

The Economic Outlook for 2007

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Presented (with minor modifications) by:
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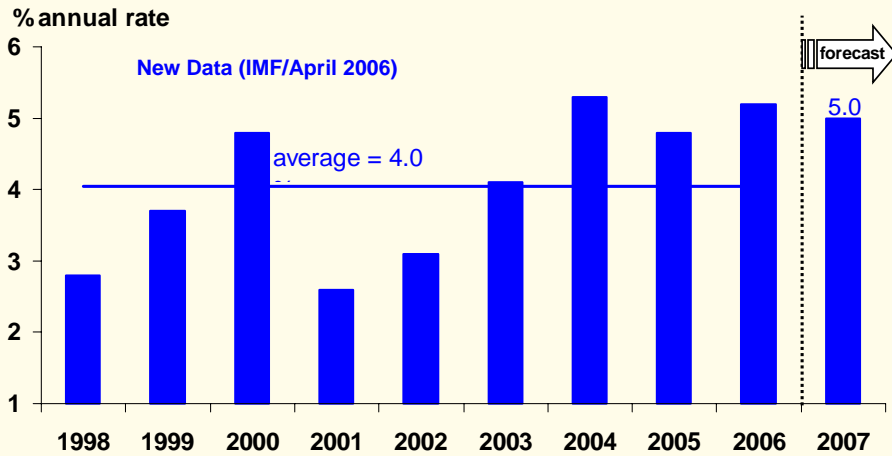
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Themes

- Most Likely Scenario
 - Growth likely to maintain a healthy pace
 - Healthier labor market will underpin consumption
 - Financial conditions remain generally conducive to continued expansion; but mortgage credit tightening
 - Housing correction will continue throughout most of 2007
 - Inflation will drift down towards 2%

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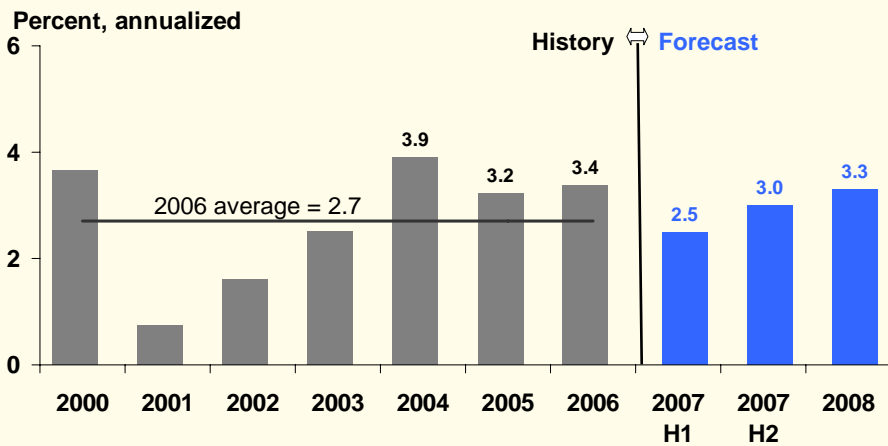
Global GDP Growth To Remain Healthy



Source: World Economic Outlook (IMF) World Development Indicators (World Bank); Forecast by H. Rosenblum

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U.S. GDP Growth On Healthy Trend



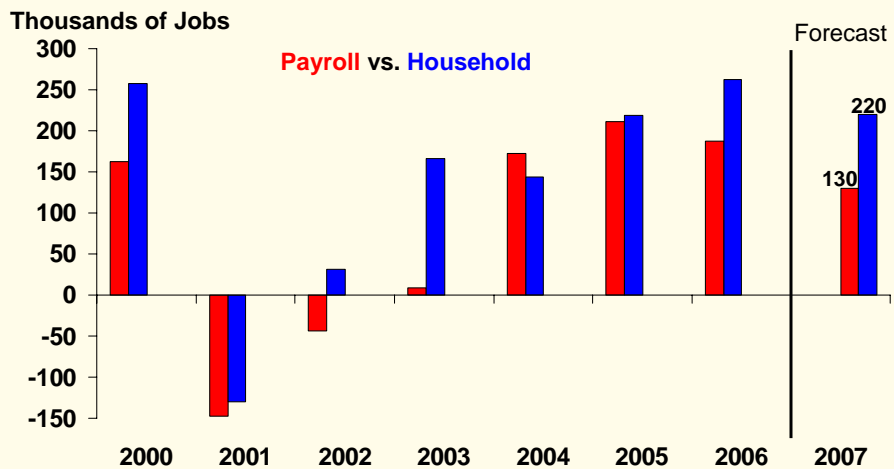
Forecast, Harvey Rosenblum

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Job Growth To Continue At A Healthy Pace, Constrained By Availability Of Workers

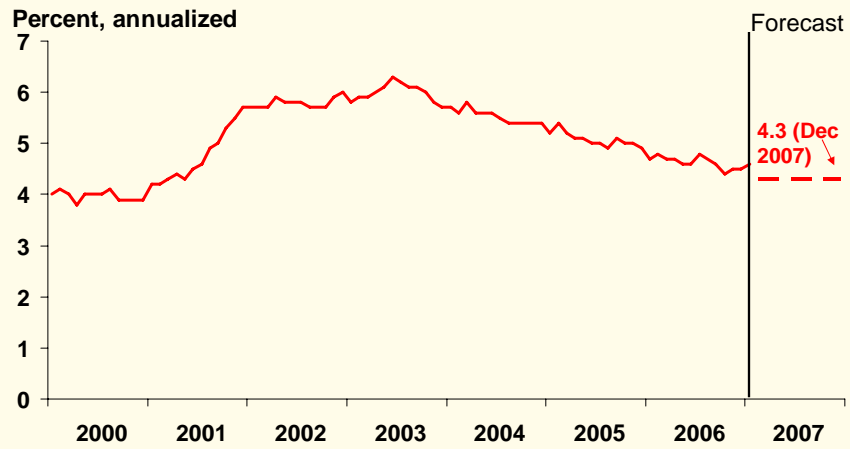
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Average Monthly Employment Gains Likely To Slow



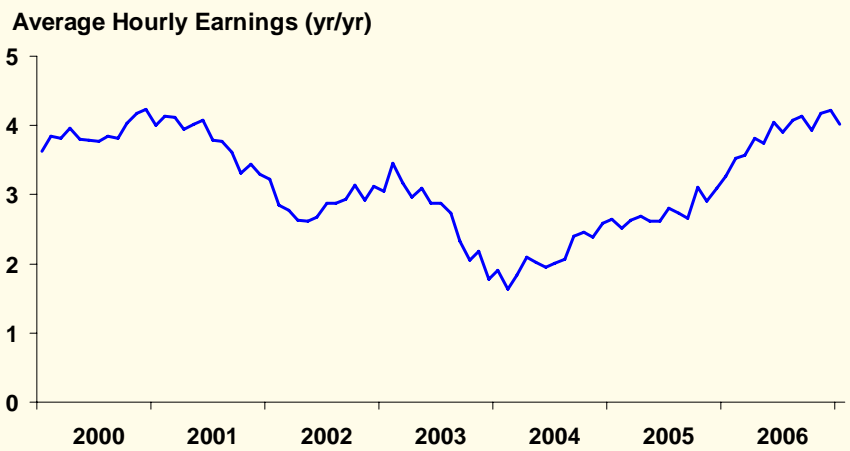
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Unemployment Rate To Edge Down



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Adding Pressure To Wages

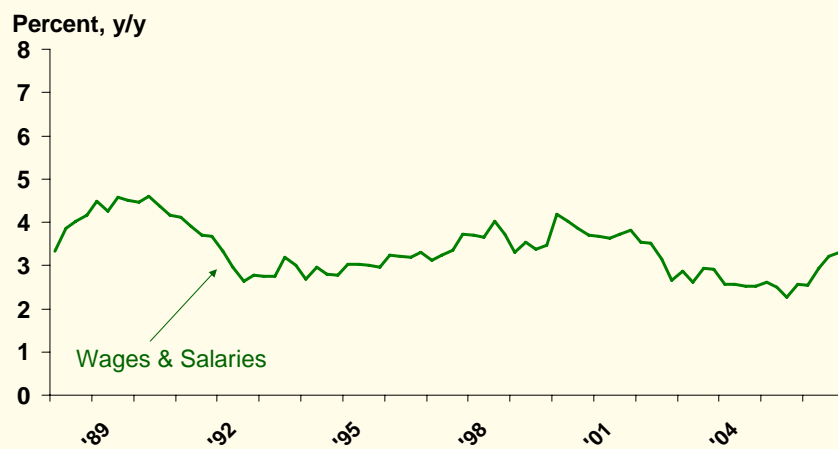


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But Slowing Benefit Gains Hold Down Compensation Growth

