U.S. ECONOMICS

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Neutral Sound Bites

Outlook at a Glance...

%	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05	2004	2005	2006
Real GDP	4.0	3.1	3.7	3.7	3.3	3.3	4.4	3.5	3.2
Private consumption	5.1	4.6	3.6	3.6	3.0	3.0	3.8	3.7	3.2
Government expenditure	0.7	0.9	2.0	2.0	2.0	2.0	2.0	1.7	2.0
Non res fixed invest	13.0	10.3	4.1	8.4	8.4	8.8	10.3	8.5	8.0
Residential fixed invest	1.6	0.3	3.0	-2.0	-5.0	-5.0	9.5	0.6	-3.6
Exports	6.0	-3.9	8.0	8.0	10.0	10.0	8.1	5.8	9.5
Imports	4.6	9.1	4.2	5.3	5.0	5.0	9.8	6.0	5.6
Contributions to GDP:									
Domestic final sales	5.1	4.4	3.2	3.6	3.1	3.1	4.6	3.8	3.1
Inventories	-1.0	0.4	0.3	0.1	0.0	0.0	0.4	0.1	0.0
Net trade	-0.1	-1.7	0.1	0.0	0.2	0.2	-0.7	-0.3	0.1
Unemployment rate	5.4	5.4	5.3	5.2	5.2	5.2	5.5	5.2	5.2
Non-farm payrolls, 000	134	202	170	165	160	160	186	164	159
Consumer prices	2.7	3.4	3.0	2.6	2.6	2.6	2.7	2.7	2.5
Core CPI	1.8	2.1	2.3	2.3	2.5	2.5	1.8	2.4	2.7
Core PCE deflator	1.5	1.6	1.4	1.5	1.9	2.0	1.5	1.7	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	3.50	3.50	2.25	3.50	4.00
3-month USD LIBOR	2.02	2.56	3.00	3.30	3.55	3.80	2.56	3.80	4.20
TSY 2-year note	2.53	2.81	3.30	3.55	3.65	3.80	2.81	3.80	4.20
TSY 5-year note	3.50	3.49	3.75	4.10	4.20	4.30	3.49	4.30	4.40
TSY 10-year note	4.29	4.16	4.25	4.70	4.90	5.00	4.16	5.00	5.40

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 February 25. All forecasts are modal forecasts (i.e., the single most likely outcome).

Source: Lehman Brothers

Capital News

Capital goods orders hint at stronger 1Q05 GDP growth.

More positive news has appeared on the growth front. As expected, 4Q04 GDP growth was revised up from 3.1% to 4%, reflecting new data on inventories, trade and construction. Data in the past week also hinted at more of the same in 1Q05. Most importantly, there is no sign of any slowing in spending on capital equipment. We had thought that the expiration of tax incentives for investment might cause a soft patch in 1Q05. The robust durable goods orders data for January put any lingering doubts to rest: Non-defense capital goods excluding aircraft jumped 2.9%, following a 3.3% gain in December. The shipments numbers, which are used directly in calculating quarterly GDP, were equally strong. All of this suggests upside risks to our 3.7% 1Q05 GDP forecast.

Claims Conundrum

Jobless claims have moved lower since last autumn…

Another sign of solid growth last week was continuing low jobless claims. Claims are now running at a 309,000 four-week average, down from the 330,000–340,000 range last autumn. Historically, claims have been the best early warning indicator of payroll employment growth. The link has been far from perfect: Claims capture involuntary departures from jobs, while payrolls are the net of all departures and new hiring. Thus, in theory, jobless claims should have a tight predictive fit only when job outflows are the main source of variation in the job market. Research by McConnell shows this indeed to be the case: Claims are a better predictor of payrolls during recessions.[1]

