

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **More Strong Economic Reports Out Today! The Fed and Bond Investors: Are they Now On A Collision Course?**

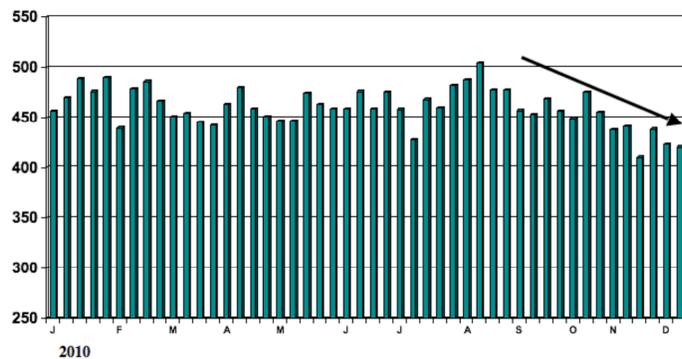
Another round of positive economic news arrived today, further reinforcing the view that this recovery is self-sustaining. These cumulative reports showing unambiguous signs of strength raises serious questions whether the Federal Reserve realizes the delicate and dangerous dance it now has with the bond market.

Let's first look at the latest gauges on economic activity. Topping the list of importance is the weekly barometer on jobs. **Claims for unemployment benefits** dropped 3,000 to 420,000 during the week ending December 11th, bringing new filings down to a three-week low. Better yet, if you take out the week-to-week volatility and focus on the four-week moving average, the number of new applications fell to 422,750, the lowest since early August. This gradual decline in layoffs has critical implications for Fed policy, a point I'll return to in a moment.

In addition to the drop in claims for jobless benefits, we got some fairly good news on the housing front. **Housing starts** rose 3.9% in November, which bumped up new construction to a 555,000 annual rate. However, this aggregate number on starts is not the best number to track because it includes apartment dwellings. A far better gauge of future industry activity is new construction of single-family homes. Single-family starts have always been a better leading indicator of the economy because it reacts more quickly consumer confidence and homebuying demand. In contrast, decisions to break ground on multi-unit buildings are often based on the whim of investors, changes in local tax codes, and the ability to obtain larger construction loans. Single-family units make up 80% to 85% of all new starts and for November it rose 6.9%, to a pace of 465,000 annual units. That is the most since last April when homebuyers were able to take advantage of tax credits of up to \$8,000.

**With economic growth picking up speed,  
companies are issuing fewer pink slips**

New applications for unemployment benefits: weekly, in thousands - seasonally adjusted



Source: Bureau of Labor Statistics

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A similar story emerges with permits for future construction. On an aggregate basis, permits filed declined 4% last month. However, those filed for single-family homes rose 3%, to 416,000 annualized, the best showing since last June.

What could explain the pick up in single-family home construction and permits? As we saw yesterday from the Housing Market Index (by the National Association of Home Builders), builders still expressed great caution about the future. Yet the fundamentals for this industry are looking better. The economic outlook is clearly improving and that may spark more demand for brand new homes at a time when the supply of such homes is the lowest in more than 40 years. So we expect home builders will continue to ramp up new construction in the months ahead.

A third market-moving report out today was the **Philadelphia Fed's Business Outlook Survey** for December where the index rose much higher than anyone expected. The survey, which looks at factory activity not only in Philadelphia but also eastern Pennsylvania, southern New Jersey and the state of Delaware, noted the activity index shot up to 24.3 this month, the highest level of activity since April 2005! Both new orders and the factory workweek rose in the report.

## Federal Reserve Bank of Philadelphia

<i><b>BUSINESS OUTLOOK SURVEY December 2010</b></i>	December vs. November				
	<i>Previous Diffusion Index</i>	Increase	No Change	Decrease	Diffusion Index
What is your evaluation of the level of general business activity?	22.5	36.1	52.1	11.8	24.3
Company Business Indicators					
New Orders	10.4	33.0	46.5	18.3	14.6
Shipments	16.8	30.1	46.0	22.8	7.3
Unfilled Orders	3.7	18.8	68.8	12.4	6.5
Delivery Times	2.1	9.9	87.4	1.5	8.5
Inventories	-5.9	15.3	62.0	17.3	-2.0
Prices Paid	34.0	51.9	47.3	0.7	51.2
Prices Received	-2.1	21.1	68.5	10.4	10.7
Number of Employees	13.3	16.8	70.2	11.7	5.1
Average Employee Workweek	10.9	19.3	78.2	0.0	19.3
Capital Expenditures	-	-	-	-	-

Clearly, the economy continues to move in the right direction. What troubles me is that the Federal Reserve doesn't fully realize the nuanced relationship it has with the bond market as this critical stage in the recovery.

