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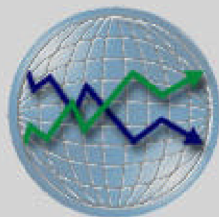


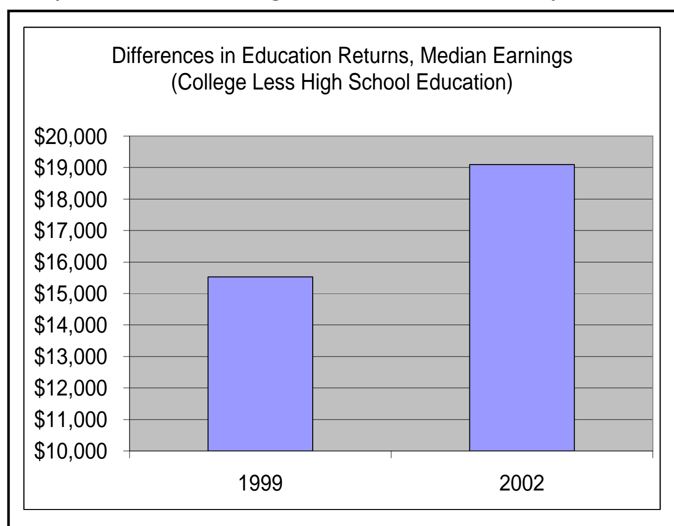
Economics Group

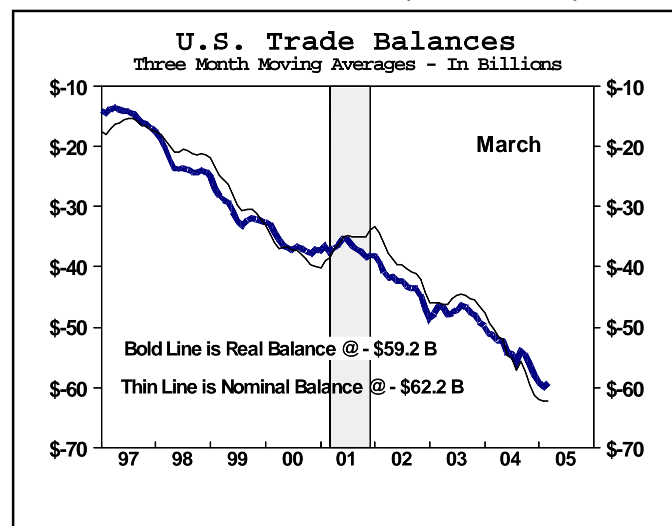
Weekly Economic and Financial Commentary

May 13, 2005

Executive Summary

- **Antidote to Casual Commentary: The Facts:** One recent line of commentary has been the assertion that the return to college education relative to a high school education had declined in recent years. Of course this is incorrect. U.S. Census data allow us to calculate the difference in returns to education. These returns have actually risen fairly significantly just between the years 1999 to 2002 (graph lower left) contrary to some recent commentary.
- Despite the sharp drop in the trade deficit in March, the U.S. current account deficit likely will widen further this year. Solid growth in U.S. domestic demand will continue to draw in imports, while sluggish domestic demand will constrain export growth. In Germany, real GDP in the first quarter grew at the strongest rate in about four years. However, growth was due entirely to net exports -- domestic demand in Germany remains very weak.





This Week's Data

U.S.

- Wholesale Inventories: Mar 0.4% vs Feb 0.6%
- Trade Balance: Mar -$55.0B vs Feb -$60.6B
- Monthly Budget: Apr $57.7B vs Mar $17.6B
- Retail Sales: Apr 1.4% vs Mar 0.4%
- Retail Sales, ex Autos: Apr 1.1% vs Mar 0.2%
- Import Price Index (MoM): Apr 0.8% vs Mar 2.0%
- Import Price Index (YoY): Apr 8.1% vs Mar 7.4%
- Business Inventories: Mar 0.4% vs Feb 0.5%
- U. of Michigan Confidence: May 85.3 Apr 87.7
- Initial Jobless Claims: 340K vs 336K

International

- BOE Rates: May 4.75% vs Apr 4.75%
- U.K. Indust Production: Mar -1.2% vs Feb -0.5%
- U.K. Manuf Production: Mar -1.6% vs Feb -0.6%
- French Indust Production: Mar -0.5% vs Feb -0.6%
- French Manuf Production: Mar -1.0% vs Feb -1.2%
- Italian Indust Production: Mar -0.6% vs Feb 0.0%
- German Indust Production: Mar -0.8% vs Feb -2.1%
- German Exports: Mar 2.1% vs Feb -3.0%
- German GDP (QoQ): 1Q'05 1.0% vs 4Q'04 -0.1%
- Euro-zone GDP (QoQ): 1Q'05 0.5% vs 4Q'04 0.2%

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What Does the Economic Outlook Mean for Decision Makers?

