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FORECAST AND COMMENTARY BY DICK CONWAY AND DOUG PEDERSEN

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What Matters

Did Airbus really win last year's skirmish over airplane orders? Excluding cancellations and conversions, the European airplane maker claimed that it booked 1,111 firm orders, 82 more than Boeing. But recent news reports have questioned a last-minute deal with six Chinese airlines for 150 airplanes. Some airline officials said that they still had not paid a deposit to Airbus, since they were undecided about the allocation of airplanes. Normally, deposits are required before orders are counted as firm.

In any event, the order game matters less than it might seem. In the battle for supremacy of the skies, there are three things more important than the tally of orders: the value of orders, the number of airplanes eventually produced, and the ensuing profit. On the first score, there

was a clear winner in 2005. Since Boeing captured 70 percent of the market for larger airplanes (e.g., the 787), it signed orders worth \$116 billion, \$20 billion more than Airbus. With regard to production and profit, we have to wait and see. But Wall Street seems pleased with Boeing, as it boosted the company's stock price to an all-time high in February.

What matters most to the Puget Sound economy is the number of new jobs. For nearly three years, we have stuck with essentially the same forecast: as airplane production doubles, Boeing will hire back about 20,000 workers between 2004 and 2008. Boeing's record number of orders last year did nothing to change our mind.

Riding the wave of the current aerospace expansion, the regional economy will continue to grow at twice the national rate for the next two years. After rising 3.0 percent in 2005, regional employment will increase 2.9 percent in 2006 and 2.6 percent in 2007.

Summary Forecast

Annual Percent Change	2004	2005	2006	2007
Puget Sound Region				
Employment	1.4	3.0	2.9	2.6
Personal income (cur. \$)	8.3	1.8	6.6	6.6
Consumer price index	1.1	2.8	2.4	2.4
Housing permits	12.5	9.4	5.0	1.0
Population	0.7	1.0	1.4	1.5
United States*				
GDP (\$00)	4.2	3.6	3.4	3.1
Employment	1.1	1.6	1.6	1.3
Personal income (cur. \$)	5.9	5.4	6.0	5.7
Consumer price index	2.7	3.4	2.9	2.3
Housing starts	5.2	5.9	-8.0	-4.3

*Source: Blue Chip Economic Indicators

Regional Outlook

Still number one.

The history of the Puget Sound aerospace industry is almost as long as the history of the airplane. In 1916, thirteen years after the Wright brothers took the first heavier-than-air flight at Kitty Hawk, William Boeing founded the Boeing Airplane Company. When the Seattle enterprise opened for business, it employed 16 workers earning 14 to 40 cents an hour. Boeing built bi-planes for the army and navy during World War I and soon developed into a major aircraft manufacturer.

But the airplane company, as we know it today, did not take off until 1958, when Boeing delivered its first commercial jet aircraft, a 707-120, to Pan American Airlines. Carrying up to 200 passengers at 600 miles per hour, the 707 flew comfortably above turbulent weather and totally transformed air travel. The key to the success of jet airplanes, however, has been their ability to lower the cost of flying over time, making air travel economically feasible for an increasing number of people.

As world-wide demand for air travel soared in the 1960s, Boeing production climbed to 376 airplanes in

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INSIDE

Regional Outlook

1968, while aerospace employment in the Puget Sound region skyrocketed to 104,200. Taking into account the multiplier effect, the impact of the industry amounted to an estimated 250,000 jobs or 37 percent of the 680,000 jobs in the region. With one-third of its economy tied to Boeing, Seattle certainly deserved its reputation as a one-horse town.

Since then Boeing and its aerospace cohorts have played

Because of its large size and volatile nature, Boeing still has the potential to swing the economy like nothing else. During the international trade boom of the 1980s, Boeing tripled its airplane delivery rate and boosted its payroll by nearly 50,000 workers. Including the indirect impact, the aerospace expansion accounted for one-third of the 400,000 regional jobs created between 1983 and 1990. The 9/11 Boeing downturn cost the region 43,000 jobs altogether, about one-half of the total employment lost during the 2001-03 recession.

Boeing recovery.

In general, Boeing has struggled in recent years. Leading up to 9/11, the company suffered a series of setbacks: a slump in the early 1990s; the short-lived 1996-99 expansion, which was plagued by production problems and disappointing profits; and the 2000 downturn triggered by the Asian economic crisis. Boeing appeared to be getting back on its feet in 2001 when 9/11 dealt it another blow.

