Fourth Quarter 2006 Performance Review and Outlook for the 2007 Economy

Advanced estimates by the Bureau of Economic Analysis shows an accelerated real GDP growth rate of 3.5% in the fourth quarter of 2006 compared to a revised 2% rate for the third quarter. Fourth quarter growth was well ahead of a consensus 3% forecast. For the year, GDP growth was 3.4%. Real final sales, measured as GDP minus the change in private inventories, posted an even stronger 4.1% annualized growth rate. The stronger than expected economic performance did not fuel inflation. The GDP deflator for the fourth quarter was 1.5% compared to rates of 1.9%, 3.3% and 3.3% in the prior three quarters. The Fed's preferred measure of inflation, the core Personal Consumption Expenditure index (PCE), moved up 2.1% in the fourth quarter compared to a 2.2% increase in the third quarter. However, the stronger than expected GDP growth may raise inflation expectations going forward in 2007. The Fed is currently holding the Fed Funds rate steady at 5.25% with a slight bias toward raising the rate if inflation does not remain under control. The 3.5% growth rate is about 50 basis points above the generally accepted threshold for non-inflationary growth of the U.S. economy. The strong fourth quarter growth is likely to delay any Fed initiative to deal with the expected economic slowdown.

The outlook for the remainder of 2007 calls for an economic slowdown of growth to the 2% to 2.5% rate. The relatively tight labor markets reflected by the 4.6% unemployment rate and relatively high capacity utilization rates provide an inflation bias that is likely to emerge for growth higher than 3%. Consumer spending remains strong, but the housing slowdown should eventually move consumers back toward higher savings. A general slowdown in business investment in structures, equipment, and software should rein in growth. On the positive side, exports have picked up to provide some added support for growth. The chronic weakness of the dollar linked to increasing global expansion appears finally to be easing the huge trade deficit. On balance, the economy should generate slower growth without much added inflationary pressure, unless oil shocks occur.

Decreases in the Fed Funds Rate are off the Table

Going into the third quarter of 2006, many analysts believed the Fed might reverse its course by cutting the fed fund rate in response to a soft economy. A severe housing slump coupled with slowdowns in durable goods in general, and autos in specific, provided a background for forecasts of slow fourth quarter growth. The potential for a weak set of macroeconomic numbers did not materialize in the fourth quarter. This is not to say that there are not significant weaknesses in housing and high uses of consumer debt, but the overall economic growth of 3.5% in the fourth quarter is a full .5% higher than expected. As the stronger than expected fourth quarter developed, the Fed maintained its wait-and-see posture by holding the fed fund rate steady at 5.25%. In the Fed's most recent announcement, stronger language with respect to potential inflationary pressures suggests that interest rate cuts are off the table for the first quarter of 2007, if not for the first half of the year.

Targets for sustainable growth continue to be in the 2.5% to 3% range. Labor markets remain tight even with the most recent upward movement of the unemployment rate to 4.6%. Falling energy prices have gone a long way in muting inflationary pressures in the first months of 2007, but the potential for labor market pressures on prices remains. Worker productivity gains are now showing signs of lagging behind market wage increases, shifting much of the Fed's attention to the domestic labor market. Unless economic growth falls back into a range closer to 2.5%, the prospects for interest rate cuts are off the table.

Financial markets

Equity markets recorded attractive gains in the second half of 2006 with momentum carrying into the first quarter of 2007. Equity markets improved as investors gained confidence in sustained corporate earnings growth aided by lower energy prices, relatively warmer weather over the winter months, and relatively low interest rates on a historical basis. Money that has been on the sideline flowed back to equities with added support from higher than average bonuses linked to strong earnings of corporations and continued cash-out from housing refinancing. Stock indexes charged through key psychological barriers set prior to the 9/11 attack. Relatively low inflation will help keep interest rates low, providing room for equity values to grow. However, expected slowdowns in the economy, especially later in 2007, should moderate equity returns in 2007.

Cyclical stocks have had a good run since 2004, but a slower economy should dampen returns to these stocks. Oil and energy stocks are likely to have lost favorable conditions linked to higher energy prices. As 2007 unfolds, defensive stocks are more likely to come to the forefront of investor portfolios. Export-driven sectors are also likely to gain favor with investors due to positive export gains from a weaker dollar and higher income growth abroad.

