STATE OF THE ECONOMY
2nd Quarter 2004

Introduction

Economic activity continued to expand in the second quarter of 2004, though at a more moderate pace than the previous quarters due to steadily increasing energy prices. United States real gross domestic product (GDP) grew at an annual rate of 3% in the second quarter following a 4.5% increase in the first quarter and increases of 8.2% and 4.1% in the third and fourth quarters of 2003, respectively. Continued strength in the broader economy including a still robust housing market, continued low (but increasing) interest rates, price stability, and strong gains in the labor markets enabled the economy to continue to expand during the second quarter albeit at a more moderate pace. The continued improvements in the United States economy over the last several quarters indicate favorable prospects for the remainder of the year, though growth prospects may be tempered by concerns over continued high energy prices, increasing interest rates, the presidential elections, and geopolitical issues.

Gross Domestic Product

According to advance estimates[1] released by the Bureau of Economic Analysis (BEA), real GDP increased at an annual rate of 3% in the second quarter of 2004. This is slightly lower than the median forecast of 4.5% annual growth in real GDP anticipated by thirty-two forecasters surveyed by the Federal Reserve Bank of Philadelphia[2]. The second quarter growth in GDP was also lower than the revised rate of 4.5% for the first quarter of 2004[3]. Lower growth in the second quarter was a result of a deceleration in personal consumption expenditures and private inventory investment. Personal consumption expenditures were one of the primary drivers of the strong first

[1] The BEA press release on July 30, 2004 states the following with respect to advance estimates: The Bureau emphasized that the second-quarter "advance" estimates are based on source data that are incomplete or subject to further revision by the source agency. The second quarter "preliminary" estimates, based on more comprehensive data, will be released on August 27, 2004.
[2] *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, May 24, 2004.
[3] Quarterly data is expressed at a seasonally adjusted annual rate. Real estimates are in chained (2000) dollars.

quarter growth in GDP. Private inventory investment continued its trend of increasing at a decreasing rate in the second quarter.

Real personal consumption expenditures increased by 1.0% in the second quarter at a seasonally adjusted annual rate, significantly less than the 4.1% increase in the first quarter. Purchases of durable goods decreased 2.5% in the second quarter, primarily as a result of a roughly 2% decline in motor vehicle expenditures during the second quarter. This decline is likely the result of lower purchases due to higher energy prices. Personal consumption expenditures on furniture and household equipment increased by roughly 1.3% in the second quarter, following a 2.7% increase in the first quarter. Data from the Federal Reserve Beige Book released on July 28, 2004 indicated that several Federal Reserve Districts experienced favorable sales of home furnishings and home improvement items late in the second quarter. Personal consumption expenditures of nondurable goods decreased by 0.1% in the second quarter, as compared to a 6.7% increase in the first quarter, due largely to a roughly 1.5% decline in clothing expenditures.

Real residential fixed investment, which increased by 5.0% in the first quarter, increased at a substantially higher rate of 15.4% in the second quarter. Following increases in April and May to 2,006,000 and 2,097,000, respectively, from 1,975,000 in March, building permits for privately-owned housing units decreased 8.2% in June to 1,924,000 at a seasonally adjusted annual rate[4]. The June 2004 building permits of 1,924,000 represents a roughly 2.8% increase over the June 2003 figure of 1,871,000. Building permits in April and May of 2004 increased by roughly 14% and 12%, respectively, on a year-over-year basis.

Privately-owned housing starts decreased 8.5% in June to a seasonally adjusted annual rate of 1,802,000 as compared to 1,963,000 in April and 1,970,000 in May. On a year-over-year basis, housing starts in June decreased by roughly 2.6% from the June 2003 rate of 1,850,000. This softness in housing starts follows year-over-year increases of 20% in April and 13% in May[5]. However, as the U.S. Department of Commerce/U.S. Census

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[4] From the July 20, 2004 New Residential Construction in June 2004 joint press release of the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing & Urban Development.
[5] From the June 16, 2004 New Residential Construction in May 2004 joint press release of the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing & Urban Development.

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.*

Therefore, it would be premature to conclude that the decline in activity in June is indicative of a trend in the real estate market rather than a statistical aberration. The Federal Reserve Beige Books from June 16, 2004 and July 28, 2004 indicate that residential real estate activity throughout the twelve Districts remained robust during the second quarter with home sales generally rising.

