# First Quarter 2007 Performance Review and Outlook for the Economy

*Real GDP growth slowed to a 1.3% annualized rate in the first quarter according to advanced estimates by the Bureau of Economic Analysis. The consensus forecast called for a 1.9% first quarter GDP growth rate. Fourth quarter GDP growth was revised downward to a 2.5% rate from the advanced announcement of 3.5%. On a "year-ago" basis the first quarter GDP growth rate was 2.1%. By any measure, first quarter growth fell behind a 3% target considered to be the economy's sustainable potential growth rate. Real final sales of domestic product, defined as GDP minus the change in inventories, increased only 1.6% in the first quarter compared to a 3.7% increase in the fourth quarter of 2006. Demand for U.S. produced goods and services has not been this soft since the fourth quarter of 2005. Key drivers of a slower growth rate included declining exports, slower consumer spending on durable goods, and lower federal spending compared to the fourth quarter. Real investment in residential construction took another large decline in the first quarter, falling 17% on an annual basis.*

*The slower real GDP growth rate helped moderate core inflation. The PCE deflator, which excludes food and energy prices, increased in the first quarter at an annualized rate of only 2.2%. The Fed tends to prefer the PCE deflator as a measure of fundamental inflation pressures in the economy. Other indexes followed a similar pattern with relatively low core inflation. Nevertheless, when energy and food prices are included in the indexes, first quarter inflation is much higher. The PCE index with food and energy components increased at an annual rate of 4.07% in the first quarter. Most analysts believe the Fed will be more inclined to consider rate cuts if the core inflation rates remain relatively low going into the second quarter. Inflation remains a problem, but the spike in gasoline prices is not due to higher crude oil prices. When the refining capacity bottlenecks are eased, the key driver of energy price increases should lose steam.*

*The outlook for the remainder of 2007 continues to be for an economic slowdown with real GDP growth in the 2% to 2.5% rate. A slumping housing market will continue to be a drag on the economy for most of 2007. Consumer spending is likely to be sluggish even though personal income has good growth. Consumers should begin repairing their poor credit conditions and begin to correct negative savings rates. Relatively tight labor markets, reflected by the 4.5% unemployment rate, and relatively high capacity utilization rates provide an upward bias for core inflation if GDP growth exceeds the 2% to 2.5% benchmark. On balance, the economy should generate slower growth without much added inflationary pressure, unless oil shocks occur.*

## Discussions of Lower Fed Funds Rates may be back on the Table

The Fed is expected to hold the 5.25% Fed Fund target steady going into the summer, but conditions for a rate cut later in the year are taking shape. Core inflation is moderate based on both the PCE and CPI indexes. Low core inflation, which tends to be directly linked to economic activity, gives the Fed room to consider rate cuts. Energy and food prices are pushing overall inflation to high levels, but many argue that these factors are not linked to domestic demand and GDP growth. The door to a discussion on lower rates is opening as tight credit conditions threaten a recovery in housing and GDP growth continues to falter below targeted potential. Higher real GDP growth that does not push the core inflation rate too high may become a Fed objective, especially in an election year.

The yield curve remains inverted with higher short term yields than long term yields. This condition is not stable in the long run, since it provides negative liquidity premiums. But, several factors have allowed the inversion to last an unusually long time. Most analysts believe the healthy infusion of foreign capital, largely due to our large trade deficits, has been a key factor in boosting long term bond prices and reducing long term yields. Meanwhile, successive increases in the Fed Fund rate over the last year pushed short term yields higher. Finally, market expectations of lower short term rates in the future help sustain the inverted yield curve. Investors lock in lower long term rates even though short term rate are higher because they expect short term rates to be lower in the future when the short term investments must be rolled over. In a longer run context, less foreign capital in the long term end of the market and a lower Fed Fund rate should develop. The long run average of the T-bill yield is only 3.8% with a 3.2% long run average inflation rate. Based on this standard, real rates of return at the short term end of the yield curve are well above normal, largely due to the Fed's preoccupation with inflation over the last ten years. Sluggish growth with a weak housing industry may prompt a slight reversal in the Fed's position on interest rates.

