

Global Indicators

U.S. Financial Markets
August 2006



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Monthly Financial Market Highlights August 2006

- *The Beige Book prepared several weeks prior to a meeting of the Federal Open Market Committee shows economic growth slowed in most Districts of the United States.*
- *The financial future's market projects a 40 percent probability the central bank will increase the trading range of federal funds another ¼ of one percent by year-end.*
- *Officials at the Federal Reserve project inflation to accelerate for the remainder of 2006 but believe appropriate monetary policy will alleviate some of the price pressures by 2007.*
- *The yield curve inverts in July trading and increases the probability of a recession occurring in the United States within the next twelve months, but stable corporate bond credit spreads discount a likely contraction.*
- *The federal fiscal deficit is projected to decrease to under U.S. \$300 billion for fiscal year 2006 given strong tax revenue growth; the deficit is expected to increase in 2007.*
- *Consumer and producer prices continue to exhibit worrisome trends that range between four and five percent over the past year; the financial markets project the central bank will curtail price pressure and expect average annual inflation of 2.6 percent over the next decade.*
- *The Index of Leading Indicators increases in June but decreases for the first half of 2006, which is consistent with the economy expanding at a rate less than three percent.*
- *Industrial production increases sharply in June and capacity utilization rates top 82 percent as factories, mines and utilities all report strong growth.*
- *The equity market's perception of earnings growth changes little in July trading and maintains a price-earnings multiple of 13.9 times next year's earnings.*
- *Retail sales exhibit little growth mid-year despite job growth and an unemployment rate of 4.6 percent.*
- *New home sales, existing home sales, housing starts and building permits all decline as the supply of homes on the market sharply increase and price appreciation is now limited.*
- *Increased commercial construction expected to offset some weakness in the residential market given high capacity utilization rates and expanding employment.*

Monthly Financial Market Trends August 2006

Pace of Growth Slows

Federal Reserve "Pause" Projected

Gross domestic product (GDP) increased by an annualized pace of 2.5 percent in the second quarter of 2006 versus the blistering and unsustainable rate of 5.6 percent posted in the first quarter of the year. The *Beige Book* prepared by the Federal Reserve System several weeks prior to a meeting of the Federal Open Market Committee (FOMC) indicated, "Reports from all twelve Federal Reserve Districts generally indicated continued economic growth during June through mid-July, with numerous individual reports pointing to evidence that the pace of growth has slowed. Increases in wages and in prices of final goods and services remained modest on net. Upward pressure from

the elevated prices of energy and other inputs persisted." The tepid growth and anecdotal information regarding inflationary pressures contained in the *Beige Book* suggest the FOMC may pause from raising interest rates in their early-August or mid-September meetings. The financial future's market now assigns a 30 percent probability the central bank will raise rates another ¼ of one percent by September and a 40 percent probability by year-end. It remains too early to determine if the prior 17 increases in the trading range of federal funds by the FOMC will be sufficient to achieve a "soft landing" or whether the rate shocks will "overshoot" and lead to an economic recession next year.

Table 1
Monthly Interest Rate Trends

Money Market (Three-month)	July 2006		June 2006		
	Rate	Spread	Rate	Spread	
U.S. Treasury Bill		5.08%	0.00%	4.89%	0.00%
Commercial Paper	5.44%	0.36%	5.35%	0.46%	
Certificate of Deposit	5.50%	0.42%	5.43%	0.54%	
Capital Market (20 to 30 Years)					
U.S. Treasury Bond	5.20%	0.00%	5.35%	0.00%	
Corporate Bond					
High-grade (Aa)	6.20%	1.00%	6.34%	0.99%	
Medium-grade (Baa)	6.59%	1.39%	6.75%	1.40%	
Low-grade (B)	8.46%	3.26%	8.59%	3.24%	
Mortgage-backed Security					
Fannie Mae (FNMA)	6.22%	1.02%	6.31%	0.96%	

Source: *The Wall Street Journal* and *Merrill Lynch Indices*

Table 1 illustrates the monthly change in U.S. interest rates for key short-term money market, and long-term capital market instruments. Interest rates respond to shifts in the global supply of and demand for funds, and to perceptions of expected inflation. Short-term U.S. Treasury bill interest rates increased another 20 basis points in the hot month of July while long-term U.S. Treasury bond interest rates declined 15 basis points. The increase in money market interest rates reflects continued monetary tightening implemented by the Federal Reserve. The long-term interest rates declined given lesser growth and expectations the central bank will remain vigilant against inflation. Alan Greenspan has often noted, "Inflation represents bad money." The *Press Release* provided by the FOMC after their late-June meeting said,

"Although the moderation in the growth of aggregate demand should help to limit inflation pressures over time, the Committee judges some inflation risks remain." The central bank is clearly concerned with containing price pressure.

