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GLOBAL ECONOMIC RESEARCH

US WEEKLY ECONOMIC UPDATE

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US Economic and Investment Perspectives

Global Growth Cycle Still Secure

Over the past few years, the global economy has been enjoying a virtuous cycle—one fueled by the strong US housing market and the attendant wealth gains, which in turn have fueled a long and powerful consumer spending spree. This spending has boosted industrial production outside the US, helping many economies sustain a relatively fast pace of growth while jolting others from sluggish growth cycles. Faster growth, especially in Asia, and recovery, notably in Japan, have in turn fueled a boom in global capital investment. This investment has fed directly into the US, as reflected in the record increase in order backlogs for US manufacturers in 2005.

With energy prices racing to fresh record highs, the key question is whether they are putting global growth at risk, or merely suggesting a change in growth leadership away from US-centric consumer spending toward investment and growth outside the US. History indicates that rising commodity and energy prices are by-products of a global growth cycle rather than deterrents to it. Economic cycles tend to age, mature and slow when the interest rate side of the equation changes significantly.

Apart from the Federal Reserve's rate hikes in the US—where monetary policy remains accommodative—most central banks continue to maintain very relaxed policies. We think that this indicates that global economic growth remains secure, although a change in leadership might be at hand. As we noted in last week's commentary, while the rate of real US consumer spending growth will likely slow in coming months due to the lagged effects of higher energy prices, it will likely be offset both domestically by faster investment and construction spending. At the same time, higher energy prices should propel investment and growth in other parts of the world, making the global cycle less US-consumer dependent and hopefully more durable and better balanced.

Global and US Economic Cycles

Based on our calculations, non-US real GDP growth has been running over 4% in 2005, above our earlier estimates, led by strength in the emerging-market economies, especially in Asia. A few industrialized economies, such as Australia and Canada, also continue to do at least as well as expected while growth in Japan has far exceeded expectations. Indeed, not only did real GDP growth in Japan improve in the first half of 2005; its 4.5% annualized growth rate was a full percentage point higher than that of the US.

Importantly, the strength in the global economy has made the US economic cycle stronger and better balanced. When the world economy experiences relative growth, US manufacturers benefit in a meaningful way **(Display 1)**. For example, in 2005—a period of relatively strong global growth—US durable-goods manufacturers have seen their order backlogs climb by $42 billion, the largest gain on record. This has been concentrated in commercial aircraft and parts and in technology. No doubt much of this is destined for overseas customers, so in coming months gains in exports and construction spending are likely to offset some of the slower growth we expect in the consumer sector.

In a fundamental sense, global equity and commodity markets (and even the oil markets) not only reflect the strength and breadth in the world economy, but also signal that the global growth cycle is not likely to end anytime soon **(Display 2)**. World equity markets hit a new cycle high this month. This might seem unusual at a time when crude-oil prices are racing to their own new highs. But demand-driven increases in energy prices reflect a strong sales environment and, presumably, a good profit picture as well. So while the rise in energy prices has triggered some dislocation and slower spending, the market seems to be suggesting that this is not significant enough to undo the powerful global or US growth cycles.

We agree with this assessment. As we see it, global economic, equity and commodity cycles continue to flourish principally because global monetary conditions remain very relaxed. To be sure, Japan is still operating with official rates at 0% and one-year lending rates in China are stuck at 5.5%, less than half the rate of nominal GDP. And in the US, although the Federal Reserve began lifting official rates in June 2004, policymakers still believe that monetary policy is accommodative.

We currently don't expect any meaningful change in global monetary conditions until early 2006. At that point, the Bank of Japan is expected to begin to lessen the amount of liquidity it is providing to the economy. In the second half of this year, we expect it to start lifting official rates incrementally.

But with Japanese official rates at zero and likely to remain there another year or so, it will be a long time before monetary policy change there and elsewhere alter global liquidity conditions materially. Until then, change to the global growth cycle is more likely to come in its leadership—i.e., more investment and less consumer—than in its strength.

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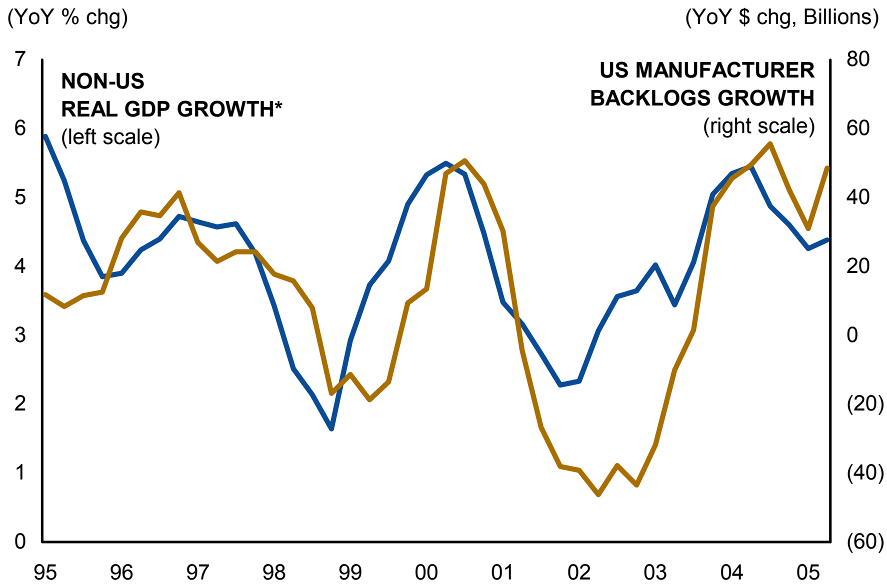
Display 1: Global Growth Cycle Lifts US Manufacturer Order Books
Global Growth vs. US Manufacturer Backlogs

