

U.S. ECONOMICS

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Taking the Measure of Monetary Policy

Outlook at a Glance...

%	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05	2004	2005	2006	1Q06	2Q06	3Q06	4Q06
Real GDP	4.0	3.8	4.5	4.0	3.3	3.0	4.4	3.9	3.1	3.0	3.2	3.3	3.3
Private consumption	5.1	4.2	4.0	4.0	3.3	3.0	3.8	3.9	3.1	3.0	3.0	3.0	3.0
Government expenditure	0.7	1.2	2.0	2.0	2.0	2.0	2.0	1.7	2.0	2.0	2.0	2.0	2.0
Non res fixed invest	13.0	14.0	7.9	10.7	10.8	10.0	10.6	10.9	10.2	10.1	10.1	10.1	10.2
Residential fixed invest	1.6	2.1	6.5	3.0	0.0	-3.0	9.6	3.5	-2.8	-5.0	-3.0	-3.0	-3.0
Exports	6.0	2.4	9.0	7.5	7.0	7.0	8.5	6.6	7.0	7.0	7.0	7.0	7.0
Imports	4.6	11.4	8.0	8.0	7.5	6.5	9.9	8.3	6.1	6.0	5.5	5.0	5.0
Contributions to GDP:													
Domestic final sales	5.1	4.6	4.3	4.4	3.8	3.3	4.6	4.3	3.4	3.3	3.4	3.4	3.4
Inventories	-1.0	0.6	0.5	0.1	-0.1	0.0	0.5	0.2	0.0	0.0	0.0	0.0	-0.1
Net trade	-0.1	-1.4	-0.4	-0.5	-0.5	-0.3	-0.6	-0.6	-0.3	-0.2	-0.2	-0.1	-0.1
Unemployment rate	5.4	5.4	5.3	5.1	5.0	5.0	5.5	5.1	5.0	5.0	5.0	5.0	5.0
Non-farm payrolls, 000	134	202	211	210	180	160	186	190	178	160	160	160	160
Consumer prices	2.7	3.4	3.0	2.6	2.6	2.6	2.7	2.7	2.5	2.6	2.6	2.5	2.4
Core CPI	1.8	2.1	2.3	2.3	2.5	2.5	1.8	2.4	2.7	2.6	2.6	2.7	2.7
Core PCE deflator	1.5	1.6	1.4	1.5	1.9	2.0	1.5	1.7	2.2	2.2	2.2	2.2	2.3
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	3.75	3.75	2.25	3.75	4.25	4.00	4.25	4.25	4.25
3-month USD LIBOR	2.02	2.56	3.00	3.30	3.55	3.80	2.56	3.80	4.20	4.00	4.00	4.20	4.20
TSY 2-year note	2.53	2.81	3.65	3.70	3.75	3.85	2.81	3.85	4.20	3.90	4.00	4.10	4.20
TSY 5-year note	3.50	3.49	4.15	4.30	4.40	4.50	3.49	4.50	4.40	4.40	4.50	4.60	4.40
TSY 10-year note	4.29	4.16	4.55	4.80	5.00	5.00	4.16	5.00	5.40	5.10	5.20	5.30	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 March 18. All forecasts are modal forecasts (i.e., the single most likely outcome).

Source: Lehman Brothers

We look for no change in language from the FOMC, but we have boosted our growth and funds rate forecasts.

More Strong Growth = More Fed Tightening

We have boosted our growth estimates and added a rate hike to our expectations.

In the face of strong data and continued favorable financial conditions we have boosted our estimates for 1Q05 GDP growth from 3.7% to 4.5% and for 2Q05 growth from 3.7% to 4%. We had already expected core PCE inflation to drift above the Fed's 1.5%-1.75% forecast for this year, and now—at least for the first half of the year—we also expect GDP growth to exceed the Federal Reserve Board's 3.75%-4.0% projection for 2005. In our old forecast, we expected a pause in the Fed's rate raising after August, with a 3.5% funds rate; now we look for the pause after the September meeting. The underlying logic remains the same: The Fed will continue pushing rates up until it sees some financial restraint or signs of sub-potential GDP growth.

