

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Second Quarter of 2005 through the Fourth Quarter of 2008

The U.S. economy is expected to transition from overachiever to slight underachiever during the next few years. This can be seen in the real GDP data. Last year the nation's inflation-adjusted output increased by 4.4%. Not only was it the strongest showing so far this decade, it was well above its estimated potential pace of 3.3%. It is anticipated real GDP will advance slower this year than last. Specifically, real GDP is expected to rise 3.5%, which is still slightly higher than its potential. Beginning in 2006, real GDP growth is forecast to slip to around 3% for a couple of years, which is slightly below its potential. It needs to be pointed out the 3% growth anticipated in 2006 and 2007 may be low compared to the two previous years, but is still stronger than growth experienced in the first years of this decade. It also needs to be stressed the economy will slow, but it will not stall nor retreat during the forecast period. Real output growth is expected to rally in 2008 to 3.3%, bringing it back to its potential.

The economy's recent and near-term future performance is linked to the housing market. The combination of strong demand and low interest rates have resulted in a red-hot housing market that is on track to hit 2 million starts this year for the first time since 1978 and average existing home prices are expected to appreciate a healthy 7.2%. Unfortunately, it appears the housing sector is near its peak. This is because housing prices cannot rise at present rates indefinitely, since they will eventually move out of line with the fundamentals of income and interest rates. There is evidence this may be taking place.

The National Association of Realtors produces an affordability index for single-family homes. It measures the degree to which a family earning the median income can qualify for a conventional mortgage on an existing median-priced home. An index of 1.0 means the median-income family just qualifies for the mortgage; above 1.0 means it is more than qualified; and less than 1.0 means it does not qualify. The good news is the index is currently above 1.0. As a result, housing is more affordable than at the time of the last major national housing downturn in the late 1980s. The bad news is the index has fallen since the mid-1990s, suggesting housing is becoming less affordable. Despite this, the national housing market does not appear to be on the verge of a collapse.

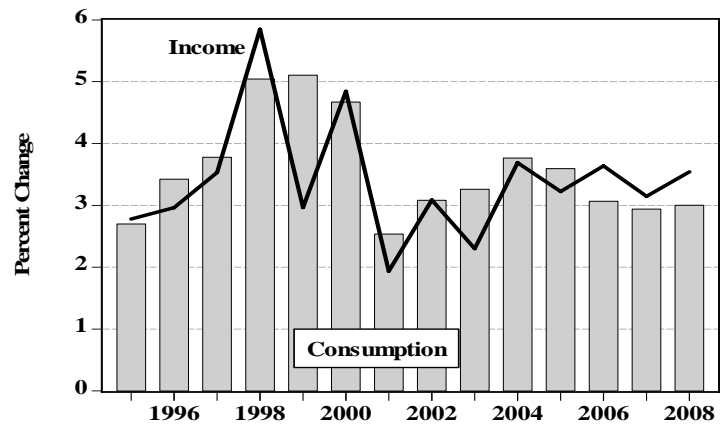
Of course, regional housing markets performance may vary from the national housing markets. For example, the affordability index for the West has dropped well below 1.0. This is because the West includes California, which has some of the nation's hottest and most expensive real estate markets. Given this situation, families have increasingly turned to unconventional methods for purchasing homes. One popular vehicle is the interest-only mortgage that lowers initial mortgage payments by back-loading principal repayment. The Mortgage Bankers' Association found interest-only mortgages accounted for 17% of all mortgage loans in the second half of 2004, and some estimate these mortgages accounted for 60% of mortgage loans in California in early 2005.

