



Quarterly Economic Report – 3rd Quarter 2006 (Sept.)

The Balancing Act

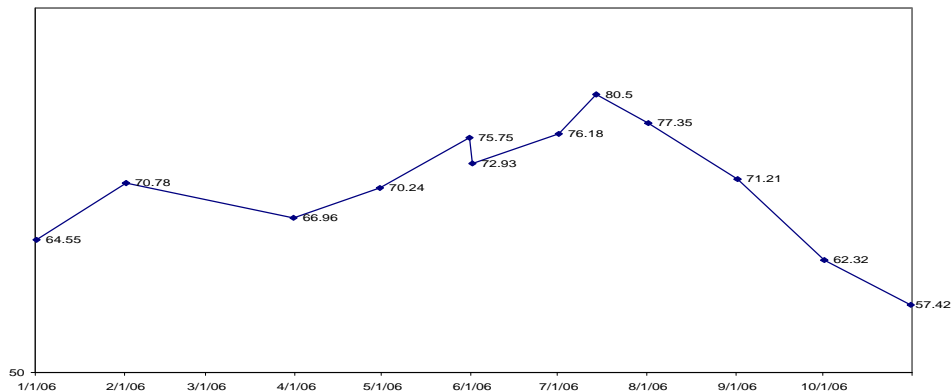
When the Federal Reserve Open Market Committee announced on August 8th that they were finally ending the “measured pace” of their tightening of monetary policy that began in mid-2004, they stated that they felt there was now a “balance” between increasing inflationary pressure going forward and the “moderation” of US economic growth that was already underway. By any measure the pace of growth in this country was no longer robust, and although some of the drag on the economy caused by record high energy prices had subsided, there remained an undercurrent of inflationary pressures that was raising eyebrows at the Fed. This has widened the rhetoric of dissidence on the Committee and kept recent votes on monetary policy from being unanimous.

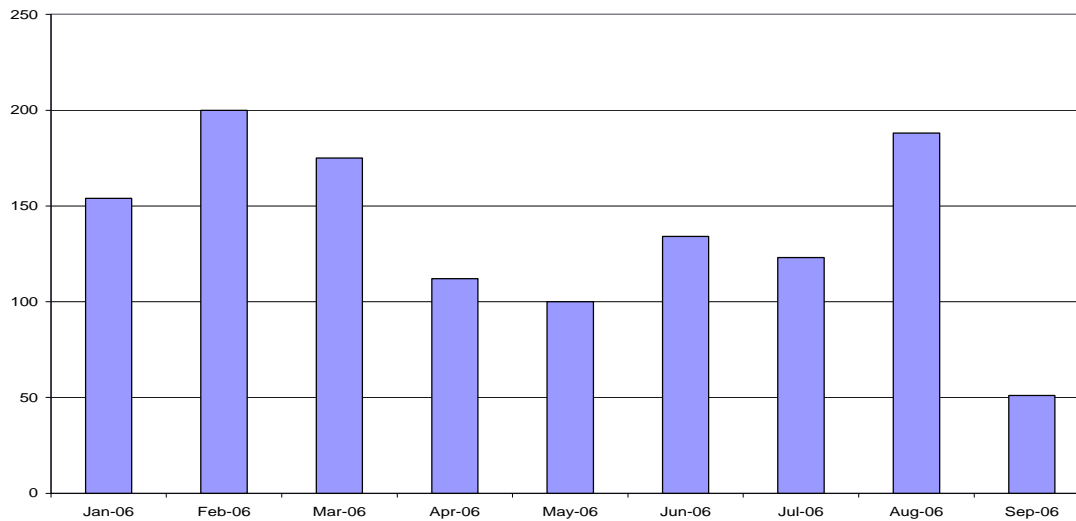
Earlier in the year commodity prices soared as concerns over rising demand for gasoline and other crude oil based products (jet fuel, petro-chemicals, etc.) lead the charge. Not far behind was gold and other precious metals as they faced equal all time record demand from the newly emerging middle class of India and the People’s Republic of China. For the first time, this bloc of well over a billion people are getting access to improved wages and business profits and are demanding access to consumer goods, like cars and jewelry. The groundswell of demand has placed a floor on commodity prices and exacerbated price increases when the potential for a shortfall in supply arises.

