

Sustainable recovery or double dip?

The Fed's decision Wednesday to keep monetary policy steady and maintain the language in its policy statement that interest rates will remain low for an extended period was widely expected. The Fed's decision to make no change in the extended period language in the policy statement suggests that the Fed still does not see the US recovery self-sustaining and that the US economy requires continued Fed support. In its policy statement however the Fed did change its language about the strength of the US economy and the labor market and said equipment and software spending increased significantly. The Fed says the US economy continues to strengthen and the labor market has stabilized. This language is a bit more upbeat than the prior policy statement and may encourage analysts to look for the Fed to drop the extended period language possibly as soon as April policy meeting. Dropping the extended period language would set the stage for future Fed rate hikes and the end of easy money. Much of the recent recovery of the US economy has been attributed to fiscal and monetary stimulus. Fiscal stimulus is expected to diminish into year end and a shift in Fed policy may emerge in Q4 2010.

The debate continues over whether the US is on a sustainable recovery path and what the shape of that recovery may be, V-shaped or U-shaped. In the V-shaped camp are economists Brian Wesbury and Robert Stein. These economists see strong consumption in February despite the blizzards, a bottom in the housing market, increased business investment and a shrinking trade deficit which they think points to V-shaped recovery for the US economy. In the U-shaped recovery camp is New York University economist Roubini. Roubini says that recent US economic data has been weak. Consumer confidence, home sales, construction and employment have been coming in weaker than expected. He also says the real disposable income was negative in January and the expansion in manufacturing PMI has lost momentum. According to Roubini this data suggests that there are downside risks to the already anemic levels of growth in the US economy and challenges in the second half of the year include the removal of fiscal stimulus and tightening of Fed policy which will increase the risk of a double dip recession.

The timing of withdrawal of stimulus remains the key to whether the US experiences a V-shaped or U-shaped recovery. The Fed's March policy statement confirms that there was one dissenter to maintaining the extended period language. That dissenter was Hoenig. Hoenig said that low rates for extended period is no longer warranted. His main concern is the massive expansion of the Fed's balance sheet raises the risk of inflation if the Fed does not begin to withdraw liquidity. Hoenig's dissent may bring the Fed closer to a decision to withdraw stimulus and tighten monetary policy. In the March policy statement the Fed said the housing market remains weak. Nobel laureate Joseph Stiglitz says that the Fed's decision to allow the mortgage purchase programs to end this month could contribute to a worsening of the US housing market crisis. According to Stiglitz the Fed has misjudged things and he sees the main danger to the US and global recovery a too quick exit of monetary stimulus by central banks sparked by an irrational fear of inflation risk. He went on to note that China is taking action to tighten monetary conditions try to prevent asset bubbles. Tightening in China means that the global economy will unlikely return to robust growth anytime soon. Stiglitz says that double dip recessions tend to be rare but he sees a significant risk of a slowdown in global growth and that the US economy will likely see growth weakening at the end of the year. If the Fed tightens policy too soon it may tip the scales in the direction of the double dip recession. Based on the strength of global equity markets which are trading at a 19 month high and the Fed policy statement it appears that economic optimism trumps fear the economy will relapse.

By Michael J. Malpede,

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