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MACROCOSM

Two Economies, One Funds Rate

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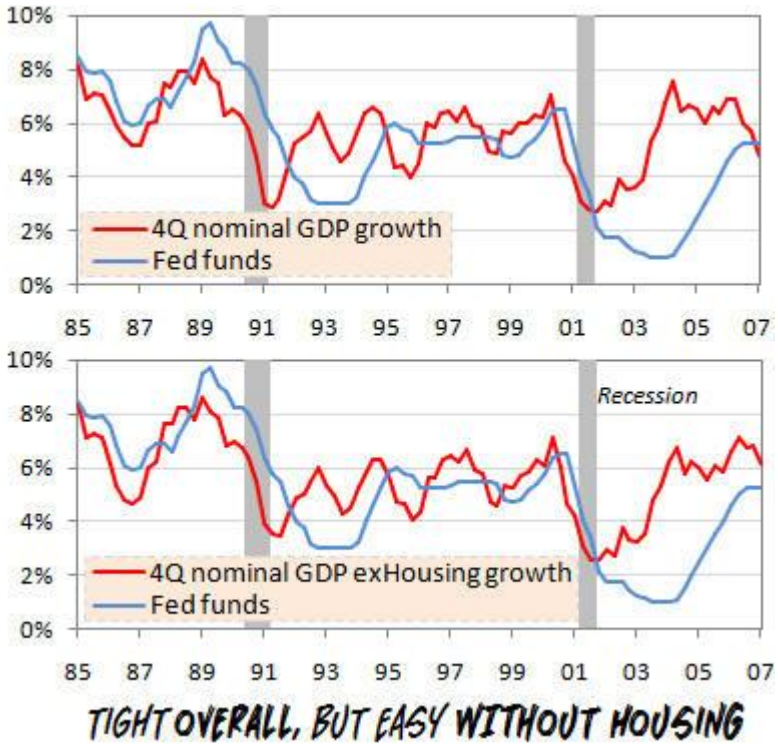
The Fed is letting 5% of the economy make 100% of its policy decisions.

While residential investment represents only about 5% of the economy, weakness in that sector has been so severe as to drag down overall GDP growth. This masks the fact that the rest of the economy -- the other 95% -- has been quite strong. So while it's not untrue to say "the economy has been sluggish" for the last four quarters, it misses a fundamental dimension of the current growth picture: there are *two economies* now, a small one facing intense stress and a large on that is doing very well. So what should the Fed do, given that it has but one fed funds rate to set for two economies?

Update to strategic view
FED FUNDS: The Fed is stuck at 5.25%. Relentless acceleration in reported inflation, and continuing absence of evidence of housing contagion, will ultimately lead to renewed rate hikes.
[see Investment Strategy Dashboard]



On a 4-quarter basis, overall nominal GDP growth has been 4.8%. With the funds rate at 5.25%, 45 bps higher than nominal GDP growth, a rough-and-ready analysis would suggest that the Fed is too tight. If nominal GDP is a proxy for the available returns in the overall economy, then a funds rate higher than that is a disincentive to investment. Historically, without exception, every easing cycle has begun with the funds rate above nominal growth, just as it is today. But that analysis assumes a single monolithic economy, when in fact there are two economies -- housing and ex-housing. In the housing sector alone, 4-quarter nominal output has been *negative* 15%. For that sector, the Fed is massively too

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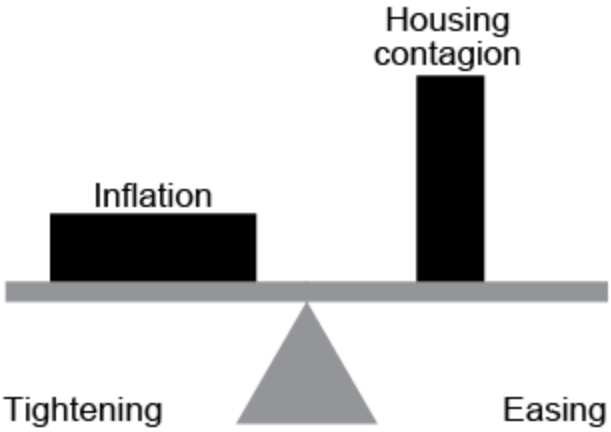
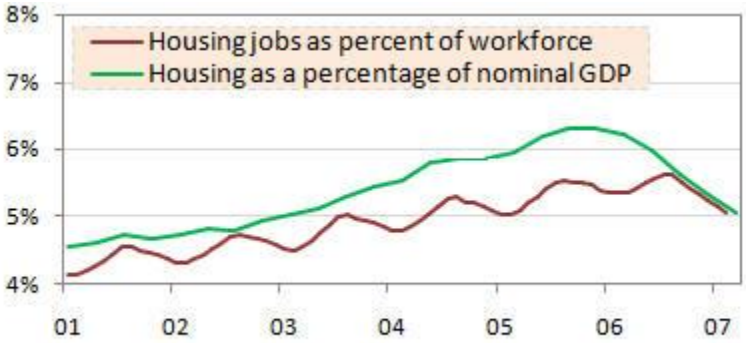
tight. But for the other 95% of the economy -- the ex-housing economy -- the Fed is quite accommodative. 4-quarter nominal GDP growth in the 95% of the economy other than housing is 6.1%, far above the funds rate of 5.25%. If 6.1% is the level of available returns, then a funds rate of 5.25% is an incentive -- if not a downright subsidy -- to investment.

