Outlook for the Economy: First Quarter of 2006

The economy grew at a 4.8% real rate in the first quarter according to preliminary data released by the Commerce Department. Labor markets are tight with a 4.7% unemployment rate, but employment costs remain relatively low. The Employment Cost Index rose only .6% in the first quarter compared to consensus estimates of .9%. Capacity utilization edged up above 80% to what might be considered full employment levels. Price pressures from oil and commodities are partly offset by strong profit margins allowing business to absorb part of the price shocks rather than engage in inflation pass through. Both consumer spending and private investment rebounded from dismal fourth quarter levels.

Growth in the second quarter will be slowed by a number of factors taking shape in the economy. Housing demand is cooling off and the price of the median house price actually dropped in March. Housing inventories are building but demand is slumping due to higher interest rates, especially for adjustable rate mortgages. A housing slowdown in the remainder of 2006 will be a drag on growth. Gasoline prices appear to have peaked, but consumers are diverting more spending toward transportation and away from other goods and services. The Fed is not accommodating higher energy prices with an expansion of the money supply, which should dampen economic activity.

Inflation continues to be a risk factor. Low wage growth and a slowdown in benefit costs have helped keep inflation in check. Rising energy costs have been partially absorbed by businesses. Going forward, the tight labor market may require higher employment costs. Profit margins may eventually be too narrow to prevent inflation flow-through. Most analysts expect the Fed to pause after moving the Fed Fund rate to 5% in May, but any spurt in inflation may bring on another round of higher interest rates. An inflation bias is likely as the markets undergo adjustments to higher energy prices. A slumping housing market is the only sector where prices are likely to hold steady or fall.

Strong Manufacturing but Wary Investors

Manufacturing should remain strong through the second quarter. Global growth is now helping stimulate export demand, inventories are in check, and unfilled orders are growing. Corporate profits remain high and balance sheets are strong. Core inflation remains low and Fed policy appears to be moving back to a neutral position after the expected Fed Fund rate hike to 5% in May. Both consumer spending and private investment should remain strong through the second quarter, but housing will create a drag on overall GDP growth. The economy should move back closer to a sustainable growth rate of 3%. Short term interest rates should stabilize and long term interest rates may tick up as slightly higher inflationary expectations are priced in the market. Another factor that could return the yield curve to a more normal shape is the potential strengthening of the trade account due to the weaker dollar. A stronger trade account will reduce the flow of dollars back into our longer term capital markets.

Investors appear to be wary about market direction after a good equity run-up in the fist quarter. Risks abound with higher energy prices (gasoline), an impending slowdown in housing, continued imbalances in both the trade account and fiscal account, and weaker household credit. In a recent survey, 39% of investors planned to use tax refunds to pay off routine household debts. This figure is 32% higher than last year, reflecting a growing concern for household debt. The average refund is expected to be $2,400.

Housing Slowdown

The major drag on the economy throughout 2006 is likely to be a slumping housing market. The demand for housing is softening in response to rising mortgage rates, weaker personal finance positions of households, spent-up demand, and relatively high existing housing prices. Home sales are down 7% on a year-over-year basis and new home sales fell by 33% in the first quarter compared to the fourth quarter of 2005. The median price for homes fell 1.6% in March and the National Association of Homebuilders (NAHB) index of builder optimism sank to its lowest level since November 2001.

As short term interest rates rise, creative financing packages based on adjustable rates and interest only options, will no longer be effective vehicles for homebuyers. This may be especially problematic in high-priced markets. The relatively large number of housing investors and homeowners holding variable rate mortgages adds downside risk to the housing market, especially given relatively high household debt levels.

Fed Watch

The new Federal Open Market Committee (FOMC) Chairman, Ben Bernanke, recently signaled that a pause in interest rate increases may take place after the May meeting. The markets fully expect the Fed Fund target to move up to 5% in May, but the Fed may well pause to collect data to determine if the greater threat is inflation or a slumping economy. The Fed has been operating under an inflation bias, but relatively tame core inflation linked to what could be a slower economy in the later half of 2006 poses a tricky balance for the Fed. A premature act in the wrong direction at this point could be costly. Most analysts expect a pause in June to allow the Fed to gain a clearer picture of long term inflation pressures separate from recent oil shocks. Several Fed researchers are also pointing to a cumulative effect of interest rate increases that may take hold in 2006. While each incremental increase has a modest effect, at some point the full weight of the cumulative move to higher rates in such a short time period may make for more dramatic reactions from additional increases. This “nonlinear” view of market reactions to interest rate moves is another strong argument in favor of a pause in Fed interest rate increases.

