Outlook for the Economy – First Quarter 2005

The economy grew at a less than expected 3.1% rate in the first quarter of 2005 following a 3.8% GDP growth rate in the fourth quarter of 2004. The economy softened late in the fist quarter, largely due to higher energy prices and slumping consumer confidence. Inflation measures were higher than expected, raising concerns that Fed policies might vary from a slow and predicted upward movement of Fed Fund rates. The CPI increased at a 3% annual rate in the first quarter while the PCE index moved up at a 4% annual rate. However, core inflation measures were considerably lower. Higher oil prices were largely responsible for the higher than expected inflation numbers. Modest increases in the employment cost index helped moderate inflation. Unemployment remained at a low 5.2% level. Housing continues to be a strong sector of the economy, largely due to the resistance of long-term interest rates to short-term interest rate increases.

The relatively low level of economic performance in the latter stages of the first quarter is likely to carry over into second quarter performance. Consumer sentiment remains low and durable good orders are likely to remain soft as interest rates increase. Oil prices should reverse the upward trend of the first quarter, helping set the stage for improved economic performance in the third and fourth quarters of 2005. GDP growth is likely to be in the 3.25% to 3.5% range in the second quarter with stronger growth in the 3.75% to 3.9% range over the remainder of the year. Unemployment should remain close to 5.2% with moderate wage gains. Inflation rates will ease to something closer to the 2.5% target rate if oil prices move closer to $42 per barrel. The Fed should close in on a 4% Fed Fund rate by the end of the year, causing short-term rates to increase about 125 basis points. Longer-term rates are not likely to respond in full to the short-term rate increases, with only a 125 to 150 basis point spread for long term bonds yields over two-year bond yields.

Energy Prices

Crude oil prices approached $58 per barrel several times in the month of March, resulting in lower consumer sentiment, and reduced economic performance. Higher energy prices affected retail sales, production, payrolls, and inflation. A commonly used rule is that every sustained $10 per barrel increase in oil prices reduces subsequent annual GDP growth by as much as three-quarters of a percentage point. For example, if oil prices do not move down closer to the $42 per barrel mark, GDP growth for the remainder of the year is more likely to finish near 3% than to finish near 4%. Higher energy prices have also increased the downside risks for the economy.

Energy-intensive manufacturers and transportation companies are hit hardest by higher oil prices. Chemical, paper, apparel, textile, steel, stone, and clay and glass manufacturers are especially vulnerable to rising energy prices. A secondary effect of higher oil prices occurs when firms spend more on energy-saving projects, diverting investment away from productivity enhancing programs. For consumers, there is little chance to use savings to absorb higher energy prices, given the record low saving rates.

Soft Patch or Slower Trend Growth?

The economy finished with very weak performance in March. Orders for big-ticket manufacturing goods took a dive with durable good orders falling 2.8% in March. Higher interest rates, inflation concerns, and weak asset prices all contributed to a pull back in consumer and business spending on durables. Durable goods have a long life and are generally the first purchases to decline when spending slows. Durable good orders fell in every month of the first quarter with declines of 1.2% in January and .2% in February leading up to the whopping 2.8% decline in March. Durable good orders have not fallen for three straight months since the summer of 2001. Consumers have a good stock of durable goods from strong purchases in 2004 and they may wait to replace these goods until overall conditions improve.

Payroll employment and retail sales also slowed significantly in March. Toward the end of the first quarter, analyst generally revised economic expectations downward, but they still over estimated the GDP growth rate. First quarter increases in gasoline prices, declining consumer confidence, and higher inflation numbers all combined to slow the economy. These forces remain in tact for the first weeks of April, suggesting that second quarter growth may also be below trend. The trade deficit hit another record high in February presenting another drag on the economy that is not likely to improve much in the remainder of 2005.

The key question is whether the dismal economic performance at the end of the first quarter is a soft patch, much like last summer's economic performance, or whether a slower growth trend is developing. The risk of downside performance is now higher, but moderating oil prices will likely put the economy back on the path toward 4% GDP growth. Oil inventories are building and higher production rates are likely to materialize in the second quarter. Oil prices are now falling below the $50 a barrel mark and many analysts expect oil prices to reach a $42 per barrel level by the end of the year. However, the risk of continued energy price shocks cannot be dismissed. On balance, most analysts believe the softness in the economy in March and early April will not continue in to the third and fourth quarters, allowing the economy to return to a 3.5% to 4% growth trend.

Measured Moves toward a 4.5% Fed Fund Rate

The current policy of the Fed is to move short-term interest rates back to a neutral position from record-level lows set to help a sluggish economy in 2001. The policy calls for gradual increases in the Fed Fund rate until reaching a neutral target of 4.5%. The Fed described this policy as a measured response to low interest rates from prior expansionary moves. The Fed's intention was to allow a clear and gradual movement of interest rates that the market could anticipate and price in advance of announcements. The next FOMC meeting is expected to result in another 25 basis point increase in the Fed Fund target.

