U.S. ECONOMICS

Ethan S. Harris 1.212.526.5477 eharris@lehman.com

Cautious Christmas

Outlook at a Glance...

%	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	2003	2004	2005
Real GDP	4.5	3.3	3.9	4.0	3.0	3.5	3.0	4.4	3.6
Domestic final sales	4.1	3.6	5.1	4.0	3.2	3.5	3.6	4.6	3.7
Inventories	1.2	0.8	-0.9	0.5	0.0	0.0	-0.1	0.5	0.1
Net trade	-0.8	-1.1	-0.3	-0.5	-0.2	0.0	-0.5	-0.6	-0.2
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	209	103	225	165	165	-5	184	163
Consumer prices	1.8	2.8	2.7	3.5	3.0	2.4	2.3	2.7	2.6
Core CPI	1.3	1.8	1.8	2.2	2.3	2.1	1.5	1.8	2.4
Fed funds	1.00	1.25	1.75	2.25	2.50	2.75	1.00	2.25	3.25
TSY 2-year note	1.66	2.43	2.53	2.80	2.90	3.00	1.83	2.80	3.30
TSY 5-year note	2.97	3.71	3.50	3.55	3.65	3.80	3.19	3.55	4.20
TSY 10-year note	4.00	4.58	4.29	4.40	4.40	4.40	4.27	4.40	5.00

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 3 December. All forecasts are modal forecasts (ie, the single most likely outcome).

Source: Lehman Brothers

Payrolls surprised yet again in November, rising just 112,000 with net downward revisions of 54,000 to the prior two months. The up-down pattern of recent data still average out to above-trend job growth. Fourth quarter GDP growth is shaping up a little stronger than we had expected, and we are revising up the quarter from 3.5% to 4%. The revision reflects strong October indicators and revisions to 3Q inventories, which give room for inventory building in 4Q. Despite the change, our fundamental view remains the same. We expect the economy to slow in the first half of next year as tax incentives for capital spending expire and as the consumer comes down to earth.

Making a List, Checking It Twice

We look for a choppy, cautious Christmas.

While we have revised up 4Q GDP, we do not feel particularly bullish about growth in the coming months. The immediate concern is the holiday shopping season. The season started off on a choppy note, with strong sales on the Friday after Thanksgiving, but weak sales over the rest of the extended weekend. Sales were particularly soft for retailers—such as Wal-Mart Stores Inc.—that did not aggressively discount items or that focus mainly on low- and middle-income customers. The Lehman Brothers index of Broadlines/Department same-store sales rose just 1% in November, which is much less than the 5% trend of the past couple of years.

Retailers would like to believe that the days of a discount-driven consumer are behind them, but a quick run-down of the list of economic fundamentals points to uneven, cautious holiday spending. Overall, we look for sales to rise 4% this holiday season, down from 5.2% last year (Figure 1).

Nice

The biggest boost to sales will come from the solid job market…

The biggest positive factor in this holiday season is the sharp pick-up in the labor market. More than 2 million jobs have been created in the past 12 months, and the 1.7% increase is a huge improvement from the small losses of the previous two years (Figure 3). This swing alone is worth about 2% faster spending. Surveys of purchasing intentions also point to increased sales. For example, the Gallup poll finds that people expect to spend the same amount on gifts as they did last year, but this survey has a downward bias, and historically, a flat reading has been associated with a modest sales gain (compare Figures 1 and 2).

Neutral

…but most indicators are sending ambiguous signals…

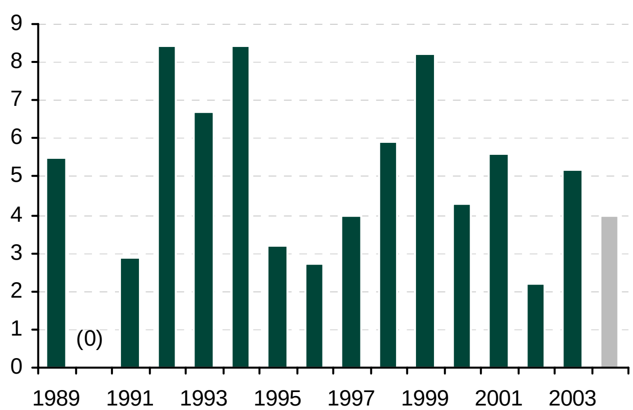
Most indicators are sending ambiguous signals. Judging from the major consumer confidence surveys, consumers are in only a slightly better mood this year than last year. Household net worth is also slightly higher. Interest rates are mixed, with short-term rates higher but longer term rates such as mortgages slightly lower.

