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US WEEKLY ECONOMIC UPDATE

August 20, 2004

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US Economic and Investment Perspectives

US Economy: Stronger than Current Headlines Suggest

Once again, economic worries abound. Recent weak job and spending numbers have raised concerns about the sustainability of the consumer spending cycle; a host of technology companies have issued cautious comments while product inventories have gone up, raising concerns that the tech capital spending cycle has peaked. And, to make matters worse, crude-oil prices have rocketed to a new high of $48 a barrel.

As bad as all this seems, we believe things are better than they appear. Also, every economic series is subject to revision and final counts are still a long way off. As a result, it's always best to try to confirm what appears in the preliminary estimates with other series or survey results.

While it's not uncommon for the economic data and survey results to differ from one another, the gap is now unusually wide**.** In general, business and industry surveys tend to lead the economic data because survey respondents are providing up-to-date information on the tone of business conditions. Eventually those insights show up in the economic data, but there can be a lag of a few months as it takes time for the government to compile, aggregate and disseminate the economic information.

Importantly, recent surveys of consumers, small businesses, homebuilders, CEOs and manufacturing and service firms all paint a much brighter picture than what can be gleaned from the economic data (**Display 1**). These surveys support what we see in liquidity flows, profits and tax receipts, and make us think that economic news will turn more positive relatively soon. As a result, we remain bullish on the economy. The only real concern at present is soaring oil prices, which could harm the economy if they don't reverse soon.

Surveys Suggest Jobs Market is Improving

The weak jobs reports for June and July have raised concerns not only about the health of the consumer, but the general economy as well. Payroll employment rose a meager 78,000 in June and that was followed by an even smaller gain of 32,000 in July. However, the weak jobs reports doesn't reflect recent consumer surveys which show a rise in optimism tied to improved labor market conditions. Indeed, the Conference Board's measure of consumer confidence hit a two-year high in July and the Board stated that recent increases in confidence "have been fueled by gains in employment."

Importantly, recent trends in federal withheld income tax receipts tell us that the consumer survey findings are more accurately capturing the basic trends in the labor markets than payroll data of the past few months. As can be seen in **Display 2,** federal withheld income tax receipts have turned up very sharply over the last two months, increasing by roughly 7% over year-ago levels. Up until July, the growth in tax receipts was lagging behind that of wage and salary growth due to the cumulative effects of last year's reduction in tax rates. But now that the tax cut has been in place for a full year, tax receipts data is comparable to year-earlier figures, and the strong rebound tells us that workers' income is increasing faster than what is being reported.

Capital Spending Still Strong

Another area of concern is capital spending, especially in the technology space. Several companies missed profit estimates in the second quarter while others offered cautious guidance about the second half. Rising product inventories have also caused concern.

Yet, macro data on technology paints a brighter picture. Order backlogs at the end of June stood at record levels. And even though product inventories have moved up in the second quarter, they still are at historically low levels. In fact, except for the past few months, product inventories are more than 25% below 2000 levels, and currently stand at 1994 levels. Moreover, in relation to order backlogs, tech inventories are at record lows (**Display 3**). Clearly, the macro data indicates that while some firms might be underperforming relative to plan, many more are doing as well if not better than expected.

Business and industry surveys suggest a similar view. The National Federation of Small Business optimism index hit a new all-time high in July, and capital spending and hiring plans remained at the highs of the year. The Conference Board's CEO confidence index fell slightly in the second quarter, but the reading was still the second highest in the last 20 years. CEOs also remain upbeat about their industry prospects. And homebuilder optimism seems to be undaunted. The homebuilder market index hit a new high for the year in August, and traffic of prospective buyers and sales expectations for the next six months were at or near-all-time highs. Purchasing agents in both the manufacturing and non-manufacturing sectors indicated business conditions were improved in July and the gains were broad based. Eighteen of 20 manufacturing industries reported better conditions in July, as did 12 of 17 non-manufacturing firms.

Oil Prices

Admittedly, high energy prices remain a major concern. History indicates, however, that the current price of crude oil is out of line with inventories (**Display 4**), suggesting that the energy markets have built in a huge premium for a potential supply disruption. Given that oil supply seems to be running at about two million barrels a day over global demand, the odds of a sharp break in crude oil prices seems to be increasing with each passing day.

