



# CAPITAL CONNECTIONS

## Economic Supplement

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### Will the Fed Cut Rates Again?

The Federal Reserve kept the benchmark interest rate, the federal funds rate, at a 40-year low of 1.75 percent when the Federal Open Market Committee (FOMC) met June 26. The U.S. economy is being buoyed by consumer spending on cars and houses, which will keep it from slipping back into recession, according to William Poole, president of the Federal Reserve Bank of St. Louis.

Wall Street investment firm Goldman, Sachs & Co. is predicting a series of Fed interest-rate cuts this year. Some economists are saying the economy may slip back into recession, according to an article released by Bloomberg News. On the other hand, as investors have recently fled stocks, many turned to the perceived safety of Treasury securities. That has pushed down bond yields, which should help stimulate the economy, according to many analysts.

Fed funds futures, a barometer of expectations for the direction of interest rates, show that investors have begun to price in a chance the central bank will lower rates in the coming months. The September fed funds futures market has an implied yield of 1.65 percent, down from 1.71 percent from a week ago. The Fed next meets on August 13; it is widely expected that the Federal Reserve will leave rates unchanged at 1.75 percent, as well as maintain a neutral outlook.

### Economic Growth Weakening

Gross domestic product grew at a 1.1 percent annual rate in the second quarter of this year, less than half what economists had expected, according to the Commerce Department. Second-quarter economic growth was predominantly restrained by a cool consumer spending pace and a worsening trade deficit. A survey of purchasing executives showed that manufacturing in the Chicago area expanded this month at the slowest pace since contracting in January. Federal Reserve bankers reiterated their conviction that growth has been extremely uneven at best.

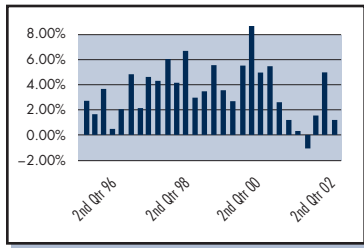
The total of goods and services produced in the U.S. contracted for nine months last year, instead of the three months earlier estimated by the Commerce Department. The Fed's "beige book," a compilation of anecdotal reports, indicated the economy "expanded modestly in recent weeks." Demand for labor was "slack but relatively stable" in most parts of the country. Retail sales were "mixed," and companies expressed concern that declining stock prices would dampen growth. Meanwhile, economists at Lehman Brothers Inc. indicated they expect the economy to grow at a 2 percent annual rate in the third quarter and 2.5 percent in the fourth.

### Key Interest Rates

*On August 2, 2002*

FEDERAL FUNDS RATE	3-MONTH LIBOR	BANK PRIME RATE
1.75%	1.80%	4.75%

## GROSS DOMESTIC PRODUCT *On July 31, 2002*



- The U.S. economy's rebound from recession may be faltering, according to a recent article published in Bloomberg News.

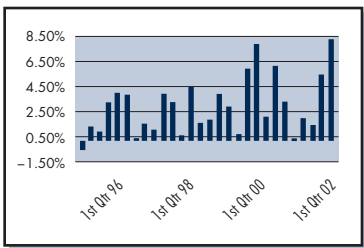
• GDP grew at a 1.1 percent annual rate in the second quarter, less than half what economists expected, according to the Commerce Department. GDP in the first quarter grew by a revised 5 percent.

## PERSONAL CONSUMPTION EXPENDITURE (PCE)

*On July 31, 2002*

- The personal consumption expenditures price index, a measure of inflation watched by Federal Reserve officials and tied to spending, rose at a 2.5 percent annual pace, following a 1.1 percent rise in the first quarter.
- Real personal consumption expenditures increased 1.9 percent in the second quarter, compared with a revised increase of 3.1 percent in the first.

## U.S. PRODUCTIVITY *On August 5, 2002*



- U.S. productivity grew during the first quarter at the fastest pace in almost 20 years as companies kept payrolls lean in a recovering economy.

• The Labor Department's measure of how much an employee produces for every hour of work rose at a revised 8.4 percent annual rate from January to March 2002.

- Productivity probably grew at a 2.5 percent annual rate in the second quarter, economists said. In addition, the first quarter number will most likely be revised lower, according to many analysts. The Labor Department is expected to release the latest productivity report on August 9.

