EconomicView

Payden&Rygel

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

Highlights

- Fed reduces the federal funds rate 25 basis points to 4.50%.
- FOMC adopts a neutral bias, saying the "upside risks to inflation roughly balance the downside risks to growth."
- Although economic growth was "solid" in the third quarter, the FOMC expects the "pace of economic expansion will likely slow in the near term."
- Softer economic data could prompt the Fed to cut interest rates again by the beginning of next year.

Market Bullies Fed Into Cutting

In recent weeks, the financial markets have been like a playground bully, sitting on the Fed's chest waiting for Ben Bernanke to hand over his Halloween candy. Well, today they got their wish as the Federal Open Market Committee reduced its benchmark lending rate by 25 basis points to 4.50%. The vote was 8 to 1 in favor of the cut with Kansas City Fed President Thomas Hoenig the one stalwart who preferred no change.

In the statement accompanying the announcement, the Fed said, "Economic growth was solid in the third quarter, and strains in financial markets have eased somewhat on balance." Indeed, ahead of the Fed meeting, the Commerce Department reported that real gross domestic product (GDP) rose at an annual rate of 3.9% in the third quarter of 2007. The key drivers of economic growth were consumer spending and exports, while housing remained the primary drag. Export growth alone accounted for nearly half the increase in GDP as the weaker dollar made US products more attractive to overseas consumers.

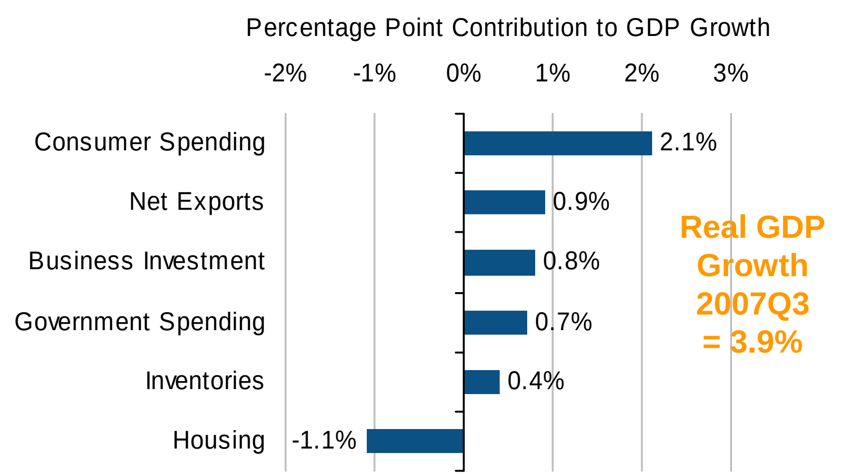
As Good As It Gets?

However, this GDP report is largely old news and does not reflect the lagged effects of higher energy prices and the credit crunch. The Fed also acknowledged this in their statement noting that "the pace of economic expansion will likely slow in the near term, partly reflecting the intensification of the housing correction."

We have already witnessed the initial effects of the credit crunch on the home sales data. In the coming weeks, the Fed will be watching for signs of spillover effects from the downturn in housing on the rest of the economy, particularly the consumer. The central bank is well aware that roughly $1 trillion in adjustable-rate mortgages will be resetting to higher interest rates in the coming months. The Fed also knows that additional layoffs of construction workers, real estate agents and mortgage brokers are in the pipeline.

Looking ahead, the Fed adopted a neutral policy bias saying that "after this action, the upside risks to inflation roughly balance the downside risks to growth." This leaves us data-dependent as we approach year end. The Conference Board reported earlier this week that consumer confidence slipped in October, the question is whether this loss of confidence shows up in the form of weaker holiday retail sales numbers. If the data come in softer in the next couple of months, as we suspect, then the Fed could be cutting interest rates again by the beginning of next year.

Consumers and Exports Drive Growth in Third Quarter



Source: Bureau of Economic Analysis
Numbers may not add to total due to rounding.