At this writing, it is difficult to assess the potential economic damage from the rise in crude oil prices. In order for rising crude oil prices to hurt consumer wallets, product prices have to rise as well. Yet, average retail gasoline prices have been falling over the past few months, despite the ongoing rise in crude oil prices (**Display 5**). Now that the summer peak driving season is behind us, there is probably less of a risk on the gasoline side and more of a risk on the home heating oil side. But there is probably a window of at least 90 days before that will begin to hurt the consumer, because seasonal demand for heating oil doesn't actually begin until early-to-mid fourth-quarter. By then, the incremental supply of crude oil should be reflected in higher levels of stock and lower prices, thus reducing the economic fallout from today's record high crude oil prices.

Expansion Plans Still On Track

While the high crude oil price is causing concern, it has not reduced business optimism or stopped CEOs from moving forward with their expansion plans. In the August Business Outlook Survey, conducted by the Federal Reserve Bank of Philadelphia, business expectations for the next six months jumped 16 points to 52.7%, the highest reading in seven months. Nearly 55% of the manufacturing executives expect improvement in business in the next six months and only 2% expect decreases. In addition, 32% of the manufacturers plan to add to their payrolls in the next six months.

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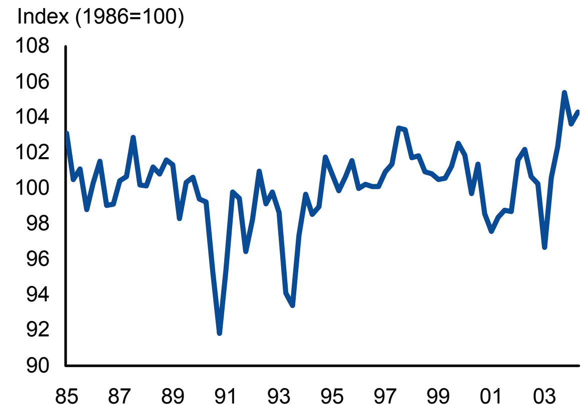
Display 1: Consumer, Business and Industry Surveys Paint a Bright Picture of the Economy

Small Business Confidence



Source: National Federation of Independent Business and Haver Analytics

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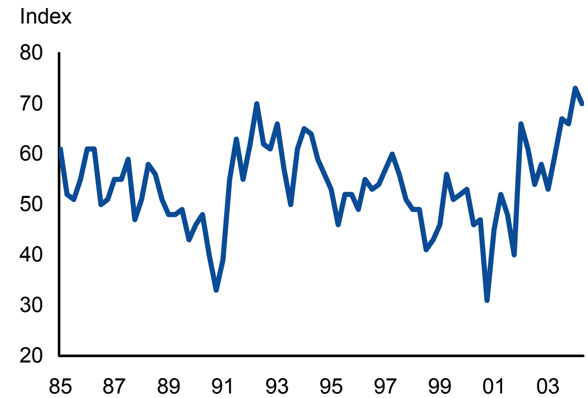
CEO Confidence



Source: The Conference Board and Haver Analytics

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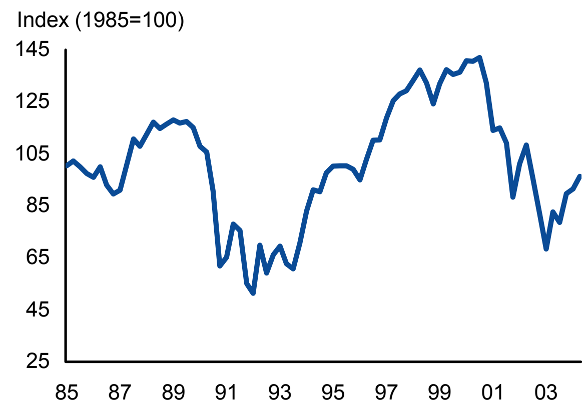
Consumer Confidence



Source: The Conference Board and Haver Analytics

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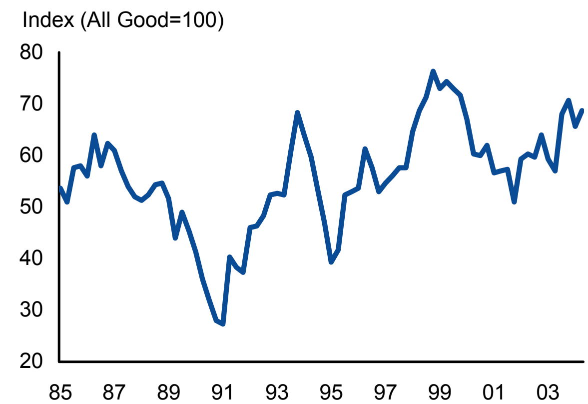
Home Builders Survey