Minutes from the last FOMC meeting in March revealed a debate on whether or not to continue the measured policy or follow a bias toward higher rate increase. Fed views on

inflation were revised upward due to higher than expected pressures on prices in the first quarter. The potential for higher than 25 basis point moves in the Fed Fund target may become part of the Fed's policy if inflation pressures do not subside in the second quarter. Lower core inflation measures helped moderate the Fed's view, resulting in a continuance of the measured policy. However, the debate on higher than expected moves in the Fed fund target will continue in the early May FOMC meeting and analysts will look for any potential change in Fed policy addressing higher than expected inflation.

Summary of Recent Data Announcements

Gross Domestic Output and Production

- Growth in real GDP was 3.1% for the first quarter of 2005, well below revised analyst expectation of 3.7% and fourth quarter growth of 3.8%.

- New orders for durable goods declined 2.8% in March, following a revised .2% decline in February and 1.2% decline in January. On an annual basis, orders for durable goods declined 16% in the first quarter. The decline in durable good orders suggests a slowdown in manufacturing activity that is likely to carry into the second quarter.

- Orders for machinery fell 7.6% in March as business investment weakened in the first quarter.

- First quarter business fixed investment grew at an annualized rate of only 5% following growth of 10.5% in the fourth quarter of 2004 and 8.8% growth in the third quarter of 2004. Business fixed investment increased 9.5% on a year-over-year basis.

- Business inventories increased .5% in February following a .9% increase in January. March inventory figures will be released on May 13. The inventory to sales ratio had a modest increase in February moving up to 1.31 from 1.30. First quarter inventory accumulation is well below levels recorded in 2004.

- Industrial production increased 3.8% in the first quarter of 2005, below the twelve-month average increase in industrial production of 4.4%.

- Capacity utilization edged up to 79.4% in March from the 79.3% utilization rate in February. The average utilization rate for the first quarter was 79.3% and the twelve-month average utilization rate was 78.6%. The utilization rate is moving close to the low 80% range where bottlenecks and supply constraints often occur.

Interest Rates

- The Fed's policy of "measured" increases in the Fed funds rate continues to be in place, even though recent minutes of the FOMC suggest that the Fed may now be biased toward larger interest rate increases to thwart inflation. The Fed fund rate is currently 2.89% (April 28th) and is expected to be targeted at 3% in next weeks FOMC meeting. The Fed Fund rate increased 1.63% from one year ago. Most analysts believe the Fed will continue its measured policy of 25 basis point increases in the Fed Fund rate to reach a target of 4.5%.

- The yield curve has been taking a flatter shape over the last year as the Fed increases short-term rates without commensurate increases in the long-term yields. Currently, the spread between 10-year Treasury securities and 3-month Treasury yields is only 126 basis points. This spread is 122 basis points lower than one year ago. Most analysts believe the flatter yield curve beyond the two or three-year maturity indicates that the market does not expect long-term inflation, with corresponding higher interest rates. However, higher interest rates over the course of the next few years are already built into the yield curve, reflected by the steep segment of the yield curve out to the two to three-year maturity suggests.

- Moody's Corporate-Treasury bond yield spread is 175 basis points as of 29 April. The spread is a reflection of the market risk premium required for investors to take on the riskier corporate securities. The risk spread is 72 basis points lower than one year ago, suggesting a reduced market risk premium.

Inflation

- The core value of the personal consumption expenditure inflation index (PCE) increased .3% in March with the full index advancing .5%. The PCE index increased .3% in February and .2% in January. The PCE inflation measure is a key indicator used by the Fed. For the first quarter, the PCE index growth translates into an annual rate of just over 4% inflation for the year.

- The consumer price index rose by 3.2% in March and by 3% for the first quarter of 2005. The first quarter increase in the CPI matched the twelve-month increase of 3%.

- Crude oil stocks increased by 5.4 million barrels from April 15th to April 22nd; according to the American Petroleum Institute's inventory numbers. Since March 4th, crude oil inventory increased by 22 million barrels. Oil prices should fall below the $50 a barrel mark in the second quarter and may approach a $40 a barrel price by the end of the year.

Consumer Income and Spending

- The Commerce Department announced a .5% increase in personal income in March, which is the highest gain since a 3.7% gain in December. Income grew .4% in February after falling 2.4% in January. Consumer spending increased .6%

in March following a .7% gain in February and no change in January. Consumer spending increased 3.5% for the first quarter as a whole, below the 4.2 % spending in the fourth quarter of 2004. The gains in income and spending were higher than expected, especially given the overall poor performance of the economy in March.

- On a year-over-year basis, real consumer spending grew by 3.6%, approximately matching the GDP growth rate for that period.

