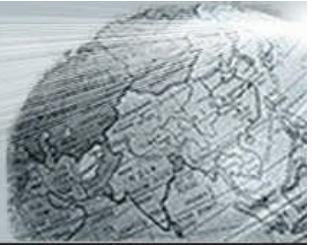


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State of the Economy 3rd Quarter 2006

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Introduction

After showing signs of markedly slower growth in the second quarter, economic activity decelerated to a much more subdued pace during the third quarter. Real gross domestic product (GDP) increased at an annual rate of only 1.6% in the third quarter following an increase of 2.5% in the second quarter and 5.6% during the first quarter of 2006. The third quarter figure is lower than the paltry increase of 1.8% in the fourth quarter of 2005. Real GDP increased at an annual rate of 3.2% for the full year 2005 on a revised basis. The deceleration in real GDP continued in the third quarter despite a pause in rate tightening by the Federal Reserve's Federal Open Market Committee (FOMC) and noticeable weakness in energy prices that had been at elevated levels for over a year. Economic activity was restrained partly due to a decreased level of private inventory investment, perhaps as businesses sought a draw down in inventory levels that may have accumulated during the first half of the year, and increased import activity.

Gross Domestic Product

Advance estimatesⁱ released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 1.6% during the third quarter following a revised increase of 2.6% in the second quarter and 5.6% in the first quarter. This increase in GDP was lower than the 4.2% increase in real GDP in the third quarter of 2005ⁱⁱ. Economic growth during the quarter was below the consensus forecast of 2.7% annual growth in real GDP (down from 3.1% anticipated when surveyed during the second quarter) anticipated by fifty-one forecasters surveyed by the Federal Reserve Bank of Philadelphiaⁱⁱⁱ. The consensus forecast is for a 2.9% increase in real GDP in the fourth quarter and an increase of 3.4% for the full year. Real GDP increased at an

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annual rate of 3.2% in 2005 as compared to an increase of 3.9% in 2004 and 2.5% in 2003.

Real personal consumption expenditures, which accounts for about two-thirds of economic activity, showed signs of strengthening during the third quarter with an increase of 3.1% as compared to an increase of 2.6% in the second quarter and a 4.8% increase in the first quarter. Following an increase of 19.8% in the first quarter, purchases of durable goods decreased by 0.1% in the second quarter then rebounded in the third quarter with an increase of 8.4%. This increase in purchases of durable goods was due to a roughly 13% increase in expenditure on motor vehicles and parts as compared to a 5% increase in the first quarter and a 1% decline in the second quarter. This increase in expenditures on motor vehicles may be attributed to a shift in demand towards more fuel efficient vehicles and foreign brands. Purchases of furniture and household equipment increased by roughly 7% in the second quarter following an increase of roughly 3% in the second quarter (based on revised figures) and a 4.2% increase in the first quarter. Personal consumption expenditures on nondurable goods increased by 1.6% during the third quarter following a 1.4% increase during second quarter and a 5.9% increase during the first quarter.

Real nonresidential fixed investment increased at an 8.6% rate in the third quarter as compared to a 4.4% rate in the second quarter and a 13.7% rate in the first quarter. Equipment and software investment activity, which increased by 15.6% in the first quarter and decreased by 1.4% in the second quarter, rebounded during the third quarter with an increase of 6.4%.

As anticipated, the slowing in consumer spending that began to emanate during the second quarter likely prompted businesses to cut back production and reduce inventory build-ups in order to allow inventory levels to come in line with reduced demand expectations. Following increases of \$41.2 billion in the first quarter and \$53.7 billion in the second quarter, private businesses increased inventories by \$50.7 billion in the third quarter. The second quarter real change in inventories added 0.44% to the change in real GDP. The third quarter real change in inventories subtracted 0.1% from the change in real GDP. This deceleration in the increase in inventories may tend to suggest that businesses feel inventory stocks have accumulated beyond desired levels and require a period to allow for a draw down to levels more in line with actual demand.

Real residential fixed investment, which decreased in the first and second quarters of 2006 by 0.3% and 11.1%, respectively, decreased again in the third quarter by 17.4%. This decline is likely indicative of a continued slowing in real estate activity, consistent with the deflating of the real estate bubble that is believed to have previously existed. This decrease in real residential fixed investment is likely the result of continued removal of accommodative monetary policy by the Federal Reserve and more cautious lending by financial institutions for real estate transactions.

Data on new residential construction from the U.S. Census Bureau and U.S. Department of Housing and Urban Development indicated that activity continued to

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weaken in the third quarter, continuing a trend that has been evident for most of 2006. Privately-owned housing units authorized by building permits ended the fourth quarter of 2005 at 2,075,000. For the first quarter, new privately-owned housing units authorized by building permits advanced in January to 2,195,000 before falling to 2,147,000 in February and 2,085,000 in March. For the second quarter, new privately-owned housing units authorized by building permits continued to decline, falling to 1,973,000 in April, 1,946,000 in May, and 1,869,000 in June. As a result, new privately-owned housing units authorized decreased on a year-over-year basis by 8.5% in April, 7.8% in May, and 14.9% in June. For the third quarter, new privately-owned housing units authorized by building permits declined to 1,763,000 in July, 1,727,000 in August, and 1,619,000 in September. These figures represent a year-over-year decline of 20% in July, 21.7% in August, and 27.7% in September.

Privately-owned housing starts, which ended the fourth quarter of 2005 at 1,989,000, increased in January to 2,265,000 then declined in February and March to 2,132,000 and 1,972,000, respectively. In the second quarter, privately-owned housing starts decreased in April to 1,832,000, rebounded to 1,953,000 in May, then declined again in June to 1,833,000. On a year-over-year basis, housing starts declined in April by 11.9%, increased by 4% in May, and declined by 11% in June. In the third quarter, privately-owned housing starts decreased to 1,760,000 in July and to 1,674,000 in August before rebounding to 1,772,000 in September. On a year-over-year basis, these figures represent a decline of 15% in July and 19.3% in August and an increase of 17.9% in September.

Sales of new and existing homes, which had decelerated during the first half of the year, continued to exhibit weakness during the third quarter of 2006. Data from the National Association of Realtors (NAR)^{iv} indicates that, after ending December 2005 at 6,750,000 units on a seasonally adjusted annualized basis, existing home sales continued to decline in January, falling to 6,570,000. Existing home sales rose to 6,900,000 in February and 6,900,000 in March. For the second quarter, existing home sales declined to 6,750,000 in April, 6,710,000 in May, and 6,600,000 in June. For the third quarter, existing home sales continued to decline, falling to 6,330,000 in July, 6,300,000 in August, and 6,180,000 in September, a year-over-year decline of roughly 14%.

The inventory of existing homes on the market increased during the second quarter to 3,730,000 in June as compared to 3,194,000 in March. As a result, the backlog of existing homes increased further from 5.1 months in December to 5.5 months in March to 6.8 months in June. For the third quarter, the inventory of existing homes ended September at 3,750,000. Based on this figure for September, it would take 7.3 months to exhaust the inventory, a slight increase from the backlog at the end of the second quarter. On a year-over-year basis, existing homes inventories were 35% higher during the quarter.

