

# Investment Strategy Weekly

OAK ASSOCIATES, *ltd.*

March 28, 2005

Dr. Edward Yardeni

330-668-3326  
eyardeni@oakassociates.com

## THE FED'S CONUNDRUM

Here's my theory: The Fed folks aren't really worried about a broad-based inflation problem. They are mostly worried about another speculative bubble, this time in real estate. So they are trying to talk the bond yield up to drive mortgage rates higher. Why not just replace the 25-basis-points-per-meeting, "measured" approach to raising the fed funds rate with a more aggressive credit tightening program? The problem is that if they raised the fed funds rate more aggressively, the bond market might actually rally! The Bond Vigilantes might actually cheer that tougher monetary policy will probably keep inflation at bay. It might also burst the housing bubble and send the economy into a recession. In the old days, i.e., the 1960s and 1970s, the Fed could rely on Regulation Q to cause a credit crunch in housing as short-term rates rose above maximum ceiling rates that banks were allowed to pay on their deposits. Financial deregulation during the 1980s eliminated this very effective brake on housing and the economy for the Fed. What a conundrum!

**Greenspan Speaks.** Of course, "conundrum" will now and forever be included in the list of classic "Greenspan-speak." In his Congressional testimony on February 16, 2005, he said:

For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience.<sup>1</sup>

This marked the beginning of the Fed's campaign to talk bond yields up. It may be working. The 10-year Treasury yield was 4.1% on February 15. Recently, it rose to 4.6%. The problem is that this may not be enough to slow home price inflation. It may actually boost it if would-be homebuyers rush into the housing market before mortgage rates and home prices go much higher.

In the late 1990s, Mr. Greenspan told us that it isn't the Fed's job to pop speculative bubbles in the stock market, but rather to clean up the mess quickly once the bubble has burst. He still believed this in early 2004:

It is far from obvious that bubbles, even if identified early, can be preempted at lower cost than a substantial economic contraction and possible financial destabilization—the very outcomes we would be seeking to avoid. In fact, our experience over the past two decades suggests that a moderate monetary

Please visit our websites at  
[www.yardeni.com](http://www.yardeni.com) &  
[www.oakassociates.com](http://www.oakassociates.com)

<sup>1</sup> See [Hhttp://www.federalreserve.gov/boarddocs/hh/2005/february/testimony.htm](http://www.federalreserve.gov/boarddocs/hh/2005/february/testimony.htm)H.

tightening that deflates stock prices without substantial effect on economic activity has often been associated with subsequent *increases* in the level of stock prices. Arguably, markets that pass that type of stress test are presumed particularly resilient. The notion that a well-timed incremental tightening could have been calibrated to prevent the late 1990s bubble while preserving economic stability is almost surely an illusion. Instead of trying to contain a putative bubble by drastic actions with largely unpredictable consequences, we chose, as we noted in our mid-1999 congressional testimony, to focus on policies “to mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion.”<sup>2</sup>

**Ambiguity At The Fed.** This helps to explain the ambiguity of the Fed’s latest policy statement released immediately following the March 22 meeting of the Federal Open Market Committee (FOMC). The FOMC seems intent on stirring inflationary fears to drive bond yields higher, while sticking with the measured approach to raising the fed funds rate. Here is the part of the statement that really unnerved the bond market:

Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices.

This obviously suggests more concern about inflation than the previous February 2 meeting’s statement on the subject:

Inflation and longer-term inflation expectations remain well contained. The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured.

Even in his February 16 testimony, the Fed chairman said: “All told, the economy seems to have entered 2005 expanding at a reasonably good pace, with inflation and inflation expectations well anchored.” One month later, the Fed seems less convinced that inflation is anchored.

So why did the Fed keep the “measured” language in the latest statement?

The Fed chairman retires on February 1, 2006. He certainly doesn’t want to burst the housing bubble now and push the economy into a consumer-led recession. Indeed, in his February 16 testimony, he acknowledged that rising home prices have boosted consumer spending and economic growth:

---

<sup>2</sup> “Risk and Uncertainty in Monetary Policy,” January 3, 2004.  
<http://www.federalreserve.gov/boarddocs/speeches/2004/20040103/default.htm>.



The rapid rise in home prices over the past several years has provided households with considerable capital gains. Moreover, a significant increase in the rate of single-family home turnover has meant that many consumers have been able to realize gains from the sale of their homes. To be sure, such capital gains, largely realized through an increase in mortgage debt on the home, do not increase the pool of national savings available to finance new capital investment. But from the perspective of an individual household, cash realized from capital gains has the same spending power as cash from any other source.

So the Fed is likely to continue raising the fed funds rate by 25 basis points per meeting. I reckon there are likely to be three more tightening moves bringing the federal funds rate to 3.50%, which would be two percentage points above my projected core inflation rate of 1.5%, as measured by the personal consumption expenditures deflator. Fed officials might continue to contribute to the current inflation scare in an effort to push the bond yield higher.

**Pipeline Inflation Is Actually Moderating.** I don't expect they will succeed because I think that inflation will remain subdued. Two weeks ago, I argued that the current inflation scare isn't supported by most of the data, especially the "hard core" measures of productivity, wages, and unit labor costs.<sup>3</sup> Now let me review the "pipeline" inflation data that also mostly show that these pressures may be subsiding already.

- 1) One of the best leading indicators of inflation in industrial commodity prices, PPI crude goods excluding food and energy, and non-oil import prices is the yearly percent change in FRODOR (foreign official dollar reserves). It is my favorite indicator of global liquidity.<sup>4</sup> On a year-over-year basis, it peaked at 36.2% during the week of August 18, 2004. During the week of March 23, it was down to 16.3%. It actually leads the level of the CRB raw industrials spot price index by 52 weeks and strongly suggests that industrial commodity prices are likely to peak soon (Figure 1).
- 2) The growth of FRODOR coincides with the yearly percent change in the core PPI crude goods index, which is also down sharply recently (Figure 2).
- 3) FRODOR also strongly suggests that inflation in non-oil import prices, which was 2.9% in February, is at or near a cyclical peak (Figure 3). It sometimes (but not always) is also a useful 12-month leading indicator of the core PPI finished goods inflation rate, which rose to 2.8% in February (Figure 4).
- 4) An even more compelling sign that inflationary pressures are moderating in the pipeline is that the core PPI crude goods inflation rate, which leads the core PPI finished goods inflation rate by roughly 12 months, peaked at 32% during August 2004 and plunged to 5.0% in February (Figure 5). Core PPI intermediate goods inflation, which tends to be much more volatile than the core PPI finished goods inflation, may have peaked in January (Figure 6).

---

<sup>3</sup> "Inflation Scare," March 14, 2005, [www.yardeni.com/pub/a\\_050314.pdf](http://www.yardeni.com/pub/a_050314.pdf).

