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The U.S. Economic Outlook: Soft Patch, Sink Hole, or Springboard?

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Not an official Document

Outline of Talk

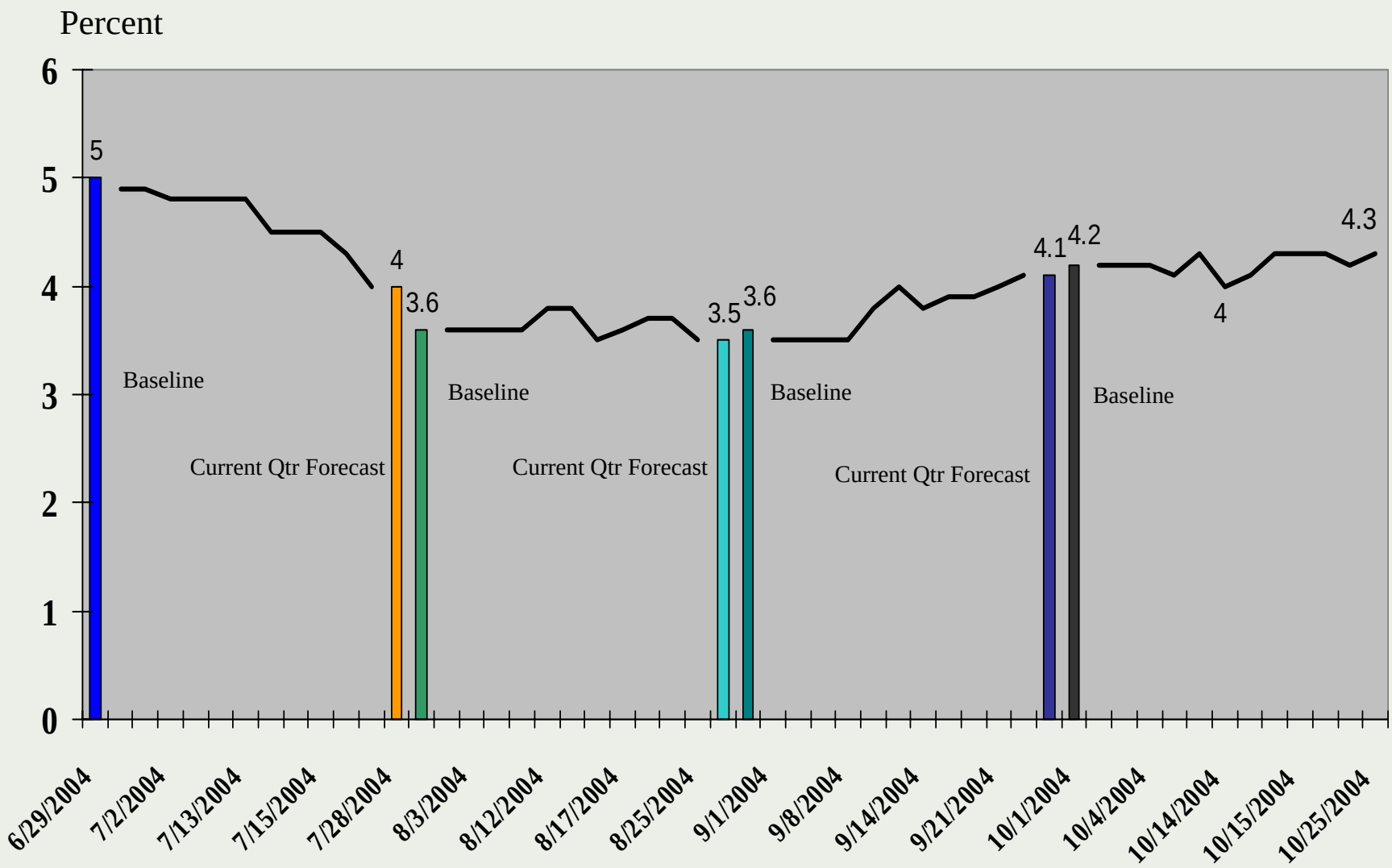
- Current Conditions (are we past the soft patch?)
- The Consensus Forecast
- Risks to the Consensus Forecast

Current Conditions

- Economic conditions firm in the third quarter, following the second-quarter “soft patch”

> “Economic activity hit a soft patch in late spring after having grown briskly in the second half of 2003 and the first part of 2004. . . That softness in activity no doubt is related, in large measure, to this year's steep increase in energy prices.”
>
> Chairman Greenspan, Congressional Testimony, September 18, 2004

“Tracking” Forecast: 2004/Q3 Real GDP Growth



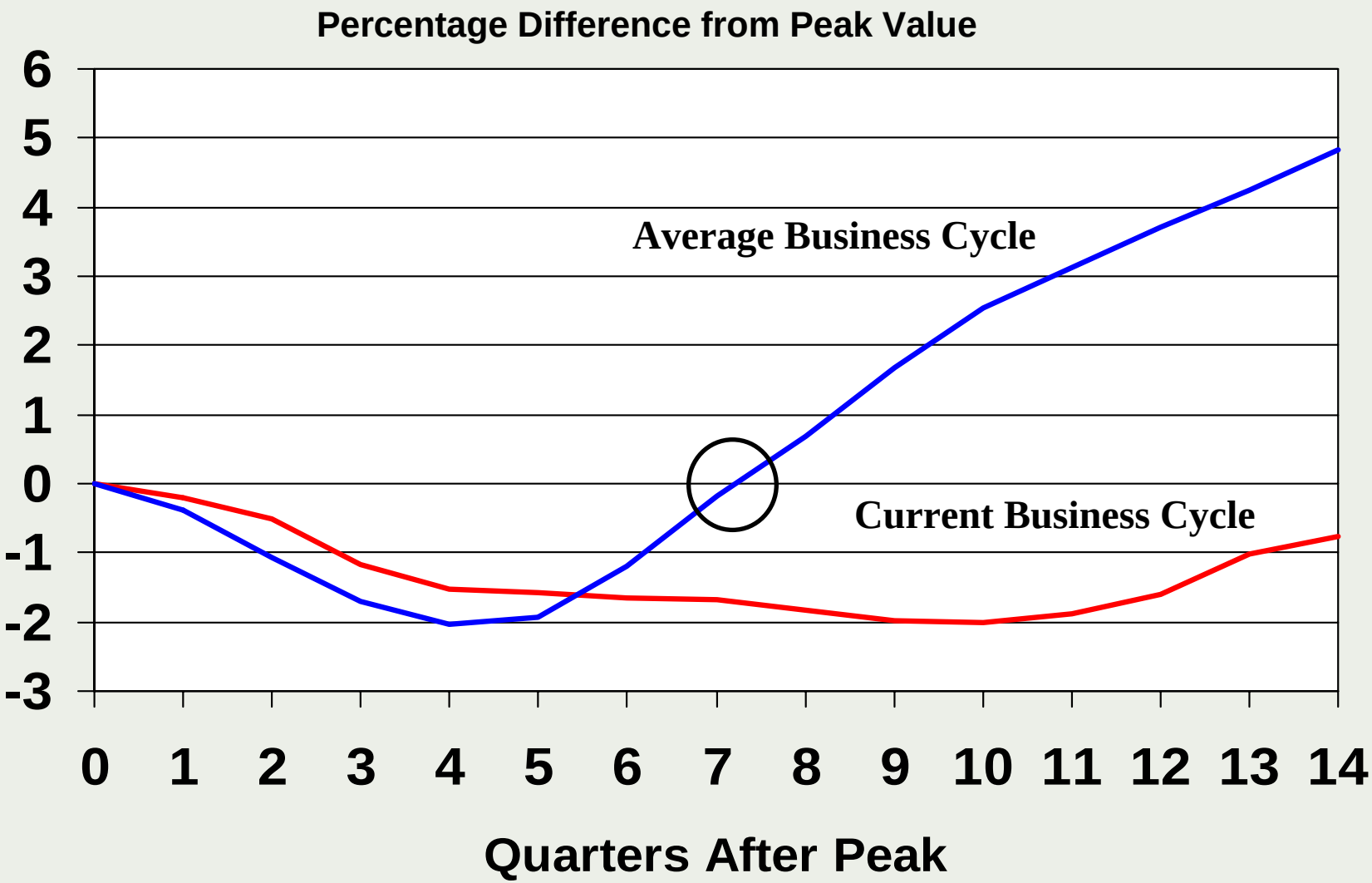
Source: Macroeconomic Advisers

Current Conditions

- Economic conditions firm in the third quarter, following the second-quarter “soft patch”

