ALLIANCE CAPITAL FIXED INCOME℠ | INVESTMENT RESEARCH AND MANAGEMENT

US WEEKLY ECONOMIC UPDATE

April 15, 2005

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US Economic and Investment Perspectives

Wider Trade Deficit Has Reduced Growth Prospects

US trade flows have plainly failed to follow our expectations. Rather than declining, the US deficit has continued to set new records. In February, it totaled $61 billion and now looks like it is headed toward $730 billion by year-end. Except for the recession year of 2001, the US trade deficit has widened annually since 1995, increasing seven-fold over this period.

Ominously, the trade deficit continues to widen across all product areas and against all regions. Over the past year, it has even widened against Canada and Europe, where the foreign exchange value of the dollar has dropped sharply in the past few years.

Trade improvement has been an important component of our upbeat 2005 GDP forecast. Without it, growth in exports, capital spending and inventory building could trail our initial estimates, while import growth could exceed our estimates. Last week, we noted that the slowdown in liquidity growth was a harbinger of slower growth ahead.

Now that we have identified one of the likely sources of this weaker growth, we have reduced our 2005 real GDP forecast by 0.5%, from 4.2% to 3.7%, but may lower it further depending on the extent to which capital spending, inventory building, production and jobs are affected. The risks are now clearly skewed to the downside given negative trends in liquidity and trade.

Longer term, the rising trade deficit could have more worrying ramifications if politicians on Capitol Hill seek to protect US jobs by instituting protectionist measures. In our view, any such action would be counter-productive, as US interests are best served by promoting freer markets and welcoming investment to the US without fear or favor.

A Deeper Hole

Analysts often look no farther than supply/demand dynamics and relative price trends to explain why the US deficit continues to worsen. Fundamentally, domestic demand remains too strong in the US and too weak overseas. Although domestic demand growth appeared to have slowed at the end of the first quarter, it nonetheless grew an estimated 3.5% annualized for the quarter and has been averaging between 3.5% and 5.5% for two years. In contrast, domestic demand growth in a number of major economies is much slower, and in Japan and Europe it is less than 2%, if not 1%. At the same time, economic weakness abroad has limited the ability of US exporters to take advantage of the weak dollar, while foreign suppliers have gone to extraordinary lengths to keep their grip on US customers by absorbing the impact of a cheaper dollar.

Looking deeper, in our view it is apparent there are also structural issues crippling trade adjustments. For example, US manufacturing fundamentally lacks sufficient scale to offset higher levels of imports and requires significantly more investment to reverse these trends—something that does not appear to be forthcoming any time soon.

If anything, US manufacturers are investing more in their overseas affiliates than in their home operations. According to data from the Department of Commerce and the Bureau of Census, this shift started in 1999, and the gap has widened ever since. In the past five years, US manufacturing firms have spent approximately $50 billion more on their overseas affiliates than on their domestic operations. Obviously, the shift in investment patterns partly explains why the yawning trade gap keeps getting bigger.

A Smaller Manufacturing Footprint

This week, the Bureau of Census released its 2003 annual survey of manufacturing. The capital-spending data offers a very bleak picture of America's ability to compete globally, showing more hollow manufacturing sector than we originally thought. Capital spending in the manufacturing sector totaled $115 billion in 2003, about 25% below the levels of the late 1990s. But capital spending in some key capital goods sectors, such as computers and electronic products, is roughly half what it was five years ago. In many sectors, capital spending is not even keeping pace with obsolescence, indicating a shrinking capital stock

In the short run, export growth will be less robust and import growth will strengthen. At the beginning of the year, our forecast called for exports to rise 8% and for imports to rise only 4%. It now appears that imports will rise twice as fast as we had originally expected, while exports will have risen at least a percentage point slower than we had predicted. This by itself is enough to lower our 2005 real GDP forecast.

The longer-term effects of the ever-growing trade imbalance could be even more damaging, creating significant imbalances in other parts of the global economy that risk destabilizing local economies. For instance, our analysis shows that since 2001, China has generated over eight million new manufacturing jobs, while the US has lost more than two million and other top economies 1.3 million. In a world of integrated production and markets, it is understandable that lower-cost producers would gain over higher-cost ones. But it is unlikely that US legislators will stand idle while a trading partner records huge increases in manufacturing jobs and the US experiences huge losses.

