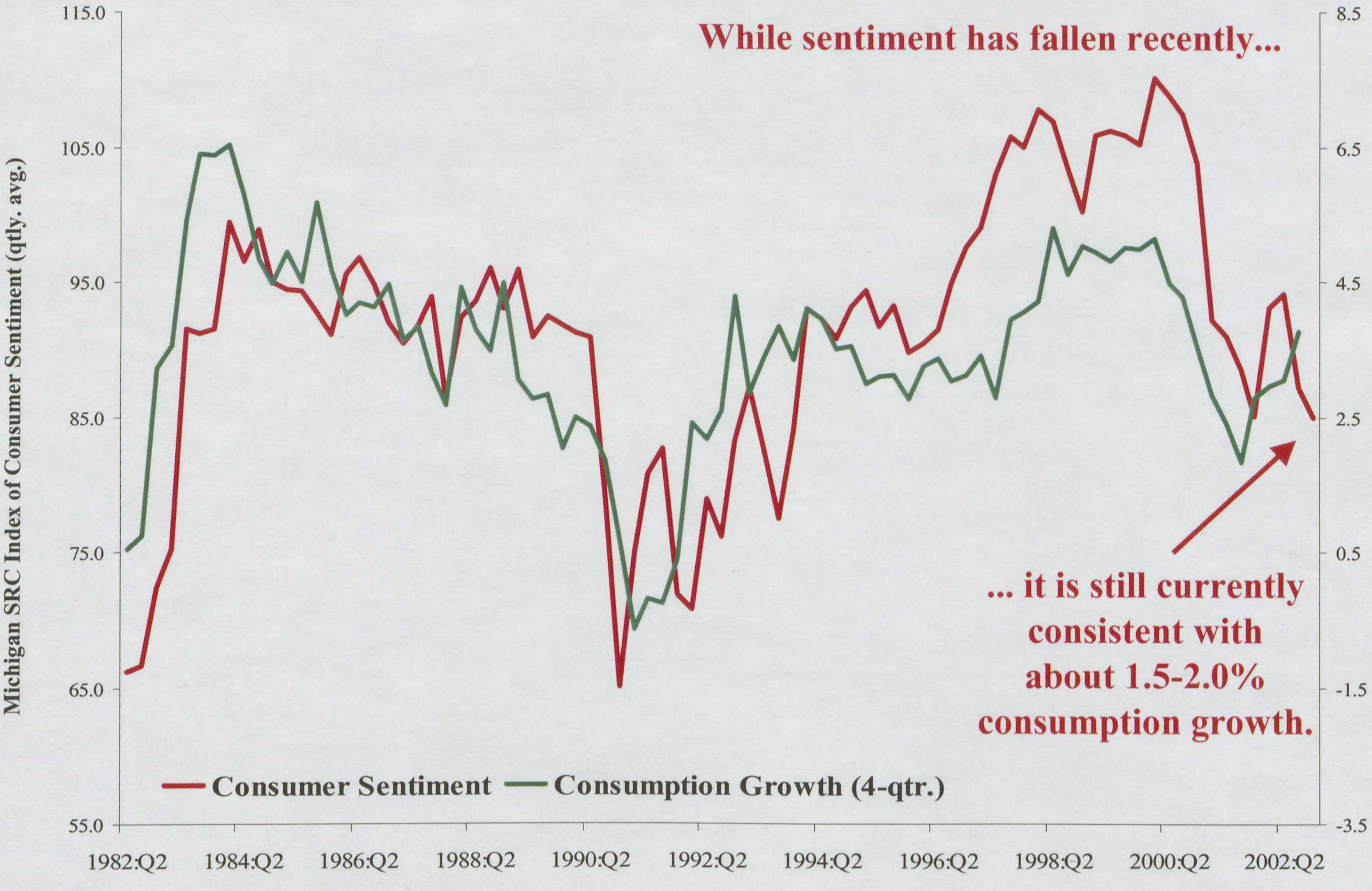
Boston Security Analysts Society

November 19, 2002

A Delicate Balance

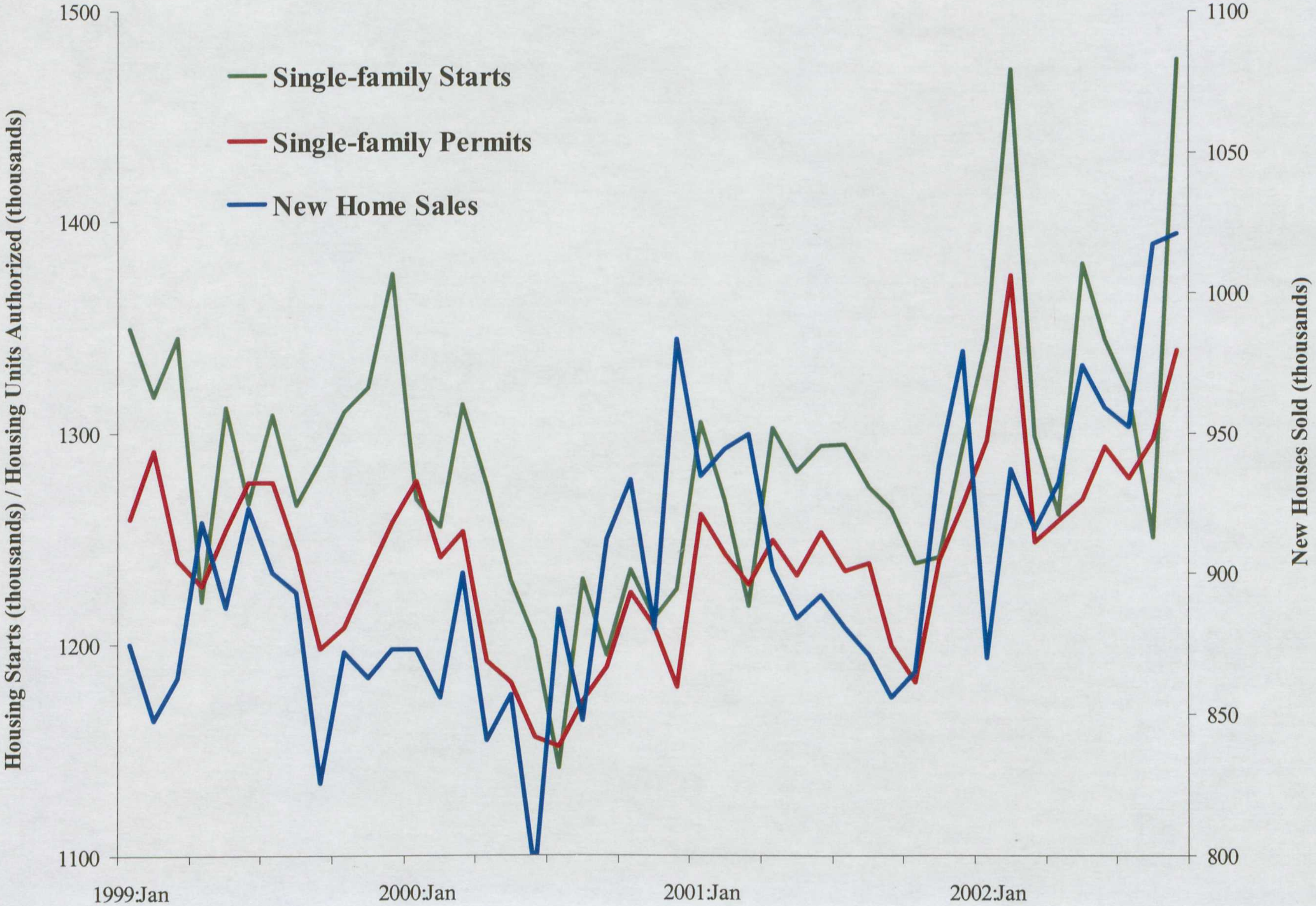
- Consumer confidence continues to have some strength
  - Evident in conventional measures of confidence
  - More clearly seen in spending behavior
    - Spending on houses
    - Spending on autos
- Business confidence has been shaky
  - As a result, hiring has been anemic
    - Posing a risk for consumer spending
  - Investment is still largely a twinkle in firms' eyes
    - But due to strong productivity growth, it is a twinkle that remains in the eyes of most forecasters too.
- This balance has kept us growing modestly
  - But left us with unused capacity
  - And with continued uncertainty

