

U.S. ECONOMIC PROJECTIONS

INVESTMENT STRATEGIES GROUP

Week of August 29, 2005

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Tilting at windmills

Current market focus

In contrast to Spanish celebrations honoring the 400th anniversary of Miguel de Cervantes' *Don Quixote*, soaring oil prices made it difficult for U.S. investors to be optimistic about the outlook. Economic data released this week also reflected conflicting images of the landscape.

The housing picture, for example, remained blurred. Sales of existing homes slipped 2.6% in July, and inventories rose to 4.6 months' supply. In contrast, sales of new single-family homes jumped 6.5% last month to a new all-time high.

On the distinctly negative side, durable goods orders plummeted 4.9% following three months of solid gains. Declines in the volatile defense and commercial aircraft groups were not surprising, but weakness in other capital goods orders was also substantial. At this point, the downturn could simply reflect the month-to-month swings often seen in this series. The decline would be cause for concern, however, if not reversed in the August report.

Finally, on the consumer side, weekly jobless claims receded to 415,000 — a relatively low level identical to the four-week moving average. But, rising gasoline prices appear to be offsetting some of this positive news from the job market. The University of Michigan's final reading on consumer confidence for August fell significantly from both the level initially reported and July's reading.

The week ahead

Next week's data quest will find a number of important landmarks meriting attention. These include revised numbers on second-quarter GDP (gross domestic product) and July figures on auto sales, purchasing managers' indices and employment.

Look for last quarter's GDP growth rate to be revised upward to around 3.7% from 3.4%, with a reduction in the estimated amount of inventory liquidation taking place during the period. This would reduce, however, some of the potential momentum initially anticipated for the third quarter.

Numbers on economic activity during August are unlikely to be as strong as those published for July, although they should still reflect an economy that retains considerable fortitude.

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Look for both the Chicago Purchasing Managers' Index and the national ISM (Institute for Supply Management) Index of Manufacturing Activity to retreat from their July posts but to still suggest healthy expansion. Auto sales also are likely to dismount from their near-record high of the prior month while still holding at a good level.

The latest job market data will represent the climax of the week. Expect nonfarm employment to have advanced by about 185,000 in August. While shy of the 207,000 jobs created in July, such growth was likely sufficient to hold the jobless rate steady at 5.0% for the month. Workers are also beginning to see slightly larger raises.

The stock market

Oil prices cut chinks in the stock market's armor this past week, raising concerns over the potential damage to economic growth and corporate earnings. As of noon Friday, both the Dow Jones Industrial Average and S&P 500 Index were headed for their second consecutive weekly loss. Nasdaq appeared on track for a fourth straight weekly decline.

Oil prices, measured in terms of the West Texas Intermediate crude oil benchmark, swung to a new record of \$67.62 per barrel on Friday versus the prior week's close of \$65.35. Fears of possible damage to oil facilities in the Gulf of Mexico by Hurricane Katrina were the primary driver of this week's run-up.

If the storm bypasses these facilities or the damage is limited, oil prices should subside, proffering equity investors some relief. August's economic numbers will still need to be relatively favorable, however, to embolden equity investors once again.

The bond market

Fixed-income investors grew more confident in their forecasts for lower interest rates following the release of this week's sagging data on durable goods orders and consumer confidence. As of midday Friday, 10-year U.S. Treasury notes were trading at around 4.17% versus 4.21% at the prior week's close.

The bond market continues to view the potential impact of higher oil prices differently from the Federal Reserve. Monetary policymakers recently have focused on the risk of higher inflation from rising oil costs. They fear that energy prices could start to feed through to product prices, wage demands and inflationary expectations. Bond investors, in contrast, have remained relatively sanguine about inflation prospects, focusing more on the dampening effects on consumer and business spending.

Next week's behavior of oil prices and August's reports on the economy thus will be pivotal in determining the near-term path of long-term interest rates.

Meanwhile, Federal Reserve Board Chairman Alan Greenspan in prepared remarks to the annual Federal Reserve symposium at Jackson Hole, Wyoming, reiterated earlier warnings about the low risk premiums currently embedded in some asset prices. Any erosion in investor confidence could cause spreads over Treasury securities to quickly widen.

—August 26, 2005

Indicators to watch

Indicator	New Factory Orders – July
Release Date	August 30, 10 a.m. Eastern
June	0.9%
Forecast	-2.2% (-2.5% to -2.0% range)
Comments	Anticipate a large decline based on the plunge in durable goods orders already reported. Although revised numbers may lessen the anticipated drop, it should still be large and only slightly offset by an expected third consecutive rise in nondurable goods orders.

Indicator	Consumer Confidence (Conference Board) – August
Release Date	August 30, 10 a.m. Eastern
July	103.2
Forecast	101.7 (101.5 to 102.0 range)
Comments	Do not be surprised to see consumer confidence fall back as higher gasoline prices impact this index in a fashion similar to the University of Michigan’s report.

