

STATE OF THE ECONOMY 1st Quarter 2004

Introduction

The strength and stability of the economic recovery was once again confirmed in the first quarter of 2004, despite looming geopolitical issues surrounding Iraq and higher energy prices. Following an 8.2% and 4.1% annual growth in real gross domestic product (GDP) in the third and fourth quarters of 2003, respectively, the United States economy grew at an annual rate of 4.2% in the first quarter. This favorable growth rate in the first quarter was supported by a number of factors in the broader economy including a robust housing market, continued low interest rates and price stability, and improvements in the labor markets. The strengthening of the United States economy over the last several quarters has continued to foster generally improved business conditions during the beginning of 2004. As a result of the further strengthening of the economy during the first quarter, the outlook for 2004 remains favorable despite concerns regarding energy, interest rates, and Iraq, all of which may serve to adversely impact demand in the coming months.

Gross Domestic Product

According to advance estimates¹ released by the Bureau of Economic Analysis (BEA), real GDP increased at an annual rate of 4.2% in the first quarter of 2004. This is slightly lower than the consensus forecast of 5% annual growth in real GDP². The first quarter growth in GDP, however, was slightly higher than the revised rate of 4.1% for the fourth quarter of 2003³. Growth in the first quarter was a result of strength in personal consumption expenditures and government spending, both of which increased as compared to the fourth quarter. Exports and private inventory investment, though contributing to the growth in GDP during the first quarter, increased at a decreasing rate over the fourth quarter.

¹ The BEA press release on April 29, 2004 states the following with respect to advance estimates: The Bureau emphasized that the first-quarter “advance” estimates are based on source data that are incomplete or subject to further revision by the source agency. The first quarter “preliminary” estimates, based on more comprehensive data, will be released on May 27, 2004.

² *The Financial Times*, April 30, 2004

³ Quarterly data is expressed at a seasonally adjusted annual rate. Real estimates are in chained (2000) dollars.

Real personal consumption expenditures increased by 3.8% in the first quarter at a seasonally adjusted annual rate, slightly higher than the 3.2% increase in the fourth quarter but less than consensus expectations. Purchases of durable goods decreased 4.7% in the first quarter following a slight 0.7% increase in the fourth quarter, primarily as a result of a decline in motor vehicle sales during the first quarter. This decline is likely the result of lower purchases following the holiday season as well as fewer factory incentives for buyers and weather conditions that adversely impacted buyers' willingness to visit automotive dealers. However, data from the Federal Reserve Beige Book released on March 3, 2004 indicated that most of the twelve Federal Reserve Districts experienced strong sales of electronics, appliances, and home furnishings in January and February.

Personal consumption expenditures of nondurable goods increased by 6.4% in the first quarter, slightly higher than the 5.4% increase during the fourth quarter largely due to a roughly 8% and 15% increase in food and clothing. The Federal Reserve Beige Book from April 21, 2004 indicated that most of the Districts continued to experience improvements in retail sales. Apparel sales were particularly strong during the period, perhaps as consumers prepared their wardrobes for spring and summer.

Real residential fixed investment increased at a decreasing rate of 2.1% in the first quarter compared to a 7.9% increase in the fourth quarter. After decreasing in January and February to 1,932,000 and 1,909,000, respectively, from 1,953,000 in December 2003, building permits for privately-owned housing units increased 1.9% in March to 1,946,000 at a seasonally adjusted annual rate⁴. The slowdown in January and February may be attributed to inclement weather in parts of the nation with milder weather following in March accounting for the upturn in building permits. The March 2004 building permits of 1,946,000 represents a roughly 15.3% increase over the March 2003 figure of 1,688,000. Building permits in January and February of 2004 increased by roughly 9% and 7%, respectively, on a year over year basis.

Privately-owned housing starts increased 6.4% in March to a seasonally adjusted annual rate of 2,007,000 as compared to 1,938,000 in January and 1,887,000 in February. On a year over year basis, housing starts in March increased by roughly 15.2% from the March 2003 rate of 1,742,000. This

⁴ From the April 16, 2004 New Residential Construction in March 2004 joint press release of the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing & Urban Development.

strong growth in housing starts follows year-over-year increases of 6% in January and 15% in February⁵.

