



State of the Economy 3rd and 4th Quarters 2007

Introduction

Real gross domestic product (GDP) weakened in 2007 with an increase of 2.2% on an annual basis. This is lower than the 2.9% increase for the full year 2006. Economic activity showed mixed results throughout 2007. Real GDP increased only 0.6% in the first quarter but showed marked improvement in the second quarter, increasing by 3.8%. GDP growth seemed to have stabilized during the third quarter with an increase of 4.9%, though hopes of continued robust expansion were dashed by the virtually flat performance during the fourth quarter when GDP increased by 0.6%. The declining trend in real GDP growth has most likely been the result of further deterioration in the housing markets, a subprime mortgage crisis that has had a systemic impact throughout financial markets despite easing of monetary policy, and further elevated energy prices and the inflationary impact upon consumer prices.

Gross Domestic Product

Overview

Advance estimatesⁱ released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 0.6% during the fourth quarter as compared to an increase of 4.9% in the third quarter. In the first and second quarters 2007, real GDP increased 0.6% and 3.8%, respectivelyⁱⁱ.

Economic growth during the third quarter was above the consensus forecast of 2.5% annual growth in real GDP anticipated by forty-nine forecasters surveyed by the Federal Reserve Bank of Philadelphiaⁱⁱⁱ. Real GDP growth was below the fourth quarter consensus forecast of 2.7%. Real GDP growth of 2.2% for 2007 was above the consensus of 1.9% annual growth in 2007. The consensus forecast is for a 2.7% increase in real GDP in the first quarter 2008 and an increase of 2.9% for the second quarter.

Personal Consumption Expenditures

Real personal consumption expenditures showed mixed results over the second half of 2007. Real PCE increased 2.8% in the third quarter and 2.0% in the fourth quarter. This compares to 3.7% growth in the first quarter and 1.4% in the second quarter. Durable goods expenditures experienced favorable growth in the second half of 2007, increasing 4.5% and 4.2% in the third and fourth quarters, respectively. This follows an increase of 8.8% in the first quarter and a 1.7% increase in the second quarter. The strength in purchases of durable goods during the second half of the year was boosted predominantly by increased expenditures on furniture and household equipment. Personal consumption expenditures on nondurable goods followed a similar pattern, increasing by 2.2% during the third quarter and by 1.9% during the fourth quarter, as compared to an increase of 3.0% during the first quarter and a decline of 0.5% in the second quarter.

Nonresidential Fixed Investment

After starting off the year with a relatively weak 2.1% increase in the first quarter, real nonresidential fixed investment expanded by a robust 11.0% in the second quarter. The third and fourth quarters saw continued expansion in real nonresidential fixed investment albeit at lower rates of 9.3% and 7.5%, respectively. The strong performance in the second half of the year was attributable to continued hearty investment in nonresidential structures, which increased 6.4% in the first quarter, 26.2% in the second quarter, 16.4% in the third quarter, and 15.8% in the fourth quarter. Equipment and software investment (which experienced an increase of 4.7% in the second quarter as compared to an increase of 0.3% in the first quarter) continued to expand during the second half of 2007 with increases of 6.2% and 3.8% in the third and fourth quarters, respectively.

Private businesses increased inventories by \$0.1 billion in the first quarter and by \$5.8 billion in the second quarter 2007. In the third quarter, inventories increased by \$30.6 billion, most likely a result of a build up of stock in anticipation of a strong holiday shopping season in the fourth quarter. Inventories decreased by \$3.4 billion during the fourth quarter, as stocks were drawn down by consumers. The strong third quarter change in inventories added 0.89% to the change in real GDP for the quarter. The draw down of inventories in the fourth quarter subtracted 1.25% from the real change in GDP for the quarter. The decline in inventories during the fourth quarter may also tend to indicate that businesses have become increasingly less optimistic regarding the outlook for economic performance in the coming months and have been satisfied to lower production in bring inventories down to levels more consistent with projected demand expectations for 2008.

Residential Fixed Investment & Related Residential Data

The first and second quarters of 2007 saw real residential fixed investment decline by 16.3% and 11.8%, respectively. The trend continued at an even more

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pronounced rate in the third and fourth quarters with real residential fixed investment retrenching 20.5% and 23.9%, respectively. Real residential fixed investment decreased in 2006 by 4.6%. This illustrates the continued fall out from the deflating of the real estate bubble and is consistent with the continued weakness in general real estate markets. This more pronounced weakness in the second half of the year may well be reflective of the systemic impact from the subprime mortgage crisis that began to unfold during the summer and continued to rattle real estate and financial markets late into 2007.

