Third Quarter 2007 Performance Review and Outlook for the Economy

The 3.9% advanced estimate for third quarter real GDP growth exceeded expectations by almost a full percentage point. After revisions, second quarter GDP growth was 3.6%. GDP growth for both of the last two quarters exceeded generally accepted targets for sustainable expansion. Private non-housing related industries recently reported jobs growth of nearly 200,000 in October, making up for more modest jobs growth in August and September. The unemployment rate of 4.7% is well below the generally accepted 5% threshold of full employment. Recent upbeat reports on jobs and increased construction spending make it likely that we will see an upward revision in the third quarter GDP growth rate. The surprisingly strong overall performance of the economy has not contributed to high levels of inflation. Over the past year, core CPI inflation increased at a 2.1% rate and the core PCE index grew only 1.8%. The core producer price index increased by only 1.5%. Inflation data are well within Fed targets, allowing the Fed to cut the Federal Funds target to 4.5% in its October meeting. Looking forward, Fed rhetoric suggest that the risk of slow GDP growth is now balanced equally against the risk of unacceptable inflation, making it less likely for the Fed to lower the Fed Fund target in the remainder of this year. Overall, the economic picture coming out of the third quarter looks good, but significant weaknesses continue in housing-related industries and vehicle manufacturing.

Fourth quarter growth is likely to be below a targeted non-inflationary potential of 2.7% due to negative wealth effects from rapid deterioration in housing markets, tight credit conditions for consumers, financial market instability due to the subprime mortgage fallout, and slumping consumer sentiment. GDP growth is likely to be in the 1.5% to 2% range in the fourth quarter with specific weaknesses concentrated in the housing and durable good sectors. The trend for the index of leading economic indicators is flat, consistent with slow growth scenarios. Core inflation should remain moderate in the fourth quarter as consumer spending cools but prices for energy, commodities, and food will continue to grow more rapidly. Lower discount rates and Fed Fund rates over the past quarter improved liquidity, but high credit risk premiums prevent parallel declines in the prime rate and other key consumer borrowing rates

Economic Imbalances and Vulnerable Structures in the Economy – Downside Risk

While economic analysis often focuses on one set of economic relationships, an interconnected set of balances or offsetting imbalances work together at any point in time. A short summary of interrelated economic balances include the balance of trade, balance in fiscal policy budgets, household balance of income and consumption, and business balance of inventory investment with planned investment. Either an overall equilibrium in these relationships occurs or there will be adjustments in market prices, returns, currency values, and interest rates. Just like water, shifts in one imbalance will result in an adjustment somewhere else until an equilibrium occurs. For example, if we ignore all other relationships (everything else equal), excessive consumer spending and low savings results in a low supply of loanable funds and corresponding higher interest rates. However, if we match high consumer spending with a trade deficit in international relationships, excess dollar accumulation from trade will flow back into domestic markets to make up for the low level of domestic savings. One imbalance offsets another imbalance for a period. This is true for any collection of relationships. An adjustment in market prices or rates occurs if one imbalance does not fully offset another imbalance. We could just as easily have used the government fiscal deficit and trade to illustrate how the balance of trade imbalance provides loanable funds to offset increased government demand for credit. If these imbalances are not offsetting, we see adjustments in interest rates and a chain of events from interest rates to prices to equity values to exchange rates. Any attempt to block an adjustment in one imbalance results in a necessary correction elsewhere.

The larger point here is that the current U.S. economy rests on a collection of imbalances that may not be sustainable in the longer run. The economic consequences of corrections to an imbalance have potentially large negative ripple effects throughout the economy. For example, most recessions start with business adjustments to a large inventory overhang. The process of adjustment starts with lower orders, reduced manufacturing, more unemployment, lower spending, and economic deterioration. The slowdown need not be severe if the there is an appropriate timing of other imbalances through increased government deficits, increased consumer spending from income, or higher demand for U.S. goods from the foreign sector. The timing of adjustments occurs with lags, suggesting that recessions are temporary consequences from fundamental adjustments to an imbalance.

