

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Fourth Quarter of 2002 through the Fourth Quarter of 2006

The nation's economic recovery trajectory has been lowered compared to the previous forecast. Global Insight continues to anticipate a noticeable jump in economic activity beginning in the second half of this year after several quarters of disappointing growth, but this jump should be smaller than was previously forecasted. In the earlier *Forecast*, it was believed real GDP would return to near its potential of around 4.2% in the second half of this year. In the current forecast it averages about 4.0%. Real GDP is forecast to rise 2.7% in 2003, 4.3% in 2004, 3.4% in 2005, and 3.1% in 2006.

Unfortunately, the nation's unemployment rate should stay stubbornly high during 2003. Specifically, it is expected to peak at 6.1% in the second quarter of this year and fall slightly to 5.8% by year's end. This reflects the sluggish job market. Nonfarm employment is expected to shrink 0.3% in the first quarter of 2003, rise 0.3% the next quarter, and increase 0.7% in the third quarter. It should jump 2.0% in the fourth quarter of 2003 and enjoy growth of over 2.0% in each quarter of 2004. As a result of the stronger job market next year, the unemployment rate is anticipated to be 5.2% by the end of 2004. After 2004, U.S. nonfarm employment growth is forecast to dip below 2.0%, but it will be strong enough to pull the unemployment rate toward 5.0%.

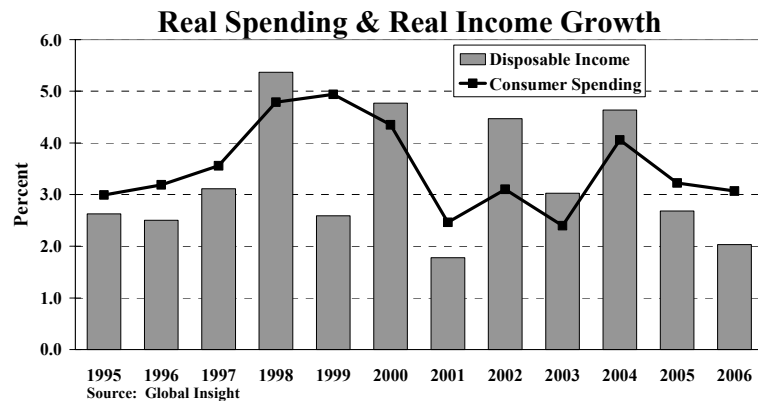
Another area of worry has been business investment. After a stunning expansion in the late 1990s and most of 2000, real U.S. nonresidential fixed investment began retreating in the fourth quarter of 2000. A leading contributor to this retrenchment has been the collapse in real investment on equipment. Specifically, in the second quarter of 2000 real business investment on equipment was rising at a 10.9% annual rate. It stalled in the next quarter and had been shrinking until the second quarter of 2002. Thus, investment has been seen as a missing element of the recovery. However, recent growth has been the cause of limited optimism. Real business equipment investment should advance, but slower than previously believed. Real investment in equipment was expected to grow at an 8.4% annual average from 2002 through 2006 in the last forecast (January 2003). This has been scaled back to an 8.0% average annual rate in the current forecast.

The current forecast assumes the Federal Reserve will continue its "wait-and-see" policy until it is convinced of the economy's strength. The nation's central bank has passed on several recent opportunities to raise its federal funds rate from 1.25%. Eventually, the Federal Reserve will raise this bellwether rate. Specifically, this forecast assumes the Federal Reserve will gradually increase the federal funds rate in the second half of this year, and it will near 2.0% by year's end.

