ALLIANCE CAPITAL FIXED INCOME℠ | INVESTMENT RESEARCH AND MANAGEMENT

US WEEKLY ECONOMIC UPDATE

February 11, 2005

Joseph G. Carson

US Economist and Director
Global Economic Research

US Economic and Investment Perspectives

US Liquidity Still Strong, Despite Higher Official Rates

As interest rates continue to rise and the Treasury yield curve flattens dramatically, more forecasters are predicting slower US economic growth in 2005. This is not surprising, as history suggests that higher official rates and the narrowing of spreads between long- and short-term interest rates usually lead to slower economic growth.

But there is a counter argument to this view. Although the federal funds target rate has increased 150 basis points since June, Treasury market rates have barely budged—remaining unusually low both in nominal terms and in relation to underlying inflation. At the same time, borrowing costs for consumers and businesses have remained quite low and not increased relative to year-ago levels.

History also shows that liquidity is the primary fuel for fast growth cycles and we believe these accommodative financial conditions will continue to drive the economy in 2005. Our forecast calls for 4.1% growth—close to last year's healthy 4.4% pace—and we would not be surprised if the final numbers exceed our estimates.

Our proprietary liquidity index, which has risen 4.6% over the past year, indicates the economy has plenty of fuel to support another year of above-trend growth. Moreover, gains in liquidity usually lead growth in the economy, and the gains in each usually match one another.

Today's liquidity levels contrast sharply with those of previous Fed-tightening cycles. During the four tightening cycles that took place between 1988 and 2000, interest-rate hikes ranged between 100 and 250 basis points, triggering a slowdown in liquidity growth of about 1 percentage point over the course of a year. Today, the opposite is true: Growth in liquidity flows is almost 1 percentage point faster than a year ago. In other words, demand for capital has remained strong because borrowing costs have not increased for consumers and businesses even though official rates have moved up sharply over the past eight months.

Meanwhile, in the months ahead we think that there could be positive surprises in store for housing, capital spending and manufacturing. If this proves to be the case, growth could push above our 4.1% forecast, which is at the high end of the market consensus.

Homebuilding

Strong liquidity flows—driven by low borrowing rates—are always positive for the housing market. Although the housing sector has just finished a third consecutive year of record growth, financial conditions suggest 2005 will be another strong year. Homebuilders remain optimistic. Toll Brothers, for example, reported that, as of the end of their first fiscal quarter, homebuilding contracts had increased 60% from year-ago levels, and that their first-quarter backlog is the highest in the company's history.

Capital Spending

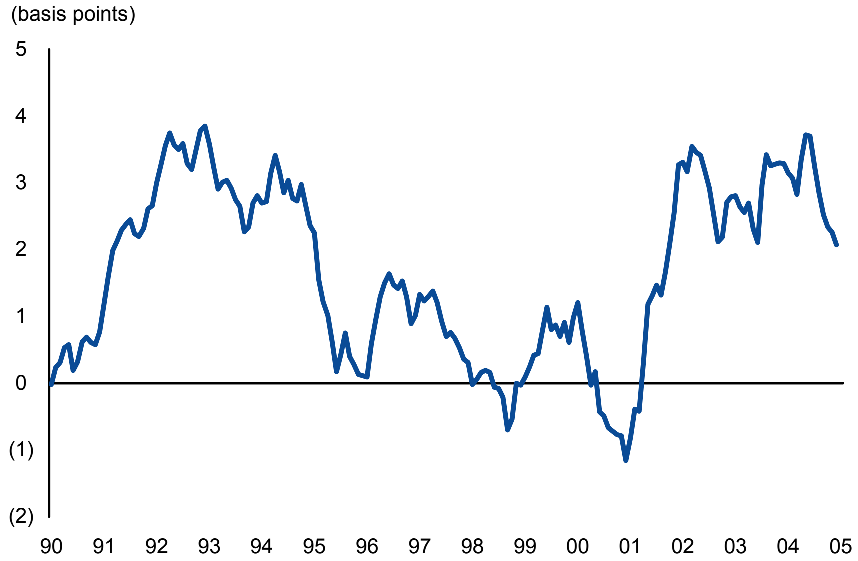
Firms ended 2004 with record profits, record free cash flow and the largest order backlogs in history. Importantly, last year's rise in backlogs was broad based, led by metals and machinery, technology, and transportation. In the late 1990s, the explosion in order backlogs was confined almost exclusively to the technology sector. History shows that the strongest capital-gains cycles tend to be those that are widespread, encompassing all major industries. Another plus-factor is that firms are now eager to grow their businesses and, thus, must invest more. All of this means capital spending could rise more strongly than many, including us, currently expect.

