Value Highlights™

Electronic Newsletter for Company Principals and Trusted Business Advisors

Volume 2006-07 ► July 2006
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State of the Economy 2nd Quarter 2006

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Introduction

Economic activity finally began to exhibit additional signs of significant slowing in the second quarter after mixed signals from various economic data indicators and strong economic growth during the first quarter. Real gross domestic product (GDP) increased at an annual rate of 2.5% in the second quarter following an increase of 5.6% at an annual rate during the first quarter of 2006. These figures compare to an increase of 1.8% in the fourth quarter of 2005 and an increase of 3.2% for the full year 2005 on a revised basis. The slowdown in real GDP comes at a time of continued high energy prices and further tensions stemming from geopolitical risks. These factors likely weighed on consumers who reigned in spending during the second quarter. In addition, economic activity was restrained due to decreases in federal spending and real residential fixed investment as well as significant slowdowns in real nonresidential fixed investment and exports of goods and services.

Higher energy prices, which likely had an adverse impact upon consumer sentiment and which contributed to increased inflationary pressures, continue to be a trend that may contribute to further economic softening in the coming quarters. To be sure, the economy in the remainder of 2006 is likely to exhibit signs of slowing, with growth advancing at a rate below the long-term sustainable rate of growth for the economy.

Gross Domestic Product

Advance estimates[i] released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 2.5% during the second quarter following a revised increase of 5.6% in the first quarter. This increase in GDP is lower than the 3.3% increase in real GDP in the second quarter of 2005[ii]. Economic growth during the quarter was below the consensus forecast of 3.4% (unchanged from 3.4 % anticipated when surveyed during the first quarter) annual growth in real GDP anticipated by fifty-three forecasters surveyed by the Federal Reserve Bank of Philadelphia[iii]. The consensus forecast is for a 3.1% increase in real GDP in the third quarter and an increase of 3.4% for the full year. Real GDP increased at an annual rate of 3.2% in 2005 as compared to an increase of 3.9% in 2004 and 2.5% in 2003.

Real personal consumption expenditures, which accounts for about two-thirds of economic activity, weakened in the second quarter of 2006, increasing by 2.5% as compared to a 4.8% increase in the first quarter and a 0.8% increase in the fourth quarter. This advance in real personal consumption expenditures in the first quarter is the slowest pace of increase since the first quarter of 2005 during which real personal consumption expenditure increased by 2.7%. Following an increase of 19.8% in the first quarter, purchases of durable goods decreased by 0.5% in the second quarter. This decrease in purchases of durable goods was due to a roughly 1% decrease in expenditure on motor vehicles and parts as compared to a 5% increase in the first quarter. This decrease in purchases of motor vehicles may be attributed to weakened consumer sentiment and restrained spending in light of generally tepid economic conditions. This slowdown in purchases of motor vehicles comes despite reintroduction of sales incentives by automobile manufacturers. Purchases of furniture and household equipment decreased by roughly 0.1% in the second quarter as compared to a 4.2% increase in the previous quarter.

Data from the Federal Reserve Beige Books released in the second quarter indicated that several of the Federal Reserve Districts noted that retail sales had been disappointing overall during the observation period. Sales were characterized as weak amongst the big box retailers, restrained by continued elevated gasoline prices. The trend towards more fuel efficient vehicles in light of the elevated energy prices and preference for foreign brands over domestic automobiles continued during the second quarter.

Personal consumption expenditures on nondurable goods increased by 1.7% during second quarter as compared to 5.9% during the first quarter and 5.0% during the fourth quarter. After showing signs of strength during the first quarter, retail sales weakened during the second quarter, increasing at a modest pace over the prior year. Some retailers characterized the growth in sales as disappointing or below expectations, according to the Beige Book reports. The strength in retail sales during the first quarter may have been a result of the redemption of holiday gift cards. The weakness in retail sales during the second quarter may have been the result of continued high energy prices and gasoline prices that served to squeeze household finances and restrain spending.

Real nonresidential fixed investment increased at a 2.7% rate in the second quarter as compared to a 13.7% rate in the first quarter and a 4.5% increase in the fourth quarter. Equipment and software investment activity, which increased by 5% in the fourth quarter and by 15.6% in the first quarter, decreased by 1.0% in the second quarter.

Following increases of $43.5 billion in the fourth quarter and $41.2 billion in the first quarter, private businesses increased inventories by $52.6 billion in the second quarter. The second quarter real change in inventories added 0.4% to the change in real GDP as compared to subtracting 0.03% from the first quarter change in real GDP. This increase in inventories may tend to suggest that businesses continued to increase inventory stocks that had been drawn down during the fourth quarter holiday season and during the first quarter. Businesses may also have increased inventory levels in anticipation of increased demand in coming quarters. With the slowing in consumer spending that began to emanate during the second quarter, businesses may begin to cut back production and reduce inventory build-ups in order to allow inventory levels to come in line with reduced demand expectations.

Real residential fixed investment which increased by 2.8% in the fourth quarter of 2005, decreased in the first and second quarters of 2006 by 0.3% and 6.3%, respectively. This lower growth rate is likely indicative of a continued slowing in real estate activity, consistent with the deflating of the real estate bubble that existed. This decrease in real residential fixed investment is likely the result of continued removal of accommodative monetary policy by the Federal Reserve and a subsequent increase in mortgage rates along with more cautious lending by financial institutions for real estate transactions and adverse pressures on consumer finances due to continued high energy prices.

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 weaken in the second quarter. Privately-owned housing units authorized by building permits ended the fourth quarter at 2,075,000. For the first quarter, new privately-owned housing units authorized by building permits advanced in January to 2,195,000 before falling to 2,147,000 in February and 2,085,000 in March. For the second quarter, new privately-owned housing units authorized by building permits continued to decline, falling to 1,973,000 in April, 1,946,000 in May, and 1,862,000 in June. As a result, new privately-owned housing units authorized decreased on a year-over-year basis by 8.5% in April, 7.8% in May, and 14.9% in June.

Privately-owned housing starts, which ended the fourth quarter at 1,989,000 (below the 2,160,000 level at the end of the third quarter), increased in January to 2,265,000 then declined in February and March to 2,132,000 and 1,972,000, respectively. In the second quarter, privately-owned housing starts decreased in April to 1,832,000, rebounded to 1,953,000 in May, then declined again in June to 1,850,000. On a year-over-year basis, housing starts declined in April by 11.9%, 4% in May, and by 11% in June.

