

STATE OF THE ECONOMY 3rd Quarter 2004

Introduction

Despite large increases in energy costs and uncertainty regarding geopolitical events, particularly the United States' presidential elections, the economy continued its steady expansion with real gross domestic product (GDP) increasing at an annual rate of 3.7% in the third quarter. This modest increase follows a lower 3.3% increase in economic activity in the second quarter and a 4.5% increase in the first quarter. The slightly higher economic expansion in the third quarter as compared to the second quarter was the result of strength in personal consumption expenditures and federal government consumption expenditures along with continued accommodative monetary policy, price stability and further gains in the labor markets. Though the energy markets and geopolitical risks still weigh upon the economy and may restrain demand, the trend in improved economic activity for the last three quarters is likely indicative of a robust U.S. economy poised for continued favorable growth in the quarters ahead.

Gross Domestic Product

Advance estimates¹ released by the Bureau of Economic Analysis (BEA) indicate that real GDP increased at an annual rate of 3.7% in the third quarter of 2004, slightly higher than the revised rate of 3.3% for the second quarter. Third quarter economic growth was higher than the consensus forecast of 3.5% annual growth in real GDP anticipated by thirty forecasters surveyed by the Federal Reserve Bank of Philadelphia². The second quarter growth in GDP was revised higher from an annual rate of 3.0% to 3.3%, still lower than the 4.5% annual growth in real GDP for the first quarter of 2004³. The increase in economic activity in the third quarter was a result of improvements in personal

¹ The BEA press release on October 29, 2004 states the following with respect to advance estimates: The Bureau emphasized that the third-quarter "advance" estimates are based on source data that are incomplete or subject to further revision by the source agency. The third quarter "preliminary" estimates, based on more comprehensive data, will be released on November 30, 2004.

² *Survey of Professional Forecasters*, Research Department Federal Reserve Bank of Philadelphia, August 20, 2004.

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

consumption expenditures, federal government consumption expenditures, exports, and residential fixed investment. Personal consumption expenditures, which was one of the primary drivers of the strong first quarter growth in GDP, tapered significantly during the second quarter. Federal government consumption expenditures followed a similar pattern with strength returning during the third quarter.

Real personal consumption expenditures increased by 4.6% in the third quarter at a seasonally adjusted annual rate, significantly higher than the 1.6% increase in the second quarter and slightly higher than the 4.1% increase in the first quarter. Purchases of durable goods, which decreased 0.3% in the second quarter, surged 16.8% in the third quarter due to strength in motor vehicle expenditures and expenditures on furniture and household equipment. Data from the Federal Reserve Beige Book released on September 8, 2004 indicated that many Federal Reserve Districts noted improvements of motor vehicle sales during the quarter, despite rises in energy prices. Personal consumption expenditures of nondurable goods rebounded heartily during the third quarter with a 3.9% increase, following a decrease of 0.1% in the second quarter, due to improvements in clothing and shoes and gasoline and energy products, expenditures both of which declined in the previous quarter.

Real residential fixed investment, which increased by 5.0% in the first quarter and strengthened by 16.5% in the second quarter, tempered in the third quarter with an increase of 3.1%. Following increases in April and May and a decline in June, new privately-owned housing units authorized by building permits increased roughly 6.2% in July to 2,066,000 at a seasonally adjusted annual rate⁴. This figure decreased by roughly 4.7% in August to 1,969,000 before rebounding 1.8% to 2,005,000 in September. The September 2004 figure represents a roughly 3.2% increase over the September 2003 figure of 1,943,000. New privately-owned housing units authorized by building permits increased in July by roughly 9.2% on a year-over-year basis and showed virtually no gain in August over the prior year.

Following a decrease of roughly 8.1% in June to a seasonally adjusted annual rate of 1,817,000, privately-owned housing starts increased 9.2% in July and 1.8% in August to 1,985,000 and 2,020,000, respectively. These figures are roughly 4.8% and 10.1% higher on a year-over-year basis. Housing starts declined 6.0% in September from August and by 1.2% on a year-over-

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.

year basis. 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.

This, in conjunction with the strong growth for July and August, suggest that it would be premature to conclude that the decline in activity in September is indicative of a trend in the real estate market rather than a statistical aberration, such as that for the month of June. The Federal Reserve Beige Book from September 8, 2004 indicates that residential real estate activity throughout most of the twelve Districts remained at high levels during the third quarter, as was the conclusion based on data during the second quarter, with only slight signs of cooling in activity.