The robust activity in the real estate markets over the last year has been aided largely by the accommodative monetary policy by the Federal Reserve. Expectations regarding the Federal Reserve's future actions with respect to increasing interest rates at a measured pace may ultimately serve to temper the level of activity in the real estate markets. Mortgage rates, however, remained favorable for consumers seeking homeownership during the second quarter. Thirty-year conventional mortgages according to Freddie Mac[6] trended higher during the second quarter from 5.52% as of April 1, 2004 to a high in the second quarter of 6.34% at May 13, 2004 before falling slightly to 6.21% at July 1, 2004. Fifteen year mortgages experienced a similar pattern of rising from 4.84% as of April 1, 2004 to 5.72% at May 13, 2004 before falling to 5.62% by the end of the quarter. Though the uptick in interest rates from the mid-March lows may be indicative of expectations of higher future interest rates, there is likely some latitude for rate increases before any major adverse impact upon the housing market. It would be expected that a trend in higher interest rates would dampen the strength of the real estate market, which could tend to suppress economic growth slightly. As Alan Greenspan, Chairman of the Federal Reserve, stated on May 6, 2004[7]:

> *In a related concern, a number of analysts have conjectured that the extended period of low interest rates is spawning a bubble in housing*

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[6] Data from Freddie Mac Weekly Mortgage Market Survey
[7] Remarks by Chairman Alan Greenspan, *Globalization and Innovation*, at the Conference on Bank Structure and Competition, sponsored by the Federal Reserve Bank of Chicago, Chicago, Illinois (via satellite), May 6, 2004.

prices in the United States that will, at some point, implode....A softening in housing markets would likely be one of many adjustments that would occur in the wake of an increase in interest rates. But a destabilizing contraction in nationwide house prices does not seem the most probable outcome. Indeed, nominal house prices in the aggregate have rarely fallen and certainly not by very much.

Exports of goods and services increased at a 13.2% rate during the second quarter, higher than the 7.3% increase in the prior quarter. Continued weakness of the dollar during the second quarter of the year may have contributed to the increase in exports. At the end of the first quarter, the dollar/sterling ($/£) exchange rate stood at roughly $1.85 with a dollar/euro ($/€) and yen/dollar (¥/$) exchange rate of $1.23 and ¥104, respectively[8]. The dollar strengthened slightly to roughly $1.79/sterling in April before falling back to $1.82 by the end of the quarter. The dollar's performance against the euro was similar with the dollar strengthening to $1.19/€ before ending the quarter at $1.22/€. The yen also weakened during the second quarter before strengthening again towards the latter half of the quarter. The ¥/$ exchange rate stood at roughly ¥104 at the end of the fourth quarter. The exchange rate fell to ¥113 in early May before strengthening once again to ¥109 by the end of the quarter.

Continued weakness of the dollar would be expected to have a favorable impact upon exports as U.S. goods become relatively cheaper to foreigners. This could result in improvements in the U.S. domestic manufacturing sector, as manufacturers increase production to satisfy the increased demand for exported goods.

Federal government consumption expenditures increased at a decreasing rate of 2.7% in the second quarter compared to the 7.1% increase in the first quarter. This slower rate of federal government consumption expenditures was the result of a decline in national defense expenditures from 10.6% in the first quarter to 1.9% increase in the second quarter. Nondefense spending increased by 4.3% in the second quarter, higher than the 0.2% increase in the first quarter.

Private businesses increased inventories by $47.5 billion during the second quarter of 2004, following an increase of $40 billion in the first quarter. The increase in private business inventories added 0.28% to the increase in

[8] Source: *The Economist*

GDP for the second quarter as compared to adding 1.17% to the first quarter change in real GDP. This buildup of inventories suggests increased activity within the business sector, as companies attempt to increase production to meet expected increases in demand. This trend may be confirmed by the 8.9% increase in real nonresidential fixed investment in the second quarter, higher than the first quarter increase of 4.2%. This further suggests that the business environment continues to be favorable as the pace of economic expansion stabilizes.

The Federal Reserve

The Federal Reserve continued its generally accommodative monetary policy during the second quarter of 2004, though it began a measured tightening at the June 30, 2004 meeting with an increase of twenty-five basis points in the federal funds rate to 1 ¼%. At its May 4, 2004 meeting, the Federal Open Market Committee (FOMC) maintained its position that economic activity continued to be supported by accommodative monetary policy along with robust underlying productivity growth. In the press release following the meeting, the FOMC indicated that output was expanding at a solid pace, with long-term expectations of increases in inflation largely contained, and that there were signs of further improvements in the labor markets. The FOMC also maintained its position that the risks to price stability had moved into balance.

Following previous statements that it could be patient in removing policy accommodation, the FOMC shifted its stance towards tightening with the following statement:

> *At this juncture, with inflation low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured.*

At its June 30, 2004 meeting, the FOMC began removing its policy accommodation by raising the target for the federal funds rate by twenty-five basis points to 1 ¼%[9]. Despite the increase in the federal funds rate, the FOMC maintained its belief that monetary policy was accommodative and provided ongoing support to economic activity. Further, the Committee believed that the risks to sustainable growth and price stability were equal for the coming quarters. With inflation data prior to the meeting slightly elevated, the Committee indicated that:

[9] The Board of Governors also increased the discount rate by twenty-five basis points to 2 ¼% at the June 30, 2004 meeting.

