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Economic Outlook Symposium: Summary of 2005 results and forecasts for 2006

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The nation's economic growth will soften slightly in 2006, inflation will decrease, and the unemployment rate will remain stable, according to the median forecast of participants at the Federal Reserve Bank of Chicago's most recent Economic Outlook Symposium.

Real gross domestic product (GDP) grew at a solid pace throughout the first three quarters of 2005. Growth ranged from 3.3% to 4.1% in each quarter. This unusually stable growth has existed since the fourth quarter of 2003. Quarterly growth over this period has been between 3.3% and 4.3%. The unemployment rate, which averaged 5.4% in the final quarter of 2004, fell to 5.0% in the third quarter of 2005. Employment expanded by just over two million jobs between November 2004 and November 2005. An average of 172,000 jobs were added each month—an impressive gain, especially given the negative economic shock brought on by the hurricanes that hit the Gulf Coast states in late summer and early fall.

1. Median forecast of GDP and related items

	2004 (Actual)	2005 (Forecast)	2006 (Forecast)
Real gross domestic product[a]	3.8	3.6	3.2
Real personal consumption expenditures[a]	3.8	3.1	3.0
Real business fixed investment[a]	10.9	7.0	6.4
Real residential investment[a]	6.6	7.0	–0.8
Change in private inventories[b]	50.1	22.3	30.0
Net exports of goods and services[b]	–634.1	–629.8	–620.3
Real government consumption expenditures and gross investment[a]	2.1	2.4	2.0
Industrial production[a]	4.3	2.4	3.2
Car & light truck sales (millions of units)[c]	16.9	17.0	16.8
Housing starts (millions of units)[c]	1.95	2.04	1.90
Unemployment rate[d]	5.4	5.1	5.0
Consumer Price Index[a]	3.4	3.9	3.0
1-year Treasury rate (constant maturity)[d]	2.47	4.18	4.70
10-year Treasury rate (constant maturity)[d]	4.17	4.60	5.11
JPMorgan trade weighted dollar index[a]	–4.7	0.1	–0.4
Oil price (dollars per barrel of West Texas Intermediate)	48.31	61.21	55.69

[a]Fourth quarter over fourth quarter percent change.
[b]Billions of chained (2000) dollars.
[c]Fourth quarter average.
[d]Percent.
SOURCES: Actual data from Haver Analytics; median forecasts from Economic Outlook Symposium participants.

Inflation rose during 2005. The personal consumption expenditures deflator increased 2.3% in the first quarter, 3.3% in the second quarter, and 3.7% in the third quarter. This was in large part due to significant increases in energy prices. West Texas Intermediate oil prices averaged just over $43 per barrel in December 2004, and these prices increased to $65 per barrel by September 2005—an increase of over 50% in this short period. Gasoline prices in September were 67% higher than they were a year earlier, although even with this sharp increase, gasoline sales in September were 3.7% higher than they were a year before. This strength in demand was supported by consumers dipping into savings. Consumer savings, which averaged 1.7% during 2004, was negative throughout much of 2005, averaging –0.5% for the first three quarters of the year.

Removing food and energy, core inflation rates moderated during 2005, with prices rising 2.4%, 1.7%, and 1.4% during the first, second, and third quarters of 2005, respectively.

Much like GDP growth, consumer spending rose at a very steady pace throughout 2005. Personal consumption expenditures rose by 3.5% in the first quarter, 3.4% in the second quarter, and 4.1% in the third quarter of the year. This was much faster than the increase in income. Disposable personal income fell 3.4% in the first quarter, rose 0.2% in the second quarter, and fell 2.0% in the third quarter. The solid spending growth, slow income growth, and negative savings rate led to an 8.2% increase in household debt during the first three quarters of 2005, and an increase in the household debt service ratio from 13.09% in the fourth quarter of 2004 to a record 13.75% in the third quarter of 2005.

