Investment Strategy Weekly

OAK ASSOCIATES, *ltd.*

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THE FED'S BARK

It was a bad start to the New Year in the stock market. I started the New Year by observing last week that years ending in "5" were good ones for stocks. The seven "5" years since 1935 were up on average by 28.5%, with the lowest gain of 9.1% during 1965 and the highest gain of 41.4% during 1935. Stocks rose during all seven of those "5" years, but started three of those years down during the first week. Blame the Fed for the first-week hangover following the New Year's festivities. Some Fed officials are starting to bark that they think inflation may be stirring. Investors fear that the Fed may be setting the stage for raising the federal funds rate—currently 2.25%—above 3.00% this year, maybe all the way up to 4.00%. The "measured" approach to raising the federal funds rate could be replaced by a more aggressive approach.[1]

How Hard Will It Bite? Will the Fed's barks in the December 14 minutes of the Federal Open Market Committee (FOMC) meeting, which were released last week, lead to interest-rate levels that will soon bite borrowers and investors much harder than most economists anticipated at the end of last year? According to *The Wall Street Journal's* semiannual survey, the consensus federal funds rate forecasts of 56 market economists at the end of last year was 3.0% and 3.5% by the middle and the end of 2005, respectively.[2] I predict that the Fed will raise the federal funds rate three more times this year, by 25 basis points at each of the next three meetings of the FOMC on February 2, March 22, and May 3. That should do it for the rest of the year, in my opinion.

Non-Accelerating Inflation Rate. The reason for my relatively optimistic outlook for the federal funds rate is that I believe that the core inflation rate will remain surprisingly low this year as it did last year. Over the 12 months through November 2004, the CPI rose 3.6%, twice as much as it did in 2003. However, the CPI excluding food and energy rose only 2.2% over the past 12 months. That, too, was twice as fast as during 2003 (Figure 1). But that is a good thing since the Fed's objective in lowering the federal funds rate to 1% in June 25, 2003, and holding it there through the end of 2003 was to avert deflation by reviving inflation just a little bit. The folks at the Fed succeeded, but did they succeed too well—forcing them now to raise the "non-accelerating inflation rate of the federal funds rate," a.k.a. the "neutral" federal funds rate, well above 3.00%, maybe to 4.00% or even higher (Figure A)?

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[1] The FOMC first started to use the word "measured" to describe the pace at which it would remove policy accommodation in its statement following the May 4, 2004, meeting. A complete history of these statements since 1997 is available at http://www.yardeni.com/FOMC.aspx.
[2] See http://online.wsj.com/article/0,,SB110451275000514206,00.html?mod=economicforecast%5F1.

Figure A: The "Neutral" Federal Funds Rate

On July 13, 2003, Dick Rippe, the Chief Economist of Prudential Equity Group, and I hosted a telephone conference call with Laurence H. Meyer, who was a governor of the Federal Reserve Board from June 1996 to January 2002. His book about his experiences had just been released the week before. The book, titled "A Term At the Fed: An Insider's View," is a fast read and provides very interesting insights into the workings of the Federal Open Market Committee (FOMC) during one of the more turbulent periods in monetary policymaking. On our conference call, Mr. Meyer added some color and additional insights, especially into Fed Chairman Alan Greenspan's leadership of the FOMC. I was especially intrigued by Mr. Meyer's discussion of inflation targeting and the "neutral" federal funds rate.

Mr. Meyer's unique perspective helps to explain why the FOMC has been so "measured" in raising interest rates since May of last year. The FOMC has an off-the-record inflation target. Currently, it is probably 1.5% for the core personal consumption expenditures deflator (PCED). In November, this measure was up 1.5% from a year ago. The core CPI was up 2.2% over the 12 months through November, very close to my guess for the Fed's internal target of 2.0%.

With the two core inflation rates running close to the Fed's targets, no wonder the FOMC has been in any rush to raise the federal funds rate more aggressively toward neutral. The question is, What is the neutral rate? Conceptually, it is the rate at which inflation remains stable. Temporally, it should coincide with the non-accelerating inflation rate of unemployment (NAIRU), the jobless rate at which inflation neither increases nor decreases. By the way, there is no reason why the inflation rate at NAIRU has to be zero. In other words, NAIRU implies stable inflation, not price stability. Put yet another way, if the Fed is targeting price stability—i.e., an inflation target at or near zero—the unemployment rate may very well be above the NAIRU.

At Mr. Meyer's first meeting of the FOMC on July 2 and 3, 1996, Mr. Greenspan raised the issue of whether the Fed should have an inflation target. Governor Janet Yellen said that 2% was a good target. Zero, she said, implied deflation for some industries and workers. To avoid deflation she recommended some "cushion." Also, she noted that at zero inflation, the Fed can't lower the "real" interest rate below zero. Mr. Greenspan favored price stability, i.e., "a state in which expected changes in the general price level do not effectively alter business or household decisions." Following a discussion, Mr. Greenspan summarized, "We have all agreed on 2 percent" for the core CPI inflation rate. However, he warned everyone at the meeting never to publicly reveal that the Fed had an inflation target. Meyer isn't disclosing a state secret, since the transcripts of all FOMC meetings are posted on the Fed's website five years after the fact.*

In his book, Mr. Meyer suggests almost in passing that the neutral real federal funds rate might not be a fixed variable: It may be that the "neutral" real fed funds rate rises by about one percentage point for every percentage-point rise in productivity growth. In his conference call with Dick and me, he had much more to say on the subject. He said that the real federal funds rate "probably varies over time." He believes that, the Fed is most likely using 2.75% as the historical average. It adds 1.5% to that to get its price stability target. So at price stability, the nominal neutral federal funds rate should be 4.25%.

Continued…

Figure A: …Continued

Mr. Meyer observed that the Fed was just starting to do research on the time-varying neutral real federal funds rate just as he was leaving in late 2001. Now, he said, the estimate is reported in every Blue Book, the staff's assessment of the economy. "And the committee, and the staff, pays a lot of attention to it. It's important because today their estimate of the equilibrium real rate is almost surely well below two-and-three-quarters [or] something, probably a percentage point or so below that." This explains why the FOMC isn't rushing to raise the nominal federal funds rate back to 4.25% from 2.25% currently. Mr. Meyer stated, "And the real rate that's going to be required to push the economy back to full employment in the face of less willingness to take risks, et cetera, less animal spirits, is going to be lower than normal."

* See http://www.federalreserve.gov/FOMC/Transcripts/.

In the past, Fed officials, especially Fed Chairman Alan Greenspan, have indicated their preference for the personal consumption expenditures deflator (PCED) as a better measure of consumer price inflation than the CPI. I also favor the PCED. It, too, shows that inflation has accelerated, but from 1.6% during 2003 to only 2.6% over the past 12 months through November 2004. The core PCED is even lower at only 1.5%, which is barely up from the 1.1% rate of 2003 (Figure 2). That's not much acceleration, suggesting that the Fed may not have to push the federal funds rate much higher to avoid accelerating inflation.

Slicing & Dicing Inflation. Why are the CPI measures of inflation so much higher than the PCED rates and showing more acceleration? To review:

1) Over the latest 12 months through November, the CPI inflation rate is 3.6%, up 180 basis points, while the PCED inflation is 2.6%, up 100 basis points. Actually, the former tends to exceed the latter, with an average spread of 92 basis points since 1990, for example (Figure 3).