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LEHMAN BROTHERS

The Consumer Is King

*Consumption has surprised
on the upside...*

A key component of the strong growth picture is the consumer. Despite an abysmal saving rate, fading tax stimulus, and a lack of pent-up demand for cars and other durable products, the U.S. consumer continues to motor along. The latest sign: strong retail sales figures, with non-auto sales rising at an 8% annualized rate for the last three months (Figure 1). This implies a solid 4% growth in real consumer spending in 1Q05.

...driven by higher income...

This retail resilience is partly due to a pick-up in income growth. For each of the last several years, successive tax cuts have added about one percentage point to growth in disposable income, helping to supplement weak personal income growth (Figure 2). More recently, the tax effects have disappeared, but personal income growth has accelerated, matched by job gains, an increase in proprietors' income, and rising health care benefits. None of these income drivers are likely to fade in the next few quarters. For example, we look for payrolls to average about 200,000 in the coming months.

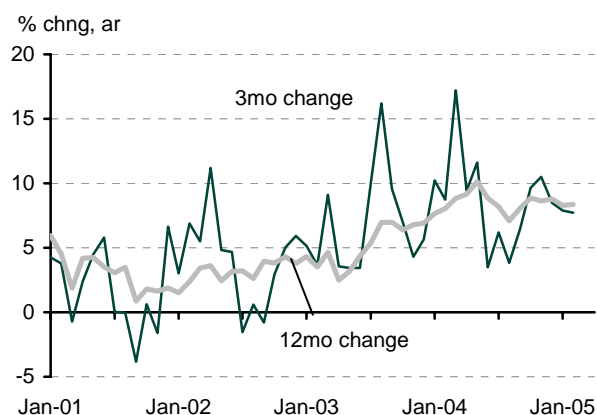
...and surging asset prices.

An even bigger driver of spending is the continued growth in household wealth. In the past year, household assets increased by more than 9%, with strong gains in private equity, stock market holdings, and especially real estate. The surge in net worth, however, has been driven by asset appreciation rather than an increase in the volume of assets. Not only has the savings rate plunged sharply, but the net acquisition of financial assets last year was about \$1.3 trillion less than the acquisition of debt. Nevertheless, the strong asset price appreciation has boosted the ratio of net worth to disposable income to the highest level in years (Figure 3).

Home Sweet Home

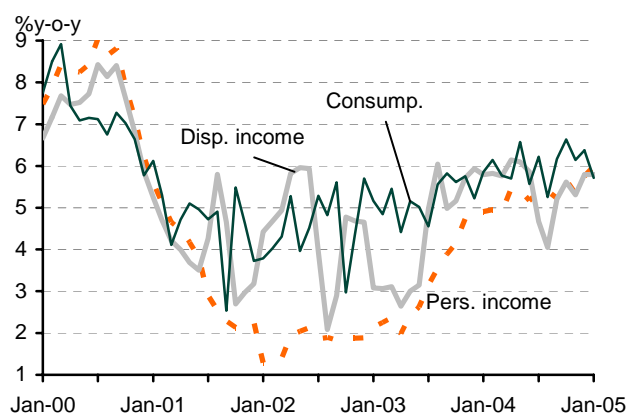
Home price inflation is becoming an increasingly important driver of consumer spending. Last year, \$1.7 trillion of the \$3.9 trillion increase in net worth was due to an 11% increase in quality-adjusted home prices. This is having both wealth and confidence effects on the consumer. While we think a bubble is developing in the housing market, we believe it will take a number of months of higher interest rates and a meltdown in several regional markets before prices stop rising at the national level. If home prices level off—as we expect—and if the stock market grows in line with income, net worth will begin to fall relative to income. This in turn will probably induce a slow upward climb in the saving rate, finally undercutting the long consumption boom. However, this is a second half story; for now, it is “shop until you drop.”

Figure 1: Growth in Non-Auto Retail Sales



Source: Census Department and Lehman Brothers

Figure 2: Income and Consumption Growth



Note: The impact of the Microsoft dividends is removed from the income data.

Source: BEA and Lehman Brothers

Say the Magic Word

Some argue that the Fed will drop the "measured" mantra...

...but we expect no significant changes in Fed language.

