

Did the Fed Overreact?

When the Federal Open Market Committee (FOMC) cut the Fed Funds rate target by a half percentage point on September 18, the decision was universally welcomed as a bold but necessary move. At the time, various parts of the financial market were frozen and needed some serious thawing. The 50-basis-point cut raised the setting of the financial thermostat by a notch or two. The rate cut also provided the cooling economy with much needed support.

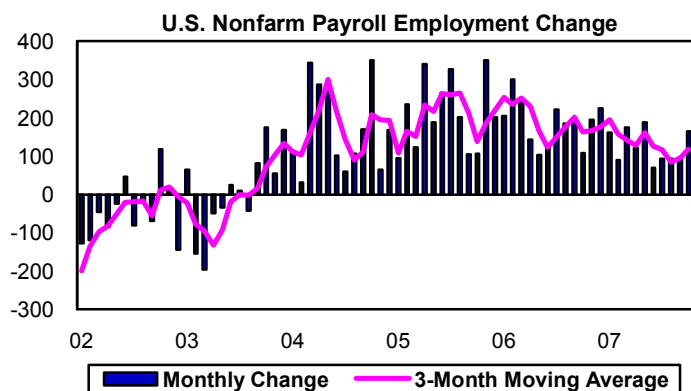
Or so it seemed back then. The employment report showed that nonfarm payroll employment decreased by 4,000 in August. In a national labor market with more than 138 million workers, 4,000 jobs is a drop in the bucket, but the very first decrease in four years spooked many people, perhaps including the members of the FOMC.

The latter fortunately received positive news regarding inflation just before the September meeting: The seasonally adjusted Producer Price Index (PPI) for finished goods fell 1.4% in August. The benign PPI data eased concerns about price inflation, and made the Fed feel more comfortable providing stimulus to the economy in the form of a rate cut, even though the lower PPI was a reflection of falling oil prices.

The economic landscape changed.

When the FOMC reconvened at the end of October, the economic landscape had shifted somewhat. Crude-oil prices were hovering above \$90 per barrel, up more than \$10 since the previous meeting, and both the PPI and the Consumer Price Index were up in September.

A subsequent data revision erased that shocking reduction in employment in August. Based on the latest estimate, payroll employment *increased* by 93,000 in August, followed by an increase of 96,000 jobs in September. An additional 166,000 jobs were gained in October. (See the chart below.)



In thousands. Seasonally adjusted data. Source: Bureau of Labor Statistics.

Just hours before the FOMC announced another 25-basis-point reduction of the Fed Funds rate target on October 31, the Bureau of Economic Analysis released the Gross Domestic Product (GDP) data, showing that the U.S. economy expanded at an annualized rate of 3.9% during the third quarter of 2007.

Real GDP Growth (% Annualized)			
	3Q07	2Q07	2006 Annual
Total GDP	3.9	3.8	2.9
Consumer Spending	3.0	1.4	3.1
Business Investment	7.9	11.0	6.6
Housing Investment	-20.1	-11.8	-4.6
Exports	16.2	7.5	8.4
Imports	5.2	-2.7	5.9
Government Purchases	3.7	4.1	1.8

Source: Bureau of Economic Analysis (BEA).

It was the strongest quarterly growth we had experienced in a year and a half. As the table above demonstrates, details were even more encouraging than the headline number. Consumer spending rebounded to 3.0% from the 1.4% pace during the second quarter.

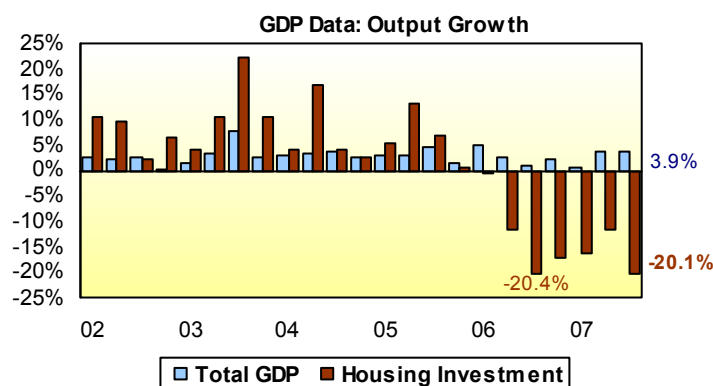
Growth of business investment was more subdued than in the second quarter, but the deceleration was largely due to slower growth of commercial construction activities. U.S. companies stepped up investment in equipment and software, from 4.7% in the second quarter to 5.9% in the third quarter, suggesting that they are still preparing for future business growth. Exports expanded strongly at 16.2%, but this number will likely be revised as additional trade data become available in coming months.

