

STATE OF THE ECONOMY 1st Quarter 2005

Introduction

Signs of slowing economic growth began to emerge during the first quarter of 2005, with real gross domestic product (GDP) increasing by 3.1% during the quarter. This tepid growth follows a 3.8% increase in GDP during the fourth quarter of 2004 and a 4.0% increase during the third quarter. The pace of economic expansion has apparently slowed over the last three quarters with GDP increasing at a decreasing rate since the first quarter of 2004. The 3.1% increase during the first quarter of 2005 follows a 4.5% increase during the same period a year ago and represents the slowest growth for the United States economy in two years. Signs of economic softness were evident throughout the broader economy with personal consumption expenditures increasing at a much more tempered rate, retail sales weakening, continued elevated energy prices, and an increase in inflationary pressures. The Federal Reserve's gradual removal of accommodative monetary policy may have also contributed to the deceleration in real GDP in the first quarter of the year. With the economy showing muted signs of abating growth, a number of factors may, in combination, be at work to impede further robust growth in the short-term. To be sure, the economy in 2005 is likely to experience continued growth, albeit at a much more modest pace, due to a number of adverse conditions that may restrain demand.

Gross Domestic Product

Advance estimates¹ released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 3.1% in the first quarter of 2005, declining from the revised rate of 3.8% for the fourth quarter. Economic growth during the first quarter was also lower than the consensus forecast of 3.7% annual growth in real GDP anticipated by thirty-six forecasters surveyed by the Federal Reserve Bank of Philadelphia². Wall Street economists

¹ The BEA press release on April 28, 2005 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 May 26, 2005.

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

were slightly more optimistic with expected first quarter GDP growth of 3.6%³. The fourth quarter growth in real GDP was revised higher from an annual rate of 3.1% to 3.8%, still lower than the 4.5% and 4.0% annual growth in real GDP for the first and third quarters of 2004⁴, respectively, but higher than the 3.3% rate during the second quarter. The slowdown in real GDP growth during the first quarter of 2005 was the slowest rate of growth since the 1.9% increase for the first quarter of 2003. The slowdown in economic growth in the first quarter was a result of a slower increase in personal consumption expenditures and equipment and inventory along with an increase in imports (which are a subtraction from GDP).

Real personal consumption expenditures, which accounts for about two-thirds of economic activity, increased by 3.5% in the first quarter as compared to a 4.2% increase in the fourth quarter at a seasonally adjusted annual rate. Purchases of durable goods, which increased 17.2% in the third quarter and 3.9% in the fourth quarter, were unchanged in the first quarter, due largely to a decline in expenditure on motor vehicles and parts. Personal consumption expenditures on nondurable goods, which increased by 5.9% in the fourth quarter, were tempered with an increase of 4.9% in the first quarter. Data from the Federal Reserve Beige Book released on March 9, 2005 and April 20, 2005 indicated that many Federal Reserve Districts noted motor vehicle sales during the quarter were softer than previous quarters. Retail sales exhibited mixed strength during the quarter and were characterized as being stable, though there was weakness of sales of big-ticket items. There were also some signs of increased prices and pricing power amongst retailers.

Real nonresidential fixed investment increased by 4.7% in the first quarter, substantially below the 14.5% advance in the fourth quarter and 13.0% increase in the third quarter. Equipment and software investment activity, which increased by 18.4% in the fourth quarter, increased by a modest 6.9%. Investment in structures decreased by 2.6% in the quarter following a 2.1% increase in the fourth quarter. The slowdown in equipment and software investment to 6.9% was the slowest growth since the 4.5% rate in the first quarter of 2003.

Following an increase of \$47.2 billion in the fourth quarter, private businesses increased inventories by \$80.2 billion during the first quarter. The increase in private business inventories added 1.21% to GDP for the quarter as

³ "Economy Grows at Softest Pace in 2 Years," Reuters, April 28, 2005.

⁴ Quarterly data is expressed at a seasonally adjusted annual rate. Real estimates are in chained (2000) dollars.

compared to adding 0.46% to the fourth quarter change in real GDP. This increase in additions to inventories may suggest that businesses were anticipating increased economic activity and demand expectations during the first half of the year or that production was increased to replenish stocks drawn down during the holiday season. However, in the event that the demand expectations for the first half of 2005 do not materialize, production in the second and third quarters could slow sharply in order for businesses to adjust inventory levels. This could have an adverse impact upon economic activity and production during the second and third quarters in the form of a drag on GDP growth.

Real residential fixed investment increased by 5.7% during the first quarter, following an increase of 3.4% during the final quarter of 2004. This strong growth continues a trend that has been evident for nearly a year, as real residential fixed investment increased by 5.0% in the first quarter, 16.5% in the second quarter, and 1.6% in the third quarter. This could be the result of continued accommodative monetary policy and favorable mortgage rates.

