

U.S. ECONOMICS

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Arnold and Alan Want to Pump You Up

Outlook at a Glance...

%	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	2003	2004	2005
Real GDP	4.5	2.8	3.3	3.7	3.0	3.3	3.0	4.2	3.3
Domestic final sales	4.1	3.6	3.6	4.1	2.9	3.2	3.6	4.4	3.6
Inventories	1.2	0.7	0.3	0.1	0.1	0.1	-0.1	0.6	0.1
Net trade	-0.8	-1.5	-0.6	-0.5	0.0	0.0	-0.5	-0.7	-0.4
Unemployment rate	5.6	5.6	5.4	5.2	5.2	5.2	6.0	5.5	5.2
Non-farm payrolls, 000	198	224	150	170	155	155	-5	186	160
Consumer prices	1.8	2.8	2.8	3.1	2.7	2.0	2.3	2.6	2.2
Core CPI	1.3	1.8	1.8	2.1	2.1	1.9	1.5	1.8	2.0
Fed funds	1.00	1.25	1.75	2.00	2.00	2.25	1.00	2.00	2.75
TSY 2-year note	1.66	2.43	2.40	2.60	2.70	2.80	1.83	2.60	3.20
TSY 5-year note	2.97	3.71	3.40	3.60	3.70	3.80	3.19	3.60	4.10
TSY 10-year note	4.00	4.58	4.20	4.40	4.50	4.60	4.27	4.40	4.80

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

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

Table last revised 27 August. All forecasts are modal forecasts (ie, the single most likely outcome).

Greenspan faithfully
presented the "glass half full"
view of the economy...

One of the most notable comments on the U.S. economy this year came from California Governor Arnold Schwarzenegger. Speaking at the Republican convention he said: "To those critics who are so pessimistic about our economy, I say: 'Don't be economic girlie men!'" In a less colorful way, Fed Chairman Alan Greenspan is also trying to talk up the economy. With still fragile confidence and less-than-full employment, the Fed does not want to undercut the recovery with pessimistic talk. Hence, in his latest testimony to Congress, he faithfully presented the "glass half full" view of the economy. The economy hit a "soft patch" earlier in the year, "related, in large measure, to this year's steep increase in energy prices," but recent data suggest the economy has "regained some traction." The coded message to Wall Street: another rate hike is coming.

...and the markets have
taken the hint, pricing in a
25-basis-point hike.

The market has heeded the Fed's warning, and now sees almost a 100% chance of a 25-basis-point hike at the September 21 meeting (Figure 1, next page). In other words, the Fed has done a great job of telegraphing its next move. In the run-up to an election, the last thing the Fed wants to do is surprise the markets on the day of the meeting and thereby draw

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attention to itself. Looking further ahead, investors have very little confidence in the outlook and are pricing in a funds rate of anywhere from 1.75% to 3.25% at the March 2005 FOMC meeting. We are more optimistic. Once the election is over, with likely continued moderate growth and inflation, we expect the Fed to drop its “measured” mantra and adopt a “wait and see” attitude. The market sees about a 20% probability of a 3%-plus funds rate by March. We think the likelihood of such an outcome is close to zero: such an aggressive tightening is possible only if the Fed hikes rates at each of the next five meetings, including one or more 50-basis-point hikes.

Serial Soft Patch

The soft patch theory puts too much emphasis on oil prices.

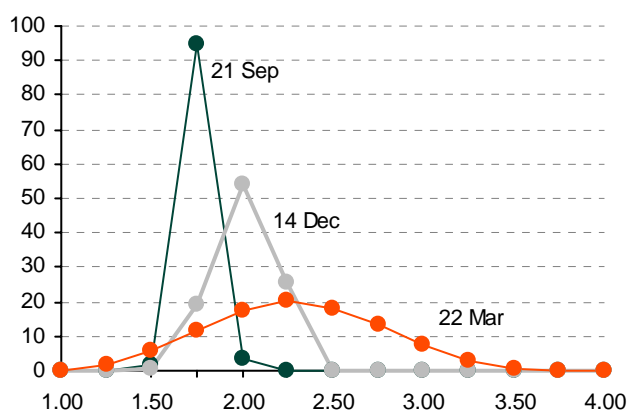
The problem with the soft patch theory is that it puts too much emphasis on the run-up in oil prices. A series of factors are weighing on growth:

