

***Overview of the U.S. Economy***  
***September 30, 2007***

The problems in the subprime mortgage market, along with the spiraling housing market, have economists across the country worried about the risks of recession. The fact that the Federal Reserve Board (Fed) lowered interest rates by a greater-than-expected half a percentage point to 4.75 percent, and cut the discount rate by half a point to 5.25 percent, is recognition that the economy is under pressure.

On the other hand, most Federal Reserve Districts reported economic activity continued to expand through the third quarter of 2007, though in some areas the rate of expansion has slowed.<sup>1</sup> Liz Ann Sonders, chief investment strategist with Charles Schwab & Co. reports low inflation and a healthy money supply are two positive forces in the current U.S. economy, while high oil prices and increasing unemployment claims are negative indicators, as indicated in the table below.<sup>2</sup>

***Table 1: Current U.S. Economic Picture***

POSITIVES	NEGATIVES
Low inflation	Oil at \$80 barrel
Low long-term interest rates	Sudden increase in unemployment claims
Healthy liquidity (money supply)	Declining home sales
Healthy corporate balance sheets	Weak construction and capital spending
Lean inventories	Vehicle production costs

Source: Liz Ann Sonders, Charles Schwab & Co.

***Gross Domestic Product***

Gross Domestic Product (GDP), the output of goods and services produced by labor and property in the U.S., is the broadest measure of economic activity. In the second quarter of 2007 real GDP increased at an annual rate of 3.8 percent, compared with a 0.6 percent in the first quarter. As shown in the table below, the rate of growth in real GDP has slowed during the past three years.<sup>3</sup>

**Table 2: Gross Domestic Product**

	2004	2005	2006	2007 (F)
Real GDP	3.6	3.1	2.9	2.0
Personal Consumption	3.6	3.2	3.1	2.8
Corporate Profits Before Taxes*	24.0	11.5	13.2	1.0

Source: Wachovia Economics Group, September 28, 2007. \*Year-over-Year Percentage Change.

According to the Bureau of Economic Analysis (BEA), the growth increase in real GDP during the second quarter is due primarily to positive contributions from personal consumption expenditures for services, exports, nonresidential structures, federal government spending, state and local government spending, and equipment and software. These expenditures were offset to a degree by a negative contribution from residential fixed investment, and a decrease in imports, which are a subtraction in the calculation of GDP.<sup>4</sup>

In response to the GDP increase Commerce Secretary Carlos M. Gutierrez remarks: “Our second quarter GDP growth shows the remarkable flexibility and resiliency of our economy in the face of some substantial challenges. Today’s report confirms that the economy was able to switch gears and derive a significant boost from rising net exports. For almost six years we’ve experienced uninterrupted economic growth and historically low levels of unemployment that are better than the average in each of the past four decades.”<sup>5</sup>

### ***Inflation***

Core consumer prices increased 0.1 percent in August, the smallest increase in more than three years and a change that may relieve fears of inflation.<sup>6</sup> The Consumer Price Index (CPI), which reflects changes in prices for the goods consumers pay over a period of time, decreased 0.1 percent in August and 2.4 percent year over year. According to Wachovia Corporation economist Mark Vitner, the economic factors concerning the core CPI were declining gasoline prices, moderate housing costs, and moderating medical costs. However, increases in food prices offset some of the gains.<sup>7</sup>

The personal-consumption-expenditures (PCE) deflator, a key gauge watched closely by the Federal Reserve, increased 1.8 percent between August 2006 and August 2007, an increase that is “within the Fed's comfort zone of between 1% and 2% for inflation,” writes Elizabeth Strott for *MSN Money*.<sup>8</sup> On the other hand, “Core inflation is near the upper end of the Fed’s comfort zone,” writes Vitner.<sup>9</sup> This “will mark the end of the year-over-year "honeymoon" for various U.S. headline inflation measures since the jumbo commodity price free fall starting in August of last year,” writes Michael Englund of *Business Week Online*.<sup>10</sup>

After increasing 0.6 percent in July, producer prices decreased considerably in August. The decrease is attributed to lower energy prices, especially gasoline, which in August fell 6.6 percent 13.8 percent respectively.<sup>11</sup> The 49 forecasters surveyed by the Federal Reserve Bank of Philadelphia reduced their near-term estimates for core inflation in August 2007. Core PCE inflation is estimated at 1.9 percent this year, a decrease from the previous estimate of 2.1 percent.<sup>12</sup>

***Employment and Labor***

The nation’s payrolls declined in August for the first time in four years, suggesting that the employment situation may not be as grim as last month's decline in payrolls suggested. Employment increased in September, and the unemployment rate is as its lowest rate in two years, and remained unchanged at 4.7 percent, as indicated in the table below. The health care, food services, and professional and technical services sectors continued to add jobs in August; the manufacturing and construction sectors trended down. Average hourly earnings rose by or 0.4 percent, or seven cents.<sup>13</sup>

***Table 3: Unemployment***

	2004	2006	2006	2007 (F)
Unemployment Rate	5.5	5.1	4.6	4.6

Source: Wachovia Economics Group. September 28, 2007. \*Year-over-Year Percentage Change.