One upshot of Boeing's turmoil has been the emergence of Airbus as the world's top producer of commercial airplanes. Much ado has been made of this, especially

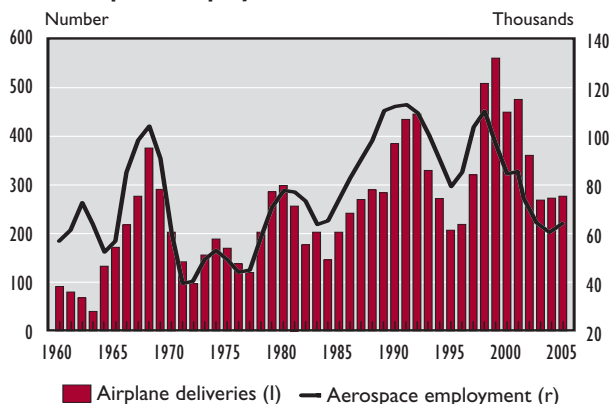
across the Atlantic.

But is the European airplane maker the undisputed leader? How this question is answered depends upon one's perspective: while Airbus out-produced Boeing in the last three years (1,003 airplanes versus 819), Boeing out-produced Airbus in the last five years (1,656 versus 1,613). Given that 9/11 was a financial disaster for U.S. airlines, including some of Boeing's biggest customers, Airbus' slim lead might best be described as tenuous.

Last year's aircraft orders race only muddied the waters regarding industry leadership. Airbus won at the tape by booking 400 orders in December. One Boeing official could not imagine the concessions Airbus had to make to close the deals. Even so, the Airbus victory was questionable. One news report cast doubt on the legitimacy of 150 orders by six Chinese airlines since no deposits were made. Moreover, Boeing beat Airbus by \$20 billion in the race for the value of orders, arguably the more important race, since Boeing dominated the orders for the larger and more expensive airplanes.

Excluding cancellations and conversions, Boeing booked 1,029 orders worth an estimated \$116 billion in 2005. The number of orders, which was nearly four times the total in 2004, established

Puget Sound Airplane Deliveries and Aerospace Employment



an increasingly smaller role in the local economy. Between 1968 and 2005, while the region more than doubled its total employment, the aerospace industry lost 40,000 jobs, mostly from productivity gains. As a result, the number of aerospace workers was down to 64,200 in 2005, less than 4 percent of total regional employment. Including the ripple effect, the aerospace impact amounted to only 10 percent of the local jobs.

But this does not imply that Boeing no longer matters. Its diminishing impact notwithstanding, no company, including Microsoft, has more influence on local business conditions. Look at it this way: if Boeing were unimportant, why did the state government grant it \$3 billion in tax breaks to build the 787 in Everett?

Puget Sound Aerospace Industry 2005

	Employment	Total Wages (mils. \$)	Average Wage (\$)
Aircraft manufacturing	56200	4945.6	88000
Aircraft engines and parts	100	6.2	61600
Other aircraft parts	7200	362.9	50400
Space vehicles	700	43.3	61900
Aerospace industry	64200	5358.0	83500
Puget Sound Region	---	---	50200

a record. Clearly, Boeing had a banner year.

There are three immediate reasons for Boeing's turnaround in orders: the long-term success of the 737 (which accounted for 574 orders in 2005); strong demand in Asia (407 orders); and the popularity of the new 787 Dreamliner (235 orders). But overriding all this is evidence of the success of Boeing's "point-to-point" strategy. While Airbus has placed a big bet on its superjumbo A380, which will operate within a hub-and-spoke system, Boeing has put its money on smaller planes, like the 787, which will fly more directly between origins and destinations.

**Boeing and Airbus Airplane Orders*
 2005**

Boeing	Orders	Airbus	Orders
737	574	A300	7
747	48	A320	918
767	19	A330	64
777	153	A340	15
787	235	A350	87
---	---	A380	20
Total	1029		1111

*Excluding cancellations and conversions.

Airbus booked only 20 orders for the A380 in 2005.