While claims are the best payroll indicator, claims models still have a relatively poor track record. For example, using data from 1997 to 2004, regressing the monthly growth in payrolls on lagged payroll growth and monthly claims, yields:

$$PAY = 1016 + 0.13*PAY_{t\text{-}1} - 2.62*CLAIMS$$

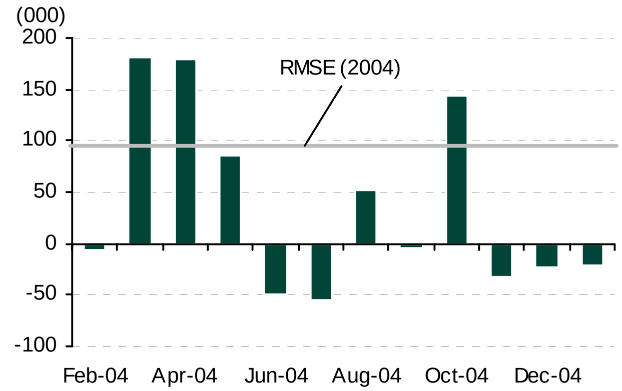
…but the relationship between claims and payrolls is fickle.

This equation explains 65% of the variation in monthly payroll growth. However, the "standard error" is quite high at 110,000, and the coefficients are relatively unstable: Depending on the sample period and other variables in the model, claims have a coefficient anywhere from –1.9 to +3.1. This is also a time of year when claims tend to be particularly erratic. These large errors are a reminder of how irrational the bond market can be in responding to the employment numbers: 100,000-claim swings in payrolls are well within the range of random errors in the data and normal forecast error of economists, yet such swings can cause 10-basis-point or greater moves in yields.

A natural question is: Why not add more variables if the model is so poor? The answer is that other early warning numbers such as help wanted, layoff announcements and surveys of hiring intentions add more noise than news to these models. For example, both the manufacturing and the non-manufacturing purchasing managers' surveys have been consistently too optimistic about the job market.

[1] McConnell, M, "Rethinking the Value of Initial Jobless Claims as a Forecasting Tool", Federal Reserve Bank of New York, Current Issues in Economics and Finance, November 1998.

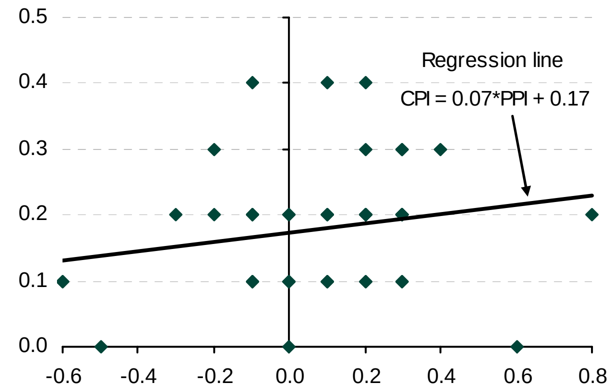
Figure 1: Claims Model Forecast Errors



Note: The model is estimated using a lagged dependent variable over the 1997–2004 period. The RMSE is the average monthly error without regard to sign.

Source: Bureau of Labor Statistics and Lehman Brothers

Figure 2: Scatter Plot: Core PPI and Core CPI



Source: Bureau of Labor Statistics and Lehman Brothers

For this month the claims model is predicting a gain of 225,000. As Figure 1 shows, the equation has over-predicted by about 30,000 in each of the last three months and, over the past year, has had an average absolute error of approximately 100,000. Our 200,000 forecast implicitly assumes this error repeats.

Creeping Price Inflation

Financial markets breathed a sigh of relief last Wednesday as core CPI inflation came in at a benign 0.2%. While there is a very weak correlation between the core PPI and CPI (Figure 2), investors had worried about a replay of the 0.8% jump in the core PPI.

