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Industry Update

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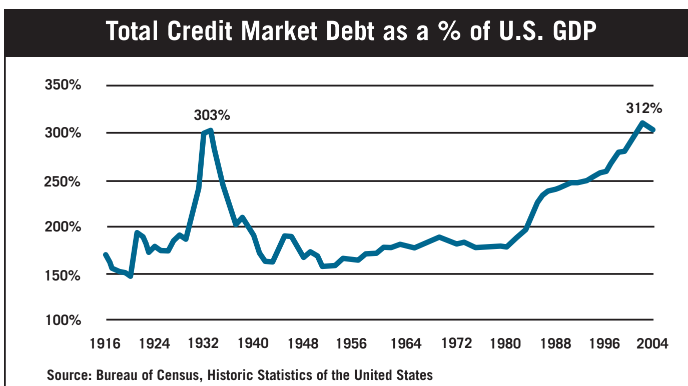
How Will the Economy Cope Without Its Caffeine and Sugar Fix?

What happens when the biggest monetary and fiscal stimulus in modern history is drawn out of an economy? We're about to find out.

As we have discussed at length over the past three to four years, the United States economy has been injected with unprecedented stimulus to offset the aftermath of the massive overinvestment and misinvestment in the technology and telecom sectors that occurred during the late 1990s. The "Internet bubble" allowed venture-backed technology and telecom startups, aided by Wall Street investment banks, to take advantage of the rapid increase in Internet usage and applications by raising huge sums in the capital markets, creating millionaires and even billionaires overnight. The consequences of the bubble bursting under the weight of excess capacity, flawed business models and sky-high valuations were record-number corporate bankruptcies and billions of investor losses.



The federal government and the Federal Reserve went to great lengths between 2001 and June 2004 to soften the blow of the Internet bubble's collapse. ***Unfortunately, these efforts created their own structural imbalances that collectively represent the potential for the bursting of a second bubble***. This second bubble may not be as concentrated or as obvious to see, lacking the easy stereotypes of the Internet boom. Yet its impact could be more widespread, reaching all aspects of the economy.

In the wake of the unprecedented stimulus to address potential deflationary pressures in the economy, many observers focused on the potential for *price* inflation that could have resulted from a monetary policy that may have been too accomodative. However, due to the excess capacity in the corporate sector and the deflationary effects of China and India, inflation has remained relatively tame, but for a few sectors like healthcare and education. Instead, what this abundance of liquidity and stimulus has created is asset value inflation. This is most notably evident in residential real estate, but has also affected the debt and equity markets, commodities, commercial real estate and other assets. This asset inflation has been largely fueled by cheap and easy credit. As the chart above indicates, the total U.S. credit market has risen above 300% of GDP, a level last reached just before the Great Depression.

While we do not expect the asset valuation bubble of 2005 to deflate at anywhere near the speed of the Internet bubble in 2000, or result in an economic depression akin to the 1930s, we do think it poses great difficulties for the U.S. economy and the financial services sector in particular in 2005 and beyond. Failure to

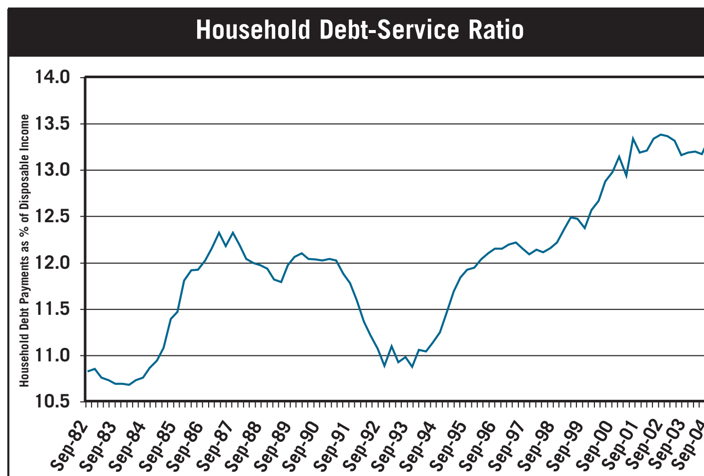
navigate these obstacles could have a major impact on economic growth, valuations and America's status in the world. ***The impending reversal of what has been a continuous cycle of low interest rates, record government stimulus and asset inflation could reveal cracks in the structural health of the U.S. economy that will be very difficult to repair.***

