

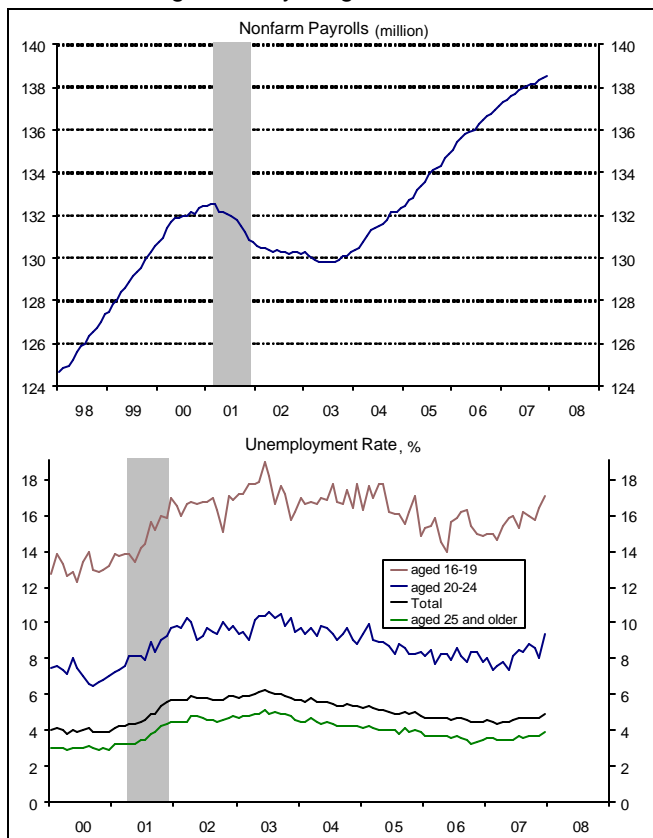
Economic Research – Scott J. Brown, Ph.D.

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Addressing Increased Downside Risks

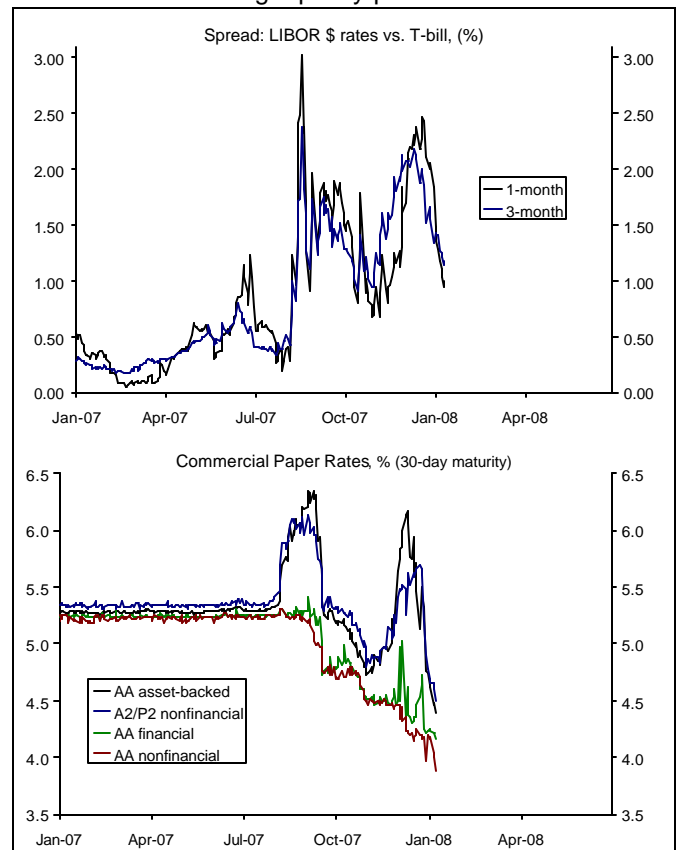
- *The U.S. economy appears likely to grow at a relatively slow pace in early 2008.*
- *Downside risks to the growth outlook have become “more pronounced,” according to Fed Chairman Bernanke. Consumer spending will be restrained in the near term by higher energy prices, lower stock prices, and lower home prices. Weaker job growth would further dampen the consumer spending outlook.*
- *Bernanke indicated that the Federal Reserve “stands ready to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks.”*

The December Employment Report was weaker than expected, adding to concerns about a possible recession. Nonfarm payrolls rose by just 18,000 and the unemployment rate jumped to 5.0% (from 4.7%). December’s weakness appears to have been exaggerated somewhat. For example, payroll weakness was concentrated in manufacturing and construction, and lower-than-normal seasonal hiring resulted in a seasonally adjusted decline (ex-manufacturing, construction, and retail, payrolls rose by 122,000). The unemployment rate was boosted partly by jumps in the rates for teenagers and young adults.



