



Courtesy of Highland Global, LLC
www.HighlandGlobal.com

State of the Economy 4th Quarter 2005

Introduction

After showing signs of remarkable resilience despite the devastating effects of Hurricanes Katrina and Rita in the Gulf states during the third quarter of 2005, with real gross domestic product (GDP) increasing by 4.1%, economic activity slowed considerably during the fourth quarter, increasing by a paltry 1.1%. This significantly weaker 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

favorable rate in the third quarter, the weakness in the fourth quarter would suggest that the hurricanes in the third quarter had a more detrimental economic impact than originally anticipated by many forecasters. The apparent resilience of the U.S. economy in light of adverse exogenous shocks stemming from natural disasters and the resulting spike in energy prices during the third quarter was likely an optimistic expectation perpetuated by skewed economic data for the third quarter that was boosted by firm economic activity prior to the hurricanes in September. However, real GDP for the full

Highland Global article to appear in the
NACVA's *The Value Examiner*

"The Direct Market Data Method: Value Disparity Issues" by Highland Global Principal Robert M. Clinger III, AVA has been selected by the editorial Board of *The Value Examiner* for inclusion in the March/April issue. *The Value Examiner* is the bimonthly publication of the National Association of Certified Valuation Analysts. Mr. Clinger's article discusses how to best address the disparity between value indications produced under the direct market data method and the multi-period discounted earnings method. More details to follow in the next newsletter...

year 2005 still grew at an annual rate of 3.5%, boosted by the strength of economic activity during the first three quarters of the year. The 1.1% increase during the fourth quarter of 2005 is lower than the 3.3% increase during the same period of 2004.

With the lingering impact of the hurricanes continuing to manifest and the likelihood that the reconstruction of the affected areas will significantly boost economic activity now a low probability event, conditions that would tend to suggest further economic weakness in the coming quarters now exist. To be sure, the economy in 2006 is likely to slow, with growth advancing at a tempered rate comparable to that of the fourth quarter, due to a number of adverse conditions that may restrain demand such as continued high energy costs and rising interest rates, which are likely to significantly restrain consumer spending.

Gross Domestic Product

Advance estimates¹ released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 1.1% in the fourth quarter as compared to a revised rate of 4.1% in the third quarter and a 3.3% rate in the second quarter of 2005. This weak increase in real GDP is the slowest rate of growth since the first quarter of 2003 when real GDP increased at a rate 1.7% and the fourth quarter of 2002 when real GDP increased at a rate of 0.2%. Economic growth during the fourth quarter was lower, once again, than the consensus forecast of 3.2% (revised downward from 3.6% anticipated when surveyed during the third quarter) annual growth in real GDP anticipated by fifty-one forecasters surveyed by the Federal Reserve Bank of Philadelphia². The third quarter growth in real GDP was slightly higher on a revised basis at 4.1% at an annual rate as compared to earlier estimates of 3.8% growth³ For 2005, real GDP increased at an annual rate of 3.5% as compared to an increase of 4.2% in 2004 and an increase of 2.7% in 2003.

Real personal consumption expenditures, which accounts for about two-thirds of economic activity, increased by 1.1% in the fourth quarter as compared to a 4.1% increase in the third quarter, a 3.4% increase during the second quarter and a 3.5% increase in the first quarter at a seasonally adjusted annual rate. Purchases of durable goods, which surged by 9.3%

¹ The BEA press release on January 27, 2006 states the following with respect to advance estimates: The Bureau emphasized that the fourth-quarter “advance” estimates are based on source data that are incomplete or subject to further revision by the source agency. The fourth quarter “preliminary” estimates, based on more comprehensive data, will be released on February 28, 2006.

² *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, November 14, 2005.

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

during the third quarter following a robust 7.9% increase in the second quarter and a 2.6% increase in the first quarter, decreased by 17.5%. This surge in purchases of durable goods was due largely to a 13.8% decrease in expenditure on motor vehicles and parts, likely due to the gradual withdrawal of numerous incentives offered to the general public by the major automakers that had been quite successful during the second and third quarters. Purchases of furniture and household equipment increased by roughly 3%, helping to offset some of the negative impact from the decline in expenditures on motor vehicles and parts. Data from the Federal Reserve Beige Book released November 30, 2005 and January 18, 2006 indicated that almost all of the Federal Reserve Districts noted declines in motor vehicle sales during the fourth quarter with a continuing trend towards more fuel efficient vehicles in light of the elevated energy prices. Demand for domestic automobiles was noticeably less than that for foreign brands.

Personal consumption expenditures on nondurable goods increased by 5.1% during the fourth quarter, higher than the 3.5% increase in the third quarter and the 3.6% in the second quarter. Retail sales, which had exhibited modest strength during the third quarter, experienced generally mixed results during the fourth quarter. Food, luxury items, and electronics were particularly strong sellers during the fourth quarter holiday season, which could be characterized as favorable with all but one of the Federal Reserve Districts (Cleveland) reporting increased retail sales during the quarter on a year-over-year basis.

Real nonresidential fixed investment, which increased by 8.5% in the third quarter and 8.8% in the second quarter, increased at a more tempered rate of 2.8% in the fourth quarter. This rate of growth is lower than the 5.7% increase in the first quarter as well. Equipment and software investment activity, which increased by 10.9% in the second quarter and by 10.6% in the third quarter, showed weakness as well, increasing by only 3.5%.

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 \$13.3 billion in the third quarter. For the fourth quarter, however, private businesses increased inventories by \$25.7 billion, adding 1.45% to the fourth quarter change in real GDP. The decrease in private business inventories subtracted 0.43% from GDP for the third quarter as compared to subtracting 2.14% from the second quarter and adding 0.29% to the first quarter change in real GDP. This increase in inventories suggests that businesses had allowed built-up inventory stocks to be drawn down during the second and third quarters. Given this drawdown and the anticipated increased demand during the fourth quarter holiday season, businesses likely increased production during the late third quarter and early fourth quarter in order to maintain adequate supplies going into the holidays which were expected to experience favorable demand despite continued high energy prices. As a result

of this increased production intended to balance supply with demand expectations, production could be expected to taper during the first quarter of 2006 in order for businesses to draw down the increased inventories.

