

WEEK OF OCTOBER 16, 2006—INFLATION EASING?

What to make of the latest inflation figures? Plunging energy prices have brought down both wholesale and retail inflation, but the so-called core rate without food and energy is still rising. This is in part because housing rents, which make up 40 percent of the Consumer Price Index (CPI), have been surging this year as more households rent rather than buy into the still expensive housing market.

Wages are also rising at a 4+ percent clip for the first time since 2000, which will continue to put upward pressure on consumer prices. But September's unemployment report showed weak job payroll growth, even though the unemployment rate remained at 4.6 percent. The jobless rate is based on a smaller household survey that includes the self-employed, so is not considered as accurate as the payroll survey which covers actual businesses.

Federal Reserve officials, such as Vice-Chairman Donald Kohn, believe that inflation will moderate as the economy slows. They believe that decline of housing sales will be one factor, since housing and its subsidiary industries like financial services, insurance, and construction have provided some 40 percent of economic growth since 2004.

How much longer will the correction in housing last, and how much deeper will it go? Dr. Kohn does not have a definitive answer but ventures some observations. "Calculations about the sustainable level of housing starts based on demographic factors, such as population growth and household formations, suggest that starts may be closer to their trough than to their peak," he said in a recent speech. "Although such calculations are, in general, not particularly useful for near-term forecasting, they do suggest that any overbuilding in 2004 and 2005 was small enough to be worked off over coming quarters at close to the current level of housing starts."

This is while...the Federal Reserve has returned short-term interest rates only to more-normal levels and long-term rates are unusually low relative to those short-term rates," continued Kohn. "This situation stands in sharp contrast to some past downturns in the housing market that followed actions by the Federal Reserve to tighten credit conditions significantly. Lastly, continuing growth in real incomes should underpin the demand for housing and, as home prices stop rising, help to erode affordability constraints."

Another index, the Conference Board's Index of leading economic indicators (LEI), also shows slower growth ahead. It rose 0.1% in September after falling in July and August. The index has dropped in five of the past eight months, and is down 0.9% in the past six months. But new housing construction picked up slightly, in line with some renewed optimism by builders on future sales.

**HOUSING STARTS**—New construction rose slightly to 1.77 million annualized units in Sept., while permits for new construction fell to 1.62 million, when annualized. This seems to be an adjustment to the reality that new-home sales may be lower next year.

The National Association of Home Builders took heart from the numbers, as their sentiment survey rose slightly after plunging to a 15-year low.

UNEMPLOYMENT—The Bureau of Labor Statistics report repeated the words “unchanged”, “essentially unchanged”, or “little changed” 7 times in the first page of its press release, to be sure we got the message. But the unemployment rate actually dropped from 4.7 to 4.6 percent, back to its lowest rate reached in May-June. So what is unchanged? Perhaps it is the fact that though the civilian labor force increased 101,000, 152,000 more were “not in the labor force”—i.e., stopped looking for work—more than canceling out the former figure! (This totally confuses the picture, of course, and only highlights the inexact nature of these statistics.)

LEI—The Conference Board’s index is supposed to predict forward economic activity 6 month out. The decline is because of lower manufacturing hours and new orders, the inverted Treasury yield curve and fewer building permits.

All the indicators point to a slowing economy in coming months, whether fewer jobs, slowing manufacturing output, or lower construction activity. This is why the Federal Reserve is counting on lower inflation in coming months. Energy and commodity prices are already trending lower, another sign of flagging demand.

But the Fed is not ready to lower interest rates just yet. CBS Marketwatch economist Irwin Kellner said it best: “From an economist's viewpoint, steady as she goes makes sense. After all, the Fed has two objectives: the first is to keep inflation low while the second is to accomplish the first without slamming on the brakes and throwing the economy through the windshield (read recession).”