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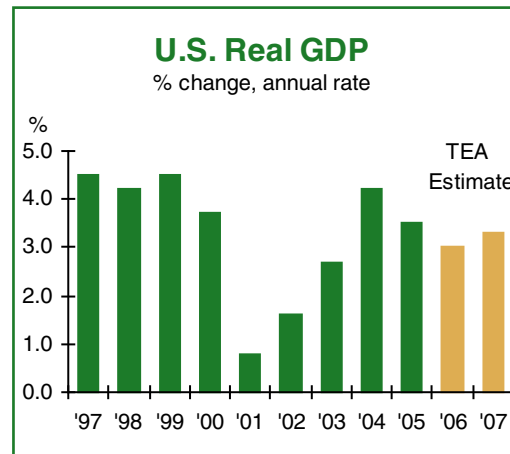
# Summertime View

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## The U.S. Economy

...solid growth continues

The strong 5.3% real (inflation adjusted) annual growth rate in 2006's first quarter is expected to give way to a 3.0% growth pace over the balance of the year. This compares to 3.5% real growth in 2005 and 4.2% growth in 2004. The economy's ability to offset the headwinds of rising short-term interest rates and high energy prices remains impressive.



## The Federal Budget

...less red ink

Sharply higher corporate and individual tax receipts have reduced the projected budget deficit for fiscal year (FY) 2006, which ends on September 30, to less than \$300 billion. This compares to the \$318 billion shortfall in FY2005 and the record \$412 billion shortfall in FY2004. Budget issues become more challenging in coming years.

## Employment

...tighter labor markets

The nation's unemployment rate averaged 4.7% during 2006's first five months. By comparison, the jobless rate averaged 5.3% in 2004/05 and 5.9% in 2002/03. Further slight reductions should occur over the next 12 months.

Net job creation via the "official" survey of 400,000 businesses has been modest during the past 24 months, with the addition of 3.7 million new jobs. The "other" employment measure, the household survey, has registered much stronger growth, an indication that small business job growth has been strong.

## Inflation

...stubborn oil prices

Overall consumer prices are expected to rise 3.2%-3.5% in 2006 as oil prices stay stubbornly high. By comparison, consumer prices rose 3.4% in 2005, 3.3% in 2004, and 1.9% in 2003.

Most forecasters see 2007 consumer inflation closer to 2.6%. Intense global competition, price-sensitive consumers, more effective use of technology, and the competitive nature of the Internet will help keep inflation in check.

## The Federal Reserve

...end is near

The Federal Reserve has consistently withdrawn excess monetary stimulus during the past 24 months. A total of 16 0.25% tightening moves now find the critical "federal funds rate" at 5.00%, as compared to a 46-year low of 1.00% between June 2003 and June 2004.

The Fed's next Open Market Committee meeting is June 29, with a move to 5.25% widely expected. A further move to 5.50% is possible, with a minority of forecasters expecting the rate to move as high as 6.00% in coming months. New Fed Chair Bernanke has kept financial market players on their toes (see page 2).

## Long-Term Interest Rates

...still not bad

Mortgage rates moved to four-year highs around 6.55%-6.65% in recent weeks. Mortgage rates could move modestly in either direction in coming weeks, tied to how the stock market performs.

Mortgage interest rates have been at or near 40-year lows during the past four years. The result?...the strongest new home sales and existing home sales on record.

## Home Prices

...interior looks better

Surging home prices of recent years on both coasts and in the Southwest have largely given way to weaker performance in 2006. We expect greater home price strength to now occur in the nation's interior as relative values (compared to the coasts) are cheap.



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## The Global Economy

### ...modest slowing likely

Most forecasts see slightly weaker global economic growth during 2006, following impressive growth during the prior three years. Solid growth for four straight years would be first such occurrence since the early 1970s. As before, risks to this view include any major new terrorist atrocities (especially on American soil), bird flu, even higher oil prices, and a worsening of Middle East tensions.

## The Bottom Line?

U.S. economic growth during the past 36 months has been impressive, with plenty of government stimulus in play. Solid growth is likely to continue. In addition, we expect: another 12-digit budget imbalance...consistent employment gains...declining inflation pressures...relative stability in both short- and long-term interest rates...softer coastal housing markets, with more impressive interior performance...and an anxious but impressive global marketplace.

## The Emperor Has Clothes

New Federal Reserve Chairman Ben Bernanke has stumbled a few times as he gets comfortable in what is arguably the second most important job on the planet. His every word has drawn intense scrutiny and analysis (almost as much as the infrequent words of Angelina and Brad).

The learning curve of the Fed Chair is a very difficult one and not for the faint of heart. Bernanke has the big shoes of Alan Greenspan to fill, just like Greenspan had a learning curve to fill the big shoes of Paul Volcker in the mid-1980s.

Bernanke's on- and off-the-record comments have found him in hot water at times. You can bet he will keep his views close to the vest when speaking with financial reporters at parties in coming months and years.

Bernanke has somewhat confused Wall Street in recent months with talk of 1) a potential pause in tightening, 2) a willingness to cease tightening even as acknowledged inflation pressures are higher than desired, and 3) most recently, with his "throwing down the gauntlet" speech where he effectively said that financial market players should not even question the Fed's resolve to keep inflation at bay.

Such confusion, combined with a modest emerging market meltdown around the world, has contributed to stock market weakness of recent weeks. Precious metal prices have been hit hard in recent days.

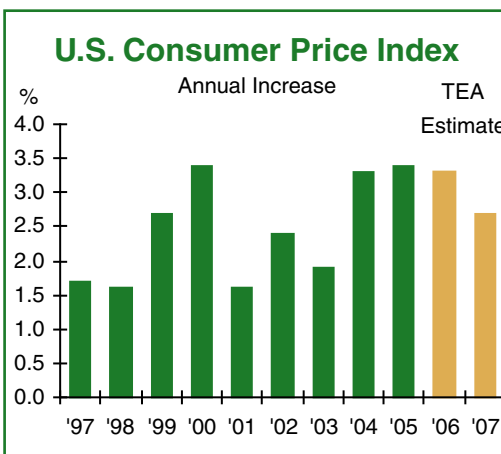
Every Fed Chair is forced early in their reign to give what I call "the Speech." It is a no-holds-barred personal testament that the Fed under their control will keep inflation at low levels, even as such policy can upset politicians, consumers, and market players in the U.S. and around the world. While such resolve can clearly disappoint financial markets in the short-run (as now, for instance), such policy is the essential groundwork for sustained, non-inflationary growth and higher stock and bond prices in coming years.

Many people had questioned Bernanke's inflation-fighting resolve in recent months as he talked of a pause in policy actions. This perception needed to be reversed quickly.

The Federal Reserve is a most unique institution. It has the ability to create and destroy "money" at will. (Note: this process has very little to do with a printing press and a great deal to do with what are known as "open market operations.") Such power is an awesome responsibility.

The Fed MUST have unquestioned credibility as an inflation fighter. The Fed under Chairmen Burns and Miller (1970s) lost it...the Fed under Volcker gained it back...the Fed under Greenspan strengthen it.

Without that credibility...                      ...the Fed has nothing



## "TEA"ser

Whatever women do they must do twice as well as men to be thought half as good. Luckily, this is not difficult.

—Charlotte Whitton



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