



SIFMA™

Securities Industry and
Financial Markets Association

December 11, 2006

ECONOMIC OUTLOOK

Economic Expansion Maintained Through 2007 Despite Housing Correction; Lower Inflation Expected

Members of the Securities Industry and Financial Markets Association's Economic Advisory Committee expect the U.S. economic expansion to continue in 2007. In the year-end survey, the median forecast anticipates that GDP growth will moderate from an estimated 3.3 percent pace in 2006 to a below-trend rate of 2.5 percent in 2007 as the economic cycle matures and the economy works through the housing sector correction¹. The combination of expansionary fiscal policy, supportive financial markets, reduced energy costs and moderating productivity gains provides the backdrop for sustained economic growth. Business investment again is expected to lead the way although at a slightly reduced growth rate. Consumer spending will continue to grow with support from lower energy costs, and with solid employment and personal income gains compensating for the drag from weaker house prices.

The unanimous opinion of the committee is that the FOMC will keep the target Fed funds rate at 5.25 percent at its meeting on December 12. The panelists agree that the accompanying policy statement will be similar to October 24-25 language of "the economy expanding at a more moderate pace" and "inflation pressures seem likely to moderate over time." However, while the strong consensus is that the statement will be substantially unaltered, a number of panelists expect language that retains a focus on heightened inflation risks and avoids a premature validation of a rate cut. Other panelists expect the policy statement to take note of the effect on economic growth of weaker manufacturing data.

Forecast Highlights

THE ECONOMY The median forecast anticipates GDP growth of 3.3 percent for calendar year 2006 and 2.5 percent for 2007². Growth is expected to be about 2.6 percent in the first half of the year before rising to 3 percent in the second half of 2007. Measured fourth quarter to fourth quarter³, the median forecast is for 3.0 percent growth for 2006 and for 2.8 percent in 2007.

The committee expects business capital investment to continue expanding at a robust pace before tailing off slightly in the latter part of 2007, growing by 7.8 percent for full-year 2006 and 7.0 percent in 2007⁴. The median forecast expects quarterly growth rates to be 6.8 per-

¹ The survey was conducted the week of November 27– December 4. The forecasts discussed in the text and appearing in the accompanying data table are medians of the 21 individual members' submissions.

² The panelists' estimates for GDP growth ranged from 1.6 percent to 2.9 percent for 2007.

³ All growth rates are inflation adjusted, and annual comparisons are measured fourth quarter to fourth quarter.

⁴ The range of individual panelists' forecasts for business fixed investment ranged from 4.8 percent to 8.3 percent for 2007.

cent in the first half of the year and 6.4 to 6.5 percent in the second half. Business investment continues to benefit from strong internally generated cash flow, historically favorable interest rates and credit spreads, and aggregate demand. A lower dollar and stronger global economic growth may boost demand business capital spending.

The consensus view is that lower energy prices would have some buoying effect on consumer spending, but there were more durable factors at work such as employment and personal income growth. The median forecast calls for consumer spending to increase by 3.1 percent for full-year 2006, but to grow at a 2.8 percent clip in 2007, reflecting the diminished stimulus from housing wealth amid sustained real income gains. To date, the housing downturn has had only a limited effect on consumer spending. Consumer outlays are expected to remain on track as recent profit and earlier productivity gains flow through to workers in rising income growth in a relatively tight labor market. The median forecast sees the average monthly unemployment rate edging up to 4.7 percent in 2007 from 4.6 percent in 2006 with non-farm payrolls increasing by 1.7 million in 2006 and 1.4 million in 2007⁵.

The threat of higher inflation remains a concern in the markets. The median forecast of the panel is that “headline” inflation as measured by the PCE deflator will slow from 2.8 percent to 1.9 percent in 2007. The core PCE deflator is expected to rise at a 2.3 percent rate in 2006 and at 2.2 percent clip in 2007⁶. The core inflation rates for both years lie at or near the top of the range that many Federal Reserve officials would deem desirable. The panelists indicated that monetary policy, energy prices, labor costs relative to productivity and slack in the economy were the most important considerations affecting their inflation outlook. Relatively low inflation expectations and Fed credibility have helped to anchor wage and price setting patterns, and global competition is also likely to keep inflationary pressures muted. The recent decline in the value of the dollar could add to inflationary pressures.