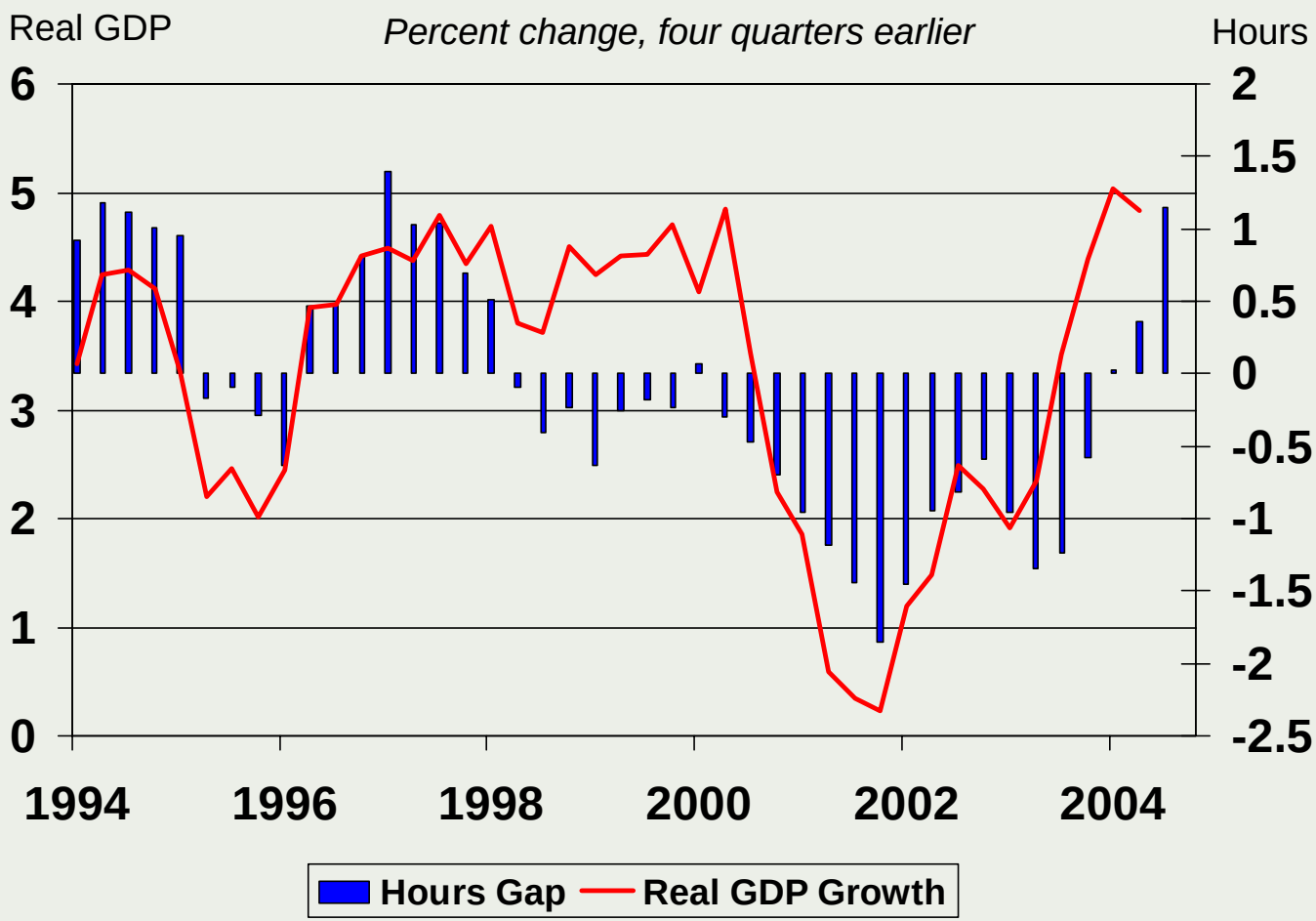
- Payroll employment growth weakened in 2004:Q3, but hours growth accelerated at fastest rate in more than 7 years

Payroll Employment During the Current & Average Business Cycle



NOTE: Average excludes the 1980 peak; post-WW II period.

Real GDP Growth and the Hours Growth Gap



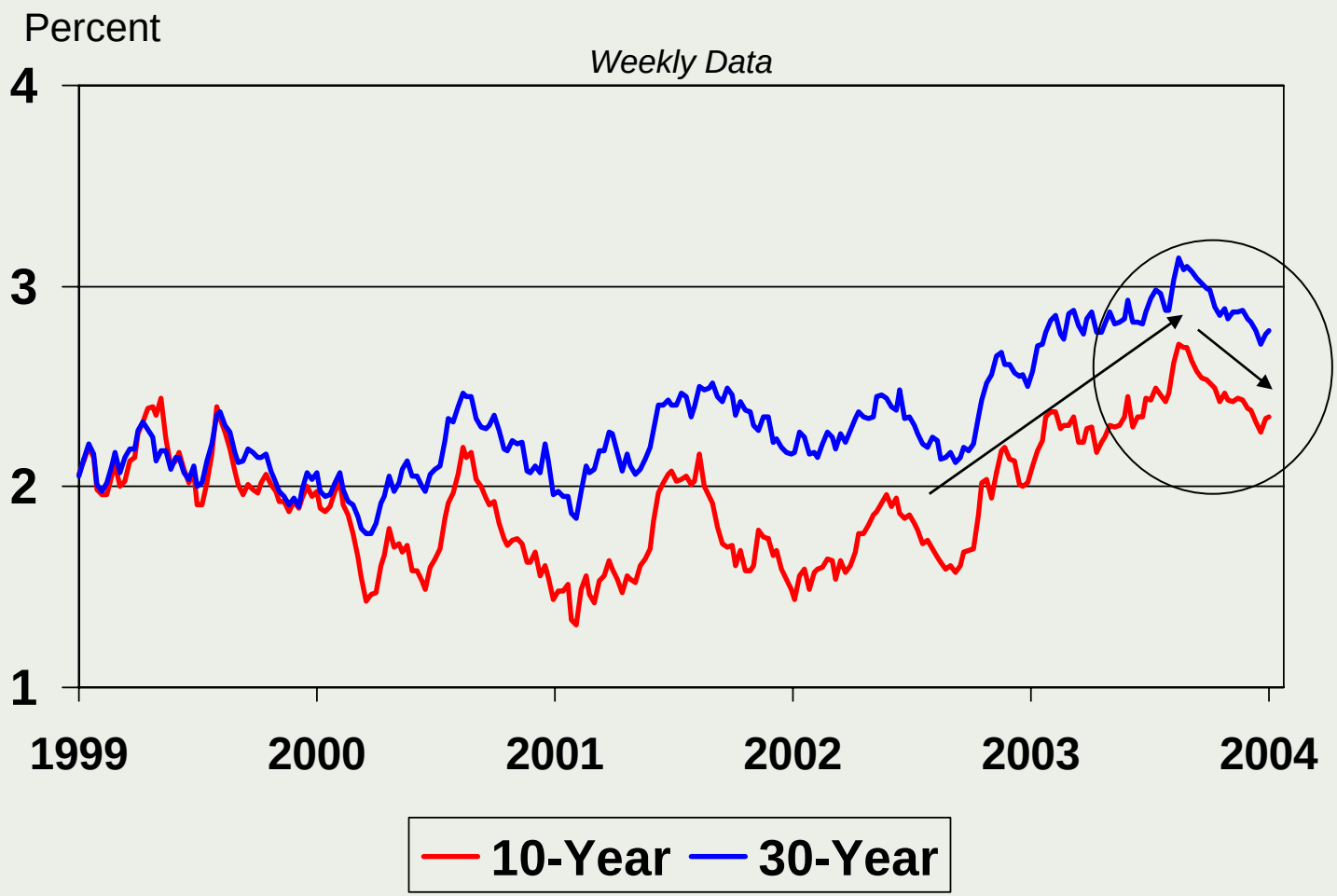
Average Real GDP Growth (1965-2004) When:	
Employment Growth > Hours Growth:	2.57
Hours Growth > Employment Growth:	4.73