New home sales also declined in the first quarter of 2006, falling in January to 1,197,000, in February to 1,038,000, and increasing sharply in March to 1,121,000. On

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a year-over-year basis, however, new home sales in March declined roughly 7%. For the second quarter, new home sales remained steady at 1,121,000 in April, 1,101,000 in May, and 1,078,000 in June. Through the end of the first half of the year, new home sales were roughly 14% lower on a year-over-year basis. In the third quarter, new home sales fell to 984,000 in July before rebounding somewhat to 1,021,000 in August and 1,075,000 in September. Despite the slight rebound on a month-over-month basis, new home sales were 14% lower in September than in the prior year. For the nine months, new home sales were roughly 17% lower than the same period a year ago. The inventory of new homes was virtually flat at 6.4 months supply in September as compared to 6.5 months supply in June and 5.5 months supply in March. This is still a sharp increase from the 2005 level of 4.3 months.

The national median sales price of all existing homes fell from \$222,000 in December to \$218,000 in March, lower than the high of \$229,000 first set in June 2005. For the full year 2005, the median price was \$219,600. By June 2006, the national median sales price of existing homes had trended upwards to roughly \$230,000^v. At the end of the third quarter, the national median sales price of existing homes had fallen to \$220,000, a 2.2% decline on a year-over-year basis. The median price of new homes was \$217,000 in September, a 10% decline over the preceding twelve months.

The Beige Books released on July 26, 2006 and September 6, 2006 continued to indicate a slowing in residential real estate activity. Virtually all of the Districts reported declines in home sales and construction activity. Most Districts noted an increase in the inventory of unsold homes and some areas saw foreclosures on the rise. The outlook for residential real estate remained weak during the third quarter with most contacts expecting continued weakness in the months ahead or even worsening conditions. Virtually all Districts noted softness in house prices with many areas experiencing retrenchment in pricing.

Thirty-year conventional mortgage rates, according to Freddie Mac^{vi}, rose slightly during the first quarter from 6.27% at the end of 2005 to a high of roughly 6.37% in early March before ending the quarter at 6.35%. By mid-April, thirty-year rates had increased further to 6.49%. Thirty-year rates continued to climb during the second quarter, reaching a high of 6.78% on June 29, 2006. During the third quarter, thirty-year mortgage rates briefly touched 6.80% in late July before falling to roughly 6.31% by the end of the quarter. After ending the fourth quarter at approximately 5.82%, fifteen-year mortgage rates increased to 6.00% by early March. After ending the first quarter at 6.00%, fifteen-year rates increased further to 6.14% by mid-April. By the end of the second quarter, fifteen-year rates had risen to 6.43%. During the third quarter, fifteen-year rates declined steadily to end the quarter at roughly 5.98%.

The rise in mortgage rates coincides with U.S. Treasury yields on the 10-year note, which increased from 4.39% at the end of December 2005 to 4.53% by the end of January. By the end of the first quarter, the yield on the 10-year note had increased to 4.86%. The yield continued to increase through mid-April to roughly 5%. The yield reached a high of 5.19% in mid-May before falling to 4.97% in early June. By the end of

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the second quarter, the yield on the 10-year note had increased again to 5.15%. During the third quarter, the yield on the 10-year note fell again to end the quarter at 4.64%. By the end of the fourth quarter, the yield curve had inverted with the two-year yield rising just slightly above the yield on the ten-year note^{vii}. Though this inversion was reversed in early January, the yield curve inverted once again by the middle of the month before reversing by the end of January. The yield curve remained virtually flat during the remainder of the first quarter. During the second quarter, the yield curve inverted again in early June and remained inverted or flat for the duration of the second quarter. The yield curve was inverted or virtually flat again for the duration of the third quarter of 2006. This may tend to suggest that the markets may anticipate economic weakness in the future that would prompt easing of monetary policy by the Federal Reserve.

Following a revised increase of 14% in the first quarter and 6.2% in the second quarter, real exports of goods and services for the third quarter increased at a rate of 6.5%. Imports, a subtraction from GDP, increased 7.8% in the third quarter following an increase of 1.4% in the second quarter and an increase of 9.1% in the first quarter. The third quarter increase in imports subtracted 1.28% from the change in real GDP as compared to subtracting 0.24% and 1.46% from the second and first quarter changes in real GDP, respectively.

The dollar/sterling (\$/£) exchange rate ended 2005 at \$1.75. During the first quarter, the dollar weakened to \$1.79 against the pound sterling by the end of January before gaining to end the quarter at \$1.72. During the second quarter, the dollar weakened further to \$1.89 by the end of May before gaining slightly to end the quarter at \$1.82. During the third quarter, the dollar continued to weaken against the pound sterling, falling to \$1.92 by early August before gaining some ground to end the quarter at \$1.89. The dollar/euro (\$/€) exchange rate was \$1.20 at the end of the fourth quarter of 2005. During the first quarter of 2006, the dollar weakened to \$1.22 against the euro by the end of January. By the end of the quarter, the dollar had strengthened to \$1.20. The dollar weakened against the euro during the second quarter to \$1.28 by the end of May before rising to \$1.25 by the end of the June. During the third quarter, the dollar weakened to \$1.28 where it remained until ending the quarter at \$1.27. At the end of 2005, the yen/dollar (¥/\$) exchange rate stood at ¥116. During the first quarter of 2006, the dollar continued to gain strength against the yen. By early February, the dollar had strengthened to ¥119^{viii} before retrenching slightly to ¥118 by the end of the quarter. During the second quarter, the dollar weakened to ¥111 around the end of May before rising slightly to ¥116 by the end of June. The dollar fluctuated against the yen during the third quarter, strengthening to ¥118 before ending the quarter at ¥117. The slight improvement in the dollar against the yen may be a result of expectations of an easing of monetary policy by the Bank of Japan.

As growth expectations were revised upwards and expectations for a rebound in economic activity began to manifest during the middle of the first quarter, investors may have had renewed confidence in prospects for economic growth in the U.S, which may have prompted the strengthening of the dollar late in the first quarter against other currencies. However, this strength of the dollar was short-lived, particularly in light of

weaker economic activity during the second quarter and lower growth expectations and higher inflation expectations going forward. The continued weakness of the dollar during the third quarter may have been the result of further economic softness in the U.S. and renewed expectations of economic weakness during the fourth quarter of 2006 and first quarter of 2007.

For the third quarter of 2006, the current account deficit increased to \$201.3 billion (seasonally adjusted) compared to \$193.8 billion in the second quarter and \$191.1 billion for the first quarter. The current account deficit was \$716.7 billion for the full year 2005^{ix}. Through the third quarter of 2006, the current account deficit was \$586.2 billion as compared to \$522 billion for the same period in 2005. To be sure, continued rapid rises in the current account deficit are unsustainable in the long-term. In order to reduce the current account deficit, U.S. exports would have to increase substantially or the dollar would have to depreciate significantly whilst accompanied by a sharp reduction in domestic demand. With foreigners acquiring U.S. assets in order to satisfy the U.S. consumption of imported goods, there is a great risk to economic growth stemming from reliance upon foreigners' continued willingness to fund the current account. Should the proclivity of foreign investors towards dollar denominated assets fall, the dollar would likely weaken significantly and interest rates would be forced to rise significantly in order to attract investment in U.S. financial assets.

