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US WEEKLY ECONOMIC UPDATE

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US Economic and Investment Perspectives

US GDP Advances, Underscoring Economy's Strength, and New Data Shows Faster Wage Growth

During the third quarter, the US gross domestic product (GDP) rose an annualized 3.7%, according to the Department of Commerce. The gain in the third follows a 3.3% advance in the second and a 4.5% advance in the first. Although the gain in third-quarter real GDP growth was slightly below our estimate of 4%, the gain was still impressive, considering that four powerful hurricanes struck the southeast region during the quarter while oil prices raced to record highs.

The GDP advance also shows the dynamic nature of this business cycle and the importance of liquidity flows. While history shows that economic growth varies from quarter to quarter, growth cycles such as the current one tend to exhibit powerful common elements: improved liquidity, a rebound in final demand and the rebuilding of inventories. These gains are mutually reinforcing as ongoing gains in liquidity trigger incremental gains in demand, which require even more inventory rebuilding.

During the quarter, real final sales advanced at a 4.2% annualized rate, well above the 2.9% average gain recorded in the prior two quarters. Real consumer spending increased 4.6% annualized, led by very strong gains in durable-goods purchases. Business spending on equipment and software jumped 14.9%, the strongest quarterly gain in a year, and the gains were led by a strong advance in industrial machinery and transportation. Spending on nonresidential and residential structures rose 1.4% and 3.1%, respectively, but the gains were slowed by all the weather-related disruptions during the period. Exports had another good performance, rising 5.1%, while overall government spending increased 1.4%.

While final sales accelerated, the pace of inventory building decelerated. Total real business inventories expanded at a $48 billion annualized rate, following a gain of $60 billion in the second quarter. On the surface, the back-to-back quarterly inventory build looks large, but it's not. The overall stock of real inventory stands at $1.525 trillion, so if final demand is growing at a 4% pace, overall inventory would have to rise at a $60 billion rate merely to stay in line with sales growth.

There are signs that businesses think inventory positions are too low. In the purchasing manager's survey, the customer-inventory index remains well below the all-important 50% level, indicating that they do not believe their customers have adequate product levels. Purchasing managers also think they themselves lack enough inventory. According to the monthly survey of purchasing agents, the lead time for production materials has risen sharply over the past six months (**Display 4**), indicating they are also worried about inadequate stocks of materials and supplies and rising prices.

Inventory needs are ultimately linked to strength in final demand, so the ongoing rise in order backlogs indicates that demand remains strong. In the past 12 months, order backlogs have increased $47 billion, the second-biggest increase in the last 15 years, topped only by the gain in 2000. This year there have been strong order backlogs across primary and fabricated metals, machinery, technology and transportation.

The combination of strong order backlogs and solid gains in liquidity flows suggests that the economic growth cycle is alive and well. We see real GDP growth staying around 4% in the fourth quarter. If oil prices move back to the low $40s per barrel, as we expect, economic growth should also remain relatively strong in 2005.

US Wages Make Further Strides

Separately, data contained in the quarterly Census of Employment and Wages strongly suggest that the pay of American workers has risen much faster than generally believed. The data provides a more complete and, in our view, accurate count on wages. In the year ended March 31, 2004, the quarterly census reports average weekly wages increased 3.8%, against the 1.6% rise cited in the payroll employment report. The gap between the earnings reported by two surveys is more than twice the average of the past decade.

The quarterly census also shows that 1.05 million jobs were created, while the weekly payroll series counts only 668,000. While the Bureau of Labor Statistics has already accounted for 236,000 of this difference in its preliminary benchmark revision estimates to the payroll data, there remain 146,000 jobs that could show up in its final payroll tally, which will be released early next year.

We have long argued that the quality of the hourly-wage and weekly-earnings data in the payroll survey was suspect. The data only counts non-supervisory workers but less than 40% of the companies that provide payroll data also provide wage data. In our view, the quarterly census offers the most comprehensive set of payroll and wage information because it covers 98% of the employed workforce and its data comes directly from company quarterly reports. Because the census data is published six months after quarter-end, its data is cited less frequently. But it is a more reliable guide than the monthly payroll data, which is based on a small sample of establishments.