One last point: Boeing orders last year still reflected how difficult it has been for U.S. carriers to recover from 9/11 and other travails, like high fuel prices. Whereas airlines in North America accounted for 75 percent of Boeing airplane orders in 2000 (451 of 598), they accounted for only 25 percent (245 of 1,029) in 2005. Simply a return to normalcy in the North American market would give Boeing another good lift.

A question of jobs.

As of January 31, 2006, Boeing

reported that it employed 62,800 people in the Puget Sound region. This constituted about 90 percent of the employment in the aerospace industry.

In December, Alan Mulally, head of Boeing Commercial Airplanes, said that in response to the strong demand for airplanes the company would continue to augment its workforce in 2006.

The number of new jobs, however, remained up in the air.

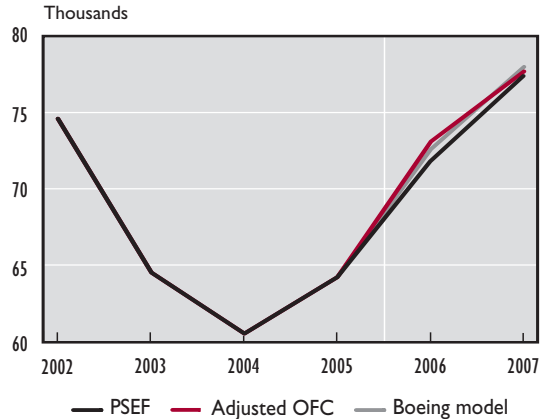
Generally, we base our aerospace employment forecasts on three considerations: Boeing

announcements; predictions made by Washington Office of the Forecast Council (OFC) staff, who produce the state economic forecast and are sometimes privy to Boeing's intentions; and a forecasting model based on the Boeing backlog-delivery ratio utilized in our

leading index.

Currently, we anticipate that aerospace employment will rise from 64,200 in 2005 to 71,800 in 2006 and 77,400 in 2007, a total gain of 13,200. As shown in the chart, these forecasts (designated PSEF) fall just below the OFC projections (adjusted to yield regional forecasts) and the predictions from the Boeing model. Since the aerospace industry is expected to spin off another 17,000 jobs in the economy, its total impact will amount to 30,200 jobs. This is nearly one-third of the 95,800 jobs that

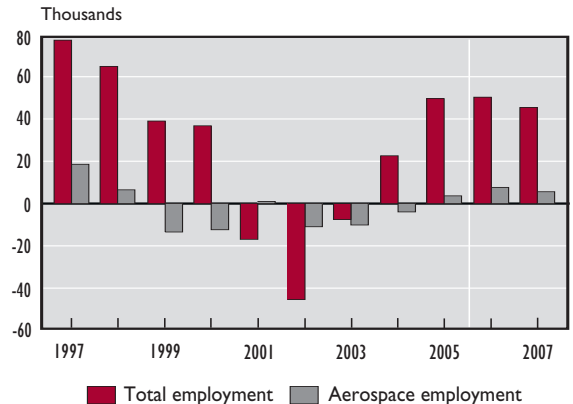
Puget Sound Aerospace Employment



the economy will add over the two-year period, according to our latest outlook.

Led by Boeing, the Puget Sound region will continue to outpace the nation by a healthy margin. Following a 3.0 percent gain in 2005, employment will increase 2.9 percent this year and 2.6 percent next year. Each of the two forecast rates is 1.3 percentage points higher than the corresponding national rate. As the economy boosts its job count by roughly 50,000 per year, the unemployment rate will drop below 5 percent. However, improvement in the jobless rate will be mitigated by a sharp upturn in the population growth rate, from 1.0 percent in 2005 to 1.5 percent in 2007, which will enlarge the labor force. In line with the healthy gains in employment, personal income will rise at a 6.6 percent rate in both 2006 and 2007.

Puget Sound Employment Change



Retail Sales

Hale and hardy.

Strong growth in personal income, an unflagging rate of homebuilding, a rising tide of new residents, falling unemployment, and manageable hikes in interest rates provide the basis for a healthy retail sales forecast.