After increasing by 8.8% in the first quarter, real federal government consumption expenditures decreased by 4.5% during the second quarter. For the third quarter, real federal government consumption expenditures increased by 1.7%. National defense spending, which increased by 8.9% in the first quarter, decreased 2.0% in the second quarter and 0.7% in the third quarter. Nondefense spending, which decreased 9.3% in the second quarter after an increase of 8.5% in the first quarter, increased 6.9% in the third quarter.

The Federal Reserve

The Federal Reserve's gradual removal of monetary policy accommodation ended during the third quarter with the Federal Open Market Committee (FOMC) holding the federal funds rate to 5 1/4%^x.

At its meeting on January 31, 2006, the final meeting chaired by Alan Greenspan, the FOMC agreed its fourteenth twenty-five basis point increase in the target for the federal funds rate to 4 1/2%^{xi}. The FOMC stated that it believed economic activity remained solid, with core inflation remaining relatively low and long-term inflation expectations contained. The Committee also judged that resource utilization increases and continued high energy prices could add to inflationary pressures. The Committee also concluded that further policy firming could be necessary.

At its meeting on March 28, 2006, the first chaired by Ben Bernanke, the FOMC agreed another twenty-five basis point increase in the target for the federal funds rate to

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4 $\frac{3}{4}\%$ ^{xii}. At the May 10, 2006 meeting, the FOMC increased the federal funds rate by twenty-five basis points to 5%^{xiii} and indicated the following:

Economic growth has been quite strong so far this year. The Committee sees growth as likely to moderate to a more sustainable pace, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices.

At its June 29, 2006 meeting the FOMC agreed another increase in the federal funds rate to 5 $\frac{1}{4}\%$ ^{xiv}, the Committee's seventeenth consecutive increase. The Committee reiterated that the cooling housing market and effects of interest rate increases and higher energy prices had contributed to the gradual cooling in economic activity.

In the *Monetary Policy Report to the Congress*, released July 19, 2006, the Federal Reserve policymakers indicated that the economy was transitioning from a period of growth that is above the long-run sustainable rate to a more moderate and sustainable rate. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3 $\frac{1}{4}\%-3\frac{1}{2}\%$ (central tendency) in 2006 as compared to real GDP growth of 3.5% in 2005^{xv}. Real GDP is expected to increase by 3%-3 $\frac{1}{4}\%$ in 2007. The personal consumption expenditures chain-type price index (the Federal Reserve's preferred measure of inflation) excluding food and energy is expected between 2 $\frac{1}{4}\%-2\frac{1}{2}\%$ in 2006, as compared to the 1.9% increase in 2005. For 2007, the PCE price index excluding food and energy is expected to be 2%-2 $\frac{1}{4}\%$. The civilian unemployment rate is anticipated to range from 4 $\frac{1}{2}\%-5\%$ in 2006, against 5% for 2005, and 4 $\frac{1}{4}\%-5\frac{1}{4}\%$ in 2007.

In testimony accompanying delivery of the *Semiannual Monetary Policy Report to the Congress* before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on July 19, 2006 Chairman Ben Bernanke indicated the following:

The U.S. economy appears to be in a period of transition. For the past three years or so, economic growth in the United States has been robust. This growth has reflected both the ongoing re-employment of underutilized resources, as the economy recovered from the weakness of earlier in the decade, and the expansion of the economy's underlying productive potential, as determined by such factors as productivity trends and growth of the labor force. Although the rates of resource utilization that the economy can sustain cannot be known with any precision, it is clear that, after several years of above-trend growth, slack in resource utilization has been substantially reduced. As a consequence, a sustainable, non-inflationary expansion is likely to involve a modest reduction in the growth of economic activity from the rapid pace of the past three years to a pace more consistent with the rate of increase in the nation's underlying productive capacity. It bears emphasizing that, because productivity growth seems likely to remain strong, the productive capacity of our economy should

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expand over the next few years at a rate sufficient to support solid growth in real output.

As I have noted, the anticipated moderation in economic growth now seems to be under way, although the recent erratic growth pattern complicates this assessment. That moderation appears most evident in the household sector. In particular, consumer spending, which makes up more than two-thirds of aggregate spending, grew rapidly during the first quarter but decelerated during the spring. One likely source of this deceleration was higher energy prices, which have adversely affected the purchasing power of households and weighed on consumer attitudes.

At the August 8, 2006 meeting, the FOMC ended the removal of accommodative monetary policy by holding the target federal funds rate at 5¼%. In its press release following the meeting, the FOMC indicated that economic growth had moderated from a strong pace evident earlier in the year due in part to a gradual cooling of the housing market and lagged effects of higher interest rates and energy prices. The Committee also recognized that core inflation readings had increased and that high resource utilization and higher commodities prices may continue to fuel inflation pressures. The statement indicated that additional firming in monetary policy would depend on the outlook for inflation and economic growth in coming months. As an interesting note, the decision to keep rates on hold was not unanimous with one vote to increase the target federal funds rate by twenty-five basis points.

The FOMC held rates steady again at its meeting on September 20, 2006. The press release following the meeting indicated the following:

The moderation in economic growth appears to be continuing, partly reflecting a cooling of the housing market.

Readings on core inflation have been elevated, and the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.

Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Again at this meeting, one member of the FOMC voted against holding rates steady, preferring a twenty-five basis point increase in the target federal funds rate.

To be sure, the impact of higher energy prices is likely to continue to be felt for quarters to come. Inflation is likely to feel continued upward pressures, placing the

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FOMC in a precarious position of confronting higher inflation during a period of slowing economic growth. Though the engines of economic growth in America remain well oiled, they are unlikely to continue running at a robust pace in the short-term, particularly under the burden of slowing real estate activity, higher energy prices, rising interest rates, mounting inflationary pressures and the attending impacts these factors have upon consumer sentiment and consumption.

The Federal Reserve Beige Books^{xvi} released on July 26, 2006 and September 6, 2006 confirmed the slowdown in economic activity throughout the twelve Districts^{xvii} during the third quarter. The Beige Book conclusions included the following:

- *Consumer spending increased slowly in most Districts, weighed down by sluggish sales of vehicles and housing-related goods. While a number of districts noted some bloating in automobile inventories, most non-auto retailers indicated satisfaction with inventory levels. A number of Districts also indicate that persistently high energy prices are perceived to have crimped consumer demand in general.*
- *Manufacturing activity was reported as generally expanding in all Districts, and contacts were optimistic that activity would continue to grow in the months ahead. Factory activity was reported as declining in some sectors but increasing in others. Several Districts reported a decline in activity in the motor vehicle industry, although Cleveland noted that some of this decline was likely seasonal... Steel demand also remained strong according to the Cleveland and Chicago Districts. Activity was reported as rising in aircraft and defense sectors.*
- *Commercial real estate markets were uniformly described as strong and, in most cases, increasingly so. Office markets showed noticeable signs of improvement in the Boston, New York, Philadelphia, Atlanta, Chicago, Minneapolis, Kansas City, Dallas and San Francisco Districts. However, market conditions were described as mixed in the Richmond and St. Louis Districts. The reports on markets for industrial space were not as uniformly positive: Philadelphia, Richmond, and Atlanta reported some firming, whereas Minneapolis noted some softening; industrial markets were described as generally steady in the New York and St. Louis Districts. With widespread tightening in commercial real estate markets, most Districts also reported increases in commercial development and construction.*
- *Labor markets around the nation have generally been steady since the last report. Scattered labor shortages continued to be reported in a number of Districts, though these do not appear to have intensified, except in the Dallas District. Job growth was described as brisk in the Kansas City District, and recent acceleration was noted in the Richmond District. Labor markets were characterized as steady or expanding moderately in the other ten Districts... Wage pressures were reported in a number of Districts, though they*

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were most often limited to certain sectors and most pronounced for workers with specialized skills.

