Monthly Economic Outlook

February 10, 2006

U.S. Overview

Shifting Winds and Shallow Water Alter the Choices for Decision-Makers

During the American Revolution, supply ships from New England kept the rebels supplied along the North Carolina coast. The larger, heavier, British ships could not navigate the islands and shoals. For decision-makers today, the changing winds (composition of growth) and shallow water (lower pace of growth) present significant challenges. Maneuverability and the awareness of the risks will be essential to maneuvering through the economic transition.

In the year ahead, our outlook is for slower economic growth with slower growth in consumer spending, especially on durables, with slower growth in residential construction for both starts and remodeling as the housing markets adjusts to changing wind direction. Tailwinds still favor business investment in both equipment and structures, while government will help with a dose of federal spending.

Inflation and interest rates will rise (graph lower left) and profit growth will slow, as we have expected for some time. These trends were already in place during the second half of 2005 and should continue in the year ahead. These changing financial currents, combined with shifting winds, increase the risk for decision-makers.

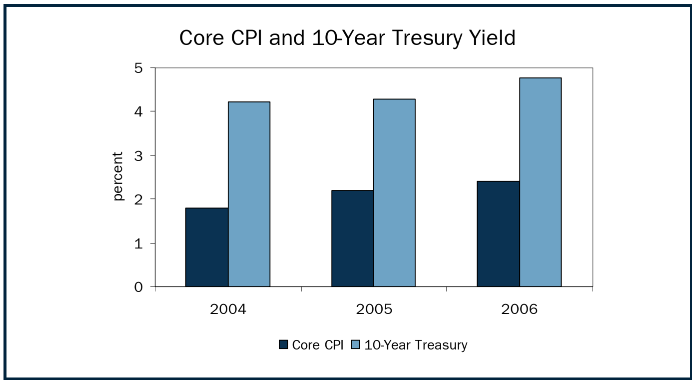
Typically, risk increases at this stage of the business cycle. As growth slows and profit margins get squeezed, marginally profitable projects become losers and must be closed down. Top line sales are more difficult to generate and the risk rises that more deals are brought without adequate credit protection. At this stage of the cycle, the stretch deals of today become the money losers in the next recession.

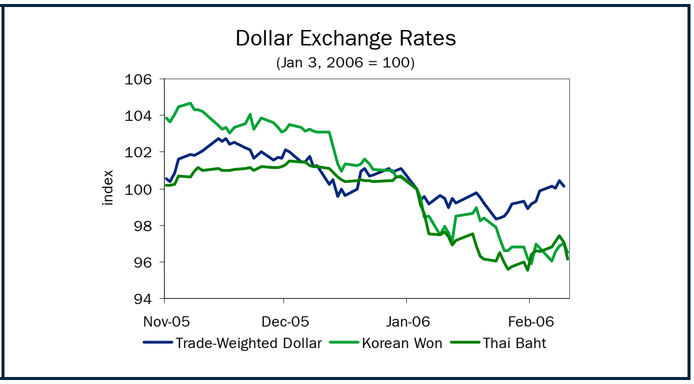
International Overview

The dollar has remained rather resilient versus many European currencies, but it has depreciated somewhat against most Asian currencies thus far in 2006. Foreign exchange reserves have been rebuilt to record levels *via* foreign exchange market intervention that helped to check the appreciation of many Asian currencies vis-à-vis the greenback. However, Asian governments may be more inclined to allow their currencies to strengthen now that their holdings of foreign exchange reserves are ample. In addition, currency appreciation could help to keep inflation rates, which have risen recently in many Asian countries, in check. We project that most Asian currencies will continue to trend higher versus the greenback going forward.

Although the Chinese renminbi has barely budged following its 2% revaluation against the dollar last July, we expect that Chinese officials will permit their currency to appreciate at a faster rate going forward. For starters, currency appreciation could help to offset any rise in inflation that strong Chinese growth could engender. Perhaps more importantly, however, Chinese officials are mindful of rising protectionist sentiment in Washington. A faster rate of renminbi appreciation would give the Bush administration the political cover it needs to resist protectionist pressures on Capitol Hill.

