

The Sound Investor Series #84

Fed Watching
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Which way will the Federal Reserve Board move interest rates next? Yesterday, it decided to hold short-term interest rates steady and in a statement explaining its stable approach, the Fed cited the strength of the economy and the progress made in lowering inflation.

Before we discuss yesterday's decision, let's briefly take a look at the Fed. The Fed has many functions, the most important being its twin mandates to control inflation while also keeping the economy on a healthy growth track. To achieve these objectives one of the Fed's most influential tools is its control over very short-term interest rates, called the Fed Funds rate. The Fed Funds rate is very narrow in scope and only applies to how much banks charge each other for overnight loans.

In broad terms, if the Fed thinks the economy is weak, it will try to lower interest rates to give the economy a boost. On the other hand, if it is trying to tame inflation it will push interest rates higher to slow economic activity, and in turn, hopefully inflation.

The rub is the Fed only controls very short-term interest rates and has no direct control over longer-term rates, which really drive economic activity. Long-rates are set in the marketplace where investors and issuers buy and sell bonds.

Most of the time there is a connection between short-term and long-term interest rates and usually short-term rates are lower than long-term rates. This is because there is less risk with less time. In these "normal" circumstances, if the Fed lifts or reduces short-term rates, long rates will also probably rise or fall.

But sometimes interest rates become "inverted" and short-term rates are higher than long-term rates. This is where we are in the current environment with the Fed Funds rate at 5.25 percent while the ten-year U.S. Treasury note yields 4.85 percent. This inverted yield curve developed over the last three years as the Fed moved Fed Funds from 1 percent to 5.25 percent while long term rates only moved from 4.25 percent to 4.85 percent. The Fed would have preferred long-term rates move higher as they raised short-term rates, but in this case it did not pan out that way. In effect the Fed found itself "pushing on a string."

With the Fed holding steady yesterday it means it is fairly comfortable with the lookout for both inflation and economic growth. This view is clearly backed up by recent economic reports as inflation appears to be under control. The Fed is happy that energy prices have fallen, but it is probably more thrilled that last year's run-up in energy prices did not create inflationary pressures in other goods and services.

I am also sure the Fed is happy its interest rate policy has slowed the economy just enough, but without causing a recession. This is the so-called "Goldilocks" scenario with the economy not too hot; and not too cold. In fact, yesterday's report on 4th quarter Gross

Domestic Product (GDP) revealed a stronger economy than most observers forecast. Growth in the quarter accelerated to an annual rate of 3.5 percent from 2.0 percent in the third quarter. For all of 2006 the economy expanded 3.4 percent compared to 3.2 and 3.9 percent in 2005 and 2004 respectively.

Surprisingly, the economy is humming along even in the face of a weak housing market. Residential construction spending fell sharply in the second half of 2006. It was down an annualized 18.7 percent in the third quarter and dropped another 19.2 percent (annualized) in the last quarter. In both periods the decline reduced GNP by over one percentage point.

While this plunge in housing construction is painful for those involved, its swiftness will likely shorten the time before the market starts to recover. The slower construction has helped bring down the inventory of unsold homes and also reduced the necessity for builders to offer incentives to move their houses, which hurts the whole housing market.

The adjustments in the housing market are starting to have a positive impact on expectations for housing prices. Looking at the housing price futures, the pessimism on prices is lifting after hitting a bottom in November. These financial futures still predict a fall in prices in 2007, but less than previously.

Speaking of housing, before the Fed meeting one of my friends asked me how the Fed would affect mortgage rates. We discussed that since mortgage rates are affected by long-term interest rates, the Fed will have an influence on these rates but it doesn't directly control them. To reiterate, long-term rates are dictated by supply and demand; as well as the inflation outlook.

Long-term interest rates (and mortgages) are low as demand for U.S. Treasuries has been strong. Some of this strength is probably due to money flowing back to the U.S. from oil producing countries. So somewhat perversely, while lower oil prices might lead to lower inflation, less demand for bonds might cause interest rates to rise.

I also reminded my friend that long-term rates could easily move in the opposite direction to any Fed move. For instance, if the Fed lowered rates to help the economy, bond investors might get more concerned about inflation and drive rates higher. On the flip side, if the Fed raised short-term rates, investors might feel more confident inflation will stay low and accept lower long-term rates.

Is the Fed's next act to move rates higher or lower? The consensus over the past few months was that rates would come down but this is shifting and at this point it feels like an even bet. Of course, that could all change when we get to see the unemployment report tomorrow morning!

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