INVESTMENT GUIDE

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THIRD QUARTER ECONOMIC REVIEW

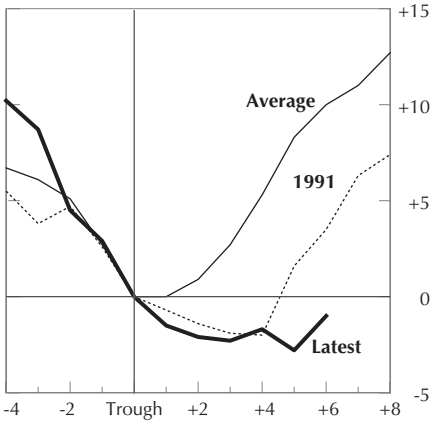
The economy's performance improved dramatically during the third quarter. Mortgage refinancing and auto financing deals more than offset continuing labor market weakness and buoyed consumer spending, which grew at an annualized rate near 6% during the quarter. The economy's improvement has so far failed to include a boom in manufacturing employment, and so trade concerns now bid to follow the lack of employment growth as the economic issue of the day. With rising complaints that China's undervalued yuan is unfairly penalizing U.S. manufacturing interests, the stage is being set for some combination of political and economic responses to growing trade tensions. While it will continue halfheartedly to pressure the Chinese government and central bank to allow the yuan to float (and presumably strengthen) against the dollar, the Bush administration is likely publicly to tolerate—and privately to welcome—gradual declines in the exchange value of the dollar against other currencies around the world.

Housing and Consumer Spending

Spending on durable goods and housing propelled the economy during the third quarter. As this is written (in the week before the release of third-quarter GDP figures) it appears that growth in personal consumption expenditures will be reported near a 6% annual rate for the third quarter, with spending on durable goods increasing at about a 25% annual rate. The growth in durables spending reflects a sharp gain in auto sales, from a 16.0-million unit annual rate in the second quarter to 18.0 million during the third. Auto manufacturers, both domestic and foreign, continued to offer below-market financing deals to boost sales in the U.S. market.

While auto sales accelerated, the housing market continued to boom. Sales of new homes and resales of existing properties both increased during the quarter. In July and August, new homes were sold at a 1.13 million-unit annual rate, after 1.09 million in the second quarter; resales proceeded at a 6.30 million-unit rate, following 5.83 million in the second quarter. Mortgage rates were higher in the third quarter than they'd been in the second; the rate on conventional 30-year fixed-rate loans rose from an average 5.5% in the second quarter to 6.0% in the third. The third-quarter gains in home sales may therefore reflect prospective buyers acting with greater urgency in a rising-rate environment. In an historical context, however, mortgage rates are still at relatively low levels, so barring a sharp increase in rates, a meaningful slowdown in housing activity appears unlikely in the short term.

Chart 1: **Real Nonresidential Fixed Investment**



Note: The average was calculated from the previous six completed recovery periods. The curves show the percentage differences (vertical scales) in the series values from the value of that series at the trough of the respective business cycle. These differences are shown for the 4 quarters before and 8 quarters after the business-cycle trough.

Although third-quarter figures are not yet available, it's likely that mortgage refinancing continued to be an important foundation for the growth in consumer spending. During the first half of the year, refinancing loans totaled $1.21 trillion, or 70% of total mortgage originations. The Mortgage Bankers Association projects a decline in the volume of refinancing loans for the second half of the year, to $0.91 trillion. Even at this slower projected pace, however, refinancing will remain an important prop to household spending.

Industrial Activity

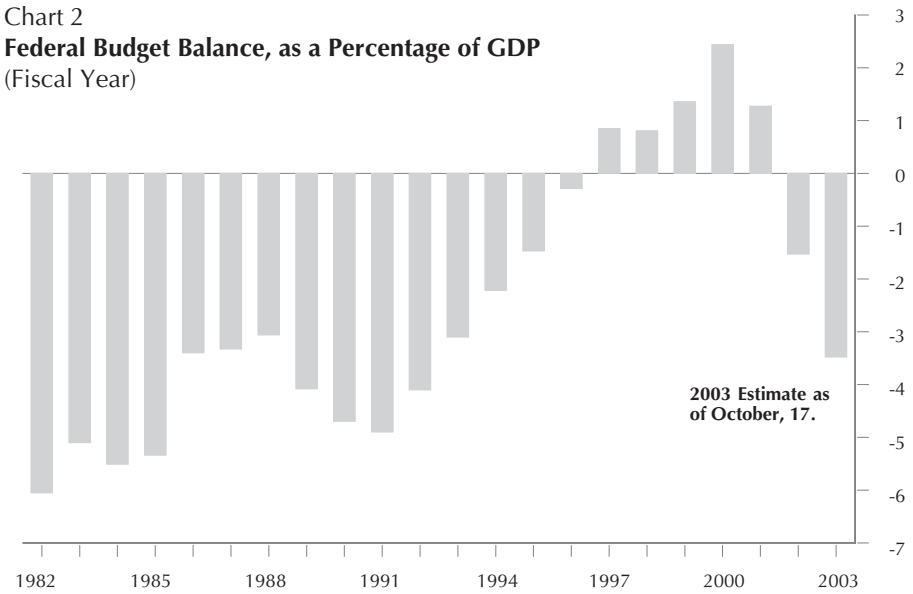
There were several indications of a revival in the U.S. manufacturing sector during the third quarter. Industrial production increased at a 3.3% annual rate during the July-September period, its largest quarterly gain since the third quarter of 2002. With those gains in output, capacity utilization rates began to rise in a variety of industries during the quarter, notably including the high-tech sector. For the manufacturing sector as a whole, the Federal Reserve's index of capacity utilization averaged 74.6% in the third quarter, after 74.2% in the second. In high-tech industries, the third quarter utilization rate was 64.6%, following 62.6% in the second.

