

# UBS Investment Research

## US Economic Perspectives

**October 3, 2003**
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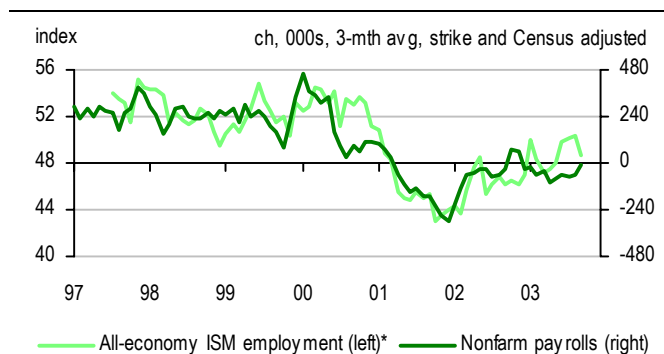
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■ **Encouraging labor data.** The precise degree of strength in third quarter real GDP is still unclear, but most people agree that it was a strong quarter. We have been estimating third quarter growth at a 4.5% annual rate, and, if anything, the data have suggested upside risk to that estimate. The focus has turned to sustainability rather than magnitude however, on the basis that much of the strength reflected a one-time boost from the latest tax cut and an easing of geopolitical anxiety. The job market has become a focal point on the issue of sustainability. On that score, the September employment report was at least somewhat encouraging, with payrolls reported up 57,000. Given the volatility in payrolls, one month should never be taken too literally, but some improvement is credible. Notably, there has been a clear pickup in the employment indexes in the Institute for Supply Management (ISM) surveys and the hiring plans index in the National Federation of Independent Business (NFIB) survey of small businesses. **3**

■ **Deficit: Less than feared—now.** Preliminary data suggest the deficit was smaller than expected in fiscal 2003, at around \$380 billion or 3.5% of GDP. We do not believe the surprise was the result of a shrinking cyclical deficit, however. And the structural deficit is still expanding. Thus, we still expect the fiscal 2004 deficit to total at least \$500 billion (4.5% of GDP). **7**

■ **The week ahead.** Jobless claims will be assessed in coming weeks for corroboration of the improvement in payrolls in September. **11**

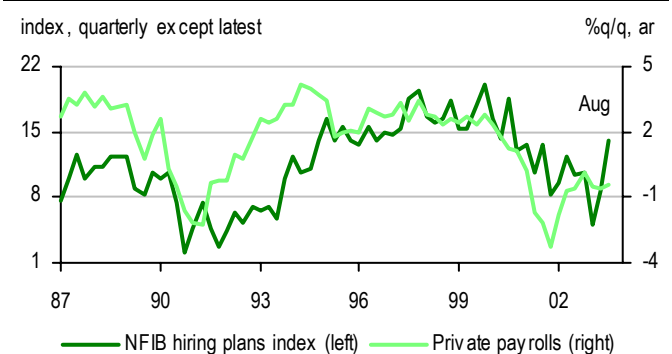
**Some improvement in the trend in employment has been signaled by the ISM employment indexes. (The indexes have an empirical break-even level of around 48, below the theoretical mark of around 50.)**



\* A payroll-weighted average of the manufacturing and non-manufacturing ISM employment indexes

Source: Institute for Supply Management and UBS

**Small business hiring plans show a clear pickup.**



Source: National Federation of Independent Business and Bureau of Labor Statistics

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## Encouraging Labor Data

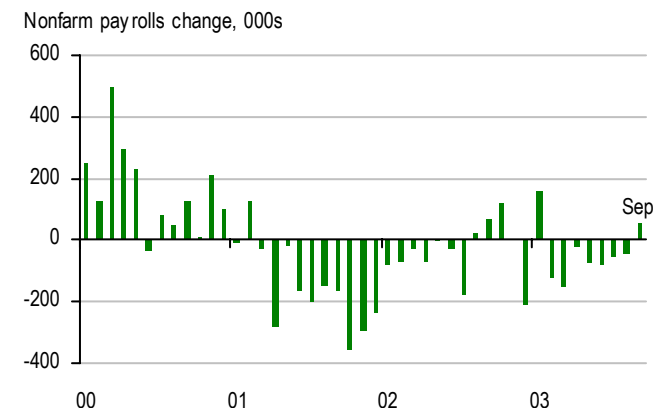
The precise degree of strength in third quarter real GDP is still unclear, but most people agree that it was a strong quarter. We have been estimating third quarter growth at a 4.5% annual rate, and, if anything, the data have suggested upside risk to that estimate—particularly the consumer spending portion. The focus has turned to sustainability rather than magnitude however, on the basis that much of the strength reflected a one-time boost from the latest tax cut and an easing of geopolitical anxiety. Our view has been that the booming pace would not be repeated, but the net result would still be a sustained pickup relative to the 2.7% growth rate averaged in the first six quarters of the recovery (from the first quarter of 2002 through the second quarter of 2003). This is still our view. We forecast a 3.5% rate of growth in real GDP in fourth quarter 2003 and 3.6% on average in 2004 (fourth quarter to fourth quarter). Moreover, we expect that net pickup to be reflected in increased hiring in coming months.

**Q3 GDP surge unlikely to be repeated, but net result should be a sustained pickup**

The job market has become a focal point on the issue of sustainability. On that score, the September employment report was at least somewhat encouraging, with payrolls reported up 57,000 in September and August's decline revised down to 41,000 from 93,000. Given the volatility in payrolls, one month should never be taken too literally, but some improvement is credible. Notably, there has been a clear pickup in the employment indexes in the Institute for Supply Management (ISM) surveys (particularly the non-manufacturing survey) and the hiring plans index in the monthly National Federation of Independent Business survey of small businesses. And hiring of "temps" has picked up in recent months—potentially a leading indicator of more permanent hiring. The unemployment rate stayed at 6.1% in the September report, down from the recent peak of 6.4%; this also suggests some improvement in labor markets. Even a flat trend in the unemployment rate usually requires some employment growth to offset labor force growth.

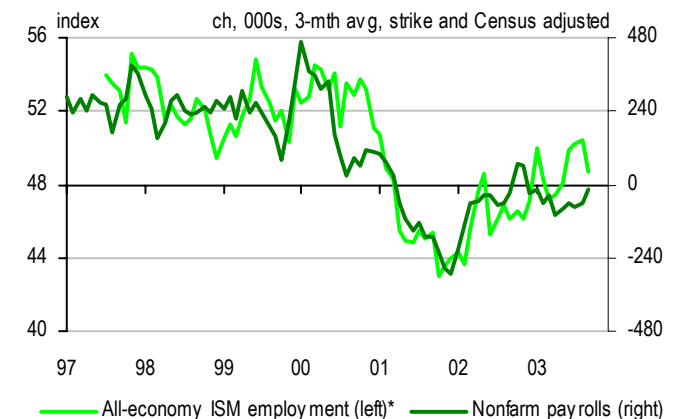
**Some positive signs in labor market data**

**The 57,000 rise in payrolls in September was the first positive number since January 2003. One month hardly makes a trend, but improvement is more credible this time.**



Source: Bureau of Labor Statistics

**Some improvement has been signaled by the ISM employment indexes, even with a dip in September. (The indexes have an empirical break-even level of around 48, below the theoretical mark of 50.)**



\* A payroll-weighted average of the manufacturing and non-manufacturing ISM employment indexes

Source: Institute for Supply Management and UBS

Of course, there are plenty of counter-arguments. As noted, one month hardly makes a trend. And, at around 400,000 per week, jobless claims have yet to show decisive improvement. They are down from their recent peak, however—the four-week average was as high as 447,000. Also, as important as we believe the claims data to be, they are not infallible. In the early 1990s, payrolls started to pick up in mid-1992, yet claims did not show a decisive decline until the fourth quarter of 1992. That said, a pickup in payrolls is unlikely to extend very far without more corroboration from claims before long.