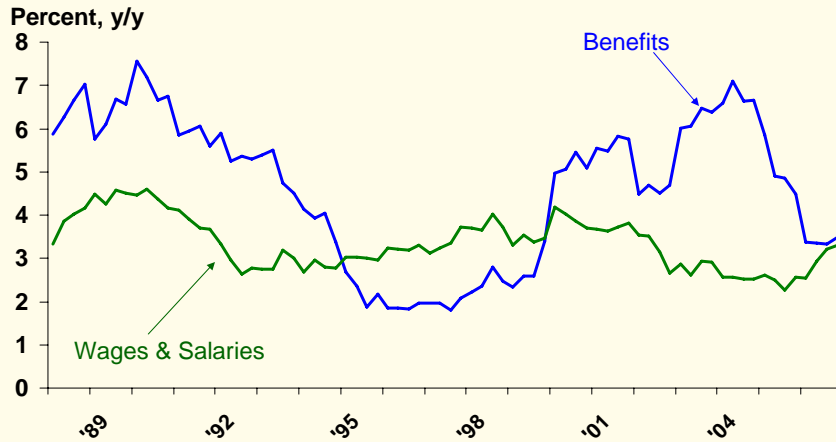
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ECI = Wages & Salaries + Benefits



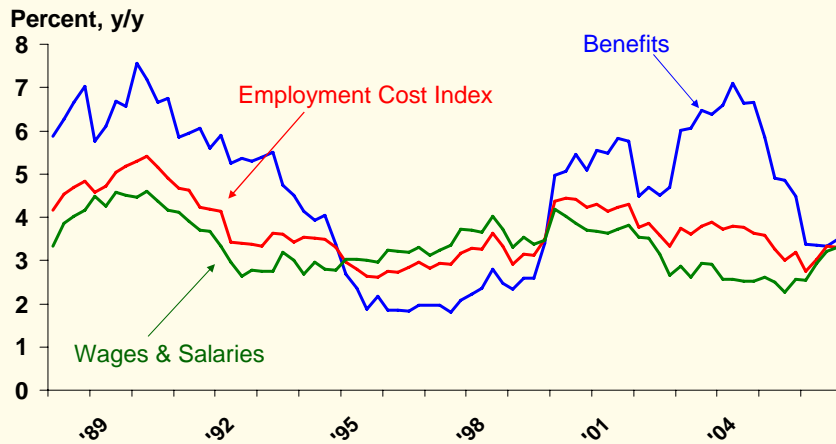
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ECI = Wages & Salaries + Benefits



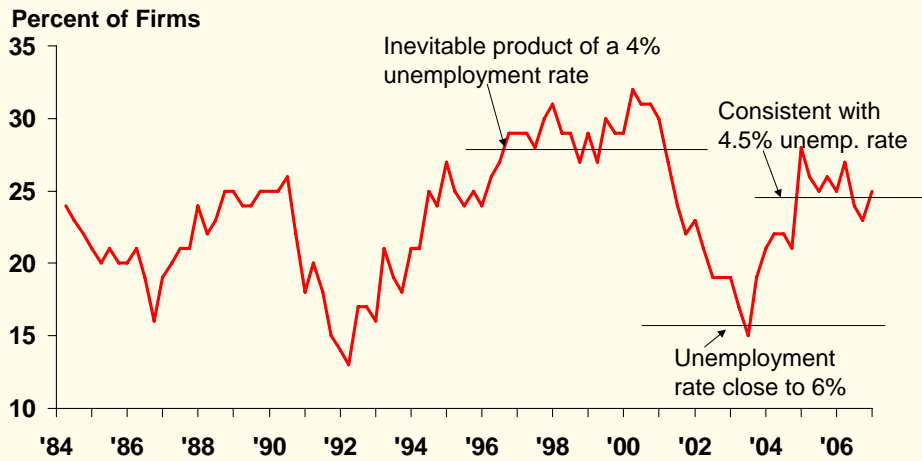
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ECI = Wages & Salaries + Benefits



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NFIB: Changes In Labor Compensation

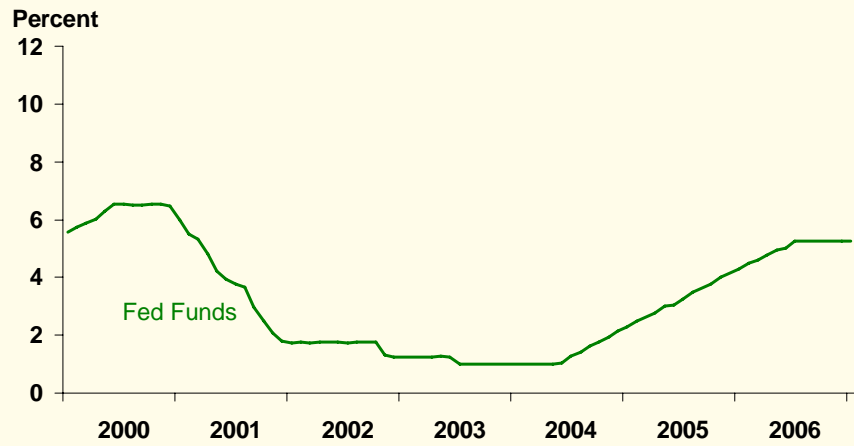


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**Financial Conditions Conducive
To Continued Expansion**

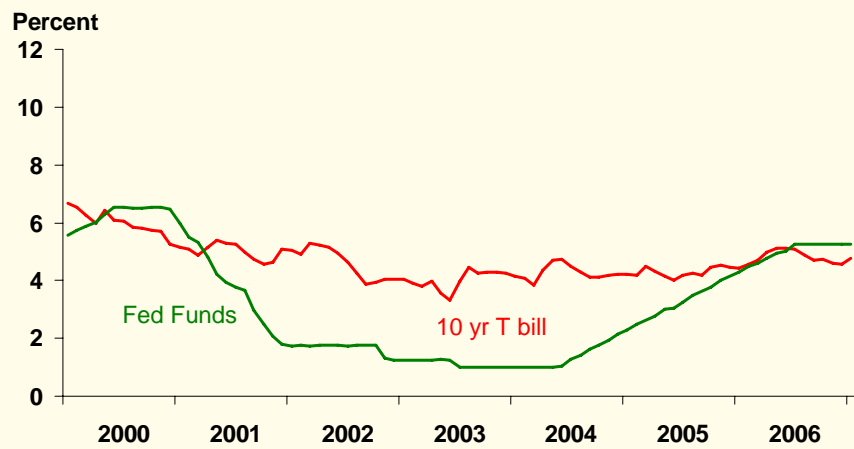
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Selected Interest Rates



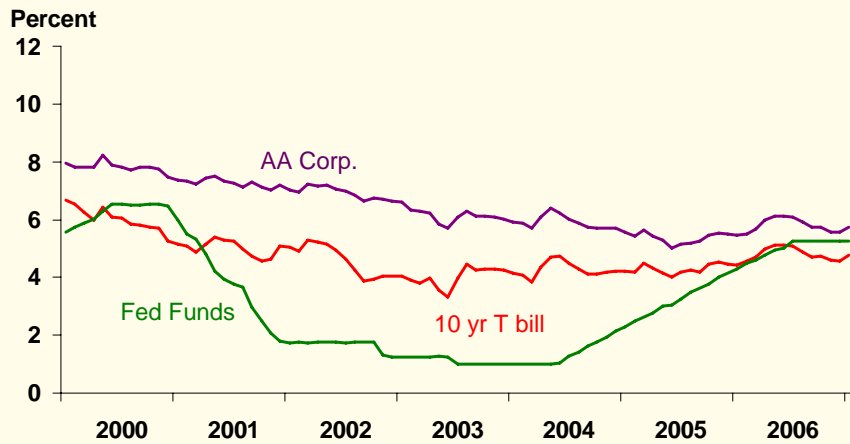
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Selected Interest Rates



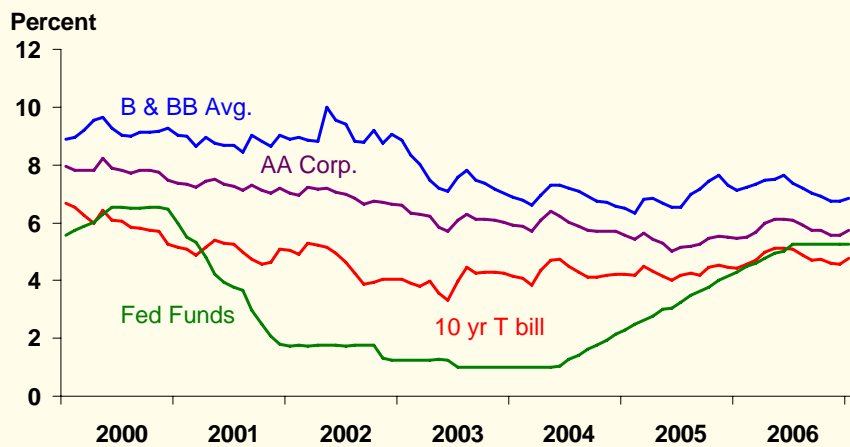
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Selected Interest Rates