<sup>4</sup> For more on FRODOR, see my "Lord of the Rings," February 15, 2005, [www.yardeni.com/pub/a\\_050215.pdf](http://www.yardeni.com/pub/a_050215.pdf).



- 5) In March, the Philadelphia Fed's survey of manufacturers in the region found significant declines in both the prices-paid and prices-received indexes. This suggests that the ISM prices-paid index, which peaked at 88 during April 2004 and fell to 65.5 during February of this year, probably fell again in March (Figures 7 and 8).
- 6) On the other hand, the National Federation of Independent Businesses found that more small businesses are raising prices, and even more are planning to do so (Figure 9). However, competition tends to be intense for small businesses so the net percent actually raising prices in February was only 19%. Manufacturing capacity utilization rose to 77.9% in February. This is still a relatively low rate and not likely to trigger significant price hikes (Figure 10).
- 7) Average hourly earnings were unchanged in February and up 2.5% from a year ago. This is good news all by itself because wages are among the key determinants of unit labor costs. However, wage inflation also seems to have an impact on rent inflation in the CPI, which was 3.0% during February compared to a year ago (Figures 11 and 12). It is likely to remain low if wage inflation remains low.

**Home Price Inflation Is Rising.** I believe that the Fed is becoming increasingly alarmed about the rapid increase in home prices. In February, the median existing home price rose to \$188,200, up 8.5% from a year ago on a 12-month moving average basis and 25% over the past three years. The one-year rate of appreciation now exceeds all previous cyclical peaks since 1982 (Figures 13 and 14).

Of the country's four major regions, the Northeast and the West stand out as the most speculative and the most prone to a painful adjustment. Median price increases in the Northeast actually peaked at 17.8% on a 12-month moving average during June 2004, but still rose 14.5% in February of this year. During the previous bubble in the Northeast, home price gains peaked at 27% during December 1987. By December 1989, they were down 10%. In the West the median existing home price is up 14.0% in February, exceeding the previous cyclical peak of 13.4% during January 1988 (Figure 15).

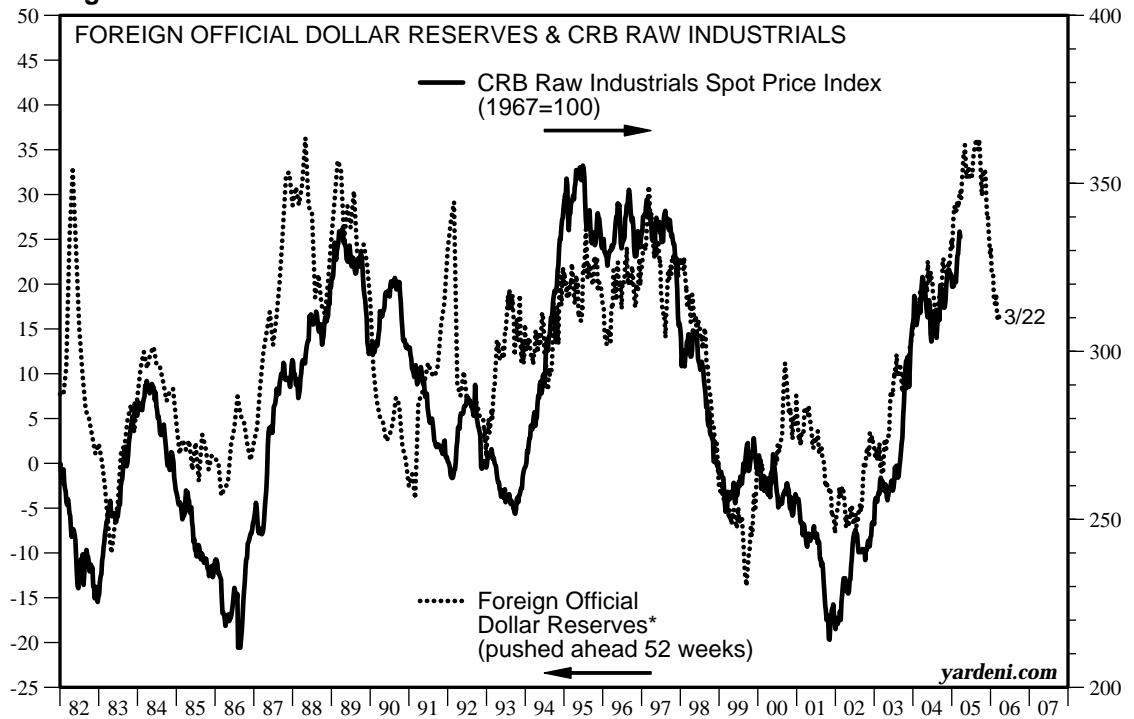
I am not convinced that the housing bubble is about to burst. There are certainly many pockets of speculative excess in the housing market. However, the market remains rational in most areas of the country, with values appropriate relative to incomes and mortgage terms. Besides, everyone "knows" that there is a bubble that could burst any minute, so it will probably get even bigger before it does so. The cover story of the Sunday, March 27 issue of real estate section of *The New York Times* is "What Happens If It Bursts?"

\* \* \*



# - FRODOR & Inflation -

Figure 1.

