

Thursday, September 13, 2007

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

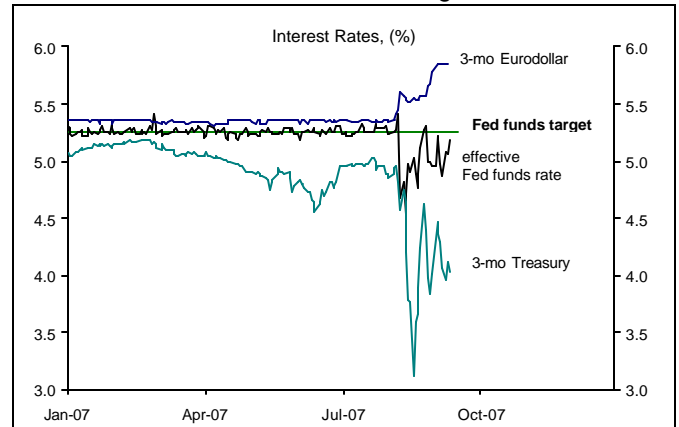
Moderate Outlook, Increased Downside Risks

- Economic indicators have been mixed, but moderate. The housing market correction and continued problems with subprime adjustable-rate mortgages will remain a drag on overall growth into 2008.
- However, the ongoing liquidity crisis has boosted downside risks to the growth outlook.
- Federal Reserve officials have responded to credit market problems by lowering the discount rate and making other efforts to provide liquidity. The Fed is likely to lower the Fed funds rate target, but probably less than is expected by many financial market participants.

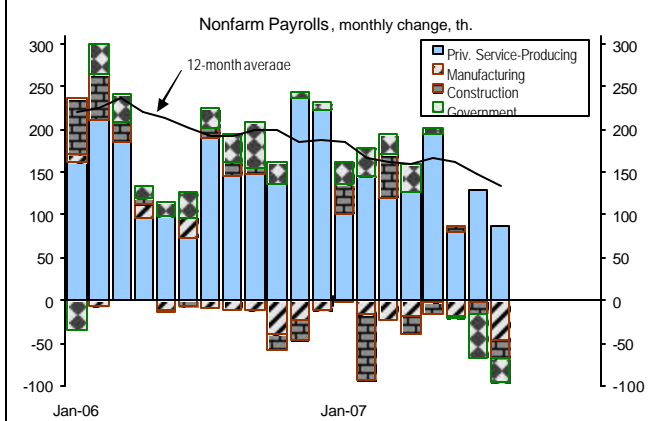
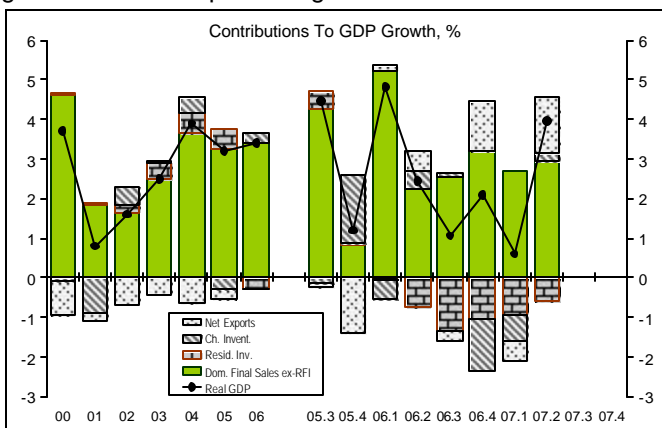
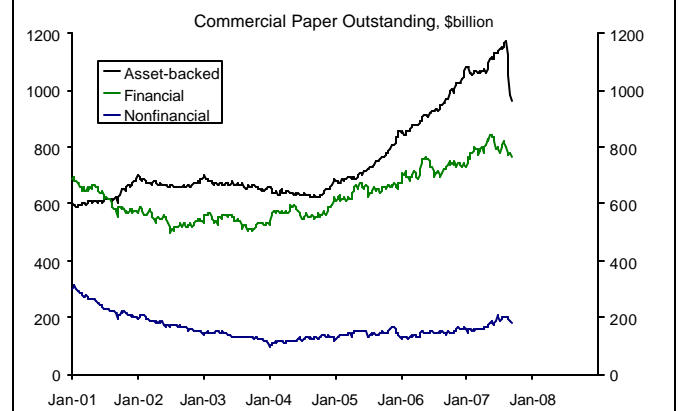
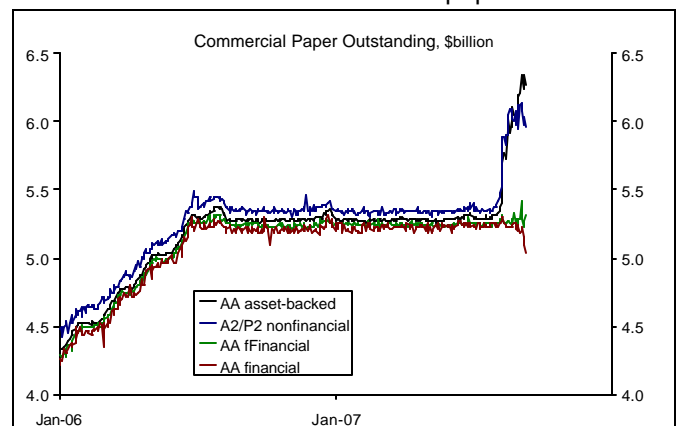
Real GDP rose at a 4.0% annual rate in 2Q07, according to the government's first revision. That followed a meager 0.6% pace in 1Q07. While GDP growth has been choppy, growth in Domestic Final Sales ex-residential fixed investment has been relatively stable, averaging a 2.7% annual rate over the last five quarters (at the same time, residential fixed investment has subtracted 0.9% from GDP growth on average).