**Some caveats: just one positive month, and claims are still high**

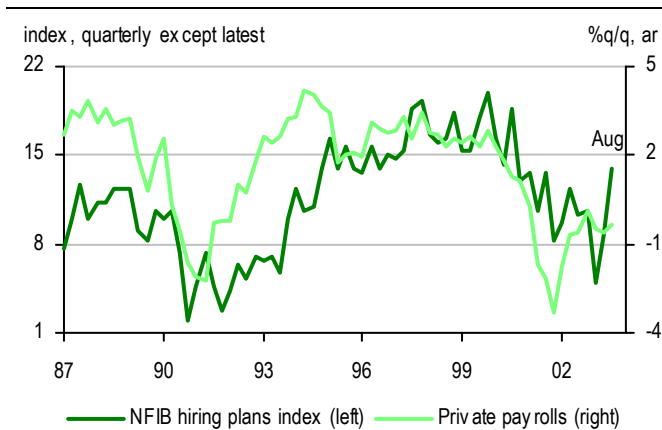
The lack of a precise relationship between net employment growth and claims reflects the partial information in claims. In effect, claims measure gross layoffs in the economy, but net employment growth also depends on gross hiring. The magnitude of such hiring and firing is evident in the new report on such flows just released by the Bureau of Labor Statistics (BLS). (See chart on following page.) Unfortunately, the data are only available through December 2002, so they are not very useful as a timely supplement to the claims data. Through December 2002, the data show a sharp decline in gross layoffs in 2002, but no pickup in new hiring.

**Jobless claims capture layoffs; net employment growth also depends on new hiring**

Most of the pickup in payrolls in mid-1992 was not evident at the time. Instead, it showed up in a revision much later. Upward revisions to initially reported payroll data have become the norm for early recovery periods, with the payroll survey typically undercounting employment growth from new business formation—the monthly data are based on a sample; with a lag, the BLS gets more complete records for each March and then “rebenchmarks” the data. Given that history, the announcement by the BLS that the preliminary estimate of the March 2003 benchmark revision was down 145,000 was a surprise, especially given the relatively stronger household survey employment data recently. Of course, it is possible that more recent payroll data (since March 2003) have been undercounted. That is the message from the dip in the unemployment rate, although we are reluctant to take that decline as the start of a downtrend until we see corroboration in the job market perceptions components of the Conference Board’s confidence survey. A similar decline in mid-1992 was corroborated by the Conference Board survey at the time.

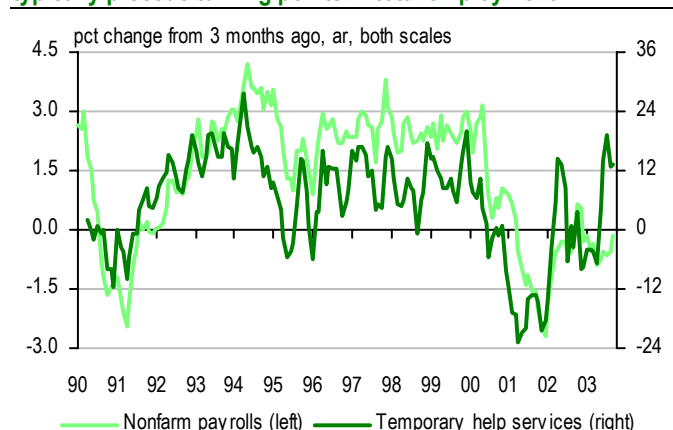
**Dip in unemployment rate raises possibility that payrolls have been undercounted, notwithstanding March 2003 benchmark revision announcement**

**Small business hiring plans show a clear pickup.**



Source: National Federation of Independent Business and Bureau of Labor Statistics

**“Temps” hiring has picked up. Turning points in temps typically precede turning points in total employment.**



Source: Bureau of Labor Statistics

All told, there is no evidence yet that the labor market has picked up decisively. Enough positive signs exist for us to be encouraged, however. We expect the signs of improvement to build gradually in coming months.

**Net net: labor data are mixed, but somewhat encouraging**

On the surface, much of the other September data released during the past week raised the possibility that demand slowed sharply before any pickup in hiring became a trend—indeed, that the slowing began before the third quarter ended. There were declines in the chain store sales indexes, auto sales, consumer confidence, and both Institute for Supply Management (ISM) surveys. The data need to be put in perspective, however. Given the degree of strength through August, some payback was probably inevitable.

**Weakening in other data in September can be discounted as payback for July/August surge**

Through August, real consumption for the quarter to date was up 7.6% at an annual rate from the second quarter average. Meanwhile, the expectations component of the Conference Board's consumer confidence survey, the part that correlates most closely with spending, is at a level typically associated with about a 3% trend in real consumption growth—far from the booming pace of spending in July and August, but hardly suggestive of a collapse. Confidence should move higher if the job market is finally improving.

**Consumer expectations remain high enough to be consistent with about a 3% trend in real consumption growth**

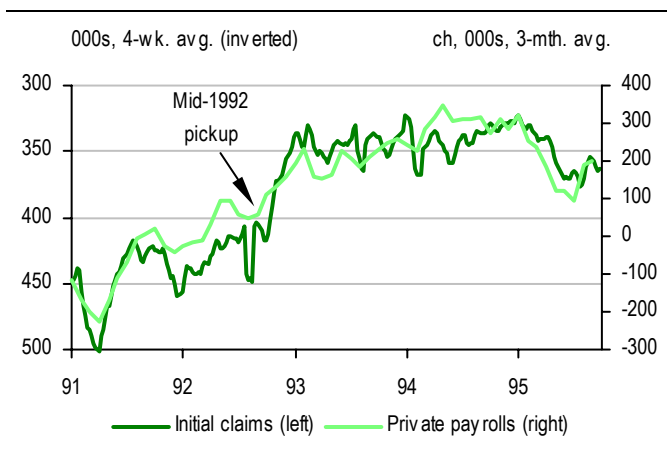
The performance of the job market will be especially important for the consumer sector. Consumer spending is not the only part of the economy, however. And while the consumer sector has been key to respectable GDP growth thus far in the recovery, business investment has shown clear signs of improvement recently, consistent with stronger profits.

**Capex is improving, lessening reliance on the household sector**

Although orders for nondefense capital goods excluding aircraft were reported down 1.1% month over month in August, the third quarter to date still shows a solid 7.9% annual growth rate. That follows an 8.7% growth rate in the first half of the year (second quarter 2003 versus fourth quarter 2002).

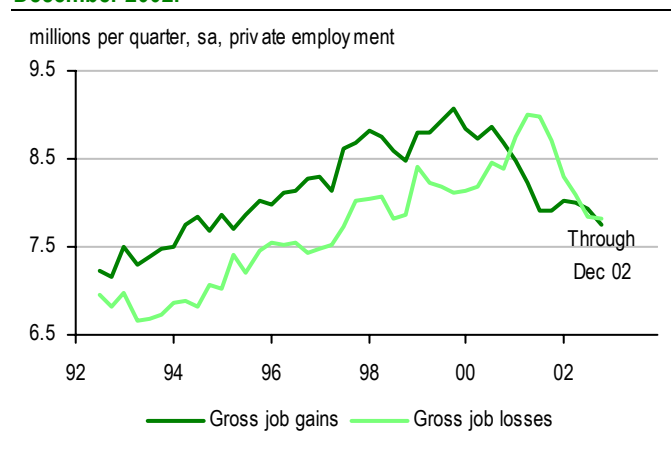
**Capital goods orders rising at about an 8% annual rate**

**Jobless claims lagged slightly the pickup in employment in mid-1992.**



Source: Department of Labor

**A new BLS data set shows a fading of layoffs but no pickup in hiring. Unfortunately, the data are only available through December 2002.**



Source: Bureau of Labor Statistics

More broadly, the orders index in the manufacturing Institute for Supply Management survey continued to climb in September—to 60.6 from 59.6 in August—even as the overall ISM index fell a little—to 53.7 from 54.7. That overall level was still more than two points higher than the 51.3 level averaged in the first six quarters of the recovery (when real GDP growth averaged a 2.7% pace). According to ISM officials, a 53.7 reading for the index is typically associated with about a 4% trend in real GDP growth.