Economic factors define three key trends for decision makers: top line revenue growth, pricing and the cost of financing growth. This month's outlook provides a framework to address these three trends.

Fundamentals Behind Top Line Revenue Growth

Top line revenue growth follows the pattern of nominal GDP growth. Our outlook is for six percent nominal growth in the second half of the year compared to a gain of 6.6 percent last year (graph lower left). Real economic growth is expected at a 3.3 percent pace through the remainder of this year. Consumer spending is still expected to moderate but growth has been raised a few tenths of a percentage point, reflecting the stronger job numbers reported for the past four months and the upward adjustment to income we expect to see in coming months.

One positive for top line revenue growth has been the recent decline in oil prices back below $50 a barrel alone with the drop in gasoline prices for four straight weeks. The drop in gasoline prices should help stabilize real income gains by households and reduce business non-labor costs.

Business investment is also expected to moderate in the second half of this year as equipment & software spending remain strong. However, spending on nonresidential structures is expected to moderate in the second half of the year. Structures spending will be adversely impacted by higher oil prices and higher financing costs. Residential construction has remained red hot, especially in certain regions, and recent declines in mortgage rates suggest demand for new and existing homes will remain strong throughout the key spring selling season. Financial liquidity supporting the housing market still appears plentiful while consumer income gains appear sufficient to maintain overall housing affordability levels. Regional differences in building permits and home price appreciation remain significant What may be considered a housing bubble in certain areas. may reflect the conflict of in-migration and income gains against the background of very limited available land. This is especially true in areas around DC, Florida and the West Coast.

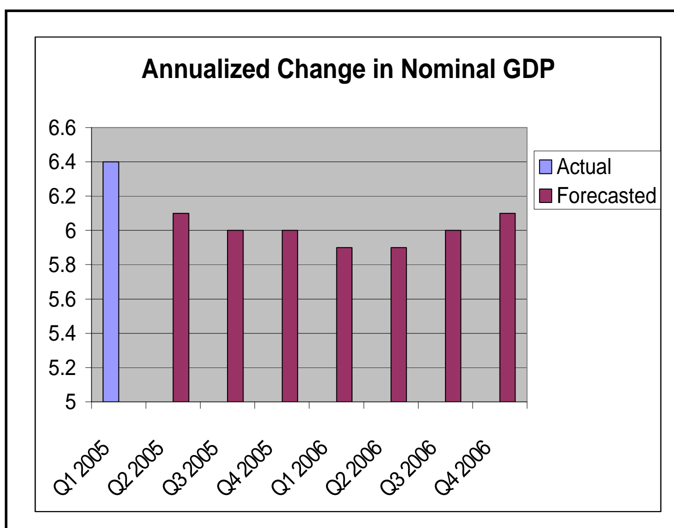
Inflation: Input Costs and Pricing Power

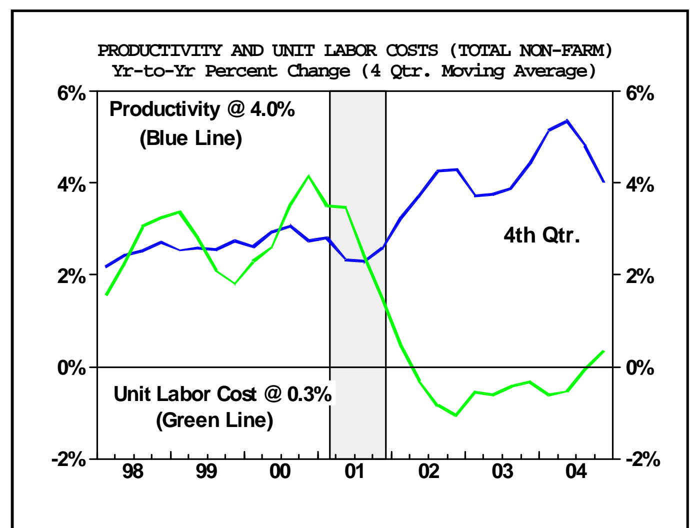
Profit margins will reflect the relative increases in input and output prices in the year ahead. Labor input costs are clearly rising as evidenced by the rise in unit labor costs as compensation cost increases are outpacing labor productivity gains (graph lower right) . Unit labor costs rose 2.3 percent in the fist quarter compared to a decline of 0.9 percent this time a year ago. Non-labor costs are reflected by producer prices. These prices have moved up steadily in recent months as well. Year-over-year producer prices are up 4.9 percent as of March compared to a year ago gain of just 1.5 percent. The prices paid index of the Institute for Supply Management remains high suggesting that input pricing pressures remain.

