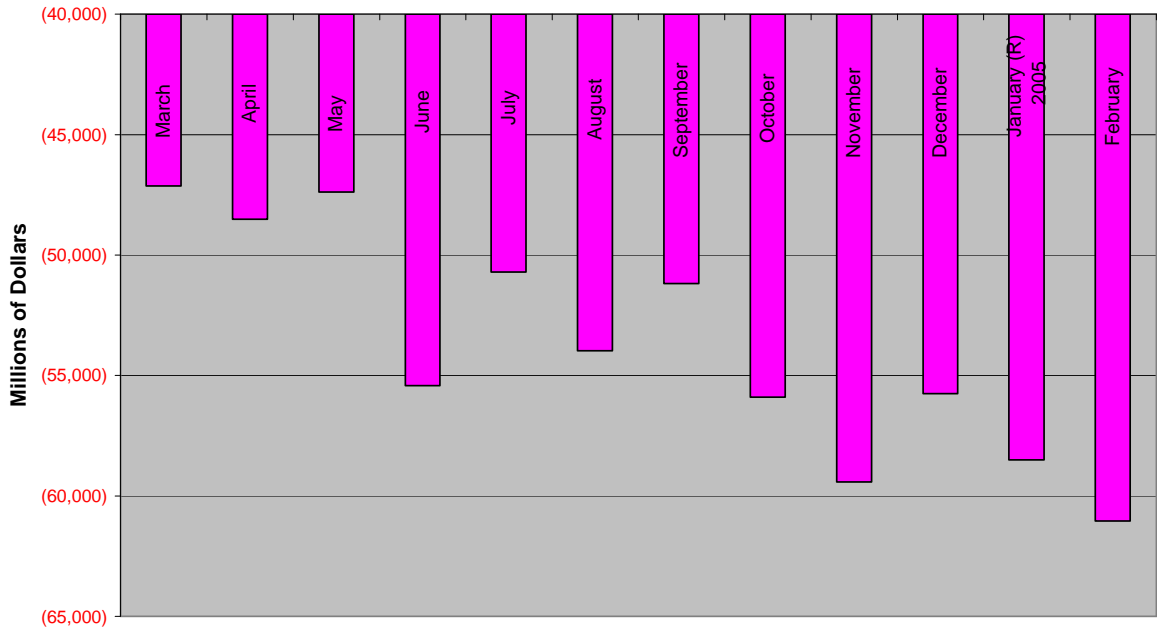
*Extracted from Department of Commerce
April 12, 2005 (January revised)*



The Bad (Imports Mar 2004 - Feb 2005)
Extracted from Department of Commerce
April 12, 2005 (January revised)



The Ugly (Trade Balance Mar 2004 - Feb 2005)
Extracted from Department of Commerce
April 12, 2005 (January revised)





CPI 0.6% (March) / PPI 0.7% (March) (Seasonally adjusted)

CPI – On a seasonally adjusted basis, the CPI-U (all urban consumers), which had increased 0.4% in February, rose 0.6 percent in March (reflecting a 3.1% unadjusted annual increase from March 2004). Adding to the increase in costs for the month was energy where costs rose 4.0 percent and transportation 1.9%. In the twelve month period, March 2004 – March 2005, energy costs rose 12.4% and transportation by 5.2%.

Next release (for April) – May 18, 2005, at 8:30 A.M. (EDT).

News Release - <http://bls.gov/news.release/cpi.nr0.htm>

PPI – On a seasonally adjusted basis, the Producer Price Index for Finished Goods increased 0.7 percent in March 2005, following a 0.4 rise in February (reflecting a 4.9% unadjusted annual increase from March 2004).

Again, from March 2004 to March 2005, prices for finished goods increased 4.9 percent. Among finished goods, the index for energy goods advanced 15.3 percent, prices for consumer foods climbed 3.6 percent, and the index for goods other than foods and energy moved up 2.6 percent.

Next release (for April) – May 17, 2005 at 8:30 A.M. EDT.

