

STATE OF THE ECONOMY 2nd Quarter 2005

Introduction

After initial signs of slowing economic growth during the first quarter of 2005, economic activity continued at a tempered pace in the second quarter with real gross domestic product (GDP) increasing by 3.4% during the quarter. This tepid growth follows a 3.3% increase in GDP during the fourth quarter of 2004 and a 3.8% increase during the first quarter of 2005 and appears to provide further evidence that the pace of economic expansion has apparently slowed over the first half of the year with GDP increasing at a decreasing rate. The 3.4% increase during the second quarter of 2005 is almost unchanged from the 3.5% increase during the same period a year ago. Signs of the deceleration in the previously robust economic expansion remained evident throughout the broader economy with personal consumption expenditures increasing at a much more tempered rate, 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 during the first half of 2005. With the economy continuing to show signs of slower growth, a number of factors may, in combination, be at work to further temper economic growth in the coming quarters. To be sure, the economy in 2005 is likely to experience continued growth, albeit at a much more modest pace than in 2004, 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 3.4% in the second quarter of 2005, declining from the revised rate of 3.8% for the first quarter. Economic growth during the second quarter was slightly higher, however, than the consensus forecast of 3.0% (revised downward from 3.7% anticipated earlier in the year) annual growth in real GDP anticipated by forty-six

¹ The BEA press release on July 29, 2005 states the following with respect to advance estimates: The Bureau emphasized that the second-quarter "advance" estimates are based on source data that are incomplete or subject to further revision by the source agency. The second quarter "preliminary" estimates, based on more comprehensive data, will be released on August 31, 2005.

forecasters surveyed by the Federal Reserve Bank of Philadelphia². The first quarter growth in real GDP was revised higher from an annual rate of 3.1% to 3.8%³. The slowdown in economic growth during the second quarter was a result of a slower increase in personal consumption expenditures and a reduction in private business inventories.

Real personal consumption expenditures, which accounts for about two-thirds of economic activity, increased by 3.3% in the second quarter, slightly below the 3.5% increase in the first quarter at a seasonally adjusted annual rate. Purchases of durable goods surged by 8.3% in the second quarter following a 2.6% increase in the first quarter, due largely to an increase in expenditure on motor vehicles and parts resulting from “employee” discounts offered to the general public by the major automakers. Data from the Federal Reserve Beige Book released on June 15, 2005 and July 27, 2005 indicated that many Federal Reserve Districts noted motor vehicle sales during the quarter were stronger than previous quarters, which had seen considerable weakness in auto sales. Personal consumption expenditures on nondurable goods, which increased by 5.3% in the first quarter, increased at a lower rate of 3.3% in the second quarter. Retail sales exhibited mixed strength during the first part of the second quarter but seemed to gain strength as the quarter drew to a close, with many of the Federal Reserve Districts reporting generally positive retail sales activity and expectations, despite the continued high cost of gasoline.

Following a 5.7% increase in the first quarter, real nonresidential fixed investment increased by 9.0% in the second quarter, closer to the 10.4% advance in the fourth quarter of 2004. Equipment and software investment activity, which increased by 8.3% in the first quarter, showed continued strength in the second quarter with an increase of 11.0%.

Following an increase of \$58.2 billion in the first quarter, private businesses drew down \$6.4 billion in inventories during the second quarter. The decrease in private business inventories subtracted 2.32% from GDP for the quarter as compared to adding 0.29% to the first quarter change in real GDP. This decline in inventories may suggest that businesses had slowed production in light of the weak economic data from the first quarter and were allowing built-up inventory stocks to be drawn down. Businesses may have

² *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, May 16, 2005.

³ Quarterly data is expressed at a seasonally adjusted annual rate. Real estimates are in chained (2000) dollars.

been apprehensive to continue normal production levels with managers unsure whether the softness in economic growth during the first quarter was merely a temporary phenomenon or an indication that long-term growth prospects were cooling. Given the large drawdown in inventories during the second quarter, production may increase during the third quarter in anticipation of increased economic activity and demand expectations during the latter half of the year and to replenish stocks for the holiday season. Typically, this increased production to add to business inventories would be expected to contribute to economic growth in the coming quarters. However, in the event that the demand expectations for the second half of 2005 do not materialize early in the third quarter, production in the second half could be tempered. This could have an adverse impact upon economic activity and production during the latter half of the year in the form of a drag on GDP growth.

Real residential fixed investment remained robust during the second quarter, increasing by 9.8%. This increase follows a similar increase of 9.5% during the first quarter. This strong growth continues a trend that has been evident for nearly a year, as the real estate markets have experienced noticeable gains and heightened activity from consumers and investors. This marked increase in real residential fixed investment could be the result of continued accommodative monetary policy and still favorable mortgage rates.

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 but rebounded during the second quarter. Privately-owned housing units authorized by building permits ended the year at 2,069,000 and ended the first quarter at 2,021,000. New privately-owned housing units authorized by building permits increased slightly in April to 2,148,000, representing a year-over-year increase of 3.8%. In May, however, figures decreased to 2,062,000 before rising to 2,111,000 in June. On a year-over-year basis, new privately owned housing units authorized by building permits decreased 3.2% in May and increased by 4.8% in June.