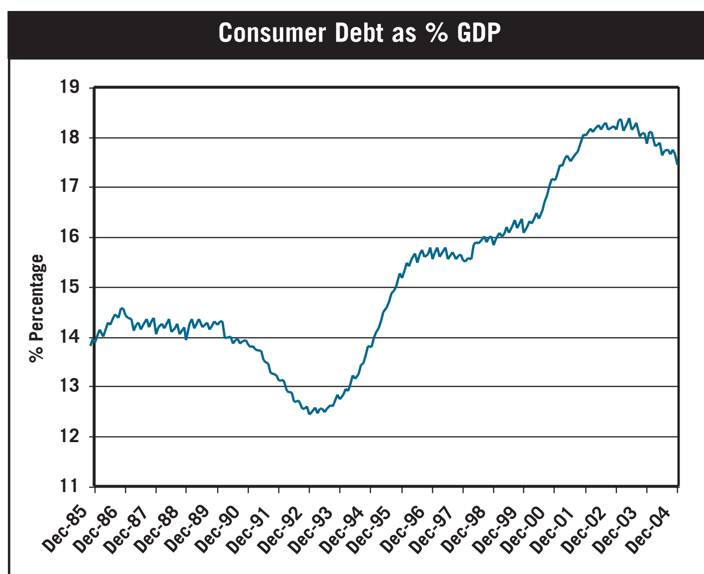
While we have addressed these credit and structural imbalances in prior *Industry Updates*, the key difference now is that the Federal Reserve has moved from an accommodative to a tightening stance. The Fed appears poised to maintain this policy for the foreseeable future to control price inflation and address the excessive speculative activity and asset inflation that has already occurred. The presumed Fed actions, along with the impact of the five rate increases already enacted in the second half of 2004, occur against a backdrop of a stretched consumer; a miniscule individual savings rate; and record budget, trade and current-account deficits. Because the U.S. now depends on the rest of the world to finance so much of our borrowing as well as to manufacture so many of our products, we have lost some of our ability to control our own interest rates—at a time when a rapid spike in rates could have a devastating impact on the economy.

As we have done for the past five years, in this annual *Industry Update*, we will expand on these themes as we consider our outlook for the economy. We will address the consumer, real estate, corporate and capital markets sectors as well as the role of the federal government in influencing the financial services sector and the economy overall.

Consumer Sector

The U.S. consumer represents our area of greatest concern for the overall economy. The consumer has continued to defy expectations of a slowdown for years, with consumer spending continuing to increase throughout the recession and serving as the key engine for the recovery. However, with interest rates rising from abnormally low levels, we are concerned that consumer spending will no longer be able to carry the load for the U.S. economy through 2005 and into 2006. With jobs and income growth modest in recent years, the steady spending increases have led to record highs in debt levels and debt-service ratios, and record-low savings rates. U.S. household debt payments have been stuck at all-time highs, above 13% of disposable income since 2002, even as the economy has emerged from recession (see chart). Mortgage and other consumer debt now total an all-time record of more than 80% of GDP.

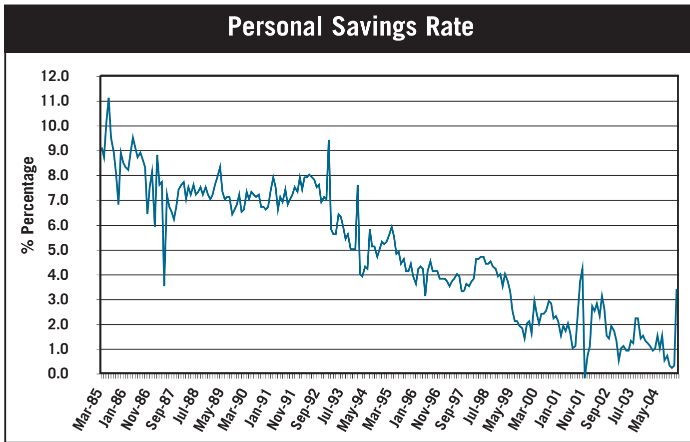




Note: The "Consumer Debt as a % of GDP" chart does not include mortgage debt

In prior cycles of declining interest rates, typically the result of a softening economy, consumers usually restrain spending to save and restore household balance sheets. However, in this recent period, the average consumer has utilized low rates and easily available credit to fuel even higher spending. As a result, household balance sheets have taken on considerable debt, and personal savings as a percentage of disposable income declined to just 0.2%, continuing a steady decline for much of the past decade (see chart on following page). The decline in savings leaves consumers with less of a cushion to soften the blow should economic conditions deteriorate or borrowing costs continue to rise.

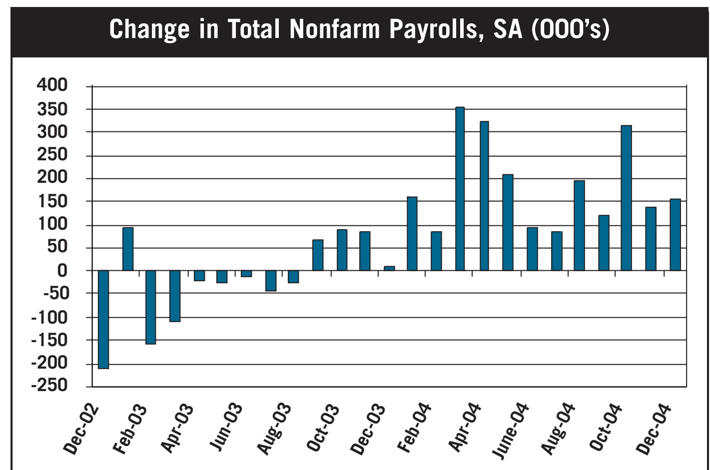
Optimists would argue that as long as interest rates remain low by historical standards, consumers will likely be able to service their debt. We would not refute this assertion. Indeed, many bankers may wonder how the consumer could be in poor shape given that consumer credit is, for the most part,