Residential construction fared just as poorly in the second half of 2007 as in the first half, based on data on new residential construction from the U.S. Census Bureau and U.S. Department of Housing and Urban Development. For the first quarter 2007, new privately-owned housing units authorized by building permits declined in January to 1,566,000 before falling to 1,541,000 in February and increasing to 1,569,000 in March^{iv}. On a year-over-year basis, these figures represent declines of 28.7%, 28.2%, and 24.8%, respectively. For the second quarter, new privately-owned housing units authorized by building permits fell to 1,457,000 in April, increased slightly to 1,520,000 in May, and dropped again in June to 1,413,000. On a year-over-year basis, these figures represent declines of 26.2%, 21.9%, and 24.8%, respectively. For the third quarter, new privately-owned housing units authorized by building permits dropped to 1,389,000 in July (down 21.7% on a year-over-year basis), 1,322,000 in August (-23.6% year-over-year) and 1,261,000 in September (-23.8% year-over-year). The fourth quarter exhibited continued retrenchment in housing activity with units authorized by permits falling to 1,170,000 in October, 1,162,000 in November, and 1,068,000 in December. Year-over-year these figures represent declines of 25%, 23.9%, and 34.4%, respectively. This indicates that builders retrenched plans to expand real estate developments of late. The decline in building permits further tends to indicate a greater degree of pessimism amongst builders regarding the outlook for the short-term.

Privately-owned housing starts followed a similar pattern of general decline, falling to 1,403,000 in January and rebounding to 1,487,000 in February and 1,491,000 in March. On a year-over-year basis, these figures represent declines of 38.1%, 30.3%, and 24.4%, respectively, for the first quarter. For the second quarter, privately-owned housing starts fell to 1,485,000 in April and to 1,440,000 in May then increased to 1,470,000 in June. These figures represent year-over-year declines of 18.9%, 25.9%, and 19.2% for April, May, and June 2007, respectively. In the second half of the year, privately-owned housing starts continued to retrench. In the third quarter, privately-owned housing starts fell to 1,371,000 in July, 1,347,000 in August, and 1,182,000 in September, reflecting year-over-year declines of 21.5%, 18.2%, and 31.3%. Despite a brief uptick in activity in October to 1,274,000, privately-owned housing starts weakened even further to 1,173,000 in November and 1,006,000 in December. These figures represent year-over-year declines of 13.3%, 25.1%, and 38.2%, respectively.

Sales of existing homes continued to closely mirror the data related to new home construction that exhibited further weakness during the second half of the year. Data from the National Association of Realtors (NAR) indicates that existing home sales fell

from 6.44 million in January to 6.15 million in March, and to 5.76 million in June at seasonally adjusted annual rates. For the second half of the year, existing home sales fell to 5.75 million in July, 5.48 million in August, 5.03 million in September, and 4.98 million in October, rebounded to 5.0 million in November only to retrench to 4.89 million in December on a seasonally adjusted annual basis. Concurrently, the inventory of existing homes increased further as 2007 progressed. At the end of 2006, the inventory of existing homes was 6.6 months supply. By the end of the first quarter and second quarters, the inventory of existing homes had increased to 7.4 months supply and 9.1 months supply, respectively. At the end of the third quarter, the inventory of existing homes had increased further to 4,370,000 or 10.4 months supply. By the end of the year, however, the inventory of homes had fallen to 3,905,000 or 9.6 months supply.

Thirty-year conventional mortgage rates, according to Freddie Mac[®], rose overall during the first half of 2007. Thirty-year rates started 2007 at roughly 6.18% and rose to a first-quarter high of 6.34% in early February before retrenching to end the quarter at 6.16%. During the second quarter, thirty-year mortgage rates rose steadily to a high of 6.74% in mid-June before falling slightly to end the quarter at 6.67%. Thirty-year rates peaked early in the third quarter at 6.73% before beginning a gradual descent. At the end of the third quarter the thirty-year conventional mortgage rate stood at roughly 6.42%. By the end of the fourth quarter, the thirty-year mortgage rate had bottomed out at 5.96% before increasing slightly to end the year at 6.14%.

Fifteen-year mortgage rates increased from 5.94% at the beginning of the year to 6.06% in early February then fell back to 5.86% by the end of the first quarter 2007. By the end of the second quarter, fifteen-year rates had risen steadily to a quarter high of 6.43% before ending the quarter at 6.34%. Fifteen-year rates followed a similar pattern as thirty-year mortgage rates in the third and fourth quarters, topping out early in July at 6.39% then falling gradually to end the year at roughly 5.79%. The drop in the mortgage rates coincided with the subprime mortgage crisis that created major concerns amongst financial markets and equity markets and contributed to a liquidity crunch in late summer. These factors, combined, prompted the Federal Reserve's Federal Open Market Committee to begin easing monetary policy in August.

Exports & Imports

After increasing by 1.1% and 7.5% in the first and second quarters, respectively, real exports of goods and services increased at a significantly higher rate of 19.1% in the third quarter and 3.9% in the fourth quarter. For the first and second quarters, the increase in exports added 0.13% and 0.85% to the change in real GDP, respectively. For the third and fourth quarters, the change in exports added 2.10% and 0.46% to real GDP. The robust performance in exports in the third quarter may be the result of a weaker dollar in foreign exchange markets as well as increased buying by foreigners prior to the holidays. Imports, a subtraction from GDP, increased 3.9% in the first quarter 2007 then decreased 2.7% in the second quarter. Imports increased 4.4% in the third quarter and 0.3% in the fourth quarter. The increase in imports in the first quarter subtracted 0.63% from real GDP; however, the decrease in imports in the

second quarter added 0.47% to the second quarter real GDP. The increases in imports during the third and fourth quarters subtracted 0.72% and 0.06% from real GDP, respectively.