Consumer confidence: Consumer spending has been a source of strength



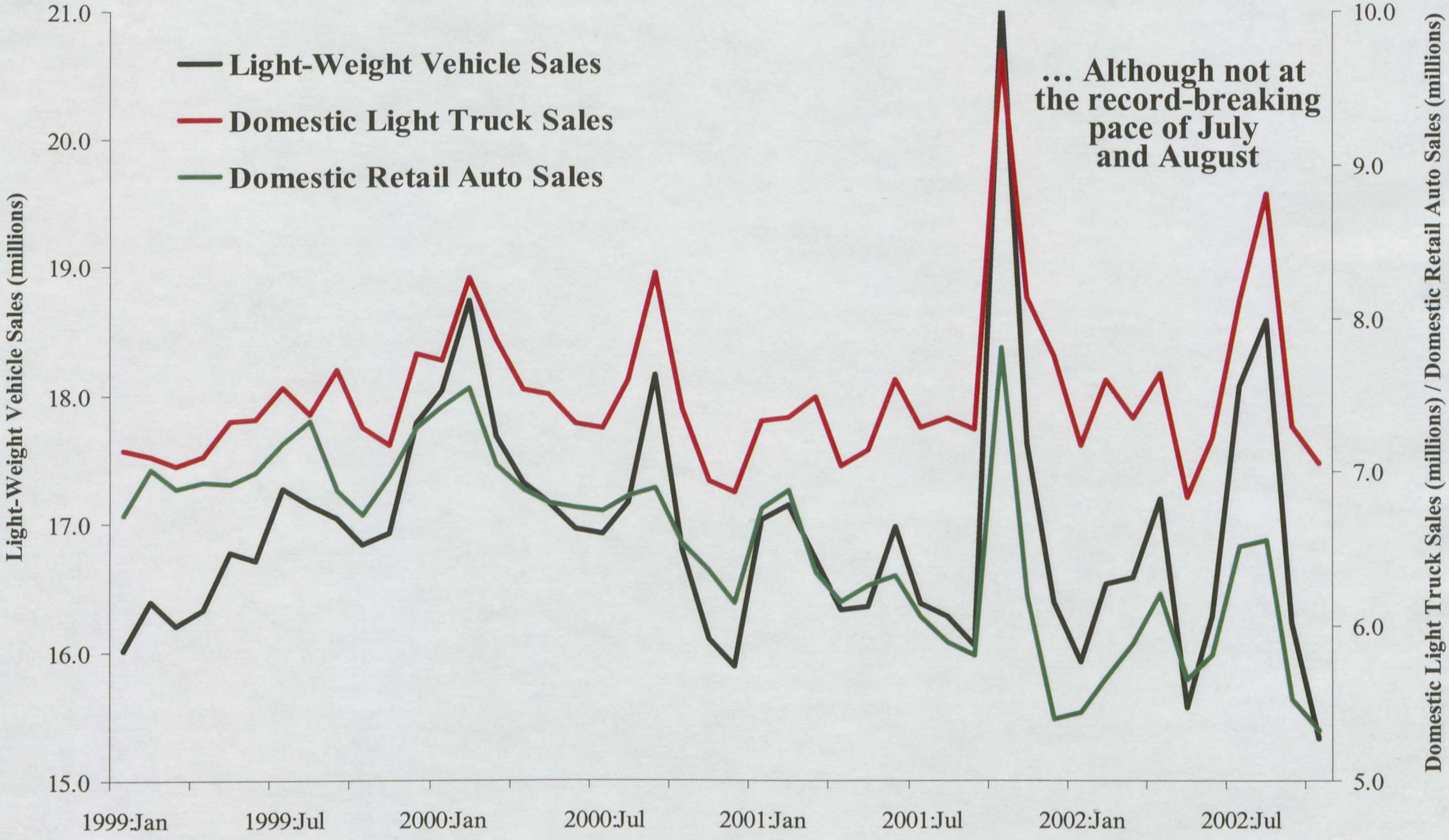
Sources: Consumer Sentiment (NSA, 1966:Q1 = 100): University of Michigan. Personal Consumption Expenditures (SAAR, Chained 1996$): Bureau of Economic Analysis.
Note: Consumer Sentiment 2002:Q4 represents November only.

Consumer confidence as revealed through spending: Housing activity remains robust



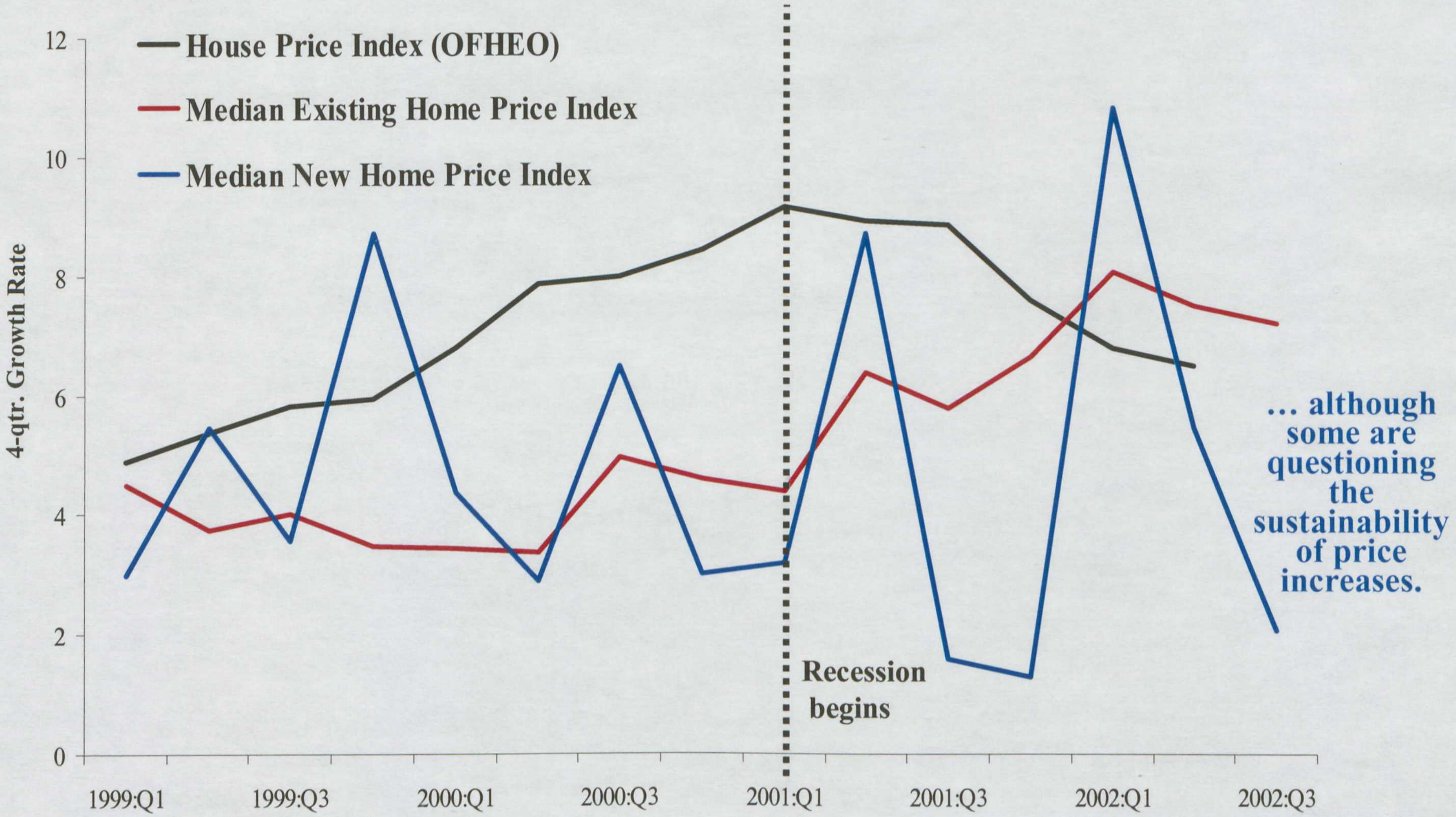
Source: Single-family Housing Starts, Housing Units Authorized, and New Houses Sold (SAAR, Thousands): Bureau of the Census.

