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Remarks on the Economic Outlook
at the CFA Day luncheon, Louisville KY

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Views expressed herein are solely those of the author, and are not necessarily those of the Federal Reserve Bank of St. Louis, the Board of Governors of the Federal Reserve System, the Federal Open Market Committee, or their staffs. I wish to thank Kevin Kliesen and Charles Gascon for assistance.

Overview

During the first quarter, the U.S. economy grew at its slowest pace in more than four years. Recent incoming economic data from labor, product, and financial markets suggest that the economy is strengthening. Forecasters now expect that real GDP will increase during the second quarter at approximately its longer-run trend annual growth rate of about 3 percent.

In response to the rebound suggested by recent data, financial markets largely expect the Federal Open Market Committee to maintain the federal funds rate target at its current level for the balance of the year. The greatest risk to growth is a rebound of inflation. Currently, abstracting from higher energy costs, underlying core inflation in most goods and services continues to slow.

Turning to specifics:

- Real output of goods and services in the U.S. economy increased at a sluggish 0.6 percent annual rate in the first quarter of 2007. This was the slowest pace since the fourth quarter of 2002. Forecasters foresee stronger growth during the current quarter, near to real GDP's long-term 3 percent trend. In large part, the first-quarter fillip was due not to a slowdown in domestic demand for goods and services—final sales of goods and services to domestic purchasers increased at a 2-1/2 percent annual rate. Rather, the weakness largely reflected residential housing—the combined effects of sharply slower construction activity and a reduction in inventory.
- Consumer spending remains solid, growing at about a 4 percent rate in the first quarter. Some analysts had feared that weakness in house prices would attenuate consumer spending—in fact, robust gains in disposable income suggest continuing strength. A risk is the jump in gasoline prices, which some analysts fear will slow the growth of consumer spending in the second quarter to about half of its increase during the first quarter. But, such predictions are highly uncertain. Data released today show that retail sales, net of gasoline, increased 1.2 percent in May.
- Domestic light vehicle sales, after rising 1-1/4 percent in April, fell about 1-3/4 percent in May. A nearly 11 percent jump in retail gasoline prices led to a nearly 9 percent decline in domestic light truck sales. Since then, gasoline prices have retreated a bit and futures prices point to further decreases. Helping to reduce gasoline prices was a 31 percent jump in gasoline imports between April and May, but these imports also contributed to a larger trade deficit and further downward pressure on the U.S. dollar relative to other currencies. Most analysts expect 2007 light vehicle production in the United States to be approximately unchanged from 2006, at 15.3 million units. Industry analysts also see only a small shift in product mix, from 45 percent light trucks to perhaps 43 or 44 percent.
- “Cap X” -- business capital spending on equipment and software – is strengthening but remains below many analysts expectations, given strong product demand and relatively low financing costs due to rising equity prices and attractive debt market interest rates. New orders for nondefense capital goods excluding aircraft rose 2.1

percent in April following a 4.6 percent jump in March. As a result, industrial production posted solid gains in both months, and business confidence strengthened in May. The Institute for Supply Management's manufacturing and non-manufacturing indices both posted stronger-than-expected gains last month.

