

Economic Update

The Quick Read

- Earlier hopes of an improvement in economic activity during the second half of 2008 are fading fast
- Fed Chairman Ben Bernanke said that he expects the economy will grow “appreciably below its trend rate” for the remainder of this year and that there were “significant downside risks to the outlook”
- Consumers are seeing a bit of relief now that gas prices are edging downward and tax rebate checks of \$100 billion have been received. Confidence edged up slightly in July
- Employment continues to deteriorate. Unadjusted employment is off from its year-ago level – the first time this has happened since 2003
- The housing depression, and the impact that it’s having on consumers’ balance sheets, remains a serious issue for consumers
- The situation is tenuous in manufacturing. Industrial production has dipped slightly, to date. Numerous companies are reporting sharp price increases in their raw materials purchases

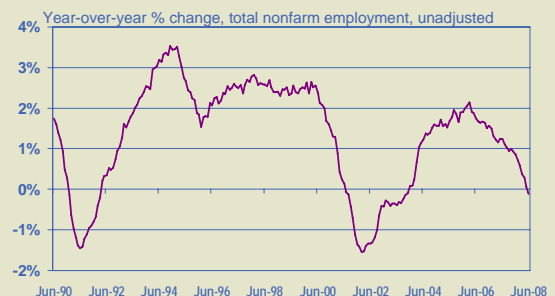
Tying it Together

Sadly, the Men’s Dress Furnishings Association, which represented tie manufacturers, closed up shop in June. Seems there aren’t enough men buying ties anymore. A recent Gallup poll found that a mere 6% of men now wear ties to work every day.

In a similar fashion, it remains a difficult process trying to tie up all the pieces of this complex economy. Earlier, a widespread belief was that the economy would slowly improve in the second half of 2008. The situation, however, remains somewhat knotted up as a result of the long-running housing depression, the severe lending pullback, and a worsening employment downturn. Further, initial estimates of activity keep getting revised lower. Retail sales and employment in April and May, for example, are now said to be weaker than originally reported.

Some analysts are continuing with their recession forecasts while others remain of the opinion that we’ll manage to avoid one. This split in thinking has been pretty much ongoing since the start of the year. The latest survey of economists from the National Association for Business Economics (NABE) found a high level of uncertainty for the remaining six months of this year: 44% felt the economy would grow 1% or more, annualized, in the second half of 2008; 45% felt it would have slower growth of 0 – 1%; and 10% expected a decline in real GDP. Fed Chairman Ben Bernanke told Congress in July that he expects the economy will grow “appreciably below its trend rate” for the remainder of this year and that there were “significant downside risks to the outlook.”

Employment Has Slipped Below Its Year-Ago Level



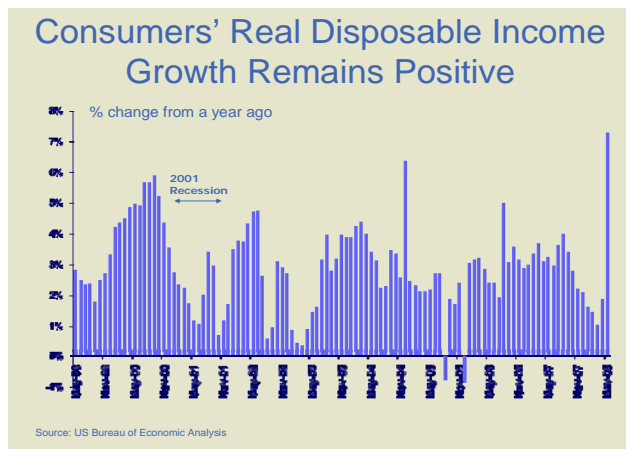
Source: US Labor Dept.

Tie Died

But the consumer lives on, even while experiencing numerous difficulties. Higher gas prices, declining home values, rising food prices, severe mortgage payment problems, a declining stock market, and negative growth in employment – consumers continue to face a host of adverse fundamentals that are impacting their ability to spend. Yet even though spending gains have slowed – quarterly retail sales, excluding motor vehicles and gasoline, are up about 3% from a year ago -- growth remains slightly healthier than what was experienced in the prior two recessions.