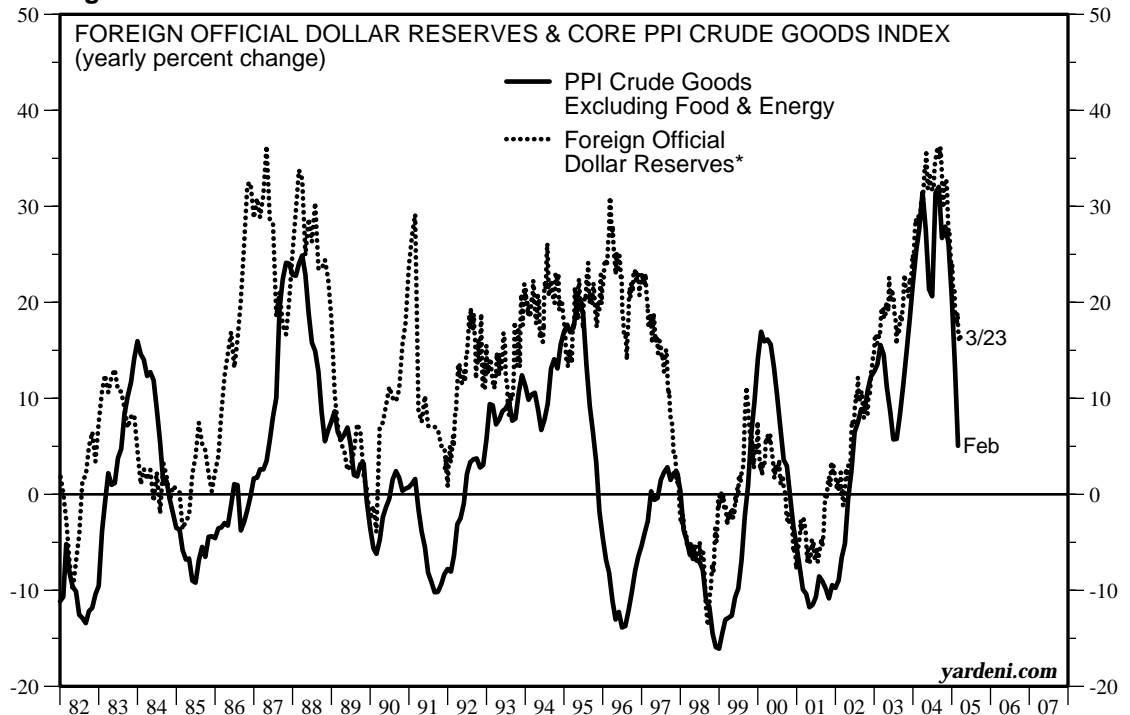


FRODOR (global liquidity) is a great leading indicator of industrial commodity prices. It suggests that these prices are at or nearing a cyclical peak.

\* Yearly percent change. U.S. marketable securities held in custody for foreign official and international accounts at the Fed. Monthly data from 1952 to 1990 include only U.S. Treasury securities. Weekly data from 1991 to 1999 include U.S. Treasuries. Weekly from 2000 on include U.S. Treasury and Federal agency securities.

Source: Board of Governors of the Federal Reserve System and Commodity Research Bureau.

Figure 2.



There is a decent correlation between FRODOR and core PPI crude goods inflation. The year-over-year percent change in both is falling suggesting that "pipeline" inflation is actually moderating.

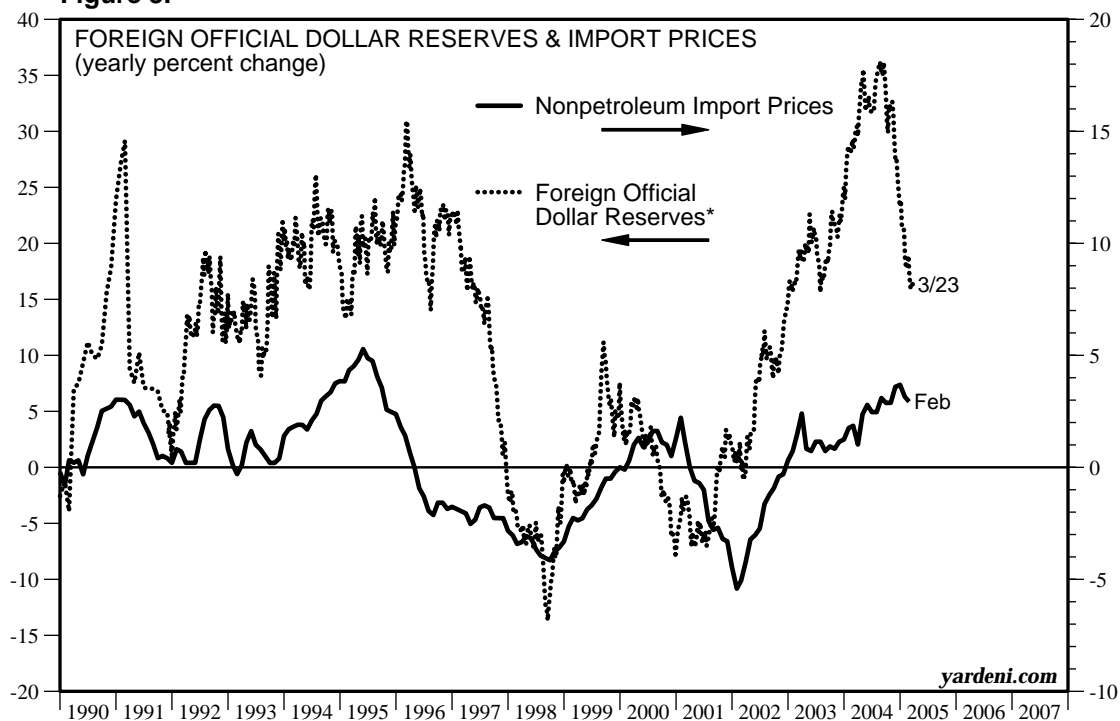
\* U.S. marketable securities held in custody for foreign official and international accounts at the Fed. Monthly data from 1952 to 1990 include only U.S. Treasury securities. Weekly data from 1991 to 1999 include U.S. Treasuries. Weekly from 2000 on include U.S. Treasury and Federal agency securities.

Source: IMF International Financial Statistics and Bureau of Labor Statistics



# - FRODOR & Inflation -

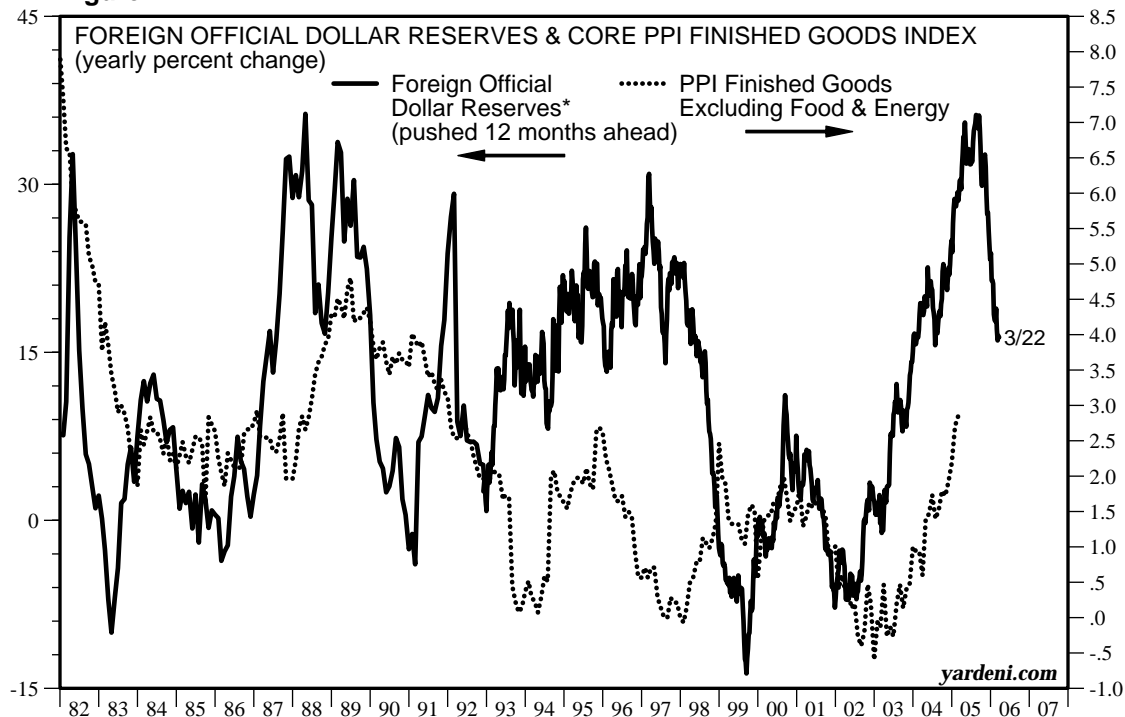
**Figure 3.**



The growth in FRODOR, which is also highly correlated with the yearly percent change in nonoil import prices, suggests that these inflationary pressures are likely to moderate.

