STATE OF THE ECONOMY
4th Quarter 2004

Introduction

Though the pace of economic expansion slowed slightly during the fourth quarter with real gross domestic product (GDP) increasing at an annual rate of 3.1%, economic activity continued the favorable performance that characterized 2004 despite concerns regarding higher energy prices and the presidential elections. The 3.1% increase in real GDP in the fourth quarter follows a revised 4.0% increase in the third quarter and increases of 4.5% and 3.3% in the first and second quarters, respectively. Though personal consumption expenditures, private inventory investment and government spending remained strong during the fourth quarter, the deceleration in exports and personal consumption expenditures of durable goods along with an increase in imports served to suppress real GDP growth slightly. Though inflation remained tame during the fourth quarter and for the year and the labor market continued to post gains, increased interest rates associated with the Federal Reserve's gradual removal of accommodative monetary policy may have also contributed to the deceleration in real GDP in the final quarter of the year. However, on a year-over-year basis, the U.S. economy's performance in 2004 surpassed that in 2003. In addition, conditions appear favorable for continued strength in the economy in 2005.

Gross Domestic Product

Advance estimates[1] released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 3.1% in the fourth quarter of 2004, slightly lower than the revised rate of 4.0% for the third quarter. Fourth quarter economic growth was also lower than the consensus forecast of 3.7% annual growth in real GDP anticipated by thirty-four forecasters surveyed by the Federal Reserve Bank of Philadelphia[2]. The third quarter growth in real GDP was revised higher from an annual rate of 3.7% to

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[1] The BEA press release on January 28, 2005 states the following with respect to advance estimates: The Bureau emphasized that the fourth-quarter "advance" estimates are based on source data that are incomplete or subject to further revision by the source agency. The fourth quarter "preliminary" estimates, based on more comprehensive data, will be released on February 25, 2005.
[2] *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, November 22, 2004.

4.0%, still lower than the 4.5% annual growth in real GDP for the first quarter of 2004[3] but higher than the 3.3% rate during the second quarter. On a year-over-year basis, real GDP increased by 4.4% in 2004 as compared to an annual increase of 3.0% in 2003 and 1.9% in 2002. The acceleration in economic activity in 2004 was a result of continued strength in personal consumption expenditures, federal government spending, exports, equipment and software, and residential fixed investment. Increased private inventory investment also contributed to the increase in real GDP in 2004.

Real personal consumption expenditures increased by 4.6% in the fourth quarter at a seasonally adjusted annual rate, slightly lower than the 5.1% increase in the third quarter. For 2004, real personal consumption expenditures increased 3.8% as compared to increases of 3.1% and 3.3% in 2002 and 2003, respectively. Purchases of durable goods, which increased 17.2% in the third quarter, tapered in the fourth quarter, increasing by a more modest 6.7% due to less expenditure on motor vehicle and furniture and household equipment. For 2004, personal consumption expenditures on durable goods increased by 6.9% as compared to a 6.5% increase in 2002 and a 7.4% increase in 2003. Personal consumption expenditures on nondurable goods, which increased by 2.6% and 3.7% in 2002 and 2003, respectively, continued its favorable trend with a 4.5% increase in 2004. Data from the Federal Reserve Beige Book released on December 1, 2004 and January 19, 2005 indicated that many Federal Reserve Districts noted a decline of motor vehicle sales during the quarter though retail sales exhibited mixed strength during the quarter with consumer spending increasing closer to the Christmas holiday.

Real nonresidential fixed investment increased by 10.3% in the fourth quarter as compared to a 13.0% increase in the third quarter due to robust equipment and software investment activity, which increased by 14.9% in the fourth quarter following a 17.5% increase in the third quarter. Following a 5.5% decline in fixed investment in equipment and software in 2002, activity rebounded in 2003 and 2004, increasing by 6.4% and 13.4% annually.

Real residential fixed investment, which increased by 5.0% in the first quarter and by 16.5% in the second quarter, tempered in the third and fourth quarters with lower increases of 1.6% and 0.3%, respectively. On an annual basis, however, real residential fixed investment has shown strong increases in the last several years—4.8% in 2002, 8.8% in 2003, and 9.5% in 2004—likely

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

as a result of accommodative monetary policy orchestrated by the Federal Reserve and favorable long-term mortgage rates.

During the fourth quarter, new privately-owned housing units authorized by building permits increased slightly from the third quarter with a 1.0% increase in October to 2,018,000 at a seasonally adjusted annual rate, a 0.5% increase in November to 2,028,000, and a 0.3% decline in December to 2,021,000[4]. On a year-over-year basis, new privately-owned housing units authorized by building permits increased 0.15% in October, 5.6% in November, and 2.1% in December. Annually, this figure increased by 6.8% in 2004 to 2,018,000 from 1,889,000 in 2003.

Following an increase of roughly 8.4% in October to a seasonally adjusted annual rate of 2,065,000, privately-owned housing starts decreased by 12.5% in November to 1,807,000 before rebounding by 10.9% in December to 2,004,000. These figures are roughly 4.1% higher on a year-over-year basis in October but 12.0% and 3.0% lower on a year-over-year basis in November and December. 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.*

Annually, housing starts increased 5.7% in 2004 to 1,953,400 from 1,847,700 in 2003.