Real residential fixed investment increased by 3.5% in the fourth quarter following a 7.3% increase in the third quarter and a 10.8% increase in the second quarter. This more tempered growth comes at a time of noticeable slowing in real estate activity as speculation over the existence of a real estate bubble has mounted. This comes in the wake of strong growth that has been evident for nearly a year as investors and consumers have sought safe and better returns in the real estate markets. This tempered increase in real residential fixed investment could be the result of adverse impacts arising from removal of accommodative monetary policy at a measured pace by the Federal Reserve and the subsequent increase in mortgage rates.

Data on new residential construction from the U.S. Census Bureau and U.S. Department of Housing and Urban Development indicated that activity cooled noticeably in the fourth quarter. Privately-owned housing units authorized by building permits, which ended 2004 at 2,069,000 and ended the third quarter at 2,219,000, fell throughout the fourth quarter to 2,103,000 in October, 2,163,000 in November and to 2,068,000 at the end of the year. For the fourth quarter, new privately-owned housing units authorized by building permits increased slightly on a year-over-year basis at a rate 0.5%. In November, new privately-owned housing units authorized by building permits increased by roughly 3.3% on a year-over-year basis then decreased by 0.6% on a year-over-year basis in December.

Privately-owned housing starts, which ended the third quarter at 2,160,000, also decreased throughout the fourth quarter to 2,051,000 in October, 2,121,000 in November, and to 1,933,000 in December. On a year-over-year basis, privately-owned housing starts decreased 0.5% in October, increased 17.4% in November, and decreased by 5.7% in December. For September, housing starts increased to 2,160,000 or by roughly 13% on a year-over-year basis.

Housing starts in the fourth quarter decreased from the third quarter levels and were at the lowest levels of the year. This may foreshadow the beginning of a period of less robust growth in the real estate markets and may support other data that indicates as such. 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, 6 months for total starts, and 6 months for total completions.

At this point, it is still 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. Data from the National Association of Realtors (NAR) seem to confirm the fourth quarter slowdown in real estate activity. After homes changed hands at the fastest pace in the second and third quarters since the 1970s, existing home sales fell 5.7% to 6,600,000 units on a seasonally adjusted annualized basis in December. On a year-over-year basis, sales of existing homes decreased 3.1% in December. For the year, however, existing home sales increased 4.2% in 2005 as compared to 2004 to 7,072,000, the fifth consecutive annual record since the NAR began tracking sales in 1968. The national median price of all housing types increased 10.5% in December on a year-over-year basis to \$211,000. For the full year, the median price was \$208,700, an increase of 12.7% from the \$185,200 level in 2004. For single family homes, sales declined 6.8% in December to a seasonally adjusted annual rate of 5,720,000 from November. On a year-over-year basis, sales of existing single family homes declined 4.2% in December. For the full year, however, single family home sales increased 3.6% as compared to 2004. The median price of existing single family homes was \$209,300 in December, an increase of 10.8% over the December 2004 median price. For the year, the median single family home price increased 12.6% to \$207,300⁴.

These rapidly increasing price figures for existing home sales have, in part, 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 voiced concerns with the activity in the U.S. real estate markets, warning in testimony to the Joint Economic Committee of the Congress on June 9, 2005⁵:

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

⁴ "Existing-Home Sales Down in December But 2005 Sets a Record," National Association of Realtors, Washington, D.C., January 25, 2006.

⁵ Testimony of Chairman Alan Greenspan, *The Economic Outlook*, Before the Joint Economic Committee, U.S. Congress, June 9, 2005.

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 following⁶:

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.

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

⁶ Remarks by Chairman Alan Greenspan, *Mortgage Banking*, to the American Bankers Association Annual Convention, Palm Desert, California (via satellite), September 26, 2005.

purchase a home that would otherwise be unaffordable, their use is adding to pressures in the marketplace.

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.

The Beige Book released on November 30, 2005 and January 18, 2006 indicated moderation in residential real estate activity in most of the twelve Districts during the fourth quarter. Homes sales reportedly slowed in many Districts, with the inventory of homes available for sale increasing as well as the amount of time homes were on the market, and price appreciation experienced a more muted rate. The data included in the Beige Book seems to confirm signs of cooling that had begun to manifest in the third quarter.

After ending the year at 5.81%, thirty-year conventional mortgages according to Freddie Mac⁷ 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

⁷ Data from Freddie Mac Weekly Mortgage Market Survey

roughly 5.91%. During the fourth quarter, thirty-year conventional mortgage rates increased to a high of roughly 6.33% in November before ending the year at roughly 6.27%. 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. For the fourth quarter, fifteen-year rates increased to 5.86% in November and ended the year at roughly 5.82%.

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%. For the fourth quarter, the yield on the 10-year Treasury note rose to a quarterly high of 4.66% by early November before falling to end the quarter at 4.37%, virtually unchanged from the level at the beginning of the quarter. By the end of the quarter, the yield curve had inverted briefly with the two-year yield rising above the yield on the ten-year note. Though this inversion was reversed in early January, the yield curve inverted once again by the middle of the month.

This yield curve inversion results from an increase in short-term rates associated with the Federal Reserve's removal of accommodative monetary policy at a measured pace and market expectations of slower economic growth in the future. Since the 1970s, every U.S. recession has been preceded by an inverted yield curve. However, not all inverted yield curves have historically been followed by a recession. As a result of these developments, there is a growing number of economists, business leaders, and analysts who now believe that the current economic conditions may be a precursor to a recession.

Continued interest rate increases may contribute to a slowing of real estate activity and residential construction in the coming quarters. 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.