Despite the increase in real residential fixed investment reported in GDP figures, data on new residential construction from the U.S. Census Bureau and U.S. Department of Housing and Urban Development indicated that activity decreased during the first quarter of 2005. Privately-owned housing units authorized by building permits ended the year at 2,069,000. New privately-owned housing units authorized by building permits increased slightly in January to 2,132,000, representing a year-over-year increase of 8.2%. However, figures decreased in February and March to 2,107,000 and 2,023,000, respectively, or roughly 4% each month. On a year-over-year basis, however, new privately owned housing units authorized by building permits increased 7.7% and 0.2% in February and March.

Following an increase of roughly 5.8% in January to a seasonally adjusted annual rate of 2,183,000, privately-owned housing starts increased by 2.1% in February to 2,229,000 before decreasing 17.6% in March to 1,837,000—the largest monthly fall in fourteen years. These figures are roughly 12.9% and 17.6% higher on a year-over-year basis in January and February but 8.2% lower on a year-over-year basis in March. However, as the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing and Urban Development state in the new residential construction press releases:

In interpreting changes in the statistics in this release, note that month-to-month changes in seasonally adjusted statistics often show movements which may be irregular. It may take 4 months to establish an underlying trend for building permit authorizations, 5 months for total starts, and 6 months for total completions.

At this point, it is too early to tell if the decrease in residential construction is the start of a cooling in the robust residential real estate market or merely a statistical aberration. It should be noted that residential construction activity experienced mixed results during the fourth quarter of 2004. It may not be unreasonable to conclude that recent signs of economic softness may have contributed to the decrease in residential construction towards the end of the first quarter as consumers become more wary regarding the economic outlook. In addition, continued interest rate increases may contribute to a slowing of real estate activity and residential construction in the coming quarters.

The Federal Reserve Beige Book from March 9, 2005 and April 20, 2005 indicates that residential real estate activity throughout most of the twelve Districts remained strong during the first quarter with many Districts noting increased activity late in the quarter. Several Districts also experienced noticeable increases in home prices. The strength in the residential real estate markets in the first quarter continues a favorable trend that has characterized real estate throughout the twelve Districts for much of the last year.

After ending the year at 5.81%, thirty-year conventional mortgages according to Freddie Mac⁵ declined during the first quarter from 5.77% to a low of 5.57% in February before climbing to 6.04% by the end of March. Fifteen-year mortgages experienced a similar pattern, falling from 5.21% at the first of the year to a low of 5.10% in February before ending the first quarter at 5.58%. The continued low mortgage rates coincide with U.S. Treasury yields on the 10-year note that have increased only slightly from 4.29% in January to 4.55% by the end of March, despite an increase in short-term rates associated with the Federal Reserve's removal of accommodative monetary policy at a measured pace. With the Federal Reserve likely to continue its removal of accommodative monetary policy in the coming quarters, long-term Treasury yields and mortgage rates will ultimately increase in conjunction with rising short-term rates at some point. With the gradual removal of monetary policy accommodation and the ultimate rise in long-term rates, the real estate activity

⁵ Data from Freddie Mac Weekly Mortgage Market Survey

may begin to cool in the coming quarters, particularly as signs of economic softness may serve to restrain consumer confidence and their desire to seek long-term real estate investments.

Real exports of goods and services increased 7.0% in the first quarter following a 3.2% increase during the fourth quarter of 2004. The growth in exports, likely due to continued weakness of the dollar in foreign exchange markets, contributed to the increase in GDP during the first quarter. This increase in exports follows a 6.0% increase during the third quarter and a 7.3% increase during the second quarter of 2004, during which time the dollar weakened against foreign currencies. Imports, a subtraction from GDP, increased during the first quarter by 14.7% compared to an 11.4% increase during the fourth quarter. This increase in imports is the largest since the fourth quarter of 2003 when imports grew by a rate of 17.1%.

The weakness in the dollar that began in 2004 abated slightly during the first quarter of 2005. At the end of the first, second, third, and fourth quarters of 2004, the dollar/sterling (\$/£) exchange rate stood at roughly \$1.85, \$1.82, \$1.79, and \$1.92, respectively. During the first quarter, the dollar gained some ground against the pound to \$1.85 mid-quarter before falling again to end the quarter at \$1.89. The dollar/euro (\$/€) exchange rate was \$1.19 at the end of the first quarter, \$1.23 at the end of the second quarter, \$1.23 at the end of the third quarter, and \$1.35 at the end of the fourth quarter. During the first quarter of 2005, the dollar strengthened slightly to \$1.28 before weakening to end the quarter at \$1.30. At the end of the first, second, third, and fourth quarters of 2004, the yen/dollar (¥/\$) exchange rate stood at ¥104, ¥109, ¥111, and ¥104, respectively⁶. By the end of the first quarter the dollar stood at ¥107.