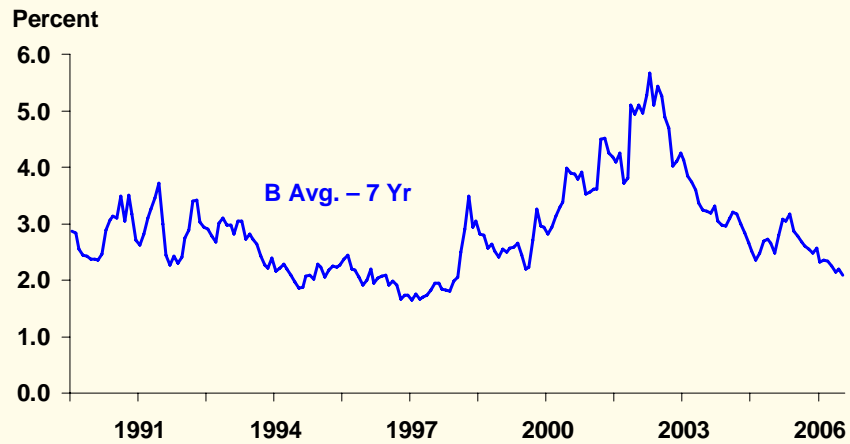
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Selected Interest Rates



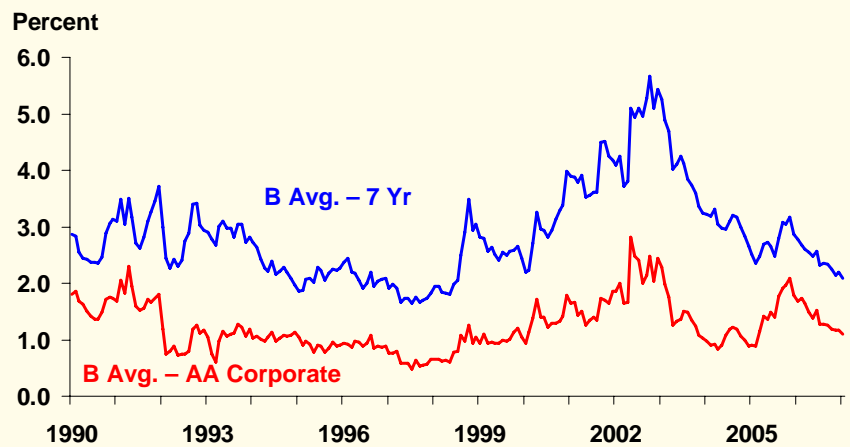
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Junk Bond Credit Spreads Quite Low



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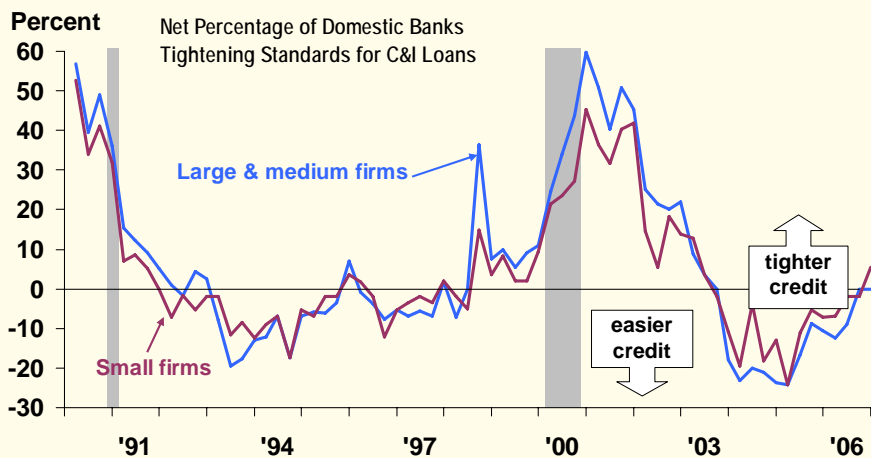
Junk Bond Financing Increases In Importance

Percent of S&P-rated Corporate Bonds

	1980	2006
Investment grade AAA, AA, A, BBB	68%	29%
Below investment grade BB and below	32%	71%

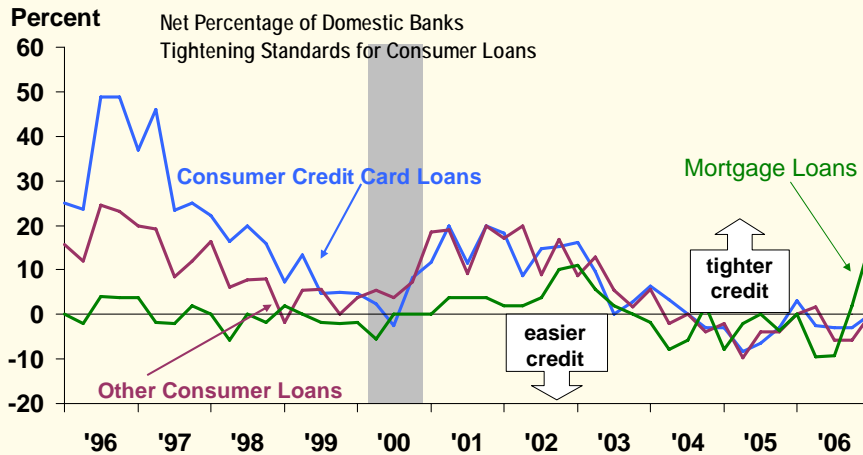
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Firming Bank Credit Standards For Business Loans



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Firming Bank Credit Standards For Consumer Loans



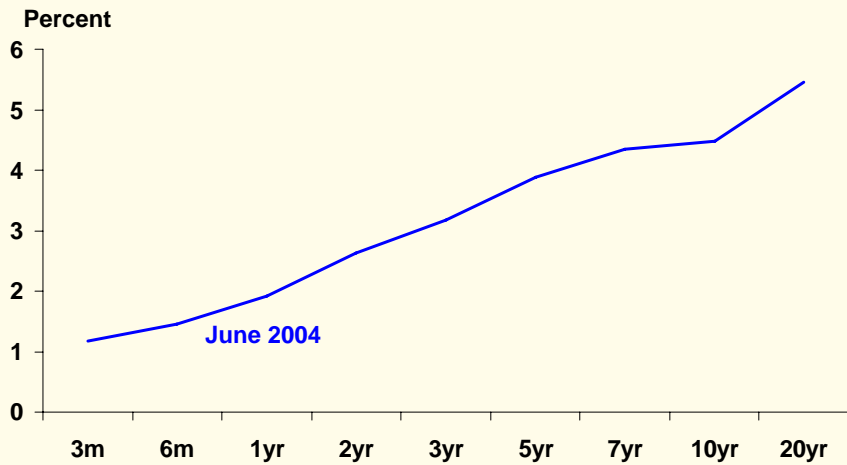
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Banking Industry In Top Shape

- Near-record profits
- Low loan delinquencies
- Credit losses declining, but noncurrent loans on the rise
- Few problem banks
- But some nonperforming securitized mortgages may come back and sap profits somewhat

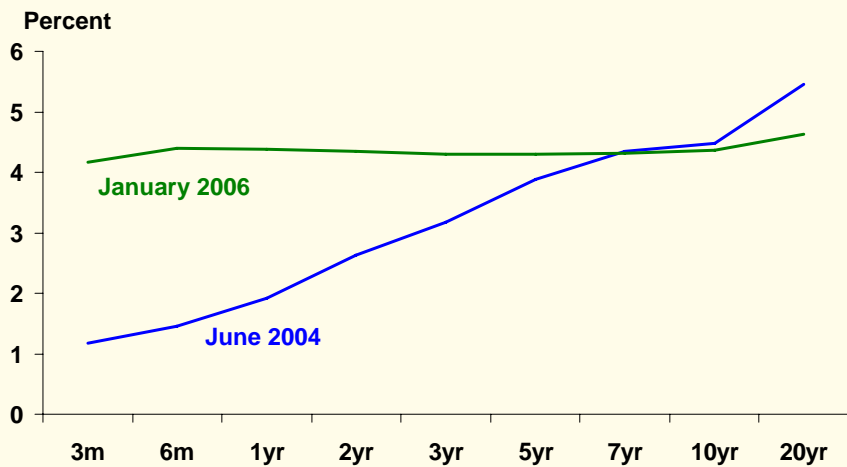
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Yield Curve Becomes Inverted



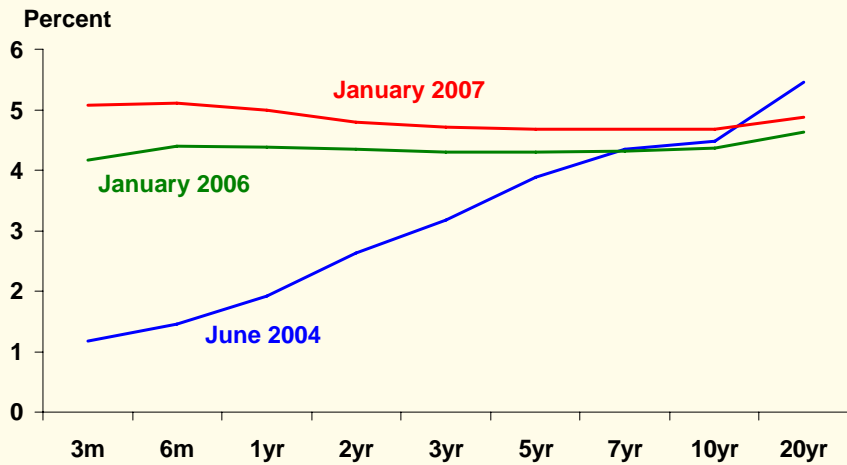
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Yield Curve Becomes Inverted