The underlying growth in Puget Sound retail spending is best revealed without the impact of the volatile motor vehicle and gasoline components. Excluding these categories, current-dollar retail sales are expected to rise 5.8 percent this year and 6.0 percent next year. This follows last year's increase of 6.4 percent, which was fueled by the strongest growth in building materials, furniture, and electronics sales in six years. Without the benefit of generous sales incentives, motor vehicle sales will climb 4.2 percent on average this year and next. Assuming that gas prices stabilize, gasoline sales will

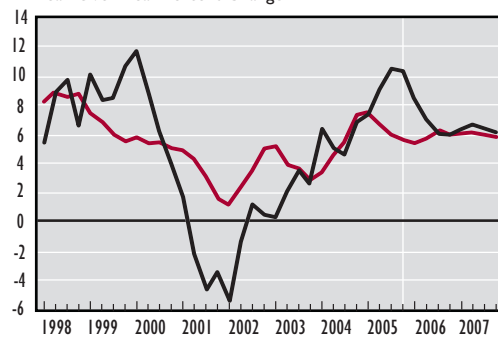
increase 5.1 percent on average.

A fundamentally sound economy will also support vigorous growth in taxable retail sales. Puget Sound taxable sales, hard hit by the recession, essentially moved sideways between 2000 and 2003, imposing severe constraints on county and city budgets. But taxable sales recovered in 2004 and based on preliminary data rose an impressive 9.4 percent in 2005. Large cities reported double-digit increases in taxable sales between the third quarter of 2004 and the third quarter of 2005: Bellevue (12.7 percent), Everett (10.7 percent), Seattle (11.7 percent), and Tacoma (13.8 percent). Led by non-retailing activities, such as manufacturing and wholesaling, total taxable retail sales are expected to climb 6.9 percent in 2006 and 6.5 percent in 2007.

What might hamper retail spending? An unexpected jump in inter-

Puget Sound Retail Sales and Taxable Retail Sales*

Year-Over-Year Percent Change



— Retail sales — Taxable retail sales

*Retail sales excludes motor vehicles and gasoline.

est rates could restrain durable goods sales. The forecast assumes a 0.70 percentage point increase in short-term interest rates and a 0.60 percentage point rise in long-term rates between the fourth quarter of 2005 and the fourth quarter of 2007. Perhaps more problematic is the prospect of moderating home price appreciation, which could reduce equity extraction, an important source of funding for retail spending in recent quarters.

PUGET SOUND RETAIL SALES

	2005		2006			Years			
	3	4	1	2	3	2004	2005	2006	2007
Retail sales (bils. \$)	54.978	55.831	56.380	57.057	57.850	51.022	54.647	57.491	60.735
Building materials	4.206	4.366	4.434	4.455	4.539	3.858	4.222	4.516	4.781
Motor vehicles and parts	13.005	13.201	13.266	13.447	13.548	11.970	12.978	13.483	14.087
Furniture and electronics	2.980	3.060	3.085	3.122	3.179	2.699	2.961	3.153	3.329
General merchandise	6.670	6.791	6.878	6.989	7.101	6.278	6.658	7.046	7.515
Food and beverage	6.867	6.915	6.975	7.045	7.124	6.572	6.834	7.086	7.381
Gasoline stations	5.139	5.120	5.095	5.083	5.166	4.547	4.951	5.150	5.469
Clothing and accessories	2.721	2.750	2.789	2.819	2.854	2.576	2.714	2.838	2.979
Food services and drinking	5.141	5.236	5.305	5.385	5.465	4.874	5.134	5.425	5.735
Other retail sales	8.250	8.392	8.553	8.710	8.875	7.646	8.195	8.795	9.459
Taxable retail sales (bils. \$)	64.985	66.155	67.000	67.780	68.947	58.547	64.040	68.470	72.890
Retail trade	29.037	29.364	29.662	29.993	30.387	26.337	28.480	30.210	31.829
Other taxable sales	35.948	36.791	37.339	37.787	38.560	32.210	35.560	38.260	41.061
Annual growth (% change)									
Retail sales	5.6	6.2	3.9	4.8	5.6	5.3	7.1	5.2	5.6
Taxable retail sales	10.7	7.2	5.1	4.7	6.9	5.8	9.4	6.9	6.5

Quarterly data are seasonally adjusted and expressed on an annual basis.

Construction and Real Estate

Speculative demand.

Like stocks, housing is subject to speculative demand. In simple terms, speculative demand is the decision to purchase a home based on the expectation of rising home prices. "Home flippers," who buy and sell houses in the hope of turning a quick profit, are a prime example of speculative buyers.

