

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

Thursday, August 9, 2007

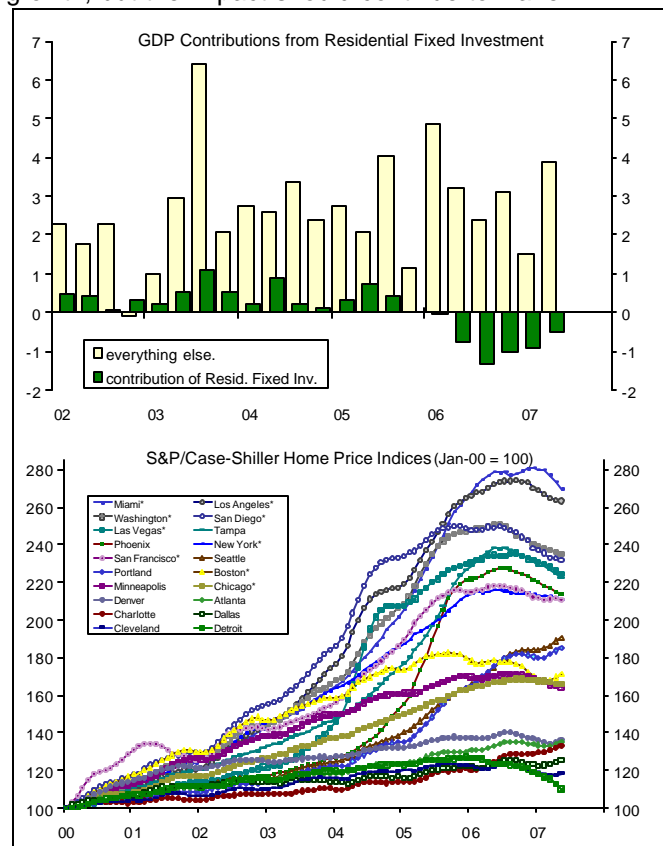
A Nervous Optimism

- *Financial market volatility has increased. Credit has gotten tighter for some businesses and consumers.*
- *Economic growth is likely to be mixed, but moderate, in the near term. Core inflation should edge lower.*
- *Federal Reserve officials are unlikely to lower short-term interest rates to calm market fears. However, should labor market conditions deteriorate significantly, the Fed would be more inclined to act. Most likely, growth will be slow enough to allow the Fed to move to a more neutral policy position by early 2008.*

The financial markets are currently facing two important issues. The first is the problem with subprime lending and related weakness in the housing market. The other is the general repricing of risk.

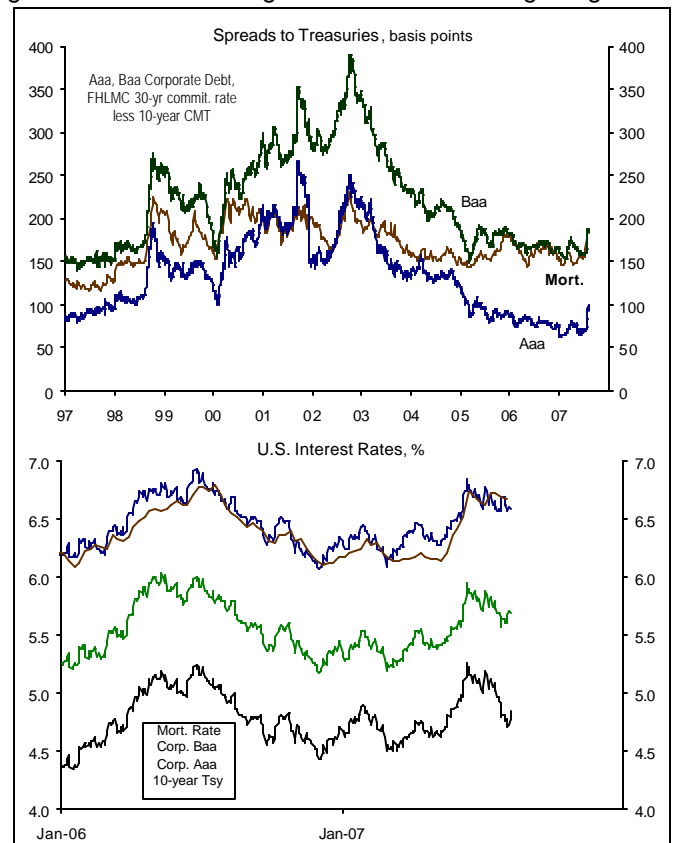
Delinquency rates and foreclosures for subprime adjustable-rate mortgages are rising, especially in economically distressed areas (MI, OH) and areas that had experienced rampant home price speculation (FL, CA, AZ, NV). These problems will almost certainly increase in the months ahead as rates reset.