## TRADE DEFICIT *On July 31, 2002*

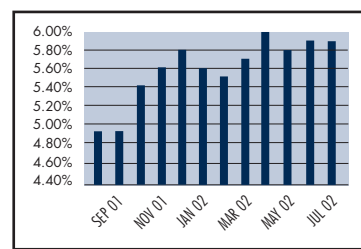
Imports surged at a 23.5 percent rate in the second quarter after rising at an 8.5 percent in the first. Exports rose at an annual rate of 11.7 percent in the second quarter after rising 3.5 percent in the first. That left a wider trade deficit.

## Labor Market: Unemployment Steady at 5.9%

The U.S. economy added fewer jobs than expected in July, and the unemployment rate remained at 5.9 percent. The snail's pace of the economic recovery is leaving companies reluctant to hire—keeping the unemployment rate near its high of 6 percent posted back in April.

The stock market slide that pushed the S&P Index to a five-year low may also have caused some companies to delay hiring. Payrolls increased by 6,000 last month, but economists had expected a gain of 60,000. May and June witnessed gains that were higher than previously estimated, which helped mitigate the slow growth in July.

## EMPLOYMENT REPORT *On August 2, 2002*



- Average hourly earnings rose 0.3 percent in July, or 4 cents following a 0.4 percent increase in June.
- Analysts were expecting payrolls to increase by 60,000 compared with the 6,000 reported. May

and June's initially reported payroll increase of 60,000 was revised upward to post a gain of 88,000.

## EMPLOYMENT COST INDEX *On July 25, 2002*

- The employment cost index, the government's best measure of how workers are compensated, rose 1.0 percent in the second quarter. This was faster than the 0.8 percent increase seen in the first quarter of 2002.
- Wages and salaries increased 1.0 percent during the second quarter of 2002, higher than the 0.8 percent rise seen in the first quarter.
- In the last 12 months, labor costs are 4 percent higher, compared with a 3.9 percent increase in the 12 months through June 2001.

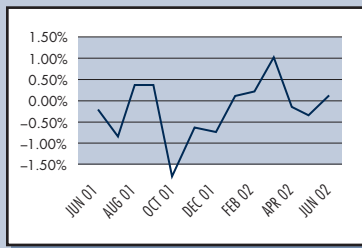
## Inflation: Still Subdued

Inflation remained tame again in June as both CPI and PPI rose a mere 0.1 percent. Such benign postings give the Federal Reserve more time to decide when to raise rates.

"Inflation is expected to be subdued throughout," Fed Chair Alan Greenspan told Congress this month during his semi-annual testimony. When asked if the Fed saw any possibility of rising inflation, he said, "None that's evident to any of the analysts in our organization."

A good portion of the slight rise in consumer prices was due to a jump in tobacco prices according to Bloomberg.

## PRODUCER PRICE INDEX *On July 11, 2002*

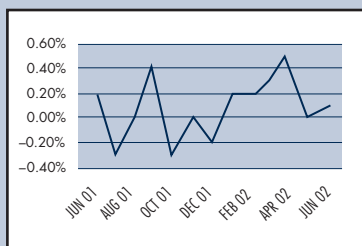


- Producer prices rose 0.1 percent in June after a 0.4 percent decrease in May. Economists were expecting no change in the index for June.
- The “core” index, which excludes the

volatile food and energy sectors of the economy climbed 0.2 percent in June from the previous month. Analysts were expecting a 0.1 percent increase.

- Wholesale prices remain 2.1 percent lower than they were in June 2001, early in the recession.

## CONSUMER PRICE INDEX *On July 19, 2002*



- Consumer prices rose 0.1 percent in June after remaining flat in May. Economists expected a 0.1 percent increase for May.

- Meanwhile, the “core” index rose 0.1 percent in

June, the smallest increase in three months. The index rose 0.2 percent in May. Wall Street had forecasted a 0.2 percent increase.

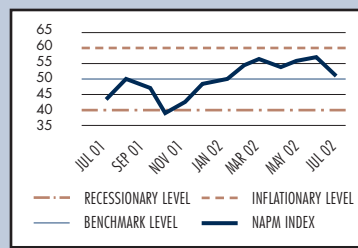
- Prices paid in June by consumers for goods and services were 1.1 percent higher than they were at the same time last year.