Nonfarm payrolls fell by 4,000 in August, pushed down by a quirk in local government education, as well as declines in manufacturing and construction. Job growth in service-producing industries is moderate.

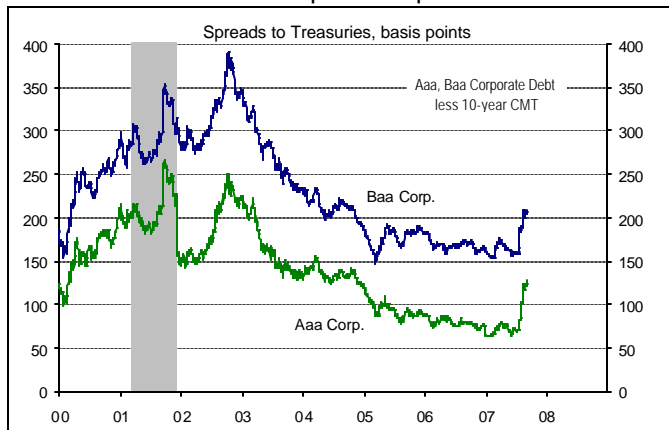
Credit market conditions are still tight. The three-month Eurodollar rate remains elevated. Seeking liquidity, investors have pushed Treasury yields sharply lower. To address liquidity problems, the Fed's Board of Governors lowered the discount rate (the rate the Fed charges banks for short-term borrowing) on August 17, extended the terms for discount-window borrowing, and expanded the list of acceptable collateral. The Federal Open Market Committee has also allowed the Fed funds rate to trade below the Fed funds target rate.



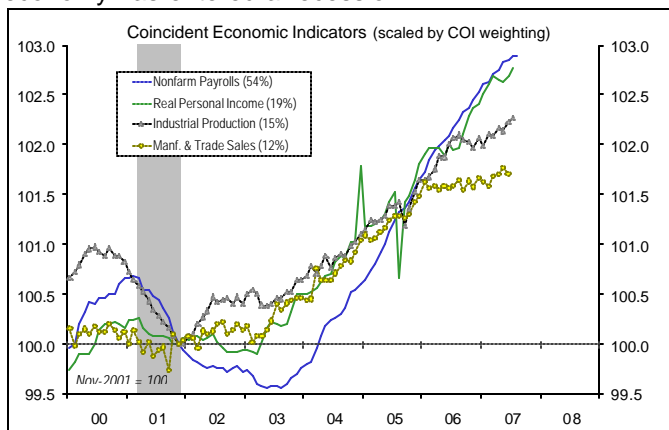
Subprime mortgage worries have spread to the market for asset-backed commercial paper.



