

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

Friday, December 14, 2007

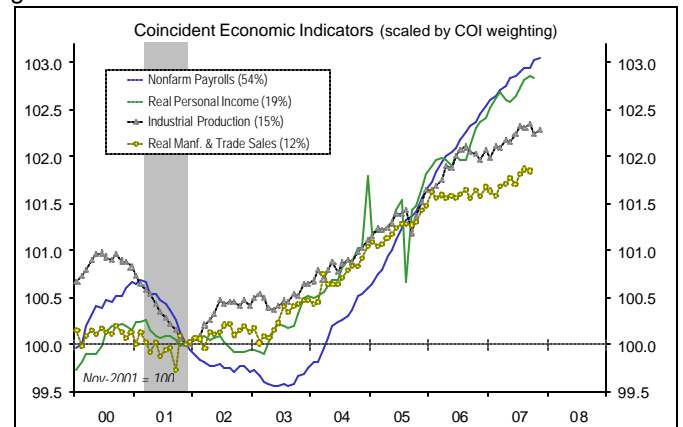
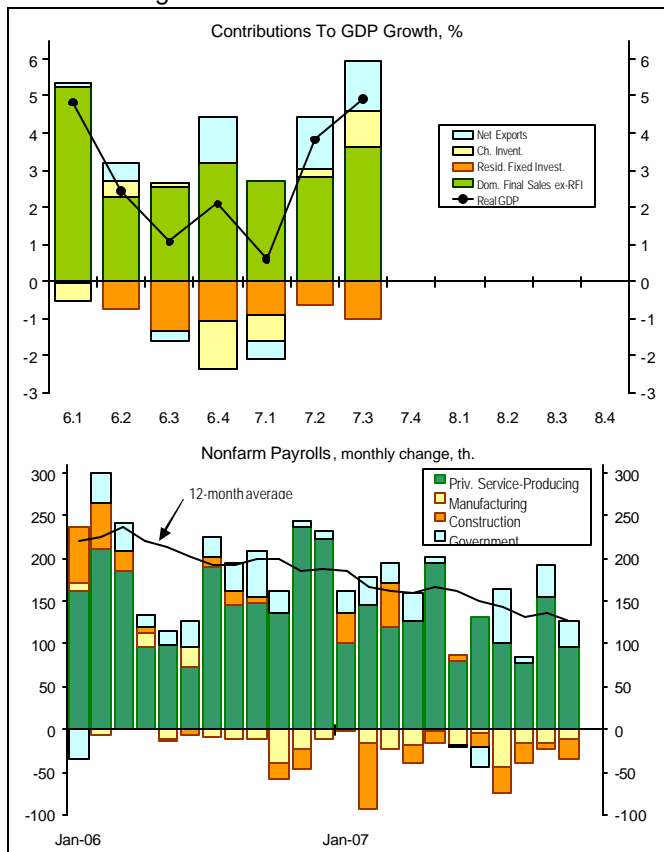
The 2008 Outlook – Avoiding Peril

- *The U.S. economy appears poised to grow at a below-potential pace in early 2008, picking up over the course of the year as the drag from residential homebuilding fades.*
- *However, there are a number of downside risks to growth. The housing correction could be more severe than expected. A slowdown in corporate profits could restrain business fixed investment and new hiring. Credit conditions could tighten further. Higher energy prices could restrain consumer spending growth.*
- *The Federal Reserve and other central banks are well aware of credit market difficulties and have made efforts to provide liquidity to the markets. While central bank action will not bring the housing correction to an end or stop the economy from slowing, it should prevent a more severe economic downturn.*

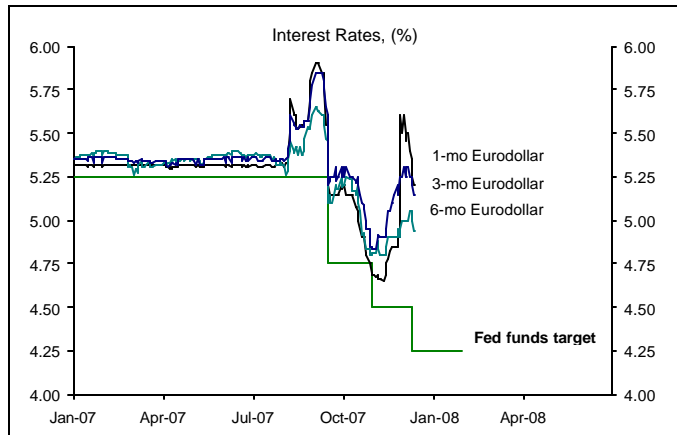
U.S. economic growth was uneven in 2007. GDP growth started slow and picked up in the middle of the year. However, Domestic Final Sales, a smoother measure of underlying domestic demand, was relatively steady and moderate. Job growth slowed over the course of the year, with weakness concentrated in manufacturing and residential construction.