\* U.S. marketable securities held in custody for foreign official and international accounts at the Fed. Monthly data from 1952 to 1990 include only U.S. Treasury securities. Weekly data from 1991 to 1999 include U.S. Treasuries. Weekly from 2000 on include U.S. Treasury and Federal agency securities.  
Source: IMF International Financial Statistics and Bureau of Labor Statistics

**Figure 4.**



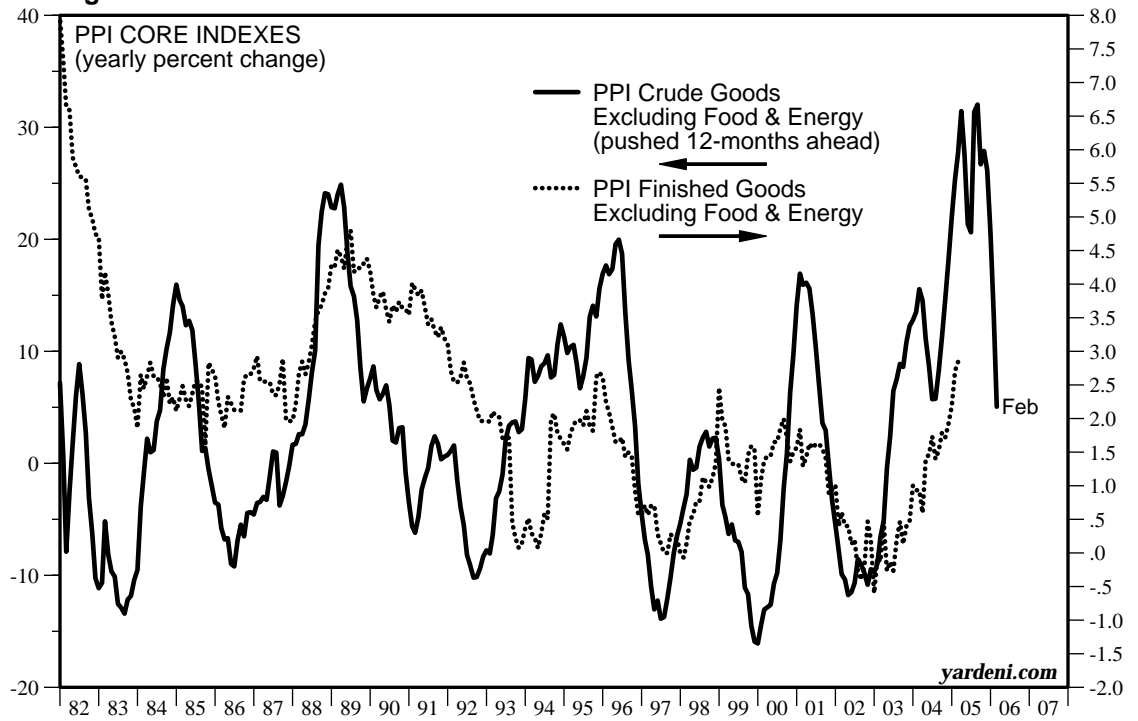
FRODOR leads core PPI finished goods inflation, which is also likely to peak soon.

\* U.S. marketable securities held in custody for foreign official and international accounts at the Fed. Monthly data from 1952 to 1990 include only U.S. Treasury securities. Weekly data from 1991 to 1999 include U.S. Treasuries. Weekly from 2000 on include U.S. Treasury and Federal agency securities.  
Source: IMF International Financial Statistics and Bureau of Labor Statistics



# - PPI Pipeline Inflation -

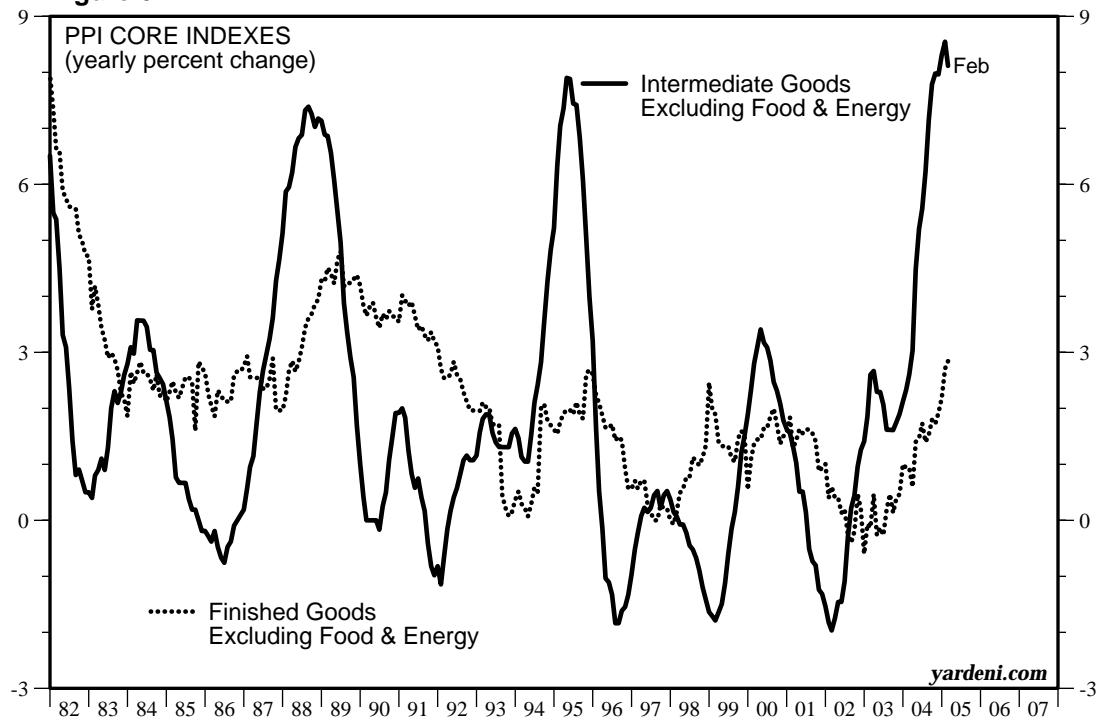
Figure 5.