## Housing – A Dismal Year Ahead

The decline in the housing industry presents a major drag on economic activity. Many consumers count the value of their home in wealth computation and spending patterns. Equity loans are largely responsible for a healthy boost in consumer spending and negative savings rates over the last year. As loan defaults and the subprime loan market problems are absorbed by the financial markets, potential homebuyers will face more restricted access to loans. Both existing and new home sales continue to fall below expectations and pressure is building for lower housing prices. The weak housing market will not only put a damper on housing construction and durable good orders by new homeowners, but it may well lead to slower consumer spending. This double whammy on the economy is not likely to be worked out until 2008.

## Consumers – Tapped Out?

Personal income is growing at a healthy rate and unemployment remains low at 4.5%. Normally, these factors would suggest healthy consumer spending going into the second quarter of 2007. But, much of the fuel for consumer spending has been equity loans and refinancing of mortgages, both of which are now much less likely as housing values soften. Negative savings rates are largely explained by a combination of refinancing wealth, home equity loans, and increased use of revolving credit. Going forward, these factors are not likely to provide as much support for spending. The successive quarters of negative saving have created a large overhang of household debt with more limited growth potential. Higher prices for gasoline have diverted a chunk of consumer spending away from other goods. The softer sales numbers in the first quarter may be indicative of a general pattern of slower consumer spending in the remaining quarters of 2007.

## Review of First Quarter 2007 Economic Performance

Table 1 provides a summary of key data for the economy in the first quarter. Several key overall patterns are consistent with the weak 1.3 % GDP growth of the first quarter. Inflation data show moderate core inflation with much higher inflation when energy and food components are added. Producer prices, which are only indirectly linked to the other inflation index numbers, show much higher inflationary pressures. Data on consumers and labor markets illustrate a tight labor market with low unemployment. Personal consumption remains strong but the negative savings rates show that much of that spending is dependent on access to credit. Consumption of durable goods lags behind consumption of other goods. Average hourly earnings continue to be modest and should not be a major factor in inflation. Industrial production, manufacturing, and durable goods orders are all low. Inventory to sales ratios remain stable and within acceptable ranges for a modest expansion. The ISM manufacturing index is above the 50% mark that is normally linked to an expansion. April showed significant improvement in the index. Retail sales are relatively low.

Housing data in Table 1 are all well below the standards for housing starts and sales established in the past several years. The housing slowdown is expected to continue throughout 2007. Interest rates illustrate the inversion in the yield curve with a higher yield on the short term end. Credit risk spreads, measured by the difference in comparable AAA and Treasury bonds expanded in April. Finally, the trade numbers illustrate the large imbalance in trade. The trade deficit is now approaching 5% of GDP. Relatively low import price increases have helped keep domestic inflation down.