On the output side, consumer prices are up 3.1 percent while core consumer prices are up 2.3 percent. Energy costs are up over 12 percent year-over-year while medical care prices are up over four percent. On balance the challenge remains for decision makers in those sectors that use significant amounts of energy and labor to produce output that is sold in competitive consumer markets.

Interest Rates and the Price of Financing Growth

Short term rates are expected to follow the Fed's measured approach while long-term rates are expected to rise but not as quickly as short rates thereby giving us a flatter yield curve (see our interest rate section on page four).





Data released this week showed that the U.S. trade deficit dropped from $60.6 billion in February to "only" $55.0 billion in March. The trade gap in March was smaller than most market participants had expected, which contributed to the dollar's appreciation this week. Indeed, the dollar/ euro exchange rate broke an important technical support level, and the greenback ended the week at its highest level versus the euro this year. Does this mean that the dollar will trend higher over the next year or so?

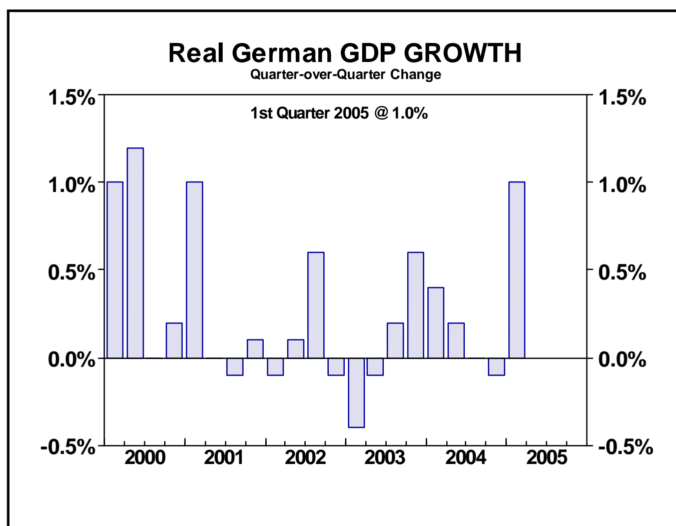
We doubt it. For one thing, we expect that the U.S. current account deficit will continue to widen. Although the decline in the trade deficit in March was welcome news, it may have been something of a statistical fluke. Exports were up $1.5 billion in March after two flat months in the beginning of the year, while imports dropped $4 billion after surging early in 2005. Therefore, it seems that there was a bit of statistical payback in both exports and imports in March. Moreover, recent economic data indicate that growth remains sluggish in many foreign economies, which should constrain export growth going forward. On the other hand, domestic demand in the U.S. remains fairly solid, which should continue to draw in imports.

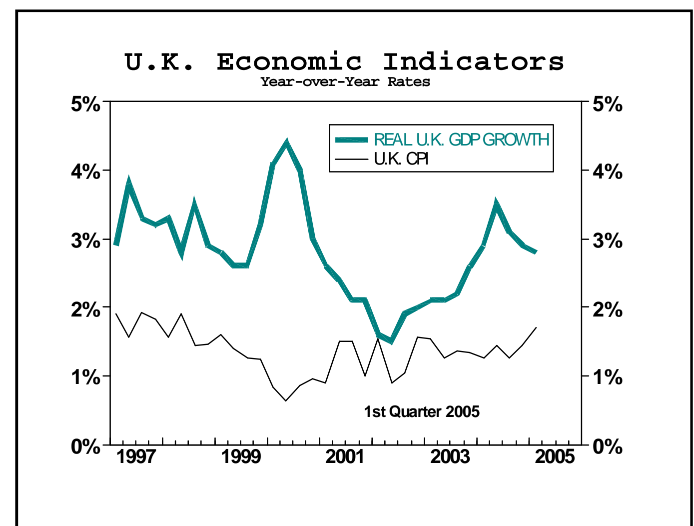
As the graph on the front page shows, the "real" trade balance (*i.e.*, the volume of exports minus the volume of imports) shows very few signs of stabilizing, let alone turning around. If the nominal U.S. trade deficit were to begin to narrow, it would show up first in the real trade balance. As noted above, with growth in the U.S. remaining rather solid and growth abroad generally rather weak, we expect that the current account deficit will continue to widen over the course of the year, putting downward pressure on the dollar.