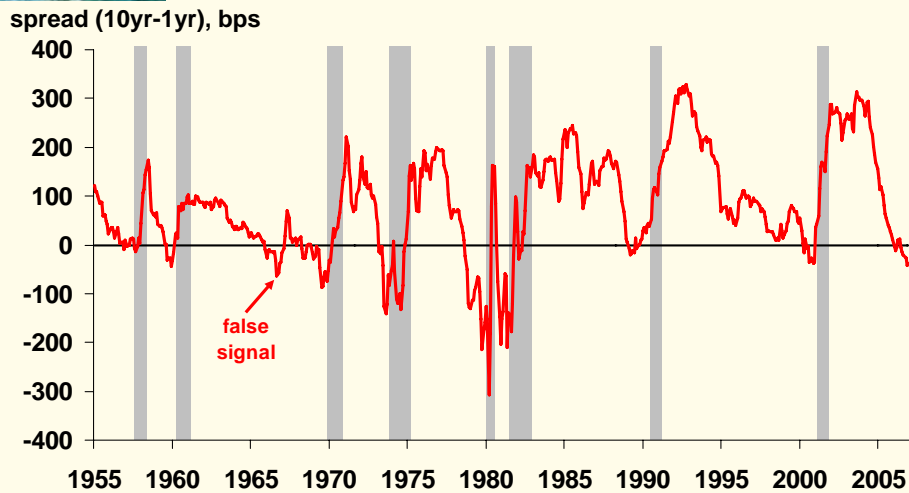
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Yield Curve Becomes Inverted



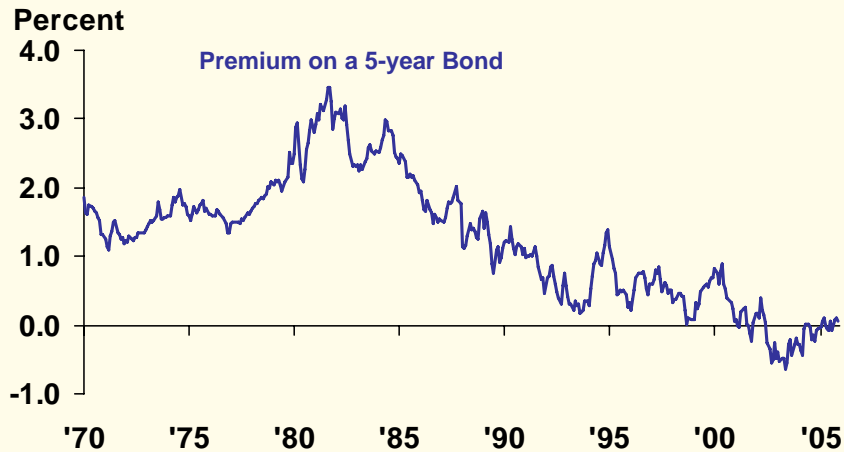
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Inverted Yield Curves Precede Recessions



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Inflation Uncertainty Premium Disappearing



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Yield Curve Recession Forecast
Inconsistent With Credit Spreads
And Job Market Strength

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Stock Market Gains Add To Financial Wealth

	<u>2006 Gains (%)</u>
Dow	15.8
S & P 500	13.3
Wilshire 5000	13.7

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But Housing Wealth – Which
Impacts A Wider Range Of
Households – Could Decline

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Housing: Improving News

- Housing starts ticked up in December by 4.5%
- New 1-family houses sold grew by 4.8% in December
- 69% of U. Michigan survey participants responded that it was a good time to buy a house, up 7.8% from last month
- Median sale price of existing single family homes rose 2.3% in December

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Housing: Worsening News

- Weather temporarily boosted housing in December
- Homeowner vacancy rate reaches 2.7%, a new record high; condo vacancy rate about 11%
- Supply overhang of 1.5 million units should reduce housing starts further and take 3 years to absorb
- Home prices flat in 2006, after double-digit gains in '05
- U.S. foreclosures up 42% in 2006 (145% in California)
 - \$1.5 trillion in mortgages will reset in 2006 and 2007
 - Subprime mortgage delinquencies are starting to rise

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Why 2007 Should Differ From Early '80s And Early '90s

- Higher home ownership rates
- Wealthier society
- Lower interest rates
- Better job market
- Increased access to housing finance
 - Homeowners use homes like ATMs
 - Riskier mortgage practices

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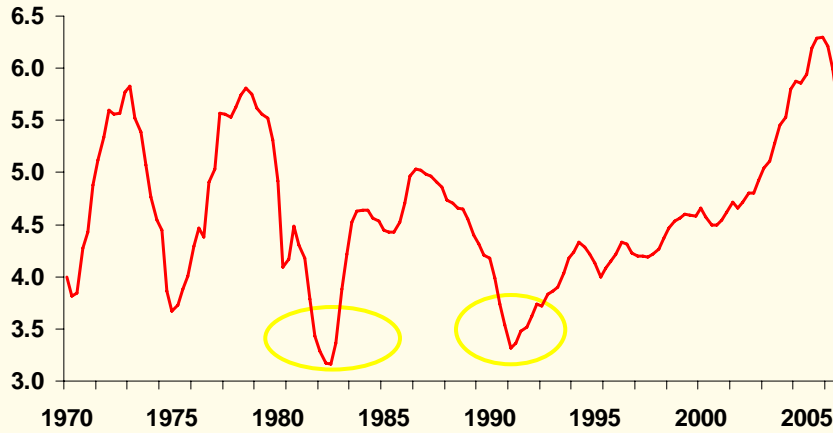
Housing's Impact on the Economy

- Construction correction (half way done?)
 - Added 1.1 points to GDP growth in 2005:q2, but subtracted 1.2 in last half 2006
 - Home building jobs more losses to come (1/4 done?)
- Consumption wealth effects (just starting):
 - Added 0.5 to 2.5 percentage points to GDP growth in '06
 - Home price appreciation drove borrowing and spending, end of appreciation could slow GDP—don't need price declines
- Mortgage distress could add further effects
 - Rise of exotic and riskier mortgage practices
 - Signs of sub-prime distress

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Significant Housing Correction Behind Us, But More Remains

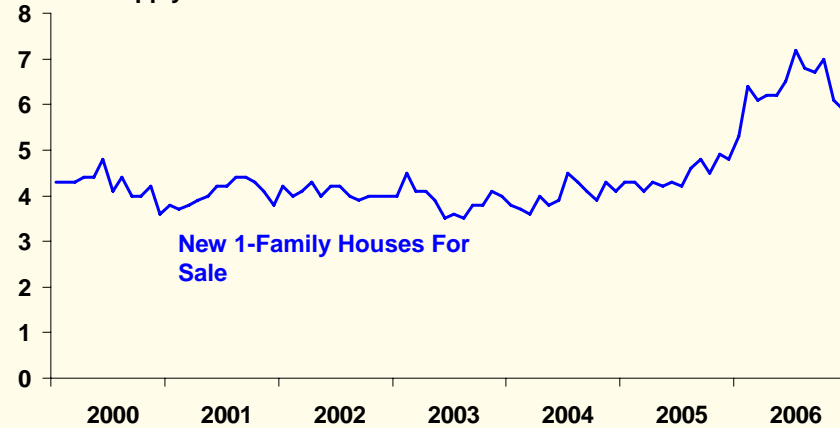
Private Residential Investment as % of GDP



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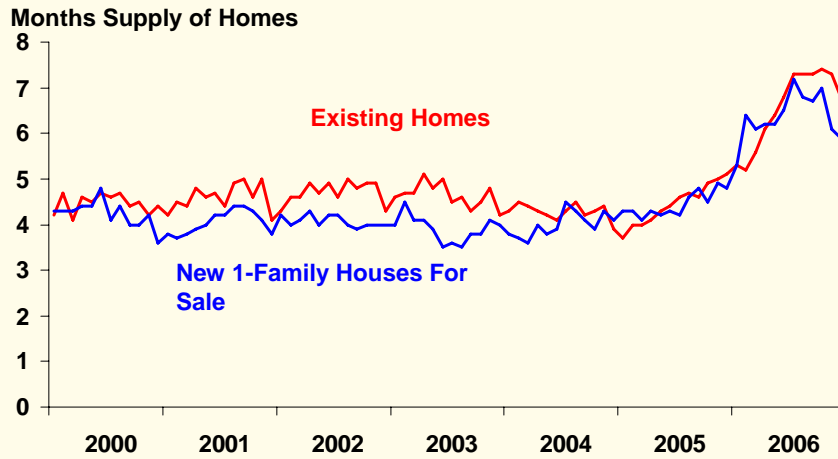
Rising Inventory Of New And Used Homes

