Outlook for the Economy and Fourth Quarter 2005 Summary

The advanced estimate of 1.1% real GDP growth in the fourth quarter of 2005 came as a big surprise to analysts who expected real growth to be about 2.8%. For the year, GDP growth was 3.5%, continuing a solid annual growth pattern for the third year in a row. Inflation driven by higher fuel prices picked up in 2005 with a 3.4% increase in the CPI. Core inflation remained within a lower band considered to be acceptable by the Fed. Labor markets tightened with unemployment dropping to 4.9% and below trend jobless claims. The Fed increased its Fed Fund target to 4.5%, which many economists believe to be a neutral rate. Further increases are unlikely unless inflation shows more strength. The Treasury yield curve remains very flat at intermediate and long term maturities, suggesting low inflation expectations in the market.

The unexpected weakness in the fourth quarter of 2005 will carry over to the first quarter of 2006 somewhat, but analysts continue to forecast good growth with moderate inflation. Job markets are likely to continue to strengthen as firms add jobs. Wages should continue the pattern of low pressure on costs, given global competition. Consensus estimates call for GPD growth of 3.4% for 2006, which is only slightly below the 2005 growth rate. The unemployment rate should remain close to the current 4.9% level. The consensus analyst forecasts call for lower inflation in 2006 with a median forecast of only 2.4% increase in the CPI. If this forecast holds true, it would be consistent with an end to incremental increases in the Fed Fund target.

Forecasts for 2006 from a Survey of Professional Forecasters

The Federal Reserve Bank of Philadelphia conducts a survey of professional forecasters to generate consensus forecasts. The table below provides the 2006 consensus results from a panel of 51 professionals compared to the data from 2005.

Table 1.
2005 Actual versus 2006 Forecast Based on a Survey of 51 Professional Forecasters

	GDP	GPD Price	CPI	Annual Average Rate		
	Growth	Deflator (%)	Annual (%)	Unemployment	3-month T-bill	10-year Tr-Bond
2005	3.5	2.7	3.4	5.1	3.2	4.3
2006	3.4	2.4	2.4	4.9	4.5	5.1

Source: Federal Reserve Bank of Philadelphia

By comparison, the consensus forecast calls for only slightly lower growth with lower inflation. Unemployment is expected to remain in its current range. Consensus interest rate forecasts call for additional flattening in the Treasury yield curve with only a 60 basis point spread between the 3-month Treasury bill yield and the 10-year Treasury bond yield. The average spread in 2005 was 110 basis points. Slower growth in 2006 is consistent with data showing lower productivity rates as the U.S. moves deeper into the business cycle. If correct, the combination of 3.4% real GDP growth with a 2.4% inflation rate would be very good performance.

One pessimistic view points to the potential slump in consumer expenditures over the next year due to flat or rising long-term interest rates and slumping housing prices. Consumer spending has been driven by refinancing and increased wealth from higher values of home equity. Without falling long term interest rates there is little room for refinancing as an added source of income. If housing price appreciation returns to a more normal pattern linked to the inflation rate, consumers will not see the same rapid increase in home equity values. Real GDP forecasts at the low end of the survey may well be justified if this more pessimistic view of the consumer bears out to be true.

Gail Foster, Executive Vice President and Chief Economist of the Conference Board, is one of the more pessimistic forecasters. Her view links rising oil prices to a slowing U.S. economy. Higher oil prices are already showing signs of diverting consumer income away from other forms of consumption. Her forecast for 2006 growth is only 2.6%.

What Went Wrong in the Fourth Quarter of 2005?

The forecast errors in fourth quarter GDP growth are unusually large. Analysts clearly missed the mark and failed to account for a weaker level of performance. The dismal 1.1% fourth quarter growth rate may be revised upward when a more complete announcement comes out on February 24. Nevertheless, the 1.1% growth rate is well below analyst expectations for growth of 2.8%. Fourth quarter growth was also well below the revised 4.1% third quarter GDP growth rate. Table 2 below shows the history of quarterly GDP growth and the stark comparison of the fourth quarter 2005 growth rate to prior quarters.

Table 2. Quarterly Real GDP Growth from 2003 to 2005

2003				2004				2005			
I	II	III	IV	I	II	III	IV	I	II	III	IV
1.7	3.7	7.2	3.6	4.3	3.5	4.0	3.3	3.8	3.3	4.1	1.1*

* Advanced Estimate by the Bureau of Economic Analysis

The key miscalculation for the fourth quarter appears to be the dramatic reduction in defense spending. Government consumption and investment fell 7% during the fourth quarter compared to an increase of 7.4% in the third quarter. Other weak spots in the fourth quarter include declines in private inventory investment and slower personal consumption expenditures. After-effects of hurricanes may have also played a role in the poor numbers. Many analysts believe that these factors are not permanent drags on economic performance, allowing for more optimism in 2006 forecasts.

How Will the Fed Weigh-In on the 2006 Economy?

As the Greenspan era comes to a close, the Fed may now enter a pause with respect to raising the Fed Fund rate. Some analysts believe that the current 4.5% rate is a neutral level where the Fed has achieved its goal of reversing the stimulus provided to the economy in 2001. The table below shows the five-year history of the Fed Fund rate and other key macroeconomic variables.

