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Securities Industry and
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ECONOMIC OUTLOOK

Economic Growth Flows, Inflation Ebbs

Members of the Securities Industry and Financial Markets Association's Economic Advisory Roundtable expect the pace of U.S. economic growth to accelerate after the slow first quarter through the balance of the year and into 2008. In the mid-year survey, the median forecast anticipates GDP to grow at a below-trend pace of 2.2 percent in 2007, but increase to 2.8 percent in 2008 as the economy works through the housing sector correction.[1] The combination of still expansionary fiscal policy, supportive but softening financial market conditions, tighter labor market conditions and a global economic expansion provides the backdrop for the sustained, modest economic growth. Consumer spending will continue to be an important driver with employment and personal income gains more than offsetting the effect of lower housing price trends. Capital spending by businesses is expected to pick up modestly in 2008 following a reduced growth rate in 2007.

The near-unanimous opinion of the Roundtable is that the FOMC will keep the target Fed funds rate at 5.25 percent at the upcoming June 27-28 meeting. Furthermore, a majority of the panelists expect the FOMC to leave the key rate unchanged for at least the balance of the year and into 2008. While not unanimous, the strong consensus is that the accompanying policy statement will continue to put an emphasis on inflation risk. The panelists agree that there will be little if any change in the policy statement from the May 9 statement.[2] Some panelists did suggest that the statement may refer to concerns about the housing sector and the pace of the housing recovery and make mention of higher benchmark Treasury yields. A few panelists also commented that the risks of "extreme outlier scenarios" of heightened inflation or recession have declined.

Forecast Highlights

THE ECONOMY The median forecast anticipates GDP growth of 2.2 percent for full-year 2007 and 2.8 percent in 2008.[3] Growth is expected to increase from the anemic 0.6 percent rate in the first quarter to 3.2 percent in the second quarter, 2.6 to 2.8 percent during the second half of 2007, and 2.9 percent in the first half of 2008. Measured fourth quarter to fourth quarter[4], the median forecast is for 2.4 percent growth in 2007 and for 3.0 percent in 2008.

The median forecast calls for consumer spending to increase by 3.3 percent for full-year 2007, falling to 2.7 percent in 2008 reflecting the cumulative effect of housing price deceleration off-

[1] The survey was conducted the week of June 11 - June 18. The forecasts discussed in the text and appearing in the accompanying data table are medians of the 21 individual members' submissions.

[2] That statement commented that the "the economy seems likely to expand at a moderate pace over coming quarters," "although inflation pressures seem likely to moderate over time, the high level of resource utilization has the potential to sustain those pressures," and "the predominant policy concern remains the risk that inflation will fail to moderate as expected." See Federal Open Market Committee of the Federal Reserve System, Press Release, May 9, 2007.

[3] The panelists' estimates for GDP growth ranged from 1.7 percent to 2.4 percent for 2007 and 1.9 percent to 3.5 percent for 2008.

[4] All growth rates are inflation adjusted, and annual comparisons are measured fourth quarter to fourth quarter.

set by employment and income gains. The consensus view is that employment and income gains are the dominant drivers of consumer spending, ahead of the negative effects of energy and food price increases and the housing correction. Panelists note that the equity market wealth effect is also offsetting some of the effect of the housing correction. Consumer spending is expected to remain solid as profit and productivity gains are being passed on to workers in rising income growth in the midst of the maturing cycle and tighter labor market. The median forecast sees the average monthly unemployment rate remaining near the current historically low level over the next year at 4.6 percent in 2007, edging up to 4.7 percent in 2008.[5] Nonfarm payrolls will increase by a total of 1.6 million annually in 2007 and in 2008.

Business capital investment is expected to tail off this year to 3.7 percent, recovering to 5.0 percent in 2008, but still lower than the more robust capital spending growth rates of the last few years.[6] The median forecast expects second quarter business investment spending to bounce back to 6.4 percent in the second quarter from 2.9 percent, boosted by an inventory build up. Quarterly business spending will grow at annual rates of around 5.0 percent during the second half of 2007 and first half of 2008. Business investment is expected to benefit most from aggregate demand from global economic expansion, high levels of capacity utilization, and productivity gains. Internally generated cash flow and favorable borrowing terms in the corporate bond and loan markets should continue to facilitate capital spending, but the panelists see these tailwinds diminishing over time. Uncertainty about the future economic environment, on the other hand, is dampening investment spending and encourages greater corporate CFO caution.

