

U.S. ECONOMICS

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No Pain, No Gain

Outlook at a Glance...

%	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05	2004	2005	2006
Real GDP	4.0	3.7	3.7	3.7	3.3	3.3	4.4	3.6	3.3
Domestic final sales	5.1	4.2	3.4	3.6	3.0	3.1	4.6	3.7	3.2
Inventories	-1.0	0.5	0.2	0.1	0.0	0.0	0.5	0.1	0.0
Net trade	-0.1	-1.0	0.2	0.0	0.2	0.2	-0.6	-0.2	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
Fed funds	1.75	2.25	2.75	3.25	3.50	3.50	2.25	3.50	4.00
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 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 21 January. All forecasts are modal forecasts (ie, the single most likely outcome).

Source: Lehman Brothers

We have boosted our GDP
forecast for 1H05...

After warning that we might have to adjust our forecasts in recent weeks, we are now formally changing our forecasts for growth and monetary policy. We are revising down 4Q GDP slightly, but raising growth in the first two quarters of the year such that we now expect 3.7% growth in all three quarters. The somewhat stronger forecast reflects three overlapping factors: 1) unexpectedly easy financial conditions have postponed any softening in consumer and housing expenditure; 2) December data point to some momentum going into the first quarter; and 3) capital goods orders late in 2004 suggest the expiration of tax incentives for equipment will have a smaller negative impact on 1Q investment spending than we had expected.

...and accelerated the pace
of Fed tightening.

We are also accelerating and adding one rate hike for the year. Our old forecast assumed that the Fed would slow its rate hikes after the February meeting, but as we discuss in detail below, continued easy financial conditions suggest there is no near-term impediment to Fed tightening. We now expect the Fed to hike rates at each of the first five meetings this year.

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Once the Fed gets the financial restraint it wants, we look for much slower hikes in the second half of 2005 and 2006.

Attitude Adjustment

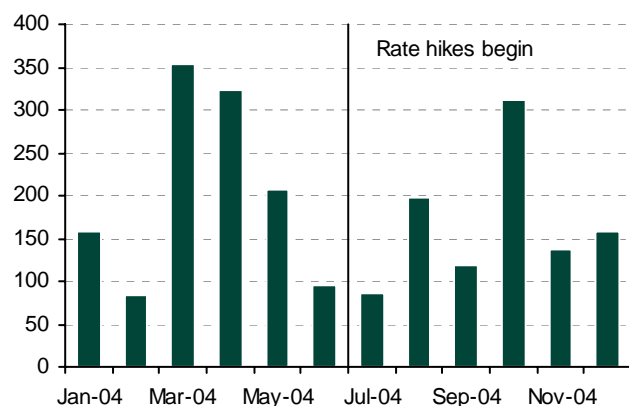
From the beginning of the tightening cycle we have argued that the Fed would feel its way forward, looking for a "point of pain" where financial market weakness begins to cool growth in the economy. Given the loss of fiscal stimulus and the overextended nature of the U.S. consumer, we believed the Fed would find this threshold well before the funds rate returned to its long-run "neutral" level of about 4.5%. Thus we believed that a modest amount of financial restraint would be enough to cool GDP growth back to trend and slow the Fed to a crawl.

Since the Fed began to tighten in June, the trend in growth indicators and core inflation has remained the same (Figures 1 and 2). Indeed, the latest data for December—a 157,000 increase in jobs and a 0.2% rise in the core CPI—were well within the Fed's comfort zone.

What is missing from this blissful scene is some sign—any sign—that the Fed tightening is restraining U.S. financial markets. Monetary policy does not work by magic; it constrains growth by imposing pain, or at least restraint, on some part of financial markets. Yet, financial markets have celebrated the rate hikes with a drop in bond yields, tightening interest rate spreads, and hot home prices. Even the dollar has refused to cooperate, weakening on the abysmal trade news rather than strengthening in response to monetary tightening. On net, financial conditions are easier today than when the funds rate was 1% last June. And most strategists remain cautiously bullish about their respective markets over the next several months.

