Third Quarter 2006 Outlook for the Economy and Markets

The economy grew at a real rate of only 1.6% in the third quarter, according to preliminary data released by the Commerce Department. Weak third quarter growth followed moderate growth in the second quarter of 2.6% and strong growth of 5.6% in the first quarter of 2006. Slower growth is largely due to the slumping housing market where a 17.4% decline in residential construction resulted in an estimated 1.1% reduction in third quarter growth. At the same time, the unemployment rate fell to a five-year low of 4.4% in October, suggesting very tight labor markets. Inflation moderated as energy prices fell. The Fed's favorite inflation barometer, the Personal Consumption Expenditure Index (PCE), increased 2.5% at an annual rate in the third quarter. The core PCE, excluding the volatile energy and food components, increased 2.3%. When taken together, the data offer a mixed picture for the economy. Slower growth with more moderate inflation met expectations, but the strength of the labor market runs counter to the slowdown scenario. Wage and benefit pressures remain in the system. If energy prices or a random shock to commodity prices enters the picture, the inflation picture can develop even with GDP growth running below its full potential.

Financial markets took note of strong earnings, lower inflation, and a halt in the Fed's policy of incremental interest rate increases in the third quarter. Financial market optimism will wane somewhat going into the fourth quarter due to strong job market data. Repercussions from the weak housing market, consequences from the overhand of variable rate financing behind many mortgages, and falling housing prices will be a drag on fourth quarter GDP growth. Meanwhile, the Treasury yield curve remains inverted with short term yields in the 4.93% range while five-year rates are 4.68% and ten-year rates are 4.71% at the time of this writing. Most analysts interpret this inversion to be a result of market expectations for lower interest rates in the future combined with a strong demand for longer-term Treasury securities by foreign investors, driving longer-term Treasury prices up and driving yields lower. Consumer spending and seasonal shopping will be weaker than expected, largely due to the large outstanding debt burden of consumers coupled with the erosion of wealth linked to declining housing values.

Fourth quarter GDP growth is shaping up to be in the 2.3% to 2.6% range with inflation remaining close to the 2.5% annual rate experienced in the third quarter. Most analysts believe the Fed will continue a pause in interest rate increases, but a decrease in interest rates is probably now off the table with the latest strong jobs market data. Business investment must remain strong to keep the economy on a path above 2%.

Housing Weighs Down the Economy

The good news about the housing market is that the number of months of housing in inventory is beginning to fall and mortgage rates are not likely to pick up soon. Housing prices are easing down with little investment demand and virtually no pent-up demand. The bad news is that the adjustment prices and its consequences are likely to take at least a year to work through the economy. The inventory of unsold houses remains high with continued pressure weighing down on housing prices, consumer wealth, housing construction, and the economy. Many homes purchased in the low inflation environment used forms of variable rate financing to allow financing of more expensive homes. Now the upward pressure on rates used as the re-set rates will slowly increase monthly payments of many homeowners, sucking money away from consumption. The drags from the housing slowdown are likely to more than offset gains from falling energy prices over the next few quarters. If energy prices should spike, the economy is vulnerable to a form of stagflation with slow growth and higher inflation pressures. This scenario poses a risk for the economy that will not ease until sometime early next year.

Are Decreases in the Fed Funds Rate off the Table?

Many analysts believed that the Fed would consider reversing its policy of increasing the Fed Fund rate if the economic growth remains sluggish. The Fed's target for sustainable growth is somewhere in the 2.5% to 3% range. On the other side of the coin, the Fed's comfort zone for inflation is somewhere below 2%, as measured by the PCE. Lower inflation linked to falling energy prices and slower provided an argument that the FEd might reverse the two-year policy of increasing the Fed Fund rate. The decrease of the unemployment rate to 4.4% from 4.6% and the strength of job creation going into the holiday season are likely to derail any hopes of lower interest rates from Fed policy.

The Fed Fund future contract provides an indicator of the market's view on Fed policy. When the Fed Fund future prices go up, market pricing reflects an expectation of higher Fed Fund rates in the future. The pricing of the Fed Fund future has been erratic, largely because the Fed under its new Chairman has not provided clear and consistent signals of its policies. Nevertheless, the Fed Fund market now has retreated from the expectation of a Fed Fund decline in the coming six-months. The minutes from the last Federal Open Market Committee meetings do not offer a clear picture of the course of future policy. The Fed paused at its last three meetings, but at least one Fed President continues to maintain a bias in favor of raising rates. The Fed continues to warn against inflation and maintains its focus on achieving stable prices as a priority. When taken as a whole, the data suggest that a policy move to lower interest rates in response to a sluggish economic growth rate is not on the table.

