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US WEEKLY ECONOMIC UPDATE

May 20, 2005

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US Economic and Investment Perspectives

Conditions Remain Accommodative Despite Flatter US Yield Curve

In the past year, the spread between the fed funds target and 10-year US Treasuries has narrowed from 370 basis points to around 110 basis points today. This has fueled perceptions that the cycle is maturing because the yield curve typically flattens late in the business cycle, when policymakers are tightening and short-term rates are rising faster than long-term ones. When this happens, the cost of both short-term financing and longer-run investment borrowing rise, restraining economic activity.

However, that is not happening now. Although US short-term rates have risen with the 200-basis-point increase in official rates since last June, long-term rates have not gone up. Moreover, both short-term and long-term borrowing costs for households and businesses remain unusually low relative to inflation or overall revenue and income growth at any stage of the cycle.

Credit has been more available at all stages of a cycle since financial markets in the US were deregulated in the early 1980s. At the same time, the price of credit (i.e., interest rates) has become more variable. As a result, the alignment of interest rates to nominal revenue and income growth (i.e. GDP) has become just as important an economic reflector as the shape of the yield curve. Today's flatter yield curve is at odds with the low level of rates relative to nominal income and revenue growth—the former suggests tighter financial conditions, the latter the opposite. So it is essential to look elsewhere to ascertain how accommodative or restrictive financial conditions really are, and where exactly we are in the economic cycle.

In our view, indicators clearly suggest that the current cycle remains young. First, real official rates are still negative, in contrast with the latter stages of the last two business cycles, when they ranged from 3% to 4%. Second, housing—a cyclical "leader" because of its dependence on relatively low rates—is showing no sign of slowing. Sales of new and existing homes hit a new record in the first quarter, and rising confidence among homebuilders and higher building-permit issuance suggest more gains ahead.

Third, corporations are flush with cash, a situation characteristic of the early stages of the cycle. Moreover, the ratio of capital spending to net cash flow is at its lowest level in more than 40 years. Ordinarily, it tends to rise—not fall—during the latter stages of a business cycle. Lastly, profit margins are still rising, another sign the cycle is not advanced.

As the factors affecting cycles have changed, it has become essential to look beyond single metrics such as the yield curve to assess where one is in an economic cycle. The yield curve will undoubtedly remain an important yardstick—but no more so than others. Evidence suggests it is currently out of sync with other important economic and financial indicators.

So instead of warning of a downturn in the cycle, we think the flattening yield curve is signaling a transition from an above-trend growth of more than 4% to a trend level of 3% to 3.5%—a level that is, not coincidentally, consistent with our proprietary measure of liquidity in the US economy.

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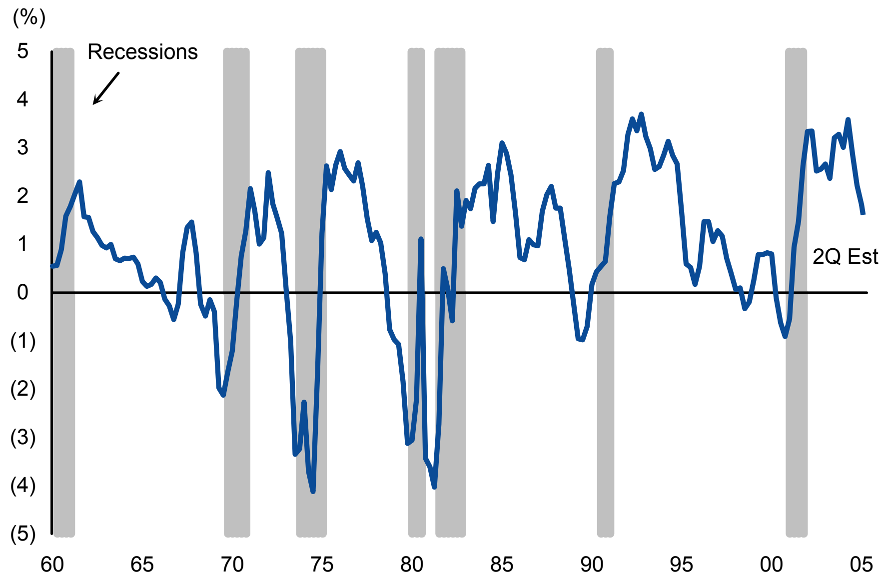
Display 1: Flatter Yield Curve Is Signaling Later-Stage Cycle

