FOIA Number: 2019-0568-F

FOIA MARKER

This is not a textual record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

Collection/Record Group: Clinton Presidential Records

Subgroup/Office of Origin: National Economic Council

Series/Staff Member: Gene Sperling

Subseries:

OA/ID Number: 20231

FolderID:

Folder Title:
Goldman Sachs Weekly January 1997 - April 1998 [binder] [2]

Stack:	Row:	Section:	Shelf:	Position:
S	16	4	4	1

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

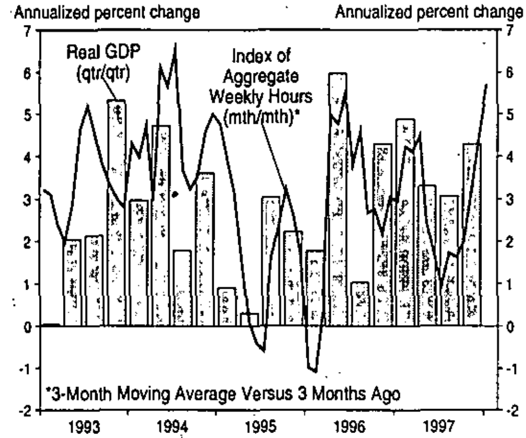
Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

U.S. Economics Analyst

Employment Cost Upswing Likely to Persist

- The tug-of-war between a strong domestic economy and the trade drag being exerted from Asia became more visible this past week. On one hand, the latest soundings on confidence and spending indicate that the momentum of the domestic economy remains intact. On the other hand, the sharp downtick in the export orders index of the NAPM survey suggests that the trade shock was beginning to be felt in January.
- The labor market data for January fell firmly on the strong side of this tug-of-war, as nonfarm payrolls posted another large, broadly based gain and the index of hours worked moved up to a level well above the fourth-quarter average. Although average hourly earnings gains were modest, the pattern clearly remains one of acceleration.
- The removal of the FOMC's asymmetric directive in December was a bit of a surprise in terms of timing, but it has no meaningful implications for the outlook of monetary policy. After all, Chairman Greenspan has indicated that policy is locked on hold, and the December minutes noted that many FOMC members still thought that the next policy adjustment was more likely to be a tightening than an easing.
- The pickup in compensation costs remains the biggest thorn in the Fed's side. A close examination of the employment cost index data indicates that the pickup in wage costs has been widespread, especially outside of manufacturing. Moreover, historical evidence suggests that wage cost acceleration, once underway, has considerable inertia. This suggests that the uptrend is likely to continue throughout 1998.

Hours Worked Trend Still Firm



Source: Department of Labor.

ECI Wages and Salaries, by Occupational Type (December-to-December percent change, not seasonally adjusted)

	1995	1996	1997
Total Private, Excluding Sales	2.8%	3.3%	3.8%
White-Collar, excluding Sales	2.9	3.4	4.2
Professional Specialty and Technical	2.5	3.0	3.8
Executive, Administrative, and Managerial	3.2	3.9	5.0
Administrative Support, including Clerical	3.0	3.1	3.6
Blue-Collar	2.9	3.0	3.2
Precision Production, Craft, and Repair	3.0	3.0	2.9
Machine Operators, Assemblers, and Inspectors	2.9	3.4	3.3
Transportation and Material Moving	2.6	2.1	3.3
Handlers, Equipment Cleaners, Helpers, and Laborers	3.1	3.7	3.7

Source: Department of Labor.

Trade Recommendations

- Stay short September '98 Eurodollar futures, with a target of 94.10 and a stop on a close above 94.64.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

Issue No: 98/6
February 6, 1998

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

The Incredible Flattening Yield Curve:
Risk Premia in the U.S. Treasury Market

- Monetary Policy, Inflation, and Budget Outlook Key to Treasury Risk Premia
- Yield Curve Magnifies Changes in Short-Rate Expectations
- Flattening Justified by Improved Fundamentals
- Long End Better Protected Than Short End

Alex Patelis

January 16, 1998

Important disclosures appear on the back cover of this publication

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

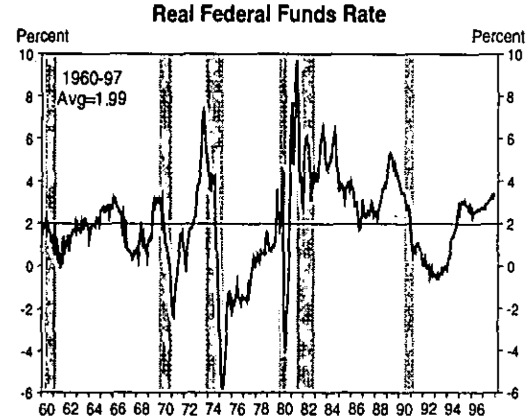
Goldman Sachs

U.S. Economics Analyst

The Fed on Autopilot

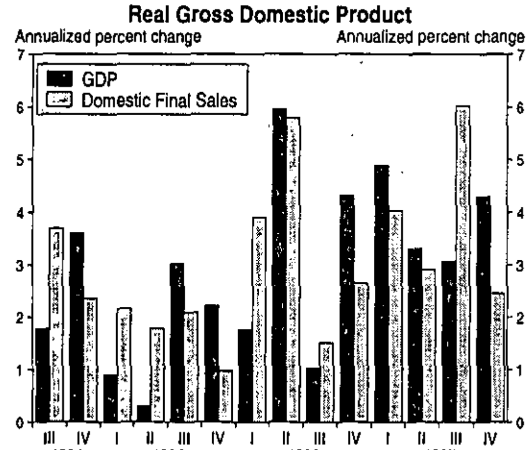
- Chairman Greenspan's testimony to the Senate Budget Committee was brief and balanced, indicating that he wants to keep his options open. It confirms that monetary policy is likely to be locked on hold for quite some time.
- Fed officials are likely to keep monetary policy on autopilot for two reasons: 1) There is significant uncertainty about how the tug-of-war between the strong domestic economy and the trade drag from the Asian crisis will be resolved; and 2) there are few signs that the current stance of monetary policy is inappropriate.
- The notion that monetary policy is too tight because real interest rates exceed historical norms is contradicted by the performance of the economy and its interest-rate sensitive sectors.
- Conversely, the case that policy is too easy has become harder to make given the exceptional performance of inflation recently and the fact that Asia will work in the direction of slowing the economy and dampening inflation further over the next few months.
- In a sense, the impact of the Asian crisis on the U.S. economy is arriving in the nick of time, because strong growth has tightened the labor market to the point where compensation costs are climbing more quickly. In this regard, the 4.3% annualized growth pace of real GDP in the fourth quarter confirms that the economy ended 1997 on a firm note. However, almost half of this growth resulted from stepped-up inventory accumulation and a statistically suspect trade improvement. Other data—on orders for durable goods, for example—imply that the momentum in U.S. growth may be fading somewhat.

Real Federal Funds Rate



Note: Federal funds rate less the percent change year ago in the CPI excluding food and energy.
Source: Federal Reserve Board. Department of Labor.

Real Gross Domestic Product



Source: Department of Commerce.

Trade Recommendations

- Stay short September 1998 Eurodollar futures, with a stop on a close above 94.64 and a target of 94.10.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

Issue No: 98/5
January 30, 1998

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

Goldman Sachs

U.S. Economics Analyst

Bracing for a Nor'easter (from Asia)

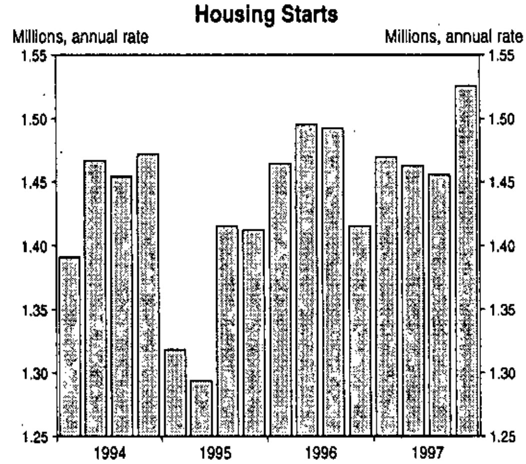
- We have revised our estimate of fourth-quarter real GDP growth up to 4.0% annualized, based on an even larger-than-expected decline in the trade deficit during October and November, as well as relatively solid factory production statistics released last week.
- The narrowing in the trade gap during those two months, however, does not foot with the rising surpluses that many Asian countries are reporting for their trade with the United States or with purchasing managers' reports of rising imports and flagging export orders. This cognitive dissonance is mainly due to inadequate seasonal adjustment of the U.S. trade data.
- A dramatic deterioration in U.S. trade results is a likely prospect for early 1998, as these statistical anomalies are reversed and the economic storm emanating from Asia hits with full force. This should pull aggregate output growth down well below the recent strong trend in the first half of the year.
- Given long lags in reporting official export and import figures, however, it will be necessary to look elsewhere, particularly to manufacturing orders and production and consumer spending indicators, for advance assessments of the damage to be suffered from the net exports sector.
- Solid domestic demands continue to serve as a buffer against the incipient Asian shocks. For example, low mortgage interest rates and buoyant household incomes and confidence are sustaining high levels of home sales and construction.

Asian Countries' Trade Balance with the U.S.
(US$ in millions)

	Change in Trade Balance from Year Earlier for 3 Months Ending: Aug. 1997	Nov. 1997
China	$413.6	$508.8
Hong Kong	101.0	280.0
Indonesia (a)	-18.1	29.4
Korea	405.5	457.5
Malaysia	-241.9	0.6
Philippines (a)	17.4	188.9
Singapore	-21.9	-22.3
Taiwan	-183.5	104.2
Thailand (a)	192.1	180.5
Total	$664.2	$1,727.5
Annualized	$7,970.2	$20,730.6

(a) Latest data through October for Philippines and Thailand and through September for Indonesia.
Source: Goldman Sachs.

Housing Starts



Source: Department of Commerce.

Trade Recommendations

- Stay short September 1998 Eurodollar futures, with a stop on a close above 94.64 and a target of 94.10.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
Issue No: 98/4
January 23, 1998
E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

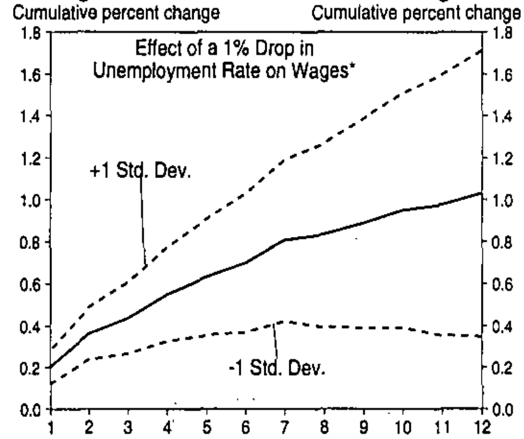
Goldman Sachs

U.S. Economics Analyst

Tug of War Between Inflation and Wages

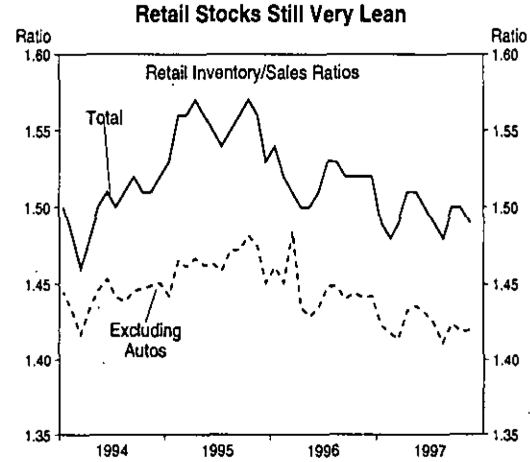
- The tug of war between falling inflation and rising wages is going to continue in the year ahead. This tug of war is particularly important for the equity and fixed income markets because of its implications for profits and inflation.
- Wage growth is not likely to moderate in 1998 because we find that wage growth depends primarily on the tightness of the labor market—which we expect to continue—rather than the rate of inflation.
- Inflation, on the other hand, should be well-behaved, caught between the deflationary forces from Asia and the inflationary pressures from domestic labor markets. This implies that, unless productivity growth keeps climbing, profit growth will slow.
- Sluggishness in underlying retail spending last quarter substantially reflects a payback for third-quarter strength and declining goods prices, especially in the energy sector. Overall consumer demand is still displaying solid advances, and the fundamental circumstances augur for more of the same in the first part of 1998.
- Industrial output gains are likely to slow appreciably from last year's robust trend, but the evident lack of an inventory overhang among retailers is a sign that a major production retrenchment of the sort experienced in 1995 is improbable. The Federal Reserve, therefore, will probably be less inclined to consider cutting interest rates than many now anticipate.

Tighter Labor Market Feeds into Wages



*Wages are measured in average hourly earnings.
Source: Department of Labor. Our calculations.

Retail Stocks Still Very Lean



Source: Department of Commerce.

Trade Recommendations

- Stay short September 1998 Eurodollar futures, with a stop on a close above 94.64 and a price target of 94.10.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

Issue No: 98/3
January 16, 1998

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

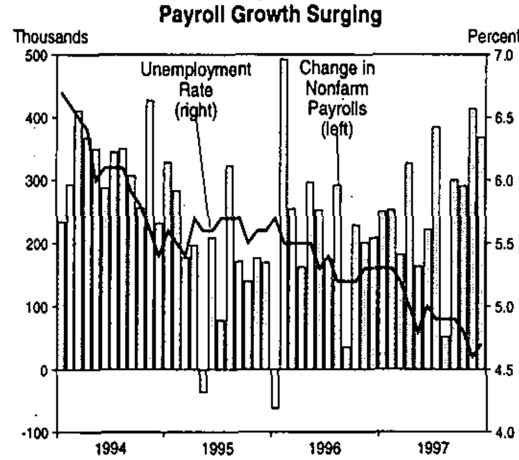
Goldman Sachs

U.S. Economics Analyst

Budget Surplus Sets Stage for Tax Stimulus

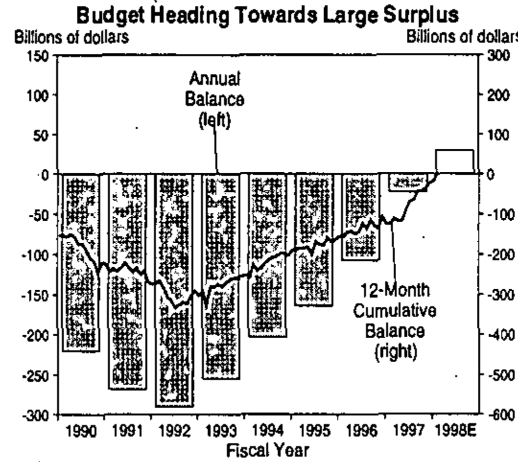
- Domestic demand continues to be robust, with new home sales (November) and motor vehicle sales (December) both jumping sharply. Chain store results also turned out to be better than expected as sales were firm in the week following Christmas.
- Labor market conditions are strong as well, with payroll gains averaging over 350,000 per month in the fourth quarter. With hours worked rising at a 4.4% annual rate during the fourth quarter, the domestic economy continues to have solid momentum suggesting that Fed policy will remain locked on hold for the time being, despite the turmoil in Asia.
- The federal budget appears poised to move into surplus in fiscal 1998. Final tax settlements are likely to be strong given robust growth in 1997 and a surge in capital gains realizations generated by the rise in stock prices and the reduction in the top capital gains tax rate in 1997. In this regard, the Congressional Budget Office estimate, which still shows a modest deficit for fiscal 1998, is likely to be too conservative.
- The surplus should cause Congress to push hard for tax cuts in 1998. After all, it is an election year. Moreover, with the growth pace slowing in the first half of the year, this may reinforce the pressure to return some of the tax windfall to the voters.
- If taxes are cut as we expect, this suggests that the long period of fiscal restraint that has characterized the 1990s will end this year. This may set the stage for faster growth in 1999 and some renewed upward pressure on interest rates.

Payroll Growth Surging



Source: Department of Labor.

Budget Heading Towards Large Surplus



Source: Department of Treasury. Our estimates.

Trade Recommendations

- Go short the September '98 Eurodollar futures contract with a stop on a close above 94.63 and a target of 94.10.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
Issue No. 98/2
January 9, 1998

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

Goldman Sachs

The Weekly Analyst

1998 – A New Year

- In this week's Weekly, we provide detailed rationale for our Top 10 Trades for 1998, which are again listed, together with their performance since December 16th inception.
- The Dollar has performed extremely well over the holiday period, but with 'full' markets returning this week, we expect $/DM to soon renew a down trend. DM/Yen should start to accelerate on the upside on a successful break above 73.60.
- In coming days, economic data in Germany will be interesting to observe to see whether it demonstrates the same signals of recovery evident in France. Accelerating albeit modest activity in Europe, and deceleration in the US could be the early 1998 theme.
- On bonds, with continued instability in Asia and Greenspan's reference to deflation fears, developments over the holiday period support the idea that new yield lows will be hit before the end of the first quarter.
- We remain broadly comfortable with the portfolio advice given before the holidays to overweight Europe, to underweight Japan and to be neutral in the Dollar bloc.
- Stronger economic data from Germany, taken together with the recent softness of the DM, would make us look to re-balance some risk from Core Europe in favour of the Dollar bloc.

Top 10 Trades for 1998

Trade	16/12/97	Target	% Chg so far.
1. Sell $/DM	1.7640	1.58	-3.7
2. Buy DM/Yen	73.60	85.0	-0.8
3. Sell GBP/NOK	12.00	9.88	-1.3
4. Sell CHF/buy FIM	3.72	3.30	-0.4
5. Buy 3-Mth $/DM & $/Yen vols.	10.4 & 13.1	13.0 & 15.0	+11.0
6. Buy CNY/Sell HK$ 6-Mth outright	1.11	1.00	-2.5
7. Buy DM/GRD	156.80	188.20	+0.8
8. Short CZK/Buy PLN	0.1052	0.099	+6.4
9. Short KIWI/Long CAD	0.8490	0.7425	+4.9
10. Buy a basket of Asian currencies	?	?	?

Bonds: Recommended Portfolio Weights*

	Neutral Bond Weighting	GS Bond Recommendation	Neutral Bond Duration	GS Bond Duration
US	36.3	16	5.2	7.8
Japan	17.5	7	5.8	2.5
Europe	41.9	73	-	-
-UK	6.9	3	6.2	7.7
-Germany	8.1	16	4.2	6.3
-France	7.5	15	5.3	6.5
-Italy	6.9	22	4.1	2.1
Canada	3.5	3	5.7	4.9
Australia	0.8	1	4.4	6.7
Total	100	100	5.2	5.2

*1 month horizon, hedged benchmark. Last updated: 18th December 1997

Trading Recommendations

- See our Top 10 trades for 1998.
- Also stay short AUD, stops now 2 day close above 0.66.
- Try short IEP/long ITL also with 2 day stops above 2,550.0.
- Hold longs in June Euro DM and March bunds with trailing stops to protect profits.
- Long June BAX/Eurodollar spread, target 80bp with a stop below 20bp.
- Cut JGB shorts.

Contributors: Jim O'Neill, Andrew Bevan, Martin Brookes, Stephen Hull, John Simpson
Issue No: 98/01
6th January 1998

Important disclosures appear at the end of this document.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

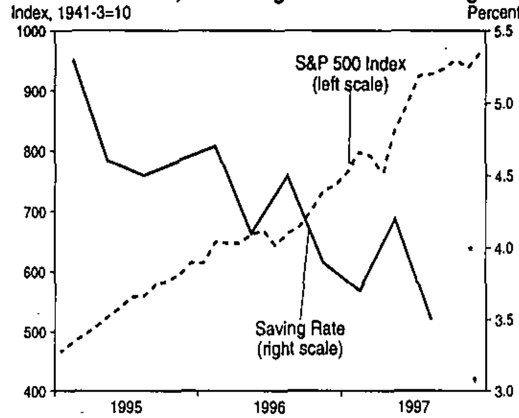
Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

U.S. Economics Analyst

1998: Main Street Looks to Wall Street

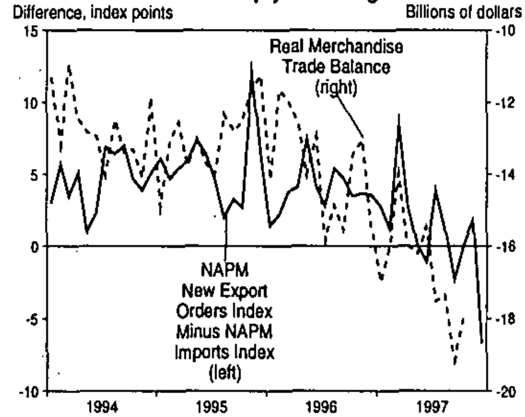
- The 1998 economic outlook shapes up as a tug of war between the trade drag from Asia and the strength of domestic demand. Asia will most likely dominate the first half of the year, while strength in the domestic economy and its tight labor market are likely to regain preeminence in the second half of the year.
- The key risk to this view is the behavior of the U.S. stock market, which has boosted spending by both households and businesses in recent years. Although the pieces are falling into place for a material slowing in corporate profit growth, stock prices should nevertheless hold up in an environment where inflation and interest rates remain low and earnings of S&P 500 companies suffer comparatively less.
- Purchasing managers report an incipient slowing of growth among factory firms, with signs that the Asian economic shocks are already causing a fresh deterioration in the U.S. trade performance. Moreover, goods pricing conditions continue to soften, giving Federal Reserve officials every reason to maintain their cautious monetary policy approach well into the new year.
- At the same time, the fundamental supports for domestic demand remain highly favorable. Attitudes about job availability are exceptionally positive, and sales of existing houses remain close to record levels, with sturdy prices for resales. The resultant buoyancy in consumer confidence, coupled with ample financing capacity, should keep U.S. spending on a solid path in coming months.

Stocks Rise, Provoking A Decline in Saving



*Q4 estimate.
Source: Department of Commerce, Standard and Poor's.

NAPM Trade Indexes Imply Widening Trade Deficit



Source: National Association of Purchasing Management. Department of Commerce.

Trade Recommendations

- Stay neutral on T-bond and Eurodollar futures pending key reports next week.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis, (212) 902-6807
E-mail Address: william.dudley@gs.com

Issue No: 98/1
January 2, 1998

Important disclosures appear on the inside back cover.

Goldman Sachs

U.S. Economics Analyst

Our Views Have Changed

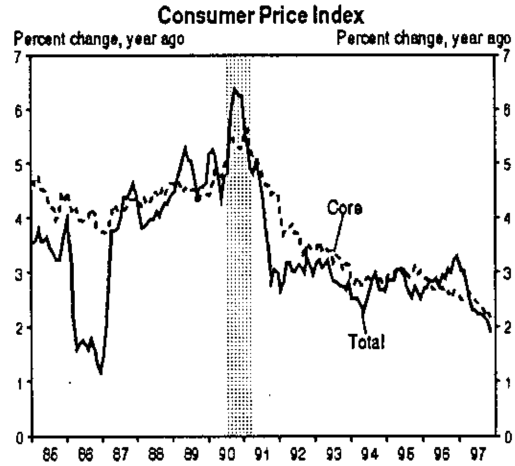
Interest Rates in 1998: Asia Restrains for Awhile

- We have become more optimistic about the near-term interest rate outlook. That is because turmoil in Asia should ensure slower growth and subdued inflation during the first half of 1998. As a result, Fed officials are likely to stay on the sidelines throughout the first half of the year. Combined with shrinking Treasury issuance, that should keep bond yields well-behaved over this period.
- Longer term, however, any relief for interest rates generated by Asia is likely to prove temporary. The U.S. economy has significant momentum, and its labor markets are very tight. Thus, both short- and long-term rates still appear poised to head higher, even though the magnitude of the rise in 1998 is likely to be more muted than we previously had anticipated.
- Recent reports on activity in the industrial and residential construction sectors provide fresh evidence of the economy's strong momentum. November's 0.8% jump in industrial production puts factory output on a 7½% annualized growth track, while the 3-month average of housing starts has risen to a new high for this expansion. As a result of these and previous reports, we now estimate that real GDP is rising at a 3.2% rate this quarter, up from 2.7% previously.
- Notwithstanding this strength, inflation remains benign, with the year-to-year trend in consumer price increases dropping below 2% in November for the first time in more than ten years. Given the constraints on pricing imposed by the Asia crisis and the Fed's revisions to capacity usage and growth, we have reduced our estimate for inflation in 1998 to 1.9%, from 2.4% previously.

U.S. Interest Rate Forecasts
(quarter-end)

	1997 Q4	1998 Q1	1998 Q2	1998 Q3	1998 Q4
Federal Funds	5.5	5.5	5.5	5.8	5.8
3-month LIBOR	5.8	5.7	5.8	6.1	6.2
2-Year Treasury	5.6	5.5	5.6	5.9	6.0
10-Year Treasury	5.7	5.6	5.7	6.0	6.2
30-Year Treasury	5.9	5.8	5.9	6.1	6.3

Consumer Price Index



Source: Department of Labor.

Trade Recommendations

- None for now. Happy Holidays!

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

Issue No: 97/51 December 19, 1997

Important disclosures appear on the inside back cover.

I. Weekly Wrapup

Economic and Market Overview

Yields on U.S. government bonds have fluctuated in a fairly narrow range in recent days, hovering slightly below 6%, as retail inflation receded further despite continued strong growth in U.S. economic activity. However, equity prices have retreated in response to several high-profile earnings disappointments and developments in Japan and Korea.

The consumer price index rose just 0.1% last month, dragging the 12-month trailing trend rate of inflation below 2% for the first time since early 1987, when a 50% collapse in oil prices temporarily suppressed the headline rate of inflation. In the case of the core index, which was also up only 0.1% in November, the 2.2% trend rate of increase was at its lowest point in more than 30 years. In view of the Federal Reserve's recent benchmark revisions to capacity utilization and growth, it now appears that inflation will remain benign for awhile longer. Accordingly, we now foresee only a 1.9% (year-to-year) increase in the consumer price index in 1998, down from 2.4% previously and identical to the latest 12-month trend.

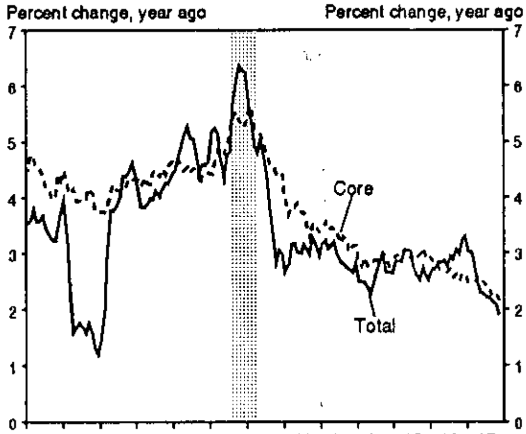
Key indicators of output in the cyclically sensitive industrial and residential construction sectors were surprisingly strong in November. Industrial output surged 0.8%, with output in the factory sector up an even sturdier 1.0%. For the quarter as a whole, manufacturing output is rising at a brisk 7½% clip. Meanwhile, starts of new housing units also increased 0.8% in November from an already high October reading. On a three-month moving average basis, housing starts are at their highest point of the current expansion. Based on these data and previous reports, we now estimate that real GDP is rising at a 3.2% annual rate this quarter, up from 2.7% previously.

Demand indicators have been more mixed. The U.S. trade balance narrowed sharply to $9.4 billion in October from $11.2 billion in September, driven mainly by a 2.4% rise in exports. However, both this surge in exports and the resulting trade improvement appear due to faulty seasonal adjustment and, in any event, they are apt to reverse once the effects of the Asian crisis filter into the data over the next few months. Meanwhile, weekly indexes of retail sales have been lackluster.

Federal Reserve Policy

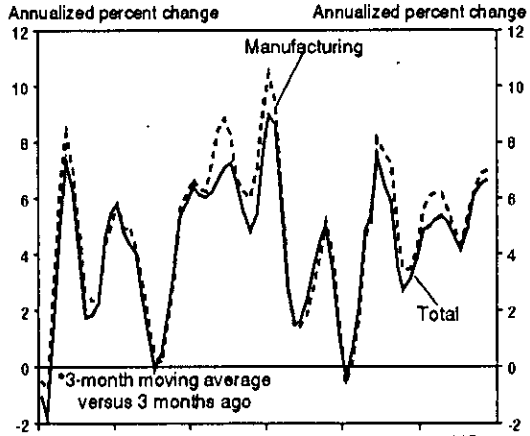
Perhaps the least surprising development of the week was the FOMC's decision to keep interest rates unchanged at its latest meeting on December 16. Apart from a dissent in favor of an immediate tightening by Alfred Broaddus, easily the panel's most hawkish member, the minutes of the November 12 session also contained no surprises. At that time, the committee maintained a directive biased toward restraint and, while members continued to fret about the risks of overheating, the tone of their sentiments did not shift noticeably from earlier meetings. The decision to stand pat reflected two uncertainties—the effect of the Asia crisis and the durability of stronger productivity growth—which overcame ongoing worries about labor-market tightening. As neither uncertainty is apt to be resolved very soon, we now think it unlikely that Fed officials will tighten before mid-1998, as amplified in the center section (pp. 4-6).

Consumer Price Index



Source: Department of Labor.

Industrial Production



Source: Federal Reserve Board.

Fiscal and Political Developments

Although Congress is out of session, all is not quiet in Washington, as the issues to be dealt with in the next legislative session take shape. Funding for the IMF will surely be one of the items at the top of the agenda. Congress has already rejected a $3.5-billion U.S. contribution to the IMF's New Arrangements to Borrow program; now Michel Camdessus, Managing Director of the IMF, is seeking both reconsideration of this funding and $14.5 billion more as part of a 45% increase in the IMF's quotas already agreed to at the annual meeting in Hong Kong. Mr. Camdessus is slated to present his case in testimony before the Senate Budget Committee on January 8.

