

STATE OF THE ECONOMY 3rd Quarter 2005

Introduction

Despite the devastating effects of Hurricanes Katrina and Rita in the Gulf states and initial signs of slowing during the first half of 2005, economic activity remained surprisingly firm in the third quarter with real gross domestic product (GDP) increasing by 3.8% during the quarter. This favourable growth follows a 3.3% increase in GDP during the second quarter and a 3.8% increase during the first quarter of 2005. Though economic activity increased at a lower rate in the second quarter, the third quarter appears to provide further evidence of the resilience of the U.S. economy even in light of adverse exogenous shocks stemming from natural disasters and the resulting spike in energy prices. The 3.8% increase during the third quarter of 2005 is slightly lower than the 4.0% increase during the same period of 2004. With the economy continuing to show signs of modest growth, albeit slower on a year-over-year basis, a number of factors may, in combination, be at work to further temper economic growth in the coming quarters. To be sure, the economy for the remainder of 2005 is likely to experience continued growth, though at a more modest pace than in 2004, due to a number of adverse conditions that may restrain demand. For 2006, economic activity may be negatively impacted by various developments during the second half of 2005 stemming from lingering effects from the hurricanes in the third quarter, higher energy costs, and rising interest rates.

Gross Domestic Product

Advance estimates¹ released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 3.8% in the third quarter as compared to 3.3% in the second quarter of 2005. This increase in real GDP is in line with the growth in economic activity experienced during the first quarter of the year. Economic growth during the third quarter was lower, however, than the consensus forecast of 4.2% (revised upward from 3.5% anticipated earlier in the year) annual growth in real GDP anticipated by fifty-

¹ The BEA press release on October 28, 2005 states the following with respect to advance estimates: The Bureau emphasized that the second-quarter "advance" estimates are based on source data that are incomplete or subject to further revision by the source agency. The second quarter "preliminary" estimates, based on more comprehensive data, will be released on November 30, 2005.

three forecasters surveyed by the Federal Reserve Bank of Philadelphia². The second quarter growth in real GDP was virtually unchanged on a revised basis at 3.3% at an annual rate as compared to earlier estimates of 3.4% growth³.

Real personal consumption expenditures, which accounts for about two-thirds of economic activity, increased by 3.9% in the third quarter, higher than the 3.4% increase during the second quarter and the 3.5% increase in the first quarter at a seasonally adjusted annual rate. Purchases of durable goods surged by 10.8% during the third quarter following a robust 7.9% increase in the second quarter and a 2.6% increase in the first quarter. This surge in purchases of durable goods was due largely to a 17.6% increase in expenditure on motor vehicles and parts, likely due to the continuation of “employee” discounts offered to the general public by the major automakers that had been quite successful during the second quarter. Purchases of furniture and household equipment, which increased by 12%, also contributed to the increase in personal consumption expenditures. Data from the Federal Reserve Beige Book released July 27, 2005 and September 7, 2005 indicated that almost all of the Federal Reserve Districts noted strong motor vehicle sales during the quarter with a particular increase in more fuel efficient vehicles. Personal consumption expenditures on nondurable goods increased by 2.6% in the third quarter, as compared to a rate of 3.6% in the second quarter. Retail sales which strengthened during the latter part of the second quarter showed modest increases during the third quarter, though many of the Federal Reserve Districts reported negative expectations regarding retail sales activity and due to the continued high cost of gasoline.

Real nonresidential fixed investment increased by 6.2% in the third quarter, as compared to the 8.8% advance in the second quarter. This follows a 5.7% increase in the first quarter. Equipment and software investment activity, which increased by 10.9% in the second quarter, showed further gains in the third quarter, increasing by 8.9%.

Following an increase of \$58.2 billion in the first quarter, private businesses drew down \$1.7 billion in inventories during the second quarter and an additional \$16.6 billion in the third quarter. The decrease in private business inventories subtracted 0.55% from GDP for the quarter as compared

² *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, August 15, 2005.

³ Quarterly data is expressed at a seasonally adjusted annual rate. Real estimates are in chained (2000) dollars.

to subtracting 2.14% from the second quarter and adding 0.29% to the first quarter change in real GDP. This decline in inventories further suggests that businesses were allowing built-up inventory stocks from the first quarter to be drawn down. Given the drawdown in inventories during the second and third quarter, production may increase early during the fourth quarter in anticipation of increased demand expectations for the holiday season. However, in the event that the demand expectations for the holiday season are adversely impacted by higher energy costs in the aftermath of the hurricanes, production in late 2005 and early 2006 could be tempered. This could have a drag on GDP growth in coming quarters.

Real residential fixed investment, which increased by a robust 10.8% in the second quarter, remained firm but increased at a much more modest rate of 4.8%. This tempered growth follows a trend of strong growth that has been evident for nearly a year, as the real estate markets have experienced noticeable gains and heightened activity from consumers and investors. This tempered increase in real residential fixed investment could be the result of removal of accommodative monetary policy at a measured pace by the Federal Reserve and the subsequent negative impact of increasing mortgage rates on real estate activity.

Data on new residential construction from the U.S. Census Bureau and U.S. Department of Housing and Urban Development indicated that activity continued to increase at a modest pace in the third quarter. Privately-owned housing units authorized by building permits ended 2004 at 2,069,000 and ended the first and second quarter at 2,021,000 and 2,132,000, respectively. For the third quarter, new privately-owned housing units authorized by building permits increased slightly in July to 2,171,000, representing a year-over-year increase of 2.7%. In June, new privately-owned housing units authorized by building permits increased by roughly 5% on a year-over-year basis. In August, however, figures decreased to 2,138,000 before rising to 2,189,000 in September. On a year-over-year basis, new privately owned housing units authorized by building permits decreased 3.9% in August and increased by 7.4% in September.

Privately-owned housing starts decreased roughly 18% in March to 1,833,000—the largest monthly fall in fourteen years—before rebounding 9.4% to 2,027,000 in April. Privately-owned housing starts increased to 2,041,000 in May and to 2,065,000 in June before slowing to 2,062,000 in July and to 2,038,000 in August, representing year-over-year increases of 3.8% and 0.6%.

For September, housing starts increased to 2,108,000 or by 10.3% on a year-over-year basis.

Housing starts in the third quarter, though increasing over the second quarter, remain below the level of earlier in the year. This may foreshadow the beginning of a period of less robust growth in the real estate markets. However, as the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing and Urban Development state in the new residential construction press releases:

In interpreting changes in the statistics in this release, note that month-to-month changes in seasonally adjusted statistics often show movements which may be irregular. It may take 4 months to establish an underlying trend for building permit authorizations, 5 months for total starts, and 6 months for total completions.

At this point, it is too early to tell if the flattening in housing starts is the start of a cooling in the robust residential real estate market or merely a statistical aberration. Despite this, data from the National Association of Realtors (NAR) and the Census Bureau indicate continued robust real estate activity. Homes changed hands at the fastest pace in the second quarter since the 1970s with existing home sales rising 4.5% to 7,180,000 units on an annualized basis in April alone⁴. In August, sales of existing homes rose by 2% on an annual basis to 7,290,000. The price of a single family home increased over 15% during the second quarter on a year-over-year basis to \$203,800—the largest increase since 1979. For the twelve month period ending in August 2005, the price of existing homes increased by roughly 15.8%⁵.

These figures have fueled debate that the U.S. real estate market is experiencing an unsustainable bubble in asset prices. Indeed, the Mortgage Bankers Association indicated that more than 60% of the dollar value of new mortgage loans were adjustable-rate or interest-only during the second half of 2004. This could create significant problems for borrowers as rates begin to increase and the adjustable-rate mortgages are reset, forcing many buyers and investors out of the market. Indeed, even Alan Greenspan has voiced concerns

⁴ “Big surge in price of US homes fuels fears of bubble,” Christopher Swann, *The Financial Times*, May 25, 2005.