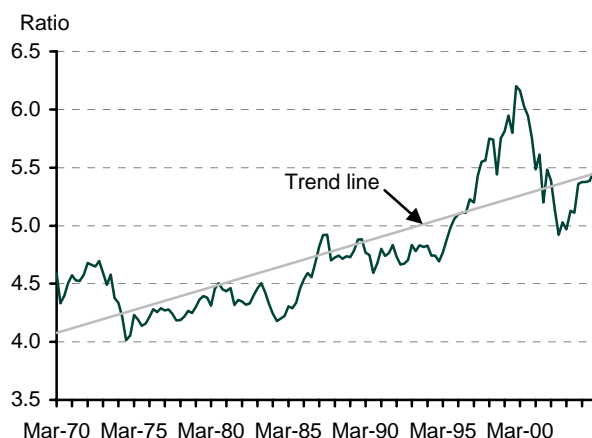
In the somewhat bizarre world of central bank watching, a word spoken or left unspoken can take on major meaning. Today, the magic word is "measured." Some analysts believe the Fed is about to drop its "measured pace" language. They note that Chairman Greenspan failed to use the word in his biannual monetary policy testimony and that some regional presidents such as Jack Guynn and Anthony Santomero have said that the language will go at some point. For example, Mr. Santomero told the German magazine *Handelsblatt* "it's neither customary nor necessary for the Fed or any other central bank to announce long-term policy in its statements."

We see three reasons to believe the language will be retained for at least a couple more meetings. First, the suggestions for a change in language are intentionally vague about timing. Second, most FOMC members have dutifully repeated the measured mantra in recent speeches. Third and most important, the language will stay because it accurately describes the likely path of policy. We see little reason for the Fed to go on hold: Overall financial conditions remain quite accommodative, and growth is solid. Further, only one of the last 13 Fed hikes has been a 50-basis-point move, and that move was adopted as a way to end the 1999–2000 tightening cycle rather than speed it up. Some FOMC members have always been a bit uncomfortable with long-term policy commitments, and some minor word fiddling is possible—but now would be a strange time to drop the "measured" language.

Other parts of the directive will also change slowly. With a very low real funds rate and with financial markets in a good mood, the FOMC will likely continue to describe policy as "accommodative." With unemployment still above most measures of the non-accelerating inflation rate of unemployment (NAIRU), the Fed is comfortable with slightly above-trend growth and likely will describe the risks around "sustainable growth" as "balanced." Despite signs that inflation is creeping higher, FOMC members seem determined to describe inflation risks as "balanced," as well.

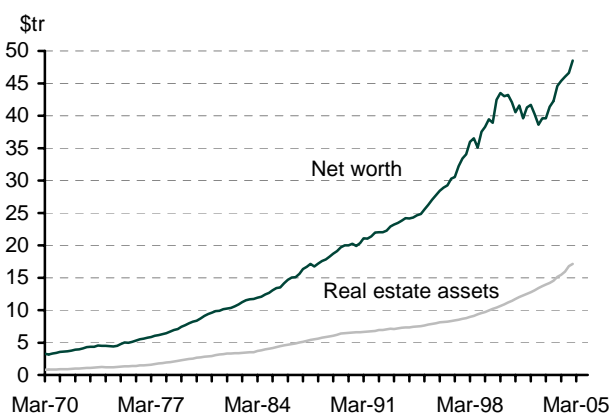
The current directive will not be in place forever. The Fed has been telegraphing its moves since August 2003, promising to be accommodative for a "considerable period" for four meetings, then saying they would be "patient in removing...accommodation" for two meetings, and now repeating the "measured pace" mantra in seven directives. In each case, it took a significant shift in economic circumstances to change the Fed's language.

Figure 3: Ratio of Net Worth to Disposable Income



Source: Federal Reserve and Lehman Brothers

Figure 4: Rising Wealth



Source: Federal Reserve and Lehman Brothers

The Week Ahead

Most of the market's attention will be on the core CPI, which we expect to post a 0.2% increase. Rising commodity prices and the falling dollar increase the chances that core CPI might accelerate faster than anticipated in February. We expect the Fed to raise the funds rate another 25 basis points and retain its "measured pace" language.

Data Preview

PPI (Tuesday)

We expect the overall PPI to rise 0.1% and the core to fall by a similar amount.