Naughty

…and "available income" is growing very slowly.

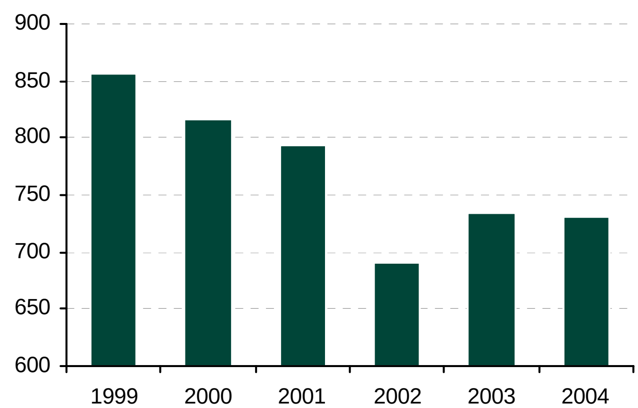
The biggest argument against a strong holiday season is the precarious nature of household balance sheets. While job growth is adding almost two percentage points to income growth, income available for shopping is actually growing much more slowly this year than last. This is the first Christmas in four years where there is no new tax cut boosting disposable income. We estimate that fiscal stimulus added between one and two percentage points to holiday spending in each of the past three years. Moreover, rising food, energy, and medical costs are cutting severely into household budgets. Overall, our measure of "available income" that nets out taxes, food, energy, and medical spending is growing almost two percentage points slower than in the previous holiday season (Figure 4).

Figure 1: Holiday Sales (% year over year)



Note: General merchandise, apparel and furniture, November and December.
Source: Census Department and Lehman Brothers Global Economics

Figure 2: Christmas Spending Plans (mean dollar amount)



Source: Gallup Poll, mid-November, all years

Of course, consumers can circumvent the constraints of income growth by dipping further into savings. However, the personal saving rate has now reached just 0.2% of income, down from its historic norm of about 10%. And while it can go negative (collectively households could borrow more than they invest), we would expect sobriety to kick in at any time.

Stocking Stuffers

Other factors such as the Microsoft dividend should have minor effects.

A number of other factors could affect the shopping season. This year, there are 29 days between Thanksgiving and Christmas, up from 27 days last year. This presumably increases total store sales, although it should not affect the seasonally adjusted data the government reports. Another possible source of extra spending is the $32 billion special dividend payout from Microsoft Corp. last week. However, little of this money is likely to make it to the cash registers. A rational investor will know that the payout lowers the equity value of the company more or less one-for-one with the dividend. Most of the dividend will go to either very wealthy individuals or to mutual funds. There is also some coal in this stocking: December sales will be hurt by the trend toward gift certificates and online shopping.

It Ain't Over 'Til the Fat Man Flies

The consumer has been defying speculation about his demise for some time, but absent the gimmicky stimuli of tax cuts, mortgage-related cash and new even easier lending rules, the consumer is unlikely to be a drag rather than a driver of growth.

The Week Ahead

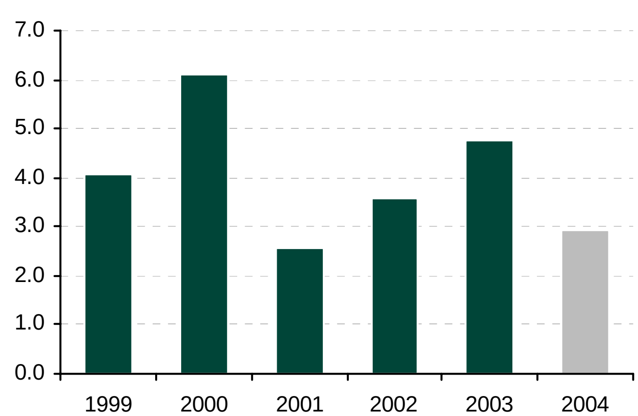
We look for modest, across-the-board gains in inflation indicators this week, with some deceleration in energy prices. Commodity costs are leaking into the core, but spare capacity should prevent a major acceleration.

