ECOMENTARY™

Fed Worries More About Investment Than Inflation

It appears to us that the Fed has some serious concerns about its initial diagnosis and the remedy that is appropriate. A more careful examination of the text of the last three meetings suggests that at the (regular) March 20, FOMC meeting, there were two themes: inventory adjustment and the consumption that was dependent upon the 'wealth effect.' ("…declines in equity wealth..")

On March 20, this is how the FOMC 'keyed' its decision:

The Federal Open Market Committee at its meeting today decided to lower its target for the federal funds rate by 50 basis points to 5 percent. In a related action, the Board of Governors approved a 50 basis point reduction in the discount rate to 4-1/2 percent.

Persistent pressures on profit margins are restraining investment spending and, through declines in equity wealth, consumption. The associated backup in inventories has induced a rapid response in manufacturing output and, with spending having firmed a bit since last year, **inventory adjustment appears to be well underway**.

By mid April, a note of real concern begins to emerge---and clearly it was the basis of the intermeeting move---despite considerable pre-meeting criticism's (some by FOMC members) concerning changing rates out of the normal sequence of FOMC meetings. Attention shifts first from a inventory reduction that "seems well advanced" to an entire paragraph focused on softening of capital investment and the 'rising uncertainty about the business outlook.' To us, that suggested real concern about what the future might bring. ("…seems poised to dampen capital spending going forward.")

On April 18, the FOMC (intermeeting) 'keyed' as follows:

The FOMC has reviewed prospects for the economy in light of the information that has become available since its March meeting. **A significant reduction in excess inventories seems well advanced**. Consumption and housing expenditures have held up reasonably well, though activity in these areas has flattened recently. Although measured productivity probably weakened in the first quarter, the impressive underlying rate of increase that developed in recent years appears to be largely intact.

Nonetheless, capital investment has continued to soften and the persistent erosion in current and expected profitability, in combination with rising uncertainty about the business outlook, seems poised to dampen capital spending going forward. This potential restraint, together with the possible effects of earlier reductions in equity wealth on consumption and the risk of slower growth abroad, threatens to keep the pace of economic activity unacceptably weak. As a consequence, the Committee agreed that an adjustment in the stance of policy is warranted during this extended intermeeting period.

What now concerns the FOMC? "Investment in capital equipment, however, has continued to decline." If priority comes from relative positioning within the statement, then the FOMC has now elevated the capital equipment bust to a higher level of concern. There is little attention given to any inflation concern, but there is a change in the treatment of productivity---the anchor for the prior boom. Note the change from "measured productivity probably weakened in the first quarter," to an out and

out admission that "measured productivity growth has stalled in the first quarter." Still, there is the core belief that the "impressive underlying rate of increase that developed in recent years appears to be largely intact." Some economists would question that. Time will tell.

This leaves us with a puzzle to solve and the statement today could be read in several ways. Does it tell the market anything about future reductions in rates? We think not.

Their focus is on regaining spending momentum and that means both consumption and investment need further stimulation. It is the latter, however, that is clearly growing as a concern of the FOMC. Investment spending is, after all, the key to continued productivity growth. They surely don't want to see the "stall " continue!

On May 15,

A significant reduction in excess inventories seems well advanced. Consumption and housing expenditures have held up reasonably well, though activity in these areas has flattened recently. **Investment in capital equipment, however, has continued to decline. The erosion in current and prospective profitability, in combination with considerable uncertainty about the business outlook, seems likely to hold down capital spending going forward. This potential restraint, together with the possible effects of earlier reductions in equity wealth on consumption and the risk of slower growth abroad, continues to weigh on the economy.**

With pressures on labor and product markets easing, inflation is expected to remain contained. **Although measured productivity growth stalled in the first quarter**, the impressive underlying rate of increase that developed in recent years appears to be largely intact, supporting longer-term prospects.

Inflation is not on the scoreboard at this moment. It may be in the future, but not now.