We expect the overall PPI to rise by 0.1% in February, which would push the year-over-year growth rate to 4.4%. Excluding food and energy prices, we anticipate the core PPI will decline by 0.1%, keeping the year-over-year growth rate stuck at 2.7%.

While we do not expect food prices to be much of a factor this month, they have been fairly volatile in the past year, with the standard deviation in the month-over-month change at 0.2. There were no reports of price spikes in dairy or meats, which together have been responsible for most of the volatility in wholesale food prices. As a result, we look for flat food prices.

We expect a 0.9% increase in energy prices.

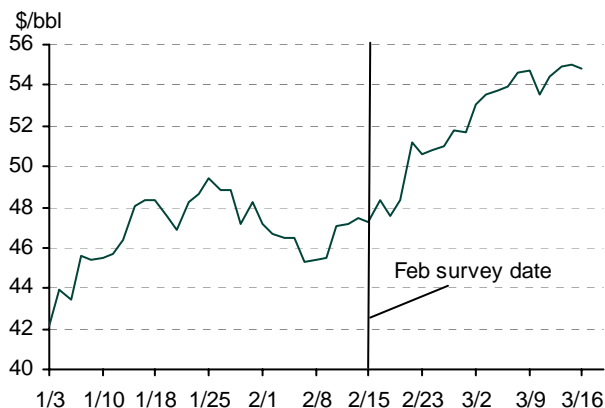
By contrast, we predict energy prices will rise 0.9% in February. Energy prices were a bit difficult to forecast during the month—largely because of the survey's timing. The survey was taken on February 15, immediately after a week or so of declining gasoline and natural gas spot prices (after seasonal adjustment). However, within days of the survey, oil prices began a sustained push above \$50/bbl (Figure 5). As a result, we expect PPI energy prices to rise 0.9%, although there is a possibility that the energy component could be significantly different than we (and the consensus) anticipate.

Core prices should be better behaved this month.

Core PPI should prove more interesting, in light of last month's unanticipated 0.8% increase (Figure 6). We judge there are two reasons to look for a more benign reading this month.

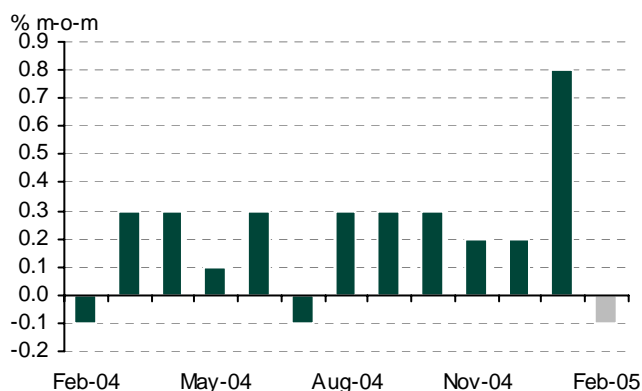
First, approximately half of last month's surge was concentrated in just three components: tobacco (up 3.2%), alcohol (up 2.8%), and autos (up 1.2%). These increases look like one-time events. Tobacco and alcohol prices have been flat to lower over the past several years, and with auto inventories surging amid production cut-backs, we suspect that the weakness at the retail end will feed through to wholesalers fairly quickly. As a result, we look for a sharp cooling in all three components, with tobacco and alcohol prices each falling 3% and auto prices flat in February.

Figure 5: Oil Prices



Source: Bloomberg and Lehman Brothers

Figure 6: Core PPI



Source: Bureau of Labor Statistics and Lehman Brothers

Second, the core PPI is normally fairly volatile in the first quarter. Wholesalers frequently use the calendar change-over as an opportunity to revisit their pricing policies and update their catalogues and price quotes. As a result, prices can have a bit of an upward bias during the quarter, and this is one of the reasons why month-over-month movements in the January core index are the second-most volatile of the year (December happens to be the most volatile month, while February is also noisy). Over the past nine years, there is a tendency for any price spike in the first quarter to be short-lived. In seven of the last nine years, the core PPI has had at least one flat or negative reading during the first quarter—particularly after an unusually steep increase in prices. This makes February 2005 a prime candidate for some type of reversal in prices.