With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

In semi-annual testimony before the Congress on July 20, 2004[10], Chairman Alan Greenspan noted that economic developments had been favorable for the first half of 2004, supporting the belief that the expansion is self-sustaining. With the pace of economic activity having increased and become more broad-based, employment experienced gains during the first half of the year with private nonfarm payrolls increasing by an average 200,000 per month. However, as economic activity increased, signs of inflationary pressures became evident though this is likely attributed to transitory factors such as rising energy prices. Noticeably higher energy prices served to dampen consumer spending during the period, though this is anticipated to be short-lived.

Chairman Greenspan also indicated continued favorable prospects for further economic expansion in 2004:

The improvement in labor market conditions will doubtless have important follow-on effects for household spending. Expanding employment should provide a lift to personal disposable income, adding to the support stemming from cuts in personal income taxes over the past year. In addition, the low interest rates of recent years have allowed many households to lower the burdens of their financial obligations. Although mortgage rates are up from recent lows, they remain quite attractive from a longer-run perspective and are providing solid support to home sales. Despite the softness of recent retail sales, the combination of higher current and anticipated future income, strengthened balance sheets, and still-low interest rates bodes well for consumer spending.

Confident that the FOMC's accommodative monetary policy had contributed to the growth of aggregate demand that appeared to be sustainable along with gains in employment, Chairman Greenspan indicated that such accommodative policy had become increasingly unnecessary. This led to the

[10] Testimony of Chairman Alan Greenspan, Federal Reserve Board's semiannual Monetary Policy Report to the Congress, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 20, 2004

FOMC's decision on June 30, 2004 to raise interest rates by twenty-five basis points as part of a measured removal of policy accommodation. In explaining this decision, Chairman Greenspan stated:

> *The FOMC judged this extended period of exceptionally low interest rates to have been helpful in assisting the economy recovering from a string of adverse shocks. … In short, financial markets along with households and businesses seem to be reasonably well prepared to cope with a transition to a more neutral stance of monetary policy. Some risks necessarily attend this transition, but they are outweighed in our judgment by those that would be associated with maintaining the existing degree of monetary policy accommodation in the current environment.*

In the Monetary Policy Report to the Congress, the Federal Reserve policymakers indicated that the economic expansion that had begun to manifest itself during 2003 became increasingly well established during the first half of 2004. Indeed, the Report states the following with respect to the outlook for the U.S. economy:

> *Although some of the recent data have been on the soft side, the available information on the outlook for the U.S. economy is, on balance, positive. Households are enjoying a generally improving job market, rising real incomes, and greater wealth, all of which are providing them with the confidence and wherewithal to spend. In the business sector, capital spending apparently is continuing to increase briskly, bolstered by expectations of strong sales as well as by booming profits and supportive financial conditions; investment should also continue to be buoyed by firms' adoption of productivity-enhancing technologies. Moreover, inventories appear to be lean relative to sales even after taking account of the substantial improvements firms have made in managing their stocks, suggesting that stockbuilding may provide some impetus to production in the near term. The brightening outlook for economic activity abroad suggests that demand for U.S. exports should grow and provide a further lift to domestic production.*

The Federal Reserve Board of Governors and Federal Reserve Bank Presidents project that real GDP will increase by 4%-4 ¾% in 2004 and 3 ½%-4% in 2005[11]. 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%

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

in 2005. The civilian unemployment rate is anticipated to range from 5 ¼%-5 ½% in 2004 and 5%-5 ½% in 2005.

The Federal Reserve Beige Book[12] released on June 16, 2004 and July 28, 2004 indicated that economic activity continued to expand during the second quarter, though the pace of growth across the twelve Districts[13] began to moderate late in the quarter. The Beige Book conclusions included the following:

- Consumer spending was generally favorable during April and May, propelled by strength in retail sales and modest increases in auto sales, but moderated in June due to softness in retail sales and weakness in auto sales.
- Manufacturing activity continued to increase in all of the Districts during the second quarter, continuing the trend in increased production that began earlier in the year. This improvement in manufacturing was broad-based with a number of various industries experiencing strong gains in production. Several Districts reported scattered shortages and longer lead times late in the second quarter, indicating favorable prospects for continued strength in manufacturing in the third quarter. The continued weakness of the dollar as compared to foreign currencies may be one of the drivers behind increased manufacturing activity.
- Residential real estate activity remained robust during the second quarter with new home sales remaining strong throughout the twelve Districts, as many home buyers were attempting to secure real estate prior to increases in mortgage rates. Some Districts, however, noted that home sales were starting to take longer than earlier in the year, perhaps indicating a slight cooling of the real estate markets. Commercial real estate activity remained flat during the second quarter, though some Districts noted modest signs of improvement which added to optimism regarding the prospects for commercial real estate in coming quarters.
- Labor markets strengthened in most Districts as a result of increased demand for labor stemming from plant expansions, plant openings, and increased activity in a wide range of sectors. There remained little upward wage pressure throughout the twelve Districts, despite increased

[12] The press release on June 16, 2004 states the following: This document summarizes comments received from businesses and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.
[13] The Twelve Districts of the Federal Reserve system include: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

labor demand. Increases in healthcare costs remained a significant concern for businesses throughout the Districts.

