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US WEEKLY ECONOMIC UPDATE

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US Economic and Investment Perspectives

The US Economy Looks Well Positioned for 2005

The US economy continues to expand at a solid pace, with real first-quarter GDP currently growing at a 4.5% annualized rate—modestly above the 4% growth in liquidity. The economy has built upon impressive growth in capital spending and housing, as well as solid gains in consumer spending and some modest gains in exports.

Granted, exports are still substantially overshadowed by huge import growth, which has dampened momentum. Also, strong growth has led to a modest rise in core inflation.

Overall, the outlook remains a fundamentally positive one. We believe the underlying strength of the economy is such that 2005 could well be the third consecutive year in which GDP growth averages 4%. And, encouragingly, the basic trend in retail inflation remains modest due to strong underlying productivity growth and stiff competitive pressure from overseas. In this environment, we think the Federal Reserve will continue to raise interest rates at a measured pace over the next several months and that market rates, which have remained stubbornly low, will follow.

Consumption and Income

First-quarter consumer spending is running close to the 4.2% annualized gain in the fourth quarter, but the composition is markedly different. While motor-vehicle sales were key last quarter, this period spending on furniture, appliances and electronics is more notable—increasing at an annual rate of 8.5%, the fastest quarterly gain in almost two years. Sales of soft goods are also strong; gains by general merchandise and clothing stores could top 10% this quarter.

Labor markets and income growth have improved: Payroll job growth is averaging 200,000 a month, and wages have risen 2.5%. Looking deeper, wages, salary and income are probably growing much faster. In the last month or so, withheld income-tax receipts have been running almost 10% ahead of year-ago levels. Even allowing for a sizable increase in bonus payments, the tax-receipts data suggest that earned income is running above what official statistics suggest. The Department of Commerce raised its measure of third-quarter 2004 wage-and-salary income growth by $28 billion annualized because the complete tally of jobs and wages provided by the states indicated a significant understatement of wage-and-salary income. We suspect a similarly large understatement is occurring in the first quarter.

Housing and Construction

The housing market is still red-hot. In the past two weeks, commercial-bank real-estate loans jumped $48 billion, surpassing gains during the huge re-financing wave of mid-2003. Robust buyer demand continues to sustain the new-home market, with no sign of let-up, according to the National Association of Home Builders.

Second-home purchases have become an increasingly important part of the housing market. According to a study by the National Association of Realtors, second-home sales represented approximately 35% of total home sales last year. The study found that purchases were driven by the wish to diversify investments (30%), to generate rental income (28%), or to establish a family retreat or vacation home (20%) or primary residence after retirement (18%).

Importantly, this demand has triggered the biggest increase in housing construction in more than 25 years. Total housing starts in February reached 2.197 million units, the highest monthly level since 1984. The increase was broad based, with three of the four regions reporting higher activity. Single-family and multi-family starts both rose as well.

Housing construction will be a large contributor to first-quarter real GDP growth since starts in the current period are running 10% (not annualized) over the fourth-quarter average. Nonresidential construction also looks strong, rising 1% in January, thereby extending the strong gains of the fourth quarter. Commercial construction should also expand strongly in 2005, given the fall in vacancy rates and increases in construction hiring. Several real-estate firms have indicated that demand for office space is rebounding.

Profits and Investment

Solid economic growth and strong productivity growth should push operating profits up about 12% this year, although the mix could be less broad than last year if oil prices stay at record levels, squeezing margins in many industries.

Capital spending increased at an 18% annualized rate in the final quarter last year and 14% for the entire year. Many analysts expected that the pace would slow early this year as a result of the expiration of the accelerated-depreciation allowance on December 31. But non-defense capital-goods shipments rose 3.7% in January, coming on the heels of a 3.1% gain in December—indicating that capital spending is still growing.

Unlike the capital-spending boom of the late 1990s, which was heavily concentrated in technology, the current cycle is broad based. Spending on both technology and industrial equipment spending rose by strong double digits in 2004, and order backlogs are up sharply across the board. In fact, the gains in the metals and machinery industries exceed those in technology. Order backlogs are rising in transportation but lag other sectors because of the relative weakness of the commercial airline industry. A strong increase in foreign orders should push overall transportation order backlogs significantly higher over the course of the year.

