

Economic Growth May Slow in 2006

Fall-off likely in consumer spending, housing prices



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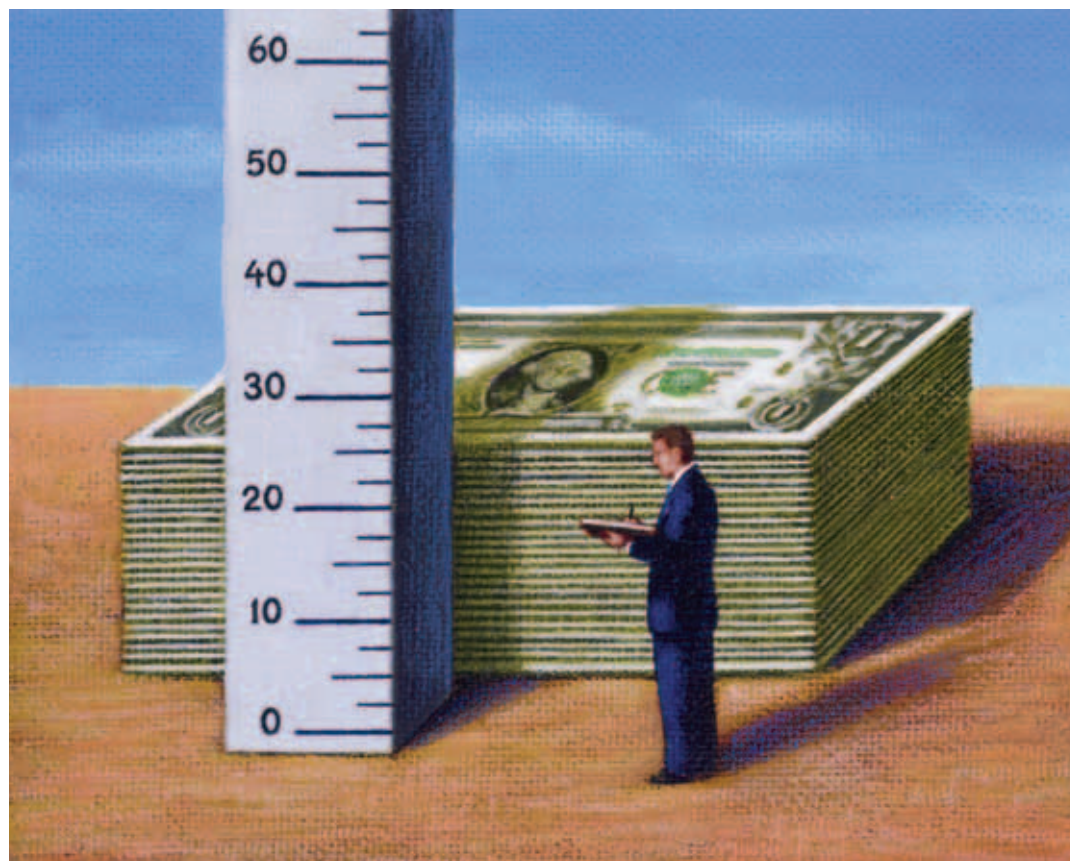


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In 2006, two factors are likely to contribute to the slowing of economic growth: housing prices coming down off their peaks and mounting consumer debt taking its toll on personal consumption. As incoming Chairman Ben Bernanke takes the reins of the Federal Reserve, we expect the Fed to slow its interest rate increases and reach a "neutral" interest rate point.

U.S. Economic Growth Slowing

Economic growth began slowing in 2005. By the

third quarter of 2005, economic growth had moderated to about 3½% on a year-over-year basis, bringing it close to its long-term average and current expectations for potential future growth. In 2006, growth is expected to further decline, falling to approximately 3% year-over-year by year-end.

Real personal consumption expenditures — which account for about 70% of GDP — fell in both August and September, and only grew by 0.1% in October. One quarter of slower growth, of course, could be just a temporary "soft patch."

But the index of Leading Economic Indicators is signaling a sustained slowdown in real GDP growth going forward. On a year-over-year basis, real GDP grew at 3.8% in the 4th quarter of 2004 and is likely to moderate to 3.6% in 2005 and 3.0% in 2006.

Fall in Housing Prices Will Help Drop Consumer Spending

Consumer spending tailed off abruptly in the third quarter of 2004, led by the largest collapse in motor vehicle sales since 1980. In the three months ending in October 2004, total motor vehicle sales, both domestic and imported, contracted at an annualized rate of 74%. While the recent decline in gasoline prices will provide some rebound in consumer spending, household spending growth is unlikely to be as strong in the next two years as it has been recently.

The combination of sharply higher home prices — a record high of 211% of after-tax household income — and the rise in short-term interest rates has produced the lowest level of housing affordability since 1991.

Households have been able to spend more than their after-tax incomes on consumer goods and houses by borrowing against the appreciation of their assets — primarily on their homes. In the past five years, home price appreciation was the dominant factor responsible for increases in net worth. However, both sales and prices of new homes appear to have peaked. As a result, households will have to slow their spending if they want to continue building net worth.

Despite the fact that interest rates — both long- and short-term — are relatively low in a historical context, households' required payments on debt are at a 25-year high relative to their after-tax incomes. This high level of household borrowing appears to be catching up with consumers. In the second quarter of 2005, credit card loan delinquencies reached a record high of 4.81%.

Inflation in 2006 Likely to Be Lower, Too

The spike in energy prices has been the primary contributor to the recent acceleration in consumer inflation. Nevertheless, core consumer inflation peaked in November 2004 at 2.3% and has been trending lower ever since. The Fed has been putting an emphasis on labor costs as the source of inflationary pressures, but the growth in unit labor costs has settled down in 2005, with costs contracting in both the second and third quarters.

With energy prices stabilizing, core consumer inflation already trending lower, labor costs behaving benignly and aggregate demand moderating, we expect inflation to trend lower in 2006.

Fed Likely to Pause, Even Cut Rates, When Bernanke Takes Helm

After raising the interest rate on overnight funds by ¾ percentage points between late June 2004 and mid-December 2005, the Fed now has set the rate close to its long-run average relationship above the underlying rate of inflation.

In addition, there is some evidence that incoming Chairman Bernanke believes in the concept of a "neutral" Fed funds rate. With indications that economic growth is slowing and inflationary pressures are abating, we would predict the Fed will not be likely to push the rate higher than 4½%. If the yield curve continues to be flat (which we expect will be the case), when Bernanke chairs his first Federal Open Market Committee meeting on March 28, 2006, we expect he will conclude that 4½% Fed funds rate is at least neutral if not a little restrictive.

Further, if the unemployment rate is rising in the second half of 2006, as it is expected to do, the possibility exists that the Fed may even start to lower short-term interest rates which, in turn, may bolster market confidence. ■