- Activity in the energy sector remained high due to continued high oil prices.

Consumer Confidence

Consumer confidence, which declined slightly during the first quarter, improved during the second quarter. The Conference Board's Consumer Confidence Index[14], which ended the first quarter at 88.5, rose to 93.0 in April, 93.1 in May, and 101.9 in June. The June level was the highest level for the index since June 2002. The increase for the second quarter was likely a result of optimism regarding favorable economic growth prospects and additional gains in employment growth, both of which bolstered consumers' short-term outlook. In addition to the increase in the Consumer Confidence Index in the second quarter, the Expectations Index increased from 91.3 in March to 94.8 in April and May to 100.0 in June. This increase in expectations was largely due to consumers' assessment of improved labor markets and overall business conditions. The June survey indicated a significant increase in the number of those expecting more jobs becoming available in the next six months—19.7% in June compared to 15.7% in March.

Consumers' assessment of business conditions over the next six months also improved during the second quarter. For March, 20.5% expected business conditions to improve in the next six months with this figure improving to 23.4% by the end of June. Optimism regarding current business conditions also improved during the second quarter with consumers rating conditions good improving from 20.7% in March to 25.6% in June. The favorable outlook and gains in consumer confidence are likely the result of strong jobs growth during the first half of the year as well as continued strengthening of the overall economy. The consumer confidence figures for the second quarter do not appear to have been adversely impacted by the Federal Reserve's stated bias that monetary policy accommodation could be removed at a measured pace.

[14] www.conference-board.org The June 29, 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."

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The Business Sector

Industrial production improved further during the second quarter, providing additional evidence of the increased economic activity. Industrial production figures as compiled by the Federal Reserve[15] posted strong gains in April and May, rising 0.8% and 0.9% at a seasonally adjusted annual rate to 115.5 and 116.5, respectively, before experiencing a 0.3% retrenchment in June to 116.2. This shows steady gains from the 114.7 level at the end of March. For June 2003, industrial production increased 5.6% on a year-over-year basis with a second quarter annual increase of 6.0% as compared to a revised annual increase of 6.6% for the first quarter. This slight decline in industrial production gains mirrors the overall decline in real GDP for the second quarter during which activity slowed from its exceptional performance in prior periods. Manufacturing production increased at an annual rate of 7.1% in the second quarter, slightly higher than the 6.5% increase in the first quarter. Data in the Beige Book indicating strong improvements in manufacturing in the twelve Districts of the Federal Reserve System provides clear evidence of the improving trend in manufacturing. Manufacturing production increased by 5.9% in June on a year-over-year basis as compared to a 3.6% increase in March. Consumer goods output increased by 3.4% in the second quarter with business equipment production increasing at an annual rate of 10.9%. These figures are lower than the first quarter performance when consumer goods output increased by 6.4% at an annual rate and business equipment production increased by 12.3%. On a year-over-year basis, consumer goods and business equipment increased 3.8% and 9.7% in June, respectively, as compared to increases of 1.7% and 5.3% in March. This is consistent with GDP data previously discussed.

Capacity utilization continued to show improvements in the second quarter, increasing from 76.6% in March to 77.0%, 77.6%, and 77.2% in April, May, and June, respectively. This is higher than the 75.8% capacity utilization in December 2003. Manufacturing capacity utilization, which increased from 74.4% in December to 75.5% in March, increased further to 75.9% in April, 76.2% in May, and 76.0% in June. Continued growth in industrial production and capacity utilization may be the result of the weakness of the dollar on foreign exchange markets, which has likely increased exports of U.S. goods and services.

[15] Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release from July 15, 2004.

The Department of Commerce, Census Bureau's Manufacturers' Shipments, Inventories, and Orders for June 2004 industrial report provides further evidence of improvements in manufacturing activity during the second quarter. Preliminary estimates of new orders for manufactured goods increased to a seasonally adjusted $363.2 billion in June, representing a 0.7% increase from May and up from $360.7 billion in March. Year-to-date, new orders for manufactured goods has increased by roughly 11.4%, adjusted for trading-day and calendar-month variations. New orders for nondurable goods increased 0.5% in June to $171.2 billion following a 2.0% increase the previous month but 10.4% higher on a year-to-date basis than 2003. New orders for durable goods increased by 0.9% in June to $192.0 billion following a 0.9% decline in May on a seasonally adjusted basis. Year-to-date, new orders for durable goods increased 12.2%.