Privately-owned housing starts decreased roughly 18% in March to 1,833,000—the largest monthly fall in fourteen years—before rebounding 9.4% to 2,005,000 in April. On a year-over-year basis in April, privately-owned housing starts increased by 1.9%. Housing starts were virtually flat in May and June at 2,004,000, representing year-over-year increases of 1.5% and 9.7%, respectively. This slowdown in housing starts during the second quarter may be indicative of a soft patch in the robust real estate markets. 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 flattening in housing starts is the start of a cooling in the robust residential real estate market or merely a statistical aberration. Despite this, data from the National Association of Realtors (NAR) and the Census Bureau indicate continued robust real estate activity. Homes changed hands at the fastest pace in the second quarter since the 1970s with existing home sales rising 4.5% to 7,180,000 units on an annualized basis in April alone. The price of a single family home increased over 15% on a year-over-year basis to \$203,800—the largest increase since 1979. The price of condominiums rose over 18.4% on a year-over-year basis⁴. The NAR also indicated that about 25% of home purchases may have been made for investment purposes.

These figures have fueled debate that the U.S. real estate market is experiencing an unsustainable bubble in asset prices. Indeed, the Mortgage Bankers Association indicated that more than 60% of the dollar value of new mortgage loans were adjustable-rate or interest-only during the second half of 2004. This could create significant problems for borrowers as rates begin to increase and the adjustable-rate mortgages are reset, forcing many buyers and investors out of the market. Indeed, even Alan Greenspan has voiced concerns with the activity in the U.S. real estate markets, warning in testimony to the Joint Economic Committee of the Congress on June 9, 2005⁵:

That said, there can be little doubt that exceptionally low interest rates on ten-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of homebuilding and home turnover, and especially in the steep climb in home prices. Although a "bubble" in home prices for the nation as a whole does not appear likely, there do appear to

⁴ "Big surge in price of US homes fuels fears of bubble," Christopher Swann, *The Financial Times*, May 25, 2005.

⁵ Testimony of Chairman Alan Greenspan, *The Economic Outlook*, Before the Joint Economic Committee, U.S. Congress, June 9, 2005.

be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels...

The apparent froth in housing markets may have spilled over into mortgage markets. The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages, are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace.

It may not be unreasonable to conclude that recent signs of less aggressive economic growth may have contributed to the mixed activity in residential construction during the first half of the year as consumers became more wary regarding the economic outlook. Continued interest rate increases may contribute to a slowing of real estate activity and residential construction in the coming quarters, should the rise in short-term rates ultimately translate into a gradual rise in long-term rates. Such increases may have an unwelcome, adverse impact upon speculators in the real estate markets and investors who have committed to degrees of leverage which they may not be able to service as rates increase. This could have the effect of removing some of the “froth” in certain local real estate markets.

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. The Beige Book released on June 15, 2005 and July 27, 2005 indicates that the real estate markets remained positive, though signs of cooling were noted in some areas. Several Districts that had experienced noticeable increases in home prices earlier in the year indicated that price appreciation had begun to normalize from frenzied levels. In addition, several Districts noticed that housing activity had decelerated from earlier aggressive levels. The strength in the residential real estate markets in the first half of 2005 continued a favorable trend that had 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 Mac⁶ declined during the first quarter from 5.77% to a low

⁶ Data from Freddie Mac Weekly Mortgage Market Survey

of 5.57% in February before climbing to 6.04% by the end of March. During the second quarter, thirty-year conventional fixed rate mortgage rates fell steadily during the quarter, ending June at 5.53%--a low for the year. Fifteen-year mortgages experienced a similar pattern, rising from 5.21% at the first of the year to 5.58% at the end of the first quarter then falling during the second quarter to 5.12%. The continued low mortgage rates coincide with U.S. Treasury yields on the 10-year note, which increased only slightly from 4.29% in January to 4.55% by the end of March before declining to roughly 4.0% by the end of June. This decline in long-term yields on Treasuries comes despite an increase in short-term rates associated with the Federal Reserve's removal of accommodative monetary policy at a measured pace and has led to the conundrum surrounding low long-term rates in an environment of increasing short-term rates. With the preponderance of the Federal Reserve likely to remain a continued removal of accommodative monetary policy in the coming quarters, long-term Treasury yields and mortgage rates are likely to 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 would likely begin to cool in the coming quarters.

Real exports of goods and services increased 12.6% in the second quarter following a 7.5% increase during the previous quarter. The strength of exports is likely due to some weakness, though abating, of the dollar in foreign exchange markets. Imports, a subtraction from GDP, decreased by 2.0% during the second quarter as compared to a 7.4% increase during the first quarter. This decrease in imports is the first decrease since the first quarter of 2003 when imports decreased by a rate of 2.5%.

Following weakness that began in 2004, the dollar gained strength against foreign currencies in the second quarter, continuing a modest trend that began earlier in the year. At the end of the fourth quarter of 2004, the dollar/sterling (\$/£) exchange rate stood at roughly \$1.92. The dollar strengthened against the pound sterling during the first quarter to end the period at \$1.89. The dollar continued to gain ground against the pound sterling during the second quarter, rising gradually to \$1.82 by the end of the quarter. The dollar/euro (\$/€) exchange rate was \$1.35 at the end of the fourth quarter of 2004 and \$1.30 at the end of the first quarter of 2005. During the second quarter, the dollar strengthened to \$1.20 against the euro. At the end of the fourth quarters of 2004, the yen/dollar (¥/\$) exchange rate stood at ¥104. By the end of the first quarter the dollar stood at ¥107. The

dollar continued to gain strength against the yen during the second quarter, ending the period at ¥110⁷.