- **Refi regression:** the stimulus from mortgage cash is already fading.
- **Nothing from zero:** after years of bargains, special financing deals for consumer durable products are losing traction.
- **Election angst:** a negative campaign and fear of terrorism in the run-up to the election could be crimping corporate confidence.
- **Fiscal fade:** after adding more than a percentage point to domestic spending in each of the last three years, fiscal policy turns neutral in January.
- **Housing hiatus:** the housing market is overextended in every respect—turnover, construction, and pricing—and a correction is just a matter of time.

Our wimpy conclusion: trend-like growth.

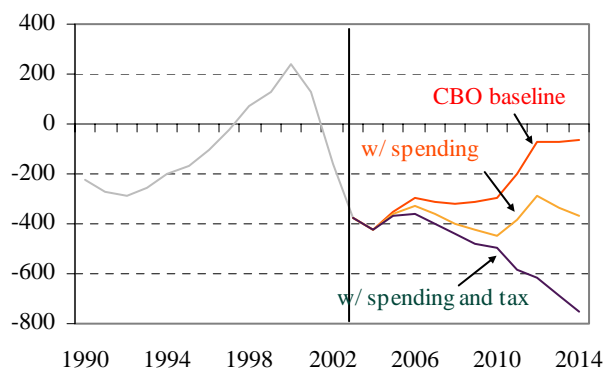
Not all is doom and gloom. The soft patch has not been that soft: recent data are consistent with trend-like growth. Hopefully, the shock from oil prices will continue to fade. After November, the airwaves will no longer contain election vitriol. In addition, the business side of the economy is in excellent shape, suggesting continued solid hiring and capital equipment spending, even as the consumer cools off. Our wimpy conclusion: trend-like growth.

Figure 1: Fed Funds Rate Probabilities (%)



Source: Lehman Brothers' FESISCOPE model

Figure 2: Federal Budget Balance (\$ billions)



Note: Chart takes CBO baseline and then adds the impact of discretionary spending growing with GDP and then the impact of not allowing tax cuts to expire.

Source: CBO and Lehman Brothers

Fiscal Fiasco

Absent new policies, the deficit will likely plateau at \$300 billion.

Greenspan's testimony and the latest report from the Congressional Budget Office underscored the poor outlook for fiscal policy. The CBO lowered its deficit estimate for this year from \$477 billion to \$422 billion. That amount is still a record in dollar value, but at 3.6% of GDP, it is much less than the deficits in the late 1980s. Looking ahead, the CBO threw cold water on the idea that the deficit will go away on its own. Assuming no change in tax laws and assuming that discretionary spending grows in line with inflation, we believe the deficit will fall to about \$300 billion by 2006 and then sit there until the tax cuts expire.

The deficit is likely to be higher than the baseline, regardless of who wins the election.

Unfortunately, the actual deficit is likely to be worse than the baseline regardless of who wins the election. In our opinion, neither candidate offers a credible plan to stop the double-digit growth in spending. Each talks of restraint in a general sense, but then offers up a new laundry list of programs. If discretionary spending grows in line with nominal GDP, it adds \$180 billion to the 2011 deficit (Figure 2). Kerry talks of rescinding the tax breaks for high-income tax payers (which under current law would expire in 2011 anyway), but offers a health care proposal that would cost at least twice as much. Bush wants to make the tax cuts permanent (adding more than \$200 billion to the 2011 deficit), to index the Alternative Minimum Tax to inflation (adding \$60 billion), and to create private accounts for Social Security (each dollar in these accounts adds an equal amount to the deficit).

Supply-Side Silliness

Economists have provided intellectual cover for the loss of fiscal discipline.

