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Economic Outlook

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What Markets Are Saying

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Paul Samuelson once quipped elegantly that (falling) stock prices had predicted seven out of the last three recessions. There is indeed wisdom in the suggestion to ignore wiggles in the financial markets as indicators of the behavior of the real economy that produces goods and services.

But sometimes the financial markets persistently send a clear signal that is ignored when it should be heeded. Federal Reserve chairman Alan Greenspan has called the persistence of low yields on long-term Treasury securities even though short-term rates have risen significantly a "conundrum." The chairman's view is not surprising since he and the Fed believe that, despite some wobbles in the first half of this year, the U.S economy is on track for 4-percent growth and stable inflation around 2 percent for the second-half of the year and well into 2006. If markets believed that rosy picture, we would expect yields on ten-year notes to be between 5.5 and 6 percent and stocks to be at higher levels than they were at the start of the year. Instead, yields on ten-year notes are approaching 4 percent and, adjusted for inflation, are close to 1.6 percent—a level consistent with recession.

Extraordinarily low yields on government securities are not confined to the United States; the phenomenon is evident in Europe and Japan as well. Meanwhile, stock prices are lower globally. The S&P 500 Index is down on the year while the NASDAQ composite, a measure of the outlook for technology stocks, is down on the year as well. The German stock market is also lower, and the Japanese stock market is down, notwithstanding claims by many observers that the Japanese economy is poised for a remarkable recovery.

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Economic Reality Check

Two underlying drags are hindering the economy. First, the rise in energy prices over the past year by nearly 50 percent will shave more than a percentage point off growth in the remainder of 2005 and the first quarter of 2006. Meanwhile, higher energy prices will put sustained upward pressure on inflation, which brings us to the second drag: Fed tightening. Having already raised short-term interest rates by a full 2 percentage points from an extraordinarily low 1 percent to 3 percent, the Fed will be pressured by persistent signs of inflation to continue to raise interest rates further. The Fed's own models, rightly or wrongly, suggest that the current federal funds rate ought to be a full percentage point higher, at about 4 percent, and so the Fed, confident that the economy will continue to grow, will continue to move interest rates up toward that level and beyond if higher inflation continues to threaten.

Suppose for a moment we stop reading the newspapers and listening to the rosy scenario for the U.S. economy painted by the Fed, most commercial banks, and the stock brokerage industry dedicated to hyping the market. What if, instead, we simply step back and look at some facts. Over the past year, energy costs have risen far more than expected, as indicated by the steady increase in the price of oil from an average of about $30 a barrel to an average of about $50 a barrel or higher. This puts a drag on the economy that, contrary to most newspaper babble, does not ebb

and flow with the daily or weekly movements of volatile oil prices from $55 to $45 a barrel. The Fed's tightening is removing the extraordinarily stimulative policy that was implicit in the negative 50-basis-point real fed funds rate from the end of 2001 to the middle of 2004 (when growth averaged just 3.3 percent).

Simultaneously, tax cuts have ended save for a modest boost of about $20 billion that was provided to low-income households from special tax programs during the first quarter. Since then, sustained higher energy prices and a sharp drop-off in tax refunds have lowered disposable income. By April, low-income households were struggling with higher energy prices, as indicated by weakening sales at Wal-Mart.

Beyond lower interest rates and weaker equity prices, signs of weakness are emanating from falling commodity prices, falling prices of computer memory capacity, falling prices of lumber, and falling freight charges. The turnaround in commodity markets is recent, but fairly intense. Commodity prices ran up sharply during February and early March, but have since dropped by nearly 10 percent.

Market signs of weakness are reflected in tangible financial problems. The bonds of General Motors and Ford were downgraded to "junk" status early in May based on the perceived inability of those two companies to compete with foreign auto producers and the huge underfunded pension and health care liabilities that each firm faces. United Airlines, bankrupt since 2002, was meanwhile permitted effectively to default on its pension liabilities, handing them over to the federal government's Pension Benefit Guarantee Corporation. The pilots at United Airlines, who had expected pension benefits of over $100,000 a year, will now be receiving a maximum of about $44,000 as mandated by operating rules of the federal government's pension corporation.

