The Economic Outlook

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U.S. Growth Is Cooling

(Annualized rate of growth)

Real GDP - Consumer Spending
Residential Construction Is Turning Down

(Residential fixed investment, percent of GDP)

Housing Affordability Has Deteriorated...

A higher index means homes are more affordable

Affordability Index for Existing Single-Family Homes

Source: National Association of Realtors
...And Is Becoming a Major Problem in Some Regions

A higher index means homes are more affordable

Source: National Association of Realtors

Home Inventory Is Now Rising Sharply Relative to Demand

(Months’ supply at current selling rate, single-family homes)

Source: National Association of Realtors
The Housing Downturn

Consumer Spending Won't Outpace Income Growth Forever
Oil Prices Are A Wild Card

Impact of a $10 Rise in Oil Prices On the U.S. Economy in the Global Insight Model
The Business Capital Spending Cycle: Construction To Take The Lead

Equipment and Software vs. Buildings

U.S. Export Growth Is Catching Up With World Trade Growth — Helped By The Falling Dollar

U.S. Export Growth vs. World Import Growth (Excluding U.S.)
Core CPI Inflation Is Moving Well Above 2%

(Ex-food and energy: percent change from a year earlier)

Homeowners’ Rent Has Driven Most Of the Pick-Up in Core CPI Inflation

(3-month moving average; annualized rate of inflation)
Are Labor Costs Actually Rising Or Not?

(Percent change, year-on-year)

- Official Unit Labor Costs
- Alternative Using the Employment Cost Index

The Fed May Have A Bit More Work to Do – But We Expect It To Cut Rates in 2007

(Percent)

- Federal Funds
- 10-Year Treasury Yield
The Federal Budget Deficit Is Doing Much Better Than Expected

The Profits Boom Is Nearing Its End
Bottom Line

- Growth is slowing towards 2%
- Consumption & housing momentum are weakening
- But core inflation is still edging higher; the Fed may not yet be done raising rates
- U.S. dollar to fall further
- Risks (1): Stubbornly above-comfort-zone inflation might mean that rates have to rise above our 5.50% federal funds peak
- Risks (2): Housing downturn may turn into a rout
- Risks (3): Vulnerability to another energy shock remains high

U.S. Economic Growth by Sector

(Percent change unless otherwise noted)

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>3.2</td>
<td>3.4</td>
<td>2.2</td>
<td>3.1</td>
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<tr>
<td>Consumption</td>
<td>3.5</td>
<td>3.2</td>
<td>2.5</td>
<td>3.0</td>
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<tr>
<td>Light Vehicle Sales (Millions)</td>
<td>16.9</td>
<td>16.5</td>
<td>16.3</td>
<td>16.5</td>
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<tr>
<td>Residential Investment</td>
<td>8.6</td>
<td>-3.5</td>
<td>-11.4</td>
<td>-2.9</td>
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<tr>
<td>Housing Starts (Millions)</td>
<td>2.07</td>
<td>1.87</td>
<td>1.64</td>
<td>1.64</td>
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<tr>
<td>Business Fixed Investment</td>
<td>6.8</td>
<td>8.2</td>
<td>6.3</td>
<td>4.2</td>
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<tr>
<td>Government</td>
<td>0.9</td>
<td>2.1</td>
<td>1.4</td>
<td>1.5</td>
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<tr>
<td>Exports</td>
<td>6.8</td>
<td>8.9</td>
<td>8.9</td>
<td>8.8</td>
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<tr>
<td>Imports</td>
<td>6.1</td>
<td>5.9</td>
<td>3.7</td>
<td>4.4</td>
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<td>Employment</td>
<td>1.5</td>
<td>1.4</td>
<td>1.0</td>
<td>1.3</td>
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<tr>
<td>Unemployment Rate (%)</td>
<td>5.1</td>
<td>4.7</td>
<td>5.0</td>
<td>5.0</td>
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<tr>
<td>CPI Inflation</td>
<td>3.4</td>
<td>3.5</td>
<td>2.7</td>
<td>1.9</td>
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<td>Oil Prices (WTI, US$/bbl)</td>
<td>56.56</td>
<td>70.82</td>
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<tr>
<td>Core CPI Inflation</td>
<td>2.2</td>
<td>2.6</td>
<td>2.7</td>
<td>2.2</td>
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<td>Federal Funds Rate</td>
<td>3.21</td>
<td>5.01</td>
<td>5.23</td>
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<td>10-year Government Bond Yield</td>
<td>4.29</td>
<td>4.90</td>
<td>4.95</td>
<td>5.29</td>
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<td>$ (Major Currency Index, 2000=1)</td>
<td>0.83</td>
<td>0.81</td>
<td>0.75</td>
<td>0.72</td>
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