Though the Federal Reserve began removing monetary policy accommodation at a measured pace earlier in the year, the real estate markets have largely been unaffected by the slight increases in interest rates and expectations regarding the Federal Reserve's future tightening of monetary policy. Though the increases in the federal funds rate would be expected to have an adverse impact upon mortgage rates and real estate activity, mortgage rates have remained favorable for consumers seeking homeownership during the second and third quarters. After trending higher during the second quarter from 5.52% to 6.21%, thirty-year conventional mortgages according to Freddie Mac⁵ declined during the third quarter to 5.72% by September 30, 2004. 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 end September at 5.12%. The decline in mortgage rates coincides with a fall in U.S. Treasury yields on the 10-year note to below 4%, a five month low, as expectations regarding long-term inflation eased. As a result of this decline in interest rates and rate expectations, mortgage refinancing rose to four month highs based on the Mortgage Bankers' Association index of refinancing activity. Though policy tightening by the Federal Reserve is likely to continue in the coming quarters, long-term rates and mortgage rates may largely be unaffected by further rate increases in the near term. However, at

⁵ Data from Freddie Mac Weekly Mortgage Market Survey

some point, rate increases will ultimately precipitate an increase in long-term Treasury yields and mortgage rates. Until such time, the real estate market is likely to remain robust, particularly as refinancings increase due to declines in mortgage rates. As such, there is likely some latitude for rate increases before any major adverse impact upon the housing market.

Real exports of goods and services increased at an annual rate of 5.1% during the third quarter as compared to a 7.3% increase during the second quarter. Weakness of the dollar that began much earlier in the year continued during the third quarter and may have contributed to the increase in exports. At the end of the first and second quarters, the dollar/sterling (\$/£) exchange rate stood at roughly \$1.85 and \$1.79, respectively. The dollar/euro (\$/€) exchange rate was \$1.23 at the end of the first quarter and \$1.22 at the end of the second quarter. The yen/dollar (¥/\$) exchange rate stood at ¥104 and ¥109, respectively⁶. By the end of the third quarter the dollar strengthened to roughly \$1.79/sterling and to ¥111. The dollar's performance against the euro was minimal, weakening slightly to end the quarter at \$1.23/€.

The currency markets during the third quarter were uneasy regarding the U.S. trade deficit, which set a record of \$55 billion in June and \$54 billion in August, as well as the U.S. budget deficit both of which require significant foreign investment and consumption to maintain. However, as mentioned in previous economic commentaries, 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 a number of U.S. industries and sectors, as domestic production increases to satisfy the increased demand for exported goods.

Following a 2.7% increase in the second quarter, a lower rate than the 7.1% increase in the first quarter, real federal government consumption expenditures rebounded to a rate of 4.6% in the third quarter. This improved rate of federal government consumption expenditures was the result of a 9.3% increase in national defense expenditures, fueled in part by continued military presence and action in Iraq, as compared to a 1.9% increase in the second quarter. Nondefense spending increased by 4.7% in the third quarter following 0.2% and 4.4% increases in the first and second quarters, respectively.

Following a \$61.1 billion increase in the second quarter, private businesses increased inventories by \$48.1 billion during the third quarter. The

⁶ Source: *The Economist*

increase in private business inventories subtracted 0.48% from GDP for the third quarter as compared to adding 0.78% to the second quarter change in real GDP. This slowdown in additions to inventories suggests that buildups during the second quarter had yet to be drawn down by increased economic activity and demand expectations. This may be indicative of robust expectations for economic activity during the fourth quarter when retail sales are likely to contribute to a favorable business environment and an increased pace of economic expansion.

The Federal Reserve

The Federal Reserve continued its measured tightening of monetary policy, originally initiated with a twenty-five basis point increase in the federal funds rate at the June 30, 2004 meeting, during the third quarter. At its August 10, 2004 meeting, the Federal Open Market Committee (FOMC) increased the federal funds rate by twenty-five basis points to 1 ½% and maintained its position that economic activity continued to be supported by accommodative monetary policy along with robust underlying productivity growth⁷. In the press release following the meeting, the FOMC indicated that output growth had moderated in the previous months as a result of the sustained rise in energy prices. The FOMC also noted the following:

The economy nevertheless appears poised to resume a strong pace of expansion going forward. Inflation has been somewhat elevated this year, though a portion of the rise in prices seems to reflect transitory factors.