Source: National Association of Home Builders and Haver Analytics

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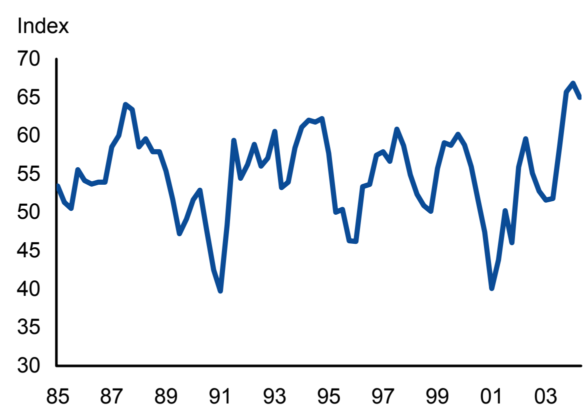
ISM Manufacturing



Source: Institute for Supply Management and Haver Analytics

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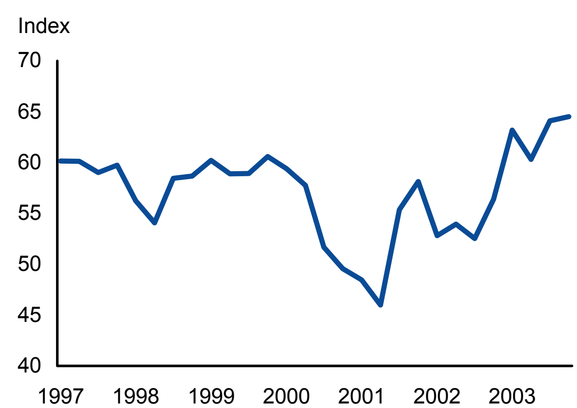
ISM Non-manufacturing



Source: Institute for Supply Management and Haver Analytics

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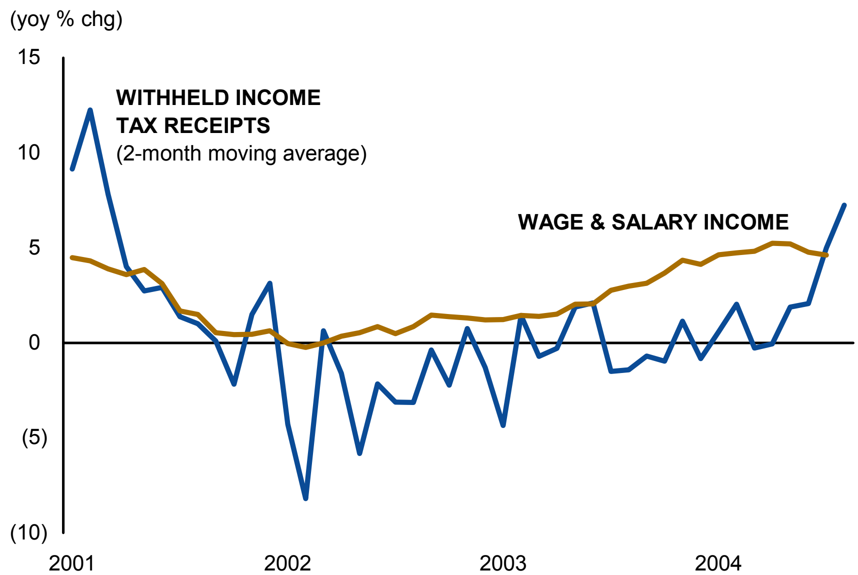
Display 2: Tax Receipts Suggest Income Growth Is Understated
Wage & Salary Income vs. Income-Tax Withholdings