Following increases of 7.5% in the first quarter, 10.7% in the second quarter, and 2.5% in the third quarter, real exports of goods and services for the fourth quarter increased 2.4%. Imports, a subtraction from GDP, increased 9.1% in the fourth quarter following a 2.4% increase during the third quarter. Imports decreased 0.3% during the second quarter and increased 7.4% during the first quarter.

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. During the fourth quarter, the dollar weakened to \$1.79 against the pound sterling by early November before gaining to end the quarter at \$1.75, unchanged from the beginning of the fourth quarter. For the year, the dollar strengthened from \$1.92 to \$1.75 against the pound sterling. 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 ended the third quarter at \$1.20 against the euro before strengthening to \$1.16 by mid-November. The dollar ended the fourth quarter unchanged at \$1.20 against the euro, stronger than the \$1.35 rate at the end of 2004. 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 ¥110⁸. During the third quarter, the dollar made further gains against the yen, rising to ¥113 by the end of the quarter. By the end of the year, the dollar had made further gains against the yen, rising to a high of ¥121 by early December before retrenching to ¥116 by year end.

The strengthening of the dollar during the year may stem from a variety of issues such as continued weak economic data in the euro zone, continued increases in interest rates as part of the Federal Reserve's removal of accommodative monetary policy, and low inflation expectations in the United States. These factors may have driven the dollar higher against other foreign currencies, despite continued higher federal budget deficits in the United States. In addition, Middle Eastern oil exporters began holding a higher proportion of OPEC deposits in dollars—69.5% as compared to 61.5% in the prior year. Subsequently, OPEC's share deposits in euros fell from 24% to 16%, based on estimates from the Bank for International Settlements. This recycling of petrodollars has likely been the cause of the gains the dollar has made against other currencies, particularly as interest rate increases in the United States increased the return on deposits relative to those in the European Union⁹. However, with the European Central Bank having instituted its own cycle of rate increases in December, oil exporters may shift deposits to euros should the interest rate differential narrow between the two currencies.

⁸ Source: *The Economist*

⁹ "Dollar's rise aided by OPEC holdings," Steve Johnson, *The Financial Times*, December 5, 2005.

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 7.4%. For the fourth quarter, real federal government consumption expenditures decreased by 7.0%. This decrease in the rate of federal government consumption expenditures was the result of decreased national defense spending. After increasing 3.0%, 3.6% and 10.0% in the first, second, and third quarters, respectively, national defense spending decreased 13.1% in the fourth quarter. Nondefense spending, which increased by only 1.1% in the first quarter, decreased by 0.2% during the second quarter and increased by 2.4% during the third quarter. For the fourth quarter, nondefense spending increased 6.9%.

The Federal Reserve

The Federal Reserve continued to tighten monetary policy during the fourth 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.

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 ¾%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 ¼%. The Committee continued to believe that monetary policy was accommodative and, along with productivity gains,

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.

¹² The Board of Governors also increased the discount rate by twenty-five basis points to 3 ¾% 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 ¼%, respectively.

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.

In the *Monetary Policy Report to the Congress*, released in July, 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 ¾% in 2005 (as compared to previous forecasts of 3 ½%-4%) as compared to real GDP growth of 3.7% in 2004¹⁴. Real GDP is expected to increase by 3 ¼%-3 ¾% 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 ½%-2 ¼% in 2005 (as compared to earlier forecasts of 1 ½%-2%), higher than the 1.6% increase in 2004. For 2006, the PCE index excluding food and energy is expected to range from 1 ½%-2 ½%; earlier forecasts suggested core PCE increases in 2006 of 1 ½%-2%. The civilian unemployment rate is anticipated to range from 5%-5 ¼% (compared to earlier forecasts of 5%-5 ½%) in 2005, against 5.4% for 2004, and roughly 5% in 2006 (earlier forecasts were for 5%-5 ¼%).

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, 2005¹⁵, bringing the federal funds rate to 3 ½% and 3 ¾%. 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

¹⁴ Changes are from average for fourth quarter of 2004 to average for fourth quarter of 2005.

¹⁵ 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 ½% and 4 ¾%, 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 FOMC raised the federal funds rate by an additional twenty-five basis points at the November 1, 2005 meeting and again at the December 13, 2005 meeting. As a result, the federal funds rate ended the year at 4 ¼%¹⁶. In its press release following the December 13, 2005 meeting, the FOMC indicated that further measured policy firming would likely be needed to balance sustainable economic growth and price stability. However, the FOMC made the following assessment:

Despite elevated energy prices and hurricane-related disruptions, the expansion in economic activity appears solid. Core inflation has stayed relatively low in recent months and longer-term inflation expectations remain contained. Nevertheless, possible increases in resource utilization as well as elevated energy prices have the potential to add to inflation pressures.

Though the FOMC initially anticipated that the hurricanes in the third quarter would have little economic impact, that assessment seems to have been misguided given the significant deceleration in economic growth during the fourth quarter. This would tend to suggest that the systemic impacts of the hurricanes, which helped to boost energy prices higher from already elevated levels, are likely to be felt for quarters to come. In addition, inflation pressures seem to have been mounting in the last two quarters, placing the FOMC in a precarious position of confronting higher inflation during a period of slowing economic growth. Though the engines of economic growth in America have not shut down, they have certainly shown signs of slowing under the burden of higher energy prices, rising interest rates, mounting inflationary pressures and

¹⁶ The Board of Governors also increased the discount rate by twenty-five basis points at the November 1, 2005 and December 13, 2005 meetings to 5% and 5 ¼%, respectively.

the attending impacts these factors have upon consumer sentiment and consumption.

