

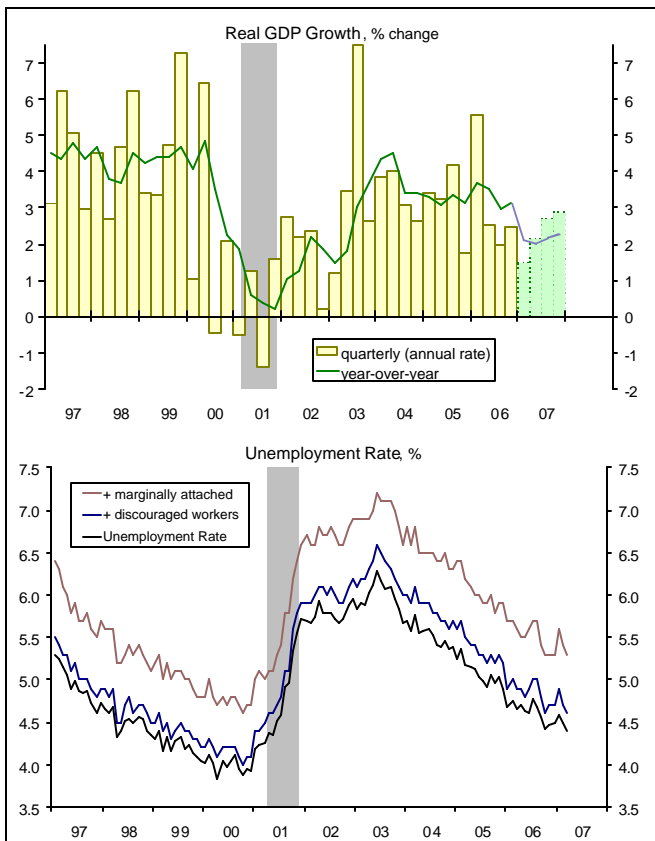
Economic Research – Scott J. Brown, Ph.D.

Friday, April 13, 2007

A Moderate Outlook, But Growing Risks

- *The economic outlook hasn't changed much in the last couple of months. While first quarter remained soft, growth is expected to pick up over the course of the year as the drag from homebuilding fades.*
- *Important downside risks include a sharper decline in the housing market, prolonged weakness in business investment, slowing productivity growth, and (once again) the impact of high gasoline prices.*
- *Fed officials are united in their view that inflation is "the predominant risk" in the economic outlook. However, recognizing downside risks, policymakers have sought greater flexibility, abandoning the assumption that the next move will likely be a rate hike.*

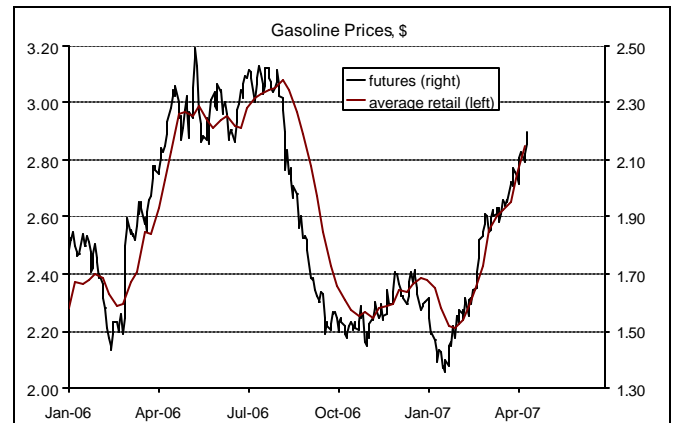
GDP rose at a 2.5% annual rate in 4Q06, reflecting mixed conditions across sectors. Growth in the first quarter (advance estimate due April 27) is likely to have been lackluster, with a further expansion in consumer spending, a decline in residential homebuilding, and further softness in business fixed investment.



Despite soft economic growth, labor market conditions have remained relatively tight. Nonfarm payrolls averaged a 152,000 monthly gain in 1Q06 (beyond a long-term sustainable pace), while the unemployment rate edged down to 4.4% – a six-year low.

