GLOBAL ECONOMIC RESEARCH

US WEEKLY ECONOMIC UPDATE

July 22, 2005

***Joseph G. Carson**

US Economist and Director
Global Economic Research

* Joe Carson is not licensed with the Hong Kong SFC and does not intend to provide investment advice in Hong Kong.

US Economic and Investment Perspectives

When Will the Fed Pause?

For months now, the market has been trying to gauge when the US Federal Reserve will end its protracted rate-tightening cycle, initiated June 30 last year. In the year since that date, policymakers have brought the federal funds target rate from 1% to 3.25%, raising official rates 25 basis points at every policy meeting.

The fed fund futures market currently suggests that the Federal Reserve will raise official rates a quarter point three more times, bringing them to 4% by year-end. Beyond that, it indicates that rates will be on hold for an extended period—a forecast in line with ours.

But perhaps the more important question is what will actually trigger an end to the tightening cycle. This would help to understand how far the Fed must raise rates before stopping.

Contrary to conventional wisdom, we do not think this will occur when the spread between the fed funds rate and core inflation approaches its historical average of around 200 basis points. While policymakers will most likely consider the rate/inflation spread, it is important to note that they have not directly linked the tightening cycle to inflation readings. Rather, their aim has been to phase out overly-accommodative monetary policy. They have also sought a better balance in the economy. Throughout his tenure as Federal Reserve chairman, Alan Greenspan has stressed that monetary policymakers are focused on imbalances that threaten the economic expansion or risk greater inflation.

But what constitutes a better-balanced economy? We think that much of the answer hinges on trends in the labor and housing markets, which appear to confirm the need for additional rate hikes. But it is unclear whether three more rate hikes will be sufficient to accomplish this.

Labor-Cost Pressures?

As the jobless rate declines, the Fed is faced with some important challenges. On the surface, it implies that the economy is growing above its potential and thus runs the risk of aggravating wage and price pressures. As Federal Reserve Governor Donald Kohn noted in May: “Labor is the major element of business cost and, as such, often occupies a prominent role in policy discussions of inflation prospects, and the unemployment rate often proxies for resource slack more generally.”

Similarly, Greenspan noted in his semi-annual Congressional testimony this week: “With regard to the outlook for inflation, future price performance will be influenced by the trend in unit labor costs.” While these costs have turned up recently, temporary factors may be partly responsible.

Admittedly, more information is needed to discern the basic trends in labor costs. But judging by the broad geographic gains in average weekly wages, as reported in the Bureau of Labor Statistics’ quarterly census on employment and wages this week, it would appear they are growing faster than many think. The gains also appear to be tied as much to rises in the housing market as these are tied to increases in bonus income.

Housing Market

The housing market may be the most important factor in defining the Fed’s ideal balance. It has boosted economic activity through increased starts, sales and jobs—and apparently through increased wages as well. It also provides an indirect boost via wealth creation and capital gains. There is little evidence in mortgage applications, real-estate loans, homebuilders’ surveys and comments from industry analysts to suggest the housing market is cooling in a meaningful way. In the past six weeks, the growth in real-estate lending has reaccelerated, and the homebuilders’ sentiment index for July stood at 70, close to the highs of the current cycle.

In his testimony, Greenspan noted that: "Historically, it has been rising real long-term interest rates that have restrained the pace of residential building and have suppressed existing home sales." But he also observed that real long-term rates are not rising due to favorable global saving and investment trends and reduced inflation expectations—two factors we noted in our July 15 commentary, "Low Real Rates Should Continue to Fuel Real Asset Prices."

Greenspan said that the Fed will be closely monitoring global influences on mortgage-rate trends and longterm rates in general. The tone of his comments suggests to us that if long rates do not rise and the housing market remains robust, then the Fed might be compelled to lift rates beyond the 4% threshold we and the markets currently expect. Stay tuned.

Joseph G. Carson
Global Economic Research
July 22, 2005

Display 1: The Fed Paints an Optimistic Picture of Growth and Inflation

US Federal Reserve Economic Projections for 2005 and 2006

	2005		2006	
	Range	Central Tendency	Range	Central Tendency
Change, 4Q/4Q*				
Nominal GDP	5.00 – 6.25	5.50 – 5.75	5.00 – 6.00	5.25 – 5.50
Real GDP	3.00 – 3.75	3.50	3.25 – 3.75	3.25 – 3.50
PCE Price Index (excl. Food & Energy)	1.50 – 2.25	1.75 – 2.00	1.50 – 2.50	1.75 – 2.00
Average Level, 4Q				
Civilian Unemployment Rate	5.00 – 5.25	5.00	5.00	5.00

