July 2008

No change in our outlook for Fed policy

Key trends

- **Spot oil prices have increased from $US100/bbl to $US140/bbl since the bailout of Bear Sterns in mid-March, compared with the year in which it took the price to rise from $US60/bbl to $US100/bbl.** While recent increases in bulk commodity contract prices re-affirm fundamental tightness in global commodity markets, it is not clear that oil markets have tightened by such an extent in the past quarter to warrant a 40% jump in prices. Inflationary risks accompanying the global monetary policy stance, OPEC intransigence, negative real carry costs and poor returns from other asset classes are all conducive to heightened speculative activity.

- **In the meantime, however, it is primarily households (in the US) that are bearing the brunt of the upward lurch in commodity prices and the decline in the US terms of trade.** To be sure, the tax rebates appear to have been successful in halting the downturn in consumer spending growth. In our view, however, this only highlights the extent of the tightening squeeze on US households (and in any event the rebates are simply a 'one-off' boost).

- **Moreover, through the erosion in underlying real income growth and household debt servicing capacity,** sharp increases in commodity costs threaten to curtail the recent tentative signs of stabilisation in US housing demand, in turn contributing to further write-offs and credit market problems. Correspondingly, while GDP most likely will expand moderately in the second and third quarters, there is now a high risk output will contract in the fourth quarter.

- **By contrast, reflecting the weak dollar, much of the US non-financial corporate sector appears to be enjoying considerably more success in passing on higher costs.** Some series suggest underlying US inflation is now closer to 3% (rather than the 2% suggested by 'exclusion' measures), which along with sustained high headline inflation is now starting to feed through into higher inflation expectations. The Fed's policy stance is further contributing to rising inflation expectations by exporting strong monetary growth to those developing economies that peg their exchange rates to the US dollar, in turn helping to sustain fundamentally strong commodity demand.

- **Against this backdrop, markets are now flirting with the possibility of the Fed moving to lift rates in late 2008.** In the absence of a renewed rise in wages growth, however, we view this as a rather unlikely scenario (particularly with the potential adverse impact on credit quality and financial stability). In contrast to the ECB, the Fed has less concern over the capacity of wage indexation arrangements to underpin 'second-round' effects.

- **Our base case assumes broadly flat oil prices over the forecast horizon, leading to expectations of a decline in annual headline inflation in the second half of next year.** Correspondingly, the Fed remains on hold until the third quarter of 2009, by which time the housing sector should be in the early stages of recovery and unemployment has most likely peaked (possibly supported by a new fiscal response with the change in presidential administration).

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Amid recent market volatility there has been some good news: the US tax rebates are working! US retail sales jumped by 1.0% in May, accompanied by substantial upward revisions to estimates for April and March. Excluding the contrasting impacts of surging energy costs and slumping auto sales (discussed below), core retail sales subsequently grew at an annualised rate of 6.8% in the three months to May, up from 0.5% as recently as the three months to February. The renewed strengthening in consumer spending contributed to the modest upward revision in first quarter GDP growth (from 0.9% to 1.0%), and has also diminished the risk of a contraction in the second quarter.

Now for the bad news. Rather than pointing to a sustainable upturn in US GDP growth, we interpret the preference to spend such a large proportion of the rebates as a sign of the tightening vice on US consumers. Despite the aggressive easing in monetary policy, we continue to believe households face a further period of balance sheet consolidation, which in turn poses renewed threats to GDP growth as the effects of the rebates fade.

In mid-2008, national economies across the globe remain characterised by marked differences in the strength of income growth. While these divergences are defined largely by the stage of economic development, there are also substantial disparities across and within the developed economies. At this level, the divergences are driven primarily by the extent to which regions or sectors are net consumers or net producers of commodities; producers of capital or consumer goods; the extent of leverage and exposure to housing sectors; and sensitivity to movements in the US dollar. The US household sector fares poorly on most of these counts.

