U.S. ECONOMICS

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The Terrible Twos

Outlook at a Glance...

%	1Q06	2Q06	3Q06	4Q06	1Q07 E	2Q07 E	3Q07 E	4Q07 E	2006	2007 E	2008 E
Real GDP	5.6	2.6	2.0	2.5	2.0	2.5	2.5	2.5	3.3	2.3	2.5
Private consumption	4.8	2.6	2.8	4.2	3.2	2.3	2.1	2.0	3.2	2.9	2.0
Government expenditure	4.9	0.8	1.7	3.4	2.5	2.5	2.5	2.5	2.1	2.5	2.5
Non res fixed invest	13.7	4.4	10.0	-3.1	4.5	5.6	5.3	5.3	7.2	4.1	5.3
Residential fixed invest	-0.3	-11.1	-18.6	-19.8	-15.0	-7.0	-4.0	0.0	-4.2	-12.6	-1.0
Exports	14.0	6.2	6.8	10.6	5.5	7.0	7.0	7.0	8.9	7.2	7.0
Imports	9.1	1.4	5.6	-2.6	3.7	4.5	4.5	4.5	5.8	2.9	4.8
Contributions to GDP:											
Domestic final sales	5.4	1.6	2.0	1.9	2.2	2.2	2.1	2.3	3.1	2.2	2.4
Inventories	-0.1	0.4	0.1	-1.2	-0.3	0.1	0.2	0.0	0.2	-0.2	0.0
Net trade	0.0	0.4	-0.2	1.6	0.0	0.1	0.1	0.1	0.0	0.3	0.0
Unemployment rate	4.7	4.6	4.7	4.5	4.6	4.7	4.7	4.7	4.6	4.7	4.8
Non-farm payrolls, 000	252	124	202	177	120	120	110	110	189	115	110
Consumer prices	3.7	4.0	3.4	1.9	2.5	2.3	2.2	3.4	3.2	2.6	2.6
Core CPI	2.1	2.4	2.8	2.7	2.7	2.5	2.4	2.6	2.5	2.5	2.4
Core PCE deflator	2.0	2.2	2.4	2.2	2.3	2.2	2.2	2.2	2.2	2.2	1.9
Federal deficit (fiscal yr, $bn)									-248	-200	-200
Current account deficit (% GDP)									-6.5	-6.5	-6.5
Fed funds	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	4.75
3-month USD LIBOR	5.00	5.48	5.37	5.36	5.35	5.40	5.40	5.40	5.36	5.40	5.10
TSY 2-year note	4.82	5.15	4.68	4.81	4.58	4.80	5.00	5.00	4.81	5.00	4.80
TSY 5-year note	4.82	5.09	4.58	4.69	4.54	4.75	4.80	4.80	4.69	4.80	4.80
TSY 10-year note	4.86	5.14	4.63	4.70	4.65	4.75	4.80	4.80	4.70	4.80	4.80

Notes: Real GDP and its contributions are seasonally adjusted annual rates. Unemployment is measured as a percentage of the labor force. Inflation measures are y-o-y percent changes. Interest rate forecasts are end of period. Payrolls are monthly average changes. Table last revised 5 April. All forecasts are modal forecasts (i.e., the single most likely outcome).

Source: BLS, BEA, Federal Reserve Board, and Lehman Brothers

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Core inflation has been consistently elevated above 2%, which presents a significant hurdle to Fed rate cuts. We view inflation risks as remaining to the upside.

Elevated

The recent inflation news and fundamentals continue to point to upside price pressures. February's core personal consumption expenditure (PCE) deflator came in at 0.3% m-o-m, or 2.4% y-o-y. Compared with the Fed's "comfort zone" of 1%-2% for the core PCE deflator, inflation is running high. But markets have taken the inflation news in stride, continuing to expect roughly three rate cuts despite the Fed's exhortation that its "predominant policy concern remains the risks that core inflation will fail to moderate as expected".

In our view, the recent elevated inflation numbers are not a temporary phenomenon.

The recent inflation numbers are hardly an aberration. While the data naturally wiggle around on a monthly and quarterly basis, the annual numbers show two key features (Figure 1). First, the elevated state of inflation is not a temporary phenomenon: inflation has been on the strong side for the past three years. Second, a core PCE deflator running above 2% is not the normal state of affairs: inflation was below 2% for eight straight years before its recent elevation. The Fed cannot ease up on fighting inflation without taking a severe hit to its credibility.

