

Unstable

Equilibrium

2007 *Economic Forecast*

UPDATE

usbank
Five Star Service Guaranteed 

Elqui·lib·rilum — A state of balance between opposing forces such that, if there is a chance departure from that balance, there are forces that will drive the system over time back to the initial equilibrium.

Preliminary data on output (gross domestic product) growth in 2006 indicate it was a bit slower than we expected in nominal (2006 dollars) terms, but faster in real (inflation-adjusted) dollars. Consumer inflation, which we had estimated at 3.8%, averaged only 3.2%, thanks to a 34% decline in oil prices in the second half of the year.

Housing permits fell even more sharply than we anticipated, down 14.8% versus our forecast of a 9.7% decline. Auto and truck sales declined as we expected, down 2.5% to 16.55 million. The unemployment rate, at 4.6%, was in line with our estimate of 4.8%.

Interest rates were a bit slower to increase than we anticipated when the forecast was written last summer. The 10-year Treasury bond rate declined from 5.2% at the end of June to 4.5% in early December, for a 2006 average of 4.8%. However, by February it was almost 5.0%. The 30-year conventional mortgage rate followed the same pattern, falling to 6.1% in early December from 6.8% last July. By late February it was 6.3%. The 90-day Treasury bill rate averaged 5.2% in February, up from 4.7% for 2006. The Federal Reserve has left short-term interest rates unchanged since June.

In Colorado, growth in 2006 was generally a bit slower than we estimated last July. Personal income growth was

revised down for 2005 and was actually negative in the second quarter of 2006. Retail sales growth remained strong, up 9.0% through November. However, it slowed to 5.1% in November from double-digit rates in the first half of the year. Housing permits dropped three times as fast as we anticipated, down 14.3%. The value of nonresidential construction contracts was revised up dramatically for 2005, a 28.3% gain rather than the 8.6% increase originally reported. As a result, the rate of growth in 2006 was substantially below what we estimated, only 2.1%. The Denver-Boulder inflation rate was 3.6% for the year, close to our forecast of 3.5%.

Employment: The most important indicator of an economy's health is employment growth. These data provide some evidence that our original forecast may have been too pessimistic. In October, the Bureau of Labor Statistics announced that nonfarm payroll employment in 2006 would be revised up by 810,000 jobs, the largest revision in the history of the survey. This added about 0.5 percentage points to 2006 job growth, although it does not affect the unemployment rate, which is based on a different survey. Some industries were reporting labor shortages as 2007 began. The weekly wages of non-supervisory workers increased 2.1% after adjustment for inflation in 2006, the biggest gain since 1997 and the first increase since 2002.

NATIONAL ECONOMIC INDICATORS

	2005	2006	2007f	04/05	05/06	06/07f
Gross Domestic Product (billions)	\$12,455.8	\$13,244.6	\$13,827.4	6.3%	6.3%	4.4%
Real GDP (billions of 2000 dollars)	\$11,048.6	\$11,413.6	\$11,653.3	3.2%	3.4%	2.1%
Unemployment Rate	5.1%	4.6%	5.0%	n/a	n/a	n/a
Housing Permits (million units)	2.16	1.84	1.61	4.1%	-14.8%	-12.3%
Auto/Truck Sales (million units)	17.0	16.6	16.2	0.6%	-2.5%	-2.4%
Consumer Price Index (1982-84=100)	195.3	201.6	207.1	3.4%	3.2%	2.9%
90-Day Treasury Bill Rate	3.2%	4.7%	5.1%	n/a	n/a	n/a
10-Year Treasury Note	4.3%	4.8%	5.1%	n/a	n/a	n/a
30-Year Conventional Mortgage Rate	5.9%	6.4%	6.7%	n/a	n/a	n/a

n/a = not applicable f = forecast

Dis·equi·lib·rium — A state of balance between opposing forces such that, if there is a chance departure from that balance, the system may be: **1** driven to an alternative equilibrium position through oscillations that fade gradually over time, or **2** prevented from reaching a new stationary equilibrium through oscillations that increase in amplitude.

On the negative side, the unemployment rate was essentially unchanged over the year – 4.7% in January 2006 and 4.6% a year later. There was almost no change in the number of workers marginally attached to the labor force – 1.6 million. These are workers who have looked for a job in the last 12 months and still want and are available for work, but haven't looked in the last four weeks, and therefore aren't counted as unemployed. If they were counted, the unemployment rate would be 5.6%.

In Colorado, the preliminary estimate of job growth for 2006 was 2.1%, just below our forecast of 2.2%. This figure is likely to be revised up slightly in the March benchmarking. Although this is very slow job growth by Colorado standards, as 2007 began there were numerous "help wanted" signs outside retail establishments such as department stores, gas stations and grocery stores. The unemployment rate in 2006 declined from 4.7% in January to 4.0% in December, the lowest level since August 2001

Recession triggers: Our forecast cited three factors that might trigger a recession by year-end: higher long-term interest rates, rising energy prices and/or the collapse of the housing bubble. Any of these would force households already burdened by high levels of debt and no saving out of income to reduce their spending.

