



State of the Economy 4th Quarter 2006

Introduction

Real gross domestic product (GDP) showed some improvement in the fourth quarter of 2006 with an increase of 3.5% at an annual rate as compared to a 2.0% increase in the third quarter. Real GDP increased by 2.5% in the second quarter and 5.6% during the first quarter of 2006. Real GDP increased by 1.8% in the fourth quarter of 2005 and at an annual rate of 3.2% for the full year 2005 on a revised basis. For 2006, real GDP increased at an annual rate of 3.4%. The advance in real GDP during the fourth quarter was helped by gains in personal consumption expenditures, exports, and government spending. The increase in real GDP during the last quarter of 2006 came despite continued weakness in the housing markets and still elevated energy prices.

Gross Domestic Product

Advance estimatesⁱ released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 3.5% during the fourth quarter as compared to a 2.0% increase during the third quarter. This follows a revised increase of 2.6% in the second quarter and 5.6% in the first quarter. This increase in GDP was higher than the 1.8% increase in real GDP in the fourth quarter of 2005ⁱⁱ. Economic growth during the quarter was above the consensus forecast of 2.5% annual growth in real GDP (down from 2.9% anticipated when surveyed during the previous quarter) anticipated by fifty-one forecasters surveyed by the Federal Reserve Bank of Philadelphiaⁱⁱⁱ. For 2006, real GDP increased at an annual rate of 3.4% as compared to 3.2% in 2005, 3.9% in 2004, and 2.5% in 2003^{iv}.

Real personal consumption expenditures, which accounts for about two-thirds of economic activity, continued to show favourable signs of strengthening during the fourth quarter with an increase of 4.4% as compared to increases of 2.8% in the third quarter, 2.6% in the second quarter, and 4.8% in the first quarter. Following an increase of

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19.8% in the first quarter, purchases of durable goods decreased by 0.1% in the second quarter. Durable goods expenditure increased 6.4% and 6.0% in the third and fourth quarters, respectively. This increase in purchases of durable goods during the third and fourth quarters was fueled in part by large increase in expenditures on furniture and household equipment. This may reflect consumers' willingness to invest in their homes as opposed to acquiring newer homes, as evidenced by the slowdown in the real estate markets. Personal consumption expenditures on nondurable goods increased by 6.9% during the fourth quarter as compared to a 1.5% increase during the third quarter. Nondurable goods expenditures increased 1.4% during second quarter and 5.9% during the first quarter.

Real nonresidential fixed investment decreased 0.4% in the fourth quarter as compared to an increase of 10% in the third quarter. Real nonresidential fixed investment increased at a 4.4% rate in the second quarter and a 13.7% rate in the first quarter. Equipment and software investment activity, which increased by 15.6% in the first quarter and decreased by 1.4% in the second quarter, rebounded during the third quarter with an increase of 7.7%. Equipment and software investment declined in the fourth quarter by 1.8%.

Following increases of \$41.2 billion in the first quarter and \$53.7 billion in the second quarter, private businesses increased inventories by \$55.4 billion in the third quarter, perhaps in anticipation of increased demand for the holiday shopping season in the fourth quarter. Private businesses increased inventories by a lower rate of \$35.3 billion in the fourth quarter, which subtracted 0.71% point from the real GDP figures. The second quarter real change in inventories added 0.44% to the change in real GDP. The third quarter real change in inventories added 0.06% to the change in real GDP. The slower pace of inventory production may suggest that businesses require a period of decelerated production to allow for a draw down to levels more in line with actual and projected demand for the fourth quarter and first quarter 2007.

Following a revised increase of 14% in the first quarter and 6.2% in the second quarter, real exports of goods and services for the third quarter increased at a rate of 6.8% and at a rate of 10% in the fourth quarter. Imports, a subtraction from GDP, increased 5.6% in the third quarter following an increase of 1.4% in the second quarter and an increase of 9.1% in the first quarter. The third quarter increase in imports subtracted 0.93% from the change in real GDP as compared to subtracting 0.24% and 1.46% from the second and first quarter changes in real GDP, respectively. In the fourth quarter, imports decreased 3.2% which added 0.56% to the fourth quarter change in real GDP.