In September 8, 2004 testimony before the Committee on the Budget in the U.S. House of Representatives⁸, Chairman Alan Greenspan noted that softness in activity during the second quarter was likely the result of the heightened gains in the energy markets and also that the economic expansion had recently regained some traction. In his testimony, Chairman Greenspan further states the following:

Consumer spending and housing starts bounced back in July after weak performances in June...In addition, business investment remains on a solid upward trend. In the manufacturing sector, output has continued to move up in recent months...In the labor market, though job gains were

⁷ The Board of Governors also increased the discount rate by twenty-five basis points to 2 ½% at the August 10, 2004 meeting.

⁸ Testimony of Chairman Alan Greenspan, *Economic Outlook*, Before the Committee on the Budget, U.S. House of Representatives, September 8, 2004.

smaller than those of last spring, nonfarm payroll employment growth picked back up in August...Despite the rise in oil prices through mid-August, inflation and inflation expectations have eased in recent months.

At its September 21, 2004 meeting, the FOMC continued its tightening policy with a twenty-five basis point increase in the target for the federal funds rate to 1 ¾%⁹. Despite the increase in the federal funds rate, the FOMC continued to believe 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. The Committee indicated that:

After moderating earlier this year partly in response to the substantial rise in energy prices, output growth appears to have regained some traction, and labor market conditions have improved modestly. Despite the rise in energy prices, inflation and inflation expectations have eased in recent months.

The Federal Reserve Beige Books¹⁰ released on September 8, 2004 and October 27, 2004 indicated that economic activity continued to expand during the third quarter, though the pace of growth across the twelve Districts¹¹ was mixed as compared to the previous quarter. The Beige Book conclusions included the following:

- Consumer spending was generally tempered during the third quarter with retail sales mixed throughout the Districts. The number of hurricanes that threatened and hit the Southeast disrupted retail sales during the quarter but prompted higher sales of building materials. Auto sales were mixed during the first part of the third quarter throughout the Districts but were described as solid in September.
- Business spending appeared to post noticeable gains during the third quarter, with many manufacturing firms increasing capital outlays. On

⁹ The Board of Governors also increased the discount rate by twenty-five basis points to 2 ¾% at the September 21, 2004 meeting.

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.

balance, manufacturing activity continued solid expansion in all of the Districts, continuing the trend in increased production that began earlier in the year. Activity in the Atlanta District was slightly disrupted by the hurricane activity during the third quarter. Though the expansion in manufacturing activity was broad-based, production of durable goods posted stronger gains than production of nondurable goods. Increased auto sales late in the third quarter enabled dealers to draw down inventories to more desirable levels. As a result of increased manufacturing activity, many Districts experienced strong demand for transportation services. West Coast seaports, for example, were operating at capacity during the first part of the third quarter, and the Port of New York and New Jersey indicated substantial increases in volume in July and August. Weakness of the dollar as compared to foreign currencies, which has been one of the drivers behind increased manufacturing activity during the past quarter, is likely to continue to contribute to increased demand from overseas consumers and, thus, to provide stimulus for domestic manufacturing activity.

- Residential real estate activity remained robust during the third quarter but showed some signs of cooling in several Districts. Home price appreciation was relatively muted during the third quarter. This appears a natural extension of earlier reports indicating home sales were starting to take longer. With mortgage rates falling once again during the third quarter, real estate activity is likely to experience a pickup during the fourth quarter as a result of refinancing and homebuyers seeking acquisitions at favorable rates. Commercial real estate activity, flat during the second quarter, showed some signs of improvement during the third quarter, though many Districts continued to be plagued by high vacancies and low (but steady) rents.
- Labor markets continued to strengthen in most Districts during the third quarter, particularly in sectors such as energy, transportation services, durable goods manufacturing, and health-care. Several Districts noted an increase in the conversion of temporary workers into permanent workers. Though wage pressures remained relatively contained, there were some indications of trending higher wage costs in occupations where skilled professionals may have been in short supply. As with previous reports, healthcare costs and employee benefits remained a significant concern for businesses throughout the Districts. Rising energy costs, which compounded rising healthcare costs, were also a

major concern for several sectors such as manufacturing, transportation, and construction.

