

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

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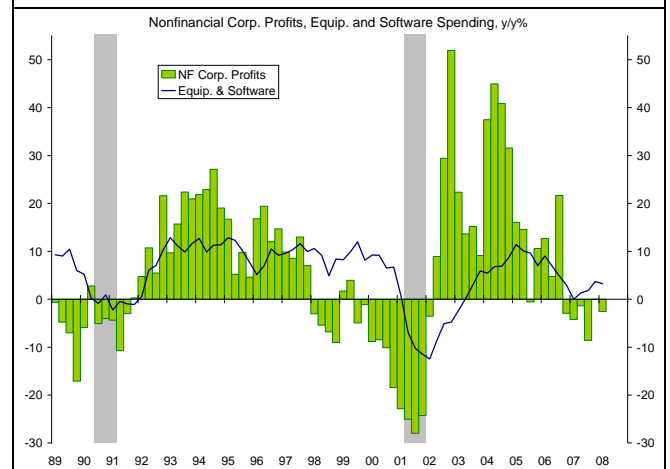
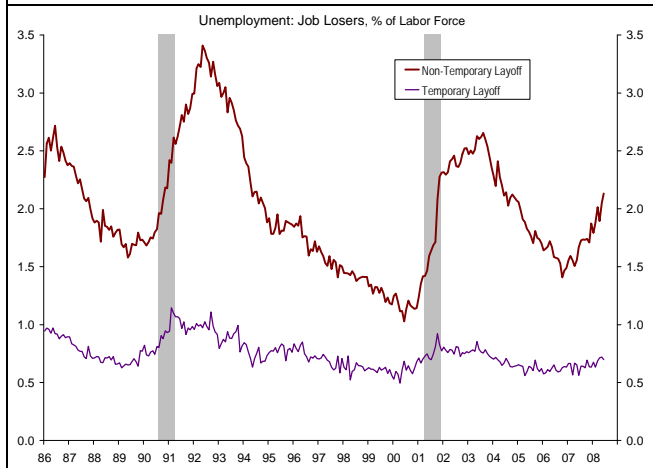
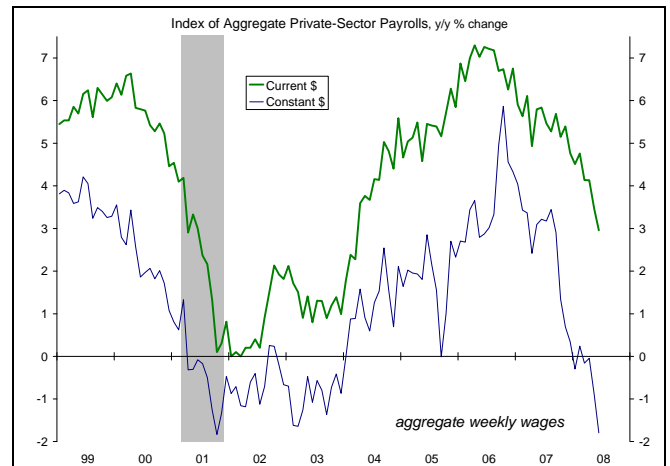
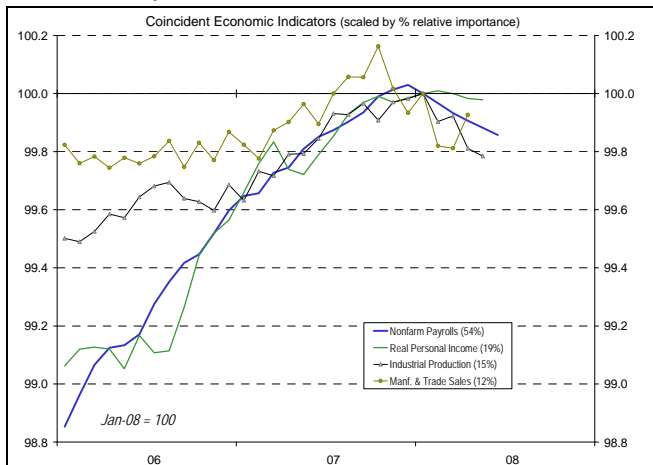
No Second Half Recovery

- Economic data have remained mixed, but generally weak. Higher food and energy prices and a weakening job market will restrain consumer spending growth.
- The outlook for Federal Reserve rate hikes has been scaled back from a month ago, but the Fed is still expected to raise rates before the economy recovers.
- The price of oil remains the key wildcard in the outlook. A stabilization in oil prices would help improve consumer purchasing power over time. A decline in oil prices would help bring the recovery closer.