After increasing by 8.8% in the first quarter, real federal government consumption expenditures decreased by 4.5% during the second quarter. For the third and fourth quarters, real federal government consumption expenditures increased by 1.3% and 4.5%, respectively. National defense spending, which increased by 8.9% in the first quarter, decreased 2.0% in the second quarter and 1.2% in the third quarter. During the fourth quarter, national defense spending increased 11.9%. Nondefense spending,

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which decreased 9.3% in the second quarter after an increase of 8.5% in the first quarter, increased 6.5% in the third quarter. Nondefense spending decreased 9.3% during the fourth quarter 2006.

Real residential fixed investment, which decreased in the first and second quarters of 2006 by 0.3% and 11.1%, respectively, continued a decreasing trend in the second half of the year. Real residential fixed investment decreased in the third quarter by 18.7% and by 19.2% in the fourth quarter. This further highlights the continued deflating of the real estate bubble that previously existed and is consistent with the continued weakness in general real estate markets.

Data on new residential construction from the U.S. Census Bureau and U.S. Department of Housing and Urban Development indicated that activity during the fourth quarter 2006 showed continued weakness as compared to the prior year. 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^Y. 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 1,869,000 in June. For the third quarter, new privately-owned housing units authorized by building permits declined to 1,763,000 in July, 1,727,000 in August, and 1,638,000 in September. In the fourth quarter, new privately-owned housing units authorized by building permits declined to 1,553,000 in October and to 1,513,000 in November before rebounding slightly to 1,613,000 in December. On a year-over-year basis, these figures represent a decline of 27% in October, 31% in November and 23% in December.

Privately-owned housing starts, which ended the fourth quarter of 2005 at 1,989,000, 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 1,833,000. In the third quarter, privately-owned housing starts decreased to 1,760,000 in July and to 1,674,000 in August before rebounding to 1,772,000 in September. Privately-owned housing starts showed mixed activity during the fourth quarter, decreasing in October to 1,478,000 then increasing to 1,565,000 in November and 1,643,000 in December. On a year-over-year basis, these figures represent a decline of 28% in October, 27% in November, and 18% in December.

Sales of existing homes, which had decelerated during the first half of the year, continued to exhibit weakness during the third and fourth quarters of 2006. Data from the National Association of Realtors (NAR) indicates that, after ending December 2005 at 6,750,000 units on a seasonally adjusted annualized basis, existing home sales continued to decline in January, falling to 6,570,000. Existing home sales rose to 6,900,000 in March. For the second quarter, existing home sales declined to 6,710,000 in April, 6,680,000 in May, and 6,490,000 in June. For the third quarter, existing home sales continued to decline, falling to 6,320,000 in July, 6,310,000 in August, and 6,230,000 in September, a year-over-year decline of roughly 14%. During the fourth quarter, existing homes sales were stagnant at 6,270,000 in October, 6,250,000 in

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November, and 6,270,000 in December. For 2006, existing home sales averaged 6,478,000 as compared to 7,076,000 in 2005, representing a year-over-year decline of roughly 8.5%. The inventory of existing homes continued to increase in 2006, ending the year at 3,450,000 or a 6.6 months supply as compared to 4.5 months supply for 2005.

The national median sales price of all existing homes fell from \$222,000 in December 2005 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. By June 2006, the national median sales price of existing homes had trended upwards to roughly \$230,000^{vi}. At the end of the third quarter, the national median sales price of existing homes had fallen to \$220,000. The median price of existing homes was \$220,900 in September and \$221,600 in December 2006, showing very little price appreciation. For 2006, the median price of existing homes was \$221,900 as compared to \$219,600 for 2005.