While Greenspan and the CBO warn of the risks of high deficits, some economists have provided intellectual cover for politicians by taking sensible ideas and blowing them out of proportion. In the 1960s and 1970s, the intellectual cover came from a misuse of Keynesian economics. Keynesians argued that *temporary* budget deficits should be used to fight recessions. However, in the hands of politicians, this argument became an excuse for growing government and chronic deficits.

Sensible supply-side arguments have been blown out of proportion.

Today, we believe supply-siders are providing a new excuse for undisciplined fiscal policy. Supply-side economists correctly point out that taxes distort economic behavior and reduce the incentive to work and to invest, particularly when tax rates are high. This simple truth has spawned a number of myths, in our opinion:

- Tax cuts can "pay for themselves." The consensus of the literature is that this claim is true only in extreme cases of tax distortions.
- The recent tax cuts have prevented an even weaker economy by stimulating a surge in work effort and entrepreneurial energy. This effect may happen in the long run, but in the short run, the labor force participation rate has fallen, worker hours have been sluggish, the capital spending recovery has been slow, IPO activity has been weak, and so on. Meanwhile, consumer spending has boomed. It sure looks to us like a Keynesian demand stimulus, not a supply-side stimulus.
- Deficits do not hurt the economy. With the Fed pushing down interest rates and Asian central banks supplying plenty of credit to the United States, interest rates have remained low, despite the deficits. However, in the long term, the switch from taxes to borrowing damages the economy, lowering national saving and investment and increasing external debt. A tax cut financed by borrowing rather than spending cuts usually does more harm than good to the long-run growth potential of the economy.

The Week Ahead

Anemic growth in nonauto retail sales and a further leveling off in the core CPI are unlikely to stop the Fed in its tracks, with another 25-basis-point rate hike expected on September 21. Industrial production is likely to get a boost from the solid August employment data.

Data Preview

Current Account Balance (Tuesday)

We look for another significant widening in the current account deficit.

The current account deficit should rise again, to \$160bn in Q2, up from Q1's \$144.9bn deficit (Figure 3). The lion's share of the deficit is already known, as the three months of merchandise trade deficits from April to June add up to roughly \$150 billion. Adding in the other two components of the current account—net unilateral transfers and net investment income—should push up the deficit another \$10 billion, as the usually negative transfer component likely will be offset somewhat by surprisingly positive investment income.

Retail Sales (Tuesday)

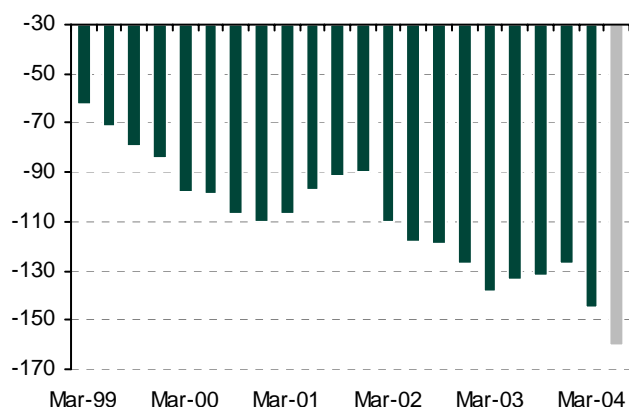
Retail sales are projected to decline by 0.2%.

We look for retail sales to lose ground in August, slipping 0.2%, compared with a 0.7% increase in July. Excluding autos, we look for a gain of just 0.2% (Figure 4). While the August outturn is undeniably on the soft side, the figures are probably not weak enough to prevent the Fed from raising rates at their upcoming September meeting. Instead, it looks as if real consumer expenditures will manage to post at least a 3% increase in 3Q.

Downside risks predominate.