Our trade imbalance and government fiscal budget imbalance may be chronic but they tend to be offsetting. Both imbalances show signs of improvement. Inventory imbalances no longer pose real problems since businesses now manage production and sales with much lower inventory stocks. The household sector presents a different set of problems as it enters uncharted territory with a very fragile safety net. Consumer credit balances are at historic highs while savings rates are miniscule. This imbalance in income and spending persists largely because labor markets are strong, foreign capital inflow offsets low domestic saving, and household asset values supplement income to support spending. Home refinancing, wealth from appreciating equity values, low unemployment rates, and relatively ample consumer credit supported this consumption imbalance. The slumping housing sector, increased credit risk premiums, and volatile equity market have all emerged as threats to continued imbalances in household finance. If labor markets soften significantly and household assets continue to fall in value, we could see a default rate on consumer credit that would both signal major corrections in economic activity and shock financial markets in much the same way as the subprime loan debacle. A slowdown in consumer spending can be offset by some combination of increased private investment, increased government spending or increased exports. However, the magnitude of corrections could be severe since the consumer sector provides approximately two-thirds of all spending in the economy. Finally, the timing of offsetting corrections is not likely to be finely tuned, leaving a potential for significant economic downturns.

Prospects for a Recession

Most surveys suggest that the probability of a recession is about 35% compared to the alternative 65% probability of continued expansion at some level. When all perspectives are put together into a consensus forecast, a slow growth scenario is most likely. Yet, the underlying imbalances in the economy, especially with respect to the consumer sector, present another dimension. If we do have a recession, it could be very severe as the fundamental adjustment in the household budget works its way through the economy.

Those analysts who tend to place a higher probability on the recession scenario point to the importance of existing economic imbalances and the magnitude of the necessary housing adjustment. Preemptive moves by the Fed to cut the Fed Fund target and provide liquidity to the market may not be effective until sometime late next year, which may be too late. Liquidity in the banking sector will help banks clean up their balance sheets, but there is little evidence that relief will find its way down to households. The prime rate, which has a link to most household variable rates, has not moved in tandem with the Fed Fund rate. The economy walks a tight rope where one slip in employment, asset values, or stock market values could push the consumer over the edge and that will take a good part of the economy with it.

Summary of Economics Weaknesses and Strengths

Weaknesses– Fragile Conditions	*Strengths – Favorable Conditions*
High debt burdens	*Low unemployment*
Low Savings	*Low Inflation*
Credit Standards Higher	*GDP growth stronger than expected*
High gas prices	*Good Equity Fundamentals*
High commodity prices	
Falling housing prices	
Volatile Equity values	
Falling dollar value	
Global risks and uncertainty	

Flight to Quality

Both domestic and international investors continue to become more risk averse as financial markets try to digest a growing number of subprime loan defaults. While the Fed followed preemptive Fed Fund rate cuts to stabilize economic growth, lower interest rates and related declines in the value of the dollar made long-term U.S. securities less attractive to foreign investors. Prospects of lower dollar values make U.S. long-term securities riskier in terms of what they are worth when repatriated back to the currency of the investor. The flight to quality expanded credit risk premiums between riskier and safer security classes as investors bid prices of safer securities up and their yields fell. International capital flows turned negative in August, a phenomenon that has not occurred since the 1999 crisis with the LTCM hedge fund and the Russian debt default. This is probably a one-time phenomenon, but it would signal trouble for the economy if foreign savings do not continue to supplement the low level of domestic saving in the U.S. economy.

Emerging Markets (EMs)

Capital continues to filter into EMs even with the subprime contagion and financial market weaknesses in the U.S. EM credit markets show improvement as primary investors in EM debt tend to be unlevered investors capable of riding out financial market volatility. On net, EM countries are now creditors with stronger fundamentals than in prior years. EM solvency is much improved. Spreads between EM bonds and U.S. Treasuries are now just under 200 basis points. As the Fed provided more liquidity to domestic markets and lowered the Fed Fund rate, the credit risk premium for EM debt fell. With the reduced likelihood of additional rate cuts over the next quarter, credit spread for EM debt will widen. A key concern is that EM investing may now be the new "bubble" where investors chase the highest returns without full risk assessment. There is likely to be more room in this EM expansion, but risk assessment is crucial. It is easy to be the follower in moves like the shifts we have seen from stocks to real estate to EMs. The greater skill comes from knowing when to stay out.

Complete Summary of Key Economic Data Released for the Third Quarter

Production, Sales and GDP

- Based on preliminary estimates by the Bureau of Economic Analysis, the economy grew at a 3.9% real rate in the third quarter of 2007. Recent data releases suggest that subsequent revisions are likely to show a higher growth rate closer to 4.3%.

- Third quarter growth was broad based with contributions by consumer spending (+3%), trade (+.9%), inventories (+.4%), structures (+12.3%), and equipment and software investment (+5.9%). Residential investment was the major drag on growth with a 20.1% decline.

- Factory orders increased .2% in September following a revised 3.5% decline in August and 3.4% gain in July.