Thirty-year conventional mortgage rates, according to Freddie Mac^{vii}, rose slightly during the first quarter from 6.27% at the end of 2005 to end the quarter at 6.35%. Thirty-year rates continued to climb during the second quarter, reaching a high of 6.78% on June 29, 2006. During the third quarter, thirty-year mortgage rates briefly touched 6.80% in late July before falling to roughly 6.31% by the end of the quarter. During the fourth quarter, thirty-year rates continued to fall, bottoming out at 6.11% in early December before rebounding to end the year at approximately 6.18%.

After ending the fourth quarter 2005 at approximately 5.82%, fifteen-year mortgage rates increased to 6.00% by early March. By the end of the second quarter, fifteen-year rates had risen to 6.43%. During the third quarter, fifteen-year rates declined steadily to end the quarter at roughly 5.98%. Fifteen-year rates held fairly steady during the fourth quarter 2006, rising to above 6% in early November before retrenching to end the quarter at 5.93%.

The Federal Reserve

The Federal Reserve's gradual removal of monetary policy accommodation ended during the third quarter with the Federal Open Market Committee (FOMC) holding the federal funds rate to 5 ¼%^{viii} at the August 8, 2006 meeting. In its press release following the meeting, the FOMC indicated that economic growth had moderated from a strong pace evident earlier in the year due in part to a gradual cooling of the housing market and lagged effects of higher interest rates and energy prices. The Committee also recognized that core inflation readings had increased and that high resource utilization and higher commodities prices may continue to fuel inflation pressures. The statement indicated that additional firming in monetary policy would depend on the outlook for inflation and economic growth in coming months. As an interesting note, the decision to keep rates on hold was not unanimous with one vote (by Jeffrey M. Lacker) to increase the target federal funds rate by twenty-five basis points.

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The FOMC held rates steady again at its meeting on September 20, 2006. Again at this meeting, one member of the FOMC voted against holding rates steady, preferring a twenty-five basis point increase in the target federal funds rate. This trend continued at the FOMC's October 25, 2006 and December 12, 2006 meetings.

In press release from the December 12, 2006 meeting, the FOMC statement included the following:

Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters.

Readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.

Nonetheless, 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.

To be sure, the impact of sustained elevated energy prices is likely to continue to manifest for quarters to come. Inflation may well feel continued upward pressures, placing the FOMC in a precarious position of confronting higher inflation during a period of slowing economic growth. Though the base of economic growth in America remains solid, economic activity is unlikely to continue running at a robust pace in the short-term, particularly under the burden of slowing real estate activity, higher energy prices, higher interest rates, mounting inflationary pressures and the attending impacts these factors have upon consumer sentiment and consumption.

The Federal Reserve Beige Books^{ix} released on October 12, 2006 and November 29, 2006 indicated mixed results in economic activity throughout the twelve Districts^x during the fourth quarter. The Beige Book conclusions included the following:

- *Most Districts reported increased consumer spending overall. However, there was some regional variation in the rate of increase. For instance, solid increases were reported by Kansas City and Richmond, while modest improvements in retail spending were noted in the Atlanta, Chicago, Minneapolis, New York, and St. Louis Districts. Meanwhile, sales softened in the Boston District and were below expectations in the Dallas District. Strong selling products varied by region, but most Districts reported that sales of home-related items remained weak. Several Districts noted a cautiously optimistic outlook for the holiday*

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season... Most Districts reported continued softness in vehicle sales, led by weaker sales for the Big Three U.S. auto makers.

