Can’t Blame the Fed for Everything

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Fed’s Duties

Contrary to the belief of many bullish investors, the Fed has not increased rates simply to put an end to the party. Greenspan has been marked as the villain because he’s an easy target to blame for the flattening yield curve. It is true that the Federal Open Market Committee’s decision to push short-term rates higher contributed to the flattening curve. However, it is highly doubtful that the Fed ever intentionally tries to put an end to a good thing. If anything, one key word is probably in the forefront of the FOMC’s thinking minds, and that word is ***stability.***

According to Jack Guynn, President of Federal Reserve Bank of Atlanta, the Fed must strategically “act before the appearance of widespread price increases to keep inflation and inflation expectations firmly in check.” The objective, which eludes laymen, is to make preemptive moves before excessive inflation is present. If high inflation appears in core inflation benchmarks, then the Fed has not moved aggressively enough. By then it would be too late, and the Committee would be forced to take a tighter stance and make steeper hikes.

However, the Fed does not always make all the right moves. The Committee has in the past pushed rates too high, which have triggered a slowdown or even a recession. Monetary policy is not an exact science; indeed it is more like chess match with the outcome in doubt. While the Fed carefully and diligently observes relevant data, and develops a strategy that they feel is best, the outcome is not always what is desired. The following topics are some matters that the Fed and Wall Street are taking into consideration before they make their moves.

Situation with Oil

How much oil is needed to make the world turn? Apparently the world needs 84.3 million barrels per day (mb/d) to run its activities. [1] Of that amount, the United States consumes 20.7 mb/d, or approximately 25% of total world supply.[2] U.S. imports almost 60% of its crude oil mostly from Canada (1.6 mb/d), Mexico (1.6mb/d), Saudi Arabia (1.5 mb/d), Venezuela (1.4 mb/d), and Nigeria (1.1 mb/d).[3]

Since U.S. imports a majority of its oil consumption, it depends on stable foreign relations with suppliers. However, OPEC does not seem to have much direct impact on U.S. consumption, since our top two oil providers in 2004 were Canada and Mexico. Then again, OPEC supplies

[1] International Energy Agency, May 11, 2005.
[2] Energy Information Administration (Department of Energy), January 2005
[3] Energy Information Administration (Department of Energy), January 2005

about 40% of world's total consumption.[4] Therefore, OPEC directly impacts the U.S. through its ability to affect world oil prices.

Moving prices by adjusting production levels only explain part of the story. Demand also drives market prices of oil as with any other commodity. Much of the demand for oil has lately been attributed to China and India; both of which have been experiencing strong growth over the recent years. In the short-run, OPEC's production levels and growth in China and India will contribute to oil price increases.

Some reports show concerns that there may be a decline in worldwide oil reserves. London-based Oil Depletion Analysis Centre (ODAC) foresees oil production to peak at 85 mb/d by 2008, when oil extraction is expected to reach its highest point and then start to decline. International Energy Agency (IEA), on the other hand, does not expect "peak oil" until sometime between 2013 and 2037. These outlooks may have helped push recent oil prices to reach record levels. Nevertheless, economics 101 tells us that shifts towards substitutes will occur before a certain resource (i.e. oil) runs out. Greenspan believes that "in the decades ahead, natural gas and oil will compete in the United States with coal, nuclear power, and renewable sources of energy."[5]

A Reluctant China

Some U.S. policymakers have expressed their disapproval of China's currently erroneous policies involving trade and exchange rate manipulation. Bush's administration continues to push China to revalue the Yuan. Bush continues campaigning that he will save U.S. jobs by trying to keep Chinese import prices at reasonable levels, so that U.S. domestic producers can stay competitive. The artificially weak Yuan also makes prices of U.S. exports expensive relative to competing Chinese products. U.S. exports to China have suffered from this currency imbalance.

The Bush Administration's principled intentions are respectable and reasonable, but its "persecuting" methods may be doing more harm than good. One thing we would want to avoid is a trade war with China. U.S. has recently imposed quotas, limiting Chinese imports to 7.5 percent a year.[6] This quota particularly affects Chinese textile product prices in the U.S. While this quota may protect domestic textile producers, it hurts U.S. clothing producers and does not help consumers that buy clothes or the overall inflation situation.

