MCB Bank Limited

Treasury & FX Group

Quid Pro Quo

Issue # 26 **Economic report** ***Dec 27th 2006***

To be or Not to be!

The Federal Open Market Committee in its most recent meeting held on 12th December 2006 announced to keep its target for the Federal Funds Rate at 5.25%. The Federal Reserve had raised rates seventeen consecutive times since June 2004 through June this year in a bid to control inflation and has been on hold since.

This has slowed the pace of the booming housing market, automobiles sales and financial markets. In the wake of this economic slowdown, investors are hoping for a cut in the fed rates while the Federal Reserve gives no clear indication regarding its next move. This issue analyzes the current ambiguous picture of the US economy as presented by mixed economic indicators to predict the Federal Reserve's move in relation to the federal funds rates.

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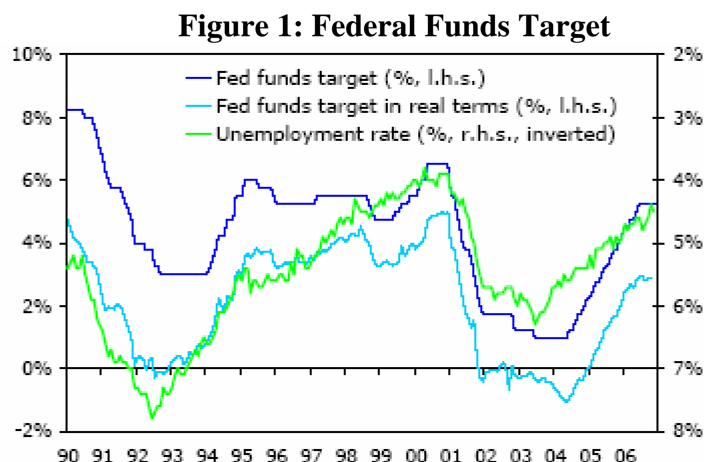
Hiking Higher

All banks and thrift institutions in the United States are required to keep a fixed percentage of the total value of the bank's demand accounts in the form of no interest bearing reserves with the Fed. In order to maintain its reserves at the Fed at the legally required level, these depository institutions often borrow funds amongst each other at a negotiated rate of interest. The weighted average of this rate across all banks is the effective Federal Funds Rate. This formally defines the federal funds rate as the interest rate at which depository institutions lend federal funds at the Federal Reserve to other institutions overnight. Though it is not possible for the Fed to set an exact value for this rate, the governors of the Federal Reserve often set a nominal target range for this rate that they enforce primarily by open market operations.

In the most recent meeting held on 12th December 2006, the Federal Open Market Committee announced to keep the fed funds rate at 5.25%. This was the fourth consecutive meeting that the FOMC left rates unchanged since June this year. In the current decade, the Federal Reserve initially raised rates in June 2004 when the benchmark overnight lending rate stood at 1%; this is recorded as the lowest level in nearly half a century.

This overnight lending rate influences rates on many consumer and business loans and therefore is highly crucial in determining the pace of economic growth. The low rates in 2004 stimulated flows of easy money that helped fuel a boom in housing and consumer spending on big-ticket items. However, since June 2004 through June of this year, the Federal Reserve has brought seventeen successive hikes in the fed funds rate. Though each quarter percentage point increase barely seemed noticeable to most consumers and business executives, it is important to note that today the rate stands at 5.25% - 425% higher than it was two years ago in June 2004.

Figure 1: Federal Funds Target



Source: BLS

Bursting the Bubble!

