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MACROCOSM

# Fear Itself

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**The Fed is helping the economy talk itself into a slow patch.**

Soon after taking office during the darkest days of the Great Depression and in the midst of a banking panic, president Franklin D. Roosevelt famously warned, "The only thing we have to fear is fear itself." While current circumstances are far less frightful, a not entirely dissimilar dynamic may be at work. Widely shared pessimism about the economic and financial outlook among the media, analytic and government establishments -- including the Fed -- risks becoming self-fulfilling, bringing about a weakening of economic activity that is not likely to develop into an outright recession, but could yield a slowing in reported growth. Importantly, though, we view this as a passing phase that is unlikely to take on vicious-cycle qualities that would put the economy on a downward vector.

| **Update to strategic view** |
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| **US MACRO:** The economy is showing some signs of suffering from a fear-induced drag on activity, with a preponderance of negative sentiment creating self-fulfilling effects. But from all evidence, the fundamentals of a highly resilient, flexible, and adaptable economy remain sound. In all likelihood, this spasm of pessimism will be endured with a short-lived and relatively modest decline in the pace of expansion, after which growth should be poised to return to at least trend levels. |
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In the financial markets, this "fear itself" effect has been seen in the recent widening of risk spreads and rush to safe-haven assets in response to the most dire interpretations being put on news about several major financial institutions taking significant write-downs on their subprime mortgage exposure. An alternative analysis could plausibly be offered -- that these entities are taking an accounting hit, but once their balance sheets are cleansed of these bad assets, they remain well capitalized and are poised to move forward as viable, profit-seeking enterprises. But in this anxiety-ridden climate, that analysis is decidedly not in favor. Still, while the Merrill high-yield spread has jumped more than 100 basis points over the past month, and is more than double its unsustainable lows of last summer, at slightly above 500 bps it remains at levels that in the past have been consistent with healthy growth. A damaging spike in credit risk-aversion is still not apparent here.

Since the intensification of financial market turbulence in mid-August, the Fed's economic view has taken a decidedly bearish turn, manifest in its surprisingly aggressive 50 bp September rate cut. In addition to performing the technical task of a central bank, the Fed holds a prominent place as a thought leader, and its pronouncements can have far-reaching influence on the perceptions of economic actors about economic circumstances. One recent survey suggests

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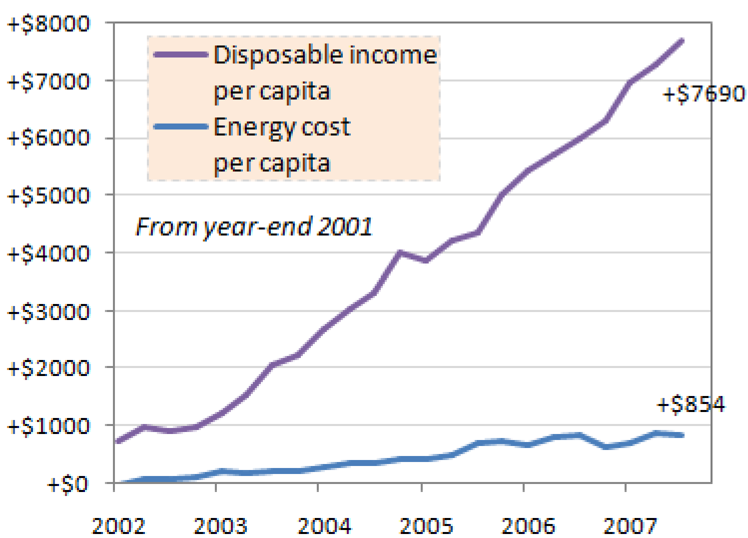
that small businesses -- the backbone of the economy -- have taken to heart the Fed's warnings, and are responding in kind. "Things were looking good until September 18 when the Fed warned that the economy was sinking," said William Dunkelberg, chief economist of the National Federation of Independent Business, releasing a survey showing a decline in the group's small business optimism index. "The logical response of small-business owners was to cut hiring, capital spending and other growth-related activities."

In one area, though, feedback from these business people could meaningfully inform the Fed's own perspective. Fed officials have maintained that a tightening of credit conditions is a factor likely to pose a drag on near-term growth, and in his testimony last week to the Joint Economic Committee, Fed chairman Ben Bernanke cited "a greater measure of financial restraint on economic growth as credit becomes more expensive and difficult to obtain." According to the NFIB, however, "On Main Street, credit conditions continue to look normal." Only a net 6% of owners reported loans as more difficult to get in recent months, which NFIB said was a "typical" reading for the past several years. "Clearly we are not experiencing a credit crunch by any standard," said Dunkelberg.

Earlier this month, in its quarterly survey of senior loan officers, the Fed reported that "about one-fifth of domestic institutions…reported that they had tightened their lending standards on C&I loans to large and middle-market firms over the past three months." However, only about 10% reported a tightening of standards for small firms, a rate similar to the previous survey in July. Certainly, where the rubber meets the road, a drop-off in credit availability is difficult to detect. Commercial and industrial lending is growing at a record rate of nearly 40% on a 13-week annualized basis, and total commercial bank credit is now expanding at about a 20% annual rate.

The recent move higher in crude oil prices above $90 per barrel, it is now widely agreed, is another factor likely to prove a drag on growth. The media was nearly unanimous that the relatively soft 0.2% gain in retail sales reported for last month at least partly reflected higher oil prices, and there was broad concurrence that the data foreshadow a weak holiday season and a significant slowdown in fourth quarter growth. Second and third quarter GDP, however, expanded at an annual pace around 4% per quarter, with retail sales showing average monthly growth of 0.3%. Despite the unassailable conviction of accepted economic wisdom that "the consumer" is the irreplaceable source of growth, half the months during the past two quarters saw retail sales registering less growth than last month's level.




While the move in crude above $90 was certainly eye-catching, the more significant escalation in oil prices came earlier. From late 2003 through mid 2006, the price more than doubled from about $30 to more than $70. But during this period, both real GDP and real personal consumption expenditures (of which retail sales account for less than half) averaged growth of about 3.4% on a four-quarter basis. What is usually overlooked in the analysis suggesting that higher oil prices will extract a considerable growth penalty is that disposable personal income gains have dwarfed the increased burden attributable to rising energy prices. Since the fourth quarter of '03, energy expenditures are up by nearly $160 billion. Disposable personal income, however, has grown by about $2 trillion. In *per capita* pocketbook terms, that means $854 per year in higher energy costs have been offset by $7,690 per year in higher income. But the constant drumbeat of negativism about oil prices is taking a toll, as seen most clearly in the recent drop in measures of consumer confidence. Historically, the relationship between consumer confidence and spending has been weak. In the current environment, however, with gloom and doom sentiment at such heightened levels, the decline in confidence is likely to be consistent with at least marginally reduced spending levels.

**BOTTOM LINE:** The economy is showing some signs of suffering from a fear-induced drag on activity, with a preponderance of negative sentiment creating self-fulfilling effects. But from all evidence, the fundamentals of a highly resilient, flexible, and adaptable economy remain sound. In all likelihood, this spasm of pessimism will be endured with a short-lived and relatively modest decline in the pace of expansion, after which growth should be poised to return to at least trend levels.