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Fed slashes interest rates, retail sales tumble

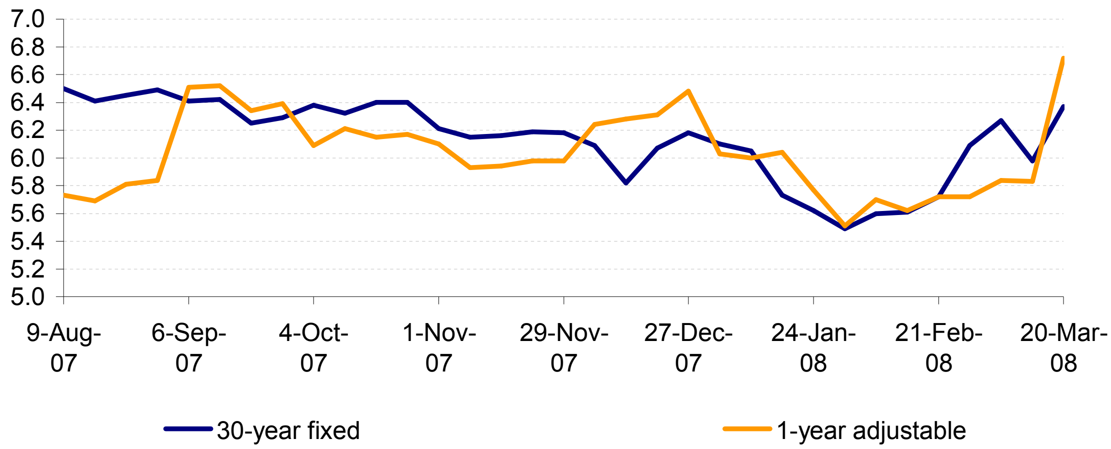
WE SUGGEST: Bond market unlikely to tolerate high US inflation for long

SUMMARY: The Fed's slashing of interest rates can only be justified if it avoids a recession (or a protracted slowdown). But recent data on retail sales rather point in the opposite direction. The negative yield on the five-year TIP is a warning sign of worse to come if bond markets lose faith in Messrs Bernanke et al.

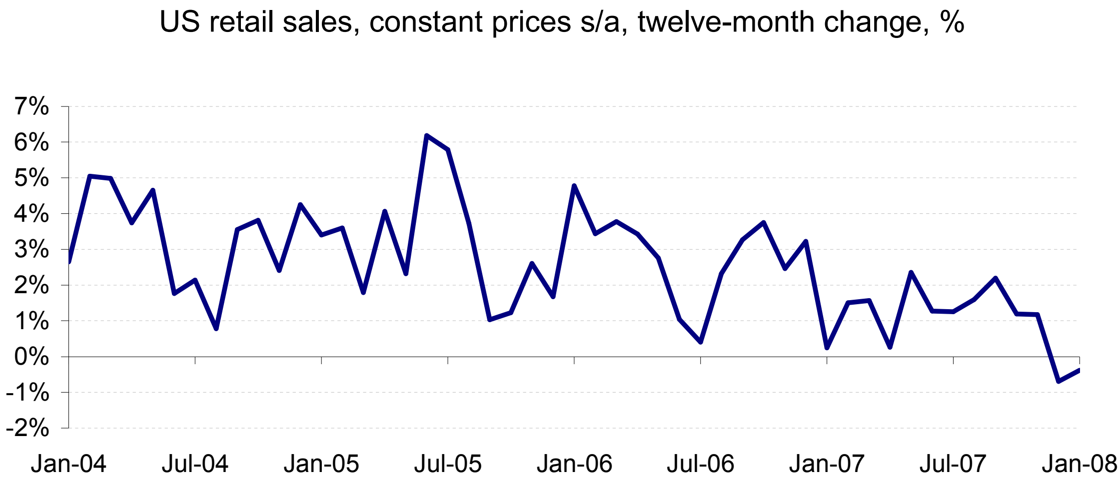
Since last summer, the Fed has slashed interest rates by 225bps – 125bps of which have been in the past two months alone. While this is not the source of US inflation, the easing of monetary policy has certainly helped to stoke it. Obviously, if lower interest rates manage to stave off a recession, the Fed's gamble is well worth it and inflation can be dealt with at (relative) leisure. Sadly for the Fed, there is every indication that its policy is not working.