2) Over the past 12 months through November, the core CPI inflation rate is 2.2%, up 110 basis points, while the core PCED inflation is 1.5%, up 30 basis points. Again, the former tends to exceed the latter, with an average spread of 70 basis points since 1990, for example (Figure 4).

On my website, www.yardeni.com, I have a monthly chart book that compares all of the major components of the CPI and PCED.[3] The PCED inflation rates tend to be lower than their comparable CPI measures because prescription drugs, medical care services, computer, and airfare prices tend to rise at a slower pace as reflected in the PCED than in the CPI (Figures 5, 6, 7, and 8). I am not sure why this is so for computers and airline fares. However, I do know that the deflator captures private-sector health care costs (paid directly by the consumer and indirectly by health insurance providers) as well as public-

[3] See Consumer Prices Chart Book, http://www.yardeni.com/pub/consumerprice.pdf.

sector costs, which tend to be lower because of the power of the government to demand lower prices for the health care goods and services it pays for. The CPI picks up only the private sector's health care costs.

The spread between medical care services in the CPI and PCED is huge, averaging 272 basis points since 1990. It was a whopping 240 basis points in November last year when the CPI component was up 5.0%, while the PCED component was up only 2.6% (Figure 6). During November of last year, personal consumption expenditures on medical care services totaled $1.4 trillion. Government transfer payments in personal income are mostly attributable to public health care programs, which now equal 37% of consumer spending on medical care, up from about 32% in 1990 (Figures 9 and 10). The government has a bigger and bigger role in determining the cost of providing health care to all consumers. This is a trend fully captured by the PCED, but not by the CPI, which focuses on the health care costs of urban workers.

Renting Your Home To Yourself. Pimco's widely respected Bill Gross, among others, has argued that inflation measures would be higher if they weren't distorted by the government statisticians' adjustments for consumers' tendency to switch from expensive to less expensive substitutes and for quality improvements, i.e., so-called "hedonic pricing."[4] I am not as incensed as Mr. Gross about these adjustments. Indeed, I believe they make sense. Much less sensible is the inclusion of "owners' equivalent rent of primary residence" in both the CPI and PCED, with large weights of 23.4% and 10.9%, respectively (Figure 11). The statisticians, in effect, estimate how much owners of homes would have to pay themselves to rent their own homes from themselves.

Got that? They do this by partly basing their estimates on actual rents paid by actual renters. Rent inflation has dropped dramatically in recent years because extremely low mortgage rates caused many households to buy a house rather than continue to rent (Figure 12). Obviously, this doesn't imply that the equivalent rent paid by homeowners to themselves would have dropped as much or at all. That's if you even understand this bizarre concept and why it should be reflected at all in measures of consumer prices, let alone with such big weights!

In any event, if we exclude owners' rent from the core PCED, the resulting inflation rate is still very low at 2.7% over the 12 months through November, though it is up from 1.5% during 2003 (Figures 13 and 14).

Sensitive Stocks. While stock prices fell sharply when the latest FOMC minutes were released, the bond market barely flinched. The 10-year Treasury bond yield remains under 4.3%. A year ago, when the Fed just started the latest round of rate hikes, the yield was 4.6%. The spread between A-rated corporate bonds and the Treasury yield was 156 basis points at the end of last year versus 190 basis points a year ago. Interest-rate sensitive stocks have performed remarkably well. The S&P 500 Homebuilders index is actually up 29% from a year ago (Figure 15). The S&P 500 Utility index is up 15.5% from a year ago (Figure 16).

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[4] See Bill Gross, "Haute Con Job," October 24, 2004. at http://www.pimco.com/LeftNav/Late+Breaking+Commentary/IO/2004/IO_Oct_2004.htm.

So What's The Fed's Problem? At the end of the latest minutes of the FOMC, the members of the committee voted unanimously to maintain the "measured" approach to removing "policy accommodation." They continued a balanced between upside and downside risks to economic growth and price stability, with "underlying inflation expected to be relatively low."

The problem is that in the minutes, FOMC members expressed concerns suggesting to many stock market traders and commentators that the monetary officials may be starting to lean towards seeing more upside inflation risks. I think these Fed watchers are overreacting. What do you think the following key sentence in the minutes means?

> A number of participants cited the recent depreciation of the dollar on foreign exchange markets, elevated energy costs, and the possibility of a slowing in underlying productivity growth as factors tending to boost the upside risks to their inflation outlook, though, on net, they saw the risks to stable underlying inflation as still balanced.

Figure B excerpts two longer paragraphs from the minutes about the prospects for inflation. The first elaborates on the concerns listed in the above-quoted sentence, and the second explains why these concerns might not be inflationary.

I was especially interested to see the minutes note that recent studies suggest that there may not be much pass-through of exchange-rate changes into domestic prices. I've been saying that for more than two years, though I didn't read the studies. I'll get the studies and let you know what I find.

The minutes also noted that a number of FOMC members are concerned about the twin deficits in the federal budget and the current account. They seemed to be pessimistic on the prospects for any immediate solution to these deficits. However, the minutes didn't suggest that they felt they could do much with monetary policy. There was certainly no suggestion that monetary policy would be tightened more aggressively as a result of the twin deficits. Members noted that there was a remote possibility that better economic growth overseas might help to reduce our trade deficit. Obviously, they must know that raising interest rates aggressively in the United States won't help the rest of the world to grow.

Figure B: Excerpt From FOMC Minutes, December 14, 2004

In their discussion of the outlook for prices, a number of participants cited developments that could pose upside inflation risks. Although oil prices had fallen of late, they were still considerably higher than they had been in the spring, and the recent decline in the dollar would raise import prices and diminish competitive pressures on many industries. The pass-through from both sources should be limited, but they were still a potential source of upward pressure on prices that could get embedded in higher inflation under certain circumstances. In addition, productivity growth had slowed appreciably in the most recent quarter and unit labor costs had increased, raising questions about cost pressures going forward. A few participants also noted that uncertainty about the extent of resource slack in the economy was considerable and that it was quite possible that the economy could soon be operating close to potential, particularly if labor force participation rates did not turn up much while employment continued to register gains. The increase over the last few months in five-year measures of inflation compensation derived from Treasury nominal and inflation-indexed securities might be a warning sign that expectations were not as well anchored as they had been over the summer.

Despite these concerns, participants generally expected that inflation would remain low in the foreseeable future. While the depreciation of the dollar over recent months had been notable, some participants found persuasive the evidence from recent studies pointing to a decline over time and across countries in the pass-through of exchange rate movements into domestic prices. Forward market-based measures of inflation compensation beyond the next five years as well as survey measures of both short- and long-term inflation expectations had been quite stable of late, despite the previous rise in energy prices and the lower dollar. Moreover, several participants cited factors that likely would continue to provide a counterweight to any upside risks. Although participants generally acknowledged that the degree of economic slack was quite uncertain, the moderate pace of wage and compensation growth in recent months in the face of higher energy prices and several years of rapid productivity growth was consistent with an economy still operating somewhat below its potential. In a similar vein, the recent quarterly dip in productivity growth notwithstanding, there were no clear signs that underlying productivity had slowed appreciably of late, and a close reading of recent history suggested that upside risks to the outlook for productivity growth could be significant. Even if structural productivity growth were to slow, price markups remained quite elevated and some participants noted that further increases in unit labor costs could well be absorbed for some time by a return of markups to more normal levels.