In the US Senate, Lindsey Graham, a Republican from South Carolina, and Charles Schumer, a Democrat from New York, have co-sponsored a bill calling for the US to levy 27.5% tariffs on all imported goods from China if it does not revalue its currency. While passage of this legislation is unlikely, the bill does have strong bi-partisan support—suggesting that there is broad and growing frustration with China's refusal to break its currency peg. Such dissatisfaction could spawn other legislative actions, especially given China's likely refusal to bow to devaluation pressures.

Breaking the renminbi peg to the dollar would help at the margin. But it is not the root of the US trade deficit, which is too big and too broad to be addressed by a currency correction alone.

Rather than erecting trade barriers, America needs a policy that invites and encourages greater investment in manufacturing operations. If US companies are not going to be the engine of new investment, then the government should encourage non-US companies to invest here. A large part of foreign direct investment in the US goes into real estate or other passive holdings. While these investments help finance the trade deficit, they don't reduce it. Greater foreign ownership in the US is an inevitable by-product of today's trade and current deficit; only when we turn the capital inflows toward the manufacturing sector will we be able to reverse the structural aspect of the yawning trade gap.

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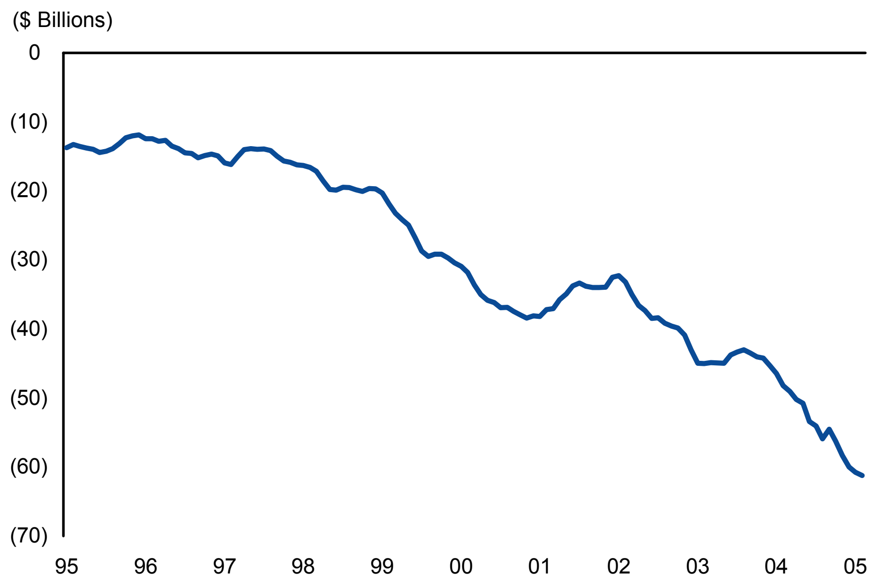
April 15, 2005

Display 1: The Ever-Widening Trade gap

US Trade Deficit



Three-month moving average

Source: Census Bureau, Haver Analytics and Alliance Capital Fixed Income, April 15, 2005

The US trade deficit appears likely to end the year near $730 billion. Except for the recession year of 2001, the US trade deficit has widened annually since 1995, increasing seven-fold over this period.

Display 2: A More Hollowed Manufacturing Sector

Capital Expenditures for US Manufacturers By Industry Group ($ Billions)

