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BUY THE NUMBERS

Economic Analysis

Fall 2006

**A Quarterly Research Report Provided By:
[Portfolio Solutions, LLC](#)**

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INTRODUCTION

Buy The Numbers: Economic Analysis

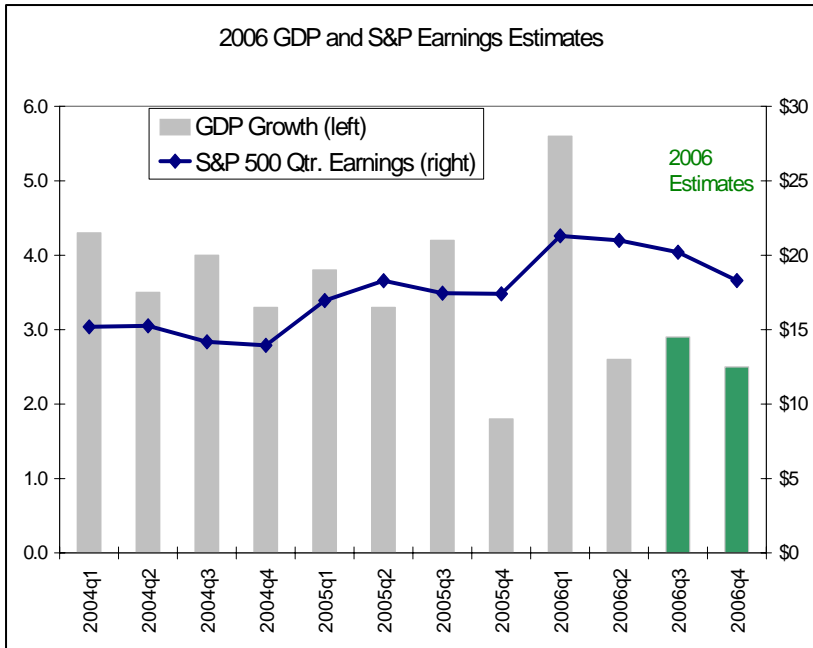
Economic news is an important variable in asset pricing. Financial markets relentlessly seek fair value based on economic news and a consensus estimate of future conditions. Economic variables tend to trend one direction or another for several months or even years before reversing course. The challenge of investors is to recognize those trends and anticipate changes. In the short-term, a small change in an economic variable can cause a dramatic shift in asset pricing as investors attempt to forecast future data. In practice, a near infinite number of variables drive an economy, making forecasting more of an art than a science. Only in retrospect can we know for sure what happened and why it happened. That means while the markets can be in an overvalued or undervalued situation, it is extremely difficult to recognize it at the time.

Buy The Numbers: Economic Analysis attempts to explain some of the variables that underlie U.S. economic activity. While we do make some rough forecasts, the report is meant to educate rather than be used as a market timing tool. The report is broken down into the five components of Gross Domestic Product (GDP), the leading measure of a country's economic output and spending. GDP is defined as the sum total of final goods and services produced in the U.S., adjusted for inflation. The four major components of GDP are Consumption (C), Investment (I), Government (G), and Net Exports minus Imports (X-M). The formula for $GDP = C+I+G+(X-M)$.

Consumption is 70 percent GDP. Two parts of consumption discussed in this reports are consumer sentiment and retail sales. **Investment** is the second component of GDP. The housing market and residential fixed investment are reviewed. The **Government** section looks at total government receipts and expenditure, and highlights the current fiscal deficit. **Trade** is a measure of exports minus imports. In this quarter, we discuss the balance of trade. **Inflation** has a significant impact on the performance of an economy. The bellwether measure of inflation is the Consumer Price Index (CPI). In this report we discuss the impact of the CPI and core CPI, as well as the spread on TIPS, an indication of inflation expectations.