Speaking of foreign economies, data released this week showed that German real GDP rose 1.0% (not annualized) in the first quarter relative to the previous quarter. Not only was the outturn the strongest quarterly growth rate in about ten years, it also was about twice as strong as most investors had expected. Does this mean that the German economy has finally turned the corner?

We doubt it. A detailed breakdown of GDP into its demand components is not yet available, but the German statistical agency that compiles the GDP data said that growth was largely due to net exports. Indeed, monthly data through February suggest that the volume of exports may have risen in the first quarter, which is good news, but that the volume of imports likely fell, which is bad news. A decline in the volume of imports is usually synonomous with weak growth in domestic demand, which would be consistent with other German economic indicators recently. Unless domestic demand accelerates, which we think is not very likely in the near term, GDP growth in Germany likely will weaken again. More broadly, the Eurozone economy grew only 0.5% in Q1, pulling the year-on-year growth rate down to a paltry 1.4%. Quarterly declines in real GDP in Italy and the Netherlands constrained overall Eurozone growth.

The Bank of England suggested this week that short-term rates in the U.K. are not likely to rise, at least not in the near term. In its quarterly Inflation Report the Bank said that "the balance of risks to growth is on the downside, while the risks to inflation are broadly balanced." The graph below supports the Bank's view of the economy. Real GDP growth in the U.K. has moderated over the past few quarters due in part to deceleration in consumer spending. Not only have higher energy prices helped to slow consumer spending, but the increase in interest rates since late 2003 also has raised monthly mortgage payments. (Floating rate mortgages are still very common in the U.K.) Although growth has downshifted, the Bank is not likely to cut rates in the near term with CPI inflation very close to the Bank's 2.0% target. However, if growth continues to slow, inflation will begin to recede, which eventually will give the Bank leeway to cut rates, perhaps late this year.





Interest Rate Watch

Outlook for A Flatter Yield Curve for Second Half of 2005

Fed restraint and moderating nominal GDP growth in the second half of this year are the key fundamentals supporting our expectation for a flatter yield curve. This pattern is actually quite typical for this phase of the business cycle.

Monetary policy appears geared to raising the Fed funds rate toward "neutral." While this neutral level remains uncertain our estimate is that the Fed will push the funds rate to four percent by the end of this year. How far will the Fed raise the funds rate? Our guess is that the Fed will raise rates until the nominal rate exceeds the core inflation rate by at least one percent so 3.75 to 4.0 percent is the target. Along the way we will watch three indicators as signals about how far the economy is slowing down. Jobless claims, the Institute for Supply Management- Manufacturing (ISM) index and factory orders remain our key indicators. For simplicity watch for the four week average jobless claims above 350,000 and ISM below 50 as break points for a neutral policy.

At the long end of the yield curve the ten year Treasury rate is expected to rise in line with nominal GDP growth adjusted for expected foreign capital inflows and the target Fed funds rate. However, our view is that the rise in the ten year yield will be less than the rise in the funds rate because the expected increase in anticipated inflation will not keep up with the rise in the funds rate.

A flatter yield curve at this stage of the business cycle is the usual pattern but the narrowness of the spread is historically low. This narrowness reflects the distortions to the traditional ten-year model due to foreign central bank pegging the exchange rate as well as strong foreign private capital inflows due to the relative attractiveness of US returns.

Topic of the Week

Consumers Sober Up with Expansion

As the party-time atmosphere of the economic recovery comes to an end and a more moderate expansionary environment begins, U.S. consumers are starting to show signs of sobering up. Consumer sentiment, as measured by the University of Michigan survey, has fallen for the fifth straight month. Across census regions, age ranges, and income categories, consumers report that they simply aren't as happy as they were to end the year. Assessments of current conditions have fallen, and expectations have fallen even more. What gives?

Commentators can point to any number of reasons for consumers to be in a sour mood. After all, it has not been the most pleasant of years by a number of measures - tax refunds are lower, interest rates are higher, the stock market cannot seem to find any legs, and gasoline prices are putting the squeeze on discretionary income. However, there are several things for consumers to be excited about too. Job openings are on the rise, unemployment is falling, incomes are increasing. Further, the U.S. economy is expanding at a rather steady pace, particularly in comparison to several industrialized economies around the globe that are falling into are teetering on the edge of recession.

