

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

Friday, October 12, 2007

Finding The Right Balance

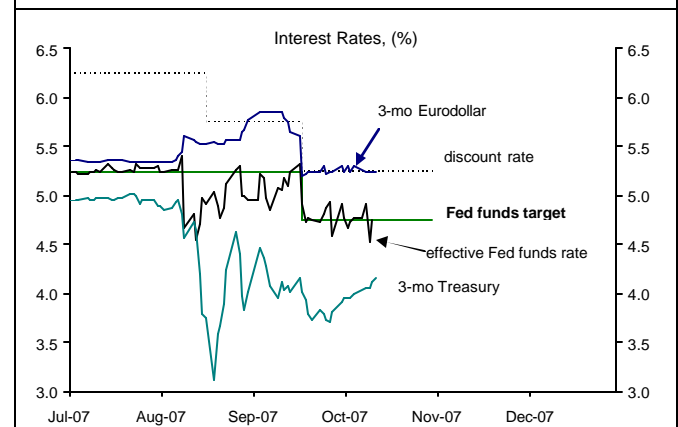
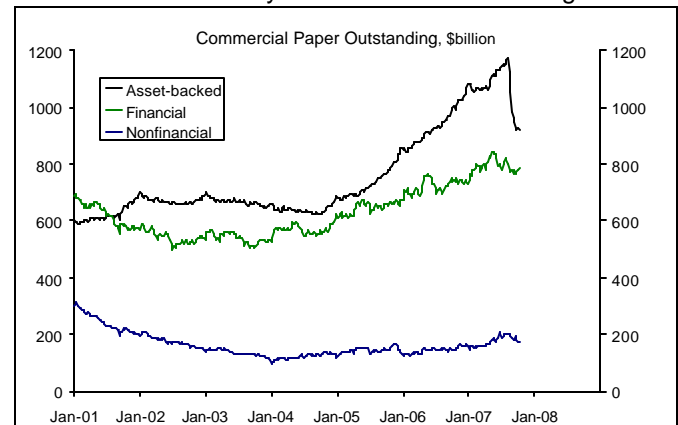
- Recent data have been consistent with moderate, below-potential economic growth. Inflation pressures appear mixed, but balanced on average.
- Short-term credit market conditions have stabilized, but remain far from normal. Liquidity remains spotty.
- Following a more aggressive policy response in September, Federal Reserve officials made no presumption about future moves. However, another ease may be likely be the end of the year.

Real GDP rose at a 3.8% annual rate in 2Q07, according to the government's "final" estimate. The advance estimate for the first quarter will be released on October 31, the date of the Fed's next policy decision. Domestic economic growth appears to have remained moderate, but overall GDP will again be boosted by a narrower (inflation adjusted) trade deficit.

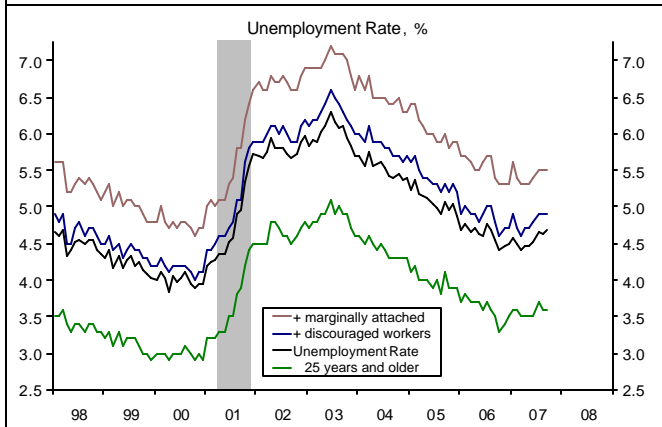
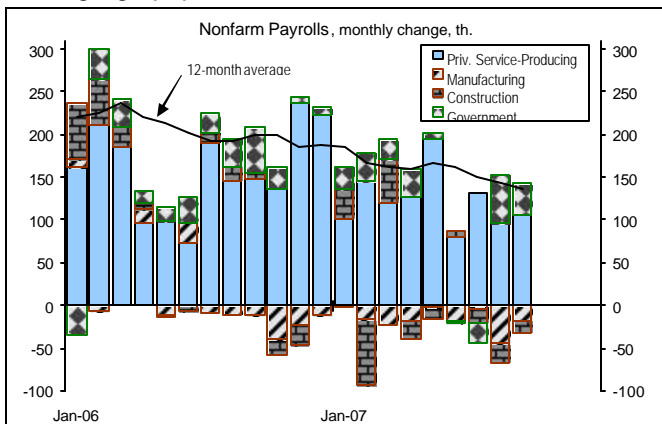
Nonfarm payrolls rose by 110,000 in September. The August change, initially reported as a decline of 4,000, was revised to an 89,000 gain. Yet, the pace of job growth has slowed. Payrolls averaged a 90,000 gain over the last four months, below the 120,000 to 130,000 monthly gain needed to keep pace with the growth in the working-age population.