Given the resistance Congress has already shown on the issue, the administration obviously faces an uphill fight. To lay the groundwork, Treasury and Defense Secretaries Rubin and Cohen, along with Federal Reserve Chairman Alan Greenspan, recently met with Republican congressional leaders to brief them on developments in Asia and the importance of adequate funding for the IMF. President Clinton also stressed his commitment to this issue in a recent news conference. In all likelihood, proponents will follow the strategy of combining the IMF funding proposals and a reconsideration of granting the president "fast track" authority into one omnibus trade bill.

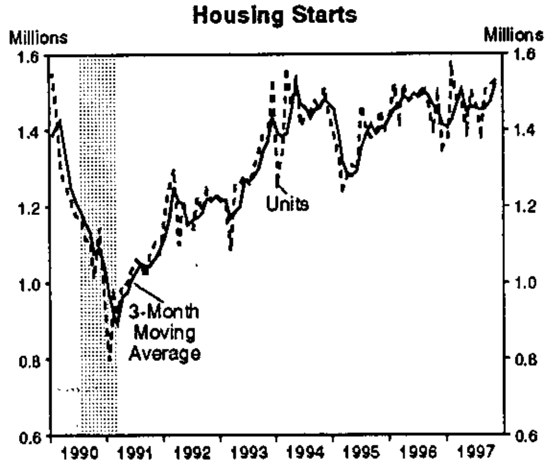
Market Outlook and Comments on Value

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

As we go into the thin holiday trading season, we have no strong trading views. In the short end, not much price movement is likely as the Fed is locked on hold for the time being until uncertainties about Asia and the impact of productivity on the inflation outlook are resolved. That is likely to take time. For the more adventurous, selling volatility in the front end out through February/March appears attractive as no Fed action is likely over that time frame.

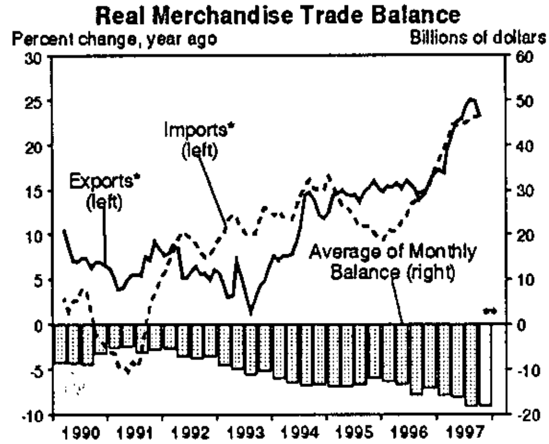
In the long end, the bond market is likely to take its cue more from international developments than domestic events. That can be seen in the ability of the bond market to shrug off strong U.S. data over the past few weeks. Most likely, bond prices will grind still higher over the near term. We are unwilling to take positions right now, however, because markets will be thin and the flatness of the yield curve will make any push to lower yields slow and difficult.

Housing Starts



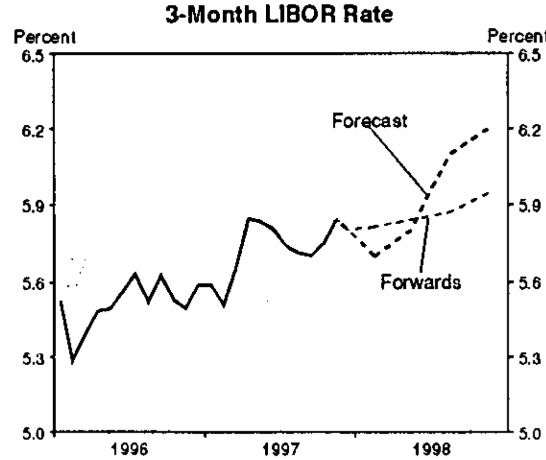
Source: Department of Commerce.

Real Merchandise Trade Balance



*3-month moving average. **Represents October.
Source: Department of Commerce.

3-Month LIBOR Rate



Source: Federal Reserve Board. Wall Street Journal.

II. The Interest Rate Outlook: Asia Restrains for Awhile

We have become more optimistic about the near-term outlook for U.S. interest rates. This reflects the fact that the turmoil in Asia should cause growth to slow and inflation to remain subdued for a couple of quarters, keeping Fed officials on the sidelines during that period. In turn, the yield curve has some scope to flatten a bit further, especially if speculation were to grow that the next Fed move could be an easing. Longer term, however, a bearish stance still appears warranted. The impulse from Asia is likely to be transitory. Moreover, the domestic economy remains robust, with few signs that U.S. monetary policy is restrictive. Finally, the tightness of U.S. labor markets is likely to persist, driving up wage inflation. Ultimately, Fed officials will respond to this by tightening monetary policy.

Compared to our previous forecast, we have scaled back the magnitude of tightening in 1998 to only 25 basis points from 50-100 basis points previously. This reflects the fact that Fed officials are likely to start later and tighten less aggressively because inflation will generally stay muted next year. A friendlier short-term rate path should also lead to a more benign bond market. We now believe that long-bond yields could fall as far as 5¾% (down from 6%) during the first half of the year as growth slows and inflation moderates further. Longer term, we have reduced our upper bound for T-bonds in 1998 to 6½% from 7%.

A Benign Environment for Now

To validate the current flat shape of the yield curve, investors need to believe that short-term rates are high and that the next move from the Fed is likely to be an easing of monetary policy. Although we think that this perception ultimately will prove to be incorrect, a slowdown in the economic growth pace during the first half of 1998 coupled with good inflation news could cause such a view to become more prevalent over the next few months.

U.S. Interest Rate Forecasts (quarter-end)

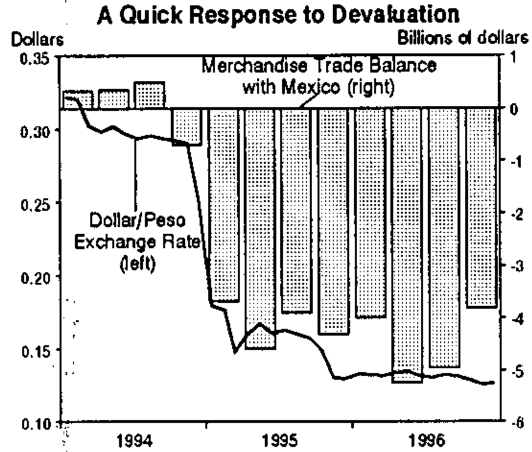
	1997 Q4	1998 Q1	1998 Q2	1998 Q3	1998 Q4
Federal Funds	5.5	5.5	5.5	5.8	5.8
3-Month LIBOR	5.8	5.7	5.8	6.1	6.2
2-Year Treasury	5.6	5.5	5.6	5.9	6.0
10-Year Treasury	5.7	5.6	5.7	6.0	6.2
30-Year Treasury	5.9	5.8	5.9	6.1	6.3

On the growth side of the ledger, a slowdown appears very likely for two reasons. First, the Asian currency crisis should cause a sharp contraction in the demand for goods and services, especially from the ASEAN-4 countries and Korea. Combined with increased import penetration, this should exert a trade drag on the U.S. economy equal to about ½% of GDP in 1998. On a quarterly basis, the impact is likely to be even greater because the effects are likely to be concentrated mainly in the first half of 1998. The lesson of the Mexican peso crisis for trade was clear: The adjustment process is fast (see chart below). Thus, weakening domestic demand growth in Asia should rapidly become evident in U.S. export performance.

In addition, capital spending growth is likely to be somewhat less robust. This reflects two factors: 1) the squeeze on profits exerted by Asian trade drag and lower import prices, and 2) the fact that Federal Reserve statisticians have found that capacity utilization rates are lower and the growth rate of capacity higher than had earlier been estimated. Put simply, with capacity growing fast, there is not a great need for large gains in investment to raise the capacity growth rate still further.

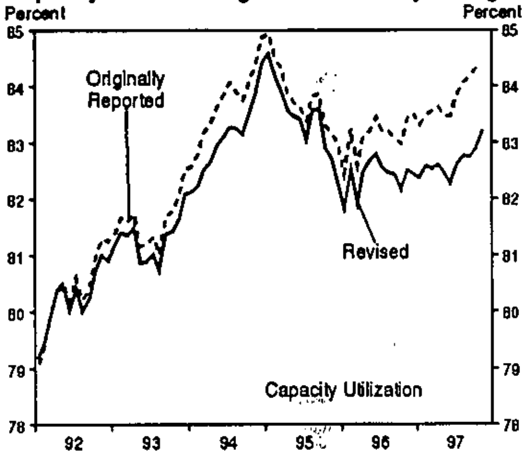
As shown in the accompanying chart, the net revision to the industrial capacity utilization rate has been sizable. After revision, the capacity utilization rate is 1.4 percentage points lower than originally reported

U.S. Trade with Mexico: A Quick Response to Devaluation



Source: Department of Commerce.

Capacity Less Binding than Previously Thought



Source: Federal Reserve Board.

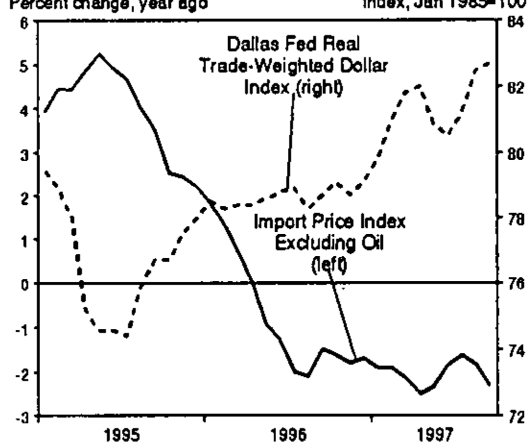
for October. This helps to explain the anecdotal reports of an absence of "pricing power." In addition the growth rate of manufacturing capacity has been revised up by 1 percentage point, to a 5.3% annual rate, suggesting a lessened need for further gains in capital spending to expand the capacity growth rate.

The continued absence of inflationary pressures is the second important element underpinning a more benign interest rate outlook over the next few months. The dollar continues to strengthen on a trade-weighted basis, and this implies a further decline in import prices. As shown in the accompanying table, the dollar has appreciated by nearly 14% since midyear on a U.S.-import-weighted average basis against a broad group of emerging-market currencies. Assuming that about half of this appreciation shows up in the form of lower import prices, this implies a direct deflationary impulse of about 0.3%. The indirect effect—the constraint on domestic producers' ability to raise prices—is also likely to be sizable.

In addition, the Bureau of Labor Statistics is updating its basket of goods for the consumer price index and changing its methodology in calculating movements in computer prices. Together, these two changes will cut about 0.2% from the inflation rate in 1998. Thus, during the first half of 1998, the annualized consumer price inflation rate is likely to be no higher than 2% (versus our earlier forecast of 2.4%).

Besides gaining support from a more optimistic view about the future path of short-term interest rates, the bond market should also benefit from factors that keep the bond risk premium narrow. In particular, Treasury supply should continue to diminish. Just as 1997 saw a hugely favorable budget deficit surprise, another positive surprise is likely in 1998. Strong growth in 1997 should ensure robust final tax settlements. Moreover, capital gains realizations are likely to climb further given the past year's strength of the stock market and the reduction in capital gains tax rates, which should encourage some investors to realize gains who had been waiting until such legislation was enacted. At a minimum, budget balance is likely in fiscal 1998. And judging from October/November data, which shows a sharp improvement from a year ago, a $20-to-$30-billion surplus is possible. With the expansion of the Treasury's inflation-protected securities program continuing in 1998, our expectation of a balanced budget implies about a $60 billion paydown of nominal Treasury marketable borrowing in fiscal 1998, compared to virtually no change in net issuance in fiscal 1997 (see accompanying chart).

Dollar Strength Pushes Import Prices Lower



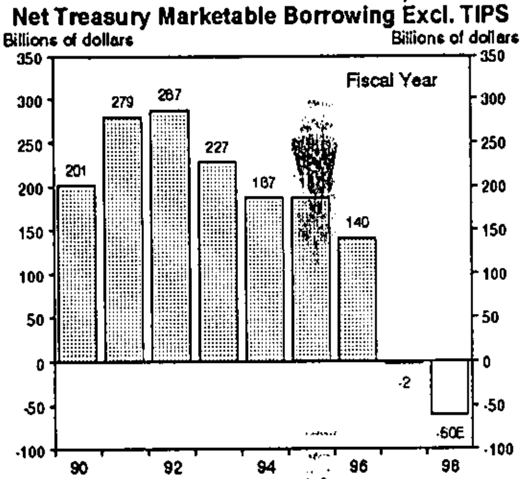
Source: Federal Reserve Bank of Dallas. Department of Labor.

Import-Weighted Devaluation of Emerging Market Currencies

Country	Share of U.S. Merchandise Imports	% Change in Currency Jul 1 - Dec 16	% Change in Currency Weighted by Share of Total
Indonesia	1.1 %	-56.6 %	-1.8 %
Thailand	1.4	-46.0	-2.0
Korea	2.7	-37.8	-3.0
Malaysia	2.1	-34.7	-2.2
Philippines	1.1	-34.5	-1.2
Singapore	2.4	-16.1	-1.2
Taiwan	3.7	-15.6	-1.7
India	0.8	-9.1	-0.2
Brazil	1.1	-3.3	-0.1
Mexico	9.7	-1.7	-0.5
China	7.0	0.1	0.0
Total	33.2 %		-13.9 %

Source: Department of Commerce. Goldman Sachs.

Net Treasury Marketable Borrowing Excl. TIPS



Source: Goldman Sachs.

In addition, two other factors suggest a narrow bond risk premium. First, the turmoil in Asia has reawakened an interest in U.S. mutual fund investors to invest in bond funds. This is likely to continue until the crisis is resolved. In essence, bonds are gaining a safe-haven bid as volatility in other financial markets rises. Second, interest rate differentials between the United States and other G-7 countries are anticipated to remain wide. Thus, the appetite of foreign investors for Treasuries should remain strong, also providing support for the Treasury bond market.

The combination of a more optimistic assessment about the prospects for Fed easing and a narrow bond risk premium suggest that the yield curve—although already unusually flat—could flatten a bit further, with long-bond yields falling to as low as 5¾%. An inverted yield curve (bonds to fed funds) is very unlikely, however. In the United States, all episodes of yield curve inversion have been associated with aggressive monetary policy tightening.

Longer Term, Still Bearish

Over the longer term, we continue to expect bond yields to rise. The bond market faces three obstacles to a sustained advance. First, Fed officials are unlikely to ease monetary policy in 1998. The threshold to easing is high because the domestic economy retains considerable momentum, the trade drag from Asia is likely to be modest, and U.S. labor markets are very tight. In fact, tightening is much more likely, which we expect to commence sometime in the second half.

Second, the upward pressure on prices is gradually intensifying beneath the surface, even as this pressure is obscured by dollar strength and methodological changes engineered by the BLS that result in a lower reported rate of consumer price inflation. The tightness of U.S. labor markets has caused wage inflation to move higher. Once the dollar's strength diminishes, these pressures are likely to become dominant, setting the stage for an uptick in inflation in 1999. Moreover, unlike the past few years, productivity gains are unlikely to keep pace with the rise in compensation costs. In fact, productivity growth is likely to fall. This is the typical outcome when the economic growth pace slows and the business expansion becomes mature.

Third, the budget surprise of fiscal 1998 is likely to result in fiscal policy stimulus in fiscal 1999. If the budget is in balance or surplus in fiscal 1998, pressures for tax cuts will grow irresistible in a congressional election year. Combined with the moderation of trade drag from Asia, fiscal stimulus should ensure sufficient growth in 1999 to keep unemployment low and wage inflation up.

If Fed officials do tighten monetary policy later in 1998, then 30-year Treasury bond yields are likely to climb back into a 6%-6½% range. A rise above 6% would be almost inevitable given the flatness of the yield curve and the optimistic assessment about the path of short-term rates priced into the Eurodollar futures market. Conversely, an increase above 6½% also appears unlikely. For bond market yields to climb that sharply, the inflation news would have to disappoint, leading to a loss of confidence in the credibility of the central bank in resisting the buildup of inflationary pressures.

Our views on interest rates imply a close-to-shore attitude for the time being. Although yields could decline a bit further over the next few months, uncertainty is high and a fair degree of optimism is already priced into the Treasury bond market. This spring, when the full effects of the Asian turmoil are buffeting the U.S. economy, should provide a good opportunity for shortening duration. Unless the U.S. stock market declines significantly or the Asian crisis spreads more broadly, bond yields should be bottoming at that time and then be poised to head higher as it becomes clear that monetary policy tightening will still be required to keep the economy from overheating.

Bill Dudley

Key U.S. Economic Data

	Latest Monthly Data '97 Nov	'97 Oct	'97 Sep	'97 Aug	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. Thousands)	404	287	300	52	275	253	Jan 9
Unemployment Rate (%)	4.6	4.7	4.9	4.9	4.8	5.0	
Index of Hours Worked (% ch)	1.1	0.4	-0.1	0.4	4.0	3.6	
Average Hourly Earnings (% ch)	0.6	0.4	0.3	0.6	4.6	4.1	
Producer price finished goods index (% ch)	-0.2	0.1	0.5	0.3	0.9	-0.6	Jan 8
Excluding food and energy	-0.1	0.0	0.4	0.1	0.7	0.3	
Consumer price index (% ch)	0.1	0.2	0.2	0.2	2.1	1.9	Jan 13
Excluding food and energy (% ch)	0.1	0.2	0.2	0.1	1.8	2.2	
Retail sales (% ch)	0.2	-0.2	-0.3	0.4	4.3	3.8	Jan 14
Excluding motor vehicles (% ch)	-0.2	0.3	0.2	0.0	4.0	4.0	
Industrial Production (% ch)	0.8	0.5	0.4	0.6	6.6	5.6	Jan 16
Manufacturing	1.0	0.6	0.2	0.7	7.4	6.3	
Capacity utilization (%)	83.2	82.9	82.8	82.8	82.8	82.6	Jan 16
Manufacturing	82.3	81.8	81.7	81.8	81.7	81.6	
Housing Starts (annual rate, thousands)	1531	1519	1507	1395	1487	1464	Jan 22
Single-family	1166	1138	1187	1091	1143	1135	
Trade balance (billions, monthly)	--	-9.7	-11.2	-9.1	-9.5	-9.4	Jan 21
Merchandise	--	-17.1	-18.5	-16.6	-16.8	-16.6	
Factory Orders (% ch)	--	0.3	0.4	1.2	7.3	4.6	Jan 6
Durable Goods	--	-0.1	0.0	2.5	10.2	6.2	Dec 23
Personal Income (% ch)	--	0.5	0.3	0.6	5.1	6.0	Dec 24
Wages and Salaries	--	0.6	0.3	0.8	6.1	6.9	
Purchasing Managers' Index (%)	54.4	56.0	54.2	56.8	56.0	55.1	Jan 2
Consumer Sentiment U Mich (Feb 66=100)	107.2	105.6	106.0	104.4	105.8	102.8	Dec 23
Conference Board (1985=100)	128.3	123.4	130.2	127.6	127.6	123.5	Dec 30

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

©1997 Goldman, Sachs & Co. All rights reserved.

This material is for your private information, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy or sell, the securities, or derivatives (including options) thereof, of companies mentioned herein. No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without Goldman, Sachs & Co.'s prior written consent.

This material has been issued by Goldman, Sachs & Co. and/or one of its affiliates and has been approved by Goldman Sachs International, which is regulated by The Securities and Futures Authority, in connection with its distribution in the United Kingdom and by Goldman Sachs Canada in connection with its distribution in Canada. This material is distributed in Hong Kong by Goldman Sachs (Asia) L.L.C.; and in Japan by Goldman Sachs (Japan) Ltd. This material is not for distribution in the United Kingdom to private customers, as that term is defined under the rules of The Securities and Futures Authority; and any investments, including any convertible bonds or derivatives, mentioned in this material will not be made available by us to any such private customer. Neither Goldman, Sachs & Co. nor its representative in Seoul, Korea, is licensed to engage in the securities business in the Republic of Korea. Goldman Sachs International and its non-U.S. affiliates may, to the extent permitted under applicable law, have acted upon or used this research, to the extent it relates to non-U.S. issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

Further information on any of the securities mentioned in this material may be obtained upon request, and for this purpose persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan, or at its London branch office at 133 Fleet Street, and persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 3 Garden Road. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

Goldman Sachs

U.S. Calendar

Focus for the Week Ahead

- Our best estimate for durable goods orders is that sharp changes in volatile categories (defense up; aircraft and autos down) will obscure firm increases in bookings in other, more stable components. However, this report is one of the first places to look for effects from the Asia crisis; hence, the risks are skewed to the downside (December 23).
- A surge in wages and salaries, signaled by large gains in hours worked and average hourly earnings, should have paced the growth in personal income in November. Meanwhile, consumer spending figures will have a firmer tone than the retail sales report, reflecting gains in unit auto sales and a persistent growth trend in service outlays (December 24).

Economic Releases and Other Events

Date	Time	Indicator	Estimate GS	Estimate Consensus	Last Report
Tue Dec 23	8:30	Real GDP (Q3 '97—Rev.)	+3.3%	+3.3%	+3.3%
	8:30	Chain-Weight Price Index (Q3 '97—Rev.)	+1.5%	+1.5%	+1.5%
	8:30	Durable Goods Orders (Nov)	+0.2%	+0.5%	-0.1%
Wed Dec 24	8:30	Personal Income (Nov)	+0.6%	+0.7%	+0.5%
	8:30	Personal Consumption (Nov)	+0.4%	+0.4%	+0.5%

- **Treasury 2-Year Note Auction (Mon, Dec 22)**
- **U. Michigan Consumer Sentiment—Final (Tue, Dec 23 - 10:00)**
- **Treasury 5-Year Note Auction (Tue, Dec 23)**
- **Treasury Announces 1-Year Bill (Wed, Dec 24 - 12:00)**

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.8%	6.1%
Forward	5.8	5.8	5.9
2 Yr T-Note	5.5	5.6	6.0
Forward	5.7	5.7	5.8
10 Yr T-Note	5.6	5.7	6.2
Forward	5.8	5.8	5.8

Key Numbers in the Business Outlook

	1997 Q3	1997 Q4E	1998 Q1E	1997E	1998E
Real GDP	3.3%	3.2%	2.1%	3.8%	2.8%
Ind. Prod., Mfg.	6.2	7.5	4.0	5.6	5.2
CPI	2.0	2.2	1.5	2.4	1.9
After-Tax Profits*	10.0	10.8	6.3	9.8	3.1
Unemployment	4.9	4.6	4.6	4.9	4.5

* Excluding inventory profits; adjusted for depreciationdistortions.

Goldman, Sachs & Co.,
One NY Plaza, New York, NY 10004

Tel.#: (1) 212-902-6807
Fax #: (1) 212-346-3115

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

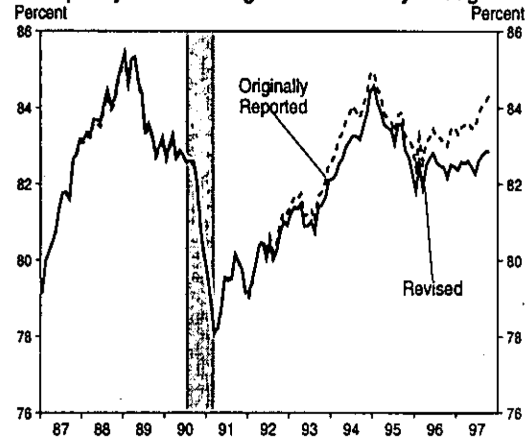
Goldman Sachs

U.S. Economics Analyst

Services Consumption a Stiff Tailwind for Growth

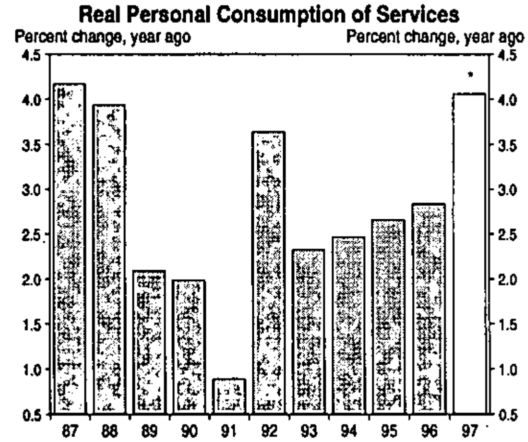
- Rising concerns about deteriorating economic and financial conditions in Asia spurred a sharp bond market advance, pushing the 30-year Treasury bond yield through the previously durable 6% barrier. This rally may extend somewhat further, because the U.S. economic growth pace is likely to slow and inflation remain benign during the early part of next year.
- On the inflation front, finished producer goods prices fell by 0.2% overall, with the core reading down 0.1% and no meaningful price pressures visible further back in the pipeline. Federal Reserve revisions showing much lower rates of capacity utilization and a faster growth rate of capacity help to explain the absence of goods price pressures.
- Retail sales for November were soft, and figures from prior months were revised down a bit as well. Consumers appear to have substantially moderated their spending on goods in the current quarter.
- While personal outlays for goods have fluctuated widely in the past year, the larger services component of total consumption expenditures has been steadily strong, accelerating to a 10-year high. A robust trend in wage and salary income implies a likelihood that rapid gains in these expenditures will persist into 1998.
- Service demands tend to gain importance in overall consumption patterns as an expansion matures, and they have historically been very difficult to suppress through modest monetary tightening. Thus, if the Fed at some point determines that a slower aggregate spending pace is desirable, it is unlikely that a small rate hike will prove adequate to the task.

Capacity Less Binding than Previously Thought



Source: Federal Reserve Board.

Real Personal Consumption of Services



*August/October average versus 4Q96.
Source: Department of Commerce.

Trade Recommendations

- Close short March 1998 Treasury bond future positions.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
E-mail Address: william.dudley@gs.com

Issue No. 97/50
December 12, 1997

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

Goldman Sachs

U.S. Economics Analyst

Strong U.S. Momentum Continues

This issue of the U.S. Economics Analyst is in an abridged, four-page format. The center section and the tables of historical and forecast data have been omitted. Our regular format will resume with our next issue, dated December 5, 1997.

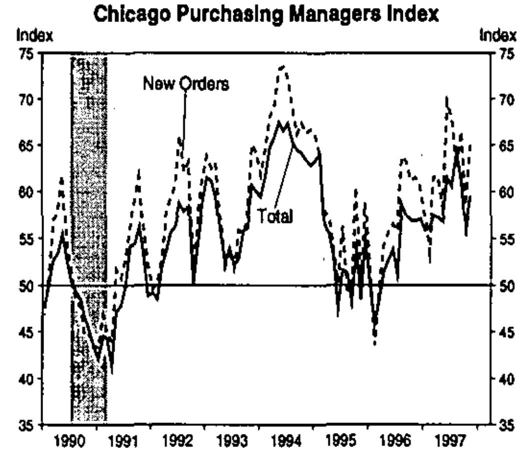
- Domestic production and spending indicators continue to show an unexpectedly firm tone. On the production side, purchasing managers in the Chicago area reported a 3½-point increase in their summary measure of business conditions for November, led by gains in output and orders. Although factory orders slipped in October, this followed several months of very large increases.

- Meanwhile, personal income and spending rose 0.5% apiece in October. The spending increase, which was much firmer than generally expected, puts real consumer outlays on a 3% annualized growth track for the fourth quarter, following a (upward-revised) 5.8% gain in the third.

- Both consumers and employers see a relentlessly strong labor market. Major confidence indexes rose in November despite market turbulence, as individuals became more optimistic about job availability. At the same time, the latest hiring survey by Manpower, Inc. shows continued firm hiring intentions for early 1998.

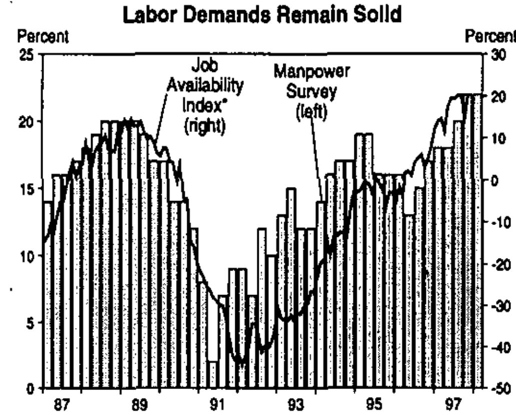
- Against this strong domestic backdrop, Federal Reserve Chairman Alan Greenspan addresses the New York Economics Club on Tuesday, December 2. His remarks will be important in assessing how U.S. central bankers are weighing domestic momentum against the threat from the currency crisis abroad.

Chicago Purchasing Managers Index



Source: Purchasing Management Association of Chicago.

Labor Demands Remain Solid



*Percent of respondents who say that jobs are plentiful less those viewing jobs as hard to get.
Sources: Conference Board. Manpower Inc.

Trade Recommendations

- We would recommend short positions in the March '98 Eurodollar contract at or above 94.25, with a stop on a close above 94.35 and a target of 94.00.

