

U.S. ECONOMICS

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Animal House

Outlook at a Glance...

%	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05	2004	2005	2006	1Q06	2Q06	3Q06	4Q06
Real GDP	4.0	3.8	4.6	4.0	3.3	3.0	4.4	3.9	3.1	3.0	3.2	3.3	3.3
Private consumption	5.1	4.2	4.0	4.0	3.3	3.0	3.8	3.9	3.1	3.0	3.0	3.0	3.0
Government expenditure	0.7	0.8	2.0	2.0	2.0	2.0	1.9	1.6	2.0	2.0	2.0	2.0	2.0
Non res fixed invest	13.0	14.5	7.9	10.7	10.8	10.0	10.6	11.0	10.2	10.1	10.1	10.1	10.2
Residential fixed invest	1.6	3.4	6.5	3.0	0.0	-3.0	9.7	3.8	-2.8	-5.0	-3.0	-3.0	-3.0
Exports	6.0	3.2	9.0	7.5	7.0	7.0	8.6	6.8	7.0	7.0	7.0	7.0	7.0
Imports	4.6	11.4	8.0	8.0	7.5	6.5	9.9	8.3	6.1	6.0	5.5	5.0	5.0
Contributions to GDP:													
Domestic final sales	5.1	4.8	4.3	4.4	3.8	3.3	4.6	4.4	3.3	3.3	3.4	3.4	3.4
Inventories	-1.0	0.5	0.7	0.1	-0.1	0.0	0.4	0.2	0.0	0.0	0.0	0.0	-0.1
Net trade	-0.1	-1.4	-0.3	-0.5	-0.5	-0.3	-0.6	-0.6	-0.3	-0.2	-0.2	-0.1	-0.1
Unemployment rate	5.4	5.4	5.3	5.1	5.0	5.0	5.5	5.1	5.0	5.0	5.0	5.0	5.0
Non-farm payrolls, 000	134	202	211	210	180	160	186	190	178	160	160	160	160
Consumer prices	2.7	3.4	2.9	2.9	3.0	2.7	2.7	2.9	2.7	2.9	2.6	2.7	2.6
Core CPI	1.8	2.1	2.4	2.5	2.6	2.7	1.8	2.6	2.8	2.8	2.8	2.8	2.8
Core PCE deflator	1.5	1.6	1.4	1.5	1.9	2.0	1.5	1.7	2.2	2.2	2.2	2.2	2.2
Federal deficit (fiscal yr, \$bn)							-413	-375	-350				
Current account deficit (% GDP)							-5.7	-6.7	-6.5				
Fed funds	1.75	2.25	2.75	3.25	3.75	3.75	2.25	3.75	4.25	4.00	4.25	4.25	4.25
3-month USD LIBOR	2.02	2.56	2.84	3.55	4.00	4.00	2.56	4.00	4.40	4.10	4.20	4.40	4.40
TSY 2-year note	2.53	2.81	3.44	3.90	4.00	4.10	2.81	4.10	4.60	4.25	4.45	4.55	4.60
TSY 5-year note	3.50	3.49	3.89	4.40	4.50	4.60	3.49	4.60	4.90	4.70	4.80	4.85	4.90
TSY 10-year note	4.29	4.16	4.30	4.80	5.00	5.00	4.16	5.00	5.50	5.15	5.25	5.35	5.50

Notes: Real GDP and its contributions are seasonally adjusted annual rates. Unemployment is measured as a percentage of the labor force.

Inflation measures are y-o-y percent changes. Interest rate forecasts are end of period. Payrolls are monthly average changes.

Table last revised April 1. All forecasts are modal forecasts (i.e., the single most likely outcome).

Source: Lehman Brothers

Moderate employment and inflation data support our view that the Federal Reserve Board will continue to hike rates at a measured pace. Momentum in the economy is increasingly beholden to the housing market.

May Day?

The latest data offer
temporary relief from inflation
fears.

With the markets on high alert for signs of inflation, the latest data gave some temporary relief. The core CPI jumped 0.3% in February and investors worried that there would be a similar print from the Fed's favorite measure—the core PCE deflator. In the event, it rose an inconclusive 0.2%. On a year-over-year basis, the core PCE has accelerated from 1% one year ago to 1.6% in March. This is still well within the 1%–2% comfort zone of Governor Bernanke and a number of other FOMC members (Figure 1), but if the 0.2% increases continue, the upper boundary will be breached by the fall.