This pattern of consumer behavior makes more sense when we look at how certain assets performed over this period. Equity prices over the first three quarters increased by 5.3%, and median existing home prices rose by more than $28,000 in the first three quarters of 2005, a 15% increase in value. The increase in housing values is impressive when you consider that household income during the first three quarters of 2005 averaged just under $83,000. And in 2005 nearly 69% of all households owned their own homes, an increase of 5 percentage points from ten years ago.

The consumer kept the housing market active. Housing starts were 6.5% higher in the third quarter of 2005 compared with the fourth quarter of 2004. Yet concerns about slowing conditions in the housing market began to appear late in 2005 as mortgage rates, which had been stable at 5.75% for the first nine months of the year, rose to 6.07% in October and 6.33% in November. The supply of new single family homes on the market rose throughout 2005.

Light vehicle sales averaged 16.8 million units during the first 11 months of 2005, just a bit ahead of the 16.7 million unit average over the comparable period in 2004. While the past seven years have been the industry's highest selling years, the amount sold has shown no growth, ranging between 16.6 million and 17.3 million units each year. Yet the Big Three's market share fell from an average of 59.2% for the first 11 months of 2004 to 57.0% for the first 11 months of 2005. It has been a very tough year for the Big Three, culminating with Delphi, a major parts supplier to GM, filing for bankruptcy in October.

Against this backdrop, the Federal Reserve Bank of Chicago held it nineteenth Economic Outlook Symposium on December 2, 2005. More than 90 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews the previous year's forecasts for 2005 and summarizes the presentations at the 2005 conference (see figure 1).

While most sectors are anticipated to slow their expansion moderately, the housing sector, facing rising interest rates, is forecasted to decline in 2006.

Looking back to 2005

In 2004, the forecasters were anticipating that the economy in 2005 would grow near potential (a growth rate associated with a stable unemployment rate and no inflationary pressures). The economy performed slightly better than the consensus expected. The economy started off a bit faster than forecasted, rising 3.8% in the first quarter compared with the 3.0% predicted. Second quarter output increased by 3.3%, as predicted. Third quarter GDP expanded by 4.1%, faster than the 3.2% forecasted. The unemployment rate was forecasted to remain fairly stable, edging down from 5.4% in the first half of 2005 to 5.3% in the second half. The year started off with a more marked reduction in the unemployment rate. The unemployment rate fell to 5.2% in the first quarter and trended lower from there, averaging 4.9% in the fourth quarter.

In general the consensus forecast was fairly accurate with the exception of two sectors. West Texas Intermediate oil prices were forecasted to average $45.00 per barrel in the first quarter and then fall to $40.00 per barrel by the fourth quarter. Oil prices averaged nearly $50.00 per barrel in the first quarter and rose to average $60.00 per barrel in the fourth quarter. This underestimation of the rise in oil prices led to an underprediction of inflation during 2005. Inflation was forecasted to average 2.4% during the first three quarters of 2005, but in fact averaged 3.9% during this period. Housing starts were expected to average 1.89 million in the first quarter and fall to average 1.85 million by the third quarter. In fact, housing starts averaged over 2.04 million starts in each of the first three quarters of 2005.

Industrial production was forecasted to average 3.9% growth for the first three quarters, much faster than the 1.7% that actually occurred. The consensus forecast did a better job when it came to the automotive sector. Light vehicle sales were forecasted to average 16.8 million units during 2005, in line with the 16.9 million units that were sold.

Looking ahead to 2006

According to the consensus group, real GDP is expected to have increased in 2005 by 3.6% and then rise in 2006 by 3.2% (figure 1), a rate in line with what the group regards as potential. With growth at potential, the unemployment rate is forecasted to remain unchanged at 5.0% each quarter during 2006. While virtually all sectors are predicted to experience more moderate growth during 2006, it is the housing sector that is anticipated to experience the most significant change in activity. Housing starts are forecasted to average 1.90 million units in 2006 after averaging 2.04 million in 2005. This will lead to a substantial weakening in residential investment during 2006. After rising by 7% in 2005, residential investment is forecasted to edge a bit lower in 2006. A predicted increase in interest rates will play a role in slowing the housing market. Forecasters expect the ten-year Treasury rate to rise to just over 5% by the final quarter of 2006, a 62 basis point increase from the fourth quarter of 2005.