Sales of new and existing homes, which had decelerated during the first quarter, continued to slow during the second quarter of 2006. Data from the National

Association of Realtors (NAR) [iv] indicates that, after ending December at 6,750,000 units on a seasonally adjusted annualized basis (down from 7,200,000 in September), existing home sales continued to decline in January, falling to 6,570,000. Existing home sales rose to 6,900,000 in February and 6,900,000 in March. On a year-over-year basis, sales of existing homes decreased 1% in March and by 8.9% in June. The inventory of existing homes on the market continued to increase during the second quarter to 3,730,000 as compared to 3,194,000 in March. As a result, the backlog of existing homes increased further from 5.1 months in December to 5.5 months in March to 6.8 months in June. New home sales also declined in the first quarter of 2006, falling in January to 1,197,000, in February to 1,038,000, and increasing sharply in March to 1,121,000. On a year-over-year basis, however, new home sales in March declined roughly 7%. For the second quarter, new home sales remained steady at 1,121,000 in April, 1,130,000 in May, and 1,120,000 in June. Through the end of the first half of the year, new home sales were roughly 14% lower on a year-over-year basis. The inventory of new homes also continued to increase to 6.5 months supply in June as compared to a 5.5 months supply in March. This is a sharp increase from the prior year's level of 4.3 months.

The national median sales price of all existing homes fell from $222,000 in December to $218,000 in March, lower than the high of $229,000 first set in June 2005. For the full year 2005, the median price was $219,600. The median price of new homes was $224,000 in March, a decline of 2% in the last year. By June, the national median sales price of existing homes had trended upwards to roughly $230,000, an increase of 0.9% on a year-over-year basis[v].

Ben Bernanke, Chairman of the Federal Reserve, suggested that the real estate markets were likely experiencing a period of cooling activity, stating in testimony to the Committee on Financial Services, U.S. House of Representatives, on February 15, 2006 upon delivering the *Semiannual Monetary Policy Report to the Congress*[vi]:

> *…Some cooling of the housing market is to be expected and would not be inconsistent with continued solid growth of overall economic activity. However, given the substantial gains in house prices and the high levels of home construction activity over the past several years, prices and construction could decelerate more rapidly than currently seems likely. Slower growth in home equity, in turn, might lead households to boost their saving and trim their spending relative to current income by more than is now anticipated…*
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> *…However, as I have already noted, some signs of slowing in the housing market have appeared in recent months: Home sales have softened, the inventory of unsold homes has risen, and indicators of homebuilder and homebuyer sentiment have turned down. Anecdotal information suggests that homes typically are on the market somewhat longer than they were a year or so ago, and the frequency of contract offers above asking prices reportedly has diminished. Financial market conditions seem to be consistent with some moderation in housing activity…Thus, at this point, a leveling out or a modest*

> *softening of housing activity seems more likely than a sharp contraction, although significant uncertainty attends the outlook for home prices and construction.*

Chairman Bernanke reiterated this position of cooling activity in the real estate markets in testimony to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on July 19, 2006 upon delivering the *Semiannual Monetary Policy Report to the Congress*[vii]:

> *Outlays for residential construction, which have been at very high levels in recent years, rose further in the first quarter. More recently, however, the market for residential real estate has been cooling, as can be seen in the slowing of new and existing home sales and housing starts. Some of the recent softening in housing starts may have resulted from the unusually favorable weather during the first quarter of the year, which pulled forward construction activity, but the slowing of the housing market appears to be more broad-based than can be explained by that factor alone. Home prices, which have climbed at double digit rates in recent years, still appear to be rising for the nation as a whole, though significantly less rapidly than before. These developments in the housing market are not particularly surprising, as the sustained run-up in housing prices, together with some increase in mortgage rates, has reduced affordability and thus the demand for new homes.*

The Beige Books released on January 18, 2006, March 15, 2006 and April 26, 2006 indicated moderation in residential real estate activity in most of the twelve Districts during the first quarter, following some cooling of activity 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. However, residential construction was mixed throughout with country, with continued strong activity in the West and South. Kansas City, Minneapolis, St. Louis, and Chicago all noted slower residential construction activity. Condominium projects throughout the South were put on hold during the first quarter as demand for condos remained soft.

The Beige Books released on June 14, 2006 and July 26, 2006 confirm earlier reports of a slowing in real estate activity. Most of the Districts reported slower homebuilding and sales of existing homes. Only Dallas and Richmond indicated that activity remained strong during the first half of the second quarter. Condominium sales showed weakness in many Districts, with projects in the Atlanta District being cancelled due to lack of interest. By the end of the second quarter, only St. Louis and Dallas indicated resilience in the real estate markets. Overall, the data included in the Beige Books from the second quarter continue to confirm signs of weakening real estate markets, a trend that originally began to manifest in the third quarter of 2005.

Thirty-year conventional mortgage rates, according to Freddie Mac[viii], rose slightly during the first quarter from 6.27% at the end of 2005 to a high of roughly 6.37% in early March before ending the quarter at 6.35%. By mid-April, thirty-year rates had increased further to 6.49%. Thirty-year rates continued to climb during the second quarter, reaching a high of 6.78% on June 29, 2006. After ending the fourth quarter at approximately 5.82%, fifteen-year mortgage rates increased to 6.00% by early March. After ending the first quarter at 6.00%, fifteen-year rates increased further to 6.14% by mid-April. By the end of the second quarter, fifteen-year rates had risen to 6.43%.

The rise in mortgage rates coincides with U.S. Treasury yields on the 10-year note, which increased from 4.39% at the end of December 2005 to 4.53% by the end of January. By the end of the first quarter, the yield on the 10-year note had increased to 4.86%. The yield continued to increase through mid-April to roughly 5%. The yield reached a high of 5.19% in mid-May before falling to 4.97% in early June. By the end of the second quarter, the yield on the 10-year note had increased again to 5.15%. By the end of the fourth quarter, the yield curve had inverted with the two-year yield rising just slightly above the yield on the ten-year note[ix]. Though this inversion was reversed in early January, the yield curve inverted once again by the middle of the month before reversing by the end of January. The yield curve remained virtually flat during the remainder of the first quarter. During the second quarter, the yield curve inverted again in early June and remained inverted or flat for the duration of the second quarter.

The Federal Reserve's removal of accommodative monetary policy in the second quarter may also contribute to further slowing of real estate activity in the coming quarters. The adverse impact rising mortgage rates may have upon speculators in the real estate markets and investors who have committed to degrees of leverage which they may not be able to service could have the effect of continuing to remove some of the "froth" in certain local real estate markets throughout the U.S. However, this may create certain increased risks for investors and holders of debt secured by real estate which could translate into heightened dangers for the economy as a whole should investors in real estate be squeezed out of the market and be forced to sell properties at reduced prices.

Following a revised increase of 5.1% in the fourth quarter and 14% in the first quarter, real exports of goods and services for the second quarter increased at a more modest rate of 3.3%. Imports, a subtraction from GDP, increased 0.2% in the second quarter as compared to an increased of 9.1% in the first quarter and a 12.1% increase in the fourth quarter of 2005.