Speculative demand often arises during the final stage of a housing boom. At this point in the cycle, there is a tendency for home prices to escalate rapidly and for mortgage rates to remain relatively low. In the eyes of a speculator, this means that the potential returns on investment are high while the carrying costs are low.

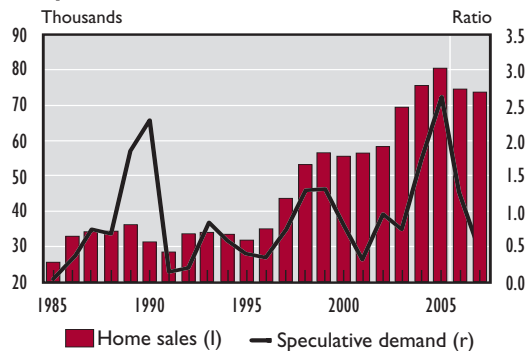
But speculative demand can be an insidious and destructive force in the housing market. When speculative demand surfaces, it tends to push home prices up even higher, which leads to more specu-

lative demand. If it continues to feed on itself, speculative demand can result in spiraling home prices and a rapid decline in housing affordability. If prices soar too high, the housing market may collapse, especially if speculators beat a hasty retreat.

In forecasting, we utilize an indicator of speculative demand: the percentage change in the average home price divided by the average mortgage rate over the past four quarters. Generally, this ratio is positively correlated with home sales. In the past, however, rapid run-ups in the speculative demand indicator have signaled impending downturns in the housing market.

Between 1988 and 1990, the home price appreciation rate surged from 7 percent to 23 percent, while the mortgage rate stayed at 10 percent, causing the speculative demand ratio to jump from 0.7 to 2.3. Whether or not

Puget Sound Home Sales and Speculative Demand*



*Ratio of home price appreciation rate to mortgage rate.

speculative demand was the immediate cause, home sales plummeted 21 percent between 1989 and 1991. Relatively weak home sales followed sharp upturns in the speculative demand index in 1993 and the late 1990s.

Is the housing market currently in a similar fix? It would appear so. In 2005, with a 15.4 percent appreciation rate and a 5.9 percent mortgage rate, the speculative demand ratio hit 2.6, its highest level in two decades. And we are predicting a 9 percent decline in home sales between 2005 and 2007.

PUGET SOUND CONSTRUCTION AND REAL ESTATE

	2005		2006			Years			
	3	4	1	2	3	2004	2005	2006	2007
Housing permits (thous.)	27.8	30.6	28.2	27.9	29.1	25.0	27.4	28.7	29.0
Single-family	19.6	19.8	18.5	18.5	19.3	16.9	18.9	18.9	19.1
Multi-family	8.2	10.8	9.6	9.4	9.8	8.1	8.5	9.8	9.9
Housing permits (mils. \$)	4623.3	5014.7	4622.7	4591.6	4796.2	3742.0	4500.5	4727.7	4882.9
Single-family	3854.3	4004.8	3703.2	3689.7	3853.7	3015.4	3701.1	3792.7	3906.3
Multi-family	769.0	1009.9	919.5	901.8	942.5	726.7	799.4	934.9	976.7
Average home price (thous. \$)	353.6	369.8	372.2	374.3	375.3	301.5	348.0	374.7	383.5
Active home listings (thous.)	14.9	15.8	16.7	17.0	17.2	18.0	15.1	17.1	17.6
Home sales (thous.)	83.4	81.6	76.3	74.5	74.5	76.1	81.1	75.1	74.2
Apartment vacancy rate (%)	5.3	5.1	5.0	4.9	4.8	7.3	5.7	4.9	4.7
Average apartment rent (\$)	814	826	836	846	858	795	811	852	901
Annual growth (% change)									
Housing permits (mils. \$)	42.0	33.9	-31.3	-2.7	17.8	12.7	20.3	5.0	3.3
Average home price	15.9	18.2	2.7	2.2	1.2	10.1	15.4	7.7	2.4
Average apartment rent	4.0	5.9	4.6	5.2	5.4	-1.2	2.1	5.1	5.6

Quarterly data are seasonally adjusted and expressed on an annual basis.

Special Topic: California

South on I-5.

Like it or not, we have always been well connected to California. During the California Gold Rush, mills on the Kitsap Peninsula produced lumber for that state's booming economy. In 1851, San Franciscans got their first taste of Olympia oysters harvested from Puget Sound.

