

Tea Leaf

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Pause

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The Federal Reserve's Chinese water torture approach to monetary policy took a breather yesterday, with the first non-tightening move at a Federal Open Market Committee (FOMC) meeting in 26 months. The "drip, drip, drip" approach of 17 consecutive 0.25% tightening moves since June 2004 had taken the Fed's most important interest rate, the federal funds rate, from a 46-year low of 1.00% between June 2003 and June 2004 to its current level of 5.25%.

The accompanying policy statement made it clear that the Fed will remain vigilant against inflation, even as Fed officials noted that *"inflation pressures seem likely to moderate over time...."* Additional tightening could occur in coming months IF inflation pressures increase or IF the U.S. economy unexpectedly picks up speed.

The Hawks

The Fed will continue to draw criticism from both the hawks and the doves. The hawks, who see inflation under every rock, are critical that the Fed has not been aggressive enough in diffusing inflationary expectations. They point out that various measures of inflation are at as much as 14-year highs.

The hawks point out that the Fed's preferred measure of inflation, the core PCE price index, is up 2.4% during the past 12 months, the largest gain in nearly four years. This compares to the Fed's presumed comfort level of around 1.0% - 2.0%. The hawks strongly argue that the Fed should have taken its key rate to 5.50% on August 8, with a final move to at least 6.00% in coming months necessary.

The Doves

The doves argue aggressively that the economy could soon be on the brink of the "r" word...recession. The doves argue passionately that the Fed has already gone too far and should soon consider easing monetary policy.

They see the combination of 17 tightening moves, a tripling of oil prices over the past three years, and the housing

bubble deflating on both coasts as signs that a downturn is already in the cards.

The doves point to four disappointing employment reports in a row, as well as the less-than-expected 2.5% real GDP annual growth rate in 2006's second quarter. One economist, whose commentary I occasionally read, raised his odds earlier this week of recession by year-end 2006 from 50% to 70%.



Federal Reserve
Chairman
Ben Bernanke

The Fed's move to the sidelines is now in contrast to developments around the globe. In the past month alone, 15 central banks around the world have tightened monetary policy, including the European Central Bank and the Bank of England last week (*The Wall Street Journal*). Additional increases are expected in Europe and in Japan.

The Markets

The bond market's response to the non-move was almost nil. Market players had already pushed the yield (return) of the 10-year U.S. Treasury note from a recent high around 5.25% in late June to the 4.90% level of recent days. The yield had largely declined because of more signs of slowing U.S. economic growth.

The stock market, while largely expecting the pause, was disappointed that the accompanying statement did not strongly suggest that the Fed's job is done. In any case, stock prices in recent days had somewhat limited upside potential as the DJIA exceeding 11200 pre-Fed announcement was near its high of the past three months. The stock market's reaction was perhaps also a bit of the old market standard, "buy on the rumor...sell on the news."

Job Softly

American employment gains in July came in below expectations for the fourth consecutive month. The net rise of 113,000 new jobs was below the financial market consensus view closer to 143,000 jobs. As a minor offset to the disappointing July data, net job gains in May and June were revised higher by 11,000 jobs in aggregate.

While job gains were weaker than expected, the sharp rise in the nation's unemployment rate was a major surprise. The nation's jobless rate rose to 4.8% in July, up sharply from the 4.6% rate of the two prior months. July's 4.8% jobless rate was the highest since February.

We have written frequently in the *Tea Leaf* about the fact that job gains as measured by the monthly survey of 60,000 households (from which the unemployment rate is derived) were much stronger in recent years than what was being reported by the "official" monthly survey of nearly 400,000 medium- and large-sized businesses...

...a modest decline in that wide disparity took place in the July data

The nation's jobless rate rose to 4.8% because the household survey reported a larger labor force (up 213,000 to 151,534,000 people), an actual decline in reported employment (down 34,000 to 144,329,000), and hence, a larger number of people considered unemployed (up 247,000 to 7,205,000).

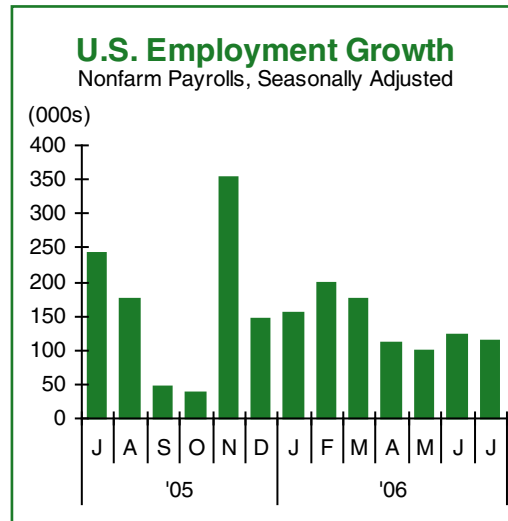
However the longer-term disparity between the two surveys remains enormous. The official employment measure notes a net gain of 3.4 million jobs during the past 60 months. The household survey for the same 60-month period notes a net employment rise of 7.3 million jobs, or more than twice as many.

In my opinion, the jobs differential is still primarily explained by a surge in small business creation and expansion...

...jobs *counted* in the household survey
...jobs *overlooked* in the business survey

Employment gains in July were found exclusively in service providing sectors,

which added 115,000 net new jobs. As usual, gains were led by professional & business services (up 43,000 jobs, with the highest wages of all sectors), with particular strength in computer system design (+12,000 jobs), architecture and engineering (+10,000), and management & technical consulting (+6,000).



The leisure & hospitality sector added 42,000 net new jobs, led by the addition of 29,000 jobs in food services and drinking places. The education & health services sector added another 24,000 net new jobs in July, with almost all job gains in hospitals, nursing, and residential care facilities. Health care employment rose by 274,000 jobs during the past 12 months. The retail trade and government sectors recorded no change in employment during the month.

Goods producing employment fell by 2,000 jobs in July, led by a loss of 15,000 manufacturing jobs. In contrast, the manufacturing sector added 22,000 net new jobs in June. The nation's construction sector added 6,000 jobs in July, after losing jobs over the two prior months. Mining employment rose by 8,000 jobs, and has added 123,000 net new jobs since its most recent low in March 2003.

Average hourly wages rose 0.4% (seven cents) in July to \$16.76. Average hourly earnings are up 3.8% over the past 12 months, versus the 3.9% rise in the prior 12-month period.

"TEA"ser

If most accidents occur within five miles of home, why don't people just move?

—Scott Friedman



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