The forecasters expect spending growth in the consumer sector to expand at roughly the same rate as in 2005, edging down slightly from 3.1% growth in 2005 to 3.0% in 2006. This steady pace reflects a flat outlook for light vehicle sales, which are forecasted at 16.8 million units in 2006.

The business sector is expected to have another solid year, with growth in business fixed investment rising by 6.4% in 2006, although less than the 7.0% in

2005. Industrial production, which is expected to have risen 2.4% in 2005, should increase 3.2% in 2006.

Government spending is anticipated to rise by 2.0% in 2006, a slower pace than in 2005. The international trade deficit is expected to decrease somewhat, falling from $629.8 billion in 2005 to $620.3 billion in 2006.

Oil prices are expected to have peaked in the fourth quarter of 2005 and then fall moderately throughout 2006, reaching $55.69 per barrel by the end of the year. With a slower pace of economic activity, inflation is forecasted to moderate in 2006. Prices are predicted to rise by 3.6% in the first quarter and then gradually slow their rate of increase, rising by 2.7% in the final quarter of the year.

Outlook by sector

Diane C. Swonk, senior managing director and chief economist for Mesirow Financial, presented the outlook on banking and consumers for the 2005 holiday shopping season. In her presentation she emphasized that people in the United States essentially fall into two economic strata: high-income households and middle- and low-income households. High-income households have an average income of over $100,000 a year; those households should have no problem paying for both high energy costs and expensive holiday gifts. While wealthier households were expected to continue "to live it up" this season, middle- and low-income households appeared to be cutting back spending by shifting certain elective expenditures.

Swonk went on to provide a few examples of the trade-offs that middle- and low-income households are making in order to save cash without drastically changing their living habits. First, she cited the example of renting videos instead of going to the movie theater. Video and DVD rental businesses are doing well, but movie box office sales are down; for a family of four, substituting a DVD rental for a trip to the movie theater amounts to significant savings. Second, Swonk said that while time-strapped families are still in a rush to eat, more are choosing to buy pre-made meals at grocery stores rather than purchase takeout from restaurants. The popularity of prepared foods has increased sales for grocery stores at the expense of lowering sales at more expensive takeout establishments. Last, Swonk noted that purchasing alcohol at a liquor store for consumption at home is less costly than buying drinks at a bar, and many adults are choosing the lower cost option.

According to Swonk, the devastation of the three recent hurricanes in the Gulf Coast states is expected to increase replacement demand for products from appliance stores and furniture retailers that are still operating within the region. In addition to these predictions of consumer activity in certain retail segments and geographic regions, Swonk envisioned an overall positive outlook for the 2005 holiday shopping season. High-end consumers were expected to continue to spend aggressively, she said, even with the ongoing concerns about high energy costs.

Robert J. DiCianni, marketing manager for Mittal Steel USA, delivered the outlook on the steel industry. For 2006, he predicts continued growth for the overall economy, only at a slightly slower pace, with the steel outlook remaining positive. While housing starts are expected to decrease from their high levels in 2005, DiCianni said, the nonresidential construction market, which is one of the biggest consumers of steel, is forecasted in 2006 to outperform its 2005 level of activity. One reason for the increase in nonresidential construction in 2006 is the necessary rebuilding of the Gulf Coast states in the wake of the devastation caused by the hurricanes.