Today, the links between the Puget Sound region and California are varied and strong, especially when it comes to the matter of trade. We exchange salmon, software, and airplanes for oranges, computers, and movies. We swap electricity to help heat our homes in the winter and cool their homes in the summer. As tourists, we travel up and down I-5 taking in the attractions of each other's state.

Even on a personal level, we are bound together. Many Puget Sound residents are natives of California or have lived there at some time. More than a few of us were educated at California universities.

According to the Washington Department of Licensing, one-fourth of the out-of-state drivers

who obtain a Washington driver license hail from California. By comparison, second-ranked Oregon provides one-eighth of the new drivers from out of state. Since net migration typically accounts for one-half of the yearly change in population, this implies that Californians constitute one-eighth of the population growth in the Puget Sound region.

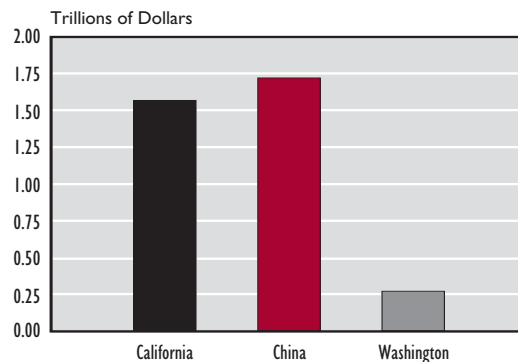
As evident by licensing data, the Puget Sound region interacts substantially more with California than Oregon, despite the Beaver State's proximity. This illustrates the geographer's version of Newton's law of gravity: the degree of interaction between two places is directly related to the size of the places and inversely related to the distance between them. California may be five times farther away from us than Oregon, but it is ten times bigger.

Indeed, big is the best word to describe the California economy. In 2004, with Gross Domestic Product totaling \$1.6 trillion, California rivaled China in economic might.

As the California Chamber of Commerce likes to point out, the Golden State has the eighth largest economy in the world.

Although the California economy, which produces one-eighth of the nation's output, is approximately nine times bigger than the Puget Sound economy, it is not necessarily better off. As measured by job growth since 1970, California has expanded at an appreciably slower rate (2.2 percent annually) than the Puget Sound region (2.8 percent). Moreover, compared to the region, the state had a higher unem-

Gross Domestic Product, 2004



ployment rate (5.3 percent versus 5.0 percent) and a lower per capita income (\$36,788 versus \$41,763) in 2005.

Despite their size difference, California and the Puget Sound region have remarkably similar industrial structures. Among the high-wage industries, both have 10 percent of their employment in manufacturing and 28 percent in information and professional and business services. Given its reputation as a tourist destination, it is not surprising that California has a higher employment share in the leisure and hospitality industry (10 percent) than the Puget Sound region (9 percent), but the difference is small.

Since California is an important economic partner, it bears watching. Because of its large size and great diversity, the California economy looks and acts a lot like the U.S. economy. Between 1990 and 2005, for example, California employment expanded at a 1.0 percent annual rate, while U.S. jobs grew at a 1.3 percent rate.

This similarity suggests that a good back-of-the-envelope forecast for the California economy is the national outlook. According to the November 2005 California Governor's Budget Forecast, state employment and personal income will increase 1.3 percent and 5.8 percent, respectively, in 2006. Our current forecasts for national employment and income are not much different: 1.6 percent and 6.0 percent, respectively.

California and Puget Sound Economic Characteristics, 2005

	California	Puget Sound
Employment (thous.)	14729.5	1724.2
Employment growth rate, 1970-05 (%)	2.2	2.8
Personal income (bils. \$)	1337.6	143.6
Per capita income (\$)	36788	41763
Unemployment rate (%)	5.3	5.0
Population (thous.)	36359.6	3439.3
Percent of total employment		
Manufacturing	10.2	10.0
Information	3.2	4.6
Professional and business services	14.6	13.0
Leisure and hospitality	10.0	9.2

