WEEK OF JULY 24, 2006—GROSS DOMESTIC POLICY

The “Advance” estimate of second quarter economic growth highlights the dilemma that faces consumers and businesses in the coming months. Economic growth using the broadest measure—Gross Domestic Product, or the total of goods and services produced domestically—slowed to 2.5 percent in Q2 from a 5.6 percent rate in Q1, yet wages and prices continue to rise, a sign that inflation remains the problem.

And if the Fed sees inflation still rising, you can bet interest rates will continue to rise. Consumers have already reduced spending—which grew just 2.5 percent after a 4.8 percent gain in Q1. It is not only soaring gas prices causing the dilemma, but a slowing real estate market, which is deflating under the pressure of higher rates.

Merrill Lynch economist David Rosenberg believes this situation will only worsen. In fact, he will give 40 percent odds that the economy will slip into a recession in 2007. Why? Housing, which has accounted for one third of all job growth over the past 3 years, will continue to decline. And the housing sector includes jobs in finance, insurance and construction.

Both new and existing-home sales slowed in June, as did their price rises. Median prices for new and existing homes rose just 2.3 and 0.9 percent in a year, respectively, in June. This is while for sale inventories are the highest since 1997, according to the National Association of Realtors, which was the beginning of the latest surge in housing prices.

The GDP report showed a big drop in residential investment, down 6.3 percent, for the third consecutive quarter. It was also the largest quarterly decline in investment since 1995, according to the Economic Policy Institute, and means fewer jobs in the housing sector.

Was there any good news in the Commerce Department’s GDP report? Exports increased 3.3 percent, while imports grew just 0.2 percent, which is good for domestic manufacturing jobs that make higher wages than service sector employees. And a slowing economy may cause the Fed to think that inflation could moderate in coming months.

In other news, consumer confidence held up, even though gas prices now average more than $3 per gallon, nationally. But a divide is growing between the upper and lower income brackets.

CONSUMER CONFIDENCE—“Consumer Confidence Stabilizes As Gap Widens Between Income Groups”, said headline for the U. of Michigan survey. Both the Conference Board and U. of Michigan sentiment surveys improved slightly in July, which may be due to a rise in incomes as employment continues to grow.

The Conference Board’s sample of 5,000 households showed “Present day conditions remain favorable, though not as strong as earlier this year,” said survey director Lynn Franco. “Expectations for the months ahead remain cautious and also below levels earlier this year.”

What is the income gap? A “worsening financial situation” was reported twice as frequently in the U. of Michigan survey among the bottom third, compared with the top third of the income distribution, with complaints about high prices voiced three times as frequently. More ominously, buying plans for homes, vehicles and large household durable goods are down, with home buying plans falling to a fifteen year low, said the U. of Michigan.

So the Fed Governors may face the same dilemma as consumers, in deciding how much inflation to allow. Real Disposable incomes—after taxes and inflation are factored in—actually rose 0.4 percent in June, versus a 0.1 percent drop in May.

Rising inflation is a sign of rising incomes, as well as rising energy prices. So the Fed may be attacking the first rise in real incomes since 2000, if it continues with its rate hikes, thus increasing the odds of a recession in 2007.