The base-case forecast for 2008 calls for slower growth in the near term, as higher energy costs pinch household budgets, bank credit tightens, and the housing correction continues. The direct impact of the housing correction – the decrease in homebuilding – has remained moderate. Residential fixed investment has subtracted about a full percentage point from GDP growth over the last several quarters. Certainly, a serious impact on overall growth, but not enough (by itself) to push the economy into a recession. The direct impact of the housing correction should fade in 2008, as the housing market approaches a bottom. However, the indirect effects (tighter credit markets, a decrease in mortgage equity withdrawal, etc.) are likely to be more significant. Credit conditions were troubled in the second half of 2007 and could get worse in 2008. Growth in corporate profits is expected to slow, but perhaps more than expected, limiting overall growth. Energy prices are always a wildcard in the economic outlook. Higher crude oil prices would threaten the outlooks for both growth and inflation.

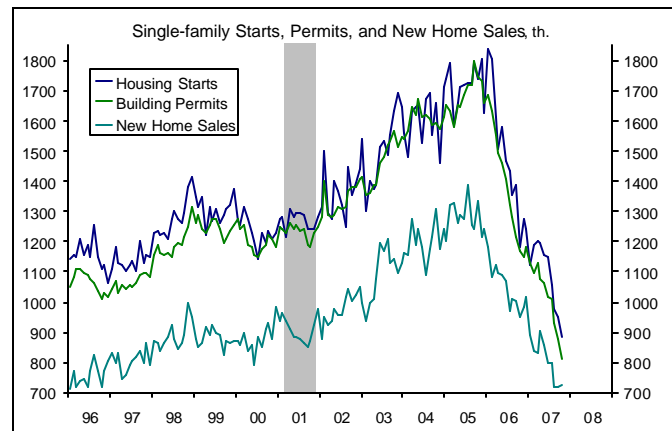
Recall that a recession is defined as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.” There’s no sign that the economy has entered a recession. However, most indicators have suggest a slower pace of economic growth in the near term.



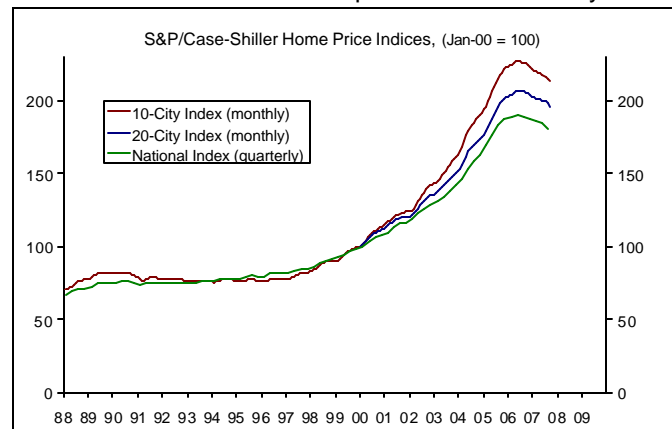
While the housing sector has been a noticeable drag on overall GDP growth, other components of domestic demand have remained relatively strong. However, the main policy concern has been the tightening in credit markets. The market for securities backed by subprime mortgages collapsed in the summer of 2007, kicking off a broader liquidity crisis. In addition, there was an overdue reappraisal of risk in the credit markets. Conditions improved in September and October, but worsened in November and early December.



