National Association of Manufacturers

THE OUTLOOK FOR THE U.S. ECONOMY AND MANUFACTURING JANUARY 2006

Downshifting from Cruise Control

Hurricane-induced rise in energy prices exacerbates already tight energy supplies and slows the economy in the winter months. Energy prices then moderate somewhat as more Gulf Coast production resumes in the spring, but remain much higher than normal.

Historically high energy prices, especially natural gas, remain a thorn in the side of the recovery as it enters its fifth year. Following 3.6 percent growth in 2005, the economy is forecasted to grow by just 3.3 percent in 2006 — the slowest pace since 2002.

Following the 2001 recession, stagnant investment and export growth resulted in an anemic start to the current recovery: from the fourth quarter of 2001 through the first quarter of 2003, GDP growth averaged just 1.8 percent.

With exports and business investment getting on track in the second half of 2003, GDP growth has since averaged 4.1 over the past ten quarters.

According to the Commerce Department's preliminary report on November 30th, GDP rose at a 4.3 percent annual rate in the third quarter of 2005.

However, the pace of economic growth is poised to slow. Due to rising energy prices, consumer spending and business investment, outside of computers and software, are expected to show little-to-no growth in the fourth quarter. While the economy is forecasted to grow by a respectable 3.4 percent in the fourth quarter of 2005, 90 percent of this growth will come from a temporary restocking of inventories, which were at near historic lows at

Outlook Summary

High energy costs and slow economic growth persist through the winter of 2006. Faster growth then resumes for the duration of the year. Consumer spending moderates in the wake of higher energy prices. As a consequence, the economy slows in the fourth quarter and continues sluggish growth in the first quarter of 2006. Energy prices fall marginally as more Gulf production comes back on line. Inflation moderates and economic growth accelerates in the second quarter.

The economy is also aided by reconstruction efforts in the Gulf area, which boost business investment spending. At the same time, housing investment falls throughout the year, partly due to higher interest rates but primarily from a natural correction from extremely strong growth over the past few years.

The Economic Forecast: After growing by 3.6 percent in 2005, the GDP will moderate to 3.3 percent growth in 2006 (mainly due to slow consumer spending in the first quarter and a pullback in residential investment.) Business spending on computers and software remains solid and exports accelerate modestly and imports slow. In 2007, more robust 3.6 percent GDP growth is anticipated.

	2006 (% Change, SAAR)			(Q4/Q4 % change)
	Q1	Q2	2nd Half	Full Year
GDP	2.6	4.0	3.4	3.3
Consumption	2.4	5.4	3.7	3.7
Business invest	10.1	8.8	7.4	8.4
Housing	-10.7	-12.8	-11.3	-11.5
Trade Deficit*	-622	-613	-605	-611
Exports	6.0	6.2	6.4	6.2
Imports	2.0	2.2	3.1	2.6
Gov	3.5	2.4	2.0	2.5
Inflation				
CPI	5.8	-2.1	2.3	2.0
Productivity	1.6	3.4	2.9	2.7
Disposable Income	3.9	7.6	4.0	4.9

*Billions of Chained (1996) dollars

Manufacturing: After rising just 2.3 percent in 2005, manufacturing production will increase by 4.5 percent in 2006.

Employment: After increasing by 2.1 million in 2005, nonfarm payroll employment will increase by a slightly slower 1.8 million in 2006, while the unemployment rate will remain at 5.1 percent. Manufacturing employment should increase by about 150,000 in the latter half of 2006 as more robust growth begins to outpace productivity the manufacturing, wholesale and retail level of the economy in the third quarter of 2005.