Economic Perspectives

Tables 1 and 2 shown below provide some background and perspective to the movement of the economy over time. Clearly, the 4.8% GDP growth in the first quarter of 2006 is at the high end of trend growth and is not likely to be a sustainable growth level. In

Table 2 we see the upward trend in inflation since 2002 along with the improvement in GDP growth. The rather dramatic increase in the Fed Fund target since the start of 2004 is also easy to see. The change from the start of 2004 to May of 2006 is 400 basis points. With a Fed Fund rate of 5%, the market is not yet back to where it was at the start of 2001. Finally, while economic growth has picked up, the unemployment rate lagged behind. We are just now back to a 4.7% unemployment rate at the end of the first quarter of 2006.

Table 1. Quarterly Real GDP Growth from I/2003 through I/2006

2003				2004				2005				2006
I	II	III	IV	I	II	III	IV	I	II	III	IV	I
1.7	3.7	7.2	3.6	4.3	3.5	4.0	3.3	3.8	3.3	4.1	1.1	4.8*

* Advanced Estimate

Table 2. Inflation, GDP Growth, Unemployment, and Fed Fund Rate 2001-2005

	2001	2002	2003	2004	2005	I/*2006*
Inflation (CPI-all Items)*	2.8%	1.6%	2.4%	2.7%	3.4%	4.3%
GDP Real Growth[+]	0.8%	1.6%	2.7%	4.2%	3.5%	4.8%
Unemployment Rate[#]	4.7%	5.8%	6.0%	5.5%	5.1%	4.7%
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.
@ The Fed Fund rate target increased to 4.75% in the March 27 meeting and is expected to be set at 5% in the May 10 meeting.

Summary of Recent Economic Data

Output and Growth

First quarter growth exceeded a sustainable target rate of 3.5%, consistent with low inflation. With capacity utilization above long-run averages and unemployment at a cyclical low, the economy approaches full employment. There is not much slack left in the economy going forward into 2006. Most analysts expect slower growth as the economy backs off the unsustainable growth achieved in the first quarter.

- The advanced estimate of GDP growth from the Commerce Department was 4.8%. The 4.8% growth rate was slightly below the consensus estimate and significantly above the 1.7% annualized growth rate in the fourth quarter of 2005.

- Growth picked up for consumption, investment, and government spending. Housing slowed while the trade account presented a drag on growth.

- The Fed's April Beige Book reports expanded economic activity on economic activity across the 12 various Federal Reserve Districts. Solid economic growth occurred in all districts with a generally tighter labor markets.

- Durable good orders rose 6.1% in March, following a 3.4% increase in February and a decline of 8.9% in January. The surge in orders for March brought first quarter durable good orders back to about where they were at the end of 2005.

- Capacity utilization in manufacturing is now just above 80% while overall capital utilization is 81.3%. Utilization rates are now above historical long run averages.

- Manufacturers' inventories increased in April for the first time in the last 12 months. The inventory to sales ratio remains low, suggesting that manufacturers continue to monitor inventories closely.

- Industrial production increased .6% in March following an increase of .5% in February and a decline of .4% in January.

- The inventory to sales ratio remains steady at 1.3 following a patter since July of last year. The stability of the inventory/sales ratio is a reflection of modern inventory adjustment techniques that prevent cyclical accumulation and depletion patterns affecting production.

Labor and Employment

Labor markets are tight with unemployment falling to a cyclical low of 4.7% backed by healthy job creation. Wage increases continue to lag behind employment growth and provide no sign of a wage-induced inflation spiral linked to full employment.

- The unemployment rate fell to 4.7% in March from a 4.8% rate in February.