FORECAST DETAIL 65 Percent Probability

	2005		2006			Years			
	3	4	1	2	3	2004	2005	2006	2007
Employment (thous.)	1727.0	1748.4	1756.3	1768.5	1780.8	1674.6	1724.2	1774.6	1820.0
Goods producing	279.1	291.4	292.8	295.2	298.0	268.7	282.1	296.8	307.5
Natural resources and mining	1.7	1.7	1.7	1.7	1.7	1.8	1.7	1.7	1.7
Construction	108.1	111.1	111.7	112.6	114.0	100.6	107.7	113.4	118.0
Manufacturing	169.3	178.6	179.4	180.9	182.4	166.3	172.6	181.7	187.8
Aerospace	60.8	68.8	69.9	71.1	72.4	60.5	64.2	71.8	77.4
Other durable goods	70.3	71.6	71.4	71.5	71.7	67.7	70.5	71.6	72.0
Nondurable goods	38.2	38.2	38.2	38.3	38.3	38.0	38.0	38.3	38.3
Services producing	1447.9	1457.1	1463.5	1473.3	1482.7	1405.9	1442.2	1477.8	1512.5
Wholesale and retail trade	270.7	272.4	273.4	275.0	276.4	262.0	269.4	275.6	279.6
Transportation and public utilities	61.3	61.3	61.5	61.9	62.2	60.7	61.4	62.0	63.0
Information	79.5	79.7	80.2	80.9	81.6	77.5	79.1	81.2	83.9
Financial activities	107.4	108.3	108.7	109.1	109.5	107.0	107.5	109.4	111.3
Professional and business services	225.1	229.6	231.4	234.2	236.6	211.4	224.1	235.3	245.5
Other services	423.1	424.8	426.7	429.7	432.9	407.7	420.3	431.2	442.6
Government	280.8	280.9	281.7	282.5	283.4	279.6	280.4	283.0	286.6
State and local	231.6	231.9	232.6	233.4	234.2	230.4	231.3	233.8	237.2
Federal	49.2	49.1	49.1	49.1	49.2	49.3	49.1	49.2	49.3
Unemployment rate (%)	5.1	5.0	5.1	5.0	5.0	5.6	5.0	5.0	4.9
Personal income (bils. \$00)	128.1	130.4	131.4	133.1	134.7	130.3	129.0	133.9	139.5
Personal income (bils. \$)	143.3	146.9	149.1	151.8	154.5	141.1	143.6	153.1	163.2
Wage and salary disbursements	86.8	88.6	89.9	91.6	93.3	81.2	86.6	92.4	98.5
Other income	56.5	58.3	59.1	60.2	61.2	59.9	57.0	60.7	64.7
Per capita personal income (\$)	41618	42511	42990	43619	44226	41417	41763	43906	46110
Consumer price index (82-84=1.000)	1.999	2.021	2.031	2.042	2.053	1.947	2.001	2.048	2.097
Housing permits (thous.)	27.8	30.6	28.2	27.9	29.1	25.0	27.4	28.7	29.0
Population (thous.)	3443.7	3455.0	3467.1	3480.0	3493.3	3406.0	3439.3	3486.8	3540.2
Net migration (thous.)	18.3	23.2	26.6	29.6	31.2	4.8	16.3	29.9	31.4
Three-month treasury bill rate (%)	3.4	3.8	4.3	4.6	4.6	1.4	3.1	4.5	4.6
Conventional mortgage rate (%)	5.8	6.2	6.5	6.7	6.7	5.8	5.9	6.6	6.8
Annual growth (% change)									
Employment	1.9	5.0	1.8	2.8	2.8	1.4	3.0	2.9	2.6
Personal income (cur. \$)	1.1	9.9	5.9	7.4	7.1	8.3	1.8	6.6	6.6
Consumer price index	-1.4	4.4	1.9	2.2	2.2	1.1	2.8	2.4	2.4
Housing permits	44.8	41.4	-32.3	-3.0	16.7	12.5	9.4	5.0	1.0
Population	1.2	1.3	1.4	1.5	1.5	0.7	1.0	1.4	1.5

Quarterly data are seasonally adjusted and expressed on an annual basis.

Leading Index

Near perfect.

The Puget Sound leading index jumped 1.3 percent last quarter. It was the thirteenth consecutive rise in the index and signaled the continued expansion of the economy.

Although six of the seven components made positive contributions, the gain was led by stronger durable goods sales, an increase in housing permits, and fewer initial claims for unemployment insurance. The only negative factor was the interest rate spread.