The dollar/sterling ($/£) exchange rate ended 2005 at $1.75, stronger than at the beginning of 2005 when the exchange rate was roughly $1.92. During the first quarter, the dollar weakened to $1.79 against the pound sterling by the end of January before gaining to end the quarter at $1.72. During the second quarter, the dollar weakened further to $1.89 by the end of May before gaining slightly to end the quarter at $1.82. The dollar/euro ($/€) exchange rate was $1.35 at the end of the fourth quarter of 2004 and $1.20 at the end of the fourth quarter of 2005. During the first quarter of 2006, the dollar weakened to $1.22 against the euro by the end of January. By the end of the quarter, the dollar had strengthened to $1.20. The dollar weakened against the euro during the second quarter to $1.28 by the end of May before rising to $1.25 by the end of the June. At the end of 2005, the yen/dollar (¥/$) exchange rate stood at ¥116.

During the first quarter of 2006, the dollar continued to gain strength against the yen. By early February, the dollar had strengthened to ¥119[x] before retrenching slightly to ¥118 by the end of the quarter. During the second quarter, the dollar weakened to ¥111 around the end of May before rising slightly to ¥116 by the end of June.

The initial weakening of the dollar during January may have been the result of weak economic data for the fourth quarter. As growth expectations were revised upwards and expectations for a rebound in economic activity began to manifest mid-quarter, investors may have had renewed confidence in prospects for economic growth in the U.S. This may have prompted the strengthening of the dollar late in the first quarter. However, this strength of the dollar was short-lived, particularly in light of weaker economic activity during the second quarter and lower growth expectations and higher inflation expectations going forward.

However, the U.S. current account deficit remains a significant threat to the strength of the dollar. For the first quarter of 2006, the current account deficit decreased to $208.7 billion from $223.1 billion in the fourth quarter of 2005. The current account deficit was $185.4 billion in the third quarter of 2005 and $805 billion for the full year[xi]. To be sure, continued rapid rises in the current account deficit are unsustainable in the long-term. In order to reduce the current account deficit, U.S. exports would have to increase by upwards of 70% or the dollar would have to depreciate significantly accompanied by a sharp reduction in domestic demand. With foreigners acquiring U.S. assets in order to satisfy the U.S. consumption of imported goods, there is a great risk to economic growth stemming from reliance upon foreigners' continued willingness to fund the current account. Should the proclivity of foreign investors towards dollar denominated assets fall, the dollar would likely weaken significantly and interest rates would be forced to rise significantly in order to attract investment in U.S. financial assets.

After increasing by 8.8% in the first quarter, real federal government consumption expenditures decreased by 3.4% during the second quarter. This compared to a decrease of 2.6% in the fourth quarter of 2005. National defense spending, which increased by 8.9% in the first quarter as compared to a decrease of 8.9% in the fourth quarter, decreased 1.0% in the second quarter. Nondefense spending decreased 7.8% after an increase of 8.5% in the first quarter.

The Federal Reserve

The Federal Reserve's gradual removal of monetary policy accommodation continued during the second quarter of 2006, with the Federal Open Market Committee (FOMC) increasing the federal funds rate to 5 ¼%[xii].

At its meeting on January 31, 2006, the final meeting chaired by Alan Greenspan, the FOMC agreed its fourteenth twenty-five basis point increase in the target for the federal funds rate to 4 ½%[xiii]. The FOMC stated that it believed economic activity remained solid, with core inflation remaining relatively low and long-term inflation expectations contained. The Committee also judged that resource utilization increases and continued high energy prices could add to inflationary pressures. The Committee further concluded that further policy firming could be necessary.

At its meeting on March 28, 2006, the first chaired by Ben Bernanke, the FOMC agreed another twenty-five basis point increase in the target for the federal funds rate to 4 ¾%[xiv]. The Committee indicated the following:

The slowing of the growth of real GDP in the fourth quarter of 2005 seems largely to have reflected temporary or special factors. Economic growth has rebounded strongly in the current quarter but appears likely to moderate to a more sustainable pace. As yet, the run-up in the prices of energy and other commodities appears to have had only a modest effect on core inflation, ongoing productivity gains have helped to hold the growth of unit labor costs in check, and inflation expectations remain contained. Still, possible increases in resource utilization, in combination with the elevated prices of energy and other commodities, have the potential to add to inflation pressures.

The Committee judges that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives.

…Still, possible increases in resource utilization, in combination with the elevated prices of energy and other commodities, have the potential to add to inflation pressures.

At the May 10, 2006 meeting, the FOMC increased the federal funds rate by twenty-five basis points to 5%[xv] and indicated the following:

Economic growth has been quite strong so far this year. The Committee sees growth as likely to moderate to a more sustainable pace, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices.

At its June 29, 2006 meeting the FOMC agreed another increase in the federal funds rate to 5 ¼%[xvi], the Committee's seventeenth consecutive increase. The Committee reiterated that the cooling housing market and effects of interest rate increases and higher energy prices had contributed to the gradual cooling in economic activity. With respect to inflation, the Committee indicated the following:

Readings on core inflation have been elevated in recent months. Ongoing productivity gains have held down the rise in unit labor costs, and inflation expectations remain contained. However, the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures.

> *Although the moderation in the growth of aggregate demand should help to limit inflation pressures over time, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support attainment of its objectives.*

In the *Monetary Policy Report to the Congress*, released July 19, 2006, the Federal Reserve policymakers indicated that the economy was transitioning from a period of growth that is above the long-run sustainable rate to a more moderate and sustainable rate. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3 ¼%-3 ½% (central tendency) in 2006 as compared to real GDP growth of 3.5% in 2005[xvii]. Real GDP is expected to increase by 3%-3 ¼% in 2007. The personal consumption expenditures chain-type price index (the Federal Reserve's preferred measure of inflation) excluding food and energy is expected between 2 ¼%-2 ½% in 2006, as compared to the 1.9% increase in 2005. For 2007, the PCE index excluding food and energy is expected to be 2%-2 ¼%. The civilian unemployment rate is anticipated to range from 4 ½%-5% in 2006, against 5% for 2005, and 4 ¼%-5 ¼% in 2007.

