

## NATIONAL FORECAST DESCRIPTION

### The Forecast Period is the First Quarter of 2000 to the Fourth Quarter of 2003

The Federal Reserve is attempting to execute an unprecedented second “soft landing.” Last June, the nation’s central bank began raising interest rates in order to prevent the U.S. economy from overheating. A year later, recent signs in employment, housing, and consumer demand all suggest the impacts of the Federal Reserve’s current round of tightening are arriving right on schedule. (The normal lag for interest rate movements is 9 to 12 months.) In May 2000, the U.S. unemployment rate inched back above 4.0%. Even with this rise, the U.S. labor market remains extremely tight. The housing market is the most sensitive sector of the economy. This spring, housing sales showed signs of weakening. For example, new home sales dropped 5.8% in April 2000. This forecast assumes the Federal Reserve will succeed in its second soft landing. As such, no recession is expected over the forecast period.

As with any difficult maneuver, a successful soft landing is not guaranteed. The Federal Reserve seems to have pulled off the slowing down stage. However, it now must prevent this controlled descent from turning into a free fall. The soft landing will be complicated by three factors. They are: inflation, debt, and the stock market.

The major worry for the Federal Reserve is inflation. Signs of inflation had been sparse. But recently, there has been acceleration in both employment costs and core consumer prices. The former is partly the result of the higher wages dictated by the tight labor market. In addition, employer costs are also feeling the pressure of rising health care costs. Another major inflation threat comes from commodity and import prices. The price of crude oil soared above \$30 per barrel this spring. Gasoline rose above \$2 per gallon in some U.S. markets, as inventories remained low. Natural gas prices jumped because of its rising use for electricity generation. Spot electricity prices rose several fold due to strong demand and capacity limitations. The low inflation of recent years has given the Federal Reserve ample room to implement its policies. But the new rising inflationary pressures will reduce the Federal Reserve’s margin of error.

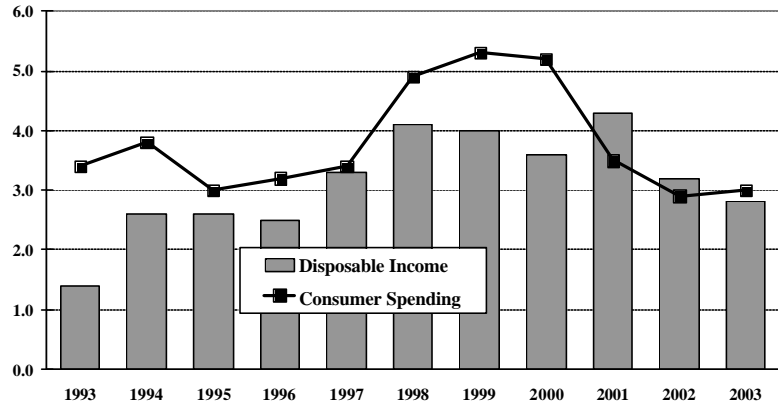
The high levels of debt are another potential problem for the U.S. economy. The ratio of debt to book value for corporations is rising, while the ratio of household debt to income is at a record level. In 1999, a record 103 rated corporations defaulted worldwide, with 75 of these in the U.S. The number of household bankruptcies declined from 1998 to 1999, but still remained high. Despite its current levels, debt is unlikely to cause a recession. More likely, the high level of debt could cause the number of defaults and bankruptcies to rise sharply in the event of a recession. This disproportionate negative impact on consumer spending and corporate investment would exacerbate an economic downturn.

The stock market is also an uncertainty. Over the last few years, the stock market has created a surge in wealth that has more than offset the higher debt. But the strong run of double-digit growth appears to be over. At one point this spring, the capitalization rate for the total U.S. stock market had dropped by almost \$2 trillion. The question is how will this affect consumers and corporations. It has had limited impact so far. Consumer confidence remains strong. This is because consumers regard these set-backs to be temporary. Another reason consumers have not retreated is because stock market declines have been highly localized. Technology stocks have taken the hardest hit, but any decline must be measured against the 500% gain these stocks enjoyed since 1996. More traditional stocks experienced much smaller declines. At this point, it is unlikely that a stock market correction will trigger a recession.