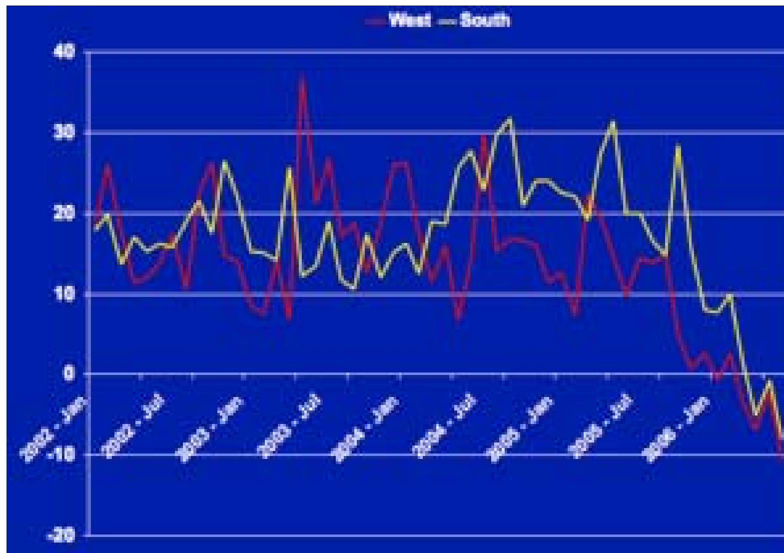
The Federal Reserve raised fed funds rate seventeen consecutive times since June 2004 through June this year by almost five times to 5.25% and since has held the rate steady. The accumulated weight of these seventeen straight interest rate hikes have sagged the healthy economy as the cumulative impact is progressively more apparent across the most rate sensitive segments of the economy including housing and automobile sales.

The housing market initially picked up momentum in 2000-01, following the decline in federal funds rate. The Fed had acknowledged the relation between lower interest rates and higher home values, cutting short term interest rates to historically low levels (as low as 1% in 2004). House prices like other asset prices are influenced positively by lower interest rates that fuels increased liquidity. For this reason the housing market is a key channel of monetary policy transmission in some countries. The Fed moved to vote for rate cuts initially in 2000-01 when the economy was slipping into a recession due to a stock market crash especially in the dot com and technology sectors. As a result the home prices began to rise significantly and the speculative purchases of homes increased. The stock market crash further stimulated this momentum as investors shifted their investments from the stock market to the more reliable real estate sector. This caused the house valuations to rise dramatically, providing private households with the collateral that allowed them to replace the missing income growth with a borrowing binge.

However the housing balloon that the Fed had inflated with rate cuts is already bursting as a result of seventeen successive hikes in interest rates between 2004 and 2006. The house sales and construction are slowing as mortgage applications decline, delinquencies rise and builder sentiment falls sharply. This has made homes less affordable to new buyers and hence has cut into home price appreciation. House prices have fallen substantially in the North East, parts of California and in Detroit.

As a result the booming housing market appears to have halted abruptly since summer of 2005 and most economists are warning the Fed of an approaching housing crisis. The median price of new homes has dropped almost 3% since January 2006 and the new home inventories stand at significantly high levels as they have grown almost 39% since last year, hitting a record in April. Sales turnover has dropped sharply as sales are almost down by 10% and homebuilders have responded by slashing housing starts. During 2001-05 residential investment contributed about 0.4 % to GDP growth every year but since last 12 months has reduced 0.4% in growth. This drag of 0.8% on GDP growth accompanied by weaker gains in employment and incomes for real estate agents, mortgage brokers and builders has dipped GDP growth below trend.

Figure 2: Condominium Price Depreciation (percentages) in the South and West United States between 2002 and 2006.



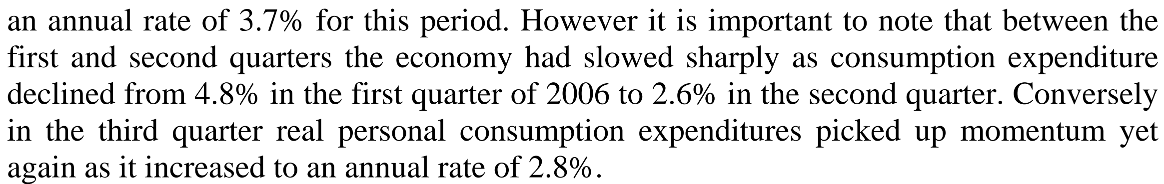
Source: NAR

It is important to note that the cumulative impact of the Fed's two years of rate hikes are showing up fairly consistently across many other economic sectors besides housing. For example, several markets including automobiles are also facing the issues of expanding inventories, falling prices and sharply reducing sales volumes. This has prompted several economists to rally for a rate cut as they argue that an accelerating downturn in the housing market and other sectors could undermine the overall economy, just as the crash of the dotcom bubble in 2000 contributed to the consequent recession.