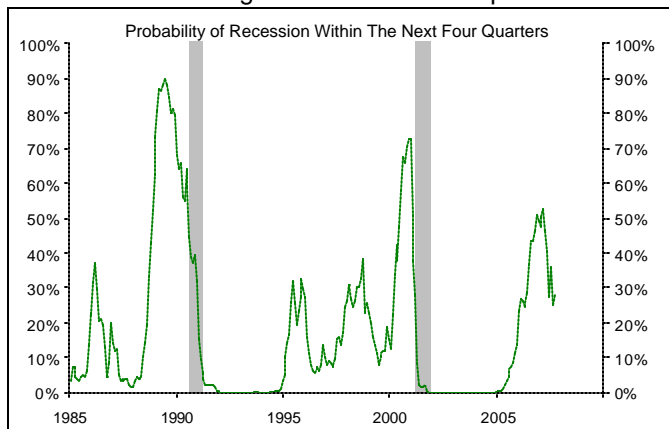
Corporate credit spreads have widened in a reappraisal of risk. The increase should contribute to a healthier financial backdrop in the quarters ahead.



Financial market anxieties have risen on the perceived risk of recession. Recall that a recession is a period of economic weakness (usually lasting two quarters or more) characterized by declines in employment, real personal income, industrial production, and real business sales. So far, it doesn't look like the economy has entered a recession.

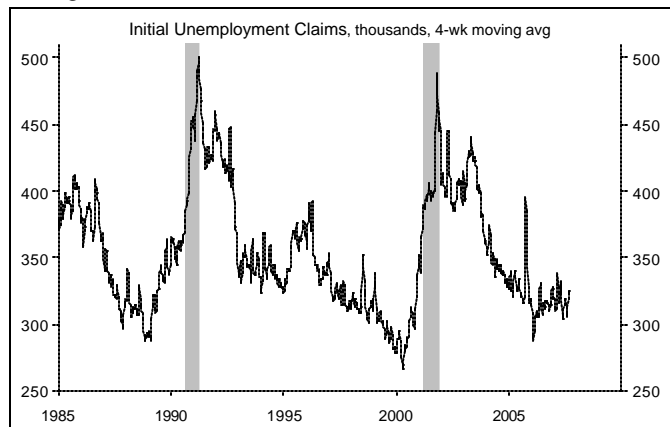


Recession-probability models are largely dependent on the slope of the yield curve. A simple model based on the Fed funds rate and the spread between the 10-year Treasury yield and the 3-month T-bill suggests that the odds of recession have *decreased*. However, recession forecasting models are not foolproof.

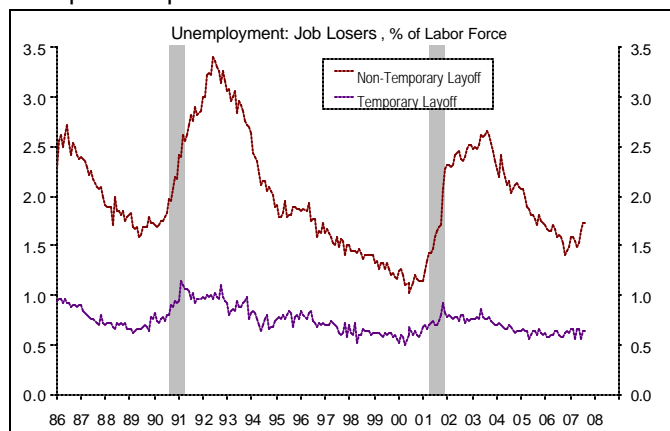


Weekly claims for unemployment insurance benefits have continued to trend at a relatively low level (although they were up a bit in August, following unusually low