Table 1 also illustrates the monthly shift in interest rate spreads; a spread reflects the difference in yield between a corporate or agency security and a U.S. Treasury instrument of comparable maturity. Interest rate spreads change in response to perceptions of and tolerance for risk by investors and traders. Credit spreads changed little in the first month of the III quarter of the year. The economy continues to expand, albeit at a lesser pace consistent with expectations that inflationary pressures will subside.

Table 2
Monthly Interest Rate Spread Trends

Spread	July 2006	June 2006
Yield Curve	-0.04%	0.31%
Medium-grade Corporate	0.39%	0.41%
Low-grade Corporate	2.26%	2.25%
Inflation	2.60%	2.59%

Source: The Wall Street Journal and Merrill Lynch Indices

Several interest rate spread relationships, to include the yield curve spread, corporate bond credit spreads, and the U.S. Treasury Note/Treasury Inflation-protected Security spread provide information that may be used to project future economic conditions, and to confirm recently -released information about trends within the U.S. economy. Although individual indicators may provide false indications of strength or weakness, the composite spreads provide a reasonable representation of market expectations. Table 2 illustrates the monthly trend for each of the key interest rate spreads.

- **Yield Curve Spread** -- The yield curve provides a graphical relationship between the yield and the remaining term of a U.S. Treasury security. The yield curve spread is defined as the difference in yield between ten-year U.S. Treasury notes and three-month U.S. Treasury bills. The slope of the yield curve partly reflects expectations of interest rates in the future. A negative slope suggests the market expects interest rates to decrease in the future, and highlights the market's fear the central bank will "overshoot." The yield curve spread has approximated 180 basis points over the past 20 years. The yield curve spread plunged

from over 300 basis points in 2003 and almost 200 basis points in 2004 to the current negative level as of mid-year 2006. The spread plummeted from a positive 31 basis points as of June to negative four basis points as of July. Based on historical experience, the slight negative spread to the yield curve suggests a **20 to 30** percent chance of a recession occurring in the United States during the next twelve months. A recession is not yet likely. A contraction could occur if the household sector curtails retail spending as a result of being unable to refinance home loans with equity takeouts, or is unable to maintain income given tepid job growth or low wage gains.

- **Corporate Credit Spreads** -- The corporate credit spread reflects the difference in yield between corporate securities of comparable maturity but different asset quality. The low-grade corporate bond spread provides an especially good gauge of the market's perception of and tolerance for credit risk. The yield spread between low-grade (e.g., BB, B and CCC credit ratings) and high-grade (e.g., AAA and AA ratings) corporate debt was largely unchanged in July trading. The 226 basis point spread is less than 250 basis points exhibited at the beginning of the year. The corporate bond spread decreases when traders believe the economy will continue to expand and/or investors are willing to accept more credit risk to obtain higher portfolio returns. Meanwhile, the spread between medium-grade (e.g., A and BBB ratings) and high-grade corporate bonds declined by two basis points to 39 basis points as traders and portfolio managers head to summer vacations at the shore. The credit market shows investors continue to believe the U.S. economy will expand, albeit at a lesser pace, and do not project an eminent recession.
- **Inflation Spread** -- The popular price indices illustrate **historical** price trends. Core consumer prices have increased by 2.6 percent over the last year while core

producer prices have increased by 1.9 percent. The financial markets can be analyzed to identify **future** inflation expectations by focusing on the difference between the nominal yield for 10-year U.S. Treasury notes, which were used to derive the U.S. Treasury yield curve spread, and the real rate for 10-year Treasury Inflation-protected securities. The inflation spread increased by about 30 basis points during the first half of 2006 but changed little in July. The financial markets project average annual inflation of approximately 2.6 percent over the next decade, which is consistent with recent price experience. The value of the dollar is hurt when foreign exchange traders perceive inflation will persist or accelerate. After gaining value for much of 2006, the U.S. dollar declined .9 percent against the euro and .3 percent against the yen in July trading. The cost of imported goods increases when the U.S. dollar loses value and exporters can more easily increase the price of their goods given the less expensive dollar cost of exports.