Federal Government Consumption Expenditures

After a 6.3% decrease in the first quarter, real federal government consumption expenditures increased by 6.0% during the second quarter. An 8.5% increase in national defense spending in the second quarter helped to increase real GDP for the quarter. In the first quarter, national defense spending decreased 10.8%. Nondefense spending increased by only 0.9% in the second quarter as compared to a 3.8% increase during the first quarter.

For the third and fourth quarters, real federal government consumption expenditures increased 7.1% and 0.3%, respectively. The 10.1% increase in national defense spending in the third quarter contributed to the increase in real GDP. National defense spending in the fourth quarter declined 0.6%. Nondefense spending increased 1.1% in the third quarter and 2.2% in the fourth quarter, offsetting the lower increase in national defense spending during the fourth quarter.

The Federal Reserve

After holding the federal funds rates steady at 5¼% during the first half of 2007, the Federal Reserve's Federal Open Market Committee (FOMC) began easing monetary policy during the second half of the year. In his semi-annual testimony before the Congress to discuss the *Monetary Policy Report to the Congress* (July 18, 2007), Chairman Ben Bernanke maintained a generally favourable outlook for U.S. economic activity whilst noting the significant risks posed by the correction in the housing market and the attending impact upon the broader economy. In his testimony, Chairman Bernanke indicated the following:

After having run at an above-trend rate earlier in the current economic recovery, U.S. economic growth has proceeded during the past year at a pace more consistent with sustainable expansion. Despite the downshift in growth, the demand for labor has remained solid, with more than 850,000 jobs having been added to payrolls thus far in 2007 and the unemployment rate having remained at 4-1/2 percent...

To a considerable degree, the slower pace of economic growth in recent quarters reflects the ongoing adjustment in the housing sector. Over the past year, home sales and construction have slowed substantially and house prices have decelerated. Although a leveling-off of home sales in the second half of 2006 suggested some tentative stabilization of housing demand, sales have softened further this year, leading the number of unsold new homes in builders' inventories to rise further relative to the pace of new home sales. Accordingly, construction

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of new homes has sunk further, with starts of new single-family houses thus far this year running 10 percent below the pace in the second half of last year.

The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening in lending standards and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment as well as by mortgage rates that--despite the recent increase--remain fairly low relative to historical norms. However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further as builders work down stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time.

Real consumption expenditures appear to have slowed last quarter, following two quarters of rapid expansion. Consumption outlays are likely to continue growing at a moderate pace, aided by a strong labor market. Employment should continue to expand, though possibly at a somewhat slower pace than in recent years as a result of the recent moderation in the growth of output and ongoing demographic shifts that are expected to lead to a gradual decline in labor force participation. Real compensation appears to have risen over the past year, and barring further sharp increases in consumer energy costs, it should rise further as labor demand remains strong and productivity increases.

The Board of Governors' and Federal Reserve Bank presidents' expectations for economic activity moderated from the projections that were part of the February 2007 *Monetary Policy Report to the Congress* to the July 2007 report. As of the July report, the central tendency for real GDP growth was 2¼%-2½% for 2007 and 2½%-2¾% for 2008. The central tendency for the personal consumption expenditures price index excluding food and energy for 2007 was 2%-2¼% in the July report. For 2008 the PCE price index excluding food and energy was projected at 1¾%-2%. The 2007 and 2008 projections for the civilian unemployment rate had a central tendency of 4½%-4¾%.

At the time of Chairman Bernanke's testimony before the Congress, the subprime mortgage crisis had just begun to unfold and financial markets had not yet been spooked by the impact this would ultimately have upon the economy. However, conditions deteriorated quickly during the summer with liquidity drying up in the process, prompting the FOMC to take action prior to its scheduled meeting in September. In a press release on August 17, 2007, the FOMC recognized financial market conditions had deteriorated as a result of severe concerns regarding the subprime mortgage market and the attending liquidity crunch that developed. The FOMC indicated that there had been an appreciable increase in the downside risks to the economy. In a related action, the FOMC issued a press release on the same day announcing temporary changes to the discount window borrowing facilities for financial institutions that allows for term financing for as long as thirty days.

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Following this, the FOMC cut the federal funds rate fifty basis points to 4¾% at its September 18, 2007 meeting. The FOMC's press release indicated that the cut was aimed at stemming the adverse impact the liquidity crisis may have on financial markets and the broader economy. This assessment comes against the backdrop of tighter credit conditions that were tending to intensify the housing market downturn and slow overall economic growth^{vi}.

At the October 31, 2007 meeting, the FOMC cut the federal funds rate by an additional twenty-five basis points to 4½%^{vii}. Surprising, the vote was not unanimous with one member of the FOMC dissenting, voting for no decrease in the federal funds rate. The FOMC indicated the following in its press release:

Economic growth was solid in the third quarter, and strains in financial markets have eased somewhat on balance. However, the pace of economic expansion will likely slow in the near term, partly reflecting the intensification of the housing correction. Today's action, combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time.

Readings on core inflation have improved modestly this year, but recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation. In this context, the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully.

The Committee judges that, after this action, the upside risks to inflation roughly balance the downside risks to growth.

At its December 11, 2007 meeting, the FOMC once again cut interest rates by twenty-five basis points to 4¼%^{viii}. Again, the vote was not unanimous with one member opting for a fifty basis point cut. The FOMC's action was intended to promote moderate growth in a period of strained financial markets and a more intense housing correction.