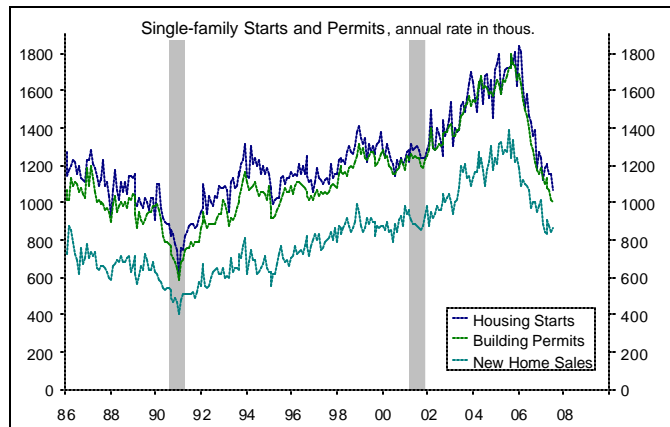
figures in July). Jobless claims are a leading economic indicator. Increases have presaged the last two recessions. The recent trend suggests a limited pace of job losses. Announced corporate layoff intentions rose in August, but the increase was concentrated in finance.



The household survey data reflect a mild increase in structural layoffs in recent months. Permanent layoffs have picked up ahead of each of the last two recessions.



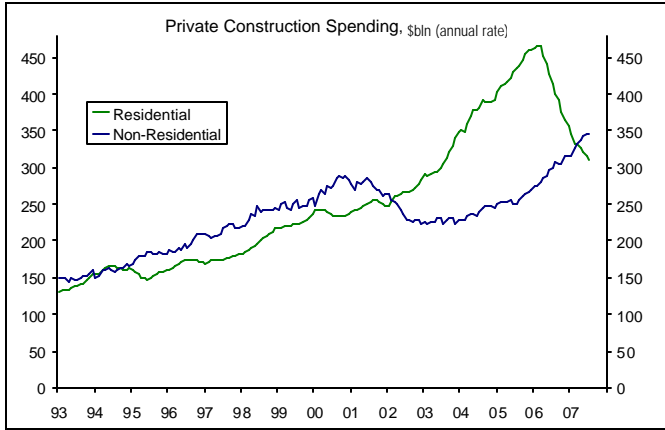
Housing market weakness has continued, and should remain a drag on overall growth into 2008. Problems are compounded by a high volume of homes for sale, a large percentage of homes not occupied (that is, purchased for speculative reasons), and a tightening of mortgage credit for low-end borrowers. Still, the pace of decline in homebuilding should continue to wane.



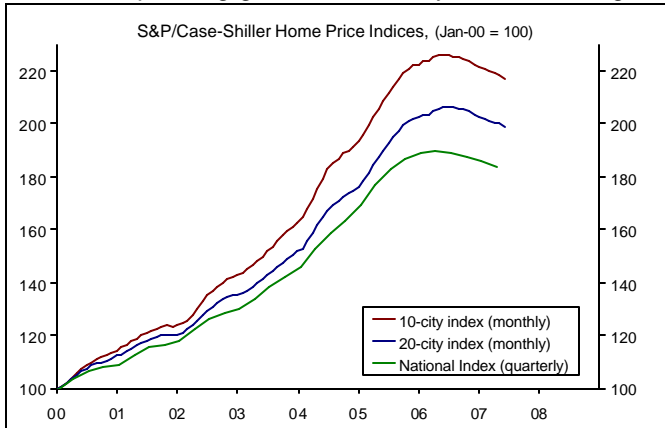
Subprime adjustable-rate mortgage delinquencies and foreclosures will continue to rise into 2008. Recent problems have been concentrated in four states (California, Arizona, Nevada, and Florida), with some

weakness also in Ohio and Indiana. Delinquency rates for subprime fixed-rate mortgages and prime mortgages (fixed and adjustable) have remained at normal levels.

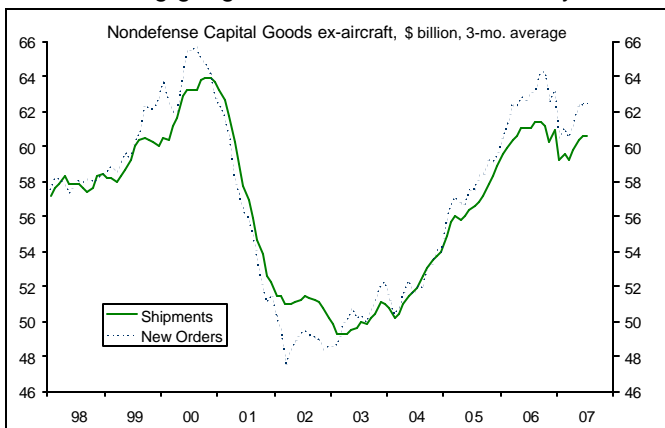
The decrease in residential construction activity has been partly offset by increased nonresidential building.