Consumer Confidence

The Conference Board's Consumer Confidence Index^{xviii} ended 2005 at 103.8 and continued the strengthening trend in the first quarter, rising to 106.8 in January, falling to 102.7 in February, and rebounding to 107.5 in March. At the end of the first quarter, the Consumer Confidence Index had risen to the highest level in nearly four years. Lynn Franco, Director of The Conference Board's Consumer Research Center, indicated the following with respect to the consumer confidence figures:

The improvement in consumers' assessment of present-day conditions is yet another sign that the economy gained steam in early 2006. Consumer expectations, while improved, remain subdued and still suggest a cooling in activity in the latter half of this year.

During the second quarter, the Consumer Confidence Index rose slightly in April to 109.8, declined significantly to 104.7 in May, and improved modestly to 105.4 in June. After reaching a four year high in April, consumers' concern regarding the short-term outlook for the economy and labor markets prompted the retrenchment in May. This is likely a result of the incoming economic data that dampened consumers' spirits regarding the strength of economic activity.

During the third quarter, the Consumer Confidence Index gained slightly in July to 107.0 before plummeting in August to 99.6, the lowest level of the year, before rebounding sharply in September to 105.9. Lynn Franco, Director of The Conference Board's Consumer Research Center offered the following in the August 2006 press release:

Consumer confidence lost significant ground in August and is now at its lowest level this year. Less favorable business conditions coupled with a less favorable job scenario have resulted in the largest one month decline in confidence since Hurricane Katrina last year. Looking ahead, the glass remains half empty as consumers are growing increasingly more pessimistic about the short-term outlook.

After ending 2005 at 92.6, the Expectations Index declined to 92.1 in January and 84.2 in February before rising to 90.3 in March. The decline in the Expectations Index during the first quarter may be attributed to consumers' anticipation of slowing economic growth and less favorable jobs prospects. The drop to 84.2 in February placed the Expectations Index at its lowest level in three years, with the exception of the two months following Hurricane Katrina. During the second quarter, the Expectations Index followed a pattern similar to that of the Consumer Confidence Index—rising slightly in April to 92.3, falling to 85.1 in May and improving slightly to 87.5 in June. The fall in the Expectations Index likely suggests the potential for continued slowing of

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economic activity in the second half of the year. During the third quarter, the Expectations Index increased to 88.9 in July, declined to 83.8 in August, and rebound to 91.0 in September. The wide variance in the Expectations Index likely indicates a mixed but cautious outlook for the coming quarters.

Consumers' outlook for the next six months was less favorable during the first quarter. In January, February, and March, 17.9%, 16.2%, and 17.8%, respectively, expected business conditions to improve in the next six months. Those expecting conditions to worsen decreased in March to 9.8% from 10.9% in February and 10.5% in January. In the second quarter, consumers expecting conditions to improve in the next six months stood at 17.3% in April, 16.5% in May, and 16.8% in June. Those expecting conditions to worsen in the second quarter decreased in April to 9.3%, increased in May to 12.9% and decreased in June to 11.8%. For the third quarter, consumers expecting conditions to improve stood at 16.1% in July, 15.9% in August, and 16.5% in September. Those expecting conditions to worsen in the next six months rose from 10.9% in July to 12.9% in August before falling to 10.3% in September. The erratic nature of the sentiments may reflect respondents' sensitivity to incoming economic data.

Consumers' assessment of current business conditions was mixed during the first quarter. With 24.4% of respondents characterizing current conditions as "good" in December 2005, this figure improved to 25.9% in January, 26.4% in February, and 27.9% in March. Those characterizing conditions as "bad" stood at 14.9% in December 2005. In January, February, and March, 15.9%, 15.4%, and 14.7% characterized conditions as "bad," respectively. In April, May, and June, 29.7%, 28.5%, and 26.6% characterized conditions as "good," a slight drop from the end of the first quarter. Those characterizing conditions as "bad" stood at 15.1% in April, 15.2% in May, and 15% in June. These figures are higher than at the end of the first quarter but slightly below the levels gauged earlier in the year. For the third quarter, those characterizing conditions as "good" increase to 27.3% in July, fell to 26.1% in August, and increased to 27.3% in September. Those characterizing conditions as "bad" during the third quarter stood at 15% in July, 16.7% in August, and 15.6% in September.

The improvement in the first quarter may have been the result of momentum in consumer confidence that paralleled momentum in economic activity during the same period. The shift to a more guarded assessment of economic activity during the second quarter may have been the result of incoming economic data that tended to show weakening from previously robust levels. The deterioration in optimism during the second quarter and cautious sentiments in the third quarter may indicate that consumers are becoming more concerned regarding the actual long-term threats to economic growth stemming from factors such continued elevated energy prices, increased interest rates, a slowing housing market, etc. As the actual impact these factors have upon economic activity continues to manifest in coming months, consumer confidence may remain volatile.

The Business Sector

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Industrial production, as compiled by the Federal Reserve^{xix}, increased at a revised annual rate of 5.3% during the fourth quarter of 2005 and by 5.1% for the first quarter of 2006^{xx}. For the second quarter, industrial production increased at an annual rate of 6.6%. For the third quarter, industrial production increased at an annual rate of 3.6%. Industrial production increased by 3.1%, 3.3%, and 3.6% for the twelve months ending in January, February, and March, respectively, and by 4.7%, 4.3%, and 4.5% for the twelve months ending in April, May, and June, respectively. During the third quarter of 2006, industrial production increased by 4.9%, 4.7%, and 5.6% for the twelve months ending in July, August, and September, respectively.

Manufacturing production, which increased at an annual rate of 5.3% in the first quarter, advanced by an annual rate of 5.1% in the second quarter of 2006 and by 3.8% in the third quarter. Once again, the continued strength in manufacturing, albeit at a more tempered rate, is confirmed by anecdotal evidence contained in The Beige Book releases from the Federal Reserve, which indicated generally favorable manufacturing gains throughout the twelve Districts. Manufacturing production increased by 4.5%, 4.2%, and 4.8% for the twelve months ending in January, February, and March, respectively, and by 5.5%, 4.9%, and 5.7% in April, May, and June, respectively. During the third quarter, manufacturing production increased by 5.6%, 5.4%, and 5.9% for the twelve months ending in July, August, and September, respectively.

Durable consumer goods production, which declined at an annual rate of 1.8% in the first quarter, advanced at an annual rate of 1.2% in the second quarter but declined again in the third quarter by 5.5%. Nondurable consumer goods production, which decreased by 0.8% in the first quarter of 2006, advanced at an annual rate of 4.6% in the second quarter of 2006 and by 4.8% in the third quarter. Defense and space equipment production continued to experience strong gains, increasing by 6.8% and 5% in the first and second quarters, respectively. Defense and space equipment production advanced at a more modest 3.9% for the third quarter of 2006. Construction supplies advanced by a modest 3.2% in the first quarter and declined by 1% in the second quarter. This retrenchment in construction supplies is likely the result of continued cooling in housing activity nationwide. Surprisingly, construction supplies advanced by 0.8% in the third quarter based on preliminary figures.

