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Global Equity Research

U.S. ECONOMICS

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Is the Recovery in Jeopardy?

Outlook at a Glance…

%	3Q03	4Q03	1Q04	2Q04	3Q04	4Q04	2003	2004	2005
Real GDP	7.4	4.2	4.5	3.0	3.7	4.0	3.0	4.4	3.7
Domestic final sales	6.2	4.4	4.1	2.8	3.8	4.1	3.6	4.3	3.7
Inventories	0.6	0.5	1.2	0.3	0.1	0.1	-0.1	0.5	0.1
Net trade	0.6	-0.7	-0.8	-0.1	-0.2	-0.2	-0.5	-0.4	-0.1
Unemployment rate	6.1	5.9	5.6	5.6	5.4	5.2	6.0	5.5	5.0
Non-farm payrolls, 000	-1	60	198	224	150	200	-5	193	185
Consumer prices	2.2	1.9	1.8	2.8	3.2	3.6	2.3	2.9	2.7
Core CPI	1.3	1.1	1.3	1.8	2.1	2.4	1.5	1.9	2.5
Fed funds	1.00	1.00	1.00	1.25	1.75	2.25	1.00	2.25	3.25
TSY 2-year note	1.65	1.83	1.66	2.43	3.05	3.35	1.83	3.35	3.80
TSY 5-year note	3.09	3.19	2.97	3.71	4.05	4.25	3.19	4.25	4.55
TSY 10-year note	4.20	4.27	4.00	4.58	4.95	5.15	4.27	5.15	5.30

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 13 August. All forecasts are modal forecasts (ie, the single most likely outcome).

Source: Lehman Brothers

"Super-Freaky, Yow!"

U.S. growth recently has flipped from strength to weakness.

The economy has taken on a freakish, light switch quality recently—flipping between strong and lackluster economic growth with amazing speed. Not long ago, economic growth was projected to exceed 4% in the second half of the year, with the Fed funds rate expected to end 2004 at 2.50% (Figure 1, next page). Dismal June data, followed by signs of additional job market weakness in July, have prompted a wave of downward forecast adjustments, with the consensus now looking for softer GDP growth through year-end, and a funds target of no more than 2%. The Federal Reserve, however, is not worried.

"When I Make My Move…It's the Right Time"

As expected, the Fed hiked by 25 basis points this week…

To no one's surprise, the Fed hiked rates 25 basis points. The FOMC statement hinted that the Fed is not overly troubled by the recent spate of weaker-than-expected data. Instead, it noted that the softness in consumer spending, employment, and capital goods orders "likely owes importantly to the substantial rise in energy prices." In the next line, it noted that despite the surge in energy prices, "the economy nevertheless appears poised to resume a stronger pace of expansion going forward." Given the tone of this statement, we continue to look for the Fed to hike rates at the September 21 FOMC meeting.

…but what it does in November and December will depend heavily on the data flow.

That said, the FOMC statement also has a conditional element that leaves it open for the Fed to halt in its tracks after the September FOMC meeting, depending on the strength of demand and inflation. Consequently, these outer-month probabilities remain very much in play. Immediately following Tuesday's meeting, the markets were pricing in a November and December funds rate of 1.90% and 2.00%, respectively, up slightly from before the payroll report. However, what are the chances that growth could disappoint in the coming months?

The Good…

The economy's underpinnings remain solid…

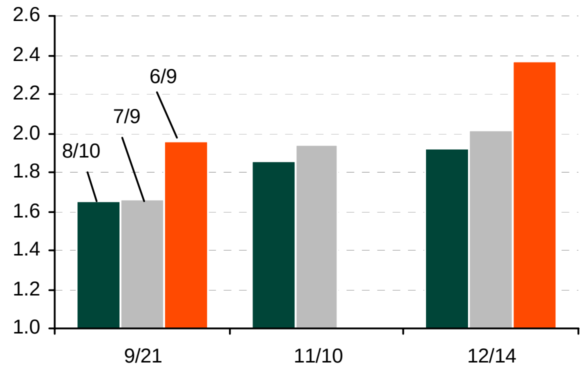
The case for solid, above-potential growth in the second half of the year rests on a variety of factors. First, capital spending has solid underpinnings—cash levels are high, and there is a strong need to replace worn-out capital, particularly with the aggregate rate of depreciation on the U.S. capital stock having risen. At the same time, business confidence is resilient—the ISM purchasing managers' index has been more than 60 for nine consecutive months—for the first time in more than 30 years. Likewise, smaller firms are feeling more optimistic, with the National Federation of Independent Business' small-business optimism index continuing to advance. At the same time, consumer confidence measures have rebounded from their May lows (Figure 2). While non-auto sales rose less than expected, with significant upward revisions to the June figures, it looks as if real consumption will reach 3.5% in 3Q, after all.

