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GLOBAL ECONOMIC RESEARCH

US WEEKLY ECONOMIC UPDATE

June 3, 2005

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US Economic and Investment Perspectives

Fed Has Plenty of Tightening Left to Do

In recent weeks, a number of countries have experienced sharp declines in government bond yields, fueling perceptions that globalization continues to interlink both economies and interest rates.

While this one-world concept has a certain appeal and logic, in reality, interest-rate patterns must ultimately reflect the fundamentals of the home country (**Display 1**). If they do not, the odds are high that major imbalances will eventually build, leading to inflationary pressures that could ultimately threaten the country's expansion.

At this juncture, relatively low or declining yields appear to make sense in the economies of countries such as Japan and Germany. Both have experienced very little real growth in the past year; in Japan, a mild whiff of deflation lingers.

On the other hand, it is far more difficult to justify persistently low yields in the United States, where inflation and volume growth has been quite strong. Regardless, this week the 10-year Treasury bond slid further, falling to 3.85%—the lowest level in 14 months. The decline came after Richard Fisher, recently installed as president of the Federal Reserve Bank of Dallas, said in a TV interview that the Fed was in the "eighth inning" of its tightening cycle. His comments were followed by a relatively small advance in May payroll employment.

The way we see it, low and declining US bond yields are at odds with domestic fundamentals, and do more harm than good. Although May payrolls rose 78,000, household employment rose 376,000, and the jobless rate—a good gauge of whether the economy is growing beyond its potential—fell 0.1% to 5.1%, the lowest level of the current cycle. In addition, aggregate hours worked for the second quarter are running at a 3.6% annualized rate—the fastest quarterly gain of the cycle—indicating the economy retains strong forward momentum.

Declining yields, meanwhile, promote more relaxed financial conditions at a time when policymakers are toiling to reduce financial accommodation. Official rates are still well below levels generally viewed as consistent with stable long-term price trends. As a result, we believe policymakers are almost certainly focused on relative inflation risks.

Low Bond Yields Are Fueling Risks

Some continue to see low US bond yields as evidence of the country's superior risk-reward characteristics—given that comparable investments in other major markets fetch 100 to 200 basis points less. While it is certainly true that prospective yields (i.e., returns) are relatively higher, we would argue that risks have increased, necessitating higher official interest rates.

As Federal Reserve Governor Donald Kohn stated last month, "Nothing is more important to the conduct of monetary policy than understanding and predicting inflation." Kohn argued that since labor costs represent the largest part of a business's cost structure, unit labor costs and changes in unemployment rates play prominent roles in policy discussions about inflation prospects.

On that score, revised figures show that unit labor costs in the non-farm business sector have increased 4.3% over the past year, well above what the prior data had indicated—suggesting that labor-cost pressures have been greater than previously believed. The gain in unit labor costs is the fastest since early 2000 and indicates that policymakers have a long way to go before they arrest inflation pressures in the economy (**Display 2**).

Kohn noted that "unanticipated changes in the natural rate (of unemployment) have contributed to forecasting errors over the past two decades." It's possible that another forecasting error is occurring today. That is because the decline in the jobless rate has generated much higher compensation and unit

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labor costs than policymakers and others—ourselves included—had anticipated.

Policymakers are also concerned about imbalances that threaten the cycle. As Kohn has observed recently, "Anything that has the potential to threaten the stability of output and prices is of concern to us." Policymakers have become more worried about the explosive rise in housing prices and the impact of increased housing wealth on consumers and the economy in general.

This week, the Office of Federal Housing Enterprise and Oversight (OFHEO) released data showing housing prices appreciation of 2.21% during the first quarter—an annualized gain of 8.82%. Over the past year, house prices have increased 12.5%. The OFHEO, for its part, has said low interest rates are an important driver: "There are a number of likely reasons for sustained rapid price increases, including continued low interest rates, income growth and the apparent impact of speculation in some real-estate markets."

Historically, Alan Greenspan's Federal Open Market Committee has adjusted monetary policy to sustain the economic growth cycle—not end it. We think relatively low interest rates and relaxed bank lending standards risk generating more inflation and other imbalances that could threaten the current expansion. This suggests we are nowhere near the "eighth inning" of the tightening cycle. Rather, we think the Fed will need to continue to lift official rates—at a minimum through the end of the year, if not beyond.