Consumer confidence as revealed through spending: Auto sales continue at high levels ...



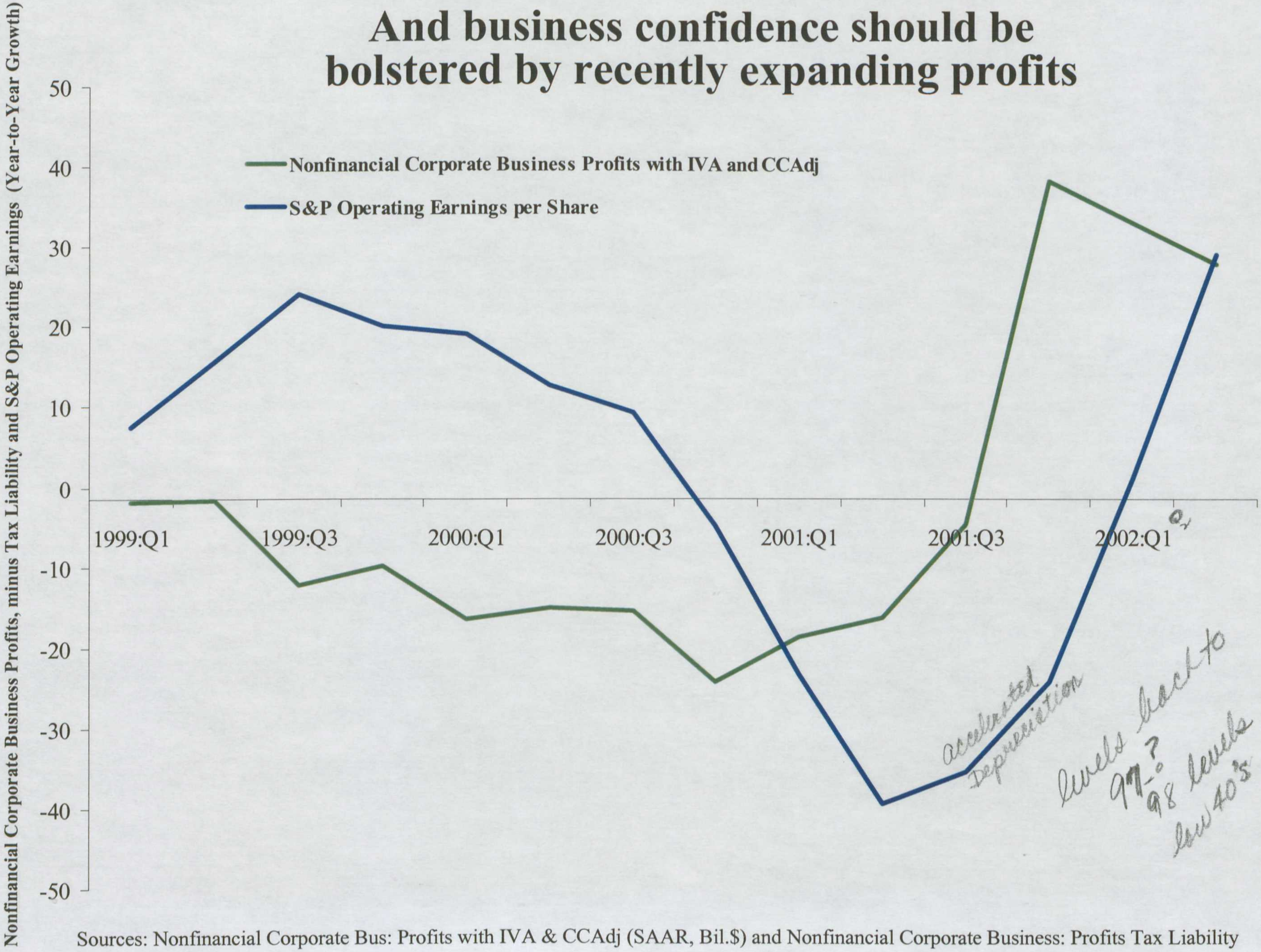
Source: Light-Weight Vehicle Sales (US Purchases of Autos and Light Trucks), Domestic Truck Sales (US Purchases of Light Trucks Assembled in North America, 0-10,000 Lbs. GVW) and Domestic Retail Auto Sales (US Purchases of Autos Assembled in North America, SAAR, Millions): Bureau of Economic Analysis.

Another support for consumer spending: Housing prices continue to grow,
Reflecting strong demand and providing a source of strength



Sources: House Price Index (1980:Q1 = 100): Office of Federal Housing Enterprise Oversight. Existing 1-Family Homes, Median Sales Price (NSA): National Association of Realtors. New 1-Family Homes, Median Sales Price (NSA): Bureau of the Census.

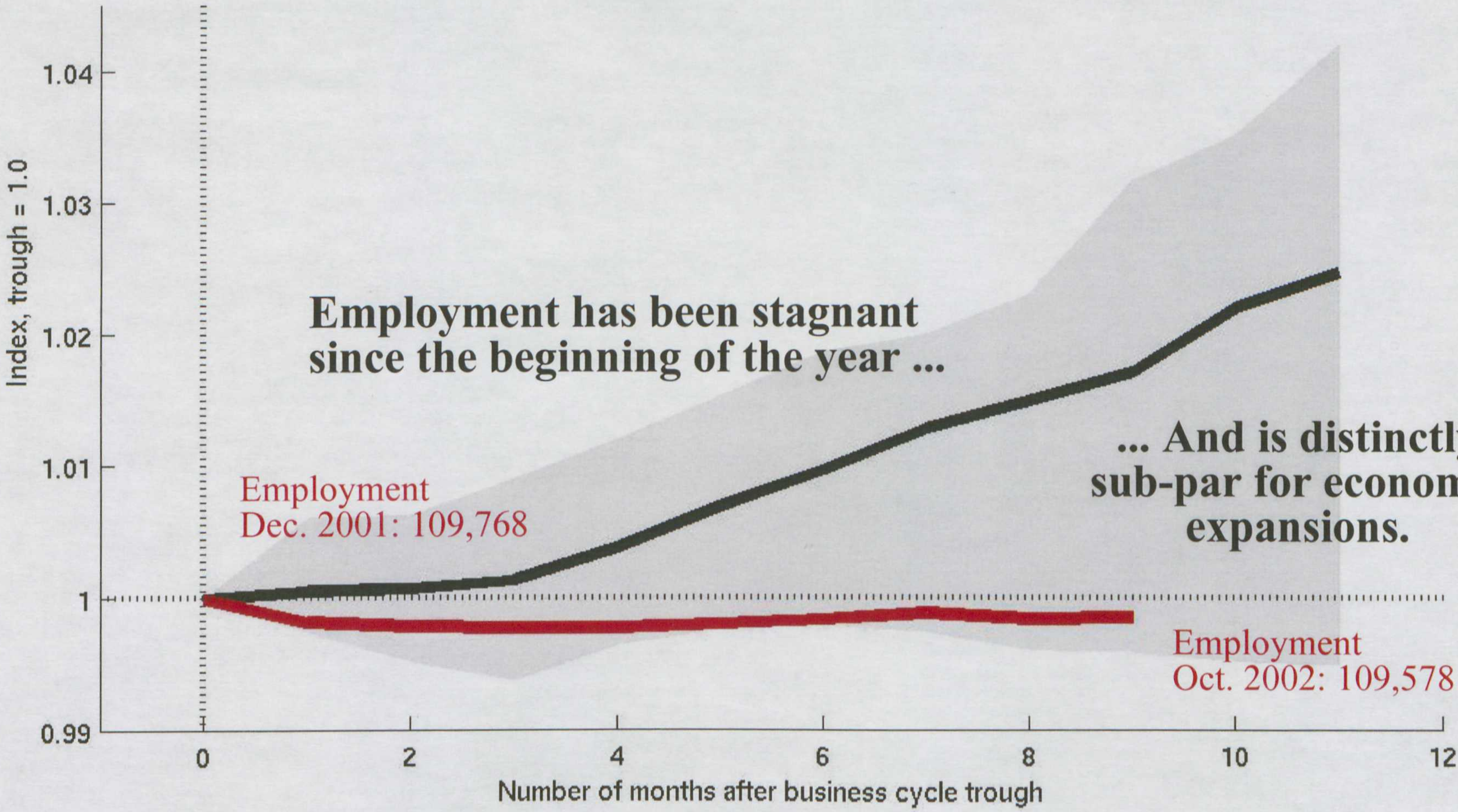
And business confidence should be bolstered by recently expanding profits