Exports

Lastly, overseas growth remains relatively strong, with the full impact of the dollar decline not yet fully reflected in US trade. In 2004, US merchandise exports rose 13%, and we think US exports could rise that much or more again in 2005. A strong export cycle would be a happy surprise to the manufacturing sector, lifting orders, production and profits in the process.

Joseph G. Carson
Global Economic Research
February 11, 2005

Display 1: Narrowing Yield Curve Provokes Growth Concerns
Spread Between 10-Year Treasury Yield and Federal Funds Rate



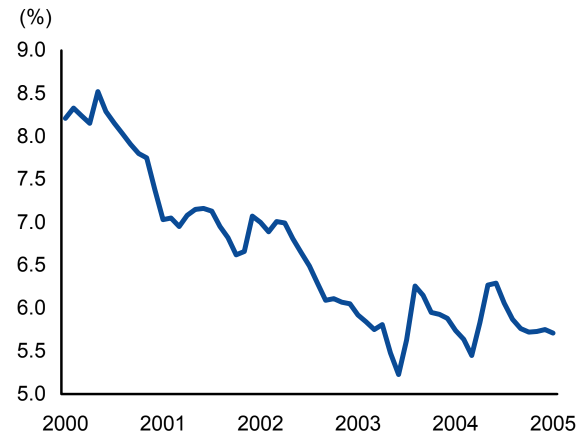
Source: The Conference Board and Haver Analytics, February 11, 2005

The spread between the yield on the 10-year Treasury and the target on the federal funds rate has narrowed a lot in the past year, leading some analysts to conclude that the pace of economic growth will slow in 2005.

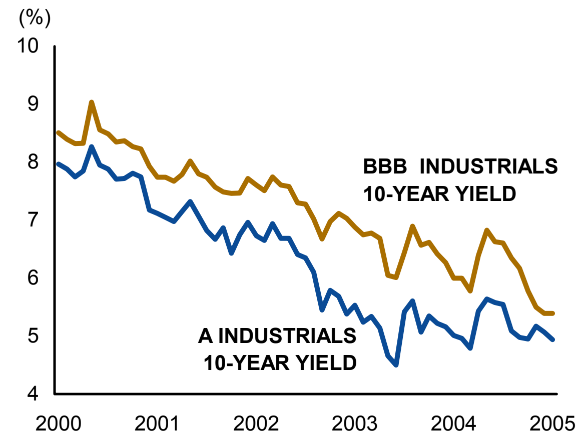
Display 2: Business and Consumer Borrowing Costs Are Still Low

Interest Rates and Corporate Bond Yields

30-Year Mortgage Rate



10-Year Corporate Bond Yields

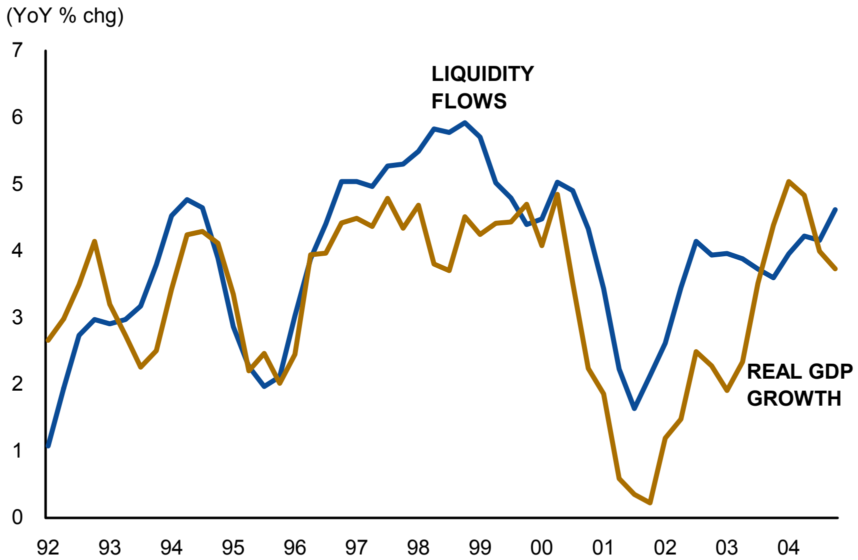


Source: Federal Reserve Board and Haver Analytics, February 11, 2005

Although official rates have increased 150 basis points since June 2004, borrowing costs for households and businesses have not increased.