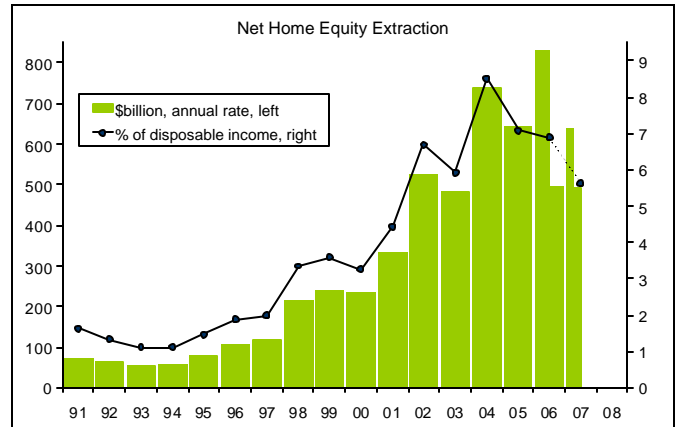
Problems with subprime mortgage securities have not been isolated in the U.S. Much of the paper was bought by overseas investors. One sign of trouble has been the widening of spreads between Eurodollar rates (the cost of borrowing in dollars overseas) and short-term interest rates in the U.S. The markets appear to be responding to the December 12 decision by the Federal Reserve and foreign central banks to provide liquidity. The Fed set up temporary swap provisions between the European Central Bank and the Swiss National Bank to help ease many of the credit problems. Many banks have been reluctant to lend to each other. The Fed has encouraged borrowing from the discount rate, but there's a stigma attached. The latest efforts show that the Fed and other central banks are on top of the situation and willing to provide needed liquidity.



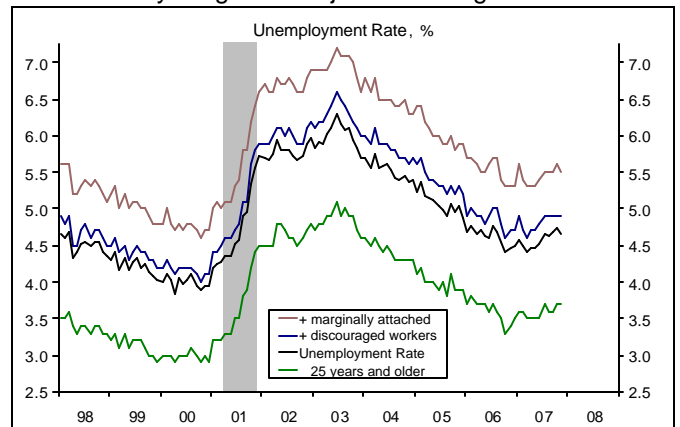
There is not much the Fed can do about the housing market correction, but active monetary policy can help offset some of the broader impact on the economy.



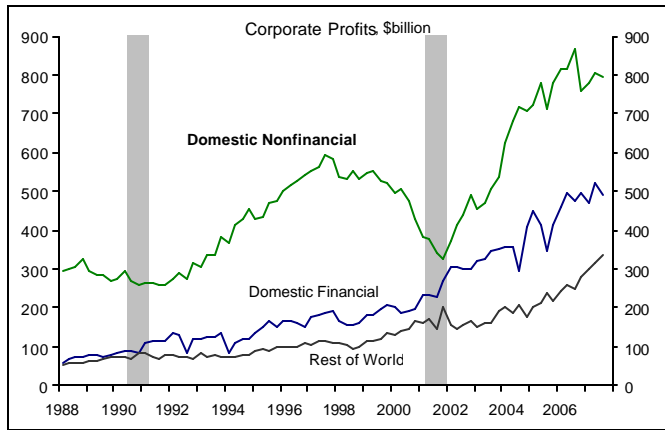
A major factor in the housing correction has been that home prices rose much more rapidly than incomes in recent years. Affordability should improve as wages advance. However, home prices are generally sticky to the upside – that is, they go up easily enough, but are reluctant to come down. That means that the housing correction will likely be prolonged. The best case scenario may be that the housing sector simply stop falling. A “V”-shaped recovery is unlikely. There is some danger, in fact, that home prices could fall more significantly in the months ahead. As a consequence, a greater percentage of recent homebuyers (those who bought within the last three years) would find themselves owing more than the home is worth.



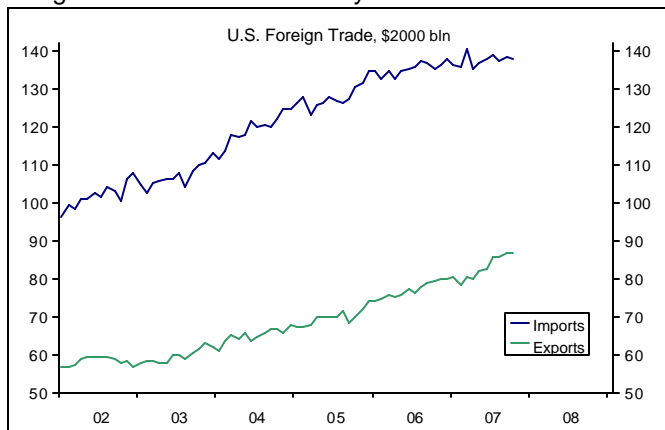
Those who have been in their homes for more than a few years are generally still sitting on a sizable increase in home equity, which they may tap into if needed. The extraction of home equity through refinancing has fallen off its peak of a few years ago, but has remained relatively high by historical standards. Mortgage equity withdrawals have been a major factor supporting consumer spending growth in the last several years, but the pace should slow further in 2008. As a result, consumer spending growth will depend even more critically on growth in jobs and wages.