While several regions are at risk of a correction, national housing starts are expected to experience an orderly decline from their recent peak. National home prices will advance slower than in the last few years, but not retreat. As a result, the housing sector is not expected to be the growth engine it has been in recent years. However, neither is it anticipated to be a major drag on the economy.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: Real consumer spending is expected to advance more slowly over the forecast period than in recent years, but it will not retreat. Rising interest rates, higher tax burdens, high energy prices, and fewer mortgage refinancing cash-outs will restrain—but not derail—consumer spending this year. There is evidence this slowing has already begun. Real consumer spending growth has decelerated from a recent high of 5.1% in the third quarter of 2004 to 3.6% in the first quarter of 2005 and an estimated 3.2% in the second quarter of this year. Spending on light vehicles has recently stalled, a reflection of high energy costs and the apparent waning appeal for larger SUVs. Real consumer spending growth is expected to slow from 3.8% in 2004 to 3.6% in 2005 and 3.1% in 2006. The expected cooling of the housing sector causes part of this slowing. New and existing home sales during the second half of this year are projected to decline, which will dampen real spending on home furnishings and equipment. Specifically, this category’s real growth falls from almost 12% in 2004 to less than 6% in 2006. Home price appreciation, which has been white hot in several markets, is also expected to cool, and this will also have a dampening effect on consumer spending. It is anticipated the average price for an existing home, after rising 9.0% in 2004, will increase 7.2% this year, 3.0% next year, 2.2% in 2007, and 3.2% in 2008. As housing price gains decelerate, homeowners should become more reluctant to leverage their housing assets to continue their spending spree. In addition, consumers will not tap their bank accounts because the U.S. personal savings rate is virtually zero. And with the ratio of household debt to disposable income already at a record level, consumers are unlikely to turn to credit. As consumers watch their financing options dwindle, they will be forced to spend within their means. As a result, real consumer growth should more closely reflect real disposable income growth than it has in the recent past. Real spending grew faster than real disposable income in four of the five years from 2001 to 2005, but it is expected to grow slower than real disposable income in every year from 2006 to 2008. Again, real consumer spending growth is forecast to slow from its recent lofty base, but it will not retreat.

U.S. Real Consumption and Disposable Income Growth

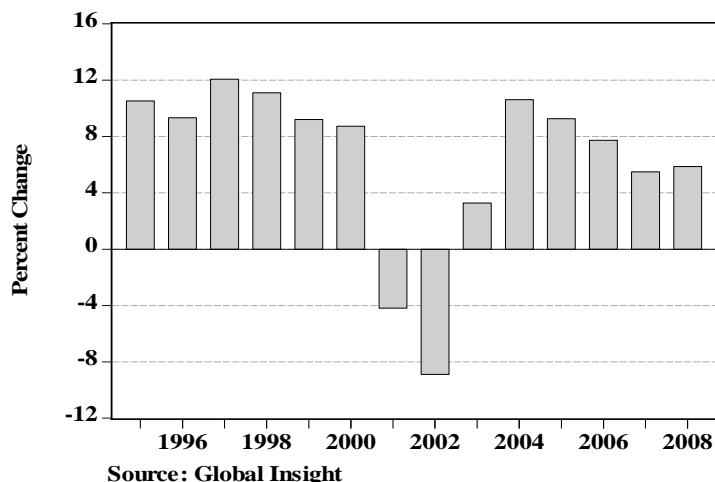


Source: Global Insight

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Business Investment: Many reports have focused on the impact of spending on office equipment and software and real business investment. This attention makes sense because business investments recent highlights and lowlights can be traced to spending on office equipment and software. For example, after shrinking in both 2001 and 2002 and posting a mediocre showing in 2003, real spending on equipment and software expanded 13.6% in 2004. Not surprisingly, total business investment retreated 4.2% in 2001 and 8.9% in 2002, eked out just 3.3% growth in 2003, and advanced 10.6% in 2004. With all the attention focused on the office equipment and software category, other business investment categories have been neglected. One of these is spending on nonresidential structures. Ironically, its recent history is similar to its office equipment and software brethren. Real spending on nonresidential structures shrank in 2001, 2002, and 2003, which also weighed down overall business investment. The question is whether structural investment will continue to hamper overall investment or fuel its future growth. It appears spending on structures will revive, but there are risks attached to this prognosis because nonresidential structural investment’s road to recovery has been littered with disappointments. In September 2000—six months before the start of the most recent recession—real spending on nonresidential construction peaked. It then began a slide that continues to the present. This downturn