The direct impact of housing market weakness (the decline in residential homebuilding) will remain a drag on growth, but the impact should continue to wane.



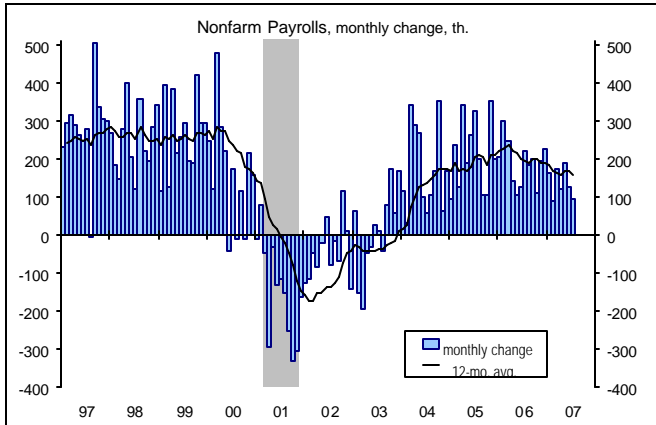
In contrast, the indirect or spillover effects from the housing slowdown are likely to increase in the months ahead. However, the damage to the overall economy, while significant, is unlikely to be severe. Treasury Secretary Paulson and Fed Chairman Bernanke have called the subprime problems “*contained.*” That means that these problems are unlikely to be large enough to force the economy into a recession. However, subprime woes and continued housing weakness leave the economy susceptible to shocks or an adverse credit event. A further decline in home prices could limit the consumer’s ability to borrow, which would have a detrimental effect on consumer spending growth.

The other major issue for the markets is the repricing of risk. Easy credit helped fuel leveraged buyouts and private equity takeovers in the spring and early summer. That liquidity has become spotty. Credit spreads have widened. A number of equity and bond deals have been shelved over that last few weeks. However, this is not a credit crunch. While the market for subprime mortgage debt may have ground to a halt, the credit markets in general are functioning well. Deals are still getting done.



While corporate credit spreads have widened, they are below their ten-year averages. The widening has been due largely to Treasury yields falling faster than corporate bond yields. Still, there is a potential for credit spreads to widen more substantially in the months ahead.

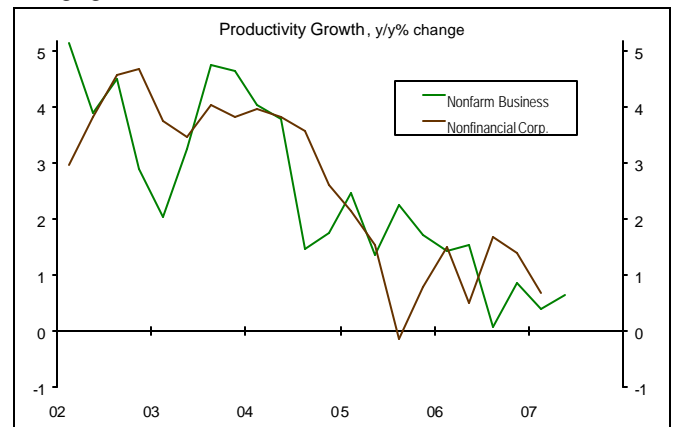
In the August 7 policy statement, Fed officials acknowledged financial market volatility, tighter credit conditions for “some” households and businesses, and the ongoing housing correction. The Fed indicated that “downside risks to growth have increased somewhat.” However, the risk of inflation remained the Fed’s “predominant policy concern.” It is not the Fed’s job to appease the markets. The key question is whether subprime problems and the repricing of risk will have a sufficiently negative impact on overall economic growth.



While noting areas of concern in its policy statement, the Fed retained its moderate growth outlook. Officials expect the economy to be supported by “solid growth in employment and incomes and a robust global economy.” Growth in nonfarm payrolls has slowed somewhat in recent months. However, seasonal adjustment problems may have played a role in July (government jobs fell by 28,000 – down 1.069 million prior to adjustment, reflecting the end of the school year). Private-sector payrolls advanced by 120,000 in July, in line with the recent trend and roughly consistent with a steady unemployment rate. The unemployment rate edged up to 4.6% in July. However, the increase was not statistically significant. Other labor market indicators have continued to suggest relative strength, with a limited pace of job destruction.

