Outlook for the Economy: Second Quarter 2006

Advanced reports show that the economy grew at a 2.5% real rate in the second quarter of 2006 following a revised growth rate of 5.6% in the first quarter. A preliminary analysis of inventory data and construction growth suggests that the 2.5% growth rate is likely to be revised upward. Nevertheless, growth slowed in the second quarter of 2006 as expected. The unemployment rate, which has been steadily falling over the last few years, inched back up to 4.8% on the heels of weaker than expected job growth. The housing market continued to cool off and auto sales took a big hit in July. The inventory to sales ratio held steady but the dollar value of inventories reached a relatively high level. Any sales slump will result in an immediate curtailment of factory orders in the third quarter.

Inflation pressures continue to build on several fronts. The seasonally adjusted consumer price index increased 4.1% on a year-over-year basis in June. Core consumer prices, excluding more volatile food and energy components, increased 2.69% on a year-over-year basis in June, exceeding the 2.5% upper limit of the Fed's comfort zone. The producer price index for intermediate goods grew at a 7.2% rate for the year ending in June. Producers have not fully passed on the intermediate good prices to consumers due to a favorable profit cycle and low unit labor costs. The potential for significantly higher inflation exists if corporate profits weaken. Signs of increases in unit labor costs are already developing. Employer costs increased .9% in the second quarter, surpassing analyst expectations. On a year-over-year basis, employer costs increased 3% in the second quarter following an increase of 2.8% in the first quarter. The higher trend in labor costs suggests a potential for more wage-induced inflation pressure in the third quarter.

The economy continues to perform within or close to acceptable ranges of growth and inflation. The recent unexpected increase in the unemployment rate will moderate inflation expectations somewhat and weak jobs data prompted many analysts to lower the chances for another fed fund rate hike at the August 8 FOMC meeting. Nevertheless, a careful analysis of the data suggests that the biggest threat to the economy continues to be inflation. Given the problem of slowing inflation once it is firmly rooted in the economy, a move of the fed fund rate to 5.5% is warranted. Central banks in Japan and the Euro zone are also likely to move to higher interest rates. China is likely to allow an appreciation of the yuan in response to their over-heated economy. Global inflationary pressures should not be ignored for long.

Inflation, Inflation, Inflation

After seventeen consecutive increases of 25 basis points in the fed fund rate, the Fed is no longer in neutral territory with respect to monetary policy. The real fed fund rate now exceeds the long run average, placing the Fed in a contractionary zone. Recent minutes from the FOMC meetings in July suggest that the resolve to continue to raise rates is weakening. Most analysts are pointing to soft second quarter economic growth (2.5%) and higher unemployment rates (4.8%) as reasons why the Fed will pause and hold rates where they are until third quarter numbers take

shape. Higher interest rates are now taking effect in housing and durable good purchases, such as autos.

The Fed is expected to pause at the August 8 meeting without an increase in the fed fund rate, but the risks are high. Without further restraint, the economy faces higher inflation fueled by both excess demand and energy driven supply pressures. The economy is now operating at a little over 82% in capacity utilization, approaching the point where production bottlenecks lead to excess demand and higher prices. Firms may be reluctant to invest in long-term capacity given slower growth expectations, making it likely that capacity utilization will go even higher. Global economies are on track to grow at a 3.5% annual rate with several economies now looking to cool off domestic demand. Pressure at the producer price level is mounting and higher consumer prices for finished goods have been stalled by a combination of high corporate profits with low labor costs. Neither of these conditions is guaranteed to continue throughout 2006.

Going Forward – 2007

The Fed's central tendency forecasts for 2007 reveal a number of interesting benchmarks. The Fed forecast is based on the average of the FOMC members' expected optimal policy path. The forecast represents what optimal performance "should be" in 2007. Based on the Fed's central tendency forecast, GDP growth should slow to between 3% and 3.25% from fourth quarter to fourth quarter of 2007. While this expectation is technically lower than the 3.5% average growth rate achieved over the last few years, it does not fall below the mark too much. As such, it is slightly on the low side of past performance. The core personal consumption expenditure index falls in the 2% to 2.25% inflation range, which is lower than the current 2.4% PCE inflation rate. Unemployment should remain between 4.75% and 5%, which allows for slightly higher unemployment than the current 4.8% rate.

The table below provides a comparison of the Fed's central tendency forecast for 2007 with forecasts provided by the Blue Chip Financial Forecast, and Moody's.