The persistent weakness of the dollar stems from a variety of concerns. Traders continued to be concerned that persistent high oil prices would suppress demand in the U.S. and slow economic growth, prompting foreign investors whose portfolio flows into U.S. assets helped cover the current account deficit to move investments to other currencies and economies offering better returns. Comments made by Alan Greenspan, Chairman of the Federal Reserve, at a banking conference in Frankfurt, Germany, in late November suggested that the current account deficit was “increasingly less tenable,” prompting further falls in the dollar during the fourth quarter. In early January, the dollar rebounded slightly to \$1.30/€ following comments from

⁶ Source: *The Economist*

John Snow, Treasury Secretary, indicating that the U.S. would make efforts to address the government's fiscal deficit and reiterating the administration's belief that a strong dollar was in the national interest.

Real federal government consumption expenditures tapered in the first quarter, increasing by 0.6%, as compared to a 1.2% increase during the fourth quarter. This slowdown in the rate of federal government consumption expenditures was the result of lower nondefense spending, which increased by only 1.3% in the first quarter following a 5.3% increase in the fourth quarter. Defense spending increased only slightly by 0.2% following a decrease during the fourth quarter of 0.6%.

The Federal Reserve

The Federal Reserve continued its measured tightening of monetary policy during the first quarter. Their actions originally began with a twenty-five basis point increase in the federal funds rate at each of the June 30, 2004, August 10, 2004, September 21, 2004, November 10, 2004, and December 14, 2004 meetings. By the end of 2004, the Federal Open Market Committee (FOMC) had increased the federal funds rate to 2 ¼%⁷.

At its meeting on February 2, 2005, the FOMC continued its tightening policy with a twenty-five basis point increase in the target for the federal funds rate to 2 ½%⁸. The FOMC once again stated that it believed monetary policy remained accommodative and continued to provide ongoing support to economic activity. Further, the Committee believed that the risks to sustainable growth and price stability were equal for the coming quarters. The Committee indicated that:

Output appears to be growing at a moderate pace despite the rise in energy prices, and labor market conditions continue to improve gradually. Inflation and longer-term inflation expectations remain well contained.

At its meeting on March 22, 2005, the FOMC agreed another twenty-five basis point increase in the target for the federal funds rate to 2 ¾%⁹. The FOMC continued to believe that the risks to sustainable growth and price

⁷ The Board of Governors also increased the discount rate by to 3 ¼% by the end of 2004.

⁸ The Board of Governors also increased the discount rate by twenty-five basis points to 3 ½% at the February 2, 2005 meeting.

⁹ The Board of Governors also increased the discount rate by twenty-five basis points to 3 ¾% at the March 22, 2005 meeting.

stability were equal for the coming quarters. The Committee, however, indicated that:

Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices.

In semi-annual testimony before the Congress on February 16, 2005¹⁰, Chairman Alan Greenspan noted since his last testimony the economy had firmed while overall inflation subsided and core inflation remained low. In addition, he indicated that evidence suggested that economic fundamentals had steadied and that consumer spending had been supported by increases in disposable income, gains in net worth, and accommodative credit market conditions. Chairman Greenspan also indicated that, although capital spending and corporate borrowing had firmed in the recent months, business executives remained cautious. With respect to the prospects for the economy in 2005, Chairman Greenspan indicated the following:

All told, the economy seems to have entered 2005 expanding at a reasonably good pace, with inflation and inflation expectations well anchored. On the whole, financial markets appear to share this view. In particular, a broad array of financial indicators convey a pervasive sense of confidence among investors and an associated greater willingness to bear risk than is yet evident among business managers.

Despite the FOMC's tightening of monetary policy over the preceding several months, long-term interest rates remained at low levels in contrast to most historical experience that suggests an increase in short-term rates is accompanied by a rise in longer-term yields. As a result of the continue low long-term rates, analysts worried that the markets may have a more pessimistic view of economic growth for the future as a result of higher energy prices. Chairman Greenspan addressed this by stating:

But this interpretation does not mesh seamlessly with the rise in stock prices and the narrowing of credit spreads observed over the same interval...But we should be careful in endeavoring to account for the decline in long-term interest rates by adverting to technical factors in the

¹⁰ Testimony of Chairman Alan Greenspan, Federal Reserve Board's semiannual Monetary Policy Report to the Congress, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 16, 2005.

United States alone because yields and risk spreads have narrowed globally...For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience.

In the *Monetary Policy Report to the Congress*, the Federal Reserve policymakers expressed optimism for continued economic expansion in 2005 with low inflation. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3 ½%-4% in 2005 as compared to real GDP growth of 3.7% in 2004¹¹. The personal consumption expenditures chain-type price index (the Federal Reserve's preferred measure of inflation) excluding food and energy is expected to range from 1 ½%-2% as compared to 1.6% in 2004. The civilian unemployment rate is anticipated to range from 5%-5 ½% as compared to 5.4% for 2004. With respect to projections for 2006, the Federal Reserve Board of Governors and Federal Reserve Bank Presidents anticipate real GDP growth of 3 ¼%-3 ¾%, core PCE increases of 1 ½%-2%, and unemployment of 5%-5 ¼%.