NOTE: Hours gap is the four-quarter growth of nonfarm hours less the four-quarter growth of aggregate nonfarm employment.

Current Conditions

- Economic conditions firm in the third quarter, following the second-quarter “soft patch”
- Payroll employment growth remains relatively weak, but hours growth accelerates
- Monetary policy remains accommodative; FOMC moving in a “measured” pace toward neutrality
- Oil prices move past $50/bbl, but inflation expectations remain stable

Financial Market Inflation Expectations

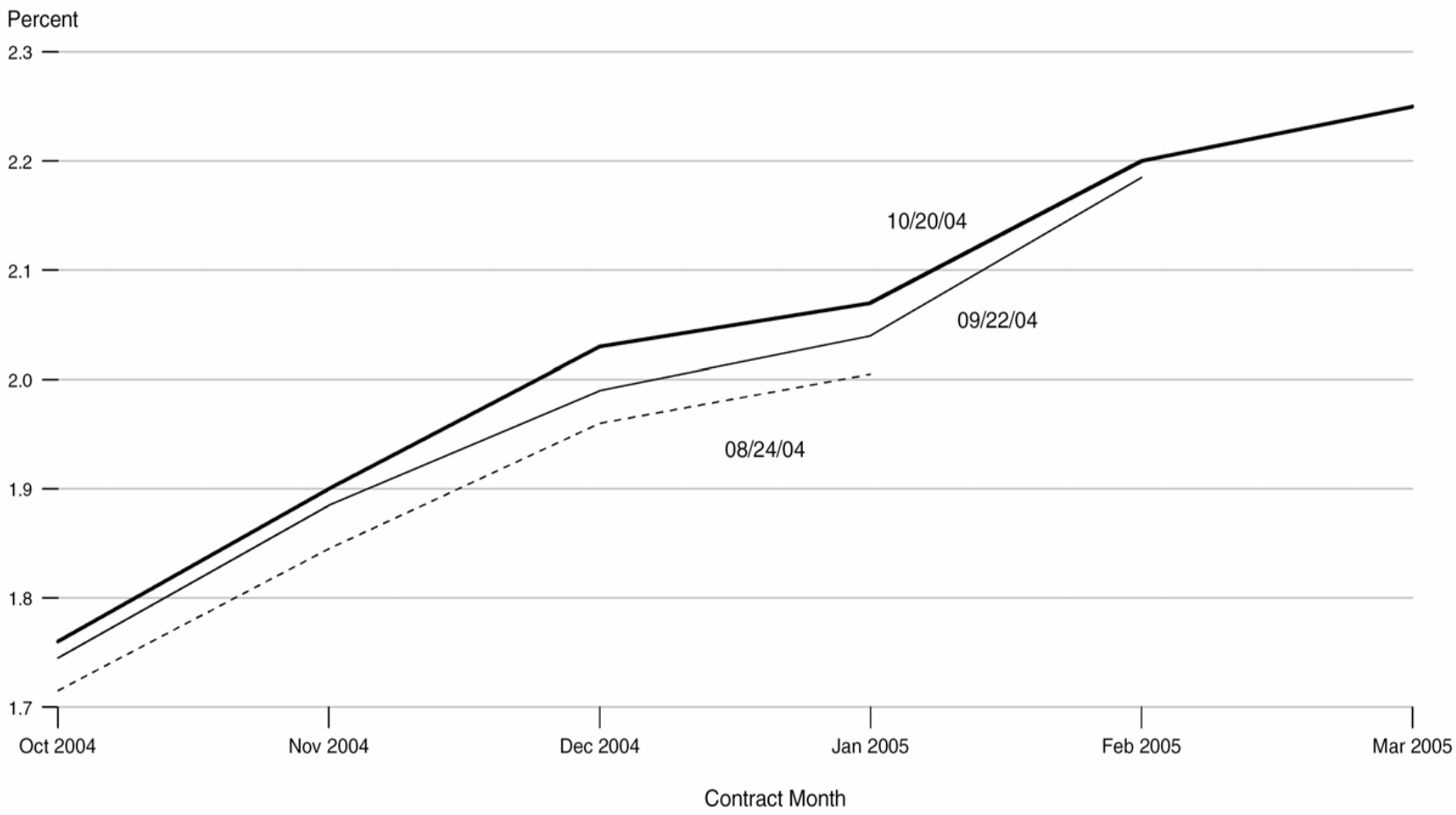


NOTE: Yield spreads between nominal and inflation-indexed U.S. Treasury securities.