Housing investment obviously was the weakest link in the economy, declining 20.1% from the second quarter. Luckily, it was the only significant drag on the economy. The residential sector subtracted 1.1 percentage points from the overall GDP growth rate. In other words, without the housing-sector weakness, the U.S. economy would have expanded at an extremely strong 5.0%! This is by no means a picture of an economy on the brink of recession. The feared "contagion of weakness" from the housing sector to the rest of the economy has not happened so far.

Housing suffered another setback in the summer.

The 20.1% drop in housing investment during the third quarter represented the seventh consecutive quarterly decline. It was only slightly smaller than the 20.4% reduction recorded a year earlier. This decline in housing investment continued to get smaller during the past year, as the following chart

shows, raising hopes that the worst of the housing correction was over. The turmoil in the mortgage market this summer, however, brought the housing sector to an almost complete standstill.



As the bad news about subprime mortgages mounted, even financing for borrowers with good credit history became harder to obtain. Consequently, sales volume of both new and existing homes plummeted. Industry sources now report improved availability of prime mortgage loans, even though the subprime segment remains in a deep freeze.

A large number of subprime mortgage loans are yet to go through rate-resetting, which will significantly increase the amount of monthly payments and will likely trigger loan defaults. The full effect of the subprime mortgage debacle upon the U.S. financial sector and the overall economy will not be known until this wave of rate-resetting has passed.

The Fed took out an insurance policy on October 31.

So how should we evaluate the Fed's decision to cut the short-term interest rate in October? Did the Fed overreact, as some pundits suggest? My own take is that Bernanke and company acted rationally, considering the lingering fear and anxiety in the global financial market. The most recent rate cut was

needed to calm down the skittish financial market and ensure continued growth of the U.S. economy.

The Fed stated after the October FOMC meeting that "growth was solid in the third quarter," but with their decision to lower rates the central bankers wanted to "help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets." (The FOMC Statement, October 31, 2007.)

The rate reduction was an insurance policy—to ensure that the economy won't slip into a recession. The probability of a dramatic slowdown may be limited, but the cost of ignoring such a risk could be huge, both economically and politically, for the Fed. A 25-basis-point cut was a small premium to pay for such insurance. And, if the policy turns out to be superfluous, it can easily be abandoned by reversing the cut.

Which "R" word?

It is obvious that the Fed must keep one eye on the economy, while keeping the other on the financial market ravaged by subprime mortgage troubles. The extremely nervous financial market, coexisting with relatively healthy macroeconomic data, is the sign of a current disconnect between Wall Street and Main Street.

American consumers, business owners and executives ("Main Street") seem more sanguine about the future than some investors and security analysts ("Wall Street"). Right now, consumers continue spending and businesses keep on hiring and investing, while investors are jittery and suspicious. When the frayed nerves of the latter are finally calmed, however, we are likely to see that the most important "R" word associated with the U.S. economy is resilience, not recession.

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Economic Forecasts – November 2007

UNITED STATES	2005	2006	2007	2008
Real GDP Growth (%)	3.1	2.9	2.2	3.0
Unemployment (%)	5.1	4.6	4.6	4.8
Payroll Employment Growth (%)	1.7	1.8	1.3	0.9
CPI Change (%)	3.4	3.2	2.7	2.3
Federal Funds (%)	3.2	5.0	5.1	4.5
Housing Starts (millions)	2.07	1.81	1.38	1.31
Car/Lt. Truck Sales (millions)	16.9	16.5	16.1	16.2

Bold: Actual.

The information in this report is based on data available as of November 7, 2007, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied upon as the sole source of information and opinion.