We are not arguing that the renminbi will strengthen significantly anytime soon. Every economic policy that the Chinese government undertakes is viewed through the lens of social stability. Significant currency appreciation could lead to weaker export growth that would weigh somewhat on overall economic growth. Rising unemployment could then lead to social instability. Our forecast calls for the renminbi to strengthen less than 10% between now and the end of 2007.





Graveyard of the Atlantic: Maneuvering Through an Economy of Slower Growth, Higher Interest Rates

When the winds change, we adjust the sails. For the last six months, the winds and the currents have changed and decision-makers need to adjust their strategy. There are four essential markers to watch. First, real growth is slowing. Second, core inflation is inching up and will exceed the Fed's presumed two percent target. Third, interest rates are likely to rise further. Finally, profit growth is expected to slow. Overall, the pattern of change suggests an increase of risks for the economy and a need for decision-makers to adjust their sails to changing conditions.

Slower Growth: Less Wind at our Backs

Over the year ahead, we expect that growth will moderate from the pace of 2004-2005 to a trend-like 3.3 percent. This moderation reflects a modest slowing in consumer spending, as well as a slight decline in residential investment, as signaled by a modest decline in single family housing starts. Consumer spending reflects the growth in real disposable income, which we see as up a solid three percent plus this year. Therefore, the slowdown we see in spending remains modest and not a sharp decline. The genesis of the slowdown reflects the drop-off we anticipate in home equity withdrawals, as well as the negative impact on consumer durable spending, as interest rates rise and credit supply tightens. Higher interest rates and slower top-line revenue growth also could combine to take a little off the investment boom in equipment and software. There is also a slight slowdown in government purchases in 2006 as well as a wider trade deficit. On the plus side, there is a pickup in spending on business structures, as is typical for this stage of the business cycle.

Core Inflation Rises

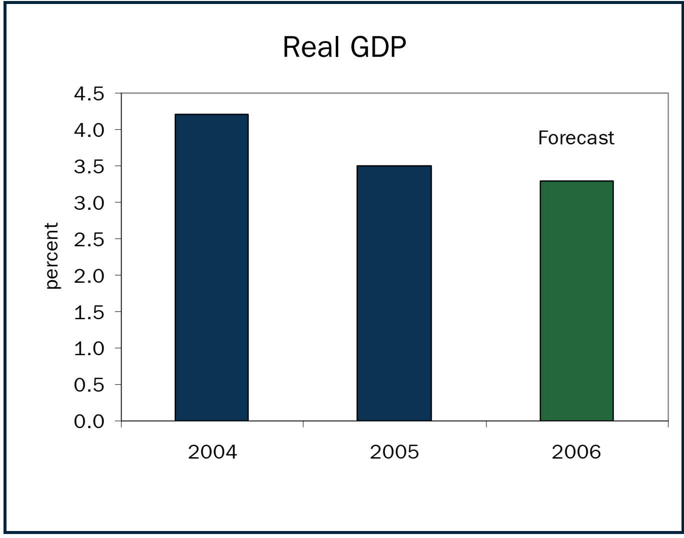
Inflation, as measured by the core consumer price index (prices, less food & energy), are expected to rise modestly in 2006. Rising unit labor costs are expected to feed into the pricing process and provide upward pressure to consumer prices. In addition, energy prices are expected to push prices up as well. The pace of inflation gains remain modest, however, and are not taken as a sign of a significant upswing in inflation.