Consensus Forecast

- Key assumptions

Rates on Federal Funds Futures on Selected Dates



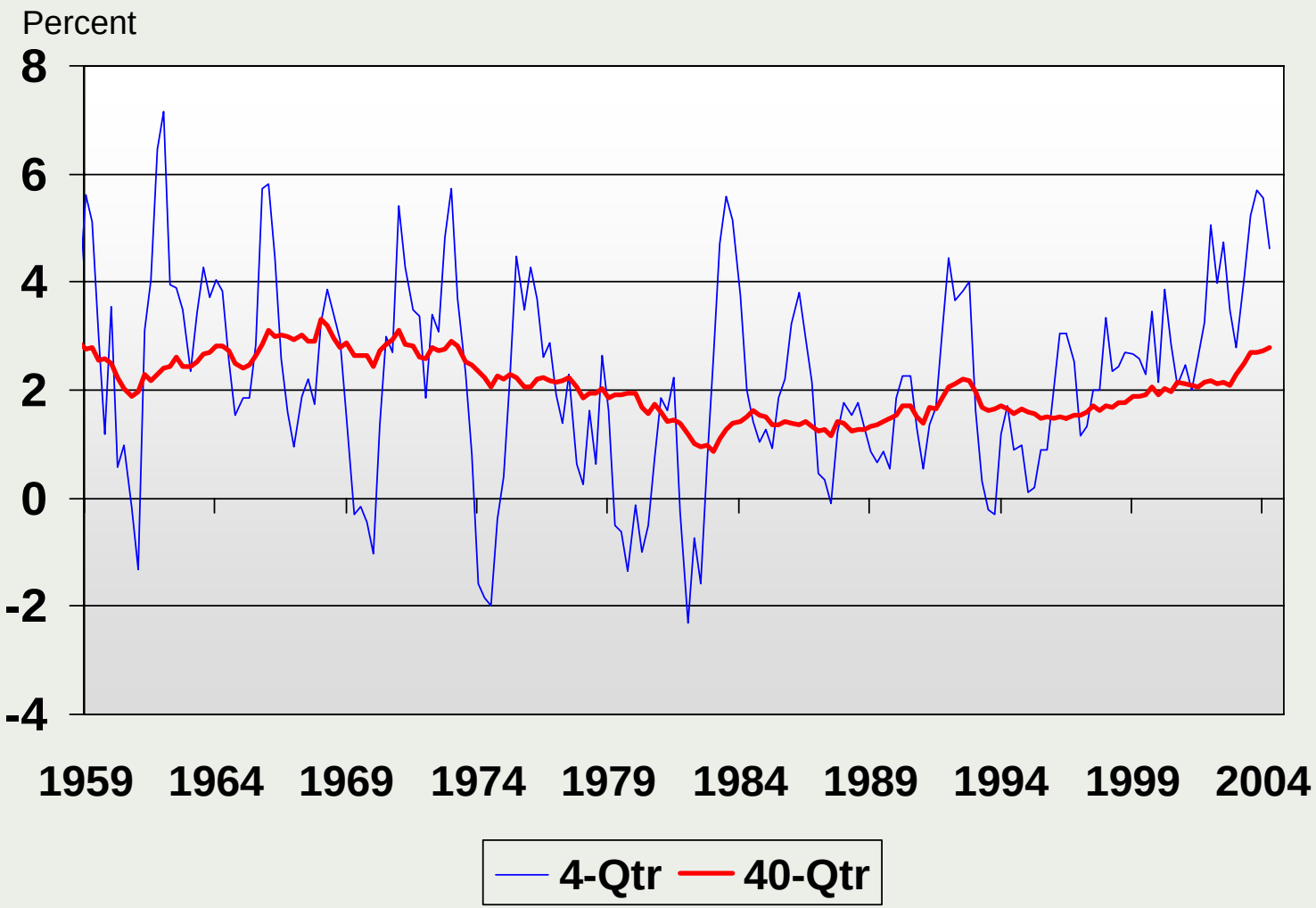

Crude Oil Futures Prices
West Texas Intermediate
Dollars per barrel
55
54
53
52
51
50
49
48
47
10/20/2004
10/13/2004
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
2004
2005

Consensus Forecast

- Key assumptions

- Continued strong structural productivity growth boosts real incomes, spending, and holds down growth of unit labor costs and prices

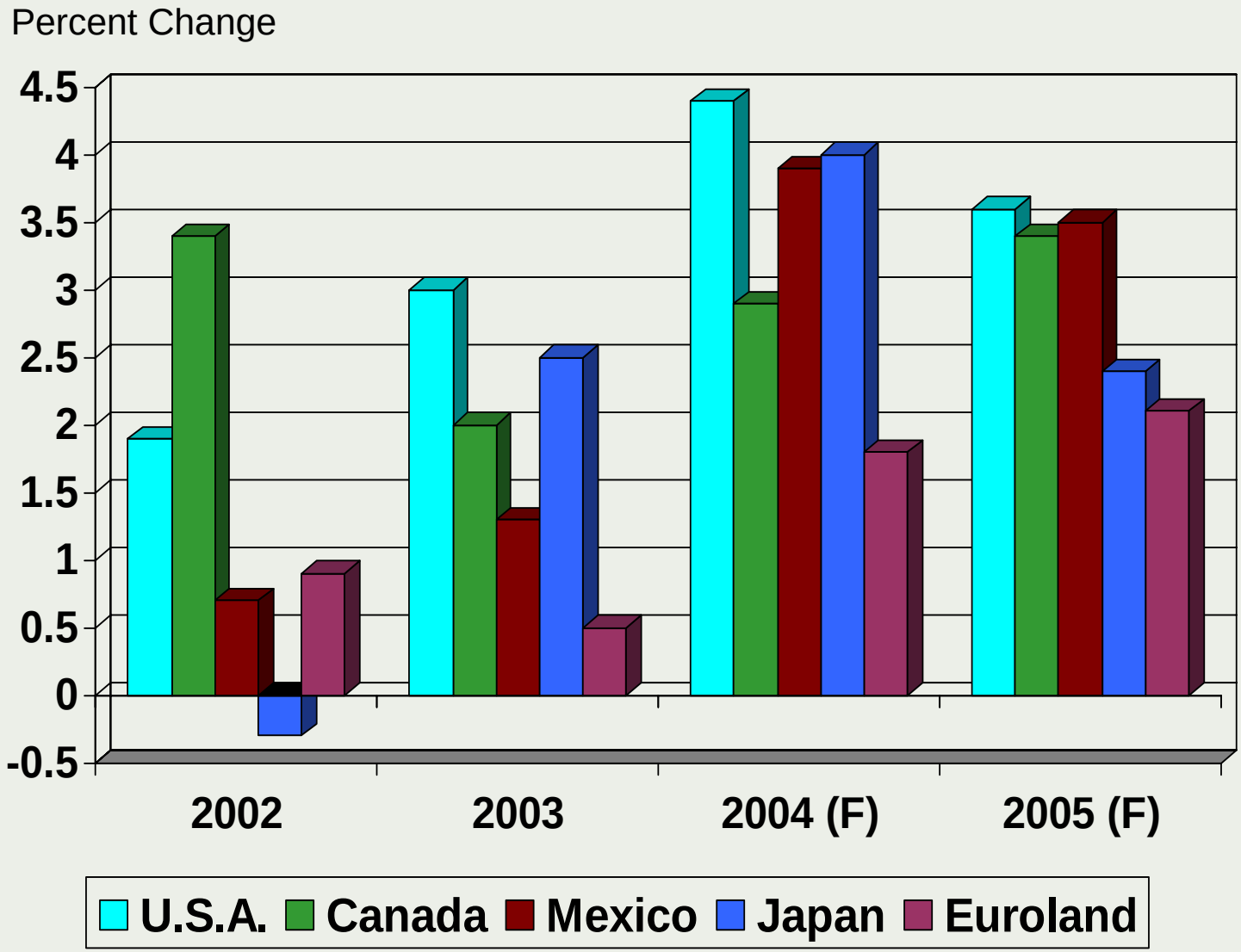
Four- and 40-Quarter Growth Rates of Nonfarm Labor Productivity



Consensus Forecast

- Key assumptions
- Continued strong structural productivity growth boosts real incomes, spending, and holds down growth of unit labor costs and prices
- Robust profits, low cost of capital keeps business capital spending growing briskly
- Weaker foreign growth in 2005

U.S. & Foreign Economic Growth Rates



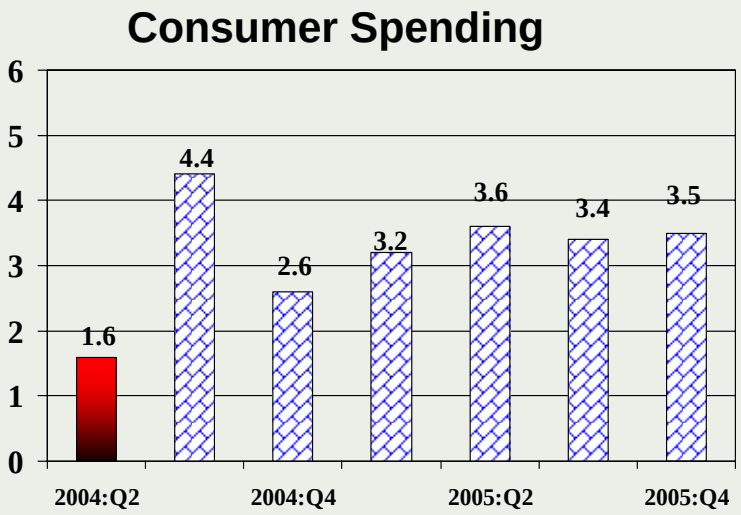
SOURCE: Blue Chip Economic Indicators (October 10, 2004)