## SELECTED NATIONAL ECONOMIC INDICATORS

**Consumer Spending:** Real consumer spending is forecast to cool considerably later this year. Fueled by a strong showing from its durable goods category, real spending advanced at an impressive 7.5% annual rate during the first quarter of 2000. The 22.4% jump in spending on real durable goods reflected healthy increases in all of its components. Computers displayed the strongest growth, with a 49.5% annual pace. Motor vehicle and parts spending rose an astounding 27.7%, as Americans bought cars and light trucks at an 18.3 million-unit annual rate. Auto sales

### Real Spending & Real Income Growth



Source: Standard and Poor's DRI

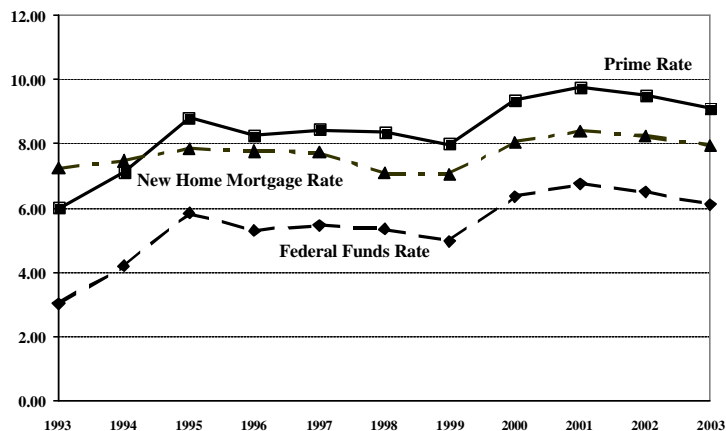
did slip 2% in May 2000, but from such a high level that manufacturers are still finding it hard to keep up with demand. Capacity utilization by auto and light truck manufacturers was running at 90% in early summer—a level not seen since the late 1970s, when manufacturers were pushing out small cars to help motorists cope with high gasoline prices. The difference this time is automakers are scrambling to meet the demand for light trucks. Furniture sales climbed thanks to booming home sales. The strong showing in durable goods spending reflects consumers' optimism. The University of Michigan's Index of Consumer Sentiment was still well above 100% in early 2000. This positive outlook suggests the momentum from recent good times have somewhat offset the negative impacts from rising interest rates and fuel prices. Indeed, real spending got little support from real disposable income that grew a paltry 2.2% during this year's first quarter. The current forecast calls for consumer confidence to fall gradually beginning in the second half of this year. As durable goods has benefited from strong consumer sentiment, it will be hurt as it cools. For example, after opening this year with a 22.4% growth pace, real durable goods spending should close the year at a 4.9% rate. Thanks to the first quarter's strong showing, real spending on durable goods should average 10.2% growth in 2000. Growth is lower in the remaining years of the forecast. As the consumer sentiment index drops from 109.1 in 2000 to 96.0 in 2003, real durable goods spending growth is forecast to slow from 10.2% to 5.2%. As a result, the pace of total real consumer spending should more closely track gains in real disposable income. Specifically, real disposable income is projected to rise 3.6% this year, 4.3% next year, 3.2% in 2002, and 2.8% in 2003. Real personal consumption should increase 5.2% in 2000, 3.5% in 2001, 2.9% in 2002, and 3.0% in 2003. As a result of the slower spending, the growth of outstanding credit should cool. Thus, the ratio of credit to disposable income should decline to 20.0% in 2003 after peaking at 20.8% in 2000. The personal savings rate should raise from this year's projected 0.8% to 1.4% in 2003.

