

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

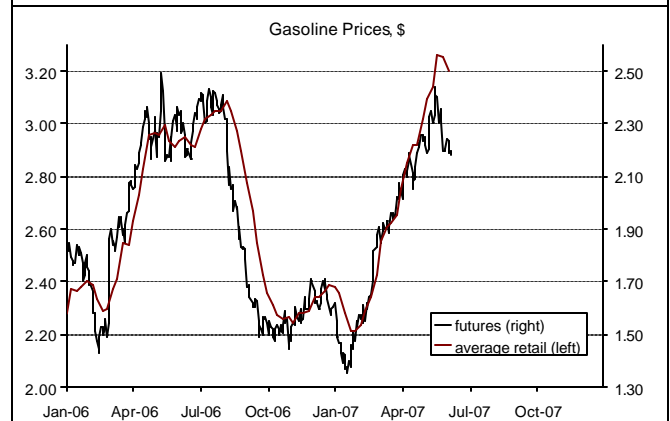
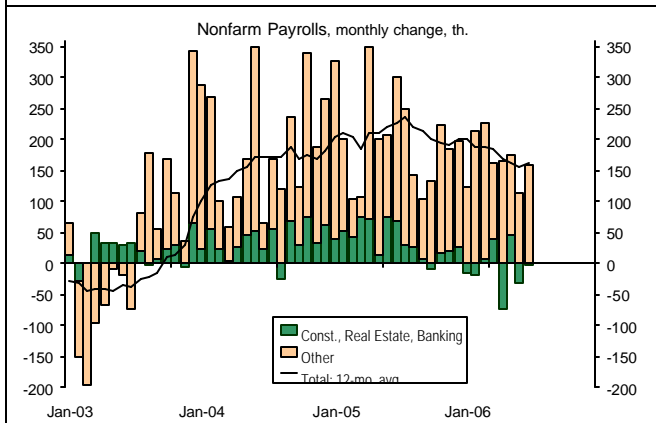
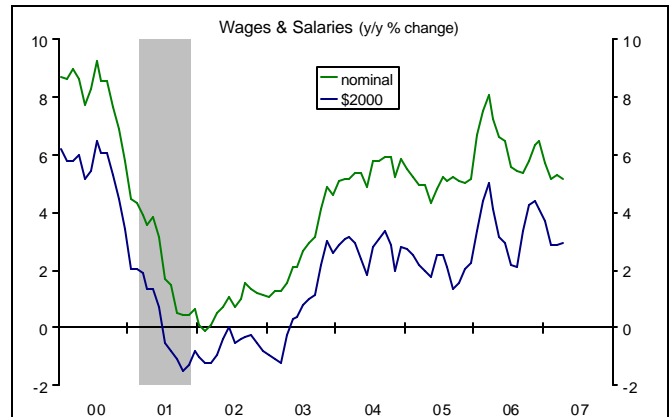
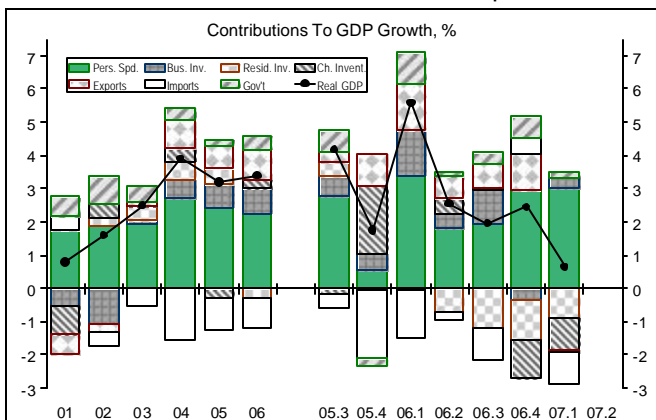
Friday, June 8, 2007

Same Outlook, Different Worries

- Economic growth is expected to pick up somewhat, although conditions will remain mixed across sectors.
- There are a number of risks to the outlook: higher energy prices, a further correction in the housing market, slower productivity growth, and higher bond yields.
- Core inflation is likely to moderate gradually, but Fed officials remain united in their concerns about upside risks to the inflation outlook. Short-term interest rates should remain on hold. Long-term rates seem likely to settle into a somewhat higher range in the near term.