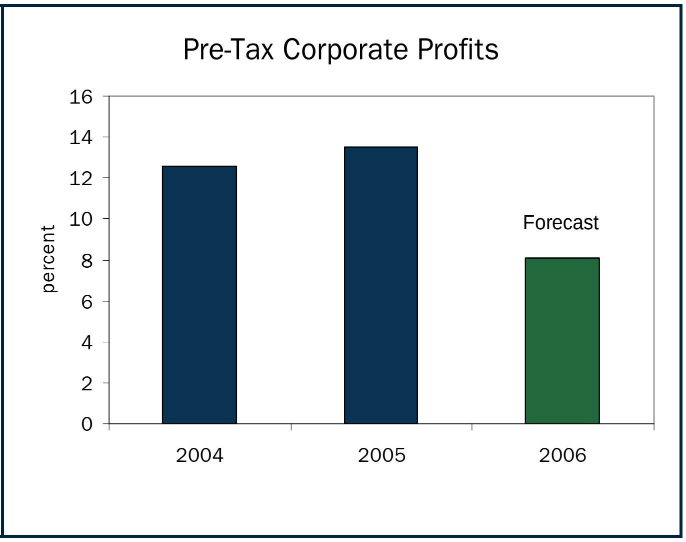
Interest Rates: Shift to Neutral

With slower growth and a modest rise of inflation we do not expect an extended period of Fed restraint nor a significant back up of long-term rates. By mid-year we expect the Federal Reserve to pause as growth slows in the second quarter of 2006 to slightly below trend. This slowdown, and only modest inflation pressures, will allow the Fed enough time to pause and survey the economic seas. Long-term rates, as measured by the ten-year Treasury rate, are expected to rise to five percent and remain in that area for the remainder of the year.

Profit Growth Slows

Finally, profit growth is expected to slow, as top line revenue growth slows and unit labor costs increase. Slower profit growth feeds back into slower capital spending and dividend and investment income for consumers as well as a slowdown in government revenues. This suggests that federal budget deficits will be rising this year and could engender upward pressure on interest rates and downward pressure on the dollar.





(Percentage Changes)