## Industrial Sector: Manufacturing Weakening

Slower consumer demand and a sluggish stock market are raising concerns that the economy’s rebound may be faltering. The Institute for Supply Management’s factory index fell to 50.5 last month, a reading only barely above the threshold 50 mark that signifies economic growth. Economists had expected a reading of 55 in the factory index, based on the median of 58 forecasts in a Bloomberg News survey.

Meanwhile, stocks fell and Treasury securities rose amid signs manufacturing may struggle as the economy’s rebound stumbles. The current market environment is making companies reluctant to place orders and invest in new equipment, economists said.

## THE INSTITUTE FOR SUPPLY MANAGEMENT’S FACTORY INDEX *On August 1, 2002*



- The pace of expansion in U.S. manufacturing slowed more than expected in July, adding to evidence the rebound from recession is waning.

- The Institute for Supply Management’s factory

index fell to 50.5 last month, the weakest reading since the manufacturing rebound started in February. It was 56.2 the previous month.

- The Tempe, Arizona, institute surveys more than 400 companies in 20 industries, including clothing, printing, transportation, furniture and plastics. Manufacturing accounts for about one-sixth of the U.S. economy.
- A weak stock market seems to be the most logical explanation for the low posting, as businesses are cautious about investing in equipment and consumers are wary of major expenditures.
- **Industrial Production (7/16)** rose in June by the largest amount since October 1999 as factories turned out more autos and utilities increased power generations, the Federal Reserve reported. The 0.8 percent rise in work performed at factories, mines and utilities was larger than expected and followed a 0.4 percent gain in May that was larger than previously reported. Manufacturing, which accounts for 90 percent of the report, rose 0.7 percent after rising 0.5 percent the previous month. The increases in total production level and for manufacturing were the sixth in a row.
- **Capacity Utilization (7/16)**, the amount of factory, mine and utility capacity in use, rose last month to 76.1 percent, the highest mark since August 2001, and up from 75.6 percent in May. The capacity utilization reading has climbed back from an almost 19-year low of 74.4 percent in December, although it’s still well below the average 81.8 percent rate posted during the record expansion from March 1991 to March 2001.
- **Orders for Durable Goods (7/25)** dropped in June by the largest amount in seven months, indicating the factory rebound may be slowing. The negative result surprised many economists who were expecting an increase in factory order bookings. The decline was broad-based as orders fell for computers, machinery, automobiles and communications equipment.
- **Factory Orders (8/1)**, orders placed with U.S. factories, declined in June by the largest amount in seven months, adding to evidence the manufacturing rebound is waning.

The 2.4 percent decrease in new orders followed a revised 0.6 percent rise in May, the Commerce Department said. The decline in June reflected falling orders for machinery, computers, metals and commercial aircraft, and was the largest since a 4.1 percent plunge in November.

- **Construction Spending (8/2)** unexpectedly fell in May, reflecting less work on offices and other nonresidential buildings. Housing construction held at a record high as mortgage rates boosted sales. Housing continues to be in good shape and should continue to contribute to economic growth.

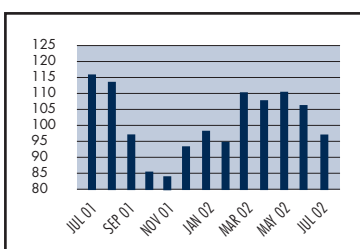
## Housing: Strong but Poised to Slow

The housing market continues to remain strong, despite mixed sales data in June. Even though housing starts fell in June, the pace still exceeds the number of homes built in 2001—the third-best year for homebuilders since 1988. Home prices continue to rise, making housing a better investment than the Dow, which has fallen more than 21 percent in the past year.

Economists expect the housing market to remain strong, especially with the average 30-year mortgage rate remaining below 7.0 percent. However, housing prices have been rising faster than income and the disparity between mortgages and rent has widened. Therefore, the housing market could be poised for to ease within the next year.