The US Current Account Deficit and Exchange Rates

The US current account deficit was a record $665.9 billion in 2004, with imports growing a stunning 16.3% and overshadowing the 12.4% rise in exports. This acceleration reflects a simple fact: The US does not have sufficient manufacturing capacity to meet the rising demands of US households and businesses, much less a substantial increase in exports. As long as this is true, the US will continue to record very large trade and current account deficits, placing downward pressure on the foreign-exchange value of the dollar.

The weaker dollar has clearly made the US a more attractive investment choice than Europe, Japan or Canada, but global investment patterns have yet to favor the US. This suggests that the US dollar will remain structurally weak for an extended period. The main risk is that the US dollar will fall much lower if China does not loosen its foreign exchange policy soon.

Prices, Unit Costs and Productivity

While overall inflation remains modest, we expect core retail prices to rise nearly 3% in 2005, up from 2.2% in 2004. Rising prices for materials and supplies for both primary and intermediate processing have placed some upward pressure on finished-goods prices. In January, producer prices of finished goods rose 0.8%, the largest monthly gain since 1998. Higher producer prices of goods should work their way to the retail level in coming months, pushing up core retail prices.

But the cost-push effect on inflation should be modest, given the ongoing gains in productivity and strong competitive pressures from overseas. Business productivity rose 4% in 2004, slightly less than the 4.4% average of the prior two years. Nonetheless, strong productivity gains have enabled firms to absorb some of the cost increases because unit labor costs remain relatively low, rising only 1.3% in 2004.

The rising price of crude oil is the wild card in the inflation picture. At the beginning of the fourth quarter, with crude-oil inventories unusually low and seasonal demand likely to rise with winter looming, crude-oil prices rocketed to a record $55 a barrel. Yet with the cold of winter passed and crude-oil stocks comfortably over 300 million barrels, crude-oil prices still hover around $55. Clearly, the high oil price remains a puzzle because it no longer appears linked to the amount of oil in storage but rather to the expected growth in demand and the limited capacity of OPEC and other countries. But we must acknowledge that the longer oil prices stay near current levels, the more the risks to our forecast tilt toward higher inflation and less real growth.

Financial Trends and Monetary Policy

Near the end of the first quarter, stock prices are generally slightly lower on the year, while market interest rates are up across the yield curve. Short-term interest rates are up about 50 basis points since the start of the year, while longer-term yields are up about 25 basis points. Nevertheless, interest rates remain relatively low for all borrowers in relation to underlying inflation and nominal GDP growth and thus do not threaten to slow or derail the economic expansion any time soon.

At next week's meeting of the Federal Open Market Committee (FOMC), we expect policymakers to raise official rates by 25 basis points, lifting the target on the federal funds rate to 2.75%. It is less clear, however, whether policy makers will reiterate that "policy accommodation can be removed at a pace that is likely to be measured," or remove this wording out of concern about the relaxed bank lending standards. The Senior Loan Officer Survey in January found that banks have eased lending standards significantly for commercial and industrial loans as well as consumer loans. Some participants see the easy lending standards as another indication that financial conditions are far too accommodative and could, if left unchecked, lead to more inflation down the road. Whatever the wording, we still expect the FOMC to raise rates in increments of 25 basis points at each of the next three meetings.