Forecasting

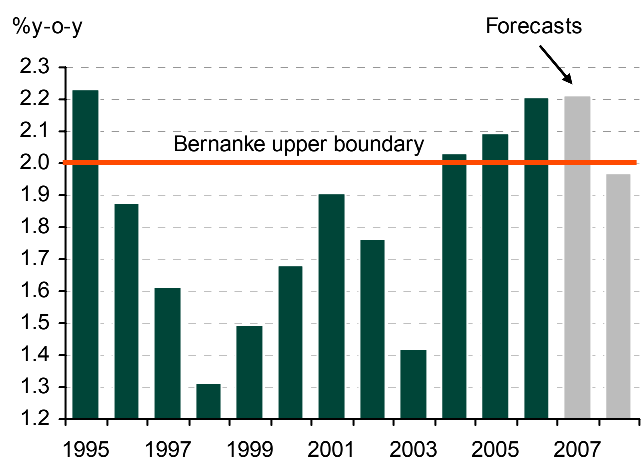
The key macro factor in inflation is excess capacity…

Traditionally, the key macroeconomic determinant of inflation is excess capacity. Markets seem to have embraced the view that growth will slow down enough to soften inflation on its own. But neither the growth picture nor the labor market point to any significant excess capacity being generated in the near term.

…but identifying excess capacity has its own issues…

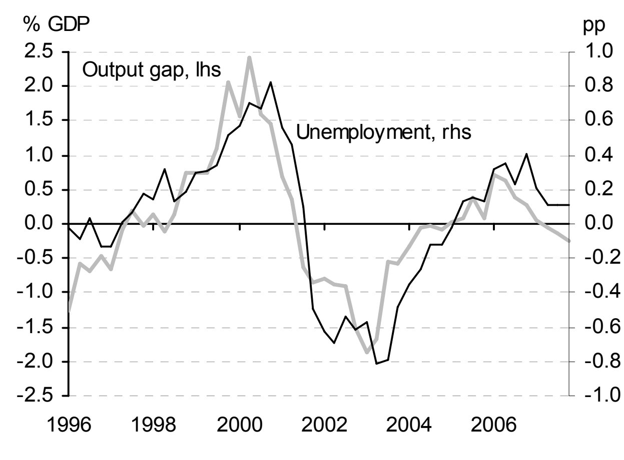
That said, there are several crucial uncertainties in the inflation forecast. The first problem lies in trying to identify the degree of "excess capacity." The standard measure is the difference between the actual level of GDP and its potential level, but the unemployment rate (relative to NAIRU) can serve as a proxy. According to a standard technique for filtering out short-term fluctuations in variables, both measures point to the economy currently operating at around capacity (Figure 2). Such a state is neither inflationary nor disinflationary, meaning that inflation is likely to remain elevated.

Figure 1: Annual Core PCE Inflation



Source: Commerce Department and Lehman Brothers Global Economics.

Figure 2: Measures of Over- or Under-capacity



*Above zero indicates over capacity; estimated using Hodrick-Prescott filter

Source: Commerce Dept., BLS, and Lehman Brothers Global Economics.

…and while inflation previously had been thought to be persistent …

A second uncertainty is the persistence of inflation. Historically inflation was considered a random walk, implying that the best forecast of inflation this year was inflation last year. For example, in annual data, estimating the very simple relationship:

$$\pi_t = \alpha + \beta\pi_{t-1} \text{ (where "}\pi\text{" is inflation)}$$

generates a very significant coefficient of 0.9 for the core PCE, and a similarly significant estimate of 0.85 for CPI, core CPI, and PCE. All estimates are insignificantly different from 1[1]. A glance at the annual data suggests an obvious relation (Figure 3), albeit possibly a dated one since much of the recent annual inflation is centered on 2%.

…persistence may now be falling.

