

economic commentary

Special Edition: U.S. Economic Outlook - Kickin' It Up a Notch

Summary

- ◆ Forget garlic and cayenne pepper – monetary policy can do the trick. We've raised our 2005 outlook for GDP growth through the four quarters of 2005 to 4¼% or so.
- ◆ Fed funds should end next year in a 3½%-4% range (and a bit higher in 2006) while the 10-year approaches 5% in a year and hits a cyclical peak of 5%-5½% in early 2006, well below previous market tops.
- ◆ The dollar should continue its sizeable but orderly decline and while inflation fears may crop up, the Fed appears ready to do what is necessary to keep those fears from becoming reality.

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Strategist Certification
and
Important Disclosures

***Note:** It's out! Citigroup's annual "Prospects for Financial Markets," our outlook for the economies and financial markets around the world has just been released. Prepared by our Economic and Market Analysis group, under the supervision of Chief Economist Kim Schoenholtz, this year's theme is "Policy Evolution and Normalization – Market Implications for 2005 and Beyond." Our U.S. economic forecast summary appears below...*

Smith Barney U.S. Forecast Summary

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| GDP: | Seemingly drawing strength from a modest spring soft spot, the economy stared down an autumn resurgence of energy prices -- and won. We look for fourth quarter real GDP growth of 3½%-4% and 4%-4½% through the four quarters of 2005. Geopolitical concerns remain, oil prices could wander from the futures path and both long- and short-term rates should move still higher, but, for the moment at least, monetary policy still is accommodative. |
| Consumer: | Consumers have been up against a lot but, as usual, have spent their way through. Inflation remains restrained while job growth is approaching 2 million in 2004, raising compensation. Confidence has lagged and there's always fear of "too much debt" but that fear has been around since the 1970s and it's yet to come to fruition. Besides, the debt burden is down and studies have shown that the "cash-out" refi binge improved balance sheets. Consumers have the capacity to borrow and banks maintain the willingness to lend. |
| Housing: | Housing markets continue elevated for now and the fall's data contraindicated the summer's suggestion of a modest inventory build. Rates remain historically low, however, and ARMs are becoming more popular. Affordability is high. Ownership rates are rising, as the renter becomes a buyer. |
| Autos: | Sales alternatively surprise and disappoint with the ebb and flow of incentives. Will the consumer continue to respond? Indications are that everyone still loves low financing rates, even the automakers. |

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| Capital Spending: | Capital spending began 2004 on a strong note and the pipeline is still heating up. Despite technology CEO's concerns, capital spending is proceeding at roughly a 10% real growth rate. The "technology" component is rising even faster. Small business is participating. A healthy economic outlook, low capital costs and improved cash flow all help. |
| Inflation: | First quarter core CPI growth rate accelerated sharply, but increasingly it appears to have been just a one-time affair. The monthly change in the core PCE price index has been either zero or up 0.1% every month since April and its year-to-year increase stands at just 1.5% - it's been there virtually all year. Greenspan and friends will continue to look more closely at inflation expectations, which have remained modest. |
| Federal Budget: | The FY2004 deficit hit \$413 billion but the year ended with corporate tax receipts strong and withheld tax payments picking up, confirming recent employment strength. We look for declines to \$380 billion in the current fiscal year and \$360 billion in FY2006 but caution that these declines represent cyclical improvements, not structural improvements. |
| Earnings: | S&P earnings rose 15.8% in 2003, ending the year on a still-stronger note. For this year, S&P earnings should rise by more than 19% (to \$66.25), another 8.7% (to \$72.00) in 2005 and another 6.3% (to \$76.50) in 2006. Dividend growth should be close to 12% in 2004 and slow to 5% or so in 2005 and 2006. |
| Short-term Rates: | The Fed should remain on its "measured" road away from an accommodative policy but even a couple of small bumps in the fed funds rate will keep policy on an accommodative tilt which may not end until funds move closer to 4%. We see funds in a 3½%-4% range in a year. Remember it takes time for changes in monetary policy to impact the economy. We look for a 25 bp rate hike at the December 14 meeting. |
| Long-term Rates: | Yields on 10-year Treasury notes have moved back above 4¼% as concern about the dollar and the continued desire of foreign investors to invest in our markets weigh heavily upon investors. Yields should continue to march on toward 5% in 2005 and eventually top out in a 5%-5½%, well below recent cycles. Any further (or quicker) increases are dependent upon the market's assessment of the Fed's inflation-fighting capabilities. We believe they're up to the task. |
| Dollar: | The dollar has taken it on the chin lately as the burden of the twin deficits and how they are going to be financed exacts a toll. Another sizeable decline in the dollar against most currencies is anticipated, especially those in emerging Asia. China probably will allow a modest widening of its currency band next year. We expect the decline to remain orderly unless U.S. policymakers are viewed as seeking to depress the dollar or fostering further protectionist creep. |

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