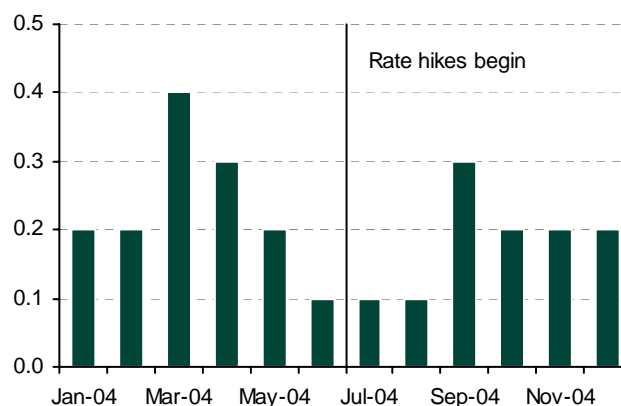
The markets are sending three messages to the Fed. First, there is little downside risk to the economy from continuing to hike rates at every meeting. Second, there is a growing risk of speculative excess in the economy. Thus, in the recent Fed minutes, "some participants believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk taking." Third, there is a growing risk that the economy may not achieve the soft landing the Fed is looking for, but instead begin to reaccelerate. Again, the minutes noted "that increasing equity and home prices had boosted net worth, leaving consumers well positioned to maintain a brisk pace of spending."

Figure 1: Non-Farm Payrolls (change, 000)



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 2: Core CPI (% , month over month)



Source: Bureau of Labor Statistics and Lehman Brothers

Fed officials have been jawboning the markets.

Since the minutes were released earlier this month, FOMC members have continued to jawbone the markets (Figure 3). Thus far, the Fed's more hawkish rhetoric has failed to impress, but this simply encourages them to continue to caution.

Figure 3: Federal Reserve Official Quotes

Official	District	Voter	Comment
Hoening	KC	No	"...I recognize that inflationary pressures are more likely to emerge as the economy moves closer to full resource utilization in an environment in which monetary policy is still very accomodative." (6 January)
Guynn	Atlanta	Yes	"...I continue to be struck by talk of price increases that my business contacts say they are planning as the economy expands." (10 January)
Minehan	Boston	No	"However, one has to be very humble about one's ability to peg exactly how the economy will operate in this phase of the cycle. Clearly there are risks here..." (12 January)
Santomero	Phil	Yes	"If signs of price pressure emerge on a consistent basis, we will need to consider quickening the pace [of tightening]". 18 January
Pianalto	Cleveland	No	"...the momentum in the inflationary process has clearly shifted away from disinflation." (18 January)

Source: Various regional Federal Reserve Web sites

"For Whom the Bell Tolls"

The Fed will continue tightening until financial markets take notice.

Unless the economy slows on its own, the Fed will continue to tighten until financial markets take notice. The Fed does not have any particular part of the market in mind, although there are three areas that seem particularly at risk: the short end of the curve, the bond market, and the housing market. First, our forecast of a funds rate at 3.50% by August is 25 basis points more than is priced into the Eurodollar curve, so further pressure on short-dated treasury yields is likely. Second, the bond market is also at risk: more hikes and more jawboning from the Fed, combined with a widespread sense that the market is overbought, should be enough to get some upward movement in yields. Finally, the housing market, in particular, and consumers more generally are vulnerable to higher interest rates. The housing market has become increasingly stretched, with rapid price appreciation forcing buyers into adjustable rate, interest-only, and no-money-down mortgages.

The Fed does not want to crush the markets or the economy, so a 50-basis-point hike is only likely as a last resort. Instead, look for steady doses of tightening and jawboning until the markets respond.

The Week Ahead

The chorus of Fed officials should quiet down this week ahead of the FOMC verdict on February 2. We look for a modest increase in durable goods orders of 1.0% and a small cooling in consumer confidence and existing home sales.

Data Preview

Treasury Two-Year Note Announcement (Monday)

The Treasury will announce and auction what is likely to be a \$24 billion two-year note, matching the auction size for each of the past six months.

Fed Guynn (Monday)

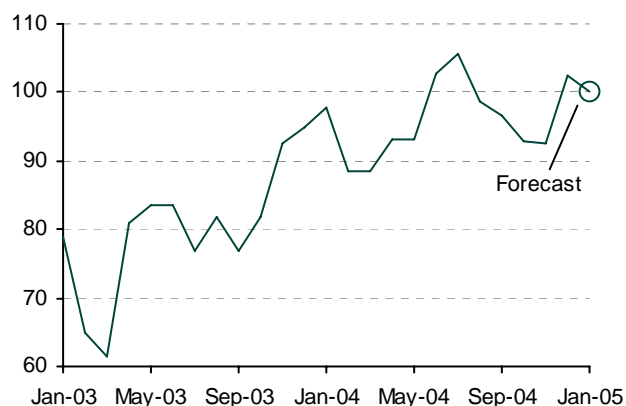
Mr. Guynn discusses the economic outlook.