The U.S. financial markets have been little affected by the outbreak of war between Lebanon and Israel, and the increase in terrorist activity in Iraq. The commodity markets, by contrast, have reacted to the global tension and potential for sharply higher cost of oil given global unrest. Gold prices jumped eight percent and oil prices increased five percent in July trading. The U.S. economy has proven resilient to domestic terrorism, such as 9/11, and the devastating hurricane season of 2005 to maintain an enviable path of sustainable growth since 2003. The *Blue Chip Economic Forecasters*, however, project GDP growth over the next year will drift below long-run experience of approximately three percent. Continued economic expansion will be achieved if the central bank is successful in its fight against inflation, and if job gains and wage growth are sufficient to offset unmistakable weakness developing in the housing market.

Inflation Indicators Remain Elevated

The popular price indices continue to show evidence of accelerating price pressure.

- Gold prices jumped 8.6% in July while oil prices increased 5.2%. The higher cost commodities suggest heightened inflation pressures remain within the U.S. market.
- The Consumer Price Index increased .2% in June; consumer prices have increased 4.3% during the past year. Core consumer prices, which remove volatile energy and food costs, jumped .3% in June and are now 2.6% above year-earlier levels.
- The Producer Price Index soared .5% in June; producer prices have increased 4.9% during the past year. Core producer prices increased a more moderate .2% in June and are just 1.9% higher than a year ago.
- The core rate of inflation derived from the Personal Consumption Expenditure (PCE) Index increased .2% in May and is 2.1% above year-earlier levels. The FOMC closely tracks this index and selected voting members at the central bank prefer the inflation gauge to range between one and two percent.
- The costs of imports increased just .1% in June but are 7.2% higher than a year ago. The costs of exports, by contrast, increased .8% in June and are 4.2% higher than 2005.

The FOMC has now increased interest rates 17 times in the last several years as the central bank changed its monetary stance from one of accommodation to neutrality. The *Press Release* compiled after the late-June FOMC meeting indicated, “The extent and timing of any additional firming that may be needed to address

inflation will depend on the outlook for both inflation and growth.” The consensus outlook by the Federal Reserve suggests inflation will not subside soon.

Federal Reserve officials now project higher inflation than previously forecast six months ago.

- The 2006 core rate of inflation applicable to the PCE Index increased from a projection of about 2.0% in February to a range between 2.25% and 2.50% as of July.
- The 2007 core rate of inflation applicable to the PCE Index increased from a projected range between 1.75% and 2% in February to a range between 2.00% and 2.25% as of July.

The forecast suggests the central bank project lesser inflationary pressure next year. However, the FOMC may need to raise interest rates another ¼ of one percent to ensure that projection is realized.

The federal government’s fiscal deficit is benefiting from strong tax payments by companies and individuals. The Office of Management and Budget now project the 2006 fiscal deficit will equal U.S. \$296 billion versus the \$318 billion of red ink in 2005 and \$413 billion shortfall posted in 2004. The lesser deficit reflects tax revenues growing at an eleven percent pace versus expenditure growth of nine percent. The deficit is projected to again increase to \$339 billion in fiscal year 2007 as tax revenue growth slows. The fiscal drain on the economy is expected to equal 2.3 percent of GDP this year and 2.4 percent in 2007. The mid-year Congressional elections will focus on the war in Iraq, the still large fiscal deficit, and spending and taxation priorities. The economy will be central to evolving political platforms.

Index of Leading Indicators Inch Up

Industrial Production Improves

The Index of Leading Indicators compiled by the Conference Board increased a miniscule .1 percent in June after declining the prior two months. The Index has now dropped .3 percent in the first half of 2006, which is consistent with a slowing economy over the next year. Yet, the industrial and manufacturing sectors continue to exhibit strength.

- Industrial production increased .8% in June and is 4.9% above last year's pace.
- Capacity utilization at factories, mines and utilities increased to 82.4% in June from 81.8% posted in May and 80.3% a year ago. Plant and equipment capacity has expanded 1.9% during the past year.
- Orders for durable goods increased by 3.1% in June.
- The monthly index compiled by the Institute for Supply Management for the manufacturing sector declined to 53.8 in June from 54.4 posted in May. Despite the decline, a reading above "50" indicates expansion. The purchasing

managers polled noted strong new orders, a healthy backlog of orders and increasing new export orders.

The business sector is expanding nicely and contributing to economic growth in the face of weaker retail sales and a quickly weakening home market.

