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## Crawling Back From the Lunatic Fringe

*This issue of the US Economics Analyst is in an abridged, four-page format. The center section and the table of historical and forecast data have been omitted. Our regular format will resume with our issue dated September 7, 2007.*

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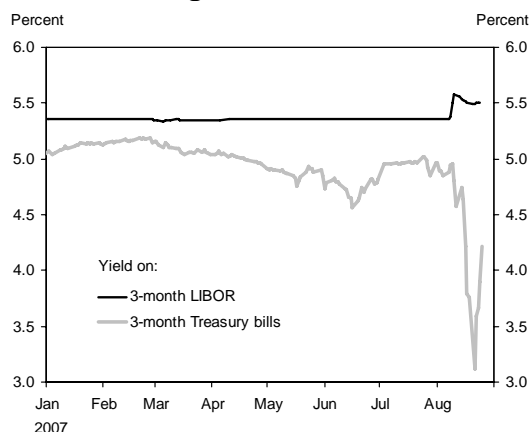
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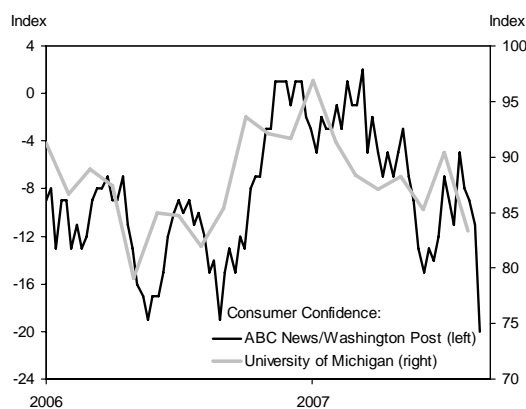
- Financial markets appear to be crawling back a bit from the lunatic fringe they have occupied for most of the past couple of weeks. The strongest evidence of this is in the equity market; credit spreads have also stabilized for the most part.
- Progress in the short-term money markets has been slower and more selective, with risks of continued liquidity shortages in some sectors likely to keep pressure on the Federal Open Market Committee (FOMC) to cut the federal funds rate target. It is obviously reluctant to take this step in the absence of more tangible evidence of economic weakness, judging from its reliance on all other tools at its disposal.
- If the markets can weather the near-term storm, the focus will shift to the economic data. Here we expect three main themes in coming months: 1) another dramatic leg down in housing, 2) soft consumer confidence and spending, 3) labor market deterioration. We think the data will be weak enough to generate 75 basis points of Fed easing by the end of 2007.
- If Fed officials have a different view, market participants will have plenty of opportunities to find out, including next week's release of minutes from the August 7 FOMC meeting and most importantly, Chairman Bernanke's speech opening the Fed's Jackson Hole Conference. The following week has more speeches and the Beige Book roundup of anecdotal input.

### A Flight to Treasuries



Source: Federal Reserve Board, Financial Times.

### Consumer Confidence Shaken



Source: ABC News, Washington Post, University of Michigan.

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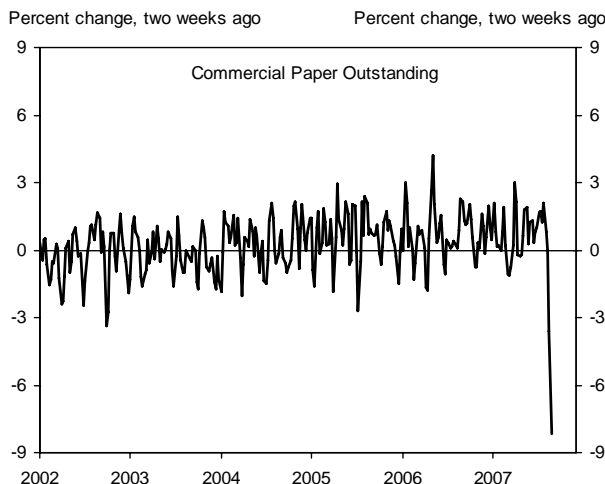
# Crawling Back From the Lunatic Fringe

Financial markets appear to be crawling back a bit from the lunatic fringe they have occupied for most of the past couple of weeks. The strongest evidence of this is in the equity market, where major indexes are currently about 4½% above last week’s lows. Credit spreads have also stabilized for the most part.

However, until very recently conditions have been rockier in the short-term money markets, where in some sectors liquidity remains very much in short supply despite the Fed’s “pull out all but that one stop” strategy. For example, in the commercial paper market, the lifeline of short-term financing for many companies, all but the most creditworthy issuers are having difficulty rolling paper for more than a few days, as investors—mainly money market funds—remain fearful of large redemptions at month end. As a result, the outstanding volume in this market fell another 4% last week, bringing the two-week change to -8.2%, an unprecedented move as shown in Exhibit 1. Much of this occurred in asset-backed paper (ABCP). Meanwhile, the flight to safety has created an acute shortage of collateral; as a result, spreads between Treasury bills and other money market instruments blew out, as shown in Exhibit 2. In an effort to open up these channels, the New York Fed cut the fee it charges to lend securities from the System Open Market Account (SOMA) in half and more recently has apparently liberalized collateral requirements for ABCP at the discount window. Time will tell how successful these moves have been; the initial results are somewhat encouraging.