Financial Market Stress

Other events occurring in financial markets suggest considerable distress. The generic reason offered for such problems is hedge fund excesses, but really that is just a name for a broader phenomenon. Over the past few years, many new funds have emerged under the heading "hedge funds promising investors high returns."

Most of those funds have sought higher returns by undertaking riskier strategies that provide higher expected yields without taking steps to anticipate possible higher risks tied to those higher yields. Complex arbitrage strategies that may, under ideal conditions yield about a 10-percent annual return, have been more highly leveraged to yield a 20-percent return. The standard investment bet at the start of this year was for higher stock prices and higher interest rates in the expectation of continued strong economic growth. Falling interest rates and falling stock prices have produced losses on those bets.

Many investors (hedge funds, banks, and mutual funds included) have sought alternative ways to enhance return through more complex strategies employing derivatives and options. For example, some investors had placed large bets on a fall in GM's stock price and a rise in its bond price as pension funds sought to own more bonds and sell stocks. Unfortunately, for those investors, two events in the same week pushed up stock prices and lowered bond prices. Kirk Kerkorian's bid for about $800 billion of GM's stock caused the stock price to jump just as rating agencies were downgrading GM's bonds to junk status, causing the bond prices to fall. Normally, such events would be a manageable problem for investors positioned the wrong way, but for highly leveraged investors a quick move both against the short equity position and the long bond position in GM forced liquidation of positions that triggered other problems with complex derivative trades.

The financial ripples now occurring just below the surface in financial markets are a reflection of large illiquid and heavily leveraged bets on what was deemed a highly likely set of events that has not come to pass. As a result, the terms on which investors can exit those positions are very bad and entail large losses. Essentially, many investors have tried to enhance expected returns essentially by giving up liquidity—that is, by collecting a premium for being unable to easily exit a trade position. An unanticipated need to exit such positions can entail large losses, which in turn, jeopardize other liquidity-selling strategies.

It is important to recognize that the problems in the financial markets that are becoming serious enough to negatively impact the real economy are not just arising out of the blue. Extraordinarily inexpensive credit resulting from the very low short-term interest rates engineered by the Fed together with the Fed's assurances that such accommodating rates will not be removed quickly or unexpectedly, have made many of the liquidity-selling and related strategies possible and, ex ante, attractive. Pressures that are emerging in financial markets are a reflection of events in the real economy that were not

anticipated. But unwinding highly leveraged bets based on a rosy-economy scenario will be highly disruptive to financial markets and will further penalize growth prospects in the real economy. Exiting illiquid positions induces increased market volatility—more risk—that can cause banks to curtail their liquidity-producing role, thereby jeopardizing loan availability for businesses and households.

Global Problems

Disappointments in the real economy are not confined to the United States. The path of monetary policy and the economy in the United Kingdom provides a preview of events in the United States. The Bank of England steadily tightened monetary policy in 2003 and 2004 to combat a housing bubble. By mid-2004, housing price inflation that had reached nearly 25 percent a year began to fall, dropping almost to zero by the end of the year. A modest rebound in housing prices has since been reversed. The weakness in the housing sector has been translated into sharply weaker retail sales and a slowdown in the U.K. economy. Some modest stimulus from government programs was provided during the run-up to the early May election, but now that that support is no longer forthcoming, the outlook for the U.K. economy has deteriorated. Expectations are rising that the Bank of England will need to cut short-term interest rates later this year.

The European and Japanese economies continue to be weak and will grow weaker if U.S. growth slows. Japan just reported zero growth in year-over-year nominal GDP because of continued deflation. Italy has slipped into recession. The prospective weakness in the U.K., European, and Japanese economies has been reflected in a weakness of all their currencies against the dollar. As problematic as the outlook is for the U.S. economy and U.S. financial markets, the safety of U.S. Treasury securities, along with yields 80 to 100 basis points higher than those in Europe and 250 to 300 basis points higher than those in Japan, have attracted a flow of funds into the United States.

