

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

Thursday, November 8, 2007

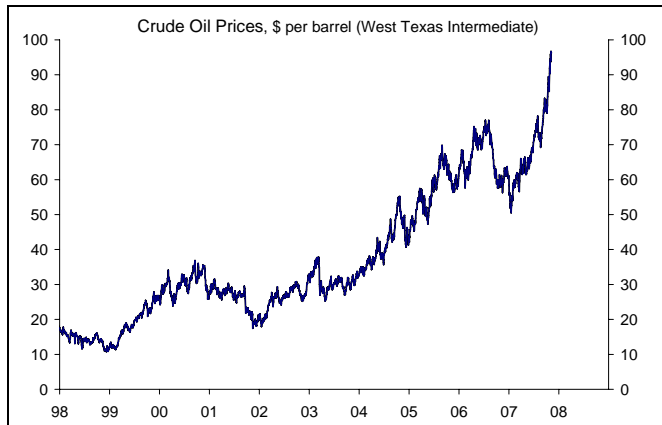
Facing Risks

- After solid growth in 3Q07, the economy is poised for a near-term slowdown, with a return to moderate growth (with moderate inflation) in 2008. There are downside risks to growth and upside risks to inflation.
- Higher oil prices will dampen consumer spending growth and the weaker dollar will add to inflation pressures. However, the biggest worry may be that credit conditions will tighten further.
- Following a 25-basis-point rate cut on October 31, the Fed signaled that short-term interest rates will be held steady – but the short answer is “it depends.”

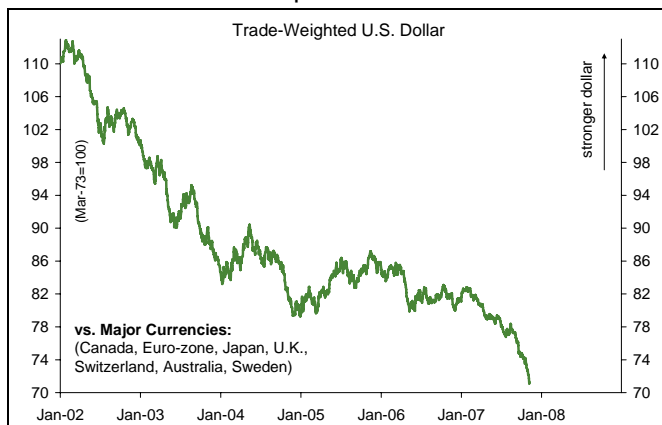
Real GDP rose at a 3.9% annual rate in the government’s advance estimate for 3Q07. Growth was boosted by a surge in exports, strength in business structures, higher defense spending, and a pickup in inventory growth. Consumer spending rose at a 3.0% pace, while business spending on equipment and software advanced 5.9%. Following less deterioration in 2Q07, residential fixed investment reaccelerated to the downside, subtracting 1.05 percentage points from headline GDP growth. Inflation gauges were mild.

Nonfarm payrolls rose by 166,000 in October, following softer job growth in the four previous months.

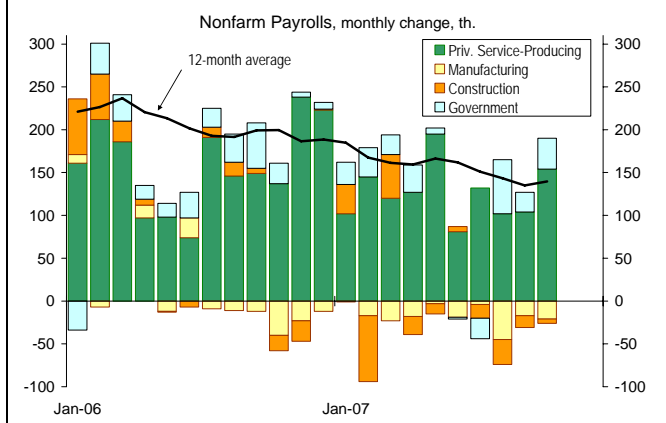
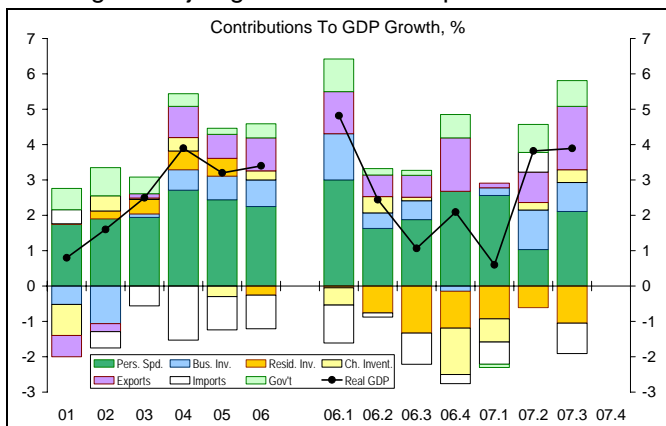
Crude oil prices have advanced sharply in recent weeks. Gasoline prices have not risen accordingly, but will catch up in the weeks ahead. Oil at around \$95 would appear to correspond to a gasoline price of about \$3.50 per gallon (national average). Higher gasoline prices should restrain consumer spending growth in the holiday shopping season, but will likely be an even larger drag in early 2008. As usual, the impact of higher gasoline prices falls unevenly across the income scale, with the balance sheets of middle-income households feeling a greater pinch over the intermediate term.