However, the annual numbers obscure a consistent finding in the literature on inflation: persistence appears to be falling, although statistically it is still close to being a random walk. While the evidence is hazy even by statistical standards, it may now be possible for inflation to fall more quickly now that shocks to prices are shorter-lived.[2]

Taking A Stand

We compare our own inflation outlook with the typical benchmarks…

Despite all the uncertainty, standard models still provide a useful benchmark for forecasting inflation. We compare our own inflation outlook with the conventional Phillips curve model, which relates inflation in the core PCE deflator to measures of capacity utilization and other variables:[3]

$$\pi_t = \sum_{i=1}^{4} \alpha_i \pi_{t-i} + \beta u_{t-1} + \gamma x_{t-1}, \sum_{i=1}^{4} a_i = 1$$

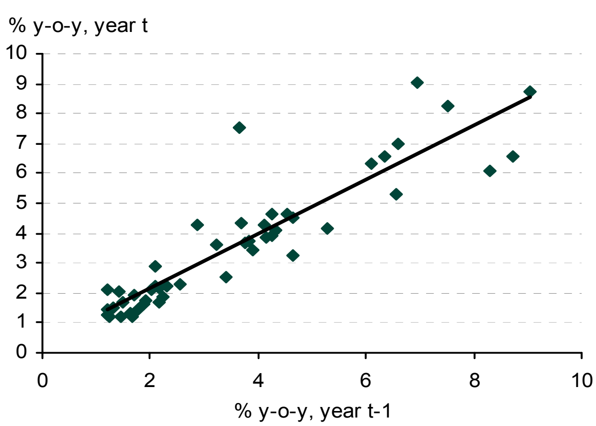
…using a variety of measures of capacity and other possible predictors.

where u_{t-1} is a measure of capacity utilization (such as the unemployment rate less NAIRU or various measures of the output gap), and x_{t-1} represents all the other variables tested, including forward-looking inflation expectations and commodity prices as measured by the ISM prices paid index.

The range of forecasts still points to elevated inflation in the medium term.

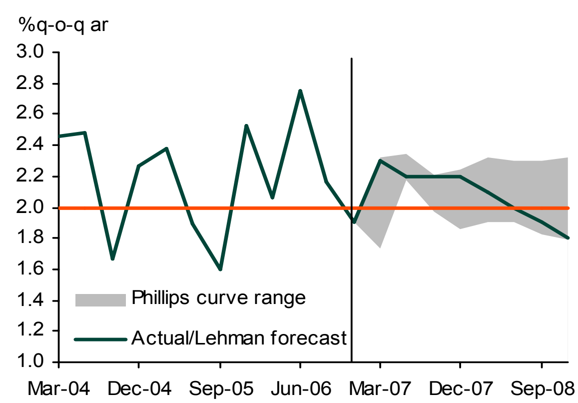
The range of forecasts from the Phillips curve variants, along with our official forecast, is shown in Figure 4. Compared to the former, our forecasts are a bit higher in the shorter term, but lower in the longer run. But one feature stands out clearly: despite the range of uncertainty, the various models generally point to core inflation remaining above the 2% comfort zone through the middle of next year, and falling within target only by the end of 2008. Therefore, even if persistence fades further, it looks like it will still be some time before the Fed can let down its guard.

Figure 3: Annual Core PCE, From Year *t-1* to *t*



Source: Commerce Dept. and Lehman Brothers Global Economics.

Figure 4: Inflation Forecasts: Phillips Curves and LB



Source: Commerce Department and Lehman Brothers Global Economics.

[1] Annual inflation data pass "unit root tests".
[2] 2. Mishkin, F. "Inflation Dynamics", March 2007.
[3] 3 Williams, J. "The Phillips Curve in an Era of Well-Anchored Inflation Expectations", SFFed Mimeo 2006.

The Week Ahead

A handful of Fed speakers and the minutes of the March 21 FOMC meeting will be the focus in a relatively light data week. In the minutes, we expect the Fed to elaborate on its inflation bias. Elsewhere, the trade balance should deteriorate slightly, falling to -$60 billion, while rising energy prices should provide a boost for headline inflation.

Budget Balance (Wednesday)

We expect receipt growth to have remained strong into March but also anticipate that outlays growth outpaced inflation. Thus, we look for the March deficit to be unchanged from last year at $85 billion (Figure 5). For the year, we still expect a deficit of $200 billion, with a growing risk that the deficit will prove smaller than we have forecast, based on incoming non-withheld taxes. However, a slowdown in corporate earnings could lead to a smaller corporate tax take than we had forecast at the beginning of the year.

