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A Reassessment After Hurricane Katrina

Estimates of the damage wrought by the massive flooding and destruction of homes and buildings are still fluid at this writing. But by all accounts, Hurricane Katrina will likely go on the record as America's greatest natural disaster.

New disasters inevitably prompt historical comparison. But the economic consequences of a natural disaster vary a great deal depending on location, scale, policy response and the general health of the economy prior to the event. While the latter point is often overlooked, we believe it is a significant factor in determining the macroeconomic fallout.

The good news is that the US economy was relatively robust prior to the hurricane. Based on job gains and the decline in the jobless rate in August to 4.9%—the first drop below 5% since 2001—the economy appeared to be growing at a roughly annualized 4% rate prior to Hurricane Katrina. This view was supported by the Federal Reserve's survey of economic conditions prior to the hurricane—the so-called beige book—which also suggested the economic expansion was broad based, with retail sales, services, finance, construction, manufacturing, mining, energy and tourism all growing.

No doubt, the fallout from the hurricane—the flooding and building damage, disruptions to the flow of commerce, displaced workers and higher energy prices—has slowed the pace of economic activity for the period. But its location was critical because so much of the nation's energy production and processing facilities are located on the Gulf Coast. Katrina's impact on the local economy, while devastating, will be far less important than its effect on national energy prices and the knock-on effect on businesses and consumers elsewhere in the country. Of the 7% cumulative growth in the nation's real GDP in 2003 and 2004, Louisiana and Mississippi's real GDP together accounted for only 0.1 percentage point.

Our best guess is that the nation's third-quarter real GDP growth will be reduced by about 0.5%. There is, however, a lot of wiggle room in that estimate, which depends on how long energy prices remain at record levels and how quickly the federal government accelerates delivery of aid to victims and businesses on the Gulf Coast.

Clearly, the policy response to the hurricane will have a large and direct influence on the economy's growth and inflation trends over the next year or so. The comments of policymakers in Congress suggest that the federal government might have to spend as much as $150 billion to $200 billion to repair and rebuild all of the areas affected. Congress has already approved more than $60 billion in aid, all of it earmarked for housing, cash payments for victims and healthcare. Much more will be needed for infrastructure spending, as well as assistance to a host of small businesses and workers.

History shows the construction sector to be among the chief beneficiaries of the rebuilding effort that follows the devastation of a hurricane. For example, in the two years after Hurricane Andrew, overall construction spending increased two to three percentage points faster than overall GDP growth. Admittedly, not all the extra spending was the result of the hurricane, but at the margin it added a lot of dollars to overall construction activity.

The current situation is somewhat unusual because construction had already been leading the economy in recent years, driven by relatively strong homebuilding activity. Private-sector construction activity rose 13.6% in 2004, twice as fast as overall nominal GDP. In the first half of 2005, it was still running at a relatively fast pace, up 11.5% over year-ago levels. In more recent months construction activity had broadened as non-residential building began to recover.

This was apparent in new construction-award data published by McGraw Hill Construction Dodge Report (formly known as FW Dodge), which showed activity at a new high in July largely as a result of the recovery in private non-residential building. Its index of new construction contracts was 11.5% above year-ago levels, suggesting a lot of upside for the construction sector. In August, Congress passed a record $286-billion highway bill, which will likely be followed by with legislation authorizing billions more to repair and rebuild infrastructure along the Gulf Coast.

So one of the unintended—if not overlooked—consequences could well be more inflation, especially in prices for construction materials and supplies, and possibly labor. Higher energy prices will also fan inflation in coming months and quarters.

In the final analysis, the economy's basic strength, coupled with the federal government's expected policy response, should limit the macro-economic fallout from the hurricane. On the other hand, there will be a number of important micro-economic changes stemming from the events of the past few weeks. For instance, the mix of economic growth will be skewed toward construction and government spending and away from consumer spending.

Impact from Rising Cost of Fuel

The potential slowdown in consumer spending is hard to gauge, but the direction is not in doubt. Prior to the hurricane-related increase in energy prices, consumers were already spending 3% of overall personal income on gasoline, fuel oil and other energy products (but not energy services such as electricity and natural gas). That's a half-point higher than last year and a full point above the 2003 level, and the highest level in 20 years. The latest price increases will further add to household fuel expenses, forcing spending adjustments elsewhere.

As we have noted before, consumers' ability to adjust to higher energy prices will depend a lot on job and wage gains. As long as the labor markets remain moderately strong—as appeared to be the case through August—they should be able to handle higher prices without making huge adjustments elsewhere.

