The Economy at a Glance
Forecast & Business Implications

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SUMMARY – EARLY RECOVERY WILL BE SLOW

- **The recession was mild and little pent-up demand for consumer durable goods and housing was created.**
- **Business investment was the main recession driver.**
- **Business investment recovers slower than consumer spending and housing.**
- **Investor mistrust will hurt equity markets and add to the slowness of the recovery.**

RESULTS - INTEREST RATES WILL REMAIN LOW

- **Interest rates will remain low until a sustained expansion is clearly evident - second half of 2003.**
- **Reported profits will lag economic profits as charges are taken and options are expensed.**
- **Financial markets will lag the real markets, creating buying opportunities,**
- **New business opportunities will be under-priced.**

DISCUSSION

Introduction – The Recession and Real GDP

The American economy is currently experiencing the type of weak recovery that is to be expected after a shallow recession. In fact, in this recession there was no decline in real gross domestic product (GDP) on an annual basis (Chart 1.), The last time real GDP grew in a recession was 1970.

On a quarterly basis, real GDP growth slowed in the second half of 2000, coinciding with the bursting of the Y2K high tech bubble and the NASDAQ collapse (Chart 2.). Real GDP then declined for the first three quarters of 2001. This is in contrast to earlier reports that showed only one decline in the third quarter of 2001.

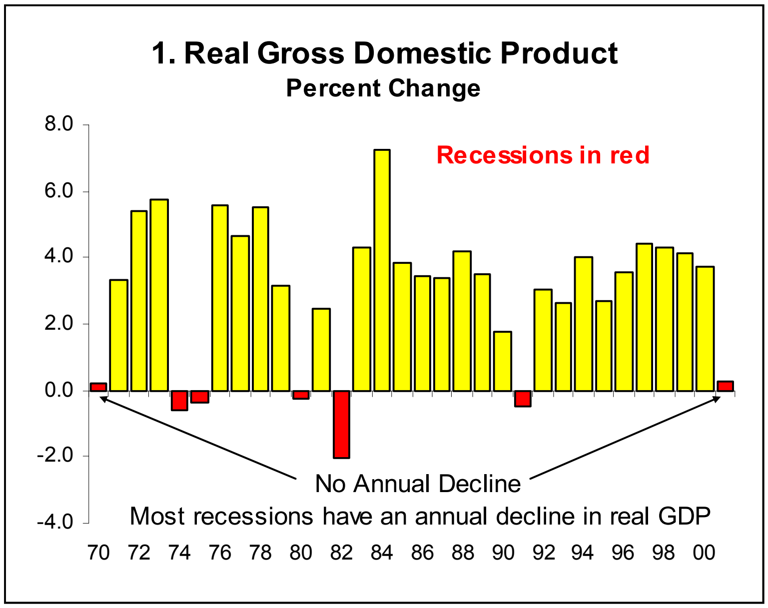
The Shape of the Recession

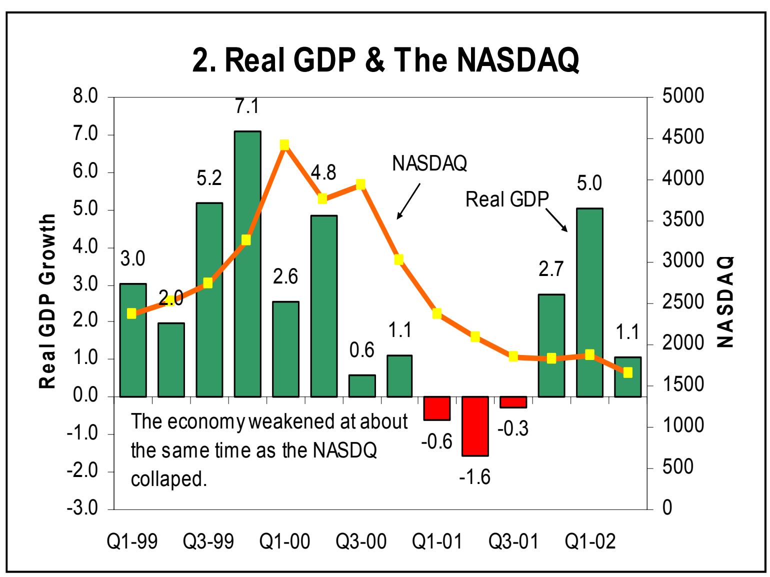
Previous business cycles have been characterized by substantial declines in interest sensitive sectors, such as durable consumer goods and housing (Chart 3., left side). Sharp declines in these sectors created pent-up demand that was quickly filled, once interest rates fell in response to Federal Reserve (Fed) easing.

The Fed was particularly quick acting in this business cycle, reducing interest rates before the recession was officially called in March, 2001 (Chart 4.).

FORECAST

%Change	1999	2000	2001	2002	2003
Real GDP	4.1	3.8	0.3	2.3	3.2
CPI	2.2	3.4	2.8	1.5	2.0
Federal Funds Rate	5.0	6.2	3.9	1.8	2.2
10 Year Treasury Bond	5.6	6.0	5.0	4.8	5.2
Unemployment Rate (%)	4.2	4.0	4.8	6.0	5.8





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Low interest rates, combined with the tax cut kept consumer durable spending and housing at high levels. This recession was characterized by a sharp decline in business investment (Chart 3., right side). Equipment investment, particularly on communication equipment, started falling at the beginning of 2001. Associated with this decline was the sharp drop in the NASDAQ, as the high tech bubble burst.

The Shape of the Recovery

While consumer and housing spending can turn up quickly when sentiment changes, shifts in business spending are slowed by the need to follow business plans, Therefore, a recovery led by business spending will initially be slower and weaker than a consumer led recovery. Until pricing power and profits return, businesses are unlikely to make major investments in expanding their productive capacity.

While there are good reasons for this recovery to take its time, expansions always take longer than people would like. After the disruptive impact of a recession on business profits and management confidence, it take time for investment and hiring to turn up. These business lags are more significant to overall growth when consumer pent-up demand is not present to offset the lack of business spending.

Despite these lags, business investment will recover and help drive the expansion. Business investment, particularly high tech investment is needed to restart the virtuous circle of strong investment-high productivity growth-low inflation-high economic growth that characterized the American economy in the second half of the 1990's (Chart 5.). The Fed understands these dynamics and will not increase interest rates until a sustainable expansion in investment spending is evident.

Summary-Business Implications

- **Extraordinary amount of monetary and fiscal stimulus almost guarantee a significant expansion going forward.**
- **Lack of pent-up consumer and housing demand will slow the early recovery period leading to uncertainty that will create opportunities.**
- **Uncertainty will keep interest rates and prices low producing a positive environment for financial investment, mergers and acquisitions, new businesses, and organic growth.**