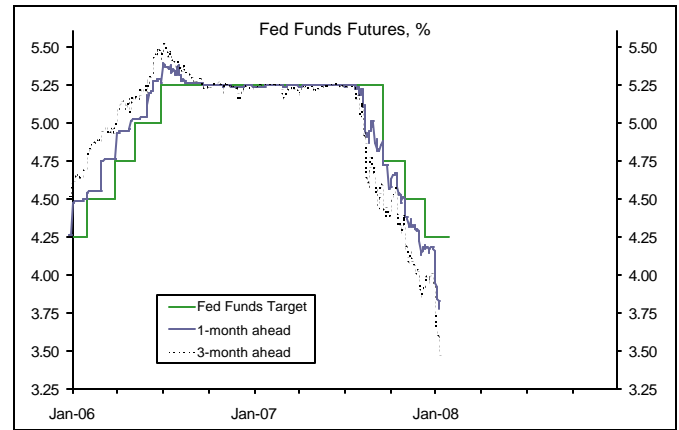
Still, the pace of job growth was already trending below a rate consistent with the growth in the working-age population, leading to expectations of a gradual increase in the unemployment rate. To date, job destruction appears to have remained relatively limited. However, concerns about potential economic weakness have contributed to a reduced rate of new hiring. Wage growth has been moderate in recent months, but higher inflation (led by food and energy price increases) has offset increases in nominal wages.

The Fed’s monetary policy focus has been on the strains in financial markets. Liquidity problems and other stresses surged amid the initial crisis last summer, improved after the Fed lowered rates in September and through October, but worsened again in November and December. Traditional year-end liquidity needs likely made problems worse. The Fed’s Term Auction Facility, initiated in mid-December, appears to have been successful in reducing liquidity problems.



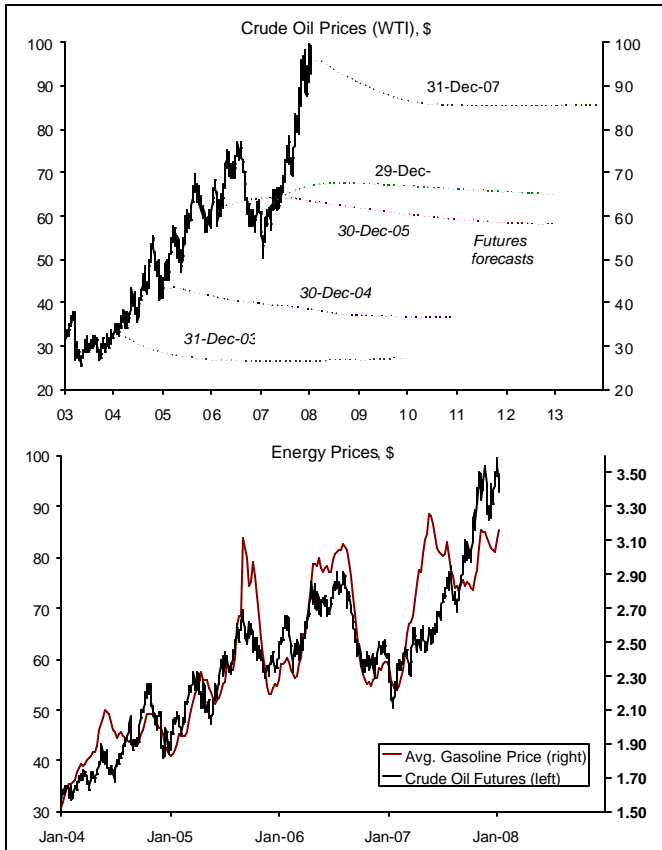
Financial strains have lessened into early 2008. The spread between LIBOR dollar rates (the cost of borrowing dollars abroad) and Treasury bill rate has declined. Spreads on asset-backed commercial paper have eased and issuance of ABCP appears to have bottomed. Yet, conditions are far from “normal.”

Energy prices, always a wildcard in the economic outlook, have been elevated. Higher costs of gasoline and home heating oil have added to inflation pressures and squeezed household budgets. The futures market (which has not been an accurate predictor over the last several years) indicates that crude oil prices are expected to moderate in the months ahead, probably in line with expectations of slower growth in the world's major economies. Flat or lower energy prices should help to boost real earnings in the second half of the year. Energy is not expected to be an inflationary force in 2008.