US household sector hemmed in on all sides

At the national level, the commodity 'supercycle' and the shift in relative prices is driving a major transfer of incomes from net commodity importing countries (consumers) to net exporters (producers). In the US, moreover, it is the household sector currently bearing the full brunt of the accompanying decline in the US terms of trade. With

Chart 1

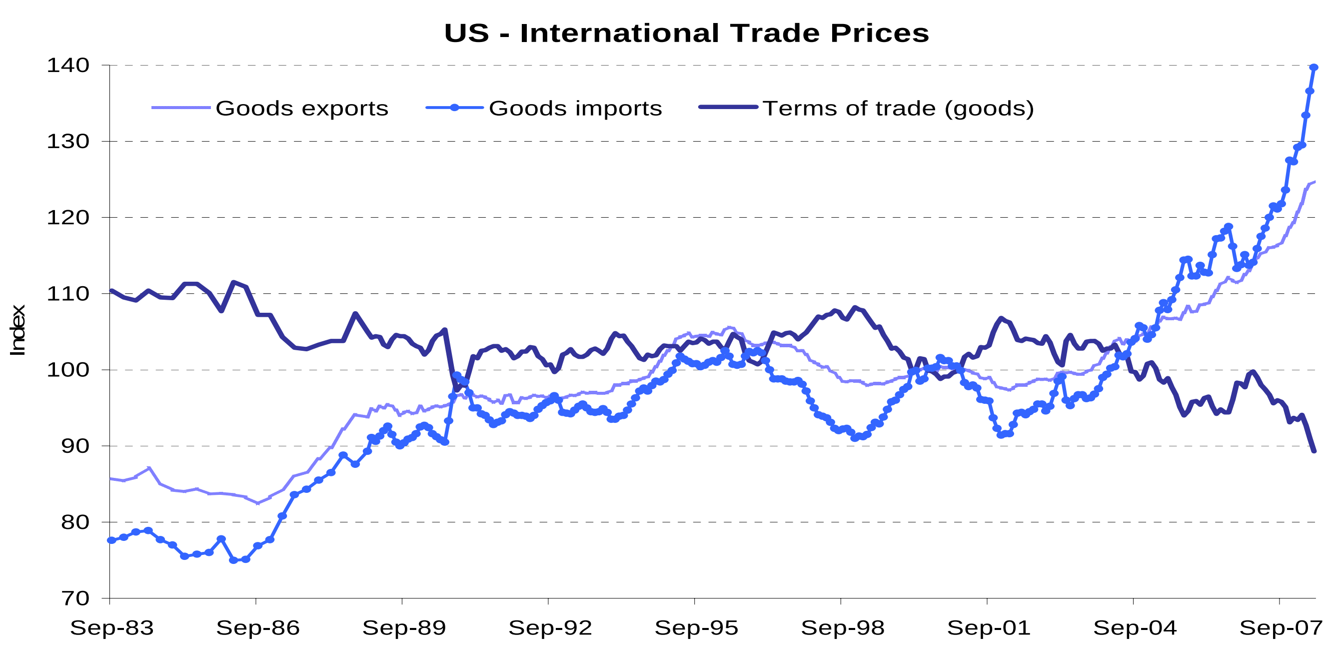
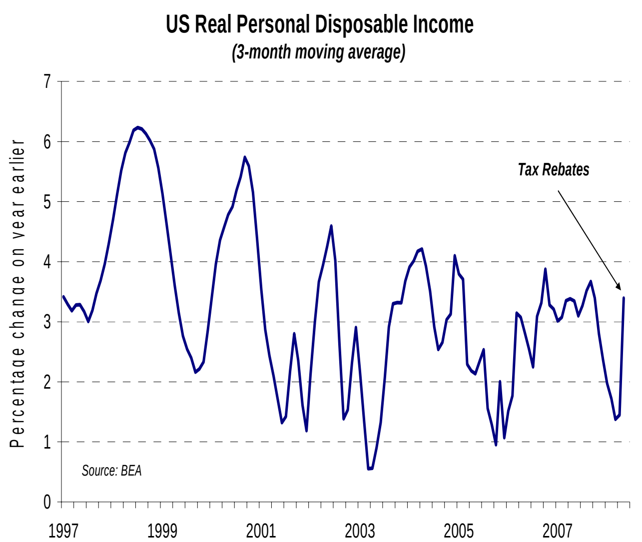
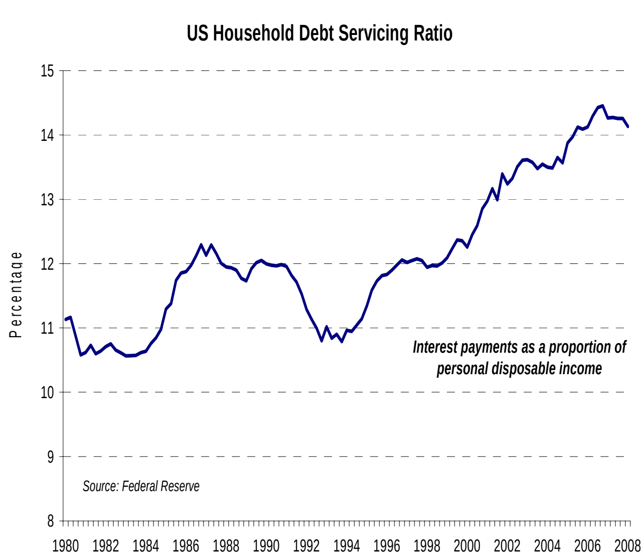