- *Manufacturing activity was generally positive in most Districts. New York said manufacturers noted brisk growth in activity. Boston, Dallas, Kansas City, and San Francisco reported that production trends in high-tech industries were positive. Cleveland reported that durable goods production was up slightly on a year-over-year basis, although demand for steel products continued to soften. Manufacturing in the Chicago District expanded at a modest pace, with manufacturers of machine tools and equipment reporting strong demand outside of the motor vehicle industry. Dallas noted that energy-related manufacturing activity remained strong. In the Philadelphia region, manufacturers posted small increases in shipments, but there were also marginal declines in new orders. Most Districts reported that orders for homebuilding materials and related equipment have trailed off substantially. In addition, some softness in auto and auto-related production was noted by Atlanta, Chicago, Cleveland, Kansas City, and St. Louis.*
- *Almost all Districts reported that overall housing market activity continued to slow, especially in the single-family segment. Most Districts cited declining sales and rising home inventories. There were also scattered reports of price reductions, while the use of non-price sales incentives was reported in the Cleveland, Dallas, New York, Philadelphia, and San Francisco Districts. Most Districts reported declines in residential construction.*
- *Reports suggest that labor markets remained tight since the last report, especially for high-skilled occupations. Richmond reported strong demand for workers with sales, life sciences, engineering, and financial skills. Boston said that there was strong demand in industries such as health care, biotechnology, and engineering...Wage growth remained generally moderate, but Boston, New York, and San Francisco reported faster wage growth for some specialized professions. San Francisco noted continued rapid wage growth for health care, finance, and construction workers. According to Boston, pay levels for professional and technical jobs were being boosted in order to recruit new workers and reduce staff turnover. Employers in the Philadelphia District indicated that wages have been rising more rapidly in the past few months than earlier in the year, whereas the pace of wage increases was steady according to Chicago.*

Consumer Confidence

The Conference Board's Consumer Confidence Index^{xi} ended 2005 at 103.8 and continued the strengthening trend in the first quarter, rising to 106.8 in January, falling to 102.7 in February, and rebounding to 107.5 in March. 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. During the third quarter, the

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Consumer Confidence Index gained slightly in July to 107.0 before plummeting in August to 99.6, the lowest level of the year, before rebounding sharply in September to 105.9. During the fourth quarter, the Index fell to 105.4 in October and 105.3 in November before rebounding to 109.0 in December.

Lynn Franco, Director of The Conference Board's Consumer Research Center offered the following in the December 2006 press release:

Despite the latest improvement in the Index, there is little to suggest that the pace of economic activity in the final quarter of 2006 is anything but moderately better than its uninspiring performance earlier this year. Given the see-saw pattern in recent months, it is too soon to tell if this boost in confidence is a genuine signal that better times are ahead.

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. During the second quarter, the Expectations Index rose slightly in April to 92.3, fell to 85.1 in May and improved slightly to 87.5 in June. The Expectations Index increased to 88.9 in July, declined to 83.8 in August, and rebounded to 91.0 in September. For the fourth quarter, the Expectations Index increased to 92.6 in October, fell to 91.9 in November, and improved to 95.1 in December. The Expectations Index has shown marked improvement since the second quarter, perhaps indicating a favorable but guarded outlook for the coming quarters.

The Business Sector

Industrial production, as compiled by the Federal Reserve^{xii}, increased at a revised annual rate of 5.3% during the fourth quarter of 2005 and by 5.0% for the first quarter of 2006^{xiii}. For the second quarter, industrial production increased at an annual rate of 6.5%. For the third quarter, industrial production increased at an annual rate of 4.0%. Industrial production declined by 0.5% in the fourth quarter 2006. During the third quarter of 2006, industrial production increased by 4.9%, 4.7%, and 5.6% for the twelve months ending in July, August, and September, respectively. For the fourth quarter, industrial production increased by 4.9%, 3.8%, and 3.0% for the twelve months ending in October, November, and December. For the fourth quarter 2006, industrial production increased by 3.7% as compared to the fourth quarter of 2005.

Manufacturing production, which increased at an annual rate of 5.5% in the first quarter, 5.5% in the second quarter and 4.4% in the third quarter, decreased by 1.4% in the fourth quarter of 2006. Surprisingly, the decline in manufacturing in the fourth quarter is contrary to anecdotal evidence contained in The Beige Book releases from the Federal Reserve, which indicated generally favorable manufacturing activity throughout the twelve Districts. During the third quarter, manufacturing production increased by 5.6%, 5.4%, and 5.9% for the twelve months ending in July, August, and September, respectively. During the fourth quarter, manufacturing production increased 4.1%, 2.4%, and 3.3% for the twelve months ending October, November, and December.