Joseph G. Carson
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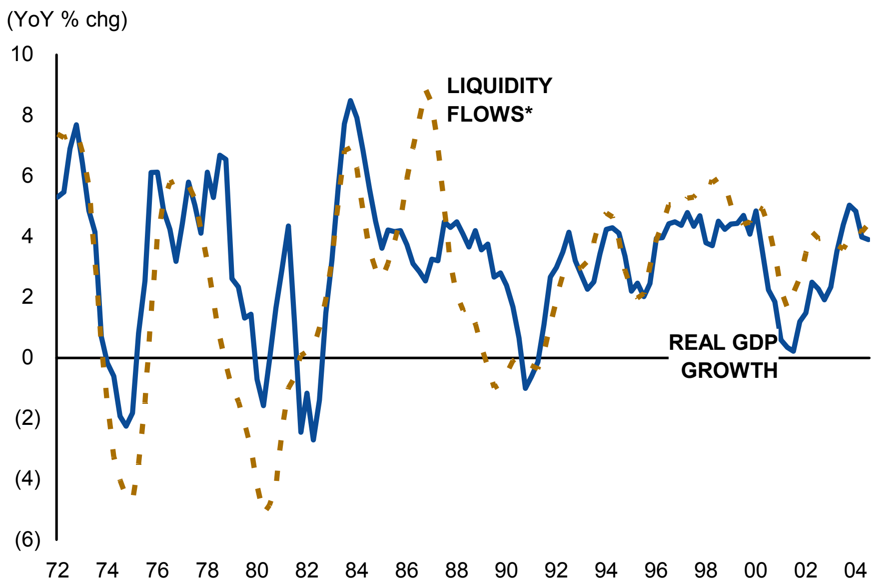
March 18, 2005

Display 1: Recent Economic Momentum Is Sustainable
Liquidity* Flows and Real GDP Growth



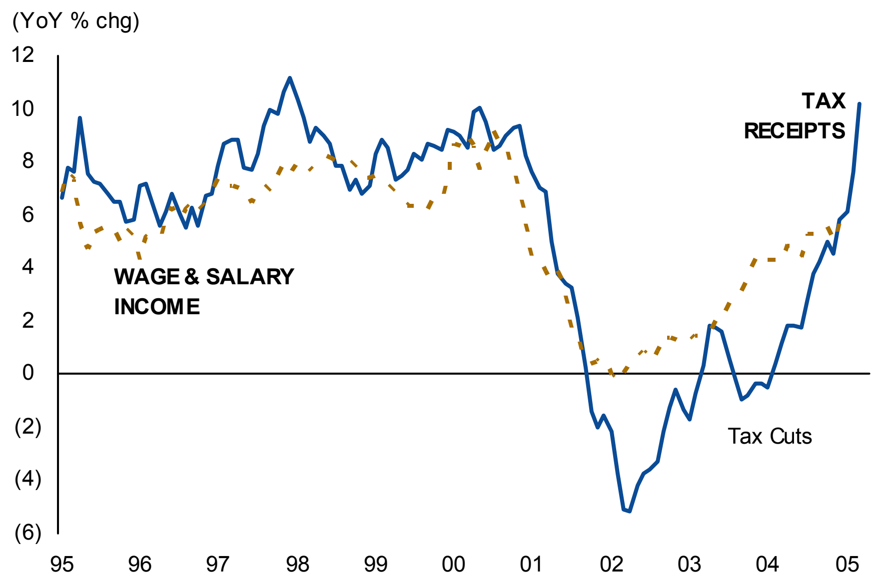
**Liquidity is a measure of real money growth, growth in business and consumer credit, growth in short-term liquid assets, foreign purchases of US securities and net cash flow into bond and stock funds*

Source: Bureau of Economic Analysis, Haver Analytics and Alliance Capital Fixed Income, March 18, 2005

Because real GDP has followed the script of liquidity flows for the past several years, we don't find recent strong growth surprising.