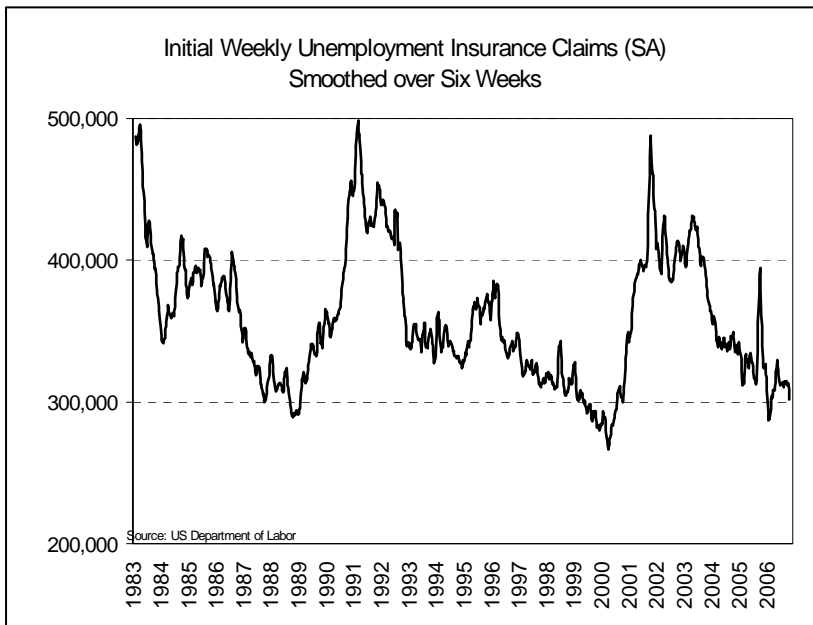
GROSS DOMESTIC PRODUCT

Real gross domestic product for the first quarter of 2006 increased at an annual rate of 5.6%. In the second quarter GDP increased at an annual rate of 2.6%. The increases in GDP were primarily attributed to the increases in expenditures on services, exports, state and local government spending, nonresidential structures and private inventory investment. The increases in GDP were partly offset by contractions in residential fixed investment, increases in federal government spending and imports. However, estimates for the third quarter look optimistic, with GDP slated to grow at an annual rate of 2.9%.



GDP growth may slow in the final quarter of the year. However, the slow down does not look to be significant from the consensus estimates. Corporate earnings estimates continue to be robust.