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Durable consumer goods production, which declined at an annual rate of 2.3% in the first quarter, advanced at an annual rate of 1.0% in the second quarter but declined again in the third quarter by 4.6%, declined again in the fourth quarter by 3.8%. Nondurable consumer goods production, which decreased by 0.8% in the first quarter, advanced at an annual rate of 3.7% in the second quarter and by 5.0% in the third quarter, increased at an annual rate of 0.1% in the fourth quarter.

On a quarterly basis, capacity utilization increased to 82.3% for the third quarter but declined to 81.7% in the fourth quarter. This level is slightly above the 1972 to 2005 average of 81%. For the third quarter, manufacturing capacity utilization increased to 80.9% before falling back to 80.2% in the fourth quarter. At this level, capacity utilization is still slightly above the 1972 to 2005 average of 79.8%. At these levels of resource utilization, there is still 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. However, the Federal Reserve has mentioned that high resource utilization rates may stoke inflationary pressures in the future.

The Department of Commerce's^{xiv} advance monthly sales for retail trade and food services increased from \$365.3 billion in September to roughly \$369.9 billion in December^{xv}. Total retail sales increased from the September level of \$329 billion to \$332.4 billion in December. For the fourth quarter, advance monthly retail and food service sales increased 0.1% from the prior quarter and by 4.9% over the fourth quarter of 2005. For the third quarter, advance monthly retail and food service sales increased 1% from the prior quarter and by 5.6% on a year-over-year basis. On a year-over-year basis, advance sales for retail trade and food services increased 8.3% in the first quarter. In the second quarter, sales for retail trade and food services increased 6.8% on a year-over-year basis.

Retail sales declined 0.2% in the fourth quarter as compared to the third quarter but increased by 4.6% over the fourth quarter of 2005. Total sales excluding motor vehicles and parts declined 0.3% in the fourth quarter over the prior quarter but increased 4.6% over the fourth quarter 2005. Third quarter 2006 retail sales increased 5.3% as compared to the third quarter of 2005; total sales excluding motor vehicles and parts increased 7.2% on a year-over-year basis. During the fourth quarter, sales of motor vehicles and parts increased 1.3% as compared to the third quarter and by 6.2% as compared to the fourth quarter 2005.

Inflation

Following a 4.3% increase in the consumer price index (CPI)^{xvi} for the first quarter of 2006 at a seasonally adjusted annual rate and a 5.1% increase for the second quarter, the CPI increased by a compound annual rate of 0.8% for the third quarter 2006 and by 0.2% for the fourth quarter. For the twelve months ending in March, the CPI increased at an annual rate of 3.4%. For the twelve months ending in

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June, the CPI increased at an annual rate of 4.3%. For the twelve months ending in September, the CPI increased at an annual rate of 2.1%. For the twelve months ending in December, the CPI increased at an annual rate of 2.5%. For the six months ending in June and December, the CPI increased 4.7% and 0.5%, respectively. The CPI increased by 3.3% and 3.4% in 2004 and 2005, respectively.

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 third quarter, the energy index declined 15.6% as a result of declines in oil prices. For the fourth quarter, the energy index declined by 11.2%. For the twelve months ending in March and June, the energy index advanced by 17.3% and 23.3%, respectively. For the twelve months ending in September, the energy index declined 4.3%. However, for the twelve months ending in December, the energy index increased 2.9%. For the first, second, and third quarters of 2006, the food index advanced at an annual rate of 2.5%, 1.7%, and 3.5%, respectively. For the fourth quarter, the food index increased 1.0%. For the twelve months ending in March, June, and September, the food index increased by 2.6%, 2.2%, and 2.5%. For the twelve months ending in December, the food index increased 2.1%.

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. For the third quarter, the core CPI increased by 2.7%. For the fourth quarter, the core CPI advanced 1.4%. For the twelve months ending in December, the core CPI increased 2.6%. The core CPI advanced at a rate of 2.2% for both 2004 and 2005. For the twelve months ending in September 2006, the core CPI increased 2.9%.

