

U.S. ECONOMICS

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A Relatively Slow Data Week...

Outlook at a Glance...

| % | 3Q04 | 4Q04 | 1Q05 | 2Q05 | 3Q05 | 4Q05 | 2004 | 2005 | 2006 |
|------------------------|------|------|------|------|------|------|------|------|------|
| Real GDP | 4.0 | 4.0 | 3.0 | 3.4 | 3.7 | 3.7 | 4.4 | 3.6 | 3.5 |
| Domestic final sales | 5.1 | 4.0 | 3.2 | 3.4 | 3.4 | 3.5 | 4.6 | 3.7 | 3.4 |
| Inventories | -1.0 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.5 | 0.1 | 0.0 |
| Net trade | -0.1 | -0.5 | -0.2 | 0.0 | 0.2 | 0.2 | -0.6 | -0.2 | 0.1 |
| Unemployment rate | 5.4 | 5.4 | 5.2 | 5.2 | 5.2 | 5.2 | 5.5 | 5.2 | 5.2 |
| Non-farm payrolls, 000 | 103 | 200 | 165 | 165 | 160 | 160 | 178 | 163 | 159 |
| Consumer prices | 2.7 | 3.5 | 3.0 | 2.6 | 2.6 | 2.6 | 2.7 | 2.7 | 2.5 |
| Core CPI | 1.8 | 2.2 | 2.3 | 2.3 | 2.5 | 2.5 | 1.8 | 2.4 | 2.7 |
| Fed funds | 1.75 | 2.25 | 2.50 | 2.75 | 3.00 | 3.25 | 2.25 | 3.25 | 3.75 |
| TSY 2-year note | 2.53 | 2.80 | 3.10 | 3.20 | 3.40 | 3.60 | 2.80 | 3.60 | 4.20 |
| TSY 5-year note | 3.50 | 3.55 | 3.70 | 3.90 | 4.10 | 4.30 | 3.55 | 4.30 | 4.80 |
| TSY 10-year note | 4.29 | 4.40 | 4.40 | 4.40 | 4.70 | 5.00 | 4.40 | 5.00 | 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 24 December. All forecasts are modal forecasts (ie, the single most likely outcome).

Source: Lehman Brothers

The tsunami disaster has dominated headlines this week.

The typically slow week between Christmas and New Year's has unfortunately been dominated by the horrible headlines from the Asian tsunami. Our economics team based in Tokyo writes that although the tsunami is a major disaster with terrible social consequences, the impact from a narrow macroeconomic perspective is likely to be relatively minimal, with damage to tourism and fishing industries.

Interestingly, measures of consumer attitudes from the Conference Board, the University of Michigan, and the ABC/Money Magazine surveys are now all at essentially the same levels as they were in the middle of the summer. They dipped down around the election but have recovered at the end of the year.

Meanwhile, retailers are reporting slightly better news around the holiday shopping season after a mixed beginning. On-line purchasing and luxury items have enjoyed a consistently

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solid Christmas season. Meanwhile, other retailers began discounting aggressively and sooner as shopping got off to a slow start, but purchasing appears to have recovered a bit. With gift cards playing an ever-larger role, more and more holiday shopping has been occurring after Christmas. But on net, the holiday news does not do much to change our near-term macroeconomic outlook.

Key Themes in the Weeks Ahead

Modest gains in payrolls, subdued inflation, and what looks so far to be only a ho-hum holiday shopping season suggest the Fed can still afford to maintain a measured pace.

Construction Expenditures (Monday)

Construction expenditures are expected to rise 0.5%.

November construction expenditures should rise 0.5%. The key impetus should be increases in residential construction, which has fallen surprisingly in the past two months despite the strong tone of the housing data. Combined with decent commercial and industrial construction activity and increased public construction, which has grown in four out of the past five months, total construction expenditures should show a solid gain.

ISM (Monday)

The ISM is expected to retreat in December.

We look for the national ISM to slip to 56.5 in December from 57.8 in November (Figure 1). This would be the lowest monthly reading for the national purchasing managers' index since September 2003. Nevertheless, with the index still above the critical 50 threshold, the factory sector continues to expand, although at a slower rate.

Among the sub-indexes, we look for the employment index to retrench in December, as other indicators, like the Manpower hiring intentions survey, point to some lingering softness in factory hiring. The new orders and production indexes are also expected to cool in December. Meanwhile, the price index is expected to hold steady at 74.0 this month, as lower energy prices offset an acceleration in other commodities.

Fed Lacker (Monday)

Richmond Federal Reserve President Lacker returns on the first business day of the New Year to outline his expectations for economic growth and inflation. As with his earlier remarks, we expect Mr Lacker to emphasize the healthy state of the economy and persistent worries about overly accommodative policy leading to a pick-up in inflation.