The inflation picture continues to worsen…

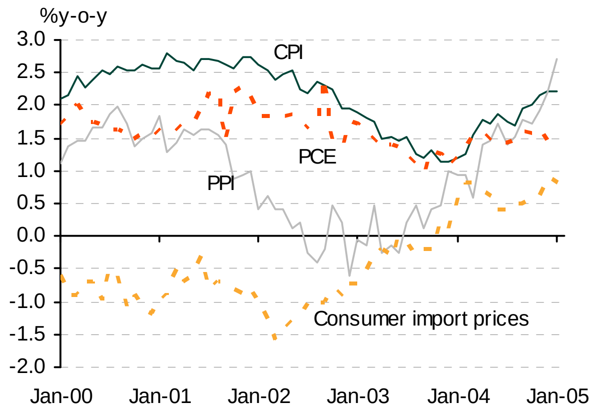
Stepping back from the monthly gyrations, however, the inflation picture slowly continues to worsen. The Fed's favorite inflation gauge—the core PCE deflator—has been stable in the last few months, but cost pass-through effects are showing up in every other core measure (Figure 3). Initially, little commodity pressure was showing up in finished goods prices, but over time companies' ability to absorb these costs has diminished, causing the core PPI and the core goods CPI to accelerate. The pass-through from the dollar to import prices is also growing, as evinced by the pick-up in price of consumer goods imports. Looking ahead, with the dollar in the middle of a secular decline and with commodity demand still strong, it is not clear what could cause these trends will end. The only good news is that wage growth remains feeble and some of the inflation pick-up seems to be due to wild swings in used-car prices.

…while a split over the inflation outlook appears to be opening up on the FOMC.

Within the Fed a split is beginning to emerge around inflation. In the latest minutes the majority view (presumably including Chairman Greenspan) was "that the rate of core inflation likely would remain low and stable, assuming further removal of policy accommodation." Indeed, as the table shows, FOMC members believe GDP growth can remain above trend in the year ahead, with only a minor pick-up in inflation.

However, a minority on the FOMC are becoming concerned. Again, turning to the minutes, "… several participants suggested the possibility of an upward skew to the distribution of inflation outcomes, especially if there were appreciable further declines in the foreign exchange value of the dollar or in structural productivity growth; already some participants were hearing anecdotal reports from firms of an increased ability to pass cost increases through to product prices, perhaps because of increasing confidence in the outlook for the economic expansion." That makes sense to us, and we expect the FOMC progressively to take a less benign view of above-trend growth and the inflation risks it entails. With inflation inching higher, we believe that the Fed will not move to the sidelines until it sees some signs of restraint in financial markets or below trend GDP growth.

Figure 3: Measures of Core Inflation



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 4: FOMC Central Tendency Forecasts

% Q4/Q4	**2005**	**2006**
Nominal GDP	5.50-5.75	5.00-5.50
Real GDP	3.75-4.00	3.5
Core PCE	1.50-1.75	1.50-1.75
Core CPI (e)	2.00-2.50	2.00-2.50

Source: Federal Reserve Board and Lehman Brothers. The Federal Reserve does not publish core CPI forecasts; we have estimated them based on the historical relationship between core PCE and core CPI.

The Week Ahead

We look for strong payroll figures and a flat unemployment rate to accompany a barrage of Federal Reserve speakers tackling topics as diverse as the economic outlook and inflation targeting. Mr. Greenspan returns to Capitol Hill to discuss the budget deficit.

Personal Income (Monday)

We expect personal income to fall 2.5% in January.

We expect personal income to fall by 2.5% in January as Microsoft's $32 billion special dividend washes out of the data. Since the dividend was a one-time occurrence, the January figures will decline by roughly the same amount of the December spike—in this case almost $300 billion at an annual rate.

Outside of this distortion, we will be most focused on the behavior of the core wage and salary series. In December, wages and salaries income increased 0.4%, which is about in line with their recent trend. But in January, growth in average hourly earnings was only a tepid 0.2% and the workweek contracted, so that private wage and salary income look to have fallen by about a tenth. However, we expect some offsetting strength in government pay. In January, the government typically increases the pay of active duty soldiers, and Federal employees, but because the increases are not consistent from year to year, they are not completely eliminated by seasonal adjustment factors. We expect this year's pay increase to be about 1%—roughly in line with past experience (Figure 5). January is also the month in which the Social Security Administration applies its annual cost of living adjustment, which this year should be larger than past years given the energy-boosted push to the CPI last year. Taking these factors together, we judge that there is small upside risk to the personal income figures this month; however, it is likely to be buried deep in the data.