Shipments in June of all manufactured goods increased 0.7% to $367.2 billion from $364.7 billion in May. Shipments have increased by 10.6% year-to-date as compared to 2003. Durable goods shipments, which have increased seven of the last ten months, increased 0.8% in June to $196.0 billion compared to declines of 0.8% and 0.6% in April and May. Year-to-date, durable goods shipments have increased 10.8%. Nondurable goods shipments increased 0.5% to $171.2 billion, the ninth increase in the last ten months. On a year-over-year basis, shipments of nondurable goods increased 10.4% as compared to 2003.

Data from the Federal Reserve Beige Book indicating solid but softening retail sales in the second quarter is once again confirmed by the advance monthly sales for retail trade and food services in June 2004 released by the Department of Commerce[16]. In June, retail and food service sales decreased 1.1%[17] to $331.9 billion. This, however, was still a 6.3% increase on a year-over-year basis. Second quarter retail and food service sales for 2004 increased by 1.4% from the first quarter of 2004 and by 7.7% from the second quarter of 2003. Total sales excluding motor vehicles and parts increased 8.3% in June on a year-over-year basis and increased 1.8% from the first quarter. On a year-over-year basis, this represents a 9.2% increase from the second quarter 2003. Retail sales declined 1.2% in June from the previous month but increased 6.3% on a year-over-year basis. For the second quarter, retail sales increased 1.6% from the first quarter and by 7.6% on a year-over-year basis. Retail sales of motor vehicle and parts decreased by 4.3% in June from the previous month and by 0.1% on a year-over-year basis. This is consistent with

[16] Press release from the Department of Commerce on July 14, 2004.
[17] Adjusted for seasonal, holiday, and trading day differences but not for price changes.

data from the Beige Book and GDP data showing weakness in auto sales during the second quarter. Electronics and appliances, building materials, and clothing also posted strong year-over-year gains on a quarterly basis for the second quarter of 9.9%, 17.2%, and 7.2%, respectively.

The continued strengthening of the business sector during the first half of 2004, based on various data, confirms the sustained increase in economic activity that has been underway for the last year. Though consumer spending softened during the second quarter, business spending made up for that weakness with spending on equipment growing by roughly 10% and inventories continuing to increase. The Institute for Supply Management's index of manufacturing activity stood at 61.1% in June, well above the 50% level indicative of business growth[18]. Given that the ISM index has been above 60% for eight months in a row, conditions appear favorable for further gains in business activity during the second half of the year. Indeed, according to the ISM, the roughly 62% average for the index during the first half of the year would likely be indicative of an approximately 7% growth rate, if past relationships hold. This further bodes well for continued strong economic activity in the second half of the year.

The manufacturing sector has also benefited from a continued weak dollar relative to other major currencies, fueling strong exports that have contributed to the increase in output. As demand for goods continues to increase, businesses will most likely be inclined to increase employment in order to provide adequate supplies for the strengthening demand. Though consumer sentiment may be slightly dampened by interest rate rises in the near future, favorable economic and business conditions should continue to provide a solid foundation for sustained growth for the next several quarters.

Inflation

Following a 5.1% increase in the consumer price index (CPI) [19] during the first quarter at a seasonally adjusted annual rate, the CPI increased by 4.8% in the second quarter. Following a 0.2% and 0.6% increase in April and May, the CPI increased by 0.3% in June on a seasonally adjusted basis. For the twelve month period ending June 2004, the CPI increased by an unadjusted annual rate of 3.3%. For the first half of the year, the CPI increased by a seasonally

[18] From Standard & Poor's Equity Research, "U.S.: Corporate America Picks Up the Baton," August 6, 2004.
[19] Based on data from the Consumer Price Index: June 2004 press release on July 16, 2004 by the Bureau of Labor Statistics, United States Department of Labor.

adjusted annual rate of 4.9%, as compared to an increase of 1.3% for the full year 2003. Energy prices increased by 0.1%, 4.6%, and 2.6% in April, May, and June, respectively, resulting in a compound annual rate for the second quarter of 33.5%. For the twelve months ended June 2004, energy prices rose by an unadjusted rate of 17%, as compared to a 6.9% increase for 2003. For the first half of the year, energy prices rose at a seasonally adjusted annual rate of 36%. This surge in energy prices contributed an estimated 50% of the increase in the CPI for the first half of the year. Increases in food prices remained relatively tame during the first and second quarters, staying unchanged in January then increasing 0.2% in February, March, and April. Food prices experienced a jump of 0.9% in May before increasing by a much lesser rate of 0.2% in June. For the first quarter food prices increased at a seasonally adjusted annual rate of 1.3%. For the second quarter, food prices increased by a compound annual rate of 5.1%. For the twelve months ending in June 2004, food prices rose by an unadjusted rate of 3.7%.