Factory Orders (Tuesday)

Factory orders should grow 0.8% in November, a bit faster than October's 0.5% gain. We expect growth in the durable goods half of the report, and we look for the usually less-volatile non-durable goods portion to slow this month, rising 1% after registering a 2.4% surge in October that was likely related to higher energy prices.

Domestic Vehicle Sales (Tuesday)

Auto sales are expected to rebound.

A number of manufacturers ramped up incentives in December in order to prevent sales from falling as they did in November. We therefore look for domestic auto sales to rise to 13.0 million units, from 12.8 million last month. However, at the time of writing, it was unclear how much of a rebound was likely to occur in sales or if it would be matched by foreign manufacturers, some of whom, without domestic assemblies, are suffering as the dollar declines. Nevertheless, it still looks to be a fairly solid month for overall vehicle sales which, once again, should easily top 16.0 million units, averaging an extremely vigorous 16.7 million units for the year.

Non-Manufacturing PMI (Wednesday)

We expect to see little change in the December non-manufacturing ISM reading, which is reckoned to have slipped a touch from 61.3 to 61.0.

Initial Jobless Claims (Thursday)

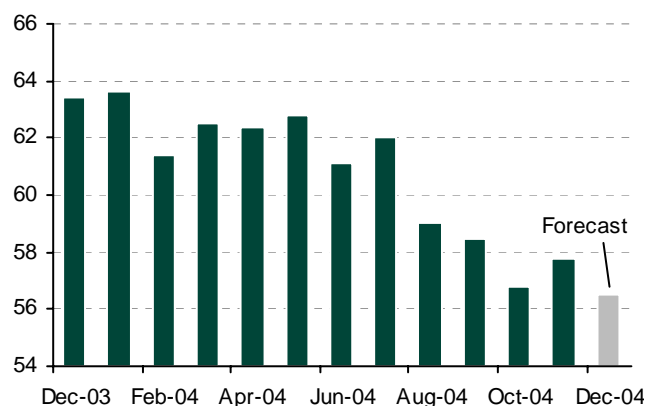
We look for jobless claims to move up slightly from 326,000 to 335,000.

Employment (Friday)

Non-farm payrolls are expected to rise by 175,000.

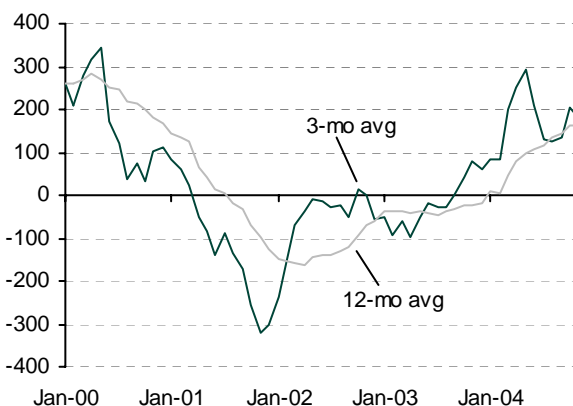
We look for non-farm payrolls to rise by 175,000 in December, which should keep hiring on track to average 185,000 this year and in line with the pace over the past three months (Figure 2). Early in December, the jobless claims figures moved above the 350,000 mark for the first time in several months, which, if this is the start of a new trend in layoffs, could signal a weaker pace of overall payroll growth. However, the relationship between the two series has been weak and misleading recently.

Figure 1: ISM



Source: Institute of Supply Management and Lehman Brothers

Figure 2: Non-Farm Payrolls (change, 000)



Source: Bureau of Labor Statistics and Lehman Brothers

With the holiday shopping season starting off on a somewhat indifferent note, we expect that retail and temporary help employment will be on the soft side this month. By contrast, we look for fairly solid growth in construction employment and in service sector hiring outside of retailing.

A solid gain of 175,000 this month should be enough to bring the unemployment rate down by one-tenth to 5.3%. However, given the inherent volatility in the household data and the super-charged 400,000-plus gain in November household employment and labor force data, we cannot rule out a reversal in the unemployment rate this month. Indeed, one of the surprising features of this recovery has been the large gap between the household and payroll figures that cannot be accounted for strictly based on definitional differences.

After last month's surprising decline in the non-farm work week and its surprisingly low level relative to the recession trough reading of 33.6 hours, we look for the work week to bounce higher this month from 33.7 to 33.8 hours. The anticipated increase in the non-farm work week along with the projected gain in payrolls points to a 0.4% increase in the aggregate hours index this month, which itself looks set to rise 2.2% this quarter. Meanwhile, we look for average hourly earnings to increase by 0.2%, or 2.7% for the year.

Consumer Credit (Friday)

We look for consumers to add \$6.5 billion to their installment borrowing in November, a slightly slower rate than in October. Auto sales were weaker in the month which suggests fewer auto-related loans, but consumers likely financed at least a portion of November's 0.5% gain in retail sales with their credit cards. As auto dealers offer increased incentives to boost winter sales, we could see a pick-up in consumer credit in the coming months.

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