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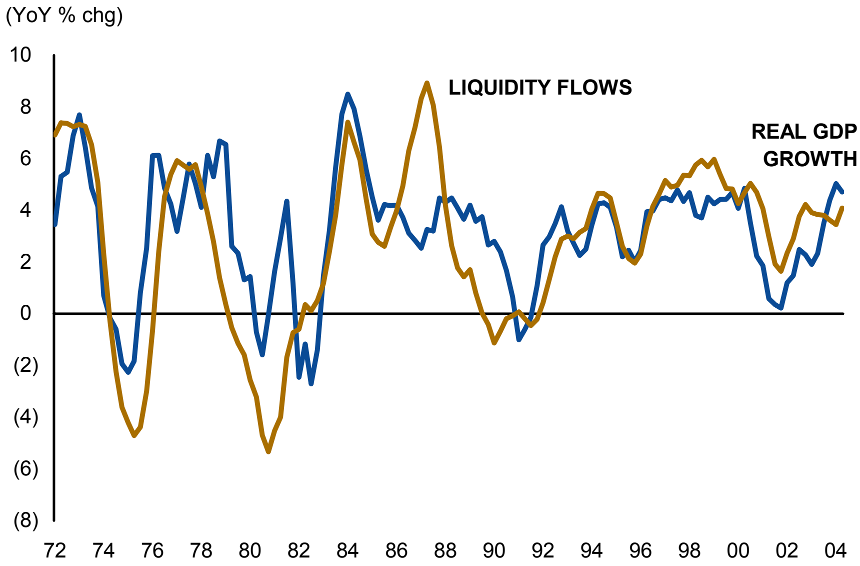
Display 1: US Economic Momentum Is Sustainable

Liquidity* Flows and Real GDP Growth



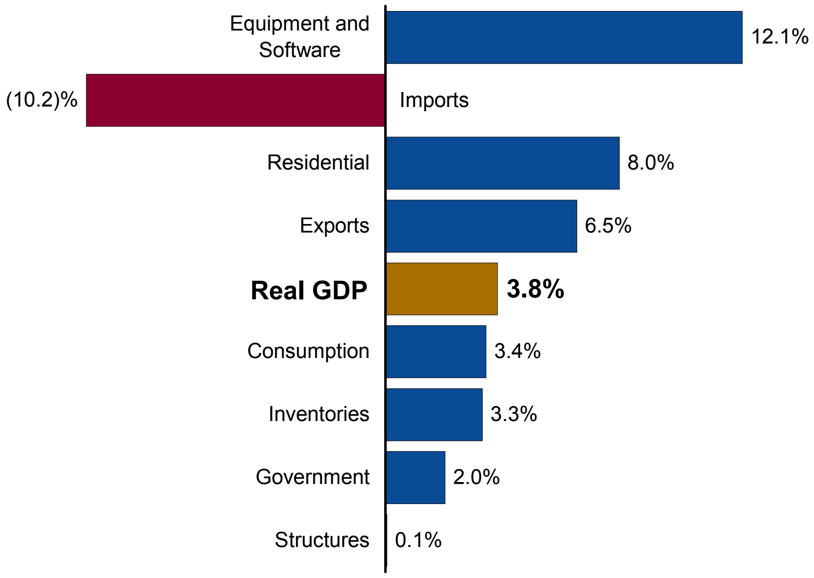
**Liquidity is a measure of real money growth, growth in business and consumer credit, growth in short-term liquid assets, foreign purchases of US securities, net cash flow into bond and stock funds.*

Source: Bureau of Economic Analysis, Haver Analytics and Alliance Fixed Income, October 29, 2004

Strong liquidity flows indicate that the economic recovery has staying power. Accordingly, we believe real GDP growth for the next 12 months should be around 4%.