- Tourism in the Atlanta and Richmond Districts was disrupted due to the number of hurricanes that made landfall or threatened to hit coastal regions and the associated evacuations. As a result, the third quarter became one of the costliest for the Southeast in terms of adverse economic impacts from inclement weather.

Consumer Confidence

After improving during the second quarter, consumer confidence dipped during the third quarter with the Conference Board's Consumer Confidence Index¹² declining from 102.8 and 106.1 in June and July, respectively, to 98.7 and 96.8 in August and September, respectively. The June and July levels were the highest 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. However, concerns over geopolitical risks and the presidential election may have served to dampen consumer confidence during the third quarter. The Expectations Index followed a similar pattern, decreasing from 100.8 and 105.8 in June and July, respectively, to 97.3 and 97.6 in August and September, respectively. This decline in expectations may also have been adversely impacted by geopolitical concerns and uncertainty regarding the presidential elections.

Consumers' assessment of business conditions over the next six months was mixed during the third quarter. For September, 21.4% expected business conditions to improve in the next six months, slightly lower than the July figure of 23.2%. Optimism regarding current business conditions was also mixed during the third quarter with consumers rating conditions "good" at 25.6% in July and 23.6% in September. The consumer confidence figures for the third quarter may have been adversely impacted by the Federal Reserve's initiation of tightening monetary policy accommodation at a measured pace at the end of the second quarter. Consumer confidence may also have been impacted by, increased energy prices, heightened geopolitical concerns regarding Iraq, Iran, North Korea, and the Middle East along with the broader

¹² www.conference-board.org The September 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."

war on terror in addition to uncertainties stemming from the forthcoming presidential elections. Given the economic expansion during the last quarter, it is difficult to determine if the decline in consumer confidence is the beginning of a long-term trend or merely a temporary phenomenon stemming from the aforementioned risks.

The Business Sector

Industrial production increased moderately during the third quarter as compared to the second quarter, providing additional evidence of the increased economic activity during the period. Industrial production figures as compiled by the Federal Reserve¹³ posted strong gains in the third quarter, rising from 115.9 in June to 116.7 in September. This shows noticeable gains from the 114.7 level at the end of March. For the third quarter, industrial production increased 4.9% on a year-over-year basis in July, 5.2% in August, and 4.6% in September. For the quarter as a whole, industrial production increased at an annual rate of 2.9%, as compared to an annual rate of 6.0% in the second quarter and 6.6% in the first quarter.

Manufacturing production also showed gains in the third quarter, albeit at a lower rate, increasing at an annual rate of 4.4% as compared to a 7.1% increase in the second quarter and a 6.5% annual rate in the first quarter. On a year-over-year basis, manufacturing production increased 5.8% in July, 6.8% in August, and 5.3% in September. Based on anecdotal evidence in the Beige Book, manufacturing throughout the twelve Districts of the Federal Reserve System increased in both the second and third quarters. Indeed, much of the growth in GDP resulted from strength in personal consumption expenditures, particularly on durable goods. During the third quarter, industrial production of durable goods increased at an annual rate of 6.3%. These figures further support data presented in the BEA's GDP release and the Beige Books indicating continued strengthening of economic activity.

Capacity utilization was relatively flat in the third quarter, ending September at 77.2%—the same level as that in June. Manufacturing capacity utilization, which stood at 76.0% in June, showed slight improvement in the third quarter to 76.3%.

Continued weakness of the dollar on foreign exchange markets, which has likely spurred higher exports of U.S. goods and services, could help further

¹³ Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release from October 15, 2004.

advance industrial production and capacity utilization as manufacturers adjust activity in order to provide supplies of goods adequate to satisfy increased demand from overseas consumers.

The Department of Commerce, Census Bureau's Manufacturers' Shipments, Inventories, and Orders for September 2004 industrial report provides mixed evidence on manufacturing activity during the third quarter in the wake of noticeable gains in the previous quarter. Preliminary estimates of new orders for manufactured goods increased in July by 1.7% on a seasonally adjusted basis then declined slightly in August and September by 0.3% and 0.4%, respectively. Year-to-date, new orders for manufactured goods increased by roughly 11.6%, adjusted for trading-day and calendar-month variations. New orders for nondurable goods increased 1.9% in July to \$196.4 billion then decreased slightly in August before rebounding 0.2% in September to \$195.9 billion. On a year-to-date basis, new orders for durable goods increased by roughly 12.1%.