Of course, neither of these explanations is completely satisfying. After all, commodity prices are moving up sharply and pipeline measures of inflation have continued to creep higher. For instance, the core intermediate price index is currently rising at an 8.5% annual rate, while the core crude index is increasing at an even more rapid 13.1% rate. And while it is possible to uncover plenty of excuses for last month's surge in the core PPI, the basic fact is probably unchanged—as the *Beige Book* noted, wholesalers and retailers are having more success in passing along price increases to their customers amid strong fundamental demand.

FOMC Rate Announcement (Tuesday)

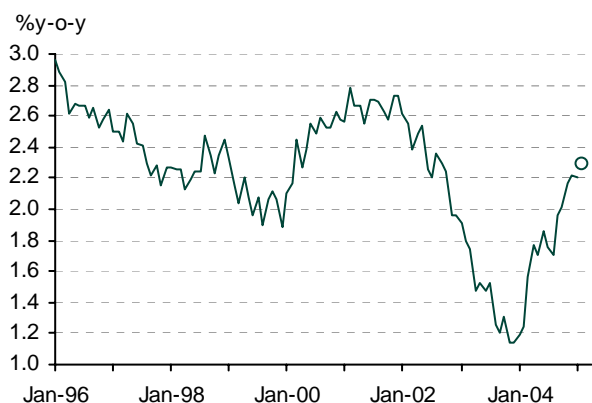
We look for a 25-basis-point increase in the funds rate...

...and expect the Fed to retain its "measured pace" language.

There is less uncertainty about the Fed's actions than its language at the next FOMC meeting. We, like virtually every other economist, look for the Fed to raise the overnight lending rate by 25 basis points to 2.75%. However, there is more divergence of opinion on the language accompanying the directive.

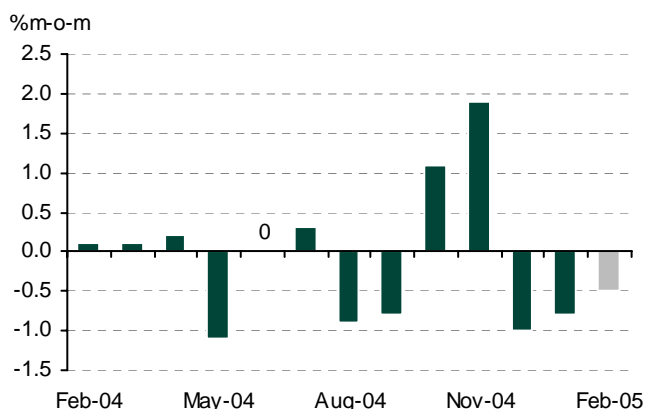
We expect the Fed's statement to look almost exactly the same as the last few: There will likely be an acknowledgment of solid economic growth, modest inflation, and the likelihood that policy can continue at a "measured pace." To use the Fed's own language: "Output appears to be growing at a moderate pace despite the rise in energy prices, and labor market conditions continue to improve gradually. Inflation and longer-term inflation expectations remain well contained." However, in our view, the odds are growing that the Fed will not be able to keep this "Goldilocks" text for long before the bears return.

Figure 7: Core CPI



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 8: Public Transportation



Source: Bureau of Labor Statistics and Lehman Brothers

However, inflation risks are rising.

In particular, we see rising inflation as the biggest “bear” in the outlook that might force the Fed to alter its text. Core measures of prices have continued to creep higher this year and by most measures are already in the upper half of the Fed’s perceived tolerance threshold. For example, for the core PCE deflator, we believe there is an implicit target of 1%–2%, although some FOMC members would put the upper end as high as 3%. Currently, the core PCE deflator is rising at a 1.6% year-over-year rate. With increasing pass-through effects from a weaker dollar and rising commodity prices, we think the odds favor a further upward creeping in prices this summer—particularly since activity measures, like consumption and industrial production, are likely to surprise on the upside. Moreover, there are signs that the benevolent combination of strong labor productivity growth and subdued wage pressures may be ending. Although wage measures remain comparatively restrained, labor markets have tightened up a bit since last winter and unutilized labor capacity is slowly shrinking. The deceleration in labor productivity from 5% to 2.5% is likely to compound this effect on unit labor costs, increasing the chances that firms will boost retail prices.