⁵ “Greenspan warns on mortgages,” Andrew Balls, *The Financial Times*, September 27, 2005.

with the activity in the U.S. real estate markets, warning in testimony to the Joint Economic Committee of the Congress on June 9, 2005⁶:

That said, there can be little doubt that exceptionally low interest rates on ten-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of homebuilding and home turnover, and especially in the steep climb in home prices. Although a "bubble" in home prices for the nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels...

The apparent froth in housing markets may have spilled over into mortgage markets. The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages, are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace.

In remarks to the American Bankers Association Annual Convention in September, Alan Greenspan commented the following⁷:

Over the past decade, the market value of the stock of owner-occupied homes has risen annually by approximately 9 percent on average, from \$8 trillion at the end of 1995 to \$18 trillion at the end of June this year. Home mortgage debt linked to these structures has risen at a somewhat faster rate...

...In the United States, signs of froth have clearly emerged in some local markets where home prices seem to have risen to unsustainable levels. It is still too early to judge whether the froth will become evident on a widening geographic scale, or whether recent indications of some easing of speculative pressures signal the onset of a moderating trend.

⁶ Testimony of Chairman Alan Greenspan, *The Economic Outlook*, Before the Joint Economic Committee, U.S. Congress, June 9, 2005.

⁷ Remarks by Chairman Alan Greenspan, *Mortgage Banking*, to the American Bankers Association Annual Convention, Palm Desert, California (via satellite), September 26, 2005.

Speculation in homes is also largely local, especially for owner-occupied residences. For homeowners to realize accumulated capital gains on a residence—a precondition of a speculative market—they must move...Transactions in second homes, of course, are not restrained to the same degree as sales of primary residences—an individual can sell without having to move. This suggests that speculative activity may have had a greater role in generating the recent price increases than it customarily has had in the past.

The apparent froth in housing markets may have spilled over into mortgage markets. The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other, more exotic forms of adjustable-rate mortgages, are developments that bear close scrutiny. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is adding to pressures in the marketplace.

It may not be unreasonable to conclude that signs of less aggressive economic growth during the second quarter may have contributed to the mixed activity in residential construction during the first half of the year as consumers became more wary regarding the economic outlook. Continued interest rate increases may contribute to a slowing of real estate activity and residential construction in the coming quarters, should the rise in short-term rates ultimately translate into a gradual rise in long-term rates. Such increases may have an unwelcome, adverse impact upon speculators in the real estate markets and investors who have committed to degrees of leverage which they may not be able to service as rates increase. This could have the effect of removing some of the “froth” in certain local real estate markets.

The Federal Reserve Beige Book from March 9, 2005 and April 20, 2005 indicates that residential real estate activity throughout most of the twelve Districts remained strong during the first quarter with many Districts noting increased activity late in the quarter. The Beige Book released on June 15, 2005 and July 27, 2005 indicates that the real estate markets remained positive, though signs of cooling were noted in some areas. Several Districts that had experienced noticeable increases in home prices earlier in the year indicated that price appreciation had begun to normalize from frenzied levels. In addition, several Districts noticed that housing activity had decelerated from earlier aggressive levels. The strength in the residential real estate markets in

the first half of 2005 continued a favorable trend that had characterized real estate throughout the twelve Districts for much of the last year.

According to the Beige Book released on September 7, 2005, residential real estate activity remained strong throughout the Districts. However, many Districts noted signs of cooling since the previous Beige Book. Several Districts also noted that although real estate activity remained strong the pace of construction was lower than the previous year. The Beige Book released on October 19, 2005 also indicated that many Districts noticed signs of slowing demand for housing. In addition, many Districts reported that homes sales were taking longer and that the inventory of homes for sale was increasing. Overall, these signs indicate that the cooling of the real estate markets which had manifested throughout the first half of the year continued into the third quarter.

After ending the year at 5.81%, thirty-year conventional mortgages according to Freddie Mac⁸ declined during the first quarter from 5.77% to a low of 5.57% in February before climbing to 6.04% by the end of March. During the second quarter, thirty-year conventional fixed rate mortgage rates fell steadily during the quarter, ending June at 5.53%--a low for the year. During the third quarter, however, thirty-year conventional fixed rate mortgages steadily increased to 5.89% by early August before retrenching slightly to 5.71% by early September and increasing once again to end the quarter at roughly 5.91%. Fifteen-year mortgages experienced a similar pattern, rising from 5.21% at the first of the year to 5.58% at the end of the first quarter then falling during the second quarter to 5.12%. For the third quarter, fifteen-year mortgages increased to 5.47% by early August, retrenched to 5.30% by early September, and increased to 5.48% by the end of the quarter.

The continued low mortgage rates coincide with U.S. Treasury yields on the 10-year note, which increased only slightly from 4.23% at the beginning of January to 4.50% by the end of March before declining to roughly 3.94% by the end of June. During the third quarter, the yield on the 10-year Treasury note increased to roughly 4.34%. This continued environment of low long-term yields on Treasuries comes despite an increase in short-term rates associated with the Federal Reserve's removal of accommodative monetary policy at a measured pace and has led to the conundrum surrounding low long-term rates in an environment of increasing short-term rates. As the short-term rates seem set to rise above the long-term rates, a phenomenon known as yield curve

⁸ Data from Freddie Mac Weekly Mortgage Market Survey

inversion, many economists have begun to consider the possibility of weaker economic growth in coming quarters. Though historic inverted yield curves have foreshadowed a recession, there are few who believe that the current economic conditions are a precursor to a recession.

With the increase in short-term rates, mortgage rates finally began to increase during the third quarter. The preponderance of the Federal Reserve is likely to remain towards a continued removal of accommodative monetary policy in the coming quarters. Long-term Treasury yields and mortgage rates are likely, then, to ultimately increase in conjunction with rising short-term rates at some point. With the gradual removal of monetary policy accommodation and the ultimate rise in long-term rates, the real estate markets would likely begin to exhibit further signs of tempered activity in the coming quarters.

Real exports of goods and services increased 10.7% in the second quarter following a 7.5% increase during the previous quarter. For the third quarter, real exports of goods and services increased 0.8%. Imports, a subtraction from GDP, were unchanged during the third quarter following a decrease of 0.3% during the second quarter and a 7.4% increase during the first quarter.

Following weakness that began in 2004, the dollar gained strength against foreign currencies in the second quarter, continuing a modest trend that began earlier in the year. At the end of the fourth quarter of 2004, the dollar/sterling (\$/£) exchange rate stood at roughly \$1.92. The dollar strengthened against the pound sterling during the first quarter to end the period at \$1.89. The dollar continued to gain ground against the pound sterling during the second quarter, rising gradually to \$1.82 by the end of the quarter. During the third quarter, the dollar made slight gains against the pound sterling to \$1.72 by the end of July before weakening to \$1.85 by early September. By the end of the quarter, the dollar had once again gained against the pound sterling to \$1.75. The dollar/euro (\$/€) exchange rate was \$1.35 at the end of the fourth quarter of 2004 and \$1.30 at the end of the first quarter of 2005. During the second quarter, the dollar strengthened to \$1.20 against the euro. The dollar weakened to \$1.25 by early September against the euro before strengthening to end the quarter at \$1.20. At the end of the fourth quarter of 2004, the yen/dollar (¥/\$) exchange rate stood at ¥104. By the end of the first quarter the dollar stood at ¥107. The dollar continued to gain strength against the yen during the second quarter, ending the period at

¥110⁹. During the third quarter, the dollar made further gains against the yen, rising to ¥113 by the end of the quarter.