- **Housing Starts (7/17)** fell 3.6 percent in June to a seasonally adjusted annual rate of 1.672 million units. Meanwhile, building permits rose 1.4 percent, indicating the housing market should remain strong in the near future.
- **Sales of Existing Family Homes (7/25)**, which account for 85 percent of home purchases, fell more than expected in June, dropping 11.7 percent to a seasonally adjusted annual rate of 5.07 million units. June’s decline in existing home sales was the largest since April 1995.
- **New Home Sales (7/25)** rose to a record pace in June, increasing 0.5 percent to a seasonally adjusted annual rate of 1.001 million units. The increase in June follows a downwardly revised 7.0 percent increase in May. Economists are expecting that 934,000 new homes will be sold this year, breaking last year’s record of 908,000.

## Consumer Sector: Scandals Leave Buyers Wary



July consumer confidence plunged to 97.1 from 106.3 in June, the biggest drop since October. Coupled with a decline in stock prices and a sluggish job market, corporate

scandals cut into Americans’ sense of financial security and trust. Economists were expecting a reading of 101.5 for July. The drop in confidence may increase the chances that consumers will cut back on purchases, dampening economic growth.

Fed Chair Alan Greenspan, however, continues to weigh consumer actions rather than perceptions saying, “Our interest is actually what people do, not what they say.” He made the comment while speaking on the subject of consumer confidence surveys earlier this month to Congress. The confidence measure was based on a survey of 5,000 households taken July 1-22—prior to the month-end slight rise in stocks.

- **Personal Income (8/1)** unexpectedly increased 0.6 percent in June, the biggest increase since July 2000, after rising a revised 0.4 percent in May. Economists were expecting incomes to rise 0.5 percent.
- **Personal Consumption (spending) (8/1)** rose 0.5 percent in June following no change in May. Economists had predicted a 0.6 percent increase in spending after a previously reported 0.1 percent drop in May. Economists say a combination of falling equities and little or no growth in employment could lead to slower spending in months ahead.
- **Retail Sales (7/12)** rose 1.1 percent during June, after a revised 1.1 percent drop in May. This is evidence that households are sustaining the economy’s rebound despite a stock pullback and diminished confidence. Economists were expecting retail sales to rise 0.7 percent. Excluding automobiles, sales rose 0.4 percent in June.

## Looking Ahead: Questions Abound

The meltdown in the equity markets the past few weeks has left the short-term prospects of the U.S. economy in question. Consumer spending was sluggish in the second quarter, rising only 1.9 percent. Spending could remain subdued in the third quarter, as \$3.9 trillion of equity wealth was lost in the first half of the year.

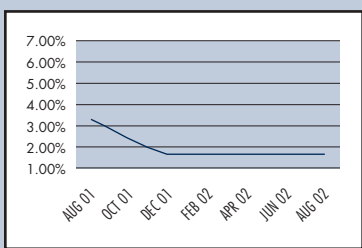
The loss in equity wealth has been somewhat countered by an appreciation of \$600 billion (or more) in household real estate assets. Typically, a drop in wealth doesn’t necessarily curtail spending, but a drop of this magnitude will definitely lead to a drop in consumption and keep growth subdued. Furthermore, capital spending will probably slow because the cost of capital has risen due to the equity slump.

- **Productivity (8/9)** – The consensus outlook is for non-farm productivity to have increased at a 2.5 percent annual rate in the second quarter—compared with a robust gain of 8.4 percent in the first quarter. Unit labor costs are expected to have increased 0.7 percent after falling 5.2

percent in the first quarter. Minimal inflation growth and the weak labor market have subdued compensation gains.

- **FOMC Meeting (8/13)** – The Fed is expected to leave the Federal Funds rate unchanged at 1.75 percent with a neutral bias. Currently, most of Wall Street expects the Fed to leave interest rates unchanged until 2003.
- **Consumer Confidence (8/27)** – If the equity markets continue to slide and the labor market remains weak, confidence could drop even lower after July’s sharp decline.

## Eye on the Fed



Fed Chair Alan Greenspan says the Federal Reserve does not need to reduce interest rates unless falling stock prices affect production, jobs or price stability. “U.S. consumers are underpinning the

economy’s recovery and are not retrenching in response to concern over falling stock prices and corporate accounting scandals,” he said.

Fed officials are expecting the economy to expand by as much as 3.75 percent this year, which is faster than the 2.5 to 3 percent they has predicted back in February. Analysts have taken this as a sign the economy is weathering the drop in stock prices.