Removing the effects of food and energy, the core CPI increased by 2.9% at a seasonally adjusted annual rate in the first quarter and by 2.3% in the second quarter. For the first half of 2004, the core CPI advanced by 2.6%, which is noticeably higher than the 1.1% increase for the full year 2003. Though the Federal Reserve remains confident that underlying inflation is likely to remain low, FOMC has stated that accommodative monetary policy can be removed at a measured pace in order to maintain price stability.

In addition to the CPI, the price index for gross domestic purchases from the BEA[20] rose by 3.5% in the second quarter, relatively unchanged from the 3.4% increase in the first quarter, yet substantially higher than the 1.3% rise in the fourth quarter of 2003. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 2.4% in the second quarter as compared to a 2.5% increase in the first quarter. These increases are still higher than the 1.5% increase in the fourth quarter of 2003. 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 with the twenty-five basis point increase in the federal funds rate at its June 30, 2004 meeting.

Though inflation experienced a noticeable increase during the first and second quarters, as a result of substantial increases in energy prices, the prospects for a rapid, sustained rise in core inflation seem remote. Given the

[20] Bureau of Economic Analysis, Gross Domestic Product: Second Quarter 2004 (Advance) release, July 30, 2004.

slack still available in labor markets and continued excess capacity in manufacturing, activity should be able to expand substantially without triggering a substantial rise in inflationary pressures in the economy.

Labor Market

After averaging 5.9% in the fourth quarter, the unemployment rate trended lower in the first and second quarters to an average 5.6%[21]. Total nonfarm payroll employment increased by 112,000 in June to a seasonally adjusted 131.3 million, following a 235,000 increase in May and a 324,000 increase in April. As a result of these gains, total nonfarm payroll employment has increased by 1.5 million since August 2003. Over the last year, health care and social assistance employment increased by 279,000 with construction adding 250,000 jobs since March 2003. Manufacturing employment, after adding 75,000 jobs in the prior four months, retrenched in June with a net loss of 11,000 jobs. The 220,000+ average increase in total nonfarm payrolls for the second quarter is higher than the roughly 171,000 per month average increase in payroll employment during the first quarter.

In remarks at the International Money Conference, Alan Greenspan, Chairman of the Federal Reserve[22] observed the following with respect to employment gains,

> *The exceptional reluctance to expand payrolls also appears to have waned this year, and businesses are once again hiring with some vigor.*

Continued favorable economic activity is likely to result in further increases in employment as productivity begins to decelerate and businesses hire more workers in order to provide supply adequate to satisfy increasing demand.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment improved during the second quarter. Consumers expecting more jobs to become available in the next six months increased to 18.2% in April from 15.7% in March. Optimism strengthened in May and June with 18.7% and 19.7%, respectively, expecting

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[21] Bureau of Labor Statistics, United States Department of Labor, The Employment Situation: June 2004, July, 2, 2004.
[22] Remarks by Chairman Alan Greenspan, *Central Bank Panel Discussion: Economic Developments*, at the International Money Conference, London, England (via satellite), June 8, 2004.

more jobs to become available in the next six months. This increased optimism regarding employment is likely the result of more favorable consumer confidence regarding the overall economy, current business conditions, and expectations for continued economic growth the rest of the year.

Equity Markets

Improving economic conditions in the second quarter continued to provide positive support for corporate profits of many publicly-traded companies. As of July 2, 2004, Standard & Poor's forecast a second quarter year-over-year increase of roughly 24% for earnings of S&P 500 companies[23]. For the last twelve months, the P/E ratio for the S&P 500 was 19.4, significantly lower than the March 2000 P/E of 27.8 and more in line with the average since 1988 of 20.0. With 85% of the S&P 500 market value reporting, operating earnings set a new record of $16.90 per share, noticeably higher than the $15.87 level from the first quarter 2004. Based on the operating earnings, quarterly corporate profits will increase 31% on a year-over-year basis to $157 billion in the second quarter. S&P forecast a year end operating P/E for the S&P 500 of 16.5 in 2004 and 15.1 in 2005[24].

Despite further economic strengthening and favorable financial performance of many public companies, the major indices were mixed during the second quarter. The Dow Jones Industrial Average (DJIA) ended the first quarter at roughly 10,358[25]. For the second quarter the DJIA fell below 10,000 in mid-May before regaining some ground to end the quarter up roughly 0.8%. Through the end of the second quarter, the DJIA was virtually flat with a slight decline of 0.1% for the year. The S&P 500 rose roughly 1.3% during the second quarter to 1,141, following a 1.5% gain during the first quarter. Year-to-date the S&P 500 has gain 2.8%. The NASDAQ composite, after declining roughly 0.6% during the first quarter, gained approximately 2.7% to end the second quarter at 2,048. Year-to-date the NASDAQ has gained 2.1%. The markets' lackluster performance may be attributed to continued concerns over geopolitical events in Iraq, significant increases in oil prices, and expectations of further interest rate increases in the coming quarters as part of the Federal Reserve's removal of accommodative monetary policy at a measured pace.