Consumers' tight collars should loosen a bit in coming months. Gas prices have come down from their record highs. Prices are in retreat partly because demand is slowing. In the first four months of this year, Americans reportedly traveled 40.5 billion fewer miles than they did in the similar period of 2007. "We have seen the longest decline in vehicular miles traveled since we started collecting this data," said US Transportation Secretary Mary E. Peters.

The tax stimulus checks are also giving a spurt to income. In May, real disposable consumer income jumped 7% from a year ago as a result of the \$48 billion in tax rebate checks that arrived in consumers' mail boxes. By early July, roughly \$100 billion in total had been mailed to 112 million households, according to the IRS.



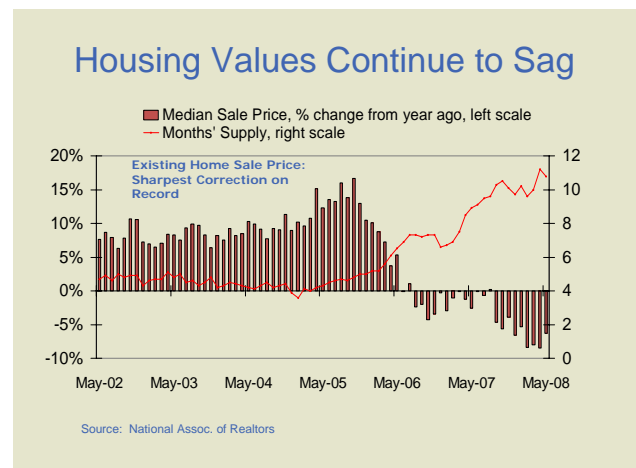
As a result of these recent improvements in consumers' balance sheets, their attitudes have turned slightly more positive. The Conference Board's Index of Consumer Confidence edged up in July to 51.9. It was the first increase since December. Confidence had plummeted so steeply that the previous month's Index had reached the lowest level in 16 years.

One area of concern for spending is that employment continues to deteriorate. In June, seasonally adjusted employment dropped for the sixth consecutive month. As noted, figures for April and May were revised downward. And as shown on the chart on the first page, unadjusted employment is off from year-ago levels – the first time this has happened since 2003. Historically, this kind of employment weakness has meant that the economy is in a recession. Further, employment is expected to continue to weaken in the months ahead.

Employment losses are widespread. In June, construction employment was down 6% from a year ago, manufacturing was off 2.6%, and the financial and retail segments each were down slightly more than 1% from year-ago levels.

The other significant pain point for consumers remains housing and the impact it's having on their balance sheets. The housing depression continues to show no signs of turning around. Somewhat perversely, the financial markets applauded June's hefty 2.6% drop in existing home sales simply because the falloff was "less than expected." The annualized rate of sales is down an exceptional 33% from the September 2005 peak. Further, the National Association of Realtors reported that about a third of sales were either foreclosures or short sales where the owner accepts less than what is owed on the house. The situation is even more dire for new homes. New home sales (roughly 20% of total home sales) were down by a neck-strangling 62% in June from the July 2005 peak.

With the inventory of unsold homes remaining at record-breaking levels, home values continue to plummet. This is having a negative wealth effect – some even call it a poverty effect – on consumers, making them feel less confident about spending. As shown below, the median sales price for an existing home in May was down 6% from a year ago. The correction in existing home prices since mid-2005 is the sharpest on record. It'll likely take until 2009 before the overhang of homes on the market gets worked down to a manageable level, thereby improving pricing.



Despite all the negativity swirling around consumers, they are managing to spend, albeit selectively and miserly. In June, seasonally adjusted retail sales, excluding motor vehicles and gasoline, advanced a slight 0.2% from May.

Mostly due to high gas prices, motor vehicle sales plummeted 3.3% in dollar terms. In unit terms, new vehicle sales in June fell to an annualized rate of 13.6 million units, the lowest figure in 15 years.