It would be premature to conclude that the decline in activity in November and December is indicative of a trend in the real estate market rather than a statistical aberration, such as that for the months of April, June and September. The Federal Reserve Beige Book from December 1, 2004 and January 19, 2005 indicates that residential real estate activity throughout most of the twelve Districts remained strong throughout the fourth quarter, after initial signs of cooling. The strength in the residential real estate markets in the fourth quarter continues a favorable trend in robust real estate activity

[4] From the October 19, 2004 New Residential Construction in September 2004 joint press release of the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing & Urban Development.

throughout the twelve Districts, as was the conclusion based on data during the second and third quarters.

After trending higher during the second quarter from 5.52% to 6.21% before retrenching to 5.72% in the third quarter, thirty-year conventional mortgages according to Freddie Mac[5] increased slightly during the fourth quarter, ending the year at 5.81%. Fifteen-year mortgages experienced a similar pattern, rising from 4.84% to 5.62% by the end of the second quarter and steadily declining during the third quarter to 5.12% before increasing to 5.23% by the end of the year. The continued low mortgage rates coincide with U.S. Treasury yields on the 10-year note that have remained flat or have declined, despite an increase in short-term rates associated with the Federal Reserve's removal of accommodative monetary policy at a measured pace. The conundrum of low long-term rates relative to increasing short-term rates could also be the result of expectations regarding low long-term inflation. With the Federal Reserve likely to continue its removal of accommodative monetary policy in the coming quarters, long-term Treasury yields and mortgage rates will ultimately increase in conjunction with rising short-term rates at some point. Despite the gradual removal of monetary policy accommodation, the real estate market is likely to remain robust in the coming quarters, as there is likely some latitude for rate increases before any major adverse impact upon the housing market.

Real exports of goods and services decreased at an annual rate of 3.9% during the fourth quarter as compared to a 6.0% increase during the third quarter and a 7.3% increase during the second quarter. The weakness in exports was a negative contributor to the fourth quarter real GDP. On a year-over-year basis, exports increased by 8.1% in 2004, following a modest 1.9% increase in 2003 and a 2.3% decline in 2002. Imports, a subtraction from GDP, increased during the fourth quarter by 9.1% as compared to a third quarter increase of 4.6%. On an annual basis, imports increased by 9.8% in 2004, following increases of 3.4% and 4.4% in 2002 and 2003, respectively.

The dollar continued to weaken during the fourth quarter of 2004, following a trend that began much earlier in the year. At the end of the first, second and third quarters, the dollar/sterling ($/£) exchange rate stood at roughly $1.85, $1.82, and $1.79, respectively. The dollar/euro ($/€) exchange rate was $1.19 at the end of the first quarter, $1.23 at the end of the second quarter, and $1.23 at the end of the third quarter. At the end of the first,

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[5] Data from Freddie Mac Weekly Mortgage Market Survey

second, and third quarters, the yen/dollar (¥/$) exchange rate stood at ¥104, ¥109, and ¥111, respectively[6]. By the end of the fourth quarter the dollar weakened further to roughly $1.92/sterling, $1.35/€, and ¥104.

The precipitous decline in the dollar on foreign currency markets in mid-October originated with data showing the U.S. current account deficit had widened to 5.7% of GDP. In addition, traders continued to be concerned that persistent high oil prices would suppress demand in the U.S. and slow economic growth, prompting foreign investors whose portfolio flows into U.S. assets helped cover the current account deficit to move investments to other currencies and economies offering better returns. Hedge funds, exploiting the dollar's weakness, may also have contributed to the decline in the dollar against the euro. Comments made by Alan Greenspan, Chairman of the Federal Reserve, at a banking conference in Frankfurt, Germany, regarding the "increasingly less tenable" current account deficit also prompted further falls in the dollar towards the end of November. However, in early January, the dollar rebounded slightly to $1.30/€ following comments from John Snow, Treasury Secretary, indicating that the U.S. would make efforts to address the government's fiscal deficit and reiterating the administration's belief that a strong dollar was in the national interest.

The continued weakness of the dollar on foreign exchange markets may have contributed to the favorable increase in exports during 2004, as domestic goods became relatively less expensive to foreign buyers with strengthening currencies. This is likely evidenced in the Institute of Supply Management's monthly index which stood at 58.6 for the month of December, up 0.8 points from the previous month. A reading above 50 is generally indicative of an expansion in manufacturing activity. Export orders rose from 54.7 in November to 60 in December, further evidence that the weak dollar may have fuelled increased manufacturing activity[7].

Following increases of 7.1%, 2.7%, and 4.8% in the first three quarters of 2004, respectively, real federal government consumption expenditures tapered to a rate of increase of 1.6% in the fourth quarter. This slowdown in the rate of federal government consumption expenditures was the result of unchanged defense spending following a 10.1% increase in national defense expenditures in the third quarter. Nondefense spending increased by 5.1% in the fourth quarter. Federal government consumption expenditures increased by 4.7%

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[6] Source: *The Economist*
[7] "Manufacturers in US Benefit from Falling Dollar" by Christopher Swann, *The Financial Times*, January 4, 2005.

annually in 2004, down from increases of 7.5% and 6.6% in 2002 and 2003, respectively. National defense spending increased by 7.4% in 2004, similar to the 7.7% and 9.0% increases in 2002 and 2003, respectively. Nondefense spending declined in 2004 by 0.5% as compared to a 7.1% increase in 2002 and a 2.4% increase in 2003.

