

Demand Not Inflation Will be the Problem

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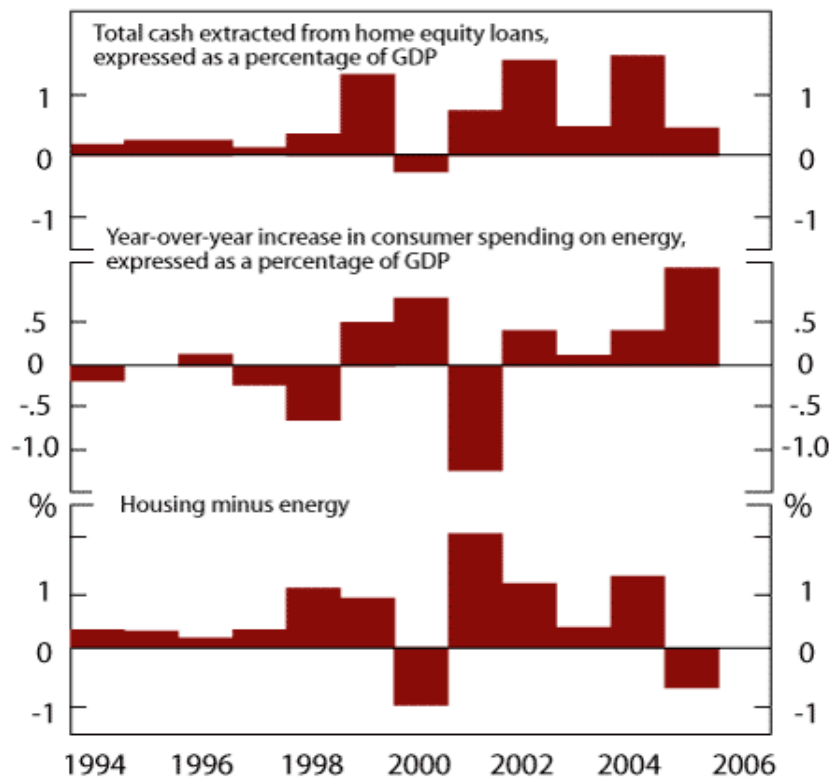
The Federal Reserve continues to raise and threaten to raise short term interest rates. Before the worlds' greatest "bubble blower" retries in January 2006 he has the opportunity to increase them 3 more times. Will he? We have publicly stated that we believe he should have stopped with the Federal Funds rate a $3\frac{1}{4}\%$, $\frac{1}{2}\%$ less than it stands today. Why do we say this? To answer both question – the first is yes and the second is income or more particularly the lack there of.

Average real wage rates from 1/1/01 through 6/30/05 (4 $\frac{1}{2}$ years) have increased from \$8.03 to \$8.21. Average weekly earnings over the same period has grown from \$275.62 to \$276.59. Compared to the average of all previous recoveries since WW II this recovery expansion to date is 10,000,000 people short in employment. That amounts to approximately \$144B of lost purchasing power before taxes. This loss of "normal" income plus high debt levels which grows daily as the consumer is not only not paying anything net on principal, but is also not paying all of the interest on his debt is a certain drag on the economy. In summary, then not only have less people been added to the work force than usual, but those that have jobs are not receiving much in the way of additional income. The consumer has to be hurting. This is reason number one for us discounting the need to raise interest rates as noted above. There is no demand boom that will cause permanent inflationary conditions.

The second reason we see no reason to be overly concerned about potential sustainable inflation is the "gasoline tax increase." The Bank Credit Analyst recently presented a chart, which plainly shows that no longer will refinancing homes add to consumer cash flow availability due to the increase in energy costs. This will become even more serious in 2006 as heating oil will fit into the spending equation. In the past Alan Greenspan has always been able to find a way to create another bubble that keeps recessions mild and short. If we are correct and next year results in a decline in consumer spending which causes a recession, then what will the bubble be? What asset can be inflated by excess credit availability and used as an ATM? We sure don't know, but the financial economy continues to innovate, (Greenspan calls it flexibility), therefore most anything is possible.

Running on Fumes

Total cash extracted from home equity loans, minus the year-over-year increase in consumer spending on energy (expressed as a percentage of GDP).



Source: BCA Research