The slight strengthening of the dollar may stem from a variety of issues such as continued weak economic data in the euro zone. In addition, there does not appear to be an end any time soon to the Federal Reserve's removal of accommodative monetary policy at a measured pace. These factors may have driven the dollar higher against other foreign currencies.

Real federal government consumption expenditures remained steady in the first half of 2005, increasing by 2.4% in the first and second quarters. During the third quarter, real federal government consumption expenditures increased by 7.7%. This increase in the rate of federal government consumption expenditures was the result of increased national defense spending. National defense spending increased during the second quarter by a rate of 3.7%, slightly lower than the 3.0% increase during the first quarter. During the third quarter, national defense spending increased by 10.2%. Nondefense spending, which increased by only 1.1% in the first quarter, decreased by 0.2% during the second quarter and increased by 2.6% during the third quarter.

The Federal Reserve

The Federal Reserve continued its measured tightening of monetary policy, which commenced in June 2004, during the third quarter of 2005. By the end of 2004, the Federal Open Market Committee (FOMC) had increased the federal funds rate to 2 ¼%¹⁰. At its meeting on February 2, 2005, the FOMC agreed a twenty-five basis point increase in the target for the federal funds rate to 2 ½%¹¹. The FOMC once again stated that it believed monetary policy remained accommodative and continued to provide ongoing support to economic activity. Further, the Committee believed that the risks to sustainable growth and price stability were equal for the coming quarters.

⁹ Source: *The Economist*

¹⁰ The Board of Governors also increased the discount rate by to 3 ¼% by the end of 2004.

¹¹ The Board of Governors also increased the discount rate by twenty-five basis points to 3 ½% at the February 2, 2005 meeting.

At its meeting on March 22, 2005, the FOMC agreed another twenty-five basis point increase in the target for the federal funds rate to 2 ³/₄%¹². The FOMC continued to believe that the risks to sustainable growth and price stability were equal for the coming quarters. The Committee, however, indicated that:

Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices.

The FOMC agreed a twenty-five basis point increase in the federal funds rate at each of its meetings on May 3, 2005 and June 30, 2005¹³, bringing the federal funds rate to 3% and 3 ¹/₄%. The Committee continued to believe that monetary policy was accommodative and, along with productivity gains, provided ongoing support to economic activity. Furthermore, the Committee indicated the following:

Although energy prices have risen further, the expansion remains firm and labor market conditions continue to improve gradually. Pressures on inflation have stayed elevated, but longer-term inflation expectations remain well contained.

The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

In semi-annual testimony before the Congress on July 20, 2005¹⁴, Chairman Alan Greenspan noted since his last testimony the economy experienced a soft patch during the spring and that core inflation had moved

¹² The Board of Governors also increased the discount rate by twenty-five basis points to 3 ³/₄% at the March 22, 2005 meeting.

¹³ The Board of Governors also increased the discount rate by twenty-five basis points at the May 3, 2005 and June 30, 2005 meetings to 4% and 4 ¹/₄%, respectively.

¹⁴ Testimony of Chairman Alan Greenspan, *Federal Reserve Board's semiannual Monetary Policy Report to the Congress*, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 20, 2005.

higher during the first half of the year. In addition, he indicated that evidence suggested the earlier soft readings on the economy did not signal a more serious slowdown in economic activity, with retail sales experiencing favorable gains, employment trending upwards, and firming of business investment.

Chairman Greenspan indicated the following with respect to the economic outlook:

Thus, our baseline outlook for the U.S. economy is one of sustained economic growth and contained inflation pressures. In our view, realizing this outcome will require the Federal Reserve to continue to remove monetary accommodation. This generally favorable outlook, however, is attended by some significant uncertainties that warrant careful scrutiny.

With regard to the outlook for inflation, future price performance will be influenced importantly by the trend in unit labor costs, or its equivalent, the ratio of hourly labor compensation to output per hour. Over most of the past several years, the behavior of unit labor costs has been quite subdued. But those costs have turned up of late, and whether the favorable trends of the past few years will be maintained is unclear. Hourly labor compensation as measured from the national income and product accounts increased sharply near the end of 2004. However, that measure appears to have been boosted significantly by temporary factors. Other broad measures suggest that hourly labor compensation continues to rise at a moderate rate...

...Energy prices represent a second major uncertainty in the economic outlook. A further rise could cut materially into private spending and thus damp the rate of economic expansion...

...The third major uncertainty in the economic outlook relates to the behavior of long-term interest rates. The yield on the ten-year Treasury notes, currently near 4 ¼ percent, is about 50 basis points below its level of late spring 2004. Moreover, even after the recent widening of credit risk spreads, yields for both investment-grade and less-than-investment-grade corporate bonds have declined even more than those on Treasury notes over the same period.

...the U.S. economy has remained on a firm footing, and inflation continues to be well contained. Moreover, the prospects are favorable for a continuation of those trends.

In the *Monetary Policy Report to the Congress*, the Federal Reserve policymakers expressed optimism for continued economic expansion at a moderate pace in 2005 with stable core inflationary pressures. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3%-3 ³/₄% in 2005 (as compared to previous forecasts of 3 ¹/₂%-4%) as compared to real GDP growth of 3.7% in 2004¹⁵. Real GDP is expected to increase by 3 ¹/₄%-3 ³/₄% in 2006; this forecast is unchanged from earlier forecasts. The personal consumption expenditures chain-type price index (the Federal Reserve's preferred measure of inflation) excluding food and energy is expected to range from 1 ¹/₂%-2 ¹/₄% in 2005 (as compared to earlier forecasts of 1 ¹/₂%-2%), higher than the 1.6% increase in 2004. For 2006, the PCE index excluding food and energy is expected to range from 1 ¹/₂%-2 ¹/₂%; earlier forecasts suggested core PCE increases in 2006 of 1 ¹/₂%-2%. The civilian unemployment rate is anticipated to range from 5%-5 ¹/₄% (compared to earlier forecasts of 5%-5 ¹/₂%) in 2005, against 5.4% for 2004, and roughly 5% in 2006 (earlier forecasts were for 5%-5 ¹/₄%).

The FOMC agreed a twenty-five basis point increase in the federal funds rate at each of its meetings on August 9, 2005 and September 20, 2005¹⁶, bringing the federal funds rate to 3 ¹/₂% and 3 ³/₄%. In its press release following the August meeting, the FOMC indicated that monetary policy remained accommodative and that aggregate spending appeared to have strengthened despite high energy prices. In addition, there were continued improvements in the labor markets, and core inflation remained relatively low, though there were upward pressures on inflation. In the September 20, 2005 press release, the FOMC discussed the impact of Hurricane Katrina on its economic outlook:

Output appeared poised to continue growing at a good pace before the tragic toll of Hurricane Katrina. The widespread devastation in the Gulf region, the associated dislocation of economic activity, and the boost to energy prices imply that spending, production, and employment will be set back in the near term. In addition to elevating premiums for some energy

¹⁵ Changes are from average for fourth quarter of 2004 to average for fourth quarter of 2005.

¹⁶ The Board of Governors also increased the discount rate by twenty-five basis points at the August 9, 2005 and September 20, 2005 meetings to 4 ¹/₂% and 4 ³/₄%, respectively.

products, the disruption to the production and refining infrastructure may add to energy price volatility.

While these unfortunate developments have increased uncertainty about near-term economic performance, it is the Committee's view that they do not pose a more persistent threat. Rather, monetary policy accommodation, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. Higher energy and other costs have the potential to add to inflation pressures. However, core inflation has been relatively low in recent months and longer-term inflation expectations remain contained.

