

## NATIONAL FORECAST DESCRIPTION

### **The Forecast Period is the Second Quarter of 2006 through the Fourth Quarter of 2009**

The U.S. economic forecast has improved marginally from the previous forecast. In the April 2006 forecast it was expected GDP growth would seesaw from 3.4% this year to 2.4% next year then average about 3.2% annual growth in 2008 and 2009. The current forecast calls for real output to expand 3.4% in 2006 and 2.6% in 2007 followed by 3.2% growth thereafter. As a result of the stronger start, U.S. real GDP is about \$30 billion higher in 2009 than in the previous forecast. The outlook for employment has also improved. In the current forecast employment grows faster in 2007 and 2008 than in the previous forecast, resulting in over one-half million more jobs in 2009. Interestingly, national real personal income is lower in this forecast than in the previous one. This difference reflects the predicted lower levels for farm proprietors' income and dividends, interest, and rent payments. Overall, U.S. real personal income should rise about 3.6% annually, which is down slightly from the previously forecasted 3.7% pace.

A marked difference between this forecast and the previous one is short-term inflation is higher in this forecast. Specifically, the consumer price index rises by 3.3% in 2006 and 2.1% in 2007. While this is relatively low by historical standards, it is above the 2.4% and 1.7% inflation rates reported in April 2006. The increased inflation expectations can be traced to energy prices that rise higher than previously expected and take longer to retreat. Oil prices illustrate this point. In the previous forecast the price of West Texas Intermediate crude was projected to peak at \$64 per barrel in the first quarter of this year and decline to \$52 per barrel by the end of 2009. In the current forecast the oil price apex of \$71 per barrel occurs in the third quarter of this year and is \$56 per barrel at the end of the forecast period. The higher oil price spills over into the price of non-energy goods and services.

The nation's central bank has been tightening in order to contain inflation while it is tame rather than try to capture it after it is out of control. However, the Federal Reserve's task is complicated by the cooling economy. The Federal Reserve is clearly worried about the risk of over-tightening, and thus sending the housing market into a tailspin. The June rate hike showed the Federal Reserve is determined above all to keep a lid on inflation. This forecast assumes the Federal Reserve will raise rates by 25 basis points on August 8, 2006. In 2007, with GDP growing below its trend and inflation easing, the Federal Reserve will begin to lower the federal funds rate to 4.75% by that year's end.

Strong economic growth is having a beneficial impact on the federal budget deficit. Despite hurricane-related spending and the launch of the Medicare prescription plan, revenues are up so sharply this year the federal budget deficit is likely to narrow. The fiscal year 2006 federal budget deficit should come in at \$289 billion, which is below last year's \$319 billion deficit. While current strong collections do not eliminate the need for strong budget medicine down the road in the form of higher taxes and/or program cuts, it does postpone when those decisions will have to be made. This forecast assumes Congress will not allow all of the president's personal tax reductions to expire as scheduled. But the forecast also assumes Congress will tinker enough to raise federal personal income tax receipts toward their historical average of 8.2% of GDP.

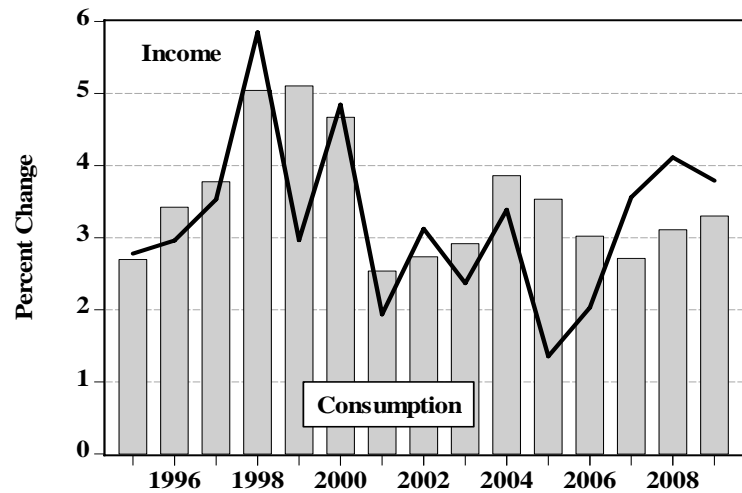
## SELECTED NATIONAL ECONOMIC INDICATORS