- Look to get short December '97 T-bond futures at or above 120.24 and long at or below 116.08, with respective stops on closes above/below 122.08 and 114.20.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
Issue No. 97/48
November 28, 1997
E-mail Address: william.dudley@gs.com

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

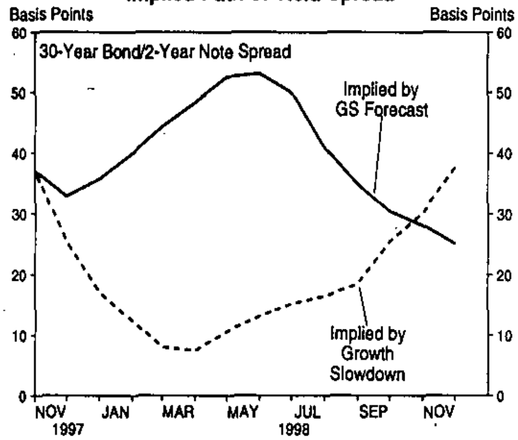
Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

U.S. Economics Analyst

A Look at the Shape of the Yield Curve

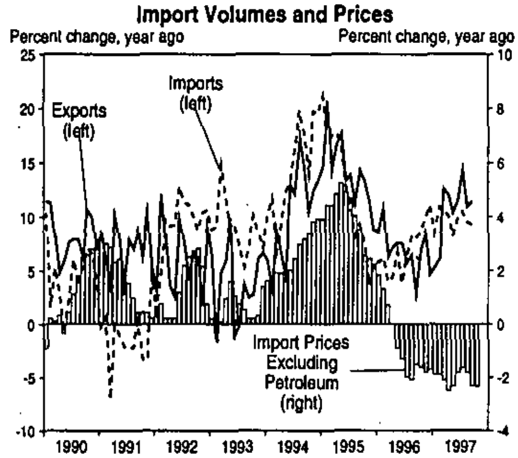
- The flatness of the Treasury yield curve between 30 years and 2 years is appropriate given the market's expectations that no Federal Reserve tightening is likely over the next two years. However, should that expectation change, then the yield curve is likely to steepen.
- We also find that Japanese interest rates are unimportant in explaining the shape of the yield curve. Thus, investors should be more preoccupied with domestic U.S. economic conditions rather than with the appetite of Japanese investors for U.S. Treasuries.
- The yield curve is unlikely to remain unusually flat for an extended period. Either the Fed will ease and ratify the market's expectations or long bond yields will climb as these expectations are disappointed.
- Price pressures remain subdued, with import prices playing an important role in that outcome. The good news on inflation should continue for a bit longer as import prices fall further due to the Asian currency crisis.
- In terms of activity, the news has been mixed. The trade deficit widened sharply in September, due to weakness in exports and a surge in imports, but industrial production and housing activity were both firm last month. Additional drag from trade is likely in coming months as the Asian financial market crisis leads to reduced demand for U.S. exports.

Implied Path of Yield Spread



Source: Goldman Sachs. Our calculations.

Import Volumes and Prices



Source: Department of Commerce.

Trade Recommendations

- We would recommend short positions in the March '98 Eurodollar contract at or above 94.25, with a stop on a close above 94.35 and a target of 94.00.
- Look to get short December '97 T-bond futures at or above 121.00 and long at or below 116.16, with respective stops on closes above/below 122.16 and 114.27.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
Issue No: 97/47
November 21, 1997

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

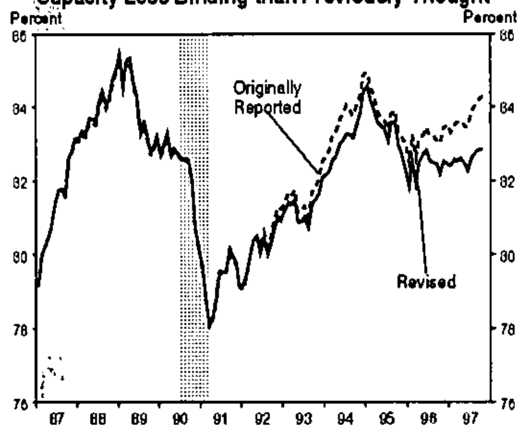
Goldman Sachs

U.S. Economics Analyst

Services Consumption a Stiff Tailwind for Growth

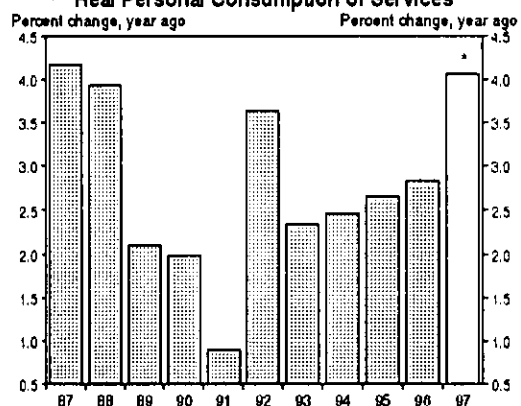
- Rising concerns about deteriorating economic and financial conditions in Asia spurred a sharp bond market advance, pushing the 30-year Treasury bond yield through the previously durable 6% barrier. This rally may extend somewhat further, because the U.S. economic growth pace is likely to slow and inflation remain benign during the early part of next year.
- On the inflation front, finished producer goods prices fell by 0.2% overall, with the core reading down 0.1% and no meaningful price pressures visible further back in the pipeline. Federal Reserve revisions showing much lower rates of capacity utilization and a faster growth rate of capacity help to explain the absence of goods price pressures.
- Retail sales for November were soft, and figures from prior months were revised down a bit as well. Consumers appear to have substantially moderated their spending on goods in the current quarter.
- While personal outlays for goods have fluctuated widely in the past year, the larger services component of total consumption expenditures has been steadily strong, accelerating to a 10-year high. A robust trend in wage and salary income implies a likelihood that rapid gains in these expenditures will persist into 1998.
- Service demands tend to gain importance in overall consumption patterns as an expansion matures, and they have historically been very difficult to suppress through modest monetary tightening. Thus, if the Fed at some point determines that a slower aggregate spending pace is desirable, it is unlikely that a small rate hike will prove adequate to the task.

Capacity Less Binding than Previously Thought



Source: Federal Reserve Board.

Real Personal Consumption of Services



a/ August/October average versus 4Q96.
Source: Department of Commerce.

Trade Recommendations

- Close short March 1998 Treasury bond future positions.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

Issue No: 97/50
December 12, 1997

Important disclosures appear on the inside back cover.

I. Weekly Wrapup

Economic and Market Overview

What a difference a week makes. The bond market has shrugged off last week's bad employment report, with 30-year Treasury bond yields piercing the 6% barrier.

The rally was triggered by news indicating a more sluggish demand trend for retail spending and no inflation pressures. On the demand side, November retail sales came in a bit below expectations (+0.2% overall and +0.2% excluding autos) and October's weak numbers were revised down. Excluding autos and building materials, retail spending in the first two months of the fourth period is now on a weaker 2.3% annual track, versus the 3.9% trend that had previously been evident and the 5.8% annual rise in the third quarter.

On the inflation front, the producer price index for finished goods fell by 0.2% overall and by 0.1% excluding food and energy. A 0.6% drop in motor vehicle prices helped pull down both measures. Even so, there was no evidence of inflation pressure in the pipeline, as core intermediate goods prices were virtually unchanged (+0.1%) and core crude prices fell sharply (-0.7%).

The Federal Reserve's benchmark revisions to its indexes of production and capacity for the industrial sector of the U.S. economy help explain the lack of price pressures. These revisions show much faster capacity growth than initially reported, sufficient to push down the industrial capacity utilization rate by more than one percentage point despite faster growth in industrial output. The revised factory utilization rate for the third quarter of 1997 is now 81.6%, below the level generally associated with the buildup of goods price pressures.

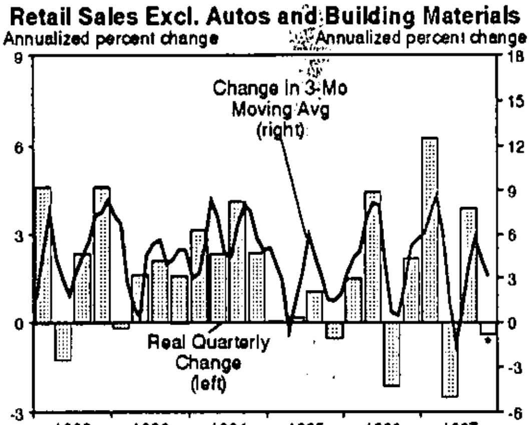
In other news, the Bureau of Labor Statistics reported that import prices fell 0.3% in November, bringing the twelve month decline to 3.9%. Even excluding the volatile energy sector, import prices have fallen 2.3% over the past twelve months. These imported deflationary pressures, stemming largely from the dollar's rise, are one of the main reasons why U.S. inflation has been so well behaved in 1997. Unless the dollar retraces some of its recent strength, falling import prices are likely to help hold inflation in check for awhile longer.

The U.S. current-account deficit increased to $42.2 billion in the third quarter (prior to the onset of the Asian flu) from a revised $37.9 billion in the second. Of interest to the bond market, a sharp reversal to net sales of U.S. Treasury bonds by Japan was mostly offset by a substantial step-up to record net purchases from Western Europe. This drop in Japanese purchases occurred without a corresponding drop in U.S. bond prices, indicating that recent market worries about the behavior of Japanese holders of U.S. securities could be somewhat overblown.

Federal Reserve Policy

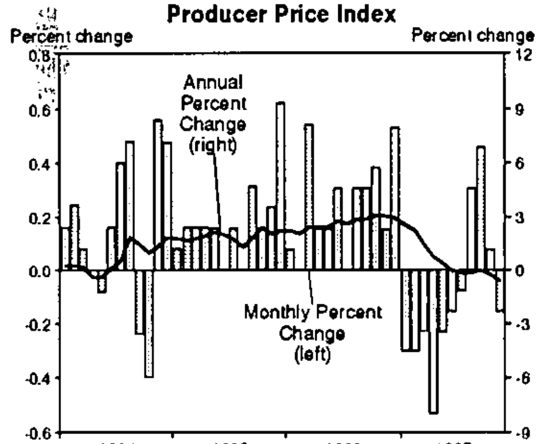
The absence of hawkish sentiments from the Fed that would prepare financial markets for a possible shift in monetary policy indicates that interest rates will almost certainly be kept steady at the December 16

Retail Sales Excl. Autos and Building Materials



*October/November average using GS forecast for inflation.
Source: Department of Commerce.

Producer Price Index



Source: Department of Labor.

FOMC meeting. Uncertainty relating to continuing weakness and instability in Asian financial markets as well as data indicating a virtual absence of goods price pressures are likely to offset worries about tightening labor markets, especially given the capacity revisions. Fed officials also presumably feel comfortable waiting given that the Asian crisis will act to both dampen growth and restrain inflation during the first half of 1998.

Fiscal and Political Developments

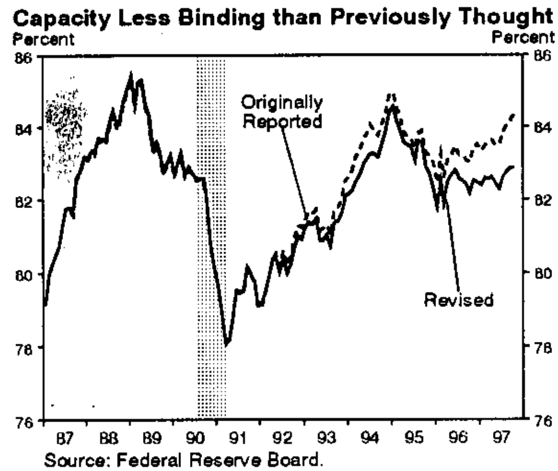
Next week's report on the federal budget balance is likely to show a deficit close to zero on a trailing twelve month basis. Such a development is going to reinforce the recent noise coming from the Republican camp pushing in favor of a tax-cut agenda for 1998. From a political standpoint it would be hard for the Democrats to reject any such suggestion outright. At the same time, there is already talk of Congress spending the anticipated improvement in government finances over the coming years. All of this indicates that an extended period of budget surpluses is not a realistic scenario in the medium term, and budget deficits could reappear sooner rather than later should growth slow.

Market Outlook and Comments on Value

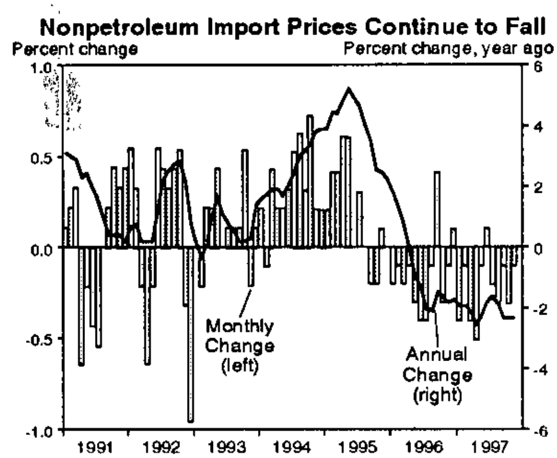
Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

We closed out our short March '98 Treasury bond futures position after the sharp rally on Thursday following the retail sales report. It is now clear to us that Asian developments, capital flows, and good inflation news are apt to dominate tight labor markets as determinants of bond yields for at least several months. Given the fact that the dollar's strength and the Asian crisis are likely to dampen both growth and inflation during the first part of next year, we now anticipate that the buoyant mood in the fixed income market is likely to persist for awhile.

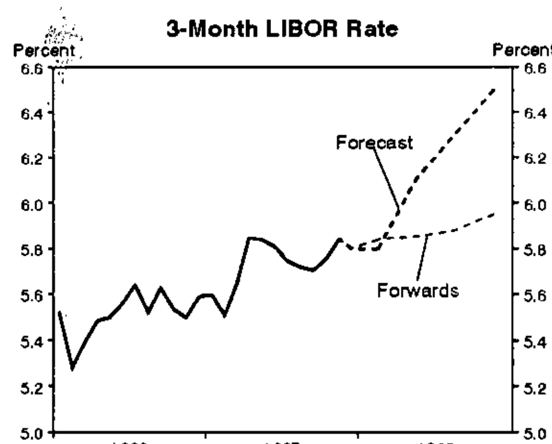
Although we continue to believe that the next move from the Fed is more likely to be a tightening than an easing, that issue is unlikely to be resolved for several months. Over the near term, events are more likely to support than to contradict the market's current bullish sentiments. The next payroll employment report should be much softer, and the economy is likely to slow sharply early next year as the trade drag from Asia begins to bite. As a result, we would stay close to shore for the time being.



Source: Federal Reserve Board.



Source: Department of Labor.



Source: Federal Reserve Board. Wall Street Journal.

II. Services Consumption a Stiff Tailwind for Growth

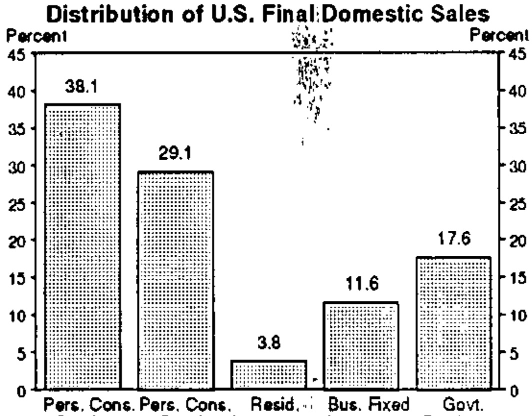
Although it typically receives little direct focus from economic prognosticators, the portion of personal spending that goes toward service industries is a very significant element of total domestic sales, exceeding all other broad categories in size. These outlays have been climbing very rapidly of late, acting as a key influence in the further pickup of real GDP growth during this year. Robust gains in real personal wage and salary income appear to bode for a continuation of relatively sturdy demands from this sector into 1998.

Services consumption tends to hold increasing sway over total household purchases as a business cycle matures, and over time this component of aggregate demand has proven remarkably resilient in the face of even aggressive doses of monetary policy tightening. Thus, in the event that Federal Reserve officials conclude at some point that a material slowdown in domestic spending is required to prevent firmer inflation pressures from emerging, they are likely to be faced with a stiff tailwind on growth from this sector that greatly complicates their task.

A Huge Sector of Demand, Growing Rapidly

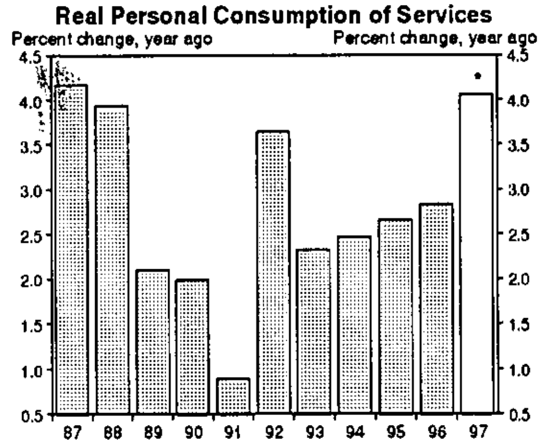
Demand from households for a wide variety of services is a major component of overall final spending in the United States. During the past three full quarters, for example, these purchases averaged 38.1% of total real domestic final sales. This comfortably exceeds the proportion of aggregate purchases represented by goods consumption (29.1%) and dwarfs all other major demand categories. Yet, there is rarely a great deal of discussion about or detailed analysis of the behavior and prospects for this burgeoning segment of the economy.

Distribution of U.S. Final Domestic Sales



*Based on first three quarters of 1997.
Source: Deparment of Commerce.

Real Personal Consumption of Services



*August/October average versus 4Q96.
Source: Department of Commerce.

The services component of personal consumption has strengthened significantly throughout 1997, accounting by itself for nearly all of the half-percent increase in overall real GDP growth. For the three months ending in October, these expenditures were up 4.0% annualized after adjusting for inflation, compared to their volume during the final quarter of 1996. If that trend continues for the full year, it will mark the fastest expansion for these outlays since 1987. Moreover, this pickup has occurred across a broad front, with all major categories under the umbrella of services consumption showing faster gains. The acceleration has been most pronounced in medical care (to 3.8% annual growth from 2.5% in 1996) and a catch-all "other" group (to 6.2% from 4.3%), which includes such diverse areas as educational, recreational, and personal business services, as well as net foreign travel.

Those who offer relatively pessimistic views of the U.S. growth outlook commonly query how overall real consumer spending can be expected to rise faster than 2.0% in 1998 if, as they speculate, it is hard to imagine much "pent-up demand" for goods remaining in the household sector after more than six years of continuous expansion. If, however, real personal spending on services over the next year should sustain the current growth trend, total consumption would climb by 2.3% without any further advance in the level of real goods purchases. Since real household spending on goods is almost never flat or

Breakdown of Real Personal Spending on Services

	Percentage of Total	Growth Rates 1996	1997+
Total	100.0%	2.8%	4.0%
Housing	25.9	1.7	2.0
Household Operation	10.7	1.5	2.4
Transportation	7.3	4.2	4.6
Medical Care	25.8	2.5	3.8
Other*	30.3	4.3	6.2

*- Comprises: personal care services, personal business services, recreational services, private education and research, religious and welfare services, and net foreign travel.

+- August/October average versus fourth quarter of 1996, annual rate of change.

Sources: Department of Commerce. Our calculations.

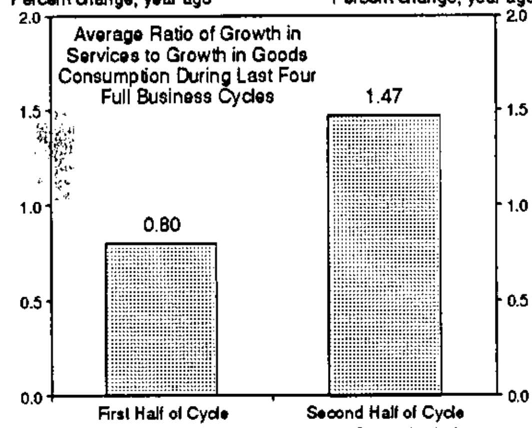
down except for recession periods, a persistence of the recent trend in services consumption would virtually ensure another year of above-average growth in total personal expenditures.

Current Real Income Strength Bodes For Solid Service Demands

An unusually strong, escalating trend in real personal wage and salary income over the past year augurs very favorably for continued positive momentum in personal spending on services next year. During the August/October period—the latest three months for which official data are presently available—nominal wages and salaries were 6.5% higher than in the same three month period a year ago. That translates to a 4.5% surge after adjusting for the modest simultaneous increase in the price deflator for personal consumption expenditures. This is one of the strongest real increases in this core household income component for any 12-month period in the past 20 years. Moreover, the latest monthly statistics suggest that real wage and salary growth is still gaining altitude, on the back of both firmer hiring patterns and a pickup in nominal hourly earnings.

The unusually high and rising trajectory for real earnings should continue to serve as a supportive influence on personal consumption of services into 1998. Since 1960, there has been a 75% positive correlation between changes in real wages and salaries and coincident consumer spending on non-energy services. Even when the real income changes are lagged by two quarters, the correlation with personal service demands remains impressively high, at 54%. These relationships have been relatively stable over time, with similarly high correlations evident during the decade of the 1990s.

Services Trump Goods Late in Cycle



Source: Department of Commerce. Our calculations.

Services Consumption Gains Importance As An Expansion Ages . . .

The proportion of total personal spending growth that is directed toward services clearly tends to rise in the later stages of an economic growth interval. In the last four sustained cyclical GDP advances—covering the 1961-1969, 1970-1973, 1975-1980, and 1982-1990 periods, but excluding the truncated 1980-1981 recovery—the growth rate of personal outlays for services has consistently risen relative to that for goods between the first and second halves of the intervals. On average, personal spending on services during these expansions grew 80% as fast as outlays for goods in the first semester, but nearly one-and-a-half times the rate for goods in the second half.

It also is noteworthy that services consumption normally loses very little of its early-cycle vigor as an expansion matures. Between the first and second halves of the last four sustained growth periods, the average deceleration in annual growth of personal expenditures for services was only 0.4% (to 4.1% from 4.5%). By contrast, growth for real goods consumption fell by half on average in the second semester of those growth periods (to 2.8% from 5.6%).

. . . And Its Momentum Is Hard For the Fed To Brake

One of the most striking characteristics of personal services outlays is how sturdy they have stayed during episodes when Federal Reserve policy makers have hiked interest rates rapidly in an effort to rein in domestic spending. For all non-recession years between 1967 and 1996, the average rate of growth in personal outlays for services was 3.9%, which is

Consumption Growth Patterns During Sustained Expansions

Period	Services		Goods	
	First Half	Second Half	First Half	Second Half
1961:3 - 1969:12	5.2%	5.0%	4.7%	3.8%
1970:12 - 1973:11	4.6	4.6	6.4	3.3
1975:4 - 1980:1	4.1	3.6	5.4	3.0
1982:12 - 1990:7	4.2	3.4	6.0	1.2
Average	4.5	4.1	5.6	2.8

Sources: Department of Commerce. Our calculations.

comparable to what has been experienced lately. Several major mid-expansion tightening rounds occurred in those years: 1968-1969, 1973, 1978-1979, 1983-1984, and 1994-1995. The mean real services consumption growth performance in those nine years of strong Fed actions to suppress spending was 3.9%—precisely the same as for all the other growth years, during many of which interest rates were stable or even declining. Indeed, the record shows that household service demands have tended to remain relatively brisk right up to the brink of a business cycle downturn. In the final year of the past four extended business expansions, real household spending on services grew by 3.0% or more every time (using three-month averages to smooth out volatility), reaching or exceeding 4.0% in half of those cases.

A Strong Tailwind For U.S. Growth

The heightened importance of services for the behavior of total personal spending in advanced stages of cyclical expansions, combined with the historical tendency for these demands to sustain solid upward momentum in a wide range of monetary policy circumstances, suggests that a decline in aggregate consumption growth below the long-term average pace is unlikely to develop anytime soon. This is a key reason why the U.S. economy tends to be relatively insensitive to modest changes in interest rates, particularly when economic growth has become well-entrenched and confidence in the prospects for continued cyclical gains is high.

With business conditions in Asia deteriorating rapidly and inflationary pressures remaining low, it remains likely that central bankers will want to keep short-term U.S. interest rates steady for awhile longer, possibly well into 1998. In the event, however, that Chairman Greenspan and other senior officials should decide it is necessary to foster an appreciable reduction in domestic spending via monetary restraint, they may well find spending on services to be relatively impervious to their efforts. Thus, it remains very doubtful that a mere 25- or 50-basis-point short-term rate rise would be sufficient to the task of actively suppressing total final sales growth to or below an historical average level.

John Youngdahl

Key U.S. Economic Data

	Latest Monthly Data '97 Nov	'97 Oct	'97 Sep	'97 Aug	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. Thousands)	404	287	300	52	275	253	Jan 9
Unemployment Rate (%)	4.6	4.7	4.9	4.9	4.8	5.0	
Index of Hours Worked (% ch)	1.1	0.4	-0.1	0.4	4.0	3.6	
Average Hourly Earnings (% ch)	0.6	0.4	0.3	0.6	4.6	4.1	
Producer price finished goods index (% ch)	-0.2	0.1	0.5	0.3	0.9	-0.6	Jan 8
Excluding food and energy	-0.1	0.0	0.4	0.1	0.7	0.3	
Consumer price index (% ch)	..	0.2	0.2	0.2	2.0	2.1	Dec 16
Excluding food and energy (% ch)	..	0.2	0.2	0.1	1.9	2.3	
Retail sales (% ch)	0.2	-0.2	-0.3	0.4	4.3	3.8	Jan 14
Excluding motor vehicles (% ch)	-0.2	0.3	0.2	0.0	4.0	4.0	
Industrial Production (% ch)	..	0.4	0.5	0.6	5.7	5.6	Dec 15
Manufacturing	..	0.5	0.2	0.8	6.2	5.9	
Capacity utilization (%)	..	82.9	82.9	82.8	82.6	82.6	Dec 15
Manufacturing	..	81.7	81.6	81.8	81.6	81.6	
Housing Starts (annual rate, thousands)	..	1528	1507	1395	1467	1461	Dec 16
Single-family	..	1142	1187	1091	1134	1133	
Trade balance (billions, monthly)	..	..	-11.1	-9.5	-9.5	-9.4	Dec 18
Merchandise	..	..	-18.1	-16.6	-16.4	-16.4	
Factory Orders (% ch)	..	0.3	0.4	1.2	7.3	4.6	Jan 6
Durable Goods	..	-0.1	0.0	2.5	10.2	6.2	Dec 23
Personal Income (% ch)	..	0.5	0.3	0.6	5.1	6.0	Dec 24
Wages and Salaries	..	0.6	0.3	0.8	6.1	6.9	
Purchasing Managers' Index (%)	54.4	56.0	54.2	56.8	56.0	55.1	Jan 2
Consumer Sentiment U Mich (Feb 66=100)	107.2	105.6	106.0	104.4	105.8	102.8	Dec 23
Conference Board (1985=100)	128.3	123.4	130.2	127.6	127.6	123.5	Dec 30

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

©1997 Goldman, Sachs & Co. All rights reserved.

This material is for your private information, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy or sell, the securities, or derivatives (including options) thereof, of companies mentioned herein. No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without Goldman, Sachs & Co.'s prior written consent.

This material has been issued by Goldman, Sachs & Co. and/or one of its affiliates and has been approved by Goldman Sachs International, which is regulated by The Securities and Futures Authority, in connection with its distribution in the United Kingdom and by Goldman Sachs Canada in connection with its distribution in Canada. This material is distributed in Hong Kong by Goldman Sachs (Asia) L.L.C.; and in Japan by Goldman Sachs (Japan) Ltd. This material is not for distribution in the United Kingdom to private customers, as that term is defined under the rules of The Securities and Futures Authority; and any investments, including any convertible bonds or derivatives, mentioned in this material will not be made available by us to any such private customer. Neither Goldman, Sachs & Co. nor its representative in Seoul, Korea, is licensed to engage in the securities business in the Republic of Korea. Goldman Sachs International and its non-U.S. affiliates may, to the extent permitted under applicable law, have acted upon or used this research, to the extent it relates to non-U.S. issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

Further information on any of the securities mentioned in this material may be obtained upon request, and for this purpose persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan, or at its London branch office at 133 Fleet Street, and persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 3 Garden Road. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

U.S. Calendar

Focus for the Week Ahead

- Industrial production should advance sharply as a large gain in manufacturing output overwhelms modest weakness in utilities and mining output (December 15).
- Consumer prices should remain well-behaved, with the risks skewed to the low side. Motor vehicle and energy prices should slip somewhat, as they did in the PPI report (December 16).
- Housing starts during November probably declined substantially due to unseasonably poor weather (December 16).
- The trade balance should show notable improvement in October, aided by a sharp drop in petroleum imports and seasonal adjustment problems, which tend to depress the fourth quarter deficits. Despite the improved overall balance, the bilateral figures of the U.S. versus most Asian countries, which are not seasonally adjusted, should show widening deficits (December 18).
- The budget balance for November should narrow markedly from a year ago, pushing the 12-month trailing deficit within a whisker of balance (December 19).

Economic Releases and Other Events

Date	Time	Indicator	Estimate GS	Estimate Consensus	Last Report
Mon Dec 15	9:15	Industrial Production (Nov)	+0.5%	+0.5%	+0.5%
	9:15	Capacity Utilization (Nov)	83.0%	83.0%	82.9%
Tue Dec 16	8:30	Consumer Price Index (Nov)	+0.1%	+0.2%	+0.2%
		Excluding Food & Energy	+0.2%	+0.2%	+0.2%
	8:30	Housing Starts (Nov)	-6.0%	-1.8%	+1.4%
Thu Dec 18	8:30	Trade Balance (Oct)	-$9.4 Bil	-$10.8 Bil	-$11.1 Bil
	10:00	Philadelphia Fed Survey (Dec)	+8.0%	n.a.	+10.1%
Fri Dec 19	2:00	Federal Budget Balance (Nov)	-$22.5 Bil	-$25.0 Bil	-$37.9 Bil

- **FOMC Meeting (Tue, Dec 16)**
- **Treasury Announces 2- and 5-Year Notes (Wed, Dec 17 - 2:30)**
- **November FOMC Minutes (Thu, Dec 18 - 2:00)**

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	6.1%	6.3%
Forward	5.8	5.9	5.9
2 Yr T-Note	5.8	6.2	6.3
Forward	5.7	5.7	5.8
10 Yr T-Note	6.0	6.3	6.4
Forward	5.8	5.8	5.9

Key Numbers in the Business Outlook

	1997 Q3	1997 Q4E	1998 Q1E	1997E	1998E
Real GDP	3.3%	2.7%	2.3%	3.7%	2.8%
Ind. Prod., Mfg.	6.1	3.4	3.6	5.0	4.3
CPI	2.0	2.4	2.6	2.4	2.4
After-Tax Profits*	10.0	10.6	6.2	9.7	3.1
Unemployment	4.9	4.7	4.7	5.0	4.6

* Excluding inventory profits; adjusted for depreciation distortions.