On a quarterly basis, capacity utilization increased to 82% in the second quarter, following an increase in the first quarter of 2006 to 81.1%. For the third quarter, capacity utilization increased to 82.3%. This level of 82.3% is 1.3% above the 1972 to 2005 average. The trend of increasing capacity utilization coincides with the increased activity in manufacturing evident through a number of other figures and resources. Manufacturing capacity utilization increased to 80.8% in the second quarter as compared to 80.3% in the first quarter. For the third quarter, manufacturing capacity utilization increased to 81.1%. At this level, capacity utilization is now above the 1972 to 2005 average of 79.8%. At these levels of resource utilization, there is still considerable slack in the productive capabilities of factories throughout the United States. As such, capacity utilization rates should not pose a significant threat to rising inflationary pressures, even though the utilization rates are slightly above the historical

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norms. However, the Federal Reserve has mentioned that high resource utilization rates may stoke inflationary pressures in the future.

The Department of Commerce's^{xxi} advance monthly sales for retail trade and food services showed solid gains in the first quarter. In March, retail and food service sales increased by approximately 0.6%^{xxii} from February to \$361 billion. Total retail sales increased by 0.7% in March from the February level to \$325.9 billion. During the second quarter, retail trade and food services sales were tepid, increasing to \$363.6 billion in April and to \$364.1 billion in May before falling to \$363.8 billion in June. Total retail sales followed a similar pattern in the second quarter, increasing to \$328.4 billion and \$328.8 billion in April and May, respectively, then falling slightly to \$327.2 billion in June. During the third quarter, total retail sales rose to \$332 billion in July then fell to \$331.9 billion August and to \$330 billion in September. Total retail and food service sales rose to \$367.4 billion July and \$367.7 billion in August then fell to \$366.2 billion in September.

On a year-over-year basis, monthly sales for retail trade and food service increased 9.4% in January, 7.5% in February, and 7.9% in March. In April, May, and June, monthly sales for retail trade and food services increased 6.9%, 7.6%, and 5.9%, respectively, on a year-over-year basis. Monthly sales for retail trade and food service increased 4.8% in July, 6.4% in August, and 5.5% in September on a year-over-year basis.

For the third quarter, advance monthly retail and food service sales increased 1% from the prior quarter and by 5.6% on a year-over-year basis. For the second quarter, advance retail and food service sales increased 0.9% from the first quarter. This compares to an increase of 3.2% in the first quarter from the fourth quarter of 2005. On a year-over-year basis, advance sales for retail trade and food services increased 8.3% in the first quarter. In the second quarter, sales for retail trade and food services increased 6.8% on a year-over-year basis. For the first quarter, retail sales increased by 3.2% from the fourth quarter and by 8.2% on a year-over-year basis.

Third quarter 2006 retail sales increased 0.9% over the prior quarter and by 5.3% as compared to the third quarter of 2005. For the second quarter of 2006, retail sales increased by 1% from the first quarter and by 6.7% as compared to the same period a year ago. Total sales excluding motor vehicles and parts increased by 1.6% in the second quarter over the first and by 8.9% on a year-over-year basis. For the third quarter of 2006, total sales excluding motor vehicles and parts increased 0.9% over the second quarter and by 7.2% on a year-over-year basis. This compares to an increase of 2.7% in the first quarter from the fourth quarter and by 9.7% on a year-over-year basis. Sales of motor vehicles and parts increased in the first quarter of 2006 by 5.2% and by 3.3% on a year-over-year basis. Sales of motor vehicles and parts declined 1.7% in the second quarter as compared to the first quarter and by 0.5% on a year-over-year basis. For the third quarter of 2006, sales of motor vehicles and parts increased 1.5% over the second quarter but declined by 0.3% as compared to the third quarter 2005.

The Chief Executives' Confidence Measure, compiled by the Conference Board in the quarterly *CEO Confidence Survey*, indicated that CEOs' confidence improved slightly in the first quarter with the index increasing to 57 from 56 in the fourth quarter of 2005^{xxiii}. However, the index declined to 50 for the second quarter of 2006 and declined again to 44 for the third quarter. In the first quarter, roughly 49% of CEO's indicated that current economic conditions were better. In the second quarter, only 27% claimed current economic conditions are better. For the third quarter, roughly 16% claim the current economic environment is better.

Inflation

Following a 4.3% increase in the consumer price index (CPI)^{xxiv} for the first quarter of 2006 at a seasonally adjusted annual rate and a 5.1% increase for the second quarter, the CPI increased by a compound annual rate of 0.8% for the third quarter 2006. The CPI increased 0.7% in January, 0.1% in February, and 0.4% in March on a seasonally adjusted basis. In April, May, and June, the CPI increased 0.6%, 0.4%, and 0.2%, respectively. In July, and August, the CPI increased 0.4% and 0.2% then declined 0.5% in September. For the twelve months ending in March, the CPI increased at an annual rate of 3.4%. For the twelve months ending in June, the CPI increased at an annual rate of 4.3%. For the twelve months ending in September, the CPI increased at an annual rate of 2.1%.

For the first quarter of 2006, the energy index increased by 21.8%, as a result of continued elevated energy prices. For the second quarter, the energy index increased 23.8%. For the third quarter, the energy index declined 15.6% as a result of declines in oil prices. For the twelve months ending in March and June, the energy index advanced by 17.3% and 23.3%, respectively. For the twelve months ending in September, the energy index declined 4.3%. For the first, second, and third quarters of 2006, the food index advanced at an annual rate of 2.5%, 1.7%, and 3.5%, respectively. For the twelve months ending in March, June, and September, the food index increased by 2.6%, 2.2%, and 2.5%.

Removing the effects of food and energy, the core CPI increased by a seasonally adjusted annual rate of 2.8% in the first quarter and by 3.6% in the second quarter, perhaps indicating a pass through of higher costs by businesses to consumers. For the third quarter, the core CPI increased by 2.7%. The core CPI advanced at a rate of 2.2% for both 2004 and 2005. For the twelve months ending in June, the core CPI advanced at a rate of 2.6% as compared to a rate of 2.1% for the twelve months ending in March. For the twelve months ending in September 2006, the core CPI increased 2.9%

In addition to the CPI, the price index for personal consumption expenditures (PCE) from the Bureau of Economic Analysis^{xxv} rose by 2.5% in the third quarter of 2006 as compared to an increase of 2.0% in the first quarter and 4.0% in the second quarter. On a year-over-year basis, the PCE rose by 3.0% in the first quarter, 3.3% in the second quarter, and 2.9% in the third quarter. The PCE excluding food and energy

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prices increased 2%, 2.2%, and 2.4% on a year-over-year basis in the first, second, and third quarters of 2006.