The government's estimate of 1Q07 growth in real GDP was revised down to a 0.6% annual rate (vs. +1.3% in the advance estimate). However, the economy was not as weak as the headline figure suggests. A decrease in net exports and a sharper correction in inventories each subtracted a full percentage point from growth. Residential construction remained a significant drag, subtracting 0.9 percentage point from overall GDP growth. However, Domestic Final Sales (GDP less net exports and inventories), a measure of underlying domestic demand, rose at a 2.5% annual rate (vs. +2.0% in the advance estimate). Consumer spending rose at a 4.4% annual rate (following +4.2% in 4Q06). Business fixed investment rose at a 2.9% pace.

Consumer spending growth in late 2006 and early 2007 was fueled by solid growth in household income. The drop in gasoline prices in the second half of last year added to consumer purchasing power. Since late January, gasoline prices have risen sharply. The impact on consumer spending shows up with a lag. Hence, the rise in gasoline prices through the early spring is having a more significant effect as we approach summer. Still, continued growth in jobs and wage income will offset much of the drag in the near term (that is, consumer spending growth should be slower, but still positive).

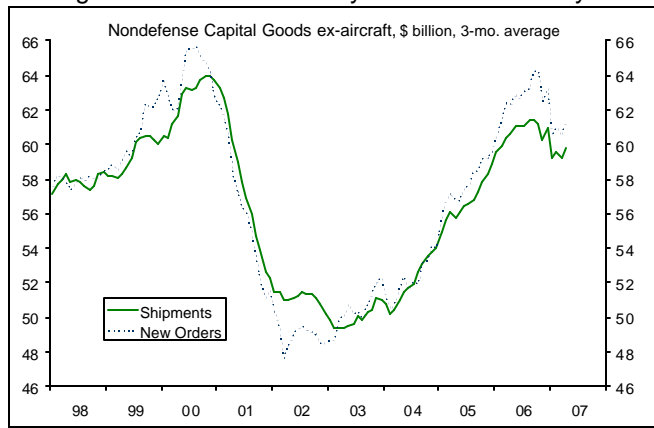


Energy prices will remain an important wildcard in the outlook. Crude oil prices have risen above the \$65 level recently, renewing concerns about higher inflation and slower economic growth. Gasoline prices have been boosted by refinery problems. A widening gap between the futures and spot price of gasoline implies that we may see some relief in gasoline prices ahead.

Home sales figures have been mixed. New home sales surged in April, but these data are notoriously erratic and subject to large revisions. Existing home sales have continued to decline. Weekly applications for new mortgage purchases are trending higher than a year ago. However, these are applications, not actual mortgages. In short, there is no solid evidence that home sales have "bottomed." However, some stabilization in home sales is likely in the near term.

The housing market correction appears to have had only a limited impact on consumer spending growth. The wealth effect on spending is relatively small and despite the retreat in home prices in most areas, cumulative price gains over the last several years remain large. Lower home prices are a problem mostly for recent homebuyers, not those who have been in their homes for more than a few years. The extraction of home equity has slowed relative to the peak pace of a few years ago. However, it has not disappeared. The recent up-tick in mortgage rates should reduce the pace of mortgage refinancings slightly in the near term.

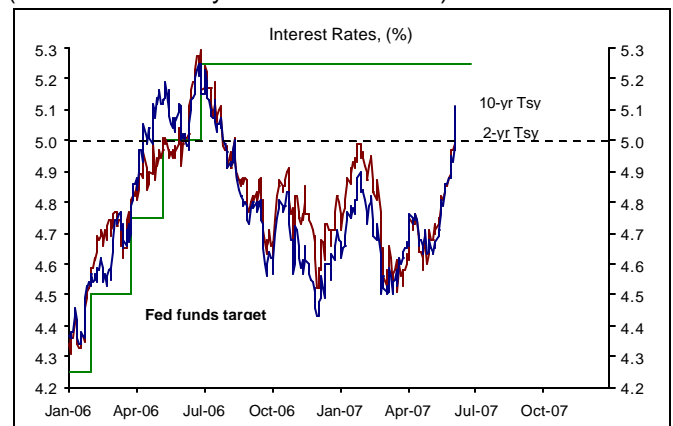
Given the large amount of unsold homes, residential construction activity is likely to weaken further, perhaps declining well into early 2008. Higher mortgage rates are not going to help. Anecdotal evidence suggests that housing market conditions vary across the country.



Business fixed investment fell in late 2006 and into the early part of this year. Despite solid growth in corporate profits and cash flows, businesses may have been cautious in their outlooks for growth for this year. Data on new orders and shipments reflect some improvement into April, but on a month-to-month basis, these figures tend to be erratic. Improvement in manufacturing surveys points to a mixed, but generally moderate, pickup in the factory sector.

