Tea Leaf

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Your guide to understanding today's economy and financial markets

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Fed Extension

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

President Obama made a solid choice yesterday to reappoint current Federal Reserve Chairman Ben Bernanke to a second four-year term. His initial four-year appointment by then-President Bush expires on January 31, 2010.

We noted in our *Tea Leaf* issue dated July 29 that such a move to reappoint Bernanke would be a wise choice. His reappointment was also supported by roughly 90% of forecasting economists. Changing horses in mid-stream is not usually a good idea…and especially this time…given the depth, slippery rocks, and icy temperatures that "Captain" Bernanke is currently steering the economy through.

The President noted that Bernanke *"has led the Fed through one of the worst financial crises that this nation and this world have ever faced. As an expert on the causes of the Great Depression, I'm sure Ben never imagined that he would be part of a team responsible for preventing another. But because of his background, his temperament, his courage, and his creativity, that's exactly what he has helped to achieve."*

The Fed Chairman thanked the President for his *"unwavering support for a strong and independent Federal Reserve."* Bernanke pledged *"to help provide a solid foundation for growth and prosperity in an environment of price stability."*

Federal Reserve Chairman Ben Bernanke

Challenges Ahead

This reappointment, as well as Bernnake's use of key terminology, was critically important because of the tough course that is yet to be followed by the Fed. At some point, the Fed will begin to withdraw much of the temporary monetary stimulus that has helped to stabilize the economy and financial markets.

These moves will be more of a two-step process than ever before. Unprecedented moves by the Fed, grouped under the banner of "quantitative easing," have been undertaken during the past two years to help domestic and global financial markets return to some level of normalcy.

Many of these moves have had the desired effect. Other markets remain more limited in scope and volume, requiring a continued Fed participation.

More public will be the Fed's first moves, expected by most forecasters sometime during mid-2010, to increase the federal funds rate from the record low target level of 0.00%-0.25%, which has been in place since mid-December 2008.

Rising Criticism

A possible series of modest tightening moves next year could draw strong Congressional criticism as it pushes financing costs higher. The Congress would make the case that "the Fed is taking the punch bowl away from the party just when the party in getting going."

Come to think of it, the Congress ALWAYS complains when the Fed is pushing its key interest rate higher. Such moves could also draw criticism from the Administration, although such views would likely be expressed behind closed doors.

At this same time of rising tensions between the Fed and our illustrious elected representatives, Bernanke is very likely to be increasingly critical of the enormous budget deficits now expected. He will make it clear that deficits of roughly $1,000,000,000,000 annually during the next decade are simply not affordable and would do great damage to this nation…

…touché

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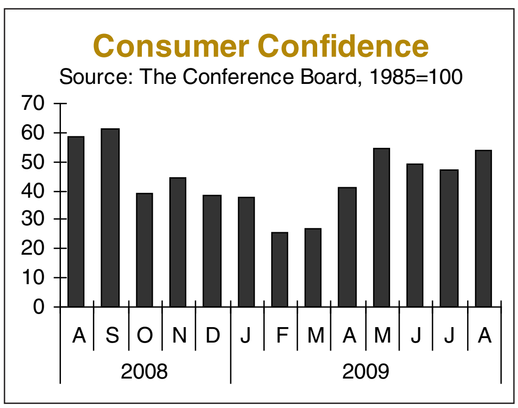
The Good, the (not so) Bad, and the Ugly

Three other economic items were newsworthy on August 25…

Consumer Confidence

The confidence of the American consumer regarding near-term and longer-term expectations rose sharply in August, following less-than-exciting data the prior two months. A more confident consumer is a key to longer-term U.S. economic performance as consumer spending still represents two-thirds of all U.S. economic activity.

The Conference Board Consumer Confidence Index, based on a survey of 5,000 U.S. households, rose to 54.1 in August, up from 47.4 in July. Consumer views as expressed in the Present Situation Index rose, reflecting some improvement in the nation's job market. The Expectations Index rose sharply to its highest level since December 2007, tied to a brighter economic assessment by consumers.



While rising confidence is a positive sign, we have a long way to go. The 54.1 August measure compares to an average of 57.9 during 2008. In addition, levels near 90 to 100 signal consumer expectations of strong U.S. economic growth…

still…it is a good sign

Home Values

The S&P/Case-Shiller Home Price Index (say that three times quickly) also recorded more upbeat information. After three solid years of decline, estimated home prices rose 2.9% during the second quarter when compared to the first quarter.

Yes, prices were down an estimated 14.9% when compared to the second quarter one year ago. Note, however, that first quarter home prices were down a more painful 19.1% when compared to the same quarter a year ago.

The S&P/Case-Shiller Home Price Index has been one of the more negative measures of home values in recent years. The Index suggests that the average American home value has plunged roughly 32% since peaking in the summer of 2006.

As one might expect, the sharp decline in home prices has led to more people being able to buy a home…if they still have a job. The combination of sharp home price declines and historically low mortgage interest rates, when compared to average family incomes, now suggests the highest level of housing affordability in a generation. Numerous housing markets are seeing much stronger levels of buying interest, particularly in California…

…another good sign

Budget Deficits

Spoiling the party is the latest estimate of budget deficits during the next decade, which are simply scary…

We can live with budget deficits averaging $150-$300 billion annually…as bad as that is…we have done it for years. In my view, we cannot live with deficits averaging $1,000,000,000,000 EACH year.

The White House now says the projected deficit over the next 10 years will reach $9.05 trillion, roughly $2 trillion higher than its estimate earlier this year. The culprits are a more serious economic downturn than expected previously, higher joblessness, and less aggressive forecasts as to future U.S. economic growth.

One piece of good news in the report, as well as found in a similar estimate by the Congressional Budget Office, is that the projected deficit for the current fiscal year, which ends on September 30, is now "merely" $1.58 trillion, down $263 billion from the projection in May. The reason is $250 billion included in the earlier estimate for an additional bank bailout is no longer needed…

…at least that's a good sign

"TEA"ser

All the world is mad save for me and thee, and sometimes I wonder about thee.

—Old Quaker saying

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