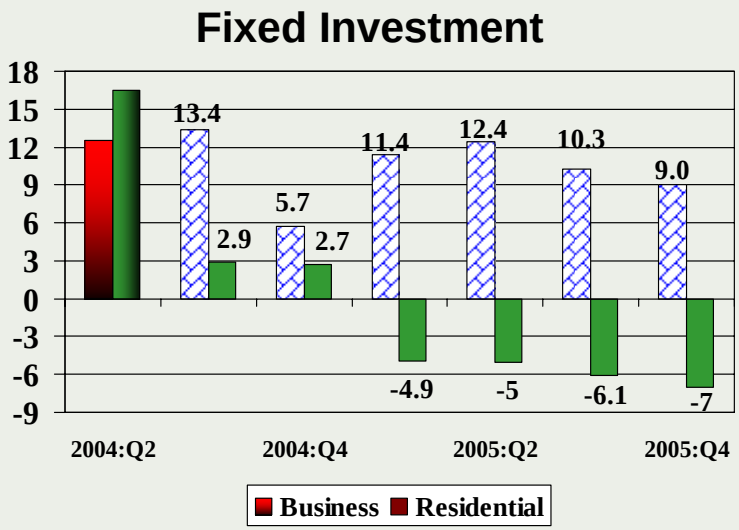
Forecasts for 2004 and 2005

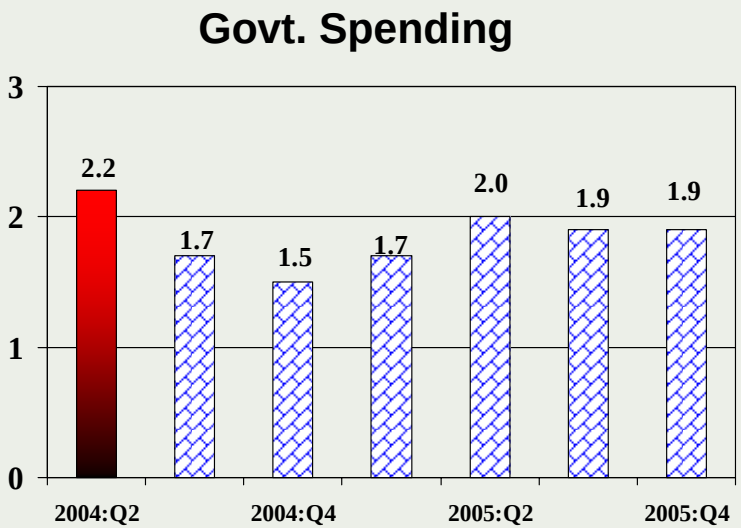
	Real GDP Growth		Core Inflation		Unemployment Rate	
	2004	2005	2004	2005	2004:Q4	2005:Q4
Blue Chip Consensus (Oct.)	3.8	3.5	2.2*	2.2*	5.4	5.2
Macroeconomic Advisers (Oct.)	3.9	4.1	1.9*	2.0*	5.3	5.1
FOMC (July, central tendency)	4.5 - 4.75	3.5 - 4.0	1.75 - 2.0**	1.5 - 2.0**	5.25 - 5.50	5.0 - 5.25
Business Council (Sept.)	N/A	2.1 - 3.5	N/A	1.1 - 2.0*	N/A	5.0 - 5.3

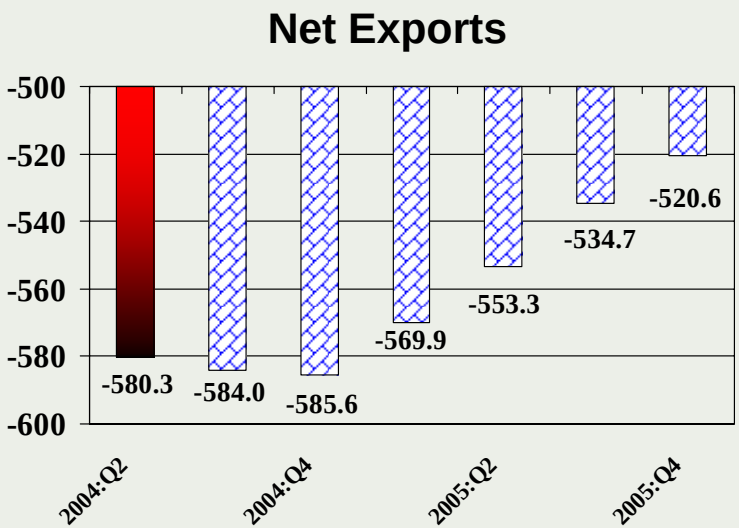
*Core CPI
**Core PCE

Forecasts of Major GDP Components







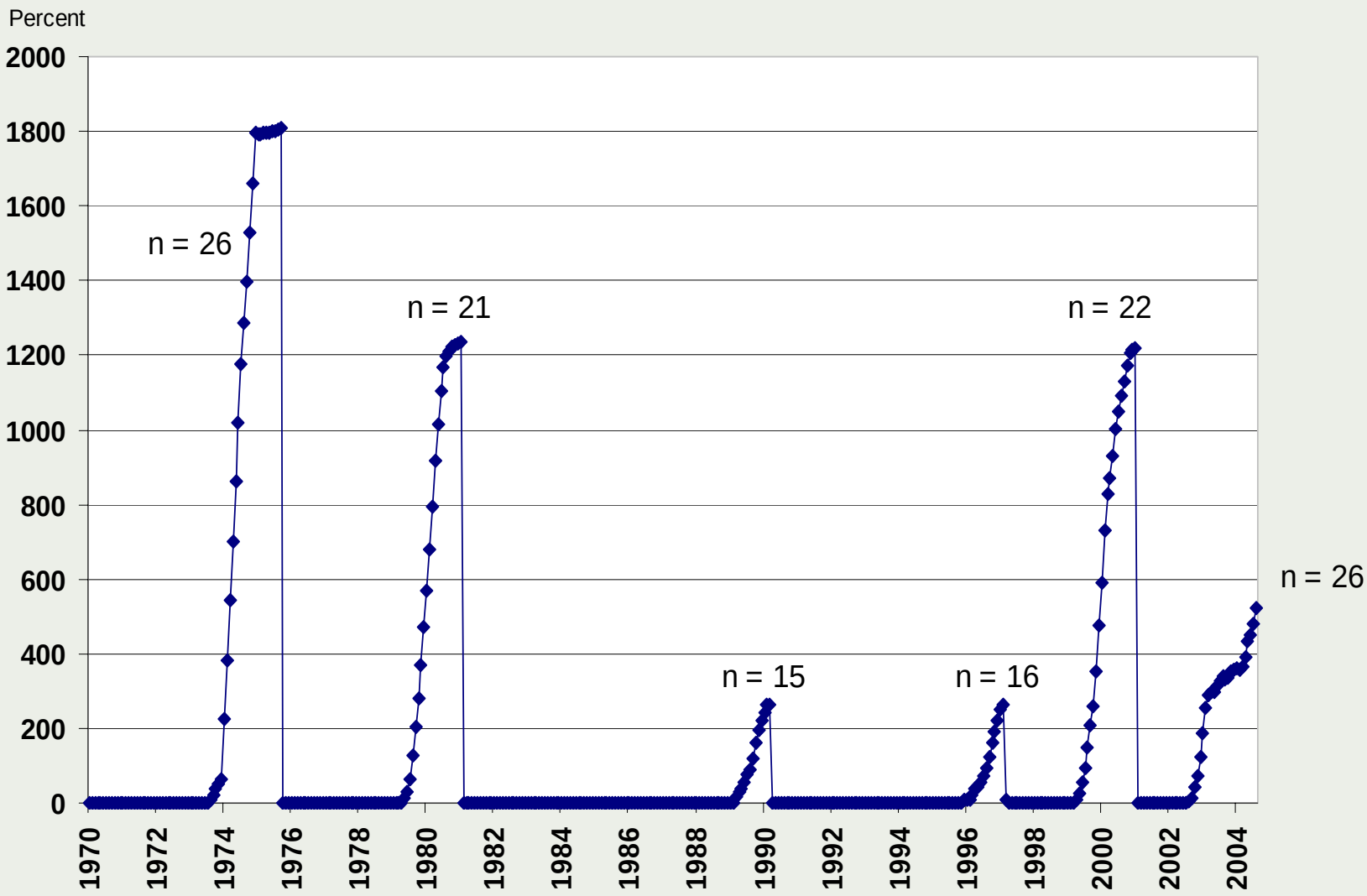


Source: Macroeconomic Advisers

Risks to the Forecast

- Oil prices continue to rise, weakening consumer spending and heightening business uncertainty

