

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

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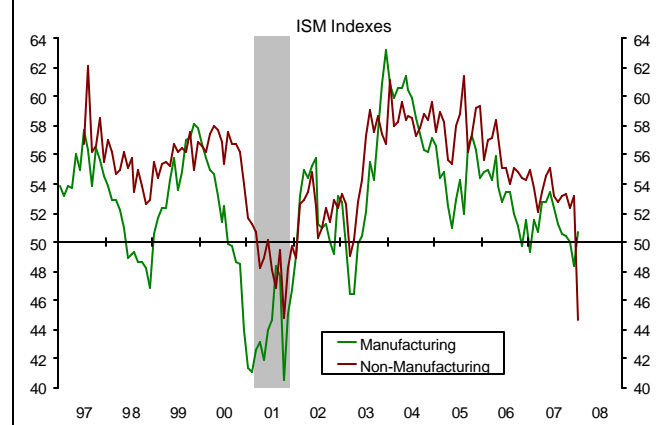
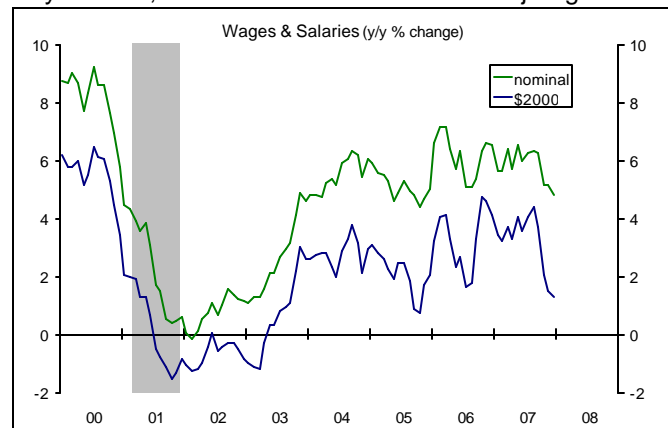
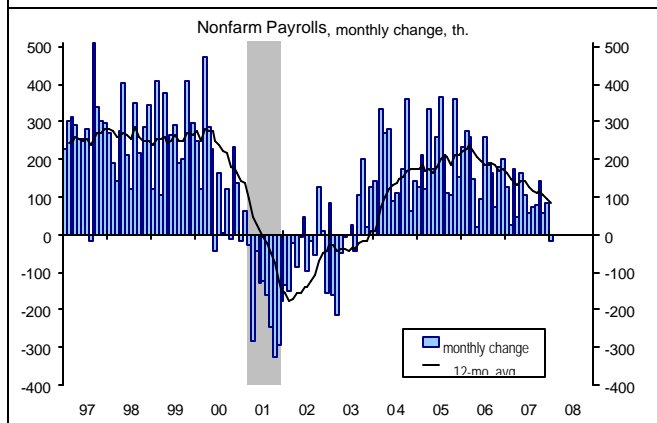
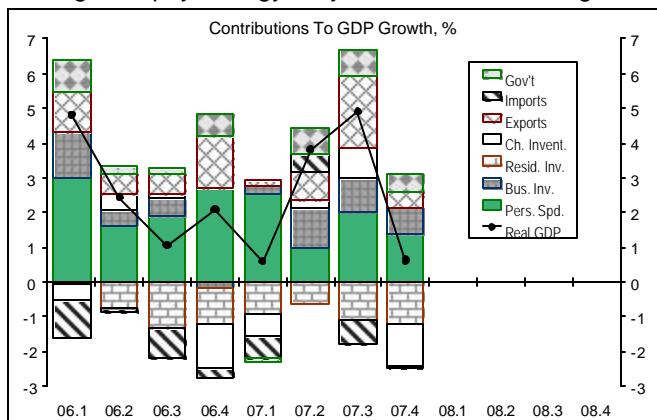
On The Cusp, Will Help Arrive In Time?

