Outlook for the Economy and Markets – Third Quarter 2005

The Commerce Department announced a third quarter real GDP growth rate of 3.8%, which is slightly ahead of expectations. Third quarter growth makes the real GDP growth on a year-to-date basis a healthy 3.6%. The economy remains resilient to unexpected shocks in oil prices, weather damage, and increased uncertainty. Nevertheless, fourth quarter growth is likely to suffer as some of these shocks work through the system later this year. Higher energy prices and hurricane destruction have both hurt consumer and investor confidence as we move into the fourth quarter.

Fourth quarter GDP is likely to be closer to a 3% annual growth rate as the economy shrugs off delayed reactions to hurricane disasters and slowly adjusts to high but moderating oil prices. Consumer and investor confidence is low, which may dampen both consumption and investment spending going forward in 2005. Energy prices continue to be high but there is some offset by lower food prices. Overall price pressure is moderated by capacity utilization of only about 78%, well below the mid-80% levels required for inflationary bottlenecks in the rest of the economy. The Fed fund rate is almost sure to be 4.25% by the end of the year with small spreads for higher maturities. While interest rates will be somewhat higher overall, the 10 year Treasury bond yield is likely to be no higher than 4.9% at the end of the quarter.

The Inflation Wild Card

Inflation remains the most immediate threat to economic stability. On a year-over-year basis the core CPI grew at a modest 2% in the third quarter, but the overall CPI rose 4.7%, reflecting the dramatic effect of higher energy prices. Inflation measured by the implicit price deflator used in GDP data adjustments increased at a much lower 3.1% annual rate for the third quarter. The personal consumption expenditure index (PCE), a measure of inflation monitored most closely by the Fed, also increased by about 3% on a year-over-year basis. Analysts agree that inflation is now at the upper end of the range considered to be tolerable by the Fed. Additional inflationary pressure will be met with a more dramatic Fed response. We could see a bump of 50-basis points at the early December FOMC meeting if inflation numbers continue to get worse.

Fed policy continues to call for incremental increases of 25 basis points at each meeting of the Federal Open Market Committee. The Fed fund rate target is now 4% as a result of a long series of increases over the past two years. Yet, long-term interest rates remain relatively low as the markets do not expect long term inflation, resulting in a rather flat yield curve beyond the five-year maturity. A strong upward movement in long term interest rates hinges on inflation reports. Signs that the Fed can not contain inflation within the 2%-3% range will prompt a series of upward movements at the long-term end of the yield curve. Higher long-term rates will clearly be bad news for stock and long term bond markets.

There is much debate over a target for the Fed fund rate that would put the Fed back in a "neutral" position. Many analysts once discussed this neutral target in terms of a 4.5% Fed fund rate, but it will now be higher than that due to higher inflation levels. This means the Fed is likely to continue its slow upward movement of the Fed fund rate into the winter and first quarter of 2006.

Industry Outlook – Overall Performance Looks Good but Threats Exist for Financial Institutions

Shocks to the U.S. economy from late summer hurricanes appear to have had little effect on industry performance outside the immediate areas of damage. Approximately 12% of oil refining capacity went offline, but crude oil prices fell back to the $60 a barrel level due to the addition of the nation's oil reserve to supply. Second quarter revenue for publicly traded companies grew a little over 13% and third quarter earnings have been strong. There is a threat that companies will delay investment spending in the fourth quarter as they assess the combined effects of higher oil prices, hurricane damage, and falling consumer confidence. Several industries typically under-perform in the coming economic environment to include most interest sensitive firms; such as autos, construction, durable good manufacturers, and financial institutions. In this report we focus on the challenges faced by financial institutions.

Financial institutions and business services entered the third quarter in very good health with second quarter growth exceeding 15% and strong third quarter performance, outside the insurance carriers. We now see insurers scrambling to cover hurricane losses and some banks are faced with charges for expected loan defaults linked to hurricanes. Looking forward, financial institutions will face new challenges that will dampen earnings growth. Rising interest rates, low spreads between costs of funds and rates on assets (linked to flat yield curves), rising household debt service ratios, weaker mortgage demand, and slower vehicle sales should take a toll on performance. Larger and more diversified financial institutions will perform better than smaller banks that tend to be concentrated in consumer lending.