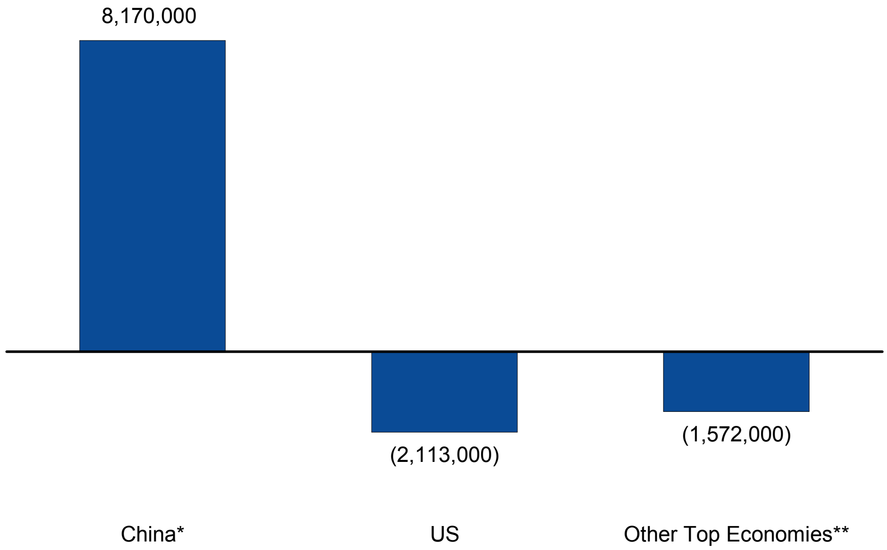
	2003	2002	2001	2000	1999	1998	1997	Change 1997–2003
Total Manufacturing	**115.0**	**126.0**	**143.1**	**154.9**	**150.3**	**152.7**	**151.5**	**(24.1)%**
Transportation Equipment	16.1	16.7	16.7	17.6	19.1	20.1	19.3	(16.2)
Chemicals	15.4	18.2	18.9	20.3	21.7	21.7	21.7	(28.8)
Computers & Electronic Prod.	12.6	13.7	25.5	28.1	21.3	22.8	24.7	(49.1)
Food	12.0	11.0	11.6	11.8	12.8	11.5	10.8	11.5
Petroleum	7.7	8.1	7.3	5.2	4.5	4.8	4.8	61.9
Fabricated Metals	7.1	8.0	8.6	10.0	9.7	9.9	9.4	(24.6)
Plastics	6.6	7.4	7.3	8.4	9.1	8.1	7.8	(15.2)
Paper	5.9	6.3	6.8	7.4	7.1	8.5	8.6	(31.1)
Machinery	5.4	6.7	8.3	9.3	9.3	9.5	8.8	(38.8)
Nonmetallic Minerals	4.8	5.2	5.7	6.0	5.4	5.0	4.8	(0.3)
Printing	3.8	3.9	4.1	4.4	4.8	4.9	5.1	(24.6)
Miscellaneous	3.4	4.0	4.2	4.0	4.0	3.9	3.4	(0.8)
Primary Metals	3.3	4.3	5.1	6.1	5.9	6.5	6.5	(48.7)
Beverages & Tobacco	2.8	3.4	2.7	2.8	2.6	2.6	3.1	(10.8)
Electrical Equipment	2.2	2.7	3.4	3.9	3.7	4.0	3.6	(37.6)
Wood Products	2.2	2.4	2.7	3.1	3.1	2.7	2.9	(24.2)
Textiles & Apparel	1.9	2.4	3.1	3.6	4.1	4.1	4.5	(58.2)
Furniture	1.6	1.8	1.6	2.1	2.2	1.9	1.7	(8.4)

Source: Census Bureau, April 15, 2005

Industry capital expenditure data paints a bleak picture. In many industries, companies are not even keeping pace with obsolescence. The declines have been greatest in many key export industries.

