Second Quarter 2007 Performance Review and Outlook for the Economy

Real GDP growth in the second quarter of 2007 exceeded expectations. Revisions of the 3.4% advanced estimates by the Bureau of Economic Analysis may occur in the future, but a big rebound from the revised .6% first quarter growth rate clearly occurred in the second quarter. Real GDP increased 1.8% on a year-over-year basis, which is well below the 3% real GDP growth rate targeted by the Fed and believed to represent the economy's non-inflationary growth potential. Second quarter growth was not fueled by consumer spending, which is a more normal form of expansion. Inventory adjustment, non-residential investment, and increased exports all provided a boost to second quarter GDP growth. Consumer spending, which is normally a large part of growth, softened in the second quarter and declining residential investment was a major drag on the economy. The housing sector should continue to weigh down the economy as the second leg of the slowdown works through the economy in the last half of the year. Consumers budgets are absorbing higher energy costs and are highly levered with debt, making it unlikely that consumer spending will rebound anytime soon. Growth for the remainder of the year depends on continued export growth and non-residential investment spending.

The unemployment rate edged up to 4.6% in August following a stable 4.5% rate in the prior months. Labor markets remain tight but the employment cost index remains in check. On a year-over-year basis the employment cost index increased 3.5%. Capacity utilization remains high across all sectors leaving little room for expansion without price pressure. By most measures, inflation appeared calmer in the second quarter, especially based on core index numbers. The economy-wide GDP deflator increased 2.7% in the second quarter while the consumer price index (CPI) increased 2.7%. The core GDP deflator increased only 1.7% and the core CPI was up 2.2%. However, the personal consumption expenditure index (PCE) posted a 4.3% annual rate of increase in the second quarter. The PCE is the Fed's preferred measure of inflation. At the last Federal Reserve Board meeting, the minutes suggest that the Fed has an upward bias toward inflation. Chances are now remote for a Fed action to ease rates and soften the credit crunch linked to the subprime lending.

Looking forward, financial markets are balancing worries over higher energy prices and credit defaults against good corporate earnings and stable interest rates. Consumers are not likely to pick up spending due to a large overhang of consumer debt, falling housing asset values, lack of refinancing opportunities, and tight credit conditions. The housing market will continue its slump throughout the remainder of 2007. Refining capacity has improved, but the market price of crude oil is on track to set new record highs. Production and manufacturing picked up in the second quarter, but much of the gains were due to inventory adjustments. The overall picture is for continued slow growth in GDP with inflationary pressures that will keep the Fed on the sidelines with respect to interest rates. The risk of recession remains low, but real GDP growth is likely to be in the 1.5% to 2.0% range without a boost from government spending. Equity markets are most likely to be choppy with a higher degree of risk aversion. Corporate bond yields will continue to trade at a relatively large spreads above Treasuries as risk premiums widen.

Subprime Contagion

When the housing boom seemed to be a certainty, many lenders offered credit to borrowers who were marginal risks. These subprime loans took on even more dangerous default profiles with variable rate and interest only structures. Securitization of these loans extended the risks into investment portfolios and hedge fund strategies. The current crash in housing not only threatens lender portfolios, but spillover effects threaten credit and investment markets overall. Lenders now employ very tight credit screens in reaction to the mistakes of the past and the outlook for very low appreciation in home values. The same credit crunch is starting to spread to other markets with higher risk premiums. Treasury yields are moving up and higher spreads over Treasuries are choking off investment and consumer spending. The magnitude of this contagion from the subprime market to other financial markets may be severe, especially if the Fed remains idle with respect to easing monetary conditions.

Minutes from the June 28 Federal Open Market Committee meetings and recent speeches by Fed officials suggest that the Fed continues to see inflation as the main threat to the economy. Policymakers perceive downside risk to the economy as having eased with stronger production and investment in the second quarter. While many measures of inflation show easing in price pressures, the Fed position holds that labor and market conditions are favorable for inflation. In this scenario, the Fed is likely to keep Fed Fund rates at the current 5.25% level with only limited easing of credit conditions. The Fed's view of the subprime loan debacle and prolonged housing slump appears to be that these are longer run issue affecting 2008 performance rather than issues to manage in the remainder of 2007. Many analysts believe the 5.25% Fed Fund rate is too high to help ease the credit quality adjustments that are now underway.