Global Economic Conditions

Overall, global economic conditions are on track to post a 3% GDP growth rate in 2005. All economies are adjusting to higher energy prices with some economies benefiting while others are hurt. High growth economies include Venezuela (9.5%), China (9.3%), India (7.1%), Turkey (6.3%), Russian Federation (5.8%), Chile (6.3%), Malaysia (5.3%), Argentina (5.2%), and Indonesia (5.1%). The primary economies that are lagging in economic growth are Japan (1%), and all of the Euro Zone countries (1.5%). From the U.S. perspective, the lagging economic performance in Japan and the Euro Zone helps keep a lid on the demand for oil, allowing for less pressure on oil prices.

Most of the rest of the world depends on solid growth in the U.S., since industrial production is geared toward selling goods in the U.S. market. The expected 3.6% growth in the U.S. for 2005 is consistent with realized growth through the first three quarters. Global inflation is modest with only a 2.6% CPI growth rate for 2005, but the producer price index (PPI) is growing at a 4% rate. If this higher inflation rate at the producer level is passed on to consumer prices we will see a much higher consumer inflation rate in 2006. One safeguard is that central banking around the world has now become much more sensitive to inflation and is not influenced by politics to the extent it was in earlier periods where global inflation was accommodated. More countries are using inflation targets and have made central banking independent of political positions.

For the U.S., import prices increased 2.3% in September, adding more to inflation pressure than expected. Oil prices accounted for most of this jump and non-petroleum prices were up only 1.2%. Export prices increased .9% in September, the highest monthly gain since April of 1995. The trade deficit increased to $59 billion in August. The goods deficit with China and the European Union continues to increase. In August, the trade deficit with China grew to $18.5 billion while the deficit with the Euro Zone grew to $11.3 billion. The U.S. deficit with Japan remained constant at $6.6 billion for the month of August. Currently, U.S. imports are about 1.6 times as large as exports, making it necessary for a very rapid growth in exports relative to imports in order to make much progress in closing the trade gap.

Summary of Recent Economic Date

Economic Growth, Production, and Investment

- Real GDP grew at a 3.8% annualized pace in the third quarter, based on advanced estimates form the Commerce Department. For the year to date, the economy grew at a real 3.6% rate. Third quarter growth exceeded the 3.3% growth in the second quarter, largely due to stronger growth in consumer spending, a smaller decline in inventories, and an increase in federal government spending. Hurricane Katrina hit about two-thirds of the way through the quarter, resulting in a limited effect on third quarter GDP.

- Private fixed investment grew at an annualized rate of 5.7% in the third quarter following growth rates of 9.6% and 7.0% in the prior quarters.

- Industrial production fell by 1.3% in September following an increase of .2% in July and 0% in August. Manufacturing output declined .5% in September, largely due to the decrease in refining output from hurricanes in the gulf. Manufacturing increased .4% in August and .3% in July.

- Capacity utilization fell 1.2% in September to a level of 78.6%. The utilization rate was 79.7% at the start of the third quarter.

- New orders for manufactured goods increased 2.5% in August, well ahead of expectations. The August increase wiped out the 2.5% decline in July.

- Inventories rose .4% in August following a decline of .4% in July and no change in June. The inventory to sales ratio remained steady at 1.3% in August and matched the same 1.3 ratio achieved in the prior 7 months.

- Construction spending increased .5% in September following increases of .6% in August and .6% in July. These third quarter numbers are much higher than for prior months.

- New orders for durable goods fell by 2.1% in September. September's decline followed an increase of 3.8% in August and a decline of 5.4% in July.

Confidence and Sentiment Data

- The University of Michigan sentiment index fell 1.5 points to 75.4 in October. The index is at its lowest level since 1993. The index may improve going forward into the fourth quarter if the psychological and economic effects of the hurricanes ease and gasoline prices continue to ease.

- The Conference Board index of consumer confidence fell 2.5 points in October to a level of 85. The index fell 18 points in September. Currently, the index is at its lowest level since October of 2003. The index started the third quarter at 103.6 and ended with a September reading of 87.5. The downward movement in consumer confidence was broad-based.

- The Conference Board Leading Indicators index fell .7% in September following declines of .1% in both August and July. Hurricanes may have been responsible for much of the decline. Higher jobless claims and weaker overall confidence both made a big impact on the index. A 2% annualized fall in the leading index over a six-month period, with more than half of the index components falling, represents the general rule required before a recession signal by the indicators. The July and August declines contributed to only a .9% decline in the index over the six-month period ending in August. While the index is falling, it is far from levels of decline required for a recession signal.

- The ABC News/Washington Post consumer comfort index fell two points to -19 for the week ending October 23. Reductions in the state of personal finances provided a key cause for the reduction in consumer comfort. The index weakened significantly since mid-August.

