

## U.S. ECONOMICS

Ethan S. Harris 1.212.526.5477 eharris@lehman.com

## Rodney Dangerfield

## 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 | 2.81 | 3.10 | 3.20 | 3.40 | 3.60 | 2.81 | 3.60 | 4.20 |
| TSY 5-year note        | 3.50 | 3.49 | 3.70 | 3.90 | 4.10 | 4.30 | 3.49 | 4.30 | 4.80 |
| TSY 10-year note       | 4.29 | 4.16 | 4.40 | 4.40 | 4.70 | 5.00 | 4.16 | 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 1 January. All forecasts are modal forecasts (ie, the single most likely outcome).

Source: Lehman Brothers

## Lightning Strikes: Payrolls as Expected

The growth data continue to be indecisive, pointing to slightly above-trend growth. As expected, it was a mediocre holiday shopping season with same store sales up less than 3% over one year ago. And for one of the few times in recent history, the employment report came in right on top of consensus forecasts, with a 157,000 gain, modest upward revisions of 34,000 to prior months, and the unemployment rate locked into 5.4%. The jury is still out on whether the fading fiscal stimulus and a more cautious consumer will slow growth in the first quarter and whether that in turn will slow down the Fed.

## No Respect, No Respect at All

The Fed is searching for the  
"point of pain" ...

From the onset of this rate cycle, we have argued that the Fed is not on some kind of pre-programmed path to neutral. Rather, it is feeling its way forward, searching for the "point of pain," where either the economy begins to slow or weakness in financial markets points to a

Lehman Brothers does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report.

Investors should consider this report as only a single factor in making their investment decision.

**PLEASE REFER TO THE BACK COVER FOR ANALYST CERTIFICATION AND IMPORTANT DISCLOSURES.**

future slowing in growth. This is why the Fed is moving in 25-basis-point increments, and this is why FOMC members present such wide—3% to 5%—estimates of the “neutral” funds rate. Fed members know that low inflation and spare capacity give them room to move slowly, and they worry that with high debt levels and fading fiscal stimulus the economy cannot handle a quick normalization of interest rates.

*...but financial markets seem to be ignoring the Fed actions.*

However, six months into the tightening cycle, Alan Greenspan must be feeling like Rodney Dangerfield. While the Fed does not want to crush financial markets, it does want the markets to take some notice. And yet, as Figure 1 shows, the economy has slowed slightly, while financial markets have remained ebullient. Indeed, if anything, overall financial conditions have eased: low bond yields, a rising stock market, tightening credit spreads, and a weaker currency are all good news for growth.

Last week, the Fed initiated its new early release policy for the FOMC minutes. Rather than wait until after the next FOMC meeting—when the minutes are largely out of date—the Fed now releases them just three weeks after the meeting, transforming them into a top ten event in the bond market. For the first early release, the markets and the business press focused on the more hawkish language around inflation, causing a mild sell-off. While the Fed’s official line is still that inflation risks are balanced, a significant minority “cited developments that could pose upside inflation risks.”

*The Fed is frustrated by the easy financial conditions...*

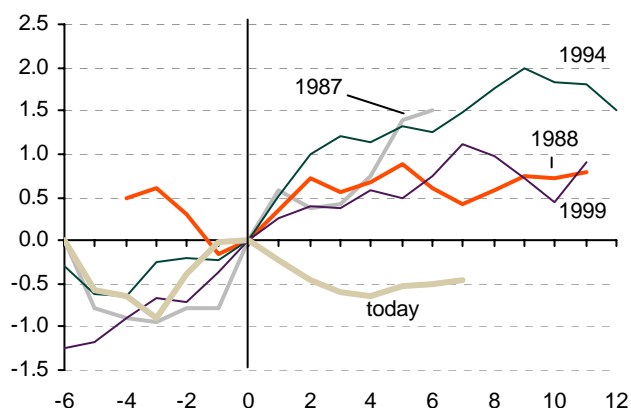
However, the bigger story was the Fed’s growing focus, and frustration, with financial markets. In the November minutes, FOMC members made only passing reference to easy financial conditions, but by December it was a major topic of discussion: “... participants noted that increasing equity and home prices had boosted household net worth, leaving consumers well positioned to maintain a brisk pace of spending... Moreover, intermediate- and long-term interest rates remained low in both nominal and real terms despite the recent firming in the stance of policy, encouraging spending on consumer durables and housing.”