In testimony accompanying delivery of the *Semiannual Monetary Policy Report to the Congress* before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on July 19, 2006 Chairman Ben Bernanke indicated the following:

> *The U.S. economy appears to be in a period of transition. For the past three years or so, economic growth in the United States has been robust. This growth has reflected both the ongoing re-employment of underutilized resources, as the economy recovered from the weakness of earlier in the decade, and the expansion of the economy's underlying productive potential, as determined by such factors as productivity trends and growth of the labor force. Although the rates of resource utilization that the economy can sustain cannot be known with any precision, it is clear that, after several years of above-trend growth, slack in resource utilization has been substantially reduced. As a consequence, a sustainable, non-inflationary expansion is likely to involve a modest reduction in the growth of economic activity from the rapid pace of the past three years to a pace more consistent with the rate of increase in the nation's underlying productive capacity. It bears emphasizing that, because productivity growth seems likely to remain strong, the productive capacity of our economy should expand over the next few years at a rate sufficient to support solid growth in real output.*

> *As I have noted, the anticipated moderation in economic growth now seems to be under way, although the recent erratic growth pattern complicates this assessment. That moderation appears most evident in the household sector. In*

particular, consumer spending, which makes up more than two-thirds of aggregate spending, grew rapidly during the first quarter but decelerated during the spring. One likely source of this deceleration was higher energy prices, which have adversely affected the purchasing power of households and weighed on consumer attitudes.

The impact of higher energy prices is likely to continue to be felt for quarters to come. Inflation is likely to feel continued upward pressures, 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 remain well oiled, they are unlikely to continue running at a robust pace in the short-term, particularly under the burden of higher energy prices, rising interest rates, mounting inflationary pressures and the attending impacts these factors have upon consumer sentiment and consumption.

The Federal Reserve Beige Books[xviii] released on May 10, 2006 and June 14, 2006 confirmed the slowdown in economic activity throughout the twelve Districts[xix] that characterized the second quarter. The Beige Book conclusions included the following:

- Consumer spending increased at a more modest rate with noticeable signs of weakness. High gasoline prices and rising interest rates were cited as possible causes for the softness in consumer spending. Retail inventories were characterized as being at desired levels throughout the country. Automobile sales were characterized as weak with vehicle inventories remaining above desired levels.

- Manufacturing activity expansion was strong once again, though more Districts indicated signs of some softening in activity. Activity in production of goods for the energy, semiconductor and aerospace industries exhibited strength in many Districts. Demand for building supplies was weak in several Districts.

- Residential real estate activity continued to cool during the second quarter, continuing a trend that was evident earlier in the year. Most Districts noted slowing home sales and homebuilding as well as a deceleration in price appreciation. Commercial real estate activity continued to exhibit strength, following the trend that originally began during the third quarter of 2005. Demand for office space continued to edge up throughout many Districts, though rising construction costs had prompted a scaling back or redesign of anticipated projects.

- Gains in employment figures prompted a slight tightening of labor markets throughout the country. There were some shortages of skilled workers noted in many Districts. Wage pressures had intensified in some Districts, particularly for skilled positions, since the previous quarter.

Consumer Confidence

The Conference Board's Consumer Confidence Index[xx] ended 2005 at 103.8 and continued the strengthening trend in the first quarter, rising to 106.8 in January, 102.7 in February, and 107.5 in March. At the end of the first quarter, the Consumer Confidence Index had risen to the highest level in nearly four years. Lynn Franco, Director of The Conference Board's Consumer Research Center, indicated the following with respect to the consumer confidence figures:

> *The improvement in consumers' assessment of present-day conditions is yet another sign that the economy gained steam in early 2006. Consumer expectations, while improved, remain subdued and still suggest a cooling in activity in the latter half of this year.*

During the second quarter, the Consumer Confidence Index rose slightly in April to 109.8, declined significantly to 104.7 in May, and improved modestly to 105.4 in June. After reaching a four year high in April, consumers' concern regarding the short-term outlook for the economy and labor markets prompted the retrenchment in May. This is likely a result of the incoming economic data that dampened consumers' spirits regarding the strength of economic activity.

After ending 2005 at 92.6, the Expectations Index declined to 92.1 in January and 84.2 in February before rising to 90.3 in March. The decline in the Expectations Index during the first quarter may be attributed to consumers' anticipation of slowing economic growth and less favorable jobs prospects. The drop to 84.2 in February placed the Expectations Index at its lowest level in three years, with the exception of the two months following Hurricane Katrina. During the second quarter, the Expectations Index followed a pattern similar to that of the Consumer Confidence Index—rising slightly in April to 92.3, falling to 85.1 in May and improving slightly to 87.5 in June. The fall in the Expectations Index likely suggests the potential for continued slowing of economic activity in the second half of the year.

Consumers' outlook for the next six months was less favorable during the first quarter. In January, February, and March, 17.9%, 16.2%, and 17.8%, respectively, expected business conditions to improve in the next six months. Those expecting conditions to worsen decreased in March to 9.8% from 10.9% in February and 10.5% in January. In the second quarter, consumers expecting conditions to improve in the next six months stood at 17.3% in April, 16.5% in May, and 16.8% in June. Those expecting conditions to worsen in the second quarter decreased in April to 9.3%, increased in May to 12.9% and decreased in June to 11.8%.

Consumers' assessment of current business conditions was mixed during the first quarter. With 24.4% of respondents characterizing current conditions as "good" in December 2005, this figure improved to 25.9% in January, 26.4% in February, and 27.9% in March. Those characterizing conditions as "bad" stood at 14.9% in December 2005. In January, February, and March, 15.9%, 15.4%, and 14.7% characterized conditions as "bad," respectively. In April, May, and June, 29.7%, 28.5%, and 26.6% characterized conditions as "good," a slight drop from the end of the first quarter. Those characterizing conditions as “bad” stood at 15.1% in April, 15.2% in May, and 15% in June. These figures are higher than at the end of the first quarter but slightly below the levels gauged earlier in the year.

The improvement in the first quarter may have been the result of momentum in consumer confidence that paralleled momentum in economic activity during the same period. The shift to a more guarded assessment of economic activity during the second quarter may have been the result of incoming economic data that tended to show weakening from previously robust levels. The deterioration in optimism during the second quarter may indicate that consumers are becoming more cognizant of the actual long-term threats to economic growth stemming from factors such continued elevated energy prices, increased interest rates, a slowing housing market, etc. As the actual impact these factors have upon economic activity continues to manifest in coming months, consumer confidence may fall further and prompt restrained spending, which could additionally contribute to weakened economic growth during the coming quarters.

The Business Sector

Industrial production, as compiled by the Federal Reserve[xxi], increased at a revised annual rate of 5.3% during the fourth quarter of 2005 and by 5.1% for the first quarter of 2006[xxii]. For the second quarter, industrial production increased at an annual rate of 6.6%. For the full year 2005, industrial production increased 3% over the 2004 level. On a year-over-year basis, industrial production increased by 3.1%, 3.3%, and 3.6% in January, February, and March, respectively, and by 4.7%, 4.3%, and 4.5% in April, May, and June, respectively.