Consumer Weakness

Normally, the consumer sector leads the economy, partly because it represents about two-thirds of GDP. Weak consumer spending in the second quarter of 2007 was masked by an inventory rebound, strong non-residential investment, and higher exports. Nevertheless, further expansion close to the 3% real GDP growth target may be difficult without increased participation of consumers. Current conditions work against any scenario of strong consumer spending. Gasoline prices remain high enough to drag down sales and force households to rearrange budget priorities. Slow housing markets with no potential for wealth gains from refinancing combined with record level debt levels of households leave consumers with little money to spend outside of regular income. Falling housing prices limit equity withdrawal from equity loans as a source of spending power. A history of low savings rates puts consumers in a position where reduced spending is the only remaining option.

A tight labor market with current unemployment at 4.6% helps cushion some of the blow to consumers. Present defaults and slower consumer spending will become more problematic if job cuts and layoffs become prevalent. Consumer optimism remains good, but the perception is that current conditions are better than future conditions for consumers. A likely outcome is a more risk averse view of investments along with more frugal spending patterns of consumers. These factors will be a drag on GDP growth over the second half of 2007.

Summary of Selected Data for the first Two Quarters of 2007

Table 1 below offers a summary of selected data for the first two quarters of 2007. Some of the entries for June are not yet available.

Table 1: Summary of Selected Data for 2007

	June 2007	**May 2007**	**April 2007**	**Mar. 2007**	**Feb. 2007**	**Jan. 2007**
Inflation						
PCE (% m/m)	0.1	0.5	0.3	0.4	0.4	0.2
PCE Core (% m/m)	0.1	0.1	0.1	0.0	0.3	0.2
CPI (% m/m)	0.2	0.7	0.4	0.6	0.4	0.2
CPI Core (% m/m)	0.2	0.1	0.2	0.1	0.2	0.3
Labor/Consumer						
Unemployment Rate (%)	4.5	4.5	4.5	4.4	4.5	4.6
Personal Consumption (% m/m)	xxx	0.5	0.5	0.3	0.7	0.6
Savings Rate (% m/m)	xxx	-1.4	-1.2	-.04	-0.8	- 0.8
Personal Income (% m/m)	0.4	0.4	-0.2	0.7	0.7	1.1
Avg. Hourly Worker Earnings (% m/m)	.03	0.4	0.2	0.3	0.4	0.2
Production/Manufacturing						
Industrial Production (% m/m)	0.4	-0.1	0.5	-0.2	0.8	-.04
Manufacturing (% m/m)	0.6	0.0	0.2	0.7	0.1	-0.6
Durable Good Orders (% m/m)	1.4	-2.3	1.0	3.4	2.4	-8.8
Inventory/Sales Ratio	xxx	1.26	1.27	1.28	1.29	1.29
ISM Manufacturing Index	56	55	54.7	50.9	52.3	49.3
Sales						
Retail Sales (% m/m)	-0.9	1.5	-0.3	0.7	0.5	0.0
Housing						
Housing Starts ($ millions, annual rate)	1.47	1.43	1.49	1.52	1.51	1.40
New Home Sales ($ millions, annual rate)	0.83	0.89	0.91	0.86	0.84	0.87
Existing Home Sales ($ millions, annual rate)	5.75	5.98	6.01	6.12	6.68	6.44
Interest Rates						
Fed Funds Target (%, annual rate)	5.25	5.25	5.25	5.25	5.25	5.25
10-year Treasury Note (%, annual rate)	5.10	4.75	4.69	4.56	4.72	4.76
AAA -10 Yr. Treasury Spread (basis points.)	0.69	0.73	0.77	0.74	0.66	0.64
International Trade Balance						
Trade Balance (Real $ billions)	xxx	-60.0	-58.7	-62.4	-57.3	-56.9
Exports (% m/m)	xxx	2.2	-0.1	2.6	-1.4	0.5
Imports (% m/m)	xxx	2.3	-2.0	4.4	-0.6	-1.5
Import prices (% m/m)	0.2	0.5	0.3	1.7	0.1	-1.1

Complete Summary of Key Economic Data Released for the First Quarter

Production, Sales and GDP

- Real GDP increased at an annualized rate of 3.4% in the second quarter, according to the Bureau of Economic Analysis advance estimate. After revisions, first quarter GDP growth was .6%. Second quarter growth exceeded expectations with stronger than expected non-residential investment, exports, and government spending. Fixed residential investment fell 9.22% in the second quarter, but this was well above the negative 16.34 % growth in the first quarter.