The FOMC continued to believe that monetary policy accommodation could be removed at a measured pace and that the risks to the attainment of sustainable growth and price stability remained equal.

The Federal Reserve Beige Books¹⁷ released on September 7, 2005 and October 19, 2005 indicated continued modest economic growth, with most of the twelve Districts¹⁸ experiencing moderate or gradual expansion. The Beige Book conclusions included the following:

- Retail sales, which showed solid results overall during the first quarter and mixed activity during the second, increased early in the third quarter before weakening in September, most likely due to disruptions following Hurricanes Katrina and Rita. High gasoline prices had had a negative impact upon retail sales as consumer confidence ebbed in some regions. Vehicle sales remained strong early in the third quarter throughout all the Districts as the price discounting offered by the major automakers prompted increased buyer traffic at car dealerships. However, buyer fatigue set in late in the third quarter, particularly as manufacturers ended their discount programs. Sales of vehicles declined sharply in September throughout the Districts.

¹⁷ The press release on June 15, 2005 states the following: This document summarizes comments received from businesses and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.

¹⁸ The Twelve Districts of the Federal Reserve system include: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

- Manufacturing continued to experience moderate to solid expansion across the country in a broad range of industry sectors. Production of construction related products was strong in many Districts. Declines in activity were noticed in the automobile industries and some textiles. Rising material and energy costs continued their trend from the second quarter into the third quarter. The Atlanta District experienced some activity displacement following the hurricanes
- Residential real estate activity, which showed some signs of cooling during the second quarter, was strong during the third quarter though there were continued signs of cooling in most Districts. Home price appreciation continued during the quarter although at a slower pace, and inventories of unsold houses rose. Commercial real estate activity continued to show favorable gains in several Districts during the third quarter. Rental rates were on the rise in several Districts, and construction of commercial buildings continued at a modest pace.
- Labor markets continued to exhibit tightening conditions throughout most of the Districts. Increased hiring was noted in various industries throughout the Districts. Skilled occupation workers remained in short supply in some Districts. Despite the tighter labor markets, wage pressures were contained; however, benefit costs continued to increase at a strong pace.
- Tourism posted increased activity throughout many Districts. However, tourism in the Atlanta District was severely disrupted by the hurricanes. Some Districts noted gains on a year-over-year basis and indicated bookings look favorable for the remainder of the season.

Consumer Confidence

Following several months of mixed results, the Conference Board's Consumer Confidence Index ended 2004 at 102.7. The Index then increased in January to 105.1 as a result of consumer optimism regarding economic growth during the first half of 2005. The Index then declined slightly in February to 104.4 and declined again in March to 103. The decline in consumer confidence in February was the result of January's initial figures being revised upwards from 103.4 to 105.1. The decline in consumer confidence in March was likely the result of rising gas prices, as the short-term outlook remained favorable.

In April, the Consumer Confidence Index¹⁹ declined substantially to 97.5 on a more cautious outlook for the coming months. The Index bounced back in May to 103.1 and increased to a three year high of 106.2 in June as consumers' moods were boosted by solid business activity and gains in the labor markets.

The Index declined in July to 103.6 before rebounding to 105.5 in August. In September, the Consumer Confidence Index declined to the lowest level in two years to 86.6. Lynn Franco, Director of The Conference Board's Consumer Research Center, indicated the following with respect to the September consumer confidence figures:

Hurricane Katrina, coupled with soaring gasoline prices and a less optimistic job outlook, has pushed consumer confidence to its lowest level in nearly two years (81.7 in October 2003) and created a degree of uncertainty and concern about the short-term future. Historically, shocks have had a short-term impact on consumer confidence, especially on consumers' expectation. Fuel prices remain high, though they have retreated in recent days, and when combined with a weaker job market outlook, will likely curb both confidence and spending for the short-run. As rebuilding efforts take hold and job growth gains momentum, consumers' confidence should rebound and return to more positive levels by year-end or early 2006.

After ending the year at 100.7, the Expectations Index declined to 100.4 in January, 96.1 in February, and 93.7 in March. For the second quarter, the Expectations Index declined to 86.7 in April before improving to 93.4 in May and 96.4 in June. The decline in the Expectations Index throughout the first half of the year may be attributed to consumers' anticipation of modest economic growth and meager income gains due to continued elevated energy prices. The upturn during the second quarter may have been due to gains in the labor markets and upward revisions to first quarter economic activity that had initially shown signs of softness. For the third quarter, the Expectations Index declined in July to 93.2, was virtually flat in August at 93.3, and declined dramatically in September to 71.7. The severe dip in September is

¹⁹ www.conference-board.org The June 2005 press release by the Conference Board states: "The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. The monthly survey is conducted for The Conference Board by TNS NFO. TNS NFO is one of TNS group of companies."

likely the result of transitory factors stemming from the psychological impact of Hurricane Katrina.

Consumers' outlook for the next six months eased during the first quarter. In January, February, and March, 22%, 17.9%, and 19.3%, respectively, expected business conditions to improve in the next six months. For April, this declined to 17.7% before rebounding in May to 19.2% and to 19.5% in June. For the third quarter, consumers became increasingly pessimistic with 17.9% expecting condition to improve in the next six months in July, 18.7% in August, and only 15.3% in September. Those expecting conditions to worsen increased in March to 8.2% after holding steady in January and February at 7.8%. Those expecting conditions to worsen increased to 9.9% in April before falling to 9.5% in May and to 9.0% in June. The readings for the third quarter were similar—those anticipating business conditions to worsen increased to 9.5% in July, 10% in August, and 19.8% in September. These readings indicate that consumers have over the first half of the year become increasingly concerned about business conditions going forward. Consumers' concerns about business conditions in the next six months were further negatively impacted by the hurricanes in the third quarter. Should these concerns prove a transitory, knee-jerk reaction to the devastation following the hurricanes, consumer expectations regarding the future business conditions would likely improve substantially.

Consumers' assessment of current business conditions was mixed during the first and second quarters. For January, 26.1% of respondents characterized current conditions as "good," up from 24.4% in December. Though this eased in February to 24.6%, optimism regarding current conditions increased to 26.3% in March. However, those characterizing conditions as "bad" were virtually unchanged in March at 15.8% from 15.7% in February. For January, those claiming conditions were "bad" was 18.1%. In the second quarter, those characterizing current conditions as "good" were virtually unchanged at 26.5% in April, 26.9% in May, and 26.7% in June. Those characterizing conditions as "bad" increased in April to 17.6% before declining to 16.4% in May and 15.3% in June. In the third quarter, those claiming conditions were "good" improved initially to 28.7% in July and to 29.7% in August before falling to 25.2% September. Those characterizing conditions as "bad" increased during the third quarter to 16.7% in July, 15.1% in August, and 17.7% in September.

Again, these mixed results may be the result of transitory factors such as high energy prices, the psychological impact of Hurricanes Katrina and Rita, economic displacement created by the hurricanes, etc. Though a jump in any one month may be the result of transitory factors weighing on the economy rather than a sustained shift in consumers' expectations regarding the economic outlook, the clear pattern of increasing negative sentiment may indicate that the previously solid foundation underpinning strong consumer confidence and sentiment has begun to show signs of weakening. Should this weakness in consumer expectations equate to lower consumer confidence and prompt consumers to restrain spending, economic growth could be adversely impacted during the coming quarters.

