

REPORTS

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ECONOMIC UPDATE

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ECONOMIC UPDATE

U.S. economic growth may well have accelerated rather than slowed in the quarter just completed. A broad range of economic indicators has emerged since we last released our Economic Outlook just five weeks ago (see *SIA Research Reports*, Vol. VII, No. 9, August 24, 2006) that suggest that some upward revisions to the forecast are in order.

For example:

- Oil prices have fallen 20% in the last two months, and consumers have seen substantial declines in prices at the gas pumps. This has both lifted consumer sentiment and freed up household purchasing power as 3Q'06 came to a close.
- The long bear market in bonds apparently came to an end this summer and a rally there and in equity markets has lifted investor sentiment and capital market activity as 4Q'06 opened.
- 2Q'06 corporate profits grew 18.5% from the same year-earlier period, which was above expectations, and analysts have raised their forecasts of this key driver of investment spending for the coming quarters.
- Corporate tax receipts are stronger than anticipated. In particular, growth in tax receipts from dividends and capital gains suggests that the reduction in tax rates on these income sources in 2003 may be producing the stimulative effect suggested by its adherents.
- The job market remained strong in 3Q'06 and the latest initial jobless claims numbers suggest that this strength may well extend into the final quarter of the year.
- The Federal Reserve model, which correctly anticipated the increase in headline and core inflation that occurred earlier this year, forecast that these inflationary pressures would subside as we approach end-year. That seems to be the case.
- With inflation stabilizing, the Fed's decision to halt the two-year string of 17 consecutive quarter-point increases in the benchmark short-term rates appears increasingly prescient and looks more like a halt to that tightening cycle rather merely a "pause". Financial markets appear to have adopted this view, with long-term rates, including mortgage rates, falling in recent weeks, and analysts looking for the Fed to begin cutting rates as early as March 2007.
- Lower mortgage rates could provide a brake to the precipitous decline in the housing sector and the latest housing starts number showed an increase, contrary to expectations, suggesting that the steepest declines in housing may be behind us.

Perhaps the most persuasive argument that growth may be stronger than most analysts suspect comes from U.S. Treasury data on income tax withholdings (which can be used to estimate the growth in the wages of salaried employees¹) and "Other Income Tax Not Withheld"² which are collections from various sources. This aggregate data for the whole population provides a much more accurate picture of the growth in jobs and personal income (and a basis for estimates and forecasts) than the data produced by the BEA, which are frequently revised estimates drawn from a relatively small sample. These two sets of estimates are shown in the chart below. The problems of relying on estimates drawn from a small sample can also be seen in the BEA estimates for overall economic growth. Since our last report just six weeks ago the BEA first revised up its estimate for real GDP growth from 2.5% to 2.9%, then revised it down to 2.6%.

If personal income growth, as measured in actual tax receipts, is faster than BEA estimates suggest, by implication jobs and the overall economy may also be growing more quickly. The disparity may arise from a larger workforce of part-time, self-employed, or unregistered workers that are not captured by the survey or, simply, shortcomings in the survey's sample. For example, estimates based on income tax data show that there are at least two million more self-employed individuals paying taxes than there were two years ago. This is job growth that is not reflected in the official jobs estimates that most analysts follow. That is the principal reason that "Other Income Taxes Not Withheld" is up 20% year over year despite declines in real estate transaction income.

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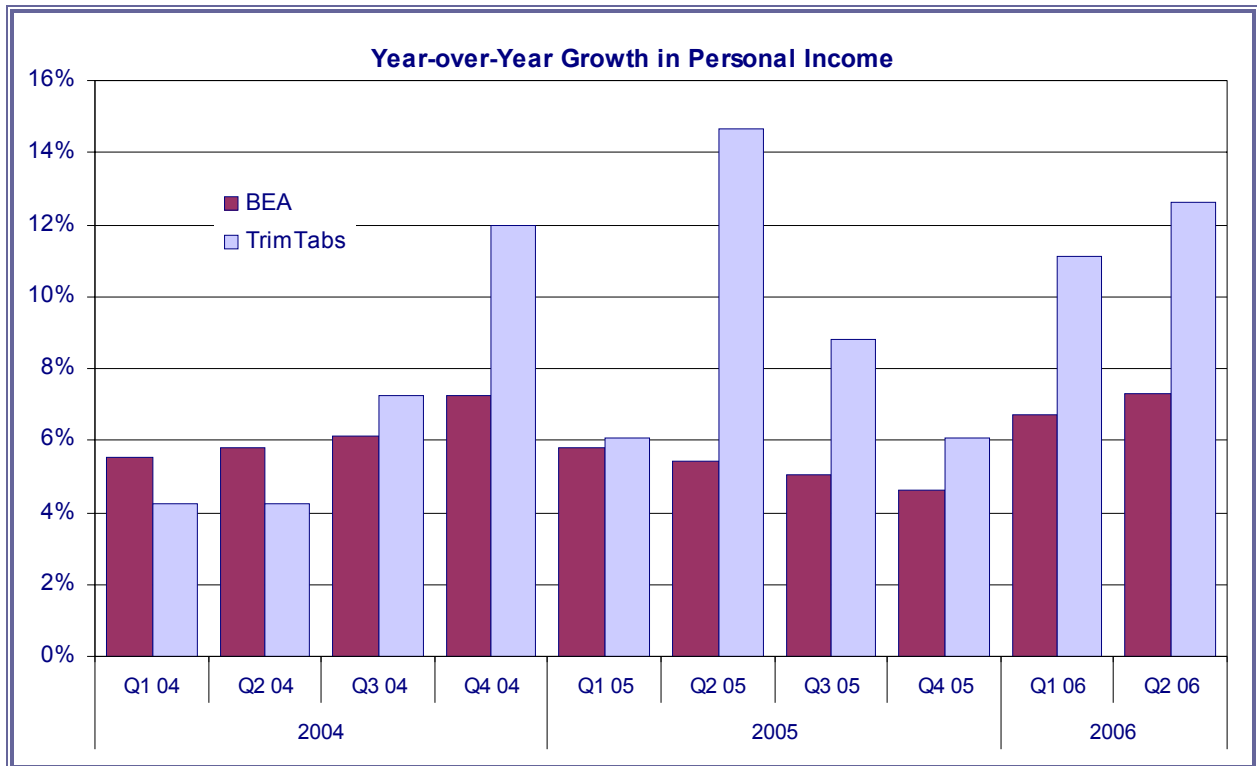
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¹ Estimates are provided by TrimTabs Investment Research.