This forecast also assumes the President and Congress will craft a set of tax cuts designed to revive the moribund economy. This forecast assumes the final budget will include a tax package worth \$60 billion in its first year and cost about \$350 billion overall. Near term, the cuts should boost consumer spending, but not investment spending. Given the federal governments' budget predicament, the odds are low it will be able to bail out state governments that are facing their worse budget woes in a generation. One recent estimate shows states are looking at a collective \$30 billion shortfall for this fiscal year and an \$82 billion deficit in fiscal year 2004.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: The nation's prosperity over the next few years largely depends on whether consumers grow weary of single-handedly supporting the economy. The consumers' role in propping up the economy during and after the recession cannot be overstated. As other sectors collapsed, real consumers spending remained afloat despite ebbing consumer confidence. Under normal conditions, consumer spending

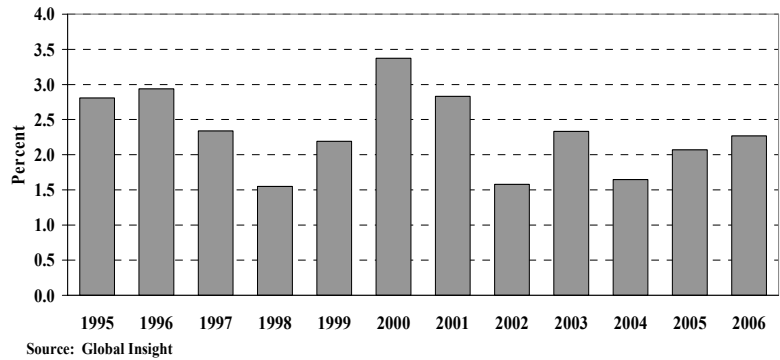


would be expected to mirror the changes in confidence more closely. However, the connection between the two blurred. From the end of 1998 to the beginning of 2000, real consumer spending expanded by at least 4.5% per quarter. The effects of falling consumer confidence were offset by the strong job market, low inflation, strong income gains, and the surging stock market. Spending growth did slow as the economy cooled and households' financial well being fell with the stock market. However, spending did not retreat during the recession. Several additional reasons have been offered to explain this resilient spending during the recession and recovery. First, the low interest rate environment has bolstered sales for durable goods. Second, automakers offered attractive financing options that consumers found hard to resist. Third, household wealth retreated from record levels, it was still relatively high. Fourth, although consumers' stock portfolios shrank, the value of one of their most valuable assets, their homes, actually improved. The increased equity and favorable interest rates allowed many consumers to take out home equity loans that would be used to finance spending. These factors provided the momentum for consumer spending to keep the economy afloat, but they cannot be expected to keep it above water indefinitely. A major threat to consumer spending was the war with Iraq. Its impacts were already surfacing earlier this year. For example, the University of Michigan's Consumer Sentiment index plunged to its lowest level since September 1993 in March 2003. In that same month, the Conference Board's confidence index slumped to its lowest point since October 1993. Two things are required to help confidence recover: A quick victory in Iraq and stronger job growth. While the former has been achieved, the latter remains elusive. Long after real GDP started its recovery, unemployment remains high. It is expected to remain near its 6.0% apex during the first three quarters of this year, and then gradually fall as companies expand their payrolls. This should provide consumers with the growing confidence they need to once again open their wallets and empty their piggy banks.

Inflation: Inflation is anticipated to remain tame over the forecast period. The economy did have a scare recently when fears of supply disruptions caused oil price to surge to nearly \$40 per barrel. The temporary jump in oil prices will contribute to the 2.3% inflation rate for this year. Since then the price of oil has retreated to \$28 per barrel. This roughly \$10 per barrel difference is the estimated war premium for oil. Inflation should retreat in 2004. There are two primary reasons for this prognosis. First, with the war over, there are no obvious threats to rising energy prices. Oil prices are expected to drop below \$25 per barrel later this year and spot natural gas prices should back down to around \$4 per million per Btu. Second, inflation should also be kept in check by slow employee compensation growth caused by sluggish employment growth. Workers are forecast to receive small increases over the next