The slight strengthening of the dollar may stem from a variety of issues such as weak economic data in the eurozone and the rejection of the European Constitution in referendum votes in France and the Netherlands. Traders' concerns that persistent high oil prices would suppress demand in the U.S. and slow economic growth seemed to abate in light of the positive economic data released regarding favorable job creation. The strength of the dollar may also have stemmed from a cut in the budget deficit forecast. With tax revenues up over 15% on a year-over-year basis for the first three quarters of the U.S. government's fiscal year, the 2005 fiscal year forecasted budget deficit was cut to \$333 billion from \$427 billion. In addition, there does not appear to be an end any time soon to the Federal Reserve's removal of accommodative monetary policy at a measured pace. These factors may have driven the dollar higher against other foreign currencies.

Real federal government consumption expenditures tapered in the first half of 2005, increasing by 2.4% and 1.3% in the first and second quarters, respectively. This slowdown in the rate of federal government consumption expenditures was the result of lower national defense and nondefense spending. National defense spending increased during the second quarter by a rate of 2.0%, slightly lower than the 3.0% increase during the first quarter. Nondefense spending, which increased by only 1.1% in the first quarter, decreased by 0.1% during the second quarter.

The Federal Reserve

The Federal Reserve continued its measured tightening of monetary policy, which commenced in June 2004, during the second quarter of 2005. By the end of 2004, the Federal Open Market Committee (FOMC) had increased the federal funds rate to 2 ¼%⁸. At its meeting on February 2, 2005, the FOMC agreed a twenty-five basis point increase in the target for the federal funds rate to 2 ½%⁹. 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.

⁷ Source: *The Economist*

⁸ The Board of Governors also increased the discount rate by to 3 ¼% by the end of 2004.

⁹ The Board of Governors also increased the discount rate by twenty-five basis points to 3 ½% at the February 2, 2005 meeting.

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 $\frac{3}{4}$ %¹⁰. The FOMC continued to believe that the risks to sustainable growth and price 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.

The FOMC agreed a twenty-five basis point increase in the federal funds rate at each of its meetings on May 3, 2005 and June 30, 2005¹¹. The Committee continued to believe that monetary policy was accommodative and, along with productivity gains, provided ongoing support to economic activity. Furthermore, the Committee indicated the following:

Although energy prices have risen further, the expansion remains firm and labor market conditions continue to improve gradually. Pressures on inflation have stayed elevated, but longer-term inflation expectations remain well contained.

The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

In semi-annual testimony before the Congress on July 20, 2005¹², Chairman Alan Greenspan noted since his last testimony the economy experienced a soft patch during the spring and that core inflation had moved

¹⁰ The Board of Governors also increased the discount rate by twenty-five basis points to 3 $\frac{3}{4}$ % at the March 22, 2005 meeting.

¹¹ The Board of Governors also increased the discount rate by twenty-five basis points at the May 3, 2005 and June 30, 2005 meetings to 4% and 4 $\frac{1}{4}$ %, respectively.

¹² 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, July 20, 2005.

higher during the first half of the year. In addition, he indicated that evidence suggested the earlier soft readings on the economy did not signal a more serious slowdown in economic activity, with retail sales experiencing favorable gains, employment trending upwards, and firming of business investment.

With respect to the prospects for the economy in 2005, Chairman Greenspan indicated the following in his February testimony:

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.

In his July testimony, Chairman Greenspan indicated the following with respect to the economic outlook:

Thus, our baseline outlook for the U.S. economy is one of sustained economic growth and contained inflation pressures. In our view, realizing this outcome will require the Federal Reserve to continue to remove monetary accommodation. This generally favorable outlook, however, is attended by some significant uncertainties that warrant careful scrutiny.

With regard to the outlook for inflation, future price performance will be influenced importantly by the trend in unit labor costs, or its equivalent, the ratio of hourly labor compensation to output per hour. Over most of the past several years, the behavior of unit labor costs has been quite subdued. But those costs have turned up of late, and whether the favorable trends of the past few years will be maintained is unclear. Hourly labor compensation as measured from the national income and product accounts increased sharply near the end of 2004. However, that measure appears to have been boosted significantly by temporary factors. Other broad measures suggest that hourly labor compensation continues to rise at a moderate rate...

...Energy prices represent a second major uncertainty in the economic outlook. A further rise could cut materially into private spending and thus damp the rate of economic expansion...

...The third major uncertainty in the economic outlook relates to the behavior of long-term interest rates. The yield on the ten-year Treasury notes, currently near 4 ¼ percent, is about 50 basis points below its level of late spring 2004. Moreover, even after the recent widening of credit risk spreads, yields for both investment-grade and less-than-investment-grade corporate bonds have declined even more than those on Treasury notes over the same period.

...the U.S. economy has remained on a firm footing, and inflation continues to be well contained. Moreover, the prospects are favorable for a continuation of those trends.