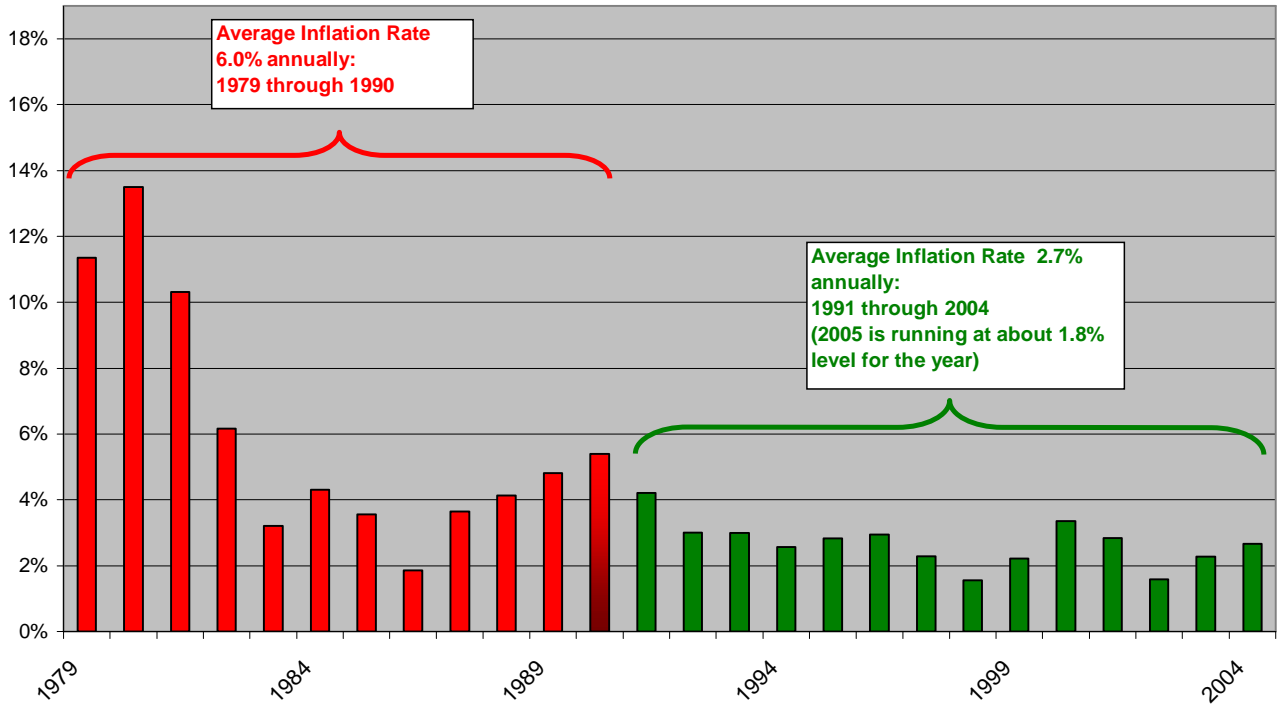
News Release - <http://bls.gov/news.release/ppi.nr0.htm>