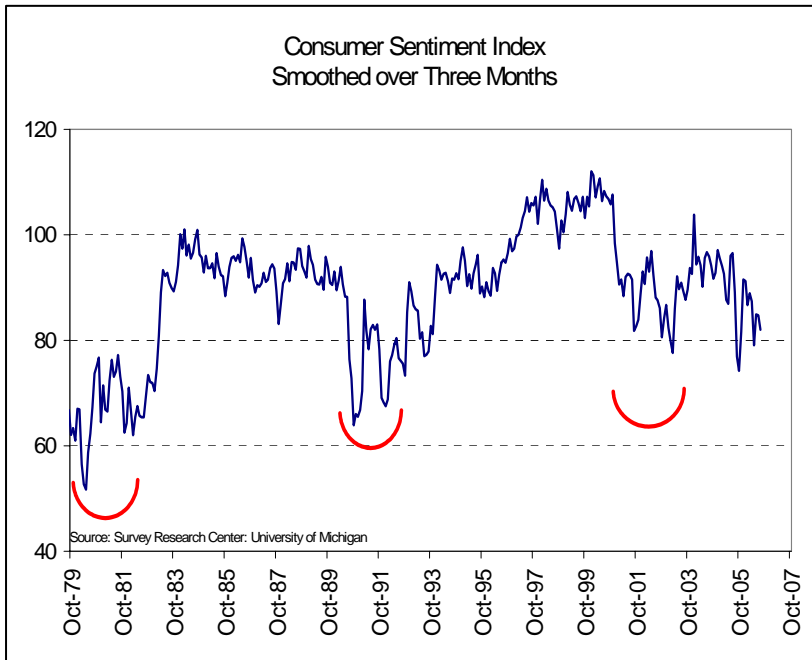
UNEMPLOYMENT



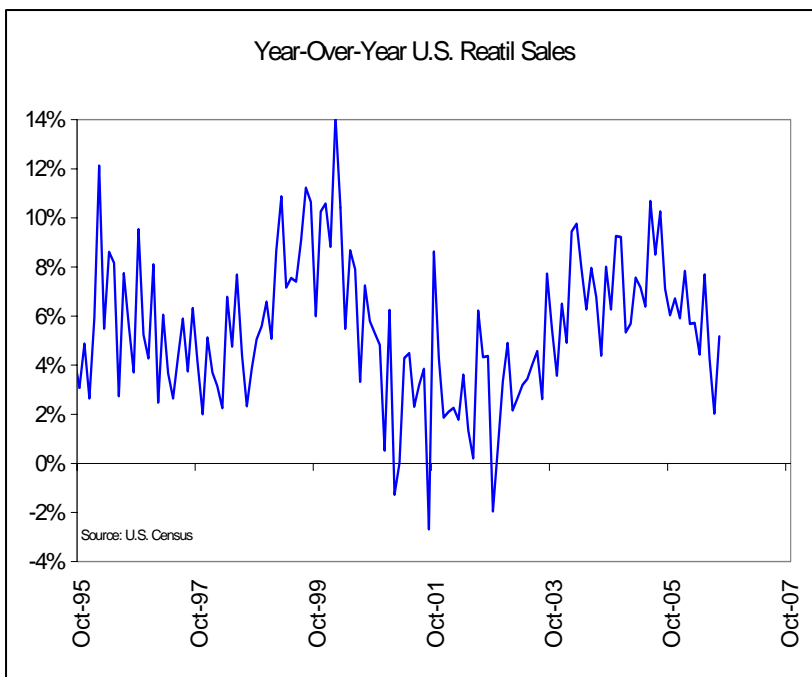
Unemployment claims continue to decline. Job creation has remained steady. These two factors could put inflationary pressure on the economy next year.

CONSUMPTION

Consumption is the most important component of GDP, accounting for over 70 percent of all economic activity. Consumption is the amount of goods and services purchased by consumers. Consumer sentiment is a good indication of the willingness of consumers to consume. U.S. retail sales are a good indication of how the economy may perform in the future.



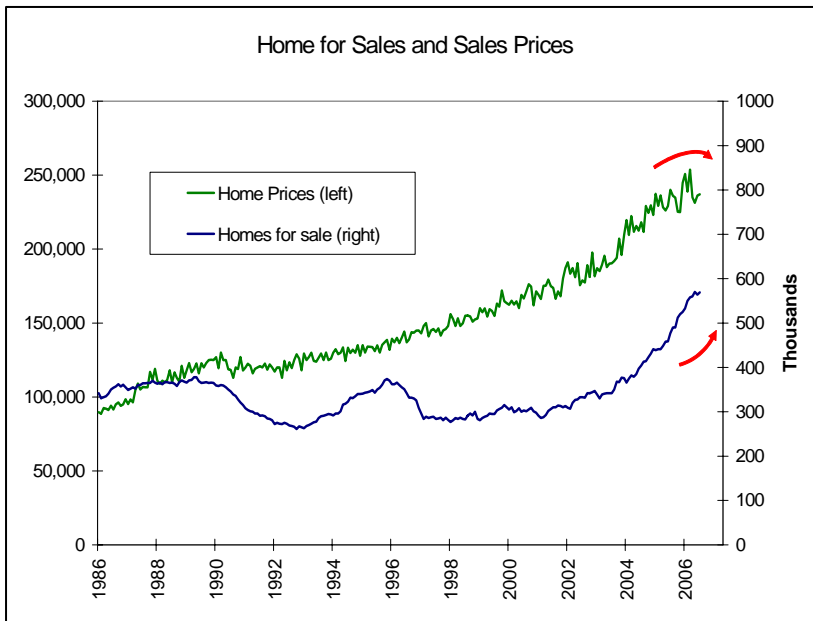
Consumer sentiment was brimming along the summer. However, the index decreased in August, putting downward pressure on GDP growth in the 4th quarter.