In this simple framework, an easy Fed -- one that sets the funds rate below available returns in the economy -- creates inflationary pressures. Economic actors respond to the subsidy of low interest rates by borrowing from the Fed, which creates excess money to fund the loans. If the economy were monolithic, or if the weighted average of nominal growth across various sectors were as good as monolithic, then we could be satisfied that today's funds rate is no longer so low as to contribute to inflation pressures. But with the housing sector alone so dramatically skewing average nominal growth --a 1.3% nominal growth detraction over the last four quarters -- it's difficult to have confidence that the weighted average is a proxy for the economy's available returns. It's highly likely, in our view, that the funds rate in fact remains quite accommodative, and continues to add to inflation pressures by subsidizing investment in the 95% of the economy outside housing. This is borne out by the relentless inflation signals coming from forward-looking market prices such as the dollar exchange rate (flirting with all-time lows on a trade-weighted basis) and commodities (flirting with all-time highs on an ex-energy unweighted basis).



THIS IS BEN BERNANKE'S BRAIN ON HOUSING

The Fed recognizes the dichotomy between the two economies -- housing and ex-housing -- having remarked often that weakness in housing has not spilled over into other sectors. The fear that spillover may occur is the major factor keeping the Fed from hiking interest rates here and now, considering that inflation has been persistently above the Fed's avowed "comfort level." So the Fed's decision paradigm here is clear. The risk of inflation has high probability, but low intensity (the Fed is confident it can manage it). The risk of housing contagion has low probability, but high intensity (the Fed is not confident that it can manage it). Thus these two risks have very different characters, yet they balance each other in the Fed's mind. Which leaves us with the peculiar irony of the Fed having more than achieved the full employment part of its dual mandate (with the unemployment rate at 4.4%), and having failed to achieve the price stability part (with inflation admittedly too high) -- yet not raising rates.



WORKING THROUGH THE HOUSING DISTORTION

In our view there are substantive reasons why the sharp housing slowdown hasn't infected the rest of the economy, and why it won't do so going forward.

- In the first place, the housing boom was in part a distortion created by the Fed's excessively accommodative posture. The removal of this distortion permits the economy to operate at higher efficiency. At 5% of nominal GDP, housing has already corrected back almost all the

way to its long-term average of 4.8%. Housing jobs are in the process of correcting, as well. So far so good: over the last year, 286 thousand housing-related jobs have been lost, at the same time as 2.3 million jobs have been created in the rest of the economy.

- Second, the ex-housing economy is especially resilient to the adjustment in housing because of the all-time record high volume of global trade flows, currently running 28% of GDP (see "Trade in the Balance" April 5, 2006). Of all the major sectors of the economy, housing is perhaps the least global -- so an increasingly globalized US economy is increasingly invulnerable to shocks from housing.

- Third, financial conditions are robust. Previous housing contractions coincided with general economic contractions, because both were caused by excessively tight financial conditions imposed by the Fed. Today credit is plentiful, and commercial and mortgage interest rates are not high by historical standards either in absolute or real terms.

- Finally, the fact that housing has not so far infected the rest of the economy provides its own reason for why it will not do so in the future, in the manner of a virtuous circle. Employment, income, and consumption are all robust, providing a strong backstop for continued weakness in any single sector.

BOTTOM LINE: The housing contraction has exerted a disproportionate influence on overall growth statistics, creating a false impression that the economy is weak and that the Fed is too tight. Weakness in housing is unlikely to spill over into the rest of the economy, making it all the more critical that overall growth be properly measured without the excessive deadweight of housing. With growth already more robust than generally perceived, and with the Fed unnecessarily worrying about contagion from housing, interest rates remain manifestly too low, and continued inflation pressures will be the result. For now the Fed is -- mistakenly -- on pause as far as the eye can see. But reported inflation will continue to edge up, and the economy will continue to be resilient in the face of the housing contraction. With each passing day for which that is so, the Fed will be gradually moved toward the inevitable resumption of rate hikes.