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Goldman Sachs

U.S. Economics Analyst

Monetary Policy Is Not Tight

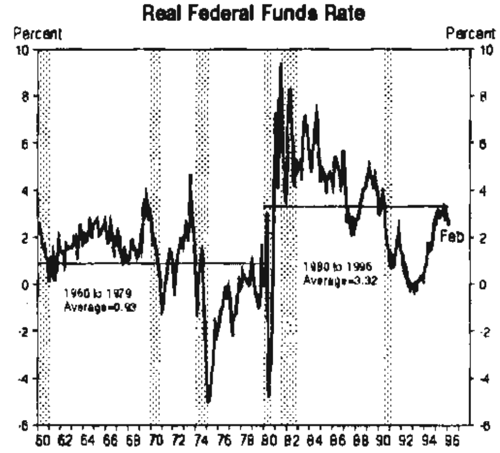
- Although M1, the narrow monetary aggregate, has been falling and the real federal funds rate is currently slightly above its long-term historical average, most indicators imply that U.S. monetary policy is not tight: M2, the broader aggregate, has recently climbed above the top end of its 1%-5% target growth range; private debt is growing at a respectable rate; credit spreads are narrow and credit is widely available; the housing and consumer durable goods sectors are doing better; and stock prices are soaring.

- If monetary policy is not tight currently, that implies that it may need to be tightened in the future. After all, if the economy begins to grow above its long-term trend again, some policy restraint will be required at some point to guard against overheating.

- If investors begin to anticipate that monetary policy will be tightened, that could trigger a second downward leg to bond prices. At current yields, the bond market is consistent with no significant change in the stance of monetary policy in either direction.

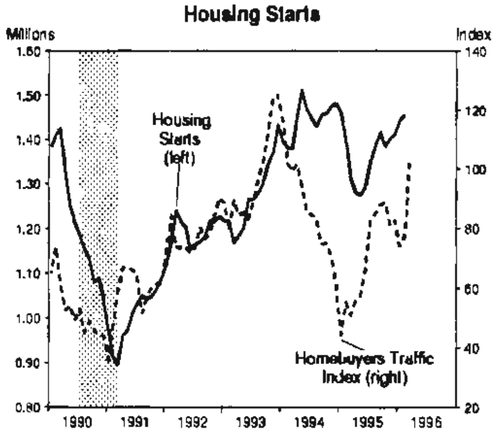
- Fed officials almost certainly will leave interest rates steady at their meeting on March 26, as signs of an economic pickup have accumulated. Central bankers may be considering the establishment of a low, official target range for inflation as a means of diffusing pressures for more growth-oriented monetary policies.

Real Federal Funds Rate



Source: Federal Reserve Board, Department of Labor.

Housing Starts



Source: Department of Commerce.
National Association of Home Builders.

Trade Recommendations

- Maintain short stance in December eurodollar futures, with target of 94.00; set stops at 94.50.

- Set short positions in June Treasury bond contracts above 113½.

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Issue No: 96/12
March 22, 1996

I. Weekly Wrapup

Economic and Market Overview

The sharp upward trend in U.S. yields since early February was interrupted this week, as a buoyant dollar exchange rate and weak overseas economic reports encouraged participants to cautiously increase debt market commitments. Most domestic indicators, though, continue to imply an incipient strengthening of business conditions. Retail sales rose 0.8% during February, led by a 2% dollar-volume increase at motor vehicle dealers, who experienced an even greater pickup in their unit deliveries. When autos and building materials are excluded, nominal retail spending over the past three months has firmed modestly. This has aided firms in reducing unwanted goods stockpiles that developed in late 1995. Transportation difficulties caused by bad weather caused business inventories to swell 0.6% during January. Among nonauto retailers, however, stocks were liquidated by 0.2%, and the inventory-to-sales ratio for those distributors has been brought back down to year-ago levels. Leaner stockpiles ought to facilitate a rebound in manufacturing industries, but so far there is little evidence in the regional data that such a recovery is yet underway. In the Philadelphia Fed district, for example, manufacturers characterize their activity as essentially flat, with a -0.1% index for general conditions this month.

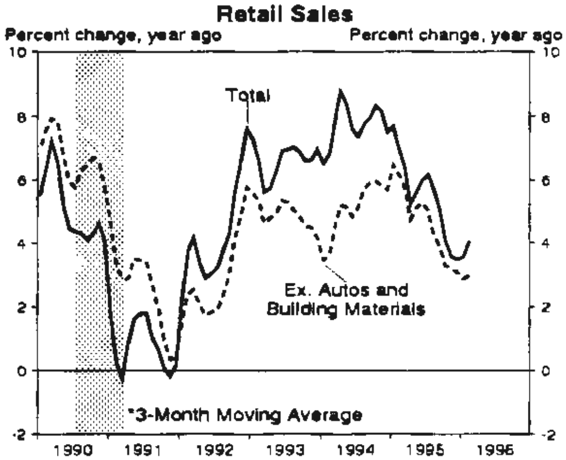
Housing construction stayed brisk in February, with overall housing starts climbing another 3.0% to a 14-month high. The latest survey of builders indicates an appreciable pickup in both buyer traffic and sales expectations over recent weeks, developments that could keep home starts fairly high for awhile despite rising inventories of unsold dwellings and a less favorable mortgage financing environment.

Federal Reserve Policy

New York Fed president William McDonough this week delivered an address that may hold some clues as to the course Chairman Greenspan intends to take in his new term at the Fed's helm. McDonough enumerated the benefits that he and other officials expect to reap from achievement of price stability, including reduced financial uncertainty, avoidance of tax distortions, and increased overall economic efficiency. He then identified a 0.5%-2.0% range for annual consumer price increases as an appropriate practical definition of price stability, suggesting that this would take account of measurement errors that are believed by many analysts to infect that inflation benchmark. McDonough's speech dovetails nicely with public remarks made by Dr. Greenspan in the past, though the chairman has never detailed precisely what level of price inflation he would regard as a policy objective.

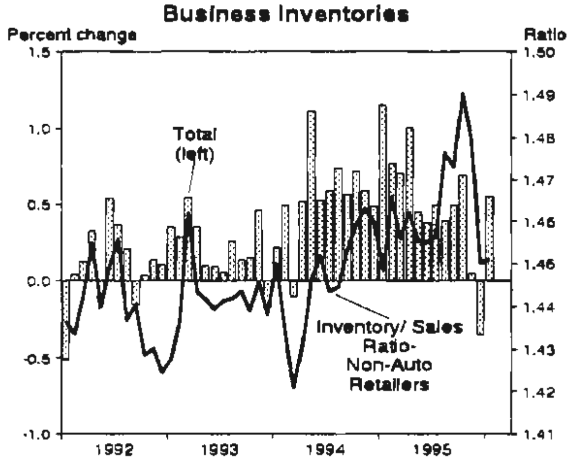
There are at least three reasons to suspect that the Fed in the third Greenspan term might adopt a low, specific target range for inflation as a main policy objective. First, this strategy has been employed by other central banks as a means to enhance their anti-inflation credibility and lower actual inflation results. Second, the establishment of a CPI target would help diffuse rising pressures for revising up estimates of

Retail Sales



Source: Department of Commerce.

Business Inventories



Source: Department of Commerce.

the economy's noninflationary speed limit. Establishment of such a long-run objective could better insulate the Fed from the widening political debate about what growth rates are possible. Third, by underscoring their commitment to sustaining disinflationary trends, officials can hope to dampen current fears in the bond market that even moderately better GDP growth will lead to a revival of price pressures.

Fiscal and Political Developments

With the Republican presidential nomination in hand, Senator Dole is moving to create a backdrop of legislative action for his campaign against President Clinton this fall. Dole's first step in this direction was to break the congressional gridlock that had barred passage of a line-item veto authority for the president. Dole and Clinton reportedly have agreed that, starting next January, the chief executive should have the right to excise specific portions of spending bills, a power that most state governors already possess. Though this measure would help to eliminate some egregious examples of wasteful spending, by itself it will not do much to reduce the structural budget deficit, because discretionary federal outlays have already been squeezed significantly by caps adopted in fiscal 1991. Durable progress toward fiscal balance depends on mandatory program spending restraint, and reforms of those areas remain bogged down in partisan squabbling.

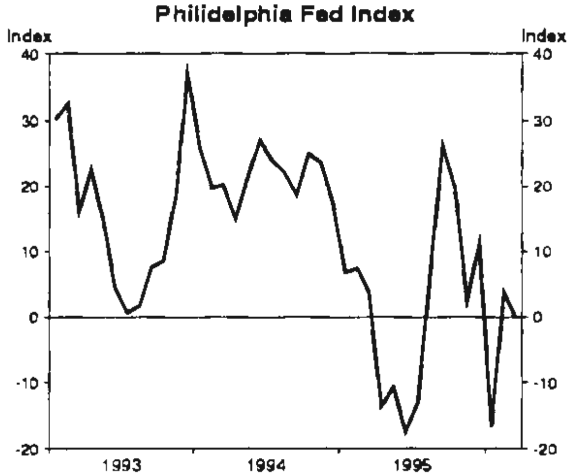
Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

We continue to anticipate a further rise in forward money-market rates, as a gradual economic speed-up fosters more neutral and, ultimately, somewhat pessimistic views of monetary policy prospects. At 5.74%, the December eurodollar futures contract yield does not provide enough marginal return versus a 5.25% federal funds rate to compensate for growing risks of a credit tightening by fall, particularly when likely yearend financing market pressures are taken into consideration. We would look for this yield to rise above 6% before covering short positions, although protective buy-stops should be set at 5.50%.

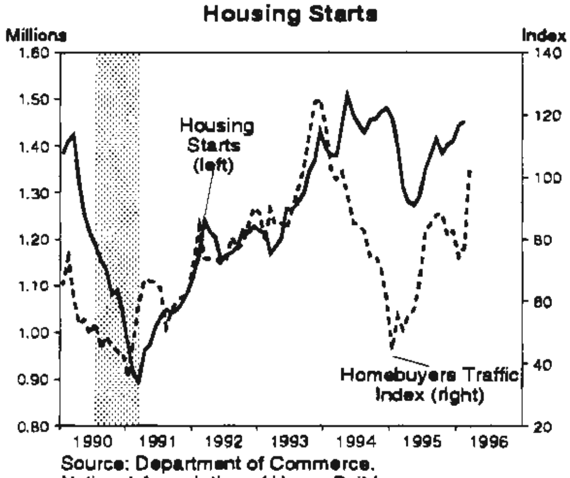
With Fed easing no longer on the horizon, it should be difficult for the market to sustain a rally below a 6.5% yield on the current 30-year Treasury issue, given normal risk premia in that sector. We therefore recommend establishing shorts in the June bond futures contract if it moves above 113½.

Philidelphia Fed Index



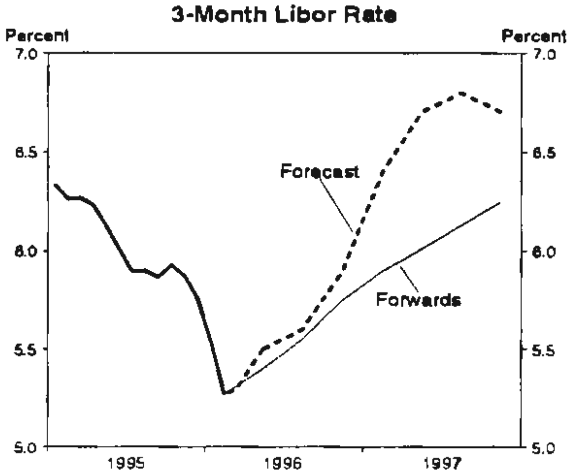
Source: Federal Reserve Bank of Philidelphia.

Housing Starts



Source: Department of Commerce. National Association of Home Builders.

3-Month Libor Rate



Source: Federal Reserve Board. Wall Street Journal.

II. Monetary Policy Is Not Tight

In considering the outlook for interest rates, one issue that is critical is a proper assessment concerning the current stance of monetary policy. After all, if monetary policy were currently tight, any rebound in economic activity would tend to fade as policy restrained economic activity. In that case, a tight policy would imply lower short-term rates eventually. In such a case, the bond market would be attractive because bond yields are currently consistent with no significant change in the level of short-term interest rates.

In contrast, if monetary policy were currently neutral or easy, then more bad news for the bond market could be expected to lie ahead. In that case, any rebound in the economy would not be restrained by monetary policy. Further tightening would be needed to keep the economy from overheating. In that case, bond yields would likely rise further as the expectation of a significant tightening of monetary policy were embodied in bond yields.

We conclude that U.S. monetary policy is not tight. Thus, we continue to expect that policy will eventually need to be tightened to prevent the U.S. economy from overheating. When that expectation becomes more widespread — an outcome that still is probably many months away — that is likely to lead to a second downward leg for the U.S. bond market.

Arguments That Policy is Tight Not Compelling

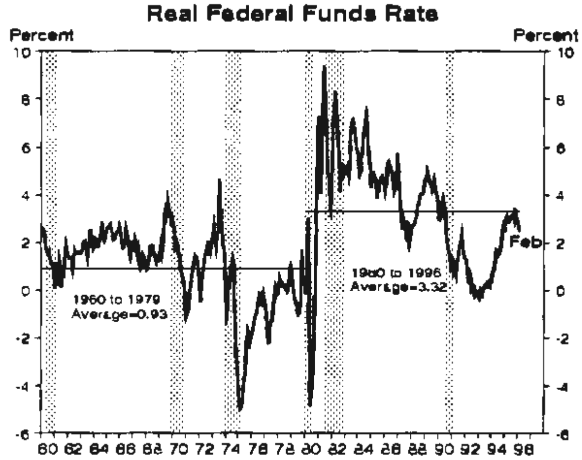
Unfortunately, most of the guideposts used to assess the stance of monetary policy over the past few decades have become unreliable. As a consequence, the degree of uncertainty concerning the stance of monetary policy and its likely impact on economic activity has risen sharply over the past decade.

Proponents of the view that policy is currently tight typically point to two measures of the monetary policy stance: 1) the level of the real federal funds rate and 2) the growth rate of the monetary base and the narrow monetary aggregate, M1.

In our view, neither of these indicators that monetary policy is tight is compelling. In terms of the real federal funds rate, we do not dispute the fact that the real federal funds rate — currently about 2 ½% — is slightly above its long-term historical average of about 2%. However, this is a very thin reed on which to base the conclusion that monetary policy is tight. First, the difference between 2½% and 2% is microscopic in the context of the wide variability in the real federal funds rate over the past 35 years. As shown in the accompanying chart, the real federal funds has been as high as 9.4% and as low as -5% over this period. The standard deviation around its average value over this period is 2.3 percentage points. In this context, the difference between 2½% and 2% is hardly material.

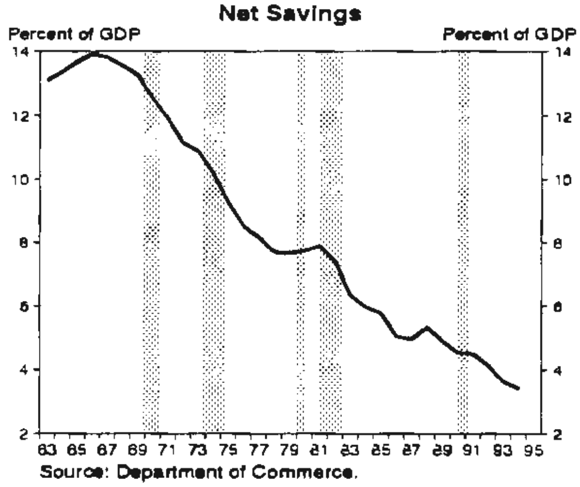
Second, although the real federal funds rate is currently above its average value since 1960, it is below its average value since 1980 of 3.32%. If the latter period is the more relevant one for comparison

Real Federal Funds Rate



Source: Federal Reserve Board. Department of Labor.

Net Savings



Source: Department of Commerce.

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purposes, then monetary policy could be judged to be accommodative by the real federal funds rate standard rather than tight.

Third, the significant decline in the national savings rate over the past thirty years suggests that the equilibrium real federal funds rate today should be higher than its historical average. After all, a diminished pool of domestic savings should lead to a higher average level of interest rates to ration that smaller pool among business and household borrowers.

The Shadow Open Market Committee (a group of academic economists with strong monetarist leanings) recently recommended to the Federal Open Market Committee that Fed officials should ease monetary policy further. Apparently, the members of the Shadow Committee are worried that the paltry 2.6% growth rate of the monetary base (i.e., currency plus bank reserves) over the past year and the 2.7% decline in M1 over the same period indicate that monetary policy is tight.

The weakness in the growth rate of the monetary base and the decline in M1 should not be taken as evidence of monetary stringency. First, the monetary base, which consists predominately of currency, is now affected as much by the demand abroad for dollars as a "hard" currency substitute for "soft" domestic currencies than by the U.S. economy. Fed officials estimate that roughly two-thirds of outstanding U.S. currency is held abroad. Second, M1 is collapsing because banks are using sweep accounts to reduce the amount of checkable deposits. Each night, checkable account deposits are swept into money market deposit and savings accounts. This enables banks to reduce their reserve requirements, which is advantageous to banks because reserves are non-interest bearing assets. Because the decline in M1 is being driven by institutional efforts to avoid reserve requirements, it is not evidence of a tight monetary policy.

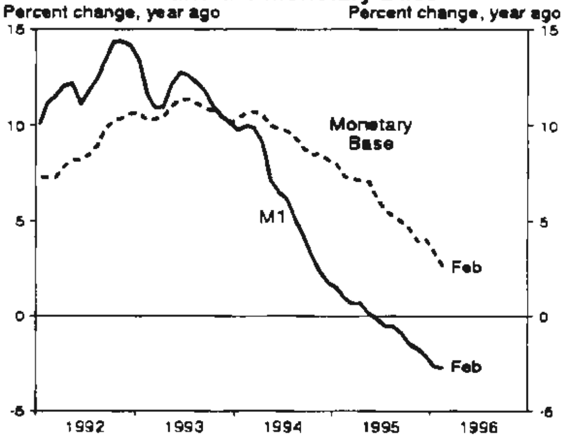
Evidence that Monetary Policy is No Barrier to Growth

There is much more evidence that policy is neutral-to-accommodative rather than tight. First, unlike the monetary base and M1, M2 growth is surging. As shown in the accompanying chart, M2 recently pierced the top end of its 1%-5% target growth range. The shifts in the composition of deposits that are affecting M1 are not influencing M2 because both types of deposits — the other checkable deposits that are declining and the savings accounts that are rising — are included in M2.

Second, other measures of monetary policy are consistent with a relatively easy monetary policy. For example, debt growth has climbed over the past year. As shown in the accompanying chart, while the growth rate of consumer installment debt has slowed slightly, the growth rate of non-federal debt (a much broader measure) is near its peak for the current expansion. Similarly, credit availability remains high and credit quality spreads remain very narrow, suggesting that monetary policy is not tight.

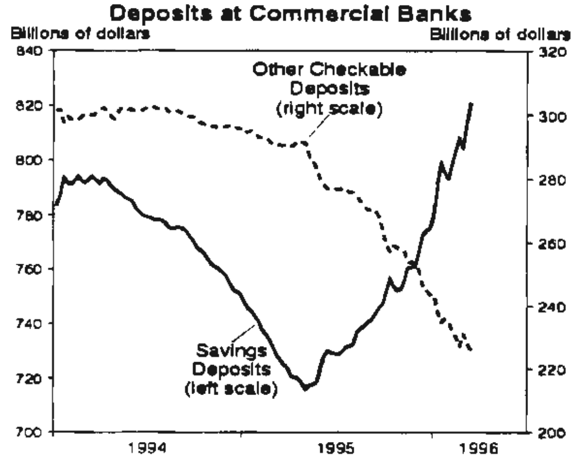
Third, the performance of the economy and the stock market is not consistent with a tight monetary policy regime. For example, housing and consumer durable sales have recovered recently. Similarly, the 35%-

M1 and the Monetary Base



Source: Federal Reserve Board.

Deposits at Commercial Banks



Source: Federal Reserve Board.

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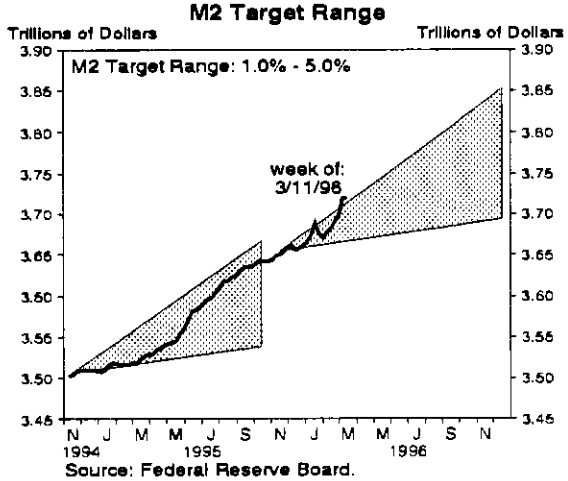
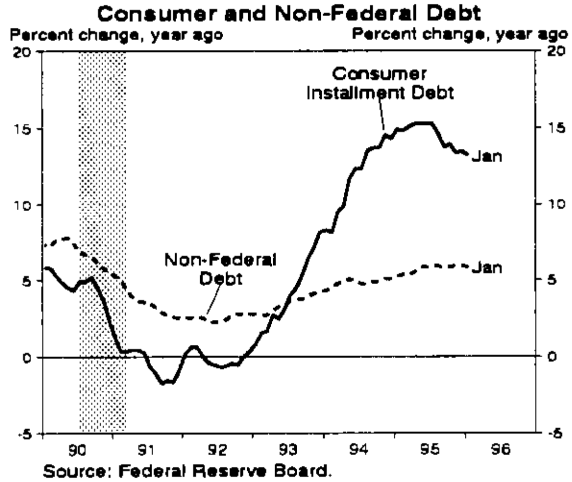


Source: Federal Reserve Board.



Source: Federal Reserve Board.

40% rise in stock prices since the beginning of 1995 does not suggest that monetary policy is tight.

Implications for Financial Markets

If we are correct in our assessment that monetary policy is not tight currently, this has three major implications for financial markets. First, this assessment implies that further monetary tightening will be needed down the road to restrain the U.S. economy and keep it from overheating. For this reason, we continue to anticipate that Federal Reserve officials will tighten monetary policy by yearend and will push the federal funds rate above 6% in 1997.

Second, it means that the bull market in bonds is over for the foreseeable future — perhaps until the end of the current business cycle, which may not occur until 1998 or even later. The rise in bond yields that has occurred this year just reflects the washing out of expectations concerning the likelihood of additional Fed easing. As long as Fed easing is on hold, 30-year Treasury bond yields are likely to remain where they are currently — within a 6½%-7% range. This level is consistent with the average 130-basis-point spread between 30-year Treasury bonds and the federal funds rate that has prevailed since 1980.

Third, further increases in U.S. bond yields can be expected once it becomes apparent that Fed officials are likely to tighten monetary policy again. Such increases probably will not happen immediately, as the U.S. economy is likely to gather strength only slowly. However, by yearend we expect upward pressure on bond yields to develop once again.

For equities, the benefit for earnings and earnings visibility from a more vibrant economy may more than offset the impact of higher interest rates on valuation. This is especially true as long as the interest rate increases remain prospective. Our Portfolio Strategy Group estimates that equities are currently trading at roughly fair value based on estimated 1996 earnings. Given the rise in earnings expected from 1996 to 1997, the stage should be set for a further rise in stock prices over the next year.

Bill Dudley

Goldman Sachs

Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	'96 Feb	'96 Jan	'95 Dec	'95 Nov	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	705	-188	145	212	173	146	Apr 5
Unemployment Rate (%)	5.5	5.8	5.6	5.6	5.6	5.6	
Index of Hours Worked (% ch)	3.2	-2.0	-0.3	-0.4	3.4	1.6	
Average Hourly Earnings (% ch)	-0.1	0.4	0.3	-0.1	3.0	2.9	
Producer price finished goods index (% ch)	-0.2	0.3	0.6	0.2	3.0	2.0	Apr 11
Excluding food and energy	0.1	-0.1	0.2	0.2	1.9	2.0	
Consumer price index (% ch)	0.2	0.4	0.2	0.1	2.6	2.7	Apr 12
Excluding food and energy (% ch)	0.2	0.3	0.1	0.1	2.7	2.9	
Retail sales (% ch)	0.8	-0.1	0.7	0.9	3.8	5.0	Apr 11
Excluding motor vehicles (% ch)	0.4	-0.2	0.4	0.8	2.9	3.2	
Industrial Production (% ch)	1.2	-0.4	0.1	0.4	1.6	1.6	Apr 16
Manufacturing	1.4	-0.3	0.2	0.1	3.0	1.7	
Capacity utilization (%)	82.9	82.1	82.7	82.9	82.9	83.3	Apr 16
Manufacturing	82.1	81.2	81.8	81.9	82.0	82.5	
Housing Starts (annual rate, thousands)	1490	1447	1425	1458	1429	1379	Apr 16
Single-family	1170	1140	1150	1129	1138	1095	
Trade balance (billions, monthly)	--	--	-6.8	-6.7	-8.2	-9.3	Mar 29
Merchandise	--	--	-12.3	-12.2	-13.6	-14.6	
Factory Orders (% ch)	--	0.5	1.7	-0.1	12.0	3.1	Apr 3
Durable Goods	--	0.2	3.1	-0.8	19.4	3.7	Mar 27
Personal Income (% ch)	--	0.1	0.6	0.3	4.2	4.6	Apr 3
Wages and Salaries	--	-0.2	0.6	-0.1	2.9	4.0	
Purchasing Managers' Index (%)	45.2	44.2	46.0	46.0	46.1	47.7	Apr 1
Consumer Sentiment U Mich (Feb 66=100)	88.5	89.3	91.0	88.2	89.3	91.0	Mar 29
Conference Board (1985=100)	97.0	88.4	99.2	101.6	96.6	98.8	Mar 26

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

U.S. Calendar

Focus for the Week Ahead

- The Federal Open Market Committee meets on Mar. 26, and on this occasion they will reveal any decisions prior to 11 a.m.; it is highly unlikely that any policy changes will be made.
- The Senate Banking Committee holds a confirmation hearing on the nominations of Alice Rivlin and Lawrence Meyer to the Federal Reserve Board (Mar. 26). This will be an opportunity to assess their views on current key monetary policy issues.
- Results of the latest Commerce Department survey of investment spending plans (Mar. 28) should provide some guidance as to whether domestic firms have adopted a more cautious approach to such outlays in the wake of the late-1995 economic slowdown.
- Purchasing managers in the Chicago area will release the results of their March activity poll (Mar. 29). A rebound from an unusually weak reading a month ago seems probable.

Economic Releases and Other Events

Date	Indicator	Estimate GS	Estimate Consensus	Last Report
Mar. 25	Existing Home Sales (Feb.)	Up	+2.4%	-4.1%
Mar. 26	Consumer Confidence (Mar.)	Up	98.0	97.0
Mar. 27	Durable Goods Orders (Feb.)	-2.0%	-0.1%	+0.2%
Mar. 29	Trade Balance (Jan.)	-$7.3 Bil	-$7.1 Bil.	-$6.8 Bil.
	New Home Sales (Feb.)	Down	-2.6%	+4.2%

- FOMC Meeting (Mar. 26)
- Import and Export Prices (Mar. 26)
- California Primary (Mar. 26)
- Confirmation Hearing For Fed Appointees (Mar. 26)
- Investment Plans Survey (Mar. 28)
- Chicago Purchasing Managers Survey (Mar. 29)
- Consumer Sentiment For March - Final (Mar. 29)
- January FOMC Minutes (Mar. 29)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.5	5.6	6.4
Forward	5.4	5.6	5.9
2 Yr T-Note	5.7	5.9	6.4
Forward	5.8	6.0	6.1
10 Yr T-Note	6.3	6.5	6.8
Forward	6.3	6.4	6.5

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	0.9%	1.0%	2.0%	2.1%	1.8%
Ind. Production	1.3	3.0	2.0	3.6	2.3
CPI	2.4	3.0	2.7	2.8	2.8
Profits*	5.2E	5.8	6.1	9.7	3.2
Merch Trade Bal. (monthly, $B)	-11.6	-14.3	-13.3	-13.3	-12.9

* Excluding inventory profits; adjusted for depreciation distortions

Goldman Sachs

U.S. Economics Analyst

Our Views Have Changed

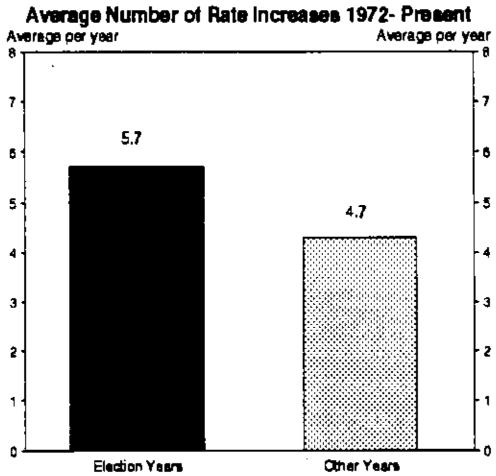
Elections And The Fed: Little Impact Evident

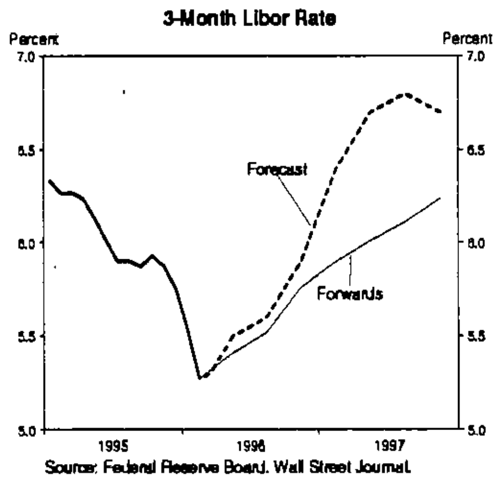
- Given the recent strength evident in the economic data, we have made a number of changes to our forecast: 1) Our GDP estimates for the first and second quarters are raised to 1% and 2% (annualized), respectively, from 0.5% and 1.7% earlier; 2) Fed officials are no longer expected to ease monetary policy further; 3) The thirty-year Treasury bond is now expected to trade generally in a 6.5%-7.0% range over the remainder of the year.

- These forecast changes reflect our assessment that the inflection point for economic growth has arrived a bit sooner than anticipated. Our forecasts beyond the first half of the year remain unchanged both for economic growth and interest rates.

- The hypothesis that the presidential election campaign could deter Fed officials from tightening is not supported by historical patterns. If anything, rate increases have been more common during national election years than otherwise, owing to the tendency toward stronger economic expansion in those periods.

- However, historical evidence suggests that there is some tendency for central bankers to avoid changing policy after Labor Day and before Election Day. This year the potential for a policy move in that period is further reduced because only one FOMC meeting will take place between mid-August and Election Day.





Source: Federal Reserve Board, Wall Street Journal.

Trade Recommendations

- Shift short positions in Eurodollar futures contracts to December from September. As noted above, tightening is somewhat more likely following the election than just before.

- On bonds, we would look to establish a short position should the market rally sufficiently to push the yield on the cash bond back below 6.5%.

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Issue No: 96/11
March 15, 1996

I. Weekly Wrapup

Economic and Market Overview

After jumping in response to the robust February employment report, U.S. yields have hovered in a narrow range as investors nervously await clearer signals about broad economic conditions. Though market participants were calmed somewhat by reports that senior government analysts are deeply skeptical of the jobs data's credibility, there is now clearly a greater willingness to acknowledge the possibility of an early upturn in spending and production.

Factory output and capacity usage achieved stronger-than-expected rebounds in February from weather-depressed levels. Not only did February output jump by 1.2% (1.4% in manufacturing), but also January's decline in factory production was cut in half to -0.3%. As a result, capacity utilization in manufacturing has climbed back up to 82.1%, which suggests a reduced risk of pronounced weakness in capital spending. In contrast to the industrial production report, the latest purchasing managers surveys and the most recent regional Fed analyses show lingering weakness. Perhaps the healthiest element of demand for U.S. products at this time comes from overseas; a surge in merchandise exports last quarter helped to push the current account deficit down to $31.1 billion, its lowest point since early 1994. The housing sector has also continued to surprise, with new home sales increasing by 4.2% in January, despite bad weather that depressed sales in the northeast.

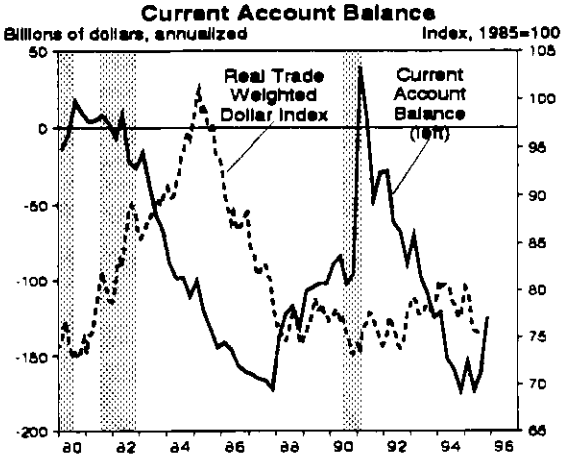
Inflation data continue to be strikingly mild. Producer prices for finished items fell 0.2% overall last month, and excluding the volatile food and energy areas they edged up just 0.1%, bringing the three-month annualized pace for this core group below 1%. Quotes for unfinished products, moreover, have been falling steadily since last summer, suggesting that there are few risks of a swift pickup in goods price gains. Retail prices were tame as well in February, with the CPI rising just 0.2% both overall and excluding food and energy.

Federal Reserve Policy

It now seems doubtful that any further Fed monetary easing will be forthcoming over the months ahead. With unemployment toward the low end of its range over the past fifteen years, and unit labor costs rising more in line with prices, senior policy makers will be wary of supplying further stimulus to an economy that may already have passed its weakest point.

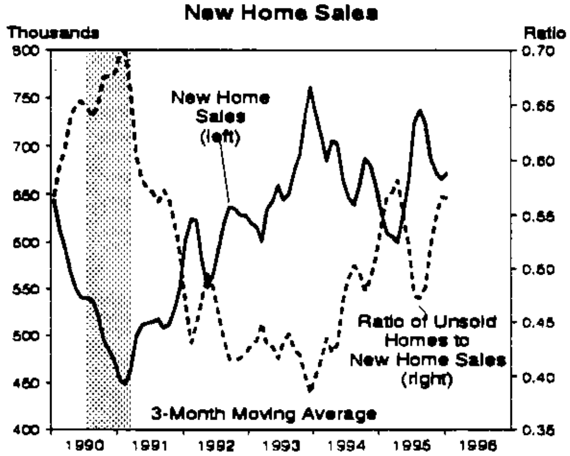
If economic growth gradually gains strength, as we expect, then it would not be unreasonable for officials at some point to give thought to the possible need for renewed tightening late this year or in early 1997. At the moment, forward money-market rates suggest that virtually no weight is being given to such a scenario, perhaps due to a common perception that the Fed will avoid raising interest rates in a presidential election year. As this week's center section article makes clear, however, historical experience gives little support to such presumptions.

Current Account Balance



Source: Department of Commerce, Federal Reserve Board.

New Home Sales



Source: Department of Commerce.

Fiscal and Political Developments

Having wrapped up the Republican presidential nomination, Senate Majority Leader Dole now can turn his focus back to Washington, where he will try to flesh out a policy record to serve as a backdrop for his fall candidacy. There should be no doubt that Dole and his advisors now wield vast control over the legislative agenda, as well as the strategies to be pursued over the balance of this congressional session. This greater influence can already be seen in the sudden willingness of the House leadership to consider a long-term debt limit increase without accompanying measures to balance the nation's fiscal accounts. Senator Dole has never been comfortable using a debt ceiling crisis to wring concessions from President Clinton, so the risk of a federal default – never high to begin with – has declined to near zero.

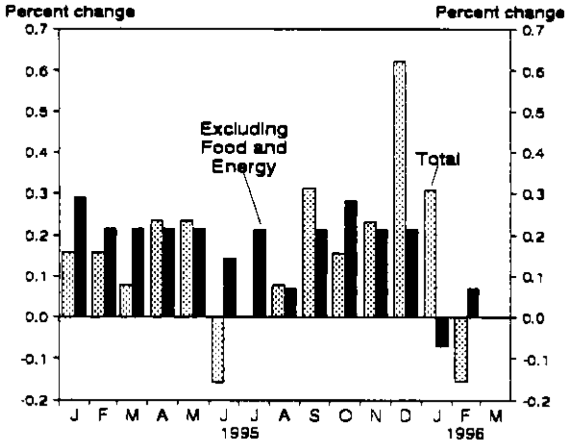
Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

The upward adjustment in yields that occurred in response to the payroll employment figures is appropriate. Market expectations had been too skewed toward significant further Fed easing. However, there is still room for further disappointment. On Thursday's close, December Eurodollar futures contracts yielded 5.76%. Given the normal premium due to a positively-sloped yield curve and the fact that the yearend contract should trade at higher yields to incorporate yearend pressure, the December yield is consistent with a flat to slightly easier monetary policy. As we expect that Fed officials will begin to tighten by yearend and anxieties about tightening will surface even sooner, we believe that investors should remain short. We would favor rolling our September Eurodollar short into December given our finding (see center section article) that the prospects for a tightening are somewhat less in the immediate runup to Election Day than thereafter. Also, yearend pressures may be intense this year because yearend is coincident with the end of the Fed's two-week reserve maintenance period. This suggests that a bigger premium for yearend pressures could be built into December than the current +5 basis points premium relative to the September/March butterfly.

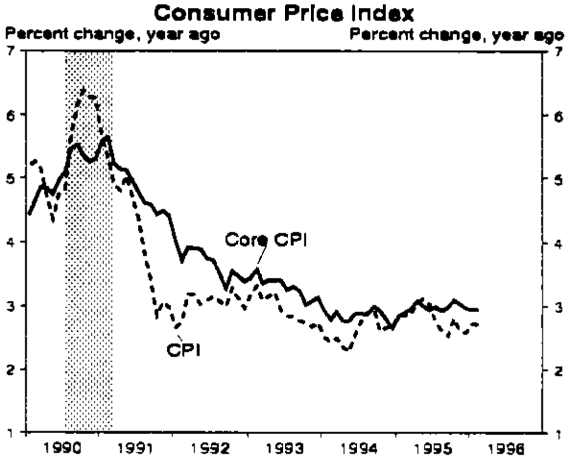
Current long bond yields of around 6.7% strike us as about right in an environment in which Fed officials are likely to keep policy unchanged for awhile. We would look, however, to get short should the bond market rebound significantly.

Producer Price Index



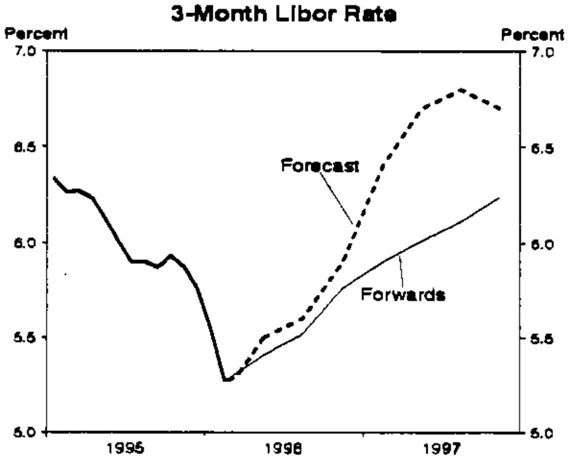
Source: Department of Commerce.

Consumer Price Index



Source: Department of Labor.

3-Month Libor Rate



Source: Federal Reserve Board, Wall Street Journal.

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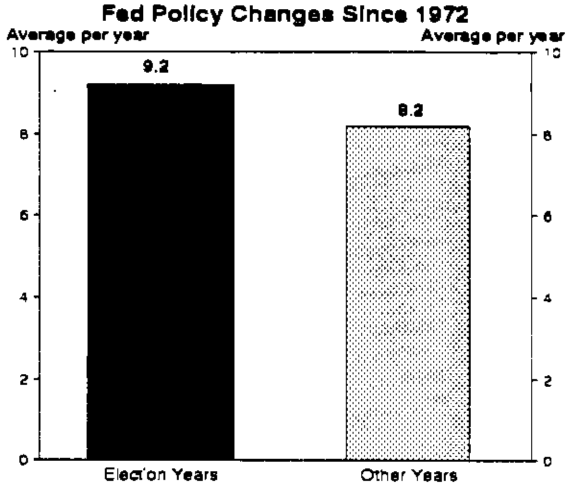
II. The Fed In Election Years: A Reality Check

During U.S. presidential election years, it is common for financial market analysts to assert that political considerations must temporarily assume a prominent or perhaps even dominant role in Federal Reserve monetary policy making. Perceptions among investors that the election calendar influences the direction or timing of short-term interest rate changes have the potential to affect the forward money-market yield profile. In addition, if they erode confidence in the central bank's independence from short-term popular pressures, these beliefs also can color judgments about acceptable risk premia on long-duration financial assets.

An examination of the modern historical record, however, reveals that political factors play a significantly smaller role in Fed actions than is generally believed. Neither the direction of rate shifts nor the timing of those steps has been materially different in years divisible by four than in other periods. In fact, if anything there has been a slightly greater tendency for short-term rates to rise during presidential elections, which can be attributed to a faster average economic growth pace over those intervals.

Fed Policy Changes Since 1972



Myth And Reality Regarding The Fed In Election Years

Based on the tone of financial market commentaries, there are three main hypotheses about the effects that presidential election campaigns have on Federal Reserve monetary policy determination. Upon close examination, two of them turn out to possess absolutely no clear basis in fact, and the third seems to have a far narrower application than is generally presumed.

Hypothesis #1: Fed Monetary Changes Are Less Frequent During Election Years

The evidence from 1972 to date directly contradicts this view. There have been six presidential election campaigns over this span, and by our count there were a total of 55 official Fed policy changes in those calendar years, or 9.2 per year on average. This is hardly different from, but in fact slightly greater than, the average number of policy moves undertaken in the eighteen non-election years (8.2).

Interestingly, the closeness of these two averages has held true for the most part under all Fed chairmanships that have bridged election and non-election periods. During the Fed regime of Arthur Burns (from 1972 through early 1978 in this sample), there were 10 policy changes in each of the two election years (1972 and 1976), and 12.7 per year otherwise. Under Paul Volcker's leadership, the FOMC adopted 24 separate moves in 1980 and 1984, or 12 per year. Over his other six years at the Fed's helm, the Volcker Fed adjusted course an average of only 6.5 times. Chairman Greenspan has been in office for two previous national elections, 1988 and 1992. Fed policy was altered 12 times in those years, or an average of six apiece. For all other months of his leadership, the annual average number of policy moves has been 5.8. Hence, there has been no obvious drift over time away from relatively routine policy behavior in election-year contexts.