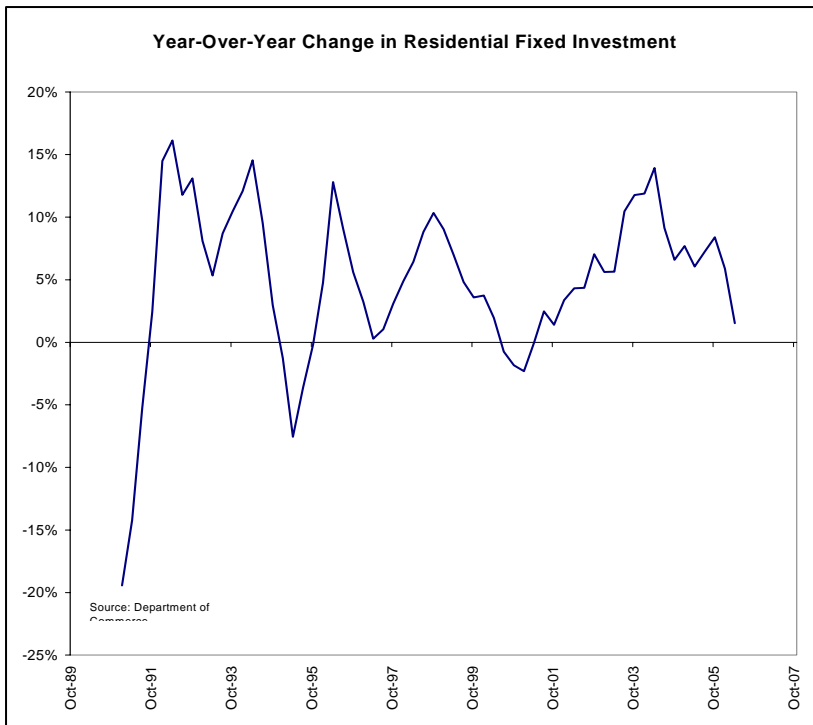
Retail sales were strong in the summer and are forecasted to remain positive in the fall and holiday seasons.

INVESTMENT

Investment is a major contribution to GDP as well as a major factor in estimating GDP growth. Investment is usually considered to contribute roughly 13 to 17 percent of GDP. In this report we focus on the housing market, including home sales and prices as well as residential fixed investment to determine the possibility of future growth or slowdowns in the housing market.



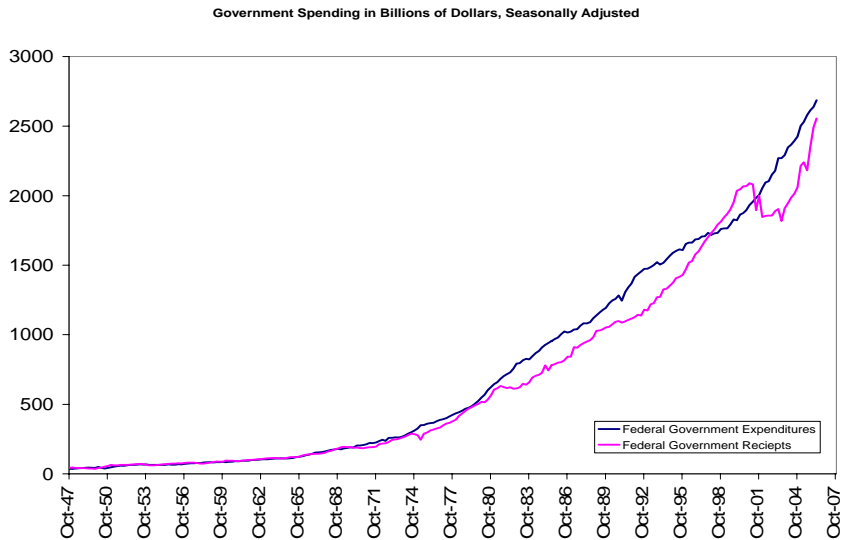
Home sale prices are gaining slightly, but are still lower than their high point, but have not broken the long-term trend. Homes for sale are up sharply to a 20 year high.