Display 2: At This Stage of the Economic Cycle, Growth Is Driven By Investment and Exports

2004 Real GDP Growth (Performance through Third Quarter 2004)

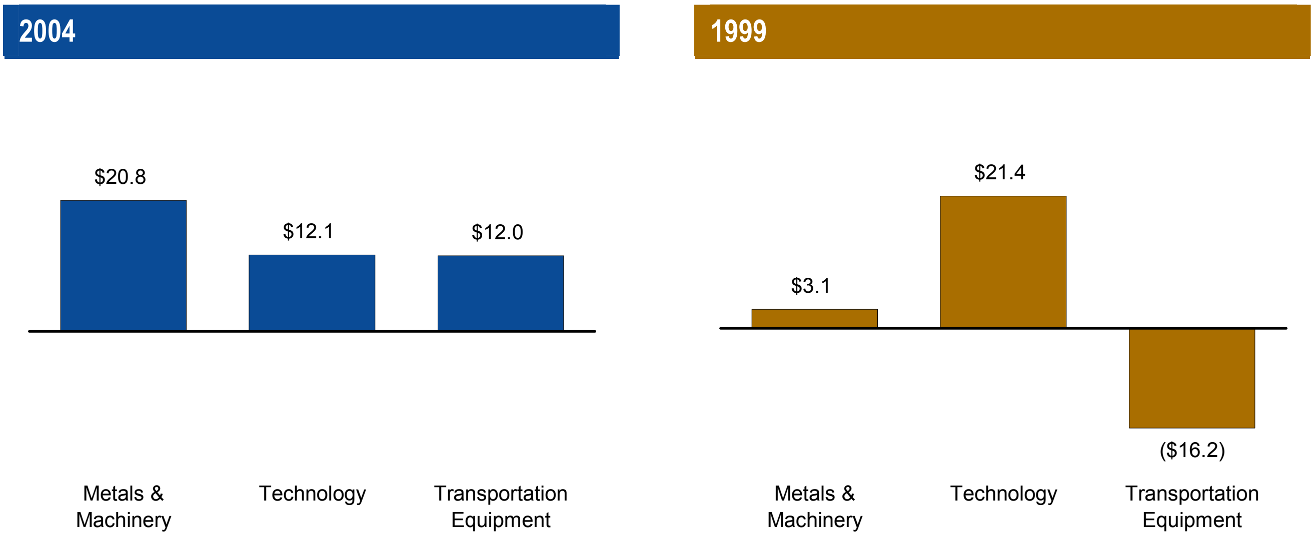


Source: Bureau of Economic Analysis, Haver Analytics and Alliance Fixed Income, October 29, 2004

The composition of real GDP growth since the start of the year illustrates a natural rotation that takes place in every economic cycle. At the current stage, capital spending and exports are becoming more important than housing and consumer spending. Next year, we expect business spending on structures to move up the ladder, its contribution to growth broadly in line with that of exports.

Display 3: Capex Cycle is Broad-Based

12-Month Change in Order Backlogs ($ Billions)

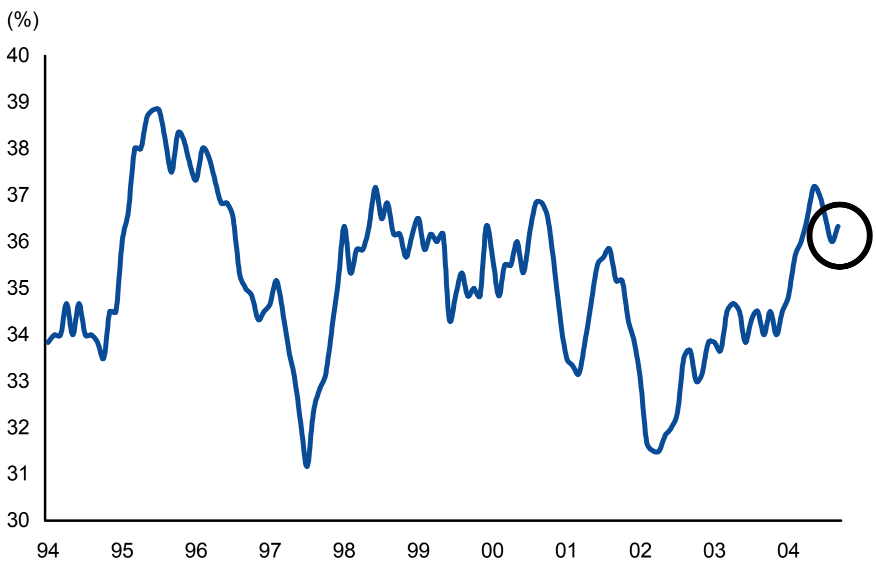


Source: Census Bureau, Haver Analytics and Alliance Fixed Income, October 29, 2004

