Monthly Economic Outlook

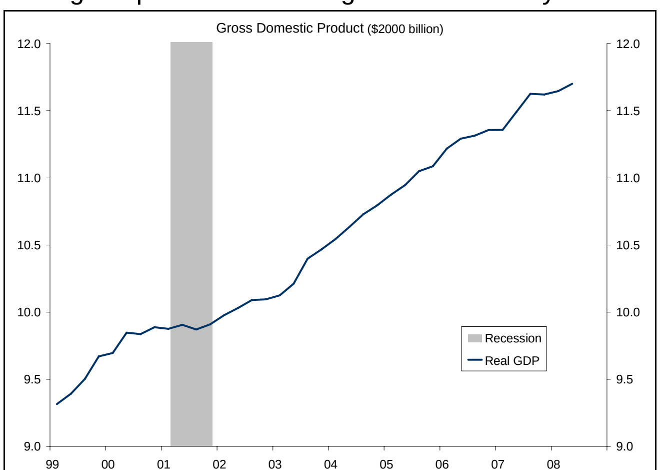
Economic Research – Scott J. Brown, Ph.D.

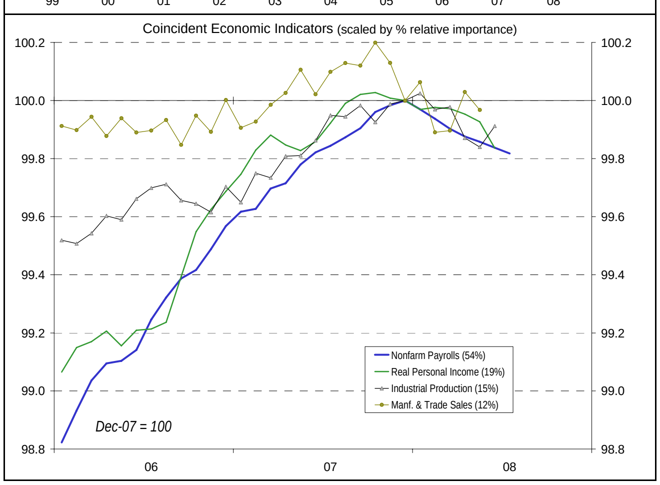
Thursday, August 7, 2008

The Fed Moves Back To Neutral

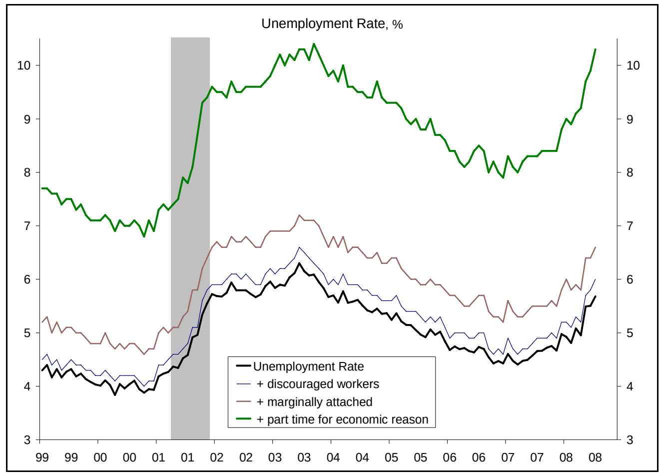
- *Economic data have remained mixed, consistent with lackluster growth and a weakening labor market. The housing correction, tight credit, and high energy prices will remain considerable restraints on growth.*
- *A sharp decline in prices of oil and other commodities will provide only modest relief for consumers and businesses in the near term. Headline consumer price inflation should decline.*
- *After stepping up the inflation rhetoric in June and adopting a small tightening bias at the June 24-25 policy meeting, the Fed moved to a neutral bias on August 5.*

Real GDP rose at a 1.9% annual rate in 2Q08, according to the government's advance estimate. While that figure is sure to be revised, the details do not suggest that the economy has entered a severe recession. The major monthly indicators of economic activity, emphasized by the National Bureau of Economic Research's Business Cycle Dating Committee, have been trending lower this year. Whether the NBER will eventually declare a recession is missing the point. Economic growth has clearly slowed.

