

Economic Research – Scott J. Brown, Ph.D.

Thursday, May 10, 2007

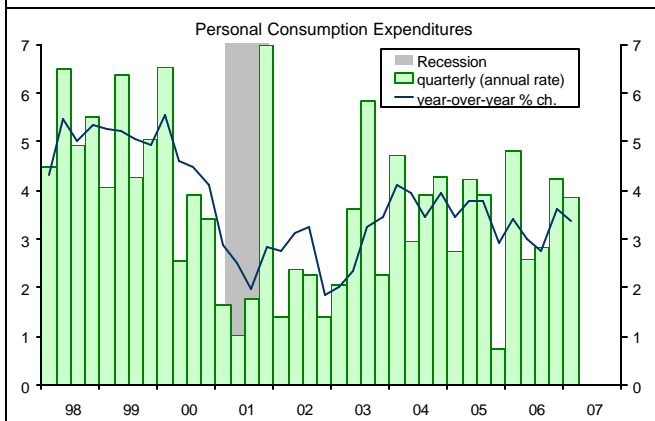
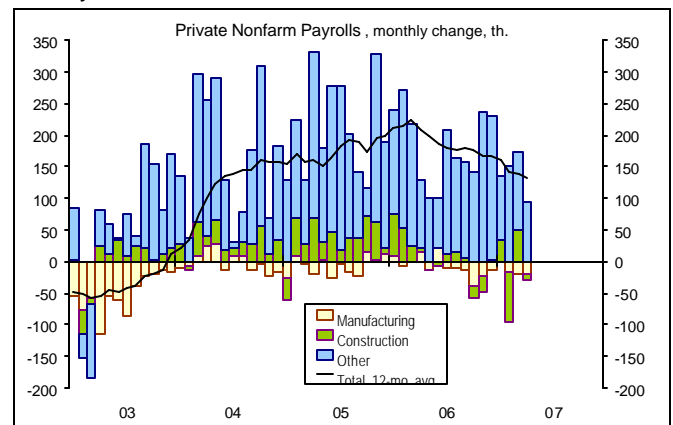
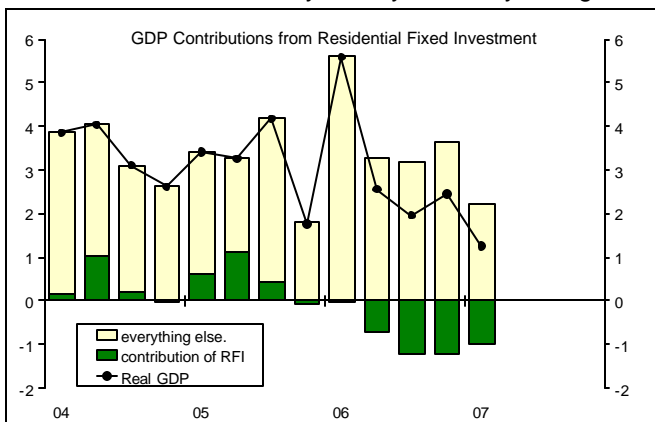
Still A Moderate Outlook

- *The general outlook (lackluster-to-moderate growth in 1H07, followed by a gradual pickup in growth as the drag from homebuilding fades) remains intact.*
- *Downside risks to growth remain, but may not be as threatening as they appeared a month or two ago. While core inflation is likely to moderate in the near term, there are upside risks over the intermediate term.*
- *Fed officials remain united in their view that inflation is “the predominant risk” in the economic outlook. However, monetary policy is likely to remain on hold, probably through the end of the year.*

Real GDP rose at a 1.3% annual rate, according to the government’s advance estimate. That figure will be revised later this month (and again at the end of June), but the story isn’t going to change much. It was another strong quarter for consumer spending growth – and a soft, but not disastrous, quarter for business investment. Residential construction continued to contract, subtracting about a full percentage point from GDP growth. A slower pace of inventory accumulation and a wider trade deficit (rebounding after a sharp narrowing in 4Q06) also subtracted from the overall growth figure. Real Final Sales (GDP less inventories and foreign trade) rose at a 2.0% annual rate, relatively steady since a year ago,

While the direct impact of the housing slowdown on construction is clear, the indirect effects are not. However, there’s little sign that the secondary effects of the housing slowdown have had an appreciable impact on the overall economy. There is some loss-of-wealth effect as potential homesellers cannot get the same prices that they could have if they had sold a year ago. However, the wealth effect is small and cumulative gains in housing wealth over the last several years have been substantial. The extraction of home equity wealth through mortgage refinancings, an important fuel for consumer spending growth in the last few years, began to wane last year, but has not disappeared completely.