Hypothesis #2: The Fed Rarely Tightens Policy During Election Years

Though widely held, this attitude actually has the relationship precisely incorrect. Since 1972, there have been 34 separate tightening steps taken during the six presidential election years, or 5.7 on average. At other times, there have been an average of 4.3 tightening occurrences per twelve months. Thus, based on recent history it might be proposed that rate hikes are roughly one-third more probable in election years!

Fed Policy Changes Per Year, By Chairman

	Election	Other
Burns	10.0	12.7
Volcker	11.5	6.5
Greenspan	6.0	5.8

While at first blush this information may seem counter-intuitive, the frequency of rate increases in election years is more understandable when relative economic growth conditions are added to the analysis. For at least the past quarter century, presidential election years have almost always been characterized by unusually strong increases in domestic final demand and real GDP. In the last six such years, for example, total output has risen an average of 4.0% at an annual rate, versus a 2.4% mean recorded during other periods. Total domestic final sales, similarly, have expanded 3.8% in election periods, against 2.5% otherwise. Against this background, the regularity of Fed rate hikes at the end of quadrennial national election cycles is much easier to comprehend.

Hypothesis #3: The Fed Shuns Policy Moves Of Any Kind Late In An Election Season

Our records show there has been a slight tendency in recent years for the Fed to skew its policy actions toward the final trimester of the year. Of the 203 total interest rate moves made since 1972, almost 37%, or 75, were undertaken within the September/December interval. This compares with 30.5% for the January/April period and 32.5% between May and August.

There is no evidence that this intra-year pattern of policy actions is notably different in election versus non-election years. Indeed, for the period under study the concentration of actions in the final trimester was marginally greater for election years (38.2%) than in others (36.5%). This contradicts the idea that Fed officials materially alter the timing of changes to interest rate policies while national election contests are in progress.

That said, there are some grounds for concluding that central bankers prefer to lower their public profile in the highly-charged political atmosphere that almost always exists in the weeks immediately prior to presidential voting. Within the year's final trimester, there is a notably reduced propensity for Fed policy to be changed in either September or October during election years, resulting in a much greater bunching of actions between November and December. In non-election periods, by contrast, rate changes are distributed nearly evenly among the final four months.

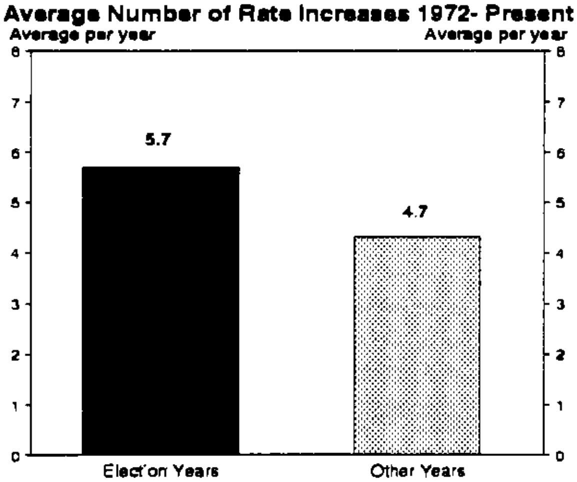
Possible Implications For Interest Rates In 1996

In view of the foregoing analysis, the following general conclusions can be drawn with respect to appropriate expectations for the course of monetary policy over the balance of this election year:

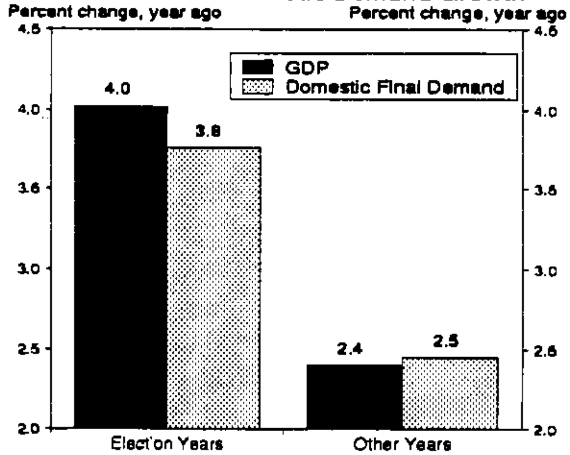
1. **It would be unwise to presume that U.S. short-term interest rates will be left on hold between now and Election Day (November 5).** Periods longer than six months without a Fed policy change are relatively rare in all circumstances, and no presidential campaign season in recent memory has been marked by such sustained rate stability.

2. **As usual, Fed policy decisions over coming months can be expected to derive primarily from new developments in the economy and pricing behavior.** Chairman Greenspan and his colleagues will not wish to damage or destroy their hard-won anti-inflation credibility by allowing political considerations to override

Average Number of Rate Increases 1972- Present



Real GDP and Domestic Demand Growth



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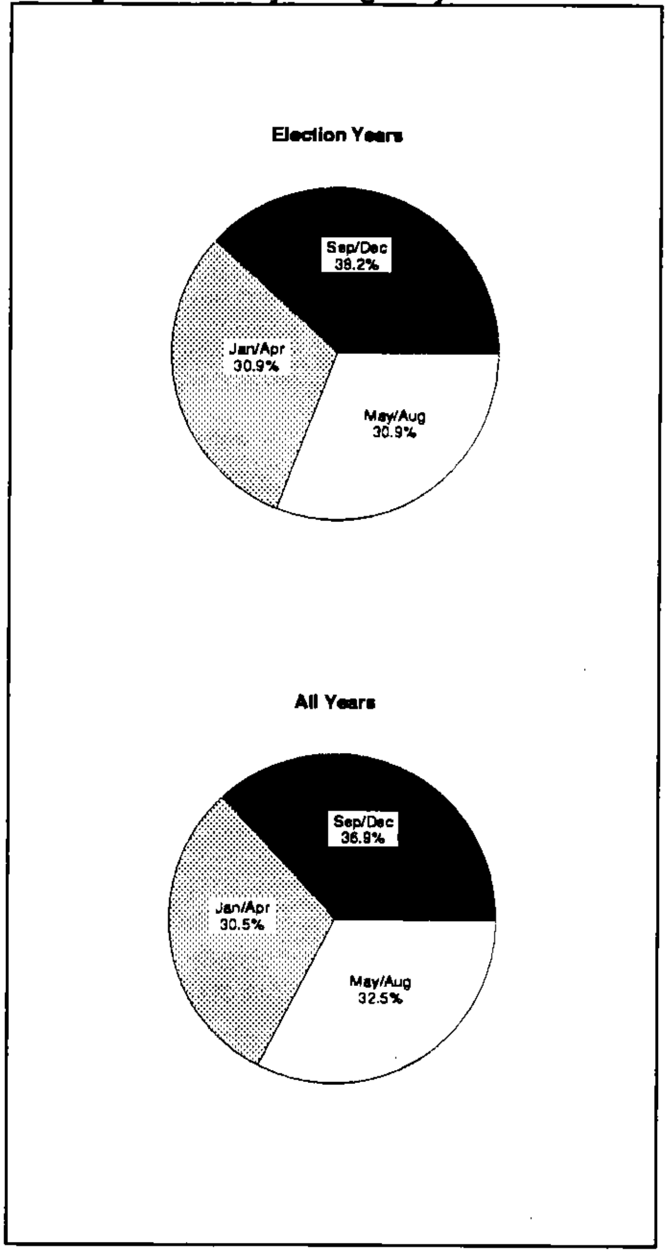
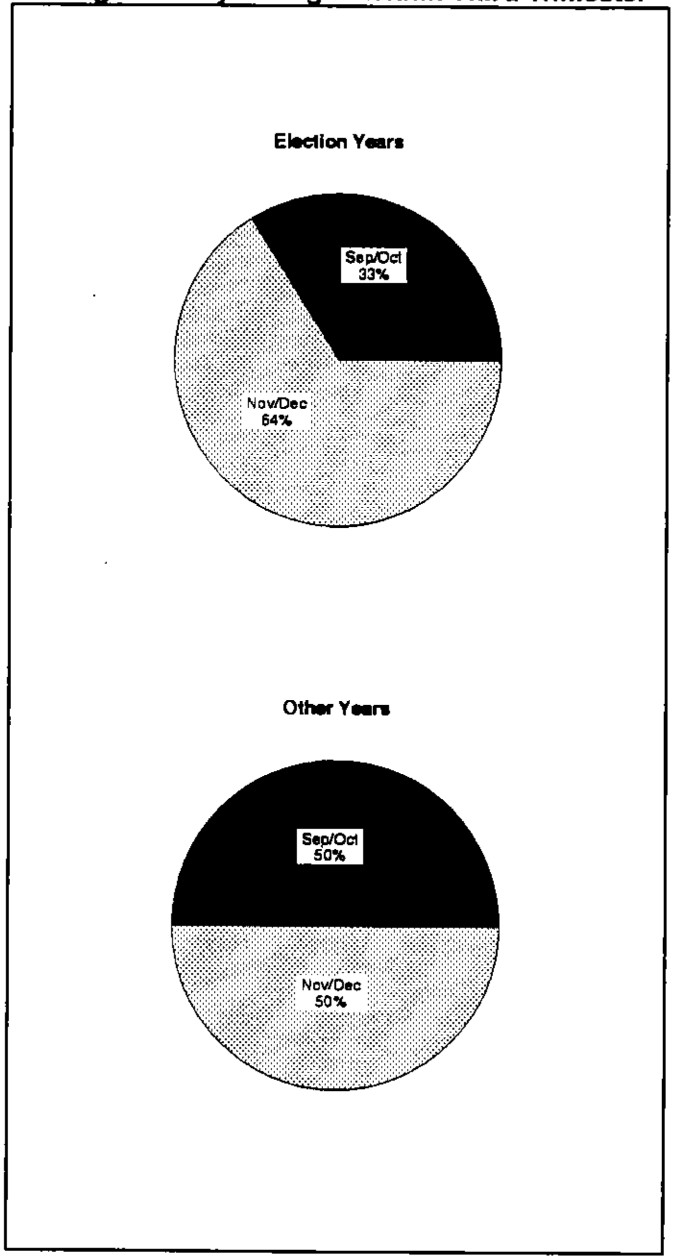
Timing of Fed Policy Changes By Trimester



Timing of Policy Changes Within Third Trimester



their fundamental central banking instincts. With unemployment already low, the FOMC probably would not hesitate to tighten credit somewhat if faster-than-anticipated real GDP growth were to give rise to discomfiting inflationary pressures.

3. **Any rate strategy changes that evolve after Labor Day (September 2) may well be pushed back until mid-November or later.** A preference for monetary stability in the final stretch run of the presidential race is apparent from the historical record. Moreover, there is only one scheduled FOMC meeting between mid-August and mid-November, and since early 1994 changes to policy have been made almost exclusively at those gatherings.

John Youngdahl

Goldman Sachs

Key U.S. Economic Data

	Latest Monthly Data '96 Feb	'96 Jan	'95 Dec	'95 Nov	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. thousands)	705	-188	145	212	173	146	Apr 5
Unemployment Rate (%)	5.5	5.8	5.6	5.6	5.6	5.6	
Index of Hours Worked (% ch)	3.2	-2.0	-0.3	-0.4	3.4	1.6	
Average Hourly Earnings (% ch)	-0.1	0.4	0.3	-0.1	3.0	2.9	
Producer price finished goods index (% ch)	-0.2	0.3	0.6	0.2	3.0	2.0	Apr 11
Excluding food and energy	0.1	-0.1	0.2	0.2	1.9	2.0	
Consumer price index (% ch)	0.2	0.4	0.2	0.1	2.6	2.7	Apr 12
Excluding food and energy (% ch)	0.2	0.3	0.1	0.1	2.7	2.9	
Retail sales (% ch)	--	-0.3	0.6	0.9	3.1	3.0	Mar 20
Excluding motor vehicles (% ch)	--	0.0	0.3	0.8	2.4	2.1	
Industrial Production (% ch)	1.2	-0.4	0.1	0.3	1.7	1.6	Apr 16
Manufacturing	1.4	-0.3	0.2	0.1	3.1	1.8	
Capacity utilization (%)	82.9	82.1	82.7	82.9	82.9	83.3	Apr 16
Manufacturing	82.1	81.2	81.8	82.0	82.0	82.5	
Housing Starts (annual rate, thousands)	--	1446	1385	1458	1407	1361	Mar 19
Single-family	--	1132	1116	1129	1125	1081	
Trade balance (billions, monthly)	--	--	-6.8	-6.7	-8.2	-9.3	Mar 29
Merchandise	--	--	-12.3	-12.2	-13.6	-14.6	
Factory Orders (% ch)	--	0.5	1.7	-0.1	12.0	3.1	Apr 3
Durable Goods	--	0.2	3.1	-0.8	19.4	3.7	Mar 27
Personal Income (% ch)	--	0.1	0.6	0.3	4.2	4.6	Apr 3
Wages and Salaries	--	-0.2	0.6	-0.1	2.9	4.0	
Purchasing Managers' Index (%)	45.2	44.2	46.0	46.0	46.1	47.7	Apr 1
Consumer Sentiment U Mich (Feb 66=100)	88.5	89.3	91.0	88.2	89.3	91.0	Mar 29
Conference Board (1985=100)	97.0	88.4	99.2	101.6	96.6	98.8	Mar 26

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- Advance retail sales figures from February and revisions to the January data will add to the information available on consumer spending this quarter. (Mar. 20).
- Treasury officials may need to attach contingency clauses to their announcements of 2- and 5-year note sales (Mar. 20), as well as a 52-week bill offering (Mar. 22), owing to the current lack of statutory borrowing authority beyond March 29.
- The Philadelphia Federal Reserve Bank will report on regional manufacturing conditions, and the Bureau of the Census will release business inventory data through January (both Mar. 21). These may help clarify the status of stockpile adjustments that have been suppressing domestic demand and production.
- Initial jobless insurance filings may begin to show upward influences from the plant shutdowns precipitated by a strike against General Motors (Mar. 21).

Economic Releases and Other Events

Date	Indicator	Estimate: GS	Estimate: Consensus	Last Report
Mar. 19	Housing Starts (Feb.)	0.0%	-1.5%	+4.4%
Mar. 20	Retail Sales (Feb.)	+1.0%	+0.8%	-0.3%
	Ex Auto (Feb.)	+0.7%	+0.6%	0.0%
Mar. 21	Business Inventories (Jan.)	+0.7%	+0.4%	-0.5%
	Federal Budget Balance (Feb.)	- $50.0 Bil	-$45.0 Bil	- $38.4 Bil *

* Level a year ago.

- OMB Fiscal 1997 Budget Report (Mar. 18)
- Homebuilders' Survey (Mar. 18)
- Illinois, Michigan & Ohio Primaries (Mar. 19)
- Treasury Announcement: 2- & 5-yr Notes (Mar. 20)
- Philadelphia Fed Survey (Mar. 21)
- Treasury Announcement: 1-yr Bill (Mar. 22)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.5	5.6	6.4
Forward	5.4	5.5	5.9
2 Yr T-Note	5.7	5.9	6.4
Forward	5.8	6.0	6.1
10 Yr T-Note	6.3	6.5	6.8
Forward	6.4	6.5	6.6

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	0.9%	1.0%	2.0%	2.1%	1.8%
Ind. Production	1.3	0.5	2.0	3.6	1.7
CPI	2.4	3.0	2.8	2.8	2.8
Profits*	5.2E	5.8	6.1	9.7	3.2
Merch Trade Bal. (monthly, $B)	-11.6	-13.3	-13.0	-13.6	-12.7

* Excluding inventory profits; adjusted for depreciation distortions

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U.S. Economics Analyst

Limited Scope for Growth

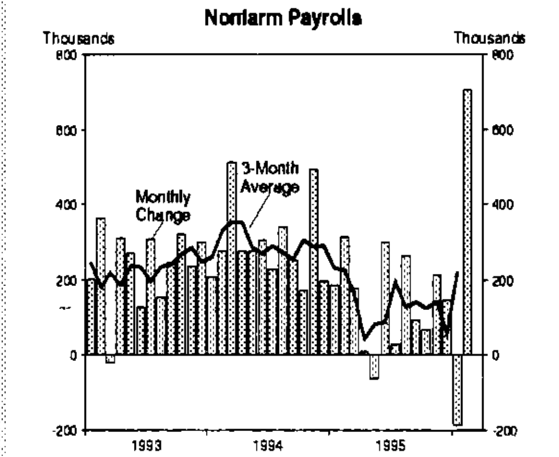
- Steep increases in payroll employment and buoyant retailers' reports have joined the list of indicators pointing to a probable material pickup in U.S. economic growth later this year.

- Meanwhile, steady inflation and signs of acceleration in labor costs imply that the U.S. economy is close to its potential output, if not a bit beyond it. Potential output appears to be rising only about 2% per year.

- This implies that the economy is subject to a 2% speed limit in the next year or two, with upward pressure on inflation and bond yields the penalty for faster growth. With inflation running about 3%, the long-term trend growth rate of corporate earnings is about 5%, although S&P earnings are apt to grow faster than this in 1996-1997.

- Amid numerous indications that the economic outlook is brightening, Fed officials are likely to keep monetary policy on hold for some time.

- Although Senate Majority Leader Robert Dole now holds a commanding lead for the Republican presidential nomination, neither he nor President Clinton have clear incentives to reach a broad-based budget agreement.



Source: Department of Labor.

Alternative Estimates of Potential Growth

1. Growth Between Periods of Comparable Unemployment (5.6% in both 1990Q3 and 1995Q4)	**1.9 %**
2. Sum of Labor Input and Productivity Trends	**1.9 %**
Equals: Growth in Labor Input	1.1 %
Plus: Productivity Trends	1.1 %
Less: Impact from Stagnation in Government Output	-0.3
3. Growth During Period of Stable Inflation	**2.3 %**
Average	**2.0 %**

Trade Recommendations

- Take profits on short April federal funds rate futures positions at 94.76, a level that already reflects a steady Fed policy decision at the March 26 FOMC meeting.

- Maintain short positions in September Eurodollar futures, with stop at 94.75 and target of 94.25.

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Issue No: 96/10
March 8, 1996

I. Weekly Wrapup

Economic and Market Overview

Capping a week of upward drift in response to signs of an impending economic rebound, U.S. bond yields jumped sharply early Friday on news that nonfarm payrolls surged 705,000 in February. While the size of this increase far outstrips the incremental strength of other indicators, and is therefore difficult to accept at anything close to face value, the broad-based strength in most other aspects of the report indicate, at a minimum, that the U.S. job market is stable to improving. In particular, the index of hours worked rose 3.2%, to a level 0.9% above its fourth-quarter average, and the jobless rate fell 0.3 points to 5.5%. Only average hourly earnings displayed any weakness, slipping 0.1% from a downward-revised January level. Even with this setback in wages, the strong rebound in employment and hours worked last month implies that personal income in February rose considerably more than the 0.3%-0.4% average of the prior six months. In turn, sustained moderate income growth should help revive consumer outlays, which in real terms plunged 0.8% during the stormy January.

Orders for U.S. manufactured products climbed in January, by 0.5% overall and 1.0% excluding the volatile civilian aircraft and defense groups. This core measure has risen at a sturdy 7½% annual rate over the past six months, led by a 24% pace for capital equipment. January's 0.7% surge in manufacturing inventories should be discounted, since heavy snowfall in the Northeast undoubtedly disrupted shipments, causing producers' stockpiles to swell temporarily.

Meanwhile, hopes for a further deceleration in retail prices were dealt a blow by the latest official figures on productivity and costs. They reveal that unit labor costs rose 3.3% for the four quarters ending last December, marking the first time since 1991 that they have outpaced prices. As these costs encroach on profit margins, firms are likely to become less comfortable with aggressive pricing strategies, and the prospects for a further decline in underlying inflation will erode.

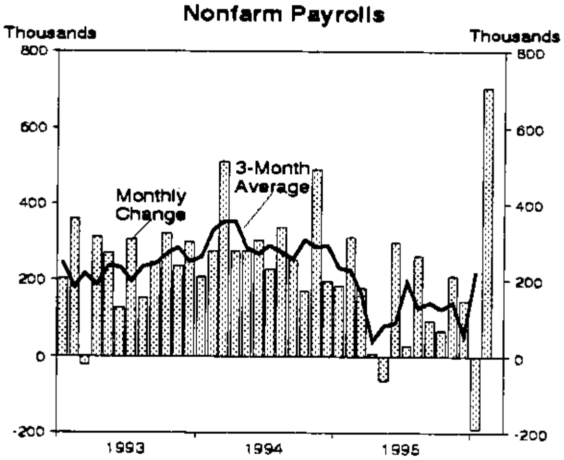
Federal Reserve Policy

With most data releases suggesting some bounce in business activity after a dismal December-January period, February's outsized increase in payrolls all but rules out a rate cut in the next month or two. A leveling off in unemployment benefit claims and further rise in orders for nondefense capital equipment should allay fears of additional production cuts by U.S. manufacturers, while brighter anecdotal commentaries and weekly surveys from retailers support the view that the late-1995 sales slump was merely a lull and not the onset of a more protracted swoon in consumer spending. Against this more reassuring statistical backdrop, and in the absence of major federal legislation that bodes for persistent fiscal policy restraint, central bankers probably will suspend their easing strategy indefinitely.

Fiscal and Political Developments

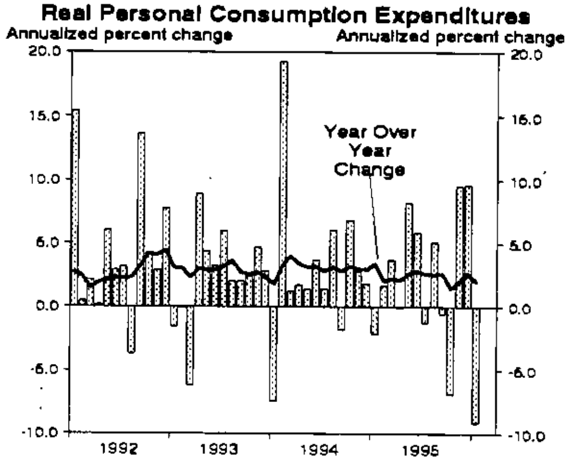
After ten primary victories in only six days, Senate Majority Leader Robert Dole has become the prohibitive favorite to capture the Republican party's

Nonfarm Payrolls



Source: Department of Labor.

Real Personal Consumption Expenditures



Source: Department of Commerce.

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nomination for president in 1996. If he wins the vast majority of convention delegates at stake in next Tuesday's seven primaries, as seems probable, Dole could possess nearly two-thirds of the delegate support needed for victory. Thus, fully eight months before the general election the two major-party candidates for the White House already appear to be in place. Also, for the first time in this century, the race would pit an incumbent president against the leader of a congressional chamber. For the rest of this congressional session, therefore, the legislative agenda is apt to be dominated by political maneuvering and strategies crafted to enhance the fall campaign positions of either Senator Dole or President Clinton.

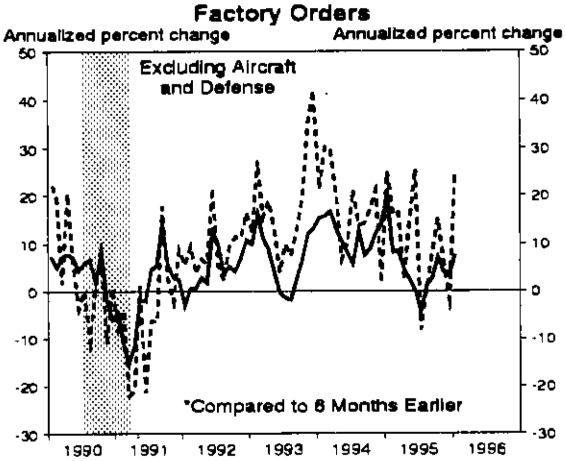
The influences that these unusual circumstances will have on the long-running federal budget battle are not immediately clear. To be sure, Dole's resurgence to a dominant position in the GOP race has created an opportunity for renewed efforts at a sweeping fiscal agreement, since he now should have much more time than before to devote to such affairs. That does not mean, however, that the principals to this debate will be inclined to show more flexibility now than two months ago. Although the president might wish to neutralize GOP claims that a new chief executive is required to resolve budgetary problems, his public standing has been enhanced by the current standoff. Opposition to Medicare and Medicaid spending restraints has also solidified lately in the Democratic congressional minorities. For his part, Senator Dole might be wary of splitting differences with Clinton on most outstanding budget disagreements, as that could undermine the arguments he and his surrogates will be making this year for a change in the White House.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

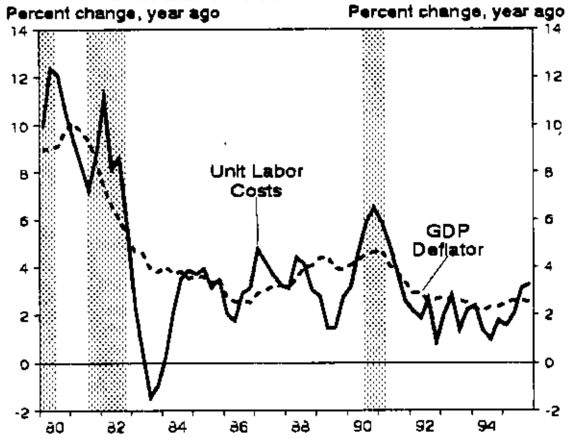
Despite the huge rise in U.S. yields since mid-February, we continue to recommend a defensive stance in the U.S. fixed-income markets. In particular, the presence of aged, unprofitable long positions in the short-duration sector should keep prices for such securities on a downward tilt for awhile longer. Hence, short positions set last week in September Eurodollar contracts at and above 94.90 should be retained, with targets of 94.25 and stops at 94.75. We would take profits on shorts in April federal funds rate futures, though, since at 94.76 those contracts have almost fully discounted a stable Fed rate decision at the March 26 FOMC meeting.

Factory Orders



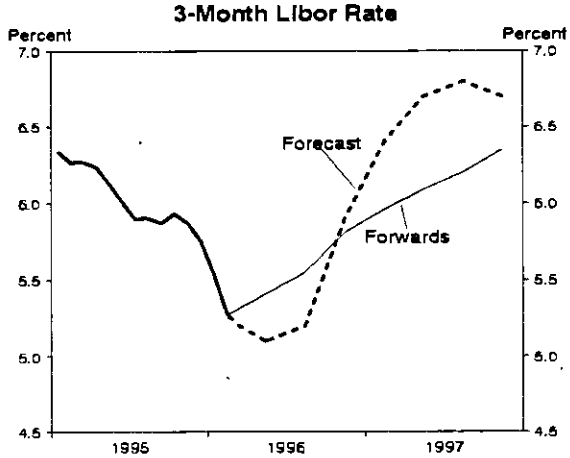
Source: Department of Commerce.

Unit Labor Costs and Inflation



Source: Department of Commerce.

3-Month Libor Rate



Source: Federal Reserve Board, Wall Street Journal.

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II. Limited Scope for Growth

Lifting U.S. economic growth has, not surprisingly, become a hot issue in this presidential election year. Republican candidate Steve Forbes has been peddling the flat tax as a growth tonic. President Clinton has complained because Senate Republicans nixed Felix Rohatyn, his original pro-growth choice for Vice Chairman of the Federal Reserve Board, before he was even named. Meanwhile, the Fed has come under fire from some who believe its policies are too restrictive to permit the economy to grow.

In the next year or two, however, any efforts to push growth above 2% are apt to stir up inflation. This is because the U.S. economy appears to be close to its potential output, despite a year of subpar growth. Moreover, this potential appears to be rising only about 2% per year, based on the new GDP measures. And those seeking stronger growth should not blame the Federal Reserve; its current policy settings are not an impediment to growth.

U.S. Economy Near Its Potential Output

Potential output is defined as that level of production consistent with stable inflation, although economists have never been clear whether it is inflation in prices, wages, or unit labor costs that is supposed to be flat. As it happens, indicators for all three imply that the economy is very close to its potential, if not slightly beyond it:

1. **Retail price increases have been remarkably steady over the past three years.** This is true of the CPI and also of its core component, excluding food and energy. The revised GDP deflator tells a similar story.

2. **The trend in labor cost inflation is flat to up, on balance.** Average hourly earnings and the index of hourly compensation both show clear signs of acceleration. In the employment cost index, the wage component is flat. Only the ECI for total compensation is decelerating.

3. **Real unit labor costs are turning up.** For the first time since the last recession, unit labor costs are rising faster than prices. Thus, average hourly compensation is rising by enough to cover both productivity gains and inflation. This is a sign that the U.S. labor market is in transition from an excess supply of workers to excess demand for them.

Declines in factory utilization and in prices of partly processed goods point in the opposite direction. They indicate, without question, that the manufacturing sector is under considerably less stress now than it was a year ago. But this sector produces only about one-fifth of all U.S. output. The stable to rising trends in broader-based price and labor cost measures imply that this easing has been offset, on balance, by the disappearance of slack elsewhere in the economy.

Potential Growth — A 2% Speed Limit

If U.S. output is as close to its potential as it appears to be, then potential growth will limit the scope for noninflationary expansion in the next year or two. There are several ways to estimate potential growth, which is somewhat lower for the new chain-weighted measure of real GDP than for the old fixed-weighted measure. On balance, these methods suggest that potential growth is not much higher than 2% per year.

1. **Growth has averaged 1.9% per year since the jobless rate was last at its current level.** The unemployment rate will generally be flat when output is keeping pace with its potential. Thus, one measure of potential growth is the economy's average rate of expansion between periods of comparable unemployment from one cycle to the

Price Inflation By Various Principal Measures
(fourth quarter to fourth quarter)

	GDP Deflator	Consumer Prices Total	Consumer Prices Core	Producer Prices Total	Producer Prices Core
1991	3.4%	3.0%	4.4%	-0.1%	3.2%
1992	2.6	3.1	3.5	1.6	2.0
1993	2.5	2.7	3.1	0.2	0.2
1994	2.3	2.6	2.8	1.4	1.7
1995	2.4	2.6	3.0	2.1	2.5

Wage and Labor Cost Inflation By Various Principal Measures
(fourth quarter to fourth quarter)

	Avg Hrly Earnings	ECI Wages	Compensation ECI	Compensation Index	Unit Labor Costs Nominal	Unit Labor Costs Real*
1991	2.9%	3.7%	4.4%	4.8%	2.6%	-0.8%
1992	2.4	2.6	3.4	4.7	0.9	-1.7
1993	2.5	3.0	3.6	1.7	2.2	-0.3
1994	2.9	2.9	3.1	2.4	1.8	-0.5
1995	3.1	2.8	2.8	4.1	3.3	+0.9

*Deflated by the GDP deflator.

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Alternative Estimates of Potential Growth

1. Growth Between Periods of Comparable Unemployment (5.6% in both 1990Q3 and 1995Q4)	**1.9 %**
2. Sum of Labor Input and Productivity Trends	**1.9 %**
Equals: Growth in Labor Input	1.1 %
Plus: Productivity Trends	1.1 %
Less: Impact from Stagnation in Government Output	-0.3
3. Growth During Period of Stable Inflation	**2.3 %**
Average	**2.0 %**

next.[1] In the fourth quarter of 1995, the latest period for which we have GDP data, the jobless rate was 5.6%. The last time it was this low, prior to the current expansion, was in the third quarter of 1990. In the intervening period, growth in real GDP averaged 1.9% per year.

2. **Labor force and productivity trends also imply a potential growth rate of about 2%.** By definition, the economy's potential output will rise by the sum of the trend rates of growth in labor input (measured by hours worked or by the labor force) and in output per unit of labor input, i.e. productivity. These trends are best measured from one business cycle peak to the next. In the current situation, the best we can do is to measure how fast the two have risen since the last peak in mid-1990.

   Since then, both measures of labor input have risen 1.1% per year, as has labor productivity. This implies a potential growth rate of 2.2%. However, potential growth is probably lower for two reasons. First, these figures apply only to the private nonfarm sector, which constitutes five-sixths of U.S. output; the other sixth is mainly government output, which has been stagnant over this period. Second, workweeks and productivity both tend to flag late in a business expansion.

3. **Real GDP growth has averaged 2.3% over the past three years of stable inflation.** This could overstate potential growth as well, because inflation tends to lag growth in output. If wages continue to accelerate, that would imply that the increase in real GDP between the end of 1992 and the end of 1995 was somewhat faster than the growth in potential output.

It is important to emphasize that these estimates of potential growth are based on the chain-weighted measure of GDP that is now the standard yardstick for output in the United States. Several prominent economists have criticized the current and previous measures of output because they do not adequately account for great strides in productivity associated with technological change.

This is a legitimate criticism, but its implications for financial markets are not as dramatic as some have assumed because measurement errors of this sort are nothing new. If growth in real output has been understated — say, by 1 percentage point per year — then growth rates of productivity and potential output have likewise been understated by the same amount. By the same token, inflation and real interest rates will have both been overstated by 1 percentage point. 'True' benchmarks for these key variables are thus different than they appear, but the future direction of inflation and interest rates will only be affected if the size of the error is changing over time. While many intuitively believe that the error is growing, there is no way to prove this, especially since the crux of the problem is measuring output! Significantly, any such error has identical effects on inflation and the rate at which unit labor costs are rising, even if the error itself is growing. Thus, the fact that unit labor costs are now rising slightly faster than prices should be taken as a warning that inflation will likely move up if output starts to grow much faster than its potential.

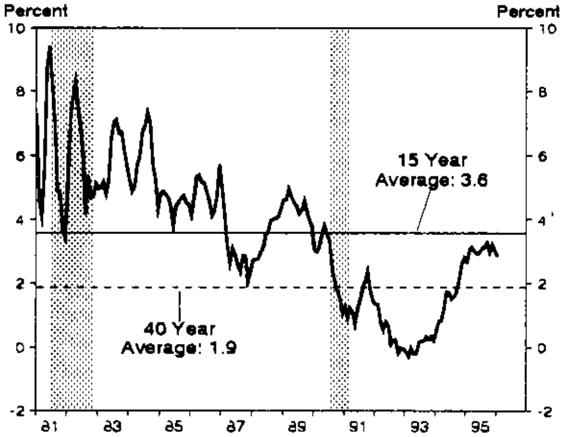
Monetary Policy Not An Obstacle to Growth

These results suggest that growth above 2% will put upward pressure on inflation. But many economists and market participants think monetary policy is too tight to permit such growth. Our review of policy indicators suggests otherwise. In particular:

1. **Short-term rates are not prohibitively high.** Those who think monetary policy is too restrictive claim that short-term interest rates are too high relative to inflation or growth in nominal GDP. The case for this is far from clear, however. At 2.5%, the real federal funds rate is about 60 basis points above its 40-year average but more than 1 percentage point below its average over the past 15 years, a period featuring above-trend 2.5% average growth. At the end of 1995, the funds rate was also about 2 percentage points above nominal GDP growth. While an inversion

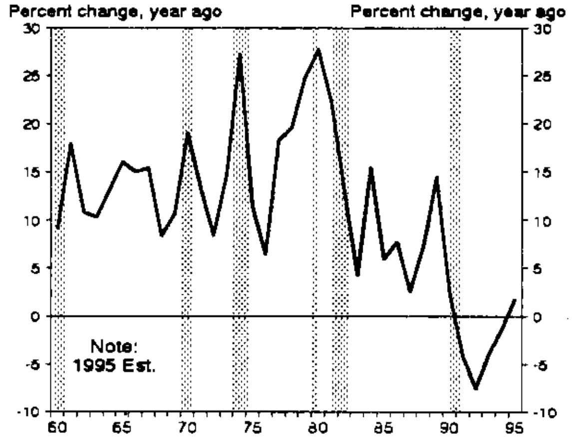
[1] This assumes that a 5.6% unemployment rate signaled just as much tightness in labor markets in late 1995 as it did in the middle of 1990. In support of this assumption, it should be noted that both periods were marked by the emergence of rising real unit labor costs.

Real Federal Funds Rate



Source: Department of Labor. Federal Reserve Board.

Net Interest



Source: Department of Commerce. Goldman Sachs Estimates.

between short rates and nominal GDP growth has usually heralded a cyclical downturn in the past, this is because net interest payments have been rising sharply, usually at annual rates of 10% or more. In contrast, net interest payments have been almost flat over the past year.

2. **Credit-sensitive activity has suffered mimimal damage.** If rates are too high, it is hard to tell from activity in the credit-sensitive housing and motor vehicle sectors. In the latter stages of past cycles, tight money has typically pushed housing starts down 30% over a period of about 3 years before the U.S. economy entered a recession. Motor vehicle sales have typically declined 15% over a 21-month period. While both indicators hit their latest highs about 20 months ago, the declines since then have been trivial — about 5% for starts and 3% for motor vehicle sales.

3. **The economy is not short of liquidity.** Growth rates of M2, M3, nonfinancial debt, and bank credit are all 5% or higher, well above the 3.8% growth in nominal GDP. M1 and bank reserves have dropped about 2.5% and 6%, respectively, over the past year. But this reflects a shift in the public's desired asset holdings, prompted by higher yields on alternative assets and expanded opportunities to use credit cards as a means of payment and encouraged by banks seeking to reduce their reserve requirements. (M1 is the only reservable aggregate.)

Key financial market indicators of monetary stringency are also consistent with our view that it is not tight enough to snuff out growth. Historically, tight policy has been signaled — and reinforced — by a falling stock market, widening credit spreads, and a strong currency. Yet equity indexes are piercing new highs, credit spreads are still narrow, and the dollar, while up over the past ten months, remains low by longer-term standards.

Some would add the yield curve to this list, citing today's comparatively flat curve as a sign that policy is too tight. Historically, a flattening yield curve reinforced the impact of tight money on the housing market, but with the deregulation of thrift institutions its significance is now mainly as a gauge of financial market expectations. In any event, the yield curve has been no flatter in the last year than in the mid-1980s, and it is now steepening.

Implications for Financial Markets

In summary, U.S. economic growth will be subject to a 2% speed limit in the next year or two, with upward pressure on inflation the penalty for faster growth. There are, in our view, two implications for financial markets: First, bond yields will come under upward pressure during the second half of 1996, as the economy pushes beyond this limit. Second, although renewed economic growth should initially reassure equity investors about prospects for continued growth in profits, they should lower their sights for longer-term earnings trends. Profit margins will not widen forever. Therefore, in a world of 2% real growth and (roughly) 3% inflation, the long-term standard for earnings growth should be about 5%.

Ed McKelvey

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Key U.S. Economic Data

	Latest Monthly Data '96 Feb	'96 Jan	'95 Dec	'95 Nov	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. thousands)	705	-188	145	212	173	146	Apr 5
Unemployment Rate (%)	5.5	5.8	5.6	5.6	5.6	5.6	
Index of Hours Worked (% ch)	3.2	-2.0	-0.3	-0.4	3.4	1.6	
Average Hourly Earnings (% ch)	-0.1	0.4	0.3	-0.1	3.0	2.9	
Producer price finished goods index (% ch)	--	0.3	0.6	0.4	3.5	2.3	Mar 14
Excluding food and energy	--	-0.1	0.2	0.4	1.9	2.2	
Consumer price index (% ch)	--	0.4	0.2	0.1	2.6	2.7	Mar 15
Excluding food and energy (% ch)	--	0.3	0.1	0.1	2.6	3.0	
Retail sales (% ch)	--	-0.3	0.6	0.9	3.1	3.0	Mar 20
Excluding motor vehicles (% ch)	--	0.0	0.3	0.8	2.4	2.1	
Industrial Production (% ch)	--	-0.6	0.2	0.2	0.6	0.1	Mar 15
Manufacturing	--	-0.6	0.1	0.1	1.1	-0.1	
Capacity utilization (%)	--	81.9	82.7	82.8	83.0	83.5	Mar 15
Manufacturing	--	81.0	81.8	82.0	82.0	82.6	
Housing Starts (annual rate, thousands)	--	1446	1385	1458	1407	1361	Mar 19
Single-family	--	1132	1116	1129	1125	1081	
Trade balance (billions, monthly)	--	--	-6.8	-6.7	-8.2	-9.3	Mar 29
Merchandise	--	--	-12.3	-12.2	-13.6	-14.6	
Factory Orders (% ch)	--	0.5	1.7	-0.1	12.0	3.1	Apr 3
Durable Goods	--	0.2	3.1	-0.8	19.4	3.7	Apr 3
Personal Income (% ch)	--	0.1	0.6	0.3	4.2	4.6	Apr 3
Wages and Salaries	--	-0.2	0.6	-0.1	2.9	4.0	
Purchasing Managers' Index (%)	45.2	44.2	46.0	46.0	46.1	47.7	Apr 1
Consumer Sentiment U Mich (Feb 66=100)	88.5	89.3	91.0	88.2	89.3	91.0	Mar 15
Conference Board (1985=100)	97.0	88.4	99.2	101.6	96.6	98.7	Mar 26

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- February readings on consumer and producer prices should extend the pattern of moderate inflation seen in most recent reports (Mar. 14 and 15).
- Senator Dole will take another big step towards the Republican presidential nomination if he wins primaries in Florida, Texas, and five other Southern and Southwestern states (Mar. 12).
- The Federal Reserve reports on recent regional economic conditions (Mar 12 and 13) and on industrial production and capacity utilization in February (Mar. 15). Rebounds from weather-depressed January levels are likely to permeate all of these reports.

Economic Releases and Other Events

Date	Indicator	Estimate GS	Estimate Consensus	Last Report
Mar. 11	New Home Sales (Dec./Jan.)	Up/Down	0.0%/-3.5%	-2.1%
Mar. 12	Current Account Balance ('95Q4)	-$36.0 bil.	n.a.	-$39.5 bil.
Mar. 14	Producer Price Index (Feb.)	-0.1%	+0.2%	+0.3%
	Ex. Food and Energy	+0.1%	+0.2%	-0.1%
Mar. 15	Consumer Price Index (Feb.)	+0.2%	+0.2%	+0.4%
	Ex. Food and Energy	+0.2%	+0.2%	+0.3%
	Industrial Production (Feb.)	+0.8%	+0.4%	-0.6%
	Capacity Utilization (Feb.)	82.3%	82.1%	81.9%

- 3- and 6-Month Bill Auctions (Mar. 11)
- Wholesale Trade (Mar 12)
- Atlanta Fed Survey (Mar. 12)
- Florida and Texas Head List of 7 Primaries (Mar. 12)
- Fed 'Beige Book' (Mar. 13)
- Preliminary Michigan Consumer Sentiment (Mar. 16)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.1	5.2	6.2
Forward	5.4	5.5	5.9
2 Yr T-Note	5.2	5.5	6.4
Forward	5.8	5.9	6.0
10 Yr T-Note	6.0	6.2	6.7
Forward	6.4	6.5	6.6

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	0.9%	0.5%	1.7%	2.1%	1.6%
Ind. Production	1.3	0.0	2.0	3.6	1.5
CPI	2.4	3.5	2.3	2.8	2.8
Profits*	12.6	6.9	11.2	10.1	5.6
Merch Trade Bal. (monthly, $B)	-11.6	-13.3	-13.0	-13.6	-12.7

* Excluding inventory profits; adjusted for depreciation distortions

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U.S. Economics Analyst

Treasury Financing Needs Dwindle

- Shrinkage in the U.S. budget deficit has caused the Treasury's financing requirements to plummet. As a result, the need for a new auction cycle should be postponed beyond fiscal 1996.