- Residential housing remains a question mark. Although lower than one year ago, housing starts increased modestly during the past three months (through April), and new home sales jumped sharply in April. Despite this favorable news, many forecasters regard the new home market as overbuilt with significant excess supply of finished unsold new homes. Forecasters differ with regard to the anticipated decrease in residential housing investment this year, with predictions ranging between 7 and 11 percent this year, relative to last year's record pace.
- Recently, a great deal of public attention has focused on the subprime mortgage market. In fact, this is small potatoes. Among outstanding mortgages, only subprime ARMs are experiencing unusual difficulty—in 2006 Q4, these were less than 8 percent of all outstanding mortgages (and only about half of all subprime mortgages). Nationally, during the fourth quarter of last year, less than 1 in 10 subprime ARMs was in foreclosure or delinquent by 90 days or more—and of those loans, the highest rates are in the Midwest: Ohio (19 percent), Michigan, Indiana, Iowa, and Kentucky (where 13 percent of subprime ARMs were delinquent). Further, the unexpectedly high delinquency rates are concentrated among loans made during late 2005 and 2006. Care must be taken in analyzing these numbers. For at least some borrowers hard-hit by the shrinkage of manufacturing employment, a subprime ARM during the last two years was forbearance against foreclosure and loss of their home; for homeowners whose economic situation has not improved, their delinquency is only a re-appearance of the same financial problem. In California—often cited in the press as a major problem area due to high house prices and creative loan contracts—delinquency rates in the fourth quarter were less than 6 percent for subprime ARMs and 2-1/2 percent for subprime fixed rate mortgages. Further, servicers of subprime mortgage loans, seeking to maximize investor return, are reported to be renegotiating terms, providing forbearance, and taking other measures to minimize foreclosure. No one can be certain what the future will bring but, for now, I suggest avoiding the crisis mentality heard in some newscasts.
- Labor market conditions improved by more than expected in May, as nonfarm payroll employment rose by 157,000. Year-to-date, monthly payroll gains have averaged a very respectable 133,000. In the May survey, the Philadelphia Fed's Survey of Professional Forecasters (SPF) projected that job gains during the coming 12 months will average between 100,000 and 130,000 per month. The unemployment rate remained at 4.5 percent in May. The national unemployment rate has been below respected estimates of the long-run neutral rate of unemployment, including those of the Congressional Budget Office, since December 2005.
- Inflation remains the greatest risk to the economic outlook. Some, if not most, policymakers likely regard as unacceptable the cost to the economy of distortions that arise when inflation is greater than approximately 1-1/2 to 2 percent. "Headline" inflation pressures moderated in April following relatively large gains in February and March—the overall consumer price index in April rose "only" at a 5.1 percent annual rate, rather than its March pace of 7.6 percent. Year-to-date since January, both the

overall consumer price index and the less well-known price index for personal consumption expenditures have increased at rapid 4 percent annual rates. This experience is unusually similar to one year ago when increases were 4-1/2 percent and 4 percent, respectively. Yet, monetary policymakers have little influence over the main culprit in these increases, energy costs—the consumer price index for energy increased 10 percent in March and 4-1/2 percent in April (monthly, not annual, rates of increase). Excluding food and energy, consumer prices have increased this year at a modest, but unacceptably rapid, 2-1/4 percent pace. In its May 9 statement, the FOMC cautioned that, while it anticipates a moderation of inflation by year-end, it is prepared to make policy adjustments if that does not occur.

- In financial markets, interest rates, bond yields, and equity prices are consistent with an improving economic outlook. Although stock market indexes often fluctuate widely, the direction generally has been up: the Wilshire 5000 index of stock prices (perhaps the closest broad index to households' stock holdings) posted a healthy 3 percent increase in May after rising more than 4 percent in April. Since May, yields on 2- and 10-year nominal Treasury securities have each risen by about 25 basis points and the 5-year constant maturity yield recently passed 5 percent. Patterns of current, future, and forward yields suggest that financial markets place a low probability on a reduction in the FOMC's federal funds target rate this year.
- In foreign exchange markets, the trade-weighted value of the U.S. dollar (measured against a broad array of currencies) has decreased approximately 3 percent since the beginning of the year, including declines against the Canadian dollar, the euro, and the British pound—all important U.S. trading partners. By contrast, the U.S. dollar continues to strengthen against the Japanese yen; the dollar has gained about 2-1/4 percent since the first of the year and more than 8 percent over the past 12 months. The fall in the dollar's value has occurred simultaneously with, and contributed to, a leveling off of the U.S. foreign trade deficit. This deficit—which increased steadily from near zero during the late 1990s to \$600 billion at the end of 2004—has, since the end of 2004, remained quite steady at that pace, encouraged by the 20 percent or so decrease in the value of the dollar that has occurred during the last 5 years. This stability also reflects robust economic growth at our trading partners.
- In other countries, the growth outlook for our trading partners is favorable. The Organization for Economic Co-operation and Development (OECD) projects, for 2007, a worldwide growth rate of 2-1/2 percent, modestly slower by 1/2 percentage point from 2006—but much of the slowing reflects slower growth in the United States itself. The pause is expected to be temporary—for 2008, real growth is projected to rebound to 2-3/4. Inflation in the OECD, unfortunately, is projected to be higher in 2007. Measured by the GDP deflator, the OECD foresees a worldwide inflation to increase by 1/2 percentage point, to a 2.3 percent pace—the most rapid in three years. Certainly, some part reflects energy costs—but these costs are expected to stabilize. In their recommendations, the OECD argues that monetary policymakers should seek a firm policy “so long as core inflation remains high.” Recently, some foreign central banks have increased their policy target interest rates to forestall further inflationary pressures, including 25 basis point increases by the Bank of England, the European Central Bank, and the Swiss National Bank.