Mixed Sentiments; Mixed indicators

The current weakness in the housing sector is expected to negatively impact the consumer spending patterns especially of the existing owners of the houses. These individuals suffer greatly as most of them are borrowers who locked in relatively low rates with adjustable rate mortgages three to five years ago. For example a borrower with a US$ 500,000 adjustable rate loan that closed in 2002 with a four year lock will witness his monthly payment rise substantially as rates adjust upward. This will reduce the individual's disposable income and hence shall reduce consumer spending. Additionally, home equity loans that have long been used for consumer spending also have lost their luster as a result of rate hikes. This is because the home price gains have moderated significantly and homeowners are left with less spare equity to borrow against.

Despite this, the data on movement of consumer expenditure presents an ambiguous picture. In the first half of the current year, real personal consumption expenditure and consequently real GDP remained considerably strong as consumption expenditure rose at



an annual rate of 3.7% for this period. However it is important to note that between the first and second quarters the economy had slowed sharply as consumption expenditure declined from 4.8% in the first quarter of 2006 to 2.6% in the second quarter. Conversely in the third quarter real personal consumption expenditures picked up momentum yet again as it increased to an annual rate of 2.8%.

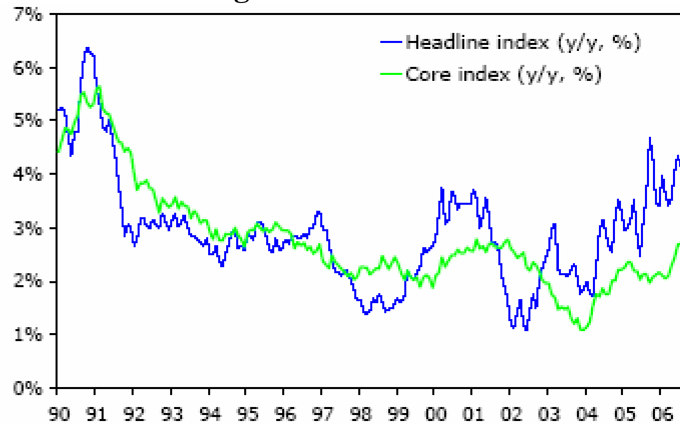
This suggests that the housing slowdown had little impact on consumer spending. However the impact may appear in the near future as when the housing boom slumped in the UK in 2005, the consumer spending did not slash till the following eighteen months. Even when the spending did come down, there was considerable controversy over whether consumers pulled back as a result of reduced borrowing, or due to decline in wealth resulting from weaker homes prices and lastly if it was the impact of higher rates on mortgage interest payments. Nevertheless the housing slowdown and rising consumer expenditure presents a mixed picture for the Fed, making it difficult to predict the future direction of the economy. Hence it is likely that the Fed may be in no hurry to cut the fed funds rate.

Battling Against Inflation

The Federal Open Market Committee in its most recent meeting held on 12th December though acknowledged the slow growth of the economy, still decided to hold the federal funds rate steady at 5.25% instead of opting for a rate cut. This was primarily due to the mixed picture presented by recent indicators as the Fed stated in the FOMC; *'Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters.'*

The Fed believes that the slow pace of growth is reflective of not only of the *substantial* cooling of the housing market but additionally the obvious weakening of the manufacturing sector. The ISM composite index fell below 50 in November while orders for durable goods declined substantially in October. Additionally the service sector which is currently resilient to high rates is likely to be influenced by lower activity in other sectors. The downtrend of the economy especially the ISM index's dip below fifty in November had raised expectations amongst investors for a rate cut. This is primarily due to a historical relation between ISM index and Fed Policy. In the recent past there were eight occasions where the composite moved below fifty and seven of these corresponded with the Fed either cutting rates in the same month or within one to five months afterward. This pumped market speculations that the Fed shall cut rates but investors were disappointed of the Fed's decision regarding maintaining rates at the same level. In the FOMC statement, the Fed expressed its concerns over high levels of core inflation and continued risks facing the economy as a result of high resource utilization and therefore voted against pleas of a rate cut.