**Financial:** The Federal Reserve is in the endgame of its current round of tightening. The nation's central bank began raising its federal funds rate in June 1999 in an attempt to cool the overheating economy. From the spring of 1999 to its last increase in May of this year, the federal funds rate has risen from 4.75% to 6.50%. It passed on its opportunity in June to raise this bellwether rate. There are several reasons for this. First, there were signs earlier this summer that the U.S. economy was already slowing. Both the weak May employment report and recent housing numbers suggest that about a year after its first action, the central bank's brakes are starting to hold. This slowing is right on schedule. A rule of thumb is that the first signs of slowing occur about a year to 18 months after the Federal

Reserve begins tightening. Second, despite the hot economy, inflation remains relatively subdued, and this has provided the Federal Reserve with some room in which to maneuver. Third, the Federal Reserve is keenly aware that while the nominal federal funds rate is not high compared to past peaks, it is very high in real terms (nominal interest rate less inflation). In fact, the last time the real rate was this

high was in 1989. Despite these factors, the Federal Reserve will likely take out some extra insurance by raising the federal funds rate another quarter point. Since the central bank traditionally avoids taking action during a presidential election, a change during the fall campaign season seems unlikely. Instead, a rate change could come as early as August or right after the election. The federal funds rate should run about 6.75% during 2001. The Federal Reserve is expected to gradually ease the monetary reins beginning in 2002, once it is convinced it has pulled off an unprecedented

### Selected Interest Rates

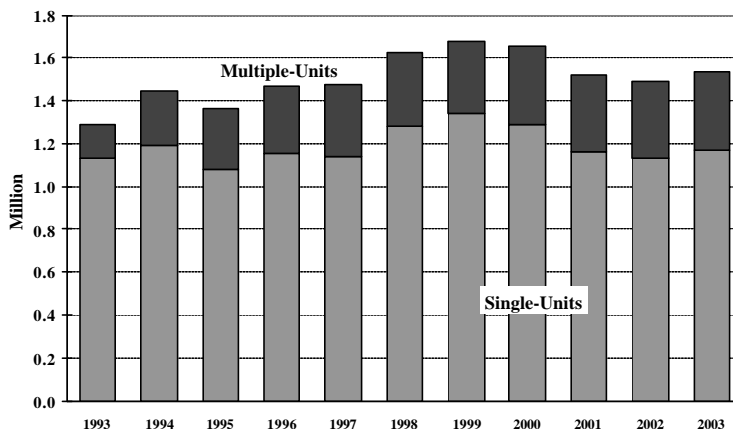


Source: Standard and Poor's DRI

second soft landing. By almost all measures, the stock market is overvalued. Almost all of that overvaluation can be traced to technology stocks. While this category of stock has run far ahead of more traditional stocks, their course has also been bumpier. For example, the Dow Index of 30 Industrials was just 8% below its January peak last spring. In comparison, the tech-laden NASDAQ was down nearly 24% in June 2000 from March 2000. After rising by 20% annually over the last five years, the U.S. stock market should slow. The S&P 500 is expected to rise 10.6% in 2000, 9.1% in 2001, 3.6% in 2002, and 11.3% in 2003.

**Housing:** The U.S housing sector began to display a few signs of slowing this spring. This was expected given the steady rise in mortgage interest rates. What has been surprising is that these increases have not taken a higher toll on this interest-sensitive industry. The mortgage rate for existing homes has risen from 6.88% in the last quarter of 1998 to approximately 8.20% in the second quarter of 2000. The U.S. Census Bureau reported sales of new one-family homes in May 2000 were at a seasonally adjusted annual rate of 875,000 units. This was about the same as the April 2000 rate of 877,000 units and just 2% below the previous May's 896,000 rate. According to the Census, privately owned housing starts in May 2000 were at a seasonally adjusted annual rate of 1.59 million units. This is lower than both the April 2000 pace (1.66 million units) and the May 1999 rate (1.65 million units). However, it is difficult to determine how much of this decline is due to higher interest rates versus the impact of unusual seasonal factors. The warm winter probably advanced some housing starts that would have occurred in the spring and early summer into the winter. This can be seen by comparing this year's cumulative housing start data against last year's data. By using the cumulative data, the effects of seasonal factors are smoothed out. During the first five months of 2000,