The threat of higher inflation remains a concern. The median forecast of the panel is that "headline" inflation as measured by the PCE deflator will be 2.3 percent for 2007, and is expected to decline in 2008 to 2.0 percent. The core PCE deflator is expected to be 2.0 percent in 2007 and in 2008, lower than last year but still near the top of the range that many Federal Reserve officials would deem acceptable.[7] Along with monetary policy, the panelists indicated that the high level of capacity utilization is an important consideration in their inflation outlook. The recent below-trend growth rate should contribute to more moderate inflation readings. Relatively low inflation expectations and market confidence in the Fed's actions have helped to anchor wage and price setting patterns, and global competition is also likely to keep the inflationary pressure in check. The decline in the value of the dollar and the effect on commodity prices from rising demand as a result of global economic growth adds to inflationary pressures.

Based on the median forecast, the Federal budget deficit is expected to narrow again this fiscal year to $164 billion and then widen modestly to $175 billion in FY 2008.[8] Cyclical factors have been the dominant reasons for the improved deficit outlook, having driven both corporate and individual tax revenues higher. The panelists believe that the cyclical benefits may be peaking over the next year with the burden of large structural deficits in the out years remaining.

INTEREST RATES As noted, the consensus view is that the Federal Reserve is expected to leave the Fed funds rate unchanged at the upcoming June 27-28 meeting. The median forecast projects the Fed funds rate will remain at 5.25 percent over the next year.[9]

5 The range of individual panelists' forecasts for the average unemployment rate ranged from 4.4 percent to 4.7 percent in 2007 and 4.2 percent to 5.0 percent for 2008.

6 The range of individual panelists' forecasts for business fixed investment ranged from 2.5 percent to 4.8 percent for 2007 and 3.2 percent to 8.1 percent for 2008.

7 The range of individual panelists' forecasts for the increase in the core PCE deflator for 2007 ranged from 1.8 percent to 2.4 percent and from 1.3 percent to 2.7 percent for 2008.

8 The range of individual panelists' forecast for the FY 2007 federal deficit ranged from -$140 billion to -$210 billion and from -$100 billion to -$242 billion for FY 2008.

9 Although the majority of the respondents expect the target Fed funds rate to remain at the current 5.25 percent through the end of 2007, there was diversity of opinion about the Fed funds rate later in the year and into 2008. The Fed funds rate forecast for year-end 2007 ranged from 4.50 percent to 5.75 percent.

The median forecast expects the yield on the 10-year Treasury note to rise only modestly from the current level to 5.20 percent during the third quarter and to 5.25 percent at year-end, and holding steady through much of next year.[10] As of June 18, the end of the survey period, the yield stood at 5.14 percent.

The panel foresees a continued transition to a positively sloped flat yield curve. The median forecast is for the 2-year Treasury yield at 5.06 percent at the end of the third quarter and 5.10 at the end of the year, declining slightly to 5.00 percent in June 2008. The panelists believe that the long end of the curve will be most affected by foreign investor demand for long dollar assets, foreign central bank interest rate policies, and inflation and Fed policy.

The panelists differed on the effect of the lower dollar on non-U.S. investment flows into the Treasury market which affect benchmark yield levels. Although some respondents believe that the lower dollar will have an effect, the majority either believe the value of the dollar will not have a meaningful effect or that other factors dominate currency issues, including interest rate policies at central banks and economic growth and inflation trends which typically drive bond yields. Foreign investor capital flows have remained brisk, but there is some expectation of gradual moderation over the next few years as non-U.S. investors consider the range of alternatives.

Housing Recovery Delayed Until 2008, Dominant Risk to Economic Growth Forecast

Recent FOMC statements have identified housing, business capital investment spending and consumer spending as the three major downside risks to economic growth. The unanimous view was that housing is the risk most likely of the three to be realized. The panelists, however, note that the housing correction has had minimal spillover effects to consumer spending and the broader economy and that other strengths such as robust corporate profits and favorable borrowing conditions have compensated for the housing correction. Panelists did note that higher rates would affect housing affordability and thus potentially increase the housing correction severity and extend the timing of the recovery. The median forecast, however, has the 30-year fixed mortgage stable over the next year at about 6.50 percent.