**Manufacturing ISM index down in September, but still strong enough to be consistent with 4% trend in real GDP growth**

The same interpretation applies to the non-manufacturing ISM survey, which shows a net pickup, even with some cooling in September. At 63.3, the business activity index was down from August's record high of 65.1, but it was well above the 54.6 averaged in the first six quarters of the recovery. Our estimated all-economy ISM index, which combines the manufacturing and non-manufacturing surveys, was 56.1 in September, down from 58.7 in August but up from 51.9 in the first six quarters of the recovery.

**Non-manufacturing survey also shows a net pickup**

All in all, we remain comfortable with our forecast that real GDP will be able to sustain at least a 3.5% trend in coming quarters—i.e., down from the third quarter, which was boosted by a fading of geopolitical anxiety and the latest tax cut, and modest by past recovery standards, but still representing a new, stronger phase of this recovery. That new phase should include at least gradual improvement in the labor market in the coming months and quarters.

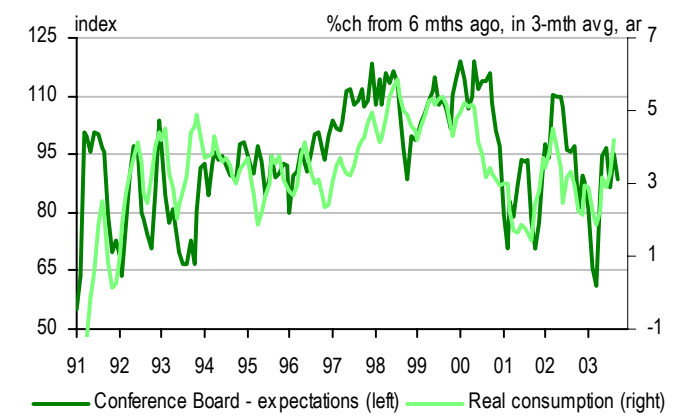
**The next phase of the recovery should include better job market**

**The dip in the unemployment rate in the last few months has not been corroborated by the Conference Board's confidence survey—in contrast to the turning point in 1992.**



Source: Conference Board and Bureau of Labor Statistics

**The expectations part of consumer confidence is high enough to be consistent with about a 3% trend in real consumption growth.**



Source: Bureau of Economic Analysis and Conference Board

**James O'Sullivan**

# Deficit: Less Than Feared—Now

The federal fiscal year (2003) has just ended. Based on limited preliminary data, we believe the deficit came in at around \$380 billion, or 3.5% of GDP. That total would be more than double the 2002 deficit (1.5% of GDP). Still, it would be well below expectations. The Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) last summer projected deficits of \$455 billion and \$401 billion, respectively.

**The fiscal 2003 deficit came in on the low side of forecasts**

## Summer deficit estimates were too pessimistic for fiscal 2003.

\$, Billions	Estimate			Deviation from Oct. 1 UBS estimate	
	Deficit	Receipts	Outlays	Receipts	Outlays
<b>UBS October 1 estimate</b>	380	1782	2162	0	0
<b>OMB Mid-session estimate</b>	455	1756	2212	-26	50
<b>CBO Summer estimate</b>	401	1770	2170	-12	8

Source: Office of Management and Budget, Congressional Budget Office, and UBS

This good news on the budget could continue if it derived only from unexpected strength in income and in turn, receipts. After all, the deficit has a significant cyclical component, which should shrink as the recovery gathers momentum. In particular, receipts should reaccelerate and spending on jobless pay should sink.

**An improvement in the cyclical component of the deficit could sustain the good news**

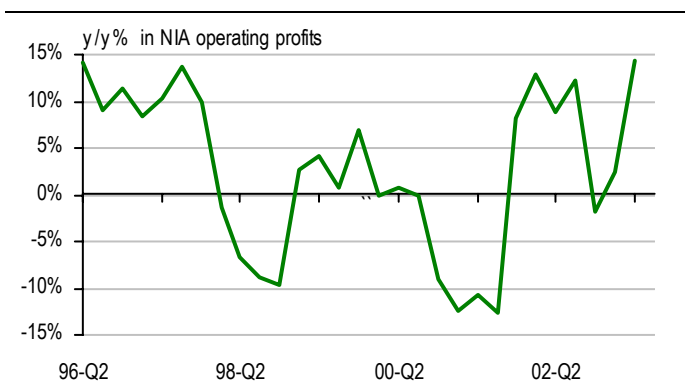
Receipts in fact accounted for 60% of the CBO's error and about one-third of the OMB's error. Moreover, with corporate profits reviving and equities generating broad-based capital gains for the first time since 1999, the deficit should be improving on cyclical grounds. The reversal in the stock market is particularly important because a plunge in capital gains realizations and options income was pivotal in the disappearance of budget surpluses.

**A stronger stock market and faster growth should help reduce the cyclical deficit**

So far, however, it is hard to discern much cyclical improvement in tax collections, as the charts below indicate. The problem is that the rise in corporate profits is relatively new and corporate taxes respond with a lag. At the

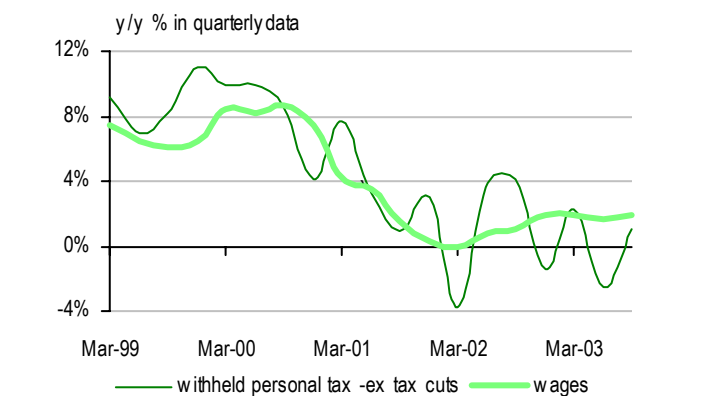
**So far, evidence of cyclical improvement in receipts is scarce**

## Profits have turned cyclically higher.



Source: U.S. Treasury and Bureau of Economic Analysis

## Wage growth has not yet reaccelerated, as hiring stays subdued.



Source: U.S. Treasury and Bureau of Economic Analysis

same time, wage and salary growth has not yet reaccelerated, although Friday's report of renewed hiring lends hope that wage gains and tax receipts will soon quicken. Finally, numerous tax cuts have short-circuited any cyclical rebound in tax collections. In particular, the May 2003 tax cut will not play out fully until next spring.

We believe the recent shortfall in spending is on shakier grounds than the overshoot in receipts. While we expect the stronger economy and stock market to eventually trim the budget gap by lifting taxes, we have less cause to hope that overall spending will stay unexpectedly low.

To be sure, the most cyclical component of spending looks close to stabilizing. The total number of people collecting jobless pay is scarcely growing now and federal unemployment benefits appear to be peaking (see charts below). However, other spending still appears to be growing faster than GDP, pointing to a further widening in the structural deficit.

The defense budget highlights this problem. The fiscal 2003 spending errors were concentrated in the defense budget, which accounted for nearly all of the CBO's spending error and about half of the OMB's overshoot. The Defense Department has not ramped up spending in Iraq as rapidly as it originally projected. Indeed, defense spending in fiscal 2003 was only about \$15 billion higher than the Administration estimated in mid-2002—before the Iraq invasion was incorporated into the budget. That \$15 billion increase compares with roughly \$60 billion that Congress approved in April to fund the war.

Now, the Administration is requesting about another \$70 billion of defense funding to stabilize Iraq. While it may not spend all of these funds in fiscal 2004, as occurred this year, it likely will ratchet up defense spending substantially faster than the economy is likely to expand. That growth mismatch points to a widening structural deficit in the new fiscal year.