Figure 1: Interest Rates and Economic Fundamentals

|                                  | Before<br>Tightening | Today |
|----------------------------------|----------------------|-------|
| <b>Economy</b>                   |                      |       |
| GDP (2Q % ch, ar)                | 3.9                  | 4.0   |
| Payrolls (6mo avg ch, 000)       | 204                  | 165   |
| Core PCE deflator (6mo % ch, ar) | 1.8                  | 1.1   |
| <b>Markets</b>                   |                      |       |
| TSY 2yr                          | 2.83                 | 3.22  |
| TSY 10yr                         | 4.70                 | 4.29  |
| S&P 500                          | 1136                 | 1187  |
| BBB spread (bp)                  | 141                  | 118   |
| High yield spread                | 411                  | 313   |
| EMG spread                       | 432                  | 311   |
| Euro/\$                          | 1.21                 | 1.32  |

Source: BEA, Federal Reserve, BLS, and Lehman Brothers Global Economics

Figure 2: 10-Year Treasury Rate (%)



Source: Bloomberg and Lehman Brothers Global Economics

*...and signs of potentially excessive risk-taking.*

That was not all: “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 in financial markets evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers and acquisition activity, and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums.”

## Easy Money

*Long rates have not moved higher like they normally do after a Fed tightening...*

Monetary policy is famously described as having long and variable lags. However, normally the lag between the policy change and the weakness in financial markets is very short, and the delay comes from the slow response of economic indicators to the financial shock. For example, the “spider” chart in Figure 2 shows how 10-year treasury yields respond to Fed tightening cycles. In the four previous tightening cycles under Greenspan, the funds rate has increased an average of about 100 basis points seven months into the rate hike. Normally, the bond market has started to anticipate the rate hikes in advance, and that has happened today as well. However, in every case—except the current cycle—the bond market has continued to sell off as the Fed has hiked rates, with the nominal rate increase roughly matching the funds rate increase. Of course, not every rate cycle is the same, and we did not expect as big a sell-off as in the past—but a rally?

In some respects the current period is similar to the 1999–2000 tightening cycle. At the time, the Fed believed that the economy was overheating and that an important element of the overheating was the wealth effect of a booming stock market. The stock market largely ignored the tightening. A common argument at the time was that the Fed tightening was good news because the Fed was engineering a “soft landing” for the economy. Forgotten in this argument was that for the economy to cool off some part of the financial markets would have to feel some pain. With the markets refusing to cooperate, the Fed simply pushed harder on the brakes.

## Back to School

We see a number of possible explanations for the Fed’s apparent impotence. As Joseph Abate wrote in a focus article this past week, despite the levelling off of interest rates, home prices continue to surge, reflecting a growing interest in homes as a pure investment play and the belief that past price appreciation is a good predictor of future appreciation.

*...perhaps because the markets are convinced of the Fed’s success in achieving a “soft landing.”*

In the stock and bond market, the Fed may be a victim of its own success. If investors are confident that the Fed will engineer a soft landing, then both the spread sectors and the stock market have reason to remain optimistic and rally through the rate hikes. And the Fed’s increased transparency may have reduced risk premiums in bond yields.

The lack of response at the long end may also reflect the growing importance of foreign investors in the U.S. bond market. Most importantly, Asian central banks have been acting as a backstop to the U.S. bond market, giving private investors some comfort around downside risks to the market. Both economists and investors in the U.S. are generally optimistic about growth and bearish about the bond market. In the latest Bloomberg survey, 57 out of 59 economists expected bond yields to rise faster than what is priced into the forward curve. By contrast, investors in both Europe and Asia look at the high debt levels and abysmal saving rates and worry about a sharp economic slowdown. U.S. bonds are attractive for investors focused only on current yield or expecting a weak U.S. economy.