Atlanta Federal Reserve President Guynn will speak about the economic outlook on Monday morning. He last discussed the 2005 outlook on January 10, and his remarks today should echo what was previously stated. Specifically, Mr. Guynn noted that he agreed with consensus estimates of 3.5%–4.0% GDP growth for 2005: “Our recent output growth has been and should remain pretty doggone good.” He also expects further support from the household sector as he is “reluctant to bet against the American consumer” whose propensity to spend is very strong, even in the face of what is likely to be a modest deceleration in income growth this year.

But Mr. Guynn is also likely to express the same inflation concerns he mentioned on January 10. Namely, the amount of excess capacity in the economy is shrinking, and there is a limit to “how long businesses can leverage productivity gains to hold prices down.” Moreover, he has noted anecdotal reports of increasing pricing power on the part of retailers as another reason for concern about the inflation outlook.

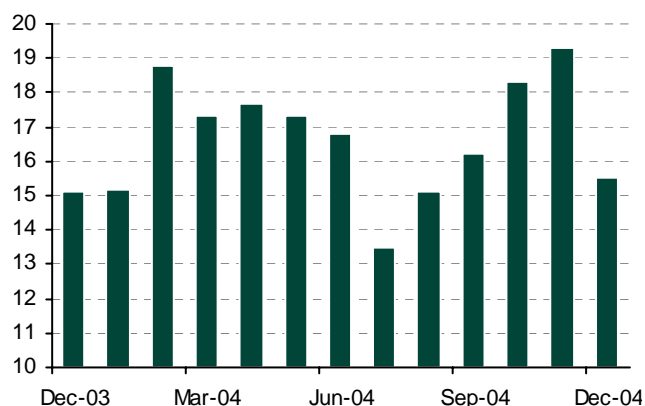
All in all, we think Mr. Guynn’s comments probably will be close to reflecting the growing consensus of opinion on the FOMC heading into next Wednesday’s rate decision.

Figure 4: Consumer Confidence (1985=100)



Source: Conference Board and Lehman Brothers

Figure 5: Jobs Hard to Get (% of respondents)



Source: Conference Board and Lehman Brothers

Consumer Confidence (Tuesday)

Consumer confidence is expected to fade in January.

We look for consumer confidence to fade a bit in January—slipping a notch from 102.3 in December to 100.0 in January (Figure 4). The anticipated decline follows a ten-point surge in

December—apparently a delayed reaction to the quick and decisive presidential election resolution and signs that the labor market, while not super-heated, remains solid.

Overall economic fundamentals have not changed much in the interval. Labor markets remain solid, and continued low claims figures suggest continued stability in the jobs component of the survey (Figure 5).

We believe the decline in consumer confidence this month has to do with factors that are least understood and poorly measured by economists. Among these factors are the level of overall confidence in the geopolitical situation and ill-defined concerns about health care, Social Security, and standard of living prospects. After such a large jump, it is not uncommon for the index to pause or even retrench a bit. Nevertheless, households remain near their most optimistic level since last July.

Existing Home Sales (Tuesday)

Existing home sales are expected to decline in December.

We expect existing home sales to decline by 2.7% in December to a still extremely vigorous pace of 6.75 million units. The anticipated decline would reverse an increase in November but leave the annual average sales pace at an astonishing 6.621 million (compared with 6.098 million in 2003 and 5.593 million in 2002)—despite higher short rates and several years of similarly robust sales (Figure 6). Part of this strength reflects continued historic lows in conventional mortgage rates. However, we suspect that will change this year, with 10-year yields projected to approach 5% by December. Coupled with an anticipated cooling in real disposable incomes, we expect this to translate into a slower existing home sales pace in 2005.

Fed Hoenig (Tuesday)

Mr. Hoenig discusses monetary policy on Tuesday.

