RSQE FORECASTS

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The U.S. Economic Outlook for 2007-2008
Executive Summary: December 2006

3rd Quarter Growth Marked Up

In late November the Department of Commerce released a revised set of estimates for GDP growth in the 3rd quarter of this year, 2006q3. This revision to the estimates released a month earlier shows that real GDP grew at a 2.2 percent annual rate in the 3rd quarter, somewhat stronger than the 1.6 percent estimated in October (see table, below).

Real GDP Growth, 3rd Quarter 2006:
November vs October Estimates
(Changes in billions of chained 2000 $s, except where indicated)

	Oct '06 Estimates	Nov '06 Estimates	Revision
Real GDP	44.8	62.4	17.6
(% Change, AR)	(1.6)	(2.2)	
Components of Real GDP			
Final Sales to Dom. Purchasers	63.9	63.6	-0.3
Exports	20.5	19.8	-0.7
Imports	36.2	25.0	-11.2
Inventory Investment			
New Light Vehicles	-8.5	-3.1	5.4
Excluding New Light Vehicles	5.5	7.4	1.9

Correspondingly, the revision pegs the GDP change in inflation-adjusted dollars at $62.4 billion, $17.6 billion more than the $44.8 billion first estimated.

A look at the components of real GDP in the table indicates virtually no revision to the estimated strength of final sales to domestic purchasers—the demand for goods and services in the domestic economy. Nor was there much of any revision to the export demand for goods and services, although import demand grew by about $11 billion less than first thought.

The net effect of the revision to these first 3 components accounts for $10.2 [= (-0.3) + (-0.7) - (-11.2)] billion out of the upward revision of $17.6 billion in GDP growth.

The rest is accounted for by stronger inventory investment, due, primarily, to the auto industry working off less of its overhang of unsold vehicles than first thought. This is probably the only part of the revision that implies any negative for the economic outlook. Those unsold vehicles will have to be unloaded, and that means lower vehicle production going forward.

The Negative Factors Influencing the Outlook

Homebuilding activity is in a slump, and vehicle demand has weakened. But both sectors experienced record or near-record levels of activity during the previous 3-4 years. It's natural that strong accumulation of new vehicles and new housing units would eventually weaken the demand for still more.

Nor is it surprising that homebuilding activity would become vulnerable to a rise in mortgage interest rates, or that vehicle sales would be hurt by significantly higher gasoline prices.

In our view these sectors will continue to drag on the economy throughout next year and into 2008. We're expecting a turnaround in the housing market in early '08 and in the auto market by late 2008.

Monetary Policy

The Fed's been in a "wait and see" mode since June, when it last raised the federal funds rate.

We do not expect inflationary outcomes that would cause the Fed to tighten monetary policy any further in the near term. Nor do we expect the economy to be so weak as to induce the Fed to lower interest rates any time soon.

Rather, the monetary policy consistent with our overall economic forecast is that the federal funds rate stays right where it is at 5¼ percent for another two years or so—in other words, monetary policy remains in the neutral zone for a good long while.

The Federal Government's Impact in 2007-2008

Likewise, we anticipate that the federal budget will exhibit something close to macroeconomic neutrality—neither stimulating nor constraining macroeconomic activity—for about the next year or so.

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Looking beyond fiscal year 2007, we anticipate that the federal budget will show slower expenditure growth as the administration changes course and lowers our troop commitment in Iraq.

We also expect the new Congress to raise the federal minimum wage in several steps, bringing it to $7.25 per hour in January 2009, up from its current $5.15 per hour. Although important to many of the working poor, this will have only minimal macroeconomic effects.

The Outlook for Year-End 2006

We are expecting the rate of growth of real GDP to come in at 2.1 percent in 2006q4, which implies a 3.3 percent growth rate for calendar 2006.

The closing quarter of the year posts a 4.5 percent unemployment rate and a payroll job count of 136 million, up about 400 thousand from 2006q3.

The Economy in 2007-2008

The slowdown in the 2nd half of 2006 produced a growth rate averaging 2.1 percent. This is followed by real GDP growth that

- *posts a 2.7 percent rate during the 1st half of 2007,*
- *slips to a 2.3 percent rate during the 2nd half of 2007, and then*
- *registers a moderate 2.4 percent during 2008 (4th-qtr-to-4th-qtr).*

The 1st half of next year is helped by a firming in consumer demand for nondurable goods, vehicle sales picking up slightly from the lows of late 2006, and residential building falling less rapidly.

GDP growth suffers a bit during the 2nd half of next year as vehicle purchases remain flat, federal expenditures slow down, and net exports worsen.

The payroll job count posts two years of moderate gains in 2007 and 2008—1.5 million and 1.0 million, respectively—down from 1.9 million jobs this year.

The unemployment rate makes no further progress, averaging 4.6 percent next year and 4.7 percent in 2008.

Housing starts drop to 1.62 million units in 2007 and then back off just a bit further to 1.6 million in '08—down from 1.84 million units this year.

Sales of light vehicles come in at 16½ million units in 2006, but slip to 16.4 million in 2007 and 16.3 million in '08.

The core CPI rises by 2.4 percent in 2007, but slows to 2.2 percent the following year. The all-items CPI inflation rate runs ⅔ of a percentage point below the core rate next year, reflecting the turnaround to lower oil prices.

	Actual	RSQE Forecast		
	2005	2006	2007	2008
GDP (Billions of Current $s)	12455.8	13250.2	13907.0	14636.6
Real GDP (Billions of Chained 2000 $s)	11048.6	11416.0	11693.0	11968.8
% Change: Year-Over-Year	3.2	3.3	2.4	2.4
% Change: 4th-Qtr-to-4th-Qtr	3.1	3.1	2.5	2.4
Nonfarm Payroll Employment (Millions)	133.5	135.4	136.9	138.0
Civilian Unemployment Rate (%)	5.1	4.6	4.6	4.7
Capacity Utilization, Total Industry (%)	80.0	82.0	82.9	83.5
Inflation (Private Nonfarm GDP Deflator, % Change)	3.1	2.7	1.6	2.6
Inflation (CPI-U, % Change)	3.4	3.3	1.7	2.3
Inflation (Core CPI, % Change)	2.2	2.5	2.4	2.2
Light Vehicle Sales (Millions)	16.9	16.5	16.4	16.3
Private Housing Starts (Thousands)	2074	1841	1623	1605
3-Month Treasury Bill Rate (%)	3.1	4.7	4.9	4.8
10-Year Treasury Note Rate (%)	4.3	4.8	5.0	5.3
Conventional Mortgage Rate (%)	5.9	6.4	6.5	6.7
Real Disposable Income (Billions of Chained 2000 $s)	8104.6	8322.3	8633.5	8864.9
% Change	1.2	2.7	3.7	2.7
Corporate Profits After Tax (Billions of Current $s)	1119.4	1338.7	1399.7	1460.9
Value of U.S. $ (FRB Broad Index), % Appreciation	-2.5	-1.9	-2.5	-1.4
Current Account Balance (NIPA Basis, Billions of Current $s)	-771.4	-834.3	-780.3	-764.9
Federal Surplus (FY, NIPA Basis, Billions of Current $s)	-334.7	-185.9	-221.8	-229.5