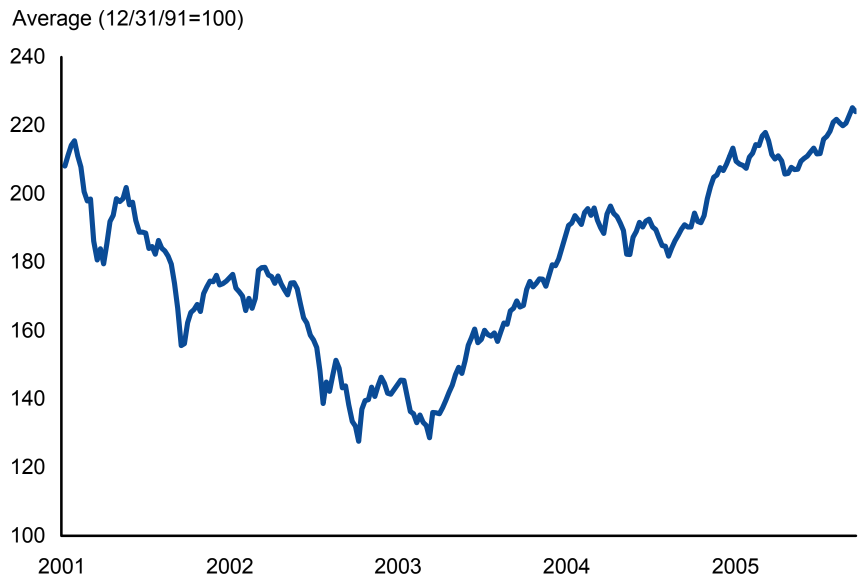


**Countries weighted by purchasing power parity.*
Source: Bloomberg, Census Bureau, Haver Analytics and Alliance Capital Fixed Income; September 30, 2005

The global growth cycle has helped make the US cycle stronger and better balanced. Indeed, rising order backlogs at US durable goods manufacturers point to stronger exports and capital spending in coming months, and should offset the slower pace of consumer spending.

Display 2: Global Equity Prices Indicate that the Growth Cycle Is Alive and Well

Dow Jones Global Stock Price Index



Source: Haver Analytics and The Wall Street Journal ; September 30, 2005

Ongoing increases in global equity prices indicate that the global economic growth cycle is not at risk. We agree with that assessment and expect to see more of a sector rotation—or change in leadership—away from the US consumer-led growth cycle to a more balanced investment-led cycle.

Alliance US Economic Forecast

September 2005

Levels (2000 Dollars)	Quarterly 1Q05	2Q05	3Q05	4Q05	1Q06	Annual 2003	2004	2005	2006
GDP	10999.3	11089.2	11180.9	11275.1	11374.1	10320.6	10755.7	11136.1	11504.6
Consumption	7764.9	7829.5	7896.1	7937.1	7984.1	7306.5	7588.6	7856.9	8062.9
Durables	1122.3	1143.9	1168.0	1163.0	1172.0	1028.5	1089.9	1149.3	1178.0
Non-Durables	2265.6	2285.9	2298.0	2315.0	2325.0	2101.8	2200.4	2291.1	2353.3
Services	4392.0	4417.6	4448.0	4477.0	4505.0	4184.0	4310.9	4433.7	4549.5
Investment									
Non-Res Structures	251.0	252.7	249.0	254.0	259.0	243.1	248.4	251.7	267.3
Non-Res Equip & Software	1014.2	1040.9	1055.0	1080.0	1100.0	846.8	947.6	1047.5	1137.3
Res Structures	584.1	599.3	600.0	603.0	604.0	509.4	561.8	596.6	604.3
Change in Inventories	58.2	-1.7	8.0	25.0	38.0	15.5	52.0	22.4	34.8
Net Exports	-645.4	-614.2	-615.0	-625.0	-630.0	-521.4	-601.3	-624.9	-637.5
Exports	1165.3	1195.4	1215.0	1235.0	1255.0	1031.2	1117.9	1202.7	1272.5
Imports	1810.7	1809.6	1830.0	1860.0	1885.0	1552.6	1719.2	1827.6	1910.0
Government	1971.9	1984.1	1995.6	2008.8	2026.8	1911.2	1952.3	1990.1	2043.6