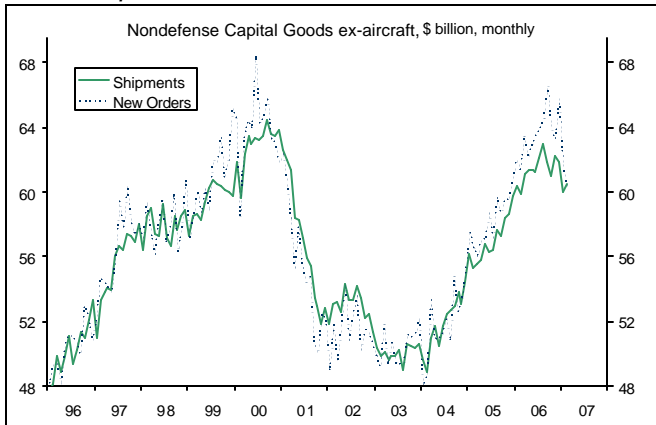
Nonfarm business productivity growth has slowed to a 1.5% annual rate since 2Q04, after rising at a 3.7% pace in the 10 previous quarters. Preliminary figures won't be reported until May 3 but it seems clear that productivity growth remained soft in the first quarter. GDP growth has been moderate over the last year, but the labor market remained relatively strong. Fed officials expect productivity growth to pick up in the months ahead. However, economists have not done a good job of projecting productivity growth in the past. Some of the recent softness may be cyclical, the consequence of a "midcycle" slowdown. However, a protracted slowdown in productivity growth would have a significant impact on the standard of living, the inflation outlook, corporate earnings, and the long-term federal budget outlook – hence, the productivity slowdown is a serious concern.

Energy prices dipped in the first few weeks of the year, brightening the economic outlook. However, crude oil prices have moved back toward \$64 and, on a national level, average gasoline prices are nearing \$3. As we saw in the aftermath after Hurricane Katrina and again last summer, \$3 gasoline has a more significant impact on the middle class. High gasoline prices will exert a large drag on 2Q07 consumer spending growth.



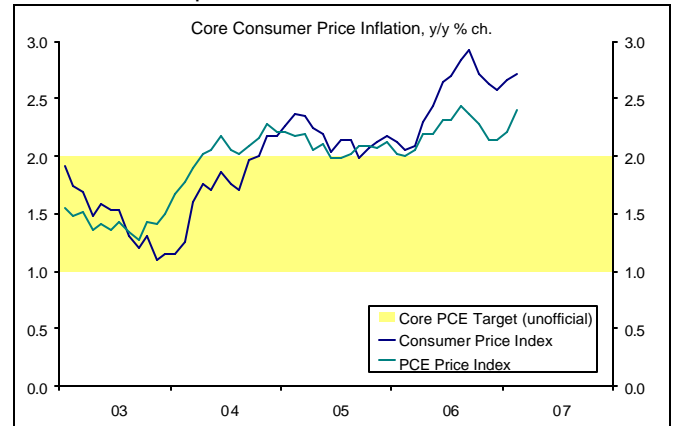
High gasoline prices will pinch household budgets and restrain average consumer spending. In addition, flat or declining home prices should lead to an increase in household savings rates (less spending out of income). However, job and wage growth should provide important support for consumer spending growth in the near term. Announced corporate layoff intentions and initial claims for unemployment insurance benefits have continued to trend lower in recent months, suggesting a limited pace of job destruction. Surveys indicate only a slightly reduced pace of new hiring in the near term. While the jobs data are encouraging, labor market conditions could change rapidly if the overall economy were to weaken more significantly. Housing market weakness and subprime loan problems appear to be largely contained, but these issues would become much more worrisome in a broader economic downturn.

Business fixed investment fell at a 3.1% annual rate in 4Q06, with spending on equipment and software falling at a 4.8% pace. Data on new orders and shipments suggest that business investment continued to weaken in 1Q07. According to the March 20-21 FOMC minutes, Federal Reserve policymakers viewed this weakness as *“surprising, given strong corporate balance sheets, high profitability, anticipated growth in sales, and favorable financial conditions.”* The Fed expects these fundamentals to support a firming in investment spending. However, weakness might be signaling that firms are more uncertain about the outlook or expect more modest gains in sales – hence, *“the possibility of persistently sluggish investment spending was an important downside risk to the outlook.”*



In the March 21 policy statement, the FOMC toned down its rhetoric, but continued to emphasize that the predominant concern remained the risks that inflation would fail to moderate. In congressional testimony, Fed Chairman Bernanke said that the Fed had not, as was widely reported, moved to a neutral policy bias (and hence, was not preparing the markets for a cut in short-term interest rates). The Fed retained an inflation bias, said Bernanke, adding that, due to increased uncertainty, *“a little more flexibility might be desired.”*