We look for personal consumption to contract by 0.1%.

We look for consumer expenditures to decline by 0.1% in the month, led lower by a pull-back in auto sales. Unit sales fell sharply in January after a very strong December, so this month's anticipated decline in personal consumption expenditures is probably temporary—especially as most of the major manufacturers reintroduced aggressive incentives in February. Indeed, for the quarter we expect a solid 3.6% annualized gain in real consumption. The combination of weak consumption and even weaker income implies a drop in the savings rate—slipping from the dividend-boosted 3.4% to 0.6%, which is more consistent with the recent trend in household thrift.

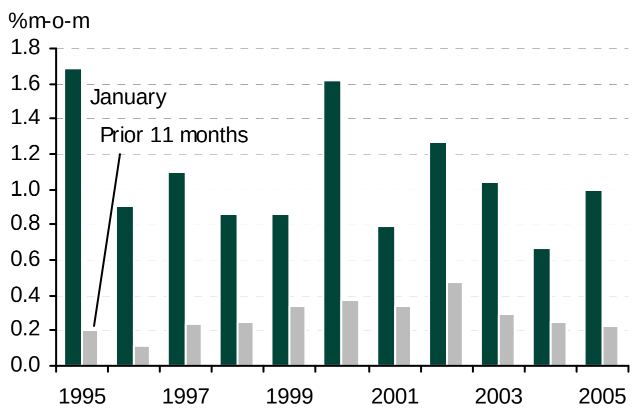
Perhaps the key number in the report, however, is the core PCE deflator, which is now the Fed's preferred gauge of inflation. On a monthly basis the core PCE typically grows at the same rate or one-tenth lower than the core CPI. In January, the core CPI rose 0.2%, but in the unrounded data it looks to have been on the high side of 0.2%. Hence, we expect the core PCE to also come in at 0.2%. Nonetheless, this would imply benign year-over-year inflation of just 1.4%—right in the middle of the Fed's perceived 1% to 2% comfort zone.

New Home Sales (Monday)

We expect new home sales to inch up slightly in January—to 1.10 million units (Figure 6). This is barely above the December and November readings of 1.098 million and 1.097 million, respectively. Sales in November were depressed by adverse weather. In January, conditions were generally mild, and thus more potential home buyers were able to get out and look at new properties.

The fact that sales remain strong even in the face of Fed tightening is no surprise given the behavior of long rates, which have fallen more than 40 basis points since last June. But, as Chairman Greenspan recently stated, the behavior of long rates is a bit of a conundrum and could prove to be temporary. Our sense is that sales could cool quite sharply if long rates move significantly higher.

Figure 5: Government Wages & Salaries



Source: Bureau of Economic Analysis and Lehman Brothers

Figure 6: New Home Sales

Source: Census Department and Lehman Brothers

Chicago PMI (Monday)

We look for the Chicago PMI to slip to 61.0.

We look for the Chicago PMI to slip a notch to 61.0 in February from January's reading of 62.4. However, this would still leave the index well within its recent range.

Manufacturing activity was generally upbeat in the latest regional Beige Book report. The report noted that activity remained steady at a high level. Production and new orders were especially strong for machine tools, steel, and other industrial equipment. Consistent with last month's Chicago PMI, we expect further strength in the new orders and production indexes amid signs of a growing order backlog.

Fed Moskow (Tuesday)

Chicago Federal Reserve Bank President Moskow will discuss job losses and the overall health of the labor market before an audience of state workforce agencies. We suspect that his remarks will be as upbeat as Greenspan's Humphrey-Hawkins testimony. Specifically, Mr. Moskow is likely to present the Fed's case for an improvement in the labor market, based on rising aggregate demand and the diminishing scope for further gains in labor productivity, forcing employers back into the labor market in order to expand capacity.

Moskow will discuss the labor market on Tuesday morning.