Goldman, Sachs & Co.,
One NY Plaza, New York, NY 10004

Tel.#: (1) 212-902-6807
Fax #: (1) 212-346-3115

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

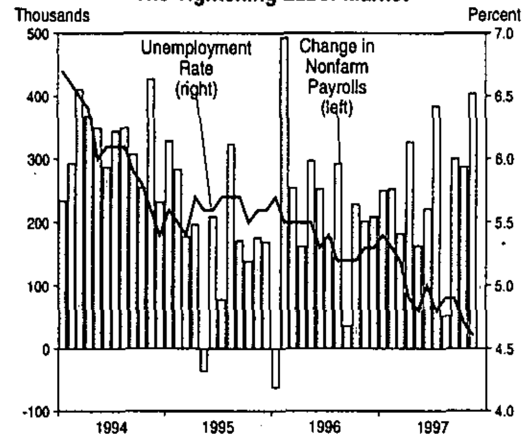
Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

U.S. Economics Analyst

A Flattening Yield Curve and the Implications for Growth

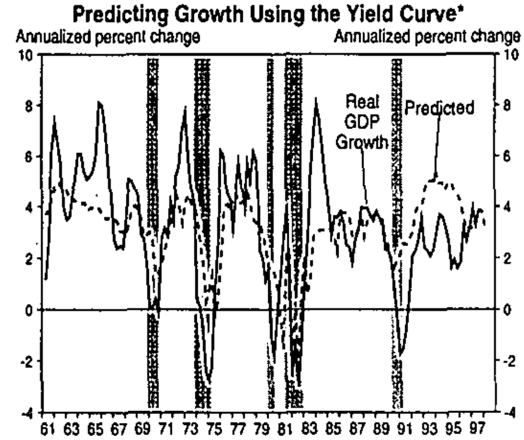
- The strong payroll and household employment reports underscore the strength of the domestic economy and the tightness of U.S. labor markets.
- Despite this strength, Fed officials will probably decide to keep monetary policy unchanged at the December 16 FOMC meeting. The fact that Chairman Greenspan did not discuss the U.S. economy in his speech to the New York Economic Club indicates an inclination to "wait and see" for the time being. If his views change, then a much more hawkish tone is likely to emerge from the Fed as policymakers work to prepare the markets for a monetary policy tightening.
- A flatter yield curve implies slower growth. But it is important not to overstate the power of this relationship. Based on historical relationships, the flattening that has occurred this year implies only a modest slowdown in economic activity.
- Moreover, the implications for growth now are likely to be even weaker than has been typical. Not only has the linkage between the yield curve shape and economic activity loosened since the early 1980s, but also the association between the yield curve and subsequent economic activity tends to be looser when the flattening is mainly driven by a drop in long-term interest rates.
- The predictions of the yield curve are only as good as the expectations embodied in it. The recent shape has been consistent with a modest easing of monetary policy next year. If expectations about easing are dashed, then the yield curve is likely to become steeper, not by short-term rates falling, but by a rise in long-term interest rates.

The Tightening Labor Market



Source: Department of Labor.

Predicting Growth Using the Yield Curve*



*Yield curve represents 10-year note/federal funds spread.
Source: Department of Commerce. Our calculations.

Trade Recommendations

- Get short March '98 Treasury bond futures (currently 118.11), with a target of 114.16 and a stop on a close above 119.16.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

Issue No: 97/49
December 5, 1997

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

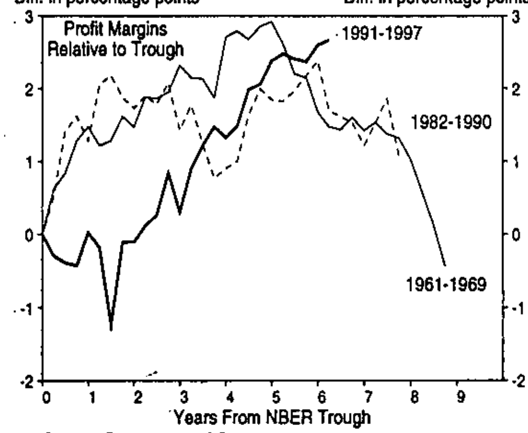
Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

U.S. Economics Analyst

The Impending Slowdown in Corporate Profit Growth

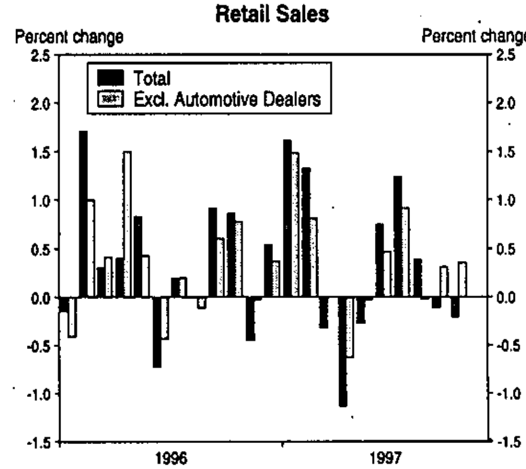
- In the context of the market turmoil generated by the devaluation of a number of emerging market currencies, the FOMC's decision to leave policy unchanged at its November 12 meeting was no surprise. However, the tenor of the minutes of the September session, coupled with a generally robust set of data released in the interim, clearly point to tightening as the ultimate next move.
- Although uncertainty about the U.S. economic and financial outlook has increased markedly in the wake of the market turbulence, one thing seems certain: Slower real GDP growth in 1998, coupled with an end to profit margin expansion, implies a slowdown in corporate profit growth.
- Margin expansion is likely to end in 1998 for four reasons: (1) the slowdown in growth, (2) a likely pickup in labor compensation inflation, (3) a slowing in productivity growth, and (4) the additional costs companies incur as they fix computer systems for the year 2000 problem.
- As a result, we see overall profit growth slowing to about 3% in 1998 from 10% in 1997. Firms in the Standard and Poor's 500, however, should experience a more moderate slowing in earnings per share, to 8½% in 1998 from 10½% in 1997 on an operating basis.
- The latest data continue the pattern of robust growth in economic activity with no evidence of emerging inflation pressure. Retail sales, while down overall, remain on a firm upward trend in the critical nonauto category, and claims for jobless benefits remain low. But producer prices remain stable, reflecting to some degree large gains in productivity.

Profit Margins During Long Expansions



Source: Department of Commerce.

Retail Sales



Source: Department of Commerce.

Trade Recommendations

- Our long December 1997/short March 1999 Eurodollar futures spread trade was stopped out on a close below 23 basis points.
- No new positions are recommended at this time; look to buy December Treasury bond futures in the event of a material downward price adjustment.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
E-mail Address: william.dudley@gs.com

Issue No: 97/46
November 14, 1997

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

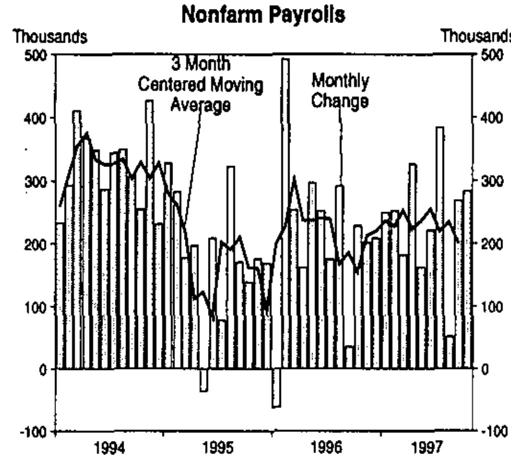
Goldman Sachs

U.S. Economics Analyst

Life Without Federal Budget Deficits

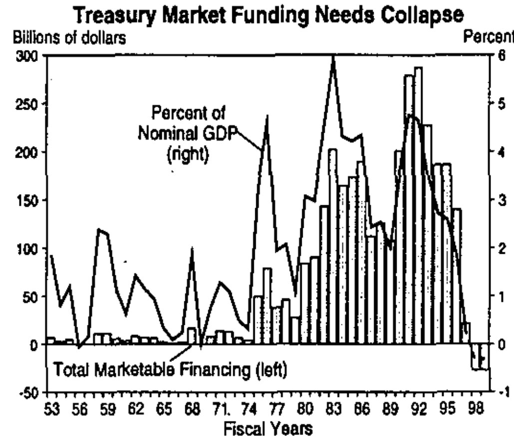
- The economy continues to have significant forward momentum. This can be seen in the large gains in payroll employment reported for October and, on revision, for September. In addition, the NAPM index rose to 56.0% in October, factory orders rose 0.4% in September, and the Goldman Sachs Retail Index posted a 4.5% year-over-year growth rate in October, up sharply from 2.1% in September.
- The only meaningful sign of weakness in recent weeks has been in exports. The NAPM export component managed to increase only slightly in October after dropping sharply in September.
- Notwithstanding the overwhelming strength of recent indicators, Federal Reserve officials are unlikely to tighten policy at the November 12 FOMC meeting as they seek more time to assess the potential impact of currency turmoil in Asia and Latin America on U.S. economic activity.
- The federal budget deficit is likely to vanish altogether this current fiscal year. But large surpluses are unlikely. That is because the politicians will want to use any windfall to cut taxes. This week's election results underscore that tax cutting remains a very successful formula to attract votes.
- The elimination of the budget deficit has three major consequences: 1) The recent era of fiscal drag that has helped to keep the economy from overheating is ending; 2) Treasury officials are likely to review and restructure the Treasury debt offering structures, with relatively more Treasury bills and fewer Treasury notes; and 3) the yield curve should generally remain quite flat as the supply of longer-duration Treasury securities is reduced.

Nonfarm Payrolls



Source: Department of Labor.

Treasury Market Funding Needs Collapse



Note: 1998 and 1999 based on our forecast.
Source: Department of Commerce. Department of Treasury.

Trade Recommendations

- Stay long the December '97/March '99 Eurodollar calendar spread, with a stop on a close below 23 basis points and a target of 70 basis points.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
E-mail Address: william.dudley@gs.com

Issue No: 97/45
November 7, 1997

Important disclosures appear on the inside back cover.

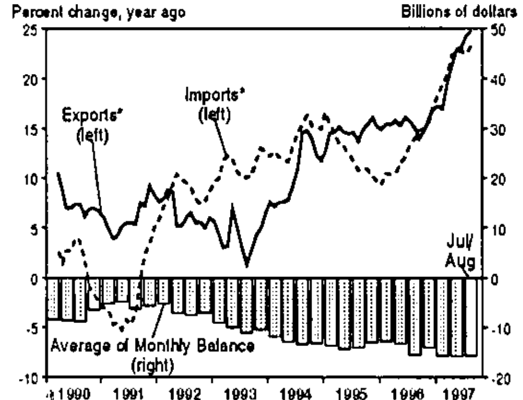
Goldman Sachs

U.S. Economics Analyst

That High (and Rising) Real Federal Funds Rate

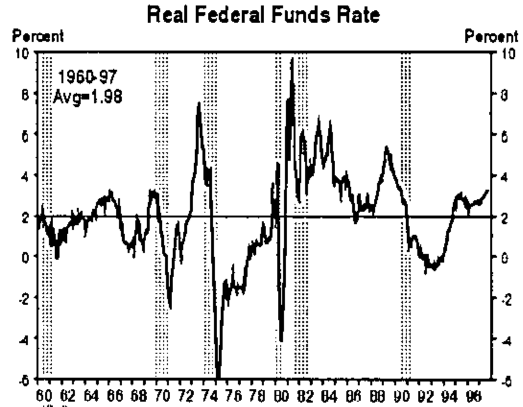
- Asian currency woes have spread, increasing the potential size of the trade shock to the United States. This suggests that Fed officials are unlikely to tighten monetary policy at the November 12 FOMC meeting. Prudence counsels patience until the size of the shock can better be assessed. Moreover, a Fed tightening could exacerbate the problem, which would be counterproductive to U.S. interests.
- The real federal funds rate exceeds its historical average. Despite this, there is little supporting evidence that U.S. monetary policy is tight. This apparent inconsistency is readily resolved. The equilibrium real federal funds associated with a neutral monetary policy today is higher than its long-term average due to structural changes in the economy and the advanced stage of the current business cycle.
- The structural changes in the economy that are leading to a strong stock market, increased investment, and a decline in the household saving rate also imply a higher real federal funds rate. That is the mechanism that equilibrates what would otherwise be an imbalance between investment and saving.
- In addition, the rise in the real federal funds rate that has occurred over the last six months is not constraining the economy. Examining the transmission mechanisms of monetary policy, the rise is unlikely to have any sizable effect on consumer durable goods purchases, housing, or the stock market. The only impact has been that the high real rate has helped to lift the dollar somewhat.

Real Merchandise Trade Balance



*3-Month Moving Average.
Source: Department of Commerce.

Real Federal Funds Rate



Note: Federal funds rate less the percent change year ago in the CPI excluding food and energy.
Source: Federal Reserve Board. Department of Labor.

Trade Recommendations

- Cover short September '98 Eurodollar position.
- Go long the December '97/March '99 Eurodollar calendar spread, with a stop on a close below 23 basis points and a target of 70 basis points.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

Issue No: 97/43
October 24, 1997

Important disclosures appear on the inside back cover.

I. Weekly Wrapup

Economic and Market Overview

Steep declines in Asian currency and equity values provided a lift for U.S. bond prices this week, as financial market participants braced for an onslaught of important economic statistics, Treasury securities auctions, and monetary policy testimony just ahead. The only major government report in recent days concerned international trade, and it showed a continuation of upward pressure on the goods and services deficit with the rest of the world. At $10.4 billion, the trade gap for August was only slightly larger than in July but remained well above levels experienced in the first half of 1997. Growth in nonpetroleum merchandise imports has accelerated from about 4% to roughly 11% in the past year, despite declining prices. This reflects the consistently strong upward trend in domestic spending on goods over the interval. Exports, meanwhile, have also been solid, climbing almost as rapidly as imports once the volatile aircraft component is excluded. Given favorable prospects for continued solid U.S. spending by both consumers and businesses, as well as the likelihood of a negative external demand shock from the spreading currency turmoil in Asia, the real net exports deficit can be expected to widen further during the next few quarters.

Other data series do not indicate any major retrenchment in retail spending or home sales as yet. Although the BTM/Mitsubishi Bank chain-store sales index has been flat to down since late August, the same pattern prevailed in two of the prior three years, suggesting a seasonal adjustment problem. On a year-to-year comparison, the BTM/Mitsubishi measure is up a relatively sturdy 5%. In addition, the volume of mortgage applications for new purchases is up close to 20% from this time last year, suggesting that sales of new and existing homes—which tend to lead personal consumption of durables—are not receding.

Federal Reserve Policy

When he testifies to the Joint Economic Committee of Congress next Wednesday, Chairman Greenspan will likely restate his concerns that unusually low unemployment combined with signs of slower labor force expansion create fertile conditions for a pickup in labor compensation growth, which could undermine the substantial progress made against inflation in this decade. At the same time, it is doubtful that he will signal a high probability of an imminent interest rate increase, for two reasons. First, at the time of the testimony the chairman will lack the details of the October employment report (due November 7), which help determine whether labor scarcity is intensifying. Second, the uncertainties growing out of the Asian currency and stock market slumps provides a fresh reason for Fed officials to remain cautious about shifting into a more restrictive stance. Because it is unclear how spreading problems in the Far East might affect domestic production going forward, the preference for patience that has dominated Fed policymaking throughout this year should once again prevail.

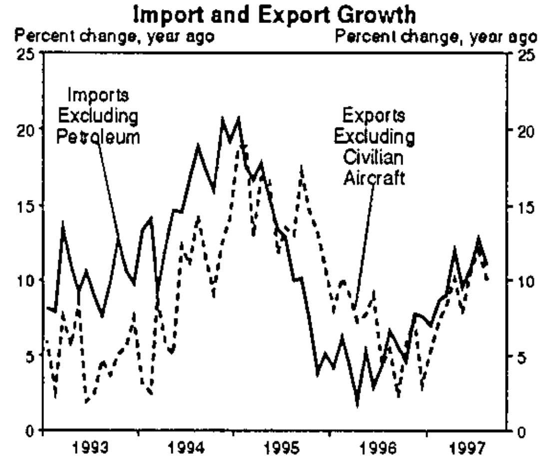
Fiscal and Political Developments

The politics of the impending presidential battle in 2000 among Democrats appears to have had two

Real Merchandise Trade Balance

*3-Month Moving Average.
Source: Department of Commerce.

Import and Export Growth



Source: Department of Commerce.

major policy influences this month. Amid fierce opposition from labor unions and many House Democrats led by Richard Gephardt (D-Missouri)—an almost certain primary election opponent for Vice President Gore—the outlook for congressional approval of broad trade pact negotiating authority requested by President Clinton now looks very dim. With no more than a handful of Democratic votes for the bill in the lower chamber at this time, the administration probably will let this matter slip into 1998 rather than risk losing a vote outright. In addition, this week the administration executed a sharp reversal of strategy in endorsing a proposal to significantly reform the Internal Revenue Service immediately after Rep. Gephardt let it be known that he would back the plan. Judging from these developments, it will be important to stay abreast of the policy views of Gephardt and other potential future candidates for the presidency in order to anticipate the evolution of policies on politically sensitive issues.

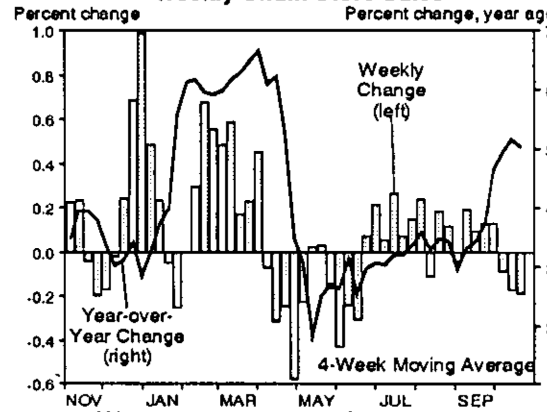
Market Outlook and Comments on Value

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

We would cover our short September '98 Eurodollar position (currently 94.97) because we expect the employment cost index report to be generally benign and do not expect Chairman Greenspan's testimony, while cautionary, to signal an imminent tightening of monetary policy. At the same time, because we continue to expect that about 100 basis points of Fed tightening will be forthcoming next year as U.S. labor markets tighten further, we would put on a long Eurodollar calendar spread trade, going long the December '97 and short the March '99 Eurodollar contracts (current spread of 29 basis points), with a stop on a close below 23 basis points and a target of 70 basis points. Essentially no tightening is priced in beyond December, which is quite surprising given Chairman Greenspan's warning two weeks ago that the economy was on an unsustainable growth trajectory.

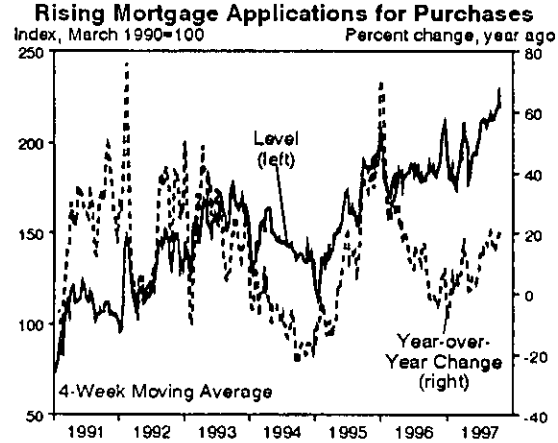
In terms of the long end of the curve, we remain neutral, with the 30-year yield in the middle of the 6%-6¾% range that we expect will persist into 1998. The near-term direction is likely to be established by the tenor of the forthcoming data and the news out of Asia.

Weekly Chain Store Sales



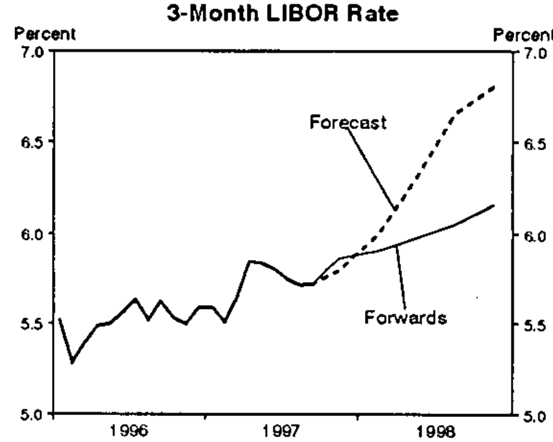
Source: Bank of Tokyo - Mitsubishi Bank.

Rising Mortgage Applications for Purchases



Source: Mortgage Bankers Association.

3-Month LIBOR Rate



Source: Federal Reserve Board, Wall Street Journal.

II. That High (and Rising) Real Federal Funds Rate

The real (*i.e.*, inflation-adjusted) federal funds rate is significantly above its long-term historical average. Moreover, over the past six months it has been rising—pushed upward by the Fed's March 25 rate hike and a decline in the inflation rate. Does this indicate that monetary policy has been tight and is tightening further? If that were true, then the economic growth pace would presumably subside on its own. Under such circumstances, there would be little reason for Fed officials to tighten monetary policy further.

We reach a very different conclusion: The current level of the real federal funds does not imply that monetary policy is restrictive. The strongest support for this conclusion is the economy's performance. Demand growth has gradually been accelerating over the past two years despite a monetary policy regime that has not changed very much.

The above-average real federal funds rate has not had a dampening effect on the economy because the real rate consistent with a neutral monetary policy is not fixed. Instead, it changes over time as the structure of the economy evolves and as the economy moves through different stages of the business cycle.

Nor does the recent rise in the real federal funds rate indicate that policy has become much more restrictive. That is because the rise is having little impact on consumption, housing, and trade—the sectors that typically are most affected by shifts in the stance of monetary policy.

Thus, the fact that the real federal funds rate is high and rising is not likely to prevent Fed officials from eventually being forced to tighten monetary policy further. Instead, as the economy continues to grow at an above-trend pace and the labor markets tighten further, Fed officials are likely to be forced to push the nominal (and real) federal funds rates higher over the next year.

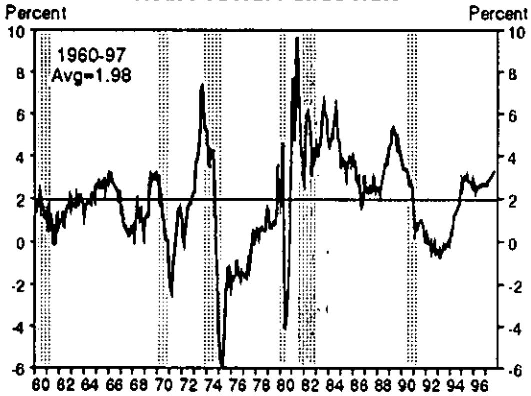
High and Rising

The real federal funds is both high by historical standards and rising. Using the 12-month change in core consumer price inflation to deflate the nominal federal funds rate, the current real rate is about 3.3%, well above the 2% average of the 1960-1996 period. Moreover, as can be seen in the accompanying chart, the real rate has risen by over 0.5 percentage points this year, pushed upwards by both the Fed's March tightening step and some moderation in the core CPI inflation rate. Based upon this evidence, one might conclude that U.S. monetary policy was already tight and recently has become even tighter.

High, But Not Too High

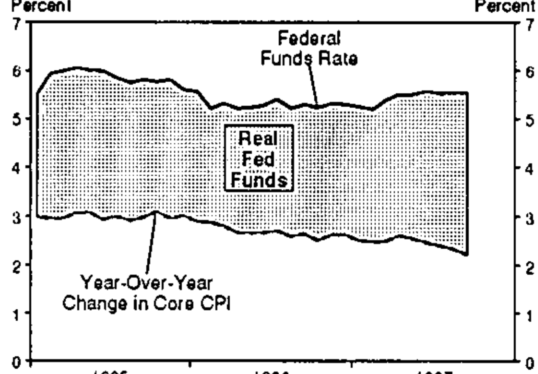
But this would be the wrong conclusion. In particular, there are good reasons why the real equilibrium federal funds rate consistent with a neutral monetary policy should be significantly higher today than in the past. Moreover, a close examination of the transmission mechanism of monetary policy to the real economy suggests that the recent rise in the real federal funds rate has had virtually no impact on the growth rate of economic

Real Federal Funds Rate



Note: Federal funds rate less the percent change year ago in the CPI excluding food and energy.
Source: Federal Reserve Board. Department of Labor.

Falling Inflation Leads to Higher Real Fed Funds



Note: Federal funds rate less the percent change year ago in the CPI excluding food and energy.
Source: Federal Reserve Board. Department of Labor.

activity. The rise in the real federal funds rate has not constrained activity in those sectors that are typically affected by a tighter monetary policy.

There are three reasons why the real equilibrium federal funds rate consistent with monetary policy neutrality should currently exceed its long-term average value. First, changes in the structure of the economy that are leading to longer business expansions should also have an impact on the equilibrium level of interest rates. It is logically inconsistent to argue that this business cycle is different, but that the old benchmark for the equilibrium real federal funds rate still applies.

If the business cycle has been dampened and extended, then there should be at least three consequences: 1) Equity market valuations should climb; 2) business investment should rise; and 3) the household saving rate should fall. The consequence should be an increase in the *ex ante* demand for saving and a fall in the *ex ante* supply. To equilibrate the two, real interest rates should rise.

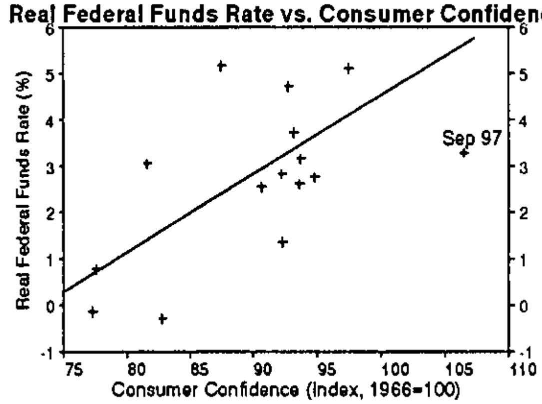
In terms of the current business expansion, all three effects are visible. Equity valuations have climbed sharply; business fixed investment as a share of GDP has risen significantly; and the household saving rate has fallen, despite the fact that the population is aging, which should be gradually nudging the saving rate higher.

Second, the real level of the federal funds rate consistent with neutrality should depend on the phase of the business cycle. After all, when consumers and businesses are confident, the demands placed on the pool of savings are likely to be higher than when confidence is depressed.

A scatter plot that relates the level of consumer confidence to the real federal funds rate over the 1983-1997 period indicates that there has been a positive relationship between these two variables. As can be seen in the chart, based on the fitted relationship over this period, the real federal funds rate is actually low relative to the current high level of consumer confidence. Put simply, with consumer confidence at its highest level in more than 25 years, is it any wonder that the current level of real interest rates has not been sufficiently high to discourage further rapid gains in spending?

Third, in any real federal funds rate that is derived using the consumer price index, it is important to remember that the Bureau of Labor Statistics has been making methodological changes in calculating the CPI that have reduced the reported inflation rate by about 0.2% to 0.3% since early 1995. Since earlier CPI data have not been revised, these changes have acted to artificially push up the real federal funds rate compared to its long-term historical average. With the BLS likely to make further methodology changes that will cut an additional 0.4% from the annualized inflation rate by yearend 1999, this distortion to a CPI-based real federal funds will grow even larger in the future.

Real Federal Funds Rate vs. Consumer Confidence



Note: Fed funds less the percent change year ago in the CPI excluding food and energy.
Source: Federal Reserve Board. Department of Labor. University of Michigan.

Rising, But Little Impact

Similarly, we do not find that the rise in the real federal funds rate since March has constrained economic activity.

Looking at how monetary policy restrains or boosts the real economy, there are three major transmission mechanisms: 1) the consumer durable goods and housing sectors by the impact of interest rates on affordability, 2) consumption by the impact of interest rates on household net worth and the saving rate, and 3) trade, via the impact of real rates on the exchange value of the dollar.

Looking at these three transmission mechanisms, there is little evidence that the rise in real short-term rates will have much impact. For consumer durables, the trajectory remains upward. This should not be considered surprising given that a rise in real rates caused by falling prices probably increases consumption rather than deters it by making such purchases more affordable. First, debt service does not climb as long as nominal rates are unchanged.

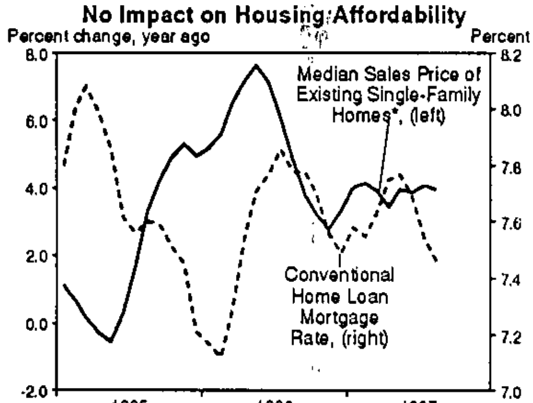
Second, a lower inflation rate tends to boost real income.

Similarly, for housing, the rise in the real federal funds rate has not constrained demand. That is because the rise in the real federal funds rate has not raised the cost of home ownership. To see this, consider that the effective cost of home ownership is determined mainly by the difference between the nominal interest rate and the rate of expected home price appreciation. Nominal rates have not risen. In fact, mortgage rates have fallen since March when the monetary authorities tightened. Moreover, as shown in the accompanying chart, the rate of home price appreciation has not declined. Thus, the effective cost of home ownership has been falling despite the modest rise in the nominal federal funds rate.