Following a $61.1 billion increase in the second quarter and a $34.5 billion increase in the third quarter, private businesses increased inventories by $45.8 billion during the fourth quarter. The increase in private business inventories subtracted 0.42% from GDP for the fourth quarter as compared to subtracting 0.97% in the third quarter and adding 0.78% to the second quarter change in real GDP. This increase in additions to inventories may suggest that buildups during the second quarter were drawn down by increased economic activity and demand expectations during the third quarter and that inventories were increased in anticipation of a strong holiday season during the fourth quarter.

The Federal Reserve

During the fourth quarter, the Federal Reserve continued its measured tightening of monetary policy, which was originally initiated with a twenty-five basis point increase in the federal funds rate at the June 30, 2004 meeting followed by a twenty-five basis point increase at the August 10, 2004 and September 21, 2004 meetings. At its November 10, 2004 meeting, the Federal Open Market Committee (FOMC) increased the federal funds rate by another twenty-five basis points to 2% and maintained its position that economic activity continued to be supported by accommodative monetary policy along with robust underlying productivity growth[8].

At its December 14, 2004 meeting, the FOMC continued its tightening policy with a twenty-five basis point increase in the target for the federal funds rate to 2 ¼%[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. The Committee indicated that:

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[8] The Board of Governors also increased the discount rate by twenty-five basis points to 3% at the November 10, 2004 meeting.
[9] The Board of Governors also increased the discount rate by twenty-five basis points to 3 ¼% at the December 14, 2004 meeting.

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

The Federal Reserve Beige Books[10] released on December 1, 2004 and January 19, 2005 indicated favorable economic growth during the fourth quarter, with most of the twelve Districts[11] experiencing expansion at a faster pace than previous reports. The Beige Book conclusions included the following:

- Though consumer spending was generally tempered during the third quarter, a trend that continued during the first half of the fourth quarter, most of the Districts reported increased retail sales during the latter half of the fourth quarter, particularly around the holidays. Auto sales were generally weak during the fourth quarter with only four of the Districts (Atlanta, Chicago, Cleveland, and Kansas City) noting higher sales. Luxury goods and premium merchandise sold well during the fourth quarter, suggesting higher end customers have largely been unaffected by the increase in energy prices. Inventories appeared in line with sales with no major imbalances throughout the Districts.

- Manufacturing continued to expand at a solid pace across the country. On balance, output rose in manufacturing during the fourth quarter and several reports indicated increased capital investment and hiring. Strength was particularly evident in production of building materials, heavy equipment, electrical machinery, and transportation equipment. Textile and apparel manufacturers and automotive industry suppliers noted continued weakness throughout the fourth quarter. The outlook for manufacturing in 2005, however, was generally positive throughout the twelve Districts with most manufacturers planning on increased capital spending in the coming year despite some concerns regarding the sustainability of the U.S. economic recovery.

- Residential real estate activity remained strong during the fourth quarter after several Districts reported signs of cooling in housing markets early

[10] The press release on September 8, 2004 states the following: This document summarizes comments received from businesses and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.
[11] 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.

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in the quarter. However, these Districts reported improved strength towards the end of 2004 and into early 2005. Home price appreciation was mixed throughout the Districts during the fourth quarter. Commercial real estate activity, weak early in the fourth quarter, showed signs of improvement at the end of the year with many Districts reporting increased leasing activity. Office leasing was particularly strong in Washington, D.C. and New York City, two of the strongest markets for commercial real estate in the country. Vacancy rates, though declining in San Francisco, St. Louis, and Kansas City, generally remained steady in other areas.

- Labor markets were firm at the end of 2004 with several Districts reporting improvements on the job front, including increased hiring. Wage pressure remained contained, though rising benefit costs continued to increase total compensation packages. Manufacturing employment, particularly durable goods manufacturers, anticipated increased hiring in the coming months with other industries having mixed plans regarding hiring.

- Tourism posted strong performance during the fourth quarter, particularly during the holidays. Occupancy rates increased in many Districts, particularly in the south where theme parks were filled to capacity and mild weather attracted visitors to the coastal region.

Consumer Confidence

After improving during the second quarter and retrenching during the third quarter, consumer confidence was mixed during the fourth quarter with the Conference Board's Consumer Confidence Index[12] declining from 96.7 in September to 92.9 in October to 92.6 in November before rebounding sharply to 102.3 in December. The decline in consumer confidence in October and November was likely the result of weak expectations regarding the momentum of economic growth in 2005 rather than lower sentiment regarding present conditions. However, at the end of the year, consumer confidence rebounded strongly as consumers reflected upon the overall improvements during the past year and favorable expectations regarding continued economic expansion in 2005. The Expectations Index followed a similar pattern, decreasing from 97.7

[12] www.conference-board.org The November 2004 press release by the Conference Board states: "The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. The monthly survey is conducted for The Conference Board by TNS NFO. TNS NFO is one of TNS group of companies."

in September to 92.2 in October to 90.2 in November before jumping to 99.9 in December. The decline in expectations may have been the result of continued concerns over labor markets and geopolitical risks as well as the level of growth for 2005.

