

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

Monday, July 9, 2007

Choppy Waters

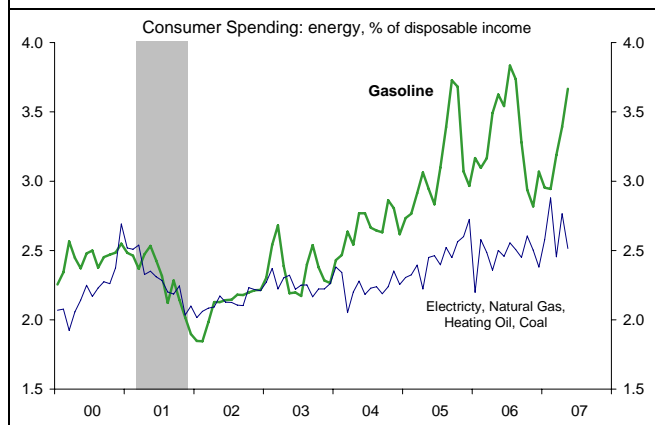
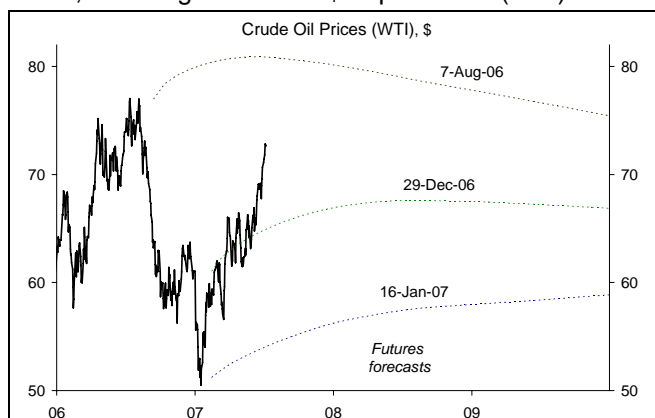
- *Economic growth appears to have been mixed, but moderate, in 2Q07. Expect more of the same in 2H07.*
- *Food and energy price increases should continue to pressure overall inflation in the near term, but core inflation is gradually moderating.*
- *Federal Reserve policy is likely to remain on hold for the foreseeable future, but officials will remain on guard against the possibility of higher future inflation.*

Real GDP grew at a 0.7% annual rate in the government's "final" estimate (second revision) for 1Q07. The headline growth figure was pushed down by a decrease in inventories, a narrower trade deficit, and a further contraction in homebuilding activity. The first quarter GDP figure is subject to revision when annual benchmark revisions (back to 1Q03) are released (along with the advance estimate for 2Q07) on July 27. However, the story is likely to remain the same.

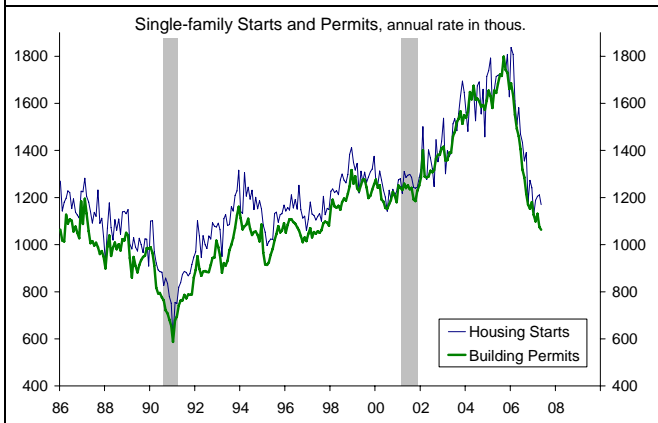
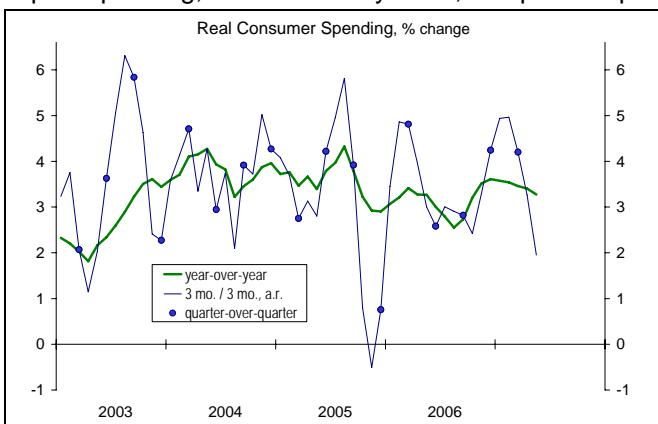
The economic mix changed in the second quarter. Consumer spending growth clearly slowed, as higher gasoline prices took a larger bite out of household budgets. However, manufacturing activity has improved (although conditions remain mixed across industries). Capital spending, weak into early 2007, has picked up.