The Business Sector

The moderate gains in industrial production during the first quarter continued during the second quarter of 2005 as a result of continued economic strength. Industrial production figures as compiled by the Federal Reserve²⁰ rose from 117.9 in December to 118.5 by the end of March and to 119.7 by the end of June. For the first quarter, industrial production increased at an annual rate of 3.6% following an increase of 4.5% in the fourth quarter of 2004. The 2.1% increase (at an annual rate) for the second quarter was the lowest quarterly growth since the second quarter of 2003. For the third quarter, industrial production increased at an annual rate of 1.3%, following a trend of growth rates increasing at a decreasing rate. On a year-over-year basis, industrial production increased by 3.9%, 3.5%, and 3.9% in January, February, and March, respectively. During the second quarter, industrial production increased by 3.1%, 2.7%, and 3.9% in April, May, and June, respectively, on a year-over-year basis. For the third quarter, industrial production increased by 3.0%, 3.1%, and 2.0% in July, August, and September, respectively, on a year-over-year basis.

Manufacturing production also showed gains in the first quarter, increasing by 4.0% at an annual rate. For the second quarter, manufacturing production increased by a much slower annual rate of 1.5%, likely due to the slowing of production to enable inventory stocks that had built up to be drawn down. Manufacturing production increased by 2.3% at an annual rate in the third quarter. Manufacturing production increased by 5.2%, 4.7%, and 4.1% on a year-over-year basis in January, February, and March, respectively, and

²⁰ Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release from July 15, 2005.

by 3.5%, 3.4%, and 3.8% in April, May, and June, respectively. In the third quarter, manufacturing production increased 3.0%, 2.9%, and 2.9% on a year-over-year basis in July, August, and September, respectively. This improvement in manufacturing is further evidenced by information from the twelve Districts of the Federal Reserve System, many of which reported moderate gains in manufacturing activity during the third quarter following heightened activity during the first quarter and weaker activity during the second quarter.

Durable goods production, which increased by 0.5% in the first quarter, declined at an annual rate of 3% in the second quarter but surged by 11.0% in the third quarter. Nondurable goods production increased by only 0.6% in the third quarter following a 2.7% increase in the second quarter and a 2.2% increase in the first quarter. Defense and space equipment production, which increased by 17.1% in the second quarter as compared to an increase of 9.4% in the first quarter, posted continued strong growth yet at a more tempered rate of 6.5% in the third quarter. Following a first quarter increase of 4.4%, construction supplies increased by 2.0% in the second quarter and by 3.4% in the third quarter.

Capacity utilization, which ended 2004 at 79.2%, increased in the first quarter of 2005 to 79.5% for March. Though capacity utilization increased slightly during the first quarter, this level of 79.5% remained 1.5% below the 1972 to 2004 average of 81%. For the second quarter, capacity utilization increased to 80.0% in June, following minimal declines to 79.2% and 79.4% in April and May. Capacity utilization in June of 79.8% was higher than the year ago level of 77.8% and continues to creep closer to the 1972 to 2004 average of 81%. Capacity utilization remained relatively flat in the third quarter at 79.7% in July, 79.8% in August, and 78.6% in September. For the first three quarters of the year, capacity utilization was 79.3%, 79.4%, and 79.4%, respectively. Manufacturing capacity utilization, which stood at 77.9% in December 2004 and at 78.1% in March 2005, also increased slightly to 78.4% by the end of the second quarter. The June 78.3% level is higher than the year ago level of 76.5% but is lower than the 1972 to 2004 average of 79.8%. For the third quarter, manufacturing capacity utilization exhibited a pattern similar to that of total capacity utilization. In July, August, and September, manufacturing capacity utilization was 78.3%, 78.5%, and 77.9%, respectively.

The advance monthly sales for retail trade and food services in the second quarter released by the Department of Commerce²¹ continue to suggest increased economic activity. In March, retail and food service sales increased by approximately 0.3%²² from February to \$339.3 billion. This gain in March follows a 0.5% increase in February and a 0.3% decline in January's figures. In June, retail and food service sales increased 1.7% to \$350.8 billion from the previous month's level. For the third quarter, advance monthly sales for retail trade and food services increased to \$357.3 billion in July, declined to \$350.6 billion in August, and increased slightly to \$351.5 billion in September. On a monthly basis, total retail sales increased by 1.9% in July, decreased by 1.9% in August, and increased by 0.3% in September.

On a year-over-year basis, monthly sales for retail trade and food service increased 8.1% in January, 7.8% in February, and 5.8% in March. For the second quarter, monthly sales for retail trade and food service increased 8.9% in April, 6.4% in May, and 9.6% in June on a year-over-year basis. During the third quarter, total retail sales and food service increased 10.4% in July on a year-over-year basis, 8.1% in August, and 6.5% in September. For the first quarter, retail and food service sales increased by 1.3% from the fourth quarter and by 7.2% on a year-over-year basis. For the second quarter, retail and food service sales increased by 2.6% from the first quarter and by 8.4% from the second quarter a year ago. For the third quarter, total retail and food service sales increased by 1.6% from the second quarter and by 8.3% from the same period a year ago.

Total sales excluding motor vehicles and parts increased 1.7% in the first quarter as compared to the fourth quarter of 2004 and by 7.8% on a year-over-year basis. For the second quarter, total sales excluding motor vehicles and parts increased by 2.2% from the first quarter and by 8.3% on a year-over-year basis. Total sales excluding motor vehicles and parts increased 2.3% during the third quarter as compared to the second quarter and 9.1% on a year-over-year basis. Retail sales, which increased 1.3% in the first quarter over the prior quarter and 7.2% on a year-over-year basis, increased by 2.6% in the second quarter as compared to the first and by 8.4% on a year-over-year basis. For the third quarter, retail sales increased 1.8% over the second quarter and 8.5% on a year-over-year basis.

²¹ Press release from the Department of Commerce.

²² Adjusted for seasonal, holiday, and trading day differences but not for price changes.

Slower economic growth and consumer spending during the first quarter resulted in a build-up of private inventories during the first quarter. These stocks, however, were largely drawn down during the second and third quarter. As a result, manufacturing activity softened somewhat during the second quarter of 2005 but began to rebound during the third quarter. This suggests that manufacturing activity may increase in the third quarter so that businesses may replace the inventories that were drawn down during the second quarter in anticipation of strong demand toward the holiday season late in the fourth quarter. However, with energy prices remaining at elevated levels and with consumer confidence dampened by the hurricanes that devastated the Gulf region, businesses may be inclined to, once again, reign in spending and pass along increased costs to their customers. Overall, these factors continue to suggest that the favorable economic and business conditions that were prevalent in late 2004 and early 2005 may be more muted in the second half of 2005 and into 2006.

Inflation

Following a 3.0% increase in the consumer price index (CPI)²³ during the fourth quarter of 2004 at a seasonally adjusted annual rate and increases of 4.3% and 1.9% during the first and second quarters of 2005, respectively, the CPI increased by a compound annual rate of 9.4% in the third quarter of 2005. The third quarter increase in the CPI of 9.4% is significantly higher than the 3.3% increase for all of 2004. Thus far for 2005, the CPI has increased by 5.1%, also significantly higher than the increase for 2004. Following a flat reading in December 2004, the CPI increased by 0.1% in January, 0.4% in February, and 0.6% in March on a seasonally adjusted basis. In April, May, and June, the CPI increased by 0.5%, -0.1%, and 0.0%, respectively. In July, August, and September, the CPI increased by 0.5%, 0.5%, and 1.2%, respectively. The CPI increased at an annual rate of 4.7% for the twelve months ending in September.