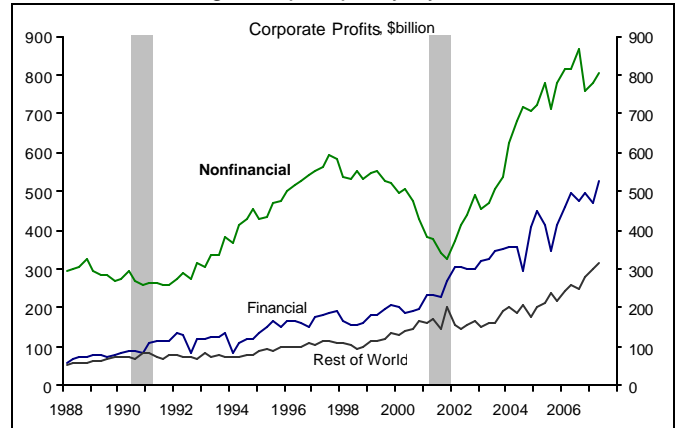
Home prices are declining in many (but not all) areas of the country. Lower home prices have a bigger impact on recent homebuyers (about 25% of which took out "high priced" mortgages over the last couple of years). If home prices continue to fall, the consumer's ability to borrow will be curtailed (implying some restraint on consumer spending growth). The extraction of home equity through mortgage refinancing, a major support for consumer spending growth in recent years, is waning.



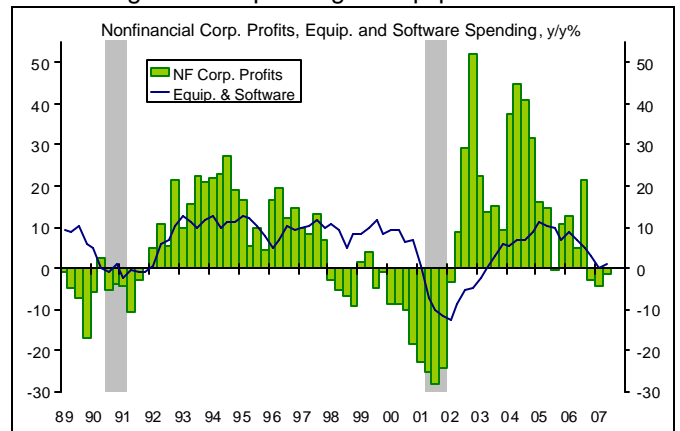
Following an inventory correction in late 2006 and early 2007, orders for capital equipment have improved. However, business attitudes remain generally cautious, which may also limit the pace of new hiring. Manufacturing gauges have been mixed recently.



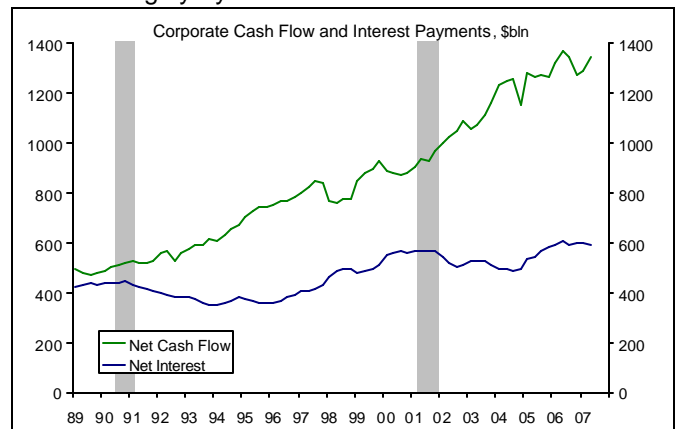
Corporate profits have continued to improve, although results for the domestic nonfinancial corporate sector have been a bit spotty. Following the seizing up credit markets and the repricing of risk, profit growth for the financial sector looks more doubtful in the near term. The strengthening global economy has sharply boosted U.S. firms' earnings, helped partly by a softer dollar.



