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Highlights

- Fed Chairman Ben Bernanke testified before Congress about the US economic outlook, emphasizing that the risks to economic growth and inflation were roughly balanced.
- Investors zeroed in on the Fed Chairman's comment that "the growth of economic activity would slow noticeably in the fourth quarter."
- We continue to believe that resets of adjustable rate mortgages and lay-offs in housing-related industries will prompt further Fed easing by early next year.

Fed Chairman Bernanke Puts In His Two Cents

Today, Federal Reserve Chairman Ben Bernanke testified before the Joint Economic Committee of Congress about the US economic outlook. In his prepared remarks, he emphasized that the risks to economic growth and inflation were roughly balanced, echoing the policy statement released after the Fed's October 31 meeting. Mr. Bernanke also noted that there has been "scant evidence of spillovers from housing" on to other sectors of the US economy.

However, investors zeroed in on the Fed Chairman's comment that "the growth of economic activity would slow noticeably in the fourth quarter" and the US economy would remain "sluggish during the first part of next year." After that, the Fed expects the economy to strengthen as the drag from tight credit conditions and housing wanes. In our view, the Fed may be underestimating the effects of resets on adjustable rate mortgages and lay-offs in housing-related industries on consumer demand. Therefore, we believe further easing of monetary policy will be necessary before the US economy turns around.

The initial reaction of financial markets was mixed with stocks selling off and bonds rallying. The S&P 500 stock index was down more than 1.5%, before turning around and ending the day unchanged. By contrast, Treasury prices rose immediately and yields fell especially at shorter maturities, resulting in the steepest yield curve since February 2005.

During the Q&A, several members of Congress chose to make statements rather than ask questions of the Fed Chairman. For example, Loretta Sanchez (D - California) let Mr. Bernanke know that she has an 800 credit score and can't get a home loan. Ron Paul (R -Texas) complained that the Fed is debasing the value of the US currency and making Americans worse off. In between, Mr. Bernanke shared his views on some of the key issues facing the US economy. We highlight some of his main points below.

Question 1: What Is the Likelihood of Recession on a Scale of 1 to 10?

The Fed Chairman said that economists are notoriously bad at predicting turning points, but that the economy had demonstrated remarkable resilience outside of housing. Mr. Bernanke's best guess is that growth will be slower but moderate in the coming months and that inflation will be in a range consistent with price stability next year. However, the Fed Chairman noted there are considerable risks to this forecast. Consequently, Mr. Bernanke said the central bank cannot be dogmatic in its views and instead must be flexible in interpreting new information on the economy.

Question 2: What are the Risks Posed by China's Diversification of Reserves?

Mr. Bernanke said he does not believe there will be any broad changes in the composition of global foreign exchange reserves. The US dollar will remain the dominant holding of most central banks. Financial markets in United States are still deepest and most liquid in the world and trade in third countries is often still invoiced in dollars. He expects these trends to continue.

Question 3: Do Declining Home Prices Pose a Risk to Consumer Spending?

Mr. Bernanke said the Fed does not take an alarmist view on this issue. He estimates that the wealth effect from declining home prices on consumer spending is approximately 4 to 9 cents per dollar decline in home prices. He pointed out that while falling home values and high oil prices are certainly negatives for consumer spending, the relatively healthy labor market and strong income gains should be supportive in the coming months.

Question 4: Is Raising the Conforming Loan Limit for Government Sponsored Enterprises (GSE) A Good Idea?

Mr. Bernanke said he would support a temporary increase in the conforming loan limit for Fannie Mae and Freddie Mac perhaps to as high as $1,000,000 with the Federal Government acting as a guarantor. However, he was against taking any actions that might endanger safety and soundness of the GSEs.

Question 5: Can the Master Liquidity Enhancement Conduit (M-LEC) Help Speed Up the Price Discovery Process on Some of the More Obscure Structured Products?

Mr. Bernanke said M-LEC could help speed the price discovery process, but it depends on how it is executed. If it involves the oversight by investors and a range of financial institutions, then ideally the assets would go into the M-LEC at fair or market value. If it works properly, it would speed up the recognition of valuations in part because it would remove some of the risk of fire sales and allow the markets to stabilize.

Question 6: Should We Be Worried About Sovereign Wealth Funds?

Mr. Bernanke said that the G-7 had already been discussing the establishment of a code of conduct for Sovereign Wealth Funds, which included criteria on transparency, governance, and ensuring investment decisions are economically motivated by profits. In return, the United States should keep our markets open and allow SWFs access to Rockefeller Center if that is what they want to buy next.