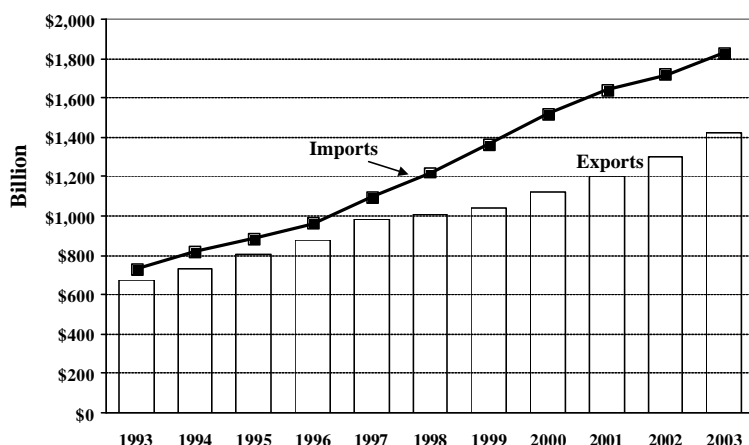
### U.S. Housing Starts



Source: Standard and Poor's DRI

there were 671,300 housing units started. This was virtually identical as the 671,600 units started during the same period last year. There are several reasons the U.S. housing sector continued to perform well in 2000 despite rising mortgage interest rates. First, the so-called “fence-sitters” jumped to lock in rates at the first sign they were on the rise. This boosted starts and sales. Second, housing buyers turned from fixed-rate mortgages to adjustable rate mortgages. The latter has become much cheaper than fixed-rate mortgages over the last few months. Third, housing has become increasingly affordable over recent years. Specifically, the effective after-tax cost of single family housing as a percent of disposable income is an estimated 25.6% in 2000 compared to almost 50% in the early 1980s. Housing should remain affordable through the forecast period, which will dampen the impacts of negative factors affecting the housing sector. U.S. housing starts are forecast to be 1.65 million units in 2000, 1.52 million units in 2001, 1.49 million units in 2002, and 1.88 million units in 2003. Interestingly, not all components have been immune from higher interest rates. Mobile homes tend to be purchased by households with lower discretionary income. As such, they tend to be more sensitive to interest rate changes, especially given the fact that rates on prefabricated homes tend to be much higher than those on site built homes. As a result, mobile home sales so far this year are down over 20.0% from last year. Mobile home shipments are expected to be 0.31 million units in 2000, 0.32 million units in 2001, 0.34 million units in 2002, and 0.35 million units in 2003.

### Real U.S. Imports and Exports



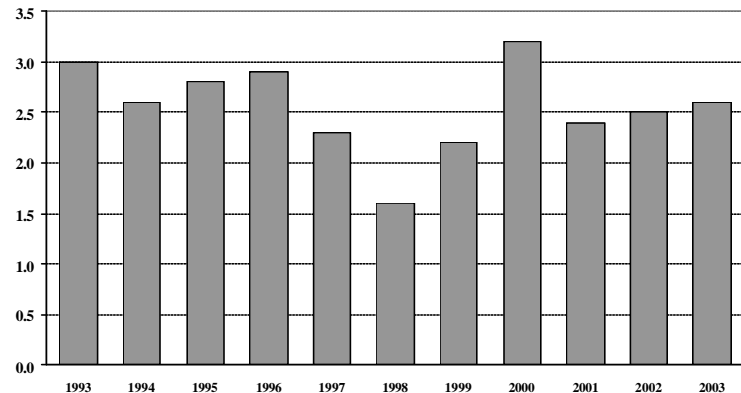
Source: Standard & Poor's DRI

**International:** The U.S. real trade deficit is forecast to increase through 2002. This should not come as a surprise. Over the past few years, America has not only been the world’s largest economy, but also its healthiest. This situation favored the flow of goods into the U.S. As a result, the real trade deficit rose from about \$20 billion in 1992 to \$323 billion in 1999. It is expected to swell to nearly \$400 billion this year. With the Asian and Russian financial crises behind, and as the U.S. economy cools, the scales will once again