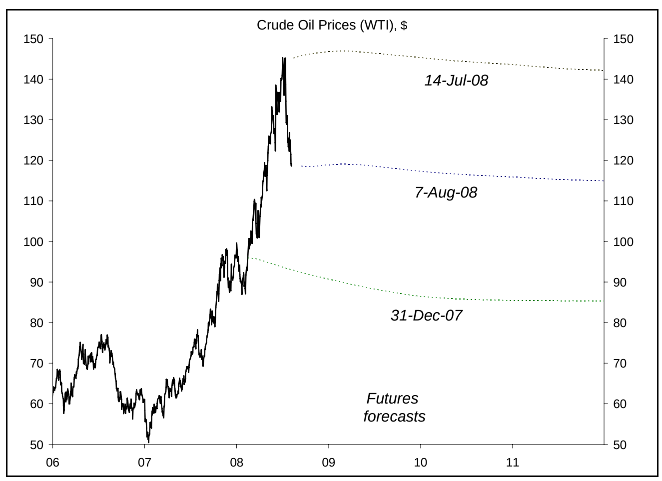




Growth has been well below potential, as evidenced by the increase in the unemployment rate. At 5.7% in July, the unemployment rate is not particularly high by historical standards. However, it was 4.7% a year ago. Measures of underemployment (those wanting jobs but not actively looking for employment and those working part-term for economic reasons) have risen sharply. The first half of the year was characterized largely by a lack of new hiring (which showed up as a decline in seasonally adjusted nonfarm payrolls), but job losses are likely to pick up in the second half of the year.



After dipping below $90 per barrel in early February, the price of crude oil moved higher into mid-July. In the last few weeks, oil has fallen nearly 20% from its peak. The average retail price of gasoline has dropped below $4. Oil at $120 is nothing to celebrate. High energy prices will remain a significant restraint on consumer spending growth in the near term. However, for the consumer, $120 oil is much better than $145 oil.



Corn prices have fallen more than 30% from the peak set in early July. This will not translate into a broader drop in food prices at the consumer level, but it's a start.

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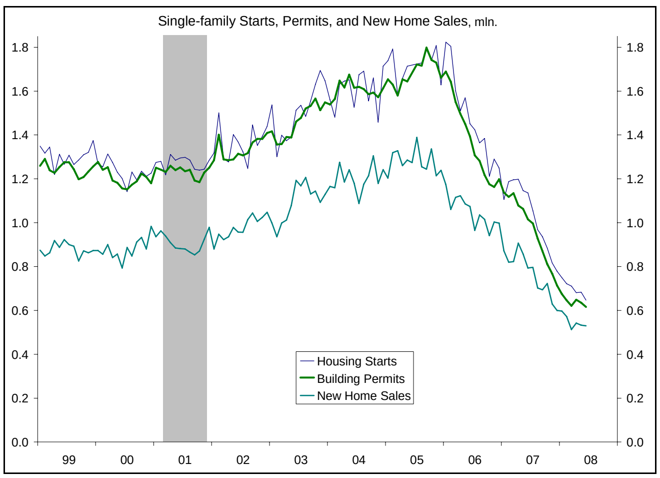
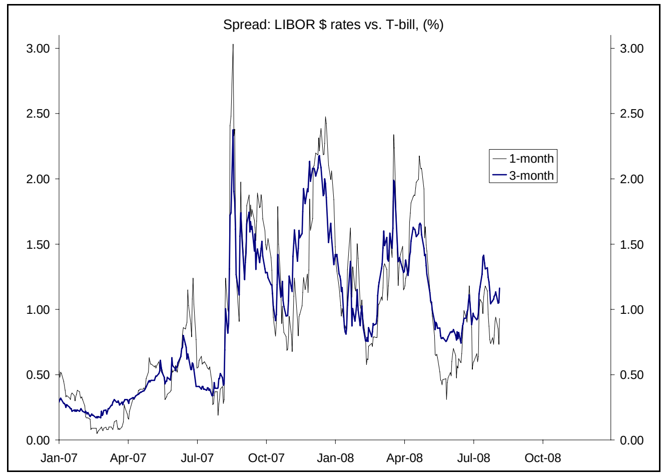
The recent drop in commodity prices has been driven partly by downward revisions in expectations of global growth. The increase in commodity prices earlier this year, in combination with shakier global credit market conditions, have dampened the growth outlook. Stagflation (slower growth and higher inflation) is a greater concern in the UK and Euro-zone than in the U.S. – these economies have clearly weakened and wage pressures are a much more immediate threat to inflation compared to the U.S. The dollar is likely to gain further ground against the major currencies, helping to push commodity prices lower. The soft dollar had been a factor in gains in U.S. exports in recent quarters, but strong global growth was likely the more dominant force. Slower global growth should dampen U.S. export growth in the quarters ahead (hopefully, as domestic demand begins to recover). However, lower commodity prices would help reduce the dollar value of imports, so a rapid increase in the trade deficit is unlikely.



The housing correction is ongoing. Declines in sales and construction activity appear to be slowing and may flatten out in the not too distant future. Wealth and credit effects from the housing weakness will remain.

Credit market conditions are still far from normal. The recapitalization of the banking system and general deleveraging will continue. Tighter credit remains a significant restraint on economic growth. Despite aggressive Fed rate cuts earlier this year, it may be some time before bank lending to consumers and businesses begins to ease. In July, the Fed and the Treasury made the government's backing of Fannie Mae and Freddie Mac explicit, promising to lend funds *if needed*. Should such action be required, the credit markets will likely remain on edge or weaken further.