Display 3: Liquidity Flows Are Reaccelerating, Signaling Faster Growth

Liquidity* Flows and Real GDP Growth

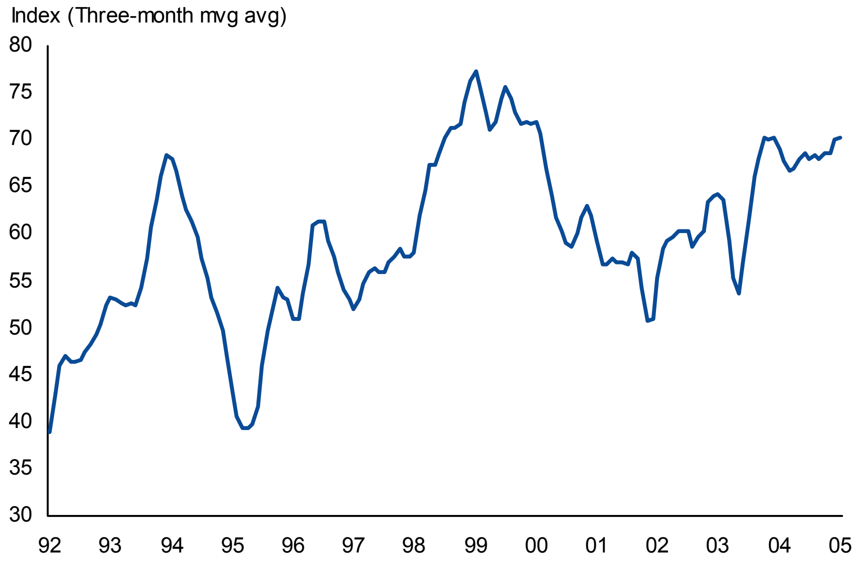


**Liquidity is a measure of real money growth, growth in business and consumer credit, growth in short-term liquid assets, foreign purchases of US securities and net cash flow into bond and stock funds*

Source: Bureau of Economic Analysis, Haver Analytics and Alliance Capital Fixed Income, February 11, 2005

Liquidity flows have reaccelerated in the past several months, indicating that overall financial conditions remain very accommodative.

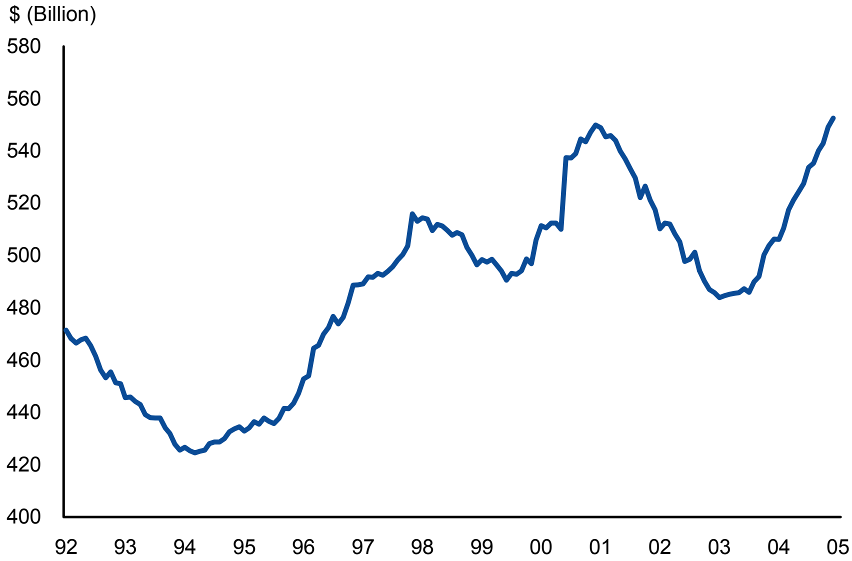
Display 4: Homebuilders Are Upbeat
US Homebuilders' Housing Market Index



Source: National Association of Home Builders and Haver Analytics, February 11, 2005

Homebuilders are upbeat, and for good reason: Mortgage rates are relatively low and people are still eager to buy.

Display 5: Backlog Boom
Order Backlogs of US Manufacturers



Source: Census Bureau and Haver Analytics, February 11, 2005

US manufacturers ended 2004 with record backlogs. Moreover, the gain in backlogs in 2004 encompassed all major industries. That's good news for capex in 2005.