Underlying questions in the sentiment survey provide some insight into what is going through consumers minds. Interestingly, it is not the interest rate scenario that is worrying consumers more this spring, nor is it buying conditions. Perceptions of personal finances have also not changed significantly. The component bringing consumers down is business conditions. Consumer expectations regarding business conditions 12 months as well as 5 years out have plummeted.

What does this mean for consumer spending? Not a lot. Consumers might slow purchases as they feel concern over business prospects going forward, but they certainly aren't going to throw in the towel over it. Income growth will still drive purchases.

Next Week's Highlights

- **Domestic highlights** next week will include inflationary indicators PPI and CPI, as well as Industrial Production.
- **International data** next week will be headed up by Japanese GDP on Monday. The data will tell whether Japan has recovered from three consecutive quarters...or not. Market mavens will also eagerly await U.K. retail sales, in the wake of the weak British industrial and manufacturing production data.

SUBSCRIPTION INFORMATION

Wachovia's' *Weekly Economic & Financial Commentary* is distributed to subscribers each Friday afternoon by e-mail. The *Weekly Economic & Financial Commentary* is also available via the Internet at http://www.wachovia.com/economics .

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U.S. Interest Rates

	Friday May 13	1 Week Ago	1 Year Ago
3-Month T-Bill	2.81	2.86	0.99
3-Month LIBOR	3.27	3.23	1.25
1-Year Treasury	3.37	3.28	1.83
2-Year Treasury	3.62	3.72	2.65
5-Year Treasury	3.84	3.95	4.02
10-Year Treasury	4.14	4.26	4.85
30-Year Treasury	4.50	4.63	5.56
Bond Buyer Index	4.35	4.38	5.01

Foreign Interest Rates

	Friday May 13	1 Week Ago	1 Year Ago
3-Month Euro LIBOR	2.12	2.12	2.09
3-Month Yen LIBOR	0.06	0.05	0.05
3-Month Canadian LIBOR	2.62	2.62	2.13
3-Month Sterling LIBOR	4.88	4.93	4.48
10-Year German	3.31	3.45	4.35
10-Year Japanese	1.29	1.23	1.51
10-Year U.K.	4.38	4.60	5.14
10-Year Canadian	4.05	4.23	4.89

Commodity Prices

	Friday May 13	1 Week Ago	1 Year Ago
W. Texas Crude/Barrel	48.20	50.83	40.77
Gold ($)/Ounce	420.20	426.20	374.85
Hot-Roiled Steel ($/Short Ton)	600	600	565
Copper ($)/Pound	151.34	159.43	131.89
Soybeans ($)/Bushel	6.17	6.19	9.95
Natural Gas ($)/BTU	6.62	6.66	6.42
CRB Spot Inds.	333.76	333.91	311.38

Foreign Exchange Rates

	Friday May 13	1 Week Ago	1 Year Ago
Euro ($/€)	1.26	1.28	1.18
Yen (¥/$)	107.13	105.06	114.52
Pound ($/£)	1.85	1.89	1.76
Canadian Dollar (C$/$)	1.26	1.24	1.39
Mexican Peso (MXN/$)	11.02	10.95	11.63
Australian Dollar (US$/A$)	0.76	0.78	0.69
U.S. Dollar Index	86.03	84.62	91.96

Economic Calendar (Wachovia Estimates)

Monday	Tuesday	Wednesday	Thursday	Friday
16	**17**	**18**	**19**	**20**
Empire Manufacturing April 3.1 May	**PPI (MoM)** Mar 0.7% Apr **PPI, Core (MoM)** Mar 0.1% Apr **Industrial Production** Mar 0.3% Apr	**CPI (MoM)** Mar 0.6% Apr **CPI, Core (MoM)** Mar 0.4% Apr	**Leading Indicators** Mar -0.4% Apr **Philadelphia Fed** Apr 25.3 May	
23	**24**	**25**	**26**	**27**
	Existing Home Sales Mar 6.89M Apr 7.00M (W)	**Durable Goods Orders** Mar -2.3% Apr **New Home Sales** Mar 1431K Apr 1300K (W)	**GDP** 1QA 3.1% 1QP 3.6% (W) **GDP Deflator** 1QA 3.2% 1QP	**Personal Income** Mar 0.5% Apr **Personal Spending** Mar 0.6% Apr **PCE Deflator** Mar 2.4% Apr

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