The year-over-year change in residential fixed investment decreased in the second quarter and third quarters of 2006. This is contributing to the slowdown in the housing market and also lowering GDP growth forecasts.

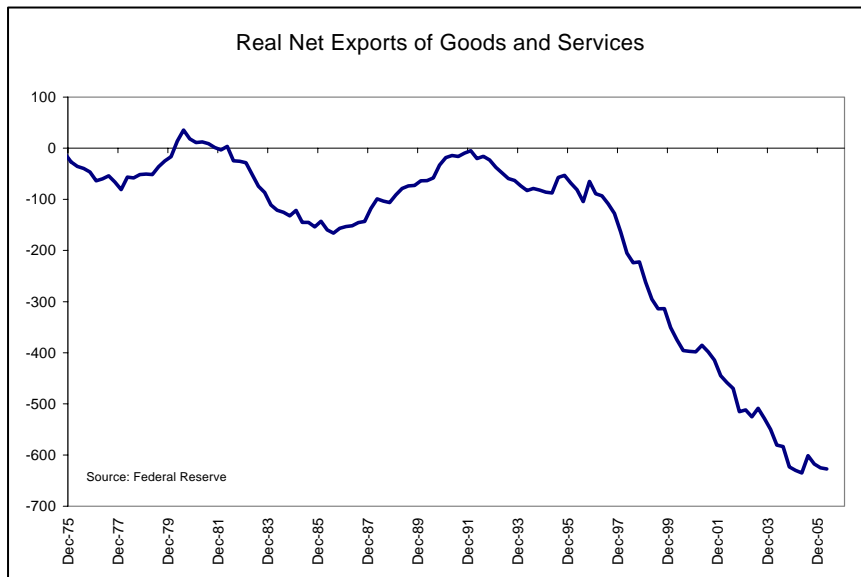
GOVERNMENT

Increases in government spending increase the national output of a country. However, it is a double edged sword. The government must pay for spending in the form of taxes, which have a negative effect on national output, or through debt, which will reduce future spending, and may increase real interest rates.



Government spending has increased steadily over time; however the U.S. continues to run a large fiscal deficit, which is impacting the value of the dollar as well as the attractiveness of U.S. debt to foreign investors.