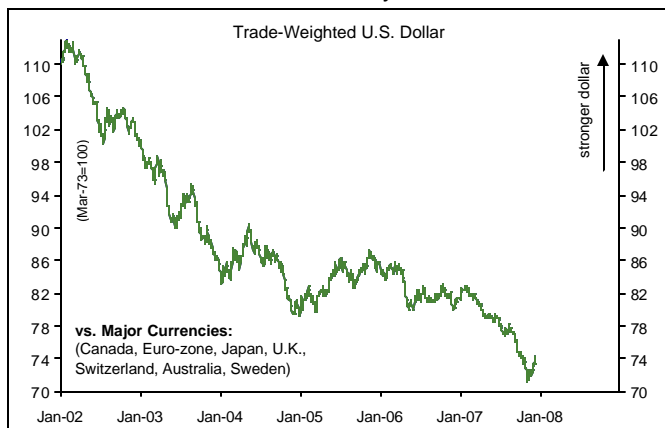
Unemployment rates are still low, but have trended modestly higher in recent months. Job losses have remained limited. Announced corporate layoff intentions and initial claims for unemployment insurance benefits have continued to trend at low levels. However, firms remain cautious about the future and are reluctant to hire. Productivity growth estimates are choppy and unreliable, but output per worker appears to have picked up, allowing firms to do more with fewer workers.



Growth in domestic corporate profits, while uneven, appears to have slowed in recent quarters. Profits from the rest of the world have surged due to better growth abroad and a softer dollar, which makes U.S. goods more affordable abroad and boosts the dollar value of foreign earnings. Profit growth should slow in 2008, along with the overall economy.



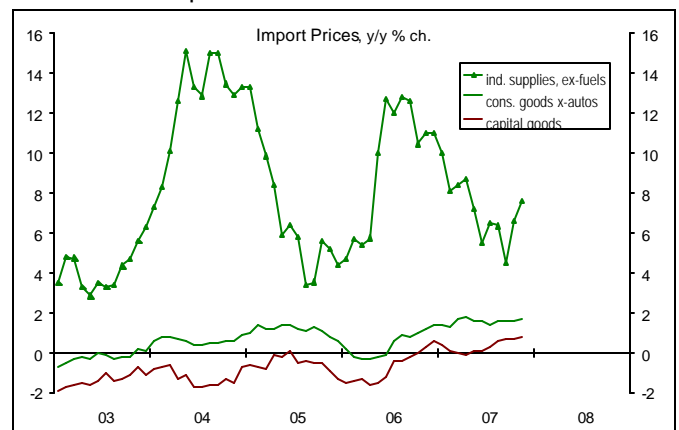
Softer growth in domestic demand has contributed to a slowing in import growth, while a strong global economy and a softer dollar has led to a pickup in exports. Net exports added 1.3 percentage points to GDP growth in 2Q07 and 1.4 percentage points in 3Q07. However, the contribution is likely to be smaller in 4Q07.



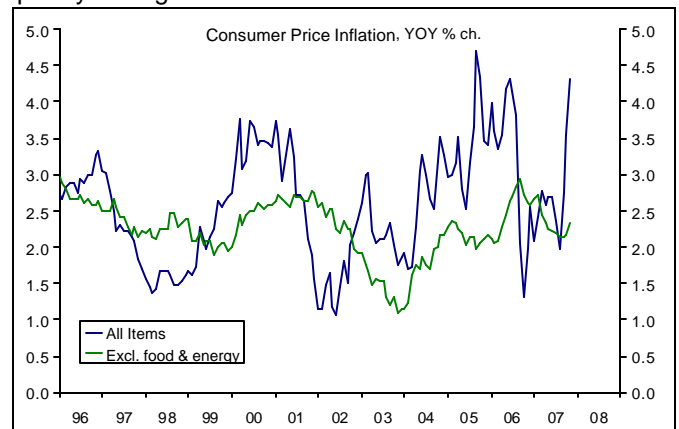
The weaker dollar has been a function of short- and long-term factors. Longer-term, the wide U.S. current account deficit has been on an unsustainable track. A correction, likely to occur over a lengthy period of time, involves an increase in exports and slower growth in imports – a weaker dollar is one way to achieve this. In

