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Key Issues In The Global Economy

March, 2005

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Key Issues in the Global Economy

- Do the fundamentals support $50 a barrel crude?
- Is the US recovery sustainable?
- Have we under-estimated the inflation threat in the US?
- How far and fast will US administered rates rise?
- Will the Japanese recovery regain momentum?
- Will the eurozone recovery finally gain traction?
- When will the Canadian economy get back on track?
- Will the US dollar crash?

Oil

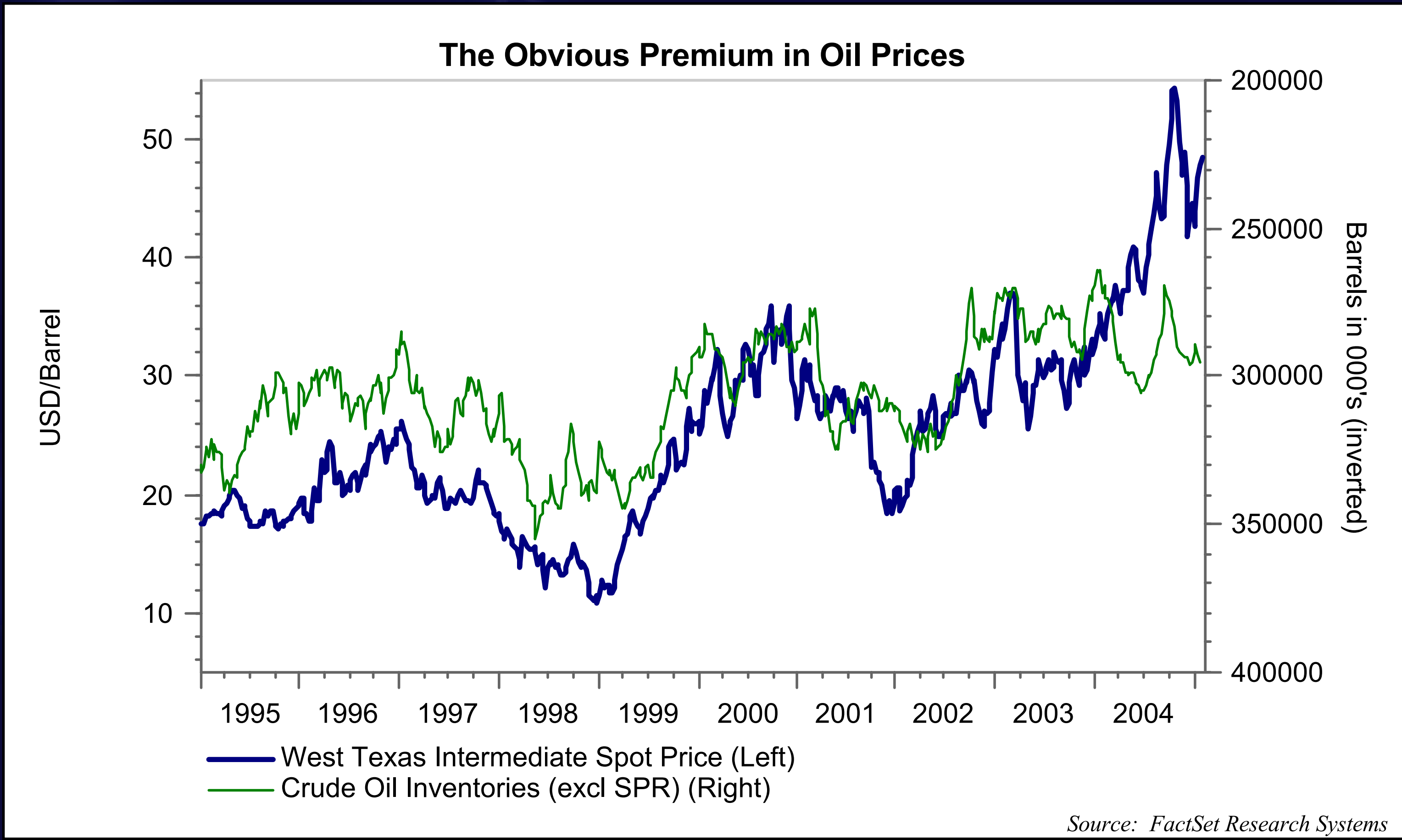
	2004	2005
World Demand (mmbd)	82.2	84.0
- Non-OPEC Supply	50.2	51.4
- Iraqi Supply	2.0	2.0
- OPEC NGL and Condensate	4.4	4.8
= Call on OPEC 10 Crude Oil	25.6	25.8
- Actual OPEC 10 Production	26.8	26.8
= Inventory Build/Draw	+1.2	+1.0

Oil

	2003	2004	2005
Inventory Build/Draw (mmbd)		+1.2	+1.0
+ Previous Inventories (bbn)	4.6	4.9	5.1
Days of Forward Supply	**55.9**	**58.6**	**60.3**

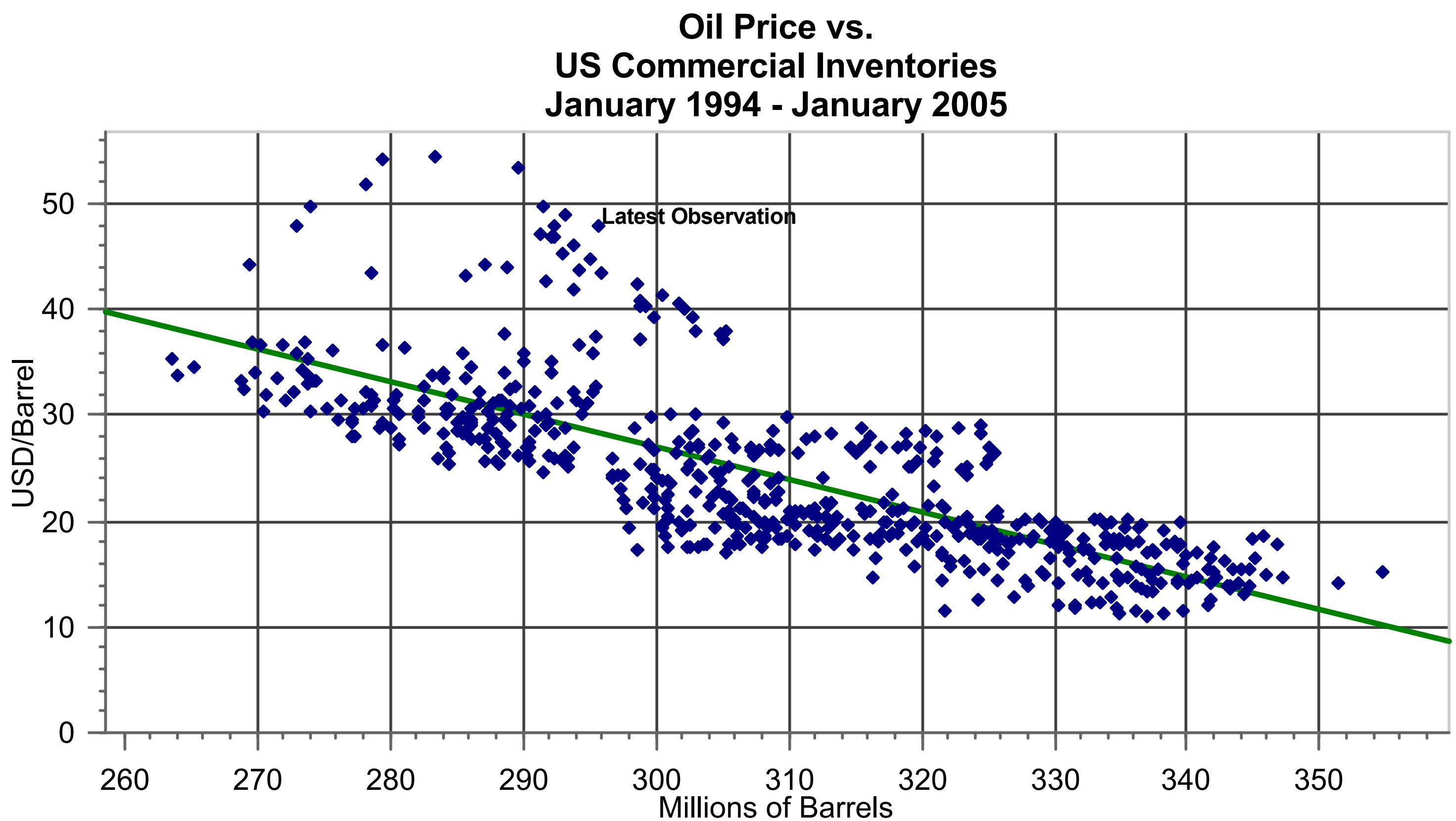
The last time forward supply hit 60 days WTI was around $20 a barrel (1997-1998)!

Oil



The Obvious Premium in Oil Prices
USD/Barrel
10
20
30
40
50
200000
250000
300000
350000
400000
Barrels in 000's (inverted)
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
West Texas Intermediate Spot Price (Left)
Crude Oil Inventories (excl SPR) (Right)
Source: FactSet Research Systems

Oil



Source: FactSet Research Systems

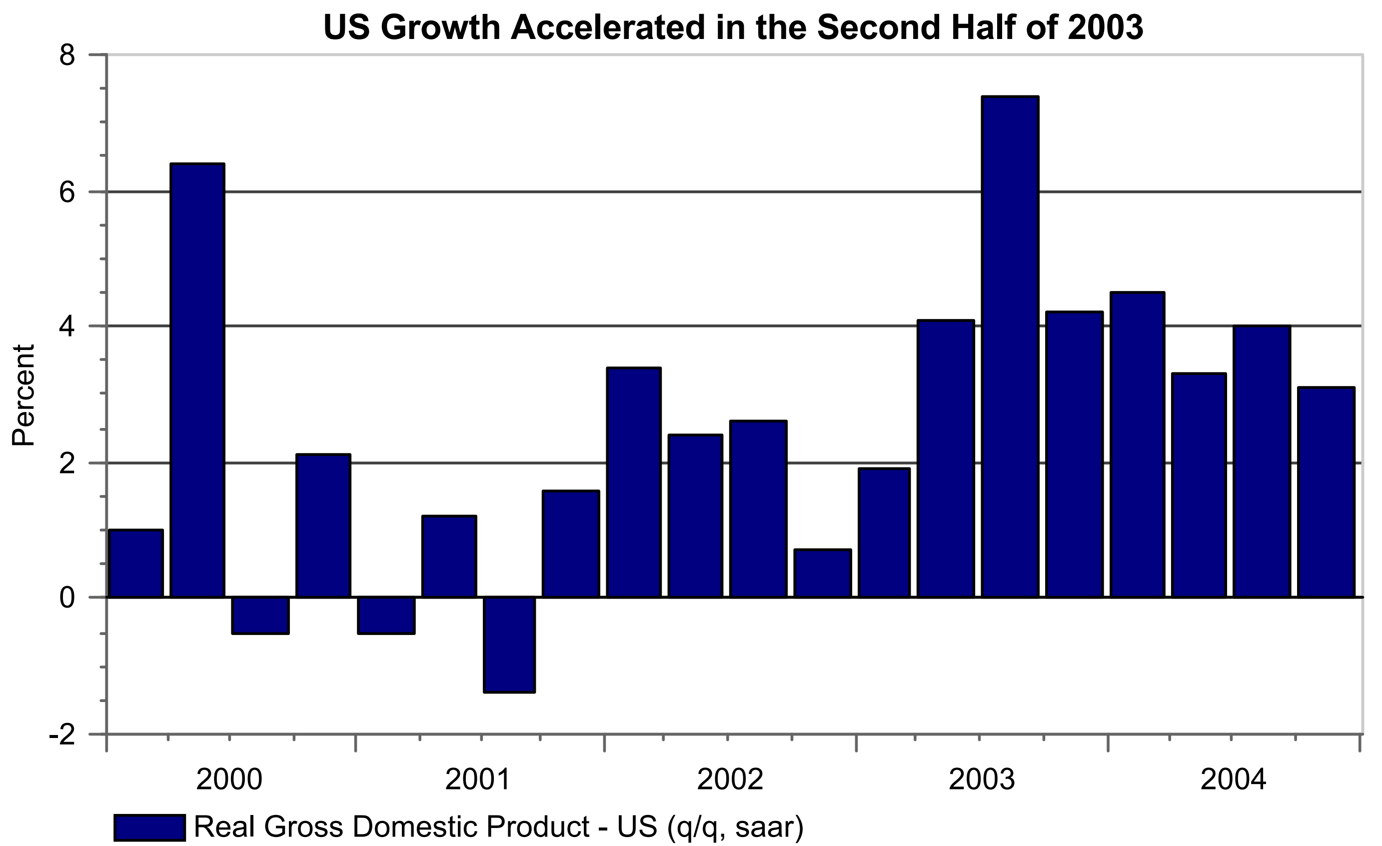
Oil

- Most oil analysts seem to feel that the fair price of a barrel of oil is somewhere between $30-$35 a barrel.
- Our analysis of the relationship between inventories and prices is broadly consistent with that view.
- However, the Saudis have recently stated that oil prices should average between $40-$50 a barrel this year.
- So, a premium seems likely to persist for the foreseeable future
- We expect oil prices to settle in the $40-$45 a barrel range over the near term