The yield curve will continue to be slightly inverted or flat for longer maturities. Short-term yields remain relatively high from prior Fed policies. Long-term yields are relatively low, partly due to flows from high saving countries like China and Japan. Inflows of foreign savings should moderate and a strong demand for credit by the Federal government will continue as deficits persist. These factors should eventually bring the yield curve back to a positive slope, but this adjustment is not likely until later in 2007.

Review of Economic Performance for the Past Year

The table below summarizes key economic statistics for 2006. The data clearly show the drag that residential construction had on the economy. Improved exports, reduced imports, government spending and higher consumption spending helped offset the negative effects of the housing slump. A steady pattern of lower inflationary pressures is also evident.

Summary of Key Economic Data for the Last Four Quarters

	IV Quarter 2006	III Quarter 2006	II Quarter 2006	I Quarter 2006
GDP Growth*	3.5	2.0	2.6	5.6
Consumption*	4.4	2.8	2.6	4.8
Fixed Residential Inv.*	-19.2	-18.6	-11.1	-.03
Fixed Non-residential Inv.*	-0.4	10.0	4.4	13.7
Exports (%)*	10.0	6.8	6.2	14.0
Imports (%)*	-3.2	5.6	1.4	9.1
Government (%)*	3.7	1.7	0.8	4.9
GDP Deflator (%)*	1.5	1.9	3.3	3.3
PCE Deflator (%)*	-0.792	2.35	4.03	2.04
Producer Price Index (%)*	0.4	3.6	6.5	-3.7
Capacity Utilization (%)#	81.6	82.4	80.5	80.1

* Measures as an annualized percentage change from the prior quarter.
\# Measured as the percent of total capacity.

Summary of Recent Data

GDP Growth and Production

- Advanced estimates by the Bureau of Economic Analysis shows an accelerated real GDP growth rate of 3.5% in the fourth quarter of 2006 compared to a revised 2% rate for the third quarter. For the year, GDP growth was 3.4%.

- Construction spending fell by .4% in December. Private construction decreased .8%, largely due to a 1.6% decline in residential construction. Public construction increased .9%. Private residential construction decreased 1.6% in December and ended the year 1.9% lower than one year ago. Private residential construction makes up two-thirds of private construction.

- On a year-over-year basis, new residential construction fell 18%.

- New orders for durable goods increased 3.1% in December following increases in 2.2% in November and a negative 8.1% in October.

- Manufacturing data for the fourth quarter of 2006 was very weak. Both core capital goods orders and shipments declined at a rate not seen since 2004. For example, non-defense capital goods orders increased 9% in December following declines of .3% and 14.4% in the prior months. Non-defense capital goods shipments fell .4% in December following a 1.8% increase in November and a 2.3% decline in October.

- Industrial production rose at a faster-than-expected .4% in December. December's production numbers reversed a three-month decline.

- Total capacity utilization for December was 81.8% while capacity utilization in manufacturing was 80.4%. Both numbers are below the utilization rates of the second quarter of 2006 where total capacity utilization reached 82.4% and manufacturing utilization reached 81.1%.

- Business inventories increased in line with expectations for November, posting a .4% increase. The inventory to sales ratio for total sales held steady at 1.3.

- The ISM index for the manufacturing sector increased 2.32% in January. The index was 59 in January compared to a reading of 54.6 in September. The non-manufacturing ISM index retreated in January to a 49.3 reading. The non-manufacturing index stood at 52.7 in September. Overall, the index is consistent with positive expansion, but at a low rate.

Inflation

- The seasonally adjusted consumer price index (CPI) increased .5% in December following a flat November and a .5% decline in October. The core CPI, excluding food and energy, increased 1.4% in December following increases of 1.6% in November and 2.3% in October. For the year, both the CPI and core CPI increased 2.6%. The inflation rates are slightly lower than expected.

- The producer price index (PPI) for finished goods rose .9% in December with food and energy prices driving much of the increase. Core PPI increased by .2%. On a year-over-year basis, the PPI for finished goods increased 2%.