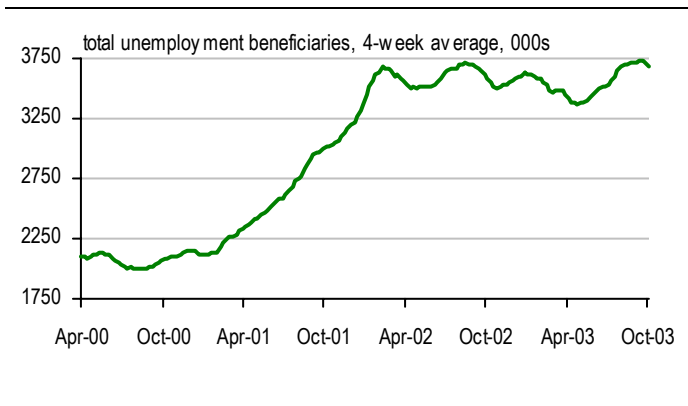
**Spending is less likely to surprise on the low side next year**

**The most cyclical federal spending seems to be peaking**

**And defense spending has not kept pace with predictions**

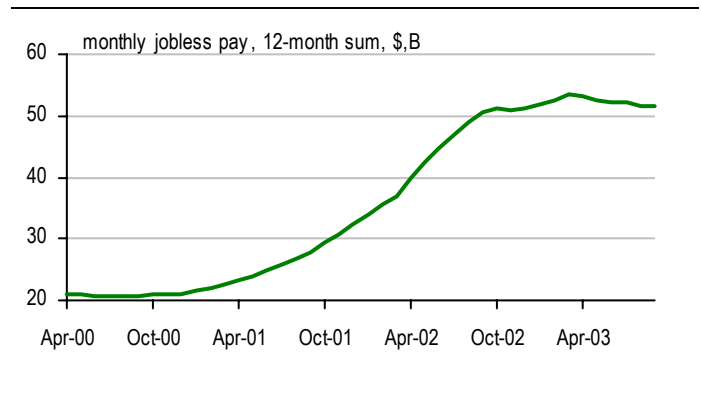
**But spending requests for Iraq continue to signal that spending will outpace the economy**

**Beneficiaries of unemployment compensation are about flat now.**



Source: U.S. Treasury and Bureau of Economic Analysis

**And jobless pay has stabilized.**



Source: U.S. Treasury and Bureau of Economic Analysis

Congress also is likely to expand nondefense spending faster than GDP will probably grow. If Congress approves the \$20 billion of nondefense funding that President Bush has requested to rebuild Iraq, we expect nondefense discretionary spending to rise more than 10% in fiscal 2004.

**The military budget is not the only culprit**

The bottom line is that the structural deficit is still likely to grow quickly, while the cyclical deficit is improving only slowly. As a result, the deficit looks unlikely to surprise again on the low side in fiscal 2004. We continue to expect a deficit of at least \$500 billion (4 ½% of GDP). A 5-10% overshoot would not surprise us.

**The bottom line is spending is still rising faster than GDP, expanding the structural deficit**

Under these circumstances, the Treasury will need to step up its borrowing. In Q3(03), the Treasury issued about \$22 billion less new debt than it originally planned, keeping pressure off the bill market in particular. Bills outstanding shrank by about \$10 billion last quarter. As the structural deficit continues to expand, pressure on the bill market is likely to intensify. And the Treasury will also likely be forced to boost offering sizes in its newly enlarged coupon offering cycle.

**Treasury borrowing is not likely to repeat its sizable Q3(03) shortfall**

The renewed pressure could emerge as soon as this quarter if Congress quickly approves the President's Iraq request and the Administration spends the money soon. However, we suspect that the spending could be slow to emerge again. Congress is also moving as deliberately as usual on approving nondefense spending authorization legislation. The implication is that Treasury borrowing may not really begin to reflect the bigger projected 2004 budget deficit until sometime early next year.

**The pressure on borrowing is likely to intensify, particularly in Q1(04)**

**Susan Hering**

# U.S. GDP, Interest Rate, and Inflation Forecasts

Seasonally adjusted at annual rates, except where noted, as of 10/3/03, in percent

	2003				2004				Annual change			4Q/4Q change		
	1QA	2QA	3QE	4QE	1QE	2QE	3QE	4QE	2002A	2003E	2004E	2002A	2003E	2004E
<b>Real GDP (Chain)</b>	<b>1.4</b>	<b>3.3</b>	<b>4.5</b>	<b>3.5</b>	<b>3.1</b>	<b>3.3</b>	<b>3.9</b>	<b>4.1</b>	<b>2.4</b>	<b>2.6</b>	<b>3.5</b>	<b>2.9</b>	<b>3.2</b>	<b>3.6</b>
Personal consumption expenditures	2.0	3.8	4.5	3.5	2.7	3.0	3.5	3.5	3.1	3.0	3.4	2.7	3.5	3.2
Durable goods	-2.0	24.3	8.1	3.8	2.5	2.8	5.9	5.9	7.3	6.1	5.3	1.9	8.1	4.2
Nondurable goods	6.1	1.4	5.1	3.5	2.3	3.2	3.2	3.2	3.2	3.7	3.1	3.4	4.0	3.0
Services	0.9	1.4	3.1	3.4	3.0	3.0	3.0	3.0	2.2	1.9	3.0	2.5	2.2	3.0
Fixed investment	-0.2	7.1	4.6	6.4	4.9	5.0	6.7	6.8	-3.1	3.0	5.6	0.6	4.4	5.9
Business fixed investment	-4.4	7.3	6.3	9.6	8.4	8.4	10.6	10.6	-5.7	1.7	8.7	-1.7	4.6	9.5
Equipment & software	-4.8	8.2	7.5	11.5	10.0	10.0	12.0	12.0	-1.7	4.1	10.2	3.3	5.4	11.0
Structures	-3.0	4.2	0.0	0.0	0.0	0.0	2.5	2.5	-16.4	-6.1	0.7	-15.9	0.3	1.2
Residential	10.1	6.6	0.0	-2.5	-5.0	-5.0	-5.0	-5.0	3.9	5.5	-3.2	6.7	3.4	-5.0
Government purchases	0.4	8.5	2.8	2.1	1.2	1.5	2.1	2.1	4.4	3.5	2.3	3.6	3.4	1.8
Federal	0.7	25.5	4.0	4.0	1.7	2.3	2.3	2.3	7.5	8.5	4.0	7.5	8.1	2.2
State & Local	0.2	-0.2	2.0	1.0	1.0	1.0	2.0	2.0	2.8	0.7	1.2	1.6	0.8	1.5
Net exports (\$ bil.)	-510.3	-546.1	-586.6	-598.8	-604.8	-606.7	-610.7	-611.9	-488.5	-560.5	-608.5	-532.2	-598.8	-611.9
Exports	-1.3	-1.0	6.0	6.8	7.9	8.6	9.8	10.6	-1.6	0.9	7.5	3.9	2.6	9.2
Imports	-6.2	8.8	14.7	7.4	6.5	6.0	7.3	7.1	3.7	5.3	7.8	10.1	5.9	6.7
Change in inventories (\$ bil.)	4.8	-17.6	19.9	19.9	28.2	30.7	33.2	35.7	5.2	6.7	31.9	25.8	19.9	35.7
Real domestic purchases	0.6	4.4	5.7	3.7	3.1	3.2	3.9	3.9	3.0	3.1	3.8	3.7	3.6	3.5
Final sales	2.3	4.0	2.7	3.4	2.7	3.2	3.8	4.0	1.8	2.5	3.2	1.7	3.1	3.4
Domestic final sales	1.4	5.1	4.2	3.7	2.8	3.1	3.8	3.8	2.4	3.0	3.5	2.5	3.6	3.4
Net exports contribution (pct pts)	0.8	-1.1	-1.3	-0.2	0.0	0.1	0.1	0.2	-0.6	-0.5	-0.2	-0.8	-0.4	0.1
Inventory contribution (pct pts)	-0.8	-0.8	1.8	0.1	0.4	0.1	0.1	0.1	0.7	0.1	0.3	1.2	0.1	0.2
Nominal GDP	3.8	4.3	5.5	4.3	4.2	4.5	5.2	5.5	3.6	4.1	4.7	4.3	4.5	4.9
<b>Key business indicators</b>														
FRB industrial production index	0.3	-3.8	3.0	5.1	5.2	5.6	7.0	7.3	-0.8	0.1	4.8	1.4	1.1	6.3
Capacity utilization rate (%)	75.2	74.2	74.6	75.2	75.9	76.7	77.7	78.8	75.6	74.8	77.3	75.3	75.2	78.8
Civilian unemployment rate (%)	5.8	6.2	6.1	6.3	6.2	6.2	6.0	5.8	5.8	6.1	6.1	5.9	6.3	5.8
Housing starts (millions)	1.74	1.74	1.75	1.65	1.60	1.55	1.55	1.50	1.71	1.72	1.55	1.74	1.65	1.50
Current account balance (% of GDP)	-5.2	-5.1	-5.5	-5.6	-5.6	-5.6	-5.6	-5.6	-4.6	-5.3	-5.6	-4.9	-5.6	-5.6
<b>Inflation</b>														
GDP Chain Price Index	2.4	1.0	1.0	0.8	1.1	1.2	1.3	1.3	1.1	1.5	1.1	1.3	1.3	1.2
CPI-U*	3.9	0.6	0.4	1.5	1.8	1.9	2.0	2.0	1.6	2.1	1.5	2.2	1.6	1.9
Core CPI-U*	1.3	0.8	1.5	1.6	1.7	1.8	1.9	2.0	2.3	1.5	1.7	2.1	1.3	1.8
PCE Chain Price Index	2.7	0.8	-0.2	0.9	1.1	1.2	1.3	1.3	1.4	1.6	0.9	1.8	1.0	1.2
Core PCE Chain Price Index	0.8	1.1	1.0	1.1	1.2	1.3	1.4	1.5	1.7	1.2	1.2	1.6	1.0	1.3
PPI-finished goods*	9.6	-1.8	2.5	0.0	0.5	1.0	1.5	1.5	-1.3	2.9	0.8	1.0	2.5	1.1
<b>Income indicators</b>														
Average hourly earnings	3.2	2.0	3.0	3.0	3.0	3.3	3.5	3.5	2.9	3.1	3.1	3.1	2.8	3.3
Nonfarm business compensation	4.1	3.8	4.0	4.0	4.0	4.3	4.5	4.5	2.8	3.3	4.1	2.8	4.0	4.3
Employment cost index	5.3	3.4	3.8	3.8	3.8	4.1	4.3	4.3	3.8	3.9	3.9	3.5	4.1	4.1
Real disposable income	1.6	2.6	10.3	0.9	4.9	3.7	3.9	3.9	4.2	2.9	4.2	5.2	3.8	4.1
Saving rate	3.5	3.2	4.5	3.9	4.4	4.5	4.6	4.7	3.6	3.9	4.7	3.7	3.8	4.6
<b>Memo: Nonfarm business productivity</b>	<b>2.1</b>	<b>6.8</b>	<b>3.9</b>	<b>3.7</b>	<b>2.9</b>	<b>2.0</b>	<b>2.5</b>	<b>2.6</b>	<b>5.3</b>	<b>3.6</b>	<b>3.2</b>	<b>4.4</b>	<b>4.1</b>	<b>2.5</b>