Display 2: Earned Income Growth Is Understated

Withheld Income Tax Receipts vs. Wage and Salary Income

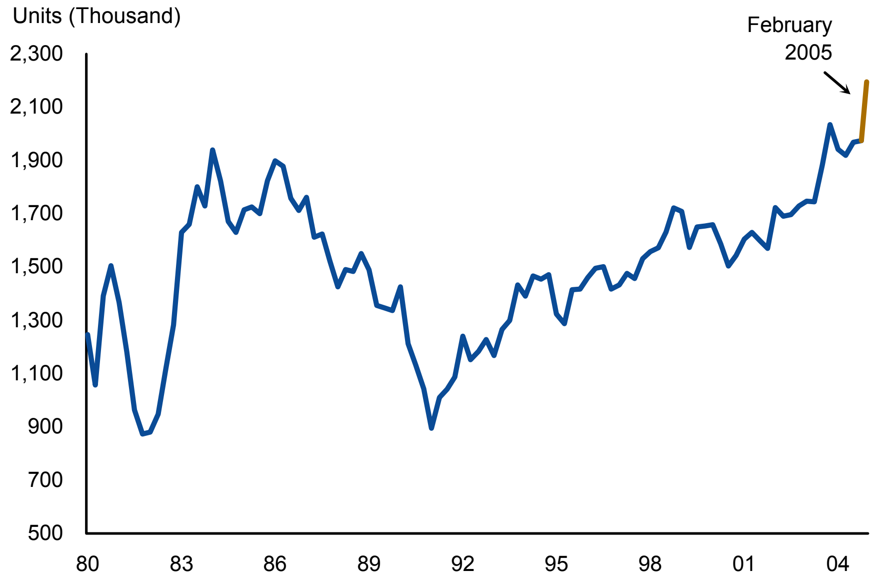


Source: Bureau of Economic Analysis, Internal Revenue Service, Haver Analytics and Alliance Capital Fixed Income, March 18, 2005

The strong acceleration in withheld income-tax receipts implies that reported wage-and-salary income growth is understated.

Display 3: Housing Market Remains Robust

Quarterly Housing Starts

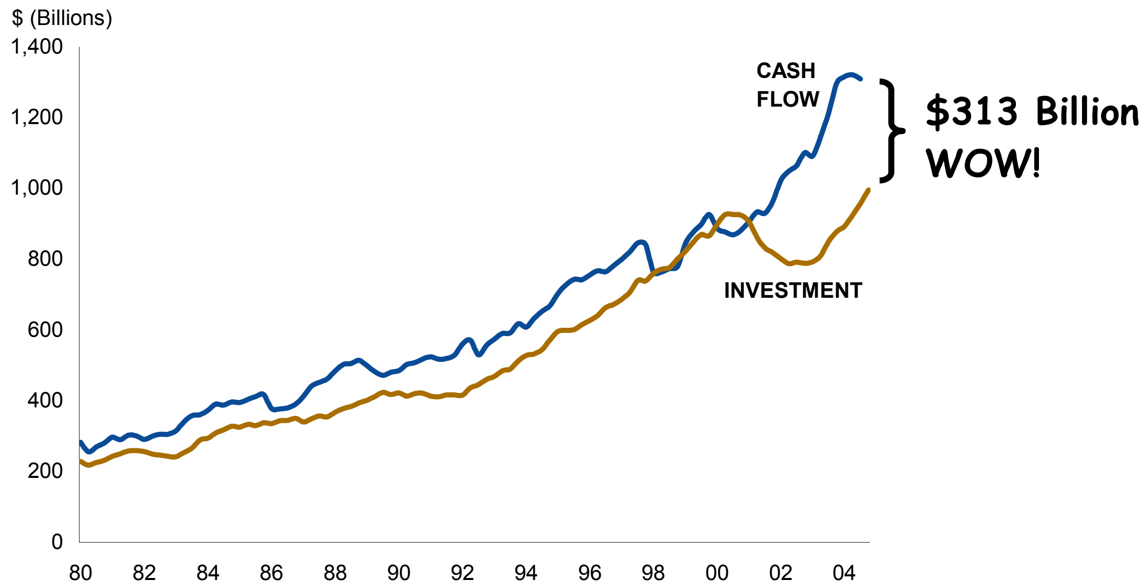


Source: Census Bureau and Haver Analytics, March 18, 2005

Evidence of continued strength in the residential housing market is seen in housing starts, which surged in February to their highest level since 1984.