For the first six months of 2008, total retail sales are up a slightly 3.1% from the first half of 2007. Should this pace hold for the remainder of the year it would represent the weakest performance since 2002.

Economic Indicators				
	2007 Year	April 2008	May 2008	June 2008
Employment (change in nonfarm, 000)	128*	-67	-62	-62
Unemployment Rate (Seas. Adjusted %)	4.6*	5.0	5.5	5.5
Consumer Price Index (% ch. prior period)	2.9	0.2	0.6	1.1
Consumer Confidence (1985 = 100)	103.4	62.8	58.1	51.0
Personal Income (current \$, % chg. from prior period)	6.2	0.3	1.9	NA
• Wages & Salaries	5.8	-0.1	0.3	NA
Personal Consumption Expenditures (current\$, % change)	5.5	0.4	0.8	NA
• Services	6.1	0.4	0.7	NA
Consumer Debt as % of Disposable Pers. Income	24.3	24.2	23.0	NA
Wholesale Trade (% ch.)	8.6	1.6	1.6	NA
Industrial Production: Mfg. (% change)	1.8	-0.9	0.0	0.2
Capacity Utilization, Mfg., %	79.3	77.7	77.6	77.6
Existing Home Sales (mil.)**	5.65	4.89	4.99	4.86
Retail Sales (% change from prior period):				
• Total (incl. Food Service)	4.1	0.2	0.8	0.1
• Motor Vehicles & Parts	2.3	-3.1	-0.6	-3.3
• Total, excluding Autos	4.5	1.0	1.2	0.8
• GAF	3.8	0.7	1.1	0.2e
– General Merchandise Stores	4.4	0.7	1.3	0.4
– Apparel & Accessories Stores	4.5	0.5	0.8	0.6
– Furniture & Home Furnishings Stores	0.8	-0.2	0.3	-1.4
– Electronics & Appliance Stores	2.8	1.4	1.7	-0.6
– Other	3.5	0.9	0.6	0.5e

Note: % changes calculated from seasonally adjusted data in current dollars, i.e., not adjusted for inflation.

*Monthly average. NA=Not Available. e=Estimate.

**Monthly data = Seasonally Adjusted Annual Rate.

GAF = General merchandise, Apparel, Furniture/furnishings, electronics/appliances, and other, which includes sporting goods, hobby, book, music, gift, novelty, office supply and stationery stores.

Manufacturing: Knot the Issue

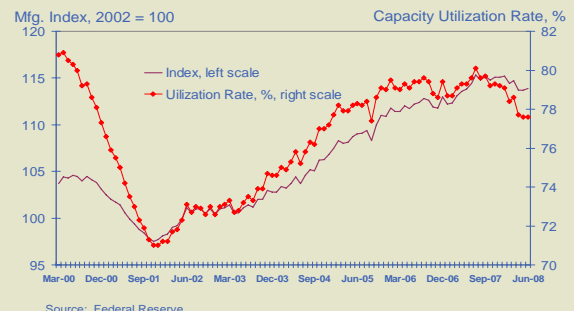
Most of the current round of economic softness is tied to the hesitant consumer. This is in contrast to the 2001 recession which was heavily centered in manufacturing. Currently, unfilled orders in the manufacturing sector are running 15% - 20% higher than they were a year ago. During 2001-2003, there was an extended 29-month period when unfilled orders were below year-ago levels. Manufacturers' shipments also continue to grow, compared with declines in 2001-2002.

Manufacturers' Unfilled Orders Remain at Healthy Levels



Industrial production has experienced some deterioration over the past year, but the decline has not come close to the 7% drop that occurred during 2000-2001. Further, the current dip in the utilization rate of our nation's factories is a far cry from what was experienced in the prior recession.

Industrial Production for Manufacturing: Slight Weakness



Another area that is helping manufacturing is strong export growth, which is aided by the weak dollar. The value of our exports of goods in May was up roughly 30% from two years ago.

As noted earlier, the risks going forward are related mostly to the consumer and are all on the downside. Several surveys of back-to-school spending intentions, including one from Deloitte, suggest extremely cautious spending, which does not bode well for the year-end holiday period.

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