For the first half of 2005, the energy index increased by 14.1% on a seasonally adjusted annual basis, as compared to a 16.1% increase for all of 2004. In the first and second quarter, the energy index increased at annual rates of 21.1% and 7.5%. For the third quarter, the energy index increased by 122.1%, inflated by the spike in energy prices following Hurricanes Katrina and Rita. For the first three quarters of 2005, energy costs have risen by a

²³ Based on data from the Consumer Price Index: June 2005 press release on July 14, 2005 by the Bureau of Labor Statistics, United States Department of Labor.

seasonally adjusted annual rate of 42.5% as compared to a 16.6% increase for all of 2004. Food prices during the first half of the year also increased, with the food index advancing at an annual rate of 2.2% for the first nine months of the year, lower than the 2.7% annual rate for the full-year 2004.

Removing the effects of food and energy, the core CPI increased by 1.4% in the third quarter as compared to a 1.2% increase in the second quarter and an increase of 3.3% in the first quarter. The core CPI advanced at a rate of 2.2% for 2004. For the three quarters of 2005, however, the core CPI increased by 2.0%, roughly in line with the 2004 full-year increase. For the twelve month period ending with March 2005, the core CPI increased by 2.3%. For the twelve months ending in June 2005, the core CPI increased by 2.0%. For the twelve months ending in September 2005, the core CPI increased by 2.0% yet again.

In addition to the CPI, the price index for gross domestic purchases from the BEA²⁴ rose by 4.0% in the third quarter following a 3.3% increase in the second quarter and a 2.9% increase in the first quarter. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 2.2% in the third quarter, 2.1% in the second quarter, and 3.0% in the first quarter. The price index for personal consumption expenditures increased by 3.7% in the third quarter following a 2.3% and 3.3% increase in the first and second quarters, respectively. These figures, closely watched by the Federal Reserve, continue to suggest that inflation has picked up in recent months. This further supports the FOMC's decision to continue removing monetary policy accommodation at a measured pace. It does not appear that core inflation accelerated at an alarming rate during the third quarter, continuing a trend of relative price stability once the effects of volatile food and energy prices are removed. However, should continued high energy prices prompt core inflation to accelerate at a more rapid rate in the coming months as businesses attempt to pass along cost increases to consumers, the Federal Reserve may be forced to remove monetary policy accommodation at a more aggressive pace or risk higher inflation premiums that would tend to suppress economic growth.

Labor Market

After averaging 5.4% in the fourth quarter of 2004 and 5.3% in the first quarter of 2005, the unemployment rate continued to trend lower in the second

²⁴ Bureau of Economic Analysis, Gross Domestic Product: Third Quarter 2005 (Advance) release, October 28, 2005.

and third quarters to an average 5.1% and 5.0%, respectively²⁵. On a monthly basis, unemployment was 5.2% in January, 5.4% in February, 5.2% in March, 5.2% in April, 5.1% in May, and 5.0% in June. For the third quarter, unemployment was 5.0% in July, 4.9% in August, and 5.1% in September. Total nonfarm payroll employment increased by 124,000 in January, by 243,000 in February, and by 110,000 in March, for a first quarter average of 159,000 monthly job gains. As a result of these gains, total nonfarm payroll employment increased by 477,000 during the first quarter after adding over 600,000 jobs in the fourth quarter. For the second quarter, total nonfarm payroll employment increased by roughly 542,000 for an average of 181,000 per month. In June, total nonfarm payroll employment increased by 146,000 to 133.5 million following increases in April and May of 292,000 and 104,000, respectively. Total nonfarm payroll employment increased by 277,000 in July, 211,000 in August, and decreased by 35,000 in September (which reflect the impact of Hurricane Katrina). In the third quarter, total nonfarm payroll employment increased by 453,000 or an average of 151,000 per month.

Payroll gains in the quarter included increases in health care and professional & business services. Education and health services added 138,000 jobs in the third quarter. Professional & business service employment's third quarter average increased by 140,000 over the second quarter. However, much of this increase may be attributed to temporary hiring associated with recovery efforts in the Gulf region following Hurricane Katrina. Manufacturing employment for the third quarter lost nearly 37,000 jobs as compared to the second quarter average employment.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment was mixed during the third quarter following generally favorable readings during the second quarter. Consumers expecting more jobs to become available in the next six months, which had decreased during the first quarter from 16.6% in January to 15.1% in March, fell to 14% in April before rebounding to 15.2% in May and June. Those expecting more jobs to become available in the next six months increased to 15.6% in July to 16.4% in August before falling to 14% in September, negatively impacted by Hurricane Katrina. Those expecting fewer jobs to become available increased again in the third quarter to 16.7% in July, 17.3% in August, and 25% in September. In June the number of consumers expecting fewer jobs to become available increased to 16.5% as compared to

²⁵ Bureau of Labor Statistics, United States Department of Labor, The Employment Situation: June 2005, July 8, 2005.

15.9% in May and 18.4% in April. Further increases in economic activity, even at a more tempered rate, should provide a foundation for continued increases in payroll employment for the coming quarters, though this growth may also be at a more muted rate. Should the adverse psychological impact of Hurricanes Katrina and Rita prove transitory, consumers' optimism regarding employment should improve in the fourth quarter, particularly as hiring for recovery efforts intensifies.

Equity Markets

Following strong gains during the fourth quarter, possibly in response to continued economic strength and the easing of tensions and uncertainty surrounding the presidential election, the major indices declined during the first quarter and posted mixed results for the second quarter. After ending the year at roughly 10,850, the Dow Jones Industrial Average (DJIA) fell roughly 3% in the first quarter²⁶. The S&P 500, after an increase of 8.9% during the fourth quarter to roughly 1,200, declined by 2.6% in the first quarter. The NASDAQ composite experienced the largest gain during the fourth quarter of roughly 15% to end the year at approximately 2,200 and experienced the largest loss during the first quarter, falling roughly 8%. For the second quarter, the DJIA declined roughly 1.6% (through June 29th) to 10,375. The NASDAQ and the S&P 500, however, both posted gains of 3.2% and 1.6%, respectively, ending the second quarter at roughly 2,069 and 1,200. For the third quarter, the DJIA increased by only 1% to end the quarter at 10,473 (as of September 28th). The S&P 500 and the NASDAQ increased by 1.4% and 2.2% in the third quarter to 1,217 and 2,115, respectively. The mixed performance may have been a result of seasonally light volume during the summer and caution on the part of investors due to continued high oil prices and the impact upon economic activity, uncertainty regarding geopolitical events, and the psychological impact of Hurricanes Katrina and Rita.

The market's tepid activity during the third quarter, like the preceding quarter, may largely be the result of concerns over sustained higher energy prices, particularly following Hurricanes Katrina and Rita and the adverse impact it may have upon economic growth. However, according to Thomson First Call, the annual growth rate in earnings for U.S. companies in the third quarter was expected to be roughly 16%²⁷, based on 90% of companies having reported. Gains in the energy sector contributed substantially to the increase

²⁶ Based on data from *The Economist*.

²⁷ "The Short View", Philip Coggan, *The Financial Times*, November 10, 2005.

in earnings. Removing the effects of increases in energy companies' earnings, the annual growth rate was still estimated to be in excess of 11%. In addition, Banc of America Securities estimates that fourth quarter earnings will increase by 11% with the first quarter of 2006 earnings increasing by 13%. However, earnings guidance has generally been negative with respect to future prospects. Tobias Levkovich of Citigroup indicated that roughly 35% of guidance has been to lower forecasts, as compared to only 30% guiding lower in the second quarter, and only 25% in the first.

Chief executives' confidence in the economy and its growth prospects has eroded since the start of the year. According to a McKinsey survey of U.S. company executives, only 44% of those surveyed had favorable views of the economic outlook. This is significantly lower than the 69% who had a favorable view of the economy in March²⁸. This is the weakest result amongst U.S. executives in the eighteen months that the survey has been conducted. However, expectations for favorable corporate profit growth in the coming quarters remain in tact.