This assumes the 40- to 50-cent rise in the price of gasoline will start to reverse once the Gulf Coast facilities begin to come back on line over the next several weeks. Even so, the rise in consumer spending should slow to 2.5% to 3% over the next six months, down from the 3.5% to 4% pace of the past two years.

All this has implications for monetary policy, given the potential inflation associated with increases in government spending, the rebuilding effort and higher energy prices. Even if policymakers forgo another rate increase at the September 20th Federal Open Market Committee meeting, the need and the pressure to raise official rates will only grow, given the size of the fiscal response to Katrina. (Note: Odds of policymakers pausing in September seem to be falling with each passing hour for the simple reason that the federal response has been very swift and large.)

Only last month, policymakers acknowledged that official rates were still below levels they believe necessary to keep inflation at bay long term. So if anything, it seems to us the economic, financial and fiscal actions of the past few weeks have raised—rather than lowered—the fair-value level of the federal funds rate.

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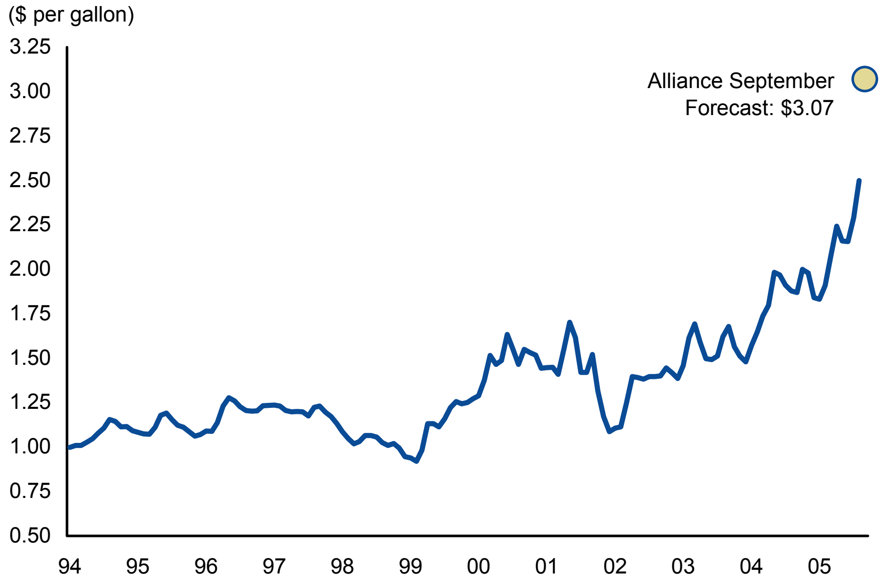
Display 1: Spending on Energy is Rising Relative to Overall Income

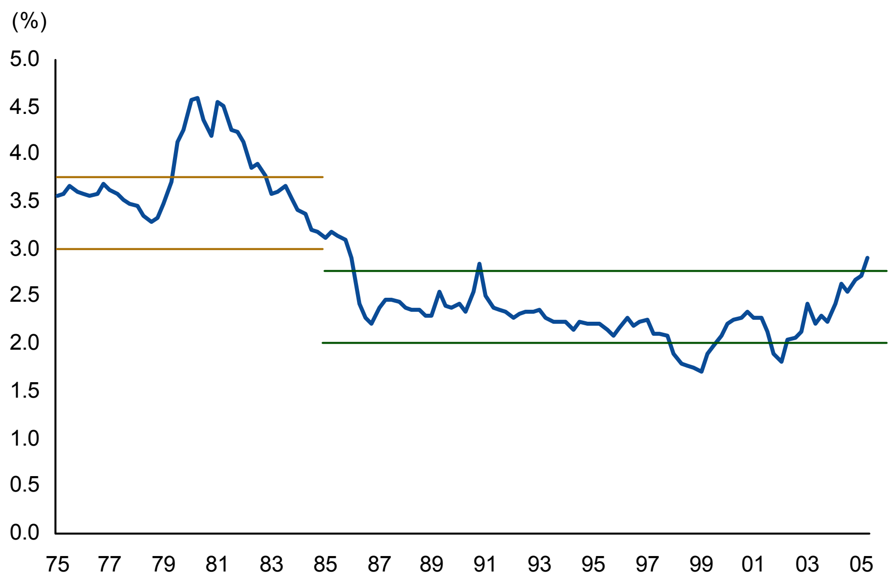
US Gasoline Prices (Monthly Average)



Source: Department of Energy; September 9, 2005

Given that the economies of Louisiana and Mississippi are relatively small, the hurricane's real impact on the broader economy will come through higher energy costs and supply disruptions.