The Economic Advisory Roundtable believes that the housing sector correction will run through the balance of the year before beginning to recover next year. The recovery has been delayed by a continued housing supply and demand imbalance and slowed by homebuilder and buyer caution. Housing prices are the transmission mechanism to bring supply and demand into balance. The median survey response has 2007 prices declining by about 3 percent nationally and 2008 housing prices flat. Housing sales are expected to dip to 6.9 million units in 2007 (6.0 million existing home sales and 0.9 million new home sales) but increase to 7.2 million (6.2 million existing home sales and 1.0 million new home sales) in 2008. Housing starts are forecast to slip to 1.4 million units in 2007 but increase slightly to 1.5 million units in 2008.

Economic Advisory Roundtable Split on the "Full Employment Rate" as a Measure of the Economy's Capacity for Non-inflationary Growth

The non-accelerating inflation rate of employment (NAIRU), or the "full employment rate," has been considered to be a measure of full capacity utilization and has developed a certain adherence over the years among some policy makers. The median response to the survey placed the NAIRU at about 4.5 percent.

The panelists, however, were evenly divided as to the value of the NAIRU as a monetary policy guide. Even the critics agree that it is a useful resource limitation metric. Critics of the measure,

[10] The individual panelist forecast for the 10-year Treasury yield at the end of September ranged from 4.40 percent to 5.50 percent and 4.45 percent to 5.70 percent at the end of June 2008. The 30-year fixed-rate mortgage forecasts ranged from 5.10 percent to 7.00 percent at the end of September and 4.80 and 7.30 percent at the end of June 2008.

however, note that lower levels of unemployment could be reached without inflation consequences. The recent history of low and stable inflation and inflationary expectations has brought into question the NAIRU framework.

Corporate Profits Continue to Grow; Margins to Moderate

Over the last few years, consistent double digit growth in corporate profits and margins have exceeded expectations. Even as the cycle has matured, profits as a share of GDP growth have increased or kept pace. From these elevated levels, the Economic Advisory Roundtable consensus view is that pre-tax profit growth should continue, albeit at a reduced pace, at medium to high single digit percentages. A majority expects profit margins to contract modestly. Panelists indicated that their profit outlook is most influenced by economic growth, both U.S. and global, followed by operating margin trends. An additional constraining factor going forward is likely to be the rise of real global yields.

Corporate Bond Credit Spreads Expected to Widen Modestly

Corporate bond credit spreads for both high yield and investment grade sectors have been tight and declining in recent years, which reflect strong profit growth, liquid balance sheets, cyclically low default rates, low volatility, strong market liquidity and investor demand for credit assets. This year, credit spreads have remained relatively stable despite the recent rise in benchmark yields, rate volatility, and record corporate bond issuance levels boosted by mergers and acquisitions (M&A) and leveraged buyout (LBO) activity.

A majority of panelists expect credit spreads to widen from these historically tight levels to some degree over the next year but do not expect a significant "blow out." That consensus is stronger for the high-yield sector than the investment grade sector. This view is based on anticipated moderation in economic and corporate profit growth, the cumulative effect of increased leverage, slowly rising default levels closer to historic norms, and eventual increased investor risk sensitivity, as well as a view that the current investment flows into corporate credit products have kept credit spreads "unsustainably" tight. Panelists expecting stable credit spreads base that view on continued demand by investors, both foreign and domestic, for credit products, heightened risk tolerance, and the strong corporate cash levels built up during the profit surge.

Equity Prices to Continue Ascent in the Second Half of the Year, Reach Record Territory

Panelists agreed that the S&P 500 index level at the end of 2007 would be above the current level and reach record territory. The S&P 500 will be at 1,575 by year-end 2007, according to the median forecast, which would represent a better than 10 percent increase from the year-end 2006 level of 1,418. (On June 25, the S&P closed at 1,503.) The consensus view is that equity market outlook is driven mostly by economic growth expectations followed by the effect of shareholder friendly strategies such as LBOs and M&As. The panelists did caution that higher interest rates could cut into P/E valuations.