Kansas City Federal Reserve President Hoenig will discuss monetary policy on Tuesday afternoon. Coming a week before the start of an FOMC meeting, we doubt that Mr. Hoenig will have many specifics to outline. To the extent that he discusses the current economic outlook, we expect remarks similar to Mr. Guynn's from Monday—namely, that output growth is solid, but worries about accelerating inflation are increasing.

Treasury 20-Year TIPs Auction (Tuesday)

The Treasury will auction \$8 billion in re-opened 20-year TIPs on Tuesday.

The Treasury will auction \$8.0 billion in 20-year TIPs, a re-opening of the July 2004 issue. This would bring the total size of that issue to \$19 billion, with an additional \$6 billion expected to be auctioned in July.

Treasury Two-Year Note Auction (Wednesday)

The Treasury will auction \$24 billion in new two-year notes this afternoon.

Initial Jobless Claims (Thursday)

We look for jobless claims to rebound to 340,000 in the week of January 22 after a surprising decline to 319,000 in the previous week. These swings have more to do with faulty seasonal adjustment than any dramatic improvement in the labor market climate. A similar adjustment problem occurs every January.

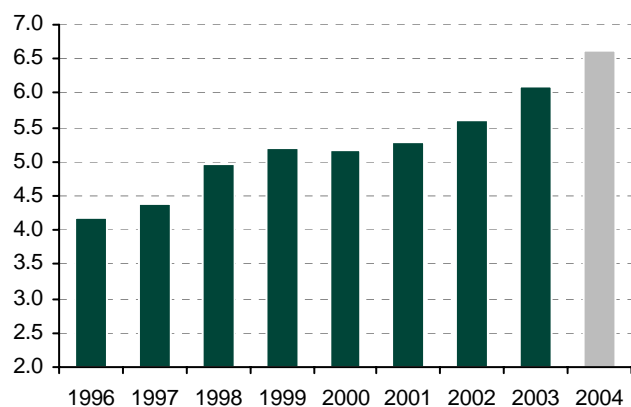
Durable Goods Orders (Thursday)

Durable goods orders are expected to rise by 1.0%.

We expect the volatile durable goods orders data to rise 1.0% in December, nearly matching November's 1.4% advance. Factories pushed up hiring slightly during December, and manufacturing surveys reported that new orders accelerated during the month. Moreover, aircraft companies experienced a surge in orders, which could also push up the overall number, especially as durable goods orders is a very lumpy series that can be heavily influenced by the timing of aircraft manufacturers booking their orders. We also project non-defense capital goods orders excluding aircraft to rise 1.0% in December, which would

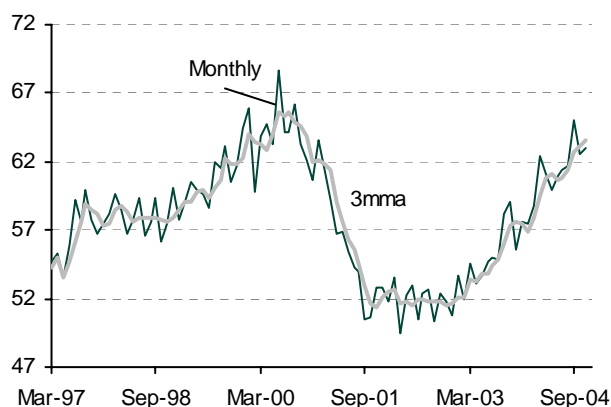
suggest that capital spending continues to stage a steady recovery following the 2001 recession and the 2002–03 spending freeze (Figure 7).

Figure 6: Existing Home Sales (millions, SAAR)



Source: National Association of Realtors and Lehman Brothers

Figure 7: Non-Defense Capital Goods Orders (\$ in billions)



Source: Census Department and Lehman Brothers

Help Wanted Index (Thursday)

The help wanted index is expected to increase by one point.

We look for the help wanted advertising index to nudge up one point to 37 in December, after falling back down to 36 in the prior month. The index seems oblivious to the improvement the labor market has experienced in the past year and has refused to budge from the 36–41 range it has been locked in since March 2002. The last time the help wanted index registered below 36 was in September 1961, when it was at 35 and the unemployment rate was a much higher 6.7%. We continue to expect this index to improve, reflecting firms' intentions to hire; however, until we are able to identify the degree to which Internet-based ads have replaced print ads, the index is likely to remain elusive.

GDP (Friday)

We look for a 3.7% reading on 4Q GDP...