In addition to the CPI, the price index for personal consumption expenditures (PCE) from the Bureau of Economic Analysis^{xvii} rose by 0.1% in the fourth quarter as compared to an advance of 2.2% in the third quarter, 4.0% in the second quarter and 2.0% in the first quarter. On a year-over-year basis, the PCE price index rose by 3.0% in the first quarter, 3.3% in the second quarter, 2.8% in the third quarter, and 1.9% in the fourth quarter. The price index for PCE excluding food and energy prices increased 2%, 2.2%, 2.4%, and 2.3% on a year-over-year basis in the first, second, third, and fourth quarters of 2006. The price index for PCE increased 2.6% in 2004, 2.9% in 2005, and 2.8% in 2006.

It appears that the acceleration in the increase in core inflation in the second quarter may have been prompted by a willingness of businesses to begin passing increased costs onto the consumers. The slowdown in the increase in inflation during the third and fourth quarters was likely prompted by less firm conditions in energy prices. Energy costs increased 22.8% in the first half of 2006 but declined by 13.4% in the second half of the year. Overall energy prices advanced by 2.9% for 2006. However, further rises in 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

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to pass along cost increases to consumers. An unexpected increase in core inflation may result in higher inflation premiums in the markets that would tend to suppress economic growth.

Labor Market

The unemployment rate fell to 4.7% in the first quarter and held steady at that rate for the second and third quarters^{xviii}. The unemployment rate fell to 4.5% for the fourth quarter of 2006. On a monthly basis, unemployment was 4.4%, 4.5%, and 4.5% in October, November, and December, respectively.

For the third quarter, total nonfarm payroll employment increased by 372,000 or a monthly average of roughly 124,000. During July, August, and September, total nonfarm payroll employment increased 133,000, 188,000, and 51,000, respectively.

For the fourth quarter, total nonfarm payroll employment averaged 136.051 million as compared to an average of 135.595 million for the third quarter. During October, November, and December, total nonfarm payroll employment increased 86,000, 154,000, and 167,000, respectively, for a total quarterly gain of 407,000 jobs.

Manufacturing employment retrenched in the third and fourth quarters with losses of roughly 46,000 and 65,000 jobs, respectively. Construction employment lost roughly 44,000 on average in the fourth quarter as compared to the prior quarter. Professional & business services, education & health services, leisure & hospitality, and government saw payroll gains in the fourth quarter over the prior quarter with average increases of 98,000, 120,000, 120,000, and 88,000, respectively.

The slowdown in economic activity that continued to manifest during the third and fourth quarters may result in lower payroll employment gains in the coming months. This may be more pronounced should businesses and manufacturers continue to adjust payrolls to compensate for lower demand expectations. Given a slowing in economic activity, further drops in the unemployment rate are unlikely and would, in all likelihood, be temporary. A rising unemployment rate would likely ease the shortages of skilled workers that have been noted throughout the nation. As a result, any wage pressures that may have attended the shortage of skilled workers would also likely ease.

Equity Markets

The Dow Jones Industrial Average (DJIA) ended 2005 at roughly 10,718^{xix}. 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. The second quarter's weak economic activity accompanied a 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. By the end of the third quarter,

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however, the markets had regained ground lost during the previous quarter with the DJIA gaining roughly 6.5% to end the quarter at nearly 11,700. The S&P 500 and the NASDAQ composite each gained roughly 7% to finish the third quarter at 1,330 and 2,260, respectively. The markets continued to perform well in the fourth quarter with the DJIA, S&P 500, and the NASDAQ composite gaining roughly 7% to 12,475, 6% to 1,417, and 7% to 2,423, respectively.

The rebound in the equity markets during the third and fourth quarters may be the result of continued optimism regarding the strength of the holiday season shopping, strength in corporate profits, record merger and acquisition deals, and a perceived value of equity prices relative to other risky asset classes, particularly in light of the significant slowdown in the real estate markets. This diminishing opportunity for superior returns in the real estate markets may have prompted investors to return to the equity markets and other asset classes.