FOMC Minutes (Wednesday)

Despite uncertainty about whether the last FOMC statement contained an inflation bias, we expect the minutes to be unambiguous. Although the minutes will very likely acknowledge the recent deterioration in the economic outlook, they will probably likewise acknowledge the increasing divergence between the Fed's view of inflation gradually falling and the reality of the recent inflation indicators.

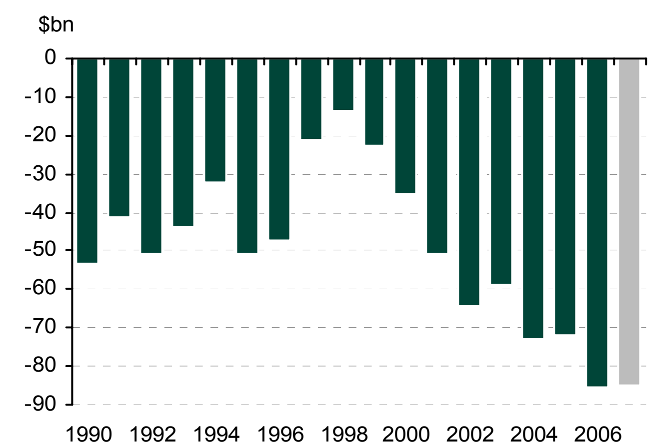
The FOMC minutes should sound similar to Bernanke's JEC testimony.

We think the FOMC minutes will sound much like Bernanke's testimony before the Joint Economic Committee. Specifically, we look for more in-depth discussion around the sub-prime mortgage issue and the housing market generally. There should also be some commentary on the unusually low level of business investment and the risks that continued weakness in this growth driver could pose to the outlook. On inflation, the Fed is likely to have little to say beyond that inflation remains above its "comfort zone" and seems unlikely to move back within that boundary before the end of the year. At the same time, the FOMC is likely to reiterate that inflation expectations remain contained.

Some members may have favored a balanced risk statement.

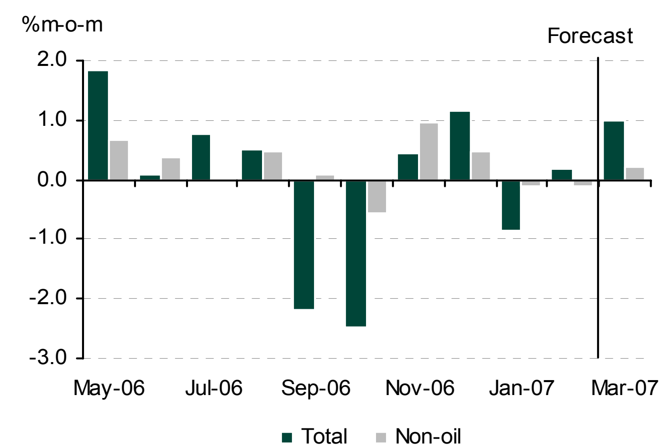
Given the shift in the statement's tone, it also seems possible that some FOMC members may have wanted to eliminate the inflation bias in favor of a more neutral stance. However, should such a discussion be absent from the minutes, it would only highlight that inflation is the "predominant" concern. Recent comments by St. Louis Fed President Poole have suggested

Figure 5: March Budget Balance



Source: Department of the Treasury

Figure 6: Import Prices



Source: BLS and Lehman Brothers Global Economics less dissension in the ranks than might be inferred from the statement and the market reaction. A lack of internal debate on this topic should be viewed as quite hawkish.

Import Prices (Thursday)

Imports prices should rise 1.0%, or 0.2% excluding oil.

Import prices should rise 1.0% in March, up from February's 0.2% increase. The headline number will largely reflect higher oil prices, not more fundamental price pressures. Excluding oil, we would look for a more moderate increase of 0.2%, which would also reflect cooling natural gas prices. Prices of finished goods should come in at trend–like rates as well, as the very gradual depreciation in the U.S. dollar over the past couple of quarters is likely too small to be significantly reflected in imports at this point. In particular, consumer goods import prices should rise 0.2% m-o-m.

Trade Balance (Friday)

We look for the trade balance to fall to -$60 billion.