Source: Federal Reserve Board of Governors, http://www.federalreserve.gov/FOMC/minutes/20041214.htm

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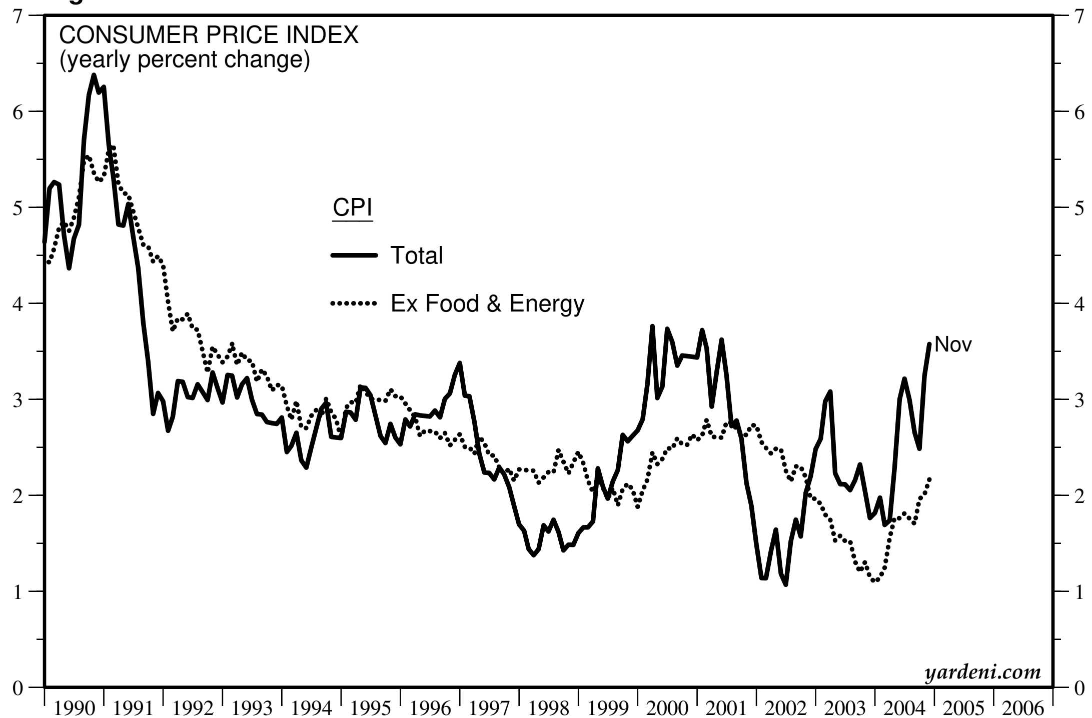
- Consumer Prices -

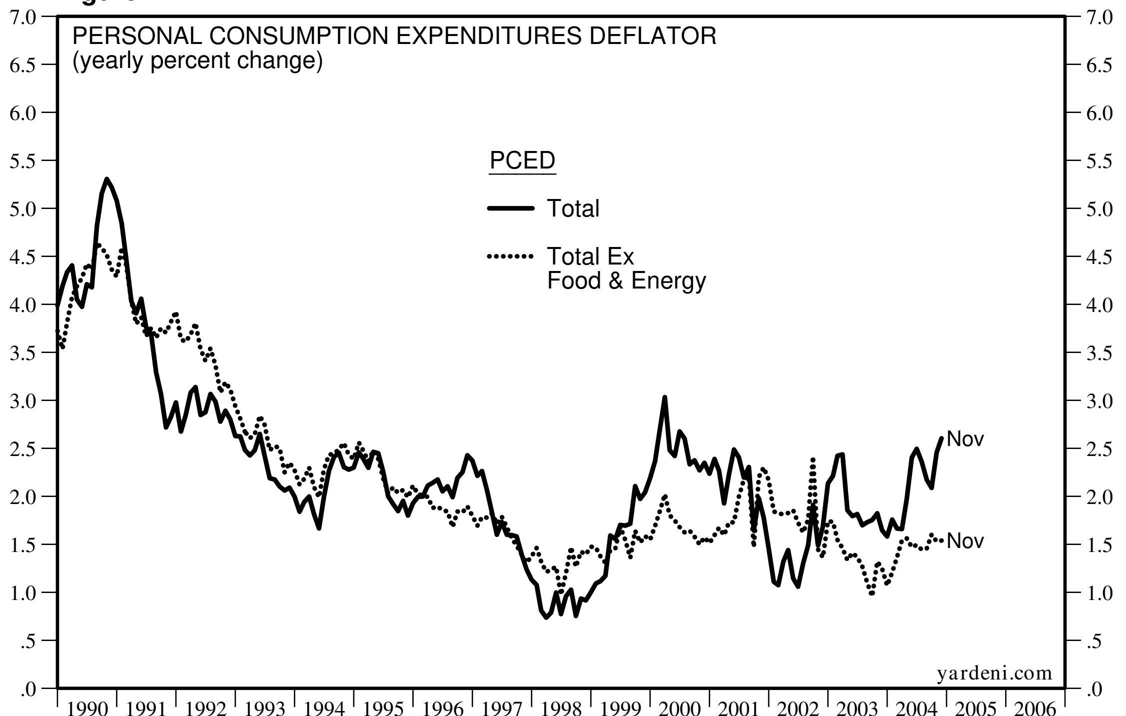
Figure 1.



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

Consumer price inflation rose sharply last year as a result of the jump in petroleum prices. Excluding food & energy, CPI rate still rose to 2.2% from 1.1% in 2003. However, PCED core rate has been very steady around only 1.5% in recent months.

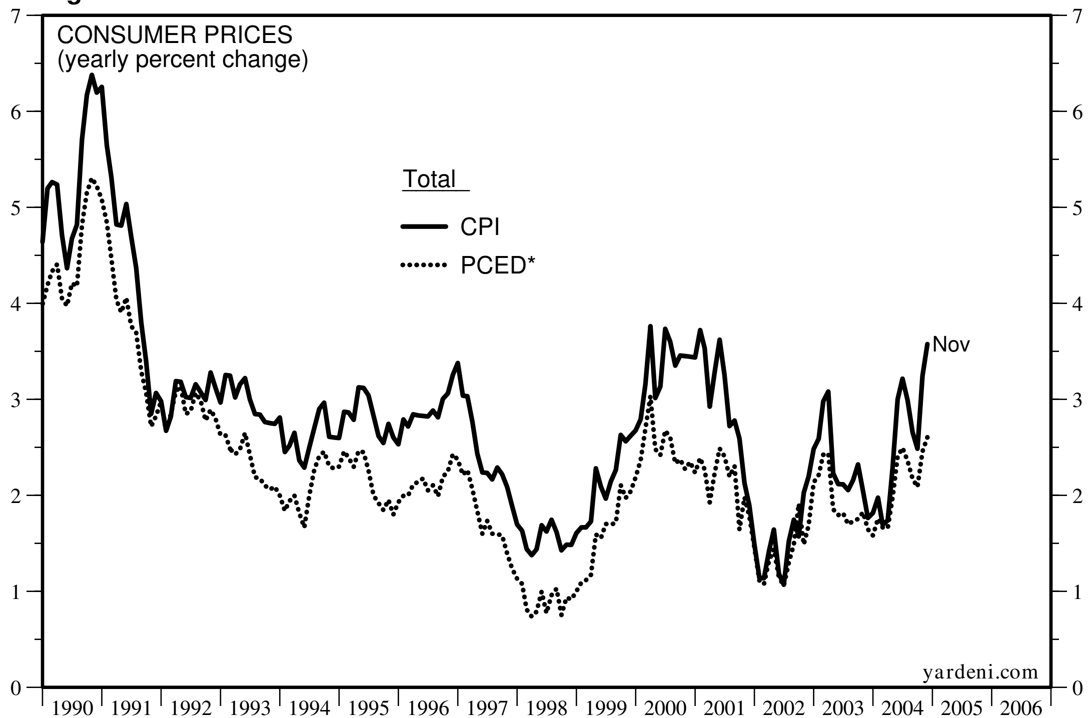
Figure 2.