- In October, the UBS Index of Investor Optimism reversed its losses in September. The index rose to 47 in October following an index of 34 in September. However, the index was 61 in August and 58 in July. Perceptions of the U.S.

economy by investors remained weak. Key concerns for investors include the size of the federal deficit, rising interest rates, and a dormant stock market.

Inflation

- Producer prices for finished goods increased 1.9% in September, which was well ahead of expectations. Energy prices increased 7.1%, explaining a large part of the jump in the index. The core index of producer prices, excluding energy and food, rose .3% after no change in August. In September, finished goods were 6.7% higher than one year ago, which is the highest increase since 1981. Core finished goods were 2.5% higher than one year ago.

- Consumer prices jumped 1.2% in September, largely due to the 12% increase in energy prices. Consumer price increased 4.7% over the last 12 months. The 4.7% annual increase in the CPI is the highest since 1991. The CPI movement makes additional increases in short-term interest rates by the Fed more likely. Core inflation, excluding energy and food, remained relatively low at .1%. The annual core inflation rate is only 2%.

- The implicit price deflator, used to adjust nominal GDP to real GDP, increased 3.1% at an annual rate in the third quarter following increases of 2.6% and 3.0% in the prior two quarters of 2005.

- Agricultural prices declined 6% from September to October and have generally been falling since May.

- The ISM index for October fell to 59.1 from 59.4 in September. A key finding from the October data is that purchasing managers face soaring price increases, suggesting that inflationary pressures are building. The “prices paid” component of the index rose to 84 from 78 in September and only 48.5 in July. The prices paid index is the highest since May of 2004. We have not seen the pass through of these higher prices faced by purchasing managers. The movement of this index will be monitored closely in coming months.

Labor Market and Unemployment

- Employer costs increased .8% in the third quarter of 2005 following increases of .7% in both the second and first quarters. On a year-over-year basis, employment costs are up 3.1%. This is the weakest growth in employment costs since 1999.

- The wage component of employer cost grew only 2.3% on a year-over-year basis. Benefit costs have the largest influence on employment costs, but these costs have moderated somewhat over the past year. Benefit costs increased 1.3% in the third quarter and 5.1% over the past year.

- The unemployment rate reached 5.1% in September following a 4.9% rate in August. The unemployment rate has bounced around 5.1% over the past several months. The labor force participation rate remained unchanged at 66.2%.

- Average hourly earnings increased .2% to $16.18 from August to September. The average workweek was unchanged at 33.7 hours.

Consumer Income, Spending, and Financing

- Consumption increased 3.9% at an annualized rate in the third quarter following an increase of 3.4% in the second quarter and 3.5% in the first quarter. Durable good spending increased 10.8% with nondurable good purchases rising only 2.6%. Spending on services rose 3.2%.

- Personal income increased 1.7% in September after falling .9% in August. Disposable income rose 1.9% after falling 1.1% in August.

- Consumer saving remained negative in September for the fourth consecutive month.

- Consumer credit increased $4.9 billion for a 2.7% annual rate in the month of August. Consumer credit increased 3.6% in July and 8.4% in June. Year-over-year growth of 4% in consumer credit was within a range of growth experienced since 2002.

- Retail sales rose only .2% in September. Much of the decline in sales came for slumping auto sales. Year-over-year growth in sales dropped to 6.5%.

- Vehicle sales fell to 16.4 million in September following sales of 16.8 in August and 20.7 in July. September was the lowest one-month sales pace since mid-1998.

Housing

- Investment in residential structures increased 8.9% in the third quarter. While the third quarter growth was good, it fell below the 10.9% rate of the second quarter.

- Existing home sales were unchanged in September from the 7.28 million units sold in August. Prices of existing houses were up 13.4% from one year ago, but there are signs of a deceleration in housing prices.

- New home sales in September were up 2.1% from August. But, on a year-over-year basis, home sales are flat.

- Slower sales combined with a record level of builder inventory pushed the number of months of available inventory to 4.9, which is the highest since December of 1996.

- Total housing starts increased 3.4% in September from August. Building permits increased 2.4% for the month. Housing starts have been ahead of permits for the last several months.

Treasury Budget and Deficit Spending

- The unified federal budget surplus for September was $35.8 billion. For the whole 2005 fiscal year, the federal government ran a deficit of $319 million. Fiscal year 2005 deficit numbers were down $94 billion from the prior year.

- The federal budget should narrow over the next few budget cycles as the economy continues to expand. In the longer term, deficits are likely to persist indefinitely with a growing total national debt.