

Tea Leaf

...weekly since 1976

September 20, 2006

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Pawz 2

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

The Federal Reserve maintained its comfortable position under the shade tree today, with a second consecutive “pause” in regards to possible monetary tightening. The Fed had previously pushed its key interest rate—the federal funds rate—higher in one-quarter percent increments 17 consecutive times from June 30, 2004 through June 29, 2006. We have affectionately referred to this process as the Chinese water torture approach to monetary policy.

The Fed’s Open Market Committee meets roughly each 45 days. The 17 consecutive tightening moves pushed the rate from a 46-year low of 1.00% between June 2003 and June 2004 to the current target rate of 5.25%. The Fed’s intent has been to slow the economy (and to diffuse inflation pressures) by pushing borrowing costs higher.

A combination of 1) moderation in U.S. inflation pressures (see following page), 2) concerns about current home price weakness following an excessive rise in values, 3) sharp declines in oil prices, and 4) other signs of modest U.S. economic slowing support our view that the Fed’s tightening program is essentially complete. We think the Fed will remain at rest through the end of the year, with a real possibility that the next move by the Fed could be to reduce its key rate early next year. In contrast, a minority of

economists think one or two additional hikes remain likely.

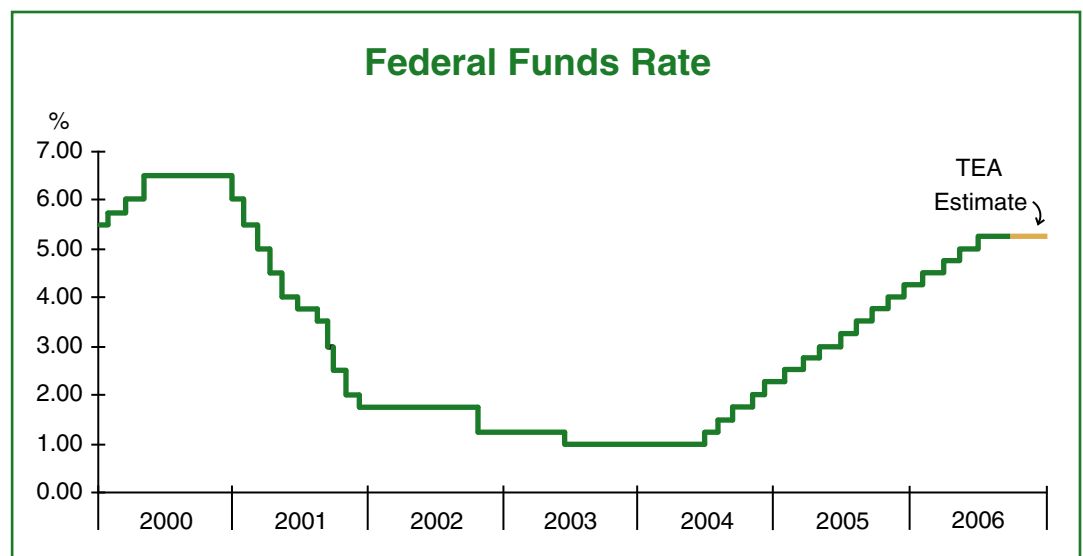
The Fed noted in the formal statement released following today’s meeting that, *“Inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.”*

In regards to the overall economy, the Fed added, *“The moderation in economic growth appears to be continuing, partly reflecting a cooling of the housing market.”*

And in regards to future monetary policy moves, the Fed added, *“The committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.”*

The FOMC’s next meeting is October 24. Financial markets currently suggest a “1 in 25” chance of an 18th tightening move at that meeting. The Fed concludes the year’s meetings on December 12. A fourth pause at that meeting is today’s best guess...

...stay tuned



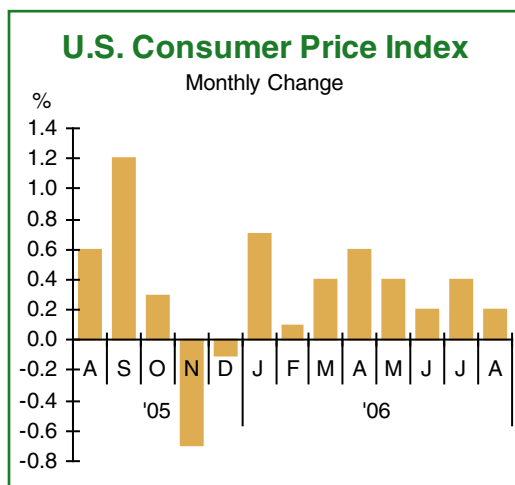
Inflation Less

U.S. inflation pressures moderated in August, one more puzzle piece suggesting the Federal Reserve's move to the sidelines on August 8 was a good call. Given the ongoing decline in oil prices, further progress in minimizing inflation pressures is on the horizon.

Consumer Prices

The Consumer Price Index (CPI) rose 0.2% in August, identical to the consensus forecast of economists. The August rise was half of the 0.4% rise in consumer prices as reported for July.

The 3.8% rise over the most recent 12-month period (year-over-year) was a modest improvement as compared to the 4.1% year-over-year rise reported for July 2006. It was a more substantial improvement versus the 4.3% 12-month rise reported for June 2006.



More importantly, the year-over-year rise to be reported on October 18 for September 2006 could easily fall to between 2.5% and 2.9%. Why?...Two primary reasons.

The first is that the ugly 1.2% inflation spike of September 2005 falls from the 12-month calculation. For example, if the CPI to be released for September 2006 was a rise of 0.2%, the year-over-year number would dive to 2.8%...(thank you for staying with me on this technical stuff).

Second, the sharp decline in oil and gasoline prices of recent weeks has yet to positively (in a good way) impact the CPI.

Should oil and gasoline prices remain low, the year-over-year CPI could be even more financial-market friendly.

Such favorable inflation news would further validate the Fed's "pause" in monetary tightening announced on August 8, following 17 consecutive tightening moves from June 2004 through June 2006.

The news regarding the "core" CPI (excluding volatile food & energy prices) was mixed. The 0.2% core rise for August was in line with expectations. It also followed four consecutive months of 0.3% increases. However, the core CPI has now risen 2.8% over the most recent 12-month period, up slightly from the 2.7% year-over-year rise reported for July 2006. The 2.8% core rise is the largest 12-month rise since December 2001.

Producer Prices

The Producer Price Index (PPI, a measure of wholesale inflation) came in below expectations, especially as the "core" rate was concerned. The PPI rose only 0.1% in August, matching July's rise. Producer prices are up 3.7% during the most recent 12-month period, a major improvement versus the 4.2% year-over-year rise in July, and especially versus the alarming 4.9% 12-month rise reported for June.

Similar to the CPI, the year-over-year comparisons will get much more financial-market friendly over the next two months. A 1.4% spike in September 2005 leaves the 12-month calculation in mid-October, while an additional 0.8% spike in October 2005 leaves the 12-month calculation in mid-November.

The "core" rate declined 0.4% as reported for August, in line with the 0.3% decline reported last month. The consecutive declines were the first in more than three years. The "core" PPI is up a modest 0.9% during the past year.

...inflation pressures are in decline

"TEA"sers

Signs

At an auto body shop:
May we have the next dents?

On a maternity room door:
Push...Push...Push

In a veterinarian's waiting room:
Be back in five minutes.
Sit! Stay!



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