Consumers' assessment of business conditions over the next six months was mixed during the fourth quarter. For October, 20.7% expected business conditions to improve in the next six months, slightly lower than the September figure of 21.6%. Optimism declined in November with 20.3% expecting business conditions to improve. However, consumers expecting conditions to improve increased to 22.0% for December. Optimism regarding current business conditions improved throughout the fourth quarter with consumers rating conditions "good" at 21.6% in October, 23.2% in November, and 24.4% in December.

Consumer confidence may also have been initially adversely impacted by uncertainties regarding the presidential election. With the re-election of President Bush and the absence of any terrorist attacks or lengthy legal battles delaying the outcome of the election, restrained consumer confidence may have been released. Given the continued economic expansion during the fourth quarter, the rebound in consumer confidence and expectations at the end of the year are likely indicative of improved consumer optimism and expectations for favorable economic performance in 2005.

The Business Sector

Following moderate gains in the third quarter, industrial production continued on an increasing trend during the fourth quarter as a result of continued economic strength. Industrial production figures as compiled by the Federal Reserve[13] posted strong gains in the fourth quarter, rising from 115.7 in September to 117.8 in December, representing a 4.1% annual increase for the fourth quarter as compared to increases of 5.6%, 4.3%, and 2.7% in the first, second, and third quarters, respectively. For the fourth quarter, industrial production increased 4.2% from the fourth quarter of 2003. On a year-over-year basis, industrial production increased by 4.4% in 2004 as compared to 2003.

Manufacturing production also showed gains in the fourth quarter, increasing at an annual rate of 4.1% as compared to a 4.0% increase in the

[13] Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release from January 14, 2005.

third quarter. Manufacturing production increased by 5.6% and 6.0% in the first and second quarters at an annual rate. On a year-over-year basis, manufacturing production increased 5.1% in 2004. This strength in manufacturing is further evidenced by information from the twelve Districts of the Federal Reserve System, many of which reported solid manufacturing expansion during the year and especially the fourth quarter. Defense and space equipment production increased by 8.1% in the fourth quarter, following a 9.1% increase in the third, and was 9.0% higher on a year-over-year basis. Business equipment production increased by 5.9% in the fourth quarter as compared to 12.0% in the third quarter and 9.8% for 2004 as compared to 2003. Durable goods manufacturing production increased by 6.6% in the fourth quarter, following increases of 8.1%, 6.0%, and 5.9% in the first, second, and third quarters. On a year-over-year basis, durable goods manufacturing production increased by 6.7%. This increase in durable goods production during the year helped fuel the strong economic performance in 2004. These figures further support data presented in the BEA's GDP release and the Beige Books indicating continued strengthening of economic activity.

Capacity utilization increased in the fourth quarter, ending December at 79.2% up from 78.0% in September. For the year, capacity utilization was 2.4% higher in 2004 as compared to 2003 but remained 1.9% lower than the historical average from 1972 to 2003. Manufacturing capacity utilization, which stood at 76.0% in June and 76.8% in September, also improved in the fourth quarter to 77.8%, an increase of 2.8% on a year-over-year basis.

Continued weakness of the dollar on foreign exchange markets spurred higher exports of U.S. goods and services during 2004. Continued weakness of the dollar in 2005 could help further advance industrial production and capacity utilization in the coming quarters. However, a strengthening of the dollar in 2005 could have an adverse impact upon the manufacturers as demand from overseas consumers would fall.

The advance monthly sales for retail trade and food services in the fourth quarter released by the Department of Commerce[14] continue to suggest strength with respect to increased economic activity. In December, retail and food service sales increased by approximately 1.2%[15] to $349.4 billion from November and by 1.3% from October's level of $345.0 billion. The December 2004 level was an increase of 8.7% over the 2003 level. For the fourth quarter, retail and food service sales increased by 2.5% from the third quarter and by

[14] Press release from the Department of Commerce on January 13, 2005.
[15] Adjusted for seasonal, holiday, and trading day differences but not for price changes.

8.2% on a year-over-year basis. For 2004, retail and food service sales increased by 8.0% on a year-over-year basis. Total sales excluding motor vehicles and parts increased 2.2% in the fourth quarter as compared to the third and by 8.9% on a year-over-year basis for the full year 2004. Retail sales increased 2.5% in the fourth quarter over the prior quarter and increased 8.3% on a year-over-year basis. For the year, retail sales increased by 7.8% over the 2003 level.

The aforementioned data confirm the continued strengthening of the business sector throughout 2004. With demand for exports strong, fueled by a weak dollar in foreign exchange markets, industrial production and manufacturing have benefited significantly from the increase in demand. As this demand for goods continues to increase, businesses will most likely be inclined to increase employment in order to prevent any imbalance between supplies and strengthening demand. The Beige Book indicates that many businesses throughout the Federal Reserve's twelve Districts noted increased hiring during the latter part of the year and increased expectations for hiring for 2005. Overall, these factors suggest that the favorable economic and business conditions that were evident throughout 2004 are likely to continue into 2005, supporting solid economic activity for the coming quarters.