Months Supply of Homes



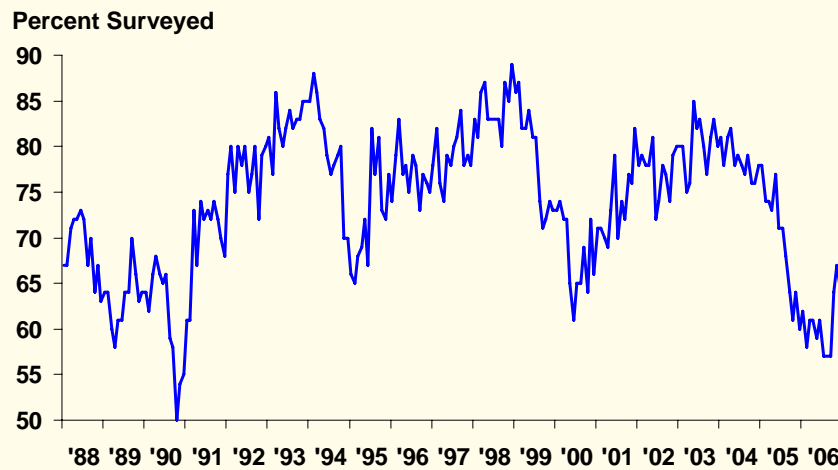
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Rising Inventory Of New And Used Homes



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Good Time To Buy A House Survey

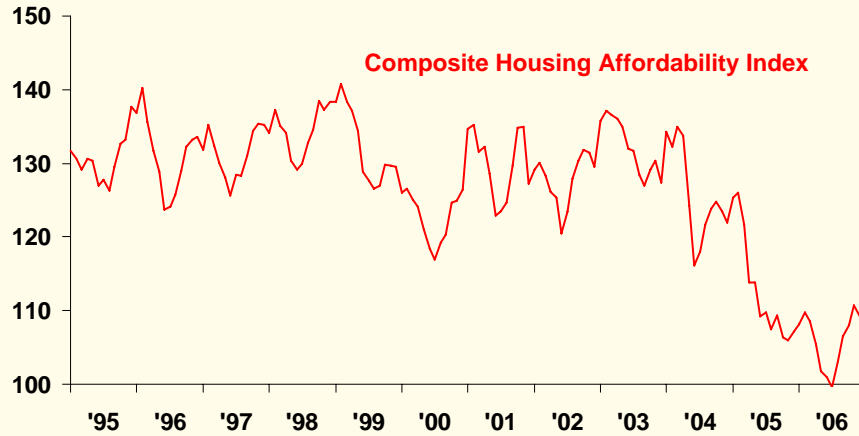


Source: University of Michigan

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Housing Affordability On Declining Trend

Index: Median Inc = 100



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Percent Of Families That Can Afford Median Priced Homes

	1999:q4	2006:q2
Los Angeles	43%	2%
Miami	59%	12%
Chicago	61%	46%
Dallas	64%	59%

Source: National Association of Home Builders and Wachovia Bank Housing Opportunity Index.

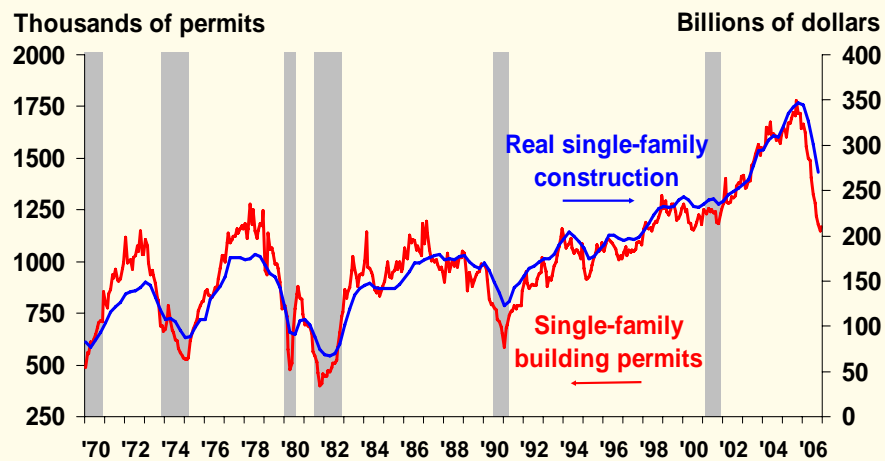
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Changes In The Housing Market

	Housing Permits	Housing Starts	Housing Sales
12-Month Change %	-23	-18	-11
3-Month Change %	-2	-5	10
Latest 1-Month Change % (Dec)	7	4	5

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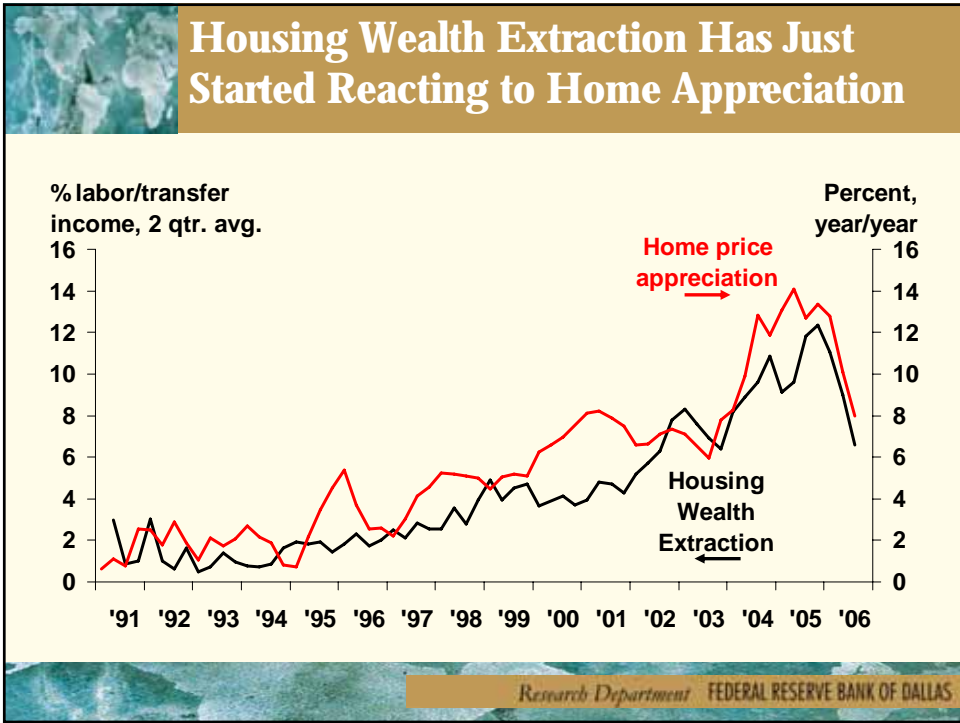
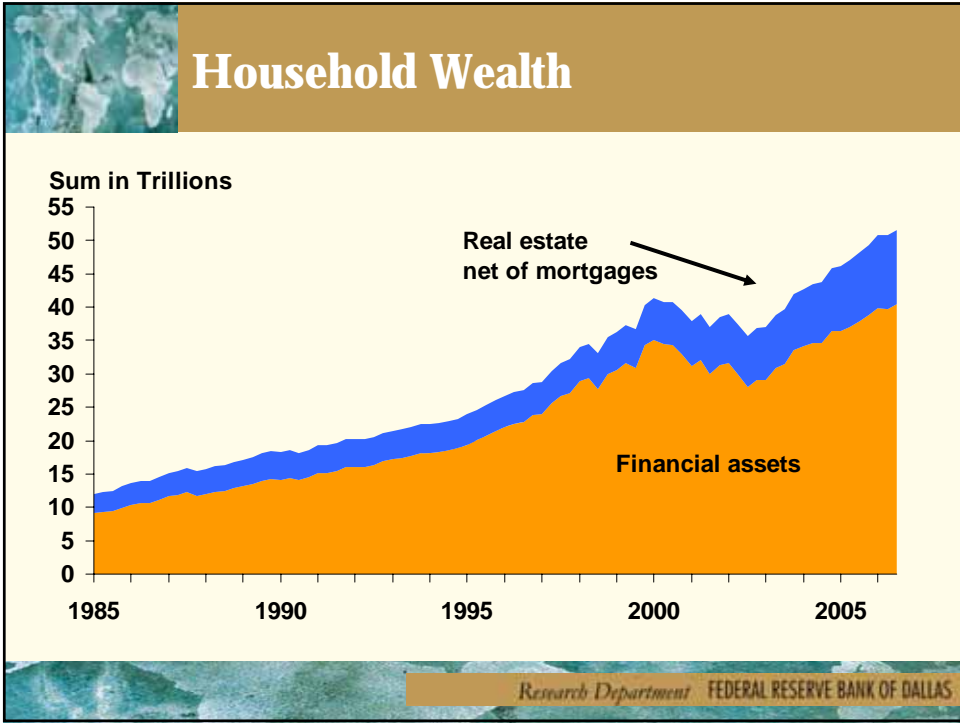
Falling Permits Point To Slowing Home Construction