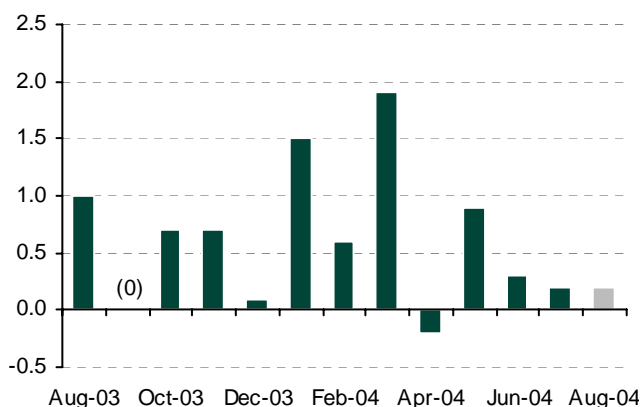
However, downside risks predominate. Hurricane Charley probably kept shoppers along the East Coast too busy preparing for the storm (or cleaning up afterwards) to have much time to shop for clothing, computers, and back-to-school supplies. Any effect from increased purchases of hardware for repairs is more likely to show up in the September retail sales figures as it takes a while for households to get organized and to receive any insurance proceeds. Gasoline prices remain high, with some shoppers forced to pay more than \$50 a week to fill up their tanks. This added expense is likely causing households to rein in their discretionary spending somewhat. Consumer confidence measures have retreated in August, with households reporting growing unease about the status of the labor market. Geopolitical security and presidential election uncertainties are further undermining consumer confidence and sapping the will of shoppers to spend.

Figure 3: Current Account Balance (\$ billions)



Source: Commerce Department and Lehman Brothers

Figure 4: Nonauto Retail Sales (% month over month)



Source: Census Department and Lehman Brothers

Weakening income growth in recent months is probably also contributing to the softer tone in retail consumption lately. Growth in wages and salaries remains sluggish—averaging between 2.0% and 2.5% in the past year. The fading of last year's tax cut, together with the reduction in home refinancing, has meant that households are no longer able to offset the softness in their wage income or the effect of higher energy prices. Given the level of anxiety in the household sector, we doubt that they have been willing to ramp up their credit card balances either.

Auto sales were disappointing.

Auto sales exemplify some of these downside risks. Although the volume of sales remains vigorous by historical standards at 16.7 million units, they were about 2.6% less than the extremely robust July level. Sales were artificially inflated by fleet sales (rental, police, and taxi cab vehicles) and very aggressive incentive packages, reaching as much as \$6,000 a model. The litany of downside headwinds seems to have offset these stimuli. As a result, we look for sales at auto dealers to fall by 1.5% in August.

Business Inventories (Wednesday)

We expect business inventories to rise by 0.6%.

Business inventories likely rose 0.6% in July, slightly less than June's 0.9% gain. Both manufacturing and wholesale stockpiles were strong in the month—up 0.8% and 1.3%, respectively. We believe that the latter were driven sharply higher by rising energy prices that boosted valuations, rather than a strong increase in physical stocks. Retail stockpiles are expected to post a smaller gain this month—consistent with the recent pattern whereby most of the buildup seems to be occurring at the earliest stages of production. However, we expect firms to be slightly more cautious in accumulating inventories for the remainder of the year, as risks to demand persist.

Empire State Survey (Wednesday)

We expect the Empire State manufacturing survey to rebound in September following an unusually steep decline in August. We look for the index to rise from 12.6 to 18.0 this month. Regionally, manufacturing conditions appear solid, with the Beige Book noting expanding activity in all regions, except St. Louis. In addition, while the Beige Book was compiled before September, we think that much of the regional strength carried over into this month's Empire State reading.

Industrial Production (Wednesday)

Industrial production is expected to rise 0.7%.

We expect industrial production to rise by 0.7% in August, following a 0.4% increase in July. Capacity utilization is projected to rise by 0.5% to 77.6%. At 77.6%, the utilization rate is still a long way from its historical inflationary threshold of 81%.

The strength in this month's industrial production reading primarily reflects an improvement in manufacturing output. In August, the aggregate hours index for manufacturing rose 0.3%; driven higher by the continued pick-up in manufacturing employment. Adding in the sector's very rapid rate of productivity growth, factory output should easily rise by 0.6% in August.