- For the first quarter of 2005, wages and job benefits rose .7% according to data released by the Labor Department. Fourth quarter 2004 wages and benefits grew .8%. The .7% increase in wages and benefits during the first quarter of 2005 is the smallest increase in six years, helping to ease concerns over wage-induced inflation pressures.

- Personal savings as a percentage of disposable income dropped to .4% in March, the lowest level since a negative .3% savings rate in October 2001. The saving rates were .5 and .8 in the first two months of the quarter.

- Personal and disposable income grew by .5% in March, beating expectations by a small margin.

Sales

- Retail sales increased only 5.8% in March following stronger sales in February and January. For the quarter, retail sales increased 7.2%, which is just below the twelve-month average of 7.3%.

- Chain store sales dropped .3% in the week ending April 23rd. Year over year growth was 4%. Spending should continue to grow at a moderate pace with improvements in wages and salaries and more moderate energy prices.

Sentiment and Confidence

- Consumer confidence slipped in March. The Conference Board's Consumer Confidence Index fell to 97.7 on April 5 from 103 on March 5. The April 5 index is the first reading below 100 since last November. The decline in consumer confidence was expected. Both the current conditions and expectations components of the index were down, largely due to a weak labor market and higher energy prices. Most analysts believe the confidence index will have a flat trend with some volatility driven by uncertainty over inflation.

- The Conference Board's Leading Indicators fell .4% in March. The index had a broad base decline in eight of the ten components. The index declined in two of the last three months and in six of the last nine months. Overall, the index is lower than it was one year ago.

- The risk of recession within the next six months, as measured by Economy.com, was 18.7 for March following a measure of 19% in February and 18.3% in January. The risk of recession measure has been on a downward trend since reaching a peak of 36% in July of 2004. Weaknesses include declines in the average workweek for manufacturing and declining stock market values.

- The ECRI Weekly Leading Index reversed a positive trend established in the first part of the first quarter and has been sliding since the March 25 announcement.

Unemployment and Labor Markets

- The unemployment rate was 5.2% at the end of March, with an average of 5.3% for the first quarter. The twelve-month average unemployment rate is 5.4%.

- Employer costs increased .7% in the first quarter, which was slightly below expectations. Weak wage growth continues to offset high benefit cost growth. Wages and salaries grew at a .6% pace in the first quarter of 2005, in line with the average growth rate for 2004. Employer costs are 3.5% higher at the end of March 2005 than at the end of March 2004. On the same year over year basis, wages grew only 2.4%. Benefit costs continue to be the biggest driver of employer costs with a 1.2% increase in the first quarter and a 5.9% increase over the same period last year.

- Initial jobless claims per week should return to a trend of 335,000 established last year after following a lower trend of 330,000 set recently.

Housing

- New home sales increased by 12% in March from February with 1.431 million annualized units sold. First quarter 2005 new home sales set a record pace

- Total home sales were flat from the fourth quarter of 2004. National mortgage rate averages moved slightly higher to 5.9% in March from 5.63% in February and 5.71% in January.

- House price appreciation slowed again in March. The median new home price is down by 6% on a month over month basis and by 1.3% over the year.

- Sales of existing homes increased by 1% in March to reach 6.89 million annualized units following a pace of 6.82 million units in both February and January.

Fiscal Deficit

- Through the first six months of 2005, the cumulative fiscal year deficit is $295 billion with an expectation of a $400 billion plus deficit for the year ending in September.

- Tax cuts have reduced personal income tax receipts as a share of GDP. While government spending will likely have a slower rate of growth there will still be spending increases, making it difficult reduce the size of the deficit. Without significantly higher growth in GDP combined with higher tax rates, there is little hope for bringing the deficit back to a balance.

International Trade and Global Economic Conditions

- Global GDP, on a market value basis, is growing at an estimated 3.5% rate. The 3.5% rate is ahead of the potential growth rate estimate of 3%. Differences in growth are dramatic with China leading all expansions with a 10% growth rate, largely fueled by export growth. Both Japan and the euro zone economies are struggling to stay out of a recession.

- Commodity-producing economies should have strong performance with increased foreign-direct investment in developing economies with natural resources.

- The U.S. trade deficit continues to get worse. The current account deficit in the fourth quarter of 2004 was $750 billion at an annualized rate. The trade deficit represents a record high of well over 6% of the U.S. GDP. A current account balance last occurred in the early 1990s.

- U.S. trade with China is largely responsible for the widening deficit in the U.S. current account. China alone accounts for approximately $50 billion of the deterioration in the U.S. trade account over the last three years.

- Rising energy and commodity prices are key causes of the widening U.S. trade deficit. China's increased demand for commodities plays a large role in driving commodity prices higher.

- China's policy of fixing the value of the yuan to the dollar is causing increased pressure on trade relationships. Without a floating yuan, there may be pressure for protectionist policies, which ultimately reduce global economic performance. The growing imbalance between China on the one hand and Japan, the euro zone, and the U.S. on the other hand, may increase the danger of a global currency crisis.