The President's Report to the Board of Directors

August 3, 2006
Data since your last Directors' meeting show the economy grew in the second quarter at a slower pace than experienced during the first quarter, as expected. The slower rate in the second quarter was still solid, and representative of what is expected over the remainder of the year.

The increase in real GDP in the second quarter primarily reflected positive contributions from personal consumption expenditures, private inventory investment, nonresidential structures, exports, and state and local government spending. The contributions of these components were partly offset by negative contributions from residential fixed investment and federal government spending.

In July, consumer attitudes were unchanged from the second quarter, and initial claims for unemployment insurance eased slightly. Both the ISM manufacturing and employment indices improved in July, despite being below their second quarter averages.

Inflation became more of a concern in the second quarter, as core consumer prices accelerated after holding mostly steady over the previous three quarters. Total compensation costs, as measured by the ECI, also rose in response to further advances in wages and salaries. Oil prices continued to rise in July, after holding steady in June.

The deceleration of real GDP in the second quarter primarily reflected downturns in PCE for durable goods, equipment and software and federal government spending, a deceleration in exports and a larger decrease in residential investment. These effects were partially offset by a deceleration in imports, an acceleration in PCE for services, and an upturn in private inventory investment.
Personal income grew in the second quarter at the same rate as seen in the first, although real DPI eased a bit. Consumption followed its strong first quarter with moderate growth in the second.

Auto sales slowed a bit in the second quarter, but July’s sales were the highest since January.
Business investment grew in the first quarter, but at its slowest pace in over two years. The slowdown was due in large part to a decrease in equipment and software investment.

![Business Investment Graph]

In the second quarter, orders for both durable goods and nondefense capital goods, excluding aircraft, slowed.

![Durable Goods Orders Graph]
Residential investment decreased dramatically in the second quarter, falling by its largest rate in nearly six years.

Despite the decline in residential investment, new home sales surprisingly increased in the second quarter. Sales of existing homes, however, continued their downward trend.
Government spending slowed in the second quarter, following the strong growth seen in the first quarter.

Import and export growth rates both decelerated in the second quarter.
Consumer attitudes were mixed in the second quarter. The Conference Board's indices held steady, while the Michigan survey decreased to cancel its first quarter gains. According to both measures, however, consumer feelings exhibited little change in July.

Source: The Conference Board (confidence) and University of Michigan (sentiment).

Initial claims for unemployment insurance remained near their recent low levels through the second quarter and into July.

Source: Department of Labor, Employment and Training Administration.
Despite being below their second quarter averages, July data for both the ISM and employment indices represent improvements over June.

Growth in both total core consumer prices sped up in the second quarter, after holding steady over the previous three quarters. Producer prices grew at the same pace in the second quarter as seen in the first.
In the second quarter, total employment costs increased a bit as wages and salaries rose and benefit costs were unchanged.

Oil prices rose in the second quarter, and, after briefly leveling off in June, resumed their ascent in July.
Overall, data since your last Directors' meeting show the economy grew in the second quarter at a slower pace than experienced during the first quarter, as expected. The slower rate in the second quarter was still solid, and representative of what is expected over the remainder of the year.

Source: Federal Reserve Board of Governors.
In July, nonfarm payrolls added 113,000 jobs and the unemployment rate increased to 4.8%. June payrolls were revised to show an increase of 124,000 jobs, 3,000 more than the original estimate of a 121,000 job increase, and May payrolls were revised to show an increase of 100,000 jobs, 8,000 more than the previously reported increase of 92,000.

Productivity growth slowed to 1.1% in the second quarter, after increasing 4.3% in the first quarter. Unit labor costs rose 4.2%, the largest increase since the fourth quarter of 2004.

Redbook sales increased 0.2% in the first week of August, compared to July. Sales were 3.2% higher than during the same period last year. Oil prices rose during the past week amid concerns over the state of the Alaska Pipeline, averaging 75.9 dollars per barrel compared to last week's average of 74.2.

Payroll employment posted a modest gain in July, and revisions to the prior two months' estimates resulted in a net gain of 11,000 additional jobs. Still, the unemployment rate rose two-tenths of a percentage point in July to 4.8%.

Productivity growth slowed in the second quarter, while unit labor costs grew at their fastest pace since 2004. Compensation, however, eased during the quarter.