Manufacturing production, which increased at an annual rate of 9.1% in the fourth quarter and 5.3% in the first quarter, advanced by an annual rate of 5.4% in the second quarter of 2006. Once again, the continued strength in manufacturing is confirmed by anecdotal evidence contained in The Beige Book releases from the Federal Reserve, which indicated generally favorable manufacturing gains throughout the twelve Districts. Manufacturing production increased by 4.5%, 4.2%, and 4.8% on a year-over-year basis in January, February, and March, respectively, and by 5.5%, 4.9%, and 5.7% in April, May, and June, respectively.

Durable goods production, which increased by 2.8% in the fourth quarter but declined at an annual rate of 1.8% in the first quarter, advanced at an annual rate of 1.6% in the second quarter. Nondurable goods production, which increased by 1.4% in the fourth quarter and decreased by 0.8% in the first quarter of 2006, advanced at an annual rate of 4.9% in the second quarter of 2006. Defense and space equipment production continued to experience strong gains, increasing by 6.8% and 7.4% in the first and second quarters, respectively, compared with an increase of 8.1% in the fourth quarter of 2005. Following a fourth quarter increase of 17.4%, construction supplies advanced by a more modest 3.2% in the first quarter (revised) and declined by 0.9% in the second quarter. This retrenchment in construction supplies is likely the result of continued cooling in housing activity nationwide.

On a quarterly basis, capacity utilization increased to 82% in the second quarter, following an increase in the first quarter of 2006 to 81.1% as compared to 80.5% for the fourth quarter. This level of 82% is 1% above the 1972 to 2005 average. 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 to 80.9% in the second quarter as compared to 80.3% in the first quarter and 79.8% in the fourth quarter. At this level, capacity utilization is now above the 1972 to 2004 average of 79.8%. At these levels of resource utilization, there is still considerable slack in the productive capabilities of factories throughout the United States. As such, capacity utilization rates should not pose a significant threat to rising inflationary pressures, even though the utilization rates are slightly above the historical norms.

The Department of Commerce's[xxiii] advance monthly sales for retail trade and food services showed solid gains in the first quarter. In March, retail and food service sales increased by approximately 0.6%[xxiv] from February to $361 billion. Total retail sales increased by 0.7% in March from the February level to $325.9 billion. During the second quarter, retail trade and food services sales were tepid, increasing to $363.6 billion in April and to $364.1 billion in May before falling to $363.8 billion in June. Total retail sales followed a similar pattern in the second quarter, increasing to $328.4 billion and $328.8 billion in April and May, respectively, then falling slightly to $328.4 billion in June.

On a year-over-year basis, monthly sales for retail trade and food service increased 9.4% in January, 7.5% in February, and 7.9% in March. In April, May, and June, monthly sales for retail trade and food services increased 6.9%, 7.6%, and 5.9%, respectively, on a year-over-year basis. For the second quarter, advance monthly retail and food service sales increased 0.9% from the first quarter. This compares to an increase of 3.2% in the first quarter from the fourth quarter of 2005. On a year-over-year basis, advance monthly sales for retail trade and food services increased 8.3% in the first quarter. In the second quarter, monthly sales for retail trade and food services increased 6.8% on a year-over-year basis. For the first quarter, retail sales increased by 3.2% from the fourth quarter and by 8.2% on a year-over-year basis. For the second quarter, retail sales increased by 1% from the first quarter and by 6.7% as compared to the same period a year ago. Total sales excluding motor vehicles and parts increased by 1.6% in the second quarter over the first and by 8.9% on a year-over-year basis. This compares to an increase of 2.7% in the first quarter from the fourth quarter and by 9.7% on a year-over-year basis. Sales of motor vehicles and parts, which declined by 3.8% in the fourth quarter as compared to the third quarter and by 1.8% from the fourth quarter of the prior year, increased in the first quarter by 5.2% and by 3.3% on a year-over-year basis. Sales of motor vehicles and parts declined 1.7% in the second quarter as compared to the first quarter and by 0.5% on a year-over-year basis.

The Chief Executives' Confidence Measure, compiled by the Conference Board in the quarterly *CEO Confidence Survey*, indicated that CEOs' confidence improved slightly in the first quarter with the index increasing to 57 from 56 in the fourth quarter[xxv]. However, the index declined to 50 for the second quarter of 2006. In the first quarter, roughly 49% of CEO's indicated that current economic conditions were better. In the second quarter, only 27% claimed current economic conditions are better. Only 21% of the CEO's surveyed expect better conditions in the coming months, a decline from 41% in the fourth quarter and 35% in the first quarter.

Lynn Franco, Director of The Conference Board Consumer Research Center, stated the following with respect to the survey:

> *CEO's confidence has waned in the second quarter and expectations signal slower economic growth in the coming months. However, the majority of CEO's do not foresee slower growth having an adverse impact on corporate profits.*

With energy prices expected to remain elevated and interest rates continuing to rise, consumer confidence and confidence amongst business leaders may be further dampened and prompt a retrenchment in consumption expenditures and production. In addition, continued deterioration in the real estate markets may further weaken consumer confidence and lessen personal consumption expenditures as equity extraction from homes wanes. Overall, these factors tend to suggest that the strength of economic activity in the first quarter was likely a temporary aberration and that the slowdown in economic activity that began during the fourth quarter of 2005 may continue with weaker economic conditions in the second half of 2006.

Inflation

Following a 3.4% increase in the consumer price index (CPI) [xxvi] for the full year 2005 at a seasonally adjusted annual rate, the CPI increased by a compound annual rate of 4.3% in the first quarter of 2006 and by 5.1% for the second quarter. The CPI increased 0.7% in January, 0.1% in February, and 0.4% in March on a seasonally adjusted basis. In April, May, and June, the CPI increased 0.6%, 0.4%, and 0.2%, respectively. For the twelve months ending in March, the CPI increased at an annual rate of 3.4%. For the twelve months ending in June, the CPI increased at an annual rate of 4.3%.

For 2005, the energy index increased by 17.1% on a seasonally adjusted annual basis. For the first quarter of 2006, the energy index increased by 21.8%, as a result of continued elevated energy prices. For the second quarter, the energy index increased 23.8%. For the twelve months ending in March and June, the energy index advanced by 17.3% and 23.3%, respectively. Food prices during 2005 increased at an annual rate of 2.3%. For the first and second quarters of 2006, the food index advanced at an annual rate of 2.5% and 1.7%. For the twelve months ending in March and June, the food index increased by 2.6% and 2.2%.

Removing the effects of food and energy, the core CPI increased by a seasonally adjusted annual rate of 2.8% in the first quarter and by 3.6% in the second quarter, perhaps indicating a pass through of higher costs by businesses to consumers. The core CPI advanced at a rate of 2.2% for both 2004 and 2005. For the twelve months ending in June, the core CPI advanced at a rate of 2.6% as compared to a rate of 2.1% for the twelve months ending in March.

