

# U.S. ECONOMIC PROJECTIONS

INVESTMENT STRATEGIES GROUP

Week of January 30, 2006

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## GDP loses some of its bark

### *Current market focus*

Although this Sunday will usher in the Year of the Dog in the Chinese calendar, the U.S. economy fetched only a weak reading for the fourth quarter. Growth this quarter seems likely to retrieve its former strength.

Real gross domestic product (GDP) edged up at an annual rate of just 1.1% in the October-to-December period, a marked deceleration from the prior quarter's 4.1% climb and the slowest pace in three years. A pullback in auto sales from the prior quarter's inflated level, a surge in imports and a plunge in defense spending accounted for much of the slowing. Consumer outlays excluding autos, housing and technology spending all showed sturdy gains.

Meanwhile, more recent data suggests that the economy is far from ready to roll over. Durable goods orders advanced 1.3% in December, following two months of even larger increases. This suggests that business capital spending has lots of energy heading into 2006. Jobless claims have remained below 300,000 for two weeks in a row, suggesting that jobs will lead consumer spending higher. Even housing is not yet ready to just sit, with new home sales countering other trends and rising 3% in December.

### *The week ahead*

Investors will have a number of key economic reports to paw through during the coming week, including a few December stragglers and a pack of January figures. Look for December's personal income figure to show moderate growth as consumer spending rebounds sharply. This lift should help first-quarter GDP.

Do not be surprised to see some easing in January's auto sales following December's spike, but new models and promotions should keep sales going at a relatively healthy pace. The Institute for Supply Management is likely to report friendly numbers. Look for the Manufacturing Index to increase from its December level, with stronger orders and production. While some easing in the housing sector may gnaw a bit off the Non-Manufacturing Index, it is still likely to show a robust read.

Employment numbers will seize the leash on Friday. The recent drop in jobless claims leads us to believe that about 225,000 nonfarm jobs were created in January. This should allow the jobless rate to hold at 4.9% even as more people are coming back to the job market. Employees were also probably able to secure at least moderate raises, lifting hourly earnings up another 0.3% for the month.

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On balance, despite last quarter's slowdown, the economy still seems poised to rebound, with growth exceeding a 4.0% annualized pace in the first quarter of 2006. Looking ahead, the Year of the Dog is still on point to display some favorable traits.

### *The stock market*

Investors seemed more comfortable with the outlook this past week, even if they remained uncertain as to whether or not stocks are their best friends. As of early Friday afternoon, all three major equity indices — the Dow Jones Industrial Average, S&P 500 Index and Nasdaq — appeared headed for impressive gains for the week. These gains have largely offset the losses suffered during the prior week and put the indices well above their year-end levels.

Earnings looked more faithful to expectations this past week, with favorable readings from the industrial and technology sectors. Based on the numbers reported thus far, operating earnings in the fourth quarter were up about 14% from the year-ago level. That would match the gains recorded during the prior three quarters, suggesting that profits defied last quarter's sluggish GDP results.

Investors paid little attention to oil prices this week even as ongoing concerns about possible actions from Iran offset evidence that inventories of crude petroleum and refined products are comfortably above their averages for this time of year. As of Friday, oil was trading at \$67.40, about a dollar below the recent peak reached last Friday.

Stock investors will likely focus on three major issues in the week ahead — the Fed, employment and earnings. Investors may be somewhat disappointed that monetary policymakers are unlikely to signal an end to their rate-hiking cycle. They may take some consolation in the confidence of monetary policymakers over the prospects for growth, which is likely to be reinforced by Friday's jobs report. Finally, another busy week of earnings numbers should remind us that profits are still business's best friend.

### *The bond market*

Despite the fourth quarter's soft GDP number, bond market investors felt compelled to bury some of their pessimism about the economy's prospects along with their hopes for a quick ending to Fed rate increases. Yields on ten-year Treasury notes<sup>1</sup> reached 4.53% on Thursday, their highest level so far in 2006, before easing back to 4.50% as of Friday afternoon. The yield curve also steepened slightly, with the spread between ten and two-year Treasury notes widening to two basis points on Friday from a zero difference a week ago.