Most of the key monthly indicators have been trending flat or slightly lower in recent months. However, GDP growth has remained positive (the advance figures for 2Q08, along with annual benchmark revisions, will be released on July 31). Whether we are in a recession remains to be seen – an official declaration would still be months away – however, growth is clearly weak. Higher food and energy prices have constrained household budgets. A squeeze on corporate profits has contributed to a reduced pace of business fixed investment.

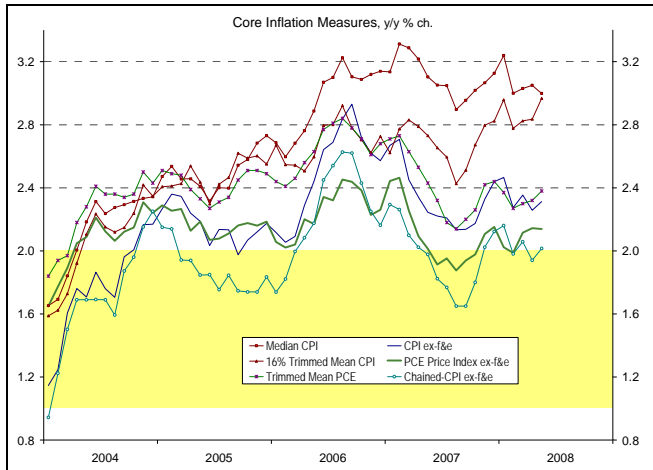
The first half of 2008 was characterized by weakness in hiring. The spring hiring season was more subdued than usual, resulting in declines in seasonally adjusted nonfarm payrolls (down in each of the last six months). The level of layoffs has been moderate, but those laid off have had a tougher time finding new jobs. Actual job losses are likely to pick up in the second half of the year. A timing quirk appeared to boost the unemployment rates for teenagers and young adults in May, but these rates only partially corrected in June, consistent with a weakening job market. The unemployment rate for those aged 25 and over rose to 4.3% in June, from 4.1% in May and 3.9% in April.

Aggregate wage income growth has slowed to a moderate level, but higher inflation has reduced consumer purchasing power substantially. If oil prices flatten out, the headline inflation rate would fall and consumer purchasing power would increase over time.



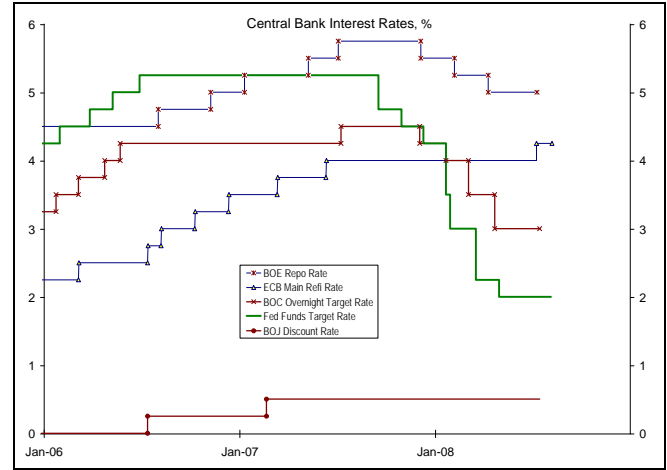
Domestic corporate profits have already begun to slow, which typically translates into a weaker rate of capital spending. Profits from the rest of the world have helped offset domestic profit weakness.

The Fed looks to the PCE Price Index (up 3.1% in the 12 months ending in May) as its main inflation gauge. Excluding food and energy, the PCE Price Index (+2.1% y/y in May) has been trending at the top end of the Fed's comfort range (1% to 2%). Other measures of core inflation, such as the trimmed mean PCE Price Index (which excludes the lowest 19.4% and the highest 25.4% of price changes) are more elevated.



Commodity price pressures remain high and there is increased evidence of greater flow-through to the wholesale level. Inflation expectations have risen. However, there's little inflation coming from the labor market (which would be a much bigger worry for the Fed) and slower economic growth should help restrain inflation pressures. In its June 25 policy statement, the Federal Open Market Committee shifted to a slight tightening bias. The FOMC noted that "although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased." The Fed does not appear likely to act on this bias anytime soon, but officials will be especially alert to wage pressures and may need to act to contain inflation expectations.