In testimony before the Committee on the Budget (U.S. House of Representatives) on March 2, 2005, Chairman Greenspan voiced concern for the economic outlook due to the federal budget:

The U.S. economy delivered a solid performance in 2004, and thus far this year, activity appears to be expanding at a reasonably good pace. However, the positive short-term economic outlook is playing out against a backdrop of concern about the prospects for the federal budget, especially over the longer run.

The Federal Reserve Beige Books¹² released on March 9, 2005 and April 20, 2005 indicated more modest economic growth, with most of the twelve Districts¹³ experiencing expansion at a slower pace than previous reports. The Beige Book conclusions included the following:

¹¹ Changes are from average for fourth quarter of 2003 to average for fourth quarter of 2004.

¹² The press release on September 8, 2004 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.

¹³ 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.

- Retail sales, which strengthened during the last half of the fourth quarter, continued to show solid results overall during the first quarter. However, late in the first quarter, several Districts began to show flat or disappointing results of retail sales. New vehicle sales were flat in most Districts during the first quarter with other retail sales having mixed results.
- Manufacturing continued to expand at a solid pace across the country, though the pace of growth was little changed. Eleven of the twelve Districts indicated that production or orders were rising. Manufacturing activity was bolstered by increased demand for various durable goods such as building materials, machinery, fabricated metals, energy-related equipment, and defense equipment. Manufacturers noted an increase in input costs, particularly energy-related inputs, though prices seemed to be rising moderately as manufacturers attempted to pass part of the increase in costs to customers. Several Districts reported that the outlook for the coming year was positive and that continued growth could bring about expansion of factory headcounts.
- Residential real estate activity remained active during the first quarter, continuing its recent trend. Home price appreciation continued during the quarter. Commercial real estate activity was stable with office vacancy rates declining in several Districts. Commercial construction activity increased in some areas.
- Labor markets remained steady or showed signs of strengthening during the first quarter, with manufacturing employment increasing in the Boston, Philadelphia, Cleveland, Chicago, and Minneapolis Districts. There were reports, though scattered, of skilled labor shortages in many Districts. Wage pressures were moderate, though rising benefit costs continued to increase total compensation packages.
- Tourism continued to post favorable results during the first quarter throughout the twelve Districts. Occupancy rates and room revenues increased in many Districts, particularly in the south where theme parks and cruise lines experience increased demand from foreign visitors. Those Districts with favorable weather during the quarter experienced stronger tourism-related growth with areas having inclement weather experiencing flat or sluggish growth.

Consumer Confidence

Following several months of mixed results, the Conference Board's Consumer Confidence Index¹⁴ ended the year at 102.7. The Index then increased in January to 105.1 as a result of consumer optimism regarding economic growth during the first half of 2005. The Index then declined slightly in February to 104.4 and declined again in March to 102.4. The decline in consumer confidence in February was the result of January's initial figures being revised upwards from 103.4 to 105.1. The decline in consumer confidence in March was likely the result of rising gas prices, as the short-term outlook remained favorable. Lynn Franco, Director of The Conference Board's Consumer Research Center indicated the following with respect to the March consumer confidence figures:

Their overall assessment of current economic conditions remains favorable and their short-term outlook suggests little change in the months ahead. In fact, while expectations have lost ground, consumers anticipate the job market will continue to improve, and easing employment concerns should help keep spending on track.

After ending the year at 100.7, the Expectations Index declined to 100.4 in January, 96.1 in February, and 93.7 in March. The decline in expectations may have been the result of continued concerns over labor markets and geopolitical risks as well as the level of growth for 2005 due to continued high energy prices that act as a tax on consumers. Consumers' outlook for the next six months eased during the first quarter. In January 22% expected business conditions to improve in the next six months. This declined in February to 17.9% before rebounding in March to 19.2%. However, those expecting conditions to worsen increased in March to 8.2% after holding steady in January and February at 7.8%. These readings, however, may be the result of transitory factors weighing on the economy rather than a sustained shift in consumers' expectations regarding the economic outlook.

Consumers' assessment of current business conditions was mixed during the first quarter. For January, 26.1% of respondents characterized current conditions as "good," up from 24.4% in December. Though this eased

¹⁴ www.conference-board.org The March 2005 press release by the Conference Board states: "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 NFO. TNS NFO is one of TNS group of companies."

in February to 24.6%, optimism regarding current conditions increased to 25.8% in March. However, those characterizing conditions as “bad” also increased slightly in March to 16% from 15.7% in February. For January, those claiming conditions were “bad” was 18.1%. Again, these mixed results may be the result of transitory factors such as high energy prices, etc. However, should this weakness in consumer expectations equate to lower consumer confidence and prompt consumers to restrain spending, economic growth could be adversely impacted during the coming quarters.

The Business Sector

The moderate gains in industrial production during the fourth quarter continued during the first quarter of 2005 as a result of continued economic strength. Industrial production figures as compiled by the Federal Reserve¹⁵ rose from 117.9 in December to 118.5 by the end of March. For the quarter, industrial production increased at an annual rate of 3.6% following an increase of 4.5% in the fourth quarter. On a year-over-year basis, industrial production increased by 3.9%, 3.5%, and 3.9% in January, February, and March, respectively.