As in our last assessment, the impact of the continued correction in the housing markets has yet to be fully felt in the economy. The spillover effects of this marked slowdown in real estate activity may well be significant. This, coupled with sustained elevated energy prices and rising consumer prices, is likely to place significant adverse pressures on the entire economy. The impact of these factors on economic activity in other sectors as well as energy prices' impact upon the outlook for inflation is likely to continue to manifest in the first half of 2008. Inflation may well feel continued upward pressures; the FOMC expressed this concern on numerous occasions in 2007. This places the rate-setting FOMC in a precarious position of confronting higher inflation during a period of slowing economic growth and could result in a stagflationary economic environment in the United States in 2008.

The Beige Book Data

The Federal Reserve Beige Books^{ix} released on July 25, 2007, September 5, 2007, October 17, 2007, November 28, 2007, and January 16, 2008 indicated modest economic activity, albeit at reduced rates, throughout the twelve Districts^x during the third and fourth quarters. Excerpts from The Beige Book for each release are included below:

July 25, 2007

Reports from the twelve Federal Reserve Banks indicated that economic activity continued to expand in June and early July...

On balance, consumer spending rose at a modest pace, although a number of Districts indicated that sales were mixed or below expectations. Several reports indicated that capital spending increased, and expenditures for most business services continued to rise. Employment increased further in most regions and in many sectors of the economy. Most Districts said that residential construction and real estate activity continued to decline. Commercial construction and real estate markets were generally more active than during the previous reporting period. District reports indicated that manufacturing activity continued to expand during June and early July...

Contacts generally reported ongoing input cost pressures, particularly for petroleum-related inputs, while prices at the retail level continued to increase at a moderate rate...Many Districts described overall wage gains as moderate and/or similar to the previous reporting period.

September 5, 2007

Reports from the Federal Reserve Districts indicate that economic activity has continued to expand...

Most Banks reported that the recent developments in financial markets had led to tighter lending standards for residential mortgages, which was having a noticeable effect on housing activity, and several noted that the reduction in credit availability added to uncertainty about when the housing market might turn around. While several Banks noted that commercial real estate markets had also experienced somewhat tighter credit conditions, a number commented that credit availability and credit quality remained good for most consumer and business borrowers. Outside of real estate, reports that the turmoil in financial markets had affected economic activity during the survey period were limited.

October 17, 2007

Anecdotal reports from the Federal Reserve Banks suggest economic activity continued to expand in all Districts in September and early October but the pace of growth decelerated since August.

Consumer spending expanded, but reports were uneven and suggest growth was slower in September and early October than in August. The manufacturing and service sectors continued to expand, but growth weakened--mostly for products and services related to home construction and real estate transactions. Several manufacturing and service firms reported that weaker domestic demand was offset by strong sales to global markets.

Residential real estate markets continued to weaken, and most Districts reported additional declines in home sales, prices and construction. Financial institutions reported an increase in delinquencies and slight deterioration in credit quality. Lenders in many Districts tightened credit standards, particularly for real estate. The majority of reports indicated an increase in business lending but a decline or slower growth in consumer lending...

...Contacts in a number of industries indicated a higher-than-usual degree of uncertainty about the outlook for economic activity. Many real estate contacts expect housing markets to remain subdued for several months. At firms without direct ties to real estate and construction, contacts are still wary that credit tightening and slowing construction might slow activity in their industry, but there is cautious optimism because few see much evidence of such spillovers at this time.

Job growth eased in some regions, but labor shortages were reported for many occupations in most Districts and are said to be restraining economic activity in some instances. Wages rose moderately except for workers in short supply, where sharp increases were reported for some positions. Upward pressure on input costs are reported in most Districts, but competitive pressures are restraining the ability to pass higher input costs to selling prices in many instances.

November 28, 2007

Reports from the twelve Federal Reserve Districts suggest that the national economy continued to expand during the survey period of October through mid-November but at a reduced pace compared with the previous survey period. Among Districts, seven reported a slower pace of economic activity while the remainder generally pointed to modest expansion or mixed conditions.

District reports indicated relatively soft retail spending; most retailers said that they were expecting a slow holiday season, with only small gains in sales

volumes compared with last year. By contrast, tourist activity expanded further in most Districts. Providers of nonfinancial services to consumers and businesses generally saw continued solid growth in demand, although a few Districts pointed to reduced demand for transportation services. Reports from the manufacturing sector were mixed across Districts and sectors, suggesting little change in activity on net. Producers in the agricultural and natural-resources sectors saw robust demand, with sales of agricultural products spurred in part by rapid growth in export demand. The glut of available homes continued, keeping downward pressure on prices and construction activity. The demand for commercial real estate remained strong in most areas but showed signs of leveling off in some. Reports from banks and other financial institutions suggested slower growth in overall loan demand, with some Districts noting a reduction in the volume of commercial and industrial lending.

Upward pressures on the prices of final goods and services remained modest overall but were significant for products and services that rely heavily on food and energy inputs. Increases in the costs of energy and selected raw materials pushed up production and transportation costs for firms in various manufacturing and services sectors, although this was offset in part by price declines for lumber and transportation equipment. Food prices remained on an upward trajectory. Outside of products and services that rely heavily on energy and food inputs, final prices were reported to be largely stable or down a bit. Wage increases were moderate in general; upward wage pressures eased in a few areas where labor markets loosened slightly, although they remained strong for assorted groups of skilled workers.