Income growth has remained relatively strong, although higher gasoline prices cut into the consumer’s purchasing power in 2Q07. Aggregate wages rose 5.6% in the 12 months ending in July, up about 3.3% adjusting for inflation. Real disposable income fell at a 0.8% annual rate in 2Q07, according to the government’s advance estimate of GDP, but rose 0.3% in June as gasoline prices began to decline. Lower gasoline prices should provide further relief through the remainder of the quarter. The net extraction of home equity slowed into the early part of 2007 and is likely to slip further as home prices edge down in many areas of the country. Thus, consumer spending growth will be even more dependent on job and income growth in the near term.

The global economic outlook has strengthened. The IMF raised its forecast for global growth in 2007 and 2008 (both at 5.2%, vs. forecasts of 4.9% made in April). Foreign central banks are continuing to tighten lending conditions, but this has been a gradual process. It’s worth noting that hedge funds’ problems with subprime mortgage debt are not confined to the U.S.



Recent data continue to indicate a significant slowing in productivity growth (and rising unit labor cost inflation) over the last year and a half. This slowing remains something of a puzzle, but the Fed believes that much of it is likely to be temporary.

	2006	3Q06	4Q06	1Q07	2007	3Q07	4Q07	1Q08	2Q08	2005	2006	2007	2008
GDP (↓ contributions)	2.4	1.1	2.1	0.6	3.4	2.0	2.5	2.7	2.8	3.1	2.9	1.9	2.7
consumer durables	0.1	0.4	0.3	0.7	0.1	0.0	0.2	0.2	0.2	0.4	0.3	0.3	0.2
nondurables & services	1.6	1.5	2.4	1.9	0.8	1.6	1.7	1.7	1.7	2.0	1.8	1.6	1.6
bus. fixed investment	0.4	0.5	-0.2	0.2	0.8	0.4	0.5	0.5	0.5	0.7	0.7	0.4	0.5
residential investment	-0.8	-1.3	-1.0	-0.9	-0.5	-0.4	-0.3	-0.2	-0.1	0.4	-0.3	-0.8	-0.2
government	0.2	0.1	0.7	-0.1	0.8	0.1	0.2	0.2	0.2	0.2	0.4	0.3	0.2
Domestic Final Sales	1.5	1.2	2.1	1.7	1.9	1.6	2.2	2.4	2.5	3.3	2.7	1.8	2.3
exports	0.6	0.6	1.5	0.1	0.7	0.8	0.7	0.7	0.7	0.7	0.9	0.7	0.7
imports	-0.1	-0.9	-0.3	-0.6	0.5	-0.6	-0.5	-0.5	-0.5	-0.9	-1.0	-0.3	-0.5
Final Sales	2.0	1.0	3.5	1.3	3.2	1.8	2.4	2.6	2.7	3.3	2.8	2.2	2.6
ch. in bus. inventories	0.5	0.1	-1.3	-0.7	0.2	0.2	0.1	0.1	0.1	-0.2	0.1	-0.3	0.1
Unemployment, %	4.7	4.7	4.5	4.5	4.5	4.6	4.7	4.7	4.8	5.1	4.6	4.6	4.7
NF Payrolls, monthly, th.	124	202	177	142	145	110	112	120	126	212	189	127	127
Consumer Price Index	5.7	0.6	0.2	4.7	5.2	2.0	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	2.3	2.0	2.0	2.0	2.0	2.2	2.6	2.1	2.0
PCE Price Index (q/q)	4.3	2.6	-0.9	3.5	4.3	2.4	1.9	2.0	2.0	2.9	2.8	2.5	2.2
excl. food & energy	2.9	2.3	1.9	2.4	1.4	1.8	1.8	1.8	1.8	2.2	2.2	2.0	1.8
Fed Funds Rate, %	4.91	5.25	5.25	5.25	5.25	5.25	5.25	5.08	5.00	3.21	4.96	5.25	5.25
3-month T-Bill, (bnd-eq.)	4.8	5.0	5.0	5.1	4.9	4.9	4.9	4.8	4.8	3.2	4.9	4.9	4.8
2-year Treasury Note	5.0	4.9	4.7	4.8	4.8	4.7	4.8	4.8	4.9	3.9	4.8	4.8	4.9
10-year Treasury Note	5.1	4.9	4.6	4.7	4.8	4.9	5.0	5.1	5.1	4.3	4.8	4.9	5.1