The Fed reports every District reported “at least modest increases in employment” during the recent survey period, except Chicago. Still, some districts, such New York,

Richmond, Atlanta, Minneapolis, and Dallas, described their labor markets as tight. Shortages of some skilled workers were reported in nine of the twelve Districts.<sup>14</sup>

### ***Consumer Spending***

Consumer spending is an important indicator of how the economy is doing because it makes up about 70 percent of the nation's economy. Consumer spending increased by 0.6 percent in August - the most positive activity in four months.<sup>15</sup> Automobile sales, a carefully watched indicator of consumer sentiment, are showing an improvement. Light motor vehicle sales increased in August over July, marking the first increase in 2007. Nevertheless, the drop of 4,000 non-farm jobs in August has some economists worried that the wavering market for new and existing homes will cause cutbacks in consumer spending.

However, consumers are still leery of the nation's economy. The Conference Board Consumer Confidence Index declined in August and September. The Index is currently at 99.8 (1985=100). "The Consumer Confidence Index is now at its lowest level in nearly two years (Nov. 2005, 98.3). Weaker business conditions combined with a less favorable job market continue to cast a cloud over consumers and heighten their sense of uncertainty and concern," remarks Lynn Franco, Director of The Conference Board Consumer Research Center."<sup>16</sup>

### ***Construction and Housing Starts***

Residential real estate and construction weakened further throughout the country while commercial construction remains solid. According to the Bureau of the Census, privately-owned housing units authorized by building permits were at a seasonally adjusted annual rate of 1,307,000 in August - a 5.9 percent decrease from the revised July rate of 1,389,000, and a 24.5 percent decrease from the revised August 2006 estimate of 1,731,000.<sup>17</sup>

Real estate sales and prices have been declining for almost two years. The S&P/Case Shiller home-price index reports home prices in 20 U.S. metropolitan areas declined 3.9 percent in the 12 months through July - most since the measure began in 2001.<sup>18</sup> According to a survey of economists by Bloomberg News, purchases of new and

existing homes dropped to a 6.32 million pace from a 6.62 million rate in July - the fewest since November 2001. It is expected that sales and prices will continue to drop because worries concerning subprime loans have made mortgages more difficult to get.<sup>19</sup>

Many believe that the recent instability in the mortgage finance system is having a negative impact on the housing market. "As our surveys have been showing, the credit crunch continues to take a heavy toll on consumers and builders alike," said Brian Catalde, president of the National Association of Home Builders (NAHB).<sup>20</sup> Home builder Lennar Corp. reported larger-than-expected losses for the third quarter. Jeffrey Mezger, KB Home's president and chief executive recently remarked: "We see no signs that the housing market is stabilizing and believe it will be some time before a recovery begins." Joseph Brusuelas, chief U.S. economist at IDEAglobal concurs: "This is staggering." Any similar price declines, he said, are "going to be debilitating."<sup>21</sup>

Nevertheless, the National Association of Realtors (NAR) is optimistic that the Fed's decision to ease its monetary policies will give a slowly rebounding housing market a boost. "The housing market has been correcting itself and restoring affordability. With interest rates on many conventional loans still at near historic lows and today's rate cut possibly making loans even more affordable, we believe the housing market will begin to recover over the coming year," says Pat V. Combs, NAR's president.<sup>22</sup>

Non-residential construction activity is offsetting the waning housing market. The Commerce Department reports a 2.3 percent increase in spending on office buildings, shopping centers and other non-residential projects, the biggest increase in this category in six months.<sup>23</sup> Public construction spending increased 1.2 percent in July and 0.7 percent in August, resulting in a year-over-year rate of 14.7 percent.<sup>24</sup>

### ***Manufacturing and Durable Goods***

Manufacturing activity was mostly upbeat positive across the country, according to the Fed.<sup>25</sup> John Engler, president of the nation's largest manufacturing trade group, the National Association of Manufacturers, concurs. "We think some of the fundamentals in the U.S. economy are still pretty strong as far as manufacturing is concerned. Exports are

up, and productivity is increasing for U.S. manufacturers. We just want to see steady progress being made."<sup>26</sup>