\* CPI and PPI are computed on a quarterly average basis.

Source: U.S. Department of Commerce, Federal Reserve Board, U.S. Bureau of Labor Statistics, and UBS estimates

## Interest rates

Percent, as of 10/3/03

	2003				2004				Annual			
	1QA	2QA	3QA	4QE	1QE	2QE	3QE	4QE	2001A	2002A	2003E	2004E
Federal funds rate	1.3	1.0	1.0	1.0	1.0	1.0	1.3	1.8	3.9	1.7	1.1	1.3
3-month T-bill rate (bond-equivalent yield)	1.1	0.9	1.0	1.0	1.1	1.3	1.8	2.3	3.5	1.6	1.0	1.6
2-year government notes	1.5	1.3	1.5	1.7	1.6	1.9	2.3	2.7	3.8	2.6	1.5	2.1
10-year government notes	3.8	3.5	4.0	4.2	4.0	4.3	4.5	4.7	5.0	4.6	3.9	4.4

Note: Quarterly forecasts are for end of period yields.

Source: Federal Reserve Board and UBS estimates

# The Week Ahead

## Weekly Store Sales (C<sup>1</sup>) (Tue, Oct 7)

	% ch, week-to-week	% ch, month-to-month	
	UBS/BTM index	UBS/BTM	Redbook
May		1.0	-2.7
Jun		0.3	0.8
Jul		1.7	0.9
Aug		0.5	1.3
Sep thru 9/27/03		-0.7	-1.3
Sep thru 10/4/03			
Weekly: 9/13/03	-0.3		
9/20/03	-1.8		
9/27/03	-0.4		
10/4/03			

Source: Instinet, Bank of Tokyo-Mitsubishi, and UBS

The store sales indexes are signaling a cooling in nonauto retail sales in September. Meanwhile, the unit auto sales data showed a decline. In both cases, the slowing follows exceptional strength in the first two months of the quarter; the third quarter as a whole still looks strong. The third quarter growth rate in total real consumption likely exceeded the 4.5% annual rate we built into our 4.5% estimate for total real GDP growth.

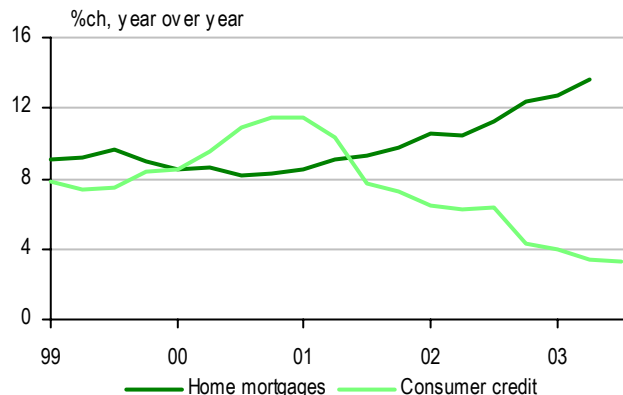
## Consumer Credit (L) (Tue, Oct 7, 3:00 pm)

	History			Aug forecast	
	May	Jun	Jul	Market	UBS
Total (ch, \$bil)	10.8	0.1	6.0	6.0	5.0
%yly	3.8	3.4	3.3		3.2

Source: Federal Reserve Board and UBS estimates

A slowing in mortgage debt because of fewer cash-out refis should lead to somewhat faster consumer credit growth in coming months (consumers have been substituting consumer credit with cheaper mortgage debt). Credit growth was probably still fairly moderate in August, however. A \$5 billion increase represents a 3.4% annual growth rate.