Home sales appear to be struggling to put in a bottom. The increase in 30-year mortgage rates since mid-May won't help, although they remain relatively low by historical standards. Given the rising volume of unsold inventories, homebuilding activity will continue to contract. However, the drag on overall economic growth should wane over the next few quarters. The biggest worry is that the housing market weakness, and a potential further decline in home prices, could lead to credit constraints – either through lending to the consumer or through financial market disruptions (hedge fund problems, etc.). So far, the impact on credit conditions has remained relatively limited.

Crude oil prices have risen sharply over the last month, reaching more than \$70 per barrel (WTI).

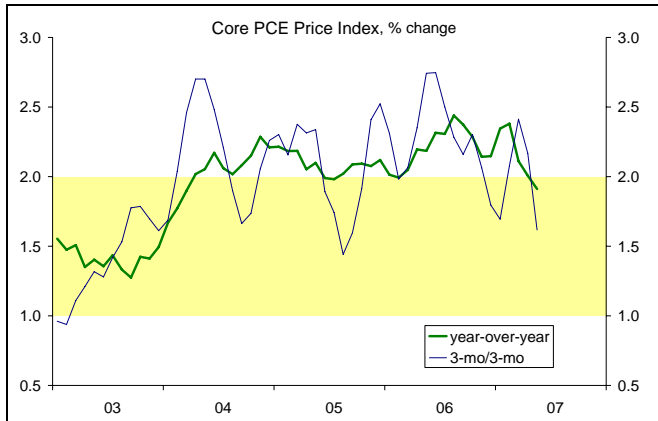


Higher gasoline prices have acted like a tax on the consumer, leaving households with less money to spend on other things. As energy prices rose over the last few years, consumers were able to borrow from their home equity to support consumer spending (although much of the mortgage equity withdrawal went into home improvements). The sharp swings in gasoline prices over the last two years have had a much clearer impact, dampening consumer spending growth with a small lag. Consumer spending is likely to remain soft in the near term, but should improve as energy prices flatten out, or perhaps decline, in the months ahead.



Recent data on new orders and production have been choppy and results across industries have been uneven. However, the underlying trends appear to have improved in recent months. Robust cash flows and corporate profits should keep business spending moving forward. A softer dollar has made U.S. firms more competitive against their European counterparts. Export growth should continue to improve.

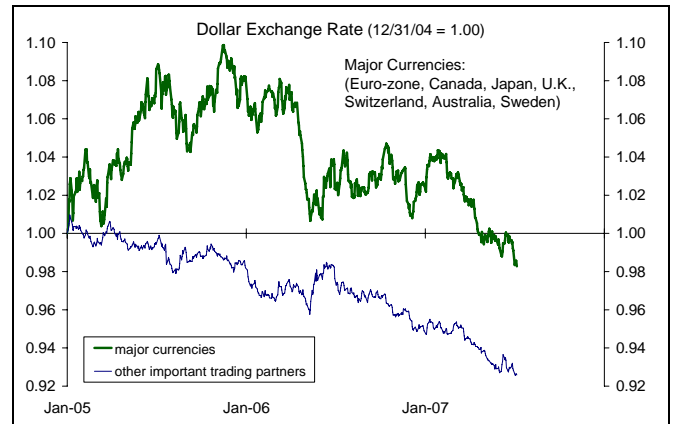
Food and energy price increases have continued to pressure overall inflation. The large push toward ethanol has lifted corn prices, which will feed through (no pun intended), in the form of higher feed costs, to prices of beef, pork, and chicken. In addition, a shift away from planting other crops is likely to boost their prices as well.



In contrast to overall inflation, core inflation has moderated recently – more rapidly than the Fed had anticipated. Ex-food and energy, the PCE Price Index rose 1.9% in the 12 months ending in May, back within the Fed’s comfort range (although not every Fed official is comfortable with this view). Beyond food and energy, there’s relatively little inflation in consumer goods. Inflation in non-energy services has moderated. Still, looking ahead, there’s no reason for Fed officials to be complacent about the inflation outlook. A year from now, inflation pressures could build through a further tightening in the labor market.

