Outlook for the Economy: Second Quarter of 2005

The economy grew 3.4% in real terms during the second quarter of 2005 following a revised first quarter growth rate of 3.8%. Second quarter growth was in line with the first quarter's <u>Outlook</u> *expectation of 3.25% to 3.5%, but it generally came in higher than most analysts expected. Significant improvement occurred on several key fronts. Inflation moderated during the second quarter, largely due to slower employment cost growth. Unemployment edged down to 5% from the 5.2% rate of the first quarter and housing continued to provide a boost to overall economic activity. Manufacturers worked off inventories in the second quarter, setting the stage for slightly higher growth in the second half of 2005. Consumers propped up with increased equity wealth, due to higher housing and equity prices, continued to keep the economy growing. Business inventory investment was soft but increased export growth and consumer spending kept the economy on trend for stable growth with low inflation.*

Growth for the second half of 2005 should exceed 3.6% with an upside of 3.7% based on increased strength in manufacturing and inventory rebuilding. Consumers will need to balance strong employment markets, low inflation, and relatively high asset values against a drag caused by high energy prices. On balance, consumers should continue to provide a strong demand for goods and services. Business investment should provide an added boost in the second half of 2005 as inventories are added and manufacturing is expanded. Exports are not likely to help GDP growth in the second half of 2005 to the extent that they did in the second quarter, but the revaluation of the yuan may signal currency realignments that would favor U.S. exports and dampen U.S. imports with China. Inflation is likely to remain moderate at the core level until next year when capacity utilization may exceed the 80% benchmark for anti-inflationary growth.

The Fed continued its march toward a 4% fed fund rate by the end of the year after setting a 3.5% target in July, but long-term rates have not followed suit. The Fed will continue to move short-term rates back to a more "neutral" level close to 4.5% over the next calendar year. The yield curve will continue to be relatively flat as long-term rates respond to relatively low inflation expectations and low risk premiums.

Greenspan's Take on the Economy – Tighter Monetary Policy

Fed Chairman Greenspan's comments during the semiannual monetary policy report to Congress and the minutes from the June 29 and June 30 FOMC meeting leave little doubt that the Fed will continue its gradual tightening of the economy through successive increases in the fed fund rate. The Fed will continue to reverse the accommodating policy initiated back in the recession that brought interest rates to historical lows. The relatively strong cyclical recovery is now well established, according to Greenspan, and the reversal of accommodating policies will continue until short-term rates are back to a

more neutral level. The Fed's economic report summarized in the Beige Book is generally upbeat, but Greenspan suggests three potential risks to the economy that require monitoring. First, slower productivity growth is taking shape and may force higher unit labor costs. Second, energy prices continue to rise, with $60 a barrel oil and strong global demand. Third, the flat yield curve presents a problem in a number of housing markets due to speculative financing of housing through adjustable rate loans and other more exotic forms of financing based on short-term rates.

Most analysts do not see higher unit labor costs in the immediate horizon. On the contrary, unit labor costs have been relatively low even with declining unemployment rates. Moderate inflation pressures also help keep unit costs low and the growth in benefit costs has also slowed. Greenspan's other two concerns are more widely accepted. Energy prices are likely to continue to rise, but consumers seem to be absorbing the price shocks without significant reductions in spending. The spread between short-term and long-term interest rates has narrowed for a variety of reasons, but the traditional narrowing associated with expectations of an economic downturn is not the explanation for the current flattening of the yield curve. Few analysts see a housing "bubble" that could burst if interest rates increase at a higher than expected pace, but many homeowners using adjustable rate financing will face higher housing costs as short-term rates rise.

Further analysis of the threats from potential increases in unit labor costs, energy prices, and a reversal of the flat yield curve coupled with higher short-term rates will be ongoing in the third quarter. Nevertheless, it is clear that the Fed will likely increase the Fed fund rate by 50 basis points by the end of the year and will push the target up another 50 basis points to 4.5% by the middle of 2006.

The Flat Yield Curve Anomaly during an Expansion

Normally, yield curves do not become flat during an expansion. The normal pattern is for yield curves to flatten only when market expectations call for lower future interest rates, which tends to occur just prior to economic downturns. Market expectations for lower interest rates result in an increased demand for long-term fixed income securities. The increased demand for long-term securities drives the prices of long-term securities up and long-term yields down. Currently, the yield curve is relatively flat and has become flatter in the first half of 2005. The table below summarizes key spreads between 3-month Treasury bill discount rates, 10-year Treasury notes, and 30-year Treasury bonds at the start of 2005 and on July 25th.