Display 4: Bright Outlook for Capital Spending

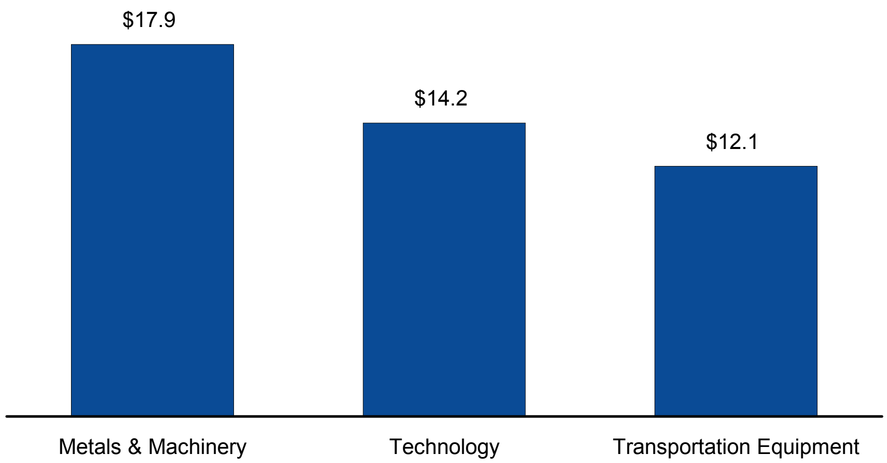
Net Cash Flow vs. Business Investment in Equipment and Software



Source: Bureau of Economic Analysis, Haver Analytics and Alliance Fixed Income, March 18, 2005

US companies have a war chest of free cash flow, suggesting a bright outlook for capital spending in 2005.

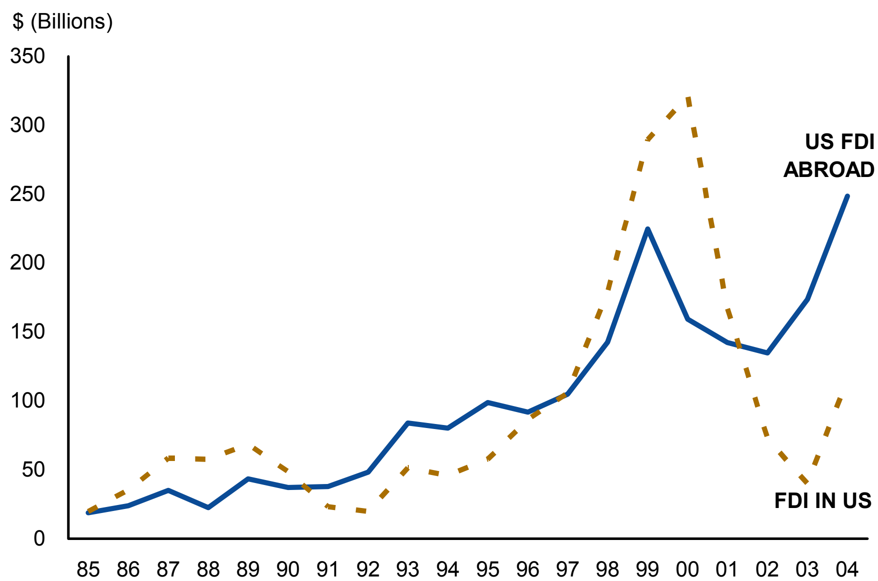
Display 5: Broad-Based Capex Cycle Is Underway
2004 Dollar Change in Order Backlogs ($ Billions)



Source: Census Bureau, Haver Analytics and Alliance Capital Fixed Income, March 18, 2005

Order backlogs are at record levels and recent gains have been broad based.

Display 6: Global Investment Patterns Do Not Favor the US
Foreign Direct Investment: US Investment Abroad vs. Foreign Flows into the US