Figure 3: CPI Inflation



Source: BLS

However at the same time the Committee disclosed its expectations of inflationary pressures to temperate in the future as a result of recent decline in oil prices, contained inflation expectations, sluggish demand and the past interest rate hikes. Despite this, the Fed clearly mentioned that inflation risks remain its chief preoccupation;

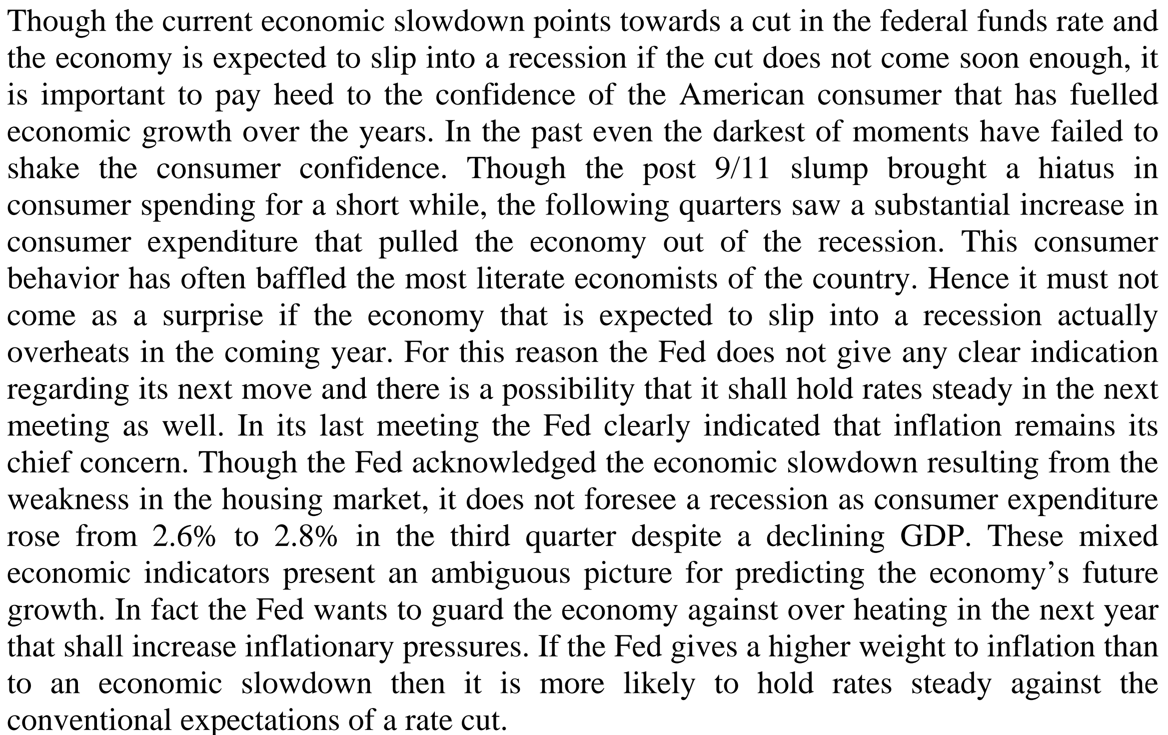
Nonetheless, the Committee judges that some inflation risks remain. The extent and timing that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

Source: FOMC Statement

Nevertheless, bearing in mind the past moves of the Fed corresponding to ISM index and low inflation rates, most investors are still betting on a rate cut in the coming quarter of the next year. The price data significantly points towards lower inflationary pressures. The CPI inflation reached its lowest level since June 2002 in October at 1.3% while the core inflation dipped the first time since January 2005 in October as it was recorded at 2.7% against core inflation of 2.9% for September. Additionally the sharp downward revision of unit labor costs in the second and the third quarter of the current year indicate further alleviation of the inflationary risks.