## Households have been substituting consumer credit with cheaper mortgage debt.



Source: Federal Reserve Board

## Mortgage Applications (L) (Wed, Oct 8, 7:00 am)

MBA indexes	Purchase index		Refi index	
	Wkly	4-wk avg	Wkly	4-wk avg
Aug 29	396.1	392.7	1981.5	2536.4
Sep 5	408.8	392.5	2883.6	2447.7
Sep 12	432.4	403.2	2438.5	2368.2
Sep 19	402.1	409.9	2429.7	2433.3
Sep 26	397.8	410.3	2506.8	2564.7
Oct 3				

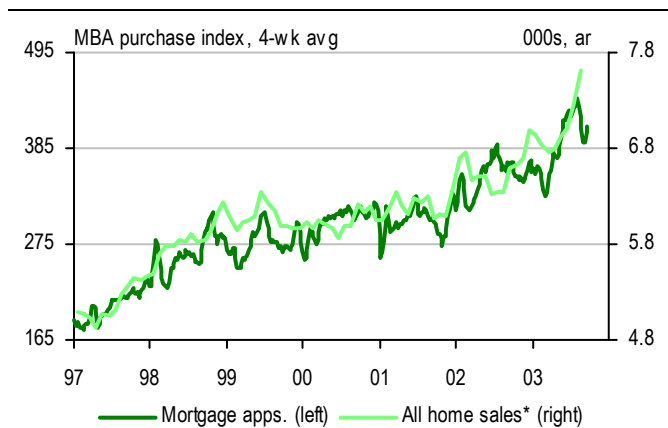
Source: Mortgage Bankers Association

At 410, the four-week average in the mortgage applications purchase index is down from the all-time high of 443 reached two months ago. The level is still high, and there is no sign of a sustained downtrend; however, it does not look high enough to be consistent with the latest home sales data (see chart).

At 2,564, the four-week average in the refi index is down sharply from the peak of 9,257 reached in June. The decline will reduce a source of growth in spending power for households. However, there should be an offset from the turnaround in the stock market and hopefully, more job creation. The refi index averaged 7,016 in the first half of 2003 and 3,388 in 2002.

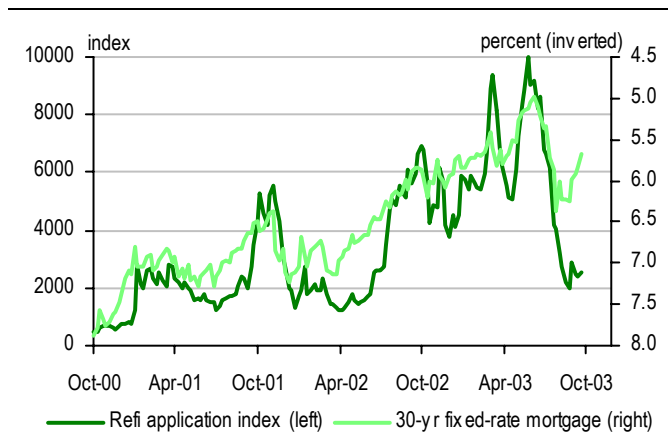
<sup>1</sup> To the extent possible, we identified reports as coincident (C), leading (L), and lagging (Lg) indicators of economic growth. Those labels are typically applied at business cycle turning points, and some reports can have different lead characteristics at peaks and troughs. Also, different parts of the same report can have different characteristics. Our labels are intended to capture tendencies early in recoveries and are analogous to the labels at business cycle troughs. Reports without a clear tendency have been labeled “undetermined” (U).

The mortgage applications purchase index remains high, albeit down from its recent peak. It signals some cooling in home sales.



\*New and existing combined.  
Source: Mortgage Bankers Association, Bureau of the Census, and National Association of Realtors

The refi index has dropped sharply. Mortgage rates have been declining again, although they remain well above June levels.



Source: Mortgage Bankers Association

**Jobless Claims (L) (Thu, Oct 9, 8:30 am)**

	New claims (000s)		Continuing claims	
	Wkly	4-wk avg	000s	%
Aug 30	419	403	3650	2.9
Sep 6	428	409	3648	2.9
Sep 13*	401	411	3611	2.9
Sep 20	386	409	3673	2.9
Sep 27	399	404		
Oct 4 forecast	Market	395		
	UBS	395	395	

\*Sample week for employment report.  
Source: Department of Labor and UBS estimates

The four-week average in jobless claims fell to 397,000 in mid-August from 447,000 in early May. It then rose to 411,000 in mid-September. The last two weeks averaged 393,000. In short, claims have essentially stalled since August. Hopefully, the slight improvement in the last two weeks represents the start of a resumed downtrend.

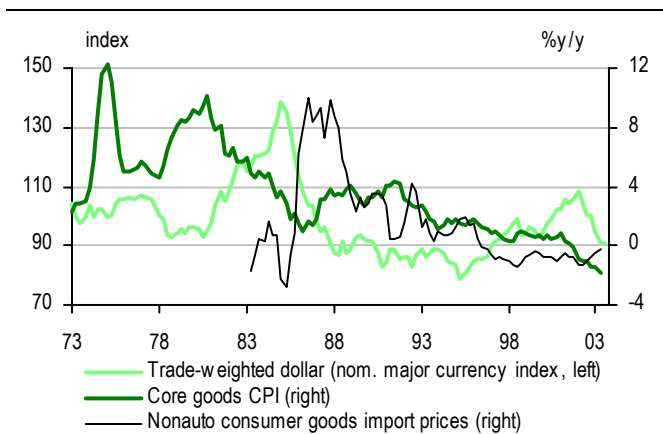
**Import Prices (U) (Thu, Oct 9, 8:30 am)**

	History			Sep forecast	
	Jun	Jul	Aug	Market	UBS
Import prices (%m/m)	0.8	0.5	0.2	-0.2	-0.3
Nonoil	0.4	0.0	-0.2		0.4
Nonauto consumer goods	0.2	0.0	-0.2		
Motor vehicles	0.1	-0.1	0.1		
Import prices (%y/y)	2.1	2.2	2.1		1.1
Nonoil	1.1	1.1	0.8		1.1
Nonauto consumer goods	0.0	-0.1	-0.3		
Motor vehicles	0.6	0.4	0.5		

Source: Bureau of Labor Statistics and UBS estimates

Total import prices have swung from negative 1.3% year over year in August 2002 to 2.1% year over year in August 2003. Most of the swing has come from stronger commodity prices, some of which can be linked to dollar depreciation but most of which can be attributed to stronger demand. More telling for dollar effects, nonauto consumer goods import prices have swung from negative 1.0% year over year to negative 0.1%—i.e., they have largely just stopped falling. The next step should be a net increase.

**Consumer goods import prices have stopped declining, but there is no sign yet of a significant pickup. Import prices picked up sharply when the dollar fell in the mid-1980s.**



Source: Bureau of Labor Statistics and Federal Reserve Board

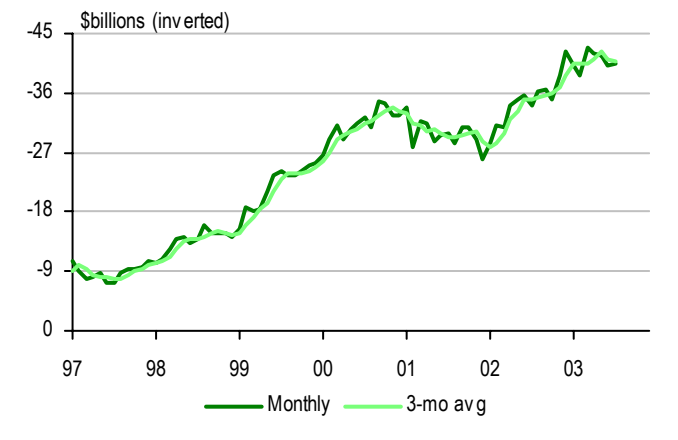
**International Trade (U) (Fri, Oct 10, 8:30 am)**

	History			Aug forecast	
	May	Jun	Jul	Market	UBS
<b>Balance (\$bil)</b>	-41.6	-40.0	-40.3	-41.5	-41.5
<b>Goods</b>	-46.7	-45.1	-45.3		-46.5
<b>Services</b>	5.0	5.0	5.0		5.0
<b>Exports (\$bil)</b>	82.5	84.5	86.1		85.5
<b>Imports (\$bil)</b>	124.1	124.5	126.5		127.0