Oil Prices

West Texas Intermediate (WTI) oil prices, which fluctuated in a band 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. For the third quarter, oil prices traded in a band from roughly \$61 to \$77 per barrel. During the fourth quarter 2006, WTI oil prices remained in a relatively tight band between \$58 and \$64 per barrel, rising during early December before retrenching to end the year under \$61 per barrel.

OPEC members made no production cuts or increases at its 142nd (Ordinary) meeting in Vienna, Austria on September 11, 2006^{xx}. However, in his opening remarks to the meeting, Dr. Edmund Maduabebe Daukoru, President of the OPEC Conference and Minister of State for Petroleum Resources of Nigeria indicated the following regarding the oil markets and the impact that events and speculators may have upon price volatility:

The specific reasons for the recent price peaks were the outbreak of hostilities in Lebanon in the middle of July and fears of hurricanes in the US Gulf closely followed by the sudden shutting-down of the Prudhoe Bay field in Alaska in the first half of August. However, this must be set against the backdrop of volatility that has prevailed in the market for the past two and half years, due principally to concern over the lack of effective global oil refining capacity, anxiety about the ability of oil producers to meet anticipated future oil demand, geopolitical developments in some producing countries and speculation in the oil futures markets.

Crude oil volatility appears to have subsided over the past year, due to ample supply, rising OPEC spare capacity, plentiful strategic reserves and abundant commercial crude inventories, which are now at their highest levels since 1998. On the other hand, the increasing volatility of gasoline can be attributed, for example, to higher demand, increasingly stringent

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product specifications and, more recently, the issue of the adequacy of ethanol supplies. In particular, the relatively low level of gasoline inventories, in terms of days of forward cover, coupled with the lack of spare refinery capacity, has left an uncomfortably thin cushion of spare supply. Hence, the growing volatility reflects an increased sensitivity to developments in the product markets, such as unexpected outages or even planned refinery shutdowns.

This leads me onto the issue of speculation, which has been inflating prices far above market fundamental levels during the present unstable period. Not only is this high level of speculation, which has been spurred on by non-commercials, disruptive to the oil industry itself, but it is also having serious knock-on effects further afield in the global economy, with potentially serious repercussions for highly indebted developing countries. It is essential, therefore, that this issue is addressed effectively soon, once and for all, particularly where it involves parties far removed from the day-to-day affairs of the industry.

OPEC members cut production by 1.2 million barrels per day effective November 1, 2006 at a consultative meeting in Doha, Qatar on October 20, 2006^{xxi}. Members cited crude oil supplies that were in excess of actual demand as the rationale for the cut in output from 27.5 million barrels per day (mb/d) to 26.3 mb/d. OPEC members cut production by an additional 500,000 barrels per day effective February 1, 2007 at the 143rd (Extraordinary) meeting in Abuja, Federal Republic of Nigeria on December 14, 2006^{xxii}. The OPEC press release following the meeting indicated the following:

Having reviewed the oil market outlook, including the overall demand/supply expectations for the year 2007, in particular the first and second quarters, as well as the outlook for the oil market in the medium term, the Conference observed that market fundamentals clearly indicate that there is more than ample crude supply, high stock levels and increasing spare capacity. The Conference noted that, although the global economy is forecast to continue to grow, economic growth is expected to slow down in 2007. Moreover, while world oil demand is estimated to increase by 1.3 mb/d in 2007, the Conference observed that this is likely to be more than offset by a projected increase of 1.8 mb/d in non-OPEC supply, its highest rise since 1984.

The Conference also noted, with satisfaction, that the decision it had taken in Doha to reduce production by 1.2 mb/d as of 1 November 2006 had succeeded in stabilizing the market and bringing it into balance, although prices remain volatile, reflecting the continuing supply overhang in the market.

In view of the above, the Conference decided to reduce OPEC production by a further 500,000 b/d, with effect from 1 February 2007, in order to

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balance supply and demand. The Conference further reiterated the Organization's determination to take all measures deemed necessary to keep market stability through the maintenance of supply and demand in balance, for the benefit of producers and consumers alike.