However, our view is that the Fed is still two or three meetings away from changing the text of the FOMC directive and that any significant alterations will be based on the strength of the upcoming inflation data flow.

CPI (Wednesday)

We look for the CPI to rise 0.3% and the core to increase by 0.2%.

We predict the CPI will rise 0.3% in February, accelerating from the 0.1% increase posted in January. On a year-over-year basis, the CPI will have risen nearly 3.0%. Excluding food and energy prices, we anticipate the core CPI will rise 0.2%, which would leave the year-over-year growth rate unchanged at 2.3% (Figure 7). The core CPI is currently growing at the upper end of the Fed’s perceived 1.5%–2.5% inflation tolerance threshold, keeping pressure on the Fed to continue moving rates higher.

Energy prices rose in the month.

Broad-based increases probably drove the energy index higher this month. We look for gasoline prices to rise by 2.5% which, coupled with similarly sized increases in fuel oil and natural gas, should pull the energy index up 1.7% this month. Despite the increase, energy prices are growing at a slightly slower annual rate than at the beginning of the year—10% compared with 16.5% at the end of last year. But eventually, we expect some of the signs of more emboldened retailers mentioned in the most recent *Beige Book* to show up as higher prices in a number of components outside of the energy index, like public transportation. So far, the collateral damage has yet to manifest—public transportation costs are falling at a 1% annual rate (Figure 8).

We do not look for any surprises from the core CPI this month.

We predict core prices will post a trend-like 0.2% increase this month. The core CPI has increased 0.2% in each of the last four months. As a result, the year-over-year growth rate has accelerated to nearly 2.4%. Outside of the usual volatile components—autos, airfares, and apparel—we believe that there is comparatively little risk of a major surprise this month.

Existing Home Sales (Wednesday)

We expect home prices to hold steady for February.

We look for existing home sales to be unchanged in February, holding steady at an extremely robust 6.8-million-unit annualized sales pace. Mortgage bankers have reported strong loan demand, and although interest rates have backed up recently, this is unlikely to affect sales until April at the earliest. Existing home sales are contract closings, so they actually represent sales done as long as two months ago, when interest rates were lower and demand was stronger. Looking forward, the back-up in mortgage rates to date has been comparatively mild by historical standards, so the additional interest rate burden on households is not expected to be particularly harsh, unless rates continue to sell off sharply. Indeed, in a normal Fed tightening cycle, long rates are 50–150 basis points higher than they were at the start. Even with the sharp sell-off of the past few weeks, long rates are about 20 basis points lower than at the start of the cycle.

Initial Jobless Claims (Thursday)

We look for jobless claims to slip by 3,000 to 315,000 in the week of March 19.

Durable Goods Orders (Thursday)

We predict durable goods orders will rise by 0.5%.

We expect durable goods orders to rise 0.5% in February, partially offsetting the 1.3% decline in the previous month. Weak transportation orders caused the drop in January, and we look for a bounce back this month. Not only were auto sales marginally stronger than expected, but after two consecutive months of steep declines in aircraft orders (totaling 36%) we think a rebound is likely in February.

Capital goods orders excluding defense and aircraft are likely to be very solid once again this month. We look for this core orders series to climb by 2.0% in February, after increases of roughly 3% in each of the last two months. The orders figures clearly suggest that there was little retrenchment in equipment spending following the expiration of the bonus depreciation allowance last December. Instead, spending has remained strong through January. Strong balance sheets and equally strong cash flows are more than compensating for marginally higher borrowing costs. Indeed, corporate spreads remain unusually tight and the corporate loan demand, while it has picked up, remains anemic for this point in a normal business cycle.

New Home Sales (Thursday)

We anticipate new home sales will rise 4% in February.

We look for new home sales to rise 4% in February to a very robust 1.150-million-unit annualized pace. Most of this month's anticipated rebound is an expected payback from last month's unusually steep 9.2% decline, which we suspect was largely weather-driven. Sales are thin this time of year, such that small movements in demand can frequently result in wild swings in seasonally adjusted sales. Homebuilders reported only mildly cooler activity, and mortgage rates moved down during the month, helping to further support sales in the near term.

Good Friday (Friday)

Markets will be closed in observance of Good Friday.

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