Core PPI crude goods inflation, which leads core PPI finished goods inflation by roughly 12 months, peaked at 32.0% during August 2004 and plunged to 5.0% in February.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

Figure 6.



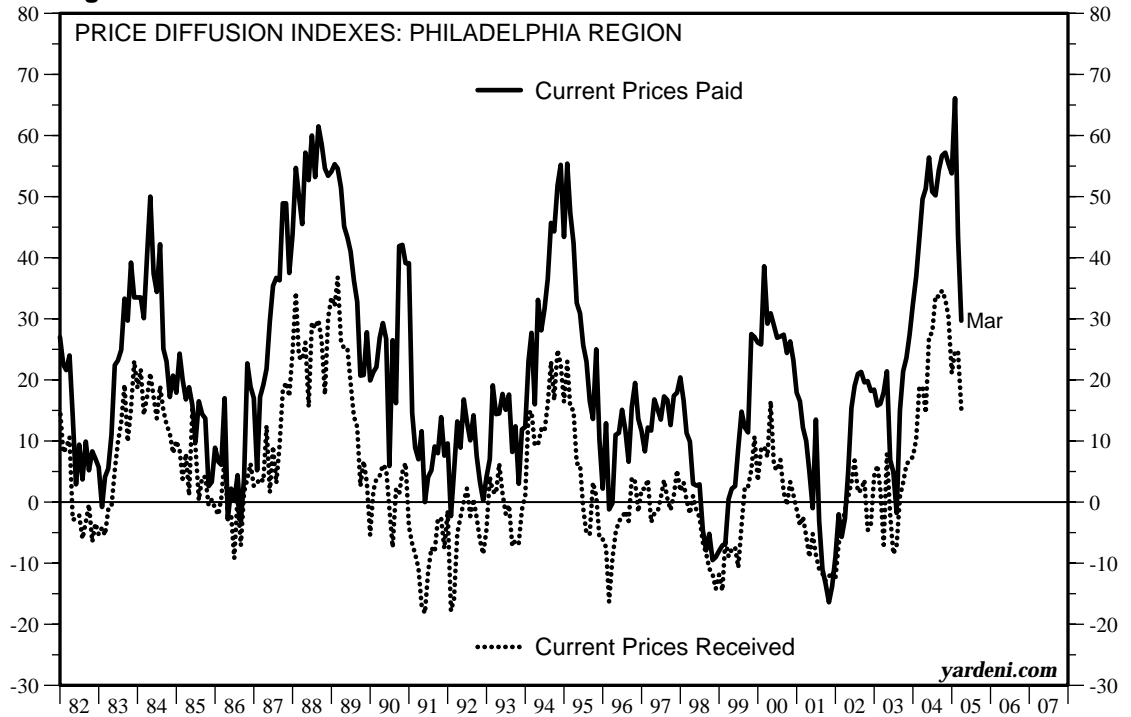
Core PPI intermediate goods inflation, which tends to be much more volatile than core PPI finished goods inflation, may have peaked recently.

Source: U.S. Department of Labor, Bureau of Labor Statistics.



# - Purchasing Managers on Pricing -

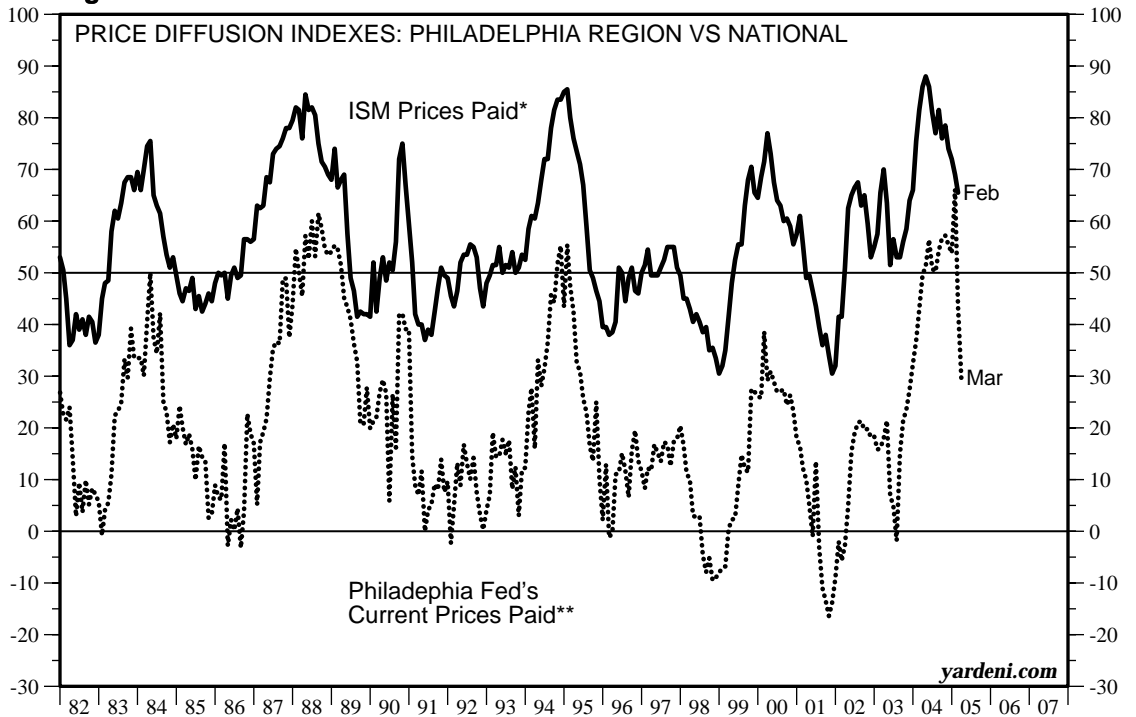
Figure 7.



Source: Federal Reserve Bank of Philadelphia, Business Outlook Survey.

Phili Fed survey shows a big drop in both current prices paid and received indexes during March. This suggests that ISM prices paid index probably fell again in March.

Figure 8.