January 16, 2008

Reports from the twelve Federal Reserve Districts suggest that economic activity increased modestly during the survey period of mid-November through December, but at a slower pace compared with the previous survey period. Among Districts, seven reported a slight increase in activity, two reported mixed conditions, and activity in three Districts was described as slowing.

Most reports on retail activity indicated subdued holiday spending and further weakness in auto sales. However, most reports on tourism spending were positive. Residential real estate conditions continued to be quite weak in all Districts. Reports on commercial real estate activity varied, with some reports noting signs of softening demand. Manufacturing reports varied across industries, with pronounced weakness noted in housing-related industries as well as the automobile industry. Strong export orders and increased demand in industries whose products compete against imports was reported by some Districts. Demand for nonfinancial services remained generally positive, although some Districts commented on continuing weak demand for transportation services.

Reports from banks and other financial institutions noted further declines in residential real estate lending, and lending to the commercial real estate sector was generally described as mixed. Some Districts reported lower consumer loan volumes, whereas the volume of commercial and industrial lending varied. Most Districts cited tighter credit standards.

Demand continued to decline for construction workers and those in housing-related industries, according to most reports, while demand generally held steady for skilled workers in nonfinancial service industries. Wage increases remained moderate overall. Increases in prices for food, petrochemicals, metals, and energy-related inputs continued to be widely reported, and production and delivery costs for many products increased because of higher fuel prices. Producers in the agricultural sector reported generally strong demand and favorable production conditions outside of the drought-stricken areas in the Southeast. Strong oil and gas exploration and production activity was noted by several Districts.

The Business Sector

Industrial Production & Capacity Utilization

Industrial production, as compiled by the Federal Reserve^{xi}, increased by 1.8% for the full year 2007 as compared to an increase of 3.5% for 2006. For the first quarter 2007, industrial production increased by an annual rate of 1.1%. For the second and third quarters, industrial production rebounded with an increase of 3.5% and 3.6%, respectively. General slowing in economic conditions saw a decrease of 1.0% in industrial production for the fourth quarter at an annual rate. For the twelve months ending in January, February, and March, industrial production increased by 2.6%, 3.4%, and 2.3%. For the second quarter, industrial production increased by 1.9%, 1.6%, and 1.4% for the twelve months ending in April, May, and June. For the third quarter, industrial production increased by 1.4%, 1.7%, and 1.9% for the twelve months ending in July, August, and September. For the fourth quarter, industrial production increased by 1.8%, 2.1%, and 1.5% for the twelve months ending in October, November, and December.

Manufacturing production, which increased at an annual rate of 3.4% in 2006, expanded by 1.7% in 2007 on an annual basis. After increasing by 0.8% and 4.3% on an annual basis in the first and second quarters, manufacturing production weakened in the third quarter with an increase of 3.6% and a decrease of 1.9% in the fourth quarter. The third quarter strength in manufacturing production may be the result of increased production ahead of the holiday shopping season. Data from the Bureau of Economic Analysis indicates that businesses added \$30.6 billion in private inventories during the third quarter, which was a contributor to the third quarter increase in real GDP. The decline in manufacturing in the fourth quarter coincides with the decrease in private inventories of \$3.4 billion as stocks were likely drawn down during the holidays.

Durable consumer goods production, which declined at an annual rate of 0.7% in the first quarter but rebounded strongly in the second quarter with an increase of 12.8%, increased by a meager 1.2% in the third quarter and declined by 8.4% in the fourth quarter. Nondurable consumer goods production, which increased by 4.7% in the first quarter but decreased at an annual rate of 0.8% in the second quarter, increased 2.0% in the third quarter and declined by 1.6% in the fourth quarter.

On a quarterly basis, capacity utilization increased from 81.3% in the first quarter of 2007 to 81.7% in the second quarter and 82.0% in the third quarter. Capacity utilization retrenched to 81.5% in the fourth quarter. Again, these figures are indicative of the overall trend in manufacturing as discussed above and relative to private inventory levels during the third and fourth quarters. These levels are slightly above the 1972 to 2006 average of 81%. Manufacturing capacity utilization increased from 79.8% in the first quarter to 80.3% and 80.6% in the second and third quarters, respectively. For the fourth quarter, manufacturing capacity utilization fell to 79.8%, right in line with the 1976 to 2006 average. At these levels of resource utilization, the slack in industrial production capacity should be enough to prevent an unwanted rise in inflationary pressures.

Retail Sales

After ending the first half of the year at \$374.7 billion, advance monthly sales for retail trade and food services from the Department of Commerce^{xii} increased to \$380.2 billion in September and to roughly \$382.9 billion in December 2007^{xiii}. Total retail sales increased from \$337.3 billion in June to \$342.4 billion in September to \$344.9 billion in December.

For the first quarter, retail and food service sales increased 3% on a year-over-year basis. For the second quarter, retail and food service sales increased 3.9% from the same quarter a year ago. For the third and fourth quarters, retail and food service sales increased roughly 4.2% and 4.9% from the same quarter in 2006, respectively. For the full year 2007, total retail and food service sales increased 4.2% from the 2006 level to \$4,512 billion.