- Overall, the inventory to sales ratio remained at 1.24 in September. However, for durable goods, the inventory to sales ratio rose from 1.45 to 1.48. The durable good ratio reached its annual high of 1.51 in February. Additional inventory accumulation in the durable good sector is limited, suggesting that production of durable goods will slow in the fourth quarter.

- The annualized rate of vehicle sales slumped to 16 million in October from 16.2 million in September. Much of the slowdown occurred in light trucks. For the full year, vehicle sales are running at an annualized 16.15 million units compared to 16.5 million in 2006. The U. S. share of vehicle sales improved to 51.6% from a low of 49.1% in the summer. North American production should decline by roughly 2% compared to fourth quarter 2006 production levels in order to adjust to the lower sales volume.

- Manufacturing slowed in October based on data from the ISM index. The October ISM index of 50.9 is barely above 50, which is the threshold for expansion versus contraction. October marked the fourth consecutive decline in the manufacturing index. The softer manufacturing sector is likely to cut back on plans to build up stocks until a clear picture of the economy develops.

- Total construction spending rose .3% in September following declines in the prior two months. Revised data show a .8% decline in construction spending in July and a .2% decline in August.

- Private non-residential construction increased 1.5% in September following a revised 1.8% increase in August. For the third quarter, nonresidential construction increased at an annual rate of 12.5%. Private residential construction spending fell 1.4% in September and is now 16.8% below one year ago.

- New orders for manufactured durable goods fell 1.7% in September following a decline of 5.3% in August. Durable good orders increased 5.9% in July.

- Industrial production increased .1% in September following a flat growth in August and a .6% increase in July. Manufacturing also increased by .1% in September following a decline of .4% in August and an increase of .8% in July. Business equipment investment increased .4% in September following a decline of .5% in August and a 1.3% increase in July. Overall, manufacturing and business equipment production rose at a strong pace in the third quarter with momentum going into the fourth quarter.

- Capacity utilization remained steady at 82.1 in September following utilization rates of 82.1 in August and 82.2 in July. The economy continues to run at close to full capacity and any push on capacity rates above 83% tends to add to inflation pressures.

- Retail sales rose .6% in September following an increase of .3% in August and .6% in July. Core sales, excluding gasoline sales, posted a more modest growth of .2% in September following a decline of .1% in August and .8% in July. On a year-over-year basis, sales grew by 5% and by 5.1% without considering auto sales. Sales numbers look good, but much of the underlying strength comes from sales of gasoline and one-time outlays for durables. Going forward, consumers are likely to spend less in reaction to higher levels of uncertainty about future economic conditions and continued stress from high credit balances.

Inflation

- The consumer spending deflator rose .2% in September to match the increase in the core Personal Consumption Expenditure (PCE) deflator. On a year-on-year basis, the core PCE increased 1.8%, which places it at the top of the Fed’s acceptable range of 1% to 2%.

- The GDP deflator increased at a modest .8% annual rate in the third quarter compared to a 2.6% rate in the second quarter. The core GDP deflator grew 1.6% in both the second and third quarters.

- The seasonally adjusted consumer price index increased .3% in September after declining .1% in August and rising .1% in July. The core CPI increased .2% in September, August, and July. Over the past year, core CPI inflation increased at a 2.1% rate.

- Inflationary pressures are not uniform across the components of the core CPI. The September services component of the Core CPI grew at a 3.3% rate in a year-over-year basis. The goods component of the Core CPI actually posted a .8% decline from one year ago.

- Producer prices for finished goods increased by 1.1% in September driven largely by increases in finished goods and energy products. Core prices for finished goods increased by a much lower 0.1%. For the third quarter as a whole, core prices for finished goods rose by only 1.5% on an annual basis.

Unemployment, Labor Markets, and Wages

- The unemployment rate held steady in October following September's 4.7% rate, well below the 5% rate that most economists believe to be full employment for the economy. The labor force participation rate held steady at roughly 66% for the first three quarters of 2007.

- The number of people affected by layoffs in October was slightly below normal while the 65,000 monthly layoff average on a year to date basis is below the 2006 pace of 70,000. However, the financial services layoffs over the ten months of 2007 already exceed the previous full-year record set in 2001.

- Personal income grew .4% for the second consecutive month in September. Disposable income grew by .4% and wages grew .6%. Real consumer spending increased 3% in the third quarter overall, which is more than double the rate set in prior quarters this year.

- Slumping sales at Chrysler prompted a three-year Recovery and Transformation plan calling for a combined 23,000 lay offs over the next three years.