Sustainability

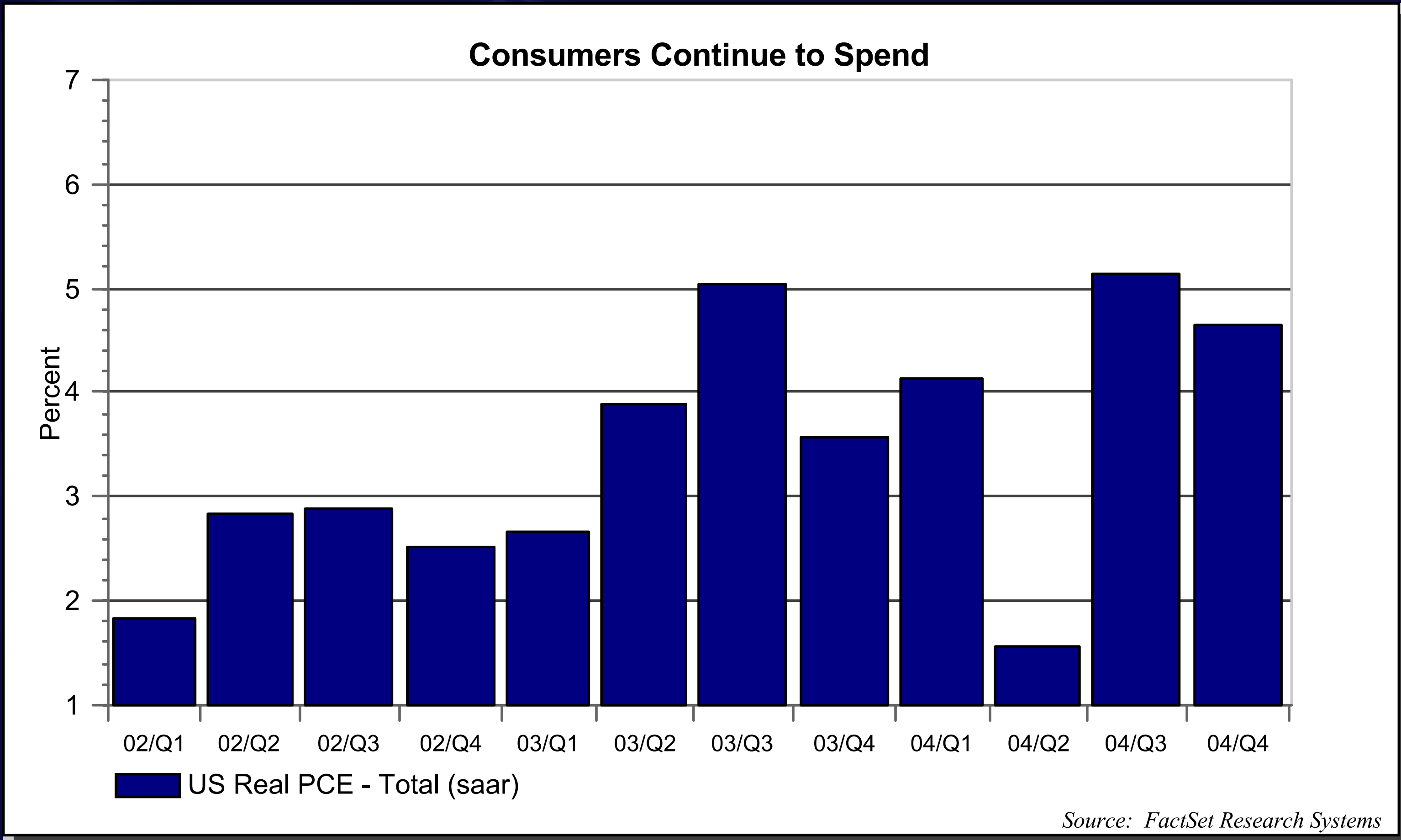
- How we got here:
  - (1) Mortgage refinancing boom, tax cut, and rebound in confidence following “end of major hostilities” in Iraq provided initial boost to consumer spending
  - (2) Business investment revived
  - (3) Labor market improved in the spring, slipped back over the summer, but picked back up in the fall