Inflation

Following a 4.8%, 5.1%, and 0.6% increase in the consumer price index (CPI) [16] during the first three quarters of 2004 at a seasonally adjusted annual rate, the CPI increased by 3.0% in the fourth quarter. For the year, the CPI increased by 3.3%, higher than the 2.4% and 1.9% increases for 2002 and 2003, respectively. Following a 0.2% increase in September, the CPI increased by 0.6% and 0.2% in October and November, respectively, on a seasonally adjusted basis and declined 0.1% in December. The increase in October was attributed to a 4.2% increase in the energy index for the month. The energy index then increased by 0.2% in November before declining by 1.8% in December. For the quarter, the energy index increased by 10.4% on a seasonally adjusted annual basis. For the year, the energy index increased by 16.6%, as compared to a 10.7% and 6.9% increase in 2002 and 2003, respectively, and accounted for roughly 36% of the total increase in the CPI for the year. Food prices during the fourth quarter increased, with the food index advancing at an annual rate of 3.0% as compared to a 1.3% increase in the

[16] Based on data from the Consumer Price Index: December 2004 press release on January 19, 2005 by the Bureau of Labor Statistics, United States Department of Labor.

third quarter. The food index rose at a 2.7% annual rate for the year, lower than the 3.6% increase in 2003 and nearly twice the 1.5% rate in 2002.

Removing the effects of food and energy, the core CPI increased by 2.0% in the fourth quarter, as compared to a 1.8% increase in the third quarter at a seasonally adjusted annual rate. This is slightly lower than the 2.9% increase in the first quarter and the 2.3% increase in the second quarter. For the year, the core CPI advanced by 2.2%, which is noticeably higher than the 1.1% increase for the full year 2003 and slightly higher than the 1.9% increase for 2002. The Federal Reserve, however, remains confident that underlying inflation is likely to remain low, but the FOMC has stated that accommodative monetary policy can be removed at a rate deemed appropriate in order to maintain price stability.

In addition to the CPI, the price index for gross domestic purchases from the BEA[17] rose by 2.7% in the fourth quarter, compared with a 1.9% increase in the third quarter. This is still lower than the 3.5% rate in the second quarter and the 3.4% increase in the first quarter. For 2004, the price index rose by 2.4% as compared to a 2.0% increase in 2003. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 1.9% in the fourth quarter, following a 1.7% increase in the third quarter and a 2.5% increase in the second quarter. On a year-over-year basis, the price index excluding food and energy increased 1.9% in 2004 as compared to a 1.8% and 1.6% increase in 2002 and 2003, respectively. These figures, closely watched by the Federal Reserve, are likely indicative that inflation has stabilized and further support the FOMC's decision to begin removing monetary policy accommodation at a measured pace.

The noticeable increase in inflation for 2004 may be the result of the substantial increases in energy prices having impacted a broader range of products, given the jump in core inflation on a year-over-year basis. In addition, the rise in core inflation may also be attributed partially to the Federal Reserve's accommodative monetary policy over the last several years that injected massive additional money supply into the economy. However, the slack still available in labor markets and continued excess capacity in manufacturing seem to indicate that economic activity should be able to expand substantially without triggering a substantial rise in inflationary pressures. To be sure, the Federal Reserve has indicated that more aggressive

[17] Bureau of Economic Analysis, Gross Domestic Product: Fourth Quarter 2004 (Advance) release, January 28, 2005.

monetary policy tightening could be implemented in the event of an unwanted, rapid rise in inflation.

Labor Market

After averaging 5.6% and 5.5% in the second and third quarters, respectively, the unemployment rate trended lower in the fourth quarter to an average 5.4%[18]. Total nonfarm payroll employment increased by 157,000 in December to a seasonally adjusted 132.3 million, following a 137,000 increase in November and a 312,000 increase in October. As a result of these gains, total nonfarm payroll employment increased by 601,000 during the fourth quarter as compared to the third quarter. For the year, total nonfarm payroll employment increased by 2.2 million.

Payroll gains in December included increases in health care and social assistance, professional and business services, wholesale trade, and financial activities. Health care added 36,000 jobs in December, bringing the yearly total to 342,000. Professional and business services added 41,000 in December for a yearly total of 546,000. Wholesale trade gained 97,000 jobs in 2004, 17,000 of which came in December. Financial activities employment, spurred by the strength of the real estate market and its job growth (42,000 additions to employment in 2004), rose by 14,000 in December and by a total of 140,000 in 2004.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment was mixed during the fourth quarter. Consumers expecting more jobs to become available in the next six months fell to 16.5% in October from 17.8% in September and was virtually unchanged in November and December. In December, however, the number of consumers expecting fewer jobs to become available declined to 15.5% from 19.3% the prior month. The continued improvements in economic activity coupled with improved consumer confidence, business conditions and industrial production should provide a solid foundation for continued increases in payroll employment for the coming quarters.