In the *Monetary Policy Report to the Congress*, the Federal Reserve policymakers expressed optimism for continued economic expansion at a moderate pace in 2005 with stable core inflationary pressures. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3%-3 ¾% in 2005 (as compared to previous forecasts of 3 ½%-4%) as compared to real GDP growth of 3.7% in 2004¹³. Real GDP is expected to increase by 3 ¼%-3 ¾% in 2006; this forecast is unchanged from earlier forecasts. 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 ¼% in 2005 (as compared to earlier forecasts of 1 ½%-2%), higher than the 1.6% increase in 2004. For 2006, the PCE index excluding food and energy is expected to range from 1 ½%-2 ½%; earlier forecasts suggested core PCE increases in 2006 of 1 ½%-2%. The civilian unemployment rate is anticipated to range from 5%-5 ¼% (compared to earlier forecasts of 5%-5 ½%) in 2005, against 5.4% for 2004, and roughly 5% in 2006 (earlier forecasts were for 5%-5 ¼%).

The Federal Reserve Beige Books¹⁴ released on June 15, 2005 and July 27, 2005 indicated more modest economic growth, with most of the twelve Districts¹⁵ experiencing expansion at a slower pace than previous reports, much as was the case with the earlier releases on March 9, 2005 and April 20, 2005. The Beige Book conclusions included the following:

¹³ Changes are from average for fourth quarter of 2004 to average for fourth quarter of 2005.

¹⁴ The press release on June 15, 2005 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.

¹⁵ 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 showed solid results overall during the first quarter, experienced mixed activity. The June 15, 2005 release indicated that unseasonable weather and high gasoline prices had had a negative impact upon retail sales in April and May. However, in June and early July, retail sales experienced solid increases, despite the continued high energy prices. Vehicle sales generally increased throughout all the Districts as the price discounting offered by the major automakers prompted increased buyer traffic at car dealerships.
- Manufacturing continued to experience moderate to solid expansion across the country, though the pace of growth had leveled off in some areas. Most of the twelve Districts indicated that factory activity had increased moderately. Several Districts reported that the outlook for the coming year was positive and that many firms were looking to expand capital spending, open or expand plants, and increase operations to meet increased demand expectations. Factory hiring was sluggish in most Districts during the quarter.
- Residential real estate activity, robust during the first quarter, continued its recent trend with favorable activity during the second quarter, though some signs of cooling were noted in several Districts. Home price appreciation continued during the quarter although at a slower pace. Real estate activity was less frenzied in many markets, as compared to earlier periods. Commercial real estate activity showed favorable gains in several Districts during the second quarter. Commercial construction activity moved forward in many areas, and office vacancy rates, though still high, trended downwards in some markets.
- Labor markets continued to exhibit increased demand for labor throughout most of the Districts. Skilled workers remained in short supply in many Districts. Despite the tighter labor markets, wage pressures were contained, though shortages of skilled workers had prompted some upward wage pressures in certain areas.
- Tourism continued to post strong results during the second quarter throughout the twelve Districts, on the heels of stronger performance during the first quarter. Occupancy rates and room revenues increased in many Districts, particularly in the south where theme parks and coastal resorts experience increased demand and year-over-year gains.

Consumer Confidence

Following several months of mixed results, the Conference Board's Consumer Confidence Index ended 2004 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 103. 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.

In April, the Consumer Confidence Index¹⁶ declined substantially to 97.5 on a more cautious outlook for the coming months. The Index bounced back in May to 103.1 and increased to a three year high of 106.2 in June as consumers' moods were boosted by solid business activity and gains in the labor markets. Lynn Franco, Director of The Conference Board's Consumer Research Center, indicated the following with respect to the June consumer confidence figures:

This month's gain in Consumer Confidence has propelled the Index to a three-year high. The improvement in consumers' mood suggests that business activity and labor market activity will continue to pick up over the next several months. And, with consumers in better spirits, and job concerns remain relatively steady, there is little reason to expect a dramatic shift in consumers' spending.

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 during the first quarter 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. For the second quarter, the Expectations Index declined to 86.7 in April before improving to 93.4 in May and 96.4 in June. The decline in the Expectations Index throughout the first half of the year may be attributed to consumers' anticipation of modest economic growth and meager income gains due to continued elevated energy prices. The upturn during the second quarter may

¹⁶ www.conference-board.org The June 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."

have been due to gains in the labor markets and upward revisions to first quarter economic activity that had initially shown signs of softness.

Consumers' outlook for the next six months eased during the first quarter. In January, February, and March, 22%, 17.9%, and 19.3%, respectively, expected business conditions to improve in the next six months. For April, this declined to 17.7% before rebounding in May to 19.2% and to 19.5% in June. Those expecting conditions to worsen increased in March to 8.2% after holding steady in January and February at 7.8%. Those expecting conditions to worsen increased to 9.9% in April before falling to 9.5% in May and to 9.0% in June. These readings indicate that consumers have over the first half of the year become increasingly concerned about business conditions going forward.

Consumers' assessment of current business conditions was mixed during the first and second quarters. For January, 26.1% of respondents characterized current conditions as "good," up from 24.4% in December. Though this eased in February to 24.6%, optimism regarding current conditions increased to 26.3% in March. However, those characterizing conditions as "bad" were virtually unchanged in March at 15.8% from 15.7% in February. For January, those claiming conditions were "bad" was 18.1%. In the second quarter, those characterizing current conditions as "good" were virtually unchanged at 26.5% in April, 26.9% in May, and 26.7% in June. Those characterizing conditions as "bad" increased in April to 17.6% before declining to 16.4% in May and 15.3% in June.

