

# Mixed economic forecasts hint of a late-blooming year

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A declining housing market, strong consumer spending and rising interest rates made 2006 a mixed year for the Philadelphia economy. While healthy consumer demand kept business spending strong and put downward pressure on unemployment, the declining housing market and rising interest rates did the opposite.

The result, what has been termed a "Goldilocks" economy — neither too cold nor too hot but rather somewhere in between a recession and over-expansion — will likely continue in the first half of 2007, and perhaps longer in the Philadelphia region, but may improve in the second half if the housing market bottoms out and credit spreads widen, economists predict.

## Late-blooming year?

Overall, annual average U.S. real gross domestic product (GDP) growth is expected to be 2.6 percent this year, down from the 3.3 estimated for 2006, according to the November release of the Survey of Professional Forecasters, a quarterly survey of macroeconomic forecasts published by the Federal Reserve Bank of Philadelphia.

However, growth is expected to be uneven over the year, with the second half exhibiting stronger growth than the first. In the December release of the Livingston Survey, a separate survey of economists' expectations published semi-annually by the Philadelphia Fed, forecasters expect growth to be 2.8 percent in the first half of 2007, rising to an annual rate of 3.1 percent in the second half of the year.

The two surveys differ in their outlook because the Livingston takes a longer-term perspective and is based on slightly more current data. Nevertheless, the surveys suggest that economists expect somewhat-slower GDP growth this year versus last, with the economy gaining speed in the second half of the year.

Regional figures, however, suggest that Philadelphia might lag national trends. The Philadelphia Fed's leading index for Pennsylvania, an indicator which uses various state, regional and national variables to forecast the nine-month-ahead change in the state's economic activity, was 0.3 for November, down from 2.1 for October and 0.9 for September. This suggests that economists have become more pessimistic about the state economy's projected growth through the first half of 2007.

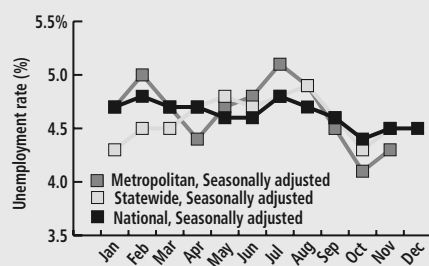
"Historically, when the data that we put into the November index is at the level that it is now, in the past it shows very little growth in the next nine months," said Timothy Schiller, a senior economist at the Philadelphia Fed, cautioning that the leading index is highly volatile and subject to frequent revision.



Schiller

## UNEMPLOYMENT RATES

Through 2006



Note: Data for metro area is not seasonally adjusted.  
Source: U.S. Bureau of Labor Statistics

## Local job gains

Nationally, unemployment dropped from 4.8 percent in July of last year to 4.5 percent in December on a seasonally-adjusted basis, according to the Bureau of Labor Statistics. In Pennsylvania, the unemployment rate experienced the same decline from July to November, while the Philadelphia metropolitan area experienced an even sharper drop, from 5.1 to 4.3 from July to November.

Schiller cautioned, however, that unemployment in the region is not evenly spread across business sectors.

"The weakness in this region has been in manufacturing, financial services and information technology," he said.

The slowdown in manufacturing, which in 2005 accounted for 15 percent of Pennsylvania's gross state product, bears some correlation to the slowdown in the housing market, since construction products and other housing-related goods are an important segment of regional manufacturing.

Similarly, the financial troubles facing U.S. automakers nationwide have had a softening effect on auto parts manufacturing in the area.

## Real estate strong

The housing market seemed to fare better near the end of 2006. According to the Census Bureau, national housing starts in December increased 4.5 percent from November levels, even though they were still 18 percent below December 2005 levels. In the Northeast, starts were down 10.8 percent from 2005.

Some economists and industry leaders predict that the slowdown in the housing market will end this year, if it hasn't already. Joan Docktor, executive vice president of sales at Devon-based Prudential, Fox & Roach Realtors, believes that the worst is over for the Philadelphia housing market.

"August, I think, was the bottom and we've been slowly seeing stronger markets since then," Docktor said, adding that 2007 will be "a good opportunity for sellers to enjoy a trade-up market and for buyers to enjoy a buyer's market."