The unemployment rate has begun to edge higher, but still the increase has been gradual. The level remains relatively low by historical standards. Announcements of corporate layoff intentions and weekly claims for unemployment insurance benefits continue to suggest a limited pace of job destruction. Wage and salary income rose 7.1% in the 12 months ending in August, although the added purchasing power will be trimmed by higher food and energy costs.

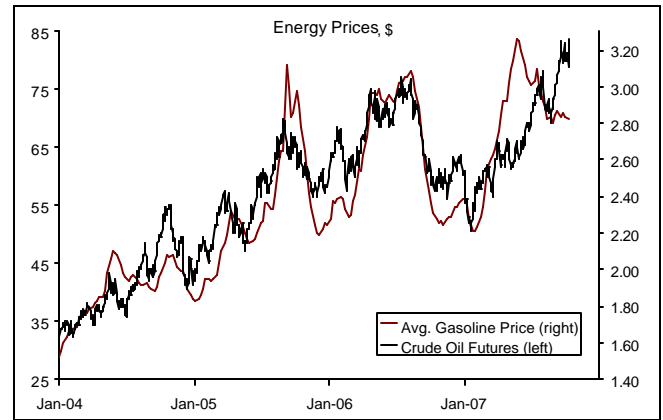
Short-term credit market disruptions, which the Fed described as the chief catalyst for the ½-point September 18 cut in the Fed funds target rate, have continued to improve. Three-month Eurodollar rates have widened relative to the Fed funds rate, and Treasury yields seem abnormally low. However, conditions have clearly stabilized relative to August.



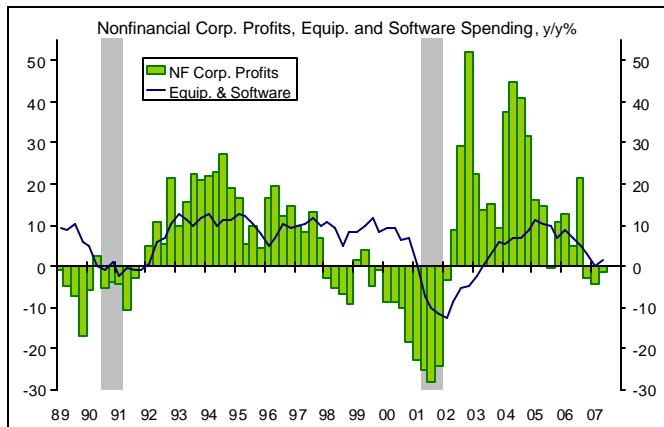
Interestingly, while the market for 30-day commercial paper fell apart in the last two months, the issuance of investment-grade corporate bonds reached a record for August, and another record for September. Bond and equity deals are getting done. Credit spreads are wider, but are still relatively low by historical standards. Short-term credit market disruptions have not led to an appreciably tightening in bank lending outside of mortgages. However, mortgage credit has gotten tighter. For example spreads on jumbo loans are higher.



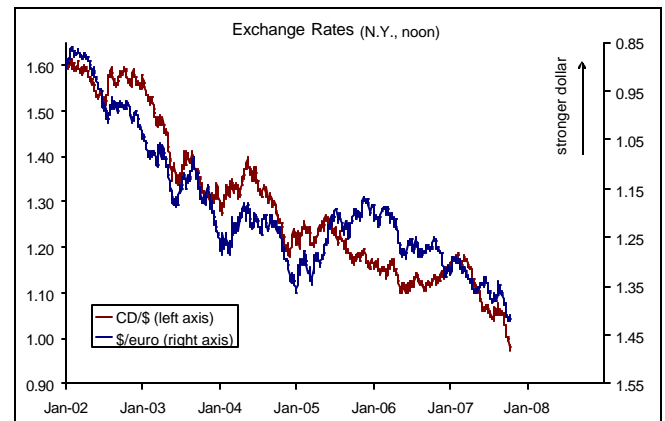
Minutes of the September 18 Fed policy meeting show little debate about whether to cut the Fed funds target rate by 25 or 50 basis points. However, there almost certainly had to be such a debate. Most likely, faced with a high level of market uncertainty, Fed Chairman Bernanke wanted to put up a united front. The FOMC minutes reinforce the view that the Fed's focus was on the potential economic impact of short-term credit market developments. A 50-basis point cut was viewed as "the most prudent course of action." In a speech, Fed Governor Kohn suggested that an improved inflation outlook allowed the Fed the chance of doing "too much, too soon." The minutes emphasized that the Fed's ease "should not interfere with an adjustment to more realistic pricing of risk or with the gains and losses that implied for participants in financial markets."