The Bad…

…but near-term downside risks remain.

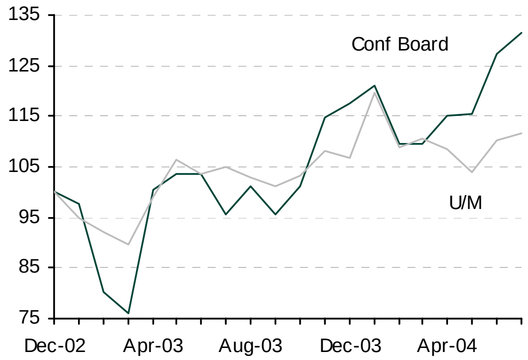
Although the economy's underpinnings still look firm, there are still some fairly significant downside risks to growth in the near term in addition to higher energy prices—particularly with respect to consumer spending. Consumption is largely a function of income and wealth growth—neither factor looks set to be particularly robust in the final months of the year. Already high energy prices, coupled with lingering sluggishness in hourly earnings, have resulted in negative real earnings growth for the first time in years (Figure 3). Macroeconomic Advisers estimate that higher fuel prices have sliced 1.3 percentage points off real disposable

Figure 1: Mean Expected Fed Funds Rate (%)



Note: Market expectations made in early June, July, and August of the funds rate of each of the next three FOMC meetings. There was no estimate for the November meeting in June.
Source: Fediscope model, Lehman Brothers Interest Rates Strategies

Figure 2: Consumer Confidence (December 2002=100)



Source: Conference Board and University of Michigan income growth during the first six months of the year (at an annual rate).[1] The unemployment rate remains 0.5% more than what we consider to be full employment, which suggests that the 2% trend in average hourly earnings will likely persist for another quarter or so, or until job growth picks up enough to pull the unemployment rate decisively closer to 5%.

Many of last year's special factors have dissipated.

Similarly, the stock market has largely been moving sideways for weeks, generating few—if any—capital gains for households, whose equity wealth rose by $3 trillion in 2003 and is expected to advance by only $0.3 trillion in 2004. Wealth effects, which added nearly 0.5% to GDP growth last year, will likely be flat this year. Likewise, households spending will not benefit from the surge in mortgage refinancing or last year's tax cuts. As a result, retailers already worry that the critical back-to-school and holiday shopping seasons will be significantly more difficult than last year's.

...And the Really Ugly

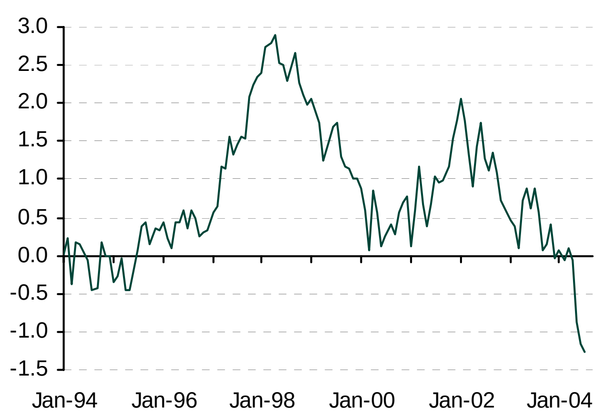
Acute dollar and financing risks are probably more of an issue in 2005.