The Federal Reserve Beige Books¹⁷ released on November 30, 2005 and January 18, 2006 suggest modest economic expansion during the fourth quarter throughout the twelve Districts¹⁸. The Beige Book conclusions included the following:

- Retail sales were favorable during the holiday season of the fourth quarter after showing signs of weakness late in the third quarter, most likely due to disruptions following Hurricanes Katrina and Rita. Retailers noted increased sales of gift cards, resulting in expectations for stronger sales in coming months as shoppers redeem the gift cards and make additional, concurrent purchases. Automobile sales were characterized as declining or sluggish across the nation, though sales of foreign brands were particularly strong.
- Manufacturing activity continued to expand throughout the country. Construction and defense and aerospace experienced noticeable gains in many Districts. Declines in activity were noticed once again in the automobile industry.
- Residential real estate activity, after showing some signs of cooling during the second quarter and firming again during the third quarter, moderated during the last quarter of the year. Some Districts noted slowing home sales and price appreciation, rising inventory levels, and longer selling times of existing homes. Commercial real estate activity continued to strengthen in general during the third quarter. Office vacancy rates fell in some Districts, and demand for office space seemed to have picked up in many markets. New commercial construction activity was generally anticipated to improve in 2006.
- Labor markets continued to experience modest gains throughout most of the Districts. Some areas noted continued tight labor markets, though wages has experienced only modest increases. Skilled professionals remained in short supply in many areas.
- Unseasonably warm weather resulted in favorable tourism activity during the fourth quarter in many Districts. Many of the previously hurricane

¹⁷ The press release on January 18, 2006 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.

affected areas noted improvements, but a lack of snow hurt some ski resorts.

Consumer Confidence

After ending 2004 at a level of 102.7, the Conference Board's Consumer Confidence Index¹⁹ ended the first quarter of 2005 virtually unchanged at 103. For the second quarter, the Index increased to a three year high of 106.2 before falling to 87.5 by the end of the third quarter—the lowest level in two years. In the aftermath of Hurricanes Katrina and Rita, Lynn Franco, Director of The Conference Board's Consumer Research Center, indicated the following with respect to the 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.

During the fourth quarter, the Consumer Confidence Index declined to 85.2 in October, rose to 98.3 in November, and increased further to 103.6 in December. In analyzing the strong rebound in consumer confidence, Lynn Franco indicated the following:

Consumer confidence continues to bounce back and is now at its highest level since Hurricane Katrina struck the Gulf Coast. The resiliency of the economy, recent declines in prices at the pump, and job growth have consumers feeling more confident at year-end than they felt at the start of 2005. Even though all of the improvement over the past twelve months has been in consumers' assessment of current conditions, and expectations remain below earlier levels, consumers are confident that the economy will continue to expand in 2006.

After ending 2004 at 100.7, the Expectations Index declined to 93.7 by the end of the first quarter and rebounded slightly to 96.4 by the end of the second quarter. The decline in the Expectations Index throughout the first half

¹⁹ 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. TNS is the world's largest custom research company.

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 dramatically to 71.7 for September. The severe dip in September is likely the result of transitory factors stemming from the psychological impact of Hurricane Katrina. For the fourth quarter, the Expectations Index fell to 70.1 in October, rose to 88.4 in November and increased to 91.6 in December. This rebound in the Expectations Index likely stems from modest improvement in consumer expectations regarding economic performance in the wake of the hurricanes in the third quarter.

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. During the fourth quarter, those expecting conditions to improve during the next six months improved from 14.1% in October to 19% in November before retrenching to 18.1% in December. 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. During the fourth quarter, those expecting conditions to worsen improved from 18.5% in October to 11.5% in November to only 9.2% in December. Though the readings suggest that consumers had, over the first half of the year, become increasingly concerned about business conditions going forward, their expectations seems to have improved modestly during the second half. Consumers' concerns about business conditions in the next six months were further negatively impacted by the hurricanes in the third quarter. As consumers appeared to have considered the impact of the hurricanes to be a transitory factor, consumer expectations regarding the future business conditions generally improved and may continue to improve during the first quarter of 2006.

Consumers' assessment of current business conditions was mixed during the first and second quarters. With 24.4% of respondents characterizing current conditions as "good" in December 2004, this figure improved to 26.3% in March. By the end of the second and third quarters, those characterizing current conditions as "good" increased to 26.7% in June and fell to 25.2% in September. For the fourth quarter, 23.3% characterized conditions as "good" in October, rising to 25.6% in November and to 24.3% in

December. As the end of the first quarter, those characterizing conditions as “bad” stood at 15.8% in March. For the second and third quarters, 15.3% and 17.7% characterized conditions as “bad,” respectively. For the fourth quarter, 18.4% characterized conditions as “bad” in October with this figure decreasing to 17.9% in November and 14.7% in December.

Again, the improvement in the fourth quarter may be the result of consumers’ recognition 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 a temporary phenomenon rather than a sustained shift in consumers’ expectations regarding the economic outlook, the increased optimism may indicate that consumers have yet to recognize the actual long-term threats to economic growth stemming from factors such as the hurricanes, rising energy prices, increased interest rates, etc. As consumers become more cognizant of the risks to the economy, consumer confidence may fall and prompt consumers to restrain spending, which could have further detrimental impacts upon economic growth during 2006.

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. For the first quarter, industrial production, as compiled by the Federal Reserve²⁰, increased at an annual rate of 3.8% following an increase of 4.5% in the fourth quarter of 2004. For the second and third quarter, industrial production increased 1.6% and 1.4% at an annual rate²¹, following a trend of growth rates increasing at a decreasing rate. For the fourth quarter, industrial production increased at a stronger annual rate of 3.8%. This more favorable increase in industrial production is likely a result of the addition to inventories that businesses made during the fourth quarter in order to replenish stocks drawn down during the third quarter and in anticipation of robust holiday demand for goods. For the full year 2005, industrial production increased 2.8% over the 2004 level.

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. During the

²⁰ Industrial production data from the Federal Reserve’s Industrial Production and Capacity Utilization statistical release.