Real Business Investment



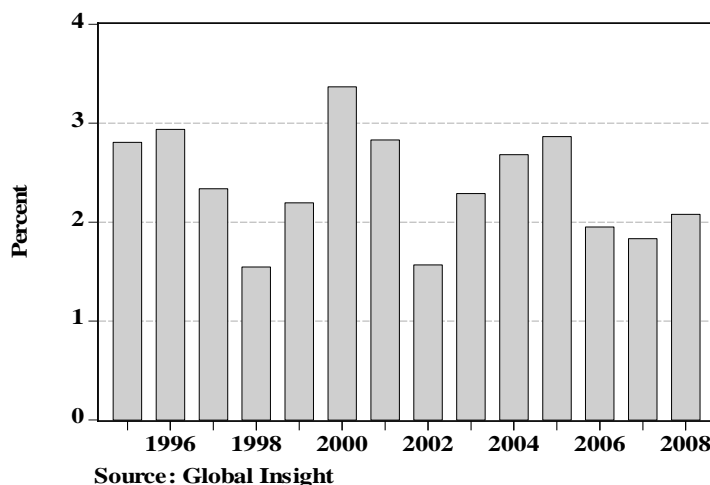
steady recovery—is typical of long-lived assets. A couple of factors should be key contributors to the nonresidential construction recovery. These are stronger manufacturing investment and commercial construction. According to the latest numbers, manufacturing construction spending is rebounding strongly, albeit from a low base. Likewise, commercial construction is making steady and broad-based gains. Since commercial construction lags developments in the housing market, it should post robust growth numbers for several quarters after the housing market peaks. Real investment in nonresidential structures is forecast to rise 2.4% this year, 7.9% next year, 4.4% in 2007, and 3.3% in 2008. Real spending on software and equipment is projected to increase 11.3% in 2005, 7.7% in 2006, 5.8% in 2007, and 6.7% in 2008. This strong showing will help real business investment grow faster than real GDP in each year of the forecast. Total business investment should expand a healthy 9.3% in 2005, 7.7% in 2006, 5.5% in 2007, and 5.9% in 2008.

Inflation: Inflation should remain contained over the forecast period. Evidence for this outlook can be seen in recent data on key inflation indicators that suggest top-line inflation has either peaked, or will peak shortly. The spring oil price surge seems to have been absorbed, which resulted in the price roll back of several downstream petroleum products. Likewise, prices for many other commodities have receded from their recent peaks. In particular, global steel prices are falling. For the manufacturing sector, this decline is probably a more important development than the recent dip in oil prices, since the cost pressures caused by the 80% surge

in steel prices across 2004 were more troublesome for many basic industries than the 50% jump in oil prices. Admittedly, it is awkward to down play the role of oil price increases when the spot price for oil crept above \$60 per barrel. Indeed, it serves as a reminder that risks associated with higher oil prices still remain. Energy markets are fragile, with market balances in both oil and natural gas markets currently being achieved through weaker demand growth and high prices, rather than an expansion of supply. In fact, with little spare production capacity, the price of oil should remain in the \$45-to-\$55

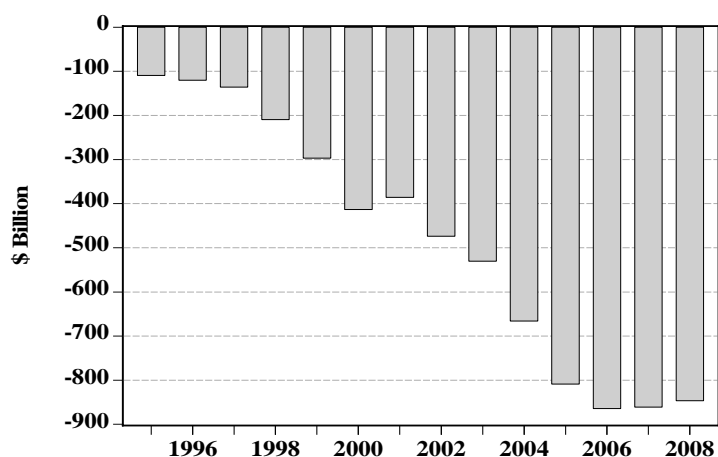
consists of two phases. Phase one is the downward slide that ended in the first quarter of 2003. Phase two began after that and is characterized by spending that oscillated around its bottom through the first quarter of 2005. However, nonresidential construction spending has recently shown signs that it has turned the corner to stronger growth. For example, nominal spending on nonresidential structures has been promising. The path that nonresidential construction is following over the current building cycle is a mirror image of its previous cycle. Namely, the pattern—a punishing downturn, followed by a long dormant period at the bottom, and finally a slow,