	Actual 2005	2006				2007				Annual (d)			
QUARTER:	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2004	2005	2006	2007
REAL GROSS DOMESTIC PRODUCT(e)	1.1	5.0	2.9	2.9	3.0	3.0	3.0	3.0	3.1	4.2	3.5	3.3	3.0
PERSONAL CONSUMPTION	1.1	4.1	2.8	2.8	3.0	2.8	2.8	3.0	3.0	3.9	3.6	3.0	2.9
BUSINESS INVESTMENT	3.0	9.7	9.4	8.5	8.6	8.7	8.7	8.0	8.0	9.4	8.9	8.3	8.5
EQUIPMENT & SOFTWARE	3.5	11.0	10.4	9.4	9.4	9.6	9.6	8.7	8.6	11.9	10.8	9.1	9.3
STRUCTURES	0.7	4.5	5.0	5.0	5.0	5.0	5.0	5.0	5.0	2.2	1.9	3.6	5.0
RESIDENTIAL CONSTRUCTION	3.5	2.0	-7.0	-5.0	-5.0	-5.0	-4.0	-3.5	-3.0	10.3	7.2	0.3	-4.6
GOVERNMENT PURCHASES	-2.4	2.4	2.3	2.4	2.4	2.4	2.3	2.3	2.2	2.2	1.7	1.5	2.4
NET EXPORTS ($ BILLIONS)	-650	-654	-662	-671	-680	-691	-701	-710	-719	-601	-632	-667	-705
% Pt. Contribution to GDP	-1.2	-0.1	-0.3	-0.3	-0.3	-0.4	-0.3	0.0	0.0	-0.8	-0.9	-0.6	-0.7
INVENTORY CHANGE ($ BILLIONS)	26	34	36	37	38	41	47	48	49	52	17	36	46
% Pt. Contribution to GDP	1.4	0.3	0.1	0.0	0.0	0.1	0.2	0.0	0.0	0.3	-0.3	0.2	0.1
NOMINAL GDP	4.2	8.2	5.8	5.7	5.8	5.6	5.6	6.4	6.4	7.0	6.4	6.3	5.7
REAL FINAL SALES	-0.3	4.5	2.8	2.8	2.8	2.7	2.7	2.6	2.5	3.9	3.8	3.1	2.9
"CORE" GDP (a)	1.5	5.1	3.1	3.1	3.3	3.2	3.2	5.8	5.8	4.9	4.4	3.6	3.2
CONSUMER PRICE INDEX (b)	3.2	3.1	3.0	2.9	2.8	2.7	2.7	2.7	2.6	2.7	3.4	2.9	2.7
"CORE" CONSUMER PRICE INDEX (b)	2.1	2.3	2.4	2.5	2.5	2.5	2.4	2.4	2.3	1.8	2.2	2.4	2.4
WEST TEXAS INTERMED. OIL ($/BBL) (f)	60.0	61.5	59.5	61.0	62.0	59.0	60.5	61.0	60.5	41.5	56.6	61.0	60.3
EMPLOYMENT COST INDEX (b)	3.1	2.8	2.7	2.7	2.6	2.7	2.8	2.8	2.9	3.9	2.9	2.7	2.8
REAL DISPOSABLE INCOME	7.0	4.1	3.6	3.4	3.3	3.2	3.2	3.1	3.0	3.4	1.4	3.6	3.1
UNEMPLOYMENT RATE (%)	5.0	4.8	4.8	4.8	4.7	4.7	4.7	4.7	4.6	5.5	5.1	4.8	4.7
HOUSING STARTS (MILLIONS)	2.10	1.94	1.91	1.89	1.87	1.83	1.80	1.78	1.77	1.95	2.08	1.90	1.80
TOTAL VEHICLE SALES (MILLIONS)	15.9	16.6	17.2	17.3	17.3	16.8	17.3	17.3	17.4	16.8	17.0	17.2	17.3
INDUSTRIAL PRODUCTION (b)	5.3	3.0	3.3	3.8	3.6	3.0	3.0	2.9	2.8	4.1	3.1	3.4	2.9
CORPORATE PROFITS NIPA B/T (b)	8.6	8.1	7.6	7.4	7.5	7.5	7.7	7.8	8.0	12.6	13.5	8.1	7.7
Quarter End - INTEREST RATES (%) (c)													
FEDERAL FUNDS (Target)	4.25	4.75	5.00	5.00	5.00	5.00	5.00	5.00	5.00	1.56	3.50	4.94	5.00
3 MONTH LIBOR	4.52	4.85	5.13	5.10	5.10	5.15	5.15	5.15	5.15	1.75	3.78	5.04	5.15
PRIME RATE	7.25	7.75	8.00	8.00	8.00	8.00	8.00	8.00	8.00	4.50	6.50	7.94	8.00
3 MONTH T-BILL (BEY)	4.08	4.55	4.75	4.88	4.90	4.90	4.90	5.00	5.00	1.53	3.37	4.77	4.95
2 YEAR T-NOTE	4.41	4.65	4.75	4.80	4.90	5.00	5.00	5.10	5.10	2.50	3.98	4.78	5.05
5 YEAR T-NOTE	4.35	4.60	4.70	4.75	4.80	4.90	5.00	5.10	5.10	3.40	4.09	4.71	5.03
10 YEAR T-NOTE	4.39	4.65	4.75	4.80	4.85	4.90	5.00	5.10	5.20	4.21	4.28	4.76	5.05
30 YEAR T-BOND	4.52	4.60	4.70	4.75	4.70	4.80	4.90	5.00	5.10	4.94	4.55	4.69	4.95

(a) Core GDP equals consumption, business fixed investment and resident
(b) Percent changes from same quarter year ago.
(c) End Of Quarter Estimate
(d) 4-Qtr Moving Average, Percent Change
(e) Qtr/Qtr Percent Change, Annual Rate
(f) Prices are Reflective of Quarterly Average of the Near Contract Price

2/10/2006

As shown on the front page, the trade-weighted value of the dollar (measured by the Fed's "Major Currency" index) is little changed on balance since the beginning of the year. This sideways movement reflects the high weights in the index that are given to the currencies of major U.S. trading partners (*e.g.,* the euro, the Japanese yen, and the Canadian dollar), which are little changed against the greenback since the beginning of the year. However, as the chart on the front page also makes clear, the Korean won and the Thai baht have appreciated noticeably versus the greenback as have most other Asian currencies. What's up?

Historically, many Asian governments have chosen to manage their exchange rates very closely versus the dollar. Because exports have been an important engine of growth in many Asian economies, most governments in the region did not want their currencies to appreciate sharply versus the greenback. However, circumstances have changed, and many Asian governments may now be inclined to allow their currencies to strengthen some more. Indeed, as our forecast on page 5 makes clear, we look for most Asian currencies to trend even higher versus the greenback going forward.