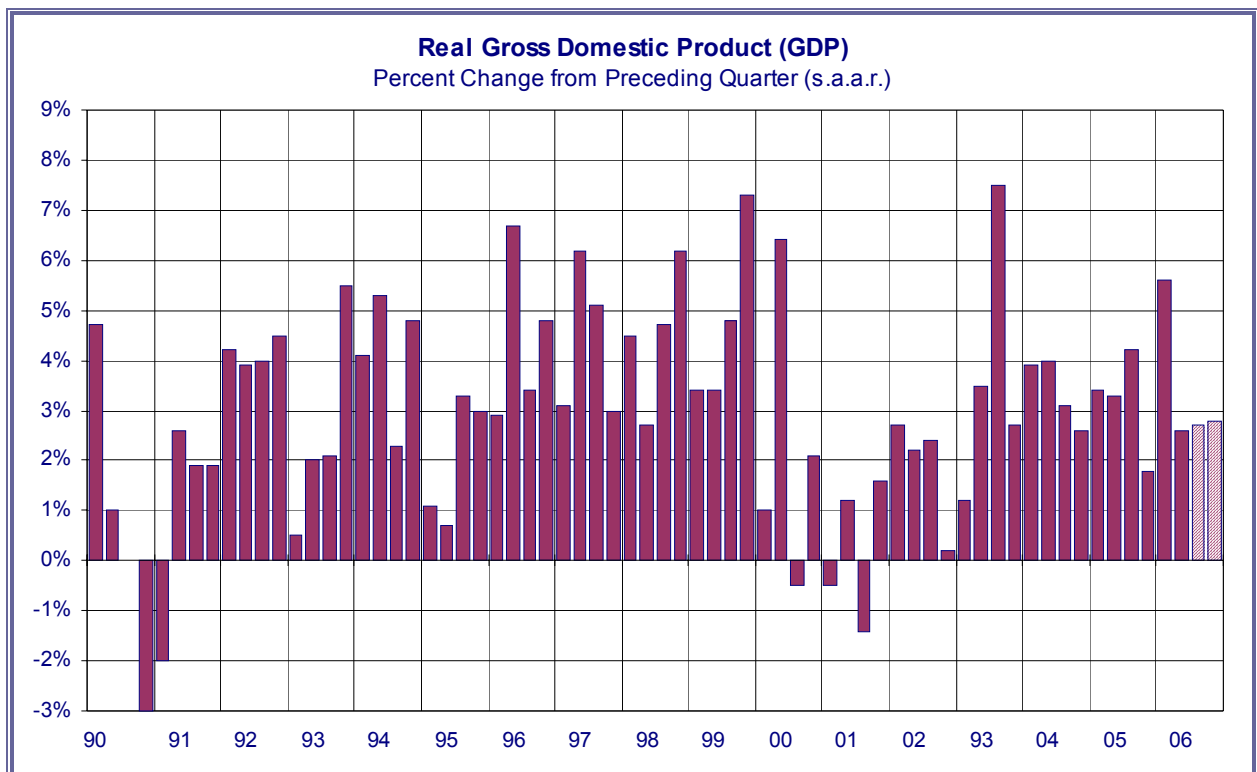
² Includes tax collections from a various sources, including: interest income; dividend income; capital gains on stock purchases; capital gains on real estate transactions, earned income from sales commissions, and 1099 income earned by self-employed individuals.

³ Current estimates from the National Income and Product Accounts, Table 2.1, Line 1

⁴ Trimtabs estimates based on U.S. Treasury data shows that wages of salaried employees rose 7.5% year-over-year for the latest three week period (a calendar quirk distorted growth rates for both the last two week and four week periods) and is also up 7.5% so far in 2006 (year-to- date versus the same period in 2005), which exceeds the 6.3% year-over-year increase during 2005. The "Other Income Tax Withheld" collections surged 18.4% year-over-year over the past four weeks (which captures the Sept.15 estimated quarterly tax payments), and for the year-to-date in 2006 is up 19.8%. Although this is down from 24.9% growth in 2005, largely due to lower real estate activity, it still indicates substantially faster growth in income and jobs than the official statistics indicate.



Source: Trim Tabs estimates based on U.S. Treasury data; Bureau of Economic Analysis, U.S. Department of Commerce



Source: Bureau of Economic Analysis, U.S. Department of Commerce; SIA forecasts



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