Who's Right?

Investors continue to act oblivious to the loud talks of the Federal Reserve regarding inflation and are still betting that the next year shall bring rate cuts. This is primarily because the considerable cooling of the housing market and the consequent economic slowdown suggests a fall in the general price level. The investor's expectations are reflective in the negative spread between long term and short term interest rates. For example the 1 Year LIBOR currently stands at 5.26% against the 6 Month LIBOR of 5.36% suggesting that the investors are already discounting for the expected fed cuts in their holdings.



Though the current economic slowdown points towards a cut in the federal funds rate and the economy is expected to slip into a recession if the cut does not come soon enough, it is important to pay heed to the confidence of the American consumer that has fuelled economic growth over the years. In the past even the darkest of moments have failed to shake the consumer confidence. Though the post 9/11 slump brought a hiatus in consumer spending for a short while, the following quarters saw a substantial increase in consumer expenditure that pulled the economy out of the recession. This consumer behavior has often baffled the most literate economists of the country. Hence it must not come as a surprise if the economy that is expected to slip into a recession actually overheats in the coming year. For this reason the Fed does not give any clear indication regarding its next move and there is a possibility that it shall hold rates steady in the next meeting as well. In its last meeting the Fed clearly indicated that inflation remains its chief concern. Though the Fed acknowledged the economic slowdown resulting from the weakness in the housing market, it does not foresee a recession as consumer expenditure rose from 2.6% to 2.8% in the third quarter despite a declining GDP. These mixed economic indicators present an ambiguous picture for predicting the economy's future growth. In fact the Fed wants to guard the economy against over heating in the next year that shall increase inflationary pressures. If the Fed gives a higher weight to inflation than to an economic slowdown then it is more likely to hold rates steady against the conventional expectations of a rate cut.

However considering the indecisive nature of consumer confidence it is not prudent to expect this alone to prevent the economy from slipping into a deep recession as it has in the past. If the confidence breaks abruptly as a result of unanticipated events it will be extremely difficult for the economic policy to deal with the aftermath. Alan Greenspan in 2001 pointed out the fickleness of consumer confidence in a rather interesting manner;

"Looking back at recent cyclical episodes, we see that the change in attitudes has often been sudden. In earlier testimony, I likened this process to water backing up against a dam until it is finally breached. The torrent carries with it most remnants of certainty and euphoria that built up in earlier periods."

Economic Snapshot

Fiscal year 06														
	Units	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov
Inflation														
Headline Inflation	%	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07
Core inflation	%	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62
Food inflation	%	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62
Non-food inflation	%	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27
T-bill (Wgt Avg)														
3 month	%	bid rej	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64
6 month	%	bid rej	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81
12 month	%	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00
External Sector														
Export	Mln US$	1,205	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383	1420	1290	1380
Import	Mln US$	2,024	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292	2450	2191	2773
Trade balance	Mln US$	(819)	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)	(901)	(1393)
Remittances	Mln US$	309	336	391	339	444	401	507	464	376	435	422	410	448
Forex reserves	Mln US$	11,341	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460

n.a = Not Available

Research Desk

Treasury and FX Group

MCB BANK LIMITED

20th Floor

MCB Tower

I.I Chundrigar Road

Karachi

Contact

Sana Qureshi

Research Analyst

Telephone: 92-21-2270025

0300-3915027

Email: sanaqureshi@mcb.com.pk

Usman Siddique, CFA

Head of Research and Structured Products

Telephone: 92-21-2270024

0333-2153438

Email: usman.siddique@mcb.com.pk

Fax: 92-21-2270094

92-21-2270109