

# Global Indicators

U.S. Financial Markets  
September 2006



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### Monthly Financial Market Highlights September 2006

- *Federal Reserve elects to keep trading range of federal funds unchanged at mid-August meeting of the Federal Open Market Committee (FOMC) after increasing rates in 17 previous meetings.*
- *The financial future's market assigns less than a 25 percent probability the FOMC will increase rates another ¼ of one percent for the remainder of 2006, but almost a 70 percent chance the central bank will reduce rates ¼ of one percent in first half of 2007.*
- *The yield curve retains an increasingly negative slope that corroborates expectations the central bank will reduce interest rates next year and suggests a higher probability of a recession too.*
- *Low-grade corporate bond spreads increase 10 basis points in August trading as investors and portfolio managers show preliminary concerns of a slowdown.*
- *Consumer prices have increased 4.1 percent during the last year, but the market projects the FOMC will successfully combat purchasing power problems and predict average annual inflation of 2.5 percent over the next decade.*
- *Gold and oil prices both decline in August trading; the short-term trend suggests the market is less concerned with accelerating prices as global economic growth slows to sustainable levels.*
- *The Index of Leading Indicators declines marginally in July, which is consistent with the inverted yield curve and increasing low-grade corporate bond spread.*
- *Industrial production continues to expand nicely and capacity utilization rates exceed 82 percent.*
- *Retail sales increase satisfactorily in summer months, but back-to-school sales activity recorded in August and September will provide an important indicator of the consumers' ability and willingness to spend.*
- *Employment expands by 113,000 new jobs in July, but the unemployment rate increases to 4.8 percent.*
- *New home sales and existing home sales decline markedly in July as inventory levels rise, absorption periods lengthen and prices remain flat.*
- *Construction spending for the non-residential and the public sectors offset weakness in the residential sector.*

## Monthly Financial Market Trends September 2006

### Economic Growth Moderating

#### *Federal Reserve Pauses*

The Federal Open Market Committee (FOMC) elected to keep the federal funds interest rate unchanged in their mid-August meeting. The central bank had increased the trading range of federal funds  $\frac{1}{4}$  of one percent at their previous 17 meetings; interest rates increased from a very low one percent to the current level of 5.25 percent. The *Press Release* accompanying the August meeting indicated, "Economic growth has moderated from its quite strong pace earlier in this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices." The central bank decision was not unanimous. The President of the Richmond Federal Reserve

Bank, Jeffrey Lacker, dissented; he voted for another  $\frac{1}{4}$  of one percent rise to contain inflationary pressures. Since the FOMC meeting, other Federal Reserve Bank presidents have suggested further rate increases are necessary. The Chicago Federal Reserve Bank President, Michael Moskow, warned, "Some additional firming of policy may yet be necessary to bring inflation back into the comfort zone." Similarly, the Atlanta Federal Reserve Bank President, Jack Guynn, indicated, "We must guard against the slippery slope of tolerating inflation in the name of economic growth."

**Table 1**  
**Monthly Interest Rate Trends**

Money Market (Three-month)	August 2006		July 2006	
	Rate	Spread	Rate	Spread
U.S. Treasury Bill	5.08%	0.00%	5.08%	0.00%
Commercial Paper	5.28%	0.20%	5.44%	0.36%
Certificate of Deposit	5.35%	0.27%	5.50%	0.42%
<b>Capital Market (20 to 30 Years)</b>				
U.S. Treasury Bond	4.99%	0.00%	5.20%	0.00%
Corporate Bond				
High-grade (Aa)	5.98%	0.99%	6.20%	1.00%
Medium-grade (Baa)	6.39%	1.40%	6.59%	1.39%
Low-grade (B)	8.33%	3.34%	8.46%	3.26%
Mortgage-backed Security				
Fannie Mae (FNMA)	6.03%	1.04%	6.22%	1.02%

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 were unchanged in August while long-term U.S. Treasury bond interest rates declined another 20 basis points in the hot, dry month. Long-term interest rates declined given lesser growth and expectations the central bank will remain vigilant against inflation. The *Press Release* provided by the FOMC after their August meeting said, "Readings on core inflation have been elevated in recent months, and the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures." The central bank is committed to containing incremental price pressure. The core rate of inflation derived from

the Personal Consumption Expenditure Index has increased 2.4 percent over the past year, which exceeds the upper limit of two percent preferred by selected voting members of the FOMC.

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. Money market spreads declined in August as firms elected to borrow funds by issuing long-term bonds given very favorable interest rates in the market. Corporate bond yields have declined almost 40 basis points in the last two months. The economy continues to expand given strong business investment and commercial real estate activity.