Sources: Nonfinancial Corporate Bus: Profits with IVA & CCAdj (SAAR, Bil.$) and Nonfinancial Corporate Business: Profits Tax Liability (SAAR, Bil.$): Bureau of Economic Analysis S&P Operating Earnings per share ($/share): Standard and Poor's.

But business confidence has proven to be weak, leading to another "jobless recovery"

Year-to-date cumulative private employment growth vs. cumulative employment growth from beginning of average expansion:



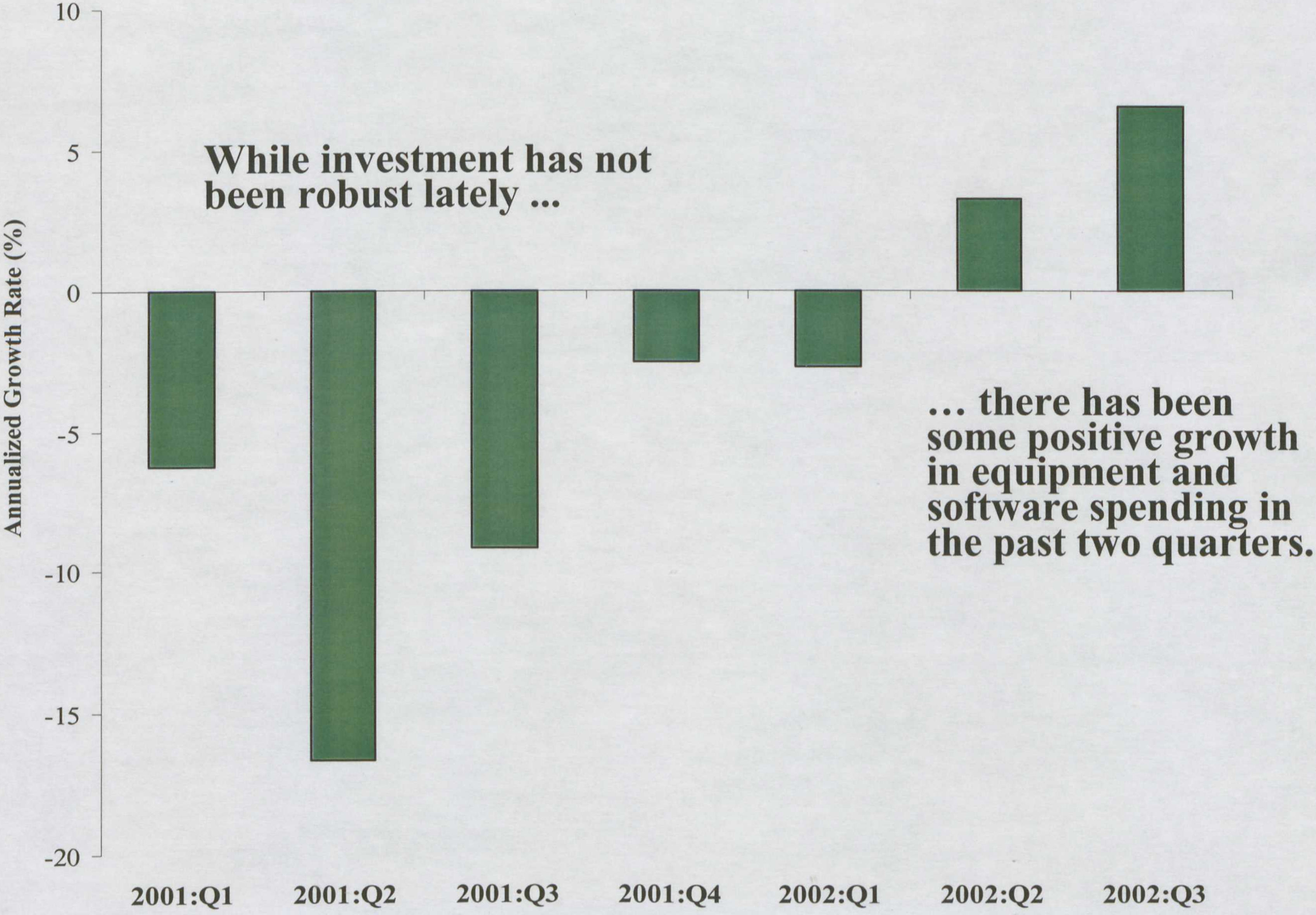
Heavy black line represents average of recessions
Heavy red line represents current experience
Shaded area shows range of outcomes across all business cycles

Source: Employment at private non-farm establishments (SA): Bureau of Labor Statistics.

As employment stagnates, the labor force continues to grow, initial unemployment claims remain elevated ...

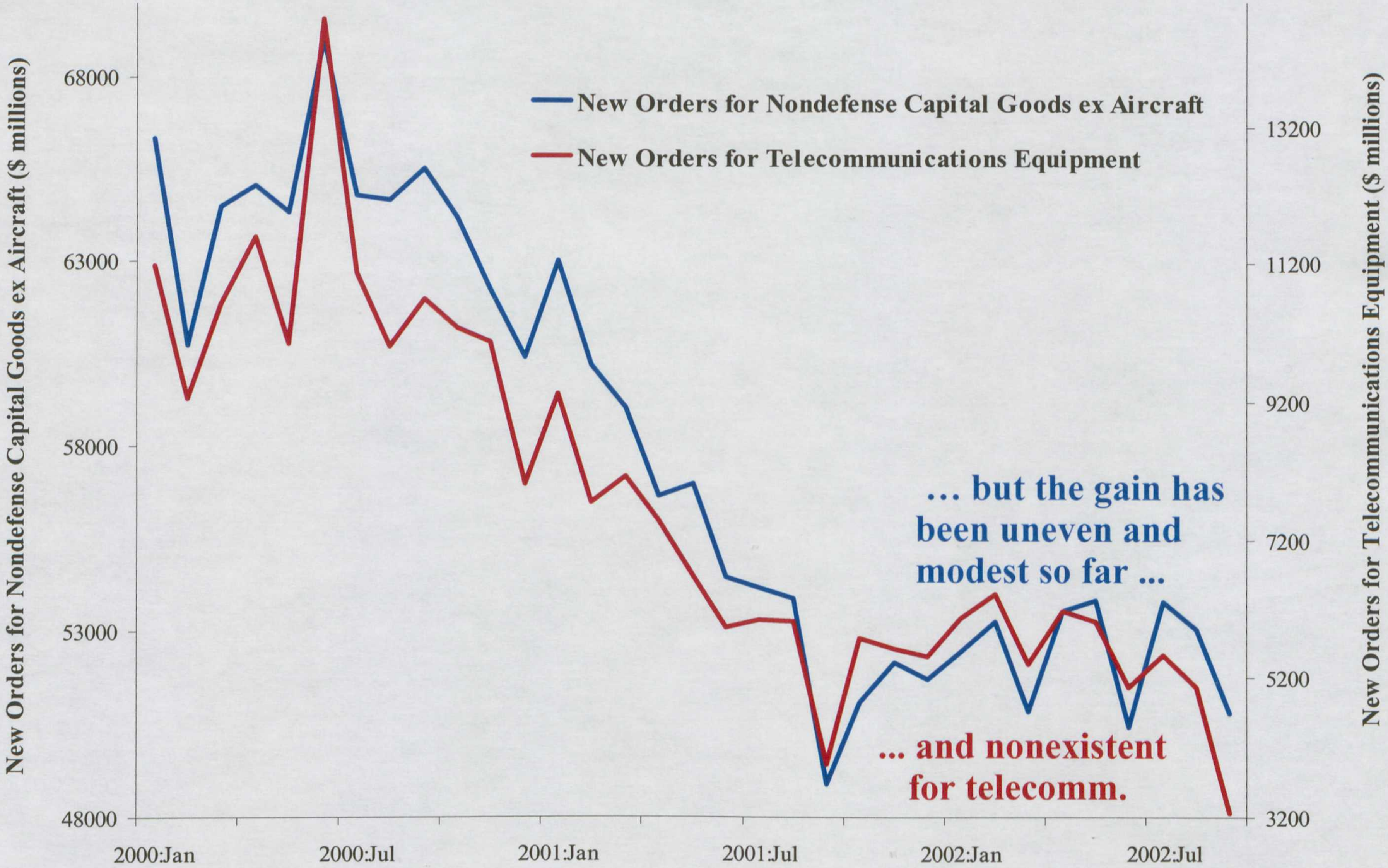
... suggesting little or no improvement in the unemployment rate, and in turn **posing a risk for consumer spending**.