### **The Fed and Bond Investors: Are they On A Collision Course?**

Here's the problem. The latest FOMC statement conveyed a clear message. It said that regardless of the emerging strength in the economy, the Fed has no intention of veering away from its goal of injecting \$600 billion of additional reserves into the financial system. The statement laid out its justification for QE2 in the first sentence; economic growth has so far been "insufficient to bring down unemployment."

What is so concerning here is that the Fed has sent out a signal to the financial markets that its policy will be guided by principally by the unemployment rate. But to declare that as the sole operative policy is a mistake.

Remember, there are usually two periods in a business cycle when the unemployment rate rises. One is during a recession when shrinking revenues force companies to cut

payrolls. That's pretty straightforward.

But the unemployment rate also has a tendency to rise when the economy bounces back from recession. However, this time the dynamics behind the rise in joblessness is quite different from what occurs in a recession. The pace of layoffs actually slows during a recovery, as we have seen lately from the decline in applications for unemployment benefits. What causes the unemployment rate to climb during a recovery is that those who out of frustration quit looking for work during the economic downturn, are more willing to resume their search for employment now that the economy has noticeably improved. That, in turn, swells the official roll of the unemployed in the labor force and this consequently drives the unemployment rate higher.

The point is rising unemployment during an economic recovery is a temporary phenomenon and reflects growing optimism among job seekers. Thus, even with 3.5% economic growth, the jobless rate could still exceed 10%.

If the declarative goal of the Fed is to use the \$600 billion in QE2 simply to lower the unemployment rate even as an economic recovery is underway, then it risks agitating bond holders who fear the central bank may overshoot by throwing yet more money into the financial system – when it is already flooded with excess reserves. Such anxieties will drive market rates higher, raise the cost of capital, and ultimately undermine the Fed's own goals.

With Fed ought to focus on is to keep the “cost of capital” down. That would encourage more economic growth and accelerate hiring in the private sector. Let's look at three ways to do this.

(1) Low returns on fixed incomes will encourage investors to purchase more stocks. Higher stock prices lowers the cost of capital. (Example: If a firm wants to raise \$100 in funds and its shares go for \$50 each, then it must issue 2 new shares. But should its share price go up to \$100, then it needs to issue only 1 share, resulting in a smaller dilution of shareholder value.) So we want to keep yields as low (and unattractive) as possible across the maturity spectrum to encourage more private capital flowing into stocks.

(2) A smaller tax on corporate profits also lowers the cost of capital. (The latest tax compromise passed by the Senate helps in that regard because it will allow firms to deduct 100% of equipment purchased in the first year.)

(3) But the most commonly understood cost of capital is the interest rate charged when you borrow funds. And at this juncture of the recovery, the most critical benchmark is the yield on 10-yr. Treasuries. Many key loans are tied to the Treasury note yield, with home mortgages and corporate bonds representing just two.

What is critical for this recovery to be sustained is to make sure yields on 10 yr. Treasuries do not suddenly spike in the weeks ahead, which it will certainly do if inflation expectations become unmoored.

What might cause inflation expectations to surge? Answer: when the Federal Reserve tells investors that it will not be deterred from going ahead with the full \$600 billion in

quantitative easing, even though economic growth is accelerating faster than expected. That is a dangerous message to send to bond holders given the unprecedented amount of reserves that have already been supplied by QE 1, plus the stimulus to come from the passage of another \$858 billion tax compromise.



**Benchmark 10 yr. T-note yield up 100 basis points in little more than a month!**

In the final analysis, the efficacy of monetary policy at this juncture of the recovery may rest more on utilizing game theory with bondholders. After all, the yield on the 10 yr. note has already jumped 100 basis points since the Fed announced on November 3rd that it was going to launch QE2. To prevent a much greater breakout in market rates and to preserve the recovery, the Fed will have to sooth the concerns of bond investors by returning to the theme that keeping inflation expectations well anchored is vital to getting the unemployment rate to fall. Unfortunately, the FOMC's latest statement emphasized the latter and failed to mention the former. That's why bond investors are getting increasingly uneasy.