- *The U.S. economy appears likely to grow at a relatively slow pace in early 2008. Monetary and fiscal policy should provide some support in the second half.*
- *Downside risks to growth remain. Home prices could fall further. A softer job market could further dampen consumer spending growth.*
- *After cutting short-term interest rates by 125 basis points in late January, Fed policymakers signaled that they are prepared to cut rates further. However, inflation worries should prevent the Fed from cutting the Fed funds target as much as the previous easing cycle.*

Real GDP rose at a 0.6% annual rate in 4Q07, held down by a further contraction in residential fixed investment and by a drop in inventories. Ex-inventories and homebuilding, growth was moderate, although consumer spending growth (strong through November) flattened in December. Nonfarm payrolls were reported to have fallen by 17,000 in January. One shouldn't put much weight on any one month's worth of data, but the underlying trend in job growth has been falling. Reports still suggest a relatively limited pace of job losses. However, firms have grown more reluctant to hire. Indeed, amid heightened talk of a possible "recession," the negative psychology may become self-fulfilling.

Key monthly indicators (payrolls, industrial production, real personal income, real business sales) suggest that the economy may be on the cusp of a recession. An official declaration, which will depend on the depth and duration of any decline in overall economic activity, would not be made until many months after the fact (such assessments are meant to be definitive, not timely). However, for the most part, this may be a question of semantics. Growth has certainly slowed and it will feel like a recession to many.

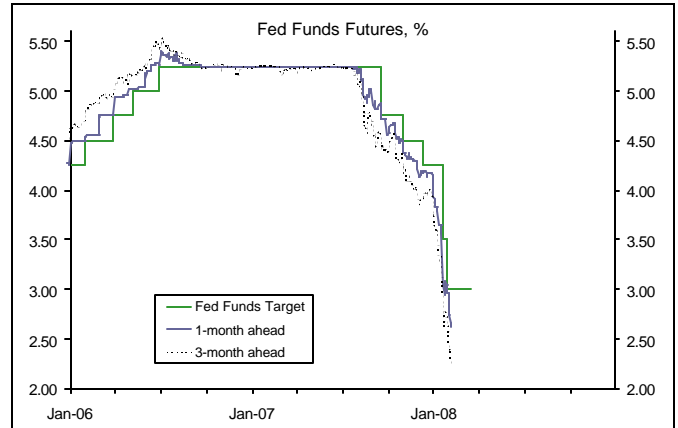
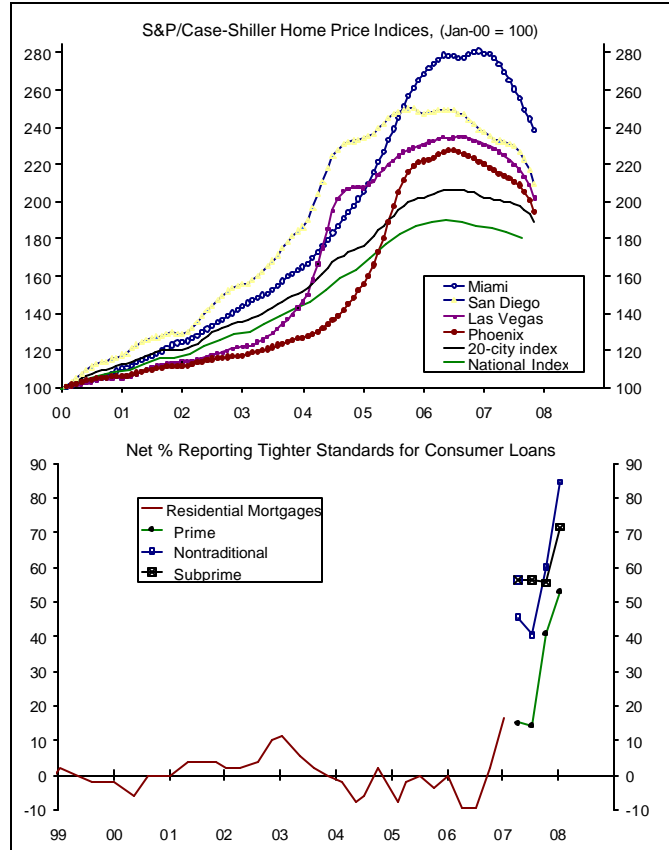
For the household sector, income growth has remained relatively strong. However, higher energy prices have sapped away the added purchasing power (especially in comparison to a year ago, when energy prices had fallen). Bank credit has become tighter and housing and stock market wealth are down. However, real wage growth is critical to sustain consumer spending growth. Energy prices should stabilize and may decline, but we need to see continued job growth.



The Institute of Supply Management reports monthly diffusion indices (which measure the relative percentage reporting increased orders, production, employment, etc. vs. those reporting declines). The manufacturing survey suggested soft factory sector growth. However, the non-manufacturing survey indicated a sharp downturn.