Source: Bureau of the Census and UBS estimates

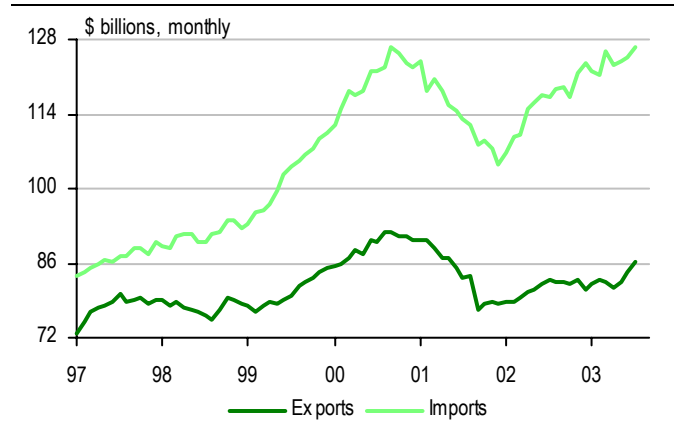
The deficit has been close to flat, on average, since late 2002. Although imports have continued to rise, exports have picked up, including an especially large increase in the last report. Although last month's rise may have been exaggerated, a pickup in the trend had been signaled by the earlier pickup in the Institute for Supply Management (ISM) export orders index (see third chart on right). The improvement could reflect the initial benefits of U.S. dollar depreciation. Exports should continue to trend up, although a reversal of some of last month's surge seems likely in the upcoming report. Meanwhile, imports should be accelerating, as some of the recent surge in consumer spending likely came from inventories. In short, we do not believe the deficit has peaked yet, even with a pickup in exports.

**The trade deficit has been close to flat, on average, so far in 2003.**



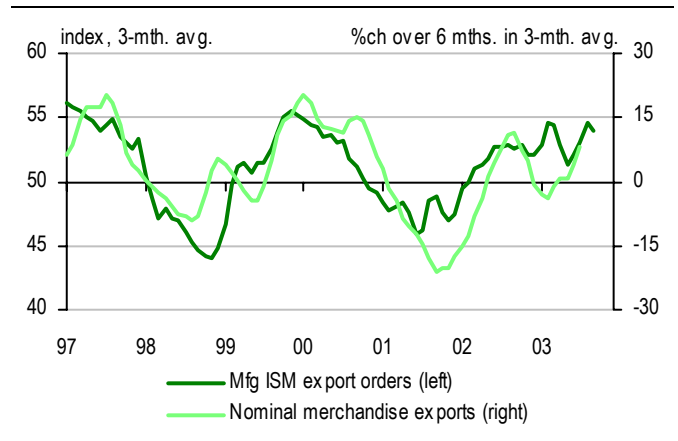
Source: Bureau of the Census

**Exports have been rising.**



Source: Bureau of the Census

**A pickup in exports is consistent with the increase in the manufacturing ISM export orders index.**



Source: Institute for Supply Management and Bureau of the Census

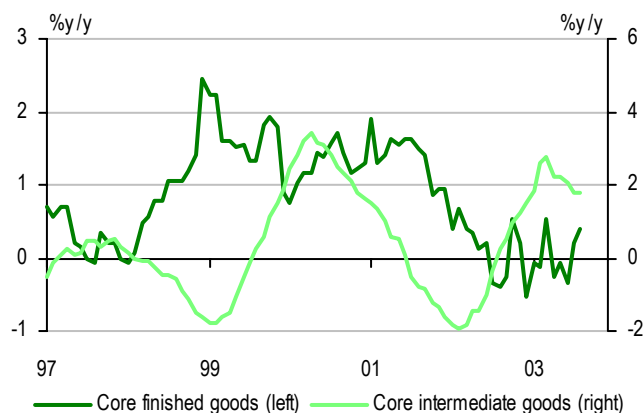
**PPI (L) (Fri, Oct 10, 8:30 am)**

	History			Sep forecast	
	Jun	Jul	Aug	Market	UBS
Finished goods (%m/m)	0.5	0.1	0.4	0.1	0.0
Core (ex food & energy)	-0.1	0.2	0.1	0.1	0.1
Core intermediate (%m/m)	0.0	-0.1	0.1		0.1
Core crude (%m/m)	0.6	0.8	3.7		1.5
Finished goods (%y/y)	2.9	3.0	3.4		3.1
Core (ex food & energy)	-0.3	0.2	0.4		0.2
Core intermediate (%y/y)	2.1	1.8	1.8		1.8
Core crude (%y/y)	4.9	3.9	8.3		10.0

Source: Bureau of Labor Statistics and UBS estimates

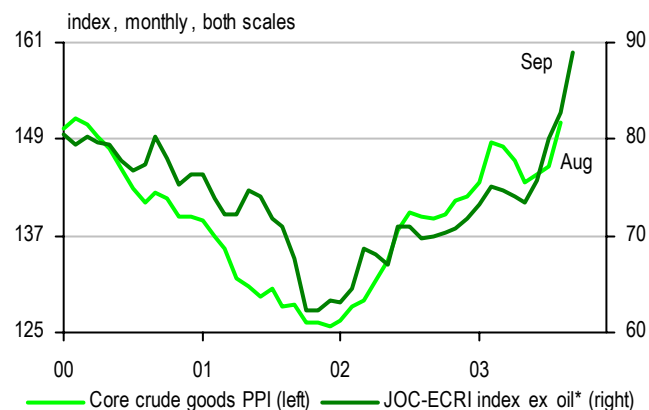
The overall finished goods PPI was probably pulled down by lower energy prices in September; higher food prices should have provided a partial offset. We expect that core finished goods prices matched last month's modest 0.1% increase, although complications relating to seasonally adjusting auto prices raise the potential for an outlier at this time of year. Through the volatility, the trend in core finished goods prices appears to have picked up slightly. At a minimum, the trend toward weakening seems to have ended, consistent with the net pickup in core crude and intermediate goods prices during the past year. Core crude prices probably rose sharply again in September, mirroring the pattern in industrial commodity prices.