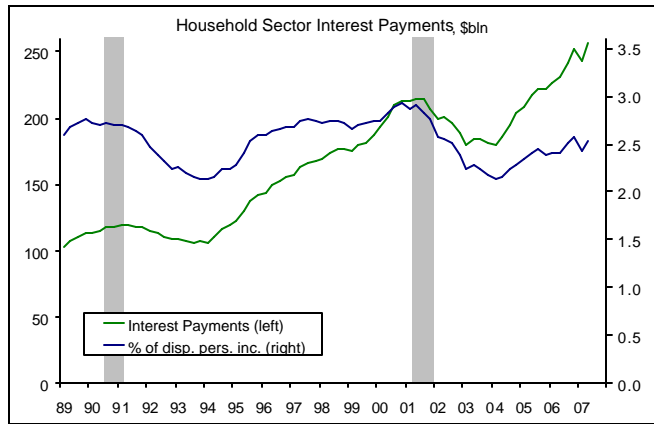
The flattening in year-over-year growth in nonfinancial corporate profits is consistent with sluggish near-term growth in spending on equipment and software.



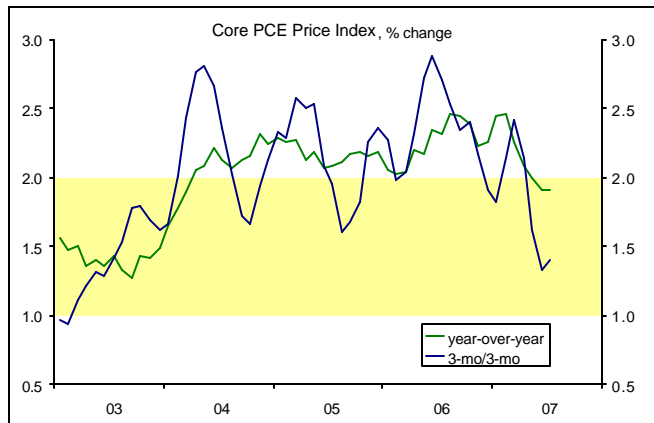
Nonfinancial firms are generally not highly leveraged at this point (an issue which has often been a problem ahead of past recessions). Capital spending has been financed largely by the use of internal cash flows.



While subprime adjustable-rate mortgage borrowers will face significant balance sheet strains in the quarters ahead, interest payment burdens for the household sector as a whole do not appear to be too onerous. Still, conditions vary considerably across households.

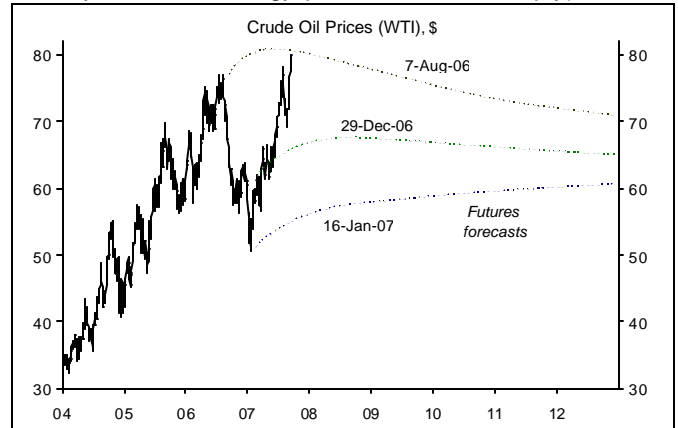


Core inflation has moderated in recent months, faster than the Fed anticipated. Year-over-year inflation in the core PCE Price Index has dropped back into the Fed's comfort range. However, the trend in productivity remains low (and the trend in unit labor costs high), implying some potential inflation pressures from labor.

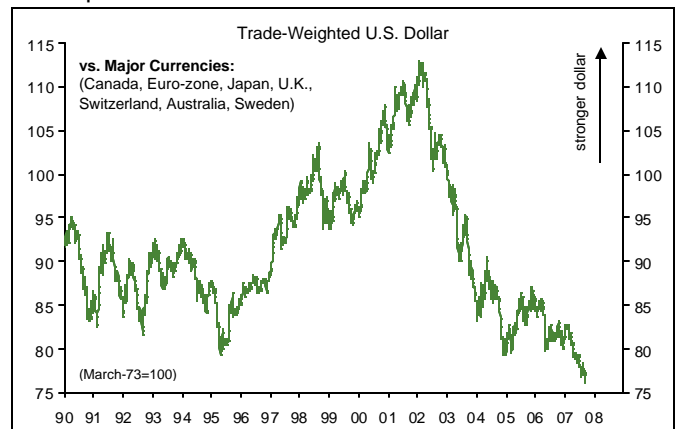


On August 17, 10 days after its policy meeting, the Federal Open Market Committee abandoned its inflation bias. Officials still see some upside risk to inflation. However, increased downside risks to economic growth have resulted in some downside risks to inflation. Hence, inflation risks are more balanced.