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[23] Based on data from Standard & Poor's, "S&P 500 Second Quarter Earnings Expected to Set Record High," July 2, 2004.
[24] Standard & Poor's, "Second Quarter S&P 500 EPS Setting Operating Record," August 5, 2004.
[25] Based on data from *The Economist.*

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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[26]. Though markets were well supplied into the first quarter of 2004, OPEC ministers concluded that a reduction in production was necessary to avoid market imbalances that would likely have downward pressure on prices. As a result of the output cut effective April 1, 2004, oil prices rose steadily during the following four weeks to a high of roughly $39 per barrel by the end of the month. The surge in prices above $40 per barrel during the first week of May was the first time crude future on the New York Mercantile Exchange had breached the level since October 1990. In addition, futures prices on crude traded at the highest continuous level since 1983. By early-May, oil prices had risen by roughly 22% since the beginning of the year.

The steadily rising price of oil during April prompted Alan Greenspan to warn in an address at an energy conference by the Center for Strategic and International Studies on April 27, 2004 that the dramatic rise in energy futures markets was "an economic event that can significantly affect the long-term path of the U.S. economy[27]." Despite pressure from various world leaders in April and comments from central bankers throughout the world warning that increased oil prices posed a risk to price stability and world economic growth, OPEC officials insisted there was nothing that the cartel could do to stem rising energy prices. Iran's OPEC representative indicated that "security fears in the Middle East and the tight US petrol market had created a $6 a barrel premium in oil prices.[28]"

Oil prices continued to move higher following the International Energy Agency's increased forecast for oil demand of 2 million barrels per day to 80.6 million barrels per day. The IEA's assessment indicated that oil demand was increasing at a rate that outstripped oil supply and the ability of oil producers to meet that increased demand as a result of capacity restraints with respect to exploration and refining. The IEA also indicated that OPEC's ability to boost

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[26] OPEC press release following the 129th (Extraordinary) Meeting of the OPEC Conference in Algiers, Algeria on February 10, 2004.
[27] "Greenspan warns rise in oil price will affect 'long-term path' of US economy," *The Financial Times*, April 28, 2004.
[28] "Central banks warn of oil price's impact on inflation," *The Financial Times*, May 7, 2004.

output and temper the rise in energy prices was hampered by little spare capacity throughout the member countries. By the fourth quarter, oil demand is anticipated to rise to an average of 82.5 million barrels per day, exceeding global refinery capacity of only 82.1 million barrels per day[29].

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[30]. 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.*

Claims of oil price distortions arising from speculators in the market were originally reported in an article in *The Financial Times* [31] in March. At that time, the article indicated oil prices were exaggerated by as much as 10% due to crude futures trading at record levels. An unwinding of hedge fund and speculator positions in the futures markets could reduce oil prices by up to $4 per barrel. *The Financial Times* article also indicated that the decline in the dollar may have contributed as much as $8 per barrel to the rise in oil prices. Hedge funds and speculators continued to be blamed for pushing up oil prices during the second quarter. In a May 26, 2004 article in *The Financial Times*, Mike Rothman, chief energy strategist at Merrill Lynch, indicated that speculators had created a speculative bubble in the energy markets. Based on supply and demand trends, Mr. Rothman estimated that the price of crude

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[29] "IEA FORECAST Fears over economic growth push up oil prices," *The Financial Times*, May 12, 2004.
[30] OPEC press release following the 131st (Extraordinary) Meeting of the OPEC Conference in Beirut, Lebanon on June 3, 2004.
[31] "Record influx of hedge funds blamed for high oil prices," *The Financial Times*, March 2, 2004.

should be closer to $30-$32 per barrel[32]. A subsequent article in The Financial Times indicated that hedge fund speculation in the oil markets may have added as much as a $10 per barrel premium to the price of oil[33]. In June 8, 2004 remarks at the International Money Conference in London, Alan Greenspan noted[34]:

> *Nonetheless, the persistence of the rise in energy prices is a worrisome element in the cost picture. Fears for the long-term security of oil production in the Middle East, along with increased concerns about prospects in other oil-producing countries, are doubtless key factors behind the nearly $9 per barrel rise in distant crude oil futures since 2000. This run-up presumably reflects a broadening of demand for claims on oil inventories beyond traditional commercial buyers and sellers of crude oil and petroleum products. The marked rise in the net long positions of non-commercial investors in oil futures and options since May 2003 has increased net claims on an already diminished global level of commercial crude and product inventories. Oil prices accordingly have surged.*

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. However, many economists remained concerned that the rise in oil prices will have a significant adverse impact upon economic activity in the coming quarters. Given the continued robust demand from China, instability in Iraqi exports, continued tensions in the Middle East, and the fear of terrorist attacks aimed at disrupting oil supplies, oil prices are likely to remain higher than OPEC's preferred price band, despite the cartel's increase in output. In addition, any exogenous shocks in the oil markets resulting in short-term price spikes or sustained higher prices would have a significant adverse impact upon global economic growth and U.S. economic activity.