The significant increase in building permits and housing starts further attests to the strength of the economic recovery over the last year. In addition, single family homes sales increased 8.9% in March to a record 1,230,000 based on information from the United States Department of Commerce Census Bureau. The March 2004 figure represents a roughly 22% increase in home sales on a year-over-year basis. The continued robust activity in the real estate markets, based on the previous data, has been aided largely by continued accommodative monetary policy by the Federal Reserve. With interest rates still at multi-decade lows, mortgage rates remained favorable for consumers seeking homeownership. Thirty-year conventional mortgages according to Freddie Mac⁶ trended lower during the first quarter from 5.85% as of January 1, 2004 to a low of 5.38% at March 18, 2004 before increasing to 5.52% at April 1, 2004. Fifteen year mortgages experienced a similar pattern of falling from 5.15% as of January 1, 2004 to a low of 4.69% at March 18, 2004 before rebounding to 4.84% by the end of the quarter. Though the uptick in interest rates from the mid-March lows may be indicative of expectations of higher future interest rates, there is likely some latitude for rate increases before any major adverse impact upon the housing market. It would be expected that a trend in higher interest rates would dampen the strength of the real estate market, which could tend to suppress economic growth slightly.

Exports of goods and services also increased at a decelerating rate during the first quarter with a 3.2% increase as compared to a 20.5% increase in the prior quarter. Continued weakness of the dollar during the first quarter of the year contributed to the increase in exports. However, slight strengthening of the dollar against the euro and the yen during part of the first quarter may have tempered the growth in exports as domestic U.S. goods became relatively more expensive to foreign buyers. At the end of 2003, the dollar/sterling (\$/£) exchange rate stood at roughly \$1.79 with a dollar/euro (\$/€) and yen/dollar (¥/\$) exchange rate of \$1.25 and ¥107, respectively⁷. The dollar weakened to roughly \$1.92/sterling by mid-February before strengthening modestly to \$1.85 by the end of the quarter. This dollar/sterling exchange rate is significantly weaker than the \$1.66/£ rate at the beginning of the fourth

⁵ From the April 16, 2004 New Residential Construction in March 2004 joint press release of the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing & Urban Development.

⁶ Data from Freddie Mac Weekly Mortgage Market Survey

⁷ Source: *The Economist*

quarter. The dollar's performance against the euro fared slightly better with the dollar weakening only marginally to \$1.28/€ in mid-February before strengthening to \$1.23/€ by the end of the quarter. This is slightly weaker than the \$1.15/€ at the beginning of the fourth quarter but slightly stronger than the \$1.25/€ rate at the end of the fourth quarter. The yen also weakened during the middle of the first quarter before strengthening again towards the latter half of the quarter. The ¥/\$ exchange rate stood at roughly ¥107 at the end of the fourth quarter. The exchange rate fell to ¥111 in early March before strengthening once again to ¥104 by the end of the quarter.

Continued weakness of the dollar would be expected to have a favorable impact upon exports as U.S. goods become relatively cheaper to foreigners. This could result in improvements in the U.S. domestic manufacturing sector, as manufacturers increase production to satisfy the increased demand for exported goods.

Federal government consumption expenditures increased by 10.1% in the first quarter as compared to an increase of 0.7% in the fourth quarter. This increase in federal government consumption expenditures was fueled by a 15.1% increase in national defense spending, perhaps in relation to spending on stabilizing Iraq in the face of growing civil unrest and uprisings by insurgents. The increased spending on national defense may also be linked to the military's replenishing of supplies drawn down during the last year as well as being linked to programs in the war against terror. Nondefense spending increased only 0.7% in the first quarter at an annual rate.

Private businesses increased inventories by \$15.3 billion during the first quarter of 2004. This follows an increase of \$9 billion in the fourth quarter of 2003, during which time private businesses began to increase inventories to replenish supplies that had been drawn down during the second and third quarters. The increase in private business inventories added 0.27% to the increase in GDP for the first quarter as compared to 0.71% for the fourth quarter. This buildup of inventories suggests increased activity within the business sector, as companies attempt to increase production to meet expected increases in demand. This may also indicate that companies and management have become more optimistic regarding the sustainability of the economic recovery and have, thus, chosen to increase their own activity with respect to investment and production. This trend may be confirmed by the 7.2% increase in real nonresidential fixed investment in the first quarter, slightly more tempered than the fourth quarter increase of 10.9%. This increase was led largely by the increase in expenditures on equipment and software of 11.5% in

the first quarter as compared to an increase of 14.9% in the fourth quarter of 2003. Though this first quarter growth was slightly less than that in the fourth quarter, this is likely a result of more moderate activity following the end of the busy holiday season and the end of the tax year for many businesses and individuals. However, this still suggests that the business environment continues to be favorable as the pace of economic expansion stabilizes.