Retail sales increased 2.9% in the first quarter on a year-over-year basis and increased by 3.7% in the second quarter of 2007 as compared to the same quarter in 2006. For the third and fourth quarters, retail sales increased 4% and 5% on a year-over-year basis, respectively. Total sales excluding motor vehicles and parts increased 3.4% in the first quarter over the same quarter a year ago and by 4.1% in the second quarter on a year-over-year basis. In the third and fourth quarters, total sales excluding motor vehicles and parts increased 4.6% and 5.7% on a year-over-year basis, respectively.

Inflation

The consumer price index (CPI) ^{xiv} increased 1.0% for the third quarter and 5.6% for the fourth quarter of 2007 at a seasonally adjusted annual rate, following a 4.7% increase in the first quarter and a 5.2% increase in the second quarter. For 2007, the CPI increased 4.1% as compared to a 2.5% increase for 2006. For the six months ending in December, the CPI increased by 3.3% as compared to an increase of 5% for the six months ending June 2007.

Following increases of 22.9% and 32.9% at a seasonally adjusted annual rate in the first and second quarters, respectively, the energy index declined 14.8% in the third quarter but increased by 37.1% in the fourth quarter on the heels of continued rises in energy prices to nearly \$100 per barrel. For the first half of 2007, the energy index increased by 27.8%. Despite the substantial increase in the fourth quarter, the energy index increased by 8.1% in the fourth quarter 2007. For the full year 2007, the energy index increased 17.4% as compared to an increase of 2.9% in 2006 and 17.1% in 2005.

For the first and second quarters of 2007, the food index advanced at an annual rate of 7.3% and 5.1%, respectively. In the third and fourth quarters, the food index increased at an annual rate of 4.9% and 2.4%, respectively. For the six months ending in June 2007, the food index increased 6.2%. For the six months ending in December, the food index increased 3.6%. For the full year 2007, the food index increased 4.9% as compared to an increase of 2.1% in 2006 and 2.3% in 2005.

Removing the effects of food and energy, the core CPI increased by a seasonally adjusted annual rate of 2.3% in both the first and second quarters. In the third and fourth quarters, the core CPI increased 2.5% and 2.7% on a seasonally adjusted annual basis, respectively. For the six months ending in June 2007, the core CPI increased by 2.3%. For the six months ending in December 2007, the core CPI increased by 2.6%. For the full years 2006 and 2007, the core CPI increased 2.6% and 2.4%, respectively. The slight rise in the core CPI in the third and fourth quarters may indicate that producers have begun to pass along to consumers increased costs for many products resulting from higher energy prices that have increased transportation and production costs.

In addition to the CPI, the price index for personal consumption expenditures (PCE) from the Bureau of Economic Analysis^{xv} increased 2.3% in the first and second quarters of 2007 as compared to the same periods in 2006. In the third and fourth quarters, the PCE price index increased 2.1% and 3.4%, respectively, on a year-over-year basis. For 2006, the PCE price index increased 2.8% on a year-over-year basis. The PCE price index increased 2.5% annually in 2007. The price index for PCE excluding food and energy prices increased 2.4% and 2.0% on a year-over-year basis in the first and second quarters of 2007 and by 1.9% and 2.1% in the third and fourth quarters, respectively.

It appears that the muted increase in core inflation in the first half of 2007 may have presaged a trend of gradually increasing inflation based on CPI data. The PCE data does not seem to indicate increased consumer prices on the same level as that suggested by the CPI figures. Headline inflation as measured by the CPI indicates that inflation was higher in 2007, particularly with respect to energy prices and food prices. As energy prices are expected to remain firm, further upward inflationary pressures may well manifest as producers attempt to slowly pass along cost increases to consumers. Any unexpected increase in core inflation may result in higher inflation premiums in the markets that would tend to suppress economic growth. It is interesting to note, however, that based on the CPI inflation figures for the fourth quarter (5.6%) and for the full year 2007 (4.1%) real interest rates as measured by the federal funds rates (4¼% as of December) are slightly negative. Real interest rates are still positive based on the change in the PCE price index for 2007 at this time.

Labor Market

After holding steady at 4.5% in the first and second quarters, the unemployment rate increased steadily to 4.7% and 4.8% in the third and fourth quarters, respectively^{xvi}. The unemployment rate reached 5% in December 2007. Total nonfarm payroll employment averaged roughly 137.5 million in the first quarter and 137.9 million in the second quarter. Total nonfarm payroll employment averaged 138.1 million and 138.5 million in the third and fourth quarters, respectively. After increasing by 425,000 during the first quarter of 2007 and by 446,000 in the second quarter, total nonfarm payroll employment increased 235,000 in the third quarter and 230,000 in the fourth quarter.

Manufacturing employment, which lost 41,000 jobs in the first quarter and 43,000 jobs in the second quarter, continued to fall with losses of 73,000 jobs in the third quarter and 64,000 in the fourth quarter. Construction employment continued to experience weakness in the wake of the housing correction. After losing 11,000 jobs in the second quarter, construction employment declined by 49,000 in the third quarter and 124,000 in the fourth quarter. Service providers including professional & business services, education & health services, leisure & hospitality, and government continued to see payroll gains in the second half of the year, offsetting some of the job losses in other sectors.