Household Spending on Energy as a Percent of Personal Income

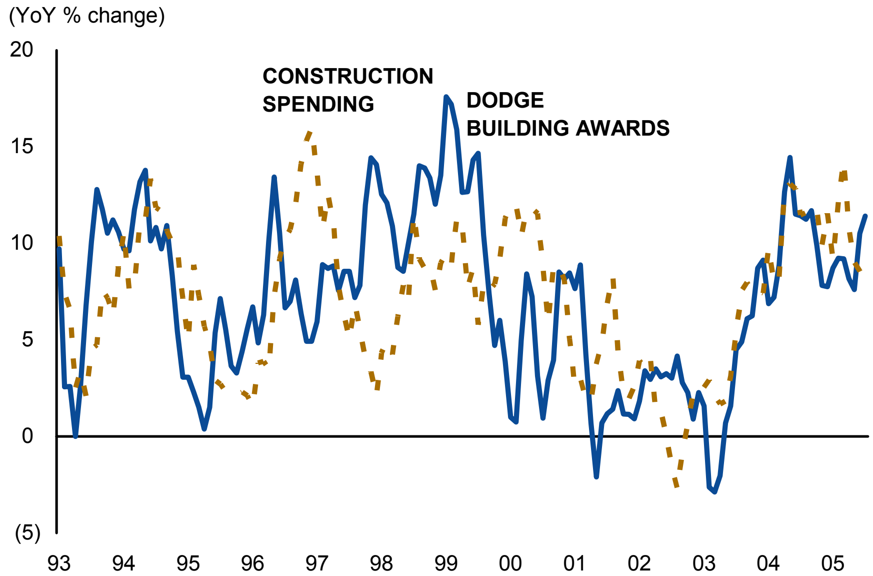


Source: Bureau of Economic Analysis, Haver Analytics and Alliance Capital Fixed Income; September 9, 2005

Consumers are vulnerable because they are already directing a high percentage of income toward the purchase of energy products. As long as economic growth and job creation hold, the higher energy price should trigger a slowdown in spending but not a collapse.

Display 2: Already Strong, Construction Activity Will Strengthen Further Thanks to Rebuilding Efforts After Hurricane Katrina

Construction Activity



Source: Census Bureau, McGraw Hill Construction and Haver Analytics; September 9, 2005

History shows that construction activity tends to get stronger following natural disasters. This time around, construction activity has already been strong and was recently boosted by the passage of the Federal Highway bill in August. The rebuilding effort following the hurricane should trigger more price increases.

Alliance US Economic Forecast

September 2005

Levels (2000 Dollars)	Quarterly					Annual			
	1Q05	2Q05	3Q05	4Q05	1Q06	2003	2004	2005	2006
GDP	10999.3	11088.6	11193.1	11294.3	11392.3	10320.6	10755.7	11143.8	11529.8
Consumption	7764.9	7823.2	7892.1	7935.1	7985.1	7306.5	7588.6	7853.8	8069.1
Durables	1122.3	1143.3	1175.0	1170.0	1178.0	1028.5	1089.9	1152.7	1187.0
Non-Durables	2265.6	2285.1	2298.0	2318.0	2330.0	2101.8	2200.4	2291.7	2358.8
Services	4392.0	4412.7	4437.0	4465.0	4495.0	4184.0	4310.9	4426.7	4541.3
Investment									
Non-Res Structures	251.0	252.7	251.0	256.0	263.0	243.1	248.4	252.7	270.8
Non-Res Equip & Software	1014.2	1039.6	1065.0	1090.0	1110.0	846.8	947.6	1052.2	1143.8
Res Structures	584.1	597.9	600.0	606.0	610.0	509.4	561.8	597.0	607.5
Change in Inventories	58.2	2.6	20.0	35.0	40.0	15.5	52.0	29.0	48.8
Net Exports	-645.4	-611.2	-615.0	-625.0	-625.0	-521.4	-601.3	-624.2	-635.0
Exports	1165.3	1201.9	1215.0	1235.0	1255.0	1031.2	1117.9	1204.3	1272.5
Imports	1810.7	1813.1	1830.0	1860.0	1880.0	1552.6	1719.2	1828.5	1907.5
Government	1971.9	1985.0	1987.6	2004.8	2016.8	1911.2	1952.3	1987.3	2032.6