Sustainability

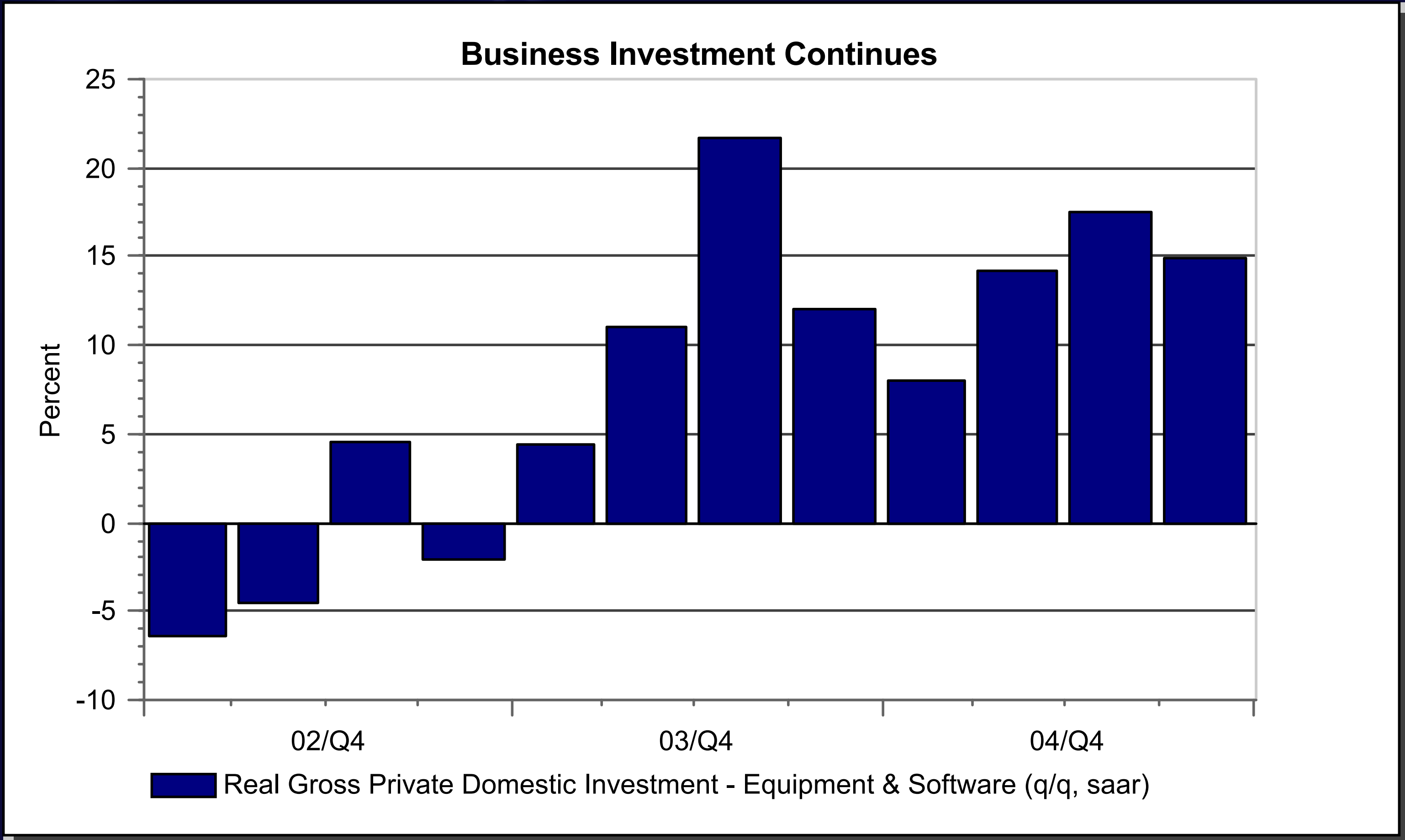


Source: FactSet Research Systems

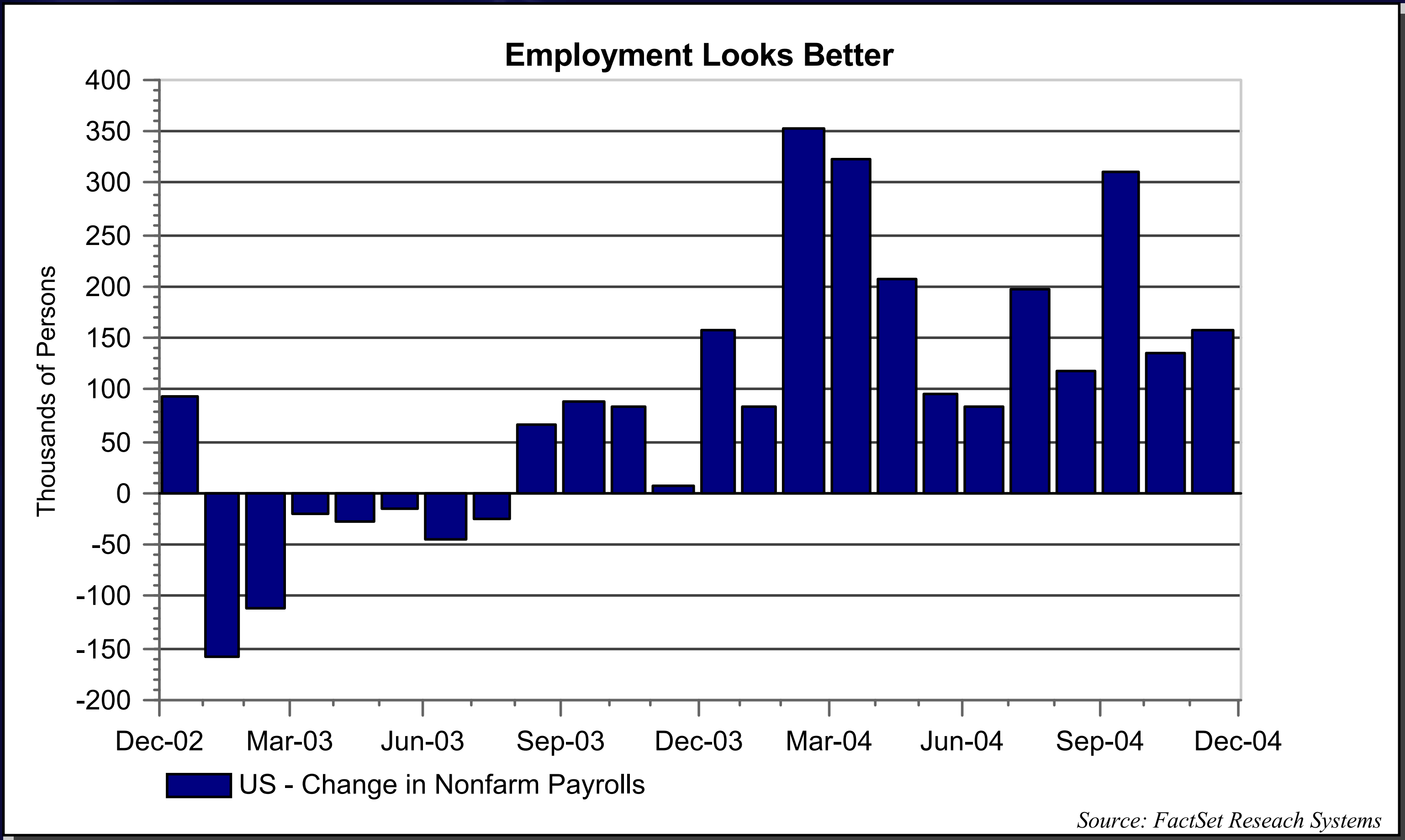
Sustainability



Sustainability



Sustainability



Sustainability

- In short, the pieces of the sustainability puzzle seem to have fallen into place.
- Plus: Positive Forces Still Abound in the US Economy:
  - Easy monetary policy
  - A lower dollar
  - Demand momentum
  - Low inventories

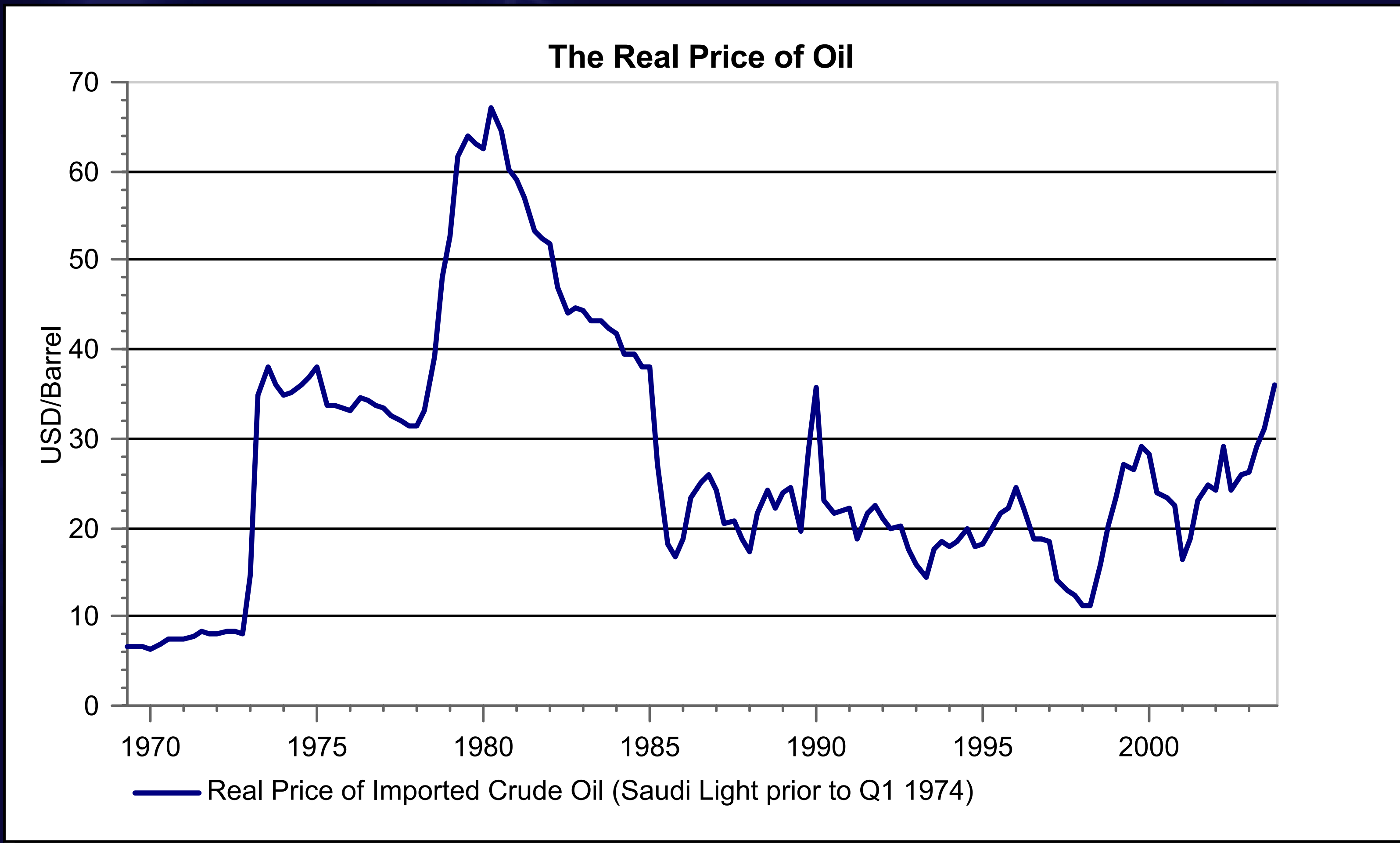
Sustainability

- Growth averaged 4.1% in first half of last year
- It slowed to 3.8% in the second half
- Assuming that (WTI) oil prices fall back to $40-45 a barrel, GDP is expected to advance by 3.5% in 2005, at the top end of the 3.25%-3.50% trend pace
  - Consumption and equipment investment lead the way
  - Inventories may help in the early part of the year
  - Housing becomes a slight drag although does not collapse
  - Trade remains a negative
  - Government becomes less stimulative

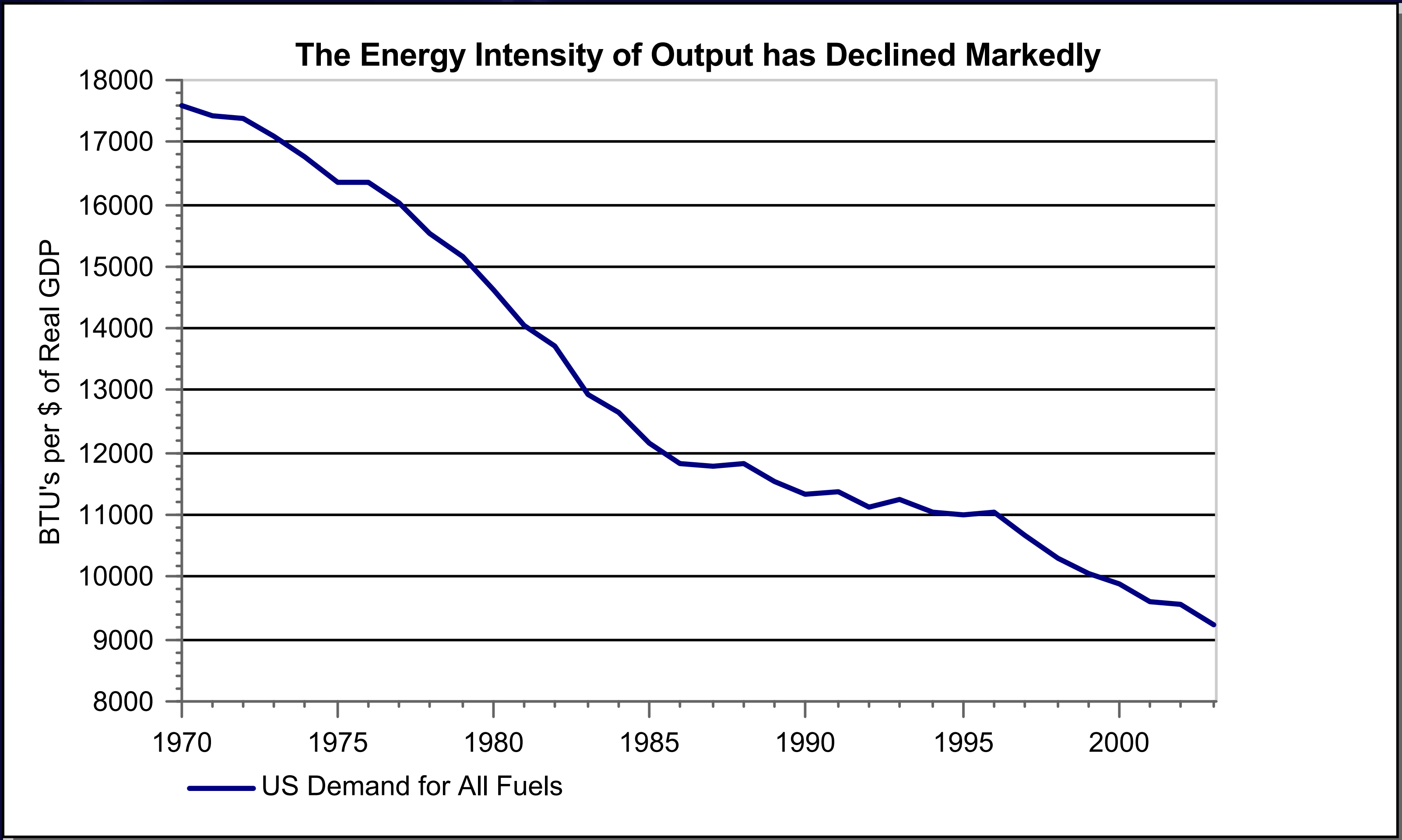
Sustainability

- Admittedly, the pace of growth in 2005 depends partially on the level of oil prices.
- But, even if they stay where they are the economy will not fall into a recession:
  - Real oil prices are not that high
  - The energy intensity of output has fallen markedly since the 1970s, making the economy less vulnerable to oil-price shocks
  - Model simulation exercise implies that if (WTI) oil prices stay at $55 a barrel through the end of next year (instead of falling back to $40-$45) then 2005 growth slows by 0.4%.