Variable	**FED**	**Blue Chip Consensus**	**Moody's**
Nominal GDP*	5 – 5.5%	5.3%	5.6%
Real GDP*	3 – 3.25%	2.9%	2.8%
Core PCE*	2 – 2.25%	2.2%	1.9%
Jobless Rate@	4.75%- 5%	4.8%	4.9%

***Variable measured as fourth quarter to fourth quarter percentage change.**
@ Variable measured as the fourth quarter 2007 average.

Forecasts provided by the Blue Chip Financial Forecast and by Moody's represent expected performance measures while the Fed's forecast represents what an optimal policy range should be. The first observation is that the expected performance numbers are not far off from the Fed targets. Real GDP growth is expected to be slightly below the Fed's optimal range. Both inflation and unemployment are very close to the optimal range forecast. Overall, the numbers call for slower growth accompanied with low inflation. The logic behind these forecasts rests on the view that prior interest rate increases will be fully felt as we move into 2007. Weaker housing and a weaker job market will take the edge off inflation. Another 25 basis point increase in the fed fund rate would also be consistent with the expectations provided by the Blue Chip Financial Forecast and by Moody's.

Summary of Recent Data Releases

Production and Capacity

- The advanced announcement for second quarter real GDP was 2.5% growth. Growth was generally slower in all the GDP components. Most analysts expected slightly higher second quarter growth following the revised 5.6% growth in the first quarter.

- The U.S. capacity utilization rate reached 82% in July. Normally, with capacity utilization at this relatively high level, business investment tilts heavily toward net new capacity. Currently, business investment tends to have a heavy emphasis on acquisitions rather than new capacity or inventories. Companies are expected to continue to use free cash to acquire other companies, limiting the potential aggregate expansion of capacity.

- Industrial production beat consensus expectations in June by increasing .8%. Manufacturing production increased 5.3% at an annualized pace.

- American automakers are experiencing severe sales slumps**.** Ford and Chrysler sales were down a little over 30% in July while GM sales were down by almost 20%. Overall, U.S. auto sales are expected to fall from 17 million units in 2005 to around 16 million units in 2006. American auto manufacturers now only represent about 40% of global automobile market share, which is well below the 60% share experienced ten years ago.

- The inventory to sales ratio held steady at 1.3 in the second quarter and has exhibited little variation over the last three quarters. Total inventories increased, especially in the retail sector.

- Total construction spending increased .3% to $1.217 trillion in June. Construction spending for both May and April was also revised upward. Overall, construction spending in 2006 lags well behind the pace set in 2005. Going forward, higher interest rates and the soft housing market should continue to be drags on construction spending.

- Factory orders were stronger than expected in May with a .7% increase.

Inflation and Interest Rates

- The seasonally adjusted consumer price index increased .2% in June following a .4% increase in May. Prices were 4.3% higher in June on a year-over-year basis following a 4.1% rate in May and a 3.6% rate in April.

- Core consumer prices increased at a .3% month-over-month rate in June, raising the year-over-year rate to 2.69%. Core consumer prices increased only 2.4% on a year-over-year basis in May following a 2.3% rate in April. Most analysts believe the Fed's comfort zone for core inflation has an upper limit of 2.5%, which is now being surpassed.

- The personal consumption expenditure deflator increased .2% for the third consecutive month in June. On a year-over-year basis, the PCE increased 3.5% in June. The core PCE increased 2.4% on a year-over-year basis.

- The producer price index (PPI) for finished goods increased .5% in June, exceeding expectations. The core PPI posted a more modest .2% increase. Inflation pressures are most severe at the intermediate and crude levels where year-over-year inflation rates are 7.2% and 33.7%, respectively. These price pressures are not yet being passed on in finished goods, largely due to a favorable profit cycle and low wage pressures. But, as profitability wanes and wage increases pick up, there is potential for much higher inflation at the finished good level.

- According to the ISM survey, 57% of surveyed manufacturers were paying higher prices for their inputs in June. The survey for May resulted in only a 42% response of higher input prices.

- The real federal funds rate, as measured by the difference between the nominal funds rate and the core CPI, is now above its long-term trend of 2.5%. This spread suggests that Fed policy and the recently announced 5.25% Fed Fund Rate represents a restrictive policy position.

- The GDP implicit price deflator increased 3.3% in the second quarter, matching the same deflator for the last three quarters. The core PCE deflator rose 2.9% on a quarter-over-quarter basis.

- The Fed raised the target fed funds rate to 5.25% at its last meeting. The increase was the seventeenth consecutive 25 basis point increase. Minutes from the last Fed Open Market Committee meeting suggest that the Fed continues to have an inflation bias. The next meeting on August 8 will weigh the extent to which the economy has slowed in the second quarter against what now looks like above-target inflation pressure. Most analysts place about a 50-50 chance for another rate increase in August.