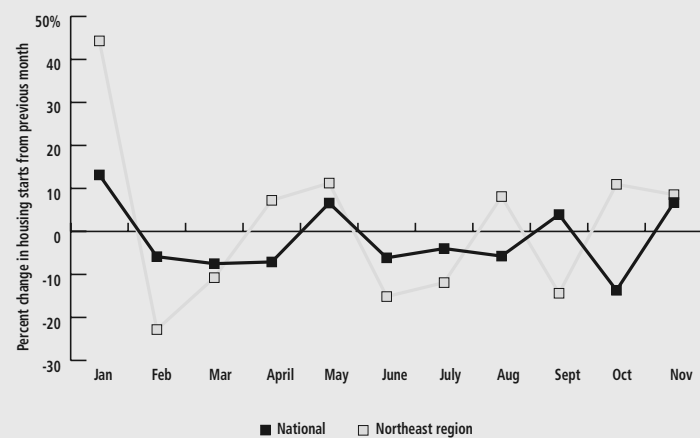
On the commercial real estate side, economists and industry leaders are cautiously optimistic that the market will stay strong this year.



Docktor

## HOUSING STARTS

2006 housing starts, seasonally adjusted.



Source: U.S. Census Bureau

"I think the commercial real estate market and specifically the office market had a very nice year in 2006. We've seen over a million square feet in net absorption in 2006 and we cautiously look for something in 2007 that will approach this," said John Gattuso, senior vice president of urban and national development at Malvern-based Liberty Property Trust.

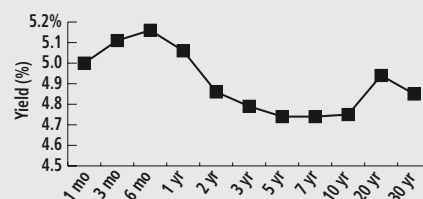


Gattuso

"The market will continue to move toward equilibrium and will gain strength."

## YIELD CURVE

Yield curve as of Jan. 16.



Source: U.S. Department of the Treasury

## Interest rates stable

Interest rates, which climbed from 4.25 percent to 5.25 percent over the course of 2006, have stabilized. "It is very hard to predict what the Fed will do but I am not so sure that they will raise them," said Jeremy J. Siegel, professor of finance at the Wharton School of the University of Pennsylvania. "Long-term rates may go up to 5 percent but those are very hard to predict."

The Survey of Professional Forecasters predicts that this year short-term interest rates, as measured by the rate on 3-month treasury bills, will average 4.8 percent, in-line with 2006 expectations. Long-term interest rates, as measured by the rate on 10-year treasury bonds, are predicted to average 4.9 percent this year, up slightly from the 4.8 predicted for 2006.

The tight spread between predicted

short-term and long-term interest rates means that, for much of the year, the economy will likely continue to operate under an inverted yield curve: a situation in which short-term interest yields are higher than long-term interest yields.

"In the past, an inverted yield curve has been seen as a sign that the economy is in trouble. But this is one of

the only times I can remember when the yield curve has been inverted at a relatively low level of interest rates," said Mark Vitner, a senior economist at Charlotte, N.C.-based Wachovia Corp. "We actually have it turning essentially flat in the second half of 2007, but it could turn positive. If it turns positive, it will only do so in a very modest way."

A positive-sloping yield curve is normally hailed as a sign that the economy is in a normal expansionary mode. This would be good news for the financial services industry in the Philadelphia region.

"Anytime you have compressed interest margins it makes it more difficult for financial services institutions like banks to earn money on the lending side," Schiller said.

Consequently, many financial services firms have sought to diversify their activities to limit their exposure to diminishing lending margins.

"Banks are increasingly going after small businesses and summon more services and generate more of their cash management and 401(k) businesses in this flat-yield-curve environment," Vitner said. He added that wealth management, investment banking mergers and even retail banking are all businesses that have been doing well in the tougher lending environment.

"We do expect our 2007 outlook to be good," Vitner said of Wachovia.

## All eyes on Congress

Despite this, much of the Goldilocks-warming-up outlook for 2007 still depends on one curveball: Congress. Some have speculated that the new Democratic Congress could try to change the so-called Bush tax laws, many of which are scheduled to sunset in 2010 unless reenacted. However, this seems unlikely so long as President Bush remains in office.

"I think the most important thing is that we still have a Republican president, which means there's going to be a lot of gridlock," said Siegel. "The capital gains and dividend tax laws expire in 2010. I doubt anyone will do anything about them until then." ■



Vitner