

# Dr. Krosby

## VITAL SIGNS

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*It's what the policy-making Federal Open Market Committee did not say after its March meeting that mattered most to investors.*

Stock markets rejoiced immediately following the Federal Reserve's March meeting—albeit at subdued volumes—over the presumed calming words offered in the Fed's closing communiqué. Suddenly, the incessant nagging worries over subprime contagion, widening credit spreads, soon-to-be felt slowing earnings, still stubbornly elevated core inflation, and headline geopolitical risk gave way to a market ready to embrace spring with a pronounced forward leap. Whether it's been a mere surge of short-covering of positions joined by bargain hunters or something more indicative of a sustained upward trend, investors were heartened that the market might be seeing good times ahead—even if “ahead” means nearly a year away. Still, it seems as if the market is in a bottoming process, and after a few weeks of bedrest, the Shanghai flu may not be over. When trading volumes begin to pick up markedly, the rally will have the feel of sustainability as it becomes clear that institutional investors feel confident enough to put more money to work. Iranian saber rattling and the continuing subprime saga, replete with FBI investigations, will test investor confidence, as well as the market's lows. Each day will be a test of both the economy's and the market's vital signs.

### **A Fed On Hold—But Flexible**

It's what the policy-making Federal Open Market Committee did *not* say after its March meeting that mattered most to investors. By dropping its reference to a need for “additional firming” of interest rates, the Fed moved one step closer to a more neutral stance. For many analysts, however, the exclusion of that phrase constituted a de facto declaration of neutrality. But with inflationary pressures still a dominant focus—core consumer inflation hovers at 2.7 percent year-over-year—and with oil prices back up above \$60 per barrel, the tightening bias, in the face of the housing deceleration, may have eased somewhat, but has by no means been expunged from a still data-dependent Federal Reserve. Moreover, policymakers assured nervous investors that the economy “seems likely to continue to expand at a moderate pace over coming quarters,” despite the housing market's ongoing adjustment.



In his March 28 Capitol Hill testimony, Fed Chairman Bernanke said, “At this juncture... the impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained.”

When asked if the Fed had reached a neutral position, Bernanke acknowledged that while inflation remained the greater risk, the Fed was seeking more flexibility because risks were arising on both sides of the equation. Moreover, Bernanke stated that the Fed does not want to give markets immediate notification that it is prepared to cut rates. Rather, it wants to describe the scenario from the Fed’s perspectives and allow the market to make its own interpretation.

Still, globally, central banks continue to tighten rates, and growth, while still solid, will certainly ratchet down accordingly. Central bankers appear determined to maintain credibility as they rein in inflationary expectations and temper the rapid appreciation of asset prices, while investors migrate from one asset class to another in search of attractive yields. Keeping inflation within an accepted comfort zone—and more stable—has become crucial for central bankers. Over the past 20 years, the median inflation rate in developed economies has declined from seven to two percent, while in developing economies the rate has fallen from nine percent to four.

This synchronized global tightening campaign will play a key role in the gradual slowing of the U.S. economy over the next couple quarters.

### **Existing Home Sales Show Signs of Life, But Subprime Fears Persist**

According to the National Association of Realtors, sales of existing homes defied expectations by climbing almost 4 percent in February, the largest

single-month gain since March 2004. The median price of houses continued to decline, however, and the inventory of unsold homes moved up by 5.9 percent in February, to 3.75 million. But concerns are mounting that the rising default rate in subprime mortgages (representing approximately 12 percent of the mortgage market), coupled with defaults in the mortgages issued in the “all day” loan market—a higher-grade market used particularly by speculative investors, accounting for approximately 10 percent of the mortgage market—will stall the reacceleration of the housing pickup. In fact, since the end of 2006, more than 30 subprime lending companies have closed amid

rising mortgage delinquencies and

defaults. The realtors association’s chief economist suggested that “the tightening in the subprime market will have a negative impact on home sales” as lenders impose stricter lending standards.

The recovery, however, would prove to be sustainable. At the beginning of the year, the

association’s affordability index rose to a nearly two-year high, helping to justify a more cautiously optimistic prognosis. Indeed, existing home sales represent 85 percent of the housing market, and with prices continuing to come down over seven consecutive months, sales are starting to pick up.