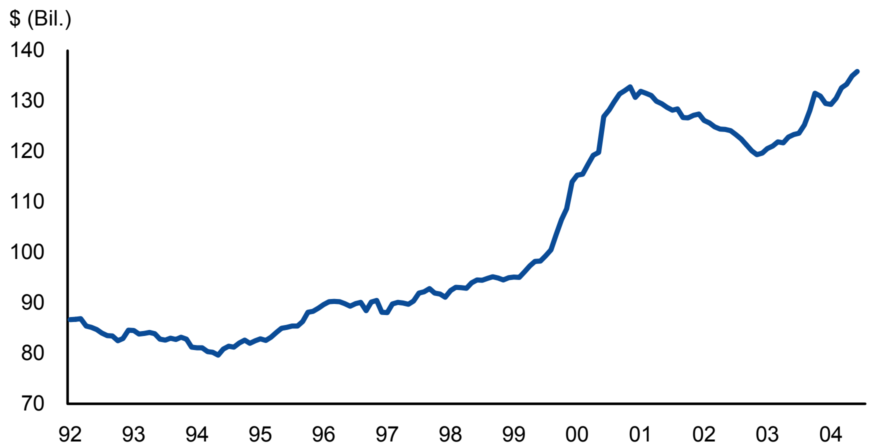


Source: Bureau of Economic Analysis, US Treasury, Haver Analytics and Alliance Fixed Income, August 20, 2004

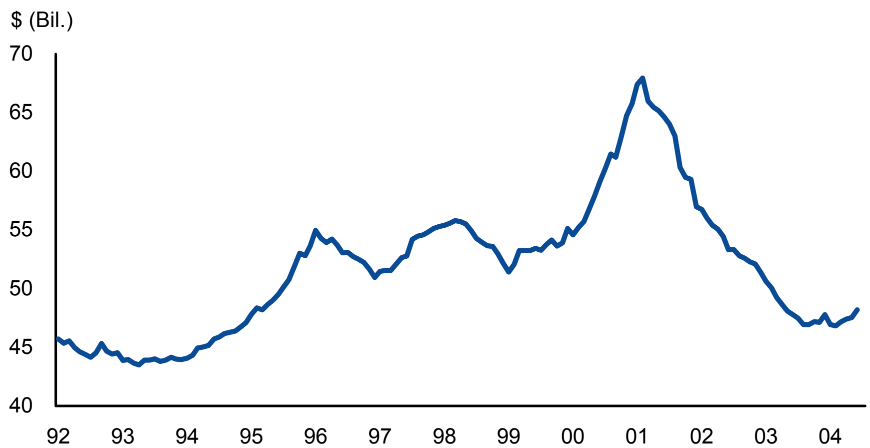
The strong rebound in federal withheld income tax receipts tells us that workers' income (and probably employment and wages) is increasing faster than the official statistics suggest.