The Federal Reserve is likely to keep monetary policy unchanged into 2008. The data are unlikely to provide *overwhelming* evidence of strength or weakness in the 12-month economic outlook. Rather, figures will almost certainly be mixed, reflecting choppiness across time and sectors. The pace of job growth should remain an important driver of monetary policy decisions. Nonfarm payrolls averaged a 145,000 monthly pace in the first half of the year – at or slightly above a sustainable, non-inflationary rate. Judging by the low trends in announced corporate layoff intentions and initial claims for state unemployment benefits, job destruction has remained limited. As the housing sector bottoms out, one could imagine a stronger pace of job growth in the months ahead. Hence, the Fed is justified to fear potential inflation pressures from the labor market. On the other hand, possible credit market disruptions could lead to a drying up in liquidity, and more serious headwinds for the economy.

Higher interest rates abroad have led to a further weakening of the dollar. Inflationary implications have not been serious, but the Fed will likely watch import price pressures closely in the months ahead.



While overall GDP growth is expected to improve, the economic data should be uneven over the next several months. The financial markets will be choppy.

	2006	3Q06	4Q06	1Q07	2007	3Q07	4Q07	1Q08	2Q08	2005	2006	2007	2008
GDP (↓ contributions)	2.6	2.0	2.5	0.7	2.5	2.6	2.8	2.8	2.9	3.2	3.3	2.0	2.8
consumer durables	0.0	0.5	0.4	0.7	0.1	0.2	0.2	0.2	0.2	0.5	0.4	0.4	0.2
nondurables & services	1.8	1.5	2.6	2.2	1.1	1.7	1.7	1.7	1.7	2.0	1.8	1.9	1.7
bus. fixed investment	0.5	1.0	-0.3	0.3	0.3	0.4	0.5	0.5	0.5	0.7	0.7	0.4	0.5
residential investment	-0.7	-1.2	-1.2	-0.9	-0.6	-0.5	-0.3	-0.2	-0.1	0.5	-0.3	-0.8	-0.2
government	0.2	0.3	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.4	0.3	0.2
Domestic Final Sales	1.6	2.0	1.9	2.4	1.5	2.1	2.3	2.5	2.6	3.8	3.1	2.0	2.4
exports	0.7	0.7	1.1	-0.1	0.8	0.8	0.7	0.7	0.7	0.7	0.9	0.7	0.7
imports	-0.2	-0.9	0.5	-0.9	-0.4	-0.5	-0.5	-0.5	-0.5	-0.9	-1.0	-0.4	-0.5
Final Sales	2.1	1.9	3.7	1.7	1.9	2.4	2.5	2.7	2.8	3.5	3.1	2.3	2.7
ch. in bus. inventories	0.4	0.1	-1.2	-1.0	0.6	0.2	0.2	0.1	0.1	-0.3	0.2	-0.3	0.2
Unemployment, %	4.7	4.7	4.5	4.5	4.5	4.5	4.6	4.6	4.6	5.1	4.6	4.5	4.6
NF Payrolls, monthly, th.	124	202	177	142	148	110	115	120	125	212	189	129	128
Consumer Price Index	5.7	0.6	0.2	4.7	5.2	2.2	2.0	2.3	2.3	3.5	2.6	3.5	2.3
excl. food & energy	3.4	2.7	1.6	2.3	2.0	2.1	2.1	2.1	2.1	2.2	2.6	2.1	2.1
PCE Price Index (q/q)	4.0	2.4	-1.0	3.5	4.3	2.5	1.9	2.0	2.0	2.9	2.7	2.5	2.2
excl. food & energy	2.7	2.2	1.8	2.4	1.4	1.8	1.9	1.8	1.8	2.1	2.2	2.0	1.8
Fed Funds Rate, %	4.91	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	3.21	4.96	5.25	5.25
3-month T-Bill, (bnd-eq.)	4.8	5.0	5.0	5.1	4.9	5.0	5.0	5.0	5.0	3.2	4.9	5.0	5.0
2-year Treasury Note	5.0	4.9	4.7	4.8	4.8	5.0	5.0	5.0	5.0	3.9	4.8	4.9	5.0
10-year Treasury Note	5.1	4.9	4.6	4.7	4.8	5.2	5.3	5.3	5.2	4.3	4.8	5.0	5.2