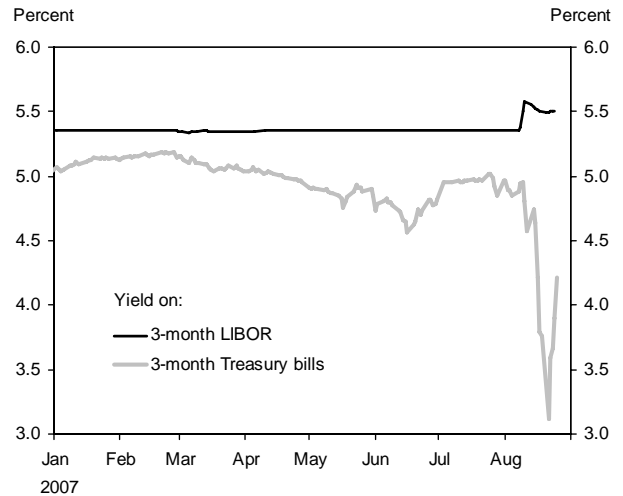
As stresses in the financial markets wax and wane, so too will pressure on the Federal Open Market Committee (FOMC) to pull out that last stop—a cut in

**Exhibit 1: Trouble in the Money Markets**



Source: Federal Reserve Board.

**Exhibit 2: A Flight to Treasuries**



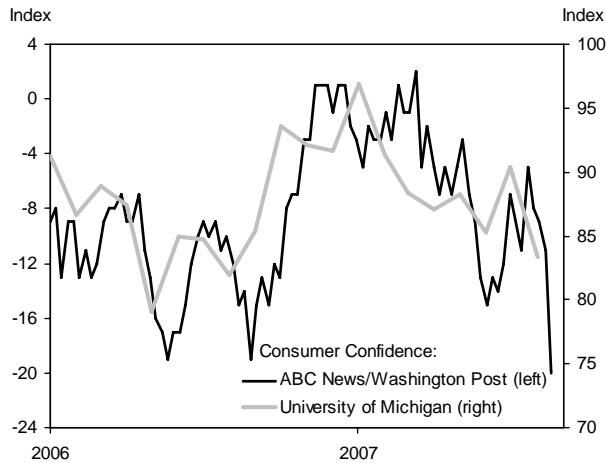
Source: Federal Reserve Board. Financial Times.

the federal funds rate. Fed officials are obviously quite reluctant to take this step in the absence of more tangible evidence of economic weakness, judging from their reliance on all the other tools at their disposal. In a speech Tuesday, Richmond Fed President Jeffrey Lacker reaffirmed this position, stressing that rate cuts should be driven by signs of economic damage rather than simply market volatility. In recent days, the markets have provided Fed officials a bit of breathing room; whether this lasts is a day-to-day proposition, to be tested especially around month-end and when the calendar of new corporate issues and leveraged buyouts heats up in September.

## Gauging the Fallout

On the presumption that the breathing room persists, the focus will shift to the hard economic data. We are confident that the following themes will play out; the more powerfully they do, the more the economy will require Fed easing to maintain its expansion.

- 1. Another dramatic leg down in housing.** Even assuming some improvement in the next few weeks, nonconforming mortgage rates will stay dramatically higher than earlier in the year. For example, the 30-year fixed jumbo mortgage rate is now around 7%, versus 6% at the beginning of the year. With economic prospects less certain and credit much more expensive, large declines in home sales, construction, and home prices in coming months are a near certainty. In this regard, we view the 2.8% increase in new home sales reported for July as “old news,” as these sales reflect deals struck before the recent credit crunch. The ultimate decline in prices of existing homes could be 15% to as much as 30%, with

**Exhibit 3: Consumer Confidence Shaken**

Source: ABC News. Washington Post. University of Michigan.

severe impacts on mortgage credit quality and activity in this sector, as discussed more fully in Wednesday's daily comment.<sup>1</sup>

## 2. Softer consumer confidence and spending.

Consumer confidence has been hammered recently, with last week's Michigan index falling sharply and Tuesday's ABC/*Washington Post* index posting the biggest one-week drop ever (Exhibit 3). Presumably, these moves largely reflect media coverage of the financial market turmoil in recent weeks; if confidence falls further, this would be an extremely bad omen for the path of consumer spending. (In contrast, the industrial sector had reasonable momentum heading into the credit crunch period, with July's durable goods report showing a 5.9% increase in orders and a marked improvement in the shipment/inventory ratio that brought this indicator in line with survey data.)