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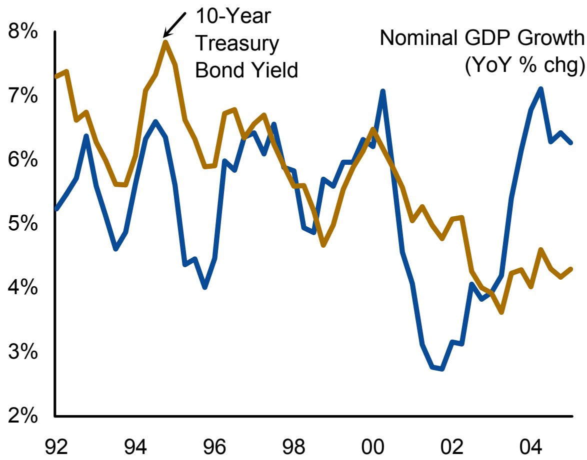
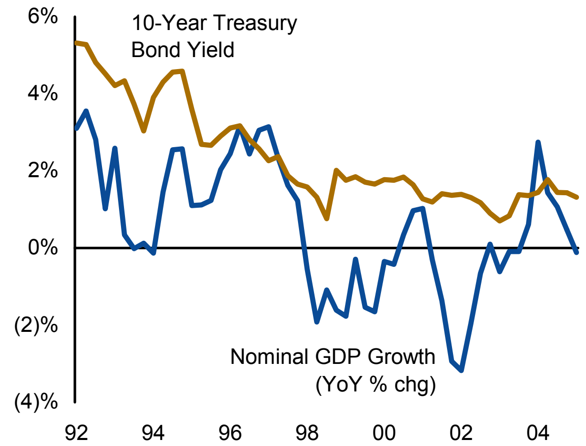
Display 1: Government Bond Yields Need To Reflect Domestic Fundamentals