Chart 2



nominal wages growth now clearly slowing (and in addition to falling employment), the 5% rise in food prices and the 17% surge in energy prices in the past year has contributed materially to the slump in real household disposable income growth. Since the secular trough in commodity prices and the peak in the US dollar in late 2001, US import prices have increased by over 50% (see chart 1).

Chart 3



The recent deterioration in real income growth also sits atop the continuing fallout from the reversal of the earlier 'supercycle' in risk appetite, and the accompanying bursting of the US housing bubble. Over the year to the March quarter, and reflecting the cumulative 8.6% fall in the median house price over the same period (National Association of Realtors measure), the value of owners' home equity fell by 2.9% and contributed to a virtual stalling in the growth of household net worth.

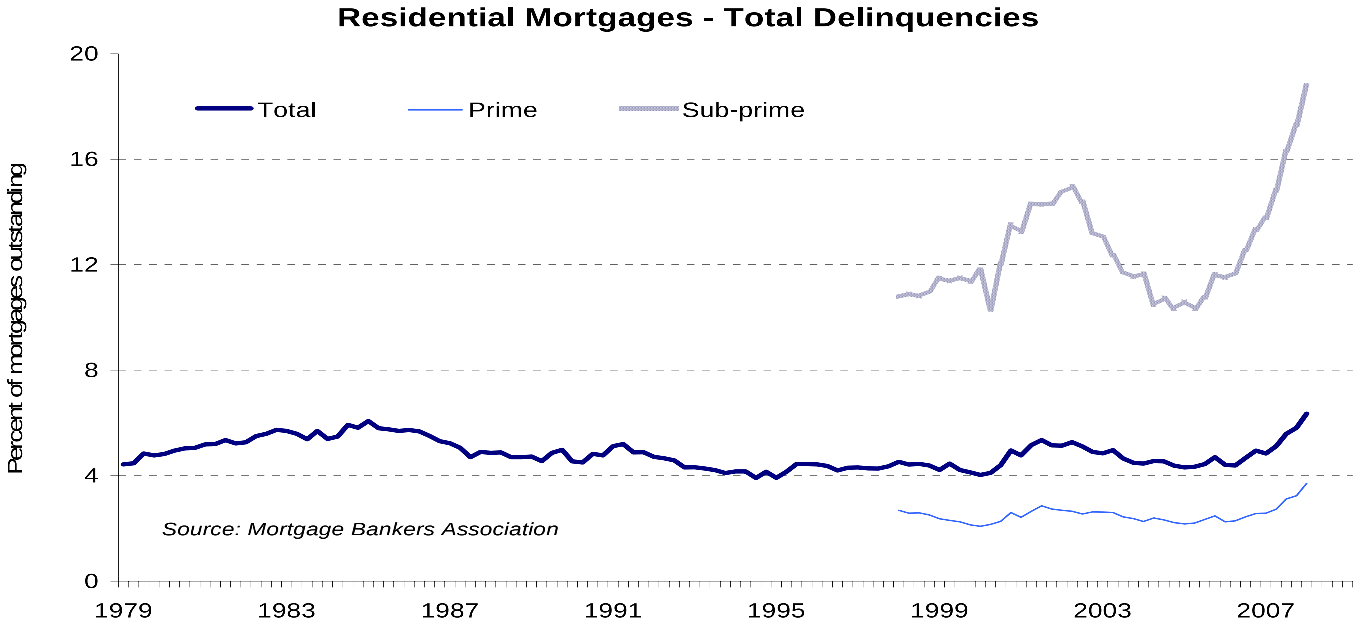
Indeed, in addition to the tightening in lending standards, the rise in energy and other commodity prices risks intensifying the downturn in the US housing sector (and house prices), and further delaying the eventual recovery. Household debt servicing obligations were not far short of record levels in the March quarter (chart 3), but renewed rises are likely in ensuing quarters as elevated commodity prices erode disposable incomes (and as inflation fears and persistently high credit spreads prevent policy easing flowing through into lower retail borrowing rates).