**Table 2**  
**Monthly Interest Rate Spread Trends**

Spread	August 2006	July 2006
Yield Curve	- 0.28%	-0.04%
Medium-grade Corporate	0.41%	0.39%
Low-grade Corporate	2.35%	2.26%
Inflation	2.53%	2.60%

*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 underlying trends developing within the U.S. economy. Although individual indicators can 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." Indeed, the financial future's market expects the FOMC to decrease the trading range of federal funds by  $\frac{1}{4}$  of one percent in the first half of 2007. The yield curve spread has approximated 180 basis points over the past 20 years. The spread plummeted from a positive 31 basis points as of June to negative 28 basis points as of August. Based on historical experience, the increasingly negative spread to the yield curve suggests a 30 percent chance of a recession occurring in the United States during the next twelve months. A contraction could occur if the household sector curtails retail spending as a result of being unable to refinance home loans with equity takeouts given flat or declining home prices, insufficient job growth and 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 increased almost ten basis points in August trading. The 235 basis point spread remains less than the 250 basis points exhibited at the beginning of the year. The corporate bond spread increases when traders believe the economy will expand more slowly and/or investors are unwilling to accept more credit risk to obtain higher portfolio returns. The spread between medium-grade (e.g., A and BBB ratings) and high-grade corporate bonds also increased by two basis points to 41 basis points as traders and portfolio managers return to work after late-summer vacations.
- Inflation Spread** -- The popular price indices illustrate **historical** price trends. Consumer prices have increased by 4.1 percent over the last year while producer prices have increased by 4.2 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 had increased by about 30 basis points during the first half of 2006 but fell seven basis points in August. The financial markets project average annual inflation of approximately 2.5 percent over the next decade relative to the 4.1 percent suffered over the past year. The market remains confident the Federal Reserve will control inflationary pressure. Price pressures should subside as economic growth moderates and unemployment rates rise.

The U.S. economy is expanding more slowly; gross domestic product increased by a preliminarily estimated 2.5 percent annual rate in the second quarter of 2006. The high cost of energy, coupled with 17 interest rate increases engineered by the FOMC, are curbing demand and dampening inflationary expectations. Housing market trends represent the key sector regarding whether the economy achieves the desired "soft landing" versus a contraction. The increasingly negative yield curve spread and the increased corporate bond credit spreads suggest the market is closely analyzing evolving economic statistics and related signals.

### ***Inflation Remains High***

The central bank believes inflation will subside, "Inflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand." The recent inflation indices, however, suggest purchasing power problems remain.

- The Producer Price Index increased .1% in July and has increased 4.2% over the past year. Core producer prices, which remove volatile energy and food prices, declined .3% in July and are just 1.3% higher than 2005.
- The Consumer Price Index increased .4% in July and has jumped 4.1% during the last twelve months. Core consumer prices increased .2% in July

and are now 2.7% above year-earlier levels.

- Consumer prices and core consumer prices derived from the Personal Consumption Expenditure Index both increased .2% in June. Consumer prices derived from this index preferred by the Federal Reserve to measure inflation are 3.5% higher than 2005 while core consumer prices are 2.4% above year-earlier levels.
- Commodity prices declined a little in August trading; gold fell 2.0% and oil declined 2.9%. Lower gold and oil prices are consistent with lesser global economic growth and reduced pressure on prices.
- Import prices jumped .9% in July and are 7.0% higher than a year ago. Export prices increased .4% in July and have increased 4.4% in the last year.

Inflation remains a threat to the U.S. economy. Selected presidents of the Federal Reserve believe it is important to continue to raise interest rates until core consumer prices increase more moderately than recent evidence. Although the unemployment rate is increasing, it remains low by historical standards. More importantly, productivity or output-per-hour worked is slowing; lesser productivity increases the danger of accelerating price pressures. Capacity utilization rates are rising to levels that will also increase inflationary concerns. The FOMC acknowledge these risks in their most recent *Press Release*, “Nonetheless, the Committee judges that some inflation risks remain.” The future’s market only assigns a 24 percent probability the FOMC will **increase** interest rates on federal funds another ¼ of one percent during the remainder of 2006. The market believes there is a 68 percent probability the central bank will **reduce** interest rates by .25 percent in the first half of 2007. The financial market is more concerned with slower growth than accelerating prices.

## Index of Leading Indicators Declines

### *Industrial Production Increases*

The Index of Leading Indicators compiled by the Conference Board declined by .1 percent in July after increasing by a similar amount in June. The Index was buoyed by higher manufacturing hours worked but hurt by fewer building permits. The Index suggests modest growth ranging between two and three percent over the next half-year. The industrial and manufacturing sector continues to perform well despite the malaise spreading over other parts of the U.S. economy.

- Business inventories surged by .8% in June while sales increased by just .2%. The important inventory/sales ratio increased marginally from 1.25 in May to 1.26 in June. Despite the small increase, the ratio is lower than 1.29 posted one year ago.
- The monthly manufacturing index compiled by the Institute for Supply Management increased to a reading of 54.7 in July versus 53.8 posted in June.

A reading above “50” suggests expansion. The managers polled noted significant price pressure on the cost of goods and services purchased.