Following consecutive years of reduced Federal budget deficits, the fiscal shortfall is expected to widen modestly to \$260 billion in FY07 from \$248 billion in FY 2006⁷. Cyclical factors have been the dominant reasons for the improved deficit outcome over the past two years. The panelists believe that the cyclical benefits may be peaking over the next year while the burden of large structural deficits in the out years remains. Following double-digit tax revenue growth, tax receipts should register gains of between 5 and 10 percent with panelists equally divided as to whether the individual or corporate tax receipts will grow at a faster rate this year.

INTEREST RATES As noted, the Committee expects the Federal Reserve to leave the Fed funds rate unchanged at the upcoming December 12 meeting. The typical forecast projects the Fed funds rate at 5.25 percent at the end of March, but anticipates one cut in rates of 25 basis points later in 2007.

The median forecast expects the yield on the 10-year Treasury note to rise modestly to 4.6 percent during the first quarter and slowly thereafter, reaching 4.7 at the end of the second quarter and 4.8 percent by the end of the year⁸. As of December 8, the yield stood at 4.55 percent, down from 4.71 percent a month earlier.

The yield curve has been inverted for much of the past year as the Fed raised short rates through June of this year. The 2- to 10-year spread was inverted by 12 basis points on December 10. The

⁵ The range of individual panelists’ forecasts for the average unemployment rate for 2007 ranged from 4.2 percent to 5.1 percent. Nonfarm payroll growth projections ranged from 1.1 million to 2.08 million.

⁶ The range of individual panelists’ forecasts for the core 2007 PCE increase ranged from 1.7 percent to 2.8 percent.

⁷ The range of individual panelists’ forecast for the FY 06 Federal deficit ranged from \$210 billion to \$300 billion in FY 2007.

⁸ The individual panelist forecast for the 10-year Treasury yield at the end of March ranged from 4.40 percent to 4.90 percent and 4.25 percent to 5.45 percent at the end of 2007. The 30-year fixed-rate mortgage forecasts ranged from 4.50 percent to 6.50 percent at the end of March and 4.60 and 7.25 percent at the end of 2007

interest rate projections suggest a transition to a flat and slightly positive sloped yield curve over the next year. The median projection foresees the 2-year Treasury yield at 4.65 percent at the end of the first quarter, 4.73 percent at the end of June, and easing back to 4.65 percent at the end of 2007. The panelists believe that the long end will be most affected by strong foreign demand and inflation trends in addition to Fed policy.

Energy prices and housing are major risks to the GDP forecast; energy prices are the dominant risk to the inflation forecast.

The panelists identified a number of factors that could affect outcomes for growth and inflation. Stabilization of prices in the housing market and further reduction in energy prices were considered the most important upside risks followed by faster productivity gains and greater than expected growth in business capital investment spending. A further significant decline in housing and rising energy costs to business and households were the leading downside risks cited, followed by higher inflation leading to tighter monetary policy.

Higher energy prices were cited as the key risk to the inflation forecast. The second most frequently mentioned upside risk to the inflation forecast was the effect of a weaker dollar. Sharply higher unit labor costs were also mentioned. Downside risks to the inflation forecast included lower energy prices, slower economic growth and greater productivity gains.

The Committee is split on the FOMC developing explicit inflation objectives.

The Committee was about evenly divided as to whether the FOMC should have an explicit inflation objective. Slightly over half (54 percent) opposed the adoption of a specific objective, while about 38 percent recommended an inflation range objective and only 8 percent advocated a specific quantitative point objective. Advocates of an inflation objective cite improved communication and further anchoring of inflation expectations. Other panelists raised a number of concerns with a specific objective or target, arguing that there are conceptual and measurement problems with empirical inflation indexes that make it difficult to adopt a specific quantitative objective. Those opposed to an explicit target said the Fed's current flexibility within its goal of price stability has worked well to curb inflationary expectations, suggesting that consistent, transparent policies are more persuasive to investors than a target. According to Committee members, while there may be benefits to stated inflation objectives or targeting with respect to controlling inflation, there was concern about public uncertainty about how a system would work and market (over) reaction to month-to-month changes in inflation numbers under such a regime. Should the Fed adopt an inflation objective, the consensus view is that the Fed should have a two to three year time frame to achieve the objective. If an explicit objective is established, the largest number of responses recommended a 1 to 2 percent range.

The long-term growth rate is seen at three percent with a modest decline expected based on demographic and labor force factors.