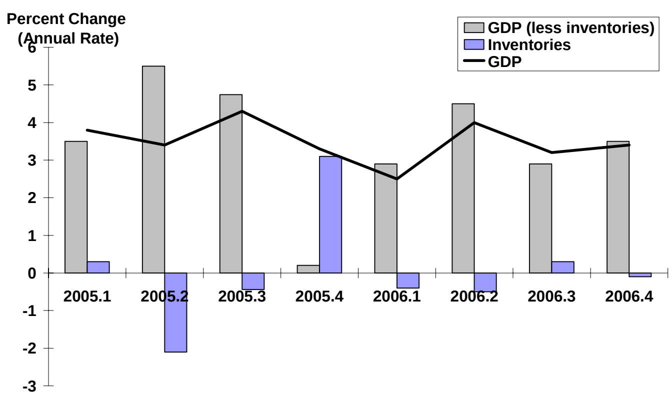
High winter heating bills will continue to suppress consumer spending in the first quarter of 2006, resulting in the economy growing at an annual rate of just 2.6 percent — the slowest quarterly growth rate since the first quarter of 2003.

As Gulf Coast energy production gradually comes back online during the first half of the year, oil and natural gas prices will start to moderate beginning in the second quarter. As a result, consumer spending will begin to improve starting in the spring.

This rebound will be partially offset by a downturn in housing construction, which after the fastest 3-year run in a decade (2002-2005), will go through a temporary downturn in 2006 and fall by 11.5 percent amid higher interest rates.

GDP growth will average 3.6 percent over the latter three quarters of 2006 (*see Chart 1*). While this is a respectable pace, it nonetheless marks a noticeable deceleration from the 4.1 average pace that the economy has set since the first quarter of 2003.

Chart 1: GDP Forecast Overview

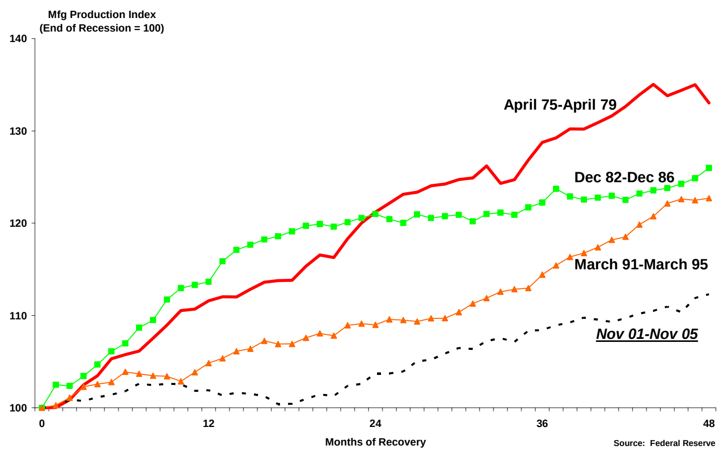


Bottom line: An energy-induced slowdown in the winter months precedes improving economic growth (outside of housing) starting in the second quarter of 2006. For the year overall, GDP will increase by 3.3 percent.

This is consistent with a recent fourth quarter Philadelphia Fed's Survey of Professional Forecasters, which anticipates 3.4 percent GDP growth in 2006.

Manufacturing: Due to a number of factors, including a delayed recovery in exports and business investment, increased import competition and more recently an unrelenting surge in energy prices that was made worse by the hurricanes that hit the Gulf Coast last year, the current manufacturing recovery has been the slowest in decades. Over the past 4 years (48 months), manufacturing production has increased just 12 percent — less than half of the average increase during the first four years of the prior three recoveries (*see Chart 2*).

Chart 2: Recent Manufacturing Recoveries



After rising at a 2 percent annual rate in the first quarter of 2006, an acceleration consumer spending and business investment will result in manufacturing output growing at a 5.4 percent pace in the latter three quarters of the year, resulting in an overall increase of 4.5 percent in 2006.

While this pace is an improvement from the 2.3 percent rise last year, much of the growth will be from the manufacture of computer and electronic products, where production is expected to exceed 10 percent. By contrast most other manufacturing sectors (including plastics, chemicals, fabricated metals, and transportation products) will experience modest growth ranging from 2.5 to 3 percent.