- Orders for durable goods without volatile transportation equipment included increased .5% in July.
- Industrial production increased .4% in July and has grown by 4.9% over the past year. The business equipment sector increased 1.1% in July and 12.2% during the last twelve months.
- The capacity utilization rate at factories, mines and utilities increased .1% in July to 82.4%. The utilization rate is 2.2% higher than 2005 even though capacity increased 1.9% in the year.

The industrial and manufacturing sector is performing well.

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

<b>Standard &amp; Poor's 500</b>	<b>August 2006</b>	<b>July 2006</b>
Index	1,293.0	1,268.4
Price-earnings Ratio		
Trailing Year	17.1x	16.7x
Next Year	14.2x	13.9x
Dividend Yield	1.84%	1.88%

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

The broad-based Standard & Poor's 500 equity index posted a gain of almost two percent in the "dog days" of August. The S&P index is approximately 6 percent above year-earlier levels. Table 3 illustrates the monthly trend applicable to statistics that portray the condition of the equity market. Equity traders appear to have confidence firms will be able to weather any economic slowdown because price-earnings ratios applied to either last year's earnings or next year's earnings increased over two percent during the past month. The market was cheered by the actions of the FOMC to pause and expectations that interest rates are more likely to decline than increase in the next year. Individual investors who had purchased residential real estate during the past five years are selling properties for gains and reinvesting the proceeds back into the equity market.

### ***Housing Market Tumbles***

The market created 113,000 new positions in July. As a result of the relatively slow growth in jobs, the unemployment rate increased .2 percent to 4.8 percent. Jobs are central to spending and consumer confidence.

- Consumer spending increased .4% in June while income increased .6%. During the past year, personal disposable income has increased by 1.7% and expenditures have increased

by 2.6%. The savings rate of Americans remains mired at a **negative** 1.5% of disposable income.

- Retail sales unexpectedly jumped 1.4% in July and are 4.8% above the same month in 2005. The large monthly gain will likely be tempered in the future given still high energy prices, rising unemployment rates and moderating home prices.
- Retail sales at stores open at least one year increased 3.1% in July. Sales at upscale stores, such as Neiman Marcus, increased by 7.9% while sales at discount stores, such as Wal-Mart, increased 2.4%. High energy costs fall disproportionately on low and moderate income households.

The consumer sector continues to shop because spending exceeds income. Moderating home prices are limiting the ability of mortgagors to refinance loans and take-out equity.

As expected, the residential home market is softening. Home sales and housing starts are already well off 2005 records.

- Construction spending increased by .3% in June; overall spending has increased 6.8% over the last twelve months. During the past year, residential construction is down .1%, but non-residential construction spending is up 21.6% and public spending on infrastructure and buildings is up 9.7%.
- New home sales declined 4.3% in July to 1.07 million annualized unit sales. New home sales are running almost 22% below 2005 levels. The median price of a new home sold has increased by less than ½ of one percent in the last year as builders resort to price cutting, and other give-a-ways to sell unwanted inventory.
- Existing home sales fell 4.1% in July to 6.33 million annualized unit sales. Existing home sales have declined by over 11% in the last year. The supply of homes on the market has ballooned to a very high 7.3 months.
- Housing starts declined by 2.5% in July to 1.8 million annualized starts. Housing starts are 13% lower than 2005. Home start permits have tumbled by 21% in the last year.

Although long-term fixed-rate mortgage interest rates have declined about ¼ of one percent in the past two months, low interest rates will not resuscitate the housing market. Market psychology is turning against home-buying and the trend will accelerate as foreclosures increase and unemployment rates rise. The weakening housing market is also putting downward pressure on jobs related to construction, remodeling, home sales and home lending.

## Summary

The U.S. economy is now achieving a “soft landing.” The increasingly negative yield curve spread and wider corporate bond credit spreads suggest a recession is possible but not yet likely. Despite the slower growth projected, inflation remains a threat and increases the likelihood the FOMC will “overshoot” and precipitate a contraction. The August FOMC meeting produced a rare dissent among voting members regarding the direction of monetary policy. The September meeting may precipitate more dissensions with some voting members arguing for lower rates to spur growth and others articulating a need for still higher rates. The future’s market does not expect the central bank to change interest rates until 2007 when lower rates are then projected.

Negative advertising associated with the November Congressional elections will soon

batter the American electorate. Images of civil war in Iraq, nuclear programs expanding in Iran, and war between Lebanon and Israel all bombard the household on a daily basis. Despite the negative news, the consumer is spending. The back-to-school shopping trends of August and September will be closely analyzed by the market as will home sales and housing starts in the residential market. Although residential construction is weakening, public construction and commercial real estate is booming. Business equipment sales and production are recording double-digit rates of growth. Industrial production is up and capacity utilization rates are approaching levels that prompt more orders for plant and equipment. Consumer spending, job growth, inflation, and housing market trends hold the answers regarding the direction of the U.S. economy in 2007 -- stable growth versus another recession.

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