Committee members were asked their views on what the long-term U.S. economic growth rate is and whether it is declining. The consensus view is that the long-term growth rate is about 3 percent with responses ranging from 2.5 percent to 3.5 percent. The panelists agree that the growth rate is declining modestly but concern about a significant reduction is exaggerated and premature. The reason for the lowered growth rate is demographics – labor force growth will slow as the population ages. The effect of a slower growing labor force is mitigated by the solid labor force productivity performance.

The housing correction still has a way to go, but should end in 2007.

While the Committee judges that the most intense phase of the housing downturn is behind us, panelists believe that that housing-related correction is not yet complete. The housing market transition began with higher inventories, sharp cuts in construction and more recently weaker prices. With homebuilding and permit volumes below sales levels, the market is beginning to

clear, although price weakness may continue based on buyer and home builder caution. The consensus view is that the downturn should end within 6 to 12 months with some expecting the correction to “bottom out” by the end of the first quarter. Total housing sales are expected to be 7.6 million (6.5 million existing home sales) in 2006 and 7.2 million (6.2 million existing home sales) for 2007 compared to 8.4 million (7.1 million existing home sales) in 2005.

Both supply and demand factors have contributed to oil prices decline over the second half of the year.

The Committee’s consensus view is that the price of oil should be at about the same level on June 30, 2007 as it is today. At the end of the survey period, the price was slightly above \$63 a barrel. The median projection for the price of a barrel of oil on June 30, 2007 is \$63 with forecasts ranging from \$55 to \$76. Panelists indicated that several factors will contribute to the reduction in oil prices over the second half of the year. About 35 percent attribute the price decline to demand factors, 14 percent to supply and 35 percent to a combination of supply and demand. In addition, roughly 15 percent cited “other” related reasons, including a relatively mild hurricane season, and a relatively less volatile geopolitical environment contributing to the recent benign energy price trends.

Corporate profit growth will moderate to a more sustainable level in late 2006 and 2007; the strongest profit growth is expected in the technology sector.

Over the last few years, corporate profits have been rising at double-digit rates. Expanding profit margins and rising productivity, along with strong demand, were important drivers of the significantly higher profit levels. The strong consensus is that profits are in the process of moderating to a more sustainable pace with about 60 percent of the Committee believing the process began in the latter part of 2006 and the balance projecting profit moderation to begin during the coming year. The technology sector is expected to have the strongest profit growth rate in 2007, followed by financials and telecommunications. Panelists indicated that their profit outlook is most influenced by economic growth, both U.S. and global, followed by corporate pricing power and operating margin trends.

Corporate bond credit spreads are expected to widen modestly.

Corporate bond credit spreads for both high yield and investment grade sectors have been tight and declining in recent years. This pattern reflects the boost from solid profit growth, a relatively modest supply of new issuance, strengthened balance sheets and a strong appetite for credit products among bond investors. Default rates have remained low, and historically low volatility has increased investor risk tolerance.

The majority of the panelists expect credit spreads to widen to some degree over the next year but not significantly. The balance of the panelists expects credit spreads to remain about where they are. The consensus favoring widening is stronger for high-yield than investment-grade sector. The panelists expecting spread widening base their view on the slowdown’s effect on profit growth, increasing investor risk sensitivity and projections of slowly rising default levels closer to historic norms. The panelists who expect stable credit spreads base that view on strong global demand for U.S. credit products, heightened risk tolerance and the strong cash levels built up during the profit surge.

The Committee expects higher equity prices.

Panelists agreed that the S&P 500 index level at the end of 2007 would be higher than its level at the time the survey was taken. The median projection had the S&P 500 at 1500 by year-end 2007, which would represent a 7.4 percent increase from the 1396 level at the time of the survey. Though not unanimous, the consensus is that the equity market outlook is being driven more by profit and economic growth expectations than changes in valuation metrics.

