



Daily Note: 26 February 2008

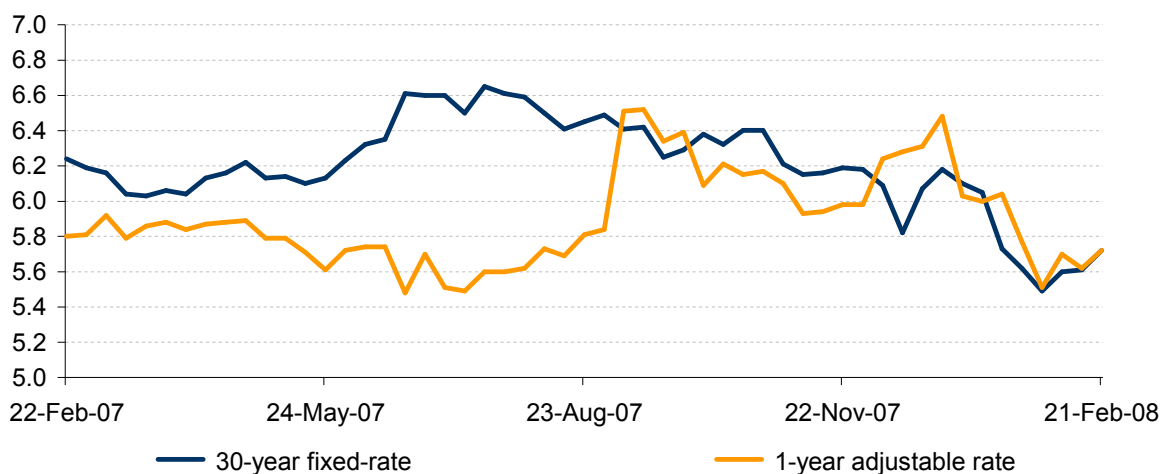
## Full speed ahead and damn the inflation!

**WE SUGGEST: If Fed gamble goes wrong, dollar and bonds will suffer**

**SUMMARY: The Fed has so far cut interest rates by 225bps since last summer and is poised to cut them even more. But, so far, the main effects are to help Wall Street and to stoke inflation. Household income is being eroded and the housing market continues to weaken. The Fed is taking a gamble that inflation eventually will subside. It could be wrong.**

Today's data shows house prices, measured by the Case-Shiller index (one of the two most comprehensive US house price indices; the other is the quarterly OFHEO index, also published today) falling by 2.1% in December, extending the house price fall to a 17<sup>th</sup> month. On a twelve-month basis house prices have 'only' fallen for 12 months (ie, throughout 2007), but the December level was down 9% from a year earlier. Lower house prices should make houses more affordable – and they do. However, the level of house prices in only one component of house affordability and hence of spending. Another is interest rates – and here is where the Fed seems to be running into problems. The Fed may have cut interest rates by 225bps – but mortgage rates have fallen by less than half of that. In early September, just before the first Fed funds cut, both 30-year fixed rate mortgages and one-year adjustable ones came with an interest rate of 6.4%. By end-February, that rate had dropped by 70bps to just above 5.7% in both cases. In fact, one-year mortgage rates are barely lower than a year ago.

US mortgage interest rates, %



So while lower interest rates certainly are benefiting Wall Street and helping banks to shore up their balance sheets, by the same token they are not helping households to the same extent. Moreover, households are being hit by a double whammy in that Fed policy is also stoking inflation – at least in the near term. Today's PPI data showed producer prices rising by 1% in January and by 7.7% from a year earlier. This is not

only the second time in three months that the twelve-month PPI exceeded 7½%, but also the highest PPI number since 1981. Nor is this likely to be the end; the crude goods index excluding food and energy rose by 4% in the month, implying that producer prices have considerably further to rise. As for consumer prices, they have been above 4% for three months running, while the core index has accelerated from 2.1% in September to 2.5% in January. As a result, household incomes are falling in real terms – as is household spending.

The Fed is taking a gamble. In an ideal world, lower interest rates would help restore the health of the financial system as well as stimulate spending. That would entail upside risks to inflation. Admittedly, the Fed currently is more worried about the downside risks to growth than the inflation danger. Moreover, Dr Bernanke (and other FOMC members) also worry about the risks of deflation. In order to avoid the danger of *deflation*, they are clearly prepared to take risks with *inflation*.

To some extent, this is probably a safe policy, at least in the short term. If the economy recovers, the Fed can tighten monetary policy again, before inflation becomes entrenched. This very much seems to be what the FOMC has in mind, judging by recent speeches and minutes. Alternatively, household income continues to be eroded, so too will household spending. The economy will continue to weaken. Eventually, there will be a negative output gap which – together with lower commodity prices and a non-falling dollar – will squeeze inflation.

Where the Fed could go wrong, is if the economy weakens, but inflation remains stubbornly high. This could be the result if the rest of the world does not slow down as rapidly as expected, meaning that commodity prices – including food – will remain high and rising. In that situation, with the US economy in stagflation, bond markets could eventually get increasingly nervous about when – or even if – the Fed will act to dampen inflation expectations; and the rest of the world, on whom the US depends to feed its overspending, could get really nervous about the dollar.

Gabriel Stein

[gabriel.stein@lombardstreetresearch.com](mailto:gabriel.stein@lombardstreetresearch.com)