Economic Outlook 2004

The Conference Board's Leading Economic Indicators increased 0.1% and 0.4% in April and May, respectively, before declining 0.2% in June to end

[32] "Speculators blamed for pushing up oil prices," *The Financial Times*, May 26, 2004.
[33] "Hedge funds reap rewards of oil rises," *The Financial Times*, June 4, 2004.
[34] Remarks by Chairman Alan Greenspan, *Central Bank Panel Discussion: Economic Developments*, at the International Money Conference, London, England (via satellite), June 8, 2004.

the quarter at 116.2. The decline in June was the first decline for the Index since March 2003[35]. Though half of the indicators declined in June, this may be the result of a temporary retrenchment of consumer spending resulting from higher oil prices as well as a decline in the average manufacturing workweek (likely due to closures surrounding President Reagan's funeral). For the six months ending in June, the LEI increased 1.5%. Over the last twelve months, the LEI index growth rate of 2.5%-3.5% at an annual rate is consistent with a 4%-5% increase in real GDP at an annual rate.

Economic conditions should remain favorable for the remainder of 2004 as a result of continued strength in consumer spending, solid consumer confidence, further gains in the job market, and improvements in corporate profits. These factors all should contribute to generally stable economic conditions favorable for solid economic growth. Our expectations for the economy include:

- Real GDP growth of 3 ¾% - 4 ½%.

- Interest rates are likely to increases slightly during the second or third quarter as the Federal Reserve removes some of the accommodative monetary policy that may be contributing to the rise in inflation. However, excess capacity in manufacturing should accommodate strong growth throughout the year without stoking any substantial inflationary pressures. It is more than likely that the FOMC will increase the federal funds rate by another twenty-five basis points in late summer and in the fall. The federal funds rate should end the year at roughly 2%.

- Inflation should remain stable in 2004 with the core CPI increasing by roughly 1 ½% - 2%.

- As the economy continues to strengthen and exhibit improved performance in various sectors, payroll employments are likely to increase during the coming quarters. It is possible that the economy will generate increases in payroll employment of 150,000 per month on average for the remainder of the year. Unemployment, then, is likely to fall to under 5 ½% for the year.

- Given the pace of economic activity, business spending will most likely continue to increase during 2004 as production increases in order to

[35] From The Conference Board's June 17, 2004 & July 22, 2004 press releases.

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 unrest in Venezuela may exert further upward pressure on prices as well as turmoil in Russia surrounding Yukos. Further instability in Iraq and speculation in the futures markets will also likely keep energy prices at artificially inflated levels.

- 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 for the remainder of 2004, which could have significant adverse impacts upon economic performance throughout the remainder of the year.

- An escalation in geopolitical concerns regarding instability in Iraq and wider concerns over 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 could also have an adverse impact upon economic activity and oil prices.

- The presidential election in November may have some impact upon consumer and business confidence, given the uncertainty of the outcome. Given the elections, there is unlikely to be any major policy initiatives during the year. It is unlikely that the elections will have anything more than a marginal impact upon economic activity in 2004.

- An increase in interest rates by the FOMC may temper any gains in the equity markets and result in trading in a narrow range for the near future. It is unlikely, however, that this will be an issue, given that any rate increases are likely priced into the markets.

Conclusion

Solid economic performance that began in 2003 continued during the first half of 2004 with real GDP in the second quarter expanding at a more modest rate of 3%. Though personal consumption expenditures were tempered

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in the second quarter, this is likely the result of temporary factors stemming from artificially high oil prices. The housing market remained robust due to favorable interest rates, despite the Federal Reserve's move to begin removing monetary policy accommodation at a measured pace. In addition, lagging payroll employment finally caught up with the pace of economic expansion with jobs growth averaging over 220,000 per month in the second quarter as compared to 171,000 per month average in the first quarter, as businesses sought to increase employment levels in order to satisfy increased demand. Though inflation trended higher due predominantly to sustained increases in energy prices, core inflation remained stable. Though the FOMC is likely to continue increasing the federal funds rate during the second half of the year, conditions are favorable for stable economic activity in rest of 2004 and into 2005.

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