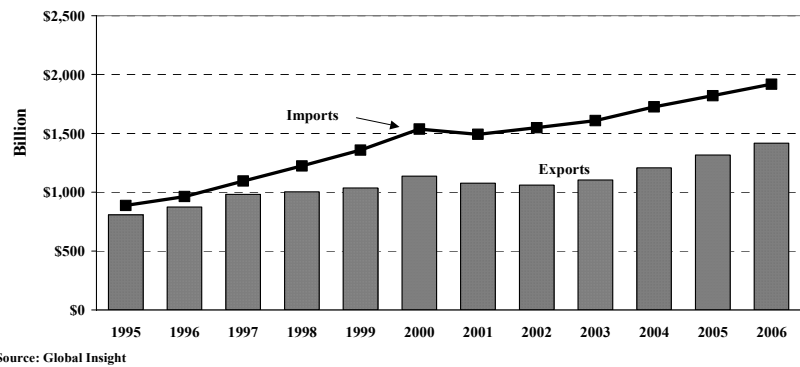
two years. As measured by the employment cost index, the annual gain in wages is projected to be 2.2% this year, the smallest gain in the quarter century this data has been recorded. Wage gains should accelerate as the job market picks up, but is not expected to grow unbridled over the forecast period. This will help keep the core (all items less food and energy) inflation rate close to 2.0% through 2006. The inflation rate for all consumer prices is forecast to be 2.3% this year, 1.6% next year, 2.1% in 2005, and 2.3% in 2006.

Consumer Price Inflation



International: The global economy's unsteady recovery has run into another "slow patch" recently. Nevertheless, the outlook should improve as the war with Iraq winds down. In addition, the world economy will get another boost when the much-anticipated U.S. business investment recovery commences later this year. One of the regions in serious need of lifting is Western Europe. European policymakers seemed to have painted themselves into a corner that prevents any bold action. While it is true the European Central Bank (ECB) has loosened recently, these moves have proven to be too little, too late to provide a boost. Furthermore, the ECB's seeming lack of concern about the suffocating impact of its policy on Germany's fragile economy is beginning to raise doubts about the viability of the European Monetary Union. Europe will also have to face and solve other challenges in the near future. The major European imbalances are potential housing bubbles, a debt-laden regional telecommunications sector, and problematic balance sheets caused by the meltdown of the region's equity market. In the longer run, Europe will have to deal with structural reforms. Due to slow market reforms, compared to the U.S., its welfare costs are more burdensome, its labor supply is less mobile, its demographics are less favorable, and its immigrants are less skilled and poorly integrated into their society. Looking further east, the picture is brighter. Growth in most Asian economies has stayed strong, thanks mainly to exports. Private consumption has also helped boost growth. Business investment has continued to contract, but at a much more moderate pace. There are also encouraging signs deflation is easing. In fact, Singapore, Taiwan, and China all registered positive consumer price inflation. Unfortunately, Japan has yet to emerge from its chronic deflation. This situation is critical because Japan is Asia's largest economy and primary growth engine. Expectations have risen for this country with the new Bank of Japan governor Toshihiko Fukui. Governor Fukui is a strong proponent of structural reform, but it remains to be seen whether he will be able to change the entrenched business culture. Japan's economy is expected to grow the slowest among the industrialized nations. However, the rest of Asia is forecast to enjoy the strongest economic growth of all regions over the next few years. South America should grow slower than Asia, but faster than the U.S. Canada is anticipated to grow about as fast as the U.S. Europe and Japan are expected to post the weakest growth over the next few years.

