

# The Boiled Frog and the Fed?

## U.S. Economic and Interest Rate Outlook



As Director of Economic Research, **Paul Kasriel** is responsible for making the corporation's economic and interest rate forecasts, which have ranked in the top five of the Blue Chip Survey for accuracy in recent years. Kasriel is also the co-author of the book "Seven Indicators That Move Markets."



Illustration by John Labbe/Getty Images

"They say that if you put a frog into a pot of boiling water, it will leap out right away to escape the danger. But if you put a frog in a kettle filled with cool water, then gradually heat the kettle until it starts boiling, the frog will not become aware of the threat until it is too late."

**W**e wonder if the Fed's forecast of 2006 U.S. economic growth is akin to the boiled-frog folklore. The Fed has been gradually raising short-term interest rates since the end of June 2004. The Fed funds futures market is pricing in still another 25 basis

point increase by the end of June. If so, this would make 16 consecutive gradual increases of heat under the kettle.

We believe the kettle is already simmering. If the Fed pushes the funds rate up to 5%, we believe the water could come close to boiling,

which might bring on cardiac arrest for the economy. Yet the Fed's forecast for 3.5% fourth quarter-to-fourth quarter real gross domestic product (GDP) growth this year is a bit higher than last year's actual growth of 3.2%.

### **First Quarter to Rebound, But Growth Trend Slows**

After nearly stalling in the fourth quarter of last year, we are forecasting a sharp rebound in first-quarter real GDP growth — around 4.5% quarter-to-quarter annualized. The warm weather in January allowed more economic activity than otherwise would have occurred, and because December consumer spending was considerably higher than the average for fourth quarter, consumer spending on a quarterly average basis is arithmetically biased upward for the first quarter.

Our proprietary GDP forecasting model shows that the trend of economic growth has definitively turned down. Our forecast of 4.5% quarter-to-quarter annualized real GDP growth in first quarter 2006 represents a 3.4% growth over first quarter 2005. If we feed this into our model, it forecasts year-over-year real GDP growth for the second quarter about 75 basis points lower than what it had forecast for the fourth quarter of last year.

Our model's forecasted values have been running above the actual values since about 2000, but it has been directionally correct. If the model is directionally correct this time but continues to forecast on the high side numerically, the coming dip is likely to be more severe than the Fed currently is bargaining for. Making an adjustment for the model's tendency to miss on the high side, it is forecasting second quarter year-over-year real GDP growth to be 2.65%.

While we would not be so foolhardy to take our model's forecast literally, we do respect its qualitative message — if the Fed gradually turns up the heat much more, this frog is going to die.

### **Slowdown Led by Cooling Housing Market**

We have expected the economic slowdown to be led by a cooling in the red-hot housing market

and a moderation in consumer spending. And we are seeing signals to that effect, especially in the housing market.

Existing home sales have been down in four of the past six months. Mortgage applications for home purchases (rather than refinancing existing mortgages) are down 25% from their early-June peak. At the same time, the supply of housing is strengthening — not exactly great fundamentals for home construction and home prices. In fact, despite the warm January, nominal expenditures on private residential construction were up only 0.2% month-to-month in January.

Motor vehicle sales, without the January boost from the car rental companies, slumped 5.8% in February. And non-motor-vehicle retail sales are not shaping up to be very good either. SpendingPulse, a retail spending data service of MasterCard, puts its seasonally adjusted measure of non-auto retail sales down 0.2% in February. So, although growth in consumer spending in the first quarter will be quite strong, based on February data, we could be limping into the second quarter.

In sum, we continue to believe economic growth is in the process of moderating to a rate below its potential of 3.5%.

### **Inflation Trending Down; Fed Should Lower Heat**

Inflation historically has tended to be a lagging economic process. If this continues to be true, economic growth must be on the down slope because core consumer inflation is trending lower. With energy prices softening, the Fed ought to be even less concerned about core “pass-through” inflation. Unit labor costs are once again trending lower, too, which should also ease Fed inflation concerns.

This leads us to believe the Fed should step away from raising the interest-rate “heat” under the economic pot to avoid boiling the frog. We also think the Fed will be lowering the temperature by dropping rates some time this fall. ■