Percent Changes	Quarterly % SAAR 1Q05	2Q05	3Q05	4Q05	1Q06	% Q4/Q4 2003	2004	2005	2006	Annual 2003	2004	2005	2006
GDP	3.8%	3.3%	3.3%	3.4%	3.6%	4.0%	3.8%	3.5%	3.3%	2.7%	4.2%	3.5%	3.3%
Consumption	3.5%	3.4%	3.4%	2.1%	2.4%	3.8%	3.8%	3.1%	2.6%	2.9%	3.9%	3.5%	2.6%
Durables	2.6%	7.9%	8.7%	-1.7%	3.1%	9.2%	5.2%	4.3%	1.9%	6.6%	6.0%	5.5%	2.5%
Non-Durables	5.3%	3.6%	2.1%	3.0%	1.7%	4.1%	4.6%	3.5%	2.8%	3.2%	4.7%	4.1%	2.7%
Services	2.8%	2.4%	2.8%	2.6%	2.5%	2.5%	3.1%	2.6%	2.6%	2.0%	3.0%	2.8%	2.6%
Investment													
Non-Res Structures	-2.0%	2.7%	-5.7%	8.3%	8.1%	1.2%	2.8%	0.7%	8.3%	-4.2%	2.2%	1.3%	6.2%
Non-Res Equip & Software	8.3%	11.0%	5.5%	9.8%	7.6%	7.2%	13.8%	8.6%	9.2%	3.2%	11.9%	10.5%	8.6%
Res Structures	9.5%	10.8%	0.5%	2.0%	0.7%	11.8%	6.6%	5.6%	0.2%	8.4%	10.3%	6.2%	1.3%
Net Exports													
Exports	7.5%	10.7%	6.7%	6.7%	6.6%	6.0%	6.1%	7.9%	4.9%	1.8%	8.4%	7.6%	5.8%
Imports	7.4%	-0.2%	4.6%	6.7%	5.5%	5.1%	10.6%	4.6%	4.0%	4.6%	10.7%	6.3%	4.5%
Government	1.9%	2.5%	2.3%	2.7%	3.6%	2.0%	2.1%	2.3%	2.6%	2.8%	2.2%	1.9%	2.7%

Key Macro Indicators	Quarterly					Annual			
Nominal GDP (Levels)	12198.8	12378.0	12616.7	12826.5	13025.8	10971.3	11734.3	12505.0	13369.9
%Q/Q SAAR	7.0%	6.0%	7.9%	6.8%	6.4%				
%Y/Y	6.5%	6.1%	6.8%	6.9%	6.8%	4.8%	7.0%	6.6%	6.9%
Industrial Production (Index)	118.2	118.7	120.3	121.4	122.4	110.9	115.5	119.7	123.7
%Q/Q SAAR	3.8%	1.5%	5.6%	3.7%	3.3%				
%Y/Y						0.0%	4.1%	3.6%	3.4%
Housing Starts (Millions)	2.08	2.04	2.05	2.05	2.00	1.85	1.95	2.06	1.96
Industry Auto Sales (Millions)	16.5	17.2	17.9	16.3	16.8	16.6	16.9	17.0	16.9
Personal Savings Rate	0.5	0.1	-0.5	1.0	1.5	2.1	1.7	0.3	2.5
Unemployment Rate	5.3	5.1	5.1	5.0	4.9	6.0	5.5	5.1	4.9
Operating Profits (%Y/Y)	12.3%	16.0%	15.5%	12.8%	8.7%	16.4%	12.6%	14.1%	8.0%
After-Tax Profits (%Y/Y)	4.1%	9.9%	12.9%	12.6%	14.8%	21.0%	15.7%	9.9%	9.2%

Inflation %Y/Y									
GDP Deflator	3.1%	2.6%	4.3%	3.3%	2.7%	2.0%	2.6%	2.9%	3.5%
Consumer Price Index	2.4%	4.2%	5.0%	3.1%	2.7%	2.3%	2.7%	3.3%	3.3%

Key Interest Rates (End Of Period)									
Fed Funds Rate	2.96%	3.25%	3.75%	4.00%	4.25%	1.00%	2.25%	4.00%	5.00%
Three-Mo T-Bill (BEY)	2.79%	3.13%	3.60%	3.95%	4.20%	0.95%	2.22%	3.95%	4.95%
Two-Yr Note	3.80%	3.66%	4.18%	4.30%	4.50%	1.84%	3.08%	4.30%	5.25%
10-Yr Note	4.50%	3.94%	4.30%	4.50%	4.75%	4.27%	4.24%	4.50%	5.45%
30-Yr Bond	4.76%	4.19%	4.55%	4.70%	5.00%	5.18%	4.86%	4.70%	5.75%

Source: Alliance Capital Fixed Income; September 30, 2005