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

- Consumer Prices -

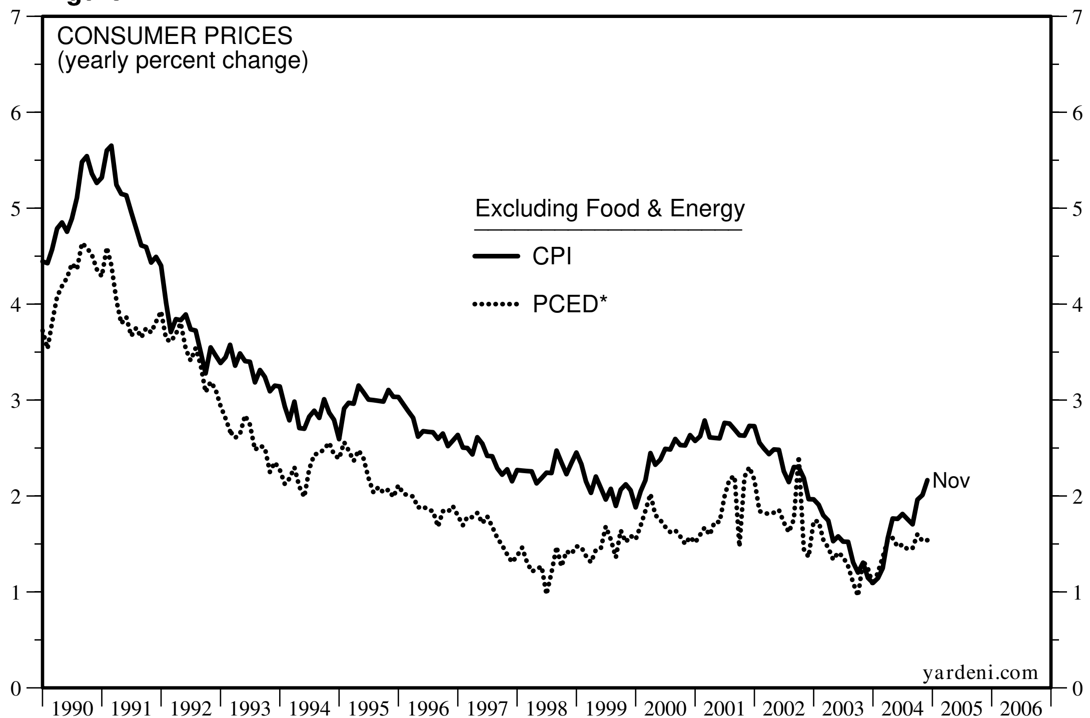
Figure 3.



* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.

CPI inflation rate tends to exceed PCED rate. Average spread in core rates was 70 basis points since 1990. It is currently 63 basis points.

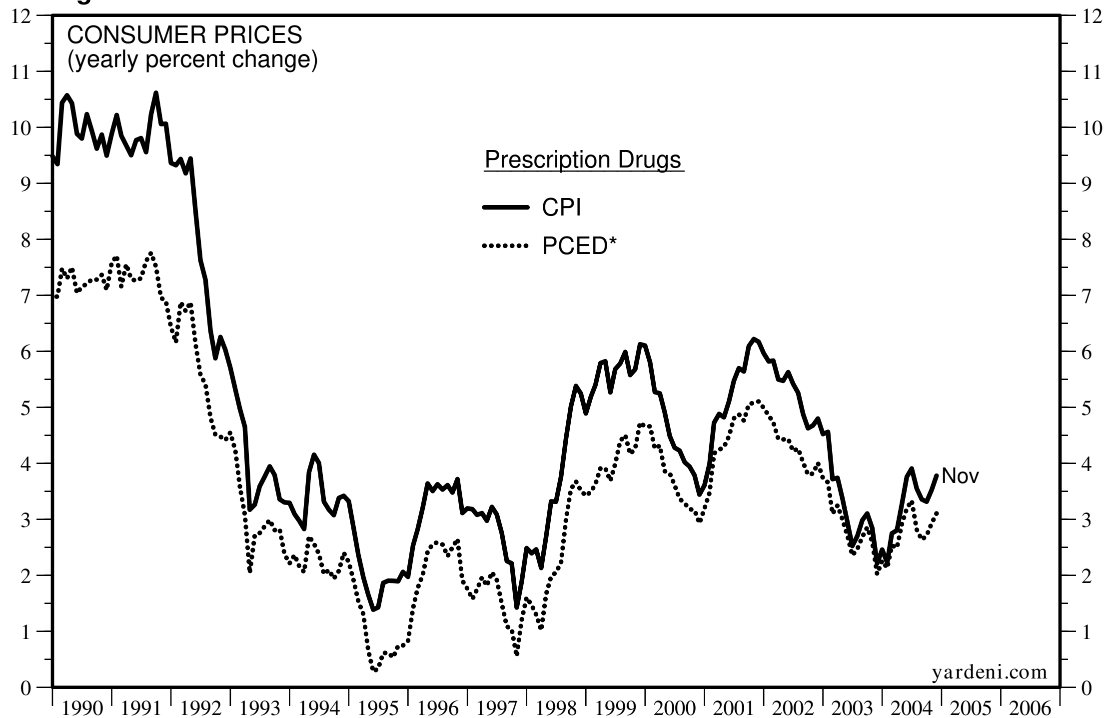
Figure 4.



* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.