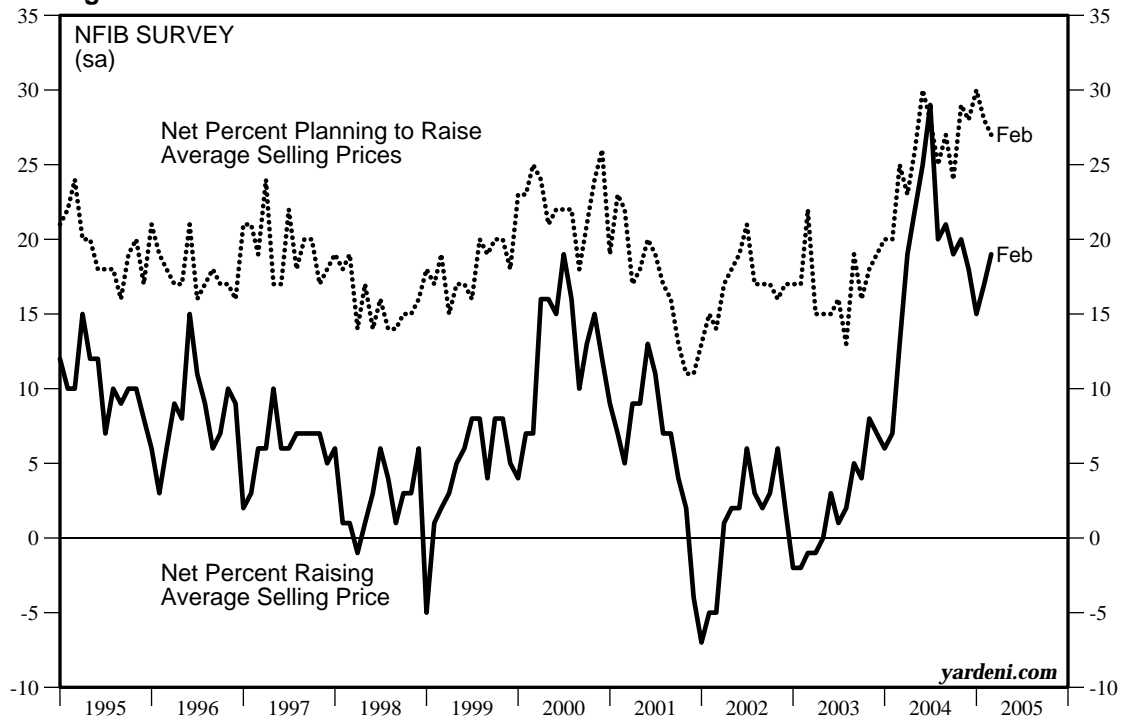


Source: \* Institute for Supply Management. \*\* Federal Reserve Bank of Philadelphia, Business Outlook Survey.



## - Other Inflation Indicators -

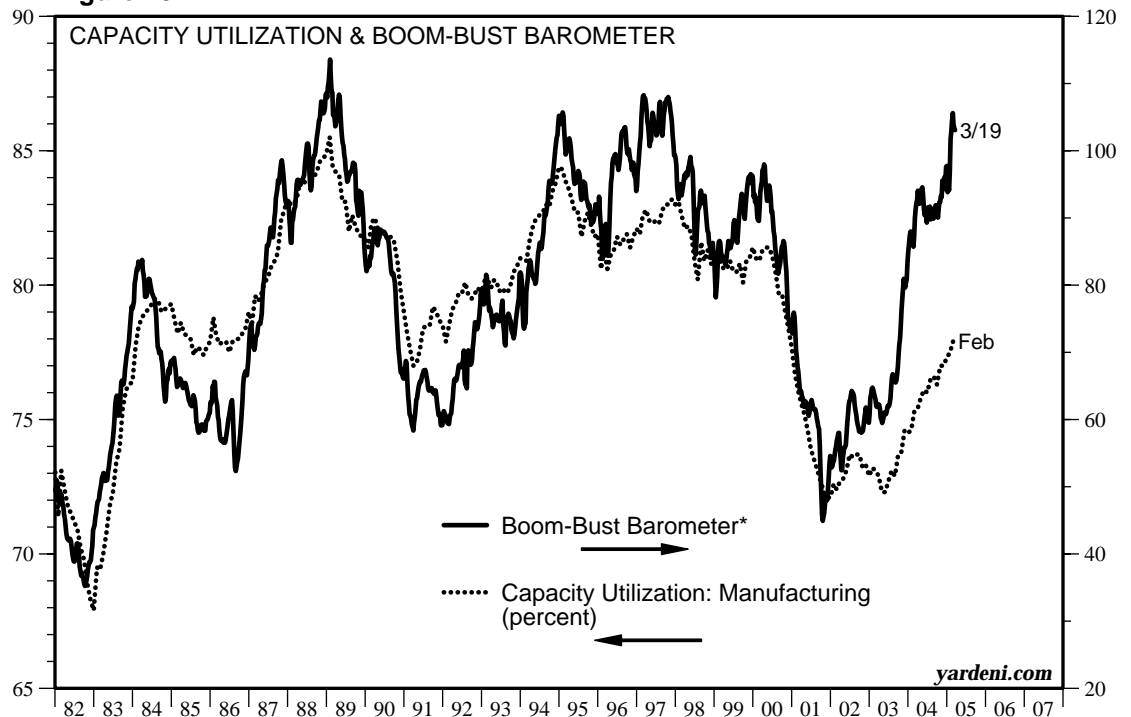
**Figure 9.**



Source: National Federation of Independent Business.

More small businesses are raising prices, though not as many as a year ago. Even more are planning to raise prices.

**Figure 10.**



\* CRB raw industrials spot price index divided by initial unemployment claims.

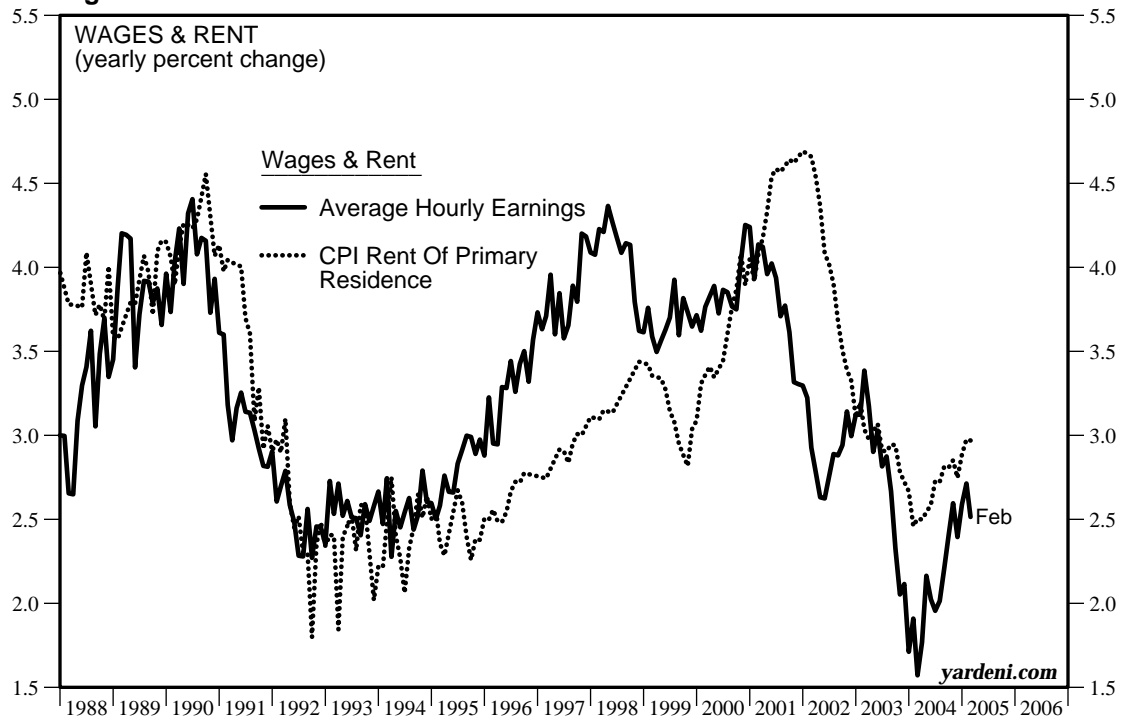
Source: Board of Governors of the Federal Reserve System, U.S. Department of Labor, Bureau of Labor Statistics and Commodity Research Bureau.