The downward spiral in the real estate markets along with competitive forces resulting in manufacturers moving production to lower labour cost countries will likely continue to negatively impact job creation in 2008. The slowing of economic activity during the fourth quarter likely contributed to the slower increase in nonfarm payroll employment during the quarter and the 474,000 jump in unemployment in December, which drove the unemployment rate up to 5%. Further cooling in economic activity or a recession in the first half of 2008 is likely to result in declines in payroll employment in the coming months. As such, an increase in the unemployment rate is likely during the coming quarters. Further rises in the unemployment rate would likely ease the shortages of skilled workers that have been noted throughout the nation. As a result, wage pressures would also likely remain in check.

Equity Markets

The Dow Jones Industrial Average (DJIA), the S&P 500, and the NASDAQ composite showed continued volatility during the second half of 2007. During the first quarter of 2007, the DJIA was virtually flat at 12,300. The NASDAQ and the S&P 500 were also flat, ending the quarter at roughly 2,417 and 1,417, respectively. The second quarter saw the markets increase from the tepid performance of the beginning of the year, with the DJIA increasing roughly 9% to end the quarter at roughly 13,427. The NASDAQ composite and the S&P 500 also rose during the second quarter by 7.8% and 6.3%, respectively, to roughly 2,605 and 1,506. From January to the end of July, the DJIA rose by roughly 7.8%, the NASDAQ composite rose by 7.5%, and the S&P 500 rose by 6.3%.

During the second half of the year, the DJIA declined roughly 1% with the S&P 500 falling roughly 2.3%. The NASDAQ composite gained 1.9% during the second half of 2007. During the third quarter, the DJIA increased to approximately 13,986, representing an increase of 4.3%. The DJIA peaked in mid-July at roughly 14,000 for the third quarter. During the fourth quarter, the DJIA fell to end the year at 13,265, representing a 5.2% fall during the quarter. For the year, the DJIA still managed to post a roughly 6.3% gain.

For the third quarter the S&P 500 rose 1.6%. For the fourth quarter, the S&P 500 declined 3.8%, ending the quarter at 1,468. For the year, the S&P 500 gained 3.7%. The NASDAQ composite gained 3.8% during the third quarter to end the quarter at 2,710. The NASDAQ composite then declined 1.8% during the fourth quarter to end the year 2,652. For the year, the NASDAQ composite still gained 9.5%.

The weakness in the equity markets during the fourth quarter may have been caused by more pervasive pessimism regarding economic prospects and the possibility of a recession in the first half of 2008.

Oil Prices

After beginning the year at roughly \$61 per barrel, West Texas Intermediate (WTI) oil prices continued to rise throughout 2007. For the first quarter, oil prices ended the quarter at roughly \$63 per barrel. For most of the second quarter, WTI oil prices remained in a relatively tight band between \$62 and \$64 per barrel. By the end of the second quarter, however, prices had risen to roughly \$69 per barrel. For the third quarter, oil prices moved erratically—rising in July to above \$74 per barrel, falling in August to \$72 per barrel, and then jumping higher in September to almost \$80 per barrel. Prices continued to climb in the fourth quarter to over \$86 per barrel in October and nearly \$95 per barrel in November. By the end of the year, oil prices had eased somewhat to about \$92 per barrel.

The rise in prices during the first half of 2007 may well have been the result of OPEC members' cut in production by 500,000 barrels per day effective February 1, 2007. This decision to cut production was made at the 143rd (Extraordinary) meeting of the OPEC conference in Abuja, Federal Republic of Nigeria on December 14, 2006^{xvii}. No action was taken to increase or decrease production at the cartel's 144th (ordinary) meeting in Vienna, Austria, on March 15, 2007. The decision was based on the conclusion that economic activity was expected to remain firm in 2007 but lower than in 2006 due to a higher interest rate environment in the United States.

In his opening address to the 145th meeting of the OPEC conference, Mohamed Bin Dhaen Al Hamli, President of the Conference and Minister of Energy of the United Arab Emirates, indicated the following^{xviii}:

Since the last Ministerial Conference, OPEC has continued to monitor carefully the oil market. We can say, without any doubt, that the present price levels are not the result of a shortage of crude. The market remains well-supplied, commercial stocks are at healthy levels and the level of upstream spare capacity has increased. OPEC will continue monitoring oil market developments, and will act in a timely and adequate manner, should there be indications of a shortage of crude.

To this end, OPEC members agreed an increase in production by 500,000 barrels per day effective November 1, 2007 at its 145th meeting of the OPEC conference. However, at its 146th (Extraordinary) meeting of the OPEC conference in Abu Dhabi, United Arab Emirates on December 5, 2007, OPEC members left production unchanged. In its press release, OPEC indicated that continuing increases in oil prices were not the result of fundamental changes in supplies of crude oil^{xix}:

At the same time, however, the Conference observed, with concern, that world oil prices remained volatile, in major part due to the perception of market tightness by market players, exacerbated by non-fundamental factors, including the heavy influx of financial funds into commodities and speculative activity in the markets, while geopolitical developments have contributed to price volatility.