tip in favor of U.S. exports. However, those expecting a quick reduction in the trade deficit will be disappointed because these turnarounds tend to have the turning radius of a super tanker. One thing hindering the reversal is the stubbornly high oil prices that will inflate the nation’s import bill. The Canadian economy should be a slightly muted echo of the U.S. economy. Like the U.S., Canada has enjoyed strong, balanced growth in recent years. It, too, is expected to cool over the next few years. Specifically, after increasing 4.0% in 2000 and 3.0% in 2001, Canadian real GDP is forecast to average 2.9% during 2002-04. This is slightly off the U.S. pace. Mexico is anticipated to grow faster than the U.S. Its real GDP is projected to grow 5.8% in 2000, 3.6% in 2001, and average 4.7% from 2002 to 2004. Having shaken off its recent setbacks, South America will grow slightly faster than Mexico. The outlook for another major trade partner, Japan, is not as bright. Despite some signs of life earlier this year, Japan’s economy should remain in the doldrums over the forecast period. Its real GDP should advance 0.9% this year, 0.7% next year, and average 1.3% thereafter. The strongest growth will be found in the so-called “Little Tigers.” These smaller Asian economies (Indonesia, Malaysia, Philippines, Taiwan, and Thailand) will average between 6.0% and 7.0% real GDP growth from 2000 to 2004. Over the forecast period, the real U.S. trade deficit will go from nearly \$400 billion in 2000, to \$437 billion in 2001, to \$415 billion in 2002, and to \$404 billion in 2003.

**Inflation:** Inflation rumblings are getting louder. Until about six months ago, signs of inflation were sparse. Since then, however, both employment costs and core consumer prices have accelerated. Of these two, the pickup in employment costs is the most troubling. There are two reasons for the acceleration of these costs. First, the tightness of the labor markets. Second, the increase in health care costs is fueling fringe benefit increases. Previously, the full impacts of these factors were masked by temporary factors. In the case of wages, the primary factor was the substitution of lower skilled

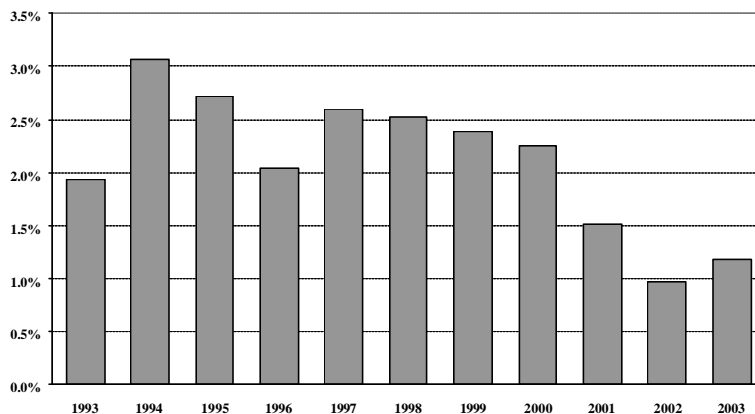
### Consumer Price Inflation



Source: Standard and Poor's DRI

workers for scarce higher skilled workers. However, the pool of lower skilled workers has also dried up, and this has put upward pressures on wages. U.S. companies have been adept at keeping their price increases at a minimum in order to remain competitive in the global market. One strategy domestic companies have used to cope is to raise their productivity by investing in capital. In many cases this move was necessary because of the shortage of skilled labor. It was further facilitated by the relatively attractive interest rates over the last few years. Firms have also tried to rein in fringe benefit costs. Some companies have been passing the higher health-care premiums back to their employees by paying a lower share of premiums or by raising copayments or reducing coverage. But this strategy seems to be reaching its limit in such a tight labor market. The allure of quick riches caused some workers in high-tech and Internet businesses to take a chunk of their compensation in stock options instead of wages. However, the disappointing performance of many high-tech stocks has caused a rethinking of this strategy. Another factor driving inflation has been energy costs. Earlier this year, it was believed that oil price spikes would be short-lived. Unfortunately, this has been proven to be wrong. Oil prices soared past \$30 per barrel this summer and gasoline prices moved above \$2 per gallon in some U.S. cities. The high gasoline prices reflect extremely low inventories. With crude oil at such high prices, U.S. refiners have resisted stocking up on oil. This has created a tight supply of gasoline. Another factor that will raise energy prices this summer is the imbalance of electrical generating capacity to demand. This is because there has been little capacity added over the last year while U.S. demand climbed 4.5% between January and May. As a result, spot on-peak (6am to 10pm) electricity prices are expected to be two to three times higher than normal.

