

Strategy Matters

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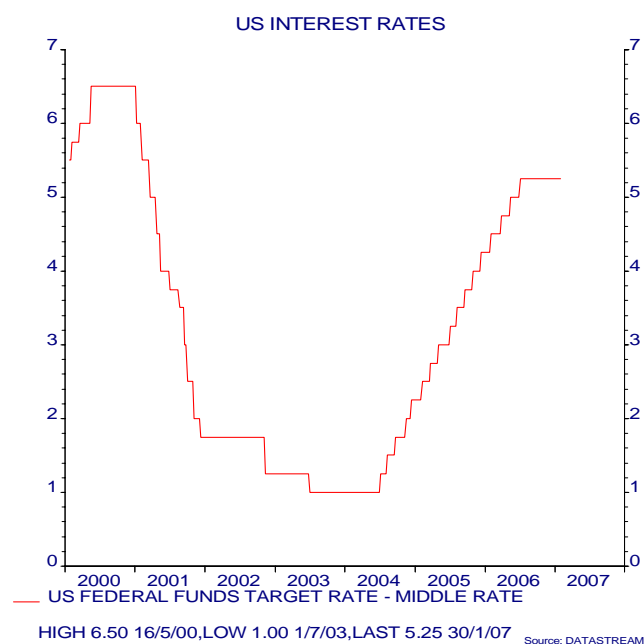
Bernanke's first year

Ben Bernanke became Chairman of the US Federal Reserve on 1st February last year. How has monetary policy evolved in his first year in office, and what has been the impact on the US economy?

Monetary policy under Ben Bernanke

As Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke is also Chairman of the Federal Open Market Committee (FOMC), the body which sets US interest rates.

Since he became Chairman of the FOMC, it has met eight times. At each of the first three meetings US interest rates were raised by 25bp, until they reached 5¼% in June last year. They have subsequently been held at this level.



The three interest rate increases should be seen in the context of what went before. At every one of the preceding fourteen FOMC meetings,

interest rates were also increased by 25bp. The actions of the FOMC at its first three meetings under Bernanke need to be seen as dealing with unfinished business. The FOMC under Greenspan started the process of lifting US interest rates from extraordinarily low levels to more normal ones. The FOMC under Bernanke simply completed the process by taking rates up to 5¼%, not far from most economists' estimates of the neutral rate.

In fact, the big decision taken by the FOMC in its first year under Bernanke was the one taken in August last year, when it ended monetary policy tightening and held interest rates at 5¼%.

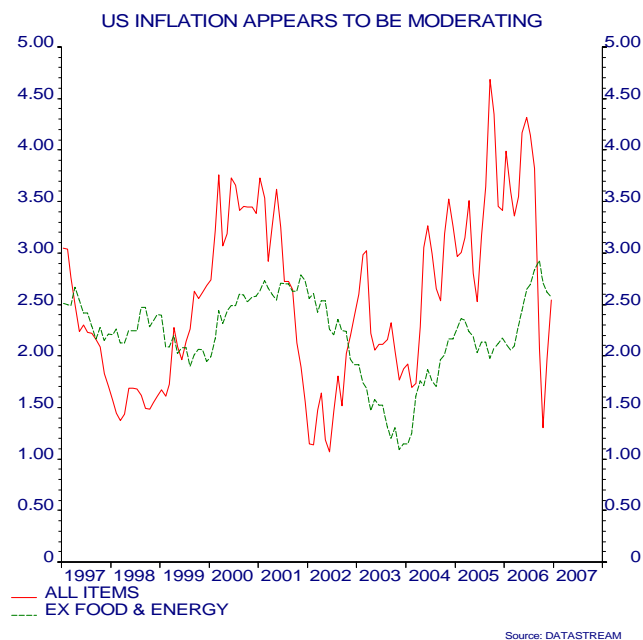
This pause in interest rates happened at a time when core inflation pressures were rising in the US and the oil price was approaching \$80 a barrel. The Federal Reserve took a view that these inflation pressures would prove transitory because moderating output growth would eventually ease capacity constraints and companies' pricing power.

Developments in inflation

Events in the last five months appear to have justified the FOMC's positive view on inflation. Lower oil prices have helped bring the headline rate of inflation down from a recent peak of 4.3% in June to 2.5% in December. Meanwhile the core rate of inflation, which excludes food and energy prices, reached 2.9% in September, but was down to 2.6% in December.

The pick-up in the core rate of inflation during 2006 was mainly due to developments in the housing rental market. Rents have a big impact on the calculation of inflation in the US because they form part of the calculation of the cost of home ownership. Soaring rents lifted inflation in

this component of the consumer price index from 2½% to 4½%.



Inflation risks do remain, however, and the FOMC have continued to emphasise this over the last five months. At present, their concerns probably centre on the labour market. Unemployment has fallen to 4½% - its lowest since the middle of 2001. Not many economists think that the unemployment rate could fall much further without the risk of an increase in inflation pressures. Indeed, on some measures these are already apparent. Average hourly earnings in the US increased by 4¼% during 2006, compared to increases of just 3% in 2005 and 2½% in 2004.

Developments in economic activity

Unemployment has continued to fall because the slowdown in US economic activity has been modest. Real GDP growth, the best measure of aggregate economic output, increased at an annual rate of 2.6% in the second quarter of last year, by 2.0% in third and by 3.5% in the fourth. Estimates of trend growth in the US centre around 3 to 3¼%, so actual growth over this period was only just below par.