In a fundamental sense, today's capital spending is much stronger and more durable than it was in the late 1990s because it is broader. Order backlogs are up sharply in every industry and at record levels in some old-economy industries.

Display 4: Longer Lead Times Mean Firms Need More Inventory

ISM Production Materials Commitments of 60 Days and More



Six-month moving average.

Source:Institute for Supply Management, Haver Analytics and Alliance Fixed Income, October 29, 2004

Lead times for production materials have increased over the past several months. Firms place orders further and further out when they are confident that the rise in new-order flow and backlogs is sustainable, and when they need additional inventory to support expanded production.

Display 5: Wage and Job Gains Are Understated
Year-to-Year Change in Employment and Wage Gains; First Quarters 2003–2004

	Employment	Average Weekly Wages
Payroll Employment Report	668,000*	1.6%
Quarterly Census of Employment and Wages	**1,050,000**	**3.8%**

**Preliminary benchmark revisions indicate that the estimate of nonfarm payroll employment will require an upward revision of 236,000.*
Source: Bureau of Labor Statistics and Census Bureau, October 29, 2004

Newly released data indicate that average wages for all workers grew much faster than indicated by the payroll report. Payroll job growth was understated as well.

Alliance Economic Forecast

October 2004

Levels (2000 Dollars)	Quarterly 04:Q1	04:Q2	04:Q3	04:Q4	01:Q5	Annual 2002	2003	2004	2005
GDP	10697.5	10784.7	10883.4	11002.0	11102.0	10083.0	10381.3	10841.9	11275.8
Consumption	7543.0	7572.4	7658.9	7703.9	7751.9	7140.4	7355.5	7619.6	7838.7
Durables	1075.5	1074.7	1117.3	1114.0	1118.0	957.2	1030.6	1095.4	1128.5
Non-Durables	2187.3	2188.0	2209.3	2228.0	2240.0	1983.3	2112.4	2203.2	2268.8
Services	4291.7	4320.0	4348.4	4378.0	4410.0	4141.8	4220.3	4334.5	4457.5
Investment									
Non-Res Structures	237.7	241.7	242.5	247.0	253.0	249.0	237.4	242.2	261.3
Non-Res Equip & Software	943.7	975.5	1009.9	1050.0	1070.0	846.7	879.2	994.8	1105.0
Res Structures	542.5	563.6	567.9	577.0	585.0	470.3	511.2	562.8	590.0
Change in Inventories	40.0	61.1	48.1	50.0	54.0	5.7	-0.7	49.8	48.5
Net Exports	-550.1	-580.3	-598.0	-588.0	-583.0	-470.6	-518.5	-579.1	-561.8
Exports	1095.4	1114.8	1128.8	1150.0	1175.0	1014.2	1031.8	1122.3	1218.8
Imports	1645.5	1695.1	1726.8	1738.0	1758.0	1484.1	1550.3	1701.4	1780.5
Government	1935.8	1946.5	1953.1	1966.5	1975.5	1836.9	1909.4	1950.5	1998.5

