Economic Review

Issue XXVII
July 2007

Nicholas S. Perna **Economic Advisor**

National Outlook

What's behind the recent run up in long-term interest rates? I don't think it is inflation fears! Hence, there's still room for the Federal Reserve to be able to cut short-term rates later this year even if bond yields rise a bit more.

The 10-year note is the most important security issued by the Treasury. It sets the borrowing costs for fixed-rate home mortgages since the ultimate purchasers of these securities view the risk-free Treasury obligation as an alternative investment. Furthermore, holders of mortgage-backed securities, especially Fannie Mae and Freddie Mac, use the Treasury note to hedge their exposure to changing interest rates. Their huge volumes of hedging sales and purchases often amplify changes in Treasury bond yields.

10-year U.S. Treasury Note Yields (%)

	4/06	4/07	6/25/07
Coupon Note	4.99	4.69	5.09
Minus: TIPS	2.41	2.26	2.67
Equals: Expected Inflation	2.58	2.43	2.42

The interest rate on the benchmark 10-year Treasury note rose about 50 basis points (bp) from April to June. One popular explanation for this rise is that fears of inflation have increased.

However, this explanation doesn't really fit the facts. You can get a very good measure of expected inflation by comparing the yield on 10-year coupon notes with TIPS (Treasury Inflation-Protected Securities) of the same maturity. That's because the only major difference between the coupon notes and TIPS is that the latter are *fully* protected from future increases in the Consumer Price Index. The spread may understate expected inflation a little because the much smaller TIPS market is less liquid and TIPS are slightly less attractive from a federal tax point of view.

Nonetheless, changes in this spread should give a good indication of shifts in expected inflation. My bathroom scale is off by a few pounds, but it does tell me whether I'm losing or gaining weight. (In case you're wondering, I've lost a little). In recent months, there's been NO change in expected inflation. It is even lower than a year ago.

All of the rise in the 10-year note is in real yields and not the inflation premium. This is very important. Most likely, it results from increased economic strength overseas as evidenced by rising short rates in Europe and elsewhere. Remember Greenspan's *conundrum:* why were long rates so low? Fed Chairman Bernanke said that a global savings glut has helped reduce long yields around the world. Maybe that global glut is coming to an end as growing foreign economies use more of their savings to finance their own expansion.

Where do we go from here? My bet is that the eventual equilibrium for the 10-year coupon note is around 5 1/2 – 5 3/4% in an economy where inflation and real GDP growth are both a little below 3%. Therefore bond yields might have a bit more to go over the next year or so.

What about the Fed? If the recent rise in bond yields was truly the result of higher inflation expectations, then the Fed would be considering hiking short-term rates further. However, with inflation expectations stable and GDP growth on the sluggish side as the housing adjustment works its way through the economy, the Fed still has room to cut short-term rates by 50 bp later this year.

It is also worth noting that the Fed's preferred measure of inflation, the Price Index for Personal Consumption Expenditures, excluding food and energy, has been decelerating in recent months. This measure, which is a close cousin of the CPI, is now at the top of the 1-2% range that the Fed seems to be targeting after climbing above earlier in the year.

But how can bond yields rise when the Fed is cutting short rates? This forecast is simply the opposite of what actually happened after the Fed started tightening three years ago. Back then, long-term yields fell while the Fed was hiking short rates! Besides, this forecast produces a more normal-looking yield curve with long rates 100 or so basis points above short-term interest.

NEW!
We hope you enjoy the new look of our newsletter. We also invite you to listen to *Economic Review* Podcasts at WebsterOnline.com/EconomicReview

Musings & Amusings

Casey Stengel, former manager of the NY Mets, Yankees, Giants and Dodgers:

"Don't cut my throat, I may want to do that later myself."

"Ability is the art of getting credit for the home runs somebody else hits."

"The secret of managing is to keep the five guys who hate you away from the four guys who haven't made up their minds."

Regional Roundup

Recent predictions of states and metropolitan areas show that jobs growth in our part of the country will continue to look more like the rest of the nation and that the housing cycle is fairly close to stabilizing.

The gap between job gains nationally and locally has been narrowing and – in some cases – reversing. U.S. economic growth has slowed significantly in response to the large rise in interest rates initiated by the Federal Reserve as well as the fallout from the nationwide housing adjustment.