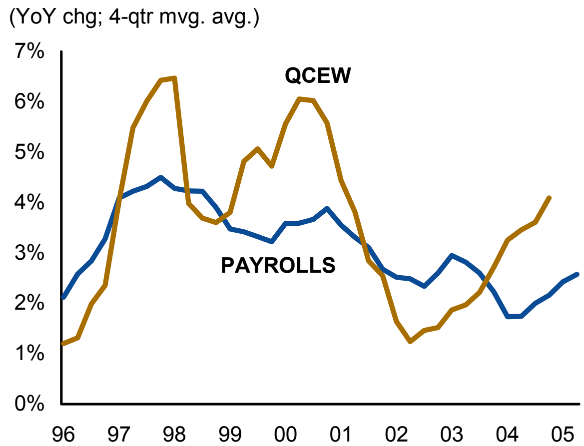
**Change from average for fourth quarter of previous year to average for fourth quarter of year indicated. July 22, 2005*

Source: Federal Reserve Board

The Federal Reserve expects continued strong economic growth and contained inflation through the end of 2006. Accordingly, Alan Greenspan has said that the fed will continue to remove monetary accommodation. We see the Fed funds rate reaching 4% at year-end.

Display 2: US Wage Growth Is a Lot Faster Than Many Think

Trends in Average Weekly Wage Growth: Monthly Payroll Report vs. Quarterly Census of Employment and Wages



Source: Bureau of Labor Statistics and Department of Labor; July 22, 2005

Top 10 Counties Ranked By Annual Growth of Average Weekly Wages (4Q/4Q)

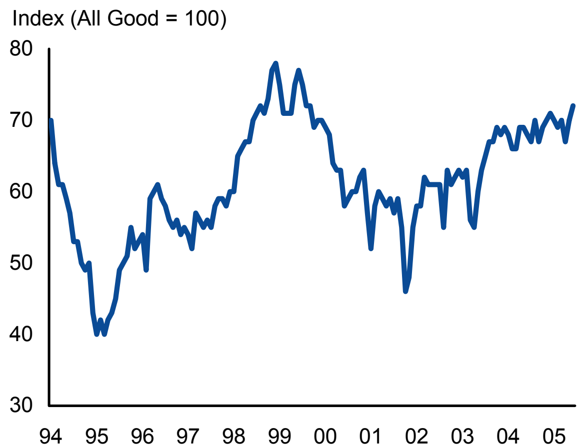
	Percent Change in Average Weekly Wage 2003–2004
US	**5.7**
Williamson, Texas	17.8
Rock Island, Illinois	14.8
Ventura, California	12.6
Henrico, Virginia	12.5
St. Louis, Minnesota	11.0
Washington, Arkansas	10.6
Hennepin, Minnesota	9.6
Santa Clara, California	9.5
Suffolk, Massachusetts	9.3
Rockingham, New Hampshire	9.3
Essex, New Jersey	9.3

Source: Bureau of Labor Statistics and Department of Labor; July 22, 2005

The quarterly census of employment and wages suggests average weekly wage growth was stronger than reported in the monthly payroll employment report. Moreover, the broad geographic gains imply that the gain is tied to more than year-end bonuses, as some of the largest gains occurred in areas with rapid new housing construction and sales growth.

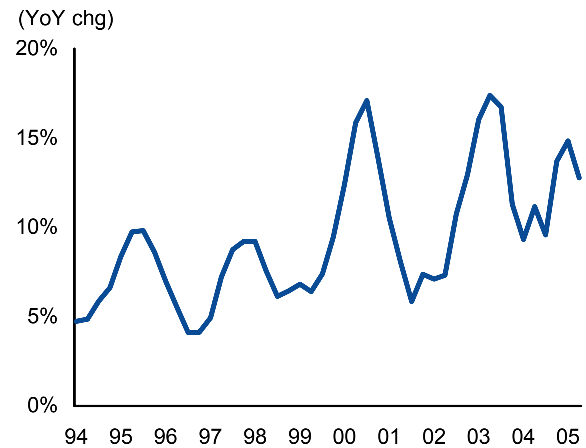
Display 3: Housing Market Remains Robust

Home Builders Sentiment Composite Index



Source: National Association of Home Builders and Haver Analytics:July 22, 2005

Growth in Real Estate Loans



Source: Federal Reserve Board and Haver Analytics; July 22, 2005

Trends in the housing market might dictate how high the target on thefFed funds rate has to go. As of this writing, there is little to suggest that the housing market is cooling. Indeed, homebuilders remain upbeat while real-estate loan growth is relatively strong.