**Consumer Spending:** As anticipated, real consumer spending growth has downshifted. Monthly gains in real consumption have subsided from a peak of 0.9% in November 2005 to about 0.2% in May 2006. In fact, monthly gains have been no more than 0.3% so far this year. This decline reflects a combination of factors. Most notably, it appears soaring gasoline prices have taken their toll on consumer confidence. The University of Michigan, Conference Board, and ABC/ Washington Post measures of confidence all declined in May 2006. It should be noted the Michigan index fell to 79.1 in May—its lowest level since the post-hurricane reading of 74.2 last October and below levels that prevailed throughout the 2001 recession. In addition to rising gasoline

prices, inflation worries and rising interest rates are also undermining consumer confidence. As consumers grow worried about the broader economic outlook as well as their personal finances, real consumer spending is projected to slow from a 5.1% annual rate in the first quarter of 2006 to a 2.1% annual pace in the second quarter. Spending should rebound slightly in the second half of this year, but remain below 3%. The deceleration is most pronounced in durable goods, especially vehicles and home furnishings. Additionally, rising prices have increased consumers' energy bills, leaving less for purchases on other items. Soaring gasoline prices have dampened the motor vehicle market, especially for large SUVs. The abrupt slowdown in home price appreciation, along with declining single-family home sales, construction, and remodeling point to weaker spending on home furnishings. Home-equity withdrawals through mortgage refinance or home-equity loans have been a popular source of funding home improvements and furnishings. But rising interest rates and slower home price increases are closing these options. Another closing door is savings; the U.S. personal savings rate is negative. With fewer options available for continuing their recent shopping spree, real consumer spending should expand more in line with real income in the future. This marks a significant change; real consumption has grown faster than real disposable income in every year since 2002. The slower real spending will also be a drag on the economy during the forecast period. Robust consumer spending kept the U.S. economy afloat in recent years. Real consumption has grown faster than real GDP in every year from 1998 to 2003. The gap between spending and output was widest in 2001, as the economy slipped into a mild recession. Real consumer spending is anticipated to expand slower in the second half of this decade than during the first half. Specifically, real spending is forecast to increase 3.0% this year, 2.7% next year, 3.1% in 2008, and 3.3% in 2009. Real disposable income benefits from the anticipated acceleration in real wages. Real household net worth is expected to grow over the forecast period, but not as fast as it had earlier this decade. The U.S. personal savings rate's return to positive territory is delayed until 2008.

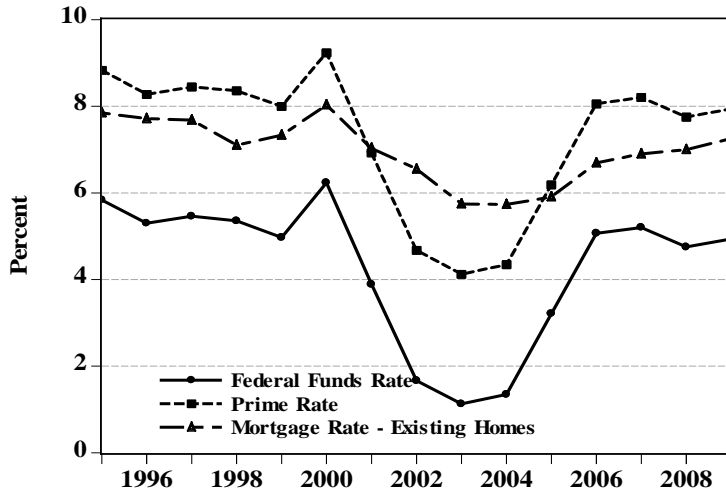
**Financial Markets:** It appears the nation's central bank is close to ending its most recent round of tightening that began on June 30, 2004. The Federal Open Market Committee voted to raise the federal funds rate to 5.25% on June 29, 2006. Whether this was its last advance in its inflation war, remains to be seen. Many experts believe the Federal Reserve will push its bellwether interest another 25 basis points in August when it meets again. What the Federal Reserve does ultimately depends on whether it believes inflation has been contained. This decision will not be easy because of sometime conflicting