- Consumer Prices -

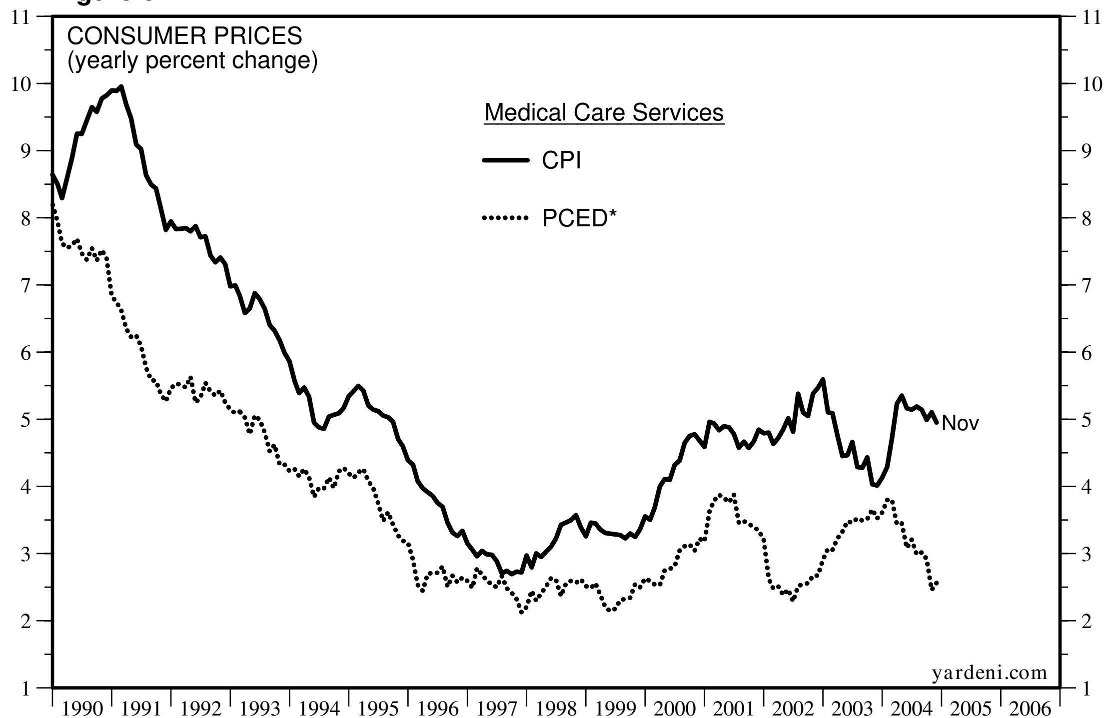
Figure 5.



* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.

CPI health-related inflation tends to exceed PCED measures for both drugs and services. Recent divergence in services measures especially wide recently.

Figure 6.

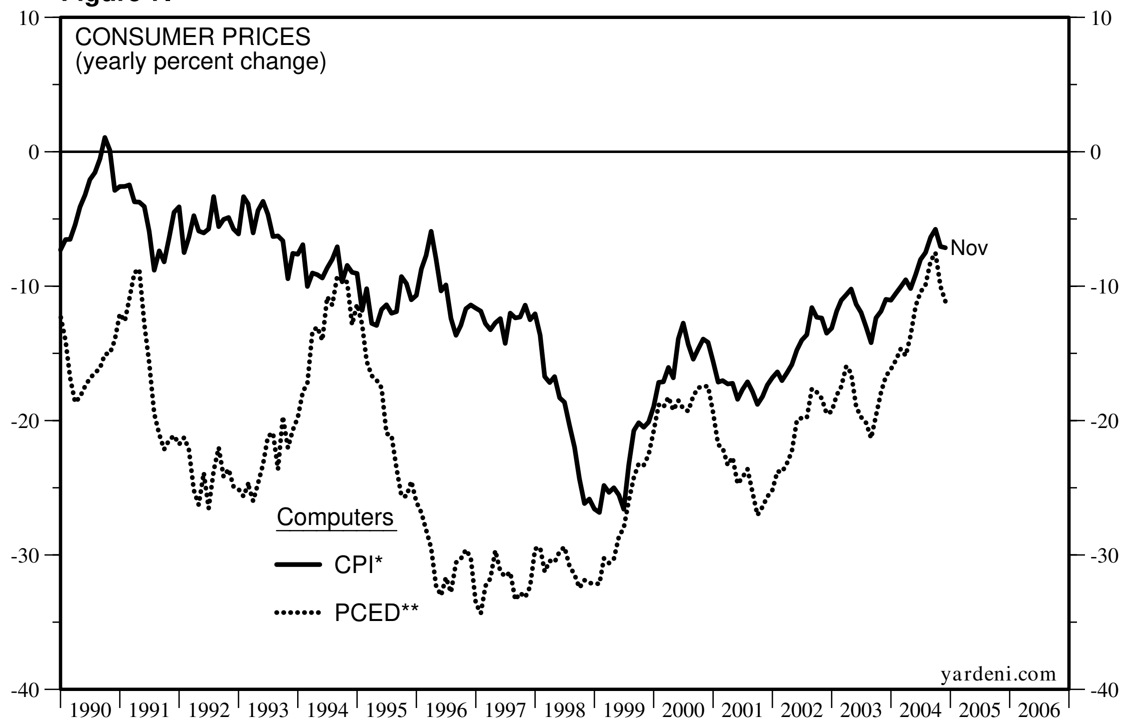


* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.

- Consumer Prices -

Computer prices continue to deflate.

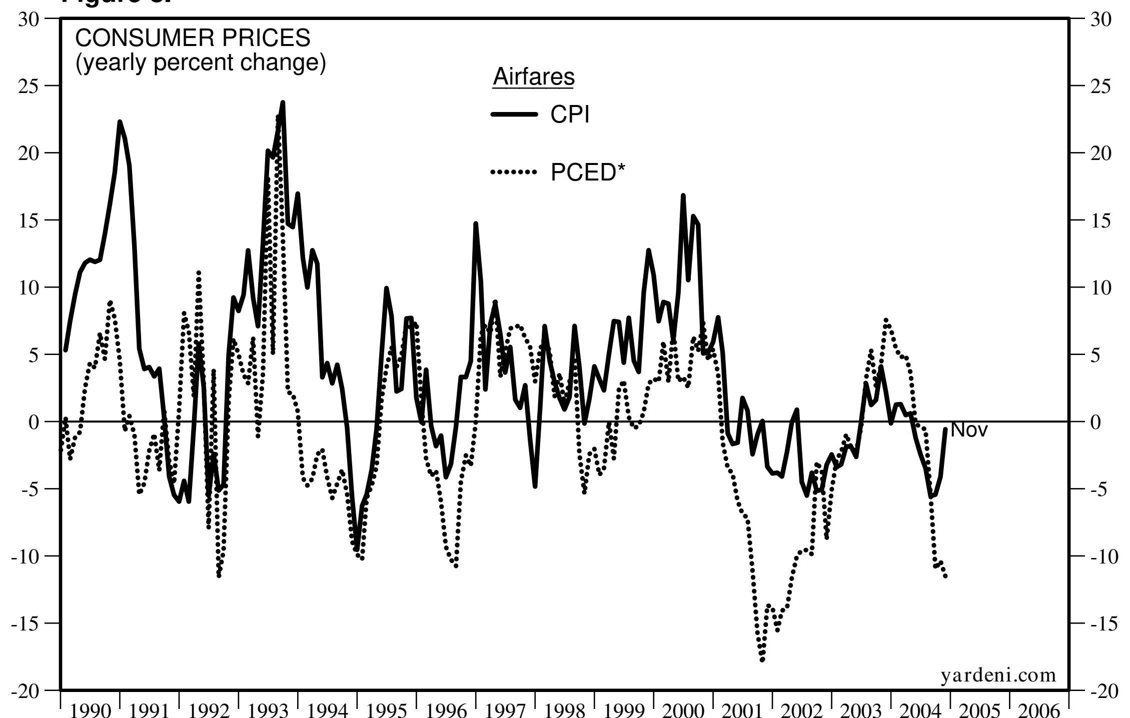
Figure 7.



* Information and information processing other than telephone services.
** Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.

Despite soaring oil prices last year, competition kept a lid on airfares.