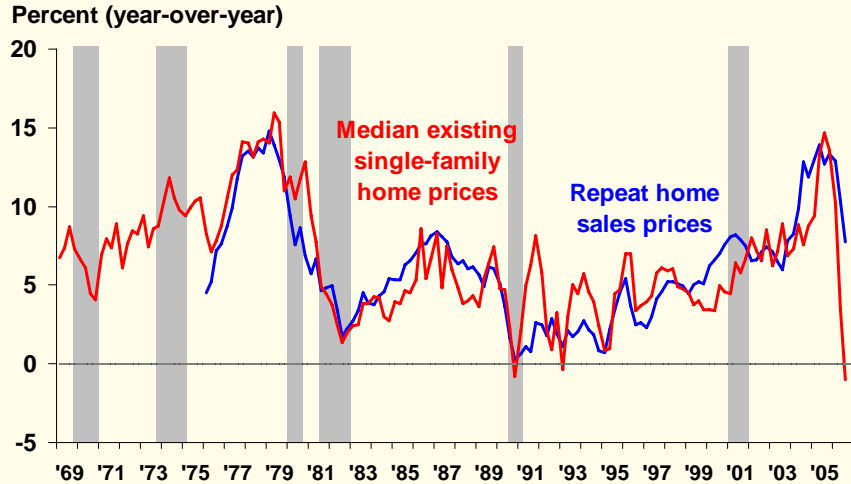
NOTES: Data are seasonally adjusted, annualized rates; contract values are chained, 2000. Shaded areas denote recessions.

SOURCES: Census Bureau; Bureau of Economic Analysis.

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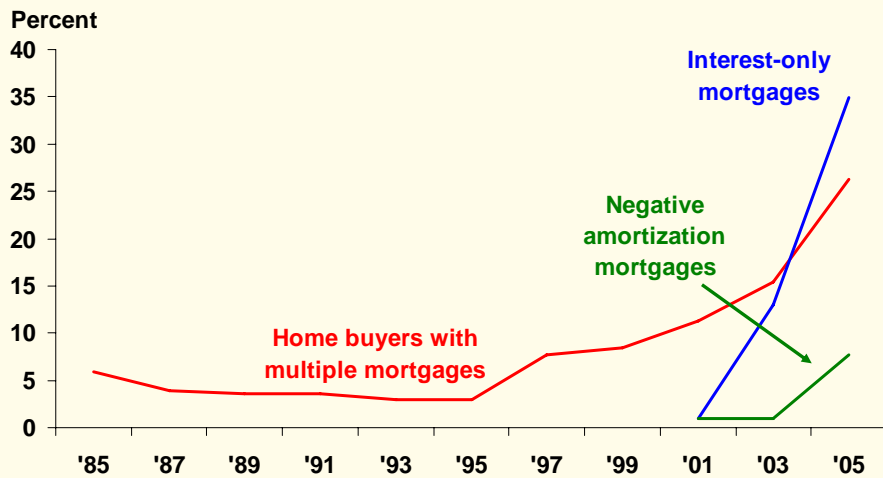
Home-Price Appreciation Slowing Sharply



NOTE: Shaded areas denote recessions.
 SOURCES: National Association of Realtors; Office of Federal Housing Enterprise Oversight.

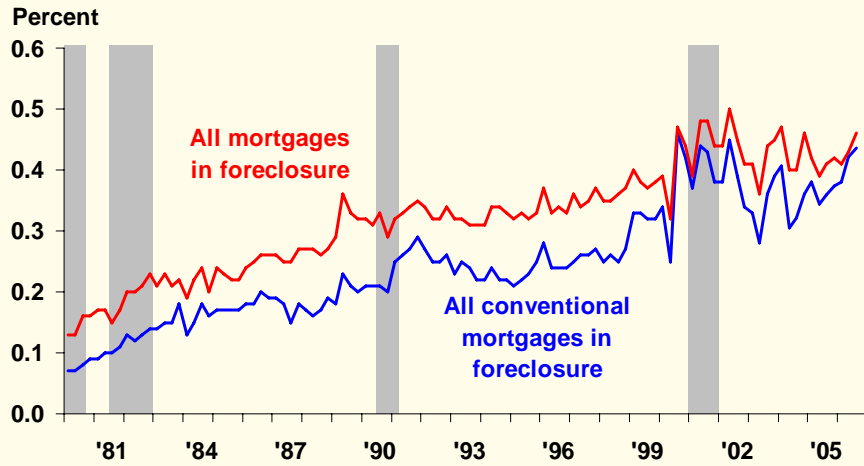
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Rise of New Mortgage Practices



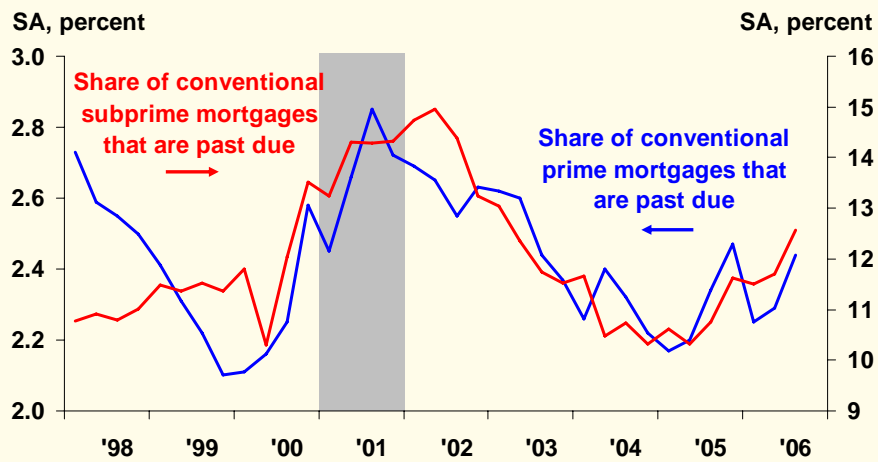
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Mortgage Foreclosure Rates Rising



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Late Mortgages More Prevalent, But It Has Been Worse



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Why Mortgage Quality in 2007 Could Differ From Early Early 2000s

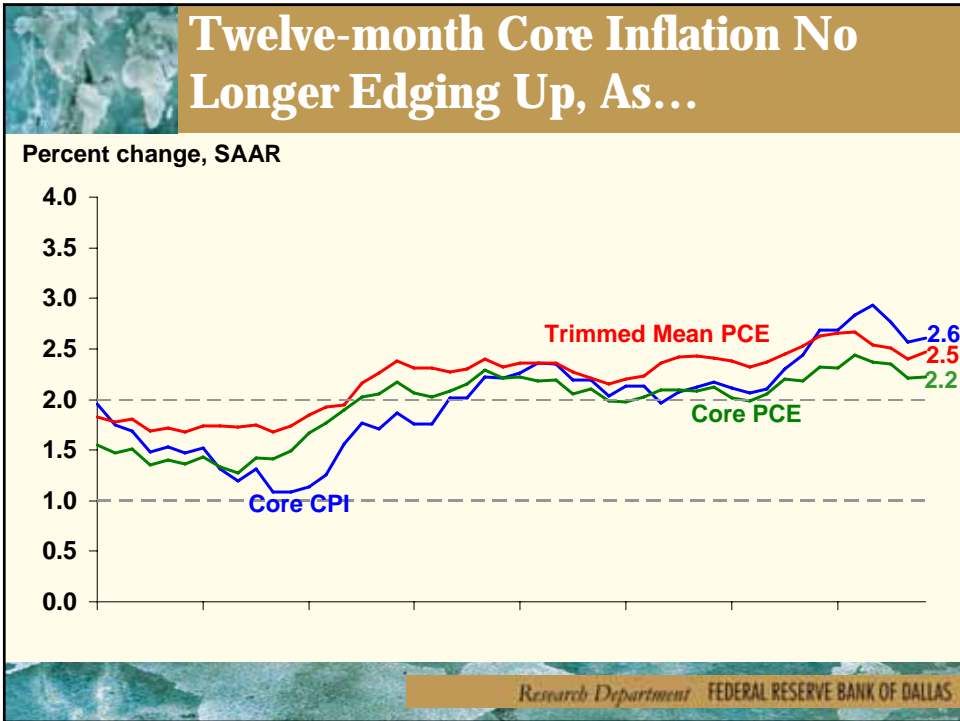
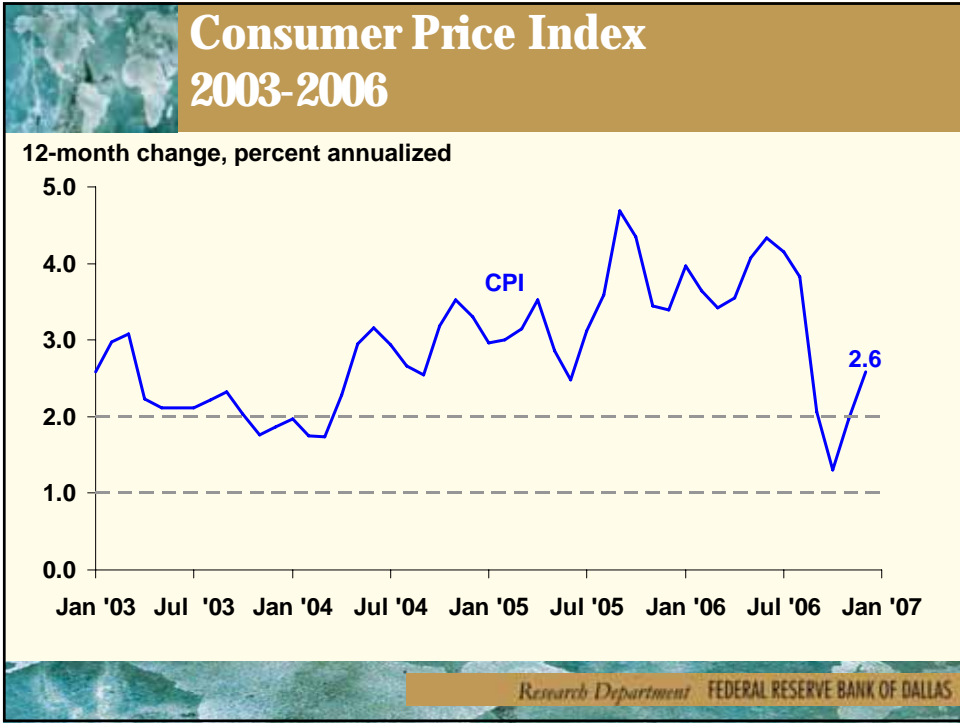
- Better job market
- But borrowers not aided by lower mortgage rates or fast home price appreciation
- Low credit quality homeowners more prevalent
 - Mortgage originations to sub-prime borrowers rise from 8.5% in 2001 to 20% in 2005
 - Mortgage originations to sub-prime, FHA, & VA borrowers rise from 16% in 2001 to 23% in 2005