All of this creates a tough situation for the Fed. Monetary policy does not work by magic; it requires some feed-through to financial markets. If the markets will not cooperate, then the Fed will simply extend the period of hikes at every meeting. The Fed must worry, however, that, like a rusty gate, the markets could succumb to the pressure and the Fed’s efforts to avoid shocking the markets would be all for naught.

## The Week Ahead

The Census Department will pass the final verdict on the holiday shopping season with the December retail sales report. We look for a fairly soft increase in non-auto sales, consistent with retailers' reports. The PPI and import price data should remain well behaved, although the impact of falling energy prices is a bit of a wild card this month.

### Wholesale Inventories (Monday)

*Wholesale inventories are expected to rise 0.7%.*

Wholesale inventories should be up 0.7% in November, after a 1.1% gain in October. Firms are still working to build up stocks, but even after more than a year of consistently rising inventory levels, stocks relative to shipments have actually continued to fall, creating further need for stockpiling.

### Treasury Auction Announcement (Monday)

The Treasury will announce plans to auction 5-year nominal and 10-year TIPs notes this week. We look for an unchanged offering of the 5-year notes of \$15.0 billion and a \$1.0 billion increase in the 10-year TIPs offering to \$10.0 billion. Both auctions are scheduled to take place this week.

### Fed Guynn (Monday)

*Guynn's remarks on the outlook should be fairly unsurprising.*

On Monday afternoon, Atlanta Federal Reserve President Guynn will discuss the economic outlook. We look for his remarks to be fairly similar to the comments made recently by Mr. Lacker and others. Namely, the economic expansion continues apace and inflation and inflation expectations, while moderate right now, pose a significant danger. His remarks are likely to make it clear that while the Fed is not quite ready to pause in its rate hike cycle, future hikes after February will be heavily dependent on the strength of upcoming data.

### International Trade Balance (Wednesday)

*We look for the trade balance to improve by \$3 billion.*

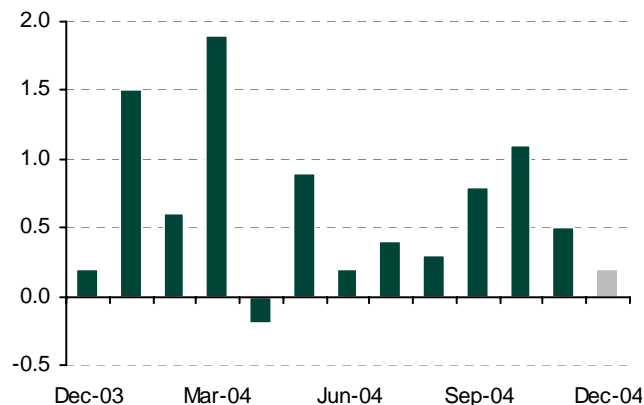
We look for the trade balance to improve by \$3 billion to a \$52.5 billion deficit in November, down from October's record (Figure 3). Much of the improvement this month should come from a reversal in petroleum prices, which should lower the nominal value of U.S. imports. Last month surging oil prices pushed up the dollar value of U.S. imports, accounting for nearly half of the \$5 billion widening in the October deficit.

Figure 3: Trade Balance (\$ billion)



Source: Commerce Department and Lehman Brothers

Figure 4: Non-Auto Retail Sales (% month over month)



Source: Census Department and Lehman Brothers

The improvement in the November balance should also be aided by a steep reversal in aircraft imports, which have doubled over the past two months. At the same time, slower, more modest growth in non-auto consumption should help restrain consumer goods imports.

Meanwhile, we expect that the continued slide in the dollar will help offset relatively soft growth overseas, leaving exports flat.

### **Treasury 5-Year Note Auction (Wednesday)**

On Wednesday afternoon, the Treasury will auction \$15.0 billion worth of new 5-year notes.