Forward-looking indicators of industrial activity pointed to an accelerating recovery. The July-August pace of manufacturing orders was 12.3% (annual rate) ahead of the second-quarter rate; for the same period, orders for durable goods increased at an 11.5% annual rate. And the widely-followed purchasing managers' survey of the Institute for Supply Management averaged 53.4% during

the quarter, a reading consistent with further expansion in the manufacturing sector.

While the third-quarter developments provide no immediate spur to capital spending, they at least point in that direction. Business investment spending had declined in the first four quarters of the current expansion, and by the second quarter of this year, was still 2% below its end-of-recession pace. The modest increase likely to be reported for the third quarter should finally bring investment spending above its pace in the fourth quarter of 2001, but leave it well behind the 10% gain typically observed at this point in previous expansions. (See Chart 1.)

Chart 2
Federal Budget Balance, as a Percentage of GDP
(Fiscal Year)



Labor Markets

The terribly sluggish labor markets may have taken a turn for the better during September. Payroll employment increased by 57,000 in the month, ending a string of declines extending back to February of this year. According to the latest government figures, total employment in the U.S. economy has declined by 336,000 during the first nine months of 2003, and by 1.04 million since the recession ended in November 2001. So although September's reported gains were encouraging news, there is a lot of ground to be made up. For the July-September quarter as a whole, payrolls shrank by 41,000, with gains in construction (+30,000) and services (+100,000) offset by declines in manufacturing (-136,000) and government (-35,000). The unemployment rate ended the quarter at 6.1%, below June's 6.4%, but still high enough to be cause for concern. And the average length of unemployment was reported at 19.7 weeks in September, just below June's 19.8 weeks, which was the highest reading since January 1984.

A recent Labor Department study, released at the end of September, provides some new perspective on the underlying dynamics of labor market developments. The new data show that the decline in payroll employment during the fourth quarter of 2002, now estimated at 100,000 jobs,

> …is the net result of 6.1 million jobs added at 1.5 million expanding establishments, 1.6 million jobs added at 345,000 opening establishments, 6.2 million jobs lost at 1.5 million contracting establishments and 1.6 million jobs lost at 333,000 closing establishments.[1]

Comparison of the yearend 2002 figures with those for previous periods leads some[2] to conclude that the recent run of declining employment may stem mainly from a slower-than-usual pace of hiring at new or expanding businesses. That view is consistent with reports of large productivity gains in the U.S. economy during recent years: With the benefit of a generation of innovation in computers and telecommunications (including the Internet), labor requirements have been reduced in a broad range of industries. If this view is correct, however, it will be quite a while before the jobs lost during and since the 2001 recession are recovered.

Monetary and Fiscal Policy

Monetary policy was on hold throughout the third quarter, for the Fed made what may be its final policy moves for a while—cutting the Federal funds rate target to 1.00 percent, and the Discount rate to 2.00 percent—at its late-June policy meeting. Concerned both with fostering a sustainable recovery and avoiding a decline in inflation, the Federal Open Market Committee made it clear that monetary accommodation would likely be maintained for some time.

The Federal government's fiscal situation similarly leaves little room to maneuver. As the 2003 fiscal year ended, the Federal budget balance as a percentage of GDP reached -3.5%, its lowest reading since fiscal year 1992 (see Chart 2). Further deterioration of the Federal budget balance is in store for the short term, especially considering the request for an $87 billion special appropriation for the war on terrorism. The latest estimates from the Office of Management and Budget call for a $475 billion deficit (4.2% of GDP) in the current fiscal year.

Ironically, the war on terrorism has been an important source of fiscal stimulus. As shown in Chart 3, the pace of national defense spending has accelerated sharply during 2003. In the second quarter, it was already 19% above its pace in the final three months of 2001, when the latest recession ended. In contrast, such spending rose by an average of less than 4% in the first six quarters of economic expansions dating back to 1961.