In addition to the CPI, the price index for personal consumption expenditures (PCE) from the BEA[xxvii] rose by 4.1% in the second quarter as compared to an increase of 2.0% in the first quarter, a 2.9% increase in the fourth quarter, and a 2.9% increase for the full year 2005. On a year-over-year basis, the PCE rose by 3.0% in the first quarter and by 3.3% in the second quarter. The PCE excluding food and energy prices increased 2% and 2.3% on a year-over-year basis in the first and second quarters of 2006.

With respect to inflation, Chairman Ben Bernanke indicated the following in his Congressional testimony from July 19, 2006:

> *…The recent rise in inflation is of concern to the FOMC. The achievement of price stability is one of the objectives that make up the Congress' mandate to the Federal Reserve. Moreover, in the long run, price stability is critical to achieving maximum employment and moderate long-term interest rates, the other part of the congressional mandate...*
>
> *Although our baseline forecast is for moderating inflation, the Committee judges that some inflation risks remain. In particular, the high prices of energy and other commodities, in conjunction with high levels of resource utilization that may increase the pricing power of suppliers of goods and services, have the potential to sustain inflation pressures. More generally, if the pattern of elevated readings on inflation is more protracted or more intense than is currently expected, this higher level of inflation could become embedded in the public's inflation expectations and in price-setting behavior. Persistently higher inflation would erode the performance of the real economy and would be costly to reverse…*

It appears that the increase in core inflation accelerated in the second quarter, prompted perhaps by a willingness of businesses to begin passing increased costs onto the consumers. Continued high energy prices may ultimately prompt further upward inflationary pressures at a more rapid rate in the coming months. The core inflationary pressures could be further pronounced should businesses be successful in continuing to pass along cost increases to consumers. An unexpected increase in core inflation may force the Federal Reserve to continue tightening monetary policy beyond levels currently anticipated by the markets or risk higher inflation premiums that would tend to suppress economic growth and that would, as Chairman Bernanke stated, be costly to reverse.

Labor Market

After averaging 5.0% in the fourth quarter of 2005, the unemployment rate fell to 4.7% in the first quarter and held steady at that rate for the second quarter[xxviii]. On a monthly basis, unemployment was 4.7% in January, 4.8% in February, 4.7% in March, 4.7% in April, and 4.6% in both May and June.

Total nonfarm payroll employment increased by 154,000 in January, by 225,000 in February, and by 211,000 in March, for a first quarter average of 197,000 monthly job gains. As a result of these gains, total nonfarm payroll employment increased by 590,000 during the first quarter of 2006 as compared to an increase of 477,000 during the first quarter of 2005. In March, total nonfarm payroll employment stood at 134.996 million.

In the second quarter, total nonfarm payroll employment increased by 325,000 or a monthly average of 108,000 job gains. For the twelve months ending in March, average monthly job gains stood at 169,000. Total nonfarm payroll employment increased by 112,000 in April, 92,000 in May, and 121,000 in June. By the end of the quarter, total nonfarm payroll employment stood at 135.230 million.

Payroll gains in the quarter included increases in professional & business services, government, and education & health services. Professional & business service employment increased roughly 82,000 in the second quarter as compared to adding 93,000 jobs in the first quarter and 123,000 in the fourth quarter. Government employment increased by 68,000 in the second quarter with education & health services increasing by 86,000. Manufacturing employment gained 26,000 jobs after losing roughly 10,000 during the first quarter.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment was mixed during the first quarter. Consumers expecting more jobs to become available in the next six months decreased in January to 13.6% from 14.3% in December. In February and March, 13.4% and 13.9% expected more jobs to become available, respectively. For the second quarter, 15.4% in April expected more jobs to become available in the coming months, 14.8% in May, and 15.6% in June. Those expecting fewer jobs to become available ended 2005 at 17.7%. In January, February, and March, 15.2%, 19.9%, and 16.6% expected fewer jobs to become available in the next six months, respectively. In April, May, and June, 16.3%, 18.0% and 17.0% expected fewer jobs to become available in the next six months.

The slowdown in economic activity that has slowly manifested during the second quarter is likely to result in lower payroll employment gains in the coming months. In addition, continued elevated energy prices and rising interest rates may negatively impact consumer sentiment, leading consumers' optimism regarding employment to deteriorate. This may be more pronounced should businesses and manufacturers adjust payrolls to compensate for waning demand. Given a slowing in economic activity, further drops in the unemployment rate are not likely. Should the unemployment rate increase due to waning demand for goods and services, the shortages of skilled workers that have been noted throughout the nation may ease. As a result, the inflationary pressures that have attended the shortage of skilled workers are likely to ease.

Equity Markets

The Dow Jones Industrial Average (DJIA) ended 2005 at roughly 10,718[xxix]. The S&P 500 and the NASDAQ composite ended 2005 at 1,248 and 2,205, respectively. During the first quarter, the DJIA gained roughly 4.7% (through March 29th) to 11,216. The NASDAQ and the S&P 500 gained 6.0% and 4.4%, respectively, ending the quarter at roughly 2,338 and 1,303. During the first quarter, the S&P 500 crossed the 1,300 level for the first time since May 2001. The second quarter's weak economic activity accompanied at downturn in the markets with the DJIA falling roughly 2% to end the quarter at roughly 11,000. The NASDAQ composite and the S&P 500 also fell during the quarter by 9.7% and 4.4%, respectively, to roughly 2,100 and 1,250.

The poor performance of the equity markets during the second quarter may have been a result of investor pessimism regarding prospective economic activity and corporate earnings in the second half of the year along with factors related to the typically slow summer season. Though the diminishing opportunity for superior returns in the real estate market may have prompted investors to return to the equity markets earlier in the year, it appears that investors turned to other, less risky asset classes. Elevated oil prices and the potential for adverse impacts upon economic activity, uncertainty regarding geopolitical events, tightening of monetary policy by the Federal Reserve, and increased inflation expectations may have also dampened investors' confidence in the equity markets.

Sustained high energy prices in the coming months could have more far-reaching adverse impacts upon corporate profits, economic activity, and the equity markets. Inflationary pressures stemming from higher energy prices feeding into the core inflation figures could also have an adverse impact upon investor confidence. As a result of the aforementioned risk factors, the ability of the equity markets to post significant gains over the coming quarters may yet be tenuous, particularly as a number of factors may contribute to further economic softness and rising inflationary pressures in the coming quarters.