**Table 1: Summary of Selected First Quarter Data**

| | April 2007 | Mar. 2007 | Feb. 2007 | Jan. 2007 | I Q* Annualized |
|---|---|---|---|---|---|
| **Inflation** | | | | | |
| PCE (% m/m) | | 0.4 | 0.4 | 0.2 | 4.07% |
| PCE Core (% m/m) | | 0.0 | 0.3 | 0.2 | 2.02% |
| CPI (% m/m) | | 0.6 | 0.4 | 0.2 | 4.9% |
| CPI Core (% m/m) | | 0.1 | 0.2 | 0.3 | 2.43% |
| PPI finished goods (% m/m) | | 1.0 | 1.3 | -0.6 | 6.97% |
| | | | | | |
| **Labor/Consumer** | | | | | |
| Unemployment Rate (%) | 4.5 | 4.4 | 4.5 | 4.6 | xxx |
| Personal Consumption (% m/m) | | 0.3 | 0.7 | 0.6 | 6.6% |
| Savings Rate (% m/m) | | -0.8 | -1.2 | -1.1 | -11.7% |
| Personal Income (% m/m) | | 0.7 | 0.7 | 1.1 | 10.5% |
| Avg. Hourly Worker Earnings (% m/m) | 0.2 | 0.3 | 0.4 | 0.2 | 3.66% |
| Durable Good Consumption (% m/m) | | 0.0 | -0.4 | 1.1 | 2.81% |
| | | | | | |
| **Production/Manufacturing** | | | | | |
| Industrial Production (% m/m) | | -0.2 | 0.8 | -.04 | 0.196% |
| Manufacturing (% m/m) | | 0.7 | 0.1 | -0.6 | 0.78% |
| Durable Good Orders (% m/m) | | 3.4 | 2.4 | -8.8 | 0.86% |
| Inventory/Sales Ratio | | | 1.29 | 1.29 | xxx |
| ISM Manufacturing Index | 54.7 | 50.9 | 52.3 | 49.3 | xxx |
| | | | | | |
| **Sales** | | | | | |
| Retail Sales (% m/m) | | 0.7 | 0.5 | 0.0 | 4.9% |
| | | | | | |
| **Housing** | | | | | |
| Housing Starts ($ millions, annual rate) | | 1.52 | 1.51 | 1.40 | xxx |
| New Home Sales ($ millions, annual rate) | | 0.86 | 0.84 | 0.87 | xxx |
| Existing Home Sales ($ millions, annual rate) | | 6.12 | 6.68 | 6.44 | xxx |
| | | | | | |
| **Interest Rates** | | | | | |
| Fed Funds Target (%, annual rate) | 5.25 | 5.25 | 5.25 | 5.25 | xxx |
| 10-year Treasury Note (%, annual rate) | 4.69 | 4.56 | 4.72 | 4.76 | xxx |
| AAA -10 Yr. Treasury Spread (basis points.) | 0.77 | 0.74 | 0.66 | 0.64 | xxx |
| | | | | | |
| **International Trade Balance** | | | | | |
| Trade Balance (Real $ billions) | | | -57.3 | -56.9 | xxx |
| Exports (% m/m) | | | -2.2 | 1.2 | xxx |
| Imports (% m/m) | | | -1.7 | -0.6 | xxx |
| Import prices (% m/m) | | 1.7 | 0.1 | -1.1 | 2.76% |

NOTES:

First quarter annualized rate is an effective rate (compounded). For example, the quarterly CPI rate is (1.006) (1.004) (1.002) = 1.2%. The annualized CPI rate based on first quarter performance is $(1.012)^4 - 1 = 4.9\%$

# Complete Summary of Key Economic Data Released for the First Quarter

## Production and GDP

- The Bureau of Economics announced an "advanced estimate" of 1.3% first quarter real GDP growth. Growth for the fourth quarter of 2006 was 2.5%. First quarter 2007 growth fell short of the consensus estimate of 1.9%. On a year-over-year basis, the real GDP growth rate of 2.1% is well below the estimated sustainable growth potential of 3%.

- Industrial production fell .2% in March, which was below expectations. The weakness in industrial production tended to be concentrated in the utilities industry due to warmer than expected weather.

- Total industry capacity utilization in March fell to 81.4% from 81.6% in February. Manufacturing capacity utilization was 79.9 in March following utilization rates of 79.5% in February and 79.6% in January.

- Business investment in equipment and software grew 1.9% in the first quarter, providing an estimated 0.2% to GDP growth. First quarter business investment reversed a dismal 4.8% decline in the fourth quarter of 2006.

- New orders for manufacturing goods increased 3.1% in March following a 1.4% increase in February and a 5.5% decline in January.

- The ISM-Manufacturing index for April increased to 54.7 from the 50.9 index in March. Analysts did not predict the strong upward movement. Going forward, analysts will watch the index to determine if momentum is building in the index.

- The ISM-Non-Manufacturing index for April increased 3.6% to an index of 56. April's index is the highest since the end of 2006. When taken with the ISM-Manufacturing index move, expectations are improving for manufacturing growth.

- Vehicle sales weakened in April, falling to a seasonally adjusted annualized sales total of 16.26 million units. Car sales fell to 7.3 million units from 7.6 million.

- Construction spending increased .2% in March following an increase of 1.5% in February and a decline of .6% in January.