In terms of the wealth effect, the stock market is substantially higher than at the start of the year, in part because of the decline in the core rate of inflation. In an expanding economy, lower inflation tends to be associated with higher equity market valuation. Thus, when real rates rise because inflation is falling, there is no negative impact on household wealth.

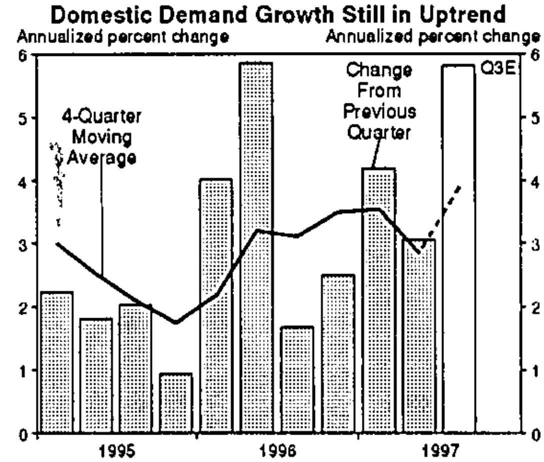
The dollar is one area in which falling inflation and rising real rates has led to some restraint on the economy. After all, the dollar has generally been appreciating since its trough in 1995. But even here, the amount of drag on activity has been relatively modest. That is because export performance is driven more by shifts in domestic demand growth abroad than by shifts in the exchange value of the dollar. To date, the dollar's strength has led to only modest deterioration in the nation's trade balance.

No Impact on Housing Affordability



*3-month moving average.
Source: Federal Home Loan Bank Board, National Association of Realtors.

Domestic Demand Growth Still in Uptrend



Source: Department of Commerce, Goldman Sachs.

The Proof of the Pudding Is in the Eating

In the end, the performance of the economy over the past two years underscores the fact that the difference between the real federal funds rate and its long-term historical average value has not been a reliable guide to the stance of monetary policy. As shown above, domestic demand growth has gradually been accelerating. This is exactly the opposite of what one might expect if monetary policy were exerting a restraining influence. Moreover, the monetary regime has not changed very much over this time period. Thus, even allowing for the long and variable lags via which monetary policy affects the real economy, enough time has passed since the regime was put in place in 1994 so that its impact on the pace of economic activity can be properly evaluated.

Although it certainly is true that monetary policy is more restrictive than it was in early 1994 when the nominal federal funds rate was 3% and the real federal funds rate was around 0%, little evidence suggests that the current level of interest rates is constraining. This suggests that Federal Reserve officials will be forced to tighten monetary policy further to bring the U.S. economy back down to its long-run sustainable growth pace. Although the absence of visible inflation pressures and ongoing turmoil in Asia suggest that no tightening is imminent (Chairman Greenspan may clarify this issue in his testimony to the Joint Economic Committee of Congress on October 29), about 100 basis points of tightening appears likely by yearend 1998.

Bill Dudley

Key U.S. Economic Data

	Latest Monthly Data '97 Sep	'97 Aug	'97 Jul	'97 Jun	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. Thousands)	215	40	384	222	225	223	Nov 7
Unemployment Rate (%)	4.9	4.9	4.8	5.0	4.9	5.1	
Index of Hours Worked (% ch)	-0.1	0.4	-0.3	0.4	0.4	1.9	
Average Hourly Earnings (% ch)	0.3	0.5	0.1	0.3	3.3	3.6	
Producer price finished goods index (% ch)	0.5	0.3	-0.1	-0.1	-0.5	0.0	Nov 14
Excluding food and energy	0.4	0.1	-0.1	0.1	0.3	0.3	
Consumer price index (% ch)	0.2	0.2	0.2	0.1	1.8	2.2	Nov 18
Excluding food and energy (% ch)	0.2	0.1	0.2	0.1	2.0	2.2	
Retail sales (% ch)	0.3	0.6	1.2	0.7	3.0	5.2	Nov 14
Excluding motor vehicles (% ch)	0.2	0.2	0.9	0.5	2.3	4.6	
Industrial Production (% ch)	0.7	0.5	0.8	0.3	6.0	5.5	Nov 17
Manufacturing	0.4	0.8	0.9	0.4	6.1	5.8	
Capacity utilization (%)	84.4	84.1	83.9	82.5	83.8	83.6	Nov 17
Manufacturing	83.4	83.3	82.9	82.5	82.8	82.6	
Housing Starts (annual rate, thousands)	1500	1390	1465	1503	1457	1450	Nov 19
Single-family	1170	1094	1149	1134	1130	1129	
Trade balance (billions, monthly)	..	-10.4	-10.0	-8.3	-9.1	-9.5	Nov 20
Merchandise	..	-17.4	-16.8	-15.2	-16.0	-16.4	
Factory Orders (% ch)	..	1.3	0.5	1.7	5.5	7.5	Nov 5
Durable Goods	..	2.7	0.1	2.9	8.8	11.6	Oct 29
Personal Income (% ch)	..	0.6	0.2	0.6	5.1	5.8	Nov 3
Wages and Salaries	..	0.8	0.1	0.8	5.5	6.6	
Purchasing Managers' Index (%)	54.2	56.8	58.6	55.7	56.1	54.4	Nov 3
Consumer Sentiment U Mich (Feb 66=100)	106.0	104.4	107.1	104.5	104.4	101.4	Oct 31
Conference Board (1985=100)	128.6	127.6	126.3	129.9	126.5	120.5	Oct 28

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

©1997 Goldman, Sachs & Co. All rights reserved.

This material is for your private information, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy or sell, the securities, or derivatives (including options) thereof, of companies mentioned herein. No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without Goldman, Sachs & Co.'s prior written consent.

This material has been issued by Goldman, Sachs & Co. and/or one of its affiliates and has been approved by Goldman Sachs International, which is regulated by The Securities and Futures Authority, in connection with its distribution in the United Kingdom and by Goldman Sachs Canada in connection with its distribution in Canada. This material is distributed in Hong Kong by Goldman Sachs (Asia) L.L.C.; and in Japan by Goldman Sachs (Japan) Ltd. This material is not for distribution in the United Kingdom to private customers, as that term is defined under the rules of The Securities and Futures Authority; and any investments, including any convertible bonds or derivatives, mentioned in this material will not be made available by us to any such private customer. Neither Goldman, Sachs & Co. nor its representative in Seoul, Korea, is licensed to engage in the securities business in the Republic of Korea. Goldman Sachs International and its non-U.S. affiliates may, to the extent permitted under applicable law, have acted upon or used this research, to the extent it relates to non-U.S. issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

Further information on any of the securities mentioned in this material may be obtained upon request, and for this purpose persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan, or at its London branch office at 133 Fleet Street, and persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 3 Garden Road. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

U.S. Calendar

Focus for the Week Ahead

- The employment cost index is likely to be relatively benign, with total compensation gains restrained by moderate benefit cost increases (October 28).
- Chairman Greenspan's testimony to the Joint Economic Committee of Congress will be closely scrutinized for clues whether a tightening in monetary policy is likely at the November 12 FOMC meeting (October 29).
- The third-quarter GDP report is likely to indicate robust demand growth and a more modest pace of inventory accumulation (October 31).

Economic Releases and Other Events

			Estimate		
Date	Time	Indicator	GS	Consensus	Last Report
Mon Oct 27	10:00	Existing Home Sales (Sep)	+0.9%	-1.2%	+3.3%
Tue Oct 28	8:30	Employment Cost Index (Q3 '97)	+0.7%	+0.8%	+0.8%
	10:00	Consumer Confidence (Oct)	125.0	127.5	128.6
Wed Oct 29	8:30	Durable Goods Orders (Sep)	-1.0%	-0.8%	+2.7%
Thu Oct 30	10:00	New Home Sales (Sep)	+3.8%	+1.9%	-2.2%
Fri Oct 31	8:30	Real GDP (Q3 '97—Advance)	+3.3%	+3.4%	+3.3%
	8:30	Chain-Weight Price Index (Q3 '97—Adv)	+1.6%	+2.0%	+1.8%
	10:00	Chicago Purchasing Managers Index (Oct)	59.0%	n.a.	61.2%

- Treasury Announces Market Borrowing Estimates (Mon, Oct 27 - 3:00)
- Greenspan Testifies: Joint Economic Committee (Wed, Oct 29 - 10:00)
- Fed "Beige Book" (Wed, Oct 29 - 2:00)
- Treasury Announces November Refunding (Wed, Oct 29 - 1:45)
- APICS Survey (Thu, Oct 30 - 8:30)
- Help-Wanted Index (Thu, Oct 30 - 10:00)
- Consumer Sentiment—Final (Fri, Oct 31 - 10:00)
- Treasury Announces 1-Year Bill (Fri, Oct 31 - 2:30)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	6.0%	6.4%
Forward	5.9	5.9	6.1
2 Yr T-Note	5.9	6.2	6.6
Forward	5.9	5.9	6.0
10 Yr T-Note	6.2	6.3	6.6
Forward	6.1	6.1	6.1

Key Numbers in the Business Outlook

	1997				
	Q2	Q3E	Q4E	1997E	1998E
Real GDP	3.3%	3.3%	2.9%	3.7%	3.1%
Ind. Prod., Mfg.	4.1	7.9A	3.5	4.9	5.1
CPI	1.1	2.0A	2.5	2.4	2.5
After-Tax Profits*	8.7	8.3	8.2	8.7	2.8
Unemployment	4.9	4.9A	4.8	5.0	4.4

* Excluding inventory profits; adjusted for depreciation distortions.

Goldman, Sachs & Co.,
One NY Plaza, New York, NY 10004

Tel.#: (1) 212-902-6807
Fax #: (1) 212-346-3115

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

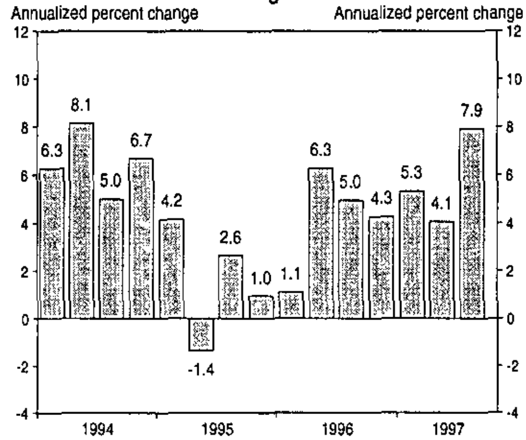
Goldman Sachs

U.S. Economics Analyst

What is Priced into the Eurodollar Forward Curve?

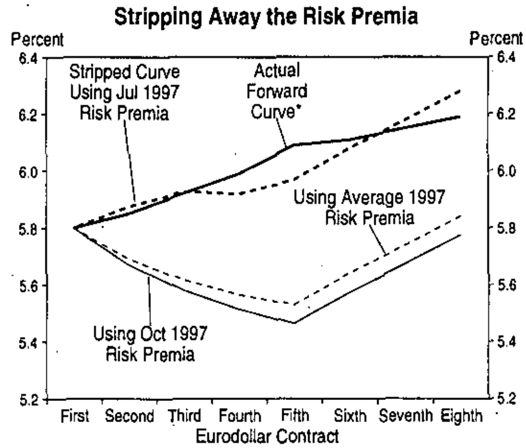
- Prospects for a continuation of above-trend U.S. economic growth are supported by the latest statistical releases. In particular, the third-quarter expansion rates for retail sales and factory production appear even stronger than before, while inventory accumulation has apparently eased.
- At the same time, the patterns of retail pricing remain very restrained, with the consumer price index up just 2.2% compared to a year ago.
- The Federal Reserve will likely steer a steady policy course for now, but pressures are building for the application of additional monetary restraint at some point. We continue to expect a 50-basis-point increase in the federal funds rate (to 6.0%) by midyear 1998.
- The center-section article this week presents our attempt to model "fair" risk premia for the Eurodollar forward curve. Using these premia we can derive implied short rate expectations and answer the question: What is priced into the curve today?
- We conclude that, currently, the forward market is either pricing lower future short-term rates or is content with practically zero risk premia. We believe market expectations are inappropriate on both counts and, therefore, continue to recommend short positions with respect to the late 1998 Eurodollar futures contracts.

Manufacturing Production



Source: Federal Reserve Board.

Stripping Away the Risk Premia



*As of October 14, 1997.
Source: Goldman Sachs. Our estimates.

Trade Recommendations

- Stay short the September '98 Eurodollar contract, moving the stop to a close above 94.02, from 94.05, maintaining a target of 93.60.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
E-mail Address: william.dudley@gs.com

Issue No: 97/42
October 17, 1997

Important disclosures appear on the inside back cover.

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

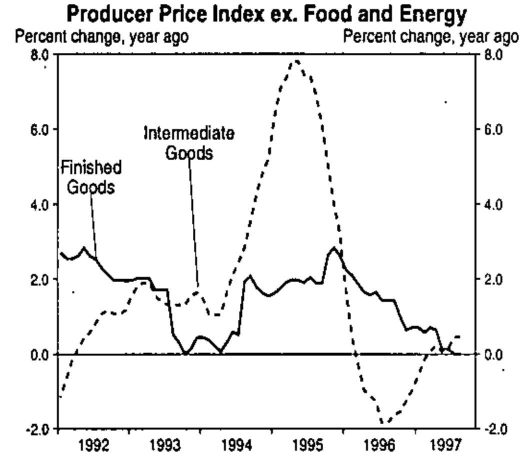
Goldman Sachs

U.S. Economics Analyst

Inflation Down But Not Out in the Brave New Business Cycle

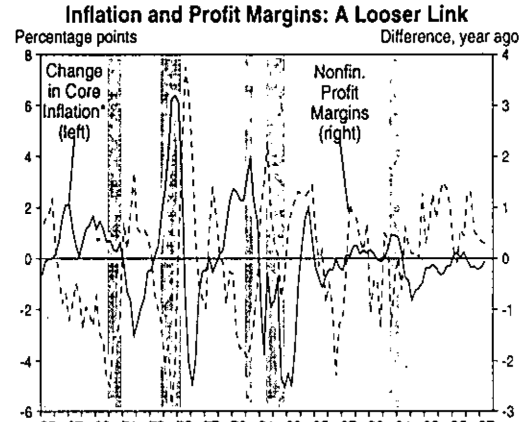
- Chairman Greenspan's rumination on labor market tightness, inserted into budget testimony, was a clear message to financial markets that the risks still tilt in the direction of tightening. As a result, market participants have backed off from pricing in a potential easing in policy.
- While his remarks have revived the possibility of a near-term tightening, the data do not yet point toward a rate hike before yearend despite a 0.5% jump in finished goods prices, which was driven mainly by sharp gains in motor vehicle and tobacco prices. Activity indicators have been mixed, with jobless benefit claims edging down further but retail sales weakening.
- Analysis of the performance of several inflation indicators since the onset of the Brave New Business Cycle suggests that it has helped protect the U.S. economy from inflation but has not provided complete immunity.
- In particular, the links between inflation and its "cost-push" indicators, such as profit margins and unit labor costs, have weakened noticeably. However, a firm test of the implied death of cost-push inflation awaits a more definitive acceleration of labor costs, which we believe is on the horizon. Such an acceleration would pose a Hobson's choice of higher inflation or smaller profit margins to equity investors.
- Meanwhile, vendor performance and commodity prices, two key "demand-pull" indicators, have lost a lot less of their predictive value, while a third, capacity utilization, has become more reliable. All three have drifted up lately, and they should be monitored closely as possible indexes of impending interest-rate increases.

Producer Price Index ex. Food and Energy



Source: Department of Labor.

Inflation and Profit Margins: A Looser Link



*Difference, from year earlier, in 4-quarter percentage change.
Source: Department of Labor, Department of Commerce.

Trade Recommendations

- Stay short the September '98 Eurodollar contract, moving the stop to a close above 94.05, from 94.15, maintaining a target of 93.60.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807
Issue No: 97/41
October 10, 1997
E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

Goldman Sachs

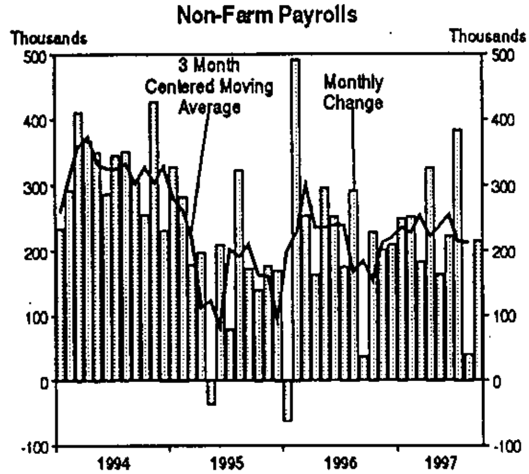
U.S. Economics Analyst

Our Views Have Changed

No Fed Tightening Until 1998

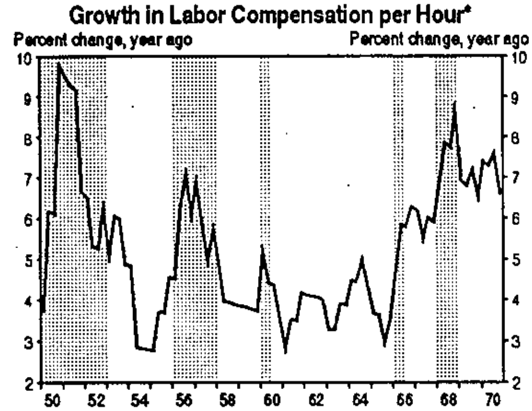
- Federal Reserve officials are likely to keep monetary policy on hold until the first half of 1998. It should take that long for tight labor markets to push compensation cost inflation high enough to scare a patient Fed into pushing short-term interest rates higher. We have altered our interest rate forecast accordingly (see page 8).
- The notion that Fed officials will be slower to tighten is also supported by recent activity data, which suggest some slowing in the growth pace in September. This can be seen in weaker motor vehicle and retail chain store sales and in the drop in the NAPM index in September to 54.2% from 56.8% in August.
- The September payroll employment report also reinforces the preference for patience, given weaker-than-expected payroll gains, a slight decline in aggregate hours worked, few signs that wages are rising more rapidly, and a stable unemployment rate.
- The center-section article, ***Labor Supply Growth Key to Compensation Prospects***, examines the process through which labor market tightness is gradually transformed into wage pressure. The key warning sign is when labor force growth slows abruptly, indicating that the pool of available workers has finally been exhausted. Not long thereafter, compensation cost pressures begin to climb more rapidly. Labor force growth has stalled in recent months, which suggests more rapid gains in compensation costs may lie just ahead.

Non-Farm Payrolls



Source: Department of Labor.

Growth in Labor Compensation per Hour*



*Shaded areas represent periods when the unemployment rate was below 5.5% and labor force growth was 1.5% annualized or less.
Source: Department of Labor.

Trade Recommendations

- Short March '98 Eurodollar contract position was stopped out on a close of 94.165 on October 2.
- Sell short the September '98 Eurodollar contract on a close below 94.00, with a target of 93.60.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

Issue No: 97/40
October 3, 1997

Important disclosures appear on the inside back cover.

I. Weekly Wrapup

Economic and Market Overview

U.S. stock and bond markets continue to advance as the latest data indicate that the economic growth pace is slowing. September employment data induced the biggest price rise this week, as payroll gains were much smaller than generally expected (+215,000), the average hourly earnings rise was modest (+0.3%) despite the imposition of a minimum wage hike on September 1, and the unemployment rate was flat at 4.9%. The weakness of the payroll report could be summed up in the 0.1% drop in the index of aggregate hours worked, which pulled the third-quarter growth rate down to just 1.1% annualized.

Earlier data were consistent with the payroll report weakness. On the manufacturing side of the ledger, the NAPM index edged lower in September, falling to 54.2% from 56.8%, with the decline concentrated in the production and orders components, which fell by 5.0 and 4.8 points, respectively. However, delivery speeds were still relatively slow in September, with the vendor performance component essentially flat at 55.2%, compared to 55.8% in August. The export component fell more than 5 percentage points to 50.8%, suggesting that the ASEAN countries' woes are starting to affect the demand for U.S. exports.

Reports on spending indicated some slippage as well, as both the Johnson Redbook and Mitsubishi retail chain store sales reports noted that sales ran a bit below retailers' plans in September. Incomplete readings on September auto sales also suggest a significant decline.

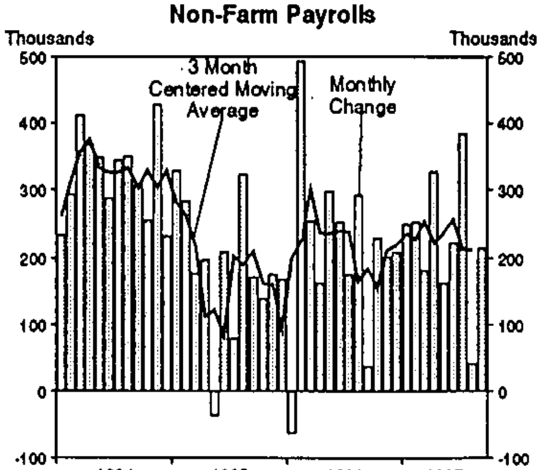
Reports from August also indicated less forward momentum, as personal consumption expenditures rose by only 0.3%, new home sales slipped by 2.2%, and construction spending fell by 0.3%, due to weakness in public outlays. However, upward revisions to consumer spending and construction spending in July offset the August weakness. Thus, real GDP growth still appears on track for about a 3.3% advance (annualized) in the third quarter.

At this point, the slowdown in consumer spending appears to be a pause rather than a major inflection point given that the fundamentals supporting such spending—confidence, income, and wealth creation—all remain very positive. For example, in September the Conference Board index of consumer confidence rose to 128.6 in September from 127.6 in August. Similarly, income growth remains solid, rising by 0.6% in August. The wage and salary component was even more robust, climbing by 0.8%.

Federal Reserve Policy

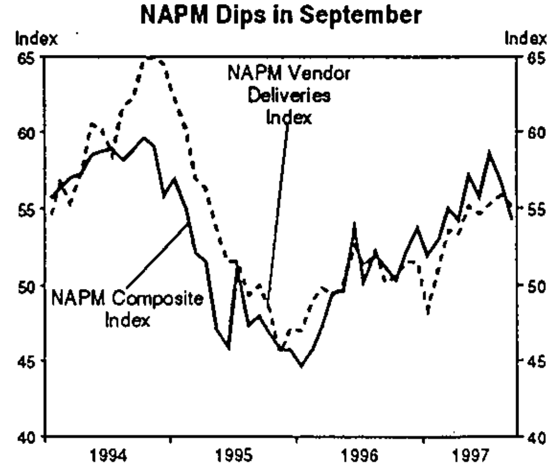
As widely expected, Federal Reserve officials kept monetary policy on hold at the September 30 FOMC meeting. With a virtual absence of inflationary pressures, Fed officials have become much more patient in reacting to a strong economy by tightening monetary policy. With the inflation outlook not likely to change soon and signs that the growth pace downshifted slightly in September, it no longer appears that a tightening in monetary policy will take place in 1997. Further tightening is still likely next year. But it will take time for tight labor markets to

Non-Farm Payrolls



Source: Department of Labor.

NAPM Dips in September



Source: Department of Labor.
National Association of Purchasing Management.

generate sufficient wage pressures to provoke the central bankers to push the federal funds rate higher.

The August FOMC minutes reflect this more patient stance. Although the outcome was the same as at the July meeting—a unanimous decision to keep policy unchanged while maintaining a bias towards tightening—the tone was distinctly less hawkish. For example, the August minutes read: ". . . all the members endorsed a proposal to maintain an unchanged policy stance." In July, the minutes read ". . . all members favored or could support a proposal to maintain an unchanged policy stance." This is a small wording difference, to be sure, but nevertheless a meaningful sign that the more hawkish members of the FOMC have pulled in their claws substantially.

Fiscal and Political Developments

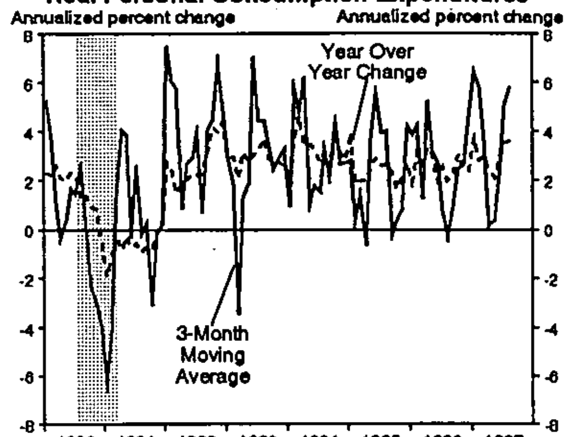
Deputy Treasury Secretary Lawrence Summers reiterated the Treasury's intention to continue the Treasury-Inflation-Protected Securities (TIPS) program next year. In fact, the Treasury plans to broaden the program to add a 30-year TIPS bond next year. Coupled with a budget deficit that continues to melt away—we now project that the fiscal 1997 deficit will be no higher than $30 billion and the fiscal 1998 deficit may vanish altogether—that means that supplies of traditional fixed-rate debt are likely to shrink, perhaps substantially. This should continue to bolster the long end of the market.

Market Outlook and Comments on Value

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

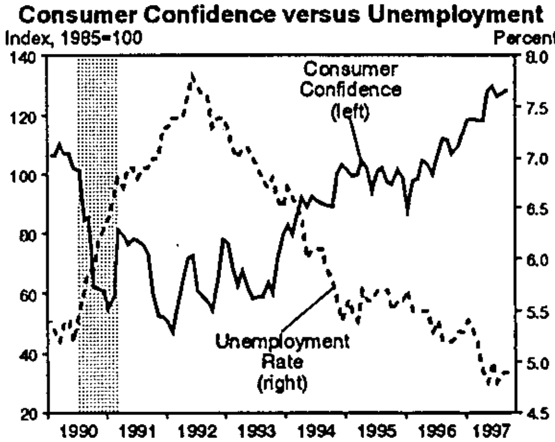
On Thursday, we were stopped out on our short March '98 Eurodollar trade on a close at 94.165. We would re-institute shorts in the short end of the market once we get evidence that the current rally has exhausted itself. At this point, the market is starting to discount the possibility that the next move from the Fed is more likely to be an easing than a tightening. We strongly disagree with this view, and therefore would get short the September '98 Eurodollar future (currently 94.15) on a close below 94.00, with a target of 93.60. On the long end, we advise stepping aside for the time being. The rally is probably already overdone—at a 5½% federal funds rate, it is difficult to see long bond yields stabilizing below 6¼%. However, given how many market participants have been caught off-side by this powerful price move, it probably will not exhaust itself immediately.

Real Personal Consumption Expenditures



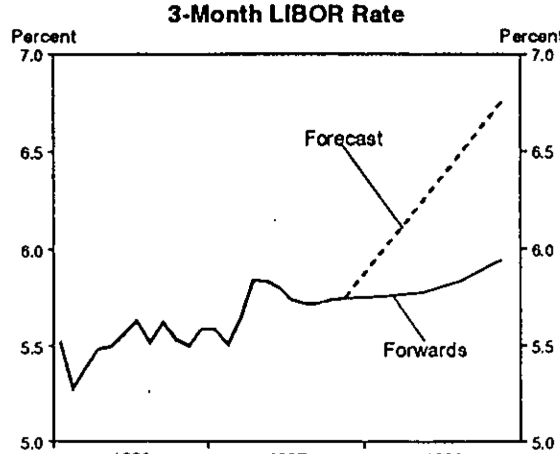
Source: Department of Commerce.

Consumer Confidence versus Unemployment



Source: Conference Board. Department of Labor.

3-Month LIBOR Rate



Source: Federal Reserve Board. Wall Street Journal.

II. Labor Supply Growth Key To Compensation Prospects

Current speculation about the risk of an early labor compensation acceleration largely centers around the concept of a NAIRU, or non-accelerating inflation rate of unemployment, below which it is believed that worker shortages will intensify pressures for higher pay awards. It is certainly logical that scarcity of a given item, once sufficiently extreme, should lead to firmer pricing for that resource. However, in looking back at compensation developments during past tight labor market periods in this half-century, it seems that in the absence of inflationary expectations the potential for stronger wage and benefits gains becomes particularly acute when growth in the stock of readily-employable labor slows or stalls out. Prior to that point, employers and employees are discouraged from granting or anticipating larger pay raises by a perception that the pool of labor can be further expanded at prevailing pay scales. This analysis would suggest that, in the present environment, special attention should be directed to any signs that labor force participation is flattening or that firms are feeling pressured to hoard existing workers.

Four Stages of Labor Market Expansion Cycles

	Labor Force Growth	Labor Compensation Growth
1. Unemployment declines as economy recovers.	Up	Stable
2. Unemployment reaches historically low rate.	Stable/Up	Stable
3. Workers begin voluntarily leaving jobs.	Stable	Up Modestly
4. Labor force participation stabilizes.	Down	Up Significantly

A Theory of Labor Market and Compensation Cycles

As a business expansion matures, the labor market moves through several stages of development. Some of these episodes may overlap, and their timing and length will undoubtedly vary across different periods depending on a host of conditions. That said, the following might serve as a broad framework for how this process normally evolves:

1. **Declining joblessness and reviving economic growth gain wider recognition, spurring an increase in labor force participation.** Perceptions of strengthened labor demands during this interval are reflected in an improving assessment among households of employment availability. Potential workers who previously had become discouraged or otherwise less attached to the labor market are thereby encouraged to make new attempts at securing employment, helping to drive solid expansion in the total labor force.

2. **As unemployment continues to fall, firms increasingly experience difficulty satisfying their labor needs, which leads to expanded recruitment and training activities.** Once labor supplies become strained, employers face a choice among: (a) slowing their expansion, (b) extending work hours, (c) retraining current labor force members and/or finding under-utilized persons to handle the extra workload, or (d) raising compensation awards to attract experienced workers. The initial preference normally will be for the less economically painful steps of maximizing the utilization of existing labor resources. Such efforts should provide fresh positive impetus to labor force expansion.