Display 3: An Unbalanced Manufacturing World

Global Manufacturing Jobs Growth: 2001–2004



**Estimate*

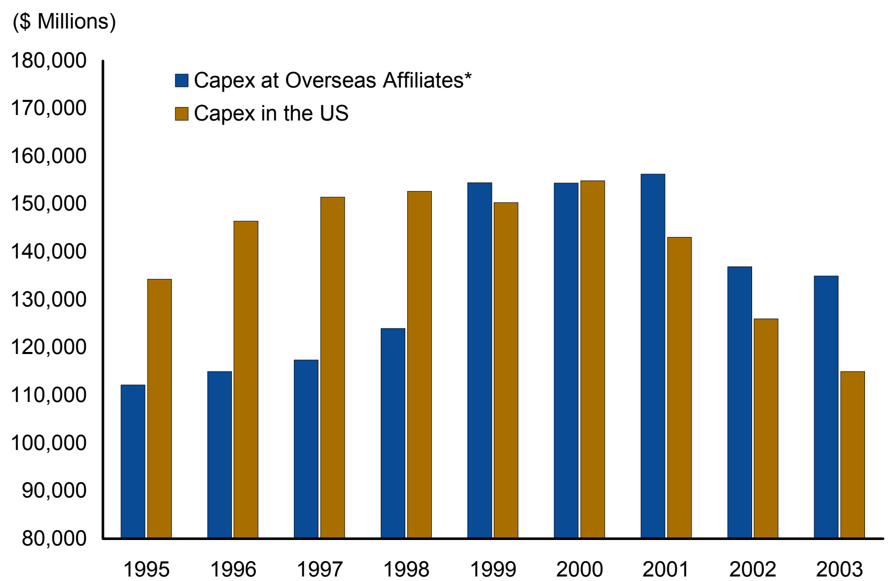
***Top 18 countries other than China and US*

Source: Haver Analytics and Alliance Capital Fixed Income estimates, April 15, 2005

According to our analysis, China has created eight million manufacturing jobs since 2001, while the US and other top economies have lost about 3.5 million jobs.

Display 4: US Firms Invest More Overseas than at Home

Capital Expenditure Trends at US Manufacturers



**2003 is an estimate*

Source: Census Bureau, Bureau of Economic Analysis and Alliance Capital Fixed Income estimates, April 15, 2005

The investment policies of US manufacturing firms have begun to favor their foreign affiliates over home operations.

Alliance Economic Forecast

April 2005

Levels (2000 Dollars)	Quarterly					Annual			
	4Q04	1Q05	2Q05	3Q05	4Q05	2002	2003	2004	2005
GDP	10994.3	11106.9	11213.9	11318.9	11397.3	10074.8	10381.3	10841.9	11259.3
Consumption	7747.0	7812.5	7873.5	7928.5	7976.5	7123.4	7355.5	7632.6	7897.8
Durables	1129.0	1128.0	1135.0	1140.0	1143.0	959.6	1030.6	1099.4	1136.5
Non-Durables	2245.3	2280.0	2300.0	2320.0	2335.0	2037.4	2112.4	2208.5	2308.8
Services	4389.2	4421.0	4455.0	4485.0	4515.0	4128.6	4220.3	4338.3	4469.0
Investment									
Non-Res Structures	242.3	245.0	249.0	253.0	256.0	251.6	237.4	240.7	250.8
Non-Res Equip & Software	1059.5	1100.0	1128.0	1153.0	1175.0	826.5	879.2	998.6	1139.0
Res Structures	570.6	577.0	582.0	585.0	582.0	470.1	511.2	560.7	581.5
Change in Inventories	47.2	60.0	52.0	47.0	35.0	11.8	-0.7	45.7	48.5
Net Exports	-621.1	-643.9	-639.9	-629.9	-619.9	-472.1	-518.5	-583.7	-633.4
Exports	1140.0	1156.0	1180.0	1210.0	1235.0	1012.4	1031.8	1120.3	1195.3
Imports	1761.2	1800.0	1820.0	1840.0	1855.0	1484.4	1550.3	1704.0	1828.8
Government	1954.0	1964.5	1977.5	1990.5	2000.9	1857.9	1909.4	1946.6	1983.4