²¹ Quarterly industrial production figures based on revised data from the December 2005 Industrial Production and Capacity Utilization statistical release.

fourth quarter, industrial production increased 1.9% in October, 2.8% in November, and 2.8% in December on a year-over-year basis.

Manufacturing production increased at an annual rate of 4.5%, 1.3%, and 2.0% in the first three quarters of 2005, respectively. For the fourth quarter, however, manufacturing production increased by 7.9%. This strength in manufacturing is confirmed by anecdotal evidence contained in The Beige Book releases from the Federal Reserve during the fourth quarter which indicated generally favorable manufacturing gains throughout the twelve Districts. Manufacturing production increased by 5.2%, 4.7%, and 4.1% on a year-over-year basis in January, February, and March, respectively, and 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. For the fourth quarter, manufacturing production increased 3.2% in October, 3.9% in November, and 3.8% in December on a year-over-year basis.

Durable goods production, which increased by 1.7% in the first quarter, declined at an annual rate of 2.5% in the second quarter but surged by 10.8% in the third quarter, increased by 1.0% in the fourth quarter. Nondurable goods production, which increased by 1.0% in the third quarter following a 3.1% increase in the second quarter and a 2.7% increase in the first quarter, declined in the fourth quarter by 1.1%. Defense and space equipment production continued a robust production pattern, increasing by 8.9% in the fourth quarter compared with increases of 12%, 11.5%, and 5.8% in the first three quarters of 2005. Following a first quarter increase of 0.9%, construction supplies increased by 4.1% in the second quarter and by 4.7% in the third quarter before surging by 14.2% in the fourth quarter. This gain in construction supplies may be the result of continue new housing activity and increases in commercial construction.

On a quarterly basis, capacity utilization increased in the fourth quarter of 2005 to 80.2% as compared to 79.9% for the first and second quarter and 79.8% for the third quarter. Though capacity utilization increased slightly during the fourth quarter, this level of 80.2% remained 0.8% below the 1972 to 2004 average of 81%. However, the trend of increasing capacity utilization coincides with the increased activity in manufacturing activity evident through a number of other figures and resources. Manufacturing capacity utilization increased throughout 2005, increasing from 78.7% in the first quarter to 79.6% in the fourth quarter. This follows a slight decline to 78.5% in the second and third quarters. At 79.6%, capacity utilization in the fourth quarter is just shy of the 1972 to 2004 average of 79.8%.

The advance monthly sales for retail trade and food services in the fourth quarter released by the Department of Commerce²² continue to suggest modest economic activity. In December, retail and food service sales increased by approximately 0.7%²³ from November to \$357.8 billion. This gain in December follows a 0.8% increase in November and a 0.3% increase in October's figures. Total retail sales increased by 0.7% in December from the November level, 0.8% in November and 0.3% in October.

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. In the fourth quarter, total retail sales and food service increased 6.0% in October, 6.8% in November, and 6.4% in December.

For the fourth quarter, advance monthly retail and food service sales increased 0.6% from the third quarter. On a year-over-year basis, advance monthly sales for retail trade and food services increased 6.3% in the fourth quarter. 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.

After increasing 1.7% in the first quarter as compared to the fourth quarter of 2004 and by 7.8% on a year-over-year basis, total sales excluding motor vehicles and parts increased by 2.2% in the second quarter from the first quarter and by 8.3% on a year-over-year basis. For the third quarter, total sales excluding motor vehicles and parts increased 2.3% as compared to the second quarter and 9.1% on a year-over-year basis. For the fourth quarter, total sales excluding motor vehicles and parts increased 1.8% from the third quarter level and by 8.7% on a year-over-year basis. Sales of motor vehicles and parts declined by 3.8% in the fourth quarter as compared to the third quarter and by 1.8% from the fourth quarter of 2004.

²² Press release from the Department of Commerce.

²³ Adjusted for seasonal, holiday, and trading day differences but not for price changes. Removing the impact of prices changes/inflation, the growth figures would be lower. For example, total retail sales increased by 6.2% on a year-over-year basis during the fourth quarter. The twelve month inflation rate, based on the CPI, was 3.4% for the twelve months ending December 2005. This would imply a real growth in total retail sales of 2.8%. Removing the impact of food and energy prices from the CPI, the inflation rate would be 2.2%. This would imply a real growth in total retail sales of 4.0% for the fourth quarter.

For the fourth quarter, total retail sales increased 0.3% from the third quarter and by 6.2% on a year-over-year basis. This follows a 1.8% increase in the third quarter as compared to the second quarter and an 8.5% increase on a year-over-year basis from the third quarter 2004. 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.

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 quarters. As a result, manufacturing activity softened somewhat during the second quarter of 2005 but began to rebound during the third quarter. This increase in manufacturing activity continued at a favorable pace into the fourth quarter as businesses added to inventories in anticipation of a strong holiday shopping season. It could be expected that manufacturing activity may maintain a modest pace in the first part of 2006 as businesses adjust production to allow for the inventories drawn down during the fourth quarter to be replenished. However, with energy prices expected to remain elevated and interest rates continuing to rise, consumer confidence may be dampened and prompt a retrenchment in consumption expenditures. In addition, deterioration in the robust level of real estate activity and home price appreciation may further dampen consumer confidence and prompt increased saving by consumers. Overall, these factors tend to suggest that the slowdown in economic activity during the fourth quarter of 2005 may continue to foster weaker economic conditions into 2006.

Inflation

Following a 3.0% increase in the consumer price index (CPI)²⁴ during the fourth quarter of 2004 at a seasonally adjusted annual rate and increases of 4.3%, 1.9%, and 9.4% during the first, second, and third quarters of 2005, respectively, the CPI decreased by a compound annual rate of 1.6% in the fourth quarter. The third quarter increase in the CPI of 9.4% was roughly three times higher than the 3.3% increase for all of 2004. The decline in the CPI for the fourth quarter was likely a statistical aberration stemming from declines in the energy index during the fourth quarter. For 2005, the CPI increased by 3.4%, roughly in line with the 3.3% increase for 2004, but still higher than the 1.9% increase in 2003.