Hurricane Katrina's Impact on the Economy.
It is estimated that Hurricane Katrina destroyed $71 billion in physical capital along the Gulf Coast. Employment losses from the storm have been estimated at 300,000 in the second half of 2005. 17 refineries were put out of action: ($3 million barrels per-day). 192 oil and natural gas rigs and platforms were damaged, sunk or set adrift. Unfortunately, energy production recovery has been gradual.

- 1 billion cubic feet (daily) of onshore natural gas production remains offline.
- 800,000 barrels (daily) of oil refining capacity remains offline.
- 150 energy platforms will be out of commission for months.
- 27 percent of oil production and 20 percent of natural gas production in the Gulf remain shut in.

A return to pre-Katrina energy production along the Gulf Coast (when prices were already at historic highs) will not take place until the second quarter of 2006 at the earliest. As a consequence, extremely tight energy supplies and higher prices will continue through the winter months.

Higher energy prices have already slowed consumer spending significantly. Over the most recent three month span (Aug.-Oct.), consumer spending has fallen at an annual rate of 4.6 percent. This is the largest three-month drop since January 1991 (almost 15 years)!

According to the U.S. Department of Energy, heating bills will be very high this winter. Compared to last year, residential natural gas bills will be 40 percent higher this winter, while heating oil costs will be 30 percent higher. This increase in energy prices will result in consumer prices overall temporarily increasing by better than a 5 percent annual rate in the first quarter.

Consumer Spending. Higher energy prices will force consumers to spend less on other goods and services. As a result, overall consumer spending will show little or no growth in the fourth quarter of 2005 and increase by just 2.6 percent in the first quarter of 2006. Then, with energy prices moderating somewhat after winter, consumer spending will accelerate and increase at an average rate of 4.2 percent in the latter three quarters of the year.

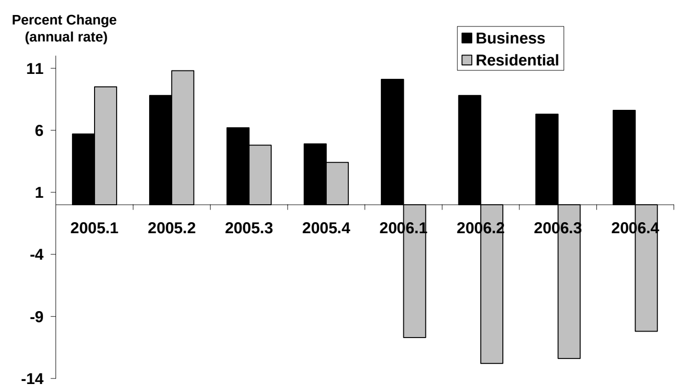
Investment. Coupled with slow consumer spending, business investment will grow modestly in the fourth quarter of 2005 and increase at an annual rate of 5 percent.

Then, aided by Gulf Coast reconstruction efforts likely to pick up in 2006, business investment will increase by 10 percent in the first quarter and then increase at a rate of 8 percent for the duration of the year. For the year overall, business investment will rise by 8.4 percent, with equipment and software purchases rising by over 9 percent and structures rising by 5.5 percent (the fastest pace in 10 years).

At the same time, residential investment (housing) will go through a cooling-off period next year. Over the past three years, residential investment spending increased at an average annual rate of 8.5 percent — the fastest three-year surge in a decade.

Following a well-defined pattern over the past 20 years after such a strong period of growth, and aided by the Federal Reserve's likely course to raise the Federal Funds rate by mid-year to 4.75 percent from its current level of 4.25 percent, housing spending is expected to decline by 11.5 percent in 2006 (*see Chart 3*).

Chart 3: Investment



Inflation. With Gulf Coast energy production gradually coming back online, energy prices are expected to come down modestly in the second half of 2006.

After nearly doubling from $6.4 to $11.6 per million BTUs in 2005, natural gas prices will nudge down to $10 per million BTUs in 2006. At the same time, after increasing 30 percent over the course of 2005 to $54 a barrel by the fourth quarter, oil prices are expected to come down to $47 a barrel by the end of 2006.