- Even though labor markets tightened in the first quarter, average hourly earnings posted only modest increases. Hourly earnings increased .2% in March following increases of .4% in February and .3% in January.

- The labor-force participation-rate for March was 66.1% and has been stable over the past year. Average weekly hours worked have also remained steady since August of last year.

- Approximately 590,000 new jobs were created in the first quarter of 2006.

- The four-week moving average of jobless claims reached 308,500 at the end of April. The series continues to move well below last year's average of 325,000 jobless claims per week. The series is consistent with stronger payroll gains in the first half of 2006.

- The employment cost index (ECI) for civilian workers increased only .6% in the first quarter compared to an expected .9% increase. First quarter employment costs grew at the lowest rate since the mid-1990s. On a year-over-year basis, the index increased 3%. While the labor market remains tight, there appears to be little pressure on labor costs. Benefit costs slowed in the first quarter, posting a .5% increase following increases of 1.3% and 1.1% in the first half of 2005.

- Trend productivity growth is slightly above 2.5%, providing added relief to any potential wage-induced pressure on prices.

Leading Indicators and Sentiment

Weakness in the University of Michigan Consumer Sentiment Index and the ABC News/Washington Post Consumer Comport Index are in stark contrast to improvements in both the ECRI Weekly Leading Index and the Conference Board Index of Consumer Confidence. The disparity is explained by an improving labor market, which tends to be a key driver of the ECRI and Conference Board measures. The University of Michigan and ABC News/Washington Post indexes are more sensitive to consumer finances and spending on energy. As we move into the second quarter of 2006 we are likely to see higher interest rates and a continued weakening in the housing market take an added toll on consumer confidence. Positive corporate profit data and low inflation will be weighed against weaker household financial conditions. Sentiment measures are likely to be choppy over the next quarter.

- The ECRI Weekly Leading Index fell for much of the first quarter, but has been on the rebound since mid-March. The index growth rate hovered around 2.8% for April, suggesting solid growth for the second quarter. Key drivers of the index are the housing market, stock appreciation, and the labor market.

- The University of Michigan Consumer Sentiment Index fell 1.5 points in April to an overall reading of 87.4 following a reading of 88.9 in March. The index is now at the bottom of the pre-Katrina range of sentiment. The index was only 74.2 last October but rebounded to 91.2 in January. Rising gasoline prices and stock market uncertainty in the first quarter dampened consumer confidence, leading up to April's measurement of 87.4. Nevertheless, the 87.4 index suggests strong economic performance in the second quarter. This is especially true given that other confidence index measures are trending much higher than the Michigan Sentiment Index.

- The Conference Board Index of Consumer Confidence gained 2.1 points to 109.6 in April to reach its highest level since May 2002. The strength of the index largely reflects improved labor market conditions.

- The ABC News/Washington Post Consumer Comfort Index is at its lowest level in two months. The decline largely reflects rising gasoline prices and weakness in the personal finances component.

- The ISM index increased to 57.3 in April, after an unexpected decline to 55.3 in March. The production component reached its highest level since last October.

- The UBS Index of Investor Optimism fell 16 points in April to a level of 63, a five-month low. The index stood at 93 in early January and reached a low of 34 last September. Both the economic and personal components of the index fell in April.

- The Conference Board's Leading Indicators fell .1% in March. February results were revised downward to a .5% decline. The index has been in a downward trend since November of 2005, but changes have not been dramatic. Overall, the pattern suggests softening in the economy over the next few quarters.

Consumption, Saving, and Personal Income

Consumers continue to provide strong support for the economy through spending. Savings rates are low and often negative as households continue to use home equity and credit lines to support consumption. Higher prices for gasoline will divert spending to transportation costs but Fed policies will keep inflation low by not accommodating higher energy prices with expanded money growth.

- Consumer consumption spending grew 5.5% in the first quarter of 2006 following dismal growth of only .9% in the fourth quarter of 2005. The first quarter rebound was largely driven by increased expenditures on durable goods.

- Retail sales increased .6% in March following a decline of .8% in February and a gain of 3% in January. On a year-over-year basis, retail sales and food grew 7.9%. Retail sales growth in March was the strongest since last August.