Sources: Civilian Labor Force, 16yr. + (SA, Thousands): Bureau of Labor Statistics. Initial Claims for Unemployment Insurance, State Programs (Weekly Average, SA, Thousands): Department of Labor.



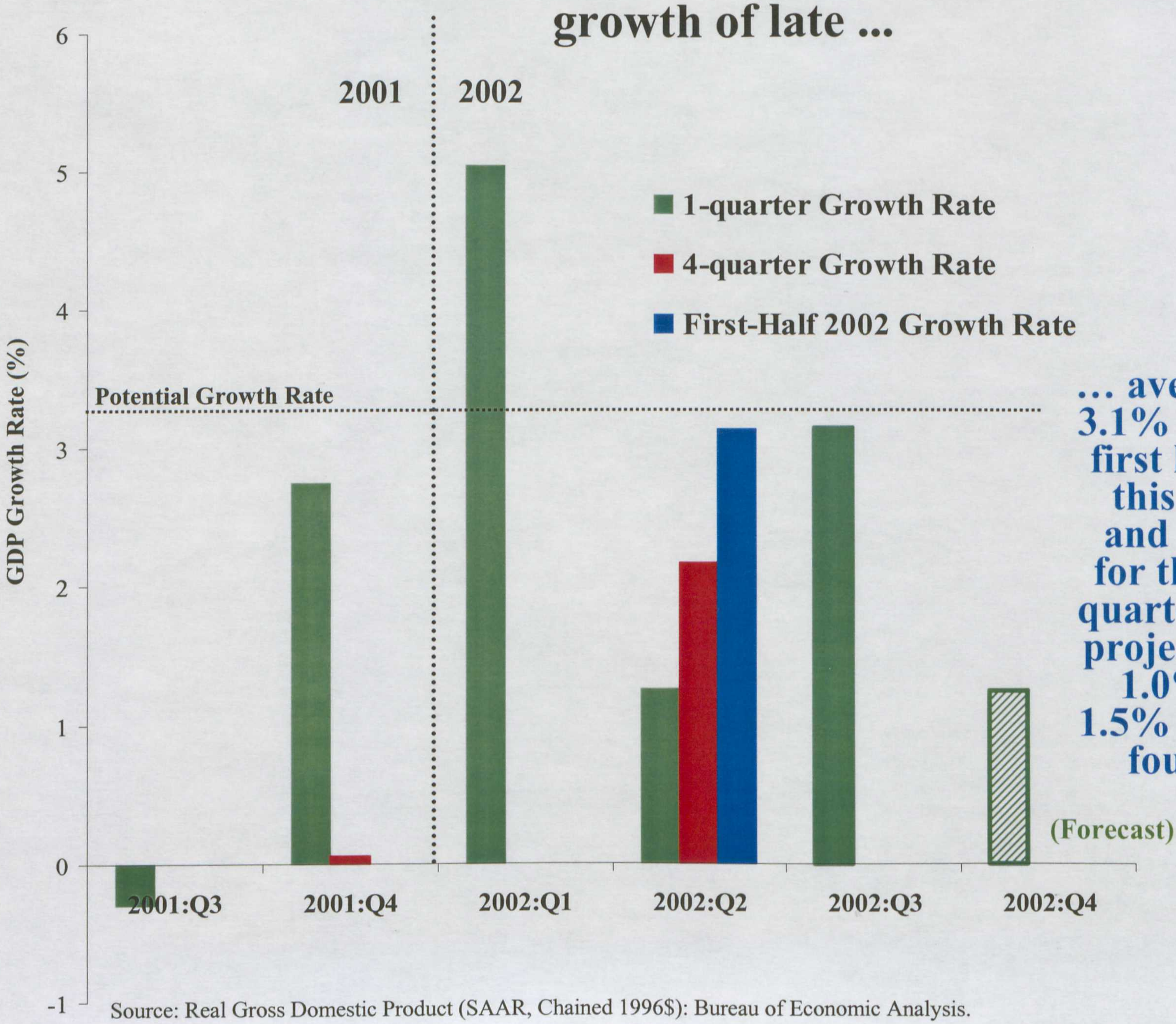
Source: Gross Private Domestic Investment in Nonresidential Equipment and Software (SAAR, Billions Chained 1996$): Bureau of Economic Analysis.

And there is *some* improvement in the outlook for capital investment ...



Source: Manufacturers' New Orders for Nondefense Capital Goods excluding Aircraft and for Communication Equipment (SA, $ Millions): Bureau of the Census.