Sustainability



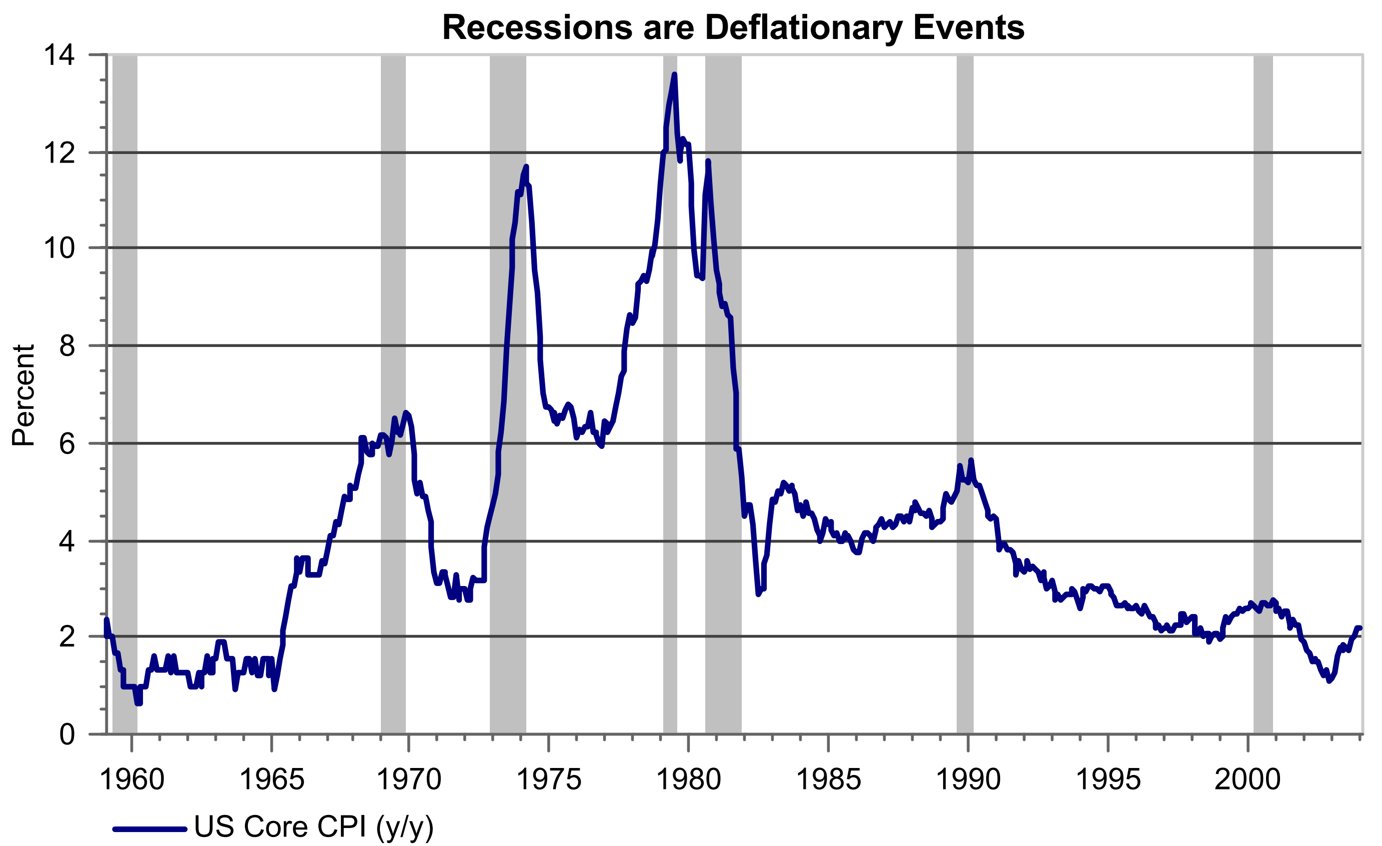
Sustainability



Inflation

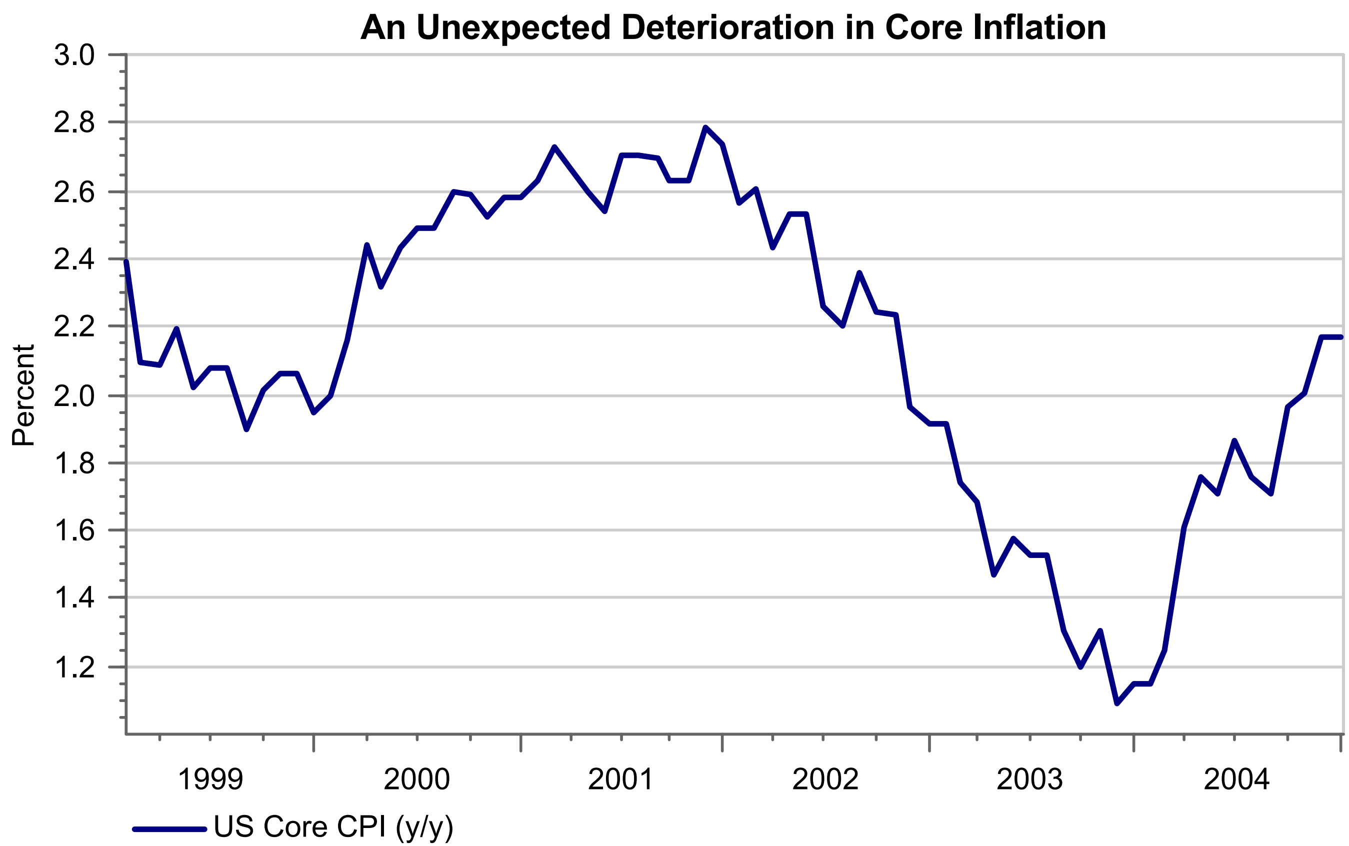
- Inflation has turned much faster than expected
- But, early 2004 data exaggerated the threat
  - Prices were artificially depressed in 2002-2003
  - Deterioration reflected the waning of these special factors
- Best news on inflation is behind us, but a sharp acceleration still appears unlikely in the near term:
  - Positive Output Gap & Low CapU
  - Slow Earnings Growth
  - Robust Productivity Growth