Table 3.
Annual Inflation, GDP Real Growth, Unemployment, and Fed Fund Rate 2001-2005

	2001	2002	2003	2004	2005	2006
Inflation (CPI-all Items)*	2.8%	1.6%	2.4%	2.7%	3.4%	
GDP Real Growth**	0.8%	1.6%	2.7%	4.2%	3.5%	
Unemployment Rate***	4.7%	5.8%	6.0%	5.5%	5.1%	
Fed Fund Rate (Start of the Year)****	5.98	1.73	1.24	1.0	2.28	4.25#

* Annual percentage change in the CPI –Urban Index for all items.
** Annual percentage change in Gross Domestic Product
*** Unemployment rate measured at the end of the year.
****Federal Fund Rate at the beginning of the year.
Fed Fund Rate as of February 1, 2006

The stimulus provided by rate cuts in 2001, combined with fiscal tax reductions, appears to have improved GDP growth while keeping inflation under control. As the Fed entered its campaign for incremental increases in the Fed Fund rate in 2004, economic growth was already well underway and the target became lower inflation. If the combination of 3.5% GDP growth and 2.4% inflation materializes in 2006, as the consensus forecast suggests, the Fed should remain neutral. One likely approach is for the Fed to now pause and increase rates later in the year if 2006 performance fails to conform to the consensus forecast.

Summary of Recent Economic Data

GDP (Disappointment in fourth quarter growth linked to lower spending by the Federal Government)

- Fourth quarter 2005 real GDP growth was only 1.1% in the "advanced" estimates by the Bureau of Economic Analysis. GDP growth may be revised upward when a more complete announcement comes out on February 24. Nevertheless, the 1.1% growth rate is well below analyst expectations for growth of 2.8%. Fourth quarter growth was also well below the revised 4.1% third quarter GDP growth rate.

- GDP growth for all of 2005 was 3.5% compared to an increase of 4.2% in 2004. Key factors for the slower growth in 2005 include declines in private inventory investment, slower personal consumption expenditures, and lower federal government expenditures.

- Real non-residential fixed investment increased 2.8% in the fourth quarter compared to an 8.5% increase in the third quarter.

- A major factor holding back fourth quarter GDP growth was a 7% reduction in government consumption and investment. Government consumption and investment grew 7.4% in the third quarter. Defense spending fell 13% compared to an increase of 11% in the third quarter.

- Private inventories increased 1.45% in the fourth quarter after a decline of .43% in the third quarter.

Inflation

- The GDP price index increased at an annualized rate of 3.3% in the fourth quarter compared to an annualized increase of 4.2% in the third quarter. The core index, excluding food and energy, increased 2.9% in the fourth quarter, which is slightly higher than the 2.5% annualized increase in the third quarter.

- For all of 2005, the GDP price index increased 3.2% compared to a 2.9% increase in 2004.

- The Consumer Price Index (CPI) fell.1% in December following a decline of .6% in November. For 2005, inflation measured by the CPI averaged 3.4% compared to a 2.7% rate in 2004. Inflation in 2005 was the highest since 2002, but remains within the Fed's "price stability" range.

- The Producer Price Index (PPI) edged up .9% in December after declining .7% in November and increasing .7% in October.

Production

- Industrial production increased .6% in December following increases of .8% and 1% in November and October.
- Capacity utilization reached 80.7% in December, which is slightly higher than in prior months.
- The inventory to sales ratio for December is not yet available, but it is expected to move up from the 1.26 level from prior months.
- Construction spending grew only .2% in November following a .8% increase in October. The announcement of November construction spending fell well below the expected .7% increase.
- New orders for manufactured durable goods in December increased 1.3%. This was the highest level since the series started in 1992.
- The productivity growth rate fell 1.8% in 2005. The rate fell 3% in 2004. Currently, the U.S. productivity rate still compares favorably with Europe but lags well behind the China's 8.7% annual productivity growth rate since 2000.

Personal Income, Consumption, and Saving

- Real personal consumption expenditures increased 1.1% in the fourth quarter of 2005 following a robust 4.1% increase in the third quarter.
- For 2005, real personal consumption expenditures increased 3.6% in 2005 and 3.9% in 2004.
- Personal income grew .4% in December and in November following .6% growth in October. For 2005, personal income grew 5.4%.
- Savings as a percentage of disposable income was -.7% in December and -.2% in November.

Sentiment and Expectations

- The Conference Board's Consumer Confidence Index increased to 106.3 in January, which is its highest level since June 2002. The index continued to move up from 103.8 in December, 98.3 in November, and 85.2 in October. A stronger job market provided a significant boost to the sentiment responses.
- The Composite Index of Leading Indicators increased .1% in December following increases of .9% in November and 1% in October. The six-month growth rate in

the leading index was 2.1% ending in the month of December. The average six-month growth rate of the leading indicator index was 1.9% for the year in 2005 while the six-month average growth rate in 2004 was 6.2%. The leading index showed strength in 2003 and 2004, but the growth rate has been flatter since mid-2004.

- The ISM index reached 54.2 in December, which is well below the expected 57.5 reading and November's 58.1.

- The University of Michigan Sentiment Index increased to 93.4 in January from 91.5 in December. The higher index reflects higher levels of confidence in the economy going into 2006.

- Over three-fourths of the executives for large U.S. manufacturers expressed optimism about the economy in a recent PricewaterhouseCoopers survey. Most of the respondents expect to increase hiring and capital spending in 2006. Energy prices remain the key potential barrier to growth, according to the survey responses.

Labor and Unemployment

- The unemployment rate dipped to 4.9% in December compared to the 5% in November.

- Factory workweek hours fell slightly in December to 40.7. The hours per workweek were 40.8 in November and 41 in October.

- Initial jobless claims have been below the 300,000 level for most of January. Lower than expected jobless claims suggest a much stronger labor market than most analysts predicted going in to 2006.

- Hourly earnings increased .3% in December compared to an expected .2% increase.

- Wages and salaries in 2005 grew by the smallest amount in nine years. Employee compensation increased 3.1% in 2005 falling below the 3.7% increase in 2004. Most of the moderation in compensation came from lower benefit costs as businesses continue to work on cost controls. The 3.1% increase in 2005 is the smallest since a 2.9% increase in 1996.