Again, these mixed results may be the result of transitory factors such as high energy prices, etc. Though a jump in any one month may be the result of transitory factors weighing on the economy rather than a sustained shift in consumers' expectations regarding the economic outlook, the clear pattern of increasing negative sentiment may indicate that the previously solid foundation underpinning strong consumer confidence and sentiment has begun to show signs of weakening. 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 first quarter continued during the second quarter of 2005 as a result of continued economic

strength. Industrial production figures as compiled by the Federal Reserve¹⁷ rose from 117.9 in December to 118.5 by the end of March and to 119.7 by the end of June. For the first quarter, industrial production increased at an annual rate of 3.6% following an increase of 4.5% in the fourth quarter of 2004. The 2.1% increase (at an annual rate) for the second quarter was the lowest quarterly growth since the second quarter of 2003. On a year-over-year basis, industrial production increased by 3.9%, 3.5%, and 3.9% in January, February, and March, respectively. During the second quarter, industrial production increased by 3.1%, 2.7%, and 3.9% in April, May, and June, respectively, on a year-over-year basis.

Manufacturing production also showed gains in the first quarter, increasing by 4.0% at an annual rate. For the second quarter, manufacturing production increased by a much slower annual rate of 1.5%, likely due to the slowing of production to enable inventory stocks that had built up to be drawn down. Manufacturing production increased by 5.2%, 4.7%, and 4.1% on a year-over-year basis in January, February, and March, respectively, and by 3.5%, 3.4%, and 3.8% in April, May, and June, respectively. This improvement in manufacturing at a slower pace is further evidenced by information from the twelve Districts of the Federal Reserve System, many of which reported soft manufacturing activity during the second quarter following heightened activity during the first quarter.

Business equipment production increased by 7.9% in the second quarter, up from 8.6% in the first quarter, representing the eighth consecutive quarterly rise. Durable goods production, which increased by 0.5% in the first quarter, declined at an annual rate of 2.5% in the second quarter. Nondurable goods production increased by 3.2% in the second quarter following a 2.2% increase in the first quarter. Defense and space equipment production increased by 16.7% in the second quarter as compared to an increase of 9.4% in the first quarter. Following a first quarter increase of 4.4%, construction supplies increased by 2.9% in the second quarter.

Capacity utilization, which ended 2004 at 79.2%, increased in the first quarter of 2005 to 79.5% for March. Though capacity utilization increased slightly during the first quarter, this level of 79.5% remained 1.5% below the 1972 to 2004 average of 81%. For the second quarter, capacity utilization increased to 80.0% in June, following minimal declines to 79.2% and 79.4% in April and May. Capacity utilization in June of 80% was higher than the year

¹⁷ Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release from July 15, 2005.

ago level of 77.8% and continues to creep closer to the 1972 to 2004 average of 81%. Manufacturing capacity utilization, which stood at 77.9% in December 2004 and at 78.1% in March 2005, also increased slightly to 78.4% by the end of the second quarter. The June 78.4% level is higher than the year ago level of 76.5% but is lower than the 1972 to 2004 average of 79.8%.

The advance monthly sales for retail trade and food services in the second quarter released by the Department of Commerce¹⁸ continue to suggest increased economic activity. In March, retail and food service sales increased by approximately 0.3%¹⁹ from February to \$339.3 billion. This gain in March follows a 0.5% increase in February and a 0.3% decline in January's figures. In June, retail and food service sales increased 1.7% to \$350.8 billion from the previous month's level. 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 second quarter, monthly sales for retail trade and food service increased 8.9% in April, 6.4% in May, and 9.6% in June on a year-over-year basis. 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. For the second quarter, retail and food service sales increased by 2.6% from the first quarter and by 8.4% from the second quarter a year ago.

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. For the second quarter, total sales excluding motor vehicles and parts increased by 2.2% from the first quarter and by 8.3% on a year-over-year basis. In June, total sales excluding motor vehicles and parts increased by 8.3% from June 2004. Retail sales, which increased 1.3% in the first quarter over the prior quarter and 7.2% on a year-over-year basis, increased by 2.6% in the second quarter as compared to the first and by 8.4% on a year-over-year basis. In June 2005, retail sales increased by 9.9% from the year ago to \$317.0 billion.

Slower economic growth and consumer spending during the first quarter resulted in a build-up of private inventories during the first quarter. These stocks, however, were largely drawn down during the second quarter. As a result, manufacturing activity softened somewhat during the second quarter of 2005. This suggests that manufacturing activity may increase in the third quarter so that businesses may replace the inventories that were drawn down during the second quarter. However, with energy prices remaining at elevated

¹⁸ Press release from the Department of Commerce on July 14, 2005.

¹⁹ Adjusted for seasonal, holiday, and trading day differences but not for price changes.

levels, businesses 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 have been prevalent may be more muted in 2005.

Inflation

Following a 3.0% increase in the consumer price index (CPI) ²⁰ during the fourth quarter of 2004 at a seasonally adjusted annual rate and an increase of 4.3% during the first quarter of 2005, the CPI increased by a compound annual rate of 1.9% in the second quarter of 2005. The second quarter increase in the CPI of 1.9% is significantly lower than the 3.3% increase for all of 2004.

However, for the twelve months ending June 2005, the CPI increased by 2.5%. 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. In April, May, and June, the CPI increased by 0.5%, -0.1%, and 0.0%, respectively. The CPI increased at a compound annual rate of 6.2% for the three months ending in April and 4.4% for the three months ending in May. For the six months ending in June 2005, the CPI increased at a seasonally adjusted annual rate of 3.1%.