pristine, as evidenced by what are extremely low levels of delinquencies and charge-offs. However, it is important to recognize that the ultra-low rate environment has made credit trends better than they otherwise would have been. Low rates mean a lower cost of debt service. In addition, the rock-bottom rates led to the residential refinancing boom that peaked in 2003, which has allowed many consumers to generate cash flow by extracting equity from their homes and lengthening the payment term of their debt. It usually takes 24 months following a significant uptick in refinancing volume (even in a flat rate environment) before credit trends return to normal levels. As the effects of the five interest-rate hikes that began in June 2004 (plus additional rate hikes we expect throughout 2005) kick in—Federal Reserve rate increases typically take nine to 12 months to fully impact the economy—consumers may have a harder time making their payments, or be less able to borrow more to finance new spending.

Clearly, sustained job and income growth would provide consumers with greater income to finance new spending while financing their debt. Yet recent employment data has been mixed, and suggests wage and income growth could continue to be muted in the near term. New job creation in four of the last six months of 2004 totaled at or below the monthly 150,000 jobs economists estimate are required to accommodate new workers entering the work force (see chart). The December unemployment rate of 5.4% is meaningfully below the 40-year average of just under 6.0%; in part, this is due to a reduction in the labor participation rate, which is at a 17-year low of 65.8%, due to the difficulties in finding well-paying jobs. As a result, personal income growth of 5.1% was only modestly ahead of the 3.3% increase in the Consumer Price Index (CPI) from 2001 to 2004.

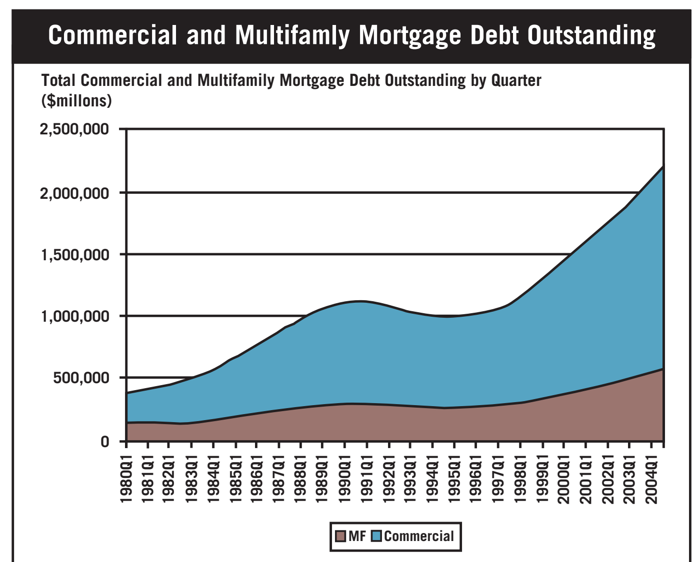
As the tailwinds of government and monetary spending are replaced by the headwinds of rising rates,



consumer spending is likely to weaken and consumer credit trends should turn negative as 2005 progresses.

Real Estate Sector

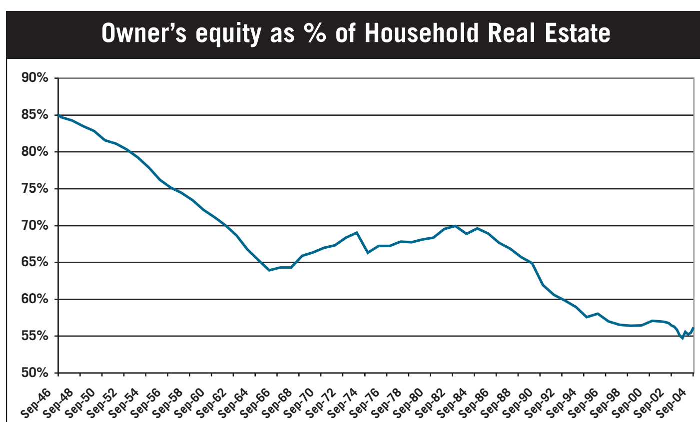
Real estate values float on a sea of finance. It is the cost of that financing, and its availability, that will significantly influence the price of real estate. Over the past several years, it is difficult to envision a period in which an individual or a corporation could find such plentiful financing for real estate at such a low cost. As such, while demographic factors have played a role in the incredible rise in real estate values in recent years, the low borrowing costs, and lenders' willingness to expand their real estate loans outstanding, have been more significant factors. For example, total commercial and multi-family mortgage debt outstanding has more than doubled in less than a decade, to more than $2.2 trillion, according to the Mortgage Bankers Association (see below). Similar to the dynamics in the consumer sector, rising interest rates should slow the pace of price appreciation and financing activity in the real estate sector in 2005.



Source: Mortgage Bankers Association

Recent data, particularly in residential real estate, would seem to contradict our pessimistic forecast for housing prices and financing activity. Average U.S. home prices increased 13.0% in the third quarter of 2004 from the year-earlier period, and at a record annualized pace of 18.5% from the second quarter, according to the Office of Federal Housing Enterprise Oversight (OFHEO). A number of coastal states experienced year-over-year increases in home prices of more than 20%, and Nevada (driven by the Las Vegas area) saw a 36% increase, the nation's highest.

