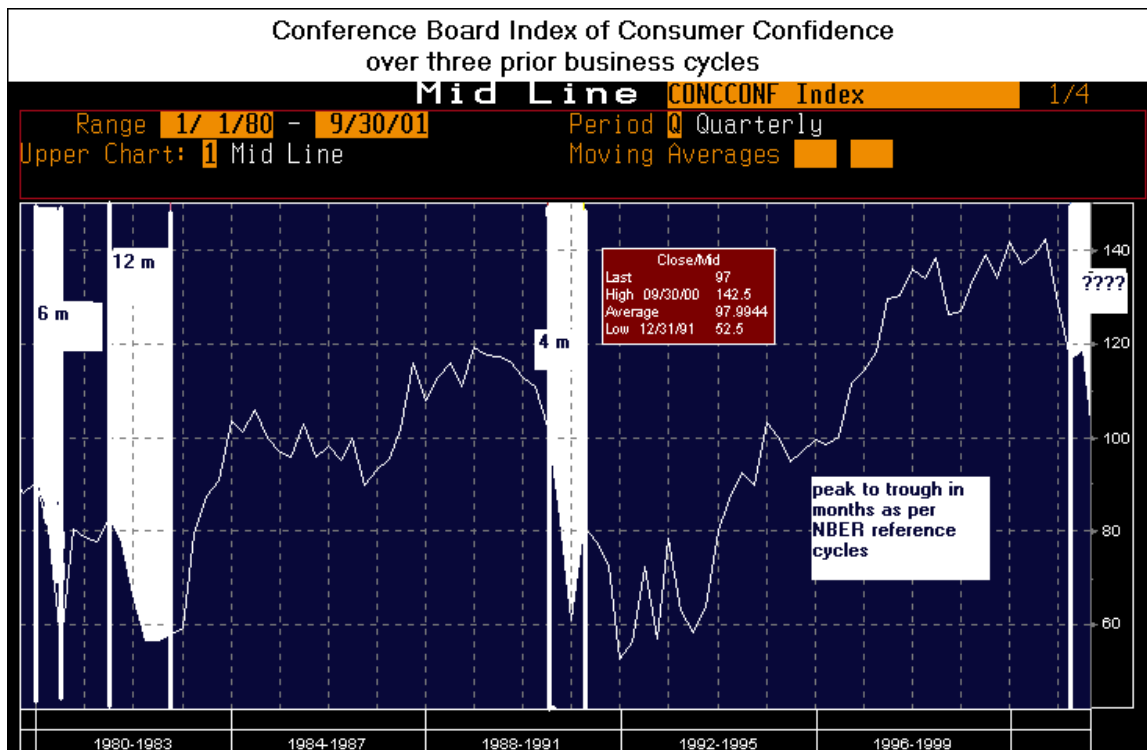




## Moving On: recovery's implications for monetary policy

### Consumer Confidence confusions

It now seems clear that many forecasters and policy makers are undertaking a substantial revision to earlier and perhaps more gloomy forecasts with regard to 2002. Similarly, the likely character of the recovery, when



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data: Bloomberg

it comes, is being recast. To the extent that the stock market forecasts recovery some six months early, that would place the recovery sometime in QII 2002. The data points today were mixed with housing sales rebounding from the previous month declines while the Conference Board Index of Consumer Confidence fell below consensus expectation. Since the NBER has now opined that a **recession** began in March 2001, it might be useful to compare confidence over the prior three business cycles as dated by the NBER. The approximate duration of the cycles is indicated in the graph. In each of the three prior cycles, the onset of recession came while confidence was eroding. It would also appear that rising levels of confidence usually mark an upturn. Still, the jury is out on whether these measures 'predict' or whether they follow underlying business conditions. In 'normal times,' we gain very little with these measures according to Governor Meyer, who spoke today in St. Louis. What these measures do signify is the force of a sudden, exogenous shock that does not stem from typical underlying economic variables. Clearly war and Attack fall into that category.

We have a variety of measures of consumer sentiment. In normal times, these measures, in my view, offer relatively little predictive power for household spending. That is because the economy usually drives psychology and mostly not the other way around. As a result, we can predict consumer confidence with the same variables we use to predict household spending. Measures of consumer confidence have relatively little incremental value in explaining consumer spending in such periods. **Lawrence Meyer, 11/27/01 NABE meetings in St. Louis.**