### U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

## Selected U.S. Interest Rates

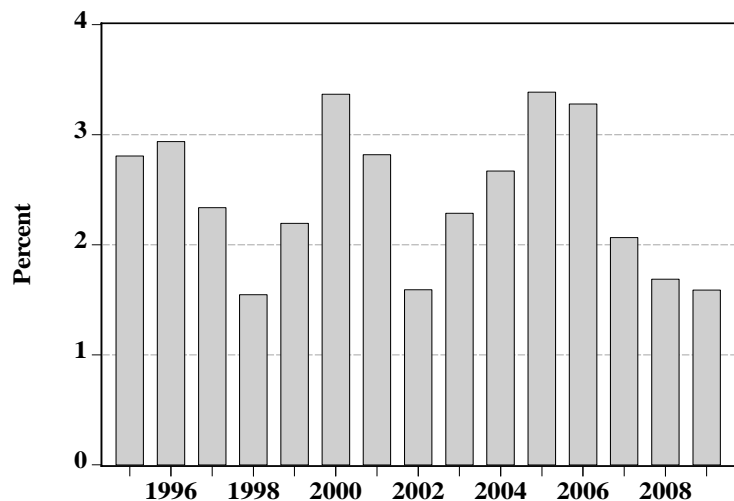


Source: Global Insight

causes the Federal Reserve to begin easing. This round of loosening is not anticipated to be as steep as the previous one where the federal funds rate dropped from 6.25% in December 2000 to 1.00% in June 2003. Specifically, the federal funds rate is projected to decline from 5.5% in the first quarter of 2007 to 4.8% by that year's last quarter. While this is the most likely path of the federal funds rate, other outcomes, while not as probable, are also possible. For example, the Federal Reserve policy would be tighter if inflation heated up. On the other hand, lower inflation would lead the central bank to adopt a more relaxed monetary policy.

**Inflation:** Consumer price inflation, as measured by the consumer price index, should be 3.3% this year and decline to half that level by 2009. Most of this year's inflation outlook reflects energy prices that began soaring last year. The price of West Texas Intermediate crude averaged \$70.96 per barrel, a 26% increase from the previous year. Factors driving up the price of crude include the start of the Gulf of Mexico hurricane season, continued tensions in Iran and Nigeria, and the outbreak of hostilities between Hezbollah and Israel. As a result of rising oil prices, the price of gasoline is near \$3 per gallon. These higher prices are not confined to petroleum products, but are beginning to spill over into a wide range of goods and services. For example, airline ticket prices reflect higher fuel prices. Interestingly, not all energy prices have been rising. The Henry Hub natural gas spot price in May 2006 was 13% below the previous year's level, partially the result of a mild winter and rising inventories. Inflation pressure should ease as oil prices gradually decline to \$56 per barrel in 2009. But part of this decline will be offset by accelerating core inflation, which is overall inflation less food and energy, that is propelled by rising labor costs. As a result the core inflation rate is actually higher than the overall inflation rate after 2006.

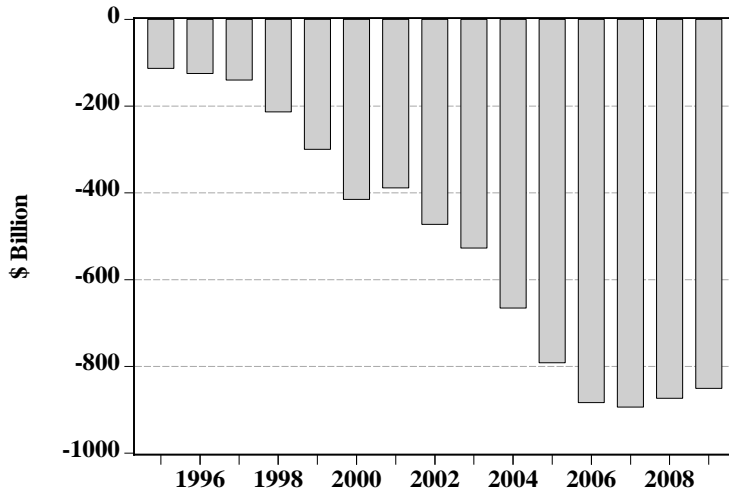
## Consumer Price Inflation



Source: Global Insight

Specifically, the consumer price index for all items is forecast to increase 3.3% in 2006, 2.1% in 2007, 1.7% in 2008, and 1.6% in 2009. Core inflation is projected to rise 2.5% in 2006, 2.4% in 2007, 2.1% in 2008, and 2.0% in 2009.