Because of the trade and payments imbalance with China (and also Japan), these countries have accumulated enormous dollar assets, which they have invested for the most part in the U. S. Treasury bond market. At some point, these foreign holders, due either to geo-political situations or a realization they have excess dollar holdings, may start selling their long-term Treasuries causing a sharp increase yields.

[4] International Energy Agency, May 11, 2005.
[5] http://federalreserve.gov/BoardDocs/Speeches/2005/200505202/default.htm
[6] http://edition.cnn.com/2005/BUSINESS/05/19/china.yuan/

Solid US Economy

Overall, the U.S. economy appears solid as the labor market has been improving and as investment spending is expected to climb. The Bureau of Economic Analysis revised recent GDP figures, saying that the inflation-adjusted GDP grew at a relatively stable and healthy rate of 3.5 percent during the first quarter of 2005. This growth, however, comes at a gradually decelerating rate since the second half of 2004**.** On the other hand, corporate profit continued to rise and reached 13.8 percent during the first quarter.[7]

The unemployment rate has been steadily declining since its recent peak in mid-2003. At the same time, the employment cost index shows that wages and salaries have been falling since 2000.[8] The rising employment signals that the economy is improving; however, falling wages has been supplementing these added jobs to the economy. While the employment picture indicates that more wealth is steadily being added to the economy, the declining salaries counters the aggregate wealth effect from the additional jobs.

Housing Situation

The falling income trend is apparent throughout the various income measures. Some may argue that falling wage inflation should ease inflationary worries. However, employers may be the only ones to benefit from falling wages.

Despite the falling wages, residential investments remain very strong, growing 6.7 percent on a year-over-year basis during the first quarter in 2005. The sizzling housing market has been fueled by the low mortgage rates. Homeownership rate is estimated to have reached nearly 70 percent nationwide.[9]

Housing is seen as a local business, and Greenspan has noted some "hot" markets. In FOMC's May minutes, there have been remarks of "speculative excesses" in certain areas. The areas cited are California, Florida and parts of the Northeast, hardly isolated instances in that these contain at least one-third of the U.S. population. Speculation poses a threat because speculators create artificially inflated prices. These property flippers generate synthetic demand for the property and pass this gain to the next purchaser.

Certainly high housing prices are not a big problem if homebuyers are buying for permanent living arrangements. It is a big problem when speculators cannot sell their assets and are left with falling housing prices and excess housing inventory. Credit lenders must carefully consider to whom they lend, and real estate agents should not relax purchasing requirements despite the increased competition among brokers.

[7] Bureau of Economic Analysis

[8] Bureau of Labor Statistics

[9] http://www.frbatlanta.org/invoke.cfm?objectid=144C6171-5056-9F06-9969F4E1D8B766F1&method=display

The increasing number of real estate brokers is of concern because they will vigorously compete for sales, pushing up prices. If speculators are allowed to continue their practices, these artificial prices will continue to balloon. The problem will arise when rising mortgage interest rates slow demand, and the excess supply will initiate the downward cycle of home prices.

Are Hedge funds in Trouble

We would hate to see another LTCM and its aftermath brewing in the current markets. There have been reports and rumors that a number of prominent hedge funds are currently experiencing troubles. Their unregulated practices make it difficult to diagnose the funds' potential problems. LTCM's past predicament should have taught us to realize that a good game will be mimicked and arbitrage opportunities will diminish quickly. Maybe we have yet to fully grasp and measure all risks.

More Hikes Up Ahead

As shown, several factors continue to contribute to the potential imbalance in the U.S. economy. Oil prices remain relatively high, and the Fed acknowledges that the high energy is negatively affecting household and business confidence. The negative trade situation with China is another issue and poses a threat to both price stability and interest rate stability. Also potential problems with hedge funds and housing situations could cause shocks to the economy. Despite the potentially dangerous conditions, Greenspan expressed that the U.S. has exhibited the ability to handle negative shocks.

Nonetheless, the Fed will continue to feed us what it sees as our necessary medicine by gradually raising rates by 25 basis points at a time. Fed fund futures shows that the FOMC will almost definitely increase rates to 3.25 percent in the upcoming meeting at the end of June. Market participants are also pricing that the Fed will continue to raise rates into next year.

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