CPI Change (1979 - 2004): *The New Paradigm*

A Continuing Bias toward Low Inflation

All City Average: Base Year 1982-1984 = 100

Department of Labor: Bureau of Labor Statistics



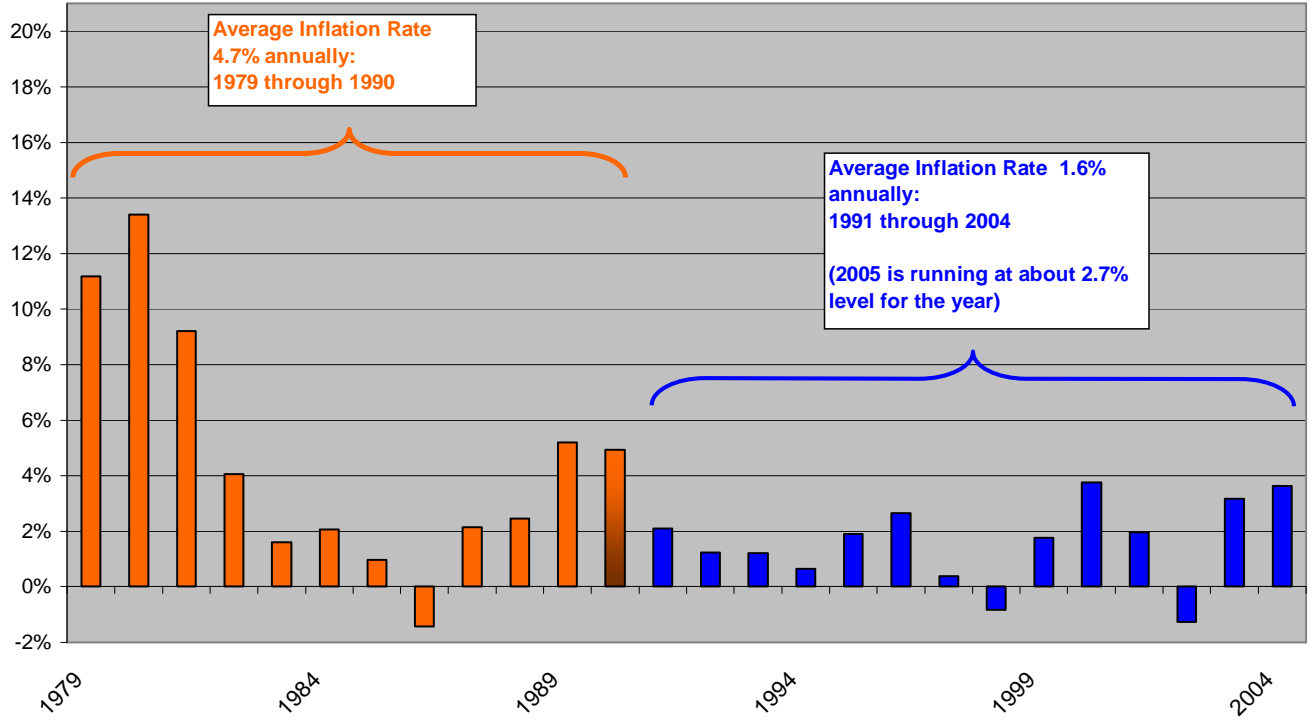
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Item: Finished goods

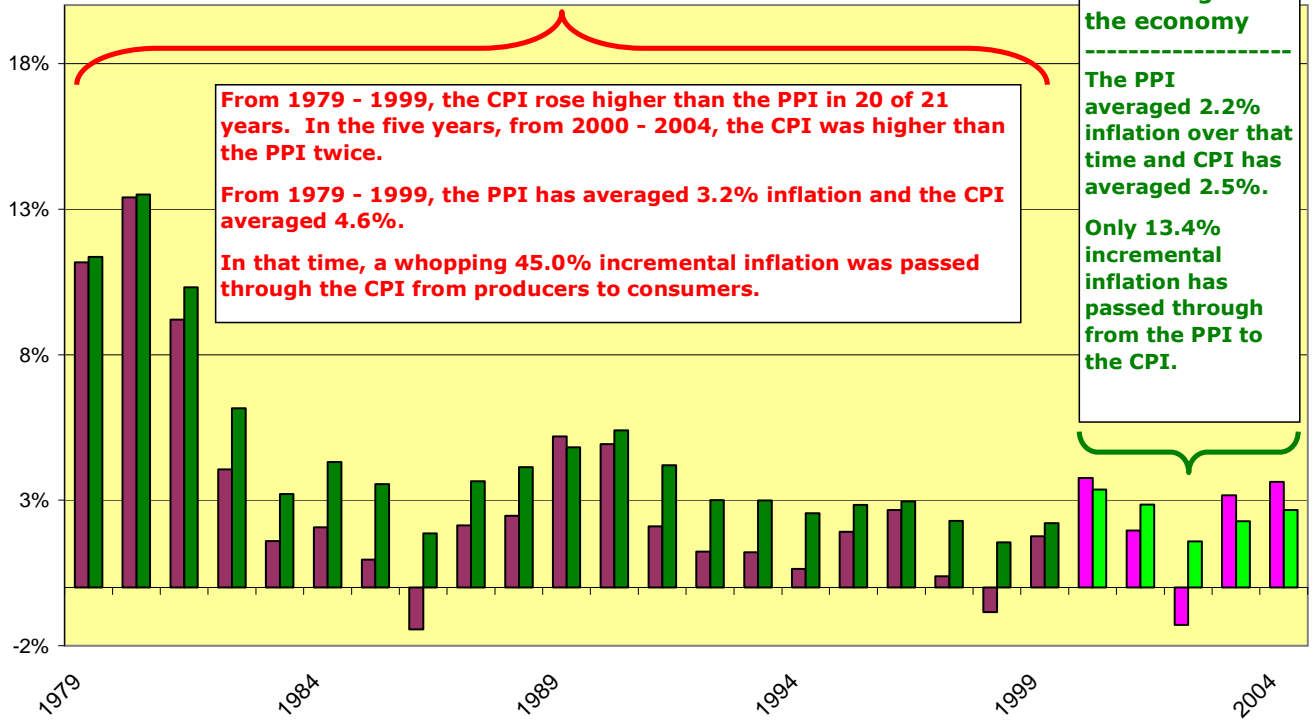
Department of Labor: Bureau of Labor Statistics



