



Broadleaf Partners, LLC

Obsessing the Point The Fed Need not Raise nor Lower April 12, 2007

The Dow Jones enjoyed eight straight up days, but as soon as the Fed opened its mouth, the string was broken. Proof, once again, that the Fed can shake things up.

The Fed remains first and foremost an inflation fighter and only secondarily, a savior of the economy. In past decades, it has been argued that the Fed has deliberately pushed the economy into recession to avoid the risk of inflation. While there may be structural issues making such deliberate action less likely today, if push comes to shove, we still think the Fed will risk recession to avoid spiraling inflation.

Irrespective of what we believe, the question becomes one of what the Fed may be thinking. In this regard, it is important to recognize that current inflation readings are based on backward looking measurements. As we wrote in our last update, [Opening Day, Top of the Second Quarter](#), we commented that the stubbornly high inflation reading would ultimately come back down; that it was not an issue of if, but when.

The high-level reasons we believe that inflation will come back down are three-fold. First, our domestic economy is slowing. Second, a booming global economy is good for competition – especially if the United States fears it may be left behind! And finally, higher commodity prices aren't necessarily inflationary, if their use allows emerging economies to be more productive in the manufacture of low priced goods that we ultimately import.

Putting these high-level views aside, however, we went back to review an important component of the backward looking CPI reading itself, the rent and owner occupied rent component. According to the Bureau of Labor Statistics and several related blogs on the subject (I love Google search), as much as 32% of the monthly CPI reading is attributable to the direction of rent prices for those who rent and a survey *estimate* of what home owners might rent their home prices for if they rented rather than owned.

This owner occupied rent factor accounts for about 24% of the CPI reading and is based on a rolling six month survey taken every month. This suggests that not only is a given monthly CPI reading backward looking, but as much as 24% of it is attributed to naturally biased optimistic surveys of home owners about what their properties might rent for if they rented. (I personally wonder how many people would say their house has declined in rental value if they haven't seen any change in their fixed mortgage payments or have even seen them go up as their variable rate mortgages adjust.)

I admit that I don't know the specifics of how these biases might, if at all be adjusted, by those who take the measures. But I would also point out that the changes are based on a

geometric, monthly average of the prior six month period of data. This suggests that the measure is not only based on a subjective survey, but one based on a derivation of data six months old.

Returning to Economics 101 for a moment, we know that the housing market has been troubled. We also know that housing prices in recent months have declined for the first time in many years. Some subprime lenders are in trouble and housing inventories may take considerably more time to work down. Economics 401 suggests that at least 20% of the monthly CPI reading should logically be under downward pressure in the coming months.

While there may not be a perfect way to measure the cost of living associated with a owning a home or renting, it may be instructive to consider the flaws inherent in any method chosen. The Fed employs many smart people who, we trust, take such matters into consideration as well.

At the risk of obsessing the point, we believe inflation will head lower in the coming months. We don't think the Fed will raise rates, but they need not lower them either for the stock market to do well.

Coasting for awhile may be all we need.

Kindest Regards,

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