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US WEEKLY ECONOMIC UPDATE

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US Economic and Investment Perspectives

Global Shifts in Manufacturing Have Impacted Inventory Levels

Last year, real inventory investment in China rose a stunning 20% (**Display 1**), compared to an 8.1% gain in final demand and a 20% increase in real industrial sales. The inventory gain was twice that of 2003, but the gains in final demand and real industrial sales were 5% to 7% below that of the prior year. All of those figures dwarf what happened elsewhere in the world.

In the US, for instance, manufacturing inventories rose by 1%, or $6 billion. While this marked the first increase following three years of declines, it was relatively small in relation to industrial-output gains. Moreover, manufacturers' inventories were still almost 4% below the start of the business cycle—unprecedented given that manufacturing production is 10% higher since the start of the cycle.

Although technology improvements have enabled US firms to operate with reduced inventory, we think lower inventory levels coincide more with US firms adopting global platforms these past few years—particularly in China. As platforms have shifted, so too have the places where manufacturing inventories are held. That means it has become more essential to look beyond domestic borders when assessing the inventory cycle.

Big Gains in Commodities, Technology

Display 2 shows that some of the biggest real inventory gains in China occurred in chemicals (+51%), petroleum processing (+47%) and metals (+37%)—all areas that have experienced strong price increases and domestic and global demand over the past few years.

Two technology sectors—electrical machinery and electronic communication and equipment—also showed very strong gains, up 27.8% and 25.1%, respectively. This contrasts sharply with the US, where real tech inventories fell 0.5% last year. In fact, China's real tech inventories, measured by US standards, would be even larger than what has been reported.

That's because China does not adjust for quality improvement in their new products as we do in the US. To be sure, technology products experience rapid quality and performance change so in the US the government statistical agencies try to capture that increased value/power by adjusting the prices downward and upwardly adjusting the real dollar value. Adjusting the Chinese tech data to the US standards would raise the growth in real inventory accumulation by several percentage points in 2004.

No doubt, China's technology inventories have risen at least in part because the country has attracted technology manufacturing platforms from around the world for products such as PC motherboards, cellular phones, personal computers, consumer electronics, printers, and telecom and networking equipment. But this may not entirely explain the extent of the inventory build up, considering the rapid product development and rapid inventory turnover in the tech sector. Our analysis shows, for instance, that the real inventory/sales ratio for technology inched up in 2004. While the I/S ratio remains low, roughly 8% of what was built last year went into inventory compared to about 5% two years earlier (**Display 3**).

At the moment, there is not enough evidence to warrant concern about an aggregate inventory overhang. Yet it should be noted that the Bank of Japan's Tankan survey, released today, showed that manufacturing firms are concerned about the prospects for exports this year. How much of this, if any, is related to China's inventory build is hard to say at this juncture. But China's huge 2004 inventory gains mean that first-quarter final demand worldwide needs to be robust in order to avoid any undesired incremental build. Stay tuned.

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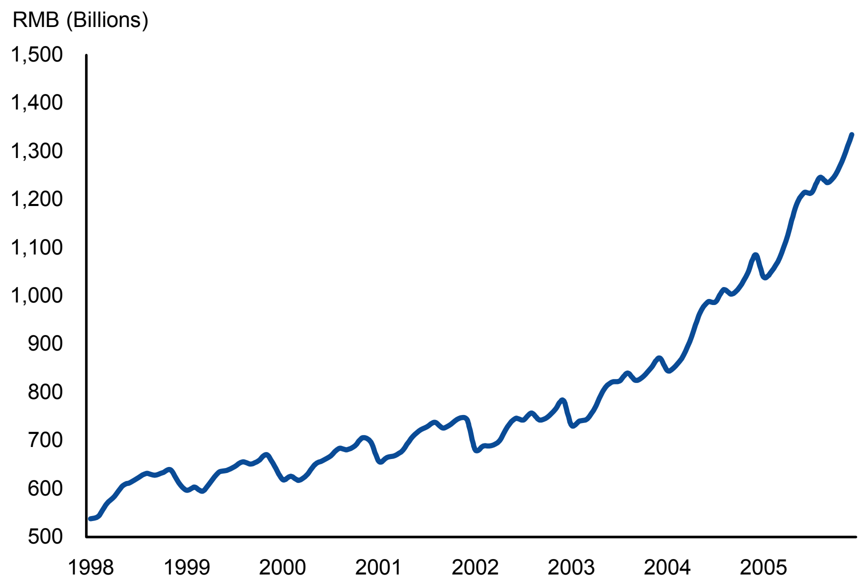
Display 1: China Real Inventories Grew Strongly in 2004