The global political scene certainly provided potential trouble spots that could have created those shortfalls. The outbreak of hostilities between Israel and Lebanon raised fears that Iran, a major OPEC producer, would become involved and possibly reduce oil exports to gain political leverage against Israel. Iran also continued to proceed with its nuclear research in spite of the UN Security Council threatening to place economic sanctions against them. The market’s fear is that the Iranian government would respond with sanctions of their own to “punish” actions against them. At the same time, North Korea has raised the ante in their attempt to gain concessions from their surrounding neighbors. With at least one underground test of a nuclear weapon having occurred along with numerous test flights of missiles that could possibly be used to delivery a weapon, the Kim Jong Il regime has taken a very serious stance. There are currently several diplomatic paths being explored but his quid pro quo for dismantling these weapons would probably be formidable.

Much of this speculation has dissipated for the time being. Oil prices have dropped by 25-30% as, once the demand for gasoline dropped off following Labor Day and the facilities in the Gulf of Mexico were spared any disruptions due to hurricanes, the supply of products far outweighed demand. Gold and prices for agricultural commodities softened as well.

2006 Crude Oil Prices

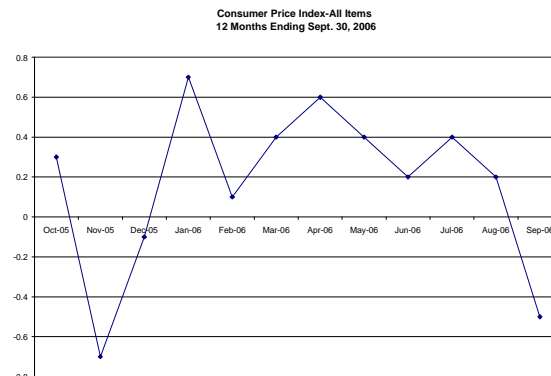




Although the inflationary pressures of high commodity prices have abated, businesses still seem reluctant to add new jobs. Whether their concern is another round of higher raw materials prices or a perceived lack of growth in orders or sales, job creation is lackluster. With the Bureau of Labor Statistics advising that we need 150K in new jobs created every month just to meet new entrants to the work force, we have seen the average for the year drop to 137K and with the most recent report in September being at 51K, it appears job creation is on the wane.

The US housing market has been hit especially hard as interest rates rose over the last 18-24 months. With a combination of record low affordability and high inventories of unsold properties, both the number of homes sold and the average price have been falling. One possible side effect is the ending of the wealth effect that home owners have seen over the last few years and that those homeowners will no longer be able to extract cash from increased home equity to either pay their bills or purchase big ticket items. It is being projected that while housing may have added 1% or more to GDP last year, it will be a negative by that amount or more for the next 12-18 months.

The “advance” look at GDP for the Third Quarter of 2006 showed that growth dropped to an annualized rate of 1.6% following a pace of 2.6% in Q2 and a very robust 5.6% in Q1. The last four quarters have averaged 2.9% and that is right at the top of the range that the Federal Reserve feels we can maintain growth without spurring inflation. If there were to be a resurgence in growth, perhaps based upon strong holiday sales creating new orders in early 2007 to rebuild inventories, then the Fed would have to move closer to a resumption of tightening monetary policy. On the other hand, if the woes of the housing and auto industries were to begin to spread to other areas of the economy, various Fed speakers have stated the obvious. The Fed would have to act quickly and decisively to ease monetary policy.



In the mean time the FOMC remains data dependent and is caught in the middle of its balancing act between growth and inflation.