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LEHMAN BROTHERS

The employment report also points to less hawkish policymaking. Payrolls rose 110,000 in March, roughly half of the consensus forecast, and the data for the prior two months were revised down by 27,000. Wages rose 0.3% on the month—a bit stronger than expected—but are still increasing at a moderate 2.6% year-over-year pace. Although the unemployment rate did fall two-tenths to 5.2% in March, the improvement just offsets the mysterious two-tenths increase in February. All of this adds up to a measured improvement in the labor market.

Measured data means a “measured” rate cycle from the Fed. Under Mr. Greenspan’s leadership there is a strong bias toward 25-basis-point moves, and shifting to 50-basis-point moves requires some convincing. There is only one set of inflation numbers before the Fed’s May 3 meeting. It would take some very ugly numbers to convince the Fed to break its measured promise and hike by 50 basis points at that meeting.

Toga, Toga

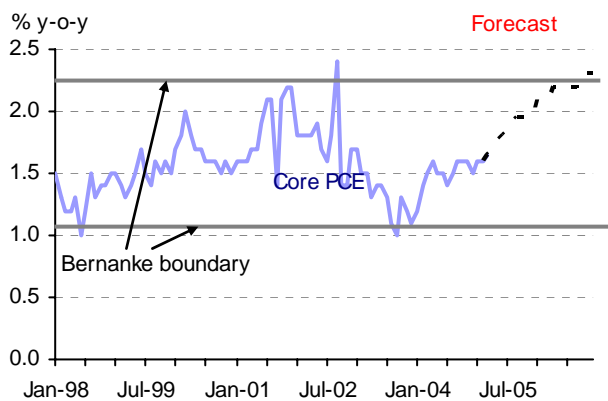
The housing market continues to be a key engine of growth.

We continue to be impressed by the strength of the housing sector and the support it is providing to the overall economy. Residential construction is about 6% of GDP, so the 10% surge in construction last year contributed a solid 0.6 percentage points to GDP growth. However, the bigger story is the indirect impact of the surge in home prices. As we have noted before, a combination of new construction and rapid home price appreciation is driving up the value of housing wealth (Figure 2). The impact on consumers can be illustrated in two different ways.

There is a strong housing wealth effect.

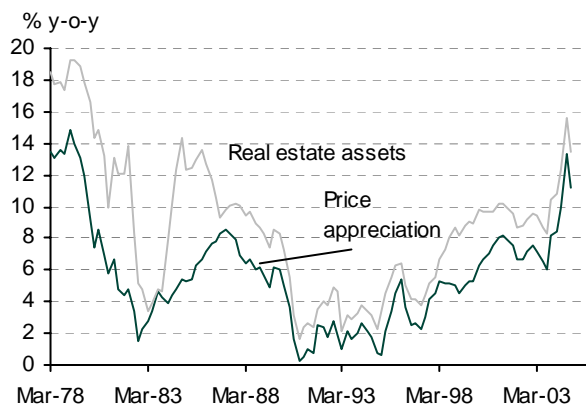
Wealth effect: Studies suggest homeowners increase their annual spending by about \$6 for every \$100 increase in housing wealth, with the impact building over three years. The 2% per year rise in home prices from 1992 to 1994 implied a stimulus to consumption of \$13 billion in 1994. With home prices rising 8% in 2003, the stimulus rose to \$75 billion, and with prices rising 11% last year, the stimulus rose to \$96 billion. If home price appreciation were to stop—and the usual lags applied—then the stimulus would drop back to close to zero over a three-year period.

Figure 1: Core PCE Inflation



Source: BLS and Lehman Brothers

Figure 2: Home Prices and Housing Wealth



Source: Federal Reserve and OFHEO

We estimate that homeowners extracted \$500 billion in home equity last year.

Cash-out effect: In an environment of rising prices there is a strong incentive to “cash out” part of the price appreciation each time a real estate transaction occurs. The most obvious example is when a family refinances its mortgage and takes out a bigger loan. However, the bigger story is the cash-out effect of the normal buying and selling of homes as people change location. In 2004 roughly 6.7 million homes were resold and 1.2 million new homes were purchased. In the process, mortgage debt increased by \$900 billion. We estimate that about \$400 billion of this new debt was used to cover the cost of additions to the stock of homes (\$250 billion) and the general improvement in the quality of the housing stock (\$150 billion). The remaining \$500 billion represents people taking out bigger mortgages when they either changed homes or refinanced.