	Quarterly % SAAR					% Q4/Q4				Annual			
Percent Changes	4Q04	1Q05	2Q05	3Q05	4Q05	2002	2003	2004	2005	2002	2003	2004	2005
GDP	3.8%	4.2%	3.9%	3.8%	2.8%	2.3%	4.4%	3.9%	3.7%	1.9%	3.0%	4.4%	3.8%
Consumption	4.2%	3.4%	3.2%	2.8%	2.4%	2.5%	3.8%	3.8%	3.0%	3.1%	3.3%	3.8%	3.5%
Durables	3.9%	-0.4%	2.5%	1.8%	1.1%	1.5%	9.9%	5.5%	1.2%	6.5%	7.4%	6.7%	3.4%
Non-Durables	5.9%	6.3%	3.6%	3.5%	2.6%	2.3%	4.6%	4.3%	4.0%	2.6%	3.7%	4.5%	4.5%
Services	3.4%	2.9%	3.1%	2.7%	2.7%	2.9%	2.2%	3.1%	2.9%	2.6%	2.2%	2.8%	3.0%
Investment													
Non-Res Structures	2.2%	4.5%	6.7%	6.6%	4.8%	-16.1%	1.5%	0.0%	5.7%	-17.8%	-5.6%	1.4%	4.2%
Non-Res Equip & Software	18.4%	16.2%	10.6%	9.2%	7.9%	-2.2%	12.1%	14.5%	10.9%	-5.5%	6.4%	13.6%	14.1%
Res Structures	3.4%	4.6%	3.5%	2.1%	-2.0%	6.9%	12.0%	6.5%	2.0%	4.8%	8.8%	9.7%	3.7%
Net Exports													
Exports	3.2%	5.7%	8.6%	10.6%	8.5%	3.5%	6.1%	5.9%	8.3%	-2.3%	1.9%	8.6%	6.7%
Imports	11.4%	9.1%	4.5%	4.5%	3.3%	9.7%	4.9%	9.8%	5.3%	3.4%	4.4%	9.9%	7.3%
Government	0.8%	2.2%	2.7%	2.7%	2.1%	3.8%	2.2%	1.6%	2.4%	4.4%	2.8%	1.9%	1.9%

Key Macro Indicators	Quarterly					Annual			
Nominal GDP (Levels)	11994.8	12194.6	12402.2	12605.5	12780.0	10487.0	11004.1	11735.0	12495.6
%Q/Q SAAR	6.2%	6.8%	7.0%	6.7%	5.7%				
%Y/Y	6.4%	6.3%	6.4%	6.7%	6.5%	3.5%	4.9%	6.6%	6.5%
Industrial Production (Index)	117.1	118.5	119.9	121.2	122.0	110.9	110.9	115.5	120.4
%Q/Q SAAR	4.4%	4.7%	4.8%	4.4%	2.7%				
%Y/Y						-0.3%	0.0%	4.1%	4.2%
Housing Starts (Millions)	1.98	2.15	2.00	1.90	1.80	1.71	1.85	1.95	1.96
Industry Auto Sales (Millions)	16.3	16.3	16.8	16.8	16.8	16.8	16.6	16.8	16.7
Personal Savings Rate (%)	1.6%	2.5%	3.0%	3.0%	3.0%	2.1%	1.3%	1.2%	2.9%
Unemployment Rate (%)	5.4%	5.3%	5.3%	5.2%	5.1%	5.8%	6.0%	5.5%	5.2%
Operating Profits (%Y/Y)	12.4%	9.4%	10.3%	18.5%	8.0%	14.0%	16.8%	15.7%	11.4%
After-Tax Profits (%Y/Y)	6.8%	15.0%	12.5%	16.3%	8.3%	12.2%	19.2%	16.1%	12.9%
Inflation %Y/Y									
GDP Deflator	2.3%	2.3%	3.0%	2.8%	2.8%	1.7%	1.8%	2.2%	2.5%
Consumer Price Index	3.6%	2.9%	3.8%	3.1%	3.1%	1.6%	2.3%	2.7%	3.2%
Key Interest Rates (End Of Period)									
Fed Funds Rate	2.25%	2.96%	3.25%	3.75%	4.00%	1.25%	1.00%	2.25%	4.00%
3-Mo T-Bill (BEY)	2.22%	2.79%	3.25%	3.75%	4.00%	1.22%	0.95%	2.22%	4.00%
2-Yr Note	3.08%	3.80%	4.15%	4.30%	4.50%	1.61%	1.84%	3.08%	4.50%
10-Yr Note	4.24%	4.50%	4.65%	4.85%	5.00%	3.83%	4.27%	4.24%	5.00%
30-Yr Bond	4.86%	4.76%	4.85%	5.00%	5.10%	4.95%	5.18%	4.86%	5.10%

Source: Alliance Capital Fixed Income, April 15, 2005