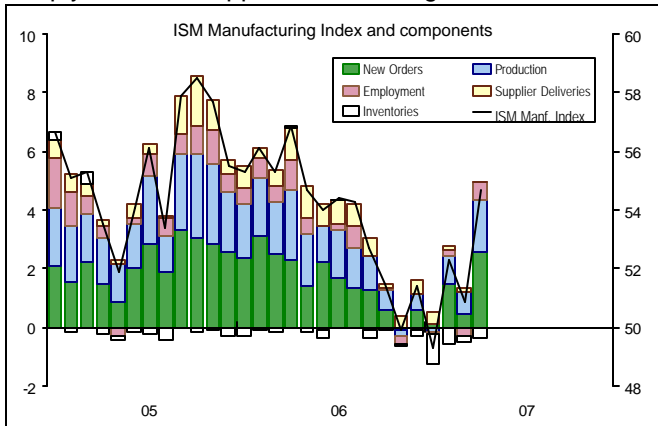
Job and wage growth provided solid support for consumer spending growth in the first quarter. Personal income rose at a 9.2% annual rate, led by a 9.5% pace in wages and salaries. The decline in energy prices from last summer added to consumer purchasing power at the start of the year. However, the increase in gasoline prices, now over \$3 per gallon on average, should dampen the pace of consumer spending growth in the current quarter. Still, moderately strong job growth is likely to continue in the near term.



Nonfarm payrolls rose by 88,000 in April, but the figure appears to have been influenced by seasonal adjustment difficulties related to the earlier Easter. The government adjusts the data for moving holidays, but it’s a hard problem. Retail payrolls fell by 26,100 following a 32,600 jump in March. In addition, unemployment rates for teenagers and young adults rose in April, while the rate for those 25 and older held steady at 3.5%.

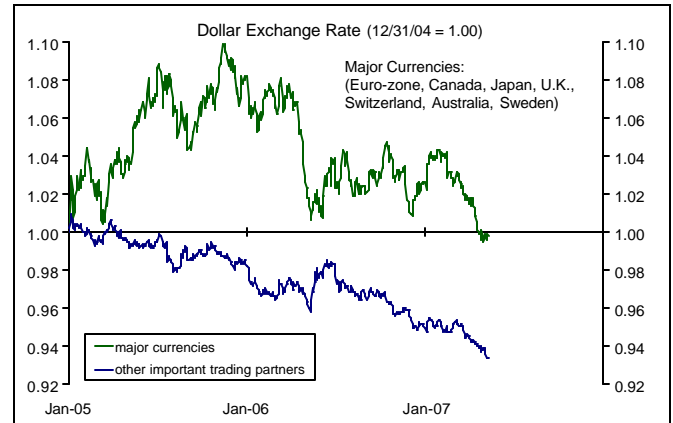
Corporate layoffs have remained relatively limited, trending lower over the last several months. Job losses in construction have been limited, as losses in residential homebuilding have been partly offset by gains in nonresidential construction. Undocumented aliens probably accounted for much of the labor input in residential construction, but they don’t show up in the government’s data. The pace of new hiring appears to have slowed over the last year, likely reflecting businesses’ concerns about the overall economy.

Worries about a possible recession may also have dampened spending on capital equipment in the last two quarters. However, concerns about the softness in business investment have been soothed somewhat by the rebound in recent manufacturing sector data. New orders picked up in March (although these data are highly volatile) and the ISM's manufacturing index rose in April (with healthy gains in the major components). The global economic outlook remains bright and U.S. exporters should benefit from a softer dollar. While capital investment still seems unlikely to charge ahead sharply, it doesn't appear to be falling off a cliff.



The preliminary estimate of nonfarm business productivity growth for 1Q07 was 1.7% (annual rate) – better than expected, but near the recent lackluster pace (a 1.5% annual rate since 2Q04, vs. 3.7% in the 10 quarters before that and 2.7% in the second half of the 1990s). As a result, overall growth has been relatively lackluster, while labor market conditions remain tight. Much of the softer trend in productivity growth is likely cyclical – a function of more moderate growth in general. However, if sustained, slower productivity growth would imply a lower rate of potential GDP growth (say 2.5% to 3.0%, rather than 3.5% to 4.0%). This would have important consequences for inflation, corporate profits, and the government's long-term budget prospects.