Although Mr. Moskow will be discussing the health of the labor market, it is highly unlikely that he will have gotten a sneak preview of Friday's February payroll data. Not only is the Bureau of Labor Statistics still working on the number, but the data are a strictly guarded secret until Thursday evening when they are released to a few very senior Administration and Treasury officials and Chairman Greenspan.

Construction Expenditures (Tuesday)

We look for construction expenditures to rise by 0.7%.

We predict construction expenditures to rise by 0.7% in January, following a 1.1% increase in December. Vigorous residential building and home improvements are expected to push overall expenditures sharply higher this month. Non-residential activity looks to have been strong in January, where we expect spending on commercial buildings and public works to increase by 1%.

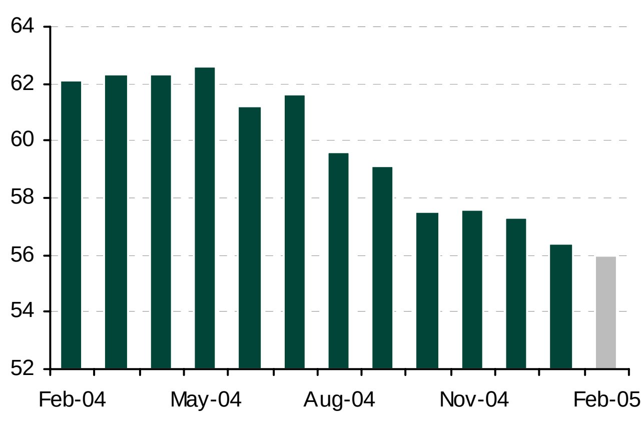
ISM (Tuesday)

A number of indicators of the manufacturing sector have recently become more upbeat. Regional assessments in the Beige Book were more positive, while the Philadelphia Fed's survey of Mid-Atlantic manufacturing conditions picked up. Other indicators suggest that expectations about the future direction of activity have also picked up. However, the pick ups in these measures may have occurred too late in the month to have much of an influence on the overall ISM. Instead, we look for the index to hold steady at 56.0 in February, from 56.4 in January (Figure 7).

Fed Santomero (Tuesday)

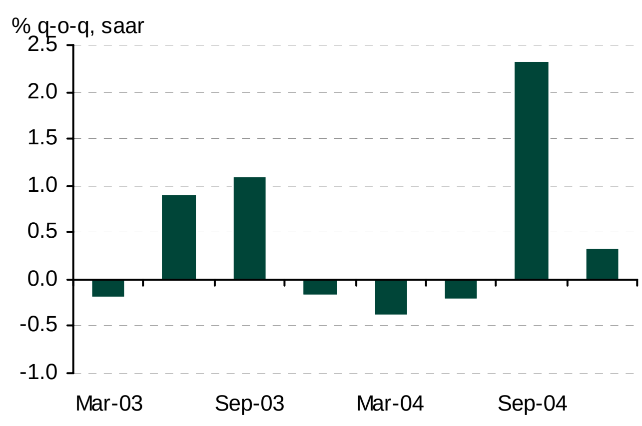
Philadelphia Federal Reserve President Santomero will be discussing business cycles on Tuesday afternoon. To the extent that his comments veer toward current conditions, we anticipate they will be fairly positive. The Federal Reserve's forecasts indicate that officials expect slightly above-potential growth accompanied by little change in either the unemployment rate or core inflation.

Figure 7: ISM



Source: Institute of Supply Management and Lehman Brothers

Figure 8: Auto Sales Contribution to Final Sales



Source: Commerce Department and Lehman Brothers

Domestic Vehicle Sales (Tuesday)

We predict domestic vehicle sales will post a small increase in February.

We look for a modest increase in domestic vehicle sales in February, with sales increasing to 13.2 million units from a 13.0 million pace in January. Including imports, we anticipate overall vehicle sales to reach 16.4 million units in February—down a bit from the 2004 average of 16.8 million but still quite strong as manufacturers show no sign of letting up on incentives. January sales were actually modestly weaker than the headlines suggested as much of the volume came from fleet sales. In February, sales will also be boosted by Presidents' Day weekend, traditionally a strong selling point.