Beginning with the good news, *energy prices* fell sharply in the second half of 2006. The New York Mercantile Exchange price for sweet crude declined from \$77 a barrel in July and August to \$51 a barrel in early January. However, a month later prices were above \$59 a barrel. Oil consumption in the 30 countries comprising the Organization for Economic Cooperation and Development fell 0.6% in 2006, the first annual drop in more than 20 years. These countries account for about 60% of global oil consumption. Due to steady growth in China and the Middle East, global oil demand rose 0.9%, but this was down from 3.9% in 2004 and 1.5% in 2005.

Cutbacks in OPEC production have increased spare capacity to about three million barrels a day. No one is sure what price OPEC is targeting – perhaps \$55-\$60 a barrel – but the return of spare capacity will help prevent wide price fluctuation.

The *housing bubble* is deflating more rapidly than was anticipated. Housing permits fell 14.8% last year and new home construction in January plunged to a 10-year low. Single-family permits declined 18.0% in 2006, while multifamily permits were down 3.4%. About 18,000 residential construction jobs were eliminated in the final quarter of 2006.

Sales of existing homes fell 8.4% last year, while the inventory of homes for sale increased 23.3% and the median price was unchanged (but down 2.7% in the fourth quarter). In the fourth quarter of 2006, prices fell in 49% of the areas surveyed by the National Association of Realtors, the widest price decline in the survey's history. The Census Bureau reported that the number of vacant homes for sale in the fourth quarter reached a 40-year high.

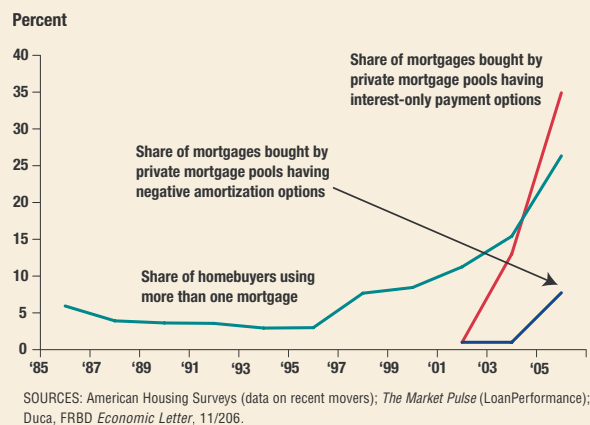
Sales of new homes fell 17.3% in 2006, the biggest plunge since 1990. The inventory of completed homes for sale in December was 50% ahead of December 2005.

We are in the early stages of the fallout from the exotic mortgages that financed much of the home sale activity in the last few years. In recent years, lenders have offered a combination of adjustable-rate, no money down, interest only, negative amortization (adding part of the interest payment due each month to the principal balance) and subprime (loans made at a higher interest rate to households with weak credit histories) mortgages.

Higher mortgage rates are causing foreclosures to soar. About \$2 trillion in adjustable-rate mortgages will readjust by the end of 2007, \$500 billion for the first time. Those taken out several years ago with rates in the 4% range

are readjusting at rates of 6% or higher, significantly increasing monthly payments.

Rising Use of Multiple, Interest-Only and Negative Amortization Mortgages in the U.S.



The Center for Responsible Lending in Durham, N.C. estimates that almost 20% of the subprime mortgages originated in the last two years will end in foreclosure, costing homeowners as much as \$164 billion. The Mortgage Bankers Association reported that 4.8% of all home loans were delinquent in the third quarter, compared with a record delinquency rate of 6.1% in 1985. Among adjustable-rate subprime loans, 13.8% were delinquent and 7.8% were in foreclosure in the third quarter.

How high *interest rates* go in 2007 is largely dependent on the investment decisions of foreign investors, particularly foreign central banks. In the third quarter of 2006 (most recent Federal Reserve Flow of Funds data available), foreigners held 43.1% of U.S. Treasury securities, up from 32.7% five years ago. In the third quarter alone, they purchased \$1.44 trillion (annualized) of financial assets in the U.S. This included the acquisition of \$163.2 billion of Treasury securities, \$212.8 billion of agency and GSE-backed securities (GSEs are government sponsored enterprises), \$343.9 billion of corporate bonds, \$97.8 billion of corporate equities and \$181.4 billion of direct investment.

If foreign investors reduce their purchases of our debt instruments and equities, either because central banks allow their currencies to appreciate or because public

and private investors decide to diversify their holdings into other countries, two things will happen. The price of the securities will fall, pushing interest rates up. And, the value of the dollar against foreign currencies will decline. China, which holds \$1.01 trillion in reserves, the majority in dollars, has already allowed the renminbi to appreciate against the dollar by 7%.