First, because although policy interest rates – ie, the Fed Funds rate – has come down – banks, keen to improve their balance sheets, have taken the opportunity of widening their margins instead of passing on lower interest rates to borrowers. Looking only at housing, a 30-year fixed rate mortgage has gone from 6.5% just before the Fed began to cut interest rates last August, to 6.37% in late March – but by way of 5.49%. As for a one-year adjustable rate, it stood at 5.73% in early August and had risen to 6.72% by mid-March. And this is not just for housing – new car loans at auto finance companies cost 4.74% in July 2007 and 4.55% in January 2008. If they have followed the same pattern as mortgage rates, they are by now probably back at their pre-August levels.

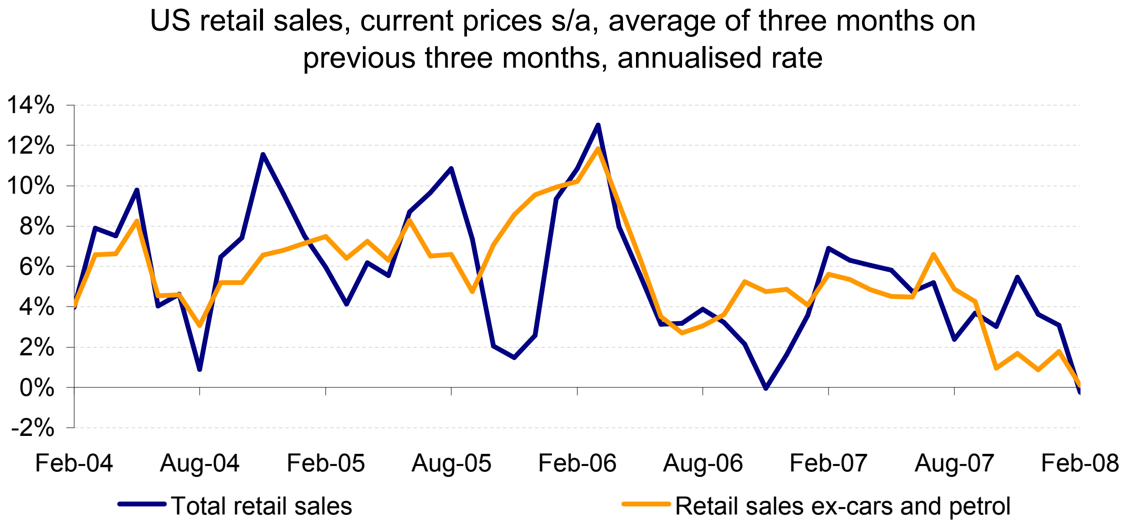
US mortgage interest rates, %



Under these circumstances, it is perhaps not surprising that household spending is getting more and more subdued. Retail sales fell by 0.6%, the second fall in three months. Moreover, this was in nominal terms. In real terms - which we won't know until the February CPI is published tomorrow – retail sales will have fallen further – the third consecutive month of below-zero real retail sales.



Moreover, bearing in mind that household spending was a key contributor to what little growth the US economy managed to achieve in Q4, the quarterly pattern of retail sales is ominous for the Q1 figure. To give an idea of its importance, unchanged household spending in Q4 from Q3 would (all else being equal) have meant a 1.3% fall in GDP instead of the 0.6% rise registered.



Today's data on business inventories and sales might at first glance seem to gainsay this pessimism. Business sales rose by 1.5% in January after a 0.6 drop in December. However, inventories also rose strongly, up 0.8% after a 0.7% rise in the previous month. Whatever the Fed's policy is doing to help Wall street, the jury is at best out on the effect it is having on Main Street.

And that brings us over to inflation. It may be premature to write about this today, as the February figure is published tomorrow. Judging by market expectations, the headline figure will be above 4% for a fourth consecutive month. For the moment, markets seem relatively sanguine about the Fed and inflation. However, the continued negative yield on the five-year TIP (highlighted by Charles Dumas in his *Daily Note*

Ben pours flames on troubled oil, 10th March) shows that there are emerging signs of worry. Again, if the Fed manages to avoid a recession, well and good – although even then it will have to prove itself willing to act decisively to rein in inflation. But if it doesn't, in six or nine months' time bond markets are likely to wreak havoc on an inflation-tolerating central bank – and on the economy it is supposed to be in charge of.

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