Bond Yields and Economic Growth

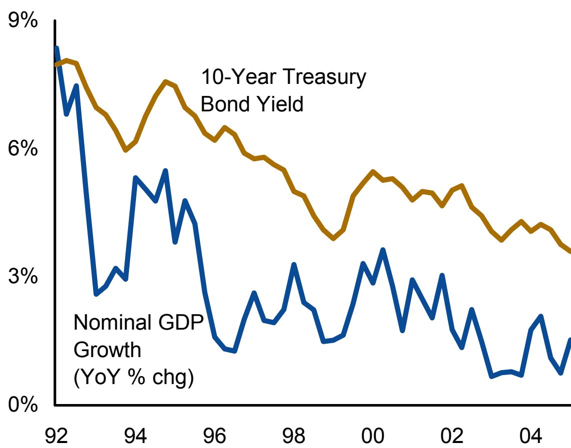
US



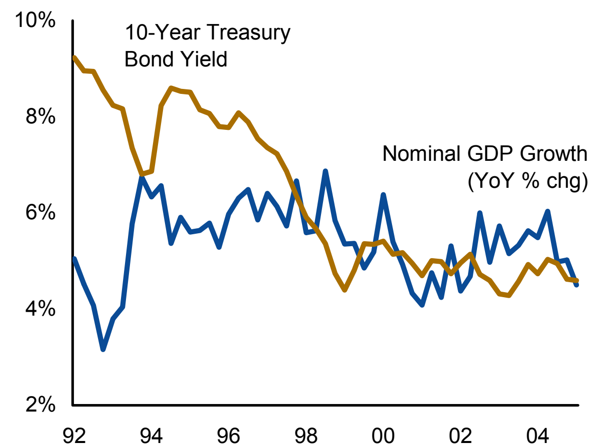
Japan



Germany



UK



Australia

Canada

All charts as of June 3, 2005

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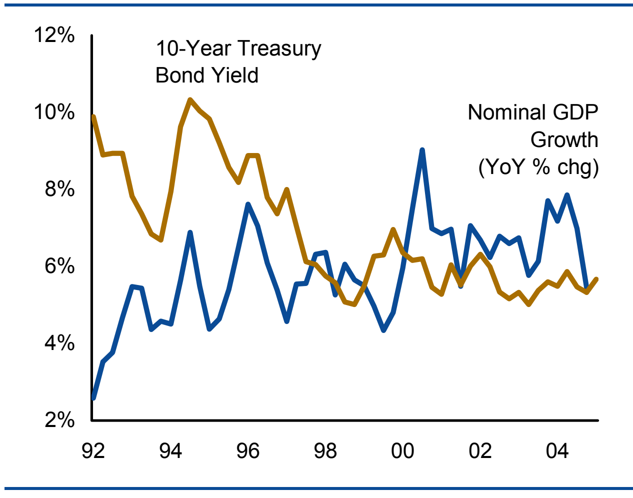
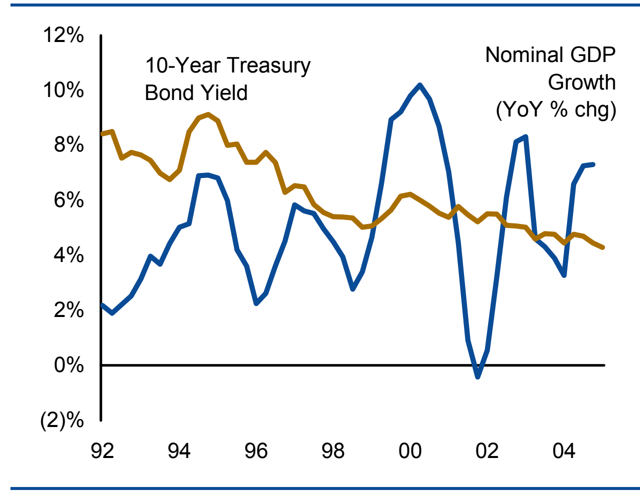


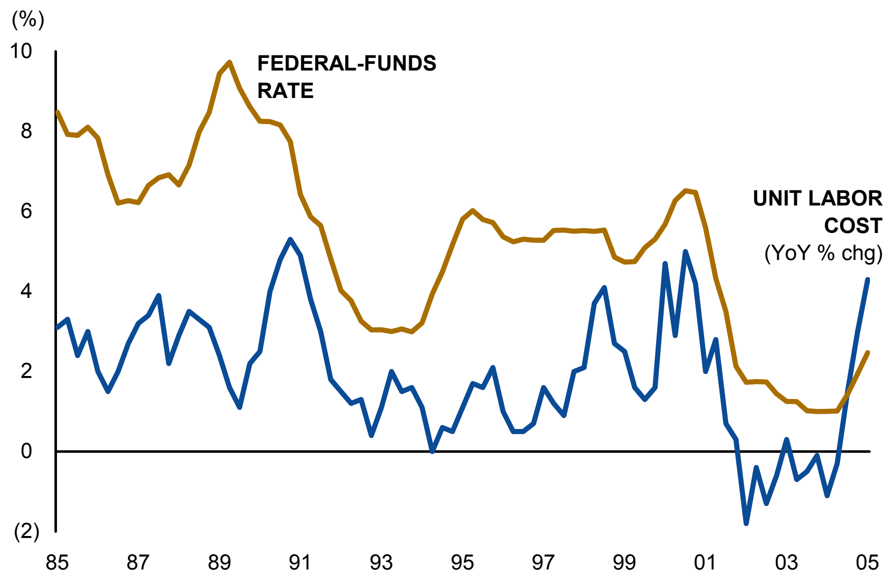


Source: Haver Analytics: June 3, 2005

June 3, 2005

Display 2: Labor Costs Are on the Rise

Growth of Nonfarm Business Unit Labor Cost vs. the Federal-Funds Rate



Source: Bureau of Labor Statistics and Haver Analytics:June 3, 2005

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Policymakers have long argued that the outlook for inflation is benign because unit labor costs are relatively tame. But revised data for the non-farm business sector show a relatively strong climb of 4.3% in unit labor costs. Given past trends, the sharp rise in labor costs points to a much higher federal-funds rate over the next year or so.

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