However, we do not project the rapid gain in manufacturing output to be shared by all sectors. Rather, we look for auto output to shrink another 1% in the month as inventory levels continue to rise and as worries about the sustainability of sales prompt manufacturers to rein in production slightly. Motor vehicle production has been steadily decelerating since February (Figure 5). Rising output is instead expected to come from high-tech and business equipment production. However, unless new orders and capital investment start to accelerate soon, these sectors may also succumb before long.

Outside of the manufacturing sector, we look for seasonable weather to push utility output up 1.5% in August. The sustained increase in energy prices has probably been long enough now to prompt some slight acceleration in mining output. We look for mining output to rise by

1.0% in the month, which would still leave the sector up 1.3% year over year (compared with the more than 6% year over year gain in manufacturing output during the period).

Budget Balance (Wednesday)

August will benefit from calendar effects that shifted entitlement payments at the beginning of the month. As a result of this shift and the continued strength of individual tax receipts, we look for the Treasury to announce a deficit for the month of just \$45 billion, more than a \$30 billion improvement from last year, but one that is consistent with our forecast for a fiscal year 2004 budget deficit of \$425 billion.

Initial Jobless Claims (Thursday)

We look for jobless claims to rise to the 335,000 level in the week of September 11. However, our forecast is largely a guess, as hurricanes and seasonal factor distortions have made projecting first-time filings for unemployment insurance extremely difficult. Our assumption is that the "true," or underlying trend in jobless claims, is about 335,000, which is close to the series' four-week moving average.

CPI (Thursday)

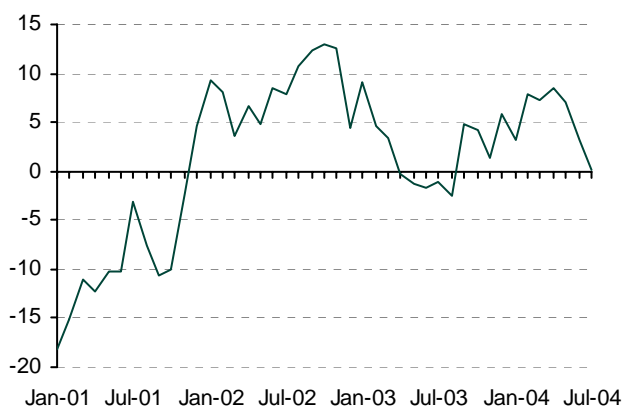
The CPI is expected to rise by 0.2%, with the core up 0.1%.

Energy prices have been somewhat of a mystery lately.

We look for the CPI to rise by 0.2% in August, with the core expected to rise by only 0.1%. On a year-over-year basis, the core CPI would be up 1.8%, having plateaued at this annual rate since April (Figure 6). As with other measures of nonfood, nonenergy inflation, the core CPI has decelerated since the spring spike. Coupled with the slowing in the employment and retail sales measures, another benign reading on the core CPI adds to the case for the Fed moving to the sidelines later this year.

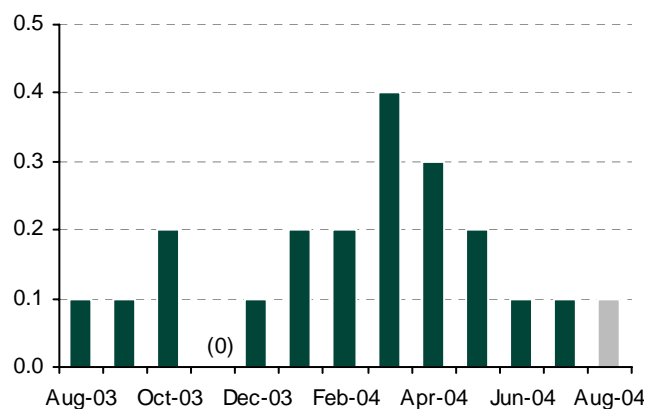
Among the components, we look for energy prices to slip 0.2%, following a nearly 2% decline in July. Lower energy prices are somewhat of a mystery, given the recent behavior of oil prices. Indeed, very little of the surge in oil prices this summer has been passed through to home heating oil or gasoline prices. Instead, after peaking at more than \$2.00 a gallon in May, gasoline prices have steadily drifted lower. Survey data from the Department of Energy and the American Automobile Association point to a decline in gasoline prices of between 0.6% and 3.5%. We have conservatively assumed that gasoline prices will fall 1.5% this month. Some of the decline, however, will be offset by a modest expected uptick in natural gas and electricity prices of 0.8%, in our opinion.