Oil Prices

West Texas Intermediate (WTI) oil prices, which fluctuated in a band from $56 to $64 per barrel during the fourth quarter and from $60 to $66 per barrel during the first quarter, remained at elevated levels during the second quarter of 2006 ranging from $66 to $75 per barrel. Oil prices rose throughout January, reaching nearly $70 per barrel by late in the month on concerns of shortages of refining capacity and the potential supply shortfalls for the anticipated increase in demand during the second quarter.

At the January 31, 2006 meeting in Vienna, Austria[xxx], OPEC ministers maintained its current production level of 28.0 million barrels per day and noted the following with respect to energy markets:

> *The Conference also noted that, although the market is well supplied with crude oil, and commercial oil stock levels in the OECD remain healthy, prices have continued to rise. This, however, is primarily a result of refining bottlenecks and other non-fundamental factors…*
>
> *…Early indications suggest that the world economy will perform well in the first half of 2006; indeed, the forecast for world GDP growth for the whole of this year has already been increased slightly, reflecting improved expectations for Europe, Japan, and China, though risks remain visible on global financial imbalances, and higher interest rates, particularly in the US. With substantial increases expected in non-OPEC supply during the year and with OPEC production already at much higher levels than current demand, it is clear we are fairly confident about the market outlook for the year…We remain totally committed to market stability, with prices at reasonable and sustainable levels. We firmly recognize the importance of a stable, orderly oil market to world economic growth, long-term investment, and the advancement of global prosperity.*

Prices eased in February, falling below $60 per barrel briefly before stabilizing around $60-$63 per barrel, perhaps as a result of crude inventory data showing stockpiles at the highest level since May 1999. At its March 8, 2006 meeting in Vienna[xxxi], OPEC members agreed to maintain its current production ceiling of 28 million barrels per day. In its press release, OPEC indicated the following:

> *Having reviewed the oil market outlook, the Conference observed that world economic performance remains strong. The Conference also noted that, although all indicators show that the market is fundamentally well-supplied with crude oil and that commercial oil stocks in the OECD are at high levels, world crude oil prices remain volatile, these being driven by geopolitical factors and associated concerns regarding potential future supply disruptions, as well as downstream bottlenecks, exacerbated by more stringent US fuel quality standards. These factors are reflected in the increased activity observed in the futures market and the pattern of disconnect between prices and commercial stock levels, that has become apparent since 2004.*

By the end of the quarter, however, prices had once again increased to around the $66 level, perhaps as a result of the loss of roughly 500,000 barrels per day in supply due to militant attacks on the Nigerian oil infrastructure.

During the second quarter, prices rose steadily through April and into early May, touching above $75 per barrel before retrenching slightly to end the quarter at roughly

$72 per barrel. Oil prices rose higher on concerns over refining capacity shortages, despite assurances from international oil companies such as BP, Royal Dutch Shell, and ExxonMobil that they did not see any shortages in global refining capacity. The rise in oil prices may also be correlated to the increased demand typically experienced during the peak summer driving months as Americans take their holidays. In addition, geopolitical tensions surrounding Iran's nuclear programme and Citgo's (a wholly-owned subsidiary of Petroleos de Venezuela) suspension of gasoline distribution to its U.S. filling stations done at the behest of Hugo Chavez, Venezuelan president, who is attempting to reduce his country's dependence on the United States as its top export market.

At the 141st (Extraordinary) Meeting of the OPEC Conference in Caracas, Venezuela on June 1, 2006, OPEC members indicated the following[xxxii]:

> *Having reviewed the oil market situation and its immediate prospects, the Conference observed that fundamentals have stayed unchanged since its last review, with the market continuing to be over supplied and commercial crude and product stocks remaining at comfortable levels in terms of days of forward cover. The Conference also noted that, similarly, world crude oil prices continued to remain high and volatile as a consequence of abiding concern over the lack of effective global oil refining capacity, in the short and medium term, coupled with anxiety about the ability of oil producers to meet anticipated, future oil demand. This price volatility is being exacerbated by geopolitical developments and speculation in the oil futures markets.*
>
> *In the light of the foregoing, the Conference decided to retain the status quo. In so doing, however, the Conference reaffirmed its determination to ensure that crude oil prices remain at acceptable levels, reiterating also its readiness to act swiftly to take whatever steps might be necessary to safeguard the interest of Member Countries, in the short and longer term. For this purpose, the Conference agreed to continue closely monitoring market developments. The Conference further agreed that its President would consider convening an Extraordinary Meeting of the Conference prior to its September Meeting, should market condition so warrant.*

It is likely that continued elevated energy prices contributed to the weak economic activity in the second quarter of 2006. To be sure, there are still a number of energy market-related risks that could further weaken economic growth. Rising demand growth as a result of China's rapidly expanding economy and concerns over inadequate refining capacity may contribute to continued elevated oil prices for the immediate future. Concerns of geopolitical risks such as Iran's suspected nuclear program and the potential for an Iranian oil embargo as a result of the nuclear showdown with the West could create an additional premium in the price of oil. Furthermore, speculative activity in the oil markets, which has been ongoing since 2004, may be artificially inflating the price of oil. In addition, exogenous shocks in the oil markets may result in short-term price spikes in excess of $80 per barrel, which would likely have a significant adverse impact upon global economic growth and U.S. economic activity. Therefore, the risks to economic activity stemming from higher energy prices remain weighted towards conditions that may perpetuate further economic weakness in the coming quarters.

Economic Outlook 2005

After ending the fourth quarter at 138.5 and the first quarter at 138.9, the Conference Board's Leading Economic Indicators ended the second quarter at 138.1[xxxiii], weakening somewhat during the first half of the year. In January, the leading index increased 0.4% before declining 0.5% in February and increasing 0.4% in March[xxxiv]. The leading index then decreased 0.1% in April and 0.6% in May before increasing 0.1% in June. From June to December of 2005, the leading index increased 1.0%. From July 2005 to January 2006, the leading index increased 1.7%. For the six months ending in February and March, the leading index increased 1.1% and 1.9%, respectively. From October 2005 to April 2006, the leading index increased 1.3%. From November 2005 to May 2006 and December 2005 to June 2006, the leading index decreased 0.2% and 0.3%, respectively. The weaknesses among the indicators were mixed during the second quarter, with declining housing permits the largest negative contributor. The behavior of the leading index would tend to indicate a slowing pace of economic growth in the near term.

In the *Monetary Policy Report to the Congress*, released July 19, 2006, the Federal Reserve policymakers indicated that the economy was transitioning from a period of growth that is above the long-run sustainable rate to a more moderate and sustainable rate. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3 ¼%-3 ½% (central tendency) in 2006 as compared to real GDP growth of 3.5% in 2005[xxxv]. Real GDP is expected to increase by 3%-3 ¼% in 2007. The personal consumption expenditures chain-type price index (the Federal Reserve's preferred measure of inflation) excluding food and energy is expected between 2 ¼%-2 ½% in 2006, as compared to the 1.9% increase in 2005. For 2007, the PCE index excluding food and energy is expected to be 2%-2 ¼%. The civilian unemployment rate is anticipated to range from 4 ½%-5% in 2006, against 5% for 2005, and 4 ¼%-5 ¼% in 2007.