Date	Spread Measure	Spread %
1/25/2005	(30-yr. T-bond – 10-yr. T-note)	(4.68% - 4.2%) = 0.48%
1/25/2005	(10-yr T-note – 3-month T-bill)	(4.2% - 2.36%) = 1.84%
7/25/2005	(30-yr. T-bond – 10-yr. T-note)	(4.47% - 4.25%) = 0.22%
7/25/2005	(10-yr T-note – 3-month T-bill)	(4.25% - 3.33%) = 0.92%

The spreads between short term and long-term rates are very low by historic standards and have been getting lower, yet the economy is expanding. Plausible explanations for this phenomenon include lower inflation expectations, lower term risk premiums, and a view that the Fed will not continue raising rates in the longer-term.

Summary of Recent Economic Data Releases

Gross Domestic Product and Production

- The second quarter advanced GDP report has a 3.4% annual real GDP growth rate following a 3.8% rate in the first quarter. The second quarter growth rate was only slightly higher than the consensus forecast of 3.3%.

- Inventory investment declined dramatically in the second quarter, taking 2.3% away from GDP growth. However, the reduction in inventory investment in the second quarter should lead to stronger investment and growth in the second half of 2005.

- Fixed investment in the second quarter was much stronger than in the first quarter, adding 1.5% to GDP growth. Business investment and housing investment were key drivers of the overall investment performance for the second quarter.

- New orders for durable goods increased 1.4% in June and were well above expectations. Durable goods numbers for June support the view that U.S. factory production will pick up in the second half of 2005. The inventory to sales ratio for durable goods manufacturers hovered around a low measure of 1.4 in the second quarter. The inventory to sales ratio for capital goods is especially low.

- These factors suggest that the economy will have an upturn in production.

- Unfilled orders for durable goods increased 2.6% in June and inventories fell .3%. Both measures suggest stronger durable good manufacturing in the second half of 2005.

- Capacity utilization reached 80% in June, the highest rate since December of 2000. The 80% utilization rate is normally a threshold for production bottlenecks and inflationary pressures, but much of the increased utilization came from expanded capacity utilization for utilities, which is not expected to be long-term use.

- The ratio of business inventories to sales hovered around 1.3 during the second quarter.

- Industrial production rose by .9% in June following increases of .3% in May and -.03% in April. Production increased 3.8% over the past year.

Inflation

- The personal consumption deflator (PCE) for the second quarter was 3.3%. The core component of the PCE deflator was only 1.8% in the second quarter compared to 2.4% in the first quarter, suggesting moderate inflation going into the second half of 2005.

- Oil prices are now hovering around the $60 a barrel mark. Demand remains strong fueled by summer gasoline consumption in the U.S. and a revaluation of the yuan that results in a cheaper dollar price of oil for China. China is now the third largest importer of oil behind the U.S. and Japan.

- The overall GDP deflator was up 2.4% in the second quarter following a 3% deflator in the first quarter.

- Overall, inflation reports came in below expectations. Both the Producer Price Index and the Consumer Price Index were flat in July announcements compared to expectations for inflation rates of .4% and .2%, respectively.

- The core Producer Price Index (PPI) fell .06% on a month-over-month basis in June. The year-to-year inflation rate dropped to 2.23% in June. During the first half of 2005, the year-to-year inflation rate was 2.23%. The headline PPI was unchanged in June and increased by 3.58% on a year-over-year basis, reflecting the effects of higher energy prices.

- The core Consumer Price Index (CPI) rose only .1% in June with a year-to-year inflation rate of 2.0%. For the first half of 2005 the core consumer prices increased 2.08% on an annual percentage basis. For the last 12-month period, the CPI inflation rate was 2.5%.

Consumer Spending

- Real personal consumption increased 3.3% in the second quarter following a 3.5% increase in the first quarter. Durable good consumption provided a big lift to overall demand while nondurable consumption slumped.

- Gas prices increased $.20 per gallon since the Memorial Day weekend, but consumers continue to travel. According to the Travel Industry Association of America, summer tourism is strong with favorable macroeconomic conditions offsetting higher travel costs.

- Weekly chain store sales increased 4.2% from one year ago, measured on July 23. Analysts see mixed support for sales growth going forward as energy prices and consumer debt burdens weigh against strong labor markets and wealth gains from real estate and equities.
- Retail sales increased 1.7% in June The retail control series (retail sales excluding vehicles and building materials) increased by 8.6% on an annual percentage basis during the second quarter.