Following an increase of 0.1% in January, 0.4% in February, and 0.6% in March on a seasonally adjusted basis, the CPI increased by 0.5%, -0.1%, and 0.0%, in April, May, and June, respectively. In July, August, and September,

²⁴ Based on data from the Consumer Price Index press releases by the Bureau of Labor Statistics, United States Department of Labor.

the CPI increased by 0.5%, 0.5%, and 1.2%, respectively. For the fourth quarter, the CPI increased by 0.2% in October and declined by 0.6% and 0.1% in November and December, respectively. For the twelve months ending in December, the CPI increased at an annual rate of 3.4% as compared to an annual rate of 4.7% for the twelve months ending in September 2005.

For 2005, the energy index increased by 17.1% on a seasonally adjusted annual basis, as compared to a 16.6% increase for 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 fourth quarter, the energy index declined by 35.2%. For the first half of the year, the energy index increased by 14.1%; for the second half of the year, the energy index increased by 20%. Food prices during the year also increased, with the food index advancing at an annual rate of 2.3%, lower than the 2.7% annual rate for the full-year 2004. On a quarterly basis, the food index increased by 1.3% in the first quarter, 3.4% in the second, 1.9% in the third, and 3.0% in the fourth quarter.

Removing the effects of food and energy, the core CPI increased by 2.8% in the fourth quarter as compared to 1.4% in the third quarter, 1.2% in the second quarter, and 3.3% in the first quarter. The core CPI advanced at a rate of 2.2% for both 2004 and 2005. For the first half of 2005, the core CPI increased by 2.2%. For the second half of the year, the core CPI increased by 2.1%.

In addition to the CPI, the price index for personal consumption expenditures (PCE) from the BEA²⁵ rose by 2.6% in the fourth quarter as compared to increases of 2.3%, 3.3%, and 3.7% in the first, second, and third quarters, respectively. On a year-over-year basis, the PCE rose by 3.5%, 3.9%, 3.8%, and 3.0% in each of the four quarters of 2005. For the year, the price index for the PCE increased 2.8% as compared to 2.6% in 2004. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 2.5% for 2005 as compared to an increase of 2.4% in 2004. The PCE excluding food and energy prices increased 2.2%, 2.0%, 1.9%, and 1.9% in the first, second, third, and fourth quarters of 2005, respectively, on a year-over-year basis.

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 a more alarming rate in 2005 as compared to 2004, continuing a trend of relative price

²⁵ Bureau of Economic Analysis, Gross Domestic Product: Fourth Quarter 2005 (Advance) release, January 27, 2006.

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 may ultimately 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 and third quarters to an average 5.1% and 5.0%, respectively²⁶. For the fourth quarter, the unemployment rate remained at 5.0%. 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. In the fourth quarter, the unemployment rate was 4.9%, 5.0%, and 4.9% in October, November, and December, respectively.

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. For the fourth quarter, total nonfarm payroll employment increased by 25,000 in October, 305,000 in November, and 108,000 in December. Total nonfarm payroll employment increased by 438,000 for the quarter or an average of 146,000 per month.

Payroll gains in the quarter included increases in professional & business services and hospitality. Professional & business service employment's increased roughly 123,000 in the fourth quarter. The hospitality industry added 69,000 jobs in the fourth quarter. Manufacturing employment, which for the third quarter lost nearly 37,000 jobs as compared to the second quarter average employment, added approximately 39,000 in the fourth

²⁶ Bureau of Labor Statistics, United States Department of Labor, The Employment Situation press release.

quarter. Average manufacturing employment in the fourth quarter was 14,268,000 as compared to 14,258,000 in the third quarter.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment increased during the fourth quarter following mixed sentiments during the third quarter. Consumers expecting more jobs to become available in the next six months decreased in October to 12.3% from 14% in September, increased to 14.1% in November and remained virtually unchanged at 14.3% in December. Those expecting fewer jobs to become available fell to 24% in October from 24.8% in September and declined again in November and December to 18.1% and 18.0%, respectively.

Further increases in economic activity, even at a much slower rate, should provide a foundation for continued increases in payroll employment for the coming quarters in 2006. However, should continued high energy prices and rising interest rates negatively impact consumer sentiment, consumers' optimism regarding employment may deteriorate into the first half of 2006, particularly if businesses adjust payrolls to compensate for slower demand.

Equity Markets

After ending 2004 at roughly 10,850, the Dow Jones Industrial Average (DJIA) fell roughly 3% in the first quarter²⁷. The S&P 500 declined by 2.6% in the first quarter with the NASDAQ composite experiencing 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.

For the fourth quarter, the DJIA advanced 2.3% to end the year at 10,717.5. For the full year, however, the DJIA lost 1.3%. The S&P 500 increased 2.6% during the fourth quarter to end the year at 1,248.3 for a gain of 2.9% for 2005. The NASDAQ composite experienced the largest fourth quarter gain of 4.3% to end the year at 2,205.3, 1.3% higher on the year.

The mixed performance may have been a result of continued caution on the part of investors due to rising oil prices and the impact upon economic activity, uncertainty regarding geopolitical events, rising interest rates, increased inflation expectations prompting a flight to quality in government bonds, and the potential for higher returns in the real estate markets.

²⁷ Based on data from *The Economist*.

Concerns over corporate earnings may have been one factor weighing upon the equity markets. Wall Street analysts had anticipated that the fourth quarter would ensure that 2005 marked the longest sustained acceleration in corporate profits since World War II, with total profits of the S&P 500 index anticipated to increase 14% on a year-over-year basis as compared to a 16% increase in the third quarter over 2004. In addition, analysts expected profits to grow by roughly 15% in 2006—12.6% in the first quarter, 11.7% in the second quarter, and 14.9% in the third quarter²⁸. However, many leading blue chip companies announced disappointing earnings soon after the close of the quarter. Both General Electric and Citigroup missed growth expectations. General Electric's revenue growth was lower than anticipated, and Citigroup reported a 3% fall in income from continuing operations in the fourth quarter. Yahoo and Motorola also failed to meet market expectations. However, of the one hundred companies in the S&P 500 index that had reported, less than 25% had missed expectations²⁹.