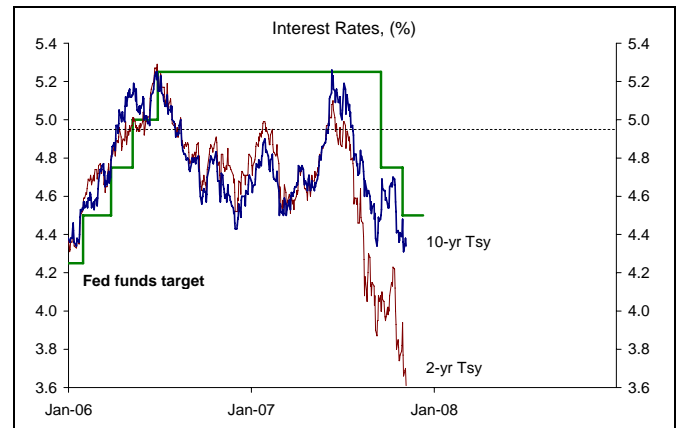
It’s no surprise that the dollar is weakening. The wide current account deficit (5.5% of GDP in 2Q07, down from 6.8% in 4Q05) set the table for a dollar decline (the worry is the speed of adjustment). The combination of stronger growth abroad and softer growth in the U.S. has helped push the dollar down. With foreign central banks raising interest rates (although many are now on hold) and the Fed easing, downward pressure has increased. U.S. financial market woes have also contributed to poor dollar sentiment.



The weaker dollar implies some inflation pressure through higher oil prices and reduced competition from foreign producers. It has also helped boost U.S. exports. Yet, many manufacturers are being squeezed by higher input costs and softer domestic demand.

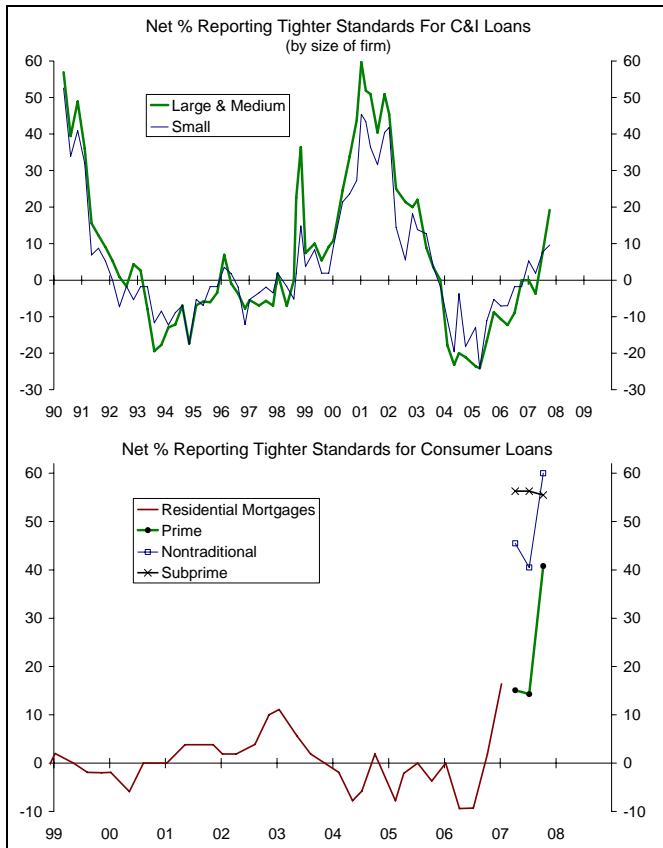


In its monetary policy statements, the Federal Open Market Committee focused on credit market disruptions and their potential to worsen the housing market correction and dampen growth in general. Credit market conditions have improved, but are still far from settled. The market for nonconforming mortgages remains impaired. The Fed's October survey of senior loan officers noted tighter terms and standards for a wide variety of loans. Terms for prime mortgage loans were generally tightened over the last three months, which will further hamper the housing market recovery.