The Federal Reserve

Monetary policy remained accommodative in the first quarter of 2004 with the federal funds rate holding at 1%. At its first meeting of the year on January 28, 2004, the Federal Open Market Committee (FOMC) maintained its position that economic activity was continuing to be supported by accommodative monetary policy along with robust underlying productivity growth. In the press release following the meeting, the FOMC indicated that output was expanding briskly, with expectations of increases in core consumer prices low, and that there were signs of improvements in the labor markets. The FOMC also maintained its position that the risk of deflationary pressures in the economy had largely dissipated, dispelling some fears that had been lingering among investors and traders since mid-2003.

The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation.

The FOMC, however, added the following statement which may be perceived as a shift in its bias towards tightening in the future.

With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation. .

In semi-annual testimony before the Congress on February 11, 2004⁸, Chairman Alan Greenspan noted that 2003 marked a shift from a period of subpar economic activity to more robust growth. Factors that contributed to this transition included strength in household spending, both real personal consumption and real outlays on residential structures, accommodative monetary policy that resulted in favorable financing conditions for consumers

⁸ Testimony of Chairman Alan Greenspan, Federal Reserve Board's semiannual Monetary Policy Report to the Congress, Before the Committee on Financial Services, U.S. House of Representatives, February 11, 2004

and businesses, low inflation, and a strengthening in capital spending particularly on equipment and software that reflected increased confidence among business executives as well as improvements in the financial conditions of their firms. Chairman Greenspan also indicated that prospects for sustained economic expansion in 2004 were favorable citing the following:

The household sector's financial condition is stronger, and the business sector has made substantial strides in bolstering balance sheets. Narrowing credit risk spreads and a considerable rally in equity prices have reduced financing costs and increased household wealth, which should provide substantial support for spending by businesses and households. With short-term real interest rates close to zero, monetary policy remains highly accommodative. And it appears that the impetus from fiscal policy will stay expansionary, on net, through this year. These circumstances all should spur the expansion of aggregate demand in 2004. At the same time, increases in efficiency and a significant level of underutilized resources should help keep a lid on inflation.

Given the slow pace of job creation during 2003, concerns had grown about the prospects of a jobless recovery. With respect to employment, Chairman Greenspan indicated that following:

In all likelihood, employment will begin to grow more quickly before long as output continues to expand. Productivity over the past few years has probably received a boost from the efforts of businesses to work off the stock of inefficiencies that had accumulated in the boom years. As those opportunities to enhance efficiency become scarcer and as managers become more confident in the durability of the expansion, firms will surely once again add to their payrolls.

Though confident that the FOMC's accommodative monetary policy was suitable for fostering sustainable economic expansion, Chairman Greenspan also indicated in testimony that such accommodative policy could not be maintained indefinitely without posing risks to sustainable growth and price stability. As such, the real federal funds rate would need to gradually rise towards a more neutral level consistent with sustained economic activity and to maintain price stability.

In the Monetary Policy Report to the Congress, the Federal Reserve policymakers expressed optimism for brisk economic expansion in 2004. The Federal Reserve Board of Governors and Federal Reserve Bank Presidents

project that real GDP will increase by 4%-5 ½% in 2004 as compared to real GDP growth of 4.3% in 2003⁹. The personal consumption expenditures chain-type price index (the Federal Reserve's preferred measure of inflation) is expected to range from 1%-1 ½% as compared to 1.4% in 2003. The civilian unemployment rate is anticipated to range from 5 ¼%-5 ½%.

At its March 16, 2003 meeting, the FOMC left the target federal funds rate at 1% and once again expressed optimism regarding the pace of economic activity. The FOMC again indicated that it could remain patient in removing monetary policy accommodation.