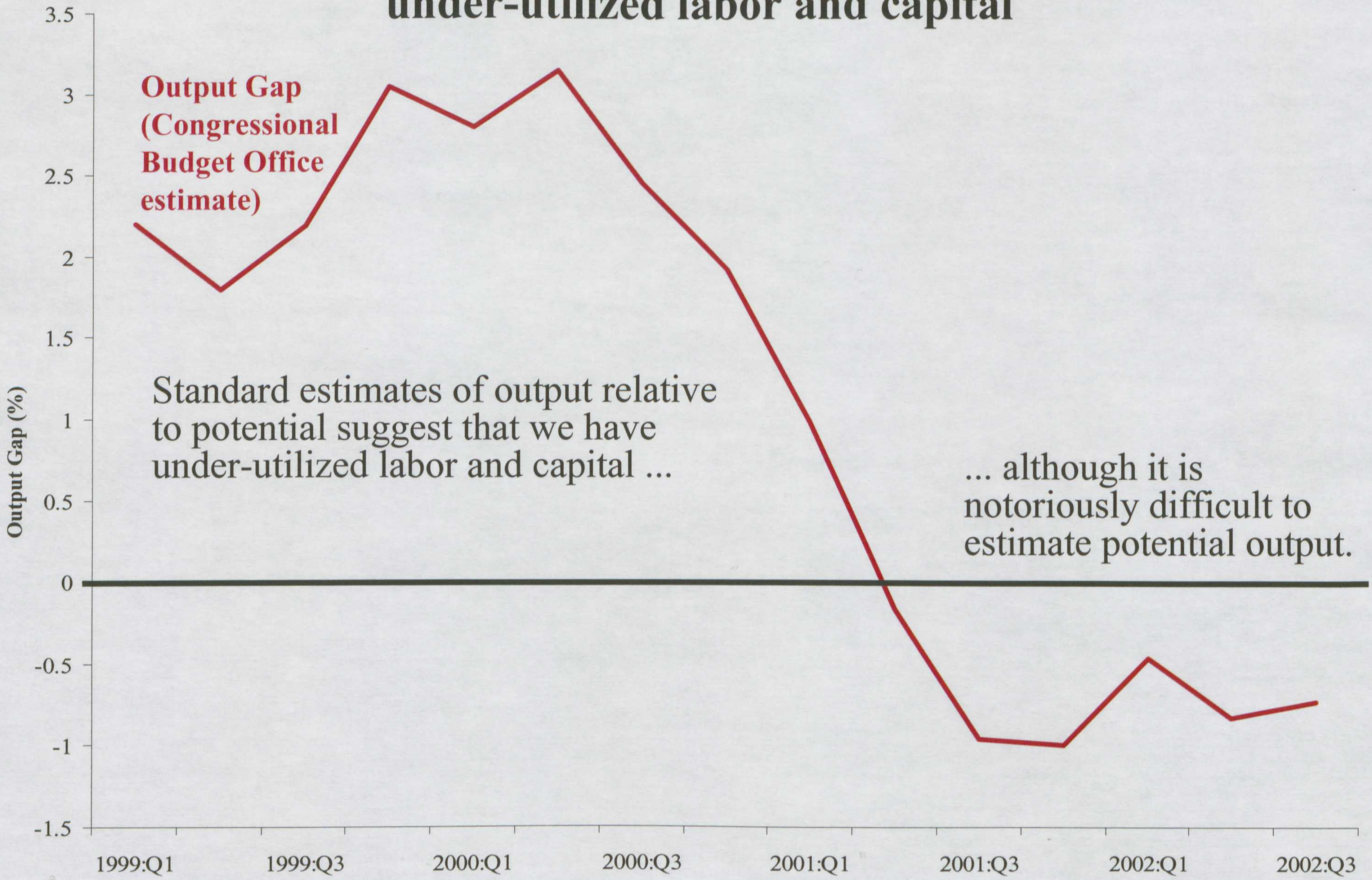
The consumer/business balance has afforded us modest growth of late ...



... averaging 3.1% for the first half of this year and 3.1% for the 3rd quarter, and projected at 1.0% to 1.5% for the fourth.

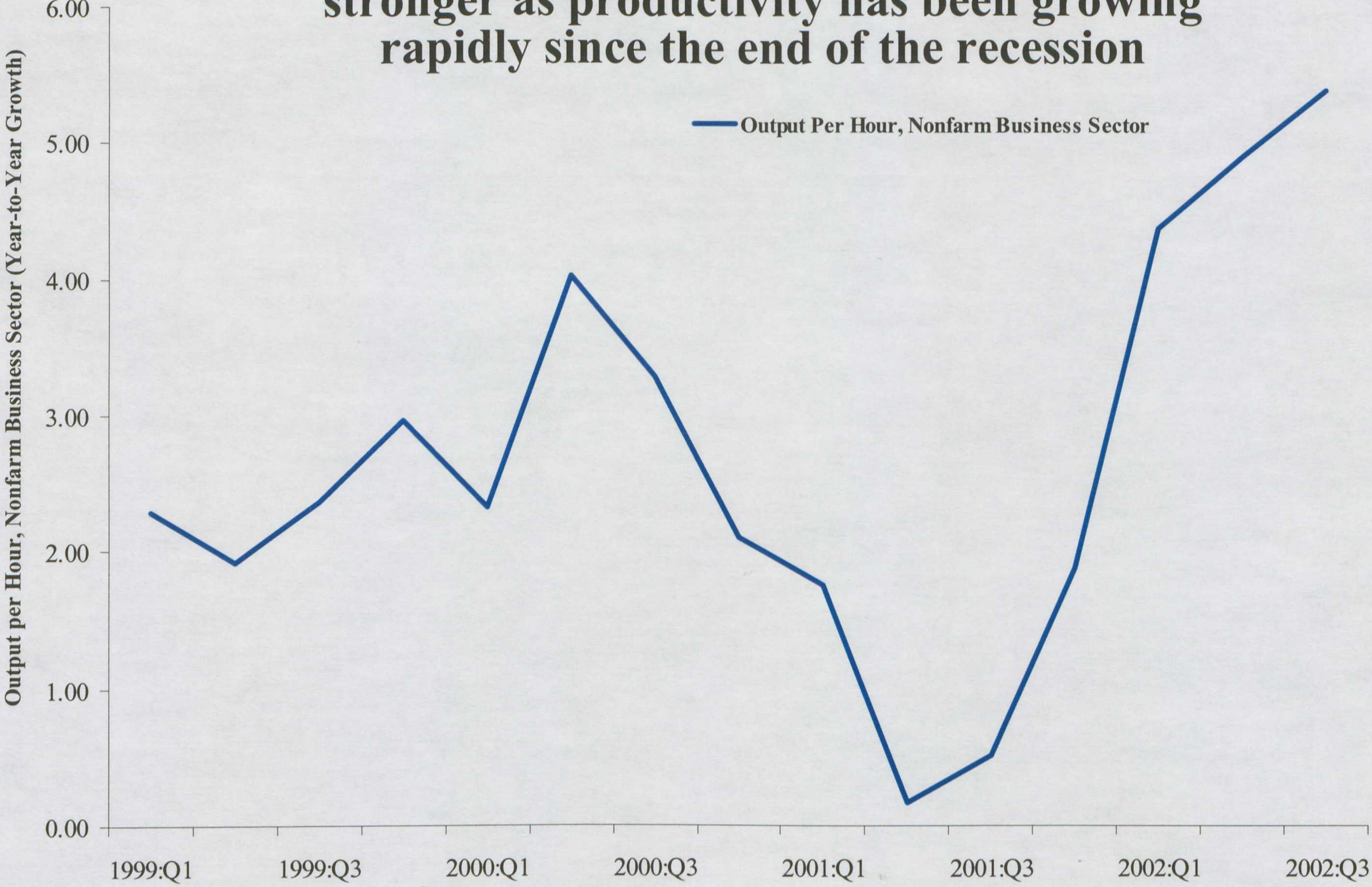
Source: Real Gross Domestic Product (SAAR, Chained 1996$): Bureau of Economic Analysis.

But this has yielded little progress in absorbing under-utilized labor and capital