However, while home-price appreciation has been extremely strong, the impact of unsustainably low rates is unmistakable. For instance, despite the recent increase in home values, owners' equity as a percentage of household real estate remains stubbornly near the record all-time low of 54% in 2003, down from 70% in the mid 1980s and more than 80% in the 1940s (see below). Refinancing volume, which briefly topped 70% of total mortgage originations when interest rates dropped to record lows in mid-2003, still accounts for over 45% of current originations. A myriad of new and re-introduced products from banks and mortgage lenders in recent years (e.g., interest-only, 40-year and negative amortization loans) allow consumers to delay principal payments on their mortgages, or use equity from their homes as collateral for home improvements, debt repayment or credit card purchases. In sum, rather than using rising home prices as a means to reduce leverage, the U.S. consumer has used this windfall as a seemingly never-ending source of "income," thereby increasing risk should the pace of home-price appreciation slow or turn negative. The price of an existing home in the U.S. now represents 3.4 times the median family income, an all-time record and up from 2.8 times just five years ago.



Note: While the residential real estate sector is the area in which we believe the level of asset inflation is the greatest, we do not plan to discuss this sector at greater length here. We are planning a separate Industry Update on this topic that will be published shortly.

The commercial real estate sector has also been distorted by the low rate environment of recent years, and is also vulnerable to the impact of rising interest rates. While the national suburban commercial real estate vacancy rate of 17% remains below highs of approximately 25% in the late 1980s, it still exceeds 20% in a number of major U.S. metropolitan areas, e.g., Dallas, Atlanta, San Francisco, Boston and Denver (see below).

U.S. Suburban Commercial Real Estate Vacancy Rates

1	Columbus	25.4
2	Dallas/Fort Worth	23.9
3	Atlanta	23.8
4	San Francisco	23.0
5	Boston	20.8
6	Denver	20.9
7	Salt Lake City	18.1
8	Charlotte	21.1
9	Cincinnati	21.4
10	Detroit	21.0
11	Kansas City	20.0
12	Philadelphia	19.1
13	Indianapolis	19.0
14	Mid Jersey	19.8
15	San Jose	18.3
16	Cleveland	19.1
17	Chicago	17.9
18	Portland	15.4
19	Houston	17.4
	United States	**17.1**

Source: CB Richard Ellis

During any other period with high vacancy rates, commercial property values would have collapsed as they did in the late 1980s and early 1990s. However, the ultra-low interest rates have changed the landscape this time around for two reasons. First, given that financing costs are typically the largest expense for commercial properties, low rates have had a material impact on most properties' income statements. Second, the low rates have caused banks to chase volume and yield and issue new loans to maintain earnings growth, while at the same time property investors are willing to demand a reduced yield (i.e., capitalization rate) in a low rate environment. This, in turn, has created a highly unusual dynamic of high vacancy rates coupled with increasing commercial property values.

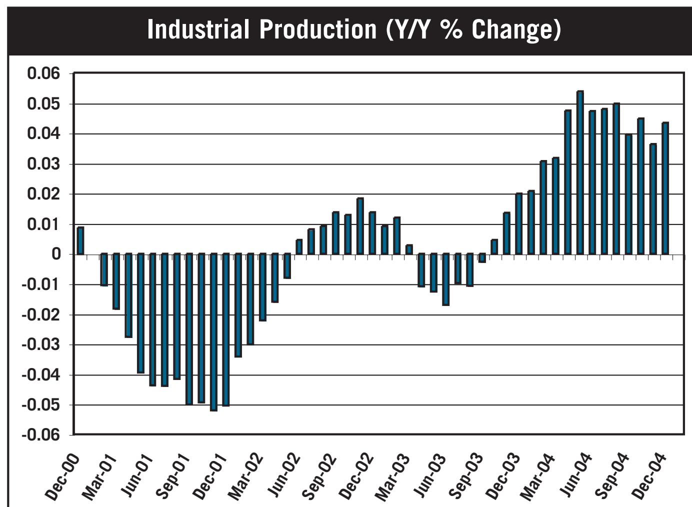
As property values have continued to lift in spite of generally weak demand, commercial real estate lenders have enjoyed low ratios of delinquencies and charge-offs, which has caused them to allocate even more capital to lending. However, loan growth and credit quality could be at risk if tenant demand does not build as interest rates continue to rise. Unfortunately, many corporations are reacting cautiously to the economic recovery and holding off on major office expansions and other large-scale projects, choosing instead to do more with less.