Figure 5: Motor Vehicle Production (% year over year)



Source: Federal Reserve and Lehman Brothers

Figure 6: Core CPI (% year over year)



Source: Bureau of Labor Statistics and Lehman Brothers

The traditional relationship between gasoline and oil prices seems to be re-establishing itself.

We doubt that the mysterious divergence between oil and gasoline prices reflects a timing issue resulting from the time it takes to convert oil into gasoline. The divergence between gasoline and oil prices has now been in place since May—far too long to be just a pass-through story. Instead, we think that gasoline prices this spring were pushed above the levels warranted by the level of oil prices because of unusually tight refinery capacity and speculative fears. However, as gasoline imports have surged and the summer driving season has ended, some of the speculative furor seems to come out of both prices. Now it seems that the traditional link between them is being re-established.

Core prices should be fairly restrained in August.

At the core level, we expect prices to be fairly restrained. Terrorist threat worries probably made August a difficult month for hotels and airlines to pass along price increases. Consequently, we look for lodging away from home to rise by just 0.3% in the month, with airfares up a similarly muted amount. Despite their relatively low overall weight in the CPI core, these two measures contributed significantly to the acceleration in the index earlier this year. While there is no guarantee that the recent deceleration in the core measures of inflation is not an aberration, we believe that the increases registered in these two components were more rebounds in the level of prices from super-depressed, post-September 11 levels, rather than a pick-up in their rate of growth. Likewise, we look for apparel prices to decline by 0.1% in August, stabilizing after what appears to have been a level shift upward this spring.

Elsewhere, we expect new vehicle prices to fall by 0.1% in August and used vehicle prices to post a trend-like gain of 0.2%, although given their 1.1% surge last month, we would not rule out a sharp decline. Forecasting new vehicle prices is complicated by the fact that while manufacturers are offering extremely generous incentives (in some cases up to \$6,000 a vehicle) and super-low financing rates, they have also been ramping up the underlying prices of their vehicles. This probably will not have much of an effect on the core CPI this month; however, several manufacturers already announced plans to push up the base price on their 2005 models. How successful this strategy (and ultimately the effect on the core CPI) will be remains to be seen.

Finally, we look for the not seasonally adjusted CPI to rise by 0.2% to 189.7 in August. The seasonal factors at this time of the year are generally small.

Philadelphia Fed Survey (Thursday)

The Philadelphia Fed index is expected to slip to 25.5.

We expect the Philadelphia Fed's Business Outlook Survey of regional activity to slip slightly in September, to a still-strong 25.5. The manufacturing sector has been the shining star of the recovery, exhibiting relatively steady expansion in a recovery plagued by a series of ups and downs. We expect this trend to continue. Among the report's components, we look for a slight retrenchment in the prices paid and expected prices indexes, as prices for energy and energy-intensive inputs have fallen in recent weeks.

Consumer Sentiment (Friday)

Consumer sentiment is expected to inch higher in early September.

We look for a slight relief rally in the confidence measures now that the Olympics and Republican National Conventions are over. How much this factor will impact the University of Michigan's measure of consumer sentiment is unclear. We think that these psychological factors will boost the index by about a point in early September—from 95.7 at the end of August to 96.5. After all, households are still struggling with the uncertainties associated with a very tight presidential race and a sluggish labor market, in which wage growth remains soft.

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