The Federal Reserve Beige Book¹⁰ released on March 3, 2004 and April 21, 2004 once again confirmed the continued strengthening of economic activity in the first quarter, though the pace of growth varied among the twelve Districts¹¹. The Beige Book conclusions included the following:

- Consumer spending remained solid with noticeable improvements in retail sales, particularly general merchandise and apparel, though automotive sales were lackluster. Retailers in most of the Districts, however, were optimistic regarding growth prospects for late spring and summer.
- Manufacturing activity generally increased in all of the Districts during the first quarter with new orders and production higher than year ago levels. This improvement in manufacturing may be attributed to the continued weakness of the dollar as compared to foreign currencies.
- The strength of residential real estate activity as depicted by data provided by the Census Bureau and Department of Housing & Urban Development was confirmed by evidence of robust real estate markets throughout the twelve Districts, though commercial real estate activity remained tepid.
- Labor markets showed improvements with most Districts reporting moderately increased hiring though wage increases were generally weak. However, contacts throughout the twelve Districts continued to report

⁹ Changes are from average for fourth quarter of 2003 to average for fourth quarter of 2004.

¹⁰ The press release on November 26, 2003 states the following: This document summarizes comments received from businesses and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.

¹¹ The Twelve Districts of the Federal Reserve system include: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

significant increases in healthcare costs—increases that were generally greater than the increases in wages.

- Economic activity in the energy sector remained strong, primarily as a result of increased oil prices that prompted more onshore exploration and production.

Consumer Confidence

Consumer confidence declined slightly during the first quarter as the Conference Board's Consumer Confidence Index¹², which stood at 91.7 in December 2003, increased to 96.4 in January before falling to 88.5 in February and remaining flat in March. For January, the Consumer Confidence Index reached its highest level since July 2002¹³. The increase for January was likely a result of optimism regarding the short-term outlook for the economy. In addition to the increase in the Consumer Confidence Index in January, the Expectations Index increased as well from 103.3 in December 2003 to 107.8. This increase in expectations was largely due to an improved outlook for employment over the first half of the year. The January survey indicated a slight increase in the number of those expecting more jobs becoming available in the next six months.

Consumer confidence tempered in February with the Index falling to 88.5 and the Expectations Index falling to 91.9. This retrenchment in confidence was due to continued frustration with the tepid pace of labor market growth. This prompted consumers to lower their expectations for economic activity for the next six months. These concerns over the weakness in the labor markets continued to dampen consumer confidence and expectations in March, with both Indices remaining virtually unchanged from the February levels. Expectations for more jobs becoming available in the next six months also declined slightly in March, adversely impacting consumers' expectations for economic growth in coming months, despite other data indicating strong economic growth in the first quarter and expectations for continued sustainable growth in the future. The restraint in consumers' outlook for economic activity may also have been the result of the Federal Reserve's comments regarding the eventual removal of such accommodative monetary policy.

¹² www.conference-board.org

¹³ The January 27, 2004 press release by the Conference Board states: "The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. The monthly survey is conducted for The Conference Board by NFO WorldGroup. NFO is one of TNS group of companies."

The Business Sector

Further improvements in industrial production provided additional evidence of the increased economic activity, particularly in the business sector. Industrial production figures as compiled by the Federal Reserve¹⁴ increased heartily in January and February, rising 0.7% and 0.8% at a seasonally adjusted annual rate, respectively, before experiencing a 0.2% retrenchment in March to 114.5. Industrial production increased 3.4% in March on a year-over-year basis with a first quarter annual increase of 6.6% as compared to a revised annual increase of 5.6% for the fourth quarter of 2003. Manufacturing production increased at an annual rate of 5.9% in the first quarter, as supported by evidence in the Beige Book indicating strong improvements in manufacturing in the twelve Districts of the Federal Reserve System. Manufacturing production increased by 3.6% in March on a year-over-year basis. Consumer goods output increased by 5.3% in the first quarter with business equipment production increasing at an annual rate of 11.7%. On a year-over-year basis, consumer goods and business equipment increased 1.7% and 5.3%, respectively, in March. This is consistent with GDP data indicating increases in business expenditure on equipment and software.

Capacity utilization once again showed improvement, increasing from 75.8% in December to 76.5% in March. Manufacturing capacity utilization increased from 74.4% in December to 75.2% in March. This favorable growth in industrial production and capacity utilization may be the result of continued increases in economic activity stemming from further growth in exports attributed to the weakness of the dollar on foreign exchange markets.