The potentially ugly aspects of the economic outlook are probably reserved for 2005 and beyond. The current account deficit seems to be set on a persistently destructive path—rising to 5.3% this year and holding near 5% in 2005 (Figure 4). We expect this increase has raised the odds of a disturbingly sharp decline in the value of the dollar—especially given the United States' heavy reliance of foreign capital inflows. A dollar decline accompanied by a sharp increase in domestic interest rates to attract foreign capital would put monetary policy in a bind—forcing the Fed to temporize between the higher inflation induced by the weaker dollar and the slower growth caused by higher long-term interest rates. This Scylla and Charybdis choice between the two economic effects is similar to the same win-loss situation in which the Fed might find itself should energy prices rise much further. For now, it looks as if the Fed has chosen to take a cheery view of the outlook, but this opinion could rapidly evaporate between now and September, forcing the Fed to cool its heels.

Key Issues in the Week Ahead

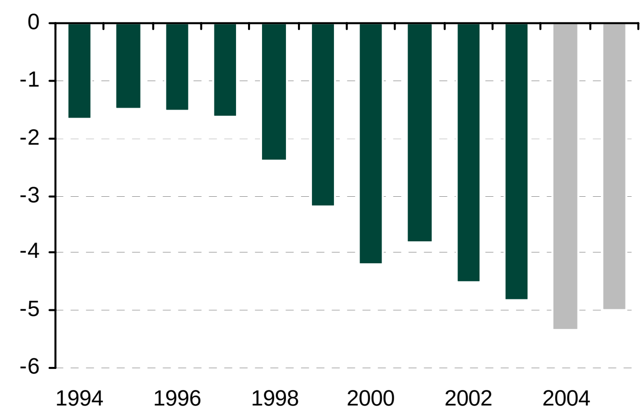
We look for a muted increase in the core CPI of 0.2% and a projected rebound in industrial production to set the market's tone this week. Reflecting the weakness in the labor market and the decline in stock prices, the index of leading indicators may remain in negative territory for the second month in a row.

Figure 3: Real Average Hourly Earnings (% year over year)



Source: Bureau of Labor Statistics, deflated using the CPI

Figure 4: Current Account Deficit (%, GDP)



Source: Commerce Department and Lehman Brothers

[1] Macroeconomic Advisers, "Economic Outlook," July 16, 2004

Data Preview

Empire State Survey (Monday)

We look for a small retrenchment in the Empire State survey.

We look for the Empire State manufacturing index to decline modestly from 36.5 to 32.5 in August. Weak July orders data may put a drag on general activity, but the high levels of backlogged July orders will probably keep existing employees busy. Relentlessly higher oil prices are probably the main culprit behind an expected rise in the price index. While we expect a slightly weaker report this month, it is still consistent with an expansion in the New York regional manufacturing sector, which we believe can continue for some time.

CPI (Tuesday)

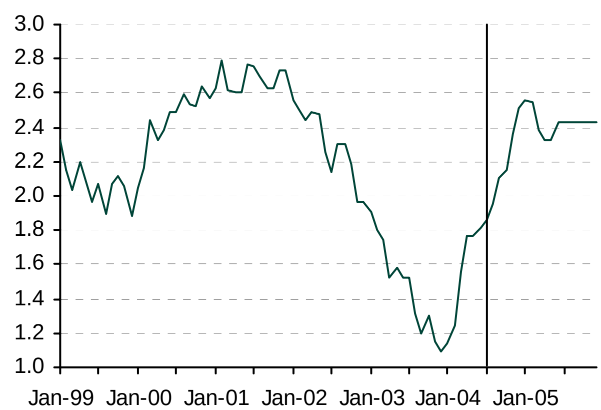
Both the total and core indexes are projected to rise 0.2% in July.

We look for fairly moderate gains in the CPI this month, with the total and the core indexes expected to rise 0.2% in July. On a year-over-year basis, the overall CPI would be up 3.3% in the month, while the core index would remain at 1.9% year over year, just barely less than the Fed's preferred inflation threshold of 2.0% (Figure 5). These inflation readings have taken on added importance in recent months, especially amid signs that some of the acceleration in prices during the first half of the year may be fading. Further deceleration in the core CPI accompanied by weakening growth statistics, similar in tone to the payrolls figures last week, might be enough to stay the Fed's hand later this year.