Manufacturing production also showed gains in the first quarter, increasing by 0.3% and 0.3% on a month-over-month basis in January and February and declining by 0.1% in March due to a drop in motor vehicle production. Manufacturing production also increased by 5.2%, 4.7%, and 4.1% on a year-over-year basis in January, February, and March, respectively. This overall improvement in manufacturing is further evidenced by information from the twelve Districts of the Federal Reserve System, many of which reported firm manufacturing activity during the first quarter. Defense and space equipment production increased by 10% in the first quarter following an increase of 8.1% in the fourth quarter. Business equipment production increased by 7.5% in the first quarter, up from 5.9% in the fourth quarter of 2004. Durable goods manufacturing production, which increased by 6.4% in the fourth quarter, rose by 5.7% in the first quarter of 2005. Nondurable goods production increased by 0.3% in the first quarter following a 2.9% increase in the fourth quarter.

Capacity utilization, which increased in the fourth quarter to end the year at 79.2%, continued to increase in the first quarter of 2005. For January, capacity utilization remained at 79.2% but increased in February and March to

¹⁵ Industrial production data from the Federal Reserve’s Industrial Production and Capacity Utilization statistical release from April 15, 2005.

79.3% and 79.4%, respectively. Though capacity utilization increased slightly during the quarter, this level of 79.4% remains 1.6% below the 1972 to 2004 average of 81%. Manufacturing capacity utilization, which stood at 77.9% in December, also increased slightly to 78.2% in February before ending the quarter at 78%.

The advance monthly sales for retail trade and food services in the first quarter released by the Department of Commerce¹⁶ continue to suggest strength with respect to increased economic activity. In March, retail and food service sales increased by approximately 0.3%¹⁷ to \$339.3 billion from February. This gain in March follows a 0.5% increase in February and a 0.3% decline in January's figures. On a year-over-year basis, monthly sales for retail trade and food service increased 8.1% in January, 7.8% in February, and 5.8% in March. For the first quarter, retail and food service sales increased by 1.3% from the fourth quarter and by 7.2% on a year-over-year basis. Total sales excluding motor vehicles and parts increased 1.7% in the first quarter as compared to the fourth quarter of 2004 and by 7.8% on a year-over-year basis. Retail sales increased 1.3% in the first quarter over the prior quarter and increased 7.2% on a year-over-year basis. Weakness in motor vehicles was evident in that the first quarter witnessed a 0.3% decline in retail sales by auto and other motor vehicle dealers as compared to the fourth quarter. This is consistent with anecdotal evidence in the Beige Books.

The aforementioned data suggest that the business sector continued to expand during the first quarter of 2005. Slower economic growth and consumer spending during the first quarter resulted in a build-up of private inventories. This suggests that manufacturing activity may soften in the coming quarters unless these inventories are drawn down as a result of increased exports, firmer consumer spending, or increased economic activity beyond expectations. With energy prices remaining at elevated levels, business may be inclined to, once again, reign in spending and pass along increased costs to their customers. Overall, these factors suggest that the favorable economic and business conditions that were evident throughout 2004 may be more muted in 2005. However, economic activity for the coming quarters is likely to increase at favorable but modest rates.

¹⁶ Press release from the Department of Commerce on April 13, 2005.

¹⁷ Adjusted for seasonal, holiday, and trading day differences but not for price changes.

Inflation

Following a 3.0% increase in the consumer price index (CPI)¹⁸ during the fourth quarter of 2004 at a seasonally adjusted annual rate, the CPI increased by a compound annual rate of 4.3% in the first quarter of 2005. The first quarter increase in the CPI of 4.3% is significantly higher than the 3.3% increase for all of 2004. Following a flat reading in December, the CPI increased by 0.1% in January, 0.4% in February, and 0.6% in March on a seasonally adjusted basis. For the first quarter, the energy index increased by 21.1% on a seasonally adjusted annual basis, as compared to a 16.1% increase for all of 2004. This increase in the energy index accounted for roughly three-eighths of the first quarter increase in the CPI. Food prices during the first quarter also increased, with the food index advancing at an annual rate of 1.3%, lower than the 2.7% annual rate for the full-year 2004.

Removing the effects of food and energy, the core CPI increased by 3.3% in the first quarter, as compared to a 2.2% increase for 2004. For the twelve month period ending with March 2005, the core CPI increased by 2.3%. The increase in the core CPI was a result of an across the board increase in most categories. However, the 4.4% increase in the index for shelter at a seasonally adjusted annual rate in the first quarter accounted for roughly 70% of the total acceleration in the core CPI. The 4.4% increase in the shelter index in the first quarter is significantly higher than the 2.7% increase for all of 2004. The Federal Reserve FOMC minutes also indicated that policymakers had become concerned by the increased inflation pressures. The minutes of the March 22, 2005 meeting indicated the following:

...[C]ircumstances had changed from those anticipated...inflation pressures could be intensifying...While underlying inflation appeared to have moved up only modestly and nearly all participants thought that core and total inflation going forward would be relatively low, they had become less certain of that outlook for the next few quarters.