Equity Markets

Following the third quarter declines in the major indices, the equity markets posted strong gains for the fourth quarter, possibly in response to

[18] Bureau of Labor Statistics, United States Department of Labor, The Employment Situation: December 2004, January 7, 2005.

continued economic strength and the easing of tensions and uncertainty surrounding the presidential election. After ending the third quarter at roughly 10,136, the Dow Jones Industrial Average (DJIA) rose 7.1% in the fourth quarter[19]. As a result of the strength in the fourth quarter, the DJIA increased a modest 3.9% for the year. The S&P 500, after a 2.3% decline during the third quarter, rose 8.9% during the fourth quarter to roughly 1,200. For the year, the S&P 500 increased by 9.4% as compared to a nearly 29% increase in 2003. The NASDAQ composite experienced the largest gain during the fourth quarter of roughly 15% to end the year at approximately 2,200. This follows a 7.5% decline in the NASDAQ composite in the third quarter. As a result of the strong performance during the fourth quarter, year-to-date the NASDAQ increased roughly 8.5%.

The market's strong performance during the fourth quarter may be attributed to the removal of uncertainties surrounding the presidential election as well as favorable financial performance of public companies stemming from further increases in economic activity. Operating earnings for the S&P 500 for the fourth quarter increased 22.2% over the same period a year ago[20]. The increase in operating earnings is the eleventh consecutive quarter of double-digit growth on a year-over-year basis. This increase in operating earnings is in line with the average quarterly increase over the last two and a half years during which time companies have benefited from higher productivity gains, and cutbacks in corporate and capital expenditures. However, S&P indicates that recent increases in capital expenditures, labor market gains, and increased merger and acquisition activity will likely temper the level of operating earnings gains in 2005. S&P is forecasting that operating earnings in 2005 will increase by 9.7%, a level that still reflects strong economic activity.

Consumer confidence and expectations ended 2004 on a high note, which may help perpetuate further gains in the equity markets in 2005. In the absence of any external shocks such as a dramatic rise in energy prices or terrorist attacks, the equity markets appear poised for favorable performance in 2005 in response to continued strength in the U.S. economy.

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[19] Based on data from *The Economist.*
[20] "S&P 500 Registers 11th Straight Quarter of Double Digit Operating Earnings," S&P Press Release, February 8, 2005.

Oil Prices

For the first quarter, West Texas Intermediate (WTI) oil prices steadily increased to approximately $36.20 due to concerns over geopolitical issues and supply shortages resulting from OPEC's decision to reduce oil output by 1 million barrels per day effective April 1, 2004 in anticipation of a projected supply surplus for the seasonally weak second quarter[21].

With oil prices continuing to rise to over $42 per barrel by the end of May, OPEC ministers at the June 3, 2004 meeting in Beirut, Lebanon, agreed a 2 million barrel per day increase in production effective July 1, 2004 to 25.5 million barrels per day with an additional 500,000 barrel per day increase effective on August 1, 2004[22]. OPEC ministers noted the following with respect to energy markets:

> *…[T]he Conference noted with concern that, as a result of several factors, prices have continued to escalate, despite the efforts by OPEC Member Countries to meet market requirements. These factors are mainly the robust growth in demand in the USA and China, which had not been fully anticipated; geopolitical tensions; and refining and distribution industry bottlenecks in some major consuming regions, coupled with more stringent product specifications. Combined, these factors have led to unwarranted fear of a possible future supply shortage of crude oil, which has, in turn, resulted in increased speculation in the futures markets with substantial upward pressure on crude oil prices.*

Following the decision by OPEC to increase production effective July 1, 2004, WTI oil prices retrenched somewhat in June, falling to roughly $35 per barrel by the end of the month as OPEC prepared for production increases and U.S. commercial crude inventories increased, suggesting adequate supply to meet current and anticipated demand.

Despite the production increase beginning July 1, 2004, WTI oil prices steadily climbed during the month over concerns of supply disruptions stemming from the Russian government's dispute with Yukos over delinquent tax bills. In response to fears of halts in Russian oil production resulting from seizure of assets or a Yukos bankruptcy, crude oil futures surged above $43

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[21] OPEC press release following the 129th (Extraordinary) Meeting of the OPEC Conference in Algiers, Algeria on February 10, 2004.
[22] OPEC press release following the 131st (Extraordinary) Meeting of the OPEC Conference in Beirut, Lebanon on June 3, 2004.

per barrel on the New York Mercantile Exchange, a twenty-one year high. At that level and with U.S. imports of crude estimated at 11.3 million barrels per day, analysts estimated the cost of importation at over $500 million daily[23]. As oil prices continued to surge into early August, OPEC issued a statement aimed at soothing concerns over supply shortages and indicating that OPEC still maintained spare production capacity of 1-1.5 million barrels per day—more than enough to allow for any further or immediate increases in production. In addition, the statement indicated that OPEC members plan to add roughly one million barrels per day of additional production by the end of 2004 and into 2005 with additional capacity available within eighteen months. The statement also included the following remarks[24]:

> *The Organization of the Petroleum Exporting Countries has been monitoring with concern the continued rise in crude oil prices on the global markets. OPEC continues in its efforts to ensure that the market is adequately supplied with crude oil at prices acceptable to both producers and consumers…The Organization, once again, wishes to reiterate its commitment to maintaining market stability and ensuring a timely response to the supply needs of the market.*