### **Budget Balance (Wednesday)**

*We look for a \$20 billion  
December budget deficit.*

We look for a \$20 billion deficit in December as strong corporate tax receipts are likely to be offset by a calendar effect that shifted Social Security payments for January into December. So far this fiscal year, the budget deficit is running slightly ahead of FY04: -\$135 billion versus -\$130 billion. Despite the higher run rate to date, we look for the budget balance to improve by \$60 billion in 2005 on the back of record corporate tax receipts and strong growth in individual tax receipts around the April 15 tax date.

### **Initial Jobless Claims (Thursday)**

We look for jobless claims to retreat to 325,000 in the week of January 8 after a seasonally distorted reading of 364,000 in the previous week. Jobless claims normally exhibit wide swings around quarter end owing to how some states calculate benefits.

### **Retail Sales (Thursday)**

The December retail sales figures are likely to be the most anticipated indicators of the week for what they will imply about the strength of consumer spending heading into the new year. While the headline number is likely to be quite strong, the core, non-auto piece may be somewhat disappointing.

*Overall retail sales are  
expected to rise 1.0%.*

We expect overall retail sales to rise 1.0% in December, led by an anticipated 3.5% gain in auto sales. Reports of aggressive incentives and a mad dash to purchase light trucks before the expiration of the bonus depreciation allowance pushed auto dealers' sales up sharply, with domestic units posting a 13% gain and reaching their highest sales pace since August 2002.

*Excluding autos, sales are  
expected to rise only 0.2%.*

Excluding autos, we expect retail sales to rise by only 0.2% in December (Figure 4). A sharp decline in gasoline prices during the month is expected to significantly lower sales at service stations. We look for service station sales to decline by 1%, or enough to subtract one-tenth from non-auto sales.

*Holiday sales were  
disappointing.*

But even excluding the impact of lower gasoline prices, this month's non-auto retail sales figures are unlikely to be impressive. Retailers reported generally disappointing sales for the holiday season outside of consumer electronics. Estimates vary for the holiday shopping season because of differences in coverage with respect to the outlet as well as the good, but compared with the National Federation of Retailers' early estimate of a 4.5% gain, the 2% to 2.5% increase being reported by a variety of surveys is a disappointment.

Retailers are offering a variety of explanations for the comparatively poor showing this year most of which center on higher gasoline prices and tighter household budgets. To be sure, gasoline prices were 30% higher than last December and disposable income growth has cooled sharply from 3.9% to 2.3% over the period. The increasing share of gift cards is also frequently cited as a reason why sales were not stronger, as these purchases only count as revenue for the retailer when they are exchanged for a good. As a result, the softer tone in the December figures may actually result in stronger sales early in the first quarter, depending on how quickly recipients redeem their certificates. Judging from the multitude of anecdotal

reports released in the week after Christmas, these gift certificates appeared to be burning a hole in consumer pockets and might have been spent late in December—too late to have much of an impact on the December retail sales figures—but just in time to push the January figures higher.

### Import Prices (Thursday)

*Import prices are expected to fall 0.2%.*

We expect import prices to fall 0.2% in December, led lower by retreating oil prices. Excluding petroleum prices, we look for import prices to decline by 0.1%. The decline in non-petroleum prices is also energy related, as natural gas prices shrank back in December after several months of gains. Declines in the prices of other imported goods should also help to hold back import prices as other commodity costs slipped in the month. But, despite three consecutive years of dollar declines, the weaker currency has yet to result in much of an increase in overall consumer price inflation.

### Treasury 10-Year TIPS Auction (Thursday)

The Treasury is expected to auction \$10 billion in 10-year TIPS this afternoon.