The FOMC lowered the Fed funds target rate by another 25 basis points on October 31 and said that upside risks to inflation "roughly balanced" downside risks to growth. The implication is that the Fed did not expect to lower rates again in December. Kansas City Fed President Hoening formally dissented in favor of no change in rates at the latest policy meeting. However, fearing higher inflation, other Fed officials were probably uncomfortable with the latest move. Indeed, some FOMC members may have bought into voting to reduce rates by the promise that rates could be raised if the inflation outlook worsened. Higher food, energy, and import prices add upward pressure to inflation. However, a softening in domestic demand should help keep overall inflation pressures in check in the near term. Consumer expectations of inflation, a key factor in the Fed policy outlook, have remained contained.

In his testimony to the Joint Economic Committee of Congress, Fed Chairman Bernanke said that growth was likely to slow in the near term, but should pick up in 2008 as the drag from homebuilding fades and credit market conditions stabilize. Yet, it's a dynamic process. Bernanke signaled an openness to further rate cuts if credit conditions worsen and inflation pressures remain in check. For the markets, the high level of uncertainty trumps the moderate outlook for growth and inflation.



	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2006	2007	2008
GDP (↓ contributions)	1.1	2.1	0.6	3.8	3.9	2.2	2.3	2.5	2.8	2.8	2.9	2.2	2.7
consumer durables	0.4	0.3	0.7	0.1	0.4	0.3	0.1	0.2	0.2	0.2	0.3	0.4	0.2
nondurables & services	1.5	2.4	1.9	0.9	1.8	1.5	1.6	1.6	1.7	1.7	1.8	1.7	1.6
bus. fixed investment	0.5	-0.2	0.2	1.1	0.8	0.3	0.5	0.5	0.5	0.5	0.7	0.5	0.5
residential investment	-1.3	-1.0	-0.9	-0.6	-1.1	-0.6	-0.6	-0.4	-0.1	0.0	-0.3	-0.9	-0.5
government	0.1	0.7	-0.1	0.8	0.7	0.2	0.2	0.3	0.3	0.2	0.4	0.4	0.3
Domestic Final Sales	1.2	2.1	1.7	2.2	2.5	1.6	1.7	2.1	2.5	2.6	2.7	1.9	2.1
exports	0.6	1.5	0.1	0.9	1.8	0.9	0.8	0.8	0.7	0.7	0.9	0.9	0.9
imports	-0.9	-0.3	-0.6	0.6	-0.9	-0.5	-0.4	-0.5	-0.6	-0.6	-1.0	-0.4	-0.5
Final Sales	1.0	3.5	1.3	3.7	3.5	2.1	2.1	2.4	2.7	2.7	2.8	2.5	2.6
ch. in bus. inventories	0.1	-1.3	-0.7	0.2	0.4	0.1	0.1	0.1	0.1	0.1	0.1	-0.3	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	94	125	100	110	120	125	189	122	114
Consumer Price Index	0.6	0.2	4.7	5.2	1.0	3.9	2.3	2.3	2.3	2.3	2.6	3.7	2.3
excl. food & energy	2.7	1.6	2.3	2.3	2.5	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	4.3	1.7	2.8	2.4	2.0	2.0	2.0	2.8	2.5	2.4
excl. food & energy	2.3	1.9	2.4	1.4	1.8	1.9	1.8	1.8	1.8	1.8	2.2	2.0	1.8
Fed Funds Rate, %	5.25	5.25	5.25	5.25	5.09	4.58	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	3.7	3.8	4.0	4.2	4.3	4.9	4.5	4.1
2-year Treasury Note	4.9	4.7	4.8	4.8	4.4	3.7	3.9	4.4	4.6	4.7	4.8	4.4	4.4
10-year Treasury Note	4.9	4.6	4.7	4.8	4.7	4.4	4.5	4.8	4.9	5.0	4.8	4.7	4.8