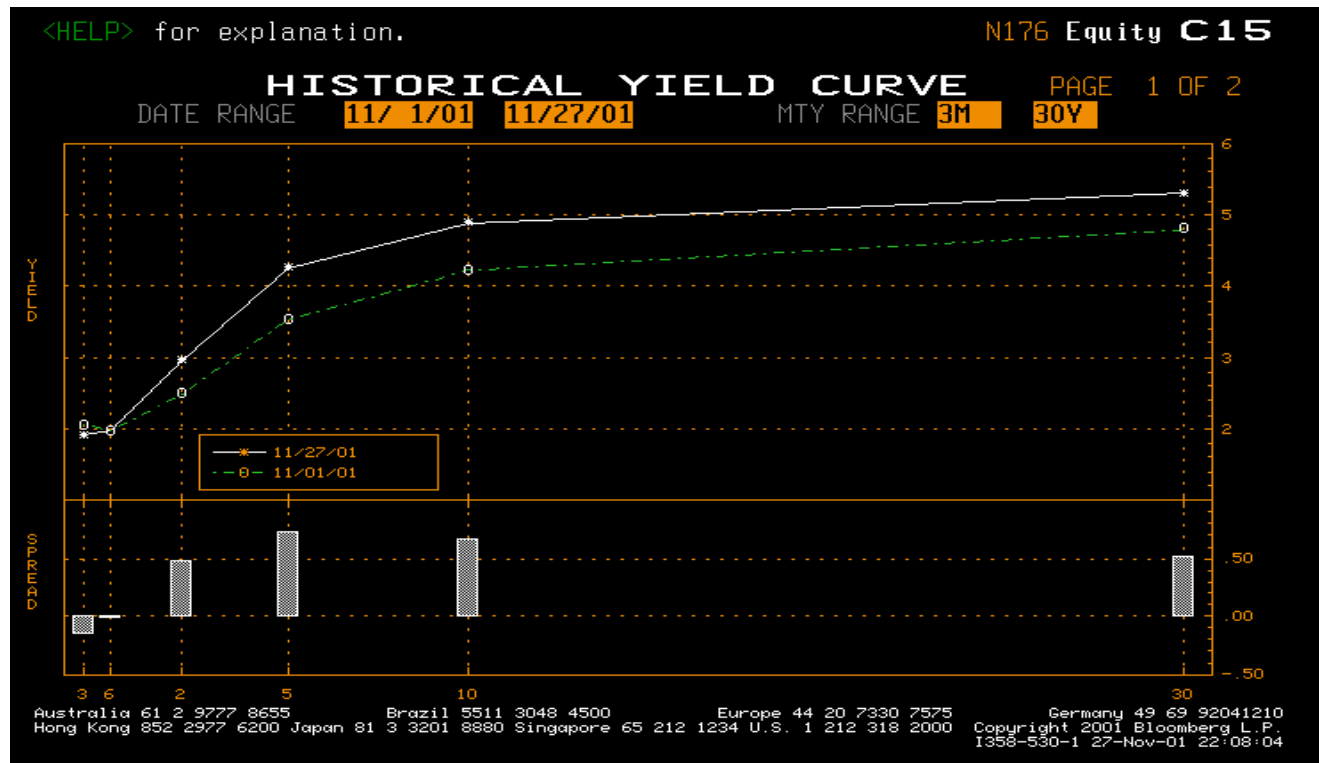


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The market was disappointed by the downturn in the Conference Board measures of consumer confidence, apparently feeling that recent evidence of better consumer buying interests would be reflected in improved confidence numbers. Bloomberg reported a consensus expectation at 86.5 but the tally was 82.2. If you mine the component numbers, a case can be made that the forward expectations are better (74.6 for November as compared to 70.7 for October), but it is still true that the “present situation” series shows a marked drop (93.5 as compared to 107.2). Investors are warned to take a close look at the Meyer statement above. The same variables that predict personal consumption expenditures also predict the confidence numbers. We may gain very little in forecasting when the recession will be over from these data. That would be the case were these ‘normal times.’ They may not be, but it is also possible that we are returning to some sort of normality.

## Bond Market Bounces

The Bond Market has been in a veritable rout since early November. Today, ‘bearish confidence’ rallied the bond market. **The issue is two-fold: (1) is recovery in sight and (2) what does that mean for the Fed, in December and then in 2002?** Governor Meyer is retiring from the Board, but his comments today were illuminating. He put the pre-Attack and post-Attack economy in perspective.



data: Bloomberg

Since November 1, the 30-year has risen nearly 52 basis points while the 10-year, 5-year and 2-year have risen 66, 73 and 48.5 basis points---as the 3 month bill has fallen 15 basis points. Steepening, indeed, yet, the Bond Bears had, up to today, thrown in the towel on further moves by the Fed. Today, their **confidence** might



have been weakened, but for how long? This sets the stage for the forthcoming debate on monetary policy.

## The Monetary Policy Debate for 2002

Meyer's speech today was illuminating on a number of points, but we will focus on just a few of them.

- 1) pre-Attack, Fed policy was aggressive, yet typical measures of the degree of ease of "financial conditions" suggest the Fed had not done enough. Meyer relates this to the enormous impact of the equity decline, centering as it did in the technology sector. **"- the reassessment of the profitability of owning and producing high-tech equipment - was, at the same time, a shock to financial markets and to aggregate demand."** The shock impacted financial markets by changing borrowing and lending conditions, thereby altering business investment demand while household sector consumption slowed through the wealth effect.
- 2) whether the Fed was sufficiently easy or not, is difficult to assess by looking at the behavior of long-term interest rates. They declined sharply **in anticipation of Fed easing**, but the budgetary impact of the recession and first fiscal response may have fed back into the bond market preventing even sharper declines from aggressive monetary policy.
- 3) **while the economy is still contracting**, there is considerable stimulus **"in train because of the combination of monetary policy easing and fiscal policy already enacted."** Further, if additional fiscal stimulus gets through the Congress, the 'internal dynamics' [inventory rebuilding, for example] will be intensified, and the recovery will gain speed. The old issue of the 'mix' is now on the table!
- 4) "Once the economy shows signs of moving to a rate of growth above trend, the Fed will have to reassess the appropriate degree of stimulus and, at some point, begin the return to a more neutral policy." Is the Fed regulating growth or the price level? We've been here before!

Retiring or not, the public debate over the Fed's degree of ease going forward has begun. Meyer re-states the 'risks are to the downside,' but he is raising the bar for additional ease in 2002! **The Bond Bears smell it in the wind.**