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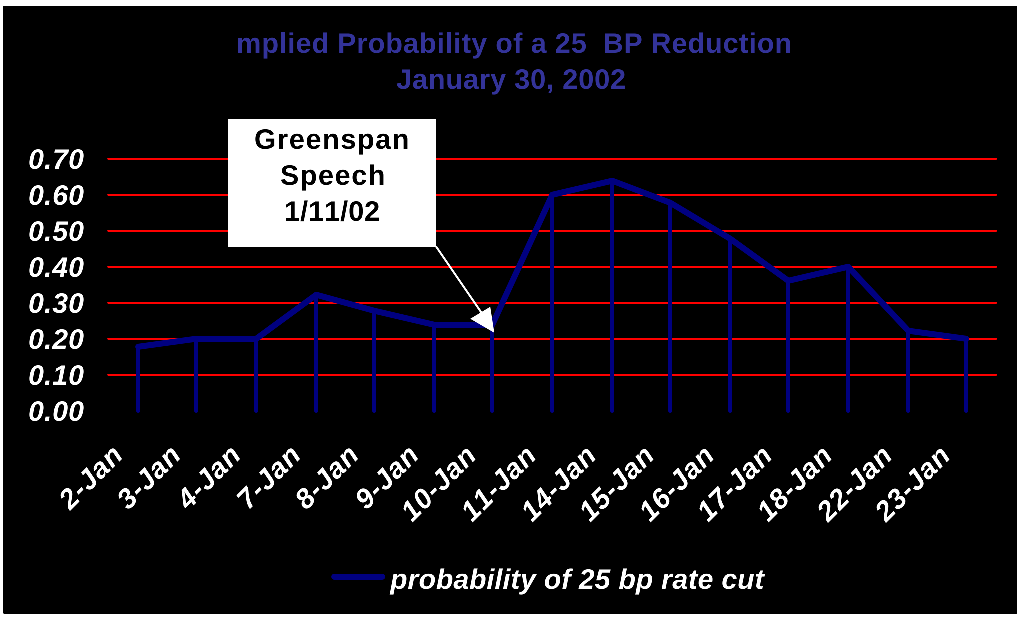
The Economic Environment Going Forward



A Gloomy Road Ahead? Greenspan testifies today at the Senate Budget Committee at a time when the economic envi ronment poses some hard choices for policy makers that have to be made under highly uncertain forecasts. This is a strange twist of fate given the consensus view that QI2002 will evidence positive GDP growth in real terms and the 'ending' of this recession. The non-consensus view, which we do not share, is that the economy will be subject to a Double-Dip because the "up" will be solely based upon an inventory bounce, not sustainable consumption and business investment. A far gloomier portrait of the road ahead is highlighted by the CBO 10 year Budget projection showing a startling drop from $5.61 Billion (the projection of January 2001) to $1.60 Billion. How that projection pans out will be heavily influenced by the manner in which the economy recovers this year and next. If a healthy recovery takes place along with an expanding equity market, the next CBO projection will lurch again toward the more optimistic views of January 2001. The first light on the policy road ahead is the upcoming FOMC meeting next Tuesday and Wednesday. In the past 10 days, the Fed Funds Market has reversed its view of what the Fed will do as can be seen in the above graph of the implied probability of a FOMC cut on January 30th of 25 basis points.

Which Face Will Show Today? Greenspan spoke on the West Coast on Friday 11th when the Bond Market had been signaling a low probability of another rate reduction. When the market opened on the following Monday (14th), February Fed Funds Futures reacted with a dramatic change upward in the implied probability of a rate cut and held above 50% mark until the 16th. Since then, the "good news" from various economic statistics has turned into "bad news" as far as further rate cuts are concerned. If we take the view that in general Greenspan will give the market what it wants, we have seen the end of this skein of rate cutting. We

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think that is the 'smart money' bet despite the Bloomberg Economist panel view that the FOMC will take out another piece of insurance on the recovery and cut one, last time. (Even the panel has shifted its view slightly with 19/51 of the economists (37%) predicting no change in rates). That is the count before this Greenspan appearance. It would not surprise us if he took a less pessimistic view of the economy's recovery than he took in his speech on the 11th. If so, the smart money bet will look better.

Signposts on Recovery Road: If the rate cutting is done, the next question is when the Fed will begin to 'reel it in.' Professor Milton Friedman raised the question in an Op-Ed piece in the WSJ on January 22nd.

> What the future brings will depend of course on how monetary policy evolves. While the current rate of monetary growth of more than 10% is sustainable and perhaps even desirable as a defense against economic contraction and in reaction to the events of Sept. 11, continuation of anything like that rate of monetary growth will ensure that inflation rears its ugly head once again.
>
> However, the Fed preempted on the downturn and I suspect it will again preempt on the upturn, so as to avoid such an outcome. ("The 1990's Boom Went Bust. What's Next?" WSJ 1/22/02).

This leads naturally to two questions that will impinge heavily on Fed decisions over the next six months: **unemployment and price level behavior.** Today, initial unemployment claims fell once again by 15,000 and that reduced the 4-week average claims to 404.3, reductions from last week. This raises the twin questions of how high will the rate of unemployment go and when will it begin to recede. Typically, the unemployment rate peaks much later than the recession trough, continuing to rise as recovery begins. The second question that will face the Fed will be the prospective behavior of the rate of inflation. Much of the reduction in the CPI in past months has been totally dominated by energy price reductions while the underlying trend of service prices has risen. Traditionally, as the economy pulls out of a recession, the CPI falls. If that pattern is replayed, it will give the Fed some breathing room. If not, the Fed will be faced with the dilemma of raising rates while unemployment continues to rise. That would not be a pleasant choice for the Fed.

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