Indeed, reflecting these developments in debt servicing and house prices, total delinquencies on residential mortgages rose in the March quarter to the highest level in at least 30 years (chart 4), with repayments on one in six sub-prime mortgages now in arrears. Foreclosures are following a similar trend, with the prospect of further rises likely to retain downward pressure on home prices, and a further deterioration in household net worth. The prospect of continuing write-offs and the need for further recapitalisation also suggests little imminent relaxation in lending standards (although any improvement remains largely immaterial while housing demand remains so constrained).

US corporate sector faring better

Rather more positively, the US non-financial corporate sector appears in generally better shape than the household

Chart 4



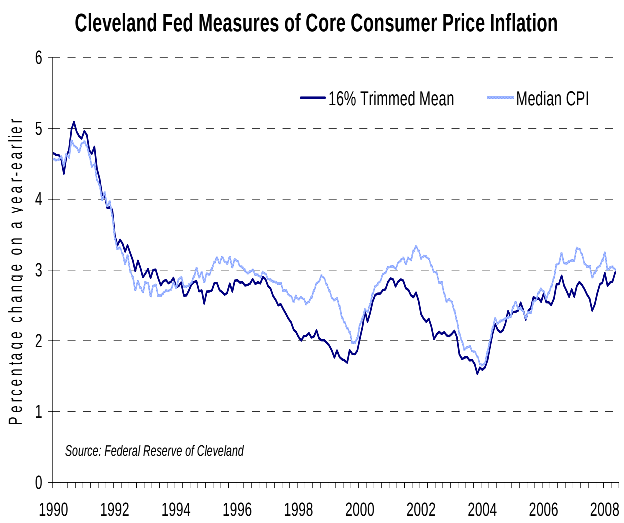
sector. We have previously noted the relative prudence in corporate hiring and investment over much of the current decade, as well as the big improvements in competitiveness flowing from the decline in the dollar. Furthermore, and again largely reflecting dollar depreciation (and in contrast to the household sector where slowing wages growth is forcing consumers to absorb the rise in commodity prices), the US corporate sector is enjoying more success in passing on energy cost increases.