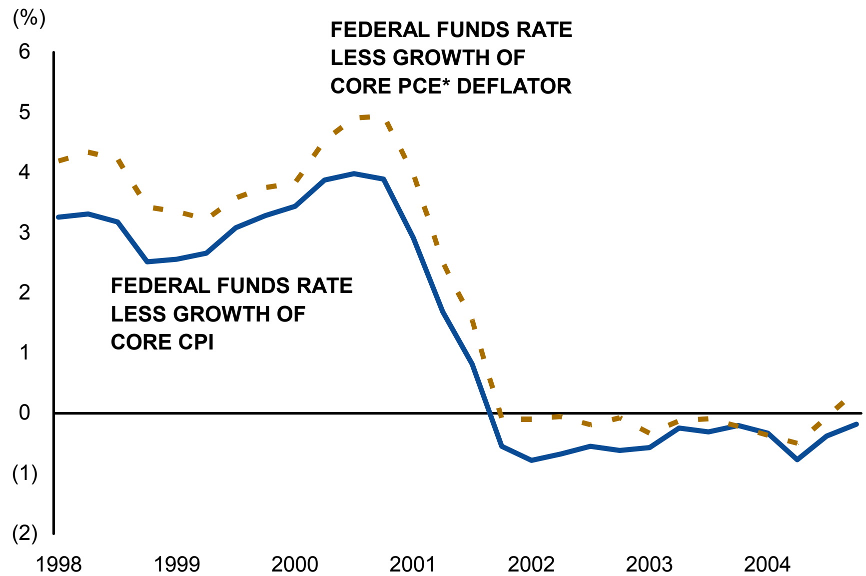


Source: Bureau of Economic Analysis and Haver Analytics, March 18, 2005

Even with the sharp fall in the dollar over the past few years, US firms invest more overseas than foreign firms invest here. This pattern must change if the US is to address its current account imbalance. An even weaker dollar might be needed to encourage the supply shift.

Display 7: Official Rates Are Still Very Low

Real Interest Rates



**Personal consumption expenditures*

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics and Alliance Capital Fixed Income, March 18, 2005

The Federal Reserve will continue to raise official rates at a moderate pace over the next several months.

Alliance Economic Forecast

Levels (2000 Dollars)	Quarterly 3Q04	4Q04	1Q05	2Q05	3Q05	Annual 2002	2003	2004	2005
GDP	10891.0	10993.3	11111.2	11221.2	11345.2	10074.8	10381.3	10841.6	11292.3
Consumption	7667.8	7746.2	7805.9	7865.9	7913.9	7123.4	7355.5	7632.4	7890.7
Durables	1118.3	1127.0	1137.0	1140.0	1145.0	959.6	1030.6	1098.9	1143.8
Non-Durables	2213.2	2246.0	2265.0	2287.0	2300.0	2037.4	2112.4	2208.6	2294.3
Services	4352.4	4389.3	4420.0	4455.0	4485.0	4128.6	4220.3	4338.4	4468.8
Investment									
Non-Res Structures	241.0	241.8	245.0	249.0	256.0	251.6	237.4	240.6	252.5
Non-Res Equip & Software	1015.6	1058.5	1100.0	1128.0	1153.0	826.5	879.2	998.3	1140.3
Res Structures	565.9	568.9	577.0	582.0	585.0	470.1	511.2	560.2	583.0
Change in Inventories	34.5	51.0	44.0	32.0	50.0	11.8	-0.7	46.7	45.3
Net Exports	-583.2	-623.4	-617.0	-605.0	-595.0	-472.1	-518.5	-584.3	-595.5
Exports	1131.1	1137.8	1160.0	1190.0	1220.0	1012.4	1031.8	1119.8	1207.5
Imports	1714.3	1761.2	1777.0	1795.0	1815.0	1484.4	1550.3	1704.0	1803.0
Government	1949.9	1955.6	1964.5	1977.5	1990.5	1857.9	1909.4	1947.0	1984.3