It is worth noting that the value of mortgages outstanding continues to surge even as waves of refinancing come and go. Over the last four years mortgage debt has grown at an accelerating rate, reflecting both additions to the “real” value of the housing stock and a willingness to take on extra debt (Figure 3). It is hard to know whether this “cash out” is having an impact on spending above and beyond the wealth effect mentioned above. But clearly homeowners are feeling good enough about their wealth position to liquefy part of their assets.

House of Cards?

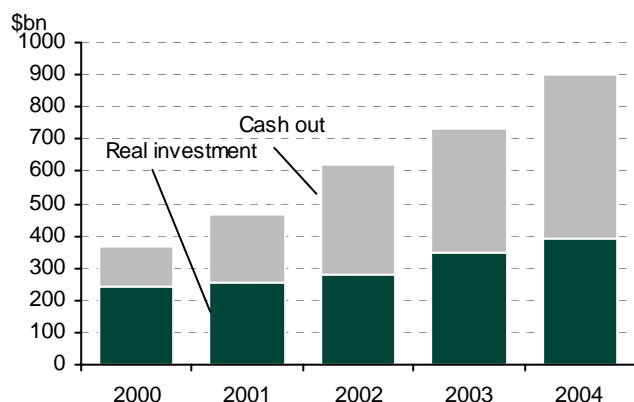
Despite a low savings rate, net worth as a share of income continues to rise.

The worry in all of this, of course, is that it depends on a continued rise in home prices. Despite a personal saving rate of about 1% of income, net worth has increased as a share of income in the last several years and is now roughly on its historic trend line. However, this apparent health is heavily dependent on the housing market. Consider a trend-like world in which income, stock valuations, and the value of unincorporated businesses all grow 6% per year but accumulation of other financial assets increases with the anemic personal saving rate. Based on this, Figure 4 considers three assumptions for quality-adjusted home prices: (1) continued 10% appreciation; (2) flat for four years; and (3) down by 10% followed by flat for three years. Clearly the underlying health of the consumer is very sensitive to home price inflation.

The Week Ahead

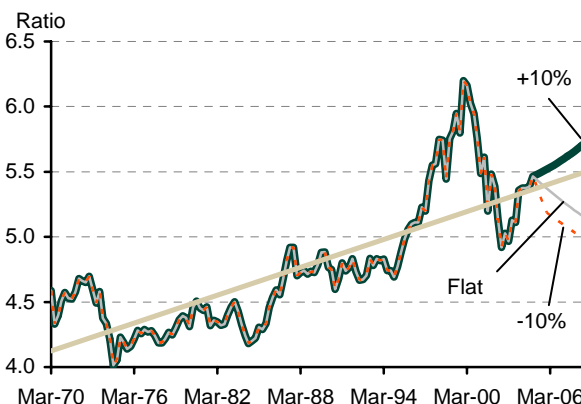
During this fairly quiet week, we expect testimony by Alan Greenspan and John Snow on government-sponsored enterprises such as Fannie Mae and Freddie Mac to attract the most attention.

Figure 3: Decomposition of Change in Mortgage Debt



Source: Federal Reserve and Lehman Brothers

Figure 4: Ratio of Net Worth to Disposable Income



Source: Commerce Department, OFHEO and Lehman Brothers

Data Preview

Non-Manufacturing Purchasing Managers' Index (Tuesday)

We look for the non-manufacturing index to slip in March.

We expect the non-manufacturing purchasing managers' index to dip in March—slipping just over a point to 58.5 (Figure 5). We suspect that higher commodity prices and a sudden spike in the cost of oil has put a temporary damper on non-manufacturers' assessments of current conditions. Nonetheless, at 58.5, the index remains high by historical standards and is broadly consistent with our expenditures-based GDP estimate of 4.5% in 1Q05.

Fed Greenspan (Wednesday)

Mr. Greenspan will testify before the Senate Banking Committee on GSEs.