Higher oil prices threaten pinch the balance sheets of middle-income households heading into the important holiday shopping period. The weaker dollar will add to inflation pressures. However, below-trend economic growth will likely keep overall inflation pressures roughly in balance. In addition, retailers should continue to resort to heavy discounting to clear merchandise.



One concern is that a slowdown in corporate profits will lead to a weakening in capital spending growth. Business fixed investment jumped in 2Q07, but largely due to a surge in business structures. In general, the degree of leverage is small for most businesses, likely preventing a sharp pullback in capital spending. Still, a more cautious outlook would lead to some curtailment of capital spending plans. Strong growth in demand for U.S. exports will offset some of the domestic softness.



Residential construction will remain a drag on overall growth well into 2008. The overall economy is likely to avoid a recession, but downside risks remain. The Fed is likely to ease further, but officials must remain wary about inflation pressures along the way.

	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2006	2007	2008
GDP (↓ contributions)	1.1	2.1	0.6	4.8	2.5	2.2	2.6	2.7	2.8	2.8	2.9	2.0	2.6
consumer durables	0.4	0.3	0.7	0.1	0.3	0.3	0.2	0.2	0.2	0.2	0.3	0.4	0.2
nondurables & services	1.5	2.4	1.9	0.9	1.9	1.5	1.6	1.6	1.6	1.6	1.8	1.7	1.6
bus. fixed investment	0.5	-0.2	0.2	1.1	0.2	0.3	0.5	0.5	0.5	0.5	0.7	0.4	0.4
residential investment	-1.3	-1.0	-0.9	-0.6	-0.8	-0.4	-0.2	-0.1	0.0	0.0	-0.3	-0.9	-0.3
government	0.1	0.7	-0.1	0.8	0.1	0.2	0.2	0.2	0.3	0.2	0.4	0.3	0.2
Domestic Final Sales	1.2	2.1	1.7	2.2	1.7	1.9	2.3	2.4	2.5	2.6	2.7	1.8	2.2
exports	0.6	1.5	0.1	0.9	1.4	0.7	0.7	0.7	0.7	0.7	0.9	0.8	0.8
imports	-0.9	-0.3	-0.6	0.6	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5	-1.0	-0.3	-0.4
Final Sales	1.0	3.5	1.3	3.7	2.8	2.1	2.5	2.6	2.7	2.7	2.8	2.4	2.6
ch. in bus. inventories	0.1	-1.3	-0.7	0.2	-0.3	0.1	0.1	0.1	0.1	0.1	0.1	-0.4	0.1
Unemployment, %	4.7	4.5	4.5	4.5	4.7	4.8	4.8	4.9	4.9	4.9	4.6	4.6	4.8
NF Payrolls, monthly, th.	202	177	142	126	97	90	105	120	122	125	189	114	118
Consumer Price Index	0.6	0.2	4.7	5.2	1.7	2.3	2.3	2.3	2.3	2.3	2.6	3.5	2.3
excl. food & energy	2.7	1.6	2.3	2.3	2.3	2.0	2.0	2.0	2.0	2.0	2.6	2.2	2.0
PCE Price Index (q/q)	2.6	-0.9	3.5	4.2	2.0	2.0	2.0	2.0	2.0	2.0	2.8	2.4	2.1
excl. food & energy	2.3	1.9	2.4	1.3	1.7	1.8	1.8	1.8	1.8	1.8	2.2	2.0	1.7
Fed Funds Rate, %	5.25	5.25	5.25	5.25	5.09	4.69	4.50	4.50	4.50	4.50	4.96	5.07	4.50
3-month T-Bill, (bnd-eq.)	5.0	5.0	5.1	4.9	4.4	4.2	4.3	4.3	4.3	4.3	4.9	4.7	4.3
2-year Treasury Note	4.9	4.7	4.8	4.8	4.4	4.2	4.4	4.6	4.7	4.7	4.8	4.5	4.6
10-year Treasury Note	4.9	4.6	4.7	4.8	4.7	4.7	4.8	4.9	5.0	5.0	4.8	4.8	5.0