the intermediate term, growth differentials have helped pull the dollar down. The U.S. economy has slowed relative to expectations, while growth abroad has improved. In the short term, exchange rates are influenced by central bank policies. The Federal Reserve has lowered short-term interest rates. Most other central banks have been raising rates (until recently). The wide current account deficit implies that there is likely to be long-term downward pressure on the dollar. However, the U.S. economy is unlikely to be as soft as many expect, while growth in many of the major industrialized countries is likely to be slower than seen earlier. While the European Central Bank still has a tightening bias, the Bank of Canada and the Bank of England have recently lowered short-term interest rates. Thus, barring a much sharper decline in the U.S. economic outlook, much of the dollar's decline against the major currencies appears to be behind us.

The dollar may still have to fall against some of the Asian currencies – the Chinese yuan, in particular. The U.S. has long sought an appreciation of the Chinese currency, but this may be a question of “be careful what you wish for.” A large appreciation of the yuan would add to inflation pressures within the U.S.

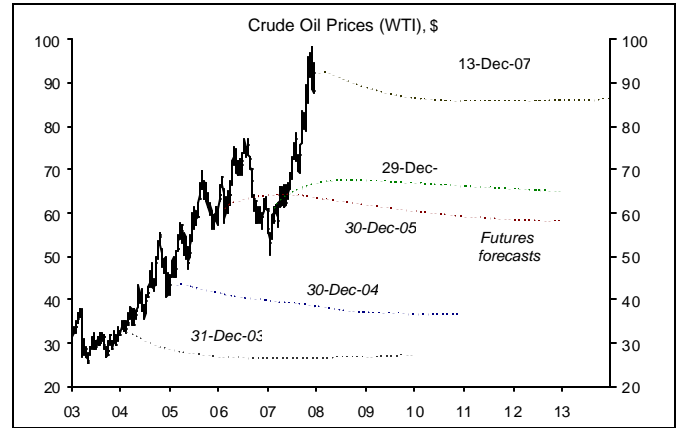


The weaker dollar has led to some inflation pressure in import prices, but mostly in raw materials rather than finished consumer goods or capital equipment. However, an appreciation of the Chinese currency could quickly change the outlook.



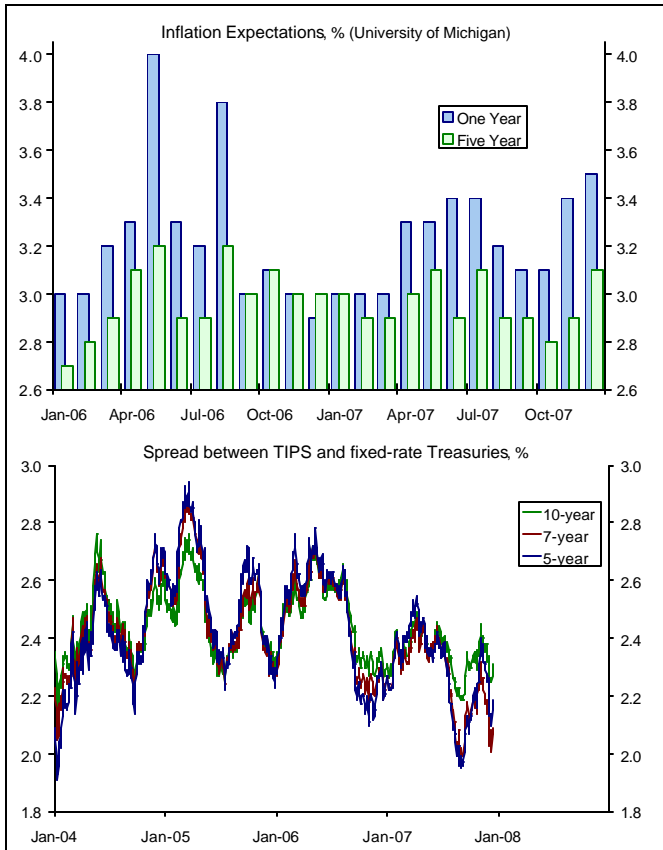
Year-over-year inflation in the Consumer Price Index has picked up. Remember, energy prices were falling a year ago. Core inflation has remained low, but high food and energy prices threaten to feed through to core inflation in the months ahead.

