



The Bottom Line

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Fed Easing Coming?

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The U.S. economy is losing momentum and price pressures continue to fall. The private sector created surprisingly few jobs in May and the most recent initial unemployment insurance claims are edging upward. The drop in retail sales last month was another bad sign, although it might have exaggerated the degree to which the consumer is cutting back. Much of the dip was in auto and light truck sales, suggesting the reported rise in unit sales reflected fleet purchases by business rather than consumer car buying. The other big drop in spending was in gasoline sales, resulting from the sharp decline in gasoline prices. This will not affect real GDP growth because the consumer spending numbers used to compute real growth are price-adjusted. Nevertheless, without these two components, retail sales fell by 0.8%, still weaker than what a robust recovery would generate. Building supply purchases were down 9.3%, in payback for the “cash-for-appliances” run up of the past couple of months, and will show up as part of the already declining residential investment component. Housing data have weakened sharply since the end-of-April expiry of the homeowner tax credit.

Moreover, the BP oil spill has killed home sales in areas of Louisiana, Alabama, Mississippi and Florida that are near water, for obvious reasons. Buyers have postponed purchases until they see how badly the oil spill damages the beaches in those states. Catastrophically, if the beaches are badly damaged, the already-weak housing markets in those regions will suffer considerable further value erosion—not to mention what could be long-standing ecological damage. Certainly, the oil spill has crushed summer tourism there, which began with a fizzle on the Memorial Day weekend. Reportedly, some resorts in Florida are begging patrons not to cancel their vacation plans, offering full money-back guarantees if the oil hits the beaches. The poor tourism traffic damages the full hospitality industry as well as retailers and service providers in the region. It has also been a disaster for the commercial and recreational fishing and seafood industries.

With this backdrop, the Fed is discussing what actions to take in the event that the economy weakens further or core inflation, already below 1%, heads further south. Clearly, there is little chance the Fed will hike rates this year. When the FOMC meets next week, it will do so in an environment of great uncertainty and underlying headwinds.

We are now running the risk of too much government belt tightening. With the mounting prospect of aggressive near-term fiscal tightening in the U.K. and the Eurozone, there is a real danger of economic contraction there that would reduce U.S. net exports and could,

potentially, derail the nascent U.S. recovery. The recent rise in the U.S. dollar is indicative of safe-haven demand. In addition, household confidence has been shaken by the recent selloff in stocks.

Despite the loss of momentum in the American economy, there appears to be mounting political pressure from some circles to reduce the 'size of government', which might preclude additional stimulus on the fiscal side despite a faltering U.S. economy. For example, the Bush tax cuts are set to expire in January. This leaves only the Fed to take action to prevent too much of a slowdown in growth.

Even some hawks on the FOMC concede that growth and inflation in the near future might surprise on the low side. While the Canadian economy has almost returned to pre-recession levels, the U.S. is unlikely to reach that benchmark until September, at the earliest.

There are still some arrows in the Fed's easing quiver. It could once again buy mortgage-backed securities in the open market. Keeping mortgage rates low will be particularly important for the hard-hit Gulf States. The Fed could also continue to emphasize in the FOMC press release that short-term interest rates are expected to remain low for an extended period.

Even the Bank of Canada is hedging its bets. On the heels of the June 1st rate hike, Governor Carney this week said, *"in light of the scale and volatility of these conflicting forces, it should be evident that no particular path for monetary policy is preordained."*

The Bottom Line: The Fed is a long way from tightening monetary policy. The U.S. output gap is still large, core inflation is likely to fall further, and negative exogenous shocks such as the oil spill and the fiscal restraint in Europe are headwinds for the U.S. economy. I wouldn't rule out a resumption of quantitative easing in coming quarters, especially if the fiscal authorities begin to tighten and core inflation dips into negative territory.

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