### Fed Poole (Thursday)

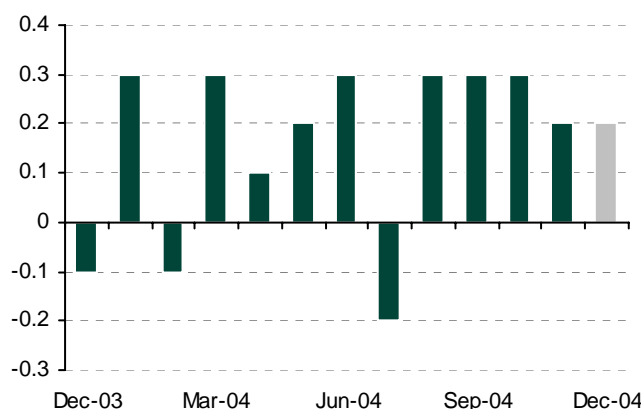
St. Louis Fed President Poole will speak on the economic outlook on Thursday afternoon. Like Mr Guynn earlier in the week, we do not expect Mr Poole to deviate from the Fed script. Instead, we expect Mr Poole to emphasize the steady improvement in growth and express worries about the potential risks overly accommodative policy implies for inflation and inflation expectations.

### PPI (Friday)

*The PPI is expected to be flat in December, with the core up 0.2%.*

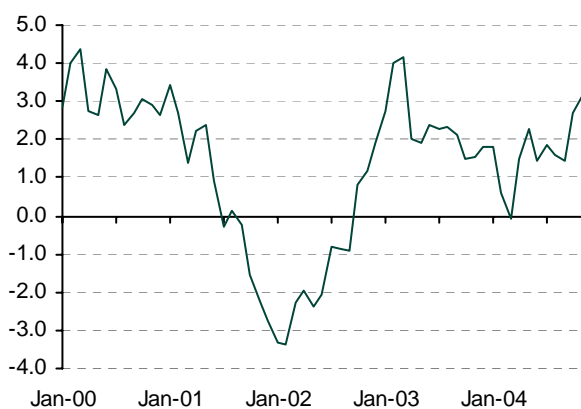
We look for a flat reading on the PPI in December, with growth restrained by falling energy prices. Excluding food and energy prices, we expect the core PPI to rise by a modest 0.2% (Figure 5). For the year, the PPI has risen 4.8%, compared with 3.9% and 1.2% gains in 2003 and 2002, respectively. However, the acceleration in the overall PPI cannot solely be blamed on higher energy prices, although energy prices have added significantly to the total (Figure 6). Food prices have actually decelerated in the past year, while the core PPI is expected to rise 2.3% in 2004 compared with a 1% increase in 2003.

Figure 5: Core PPI (% month over month)



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 6: Energy Contribution to PPI (% month over month)



Source: Bureau of Labor Statistics and Lehman Brothers

In December, we look for food prices to rise only 0.2%, as some of the distortions related to fruit and vegetable prices wash out of the data. Energy prices are projected to decline by

1.1% in the month, led by a steep decline in gasoline prices, which seems to have carried on past the early December PPI survey date. Meanwhile, we expect core prices to post a trend-like increase of 0.2% with few surprises from auto prices which have been exceedingly choppy since the summer. Despite the choppiness, passenger car prices are up only 2% in the past year, while light truck prices are 0.6% lower.

Last month, the earlier stages of production attracted a bit more attention than normal, as core prices at the intermediate and crude levels continue to advance at very rapid rates. Through November, the core intermediate index was 8% year over year, while the core crude index was up over 26%. But, there is many a slip between the cup and lip—eroding profit margins have prevented full price pass-through from these early stages of production to the finished goods level or to consumers (in the CPI). As a result, although we are concerned by the persistent strength in these indexes and the lingering threat from higher commodity prices, we are less worried by the potential for another, 2004-sized surge in consumer prices in 2005.

### **Business Inventories (Friday)**

We look for business inventories to rise 0.7% in November, following a modest 0.2% gain in October. Manufacturing inventories rose 0.7% in November, which together with our forecast for wholesale (up 0.7%) and retail stockpiles (up 0.7% as well) points to a solid recovery in the overall level this month. Yet, even with this sharp rebound, inventory levels are still low relative to shipments.