The interest rate spread is calculated as the difference between

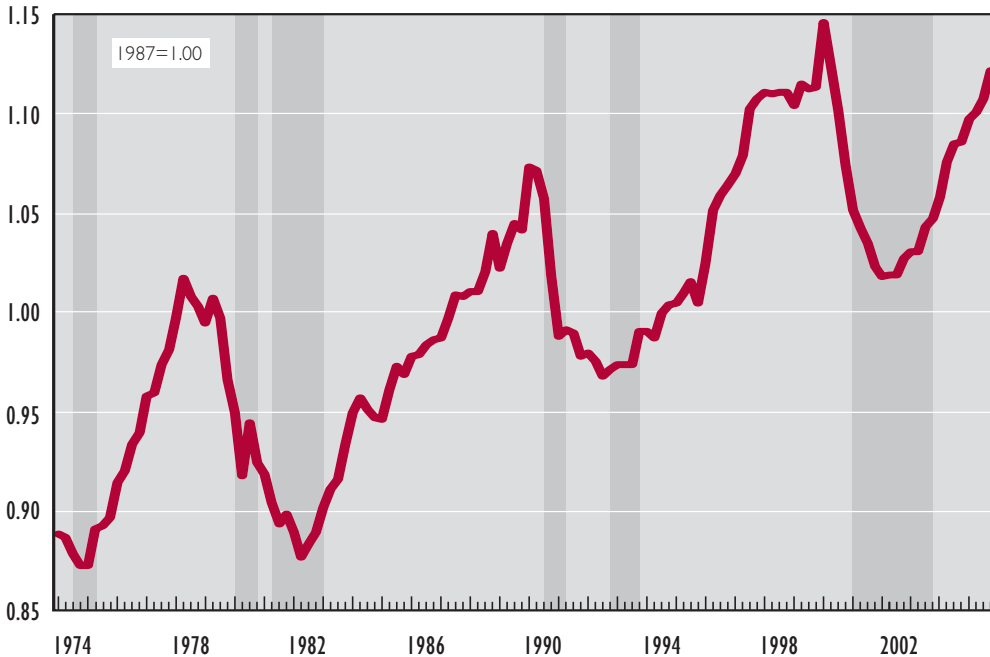
the yield on ten-year Treasury notes and the average rate on three-month bank certificates of deposit. An examination of the predictive behavior of interest rates showed that the gap between these particular rates provided the most reliable signal of turning points in the regional business cycle. Recently, the spread has narrowed from 3.35 percentage points in the second quarter of 2004 to 0.19 percentage points in the fourth quarter of last year.

Overall, the interest rate spread has a good track record of anti-

pating turning points. It turned negative ahead of six of the last seven recessions in the region. While the interest rate spread was unerring in the 1970s and 1980s, it has had mixed success in recent years. It correctly signaled the 1990 and 2001-03 recessions but missed the 1992-93 period of stagnation and flashed a false signal in 1998.

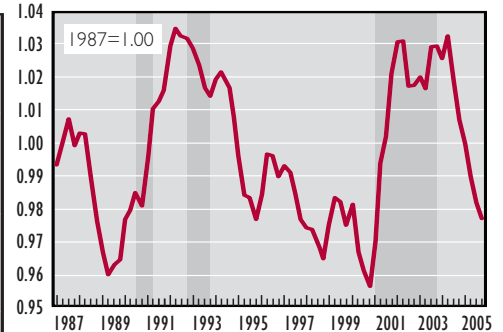
The relative stability of long-term interest rates has hampered interpretation of the current narrowing in the interest rate spread. Nevertheless, this indicator bears close watching.

Puget Sound Index of Leading Economic Indicators

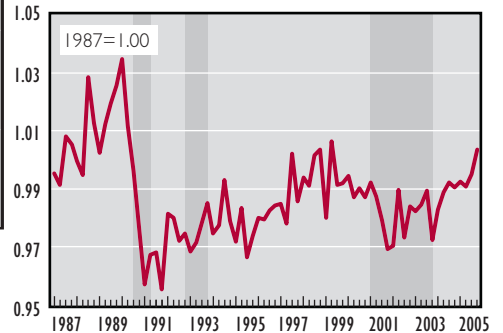


Shaded areas show recessions or periods of economic stagnation.

Interest Rate Spread



Puget Sound Housing Permits



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