- Final Domestic Sales for the second quarter (GDP minus inventories and net exports) increased at a 1.9% annual rate.

- Real GDP increased 1.8% over the prior year. This growth rate is low compared to what most economists believe to be the economy's growth potential of 3%.

- Industrial production increased .5% in June led by a .6% increase in manufacturing output. Production fell .1% in May following a .4% increase in April and .1% decline in March.

- Capacity utilization for industrial production reached 81.7% in June. The utilization rate was 81.4% in May and 81.6% in April. Capacity utilization in June is the highest since October 2006 and is within one percentage point of a cyclical high of 82.4% recorded one year ago. As the utilization rate approaches the 82.4% rate, bottlenecks and production rigidities tend to result in inflationary pressures. Capacity utilization in manufacturing reached 80% in June following rates of 79.7 and 79.6 in May and April. The 80% utilization rate in manufacturing is close to the generally accepted threshold for inflationary bottlenecks in manufacturing.

- Business inventories increased .5% in May. Retail inventories increased .6%. The total inventory to sales ratio fell to 1.26 May from 1.27 in April and 1.3 at the beginning of the year. The inventory to sales ratio is gradually moving down to a healthier level for manufacturing growth. A low inventory to sales ratio suggests room for increased orders in the future.

- Factory orders for manufactured goods fell .5% in May. New orders for durable goods fell 2.4%. Non-durable good orders rose 1.6%, which was much larger than the expected increase.

- Manufacturing inventories increased .3% in May following .4% in April and .2% in March.

- New orders for manufacturing durable goods increased 1.4% in June following an upwardly revised 2.3% decline in May.

- Chain store sales increased 2.4% in June, matching the 2.5% growth in May and well above the 1.9% decline in April. The fiscal year to date increase in chain store sales was 2.3%. The April plunge in sales was an historic low. Overall, sales are following a modest rate of increase.

- Retail sales fell by .9% in June, which was larger than expected. Retail sales increased 1.5% in May. Major drags on June sales figures came from autos, furniture, and building-supply sales. Year-over-year sales growth is 3.8% in total and 4.2% excluding autos. Personal income growth continues to support a modest sales growth overall with some erosion to sales from higher gasoline prices.

Inflation

- Data on second quarter inflation offered a mixed view on inflationary pressures in the economy. The economy-wide GDP deflator increased 2.7% in the second quarter. The core index rose 1.7% on an annualized rate. The personal consumption expenditure index (PCE) increased at a more robust 4.3% annual rate in the second quarter.

- The seasonally adjusted consumer price index (CPI) increased .2% in June following a .7% increase in May and .4% in April. The core CPI, excluding food and energy, also increased .2% in June after increasing .1% in May and .2% in April. On a year-over-year basis, the core CPI increased 2.2% with the overall CPI increasing 2.7%. Soft energy prices helped tame inflation numbers of the second quarter.

- Producer prices for finished goods fell .2% in June following increases of .9% and .7% in May and April. The core PPI rate of increase was slightly higher at .3%.

Unemployment, Labor Markets, and Wages

- The Challenger Report on the number of people affected by job cuts showed a decline to 55,726 from 67,176 in June. For the first half of 2007, job cuts are down 10% from the cuts recorded in the first half of 2006. The report suggests that job cuts in the auto industry are beginning to end and the overall soft manufacturing sector for the first half of the year shows signs of picking up. In another part of the report, 80% of human resource executives intend to match or increase hiring in the second half of 2007.

- Payrolls increased by 132,000 in June and increases in May were revised upward to 190,000. The economy continues to follow a pattern of moderate payroll gains. The unemployment rate remains unchanged at 4.5%.

- Employment gains for the second quarter average 148,000 following the first quarter average of 142,000.

- Initial jobless claims fell slightly in the final weeks of July. Overall, the average weekly jobless claims continue to bounce around 301,000.

- The employment cost index increased .8% in the first quarter of 2007. The index increased .9 in the last three quarters of 2006. On a year-over-year basis, employment costs increased 3.5%.