Bond investors took note of the strong report on durable goods orders and December's surprising rise in new home sales. The latest reading on "core" inflation also took a bite out of their confidence. The Federal Reserve's preferred measure of underlying price trends, the personal consumption price index excluding food and energy, advanced at an annualized 2.2% in the fourth quarter. This contrasted with the prior quarter's 1.4% pace and brought the latest inflation read above the 1.0%-to-2.0% range most policymakers would probably like to see.

The Federal Reserve is almost certain to raise its interest rate target another quarter percentage point to 4.50% at Tuesday's meeting. Look for little change in the accompanying policy statement, the last to be issued under Chairman Greenspan's

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<sup>1</sup> Used solely as a benchmark for long-term interest rates.

leadership. The major change in wording is likely to involve changing the clause that “further measured policy firming is *likely* be needed” to “further measured policy firming *may* be needed.” Look for the Fed to continue to express its optimism about the economy’s growth prospects while suggesting that inflation remains the larger risk. Upcoming data will dictate the next policy decision outcome on March 28. Given what we know today and our outlook over the near term, it seems likely that the Fed will come out of its March meeting with a 4.75% fed funds target that will hold through the balance of 2006.

—January 27, 2006

## Indicators to watch

Indicator Personal Income — December  
 Release Date Monday, January 30, 8:30 a.m. Eastern  
 November 0.3%  
 Forecast 0.4% (0.3% to 0.4% range)  
 Comments Look personal income to have posted moderate gains, with a better increase in real terms thanks to lower consumer prices in December.

Indicator Consumer Spending — December  
 Release Date Monday, January 30, 8:30 a.m. Eastern  
 November 0.3%  
 Forecast 0.8% (0.7% to 0.8% range)  
 Comments Expect consumer spending to show a large advance last month, boosted primarily by a rebound in auto sales. Job gains should support household spending in the first part of 2006, as the upward thrust from the housing market dissipates.

Indicator Employment Cost Index — 4Q2005  
 Release Date Tuesday, January 31, 8:30 a.m. Eastern  
 3Q2005 0.8%  
 Forecast 0.9% (0.8% to 0.9% range)  
 Comments Anticipate that compensation costs rose slightly faster in the fourth quarter, with a modest pickup up in wage increases and ongoing pressures on health and benefit expenses.

Indicator Consumer Confidence (Conference Board) — January  
 Release Date Tuesday, January 31, 10 a.m. Eastern  
 December 103.6  
 Forecast 104.5 (104.0 to 105.0 range)  
 Comments Expect continued firming in consumer confidence in the Conference Board's survey, buttressed by a strengthening labor market, despite the recently announced high-profile layoffs in the auto industry.

Indicator Chicago Purchasing Managers' Index — January  
 Release Date Tuesday, January 31, 10 a.m. Eastern  
 December 60.8  
 Forecast 61.0 (60.8 to 61.2 range)  
 Comments Look forward the industrial heartland to show further signs of strength, boosted by a solid upswing in capital spending. Ongoing cost pressures are also likely to be evident.

Indicator FOMC Meeting  
 Release Date Tuesday, January 31, 2:15 p.m. Eastern  
 Comments Anticipate a 14<sup>th</sup> consecutive increase, which will take the federal funds rate to 4.5%. Expect little change in the accompanying policy statement from that issued in December. Growth and inflation between now and the end of March will guide the fed's next decision.

Indicator Institute for Supply Management Manufacturing Index — January  
 Release Date Wednesday, February 1, 10 a.m. Eastern  
 December 54.2  
 Forecast 56.5 (56.0 to 57.0 range)  
 Comments Anticipate a stronger ISM number in January following December's decrease. Orders and production are likely to suggest that manufacturing began 2006 with considerable momentum.

Indicator Construction Spending — December  
 Release Date Wednesday, February 1, 10 a.m. Eastern  
 November 0.2%  
 Forecast 0.3% (0.2% to 0.4% range)  
 Comments Look for some slowing in housing construction and adverse weather to have limited the rise in last month's building activity. Public construction and nonresidential building are likely to be the major growth drivers for construction in 2006.

Indicator Auto Sales — January  
 Release Date Wednesday, February 1  
 December 17.2 million  
 Forecast 16.7 million (16.6 million to 16.8 million range)  
 Comments Anticipate a slippage in motor vehicle sales following December's surge, although new models and ongoing incentives should still support a relatively healthy level.