The comments and actions from OPEC officials continue to suggest that the cartel is comfortable with an oil price in excess of \$60 per barrel (WTI). It seems likely that OPEC does not intend to take any actions that would intentionally lower prices below a suitable level at or near \$60 per barrel. Continued sharp rises in demand from rapidly growing economies such as China and India could place further upward pressure on already high oil prices.

Given this and OPEC's recent production cuts, it is likely that energy prices will remain at elevated levels throughout 2007, which could further temper economic growth. Continued geopolitical risks could create an additional premium in the price of oil. Furthermore, continued speculative activity in the oil markets, which has been ongoing since 2004, is likely to continue to inflate the price of oil. 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

Though we still do not believe that the preponderance of evidence points to a recession, we maintain that economic growth will likely be at a much more tempered pace in the first half of 2007. For now, however, we contribute a higher probability that the U.S. economy will likely continue to exhibit low growth and higher inflationary pressures.

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

- Interest rates are likely to remain steady in the coming quarters, with the Federal Reserve's next move likely to be an easing of monetary policy towards the end of the year.
- Oil prices are expected to remain at elevated levels throughout 2007, which could prompt slower economic growth globally and in the U.S.
- Inflation has remained at levels above recent trends, which is consistent with slower economic growth, and is likely to remain above trend levels for the foreseeable future.

Our expectations for the economy include:

- Real GDP growth of 2 ½% - 3 ¼% for 2007.

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- The Federal Reserve is likely to hold rates steady for most of 2007. The next likely move by the Federal Reserve is an easing of monetary policy. The federal funds rate should end 2007 at roughly 5%.
- Inflation is likely to increase in 2007 with the core CPI increasing by roughly 2 ½%.
- Continued geopolitical concerns and speculation in the oil markets may result in sustained elevated oil prices. Oil prices (West Texas Intermediate) are likely to average \$70 per barrel for 2007.
- As economic activity becomes more tempered, payroll employments are likely to increase at a lower rate. Unemployment is likely to range from roughly 4 ½% - 5% for 2007.

Conclusion

Based on our current assessment of a number of economic factors, economic growth appears to have been threatened predominately by the adverse systemic impact of elevated energy prices, higher interest rates, and the bursting of the bubble in the real estate markets. Despite an end to the tightening of monetary policy by the Federal Reserve, these factors translated into modest economic growth in 2006 with real gross domestic product expanding by 3.5% in the fourth quarter (following an increase of just 2% in the third quarter) and by 3.4% for the full year 2006 as compared to 3.2% growth in 2005. Continued elevated energy prices and further weakness in the housing markets could have a further toll on economic activity in the coming quarters of 2007. These factors suggest that the risks to the economy are weighted heavily towards weaker economic activity in the coming quarters.

ⁱ The BEA press release on January 31, 2007 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, 2007.

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, November 13, 2006.

^{iv} For example, from the 2005 annual level to the 2006 annual level.

^v 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.

^{vi} Data from National Association of Realtors, *Existing Home Sales* statistical releases.

^{vii} Data from Freddie Mac Weekly Mortgage Market Survey

^{viii} The Board of Governors also held the discount rate at 6 ¼%.

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^{ix} The press release on October 12, 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.

^x 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.

^{xi} 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.

^{xii} Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release.

^{xiii} Quarterly industrial production figures based on data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release.

^{xiv} Press release from the Department of Commerce.

^{xv} 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%.

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

^{xvii} Bureau of Economic Analysis, Gross Domestic Product: Fourth Quarter 2006 (Advance).

^{xviii} Bureau of Labor Statistics, United States Department of Labor, The Employment Situation press release.

^{xix} Based on data from *The Economist*.

^{xx} OPEC press release following the 142nd Meeting of the OPEC Conference in Vienna, Austria on September 11, 2006.

^{xxi} OPEC press release following the Consultative Meeting of the OPEC Conference in Doha, Qatar on October 19-20, 2006.

^{xxii} OPEC press release following the 143rd (Extraordinary) Meeting of the OPEC Conference in Abuja, Nigeria on December 14, 2006.