Though concerns regarding the unexpected increase in inflationary pressures in the economy surfaced within the FOMC, the minutes further indicated the following with respect to future policy actions:

...required amount of cumulative tightening may have increased, an accelerated pace of policy tightening did not appear necessary at this time.

¹⁸ Based on data from the Consumer Price Index: March 2005 press release on April 20, 2005 by the Bureau of Labor Statistics, United States Department of Labor.

In addition to the CPI, the price index for gross domestic purchases from the BEA¹⁹ rose by 3.3% in the first quarter, compared with a 2.3% increase in the fourth quarter. This increase is the largest increase in the last four years. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 3.2% in the first quarter, following a 2.1% increase in the fourth quarter of 2004. The price index for personal consumption expenditures increased by 2.1% in the first quarter. Excluding food and energy, the price index increased by 2.2%. These figures, closely watched by the Federal Reserve, are likely indicative that inflation has picked up in recent months and further supports the FOMC's decision to begin removing monetary policy accommodation at a measured pace. However, should inflation accelerate further in coming months, the Federal Reserve may be forced to remove monetary policy accommodation at a more rapid pace.

Labor Market

After averaging 5.4% in the fourth quarter, the unemployment rate trended lower in the first quarter to an average 5.3%²⁰. On a monthly basis, unemployment was 5.2% in January, 5.4% in February, and 5.2% in March. Total nonfarm payroll employment increased by 124,000 in January to a seasonally adjusted 132.573 million, by 243,000 in February, and by 110,000 in March. As a result of these gains, total nonfarm payroll employment increased by 477,000 during the first quarter after adding over 600,000 jobs in the fourth quarter. Since its trough in May 2003, payroll employment has increased by 3.1 million.

Payroll gains in the quarter included increases in construction, mining, retail trade, and health care. Health care added 16,000 jobs in March, bringing the yearly total to 243,000. Construction employment rose by 61,000 during the first quarter and has added 489,000 jobs since its most recent low in March 2003. Mining employment continued to add jobs in the first quarter, mainly in support of oil and gas operations. Over the past five months, mining has added 22,000 jobs. Retail trade added 34,000 jobs during the first quarter; the industry has added 89,000 jobs in the last year.

¹⁹ Bureau of Economic Analysis, Gross Domestic Product: First Quarter 2005 (Advance) release, April 28, 2005.

²⁰ Bureau of Labor Statistics, United States Department of Labor, The Employment Situation: March, April 1, 2005.

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 during the quarter from 16.6% in January to 15.1% in March. In March, however, the number of consumers expecting fewer jobs to become available declined to 15.8% from 16.5% the prior month. Further increases in economic activity, even at a more tempered rate, should provide a foundation for continued increases in payroll employment for the coming quarters, though this growth may also be at a more muted rate.

Equity Markets

Though the equity markets posted strong gains for the fourth quarter, possibly in response to continued economic strength and the easing of tensions and uncertainty surrounding the presidential election, the major indices declined during the first quarter. After ending the year at roughly 10,850, the Dow Jones Industrial Average (DJIA) fell roughly 3% in the first quarter²¹. The S&P 500, after an increase of 8.9% during the fourth quarter to roughly 1,200, declined by 2.6% in the first quarter. The NASDAQ composite experienced the largest gain during the fourth quarter of roughly 15% to end the year at approximately 2,200 and experienced the largest loss during the first quarter, falling roughly 8%.

The market's weakness during the first quarter may largely be the result of concerns over sustained higher energy prices and the adverse impact it may have upon economic growth. However, according to the Business Roundtable in Washington, D.C., most chief executives of the largest U.S. companies expected favorable economic performance in 2005, resulting in higher sales and increased capital investment²². The survey of 118 of the top 160 companies in the United States indicated that expectations for economic growth were roughly 3.5%. In addition, the corporate confidence index hit a new high of 104.4 during the first quarter after ending the year at 98.9. The survey found that 60% of the top companies plan to increase capital expenditures over the next six months, an increase from 50% based on the previous quarter's poll. Only 36% anticipated increases in hiring as a result of gains in productivity.

Corporate profits at U.S. companies increased 13.5% during the fourth quarter of 2004 to a record \$1,268.8 billion due to strong demand and robust

²¹ Based on data from *The Economist*.

²² "Chief's Confidence Runs High," *The Financial Times*, March 2, 2005.

productivity growth²³. Though profits increased to record levels, investment spending outpaced cash flows, indicating that many companies may seek to raise funds in the capital markets should investment spending continue to surpass cash flows.