Inflation



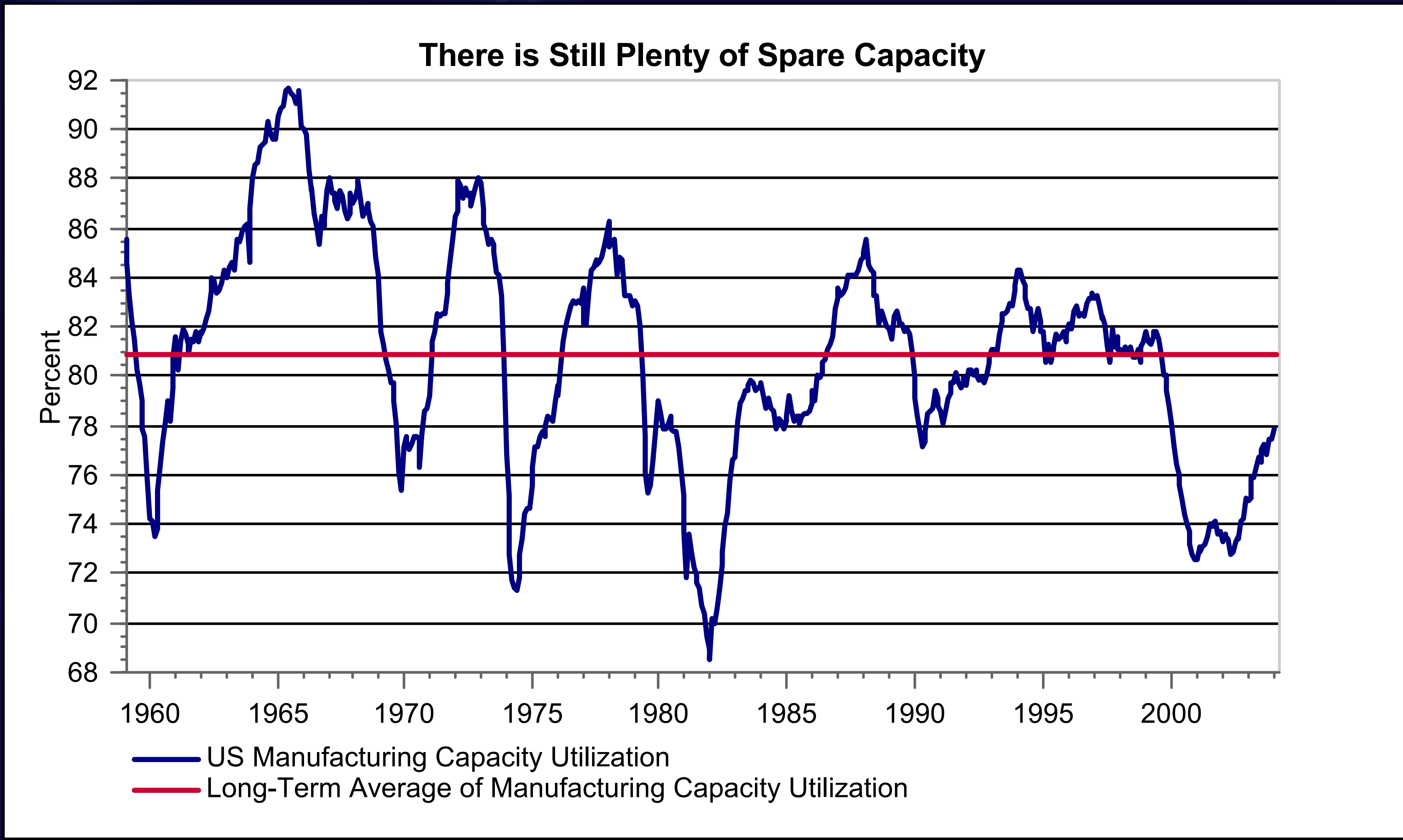
Source: FactSet Research Systems

Inflation

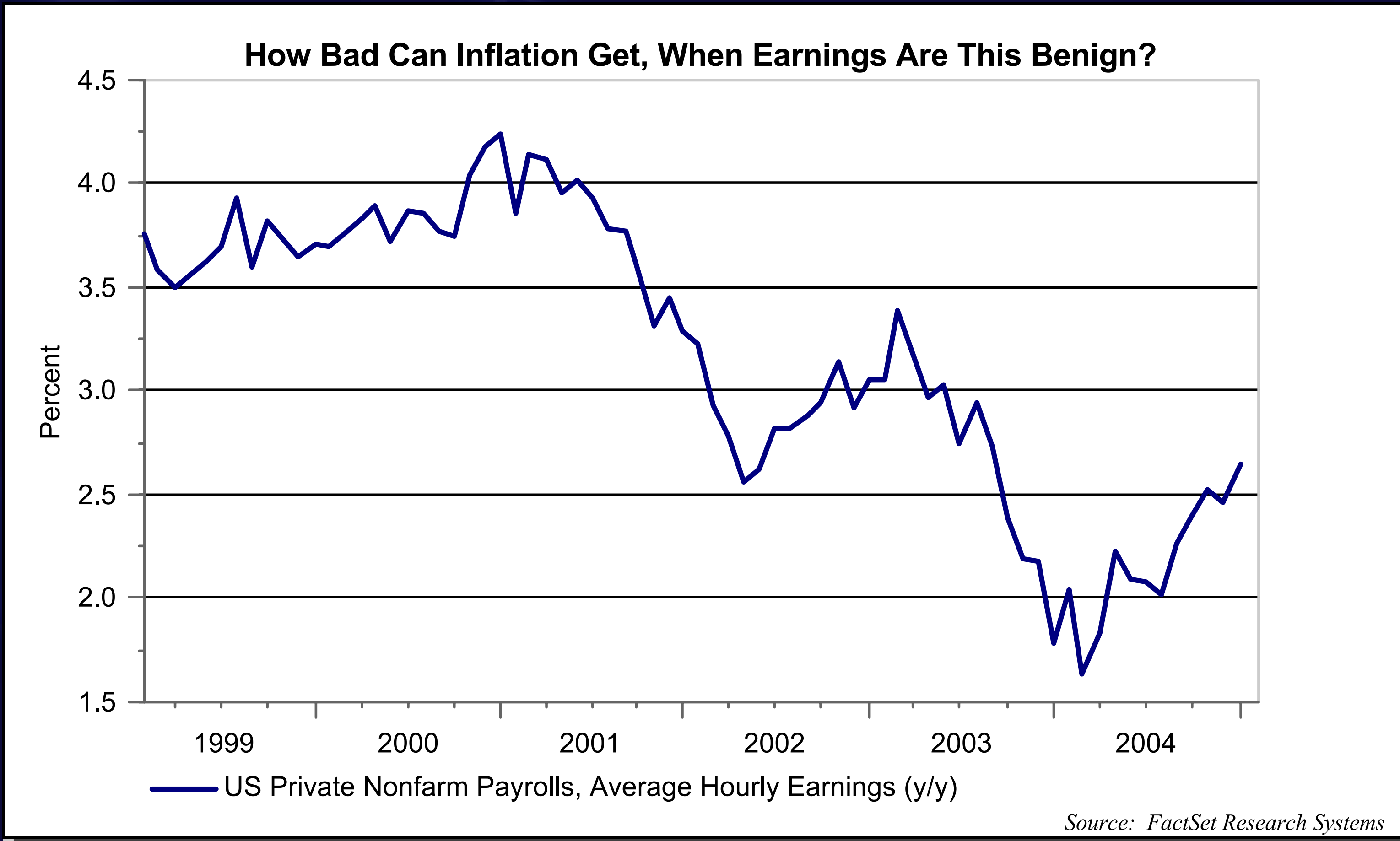


Source: FactSet Research Systems

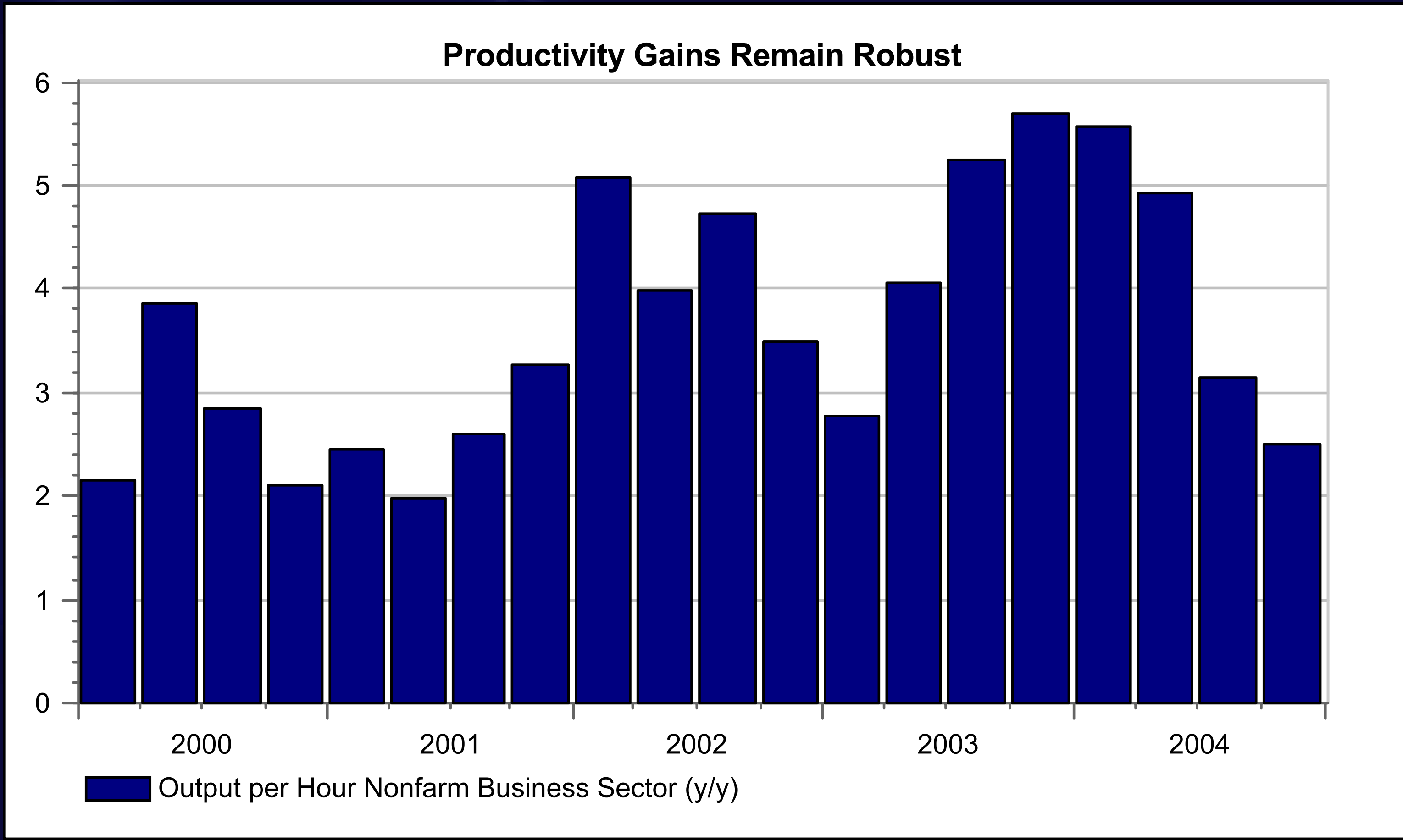
Inflation


There is Still Plenty of Spare Capacity
92
90
88
86
84
82
80
78
76
74
72
70
68
Percent
1960
1965
1970
1975
1980
1985
1990
1995
2000
US Manufacturing Capacity Utilization
Long-Term Average of Manufacturing Capacity Utilization

Inflation


How Bad Can Inflation Get, When Earnings Are This Benign?
4.5
4.0
3.5
3.0
2.5
2.0
1.5
Percent
1999
2000
2001
2002
2003
2004
US Private Nonfarm Payrolls, Average Hourly Earnings (y/y)
Source: FactSet Research Systems

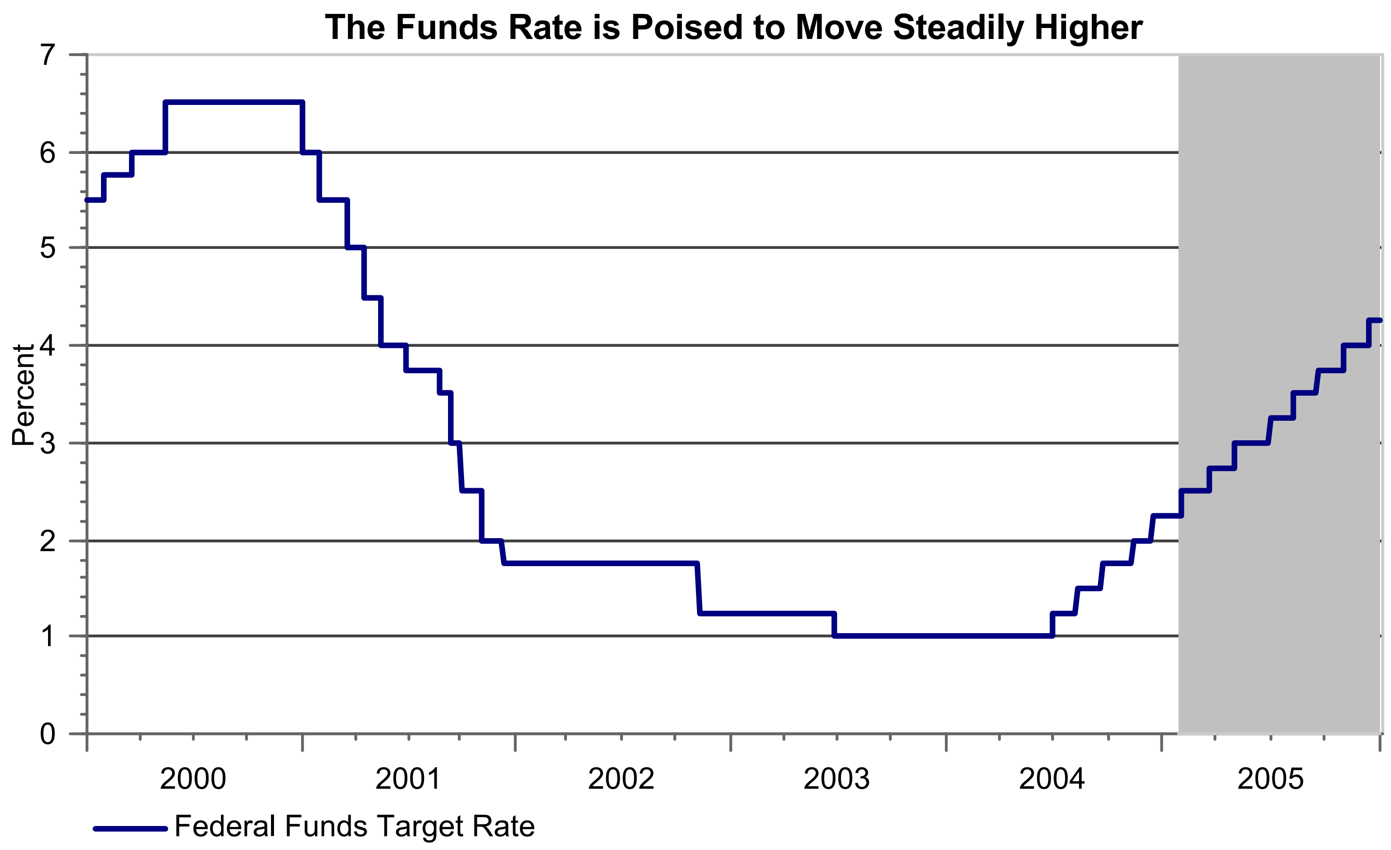
Inflation


Productivity Gains Remain Robust
6
5
4
3
2
1
0
2000
2001
2002
2003
2004
Output per Hour Nonfarm Business Sector (y/y)