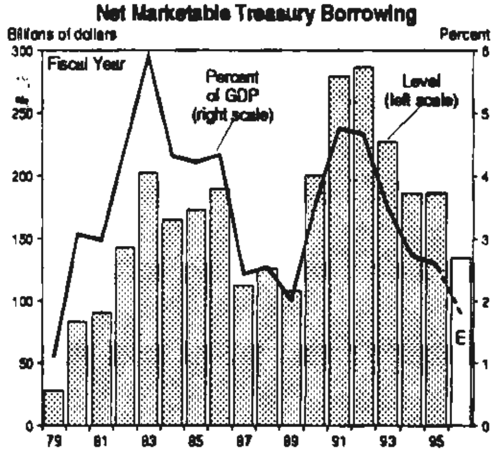
- The decline in new net issuance has also substantially slowed the shift to the shorter average maturity structure that was expected when the Clinton administration shifted the auction cycle to shorter maturities in 1993.

- Chairman Greenspan's Humphrey-Hawkins testimony should be discounted to some degree. A Fed chairman has strong incentives to be optimistic about the economy. A more pessimistic outlook could have raised awkward questions about why Fed officials had not eased monetary policy more aggressively.

- Prospects for a budget deal continue to fade despite protestations to the contrary. Senator Dole's political difficulties following his second place finish in New Hampshire will be distracting. Moreover, the issue does not appear to be resonating with the voters.

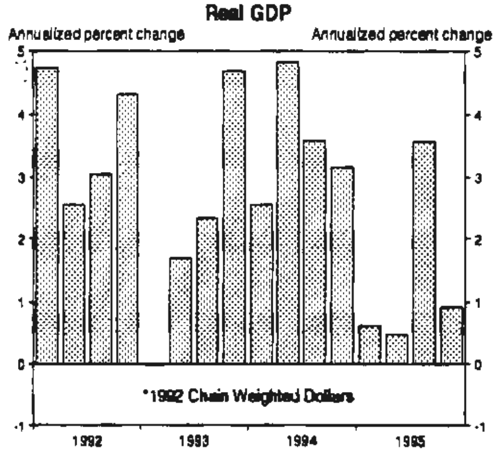
- The nominations of Alice Rivlin and Laurence Meyer to the Board of Governors by President Clinton should not change the views of the FOMC concerning monetary policy significantly. Because the choices are uncontroversial, the nominees should sail through the Senate confirmation process relatively easily.

Net Marketable Treasury Borrowing



Source: Department of Treasury. Our estimates.

Real GDP



Source: Department of Commerce.

Trade Recommendations

- We would remain close to shore right now as there is no meaningful difference between our expectations concerning the near-term trajectory of short-term rates relative to the forwards.

- With respect to longer duration securities, we would have a slight bias toward the long side for now given that this week's selloff was not based upon any change in the tone of the economic news.

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Issue No: 96/8
February 23, 1996

I. Weekly Wrapup

Economic and Market Overview

The U.S. fixed income market sold-off violently in response to Chairman Greenspan's testimony before the House Banking Committee on Tuesday, before recovering somewhat later in the week. The economic news early in the week underscored the idea that recession risks were subsiding as the index of leading indicators rose in December by 0.2%, its first rise in five months. Later in the week, the economic news was mixed, with real GDP growth in the fourth quarter somewhat weaker than expected, rising at only a 0.9% annual rate, but housing starts in January surprisingly strong, rising by 4.4%, following a 5% decline in December. On balance, the two reports were consistent with our view that the economy is likely to be somewhat weaker than expected over the near-term, but is not likely to fall into a recession.

Federal Reserve Policy

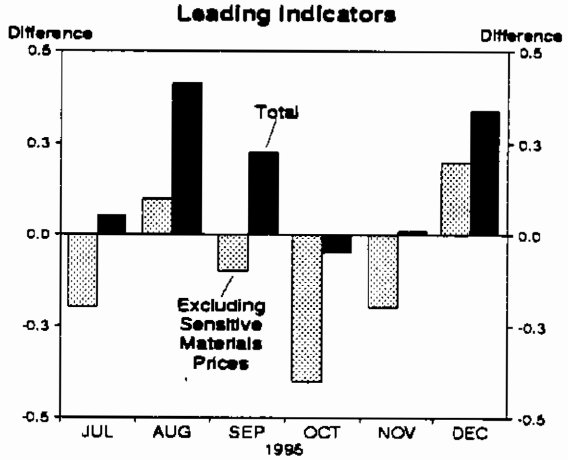
Chairman Greenspan's musings before the House Banking Committee that he expected the economy to soon strengthen after a period of weakness suggested that the roughly 75-100 basis points of easing then embodied in the December Eurodollars futures contract was overdone. While we generally agree with the sentiments expressed by the Chairman and, therefore, believe that some adjustment in expectations was warranted, we would also caution investors against taking the Chairman's testimony too literally. After all, even if the Chairman were nervous about the economy's near-term prospects, he would scarcely draw attention to such anxieties. Similarly, we would not expect the nation's chief central banker to ever ratify expectations calling for a dramatic easing of monetary policy. If the Chairman indicated that it were obvious that the Fed would need to ease further, this would just raise the legitimate question: Why wasn't the Federal Reserve easing more aggressively now, given the Chairman's outlook?

President Clinton's decision to reappoint Chairman Greenspan was unsurprising in that it was the path of least resistance in an election year given the Republican-controlled Congress and the confidence that market participants have in the current chairman. The appointments of Alice Rivlin, the Director of the Office of Management and Budget, to Alan Blinder's vacated vice-chairman slot and Laurence Meyer to the other vacant Board of Governors position should also be uncontroversial as neither has an obviously dovish inclination. On balance, these new appointments should not change the views of the Federal Open Market Committee or Board of Governors concerning monetary policy significantly. Because the nominees are well-credentialed with no strong ideological biases (except for Ms. Rivlin's reputation as a deficit hawk), they should be confirmed by the Senate without much difficulty.

Fiscal and Political Developments

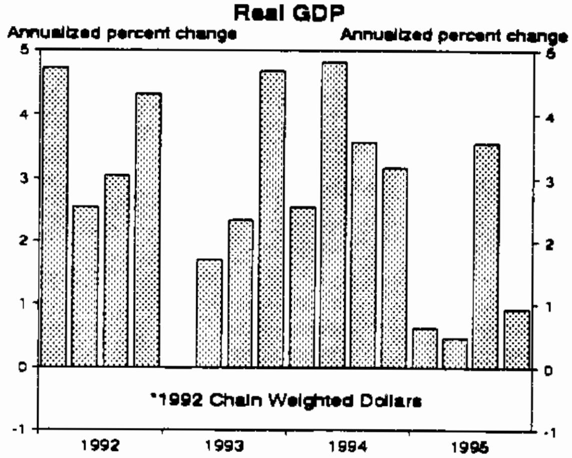
Prospects for a balanced budget agreement before the elections continue to fade for two reasons. First, Senator Dole has other fish to fry. Given his second place finish in the New Hampshire primary, he is likely to be involved in a long, difficult fight for the

Leading Indicators



Source: The Conference Board.

Real GDP



Source: Department of Commerce.

Republican nomination against Pat Buchanan and Lamar Alexander. Given that his opponents are running as Washington outsiders, Senator Dole will undoubtedly not want to underscore his insider status by slipping back to Washington for another round of budget negotiations. Second, in the Republican primaries, there is little evidence that the goal of a balanced budget is resonating with voters. Although politicians on both sides of the aisle will continue to push for a balanced budget, the motivation will be more to avoid being blamed for a failure to reach an agreement rather than a compelling desire to strike a compromise. The need to move toward a balanced budget is also undercut by the improvement in the budget balance evident in fiscal 1996. In January, the federal government budget balance improved to a surplus of $19.3 billion compared to a surplus of $15.6 billion a year earlier. Through the first four months of fiscal 1996, the deficit totals $36.6 billion compared to $57.8 billion during the comparable period in 1995.

Projections for 1996

	Federal Reserve (central tendency)	Administration
Real GDP*	2 - 2¼%	2.2%
CPI*	2¾ - 3	3.1
Civ. Unemp. Rate**	5½ - 5¾	n.a.

*4th quarter to 4th quarter
**4th quarter average

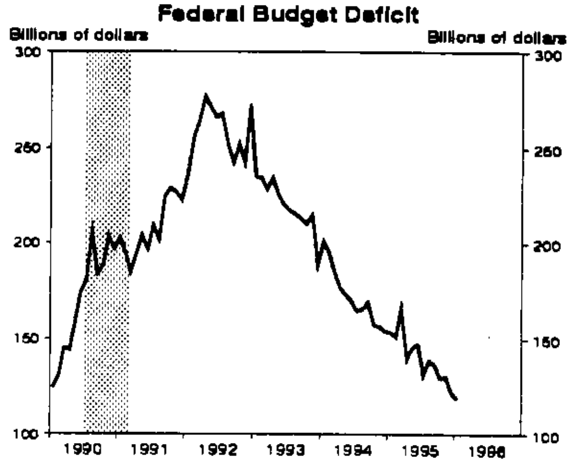
Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

Most likely, the fixed-income market will recover somewhat from this week's sell-off. Recession fears could easily intensify again. Moreover, Chairman Greenspan's comments in no way limit the ability of the Federal Reserve to push short-term rates lower over the next few months. However, a rally back to the bond market's high water mark appears unlikely for several reasons. First, as noted above, prospects for a budget agreement appear low. Thus, fiscal policy is likely to shift back toward a neutral-to-stimulative stance over the remainder of the year. Second, as time passes the economy draws closer to an inflection point. This is especially true given that the temporary factors depressing the economy such as the Boeing strike, bad weather, and the government shutdown have passed and the inventory adjustment process has been underway for several months. This is important because during past economic pauses, the bond market rallies typically ended once the economy stopped weakening.

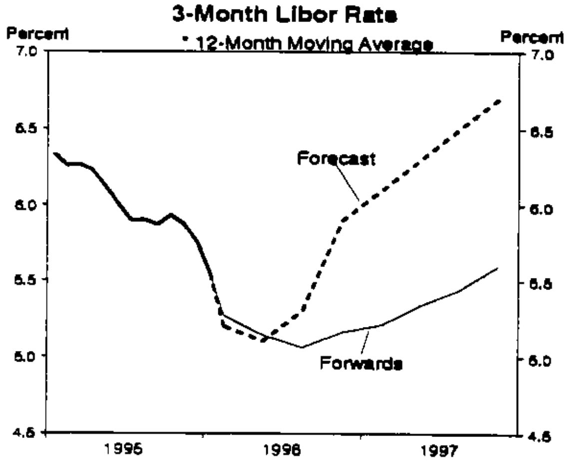
Because the timing of when the economy will reach its inflection point is very uncertain, we would stay close to shore for the time being. As shown in the accompanying chart, the market's expectation concerning short-term rates appears appropriate over the next few months. Later, however, we continue to expect a significant divergence.

Federal Budget Deficit



Source: Department of Commerce.

3-Month Libor Rate



Source: Federal Reserve Board, Wall Street Journal.

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II. Rapid Deficit Progress Retards U.S. Debt Aging

Three years ago, the Clinton Administration in its earliest days announced changes to federal debt management strategies that were intended to reduce federal interest costs by shifting more borrowing toward short-duration debt, which typically carries lower interest rates than those on long-term notes and bonds. These plans were expected at the time to shave about 20% off the average maturity of U.S. marketable debt within three years, from around 5¾ years to 4½ years.

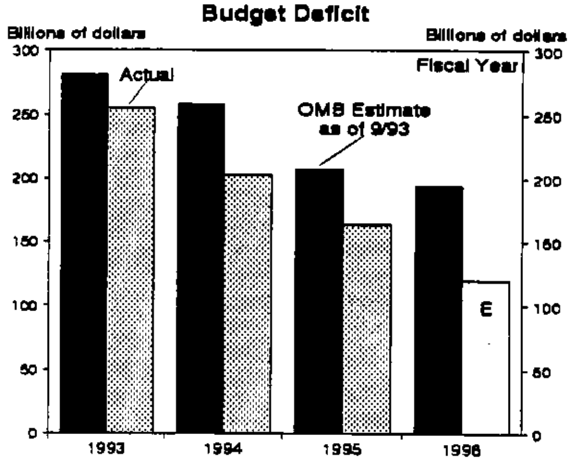
As it turns out, however, the debt has aged at a notably slower pace, owing to a much lower-than-anticipated net borrowing volume since late 1993 that has limited upward pressures on offering sizes for individual bill and short-term notes. At 5-1/3 years last September 30, the average maturity has remained in the upper half of its range over the past four decades. The steep further decline in the budget deficit and Treasury borrowing requirement this year should keep the debt life at or above 5 years into early 1997.

Another effect of the brisk shrinkage in federal borrowing needs is that it has greatly alleviated the pressure for an early expansion of the size or frequency of individual Treasury debt auctions. Earlier, it had seemed that officials would soon be forced to add new regular offerings to its auction calendar, as compensation for a surge in debt maturities when the monthly 5-year note series began to fall due in January. In light of more favorable fiscal patterns, however, it now appears that such actions can be forestalled until the fourth quarter or even later.

A Rapidly Falling Budget Deficit Has Pared U.S. Borrowing Needs,...

In the *U.S. Economics Analyst* three weeks ago, we presented evidence that the U.S. budget deficit this year will fall well below official expectations, to around $120 billion. That remains our best judgment and, judging from receipts and outlays data through January, which incorporate the depressing effects on outlays of the two government shutdowns, a deficit below $100 billion still cannot be ruled out. These developments extend a pattern of better-than-anticipated fiscal results that has been in evidence for most of the past three years. Compared to estimates compiled by the Office of Management and Budget (OMB) in summer 1993, the budget gap has been falling progressively further below expectations, with the differential this year on target to be the greatest yet, at $75 billion. Somewhat firmer-than-expected average economic growth, a rise in the corporate share of national income (which is taxed at a much higher average rate), a sharp deceleration in medical care cost inflation, and consistent congressional efforts at discretionary spending restraint have all played important roles in squeezing down the deficit over this interval.

Budget Deficit



Source: Department of Commerce, OMB, Our estimates.

One obvious upshot from a rapidly improving fiscal balance has been a similar steady decrease in net federal borrowing needs. In its mid-session review of the federal budget dated September 1993, the OMB predicted a cumulative increase in U.S. Treasury debt of just over $1 trillion for fiscal years 1993-1996. As it turns out, the actual public debt buildup in the latest two years plus our forecast for this year is on course to be a shade under $800 billion, or 20% below the original forecast. In the marketable borrowing realm (which comprises most of total financing activity), the funding requirement in fiscal 1996 looks poised to drop to $135 billion or less, down one-fourth from the $187 billion levels in 1994 and 1995. This would be the smallest absolute new-cash Treasury funding burden in seven years. Relative to nominal GDP, the prospective borrowing volume promises to be the lightest since 1979.

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...Slowed The Average Debt Aging Process...

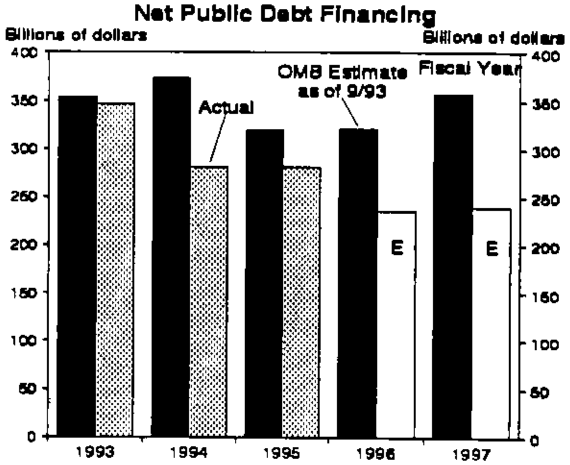
Another important effect of this materially better-than-expected fiscal and financial outcome is that it has retarded the aging of marketable Treasury debt to a much slower pace than predicted three years ago. In May 1993, the Clinton Administration enacted changes to federal debt management practices with the goal of reducing U.S. interest expenses, as one element of a broad, long-term budget deficit reduction effort. The three main elements of this strategy shift were: (1) a reduction in 30-year bond sales from quarterly to semiannual frequency, (2) elimination of quarterly 7-year note offerings, and (3) a projected increase in the volume of debt sales with initial maturities of 3 years and under. When these reforms were announced, it was widely expected that they would reduce appreciably the average maturity of publicly held U.S. marketable debt, by as much as 1½ years or 25% by the end of this presidential term.

Lower deficits, however, have put a material drag on this aging process. This has occurred because the Treasury for many years has employed short-term bill auctions as its main mechanism for absorbing deviations from planned borrowing amounts in either direction, so that potentially costly and disruptive volatility in its long-duration note and bond sales can be avoided. It can be presumed, therefore, that the vast bulk of the unexpected $200 billion shortfall in net funding over the latest three fiscal years has and will continue to come out of the bill sector. Assuming that any extra borrowing would have carried an average maturity of no more than one year, we estimate that the unforeseen decline in Treasury money-raising lifted the average public debt maturity by at least ¼ year as of last September. By the end of this fiscal year, this influence will likely have added roughly ½ year to the average federal debt life.

...And Temporarily Obviated The Need For More Frequent Debt Offerings

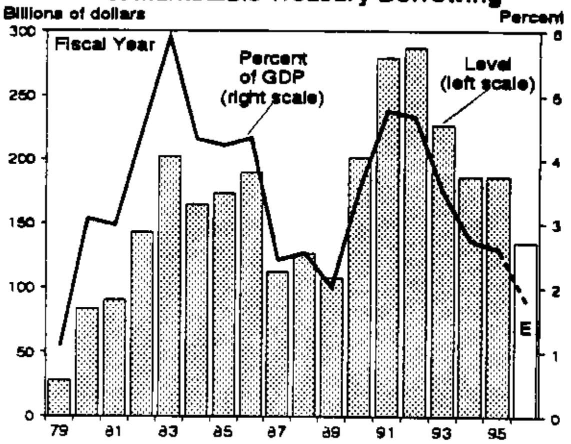
From a more immediate perspective, the timing of the steep drop in funding needs was quite fortuitous, as it is helping to offset an expected upward shift in the coupon debt rollover burden. The monthly Treasury 5-year note series that was initiated in 1991 has begun to fall due, necessitating an extra $105-$110 billion in gross marketable debt sales this calendar year purely for the purpose of redeeming old securities. Only a few months ago, it seemed that Treasury debt managers would have little choice but

Net Public Debt Financing



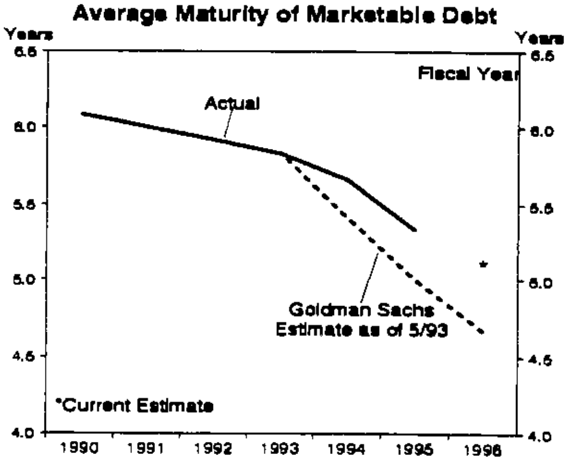
Source: Department of Treasury, OMB, Our estimates.

Net Marketable Treasury Borrowing



Source: Department of Treasury, Our estimates.

Average Maturity of Marketable Debt



Source: Department of Treasury, Our estimates.

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to quickly implement some expansion of debt offering frequencies to cope with this extra runoff, and financial market analysts were engaged in an active discussion of the various available options and the most likely course to be taken in this regard.

Now, however, it appears that half or more of this jump in note maturities is being offset by a reduction in net financing, so the rise in gross borrowing on tap for this year looks considerably less abrupt and more manageable. To be sure, senior government officials by their own admission are still studying their options for modification of the auction structure, and some changes may well prove necessary down the road, particularly if the budget deficit begins to head back up. At this point, though, in light of the very high percentage of net borrowing needs that can be fulfilled merely by maintaining current auction sizes through September, we would not expect any material intensification of gross debt sales to take place before next fall at the earliest.

John Youngdahl

Treasury Borrowing Needs

Est. Treas. marketable borrowing, FY 1996		$135.0 bil.
Less:	Amount already completed	48.1
	Amount raised if coupon auctions are unchanged	71.0
Equals:	Remainder	$15.9 bil.

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Key U.S. Economic Data

	Latest Monthly Data '96 Jan	'95 Dec	'95 Nov	'95 Oct	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. thousands)	-201	161	212	68	100	114	Mar 8
Unemployment Rate (%)	5.8	5.6	5.6	5.5	5.6	5.6	
Index of Hours Worked (% ch)	-2.0	-0.3	-0.4	0.6	-3.7	-1.8	
Average Hourly Earnings (% ch)	0.5	0.3	-0.1	0.4	3.2	3.5	
Producer price finished goods index (% ch)	--	0.5	0.5	-0.1	2.5	2.2	Feb 27
Excluding food and energy	--	0.1	0.4	0.0	2.3	2.5	
Consumer price index (% ch)	--	0.2	0.0	0.3	2.0	2.6	Feb 28
Excluding food and energy (% ch)	--	0.1	0.1	0.3	2.4	3.0	
Retail sales (% ch)	--	0.3	0.7	-0.2	1.9	3.4	Feb 27
Excluding motor vehicles (% ch)	--	0.2	0.5	-0.5	1.2	2.6	
Industrial Production (% ch)	-0.6	0.2	0.2	-0.5	0.6	0.1	Mar 15
Manufacturing	-0.6	0.1	0.1	-0.4	1.1	-0.1	
Capacity utilization (%)	81.9	82.7	82.8	82.9	83.0	83.5	Mar 15
Manufacturing	81.0	81.8	82.0	82.1	82.0	82.6	
Housing Starts (annual rate, thousands)	1446	1385	1458	1351	1407	1361	TBA
Single-family	1132	1116	1129	1109	1125	1081	
Trade balance (billions, monthly)	--	--	-7.1	-8.2	-9.0	-9.4	Feb 28
Merchandise	--	--	-12.5	-13.7	-14.4	-14.7	
Factory Orders (% ch)	--	1.3	-0.1	-0.6	7.8	2.9	Mar 5
Durable Goods	--	2.1	-0.8	-1.5	12.5	3.9	Mar 5
Personal Income (% ch)	--	--	0.2	0.7	5.5	5.6	Feb 27
Wages and Salaries	--	--	-0.1	0.9	6.3	5.1	
Purchasing Managers' Index (%)	44.2	46.0	46.0	46.6	46.5	48.4	Mar 1
Consumer Sentiment U Mich (Feb 66=100)	89.3	91.0	88.2	90.2	90.6	91.6	Mar 1
Conference Board (1985=100)	87.0	99.2	101.6	96.3	97.3	98.8	Feb 27

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- Consumer confidence, initial unemployment claims and purchasing managers' reports likely to be least affected by the weather and, thus, most useful in assessing current economic conditions.
- Underlying inflation trends likely to remain excellent even though higher energy prices will push up the overall figures. CPI report benefits from elimination of airline ticket tax.
- Republican presidential campaign moves on with Arizona and South Carolina the next major primary contests.

Economic Releases and Other Events

Date	Indicator	Estimate GS	Estimate Consensus	Last Report
Feb. 27	Producer Price Index (Jan.)	+0.4%	+0.5%	+0.5%
	Ex. Food and Energy	0.0%	+0.2%	+0.1%
	Retail Sales (Jan.)	-0.4%	-0.4%	+0.3%
	Ex. Auto	-0.2%	n.a.	+0.2%
	Consumer Confidence (Feb.)	Flat	90.0	87.0
Feb. 28	Consumer Price Index (Jan.)	+0.2%	+0.3%	+0.2%
	Ex. Food and Energy	0.0%	+0.2%	+0.1%
	Existing Home Sales (Jan.)	Down	-2.7%	-0.2%
	Business Inventories (Dec.)	+0.2%	+0.1%	+0.1%
Mar. 1	Purchasing Managers Index (Feb.)	45.5%	46.0%	44.2%
	Domestic Motor Vehicle Sales (Feb.)	Up	Up	12.7 mil.

- Arizona Primary (Feb. 27)
- Chicago Pur. Mgr. Survey (Feb. 29)
- Consumer Sentiment-Final (Mar. 1)
- South Carolina Primary (Mar. 2)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.1	5.1	6.1
Forward	5.1	5.0	5.1
2 Yr T-Note	5.0	5.2	6.3
Forward	5.1	5.2	5.3
10 Yr T-Note	5.7	5.9	6.7
Forward	6.0	6.0	6.1

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	0.9%	0.5%	1.7%	2.0%	1.6%
Ind. Production	1.3	0.0	2.0	3.5	1.5
CPI	2.0	3.5	2.2	2.8	2.7
Profits*	12.6	6.9	11.2	10.1	5.6
Merch Trade Bal. (monthly, $B)	-12.6	-13.3	-13.0	-13.6	-12.7

* Excluding inventory profits; adjusted for depreciation distortions

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U.S. Economics Analyst

Shrinking Trade Deficit Helps U.S. Economy Grow

- Shrinkage in the U.S. trade deficit added ¾ point to real GDP growth in the second half of 1995, helping cushion the U.S. economy during a period of sluggish growth. Underlying improvement began in late 1994 but was obscured by the impact of the Mexican peso devaluation.

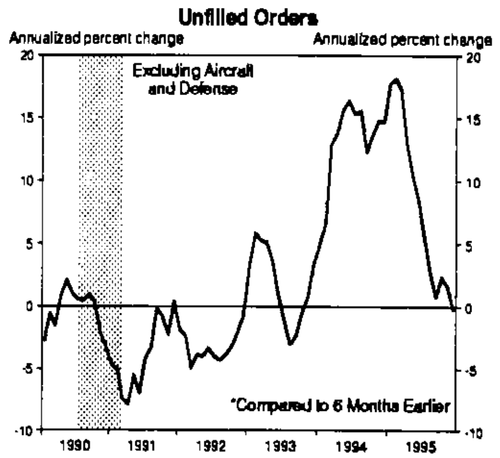
- Trade improvement should continue to provide major growth support for three reasons: Exports are competitive, growth abroad should pick up, and U.S. business equipment spending — a high penetration area — is slowing.

- The recent rise in U.S. bond yields does not appear to have been caused primarily by economic data, as most reports have been consistent with earlier impressions of stagnant production and sluggish final demands at the outset of this year.

- Monetary policy testimony by Chairman Greenspan on February 20 will likely emphasize central bankers' view that business activity will reaccelerate over the balance of 1996, while recognizing that subdued price and cost pressures allow room for additional rate cuts if necessary.

- As long as the Republican presidential selection process is murky, the probability of a revival in prospects for a multi-year budget deficit reduction pact will remain low.

Source: Department of Commerce. Goldman Sachs Estimates.



Source: Department of Commerce.

Trade Recommendations

- Our sell-stop in Treasury bonds was triggered this week; a neutral posture seems appropriate for now.

- Investors should approach short-duration U.S. debt with caution in the near term, as negative risks are posed by the coming Federal Reserve policy report and the unresolved status of Chairman Greenspan's possible renomination.

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Issue No: 96/7
February 16, 1996

I. Weekly Wrapup

Economic and Market Overview

Heavy financing volume in the corporate and sovereign debt markets has sustained upward pressure on U.S. bond yields in recent days. Indicators of business conditions, meanwhile, have underscored the weak current state of goods demand and output. All of the 1.2% net rise in total factory orders during November and December occurred in the aircraft industry, where bookings are lumpy and have little short-term impact on production. Backlogs of unfilled orders, meanwhile, declined in both months when aircraft and defense equipment are excluded. For the first time since late 1993, these backlogs have been unchanged, on balance, over a six-month period. While factory fundamentals are currently poor, the 0.6% plunge in factory production last month and the resulting slide in manufacturing utilization to 81.0% were partly due to bad weather and, hence, overstate the degree of these difficulties.

Inventory growth slowed in the middle of last quarter, with just a 0.1% rise recorded during November. A strengthening of domestic sales, though, remains the key to restoring firmer real GDP growth in the medium term. For this reason, it is important that business capital equipment spending not slide into retrenchment as a consequence of rapidly rising slack in capacity. Growth in orders for nondefense capital goods other than aircraft clearly has slowed since 1993-94, but through December this leading indicator of equipment purchases remained on a modestly positive trajectory.

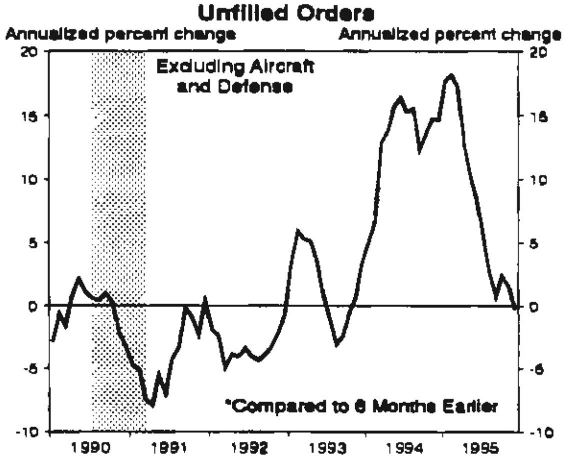
Despite a 0.9% rise in total labor compensation last quarter, it is not yet clear that this measure of labor costs has begun to accelerate. Its wage and salary component climbed just 0.7%, matching the modest gains seen in earlier months.

Federal Reserve Policy

Tuesday's semiannual report by the Federal Reserve to Congress on monetary policy and objectives is likely to stress two main points. First, the FOMC members' 'central tendency' growth projection for 1996 will probably be only slightly below the 2%-2¼% long-term trend, based on their expectation that activity will rebound fairly soon. This would imply that officials differ with the expectation of aggressive further rate cuts embedded in the forward yield curve. Second, central bankers no doubt will recognize and claim credit for the recent further abatement of inflation. In his prepared testimony, Chairman Greenspan can make the point that tame price behavior gives the Fed room to maneuver rates lower, if necessary, to sustain growth into 1997.

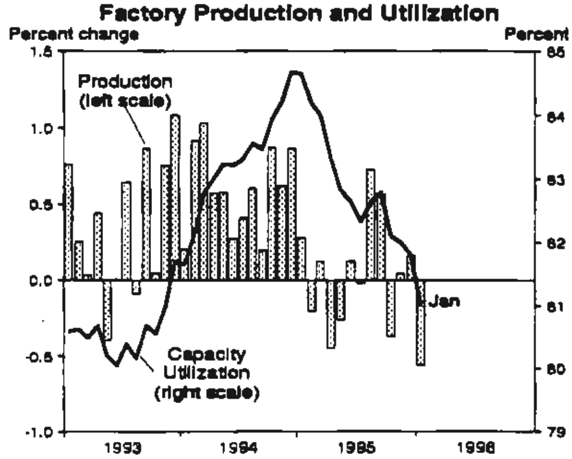
Only 15 days remain before Alan Greenspan's second term as Fed chairman expires, and as yet the president has not made his nomination intentions known. This delay may be simply the result of procrastination, or a byproduct of the unsuccessful effort to find a replacement for ex-Vice Chairman Blinder who can win Senate confirmation. While the probabilities still solidly favor Greenspan's reappointment, there is a non-zero risk that the president prefers a replacement and hopes that protracted and pointed inaction on his

Unfilled Orders



Source: Department of Commerce.

Factory Production and Utilization



Source: Federal Reserve Board.

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part might encourage the chairman to retire, as Paul Volcker did in 1987. Greenspan's departure from the Fed would be disruptive to monetary policy making, as it would take time — possibly until 1997 — to get a new leader confirmed. Moreover, any new chairman likely would face a higher burden of proof with the financial community for rate reductions, making it harder for the Fed to ease as quickly as the markets now anticipate.

Fiscal and Political Developments

The Republican Iowa caucus results have narrowed the field of viable candidates for the nomination to four. Senator Dole needs a solid victory in the New Hampshire primary next Tuesday to reestablish his status as the party's leading national figure and presumptive presidential candidate. Independent voters could be an important force in this open primary, if they turn out in large numbers. A tight New Hampshire outcome that keeps the GOP race scrambled among several choices would keep Dole distracted from Washington, maintaining the fairly low probability of a broad budget deal. However, should the primary voters vigorously back Dole or boost Alexander further, then the principals to the budget battle might develop stronger motives to fashion a compromise as a demonstration of their ability to govern.

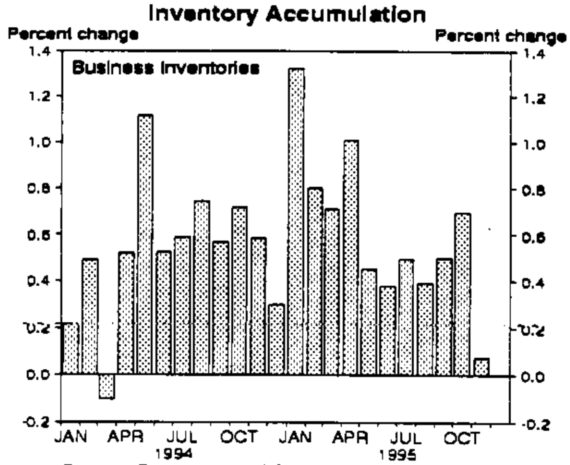
Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

We were stopped out of our long U.S. Treasury bond market position this week, and would stay close to shore now for two main reasons. First, we suspect that Chairman Greenspan's policy remarks next week will stress the adequacy of past easing steps for regenerating respectable economic growth in future quarters. In light of the aggressive assumptions concerning future rate reductions now built into forward yields, this could cause a market setback. Second, while a renomination of Dr. Greenspan remains the most likely outcome, we are uneasy about the Clinton Administration's delay over the matter, and are concerned about strongly negative market consequences if the conventional wisdom about his reappointment proves incorrect.

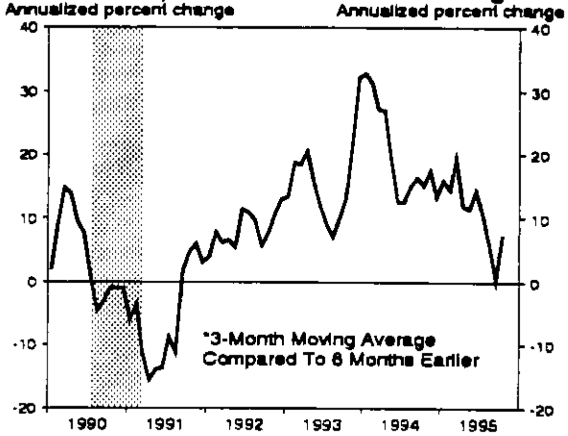
Assuming that the issue of the Fed chairmanship is settled in favor of the incumbent, we would regard any material back-up in money market rates and/or bond yields in response to the Fed's Humphrey-Hawkins report as a potential buying opportunity.

Inventory Accumulation



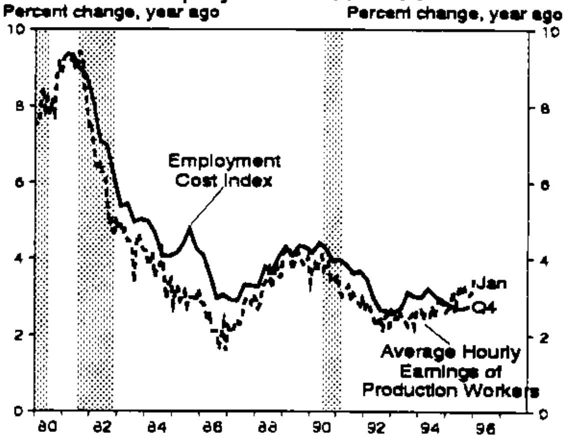
Source: Department of Commerce.

Non-Defense Capital Goods Orders Excluding Aircraft



Source: Department of Commerce.

Employment Cost Index



Source: Department of Labor.

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II. Shrinking Trade Deficit Helps U.S. Economy Grow

The U.S. trade deficit has begun to shrink, providing a substantial cushion to the U.S. economy during a time of sluggish growth in domestic demand. Underlying improvement began in late 1994, but was obscured through mid-1995 by the impact of the Mexican peso devaluation on U.S.-Mexican bilateral trade. By last November, however, the deficit in goods and services trade had fallen to $7.1 billion — the smallest gap in 17 months and the fourth consecutive reading under $10 billion. Reflecting this improvement, net exports added about ¾ percentage point to annualized real GDP growth in the third quarter of 1995 and, by our estimate, a similar amount to fourth-quarter growth.

The trade sector should continue to provide substantial support to U.S. growth in 1996 and 1997 for three reasons. First, U.S. exports are competitively priced in world markets, notwithstanding recent dollar appreciation. Second, growth in the economies of the major U.S. trading partners is likely to pick up. And finally, a shift in the mix of U.S. domestic final sales growth, away from capital goods, should result in slower import growth. All in all, trade improvement is likely to contribute about ½ percentage point to annualized growth between now and the end of 1997, with the annual deficit, whether for goods and services or for the overall current account, narrowing by about $50 billion between 1995 and 1997.

Exports Competitively Priced

One major factor driving U.S. trade improvement is that U.S. exports look extremely inexpensive to foreign buyers. In fact, the relative price of U.S. merchandise exports, expressed in terms of a trade-weighted basket of foreign currencies, reached an all-time low in mid-1995. The sell-off in the dollar early last year was only partly responsible for this. In recent years, U.S. companies have also priced their goods aggressively in world markets, matching or undercutting price changes by foreign competitors.

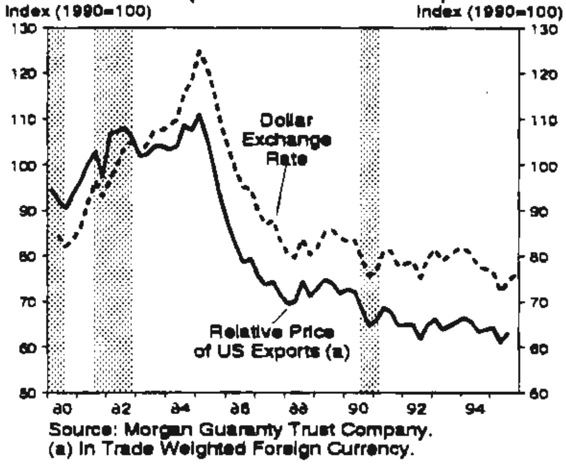
The dollar's subsequent rebound has probably not put much of a dent in this U.S. export advantage. Part of the reason is that the greenback's gain has been principally against the yen — about 26% since April 1995. Over the same period, the dollar has risen only about 8% in trade-weighted terms, not even regaining its yearend 1994 level. Even the more dramatic move against the yen has merely restored the dollar to its early 1994 level. In 1994, both the dollar/yen rate and the trade-weighted dollar were then at or near historic lows.

Moreover, changes in the currency take a long time to affect the prices at which goods are traded, because companies try to hedge against price changes or lock the prices in through long-term contracts. Thus, the dollar's 1994/early 1995 sell-off may not yet have worked its way into the prices of goods and services and the subsequent increase would therefore imply no loss in competitiveness.

Merchandise Trade Balance

Source: Department of Commerce. Goldman Sachs Estimates.

Price Competitiveness of US Exports



Source: Morgan Guaranty Trust Company.
(a) In Trade Weighted Foreign Currency.

The performance of U.S. exports in 1995 certainly attests to their competitive advantage. U.S. exporters faced tough markets last year, as real domestic demand in the economies of the major U.S. trading partners was essentially stagnant on balance. Despite this lack of growth in demand, real exports of merchandise were up 14.6% in the first 11 months of the year. Adding services to the mix, year-to-year growth in real exports appears to have been about 9%.

Growth Abroad to Pick Up

Prospects for a pickup in growth abroad should strengthen the growth in U.S. exports from this already solid base. Mexico is on the verge of an upward turn. Conditions in Japan also seem ripe, at long last, for genuine recovery. Although growth in Europe and Canada is currently sluggish, this reflects to a large degree the damping effect of the destocking cycle now underway. As this cycle comes to an end, and monetary stimulus in these countries takes effect, a firmer growth pattern should emerge.

Projections by the OECD show growth in these countries averaging 2.4% in 1996 on a U.S.-export weighted basis, nearly a 3-point pickup from the 1995 decline. Our own outlook calls for a more gradual upturn, with growth averaging 1% in 1996 and 2.7% in 1997. Either way, U.S. exporters should see growth in their major foreign markets increase by a minimum of about 1½ percentage point, and possibly by as much as 3 points, over the next year or two.

Typically, each additional percentage point of growth in real foreign domestic demand lifts the growth rate of real U.S. merchandise exports by 1½ to 2 percentage points. Exports of services are less sensitive to swings in growth, however, so the increase in total export growth tends to be 1 to 1½ times the increase in real demand growth. Thus, starting from a 1995 base of 9% growth, it seems reasonable to expect that annualized growth in real U.S. exports will easily top 10%, and possibly hit 15%, in coming quarters.

Foreign Demand Pickup to Boost U.S. Export Growth
(annualized percentage change)

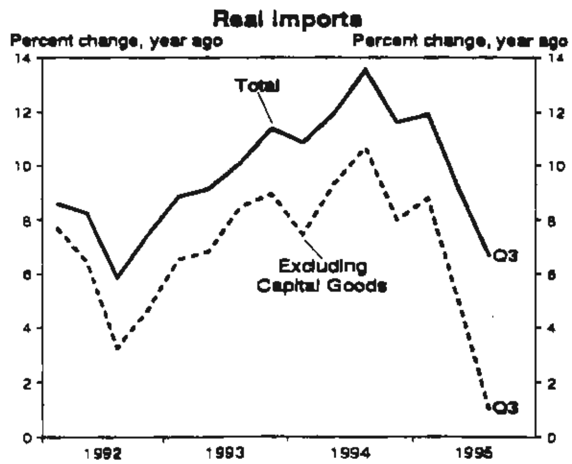
Destination	U.S. Export Share	Domestic Demand Growth 1995 Actual	1996E GS	1996E OECD
Canada	22%	1.6%	1.2%	2.3%
European Union	21	2.2	1.8	2.8
Japan	11	1.0	2.7	2.6
Mexico	8	-15.9	0.7	1.7
Weighted by U.S. export share		-0.4	1.0	2.4

Source: Commerce Department, OECD.