3. **Sensing a significant improvement in employment opportunities, workers become more willing to leave jobs in search of better positions.** In the U.S., the percentage of the unemployed who left their jobs voluntarily is normally rather small, in the 10%-15% zone. When it moves above that territory, however, this "quitter ratio" suggests that an unusually large portion of the unemployed group is comprised of persons actively seeking greater economic or other rewards. In turn, that means that the number of people available to fill positions at existing wage rates is declining. An upswing in job leaving amid labor scarcity can put pressure on firms to increase compensation for current employees.

4. **The labor force loses upward momentum, slowing to or below its long-term average.** In a robust economic growth phase, ultimately there can come a time when there has been an effective absorption into the labor market of nearly all persons interested in working at the prevailing pay rates with a moderate compensation growth expectation. A key harbinger of this development

typically is a stabilization of the employment/population ratio following a sustained rise. If at the same time there has not been a cooling of aggregate demand, then a marked additional tightening of labor availability can develop within a short interval.

5. **Employers respond to an intensified inability to satisfy labor demands from untapped sources by hoarding current workers and bidding more aggressively to attract new personnel.** Although a further dip in joblessness late in an expansion may prove absolutely small compared to what has gone before, it can have a disproportionate impact with respect to wage awards. Companies at this stage face a heightened risk of failing to satisfy demands and meet output and earnings growth targets, due to an acute shortage of workers and a rising risk of losing employees. Their response may be to hoard existing labor and to increase the pay and benefits packages they offer to fresh graduates and trained persons employed elsewhere. In these circumstances, a bidding war for labor can erupt, causing a surprisingly rapid acceleration in compensation gains. Typically this change is reversed only after the business cycle turns down.

What Does The Historical Record Show?

To test the foregoing thesis and its possible applicability to the present period, we have examined data on various measures of labor resources and compensation changes during recent decades. Our focus in this exercise is on cycles prior to the 1970's, the last lengthy era when inflationary expectations were very low and not particularly important in the wage bargaining process.

There were four major business cycles between 1950 and 1970, with the last of these lasting for 8½ years and punctuated by a near-recession in mid-course. Among these periods, we can discern five distinct labor cost acceleration episodes: 1950-1951, 1955-1956, 1960, 1966, and 1968. These pay upturns occurred at very different levels of unemployment; in 1950 it occurred with joblessness declining through the 5%-6% range, but in 1966 it took until the unemployment rate fell below 4% before higher compensation growth arose.

In all but one of these periods, however, there was a strikingly close relationship between the timing of the pickup in labor cost growth and a noticeable slowing of labor force increases. To be sure, special conditions existed in some cases. For example, beginning in mid-1950, rapid growth in the armed forces as the Korean conflict arose clearly reduced labor availability, actually causing the labor force to fall. Between 1963 and 1966, moreover, employment costs may well have been damped by the existence of voluntary national guideposts for wage increases in collective bargaining agreements. That said, it is nevertheless impressive that in no case did labor market pricing stay benign once the labor force turned sluggish or weak amidst unusually low unemployment.

The same phenomenon can be observed in charts of the year-to-year change in nominal nonfarm business compensation for labor over the 1950-1970 interval. During quarters when the unemployment rate was below 5.5%, there is a distinct difference between the patterns of compensation growth when labor force expansion was solid versus slow or weak. When unemployment was that low, but labor supplies rose more than 1.5% per year on average—the shaded periods in the first chart on the next page—

Developments in Tight Labor Markets, 1950-1970
(Year:Quarter)

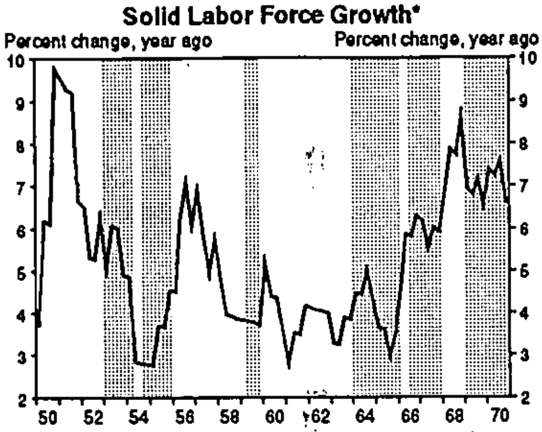
	1950-1953	1954-1957	1959-1960	1960-1966	1968-1969
Unemployment Rate Below 6%	50:2	54:4	59:1	62:1	--
Unemployment Rate Below 5%	50:3	55:1	--	65:1	--
Unemployment Rate Below 4%	51:1	57:1	--	66:1	68:1
Labor Force Growth Slowed	50:1	56:1	60:1	--	68:1
Labor Compensation Growth Accelerated*	50:2	55:4	60:1	66:1	68:1

* Based on the quarterly index for monthly nonfarm business sector compensation per hour.

Sources: Department of Labor. Our calculations.

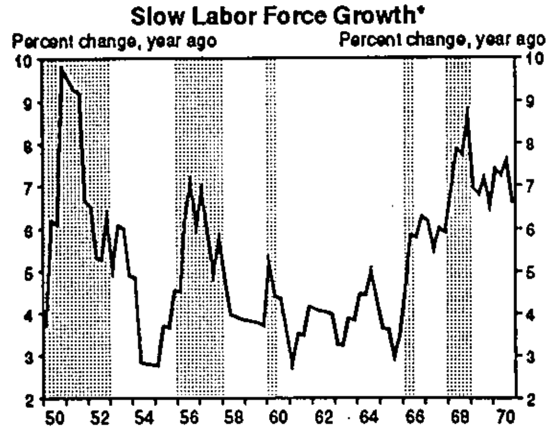
Compensation Per Hour at Low Unemployment Rates

Solid Labor Force Growth*



*Shaded areas represent periods when the unemployment rate was below 5.5% and labor force growth exceeded 1.5% annualized.
Source: Department of Labor.

Slow Labor Force Growth*



*Shaded areas represent periods when the unemployment rate was below 5.5% and labor force growth was 1.5% annualized or less.

compensation per hour was just as likely to be falling as strengthening. If, by contrast, the labor supply was tight and rising more slowly (see shaded periods in the second chart), there was a pronounced tendency for employment cost increases to be very high and/or to be turning up sharply.

Labor Force, Layoff Slowdown May Lead Employment Cost Pickup

The foregoing would suggest that a traditional NAIRU model for estimating future changes in labor compensation may need to be at least supplemented by an examination of the entry pace for new workers, in order to take account of the attitudinal and behavioral influences that can be felt by employers and employees alike from brisk increases in labor supply, despite an evident tightening in aggregate spare labor capacity. Indeed, the unexpected absence of a material acceleration in employment costs thus far in the current low-unemployment expansion phase perhaps can be better understood using this analytical framework. The civilian unemployment rate fell through 5.5% in June 1996, and over the succeeding year the labor force rose by roughly 2%, somewhat more than the long-term average pace. Consistent with what was seen in the earlier non-inflationary periods, the overall employment cost index for private sector workers has not gained speed recently; in fact, the year-to-year change has held steady just below 3% over the past 24 months.

Financial market participants, however, should be chary of increasingly common assertions that a lack of labor cost pickup thus far signals an irrelevance of labor scarcity for judging compensation growth and broad pricing prospects. In light of the clear evidence that a combination of low unemployment and slow labor force growth creates a combustible mixture with regard to business employment expenses, it would be appropriate at this juncture to pay close attention to indicators of labor force participation, voluntary job departures, and employer behavior toward existing workers. Signs from any of these measures that finding or keeping workers is becoming substantially more challenging could provide early warnings that the labor market is moving into a potentially more inflationary stage.

In fact, today there are proliferating statistical as well as anecdotal indications that labor supply constraints are becoming more binding. Initial unemployment claims have fallen below 310,000 on a four-week average basis; the employment-to-population ratio crested at 63.9% last spring and has since edged down (to 63.7% in September); growth in the labor force over the past six months has been just 0.2% annualized, down from about 2% previously; and the volume of persons working part-time for economic reasons has fallen more than 10% from a year ago.

John Youngdahl

Key U.S. Economic Data

	Latest Monthly Data '97 Sep	'97 Aug	'97 Jul	'97 Jun	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. Thousands)	215	40	384	222	225	223	Nov 7
Unemployment Rate (%)	4.9	4.9	4.8	5.0	4.9	5.1	
Index of Hours Worked (% ch)	-0.1	0.4	-0.3	0.4	0.4	1.9	
Average Hourly Earnings (% ch)	0.3	0.5	0.1	0.3	3.3	3.6	
Producer price finished goods index (% ch)	--	0.3	-0.1	-0.1	-1.8	0.1	Oct 10
Excluding food and energy	--	0.1	-0.1	0.1	-0.6	0.0	
Consumer price index (% ch)	--	0.2	0.2	0.1	1.4	2.2	Oct 16
Excluding food and energy (% ch)	--	0.1	0.2	0.1	2.2	2.3	
Retail sales (% ch)	--	0.4	0.9	0.7	0.6	5.2	Oct 15
Excluding motor vehicles (% ch)	--	0.3	0.6	0.5	1.4	4.9	
Industrial Production (% ch)	--	0.7	0.4	0.3	5.0	4.7	Oct 17
Manufacturing	--	1.0	0.5	0.4	5.7	5.3	
Capacity utilization (%)	--	83.9	83.6	82.5	83.6	83.5	Oct 17
Manufacturing	--	83.1	82.6	82.5	82.6	82.5	
Housing Starts (annual rate, thousands)	--	1363	1432	1503	1444	1442	Oct 17
Single-family	--	1072	1128	1134	1118	1123	
Trade balance (billions, monthly)	--	--	-10.3	-8.3	-9.1	-9.4	Oct 21
Merchandise	--	--	-17.1	-15.2	-16.0	-16.4	
Factory Orders (% ch)	--	1.3	0.5	1.7	5.5	7.5	Nov 5
Durable Goods	--	2.7	0.1	2.9	8.8	11.6	Oct 29
Personal Income (% ch)	--	0.6	0.2	0.6	5.1	5.8	Nov 3
Wages and Salaries	--	0.8	0.1	0.8	5.5	6.6	
Purchasing Managers' Index (%)	54.2	56.8	58.6	55.7	56.1	54.4	Nov 3
Consumer Sentiment U Mich (Feb 66=100)	106.0	104.4	107.1	104.5	104.4	101.4	Oct 31
Conference Board (1985=100)	128.6	127.6	126.3	129.9	126.5	120.5	Oct 28

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

©1997 Goldman, Sachs & Co. All rights reserved.

This material is for your private information, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy or sell, the securities, or derivatives (including options) thereof, of companies mentioned herein. No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without Goldman, Sachs & Co.'s prior written consent.

This material has been issued by Goldman, Sachs & Co. and/or one of its affiliates and has been approved by Goldman Sachs International, which is regulated by The Securities and Futures Authority, in connection with its distribution in the United Kingdom and by Goldman Sachs Canada in connection with its distribution in Canada. This material is distributed in Hong Kong by Goldman Sachs (Asia) L.L.C.; and in Japan by Goldman Sachs (Japan) Ltd. This material is not for distribution in the United Kingdom to private customers, as that term is defined under the rules of The Securities and Futures Authority; and any investments, including any convertible bonds or derivatives, mentioned in this material will not be made available by us to any such private customer. Neither Goldman, Sachs & Co. nor its representative in Seoul, Korea, is licensed to engage in the securities business in the Republic of Korea. Goldman Sachs International and its non-U.S. affiliates may, to the extent permitted under applicable law, have acted upon or used this research, to the extent it relates to non-U.S. issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

Further information on any of the securities mentioned in this material may be obtained upon request, and for this purpose persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan, or at its London branch office at 133 Fleet Street, and persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 3 Garden Road. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

Goldman Sachs

U.S. Calendar

Focus for the Week Ahead

- Chairman Greenspan will testify before House Budget Committee on the long-term budget outlook (October 8).
- Producer prices are likely to rise more quickly, driven higher by a rise in energy and cigarette prices. The index for core wholesale prices also will likely tick up again (October 10).

Economic Releases and Other Events

Date		Time	Indicator	Estimate GS	Estimate Consensus	Last Report
Tue	Oct 7	3:00	Consumer Credit (Aug)	+$4.0 Bil	+$5.0 Bil	+$6.5 Bil
Fri	Oct 10	8:30	Producer Price Index (Sep)	+0.3%	+0.2%	+0.3%
			Excluding Food & Energy	+0.2%.	+0.1%	+0.1%

- **Wholesale Trade (Wed, Oct 8 - 10:00)**
- **Greenspan Testifies Before House Budget Committee (Wed, Oct. 8 - 10:00)**

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	6.0%	6.4%
Forward	5.8	5.9	6.0
2 Yr T-Note	5.9	6.2	6.6
Forward	5.8	5.9	5.9
10 Yr T-Note	6.2	6.3	6.6
Forward	6.0	6.1	6.1

Key Numbers in the Business Outlook

	1997 Q2	1997 Q3E	1997 Q4E	1997E	1998E
Real GDP	3.3%	3.3%	3.2%	3.8%	3.1%
Ind. Prod., Mfg.	4.1	6.5	4.5	5.0	5.3
CPI	1.1	2.0	2.9	2.4	2.7
After-Tax Profits*	8.7	6.8	4.3	7.3	2.0
Unemployment	4.9	4.8	4.7	4.9	4.4

* Excluding inventory profits; adjusted for depreciation distortions.

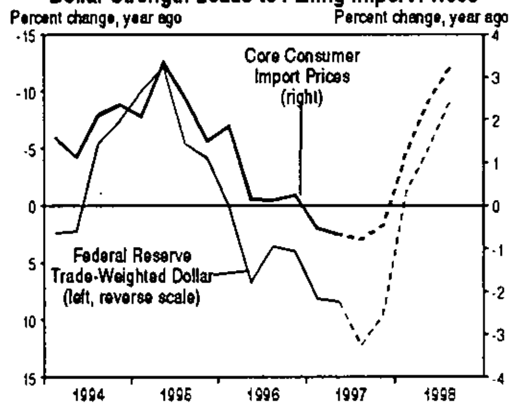
Goldman Sachs

U.S. Economics Analyst

Modest Uptick in Inflation Likely in 1998

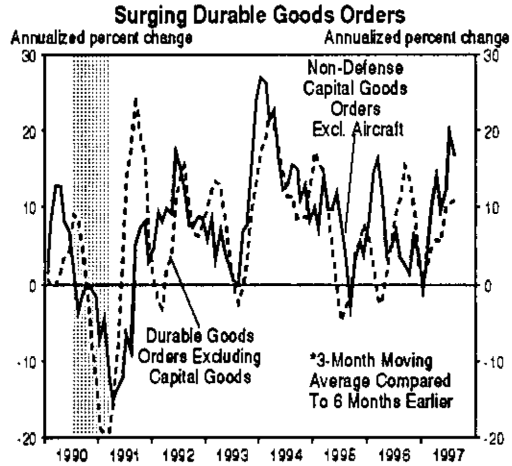
- The exceptionally good consumer price inflation performance over the past two years is due mainly to three factors—declining medical care inflation, changes in methodology in calculating the CPI, and the fall in import prices generated by the stronger dollar.
- Looking forward, while this favorable pattern is unlikely to end abruptly, a modest uptick in inflation in 1998 appears likely. Compensation costs should rise as labor markets tighten further. Medical care inflation is likely to drift up as the benefits reaped in the transition to managed care lessen. Finally, once the dollar stops strengthening, import price trends are likely to become less favorable.
- The inflation picture, however, will continue to be clouded by changes in the methodology of the Bureau of Labor Statistics in calculating consumer price inflation. By the end of 1999, additional technical changes are likely to be made that cut another 0.4 percentage points from the annualized inflation rate.
- The economy's forward momentum remains very much intact. This can be seen in the strength registered in durable goods orders and existing home sales. The further drop in initial claims also indicates that labor markets have continued to tighten.
- Fed officials will almost certainly keep monetary policy on hold at next week's meeting. A tightening requires both a continuation of the recent strong growth trend and more visible signs that inflation risks are growing.

Dollar Strength Leads to Falling Import Prices



Note: Dashed lines indicate path implied by GS forecast.
Source: Deparment of Commerce. Federal Reserve Board. Our calculations.

Surging Durable Goods Orders



Source: Department of Commerce.

Trade Recommendations

- Stay short March 1998 Eurodollar futures, with a stop on a close above 94.15 and a target of 93.50.
- Sell short December 10-year Treasury note futures on a close below 109.16, with a stop on a close above 110.18.

Contributors: Bill Dudley, Ed McKelvey, John Youngdahl, Alex Patelis (212) 902-6807

Issue No: 97/39
September 26, 1997

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

I. Weekly Wrapup

Economic and Market Overview

The U.S. bond market managed to slightly extend last week's price gains through two Treasury note auctions totaling $27 billion, but quickly lost support following news of an out-sized rise in durable goods orders and very brisk home sales. Total bookings for U.S. hard goods shot up 2.7% during August, led by a huge increase among non-capital items, which incorporate consumer goods and durable materials (+3.4%). While civilian capital goods orders weakened last month (-5.4% excluding aircraft), this followed two exceptionally large increases which totaled nearly 10%. Thus, it appears that spending for durables has remained robust overall, with the gains spreading from business equipment into consumer sectors, for which production lead times are typically shorter. This helps to explain the acceleration and broadening of factory output increases since midyear. Order backlogs, meanwhile, are also expanding (+1.1%), which should sustain incentives for firms to add workers and boost production.

Demand for consumer durables should stay high going forward, given that housing turnover hit a record level in August, according to the National Association of Realtors. Sales of existing dwellings rose 3.3% last month to 4.32 million annual units, and the lofty volume of mortgage applications for purchases suggests that the sales pace could remain sturdy into the fall.

First-time jobless insurance claims continue to creep lower, slipping 2,000 in the week ending September 20 to 306,000. The average initial claims volume thus far in September implies the slowest rate for any month during this expansion, and the total number of state unemployment insurance recipients has fallen almost 100,000 since mid-August. These data hint that labor supplies may be rapidly tightening, putting pressure on employers to hoard labor and enhance worker compensation.

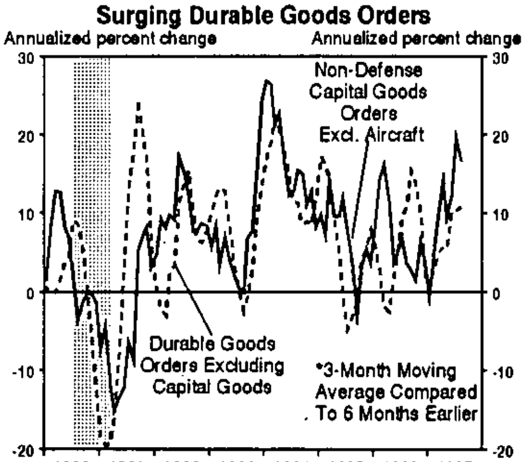
Federal Reserve Policy

There is virtually no likelihood that Fed officials will decide to tighten monetary policy at the September 30 meeting for the simple reason that the pattern of growth and inflation has not changed. The U.S. economy continues to be remarkably robust, but as yet this has not led to any meaningful rise in inflationary pressures. The timing of the meeting also counsels for the status quo because Fed officials will have much more evidence on the sustainability of the recent growth surge and its impact on unemployment and wage inflation at the following meeting on November 12. At this juncture, a tightening in November appears to be no more than a 50-50 proposition. That is because, in addition to strong growth, a tightening move probably requires more visible evidence (either distinctly higher compensation cost trends or bad consumer price data) that an inflation problem is imminent.

Fiscal and Political Developments

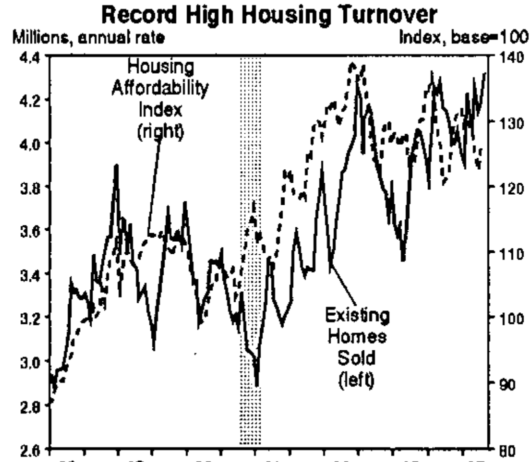
The federal government's budget results continue to be surprisingly favorable, with the deficit in August falling more than $7 billion from a year earlier, to $34.6 billion. At this point, the official estimates for

Surging Durable Goods Orders



Source: Department of Commerce.

Record High Housing Turnover



Source: National Association of Realtors.

the fiscal 1998 shortfall—which are in the $55-$60 billion range—appear too pessimistic, in part because they are based on conservative assumptions about GDP growth relative to the recent performance. If the economy expands at a 3% or higher rate over the four quarters ending next September, as we anticipate, then the budget gap probably will not exceed $50 billion and could wind up materially lower, particularly if capital gains revenues triggered by the reduction in the tax rate prove large.

All that said, from a seasonal perspective the fourth calendar quarter is a relatively high deficit and Treasury market financing period. Net federal borrowing in the October/December interval should total $35-$40 billion, marking a substantial upswing from the small debt redemption that was accomplished over the first nine months of 1997. This shift will necessitate some modest additions to the weekly bill auction size in the near term, temporarily alleviating the severe supply shortages that have plagued that sector.

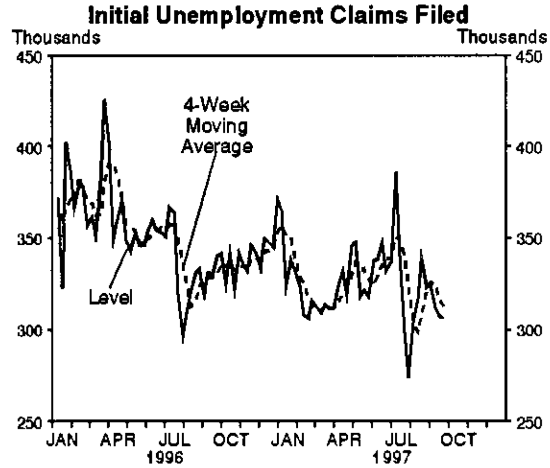
Market Outlook and Comments on Value

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

We would remain short the March '98 Eurodollar futures contract with a target of 93.50 and a stop on a close above 94.15. The economy is growing quickly. All it would take to unleash another sharp shift in sentiment would be evidence of inflationary pressures. At current prices, the March Euro contract essentially has no tightening priced in. In the absence of an easing, which seems very improbable, the risk is only that the contract will slowly converge to the spot price for 3-month LIBOR.

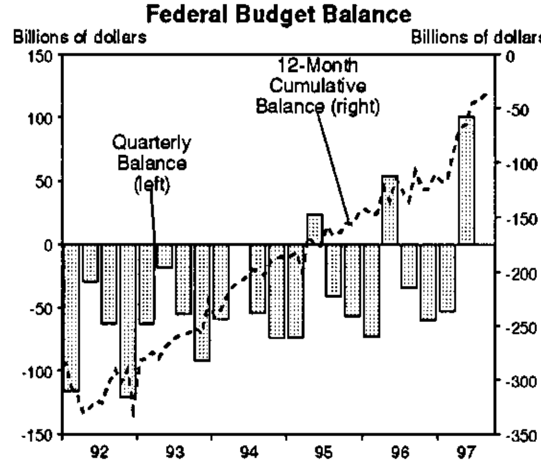
On the long end of the curve, we would look to get short the December 10-year Treasury note futures on a close below 109.16, with a stop on a close above 110.18, and a target of 107.00. A break of this level is likely to indicate a shift back in sentiment to a more pessimistic outlook about the consequences of the economy's strength for inflation and interest rates. Thus, the upward yield adjustment would be unlikely to end there.

Initial Unemployment Claims Filed



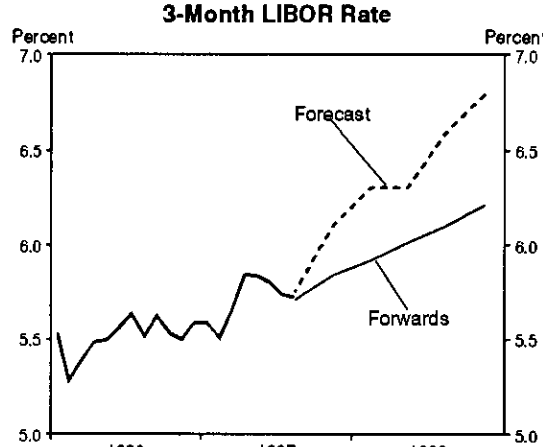
Source: Department of Labor.

Federal Budget Balance



Source: Department of Treasury.

3-Month LIBOR Rate



Source: Federal Reserve Board, Wall Street Journal.

II. Modest Uptick in Inflation Likely in 1998

The inflation news in 1997 continues to be excellent, with the recent August consumer price index data indicating a year-over-year gain of only 2.2%, down from a 2.9% rate at the beginning of 1995. The decline can be attributed to many factors—falling energy prices, moderating medical care inflation, and methodological changes implemented by the Bureau of Labor Statistics in calculating the CPI. However, the most important factor is probably developments abroad. Sluggish growth in Europe and Japan have helped to keep global inflation in check. Combined with a firmer dollar, this has caused import prices of consumer goods to decline.

Most likely, the good inflation news will last a bit longer. In particular, the lags that exist between shifts in the dollar exchange rate and its impact on import prices suggest that the dampening effect of a stronger dollar on U.S. inflation may not be exhausted yet. This is particularly true given the recent large depreciations of the currencies of several of the ASEAN countries, which just now are showing up in the form of lower U.S. import prices. With inflation staying benign over the near-term, this will tend to reinforce the inclination of Federal Reserve officials to keep monetary policy on hold.

Looking forward into 1998, however, a modest uptick in inflationary pressures continues to be likely. That is because the dollar should weaken next year, putting upward pressure on import prices. Also, medical cost inflation is likely to drift upwards now that the transition to managed care has largely been completed. Finally, upward pressure on prices will be exerted by a tighter labor market as compensation cost inflation rises.

Some of this pressure will be masked by further methodological changes that will be made by the BLS. For example, the Congressional Budget Office estimates that further changes in how the BLS computes the CPI will cut an additional 0.4 percentage points from the annualized inflation rate by yearend 1999.

An Excellent Performance, By Any Measure

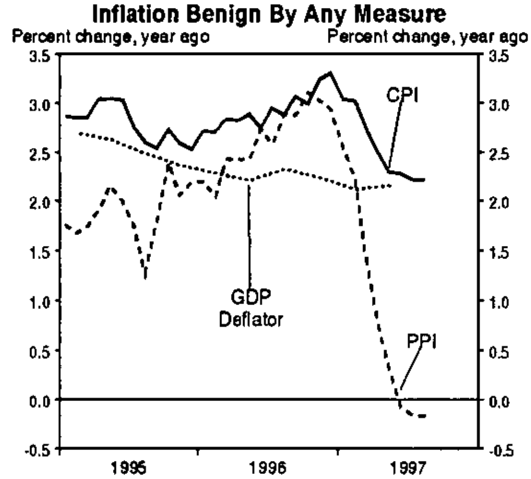
The U.S. inflation performance has been surprisingly good over the past year. All three major measures of inflation—the GDP deflator, the consumer price index and the producer price index for finished goods—have shown declines in the year-over-year rate of inflation.

Moreover, the improvement cannot be solely attributed to falling energy prices. As shown in the accompanying chart, the core measures of the producer and consumer price indices have also declined over the past two years.

Why Has Consumer Price Inflation Moderated?

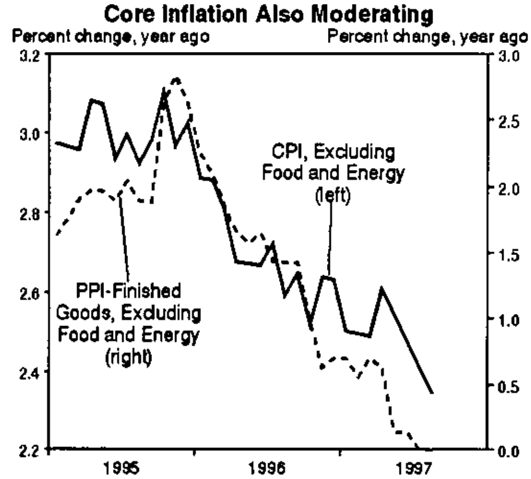
Taking apart the core consumer price index to discover which factors are responsible for its moderation, we find that three factors account for virtually all of the 0.8 percentage point reduction in the core rate of CPI inflation since the first quarter of

Inflation Benign By Any Measure



Source: Department of Labor. Department of Commerce.

Core Inflation Also Moderating



Source: Department of Labor. Department of Commerce.

1995. First, medical care inflation (about a 10% weight in the core CPI) has moderated significantly in recent years both on an absolute basis and relative to the core rate of CPI inflation. As shown below, the gap between the medical care inflation components of the CPI and the core rate has narrowed by nearly 2 percentage points since the beginning of 1995. This is due mainly to a shift to managed care from fee-for-service health care and greater coinsurance requirements that have made consumers more price-sensitive in their healthcare purchases. The relative decline in medical care inflation has helped to cut about 0.2 percentage points from the core rate of inflation.

Second, the Bureau of Labor Statistics has changed its methodology in terms of how it calculates the consumer price index. Since the beginning of 1995, the BLS estimates that these changes have cut the overall CPI inflation rate by about 0.2%-0.3%. (In an earlier report, *Now You See It...The Pattern of U.S. Inflation in 1996*, we estimated that the impact on the core CPI cumulated to about 0.4% per year by yearend 1996.) Because earlier CPI data have not been revised as these methodological changes were implemented, this has created an illusion of a steeper decline in core CPI inflation than what has actually taken place.