The Department of Commerce, Census Bureau's Manufacturers' Shipments, Inventories, and Orders for March 2004 industrial report confirms the continued rise in manufacturing activity during the first quarter. Preliminary estimates of new orders for manufactured goods increased to \$360.7 billion in March, representing a 4.3% increase from \$345.8 billion in February. New orders for nondurable goods increased 3.5% in March to \$165 billion following a 1.8% decline in February. New orders for durable goods increased by 5% in March to \$195.8 billion following a 3.9% increase in February on a seasonally adjusted basis. New orders for all manufactured goods adjusted only for trading-day and calendar-month variations increased 9.7% for the first quarter of 2004 as compared to the first quarter of 2003 with

¹⁴ Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release from January 16, 2004.

new orders for nondurable and durable goods increasing by 7.6% and 11.6%, respectively, in the first quarter on a year-over-year basis.

Shipments in March of all manufactured goods increased 3.8% from February to \$361.3 billion, the sixth increase in the last seven months. Nondurable goods and durable goods shipments increased 4.0% and 3.5% in March to \$196.4 billion and \$165 billion, respectively, on a seasonally adjusted basis. On a year-over-year basis (adjusted only for trading-day and calendar-month variations), shipments of all manufactured goods increased 8.8% in the first quarter with nondurable and durable goods shipments increasing by 7.6% and 9.9%, respectively.

Data from the Federal Reserve Beige Book indicating robust retail sales in the first quarter is once again confirmed by the advance monthly sales for retail trade and food services in March 2004 released by the Department of Commerce¹⁵. In March, retail and food service sales increased 1.8%¹⁶ to \$333 billion over February and by 8.2% on a year-over-year basis. According to *The Financial Times*, these figures were more than double the figures forecast by most economists¹⁷. First quarter retail sales for 2004 increased by 7.7% from the first quarter of 2003. Total sales excluding motor vehicles and parts increased 8.5% in March on a year-over-year basis and increased 8.1% for the first quarter from the first quarter 2003. Retail sales increased 2% in March from the previous month and 7.9% on a year-over-year basis. For the first quarter, retail sales increased 2.2% from the fourth quarter and by 7.3% on a year-over-year basis. Retail sales of furniture and home furnishing showed gains of 9.8% in March over March 2003 (a 10.4% first quarter increase over the same period last year). Electronics and appliances, building materials, and clothing also posted strong year-over-year gains on a quarterly basis for the first quarter of 11.5%, 15.7%, and 9.1%, respectively. Once again, this increase in activity follows anecdotal evidence in the Beige Book releases and GDP data.

Preliminary productivity data released by the Department of Labor, Bureau of Labor Statistics¹⁸ indicates that productivity in the business sector increased by 4.5% in the first quarter as compared to an increase of 1.8% in the fourth quarter at seasonally adjusted annual rates. Productivity in the nonfarm business sector increased 3.5% in the first quarter, slightly higher

¹⁵ Press release from the Department of Commerce on April 13, 2004.

¹⁶ Adjusted for seasonal, holiday, and trading day differences but not for price changes.

¹⁷ *The Financial Times*, April 14, 2004.

¹⁸ Press release from May 6, 2004.

than the 2.5% increase in the fourth quarter. The continued increases in manufacturing activity during the first quarter were accompanied by a productivity increase of 3.1%, lower than the 4.8% increase in productivity in manufacturing for the fourth quarter 2003. These strong rates of productivity have likely restrained the need for increased employment. However, as output continues to accelerate with growth in economic activity, productivity rates are likely to decelerate and likely necessitate increased hiring by businesses in order to avoid imbalance between supplies and growing demand for goods and services.

The favorable performance of the business sector in the first quarter, based on various data, confirms the sustained increase in economic activity that originally began in 2003. Gains in the manufacturing sector resulting from strong exports fueled by a weaker dollar have contributed to the increase in output. It is likely that employment will eventually increase in order for businesses to provide adequate supply for strengthening demand. Though consumer sentiment may be slightly dampened by the prospect of interest rate rises in the near future, favorable economic and business conditions should continue to provide a solid foundation for sustained growth for the next several quarters.