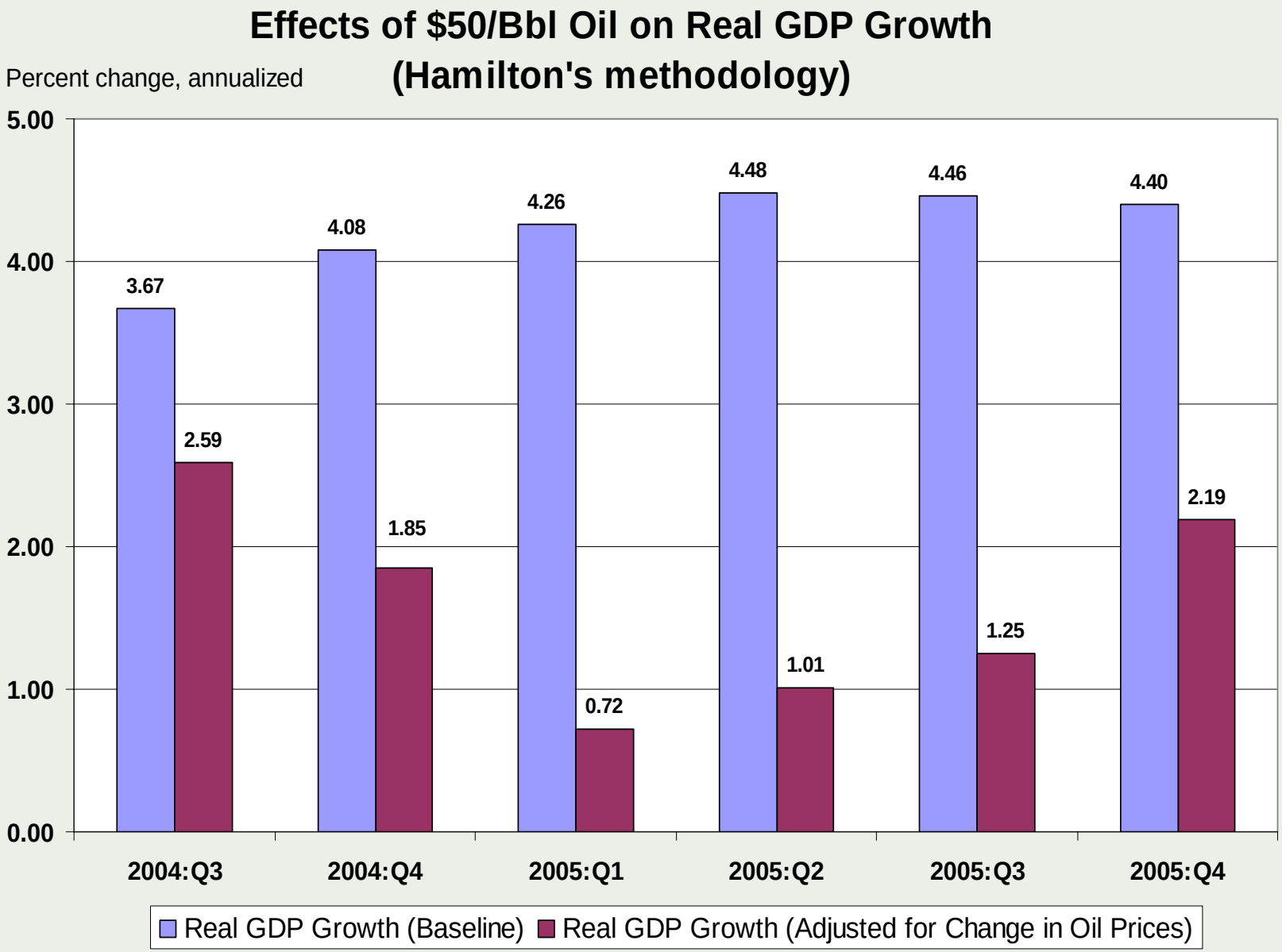
Cumulative 12-Month Percent Changes in Real WTI Prices During Oil Shock Episodes (Zero Otherwise)



Average Growth, Six Quarters Before and After Five Oil Shock Episodes

Series	Avg. Growth Before	Avg. Growth After	Delta
Real GDP	3.8	1.2	-2.6
Real PCE	4.1	2.0	-2.1
Real Business Fixed Investment	7.5	-0.3	-7.8
Real Residential Fixed Invest.	1.1	-4.6	-5.7
Industrial Production	3.2	-1.4	-4.6
CPI Inflation	4.5	6.6	2.1
Core CPI Inflation	4.1	5.9	1.9
PCE Price Inflation	3.9	5.6	1.7
Core PCE Inflation	3.5	4.9	1.3
Nonfarm Employment	2.6	0.1	-2.5
Unemployment Rate	5.2	6.0	0.8
Consumer Confidence	113.7	87.4	-26.4
10-Year Treasury Yield	6.8	7.2	0.4
Real Federal Funds Rate	2.9	1.2	-1.7
Addenda:			
Real Spot WTI Price ($)	23.40	35.00	11.6
			49.6%

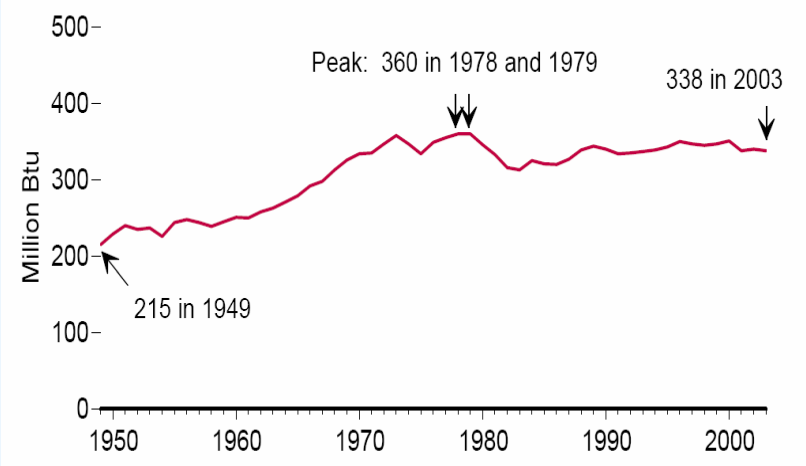
Episode 1: 1973/Q4 (T=0)
Episode 2: 1979/Q1 (T=0)
Episode 3: 1990/Q3 (T=0)
Episode 4: 1999/Q1 (T=0)
Episode 5: 2002/Q1 (T=0)



NOTE: Calculations based on methodology formulated by Hamilton (2003). Assumes spot price of WTI averages $50 per barrel from 2004:Q4 through 2005:Q4.