New home sales, however, are stalling to the slowest pace since June 2000. Inventory continues to remain high, and analysts expect that unless demand picks up, construction employment will suffer over the next few months. Finished houses that remain unsold are up 43.2 percent year-over-year. Builders continue to offer incentives to unwind inventory, but overall high-profile builders are not yet confident that the market has bottomed.

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Mortgage lenders are being scrutinized by Congress, and home builders are growing more pessimistic. One prominent home builder characterized the start of the all-important spring selling season as “pretty much a bust,” while another said: “We’re not projecting anything to bounce off the bottom at this point. There’s been a lot of buyers that have moved to the sidelines.” If prices continue to fall and interest rates remain attractive, buyers should respond, making the February data part of an upward trend, rather than a statistical aberration precipitated by warmer weather.

### **Job Growth—Slower, But Steady**

Jobless claims, which had been trending upwards, retreated for three consecutive weeks, giving solace to fears that the consumer may be facing a weaker job market. Ultimately, solid job growth and wages have provided the most important catalyst to the economy, despite looming headwinds from declining mortgage equity withdrawal and rising food and energy costs. With capital spending by corporations easing in the face of slower earnings, the health of the consumer remains a pivotal part of U.S. economic expansion. A Conference Board survey indicates that consumers are becoming more concerned about the economy, with a fall in leading indicators consistent with “moderate but choppy” economic growth. The Board’s latest consumer confidence index dropped to 107.2 in March, down from 111.2 in February. Rising gasoline prices, stock market volatility, and concerns over the deteriorating housing market contributed to consumers’ more pessimistic outlook.

In February, job growth slowed to a two-year low, but unemployment remained at a low 4.5 percent, with wages showing healthy gains. Any signs of an employment slowdown will quickly reverberate throughout the economy, and if the gross domestic product slows to between 2 and 2.5 percent, the employment picture could become increasingly

murkier. Throughout the housing market deceleration, the resiliency of the consumer has defied skeptics, yet it’s not surprising that job growth and wages have provided the economy’s solid underpinning.

### **Exports Strong, Tax Refunds Up, Money Supply Up**

Other important indicators are also showing signs of strength. The U.S. trade deficit is in an improving trend, thanks in large part to the dollar’s 16 percent decline since 2002 and solid global demand. Tax refunds are up 7 percent year-over-year, due in large part to strong stock market returns and strong corporate profits. Money growth has reaccelerated, providing added liquidity to the financial markets.

With a continuation of the slowdown unfolding, these indicators should weaken in response. Key will be the Fed’s reaction to the broadening of the slowdown. The Fed funds futures market is predicting interest rate cuts by the second half of the year, with as many as three cuts factored in. The market has been wrong before, as strong growth has trumped dismal forecasts. As the Fed remains data-dependent, so too does the market. And so, too, does the most integral piece of the economic mosaic—the consumer.

### **The Markets**

It doesn’t seem possible, or even normal, that the February 27 sell-off is finished. The Chicago Board Options Exchange’s VIX® index calmed down almost to the historic lows of the past year. The carry trade, the purveyor of liquidity and leverage, appears to be alive and well again as the Bank of Japan held rates steady at its last meeting. Mergers and acquisitions are set to print some of the biggest deals ever, and a major private equity initial public offering seems to be coming to the market. Iran is back on the front page. Gasoline prices are creeping higher. The earnings season is almost upon us with decidedly lower returns.

Markets are supposed to be forward-looking, and they may be signaling the soft landing we've come to expect. The vital signs look fine, although a bit weaker. If history is any guide, however, the market will test its previous bottom, and the Iranian scenario could provide the ammunition for another sell-off. Risk will come back into play and investor fear will reappear. What is very clear is that, should the situation deteriorate significantly, Dr. Bernanke will be prepared to aid the ailing economy quickly. He knows it, and so does the market.

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Dr. Quincy Krosby's sources of information include Bianco Research L.L.C., Bloomberg, Dow Jones, Financial Times, Investor's Business Daily, ISI, The New York Times, Strategas Research, and The Wall Street Journal.

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