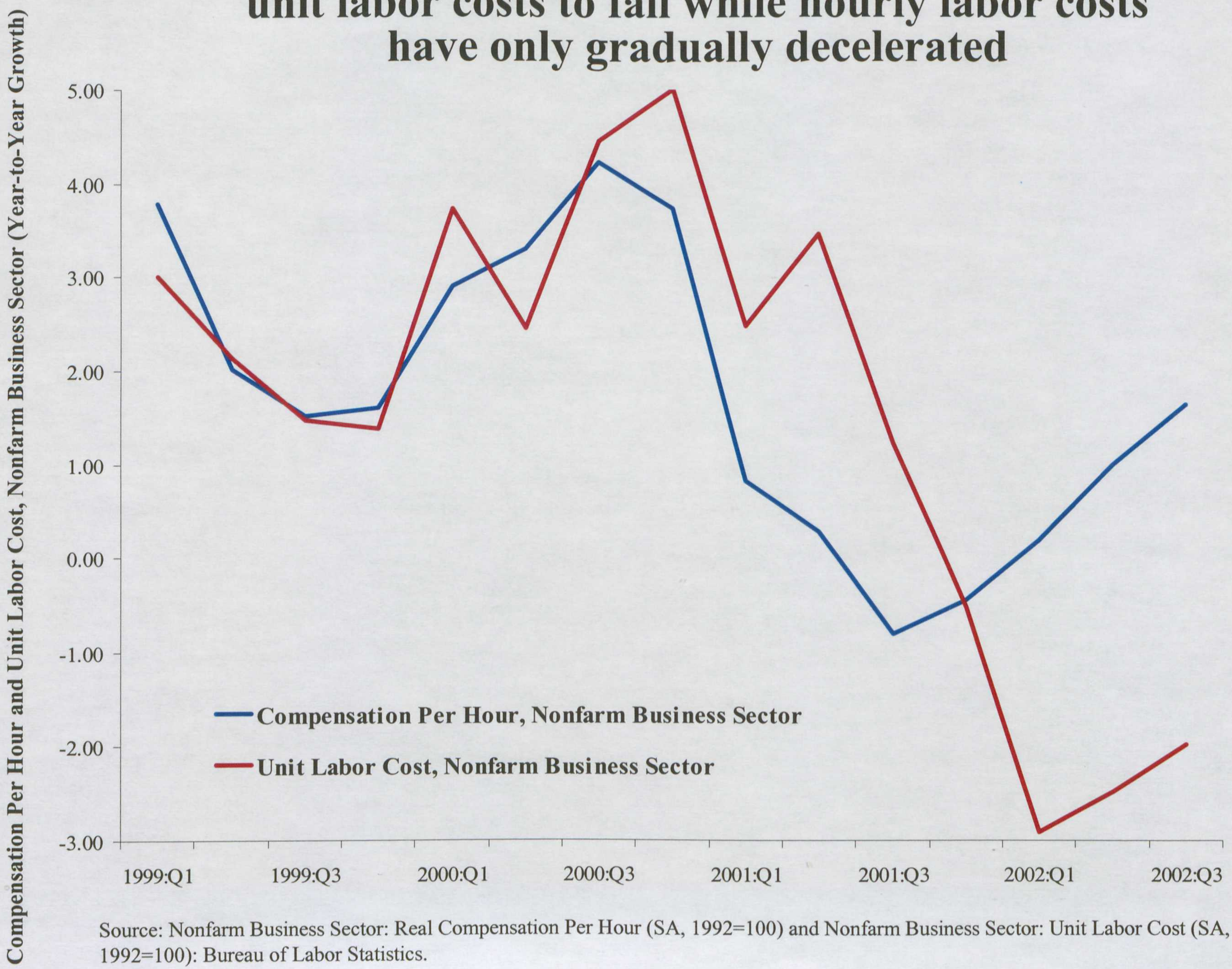
Sources: Real Gross Domestic Product (SAAR, Chained 1996$): Bureau of Economic Analysis. Real Potential Gross Domestic Product, (Chained 1996$): Congressional Budget Office.

The growth in potential may be even stronger as productivity has been growing rapidly since the end of the recession



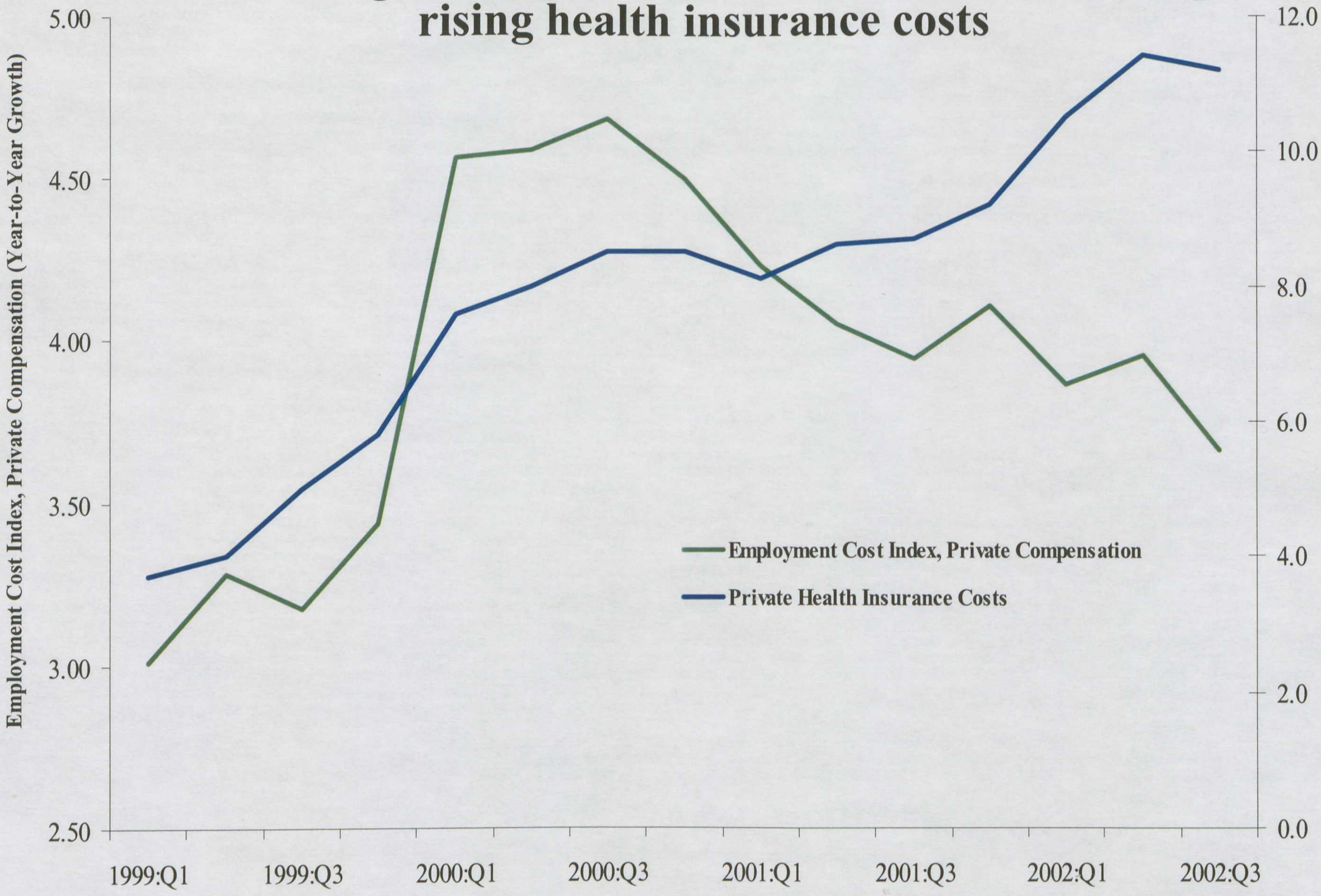
Sources: Nonfarm Business Sector: Output Per Hour/All Persons (SA, 1992=100):Bureau of Labor Statistics.

That strong productivity growth has allowed unit labor costs to fall while hourly labor costs have only gradually decelerated