Productivity growth has slowed over the last several quarters. Some of the slowing may be due to measurement problems, some of it may be cyclical (reflecting slower growth in general), and some may be more permanent (due to a decrease in potential applications of new technologies). The productivity slowdown means that labor market conditions will remain relatively tight amid slow economic growth.

The slowdown in productivity growth has resulted in an increase in unit labor costs (labor expense per unit of output produced). Labor markets remain tight. Hence, the Federal Reserve will remain focused on potential inflation pressures. Yet, core inflation, as measured by the PCE Price Index ex-food and energy, has moderated (rising 2.0% in the 12 months ending in April, at the top end of the Fed's comfort range). Inflation expectations (taken from surveys or market-based) remain contained.



The recent rise in long-term interest rates has been driven partly by a readjustment in economic expectations (the growth outlook is not as bad as many had feared), but mostly by higher long-term interest rates abroad. Where the correction in bond yields will stop is anybody's guess. However, bond yields are likely to settle into a somewhat higher range in the near term. Gasoline prices should retreat moderately and overall growth is likely to remain mixed, but improving.

	2006	3Q06	4Q06	1Q07	2007	3Q07	4Q07	1Q08	2Q08	2005	2006	2007	2008
GDP (↓ contributions)	2.6	2.0	2.5	0.6	2.5	2.7	2.9	2.9	2.9	3.2	3.3	2.0	2.9
consumer durables	0.0	0.5	0.4	0.7	0.2	0.2	0.2	0.2	0.2	0.5	0.4	0.4	0.2
nondurables & services	1.8	1.5	2.6	2.3	1.5	1.7	1.7	1.7	1.7	2.0	1.8	2.0	1.7
bus. fixed investment	0.5	1.0	-0.3	0.3	0.3	0.4	0.5	0.5	0.5	0.7	0.7	0.3	0.5
residential investment	-0.7	-1.2	-1.2	-0.9	-0.6	-0.4	-0.3	-0.1	0.0	0.5	-0.3	-0.8	-0.2
government	0.2	0.3	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.4	0.3	0.2
Domestic Final Sales	1.6	2.0	1.9	2.5	1.6	2.2	2.4	2.5	2.7	3.8	3.1	2.1	2.5
exports	0.7	0.7	1.1	-0.1	0.8	0.8	0.7	0.7	0.7	0.7	0.9	0.6	0.7
imports	-0.2	-0.9	0.5	-0.9	-0.2	-0.5	-0.5	-0.5	-0.5	-0.9	-1.0	-0.5	-0.5
Final Sales	2.1	1.9	3.7	1.6	2.0	2.4	2.6	2.8	2.9	3.5	3.1	2.3	2.7
ch. in bus. inventories	0.4	0.1	-1.2	-1.0	0.2	0.3	0.3	0.2	0.1	-0.3	0.2	-0.3	0.2
Unemployment, %	4.7	4.7	4.5	4.5	4.5	4.6	4.7	4.7	4.7	5.1	4.6	4.6	4.7
NF Payrolls, monthly, th.	124	202	177	142	120	100	110	115	120	212	189	118	123
Consumer Price Index	5.7	0.6	0.2	4.7	3.1	1.9	2.2	2.3	2.3	3.5	2.6	3.0	2.3
excl. food & energy	3.4	2.7	1.6	2.3	2.1	2.1	2.1	2.1	2.1	2.2	2.6	2.2	2.1
PCE Price Index (q/q)	4.0	2.4	-0.9	3.3	3.6	2.0	2.0	2.0	2.0	2.9	2.7	2.2	2.1
excl. food & energy	2.7	2.2	1.9	2.2	1.7	1.9	1.9	1.8	1.8	2.1	2.2	2.0	1.8
Fed Funds Rate, %	4.91	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	3.21	4.96	5.25	5.25
3-month T-Bill, (bnd-eq.)	4.8	5.0	5.0	5.1	4.9	5.0	5.0	5.0	5.0	3.2	4.9	5.0	5.0
2-year Treasury Note	5.0	4.9	4.7	4.8	4.8	4.9	5.0	5.0	5.0	3.9	4.8	4.9	5.0
10-year Treasury Note	5.1	4.9	4.6	4.7	4.9	5.0	5.1	5.1	5.1	4.3	4.8	4.9	5.1