	Quarterly % SAAR					% Q4/Q4				Annual			
Percent Changes	3Q04	4Q04	1Q05	2Q05	3Q05	2002	2003	2004	2005	2002	2003	2004	2005
GDP	4.0%	3.8%	4.4%	4.0%	4.5%	2.3%	4.4%	3.9%	4.5%	1.9%	3.0%	4.4%	4.2%
Consumption	5.1%	4.2%	3.1%	3.1%	2.5%	2.5%	3.8%	3.7%	3.0%	3.1%	3.3%	3.8%	3.4%
Durables	17.2%	3.1%	3.6%	1.1%	1.8%	1.5%	9.9%	5.4%	2.3%	6.5%	7.4%	6.6%	4.1%
Non-Durables	4.7%	6.1%	3.4%	3.9%	2.3%	2.3%	4.6%	4.4%	3.5%	2.6%	3.7%	4.6%	3.9%
Services	3.0%	3.4%	2.8%	3.2%	2.7%	2.9%	2.2%	3.1%	2.9%	2.6%	2.2%	2.8%	3.0%
Investment													
Non-Res Structures	-1.2%	1.3%	5.4%	6.7%	11.7%	-16.1%	1.5%	-0.2%	7.5%	-17.8%	-5.6%	1.3%	5.0%
Non-Res Equip & Software	17.5%	18.0%	16.6%	10.6%	9.2%	-2.2%	12.1%	14.4%	11.5%	-5.5%	6.4%	13.6%	14.2%
Res Structures	1.6%	2.1%	5.8%	3.5%	2.1%	6.9%	12.0%	6.2%	3.4%	4.8%	8.8%	9.6%	4.1%
Net Exports													
Exports	6.0%	2.4%	8.0%	10.8%	10.5%	3.5%	6.1%	5.7%	10.7%	-2.3%	1.9%	8.5%	7.8%
Imports	4.6%	11.4%	3.6%	4.1%	4.5%	9.7%	4.9%	9.8%	3.6%	3.4%	4.4%	9.9%	5.8%
Government	0.7%	1.2%	1.8%	2.7%	2.7%	3.8%	2.2%	1.7%	2.5%	4.4%	2.8%	2.0%	1.9%

Key Macro Indicators	Quarterly					Annual			
Nominal GDP (Levels)	11814.9	11988.9	12214.5	12439.9	12657.7	10487.0	11004.1	11733.5	12557.6
%Q/Q SAAR	5.5%	6.0%	7.7%	7.6%	7.2%				
%Y/Y	6.3%	6.4%	6.5%	6.7%	7.1%	3.5%	4.9%	6.6%	7.0%
Industrial Production (Index)	115.9	117.1	118.5	120.0	122.0	110.9	110.9	115.5	121.1
%Q/Q SAAR	2.7%	4.4%	4.7%	5.2%	6.8%				
%Y/Y						-0.3%	0.0%	4.1%	4.8%
Housing Starts (Millions)	1.97	1.98	2.15	2.10	2.05	1.71	1.85	1.95	2.08
Industry Auto Sales (Millions)	17.2	16.3	16.3	17.0	17.3	16.8	16.6	16.8	17.0
Personal Savings Rate	0.7	1.6	2.5	3.0	3.0	2.1	1.3	1.2	2.9
Unemployment Rate	5.4	5.4	5.3	5.3	5.2	5.8	6.0	5.5	5.2
Operating Profits (%Y/Y)	5.8%	11.2%	9.4%	10.3%	18.5%	14.0%	16.8%	15.4%	11.7%
After-Tax Profits (%Y/Y)	5.8%	6.6%	15.0%	12.5%	16.3%	12.2%	19.2%	11.9%	12.9%

Inflation %Y/Y									
GDP Deflator	1.4%	2.1%	3.0%	3.4%	2.6%	1.7%	1.8%	2.2%	2.7%
Consumer Price Index	1.6%	3.6%	2.9%	3.4%	3.1%	1.6%	2.3%	2.7%	3.2%

Key Interest Rates (End Of Period)									
Fed Funds Rate	1.75%	2.25%	2.75%	3.25%	3.75%	1.25%	1.00%	2.25%	4.00%
3-Mo T-Bill (BEY)	1.71%	2.22%	2.75%	3.25%	3.75%	1.22%	0.95%	2.22%	4.00%
2-Yr Note	2.63%	3.08%	3.50%	3.90%	4.30%	1.61%	1.84%	3.08%	4.50%
10-Yr Note	4.14%	4.24%	4.50%	4.70%	4.80%	3.83%	4.27%	4.24%	5.00%
30-Yr Bond	4.97%	4.86%	4.80%	5.00%	5.10%	4.95%	5.18%	4.86%	5.25%

Source: Alliance Fixed Income