The fifty-three forecasters participating in the Philadelphia Fed's *Survey of Professional Forecasters* expect real GDP growth of 3.1% in the third quarter, 3.0% in the fourth quarter, and an annual rate of growth in real GDP of 3.4% for 2006 and 3.0% for 2007. CPI inflation is expected to equal roughly 2.62% for 2006 and 2.35% in 2007 and 2008. The unemployment rate is forecast at 4.7% for 2006 and 4.8% for 2007.

Based on the current assessment of a number of economic factors, the previously solid foundation for economic growth finally appears to have been weakened by the adverse systemic impact of continued elevated energy prices. The continued high energy prices that have likely contributed to a rise in inflationary pressures coupled with rising interest rates as the Federal Reserve removes monetary policy accommodation and weaker real estate activity have apparently had an adverse impact on consumer spending, with personal consumption expenditures slowing markedly during the second quarter. Continued retrenchment in consumer spending could precipitate further cooling of economic activity, which could, in turn, prompt businesses to retrench slightly with respect to production and employment. As a result, economic activity could yet become more tempered in the coming quarters. These factors suggest that the risks to the economy remain weighted heavily towards weaker economic activity in the coming quarters.

Previously, we did not believe that the preponderance of evidence pointed to a recession. Currently, we still believe that economic growth will likely be at a much more tempered pace in the second half of the year. However, we now believe that the probability of the economy slipping into recession in the first half of 2007 has increased moderately. For now, we contribute a higher probability that the U.S. economy will likely exhibit a period of low growth and higher inflationary pressures.

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

- The Federal Reserve's removal of accommodative monetary policy, along with already higher mortgage rates, have likely restrained real estate activity and contributed to the further removal of the speculative froth that had developed in many markets in the preceding two years.

- Oil prices are likely to remain at elevated levels throughout 2006 and into 2007, which could prompt further slowing of economic activity globally and in the U.S.

- Inflation has remained at levels above recent trends, and will likely remain above recent levels, which would be consistent with slower economic growth.

Our expectations for the economy include:

- Real GDP growth of 2¾% - 3¼% for 2006.

- The Federal Reserve is likely to end its removal of monetary policy accommodation in light of continued economic weakness. The federal funds rate, then, should end 2006 at 5¼% - 5½%.

- Inflation is likely to increase in 2006 with the core CPI increasing by roughly 2½%-3¼%.

- As economic activity becomes more tempered, payroll employments are likely to increase at a lower rate. Unemployment is likely to range from roughly 4¾ - 5% for 2006.

- Continued geopolitical concerns will likely result in an additional risk premium in 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. Oil prices (WTI) are likely to average $68-$75 per barrel for 2006.

Conclusion

Economic activity slowed significantly in the second quarter following robust growth in the first quarter of 2006 with real GDP increasing at an annual rate of only 2.5%. Personal consumption expenditures, which had performed well during the first quarter, slowed markedly in the second quarter, perhaps as a result of a squeeze on personal finances caused by higher energy prices, a slowing housing market, and rising interest rates. These factors may create continued uncertainty regarding future economic growth in the coming quarters. Inflation remained largely contained but increased at levels not typically consistent with maximum sustainable economic growth. Based on our assessment of the state of the economy in the second quarter, conditions are likely to foster tepid economic activity during 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.

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[i] The BEA press release on July 28, 2006 states the following with respect to advance estimates: The Bureau emphasized that the first-quarter "advance" estimates are based on source data that are incomplete or subject to further revision by the source agency. The first quarter "preliminary" estimates, based on more comprehensive data, will be released on August 30, 2006.

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

[iii] *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, May 15, 2006.

[iv] With respect to trends in housing data, 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.*

[v] Data from National Association of Realtors, *Existing Home Sales* and *New Home Sales* statistical releases.

[vi] Testimony of Chairman Ben Bernanke, *Semiannual Monetary Policy Report to the Congress*, Before the Committee on Financial Services, U.S. Congress, February 15, 2006.

[vii] Testimony of Chairman Ben Bernanke, *Semiannual Monetary Policy Report to the Congress*, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 19, 2006.

[viii] Data from Freddie Mac Weekly Mortgage Market Survey

[ix] The yield curve inversion resulted 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.

[x] Source: *The Economist*

[xi] "U.S. deficit data fuel anxieties on dollar," Christoper Swann, *The Financial Times*, March 15, 2006.

[xii] The Board of Governors also increased the discount rate to 6 ¼% by the end of the second quarter of 2006.

[xiii] The Board of Governors also increased the discount rate by twenty-five basis points to 5 ½%.

[xiv] The Board of Governors also increased the discount rate by twenty-five basis points to 5 ¾%.

[xv] The Board of Governors also increased the discount rate by twenty-five basis points to 6%.
[xvi] The Board of Governors also increased the discount rate by twenty-five basis points to 6 ¼%.
[xvii] Changes are from average for fourth quarter of previous year to average for fourth quarter of year indicated.
[xviii] 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.
[xix] 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.
[xx] 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.
[xxi] Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release.
[xxii] Quarterly industrial production figures based on revised data from the December 2005 Industrial Production and Capacity Utilization statistical release.
[xxiii] Press release from the Department of Commerce.
[xxiv] 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%.
[xxv] *CEO Confidence Survey*, The Conference Board.
[xxvi] Based on data from the Consumer Price Index press releases by the Bureau of Labor Statistics, United States Department of Labor.
[xxvii] Bureau of Economic Analysis, Gross Domestic Product: Second Quarter 2006 (Advance) release, July 28, 2006.
[xxviii] Bureau of Labor Statistics, United States Department of Labor, The Employment Situation press release.
[xxix] Based on data from *The Economist*.
[xxx] OPEC press release following the 139th (Extraordinary) Meeting of the OPEC Conference in Vienna, Austria on January 31, 2006.
[xxxi] OPEC press release following the 140th Meeting of the OPEC Conference in Vienna, Austria on March 8, 2006.
[xxxii] OPEC press release following the 141st Meeting of the OPEC Conference in Caracas, Venezuela on June 1, 2006.
[xxxiii] From The Conference Board's February 17, 2005, March 17, 2005, & April 21, 2005 press releases for US Leading Economic Indicators.
[xxxiv] From The Conference Board's November 21, 2005 press releases for US Leading Economic Indicators.
[xxxv] Changes are from average for fourth quarter of previous year to average for fourth quarter of year indicated.