A number of factors suggesting economic softness may serve to temper investors' outlook for the equity markets into 2006. 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 continued 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 were more stable during the fourth quarter, fluctuating in a band from \$56 to \$64. This comes after significant increases earlier in the year. 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 \$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

²⁸ "Corporate America's earnings boom set to go on," Dan Roberts, *The Financial Times*, January 9, 2006.

²⁹ "Poor earnings weigh on Wall St," Dan Robert & David Wighton (New York), Richard Waters (San Francisco), *The Financial Times*, January 21, 2006.

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, Austria³⁰, 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 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

³⁰ OPEC press release following the 137th Meeting of the OPEC Conference in Vienna, Austria on September 20, 2005.

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."³¹

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 stability³². 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 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

³¹ "Soaring oil will hurt spending, says Wal-Mart," Jonathan Birchall, *The Financial Times*, August 17, 2005.

³² Statement on oil market stability by the Organization of the Petroleum Exporting Countries, September 24, 2005.

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.

In analyzing the impact of increased oil prices upon the United States' economy in the aftermath of Hurricanes Katrina and Rita, Alan Greenspan stated the following in testimony before the Joint Economic Committee on November 3, 2005:

... Crude oil prices moved sharply higher in August, bid up by growth in world demand that continued to outpace the growth of supply. Then Hurricane Katrina hit the Gulf Coast at the end of August, causing widespread disruptions to oil and natural gas production and driving the price of West Texas Intermediate crude oil above \$70 per barrel. Because of a lack of ready access to foreign supplies, natural gas prices rose even more sharply. At the end of September, with the recovery from the first storm barely under way, Hurricane Rita hit, causing additional damage and destruction--especially to the energy production and distribution systems in the Gulf...

Of course, the higher energy prices caused by the hurricanes are being felt well beyond the Gulf Coast region. Those higher prices resulted from the substantial damage that occurred to our nation's energy production and distribution systems. Of the more than 3,000 oil and gas production platforms in the paths of Katrina and Rita, more than 100 were destroyed, and an additional 50 suffered extensive damage. Of the 134 manned drilling rigs operating in the Gulf, 8 were lost, and an additional 38 were either set adrift by the storms or were badly damaged. At present, both oil and natural gas production in the Gulf are operating at less than 50 percent of pre-Katrina levels. Since the first evacuations of oil and gas facilities were ordered before Katrina, cumulative shortfalls represented almost 4 percent of the nation's annual production of crude oil and 2 percent of our output of natural gas.

The combination of flooding, wind damage, and a lack of electric power also forced many crude oil refineries and natural gas processing plants to shut down. The restoration of production at the affected natural gas processing facilities has proceeded particularly slowly, in part because of the lack of natural gas feedstocks and infrastructure problems. Most refineries, however, will be back on line within the next month or so, though a few may take longer...

Releases from the nation's Strategic Petroleum Reserve relieved much of the upward pressure on crude oil prices, and imports of refined products responded rapidly to ease the price pressures stemming from the loss of refinery production in the Gulf. As a consequence, the nationwide retail price of gasoline for all grades has declined 60 cents per gallon from its peak of \$3.12 per gallon in the week of September 5. Motorists appear to have economized on their driving, and gasoline demand appears to be off a bit. However, it will take time and an appreciable increase in the fuel economy of our stock of motor vehicles to fundamentally change the amount of motor fuel used on our nation's highways...

The disruptions to energy production have noticeably affected economic activity. We estimate that the storms held down the increase in industrial production 0.4 percentage point in August and an additional 1.7 percentage point in September.

At its December 12, 2005 meeting in Kuwait City, Kuwait³³, OPEC members agreed to maintain current production levels of 28 million barrels per day. In its press release, OPEC indicated the following:

Having reviewed the oil market situation, the Conference observed that the market has been well supplied and commercial stocks, especially of crude oil, have been building, in terms of absolute levels and forward days' cover. This is due to OPEC's prompt responses and willingness to provide the market, if and when needed, with the required supplies.

The Conference further considered the outlook for 2006 and noted that the ceiling adopted by OPEC in its 136th (Extraordinary) Meeting in June 2005 of 28.0 mb/d (excluding Iraq) will be adequate, if fully observed, to balance the market for the first quarter of the year. However, in view of the supply/demand outlook for the second and third quarters 2006, when demand is seasonally lower, thus requiring reduced supplies from OPEC to balance the market, the Conference decided to convene an Extraordinary Meeting in Vienna, Austria, on 31 January 2006, in order to review the situation and take the appropriate decisions on production levels for the second and third quarters of the year. The Conference also reconfirmed that its next Ordinary Meeting will convene in Vienna, Austria, on 8 March 2006.

In taking the foregoing decision, the Conference reaffirmed the Organization's determination to take all measures deemed necessary to keep market stability and maintain prices at reasonable levels through the

³³ OPEC press release following the 138th (Extraordinary) Meeting of the OPEC Conference in Kuwait City, Kuwait on December 12, 2005.

provision of adequate supplies, as it has demonstrated repeatedly in the past, including the recent offer to make its additional capacity of 2.0 mb/d available for three months, an offer that expires on 31 December 2005 and which, the Conference noted, had not been taken up by the market because it is so well-supplied.