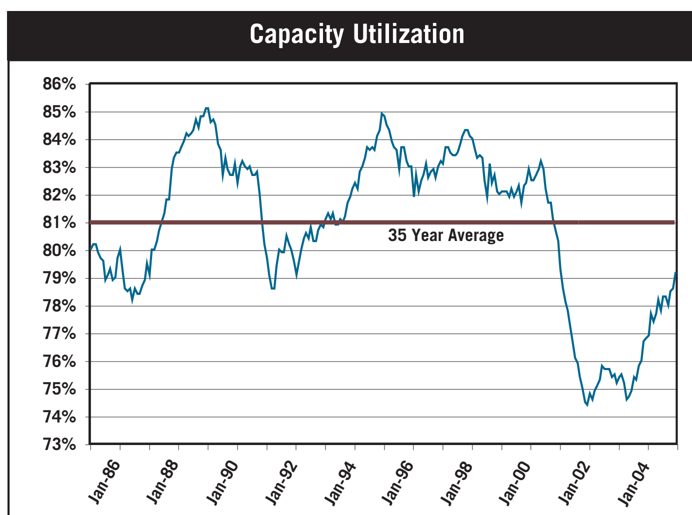
Similar to the consumer sector, the real estate sector has enjoyed artificially strong conditions in recent years due to record-low interest rates and economic stimulus. As real estate-related debt has ballooned, so have real estate values. As interest rates rise, these trends are likely to reverse, which could have negative implications not just for the real estate sector but for the banking system and the economy, which have fed off the cycle of rising property values and record refinancing volumes.

Corporate Sector

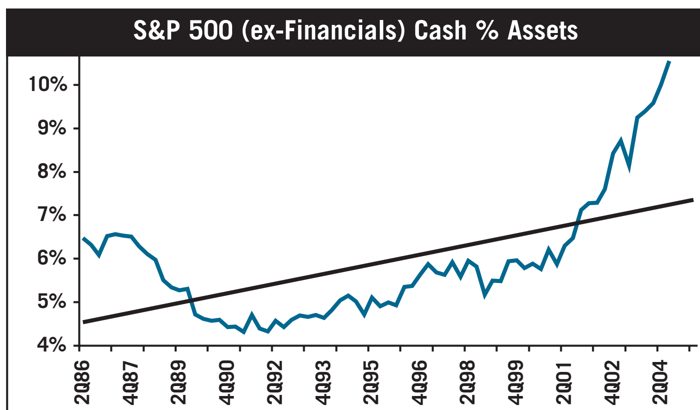
In contrast to the U.S. consumer and real estate sectors, many of the excesses of the corporate sector were purged following the collapse of the Internet bubble. Corporate bankruptcies reached record highs in 2002, led by high-profile collapses such as WorldCom and Enron. In response, many companies cut costs, streamlined operations, refinanced debt and improved corporate governance, leaving them well-positioned when the economy began to recover in 2003. As a result, the U.S. corporate sector is relatively healthy. Non-financial corporate profits have grown at 15% or more—well above historical averages—for the past eight quarters, and have almost returned to record levels reached in the late 1990s. A steady decline in corporate tax rates, helped by the Bush tax cuts, has also helped the profit rebound.

The U.S. manufacturing sector, in many ways, exemplifies the progress the corporate sector has made as the economy has emerged from recession into recovery. The Institute for Supply Management's Manufacturing Index has recovered nicely to a recent 59 from lows of about 40 amidst the depths of the recession in 2001. Some commodity-based industries, including steel, cement and coal, have capitalized on the huge demand for such products as China, India and other emerging markets build out their infrastructure at a breakneck pace. Similarly, industrial production and capacity utilization have rebounded from lows reached in 2001 and 2002. Capacity utilization, as measured by the Federal Reserve Board, has increased steadily to over 77% from a low of 74% in mid-2003. However, capacity utilization remains below the 35-year average of 81%, a sign that excess capacity remains in some industries.





A key question heading into 2005 is what U.S. companies will decide to do with the huge cash hoards they have built up as the economy has recovered while managements have kept a tight rein on expenses. According to Morgan Stanley, cash and equivalents on the balance sheets of non-financial companies in the S&P 500 components (excluding financial services companies) hit 10.5% of assets in the third quarter of 2004, having risen since the recession's end to significantly exceed the average of roughly 6% since 1986 (see chart on following page). Now, many companies are deciding whether to continue to focus on improving their balance sheets; increasing dividends and buying back their own stock; or using their excess capital to be more aggressive in pursuing acquisitions and other strategic initiatives.



Source: Morgan Stanley Research

Blue chip U.S. companies employed both strategies late in 2004. On the one hand, the record one-time $32 billion dividend paid by Microsoft Corp. in December, along with dividend increases from the likes of General Electric and Boeing, showed the buying power that can be unlocked when companies are disciplined in their focus on returning excess capital to shareholders. At the same time, a flurry of M&A announcements in December and January—Proctor & Gamble's acquisition of Gillette, SBC's bid for AT&T, Sprint's acquisition of Nextel, and Johnson & Johnson's buyout of Guidant, to name the largest but not the only examples—hinted that the industry-transforming transactions that seemed to be forgotten as the economy recovered had merely been put on a shelf for a few years, waiting for a better stock market and removal of uncertainties, such as the presidential election.