For the Fed, the inflation outlook has improved, but has not softened completely. There is still little evidence of inflation pressure through the labor market. Such pressures may eventually show up, but that will be difficult, as labor market conditions are likely to weaken further. A moderation in food and energy prices will reduce headline inflation and slower economic growth should help to contain inflation pressures.

Inventories sank in 2Q08, and if not revised, should rebound in the quarters ahead. Profit margins are under pressure, but in contrast to previous slowdowns, business balance sheets started out in good shape.

	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	2007	2008	2009
GDP (↓ *contributions*)	4.8	-0.2	0.9	1.9	**0.9**	**1.6**	**1.7**	**2.2**	**2.4**	**2.5**	2.0	**1.6**	**1.8**
consumer durables	*0.2*	*0.0*	*-0.3*	*-0.2*	***-0.5***	***0.1***	***0.2***	***0.2***	***0.2***	***0.2***	*0.4*	***-0.1***	***0.1***
nondurables & services	*1.3*	*0.6*	*0.9*	*1.3*	***0.8***	***1.0***	***1.2***	***1.4***	***1.4***	***1.5***	*1.6*	***1.0***	***1.2***
bus. fixed investment	*0.9*	*0.4*	*0.3*	*-0.3*	***-0.1***	***-0.1***	***0.0***	***0.1***	***0.2***	***0.3***	*0.5*	***0.3***	***0.1***
residential investment	*-1.1*	*-1.3*	*-1.1*	*-0.6*	***-0.4***	***-0.3***	***-0.1***	***-0.1***	***0.1***	***0.1***	*-1.0*	***-0.9***	***-0.2***
government	*0.8*	*0.2*	*0.4*	*0.7*	***0.3***	***0.4***	***0.2***	***0.2***	***0.2***	***0.2***	*0.4*	***0.5***	***0.3***
Domestic Final Sales	1.9	-0.1	0.1	1.3	**0.1**	**1.1**	**1.3**	**1.8**	**2.1**	**2.3**	1.9	**0.8**	**1.4**
exports	*2.5*	*0.5*	*0.6*	*1.2*	***0.3***	***0.1***	***0.2***	***0.2***	***0.3***	***0.4***	*0.9*	***0.9***	***0.3***
imports	*-0.5*	*0.4*	*0.1*	*1.3*	***0.1***	***-0.1***	***-0.3***	***-0.3***	***-0.4***	***-0.4***	*-0.4*	***0.3***	***-0.1***
Final Sales	4.0	0.8	0.9	3.9	**0.5**	**1.2**	**1.2**	**1.7**	**2.1**	**2.3**	2.4	**2.0**	**1.6**
ch. in bus. inventories	*0.7*	*-1.0*	*0.0*	*-1.9*	***0.4***	***0.4***	***0.4***	***0.5***	***0.3***	***0.1***	*-0.4*	***-0.4***	***0.3***
Unemployment, %	4.7	4.8	4.9	5.3	**5.8**	**6.1**	**6.3**	**6.4**	**6.4**	**6.4**	4.6	**5.5**	**6.4**
NF Payrolls, monthly, th.	71	80	-82	-55	**-55**	**-32**	**28**	**68**	**93**	**102**	91	**-56**	**73**
Consumer Price Index	2.5	6.2	3.1	7.9	**0.4**	**0.9**	**1.8**	**2.1**	**2.2**	**2.2**	4.1	**3.1**	**2.1**
excl. food & energy	2.5	2.6	2.0	2.5	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**	**2.1**	2.4	**2.2**	**2.1**
PCE Price Index (q/q)	2.5	4.3	3.6	3.6	**4.2**	**3.7**	**0.6**	**1.8**	**2.0**	**2.0**	2.6	**3.5**	**2.0**
excl. food & energy	2.1	2.5	2.3	2.1	**2.1**	**2.3**	**1.9**	**1.9**	**1.9**	**1.9**	2.2	**2.2**	**2.0**
Fed Funds Rate, %	5.09	4.49	3.18	2.09	**2.00**	**2.00**	**2.00**	**2.19**	**2.66**	**3.21**	5.02	**2.32**	**2.52**
3-month T-Bill, (bnd-eq.)	4.4	3.5	2.1	1.7	**1.7**	**1.9**	**2.0**	**2.2**	**2.7**	**3.1**	4.5	**1.8**	**2.5**
2-year Treasury Note	4.4	3.5	2.0	2.4	**2.5**	**2.9**	**3.3**	**3.9**	**4.3**	**4.4**	4.4	**2.5**	**4.0**
10-year Treasury Note	4.7	4.3	3.7	3.9	**4.0**	**4.2**	**4.6**	**4.8**	**5.0**	**5.1**	4.6	**4.0**	**4.9**