Consumer Price Inflation



per barrel range. Of course, panic buying would push the price of oil even higher, as it did in June 2005. However, the economy would be resilient to such a price surge. For example, Global Insight has explored the impacts of oil prices climbing into the \$50-to-\$60 per barrel range and found high oil prices would not plunge the economy into a recession. In a separate analysis, Standard and Poor's Chief Economist, David Wyss, determined the price of oil will not be a problem until it reaches \$100 per barrel, and no one expects it to get near that level over the forecast period. One measure worth watching is employment cost because it drives core inflation (overall inflation less food and energy). Labor markets have been one area of consistently good news on inflation over the past year. Some acceleration in compensation costs and, in turn, unit labor costs is expected over the coming year. Specifically, employment costs are projected to rise 3.3% in 2005, 3.9% in 2006, 3.8% in 2007, and 3.9% in 2008. Over this same period core inflation is expected to grow between 2.2% and 2.5% per year. After spiking at 2.9% this year, overall consumer inflation should be around 2%, as energy prices gradually recede.

U.S. Trade Deficit



Source: Global Insight

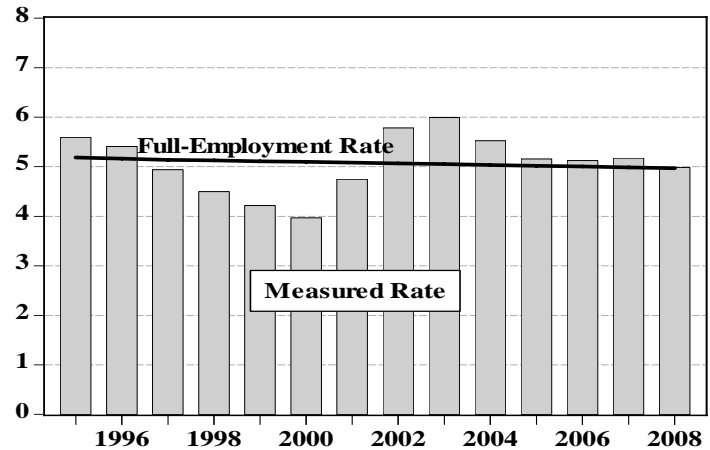
International: Anyone hoping for a quick improvement to the nation's huge trade deficit will be disappointed. Reversing the trade deficit is more akin to turning a fully loaded supertanker than spinning a nimble speedboat. The U.S. dollar's recent decline had raised some hope the stubborn trade deficit would soon disappear. It will not. Although it is true the lower dollar discourages imports while encouraging exports, these adjustments take time. In fact, the trade deficit can actually swell after the dollar's initial drop, since exchange rate changes affect prices faster than they do trade volumes.

Another reason the U.S. trade deficit is improving slowly is because China pegs the value of its currency to the U.S. dollar. Hence, the dollar has not retreated against the Chinese currency. Now for the good news; the worst may have already past. As the balance of payments graph shows, the current account deficit ballooned to an estimated \$809 billion in 2005, a \$143 billion increase from 2004. The trade deficit should grow in 2006, but the increase will be just \$55 billion. The trade deficit is expected to stabilize in 2007 then begin to retreat at a glacial pace, so that by 2010 it is \$843 billion, which is still significantly larger than it was in 2004.