	Quarterly % SAAR					% Q4/Q4				Annual			
Percent Changes	1Q05	2Q05	3Q05	4Q05	1Q06	2003	2004	2005	2006	2003	2004	2005	2006
GDP	3.8%	3.3%	3.8%	3.7%	3.5%	4.0%	3.8%	3.6%	3.5%	2.7%	4.2%	3.6%	3.5%
Consumption	3.5%	3.0%	3.6%	2.2%	2.5%	3.8%	3.8%	3.1%	2.8%	2.9%	3.9%	3.5%	2.7%
Durables	2.6%	7.7%	11.6%	-1.7%	2.8%	9.2%	5.2%	4.9%	2.1%	6.6%	6.0%	5.8%	3.0%
Non-Durables	5.3%	3.5%	2.3%	3.5%	2.1%	4.1%	4.6%	3.6%	2.9%	3.2%	4.7%	4.2%	2.9%
Services	2.8%	1.9%	2.2%	2.5%	2.7%	2.5%	3.1%	2.4%	2.9%	2.0%	3.0%	2.7%	2.6%
Investment													
Non-Res Structures	-2.0%	2.7%	-2.7%	8.2%	11.4%	1.2%	2.8%	1.5%	9.4%	-4.2%	2.2%	1.7%	7.2%
Non-Res Equip & Software	8.3%	10.4%	10.1%	9.7%	7.5%	7.2%	13.8%	9.6%	7.8%	3.2%	11.9%	11.0%	8.7%
Res Structures	9.5%	9.8%	1.4%	4.1%	2.7%	11.8%	6.6%	6.1%	0.7%	8.4%	10.3%	6.3%	1.8%
Net Exports													
Exports	7.5%	13.2%	4.4%	6.7%	6.6%	6.0%	6.1%	7.9%	4.9%	1.8%	8.4%	7.7%	5.7%
Imports	7.4%	0.5%	3.8%	6.7%	4.4%	5.1%	10.6%	4.6%	3.8%	4.6%	10.7%	6.4%	4.3%
Government	1.9%	2.7%	0.5%	3.5%	2.4%	2.0%	2.1%	2.1%	2.3%	2.8%	2.2%	1.8%	2.3%

Key Macro Indicators	Quarterly					Annual			
Nominal GDP (Levels)	12198.8	12373.1	12603.6	12810.1	13004.0	10971.3	11734.3	12496.4	13334.4
%Q/Q SAAR	7.0%	5.8%	7.7%	6.7%	6.2%				
%Y/Y	6.5%	6.1%	6.6%	6.8%	6.6%	4.8%	7.0%	6.5%	6.7%
Industrial Production (Index)	118.2	118.6	120.3	121.4	122.4	110.9	115.5	119.6	123.7
%Q/Q SAAR	3.8%	1.4%	5.7%	3.7%	3.3%				
%Y/Y						0.0%	4.1%	3.6%	3.4%
Housing Starts (Millions)	2.08	2.04	2.05	2.05	2.00	1.85	1.95	2.06	1.96
Industry Auto Sales (Millions)	16.5	17.2	18.5	16.3	16.8	16.6	16.9	17.1	16.9
Personal Savings Rate	0.5	0.3	0.0	1.0	1.5	2.1	1.7	0.5	2.5
Unemployment Rate	5.3	5.1	5.1	5.0	4.9	6.0	5.5	5.1	4.9
Operating Profits (%Y/Y)	12.3%	17.7%	15.5%	12.8%	8.7%	16.4%	12.6%	14.5%	7.6%
After-Tax Profits (%Y/Y)	4.1%	11.5%	12.9%	12.6%	14.8%	21.0%	15.7%	10.3%	8.8%

Inflation %Y/Y									
GDP Deflator	3.1%	2.4%	3.6%	2.9%	2.6%	2.0%	2.6%	2.8%	3.1%
Consumer Price Index	2.4%	4.2%	5.0%	3.1%	2.7%	2.3%	2.7%	3.3%	3.3%

Key Interest Rates (End Of Period)									
Fed Funds Rate	2.96%	3.25%	3.75%	4.00%	4.25%	1.00%	2.25%	4.00%	5.00%
Three-Mo T-Bill (BEY)	2.79%	3.13%	3.70%	3.95%	4.20%	0.95%	2.22%	3.95%	4.95%
Two-Yr Note	3.80%	3.66%	4.00%	4.25%	4.50%	1.84%	3.08%	4.25%	5.25%
10-Yr Note	4.50%	3.94%	4.25%	4.50%	4.75%	4.27%	4.24%	4.50%	5.45%
30-Yr Bond	4.76%	4.19%	4.50%	4.70%	5.00%	5.18%	4.86%	4.70%	5.75%

Source: Alliance Capital Fixed Income