The Securities and Financial Markets Association Economic Advisory Committee Forecast: December 13, 2006

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

	2005	2006	2007
Real GDP (yr - to - yr)	3.2	3.3	2.5
Real GDP (4Q - 4Q)	3.1	3.0	2.8
CPI (yr - to - yr)	3.4	3.3	1.9
CPI (4Q - 4Q)	3.7	2.0	2.5
CORE CPI (yr - to - yr)	2.2	2.5	2.4
CORE CPI (4Q - 4Q)	2.1	2.8	2.4
PCE (yr - to - yr)	2.9	2.8	1.9
PCE (4Q - 4Q)	3.1	2.0	2.1
CORE PCE (yr - to - yr)	2.1	2.3	2.2
CORE PCE (4Q - 4Q)	2.1	2.4	2.0
Personal Consumption	3.5	3.1	2.8
Nonresidential Fixed Investment	6.8	7.8	7.0
Housing Starts (millions)	2.1	1.8	1.5
Real State & Local Gov't. Spending	0.5	2.2	2.4
Current Account Deficit (billions \$)	792	872	860
New Home Sales (millions units)	1.3	1.1	1.0
Existing Home Sales (millions units)	7.1	6.5	6.2
Nonfarm Payroll Employment (millions)	1.98	1.70	1.40
Unemployment Rate (cal. yr. avg.)	5.1	4.6	4.7
S&P 500 Index Price (yr-end)	1,248	1,396	1,500
Federal Budget (FY, billions of \$)	-319	-248	-260

Quarter-to-Quarter % Changes in Annual Rates

	2006				2007			
	I	II	III	IV	I	II	III	IV
Real GDP	5.6	2.6	2.2	2.0	2.4	2.7	3.0	3.0
CPI	2.2	5.0	2.9	-1.9	2.6	2.4	2.3	2.3
CORE CPI	2.4	3.5	3.0	2.3	2.6	2.5	2.3	2.4
PCE	2.0	4.0	2.5	-0.7	2.3	2.4	2.0	2.0
CORE PCE	2.1	2.7	2.3	2.4	2.4	2.3	2.1	2.1
Personal Consumption	4.8	2.6	3.1	3.0	2.9	2.7	2.7	2.8
Nonresidential Fixed Investment	13.7	4.4	8.6	6.5	6.9	6.8	6.5	6.4

Interest Rates (monthly average %)

	Dec. 06	Mar. 07	June 07	Sept. 07	Dec. 07
Fed Funds	5.25	5.25	5.20	5.00	5.00
2 Year Treasury Note	4.68	4.65	4.73	4.70	4.65
10 Year Treasury Note	4.60	4.60	4.70	4.80	4.80
30 Year Fixed-Rate Home Mortgages	6.20	6.18	6.23	6.35	6.50
Municipals (Bond Buyer GO Index)	4.25	4.33	4.40	4.50	4.50
Moody's Corporate Bond Index (A rated)	5.50	5.50	5.60	5.80	6.00

Exchange Rates (monthly average)

	Dec. 06	Mar. 07	June 07	Sept. 07	Dec. 07
Yen/Dollar	116	114	113	111	110
Dollar/Euro	1.31	1.32	1.33	1.32	1.30

The Securities Industry and Financial Markets Association
Economic Advisory Committee consists of the following members:

Chair

Robert DiClemente
Citigroup

Vice Chair

David H. Resler
Nomura Securities International, Inc.

Richard B. Berner
Morgan Stanley & Co. Inc

Scott J. Brown
Raymond James
& Associates, Inc.

Steven Gallagher
SG Corporate
and Investment Banking

James Glassman
JP Morgan Chase & Co.

**Ethan Harris
and Michelle Meyer**
Lehman Brothers Inc.

Maury Harris
UBS Financial Services Inc.

**Jan Hatzius
and Raluca Dragusana**
Goldman Sachs

Stuart Hoffman
PNC Capital Markets LLC

Steven Davidson
Staff Advisor

Peter Hooper
Deutsche Bank
Securities Inc.

Hugh Johnson
First Albany Corporation

Mickey D. Levy
Banc of America
Securities, LLC

Christopher Low
FTN Financial

Dean Maki
Barclays Capital

Michael Moran
Daiwa Securities

Steven Ricchiuto
ABN Amro, Inc.

**David Rosenberg
and Kathy Bostjancic**
Merrill Lynch & Co., Inc.

**John Ryding
and Conrad DeQuadros**
Bear, Stearns & Co. Inc.

John E. Silvia
Wachovia Securities

Neal Soss
Credit Suisse
First Boston Corp.

Stephen Stanley
RBS Greenwich Capital

Diane Swonk
Mesirow Financial, Inc.

Gary Thayer
AG Edwards & Sons, Inc.

**David Wyss
and Beth Ann Bovino**
Standard & Poors
Rating Services

The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Market Association, is based in Hong Kong.

.NEW YORK

WASHINGTON

LONDON

HONG KONG

www.sifma.org

© 2006 The Securities Industry and Financial Markets Association