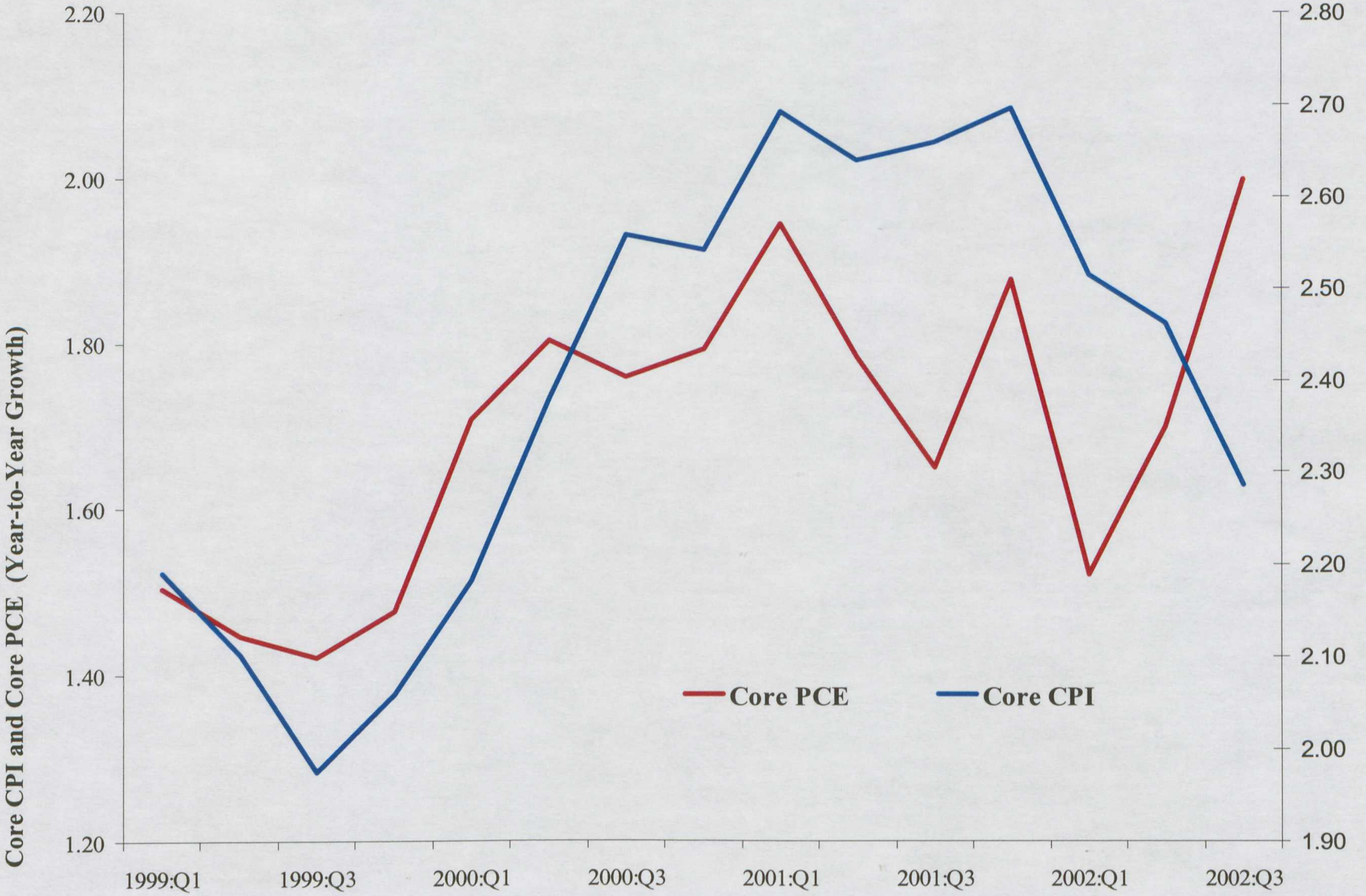
Source: Nonfarm Business Sector: Real Compensation Per Hour (SA, 1992=100) and Nonfarm Business Sector: Unit Labor Cost (SA, 1992=100): Bureau of Labor Statistics.

This slowing of compensation costs has occurred despite rising health insurance costs



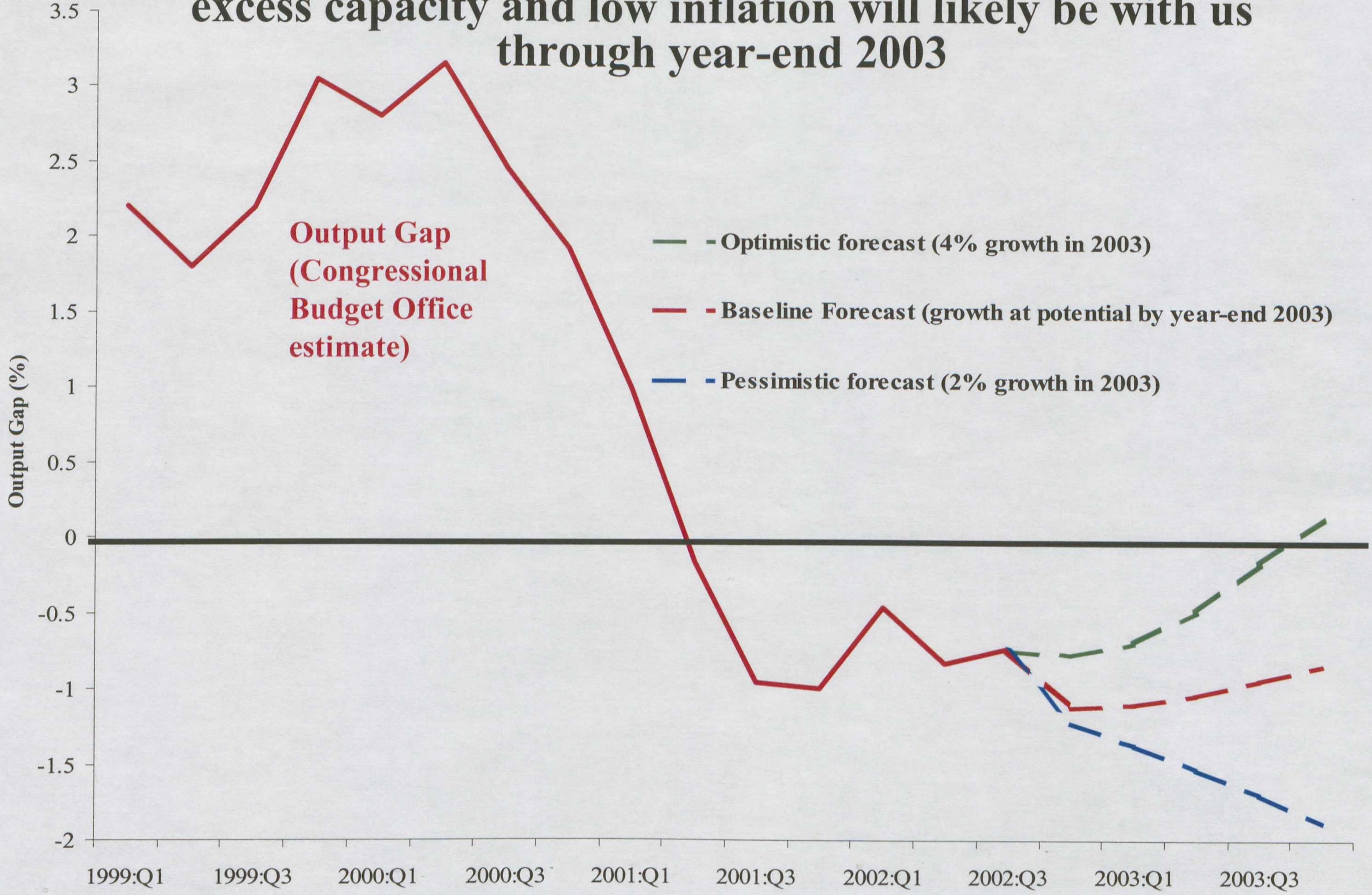
Sources: ECI: Compensation: Private Industry Workers (SA, JUN 89=100):Bureau of Labor Statistics.

As a result, core inflation has begun to decline



Source:CPI-U: All Items Less Food and Energy (SA, 1982-84=100): Bureau of Labor Statistics. and PCE less Food and Energy: Chain Price Index (SA, 1996=100): Bureau of Economic Analysis.

Looking forward, consensus forecasts suggest that excess capacity and low inflation will likely be with us through year-end 2003



Sources: Real Gross Domestic Product (SAAR, Chained 1996$): Bureau of Economic Analysis. Real Potential Gross Domestic Product (Chained 1996$): Congressional Budget Office.

Risks to Outlook

- Positive side:
  - Stimulative effects of war spending
  - Extended effects of home refinancing/cash-out
  - Recent Fed easing: provides additional stimulus and removes some uncertainty
  - Long-run effects of strong trend productivity growth
- Negative side:
  - Additional profits surprises (further corporate governance/accounting issues, oil price hikes?) → declines/volatility in equity prices
  - Geopolitical risks (war, terrorism, oil prices)
  - Growth in rest of the world sub-par
  - Weaker than expected investment demand (forecasts optimistic; business contacts less so)

Policy Considerations

- Inflation appears quiescent for now
  - Edging down a bit?
  - Possible temporary effect of oil prices
- We've attained a balance between consumers and firms to date
- The current outlook has us attaining potential growth sometime next year
  - Uncertainty remains
  - But with the last FOMC action, the risks to maintaining that balance appear to be more symmetric than before.