China Total Real Inventories



Source: CEIC data and Alliance Capital Fixed Income estimates, April 1, 2005

China's inventories grew 22% in 2004, far outpacing the gain in final demand.

Display 2: Big Inventory Build in China Manufacturing Inventories in 2004

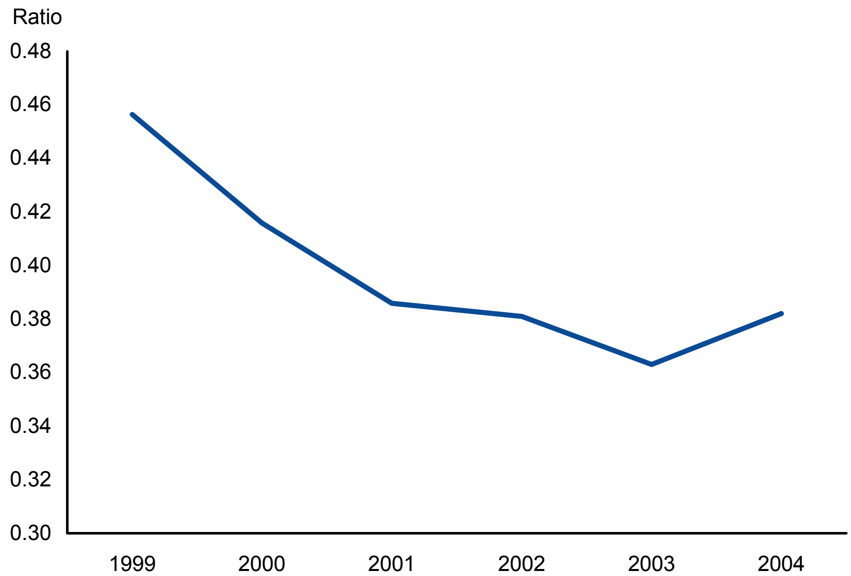
China Real Inventory Growth in 2004

	04:4Q / 03:4Q
Total Inventories	**19.60%**
Chemical Fibers	51.10%
Petroleum Processing	46.90%
Ferrous Metals Smelting	37.20%
Ferrous Metals Mining	32.50%
Leather & Fur	29.70%
Electrical Machinery	27.80%
Electronic Comm & Equipment	25.70%
Raw Chemicals	25.10%
Transportation Equipment	22.80%
Food Processing	22.40%
Metals Products	21.10%
Paper Manufacturing	17.00%
Food Manufacturing	16.60%
Ordinary Machinery	16.50%
Textile	16.30%
Plastics	15.50%
Furniture	15.30%
Timber	13.70%
Special Purpose Equipment	13.20%
Printing	12.20%
Garments	10.10%
Coal Mining	5.70%
Petroleum and Natural Gas Extraction	5.50%
Beverage Manufacturing	4.00%
Medical & Pharmaceuticals	(3.70)%
Rubber Products	(4.70)%

Source: CEIC Data Inc. April 1, 2005

The huge 2004 build in inventory investment was broad based, occurring in many of the sectors that have seen strong demand and price increases—such as chemicals, mining, petroleum processing and metals. But big inventory builds also occurred where prices where not rising, such as technology.

Display 3: The I/S Ratio in Tech Rose slightly in 2004
China Technology Sector Ratio of Inventories to Final Sales



Source: CEIC data and Alliance Capital Fixed Income estimates, April 1, 2005

According to our analysis, the I/S ratio for the tech sector inched higher in 2004.