Interest Rates

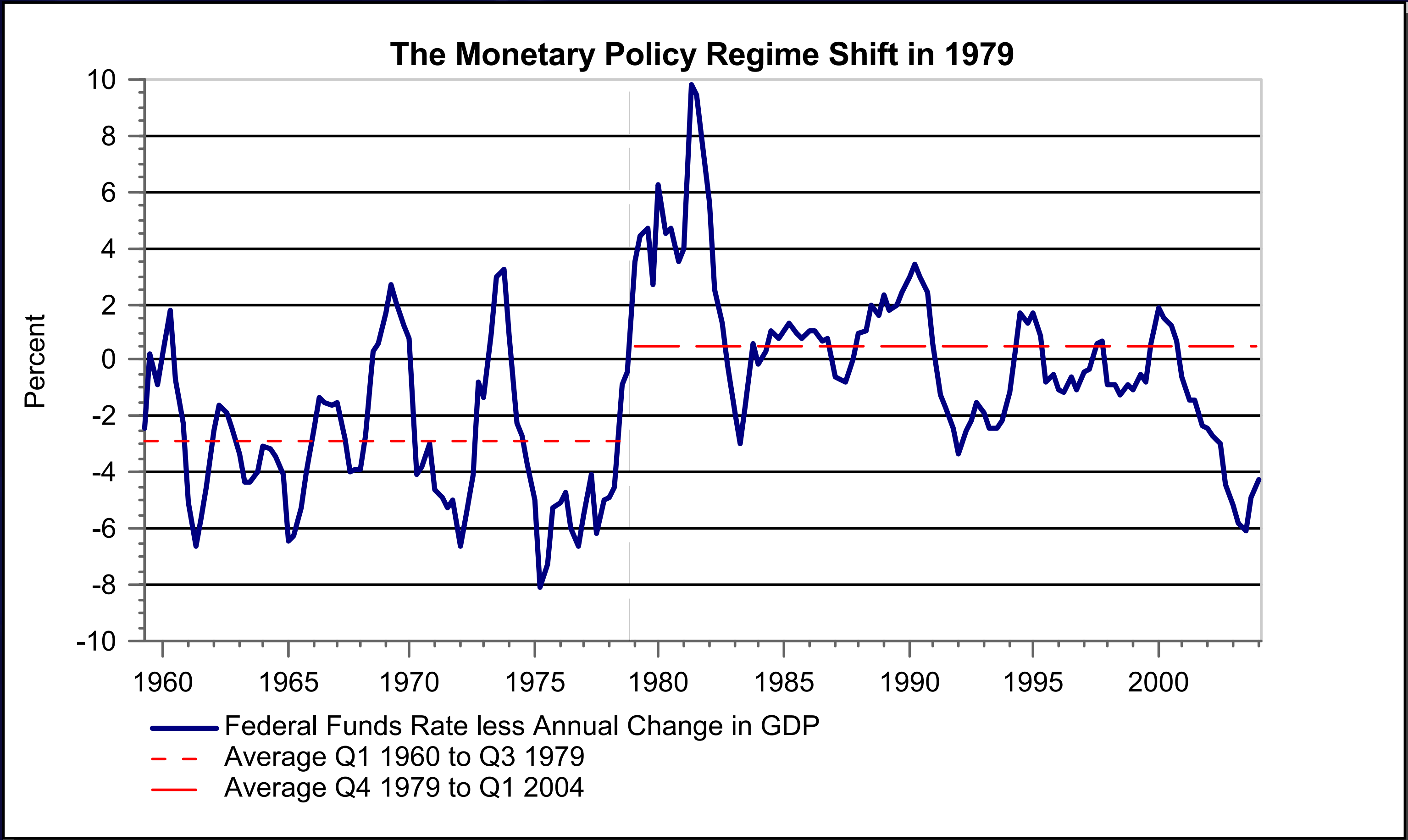
- Fed will be measured
  - Inflation is still in the “acceptable range”
  - Lingering doubts about sustainability of recovery
  - Expect another 175 basis points of tightening in 2005, leaving the funds target at 4.25% at the end of the year
  - Less if growth falls below 3.0%...more if growth accelerates to above 4.0%
- But the Fed has a long way to go
  - Economic theory and empirical observation imply that the neutral funds target is around 5%

Interest Rates



Source: SSgA Economics

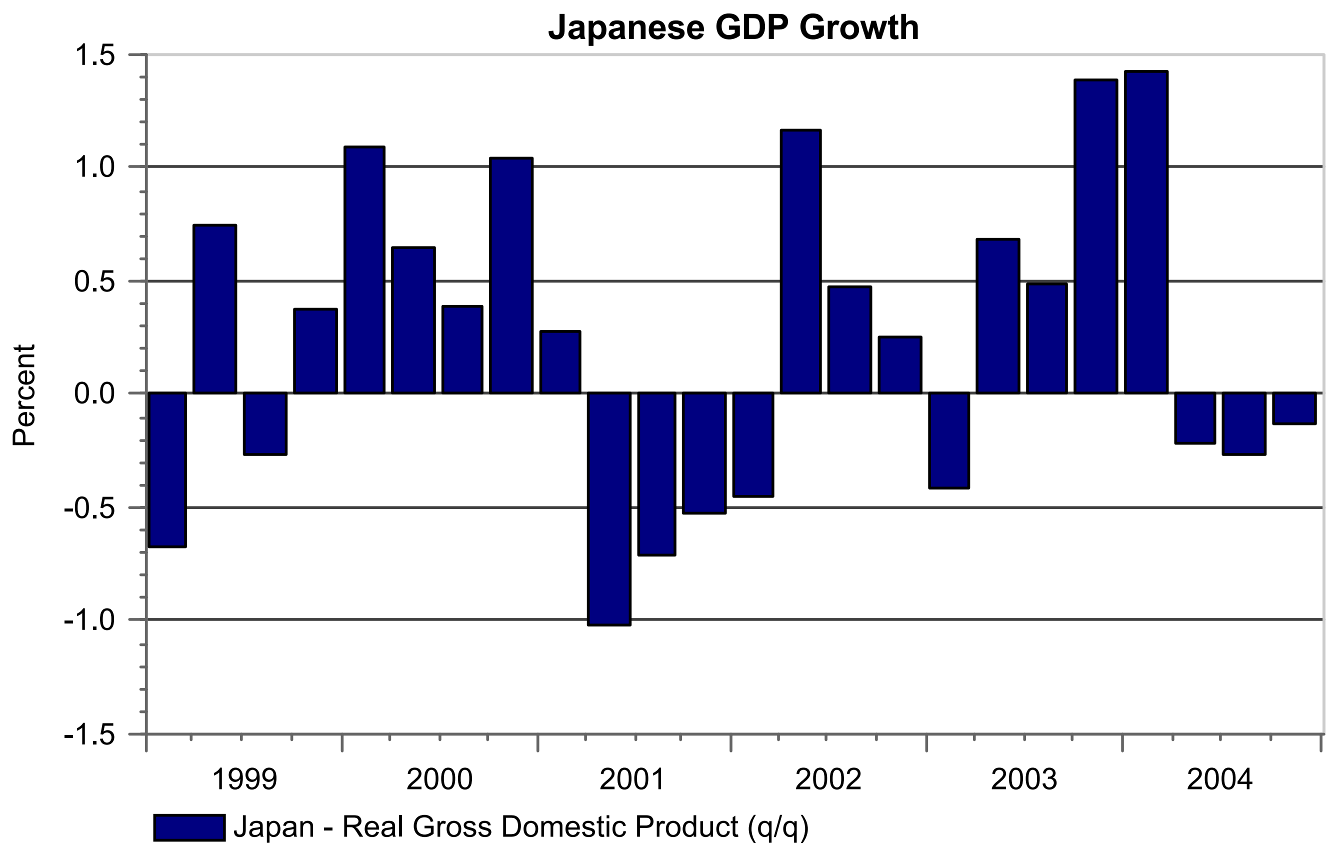
Interest Rates



Japan

- The Japanese economy did well in late 2003 and early 2004. Indeed, it seemed as if it was poised to become the third pillar of global growth, along with the US and China.
- But, the breath of the recovery was always in doubt. And when exports slowed in the spring of 2004, the economy came to a screeching halt. Indeed, GDP actually contracted in the last three quarters of 2004 technically putting the economy back into recession.
- However, there are now signs that the recovery is regaining traction thanks largely to a revival of exports

Japan

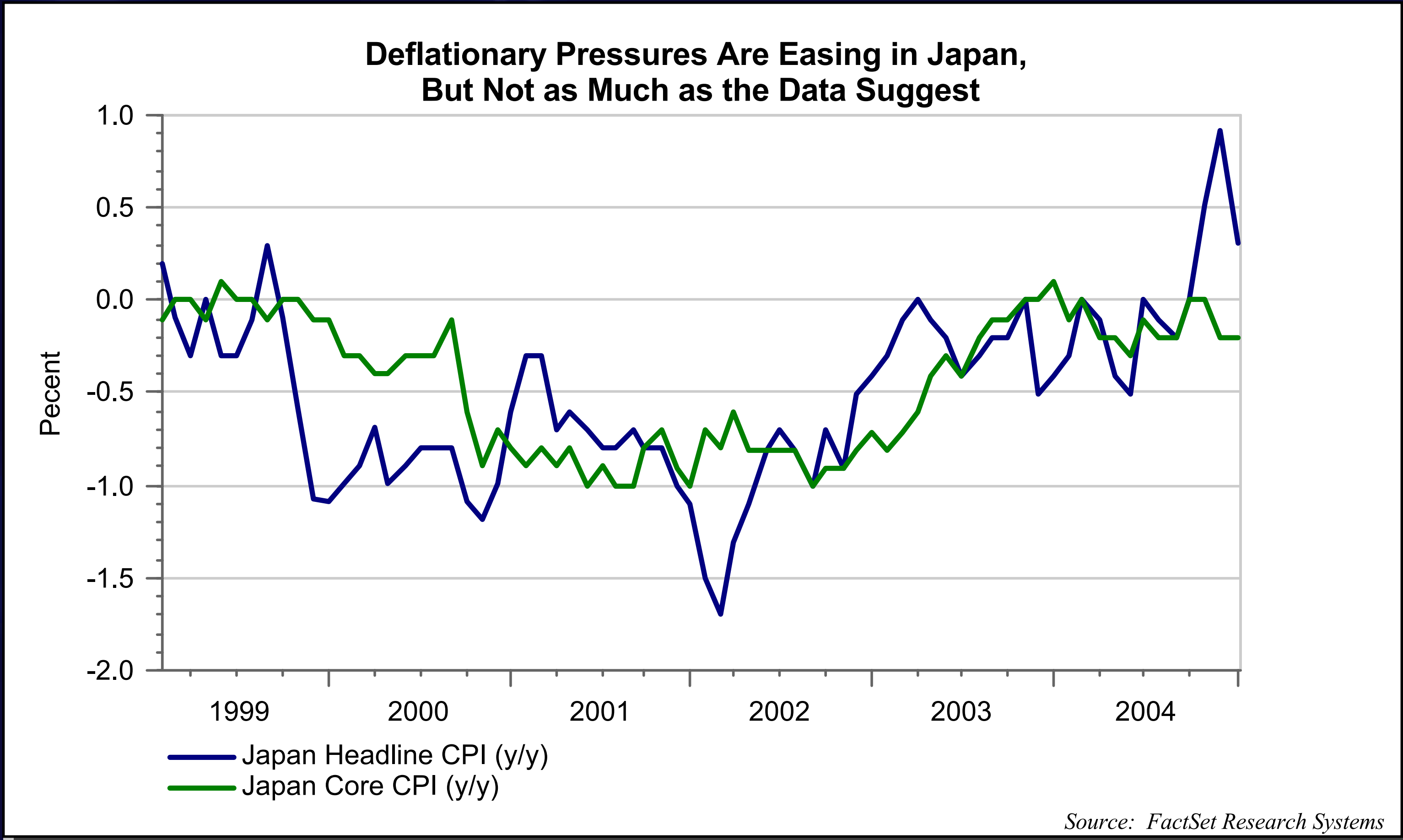


Source: FactSet Research Systems

Japan

- The OECD believes that the economy's late 2003-early 2004 performance virtually eliminated the output gap, marking genuine progress in the battle against deflation
- Indeed, inflation is expected to turn positive on a sustained basis late this year.
- This paves the way for the BoJ to exit the zero interest rate policy most likely in early 2006.
- However the risks are skewed to the downside:
  - High oil prices may slow the global and domestic recoveries
  - The Chinese authorities are attempting to effect a slowdown in what is becoming an important export market for Japan