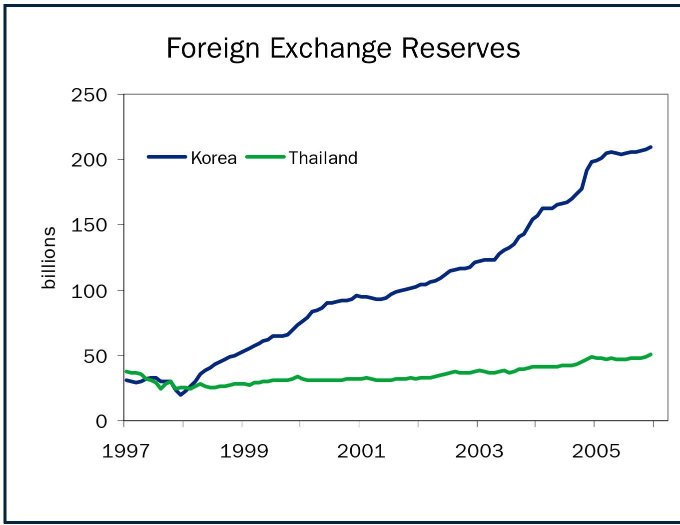
Asian governments have mitigated the strengthening tendency of their currencies by intervening in the foreign exchange market, and the resulting purchases of dollars show up as an increase in foreign exchange reserves. As shown below, FX reserves in many Asian countries have risen to extremely high levels recently. (Although Korea owns about 4 times as many reserves as Thailand, Korean imports are more than 3 times larger than Thai imports. In other words, Thailand has ample foreign exchange reserves relative to the size of its economy.) Whereas many Asian countries wanted to rebuild foreign exchange reserves following their decimation during the 1997 "Asian economic crisis", there is not much of a compelling reason anymore to accumulate reserves at a rapid pace.

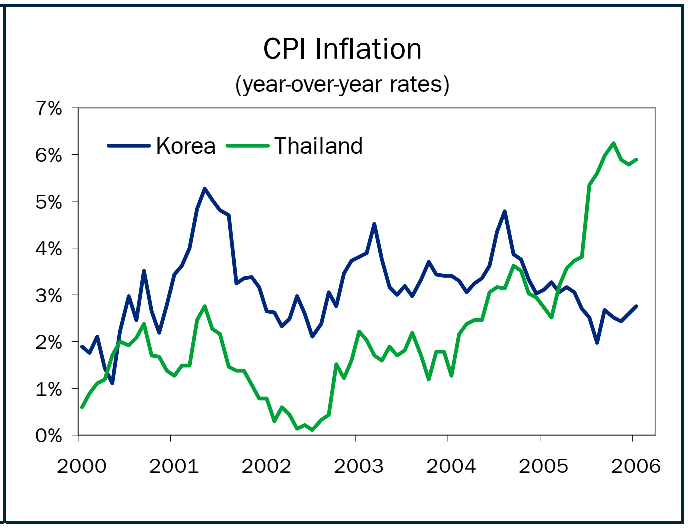
In addition, inflation rates in many Asian countries are starting to turn up (see graph below). With strong GDP growth rates at present in most Asian countries and with elevated energy prices persisting, inflation could rise further in the months ahead. One way to help check rising inflation is *via* currency appreciation, which helps to keep a lid on import prices.

We also project that Chinese authorities will allow the renminbi to appreciate at a faster pace this year. Although CPI inflation in China does not seem to be much of a problem at present (consumer prices were up only 1.6% in December relative to the same month in 2004), continued robust growth in China could lead to higher rates of inflation this year. Again, renminbi appreciation would help to contain any rise in inflation.

Perhaps more importantly, protectionist sabers are starting to rattle in Washington. Although Chinese leaders will not kowtow to the U.S. Congress, they recognize that a protectionist backlash in the U.S., which is China's most important trading partner, could have a slowing effect on the Chinese economy *via* weaker export growth. Therefore, it may be better to give a bit on the exchange rate, which would give the Bush administration the cover it needs to veto protectionist legislation, than to risk a wave of U.S. protectionism.