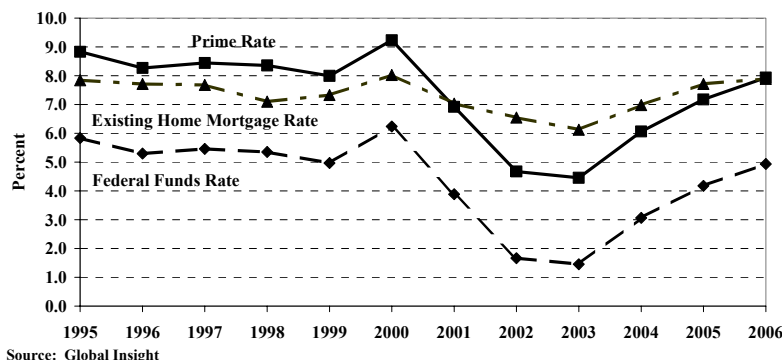
U.S. Imports and Exports



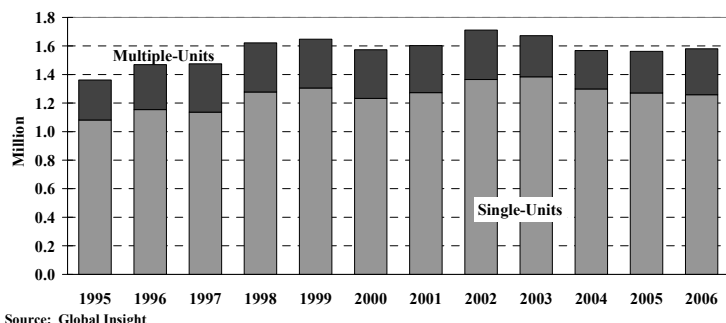
Financial: The Federal Reserve Bank of the United States has a major influence over the direction of the economy. However, it has little influence over geopolitical events. In response, the nation's central bank has taken a wait-and-see policy. The Federal Reserve has resisted lowering the rate of the federal funds rate below its current 1.25%. There are a couple of reasons for this. First, with the federal funds rate already so low,

the central bank is running out of leverage to use its most powerful policy tool. It is reserving it in case the economy deteriorates further. Second, the war with Iraq has clouded the economic picture and makes it difficult to interpret the data the Federal Reserve uses to determine its policy. It will wait until it has a clearer picture before moving interest rates. The question still remains: What will be the Federal Reserve's next move? Financial markets are betting the nation's central bank will lower rates further. They are already pricing in another 25-basis point cut by May 2003. Of course, that is just one school of thought. An argument can be made that the Federal Reserve next move will be to raise interest rates once it is convinced the economy is back on solid ground. This argument is based on the fact that Chairman has repeatedly said he believed the economy would improve after the war with Iraq. This forecast assumes the Federal Reserve will gradually increase the federal funds rate in the second half of this year, and it will near 2.0% by year's end. In contrast to the U.S. Federal Reserve, the European Central Bank has belatedly begun loosening. It finally bowed to pressure and reduced its key interest rate 25 basis points to 2.5% in early March. Further cuts are anticipated in the second quarter to offset the tightening effect of the strengthening euro. Fiscal policies are also loosening a bit. However, they will not solve longer-term problems. The structural reforms needed to make these economies more flexible and thus more attractive to businesses are still absent and will be politically difficult to achieve.

Selected Interest Rates



U.S. Housing Starts



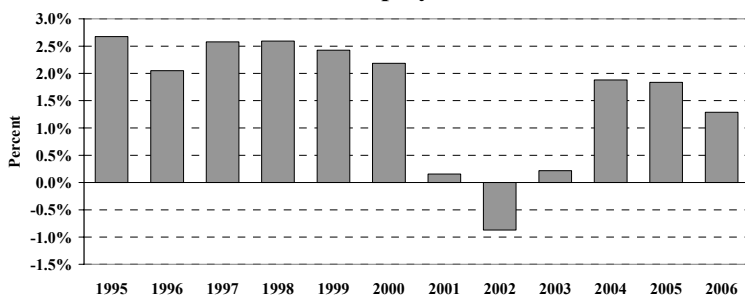
Housing: The housing industry showed signs of weakness during the first quarter of this year. Housing starts dropped 11% in February alone. Because of the severe weather during that month, however, it is hard to determine how much of it was weather related and how much of it was due to the business cycle. Conditions—as measured by confidence and walk-through traffic—took a turn for the worst in March 2003. The National Association of Home Builders' survey of housing

