

These will be an interesting summer and not just with election year politics heating up. It will be about the economy. We see the next eighteen months being driven by four key factors, which are interrelated and should not be viewed as separate or independent factors. Yes the presidential election along with other elections will provide plenty of media fodder, but here are the four key areas to watch from an economic perspective.

Interest Rates

While the Federal Reserve has lowered interest rates, spreads between borrowing and lending rates have increased. In other words, the cost of money to the lender has reduced, but the cost to the borrower has not fallen proportionately. Witness mortgage interest rates which have essentially remain unchanged. Lenders are recouping losses on new loans which are more profitable. Lenders are tightening standards, which has made obtaining credit more difficult. A few years ago sub-prime borrowers were borrowing at narrower spreads. Today, credit-worthy borrowers are obtaining loans at increased spreads. Sounds upside down. This will change over the coming months.

The Fed is signaling that it is unlikely that any more interest rate cuts are coming in the near future. What happens with mortgage rates will be important. In the 2003-2005 time frame, adjustable rate mortgages (ARMs) were very popular and used to qualify borrowers to buy more house than they could afford under a traditional fixed rate mortgage. The first wave of those ARMs are coming due for a reset and likely at a higher rate of interest. The question becomes can those consumers handle an increased mortgage payment? There will be those who cannot and must sell their houses. How much additional pressure will this put on home prices?

This leads to another delicate mandate of the Fed, which is to keep inflation in check. Anyone who has been to the gas station or purchased food over the past year has seen a bigger bite taken from their wallet. Government statistics show that "core" inflation is being held in check. However, core inflation excludes food and energy prices on the theory that those items are too volatile and distort long-term trends. The fact is for the majority of American households, food and energy costs are a significant expense, not to mention a necessity. For most businesses, energy prices will have either a direct or indirect impact. Keep an eye out for inflation becoming more widespread than in just the food and energy sectors. If inflation rises, the Fed will have no choice but to begin increasing rates.

US Dollar

Lower US interest rates are not as attractive for foreign investors. Add in concern about spending deficits and long-term US Government commitments (think Social Security and Medicare) and suddenly the US dollar is not the only option available to foreign investors. When it comes to safety, the Euro and Yen are not exactly a paradise as other developed countries have similar long-term financial issues to address. So where should the foreign investor invest when looking for both return and safety? Not many choices out there.

A lower dollar also increases the cost of imports. Case and point look at the increasing cost of oil. It costs more to ship goods from overseas. Will and when this cost be passed on to the US consumer? Will that trigger inflation? It has not happened yet, but eventually businesses that are impacted by higher costs and out of options to cut costs will likely raise prices. News reports show restaurants cutting back on portions without changing prices. Is this not a form of inflation?

The positive of a decline in the dollar is that American goods and services are more affordable to foreigners. We are exporting more which reduces the trade deficit. Tourism in the US has picked up as people come here to vacation and spend money in the US.

Energy

Higher gasoline prices are an indirect tax on the American consumer. Repealing the gas tax for the summer will have little impact other than as a political ploy. More speculators accessing oil based derivatives are certainly not helping in stabilizing world markets.

Oil is based on the US dollar. Have oil prices increased for the Europeans and other foreign nations? Think about how in Japan companies have used the yen and purchased US dollars that are used to purchase oil. While it costs more in US dollars, the Yen buys more US dollars so the net impact in Japan is not as severe as it is to the US consumer. It is really the American consumer and business that is bearing the brunt of increased oil prices.

As nations economies develop and their standard of living improves, they demand more oil. China and India are at the leading edge. We will be closely watching oil prices after the summer Olympics where China is holding a coming out party. A case can be made for both oil rising to \$150 a barrel or falling to \$75 a barrel.

Taxes

In a slowing economy raising taxes will do more harm than good. To raise taxes on the "rich" may sound good on the political stump, but basic economics has shown time and time again that it is not a good idea to raise taxes in a slowing economy. If anything, tax cuts usually produce more revenue for governments as people are encouraged to be more productive. This is not only true at the Federal level, but at state and municipal levels also. Declining housing prices could put a strain on municipalities that depend on a rising property or income taxes. And governments at all levels should consider simplifying tax codes and regulations which would further enhance benefit the economy and their tax coffers.

And speaking of government actions, what will be the long-term impact of the Federal Reserve bail-outs of Bear Stearns and Sallie Mae? Will financial markets expect the government to step in each time there is a financial "crises"? Has risk been removed or at least reduced in the market so that managers will take more risk and not be concerned with negative consequences? Is this the behavior that should be encouraged? The executive managers at Bear Stearns will still walk away with millions, however what about the employees who lost their jobs and a significant portion of their life savings when they invested in the company stock believing in management and their work? How is Bear Stearns management being held accountable? Why are all US taxpayers being forced to pay for the mistakes of one firm?

SOLUTIONS

Short-term, there are no easy answers. The problems must simply be worked through and some pain incurred. Are we serious as a nation about implementing a true fix and not just applying a band-aid? It starts with better education our society so that we understand both the symptoms and the real problems. We all must be held accountable and stop looking for government to fix each problem. Nobody forced anyone to purchase a house or car they could not afford. Ignorance is not an excuse. Government owes its constituents to act in a responsible and prudent manner. It must both cut taxes and reduce spending. The over-promises of the past will no longer work. The hole we are in just keeps getting deeper and a price will be paid be those under age 50. The younger, the steeper that price will be.

As a nation, we have been hearing for over 35 years how we must reduce our dependence on oil and diversify our sources of energy. Yes, our dependence on oil has declined as a percentage of energy consumed, however make no mistake, we still are addicted to oil. Real government leadership would implement a combination of opening up drilling in oil fields such as ANWR and in the Gulf of Mexico. Find better ways to better utilize coal and shale, build nuclear power plants, and more implementation of wind and solar power. We can reasonably and responsibly find solutions now with compromise and intelligence. The alternative is to ignore the problem that can be solved efficiently and economically today or wait for a real crisis and hope that it is truly solved.