Growing Relevance (Evidence) of the New Paradigm Less Inflation being passed on to the Consumer

Base Year 1982-1984 = 100

CPI: All City Average, all items; PPI : Finished goods
Department of Labor: Bureau of Labor Statistics





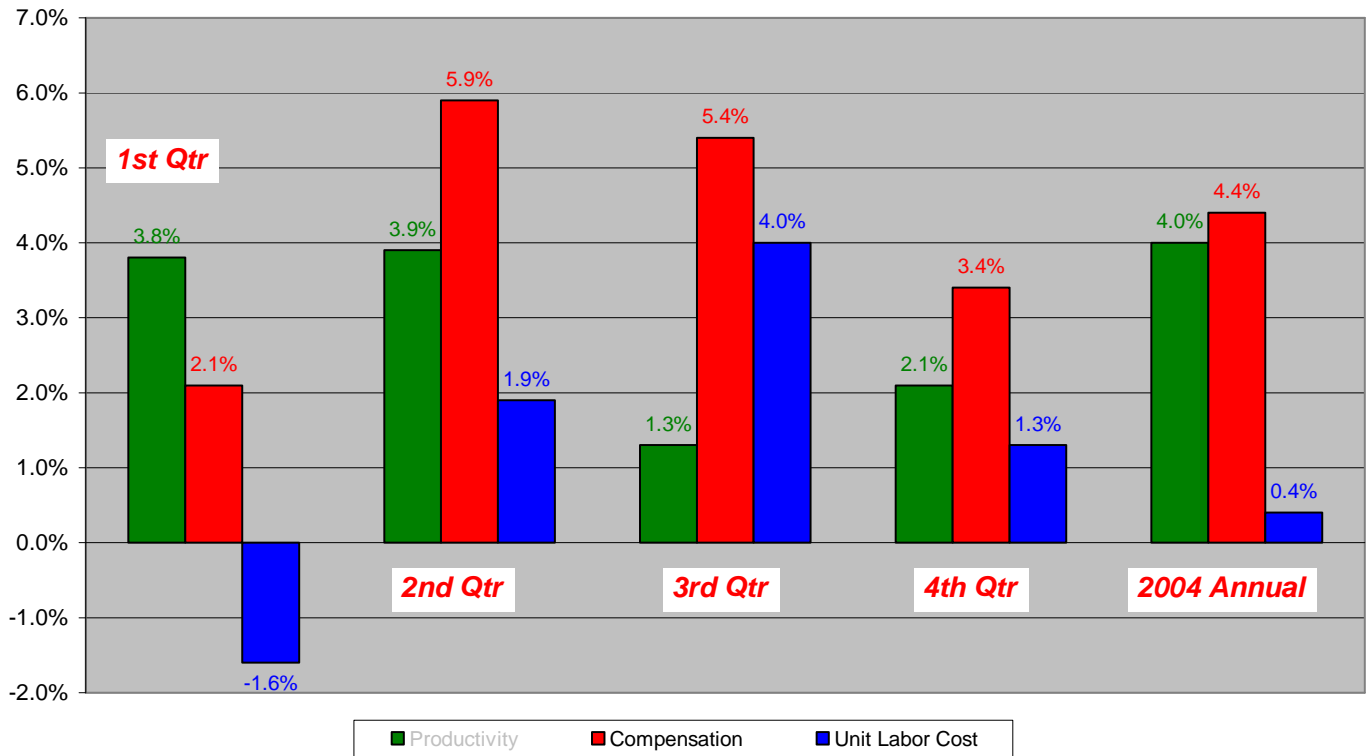
Productivity, Unit Labor Cost and Compensation (Seasonally Adjusted)

According to the Bureau of Labor Statistics, for the first three quarters of 2004 **Productivity** gains amounted to 3.8% for the 1st Quarter, 3.9% for the 2nd, 1.3 for the 3rd Quarter and 2.1 for the 4th Quarter. **Unit Labor Costs** declined by 1.6% in the 1st Quarter and rose by 1.9% in the 2nd, rose to 4.0% in the 3rd Quarter and dropped to 1.3% in the 4th Quarter 2004; and **Compensation** grew at 2.1% in the 1st Quarter, 5.9% in the 2nd, 5.4% in the 3rd Quarter and 3.4% in the 4th Quarter.