As oil prices continued to rise during August, briefly moving above $47 per barrel, the U.S. Energy Information Administration increased its central price forecast for oil to $41 for the third quarter, with prices remaining close to $40 through the winter and well into 2005[25]. The reasoning in the report included the Russian government's conflict with Yukos and the Iraqi war both creating the perception that supplies of crude were vulnerable to disruption. In addition, the report warned the following:

> *Currently, world oil surplus capacity is near its lowest point of the past three decades, providing little cushion in the event of unexpected oil market disruptions. Price spikes are still quite possible.*

With concerns that rising oil prices would derail the global economic recovery, OPEC agreed at its September 15, 2004 meeting in Vienna, Austria to

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[23] Based on data from "Oil Prices Hit Highs as Supply Fears Grow," *The Financial Times*, July 29, 2004.
[24] Statement by HE Dr. Purnomo Yusgiantoro, Minister of Energy & Mineral Resources of Indonesia and President of the OPEC Conference, Press Release, Vienna, Austria, August 4, 2004.
[25] From "US Raises its Central Oil Price Forecast to $41," *The Financial Times*, August 11, 2004.

a one million barrel per day increase in its production ceiling to twenty-seven million barrels per day effective November 1, 2004 in order to prompt a decline in prices to a more sustainable level. OPEC ministers noted the following with respect to the continued rise in energy prices since its last meeting:

> *We see a combination of factors as being responsible for the high prices and accompanying volatility. There have been: higher-than-expected oil demand growth, especially in China and the USA; geopolitical tensions; and refining and distribution industry bottlenecks in some major consuming regions, coupled with more stringent product specifications. Combined, these factors have led to unwarranted fears about a possible future supply shortage of crude oil, which, in turn, have resulted in increased speculation in the futures markets, with substantial upward pressure on prices. We believe that this may all be adding about $10-$15/b to the price of a barrel of crude.*
>
> *OPEC has no control over factors like speculation, geopolitical tensions and domestic decisions made by foreign governments. Nevertheless, we are doing everything we can to restore order and stability to the market, with reasonable prices that are acceptable to producers and consumer alike, as well as being compatible with steady growth in the world and domestic economies.*

By the end of the quarter, oil prices had broken through the $50 per barrel level, as reports indicated production from the Gulf of Mexico was returning at a slower than anticipated pace in the wake of Hurricane Ivan, which impacted the Gulf coast earlier in the month. Reports indicated that roughly thirty percent of the Gulf's production (roughly 1.7 million barrels per day) remained out of service through the first week of October[26]. At the same time, Gregory Mankiw, chairman of the White House Council of Economic Advisers, indicated that the recent dramatic rise in energy prices posed no threat to the recovery of the U.S. economy[27]:

> *Recent increases in oil prices are a drag on the economy as well as a strain on family budgets, but recent price increases do not appear to pose a significant threat to the recovery.*

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[26] "Gulf of Mexico Problems Send Oil to New Highs," *The Financial Times*, October 6, 2004.
[27] "Surge in Price of Oil 'Poses Little Threat to US Economy,'" *The Financial Times*, October 6, 2004.

Oil prices continued to climb in early October to nearly $53/barrel on concerns of disruption to global oil supplies as a result of a four day general strike by oil workers in Nigeria and by Hugo Chavez's decision to increase royalty taxes on large scale energy projects by foreign oil companies. The increase in energy prices comes despite the International Energy Agency's conclusion that growth in oil demand in 2005 would abate and OPEC would increase supply. The IEA estimated that daily global demand for oil was 82.4 million barrels in 2004, 2.5 million barrels higher than its original estimate from earlier in the year due to higher than expected demand from Asia and Russia. For 2005, the IEA reduced its estimates by 70,000 to 83.9 million barrels per day based on expectations of lower economic growth due to the higher energy prices throughout 2004[28].

Following a high of over $55/barrel at the end of October, WTI prices retrenched during November to roughly $49/barrel by the end of the month, likely as a result of OPEC's supply increase beginning on November 1, 2004. As a result of the fall in prices towards market fundamentals due to its earlier production increases and as stocks converged to a normal level ahead of the winter season, OPEC at its December 10, 2004 meeting in Cairo Egypt decided to reduce over-production by one million barrels per day from the actual output effective January 1, 2005[29]. In its press release announcing its decision, OPEC stated the following:

> *With stocks back to normal and prices having moderated ahead of the winter season, when inventories are normally withdrawn, the Conference decided to maintain the currently agreed ceiling and individual production levels. Without prejudice to the above, and while reiterating the Organization's commitment to ensuring adequate supplies of petroleum to consuming nations, and in order to prevent crude oil prices continuing to deteriorate to undesirably low levels, Member Countries, which have responded to the market need for additional supply over the course of this year by producing above their allocations, have agreed to collectively reduce the over-production by 1.0 mb/d from their current actual output, effective 1 January 2005.*

Despite this, WTI prices continued to decrease throughout December, ending the year at under $45/barrel. The muted response to OPEC's cut in production may have been attributed to the fact that the reduction of one

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[28] From "Growth in Oil Demand to Ease Next Year," *The Financial Times*, October 13, 2004.
[29] OPEC press release following the 133rd (Extraordinary) Meeting of the OPEC Conference in Cairo, Egypt on December 10, 2004.

