NEW MINERVA REPORT

Fed Change

One small announcement has sent a slight shiver down the spine of many of the world's stock markets. No it is not that Hutton has exonerated the government. No it's not that there are no weapons of mass destruction . Not that George Bush would like to know where they are like as everyone else. In fact it is nothing to do with WMD. the announcement came from the US Federal Reserve after its open market committee meeting on 28th January. The Fed decided to leave interest rates unchanged just as the markets had expected. But it made a slight change to its wording. Previously, the Fed had said that these historically low levels of interest rates could be "maintained for a considerable period". As far as the markets were concerned this meant that rising interest rates were not something about which they need concern themselves. Now the new Fed statement said that "it can be patient in removing its policy accomodation". This immediately puts the concept of an interest rate rise on the radar for investors. There is no doubt that monetary policy is very loose. There was an old rule of thumb that said that if interest rates were lower than the nominal GDP growth rate, that policy was expansionary. With 3rd Quarter GDP Growth of 8.3%, less inflation, nominal GDP was nearly 7%. Even with 4th Quarter GDP at a slower rate of 4%, to get to a neutral policy stance interest rates would need to rise by nearly 3%. Don't worry we don't expect the Fed to raise rates by this much in the foreseeable future.

What the Fed is trying to do is influence the markets with a softly softly approach. For example in their previous FOMC they changed the rhetoric from saying falling inflation is a greater risk than rising inflation. The last thing the Fed wants is a repeat of the 1994 sell-off we saw in fixed interest markets. Unlike in the UK where personal borrowing is nearly all hit by moves in short term interest rates in the US it is longer term rates that effect it. The 10-year interest rates rose last summer from 3.2% up to 4.5%. They are currently moving around the 4.2% level. This shows how steep the yield curve is. (Short rates are at 1% rising to 10-Year rates at 4.2%). It could therefore be argued that short rates could be pushed up with out upsetting borrowers. Whilst the consumer's biggest borrowing is a mortgage, there are others that would be affected by a rise in short term rates. The Fed also knows that raising short term rates does not necessarily mean that the yield curve would just flatten, sentiment could deteriorate and all yields could rise.

The Fed is really trying to position itself so that if the economy does require rising rates later in the year it can do so without creating a shock to markets which could derail any economic growth. It is also mindful of the fact that there is no certainty the economy will be able to jump the gap of being impelled by the stimuli it has been given, to having a momentum to carry on on its own.

MAKING THE JUMP

This is what is currently occupying the minds of many professional investors. Can the US economy establish a momentum of its own? There is a wonderful picture described by Bill Mott of Credit Suisse which encapsulates this question. He describes the archetypal American consumer as 'Joe Six Pack'. Bill says, "Joe Six Pack looks increasingly like the athlete whose normal capacity is to do 50 press ups. Interest rate cuts have acted like an anabolic steroid enabling him to increase his output to 200 press ups. The trouble is he is now 'limit up' on anabolic steroids, any increase in dosage will kill him. However, if the anabolic steroid is removed (interest rates rise) Joe's muscular strength will wither to such an extent that he won't be able to achieve 10 press ups." Just to complete Bill's picture, in the UK he has 'Romford Ron' who is in the same position as 'Joe Six Pack'.

Although the US and UK governments are doing all they can to become a larger part of the economy. (The consumer currently represents around 70% of GDP.) The government deficits being created will stop them being able to contribute much further. The Official Congressional Budget Office forecasts that the US Government finances have swung from an estimated 10-year surplus of $5.6 trillion in 2001 to a projected deficit of $3.8 trillion by late 2003. That is the equivalent to an extra $42,000 for every American adult. That's not bad for an American president who said he was committed to self-responsibility. He promised to bring in a new era. For too long, he said, American Society had followed mottoes like, "If you've got a problem, blame it on somebody else." But of course the deficit was not the administrations fault. "The reason we are where we are is because we went through a recession, we were attacked and we're fighting a war", he tells us.

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