Weekly Economic Commentary

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What Did the Fed Know on April 28?

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ECONOMIC CALENDAR

Monday, May 17
NY Fed Empire State Mfg
May

NAHB Housing Survey
May

Tuesday, May 18
Housing Starts
Apr

PPI
Apr

Wednesday, May 19
CPI
Apr

FOMC Minutes
(April 28 Meeting)

Thursday, May 20
Initial Claims
Wk 05/15

Philly Fed Index
May

Leading Indicators
Apr

Highlights

- European worries overshadowed another strong week for economic data in the United States.
- The economic data in China for April suggests more policy tightening is on the way.
- The minutes of the April 28 Federal Open Market Committee (FOMC) meeting could help to answer the question: What did the Federal Reserve (Fed) know on April 28?

Questions lingered last week about European economies and debt markets, including concerns as far reaching as the potential for a breakup of the Eurozone. This concern among market participants and policy makers came despite the historic $955 billion European loan guaranty package unveiled a week ago.

As a result, another very good week of U.S. economic data was overshadowed. The United States economic data continues to suggest that the U.S. economy is on track to post stronger growth in the second quarter of 2010 than it did in the first quarter.

Despite the promising tone of the U.S. economic data, and the nearly $1 trillion loan package from the European Union (EU) and International Monetary Fund (IMF) last week, concerns mounted over the course of last week about what impact a widening-out of the Greek debt crisis would have on the United States and global economies. We highlighted these concerns in last week's (May 10, 2010) Weekly Economic Commentary, but they are worth repeating in this week's commentary, given all the attention the issue has received from markets over the past week.

- Will global liquidity dry up—as it did in the wake of the collapse of Lehman Brothers in the fall of 2008—and lead to another deep global recession?
- Will Greece default on its debt and, if so, what would that mean for other countries in the Eurozone and the entities (both public and private) that hold Greek debt?
- Will the entire Eurozone—, which accounts for 15% of all U.S. exports—tip over into a recession as a result of the debt crisis, thus robbing the nascent economic recovery in the United States of a key engine of growth?

As we noted in last week's Weekly Economic Commentary, the European economies are not out of the woods yet. European countries face the need to reign in still unacceptably high budget deficits, which will dampen growth in Europe relative to the United States and Asia. In addition, the funds flowing from the stronger European nations (Germany and France) to support the $955 billion in loan guarantees diverts funds away from more pro-growth policies like job creation, further dampening economic growth in the Eurozone.

The data released last week in the Unites States was largely overshadowed by the events (both positive and negative) in Europe. Taken together, last week's U.S. economic data on:

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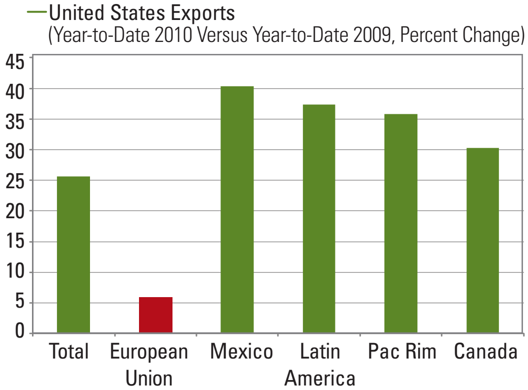
1 United States Exports Are Booming, With No Help From Europe



Source: U.S. Department of Census; Haver 5/17/10

- Retail sales,
- Industrial Production,
- Consumer Sentiment,
- Merchandise trade, and
- The budget deficit

for April and May suggest that the U.S. economy remains on track to post more robust growth in the second quarter of 2010 than it did in the first quarter, when real Gross Domestic Product (GDP) grew at a 3.2% annualized rate versus the fourth quarter of 2009. In short, the U.S. economy continues to transition from recovery to sustainable growth.

One of the key economic reports in the United States last week was the merchandise trade report for March. While the March merchandise trade deficit came in right at expectations, and close to the U.S. governments first look at real GDP in the first quarter of 2010, the components of the March trade report underscore that the global economic recovery has clearly stalled in some areas. In the first three months of 2010 (versus the first three months of 2009), overall United States exports are up +25%, but the regional differences in our exports are a stark reminder of the ongoing economic woes in Europe.