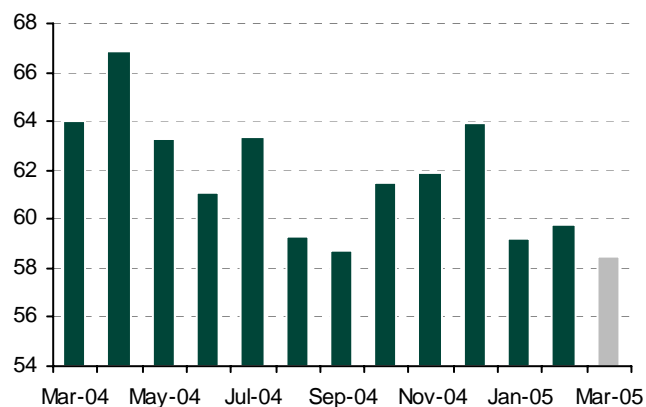
Federal Reserve Chairman Greenspan will testify before the Senate Banking Committee on government-sponsored enterprises. Although Mr. Greenspan's remarks are outside the scope of monetary policy and economic forecasting, we expect his commentary to attract attention in some markets (Figure 6).

Accounting issues have attracted regulatory scrutiny over GSEs, particularly Fannie Mae, forcing the resignation of several top officials at the company. Some members in Congress are concerned that the implicit bail-out guarantee enjoyed by enterprises like Fannie Mae gives them an unfair competitive advantage over traditional mortgage lenders and indirectly encourages these firms to take on more risky loans than otherwise. Some critics are arguing that growth in their balance sheets should be severely curtailed.

By contrast, others note that rising home-ownership rates are directly attributable to mortgage securitization undertaken by GSEs. Without this activity, they argue, mortgage rates would be considerably higher, effectively pricing out a significant portion of U.S. households. Since the stated mission of these GSEs is to increase home ownership and to make it more affordable, any limitation on the growth of its portfolio would have unintended negative consequences for the U.S. housing market.

The Federal Reserve has tended to be critical of the GSEs. Economists at the Board of Governors estimate that the impact of loan securitization on borrowing costs and home-ownership rates is relatively small. In past appearances, Mr. Greenspan has said that he would prefer some limitation on the expansion of GSE balance sheets.

Figure 5: Non-Manufacturing PMI



Source: Institute of Supply Management and Lehman Brothers

Figure 6: Agency Spreads



Source: Lehman Brothers Index Group, All Agency Spread Index

Initial Jobless Claims (Thursday)

We look for jobless claims to fall by 10,000 to 340,000 in the week of April 2. Last week's seasonal factor revision upped the recent trajectory of the series, increasing the March level of jobless filings.

Wholesale Inventories (Thursday)

We expect wholesale inventories to rise 0.8%.

We expect wholesale inventories to rise 0.8% in February, following a 1.3% increase in January. Stockpiles are rising for a number of reasons. First, strong sales and years of lean accumulation have pushed inventory levels uncomfortably low relative to sales. Second, rising commodity prices are increasing the dollar value of stockpiles, and encouraging wholesalers (but particularly manufacturers) to stock up on in-demand commodities, such as steel, chemicals, and plastics, so that there are no interruptions in their production process. We expect overall inventories (including retailing and manufacturing) to add 0.4% to 1Q05 GDP growth.

Treasury Secretary Snow (Thursday)

Mr. Snow also will testify on GSEs.

Treasury Secretary Snow will pick up where the Federal Reserve Chairman left off. Mr. Snow will appear before the same senate committee to testify about increased regulation of the GSEs. Late last week, Mr. Snow was quoted as advocating some limitation on GSE balance sheets, but he was less detailed than Mr. Greenspan has been.

Fed Santomero (Thursday)

Mr. Santomero will discuss monetary policy.

Philadelphia Federal Reserve President Santomero will discuss the implementation of monetary policy at a conference of economists. The topic of his speech is "What do we know and when do we know it?" We suspect that Mr. Santomero will avoid discussing current monetary policy; rather, he will likely dwell on the inherent uncertainties and lags in setting policy.

Consumer Credit (Thursday)

We look for consumer credit to post another sizeable increase this month. Credit is expected to increase by \$9.0 billion in February, following an increase of \$11.5 billion in January. The combination of still low financing costs and solid optimism about future income growth has kept consumers borrowing—even though most of the acceleration in consumer debt over the past two years has come from mortgages.

Fed Greenspan (Friday)

Federal Reserve Chairman Greenspan rounds off the week by delivering remarks at a consumer affairs conference. We do not anticipate any commentary regarding current policy or the economic outlook. To the extent that he does mention the current state of household balance sheets, we expect the Chairman, as in previous remarks, to be fairly optimistic, noting the still solid growth in assets and net worth.

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