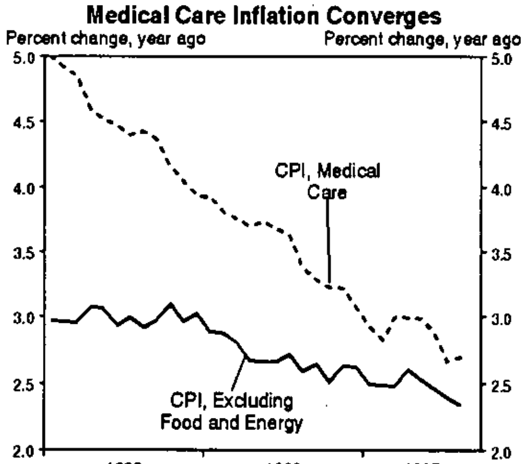
Third, import prices have been falling since the second half of 1995. This mainly reflects three factors: (1) modest inflation pressures in most U.S. trading partners, (2) weak domestic demand in foreign countries, which have created pressures on exporters to cut prices, and (3) an increase in the foreign exchange value of the dollar.

To focus on the impact of import prices on the core consumer price index, we examine the price trend of imported consumer goods, excluding food and energy. As shown in the accompanying chart, we find that the decline in import price inflation for this component of consumer prices has been more than 3 percentage points over the past two years. With imports accounting for about 10% of core consumer goods and about 6% of core consumer services, we estimate that this shift has cut the core CPI inflation rate by about 0.2% directly.

The actual impact is probably even greater. That is because when foreign producers reduce their prices in dollar terms that also puts pressure on domestic producers to restrain their prices. In this respect, the response of domestic motor vehicle prices to fluctuations in the value of the dollar is enlightening. In the first quarter of 1995, when the dollar was weakening, these prices were rising more than one percentage point (annualized) faster than the rise in core consumer goods prices In contrast, by the second quarter of 1997, the impact of the stronger dollar caused domestic motor vehicle prices to rise more slowly than core consumer goods prices.

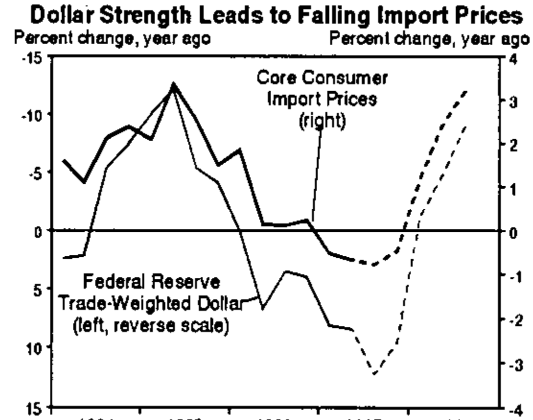
In addition to these factors, rapid declines in computer prices are also cited as a major factor behind inflation's good performance. Although the unusually rapid plunge in computer prices has helped pull down some measures of inflation significantly, it has had only a trivial effect on the consumer price index. That is because information processing receives a very low weight in the CPI (less than 1 percent) mainly because the CPI basket is based on

Medical Care Inflation Converges



Source: Department of Labor.

Dollar Strength Leads to Falling Import Prices



Note: Dashed lines indicate path implied by GS forecast.
Source: Department of Commerce. Federal Reserve Board. Our calculations.

consumption patterns in 1982-1984, when such expenditures were a much lower share than currently.

Stripping Out the Special Factors

If one strips out the impact of the three major factors highlighted above, then the decline in the core CPI virtually vanishes. As shown in the table below, the impact of the trends in medical care inflation and import prices combined with the effect of the BLS methodological changes is very close to the 0.8% decline in the core CPI inflation rate that has occurred since early 1995. Without these factors, the core CPI inflation rate would still be very close to the 2.9% pace (year-over-year) of the first quarter of 1995.

Core CPI Inflation Decline

	Percent of Decline
Decline Since 95Q1	0.8%
Factors:	
Medical Care	0.2%
BLS Methodology Changes	0.2-0.3%*
Import Prices	0.2%

* Impact on overall CPI

Sources: Department of Labor. Our Calculations.

Nevertheless, this should still be considered an excellent performance for two reasons. First, stripping out the factors that held the CPI down, artificially biases our calculation of the underlying trend in the core CPI upwards. To be fair, we should also exclude those items that have increased more rapidly in price over this period, culminating to the same weight as medical care and imported goods. However, it is difficult to find components of the consumer price index that are rising unusually rapidly in price on a sustained basis that have sufficiently large weights to make this a convincing exercise.

Second, this performance has occurred at a time that profit margins have continued to expand. This indicates that there still is little underlying cost pressures. Thus, a profit squeeze driven by higher compensation costs that leads, in turn, to greater price inflation does not yet appear to be at hand.

A Modest Uptick Ahead

Our examination of the performance of core consumer prices suggests that the behavior of import prices will be an important element shaping the inflation outlook over the next year.

In this respect, the performance of the dollar will be critical. We estimate that about 30% of the movement in the Federal Reserve's trade-weighted dollar ultimately shows up in the core consumer import prices (the remaining impact is absorbed through changes in profit margins and costs or via shifts in relative productivity growth).

If the dollar depreciates as we anticipate, then core consumer import prices will head higher. The Goldman Sachs dollar forecast implies a decline in the Federal Reserve's trade-weighted dollar index of about 9% over the next year. This would push up the rate of core import price inflation by about 3 percentage points.

Also, inflation pressures are likely to become more visible because the favorable news from medical care inflation is likely to diminish as the transition to managed care is completed. Most health care analysts expect a higher rate of medical price inflation in 1998 than in 1997. In addition, the so-called "Y2K" problem—expenditures made to ensure that computer systems function properly in processing transactions beyond the year 1999—will also push up cost pressures. The costs incurred by business and government of solving the problem could be as high as $100 billion for the United States. Finally, and most seriously, greater compensation cost pressures should gradually emerge. Although competitive pressures may prevent these costs from leaking into prices very readily, the labor cost side of the equation should also contribute to an uptick in inflationary pressures.

The main force working in the opposite direction will be BLS methodological changes in the calculation of the consumer price index. For example, the Congressional Budget Office estimates that these changes should cut the measured annual rate of consumer price inflation by another 0.4% over the next two years. This may help to mask the uptick in inflationary pressures, at least temporarily.

Fed officials, however, are likely to take the BLS impact into account in assessing the inflation outlook. If the underlying inflation trend—adjusted for the BLS changes—starts to turn up, that should be sufficient to provoke the monetary authorities to tighten monetary policy.

Bill Dudley **Alex Patelis**

Key U.S. Economic Data

	Latest Monthly Data '97 Sep	'97 Aug	'97 Jul	'97 Jun	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. Thousands)	--	49	365	222	218	207	Oct 3
Unemployment Rate (%)	--	4.9	4.8	5.0	4.9	5.1	
Index of Hours Worked (% ch)	--	0.4	-0.2	0.4	1.1	2.7	
Average Hourly Earnings (% ch)	--	0.4	0.1	0.3	3.2	3.6	
Producer price finished goods index (% ch)	--	0.3	-0.1	-0.1	-1.8	0.1	Oct 10
Excluding food and energy	--	0.1	-0.1	0.1	-0.6	0.0	
Consumer price index (% ch)	--	0.2	0.2	0.1	1.4	2.2	Oct 16
Excluding food and energy (% ch)	--	0.1	0.2	0.1	2.2	2.3	
Retail sales (% ch)	--	0.4	0.9	0.7	0.6	5.2	Oct 15
Excluding motor vehicles (% ch)	--	0.3	0.6	0.5	1.4	4.9	
Industrial Production (% ch)	--	0.7	0.4	0.3	5.0	4.7	Oct 17
Manufacturing	--	1.0	0.5	0.4	5.7	5.3	
Capacity utilization (%)	--	83.9	83.6	82.5	83.6	83.5	Oct 17
Manufacturing	--	83.1	82.6	82.5	82.6	82.5	
Housing Starts (annual rate, thousands)	--	1363	1432	1503	1444	1442	Oct 17
Single-family	--	1072	1128	1134	1118	1123	
Trade balance (billions, monthly)	--	--	-10.3	-8.3	-9.1	-9.4	Oct 21
Merchandise	--	--	-17.1	-15.2	-16.0	-16.4	
Factory Orders (% ch)	--	--	0.2	1.7	7.0	4.7	Oct 2
Durable Goods	--	2.7	0.1	2.9	8.8	11.6	Oct 29
Personal Income (% ch)	--	--	0.1	0.6	6.2	5.4	Sep 29
Wages and Salaries	--	--	0.0	0.8	6.2	5.9	
Purchasing Managers' Index (%)	--	56.8	58.6	55.7	56.2	54.2	Oct 1
Consumer Sentiment U Mich (Feb 66=100)	106.0	104.4	107.1	104.5	104.4	101.4	Oct 31
Conference Board (1985=100)	--	129.1	126.5	129.9	125.0	119.2	Sep 30

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

©1997 Goldman, Sachs & Co. All rights reserved.

This material is for your private information, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy or sell, the securities, or derivatives (including options) thereof, of companies mentioned herein. No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without Goldman, Sachs & Co.'s prior written consent.

This material has been issued by Goldman, Sachs & Co. and/or one of its affiliates and has been approved by Goldman Sachs International, which is regulated by The Securities and Futures Authority, in connection with its distribution in the United Kingdom and by Goldman Sachs Canada in connection with its distribution in Canada. This material is distributed in Hong Kong by Goldman Sachs (Asia) L.L.C.; and in Japan by Goldman Sachs (Japan) Ltd. This material is not for distribution in the United Kingdom to private customers, as that term is defined under the rules of The Securities and Futures Authority; and any investments, including any convertible bonds or derivatives, mentioned in this material will not be made available by us to any such private customer. Neither Goldman, Sachs & Co. nor its representative in Seoul, Korea, is licensed to engage in the securities business in the Republic of Korea. Goldman Sachs International and its non-U.S. affiliates may, to the extent permitted under applicable law, have acted upon or used this research, to the extent it relates to non-U.S. issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

Further information on any of the securities mentioned in this material may be obtained upon request, and for this purpose persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan, or at its London branch office at 133 Fleet Street, and persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 3 Garden Road. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

U.S. Calendar

Focus for the Week Ahead

- The personal consumption expenditures report should indicate a continuation of the robust consumption uptrend in August (September 29).
- The FOMC meeting will almost certainly end with no change in monetary policy. Expect a simple message at 2:15 p.m. E.D.T. that the meeting has ended (September 30). The August FOMC meeting minutes should show that the FOMC retained an asymmetric policy directive biased towards tightening (October 2).
- The National Purchasing Managers' index is likely to move a bit higher in September, reflecting some of the strength in durable goods orders in August. The vendor performance measure should be scrutinized for evidence of increasing bottlenecks given the rise in capacity utilization rates in manufacturing (October 1).
- Payroll employment in September will rise sharply due to the impact of the end of the UPS strike, which should add about 150,000 to payrolls. The overall increase, however, is likely to be smaller than the consensus estimate due mainly to the early timing of Labor Day (October 3).

Economic Releases and Other Events

Date	Time	Indicator	Estimate: GS	Estimate: Consensus	Last Report
Mon Sep 29	8:30	Personal Income (Aug)	+0.5%	+0.5%	+0.1%
	8:30	Personal Consumption (Aug)	+0.6%	+0.4%	+0.8%
Tue Sep 30	10:00	New Home Sales (Aug)	+1.6%	-1.5%	+0.9%
	10:00	Consumer Confidence (Sep)	130.0	128.5	129.1
	10:00	Chicago Purchasing Managers Index (Sep)	62.0%	62.1%	64.3%
Wed Oct 1	10:00	Purchasing Managers Index (Sep)	57.5%	56.5%	56.8%
	10:00	Construction Spending (Aug)	+0.9%	+0.3%	+0.5%
		Domestic Motor Vehicle Sales (Sep)	13.2M	13.5M	13.4M
Thu Oct 2	10:00	Factory Orders (Aug)	+1.7%	n.a.	+0.2%
	10:00	Leading Indicators (Aug)	+0.1%	+0.2%	+0.3%
Fri Oct 3	8:30	Civilian Unemployment Rate (Sep)	4.8%	4.9%	4.9%
	8:30	Nonfarm Payroll Employment (Sep)	+250,000	+325,000	+49,000

- **FOMC Meeting (Tue, Sep 30)**
- **APICS Survey (Tue, Sep 30 - 8:30)**
- **Treasury Announces 5-Year Inflation-Indexed Note (Wed, Oct 1 - 2:30)**
- **August FOMC Minutes (Thu, Oct 2 - 2:00)**
- **Treasury Announces 1-Year Bill (Fri, Oct 3 - 2:30)**

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	6.1%	6.3%	6.6%
Forward	5.8	5.9	6.1
2 Yr T-Note	6.2	6.3	6.7
Forward	5.9	6.0	6.1
10 Yr T-Note	6.4	6.5	6.8
Forward	6.2	6.2	6.2

Key Numbers in the Business Outlook

	1997 Q2	1997 Q3E	1997 Q4E	1997E	1998E
Real GDP	3.3%	3.3%	3.2%	3.8%	3.1%
Ind. Prod., Mfg.	4.1	6.5	4.5	5.0	5.3
CPI	1.1	2.0	2.9	2.4	2.7
After-Tax Profits*	8.7	6.8	4.3	7.3	2.0
Unemployment	4.9	4.8	4.7	4.9	4.4

* Excluding inventory profits; adjusted for depreciationdistortions.

Goldman, Sachs & Co.,
One NY Plaza, New York, NY 10004

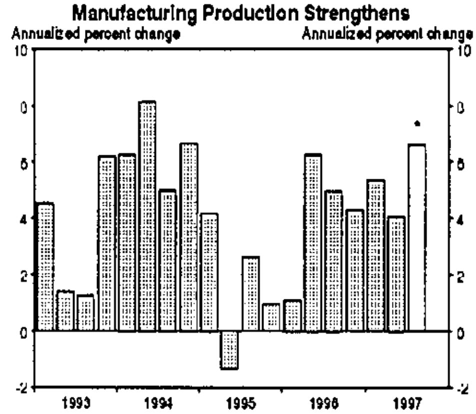
Tel.#: (1) 212-902-6807
Fax #: (1) 212-346-3115

U.S. Economics Analyst

Retail Group Also Sees Firm Spending, With Upside Risk

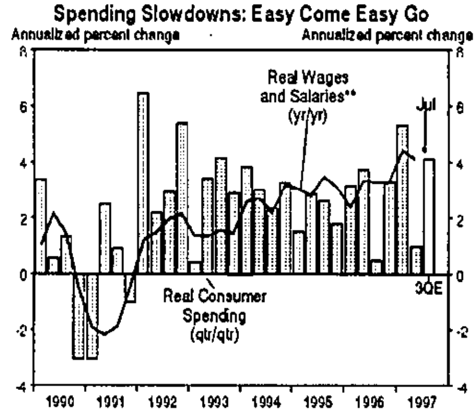
- U.S. financial markets have rallied further as continuing evidence of benign inflation has all but obliterated whatever possibility there might have been for an interest-rate hike by the FOMC at its next meeting on September 30.
- Although housing starts posted a puzzling and probably transitory decline in August, most data on current activity reveal gathering momentum. In particular, industrial production jumped 0.7% last month—1.0% in manufacturing—from a base that was revised up sharply. As a result, we have lifted our third-quarter real GDP growth estimate to 3.3%, from 2.7%.
- A principal factor behind this revision is the strength that has reemerged in real consumer spending, which appears to be rising at a 4% annual rate this quarter. Our retail analysts share our view that trends in household incomes and balance sheets point to continuing strength in real spending, emphasizing acceleration in real hourly wages and reduced borrowing.
- As a result, the trading rally that has developed in the retail sector of the stock market could well persist through yearend. Even so, overweighted positions are not recommended on a sustained basis because industrial output is outpacing real spending, as it normally does late in a cycle.
- Both groups see the risks on spending tilting to the high side. Benign inflation could allow real wages to rise even faster, while the recent capital gains tax cut could extend the wealth effect on spending as it unlocks large unrealized gains. In turn, this would raise the risk of overheating and, with it, much more Fed tightening than is now priced into U.S. financial assets.

Manufacturing Production Strengthens



*Based on July/August average.
Source: Federal Reserve Board.

Spending Slowdowns: Easy Come Easy Go



**Adjusted for tax-induced changes in income realizations.
Source: Department of Commerce.

Trade Recommendations

- Stay short March 1998 Eurodollar futures, with a stop on a close above 94.15 and a target of 93.50.
- Sell short December 10-year Treasury note futures on a close below 109.16, with stops above 110.18.

Contributors:
Bill Dudley, Ed McKelvey, John Youngdahl (212) 902-6807
E-mail Address: william.dudley@gs.com

Issue No: 97/38
September 19, 1997

Important disclosures appear on the inside back cover.

I. Weekly Wrapup

Economic and Market Overview

Softer-than-expected August inflation news spurred a sharp further advance in the U.S. bond market, which brought yields to their lowest levels in six weeks and helped buoy share prices. Despite a 1.7% jump in retail energy costs, the overall consumer price index rose just 0.2%, and excluding food and energy the CPI rise was a mere 0.1%. Declines in airline fares and apparel quotes (-4.7% and -1.0%, respectively) were crucial elements of this favorable surprise, and rebounds in both appear likely. That said, the year-to-date core CPI pace of 2.2% annualized is well below the 2.7% rise for all of 1996.

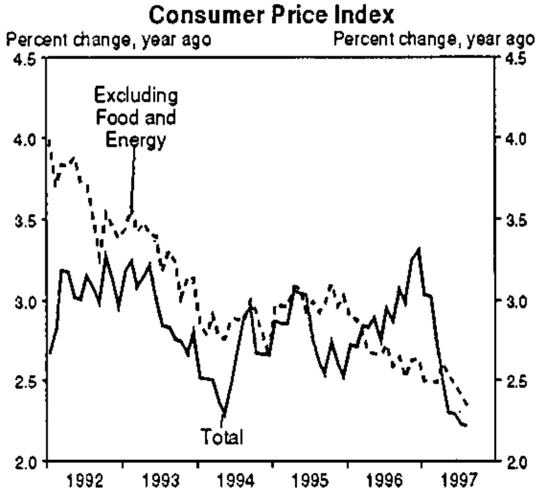
Reports on business activity, meanwhile, remain generally strong, especially as regards the goods-producing sectors. Industrial production leaped 0.7% during August, aided by a 6.3% gain among makers of motor vehicles and parts. Manufacturing output soared 1.0% in the month, and was revised up by a cumulative 0.7%, placing this large component of the overall economy on a 6.6% annualized growth trajectory so far in the third quarter, up from 4.7% in the first half on average. Consistent with these signs of appreciable forward momentum in goods production, the Philadelphia Fed reported a fourth consecutive very high result from its monthly poll of general business conditions, and initial unemployment claims fell to 306,000 in the week ending September 13, from which the payroll and household employment statistics will be culled. On the negative side of the ledger, there was a 4.8% drop in housing starts last month, which is puzzling because it comes in an environment of extraordinarily low unsold dwellings and amid builder reports of very favorable current and prospective sales. This softness likely will give way to a rebound in home construction later this year, judging from the high volume of building permits relative to starts.

The U.S. trade deficit widened to $10.3 billion during July, led by a 2.3% rise in import volumes. It is premature to judge net exports as a large drag on current growth, as this information relates to only one month of the third quarter and the import strength may signal that the recent rapid pace of stock building has been intended. In fact, based on the strikingly positive factory production reports, we have boosted our third-quarter growth estimate to 3.3% from 2.7%, implying 3¼% growth for the second half of the year versus 3% previously.

Federal Reserve Policy

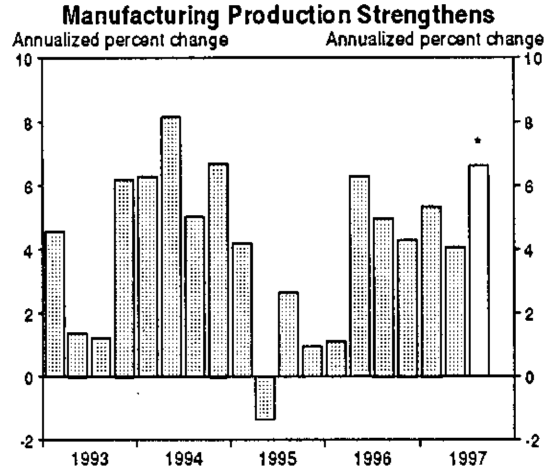
Any small potential for an interest-rate hike as early as the September 30 FOMC meeting essentially went out the window with the favorable CPI news. The distinct lack of current price pressure grants central bankers considerable flexibility to wait for more information about domestic demand and the effect of tight labor markets on wages and prices before tightening further. We continue to believe that the economy's vigor will persist into 1998, progressively expanding and exacerbating strains on resource supplies, and that the FOMC will need to tighten credit, probably at its November 12 meeting. For now, though, the patient monetary strategy that has been pursued since late March can be expected to remain in force.

Consumer Price Index



Source: Department of Labor.

Manufacturing Production Strengthens



*Based on July/August average.
Source: Federal Reserve Board.

Fiscal and Political Developments

The congressional investigation of political fund-raising abuses in the 1996 national election campaign has produced little in the way of hard evidence that laws were violated, but various polls suggest that they have led to a sharp decline in public sentiment toward Vice President Gore, who until recently was regarded as the prohibitive favorite for the Democratic presidential nomination in 2000. Two recent surveys showed a near equivalence between respondents who had positive and negative views of Gore, who now faces the threat that an independent counsel with prosecutorial powers might be appointed to investigate his activities last year. This deterioration in public sentiment is probably encouraging other Democrats to more actively explore their opportunities to bring an intra-party challenge. A preliminary list of such figures would include: Rep. Richard Gephardt (D-Missouri), the House minority leader who has been a leading opponent of NAFTA and other major free-trade legislation as well as the recent budget accord; Sen. Robert Kerrey (D-Nebraska), who ran in the 1992 primaries against President Clinton and has been a prominent advocate of entitlement program reforms; and Indiana Governor Evan Bayh, who has performed very well electorally in a state typically dominated by GOP politicians.

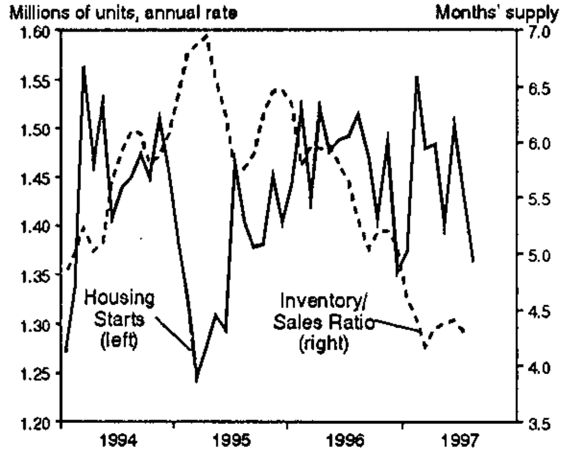
Market Outlook and Comments on Value

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

Our recommendation last week to sell short March 1998 Eurodollar futures was triggered on the discontinuous price surge above 94.05 after the favorable CPI report. We would hold such positions with a stop on a close above 94.15, which is fairly tight to the present level (94.105), on the view that current forward rates substantially underestimate the potential for a monetary tightening within the next six to nine months.

Additionally, we would establish shorts in December 10-year Treasury note contracts on a close below 109.16, which would require more than a 50% reversal of the recent rally, implying a substantial negative swing in sentiment regarding Fed policy prospects. In the event of a sharp Treasury market selloff, intermediate-duration securities yields might come under particular upward pressure due to heavy new supplies in the corporate and mortgage sectors.

New Home Starts and Inventories

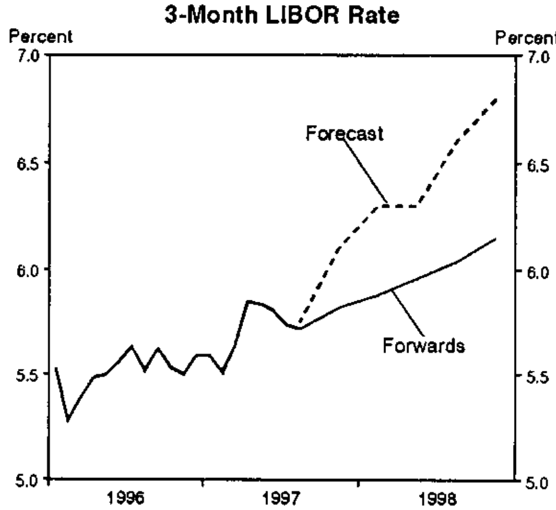


Source: Department of Commerce.

Real Merchandise Trade Balance

*3-Month Moving Average.
Source: Department of Commerce.

3-Month LIBOR Rate



Source: Federal Reserve Board, Wall Street Journal.

II. Retail Group Also Sees Firm Spending, With Upside Risk

The relief rally that has gripped U.S. financial markets in recent days began when the government reported a smaller-than-expected 0.4% rise in retail sales for August (0.3% excluding motor vehicles) on Friday, September 12. Yet this report, in conjunction with a small rise in unit motor vehicle sales in August from an already high level in July, puts real consumer spending on a solid 4% annualized quarter-to-quarter growth track for the third quarter. This implies that real spending is up nearly 3½% from its year-earlier level, the largest such gain in more than three years.

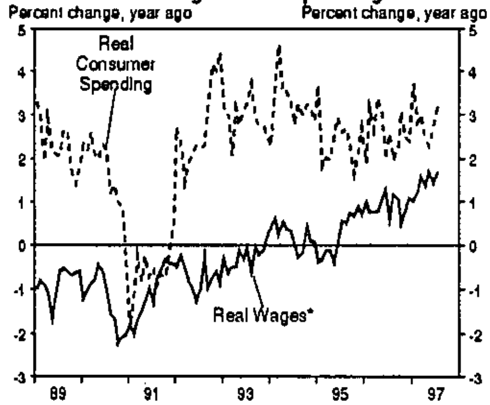
Why has consumer spending sprung back to life in the third quarter, and what is the outlook for coming quarters? In this article, we present views on these and related questions from two perspectives—our own alongside the retail analysts', represented by David Bolotsky, who covers the hardlines retailers. The bottom line for both groups is that consumer spending is likely to remain strong in coming quarters. However, the strength comes at too advanced a stage in the economic cycle to justify much more than the trading rally in the group, largely because the upturn in spending creates a risk that the economy could overheat and prompt more aggressive tightening by the Federal Reserve.

Q: Why has consumer spending rebounded so sharply in the third quarter?

Bolotsky: In our view, there are two key sources underlying the current strength in consumer spending. The most important is the increase in real hourly wage rates, which has consistently provided a lead indicator for real consumer spending, as shown in the chart nearby. Over the past year, real average hourly earnings have risen 1.7%, the largest gain in nearly two decades and a marked acceleration from the 1.1% growth rate in 1996 (December to December). Rapid growth in employment has also provided support, although this is generally a lagging indicator.

McKelvey: We basically agree, having long held the view that sturdy trends in real disposable income growth, which reflect both large real hourly wage gains and strong net hiring by businesses, would undergird growth in consumer spending. In the 12 months to July, real disposable income rose 2.6% and its wage and salary component was up 4.4%. In this context, the second-quarter weakness in spending has always looked like an anomaly induced by unusual weather patterns, which boosted real spending growth in the first quarter and suppressed it in the second.[1]

Real Wages Lead Spending



*Deflated with the personal consumption deflator.
Source: Department of Commerce. Department of Labor.

Q: Will the strength persist?

Bolotsky: Our lead indicators suggest that it will, for three reasons. First and foremost, the strong trend in real wage growth is apt to persist through the balance of 1997 and probably beyond. Second, we expect the rate of borrowing (installment debt) growth to stabilize at $50 billion, consistent with the trailing four-quarter trend. It is the change in growth of installment debt that impacts year-over-year spending growth; thus, this stabilization would imply that debt would have essentially no impact on spending growth in the coming quarters. ***This would represent a significant reversal from the past 18-month trend, when slowing debt growth exerted roughly a $50 billion drag (about 1 percentage point) on overall personal consumption expenditure growth,*** as shown in the table at the top of page 5. Finally, continued gains in employment should also help.

McKelvey: We recognize that real disposable income (incorporating both employment and wages as well as other factors) is not a leading indicator, either for consumer spending or for the economy as a whole. Nevertheless, it is by far the most important means by which spending is financed, and there is no sign yet of a break in its trend. Indeed, on several occasions

[1] For more on the impact of unusual weather patterns, see "Weather Was the Culprit for the Q2 Slowdown," *U.S. Economics Analyst*, July 11, 1997, pp. 4-6.

Installment Borrowing and its Effect on Spending

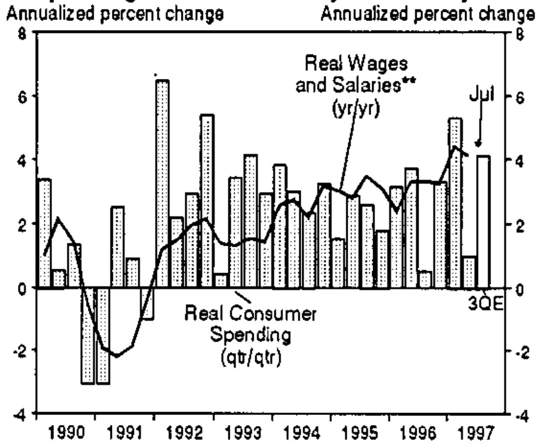
Year	Borrowing Growth ($ billions)	Change in Borrowing Growth = Impact on Spending ($ billions)	Effect on Spending Growth (%)
1993	$60.1	$56.6	1.3%
1994	121.7	61.6	1.3
1995	136.1	14.4	0.3
1996	83.3	-52.8	-1.0
1997E	59.6	-23.7	-0.4
Q1	86.0	-35.3	-0.7
Q2	52.4	-32.9	-0.6
Q3E	50.0	-36.1	-0.7
Q4E	50.0	9.6	0.2

Source: Federal Reserve Board. Department of Commerce

in the past few years, the sturdiness of this trend has correctly indicated that hiatuses in spending growth would be short-lived, as shown in the chart below.