In contrast, regional job growth has held up rather well thanks in part to the greater importance of the financial services businesses, which have been prospering – despite rising interest rates. During the coming year and a half, employment gains in Connecticut, Massachusetts and metro New York City will lag only a few tenths behind the nation. Rhode Island's faster rise reflects financial services, health care and gambling facilities.

The housing cycle, which has been uneven both nationally and regionally, should soon stabilize in terms of building and sales activity. By next year, building permits will be rising in southern New England. They're expected to decline in metro NYC where the real estate cycle has lagged the nearby New England states probably because the hottest of the financial businesses, mainly hedge funds and investment banks, are concentrated there. These are in the process of cooling as evidenced by recent problems associated with the sub-prime mortgage market meltdown. Housing demand has been stronger in New York City itself than in the nearby suburbs.

It might seem strange that house sales are predicted to slip somewhat in 2008 while permits for new homes are on the increase. However, the sales data are for *existing* homes (how about "used" or "pre-owned"?) while the permits are for *new* structures, which pick up as inventories of unsold dwellings shrink and the odds of further price declines diminish.

All the data in the table are based on annual averages, which show price declines for 2008. However, the quarterly patterns have house prices stabilizing late this year in Massachusetts and during the first half of next year in Connecticut and Rhode Island. The cumulative decline in this cycle is expected to be considerably smaller than in the deep contraction of the early 1990s. One reason is the much less exuberant construction activity this time around. For example, Connecticut issued only 54,000 permits in 2002-06 compared to 116,000 during 1984-88.

New England seems to have about the same exposure to sub-prime loans as the nation in terms of shares of mortgage originations. And there are some metropolitan areas with high and rising delinquencies and foreclosures on these loans. As with the rest of the country, delinquencies will continue to be a problem for a while as payments on variable rate mortgages rise further in a lagged response to the Federal Reserve tightening of 2004-06.

We'll have to watch carefully how the recent heartburn in the hedge fund business plays out. However, the main risks to the region are national or international in origin. We'll fare worse than these forecasts if there's a national recession or faster rise in interest rates.

REGIONAL FORECAST
(% change from previous year)

	2004	2005	2006	2007	2008
U.S.					
Jobs	1.1	1.7	1.9	1.1	1.0
House Starts	5.2	6.3	-12.3	-16.7	9.2
House Sales	8.6	4.5	-7.7	-5.9	-0.3
House Prices	8.1	12.8	2.2	-3.5	0.2
Connecticut					
Jobs	0.3	0.7	1.1	0.8	0.7
House Permits	13.4	0.4	-18.9	-8.3	5.1
House Sales	14.3	5.6	-8.8	-8.2	1.0
House Prices	9.2	9.8	1.8	-6.9	-1.5
Massachusetts					
Jobs	-0.1	0.5	1.0	1.0	0.8
House Permits	11.0	9.2	-13.8	-27.9	10.1
House Sales	17.5	3.0	-11.9	-10.1	-1.1
House Prices	10.4	6.9	-1.6	-3.2	1.6
Rhode Island					
Jobs	0.9	0.5	0.5	0.9	1.7
House Permits	10.8	12.0	-13.4	-14.6	12.0
House Sales	10.4	1.2	-10.4	-12.1	-1.7
House Prices	14.6	7.3	-1.7	-4.9	-4.5
Metro NYC					
Jobs	0.5	1.1	1.3	1.3	0.7
House Permits	22.6	20.8	-4.0	-26.3	-18.5
House Prices	12.1	16.5	5.9	-6.7	-3.0

Sources: NEEP and Economy.com. House sales and median prices are for existing homes.

Webster®
We Find a Way

Economic Review is published by Webster Financial Corporation. The opinions and views in this publication are those of Dr. Nicholas Perna, Webster's economic advisor, and are not intended to provide specific advice or recommendations for any individual. Consult professional advisors with regard to your individual situation. For more information or to submit a story idea to *Economic Review,* contact Colleen Stradtman by telephone at 203-578-2461 or by email at cstradtman@websterbank.com. For an online version of *Economic Review,* visit us at WebsterOnline.com.