Figure 3: Holiday Checklist

	Q402	Q403	Latest
Nice			
Unemp rate (%)	5.9	5.9	*5.4*
Non-farm payrolls (%, Nov/Nov)	-0.4	-0.2	*1.7*
Neutral			
Consumer confid (1985=100)	81.7	89.7	*90.5*
Consumer sentiment (1966=100)	83.8	92.0	*92.8*
HH net worth ($tr)	39.6	44.5	*46.5*
Mortgage rate (%)	6.07	5.93	*5.75*
Naughty			
Real disp income (% Oct/Oct)	2.9	3.9	*2.3*
"Available" income (% Oct/Oct)	3.6	4.8	*2.9*
Personal savings rate (%)	1.2	1.3	*0.5*
Gasoline prices ($/gallon)	1.43	1.51	*2.00*

Source: Commerce, Census and Labor Departments, Federal Reserve Board, the Conference Board and the University of Michigan

Figure 4: Available Income (% 4Q/4Q)



Note: Defined as disposable income less spending on food, medical services, and energy.
Source: Commerce Department and Lehman Brothers

Data Preview

TSY Five- and TSY 10-Year Note Announcement (Monday)

The Treasury is expected to come to market this week with an offering of $15.0 billion in five-year notes and $9.0 billion in 10-year notes. The 10s are reopened from the $14.0 billion offered last month at the quarterly refunding.

Nonfarm Productivity (Tuesday)

We look for no revision to nonfarm productivity.

We do not expect the 3Q nonfarm productivity statistics to be revised much, if at all. Productivity cooled in the third quarter—slowing from 3.9% in 2Q to 1.9%. And while the quarterly productivity statistics are highly volatile, the 3Q reading is the slowest rate of increase in output per hour since 4Q02. Recent wage data do not point to any revision to the nonfarm compensation figures, which, in turn should leave unit labor costs up 1.6% in the quarter.

Productivity is expected to cool in 2005.

The 3Q revision is more important for what it might imply about the future trajectory of productivity next year, when GDP growth likely cools from 4.4% to 3.4%. Our sense is that after several years of squeezing in the workforce, overall labor productivity is set to decelerate (Figure 5). We estimate that productivity growth will slow from about 3% currently to less than 2% in 2005 as output growth slows and hours worked increases.

Nevertheless, productivity growth of 2% or so is still robust enough to hold core inflation in check in 2005. Historically, swings in productivity growth have had a much bigger impact on profit growth than on inflation. As a result, while the Fed is likely to be somewhat disappointed by the deceleration in productivity growth, we doubt it will result in a significant acceleration in core price inflation or a more aggressive rate reaction.

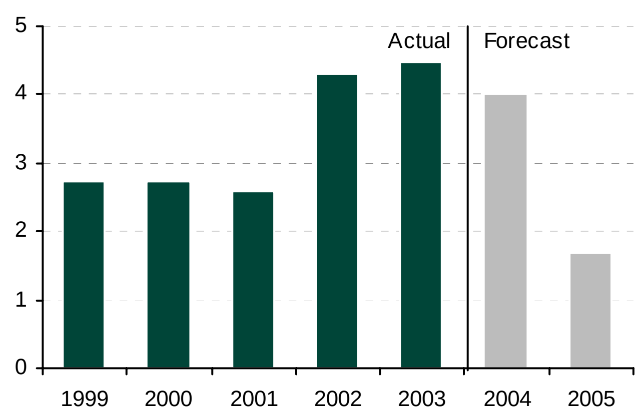
Consumer Credit (Tuesday)

Consumer credit is expected to increase by $3.5 billion.

We expect consumer credit to increase $3.5 billion in October, as consumers continue to add to total installment borrowing, but at a slower pace. Retail sales slowed in the month, and auto sales have not kept up their late-summer steam due in part to fading incentives. This should restrict upward pressure in credit card and auto-related borrowing.