The Changing Mix of U.S. Demand Growth

In view of the strong trends that have been in place for some time on the export side of the accounts, it is clear that persistent import growth has been the main obstacle to U.S. trade improvement. This, in turn, has been mainly due to the boom in U.S. capital equipment spending, a sector of deep import penetration. As a result of this boom, real imports of capital equipment surged nearly 25% between the third quarter of 1994 and the third quarter of 1995, accounting for more than 90% of the increase in imports over that period. Imports of other goods rose just 1%.

Growth in capital spending is due for a significant correction in 1996. Capacity is rising rapidly, thanks to 3½ years of strong investment, while usage of that capacity has dropped sharply over the past year. Reflecting these divergent trends, orders for capital goods other than aircraft have zigzagged throughout the first 11 months of 1996 without clear trend. And imports of these items dropped 2.5% in November. As the slowdown in such spending continues, the effect of sluggish growth in other areas of the economy will show more clearly to import growth.



Source: Department of Commerce.

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The December 1994 devaluation of the Mexican peso was also a factor boosting U.S. import growth in 1995, as Mexican goods suddenly became much cheaper in U.S. dollars. Between December 1994 and November 1995, imports from Mexico rose 32.2%, accounting for more than one-quarter of the growth in U.S. merchandise imports over that period. The peso is quite unlikely to deteriorate as much as it did a year ago, especially in real terms. Therefore, import growth from this source should also dissipate in coming months.

The last six trade reports already reveal some slowing in import growth. Between May and November, the trend rate of growth in real merchandise imports slowed from more than 15% to about 10%. Meanwhile, the growth rate of real imports of goods and services dropped to about 7%. In light of the capital spending correction and the fading influence of the Mexican collapse, additional slowing, to about 5%, seems likely in coning quarters.

Implications for Financial Markets

In summary, the U.S. trade outlook is quite positive for 1996 and 1997. The deficit in goods and services is apt to narrow from an estimated $113 billion in 1995 to about $60 billion in 1997, primarily reflecting shrinkage in the merchandise shortfall. The current account deficit should likewise drop by about $50 billion, from nearly $160 billion to about $110 billion.

The implications of trade improvement for U.S. financial assets should be constructive on balance, though varying across different markets:

Real Merchandise Import and Export Growth Rates

Source: Department of Commerce.

U.S. Trade Forecast
($ billions)

	1994	1995	1996	1997
U.S. Trade Balance	-106.2	-113.0	-98.0	-60.0
Merchandise	-166.1	-176.5	-165.0	-130.0
Services	+59.9	+63.5	+67.0	+70.0
Current Account Balance	-151.2	-159.0	-139.3	-110.5
Real Net Exports*	-108.1	-115.4	-98.0	-63.3

* 1992 dollars.

- **The U.S. dollar would clearly benefit.** Our 1997 current account balance estimate implies the smallest net supply of dollars on foreign currency markets since 1993. Moreover, evidence that trade is supporting U.S. growth would lift market estimates of U.S. interest rates vis-a-vis those of other countries.

- **Effects on U.S. bonds would probably** be **somewhat negative.** Although bond investors would welcome the inflows resulting from an upgrade in international investors' attitudes about the dollar, evidence of stronger growth would likely make current forward yield assumptions appear too optimistic as perceptions of the need for additional demand stimulus from the Fed diminish.

- **Equity values would probably rise.** Trade improvement provides protection against recession. Although prospects of stronger U.S. growth would probably cause investors to question assumptions about interest rates, they too would welcome inflows from abroad.

Ed McKelvey

Goldman Sachs

Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	'96 Jan	'95 Dec	'95 Nov	'95 Oct	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	-201	161	212	68	100	114	Mar 8
Unemployment Rate (%)	5.8	5.6	5.6	5.5	5.6	5.6	
Index of Hours Worked (% ch)	-2.0	-0.3	-0.4	0.6	-3.7	-1.8	
Average Hourly Earnings (% ch)	0.5	0.3	-0.1	0.4	3.2	3.5	
Producer price finished goods index (% ch)	--	0.5	0.5	-0.1	2.5	2.2	Feb 27
Excluding food and energy	--	0.1	0.4	0.0	2.3	2.5	
Consumer price index (% ch)	--	0.2	0.0	0.3	2.0	2.6	Feb 28
Excluding food and energy (% ch)	--	0.1	0.1	0.3	2.4	3.0	
Retail sales (% ch)	--	0.3	0.7	-0.2	1.9	3.4	Feb 27
Excluding motor vehicles (% ch)	--	0.2	0.5	-0.5	1.2	2.6	
Industrial Production (% ch)	-0.6	0.2	0.2	-0.5	0.6	0.1	Mar 15
Manufacturing	-0.6	0.2	0.0	-0.4	1.1	-0.1	
Capacity utilization (%)	81.9	82.7	82.8	82.9	83.0	83.5	Mar 15
Manufacturing	81.0	81.8	82.0	82.1	82.1	82.6	
Housing Starts (annual rate, thousands)	--	--	1420	1343	1383	1360	Feb 23
Single-family	--	--	1102	1102	1102	1079	
Trade balance (billions, monthly)	--	--	-7.1	-8.2	-9.0	-9.4	Feb 28
Merchandise	--	--	-12.5	-13.7	-14.4	-14.7	
Factory Orders (% ch)	--	1.3	-0.1	-0.6	7.8	2.9	Mar 5
Durable Goods	--	2.1	-0.8	-1.5	12.5	3.9	Mar 5
Personal Income (% ch)	--	--	0.2	0.7	5.5	5.6	Feb 27
Wages and Salaries	--	--	-0.1	0.9	6.3	5.1	
Purchasing Managers' Index (%)	44.2	46.0	46.0	46.6	46.5	48.4	Mar 1
Consumer Sentiment U Mich (Feb 66=100)	89.3	91.0	88.2	90.2	90.6	91.6	Mar 1
Conference Board (1985=100)	87.0	99.2	101.6	96.3	97.3	98.8	Feb 27

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- Chairman Greenspan delivers his semiannual 'Humphrey-Hawkins' testimony regarding monetary policy performance and objectives. He will probably indicate that the FOMC perceives only a small recession risk (Feb. 20).
- The first presidential primaries will be held in New Hampshire. Sen. Dole needs a solid victory to reestablish his position as front-runner for the GOP nomination. Publisher Steve Forbes also needs to do well to offset his poor Iowa showing and remain in the top tier of candidates (Feb. 20).
- The 'advance' GDP report for fourth quarter should confirm that real economic growth dropped back well below its 2% trend in the fourth quarter (Feb. 23).
- Housing starts data should show a sharp decline in January, due to unusually cold, icy, and snowy weather (Feb. 23).

Economic Releases and Other Events

Date	Indicator	Estimate: GS	Estimate: Consensus	Last Report
Feb. 20	Leading Indicators (Dec.)	0.0%	0.0%	-0.3%
Feb. 22	Federal Budget Balance (Jan.)	+$21.0 bn.	+$18.5 bn.	+$15.6 bn. (Jan. 95)
Feb. 23	Real GDP (95Q4)	+1.0%	+2.5%	+3.2%
	GDP Deflator (95Q4)	+3.0%	+2.4%	+2.3%
	Housing Starts (Dec./Jan.)	-2.0%/-10.0%	-3.0%/-9.0%	+5.7%

- 3 mo and 6 mo T-bill auctions (Feb. 20)
- Greenspan Humphrey-Hawkins Testimony (Feb. 20)
- New Hampshire Primary (Feb. 20)
- Kansas City Fed Survey (Feb. 21)
- 1996 Investment Plans Survey (Feb. 22)
- Delaware Caucuses (Feb. 23)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.1	5.1	6.1
Forward	4.9	4.7	4.7
2 Yr T-Note	5.0	5.2	6.3
Forward	4.9	4.9	5.0
10 Yr T-Note	5.7	5.9	6.7
Forward	5.7	5.8	5.9

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	1.0%	0.5%	1.7%	2.0%	1.6%
Ind. Production	1.0	0.0	2.0	3.5	1.5
CPI	2.0	3.5	2.2	2.8	2.7
Profits*	12.6	6.9	11.2	10.1	5.6
Merch Trade Bal. (monthly, $B)	-12.8	-13.3	-13.0	-13.6	-12.7

* Excluding inventory profits; adjusted for depreciation distortions

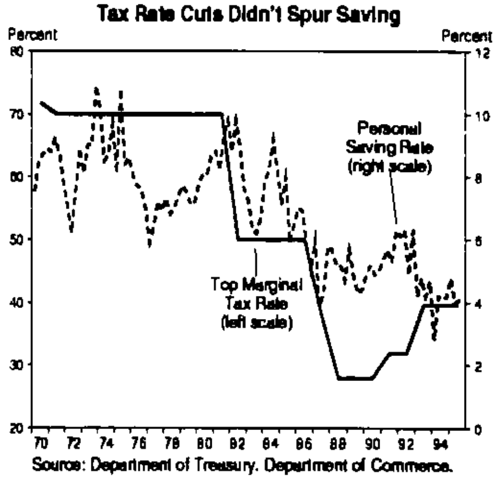
Goldman Sachs

U.S. Economics Analyst

Flat Tax Faces Many Hurdles

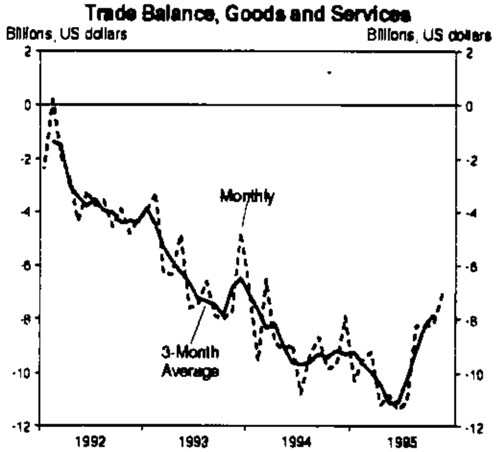
- A flat tax still faces many hurdles despite the surge of Steve Forbes in the polls and the recent endorsement by the Kemp Commission.
- Hurdles include: Political problems caused by the fact that a revenue-neutral flat tax would raise taxes on the middle-class and would favor capital income over labor income. In addition, a flat tax would face strong opposition from groups such as realtors, life insurance companies, and non-profit organizations who are favored by deductions and exemptions under the current tax system.
- Proponents of the flat tax also help their critics by overpromising in terms of its likely benefits. The flat tax is likely to have a much milder impact on growth and savings than implied by Steve Forbes or the Kemp Commission.
- Recent economic news suggests that the U.S. economy is unlikely to sink into recession. In particular, trade improvement underpins growth, and the trend in initial unemployment claims is not consistent with the rapid deterioration that typically occurs at the onset of recessions.
- The Republican campaign gets underway in earnest next week with the Iowa caucuses. Senator Dole's performance could prove important in determining when he can turn his attention back to the stalled budget talks.

Tax Rate Cuts Didn't Spur Saving



Source: Department of Treasury, Department of Commerce.

Trade Balance, Goods and Services



Source: Department of Commerce.

Trade Recommendation

- We would stay long Treasury bonds, with a sell stop at 6.25%.
- The short-end of the yield curve appears rich, relative to the further 25 to 50 basis points of easing that we expect from the Federal Reserve. It probably is too soon, however, to initiate short positions.

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Issue No: 96/6
February 9, 1996

I. Weekly Wrapup

Economic and Market Overview

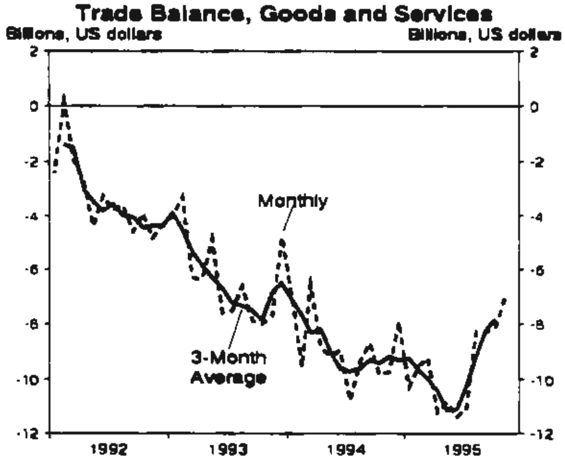
Prices of fixed-income securities hovered near the lows reached late last week, as the market struggled to absorb a heavy supply of new issues. Meanwhile, equity prices moved further into record territory. In both markets, investors appeared less concerned that the current weakness in economic activity would degenerate into recession.

For the most part, the economic indicators released during the week supported this interpretation. The strongest support came from the November trade report, which showed that the deficit for goods and services fell to $7.1 billion in that month. This was the smallest gap in 17 months and the fourth consecutive reading under $10 billion. Trend growth in exports remained solidly in double digits, while growth in imports slowed further. While the trade report could be dismissed as stale news, it was fresh evidence that trade improvement is providing a substantial cushion to the economy as it passes through the current period of weakness.

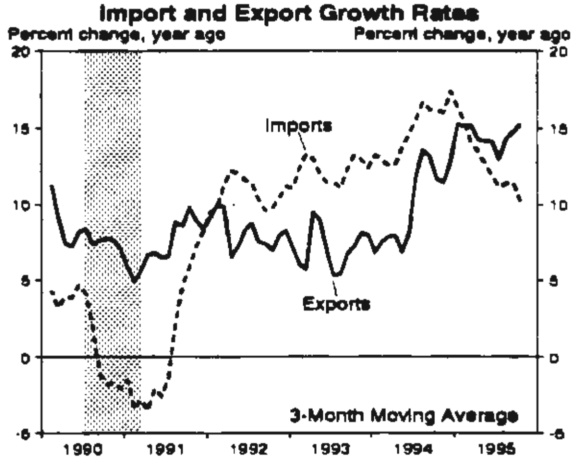
Other, more current, indicators contained small bits of reasssurance that the economy is not falling apart. Initial filings for unemployment insurance dropped 21,000, to 368,000, in the week ended February 3, pulling the 4-week average down slightly. If the economy were headed into recession, these claims would be rising sharply to much higher levels. Meanwhile, retailers' reports on January sales indicated that the trend of business had stabilized at a low level, despite unusually poor weather. And, although concerns about an excessive debt load have been cited as the main reason for the consumer slowdown, yearend figures for installment borrowing reveal only a modest tendency toward deceleration. Outstanding balances on all types of short-term installment credit rose at a 9.3% annual rate while credit-card balances were up at an even stronger 14.2% clip. Year-to-year growth in credit card debt stood at 18% in December, down only marginally from its peak. In a separate report, the Federal Reserve echoed comments by our analysts for financial institutions that loan standards are tightening in response to a deterioration in credit quality.

Federal Reserve Policy

Minutes from the December FOMC meeting, though reduced in predictive value by the easing in late January, reinforce our impression that central bank officials were not exceptionally worried about recession. At the December meeting, the staff presented a forecast of nearly trend growth for subsequent quarters. Although no one dissented from the modest easing agreed at that meeting, several committee members would have preferred no change. The decision also appeared to be independent of the state of the budget negotiations. While information on the Committee's current state of mind as of late January will not be available until the Humphrey-Hawkins hearings on February 20, at the earliest, the conservative nature of last week's easing suggests that attitudes have not shifted greatly.



Source: Department of Commerce.



Source: Department of Commerce.

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Fiscal and Political Developments

President Clinton's bare-bones fiscal 1997 budget message to Congress contained no new surprises, pending a more complete submission later next month. However, it did underscore how much the terms of debate have shifted in a year. Whereas his FY 1996 message projected a deficit in the neighborhood of $200 billion for the foreseeable future, his latest message reiterated his earlier proposal that aimed for a slight surplus in 2002.

Prospects for a comprehensive budget accord remain dim, despite a bipartisan agreement among the nation's governors on formulas for allocating Medicaid and welfare benefits across the various states. Although this could, at the margin, grease the way toward a budget deal, it does not jump-start the stalled talks. Both President Clinton and Senator Dole appear to be more comfortable running on their current platforms rather than striking a deal. Moreover, Sen. Dole is preoccupied with defending his front-runner status against a surprisingly strong assault by publisher Steve Forbes.

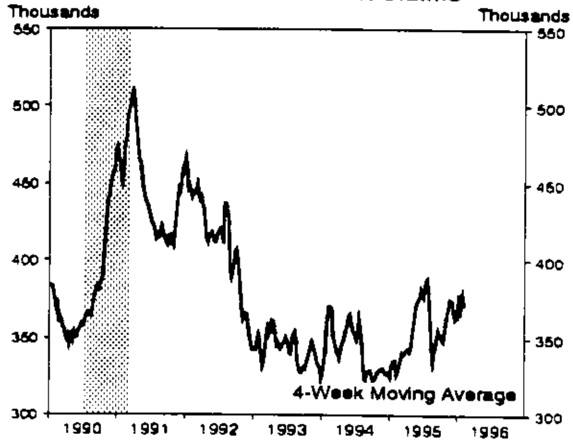
The race for the Republican nomination has focused increasingly on these two candidates on the eve of next week's Iowa caucuses. Sen. Phil Gramm (R-TX) suffered a severe setback when he lost out to commentator Pat Buchanan in a two-way race for delegates in neighboring Louisiana; by his own admission, he must recoup this damage quickly by showing at least third in the wider Iowa contest, to be held this coming Monday. Former Gov. Lamar Alexander of Tennessee could emerge if Dole and Forbes both stumble.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

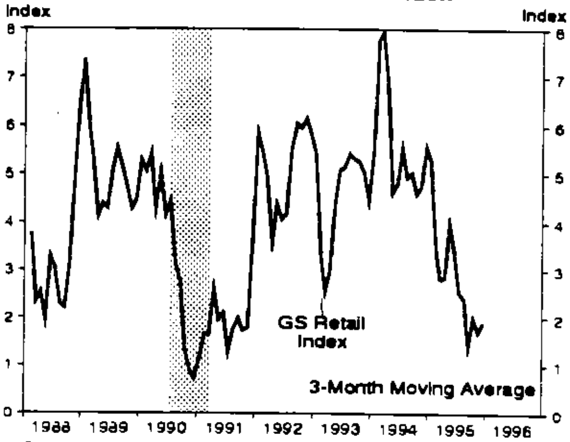
We believe that the short end of the fixed-income market is priced too aggressively to Fed easing. However, it is probably too soon to initiate short positions on this part of the yield curve given that additional signs of weakness will probably be forthcoming. Any tendency for longer-dated securities to rally should be seen as an opportunity to liquidate long positions in this sector, which now look less attractive in the light of better-than-expected economic news.

Initial Jobless Benefit Claims



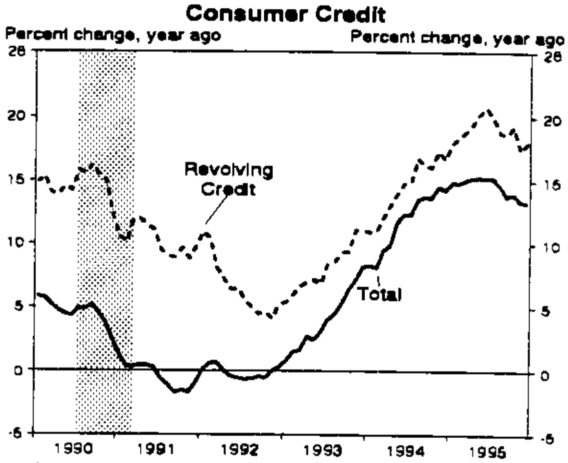
Source: Department of Labor.

Goldman Sachs Retail Index



Source: Goldman Sachs.

Consumer Credit



Source: Federal Reserve Board.

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II. Flat Tax Still Faces Big Hurdles

Steve Forbes has made the "flat" tax the centerpiece of his campaign for the Republican nomination for President. The issue appears to have found some resonance with voters as Forbes has surged in the polls over the last few weeks. Despite his rapid advance and the endorsement by the Kemp Commission of a flat tax, we still view the prospect of major tax reform along the lines of the Forbes proposal as dim for three reasons. First, there are serious political obstacles to reform. Second, flat tax advocates are supplying ammunition to their critics by overpromising in terms of the magnitude of the benefits that would flow from a flat tax. Third, the fact that the transition to a flat tax system would be disruptive reduces the benefits of implementing such a system.

A Bundle of Benefits

The flat tax proposal advocated by Steve Forbes is nearly identical to the Armey-Shelby flat tax proposal, which we examined in detail in our recent report, *Tax Reform: The Good, the Bad, and the Ugly.*

As we noted in that report, a flat tax of the type advocated by Armey-Shelby and Steve Forbes would generate a significant number of benefits. In particular:

1. **Simplification.** Not only would this reduce the costs of tax compliance, but it also would probably result in improved tax compliance.

2. **Base broadening.** By eliminating deductions for mortgage interest, state and local income taxes, and charitable contributions and by including fringe benefits, such as health care insurance, in the taxable income base, the flat tax would dramatically broaden the tax base. This would make the tax system more neutral and help increase the efficiency of investment.

3. **Pro-savings bias.** The exclusion of interest, dividend, and capital gains income from taxation would raise the return on saving, which might result in a greater propensity to save.

4. **Pro-investment bias.** The expensing of investment would reduce its effective cost and thereby raise its after-tax return.

In addition, the imposition of a flat tax — if made tamper proof — might make it more difficult for politicians in Washington to hand out tax expenditure benefits to favored constituencies.

But Big Political Hurdles

Despite these benefits and the surge of Steve Forbes in the polls, a flat tax still faces a long, uphill road. In addition to the fact that the Clinton administration opposes a flat tax, the political obstacles include 1) higher taxes for the middle class; 2) the political optics of favoring capital income over labor income; and 3) the loss of popular tax deductions.

Higher Taxes for the Middle-Class

Regardless of the precise rate (most impartial estimates are clustered around 23%) that is needed for a flat tax system to be revenue-neutral, it is obvious that the combination of a flat tax with revenue-neutrality implies a higher tax burden on the middle-class.

First, under a flat tax, the tax rate for higher income taxpayers would be cut significantly. In 1993, for example, total income taxes represented 28.1% of total adjusted gross income for taxpayers in the $200,000 and higher group.

Second, the taxable income base for high-income taxpayers would shrink as the exclusion of interest, dividends, and capital gains income from the tax base more than offset the inclusion of fringe benefits. For taxpayers with adjusted gross incomes of $200,000 or more in 1993, interest, dividend, and capital gains income represented about 28.8% of total adjusted gross income. This compares to about 7.4% for all other taxpayers.

Low-income taxpayers would also tend to pay less tax under the flat tax proposal because the standard deduction and exemption would be increased in size in order to retain a modest degree of progressivity to the tax system. The combined effect of lower taxes at both the low and high ends of the income distribution imply that income taxes for the middle class would have to be higher to keep the proposal revenue neutral.

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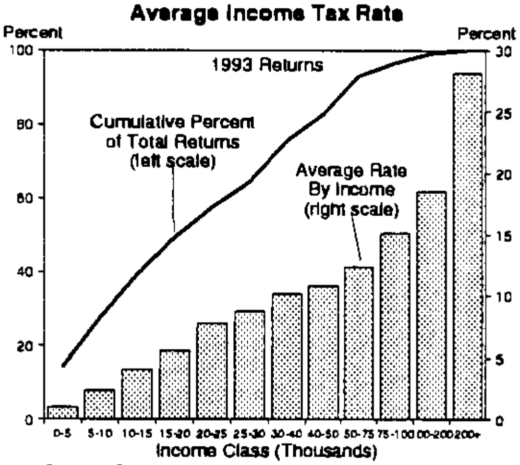
Average Income Tax Rate



Source: Department of Treasury.

Favoring Capital over Labor Income

Related obstacles to a flat tax are the political problems created by a tax reform proposal that exempts all forms of capital income from the personal income tax. Although a strong case for doing so can be made on the grounds that this income has already been taxed at the corporate level, voters are not likely to favor a tax reform effort that means that a person clipping coupons on a beach can pay no taxes, while a worker pays taxes not only on wage income, but also on fringe benefits such as health care insurance.

Loss of Deductions

A flat tax would face opposition from those groups that benefit under the current system of deductions and exemptions. These include:

1. **Realtors and homebuilders.** By eliminating the mortgage interest deduction, the Forbes flat tax proposal would raise the after-tax cost of housing finance. This would, all else equal, put downward pressure on home prices.

2. **Life insurance industry.** Currently, the tax deferral benefit embodied in whole life, universal life, and annuity products helps this industry gather assets. Under a flat tax, all income on capital would no longer be subject to tax. Thus, life insurers would lose an important competitive advantage.

3. **State and local governments.** A flat tax would generate two negative consequences for this group. First, the cost of state and local income taxes to taxpayers would rise as such taxes were no longer deductible from income. States with high marginal income tax rates such as California could be expected to complain about this change the most. Second, the cost of borrowing for such entities would go up. If all forms of interest were no longer subject to tax, tax-exempt yields would rise to the level of general interest rates.

4. **Non-profit organizations.** The loss of the deduction for charitable contributions could hurt the fund-raising efforts of such groups.

Other groups potentially negatively affected by a flat tax include health care providers (the current tax system subsidizes health care services compared to consumption funded using after-tax dollars) and pension/401(K) plan operators. With returns on capital no longer subject to tax, pension plans and 401(K) plans would tend to wither.

Overpromising Also Hurts Flat Tax Advocates

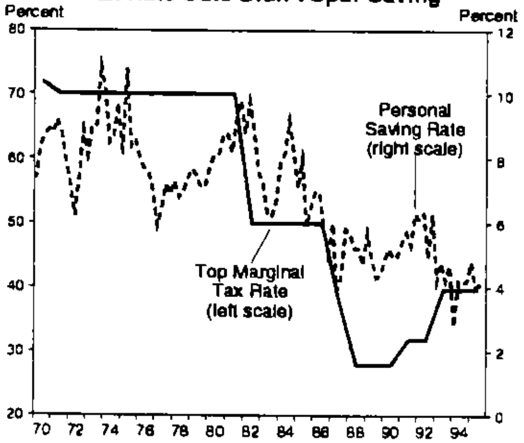
The flat tax is also vulnerable to criticism because its advocates overpromise in terms of its likely benefits. For example, the Kemp Commission states that a flat tax would help double the economic growth rate. In the same vein, Steve Forbes argues that a flat tax with a 17% rate would not lose revenue because it would result in faster growth via the avenues of higher saving and investment and greater work effort. Scrutiny of these claims reveals that neither is likely to be valid.

On the saving side of equation, it is unlikely that a flat tax would lead to a significant rise in saving because personal saving is quite insensitive to changes in after-tax yields. That is because the incentive to save more resulting from higher yields is nearly completely offset by the fact that the same higher yields reduce the amount of saving needed over time to meet a given net worth target.

In the 1980s, this proposition was tested with two large drops in the top marginal income tax rate in 1982 and 1987-1988. As shown in the accompanying chart, no favorable impact on the personal saving rate is visible as a result of these marginal rate reductions.

Without a big rise in saving, the argument for more rapid growth is impaired. That is because a rise in saving is necessary to accommodate the increase in investment needed to foster faster growth.

Tax Rate Cuts Didn't Spur Saving



Source: Department of Treasury, Department of Commerce.

Even if there were a saving response, it would have to be large to have any meaningful impact on the pace of economic growth. For example, assuming that the saving rate increases proportionally with the rise in after-tax returns, this would raise the personal saving rate by only about $30 billion per year. This is a drop in the bucket relative to the nation's private sector capital stock of $12 trillion and could be expected to raise the nation's growth rate by less than 0.1% per year.

Similarly, the claim that a flat tax would spur growth through increased work effort also appears to be exaggerated. As we see it, such an argument has several problems:

1. **Changes in marginal tax rates would not be large for most families.** Most taxpayers currently fork over 15% or 28% of each extra dollar of wage and salary income to Uncle Sam.

2. **The workweek is already quite long.** For example, in the manufacturing sector the workweek hit a record 42.5 hours in January 1995.

3. **Labor force participation rates are already quite high.** In particular, the female participation rate has stabilized at a level only modestly below the male participation rate after rising quickly since 1960.

Transition: A Final Hurdle

It also is important not to ignore the potential transitional difficulties in moving to a new tax system. A flat tax system might be the best system, but switching to it might not be worth the costs if the transitional costs were large.

Even if tax reform changed the desired capital stock only modestly, this could have large impacts in the short term because the stock of capital is very large relative to net investment.

To illustrate this, consider the housing industry. The total value of residential housing in the U.S. exceeds $4 trillion, compared to an investment rate of about $280 billion per year. If the loss of the mortgage interest deduction caused households to reduce their desired stock of housing by 5%, this would translate into a $200 billion adjustment in the stock. If the adjustment took 3 years to complete, new residential investment would be depressed about 25% for that period.

The major revisions to the tax code undertaken in 1986 illustrate the potential difficulties of such transition periods. In 1986, the changes made to the depreciation rules for real estate helped to contribute to a collapse in real estate prices. This, in turn, led to a large climb in bad loans among commercial banks. The shaky banking system, in turn, was a factor behind the recession and anemic recovery over the 1990-1993 period. Only now, nearly ten years later, has the real estate sector generally recovered from that debacle.

The probability that a flat tax will be enacted in 1997 still appears to be very low. More likely, the widespread dissatisfaction with the current system will provoke more modest efforts toward reform emphasizing greater simplicity and transparency rather than the more radical overhaul that the Forbes flat tax plan would represent.

Bill Dudley

Goldman Sachs

Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	'96 Jan	'95 Dec	'95 Nov	'95 Oct	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	-201	161	214	66	100	114	Mar 8
Unemployment Rate (%)	5.8	5.6	5.6	5.5	5.6	5.6	
Index of Hours Worked (% ch)	-2.0	-0.3	-0.4	0.6	-3.7	-1.8	
Average Hourly Earnings (% ch)	0.5	0.3	0.0	0.3	3.2	3.5	
Producer price finished goods index (% ch)	--	0.5	0.5	-0.1	2.5	2.2	Feb 27
Excluding food and energy	--	0.1	0.4	0.0	2.3	2.5	
Consumer price index (% ch)	--	0.2	0.0	0.3	2.0	2.6	Feb 28
Excluding food and energy (% ch)	--	0.1	0.1	0.3	2.4	3.0	
Retail sales (% ch)	--	0.3	0.7	-0.2	1.9	3.4	Wk of Feb 26
Excluding motor vehicles (% ch)	--	0.2	0.5	-0.5	1.2	2.6	
Industrial Production (% ch)	--	0.1	0.3	-0.4	2.2	1.1	Feb 16
Manufacturing	--	0.1	0.2	-0.4	2.4	0.8	
Capacity utilization (%)	--	82.8	83.0	83.0	83.2	83.7	Feb 16
Manufacturing	--	81.8	82.1	82.2	82.3	83.0	
Housing Starts (annual rate, thousands)	--	--	1420	1343	1383	1360	Feb 23
Single-family	--	--	1102	1102	1102	1079	
Trade balance (billions, monthly)	--	--	-7.1	-8.2	-9.0	-9.4	Feb 28
Merchandise	--	--	-12.5	-13.7	-14.4	-14.7	
Factory Orders (% ch)	--	--	--	-0.3	8.4	6.7	Feb 15
Durable Goods	--	--	--	-1.1	15.4	8.4	Feb 15
Personal Income (% ch)	--	--	0.2	0.7	5.5	5.6	Feb 27
Wages and Salaries	--	--	-0.1	0.9	6.3	5.1	
Purchasing Managers' Index (%)	44.2	46.0	46.0	46.6	46.5	48.4	Mar 1
Consumer Sentiment U Mich (Feb 66=100)	89.3	91.0	88.2	90.2	90.6	91.6	Feb 16
Conference Board (1985=100)	87.0	99.2	101.6	96.3	97.3	98.8	Feb 27

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- The race for the Republican presidential nomination gets underway in earnest with the Iowa caucus Monday evening. A muddled outcome would probably disturb bond investors as it would mean that Senator Dole's attentions would be diverted to the campaign rather than available to negotiate a balanced budget agreement.

- The employment cost index for the fourth quarter on Tuesday is likely to show a modest acceleration in labor cost trends. This would underscore the fact that the economy has been operating at full employment.

- Two months of factory orders data will be reported on Thursday. This will provide some indication about whether weakness in the capital goods area is intensifying. Also, the manufacturing inventories data will provide some clues on how much farther the inventory adjustment process must go before it is likely to have run its course.

- The industrial production report will not provide a good snapshot of the health of the manufacturing sector as output in January was clearly depressed by bad weather. A jump in aircraft output following the end of the Boeing strike in December will help offset some of the weather-induced weakness.

Economic Releases and Other Events

Date	Indicator	Estimate GS	Estimate Consensus	Last Report
Feb. 13	Employment Cost Index (Q4.)	+0.7%	+0.6%	+0.6%
Feb. 15	Durable Goods Orders (Nov./Dec.)	-0.6%/-0.5%	n.a./n.a.	-1.1%
	Factory Orders (Nov./Dec.)	-0.4%/-0.5%	n.a./n.a.	-0.3%
Feb. 16	Construction Spending (Nov./Dec.)	Down	-0.3%	+2.7%
	Industrial Production (Jan.)	-0.5%	n.a.	+0.1%
	Capacity Utilization (Jan.)	82.1%	n.a.	82.8%
	Business Inventories (Nov.)	+0.4%	+0.5%	+0.6%

- 3 mo and 6 mo T-bill auctions (Feb. 12)
- Atlanta Fed Survey (Feb. 12)
- Iowa Caucuses (Feb. 12)
- Philadelphia Fed Survey (Feb. 15)
- Michigan Consumer Sentiment, prelim. (Feb. 16)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.1	5.1	6.1
Forward	5.0	4.8	4.7
2 Yr T-Note	5.0	5.2	6.3
Forward	4.9	4.9	5.1
10 Yr T-Note	5.7	5.9	6.7
Forward	5.7	5.7	5.8

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	1.0%	0.5%	1.7%	2.4%	1.6%
Ind. Production	1.0	0.0	2.0	3.5	1.5
CPI	2.0	3.0	2.7	2.8	2.7
Profits*	10.2	8.8	6.3	7.9	4.8
Merch Trade Bal. (monthly, $B)	-12.8	-13.3	-13.0	-13.6	-12.7

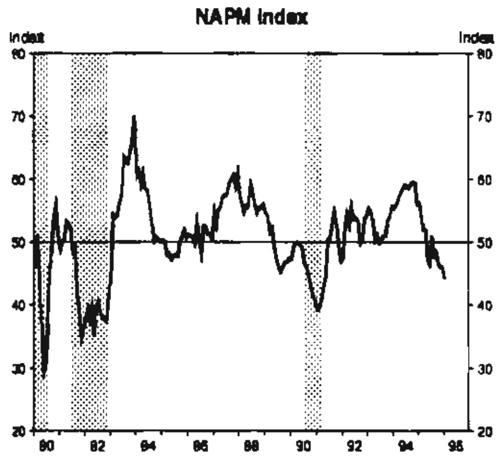
* Excluding inventory profits; adjusted for depreciation distortions

Goldman Sachs

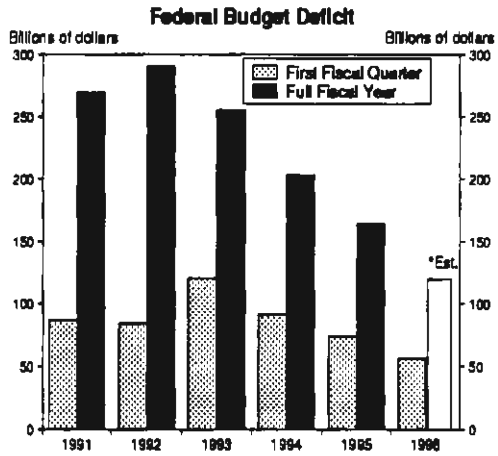
U.S. Economics Analyst

Budget Deficit Shrinking Despite Political Deadlock

- The latest business reports confirm our view that U.S. economic growth has stalled this quarter. A sag in the January purchasing managers' index shows contraction in the manufacturing sector, while consumer spending stagnated in late 1995. Inflation was remarkably subdued at yearend.
- Bad weather clearly suppressed nonfarm payrolls and work weeks in January. Even so, the hiring trend does appear to have weakened.
- In both word and deed, the Federal Reserve's 25-basis-point cuts in the discount and federal funds rates signaled a cautious attitude about future easing. But current economic weakness makes another 25-point cut likely by midyear, and the market's expectation of 50-75 basis points now looks more plausible.
- This year's deficit outlook has brightened despite dim prospects for a 7-year budget-balancing deal. We have cut our FY 1996 deficit estimate from $140 billion to $120 billion, and the final outturn could drop below $100 billion.
- Restrictive federal spending is one reason why the economy has been weak lately. But fiscal policy should be neutral to slightly stimulative going forward.
- Government default remains a remote possibility despite high-wire rhetoric. In fact, resolution of this matter could be less contentious than now anticipated, even if a full-blown budget deal remains elusive.



Source: National Association of Purchasing Management.



Source: Department of Treasury. Goldman Sachs Estimates.

Trade Recommendation

- Initiate long Treasury bond position at 6.10% yield, with sell stop at 6.25%.

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Issue No: 96/5
February 2, 1996

Goldman Sachs

I. Weekly Wrapup

Economic and Market Overview

Quarter-point cuts in the discount and federal funds rates, coupled with a string of dismal economic reports, helped sustain a constructive tone in the U.S. financial markets this week. Money-market rates have moved down moderately further in recent days, while 30-year Treasury bond yields are still hovering close to their recent low point of around 6% in the face of next week's $44.5 billion three-tranche quarterly refunding of government coupon issues. In turn, these favorable interest rate developments have helped key equity market indexes scale new heights.

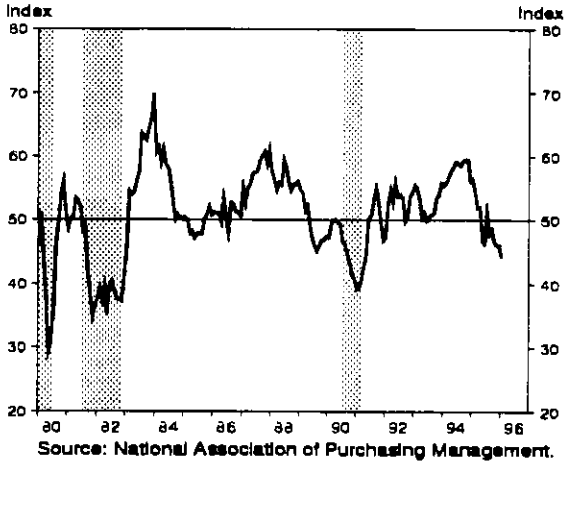
The latest business statistics reinforce our impression that real GDP growth has virtually stalled this quarter. Manufacturers are clearly in a contraction, with the national purchasing managers' composite index down to 44.2% last month, the lowest since early 1991. The index of new orders slumped to 41.6%, a level rarely seen in expansions. Although harsh weather might have biased these readings down somewhat, the evidence from similar past episodes has been mixed. Weather was clearly a factor in January's 201,000 drop in nonfarm payrolls and 2% plunge in hours worked. Even so, high levels of jobless benefit claims suggest that hiring has slowed.

U.S. consumers are not showing much life at this point either. Retail spending climbed only 0.3% in December, and nominal nonauto outlays increased a trivial 0.2% over the final three months of the year, implying a flat to negative trend in volumes. Meanwhile, households' optimistic outlook for jobs and earnings may have eroded, judging from last month's 12-point drop in the Conference Board's consumer confidence index. This deterioration, if sustained in coming months, would challenge our expectation of a moderate rebound in personal spending and, by extension, in real GDP.

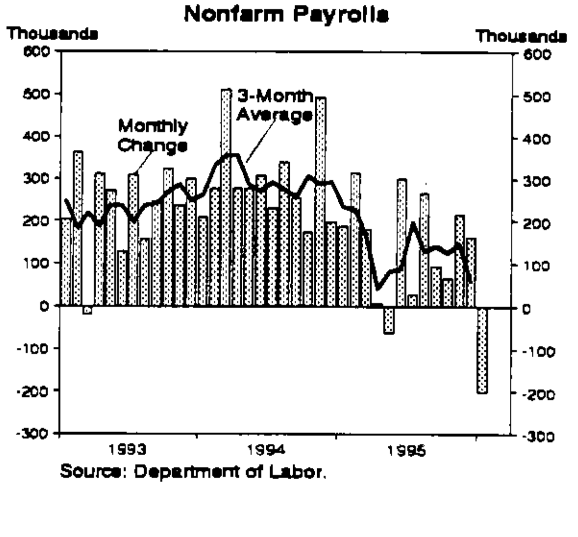
Abstracting from a spike in world oil prices, which has since been substantially reversed, the December price index reports were strikingly mild. Core indexes for both producer and consumer prices (excluding their food and energy components) inched up only 0.1%. On the same basis, intermediate goods quotes fell for the third straight month, by 0.4%.

Federal Reserve Policy

In both language and action, the Fed's latest policy step was a fairly conservative move, probably intended to telegraph to the financial markets a deliberately cautious posture toward future action. The quarter-point discount rate reduction was the smallest change in the official rate since September 1978. In addition, the formal announcement evinced no sense of panic among policy makers about the business climate, which was described merely as a 'moderating economic expansion.' When officials have become worried about a negative economic outcome in the past, they have used words such as 'weak' or 'sluggish' to convey their perceptions. These are important distinctions for an institution renowned for choosing its terms carefully, and they imply that most Committee members still believe not much more stimulus is needed to revive the economy.



Source: National Association of Purchasing Management.



Source: Department of Labor.

Fiscal and Political Developments

Federal budget results for December confirmed that a sharp positive swing has occurred in the fiscal balance for the first three months of fiscal 1996. Constraints imposed on federal spending in the standoff between the Republican Congress and President Clinton have clearly crimped government outlays for goods and services, exerting a material drag on real GDP growth in recent months. Part II deals at length with current and prospective budgetary conditions, in light of the breakdown in negotiations to reach a seven-year balanced budget accord.