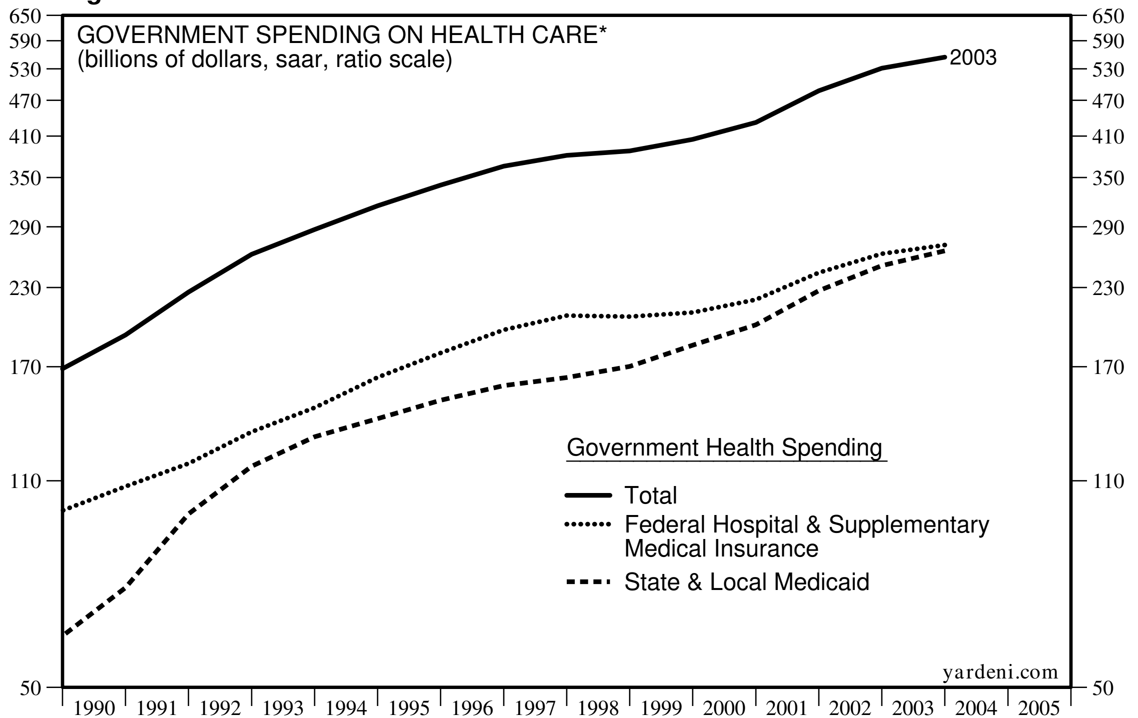
Figure 8.



* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.

- Government Health Benefits -

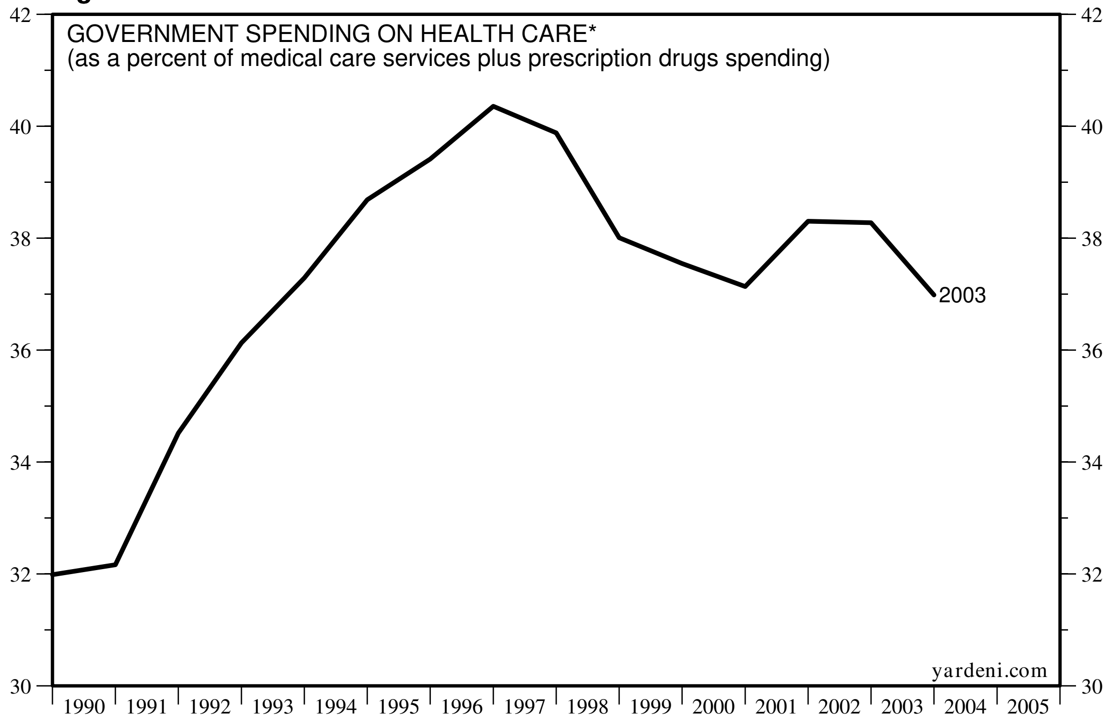
Figure 9.



* Includes federal and state and local government spending.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Government spending on health care benefits has increased from 32% of all healthcare spending in 1990 to 37% in 2003.

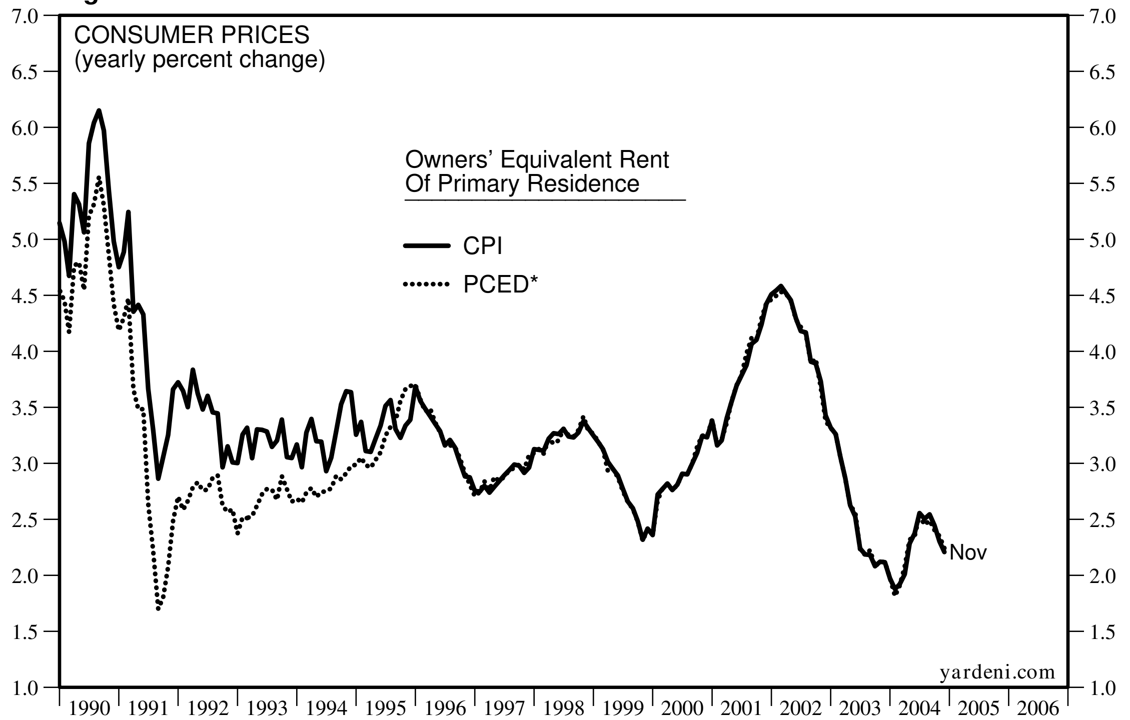
Figure 10.