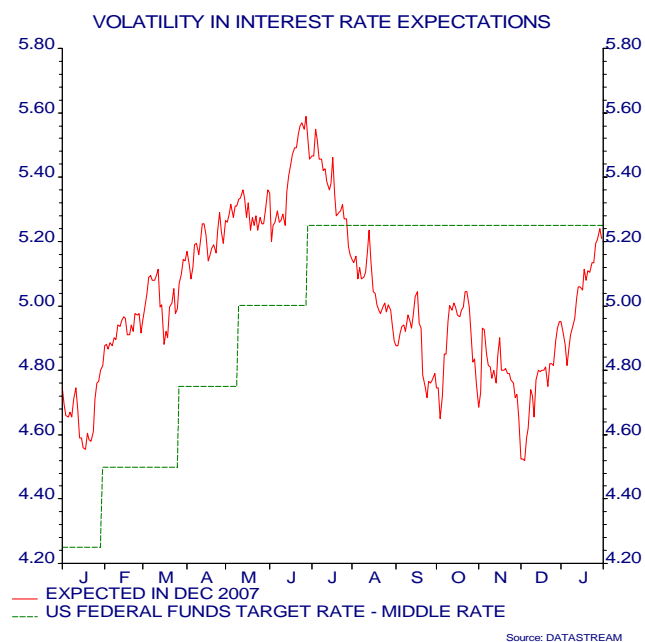
When the FOMC decided not to raise interest rates last August, one of the big worries was developing weakness in the housing market. This weakness has subsequently turned into a recession with sharp falls in house sales and

starts. The average price of a house in the US has also fallen.

As yet, though, there is little to suggest that US households are reacting to weakness in the housing market by cutting back their spending. While there has been some slackening in the growth of spending on housing-related, big-ticket items (such as carpets, curtains, kitchen appliances etc.), on the whole consumer spending has held up well. Strong employment growth and lower oil prices have ensured that households' spending power continues to expand at a healthy pace and lower unemployment has helped to maintain consumer confidence at a high level.

Market views on interest rates

While interest rates have been stable in the US over the last seven months, the same is not true of interest rate expectations.



When the FOMC left interest rates unchanged last August, the market view was that rates would be on hold for an extended period, so much so that they could still be 5¼% at the end of 2007. This view was short-lived though and markets soon began to anticipate interest rate cuts. Despite the FOMC reaffirming in the minutes of its meetings in the second half of last year that the risk to inflation remained on the upside, the market moved to price in first one,

then two, and – by early December – three interest rate cuts before the end of this year.

This move reflected, more than anything else, extreme weakness in the housing market and, arguably, was in defiance of other economic data that held up reasonably well.

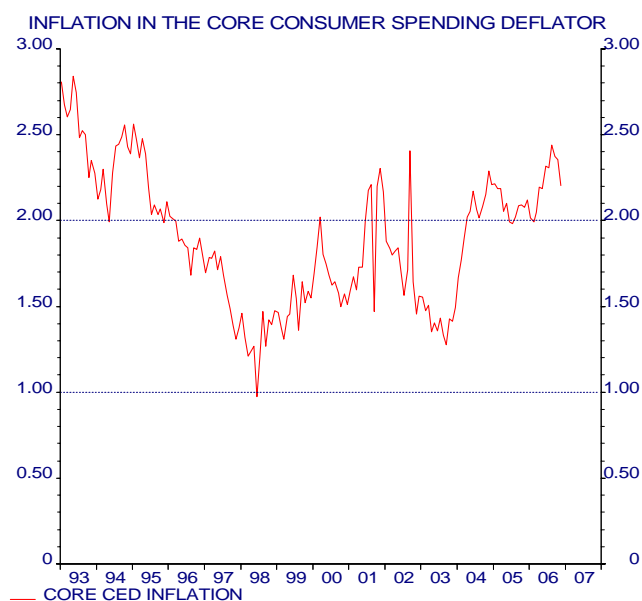
The last two months, however, have seen signs that the housing market may be stabilising (though some argue this just reflects unseasonably warm weather). These signs have helped to produce a sudden reversal in sentiment on interest rates, to the point where no interest rate cuts are now anticipated this year. In effect, we are back to where we were last August, when the FOMC first decided not to raise rates, expecting the Fed funds rate to be held at 5¼% through, at least, to the end of 2007.

It is fair to say, therefore, that so far Bernanke and the FOMC have been right. They look to have judged the right time to stop raising interest rates so as to limit the impact on output growth, while bearing down on inflation pressures (though they did get lucky with the drop in oil prices).

An inflation target?

What next? One possibility that Bernanke has floated is the introduction of a formal inflation target. He has already indicated that he is comfortable when inflation, as measured by the core consumer spending deflator, is between 1 and 2%. (Incidentally, if he had chosen a wider range of 1 to 2½%, he could have said that he was locking in the performance of the last fifteen years, and he could have claimed to have successfully kept inflation in the comfort zone in 2006.) But this is not the same as adopting a fixed inflation target, which brings with it the necessity to explain deviations from the target, measures that are being taken to bring inflation back into line with the target and the timescale over which they may work.

Perhaps, after a reasonably successful first year operating under the existing framework, Bernanke will feel less inclined to make such a dramatic switch.



Source: DATASTREAM

Conclusion

So how do we score Bernanke's first year? So far, so good would seem a fair verdict. He inherited the difficult problem of assessing when to stop hiking US interest rates and seems to have got it dead right. This should have earned him some respect in financial markets.

Unfortunately for Mr Bernanke, a central banker is only as good as his last decision. To maintain the respect of the markets, he is going to have to keep getting monetary policy right.

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