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million barrels per day came from the cartel's over-production rather than a reduction in production quotas or its ceiling.

Despite the decline in prices in December and continued strong economic growth, many economists remain concerned that the rise in oil prices will have a significant adverse impact upon economic activity in the coming quarters of 2005. Continued demand growth from China, tensions in the Middle East, and the fear of terrorist attacks aimed at disrupting oil supplies are likely to result in oil prices higher than OPEC's preferred price band. In fact, it is likely that OPEC will increase its preferred price band to reflect current market fundamentals. In addition, any exogenous shocks in the oil markets resulting in short-term price spikes could have a significant adverse impact upon global economic growth and U.S. economic activity. However, it is likely that many businesses will accept higher energy prices rather than have that factor suppress activity and expansion plans. Therefore, the risks to economic activity stemming from higher energy prices appear to be balanced at the present time.

Economic Outlook 2004

The Conference Board's Leading Economic Indicators, after decreasing in July, August, and September by 0.3%, 0.3%, and 0.2%, respectively, continued to decline in October by 0.3% before increasing 0.3% in November and 0.2% in December. As a result, the leading index stood at 115.4 at the end of the year[30]. During the second half of 2004, the leading index decreased 0.9%. The increase in the LEI in November and December follows five consecutive decreases of the index. However, six of the ten components increased during the second half of the year. In the January 20, 2005 LEI press release, the following conclusion is presented:

> *[T]he weakness in the leading indicators has become somewhat less widespread. It is now more likely that the five-month decline in the leading index was only a pause in the rising trend that has been underway since March 2003.*
>
> *The growth rate of the leading index slowed below its long-term trend (a 1.5% annual rate) in the second half of 2004, but not to a rate that has historically been associated with a recession. The behavior of the leading*

[30] From The Conference Board's November 18, 2004, December 20, 2004 & January 20, 2005 press releases for US Leading Economic Indicators.

index since the middle of 2004 is consistent with the economy continuing to expand in the near term, but more slowly than its long-term trend rate.

With respect to economic growth projections, the Federal Reserve Board of Governors and Federal Reserve Bank Presidents in the *Semi-Annual Monetary Policy Report to the Congress* project that real GDP will increase by 4%-4 ¾% in 2004 and 3 ½%-4% in 2005[31]. The personal consumption expenditures price index excluding food and energy is expected to range from 1 ½%-2% in 2004 and 1 ½%-2 ½% in 2005. The civilian unemployment rate is anticipated to range from 5 ¼%-5 ½% in 2004 and 5%-5 ½% in 2005.

Economic conditions appear conducive to favorable growth into 2005 as a result of continued strength in consumer spending, further gains in the job market, and improvements in corporate profits. These factors should contribute to generally stable economic conditions that support solid economic growth. Our expectations for the economy include:

- Real GDP growth of 4 ¼% - 4 ¾% for 2005.

- The Federal Reserve is likely to continue to remove its monetary policy accommodation, though the pace at which this is done may vary during the year. The federal funds rate should end 2005 at roughly 4%.

- Inflation should remain stable in 2005 with the core CPI increasing by roughly 1 ¾% - 2 ¼%.

- As the economy continues to strengthen into 2005, payroll employments are likely to increase. 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.

- Given the pace of economic activity, business spending will most likely accelerate in 2005 as production increases in order to balance aggregate supply and demand for goods and services from both domestic and foreign consumers.

- Oil prices are likely to remain above OPEC's preferred price band of $22 to $28 per barrel. Continued geopolitical concerns regarding Iran and

[31] Changes are from average for fourth quarter of previous year to average for fourth quarter of year indicated.

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North Korea may exert further upward pressure on prices. Any major production cuts by OPEC are unlikely. Given a market that is gradually becoming aligned with its fundamental, oil prices are likely to fall to an average of $45 per barrel for 2005 following slight increases during the first part of the year.

- Continued weakness of the dollar in foreign exchange markets should be favorable for further strong growth of exports. This would, ultimately, have a positive impact upon manufacturing, employment, and the economy at large.

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

- Continued geopolitical risks and tensions regarding instability and security in the Middle East may create uncertainty that could suppress demand in the global economy and help fuel a premium in oil prices. Uncertainty over North Korea and Iran's nuclear programs could also have an adverse impact upon economic activity and oil prices.

- Further increases in interest rates by the FOMC may temper any gains in the equity markets and may temper the robust activity in the real estate markets.

Conclusion

Though real GDP growth increased at a decreasing rate in the fourth quarter, the economic expansion posted solid results for the full year with real GDP increasing 4.4% for 2004. Personal consumption expenditures were one of the underlying sources of strength throughout the year, contributing significantly to the solid economic activity despite rising energy prices. Data presented in the Federal Reserve Beige Book indicated continued robust activity in the real estate markets, despite the increases in short-term rates as the Federal Reserve began to remove its accommodative monetary policy. Surprising, however, interest rates showed minimal increases at the long-end of the yield curve. With oil prices anticipated to remain at elevated levels, consumers and businesses appear to have adapted to the sustained rise in energy costs. Based on the state of the economy in the fourth quarter, conditions appear favorable for continued stable economic activity in 2005.