Despite this, a number of factors suggesting economic softness may serve to temper investors' outlook for the equity markets. Sustained high energy prices and their impact upon consumers could have a significant adverse impact upon corporate profits, should consumer spending slow markedly. Inflationary pressures stemming from higher energy prices feeding into the core inflation figures could also have an adverse impact upon investor confidence. In addition, rising interest rates could further dampen investors' enthusiasm for the equity markets and prompt a flight to quality to government bonds. These issues along with lower growth in GDP could restrain gains in the equity markets as investors seek other, more profitable investment opportunities. The foundation for advancement in the equity markets over the coming quarters is still tenuous, particularly as a number of factors such as high energy prices may prompt economic cooling in the coming quarters.

Oil Prices

West Texas Intermediate (WTI) oil prices increased during the second quarter of 2005, rising from \$45 per barrel at the end of 2004 to roughly \$55 at the end of the first quarter to nearly \$60 by the end of the second quarter. During the third quarter, oil prices continued to trend higher, spiking to nearly

²⁸ "US executives take gloomiest view of prospects," Chris Giles, *The Financial Times*, October 20, 2005.

\$70 per barrel following Hurricane Katrina before settling to roughly \$65 per barrel by the end of the quarter. As a result of Hurricane Katrina in the Gulf of Mexico, the United States' oil production slowed considerably. In the aftermath of the hurricane, nine refineries with total production of 1,822,500 barrels per day were shut down, with three of these having been flooded. An additional four refineries with 1,044,000 barrels per day of total production reduced output due to the storm. These closed refineries accounted for roughly 12% of U.S. refining capacity.

As a result, oil prices spiked above \$70 per barrel and gasoline prices jumped significantly to over \$3 per gallon in many areas of the U.S in the week following Hurricane Katrina. The supply disruptions at the closed refineries likely contributed to concerns over gasoline supply shortages reminiscent of those which occurred as a result of the 1973-74 Arab oil embargo. President Bush and many state government officials urged consumers to conserve their fuel use by driving only when needed.

At the September 20, 2005 meeting in Vienna, Austria²⁹, OPEC ministers noted the following with respect to energy markets:

Having reviewed the current oil market, the Conference noted that action taken by OPEC Member Countries to increase production over the preceding quarters—OPEC production being currently estimated at 30.2 mb/d (excluding Iraq 28.3 mb/d)—has led to a build-up in inventory levels, especially of crude, which now stand well above their five-year average, sufficient to ease concerns in the market about potential supply disruptions, such as those witnessed following Hurricane Katrina. The Conference further noted that Member Countries are implementing costly investment plans to accelerate the expansion of crude production capacity from about 32.5 mb/d to at least 38 mb/d by 2010, to meet future demand growth.

Acknowledging that, although growth in crude oil supply in recent years has continued to be ahead of growth in demand, and that commercial stocks, in particular of crude, are at comfortable levels, oil prices have nevertheless continued to rise, mainly on account of tightness in downstream capacity and concerns over availability of adequate future supplies leading to increasing activity in futures markets, the Conference

²⁹ OPEC press release following the 137th Meeting of the OPEC Conference in Vienna, Austria on September 20, 2005.

reiterated that the Organization will continue its proactive policy of supporting market stability by ensuring availability of adequate supply, at prices reasonable to both producers and consumers.

Towards this end, and recognizing the importance of maintaining oil market stability, for the benefit of the world economy, including, in particular, the economies of the developing world, the Conference agreed to make available to the market the spare capacity of around 2 mb/d in Member Countries, should it be called for, for a period of three months, starting 1 October 2005. The Conference further decided to review market developments at its 138th (Extraordinary) Meeting, to be held in Kuwait on 12 December 2005, and take decisions as deemed appropriate and necessary.

The overall impact of higher energy prices on the world economy slowly manifested during the third quarter. Wal-Mart's chief executive, Lee Scott, in a prerecorded statement accompanying the release of the company's second quarter results indicated that the rise in oil prices would erase the improvements in employment and real income for an important portion of the firm's customer base. As a result of the rising oil prices which cost the company an additional \$30 million in the quarter to ship its goods and dampened the world's largest retailer's earnings, Mr. Scott indicated that, "I anticipate we will face challenges as the year proceeds."³⁰

In addition, OPEC released a statement in conjunction with its meeting of the International Monetary and Financial Committee of the International Monetary Fund in Washington, D.C. commenting on oil market stability³¹. In its prepared statement, OPEC stated the following:

It is clear, however, that the present tightness in the downstream sector, especially the lack of adequate refining capacity, will continue to put pressure on prices; consequently, volatility is likely to remain a feature of the oil market for some time, until the necessary investments are undertaken. The recent behaviour of the oil market, in the aftermath of Hurricane Katrina, provides a good illustration of the critical importance of the refining sector to market stability. In this regard, OPEC Member

³⁰ "Soaring oil will hurt spending, says Wal-Mart," Jonathan Birchall, *The Financial Times*, August 17, 2005.

³¹ Statement on oil market stability by the Organization of the Petroleum Exporting Countries, September 24, 2005.

Countries have taken the initiative—on their own and in partnership with other, both inside and outside their countries—to pursue and invest in downstream projects. Nevertheless, the primary responsibility for refining capacity expansion remains with the major consuming countries. OPEC calls for these countries to create the appropriate environment and provide the necessary incentives to ensure timely and sufficient investments in this key sector. In this regard, the role of the international oil companies is also crucial. It is of note that recent increases in revenue have not been translated substantially into additional investments, despite the needs of, in particular, the downstream sector.

The world economy has so far shown remarkable resilience to high energy and commodity prices. Nevertheless, OPEC continues to express concern over the possible impact of further sustained price increases on the world economy, and especially on the economies of developing countries. Signs of such an impact appear to be emerging. OPEC will continue to help moderate crude oil prices by increasing production and capacity. At the same time, consuming countries should also do their part, including adopting measures to ease the burden of high fuel prices on the final consumer. OPEC is encouraged by recent actions that have been taken by some consuming countries in this direction.

It is likely that the current elevated level of energy prices will result in some softness in economic activity in the second half of 2005 and into 2006. Continued demand growth from China and concerns over inadequate refining capacity are likely to result in continued elevated oil prices for the immediate future. In addition, concerns of geopolitical risks such as Iran's suspected nuclear program, terrorist threats in Saudi Arabia, and insurgents in Iraq may create an additional premium in the price of oil. Furthermore, continued speculative activity in the oil markets may also contribute an additional premium to the current elevated price of oil. Any further exogenous shocks in the oil markets resulting in further short-term price spikes in excess of \$70 or \$80 per barrel could have a significant adverse impact upon global economic growth and U.S. economic activity. Based on other information, it appears that many businesses have begun to accept higher energy prices and have begun to pass on a portion of the added costs associated with higher energy prices to consumers. Therefore, the risks to economic activity stemming from higher energy prices appear to be weighted towards conditions that may perpetuate further economic softness in the coming quarters.

Economic Outlook 2005

The Conference Board's Leading Economic Indicators ended the first quarter at 136.2³² and showed improvement during the second quarter, increasing to 138³³. In the third quarter, the leading index decreased 0.1% in July, remained flat in August, and decreased 0.8% in September to end the quarter at 136.7. The leading index increased 0.4% from March through September. The leading index has remained relatively flat through the first three quarters of 2005, its growth rate fluctuating between 0.5% and 1.5% at annual rates as compared to a roughly 4% growth rate for the same period of 2004. This lower growth in the leading index coincides with a lower real GDP growth during the same period as compared to previous years.