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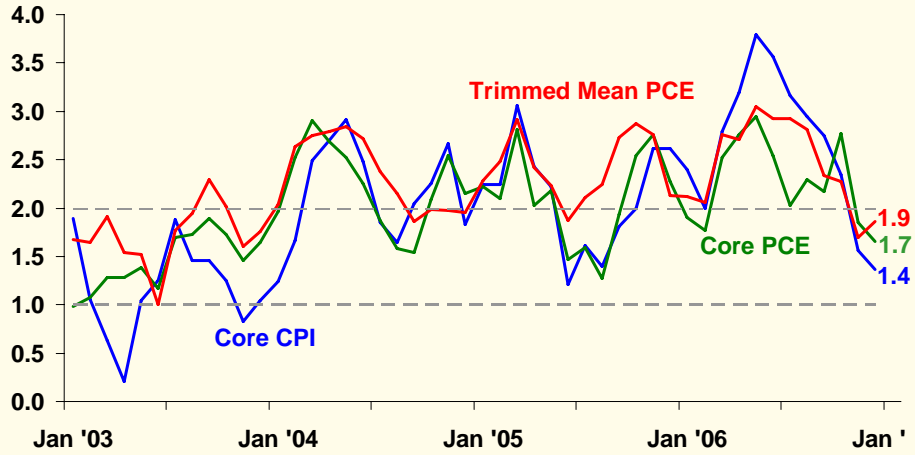
Inflation Has Peaked

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Three-month Core Inflation Has Rolled Over

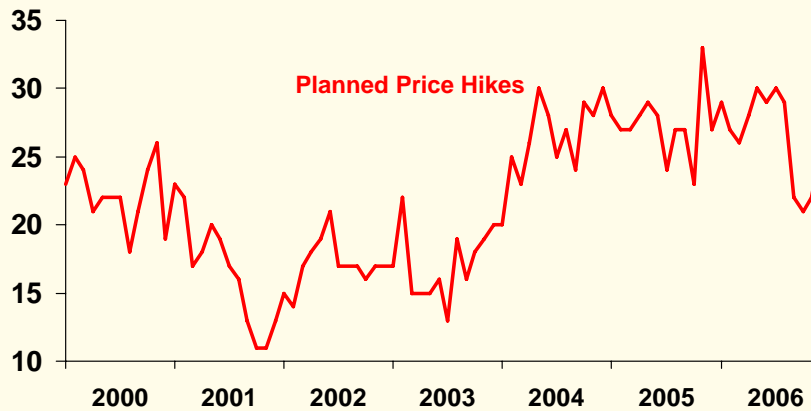
Percent change, SAAR



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Pricing Power Has Ebbed Somewhat

Percent of Firms



Source: NFIB

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Summary

- The housing market notwithstanding, growth should improve in '07 and '08
- Full employment and ebbing inflation should continue in 2007
- Key risk is a weaker than anticipated housing market with a spillover to other spending and to financial market psychology

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Constellation and Convergence of Favorable Conditions

Too Much to Continue to be True

- Three years of strong stock market returns
- Fourteen consecutive quarters of double-digit profit growth
- Moderate wage pressures in a full-employment economy
- Abundant liquidity worldwide
- Strong global growth with subdued inflation outside commodity sectors

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Downside Risks To The Outlook

- Very weak housing sector with spillover to
 - Consumption and investment
 - Investor psychology
 - Bank capital losses and reduced appetite for risk
- Tight labor markets constrain growth, add to inflation pressures, and weigh on financial market psychology
- Politics, protectionism, nationalization and kleptocracy
- Yield curve signal turns out to be correct

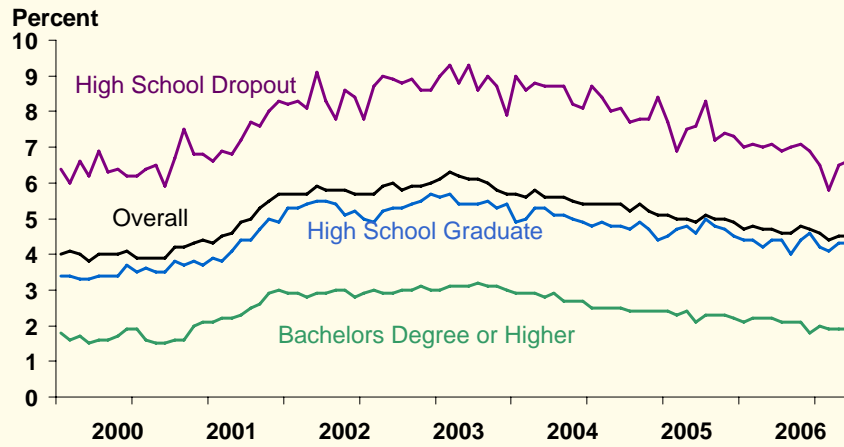
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Back Of Tray

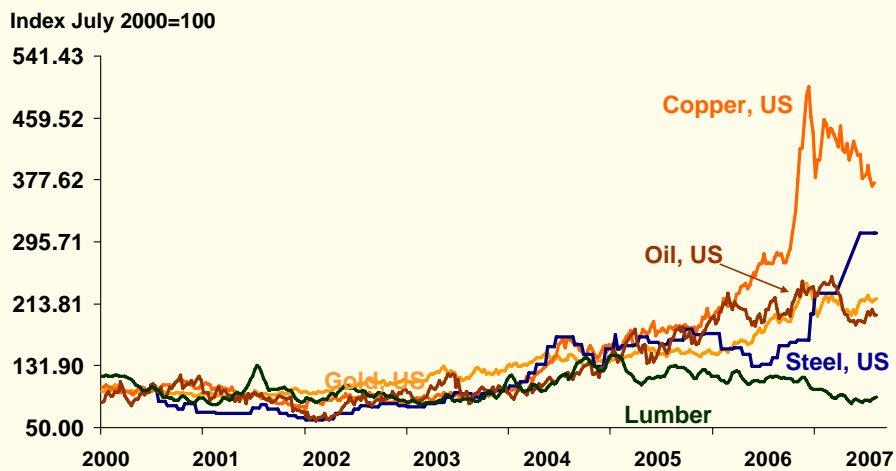
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U.S. Unemployment Rates



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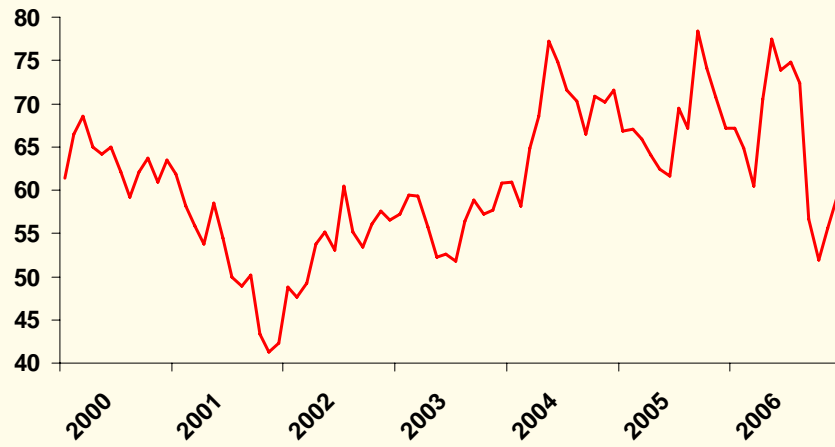
Commodity Prices