Any increase in energy prices or interest rates, along with declining home prices, will increase the *financial stress* of U.S. households. Saving out of after-tax income was negative in 2006 for the second consecutive year and only the fourth time in the country's history. The negative 1.0% was the worst performance since 1933. Household financial debt at the end of the third quarter was \$12.6 trillion, up 6.8%. During the last four years, household debt has increased between 10.6% and 11.7% annually.

At the end of the third quarter, households had \$13 trillion in liabilities and \$67.1 trillion in assets, for a net worth of \$54.1 trillion. The largest components were \$22.4 trillion in real estate (33.4%), \$11.6 trillion in pension funds (17.3%) and \$9.7 trillion in equities and mutual funds (14.5%). Wealth is vulnerable to declining real estate prices and a falling stock market. The value of the real estate component has grown over 64% in the last five years.

This enormous increase in wealth has fueled household spending while, at the same time, it made saving out of income seem unnecessary. It is easy to forget that the value of equities and mutual funds held by households declined \$2.2 trillion between 2001 and 2002, a 23.4% plunge, and pension fund reserves fell 8%. If a portion of today's wealth suddenly disappeared, it could trigger a decline in both the ability and the willingness to spend, precipitating a recession.

Revised 2007 forecast: We continue to believe that the most likely scenario is a recession beginning late in 2007, although the possibility of its being delayed until 2008 has risen over the past six months. The longer consumers continue to maintain spending by adding to debt, the deeper the recession is likely to be.

Our forecast of a 2.1% gain in real GDP, with a quarter of negative growth by year-end, remains unchanged, as does our projection of a 12.3% drop in home permits

and a 2.4% decline in auto/light truck sales. We have revised our inflation forecast down to 2.9%, in part due to the fall in commodity prices. However, unit labor costs increased 3.2% in the nonfarm business sector of the economy in 2006, the largest gain in six years. These costs are likely to be passed along in the form of price increases as the year unfolds.

We do not expect the Federal Reserve to cut short-term interest rates before the second half of 2007 at the earliest, so we have revised our 90-day Treasury bill rate forecast up to 5.1%. Long-term rates may be lower than we expected six months ago. Our current forecast is 5.1% for the 10-year Treasury bond and 6.7% for the 30-year conventional mortgage.

We have revised our population growth forecast up to 2.0%, in response to the Colorado Demography Office's new projection that net migration will be 54,000. Our job growth forecast remains at 2.1% or about 32,000 jobs. As the economy slides into recession later this year, the unemployment rate will rise to average 4.6%.

We have increased our personal income and retail sales growth forecasts a bit, to 4.8% and 4.1% respectively. Consumers continued to maintain their spending in the first quarter through a combination of debt and modest income growth. This will weaken rapidly in the second half of the year.

Housing permits will decline for the third consecutive year, down 9.1%. This is a combination of a 5% drop in single-family permits and a 25% contraction in multifamily permits. Multifamily permits rose a troubling 38.9% in 2006 despite a 6.1% decline in sales and a 1.9% decline in the median prices in the metro Denver market. In December, sales were down 27.3% and the median price dropped 6.3%.

Nonresidential construction will have a relatively flat year as current projects are completed and there are fewer new projects to replace them. Local commercial builders are already reporting that new business is difficult to come by. The value of nonresidential permits will fall 2.7%.

Inflation in the Denver-Boulder metro area will average 3.1% in 2007, higher than the U.S. rate. A stronger housing market will be the biggest factor. Since prices have not risen as much as in many other parts of the country, they do not have as far to fall before equilibrium is reached.

The recession will continue through most of 2008. Growth will not resume until consumers get their debt under control and foreclosures, housing prices and housing inventories decline. We continue to forecast a relatively hard landing for the U.S. and Colorado economies.

COLORADO ECONOMIC INDICATORS

	2005	2006	2007 ^f	04/05	05/06	06/07 ^f
Population	4,722,755	4,795,130	4,889,830	1.5%	1.5%	2.0%
Net Migration	29,789	32,000	54,000	n/a	n/a	n/a
Nonagricultural Wage and Salary Employment	2,225,500	2,272,100	2,303,900	2.1%	2.1%	1.4%
Unemployment Rate	5.0%	4.4%	4.6%	n/a	n/a	n/a
Personal Income (billions)	\$174.8	\$184.7	\$195.4	6.5%	5.7%	5.8%
Per Capita Personal Income	\$37,459	\$39,032	\$40,515	4.7%	4.2%	3.8%
Retail Sales (billions)	\$122.9	\$133.8	\$139.4	7.6%	8.9%	4.1%
Housing Permits (number of units)	45,891	39,314	35,750	-1.3%	-14.3%	-9.1%
Nonresidential Building Contracts (millions)	\$4,221.2	\$4,310.2	\$4,236.9	28.3%	2.1%	-2.7%
Denver-Boulder Consumer Price Index CPI-U (1982-84=100)	190.9	197.7	203.8	2.1%	3.6%	3.1%

n/a = not applicable f = forecast