Shipments in July and August of all manufactured goods increased 0.9% to \$375.5 billion before declining by 1.1% in September to \$371.3 billion. Year-to-date shipments have increased by 11% as compared to 2003. Durable goods shipments increased 0.5% in July and 1.9% in August to \$201.4 billion before declining 1.2% in September. Year-to-date, durable goods shipments have increased 10.9%. Nondurable goods shipments increased 1.3% to \$174.4 in July then declined by 0.2% and 1.0% in August and September, respectively. On a year-over-year basis, shipments of nondurable goods increased 11.0% as compared to 2003.

The advance monthly sales for retail trade and food services in the third quarter released by the Department of Commerce¹⁴ continue to suggest strength with respect to increased economic activity. In June, retail and food service sales decreased by approximately 1.0%¹⁵ to \$333.5 billion. Retail and food service sales increased roughly 1.0% in July, showed virtually no growth in August, and increased 1.5% in September. For the third quarter, retail and food service sales increased by 1.4% from the second quarter and by 6.5% on a year-over-year basis. For the nine months through the end of September, retail and food service sales increased by 7.8% on a year-over-year basis. Total sales excluding motor vehicles and parts increased 7.8% in September on a year-over-year basis and increased 1.2% from the second quarter. On a year-over-year basis, this represents a 7.6% increase from the third quarter 2003. Retail

¹⁴ Press release from the Department of Commerce on October 15, 2004.

¹⁵ Adjusted for seasonal, holiday, and trading day differences but not for price changes.

sales increased 1.5% in September from the previous month and increased 7.5% on a year-over-year basis. For the third quarter, retail sales increased 1.4% from the second quarter and by 6.3% on a year-over-year basis. Retail sales of motor vehicle and parts increased by 2.1% in the third quarter over the previous quarter and by 2.8% on a year-over-year basis. This is consistent with data from the Beige Book and GDP indicating improved auto sales during the third quarter following sluggish activity during the second quarter. Building materials and gasoline stations also posted strong year-over-year gains on a quarterly basis for the third quarter of 13.5% and 16.7%, respectively, though much of this is likely due to significant increases in prices in these industries.

The aforementioned data suggest a continued strengthening of the business sector during the third quarter, a trend that has been evident for much of the last year. 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 third quarter. Overall, these factors suggest that favorable economic and business conditions should persist and provide a catalyst for continued strengthening of economic activity.

Inflation

Following a 4.8% and 5.1% increase in the consumer price index (CPI)¹⁶ during the first and second quarters at a seasonally adjusted annual rate, the CPI increased by 0.6% in the third quarter. For the nine months through September, the CPI increased by 3.5%, higher than the 1.9% increase for all of 2003. Following a 0.1% decline in July and a 0.1% increase in August, the CPI increased by 0.2% in September on a seasonally adjusted basis. For the twelve month period ending September 2004, the CPI increased by an unadjusted annual rate of 2.5%. The energy index declined by 1.9%, 0.3%, and 0.4% in July, August, and September, respectively, following sharp increases in energy prices during the first half of the year. For the twelve months ended June 2004, the energy index rose by an unadjusted rate of 17%, as compared to a 6.9% increase for 2003. For the twelve months ended September 2004, the

¹⁶ Based on data from the Consumer Price Index: September 2004 press release on October 19, 2004 by the Bureau of Labor Statistics, United States Department of Labor.

energy index rose by an unadjusted annual rate of 6.7%, much lower than the twelve month rate of increase for the period ended June 2004 and more comparable to the rate of increase for the full year 2003. For the three quarters of 2004, energy costs rose at a seasonally adjusted annual rate of 18.6%. The continuing surge in energy prices resulted in a 31.7% increase in petroleum-based energy costs for the first nine months of 2004 on a seasonally adjusted annual basis. Increases in food prices remained relatively tame during the third quarter, with the food index increasing at a 1.3% annual rate as compared to a 1.3% and 5.1% increase in the first and second quarters, respectively. The food index rose at a 2.6% annual rate for the first nine months. For the twelve months ending in September 2004, food prices rose by an unadjusted rate of 3.3%.