It was thought, in light of the increased downside risks, that some Fed officials might have been leaning toward an ease in monetary policy. However, the minutes of the March FOMC meeting showed that policymakers were united in their view that inflation remained the chief concern. Core inflation measures have continued to trend above the Fed’s comfort range. In the CPI, the pickup in inflation has been concentrated in owners’ equivalent rent. Ex-shelter, core inflation has remained low. However, the Fed’s chief inflation gauge is the PCE Price Index, where shelter costs account for a much smaller portion of the total.



Commodity price pressure remain elevated. The rebound in crude oil prices once again threatens to bleed through to core inflation. Food prices are also elevated. Slower productivity growth means that wage pressures are more meaningful. Wage gains in excess of productivity growth could be passed along (as higher consumer prices) or absorbed through a reduction in corporate profit margins (restraining earnings growth).

Most likely, the U.S. economy will be able to avoid a recession. The fundamentals of the household and business sectors remain in generally good shape. However, the downside risks have become more apparent in the last several weeks. The uncertainties in the economic outlook are troublesome for investors.

	1006	2006	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	2005	2006	2007
GDP (↓ contributions)	5.6	2.6	2.0	2.5	1.0	2.0	2.7	2.8	3.0	3.0	3.2	3.3	2.0
consumer durables	1.5	0.0	0.5	0.4	0.6	0.2	0.2	0.2	0.2	0.2	0.5	0.4	0.4
nondurables & services	1.9	1.8	1.5	2.6	1.8	1.4	1.7	1.7	1.7	1.7	2.0	1.8	1.8
bus. fixed investment	1.4	0.5	1.0	-0.3	-0.3	0.3	0.4	0.5	0.5	0.5	0.7	0.7	0.1
residential investment	0.0	-0.7	-1.2	-1.2	-0.8	-0.6	-0.3	-0.2	0.0	0.0	0.5	-0.3	-0.8
government	0.9	0.2	0.3	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.4	0.3
Domestic Final Sales	5.4	1.6	2.0	1.9	1.6	1.5	2.2	2.4	2.6	2.7	3.8	3.1	1.8
exports	1.4	0.7	0.7	1.1	0.2	0.8	0.8	0.7	0.7	0.7	0.7	0.9	0.7
imports	-1.5	-0.2	-0.9	0.5	-0.5	-0.4	-0.5	-0.5	-0.5	-0.5	-0.9	-1.0	-0.3
Final Sales	5.6	2.1	1.9	3.7	1.3	1.9	2.5	2.7	2.9	2.9	3.5	3.1	2.2
ch. in bus. inventories	0.0	0.4	0.1	-1.2	-0.3	0.1	0.2	0.2	0.1	0.1	-0.3	0.2	-0.2
Unemployment, %	4.7	4.7	4.7	4.5	4.5	4.5	4.6	4.7	4.7	4.7	5.1	4.6	4.6
NF Payrolls, monthly, th.	252	124	202	177	152	115	90	105	115	120	212	189	115
Consumer Price Index	3.7	5.7	0.6	0.2	4.0	2.5	2.0	2.2	2.3	2.3	3.5	2.6	2.7
excl. food & energy	2.6	3.4	2.7	1.6	2.8	2.1	2.1	2.1	2.1	2.1	2.2	2.6	2.3
PCE Price Index (q/q)	2.0	4.0	2.4	-0.9	3.2	2.9	2.1	2.0	2.0	2.0	2.9	2.7	2.1
excl. food & energy	2.1	2.7	2.2	1.9	2.5	2.0	1.9	1.9	1.8	1.8	2.1	2.2	2.2
Fed Funds Rate, %	4.46	4.91	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	3.21	4.96	5.25
3-month T-Bill, (bnd-eq.)	4.5	4.8	5.0	5.0	5.1	5.0	5.0	5.0	5.0	5.0	3.2	4.9	5.1
2-year Treasury Note	4.6	5.0	4.9	4.7	4.8	4.7	4.8	4.9	4.9	4.9	3.9	4.8	4.8
10-year Treasury Note	4.6	5.1	4.9	4.6	4.7	4.8	4.8	5.0	5.0	5.0	4.3	4.8	4.8