- Durable goods orders rose 3.4% in March following increases of 2.4% in February and an 8.8% decline in January.

- Business inventories rose .3% in February, as were retail inventories. The ratio of business inventories to sales remained steady at 1.29. The wholesale inventory to sales ratio fell to 1.15 from 1.16. Overall, the ratios are near the 2006 averages.

- Moody's Probability of Recession index increased to 28% in March following a 21% probability index in February and 18.7% in January. Additional inversion of the yield curve along with the March correction in stock prices contributed to the increased probability of recession. The dramatic improvement in April equity values should reverse the trend of increasing probabilities of recession.

**Inflation**

- The personal consumption expenditure index of inflation increased .4% in March following increases of .4% in February and .2% in January. On an annualized basis, the PCE index of inflation increased 4.07%. On a more positive note, the core PCE was flat in March with increases of .3% in February and .2% in January. The annualized inflation rate for the core PCE is 2.02%.

- The seasonally adjusted consumer price index increased .6% in March following increases of .4% in February and .2% in January. Annualized inflation based on first quarter CPI data is 4.9%. Excluding energy and food prices, the core CPI index reflects much lower inflation. The increase in the core CPI of .1% in March followed increases of .2% in February and .3% in January. The annualized growth in core prices based on first quarter performance is 2.43%.

- On a year-over-year basis, the CPI grew only 2.8%. Over this same period, the core CPI increased 2.5%. Looking backward, inflation pressures have been modest. Looking forward, the role of rising energy prices is the major issue. Most analysts believe that energy prices will moderate to the point that the 2007 inflation rate will fall substantially below rates based on projections from first quarter data.

- Producer prices for finished goods increased significantly in the last two months of the first quarter. The PPI increased 1% in March following a 1.3% increase in February. The finished goods PPI fell .6% in January. For the year going forward, the annualized PPI finished goods rate of inflation is 6.97%. For the last year-over-year period, the PPI finished good index increased only 3.1%. Core prices increased for finished goods increased at a 2.3% annualized rate in the first quarter, illustrating the dramatic impact of energy prices on producer prices. Core prices for crude good increased at an annualized rate of 59.3% in the first quarter.

**Unemployment, Labor Markets, and Wages**

- The unemployment rate reached 4.5% in April following rates of 4.4% in March, 4.5% in February, and 4.6% in January**.** Most analysts believe that unemployment rates below 5% are consistent with tight labor markets.

- Average hourly earnings increased .2% in April following increases of .3% in March, .4% in February, and .2% in January. The annualized rate of increase in average hourly earnings for 2007 is 3.66% based on the first quarter data.

- The labor force participation rate eased downward to 66% in April from 66.2% in March and February. The participation rate was 66.3% in January.

- Nonfarm business productivity grew at a 1.7% annualized rate in the first quarter of 2007. Productivity grew 2.1% in the fourth quarter of 2006. Unit labor costs in the first quarter increased only .6% compared to a whopping 6.2% increase in the fourth quarter. Lower unit labor costs provide good news on the inflation front.

- The national jobless claims in the most recent announcement on April 28 reached 305,000 with a four-week moving average of 329,000. Overall, the weekly jobless claims totals averaged about 320,000 over the past year.

- Average hourly earnings increased by .2% in April following increases of .3%, .4%, and .2% in the prior months. First quarter annualized growth in hourly earnings was 3.66%.

- The employment cost index increased by .8% in the first quarter following increases of .9% in the prior three quarters. Benefit costs grew at the slowest pace since 1999. Civilian wages and salaries grew 1.1% in the first quarter compared to increases of .7% in the fourth quarter and .9% in the second and third quarters of 2006.

- The number of announced job cuts increased by 44% in April, reaching a total of 70,672. On a year-to-date basis, there have been 266,658 announced job cuts. First, quarter job cuts are about 15% lower than the announcement figure for the first four months of 2006. Job cuts in the financial sector, led by Citigroup's elimination of 17,000 positions, contributed heavily to the first quarter total.