Removing the effects of food and energy, the core CPI increased by 1.8% in the third quarter at a seasonally adjusted annual rate as compared to a 2.9% increase in the first quarter and a 2.3% increase in the second quarter. For the first nine months of 2004, the core CPI advanced by 2.3%, which is noticeably higher than the 1.1% increase for the full year 2003. The Federal Reserve 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 BEA¹⁷ rose by 1.8% in the third quarter, lower than the 3.5% rate in the second quarter and the 3.4% increase in the first quarter. The third quarter increase is comparable to the 1.3% rise in the fourth quarter of 2003. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 1.5% in the third quarter, lower than the 2.5% increase in the second quarter. 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.

Though inflation experienced a noticeable increase during the first and second quarters, as a result of substantial increases in energy prices, the relatively modest increase in inflation during the third quarter suggests that the prospects for a rapid, sustained rise in core inflation have diminished. The slack still available in labor markets and continued excess capacity in manufacturing seem to indicate that economic activity should be able to

¹⁷ Bureau of Economic Analysis, Gross Domestic Product: Third Quarter 2004 (Advance) release, October 29, 2004.

expand substantially without triggering a substantial rise in inflationary pressures.

Labor Market

After averaging 5.6% in the second quarter, the unemployment rate trended lower in the third quarter to an average 5.4%¹⁸. Total nonfarm payroll employment increased by 96,000 in September to a seasonally adjusted 131.6 million, following a 128,000 increase in August and an 85,000 increase in July. As a result of these gains, total nonfarm payroll employment increased by an average of 103,000 during the third quarter. In addition, total nonfarm payroll employment has increased by 1.8 million since August 2003, with roughly half this gain occurring in March, April and May. Payroll job gains have risen by 405,000 since May.

It should be noted, however, that the four hurricanes that impacted the Southeast during the third quarter likely had a negative impact upon the employment situation during this period. However, this negative impact may have ultimately yielded some job creation in the affected areas as cleanup and recovery operations required increased employment. With respect to this, the BLS stated the following in the September 2004 Employment Situation report:

For weather conditions to reduce the estimate of payroll employment, people have to be off work for an entire pay period and not be paid for the time missed. While some employed persons were off payrolls during the survey reference period because of the hurricane effects, some jobs were added as part of recovery efforts. It is not possible to quantify precisely the net impact of this unusual string of severe weather events on the payroll employment data for September. At the national level, the severe weather appears to have held down employment growth, but not enough to change materially the Bureau's assessment of the employment situation in September.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment was mixed during the third quarter. Consumers expecting more jobs to become available in the next six months increased to 17.7% in September from 16.3% in August and down from 19.4% in July. These mixed sentiments regarding employment closely mirrors the mixed results of the consumer confidence survey and are likely due to

¹⁸ Bureau of Labor Statistics, United States Department of Labor, The Employment Situation: September 2004, October 8, 2004.

concerns over geopolitical events and, perhaps, to the uncertainty surrounding the forthcoming presidential election. However, the continued improvements in economic activity coupled with improved business conditions and industrial production should provide a solid foundation for continued increases in payroll employment for the coming quarters.

Equity Markets

Despite further economic strengthening and favorable financial performance of many public companies, the major indices declined during the third quarter. The Dow Jones Industrial Average (DJIA) ended the second quarter at roughly 10,435¹⁹. For the third quarter the DJIA fell below 10,000 in early to mid-August before regaining some ground towards the end of the quarter. However, the DJIA ended the quarter roughly 3% lower, resulting in a roughly 3.5% decline year-to-date. The S&P 500 declined roughly 2.3% during the third quarter to 1,141, though the index was relatively flat on a year-to-date basis with an increase of only 0.24%. The NASDAQ composite experienced the largest decline of roughly 7.5% during the third quarter, falling from roughly 2,048 to approximately 1,900. As a result of the third quarter decline, year-to-date the NASDAQ has fallen roughly 5.6%.

The markets' lackluster performance may be attributed to continued concerns over geopolitical events in Iraq, the presidential election, 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. However, once the uncertainty regarding the presidential election abates, the markets may experience increased activity depending on the outcome of the elections. It is widely expected that a clear, decisive winner would have a favorable impact upon the markets by eliminating the potential for protracted legal action that delayed the declaration of a winner in the 2000 election. In addition, re-election of President Bush would likely be more favorable for equity markets as the President is expected to pursue permanent reductions in taxes on capital gains and dividend income. Irrespective of the winner of the presidential election, the markets are poised for favorable performance once energy cost increases abate prompting further economic strength.