In the past, our Boom-Bust Barometer tracked manufacturing capacity utilization very closely. This time while BBB is back to previous cyclical highs, utilization is still low at 77.9%.



# - Wages & Rent -

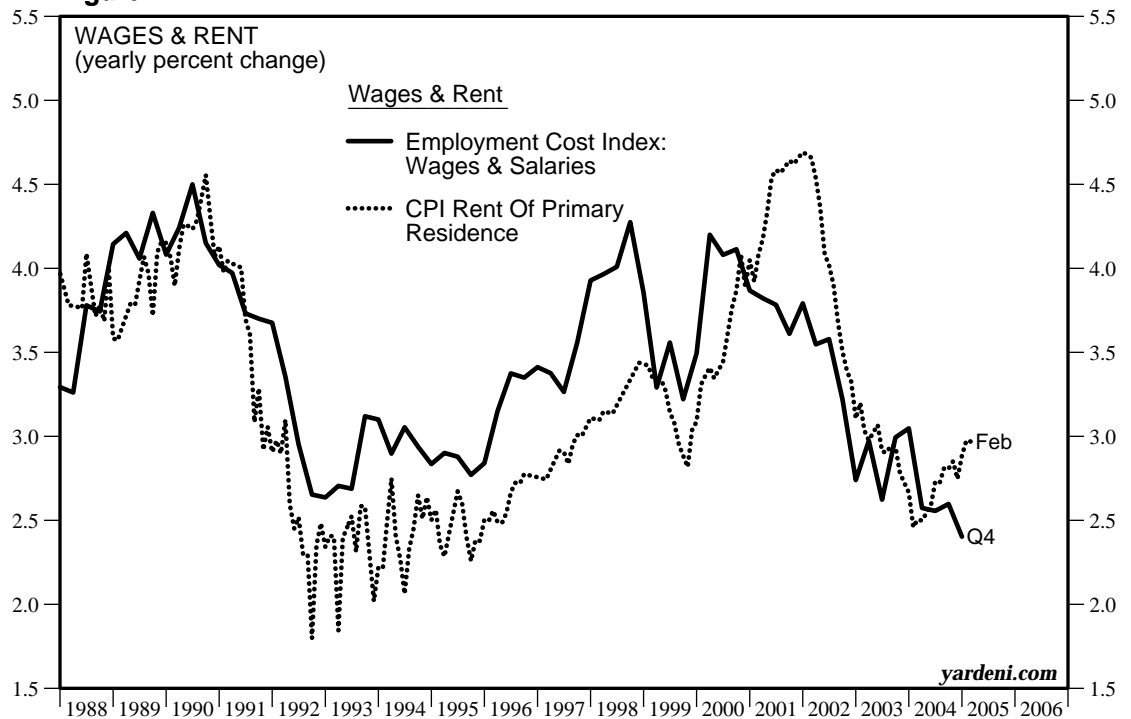
Figure 11.



Source: Bureau of Labor Statistics.

Not surprisingly, rent inflation is closely tied to wage inflation, which remains moderate and should continue to dampen rent hikes.

Figure 12.

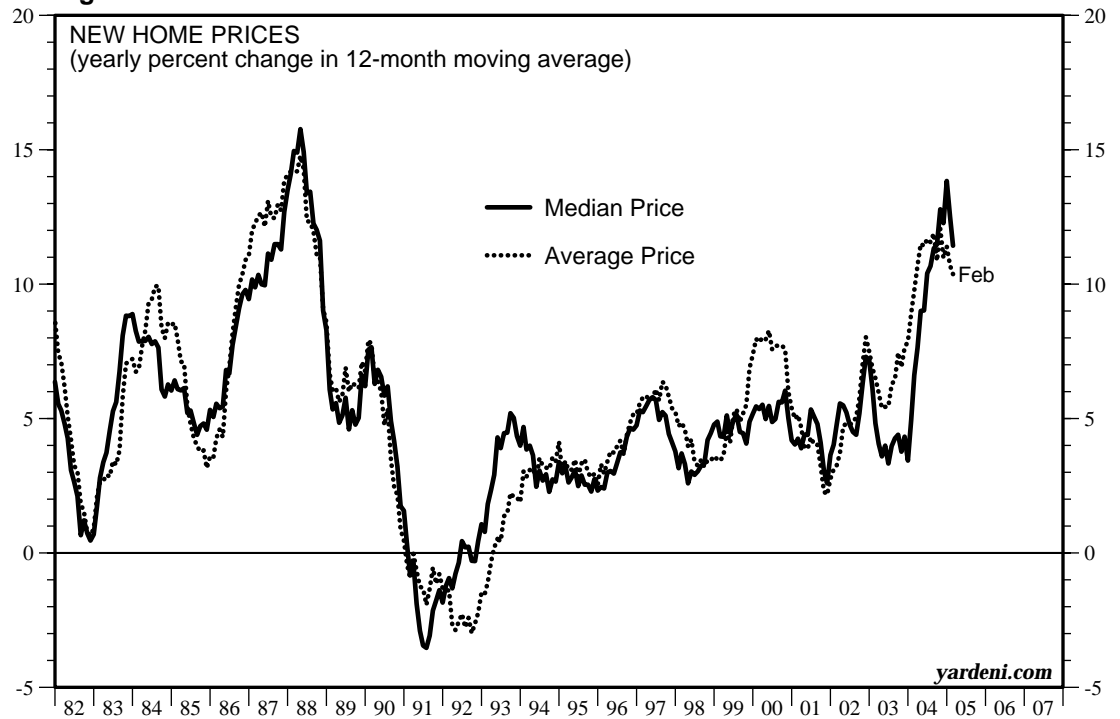


Source: Bureau of Labor Statistics.