Though chief executives' confidence is high and expectations are for strong corporate profit growth during the first quarter, a number of factors suggesting economic softness may serve to temper investors' outlook for the equity markets. Sustained high energy prices and their impact upon consumers could have a significant adverse impact upon corporate profits, should consumer spending slow further. In addition, rising interest rates and inflationary pressures could further dampen investors' enthusiasm for the equity markets and prompt a flight to quality to government bonds. These issues along with lower growth in GDP could restrain gains in the equity markets as investors seek other investment opportunities. Though the foundation for advancement in the equity markets has been set forth over the last several quarters, signs of economic cooling may temper any gains in the coming quarters.

Oil Prices

For the first quarter, West Texas Intermediate (WTI) oil prices continued to increase, rising from \$45 per barrel at the end of the year to nearly \$60 during the quarter due to strong demand from China, production at capacity, and concerns over issues such as a three day strike in Nigeria. WTI prices inched back towards \$50 per barrel in January as OPEC suspended its official oil price band of \$22-\$28 per barrel, indicating the cartel's belief that sustained higher oil prices are likely to continue for the foreseeable future. WTI prices moved above \$50 per barrel in February following comments by Ali Naimi, the Saudi oil minister, that oil prices were likely to remain between \$40 and \$50 per barrel for all of 2005, confirming OPEC's January decision to abandon the price band. This rise in oil prices came in spite of earlier reports that Saudi Arabia would increase new capacity throughout the year in order to satisfy growing demand and intended to increase production to 12.5 million b/d to 15 million b/d over the next five years as long as strong demand continues²⁴.

²³ "Profits at US companies hit a record \$1,268bn propelled by strong demand," *The Financial Times*, March 31, 2005.

²⁴ "Saudis to increase oil capacity," *The Financial Times*, February 12/13, 2005.

With oil prices continuing to rise to over \$50 per barrel by the first of March, OPEC president Ahmad Fahad Al-Ahmad Al-Sabah made the following statement on March 6, 2005:

...OPEC is concerned about this price development despite the fact that the market is well-supplied and global crude oil stocks have continued to build, now standing above their five-year average. This recent price rise is due to a number of factors, such as the late cold snap in the Northern Hemisphere and unexpected outages in the downstream sector, in addition to expectations of continued strong demand and ongoing concerns about the slowdown in the pace of growth in non-OPEC supply, as well as downstream bottlenecks. Increased investment in commodities by speculators has caused further sizeable upward pressure on prices...Currently, the Organization is producing around 29.5 mb/d, which has ensured that demand is fully met, and global crude oil stocks continue to build.

Based on his statement with respect to production, OPEC ministers informally relaxed quota compliance in order to pump around 400,000 barrels more per day than had been agreed in January. Saudi Arabia was likely the largest contributor to the increase in production as the kingdom is the only OPEC member with much spare production capacity. This comment may have been a further indication that OPEC ministers were uncomfortable with oil prices above \$50 per barrel and were concerned about the sustained higher energy prices and the impact upon global economic growth.

At the March 16, 2005 meeting in Isfahan, Iran, OPEC agreed a 500,000 barrel per day increase in its official production ceiling to 27.5 million b/d, effectively immediately, with the cartel's president authorized to increase production by another 500,000 b/d prior to its next meeting²⁵. OPEC ministers noted the following with respect to energy markets:

The Conference noted, in particular and with concern, that the shortage of effective refining capacity, especially conversion capacity, is expected to persist, continuing to create dislocations between crude and products markets as well as contributing to higher oil prices...In view of the expectation of another year of strong global oil demand, coupled with constraints in the downstream sector and the overall expectation of a slow-down in the pace of non-OPEC supply growth, requiring an increase in

²⁵ OPEC press release following the 135th Meeting of the OPEC Conference in Isfahan, Iran on March 16, 2005.

OPEC production in the second half, in particular the fourth quarter of 2005, and in order to satisfy this market demand, ensure comfortable levels of stocks in the second half as well as halt and reverse the price escalation, the Conference decided to increase the production ceiling to 27.5 mb/d, effectively immediately.

Despite this increase in production, WTI prices continued to steadily rise throughout March, ending the quarter at roughly \$54.20/barrel. The failure of OPEC's production increase to calm markets likely stems from concerns by oil traders and OPEC ministers themselves that oil production growth is falling far short of oil demand growth, particularly for the second half of the year. To be sure, the Energy Information Administration, the statistical arm of the U.S. Department of Energy, indicated that OPEC should pump 30.2 million b/d on average in order to ensure world oil markets were well-supplied and to avoid any supply shortages. The EIA also indicated that OPEC production in March was only 29.8 million b/d, well short of the required production needed to satisfy the expected surge in demand in coming quarters.

Should the current elevated energy prices continue in the coming quarters, economic activity could experience continued softness in the coming quarters of 2005. Continued demand growth from China and concerns over capacity constraints are likely to result in continued elevated oil prices. In addition, any exogenous shocks in the oil markets resulting in short-term price spikes could have a significant adverse impact upon global economic growth and U.S. economic activity. Based on other information, it is likely that many businesses have begun to accept higher energy prices rather than have that factor suppress activity and expansion plans and have begun to pass on the added costs associated with higher energy prices to consumers. Therefore, the risks to economic activity stemming from higher energy prices appear to be weighted towards conditions that may perpetuate further economic softness in the coming quarters.