¹⁹ Based on data from *The Economist*.

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 quarter²⁰.

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, 2004²¹. 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

²⁰ OPEC press release following the 129th (Extraordinary) Meeting of the OPEC Conference in Algiers, Algeria on February 10, 2004.

²¹ 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 daily²². 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 remarks²³:

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 2005²⁴. 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

²² Based on data from "Oil Prices Hit Highs as Supply Fears Grow," *The Financial Times*, July 29, 2004.

²³ 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.

²⁴ 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 October²⁵. 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. economy²⁶:

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.

²⁵ "Gulf of Mexico Problems Send Oil to New Highs," *The Financial Times*, October 6, 2004.

²⁶ "Surge in Price of Oil Poses Little Threat to US Economy," *The Financial Times*, October 6, 2004.

However, many economists remained concerned that the rise in oil prices will have a significant adverse impact upon economic activity in the coming quarters. 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, despite the cartel's increases in output. 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.

Economic Outlook 2004

The Conference Board's Leading Economic Indicators decreased in July, August, and September by 0.3%, 0.3%, and 0.1%, respectively to end the quarter at 115.6. As a result, the leading index declined four consecutive months²⁷. Six of the ten indicators declined in July, seven declined in August, and five declined in September. For the six months ending in September, the LEI decreased 0.2%. In the October 21, 2004 LEI press release for the month of September, the following conclusion is presented:

While the leading index is not yet signaling a downturn, the growth rate of the leading index has slowed below its long-term trend growth rate, which is consistent with real GDP continuing to grow 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 2005²⁸. 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. The Organisation for Economic Co-operation and Development forecasts that the U.S. economy will grow by 4.3% in 2004, down slightly from its earlier forecast of 4.7%²⁹. However, the OECD still expects the leading world economies to

²⁷ From The Conference Board's August 19, 2004, September 23, 2004 & October 21, 2004 press releases for US Leading Economic Indicators.

²⁸ Changes are from average for fourth quarter of previous year to average for fourth quarter of year indicated.

²⁹ "OECD Sees Recovery in World Economic Growth for Second Half," *The Financial Times*, September 22, 2004.

experience strong growth in the second half of the year with the G6 (the U.S., Japan, Germany, France, Italy, and the UK) growing by 3.5%.

Economic conditions should remain favorable for the remainder of 2004 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 favorable for solid economic growth, despite the increase in oil prices during the first three quarters. Our expectations for the economy include:

- Real GDP growth of 3 $\frac{3}{4}$ % - 4 $\frac{1}{2}$ % for 2004. Real GDP growth of 4 $\frac{1}{4}$ % - 4 $\frac{3}{4}$ % for 2005.
- 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 $\frac{1}{2}$ % - 2%. The core CPI is anticipated to increase by roughly 1 $\frac{3}{4}$ % - 2 $\frac{1}{4}$ % in 2004.
- 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 $\frac{1}{2}$ % for the year. For 2005, the unemployment rate is likely to fall to roughly 5% 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 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 North Korea may exert further upward pressure on prices as well as further turmoil in Russia surrounding Yukos. Instability in Iraq and speculation in the futures markets will also likely keep energy prices at artificially inflated levels. WTI is likely to average \$45 per barrel in the fourth quarter. As speculators unwind their positions in the futures markets, perhaps in the first half of 2005, oil prices are likely to fall to an average of \$35-\$40 per barrel.

- 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.
- 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

The U.S. economy continued to experience a favorable growth trend in the third quarter with GDP increasing at an annual rate of 3.7%. Though tempered in the second quarter, personal consumption expenditures were strong once again in the third quarter despite the continued rise in energy prices. Though the housing market remained robust, data presented in the Federal Reserve Beige Book indicated some signs of cooling despite a surprising decline in long-term interest rates largely expected to spur a new round of refinancing. Though oil prices are likely to remain high during the fourth quarter and into 2005, increased production by OPEC and unwinding of speculative positions may aid in reigning prices to a more sustainable long-term level. In addition, the presidential election will be resolved, thus removing some concerns and uncertainty weighing on the markets—particularly if there are no protracted legal battles or disputes regarding the outcome of the election. Based on the state of the economy in the third quarter, conditions appear favorable for stable economic activity for the rest of 2004 and into 2005.