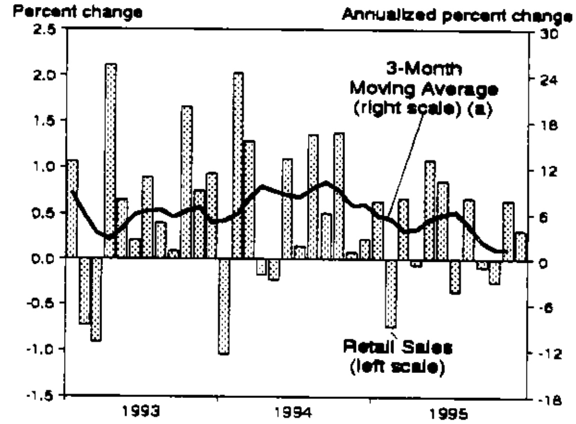
The latest opinion polls in Iowa and New Hampshire — the first two major state contests in the GOP presidential selection process — reveal a substantial erosion of support for front-running Senate Majority Leader Dole in favor of publisher Steve Forbes. In fact, two different surveys in recent days have shown Forbes taking the lead in New Hampshire, which has long been a bellwether contest. In the Republican field, Mr. Forbes is the most vocal advocate of transforming the federal income tax into a flat-tax system and reducing personal taxes to spur economic growth. So far, the main focus of media commentary has been on the flat-tax portion of Forbes' message, but this may be overlooking the potential appeal of his optimistic supply-side economic views at a time when flagging growth may be causing renewed worry about job security and income growth. Should the national economy fail to improve by this spring, Forbes' appeal to primary voters as a political novice prepared to try aggressive new policies might prove surprisingly durable.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

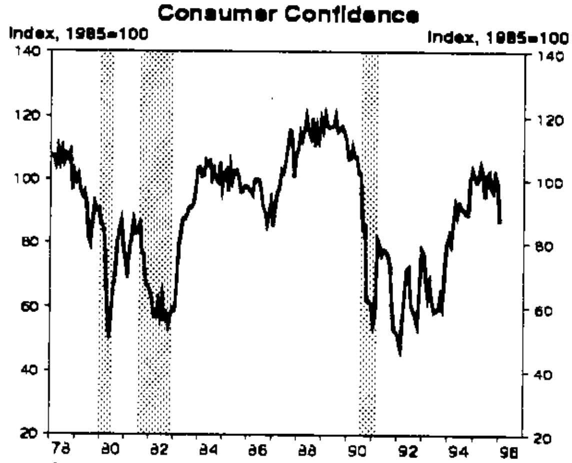
With Fed officials signaling an inclination toward patience and weakness in economic conditions apt to persist in the short term, we would recommend some long exposure to the long-duration portion of the bond market. Eurodollar futures contracts and short-dated Treasury notes already discount at least another 50-75 basis points of Fed easing by the fall and will have difficulty incorporating much more as long as central bankers are dragging their heels on rate cuts. It also appears that the debt ceiling issue will be resolved in a less contentious fashion than some investors now fear. If so, this could help bond yields decline a bit further.

Retail Sales



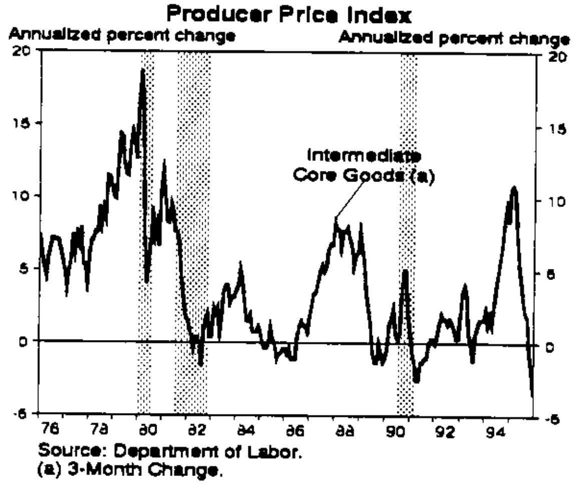
Source: Bureau of the Census.
(a)Excluding motor vehicles and building materials.

Consumer Confidence



Source: Conference Board.

Producer Price Index



Source: Department of Labor.
(a) 3-Month Change.

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II. Budget Deficit Shrinking Despite Political Deadlock

The budget negotiations have broken down, and prospects for a comprehensive multiyear agreement are dim. Even so, early returns on the fiscal 1996 deficit suggest a full-year outturn well below official expectations. For the economy, this has meant a material dose of restraint in recent months, although fiscal policy from here on will probably be neutral to slightly stimulative. Meanwhile, the probability of default by the federal government seems extremely low given the potentially catastrophic consequences that most Washington politicians and administration officials would see from such an event.

Our take on the current situation, in question-and-answer format:

Q. What is the status of negotiations to balance the budget in seven years?

The discussions appear to be at a durable impasse, despite protests to the contrary from the president and some top Washington lawmakers. Speaker Gingrich and other senior House Republicans have emphasized that fundamental differences persist between them and the administration on long-range budget strategy, and they have rejected the notion of accepting a deal that does not move significantly toward the GOP position from the last White House offer. The president has given no sign that such a shift is forthcoming. Senate Majority Leader Dole, meanwhile, faces intense competition in the presidential primaries and caucuses over the next two months, and will therefore be distracted from the budget process during this period.

Q. Is there any hope that a broad anti-deficit package can still be assembled this year?

Discussions between congressional centrists of both parties are continuing, and it is conceivable that these might yet produce bipartisan compromises on discretionary spending, entitlement reforms, and tax cuts. Bipartisanship is generally in diminishing supply during election years, however. Hence, the best opportunity for such a deal has probably passed.

Q. How can the U.S. government continue functioning with the budget-writing process deadlocked?

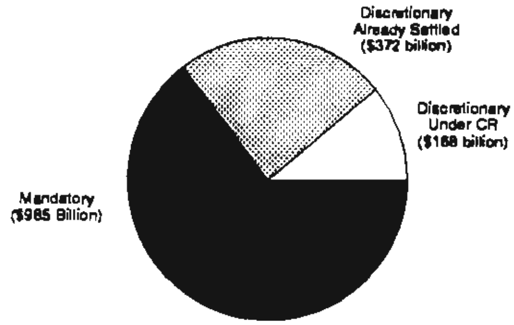
Roughly two-thirds of all federal spending is for mandated functions, including payments for social security, Medicare, Medicaid, welfare, other income support programs, and debt service. These payments operate under 'permanent appropriations,' and do not require the annual congressional reauthorization or funding needed for other functions. Until modified by legislation, spending for these purposes will continue to operate under the same rules as in the past.

Eight of the 13 annual appropriations bills covering other areas for fiscal 1996 have already been signed into law by the president. For those functions where settlements have not yet been achieved, a continuing resolution (CR) has been enacted that authorizes spending at somewhat reduced levels until March 15. This marks the fourth time in this fiscal year that a short-term CR has been used for this purpose. As long as any of the remaining appropriations measures is in limbo, congressional leaders are likely to continue depending on short-term CRs in order to keep the government on a short leash.

Q. Isn't this an exceptional state of affairs for the federal budget?

Not at all. In the past quarter-century there have been several years when the entire discretionary portion of government spending operated under a continuing resolution for a full fiscal year.

Only Small Sliver of Spending Under Continuing Resolution



Source: Goldman Sachs Estimates.

Goldman Sachs

Q. With efforts toward long-range budget reform stalled, is either side planning new fiscal initiatives?

Speaker Gingrich has proposed the enactment of a budget deficit 'down payment,' containing assorted items that have already been agreed to by White House and GOP negotiators. House Budget Committee chairman John Kasich (R-OH) has put together a list of such savings that would total an estimated $83 billion over seven years; the Speaker has said he would like to see that figure rise to $100 billion or more. It is unclear whether the White House will accept legislation along these lines or whether a filibuster blocking passage in the Senate can be averted.

Separately, there has been some discussion among GOP lawmakers of passing bills dealing with the other, unresolved areas — principally Medicare, Medicaid, welfare, and taxes. These bills would be sent to President Clinton with the full expectation that he would veto them. Any such vetoes would, in turn, provide potential fodder for candidates of both parties during the fall election campaigns.

Finally, the fiscal 1997 budget-writing effort is due to begin soon, on a delayed schedule. The Office of Management and Budget has scheduled a formal 1997 budget report for March 18, six weeks later than normal. Congress is supposed to complete a budget resolution spelling out next year's revenue and outlay plans by April 15. This deadline is also likely to slip.

Q. Amid all of this political turmoil, how is the federal budget situation for fiscal 1996 shaping up thus far?

The budget deficit is on a sharp downward path this fiscal year, falling $17.5 billion in the first quarter alone (October-December). While official estimates for the fiscal shortfall remain in the $150-$160 billion zone, we have recently lowered our estimate from $140 billion to $120 billion, with risks tilted to the downside even from this lower figure.

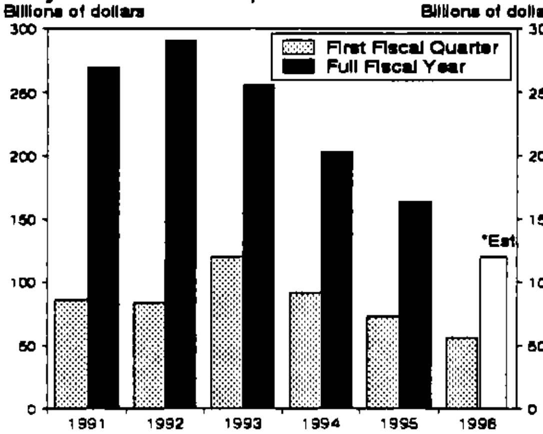
Q. What is the effect of this improved budget situation on the economy?

Fiscal policy clearly exerted a significant drag on the economy in late 1995. Total federal spending was about flat on a year-to-year basis last quarter despite growth in mandated outlays. This implies that real federal purchases of goods and services fell sharply in the October/December period.

In the absence of a budget agreement, fiscal policy will probably be roughly neutral during 1996. In our view, it is unlikely that real federal discretionary outlays will fall further following last quarter's sharp decline and the prolonged government shutdown at yearend. In fact, a modest amount of stimulus is possible as operations resume a more normal pattern.

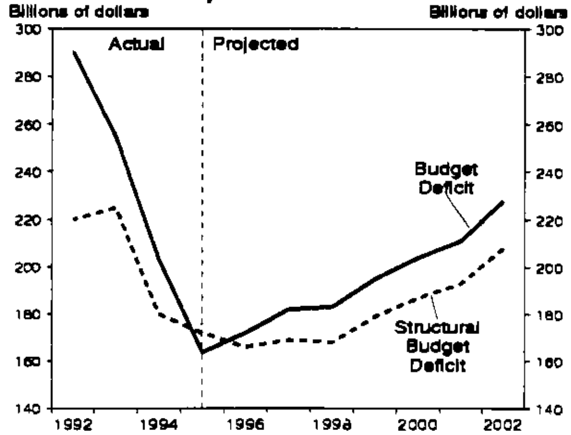
Q. If the deficit is already dropping rapidly, why does the lack of a long-term budget accord matter?

Cyclical Deficit Drop Extends Into FY 1996...



Source: Department of Treasury. Goldman Sachs Estimates.

...But CBO Projects Secular Deficit Increase



Source: CBO.

Goldman Sachs

Official projections of the federal budget balance turn distinctly more pessimistic beyond the next year or two, owing to the fiscally pernicious effects of rapid growth in entitlement outlays, which has far outstripped growth in GDP. Historical experience suggests that it is extremely difficult from a political standpoint to curtail growth in entitlement spending outside the context of a broad deficit reduction effort.

Q. What is the current status of federal debt supplies relative to the statutory borrowing limit?

As of January 30, the U.S. Treasury had no additional borrowing authority under the existing $4.9 trillion debt ceiling, but its cash balance topped $38 billion. Treasury Secretary Rubin has indicated that he plans to free up another $19¼ billion by manipulating government trust funds again. The Secretary has also said, however, that he will run through this combined $57½ billion in financial resources by March 1, and that he does not believe the current debt limit can be circumvented in a legal and prudent manner beyond that date.

Q. Will legislation be passed to hike the ceiling prior to the February 29/March 1 deadline indicated by Secretary Rubin? If not, will the Treasury default on its interest obligations?

It will be difficult for a debt-limit bill to pass the House of Representatives unless it contains some provisions addressing the budget concerns of the Republican majority in that chamber. Speaker Gingrich has proposed attaching a debt limit hike to the deficit 'down payment' legislation he favors. Such a formula might win enough GOP support to clear the House, but it is not clear that it could survive debate in the Senate or win a presidential endorsement.

In our view, senior Clinton Administration officials see a federal government default as catastrophic and are prepared to take extremely unpleasant steps, if necessary, to prevent one from occurring. Hence, should efforts to boost the statutory debt limit by March 1 prove unsuccessful, the administration will likely pursue options that have so far been ruled out for political reasons. These include gold sales, delays in payments of personal income tax refunds, and disinvestment of the Social Security Trust Fund. Alternatively, it is conceivable that President Clinton could resort to a declaration of emergency and order the disbursement of interest payments, on the grounds that a U.S. default would cause severe and long-lasting damage to the nation's international credit standing.

Late Thursday, Congress passed legislation allowing Secretary Rubin to liquidate assets held in the Social Security Trust Fund to pay monthly benefits due on March 1. If this bill is signed, as seems probable, then the risk of default would decline even further. That is because social security benefits comprise a large portion of total federal outlays, and this mechanism for circumventing debt ceiling constraints could be periodically extended whenever necessary to forestall a funding crisis.

John Youngdahl

Goldman Sachs

Key U.S. Economic Data

	Latest Monthly Data '96 Jan	'95 Dec	'95 Nov	'95 Oct	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. thousands)	-201	161	212	68	100	114	Mar 8
Unemployment Rate (%)	5.8	5.6	5.6	5.5	5.6	5.6	
Index of Hours Worked (% ch)	-2.0	-0.3	-0.4	0.6	-3.7	-1.8	
Average Hourly Earnings (% ch)	0.5	0.3	-0.1	0.4	3.2	3.5	
Producer price finished goods index (% ch)	--	0.5	0.5	-0.1	2.5	2.2	Feb 27
Excluding food and energy	--	0.1	0.4	0.0	2.3	2.5	
Consumer price index (% ch)	--	0.2	0.0	0.3	2.0	2.6	Feb 28
Excluding food and energy (% ch)	--	0.1	0.1	0.3	2.4	3.0	
Retail sales (% ch)	--	0.3	0.7	-0.2	1.9	3.4	Wk of Feb 26
Excluding motor vehicles (% ch)	--	0.2	0.5	-0.5	1.2	2.6	
Industrial Production (% ch)	--	0.1	0.3	-0.4	2.2	1.1	Feb 16
Manufacturing	--	0.1	0.2	-0.4	2.4	0.8	
Capacity utilization (%)	--	82.8	83.0	83.0	83.2	83.7	Feb 16
Manufacturing	--	81.8	82.1	82.2	82.3	83.0	
Housing Starts (annual rate, thousands)	--	--	1420	1343	1383	1360	Feb 23
Single-family	--	--	1102	1102	1102	1079	
Trade balance (billions, monthly)	--	--	--	-8.0	-9.6	-9.6	Feb 7
Merchandise	--	--	--	-13.7	-14.9	-14.9	
Factory Orders (% ch)	--	--	--	-0.3	8.4	6.7	Feb 15
Durable Goods	--	--	--	-1.1	15.4	8.4	Feb 15
Personal Income (% ch)	--	--	0.2	0.7	5.5	5.6	Feb 27
Wages and Salaries	--	--	-0.1	0.9	6.3	5.1	
Purchasing Managers' Index (%)	44.2	46.0	46.0	46.6	46.5	48.4	Mar 1
Consumer Sentiment U Mich (Feb 66=100)	89.3	91.0	88.2	90.2	90.6	91.6	Feb 16
Conference Board (1985=100)	87.0	99.2	101.6	96.3	97.3	98.8	Feb 27

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- The Office of Management and Budget on Monday will release a brief summary of fiscal 1997 budget recommendations from President Clinton. These are likely to be largely the same as those contained in his January 6 blueprint for achieving budgetary balance by 2002.
- Chain-store sales results from January, due Thursday, February 8, should show very weak year-to-year comparisons, partly owing to unusually poor weather in the eastern part of the country.
- The Treasury will auction a record $44.5 billion of notes and bonds in its February coupon refunding operation, along with $8 billion of one-week cash management bills. Taken together, these sales will raise more than $21 billion in fresh cash.
- Trade statistics from November should show the deficit remaining well below midyear levels, reflecting a sharp slowdown in imports as domestic goods producers and distributors strive to pare excess stockpiles.

Economic Releases and Other Events

Date	Indicator	Estimate GS	Estimate Consensus	Last Report
Feb. 7	Trade Balance (Nov.)	-$8.5 bil.	-$8.5 bil.	-$8.0 bil.
	Consumer Credit (Dec.)	+$7.5 bil.	+$8.6 bil.	+$8.6 bil.

- 3 mo and 6 mo T-bill auctions (Feb. 5)
- 3 yr T-note auction (Feb. 6)
- Louisiana presidential caucuses (Feb. 6)
- 10 yr T-note auction (Feb. 7)
- 30 yr T-bond auction (Feb. 8)
- Jan. chain store sales reports (Feb. 8)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.1	5.1	6.1
Forward	5.0	4.7	4.7
2 Yr T-Note	5.0	5.2	6.3
Forward	4.9	4.9	5.0
10 Yr T-Note	5.7	5.9	6.7
Forward	5.6	5.7	5.8

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	1.0%	0.5%	1.7%	2.4%	1.6%
Ind. Production	1.0	0.0	2.0	3.5	1.5
CPI	2.0	3.0	2.7	2.8	2.7
Profits*	10.2	8.8	6.3	7.9	4.8
Merch Trade Bal. (monthly, $B)	-12.8	-13.3	-13.0	-13.6	-12.7

* Excluding inventory profits; adjusted for depreciation distortions

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U.S. Economics Analyst

GDP Revisions Help Puncture the Productivity Bubble

- The publication of chain-weighted real GDP cut estimates of recent economic growth a bit more than expected. For the past three years, overall growth was shaved one point, to 2.6%, and one-third of the capital spending boom evaporated. Last year's slowdown now looks sharper than before.

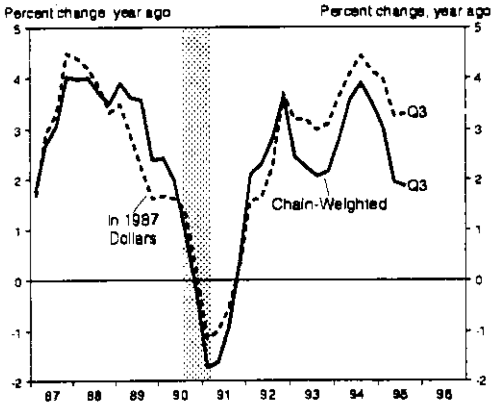
- A principal message from these revisions is that recent gains in labor productivity growth have been significantly overstated.

- In turn, lower productivity growth undercuts the main argument for renewed disinflation. The revised implicit GDP deflator now shows a pattern of acceleration in recent years.

- The FOMC is unlikely to cut rates at its January 30-31 meeting. The economic news has not been sufficiently weak, Vice Chairman Blinder's departure removes a vocal advocate for easing, and easing might look inappropriate just prior to Chairman Greenspan's expected reappointment. However, reductions in the funds rate are likely thereafter.

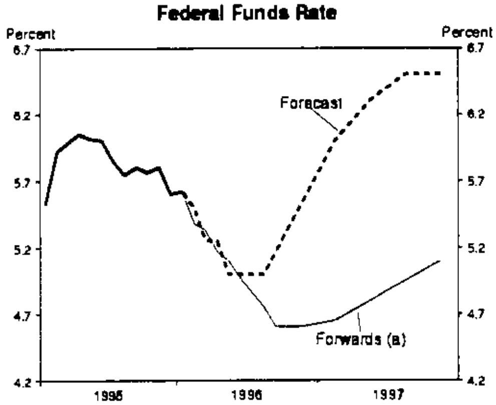
- A full-blown budget accord now appears unlikely. Instead, a package of modest spending and tax cuts may be tied to a debt ceiling increase.

Real GDP



Source: Department of Commerce.

Federal Funds Rate



Source: Federal Reserve Board.
(a) Based on Fed Funds Futures Contracts, Our Calculations.

Trade Recommendations

- Initiate long positions in March or June Eurodollar futures calls if they back up 10 basis points or more in response to a Fed decision not to cut rates on January 31.

- Equity investors should consider overweighting domestic consumer goods producers and those capital goods producers with significant export business.

Contributors:
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Issue No: 96/4
January 26, 1996

I. Weekly Wrapup

Economic and Market Overview

The U.S. fixed income market gyrated sharply during the week, with yields rising as fears concerning the budget outlook dominated further evidence of economic weakness. In particular, industrial production in December rose by only 0.1%, and that increase was due mainly to the boost in output stemming from the end of the Boeing strike. As a consequence, manufacturing capacity utilization rate continued to fall, to 81.8% in December from 82.1% in November. This decline foreshadows weakness in business fixed investment in the months ahead.

The news on the housing front was disappointing, with new home sales falling for the fourth consecutive month in November. The weakness in sales has pushed inventories of unsold new homes up. This suggests that the recent strength in residential investment is also likely to fade. Finally, the growth rate of consumer spending is also slowing. Even though real personal consumption expenditures jumped 0.9% in November, the three-month trend is only 1.5% at an annual rate. One bright spot in the consumer spending outlook is the fact that real disposable personal income growth remains strong, rising at a 3.6% annual rate over the last six months, ending in November.

Federal Reserve Policy

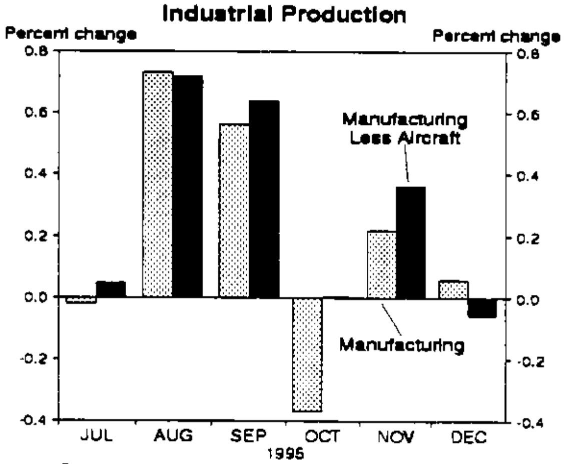
We believe (without much conviction, however) that the Federal Open Market Committee will keep short-term rates unchanged at its January 30-31 meeting. Although the soft economy certainly leaves the door open for an easing move, three factors argue against a cut in the federal funds rate at this time: (1) The economic news probably has not been sufficiently weak to persuade the Fed staff that its forecast of trend growth is materially incorrect; (2) Alan Blinder's resignation from the Board removes a strong advocate for a more accommodative monetary policy; and (3) if Chairman Greenspan engineers an easing at this meeting and then is reappointed in February, some observers would undoubtedly posit a linkage between the two events. That is an outcome that the Chairman would wish to avoid, and he can do so by postponing an easing until after his reappointment.

The key uncertainty surrounding Fed policy is in the timing, not whether short-term rates move lower. If no easing occurs in January, then we would expect an easing by the March FOMC meeting, with the federal funds rate eventually falling to 5% by about midyear.

Fiscal and Political Developments

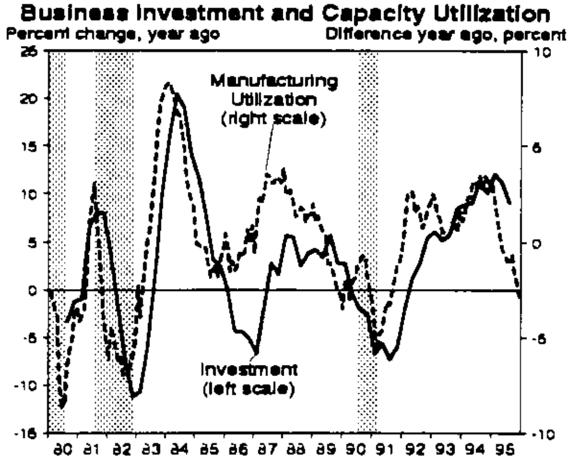
At this point, the prospects for a full-blown agreement on a balanced budget appear to have fallen sharply. Unless either the Democrats or Republicans find that a failure to agree is costing them significant political support, then a balanced budget compromise is unlikely. The key question is what the Republicans will do next, now that their strategy of using the debt limit ceiling and tough continuing budget resolutions to push President Clinton into a budget deal has

Industrial Production



Source: Federal Reserve Board.

Business Investment and Capacity Utilization



Source: Department of Commerce, Federal Reserve Board.

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failed. Apparently, two options are being considered. On one hand, some of the hard-line House Republicans want to try to force Clinton's hand once again by having a debt limit showdown in late February when the Clinton administration will find it more difficult to avoid a default. On the other hand, other Republicans, including the congressional leadership, appear more inclined to engineer a compromise: a small package of spending cuts and a child tax credit in exchange for a debt limit increase. The latter course appears more likely, with President Clinton presumably being amenable to such a compromise. The risk is that the financial markets give a thumbs-down to such a deal as it could conceivably tilt fiscal policy toward stimulus rather than restraint over the next year.

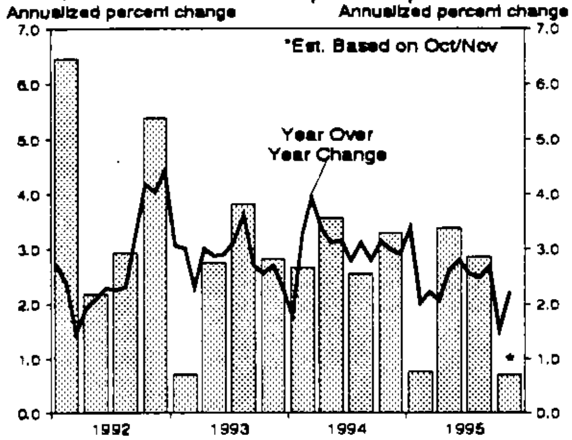
Regardless of the Republicans' choice, we believe that a government default remains only a remote possibility. Even if the budget battle continues and precipitates a debt limit crisis, we expect that the Clinton administration would decide to take unpalatable steps such as gold sales or delays in tax refund payments before allowing a default to occur. Although the focus on the effects of a default has been concentrated on the long-term impact on the level of Treasury bond rates, the potential disruption to the payments system and global financial markets poses just as serious a threat. The government securities market is the grease that keeps the financial markets operating smoothly. If it were to congeal into glue, it would be extraordinarily disruptive.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

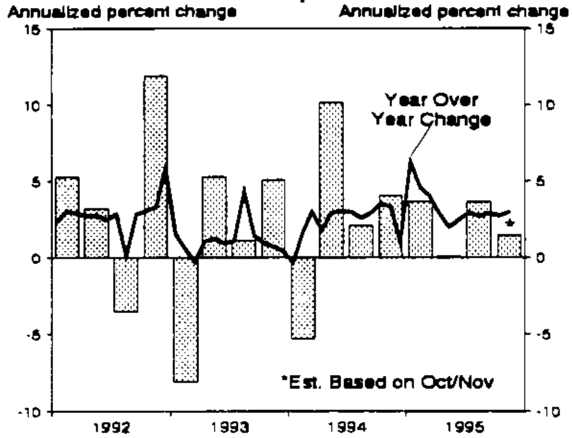
With respect to the bond market, we would remain close to shore. At current yields, long-term Treasury bonds already discount much more news of economic weakness. If anything, we expect that this past week's backup in yields could intensify modestly. A failure by the Fed to ease or a stronger-than-expected retail sales report for December are two events that could disturb the market psychology, which anticipates monetary accommodation and economic weakness. If March and June Euros contracts sell off by more than 10 basis points upon a failure by the Fed to ease, we would initiate outright long positions. Currently, the forwards and our forecast are consistent through May. The forwards would be inexpensive on a material back-up.

Real Personal Consumption Expenditures



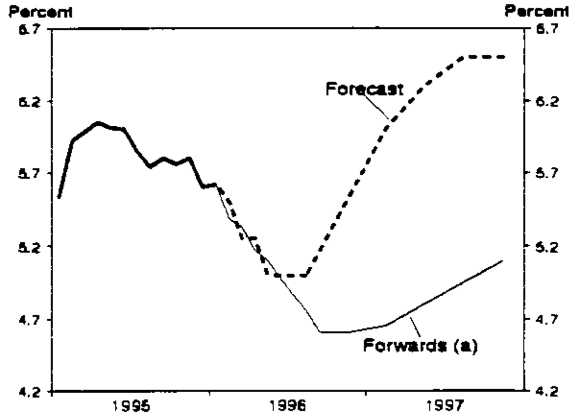
Source: Department of Commerce. Goldman Sachs Estimates.

Real Personal Disposable Income



Source: Department of Commerce. Goldman Sachs Estimates.

Federal Funds Rate



Source: Federal Reserve Board.
(a) Based on Fed Funds Futures Contracts, Our Calculations.

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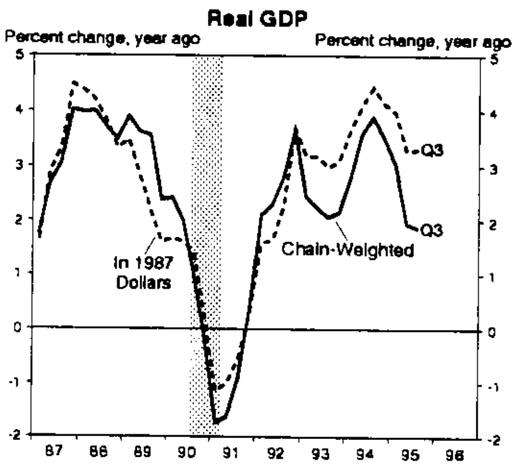
II. GDP Revisions Help Puncture the Productivity Bubble

At long last, the Commerce Department has revised its estimates of real GDP growth, restating them on a chain-weighted basis and incorporating updated information. As expected, the new figures show that the U.S. economy has grown much less rapidly since 1992 than previously thought. The revisions were especially large in business capital spending, where the surge since early 1992 was cut by one-third.

The new pattern of growth in real GDP does not materially alter our view that the economy weakened in late 1995 and will remain sluggish in early 1996. It does, however, strongly suggest that labor productivity has not been rising as fast as now reported. This, in turn, increases our conviction that a renewed episode of disinflation is not nearly as likely as some economists and participants in U.S. financial markets seem to believe. Bond and stock prices may therefore be vulnerable to disappointments on inflation even if it remains unchanged in early 1996, as we expect. In addition, the weaker growth now reported for this cycle, and especially for 1995, correlates more closely with popular perceptions of a stagnant U.S. economy. This may not bode well for President Clinton if the economy remains weak during the first half of 1996, as we think it will.

A New Yardstick Shows Slower Growth

Prior to last week's revision, real GDP was calculated as the value of goods and services expressed in terms of the prices that prevailed in 1987. Over time, however, this method of calculating real GDP proved to be deficient because it gave undue weight to items whose prices had fallen significantly relative to the general price level. For example, by mid-1995, the Commerce Department reckoned that prices of computer equipment (quality adjusted) were only 40% of their 1987 levels, whereas prices of other goods and services averaged 128% of their 1987 levels. This meant that a dollar spent on computers was getting more than 3 times the weight in real GDP as a dollar spent on other goods and services. Because demand (and hence production) tends to shift toward items whose relative prices are falling, this method of computing real GDP resulted in a progressively larger overstatement of its growth since the 1987 base year.



Source: Department of Commerce.

Thus, it came as no surprise that the new figures paint a more subdued picture of growth in recent years, although the revisions were slightly larger than those implied by previously published chain-weighted figures. The gap between the chain-weighted and 1987-dollar-based measures is especially large over the past three years. Between the third quarter of 1992 and the third quarter of 1995, the chain-weighted index of real GDP rose at a 2.6% average annual rate — a full percentage point below the 3.6% average for the 1987-dollar-based measure. Within this period, the first half of 1995 now stands out as an even more abrupt slowdown than originally reported, with growth on a chain-weighted basis barely more than 0.5% at an annual rate, as compared to 2.0% previously.

There is no reason on the basis of these new estimates to alter our view that the economy ended 1995 and started 1996 on a weak note. The estimate for third-quarter growth was revised trivially, to a 3.2% annual rate from the 3.0% increase originally reported for chain-weighted growth. Moreover, for the first three quarters of 1995, the pattern of stockpiling looks only marginally different than before — a significant drag during the first half of 1995 followed by little change (now a small further drag instead of a small uptick) in the third quarter. And, although downward revisions to federal spending in the third quarter might mean that the economy suffered less from cutbacks in this sector during the fourth quarter, any such adjustment would be easily offset by the sharp slowdown in real consumer spending reported this week for October and November.

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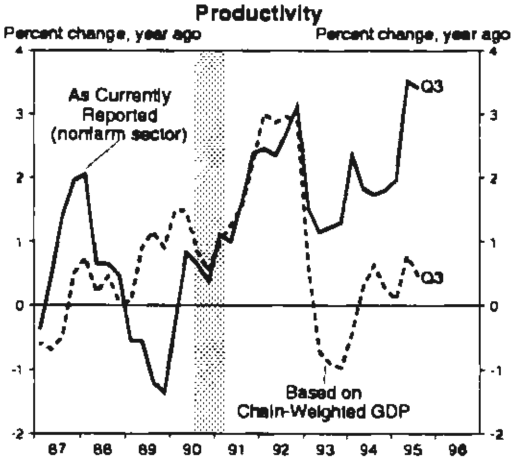
Productivity



Source: Department of Commerce. Department of Labor.

Puncturing the Productivity Bubble

Perhaps the clearest message from the new GDP figures is that labor productivity has not risen nearly as fast in recent years as has been reported. This is evident in three different aspects of the GDP revision: the reduction in overall growth, a corresponding upward restatement of inflation as measured by the GDP implicit deflator, and a substantial downward revision to growth in business capital spending.

The downward revision to real GDP growth has widened an already large gulf between productivity as it is now calculated, using 1987-based figures for nonfarm business output, and an alternative measure of productivity based on real GDP. According to the productivity figures now on record, nonfarm business output rose 4.9% between the third quarter of 1994 and the third quarter of 1995. Adjusted for a 1.4% increase in hours worked, this yields a 3.5% increase in productivity. If the 1.9% increase in chain-weighted GDP over the same period were substituted as the output measure, the productivity gain would shrivel to 0.5%.

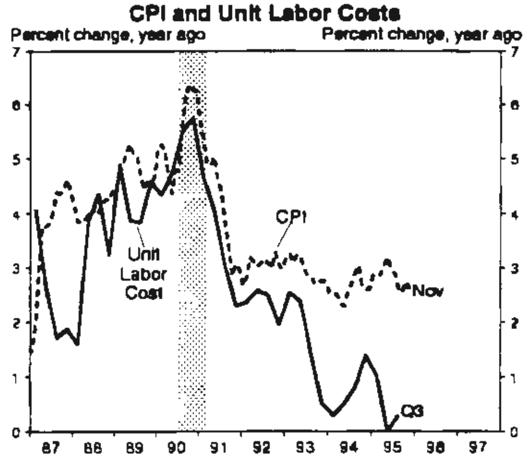
Virtually all of this 3-point difference reflects the shift to chain weights and a growing statistical discrepancy within the GDP accounts.[1] Both problems will be addressed by the Labor Department in its next release on productivity and costs, which has not yet been scheduled. At that time, the trend on productivity should be reduced sharply.

This revision will, in turn, undercut a major argument for renewed disinflation now being peddled by many economists. The huge gains reported for productivity have had their mirror image in figures suggesting virtually no change in labor costs per unit of output over the past year. In an environment of sluggish growth, the large difference between flat labor costs and 2½%-3% consumer price inflation has struck many investors as a powerful argument for lower rates of inflation in the period ahead.

Until last Friday, the implicit GDP deflator seemed to offer substantial support for this thesis. Unlike other aggregate price indexes, this one was showing a substantial abatement in inflation in recent quarters. With the revisions to real GDP, it becomes apparent that this was just the mirror image of the overstatement of real GDP growth.

Our skepticism about huge gains in productivity and flat labor costs has been reinforced by the sharp downward revision administered to business capital spending growth in the shift to chain weights. A big reduction was to be expected in this sector, given that computers were the main source of overstatement in output growth. In the event, the change was even bigger than we had anticipated. On the new chain-weighted basis, real business capital spending is estimated to have risen at only an 8% average annual rate since early 1992, as compared to 12% previously and about 9.5% according to earlier chain-weighted estimates. Moreover, plant and equipment appears,

CPI and Unit Labor Costs



Source: Department of Labor.

[1] In principle, differences in sectoral coverage could also account for some of this gap. The productivity index excludes farms, households, and all levels of government. As it happens, sectoral differences have been of trivial importance, on balance, over the past year.

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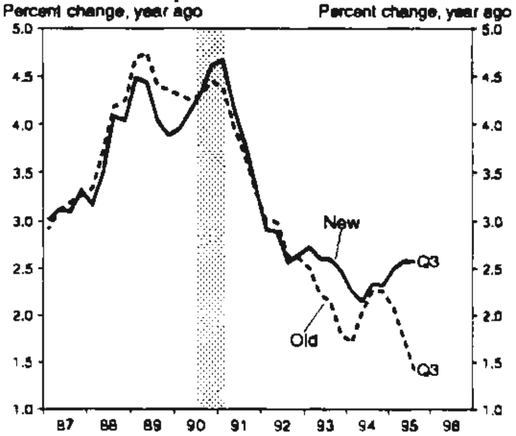
on revision, to be depreciating at a faster pace than previously estimated.

In combination, slower growth in gross investment and faster depreciation imply much slower growth in the nation's capital stock. This may not alter the Federal Reserve's estimates of capacity growth in the industrial sector, which are derived from separate survey data and include estimates for changes in the productivity of capital. It does, however, undercut claims that labor productivity has benefited greatly from unusually large increases in the capital provided to workers. At the margin, the discovery that capital spending has been less robust makes us less worried about a slump in this sector this year. But it also suggests that the underlying trend in inflation is not tilted downward, as many seem to think.

During the first half of 1996, the main surprise on the inflation front for financial markets will probably be that it is not receding materially. An outright increase in inflation is unlikely until the economy picks up steam later this year. At that time, however, we expect that inflation will creep gradually up above the 3% mark from its current 2½%-3% range.

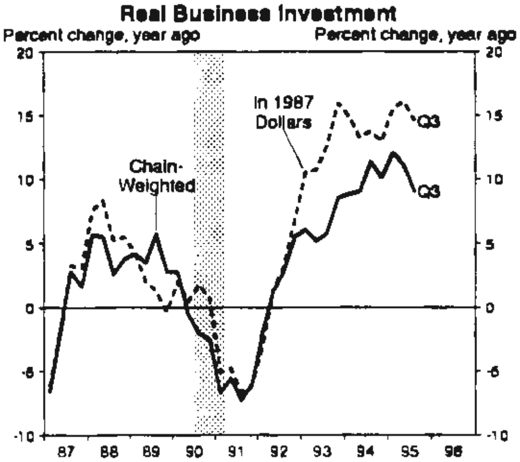
Key to this view is a judgment that resources in the United States are fairly fully employed, especially on the labor side. In this regard, investors may be tempted to think that the downward revisions to real GDP growth, coming at a time when utilization is falling, have uncovered significantly more room for noninflationary expansion. They should be wary of such thinking because potential growth is also slower when expressed in chain-weighted terms.

Implicit GDP Deflator



Source: Department of Commerce.

Real Business Investment



Source: Department of Commerce.

How much slower remains to be seen, but one rough estimate suggests that potential growth in chain-weighted real GDP is only about 2% per year. This is the average rate at which this measure of real GDP has risen since the U.S. economy was at a comparably low rate of unemployment in early 1988. It is well below the 2½% standard commonly applied to the old measure of real GDP.

Will Clinton be Bush-Whacked?

The slower rates of growth now on record for recent years bring the GDP figures into closer alignment with public perceptions about the economy and expose another implication more political in nature. We cannot help thinking that former President George Bush would have liked to see this revision come four years earlier. On the basis of the new numbers, real GDP actually grew faster from the fall of 1991 to the fall of 1992 than previously reported — 2.8% versus 2.3%. Mr. Bush might have fared better in the 1992 election if these numbers were on hand to brag about at the time.

By the same token, President Clinton may come to regret his support for the Commerce Department, the fountainhead of these new numbers. The weaker potrait they now paint for 1995 removes one possible defense against accusations that the economy has performed poorly under his leadership. If growth stays sluggish during the first half of 1996, the shift to chain weights will reinforce the impression of weakness. In that case, the president may find it harder to hold onto his office in November.