China's problems have continued to intensify, as its leaders appear to be relying more heavily on an export-led growth strategy in the midst of a relatively weak global economy. Delay on the much-needed upward adjustment of Asian currencies that would be triggered by some flexibility of the Chinese currency has engendered a backlash in the U.S. Congress, resulting in more pressure from the U.S. for trade protectionism at a time when the outlook for the global economy is in some question. The United States has already, on May 13, reimposed quotas on some categories of apparel manufactured in China. After the expiration of quotas on December 31, 2004, Chinese textile shipments to the U.S. during the first quarter of 2005 jumped 54 percent from the level of a year earlier. Meanwhile, rising trade tensions are jeopardizing a Central American Free Trade Agreement.

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Housing Still Helps—For Now

There is one offset to the numerous negative pressures on the real economy both in the United States and in many other countries. The U.S. housing sector continues to be quite strong, supported by still-low intermediate and long-term interest rates.

The housing sector supports consumption in three ways, while enhancing household wealth. During 2004, housing contributed about $1 trillion to the wealth of U.S. households, net of additional mortgage debt. Meanwhile, continued infusions of cash from refinancings and sales of housing at substantial capital gains buttressed household income. Easy credit has continued to be available through home equity loans, although rates on such loans are rising to levels that will curtail their use going forward.

When all of the sources of housing support for consumption are taken account of, the contribution to growth, at least during the first half of 2005, could be at an annual rate of just over 1 percent. So far, that is enough to overcome the growth drag from higher energy prices. But going forward, the increase in energy prices that has already occurred over the past year will, as noted above, continue to depress growth and elevate inflation with the latter putting additional pressure on the Fed to continue tightening. Meanwhile, as the Fed does continue tightening, support from the housing sector for consumption will weaken and, as housing prices begin to rise at a slower rate, the wealth contribution to household balance sheets will fall.

There are already some tentative early signs of a slowdown in housing in the hottest markets in California and

Florida. Typically, a housing slowdown takes the form of a rise in inventories of unsold properties while asking prices continue to remain steady. As the inventory accumulates, prices start to fall or at least the rate of increase begins to atrophy. When this occurs, an essential element of a housing bubble, the expectation of ever-higher prices is lost, and activity in the housing sector can slow rapidly. It is not necessary for housing prices actually to fall for the housing sector's contribution to wealth and consumption to be sharply reduced. Merely a drop in the inflation rate in the housing sector reduces the positive wealth effects from housing and also reduces the capital gains contribution to disposable income from turnover of real estate.

Steadily rising interest rates erode the level of benefits available from refinancings and the ability to liquefy housing wealth through home equity loans. In short, a housing bubble does not have to be followed by a housing bust in order for the positive contribution of housing to consumption and wealth enhancement to cease. Indeed, an actual drop in housing prices would be a true disaster for the U.S. economy, as many households have substituted housing appreciation for saving in recent years and would be forced to retrench rapidly, thereby depressing demand growth far below levels that would occur even as the contribution from housing to wealth and consumption went to zero.

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Fed Still Challenged

As negative developments in the financial sector unfold, the Fed has always faced a basic question: if those negative developments are substantial enough, do they result in a sharp fall in asset prices, including the prices of equities and housing, to a degree that threatens the orderly function of the financial system? "Systemic risk" was the rationale used after the fall of 1998 by the Fed when it stepped in to help bail out Long-Term Capital Management.

The problem with a Fed declaration of systemic risk together with more accommodative policy whenever financial markets start to fall is the familiar "moral hazard" problem. If financial managers think that the initial consequence of imprudent risk-taking, a sharp fall in asset prices, results in a rescue mission from the Fed, then going forward, financial managers will assume more risk on the expectation of a bailout. If the pressures on the U.S. and global economies and attendant pressures on highly leveraged financial markets continue, then asset prices will fall and the Fed will face a difficult test.