Inflation will remain the Fed's chief focus. In its December 11 policy statement, the Federal Open Market Committee said that "recent developments, including the deterioration in financial market conditions, have increased the uncertainty surrounding the outlook for economic growth and inflation." Fed officials are unsure of the degree of flow-through from food and energy prices. Inflation expectations play a key role in the inflation process. Measures of consumer expectations of inflation have picked up a bit recently, but market expectations have remained low.



Crude oil prices started the year at a moderate level (at least in comparison to 2006), which brightened the outlook for consumer spending growth. However, prices quickly picked up, dampening the consumer outlook. Recent retail sales figures suggest that consumer spending continued to advance in the fourth quarter, but there has been a noticeable slowing in discretionary spending (boats, motor homes, movie receipts). Interestingly, holiday gifts are not seen as all that discretionary. Spending may slow in early 2008 as the bills come due and energy takes a bigger bite out of household budgets. As usual, the 2008 outlook will depend significantly on the path of energy prices.

Looking at the 2008 forecast, 4Q07 growth is expected to be slow, partly reflecting an unwinding of several factors that boosted growth in 3Q07. Growth is expected to be below potential throughout 2008 (but of course, quarterly GDP figures will bounce around a lot more than the forecast suggests). The unemployment rate is expected to edge gradually higher. Inflation is expected to moderate as energy prices stabilize. Core inflation is expected to remain mild. The dollar (not set in the forecast table) should be mostly range-bound. The Fed may cut rates one more time as insurance, but officials should be reluctant amid inflation fears. Long-term interest rates should head moderately higher.



	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2006	2007	2008
GDP (↓ contributions)	1.1	2.1	0.6	3.8	4.9	1.2	2.0	2.4	2.8	2.8	2.9	2.2	2.5
consumer durables	0.4	0.3	0.7	0.1	0.3	0.2	0.1	0.2	0.2	0.2	0.3	0.4	0.2
nondurables & services	1.5	2.4	1.9	0.9	1.6	0.9	1.5	1.6	1.7	1.7	1.8	1.6	1.4
bus. fixed investment	0.5	-0.2	0.2	1.1	1.0	0.6	0.4	0.5	0.5	0.5	0.7	0.5	0.6
residential investment	-1.3	-1.0	-0.9	-0.6	-1.0	-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	0.8	0.1	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	2.4	1.2	1.6	2.1	2.5	2.6	2.7	1.9	2.0
exports	0.6	1.5	0.1	0.9	2.1	0.9	0.8	0.8	0.7	0.7	0.9	0.9	1.0
imports	-0.9	-0.3	-0.6	0.6	-0.7	-0.5	-0.4	-0.5	-0.6	-0.6	-1.0	-0.3	-0.5
Final Sales	1.0	3.5	1.3	3.6	3.9	1.6	2.0	2.3	2.7	2.7	2.8	2.5	2.5
ch. in bus. inventories	0.1	-1.3	-0.7	0.2	1.0	-0.4	0.0	0.1	0.1	0.1	0.1	-0.2	0.1
Unemployment, %	4.7	4.5	4.5	4.5	4.7	4.7	4.8	4.9	5.0	5.0	4.6	4.6	4.9
NF Payrolls, monthly, th.	202	177	142	126	77	115	80	90	110	120	189	115	100
Consumer Price Index	0.6	0.2	4.7	5.2	1.0	4.9	2.1	2.3	2.3	2.3	2.6	4.0	2.3
excl. food & energy	2.7	1.6	2.3	2.3	2.5	2.4	2.2	2.1	2.1	2.0	2.6	2.3	2.1
PCE Price Index (q/q)	2.6	-0.9	3.5	4.3	1.7	3.2	2.3	2.1	2.2	2.1	2.8	2.5	2.4
excl. food & energy	2.3	1.9	2.4	1.4	1.8	2.1	1.9	1.9	1.9	1.8	2.2	2.1	1.9
Fed Funds Rate, %	5.25	5.25	5.25	5.25	5.09	4.52	4.08	4.00	4.00	4.19	4.96	5.03	4.07
3-month T-Bill, (bnd-eq.)	5.0	5.0	5.1	4.9	4.4	3.5	3.8	3.9	3.9	4.0	4.9	4.5	3.9
2-year Treasury Note	4.9	4.7	4.8	4.8	4.4	3.5	3.6	4.2	4.6	4.7	4.8	4.4	4.3
10-year Treasury Note	4.9	4.6	4.7	4.8	4.7	4.3	4.5	4.7	4.9	5.0	4.8	4.6	4.8