A more accommodative Fed policy is also expected to shore up consumer spending growth later this year. The Fed has been focused on credit market strains, with the intent on preventing tighter credit from having a greater impact on the overall economy. The housing bubble was expected to unwind – there's not much the Fed can do about that. They can't make it go away, but they can lean into it, limiting the damage. More recently, however, the Fed has become more fearful of the downside risks in the housing sector. Lower home prices and tighter mortgage credit may lead to further increases in foreclosure, adding downward pressure on home prices and leading to even tighter credit and so on. Such feedback loops are difficult to predict, but the consequences would be severe. Hence, the Fed would like to step in ahead of it. Expect the Fed to continue cutting rates into the spring. Note that Fed Chairman Bernanke indicated that an increase in inflation expectations would compound monetary policy decisions and would prevent the Fed from being more flexible if growth were to slow more significantly.

The economic outlook is for slower growth in the near term, but no recession. The downside risks to the growth outlook are considerable, but Fed policy should provide support in the months ahead. Still, there is an unusual amount of uncertainty at this point.



	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2006	2007	2008	2009
GDP (↓ contributions)	2.1	0.6	3.8	4.9	1.2	1.2	1.8	2.6	2.8	2.9	2.2	2.2	2.8
consumer durables	0.3	0.7	0.1	0.4	0.4	0.1	0.2	0.2	0.2	0.3	0.4	0.2	0.2
nondurables & services	2.4	1.9	0.9	1.7	1.7	1.4	1.4	1.7	1.7	1.8	1.7	1.5	1.7
bus. fixed investment	-0.2	0.2	1.1	1.0	0.4	0.4	0.4	0.5	0.6	0.7	0.5	0.5	0.5
residential investment	-1.0	-0.9	-0.6	-1.1	-0.8	-0.6	-0.5	-0.2	-0.1	-0.3	-0.9	-0.6	-0.1
government	0.7	-0.1	0.8	0.7	0.0	0.1	0.2	0.3	0.2	0.4	0.4	0.3	0.2
Domestic Final Sales	2.1	1.7	2.2	2.5	1.7	1.4	1.7	2.5	2.6	2.7	2.0	1.9	2.6
exports	1.5	0.1	0.9	2.1	0.2	0.6	0.6	0.6	0.6	0.9	0.9	0.7	0.7
imports	-0.3	-0.6	0.6	-0.7	-0.2	0.0	-0.2	-0.5	-0.5	-1.0	-0.3	-0.2	-0.5
Final Sales	3.5	1.3	3.6	4.0	1.7	2.0	2.1	2.6	2.8	2.8	2.5	2.5	2.8
ch. in bus. inventories	-1.3	-0.7	0.2	0.9	-0.5	-0.8	-0.2	0.0	0.1	0.1	-0.3	-0.2	0.0
Unemployment, %	4.4	4.5	4.5	4.7	4.8	5.1	5.3	5.3	5.3	4.6	4.6	5.2	5.3
NF Payrolls, monthly, th.	177	142	126	77	97	70	85	110	120	189	111	96	126
Consumer Price Index	0.2	4.7	5.2	1.0	5.5	2.1	2.3	2.3	2.3	2.6	4.1	2.2	2.3
excl. food & energy	1.6	2.3	2.3	2.5	2.4	2.2	2.1	2.1	2.0	2.6	2.3	2.1	2.0
PCE Price Index (q/q)	-0.9	3.5	4.3	1.8	3.8	2.5	2.1	2.2	2.1	2.8	2.5	2.6	2.1
excl. food & energy	1.9	2.4	1.4	2.0	2.6	2.0	1.9	1.9	1.8	2.2	2.1	2.0	1.8
Fed Funds Rate, %	5.25	5.25	5.25	5.09	4.49	3.84	3.11	3.00	3.05	4.96	5.02	3.25	4.06
3-month T-Bill, (bnd-eq.)	5.0	5.1	4.9	4.4	3.5	3.1	3.0	2.9	3.0	4.9	4.5	3.0	3.9
2-year Treasury Note	4.7	4.8	4.8	4.4	3.5	2.9	3.3	4.1	4.5	4.8	4.4	3.7	4.7
10-year Treasury Note	4.6	4.7	4.8	4.7	4.3	4.1	4.3	4.6	5.0	4.8	4.6	4.5	5.1