Economic Outlook 2004

The Conference Board's Leading Economic Indicators, after increasing 0.3% in December, declined in January by 0.3%, increased 0.1% in February, and declined again in March by 0.4% to end the quarter at 115.1²⁶. Since October 2004, the leading indicators index has been virtually flat with more weaknesses than strengths among the index components. In March, only two

²⁶ From The Conference Board's February 17, 2005, March 17, 2005, & April 21, 2005 press releases for US Leading Economic Indicators.

of the components (interest rate spread and manufacturers' new orders for consumer goods and materials) increased with the other eight declining. For the six months through March 2005, the leading index decreased 0.3% with five of the components increasing. In the April 21, 2005 LEI press release, the following conclusion is presented:

The leading index has been increasing since the end of 2001, but the upward trend has been briefly interrupted twice—once from May to October 2002 and again from June to October 2004. The recent flatness of the leading index (compared to its long-term trend of 1.5% growth) is consistent with the economy continuing to expand in the near term, but more slowly than its long-term average rate.

With respect to economic growth projections, the Federal Reserve Board of Governors and Federal Reserve Bank Presidents in the *Semi-Annual Monetary Policy Report to the Congress* project that real GDP will increase by 3 ½%-4% in 2005²⁷. The personal consumption expenditures price index excluding food and energy is expected to range from 1 ½%-2% in 2005. The civilian unemployment rate is anticipated to range from 5%-5 ½% in 2005.

Economic conditions appear to have softened during the first quarter of 2005, though economic growth is expected to continue at a more modest pace in the coming quarters. Consumer spending, though still increasing, has done so at a declining rate. Interest rates are likely to continue to rise in the year ahead, which could restrain equity market gains and cool the robust real estate markets. Oil prices are expected to remain at elevated levels for the remainder of the year, which could prompt slower economic growth. Inflation is running at levels above recent trends and consistent with slower economic growth. With the build-up of inventories in the first quarter, manufacturing activity and industrial production could temper in the second quarter or until inventory stocks are drawn down to a level that is more consistent with demand conditions. Consumer confidence appears mixed at the current time. Should consumer confidence become pessimistic, personal consumption expenditures could soften and contribute to slower economic activity. Business confidence among chief executives, though high, could fall if economic activity continues to experience softness and prompt a slowdown in payroll employment gains. Though the foundation for continued economic growth is solid, these factors suggest that the risks to the economy are weighted more towards weaker economic growth in the coming quarters.

²⁷ Changes are from average for fourth quarter of previous year to average for fourth quarter of year indicated.

Our expectations for the economy include:

- Real GDP growth of 3 ¼% - 3 ¾% for 2005.
- The Federal Reserve is likely to continue to remove its monetary policy accommodation, though the pace at which this is done may vary during the year. The federal funds rate should end 2005 at roughly 4%.
- Inflation is likely to increase in 2005 with the core CPI increasing by roughly 1 ¾% - 2 ¼%.
- As economic activity becomes more tempered in 2005, payroll employments are likely to increase at a lower rate. It is possible that the economy will generate increases in payroll employment of 150,000 per month on average for the year. Unemployment, then, is likely to fall to roughly 5% for 2005.
- Continued geopolitical concerns regarding Iran and North Korea along with concerns over demand and supply imbalances stemming from heightened Chinese energy consumption may elevate oil prices. OPEC is likely to increase production during the first half of the year in order to address any potential supply shortages in the fourth quarter. Oil prices are likely to average \$45-\$50 per barrel for 2005 following slight increases during the first part of the year.

On the other hand, there are a number of risks to the economy in 2005, which could have significant adverse impacts upon economic performance during the year.

- Continued geopolitical risks and tensions regarding instability and security in the Middle East may create uncertainty that could suppress demand in the global economy and help fuel a premium in oil prices. Uncertainty over North Korea and Iran's nuclear programs could also have an adverse impact upon economic activity and oil prices.
- Further increases in interest rates by the FOMC may temper any gains in the equity markets and may temper the robust activity in the real estate markets.

- An unwelcome rise in core inflation could dampen consumer confidence and business executives' confidence, prompting a slowdown in economic activity aggravated by a more aggressive tightening of monetary policy by the Federal Reserve in response.

Conclusion

After posting solid results for the full year 2004, economic activity softened in the first quarter with real GDP advancing by only 3.1%. Personal consumption expenditures remained one of the underlying sources of strength during the first quarter. Data presented in the Federal Reserve Beige Book indicated more subdued economic activity in general. With oil prices anticipated to remain at elevated levels, consumers and businesses appear to have adapted to the sustained rise in energy costs. However, core inflation unexpectedly increased at a higher rate than anticipated in the first quarter, prompting concerns about future economic growth and the implications for long-term interest rates. Based on the state of the economy in the first quarter, conditions are likely to foster continued economic expansion in 2005, though the risks are weighted mainly towards growth at a lower rate than in the previous year.