Although auto sales have been chunky over the past year, with on-again / off-again incentives programs causing sharp inter-quarterly swings, the sector has added roughly 0.5% per quarter to the quarterly pace of final sales (Figure 8). Eventually, this net addition to growth in final sales will subside, but the timing of such a slowdown depends critically on movements in long-term interest rates and the willingness of manufacturers to push units aggressively through steep discounting and incentives. It also depends on the willingness of households to continue purchasing new models at an extremely vigorous sales pace—averaging 16.7 million units over the last three years. And so far, there has been very little reduction in the consumer's appetite for new vehicles.

Fed Lacker (Tuesday)

Mr. Lacker discusses inflation targeting this week.

Richmond Federal Reserve President Lacker will discuss inflation targeting on Tuesday afternoon. Lacker is a relative newcomer to the FOMC, and as a result we are somewhat curious as to where he stands in the inflation targeting debate. Polar positions appear already to have been staked out, with Greenspan advocating more flexibility and Mr. Bernanke more willing to consider full-fledged targeting. Although Mr. Lacker is not a voting FOMC member this year, his comments may reveal some interesting insights into the targeting debate at the February FOMC meeting.

Fed Greenspan (Wednesday)

Mr. Greenspan testifies before the House Budget committee.

Federal Reserve Chairman Greenspan will address the House Budget committee on Wednesday morning. Given the political angst surrounding Social Security and tax reform we expect Greenspan's commentary to be eagerly scrutinized.

However, in many respects, his remarks are likely to cover old ground. Specifically, we expect the Chairman will offer a bit of a justification for the 2001 tax cuts on the grounds that some sort of fiscal stimulus was necessary to pull the economy out of recession. But, in the same breath he is also likely to bemoan the loss of PAYGO—a budget accounting rule whereby new spending initiatives or tax cuts had to be offset by equally sized reductions in spending in some other part of the budget. Without some form of fiscal discipline, the deficit has deteriorated sharply since 2001 and may very well get worse in the coming decade, if new proposals such as Social Security privatization are not offset by serious spending restraint.

In his remarks last February, Mr. Greenspan commented that CBO budget projections over the next decade were "vivid and sobering" for what they reveal about financing the baby boomers' retirement starting in 2008. This clearly has not changed much in the intervening year and we expect that any comments he makes about the size of the unfunded Social Security liability to make headlines.

Interestingly, some of the Chairman's talking points are now being discussed as possible solutions to Social Security's ills. Last year, Mr. Greenspan discussed switching the indexation of Social Security recipients' first-year benefits away from wages to CPI. CPI indexation of initial benefits is seen as a key ingredient in reducing the size of the system's unfunded liability, as wage inflation tends to rise faster than prices over long periods like the typical employee's working life.

This year, we expect more direct commentary on the costs and benefits associated with full-fledged privatization. As his Humphrey-Hawkins remarks suggest, the Chairman supports some form of privatization, although he has been clear to point out that private accounts do nothing to resolve the actuarial imbalance in Social Security. As he has long said, the actuarial imbalance can only be resolved through some combination of tax increases and benefits cuts.

Fed Yellen (Wednesday)

Ms. Yellen discusses the economic outlook.

San Francisco Federal Reserve President Yellen will discuss the economic outlook on Wednesday afternoon. Several weeks ago, Yellen's remarks caused a bit of a stir in financial markets when she seemed to suggest that Fed policy was approaching neutrality and therefore Federal officials will eventually need to reconsider their "measured pace" language. Importantly, there was no time dimension associated with her remarks. After 150 basis points worth of Fed tightening in the past eight months, policy may be becoming less accommodative and the words "measured pace" were noticeably absent from Mr. Greenspan's Humphrey-Hawkins testimony. Moreover, the Board's projections suggest the Fed sees balanced non-inflationary growth over the coming two years. But none of this suggests that the Fed is ready to abandon its rate hike cycle. Instead, all it suggests is that sometime in the near future, monetary policy will become more dependent on the current data flow.