Credit conditions remain favorable for growth. Liquidity, both global and domestic, remains ample. The fallout in subprime lending has led to a shakeout in mortgage credit at the low end of the scale. However, banks remain willing to make conventional mortgage loans and home mortgage rates are relatively low. High levels of global liquidity continue to fuel an unusually high tolerance for risk. Credit spreads remain narrow. Typically, such periods of high risk tolerance, or overcomplacency, eventually give way to significant adjustments, usually in response to some sort of shock. The sharp expansion in the global financial system has provided enormous benefits to world economic growth, but it also creates a greater susceptibility to contagion.



The dollar has fallen against the major currencies, but has also begun a steady decline against other currencies (which account for about half of U.S. foreign trade). The concern is not so much whether the dollar will weaken. That seems a natural consequence of a wide current account deficit, softer U.S. growth, and better growth abroad. The key is the speed of adjustment, which hasn't been particularly severe – certainly not enough for the Treasury to intervene.

The earlier outlook (soft 1H07, better growth in 2H07) is still valid. Most likely, U.S. economic growth will be moderate in the quarters ahead.

	1006	2006	3Q06	4Q06	1007	2007	3Q07	4Q07	1Q08	2008	2005	2006	2007
GDP (↓ contributions)	5.6	2.6	2.0	2.5	1.3	2.2	2.7	2.9	3.0	3.0	3.2	3.3	2.1
consumer durables	1.5	0.0	0.5	0.4	0.6	0.2	0.2	0.2	0.2	0.2	0.5	0.4	0.3
nondurables & services	1.9	1.8	1.5	2.6	2.1	1.5	1.7	1.7	1.7	1.7	2.0	1.8	1.9
bus. fixed investment	1.4	0.5	1.0	-0.3	0.2	0.3	0.4	0.5	0.5	0.5	0.7	0.7	0.3
residential investment	0.0	-0.7	-1.2	-1.2	-1.0	-0.6	-0.3	-0.2	0.0	0.0	0.5	-0.3	-0.8
government	0.9	0.2	0.3	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.4	0.3
Domestic Final Sales	5.4	1.6	2.0	1.9	2.0	1.6	2.3	2.5	2.6	2.7	3.8	3.1	2.0
exports	1.4	0.7	0.7	1.1	-0.1	0.8	0.8	0.7	0.7	0.7	0.7	0.9	0.6
imports	-1.5	-0.2	-0.9	0.5	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-0.9	-1.0	-0.3
Final Sales	5.6	2.1	1.9	3.7	1.6	2.0	2.5	2.7	2.9	2.9	3.5	3.1	2.3
ch. in bus. inventories	0.0	0.4	0.1	-1.2	-0.3	0.1	0.2	0.2	0.1	0.1	-0.3	0.2	-0.2
Unemployment, %	4.7	4.7	4.7	4.5	4.5	4.5	4.6	4.7	4.7	4.7	5.1	4.6	4.6
NF Payrolls, monthly, th.	252	124	202	177	143	115	95	110	115	120	212	189	116
Consumer Price Index	3.7	5.7	0.6	0.2	4.7	3.2	1.9	2.2	2.3	2.3	3.5	2.6	3.0
excl. food & energy	2.6	3.4	2.7	1.6	2.3	2.2	2.1	2.1	2.1	2.1	2.2	2.6	2.2
PCE Price Index (q/q)	2.0	4.0	2.4	-0.9	3.3	3.7	2.0	2.0	2.0	2.0	2.9	2.7	2.3
excl. food & energy	2.1	2.7	2.2	1.9	2.2	1.9	1.9	1.9	1.8	1.8	2.1	2.2	2.1
Fed Funds Rate, %	4.46	4.91	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	3.21	4.96	5.25
3-month T-Bill, (bnd-eq.)	4.5	4.8	5.0	5.0	5.1	5.0	5.0	5.0	5.0	5.0	3.2	4.9	5.1
2-year Treasury Note	4.6	5.0	4.9	4.7	4.8	4.7	4.8	4.9	4.9	4.9	3.9	4.8	4.8
10-year Treasury Note	4.6	5.1	4.9	4.6	4.7	4.7	4.8	5.0	5.0	5.0	4.3	4.8	4.8