Greenspan also commented that “all the evidence we have been able to accumulate in recent weeks suggests that the economy is improving.” Talks of another rate cut in the upcoming months have been rumored on Wall Street, but futures prices have this as an unlikely event.

UPCOMING FOMC MEETINGS	WALL STREET EXPECTATIONS	FED OUTLOOK	FORECASTED FED FUNDS RATE
August 13, 2002	No Change	Neutral	1.75
Sept. 24, 2002	No Change	Neutral	1.75
Nov. 6, 2002	No Change	Neutral	1.75

## Treasury Focus

The yields on U.S. Treasuries fell again in July due to reports that the economic recovery was beginning to slow. The largest move in Treasuries occurred in late July when the stock market tumbled due to corporate accounting scandals and the WorldCom bankruptcy filing.

The yield curve steepened over the course of the month as short-term rates saw a larger decrease than longer-term

securities. The yields on the two-year note fell 65 basis points, while the yield on the 30-year note fell only 17 basis points. Investors began to sell off stocks and buy government securities as growing economic uncertainty and continuing accounting problems initiated a flight to quality.

## Treasury Rates

MATURITY	SPOT RATES ON 7/3/2002	SPOT RATES ON 8/2/2002	SPREAD DIFFERENTIALS
2-Year	2.76%	2.11%	-65 Bp
5-Year	3.95%	3.32%	-63 Bp
10-Year	4.73%	4.37%	-36 Bp
30-Year	5.45%	5.28%	-17 Bp

## MARKET MOVERS IN JULY

- In the second week of July, treasury yields rallied dramatically as investors funneled money out of the plunging stock markets and into the more secure government debt. All three major stock indices hit four-year lows, and the yield on interest rate futures fell below the Fed’s 1.75 percent target rate, suggesting the Fed may cut rates yet again.
- In the third week of July, yields continued to fall as the stock market continued to decline and weak economic data was released. Fed Chair Alan Greenspan did reassure markets when he said the economic recovery remains on track.
- Treasury note yields continued to fall in the final week of July as the stock market continued to slide, and a disappointing report on durable goods orders was released. Corporate accounting scandals continued to weaken the stock market and send investors to Treasuries in a flight to quality.

## Streetwatch: Wall Street Firms Forecast

Wall Street firms believe the economy will start to turn around in the first quarter of 2003 as the market struggles to gain a strong foothold for recovery. On average, Wall Street firms predict a 3.3 percent annual growth rate by the second quarter of 2003. Unemployment is expected to hover around 5.9 percent for the rest of the year before beginning to fall by the first quarter of 2003. Treasury yields are expected to start rising again after the recent drop in yields.

Continuing uncertainty in equities and further fallout from the recent accounting scandals has left analysts with many variables to contemplate when making their forecasts. Inflation is also expected to remain under control even in the current low interest rate environment.



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## Interest Rate Forecasts as Predicted by the Futures Market

On August 2, 2002

PERIOD	30-DAY FED FUNDS	2-YEAR T-NOTE	5-YEAR T-NOTE	10-YEAR T-NOTE	30-YEAR T-NOTE
Current	1.75%	2.11%	3.32%	4.37%	5.28%
Sep 02	1.65%	2.52%	3.52%	4.50%	5.49%
Dec 02	1.62%	2.77%	3.83%	4.67%	5.64%
Mar 03	1.66%	2.89%	4.10%	4.91%	5.72%

## Energy Price Forecasts as Predicted by the Futures Market

On August 2, 2002

PERIOD	CRUDE OIL	HEATING OIL	HENRY HUB NATURAL GAS	PROPANE GAS
Sep 02	25.01	.6615	2.850	.3888
Oct 02	24.85	.6720	2.885	.3975
Nov 02	24.79	.6830	3.190	.4025
Dec 02	24.70	.6910	3.465	.4070
Jan 03	24.50	.6950	3.625	.4125
Feb 03	24.31	.6950	3.600	.4150

## Stock Market Forecasts as Predicted by the Futures Market

On August 2, 2002

PERIOD	DOW JONES IND. AVG	NASDAQ 100	S&P
Current	8,392	1,260	873
Sep 02	8,470	902	874
Dec 02	8,462	921	874
Mar 03	8,463	925	884

CFC's finance experts can answer your questions about specific economic information. Contact:

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