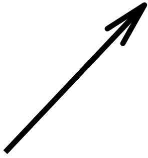
* Total health includes federal hospital & supplementary medical insurance and state and local Medicaid spending.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

- Rent -

Figure 11.



* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.



Rent inflation remains very low.

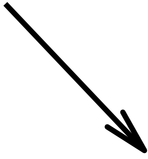
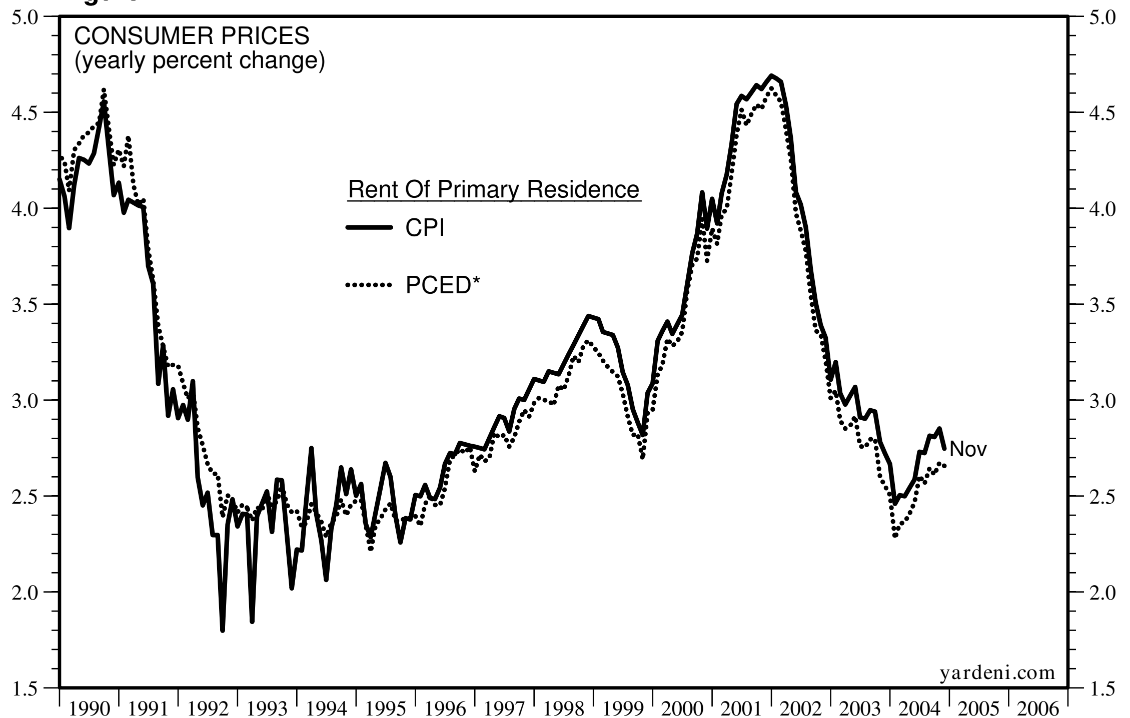


Figure 12.

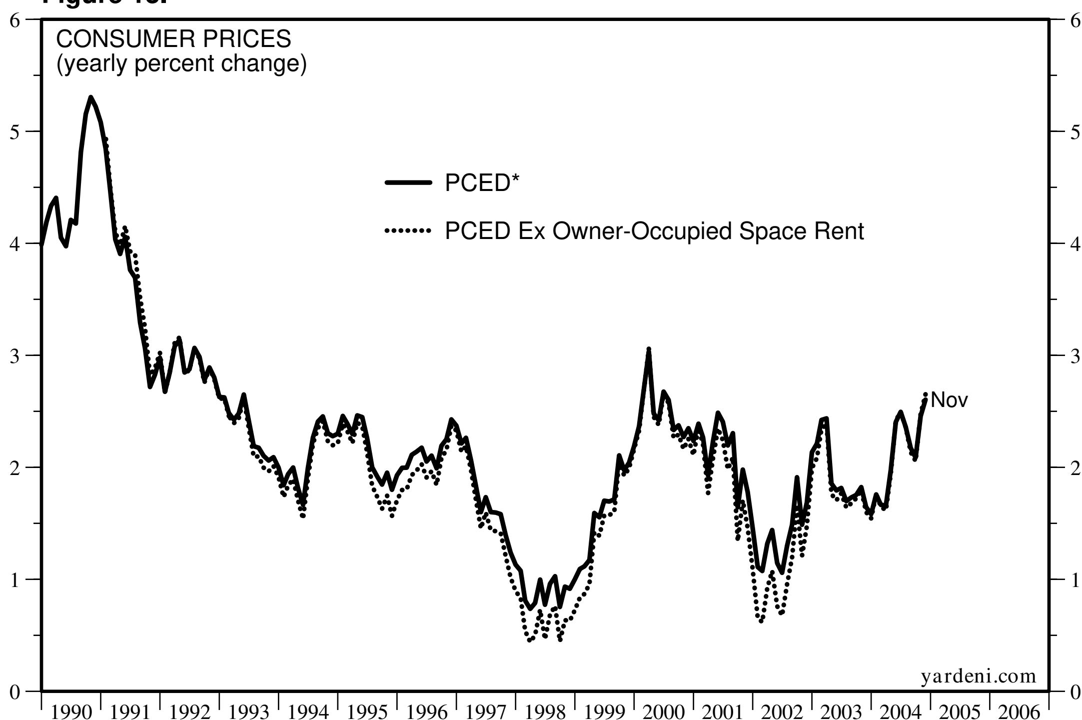


* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Labor, Bureau of Labor Statistics.

- Rent & Inflation -

Excluding the questionable "owner-occupied space rent" doesn't change the PCED inflation rate much at all.