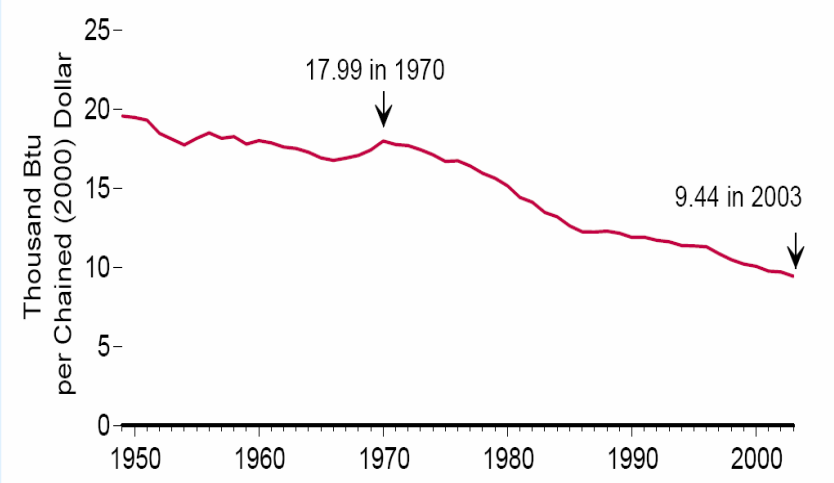
Increased Energy Efficiency: Partial Offset to Higher Prices

Figure 2. Energy Consumption per Person



Energy use per person stood at 215 million Btu in 1949. The rate generally increased until the oil price shocks of the mid-1970s and early 1980s when the trend reversed for a few years. From 1988 on, the rate held fairly steady. In 2003, 338 million Btu of energy were consumed per person, 57 percent above the 1949 rate.

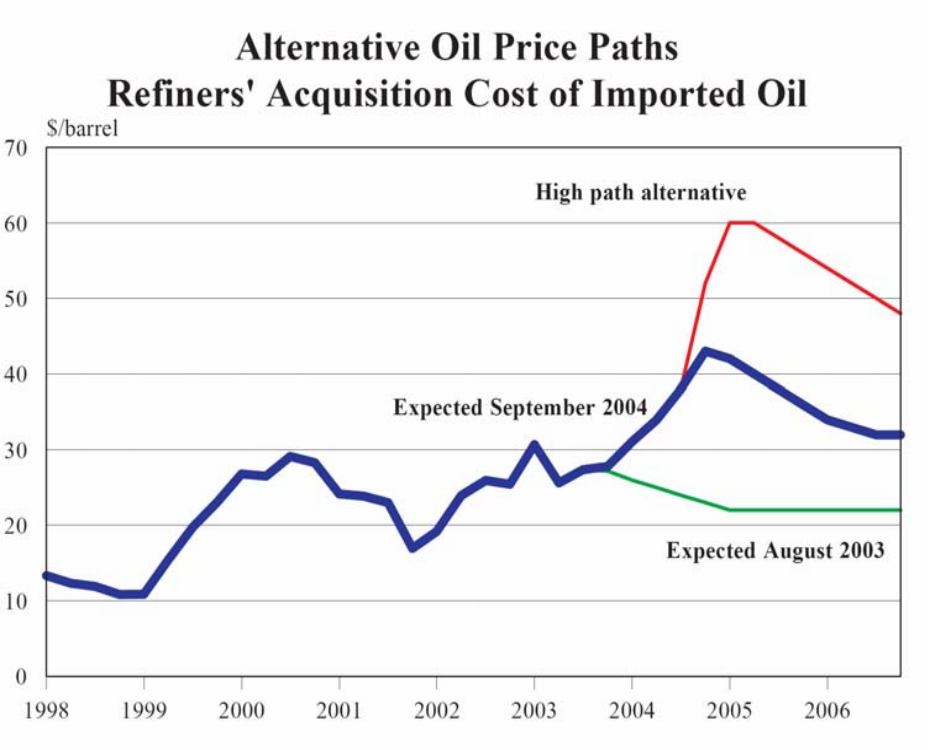
Figure 3. Energy Use per Dollar of Gross Domestic Product

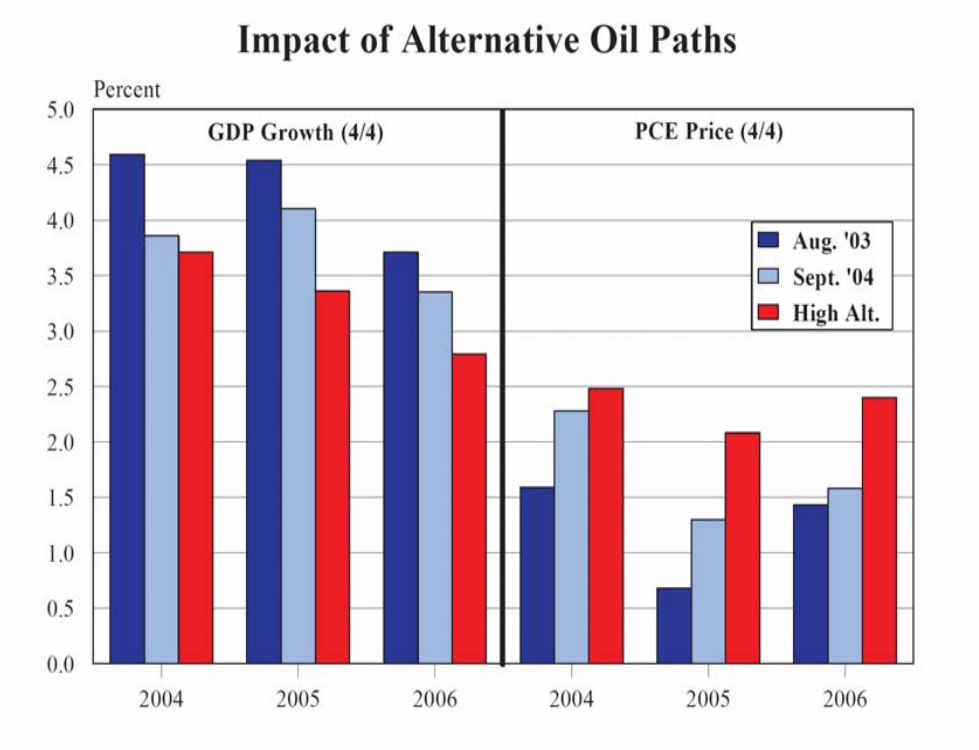


After 1970, the amount of energy consumed to produce a dollar's worth of the Nation's output of goods and services trended down. The decline resulted from efficiency improvements and structural changes in the economy. The level in 2003 was 48 percent below that of 1970.