market conditions fell in January and February from a very high reading in December then tumbled in March to a level last seen during the 2001 recession. The same survey also indicated that the proportion of builders rating conditions as poor rose from 17% in December 2002 to 38% in March 2003. Weather may have been a factor in February, but probably not in March. A look at a couple of factors reinforces the belief the slowdown in housing that had already begun. With long-term interest rates headed back up, mortgage interest rates will soon be on the rise. Therefore, the backlog of privately owned, single-family housing units that have been authorized but not yet started will not yield a surge in starts but rather a drop in permits. As a result, a repeat of 2002's strong showing of 1.71 million housing starts is not anticipated. Specifically, the forecast shows 1.67 million starts in 2003, 1.57 million starts in 2004, 1.56 million starts in 2005, and 1.58 million starts in 2006. The softening housing market will cause

housing prices to grow much slower than in 2002. In that year, the average selling price for an existing home jumped 8.8% and the average price of new homes surged 7.3%. Over the forecast period the average price for existing housing is forecast to grow by no more than 4.0% annually and new home prices should grow slightly slower.

Government: Early this year President Bush submitted his budget for fiscal year 2004. A major feature of this bill was several generous tax cuts that caught all but the most privileged budget watchers by surprise. One of the main criticisms of the spending plan was the expected price tag of the tax cuts that would cause federal budget deficits. Now that the dust has settled from the initial fallout from the president's proposal, Congress is taking a shot at crafting a federal budget. It is not believed the Congress will have the discipline to produce a balanced budget, either. This forecast assumes the final budget will include a tax package worth \$60 billion in its first year and cost about \$350 billion overall. Near term, the cuts should boost consumer spending, but not investment spending. In the longer term, the widening budget gap will put pressure on interest rates, inflation, and the dollar. Under these conditions, the unified federal deficit is anticipated to be \$380.5 billion in fiscal year 2003, \$393.5 billion in fiscal year 2004, \$329.3 billion in fiscal year 2005, and \$227.1 billion in fiscal year 2006. Given the federal governments' budget predicament, the odds are low it will be able to bail out state governments that are facing their worst budget woes in a generation. One estimate shows states are looking at a collective \$30 billion shortfall for this fiscal year and an \$82 billion deficit in fiscal year 2004.

U.S. Nonfarm Employment Growth



Source: Global Insight

Employment: A healthy labor market remains an elusive piece of the current recovery. Well over a year after real output started growing, employment remains in the doldrums. Historically, employment is one of the last sectors to improve. However, knowing this does not make it less painful. In less than a year, the U.S. unemployment rate went from well below its full-employment threshold to above it, and it has remained above it since late 2001. The U.S.

Department of Labor reported that in April 2003 the U.S. civilian unemployment rate was at 6.0%, marking the start of the second year the economy has been underemployed. The unemployment rate should near its full-employment threshold in late 2004, and it should remain near full employment through the remainder of the forecast period. While it is hard to find anything positive about the employment situation during this recovery, it is milder than during the last recession. The main reason for this is employment was already weak before the 1990-91 recession, whereas it was strong during the 2001 recession. Specifically, the civilian unemployment rate was 5.7% in the first quarter of the previous recession. At the start of the 2001 recession this same measure was 4.2%. In the last slowdown, the unemployment rate peaked at 7.6% during the third quarter of 1992 and remained above the full-employment level for around four more years. In contrast, the unemployment rate is expected to peak at about 6.0% after the 2001 recession and be back within striking distance of full employment in less than two years. The war with Iraq has had an impact on the labor market. The U.S. Department of Defense reported about 210,000 reservists had been called into duty as of March 2003. However, this is not directly transferable to the employment numbers for several reasons. Persons listed on military duty are not included on employer payrolls. Some reservist would not have been counted by nature of their employment; e.g., the self-employed. Whether a reservist is counted also depend whether they were employed during the survey week. Finally, employment counts will be affected by whether employers replace reservists with new workers. As a result, the Department of Labor's statistics will not reflect the Department of Defense's number.