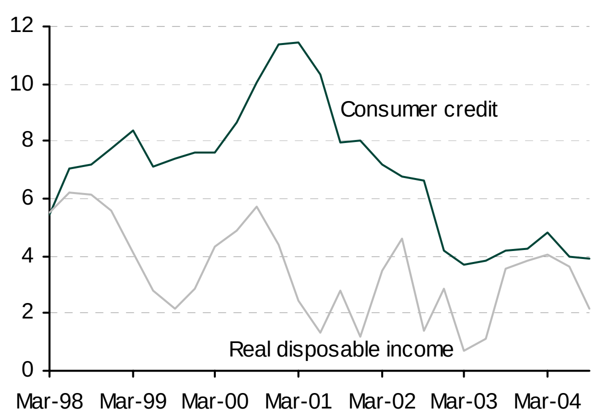
Disposable income may be another part of the story. Every quarter since last fall, Americans have seen growth in their real disposable income of 3.5% or more. In the third quarter, that growth slowed to just 2.1% as the stimulative effect of last year's tax cuts fades (Figure 6).

Figure 5: Nonfarm Productivity (% year over year)



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 6: Consumer Credit (% year over year)



Source: Federal Reserve Board and Lehman Brothers

TSY Five-Year Auction (Wednesday)

The Treasury will auction $15.0 billion in new five-year notes today.

Initial Jobless Claims (Thursday)

We look for jobless claims to fall back to their recent trend level of 335,000 in the first week of December. Claims unexpectedly spiked to 349,000 last week, probably in reaction to the Thanksgiving Day holiday closure of filing offices and seasonal factor difficulties.

Import Prices (Thursday)

Import prices are expected to rise by 0.3%.

We expect import prices to rise 0.3% in November, following a steep, oil-driven surge of 1.5% in October. Excluding petroleum products (but including natural gas), import prices are expected to be flat in the month.

The dollar fell 3.8% in trade-weighted terms in November, which, given long and variable lags, would be expected to boost import prices. Moreover, nonenergy industrial commodity prices, like steel, copper, and lumber rose in the month. However, these effects were likely offset by outright declines in consumer and capital goods prices. Imported consumer goods prices remained essentially flat in recent months with only limited evidence of dollar pass-through effects. This low pass-through helps explain the good behavior of the core CPI. However, this may change in 2005, especially if, as we expect, the dollar continues to head lower.

Wholesale Inventories (Thursday)

Wholesale inventories probably rose 0.7%.

Wholesale inventories likely rose 0.7% in October, as wholesalers attempted to keep stocks in line with sales. As demand has recovered, wholesalers have increasingly found their inventories a bit too lean, with the ratio of inventories to sales persistently stuck at a record low.

TSY 10-Year Auction (Thursday)

The Treasury will auction another $9.0 billion worth of the November 2014 note this afternoon.

PPI (Friday)

The PPI is expected to rise 0.3%; the core 0.2%.

The PPI is projected to rise 0.3% in November, or 4.8% year over year. Excluding food and energy prices, the core PPI is expected to increase by 0.2%, or 1.9% year over year. We believe that the year over year numbers will end the year on a strong note as the readings for November and December 2003 were unusually soft.

Core nonfood, nonenergy prices have been very firm over the past two months, registering gains of 0.3% in both September and October (Figure 7). We think that some of this strength reflects the vagaries of quality adjustment of new auto models, and some payback for an unusually soft core reading earlier this summer. However, it is difficult to pin down exactly what portion of the acceleration is a payback and therefore, how much and how soon it will abate. Our view is that both factors (autos and the payback) have pretty much run their course already, so that the core PPI should rise only 0.2% this month.

Some of the acceleration in core prices might reflect strengthening demand.

However, some of the acceleration in core prices may reflect a pick-up in underlying demand—the same strengthening that has been pushing raw materials and semiprocessed goods higher in the earlier stages of production. Indeed, at the crude core level prices are up 28.3%, while at the intermediate core level prices are up a still disheartening 7.8%. Capital equipment prices have accelerated from 1.0% in April to 1.9%, suggesting that demand for high tech and standard machinery is strong (Figure 8). Whether this demand simmers down at the start of next year when bonus depreciation fades remains to be seen. We look for capital equipment prices to rise by 0.2% compared with back-to-back gains of 0.4% in September and October.

