UNION BANK OF CALIFORNIA
ECONOMIC UPDATE: THE UNITED STATES

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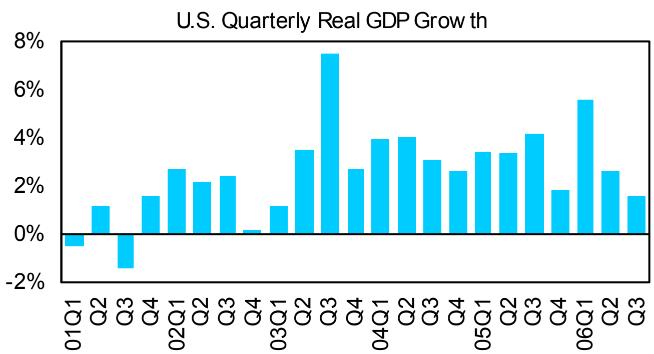
A Chill Is in the Air

The latest Gross Domestic Product (GDP) data show that the U.S. economy expanded 1.6% in the third quarter of 2006. This growth rate is considerably lower than the 2.6% rate recorded in the second quarter. (See the chart below.) The U.S. economy is clearly losing momentum. Bloomberg News recently reported, however, that earnings of U.S. companies rose 23% and the Dow Jones Industrial Average gained 4.7% during the same quarter.[1]



Annualized real GDP growth rates. Source: Bureau of Economic Analysis.

Strong corporate profit and high stock prices seem to be inconsistent with slowing economic growth. So, what's going on? People are now wondering where the economy is headed and whether a soft landing is possible.

The business cycle also has four "seasons."
In discussing economic conditions and the business cycle, I find it useful to employ the analogy of seasonal changes. Like four seasons in a year, the business cycle can be roughly divided into four phases—boom, slowdown, recession, and recovery.

A boom is a period of rapid economic expansion, heightened energy, activity, and excitement—like summertime. A slowdown follows a boom, as autumn follows summer. The economy usually maintains good momentum during the early part of a slowdown (as the currently strong corporate profits attest), but the climate soon turns from cool to cold and the economy eventually starts to contract. This phase is called a "recession."

A recession, like a winter, can be mild or severe, depending on where one is located and what industry one is associated with. The severity and duration of a recession can also vary from one business cycle to another. A recovery phase follows a recession, as predictably as winter melts into spring, and economic growth resumes.

Don't wish for an endless summer.
I like comparing the business cycle with the annual cycle of seasons because it dispels a simplistic view that growth is good and slowdown bad. Wanting perpetual growth is like wishing for summer to last forever. An endless summer might be a romantic notion, but in reality, a long summer will lead to problems like droughts and wildfires. An economic boom that lasts too long can also lead to imbalances, such as labor shortages and rapid price inflation.

Some of you must be thinking, "But surely we have no use for a recession, which causes business failures and unemployment." Yes, bankruptcies and joblessness are painful, but even a recession can have a useful function. Business failures free up resources—capital, production capacity, and labor—and allow them to be redeployed somewhere else for greater economic benefits.

It's like plants that die in winter, releasing nutrients into the soil and helping new growth in spring. A recession can be regarded as the recycling mechanism for economic resources.

Therefore, the purpose of economic policies conducted by the government is not to prevent recessions from happening, but to avoid extreme economic conditions. Using the analogy of seasons once again, the government does not try to eliminate winters. It simply attempts to create a climate like that of the Pacific Coast, where summers (booms) are moderate and winters (recessions) mild.

What should the Fed do with interest rates?
The Federal Reserve kept the short-term interest rate stable at their rate-setting meeting on October 25. Most members (except for one who cast a dissenting vote) believed that the economy was gradually decelerating and inflationary pressure was easing.

Indeed, the year-over-year increase of the Consumer Price Index (CPI) fell to 2.1% in September, from 3.8% in August and 4.1% in July. This dramatic shift is due to a large drop in energy prices that occurred in September. The annual increase of the CPI excluding food and energy items was stubbornly high at 2.9% in September, mainly due to higher housing costs.

[1] "Profits Rise 23% in U.S., Led by Banks, Insurers; Pace May Slow" by Margot Habiby, Bloomberg.com, November 3, 2006.

Still, the Producer Price Index for finished goods, which often signals price inflation in the pipeline, rose only 0.9% in September from a year earlier. This suggests that inflationary pressure will dissipate in coming months. My guess at this time is that the next move by the Fed is a rate cut in the second half of 2007.

Imports and the housing sector chilled the economy.
So where are we now in this cycle of economic seasons? Recent data suggest that the economy is entering a slowdown phase. The economic "temperature" is dropping and—as you might have guessed—a chill is in the air. The economy still has significant momentum, so winter (i.e., a recession) is still some time away.

The third-quarter GDP data show that consumer spending accelerated to a 3.1% annualized growth rate from 2.6% in the second quarter. Businesses increased their investment in buildings and equipment by 8.6% in the third quarter, following a 4.4% increase in the second quarter. Government spending rose 2.0% in the third quarter, faster than the 0.8% growth this spring.

What reduced the total GDP growth were the international and housing sectors. Rapidly increasing imports (largely due to high oil prices) knocked off 1.28 points from the third-quarter real GDP growth. Residential investment fell 17.4%, a fourth consecutive quarterly decline, and subtracted an additional 1.12 percentage points.

Fourth-quarter growth is likely to be stronger.
I wouldn't be surprised if real GDP growth bounces back in the current quarter. Oil prices plunged dramatically in late September, and lower gasoline prices buoyed consumers' mood. The stock market rally increased household net worth (mainly among the affluent) and offset the negative impact of flat or falling residential real estate prices.

Not seasonally adjusted. Source: Bureau of Labor Statistics.

The labor market remains tight, with the unemployment rate dropping to 4.4% in October, the lowest level since May 2001. Nonfarm payroll employment rose only 92,000 in the same month, but almost 2 million jobs have been gained over the past twelve months. These figures lead us to believe that workers will enjoy healthy increases in wages. In fact, the average hourly earnings for production workers rose 3.9% in October since a year earlier.

Based on these numbers, a soft landing for the U.S. economy seems quite likely. Again, lower energy prices and the recent stock market rally are big pluses. The growth in the rest of the world—Europe, Japan, China, India, and Southeast Asia—will also keep our economy from cooling too rapidly. (This is "global warming" of a good kind.)

So, let us all enjoy the golden autumn days of our economy. While we may detect some chill in the air, we are nowhere near a frosty recession.

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Economic Forecasts – November 2006

UNITED STATES	2004	2005	2006	2007
Real GDP Growth (%)	**3.9**	**3.2**	3.3	2.5
Unemployment (%)	**5.5**	**5.1**	4.7	4.8
Payroll Employment Growth (%)	**1.1**	**1.5**	1.4	1.1
CPI Change (%)	**2.7**	**3.4**	3.4	2.2
Federal Funds (%)	**1.3**	**3.2**	5.0	5.1
Housing Starts (millions)	**1.95**	**2.07**	1.85	1.65
Car/Lt. Truck Sales (millions)	**16.9**	**16.9**	16.6	16.8

Bold: Actual.