With respect to inflation, Chairman Ben Bernanke indicated the following in his Congressional testimony from July 19, 2006:

...The recent rise in inflation is of concern to the FOMC. The achievement of price stability is one of the objectives that make up the Congress' mandate to the Federal Reserve. Moreover, in the long run, price stability is critical to achieving maximum employment and moderate long-term interest rates, the other part of the congressional mandate...

Although our baseline forecast is for moderating inflation, the Committee judges that some inflation risks remain. In particular, the high prices of energy and other commodities, in conjunction with high levels of resource utilization that may increase the pricing power of suppliers of goods and services, have the potential to sustain inflation pressures. More generally, if the pattern of elevated readings on inflation is more protracted or more intense than is currently expected, this higher level of inflation could become embedded in the public's inflation expectations and in price-setting behavior. Persistently higher inflation would erode the performance of the real economy and would be costly to reverse...

It appears that the acceleration in the increase in core inflation in the second quarter may have been prompted by a willingness of businesses to begin passing increased costs onto the consumers. The slowdown in the increase in inflation during the third quarter was likely prompted by less firm conditions in energy prices which contributed to the decline in prices for transportation costs. However, rising energy prices may ultimately prompt further upward inflationary pressures at a more rapid rate in the coming months. The core inflationary pressures could be further pronounced should businesses be successful in continuing to pass along current cost increases to consumers as well as future cost increases. An unexpected increase in core inflation may result in higher inflation premiums in the markets that would tend to suppress economic growth.

Labor Market

The unemployment rate fell to 4.7% in the first quarter and held steady at that rate for the second and third quarters^{xxvi}. On a monthly basis, unemployment was 4.7% in January, 4.8% in February, 4.7% in March, 4.7% in April, and 4.6% in both May and June. During the third quarter, unemployment rose to 4.8% in July then fell to 4.7% and 4.6% in August and September, respectively.

Total nonfarm payroll employment increased by 154,000 in January, by 225,000 in February, and by 211,000 in March, for a first quarter average of 197,000 monthly job gains. As a result of these gains, total nonfarm payroll employment increased by 590,000 during the first quarter of 2006 as compared to an increase of 477,000 during

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the first quarter of 2005. In March, total nonfarm payroll employment stood at 134.996 million.

In the second quarter, total nonfarm payroll employment increased by 325,000 or a monthly average of 108,000 job gains. For the twelve months ending in March, average monthly job gains stood at 169,000. Total nonfarm payroll employment increased by 112,000 in April, 92,000 in May, and 121,000 in June. By the end of the quarter, total nonfarm payroll employment stood at 135.230 million.

For the third quarter, total nonfarm payroll employment averaged 135.516 million and ended September at 135.613 million. During the quarter, total nonfarm payroll employment increased by 372,000 or a monthly average of roughly 124,000. During July, August, and September, total nonfarm payroll employment increased 133,000, 188,000, and 51,000, respectively.

Payroll gains in the third quarter were similar to the gains in the second quarter and included increases in professional & business services, government, leisure & hospitality, and education & health services. Professional & business service employment increased roughly 100,000 in the third quarter. This follows an increase of roughly 82,000 in the second quarter and 93,000 in the first quarter. Government employment increased by roughly 49,000 in the third quarter (compared to an increase of 68,000 in the second quarter) with education & health services increasing by approximately 115,000 (compared to 86,000 in the second quarter). Leisure & hospitality added roughly 57,000 jobs in the third quarter. Manufacturing employment gained 26,000 jobs in the second quarter after losing roughly 10,000 during the first quarter. Manufacturing employment continued to retrench in the third quarter with a loss of roughly 46,000 jobs.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment was mixed during the first quarter. Consumers expecting more jobs to become available in the next six months decreased to 13.9% in March 2006. For the second quarter, 15.6% in June expected more jobs to become available in the coming months with the figure declining to 14.7% by the end of the third quarter. Those expecting fewer jobs to become available fell to 16.6% by the end of the first quarter of 2006. At the end of the second and third quarters, 17.0% and 16.5% expected fewer jobs to become available in the next six months, respectively.

The slowdown in economic activity that continued to manifest during the third quarter may result in lower payroll employment gains in the coming months. Continued elevated energy prices and rising interest rates may further negatively impact consumer sentiment, leading consumers' optimism regarding employment to deteriorate. This may be more pronounced should businesses and manufacturers continue to adjust payrolls to compensate for lower demand expectations. Given a slowing in economic activity, further drops in the unemployment rate are unlikely and would, in all likelihood, be temporary should such a drop in unemployment occur. A rising unemployment rate would likely ease the shortages of skilled workers that have been noted throughout the

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nation. As a result, any wage pressures that may have attended the shortage of skilled workers would also likely ease.

Equity Markets

The Dow Jones Industrial Average (DJIA) ended 2005 at roughly 10,718^{xxvii}. The S&P 500 and the NASDAQ composite ended 2005 at 1,248 and 2,205, respectively. During the first quarter, the DJIA gained roughly 4.7% (through March 29th) to 11,216. The NASDAQ and the S&P 500 gained 6.0% and 4.4%, respectively, ending the quarter at roughly 2,338 and 1,303. During the first quarter, the S&P 500 crossed the 1,300 level for the first time since May 2001. The second quarter's weak economic activity accompanied a downturn in the markets with the DJIA falling roughly 2% to end the quarter at roughly 11,000. The NASDAQ composite and the S&P 500 also fell during the quarter by 9.7% and 4.4%, respectively, to roughly 2,100 and 1,250. By the end of the third quarter, however, the markets had regained ground lost during the previous quarter with the DJIA gaining roughly 6.5% to end the quarter at nearly 11,700. The S&P 500 and the NASDAQ composite each gained roughly 7% to finish the third quarter at 1,330 and 2,260, respectively.

The rebound in the equity markets during the third quarter may be the result of increased optimism regarding the fourth quarter holiday season, record merger and acquisition deals, and a perceived value of equity prices relative to other risky asset classes particularly in light of the significant slowdown in the real estate markets. This diminishing opportunity for superior returns in the real estate market may have prompted investors to continue to return to the equity markets and other asset classes. In addition, the pause in the Federal Reserve's tightening of monetary policy may have contributed to increased investor sentiment in equities and the improved performance of the equity markets in the third quarter.

Sustained elevated oil prices and the potential for adverse impacts upon economic activity, uncertainty regarding geopolitical events, and increased inflation expectations may serve to dampen investors' confidence in the equity markets in coming months as these factors may well have far-reaching adverse impacts upon corporate profits, economic activity, and, by extension, the equity markets. Inflationary pressures stemming from higher energy prices feeding into the core inflation figures could also have an adverse impact upon investor confidence. As a result of the aforementioned risk factors, the ability of the equity markets to post significant gains over the coming quarters may yet be tenuous, particularly as a number of factors may contribute to further economic softness and rising inflationary pressures in the coming quarters.

Oil Prices

West Texas Intermediate (WTI) oil prices, which fluctuated in a band from \$60 to \$66 per barrel during the first quarter, remained at elevated levels during the second

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quarter of 2006 ranging from \$66 to \$75 per barrel. For the third quarter, oil prices traded in a band from roughly \$61 to \$77 per barrel.

At the January 31, 2006 meeting in Vienna, Austria^{xxviii}, OPEC ministers maintained its production level of 28.0 million barrels per day.