We expect food prices to settle down this month after posting a 1.6% gain in October, which we believe was influenced by the aftermath of the hurricanes in August and September. Likewise, we expect energy prices to decelerate—slowing from a gain of 6.8% in October to 0.7% in November. There were signs of a cooling in gasoline and fuel oil prices in the early part of the month, around the time the PPI survey was conducted. However, natural gas futures remained strong, and given their weight in the PPI energy index, may offset most or all of the slowing in gas and fuel oil.

While we think the Federal Reserve might be able to discount strong food and energy price readings, continued monthly advances in core PPI of 0.3% would not be ignored. Strong inflation would force the Fed to keep hiking at every meeting. As it is, we look for the Fed to raise the funds rate another 25 basis points on December 14.

Consumer Sentiment (Friday)

Consumer sentiment is expected to rebound this month.

Consumer sentiment rebounded by less than expected in November, but with another month's worth of improving labor market data, solid stock prices, and the election fading into history, we expect the index will rise in early December. The early December reading on consumer sentiment is expected to rise from 92.8 to 95.0.

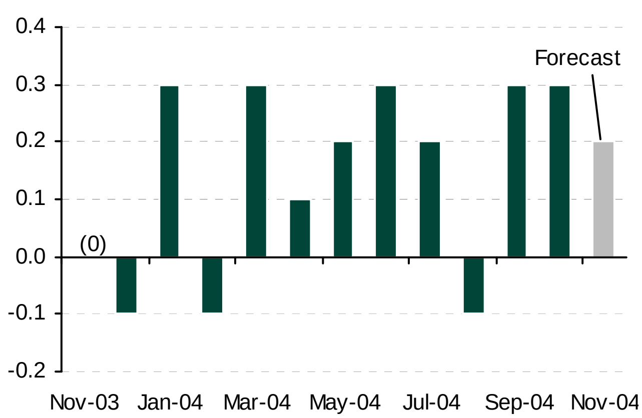
Budget Balance (Friday)

We look for a $60 billion deficit in November.

We look for a $60 billion budget deficit in November as outlays related to the war in Iraq continue to mount. While some of this may be offset by better-than-expected personal tax collections, it will not be enough to prevent the Federal government from posting a bigger monthly imbalance than last year (when it was $53 billion).

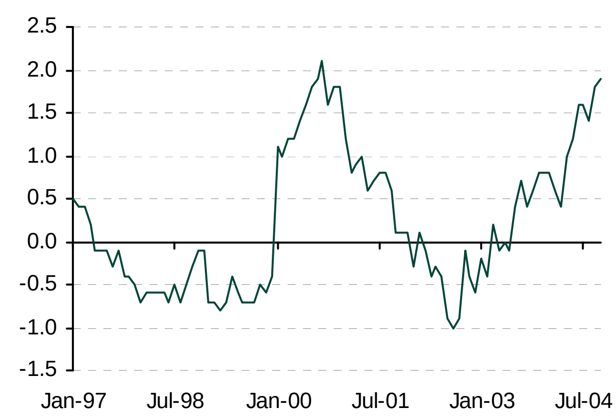
The November balance will put the fiscal year-to-date deficit at $120 billion, roughly one-third the total we are expecting for the year. However, we expect that the budget outlook will brighten in the January through April period as a growing economy and what should be a strong tax season begin to show through.

Figure 7: Core PPI (% month over month)



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 8: Capital Equipment Prices (% year over year)



Source: Bureau of Labor Statistics and Lehman Brothers

New York
745 Seventh Avenue
New York, NY 10019 USA
1.212.526.7000

London
25 Bank Street
London E14 5LE England
44.20.7102.1000

Tokyo
6-10-1 Roppongi
Minato-ku Tokyo 106-6131 Japan
813.6440.3000

Hong Kong
One Pacific Place
88 Queensway, Hong Kong
852.2869.3000

Analyst Certification

I, Ethan S. Harris, hereby certify (1) that the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Important Disclosures:

The analysts responsible for preparing this report have received compensation based upon various factors including the Firm's total revenues, a portion of which is generated by investment banking activities.

Lehman Brothers policy for managing conflicts of interest in connection with investment research is available at www.lehman.com/researchconflictspolicy. Ratings, earnings per share forecasts and price targets contained in the Firm's equity research reports covering U.S. companies are available at www.lehman.com/disclosures.

Complete disclosure information on companies covered by Lehman Brothers Equity Research is available at www.lehman.com/disclosures.

US04-2236