The President’s Report to the Board of Directors

November 2, 2006
Data since your last Directors’ meeting show the economy grew in the third quarter, but at its slowest pace since the first quarter of 2003.

The increase in real GDP in the third quarter was due mainly to positive contributions from personal consumption expenditures, exports, equipment and software, nonresidential structures, and state and local government spending. These effects were partly offset by a negative contribution from residential fixed investment and an increase in imports.

In October, consumer attitudes improved over their third quarter averages, but auto and light truck sales declined slightly. Initial claims for unemployment insurance followed some third quarter easing with further reductions in October. Both the ISM manufacturing and employment indices continued to fall through the third quarter, but the employment component improved some in October.

Lower energy prices helped slow overall consumer price growth in the third quarter, but core inflation advanced at its fastest quarterly pace in ten years. Adding to inflation concerns, unit labor costs grew at their fastest annual rate in nearly 25 years in the third quarter, and total compensation costs, as measured by the ECI, increased.

The deceleration in real GDP growth in the third quarter primarily reflected an acceleration in imports, a downturn in private inventory investment, a larger decrease in residential fixed investment, and a deceleration in PCE for services that were partially offset by upturns in PCE for durable goods and equipment and software.
Real consumption picked up in the third quarter, aided by an acceleration in real disposable incomes.

Growth in business investment nearly doubled in the third quarter, due primarily to a solid increase in equipment and software investment.
New orders for durable goods rebounded in the third quarter, offsetting some of the slowdown seen over the first half of the year. Orders of nondefense capital goods, excluding aircraft, exhibited a similar turnaround.

Residential investment decreased further in the third quarter, suffering its sharpest drop since the first quarter of 1991. The drop reduced overall GDP by 1.12 percentage points.
Home sales continued to slow in the third quarter, as sales of both new and existing homes fell to their lowest levels in over three years.

New and Existing Home Sales

Source: U.S. Census Bureau.

Government spending accelerated in the third quarter.

Government Spending

Source: Bureau of Economic Analysis.
Export growth picked up a bit in the third quarter, but imports accelerated and grew at a faster pace.

Consumer attitudes underwent some mixed, and relatively minor, changes in the third quarter, as confidence eased a bit and sentiment was unchanged. October saw attitudes improving, especially as measured by the Michigan survey.
Total auto and light truck sales were down a bit in October, after increasing slightly during the third quarter.

Initial claims for unemployment insurance eased slightly in the third quarter, and continued to decrease in October.
Both the ISM manufacturing and employment indices decreased in the third quarter, much as they had in the first two quarters of the year. The ISM index slipped further in October, but the employment index improved slightly on its September estimate.

During the third quarter, core consumer prices accelerated for the second consecutive quarter while total prices eased. Producer prices, both core and overall, slowed after holding steady in the second quarter.
Productivity was unchanged in the third quarter, and compensation per hour slowed. Unit labor costs also slowed on a quarterly basis, but their year-over-year growth was the fastest since 1982.

In the third quarter, employment costs accelerated as an increase in wages and salaries more than offset a minor slowdown in benefit costs.
Oil prices decreased late in the third quarter, and continued to fall in October.

Overall, the economy grew in the third quarter, but at its slowest pace since the first quarter of 2003. Consumption is strong and incomes are rising, but the cooling housing market and inflation concerns will play large rolls in how the economy performs throughout the rest of the year.
In October, nonfarm payrolls added 92,000 jobs and the unemployment rate fell two-tenths of a percentage point to 4.4%, its lowest level since May 2001. September payrolls, originally estimated as adding 51,000 jobs, were revised to show an increase of 148,000 jobs, and August payrolls were revised from a previously estimated gain of 188,000 jobs to a gain of 230,000.

Redbook sales increased 0.3% in the first week of November, compared to October. Sales were 3.4% higher than during the same period last year.

Oil prices decreased a bit over the past week, averaging 58.9 dollars per barrel compared to last week's average of 59.7.

In October, payroll employment posted its smallest monthly gain in a year, but job increases in the previous two months were revised sharply upward. Despite the smaller gain in October, the unemployment rate fell to a five-and-a-half year low.