For the first half of 2005, the energy index increased by 14.1% 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 35% of the increase in the CPI for the first six months of the year. Food prices during the first half of the year also increased, with the food index advancing at an annual rate of 2.3%, lower than the 2.7% annual rate for the full-year 2004, but still accounting for roughly 10% of the overall increase in the CPI for the first six months.

Removing the effects of food and energy, the core CPI increased by 1.2% in the second quarter as compared to an increase of 3.3% in the first quarter and a 2.2% increase for 2004. For the first half of 2005, however, the core CPI increased by 2.2%, in line with the 2004 full-year increase. For the twelve month period ending with March 2005, the core CPI increased by 2.3%. For the twelve months ending in June 2005, the core CPI increased by 2.0%.

²⁰ Based on data from the Consumer Price Index: June 2005 press release on July 14, 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 BEA²¹ rose by 3.2% in the second quarter, compared with a 2.9% increase in the first quarter. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 2.0% in the second quarter, following a 3.0% increase in the first quarter. The price index for personal consumption expenditures increased by 3.3% in the second quarter, as compared to 2.3% in the first quarter. 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 continue removing monetary policy accommodation at a measured pace. It does not appear that inflation accelerated at an alarming rate during the second quarter. However, should continued high energy prices prompt inflation to accelerate at a more rapid rate in the coming months, the Federal Reserve may be forced to remove monetary policy accommodation at a more aggressive pace.

Labor Market

After averaging 5.4% in the fourth quarter of 2004 and 5.3% in the first quarter of 2005, the unemployment rate continued to trend lower in the second quarter to an average 5.1%²². On a monthly basis, unemployment was 5.2% in January, 5.4% in February, 5.2% in March, 5.2% in April, 5.1% in May, and 5.0% in June. The June unemployment level of 5.0% is 1.3% lower than the most recent high of 6.3% in June 2003. Total nonfarm payroll employment increased by 124,000 in January, by 243,000 in February, and by 110,000 in March, for a first quarter average of 159,000 monthly job gains. 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. For the second quarter, total nonfarm payroll employment increased by roughly 542,000 for an average of 181,000 per month. In June, total nonfarm payroll employment increased by 146,000 to 133.5 million following increases in April and May of 292,000 and 104,000, respectively. Since the trough in May 2003, payroll employment has increased by over 3.5 million.

Payroll gains in the quarter included increases in health care and professional & business services. Health care added 25,000 jobs in June, bringing the twelve month total to 249,000. Professional & business services employment increased by 56,000 in June, resulting in over 500,000 jobs being

²¹ Bureau of Economic Analysis, Gross Domestic Product: Second Quarter 2005 (Advance) release, July 29, 2005.

²² Bureau of Labor Statistics, United States Department of Labor, The Employment Situation: June 2005, July 8, 2005.

added during the last twelve months. Manufacturing lost 24,000 jobs in June, following a loss of 6,000 jobs in May.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment was favorable during the second quarter. Consumers expecting more jobs to become available in the next six months, which had decreased during the first quarter from 16.6% in January to 15.1% in March, fell to 14% in April before rebounding to 15.2% in May and June. In June, however, the number of consumers expecting fewer jobs to become available increased to 16.5% as compared to 15.9% in May and 18.4% in April. 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

Following strong gains during 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 and posted mixed results for the second quarter. After ending the year at roughly 10,850, the Dow Jones Industrial Average (DJIA) fell roughly 3% in the first quarter²³. 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%. For the second quarter, the DJIA declined roughly 1.6% (through June 29th) to 10,375. The NASDAQ and the S&P 500, however, both posted gains of 3.2% and 1.6%, respectively, ending the second quarter at roughly 2,069 and 1,200. The mixed performance may have been a result of seasonally light volume during the summer and caution on the part of investors due to continued high oil prices and the impact upon economic activity, uncertainty regarding geopolitical events in Iran and North Korea, and the increased threat of terrorist attacks in Saudi Arabia.

The market's weakness during the second quarter, like the preceding quarter, may largely be the result of concerns over sustained higher energy prices and the adverse impact it may have upon economic growth. According to The Conference Board's *CEO Confidence Survey*²⁴, chief executives in

²³ Based on data from *The Economist*.

²⁴ www.conference-board.org. *CEO Confidence Survey* released on July 14, 2005.

corporate America were less confident about the economy in the second quarter, with the CEO Confidence Measure falling to 55 from 62 in the first. Though this reading is still above the 50 point level that signifies more positive responses, it suggests that CEOs are less confident in the strength of the economic recovery than earlier in the year. Of the one hundred business leaders surveyed in a variety of industries, roughly 44% believed economic conditions had improved during the second quarter, significantly lower than the 59% in the prior period. Lynn Franco, Director of The Conference Board's Consumer Research Center, indicated the following:

While overall confidence remains relatively positive, the latest reading reflects growing concerns that U.S. economic growth may be slowing. And, while the outlook for corporate profits remains optimistic, rising interest rates and oil prices may curb business leaders' projections.