### U.S. Trade Deficit



Source: Global Insight

**International:** The foreign trade sector should stop being a drag on GDP growth in the second quarter of this year as a result of robust exports and restrained imports. The robust export growth should continue because of solid growth overseas. The annual inflation-adjusted trade deficit expands to \$648 billion this year, but should decline thereafter. The nominal trade deficit takes longer to stabilize, as high commodity prices—especially oil—keep the nominal trade shortfall rising for half a year after the real deficit has begun to shrink. High oil prices swell the nominal trade deficit to \$801 billion in 2006 before it dips to \$770 billion in 2007 and falls further to \$671 billion in 2009. Unfortunately, not all deficits are

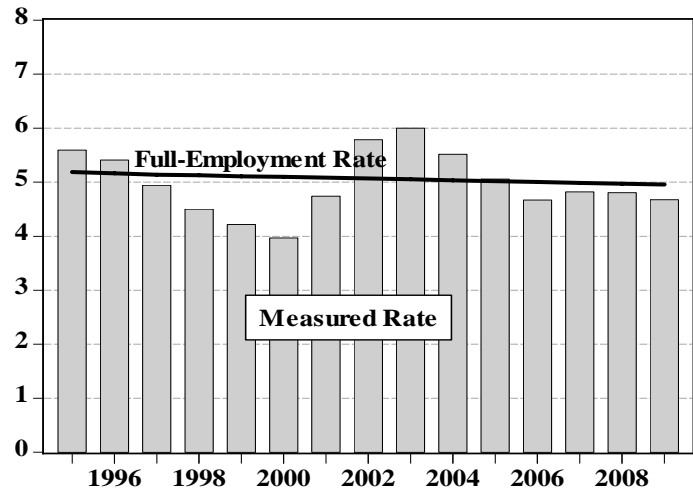
expected to shrink; the current account balance barely budges from \$883.6 billion in 2006 to \$850.3 billion in 2009. The current account deficit stays stubbornly high because declining net income from abroad and net transfers to foreigners. Net income from abroad, which was a surplus of \$11.3 billion in 2005, becomes an \$83.6 billion deficit by 2009—a swing of \$94.9 billion. The net transfer to foreigners’ deficit grows by over \$20 billion from \$86.1 billion in 2005 to \$107.2 billion in 2009. The large current account deficit exerts downward pressure on the dollar, causing it to slide over the forecast period. The greenback’s decline would be steeper but for the relatively high long-term interest rates that make investing in the U.S. more attractive compared to other countries.

**Business Investment:** National business investment will shoulder a greater share of economic growth as two growth engines, consumer spending and housing, downshift over the forecast period. Although real business spending is expected to decelerate over the next few years, it should grow faster than real GDP. As a result business spending’s share of total output will climb from 10.2% in 2004 to a peak of 11.6% in 2007. After 2007, investment should gradually recede to 11.4% of output in 2009. As in the recent past, business spending is led by investment in its equipment and software category, which in turn is fueled in large part by its information processing equipment component. Real spending on information processing equipment is expected to expand 12.8% this year, 9.8% next year, 9.0% in 2008, and 9.1% in 2009. This component’s relatively strong performance results from a combination of favorable factors. Increasingly powerful computers are viewed as one of the most cost efficient means to raise a company’s productivity. Concerns over rising energy prices have made businesses cautious about investing in other types of equipment, freeing up funds to be spent on information processing equipment. With corporate profits high, American businesses are flush with funds to purchase equipment. Interestingly, spending on heavy trucks should surge in 2006 thanks to EPA regulation that take effect in 2007. Unfortunately, because of the accelerated spending, spending on heavy trucks plummets in the first quarter of 2007. In summary, real business investment is forecast to expand 9.2% in 2006, 6.4% in 2007, and 4.7% in both 2008 and 2009.

**Employment:** The economy is expected to remain at full employment through the forecast period. Robust job growth last year caused the unemployment rate to slip below the level considered full