We are not saying that China will allow its currency to strengthen significantly anytime soon. As we wrote in this space on January 13, everything that China does is with an eye to social stability. A sharp appreciation of the renminbi could lead to deceleration in exports. As economic growth slows unemployment would rise, which could cause some social instability. However, if our forecast is realized, the renminbi would only appreciate about 8% between now and the end of 2007. In our view, China can easily withstand an appreciation of this size without suffering a sharp decline in export growth.





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	GDP Growth			CPI Inflation			3-Month LIBOR (end of quarter)							10-Year Bond (end of quarter)						
Country	**2005**	**2006**	**2007**	**2005**	**2006**	**2007**	**06-Q1**	**06-Q2**	**06-Q3**	**06-Q4**	**07-Q1**	**07-Q2**	**07-Q3**	**06-Q1**	**06-Q2**	**06-Q3**	**06-Q4**	**07-Q1**	**07-Q2**	**07-Q3**
U.S.	3.5	3.3	3.0	3.4	2.9	2.7	4.85	5.15	5.15	5.15	5.15	5.15	5.15	4.65	4.75	4.80	4.85	4.90	5.00	5.10
Japan	2.6	2.5	2.1	-0.3	0.5	0.7	0.05	0.05	0.20	0.40	0.50	0.70	0.90	1.60	1.80	2.00	2.10	2.20	2.30	2.40
Euroland	1.5	2.3	2.1	2.2	1.6	1.8	2.70	2.90	3.20	3.40	3.65	3.65	3.65	3.50	3.80	4.00	4.20	4.20	4.15	4.10
U.K.	1.7	2.1	2.3	2.1	1.8	2.0	4.60	4.40	4.40	4.40	4.40	4.40	4.40	4.10	4.00	4.00	4.10	4.15	4.20	4.25
Canada	2.9	3.4	3.1	2.2	2.0	2.0	3.75	4.20	4.40	4.60	4.60	4.60	4.60	4.20	4.50	4.65	4.80	4.80	4.75	4.70

Currency	2006-Q1	2006-Q2	2006-Q3	2006-Q4	2007-Q1	2007-Q2	2007-Q3	2007-Q4
Euro ($/€)	**1.20**	**1.24**	**1.28**	**1.30**	**1.32**	**1.33**	**1.34**	**1.35**
U.K. ($/£)	**1.74**	**1.77**	**1.82**	**1.84**	**1.86**	**1.87**	**1.88**	**1.89**
U.K. (£/€)	0.69	0.70	0.70	0.71	0.71	0.71	0.71	0.71
Switzerland (CHF/$)	**1.29**	**1.25**	**1.22**	**1.20**	**1.19**	**1.18**	**1.17**	**1.17**
Sweden (SEK/$)	**7.80**	**7.50**	**7.25**	**7.10**	**6.95**	**6.85**	**6.80**	**6.75**
Norway (NOK/$)	**6.75**	**6.40**	**6.10**	**5.90**	**5.80**	**5.70**	**5.60**	**5.55**
Poland (PLN/$)	**3.20**	**3.05**	**2.95**	**2.85**	**2.75**	**2.70**	**2.65**	**2.60**
Japan (¥/$)	**116**	**112**	**108**	**104**	**100**	**95**	**92**	**90**
Australia (US$/A$)	**0.74**	**0.73**	**0.72**	**0.71**	**0.70**	**0.69**	**0.68**	**0.67**
Singapore (S$/US$)	**1.63**	**1.60**	**1.58**	**1.56**	**1.54**	**1.52**	**1.50**	**1.48**
Korea (KRW/$)	**980**	**960**	**950**	**940**	**930**	**920**	**910**	**900**
China (CNY/$)	**8.04**	**8.00**	**7.90**	**7.80**	**7.70**	**7.60**	**7.50**	**7.40**
Canada (C$/US$)	**1.16**	**1.15**	**1.14**	**1.13**	**1.12**	**1.11**	**1.10**	**1.10**
Mexico (MXN/$)	**10.40**	**10.70**	**10.50**	**10.40**	**10.20**	**10.10**	**10.00**	**10.00**
Brazil (BRL/$)	**2.20**	**2.25**	**2.30**	**2.40**	**2.50**	**2.60**	**2.70**	**2.80**

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