Indicator Initial Claims for Unemployment Insurance — week ended 1/28/06  
 Release Date Thursday, February 2, 8:30 a.m. Eastern  
 Prior Week 283,000  
 Forecast 285,000 (283,000 to 290,000 range)  
 Comments The ability of jobless claims to hold below 300,000 for a third consecutive week could suggest a significant downward shift in layoffs as business confidence and conditions continue to improve.

Indicator Nonfarm Productivity — 4Q2005 Preliminary  
 Release Date Thursday, February 2, 8:30 a.m. Eastern  
 3Q2005 4.7%  
 Forecast 0.5% (0.3% to 1.0% range)  
 Comments Do not be surprised to see a major slowing in last quarter's productivity performance, following the prior quarter's upsurge and the year-end deceleration in GDP growth. Productivity trends still appear favorable, which should both buttress growth and restrain inflation in 2006.

Indicator Nonfarm Employment — January  
 Release Date Friday, February 3, 8:30 a.m. Eastern  
 December 108,000  
 Forecast 225,000 (220,000 to 240,000 range)  
 Comments Look forward to a healthy advance in nonfarm payrolls in January's report, with gains spread over a wide range of industries. Less-than-normal retail hiring during the holidays can be expected to produce a lower-than-usual number of layoffs.

Indicator Hourly Earnings — January  
 Release Date Friday, February 3, 8:30 a.m. Eastern  
 December 0.3%  
 Forecast 0.3% (0.2% to 0.3% range)  
 Comments Expect a third consecutive monthly earnings gain of 0.3%. With the economy moving closer to full employment, workers may have greater bargaining clout in 2006.

Indicator Unemployment Rate — January  
 Release Date Friday, February 3, 8:30 a.m. Eastern  
 December 4.9%  
 Forecast 4.9% (4.9% to 5.0% range)  
 Comments Anticipate the jobless rate to hold at December's 4.9% level, as new employment opportunities prove adequate to absorb new and returning workers.

Indicator Consumer Confidence (University of Michigan) — January final  
 Release Date Friday, February 3, 9:45 a.m. Eastern  
 December 93.4  
 Forecast 93.4 (93.2 to 93.5 range)  
 Comments Expect the University of Michigan's final estimate of January's confidence to show little change from the first estimate, with the job market's firming offsetting renewed concerns over energy prices and this month's volatility in stocks.

Indicator	New Factory Orders — January
Release Date	Friday, February 3, 10 a.m. Eastern
December	3.1%
Forecast	1.1% (1.0% to 1.5% range)
Comments	Look forward to a solid advance in December's factory orders with a rise in nondurables joining the healthy increase on the durables side reported this past week.
Indicator	Institute for Supply Management Non-Manufacturing Index — January
Release Date	Friday, February 3, 10 a.m. Eastern
December	59.8
Forecast	59.0 (58.5 to 59.5 range)
Comments	Do not be alarmed to see a slightly more moderate read on the non-manufacturing sector in January's index, reflecting possible ripple effects of some slippage in the housing and related segments. The continued overall reading close to 60.0 will still show that the non-manufacturing side of the economy remains strong as the industrial side shows greater signs of life.

## Economic forecasts

	2005Q1a	2005Q2a	2005Q3a	2005Q4a	2006Q1f	2006Q2f	2005a	2006f
Real GDP (% chg. annual rate)	3.8	3.3	4.1	1.1	4.5	4.1	3.5	3.5
CPI (% chg. annual rate)	2.4	4.2	5.1	3.2	0.5	2.1	3.4	2.4
Personal Consumption Price Index Less Food & Energy (% chg. annual rate)	2.4	1.7	1.4	2.2	2.2	2.0	2.0	2.0
S&P 500 Operating Earnings (\$ per share)	18.00	19.05	18.78	19.00	19.45	20.25	74.83	80.85
Federal Funds Rate (%, end of period)	2.75	3.25	3.75	4.25	4.75	4.75	4.25	4.75
Ten-Year Treasury Note Yield <sup>1</sup> (%, end of period)	4.50	3.94	4.34	4.39	4.80	4.90	4.39	5.00
Euro (\$/euro, end of period)	1.30	1.21	1.20	1.18	1.23	1.24	1.18	1.29
Yen (yen/\$, end of period)	107	111	114	118	115	113	118	106

Source: Investment Strategies Group

a = actual; e = estimate; f = forecast

<sup>1</sup>Used solely as a benchmark for long-term interest rates