Review of Economic Performance for the Past Year

The table below summarizes key economic statistics over the past four quarters for the U.S. economy. Analyzing the data reveals several points about key relationships in the economy. For example, the data show the link between slow growth in the third quarter of 2006 and the large decline in residential construction. Consumer spending and private business investment (non-residential investment) were actually stronger than in the second quarter. The growing deficit in our balance of trade also provided a drag on the economy in the third quarter.

Inflation patterns show improvements during the third quarter. The core PCE did not show as much improvement as might be expected given the lower energy prices for the third quarter. Producer prices continue to follow a roller-coaster ride. Finally, the data show a relatively low growth in productivity matched with higher unit labor costs. Without higher productivity gains, the tight labor market may push per unit labor costs much higher.

Summary of Key Economic Data for the Last Four Quarters

	III Quarter 2006	II Quarter 2006	I Quarter 2006	IV Quarter 2005
GDP Growth*	1.6	2.6	5.6	1.8
Consumption*	3.1	2.6	4.8	0.8
Fixed Residential Inv.*	-17.4	-11.1	-.03	-1.0
Fixed Non-residential Inv.*	8.6	4.4	13.7	5.2
Exports (%)*	6.5	6.2	14.0	9.6
Imports (%)*	7.8	1.4	9.1	13.2
Government (%)*	1.9	0.8	4.9	-1.1
GDP Deflator (%)*	1.8	3.3	3.3	3.3
PCE Deflator (%)*	2.5	4.9	xxx	xxx
PCE Core (%)*	2.3	2.7	xxx	xxx
Producer Price Index (%)*	3.6	6.5	-3.7	xxx
Capacity Utilization (%)#	80.8	80.5	80.1	xxx
Output per Hour (%growth)*	xxx	1.6	4.3	-0.1
Unit Labor Cost (%)*	xxx	4.9	9.0	3.0

* Measures as an annualized percentage change from the prior quarter.
\# Measured as the percent of total capacity.

Summary of Recent Data

GDP Growth and Production

- The Commerce Department's preliminary data on third quarter growth revealed a slower than expected 1.6% real GDP growth rate. Third quarter growth was a full 1% below second quarter growth. A significant drop in residential construction of 17.4% created a drag on GDP growth, estimated to be a reduction of about 1.1% in third quarter growth. Without the residential construction drag, the economy would have grown at a 2.7% rate, which is close to what most economists believe to be the sustainable growth rate. Most analysts called for third quarter GDP growth of 2.2%. Over the year GDP, growth has been 2.9%.

- Real investment in equipment and software grew 6% at an annualized rate in the third quarter.

- Inventory growth exceeded domestic final sales for September and October. This pattern suggests some inventory correction in the fourth quarter, which will cause a small drag on GDP growth.

- The inventory to sales ratio remained 1.26, which has been steady throughout 2006.

- Construction spending fell .3% in September after holding steady in August and falling .7% in July.

- Productivity growth for the second quarter was revised upward to a 1.6% following a strong 4.3% growth in the first quarter. For the past year, non-farm business productivity increased by a robust 2.5%.

- Industrial production declined .6% in September following no change in August and a .3% increase in July. Much of the deceleration in manufacturing is concentrated in a few industries, such as housing and autos.

- Industrial capacity utilization softened in October, easing some of the concern over pending bottlenecks and inflationary pressures for supply constraints.

- Durable goods orders increased ahead of expectations for the third quarter, largely fueled by a 28% increase in transportation equipment orders. For the year, durable goods orders increased 7.7% in the third quarter, 6.1% in the second quarter, and 5.7% in the first quarter.

Inflation

- The Fed's preferred measure of inflation, the Personal Consumption Expenditure (PCE), increased 2.5% in the third quarter following a 4% increase in the second quarter. The core inflation rate (excluding the volatile food and energy sectors) for the third quarter was 2.3% on an annual basis, following a 2.7% inflation rate in the second quarter. The PCE inflation rate was 2.4% on a year-over-year basis. The inflation rate should continue to moderate somewhat as the full effects of the housing correction slow aggregate demand.

- The Bureau of Labor Statistics announced a seasonally adjusted Consumer Price Index (CPI) decline of .5% in September following a .2% increase in August. Falling energy prices were largely responsible for the lower inflation rate. The Core CPI (excluding food and energy prices) rose .2% in September, which was the third consecutive month for a .2% increase. Over the past year, core inflation was 2.9%.