The corporate sector can alleviate some pressure should consumer spending falter. However, there are two dynamics at play that are important to consider. First, consumer spending accounts for approximately two-thirds of GDP and ultimately supports much of the corporate sector. Thus, the overall economy could be hurt if consumer spending falters, even if corporations take up some of the slack. Second, a greater portion of corporate profits are being generated from financial services—not just banks, thrifts, brokers and the like, but companies such as General Electric, GM and Ford that now generate considerable profits from their financial services units. Financials now generate approximately 40% of corporate profits, the highest level ever. As we have discussed before, financial services earnings are closely linked to the health of the U.S. consumer and the level of interest rates, so a decline in consumer spending and/or a substantial rise in rates would have substantial ripple effects in the corporate world.

Capital Markets

As we have stated in past *Industry Updates*, the capital markets are, in a sense, the gas station for an economy. The capital markets provide cash, through equity and debt underwritings, that companies need to expand and grow. To continue this analogy, the gas flowed pretty steadily in 2004, with strong increases in IPOs, secondary equity issuances and debt underwritings more robust than many had expected, and healthy equity mutual fund flows.

U.S. IPO volume in 2004 totaled $73 billion, far exceeding the total of $41 billion to $44 billion raised in each of 2001 and 2003, and within reach of the record volume of $76 billion raised in 2000, according to Thomson Financial. Similarly, total U.S. equity underwriting in 2004 was $203 billion, 30% ahead of the previous year's pace. While the forward pipeline for filed equity deals has inched down since mid-2004 as deals have been completed, a wave of new deals has started to come to market in January as issuers and financial sponsors tried to take advantage of the market rally in late 2004.

On the debt side, total U.S. underwriting volume of $2.7 trillion was off 3% year-over-year, but far exceeded the 10-20% declines from 2003's record level forecasted by many. Debt underwriting volumes notched three consecutive record years as interest rates fell in 2001 through 2003 (topping out at $2.7 trillion in 2003), leading analysts and some debt underwriters to project the rising interest-rate environment would deter issuers in 2004. However, the increased diversity of the asset-backed securitization markets, coupled with companies' interest in locking in interest rates still low by historical standards, ensured a fourth year of volumes greater than $2 trillion.

Mergers and acquisitions activity bounced from trough levels in 2001 to 2003, but remained well below levels reached in the late 1990s and 2000. U.S.-announced M&A volume totaled $782 billion in 2004, up substantially from $474 billion in 2003, according to Thomson Financial. The 2004 total still lags the $1.5 trillion to $1.7 trillion in M&A volume announced each year from 1998 to 2000, a total of more than $6.4 trillion over the three-year period. However, M&A announcements typically lag recoveries in stock prices, and, as noted above, several large recent deals (capped by the $55 billion acquisition of Gillette by Proctor & Gamble announced in late January) showed that transaction volumes can pick up quickly.

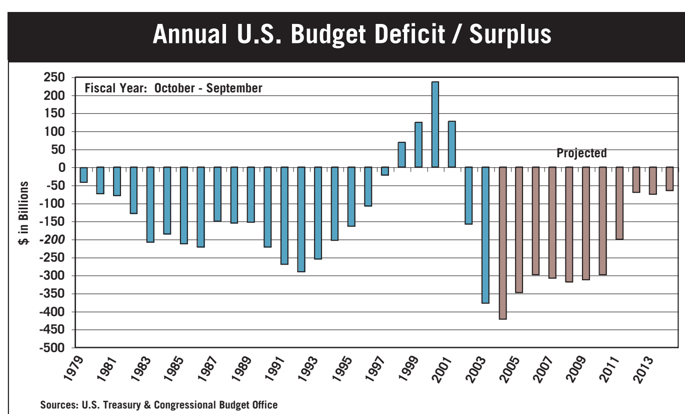
Following the market rebound in 2003, equity fund flows were strongly positive in 2004. Equity mutual funds drew net new cash flows of $168 billion through November (the latest data available), up 22% from $138 billion in the same period in 2003, according to the Investment Company Institute. Investors appeared to be increasing their equity exposure at the expense of fixed-income vehicles. Bond funds experienced outflows of $11 billion through November, reversing three consecutive years of inflows as rates fell.

Given that the capital markets benefit from corporate activity, we see healthy corporate balance sheets as positives for the outlook in 2005. However, financial companies have represented a significant chunk of overall capital markets activity in recent years given some of the trends we have discussed. Needless to say, given our earlier discussion, we think financial services companies could face a tougher environment in 2005, reducing their demand for expansion capital. Signs of increased speculative activity in the post-election rally late in 2004 also are a sign that a pullback may be in order. For instance, high-yield bond issuance in 2004 exceeded the prior record reached in 1998, and high-yield bond spreads (a measure of the additional return investors require for the increased credit risk of junk bonds) dipped to record lows. The proportion of debt rated triple C — one notch above default levels — rose to 17.1% from 8.7% in 2003, according to Deutsche Bank. It is important to appreciate that, while the underwriting environment has been robust over the past 20 months and remains so today, the capital markets can be extremely fickle, and underwriting windows can close as quickly as they open.