In addition to this, Sheikh Ahmad Fahad Al-Ahmad Al-Sabah, President of the OPEC Conference and Minister of Energy for Kuwait, indicated that there would be sufficient spare capacity to meet increased demand in the winter months. Further, he stated:

...OPEC's spare capacity will reach the comfortable level of around 2.5 million barrels a day by the end of this year, and we expect to add another million barrels per day capacity in 2006; much of this will come in the form of light and medium crudes, which are heavily in demand. OPEC is ready to bring this capacity on-stream at short notice, should the market require it. With additional supplies of 1.2–1.4 mb/d expected from non-OPEC, this means that the total growth in capacity next year will far exceed the forecast rise in world demand, of around 1.5 mb/d

OPEC ministers also remained confident that oil prices would average \$50 per barrel for 2006³⁴. This estimate comes even as oil stocks began to rise in the United States. However, several refineries in the United States have been working overtime to fill the gap created by the closure of refineries in Louisiana and Texas in the aftermath of the hurricanes in the third quarter. Those refineries that have been working overtime will be forced to shut in early 2006 in order to perform critical maintenance that has been delayed in order to keep supplies of oil flowing to U.S. markets. The closure of these refineries may cause a slight boost in oil prices should energy stocks not be enough to satisfy demand in the coming quarters and should other refineries be unable to produce enough supplies.

It is likely that elevated energy prices contributed to the softness in economic activity in the fourth quarter of 2005. Continued robust 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 may result in short-term price spikes in excess of \$70 or \$80 per barrel. This could have a significant adverse impact upon global economic growth and U.S. economic activity. Based on other information, it appears that many

³⁴ "OPEC is confident oil will stay over \$50," Carola Hoyos, *The Financial Times*, December 12, 2005.

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 remain 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 136.2³⁵ and showed improvement during the second quarter, increasing to 138³⁶. In the third quarter, the leading index decreased 0.1% in July, remained flat in August, and decreased 0.7% in September to end the quarter at 135.9. For the fourth quarter, the leading index increase 1.0% in October, 0.9% in November, and 0.1% in December. The leading index ended the quarter at 138.5. From June to December of 2005, the leading index increased 1.0%. For 2005, the average six-month growth rate of the leading index was roughly 1.9% as compared to an average of 6.2% in 2004. The strengths and weaknesses in the leading index were roughly balanced throughout 2005, though strength among the indicators was more widespread during the latter part of the year. This implies that economic growth should continue at a moderate pace in the near term.

In the *Monetary Policy Report to the Congress* released in July 2005, the Federal Reserve Board of Governors and Federal Reserve Bank Presidents projected that real GDP would 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 was expected to range from 1 ½%-2 ¼% in 2005 and from 1 ½%-2 ½% in 2006. The civilian unemployment rate was anticipated to range from 5%-5 ¼% in 2005 and roughly 5% in 2006.

Forecasters at The Conference Board expect real GDP growth of 2.9% in 2006. CPI inflation is expected to equal roughly 4% for 2006. The unemployment rate is forecast at 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 spending³⁷. Mr. Santomero indicated that the U.S. economy was growing at a healthy pace

³⁵ From The Conference Board's February 17, 2005, March 17, 2005, & April 21, 2005 press releases for US Leading Economic Indicators.

³⁶ From The Conference Board's November 21, 2005 press releases for US Leading Economic Indicators.

³⁷ "Fed official expects recovery after storms," Andrew Balls, *The Financial Times*, September 30, 2005.

prior to the storms but conceded that the hurricanes would contribute to 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.

In testimony before the Joint Economic Committee on November 3, 2005, Alan Greenspan, Chairman of the Federal Reserve, indicated that the long-term prospects for the U.S. economy remained favorable³⁸. Economic growth could be boosted by continued structural productivity growth and reconstruction in the Gulf states following the hurricanes. However, Chairman Greenspan indicated that there was uncertainty regarding inflation expectations going forward.

Based on the current assessment of a number of economic factors, the previously solid foundation for economic growth appears to have been threatened by the adverse systemic impact of elevated energy prices. Continued high energy prices, acting as a tax upon consumers, along with rising interest rates and weaker real estate activity could 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 could precipitate slower economic growth. A severe weakening of the real estate market could 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 may be at a much more tempered pace 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:

- 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.

³⁸ Testimony of Chairman Alan Greenspan, *The Economic Outlook*, Before the Joint Economic Committee, U.S. Congress, November 3, 2005.

- Oil prices are expected to remain at elevated levels throughout 2006, 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 fourth quarter, manufacturing activity and industrial production may be tempered in the first quarter of 2006.

Our expectations for the economy include:

- Real GDP growth of 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 2006 at roughly 5%.
- Inflation is likely to increase in 2006 with the core CPI increasing by roughly 2% - 2 ½%.
- As economic activity becomes more tempered, payroll employments are likely to increase at a lower rate. It is possible that the economy will generate increases in payroll employment of 100,000 per month on average for the year. Unemployment, then, is likely to fall to roughly 4 ¾% for 2006.
- 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 in the coming quarters of 2006. 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 2006. Oil prices are likely to remain at elevated levels throughout the first half of 2006, trading in a range of \$55-\$70 per barrel.

On the other hand, there are a number of risks to the economy in 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 a surprisingly firm third quarter, economic activity expanded at a paltry rate in the fourth quarter of 2005 with real GDP advancing by 1.1%. This slowdown in economic activity was likely the result of lingering impacts from the hurricanes that created significant economic displacement in the Gulf region late in the third quarter. Though personal consumption expenditures remained positive, the significant slowdown in one of the engines of economic growth may be an indicator of a tightening of the financial belts of consumers. Oil prices remained at elevated levels during the fourth quarter, with several oil refineries along the U.S. Gulf coast still closed following Hurricanes Katrina and Rita. Continuing high energy prices and rising interest rates are likely to create uncertainty regarding future economic growth in the first half of 2006. In addition, inflationary pressures, though contained, still present a great deal of uncertainty to the economic prospects. Based on the state of the economy in the fourth quarter, conditions are likely to foster tepid economic activity in the first half of 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.