International Trade

Since the monthly data on international trade flows are released with a lag of more than two months, initial

[1] New Quarterly Data on Business Employment Dynamics from BLS, available at http://www.bls.gov/news.release/cewbd.nr0.htm

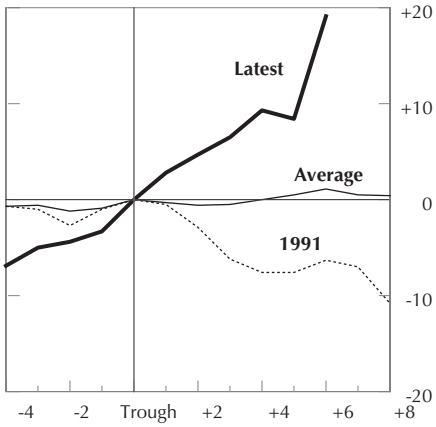
[2] See, for example Martin Feldstein's "There's No Such Thing as a 'Jobless' Recovery," Wall Street Journal, October 13, 2003.

estimates of quarterly GDP are made with incomplete trade data. The U.S. trade deficit averaged $39.6 billion in July and August (exports averaged $84.9 billion, imports $124.5 billion). That was a slightly smaller deficit than the monthly average of $41.2 billion seen in the second quarter, giving rise to hopes that an improvement in trade performance would contribute to GDP growth in the third quarter. (In national income accounting, a reduction in the trade deficit increases GDP, which is defined as the sum of consumption, investment, government spending, the change in inventories and exports *minus* imports.)

The important story on the trade front, however, has little to do with third-quarter trade flows. The U.S government, often the champion of globalization since the early 1990's, now faces all of the preconditions for an all-out trade dispute. The frictions regarding the exchange value of the dollar have centered on the exchange rate of the Chinese yuan. In a sense, however, the frictions are a mirror image of the U.S. position against most of the rest of the world. The Federal Reserve's broad foreign exchange index, with weights reflecting trade volumes with all significant trade partners, has declined by 10.2 percent since February 2002. From time to time during this period, the Bush administration has reiterated the traditional claim that the U.S. government favors a strong dollar.

In recent months, as declines in the manufacturing sector employment have continued, there have been a number of calls for pressure on the Chinese government to abandon its currency's undervalued (and fixed) exchange rate against the U.S. dollar. Since October 1998, China has fixed the value of the yuan in relation to the dollar at a rate of 8.28 yuan to the dollar. While that rate may have been appropriate five years ago, the argument goes, it now provides an unfair competitive advantage to goods manufactured in China. Moreover, the sharply lower production costs have enticed manufacturers to move manufacturing jobs out of the U.S. (and other high-cost industrialized nations) and into China. Allowing the yuan's exchange value to be determined by market forces, it is argued, would allow a decline in the yuan/dollar exchange rate, and eliminate the unfair competitive advantage imparted by the undervalued peg.

Chart 3: **Real Federal Government Spending National Defense**



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The arguments made by U.S. manufacturing interests ignore some important details. For one thing, in its efforts to maintain the yuan at its current peg, the Chinese government has become an important buyer of U.S. Treasury securities. Fixing the exchange rate requires the Chinese central bank to intervene in currency markets, buying dollars and selling yuan whenever there is downward pressure on the 8.28 yuan/dollar rate. The dollars so acquired have been invested in U.S. Treasury securities. At midyear 2003, the Bank of China held more than $120 billion in Treasury securities, one of the largest foreign holdings of U.S. Treasury debt. An end to the peg would mean an end to the Bank of China's purchases of Treasuries, and possibly the sale of a portion of its current holdings, putting upward pressure on U.S. interest rates.

A second important detail is that the growing trade deficit with China accrues to the benefit of consumers and firms in the U.S. An artificially cheap yuan translates to low-priced imports to the U.S. It is estimated, for example, that Wal-Mart accounts for about 10% of the annual $120 billion trade deficit with China. An end to the yuan peg would mean higher prices for U.S. consumers of imported goods, and lower earnings for Wal-Mart and other U.S. corporations that have outsourced production to China.

Despite these and other complications, however, the Bush administration is at least going through the motions of protesting an undervalued yuan (and other Asian currencies). Treasury Secretary Snow managed to get the participants in September's G-7 meeting in Dubai to agree to a regime of greater flexibility in exchange rate determination among the currencies of the major industrialized nations - meaning a reduction in efforts by the Bank of Japan to manage the exchange value of the yen. Earlier in the month, Secretary Snow visited the Bank of China to request an end to the yuan's current peg to the dollar; he was unable to extract any promises from the Chinese central bank.

In private, however, Bush administration officials must appreciate the importance of the two key background features of the current discussion of the dollar's exchange value. Regarding the yuan (and other Asian currencies), the willingness of the Chinese central bank (and others in Asia) to buy and hold large amounts of Treasury securities has to be appreciated as an important factor in keeping U.S. interest rates at their lowest levels in a generation. And given the fact that monetary and fiscal policy must remain on hold for now, the dollar's gradual decline against unpegged currencies around the world has to be appreciated as a welcome source of stimulus to the U.S. economy going into next year's presidential elections.

We are not altering our recommended allocations (see p. 75 of the ***INVESTMENT GUIDE***) in light of these recent developments. We assume that security prices reflect investors' collective judgment regarding the future impact of currently available information. We further believe that investors are best served by accepting these prices as the best available estimate of value, rather than speculating about the implications of news as it emerges. These allocations will provide reasonable exposure to assets that can be expected to benefit from future economic growth as well as adequate portfolio "insurance" in the event of an economic downturn.