The Securities and Financial Markets Association Economic Advisory Committee Forecast: June 26,2007

(Inflation adjusted year-over-year percentage change unless otherwise specified. Forecast numbers appear in **bold**.)

	2006	2007	2008
Real GDP (yr - to - yr)	3.3	**2.2**	**2.8**
Real GDP (4Q - 4Q)	3.1	**2.4**	**3.0**
CPI (yr - to - yr)	3.2	**2.7**	**2.4**
CPI (4Q - 4Q)	1.9	**3.4**	**2.4**
Core CPI (yr - to - yr)	2.5	**2.3**	**2.2**
Core CPI (4Q - 4Q)	2.7	**2.2**	**2.1**
PCE (yr - to - yr)	2.7	**2.3**	**2.0**
PCE (4Q - 4Q)	1.9	**2.7**	**1.9**
Core PCE (yr - to - yr)	2.2	**2.0**	**2.0**
Core PCE (4Q - 4Q)	2.2	**2.0**	**2.0**
Personal Consumption	3.2	**3.3**	**2.7**
Nonresidential Fixed Investment	7.2	**3.7**	**5.0**
Housing Starts (millions)	1.8	**1.4**	**1.5**
Real State & Local Gov't. Spending	2.1	**2.6**	**2.3**
Current Account Deficit (billions $)	856	**820**	**832**
New Home Sales (millions units)	1.0	**0.9**	**1.0**
Existing Home Sales (millions units)	6.5	**6.0**	**6.2**
Nonfarm Payroll Employment (millions)	2.26	**1.61**	**1.56**
Unemployment Rate (cal. yr. avg.)	4.6	**4.6**	**4.7**
S&P 500 Index Price (yr-end)	1,418	**1,575**	**N/A**
Federal Budget (FY, billions of $)	-248	**-164**	**-175**

Quarter-to-Quarter % Changes in Annual Rates

	2007				2008			
	I	II	III	IV	I	II	III	IV
Real GDP	0.6	**3.2**	**2.6**	**2.8**	**2.9**	**2.9**	**3.0**	**3.0**
CPI	3.8	**5.9**	**2.5**	**2.0**	**2.4**	**2.4**	**2.4**	**2.3**
Core CPI	2.3	**1.9**	**2.3**	**2.2**	**2.2**	**2.3**	**2.2**	**2.2**
PCE	3.3	**4.3**	**2.0**	**1.8**	**1.9**	**2.0**	**2.0**	**1.9**
Core PCE	2.2	**1.8**	**1.9**	**1.9**	**2.0**	**2.0**	**2.1**	**1.9**
Personal Consumption	4.4	**2.4**	**2.7**	**2.6**	**2.8**	**2.8**	**2.7**	**2.9**
Nonresidential Fixed Investment	2.9	**6.4**	**5.1**	**4.9**	**5.0**	**5.0**	**5.0**	**5.0**

Interest Rates (monthly average %)

	Sept. 07	Dec. 07	Mar. 08	Jun. 08	Sept. 08
Fed Funds	**5.25**	**5.25**	**5.25**	**5.25**	**5.25**
2 Year Treasury Note	**5.06**	**5.10**	**5.10**	**5.00**	**5.05**
10 Year Treasury Note	**5.20**	**5.25**	**5.25**	**5.25**	**5.25**
30 Year Fixed-Rate Home Mortgages	**6.51**	**6.51**	**6.49**	**6.51**	**6.50**
Municipals (Bond Buyer GO Index)	**4.54**	**4.62**	**4.79**	**4.75**	**4.80**
Moody's Corporate Bond Index (A rated)	**5.95**	**6.02**	**6.23**	**6.18**	**6.18**

Exchange Rates (monthly average)

	Sept. 07	Dec. 07	Mar. 08	Jun. 08	Sept. 08
Yen/Dollar	**121**	**118**	**117**	**116**	**116**
Dollar/Euro	**1.35**	**1.35**	**1.33**	**1.33**	**1.31**

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