



Contact:
 Thomas D. Higgins, PhD
 Chief Economist
 ph: 213 830-4302
 email: thiggins@payden-rygel.com

Fed's Semi-Annual Outlook

- Goldilocks Scenario Remains Intact** The combination of near trend economic growth and moderating inflation, popularly known as the "Goldilocks" scenario, is set to continue.
- Less Growth...** Real GDP growth to expand roughly 2-1/4 to 2-1/2% this year and 2-1/2 to 2-3/4% in 2008, which is about 1/4 percentage point lower than what the Fed projected back in February.
- Subprime Politics** The Fed Chairman devoted nearly half of his testimony to addressing subprime lending and regulatory concerns.

Testimony of Fed Chairman Ben Bernanke

Today, Federal Reserve Chairman Ben Bernanke testified about the outlook for the US economy as well as monetary policy before Congress. As we expected, the Fed lowered its forecast for economic growth in 2007 and 2008 due to the ongoing drag from housing. But to our surprise, the central bank left its forecast for inflation unchanged despite the recent easing of several key price gauges.

Even so, the Fed continues to see core inflation, which excludes food and energy, falling into its 1% to 2% comfort zone by 2008. The combination of near trend economic growth and moderating inflation, popularly known as the "Goldilocks" scenario, sparked a modest rally in the Treasury market with 10-year bond yields dropping from 5.06% to 5.03%. However, stocks were mixed due to disappointing earnings reports and some profit-taking following the recent run-up.

Fed's Forecast: Less Growth...Less Inflation

The Fed's central tendency forecast is for real GDP growth to expand roughly 2-1/4 to 2-1/2% this year and 2-1/2 to 2-3/4% in 2008, which is about 1/4 percentage point lower than what the Fed projected back in February. Mr. Bernanke said the downward revision was "largely the result of weaker-than-expected residential construction activity this year."

The Fed left its forecast for inflation unchanged and continues to see the core personal consumption expenditures (PCE) deflator averaging between 2 and 2-1/4% for 2007 and 1-3/4 to 2% in 2008. Mr. Bernanke said that "with long-term inflation expectations contained, futures prices suggesting that investors expect energy and other commodity prices to flatten out, and pressures in both labor and product markets likely to ease modestly, core inflation should edge a bit lower, on net, over the remainder of this year and next year."

Forecast Risks: The Two-Handed Economist

In typical economist form, the Fed Chairman cited both upside and downside risks to his economic growth forecast. On the one hand he said, "The ongoing housing correction might prove larger than anticipated, with possible spillovers onto consumer spending." But, on the other hand, "consumer spending, which has advanced relatively vigorously, on balance, in recent quarters, might expand more quickly than expected."

On the inflation front, Mr. Bernanke reiterated that upside risks to inflation are the Fed's predominant policy concern. The Fed Chairman worried that "energy and commodity prices could continue to rise sharply, leading to further increases in headline inflation and, if those costs passed through to the prices of non-energy goods and services, to higher core inflation as well."

Subprime Politics and Financial Markets

The Fed Chairman devoted nearly half of his testimony to addressing subprime lending and regulatory concerns. This was probably motivated more by politics than economics. As we mentioned yesterday, Congressman Barney Frank, who chairs the Committee on Financial Services, has made subprime his cornerstone issue. Unfortunately, any changes in the regulatory environment at this stage will come too late to help the millions of homeowners facing resets on their adjustable rate mortgages (ARMs) in 2008.

Mr. Bernanke seemed unfazed by recent financial market volatility in the wake of the subprime mess. Although he noted that credit spreads on lower-quality corporate debt have widened somewhat, they remain near the low end of their historical ranges, and financing activity in the bond and business loan markets has remained fairly brisk.