In this instance, the core CPI (excluding food and energy) is not an especially accurate measure of these 'second round' effects, given that owners' equivalent rent (a theoretical estimate of shelter costs) comprises almost 40% of the remaining basket. To be sure, as increases in owners' equivalent rent have moderated from over 4.0% in early 2007, the core CPI has also slowed (increasing at an annualised rate of just 1.8% in the three months to May). However, other measures, such as the Cleveland Fed's trimmed mean (which excludes 8% of the weighted components with the highest and lowest monthly movements), and also the median consumer price series, suggest underlying US inflation is continuing to run at around 3.0% (see chart 5).

Along with the moderation in wages growth, US non-financial corporate profit margins have continued to hold up relatively well during the current cyclical downturn (chart 6). Furthermore, with sales growth also buttressed by buoyant export demand, the earlier sharp fall in profits has moderated in early 2008. The continuing strength in profit growth of foreign affiliates has also precluded otherwise much steeper falls in US equity markets.

Against this backdrop, we expect a relatively shallow cyclical decline in equipment investment. Along with the ageing population and accompanying intensification of skill shortages, there is also some hope the cyclical deterioration in the labour market will fall short of the episode earlier in the decade. However, an otherwise stronger tendency to

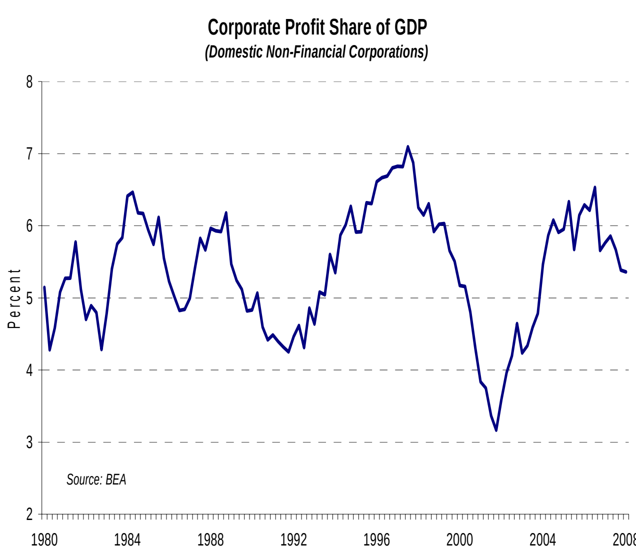
Chart 5



hoard labour also has adverse implications for labour productivity growth, and a further reason to expect a continued slowing in wages growth.

Despite the competitive boost from the exchange rate, industries sensitive to energy costs continue to languish. Auto production has fallen by over 20% in the ten months to

Chart 6



May, while employment in truck transportation has fallen by almost 2.0% over the same period. By contrast, excluding autos, and cushioned by the weak dollar and strong emerging market infrastructure demand, industrial production remains broadly flat. Elsewhere, the tightening in credit availability and rising default rates have also contributed to a downturn in the commercial real estate sector.

Implications for US monetary policy

Given this broader outlook for growth, the Fed would otherwise be in little hurry to reconsider the stance of policy. Although the systemic threats to growth from the credit crunch have receded, in turn eroding the justification for a negative real policy rate, nevertheless elevated spreads are still curbing the extent to which policy easing is feeding through into lower retail borrowing rates. And while a negative real funds rate is unlikely to stimulate household demand given the current constraints on household credit demand and supply, lifting rates against the backdrop of falling house prices would likely prove a fatal hit to confidence. It would also likely push up the US dollar, potentially undermining the one clear area of strong demand growth.

Nevertheless, despite the prospect of continued weak domestic demand growth, the Fed is aware the current policy stance is a source of global inflationary pressure. Developing economies with US dollar-linked exchange rates are also effectively importing US interest rate policy, contributing to the strength of growth in foreign exchange reserves, strong domestic money supply growth, strong domestic demand growth, and continuing strong fundamental demand for food, energy and other raw materials (the global supply of which remains relatively fixed in the short-term). Many of these economies, particularly the commodity producers, are also enjoying sharp rises in the terms of trade.