Employment: The U.S. payroll employment sector provides an excellent example of why one month's data does not make a trend. Indeed, one needs to go back just a few months to see why this is true. According to the U.S. Department of Labor, there was a net gain of 274,000 jobs in April 2005. At this pace the economy would generate an additional 3.3 million jobs in one year. However, April's strong showing was followed by a net gain of just 78,000 jobs in May 2005. Less than one million jobs would be created in a year at this pace. Each monthly estimate paints a vastly different picture of the nation's employment health than the other one. These swings should preclude the use of just one month's data to evaluate the U.S. labor situation. A simple way around this is to use averages. For example, the average gain for April and May 2005 was 176,000 new jobs, which is consistent with the year-to-date average gain of 180,000 new jobs. The nonfarm data also shows the risk of basing conclusions on preliminary data. One month after estimating the U.S. netted just 78,000 jobs in May 2005, the U.S. Bureau of Labor Statistics revised this increase to 104,000 jobs. Another way to measure the labor market is with the unemployment rate. In May 2005, the nation's unemployment rate decreased by 0.1 percentage point to 5.1%, which is 0.5 percentage point lower than in May 2004. The

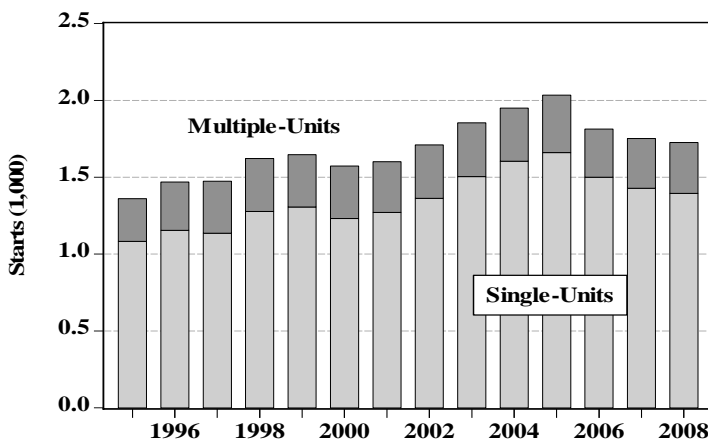
U.S. Department of Labor also reported nonfarm productivity grew at a 2.9% annual rate in this year's first quarter. Productivity growth is important because it helps to determine how fast employment will expand. Productivity is defined as output per number of hours worked. The number of hours worked, in turn, is the product of the number of jobs and the average hours worked per job. Based on the anticipated output growth and productivity, near-term employment should increase an average of 186,000 jobs per month, which is the same as last year. The average job gain per month could be boosted if output grows faster or productivity grows slower than assumed. In the current forecast, nonfarm employment is projected to increase by an average of 186,000 jobs per month in 2005, 163,000 jobs per month in 2006, 111,000 jobs per month in 2007, and 115,000 jobs per month in 2008. The U.S. civilian unemployment rate is expected to fall gradually over the forecast period, so that it averages about 5.0% by 2008.

U.S. Civilian Unemployment Rate



Source: Global Insight

U.S. Housing Starts



Source: Global Insight

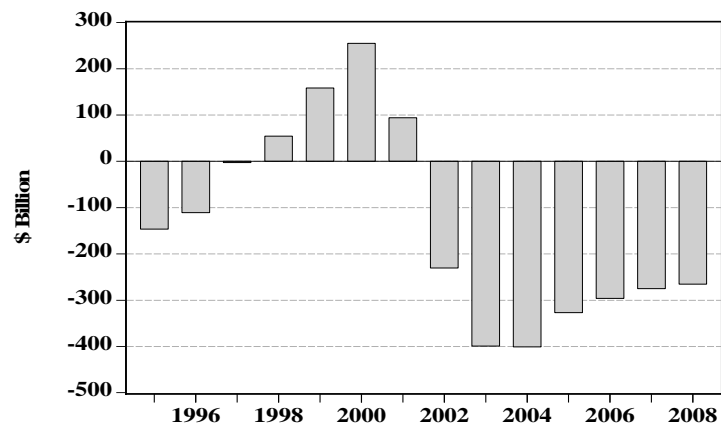
Housing: The U.S. housing forecast has markedly improved compared to the previous projections that were reported in the April 2005 *Idaho Economic Forecast*. The housing market has been revitalized by the recent fall in long-term interest rates that pushed mortgage rates down to about 5.5%. The Freddie Mac average of 30-year rates for the week ended June 9 stood at 5.56%. In June 2005, mortgage rates sank to a 14-month low and were less than 25 basis points above their March 2004 low. In fact, rates were just 35 basis points above their modern era low of 5.21% that was reached in June 2003. With rates already near historical lows it is hard to imagine they