Interest-Rate Spread: 10-Year Treasury Yield Less Federal Funds Rate

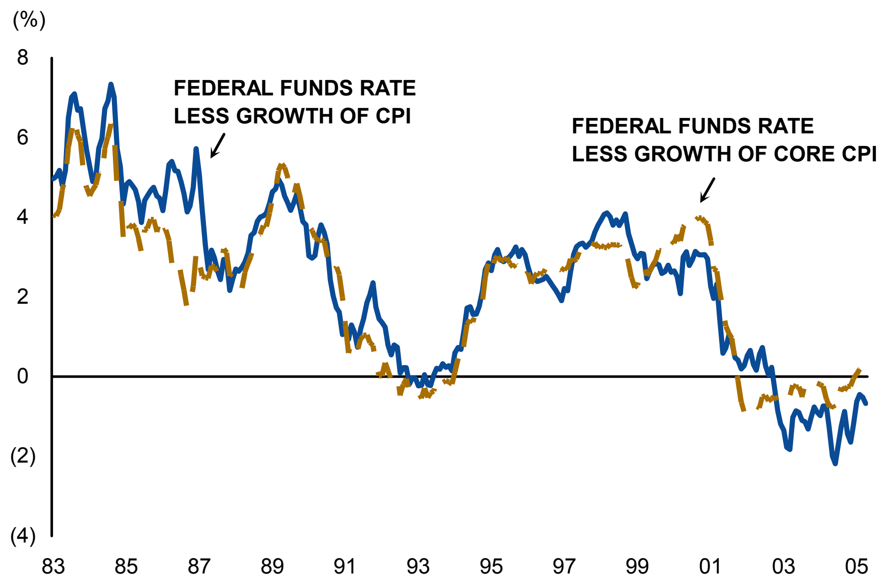


Source: National Bureau of Economic Research, The Conference Board, Haver Analytics and Alliance Capital Fixed Income

As a rule, the shape of the yield curve changes over the course of a business expansion. Flatter yield curves typify later stages in the expansion.

Display 2: Real Rates Are Still Very Low

Real Federal Funds Rate

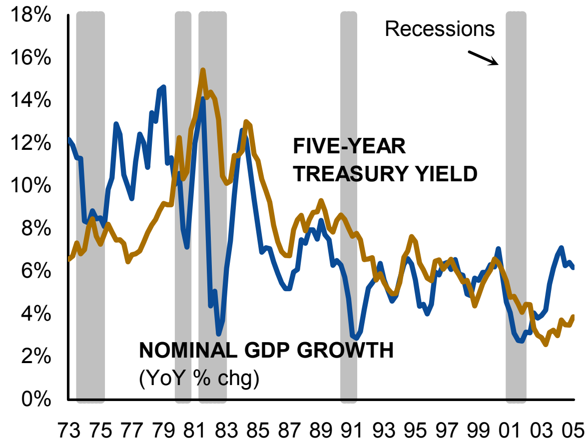


Source: Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics and Alliance Capital Fixed Income

Real rates tend to be high during the later stages of an expansion and relatively low during the early stages. Today's low rates suggest the economic expansion has a long way to go.

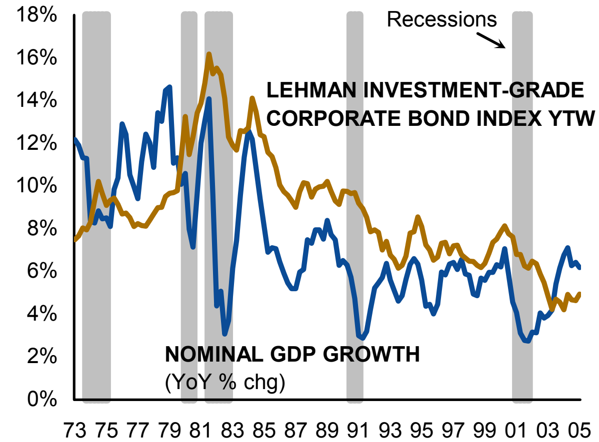
Display 3: Borrowing Costs Remain Relatively Low

Nominal GDP vs. Yield on Five-Year Treasuries



Source: Bureau of Economic Analysis, National Bureau of Economic Research, Federal Reserve Board and Haver Analytics

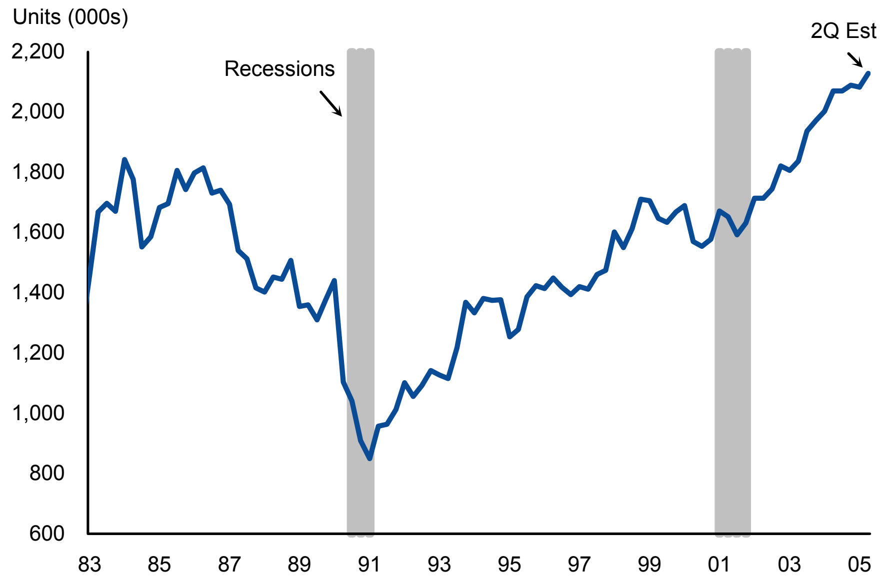
Nominal GDP vs. Corporate Bond Yields



Source: Bureau of Economic Analysis, National Bureau of Economic Research, Lehman Brothers and Haver Analytics

Credit has been more available at all stages of a cycle since financial markets were deregulated in the early 1980s. At the same time, its price (i.e., interest rates) has become more variable. The alignment of interest rates to nominal revenue and income growth (i.e., GDP) has, therefore, become as important an economic reflector as the shape of the yield curve. The low level of rates in relation to nominal GDP growth indicates the economic expansion is still relatively young.