The housing sector remains a significant downside risk to the overall economy. The drop in homebuilding activity has been orderly, subtracting about a full percentage point from GDP growth over the last several quarters. However, a further decline in home prices threatens to turn recent homebuyers upside down (owing more than their homes are worth), adding further to the number of homes on the market and depressing home prices even more. Such a collapse is unlikely on a national level, but areas that had seen the most rapid price gains are now seeing the largest price declines.

The Fed's January survey of senior loan officers showed that banks continued to tighten terms and standards for all types of loans. Mortgage credit tightened appreciably, even for creditworthy borrowers. Banks also tightened conditions on other types of consumer loans and on commercial and industrial loans.



Having disappointed the markets with a 25-basis-point cut in December, the Fed moved more aggressively in January as credit conditions tightened and downside risks escalated. In its January 30 policy statement, the FOMC indicated that “downside risks to growth remain,” suggesting that officials were prepared to lower short-term interest rates further if needed.

Most economists agree that neither monetary nor fiscal policy is well suited to fine-tune the economy, but the consensus view is that the Fed should do the heavy lifting in this kind of environment. This being an election year, it looks like we'll get a substantial fiscal stimulus package. As of this writing, the Senate is trying to work out differences with the House plan (which was supported by the Bush Administration). Currently, the plan does not have much bang for the buck – rebates are not concentrated enough on those who would be more likely to spend them – however, it's not going to hurt the economy either, and it may help confidence.

	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2006	2007	2008	2009
GDP (↓ contributions)	2.1	0.6	3.8	4.9	0.6	0.5	1.5	2.5	2.8	2.9	2.2	1.9	2.7
consumer durables	0.3	0.7	0.1	0.4	0.3	-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	1.1	1.3	1.4	1.6	1.7	1.8	1.7	1.4	1.7
bus. fixed investment	-0.2	0.2	1.1	1.0	0.8	0.3	0.3	0.4	0.5	0.7	0.5	0.6	0.5
residential investment	-1.0	-0.9	-0.6	-1.1	-1.3	-0.8	-0.6	-0.4	-0.1	-0.3	-0.9	-0.8	-0.1
government	0.7	-0.1	0.8	0.7	0.5	0.1	0.2	0.3	0.3	0.4	0.4	0.4	0.2
Domestic Final Sales	2.1	1.7	2.2	2.5	1.4	0.8	1.5	2.2	2.6	2.7	2.0	1.6	2.6
exports	1.5	0.1	0.9	2.1	0.5	0.6	0.5	0.5	0.6	0.9	0.9	0.7	0.6
imports	-0.3	-0.6	0.6	-0.7	-0.1	0.0	-0.2	-0.5	-0.6	-1.0	-0.3	-0.2	-0.6
Final Sales	3.5	1.3	3.6	4.0	1.9	1.4	1.8	2.2	2.5	2.8	2.5	2.2	2.5
ch. in bus. inventories	-1.3	-0.7	0.2	0.9	-1.3	-0.8	-0.2	0.3	0.3	0.1	-0.3	-0.3	0.2
Unemployment, %	4.4	4.5	4.5	4.7	4.8	5.1	5.3	5.5	5.6	4.6	4.6	5.4	5.6
NF Payrolls, monthly, th.	151	109	105	71	94	35	65	90	105	175	95	74	124
Consumer Price Index	0.2	4.7	5.2	1.0	5.6	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	2.7	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	3.9	2.6	2.1	2.2	2.1	2.8	2.5	2.7	2.1
excl. food & energy	1.9	2.4	1.4	2.0	2.7	2.2	1.9	1.9	1.8	2.2	2.1	2.1	1.8
Fed Funds Rate, %	5.25	5.25	5.25	5.09	4.49	3.25	2.25	2.25	2.30	4.96	5.02	2.51	3.44
3-month T-Bill, (bnd-eq.)	5.0	5.1	4.9	4.4	3.5	2.2	2.1	2.1	2.2	4.9	4.5	2.1	3.5
2-year Treasury Note	4.7	4.8	4.8	4.4	3.5	2.1	2.7	3.4	3.9	4.8	4.4	3.0	4.5
10-year Treasury Note	4.6	4.7	4.8	4.7	4.3	3.7	4.3	4.7	4.9	4.8	4.6	4.4	5.1