For example, U.S. exports to Pacific Rim nations were up 36% in the first three months of 2010 versus the first three months of 2009, while exports to Latin America were up 37%, exports to Canada (+30%), and Mexico (+40%) boomed. However, exports to Europe and the U.K. in the first three months of 2010 relative to the first three months of 2009 were up just 6%. Thus, the good news is that the export-led U.S. economic recovery has blossomed despite very weak exports to Europe. The bad news is that Europe (to which the U.S. ships 15% of its exports) is slowing, and the tighter caps on government spending put in place in recent weeks will likely slow growth further.

The bulk of the April economic data in China was released last week. Market participants continue to parse the data looking for signs that the Chinese authorities' actions to slow the economy (which began in late 2009) have taken hold. On that front, the April data was a mixed bag. About half of the April reports (bank loans, money supply growth, industrial production, investment, retail sales, and inflation) were stronger than expected, but two-thirds of the reports showed accelerating activity between March and April. The three reports of particular interest to markets were the reports on bank loans, money supply, and inflation. While bank loans surged by more than expected in April, money supply growth continued to decelerate. The April inflation data showed more acceleration, but no spike in consumer prices in April. We still expect China to allow some movement in its currency and raise interest rates over the next few months, although continued economic and policy uncertainty in Europe may delay, but not indefinitely postpone, any actions by Chinese authorities.

Our View on the Key Reports and Events of the Coming Week:

Looking ahead, this week is another busy one for economic data in the United States, Federal Reserve policy, and global central bank meetings. However, we expect the turmoil in Europe to continue to dominate the headlines.

The economic data due out in the United States this week includes data on:

- Manufacturing for May (Empire State and Philly Fed),
- Housing for May (the National Association of Homebuilders sentiment index) and April (housing starts),
- Consumer and Producer prices for April (PPI and CPI), and
- Leading indicators for April.

The key event this week in the United States is likely to be the May 19 release of the minutes and economic forecast from the April 28 meeting of the FOMC, the Fed's policymaking arm. The FOMC minutes provide an elaboration on the brief comments made in the FOMC statement that is released the day each FOMC meeting concludes.

The FOMC established new forecast ranges for key economic variables—GDP growth, the unemployment rate, overall inflation, and core inflation (inflation excluding food and energy prices)—at the April 28 FOMC meeting. These forecasts and how they have changed since the last time the FOMC published a forecast (February 17, 2010 in the minutes following the January 26-27 FOMC meeting) may be the next key event for monetary policy.

In addition, the market will be quite keen to read the minutes of the April 28 FOMC meeting for clues about how the turmoil in Europe influenced the FOMC's deliberations on monetary policy. Recall that when the FOMC released its statement on April 28, it suggested to markets that they were in no hurry to raise interest rates anytime soon.

Hopefully, the release of the April 28 FOMC minutes will provide the markets with more clarity on these important issues.

What caught our attention in the statement was the FOMC's tepid acknowledgement of the progress of the economic recovery in the United States that left some market participants, ourselves included, wondering: What does the Fed know that we don't know?

At the time of the April 28 meeting, market participants debated whether or not the Fed was worried about:

- Contagion in Europe from the Greek debt crisis,
- More fallout from the state and local budget crisis here in the United States,
- Weak commercial real estate market hurting small and regional banks in the United States,
- In addition, ongoing debate around financial services reform impacting the ability of the financial sector to provide credit to businesses.

We pointed out that the Fed was probably worried about all of those items, plus others, as the economy continues to recover from the worst recession since the Great Depression of the 1930s. Hopefully, the release of the April 28 FOMC minutes will provide the markets with more clarity on these important issues.

The next FOMC meeting is on June 23. The FOMC meets eight times per year, roughly every six to seven weeks.

In addition, six central banks, including the Bank of Japan and the central banks of India and Mexico will meet to decide policy this week. Of this group, only India is in tightening mode. In general, over the past week, markets have pushed back the onset of the first monetary policy tightening here in the United States, and scaled back their bets for further tightening by the central banks that are already raising rates (Australia, India, Israel, etc). This is largely the result of the potential slowdown in global growth due to the still unresolved economic and policy turmoil in Europe.

Consumer Price index (CPI) is a measure estimating the average price of consumer goods and services purchased by households.

Producer Price index (PPI) tracks inflation by measuring price changes.

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