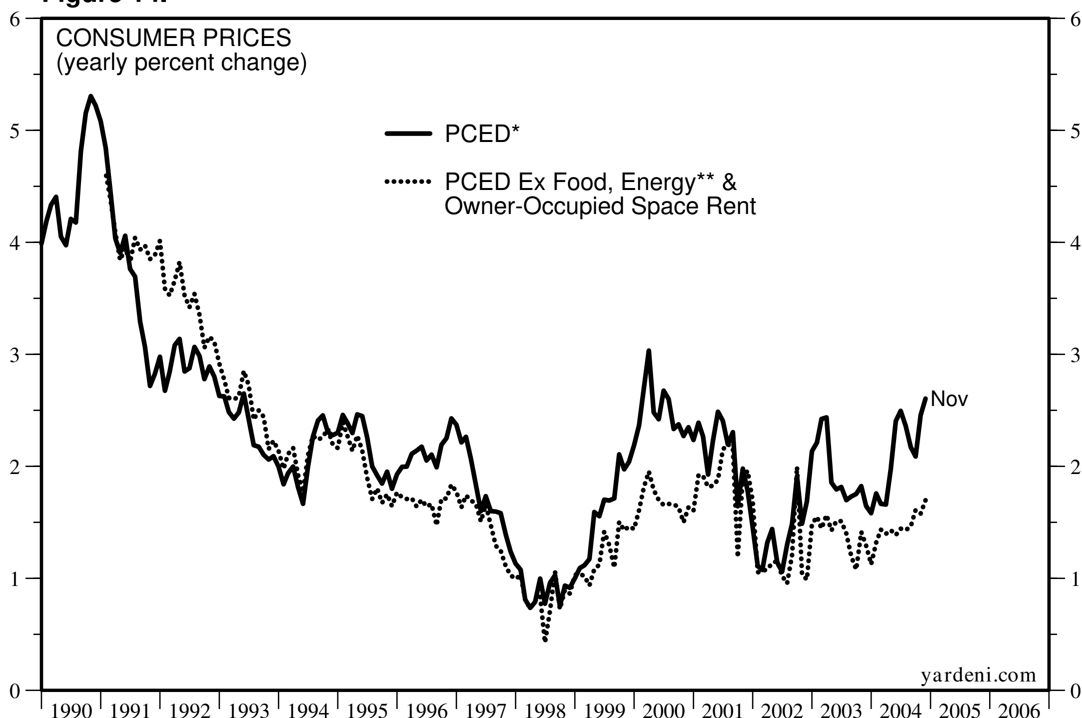
Figure 13.



* Personal consumption expenditures deflator.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Core PCED inflation rate excluding owner-occupied space rent did move higher last year, but remains very low at 1.7%.

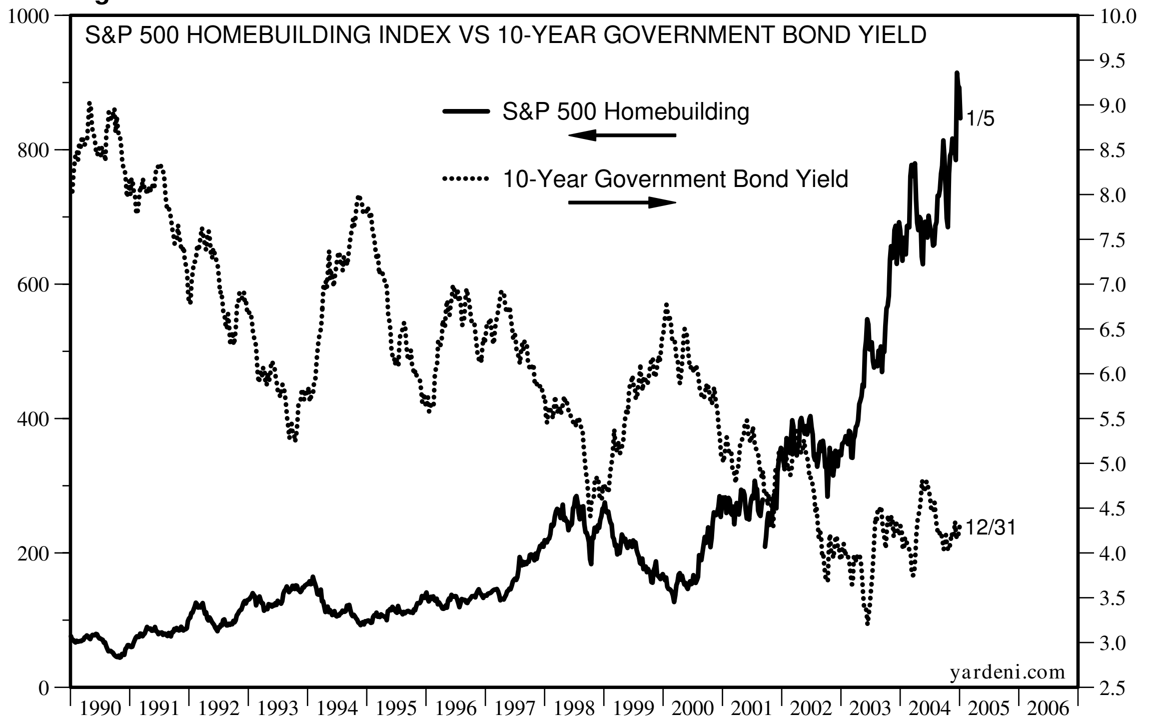
Figure 14.



* Personal consumption expenditures deflator.
** Energy includes gasoline and oil
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

- Interest Rate Sensitive Stocks -

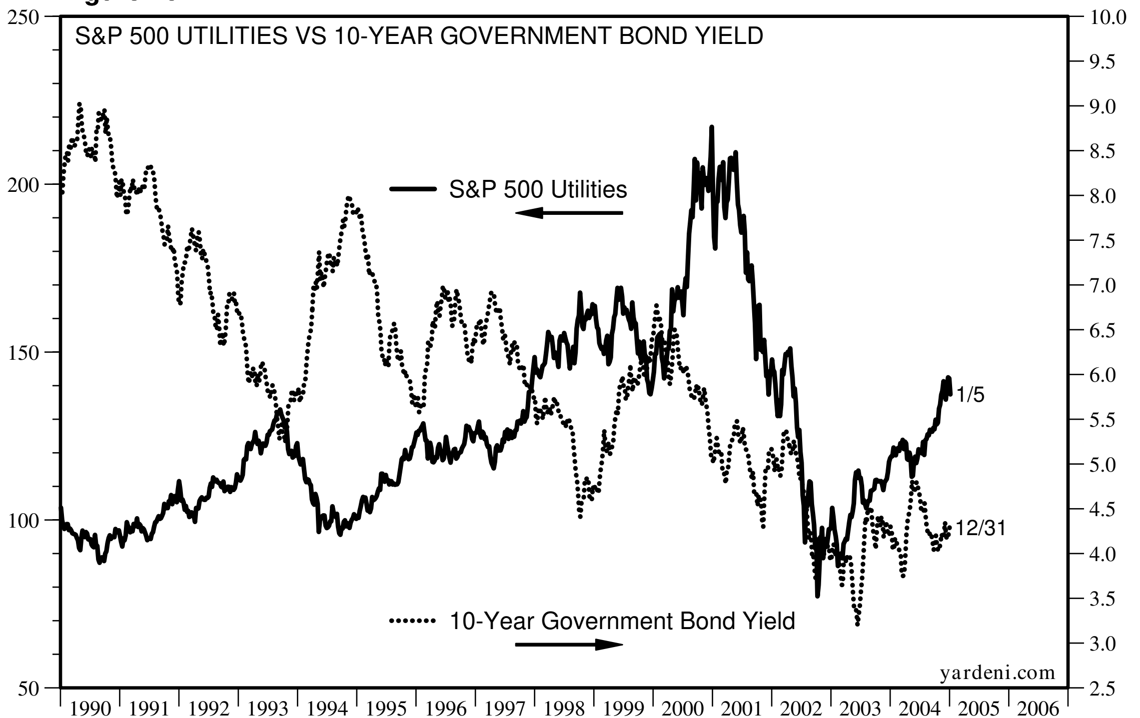
Figure 15.



Source: Standard & Poor's Corporation and Board of Governors of the Federal Reserve System.

Interest rate sensitive stocks suggest that investors expect that bond yields will remain low.

Figure 16.



Source: Standard & Poor's Corporation and Board of Governors of the Federal Reserve System.