**The core finished goods PPI shows no sign of further deceleration.**



Source: Bureau of Labor Statistics

**Pickup in nonoil commodity prices signals further acceleration in core crude goods PPI.**



\* Estimated by UBS

Source: JOC-ECRI, Bureau of Labor Statistics, and UBS

**James O'Sullivan and Team**

# U.S. Economic Databank

	Levels				Monthly % Change				Yearly % Change			
	Jun-03	Jul-03	Aug-03	Sep-03	Jun-03	Jul-03	Aug-03	Sep-03	Jun-03	Jul-03	Aug-03	Sep-03
<b>Employment</b>												
Nonfarm Payrolls (k) *	129,903	129,846	129,805	129,862	-83	-57	-41	57	-0.4	-0.3	-0.3	-0.3
Manufacturing Payrolls (k) *	14,692	14,631	14,585	14,556	-54	-61	-46	-29	-4.2	-4.4	-4.3	-4.2
Average Workweek (hrs)	33.7	33.6	33.7	33.7	0.0	-0.3	0.3	0.0	-0.9	-0.6	-0.6	-0.6
Average Hourly Earnings (\$/hr)	15.38	15.43	15.46	15.45	0.2	0.3	0.2	-0.1	3.0	3.1	2.9	2.7
Unemployment Rate (%) **	6.4	6.2	6.1	6.1	0.3	-0.2	-0.1	0.0	0.6	0.4	0.3	0.4
Labor Force (mn)	147.1	146.5	146.5	146.5	0.4	-0.4	0.0	0.0	1.5	1.2	1.0	0.6
<b>Prices</b>												
PPI	142.6	142.8	143.4	N/A	0.5	0.1	0.4	N/A	2.9	3.0	3.4	N/A
PPI Ex. Food and Energy	150.0	150.3	150.5	N/A	-0.1	0.2	0.1	N/A	-0.3	0.2	0.4	N/A
CPI	183.6	183.9	184.5	N/A	0.2	0.2	0.3	N/A	2.1	2.1	2.2	N/A
CPI Ex. Food and Energy	193.0	193.4	193.6	N/A	0.0	0.2	0.1	N/A	1.5	1.5	1.3	N/A
<b>Consumption</b>												
Disposable Personal Income (\$ bn)	8,106.6	8,232.0	8,305.6	N/A	0.4	1.5	0.9	N/A	3.3	5.1	5.7	N/A
Retail Sales (\$ bn)	313.1	317.2	319.2	N/A	0.9	1.3	0.6	N/A	5.1	5.4	5.4	N/A
Total Light Vehicle Sales (mn)	16.3	17.2	18.9	N/A	1.9	5.5	9.6	N/A	0.2	-4.7	1.5	N/A
Consumer Confidence	83.5	77.0	81.7	76.8	-0.1	-7.8	6.1	-6.0	-21.4	-20.9	-13.5	-18.0
<b>Construction</b>												
Housing Starts (k)	1,844	1,892	1,820	N/A	5.7	2.6	-3.8	N/A	7.9	13.6	11.7	N/A
Permits (k)	1,823	1,800	1,901	N/A	1.1	-1.3	5.6	N/A	4.4	3.3	11.6	N/A
Construction Spending (\$bn)	878.8	880.8	882.7	N/A	0.8	0.2	0.2	N/A	2.8	2.6	4.0	N/A
<b>Manufacturing</b>												
Durable Goods Orders (\$mn)	172.2	175.1	173.1	N/A	2.5	1.6	-1.1	N/A	4.8	-1.4	-2.0	N/A
Inventories (\$ bn)	442.7	440.8	439.7	N/A	-0.3	-0.4	-0.2	N/A	0.1	-0.4	-0.7	N/A
Industrial Production	110.4	110.9	110.7	N/A	0.2	0.5	-0.2	N/A	-1.3	-1.2	-1.5	N/A
Capacity Utilization (%)	72.6	72.9	72.7	N/A	0.1	0.4	-0.3	N/A	-2.0	-1.9	-2.2	N/A
Purchasing Managers' Index	49.8	51.8	54.7	53.7	0.8	4.0	5.6	-1.8	-9.8	2.2	8.7	5.9
Leading Economic Indicators	112.1	112.8	113.3	N/A	0.4	0.6	0.4	N/A	0.8	1.6	2.2	N/A
<b>Trade</b>												
Goods & Services Balance (\$bn)	-40.0	-40.3	N/A	N/A	-3.8	0.7	N/A	N/A	12.6	18.4	N/A	N/A
Merchandise Balance (\$bn)	-45.1	-45.3	N/A	N/A	-3.4	0.4	N/A	N/A	10.8	15.2	N/A	N/A
<b>Credit</b>												
Money Supply M2 (\$bn)	6,043.6	6,092.1	6,132.2	N/A	0.8	0.8	0.7	N/A	8.2	8.1	8.1	N/A
C & I Loans (\$bn)	927.0	930.3	922.4	N/A	-1.3	0.4	-0.8	N/A	-6.4	-4.9	-5.7	N/A
Consumer Credit (\$bn)	1,768.4	1,774.4	N/A	N/A	0.0	0.3	N/A	N/A	3.4	3.3	N/A	N/A

\* Monthly changes are in levels; annual changes are in percent. \*\* Monthly and annual changes are in levels. Source: UBS

**U.S. Economic Data and Events Calendar**

Monday	Tuesday	Wednesday	Thursday	Friday
<p>29</p> <p>Aug Personal Income (8:30) 0.2% Personal Spending 0.8%</p> <p>4-week Bill Announcement 3- &amp; 6-month Bill Auction</p>	<p>30</p> <p>UBS/BTM Store Sales (7:45) Redbook Store Sales (8:40) Sep Conf. Board Confidence (10:00) 76.8 Sep Chicago PMI (10:00) 51.2</p> <p>4-week Bill Auction</p>	<p>1</p> <p>Mortgage Applications (7:00) Sep Manufacturing ISM (10:00) 53.7 Aug Construction Spending (10:00) 0.2% Sep Challenger Layoffs (10:00) 77k Sep Light Vehicle Sales 16.6 mil</p>	<p>2</p> <p>Initial Jobless Claims (8:30) 399k Aug Factory Orders (10:00) -0.8%</p> <p>3- &amp; 6-month Bill Announcement</p>	<p>3</p> <p>Sep Nonfarm Payrolls (8:30) 57k Unemployment Rate 6.1% Average Hourly Earnings -0.1% Average Workweek 33.7 hours Sep Non-Manufacturing ISM (10:00) 63.3</p>
<p>6</p> <p>5-year Note Announcement 10-year TIPs Announcement 4-week Bill Announcement 3- &amp; 6-month Bill Auction</p>	<p>7</p> <p>UBS/BTM Store Sales (7:45) Redbook Store Sales (8:40) Aug Consumer Credit (3:00) \$5.0 bil*</p> <p>Dallas Fed Pres McTeer speaks in NY (6:15 pm) KC Fed Pres Hoening speaks on monetary policy and economic outlook (8:45 pm)</p> <p>4-week Bill Auction</p>	<p>8</p> <p>Mortgage Applications (7:00) Aug Wholesale Trade (10:00)</p> <p>Fed Gov Bies speaks on economic outlook (10:00) Fed Vice Chair Ferguson speaks about financial services (12:30) Fed Vice Chair Ferguson and Boston Fed Pres Minehan speak (5:00 pm)</p> <p>5-year Note Auction</p>	<p>9</p> <p>Initial Jobless Claims (8:30) 395k* Sep Import Prices (8:30) -0.3%* Nonoil import prices 0.4%* Minneapolis Fed Pres Stern speaks at community development conf. (12:30) Fed Pres Bernanke repeats Oct 2 speech (1:00) Fed Gov Gramlich speaks on predatory lending (1:30)</p> <p>3- &amp; 6-month Bill Announcement 10-year TIPs Auction</p>	<p>10</p> <p>Aug Trade Balance (8:30) -\$41.5 bil* Sep Producer Price Index (8:30) 0.0%* Core PPI 0.1%*</p> <p>Bond Mkt. Assn. Recommends early close for U.S. fixed income markets</p>
<p>13</p> <p><b>Holiday</b> <b>Columbus Day</b> <b>Bond Market Closed</b> <b>Stock Market Open</b></p>	<p>14</p> <p>UBS/BTM Store Sales (7:45) Redbook Store Sales (8:40)</p> <p>4-week Bill Announcement 3- &amp; 6-month Bill Auction</p>	<p>15</p> <p>Mortgage Applications (7:00) Oct Empire State (8:30) 14.0* Sep Retail Sales (8:30) -0.4%* Retail Sales excl. Autos 0.1%* Retail Sales excl. Autos &amp; Gas 0.0%* Beige Book (2:00)</p> <p>4-week Bill Auction</p>	<p>16</p> <p>Initial Jobless Claims (8:30) Aug Business Inventories (8:30) Sep Consumer Price Index (8:30) 0.2%* Core CPI 0.1%* Sep Industrial Production (9:15) 0.5%* Oct Philadelphia Fed (12:00) 16.0* Oct Housing Market Index (1:00) 68*</p> <p>3- &amp; 6-month Bill Announcement</p>	<p>17</p> <p>Sep Housing Starts (8:30) 1.800 mil* Oct Prelim. U. Mich. Sentiment (9:45) 88.0*</p>
<p>20</p> <p>Sep Leading Indicators (10:00)</p> <p>4-week Bill Announcement 3- &amp; 6-month Bill Auction</p>	<p>21</p> <p>UBS/BTM Store Sales (7:45) Redbook Store Sales (8:40)</p> <p>4-week Bill Auction</p>	<p>22</p> <p>Mortgage Applications (7:00)</p>	<p>23</p> <p>Initial Jobless Claims (8:30)</p> <p>3- &amp; 6-month Bill Announcement</p>	<p>24</p> <p><b>Daylight Savings Time Ends (Oct 26)</b></p>

\* UBS forecasts (subject to change). Source: UBS

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