Though still at historically elevated levels, slightly lower energy prices will result in lower inflation this year. After rising by 2.7 percent in 2005, the GDP price index will increase by just 1.9 percent in 2006. And consumer prices (CPI), after rising by 4 percent last year, will increase by half that pace (2 percent) this year.

International Trade. In the late 1990s the dollar rose 28 percent. This pushed down import prices, which fell by nearly 2 percent a year on average and increased import competition and penetration in the U.S. market, as well as reduced U.S. export competitiveness abroad.

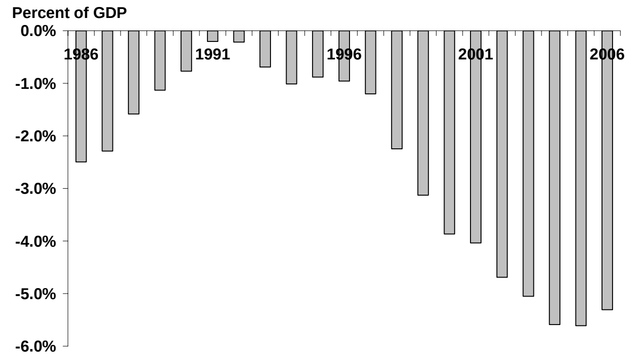
Aided by the fact that the U.S. economy was growing faster (4 percent average growth between 1997-2000) than economies overseas (3.5 percent), imports of non-petroleum goods grew 83 percent faster (13.4 percent average growth) than U.S. goods exports (7.3 percent) during this time. During the 2001 recession, both exports and imports declined. Then, during the early recovery in 2002 imports (10 percent growth) again outpaced exports (1 percent growth).

Since the first quarter of 2002, the dollar has fallen 12 percent and import prices have, in turn, increased at an annual rate of 2 percent, making imports less competitive and exports more competitive. This is beginning to have positive effects on trade flows.

Despite the fact that U.S. growth continued to outpace growth abroad (again 4 percent vs. 3.5 percent) since the middle of 2003, the gap between export growth and import growth has narrowed significantly: Imports (averaging 8.8 percent growth) have risen only slightly faster than exports (8.6 percent growth) during this time.

Looking forward to 2006, the dollar is expected to fall modestly (1 percent) and economic growth both overseas (3.2 percent) and in the United States (3.3 percent) are expected to slow slightly. Exports (rising 6.6 percent) are forecasted to increase half again as fast as imports (4.3 percent). As a result, the trade gap will narrow slightly from -$625 billion (5.6 percent of GDP) in 2005 to -$611 billion (5.3 percent of GDP) in 2006 (*see Chart 4*). This is the first improvement in the trade balance in 11 years.

Chart 4: U.S. Trade Deficit



Employment. Solid 2.7 percent productivity growth in 2006, following a similar 2.9 percent rise in 2005, along with slightly slower GDP growth will result in the economy creating 1.8 million new jobs in 2006, slightly less than the 2.1 million created this year. The unemployment rate should remain at 5.1 percent for most of the year.