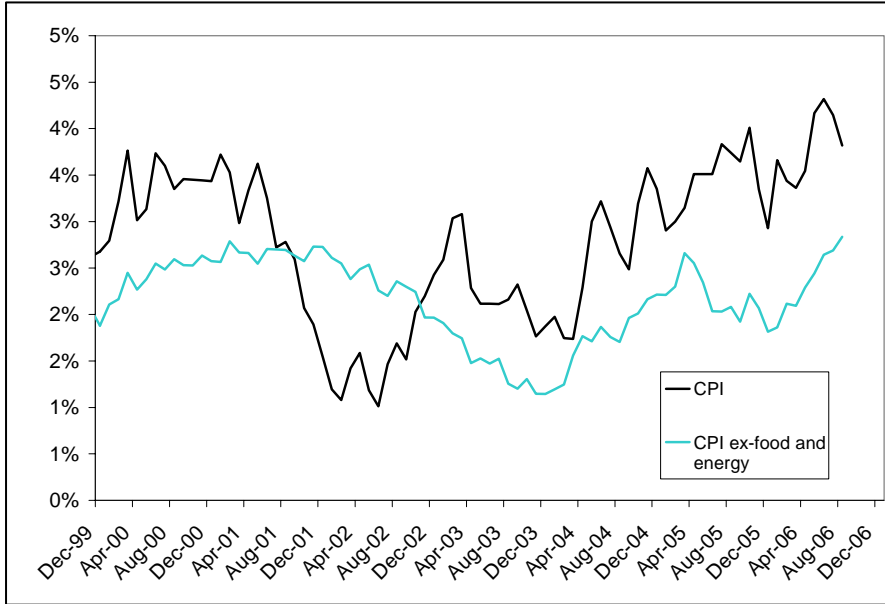
BALANCE OF TRADE



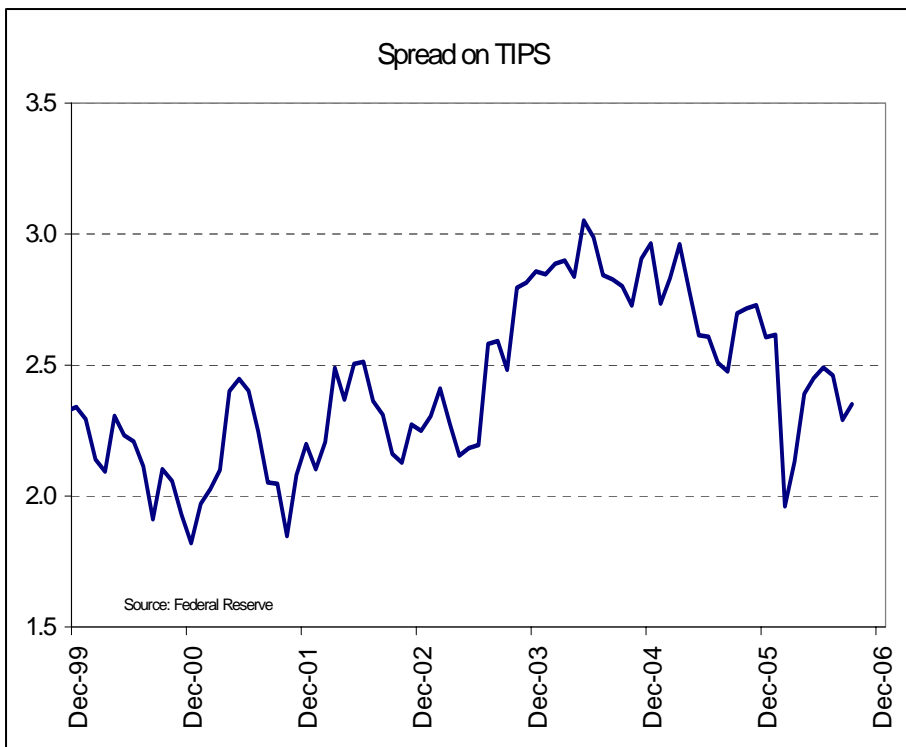
The balance of trade has continued to worsen. Imports continue to flood the economy while exports have not made significant gains.

INFLATION EXPECTATIONS

The Consumer Price Index (CPI) is widely regarded as *the* measure of inflation. Inflation is a general increase in the price of goods and services for consumers. The relationship between inflation and interest rates is the key to understanding how data like the CPI influences financial markets and your investments. In addition to the CPI, we have included a graph that shows the spread on Treasury Inflation Protected Securities (TIPS). The spread is a useful indication of inflation expectations that are revealed through market pricing.



Core inflation has been steadily increasing; however, CPI has slightly decreased, showing that inflationary pressures may be easing.



Investors were anticipating higher inflation this spring. However, inflation expectations may have reversed as energy prices subside

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Economic Analysis – news and information that shapes the financial markets

Asset Class Valuations – compares and contrasts past and current valuations.

Asset Class Correlations – charts changing dynamics between asset class returns.

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