Personal Income, Consumption, and Consumer Credit

- Consumer spending softened in the second quarter. Following consumption growth of 3.71% in the first quarter and 3.9% in the fourth quarter of 2006, second quarter consumer spending grew only 1.26%.

- Consumer credit in May reached the 2.44 trillion dollar mark. Consumers added $12.9 billion of credit in May. Revolving credit increased 10.3% and non-revolving credit increased 4.5%. These increases are unexpected and unusual in that auto and furniture sales, which are normally financed with credit, were both soft. Overall, growing levels of credit financing suggest a trend of weaker consumer credit quality going into the second half of 2007.

- Personal income rose .4% in May following a decline of .2% in April and increase of .8% in March. Personal income growth in the second quarter fell behind gains of the first quarter. First quarter growth averaged .8% and second quarter growth averaged .4%.

- Consumer spending increased .5% in May. The saving rate continued to be negative with a -1.4% saving rate in May following saving rates of -1.2% in April and – 0.4% in March.

- Auto sales fell to a seasonally adjusted annualized level of 15.6 million in June. June was the lowest level of monthly sales to this point in 2007. The percent of auto sales by U.S. brands fell to 50.7%, which is the lowest rate on record. Auto sales should decline throughout the remainder of the year.

Sentiment and Leading Indicators

- The Conference Board's Index of leading economic indicators fell .3% in June. The index gained .2% in May. The index continues to follow a choppy pattern but the six-month moving average growth rate fell to -1.3%. Overall, the key factors contributing to the negative move in June include lower building permits, weaker consumer sentiment, and an increase in jobless claims. The index is likely to continue its pattern of reversals with housing declines offset by stronger manufacturing. The data do not support a trend growth rate at the 3% target for full potential.

- The Conference Board's Consumer Confidence Index fell to 103.9 in June from 108.5 in May. The present conditions part of the survey was the key negative component in June. The index is about on par with the level achieved at this time last year. The recent index high of 111 occurred in February. Compared to other sentiment indexes, the Conference Board's Index remains the most optimistic.

- The UBS Index of Investor Optimism fell to 87 in July from 89 in June. While the index weakened, the level of confidence continues to bounce around a favorable reading of 90. The higher price of energy and slower residential housing market in July were the key drags on the index. The index has been as low as 78 this year and as high as 103. Energy prices remain the key concern within the index data with a lower overall economic outlook.

- The July University of Michigan Consumer Sentiment Index of 90.4 was well above the 85.3 index in June. The present conditions component of the index continued to be well ahead of the expectations component. Respondents are less optimistic about future conditions, but are relatively pleased with the current state of the economy.

Housing

- Downward revisions in housing start and residential investment data suggest further weakness going into the last two quarters of 2007.

- The Case-Shiller Home Price Index declined 1.4% on a year-over-year basis in the first quarter of 2007. The index has declined in three consecutive quarters.

- Homebuilder optimism declined in July, based on a decline to 24 from the index reading of 28 in June and 30 in May. The various components of the index all show signs of continued weakness in housing.

- Housing starts increased 2.3% to 1.467 million units in June while housing permits decreased 7.5%. Housing starts declined 3.4% in May and 0.4% in April. On a year-over-year basis, housing starts declined 19.4%.

- June's existing home sales numbers were worse that expected with a decline of 3.8% in June. The 6-month average for existing home sales is a negative 1.4%. The inventory-to-sales ratio remains at a high level of 8.8 months. The 6-month average for the ratio is 7.8 months.

- New Home sales declined 6.6% in June following a decline of 2.2% in May. The months of supply of new homes increased to 7.8 months and the median sales price fell by 2%.

International

- The nominal U.S. trade deficit in goods and services reached $60 billion in May, which is $1.4 billion more than in April. The trade deficit with China increased to $20 billion.

- On a year-ago basis, the trade deficit declined 9%. Both exports and imports posted strong gains. Through May, the trade deficit is on an annual pace for a $709.2 billion deficit compared to the $758.5 billion deficit in 2006.

- Imported petroleum products increased to $26.9 billion.

- The U.S. Import Price Index increased 1% in June following a 1.1% increase in May and a 1.4% increase in April. Much of the increase came from petroleum price increases. Export prices increased .3% in June following increases of .2% in May and .4% in April. On a year-over-year basis, import prices increased 2.3% and export prices increased 4.1%.