EconomicView

Payden & Rygel Economic**Research**

July 27, 2007

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GDP Highlights

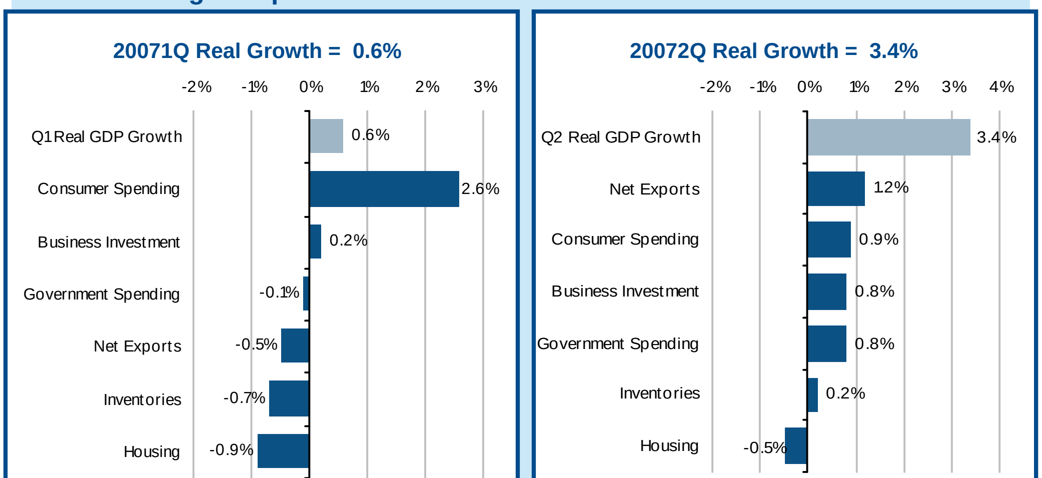
- The US economy rebounded in the second quarter and the composition of growth shifted.
- A pick up in exports offset a slowdown in consumer spending.
- Inflation pressures eased, but productivity slowdown may worry Fed.
- Real GDP growth is expected to hover in the 2% to 2.5% range in the second half.

US Economic Growth Rebounds

The pace of US economic growth rebounded to an annual rate of 3.4% in the second quarter of 2007 after increasing just 0.6% in the first quarter of the year, the Commerce Department reported today. Given the volatility of the quarterly numbers, the average growth rate of 2% over the first half of the year probably paints a more accurate picture of US economic health.

More important than the overall GDP number was the dramatic shift in the composition of growth between January and June. Consumer spending, which was the key driver of first quarter growth and makes up about 70% of the economy, slowed sharply as households reduced spending in the face of higher gasoline prices and the declining housing market. Fortunately, the slowdown in consumption was partly offset by a pick up in net exports thanks to the weaker US dollar. Growth in commercial construction and government spending also contributed to economic growth during the quarter, while residential construction was less of a drag.

The Shifting Composition of Economic Growth



Source: Commerce Department

On the inflation front, the core personal consumption expenditures deflator (PCE), the Federal Reserve's preferred inflation gauge, eased to an annual rate of 1.4% in the second quarter from 2.4% in the first quarter. Although this is within the Federal Reserve's 1% to 2% comfort zone, benchmark revisions to the national accounts data revealed that the growth/inflation trade-off for the last three years was not as attractive as it first appeared with less growth and more inflation.

Economic growth was revised down by an average of 0.3% per year between 2004 and 2006, which suggests that productivity growth will also be revised down for that time period. This is likely to catch the eye of Fed Chairman Ben Bernanke since during his semi-annual testimony before Congress he mentioned that "the underlying pace of productivity gains may have slowed somewhat." The minutes from the June policy meeting indicate that some Fed officials are concerned that slowing productivity growth will keep upward pressure on inflation.

Looking ahead, several areas will be critical to watch. The downside risks to economic growth in the second half of 2007 relate to housing and spillover effects onto consumer spending. The good news is that the weak dollar will continue to support export growth and businesses have room to add to inventories in the third quarter. We expect real GDP growth to hover in the 2% to 2.5% range in the second half of the year and for inflationary pressures to recede. This scenario should pave the way for the Fed to drop its tightening bias by year end and adopt a more balanced assessment of the risks to economic growth and inflation.