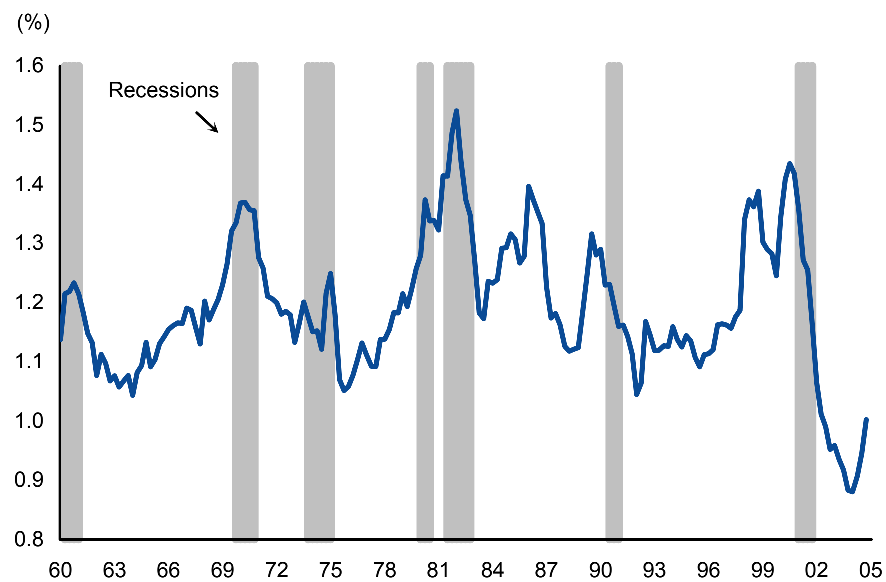
Display 4: Housing is an Early-Cyclical Industry
Building Permits



Source: Census Bureau, National Bureau of Economic Research, Haver Analytics and Alliance Capital Fixed Income

The housing market tends to recover early in the recovery and weaken well before the expansion ends. The ongoing rise in the issuance of building permits indicates the expansion has many years to run.

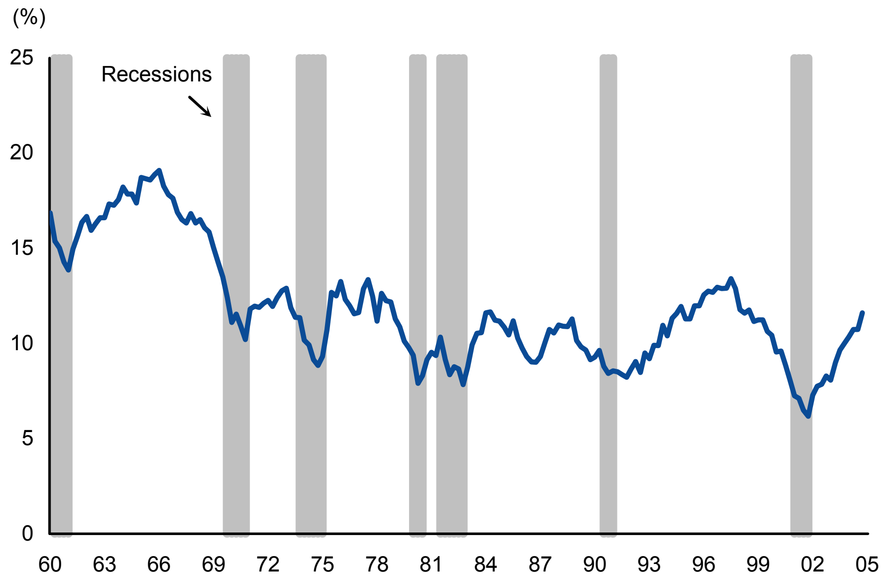
Display 5: US Firms Are Flush With Cash
Nonresidential Investment as a Percent of Net Cash Flow



Source: Bureau of Economic Analysis, National Bureau of Economic Research, Haver Analytics and Alliance Capital Fixed Income

During the latter part of a business cycle firms are usually spending well beyond internal cash flow generation. But that is not a feature of today's economy. In fact, given how little firms are spending on capex one can easily argue that we are still in the early years of the expansion.

Display 6: Real Profit Margins Are Still Rising
Real Profit Margins (Nonfinancial Corporations)



Source: Bureau of Economic Analysis, National Bureau of Economic Research, Haver Analytics and Alliance Capital Fixed Income

Operating profits tend to peak midway through an expansion. Through 2005:1Q, operating profits are still on an upward path.