- Personal income grew .8% in March while wage growth remained steady with a .4% growth rate.

- The savings rate increased in March, but was still negative. The savings rate in March was -.3% and -.6% in February.

- Consumer credit increased $3.3 billion in February following an increase of $6.1 Billion in January. Slower growth in both revolving and non-revolving credit use is largely due to the use of home equity financing, which should slow as interest rates rise over the course of the year.

Inflation

Data on producer prices and core producer goods suggest inflation pressures are building, but several factors are at work to keep consumer prices in check. Companies have wider profit margins allowing them to absorb part of the higher input costs. Monetary policy remains cautious and may not pause long after the expected move to a 5% Fed Fund rate in May if inflation pressures continue. Gasoline prices are part of the inflation up tick, but there are signs that the spike in gasoline prices is over. Finally, a slower rate of GDP growth in the remainder of 2006 should help ease inflationary pressures.

- Inflation, measured by the PCE deflator (the Fed's preferred indicator), was only 2% on an annualized basis in the first quarter. The PCE deflator was 2.9% in the fourth quarter of 2005. For March, the PCE index rose only .4%. The year-over-year rate of increase in core PCE was 2%. Higher energy prices have yet to pass-through to the broader inflation measure.

- The GDP price deflator for the first quarter was 3.3% following a 3.5% deflator for the fourth quarter of 2005.

- The Consumer Price Index increased .4% in March after rising .1% in February and .7% in January. Gasoline prices were a major contributor to the increase in consumer prices. On a percentage change basis from one-year ago, the CPI increased 3.4%. For the first quarter, the CPI increased 4.3%. Core inflation, measured by the CPI without food and energy increased 2.8% in the first quarter and 2.1% over the past year.

- Producer prices for finished goods increased .5% in March, but food and energy price increases were responsible for much of the inflation pressure. Core PPI rose only.1% in March. Finished goods prices rose 3.5% on a year-over-year basis in March.

Housing

The demand for housing is softening in response to rising mortgage rates, weaker personal finance positions of households, spent-up demand, and relatively high *existing housing prices. Long-term fixed rates remain stable but adjustable mortgage rates will continue to rise, reducing the demand. Creative financing packages based on adjustable rates and interest only options, will no longer be an effective vehicle for bring in homebuyers. This may be especially problematic in high-priced markets. The weaker housing market will play a role in slowing the economy throughout the rest of 2006. The relatively large number of housing investors and homeowners holding variable rate mortgages adds downside risk to the housing market, especially given relatively high household debt levels.*

- Sales of new homes slumped in January and February but rebounded in March with a 13.8% growth. On a year-over-year basis, sales are down 7%. For the first quarter, home sales averaged 1.16 million units, which is a 33% decline from the fourth quarter of 2005.

- Home re-sales continued a downward trend but remained stable in March. Sales are down .7% on a year-ago basis. For the first quarter, sales fell at an annualized rate of 16% from the prior quarter.

- The median house stands at a seasonally adjusted $221,000, which is 3% lower than one year ago. Based on existing home sales, the median house price fell 1.6% in March. Housing inventories continue to rise and are now up to 5.5 months of sales.

- Housing inventory is growing with slower demand and continued gains in builder starts. A slow rise in mortgage rates is likely to soften housing demand going into the second and third quarters of 2006.

- According to the National Association of Homebuilders (NAHB), their measure of homebuilder optimism fell to its lowest level since November 2001. The index now stands at a neutral level (50) where favorable and unfavorable conditions are equally balanced.

- Housing starts fell 7.8% in March following a similar 7.8% decline in February. Housing starts in January increased 16%, largely due to warmer than normal weather and continued rebuilding after Katrina. Most analysts expect housing starts to slow and set a downward trend by mid 2006.

Current Market Rates

- The benchmark 10-year rate finished at 5.06% at the end of April.
- The Fed Fund target should reach 5% at the May 10 Fed meeting.
- The dollar continues to fall against other major currencies. The slumping dollar should help stimulate U.S. exports and slow down U.S. imports, but this relationship often occurs only after a substantial lag.