could go lower, but the large margin between mortgage interest rates and 10-year bonds suggest mortgage rates could go further south. The low mortgage interest rates have resulted in a flood of new, conventional mortgage applications this spring. The low mortgage rates also helped both existing and new homes sales set records in recent months. Strong housing demand has caused the U.S. average price for existing homes to appreciate, but it does not appear there is a national housing bubble. However, this cannot be said for all housing markets. Some regional markets, where home prices have soared in relation to household income, are especially vulnerable to falling prices. Even the usually obfuscatory Alan Greenspan admitted there was "froth" in some housing markets. If there is a housing bubble, builders are not fueling it. In fact builders seem to be living by the mantra, "If they come we will build it," instead of "If we build it they will come." For example, over 40% of the new single-family homes sold in April 2005 had not even been started and less than 25% of new homes sold or for sale were even completed. Recently, the stock of new homes for sale measured a paltry 3.6 months of sales, while the number for sale and completed was less than a month's worth of sales. Clearly,

builders are merely keeping pace with the market. Eventually mortgage interest rates will rise, and this will affect the housing market. However, the U.S. housing market is not expected to collapse, but, instead, should experience a fairly orderly and gradual decline. Specifically, U.S. housing starts are anticipated to fall from just over 2.0 million units this year to 1.8 million units in 2006 and 2007, and to 1.7 million units in 2008.

Government: The federal budget deficit is expected to decline over the forecast period, but not enough to meet the President’s ambitious target to halve it from 2004 to 2009. This holds regardless of the method used to calculate the deficit. For example, on the unified basis, the federal deficit declines from its 2004 peak of \$413 billion to \$251 billion in 2009. As measured by the National Income and Product Accounts, the deficit drops from \$369 billion to \$224 billion over this same period. The process for setting the fiscal year 2006 budget is well under way. One major test of wills regarding the new budget will be the pending transportation bill. The Senate version of this bill calls for five-year spending of \$295 billion, while the House version, which is similar to the President’s plan, asks for only \$284 billion. President Bush’s proposal to spend \$284 billion over five years translates into slight increases in real spending, while the Senate’s plan incorporates more generous real spending hikes. Both the Senate and the House proposals represent an increase from the previous transportation bill that authorized about \$223 billion in spending over the 1999 to 2004 period. The high-profile transportation bill will be viewed as a litmus test of both the Executive and Legislative branches’ resolve to control federal spending. Other spending pressures worth observing are Medicare, interest payments, and defense. The good news is the federal deficit will continue to shrink despite these pressures, thanks to anticipated strong federal revenue growth. Some of this growth has already started. Revenues have surged this year thanks to the strong coincident acceleration of both corporate and individual income tax receipts. The faster pace of corporate income tax revenues reflects the expiration of the accelerated depreciation allowances at the end of 2004. It also is the result of strong profits caused by productivity gains and aggressive price hikes taken earlier in 2005. The strong growth in individual income tax receipts is due to higher employment levels, as well a jump in bonuses and other incentives that were distributed at the end of last year and the beginning of this year. These developments suggest individual income tax receipts may be stronger during this business cycle compared to previous business cycles. As a result, the federal deficit declines faster than in the previous forecast. Specifically, the unified budget deficit drops from \$413 billion in fiscal year 2004 to \$251 billion in fiscal year 2009. In the previous forecast, the unified budget deficit was expected to drop from an estimated \$400 billion in fiscal year 2004 to \$287 billion in fiscal year 2009.

**U.S. Federal Government Surplus
Unified Basis**



Source: Global Insight