Ed McKelvey

Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	'95 Dec	'95 Nov	'95 Oct	'95 Sep	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	151	166	66	94	128	141	Feb 2
Unemployment Rate (%)	5.6	5.6	5.5	5.6	5.6	5.6	
Index of Hours Worked (% ch)	-0.2	-0.4	0.6	0.5	1.1	0.8	
Average Hourly Earnings (% ch)	0.4	0.0	0.3	0.5	3.5	3.2	
Producer price finished goods index (% ch)	--	0.5	-0.1	0.3	0.9	2.0	Jan 31
Excluding food and energy	--	0.4	0.0	0.2	2.2	2.6	
Consumer price index (% ch)	--	0.0	0.3	0.1	1.8	2.6	Feb 1
Excluding food and energy (% ch)	--	0.1	0.3	0.2	2.5	3.0	
Retail sales (% ch)	--	0.8	-0.4	-0.1	2.9	3.2	Wk ofJan 29
Excluding motor vehicles (% ch)	--	0.9	-0.5	0.5	2.2	3.0	
Industrial Production (% ch)	0.1	0.3	-0.4	0.1	2.2	1.1	Feb 16
Manufacturing	0.1	0.2	-0.4	0.6	2.4	0.8	
Capacity utilization (%)	82.8	83.0	83.0	83.6	83.2	83.7	Feb 16
Manufacturing	81.8	82.1	82.2	82.8	82.3	83.0	
Housing Starts (annual rate, thousands)	--	1420	1343	1410	1383	1360	Feb 23
Single-family	--	1102	1102	1139	1102	1079	
Trade balance (billions, monthly)	--	--	-8.0	-8.2	-9.6	-9.6	TBA
Merchandise	--	--	-13.7	-13.7	-14.9	-14.9	
Factory Orders (% ch)	--	--	-0.3	1.4	8.4	6.7	Feb 15
Durable Goods	--	--	-1.1	3.0	15.4	8.4	Feb 15
Personal Income (% ch)	--	0.2	0.7	0.5	5.5	5.6	Feb 27
Wages and Salaries	--	-0.1	0.9	0.6	6.3	5.1	
Purchasing Managers' Index (%)	47.3	46.5	46.8	48.3	47.7	49.5	Feb 1
Consumer Sentiment U Mich (Feb 66=100)	91.0	88.2	90.2	88.9	91.5	92.2	Feb 2
Conference Board (1985=100)	98.7	101.6	96.3	97.3	99.6	100.0	Jan 30

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- The FOMC will probably leave short-term interest rates unchanged at its meeting this week (Jan 30-31).
- Federal budget data for December are apt to show a significant degree of fiscal restraint at yearend (Jan. 29).
- Retail sales figures should document a slow Christmas selling season (Jan 30).
- Employment and car sales reports are likely to be contaminated by harsh weather (Feb. 1-2)

Economic Releases and Other Events

Date	Indicator	Estimate GS	Estimate Consensus	Last Report
Jan. 30	Retail Sales (Dec.)	+0.1%	+0.3%.	+0.8%
	Federal Budget Balance (Dec.)	+$5.0 bil.	n.a.	-$38.5 bil.
	Consumer Confidence (Jan.)	Down	n.a.	98.7
Jan. 31	Producer Price Index (Dec.)	+0.5%	+0.4%	+0.5%
Feb. 1	Consumer Price Index (Dec.)	+0.3%	+0.3%	0.0%
	Purchasing Managers' Index (Jan.)	45.0%	n.a.	46.0%
	Domestic Motor Vehicle Sales (Jan.)	12.5 mil.	n.a.	14.2 mil.
Feb. 2	Nonfarm Payrolls (Jan.)	-25,000	+111,000	+151,000
	Unemployment Rate (Jan.)	5.7%	5.7%	5.6%

- 3 mo and 6 mo T-bill auctions (Jan. 29)
- Treasury Borrowing Estimates (Jan. 29)
- FOMC Humphrey-Hawkins Meeting (Jan. 30-31)
- Chicago Purchasing Managers' Survey (Jan 31)
- Treasury Refunding Announcement (Jan. 31)
- Michigan Consumer Sentiment Survey (Feb. 2)
- Dec. FOMC Minutes Released (Feb. 2)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.1	5.1	6.1
Forward	5.2	4.9	4.9
2 Yr T-Note	5.0	5.2	6.3
Forward	5.1	5.2	5.3
10 Yr T-Note	5.7	5.9	6.7
Forward	5.7	5.8	5.9

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	1.0%	0.5%	1.7%	2.4%	1.6%
Ind. Production	1.0	0.0	2.0	3.5	1.5
CPI	2.0	3.0	2.7	2.8	2.7
Profits*	10.2	8.8	6.3	7.9	4.8
Merch Trade Bal. (monthly, $B)	-12.8	-13.3	-13.0	-13.6	-12.7

* Excluding inventory profits; adjusted for depreciation distortions

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U.S. Economics Analyst

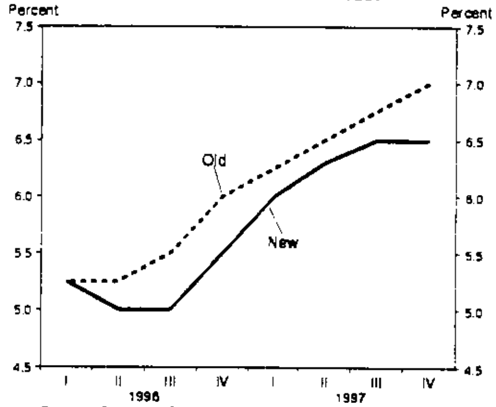
Our Views Have *Changed*

More Optimistic About Fed Easing

The U.S. Economics Analyst is a new weekly publication of the U.S. economics team. To continue receiving this publication, contact your Goldman Sachs representative (mail code ML147).

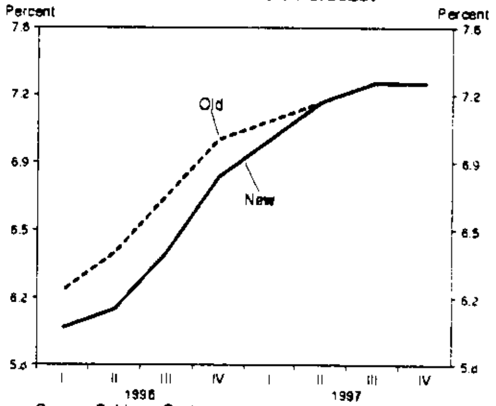
- We now expect a full 50 basis points of additional Fed monetary easing by midyear, owing to greater confidence that the economy will grow well below trend in that interval. This rate reduction should occur with or without a bipartisan federal budget accord, although a credible settlement would probably hasten the process.
- In particular, the FOMC's decision to cut interest rates at its January 30-31 meeting appears to hinge on having a budget in place at that time. Vice Chairman Blinder's impending departure has removed a vocal advocate for lower rates at this policy session.
- For similar reasons, the benign bond market environment is likely to persist for another few months, giving way to an upward yield bias once firmer patterns of business transactions emerge in the second half of the year.
- The failure of high-level budget talks to resume does not sound the death knell for this process, although time is running short. The probability of an agreement is still marginally above 50%.

Federal Funds Rate Forecast



Source: Goldman Sachs.

30-Year Bond Yield Forecast



Source: Goldman Sachs.

Trade Recommendations

- Take profits on June Eurodollar futures calls, and unwind long Euro yield curve positions.
- Equity investors should consider overweighting domestic consumer goods producers and those capital goods producers with significant export business.

Contributors:
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Issue No: 96/3
January 19, 1996

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I. Weekly Wrapup

Economic and Market Overview

Prices of U.S. fixed-income securities rallied strongly throughout most of this week, as fresh evidence of sluggish economic growth overrode the lack of overt progress in the budget talks. By late Thursday, the benchmark yield on 30-year bonds had fallen back below 6%, more than reversing the previous week's losses. Some of these gains evaporated early Friday, with news that nonfarm payrolls and average hourly earnings were up more than expected in December.

For the first time since mid-December, the U.S. financial markets had a full plate of official economic releases to digest. Although the overall tenor of the new data was mixed, the more timely information — still mainly anecdotal in nature — tilted to the soft side. For example, the Federal Reserve's 'beige book' confirmed the weak tone of earlier reports on retail and industrial activity, and the Philadelphia Fed, in a separate release, revealed a sharp falloff in local factory conditions that was only partly due to the Blizzard of 1996. In terms of hard data, the 4-week average of initial jobless claims edged up to nearly 370,000 in the period ending January 13 despite a blizzard-induced sharp drop in the final week. While nonfarm payrolls were up a greater-than-expected 151,000 in December, due in part to the end of the Boeing strike, the high level of claims probably rules out a subsequent pickup in job growth.

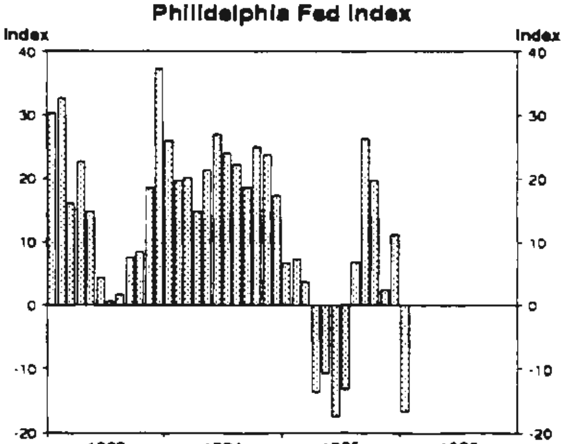
Meanwhile, reports for earlier months showed that the U.S. economy had enjoyed somewhat greater momentum in the summer and fall of 1995. The already strong third-quarter real GDP growth rate was revised up, to 3.2% on an annualized chain-weighted basis. October's trade deficit shrank further, to $8 billion, and housing starts rose 5.7% in November, albeit all in low-value-added apartments. Of these three reports, the one on trade is probably most indicative of an emerging source of strength for the economy as it moves into 1996.

Federal Reserve Policy

We now believe that the soggy business climate will induce the FOMC to cut short-term interest rates an additional 50 basis points by midyear, as discussed more fully in Part II (pp. 4-6). This is likely even if the budget talks collapse, although an accord would probably hasten the move toward lower interest rates. In particular, the willingness of Fed officials to reduce rates as early as the next scheduled FOMC meeting, on January 30-31, probably hinges on whether the broad outlines of a budget deal are in place by then.

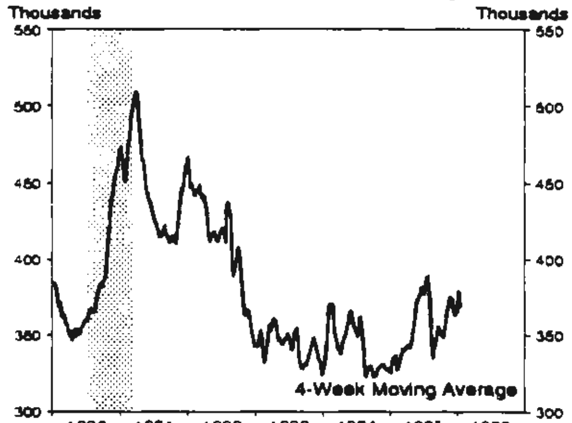
In this regard, two events this week chipped away at the probability of a Fed easing in late January. The first was the failure of budget talks to resume as scheduled on Wednesday. The second was Vice Chairman Alan Blinder's announcement that he will step down when his term as a Federal Reserve Governor expires on January 31. Mr. Blinder's latest public comments suggest that he was inclined to push for another rate cut at the next FOMC meeting. Now he will not participate in this session. Public statements by several other FOMC members reveal no sense of urgency to reduce rates now, although a budget agreement would probably tip the balance slightly in favor of a 25-basis point cut.

Philidelphia Fed Index



Source: Federal Reserve Bank of Philidelphia.

Initial Jobless Benefit Claims



Source: Department of Labor.

Fiscal and Political Developments

The failure of budget talks between the president and key congressional leaders to resume on schedule at midweek was hardly good news, but it should not be seen as the death knell for the budget process either. Meetings have been occurring almost daily at a staff level, and differences between the two sides have narrowed somewhat further. In addition, efforts to put together a budget that can gain the support of a coalition of Republicans and conservative Democrats in the House of Representatives are continuing. In light of all this, we still think the chance of an accord is above 50%, although time is clearly running short.

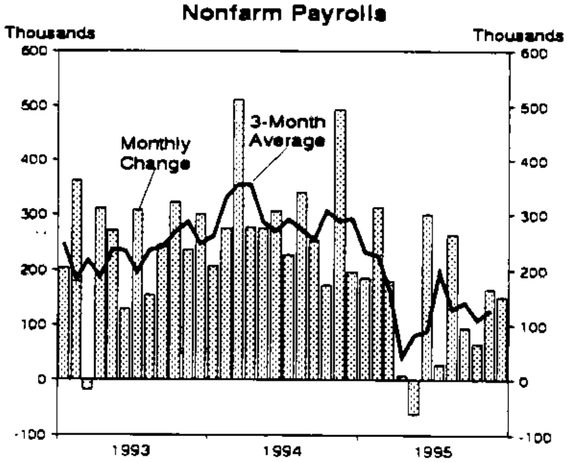
The Republican commission on tax reform headed by former Representative and HUD Secretary Jack Kemp issued its long-awaited recommendations this week. The panel stopped short of endorsing a 'flat tax,' at least as that term has come to be understood in the U.S. financial markets. Although the commission did come out in favor of a single low tax rate for both firms and individuals, as well as some form of tax incentives for saving, it sidestepped the question of whether key existing preferences, especially for mortgage interest payments and state and local interest income, should survive. Both would disappear in the most prominent and detailed flat tax plan offered by Rep. Armey (R-TX) and Sen. Shelby (R-AL). The lack of specifics in the Kemp report allows Sen. Dole (R-KS), currently the front runner for his party's presidential nomination, to stress broad themes for tax reform without being boxed in by particulars. By the same token, however, the report underscores the obstacles to tax reform outlined in our December 1995 paper, *Tax Reform: The Good, The Bad, and The Ugly*.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

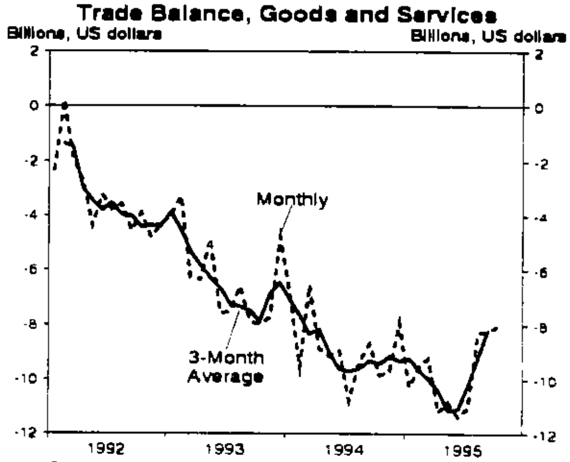
Yields on long-term bonds look less compelling than a week ago, although investors with established positions will probably find it profitable to keep them in place awhile longer. Given that the probability of Fed easing later this month has faded a bit, the rally in nearby Euro futures contracts may stall temporarily. Hence, the steepening in the money-market yield curve we had been expecting will probably be delayed.

Nonfarm Payrolls



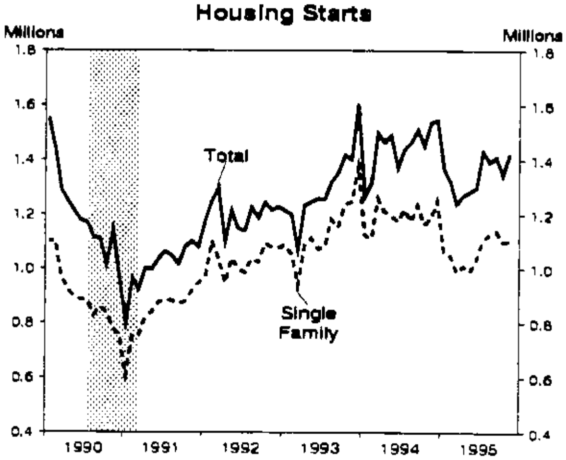
Source: Department of Labor.

Trade Balance, Goods and Services



Source: Department of Commerce.

Housing Starts



Source: Department of Commerce.

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II. Weak Economic Data Will Provoke More Fed Easing

The publication of federally compiled economic statistics, which were almost completely suspended for nearly four full weeks, has resumed. As analysts scramble to work through the backlog of releases that has built up, there will be an unusually dense concentration of this news over the next one to two months, which will color perceptions of how the economy was performing at the end of 1995 and the outset of 1996.

In our view, the data to be disseminated in the coming period are likely to convey a distinctly weak tone, owing to the combination of fundamental forces — an inventory correction and a slowdown in capital investment spending gains — and temporary negative shocks to demand from the government shutdown and the Blizzard of 1996. Federal Reserve officials will have difficulty separating the effects of these distortions from the underlying softness in activity, and hence, they will likely remain biased toward further reductions in short-term rates for most of this year's first half. Consequently, we now expect a somewhat greater cumulative monetary easing in 1996 than had previously seemed probable, with the federal funds rate reaching 5% by June and then turning up only mildly — by about 50 basis points — toward the end of the year.

Downbeat Economic News In Prospect

The floodgates have opened on the backlog of government statistical releases that built up between December 15 — the last day before the three-week partial federal shutdown — and last Friday, the fourth day last week in which federal offices in Washington were shuttered by storms. It will take weeks or, in some cases, months for government agencies to complete delayed reports and process information that was developed in the interim.

Catching Up on Old News: Revised Schedule of U.S. Economic Releases

New Date	Release	Period Covered	Original Date
Jan. 16	Housing Starts	November	Dec. 19
Jan. 17	Trade Balance	October	Dec. 20
Jan. 17	Leading Indicators	November	Dec. 19
Jan. 18	Weekly Jobless Claims	Dec/Jan	Various
Jan. 19	Real GDP-Revised	95 Q3	Dec. 19
Jan. 19	Employment Situation	December	Jan. 5
Jan. 23	Personal Income/Consumption	Oct/Nov	Dec. 21
Jan. 24	Industrial Production/Capacity Utilization	December	Jan. 17
Jan. 24	New Home Sales	November	Jan. 3
Jan. 31	Producer Price Index	December	Jan. 11
Feb. 1	Consumer Price Index	December	Jan. 12
Feb. 2	Employment Situation	January	Feb. 2
Wk of 1/29	Retail Sales	December	Jan. 12

As we have discussed in earlier reports, there are two main fundamental reasons to suspect that the underlying business climate will be soft for much of the first two quarters this year:

1. **Intensified inventory restraint.** Firms across all stages of distribution can be expected to continue, and in some cases redouble, efforts to eliminate unwanted stocks, especially in the wake of disappointing holiday sales among many major retailers. This will curtail demand for U.S. manufactured goods, suppressing industrial output and overall real GDP growth.

2. **Sharply reduced business capital outlay growth.** Rapid gains in productive capacity and declining utilization rates should foster a significantly more cautious attitude toward plant and equipment investment spending among firm managers.

More recently, there have been two events that will tend to exacerbate the appearance of a substantially softer U.S. economic environment, at least for a while:

1. **The government shutdown.** More than a quarter of a million federal workers were furloughed for a few weeks beginning December 16, freezing or reducing activity levels in a number of areas. Not only should this have reduced nondefense federal purchases of goods and services for a time, but it also probably chilled those private sector activities that depend on government financial assistance, contracts or approvals. For example, the furlough of Environmental Protection Agency employees is said to have suspended extensions of contracts for work on waste clean-up programs. A number of private companies may have been forced to postpone new projects temporarily for lack of required regulatory approval. It is difficult to estimate how significant these influences on aggregate activity were, but their influence on official data almost certainly will be negative for at least the short term.

2. **The Blizzard of 1996.** The worst blizzard in nearly half a century struck the northeast corridor on January 7-8, disrupting transportation and

forcing both workers and consumers to stay home for a good portion of last week. This happened to coincide with the survey period for the household and payroll employment surveys. Thus, although much of the postponed work and purchases will eventually be made up, measures of production and sales in January will probably suffer sharp setbacks. When similar storms have occurred over the past fifteen years, there have always been sharp downward deviations in private payroll employment from prior trends, particularly in the construction industry. In the retailing and manufacturing sectors, however, an examination of earlier storm influences suggests that recoveries tend to be relatively swift.

The February 1983 experience is an instructive case. A major snowstorm in mid-month caused disruptions across much of the northeast region, suppressing hiring and spending in a number of sectors. Total nonfarm payrolls fell 87,000 that month, versus an average net rise over the prior three months of 27,000, for a negative swing of 114,000 from trend. The bulk of this temporary setback occurred at construction firms, where the deviation was 78,000. On a seasonally adjusted basis, retail sales for the month edged up only 0.2%, less than the then-prevailing inflation rate for goods. Housing starts and industrial production both slipped despite strong cyclical upswings in those sectors. Pre-existing growth rates in all these areas were eventually restored or exceeded, but only after a one to two month period of adjustment. Home building and construction employment were especially slow to recover from storm-related problems. Thus, it would not be surprising if forthcoming reports display substantially similar if not more severe consequences from the latest storm, exacerbating the tone of underlying data weakness.

Payroll Employment and Housing Starts in Storm Periods
(Deviation from prior three-month average change)

	Total Payrolls	Constr. Payrolls	Housing Starts*
Feb 1983	-114,000	-78,000	-12.8%
Mar 1984	-175,000	-89,000	-33.6
Dec 1989	-80,000	-70,000	-8.5
Mar 1993	-266,000	-88,000	-3.0
Jan 1994	-79,000	-19,000	-24.7

*Single-family units.

New U.S. Interest Rate Forecasts 1996-97
(quarter end)

	96 Q1	96 Q2	96 Q3	96 Q4	97 Q1	97 Q2	97 Q3	97 Q4
Federal funds	5.3	5.0	5.0	5.5	6.0	6.3	6.5	6.5
3 mo LIBOR	5.3	5.0	5.2	5.9	6.4	6.7	6.8	6.7
2 yr Treas	5.0	5.0	5.4	6.1	6.6	6.9	7.0	7.0
10 yr Treas	5.6	5.8	6.1	6.6	6.8	7.0	7.1	7.1
30 yr Treas	6.0	6.1	6.4	6.8	7.0	7.2	7.3	7.3

Pressure On Fed To Cut Rates Will Remain Strong Into Spring

Taking account of the likelihood that the economy will grow considerably slower than its long-term trend throughout the three quarters ending next June, we are lowering modestly our forecasts for short-term U.S. interest rates over the balance of 1996. Specifically, we now expect the low point in the federal funds rate target to be 5.0%, versus 5.25% previously. The upturn in rates we had expected for the summer and fall quarters should be slower to develop as well, with the funds rate only rising to 5.5% on December 31, compared to our earlier expectation of 6.0%. The primary basis for this opinion change is a firmer conviction that the business climate will remain choppy and difficult through the second quarter, giving Fed officials stronger and more sustained motivations to be accommodative. The more prolonged period of weakness we now expect will also open up excess capacity, allowing central bankers greater latitude for patience before they begin unwinding their easing in response to an economic acceleration during the second half.

Our expectation of another 50 basis point cumulative rate reduction to take place by midyear does not rest on whether a broad budget deficit reduction agreement is reached between the Republican Congress and the Clinton Administration, although the outcome of the current budget dispute may well affect its timing. If the budget talks do break down, federal fiscal policy would almost surely remain restrictive this year, as GOP lawmakers use their authority over funding for discretionary outlays to shrink or eliminate a number of current federal functions. Moreover, a collapse in the budget negotiations would block a tax cut from taking effect any time before 1997, and would probably lead to some upward pressures on bond yields and mortgage interest rates as investors demand a greater risk premium on long-duration U.S. securities. Over time, those effects on borrowing costs and federal spending would tend to compound the adjustments to lower inventory and capital spending growth paths, buttressing the rationale for additional monetary easing.

In the absence of a budget accord, though, Fed officials would very likely want to keep policy on hold initially, unless incoming economic news proved to be shockingly weak. Anxieties about an erosion of anti-inflation credibility would likely be heightened by any negative disturbances in the bond market caused by a breakdown in the budget process. Conversely, should a bipartisan budget pact ultimately emerge and receive a warm reception from financial market participants, Fed officials probably would be inclined to bring rates down a bit faster than otherwise.

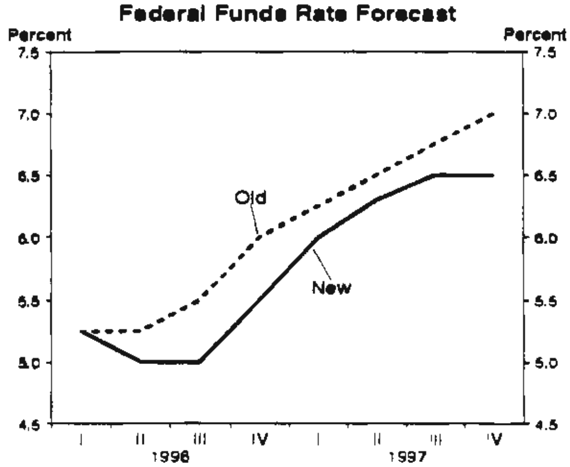
Benign Bond Market Environment To Last Awhile Longer

Against a background of torpid economic conditions and persistent pressures for a gradual further relaxation of credit, the favorable U.S. bond market psychology that has carried the 30-year Treasury yield down to 6% should linger into the springtime. We have, therefore, adjusted our medium-term expectations for bonds to show an essentially neutral yield profile between now and midyear. The actual pattern may well be bumpier, though, if the budget process devolves into a prolonged stalemate.

Beyond midyear, as the business climate brightens and monetary easing is suspended and later reversed, bond yields should assume a rising path and the yield curve develop a steeper posture to reflect more balanced attitudes about the future direction of money-market rates. Thus, we still look for 30-year Treasuries to revisit the 6.5%-7.0% yield zone during the fourth quarter.

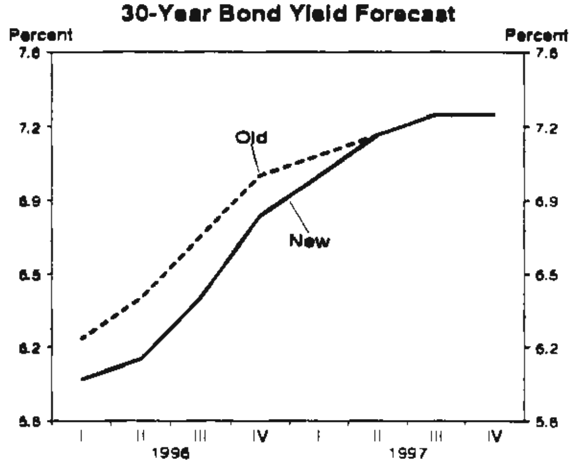
John Youngdahl

Federal Funds Rate Forecast



Source: Goldman Sachs.

30-Year Bond Yield Forecast



Source: Goldman Sachs.

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Key U.S. Economic Data

	Latest Monthly Data '95 Dec	'95 Nov	'95 Oct	'95 Sep	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. thousands)	151	166	66	94	128	141	Feb 2
Unemployment Rate (%)	5.6	5.6	5.5	5.6	5.6	5.6	
Index of Hours Worked (% ch)	-0.2	-0.4	0.6	0.5	1.1	0.8	
Average Hourly Earnings (% ch)	0.4	0.0	0.3	0.5	3.5	3.2	
Producer price finished goods index (% ch)	--	0.5	-0.1	0.3	0.9	2.0	Jan 31
Excluding food and energy	--	0.4	0.0	0.2	2.2	2.6	
Consumer price index (% ch)	--	0.0	0.3	0.1	1.8	2.6	Feb 1
Excluding food and energy (% ch)	--	0.1	0.3	0.2	2.5	3.0	
Retail sales (% ch)	--	0.8	-0.4	-0.1	2.9	3.2	Wk ofJan 29
Excluding motor vehicles (% ch)	--	0.9	-0.5	0.5	2.2	3.0	
Industrial Production (% ch)	--	0.2	-0.3	0.2	2.4	1.9	Jan 24
Manufacturing	--	0.2	-0.2	0.6	2.8	1.7	
Capacity utilization (%)	--	83.1	83.2	83.7	83.4	84.0	Jan 24
Manufacturing	--	82.2	82.3	82.8	82.5	83.2	
Housing Starts (annual rate, thousands)	--	1420	1343	1410	1383	1360	Feb 23
Single-family	--	1102	1102	1139	1102	1079	
Trade balance (billions, monthly)	--	--	-8.0	-8.2	-9.6	-9.6	TBA
Merchandise	--	--	-13.7	-13.7	-14.9	-14.9	
Factory Orders (% ch)	--	--	-0.3	1.4	8.4	6.7	Feb 15
Durable Goods	--	--	-1.1	3.0	15.4	8.4	Feb 15
Personal Income (% ch)	--	--	--	0.4	3.5	5.7	Jan 23
Wages and Salaries	--	--	--	0.5	3.5	4.9	
Purchasing Managers' Index (%)	47.3	46.5	46.8	48.3	47.7	49.5	Feb 1
Consumer Sentiment U Mich (Feb 66=100)	91.0	88.2	90.2	88.9	91.5	92.2	Feb 2
Conference Board (1985=100)	98.7	101.6	96.3	97.3	99.6	100.0	Jan 30

Note: Percentage changes are month to month for last four months, annualized for 6-12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- Some potential exists for a resumption of White House-GOP budget talks, and efforts to find agreement between Republicans and Democrats in Congress may well intensify. Probabilities still marginally favor a settlement of partisan fiscal differences, and the time for reaching such a deal is growing very short.
- In his annual State of the Union address on Tuesday night, President Clinton is likely to focus on key themes for his reelection campaign rather than dwell on the details of the current budget debate.
- Regular Treasury note auctions on Tuesday and Wednesday will raise far less new cash for the government than in the past — only $4 billion. This reflects the initiation of redemptions in the monthly 5-year note cycle.

Economic Releases and Other Events

Date	Indicator	Estimate GS	Estimate Consensus	Last Report
Jan. 23	Personal Income (Oct./Nov.)	0.7%/0.0%	0.7%/0.1%	+0.4%
	Personal Consumption (Oct./Nov.)	0.0%/0.4%	0.1%/0.6%	+0.2%
	Federal Budget Balance (Dec.)	+$5.0 bil..	n.a.	-$38.5 bil.
Jan. 24	Industrial Production (Dec.)	+0.3%	n.a.	+0.2%
	Capacity Utilization (Dec.)	83.1%	n.a.	83.1%
	New Home Sales (Nov.)	Up	0.0%	-2.7%
Jan. 25	Existing Home Sales (Dec.)	Flat	n.a.	-1.7%

- 3 mo and 6 mo T-bill auctions (Jan. 22)
- 2-year T-note auction (Jan. 23)
- State of the Union Address (Jan 23)
- 5-year T-note auction (Jan. 24)

Interest Rates: Forecast vs. Forward Yields:

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.0	5.2	6.1
Forward	5.1	4.9	4.9
2 Yr T-Note	5.0	5.4	6.6
Forward	5.0	5.0	5.1
10 Yr T-Note	5.8	6.1	6.8
Forward	5.6	5.6	5.7

Key Nos. in the Business Outlook

	1995 Q4	1996 Q1	1996 Q2	1995	1996
Real GDP	1.0%	0.5%	1.7%	2.4%	1.6%
Ind. Production	1.0	0.0	2.0	3.5	1.5
CPI	2.0	3.0	2.7	2.8	2.7
Profits*	10.2	8.8	6.3	7.9	4.8
Merch Trade Bal. (monthly, $B)	-12.8	-13.3	-13.0	-13.6	-12.7

* Excluding inventory profits; adjusted for depreciation distortions

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To: Gene Sperling
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GOLDMAN SACHS BOND MARKET TELEX
September 1, 1995

1. ECONOMIC AND MARKET OVERVIEW

A much weaker than expected report from the National Association of Purchasing Managers on industrial conditions in August has reignited expectations that more monetary easing is in store, if not in September then during the fourth quarter. This report, together with previous government soundings on manufacturers' orders and inventories, casts doubt on the expectations embedded in most economic forecasts that U.S. industrial output is in process of turning up on a sustained basis. Factory orders fell 1.3% in July, and while this was heavily influenced by auto plant shutdowns, it included an 8.1% drop in orders for nondefense capital equipment other than aircraft, a key indictor of business equipment spending. Purchasing managers reported declines in orders in August as well. Meanwhile, the accumulation of inventories in the factory sector does not appear to have abated much in June or July. Thus, although futures contracts for federal funds assign only a 50% chance of Fed easing in September, longer-dated securities imply more substantial rate cuts farther in the future and the yield curve has flattened.

Outside the manufacturing sector, the latest indicators have been more consistently upbeat about near-term growth prospects. Consumer confidence remained quite high in August, according to fresh readings from both the Conference Board and the University of Michigan. Although retailers reported disappointing sales results for August, hot weather appeared to be a significant depressing factor. The spending trend into the third quarter virtually assures an annualized increase of 3.5% or more in real terms. Moreover, income growth has been quite strong, with a 0.9% jump in wages and salaries pacing a 0.7% rise in personal income in July. At the end of the week, a solid increase in nonfarm payrolls in August confirmed several other indications -- lower claims for jobless benefits, an uptick in help-wanted advertising, and a solid Manpower employment survey -- that labor demand has improved. This should keep income flowing to the household sector and help sustain growth in domestic spending. The key issue raised by the manufacturing reports is who will get the business; the presumptive conclusion from the shortfall in orders is that import penetration remains high and that the U.S. inventory correction may not be as close to finished as it previously appeared to be.

TREASURY YIELD INDICATIONS
(Semi-annual yields, late morning)

	2-yr.	3-yr.	5-yr.	10-yr.	30-yr.
9/1/95	5.81%	5.91%	6.02%	6.24%	6.61%
8/25/95	5.95	6.05	6.20	6.44	6.79
8/18/95	6.11	6.23	6.37	6.57	6.91

2. FEDERAL RESERVE POLICY

On balance, it seems likely that Federal Reserve policy makers will stay on the sidelines in September. Although the economic outlook does not look quite as trouble-free as it did prior to the latest reports on manufacturing conditions, the bulk of evidence still points toward a return to the 2.5% growth trend by yearend. Meanwhile, Congress and the President still have to come to terms on a budget for fiscal 1996. From the latest published minutes (covering the July 5-6 meeting), it is clear that the Open Market Committee is counting on a substantial reduction in the deficit in coming years. Ideally, Fed officials would want to have an agreement in hand before deciding to lower interest rates any further. This makes a rate cut in September improbable unless additional evidence of economic weakness surfaces.

3. FISCAL AND POLITICAL DEVELOPMENTS

With Congress out of session, developments on the fiscal front have been quiet in the last week or two. That is due to change dramatically when Congress gets back to work this coming Wednesday. From that point until probably mid-November, deficit negotiations will take center stage.

Although financial market participants are currently assuming that the deficit will be trimmed considerably, two developments tend to call that assumption into question. First, the Congressional Budget Office (CBO) reduced its deficit estimates for fiscal 1995, 1996 and 1997 by $14 billion, $21 billion and $12 billion respectively. This reduces the amount by which Congress has to cut spending to meet deficit targets contained in the budget resolution agreed to in June, and this in turn means tax cuts are within easier reach as well. Second, Sen. Phil Gramm (R.-Texas) scored surprisingly well in the Iowa straw poll taken on August 20, tying front-runner Sen. Bob Dole (R.-Kansas). While the poll has no significance for delegate selection, it provided Sen. Gramm -- an avid tax cutter -- with a much-needed psychological boost to his campaign. As the endgame of the budget battle heats up, Sen. Gramm is apt to take advantage of this shot in the arm to increase his profile as a tax cut advocate in an effort to distinguish himself Sen. Dole.

Two dates loom large in the budget battle. First, the current fiscal year ends on September 30. At that time, nonessential government operations will be shut down if the requisite appropriations bills or a continuing resolution (to maintain current funding levels) are not in place. This is a distinct possibility, given the high potential for conflict between the Congress and the Administration and the Republicans' desire to show that much of the government is not essential. The second and most critical date is the time when the federal government runs up against its $4.9 trillion debt ceiling. While this date is obviously subject to change, depending on trends in receipts and outlays and whatever strategies the Administration can devise (e.g., asset sales) to buy more time, November 15 now appears to be the most likely date that the ceiling would be reached. On this date, the Treasury pays interest on long-term securities issued in its quarterly refundings, and the requisite funds would not appear to be in the coffers.

4. MARKET OUTLOOK AND COMMENTS ON VALUE

The recent upswing in prices of Treasury securities has reintroduced a presumption of monetary easing that looks unlikely. At about 6.6%, the benchmark yield on Treasury bonds now implies a sustainable level of short-term rates in the 5.0%-5.25% range. Even if deficit reduction evokes some easing from the Fed during the fourth quarter, any such rate cut is unlikely to be this large unless the economy is a lot weaker than it now appears.

In addition, political wrangling on the federal deficit is apt to be quite contentious, if not downright acrimonious, as politicians from both sides of the aisle posture themselves to appear both tough on the deficit and keen to cut taxes. In this situation, the market looks quite vulnerable to both yield increases and curve steepening.

5. UPCOMING ECONOMIC RELEASES AND EVENTS

Date	Indicator/Event	Data For	Estimate	Last Report
9/6	Congress back in Session			
9/7	Nonfarm Productivity	95Q2	+4.5%	+3.0%
9/8	Consumer Credit	Jul	+$6.0 bn.	+$9.6 bn.

Regards,

Edward F. McKelvey/John M. Youngdahl

GOLDMAN, SACHS AND CO.

ECONOMIC RELEASE COMMENT 8/30/95 Goldman Sachs Economics Group

REAL GDP AND GDP-BASED PRICE INDEXES ('95 Q2 PRELIMINARY)

Key Statistics:

	'95 Q2	Previous Report	4-Quarter Trend
Real GDP (ann. rate)	+1.1%	+0.5%	+3.2%
Real Final Sales (ann. rate)	+2.5%	+2.1%	+3.8%
Fixed-Weight Price Index (ann. rate)	+2.8%	+2.8%	+2.9%

Conclusion:

Upward revision due mainly to stronger trend in real final sales. Does not change outlook for third quarter (real GDP up 1.7%, final sales up about 3%) or for Fed policy.

Key Points:

1) Real GDP for the third quarter was revised up to show a 1.1% annualized growth rate. About two-thirds of this revision reflected an increase in real domestic final sales; the remainder reflected a revision to accumulation of farm inventories.

2) Within the final demand component, readings on consumer spending and housing activity were revised up. Real consumer spending is now estimated to have increased at a 3.4% annual rate, versus 2.6% previously. Real residential construction is now estimated to have declined at a 13.2% rate, versus 14.2% previously. Growth in real business spending on plant and equipment was left unchanged at an 11.8% annual growth rate.

3) Although the implicit deflator was revised up 0.3 points, to show a 1.6% annualized increase, the fixed-weight index was left unchanged at a 2.8% annual increase. Thus, the report contains no significant new information on prices. In combination, the larger increases in both real GDP and the deflator mean that nominal GDP rose about 1 percentage point faster than previously estimated. This made room for a better-than-expected increase in after-tax profits, which were up 1.5% from the previous quarter and about 10.7% above their year-earlier level.

DAILY FINANCIAL MARKET COMMENT 8/30/95 Goldman Sachs Economics Group

Summary

- Figures released this morning on consumer confidence and on new home sales were broadly in line with the notion that U.S. economic growth will rebound toward its 2.5% long-term trend later this year.

- We have little reason to question a wire-service report indicating that Fed officials are increasing confident about a rebound in growth and therefore less inclined to lower interest rates for the purpose of stimulating growth. Deficit reduction could prompt a cut in rates, although many hurdles remain.

- As a reminder, we expect Wednesday's revisions to real GDP to leave the second-quarter growth rate about unchanged, but to lift growth rates for final sales and domestic final sales. Preliminary after-tax profit figures should show declines of 2.5%-5.0% between the first and second quarters and little change from year-earlier levels.

Confidence, new home sales in line with growth rebound

The latest reports on consumer confidence and on home sales should help defuse expectations of lackluster U.S. economic growth, which revived after last Thursday's report on durable goods orders in July.

1. July's selling pace for new homes implies further gains in single-family home building. Typically about 60% of new single- family homes built get reported as sales. Thus, at an annual rate of 715,000, the level of new home sales is consistent with a construction pace of nearly 1.2 million units -- about 100,000 more than occurred in July. Moreover, the stock of unsold homes is only about 6 months' supply at the current selling pace.

   The 0.4% net sales increase reported for July came from a base that was revised down 2.2%. This downward revision did little to alter the general pattern of a sharp increase in sales in recent months; between April and July, sales have risen 17.2%. The one caveat in the latest home sales report was that the regional composition was quite disparate, with sales rising only in the South. Sales in that part of the country jumped 22.5% in July, offsetting declines averaging 14.8% elsewhere. This probably means that the improvement is not quite as strong as it appears in the total figures.

2. Consumers are quite confident. The Conference Board's index of consumer confidence stood at 101.0 (1985=100) in August, only fractionally below the upward-revised July reading of 101.4. This figure had originally been reported at 99.9. This result was in line with preliminary results from the Michigan survey, which showed a small uptick in confidence between July and early August. Final Michigan results are due on Friday, September 1.

   In commenting on its August survey, the Conference Board indicated that consumers saw the best of several worlds -- low unemployment, low interest rates, and low inflation. This confluence of favorable economic developments has caused many to mark up expectations of the outlook in coming months.

Chance of easing small, increasingly tied to deficit reduction

A wire service article on Tuesday (Market News at about 12:20 p.m. New York time) addresses the prospect of Federal Reserve easing from two perspectives: (1) does the economy need it? (2) will the final resolution of the deficit justify it? The answers: a clear no (for now, anyway) and a resounding maybe.

1. Fed officials now think that the economy may not need more monetary stimulus. According to the article, U.S. monetary authorities are feeling increasingly confident about the rebound in U.S. growth and therefore see no need to reduce interest rates in the near future for the purpose of stimulating the economy. This assessment is fully consistent with the points made in the previous daily comment about the July 5-6 minutes and intervening developments. It indicates that central bank officials were not unduly shaken by the July durable goods report released last Thursday, which revived market expectations of monetary easing. Indeed, the assessments attributed to Fed officials tilt in the direction of thinking that U.S. economic growth could well exceed its long-term 2.5% speed limit by yearend.

2. Under certain circumstances, deficit reduction could prompt a rate reduction by the Fed. First, it seems clear from the views attributed to Fed officials that legislation enacting deficit reduction would have to be in place before any rate reduction occurred. Although some bill will eventually be passed, the hurdles are still quite high -- passage of 13 appropriations bills, passage of a reconciliation bill, and agreement between President Clinton and the Congress. The process could easily stretch several weeks beyond the September 30 end of the current fiscal year. Second, deficit reduction cannot be too heavily concentrated in the out years. Otherwise, it is bound to reflect assumptions rather than actions and, in any event, could be undone by a future Congress. On this score, recent reductions to near-term CBO baseline estimates widen the scope for just this type of deficit reduction. Finally, some officials do not want to cut rates in response to deficit reduction before seeing that it is having some restrictive impact on the economy. In short, lots has to happen before the Fed lowers short-term interest rates on account of deficit reduction.

GDP revisions: better final sales, little adjustment to growth, lousy profits

Revisions to second-quarter GDP are due for release Wednesday, August 30. As noted in two previous daily comments (dated August 4 and 18), we expect these revisions to show:

1. No significant change to the 0.5% growth rate now on record. On balance, the information published since the last report on July 28 implies a slight upward bias to this figure. The bias is so small, however, that other pieces of information to which we do not have access could easily prove to be more important.

2. Upward revisions of about 0.5 point to growth rates of real final sales and domestic final sales. The absence of any significant revision to overall growth masks upside revisions to most major components of domestic final sales which are offset by downward revisions to inventory change. Revisions in this direction would emphasize the dichotomy between a modest slowing in demand and a much sharper reaction in output.

3. Quarter-to-quarter declines in after-tax profits, with little year-to-year change. As usual, the revisions will include preliminary estimates of profits earned in the second quarter. Although the earnings per share of premier companies in the Standard and Poors' 500 were about 20% above year-earlier levels, the same cannot be said for profits of the entire business sector. We look for after-tax reported profits (the item usually crossing the tape first) to be down about 5% from quarter to quarter and up about 3% from year to year. After correction for inventory profits and distortions from accelerated depreciation, these figures should be -2.5% and -1.3%, respectively.

In summary, the report should make the composition of last quarter's output and demand look more conducive to the rebound that now appears to be under way. Although the Commerce Department plans to shift to the new chain-weighted measures of real GDP and its components in December, it is unlikely that these new measures will be highlighted in Wednesday's report.

EFM

DAILY FINANCIAL MARKET COMMENT 8/29/95 Goldman Sachs Economics

Summary

- U.S. economic prospects have brightened since the Federal Open Market Committee (FOMC) met on July 5-6, most notably in terms of the trend rate of growth in consumer spending and labor market conditions. These developments have probably narrowed the range of disagreement among FOMC members and removed the bias toward lower interest rates that prevailed between the July 5-6 and August 22 meetings.

