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Your guide to understanding today's economy and financial markets

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Tugs of War

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

Long-term interest rates and oil prices have been embroiled in frantic tugs of war in recent weeks, as rising expectations of economic stabilization and an impending return to modest U.S. economic growth have pushed such rates and prices higher. Even higher long-term interest rates and higher oil prices could slow the economy and make the expected economic rebound even less dynamic than currently expected (see page two).

Mortgage Rates

Officials at both the Federal Reserve and the U.S. Treasury have been vocal in recent months in their desire to see long-term interest rates move lower as perhaps the most cost effective means of helping the nation's housing market to stabilize. A few months ago, the Fed announced a program to spend up to $1.1 trillion to buy U.S. Treasury notes and mortgage-backed securities as a means of pushing long-term rates lower.

The program had been somewhat successful as 30-year fixed-rate conventional mortgages averaged 4.82% between April 2 and May 21 *(Freddie Mac)*. Such rates averaged 4.91% for the period ending May 28, with many lenders quoting rates at and above 5.25%. By comparison, 30-year fixed-rate mortgages averaged 6.04% during May 2008.

Moreover, the yield (investment return) of 10-year U.S. Treasury notes rose to as high as 3.76% in recent days, versus 3.10% in mid-May and 2.50% in mid-March. Such rates, with the addition of roughly 1.50%-1.90%, are a reasonable proxy for 30-year fixed rate mortgages, although such a relationship has been broken at times during the past 18 months.

Long-term interest rates have moved higher as more and more signs of economic stabilization have emerged. Such rates have also moved higher as the reality of massive borrowing needs by the U.S. Treasury to finance a budget deficit approaching $2.0 trillion this fiscal year have pushed bond prices lower, with yields rising. Anxiety in some camps about rising inflation in coming years also led rates higher.

Whether the Fed increases its U.S. Treasury note and mortgage-backed security purchases, or whether the Fed sees rising long-term rates as one more sign of economic stability and impending growth—with no need for even greater Fed intervention—remains to be seen.

Oil Prices

Global oil prices in recent days have doubled those of just five months ago, with oil now trading above $68 per barrel. While recent higher prices don't compare to the $147 record high reached in July 2008, the recent doubling primarily reflects greater signs of U.S. and global economic stabilization, as well as rising expectations of a U.S. return to economic growth in coming months. A weaker U.S. dollar has also contributed to higher oil prices.

Stronger economic growth means greater demand for oil…hence higher prices. "Supply and demand" does work sometimes.

As with higher mortgage interest rates, rising oil prices could damage a fragile economic recovery. Were prices to reach and exceed $75-$80 per barrel, most U.S. economic growth estimates would be scaled back. Even higher prices, led by supply disruptions and/or further dollar weakness, could lead many forecasters to suggest that the current lengthy U.S. recession, now into its 19th month, could continue through the end of the year.

Our View

Our best guess suggests mortgage rates and oil prices could both move slightly higher in coming weeks…but not enough to spoil the U.S. economy's low-key, but most welcome "coming out of recession" party before year-end.

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Another Consensus View

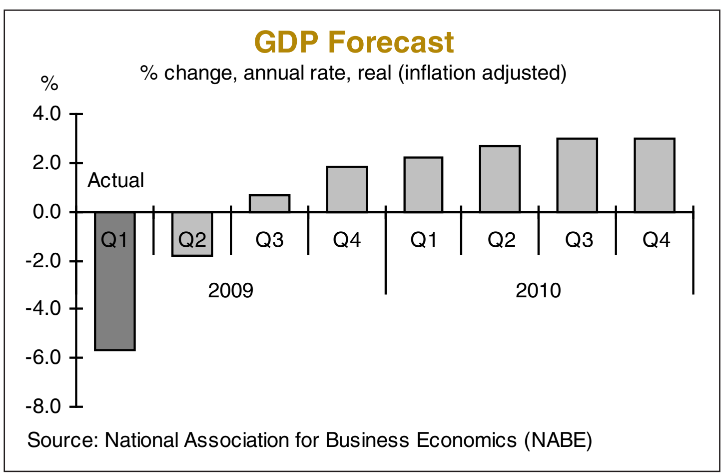
A thrice-annual survey of roughly 45 forecasting economists (including me) was released on May 27 by the National Association for Business Economics (NABE). Please note that the survey results are similar to those of two other national forecasting panels I serve on… *Blue Chip Financial Forecasts* conducted monthly and a quarterly survey by *USA TODAY*. The NABE survey results for GDP and employment are noted below…

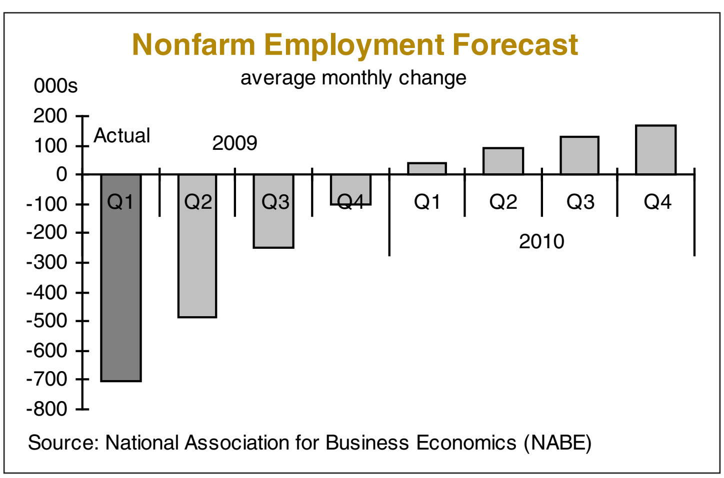
Highlights

- The NABE forecast panel expects a further decline in economic activity during the second quarter, making for the most severe economic contraction in over half a century
- The near-term weakness is largely due to a sharp retrenchment in business investment
- Rising government spending will provide vital support to the economy, as the only major expenditure area posting positive growth in 2009
- A modest second-half rebound in real GDP is still expected
- Growth in 2010 is slated for a return to near its historical trend, with real GDP rising 2.7% on a fourth quarter-to-fourth quarter basis
- Labor productivity remains impressive and is expected to improve

Also note that the U.S. Commerce Department in recent days revised its estimate of first quarter 2009 U.S. GDP (Gross Domestic Product, the most complete measure of all goods produced and services provided within U.S. borders) from a 6.1% real (after inflation) annual rate of decline to a 5.7% real annual rate of decline…

We Will Get Through This!





"TEA"ser

If you'd lose a troublesome visitor, lend him money.

—Ben Franklin

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