Though recent actions by OPEC to increase production are intended to ease price pressures, it is likely that energy prices will remain at elevated levels well into 2008, which could further temper economic growth. Continued geopolitical risks could create an additional premium in the price of oil. Furthermore, the degree to which speculative activity in the oil markets will ultimately impact the price of oil has yet to be fully demonstrated. Therefore, as in previous assessments, the risks to economic activity stemming from higher energy prices remain weighted towards conditions that may perpetuate further economic weakness in the coming quarters. However, as economic growth slows in the first half of 2008, oil consumption may well decline, thus helping to alleviate price pressures. Should the economy fall into a recession, oil consumption could decline significantly, thus contributing to further easing of energy

prices. The deeper and the longer the economic slowdown continues, the more oil consumption is likely to decline, thus easing pricing pressures.

Economic Outlook

As discussed in our previous economic assessment, economic growth appears to have finally been weakened by the adverse systemic impact of continued elevated energy prices that have contributed to rising inflationary pressures and further correction in the real estate markets and the attending impact upon mortgage markets which precipitated a liquidity crisis in the third quarter. Persistently high energy prices have contributed to a rise in inflationary pressures, particularly in food products. Economic activity remains weak despite the Federal Reserve's more accommodative monetary policy actions in the second half of 2007. Despite lowering the federal funds rate, the Federal Reserve remains concerned about inflationary pressures and the potential impact this could have upon economic activity.

As a result, economic activity is more than likely to become more tempered in 2008, with the possibility of a recession in the first half of the year. These factors suggest that the risks to the economy remain weighted heavily towards weaker economic activity in the coming quarters. Though we previously did not believe that the preponderance of evidence pointed to a recession, we now believe that the risks are weighted towards a recession and economic growth at a severely reduced pace in 2008.

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

- Despite the Federal Reserve's reinstitution of accommodative monetary policy, real estate activity will continue to contract in the year ahead. Foreclosures are likely to increase further in the coming months, despite efforts by the federal government to ease pressures on homeowners facing the risk of foreclosure. Rising default rates on mortgages are likely to have an adverse impact upon the banking sector, mortgage markets, and real estate markets.
- Oil prices are likely to remain at elevated levels throughout the first half of 2008, possibly rising to sustained levels above \$100 per barrel. This would likely prompt further slowing of economic activity globally and in the U.S.
- Inflationary pressures are likely to remain at levels above recent trends, which would be consistent with slower economic growth and a weakening dollar.

Our expectations for the economy include:

- We anticipate real GDP growth of 1% - 1½% for the full year 2008.
- The Federal Reserve is likely to continue easing monetary policy. The federal funds rate should fall to roughly 2½% in 2008.

Value Highlights™

- Inflation is likely to increase in 2008 with the core CPI increasing by roughly 2¾% - 3½%.
- Unemployment is likely to remain between 5%-5¼% for 2008
- Oil prices (WTI) are likely to remain in the range of \$85-\$100 per barrel for 2008.

Conclusion

Real GDP increased at an annual rate of only 0.6% in the fourth quarter 2007 and by 2.2% for the full year, despite the Federal Reserve's easing of monetary policy during the second half of the year in the wake of the liquidity crisis associated with the subprime mortgage market meltdown. Personal consumption expenditures increased during the second half of 2007 albeit at a more subdued rate, perhaps as a result of a squeeze on personal finances caused by higher energy prices and continued weakness in the housing markets. Inflationary pressures were evident with the CPI increasing by 5.6% at an annual rate for the fourth quarter and by 4.1% for the full year 2007. Based on our assessment of the state of the economy in the fourth quarter, conditions are likely to remain unfavourable for economic activity during the first half of 2008. As such, the risks are weighted more towards recession during the first half of the year or weak economic growth (in the absence of the economy tipping into a technical recession) accompanied by higher inflationary pressures.

ⁱ The BEA GDP press releases state the following with respect to advance estimates: The Bureau emphasized that...“advance” estimates are based on source data that are incomplete or subject to further revision by the source agency.

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

ⁱⁱⁱ *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, August 14, 2007.

^{iv} With respect to trends in housing data, the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing and Urban Development state in the new residential construction press releases

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

^v Data from Freddie Mac Weekly Mortgage Market Survey

^{vi} In a related action, the FOMC cut the discount rate fifty basis points to 5¼%.

^{vii} In a related action, the FOMC cut the discount rate twenty-five basis points to 5%.

^{viii} In a related action, the FOMC cut the discount rate twenty-five basis points to 4¼%.

^{ix} The press release states the following: This document summarizes comments received from businesses and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.

^x The Twelve Districts of the Federal Reserve system include: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

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

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

^{xiii} Adjusted for seasonal, holiday, and trading day differences but not for price changes. Removing the impact of prices changes/inflation, the growth figures would be lower. For example, if total retail sales increased by 6.2% on a year-over-year basis and the twelve month inflation rate, based on the CPI, was 3.4%, this would imply a real growth in total retail sales of roughly 2.8%.

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

^{xv} Bureau of Economic Analysis.

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

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

^{xviii} OPEC press release following the 145th Meeting of the OPEC Conference in Vienna, Austria on September 11, 2007.

^{xix} OPEC press release following the 146th (Extraordinary) Meeting of the OPEC Conference in Abu Dhabi, UAE on December 5, 2007.