Moreover, there are reasons to believe the US policy stance is also fostering a degree of speculative behaviour in global commodity markets, and especially in actively traded markets for non-renewable resources. To be sure, growth in globally tradeable crude oil supply still appears to be lagging the growth in consumption, while the recent huge increases in contracted coal and iron ore prices (which are set annually and thus less subject to speculative activity) also tends to validate the current tightness of supply across most of the commodity complex.

Nevertheless, with the recent poor returns from equity, bond and credit markets, conditions appear conducive to investor 'rotation' into commodity assets (with the typical risk of 'overshooting' valuations). Similarly, while crude oil and refined product markets remain tight, it is not clear that inventories have fallen by the extent that warrants a $US40/bbl increase in prices in the space of just three months (and the time since the Fed engineered the takeover of Bear Stearns). Moreover, negative real carry costs facilitate the accumulation of speculative inventories for delivery against substantially higher futures prices.

Chart 7

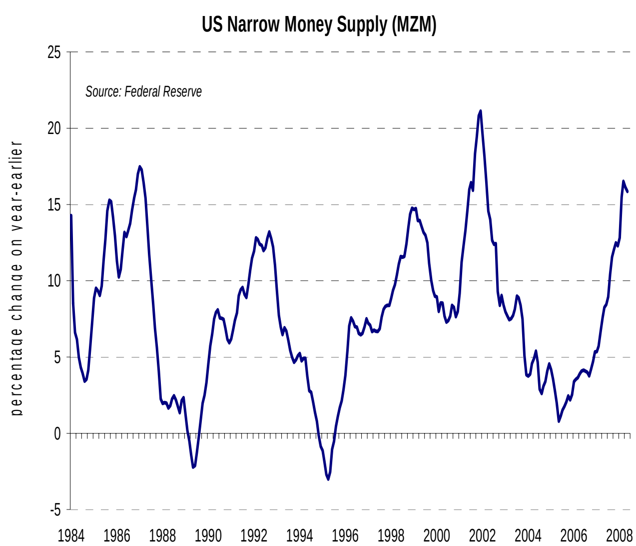
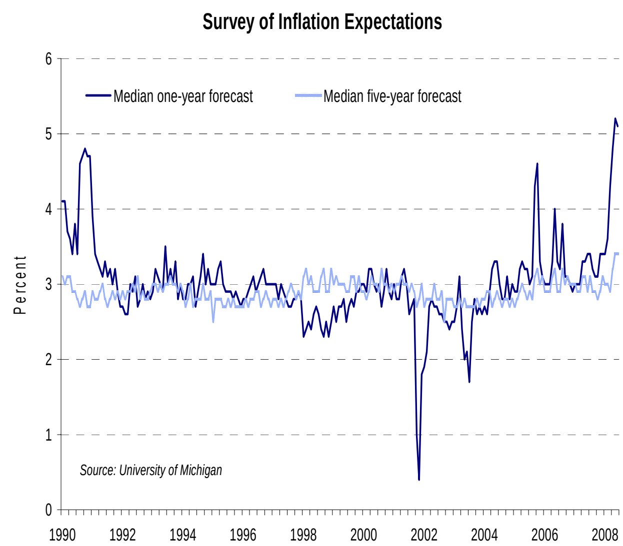