In the *Monetary Policy Report to the Congress*, the Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3%-3 ¾% in 2005. Real GDP is expected to increase by 3 ¼%-3 ¾% in 2006. The personal consumption expenditures chain-type price index excluding food and energy is expected to range from 1 ½%-2 ¼% in 2005 and from 1 ½%-2 ½% in 2006. The civilian unemployment rate is anticipated to range from 5%-5 ¼% in 2005 and roughly 5% in 2006.

Forecasters at The Conference Board expect real GDP growth of 3.8% and 3.1% in the third and fourth quarters of 2005. For the year, real GDP is expected to experience growth of roughly 3.5%. For 2006, forecasters expect real GDP growth of 2.9%. CPI inflation is expected to equal roughly 3.1% for 2005 and 4% for 2006. The unemployment rate is forecast at 5.1% for 2005 and 5% for 2006.

Anthony Santomero, president of the Philadelphia Federal Reserve, indicated in an interview with *The Financial Times* on September 30, 2005 that economic activity was likely to rebound after the hurricanes with stronger than expected growth fueled by reconstruction and government spending³⁴. Mr. Santomero indicated that the U.S. economy was growing at a healthy pace prior to the storms but conceded that the hurricanes would contribute to

³² From The Conference Board's February 17, 2005, March 17, 2005, & April 21, 2005 press releases for US Leading Economic Indicators.

³³ From The Conference Board's November 21, 2005 press releases for US Leading Economic Indicators.

³⁴ "Fed official expects recovery after storms," Andrew Balls, *The Financial Times*, September 30, 2005.

slightly weaker growth during the second half of 2005. With the adverse impact upon consumer confidence expected to be reversed as in the past, Mr. Santomero suggested that growth in 2006 would be favorable “as the rebuilding and increased spending builds its own expectations of further good times.” In addition, he indicated that he was confident the economy would continue to grow in the 3 ½%-4% range over the next year, in line with previous forecasts.

Based on the current assessment of a number of economic factors, some of which changed significantly following Hurricanes Katrina and Rita, the previously solid foundation for continued economic growth has likely been threatened by the adverse systemic impact of a spike in energy prices stemming from supply disruptions. The energy supply disruption and the accompanying high gasoline prices may have an adverse impact upon consumer confidence and consumer spending—the latter of which has been an underlying cause of the economic growth over the last two years. A retrenchment in consumer spending is likely to precipitate slower economic growth and may prompt a decline in the robust housing market. A collapse of the real estate market would also precipitate further weak economic activity. These factors, combined, could have a severe toll on economic activity in the coming quarters. These factors suggest that the risks to the economy are weighted heavily towards weaker economic activity in the coming quarters.

Though we do not believe that the preponderance of evidence points to a recession, we feel that economic growth will be severely negatively impacted by the oil supply disruptions in the U.S. and that the probability of the economy slipping into recession is low. However, we believe there is a growing possibility that the U.S. economy may exhibit a period of low growth and higher inflationary pressures.

Our assessment of the current state of the economy indicates the following:

- Consumer spending continued to increase at a declining rate, restrained perhaps by persistent high energy prices.
- Interest rates are likely to continue to rise in the coming quarters, which could restrain the robust real estate activity, removing some of the speculative froth that has developed in many markets.

- Oil prices are expected to remain at elevated levels for the remainder of the year, which could prompt slower economic growth globally and in the U.S.
- Inflation has remained at levels above recent trends and is consistent with slower economic growth.
- With the build-up of inventories in the first quarter, manufacturing activity and industrial production was tempered in the second quarter as inventory stocks began to be drawn down to a level that was more consistent with current demand conditions. In the absence of any further systemic shocks to the economy stemming from aggregate external economic factors, industrial production would be expected to increase during the second half of the year in anticipation of increased demand for the fourth quarter holiday season and to replenish the inventories that were drawn down during the second quarter.
- Consumer confidence appears to have been severely weakened in the aftermath of the hurricanes late in the third quarter. Expectations are trending towards a more cautious outlook. Should consumer confidence become pessimistic, personal consumption expenditures could soften and prompt a further slowing of economic activity.
- Business confidence among chief executives has fallen considerably and could fall further if economic activity experiences further softness in the fourth quarter of 2005 and the first quarter of 2006; this could prompt a slowdown in payroll employment gains, as management reigns in spending and hiring until the outlook becomes more certain.

Our expectations for the economy include:

- Real GDP growth of 3% - 3 ½% for 2005 and 3% - 3 ½% for 2006.
- The Federal Reserve is likely to continue to remove its monetary policy accommodation at a measured pace. The federal funds rate should end 2005 at roughly 4%. For 2006, the federal funds rate should end the year at roughly 5%

- Inflation is likely to increase in 2005 with the core CPI increasing by roughly 1 $\frac{3}{4}$ % - 2 $\frac{1}{4}$ %. The core CPI is likely to increase by 1 $\frac{1}{2}$ % - 2% in 2006.
- As economic activity becomes more tempered in 2005, payroll employments are likely to increase at a lower rate. It is possible that the economy will generate increases in payroll employment of 150,000 per month on average for the year. Unemployment, then, is likely to fall to roughly 5% for 2005. A similar unemployment rate for 2006 could be reasonably expected.
- Continued geopolitical concerns along with concerns over demand and supply imbalances and tight refining capacity may result in continued elevated oil prices. It is unlikely that OPEC will increase production further in the fourth quarter. However, even if OPEC were to do so, these increases will not likely have a material impact on lowering the price of oil. Given the developments in the oil markets since the first quarter, oil prices (WTI) are likely to average \$55-\$60 per barrel for 2005. Oil prices are likely to remain at elevated levels throughout the first half of 2006 as well, trading in a range of \$55-\$70 per barrel.

On the other hand, there are a number of risks to the economy in 2005 and 2006, which could have significant adverse impacts upon economic performance during the year.

- Continued geopolitical risks and tensions regarding instability and security in the Middle East may create uncertainty that could suppress demand in the global economy and help fuel a premium in oil prices. Escalating tensions over North Korea and Iran's nuclear programs could also have an adverse impact upon economic activity and oil prices.
- Continued elevated oil prices may have an adverse impact upon global economic growth and economic activity in the U.S. and lead to unwelcome inflationary pressures throughout the broader economy. This could ultimately prompt some retrenchment in consumer spending, which would contribute to further soft economic performance.
- Further increases in interest rates by the FOMC may temper the robust activity in the real estate markets. The adverse systemic impact

stemming from a bursting of the bubble in some real estate markets could dampen economic growth significantly.

- An unwelcome rise in core inflation could dampen consumer confidence and business executives' confidence, prompting a slowdown in economic activity, which could be further aggravated by a potentially more aggressive tightening of monetary policy by the Federal Reserve in response.

Conclusion

After softening somewhat in the second quarter, economic activity expanded at a modest rate in the third quarter of 2005 with real GDP advancing by 3.8%. Personal consumption expenditures remained firm during the third quarter and provided a source of strength for the broader economy. With oil prices already at elevated levels, disruptions to oil refineries along the U.S. Gulf coast following Hurricanes Katrina and Rita perpetuated further increases in energy prices to record highs. Continued high energy prices and rising interest rates are likely to create uncertainty regarding future economic growth. In addition, inflationary pressures, though contained, seemed to increase modestly late in the third quarter. Based on the state of the economy in the third quarter, conditions are likely to foster tepid economic activity in the fourth quarter of 2005 and into 2006. As such, the risks are weighted mainly towards growth at a more subdued rate and towards conditions that generate a higher level of inflation than in the previous year.