Government

Ironically, the unprecedented amount of government stimulus that has led to potentially unsustainable values in the real estate and financial markets was designed to respond to the recession created by the collapse of the Internet bubble early this decade. The monetary stimulus began in 2001, when the Federal Reserve started to reduce the target federal funds rate from its level of 6.5%. By the end of 2001, a series of 11 cuts had reduced the rate to 1.75%. With economic growth remaining sluggish throughout 2002 and the first half of 2003, the central bank cut rates twice more, in November 2002 and June 2003, resulting in a 45-year low for fed funds of 1.0%. The Fed also grew its own balance sheet starting in late 2002, buying Treasury securities in the open market and injecting liquidity into the financial system in an attempt to stimulate lending and capital markets activity. The federal government added to the stimulus with its spending and tax policies. Total federal spending increased nearly $300 billion in fiscal 2002 and 2003, with increased defense and homeland security accounting for a large portion of the increases. On the other side of the ledger, two of the largest tax cuts in history were passed in 2001 and 2003, lowering a wide range of taxes on income, dividends and capital expenditures.

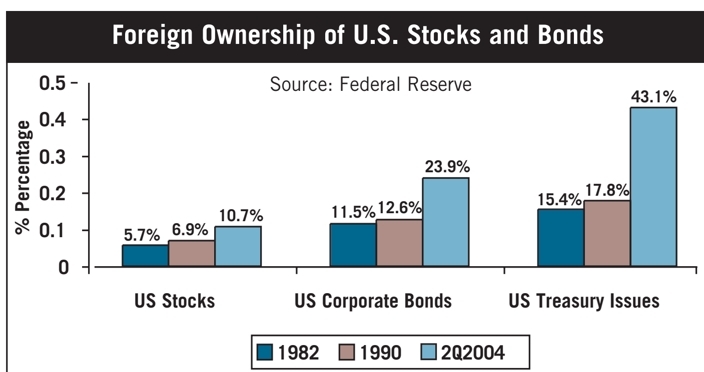
The combination of greater spending and reduced tax receipts led to soaring federal budget deficits. The federal budget, which registered surpluses in the late 1990s (granted, these figures were likely inflated by higher-than-normal tax receipts from an overheated economy), grew to a deficit of $158 billion in fiscal 2002, $375 billion in fiscal 2003, and now stands at a record $422 billion. The federal budget is expected to remain in deficit for at least the next decade, with the cumulative shortfall for the next 10 years forecasted to total more than $2.2 trillion (see below). In late January, the White House estimated that the fiscal 2004 deficit would rise to a new record of $427 billion, driven in part by an additional $80 billion spending request for the wars in Iraq and Afghanistan.



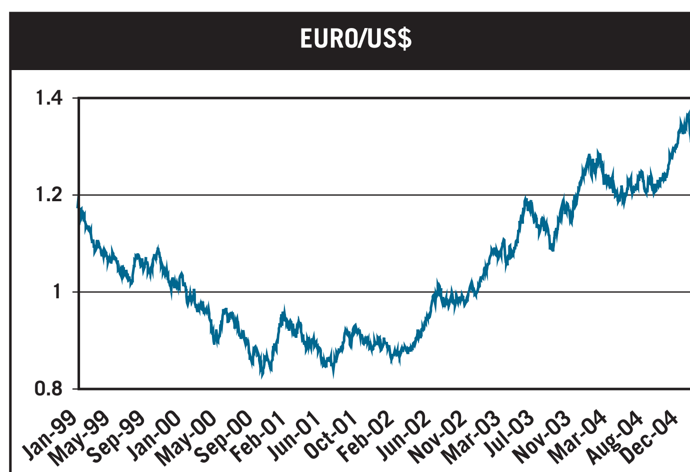
The federal government has run substantial budget deficits through prior periods of economic growth, most notably the 1980s. However, we think the risks are greater this time around for two reasons: demographics and the current U.S. dependence on foreign investors. The retirement of the Baby Boom generation—the first of which, born in 1946, will hit age 65 in just six years—will increase the burden on Social Security and Medicare at the same time that the number of workers contributing to the programs is declining. President Bush has placed Social Security reform at the top of his list of initiatives for his second term. However, the market-based initiatives the President favors—most notably, allowing participants to invest a portion of their Social Security payments in self-directed private accounts—could substantially increase costs of the

system in the short term at a time the federal government can ill afford further deficit increases.

The second major risk of the high deficit spending is the increased dependence on foreign capital. Because the U.S. savings rate is essentially zero, foreign investors—particularly central banks—have become major financiers of the U.S. deficit. Central banks of Asian countries that are major exporters to the U.S, such as Japan, China, Taiwan and South Korea, have purchased billions of U.S. government bonds and other dollar-denominated assets. The foreign governments have supported the U.S. dollar in an effort to keep their currencies competitive versus the dollar and make their exports more attractive to U.S. buyers. As a result, foreign ownership of U.S. treasuries has increased from 15% in 1982 to 43% in mid-2004, according to the Fed (see below). This phenomenon was exacerbated by the rise in oil prices in mid-2004. Oil-rich countries such as Russia took the unanticipated windfall from their oil exports and plowed the proceeds back into the safety of U.S. treasuries, keeping U.S. bond yields lower than would typically occur at a time when the Federal Reserve is raising rates.