David Huether
Chief Economist
dhuether@nam.org
(202) 637-3148

NAM Forecast Tables
GDP and Components

	2005.4	2006.1	2006.2	2006.3	2006.4	Q4 / Q4 % change 2005	2006
Gross domestic product	3.4	2.6	4	3.3	3.4	3.6	3.3
Personal consumption expenditures	0.1	2.4	5.4	3.5	3.8	2.7	3.7
Durable goods	-15.1	10	7.4	5.8	4.8	1	7
Nondurable goods	1.8	1.6	4.9	2	3	3.3	2.9
Services	2.5	1.3	5.2	3.8	4	2.7	3.6
Gross private domestic investment	25.2	-0.1	-2.5	1.9	0.7	7.6	0
Fixed investment	4.4	2.1	0.7	0.2	1.4	6.6	1.1
Nonresidential	4.9	10.1	8.8	7.3	7.6	6.4	8.4
Structures	0.5	1	8	5.8	7.5	-0.1	5.5
Equipment and software	6.4	13.3	9	7.8	7.6	8.6	9.4
Computers and software	22.3	18	13.4	12.8	12.7	20.9	14.2
Other equipment	-0.1	11.2	7.1	5.6	5.3	3.6	7.3
Residential	3.4	-10.7	-12.8	-12.4	-10.2	7.1	-11.5
Change in private inventories*	70.1	59.4	43.8	51.8	48.6	27.5	50.9
Net exports of goods and services*	-629.9	-621.5	-613	-608.5	-602.1	-625.3	-611.3
Exports	3.9	6	6.2	6.7	6.1	5.6	6.2
Goods	3.9	7	6.2	6.9	6.4	6.9	6.6
Services	3.7	3.5	6.3	6.3	5.4	2.8	5.4
Imports	6.7	2	2.2	3.5	2.7	3.4	2.6
Goods	8.1	2.9	1.5	3.3	2.3	4	2.5
Services	-0.3	-2.8	6.5	4.3	4.9	0.4	3.1
Government consumption expenditures and gross investment	0.5	3.5	2.4	1.9	2.1	2	2.5

* Billions of chained (2000) dollars

Key Indicators of Real Activity

	2005.4	2006.1	2006.2	2006.3	2006.4	Q4/Q4 % change or annual avg. 2005	2006
Private housing starts (thous. units)	2007.6	1877.8	1796.6	1713	1670.1	2051.1	1764.4
Light vehicle vales (mil. units)	15.9	16.5	16.7	16.7	16.7	16.9	16.6
Industrial production, manufacturing*	2.1	2	5.5	5.7	5	2.3	4.5
Capacity utilization (mfg, %)	78.3	78	78.4	78.8	79.1	78.2	78.6
Nonfarm payroll employment (mil.)	134.3	134.8	135.2	135.6	136	133.6	135.4
Private nonfarm hours*	0.9	1.2	1.3	1	0.8	1.2	1.1
Civilian unemployment rate (%)	5.1	5.1	5.1	5.2	5.2	5.1	5.1

Prices, Productivity, & Costs

	2005.4	2006.1	2006.2	2006.3	2006.4	Q4/Q4 % change or annual avg. 2005	2006
GDP chain-type price index*	2.1	3.5	0	2.2	2	2.7	1.9
CPI, all items (all urban)*	4.3	5.8	-2.1	2.4	2.2	4	2
PPI (finished goods)*	8.8	-7	0.6	2.2	1.8	5.5	-0.6
Compensation per hour*	3.6	4.9	4.8	5	5	4.2	4.9
Output per hour*	3	1.6	3.4	2.7	3.1	2.9	2.7
Unit labor cost*	0.6	3.3	1.4	2.2	1.8	1.2	2.2
Broad trade-weighted value of US$	111.6	110	111.3	111	110.9	110.7	110.8
Refiners' cost of imported oil ($/b)	56.1	57	56.8	57.7	58.1	49.7	57.4

Selected Interest Rates

	2005.4	2006.1	2006.2	2006.3	2006.4	Q4/Q4 % change or annual avg. 2005	2006
Federal funds rate	4	4.4	4.7	4.8	4.8	3.2	4.7
10-year Treasury note yield	4.6	4.9	5.2	5.2	5.2	4.3	5.1
Aaa corporate bond yield	5.5	5.9	6.2	6.3	6.3	5.3	6.2

Incomes & Related Measures

	2005.4	2006.1	2006.2	2006.3	2006.4	Q4/Q4 % change or annual avg. 2005	2006
Real disposable personal income*	5.1	3.9	7.6	4.1	4	0.5	4.9
Personal saving rate (%)	0.1	0.5	1	1.1	1.2	-0.1	1