Inflation

Following a 1.9% increase in the consumer price index (CPI)¹⁹ for the full year 2003, there was a noticeable uptick in inflation during the first quarter of 2004. Following a 0.5% increase in January, the CPI increased by 0.3% in February and 0.5% in March on a seasonally adjusted basis. For the first quarter, the CPI increased by 5.1% at a seasonally adjusted annual rate but by only 1.7% on a year-over-year basis. Roughly half of the increase in the CPI in the first quarter was the result of a surge in the energy price index which rose by 4.7%, 1.7%, and 1.9% in the first three months of the year, respectively. Though this equates to a 38.6% increase on a seasonally adjusted annual basis, the energy index increased by only 0.4% on a year-over-year basis. Increases in food prices remained relatively tame during the first quarter, staying unchanged in January then increasing 0.2% in February and March. Though food prices increased at a seasonally adjusted annual rate of 1.3% in the first quarter, prices increased by 3.2% on a year-over-year basis. Removing the effects of food and energy, the core CPI increased by 2.9% at a seasonally adjusted annual rate in the first quarter and by 1.6% from March

¹⁹ Based on data from the Consumer Price Index: March 2004 press release on April 14, 2004 by the Bureau of Labor Statistics, United States Department of Labor.

2003. This is noticeably higher than the 1.1% increase in the core CPI for the full year 2003. Though the Federal Reserve remained confident that inflation has stabilized, the markets began to price in a rise in interest rates at the FOMC's August meeting in order to maintain price stability by removing some of the effects of its accommodative monetary policy.

In addition to the CPI, the price index for gross domestic purchases from the Bureau of Economic Analysis²⁰ rose by 3.2% in the first quarter, substantially higher than the 1.3% rise in the fourth quarter of 2003. Excluding volatile food and energy prices, the gross domestic purchases price index rose by 2.3% compared to a 1.5% increase in the fourth quarter. These figures, closely watched by the Federal Reserve, are likely indicative that the disinflationary period predominant over much of the last year has ended, dispelling many fears from 2003 of deflation and supporting the Federal Reserve's conclusion that inflation has stabilized. This strengthens the case for a rise in interest rates during the second or third quarter of the year.

Though inflation experienced a noticeable increase during the first quarter, primarily as a result of increases in energy prices, the prospects for a rapid, sustained rise in core inflation in conjunction with increased economic activity and output seem remote. Given the slack available in labor markets and excess capacity in manufacturing, activity should be able to expand substantially without triggering a substantial rise in inflationary pressures in the economy.

Labor Market

After averaging 5.9% in the fourth quarter, the unemployment rate trended lower in the first quarter to an average 5.6%²¹. Total nonfarm payroll employment increased by 308,000 in March to a seasonally adjusted 130.5 million, following a 46,000 increase in February and a 159,000 increase in January. The increase in payrolls was fueled largely by employment increases in construction (+71,000 in March and +201,000 over the last year), professional and business services (+ 42,000 in March and +212,000 since April 2003), and retail trade (+ 47,000 in March and +123,000 since December 2003). Since August 2003, nonfarm payroll employment has increased by 759,000. Manufacturing employment remained virtually flat during the first

²⁰ Bureau of Economic Analysis, Gross Domestic Product: First Quarter 2004 (Advance) release, April 29, 2004.

²¹ Bureau of Labor Statistics, United States Department of Labor, The Employment Situation: March 2004, April, 2, 2004.

quarter. The 171,000 per month average increase in payroll employment during the first quarter coincides with other data indicating the strength and sustainability of economic activity, even though job creation has fallen short of expectations. As economic activity continues to increase, employment is likely to increase as productivity decelerates and businesses hire more workers in order to provide supply adequate to satisfy increasing demand.

According to the Conference Board's Consumer Confidence Survey, consumers' optimism regarding employment at the beginning of the year faded quickly by the end of the first quarter. Consumers expecting more jobs to become available in the next six months increased to 22% in January from 21.6% in December. Optimism faded in February and March with only 16.4% and 15.7%, respectively, expecting more jobs to become available in the next six months. Though consumer optimism regarding employment appeared bleak at the end of the first quarter, continued strengthening of economic activity leading to increased payroll employment is likely to favorably impact consumers' outlook for job creation during the coming quarters.

Equity Markets

Improving economic conditions during the last several quarters have finally begun to filter down to corporate profits of many publicly-traded companies. As of April 8, 2004, thirty-eight S&P 500 companies had reported earnings with 74% exceeding expectations. In addition, Thomson Financial First Call forecast a year-over-year increase of roughly 20% for earnings of S&P 500 companies²². As a result of improved corporate governance and increased economic activity anticipated to result in improvement in corporate profits, investors' confidence improved during the latter half of 2003 and into 2004. As such, investors became quite receptive to initial public offerings during the first quarter of 2004. Through mid-February, there were twenty-one IPOs raising proceeds of roughly \$5 billion as compared to only two IPOs raising over \$209 million for the same period in 2003, according to Thomson Financial First Call.