Display 3: Tech Sector's Fundamentals Look Bright

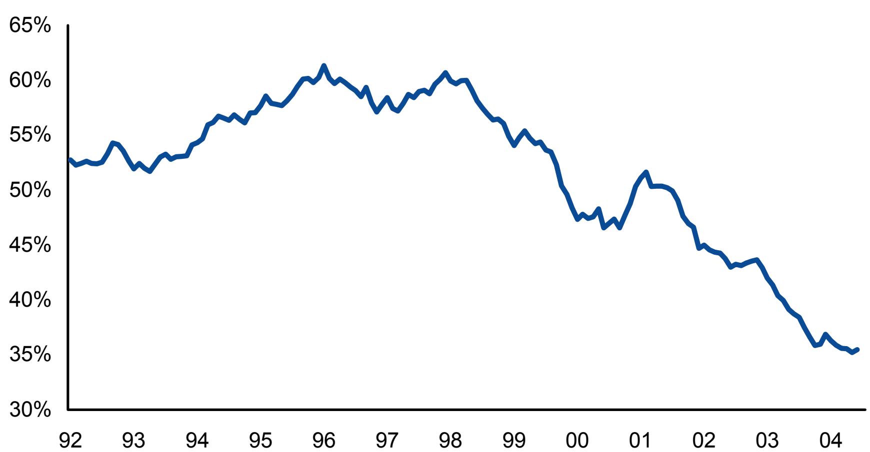
Technology Backlogs



Technology Inventories



Technology Inventories as a Percent of Backlogs

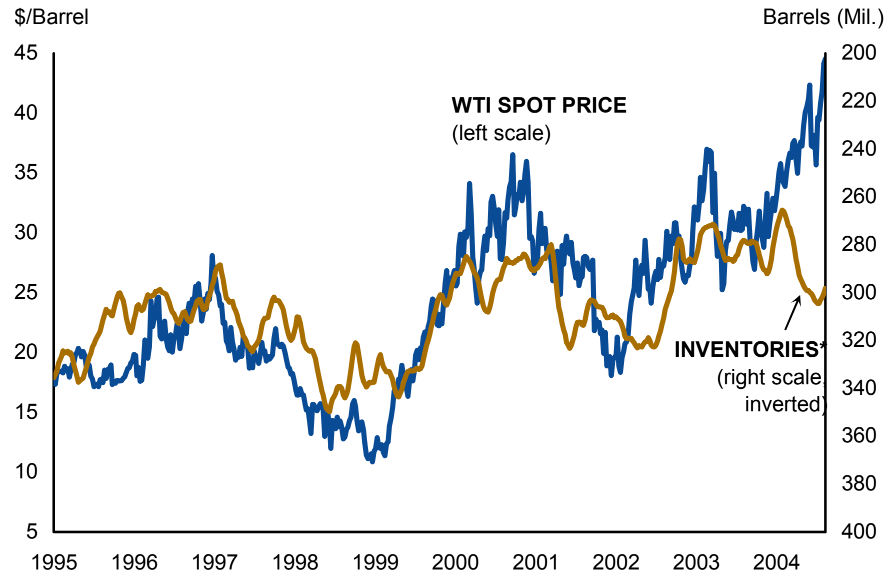


Note: Technology figures for computers and electronic products (order backlogs excludes semiconductors).
Source: Census Bureau, Haver Analytics and Alliance Fixed Income, August 20, 2004

Order backlogs for the computer and electronic products industry hit a record high of $135.8 billion in June, surpassing the prior high reached in 2000.

Although product inventories have risen in the last few months, the increase seems to be very small. Indeed, overall inventory levels are about 25% below that of 2000 and equal to that of 1994. Moreover, as a percent of backlogs, tech inventories stand at record lows.

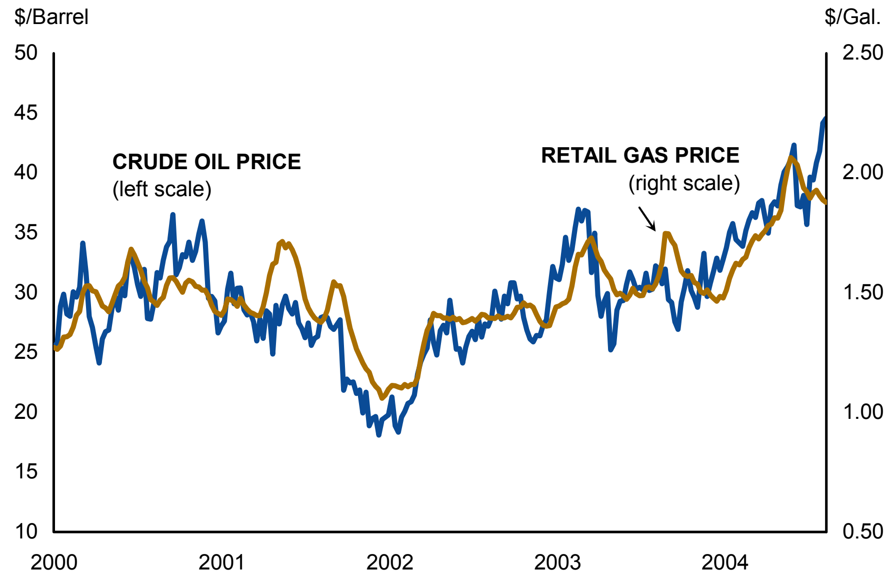
Display 4: Record Oil Prices Not Consistent With Stock Levels
Crude Oil—Inventories vs. Prices



Source: Energy Information Administration, The Wall Street Journal and Haver Analytics, August 20, 2004

Crude oil prices have hit a new record high of $48 a barrel. It appears that the market has built in a huge premium for a potential supply disruption, because current inventory levels suggest market prices should be considerably lower.

Display 5: Retail Gasoline Price Falls Despite Higher Crude Price
Prices—Crude Oil vs. Retail Gas



Source: Department of Energy, The Wall Street Journal and Haver Analytics, August 20, 2004

The near-term economic fallout from the rise in crude oil prices seems insignificant, because gasoline product prices are falling instead of rising as one would expect. But the longer crude oil prices stay at current levels, the higher the risk that product prices will begin to rise again. Hopefully, the incremental supply that OPEC is delivering to market will soon lift stock levels and lower prices, thereby limiting the economic fallout from today's record highs.