FROM HAWKS TO DOVES

by Steve Brown

By their very nature, inflation "hawks" attack with a vengeance, while "doves" are much less aggressive. The last FOMC meeting of 2006 opened the cages of some doves and placed hoods on some hawks. In short, the FOMC kept the Federal Funds rate at 5.25%, as called by 100% of economists surveyed. What was interesting, however, was that the FOMC also stated that while "some inflation risks remain," they suggested the economy may remain soft (citing "mixed" economic indicators and "moderate expansion"). The biggest grabber of them all, however, was their comment that there has been a "substantial cooling of the housing market." While word counters would say the text was very similar to last month, investors immediately zeroed in on the big changes focused on housing softness. Let's face it, the FOMC rarely uses words like "substantial" (because they don't like to rock markets), so investors jumped on them and interpreted the comments as the FOMC's way of indicating rate cuts may be coming next year. As if that weren't enough, we found it coincidentally eerie that the CEO of Wells Fargo (one of the largest single family lenders in the country) also stepped into the fray with an interview released at roughly the same time. In the interview, Kovacevich (citing internal data) indicated the housing market was "pretty ugly" and that the sector was not likely to bottom out until "late Spring." He added that home prices were "really down much more" than economic reports suggest and were being propped up by aggressive homebuilder incentives. Only time will tell whether softness in the housing market will end up being a persistent problem, but investors and the FOMC are clearly worried. Another indicator of a potential rate cut was the wording modification from "moderate expansion" to "moderate expansion over coming quarters." While some could say this is only a slight change, it implies easing is likely in the not-so-distant-future. Following the meeting, expert commentary was easy to find, but some of the most notable included Bill Gross of PIMCO (expects Fed Funds will drop to 4.50% by the end of 2007); former FOMC Vice Chairman Alan Blinder (next rate move is down) and David Darst of Morgan Stanley (the FOMC will cut rates at the 2nd meeting in 2007). Many other analysts called the wording change a slow but steady shift from an inflation bias to a growth bias. The economy continues to perform at a reasonable level, while the housing and auto sectors are the weakest points. Jobs remain strong and oil prices are reasonably contained. Meanwhile, inflation remains stubbornly higher than the FOMC's comfort zone. If housing's 1% drag on GDP goes away, the economy would bounce back closer to 3%. Given that the FOMC is filled with long-term thinkers tasked with managing inflation risk, investors may be premature at this point to expect an ease. Overall, our opinion is that the FOMC remains in a holding pattern and over the next few meetings won't do anything. Our feeling is that the market has also jumped in a bit too fast on the rate cut front. While signs point toward an eventual rate cut, the most likely scenario is that the FOMC holds rates right where they are and the curve remains inverted through 2007. While the doves are here, they are a skittish group, so we will monitor the situation and report back if we see a hawk's shadow reappear.

BANK NEWS

M&A

Banner Bank ($3.5B, WA) will acquire F&M, Spokane ($405mm, WA) for $98.8mm, about 2.52x book value.

Economy

UCLA economists (which correctly predicted the 2001 recession) have updated their quarterly forecast. Among the projections they expect consumer spending and housing to slow, but not sharply enough to trigger a recession. That said, the report indicated that the downturn would leave builders feeling like they were in a "deep depression."

Economy

A new survey finds 55% of CFOs at manufacturing companies expect the economy to expand in 2007, down from 77% last year. The biggest concerns cited were oil prices at 33% of respondents, the housing bubble at 13% and interest rates at 11%. Of 27 industries analyzed, about 22% are deemed to be in the recession phase of the business cycle.

Good Move

During the first day on the job, new CEO of U.S. Bancorp, Richard Davis, moved to raise dividends by 21% (almost 80% of current earnings), the most in 2Y.

Commercial Sector

A new report from CB Richard Ellis finds the net amount of occupied commercial space nationally rose by 20mm square feet in the 3Q, as vacancies fell to 13.7%. Meanwhile, the vacancy rate for industrial space dropped 7.9% to its lowest level in 5Y.

Sub-Prime Lending

A new study from Fitch finds about 3.3% of the $160B in sub-prime loans originated this year have payments more than 60 days late. Sub-prime borrowers made up 19% of all U.S. mortgages in the first half of the year.

Customer Leads

A new study finds about 82% of small business owners ask their accountant for advice vs. their lawyer or banker.