Percent Changes	Quarterly % SAAR 04:Q1	04:Q2	04:Q3	04:Q4	01:Q5	% Q4/Q4 2002	2003	2004	2005	Annual 2002	2003	2004	2005
GDP	4.5%	3.3%	3.7%	4.4%	3.7%	2.8%	4.4%	4.0%	3.9%	2.2%	3.0%	4.4%	4.0%
Consumption	4.1%	1.6%	4.6%	2.4%	2.5%	2.7%	3.8%	3.2%	2.8%	3.4%	3.3%	3.6%	2.9%
Durables	2.2%	-0.3%	16.8%	-1.2%	1.4%	1.8%	9.9%	4.1%	2.2%	6.5%	7.4%	6.3%	3.0%
Non-Durables	6.7%	0.1%	4.0%	3.4%	2.2%	2.7%	4.6%	3.5%	3.0%	3.0%	3.7%	4.3%	3.0%
Services	3.3%	2.7%	2.7%	2.8%	3.0%	2.9%	2.2%	2.8%	2.8%	3.0%	2.2%	2.7%	2.8%
Investment													
Non-Res Structures	-7.5%	6.9%	1.4%	7.6%	10.1%	-14.9%	1.5%	1.9%	9.3%	-18.4%	-5.6%	2.0%	7.9%
Non-Res Equip & Software	8.1%	14.2%	14.9%	16.9%	7.8%	1.6%	12.1%	13.4%	9.0%	-2.8%	6.4%	13.2%	11.1%
Res Structures	5.0%	16.5%	3.1%	6.6%	5.7%	7.1%	12.0%	7.7%	2.3%	4.9%	8.8%	10.1%	4.8%
Net Exports													
Exports	7.3%	7.3%	5.1%	7.7%	9.0%	3.3%	6.1%	6.9%	9.6%	-2.4%	1.9%	8.8%	8.6%
Imports	10.6%	12.6%	7.7%	2.6%	4.7%	9.4%	4.9%	8.3%	3.8%	3.7%	4.4%	9.7%	4.7%
Government	2.5%	2.2%	1.4%	2.8%	1.8%	4.5%	2.2%	2.2%	2.6%	3.8%	2.8%	2.2%	2.5%

Key Macro Indicators	Quarterly					Annual			
Nominal GDP (Levels)	11472.6	11657.5	11803.5	12025.0	12226.6	10480.8	11004.1	11739.7	12568.9
%Q/Q SAAR	7.4%	6.6%	5.1%	7.7%	6.9%				
%Y/Y	6.8%	7.1%	6.2%	6.7%	6.6%	4.0%	4.9%	6.7%	7.1%
Industrial Production (Index)	114.4	115.8	116.6	119.5	120.5	110.9	111.2	116.6	122.4
%Q/Q SAAR	6.5%	4.8%	2.9%	9.8%	3.3%				
%Y/Y						-0.6%	0.3%	4.8%	5.0%
Housing Starts (Millions)	1.94	1.92	1.97	2.00	1.95	1.71	1.85	1.96	1.86
Industry Auto Sales (Millions)	16.5	16.5	17.1	17.0	17.2	13.5	13.3	16.7	17.4
Personal Savings Rate	1.0	1.2	0.4	2.0	2.5	2.1	1.3	1.7	2.9
Unemployment Rate	5.6	5.6	5.4	5.4	5.3	5.8	6.0	5.6	5.2
Operating Profits (%Y/Y)	27.8%	19.0%	15.3%	8.9%	6.4%	17.4%	16.8%	17.2%	8.3%
After-Tax Profits (%Y/Y)	17.2%	19.5%	17.4%	12.3%	13.2%	11.0%	19.2%	16.5%	11.5%
Inflation %Y/Y									
GDP Deflator	2.8%	3.2%	1.3%	2.9%	3.1%	1.1%	1.8%	2.2%	2.9%
Consumer Price Index	3.6%	4.7%	1.9%	3.9%	3.0%	1.6%	2.3%	3.2%	3.5%
Key Interest Rates (End Of Period)									
Fed Funds Rate	1.00	1.25	1.75	2.00	2.50	1.25	1.00	2.00	3.50
3-Mo T-Bill (BEY)	1.00	1.25	1.75	2.00	2.50	1.21	0.95	2.00	3.50
2-Yr Note	1.75	2.85	2.80	2.75	3.25	1.84	1.84	2.75	4.00
10-Yr Note	4.00	4.75	4.25	4.35	4.60	4.03	4.27	4.35	5.50
30-Yr Bond	4.90	5.50	5.00	5.00	5.25	5.09	5.18	5.00	5.75

Source: Alliance Fixed Income, October 29, 2004