Food and energy prices are expected to move in opposite directions.

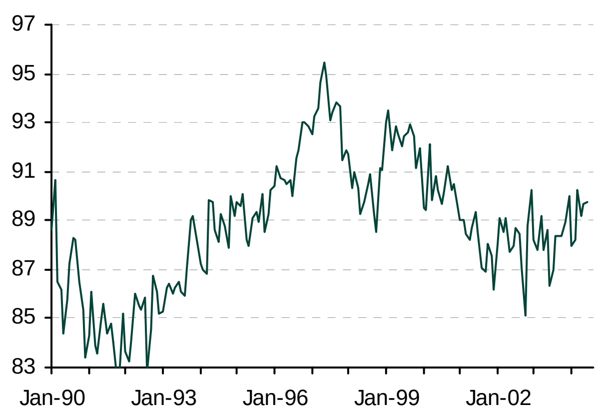
In July, we look for offsetting moves in food and energy prices of 0.2%. Food prices are expected to continue drifting higher because of tight supplies of dairy products and meat. At the same time, energy prices are predicted to fall 0.2%, led lower by a projected decline in gasoline prices and unusually cool temperatures that allowed households to run their air-conditioners less. According to the Department of Energy and the AAA, prices at the pump fell between 1.7% and 5.2% in the month. In our forecast, we assumed a 3.5% decline. Regardless of the decline this month, the recent surge in oil prices to more than $40 a barrel suggests that gasoline prices will accelerate in the coming months—even as the peak summer driving season comes to a close. Moreover, since refining capacity is so constrained (Figure 6), high summer gasoline prices will have ripple effects through the winter as a shortage of fuel oil builds during the normal seasonal inventory accumulation. The cooler-than-normal temperatures in July should prevent gas and electric utility bills from rising more than 0.5% this month.

Figure 5: Core Inflation (% year over year)



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 6: Capacity Utilization, Refining (%)



Source: Federal Reserve Board

We look for a modest acceleration in the core.

Outside these sectors, we expect the core CPI will rise 0.2%, compared to a gain of 0.1% in June. The slight acceleration this month reflects slightly stronger medical goods prices—up 0.5% in July, compared to gains of just 0.3% in each of the two previous months. At the same time, we look for a modest acceleration in apparel prices and housing costs—particularly in lodging away from home costs, which fell unexpected 0.9% in June. Hotel lodging costs are expected to follow the overall trend in travel-related expenses, with both lodging and airfares rising an estimated 0.5%, as surcharges for higher energy prices are tacked on amid stronger demand. Elsewhere, we look for new and used car prices to retreat in July, as dealers attempted to push metal off dealer lots and make way for the 2005 models. Prices are expected to decline 0.1% and 0.5%, respectively, but given the generous nature of the incentives offered last month, a potentially bigger decline is possible. Finally, we look for no surprises in tobacco prices (flat in July) or recreation expenses (up 0.1%), which represent their recent trends.

Housing Starts (Tuesday)

Housing starts are expected to post a modest increase in July.

Housing starts are expected to rise slightly in July—increasing slightly more than 1% to a 1.825-million-unit annualized pace. This increase follows June's unexplained 8.5% plunge, which surprisingly was concentrated in the normally stable single-family sector. Our guess is that construction in this sector began somewhat earlier than normal this year, and may have ended sooner than normal, causing a contraction in new starts in June. However, there are plenty of regions where a fairly deep backlog of construction projects exists, suggesting that housing starts should remain fairly stable in the near term.

Starts should get an additional boost from the 20-basis-point rally in mortgage rates during the month. The decline in mortgage rates should help restore new home construction, while boosting new building permits 0.3% to 1.95 million units.

Industrial Production (Tuesday)

Industrial production is expected to rise 0.4% in July…

The industrial production index is expected to rise 0.4% in July, with the capacity utilization rate likely to move up 0.3% to 77.5%. Neither the rate of growth in industrial production, which is expected to exceed 5% year over year, nor the level of plant use is likely to give the Federal Reserve much concern (Figure 7).