- Automakers face a difficult period where record debt burdens, spent-up consumer demand, and lower affordability of autos for households all combine to slow vehicle sales.

- The employment cost index (ECI) increased .8% in the third quarter, slightly below expectations. On a year-ago basis employment costs increased 3.3%. Both the wages and salaries and benefits components grew .8% in the third quarter. The benefits component grew 1.3% in the second quarter.

- Payroll gains exploded to 166,000 in October following average monthly jobs gains of 94,000 in the third quarter and 84,000 in the second quarter. For 2007 overall, hiring has slowed compared to the 190,000 average monthly job gains in 2006.

- Initial jobless claims continue to vary around an average of 320,000 per week for 2007. The lack of trend in the data suggests a stable jobs market.

Personal Income, Consumption, and Consumer Credit

- Personal income grew .4% in September matching August's growth rate. Personal income growth was .5% in July.

- The personal saving rate of .9% in September was in line with the .8% rate in August and .9% rate in July.

- Wage income grew .6% in September following growth of .4% in August and July.

- Consumer spending remains robust with a .3% growth rate in September following growth of .5% in August and .4% in July.

- Consumer credit increased by $12.2 billion in August, which equates to a 5.9% annual rate. Revolving credit growth was 8% at an annual rate. Nonrevolving credit increased by 4.8%. Total consumer credit reached $2.469 trillion in August. Consumer credit growth is a good indication of household credit quality conditions. Higher credit use signals a deterioration of household credit quality, raising concerns that consumer spending must eventually slow.

Sentiment and Leading Indicators

- The October Conference Board's consumer confidence index fell to 95.6 compared to a prior reading of 99.5. The October index is the lowest since October of 2005 in the post Hurricane Katrina disaster. Much of the weakness comes from more pessimistic assessment of labor market conditions. The expectations component provided a major drag on the index. Key factors in the lower expectations numbers include expectations of higher heating bills, uncertainty about the economy, and concerns for softer labor markets.

- The University of Michigan Consumer Sentiment Index fell in October to 80.9 from 83.4 in September and August. The October index reading is the lowest since May of 2006. Much of the decline came from the expectations component.

- The probability of recession in the Moody's survey increased to 32% in September from 31.6% in August and 15.3% in July. Risks increased due to tighter credit conditions, rising mortgage defaults, unsettled global financial markets, high volatility in equity values, and weakening housing values.

- The UBS Index of Investor Optimism declined in the third quarter from an index of 89 in June to 70 in October. Investor sentiment is weakening overall with a 30-point drop in the index since the start of this year.

- The Conference Board's index of leading economic indicators increased by .3% in September following a decline of .8% in August and an increase of .7% in July. The September gains in the index were broad based with only two negative factors in the collection of ten factors making up the index. Declines in building permits and wider spreads in interest rates for riskier securities provided the only negative factors. Overall, the leading indicators do not show a pattern consistent with a either a contraction or higher rate of expansion. The index averages about zero using either three or six month moving averages. The pattern tends to be consistent with modest growth below full capacity, suggesting a fourth quarter growth rate in the 1.5% to 2% range.

Housing

- September new home sales edged up by 4.8% from August's total. On an annualized basis, new home sales reached 770,000 units in September. The 12-month moving average ending in September is 870,000 units. The trend in new home sales dipped downward at the end of last year when the economy achieved approximately 1,000,000 units per year.

- Existing home sales continues a steady downward trend. Sales declined by 8% in September from the prior month. The annualized number of units reached 6.6 million at the start of 2007 and is now at 5 million units. The housing market is at about the same sales levels experienced before the housing boom. The number of months of homes available for sale is now 10.5, the highest since 1999.

- Housing inventory shows signs of stabilization at 8.3 months, largely due to reductions in new home construction. The median months on the market is also stabilizing at about six months compared to 3.5 months a year ago.

- The National Association of Home Builders (NAHB) index for the housing market plummeted to 18 in October compared to a reading of 39 in February of 2007. The index for potential buyers posted even more dramatic declines from earlier in the year. The index values in October are the lowest in the history of the NAHB index and show no sign of bottoming out.

- Housing starts decreased by 10.2% in September following declines of 3.2% in August and 6.6% in July. New residential construction fell 10.2% in September compared to a decline of 3.2% in August and 6.6% in July. Third quarter spending on new residential construction was 23.4% below the second quarter average.

- Residential investment fell 20.1% at an annual rate during the third quarter.