The Institute for Supply Management<sup>TM</sup> (ISM) also reports good news for manufacturers. The ISM's latest Manufacturing *ISM Report On Business*<sup>®</sup> reveals that economic activity in the manufacturing sector expanded in August for the seventh consecutive month. Norbert J. Ore, C.P.M., chair of the Institute for Supply Management<sup>TM</sup> Manufacturing Business Survey Committee remarks: "Viewed from the manufacturing sector, the overall economy continues to grow at a significant rate. In comparing August to July, the rate of growth in manufacturing was slightly less but continues the expansion, although at the slowest pace in the past five months. Both the New Orders Index and the Production Index are encouraging for continuing growth as we head toward the fourth quarter of 2007."<sup>27</sup>

The Purchasing Manager's Index, a leading indicator of the economic health of the manufacturing sector in the eyes of the Fed, shows that manufacturing increased at a slower rate in August. The PMI, which is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment, registered 52.9 percent in August, compared with July's reading of 53.8 percent. Nevertheless, the current PMI of 52.9 indicates the overall economy and the manufacturing sector are growing. A reading above 50 percent shows that the manufacturing economy is generally expanding and a reading below 50 percent indicates that it is generally contracting.<sup>28</sup>

### ***Interest Rates and the Stock Market***

The Federal Open Market Committee (FOMC)'s surprised the nation with a surprisingly large federal funds rate cut of 50 rather than 25 basis points. The decrease, from 5.25 percent to 4.75 percent, was the first drop since mid-2003. The reasoning behind the cut was that the tighter credit conditions could possibly worsen the housing downturn and put the overall economy at risk.<sup>29</sup> "The cut stirred much excitement; global stock markets jumped sharply. But only history can judge whether he made the right move," writes Robert J. Samuelson in *The Washington Post*.<sup>30</sup>

The combination of a meltdown in the housing, mortgage and the credit markets - caused the markets to correct this summer. Stocks dropped more than 10 percent off the year's high points.<sup>31</sup> Nevertheless, the market improved in September. "Despite a brief drop in momentum in the summer, which was linked to jitters from the sub-prime crisis, the cut in the Fed Funds rate in September got the market back on track toward achieving record issuance levels in 2007," notes Renaissance Capital.<sup>32</sup>

Closing stock market averages (except the Tokyo Nikkei Exchange) realized double digit increased over the past twelve months. For example, the Dow Jones Industrial Average increased by 19.7 percent, the Standard & Poor's 500 increased by 16 percent and the NASDAQ Composite increased by 20 percent.<sup>33</sup>

Table 4 below presents forecasted interest rates provided by Nomura Securities International, Inc.<sup>34</sup>

**Table 4: Interest Rates (monthly average %)**

	2006	2007	2008	2009
	Q4 to Q4 % Change			
Fed Funds	4.96	5.08	4.50	4.50
2 Year Treasury Note	4.82	4.48	4.10	4.38
5 Year Treasury Note	4.75	4.52	4.36	4.58
10 Year Treasury Note	4.79	4.67	4.55	4.76
Conventional Mortgages	6.41	6.40	6.23	6.26
AAA Corporate Bonds	5.59	5.61	5.83	5.99

Source: Nomura Securities International, Inc. *NSI Baseline Forecast* September 28, 2007.

### **Summary and Outlook**

Despite the Fed's move to curb the threat of recession, the U.S. economy still faces significant challenges. Martin Feldstein, economics professor at Harvard University and president of the National Bureau of Economic Research warns: "A sharp decline in house prices and the related fall in home building ... could lead to an economy-wide recession."<sup>35</sup> The Fed is expected to cut short-term interest rates at its October 31 FOMC meetings in an effort to keep the problems emanating from the housing market from spreading to other parts of the economy.<sup>36</sup>

Still, there is generally an improving trend in overall economic activity, although the positive aspects are more heavily weighted towards gains in fixed business investment and net exports. While consumer spending is still strong, the weakening job market and the problems in lending “set the stage for a visible spillover of housing weakness into both consumer and capital spending,” reports Ed McKelvey, a senior economist at Goldman Sachs Group Inc. However, while Goldman lowered its growth estimate from the fourth quarter through the end of 2008, its revised forecast doesn’t include a recession.<sup>37</sup> *Value Line* analysts predict the GDP’s rate of growth will slow to as little as two percent during the rest of 2007 and through early 2008.<sup>38</sup> November’s National Association for Business Economics (NABE) survey of 50 forecasters suggests cautious optimism for economic growth in 2007.

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<sup>3</sup> “Monthly Outlook.” Wachovia Economics Group. September 12, 2007. Internet: [www.wachovia.com/ws/econ/view/0,,3945,00.pdf](http://www.wachovia.com/ws/econ/view/0,,3945,00.pdf)

<sup>4</sup> “News Release: Gross Domestic Product and Corporate Profits.” Bureau of Economic Analysis. September 27, 2007. Internet: <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>

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