

**OUR VIEWS**

September 2005

In the second quarter of 2005, before Hurricane Katrina, the U.S. economy grew at a 3.4 percent annual

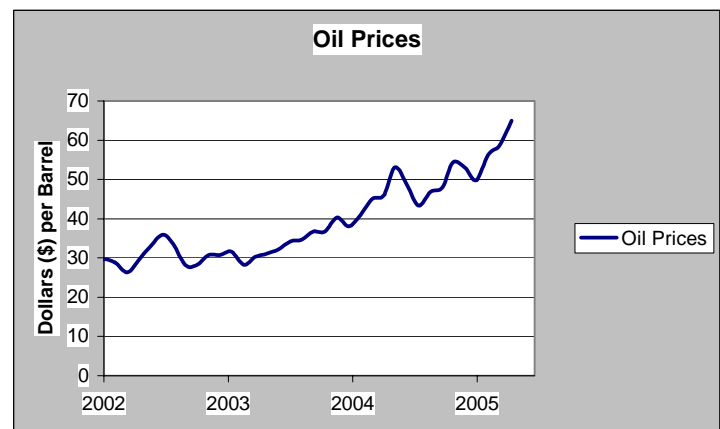


rate.<sup>1</sup> While this was lower than the annualized rate of 3.8 percent, which was achieved in the previous quarter, economists had anticipated the economy's growth rate to rise in the third quarter to approximately 4%. However, since Hurricane Katrina, which *The Wall Street Journal* is calling "the biggest test in years of the economy's resilience,"<sup>2</sup> economists are predicting that the growth rate will only reach 3.5% in the second half of the year. While this growth rate is lower than predicted, the U.S. economy has become much more flexible than ever. For example as a result of the rise of the temporary staffing industry, displaced workers can be more easily redeployed; also with the advent of new financial products, banks now package and sell their mortgages so regional banks are less subject to local economic fluctuations. Additionally, the wider acceptance and use of supply chain management software has reduced excess inventories, and logistics software has enabled transportation companies such as truckers and railroads to reroute their shipments around areas that were damaged by Katrina.<sup>3</sup>

Source: "Economy Shows Resilience in Face of Massive Jolt" *The Wall Street Journal*, September 6, 2005

Increased energy costs have also caused businesses to reduce their investment in inventories. Although oil prices hit an all time high of almost \$68 per barrel in August in nominal terms, the recent round of rising oil prices has not dramatically affected consumer

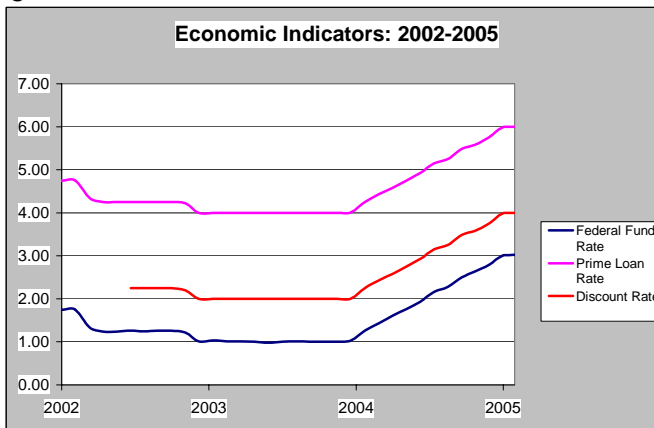
spending until recently. Personal consumption expenditures along with equipment and software spending were still important components of the country's economic growth in the second quarter. "Sharp rises in oil and gas prices have coincided with the onsets of recessions over the last 25 years."<sup>4</sup> Computer sales contributed 0.43 percentage points to the second quarter growth rate. However, if oil prices continue to remain high, more businesses will most likely pass on their higher energy costs to the consumers, which in turn will raise prices and curb economic growth.<sup>5</sup> The airlines continue to pass on some of these costs along with shippers including U.P.S. and FedEx.



Source: Federal Reserve Bank of St. Louis  
<http://research.stlouisfed.org/fred2/>

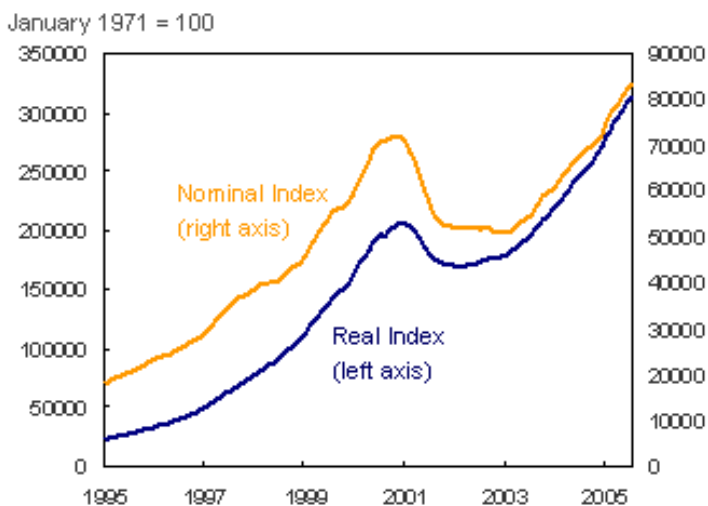
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Higher energy prices have resulted in increased prices and upward inflationary pressure. One way that the Federal Reserve controls inflation is by raising the Federal, or Fed, Funds Rate, the rate at which banks loan funds to each other.<sup>6</sup> Short-term interest rates, which have historically mimicked the movement of the Fed Funds Rate, are rising alongside the Fed Funds Rate, however, long-term interest rates are not climbing as expected. If this trend continues, it is possible that short-term interest rates could be higher than long-term interest rates. Historically, this phenomenon has preceded recessions. However, the rise in oil prices may cause the Federal Reserve to delay future increases in interest rates.



Source: Federal Reserve Bank of St. Louis  
<http://research.stlouisfed.org.fred2/>

According to the Federal Reserve Bank of New York, the Tech Pulse Index, which is a summary statistic that tracks the health of the technology sector of the economy, grew at an annualized rate of 25.7 percent and a nominal rate of 18.9 percent in July 2005, which is slightly below the rates at which these indices grew in the past twelve months. The Tech Pulse Index is compiled from data drawn from investment, consumption, employment, industrial production, and shipments in the technology sector.<sup>7</sup>



Source: Federal Reserve Bank of New York – Tech Pulse Index  
[http://www.ny.frb.org/research/national\\_economy/tech\\_pulse\\_index.htm](http://www.ny.frb.org/research/national_economy/tech_pulse_index.htm)

<sup>1</sup> Bureau of Economic Analysis. "News Release: Gross Domestic Product," July 29, 2005.  
<sup>2,3</sup> Hilsenrath, Jon E. and Ip, Greg. "Economy Shows Resilience in Face of Massive Jolt" *The Wall Street Journal*, September 6, 2005.  
<sup>4,5</sup> Leonhardt, David and Mouawad, Jad. "Economy Shows Signs of Strain From Oil Prices" *The New York Times*, August 17, 2005.  
<sup>6</sup> Board of Governors The Federal Reserve System.  
<sup>7</sup> "Tech Pulse Index" Federal Reserve Bank of New York

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