We expect GDP growth to rise by 3.7% quarter over quarter, SAAR, in 4Q, following a 4% advance in 3Q. While a touch softer than the 3Q reading, the 4Q figure remains marginally above our 3.5% estimate of the economy's long-run potential growth rate, and if sustained, could result in a further reduction in excess labor and capital capacity and eventually higher inflationary pressures.

...with real consumption up 4.0%...

Among the details, we look for a cooling in final sales during the quarter, despite what is expected to be a robust quarter for consumer spending. We predict final sales to cool from 5% in 3Q to 3.3% in 4Q (see Figure 8). Yet consumer spending is expected to increase by 4% during the quarter as auto sales were very strong—particularly in December. Without auto sales, however, real consumer spending (and GDP growth) would be about 0.5% softer, consistent with the somewhat disappointing tone reported by retailers during the holiday shopping season.

...and business investment up almost 11%.

We look for business fixed investment to rise by nearly 11% in the quarter, driven higher by a mad dash to get machinery, electronics, and high-tech capital in place before the expiration of the Treasury's bonus depreciation allowance in December. The expiration of the bonus depreciation allowance is expected to have the greatest impact on capital with a relatively long life; short-lived high-tech equipment already has very high rates of depreciation and therefore should benefit less from quicker tax depreciation. We expect non-residential construction to slip an additional 3% in 4Q, while the comparatively solid pace of housing starts (despite lousy weather) points to a modest increase in spending of 1% during the quarter.

Inventory and trade are the biggest wildcards in the 4Q GDP estimate as the Commerce Department is forced to make a guess about these items as it is missing data for December. Trade swung sharply in October and November, and the overall GDP figure will be very sensitive to the Commerce Department's December estimate. We are assuming that the deterioration seen in the monthly figures translates into a nearly 1% drag on quarterly GDP growth, which is only partly offset by an inventory rebuilding (which itself should add 0.4% to GDP).

Figure 8: GDP Components (% quarter over quarter, SAAR)

	1Q'04	2Q'04	3Q'04	4Q'04
GDP	4.5	3.3	4.0	3.7
Consumption	4.1	1.6	5.1	4.0
BFI	4.2	12.4	13.0	10.7
Nonresid. Structures	-7.5	6.9	-1.2	-3.0
Equipment & Software	8.1	14.2	17.5	15.0
Housing	5.0	16.5	1.6	1.0
Government	2.5	2.2	0.7	1.7
Inventory Investment (\$bn)	40.0	61.1	34.5	48.6
Net Exports (\$bn)	-550.1	-580.3	-583.2	-611.2
Exports	7.3	7.3	6.0	7.0
Imports	10.6	12.6	4.6	11.2
<i>Growth Contributions:</i>				
Final Sales	3.3	2.5	5.0	3.3
Inventory Invest.	1.2	0.8	-1.0	0.4
Net Export	-0.8	-1.2	-0.1	-0.8
Dom. Final Sales	4.1	3.7	5.1	4.1
Nominal GDP	7.4	6.6	5.5	5.7
Price Deflator	2.8	3.2	1.4	2.0

Source: Bureau of Economic Analysis

ECI (Friday)

We look for a 0.9% increase in the ECI in 4Q.

We look for the ECI to rise 0.9% in 4Q—exactly matching the gains recorded in each of the prior two quarters. On a year-over-year basis, this broad measure of labor compensation, which includes employee benefits as well as employers' costs for salaried workers, would be up 3.9%—matching the 2003 gain and only 0.3% higher than the 3.6% registered in 2002. Despite the improvement in the labor market since early 2003 and a half percentage point decline in the unemployment rate, employee compensation costs have remained subdued, suggesting the labor market is not yet at full employment.

Benefit costs have been pushing the overall ECI higher.

Among the components this quarter, we look for the wage and salary portion to increase by 0.6% and the benefits portion to rise by 1.8%. Wage demands remain muted largely as a result of employee perceptions about the health of the labor market. A significant proportion of workers still reckon it is a difficult time to find a job, and nearly all of the recent multi-year surge in labor productivity appears to have gone to raising corporate profits rather than employees' take-home pay. Instead, the key driver of employer costs is rising health insurance costs. Interestingly, several recent papers and work done by the Bureau of Labor Statistics suggest that the number of workers taking employer-sponsored health insurance has declined over the past decade—largely because of the increased co-payment burden.

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