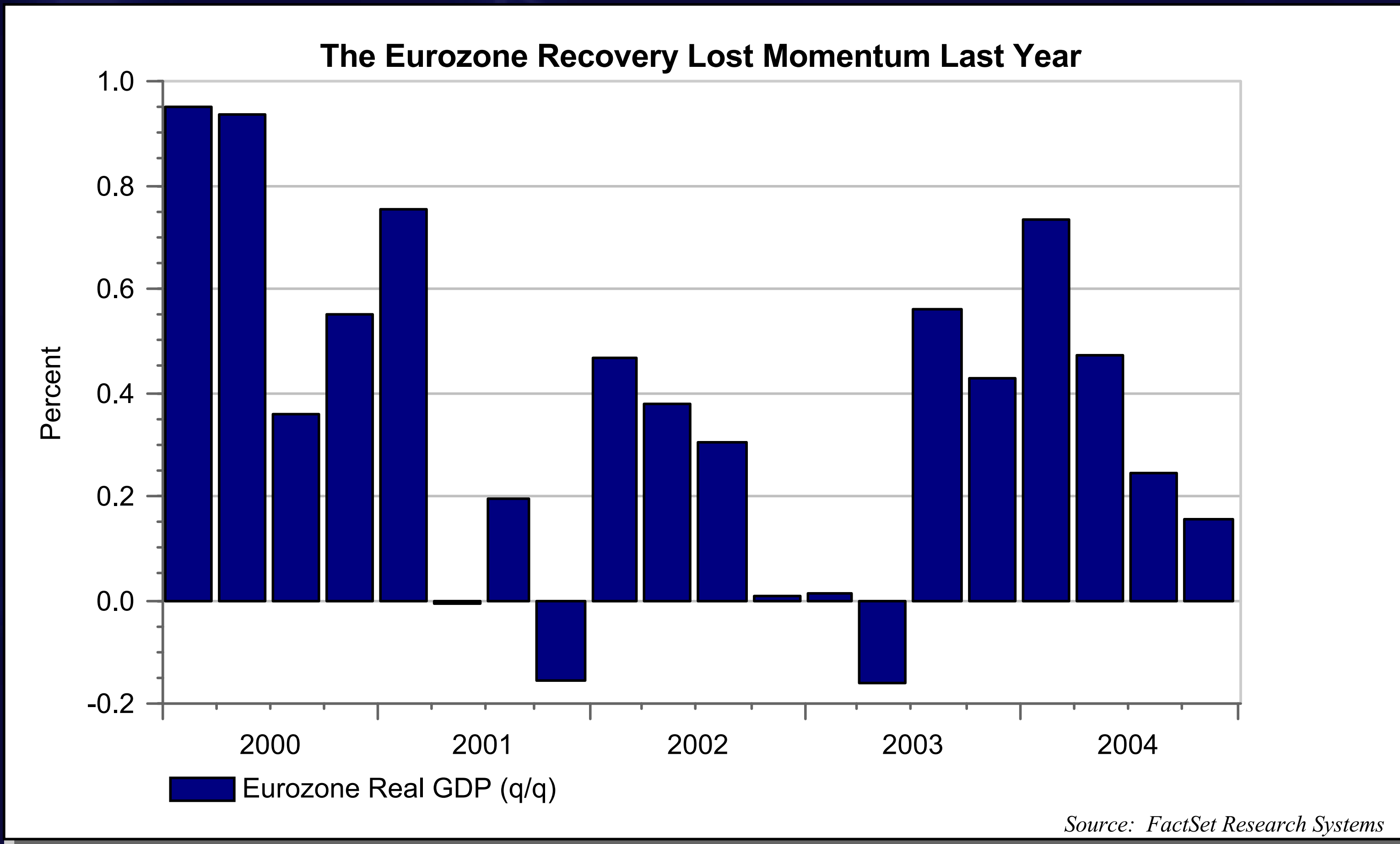
Japan


Deflationary Pressures Are Easing in Japan,
But Not as Much as the Data Suggest
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
Pecent
1999
2000
2001
2002
2003
2004
Japan Headline CPI (y/y)
Japan Core CPI (y/y)
Source: FactSet Research Systems

Eurozone

- The eurozone continues to lag the rest of the world, primarily because of the lack of domestic demand in two of the big-three economies. Hence, the region advanced only 1.8% last year and is projected to grow just by a similar 1.6% this year.
- Germany accounts for over 30% of eurozone output. Exports have suffered from the appreciation of the euro, while domestic demand—particularly consumption—has remained chronically weak, hampering overall growth
- Italy is in even worse shape. Exports have performed anemically, while consumption has remained lackluster, increasingly reflecting uncertainties created by rising oil prices, industrial strife, and political unrest.
- France is the best performing of the big three, as it enjoys a broader-based recovery, encompassing trade, investment and consumption.

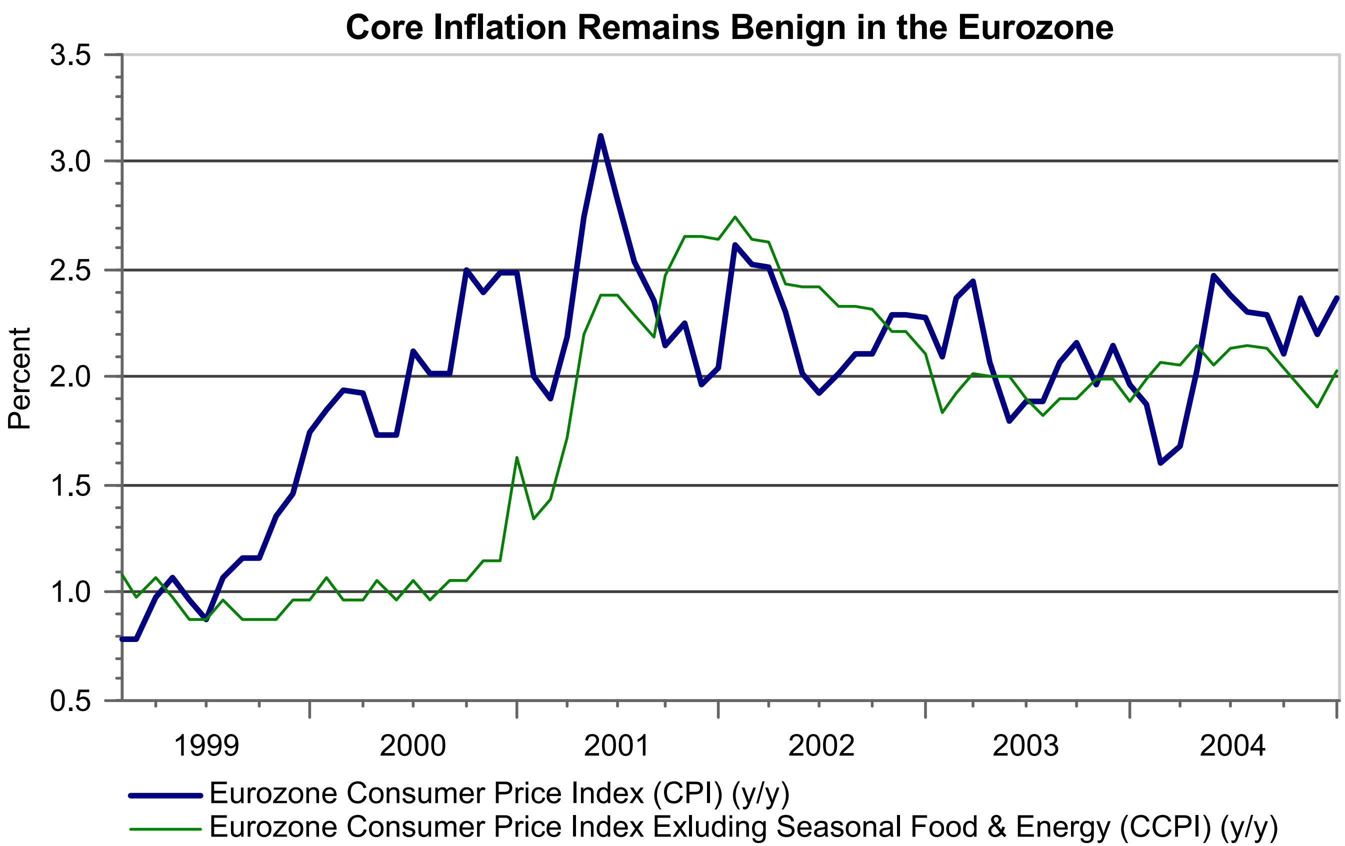
Eurozone


The Eurozone Recovery Lost Momentum Last Year
1.0
0.8
0.6
0.4
0.2
0.0
-0.2
Percent
2000
2001
2002
2003
2004
Eurozone Real GDP (q/q)
Source: FactSet Research Systems

Eurozone

- Inflation remains right around the ECB's "close to but less than 2.0% target," but that reflects a number of special factors such as higher oil prices, and frequent tobacco-tax hikes. Abstracting from these influences inflation remains benign, although seemingly sticky in a downward direction.
- Do not expect a near-term cut in interest rates.
- The next move will be up, although it increasingly seems as if the ECB will hold the line until the second half of this year.
- However, an earlier move is possible if "second-round" effects from higher oil prices emerge, or broad money growth continues to accelerate