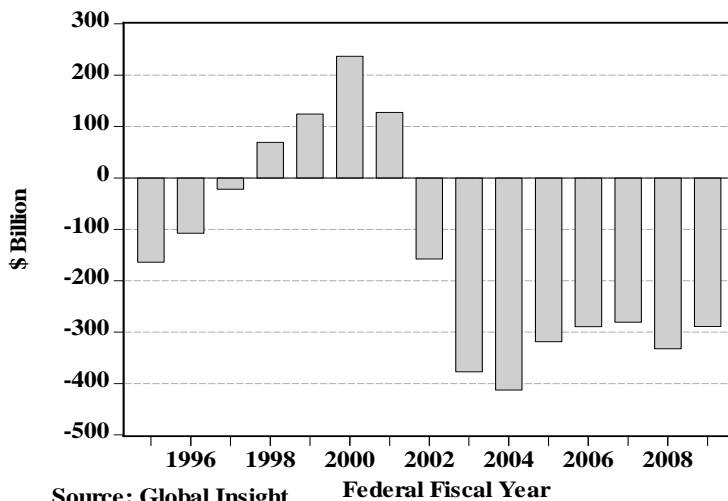
employment for the first time in four years. National nonfarm employment advanced at a 1.5% annual pace in each of 2005's first three quarters. Thanks to these job gains, the measured U.S. civilian unemployment fell to the estimated full-employment rate of 5% in the third quarter of 2005. Despite slower job growth at the end of last year, reflecting the impacts of Hurricane Katrina and Hurricane Rita, the unemployment rate managed to drop further to 4.9% in the last quarter. Recent weaker-than-anticipated job gains have raised concerns that the unemployment rate may soon be headed up once again. However, at this point such worries seem premature. Many economists were disappointed with the 121,000-job gain in June. As a result, monthly employment gains averaged 142,333 for the first half of this year, which is down slightly from 154,500 in last year's second half. It should also be pointed out the economy generated an average of 108,333 jobs per month in the second quarter of 2006, which is its weakest showing since the summer of 2003. However, there is a major difference between these two periods. The current labor market is much tighter than it was in 2003. In the summer of 2003 the unemployment rate was well above the full-employment threshold, but it is currently below the full employment level. Ironically, the low job growth may actually be a symptom of the economy's health. More people return to work as the economy improves. Eventually, the pool of jobseekers shrinks to the point where businesses have trouble finding qualified workers for job openings. As a result, job growth is not limited by the number of job vacancies, but by the number of available workers. It is also easier for workers to move into more lucrative positions when the economy is expanding. There is some evidence this may be taking place. Retail employment, which includes many entry-level jobs, has dropped over the past year. Retail jobs outside of motor vehicle dealers fell by 24,500 in the 12 months ended in June 2006. Nonfarm employment is forecast to expand 1.4% in 2006, 1.3% in 2007, 1.4% in 2008, and 1.2% in 2009.

### U.S. Civilian Unemployment Rate



Source: Global Insight

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



Source: Global Insight

**Government:** The flood of revenue pouring into federal coffers has caused experts to lower their predictions of the federal budget deficit. While this deluge is not sufficient to fill the budget gap, it does shrink it more than had been predicted just a few months ago. The executive branch recently revised its estimate of the fiscal year 2006 budget deficit to \$296 billion, a 30% decrease from its February 2006 projection of \$423 billion. Global Insight's estimate of deficit reduction for fiscal year 2006 is smaller; it drops from \$376 billion in February 2006 to \$289 billion in July 2006. Interestingly, both deficit estimates are converging over time. The federal budget deficit is expected to

improve slightly in fiscal year 2007 to \$281 billion. However, it will rise to \$332 billion in fiscal year 2008 as the cooling economy causes the federal government’s revenue growth to slow and its outlays to accelerate. As the economy improves, the federal budget deficit should shrink once again.

**Housing:** Economic forces are slowing the housing market. After five record-breaking years, a combination of rising interest rates and rising home prices have driven up the price of housing, thus reducing affordability and demand. The Office of Federal Housing Enterprise Oversight’s Housing Price Index was 12.5% higher in the first quarter of 2006 than in 2005. The cooling in the housing market, which began late last summer, is almost 10 months old. It has so far been an orderly one. If it is not there already, the housing sector is quickly approaching the point where it begins to subtract from GDP. This is a significant change since housing propped up the economy so far this decade. The housing sector will be a significant drag on GDP

growth for the rest of this year, despite evidence that demand is softening at a slower rate than it was early this year. The growing inventories of new homes—which stand at a record high—will cause a further retreat in housing starts over the course of 2006. Specifically, housing starts should drop about 10% in the second quarter and nearly 3% in the third. The slowdown then moderates, although starts still fall through mid-2007. The drop in housing starts is the key reason behind the anticipated 14–15% spending declines in single-family construction during the second and third quarters of 2006. In turn, residential construction chops 0.7 percentage point and 0.8 percentage point off GDP growth in the third and fourth quarters of this year, respectively, and 0.5 percentage point off in 2007. The impact of falling residential construction should be partially offset by expanded real spending on nonresidential structures. However, this respite is temporary, as nonresidential spending sputters in 2008. New home sales, which took a hit in the first quarter, will rebound in the second quarter even if, as the forecast assumes, sales drop in June. Afterward, the slide resumes. The largest percentage decline takes place in 2006, and the downturn extends through 2008. The downturn in existing home sales will be milder than that for new homes. In summary, as long as the economy keeps on track and interest rates do not shoot up too much, the housing industry slowdown—which is more of a transition from a market powered by low interest rates to one driven by demographics—should remain smooth.