Unemployment and Labor

- The unemployment rate edged up to 4.6% in January. Most analysts believe the labor markets remain tight as long as the unemployment rate is below 5% for this economy.

- Non-farm productivity rose 3% for the fourth quarter of 2006. For the year, productivity was volatile with a .1% decline in productivity for the third quarter following a 1.2% increase in the second quarter and a 4.25% increase in the first quarter. Overall, productivity increased 2.1% for 2006. Productivity for 2006 was the smallest annual gain since 1997.

- Worker compensation increased 4.8% in the fourth quarter following a 3.1% gain in the third quarter, a 1.2% decline in the second quarter, and a 9% increase in the first quarter. Real hourly compensation adjusted for changes in purchasing power, increased 3% for all of 2006.

- Employer costs rose .8% in the fourth quarter of 2006, about .2% below the consensus expectation. Benefit costs rose 1.1%, matching the third quarter increase. Unit labor costs for 2006 increased 3.2%, which is the highest rate of growth in six years.

Employment, Consumer Income, and Consumer Spending

- The unemployment rate edged up to 4.6% in January from 4.5%. Initial unemployment claims continue to average 300,000 per week.

- Total retail sales increased .9% in December following a revised increase of .6% in November and a decline of .2% in October.

- Consumer installment debt increased by $6 billion in December following a $14 billion increase in November. On a year-over-year basis, consumer installment debt grew 4.6%. Non-revolving debt grew 4.3% for the same period. At the end of 2006, consumer debt reached a total of $2.4 trillion.

- Total income grew 5.8% in the fourth quarter following a 5.4% increase in the third quarter. Income growth in the first half of 2006 was stronger with an 8% annual rate of growth.

Sentiment and Confidence

- The Conference Board's index of **c**onsumer confidence increased to 110.3 in January from a revised reading of 110 in December. The index dipped to 100.2 in August of 2006 and has been slowly rebounding since that time. Present economic conditions offered the strongest contribution to the construction of the index.

- The Conference Board's Leading Indicator series rose .3% in December following a flat reading in November, a decline of .1% in October, and a .4% increase in September. The three-month annualized growth rate fell to .9% from 1.5%. The six-month annualized growth rate edged .3% higher, which is the first positive reading since April. Overall, the index was only 1% higher for 2006, suggesting little momentum for growth.

- The UBS Index of Investor Optimism reached 103 in January from December's index of 90. The index has been increasing steadily since August of 2006 where the index was only 53. The January index is the highest reading since early 2004. Investor confidence is grounded in lower inflation expectations, narrow credit spreads, strong equity market returns, lower market volatility, and relatively strong economic performance.

- The University of Michigan Consumer Sentiment Survey index jumped to 98 in January following a 91.7 index level in December. January's confidence index is the highest in the past three years. Both expectations and current economic conditions components were strong.

Housing

- Existing home sales fell -.8% in December, matching expectations. Sales were 6.22 million units lower in December. Housing prices were flat from one year ago with 6.8 months in inventory in December following 7.3 months of inventory in November and 7.4 months in October.

- Residential construction declined 1.6% decline in the fourth quarter of 2006. Private residential construction makes up two-thirds of private construction, contributing to an overall .8% decline in construction for the quarter.

Interest Rates

- The Fed held the fed fund rate steady at 5.25% in January as it did in its August, September, October, and December meetings. The Fed's discount rate also remained at 6.25%. The more optimistic statement about future growth prospects for the economy make it less likely that a cut in the fed fund rate will occur in the next few meetings. The statement released by the Fed suggests a bias toward higher rates based on a view that the favorable impact of lower energy prices on inflation has run its course. The Fed statement also notes high resource utilization rates in the economy, suggesting an inflationary bottleneck for higher than expected growth.

Global Conditions and Oil

- Crude oil prices peaked out in August at $75 and are now about 27% lower.

- U.S. import prices increased 1.1% in December following increases of .5% in November and a negative 2.6% in October. Export prices rose .7% in December following increases of .4% in November and a negative .3% in October. On a year-over-year basis, import prices increased 1.7% in December compared to an increase of 4.6% in export prices.