S&P 500 operating earnings increased by 10.7% during the second quarter (on a year-over-year basis), the thirteenth straight quarter of double-digit gains, due to a number of upside earnings surprises²⁵. Over 71% of the S&P 500 companies posted positive earnings surprises with the energy sector experiencing year-over-year earnings gains of 26.4%. Industrials also experienced strong earnings gains in the second quarter, increasing 30.8% on a year-over-year basis. This suggests that companies have managed to produce strong earnings gains despite the brief soft patch in the economy earlier in the year coupled with slowing GDP growth during the first half of 2005.

Chief executives' confidence in the economy and its growth prospects has eroded since the start of the year. However, expectations for strong corporate profit growth during the second half of 2005 remain in tact. Despite this, 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 markedly. In addition, rising interest rates 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. The foundation for advancement in the equity markets over the coming quarters is less solid now than earlier in the year, as signs of economic cooling may temper any gains in the coming quarters.

²⁵ "Earnings Surprises Propel S&P 500 to 13th Straight Quarter of Double-Digit Gains Despite Street Estimate," Standard and Poor's Press Release, August 2, 2005.

Oil Prices

West Texas Intermediate (WTI) oil prices continued to increase during the second quarter of 2005, rising from \$45 per barrel at the end of the year to roughly \$55 at the end of the first quarter to nearly \$60 by the end of the second quarter. The continued increase in energy prices likely stem from strong demand from China, production at capacity in many OPEC member countries, refining capacity shortages, decreased production from Russia as a result of the break-up of Yukos, and concerns over geopolitical issues and potential terrorist attacks in Saudi Arabia.

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 continues²⁶.

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

²⁶ "Saudis to increase oil capacity," *The Financial Times*, February 12/13, 2005.

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 meeting²⁷. 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 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. After experiencing some softness in prices during May with WTI falling below \$50/barrel, oil prices surged forward in June, ending the quarter at nearly \$59/barrel. In a June 9, 2005 news release, OPEC discussed the driving forces behind the sustained rise in energy prices, stating the following²⁸:

²⁷ OPEC press release following the 135th Meeting of the OPEC Conference in Isfahan, Iran on March 16, 2005.

²⁸ OPEC news release, "OPEC commits to market stability, investment essential to supply security," Vienna, Austria, June 9, 2005.

Of significant note, is the realization of the fact that current oil prices are indeed influenced by a combination of market and non-market related factors. For instance, elements such as the effect of speculative trading and to some extent geopolitics have tended to exert considerable influence on the oil price, and, of late, obstructions to effective refining of petroleum products. OPEC Member Countries, however, have kept pace with their commitment to continue to provide the market with crude as best as they could, aimed at ensuring a stable oil market given their collective resolve towards increasing investments in a drive to improve upstream sector growth and to enhance improved capacity to meeting future incremental demand.

At its June 15, 2005 meeting in Vienna, Austria, OPEC ministers agreed an increase in the production ceiling by 500,000 barrels/day to 28.0 million barrels/day, effective July 1, 2005. The President of OPEC was given the authority to announce an additional increase of 500,000 barrels/day prior to the next meeting, should oil prices remain at the current elevated levels or rise further²⁹. In the press release following the meeting, OPEC ministers indicated the following:

Having reviewed the oil market situation and its immediate prospects, the Conference observed that the market continues to be well supplied, as a result of OPEC's decision in March 2005 to increase its production ceiling to 27.5 mb/d, and that, consequently, commercial crude and product stocks have continued to build to comfortable levels, around average in terms of days of forward cover. However, the Conference noted that world crude oil prices remain high and volatile as a result of concern about a lack of effective global oil refining capacity, in particular possible shortages of middle distillates in key consuming regions. Refineries, whilst already running at high utilization rates, are facing difficulties in coping with strong distillate demand-growth. The situation is being further exacerbated by geopolitical developments and increased speculation in the oil futures markets.

...The Conference emphasized its particular concern about the shortage of effective refining capacity required to meet future strong demand growth, as a consequence of under-investment in this sector, especially in conversion capacity, as well as excessive regulation. The Conference,

²⁹ OPEC press release following the 136th (Extraordinary) Meeting of the OPEC Conference in Vienna, Austria on June 15, 2005.

therefore, repeated its call on industry and consumer governments to urgently address this challenge which, if left unresolved, will exacerbate oil price volatility.

It is likely that the current elevated level of energy prices will result in some softness in economic activity in the second half of 2005 and into 2006. Continued demand growth from China and concerns over inadequate refining capacity are likely to result in continued elevated oil prices for the immediate future. Furthermore, speculative activity in the oil markets may be contributing an additional premium to the current elevated price of oil. 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 appears that many businesses have begun to accept higher energy prices and have begun to pass on a portion of 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 2005

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 0.7% to end the first quarter at 136.2³⁰. The Leading Economic Indicators showed improvement during the second quarter, increasing 0.2% in April, 0.0% in May, and 0.9% in June to end the quarter at 137.7³¹. The leading index increased 0.6% from January through June and at a 1.2% annual rate during the first half of 2005, with five of the ten components advancing. 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.

³⁰ From The Conference Board's February 17, 2005, March 17, 2005, & April 21, 2005 press releases for US Leading Economic Indicators.

³¹ From The Conference Board's May 19, 2005, June 20, 2005, & July 21, 2005 press releases for US Leading Economic Indicators.

The July 21, 2005 press release provided the following comments on the leading index:

The leading index increased rapidly through the first quarter of 2004 but this has been followed by a steady slowing of growth through the first half of 2005. The sharp pick up in June keeps the leading index on a slightly rising trend, and this behavior is consistent with the economy continuing to expand moderately in the near term, but at a slower pace than in recent quarters.