Despite improved economic and financial performance and more favorable expectations regarding future earnings, the major indices were flat during the first quarter. The Dow Jones Industrial Average ended 2003 at roughly 10,454²³. For the first quarter the DJIA peaked in mid-February at roughly 10,800 before retrenching to 10,360 by the end of March, representing

²² Based on data from *The Financial Times*, "Confidence in Strength of US Recovery Grows," April 12, 2004.

²³ Based on data from *The Economist*.

approximately a 1% decline during the period. After ending 2003 at 1,112, the S&P 500 rose roughly 1.5% during the first quarter to 1,126. The NASDAQ composite, ending 2003 at 2,000, declined roughly 0.6% during the first quarter to 1,994. The market's sideways performance may be the result of concerns over geopolitical events in Iraq, rising oil prices, weak labor markets, and expectations of interest rate increases in the coming quarters. These factors may serve to suppress investor confidence, despite the strengthening of economic activity that would be expected to have a favorable impact upon corporate earnings, expectations, and, by natural extension, share prices.

Oil Prices

After ending the year at roughly \$33 per barrel for West Texas Intermediate, oil prices steadily increased to nearly \$37.50 per barrel in early March before retrenching to approximately \$36.20 at the end of the first quarter. At its February 10, 2004 meeting in Algiers, Algeria, OPEC ministers reduced output by 1 million barrels per day to 23.5 million barrels per day effective April 1, 2004²⁴. The decision to reduce output, even though prices were remaining consistently above the targeted price range of \$22-\$28 per barrel, was based on the projected supply surplus for the second quarter during which demand typically decelerated. Though markets were well supplied into the first quarter of 2004, OPEC ministers concluded that a reduction in production was necessary to avoid market imbalances that would likely have downward pressure on prices.

At its March 31, 2004 meeting in Vienna, OPEC ministers reconfirmed a 1 million barrel per day reduction in production levels to 23.5 million barrels per day as agreed at the previous meeting in Algiers. OPEC also concluded that continuing high oil prices were the result of speculators in the futures markets and tight gasoline markets in the United States. Price increases were further compounded by geopolitical concerns, particularly regarding Iraq, rather than supply and demand fundamentals. Claims of oil price distortions arising from speculators in the market were confirmed by an earlier report in *The Financial Times*²⁵ that indicated oil prices were exaggerated by as much as 10% due to crude futures trading at record levels. An unwinding of hedge fund and speculator positions in the futures markets could reduce oil prices by up to \$4 per barrel. OPEC also noted that the dollar's weakness in foreign

²⁴ OPEC press release following the 129th (Extraordinary) Meeting of the OPEC Conference in Algiers, Algeria on February 10, 2004.

²⁵ *The Financial Times*, "Record influx of hedge funds blamed for high oil prices," March 2, 2004.

exchange markets had had an adverse impact upon the purchasing power of the barrel. *The Financial Times* article also indicated that the decline in the dollar may have contributed as much as \$8 per barrel to the rise in oil prices.

Many economists remain concerned that the rise in oil prices will have a significant adverse impact upon economic activity in the coming quarters. Given the tight supply of gasoline in the United States along with surging demand from China and instability in Iraqi exports, oil prices are likely to remain higher than OPEC's preferred price band, in the absence of any production increases by the cartel or non-OPEC members. In addition, any exogenous shocks in the oil markets resulting in short-term price spikes or sustained higher prices would have a significant adverse impact upon global economic growth and the U.S. economic activity. However, cheating among OPEC members is likely to ensure adequate supply that should curb any substantial price increases stemming from the 1 million barrel per day cut in production effective April 1, 2004.

Economic Outlook 2004

The Conference Board's Leading Economic Indicators increased 0.4% in January to 115.1 from 114.6 in December. The Index remained unchanged in February before increasing 0.3% in March²⁶. For the six months ending in March, the LEI increased 1.8%. Since its low in March 2003, the LEI increased by an annual rate of 4.4%, somewhat slower than in recent months. Six of the ten indicators in the LEI increased in March (vendor performance, real money supply, average weekly initial claims for unemployment insurance [inverted], building permits, manufacturers' new orders for consumer goods and materials, and index of consumer expectations), with four of the indicators (interest rate spread, stock prices, average weekly manufacturing hours, and manufacturers' new orders for nondefense capital goods) declining. These improvements in the LEI coincide with strong GDP growth during the first quarter and generally improved economic conditions.