Initial Claims (Thursday)

We look for jobless claims to slip by 2,000 to 310,000 in the week of February 26. The release of non-farm payrolls this week will likely divert attention away from the claims figures.

Non-Farm Productivity (Thursday)

We look for an upward revision to non-farm productivity.

Attention surrounding the non-farm productivity statistics has ratcheted up a notch given Fed Chairman Greenspan's repeated references to its likely slowdown and the role it will play in the upcoming inflation outlook. As a result, we expect the markets will be paying disproportionate attention to the 4Q04 productivity revision this week.

Our assumption of an upward revision to GDP and final sales growth points to a similarly sized positive adjustment to non-farm productivity. We look for non-farm productivity to be revised from 0.8% quarter over quarter to 1.7%, assuming no revision to hours worked. At the same time, assuming no revision to the compensation figures, we reckon unit labor costs will be revised lower—from 2.3% quarter over quarter to 1.5%. We believe that most of the slowdown in productivity is being absorbed by slower profit growth rather than rising price inflation.

Initial Claims (Thursday)

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Non-Manufacturing Purchasing Managers' Index (Thursday)

We look for the non-manufacturing purchasing managers' index to slip slightly—from 59.2 in January to 58.5 in February. Like the manufacturing sector, the service sector continues to expand although some temporary seasonal glitches may have slowed activity a bit. Nonetheless, most segments of the economy covered by this index—from retailing to banking and home sales—remain very solid.

Employment (Friday)

We look for a solid February employment report…

We expect the February employment report will be modestly firmer than the previous three. We predict payrolls will rise by a solid 200,000, the unemployment rate will hold steady, and growth in average hourly earnings should remain well under 3%. Together these indicators point to robust economic growth and further non-inflationary labor market improvement.

…with non-farm payrolls expected to rise by 200,000…

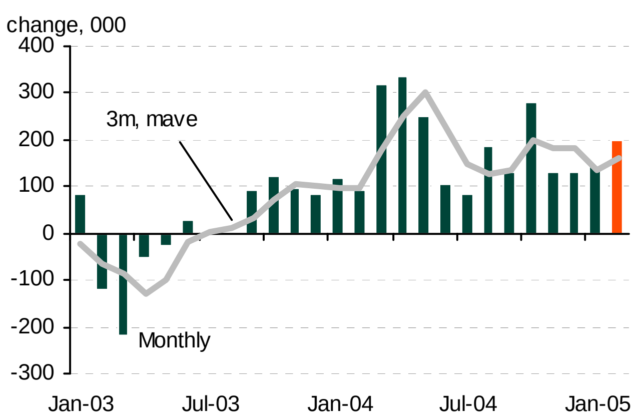
We project non-farm payrolls will rise by 200,000 in February, up from a 137,000 average over the previous three months (Chart 5). Among the components, we look for a solid rebound in construction hiring as improved weather boosted building activity on the West Coast. Construction payrolls are very volatile during the winter months, so our expectation of a 40,000 gain in February could turn out to be wide of the mark. Elsewhere, we expect manufacturing hiring will be flat in February. Since last fall, there have been few signs of a rebound in manufacturing jobs. Productivity growth in the sector remains robust, limiting the need to hire more workers or expand the workweek much. The factory workweek is expected to hold steady this month at 40.7 hours, with no change expected in overtime hours as well.

The service sector remains the key driver of overall employment. We look for retail employment to rise by 20,000 in February. Any holiday-related hiring in December and January appears to have been minor—accounting for at most a swing of about 10,000 in jobs. With consumers still eager to open their wallets up, we expect hiring will follow suit, with overall retail employment in 2005 expected to match or slightly exceed last year's modest gain of 155,000 jobs. Elsewhere, we look for trend-like gains in temporary help (up 15,000) and education and health service employment (up 35,000). We predict government payrolls will rise by 10,000, although lately hiring in this sector has become unusually volatile. Indeed, over the last three months, there has been a sharp deceleration in hiring at the state and local government level, which is a bit difficult to ascribe as hiring of public school teachers has essentially been flat.