The U.S. trade balance likely deteriorated slightly to $60.0 billion in February from January's $59.1 billion. Two main factors should push the deficit up. First, oil prices picked up during the month, which should cause a rise in petroleum imports. Second, solid U.S. consumption should translate into an appetite for more imported consumer goods. However, decent export demand from around the world will likely offset some of the negative impact of higher imports. More generally, the trade deficit has now stabilized at around the $60 billion monthly level since October, after nearing the $70 billion level last summer (Figure 7).

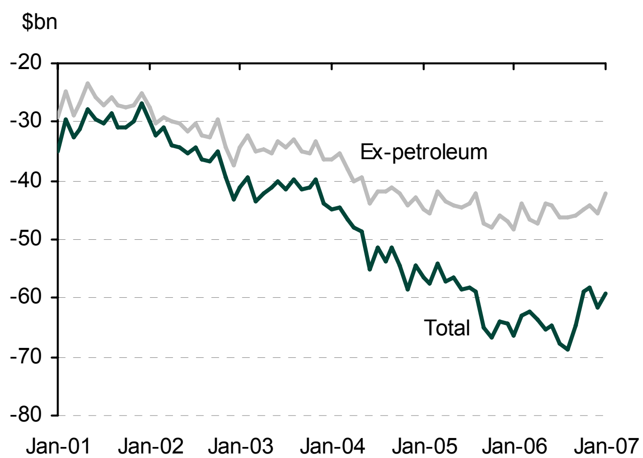
Producer Prices (Friday)

Energy prices should boost headline PPI 1.0%, while the core should increase 0.2%.

The March producer price index (PPI) should increase 1.0%, a modest deceleration from the 1.3% gain in February. We look for the core PPI to increase a trend-line 0.2%.

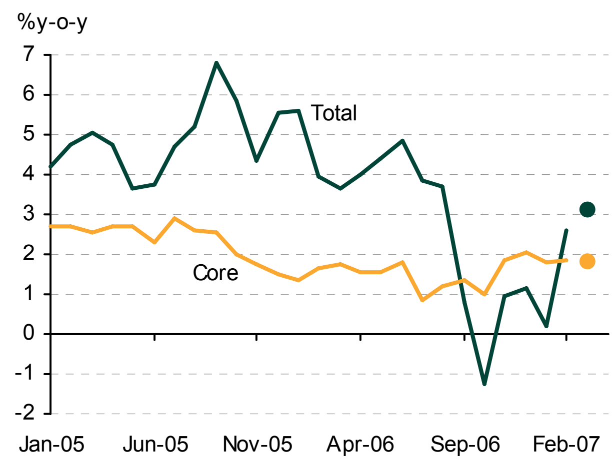
Across–the-board increases in energy prices should be the main factor holding headline PPI at elevated levels. Both retail and wholesale gasoline prices surged in March, while natural gas prices, which feed into the PPI with a one-month lag, rose sharply in February. Combined with modest increases in heating oil and electricity prices, these gains should translate into a 3.9% increase in the energy PPI component. Food prices, meanwhile, should rise a moderate 0.5%, as food–related commodity futures generally softened during the month. Outside the volatile food and energy components, core PPI should increase 0.2%, or 1.8% y-o-y (Figure 8). The 0.4% jump in the core last month was largely the result of a tobacco price surge, which is likely to prove temporary.

Figure 7: Trade Balance



Source: Census Bureau

Figure 8: Producer Prices



Source: BLS and Lehman Brothers Global Economics

The PPI has firmed in recent months.

In terms of pipeline inflation measures, we look for the intermediate core PPI to increase 0.2%, matching last month's gain, while the crude core should increase 0.7%. After softening in the latter part of 2006, both the crude and intermediate core indices have rebounded this year. While the relationship between the PPI and core consumer goods prices is quite loose, these developments do suggest to us that some firming of core inflation pressure is possible further up the supply chain

Consumer Sentiment (Friday)

Consumer sentiment should be roughly unchanged in April.

We look for April's University of Michigan consumer sentiment to print at 88, little changed from March's 88.4. Although the stock market has rebounded since the recent sell-off, concerns about the health of the economy continue to make investors nervous. At the same time, higher gasoline prices will likely depress confidence, especially among lower-income households. These households are largely "hand-to-mouth", essentially spending whatever income is available each month and responding to shifts in gasoline prices with lower spending elsewhere. We expect healthy employment and wage growth to offset some of these negative factors.

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