At its March 8, 2006 meeting in Vienna^{xxix}, OPEC members agreed to maintain its production ceiling of 28 million barrels per day. By the end of the quarter, however, prices had once again increased to around the \$66 level, perhaps as a result of the loss of roughly 500,000 barrels per day in supply due to militant attacks on the Nigerian oil infrastructure.

During the second quarter, prices rose steadily through April and into early May, touching above \$75 per barrel before retrenching slightly to end the quarter at roughly \$72 per barrel. Oil prices rose higher on concerns over refining capacity shortages, despite assurances from international oil companies such as BP, Royal Dutch Shell, and ExxonMobil that they did not see any shortages in global refining capacity. The rise in oil prices may also be correlated to the increased demand typically experienced during the peak summer driving months as Americans take their holidays. In addition, geopolitical tensions surrounding Iran's nuclear programme and Citgo's (a wholly-owned subsidiary of Petroleos de Venezuela) suspension of gasoline distribution to its U.S. filling stations done at the behest of Hugo Chavez, Venezuelan president, who is attempting to reduce his country's dependence on the United States as its top export market.

At the 141st (Extraordinary) Meeting of the OPEC Conference in Caracas, Venezuela on June 1, 2006, OPEC members again left production levels unchanged but indicated the following^{xxx}:

Having reviewed the oil market situation and its immediate prospects, the Conference observed that fundamentals have stayed unchanged since its last review, with the market continuing to be over supplied and commercial crude and product stocks remaining at comfortable levels in terms of days of forward cover. The Conference also noted that, similarly, world crude oil prices continued to remain high and volatile as a consequence of abiding concern over the lack of effective global oil refining capacity, in the short and medium term, coupled with anxiety about the ability of oil producers to meet anticipated, future oil demand. This price volatility is being exacerbated by geopolitical developments and speculation in the oil futures markets.

In the light of the foregoing, the Conference decided to retain the status quo. In so doing, however, the Conference reaffirmed its determination to ensure that crude oil prices remain at acceptable levels, reiterating also its readiness to act swiftly to take whatever steps might be necessary to safeguard the interest of Member Countries, in the short and longer term. For this purpose, the Conference agreed to continue closely monitoring market developments. The

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Conference further agreed that its President would consider convening an Extraordinary Meeting of the Conference prior to its September Meeting, should market condition so warrant.

During the third quarter, oil prices rose to a high of over \$76 per barrel in early August before beginning a period of retrenchment which saw prices fall back to roughly \$61 per barrel by the end of the quarter. The sharp rise in prices during early August may have been caused, in part, by BP's partial closure of its Prudhoe Bay oilfield in Alaska, resulting in a loss of roughly 400,000 barrels per day. In a press release of August 10, 2006, OPEC officials indicated the following^{xxxii}:

... OPEC must again express its concern about the rising level of prices and the effect it could have on global economies, especially the oil-importing developing countries. Unfortunately, the oil market is very sensitive to such happenings, as evidenced by the latest price spike. This reaction again supports OPEC's longstanding view that all parties involved in the oil market must work more closely to instill a higher level of confidence in the marketplace to prevent extreme price volatility when such events occur. In the light of the latest development, OPEC will continue to carefully monitor the situation and take all measures necessary to secure oil market stability and maintain crude prices at reasonable levels through the provision of additional supplies, as necessary.

OPEC members made no production cuts or increases at its 142nd (Ordinary) meeting in Vienna, Austria on September 11, 2006^{xxxiii}. However, in his opening remarks to the meeting, Dr. Edmund Maduabebe Daukoru, President of the OPEC Conference and Minister of State for Petroleum Resources of Nigeria indicated the following regarding the oil markets and the impact that events and speculators may have upon price volatility:

The specific reasons for the recent price peaks were the outbreak of hostilities in Lebanon in the middle of July and fears of hurricanes in the US Gulf closely followed by the sudden shutting-down of the Prudhoe Bay field in Alaska in the first half of August. However, this must be set against the backdrop of volatility that has prevailed in the market for the past two and half years, due principally to concern over the lack of effective global oil refining capacity, anxiety about the ability of oil producers to meet anticipated future oil demand, geopolitical developments in some producing countries and speculation in the oil futures markets.

Crude oil volatility appears to have subsided over the past year, due to ample supply, rising OPEC spare capacity, plentiful strategic reserves and abundant commercial crude inventories, which are now at their highest levels since 1998. On the other hand, the increasing volatility of gasoline can be attributed, for example, to higher demand, increasingly stringent

product specifications and, more recently, the issue of the adequacy of ethanol supplies. In particular, the relatively low level of gasoline inventories, in terms of days of forward cover, coupled with the lack of spare refinery capacity, has left an uncomfortably thin cushion of spare supply. Hence, the growing volatility reflects an increased sensitivity to developments in the product markets, such as unexpected outages or even planned refinery shutdowns.

This leads me onto the issue of speculation, which has been inflating prices far above market fundamental levels during the present unstable period. Not only is this high level of speculation, which has been spurred on by non-commercials, disruptive to the oil industry itself, but it is also having serious knock-on effects further afield in the global economy, with potentially serious repercussions for highly indebted developing countries. It is essential, therefore, that this issue is addressed effectively soon, once and for all, particularly where it involves parties far removed from the day-to-day affairs of the industry.

The comments from OPEC officials tend to suggest that OPEC is comfortable with an oil price in excess of \$60. It seems likely that OPEC does not intend to take any actions that would intentionally lower prices below a suitable level at or near \$60 per barrel. Indeed, it is not clear that OPEC members could substantially increase production in order lower prices significantly due to rising demand and growth from rapidly growing economies such as China and India. Furthermore, refining capacity would seem to be limited, thus further contributing to sustained higher energy prices.

It is likely that energy prices will remain at elevated levels for the coming quarters, which could further weaken economic growth. Concerns of geopolitical risks such as Iran's suspected nuclear program and the potential for an Iranian oil embargo as a result of the nuclear showdown with the West could create an additional premium in the price of oil. Furthermore, continued speculative activity in the oil markets, which has been ongoing since 2004, is likely to continue to inflate the price of oil. Therefore, the risks to economic activity stemming from higher energy prices remain weighted towards conditions that may perpetuate further economic weakness in the coming quarters.

Economic Outlook

After ending the first quarter of 2006 at 138.9, the Conference Board's Leading Economic Indicators ended the second quarter at 138.1, weakening somewhat during the first half of the year, and fell further during the third quarter to 137.7 in September^{xxxiii}. In January, the leading index increased 0.4% before declining 0.5% in February and increasing 0.4% in March. The leading index then decreased 0.2% in April and 0.5% in May before increasing 0.2% in June. For the third quarter, the leading index declined 0.3% in July and 0.2% in August before increasing 0.1% in September.

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For the six months ending in March, the leading index increased 2.3%. From December 2005 to June 2006, the leading index decreased 0.2%. For the six months ending in September, the leading index decreased 0.9% or an annual decline of 1.7%. August 2006 marked the fifth month of the last eight during which the leading index had declined. The weaknesses among the indicators were mixed during the third quarter, with declining housing permits and manufacturers' new order the largest negative contributors. The behavior of the leading index would tend to indicate a slow pace of economic growth in the near term.