- In coming months, the FOMC could be unpleasantly surprised by three developments: less fiscal restraint than anticipated, more export growth than anticipated, or stickier inflation than anticipated. While any such surprises are not likely to reverse the course of monetary policy in 1995, they could set the stage for a reversal early in 1996.

The Fed's latest minutes -- a time warp on the economy

Reading the minutes from an FOMC meeting conducted weeks earlier is almost always an exercise in time warp, because the state of the economy is constantly changing. Minutes to the July 5-6 gathering are no exception. As anticipated, they reveal a wide range of disagreement among three factions resulting from highly uncertain readings on events leading up to the meeting. One group wanted to ease aggressively, another group felt no easing was necessary, and a centrist group favored the middle ground taken -- an immediate 25-basis-point cut with a bias toward further easing in the July 6-August 22 period.

Since that contentious meeting, U.S. economic conditions have clearly improved. Two specific differences stand out:

1. **The trend in consumer spending looks much firmer than it did then.** In early July, the FOMC characterized second-quarter consumer spending as 'sluggish,' with retail sales in April and May 'about unchanged.' Upward revisions to those figures, coupled with a large increase in outlays for services, led Commerce statisticians to peg the preliminary annualized increase in real consumer spending at 2.5% in late July. The information released over the past month imply a gain closer to 3%. (Figures are due for revision Wednesday.) Real consumer spending appears headed for another 3% annualized increase in the third quarter, although some of this is weather-related.

2. **The labor market also appears firmer.** When the FOMC met in early July, the most recent employment figures on record were the precipitous 101,000 drop in nonfarm payrolls reported initially for May and a surge in initial claims for unemployment insurance to a rate of about 375,000 per week. Fed officials had some inkling from data on hours worked in the manufacturing sector that the June employment report, due for release the day after the July meeting, would not be nearly so bleak. And, in fact, the situation has improved considerably since then. According to the latest figures, payroll gains averaged 152,500 in June and July, and the May decline has been trimmed to 62,000. Meanwhile, the four-week average of claims has dropped back down to 334,750, lower than at any time since late February and consistent with a pattern of aggressive hiring. Today's Manpower Inc. survey also indicates firm hiring intentions throughout yearend.

The U.S. economic outlook has also improved in less prominent ways. For example, the prospect for a rebound in residential construction, already visible back then, has brightened with ongoing improvements in home sales and an upward turn in housing starts. And, with growth in final demand looking a bit stronger in the second and third quarters than Fed officials appeared to anticipate a few weeks ago, the risk of a prolonged inventory cycle now looks much smaller than it did in early July.

For these reasons, the FOMC elected to leave interest rates unchanged at its August 22 meeting. Minutes for that meeting will not be available until September 29. They should reveal less disagreement among members of the FOMC than did the latest minutes. In all likelihood, they will also reveal that the Committee felt no need to continue the bias toward lower interest rates that had prevailed from July 5-6 to August 22.

Potential risks in coming months

The minutes to the July 5-6 session also provide some clues on how Fed officials will evaluate economic developments in coming months. In our view, the risks are tilted in the direction of several potential unpleasant surprises to Fed officials.

1. **Fiscal policy could be much less restrictive than anticipated.** At the July 5-6 meeting, the FOMC noted that 'recent developments in Congress ... suggested that there could be greater deficit reduction over the years ahead than had been built into many forecasts. [This would] act as a restraining influence on overall economic activity over the projected horizon.' Presumably, the developments in Congress refer to the enactment of a budget resolution mandating a balanced budget by the year 2002. That resolution, however, calls for only $28 billion in spending cuts -- a small (0.4% of GDP) degree restraint that could easily be neutralized by tax cuts. And, as noted last week, downward revisions to the near-term Congressional Budget Office (CBO) baseline deficit could reduce still further the amount of near-term fiscal restraint.

2. **Exports could be stronger than anticipated.** One of the more striking parts of the Fed's minutes was the concern expressed about export growth. In our view, the main surprise on the U.S. trade front has been the failure of import growth to slow down in tandem with diminishing growth in domestic demand. But the FOMC ignored the persistent strength in imports and chose to focus instead on the potential for slower growth abroad, especially in Japan and Canada, to produce downside surprises in exports. We have noted elsewhere (p. C13 of the July/August *Pocket Chartroom*) that most of the recent growth in U.S. exports has been in shipments to other parts of the world. Moreover, Canada's growth is highly dependent on growth in the United States and, hence, should improve as the U.S. economy picks up strength. The prospects for growth in Japan are much less clear, but the dollar's recent rebound should help contain downside risks without unduly hurting the competitiveness of U.S. exports.

3. **Inflation could be stickier than anticipated.** In July, both the Fed staff and a majority of FOMC members anticipated a slight downward trend in inflation, while recognizing substantial uncertainty on this point. Reports on producer and consumer price indexes for June and July have conformed to this expectation, reflecting the easing of pressures in commodity markets that has occurred in conjunction with the first-half slowing in growth. But rates of resource utilization remain high, and a resumption of growth could easily produce undesired upside surprises. Such a surprise could simply mean that inflation fails to recede.

Surprises on these fronts are unlikely to produce another reversal in the direction of monetary policy in 1995. As of early July, members of the FOMC clearly felt that risks were tilted to the downside. Although they probably see them as more evenly balanced at the present time, they also remain impressed with how quickly growth slowed during the first half of the year. By early next year, however, a sustained improvement in U.S. economic growth could put the Fed back in tightening mode.

EFM

GOLDMAN SACHS WEEKLY ECONOMIC UPDATE 8/28/95 EMcKelvey,JYoungdahl

Summary

- Our outlook for a return of U.S. economic growth to its trend rate of about 2.5% by yearend remains intact despite a sag in durable goods orders in July. This view should be supported this week by several upbeat readings on employment, consumer spending, and activity in both the industrial and construction sectors.

- Last week's rate cut by the Bundesbank does not alter the outlook for U.S. monetary policy or yields on fixed-income securities. In coming weeks, rising prospects of an impasse in budget negotiations as the fiscal year draws to a close, coupled with more evidence of rebounding growth, should lift the benchmark yield on 30-year bonds into the 7.0%-7.25% range.

The Economy

There is an underlying distrust out there of the notion that U.S. economic growth is reviving. This was evidenced late last week by the willingness of several analysts to chop growth estimates for the third quarter by a percentage point or more in response to the July durable goods report. Although the report was unquestionably weaker than expected, our outlook for a gradual return of growth in real GDP to its trend rate of 2.5% by yearend remains intact for two reasons.

1. The durable goods report is a thin reed on which to lean. Monthly changes in durable goods are volatile under the best of circumstances and should therefore not spark large growth revisions. July's report was especially problematic because temporary auto plant shutdowns were responsible for more than three-quarters of the total decline in durable goods bookings last month. This problem has been openly acknowledged by the Commerce Department, which issued the report; it should be reversed in the August figures.

2. Our outlook already calls for substantial deceleration in business equipment spending. Outside the auto sector, the main area of weakness was in nondefense capital goods. Although unexpected, the decline came after two increases and appears consistent with our expectation that growth in real business spending will decelerate from 18.4% annualized growth in the first half of 1995 to about 5% in the second half.

Readings on a variety of indicators due for release this week should provide a more upbeat picture of U.S. economic conditions. In particular:

1. Hiring appears to be on the rise, with nonfarm payrolls estimated to have risen about 175,000 in August (Friday, 8:30);

2. Consumer spending and income posted further gains in July (Thursday, 8:30) and confidence was up in August (Tuesday, 10:00);

3. Purchasing managers probably saw a return of growth in industrial activity (Friday, 10:00, with various regional reports 24 hours earlier);

4. Construction activity appears to have turned up in July (Friday, 10:00); and

5. While new home sales probably slipped in July, this follows a 19.3% jump spaced over the preceding two months (Tuesday, 10:00).

Monetary and Fiscal Developments

The reduction in German official interest rates last Thursday does not alter our assessments of monetary policy or the bond market prospects in the United States. In fact, yields on 30-year Treasuries seem poised to move up soon into the 7.0%-7.25% range, and there is a distinct possibility that the higher end of that zone will be visited before quarter end. There are two main bases for this expectation:

1. Hopes for substantial near-term budgetary restraint are likely to fade. Once Congress returns from summer vacation next week, it will become increasingly apparent that enactment of a budget-balancing plan is far from assured. In any event, the bulk of any deficit reduction program will be tilted toward the out-years, with little or no tightening in fiscal 1996. Moreover, pressure for stimulative tax cuts probably will intensify, as jockeying among congressional candidates for the Republican presidential nomination intensifies.

2. Improving economic patterns are weakening the arguments for further Federal Reserve easing. Production indicators have begun to display a firmer tone, in response to the greatly improved demand trend since mid-spring. Sensitive employment indicators also have strengthened, implying that nonfarm payrolls will show a solid rise for August as noted above. Consequently, perceptions of the sustainable short-term U.S. interest rate level should move upward in coming weeks. Given the current flatter-than-normal yield curve profile, such a sentiment shift should be passed through more or less directly to long-term bond yields.

Upcoming Economic Releases and Events

Date	Indicator	Data For	Estimate	Last
8/29	Consumer Confidence (Conference Board)	August	Up	99.9 (1985=100)
8/29	New Home Sales	July	Down	+6.1%
8/30	Real GDP-Preliminary	'95 Q2	+0.5%	+0.5%
8/30	Fixed-Weight Price Index	'95 Q2	+2.7%	+2.7%
8/31	Personal Income	July	+0.4%	+0.4%
8/31	Personal Consumption	July	+0.3%	+0.2%
8/31	Factory Orders	July	-0.8%	-0.2%
9/1	Civ. Unemployment Rate	August	5.7%	5.7%
9/1	Nonfarm Payrolls	August	+175,000	+55,000
9/1	Leading Indicators	July	+0.1%	+0.2%
9/1	Purchasing Managers Index	August	52.0%	50.5%
9/1	Construction Spending	July	Up	+0.9%
9/1	Domestic Vehicle Unit Sales	August	Up	11.9 Mn.

GOLDMAN SACHS U.S. BOND MARKET TELEX

August 25, 1995

1. ECONOMIC AND MARKET OVERVIEW

The U.S. debt market rebounded strongly over the past few days, responding to the successful distribution of $29.25 billion in new short-term notes and surprise at an unexpected 1.7% drop in durable goods orders during July. These swift and substantial yield changes contrasted with a subdued market reaction to the lack of monetary policy change following the Federal Open Market Committee meeting last Tuesday. Though the bond yield drop began on the heels of the durable bookings release, those data alone do not justify a large change in sentiment, because upon close examination they are relatively mixed. To be sure, weakness in business capital goods orders and shipments last month (down 6.6% and 2.8%, respectively) is consistent with a pronounced slowing of equipment investment spending from the torrid 18% annualized first-half pace. This should come as no great surprise, however, since the substantial drop in factory utilization rates since the beginning of 1995 had already made that investment boom seem unsustainable. Escaping notice thus far is the fact that orders for most types of consumer hardgoods and durable materials -- another valuable cyclical indicator -- have strengthened notably. Excluding autos and parts, new orders in that category jumped nearly 2-1/2% last month, causing order backlogs outside the defense and aircraft sectors to rise 0.7%, the most since February. These data, which are in line with the last purchasing managers survey, may explain the steep falloff in first-time jobless insurance filings. At 335,000, the latest four-week average of those claims is at a six-month low, and not far above the levels experienced in the robust expansion period late last year.

In addition, housing industry information remains broadly positive. Sales of existing homes climbed another 5% in July, bringing the cumulative three-month rise to 17.7%. With conveyances of both new and existing dwellings running sharply higher than the January-May average, it stands to reason that consumer spending on durables will be firmer in coming months.

TREASURY YIELD INDICATIONS
(Semi-annual yields, late morning)

	2-yr.	3-yr.	5-yr.	10-yr.	30-yr.
8/25/95	5.95	6.05	6.20	6.44	6.79
8/18/95	6.11	6.23	6.37	6.57	6.91
8/11/95	5.98	6.11	6.28	6.52	6.89

2. FEDERAL RESERVE POLICY

Hopes for easier Fed policies were not satisfied last Tuesday, and they will likely remain frustrated for some time. The record of U.S. monetary management in the past quarter-century suggests that rate changes are most sensitive to indicators of final demand and production, and these have begun to signal an acceleration in most types of activity. The rebound in new orders among a majority of manufacturers, the steep drop in jobless claims, and the swift rise in leading indicators of homebuilding cannot have gone unnoticed by Chairman Greenspan or his colleagues. While it is possible that rates could be lowered slightly further purely in response to better inflation figures, the only times in recent years that the Fed has eased when spending was strong (final sales growth above 2-3/4% annualized) were in 1986, when an oil price plunge slashed more than 2% from the total retail inflation rate, and early 1988, when the roar of the October 1987 stock market crash was still in officials' ears.

3. FISCAL AND POLITICAL DEVELOPMENTS

Presidential politics on the Republican side will sustain pressure for a large tax cut to be included in the budget reconciliation bill this fall, heightening the probability of a protracted budget dispute with the Clinton Administration. In a straw poll taken last weekend in Iowa -- where the first test for candidates will be held in February -- GOP front runner and Senate Majority Leader Dole received unexpectedly low support, with backing from only 24% of those present. This has given new encouragement to his opponents, particularly Senator Gramm, whose aggressive organizational efforts gained him a tie for first place in the survey. Gramm has been a strong advocate of tax reductions as well as deep cuts in welfare spending, and he can be expected to hold Dole's feet very close to the fire on those two issues. That will make it difficult for the Majority Leader to adopt a softer stance in negotiations with members of his chamber or the White House, and thus, it boosts the potential for a presidential veto of the final legislative product.

The unfortunate political reality for Senator Dole is that, unless President Clinton capitulates and signs deep tax and welfare spending reductions into law, the fiscal outcome will probably be somewhat unsatisfactory to the conservative Republicans who usually dominate the nominating process, and that may give his intra-party opponents an opening. If Dole strikes a middle-ground compromise with Clinton, then he no doubt will be attacked for losing the initiative that was won in November 1994. In the event that no tax or welfare bill at all can be enacted, it will be tougher for Dole to argue that his leadership is required to achieve long-run party objectives.

4. MARKET OUTLOOK AND COMMENTS ON VALUE

Fundamental underpinnings for the present low U.S. bond yield profile and the flatter-than-average Treasury yield curve have deteriorated in recent weeks, suggesting that the bond market will soon embark upon a more negative course. Widespread expectations for persistently slow economic growth and perceptions of excessively austere monetary policies are not consistent with the signs of a solid upswing in interest-sensitive demand areas and buoyant household views concerning personal finances. The presumption of a materially restrictive fiscal path over the near term also may be jolted, as Congress returns next month to the thorny task of squeezing popular federal entitlement spending programs.

5. UPCOMING ECONOMIC RELEASES

Date	Indicator	Data For	Estimate	Last
8/29	Consumer Confidence (Conference Board)	August	Up	99.9 (1985=100)
8/29	New Home Sales	July	Down	+6.1%
8/30	Real GDP-Preliminary	'95 Q2	+0.5%	+0.5%
8/30	Fixed-Weight Price Index	'95 Q2	+2.7%	+2.7%
8/31	Personal Income	July	+0.4%	+0.4%
8/31	Personal Consumption	July	+0.3%	+0.2%
8/31	Factory Orders	July	-0.8%	-0.2%
9/1	Civ. Unemployment Rate	August	5.7%	5.7%
9/1	Nonfarm Payrolls	August	+175,000	+55,000
9/1	Leading Indicators	July	+0.1%	+0.2%
9/1	Purchasing Managers Index	August	52.0%	50.5%
9/1	Construction Spending	July	Up	+0.9%
9/1	Domestic Vehicle Unit Sales	August	Up	11.9 Mn.

Regards,
John M. Youngdahl
GOLDMAN, SACHS AND CO.

Summary

- Employment figures for August are apt to firm on balance. Nonfarm payrolls are estimated to have risen 175,000, with the job count and workweek in manufacturing both bouncing back from depressed July levels.
- Although this rate of hiring would normally imply a slight decline in unemployment, an influx to the labor force probably kept the jobless rate unchanged at 5.7%.
- Readings on wages and hours worked will probably show the customary middle-month-of-quarter weakness to some degree, but not by enough to offset recent strengthening in the trends for both indicators.

A firm August employment report, on balance

The August employment report is due for release on September 1 at 8:30 New York time. In it we expect to see the following:

1. Nonfarm payrolls rose an estimated 175,000. From a top-down point of view, the main event in recent weeks has been a significant net drop in claims for unemployment insurance. The level to which claims have fallen would justify an estimate of 200,000 or a bit more for the net change in payrolls in August. However, the interval between the July and August surveys was only four weeks. This probably held the increase slightly below the norm. In addition, the so-called `bias adjustment' factor used to correct the raw data for jobs added by business startups was reduced sharply for the third quarter.

2. The factory sector probably bounced back from an artificially weak July. The most striking aspect of the July employment report was the weakness displayed by manufacturing payrolls and workweeks -- down 85,000 and 0.2 hour, respectively. Neither figure seems consistent with other evidence -- firm reports from purchasing managers and a generally rising pattern of orders -- that imply an improvement in industrial conditions. In its initial estimate of industrial production, the Federal Reserve found sufficient evidence of increasing output to discount the manufacturing payroll and workweek figures substantially. We believe, therefore, that the August employment report will show a snap-back in both indicators, with payrolls rising an estimated 45,000 and the factory workweek rising 0.2 hour despite a tendency to decline in the middle month of a quarter. Although we are anticipating these rebounds in August, an alternative possibility is that the figures now on record for July could be revised up substantially. In other sectors, we anticipate payroll changes of +5,000 in construction (due to favorable weather and rising activity), -20,000 in retail (correcting for an outsized increase in July), +10,000 in government (following a slight decline in June), and +135,000 in all other industries.

3. The unemployment rate appears to have stayed steady, at 5.7%, although a decline is more likely than an increase. Normally, net hiring of the magnitude we are estimating would produce a small drop in the jobless rate, as would the recent decline in the number of individuals receiving jobless benefits. Our estimate of no change reflects a judgment that the number of people looking for work probably rose substantially in August, offsetting these other factors. Although the labor force jumped 650,000 in June, its growth over the past half year has still been quite small (0.6%, annualized) on balance.

4. Average hourly earnings and the index of hours worked are apt to look soft in August, but not enough to offset preceding strength. Over the past eighteen months, both indicators have tended to post smaller-than-trend increases in the middle month of a quarter, suggesting faulty seasonal adjustment. The pattern is more pronounced for the index of hours worked, whose net change in the middle month averaged 0.6% less than for the three months taken together. The expected bounce in the factory workweek should reduce this discrepancy considerably, resulting no change in the index (versus a trend that is probably about 0.2%). Such an outcome would leave the level of hours worked in July and August 0.7% above its second-quarter level, implying annual growth of nearly 3%. In the case of average hourly earnings, the bias is fairly small -- about 0.1% or so. With monthly wage gains averaging 0.25% over the past year, a reasonable expectation would be for average hourly earnings to rise 0.1% or 0.2%. Such an outcome would put the 12- and 6-month annual wage trends at 3.3% and the 3-month trend at about 5%.

ECONOMIC RELEASE COMMENT 8/24/95 Goldman Sachs Economics Group

DURABLE GOODS ORDERS (JULY)

Key Statistics:

	July	3-Month Trend	12-Month Trend
Durable Goods Orders	-1.7%	+0.2%	+0.6%
Orders Less Civilian Aircraft and Military Hardware	-1.8%	+0.1%	+0.6%
Non-Defense Capital Goods Orders Excluding Aircraft	-6.6%	+0.3%	+0.7%

Conclusion:

Weaker than expected bookings for big-ticket items last month, especially in the area of business equipment. Suggests recovery in domestic production will be gradual.

Key Points:

1) Total durable goods orders fell 1.7%, led by a 6.6% plunge in demand for capital equipment other than aircraft. Orders for consumer goods and materials held essentially steady, despite a drop in bookings for autos and parts.

2) The weakness in capital goods orders comes after two months of strong gains. On balance, data over the past few months in this area are consistent with a pronounced slowdown in business spending on capital equipment over the remainder of this year. Our latest published forecast calls for fixed investment in producers' durable equipment to increase only about 4% annualized this half year, following an 18% surge in the first half.

3) At the same time, it is somewhat encouraging that demand for most types of durable consumer goods and materials has started to improve, as this should help lift manufacturing output in the months ahead.

DAILY FINANCIAL MARKET COMMENT 8/24/95 Goldman Sachs Economics Group

Summary

The latest federal budget estimates by the Congressional Budget Office show an improved outlook for the near-term but little long-lasting improvement.

The new estimates may reduce still further the already low chance of significant fiscal restraint in 1996, but they do not significantly reduce the magnitude of budget cuts needed to achieve balance by fiscal 2002.

Budget outlook better only in the near term

Figures released Tuesday by the Congressional Budget Office (CBO) show a smaller U.S. federal deficit for the current and next two fiscal years. This is mostly due to an improved economic climate of lower-than-expected interest rates and stronger-than-expected revenue growth. The longer-term budget outlook has not changed materially, as shown in the table below. The details and implications are as follows:

1. Consistent with recent public statements, the CBO reduced its estimate of the fiscal 1995 deficit to $161 billion. This is $14 billion below its previous baseline projection in April, but probably still too high. Based on the July figures released this past Monday, we estimate that the FY 1995 deficit will be in the about $150-$155 billion, and it could be as low as $140 billion.

2. A lower CBO deficit estimate for fiscal 1996 reduces still further the already small prospect of major fiscal restraint next year. The budget resolution adopted by Congress called for $28 billion in spending cuts to achieve a deficit of $170 billion for fiscal 1996. The revised CBO deficit estimate for FY 1996, at $189 billion, implies that spending might be cut by less than $20 billion (only about 0.25% of GDP) in the next fiscal year. Tax reductions are not included in these figures and could easily neutralize them if not put the federal budget in a slightly stimulative mode.

3. But Congress is still on the hook for major long-term spending cuts. As noted in our August 22 comment, lower-than-expected federal deficits in recent months raised the prospect that official CBO deficit estimates would be trimmed substantially. This, in turn, would have lowered the amount of spending cuts Congress had to write into its appropriations bills before formulating tax cut legislation. (The budget resolution requires that CBO certify proposed spending cuts as large enough to balance the budget by FY 2002 before tax cut legislation can be written.) However, the CBO saw recent improvements in the budget as cyclical in nature and did not materially reduce its deficit estimates for FY 1998 and beyond. Over the next five years, the aggregate deficit envisioned in the latest CBO baseline is $1.129 billion, only $48 billion less than in the previous baseline.

Revisions to CBO Federal Budget Baseline

Fiscal Year	Old Baseline	New Baseline	Difference
1995	$175	$161	-$14
1996	210	189	-21
1997	230	218	-12
1998	232	229	-3
1999	247	243	-4
2000	258	250	-8
1996-2000	$1,177	$1,129	-$48

EFM

DAILY FINANCIAL MARKET COMMENT 8/23/95 Goldman Sachs Economics Group

Summary

The evidence from past Fed policy actions implies that, barring an unexpectedly swift deceleration in price inflation, real spending and output trends will be key to whether U.S. short-term interest rates fall further over coming months.

Growth and Final Demand Likely To Govern Future Fed Rate Decisions

The Federal Open Market Committee left short-term interest rates unchanged following their meeting on Tuesday, as we had expected. In typically cryptic fashion, the Fed's spokesman simply stated at 2:13 PM that the meeting had ended and no further announcements would be forthcoming. Not until September 29 will the minutes from this meeting be released; in the meantime, financial markets likely will continue to be buffeted by conflicting official commentaries and private analyses regarding the potential for additional rate reductions in coming months.

An issue that has received increased focus over recent weeks is whether a rate cut might be expected to occur purely as a function of favorable inflation data, even if economic growth and final demand return to or above long-term trend rates. This speculation was initially fueled by the language used in Chairman Greenspan's July 6 statement explaining the decision to lower rates at that time:

> `As a result of the monetary tightening initiated in early 1994, inflationary pressures have receded enough to accommodate a modest adjustment in monetary conditions.'

The historical record since 1972, however, suggests that the Fed rarely eases policy more than two years into an economic expansion when final sales growth is relatively firm. For example, note the following:

1. The Fed has reduced rates in 42 separate quarters during the 1972-94 period. Policy was in an easing mode, therefore, a little less than half of that stretch, which comprises 92 quarters. The periods involved are displayed in a table on page 10 of the July/August `Pocket Chartroom'.

2. Only 12 of those easing episodes came more than two years into business expansions (see table below). As that description attaches to 44 of the 92 quarters in question, the frequency of rate cuts declined as the growth cycles grew older. This is a sensible behavior pattern, because in a well-advanced growth environment there is a heightened risk that monetary stimulus could create excessive competition for relatively scarce resources, leading to an inflation pickup.

3. In these late-expansion contexts, there were only 3 quarters during which rates were reduced when final sales growth exceeded 2.7% annualized. Such periods numbered 23 in total during the interval, and rate reductions took place only about one-eighth of those times (two quarters in 1986, when oil prices dropped sharply, and one in early 1988, immediately after the October 1987 stock crash). Thus, the Fed has tended to shy away from credit relaxation even more when sales are moving up at least moderately and growth has been sustained.

Quarters In Which The Fed Has Eased More Than Two Years Into A Business Expansion
(1972-94; annual growth rates)

Quarter	GDP Growth	Final Sales Growth
1973 Q4	3.1%	-0.9%
1977 Q4	-0.8	2.6
1985 Q2	3.2	2.3
1985 Q4	2.3	1.3
1986 Q1	5.4	3.7
1986 Q2	-0.3	2.5
1986 Q3	2.3	5.1
1987 Q4	5.9	1.0
1988 Q1	2.6	6.3
1989 Q2	1.9	2.1
1989 Q3	1.1	2.7
1989 Q4	1.2	0.4

Our latest projections call for final sales to climb 2.8% at an annual rate in this half year, and even more quickly in early 1996. If these estimates prove accurate or too conservative, then based on their past performance Fed officials would probably approach arguments favoring easier monetary conditions with some skepticism.

That said, we continue to believe that another slight (25-basis-point) rate cut cannot be ruled out over the balance of 1995. Were inflationary pressures to diminish sharply, as they did in 1986 when global oil prices plunged, Fed leaders might perceive a stable nominal interest rate strategy as too restrictive. A more accommodative policy strategy could also be undertaken if equity values once again collapsed, as in late 1987. Such events, though, are not in the outlook at present. More realistically, a trimming of rates could take place if final sales unexpectedly lose steam later in the year, or in the event that a fiscally restrictive budget package is enacted this fall.

JMY

DAILY FINANCIAL MARKET COMMENT 8/22/95 Goldman Sachs Economics Group

Summary

The U.S. federal government posted a deficit nearly $12 billion below expectations in July. About $7 billion of this surprise appears transitory; the remaining $5 billion occurred mainly in outlays for Medicare and income security other than Social Security.

These figures continue a pattern of better-than-expected fiscal results that has dominated most of this fiscal year. They probably foreshadow an even larger cut in the Congressional Budget Office (CBO) deficit baseline than officials have so far indicated. This, in turn, should make it easier for Congress to achieve the spending cuts needed to win CBO certification for tax cuts. In this context, Senator Phil Gramm (R-Texas) is apt to highlight his advocacy for a large tax cut in an effort to distinguish himself from Senator Bob Dole, front-runner for the Republican presidential nomination.

A smaller-than-expected July budget deficit ...

The U.S. federal government posted a surprisingly small budget deficit in July. Last month's fiscal shortfall was only $13.6 billion. We had anticipated a deficit nearly $12 billion higher on the basis of daily reports.

About $7 billion of this miss appears transitory, reflecting an unusual surge in `undistributed offsetting receipts.' This category includes primarily interest paid on government securities held by various trust funds and employers' contributions for social insurance. In the first nine months of this fiscal year this offset to other outlays averaged $2.8 billion. In July, it surged to $10.2 billion, $7.0 billion above its year-earlier level.

The other $5 billion reflected lower-than-expected outlays in other areas, where the improvement could prove to be more lasting. In particular, last month's outlays for Medicare and income security (other than Social Security) were especially low -- down 4.6% and 16.0% from year-earlier levels, respectively. Altogether, outlays were down 9.9% between July 1994 and July 1995; adding back in the undistributed offsetting receipts, they were still down 4.0%. Meanwhile, receipts were up 9.3%, about as expected on the basis of the daily reports.

... continues recent trends and strengthens the hands of tax cutters

The July budget figures continue a pattern of better-than-expected fiscal performance that has prevailed throughout most of fiscal 1995. Coming two days before the scheduled release of a budget update by the CBO, the report foreshadows several events of key importance in the approaching endgame of budget negotiations and the jockeying for position in the race for the 1996 Republican presidential nomination.

1. The CBO budget baseline could be reduced considerably. At its last official report on January 5, the CBO estimated the fiscal 1995 budget deficit at $176 billion and the cumulative deficit over the next seven years at $1.54 trillion. Prior to the release of July budget figures, CBO officials had already indicated that the final result for fiscal 1995 would be closer to $160 billion. Now this figure looks too high. The July figures point to an outturn between $150 billion and $160, depending on how much of the July surprise sticks. If the $21 billion difference between the midpoint of this range and the FY1995 deficit estimate produced in January is taken as a rough measure of the unexpected underlying improvement in federal finances, the cumulative deficit over the 1996-2002 period could be reduced by nearly 10%.

2. This will make it easier for Congress to achieve the spending cuts needed to reduce taxes. In the 1995 budget resolution, the House and Senate agreed to $245 billion in unspecified tax reductions over the FY1996-FY2002 period. Before these tax cuts are formulated, however, the CBO must certify that spending cuts already passed by Congress would achieve budget balance by FY2002. This will obviously be easier to achieve if the deficit baseline is reduced.

3. Conflict is therefore likely to erupt between moderate and conservative Congressional Republicans -- in particular between presidential hopefuls Bob Dole and Phil Gramm. The certification process was the Senate's price for agreeing to tax cuts that most Senators, including many moderate Republicans in that chamber, felt the country could not afford at this time. Any significant reduction in the CBO's deficit estimates plays into the hands of the conservative Republicans who dominate the House and into the hands of one Republican Senator in particular -- Senator Phil Gramm of Texas. Until this past weekend, his campaign for president had been flagging badly, and a concerted last-ditch effort to distinguish himself from front-runner Sen. Bob Dole of Kansas seemed imminent. Sen. Gramm's surprising tie with Sen. Dole in the Iowa straw poll this past weekend, while of no significance in selecting delegates to the 1996 convention, has given the Texas Republican's campaign a psychological shot in the arm. With the deficit coming down faster than generally expected, he is now likely to be more vocal in reminding voters and other members of Congress of his long-standing support for the more aggressive $350 billion in tax cuts originally proposed by the House of Representatives in its initial budget resolution.

EFM

<u>GOLDMAN SACHS WEEKLY ECONOMIC UPDATE 8/21/95</u> <u>EMcKelvey,JYoungdahl</u>

Summary

- The chance of an upside surprise in U.S. economic growth later this year is building. An upward revision is still not warranted, but demand indicators will continue to be critical in assessing just how much hot weather boosted activity this summer.
- No change in short-term interest rates is likely at this week's Federal Open Market Committee (FOMC) meeting, and policymakers' apparent inclinations toward a neutral intermeeting directive suggest that rates will stay stable over the balance of this quarter.

The Economy

Two key production indicators -- industrial production and housing -- were both higher than expected in July, suggesting that these sectors will resume contributing to U.S. economic growth in the not-too-distant future. In addition, inventories appear to be accumulating at a slower pace than previously thought. Upside risks to growth are therefore building, although an upward revision is premature in light of the strong positive influence of hot weather on output this quarter.

1. The latest report on industrial production showed a bit more firming than we had anticipated. Revisions boosted output levels in June slightly, and figures for July were better than expected -- up 0.1% overall and down only 0.2% in the factory sector. Over the past three months, manufacturing output has been unchanged on balance outside the auto sector, indicating that the inventory correction is largely over. This is consistent with the latest inventory figures, which showed only a 0.2% increase in the book value of stocks in June.

2. Housing starts also rebounded more than expected. Starts of new units rose 6.7% in July, and the base was revised up 2.4%. This is the first solid indication that improvement in home sales has begun to generate a response in home building.

3. The better-than-expected news was not quite good enough to warrant an upward revision to third-quarter growth. As noted in last week's update, our expectation of a 1.7% annualized increase in real GDP this quarter assumes no significant growth contribution from either the industrial sector or the construction sector. These assumptions still appear valid. Manufacturing output in July, while higher than expected, was 0.3% below its second-quarter average. Gains of this magnitude must therefore occur in August and September to make the sector a wash for the quarter as a whole. Meanwhile, the upturn in housing starts has yet to translate into an upturn in real outlays.

4. But real GDP may rise faster than now expected in the fourth quarter. Our current estimate is for a 2.6% annualized increase, with nonfarm output rising at nearly a 3% annual rate. It now appears, however, that real inventories are rising at only a 1% annual rate in the third quarter. U.S. manufacturers may therefore find that large production increases are needed to keep up with growth in demand.

5. Demand indicators will be critical in coming months. Whether the economy grows more than now expected in the fourth quarter depends on just how important hot weather has been as a transitory boost to economic activity this summer. The magnitude of this contribution can only be gauged by how well the current strong trend in demand growth holds up as the influence of hot weather fades. Thus, figures on retail sales, auto sales, total consumer spending, and factory orders will be the main focal points of our assessments of economic growth in coming months.

Monetary and Fiscal Policy

Not only is the Federal Open Market Committee likely to maintain present monetary policies following their meeting on Tuesday, but attitudes toward the direction of possible future interest rate changes will probably be finely balanced in the near term. We continue to expect, therefore, that the federal funds rate target will be kept at 5-3/4% into the fall. Officials who previously had betrayed a clear bias toward easing now are expressing comfort with the state of economic and financial affairs. Some other central bankers who were slow to embrace the notion of an early-summer rate cut may now fear that move was a misstep, in light of data revisions suggesting firmer final demand and production conditions late last quarter than were recorded initially, as well as the sizable rise in U.S. bond yields over the last six weeks. Surging broad monetary aggregates -- M3 is up 10% annualized over the past three months -- provide yet another deterrent to thoughts of an easier credit stance.

There remains the potential for a major budget deficit reduction agreement later this year, an event that could foster sentiment at the Fed for lower rates to offset a fiscal policy drag on business activity. It is premature, however, to judge the outcome of the political process with respect to tax and spending decisions, and Chairman Greenspan will no doubt want to avoid policy steps that might deter lawmakers and the president from reaching agreement on a relatively restrictive budget plan. In the meantime, July budget results (Monday, 2:00) should be pleasing to all, since the deficit appears to have fallen from $33.2 billion a year ago to $25.5 billion.

Upcoming Releases and Events

Date	Indicator/Event	Data For	Estimate	Last Report
8/21	Federal Budget Balance	Jul	-$25.5 bn.	-$33.2 bn. (year ago)
8/22	Federal Open Market Committee Meeting			
8/24	Durable Goods Orders	Jul	+1.4%	-0.3%
8/25	Existing Home Sales	Jul	Flat	+6.5%
	July 5-6 FOMC Meeting Minutes			

GOLDMAN SACHS U.S. BOND MARKET TELEX

August 18, 1995

1. ECONOMIC AND MARKET OVERVIEW

Data that reinforce the probability of a U.S. economic growth rebound have kept bond yields on a rising path, especially in the short-duration sector. Information suggesting a solid recovery in aggregate demand has been present for some time, and now it appears that production has begun to turn up as well. Admittedly, the 0.1% rise in total industry output last month was merely a reflection of sharply higher utility usage amid scorching heat in much of the nation. It is a hopeful sign, however, that manufacturing production other than motor vehicles held steady last month and over the past three months on balance. This is consistent with the large rise in the national purchasing managers' index, and casts additional doubt on the reliability of the July factory payroll figures, which indicated steep further declines in employees and hours worked. With business inventory accumulation much slower now than earlier in the year (0.2% for June, versus 0.9% on average in the prior five months), manufacturers will likely be much more inclined to increase activity if sales gains persist, as is probable in view of relatively optimistic consumer attitudes. Preliminary August surveys by University of Michigan researchers gave the firmest overall sentiment readings since January, with especially favorable assessments of current finances and buying conditions. Homebuilders are already responding to stronger sales and leaner inventories. Starts of new dwellings rose 6.7% in July, from a base level that was lifted 2.4% on revision. The updated figures show four consecutive monthly increases in starts cumulating to 11.5%, pointing toward a resumption of residential investment spending growth by the fourth quarter.

Trade balance improvement remained absent through June, as softness in exports (-1.2) caused the goods and services deficit to widen slightly, from $11.0 billion to $11.3 billion. Poor business conditions in Mexico and Canada can be blamed in large measure for this disappointing trade performance, but it also reflects the relative strength of capital spending domestically versus abroad. Imports of capital equipment other than vehicles were up 22.2% on a year-to-year basis last quarter, whereas exports of the same items have risen 13.2%.

TREASURY YIELD INDICATIONS
(Semi-annual yields, late morning)

	2-yr.	3-yr.	5-yr.	10-yr.	30-yr.
8/18/95	6.11	6.23	6.37	6.57	6.91
8/11/95	5.98	6.11	6.28	6.52	6.89
8/04/95	5.90	6.03	6.20	6.49	6.91

2. FEDERAL RESERVE POLICY

It is increasingly clear that the sudden loss of economic momentum in the year's first half was not precipitated by overly-tight monetary policies. Revisions to retail outlays imply that total real personal spending advanced 3% or more at an annual rate in the April-June quarter, an impressive result in view of the negative tax shock sustained by many households during that interval. New single-family home sales are estimated to have risen 3.1% in the spring of 1995 from a year earlier, and home starts have been climbing steadily since March. Broad monetary growth accelerated dramatically in the past half-year, with the M3 measure advancing at a double-digit annual pace over the past few months. Banks are unusually well capitalized, and loan officers are by all accounts aggressively seeking to expand their portfolios. Financial market signals of general credit availability -- such as equity values and yield differentials between corporate issues of varying credit quality -- have been and remain positive. In short, there would seem to be little or no fundamental justification for additional monetary accommodation at this point and, consequently, no Fed policy adjustments should be anticipated anytime soon.

3. FISCAL AND POLITICAL DEVELOPMENTS

There have been two major developments that have further clouded President Clinton's re-election prospects. Senator Bill Bradley, a leader of the centrist Democrats in Congress, has announced a decision not to defend his seat with a view toward possibly mounting or backing an independent candidacy for president in 1996. Even if he ultimately chooses not to make a challenge himself, Bradley's statements are the first clear indication that senior party leaders are losing patience with the president and are beginning to consider other alternatives. This unhappiness no doubt partly reflects a loss of confidence that control over Congress can be wrested back from the Republicans next year. Including Bradley, there are already six incumbent senate Democrats who will be leaving, and two others are rumored to have similar intentions. That makes it highly unlikely that the party can achieve the net gain of seven seats needed to regain majority status.

Meanwhile, the investigation into possible wrongdoing in Arkansas government and financial circles has grown more serious, as multiple fraud indictments were handed up this week by a grand jury against the sitting state governor and the Clintons' two former partners in Whitewater Development Corporation. Though none of the charges are directly related to that venture, several appear to rest upon the accusations of a former municipal judge, who is said to have alleged that then-governor Clinton pressured him to make a fraudulent loan with federally-backed funds in the mid-1980s. The fact that Special Counsel Kenneth Starr has undertaken high-profile prosecutions of numerous state figures, including the governor, in at least partial reliance on that person's testimony raises a question as to whether Starr and the grand jury consider him to be a generally reliable witness.

4. MARKET OUTLOOK AND COMMENTS ON VALUE

A further increase in bond yields of all maturities should be anticipated between now and quarter-end. Stronger economic activity has significantly diminished the potential for lower short-term interest rates, and expectations of swift action to reduce federal budget deficits are subject to at least temporary disappointment. The Treasury yield curve remains prone to steepening as the bond market weakens, because domestic investors will probably move toward more neutral or cautious portfolio durations, and it is doubtful they will come to fear an immediate monetary tightening.

5. UPCOMING ECONOMIC RELEASES

Date	Indicator	Data For	Estimate	Last
8/21	Federal Budget Balance	July	-$25.5B	-$33.2B (yr. ago)
8/22	Federal Open Market Committee Meeting			
8/24	Durable Goods Orders	July	+1.4%	-0.3%
8/25	Existing Home Sales	July	Flat	+6.5%
8/25	July 5-6 FOMC Meeting Minutes			

Regards,
John M. Youngdahl
GOLDMAN, SACHS AND CO.

DAILY FINANCIAL MARKET COMMENT 8/18/95 Goldman Sachs Economics Group

Summary

- Upcoming revisions to real GDP are not likely to change its 0.5% annualized growth rate for the second quarter by much, but upward revisions to most components of real domestic final sales should push the growth rate of this broad demand aggregate to nearly 3%.

- The implied slower rate of inventory accumulation last quarter, coupled with ongoing growth in demand this summer, implies that the real stock of inventories is now rising at only about a 1% annual rate.

- The risk of a stronger-than-expected increase in real GDP next quarter is therefore rising. At this stage, an upward revision of our 2.6% estimate would be premature, given the large positive influence of hot weather on demand and utility output, but sales trends bear close watching as the weather effect fades.

Final Sales Should Look Stronger in Q2 GDP Revision ...

The sag in U.S. economic growth that buoyed financial markets this past spring and precipitated a slight easing in monetary policy in July looks less and less dramatic with each new data release. Although these reports do not call into question the Commerce Department's initial estimate that real GDP rose only 0.5% at an annual rate in the second quarter, the composition of the slowdown now appears to be even more heavily weighted toward a reduction in inventory building than was first estimated. Based on our calculations, we anticipate revisions to real GDP (due August 30) to show little change in overall growth but upward revisions, averaging 0.4 percentage points, to most components of domestic final sales, as shown in the table below. If these estimates are close to the mark, the second quarter figures will feature the following:

1. Nearly 3% annualized growth in real consumer spending. The figure now on record is already a respectable 2.5% -- remarkable for a quarter in which consumers faced unexpected tax payments and retailers sang the blues. Upward revisions to retail sales for May and June imply a 2.9% increase unless offset by downward adjustments in the service sector.

2. Solid double-digit growth in real business fixed investment. Both the structures and equipment components are due for modest upward revision from already firm readings, judging from the latest data on private nonresidential construction and shipments of capital goods. We look for the 11.8% annualized increase now on record to rise to 12.3%. The revision could even be larger judging from the ongoing strength in imports of capital goods.