- The Case-Shiller report on housing prices estimated a 5% decrease from one year ago. The OFHEO index suggested that housing prices increased 2.5% for the year, but most analysts believe the OFHEO measure has an upward bias. Both index values show a steady decline since 2005.

- Since the housing price peak late in 2005, the median house price is now somewhere between 10% and 15% lower. This lost wealth from declining housing prices may begin to weigh on consumers as we move into 2008.

International

- Long-term international capital flows in August declined by $69.3 billion compared to a positive inflow of $19.5 billion in July and a positive $99.9 billion in June. August represented the only month with a negative capital inflow in the past year. The turnaround in foreign preferences for dollar-denominated long-term U.S. financial securities hit equities, corporate bonds, and Treasury securities. Agency bonds represent the only security class with a positive inflow. The last time long-term international capital flows turned negative was in August 1999 during the crisis over Long Term Capital Asset Management and the Russian default on debt.

- The current account deficit as a share of GDP has been shrinking gradually. Improvement over the last three months linked to faster increases in exports than imports, is largely due to lagged responses to the weak value of the dollar. Continued weakness in the dollar is likely to result in a continued improvement, but not by dramatic amounts. Importers facing a lot of competition tend to adjust the foreign price to leave the dollar price of many imports the same even with the weaker dollar. This response makes improvements in the trade account more modest than expected from the magnitude of the decline in the value of the dollar. On the positive side, the tendency to keep import prices lower than justified by a weaker dollar helps moderate inflation.

- The total nominal trade balance in August was a negative $57.6 billion. Trade has been an overall drag on GDP growth for a long time, slicing about one-half of a percentage point from real GDP growth. As the trade balance improves, even though a deficit remains, improved GDP growth will materialize.

- Import prices increased by 1% in September following a decrease of .3% in August and 1.3% increase in July. On a year ago basis, import prices are 5.2% higher. Much of the import price increase comes directly from higher oil prices. When we exclude oil prices, import prices are only 2% higher than one year ago, which is in line with the 1.8% core PCE inflation rate.

- Export prices increased by .3% in September compared to increases of .2% in August and .1% in July. Overall, export prices increased 4.5% for the year ending in September. The weaker value of a dollar actually resulted in a decline in export prices when viewed in foreign currencies.

Summary of Selected Data for 2007

	Sept. 2007	Aug. 2007	July 2007	June 2007	May 2007	April 2007	Mar. 2007	Feb. 2007	Jan. 2007
Inflation									
PCE (% m/m)	0.2	0.0	0.1	0.1	0.5	0.3	0.4	0.4	0.2
PCE Core (% m/m)	0.2	0.1	0.2	0.1	0.1	0.1	0.0	0.3	0.2
CPI (% m/m)	0.3	-0.1	0.1	0.2	0.7	0.4	0.6	0.4	0.2
CPI Core (% m/m)	0.2	0.2	0.2	0.2	0.1	0.2	0.1	0.2	0.3
Labor/Consumer									
Unemployment Rate (%)	4.7	4.6	4.6	4.5	4.5	4.5	4.4	4.5	4.6
Personal Consumption (% m/m)	0.4	0.4	0.5	0.5	0.5	0.5	0.3	0.7	0.6
Savings Rate (% m/m)	0.9	0.8	0.9	0.6	0.5	0.7	1.5	0.9	0.8
Personal Income (% m/m)	0.4	0.4	0.5	0.5	0.5	0.0	0.8	0.7	1.1
Avg. Hourly Worker Earnings (% m/m)	0.0	0.0	-.03	.03	0.4	0.2	0.3	0.4	0.2
Production/Manufacturing									
Industrial Production (% m/m)	0.1	0.0	0.6	0.5	-0.1	0.6	-0.1	0.8	-.04
Manufacturing (% m/m)	0.1	-0.4	0.8	0.6	0.1	0.4	0.7	-0.1	-0.6
Capacity Utilization	82.1	82.1	82.2	81.8	81.5	81.7	81.4	81.6	81.6
Sales									
Retail Sales (% m/m)	0.6	0.3	0.6	-0.8	1.6	-0.3	1.0	0.6	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)	0.77	0.74	0.80	0.83	0.89	0.91	0.86	0.84	0.87
Existing Home Sales ($ millions, annual rate)	5.04	5.48	5.75	5.75	5.98	6.01	6.12	6.68	6.44
International Trade Balance (Billions)									
Trade Balance (Real $ billions)	xxx	-$57.6	-$59.0	-$59.4	-$59.6	-$58.6	-$62.7	-$57.9	-$57.0