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Time for Bold Action

Recent data shows the economy remains weak. August hiring, as well as retail and auto sales in the United States were all limp. European business confidence and manufacturing growth was lower. Chinese production and exports are softer. Growth forecasts are being cut. The Fed sees downside risks to growth, and the International Monetary Fund sees a weaker outlook too.

The choice now facing policymakers is between *gradual* or *bold action* in light of the weaker economy and more fragile markets.

The Fed "Twists"

Last week, we saw the Federal Reserve dig deep into their tool kit for new ways to prod along a weak economy. They turned to a strategy dubbed "operation twist," where the Fed buys longer-term Treasury bonds ($400 billion) and sells an equal amount of shorter-term Treasuries to finance the purchase. The intent of these actions is to promote lower longer-term borrowing rates for home mortgages, corporate borrowings, and other debt. This, coupled with a pledge to continue to support the mortgage market, is expected to help boost the economy.

The Fed stopped short of adding new dollars to the system by expanding the size of their holdings, as they did last year. At that time, the Fed bought $600 billion of bonds with newly created reserves in what became known as "Quantitative Easing 2," or "QE2." Those purchases were often credited for helping stocks and commodities to rally through the later part of 2010 and early 2011 at the expense of the dollar. This time, since the Fed did not go so far as to create any new dollar reserves, the market reaction was different. Instead of rallying after last week's announcement, stock and commodities fell sharply while bonds and the dollar rose. The market apparently wanted bolder action.

Markets Want More

Inflation expectations and stock prices sank after the Fed's announcement of "operation twist," and both are near 52-week lows. Markets seem convinced that weak growth and weak prices are in store for the global economy in the months ahead, and there is now a good deal of guessing about what the Fed might do next. Some guess that the Fed may choose to raise its stated "comfort zone" for inflation in order to drive consumers to borrow and spend, given expected price increases. In addition to talking about higher inflation, a third round of "quantitative easing" remains a potential tool should inflation expectations and the economy slip further. These would be bold, albeit controversial, next steps for the Fed's monetary policy at a time of slow growth and already very low interest rates.

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How has all of this translated into real dollars in the economy? One way is by providing some incremental benefit to a housing market that is central to much of what ails the U.S. economy. By our estimate, housing affordability is much improved, given lower prices and lower interest rates for those qualified borrowers looking to purchase a home.

Real Dollars for Consumers:

Mortgage Rates and Housing Affordability (Now vs. 2006)

The average interest rate on a 30-year fixed mortgage stands at a record low 4% compared to 6% back in 2006 and 5% earlier this year. The interest savings relating to a home purchase is not small. We estimate that the annual payment to own an average home in the United States is now around $9,960 compared to $15,540 back in 2006 (see table). More affordable housing is not an immediate fix for the economy, but should provide benefits to households and the housing sector through refinancing and less costly mortgages for qualified borrowers seeking to buy a home.

U.S. Housing, Mortgage & Income Data	2006	Today
Average U.S. Home Price	$270,000	$217,000
Average 30 Year Mortgage Rate	6%	4%
Mortgage Amount (Assuming 20% Downpayment)	$216,000	$174,000
Monthly Mortgage Payment	$1,295	$830
Annual Mortgage Payments	$15,540	$9,960
Median U.S. Household Income	$48,201	$49,445
Annual Mortgage P&I as Percent of Income	32%	20%

Sources: National Association of Realtors; Bankrate.com; U.S. Census Bureau

Gasoline and Commodity Prices

Average national gas prices are down to $3.54 per gallon from $4.00, and oil prices have fallen to below $80 from $115 since last spring. Commodity prices, generally, are off 20% based on the CRB Commodity Index. Although there is no one-to-one relationship between prices at the pump and the economy's growth rate, it stands to reason that consumers feel better and have more discretionary income to spend as a result. A salve on disappointing consumer spending trends could result.

Conclusion

Policymakers are soon going to have to make a choice. The choice is between gradual or bolder steps toward reviving global growth and market confidence. Restoring faith in Europe's financial system and avoiding deflation must be job number one. For now, our indicators continue to trend toward weakness, but we are watching for signs of improvement. Lower interest rates, fuel, and commodity prices may help over time. Prompt, decisive, and credible policies that restore market confidence would go even further toward reversing current trends and furthering growth into 2012.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

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