Eurozone

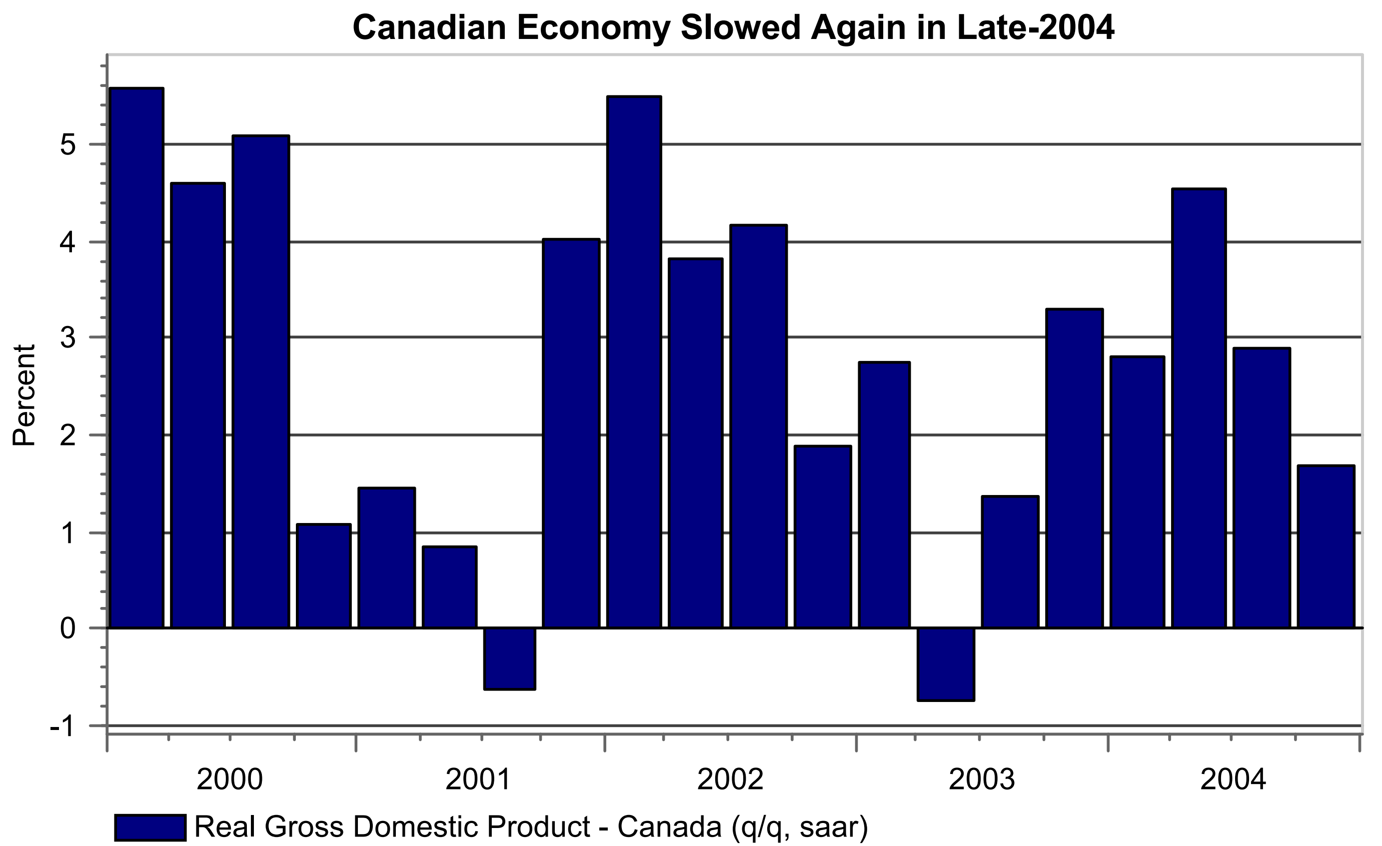


Source: FactSet Research Systems

Canada

- Growth paused briefly in 2003 as the economy was hit by the “perfect storm” of SARS, mad-cow disease, a weaker southern neighbor and a stronger currency
- But economic fundamentals were solid and the Bank of Canada (BoC) responded promptly to the softening, cutting administered interest rates by 125 basis points (from 3.25% to 2.00%) between June 2003 and April 2004
- Growth appeared to get back on track but further appreciation of the Canadian dollar linked to the run-up in commodity prices took a toll on growth
- Growth will reaccelerate over the course of this year

Canada



Source: FactSet Research Systems

Dollar

- The chronic US current account deficit (now approaching around 6.0% of GDP) will continue to weigh on the dollar
- But, there are reasons to assume that the dollar will not crash in 2005:
  - On-going signs of “sustainability” in the US
  - Fed will lead the global tightening in 2005
  - Signs that eurozone “acceptance” of stronger EUR has eroded:
    - “Brutal” comment in Jan 2004
    - Modified G7 statement out of Boca Raton
  - (The Chinese do not appear ready to remove the currency peg)

Dollar

- Hence, we feel that the dollar is caught in a tug-o-war between the negative influences of he current account deficit and the positive influences of an increasingly favorable interest rate differential.
- In the intermediate term, however, there are few grounds for optimism on the dollar as little progress is being made on the imbalances that are contributing to the current account deficit
- The US is doing little to rein in its private and public sector saving shortfalls
- Europe/Japan are doing little to stimulate domestic demand growth and become less dependent on exports
- The burden of adjustment to global imbalances is thus being thrown on to the exchange rate

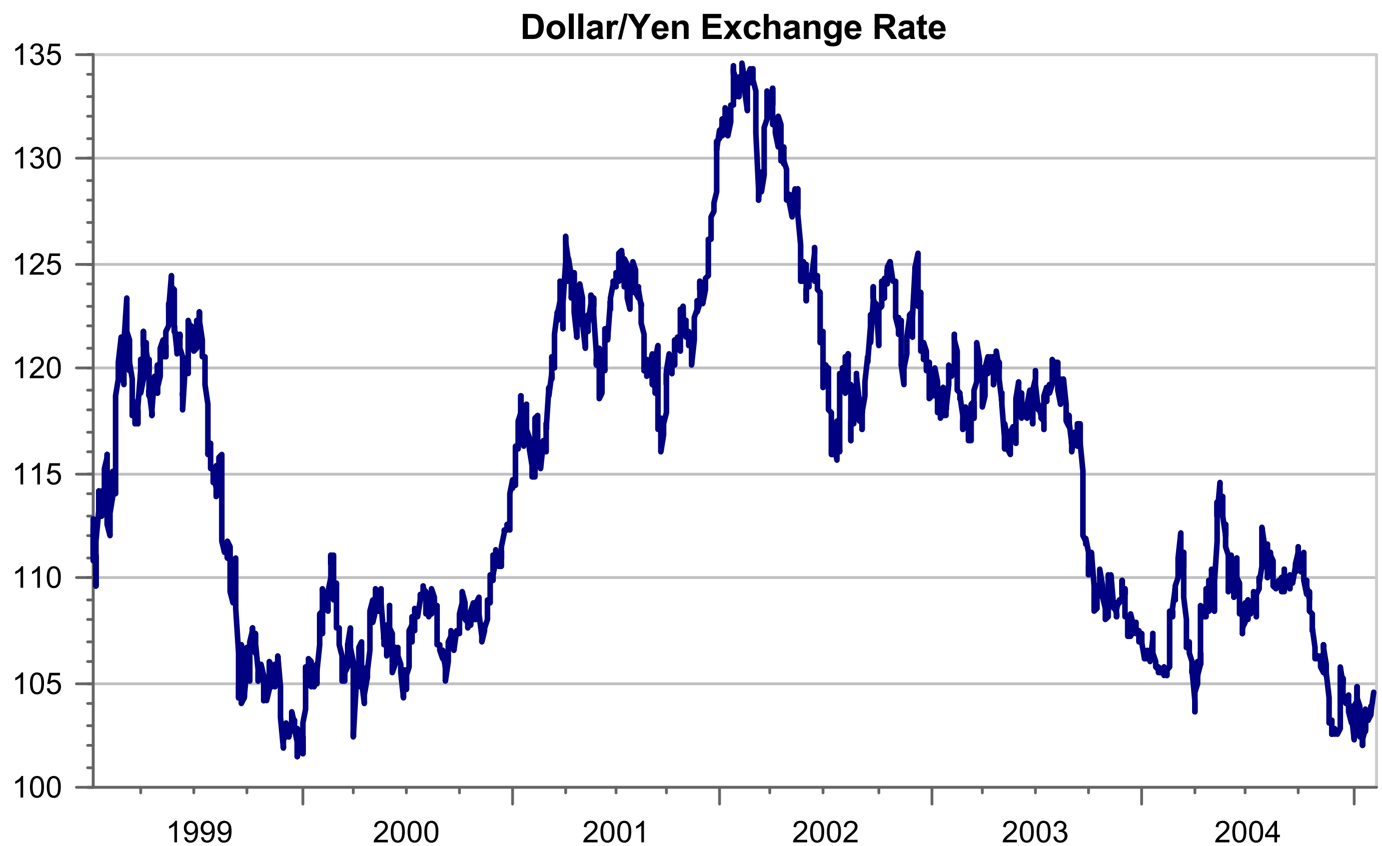
Dollar

- What happens if the dollar crashes?
  - It hurts Europe
  - It hurts Japan
  - It really hurts Canada
  - It helps the US by boosting export demand and retarding import penetration
  - However, it could also put upward pressure on long-term US Treasury yields, restricting the growth of domestic demand (consumption, housing and business investment) and ultimately slowing the rate of growth of potential output.

Dollar

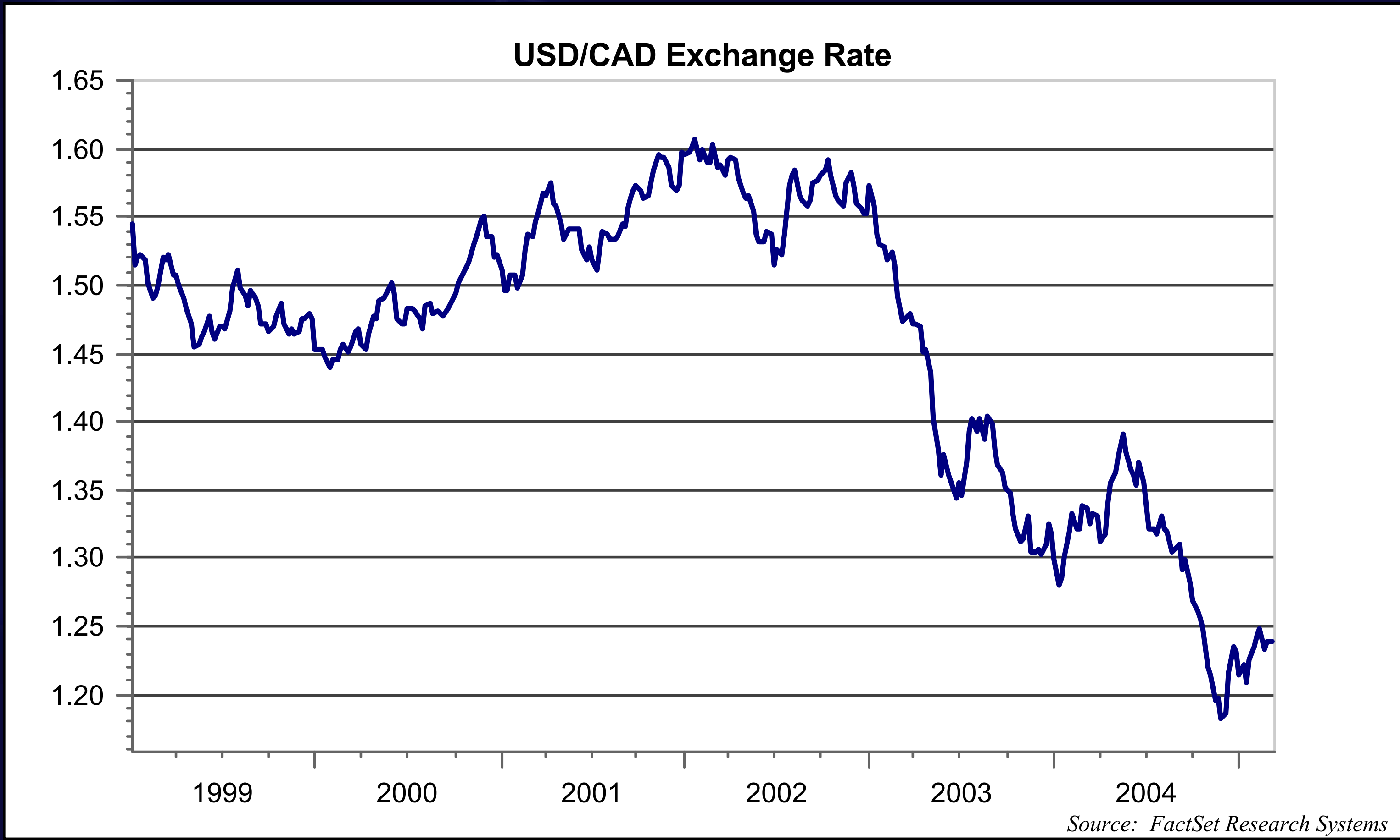
Euro/Dollar Exchange Rate
1.4
1.3
1.2
1.1
1.0
0.9
0.8
1999
2000
2001
2002
2003
2004
Source: FactSet Research Systems

Dollar



Source: FactSet Reseach Systems

Dollar


USD/CAD Exchange Rate
1.65
1.60
1.55
1.50
1.45
1.40
1.35
1.30
1.25
1.20
1999
2000
2001
2002
2003
2004
Source: FactSet Research Systems

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