3. Less damage to housing than previously reported. In its initial report, the Commerce Department estimated that residential investment fell at a 14.2% annual rate. Preliminary figures for residential construction outlays in June, coupled with an upward revision to housing starts, suggest that this decline was about 1 percentage point less steep.

4. Real final sales growing at the 2.5% long-term trend, with final sales to domestic purchasers rising even faster. In the preliminary report, most analysts were struck by the fact that real final sales did not rise all that slowly -- 2.1% at an annual rate overall and 2.5% excluding transactions with other nations. It now appears, however, that the Commerce Department understated these growth rates. Both are likely to be about 0.4 points higher on revision.

5. Slower inventory accumulation. Book-value increases in manufacturers' and wholesale inventories during June were smaller than estimated by the Commerce Department, while the increase in nonauto retail stocks was only trivially larger. The annualized accumulation of real nonfarm inventory, now estimated at $32.9 billion, will probably be revised down by more than $5 billion. This would imply a growth rate of less than 3%.

Estimated Revisions to Components of Real GDP in 1995Q2

	Estimated Revision ($ 87 billion)	Effect on Annualized Growth: Growth As Now Reported	Effect on Annualized Growth: Estimated Revision
Consumer spending	+$3.6	+2.5%	+2.9%
Residential investment	+0.6	-14.2	-13.2
Business investment	+0.9	+11.8	+12.3
State and local spending	+0.7	+1.4	+1.9
Domestic final sales	+$5.8	+2.5%	+2.9%
Exports	-1.4	+7.2	+6.3
Imports	-1.6	+9.	8.6
Trade balance	-0.2	n.m.	n.m.
Final sales	+$6.0	+2.1%	+2.5%
Net change in inventory	-$5.3	n.m.	n.m.
GDP	+$0.7	+0.5%	+0.6%

n.m.=not meaningful.

... Creating An Upside Risk to Current and Future Growth

The more pronounced slowing in inventory accumulation implied by the pattern of expected revisions to second-quarter growth creates an upside risk to U.S. growth in the second half of the year, especially in the fourth quarter. As noted in our latest Weekly Economic Update, it now appears that real final sales are rising at more than a 3% annual rate this quarter. Taken together, the revisions and the continuation of final sales growth imply one of two things: either real GDP is rising faster than the 1.7% annual rate we are estimating for the third quarter, or real inventories are rising at only about a 1% annual rate.

In our judgment, it is more likely that the accumulation rate is low. Although this week's industrial production and housing starts reports for June came in above our expectation, the differences were not large enough to warrant an upward revision to our estimated growth rate.

The same may not be true for the fourth quarter, however. The snail's pace at which inventories now appear to be rising, coupled with purchasing managers' reports of stronger orders, sets the stage for a significant snap-back in industrial output during the remainder of this year. At the same time, real residential construction outlays should turn up as well. Although our forecast anticipates upward moves in both sectors, the risk at this point is that the improvement could turn out to be larger than now expected.

To Judge How Much Growth Will Rebound, Keep A Close Eye on Demand

Retail sales reports and other demand indicators (e.g., auto sales and factory orders) will be critical in determining whether growth in the fourth quarter will be stronger than expected and, if so, how long the growth spurt will last. At this juncture, an upward revision is not appropriate. This is because weather has boosted both retail sales (via sales of air conditioners, seasonal clothing, and other similar items) and production (via heavy electric utility usage). These influences will surely fade in coming months, at which point the underlying trend in demand will be easier to assess. If it is sturdy, as we suspect it is, then businesses may once again find themselves wanting to accumulate inventory, as they did in early 1994 and the U.S. economy could climb onto an above-trend growth track as it heads into 1996.

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DAILY FINANCIAL MARKET COMMENT 8/17/95 Goldman Sachs Economics Group

Summary

It currently appears that U.S. government financing and other operations will not be substantially constrained by the current federal debt limit until October 31 at the earliest. This heightens the potential for the looming inter-branch budget fight to last well into the fourth quarter.

A lengthy delay in resolving fiscal policy uncertainties could deter Federal Reserve officials from changing monetary policy.

Fight Over U.S. Budget Could Last Into November

Our analysis of the U.S. government's prospective debt issuance suggests that the current $4.9 trillion statutory federal debt limit will not become binding until the end of October at the earliest. In the absence of a prior hike in the limit, the timely settlement of regular monthly 2-year and 5-year Treasury notes on October 31 would become imperiled. It appears at this point that those new securities can barely be accommodated under the existing debt cap, however, either by delaying their issuance for a few business days to coincide with a scheduled retirement of nonmarketable securities, or through large paydowns in preceding weekly Treasury bill auctions.

Assuming that the October 31- November 2 period can be cleared, the government should be able to continue operating under the present debt ceiling until November 15, when a huge mid-quarter coupon interest payment falls due. Thus, if the Republican Congress attaches legislation raising the debt limit to a politically controversial budget package, as they are threatening to do, then the November coupon refunding auctions (3- and 10-year notes currently slated for November 7-8) may well have to be postponed, and President Clinton could face a decision between swallowing a budget that he finds distasteful or rejecting it and risking blame for a prolonged disruption of government activities.

The relatively late timing of a potential debt ceiling crisis reinforces the probability that Congress will not complete work on a budget before mid-to-late October, well past the October 1 starting date for the new fiscal year. Since the debt limit is one of the main weapons that senior lawmakers hope to use in the coming fiscal battle with the Clinton Administration, it is unlikely that they would transmit a final budget bill to the president until a borrowing and payments crunch is near at hand. By that reasoning, in fact, it is possible that the fiscal 1996 budget could be held up all the way until November, with federal spending sustained in the interim by temporary authorizations.

Fed Leaders May Shy Away From Policy Changes While Budget Issues Remain Unresolved

Now that the U.S. economy is performing notably better in most respects than it did last quarter, the Fed's flexibility to engage in further monetary easing depends more than ever on the timing and outcome of this year's budget debate. Our forecast calls for a gradual acceleration in real GDP gains between now and early 1996, and therefore, the longer that it takes to settle budget matters, the weaker the arguments for shaving money-market interest rates may become, regardless of whether Congress can achieve its long-term spending reduction goals. Even if economic growth does not continue to gain speed, but merely proceeds at a respectable pace, top central bankers may prefer to keep their policy powder dry while the budget debate is in progress, out of concern that any change in official rates or rhetoric might undermine efforts toward a fiscally restrictive compromise. Consequently, our assessment of the debt limit outlook fits well with a view that the federal funds rate target will be left unchanged at 5-3/4% at least for the balance of this quarter, and quite possibly longer.

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INTERNATIONAL TRADE BALANCE (JUNE)

Key Statistics:

	June	3-Month Average	12-Month Average
Total Trade Balance (billions)	-$11.3	-$11.3	-$10.0
Merchandise Trade Balance	-$16.4	-$16.4	-$15.2
Services Trade Balance	+$5.1	+$5.1	+$5.2

Conclusion:

Improvement less than expected, due to a decline in exports. No major implications for GDP revisions and outlook or for Federal Reserve policy.

Key Points:

(1) The U.S. trade deficit was larger than expected in June, as exports fell 1.2%. Figures for May were revised to show a slightly narrower deficit, with most of that revision on the export side. Thus, although exports in June were somewhat disappointing, the strong upward trend remains solidly intact. For the second quarter, total exports were 13.6% above year-earlier levels; exports of merchandise were up 16.1% over the same period.

(2) Imports continue to remain strong as well. Although they slipped 0.6% in June, imports of goods and services in the second quarter were 15.4% above year earlier levels, with merchandise imports rising at a 16.6% rate. Capital goods continue to pace this increase, suggesting that U.S. businesses are continuing to invest in their operations despite reduced capacity use. In the second quarter, imports of capital goods other than autos were 22.2% above year-earlier levels, with little evidence of abatement in recent months. Imports of industrial supplies and materials have also been quite strong.

Goldman Sachs

Message ID 69286447 submitted 16 Aug 1995 9:44am

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DAILY FINANCIAL MARKET COMMENT 8/16/95 Goldman Sachs Economics Group

Summary

- U.S. homebuilders continue to grow more optimistic about their sales prospects, implying good potential for a rebound in residential construction later this year.
- Official industrial activity measures reinforce the impression of renewed stability in broad factory output. Growth in that sector probably will soon resume, with utilization levels still relatively high.

Builder Optimism Points To Firmer Construction Outlays By Late 1995

The latest monthly survey of U.S. homebuilders reveals a further rise in their assessments of both buyer traffic and sales potential over the next six months. Thirty-eight percent of respondents rate their sales expectations as good, up from 27% just two months ago, and more than double the portion who had favorable attitudes during the first quarter. Poor sales are foreseen by only 10%, the smallest figure in thirteen months. Buyer traffic at housing developments, meanwhile, was said to be high by 21.3% of builders, up from 20.1% a month ago and the most upbeat reading in a year. With the inventory-to-sales ratio for new single-family dwellings materially reduced since the turn of the year, signs of a pickup in construction of these units should soon appear, probably beginning with the July housing starts report on Wednesday morning (+4.5% to 1.32 million annual units expected).

Factory Output Decline Ceases With Utilization Rate Still Relatively High

Production figures from the Federal Reserve confirm our suspicions that factory employment and hours worked data from July substantially overstated the degree of softness in U.S. industrial activity at the outset of this quarter. Within manufacturing, output slipped only 0.2% last month, far less than had been implied by the 85,000 plunge in factory payrolls and 1.2% slashing of production work hours. Moreover, all of this relatively modest production decline occurred among motor vehicle firms; the other 95% of factories had steady production last month, and over the past three months as well. This is consistent with the July purchasing managers' survey, which placed the national production index just above the 50% mark that is said to divide expansion from contraction. Auto and truck assemblies are scheduled to increase moderately between now and the fall, and thus, it appears that growth in overall manufacturing output is likely to resume, perhaps beginning this month.

Utilization rates in most factory industries remain fairly high, meanwhile, implying a risk that capacity strains could reappear if activity were to accelerate sharply. Excluding the transportation group, which includes motor vehicle and aerospace firms, the factory utilization rate during July is estimated at 83.8%, down only 0.6% from the average in 1994 and well above the 1985-94 average (see table). Nearly one-third of all U.S. industry other than utilities (where activity was boosted artificially by hot weather) operated at or above 88% of capacity last month. These circumstances will likely deter Fed officials from lowering short-term interest rates further as long as aggregate demand readings are favorable.

Industry Capacity Utilization Rates

	Total	Manu-facturing	Factories Excluding Transportation
1985-94	81.6%	81.0%	81.5%
1993	81.7	80.9	81.8
1994	84.0	83.4	84.4
1995 H1	84.6	84.0	85.1
July	83.4	82.3	83.8

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ECONOMIC RELEASE COMMENT 8/16/95 Goldman Sachs Economics Group

HOUSING STARTS (JULY)

Key Statistics:

	July	3-Month Trend	12-Month Trend
Housing Starts	+6.7%	+2.8%	-0.4%
Single-Family Housing Starts	+6.8%	+2.9%	-0.9%
Building Permits	+5.3%	+2.6%	0.0%

Conclusion:

Sharp rise in new housing construction combined with upward revisions to prior months' data underscores likelihood of a positive residential construction spending path by the fourth quarter.

Key Points:

1) Data were stronger than expected, as total starts increased 6.7% last month, and the base level was revised up 2.4%. This is the first indication that the production side of the residential construction market is rebounding in response to reduced inventory and increases in home sales.

2) Nearly all of the pickup in starts over the past two months has been in the high value-added single-family sector. At 1.1 million annual units, the current pace of single-family construction is actually slightly below what would normally be consistent with the 700,000 or greater average home sales rate of the past two months. Thus, further gains of at least moderate dimensions can be expected in coming months.

3) This evidence of improvement in the most credit-sensitive area of the economy will make Federal Reserve officials even more confident that the existing level of short-term interest rates is not too high.

Goldman Sachs

ssage ID 69284918 submitted 15 Aug 1995 11:20am

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DAILY FINANCIAL MARKET COMMENT 8/15/95 Goldman Sachs Economics Group

Summary

- Business inventory and sales figures through June point toward an early resumption of growth in domestic goods production. Whatever decline took place in factory output last month, therefore, should prove short-lived.

Inventory Statistics Suggest Production Adjustments Largely Completed

Judging from the latest official inventory and sales reports, it would appear that U.S. goods-producing firms are in a position to resume at least moderate output increases over the remainder of 1995. Total stockpiles of goods at manufacturers, wholesalers, and retailers rose only 0.2% during June, or $1.9 billion. That compares with an average 0.9% ($8 billion) increase over the prior five months, and it is the smallest change in stock levels since March 1994. Inventory-to-sales ratios declined across all three main business groups, especially among motor vehicle dealers, who clearly have been experiencing an overhang of unwanted supplies (see table below).

Inventory-To-Sales Ratios, By Business Type

	Manu-facturing	Wholesale	Retail	Retail Vehicle Dealers
1993	1.47	1.31	1.51	1.76
1994	1.37	1.30	1.50	1.66
1995 Q1	1.34	1.31	1.53	1.78
1995 Q2	1.37	1.33	1.54	1.80
Apr 95	1.374	1.34	1.55	1.84
Jun 95	1.369	1.33	1.53	1.75

These data corroborate the findings of the Federal Reserve district banks in their latest anecdotal surveys that inventories are generally at acceptable levels. Moreover, they suggest that a likely 0.4%-0.5% decline in manufacturing output last month (to be reported on Tuesday morning) was the completion of an adjustment process, rather than the beginning of a more severe downswing in that sector. With retail sales estimated to have been roughly unchanged overall during July, and up 0.4% excluding vehicles, whatever further production cuts may have taken place would likely have pared inventory growth even further, possibly even triggering an outright liquidation. It is doubtful that such an adjustment would be fully desired by U.S. firms and, therefore, domestic goods production should soon assume a more positive course. Indeed, the results from the July survey of purchasing managers nationwide hints that this restoration of industrial sector growth may already be occurring.

JMY

ECONOMIC RELEASE COMMENT 8/15/95 **Goldman Sachs Economics Group**

INDUSTRIAL PRODUCTION AND CAPACITY UTILIZATION (JULY)

Key Statistics:

	July	3-Month Trend	12-Month Trend
Industrial Production	+0.1%	+0.1%	+0.2%
Annual Rate	+1.2%	+0.7%	+2.8%
Manufacturing Production	-0.2%	-0.1%	+0.2%
Annual Rate	-2.4%	-1.6%	+2.5%
Capacity Utilization	83.4%	83.6%	84.5%

Conclusion:

Stronger than expected performance in manufacturing, consistent with other evidence that inventory cycle is virtually over.

Key Points:

1) Output in the manufacturing sector did not decline as sharply in July as had been suggested by the employment figures released 11 days ago. Outside the motor vehicle industry, manufacturing output was unchanged in July. Revisions to prior months added slightly on balance to the level of output in June.

2) The better-than-expected nature of this report is evident in the fact that utilization slipped only 0.2 percentage points. At 83.4% overall and 82.3% in manufacturing, utilization rates for July are about 2 percentage points below year-end levels but still comparatively high in historical terms.

3) This report strengthens our conviction that Federal Reserve officials will not change monetary policy this quarter.

CONSUMER PRICE INDEX (JULY)

Key Statistics:

	July	3-Month Trend	12-Month Trend
Total	+0.2%	+0.2%	+0.2%
Annual rate	+2.4%	+2.4%	+2.8%
Excluding Food and Energy	+0.2%	+0.2%	+0.2%
Annual rate	+3.0%	+2.5%	+3.0%

Conclusion:

No change indicated in retail price inflation.

Key Points:

(1) The 0.2% increases in total consumer prices and quotes excluding food and energy last month were unsurprising. Annualized underlying CPI inflation so far this year has been 3.5%, slightly above the central tendency of Federal Reserve officials' forecasts (3-1/8% to 3-3/8%).

(2) Central bankers should regard this news as consistent with their judgment that price pressures have stabilized, and there is nothing in the report to contradict their outlook for a gradual rollback of the modest first-half inflation pickup. Consequently, the data should have little or no impact on their near-term policy assessments.

RETAIL SALES (JULY)

Key Statistics:

	July	3-Month Trend	12-Month Trend
Total	-0.1%	+0.6%	+0.5%
Annual rate	-1.3%	+7.4%	+6.2%
Excluding Motor Vehicles	+0.4%	+0.5%	+0.4%
Annual rate	+4.7%	+6.7%	+4.8%

Conclusion:

Sizeable upward revisions to non-auto sales imply a stronger underlying trend for overall personal consumption spending. Data weigh for steady Fed policy through quarter-end.

Key Points:

(1) The 0.1% dip in total retail sales during July was in line with our expectations, and reflects the weakness in unit vehicle deliveries. In the nonauto group, however, sales rose by 0.4%, implying a solid further advance in the volume of these purchases.

(2) More importantly, there were material upward revisions to retail sales results from May and June, totalling 0.3% overall and 0.5% outside of autos and building materials. The latter measure -- upon which Department of Commerce officials will focus in computing nonauto retail goods demand -- is rising at a 5.5%-6.0% nominal rate so far in the third quarter. This suggests a 4.0% or greater real spending growth pace for such items, somewhat above our forecasts.

(3) With personal outlays on a much firmer path than before, Federal Reserve policy makers are likely to prefer stability in short-term interest rates for at least the balance of this quarter.

DAILY FINANCIAL MARKET COMMENT 8/11/95 Goldman Sachs Economics Group

Summary

- The employment of simple arithmetic averages over many decades to develop a judgment concerning the proper "real", or inflation-adjusted, federal funds rate is very questionable without further considering several other factors, including the business cycle context and the status of the federal budget. When these and other influences are weighed, it is far from clear that the present fed funds rate reflects an especially restrictive U.S. monetary policy.

"Real" Federal Funds Rate Tends To Be High Late In Expansions and Amid High Budget Deficits

There has been much discussion of late concerning what level of the inflation-adjusted, or "real", federal funds rate is appropriate in the current economic environment. It has been asserted by some analysts that the present differential between the federal funds rate target (5.75%) and the 12-month trailing change in the consumer price index (3.0%, pending an update on Friday morning) is too high to permit a resumption of moderate U.S. real GDP growth. In support of these arguments, it has been regularly noted that the difference between the fed funds rate and inflation measured on this basis has averaged about 1-3/4% over the past several decades, approximately 1% less than the current level.

One problem with this sort of analysis is that it does not adequately take into account the wide variety of economic conditions and fiscal policies that have existed over a forty-year span, and the importance that these developments can have in determining the appropriate level of money-market interest rates. While it is true that the federal funds rate less consumer price inflation has averaged 1.8% since the mid-1950s, during recession periods over that interval the mean differential has been 1.32% (see table below). During economic expansions, by contrast, the real funds rate has averaged slightly over 2%. Moreover, upward pressure on this measure has tended to increase as expansions have matured. In the second half of the past seven upswings, the average real federal funds rate has been just shy of 2.2%. Given that the current growth phase is 4-1/2 years old, and economic expansions longer than nine years in duration are extremely rare, it is probably safe to assume that this late-cycle average is applicable to present circumstances.

Average "Real" Federal Funds Rates, August 1954-date
(Federal funds less 12-month trailing change in consumer prices)

All months	1.84%
During recessions	1.32
During business expansions	2.04
In second half of expansions	2.17

Additionally, it is important that the appropriateness of monetary policies at any specific time be judged in the context of the government's coincident fiscal stance, since the federal budget balance has an impact on aggregate funding demands both directly, in the form of Treasury borrowing, and indirectly, through its impact on private sector activities. The following table shows that, focusing only on periods of late-cycle expansion, there has been some historical correlation between the average level of the inflation-adjusted federal funds rate and the budget deficit as a percent of nominal GDP:

Federal Deficit As Percent of GDP Versus
"Real" Federal Funds Rate
(Second half of expansion periods, 1955-)

Period	Average "Real" Funds Rate	Budget Balance As Pct. Of GDP
2/1956- 8/1957	0.50%	+0.9%
5/1959- 4/1960	2.51	-1.3
8/1965- 12/1969	1.98	-1.0
6/1972- 11/1973	2.27	-0.8
9/1977- 1/1980	0.10	-2.4
2/1981- 7/1981	6.77	-2.7
10/1986- 7/1990	3.67	-3.4
Low deficit periods (1956-1973)	1.82	-0.8
High deficit periods (1977-1990)	2.62	-3.1

Thus, when the frame of reference is narrowed further, from all late-cycle expansion periods to those with large federal budget imbalances, the tendency for the real federal funds rate to exceed the forty-year arithmetic average becomes even more pronounced.

Official estimates of the federal deficit as a percent of GDP for the present fiscal year are at 2.3%, and roughly the same level for fiscal 1996. With that in mind, it could be argued that the inclusion of data from the 1950s, 1960s, and early 1970s in arithmetic averages for the purpose of gauging a proper real federal funds rate levels in the context of large federal budget deficits risks creating artificial downside biases to the conclusions.

There are any number of other factors that probably deserve inclusion in a thorough analysis of sustainable real interest rates, such as: the status of government policies in other major industrial nations, the central bank's strategy for monetary policy implementation, the domestic private sector savings rate, the presence or absence of regulatory ceilings on interest rates paid by depository institutions, and the liquidity or illiquidity of key financial intermediaries. The purpose of this comment has not been to try and identify a precise equilibrium level for the real federal funds rate at this time, but rather to provide a caution that more than a simple arithmetic historical average is needed to make this sort of judgment.

JMY

GOLDMAN SACHS U.S. BOND MARKET TELEX

August 11, 1995

1. ECONOMIC AND MARKET OVERVIEW

Despite benign inflation data from July, U.S. bond yields have drifted up further, and are testing the upper bounds of their ranges so far this quarter. Treasury coupon issue sales totalling $42.5 billion did not attract the volume of demand from overseas that had been hoped for, perhaps because the dollar exchange rate was well above recent averages at the time of the auctions. Producer and consumer price index results were in line with analysts' optimistic expectations, coming in unchanged and up 0.2%, respectively. Excluding the food and energy components, prices climbed 0.2% at both the producer and consumer levels, in line with their prior trends. Intermediate producer goods quotes, meanwhile, rose 0.3% excluding food and energy, confirming a diminution of price strength at early stages of processing.

On a more cautionary note for fixed-income investors, there is growing evidence that the economy is gaining speed. The 0.1% dip in total retail sales during July occurred entirely in the motor vehicle group, where deliveries had already been reported as weak. Retail purchases excluding vehicles and building materials -- the best indicator of nonauto goods consumption -- were 0.4% higher, and upward revisions to that subset totalled 0.5%. Combined with a virtually flat consumer price trend for goods, these sales figures suggest that personal outlays for all goods are rising 4% or more at an annual rate so far in the third period. That would be a sharp acceleration from the 0.7% annual growth rate in consumer spending on goods over the year's first half. It also appears that the pace of layoffs has abated since spring. Initial unemployment insurance claims over the past two weeks have averaged only 328,000, down from 377,000 per week during June. This augurs for a resumption of at least moderate monthly payroll employment gains, possibly as soon as the August labor market report.

TREASURY YIELD INDICATIONS
(Semi-annual yields, late morning)

	2-yr	3-yr	5-yr	10-yr	30-yr
8/11/95	5.98	6.11	6.28	6.52	6.89
8/04/95	5.90	6.03	6.20	6.49	6.91
7/28/95	5.89	6.03	6.19	6.45	6.89

2. FEDERAL RESERVE POLICY

In contrast with the situation just a few weeks ago, Fed officials can now hold some confidence in their projection of a reacceleration in real GDP, and consequently, their policy attitudes are probably very close to neutral. Reports on consumption, consumer sentiment, hours worked, and earnings all look much firmer now than they did in early July, and net hiring seems to have improved as well. Without a prod from poor business activity, senior central bankers are much more likely to pursue a stable interest rate strategy, even though inflation appears rather tame.

Policy makers also cannot be insensitive to the signals being given by other indicators of their monetary stance, most of which are not presently reflecting restraint. Broad monetary growth is very strong -- on a smoothed basis, over the last eight weeks M2 has risen almost 9% at an annual rate, and M3 has surged 10.5%. Equity prices are close to all-time highs, meanwhile, and yield spreads among corporate debt securities of differing credit quality are remarkably narrow. By all accounts, domestic depository institutions are flush with liquidity and aggressively pursuing new lending opportunities; in the latest Fed surveys, for example, two districts reported fierce competition among lenders on price and credit terms. With this background, those officials who earlier were agitating for a rate cut will probably fall silent, and some in the financial community may raise questions about the propriety of the July easing. In this environment, comments by Fed officials that imply room for additional rate cuts actually may become unhelpful to the bond market's tone, by undermining the central bank's anti-inflation credibility.

3. FISCAL AND POLITICAL DEVELOPMENTS

Over the next four to six weeks, optimism about the probability of a dramatic budget deficit reduction package can be expected to decline. The congressional summer recess begins this weekend, and most lawmakers will not return to Washington until early September. There are straws in the wind, however, that suggest it will take heroic efforts by the leadership this fall to keep rank-and-file Republicans in line toward fulfilling their pledge to swiftly eliminate the federal budget deficit. Top Clinton administration representatives are threatening a flurry of spending bill vetos unless the final product differs materially with the measures passed by the House, and Speaker Gingrich will have great difficulty assembling enough support among Democrats to gain the two-thirds legislative majorities needed to override such rejections. The biggest battle looms over Medicare, the federal medical services entitlement program for the aged and disabled. Congressional Budget Office bean counters are unlikely to score the budget as having achieved balance by early next decade unless there are major changes in the rules governing Medicare expenditures. Achieving those modifications will require very tough votes, however, amid loud opposition to more than minor tinkering from senior citizens' groups and the White House. Risks are high that, temporarily at least, the budget process will devolve into acrimony and partisan finger-pointing.

4. MARKET OUTLOOK AND COMMENTS ON VALUE

Disappointment regarding both the federal fiscal and monetary policy outlooks will keep U.S. bond yields under upward pressure in the near term. As analysts begin to revise up their projections for second-half economic growth, perceptions of the equilibrium short-term interest rate level will likely rise, a development for which the investor community is quite unprepared. It should no longer be presumed that the Treasury yield curve will flatten in a poor market context. Large money managers have mostly jettisoned their defensive portfolio structures, and therefore, they will have a motive to reduce duration if the market moves in an adverse fashion. Moreover, unfavorable budget news should weigh most heavily on the long-term bond sector.

5. UPCOMING ECONOMIC RELEASES

Date	Indicator	Data For	Estimate	Last
8/14	Business Inventories	June	+0.2%	+0.4%
8/15	Industrial Production	July	-0.3%	+0.1%
8/15	Capacity Utilization	July	83.1%	83.5%
8/16	Housing Starts	July	+4.5%	-0.1%
8/17	Intl. Trade Balance	June	-$10.5B	-$11.4B

Regards,
John M. Youngdahl
GOLDMAN, SACHS AND CO.

Goldman Sachs

Message ID 69280164 submitted 10 Aug 1995 9:51am

To: Gene Sperling
White House

From: G.S. Economic Research
Goldman, Sachs & Co.
Economic Research
85 Broad Street
New York, NY 10004

ECONOMIC RELEASE COMMENT **8/10/95** **Goldman Sachs Economics Group**

PRODUCER PRICE INDEX (JULY)

Key Statistics:

	July	3-Month Trend	12-Month Trend
Total	0.0%	0.0%	+0.2%
Annual rate	0.0%	-0.4%	+1.8%
Excluding Food and Energy	+0.2%	+0.2%	+0.2%
Annual rate	+2.5%	+2.8%	+2.1%
Intermediate Goods and Materials			
Excl. Food and Energy	+0.3%	+0.2%	+0.6%
Annual rate	+3.6%	+2.8%	+7.4%

Conclusion:

Data indicate that finished goods producer inflation has not abated, though pressures at early processing stages clearly have diminished.

Key Points:

(1) The flat overall reading for producer prices last month was a product of sharply lower energy quotes (-2.5%). In the core group excluding food and energy, prices for finished products advanced 0.2%, essentially in line with the 2.9% annualized first-half pace, but still firmer than the 1.6% rise in 1994.

(2) Intermediate materials prices advanced 0.3%, significantly less than the 0.8% monthly average earlier this year. This reflects the loss of momentum in factory output during the late winter and spring. Unfinished goods prices, though, are still rising faster on average than they were in 1993 and early 1994.

(3) These figures were generally unsurprising, and should provide little basis for changes in Fed policy thinking.

Summary

- Comments made on Wednesday by a centrist Federal Reserve governor are consistent with our belief that U.S. monetary policy will be held steady for the balance of this quarter, and possibly longer.
- Anecdotal reports on business conditions summarized in the Fed's latest regional surveys indicate that shortages of workers are being experienced in a majority of districts, and manufacturing input price gains have become more widespread.

Fed Governor Kelley Makes Case For A Steady Hand On Interest Rates

In a news service interview, Federal Reserve Governor Edward Kelley --generally a centrist in his voting pattern -- gave further support to our belief that there is virtually no possibility of a Fed monetary easing at the August 22 Federal Open Market Committee meeting, and little probability that short-term U.S. interest rates will be officially reduced over the balance of this quarter. Kelley took strong issue with the suggestion, made by some analysts, that Fed policy never is adjusted only slightly in any direction:

"Someone here looked back in the record and determined that this notion, which seems to be abroad in the land, is not even historically correct; there have been such reversals after one move in a certain direction. Be that as it may, that is not going to be part of any decision-making process at any FOMC meeting."

The Fed governor went on to say he believes the process of correcting for inventory imbalances is mostly complete, and that he expects personal consumption growth to be sustained in the months ahead. Together with the statements by Vice Chairman Blinder last week, when he expressed a desire to wait until at least early September before reaching a conclusion on whether additional easing might be needed, the interview with Kelley strongly suggests that majority sentiment at the Fed right now favors patience over policy change. If final demand indicators stay positive, therefore, short-term rates could be held steady for some time.

Fed Surveys Show Labor Shortages, Input Price Gains

For the most part, the results of the latest Fed district bank surveys were consistent with statistical reports in showing better housing demand, sluggish to moderate retail consumption, and mixed patterns in manufacturing activity. It is of some interest, however, that a majority of regions report shortages of both skilled and unskilled workers, and the number that are experiencing advances in factory input prices has expanded since the last set of these polls. These observations may make some senior central bankers uncomfortable about the potential for inflationary pressures to grow in the event that broad economic growth returns to or above long-term trends before long. This is another reason to doubt that rate cuts will be given serious consideration in the near term.

JMY

x x x Goldman, Sachs & Co. -- Research Portable Lite FAX x x x

To: GENE SPERLING

From: Melisse Dornier -- tel: (212)902-6807

Re: Investment Research ideas

... Misc. Economic Comment
... Daily Financial Market Comment

Date: 4-Aug-95 09:58

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MISC. ECONOMIC COMMENT

x x Employment data consistent with Q3 growth pickup x x

Economics Group (212) 902-3393 - New York Economic Research

=============== Note 9:05am 8/04/95 ===============

THE EMPLOYMENT REPORT (JULY)

Key Statistics:

	July	3-Month Average	12-Month Average
Non-Farm Payrolls	+55,000	+81,000	+199,000
Aggregate Hours Worked	+0.5%	+0.1%	+0.2%
Annual Rate	+5.6%	+0.6%	+2.4%
Civilian Unemployment Rate	5.7%	5.7%	5.6%
Average Hourly Earnings	+0.6%	+0.3%	+0.3%
Annual Rate	+7.6%	+3.2%	+3.2%

Conclusion:

A stronger report than implied by smaller-than-expected July payroll increase. Sharp decline in manufacturing employment should be discounted in light of latest NAPM survey. Wages now show clear pattern of acceleration. Fed unlikely to ease anytime this quarter.

Key Points:

(1) Nonfarm payrolls in July were 74,000 higher than the level reported initially for June -- 55,000 for July itself and 19,000 more on revision. This was in line with our expectations but below Street expectations (+125,000).

(2) The composition of payroll gains was skewed heavily toward the service sector. Manufacturing payrolls plunged 85,000; while most industries reported declines, auto plant shutdowns and layoffs in the textile industry were particularly important. The manufacturing work week also slipped 0.2 hour, to 41.3 hours. Meanwhile, private service-sector employment rose 146,000, with retail trade up 54,000. The weakness in manufacturing should be discounted in light of the July NAPM

survey, which indicated a rebound in orders and production.

(3) Hours worked rose 0.5% in July, reflecting a 0.1-hour increase in the private nonfarm work week as well as the overall payroll increase. The index of hours worked in July stood 0.7% above its second-quarter level, implying a 2.8% annualized increase this quarter if hours are unchanged on balance in August and September. This supports our expectation that real GDP will rise at a 1.7% annual rate in the third quarter, if not somewhat faster.

(4) Hourly earnings jumped 0.6% in July, following a 0.4% increase in June. All of the trend calculations in this measure of wages now show increases above 3% at an annual rate -- 3.2%, 3.6%, and 3.2% on a 3-, 6-, and 12-month basis respectively. While inferior to the employment cost index as a measure of wages, average hourly earnings tend to lead changes in the ECI.

(5) The 0.1 point increase in the unemployment rate reflects a long overdue increase in the labor force and should not be taken as a sign of weakening in the labor market. Employment as measured by the household survey that generates the unemployment rate was up 474,000.

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DAILY FINANCIAL MARKET COMMENT

x x S&P vs. NIPA profits -- the divergence persists x x

Edward F. McKelvey (212) 902-3393 - New York Economic Research

=============== Note 5:53pm 8/03/95 ===============

Summary

z The wide divergence between strong growth in profits as measured by earnings per share for the Standard and Poor's 500 and flagging growth in profits as measured by adjusted after-tax corporate profits in the national income and product accounts appears to have persisted in the second quarter. At least six factors are behind this divergence: ongoing benefits from corporate restructuring, growth in earnings abroad, currency translation, share buybacks, poor retail earnings, and growth in inventory profits.

z In addition, investors puzzling about how an economy whose growth stalled in the second quarter could generate the strong profit growth reported in the Standard and Poor's data should bear in mind that year-to-year GDP growth was still 3.1% in real terms and 4.8% in nominal terms.

S&P vs. NIPA profits -- the divergence persists

In the middle of 1994, a wide gap opened up between the growth rate of earnings per share as reported by Standard and Poor's (S&P) for the top 500 corporations and corporate profits as reported in the national income and product accounts (NIPA), as shown in the table below. For the last two quarters of 1994 and the first quarter of 1995, operating earnings per share for the S&P 500 as estimated by our Portfolio Strategy Group rose an average of 19.3% from year-earlier levels. Meanwhile, after-tax profits adjusted to remove inventory profits and to correct for distortions from depreciation of capital equipment rose only 5.3% -- 14 percentage points less.

A Widening Divergence in Measures
of Corporate Earnings Growth
(percentage change from year earlier)

S&P 500 Operating Earnings	NIPA Adjusted After-tax	Differ-

	Per Share	Earnings	ence
1993Q1	+10.2%	+3.9%	+6.3
1993Q2	+11.7	+13.0	-1.3
1993Q3	+18.9	+35.6	-16.7
1993Q4	+21.6	+20.6	+1.0
1994Q1	+12.8	+14.6	-1.8
1994Q2	+12.9	+14.4	-1.5
1994Q3	+14.5	+7.4	+7.1
1994Q4	+22.4	+0.7	+21.7
1995Q1	+21.0	+7.9	+13.1
1995Q2E	+19.0	-1.3	+20.3

Source: Standard and Poor's, Commerce Department, Our estimates.

This divergence appears to persisted in the second quarter based on preliminary estimates. Our Portfolio Strategy Group estimates that the S&P 500 earnings per share growth will come in at about 19%. Meanwhile, advance figures for GDP growth and other components of the NIPA point to a 1.3% year-to-year decline in adjusted corporate earnings.

There are at least six reasons why this discrepancy is so large:

1. Ongoing benefits from restructuring. The S&P 500 includes the companies that have done the most to restructure their operations. Hence, their earnings reflect the benefits in productivity resulting from those actions to a greater extent than do the NIPA profits. Moreover, while the adjustments made to the S&P 500 data by our Portfolio Strategy Group remove the initial charges taken at the time the restructuring is begun, they leave in subsequent charges.

2. Greater exposure of the S&P 500 to export growth. Most of the profits earned abroad accrue to the largest companies in the S&P 500. Thus, they are benefiting more substantially than other companies from the double-digit growth in export that has occurred since early 1994.

3. Currency translation. During the first half of the year, the U.S. dollar declined substantially -- about 10% on a trade-weighted basis and more against the deutschemark and the yen. This boosted the dollar equivalent of profits denominated in other currencies. Since most of those profits accrued to companies in the S&P 500, this should have helped widen the gap.

4. Share buybacks. Many companies have launched share repurchase programs in response to the sharp increase in stock prices. These programs have helped boost the S&P 500 figures, which are stated on a per share basis. The NIPA figures are not expressed in billions of dollars.

5. Poor retail earnings. In the current slowdown, retailers

suffered a disproportionate hit to the bottom line. This would help account for a large discrepancy in the second quarter because most of these companies are small and are therefore proportionately more important in the NIPA profit figures. Because most of these companies are on fiscal quarters ending in July, most have yet to report second-quarter results. While it is possible these results could pull down the 19% S&P 500 estimate, it already factors in an expectation of significant earnings disappointments in this sector. Implicitly, the -1.3% estimate for the NIPA profits figure incorporates whatever impact poor retail earnings had on overall profit growth.

6. Inventory profits. Over the past year, large price increases for materials and supplies have created short-term capital gains for goods held in inventory. For companies using accounting systems other than LIFO, these gains will boost the profits reported to shareholders, which form the basis for the S&P 500 earnings estimates. Commerce officials deduct an estimate of such profits from the adjusted NIPA earnings figures. In the first quarter of 1995, this adjustment had the effect of reducing after-tax profit growth 7.7 percentage points, from 15.6% to 7.9%. The effect diminished in the second quarter to about 4 percentage points.

Many investors have puzzled about how an economy experiencing almost no growth in the second quarter could have such strong earnings as are now being reported by the S&P 500. In addition to the reasons set forth above, we would note that year-to-year growth was a still respectable 3.1% in real terms and 4.8% in nominal terms.

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CPF	Convertible Preferreds	New CLB	New Class B Shares
CLA	Class A Shares	NVS	Nonvoting Shares
CLB	Class B Shares	OS	Ordinary Shares
CS	Common Stock	PC	Participating Certificates
CVS	Convertible Voting Shares	RBS	Registered Bearer Shares
EC	Euro Convertibles	RS	Registered Shares
ED	Equity Derivatives	W	Warrants
ES	Equity Securities	ZC	Zero Coupon Convertibles

CPF(RTRSY) News Corp. convertible preferred convertible into Reuters ordinary shares

EC(RTRSY) United News Euro convertibles convertible into Reuters ordinary shares

EC(ENT) Elf Aquitaine Euro convertibles convertible into Enterprise Corp. ordinary shares

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... Daily Financial Market Comment

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DAILY FINANCIAL MARKET COMMENT

x x Japanese package should moderate U.S. curve steepening x x

William C. Dudley (212) 902-3394 - New York Economic Research
Edward F. McKelvey (212) 902-3393 - New York Economic Research
John Youngdahl (212) 902-8124 - New York Economic Research

=============== Note 5:07pm 8/02/95 ===============

Summary

z Perceptions that the loosening of Japanese financial regulations will benefit the market for short-dated U.S. Treasury securities are misplaced for two reasons: The recycling of Japan's current account surplus into private hands should broaden the distribution of Japanese held dollar-based assets from the high concentration in short-term Treasuries now held by the Bank of Japan. Moreover, the new measures are unlikely to precipitate or facilitate an easing in U.S. monetary policy, as some market participants seem to expect. This move could mitigate the recent steepening of the U.S. Treasury curve, as demand for longer-dated Treasuries is less clearly affected.

z The Treasury's latest quarterly refunding announcement was surprising in three respects. The size of the refunding was increased despite low borrowing needs, the existing 10-year issue was not reopened, and the Treasury has decided not to introduce new auction cycles in 1996.

Japanese yen package should moderate U.S. yield curve steepening

The loosening of regulations on Japanese financial institutions has been widely assumed to benefit demand for U.S. Treasury securities. Any expectations of a benefit for shorter-dated Treasuries are misplaced for two reasons, however:

1. Japanese demand for dollar-denominated assets will broaden from the short-dated Treasuries now favored by the Bank of Japan into other types of securities. In the short run, the main impact of this package will be to diversify into private hands the central bank's large holdings of foreign-denominated assets that have accumulated as a result of Japan's persistently large current account surpluses. It is highly unlikely that private institutions will favor the short-dated (0-3 year) Treasury securities nearly as much as the Bank of Japan has. Thus,

Japanese demand for these securities should diminish, while their demand for other U.S. securities -- longer-term Treasuries, corporates, and stocks -- should increase.

2. U.S. monetary policy should be unaffected by these regulatory changes. Market participants have increased the probability they place on further easing by the Federal Reserve as a result of the positive impact that the regulatory change has already had, and is expected to have, on the yen/dollar exchange rate. It is clear, however, that moves in the dollar exchange rate, especially against a single currency, are not very important factors in Fed policy decisions. If the Federal Reserve eases again, it will be because the data on U.S. growth are sufficiently ambiguous to keep concerns about the downside risks alive. With the U.S. economy showing progressive signs of improvement in demand, and even some hints of revival in production, the probability of such a move has gone down.

Surprises in the Treasury's quarterly refunding announcement

Wednesday's announcement by the U.S. Treasury Department of its upcoming quarterly refunding contained three surprises:

1. The size of the auction was increased. This increase, to $42.5 billion from $41.0 billion in the second quarter, was surprising in light of the Treasury's low borrowing needs for the quarter. The Treasury Department has estimated this need at $26 billion; our own estimate is $30 billion. Neither figure justifies an increase in the quarterly refunding operation.

2. The existing 10-year issue was not reopened. Evidently, Treasury officials decided that they could finance more cheaply with a new issue. This is highly debatable given the shortage of current 10-years in repo market.

3. No new auction cycles will be introduced in fiscal 1996. We had anticipated new cycles in the new fiscal year to deal with the extra rollover need beginning in January 1996, as the old monthly 5-year notes begin to fall due. Instead, the sizes of existing auctions will be expanded to meet the need. Studies of possible new securities (e.g., floating-rate notes) will be continued.

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CPF	Convertible Preferreds	New CLB	New Class B Shares
CLA	Class A Shares	NVS	Nonvoting Shares
CLB	Class B Shares	OS	Ordinary Shares
CS	Common Stock	PC	Participating Certificates
CVS	Convertible Voting Shares	RBS	Registered Bearer Shares
EC	Euro Convertibles	RS	Registered Shares
ED	Equity Derivatives	W	Warrants
ES	Equity Securities	ZC	Zero Coupon Convertibles

CPF(RTRSY) News Corp. convertible preferred convertible into Reuters ordinary shares
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