The broad-based Standard & Poors 500 Index gained 1.3 percent in July trading. Table 3 illustrates the monthly trends applicable to the equity market. The S&P 500 has appreciated just three percent over the past year, which is sharply below the 12 percent average annual return posted over the past 70 years. The price-earnings multiple implied by current prices for next year's earnings was unchanged at 13.9 times in July trading. The equity market confirms concerns raised by the inverted yield curve and governmental expectations of lesser growth in corporate tax revenues in 2007; the economy should expand more slowly for the remainder of 2006 and the first half of next year. However, a recession does not appear likely.

Table 4
Quarterly Equity Market Trends
(Standard and Poor's 500)

Standard & Poor's 500	July 2006	June 2006
Index	1,268.4	1,252.2
Price-earnings Ratio		
Trailing Year	16.7x	16.7x
Next Year	13.9x	13.9x
Dividend Yield	1.88%	1.90%

Source: *Business Week* and *Standard and Poor's Corporation*

Housing Market Retrenches

The Index of Consumer Confidence compiled by the Conference Board increased to 106.5 in July from 105.4 posted in June. Despite the small monthly improvement, consumers are less ebullient than as recently as April of this year. The proportion of households polled who currently believe the economy is “bad” increased from 15.0 percent in May to 15.5 percent in June. The consumer is most affected by job growth and wage gains.

- Consumer spending and personal income both increased by .4% in May. The savings rate of Americans remains very low at a **negative** 1.7% of personal disposable income.
- The U.S. economy added 121,000 new jobs in June, which left the unemployment rate unchanged at 4.6%. The construction sector lost about 4,000 jobs.
- Retail and food service sales declined .1% in June yet remain 5.9% above year-earlier levels.
- Sales at retail stores open at least one year ago increased a mediocre 2.6% in June; Wal-Mart posted growth of 1.2% while Neiman Marcus reported sales growth of 6.1%. Affluent Americans are benefiting more from the current condition of the economy than the middle class.
- Ford, General Motors and Chrysler all reported sharply lower car and truck sales in June relative to 2005.

Job growth and wage growth are critical if the U.S. economy is to maintain a sustainable expansion.

The housing market is weakening after a remarkable five-year run of home sales, appreciation and housing starts.

- Construction spending declined .4% in May as lesser residential activity spreads through most regions of the United States.
- Sales of new homes declined 3% in June to 1.1 million annualized unit sales.
- Sales of existing homes declined 1.3% in June to 6.6 million annualized unit sales. The median price of a home sold increased just .9% above year-earlier levels. The supply of homes on the market increased to 6.8 months relative to 4.4 months a year ago.
- Housing starts fell 5.3% in June to 1.85 million annualized unit starts. Building permits declined 4.3% and are now 14.9% lower than 2005.

The biggest risk to the economy from the deteriorating housing market will be the inability of mortgagors to refinance home loans and take-out equity to repay credit card debt, purchase new vehicles, or remodel homes. Job growth and wage gains must now provide the cash flow to support expansion. The *Beige Report* focused on the real estate sector, “Slower activity on the residential side was offset in part by firmer activity on the commercial side. Demand for commercial space was strong, and the market tightened in most Districts.” Given the now high capacity utilization rate (e.g., 82.4%) posted by factories, mines and utilities, the need for commercial real estate is increasing and will offset some of the housing market slack.

Summary

The 2.5 percent GDP growth preliminarily released for the second quarter of 2006 is consistent with the U.S. economy achieving a “soft landing.” The tepid Index of Leading Indicators over the first half of 2006 points to slower growth over the remainder of the year. The inverted yield curve now suggests a higher probability of a recession within the year but stable corporate bond credit spreads indicate the likelihood of a contraction is small.

The economy is adding jobs, but wage growth is moderate. Consumer confidence has increased, but the household sector remains wary of both current and future prospects. The industrial sector is growing, but the housing market is

showing signs of slowing and distress in some regions of the country. Inflation remains a threat but the prior monetary restraint exercised by the FOMC since 2004 appears to be achieving the desired impact. The markets expect the central bank to increase interest rates no more than one more time in 2006 given current information applicable to prices and growth. Job growth and wage gains must now offset the inability of mortgagors to refinance home loans and obtain additional cash flow that has propelled the expansion over the past five years. The market will focus on evolving data applicable to jobs, wages, retail spending and inflation for those not at the beach or shore during August.

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