Indicator	Real GDP – 2Q05 preliminary
Release Date	Wednesday, August 31, 8:30 a.m. Eastern
Advance	3.4%
Forecast	3.7% (3.5% to 3.8% range)
Comments	Anticipate an upward revision in this subsequent measure of second-quarter growth, with a slower rate of inventory liquidation or even some accumulation since the initial report. This new thrust suggests that third-quarter growth is likely to be less than previously projected because of a smaller swing in inventory building.

Indicator	Chicago Purchasing Managers’ Index – August
Release Date	Wednesday, August 31, 10 a.m. Eastern
July	63.5
Forecast	60.2 (60.0 to 61.0 range)
Comments	Do not be alarmed to see this index retreat somewhat from its robust reading in July. At around 60, the index would still suggest significant strength in the industrial Midwest.

Indicator Personal Income - July
 Release Date Thursday, September 1, 8:30 a.m. Eastern
 June 0.5%
 Forecast 0.6% (0.5% to 0.6% range)
 Comments Look for a solid advance in personal income, boosted by healthy gains in employment and hourly earnings. Still, rising prices — driven largely by higher energy costs — sapped most, if not all, of this gain in terms of buying power.

Indicator Consumer Spending - July
 Release Date Thursday, September 1, 8:30 a.m. Eastern
 June 0.8%
 Forecast 1.6% (1.2% to 1.8% range)
 Comments Do not be surprised to see a surge in consumer spending. A new round of auto sales incentives is likely to push the number sharply higher, with other categories of consumer spending apt to register modest increases.

Indicator Initial Claims for Unemployment Insurance - week ended 8/27/05
 Release Date Thursday, September 1, 8:30 a.m. Eastern
 Prior Week 315,000
 Forecast 315,000 (312,000 to 317,000 range)
 Comments Anticipate a number similar to that reported in recent weeks. Various company consolidations are continuing to cause layoffs, but most firms are focusing on additional sales rather than cost-slashing efforts to drive profits.

Indicator Institute for Supply Management Manufacturing Index - August
 Release Date Thursday, September 1, 10 a.m. Eastern
 July 56.6
 Forecast 55.0 (54.0 to 56.0 range)
 Comments Do not be surprised to see some pullback in industrial activity following July's sharp gain. The anticipated reading would still be well over the breakeven 50.0 mark and represent the second highest level since March.

Indicator Construction Spending - July
 Release Date Thursday, September 1, 10 a.m. Eastern
 June -0.3%
 Forecast 0.5% (0.4% to 0.6% range)
 Comments Following June's setback, look for gains in housing, nonresidential building and public construction to bolster July's figure. Housing demand and construction remain strong, nonresidential building vacancies are falling, and government finances have improved.

Indicator Auto Sales - August
 Release Date Thursday, September 1
 July 20.9 million
 Forecast 18.0 million (17.8 to 18.2 million range)
 Comments With employee-discount programs still active in August, look for motor vehicles sales to have remained at a lofty level, although off July's results.

Indicator Nonfarm Payrolls - August
 Release Date Friday, September 2, 8:30 a.m. Eastern
 July 207,000
 Forecast 185,000 (175,000 to 190,000 range)
 Comments Anticipate a less impressive jump than that reported for July, as companies remain conservative in terms of new hiring. The estimated increase for August should still be sufficient to support a positive trend in consumer spending.

Indicator Unemployment Rate - August
 Release Date Friday, September 2, 8:30 a.m. Eastern
 July 5.0%
 Forecast 5.0% (4.9% to 5.1% range)
 Comments Anticipate unemployment to remain flat, with job growth just sufficient to absorb new entrants into the labor force.

Indicator Hourly Earnings - August
 Release Date Friday, September 2, 8:30 a.m. Eastern
 July 0.4%
 Forecast 0.3% (0.2% to 0.3% range)
 Comments Look for hourly earnings to show a relatively good gain following July's jump. Still, workers' bargaining power for wage and salary increases remains generally limited.

Economic forecasts

	2005Q1a	2005Q2a	2005Q3f	2005Q4f	2006Q1f	2006Q2f	2005e	2006f
Real GDP (% chg. annual rate)	3.8	3.4	6.0	3.4	3.7	3.7	3.9	3.9
CPI (% chg. annual rate)	2.4	4.2	3.0	1.9	2.4	2.6	3.0	2.5
Personal Consumption Price Index Less Food & Energy (% chg. annual rate)	2.0	1.8	1.9	2.2	2.1	2.0	2.1	2.0
S&P 500 Operating Earnings (\$ per share)	18.00	19.00	18.60	18.75	19.00	19.75	74.35	79.00
Federal Funds Rate (%, end of period)	2.75	3.25	3.75	4.25	4.50	4.50	4.25	4.50
10-Year Treasury Note Yield (%, end of period)	4.50	3.94	4.40	4.70	4.75	4.85	4.70	4.95
Euro (\$/euro, end of period)	1.30	1.21	1.22	1.21	1.20	1.19	1.21	1.19
Yen (yen/\$, end of period)	107	111	109	107	105	104	107	101

Source: Investment Strategies Group
a = actual; e = estimate; f = forecast

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