This symbiotic relationship has benefited both the U.S. (in the form of expanded borrowing capacity and lower interest rates) and its overseas partners (in the form of competitive currencies that help their exporters) in the short term. However, in the mid- to long-term, these structural imbalances create substantial risks for the global financial system. A sign of this is the decline in the U.S. dollar relative to foreign currencies. Since mid-2001, the dollar has fallen more than 50% against the euro, which hit a record 1.37 to the dollar in late 2004 (see below). The dollar declined in a similar, albeit less dramatic, fashion against many other foreign currencies. Should foreigners begin to question the structural health of the U.S. economy, the Federal Reserve could be forced to raise interest rates at a faster pace than the "modest" increases it has favored in the tightening cycle so far to continue to attract investors to U.S. financial assets.



In Warren Buffett's most recent Annual Report to Berkshire Hathaway shareholders, he revealed that the company held $20 billion in foreign currency contracts. "In 2002, we entered the foreign currency market for the first time in my life, and in 2003 we enlarged our position as I became increasingly bearish on the dollar," Buffett wrote. What worries Buffett is a loss of confidence in the U.S. by foreign investors. He recently told Forbes magazine, "If lots of people try to leave the market, we'll have chaos because they won't get through the door."

A recent positive development for the dollar is President Bush's apparent new willingness to constrain government spending. If he were to forcefully hold his ground on his new budget, which calls for zero growth in non-discretionary spending, and vetoes any pork-laden bill (unfortunately, to date, no spending bill has been vetoed in his presidency) the dollar could strengthen. Any movement toward budget deficit control would help support the dollar, particularly against the euro. Obviously, though, federal spending cuts do put a drag on the economy.

An increase in U.S. exports could also help to increase demand for the dollar and alleviate the pressures that could be caused by a crisis of confidence by foreign investors in U.S. financial assets. However, the U.S. has already lost much of its manufacturing capacity to countries with lower labor costs, resulting in a steadily increasing trade deficit. In early January, the U.S. Department of Commerce reported that the trade deficit hit a record $60.3 billion in November (latest data available), with exports falling to the lowest level since June 2004. In the first 11 months of 2004, the

trade deficit has totaled $561 billion, ahead of the previous record of $497 billion in 2003 (see below).

The result of a weaker dollar is that the cost of imported products rises in dollar terms, which impacts U.S. inflation. This is not to say that a weaker dollar would not help the payments deficit. It will, marginally, if U.S. exports rise, as they are now cheaper to foreigners. But, in the end, a weaker dollar cannot solve the basic problem of our cost disadvantage relative to the developing world.

Thus, what happens in the developing world, and most importantly, China, will have a large impact on our domestic economy. As discussed above, with Asian countries buying such a large percentage of our treasury debt, we have become more inter-linked with those economies. In particular, China has had a significant impact already on the world and U.S. economies. To date, it has been a mixed blessing to the U.S. economy. Obviously, it has made manufactured goods cheaper and has been a boost to world economic growth. Conversely, China has stripped the U.S. of its manufacturing base, has not upheld intellectual property and copyright laws, and has pegged its currency to the dollar, which has contributed significantly to some of the structural imbalances discussed above. China now holds hundreds of billions of dollars of U.S. treasuries and its future appetite for those securities and its economy's growth rate will have a significant influence on the U.S. economy for years to come. This should cause U.S. policymakers, business people and citizens concern given that China is a non-democratic government that aspires to be a superpower in its own right.

As in the consumer and real estate sectors, government finances are in a precarious position. Government policies over the past six years have played a key role in the creation of the current structural imbalances and heightened asset valuation levels; this could be a significant impediment to the unwinding of both in a reasonable manner and timeframe. Unfortunately, the federal government's finances are in worse shape than at almost any time in our history and, certainly, as compared to their condition in prior rate-tightening cycles. We see the record-high budget deficit, along with the increasing trade and current-account deficits, tying the government's hands should economic conditions detoriorate.

Outlook for 2005

As highlighted by the above discussion, real estate values and some sectors of the U.S. economy have become increasingly vulnerable to rising interest rates. While the Fed appears to be targeting a "Goldilocks" rate environment—not too high to stunt economic growth, but not too low to spark inflation—U.S. dependence on foreign capital has lessened the Fed's ability to control interest rates and severely limited its options to provide additional stimulus should economic conditions stagnate. High federal budget deficits, so-so jobs growth, steady inflation of real estate values and increased use of leverage to extract wealth from those higher-valued assets have left the financial sector and the economy with little firepower to use against a variety of potential shocks.

In conclusion, we head into 2005 concerned that the government-led remedies for the recession that began early this decade have created numerous difficult challenges for the U.S. economy. We believe the economy has enough steam to maintain solid economic growth through the first half of 2005. However, as we move into the second half of the year, we believe the weight of rising rates, withdrawn stimulus and structural imbalances could cause economic growth to stagnate. What will happen to the dollar? Can consumer credit hold up? Can housing prices climb still higher? Can the federal government address its deteriorating financial condition? Will cash-rich corporations ride to the rescue, spurring the economy by purchasing new equipment and hiring new employees? We'll be back in January 2006 with a progress report on these important issues.

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