### U.S. Nonfarm Employment Growth



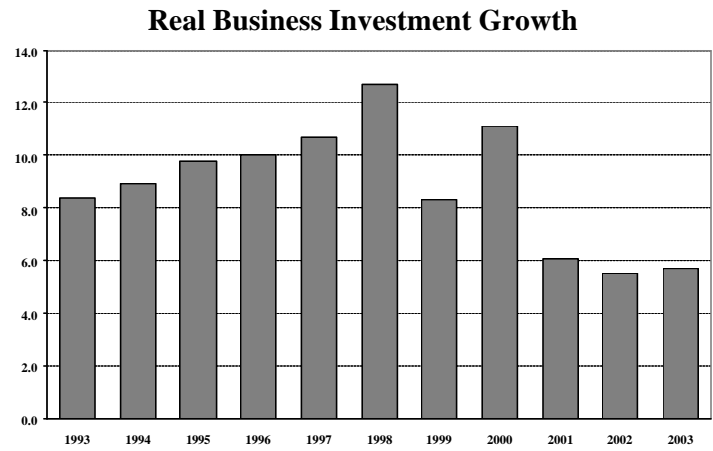
Source: Standard and Poor's DRI

**Employment:** The U.S. labor market should remain tight over the forecast period. Since October 1999, the jobless rate has hovered between 3.9% and 4.1%. This is well below almost everyone's measure of full employment. It is expected to average 4.0% this year and next. After 2001, the cooling economy will loosen the labor market and the unemployment rate will drift up. However, despite the anticipated increases, the unemployment rate should remain well below the full employment rate. Specifically, DRI estimates the full-

unemployment rate to be 5.0%. Even after two years of moving upwards, the unemployment rate is

projected to average just 4.3% in 2003. This tight labor market will contribute to the slower growth of jobs in the U.S. Employers will find it harder and harder to locate employees in this environment. Thus after growing 1.8% in 2000, the number of nonfarm jobs is predicted to advance 1.3% in 2001, 0.9% in 2002, and 1.0% in 2003. The boost employment received this year from Census hiring is almost over. In June 2000, the federal government let go of 190,000 temporary census employees. This loss was more than offset by a 206,000 increase to private sector payrolls, however.

**Business Investment:** The slowing economy is a threat to real business investment. This is because investment tends to exaggerate the ups and downs of the economy. For example, during the current expansion, investment has outgrown the economy for eight straight years, and has contributed to sharp increases in productivity. In contrast, during the last recession, fixed investment contracted for six consecutive quarters, falling into a much deeper and longer decline than the overall economy. Given rising interest rates, concerns have arisen that investment spending may cool. On net, it appears that a



Source: Standard and Poor's DRI

soft landing for investment is the most likely impact of Federal Reserve tightening. However, higher interest rates will not uniformly impact all components of investment. To see this, one needs only look at the four types of investments that have grown fastest over the expansion: computers, software, communication equipment, and light trucks. Nominal spending growth on computers will slow. But keep in mind that this slowdown is from a very high level. Real spending on computers advanced 50% per year over the last few years thanks to falling computer prices. Over the next few years, growth of 20-30% seems more likely. Software spending should be the least impacted by rising interest rates. Over the last three decades software purchases have continued to increase as a share of investment. This category may suffer a slight setback this year. It should be noted that this would be a function of an anticipated price increase, and not higher interest rates. Despite higher interest rates, investment in communication equipment is unlikely to slow in the near future. This is because businesses have too many upgrades to their communication systems in the pipeline. Investment in light trucks will be most affected by higher interest rates because it mainly consists of SUVs purchased by consumers. Not surprisingly, nonresidential construction is also vulnerable to higher interest rates. However, investment in communication-related structures will be less susceptible. The bottom line is that real business fixed investment will cool, but not collapse, during the forecast period. Specifically, after rising 11.1% this year, investment grows 6.1% next year, 5.5% in 2002, and 5.7% in 2003.