In the *Monetary Policy Report to the Congress*, released July 19, 2006, the Federal Reserve policymakers indicated that the economy was transitioning from a period of growth that is above the long-run sustainable rate to a more moderate and sustainable rate. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 3 1/4%-3 1/2% (central tendency) in 2006 as compared to real GDP growth of 3.5% in 2005^{xxxiv}. Real GDP is expected to increase by 3%-3 1/4% in 2007. The personal consumption expenditures chain-type price index (the Federal Reserve's preferred measure of inflation) excluding food and energy is expected to increase between 2 1/4%-2 1/2% in 2006, as compared to the 1.9% increase in 2005. For 2007, the PCE index excluding food and energy is expected to be 2%-2 1/4%. The civilian unemployment rate is anticipated to range from 4 1/2%-5% in 2006, against 5% for 2005, and 4 1/4%-5 1/4% in 2007.

The fifty-one forecasters participating in the Philadelphia Fed's *Survey of Professional Forecasters* expect real GDP growth of 2.9% in the fourth quarter, 2.9% in the first quarter 2007, and an annual rate of growth in real GDP of 3.4% for 2006 and 2.8% for 2007. CPI inflation is expected to equal roughly 3.3% for 2006 and 2.6% in 2007. The unemployment rate is forecast at 4.7% for 2006 and 4.9% for 2007.

Based on the current assessment of a number of economic factors, the slowdown in economic growth has continued, spawned by the adverse systemic impact of continued elevated energy prices and a weak real estate market. Retrenchment in consumer spending in coming quarters could precipitate further cooling of economic activity, which could, in turn, prompt businesses to retrench slightly with respect to production and employment. As a result, economic activity could yet become more tempered in the coming quarters. These factors suggest that the risks to the economy remain weighted heavily towards weaker economic activity in the coming quarters.

We do not believe that the preponderance of evidence points to a recession. Currently, we still believe that economic growth will likely be at a much more tempered pace in the fourth quarter and the first half of 2007. However, we now believe that the probability of the economy slipping into recession in the first half of 2007 has increased moderately. For now, we contribute a higher probability that the U.S. economy will likely continue to exhibit low growth and higher inflationary pressures.

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

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- The Federal Reserve's removal of accommodative monetary policy, along with already higher mortgage rates, have likely restrained real estate activity and contributed to the further removal of the speculative froth that had developed in many markets in the preceding two years.
- Oil prices are likely to remain at elevated levels throughout 2006 and into 2007, which could prompt further slowing of economic activity globally and in the U.S.
- Inflation has remained at levels above recent trends, and will likely remain above recent levels, which would be consistent with slower economic growth.

Our expectations for the economy include:

- Real GDP growth of 2¾% - 3¼% for 2006.
- The pause in the Federal Reserve's removal of monetary policy accommodation is likely to hold in light of continued economic weakness.
- Inflation is likely to increase in 2006 with the core CPI increasing by roughly 2½% - 3 ¼%.
- As economic activity becomes more tempered, payroll employments are likely to increase at a lower rate. Unemployment is likely to range from roughly 4¾% - 5% for 2006.
- Continued geopolitical concerns will likely result in an additional risk premium in oil prices. It is unlikely that OPEC will increase production in the coming months. However, even if OPEC were to do so, these increases will not likely have a material impact on lowering the price of oil. Oil prices (WTI) are likely to average \$60-\$70 per barrel for 2006 and \$55-\$65 per barrel in 2007.

Conclusion

Economic activity continued to slow during the third quarter following a marked slowing in activity in the second quarter. Personal consumption expenditures, which had performed well during the first quarter and slowed markedly in the second quarter, remained weak during the third quarter. Inflation remained largely contained but increased at levels above recent rates. These factors may create continued uncertainty regarding future economic growth in the coming quarters. Based on our assessment of the state of the economy in the third quarter, conditions are likely to foster tepid economic activity during the fourth quarter of 2006 and first quarter of 2007. However, the fourth quarter of 2006 may benefit from some anticipated retail sales increases during the holiday shopping season. Despite this, the risks are weighted mainly towards growth at a more subdued rate and towards conditions that generate a higher level of inflation for the foreseeable future.

ⁱ The BEA press release on October 27, 2006 states the following with respect to advance estimates: The Bureau emphasized that the third-quarter "advance" estimates are based on source data that are incomplete or subject to further revision by the source agency. The third quarter "preliminary" estimates, based on more comprehensive data, will be released on November 29, 2006.

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, 2006.

^{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 National Association of Realtors, *Existing Home Sales* and *New Home Sales* statistical releases.

^{vi} Data from Freddie Mac Weekly Mortgage Market Survey

^{vii} The yield curve inversion resulted from an increase in short-term rates associated with the Federal Reserve's removal of accommodative monetary policy at a measured pace and market expectations of slower economic growth in the future. Since the 1970s, every U.S. recession has been preceded by an inverted yield curve. However, not all inverted yield curves have historically been followed by a recession.

^{viii} Source: *The Economist*

^{ix} U.S. International Trade in Goods & Services (September 2006) press release from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, November 9, 2006.

^x The Board of Governors also held the discount rate at 6 1/4%.

^{xi} The Board of Governors also increased the discount rate by twenty-five basis points to 5 1/2%.

^{xii} The Board of Governors also increased the discount rate by twenty-five basis points to 5 3/4%.

^{xiii} The Board of Governors also increased the discount rate by twenty-five basis points to 6%.

^{xiv} The Board of Governors also increased the discount rate by twenty-five basis points to 6 1/4%.

^{xv} Changes are from average for fourth quarter of previous year to average for fourth quarter of year indicated.

^{xvi} The press release on September 6, 2006 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.

^{xvii} 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.

^{xviii} 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. TNS is the world's largest custom research company.

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

^{xx} Quarterly industrial production figures based on revised data from the December 2005 Industrial Production and Capacity Utilization statistical release.

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

^{xxii} Adjusted for seasonal, holiday, and trading day differences but not for price changes. Removing the impact of price changes/inflation, the growth figures would be lower. For example, total retail sales increased by 6.2% on a year-over-year basis during the fourth quarter. The twelve month inflation rate, based on the CPI, was 3.4% for the twelve months ending December 2005. This would imply a real growth in total retail sales of 2.8%.

^{xxiii} *CEO Confidence Survey*, The Conference Board.

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

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^{xxv} Bureau of Economic Analysis, Gross Domestic Product: Third Quarter 2006 (Advance) release, October 27, 2006.

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

^{xxvii} Based on data from *The Economist*.

^{xxviii} OPEC press release following the 139th (Extraordinary) Meeting of the OPEC Conference in Vienna, Austria on January 31, 2006.

^{xxix} OPEC press release following the 140th Meeting of the OPEC Conference in Vienna, Austria on March 8, 2006.

^{xxx} OPEC press release following the 141st Meeting of the OPEC Conference in Caracas, Venezuela on June 1, 2006.

^{xxxi} OPEC press release, "OPEC reassures market of adequate supplies," Vienna, Austria, August 10, 2006.

^{xxxii} OPEC press release following the 142nd Meeting of the OPEC Conference in Vienna, Austria on September 11, 2006.

^{xxxiii} From The Conference Board's press releases for US Leading Economic Indicators.

^{xxxiv} Changes are from average for fourth quarter of previous year to average for fourth quarter of year indicated.