In the *Monetary Policy Report to the Congress*, the Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3%-3 ³/₄% in 2005. Real GDP is expected to increase by 3 ¹/₄%-3 ³/₄% in 2006. The personal consumption expenditures chain-type price index excluding food and energy is expected to range from 1 ¹/₂%-2 ¹/₄% in 2005 and from 1 ¹/₂%-2 ¹/₂% in 2006. The civilian unemployment rate is anticipated to range from 5%-5 ¹/₄% in 2005 and roughly 5% in 2006.

Forecasters at The Conference Board expect real GDP growth of 3.8% and 3.1% in the third and fourth quarters of 2005. For the year, real GDP is expected to experience growth of roughly 3.5%. For 2006, forecasts expect real GDP growth of 2.9%. CPI inflation is expected to equal roughly 3.1% for 2005 and 4% for 2006. The unemployment rate is forecast at 5.1% for 2005 and 5% for 2006.

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

- Economic conditions, after having appeared to have softened during the first quarter of 2005, seemed to firm during the second quarter with economic growth generally expected to continue at a more modest pace during the second half of the year.
- Consumer spending continued to increase at a declining rate during the second quarter, restrained perhaps by persistent high energy prices.
- 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, removing some of the speculative froth that has developed in many markets.

- Oil prices are expected to remain at elevated levels for the remainder of the year, which could prompt slower economic growth globally and in the U.S.
- Inflation remained at levels above recent trends and was consistent with slower economic growth.
- With the build-up of inventories in the first quarter, manufacturing activity and industrial production was tempered in the second quarter as inventory stocks began to be drawn down to a level that was more consistent with current demand conditions. In the absence of any systemic shocks to the economy stemming from aggregate external economic factors, industrial production would be expected to increase during the second half of the year in anticipation of increased demand for the fourth quarter holiday season and to replenish the inventories that were drawn down during the second quarter.
- Consumer confidence appears mixed at the current time, though expectations are trending towards a more cautious outlook. Should consumer confidence become pessimistic, personal consumption expenditures could soften and prompt a further slowing of economic activity.
- Business confidence among chief executives has fallen considerably and could fall further if economic activity experiences further softness in the second half of the year; this could prompt a slowdown in payroll employment gains, as management reigns in spending and hiring until the outlook becomes more certain.

Based on the current assessment of a number of economic factors, the previously solid foundation for continued economic growth appears to be considerably weakened in recent months for the coming quarters. These factors suggest that the risks to the economy are weighted more towards weaker economic activity in the coming quarters, particularly should oil prices remain at current elevated levels.

Our expectations for the economy include:

- Real GDP growth of 3 ¼% - 3 ¾% for 2005 and 3% - 3 ½% for 2006.

- The Federal Reserve is likely to continue to remove its monetary policy accommodation at a measured pace. The federal funds rate should end 2005 at roughly 4%. For 2006, the federal funds rate should end the year at roughly 5%
- Inflation is likely to increase in 2005 with the core CPI increasing by roughly 1 ¾% - 2 ¼%. The core CPI is likely to increase by 1 ½% - 2% in 2006.
- 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. A similar unemployment rate for 2006 could be reasonably expected.
- Continued geopolitical concerns along with concerns over demand and supply imbalances and tight refining capacity may result in continued elevated oil prices. Though OPEC may increase production during the second half of the year in order to address any potential supply shortages in the fourth quarter, it is unlikely that these increases will have a material impact on lowering the price of oil. Given the developments in the oil markets since the first quarter, oil prices (WTI) are likely to average \$55-\$60 per barrel for 2005 following a potential price spike to in excess of \$70 per barrel. Oil prices are likely to remain at elevated levels throughout the first half of 2006 as well.

On the other hand, there are a number of risks to the economy in 2005 and 2006, 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. Escalating tensions over North Korea and Iran's nuclear programs could also have an adverse impact upon economic activity and oil prices.
- Continued elevated oil prices may have an adverse impact upon global economic growth and economic activity in the U.S. and lead to unwelcome inflationary pressures throughout the broader economy.

This could ultimately prompt some retrenchment in consumer spending, which would contribute to further soft economic performance.

- 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. The adverse systemic impact stemming from a bursting of the bubble in some real estate markets could dampen economic growth significantly.
- An unwelcome rise in core inflation could dampen consumer confidence and business executives' confidence, prompting a slowdown in economic activity, which could be further aggravated by a potentially more aggressive tightening of monetary policy by the Federal Reserve in response.

Conclusion

After posting solid results for the full year 2004, economic activity expanded at a slower rate in the first and second quarters of 2005 with real GDP advancing by only 3.8% and 3.4%, respectively. As was the case during the first quarter, personal consumption expenditures remained one of the underlying sources of strength for the broader economy. Data presented in the Federal Reserve Beige Book indicated more subdued economic activity in general during the first quarter, with some signs of improvement during the second quarter. With oil prices remaining at elevated levels, consumers and businesses appear to have adapted to the sustained rise in energy costs. However, continued high energy prices and rising interest rates are likely to create uncertainty regarding future economic growth. Based on the state of the economy in the second quarter, conditions are likely to foster softness in the continuing economic expansion in 2005, though the risks are weighted mainly towards growth at a more subdued rate than in the previous year.