According to DiCianni's outlook, auto industry sales are to remain steady. However, with an increase in auto imports, U.S. manufacturers are forecasted to need less steel as domestic production falls. Scrap metal is predicted to continue to have a large impact on the steel industry. Only three regions serve as primary sources for the majority of scrap metal: the U.S., Japan, and Western Europe. While scrap substitutes are becoming more readily available, shortages of scrap are putting more pressure on minimills that use scrap steel as an input.

Van Jolissaint, chief economist for DaimlerChrysler Corporation, delivered the automotive sales outlook. He explained that the global "automotive industry remains a principal driver of the world economy." This is evidenced by the fact that the automotive industry directly employs over eight million people worldwide, which constitutes more than 5% of employment in the global manufacturing industry.

Additionally, while the Big Three have struggled, the auto industry as a whole is doing well. Since the employee pricing program spiked auto sales over the summer of 2005, Jolissaint explained, it was not surprising for October and November auto sales (14.7 million and 15.7 million units, respectively) to be lower comparatively. While auto sales are not going to increase dramatically over the coming years, Jolissaint stated that a steady growth rate of 1% is forecasted for the upcoming years of 2005–12.

Even though the merger of Daimler-Benz with Chrysler Corporation took place in 1998, the new company, DaimlerChrysler, has just recently been using

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its combined purchasing power to buy auto components in larger bulk to save money. Jolissaint also explained that DaimlerChrysler is leveraging technological excellence in its constituent parts to eliminate redundancies in discovering technological innovations.

Michael Robinet, vice president of global vehicle forecasts from CSM Worldwide, gave a presentation, titled "A Global Viewpoint, Tomorrow's Auto Industry." Robinet declared that global dynamics are converging and expanding, with pressure being placed on companies to reach different emerging markets for autos. In terms of convergence for the global auto industry, trade tariffs and barriers are declining, while stricter emissions and safety standards are being implemented. However, the global dynamics for automakers are also expanding, with the new wave of the industry's future—global platforms. These are platforms that can accommodate more than one type of car, and therefore, their increased usage is forecasted to result in a higher volume of production from each platform.

Also, Robinet noted that there are further fuel economy considerations that automakers are taking into account, exemplified by the production of hybrid alternatives. There is also more pressure on carmarkers due to differences in market breadth among different countries—e.g., the market breadth in China and Russia is more dynamic than in Brazil and India, which focus on smaller vehicles.

David W. Berson, vice president and chief economist from Fannie Mae, provided the housing and mortgage market outlook. He stated that 2005 would be the fifth year in a row that home sales set a record; however, he said he expected them to slip in 2006. Berson said that both housing and consumer spending are expected to slow. One reason for the decrease in home prices is that per capita disposable income and the home price index have been spreading apart. This is seen as a positive development because it indicates that home prices should eventually come down to meet per capita disposable income. Additionally, oil prices are still a concern, but core inflation has stabilized. According to Berson, economic growth in 2006 is predicted to be no weaker than in 2005.

Frank Manfredi, president of Manfredi & Association Inc., delivered the outlook on the agricultural and construction equipment industry for 2006. He stated that the equipment market looks mixed for the coming year: He expects farm and tractor equipment sales to decline between 5% and 10%, but construction equipment sales to increase between 4% and 10%. The primary influences on this mixed outlook on agricultural equipment for 2006 are higher interest rates, higher farm input costs, and slightly lower cash receipts.

In addition, Manfredi stated that the ability to rent machinery has changed the market, with revenues from rentals standing at $26.4 billion. The chief advantage in renting machinery for farmers and builders is that they do not have to worry about their fleets becoming obsolete and less productive.

Conclusion

The year 2005 proved to be a healthy one for the economy with strong gains in GDP, employment, and housing. However, oil prices are still high, making gas prices higher. The outlook for 2006 is for growth to moderate in most sectors, with the housing industry showing the largest change. Vehicle sales are expected to remain relatively constant. The unemployment rate is forecasted to remain unchanged, and with moderating energy prices, inflation is expected to ease.