- Consumer credit fell in May by $3 billion. May's decline in consumer credit was the first since November of 2003. The decline was driven by non-revolving credit with a slight increase in revolving credit. Total consumer credit is $2,127.4 billion at the end of May.

Sentiment and Confidence Data

- The Chicago Purchase Manager's Index increased from 53.6 in June to 63.5 in July. The only soft spots in the index growth were inventory build-up and prices paid. Both of these measures provided only a modest drag on the index. The consensus forecast of the index was only 55.

- The University of Michigan Sentiment Index reading of 96.5 for July was in line with expectations and consistent with continued economic growth.

- The Conference Board's Consumer Confidence index fell three points to 103.2 in July from June's upwardly revised 106.2. Most analysts believe that July's dip in the index is insignificant, especially since the overall trend remains positive. Higher energy prices threaten confidence, but consumers feel wealthier due to housing price gains and rising stock prices. A strong labor market and relatively low interest rate levels should also help keep confidence high.

- The ECRI Weekly Leading Index has generally followed an upward trend since early June of this year.

- The Conference Board's index of leading indicators increased .2% on a month over month basis in June following gains of .01 in May and .91 in April. As the manufacturing sector picks up in the second half of 2005, the index should provide promising evidence of an expansion.

Labor Markets

- The employment cost index (ECI) for the second quarter was lower than expected. Compensation for workers rose .7% from March to June, matching the same increase from December to March. Benefit costs remain the key driver of overall employment costs with an increase of .8% in the second quarter and a 5.1% growth over the same period last year.

- Wages and salaries increased only .6% in the second quarter, matching the increase in the first quarter. Weak wage growth suggests that the labor market has slack even though the unemployment rate is relatively low.

- The four-week moving average for unemployment claims was 319,250 for the week ending on July 23.

- The unemployment rate at the end of July remains close to 5%. An increase in the labor-force participation rate may help ease tight labor market conditions and keep wage costs down.

Interest Rates

- The yield curve continues to flatten. The spread between the two and ten year Treasury notes is only 28 basis points at the end of July. Fed policy resulted in a .97% increase in the 3-month Treasury bill discount rate from January to mid-July, but longer-term yields measured by the 30-year Treasury bond fell .21% over that same period.

- Fed fund futures contracts remained stable even after two days of testimony from Chairman Greenspan, the yuan's revaluation, and solid economic growth data. Futures contracts reflect expectations for another 25 basis point increase when the Fed's Open Market Committee meets. The August target rate should be 3.5%. The futures market also prices in two more 25 basis point increases this year, bringing the fed fund rate to 4% by the end of the year.

Federal Budget Deficit

- The federal budget deficit for fiscal year 2005 ending on September 30, has been revised downward significantly. The OMB projected a deficit of $427 billion back in February, but the estimate is now only $333 billion.

Housing

- June's prices for existing homes represented the largest annual increase since 1980, according to the National Association of Realtors. June sales were 4.4% higher than levels of one-year ago and increased 2.7% on a month over month basis. The median house price increased 14.7% from one year ago.

- New home sales increased 4% in June following a 1.32% increase in May. Inventories of new home sales remain low. The housing market continues to be strong due to relatively low interest rate levels, strong demand, and continued marketing of exotic mortgages.

- Rates on 30-year mortgages are below 6%, but are slowly moving up.

- Federal Reserve Chairman Alan Greenspan pointed to signs of market speculation and use of exotic mortgages, such as interest only contracts, as potential problems in select urban markets.

- Housing price slowdowns could put a damper on economic growth, since consumers have a relatively large proportion of wealth in real estate equity.

- The National Association of Realtors housing affordability index declined in June, following an overall downward trend that started in mid-2003. The current index is 120 compared to an index of 145 for the mid-2003 period. The affordability index is very sensitive to interest rates and performance of mortgage contracts, such as adjustable-rate mortgages.

International Trade

- Exports increased at an annualized rate of 12.6% in the second quarter while imports declined 2%. The second quarter's favorable movement in the trade account had a positive influence on GDP growth. Nevertheless, the overall trade deficit is not likely to improve much over the year.

- The dollar has been generally rising since January of this year and a higher trend of interest rates in the U.S. should help support further dollar appreciation.

- The trade balance narrowed by $1.55 billion to -$55.35 billion in May