## Personal Income, Consumption, and Consumer Credit

- Personal income increased .7% in March following increases of .7% in February and 1.1% in January. Consumption increased .3% in March compared to increases of .7% in February and .6% in January. The saving rate remained negative, but was a lower negative rate than in prior months. The saving rate for March was -0.8% compared to a -1.2% in February and -1.1% in January. March's saving rate is the highest in last year. The long stretch of negative savings rates experienced over the past several years is not sustainable in the end. Consumers continue to borrow to finance spending. The negative savings rate also signals an increasing dependence on foreign savings and capital inflows.

- Borrowing eased somewhat in the first quarter but credit quality fell as delinquency rates increased to the highest level in five years. First quarter mortgage delinquency increased 10.9% on a year-over-years basis.

- Total retail sales increased .7% in March, as analysts expected. March sales growth represented a health move from the .5% sales increase in February and flat sales in January. Year-over-year growth in sales reached 3.8% with gasoline stations, apparel retailers, restaurants, and general merchandise stores leading the way. Energy prices should continue to represent a disproportionate portion of sales growth throughout the year.

- Chain store sales increased 5.9% in March following a 2.5% increase in February. The healthy increase in sales may not be indicative of future sales as higher fuel prices, soft housing markets, and declining consumer credit quality should hold back consumer spending.

## Sentiment and Leading Indicators

- The Conference Board's Index of Leading Indicators increased .1% in March. The upward movement of the index in March is the first since December of 2006. The index fell .6% in February and declined .3% in January. Two components holding the index back in March were the weak stock market and lower consumer confidence. A reversal of these two conditions in April should contribute to a stronger increase in the index. The six-month annualized growth rate fell into negative territory at -0.3%, consistent with a weak growth in GDP going forward.

- The Conference Board's Index of Consumer Confidence fell to 104 in April from 108.2 in March. The index was 111.2 in February and 110.2 in January. Weaker consumer finances played a key role in the April decline.

- The University of Michigan Sentiment Index reversed its negative trend in April. The index reached 87.1 in April compared to index numbers of 88.4 in March, 91.3 in February, and 96.9 in January. The April index is the lowest reading since September of 2006. The index is sensitive to energy prices, equity prices, housing markets, and labor markets.  Most analysts expect improvement in the index for May with more uncertainty for the rest of the year.

**Housing**

- New home sales advanced 2.6% in March on a month-to-month basis.  The advance in March follows a decline of 4.2% in February and 14.4% in January.  On a year-ago basis, new home sales fell 24%.  New home inventory declined slightly to 7.8 months compared to 8.1 months in February.  The median new home price increased by about 6% in March to a level of $255,204.

- Existing home sales fell by 8.4% in March.  Existing home sales increased by 3.7% in February and by 2.7% in January.  Prices of existing homes are flat from one year ago.  The inventory of existing homes is 7.3 months, up slightly from prior months.  The median price for existing homes was $223,800 in March.

- Housing starts grew by .8% in March following an increase of 7.6% in February.  Housing starts fell by 14.3% in January.  Housing starts tend to follow a seasonal pattern.  The low growth rate in March supports the view that the market continues to be weak.  Growing delinquency rates on mortgages along with the problems in the subprime market are responsible for much tighter credit standards in the current market.  Most analysts believe that substantial improvement in the housing market will not occur without Fed intervention with lower interest rates.

**International Trade**

- The U.S. trade deficit reached $58.4 billion in February, which is down by $0.4 billion from January.  The trade deficit has been narrowing slowly from the record high of $68.5 billion reached in August of 2006.  Through February of 2007, the trade deficit is running at a $703.9 billion level at an annual rate.

- Portfolio capital flows into the U.S. reached $58.1 billion in February with a $94.5 billion total capital inflow.  Dependence on foreign capital inflows is linked to low domestic savings rates.  Concern is growing over the potential credit crunch that could occur if foreign demand for U.S. securities wanes.  If the U.S. economy no longer offers high yields, foreign investors and central banks may diversify to a greater extent and reduce demand for U.S. securities.  This shortfall in fund inflows will present a condition where domestic interest rates would need to move higher.