Oil

- Crude oil prices increased sharply in mid-June from $65 a barrel to just over $71 a barrel. The $74.30 all-time high nominal price of oil occurred in May. Most analysts believe that oil prices are well ahead of the fundamentals, but geo-political concerns about rising tensions in the Middle East keep prices elevated.

Employment

- The unemployment rate reversed direction in July, moving to 4.8% following a steady 4.6% rate established in prior months. The higher than expected unemployment rate in July helps confirm signals that the economy is slowing in the third quarter. Many analysts believe the higher than expected unemployment rate will lower the chances of another increase in the Fed Fund rate at the next Fed Open Market meeting.

- While the July unemployment rate went up, the number of workers affected by job cut announcements fell by 50% from June. A relatively low level of job cuts is largely attributed to the resistance of auto makers to announce layoffs even though sales slumped. Increased layoffs may occur in August and deeper in 2006.

- Employer costs increased .9% in the second quarter of 2006, surpassing analyst expectations of .8%. Benefit costs increased in line with the overall employer cost. On a year-over-year basis, employer costs increased 3% in the second quarter following increases of 2.8% in the first quarter. Higher employer costs numbers suggest the potential for more wage-induced inflation pressure in the third quarter.

Sales

- Retail sales fell unexpectedly in June by .1%. Sales posted a .1% gain in May and a .7% gain in April. Year-over-year growth slowed to 5.9%. Much of the decline in June sales was directly linked to poor auto sales.

Consumer Income and Spending

- Personal income rose .6% in June following a revised increase of .4% in May and .7% in April. Spending rose .4% in June following a .6% gain in May. The saving rate was a negative 1.5% in June following negative 1.6% in May and negative 1.4% in April. Savings rates have been negative throughout 2006.

- Second quarter consumer spending grew 2.5% following growth rates of 4.8% and 0.8% in the prior two quarters. Spending continues to be supported by tight labor markets with full employment.

- Aggregate wages and salaries increased at an annualized 6.4% rate in the second quarter.

- Unit labor costs increased 3% in the second quarter of 2006 and have been on a declining trend since mid-2004 when the growth rate was 7%. Unit labor costs include wages and salaries along with benefits.

- Consumer credit increased $4.4 billion or 2.5% at an annual rate in May. Revolving credit was the key component in the increase. Nonrevolving credit decreased at an annual rate of 2%. One explanation for this shift is that consumers supplemented spending with home equity extraction in prior periods, keeping revolving credit low. Higher interest rates have shifted consumer financing back to forms of revolving credit. Higher interest rates along with higher fuel prices should dampen consumer spending throughout 2006.

Confidence and Sentiment

- The Conference Board's consumer confidence index was 105.7 in June, signaling continued expansion. The confidence index is sensitive to labor conditions, which remain strong.

- The Conference Board's Leading Indicators index rose .1% in June following declines of .6% in May and .1% in April. More important, the six-month annualized growth rate fell by .6%. Another measure of trend, the three-month annualized growth rate, fell deeper into negative territory with a -2.3% growth rate. The leading indicator patterns are consistent with a slowing economy.

- The University of Michigan's Consumer Sentiment Index reached 84.7 in July following readings of 84.9 in June and 79.1 in May. The University of Michigan Index is the only major confidence measure that is not back to its pre-Hurricane Katrina level.

- The UBS index of Investor Optimism continues to weaken. The index fell to 55 in July, which is the lowest level this year. The index was 93 at the start of the year. Key causes for the slump in the index were weaker economic conditions, a housing slump, and higher energy prices.

Housing

- Sales of existing homes continued to decline in the second quarter. A decline of 1.3% occurred in June following declines of .6% and 2.2% in May and April, respectively. On a year-over-year basis, home sales are down 8.9%.

- Fixed residential investment fell 6.3% in the second quarter following declines of .3% in the first quarter and 1% in the fourth quarter of 2005. The housing slowdown continues to present a drag on growth.

- Housing starts are down nearly 20% since the start of 2006. New home sales fell by 1.13 million units on an annualized basis in June. The decline in new home sales represents a 3% month-over-month decline and an 11% drop on a year-over-year basis.

- House-price appreciation continues to weaken. Appreciation in June was only 1% on a year-over-year basis compared to a 12% average appreciation in 2005.

International

- The Chinese yuan is appreciating amid pressure from the United States for revaluation and an expected Chinese central bank move to slow down a heated economy. A higher yuan will help slow down Chinese exports to the United States and ease the large trade U.S. deficit. Higher U.S. exports will help dampen some of the ill effects of the housing slump.