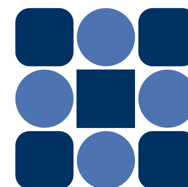
Investment Views

Perspectives

From Opus Investment Management



"Bernanke's Balancing Act"

Summer, 2006

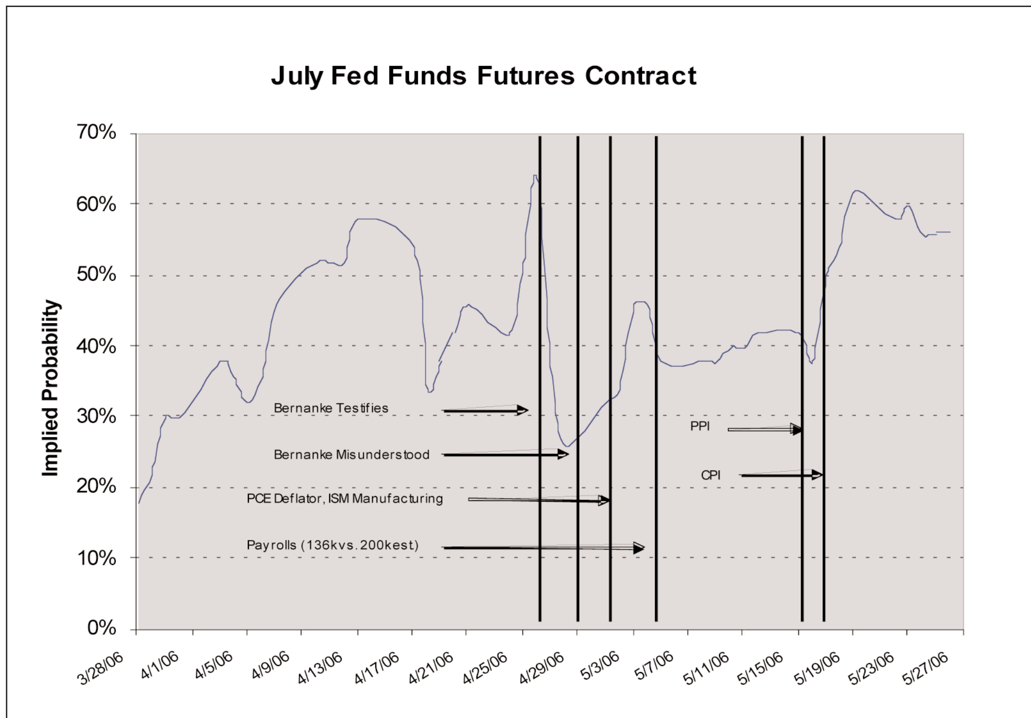
At the meeting of the Federal Open Market Committee held on May 10, 2006, the Fed increased the federal funds rate one-quarter of a point to 5.00%. More interesting than the actual rate increase was the accompanying statement as the committee further highlighted its data-dependent theme, thereby leaving open the possibility of a pause in the tightening cycle. This development is important to all investors as an inflection point in a Fed cycle is generally met with greater volatility in the fixed income market.

The current tightening cycle began in June 2004 when, after almost 3 years of slow growth, the US economy began to rebound. The Fed, in an attempt to head off burgeoning inflationary pressures, raised the federal funds rate 16 consecutive times from an accommodative 1.00% to the more normalized current level. With each accompanying statement the Fed maintained transparent language that informed the market that more rate increases were to come. Each rate increase, in effect, forces financial institutions to charge more for loans, a process that trickles through the economy and touches everything from major banking transactions down to personal credit card rates. The ensuing higher cost of capital forces both corporations and consumers to adjust their spending patterns to account for the increased cost of funds. This increase typically slows an overheated economy, thereby reducing inflationary pressures. Unfortunately, due to the transparency of the Fed, a conundrum developed in which long-term interest rates decreased as the Fed increased short-term rates. This allowed the housing market phenomenon to continue to accelerate, resulting in broad based economic expansion at a time when the Fed was trying to mitigate growth.

Presently, despite ongoing economic strength and inflation concerns, many speculate that the Fed will pause or possibly end its tightening campaign altogether this summer. At its May 10th meeting the Fed commented that it "judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of such firming will depend importantly on the evolution of the economic outlook as implied by incoming information." What this means to investors is that while inflation pressures are evident, the Fed may still choose to pause in order to assess the lag effect of the previous 16 hikes as higher borrowing costs threaten the overall health of the economy. This concern is mounting as new data suggests a cooling in the previously vigorous housing market which may result in reduced real estate valuations. Ultimately this will affect the average consumers' wealth and therefore their ability to support the economy through robust spending habits.

By pausing, the Fed would be allowing the economic data to settle in an attempt to see through the period of current strength in order to ascertain whether future weakness will develop. However, a pause in the tightening cycle is not without risks. As of April, on a trailing 12 month basis, the core Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) index are both just over 2.00%. With its desired inflation range between 1.00% to 2.00%, the Fed runs the risk of inflation surging outside their comfort zone while they search for confirmation of weakness. Meanwhile, other inflation indicators such as commodity prices have risen to historic levels over the past year. To date, these increases have not materially affected most consumer-based inflation measures as producers have experienced productivity gains and therefore have been able to maintain current price levels without reducing profit margins. However, with these productivity gains near their peak, businesses may soon have to pass on the increased input costs to consumers or face declining margins. If businesses are successful in increasing their prices, inflation may surge, resulting in price instability, the very circumstance the Fed works to prevent.

440 Lincoln Street, Worcester, MA 01653, 508-855-3856
www.opusinvestment.com



The delicate balancing act between maintaining growth and limiting inflation is further complicated by the recent appointment of Ben Bernanke as the Federal Reserve Chairman. Market participants became very comfortable with former chairman Alan Greenspan's methods and now, after 18 years of following the inflation hawk, investors must learn the techniques of a new leader. The chart above illustrates the difficulty investors are having ascertaining the Fed’s policy towards interest rates. Although considered the top macroeconomist of his generation, Ben Bernanke is considered by many to be an academic and with less than four months experience heading the FOMC, he is still viewed as an outsider by Wall Street.

Despite ongoing uncertainty, we at Opus believe that Chairman Bernanke must remain vigilant in his battle against inflation as a prolonged pause could result in the Fed being unable to regain control of price stability. Due to the disconcerting level of inflationary pressures still evident in the economy, we expect at least one more interest rate increase, most likely coming in June. We do expect the Fed to pause shortly thereafter, since we believe both GDP growth and inflation will slow during the second half of 2006 due to the housing market weakness, higher energy costs, and the lagged effect of prior Fed tightening moves. Bernanke has the benefit of Greenspan's wise counsel where he stated the better mistake to be made is to tighten too far, since corrective steps can be accomplished through easing policy. Should the Fed tighten too little, they would risk losing hard-won credibility on inflation, and that is difficult to win back indeed.