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January 2006 Briefing Note

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What Economists are Forecasting for the First Half of 2006

This Friday (January 27th), the Labor Dept. releases its first estimate of GDP growth during the 4th quarter. With all the other major economic reports for December and the quarter having already been published, we're able to compare what the U.S. economist community forecasted would occur during the second half of 2005, to what actually happened. The first table on the next page compares forecasts made late last June by fifty-six of the country's most influential economists, with the actual outcomes. The second table summarizes forecasts for the first half of 2006, made in late December.

Short-term Interest Rates – Last June's forecast was for the upward path of short-term rates to continue. The pundits were right, but got the magnitude wrong. Three month T-bills yielded 4.07% at year-end, higher than the 3.81% median forecast last July. In effect, consensus had expected the Fed to not raise the Fed Funds rate at their December meeting, but they did. Today, the median forecast is for T-bills to yield 4.63% before July. For reference, T-bills yielded just 2.21% at the end of 2004.

Long-term Interest Rates – Last June's consensus was that 10-year Treasury bond yields would rise by the same amount as T-bill yields, keeping the spread between the two at 80 basis points. This "parallel shift" in the yield curve had also been the consensus thinking a year ago. Neither forecast was close. The 10-year Treasury yield rose during the last half of 2005 to just 4.39%, lower than the 4.60% forecasted. Economists now think 10-year Treasury bond will yield 4.90% by the end of June '06.

GDP Growth – The economy grew at an unexpectedly strong 4.1% real rate in the 3rd quarter. Only two of the 56 economists were close to that figure in their forecasts last June. The consensus was for 3.5% growth. This has caused most of the group to cut back on expectations for the quarter just ended, reasoning that the strong 3rd quarter "borrowed growth" from the 4th. The median guess for Q4 growth is now down to 3.2% (it had been 3.6%), and the "whisper number" is only 2.7%. Expectations for 2006 have also been reduced. After briefly ticking up during the 1st quarter, GDP growth is now expected to sequentially weaken throughout 2006, to only a 3% annualized rate during the second half. This suggests a general slowdown from the 4.1% annualized growth rate we've experienced during the past 2½ years.

Consumer Price Inflation – Forecast last June to be only 2.8% on a trailing year/year basis, the actual November figure was 3.5%. If you've closely tracked expectations versus actual outcomes over the past 18 months, it's apparent the forecasts have consistently underestimated actual inflation. The "unforecastable" wild card has been aggressively rising energy and other hard commodity costs. Despite recent outcomes, the current forecast for May '06 is that consumer prices will be up only 3.1% year-over-year. For what it's worth, we're taking the *over* on this call (the effect of continued commodity price inflation, essentially reflecting a further weakening globally in the value of paper money).

Relative Value of the Dollar – Economists were confounded by the Dollar in 2005. After its surprising *strength* during the first half of the year (it had been forecast to be weak), last June's expectation was for a decline of 5% versus the Yen and no change versus the Euro during the second half of 2005. Instead, the Dollar *rose* 7% against the Yen and 2% versus the Euro. Now thoroughly confused, the current median forecast is for its 1% decline during the first half of 2006. (We're taking the under here)

Unemployment Rate – The economic community has pretty much gotten this right during the last year, although they've been a little too pessimistic. The actual rate was 5.0% last November, compared to the average forecast for 5.1%. Today, expectations are for employment to grow more slowly in early 2006 than it did during most of 2005, pushing the unemployment rate to 4.9% by May.

Remember the "Goldilocks economy" of 1996-7, after the "soft landing"? We've had 16 consecutive quarters of real GDP growth, most of which has been at or above the 3.5% rate which is considered the maximum sustainable without ramping up inflation (how does China grow 9-12% each year, and its consumer prices rose by only 2% in 2005?). You'd think everything and everybody would be pretty comfortable by now. So, why aren't they?

-- Second Half 2005 Forecasts -- *(Posted on July 1, 2005)*

	3 month T-Bills @ DEC '05	10 year T-Bonds @ DEC '05	GDP 3rd Qtr 2005	GDP 4th Qtr 2005	GDP 1st Qtr 2006	GDP 2nd Qtr 2006	CPI Yr/Yr Chg. @ NOV '05	¥en / $ Spot rate @ DEC '05	$ / Euro Spot rate @ DEC '05	Unempl. Rate @ NOV '05
Survey Average	3.81%	4.60%	+3.5% *(was 3.6%)*	+3.2% *(was 3.6%)*	+3.6% *(was 3.3%)*	+3.3% *(was 3.3%)*	2.8%	106 ¥/$	1.21 $/€	5.1%
Survey Range *	3.25 – 4.30	3.95 – 5.20	2.7 – 4.2	2.5 – 4.2	2.5 – 3.9	2.5 – 4.1	2.4 – 3.6	100 - 115	1.10 – 1.34	4.7 – 5.4
ACTUAL 12/31/05 ***(actual 6/30/05)***	**4.07%** *(3.13%)*	**4.39** *(3.94%)*	**4.1%**	**???**	**???**	**???**	**3.5%** *(2.8%)*	**118 ¥/$** *(111 ¥/$)*	**1.18 $/€** *(1.21 $/€)*	**5.0%** *(5.1%)*

-- First Half 2006 Forecasts -- *(as of January 3, 2006)*

	3 month T-Bills @ JUNE '06	10 year T-Bonds @ JUNE '06	GDP 1st Qtr 2006	GDP 2nd Qtr 2006	GDP 3rd Qtr 2006	GDP 4th Qtr 2006	CPI Yr/Yr Chg. @ MAY '06	¥en / $ Spot rate @ JUN '06	$ / Euro Spot rate @ JUN '06	Unempl. Rate @ MAY '06
Survey Average	4.63%	4.90%	+3.6% *(was 3.3%)*	+3.3% *(was 3.3%)*	+3.1%	3.0%	3.1%	116 ¥/$	1.19 $/€	4.9%
Survey Range *	4.0 – 5.2	4.1 – 5.6	2.5 – 4.5	2.4 – 4.0	2.1 – 3.9	2.4 – 4.2	2.4 – 3.6	108 - 125	1.09 – 1.26	4.5 – 5.3
ACTUAL 6/30/06 *(actual 12/31/05)*	**???** *(4.07%)*	**???** *(4.39%)*	**???**	**???**	**???**	**???**	**???** *(3.5%)*	**???** *(118 ¥/$)*	**???** *(1.18 $/€)*	**???** *(5.0%)*

* Excluding outliers

Sources:

"The Wall Street Journal Forecasting Survey for 2005 and 2006", 7/1/2005
"The Wall Street Journal Forecasting Survey for First Half 2006", 1/3/2006

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