# - Home Prices -

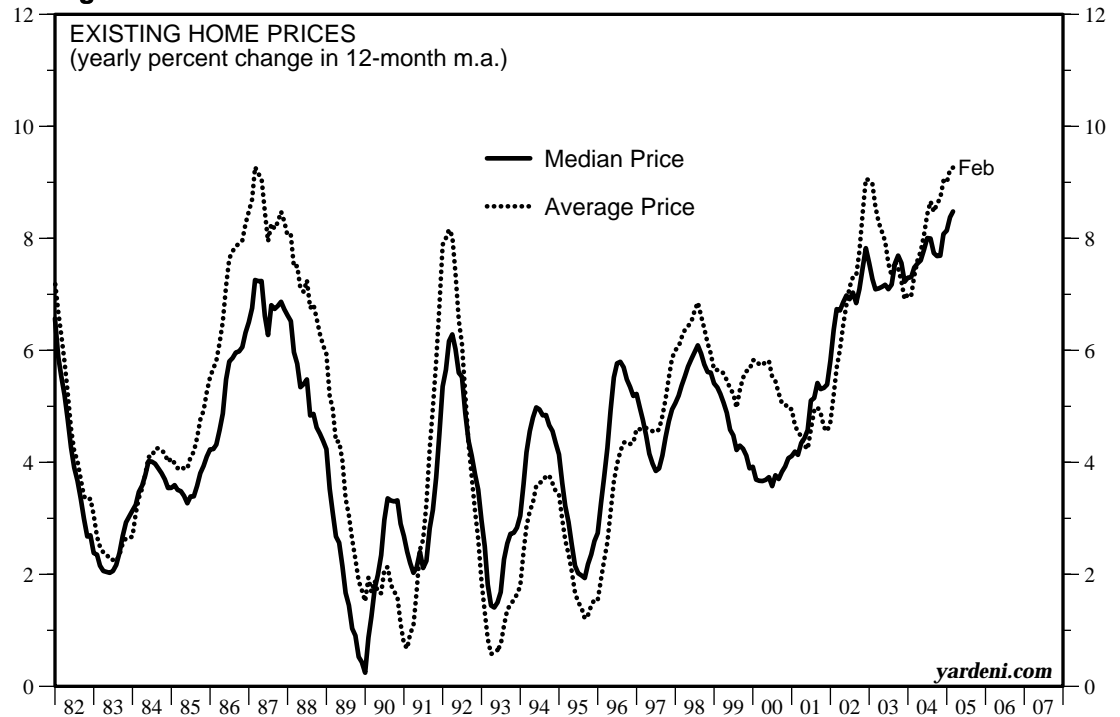
**Figure 13.**



Source: U.S. Department of Commerce, Bureau of the Census.

Both new and existing home prices are rising rapidly, increasing the potential for a drop in prices when the housing bubble bursts. The most vulnerable regions are the Northeast and West where prices are up 14% from a year ago.

**Figure 14.**

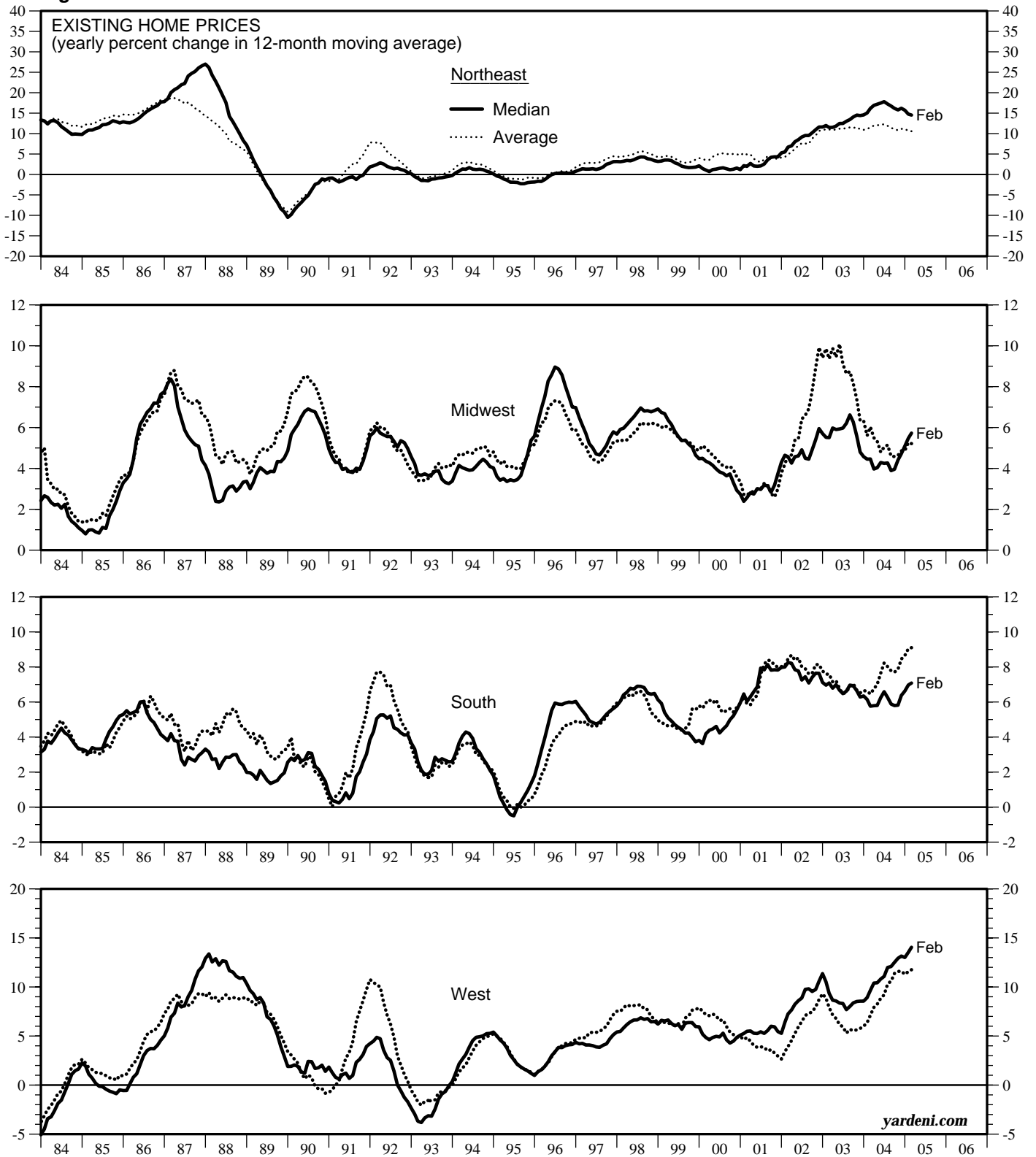


Source: National Association of Realtors.



# - Existing Home Prices -

Figure 15.



Source: National Association of Realtors.



Copyright (C) Dr. Edward Yardeni 2005. All rights reserved. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice.

**Additional Information Available on Request.**