Chart 8



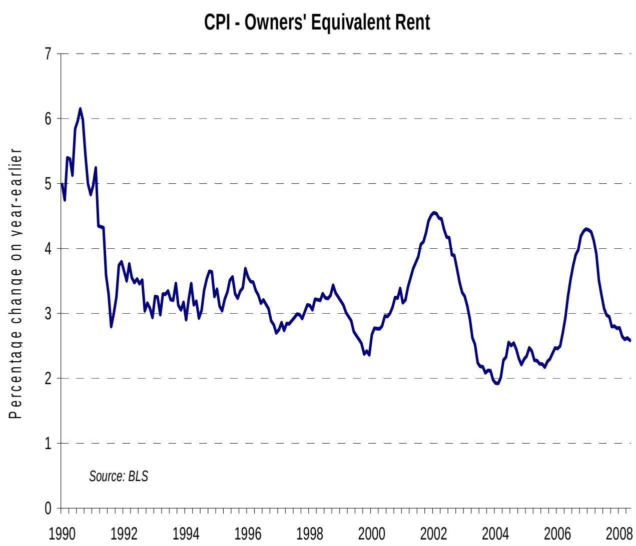
Three possible scenarios?

To this end, considerable uncertainty is now arising over the Fed's intentions. In our view, however, despite lingering credit market problems, the future course of oil prices remains a key factor in assessing when the Fed is likely to begin reversing policy. There appear to be three potential scenarios.

While acknowledging some role of speculative behaviour in recent oil price increases, our base case scenario assumes the shift in relative prices is now largely complete. With broadly flat crude oil prices over the forecast horizon, annual headline inflation should fall materially in the second half of 2009 (as the recent sharp increases wash out). The renewed weakening in US growth in the second half of 2008 should also alleviate some of the recent rise in inflation expectations accompanying the relative resilience of GDP in the first half of the year.

However, a substantial fall in inflation is precluded by the absence of an actual decline in energy costs, some lagged second round effects and the large weight ascribed to

Chart 9



owners' equivalent rent (the annual increase in which has only ever fallen once below 2% and which appears largely unrelated to fluctuations in housing sector activity or housing vacancy rates). Nevertheless, the Fed remains on hold while the unemployment rate rises further and until the housing sector clearly begins to recover. In our view, this is unlikely before mid-2009 (possibly supported by a more decisive fiscal response with the change in Presidential Administration).

A more problematic scenario (although in our view with a substantially lower probability) arises in the event oil prices continue to rise steadily, reflecting either tight commodity market fundamentals and/or the current policy stance continuing to feed speculative behaviour. Household income growth is squeezed further, pressuring house prices and finally pushing the economy into mild recession. Although still largely a shift in relative prices, the steady rise in oil prices pushes the dollar lower and places a floor under headline inflation. Inflation expectations continue to edge higher and threaten an erosion of confidence in the Fed's anti-inflation credentials.

While more reluctant than the ECB, nevertheless the Fed would almost certainly need to follow through on the tough rhetoric and tighten in late 2008. A further tightening would also possibly lead to renewed concerns about credit quality and an intensification of the credit crunch. However, it would be hoping the abrupt weakening in demand and energy consumption would eventually burst any speculative activity, containing the need for aggressive tightening.

The third scenario (perhaps with the same probability as scenario two) is a decisive and sustained fall in oil prices (possibly reflecting the impact of demand destruction in the developed economies and an unwinding of leveraged speculative positions), leading to expectations of a sharp decline in annual headline inflation in 2009. However, such a development would also promote confidence in an earlier economic recovery and diminish the potential for sharp fall in core inflation. The Fed would most likely tighten in the first half of 2009, following the election (and possibly in anticipation of fiscal easing), and after evidence the housing sector was turning up. Nevertheless, this remains the least likely scenario, with the collapse in auto sales and production suggesting US consumers and auto producers believe higher oil prices are permanent.

A new source of pressure on bond yields?

The foregoing probability-weighted scenarios point decisively to a sticky outlook for US inflation and continued sub-trend GDP growth well into 2009. The outlook for longer term interest rates is further clouded by the possibility of more aggressive fiscal action under a new presidential administration. Given that the tax rebates appear to have worked, there must be a strong temptation for the new Administration to promise a more enduring fiscal 'rescue' package. Indeed, the Fed might secretly welcome the ensuing justification to commence tightening policy and engineer a flatter yield curve.

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