## 3. Labor market deterioration.

The biggest mystery in 2007 has been the robustness of the labor market. Despite sub-par economic growth over the past year, payroll growth has been fairly healthy and the unemployment rate remains near cycle lows. The four-week average of initial jobless claims is a low 318,000, and continuing claims have crept up only slightly. Still, we see a strong likelihood of job loss in the housing construction and housing finance sectors over the next half-year, pulling payroll growth down well below 100,000 and causing the unemployment rate to drift up. This already appears to be underway in "housing boom" states such as Florida and California, and just in the last two

weeks, a variety of mortgage finance companies have shut their doors or announced substantial layoffs. The best short-term barometer of labor market health will be the weekly jobless claims report.

## Whither the Fed?

In this kind of environment, pressure on the Fed to ease is likely to be significant even if the financial markets stabilize. Markets are currently pricing in at least a 25-basis-point rate cut by the September 18 meeting, with some probability put on a 50-basis-point cut. If Fed officials have a different view, market participants will have plenty of opportunities to find out:

- 1. Minutes from the August 7 FOMC meeting** (August 28). This may seem like ancient history given that Fed officials' views have clearly shifted since then. However, the summary of the discussion at that time will still provide some color on how contentious (or not) the decision was with regard to the statement's continued emphasis on inflation risks.
- 2. Jackson Hole conference** (August 30-September 1). The theme of this year's Fed conclave is apt: "Housing, Housing Finance, and Monetary Policy." Featured Fed speakers are Chairman Bernanke, who kicks off the conference, and Governor Mishkin.
- 3. Beige Book** (September 5). Given the pace of financial market developments, real-time information on the state of the economy is particularly important. Most monthly indicators for August will not be released until mid- to late-September. Thus, the anecdotal information picked up from companies and organized in the Beige Book survey will have more than the normal degree of importance to Fed officials' thinking, and by extension to the financial markets.
- 4. Other speeches.** Besides the Jackson Hole presentations, other officials are on the docket. Fed bank presidents Poole, Fisher, and Lockhart will participate in a panel Saturday August 25 on regional economic trends, and Gov. Mishkin speaks to the New York Money Marketeters on September 10.

Andrew Tilton

Ed McKelvey

<sup>1</sup> See "House Prices Look Even More Overvalued than We Thought," *US Daily Comment*, August 22, 2007.

# US Calendar

## Focus for the Week Ahead

- Minutes of the August 7 FOMC meeting, while obviously superseded by the August 17 statement, could still provide clues about the degree of conviction about retaining the inflation bias (August 28).
- Second-quarter real GDP growth should be revised up to more than a 4% pace, reflecting strong data on net exports and modest upward revisions to consumption and business investment (August 30).

## Economic Releases and Other Events

Date	Time	Indicator	Estimate			
			GS	Consensus	Last Report	
Mon Aug 27	10:00	Existing Home Sales (Jul)	+1.0%	-0.9%	-3.8%	
	11:00	Treasury 2- & 5-Year Note Announcement				
Tue Aug 28	9:00	S&P/Case Shiller Home Price Index (Q2)	n.a.	n.a.	-1.4%	
	10:00	Consumer Confidence (Aug)	103.0	104.0	112.6	
	10:00	Richmond Fed Survey (Aug)	n.a.	1	4	
	10:00	Minutes of August 7 FOMC Meeting				
Wed Aug 29	13:00	Treasury 2-Year Note Auction				
Thu Aug 30	8:30	Real GDP—Q2 Preliminary	+4.3%	+4.1%	+3.4%	
		Chain-Weight Price Index—Q2 Preliminary	+2.7%	+2.7%	+2.7%	
		Core PCE Price Index—Q2 Preliminary	+1.4%	+1.4%	+1.4%	
	8:30	Initial Jobless Claims	n.a.	320,000	322,000	
	10:00	Help-Wanted Index (Jul)	n.a.	25	26	
	11:00	Kansas City Fed Survey (Aug)	n.a.	n.a.	10	
	13:00	Treasury 5-Year Note Auction				
	17:00	Goldman Sachs Analyst Index (Aug)	n.a.	n.a.	58.6	
	Fri Aug 31	8:30	Personal Income (Jul)	+0.4%	+0.3%	+0.4%
			Personal Spending (Jul)	+0.3%	+0.4%	+0.1%
		Core PCE Price Index (Jul)	+0.14%	+0.2%	+0.1%	
9:45		Chicago Purchasing Managers' Index (Aug)	52.0	53.0	53.4	
10:00		Factory Orders (Jul)	+3.5%	+1.0%	+0.6%	
10:00		U. Mich Consumer Sentiment—Final (Aug)	n.a.	82.5	83.3	
10:00		Chairman Bernanke spks at Jackson Hole Fed conf; WY				

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