…with manufacturing output expected to rise by at least 0.5%.

Data from last week's payroll report pointed to a fairly solid increase in manufacturing output during the month. Manufacturing payrolls rose by 10,000 in July, while the factory workweek lengthened a tenth to 40.9 hours. Together, the combination of more people working longer hours was enough to push the aggregate hours index up 0.3%. We have applied a fairly conservative productivity assumption to the labor input figure in order to arrive at our manufacturing output estimate of 0.5%. Indeed, manufacturing productivity growth has been extremely strong lately, such that a 0.7% or higher reading on manufacturing output would not be out of the question. Elsewhere, cooler-than-normal temperatures in July probably clipped utility sector output in July. We look for output to contract by 1% in the month.

Initial Jobless Claims (Thursday)

We look for jobless claims to fall another 3,000 to 330,000 in the week of August 14.

Leading Indicators (Thursday)

The index of leading indicators is expected to fall 0.3%.

The index of leading indicators is expected to fall 0.3% in July, led by declines in six of the 10 components. This month's anticipated decline would be the index's second consecutive fall (Figure 8). We look for the flatter 10s-Fed funds curve, falling stock prices, and a steep pullback in the ISM's vendor deliveries index to subtract more than 0.3% from the overall aggregate this month. Just about the only major positive contributor to the index will be the longer factory workweek, which is projected to add about a tenth.

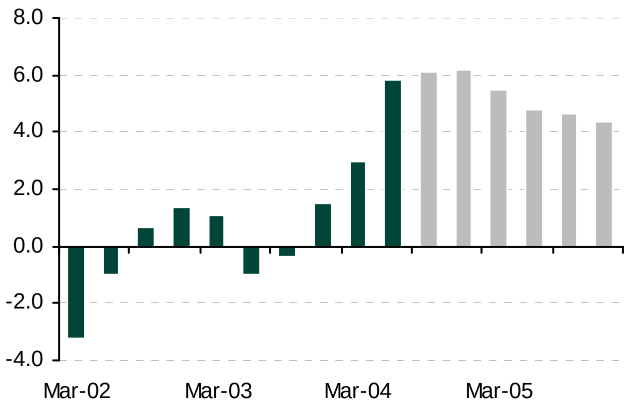
It is far too early to interpret any signals from the index as pointing to weaker economic growth. Generally, the index needs to decline throughout a period of several months, falling at least 3.5%. The cumulative decline to date (including our forecast) is barely 0.6%.

Philadelphia Fed Survey (Thursday)

The Philadelphia Fed index is expected to cool.

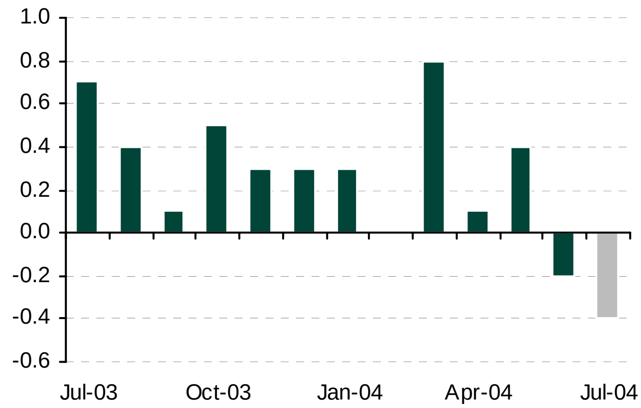
We expect the Philadelphia Fed survey of regional activity to dip in August, to a still-strong 30.5. The manufacturing sector has been barreling ahead in 2004, and recent payroll gains along with forward momentum from order backlogs and strong July activity should keep this index buoyant. It is likely that there will be an increase in the price indices, as suppliers and manufacturers are affected by soaring oil prices. However, a weaker-than-expected durable goods report for July may cause activity levels to wane, and recent fears about the sustainability of the recovery may lead to a moderation in purchasing managers' expectations for the sector's six-month outlook.

Figure 7: Industrial Production (% year over year)



Source: Federal Reserve Board and Lehman Brothers

Figure 8: Leading Indicators (% month over month)



Source: Conference Board

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