Productivity gains continue to dampen the effect of increasing compensation.

Productivity, Compensation and Unit Labor Costs 2004

Department of Labor
Extracted April 29, 2005



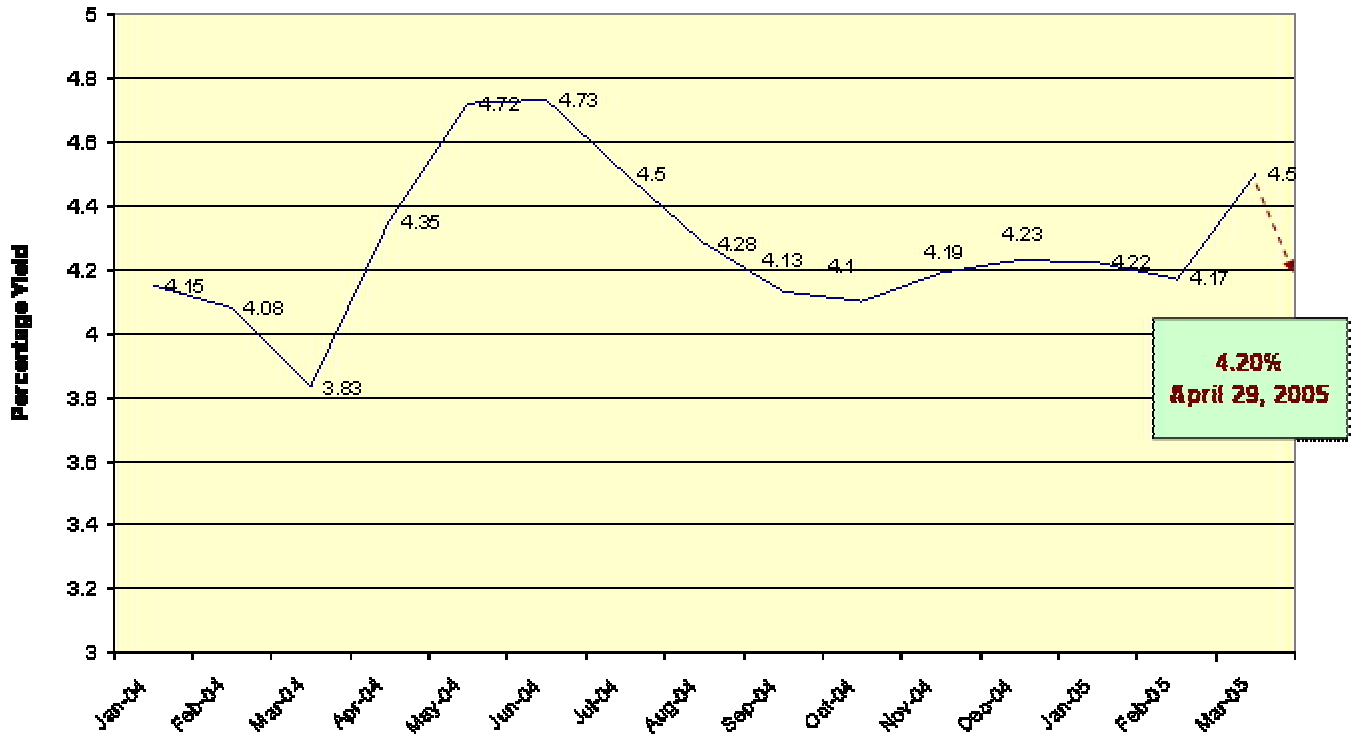


10-year U.S. Government Bond Rate

The 10-year Maturity U.S. Government Security continues to remain trading at a relatively low rate. For the month of October 2004, the yield averaged 4.10 percent.

10-Year Treasury Constant Maturity Rate

*Not Seasonally Adjusted Monthly Numbers
Board of Governor's federal Reserve System*



4.20%
April 29, 2005