SOURCE: U.S. Energy Information Administration

Simulating the Effects of Higher Oil Prices Using a Structural Forecasting Model



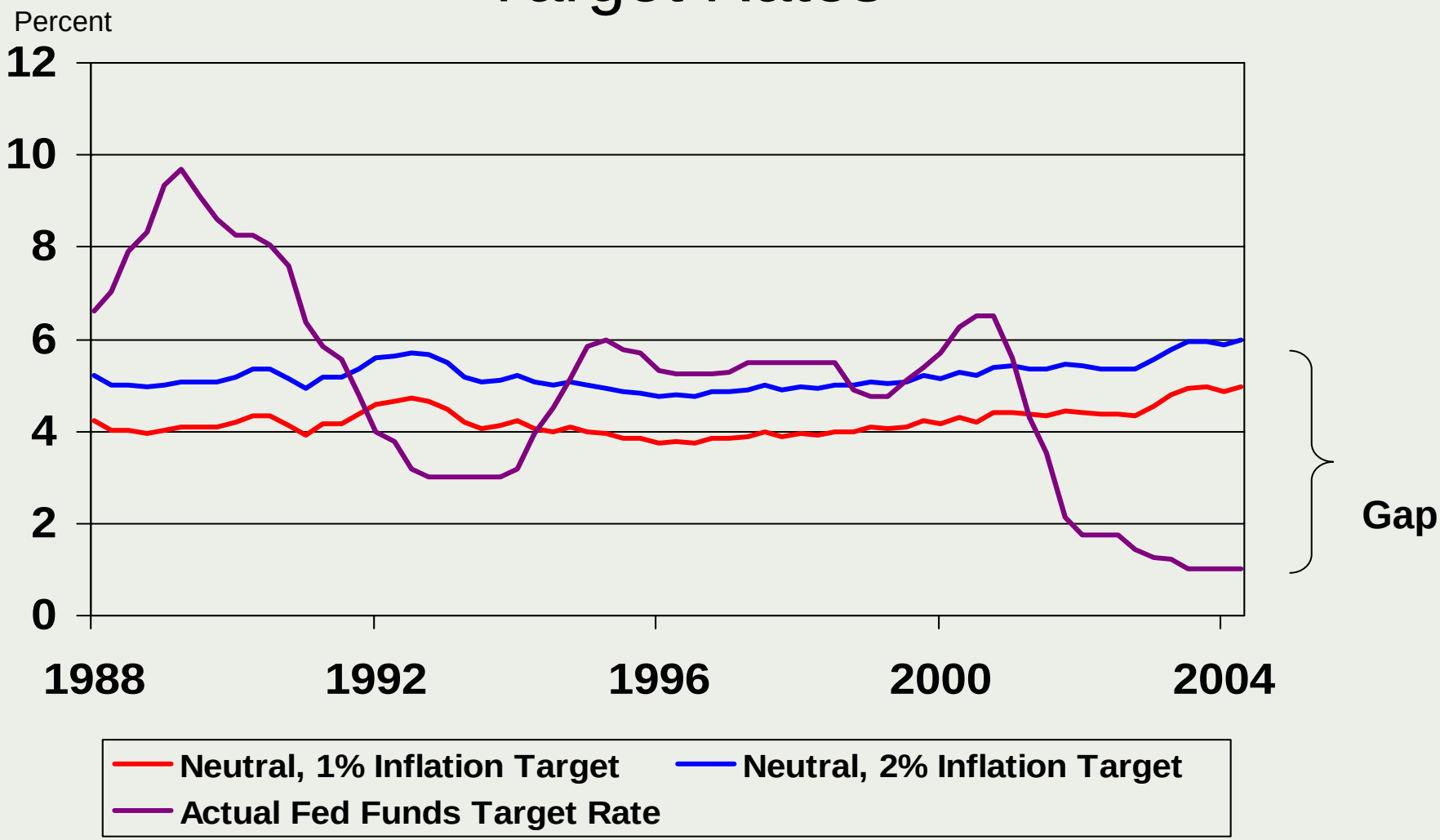


SOURCE: Macroeconomic Advisers (October 2004)

Risks to the Forecast

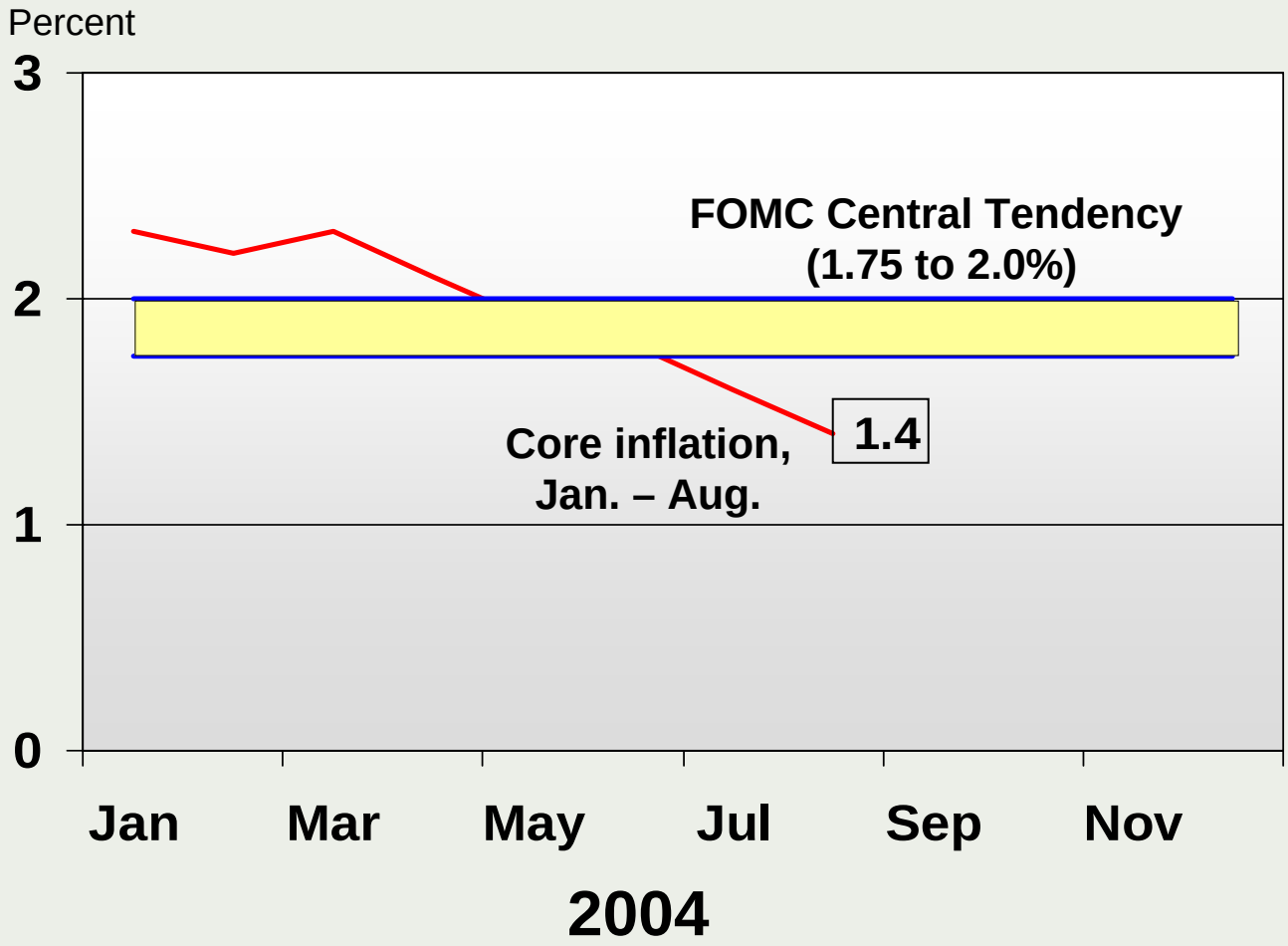
- Oil prices continue to rise, weakening consumer spending and heightening business uncertainty
- Low real interest rates cause demand growth to increase faster than expected—inflationary effects from tighter labor and product markets offset
- Output gap not as large as consensus forecast suggests; in actuality monetary policy too accommodative

Hypothetical Neutral Federal Funds Target Rates



NOTE: Hypothetical fed funds target rate is the sum of the 40-quarter annualized growth rates of labor productivity and labor force growth, plus an assumed inflation target of either 1 or 2 percent.

Year-to-date Core PCE inflation rates and the FOMC's inflation projection for 2004 made in July 2004



Questions?