…and the unemployment rate holding steady at 5.2%.

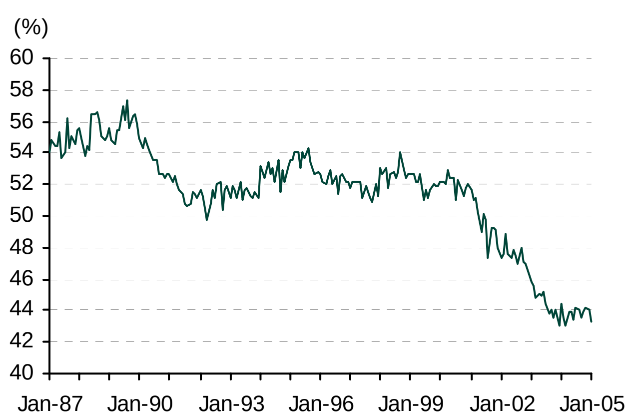
We expect the unemployment rate will hold steady in February at 5.2%. The falling unemployment rate has ratcheted up inflationary fears. However, we suspect that much of the decline is due to workers leaving the workforce—i.e., a declining participation rate, rather than an indication of strong labor demand. This is especially the case for teenagers, who account for nearly half of the decline in labor force participation (Figure 10). Like payrolls, growth in household employment is better described as "solid" rather than "booming." Since last July, it has averaged 155,000 per month—exactly matching the average monthly gain in non-farm payrolls over the period.

Figure 9: Non-Farm Payrolls



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 10: Teen Participation Rate



Source: Bureau of Labor Statistics and Lehman Brothers

We look for the non-farm workweek to increase by 0.1 hours.

The non-farm workweek is projected to rise this month. We look for the workweek to increase by 0.1 hours to 33.8%. As we have noted before, the workweek has been in a very tight range for the last two years between 33.6 and 33.8 hours. Any break out of this range would therefore be a pretty significant development and a clear indication that GDP growth was picking up. Assuming no revisions and moderate growth in payrolls and hours over the remaining month of the quarter, we look for the aggregate hours index to rise by 2.0%. This is in line with our expenditures-based 1Q05 GDP estimate of 3.7%.

Finally, we predict that average hourly earnings will rise by 0.2% in February, or a very well contained 2.6% year over year. Wage inflation remains very subdued as the unemployment rate is still above most estimates of full employment or NAIRU.

Factory Orders (Friday)

We expect factory orders to be flat in January, a deceleration from a 0.3% advance in December. The volatile durable goods orders portion of the report was already announced as having fallen 0.9%. Meanwhile, we expect nondurable goods orders to rise 0.7%, payback for its 0.6% decline the previous month. Combining the two numbers leads to a flat reading for total factory orders. Shipments should rise 1.3%, with inventories up a smaller 0.8%.

Consumer Sentiment (Friday)

We look for a flat reading on the sentiment index.

We look for consumer sentiment to hold steady in the final February reading at 94.5. Sentiment, particularly the expectations component, appears to have hit a setback as seen by declines across a number of indicators. Some are ascribing the recent reversal to the publicity surrounding Social Security reform and a sense of unease households have regarding personal accounts. While survey evidence suggests that households are less than enthusiastic about the President's proposal, it is hard to see how this might affect the sentiment index directly.

Fed Moskow (Friday)

Chicago Fed President Moskow will discuss minority business ownership on Friday afternoon. We do not expect any monetary policy remarks.

Fed Stern (Friday)

Minneapolis Fed President Stern, a voting member of the FOMC this year, will discuss business conditions on Friday afternoon. He is likely to note that the economy is perfectly balanced with strong growth, low inflation and a steadily improving labor market. However there are several key risks on the horizon that worry the Fed: from the budget and current account deficits to the overheating housing market and the expected deceleration in labor productivity. As a result, the Fed needs to guide a steady, though cautious course.

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