Economic conditions should remain favorable for the remainder of 2004 as a result of robust consumer spending and confidence and further improvements in corporate profits that would most likely have a positive impact upon the equity markets. Our expectations for the economy include:

- Real GDP growth of 4 ¼% - 5%.

²⁶ From The Conference Board's March 18, 2004 & April 19, 2004 press releases.

- Interest rates are likely to increase slightly during the second or third quarter as the Federal Reserve removes some of the accommodative monetary policy that may be contributing to the rise in inflation. However, excess capacity in manufacturing should accommodate strong growth throughout the year without stoking any substantial inflationary pressures. Furthermore, given that 2004 is a presidential election year, the FOMC may be reluctant to initiate any aggressive policy changes. It is more than likely that the FOMC will increase the federal funds rate by 25 basis points around mid-year with another rate increase of 25 basis points possible in the fall.
- Inflation should remain stable in 2004 with the CPI increasing by roughly 1 ½% - 2%.
- As the economy continues to strengthen and exhibit improved performance in various sectors, payroll employments are likely to increase during the coming quarters. It is possible that the economy will generate increases in payroll employment of 150,000 per month on average for the remainder of the year. Unemployment, then, is likely to fall to under 5 ½% for the year.
- Given the pace of economic activity, business spending will most likely increase during 2004 as production increases in order to balance aggregate supply and demand for goods and services from both domestic and foreign consumers.
- Oil prices are likely to remain above OPEC's preferred price band of \$22 to \$28 per barrel, given that OPEC minister agreed to a cut in production at its February 10, 2004 meeting in order to balance supply with the reduction in demand that is typical during the second quarter of the year. Continued unrest in Venezuela may exert further upward pressure on prices as well as further instability in Iraq and speculation in the futures markets.
- Continued weakness of the dollar in foreign exchange markets should be favorable for further strong growth of exports. This would, ultimately, have a positive impact upon manufacturing, employment, and the economy at large.

- The rapidly growing Chinese economy is likely to have a favorable impact upon economic activity as demand for domestic goods and services increases. This could fuel increases in manufacturing activity and the rest of the business sector seeking to capitalize upon profitable opportunities offered by the Chinese market.

On the other hand, there are a number of risks to the economy for the remainder of 2004, which could have significant adverse impacts upon economic performance throughout the remainder of the year.

- An escalation in geopolitical concerns regarding instability in Iraq, particularly following the return to sovereignty and the handover of power to a provisional government on June 30, 2004, may create uncertainty that could suppress demand in the global economy and create a slight premium in oil prices. Uncertainty over North Korea and Iran could also have an adverse impact upon economic activity and oil prices.
- The presidential election in November may have some impact upon consumer and business confidence, given the uncertainty of the outcome. Given the elections, there is unlikely to be any major policy initiatives during the year. It is unlikely that the elections will have anything more than a marginal impact upon economic activity in 2004.
- An increase in interest rates by the FOMC may temper further gains in the equity markets. It is unlikely, however, that this will be an issue, given that any rate increases are likely priced into the markets.
- An unexpected cooling of the Chinese economy, resulting in a substantial drop in demand for many goods and services, though unlikely, could have a significant adverse impact upon economic activity and business confidence that would serve to suppress economic growth in the coming quarters.

Conclusion

Improved economic performance that began in 2003, as a result of accommodative monetary policy as well as fiscal stimulus in the form of tax cuts in the Jobs and Growth Tax Relief Reconciliation Act, continued into the first quarter of 2004 with GDP expanding at an annual rate of 4.2%. Continued strength in personal consumption expenditures fueled strong

performance in retail sales during the quarter. The housing market remained robust due to favorable interest rates in anticipation of rate increases later in the year. The dollar's weakness contributed to strong growth in exports which also improved manufacturing activity. In addition, lagging payroll employment finally caught up with the pace of economic expansion in the first quarter with strong jobs growth in March. Though inflation trended higher due predominantly to sustained increases in energy prices, core inflation remained stable and under control, disproving speculation of deflation that arose during 2003. Though these factors are likely to prompt the FOMC to increase the federal funds rate mid-year, the foundation is strong for continued solid gains in economic activity to be sustained for the rest of 2004 and into 2005 in the absence, of course, of any exogenous shocks.