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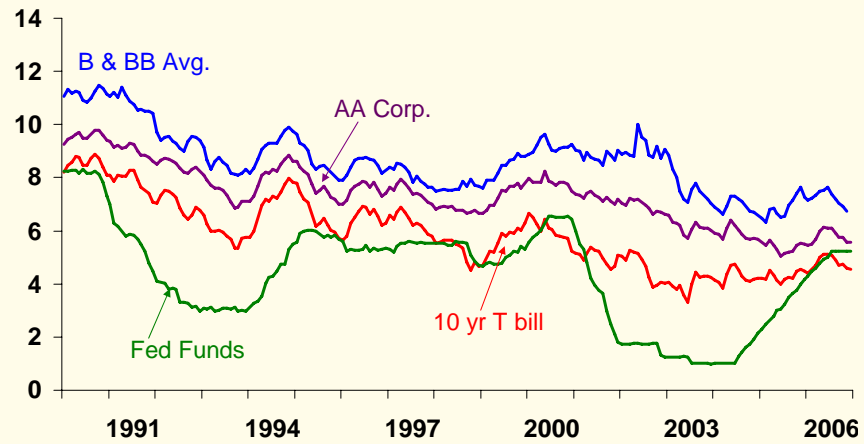
ISM Prices Paid

ISM Prices Index 50+ = Increasing



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Percent



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Composite Housing Affordability Index

Index=100 when median family income qualifies for an 80% mortgage on a median priced existing single-family home. A rising index indicates more buyers can afford to enter market.

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Median-priced Home Ownership Plunges On Coasts

Percent of Homes Affordable to Median-Income Residents

	1999:q4	2006:q2
Los Angeles	43%	2%
San Francisco	11%	8%
Seattle	49%	26%
New York	55%	6%
Boston	54%	22%
Washington	77%	21%
Miami	59%	12%
Jacksonville	76%	53%

Source: National Association of Home Builders and Wachovia Bank Housing Opportunity Index.

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Median-priced Home Ownership More Stable Inland

Percent of Homes Affordable to Median-Income Residents

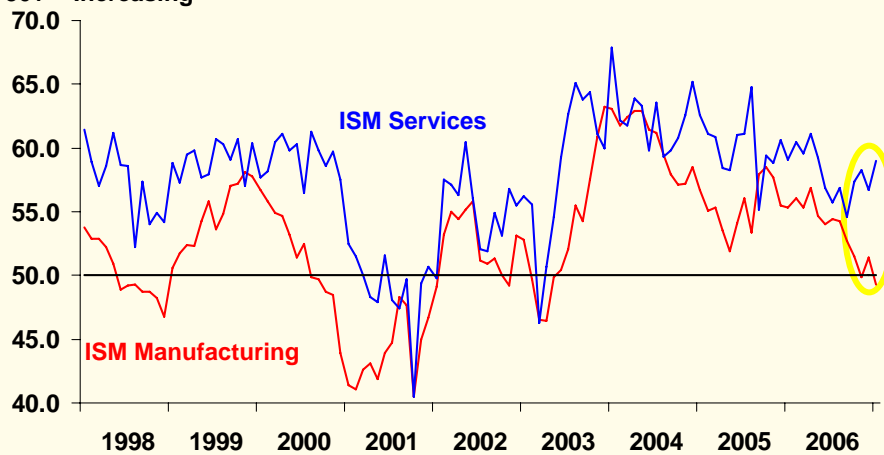
	1999:q4	2006:q2
Chicago	61%	46%
Dallas	64%	59%
Denver	58%	59%
Houston	66%	54%
Minneapolis	78%	60%
Phoenix	69%	27%
Las Vegas	70%	16%

Source: National Association of Home Builders and Wachovia Bank Housing Opportunity Index.

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Purchasing Managers Indicate Weak Manufacturing But Stronger Services

50+ = Increasing



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A Forward-looking Taylor Rule

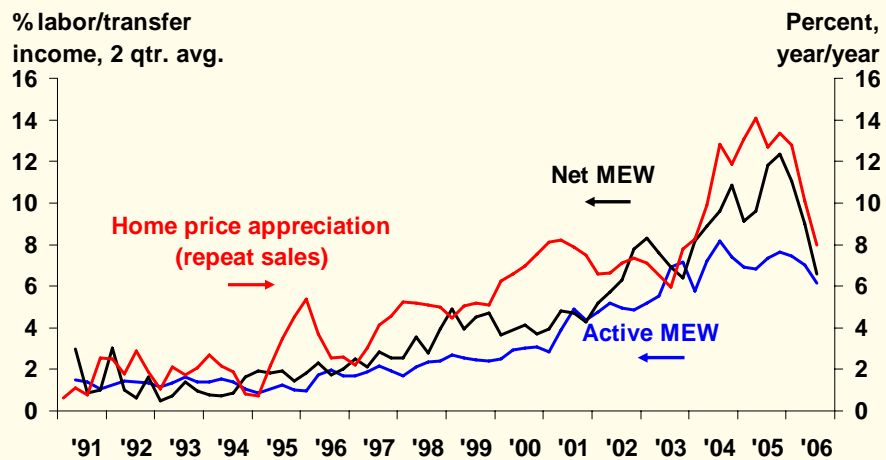
Fed Funds-Rate Response to a 1-percentage Point Increase In Each of Three Determinants

Determinant	Fed Funds-Rate Response	
	Initial (percentage points)	Eventual (percentage points)
Expected Inflation	+1.0	+1.9
Unemployment Rate	-1.0	-2.1
Expected GDP Growth	+0.4	+0.7

Source: E. Koenig, Southwest Economy, May/June 2004

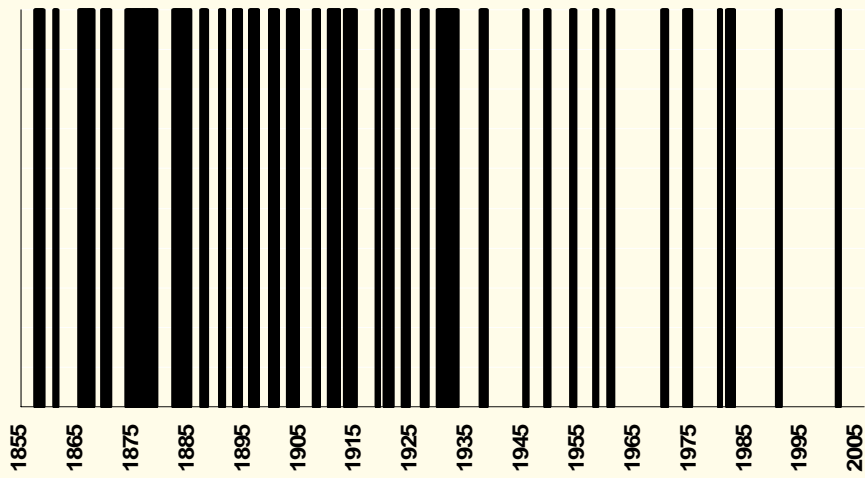
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Housing Wealth Extraction Has Just Started Reacting to Home Appreciation



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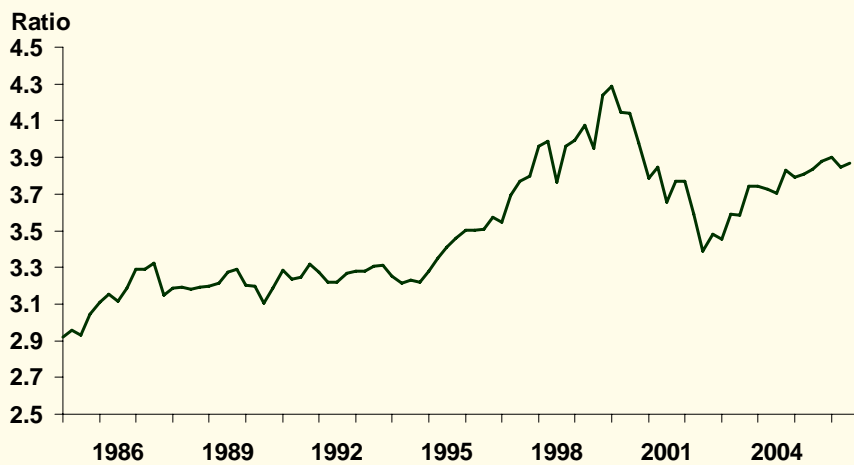
Fewer Economic Downturns



Black bars are months of contraction

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Household Wealth As Percent of GDP



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