### **Industrial Production (Friday)**

*Industrial production is expected to rise 0.4%.*

We look for the industrial production index to rise 0.4% in December, with the capacity utilization rate expected to increase to 79.0 from 78.7 in November. The increase in production reflects our expectation of a pick-up in manufacturing hiring and a rebound in the factory workweek. *(This forecast was made before the December non-farm payroll figures were released)*. However, these gains are likely concentrated in the non-auto sector. The major manufacturers have announced plans to cut back on production in order to curb bloated inventory levels. In November, auto manufacturing output fell 0.7% compared with a 0.3% advance in non-auto output. We look for a similar pattern this month, with auto production down 1% and non-auto production up 0.5%.

Last month, the Federal Reserve revised down its capacity growth assumptions, which in turn, resulted in an upward revision to the capacity utilization rate. In the earlier statistics, it looked as if capacity growth would breach 2% in 2005, but in the revised figures, with growth of only 1.2%, it seems unlikely that capacity growth will reach 2%—especially under current capital expenditure assumptions and with the expiration of the bonus depreciation tax cut. The now-higher level of plant use raises inflation risks, although at 79%, capacity utilization is still a way away from the 81% danger threshold.

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 that (1) 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.

This material has been prepared and/or issued by Lehman Brothers Inc., member SIPC, and/or one of its affiliates ("Lehman Brothers") and has been approved by Lehman Brothers International (Europe), authorized and regulated by the Financial Services Authority, in connection with its distribution in the European Economic Area. This material is distributed in Japan by Lehman Brothers Japan Inc., and in Hong Kong by Lehman Brothers Asia Limited. This material is distributed in Australia by Lehman Brothers Australia Pty Limited, and in Singapore by Lehman Brothers Inc., Singapore Branch. This material is distributed in Korea by Lehman Brothers International (Europe) Seoul Branch. This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy the securities or other instruments mentioned in it. No part of this document may be reproduced in any manner without the written permission of Lehman Brothers. With the exception of disclosures relating to Lehman Brothers, this research report is based on current public information that Lehman Brothers considers reliable, but we make no representation that it is accurate or complete, and it should not be relied on as such. In the case of any disclosure to the effect that Lehman Brothers Inc. or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company, the computation of beneficial ownership of securities is based upon the methodology used to compute ownership under Section 13(d) of the United States' Securities Exchange Act of 1934. In the case of any disclosure to the effect that Lehman Brothers Inc. and/or its affiliates hold a short position of at least 1% of the outstanding share capital of a particular company, such disclosure relates solely to the ordinary share capital of the company. Accordingly, while such calculation represents Lehman Brothers' holdings net of any long position in the ordinary share capital of the company, such calculation excludes any rights or obligations that Lehman Brothers may otherwise have, or which may accrue in the future, with respect to such ordinary share capital. Similarly such calculation does not include any shares held or owned by Lehman Brothers where such shares are held under a wider agreement or arrangement (be it with a client or a counterparty) concerning the shares of such company (e.g. prime broking and/or stock lending activity). Any such disclosure represents the position of Lehman Brothers as of the last business day of the calendar month preceding the date of this report. This material is provided with the understanding that Lehman Brothers is not acting in a fiduciary capacity. Opinions expressed herein reflect the opinion of Lehman Brothers and are subject to change without notice. The products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. If an investor has any doubts about product suitability, he should consult his Lehman Brothers representative. The value of and the income produced by products may fluctuate, so that an investor may get back less than he invested. Value and income may be adversely affected by exchange rates, interest rates, or other factors. Past performance is not necessarily indicative of future results. If a product is income producing, part of the capital invested may be used to pay that income. © 2005 Lehman Brothers. All rights reserved. Additional information is available on request. Please contact a Lehman Brothers entity in your home jurisdiction.

Lehman Brothers policy for managing conflicts of interest in connection with investment research is available at [www.lehman.com/researchconflictspolicy](http://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](http://www.lehman.com/disclosures).

Complete disclosure information on companies covered by Lehman Brothers Equity Research is available at [www.lehman.com/disclosures](http://www.lehman.com/disclosures).