The European Central Bank raised short-term interest rates by 25 basis points effective July 9. However, the ECB did not make any presumption about possible future moves. The hope is that the move will help anchor inflation expectations and prevent a wage-price spiral. Labor cost pressures are a more immediate concern for the ECB, but this justification would likely be shared with the Federal Reserve.



The Fed sets policy based on where the economy is expected to be in 6 to 12 months. With high inflation expectations, the Fed will have to adjust course – that is, raise short-term interest rates – before the recovery gathers a full head of steam. The housing correction is ongoing, but its drag on the overall economy will wane. Credit market conditions are far from normal, but have improved and are likely to get better over time. Despite aggressive Fed rate cuts in the first few months of the year, banks have tightened terms and standards on a wide range of consumer and business loans. However, the bank lending situation should eventually turn around.

There's no need for the Fed to slam on the brakes to get inflation under control, but officials must consider when to take the foot off the accelerator.

	2007	3Q07	4Q07	1Q08	2008	3Q08	4Q08	1Q09	2Q09	3Q09	2007	2008	2009
GDP (↓ contributions)	3.8	4.9	0.6	1.0	1.8	1.1	1.3	1.9	2.3	2.6	2.2	1.7	1.9
consumer durables	0.1	0.4	0.2	-0.5	-0.3	0.1	0.1	0.2	0.2	0.2	0.4	-0.1	0.1
nondurables & services	0.9	1.7	1.4	1.3	1.7	1.2	1.0	1.2	1.4	1.4	1.7	1.4	1.3
bus. fixed investment	1.1	1.0	0.6	0.1	-0.2	-0.3	-0.2	0.1	0.2	0.3	0.5	0.2	0.0
residential investment	-0.6	-1.1	-1.3	-1.1	-0.6	-0.4	-0.2	-0.1	0.0	0.1	-1.0	-0.9	-0.1
government	0.8	0.7	0.4	0.4	0.1	0.2	0.3	0.2	0.2	0.2	0.4	0.4	0.2
Domestic Final Sales	2.2	2.5	1.3	0.1	0.7	0.7	1.0	1.5	1.9	2.1	1.9	1.0	1.5
exports	0.9	2.1	0.8	0.7	0.6	0.5	0.4	0.4	0.5	0.5	0.9	0.8	0.5
imports	0.6	-0.7	0.2	0.1	0.6	0.3	-0.1	-0.3	-0.4	-0.4	-0.3	0.2	-0.2
Final Sales	3.6	4.0	2.4	0.9	2.0	1.5	1.3	1.7	2.0	2.3	2.5	2.0	1.8
ch. in bus. inventories	0.2	0.9	-1.8	0.0	-0.2	-0.4	0.0	0.2	0.3	0.3	-0.3	-0.3	0.1
Unemployment, %	4.5	4.7	4.8	4.9	5.3	5.7	6.0	6.1	6.1	6.2	4.6	5.5	6.1
NF Payrolls, monthly, th.	105	71	80	-82	-64	-70	-30	30	70	95	91	-62	75
Consumer Price Index	4.3	2.5	6.2	3.1	6.5	1.7	1.8	2.1	2.1	2.2	4.1	3.3	2.2
excl. food & energy	2.3	2.5	2.6	2.0	1.9	2.1	2.1	2.1	2.1	2.1	2.4	2.0	2.1
PCE Price Index (q/q)	4.3	1.8	3.9	3.6	3.8	3.1	1.6	1.9	2.0	2.0	2.6	3.3	2.1
excl. food & energy	1.4	2.0	2.5	2.3	1.8	1.9	1.9	1.9	1.9	1.9	2.1	2.1	1.9
Fed Funds Rate, %	5.25	5.09	4.49	3.18	2.09	2.03	2.25	2.29	2.69	3.16	5.02	2.39	2.91
3-month T-Bill, (bnd-eq.)	4.9	4.4	3.5	2.1	1.7	2.0	2.3	2.6	3.0	3.2	4.5	2.0	3.1
2-year Treasury Note	4.8	4.4	3.5	2.0	2.4	2.7	3.2	4.1	4.3	4.4	4.4	2.6	4.3
10-year Treasury Note	4.8	4.7	4.3	3.7	3.9	4.2	4.4	4.7	4.9	5.1	4.6	4.0	4.9