- Unit labor costs posted a 4.9% increase in the second quarter following a 9% increase in the first quarter. The larger than expected increase in unit labor costs created concern about higher wage-induced inflation going into the third quarter, but the slumping housing market helped cool off inflationary pressure.

Employment, Consumer Income, and Consumer Spending

- The unemployment rate fell to 4.4% in October following strong gains in jobs. The unemployment rate declined steadily in the third quarter from 4.8% in July. The labor-force participation rate held steady at 66.2 in the third quarter.

- The average workweek averaged 33.8 hours in the third quarter with a slight increase in the average manufacturing workweek fell slightly to 41.1 hours.

- Personal income rose .5% in September following a .4% increase in August. Wage growth was the strongest since June.

- Consumer spending rose .1% in September following increases of .2% in August and .8% in July. On a year-over-year basis, consumption increased 5.5%.

- The saving rate in September was a negative .2% in September following negative savings rates of .5% and .8% in August and July, respectively. The saving rate, while still negative, has been on an upward trend.

- Retail sales fell .4% in September following gains of .1% in August and 1.4% in July.

Sentiment and Confidence

- The ISM index for October dropped to a 51.2 reading. A broad decline in manufacturing activity was responsible for the softening of the index. The auto industry was especially soft with large inventory build-up and production cutbacks. The housing industry also had weaker than normal performance in the index.

- The Conference Board's Confidence Index fell in October to 105.4 from an upwardly revised 105.9 in September. The index is currently in line with the first three quarters of the year, but is not consistent with generally positive gains in sentiment in most other indexes. Part of the explanation for this phenomenon is that the Conference Board Index has been well ahead of other indexes, suggesting that the indexes are making corrections.

- The UBS Index of Investor Optimism rose for the second consecutive month in October. The overall index stands at 79 compared to a level of only 53 in August. Both higher stock prices and lower energy prices played a significant role in the rebound of the index.

- The ABC News/Washington Post Consumer Comfort Index ended October at its highest level in nearly three years. The share of respondents who believe the state of personal finances is positive climbed to 63%.

- The University of Michigan Consumer Sentiment Survey Index reached 93.6 at the end of October. The Index is now back to its pre-Katrina level and brought the index back in line with other measures of sentiment. The key leader of the index was the present conditions component. A sharp decline in gas and other energy prices provided much of the upbeat sentiment. Several trends may work toward bringing the index down in the fourth quarter, to include slower job growth, rising debt burdens, and weaker housing markets.

Housing

- Existing home sales date for September fell 1.9%. House-price appreciation was down 2.2% on a year-ago basis. The month's supply of inventory on the market increased to 7.3 months compared to a 12-month average of 6 months.

- September housing sales are 14% below the year-ago level. Overall, housing sales over the last six months are the worst since the early 1990s.

- Heavy speculative investing in housing and the use of nontraditional mortgages make the downside risk of a slumping housing market more severe.

- The new median home price fell to $221,615 in September compared to the twelve-month average of $240,502. For the quarter, the new median home price fell 2.6% in July, followed by declines of .51% and 8% in August and September, respectively.

- Mortgage rates are remaining flat, but the run-up in housing prices over the past few years and lack of pent up demand, makes housing affordability relatively low.

Interest Rates

- The Fed kept the Fed Fund rate steady at 5.25% at the last meeting of the Federal Reserve Open Market Committee, following a pause pattern since June of this year. The Fed raised the Fed Fund rate from 1% to 5.25% over the past two years. The weak housing market, slower economic growth, and moderate inflation were the primary arguments for keeping Fed Funds at the current rate.

Fiscal Deficit

- For fiscal year 2006, which ended in September, the unified budget deficit was $247.7 billion, which is 22.3% smaller than the fiscal year 2005 deficit of $318.7 billion. The deficit reduction serves to take some pressure off interest rates on the one hand, and pulls back stimulator effects on the economy. Further deficit reduction will require continued economic growth allowing an expansion of tax receipts.

Global Conditions and Oil

- World GDP growth for 2006 is expected to be 3.5% following a 3% rate in 2005, according to Moody's Global Outlook. Slower growth in the U.S. will be offset by more rapid growth in Asia, especially China. Asia now accounts for nearly one-half of world GDP. Europe is operating at what may be the peak of its expansion.

- The global economy is expected to slowdown in 2007 due to tighter global monetary policies over the last few years.

- Crude oil inventories rose 2 million barrels for the week ending October 27. Inventories are above average levels and are 4.6% higher than this time last year.

- Refiner utilization increased to 88.9% from 86.2% in the prior week as refiners came out of the fall maintenance schedules.