Higher energy and food prices remain a threat to the overall inflation outlook. Gasoline prices have not yet responded to the increase in crude oil prices (currently about \$80 per barrel, WTI), but the consumer outlook will be dampened as gasoline prices pick up again (a contrast to last year, when energy prices tumbled sharply).



A weaker dollar (as well as higher oil prices) are a consequence of the "friendlier" Fed outlook.



GDP growth still appears likely to be at a moderate pace in the next few quarters. However, an ongoing liquidity crisis would add to the downside risks.

	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2006	2007	2008
GDP (↓ contributions)	1.1	2.1	0.6	4.0	2.0	2.3	2.6	2.8	2.8	2.9	2.9	2.0	2.6
consumer durables	0.4	0.3	0.7	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.2
nondurables & services	1.5	2.4	1.9	0.9	1.6	1.6	1.6	1.7	1.7	1.7	1.8	1.7	1.6
bus. fixed investment	0.5	-0.2	0.2	1.1	0.4	0.4	0.5	0.5	0.5	0.5	0.7	0.4	0.5
residential investment	-1.3	-1.0	-0.9	-0.6	-0.5	-0.4	-0.2	-0.1	0.0	0.0	-0.3	-0.8	-0.3
government	0.1	0.7	-0.1	0.8	0.1	0.2	0.2	0.2	0.3	0.2	0.4	0.3	0.2
Domestic Final Sales	1.2	2.1	1.7	2.2	1.6	2.0	2.3	2.4	2.6	2.7	2.7	1.8	2.2
exports	0.6	1.5	0.1	0.9	1.2	0.7	0.7	0.7	0.7	0.7	0.9	0.8	0.8
imports	-0.9	-0.3	-0.6	0.6	-0.8	-0.5	-0.5	-0.5	-0.5	-0.5	-1.0	-0.4	-0.5
Final Sales	1.0	3.5	1.3	3.7	2.0	2.2	2.5	2.6	2.8	2.8	2.8	2.3	2.5
ch. in bus. inventories	0.1	-1.3	-0.7	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.1	-0.3	0.1
Unemployment, %	4.7	4.5	4.5	4.5	4.7	4.8	4.8	4.9	4.9	4.9	4.6	4.6	4.8
NF Payrolls, monthly, th.	202	177	142	126	55	90	105	120	125	128	189	103	120
Consumer Price Index	0.6	0.2	4.7	5.2	1.7	2.3	2.3	2.3	2.3	2.3	2.6	3.5	2.3
excl. food & energy	2.7	1.6	2.3	2.3	2.3	2.0	2.0	2.0	2.0	2.0	2.6	2.2	2.0
PCE Price Index (q/q)	2.6	-0.9	3.5	4.2	2.0	2.0	2.0	2.0	2.0	2.0	2.8	2.4	2.1
excl. food & energy	2.3	1.9	2.4	1.3	1.7	1.8	1.8	1.8	1.8	1.8	2.2	2.0	1.7
Fed Funds Rate, %	5.25	5.25	5.25	5.25	5.11	4.82	4.75	4.75	4.75	4.75	4.96	5.11	4.75
3-month T-Bill, (bnd-eq.)	5.0	5.0	5.1	4.9	4.5	4.6	4.6	4.6	4.6	4.6	4.9	4.8	4.6
2-year Treasury Note	4.9	4.7	4.8	4.8	4.4	4.6	4.7	4.8	4.9	4.9	4.8	4.6	4.8
10-year Treasury Note	4.9	4.6	4.7	4.8	4.7	4.6	5.0	5.0	5.1	5.1	4.8	4.7	5.0