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Watching the Economy: Has the Smoke Cleared? Not Yet

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The story goes that a central banker—maybe the Chairman, himself—walked into a pizza parlor and ordered a large pie to go. While waiting, he pored over literature describing the current state of the economy. When the pizza was ready, the chef asked, "Do you want that as eight or twelve slices?" The central banker answered, "I'm feeling pretty hungry. You better slice it into twelve."

Now, I don't know if that ever really happened, but it does illustrate the dilemma faced by the Fed. While they deliberate and we await—on pins-and-needles—their next decision, the economic dice may very well have already been cast. For the near-term—the next four to six months—there may not be anything that the Fed can do to alter or affect immediate patterns in the economy. Like the central banker's pizza, it can be sliced any number of ways—but it remains only so big. A broad series of fundamental indicators continue to point toward solidifying economic recovery. At the same time, several factors—including slow-to-subside unemployment, unsettled and shaken consumer confidence, real and psychological perceptions regarding the stock market and the sliding value of the dollar against foreign currencies—continue to undermine or at least slow the recovery.

In light of these mixed factors, expect interest rates to remain largely unchanged over the near-term. The Fed wields considerably less immediate influence over the economy, after last year's

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eleven Federal Funds rate cuts, with the rate remaining at 1.75 percent—a 40-year low. Additional cuts, in the present low inflation environment, would not have the necessary clout to accelerate economic growth more than is already the case. At the same time and in the opposite direction, the pace of recovery and expansion is unlikely to require an interest rate hike anytime soon, to rein in runaway growth. Eventually, however, the Fed will look toward controlling and moderating growth via interest rate policy levers. As a result, current interest rate forecasts continue to call for a 35 to 75 basis point increase in short rates for the remainder of the year, with longer rates climbing less. The outlook for 10-year Treasuries still falls near the middle of that range.

As for market rates, which may anticipate and precede Fed actions or may follow in response, similar static conditions prevail for now. While it is true that interest rates and the stock market often move in opposite directions, the actual determinants of interest rates include factors such as the anticipated rate of inflation (low) and exchange rates (falling dollar), as well as the supply of funds that flow in and out of the markets. There is little evidence that market set interest rates are poised to rise anytime soon, while any downward drift is likely to be modest and unsustainable.

In a word, enjoy the summer. Housing markets will remain active due to volume restrictions—that is, supply and demand imbalances. Interest rates are unlikely to upset the apple cart over the next few months. By the third-quarter—early fall—there may be some upward bias, but at present, inflation—and other—pressures remain checked.

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