In line with David's comments, we also attach special significance to the fact that real hourly wage gains account for almost two-fifths of growth in real wages and salaries, because trends in real wage growth tend to persist for longer periods of time than do trends in hiring. In addition, it is likely that the near doubling of stock prices over the past 2½ years will continue to support spending growth, as it evidently has in recent quarters. In this regard, the reduction in capital gains taxes, which took effect May 7, will probably help as some of the proceeds from asset sales are apt to find their way into spending rather than into reinvestment in new assets. The recent surge in money growth may be ancillary evidence that this is happening.

Spending Slowdowns: Easy Come Easy Go



**Adjusted for tax-induced changes in income realizations.
Source: Department of Commerce.

Q: Which way do the risks lie, and why?

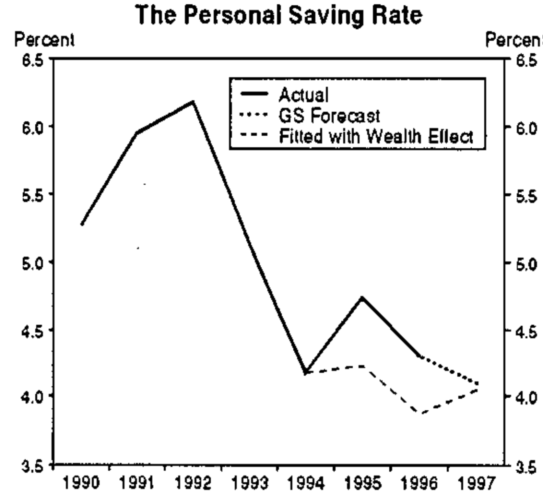
Bolotsky: Given the strength in our lead indicators, the major risk appears to be that spending will exceed our forecast and that retail stocks will meaningfully outperform the market. The sector underperformed from 1993 through 1996; thus, despite its recent rally, valuations are not extended. Meanwhile, we are most encouraged by the continued acceleration in wage growth and the likelihood of a 1 percentage point boost in spending from the improved borrowing comparisons, particularly if interest rates remain low.

McKelvey: In our view, the risks tilt to the strong side over the next six months to one year. This is largely because the wealth effect has been a bit weaker in the past two years than before. We draw this conclusion from the fact that the saving rate was about ½ point higher in 1995 and 1996 than predicted by its three principal determinants: changes in income growth relative to trend, changes in unemployment, and changes in the ratio of net worth to income. (See the chart below.) One possible explanation for this smaller-than-normal decline in saving is that capital gains tax cuts have been high on the political agenda ever since the Republicans took control of Congress, and investors have been waiting to see what would happen before realizing substantial stock-market gains. If this is the case, then strong spending could drive the saving rate even lower in coming quarters, as the wealth effect makes up for lost time.

Q: Has pricing flexibility improved in the retail sector?

Bolotsky: Over the past year, retailers have aggressively sought to "trade sales for profits," as earnings growth has taken precedence over market-

The Personal Saving Rate



Source: Department of Commerce.

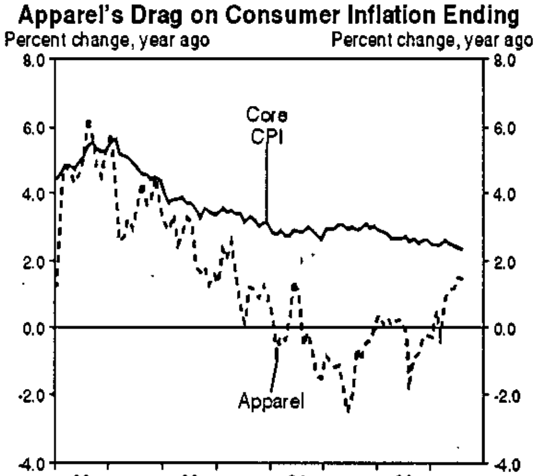
share gains after a sustained period of deteriorating profitability. One component of this new mindset has been a less promotional pricing posture, as retailers have looked to improved gross margins. In fact, fully two-thirds of the retailers we follow have enjoyed higher gross margins in 1997, some of which has been a function of less aggressive discounting. In addition, the apparel sector, which has been plagued by deflation in recent years, has experienced a material upturn in pricing over the past year, as shown in the chart below. Even so, we do not look for a sustained upward trend in pricing given the over-stored, intensely competitive environment within the retail industry. Furthermore, the retailers that are gaining share, such as Wal-Mart and Home Depot, tend to be price leaders.

Q: How is the overall economic outlook affected by the sluggish, though improved, retail pricing environment?

McKelvey: At the margin, the abatement of discounting should reduce one factor that has kept inflation so well-behaved in recent years, as also shown in the chart below. That said, it is also clear that generalized upward pressure has not yet developed; hence, any upturn in consumer inflation that does materialize is apt to be gradual rather than abrupt. Finally, as a general matter regarding the interpretation of data, market participants who look at what appear to be fairly modest year-to-year gains in retail sales should bear in mind that most of these gains are in real volumes.

Q: Does your outlook for strong spending justify an overweighted position in the retail sector?

Apparel's Drag on Consumer Inflation Ending



Source: Department of Labor.

Bolotsky: Not on a sustained basis, although we do believe that we are in the midst of a trading rally that could last for the balance of the year. Historically, we have found that the best time to buy retail stocks is when the rate of improvement in consumer spending outpaces increases in the production side of the economy. This usually occurs early in a business expansion, when the economy is emerging from recession. Later in the cycle, when the momentum in consumer spending carries through to the manufacturing sector, deeper cyclical stocks tend to outperform retail and other consumer-oriented stocks.

The current situation is typical of a late-cycle environment with one major exception. As usual, the gap between real wage and real personal consumption expenditure growth has narrowed to a modest 1-1½ percentage points, reflecting the negative impact that slowing borrowing growth has had on spending. However, job growth has remained unusually healthy, up 2.3% year-to-date, while inflation has actually slowed—a rare and fortuitous occurrence that lends credence to the possibility of steady spending growth without a rise in interest rates.

Q: Does the current economic outlook support this view?

McKelvey: Yes. Although we expect real consumer spending to rise between 3% and 3½% over the next twelve months, gains in industrial output are apt to be even larger—between 5% and 6%—over the same period. This reflects not only a sizable pass-through of consumer expenditure to U.S. production but rapid growth rates in U.S. exports and in outlays on capital equipment by U.S. business firms.

Q: Beyond the comments already made on retail stocks, what implications does the strong consumer spending outlook have for U.S. monetary policy and financial markets?

McKelvey: In our view, continued strong consumer spending poses the biggest upside risk to the U.S. economic outlook. As such, it also poses the biggest risk that Federal Reserve officials will find it necessary to increase interest rates in coming months to prevent overheating. Currently, fixed-income markets are not priced for this possibility; hence, unexpected strength in retail spending could push U.S. interest rates up, perhaps significantly.

Ed McKelvey David Bolotsky

Goldman Sachs

Key U.S. Economic Data

	Latest Monthly Data '97 Aug	'97 Jul	'97 Jun	'97 May	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. Thousands)	49	365	222	163	218	207	Oct 3
Unemployment Rate (%)	4.9	4.8	5.0	4.8	4.9	5.1	
Index of Hours Worked (% ch)	0.4	-0.2	0.4	0.3	-1.1	2.7	
Average Hourly Earnings (% ch)	0.4	0.1	0.3	0.4	3.2	3.6	
Producer price finished goods index (% ch)	0.3	-0.1	-0.1	-0.3	-1.8	0.1	Oct 10
Excluding food and energy	0.1	-0.1	0.1	-0.3	-0.6	0.0	
Consumer price index (% ch)	0.2	0.2	0.1	0.1	1.4	2.2	Oct 16
Excluding food and energy (% ch)	0.1	0.2	0.1	0.2	2.2	2.3	
Retail sales (% ch)	0.4	0.9	0.7	-0.3	0.6	5.2	Oct 15
Excluding motor vehicles (% ch)	0.3	0.6	0.5	0.0	1.4	4.9	
Industrial Production (% ch)	0.7	0.4	0.3	0.1	5.0	4.7	Oct 17
Manufacturing	1.0	0.5	0.4	0.1	5.7	5.3	
Capacity utilization (%)	83.9	83.6	82.5	83.5	83.6	83.5	Oct 17
Manufacturing	83.1	82.6	82.5	82.4	82.6	82.5	
Housing Starts (annual rate, thousands)	1363	1432	1503	1402	1444	1442	Oct 17
Single-family	1072	1128	1134	1098	1118	1123	
Trade balance (billions, monthly)	--	-10.3	-8.3	-9.6	-9.1	-9.4	Oct 21
Merchandise	--	-17.1	-15.2	-16.4	-16.0	-16.4	
Factory Orders (% ch)	--	0.2	1.7	-0.5	7.0	4.7	Oct 2
Durable Goods	--	-0.3	2.9	-0.4	13.0	6.1	Sep 25
Personal Income (% ch)	--	0.1	0.6	0.3	6.2	5.4	Sep 29
Wages and Salaries	--	0.0	0.8	0.3	6.2	5.9	
Purchasing Managers' Index (%)	56.8	58.6	55.7	57.1	56.2	54.2	Oct 1
Consumer Sentiment U Mich (Feb 66=100)	104.4	107.1	104.5	103.2	103.4	100.4	Sep 26
Conference Board (1985=100)	129.1	126.5	129.9	127.9	125.0	119.2	Sep 30

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

©1997 Goldman, Sachs & Co. All rights reserved.

This material is for your private information, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy or sell, the securities, or derivatives (including options) thereof, of companies mentioned herein. No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without Goldman, Sachs & Co.'s prior written consent.

This material has been issued by Goldman, Sachs & Co. and/or one of its affiliates and has been approved by Goldman Sachs International, which is regulated by The Securities and Futures Authority, in connection with its distribution in the United Kingdom and by Goldman Sachs Canada in connection with its distribution in Canada. This material is distributed in Hong Kong by Goldman Sachs (Asia) L.L.C.; and in Japan by Goldman Sachs (Japan) Ltd. This material is not for distribution in the United Kingdom to private customers, as that term is defined under the rules of The Securities and Futures Authority; and any investments, including any convertible bonds or derivatives, mentioned in this material will not be made available by us to any such private customer. Neither Goldman, Sachs & Co. nor its representative in Seoul, Korea, is licensed to engage in the securities business in the Republic of Korea. Goldman Sachs International and its non-U.S. affiliates may, to the extent permitted under applicable law, have acted upon or used this research, to the extent it relates to non-U.S. issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

Further information on any of the securities mentioned in this material may be obtained upon request, and for this purpose persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan, or at its London branch office at 133 Fleet Street, and persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 3 Garden Road. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

U.S. Calendar

Focus for the Week Ahead

- Among the many issues to be discussed at the G7 and IMF/World Bank meetings taking place in Hong Kong, two stand out: (1) implications of the Asian currency crisis and (2) weakness in Japanese domestic demand. The latter is likely to lead to calls for fiscal stimulus (through September 25).
- Federal budget data for August should conform to the recent pattern of year-to-year improvement, consistent with prevailing expectations of an annual shortfall in the neighborhood of $35 billion (September 22).
- Beneath a mixed pattern in the more volatile sectors—gains in defense and civilian aircraft offsetting setbacks in autos—orders for durable goods should remain firm (September 25).
- Recent increases in the index of mortgage purchase applications point to further gains in home sales from already high levels (September 25).

Economic Releases and Other Events

Date		Time	Indicator	Estimate GS	Estimate Consensus	Last Report
Mon	Sep 22	2:00	Federal Budget Balance (Aug)	-$36.5 Bil	-$38.8 Bil	-$41.8 Bil
Thu	Sep 25	8:30	Durable Goods Orders (Aug)	+0.4%	+0.5%	-0.3%
		10:00	Existing Home Sales (Aug)	+0.9%	+0.2%	+2.2%
Fri	Sep 26	8:30	Real GDP (Q2 '97—Revised)	+3.6%	+3.6%	+3.6%
		8:30	Chain-Weight Price Index (Q2 '97—Revised)	+1.5%	+1.5%	+1.5%

- G7 Meeting in Hong Kong (Sat, Sep 20)
- IMF/World Bank Annual Meeting in Hong Kong (ends Thu, Sep 25)
- Consumer Sentiment—Final (Fri, Sep 26 - 10:00)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	6.1%	6.4%	6.7%
Forward	5.8	5.9	6.0
2 Yr T-Note	6.2	6.4	6.7
Forward	5.9	6.0	6.0
10 Yr T-Note	6.4	6.5	6.8
Forward	6.1	6.2	6.2

Key Numbers in the Business Outlook

	1997 Q2	1997 Q3E	1997 Q4E	1997E	1998E
Real GDP	3.6%	3.3%	3.2%	3.8%	3.1%
Ind. Prod., Mfg.	4.1	6.5	4.5	5.0	5.3
CPI	1.1	2.0	2.9	2.4	2.7
After-Tax Profits*	8.7	6.8	4.3	7.3	2.0
Unemployment	4.9	4.8	4.7	4.9	4.4

* Excluding inventory profits; adjusted for depreciation distortions.

Goldman, Sachs & Co.,
One NY Plaza, New York, NY 10004

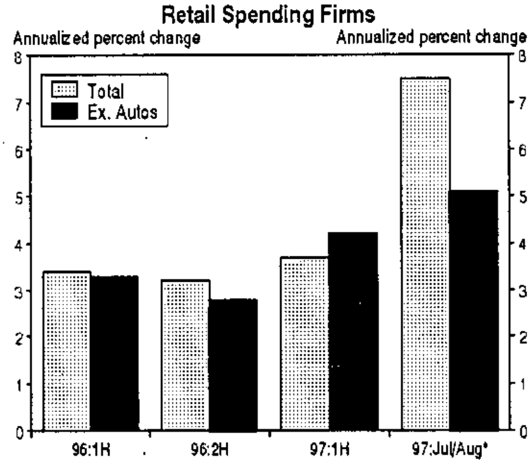
Tel.#: (1) 212-902-6807
Fax #: (1) 212-346-3115

U.S. Economics Analyst

Labor Market Tightening Proceeds Apace

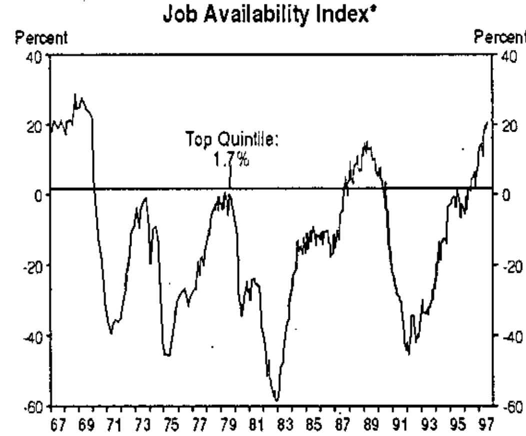
- The retail sales and producer price reports were not as troublesome as feared by financial market participants. While this has provoked a rally in the bond prices after earlier weakness, it is important not to be swept along by such shifts in market sentiment. The fact is that consumer spending remains firm and the best news on inflation appears already to have passed.
- Although the pressures on Fed officials to tighten are clearly growing, it still appears unlikely that they will move before November. Inflation is well-behaved and, by waiting, Fed officials will be in a better position to assess whether the current rebound in domestic demand is sustainable.
- Despite the absence of any further decline in the unemployment rate recently, other evidence suggests that the labor market continues to tighten. In particular, workers' assessments of job availability have climbed to a 28-year high. Moreover, the so-called "quit" ratio—a barometer of labor market insecurity—has climbed sharply in recent months. Finally, the unemployment rate among married workers is just 2¾%, the lowest since early 1970.
- This evidence implies a tighter labor market than suggested by a simple reading of the recent trend in the unemployment rate. If this is true, then signs of wage pressures could become evident relatively soon. The second increase in the minimum wage, which took effect September 1, should add to the upward pressure on labor compensation costs.

Retail Spending Firms



*Versus Q2 average.
Source: Department of Commerce.

Job Availability Index*



*Percentage of those saying jobs are plentiful less those viewing jobs as hard to get.
Source: The Conference Board.

Trade Recommendations

- Get short the March '98 Eurodollar futures contract at prices above 94.05, with a target of 93.50 and a stop on a close above 94.15.
- Get short the December 10-year T-note future on a close below 108.14, with a stop on a close above 109.16.

Contributors:
Bill Dudley, Ed McKelvey, John Youngdahl (212) 902-6807

Issue No: 97/37
September 12, 1997

E-mail Address: william.dudley@gs.com

Important disclosures appear on the inside back cover.

I. Weekly Wrapup

Economic and Market Overview

Both the bond and stock markets slipped in the run-up to Friday's key retail sales report, but weaker-than-expected headline figures reassured investors, provoking a sharp rally in bond prices. The equity market, however, has continued to slip.

Although the August advance estimates that retail sales rose 0.4% overall and 0.3% excluding autos were more modest than the market feared, they were accompanied by upward revisions to prior data. The net effect was to lift the third quarter trend of the so-called "control" portion of retail sales (which excludes autos and building materials) to a 5.3% annual rate from the previous 4.5% pace. This is a faster rise than occurred during the first half of 1997, and it indicates that consumer spending retains significant positive momentum. The producer price figures were in line with consensus market expectations, rising by 0.3% overall and 0.1% excluding food and energy. Although this snapped a string of seven consecutive monthly declines, the fact that the price pressures were concentrated in the energy component indicates that the inflation outlook in the goods area broadly remains benign.

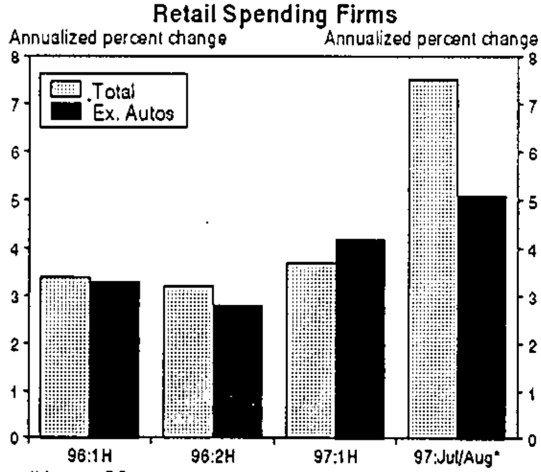
In other economic news, non-farm productivity growth was revised up sharply in the second quarter to 2.7% (annualized) from 0.6% earlier. Although this puts productivity growth in the first half of 1997 at a distinctly higher rate (about 2%) than in 1996 (1.3%) or 1995 (0.2%), the pickup is probably more a consequence of the faster growth in output in 1997 rather than evidence that a new era of higher productivity growth is now at hand.

Foreign investors continue to have a strong appetite for U.S. financial assets. Net foreign purchases increased by $151.6 billion in the second quarter, led by a surge in equity purchases to a record pace. Although the overall pace of net U.S. asset purchases was down about $30 billion from the first-quarter rate, the drop was due solely to a swing in central bank holdings from accumulation ($28.9 billion) in the first quarter to slight liquidation ($3.7 billion) in the second quarter. On balance, the foreign appetite for U.S. financial assets is still an important factor lending support to the U.S. dollar.

Federal Reserve Policy

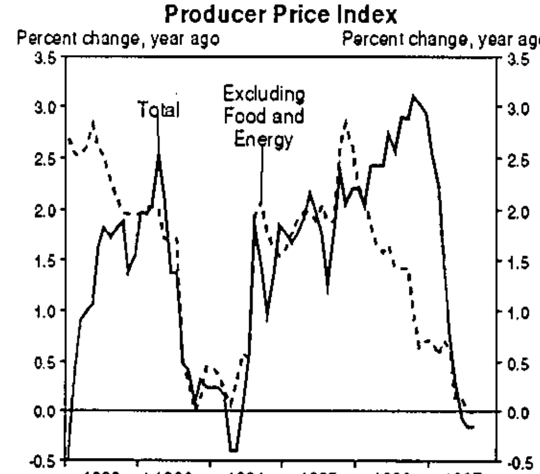
As consumer demand remains robust, the pressure on Federal Reserve officials to tighten monetary policy is gradually increasing. At this juncture, however, it still appears unlikely that a tightening move will be implemented at the September 30 Federal Open Market Committee meeting for three reasons. First, Chairman Greenspan did not foreshadow any shift in policy at his September 5 speech at Stanford University. Instead, he essentially reiterated the themes of his July Humphrey-Hawkins testimony to Congress. Second, as noted in our weekly dated August 29, when inflation is low the monetary authorities have a strong incentive to be patient. Third, the timing of the September 30 meeting also reinforces the impetus to wait because a number of important pieces of economic data will be released later that week.

Retail Spending Firms



*Versus Q2 average.
Source: Department of Commerce.

Producer Price Index



Source: Department of Labor.

Fiscal and Political Developments

The Congressional Budget Office's updated budget deficit projections now anticipate a $32 billion surplus in the year 2002. As shown in the accompanying chart, however, the balanced budget deal does not really alter the path of the deficit much before then. Almost all the improvement in the projected deficit path between now and 2001 that has taken place between March and September is due to the economy, not the efforts of Congress and the administration to balance the budget.

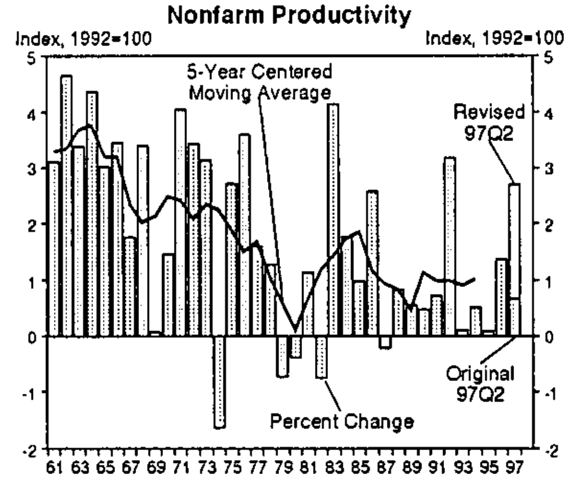
Moreover, the CBO's projections of surpluses in 2002 and beyond rest on some very questionable assumptions. For example, the economic expansion is seen persisting throughout the forecast horizon. The forecast also incorporates a large fiscal dividend, by projecting that the real 10-year Treasury note yield will decline to 2.6% in 2002 from 4.0% in 1997. It strains credulity that real rates will fall so sharply as the economic expansion persists. The economy is currently growing at an above-trend pace at the current level of real rates and the degree of fiscal drag in prospect is much more modest than what has occurred over the past few years. Finally, the CBO assumes (as it always does by convention) that Congress will enact the large cuts in discretionary spending needed to meet the spending targets for 2001 and 2002 that were agreed upon this year. The appetite for such reductions may fade when they actually have to be implemented.

Market Outlook and Comments on Value

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

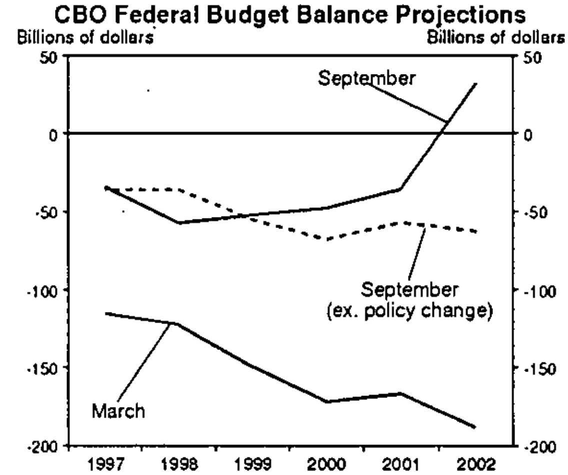
We would get short the March '98 Eurodollar futures contract at prices above 94.05 (currently 94.025), with a target of 93.50 and a stop on a close above 94.10. Strong consumer spending should cause Fed officials to tighten monetary policy later this year. Adjusting for the normal shape of the yield curve, the March contract incorporates no more than a 50% probability of a single 25-basis-point tightening over the next six months. On the long end, we would get short the December T-note futures contract on a close below 108.14, with a stop on a close above 109.16. If the Fed drags its feet and the economic news indicates continued demand strength and nascent inflation pressures, then the yield curve could steepen further.

Nonfarm Productivity



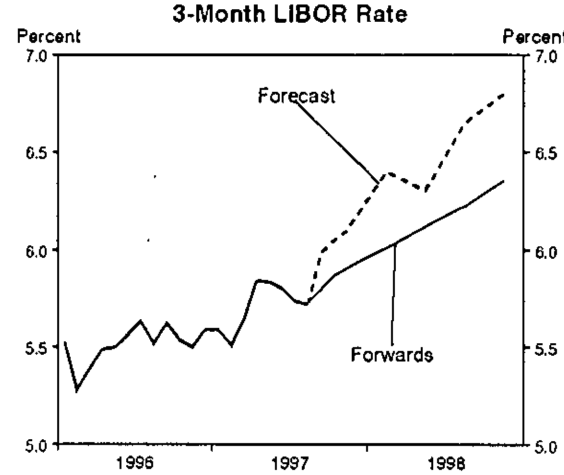
Source: Department of Labor.

CBO Federal Budget Balance Projections



Source: Congressional Budget Office.

3-Month LIBOR Rate



Sources: Federal Reserve Board. Wall Street Journal.

II. Labor Market Tightening Proceeds Apace

Since the end of 1995, the civilian U.S. unemployment rate has edged down to just below 5% from around 5½%, a modest absolute decline spread over a seven-quarter period. Meanwhile, there has been little change in key measures of total labor compensation, with the annual pace of gain in the overall employment cost index still hovering slightly under 3%. These developments, taken together, have been interpreted by some analysts as evidence that labor resource utilization, although obviously high, is not yet in a zone of potential inflationary danger. It is widely assumed that if unemployment can simply be stabilized close to the current level going forward, then appreciable upward pressure on labor compensation cost growth can be forestalled, perhaps indefinitely.

This view may well prove too sanguine, however, because several other key measures of labor scarcity have recently experienced much more substantial changes than what has been seen in overall unemployment, and in some cases have moved to extreme postures. When similar conditions in these indicators have existed in the past, there has been a decided tendency for labor compensation to accelerate, particularly in the event of a coincident upward commodity price shock. The potential for such a trend to emerge this time is not materially altered by the reduced percentage of union membership in the private sector, because changes in non-union compensation gains tend to lead those among organized labor. Financial market participants, therefore, should be on high alert for signs of an upturn in worker pay rates.

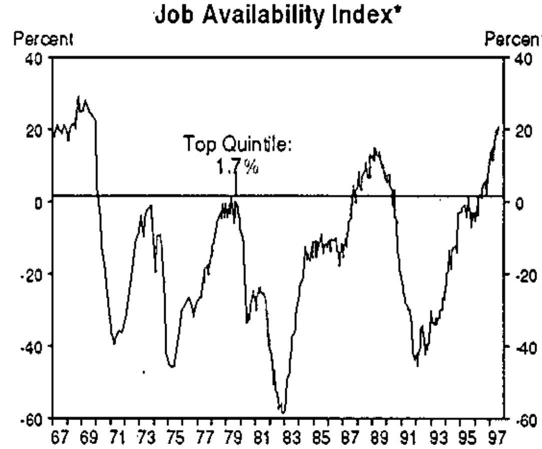
Strong Labor Demands Creating a Severe Supply Squeeze

While the current low posture of the unemployment rate—below 5% in four of the past five months—has created some concerns about a possible strengthening of labor cost pressures, to date there has not been much sign that this is happening. The increases in the total employment cost index as well as its wage and salary component over the past four quarters (2.8% and 3.2%, respectively) are only marginally higher than they were in late 1995, when the economy was sluggish and unemployment was hovering around 5½%. Since the jobless rate has edged down only a little more than a half percent over the last seven quarters, amid annualized real GDP growth of around 3½%, many analysts believe that a prompt slowdown in the economy to its long-term growth trend of 2%-2½% per year can successfully keep labor compensation growth bottled up by stabilizing labor utilization close to current levels.

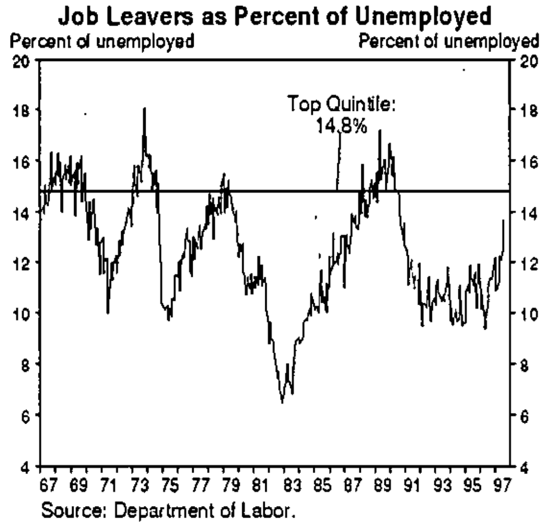
There are good reasons to question whether this optimism is justified, because other useful measures of free labor supplies have declined far more rapidly in recent quarters than would be inferred from the aggregate unemployment rate alone. For example, the differential between the percentage of consumers who perceive jobs as plentiful versus hard to get has surged to +21.0% as of August, after occupying negative territory from late 1990 straight through early 1996. This job availability index is markedly above the peaks for the series seen in the last three business expansion periods. In fact, the last time consumers assessed employment availability this favorably was in 1969, when the unemployment rate hovered around 3.5%, almost one-third lower than it is today.

A similarly impressive recent shift has occurred in the proportion of unemployed persons who have voluntarily left their jobs, presumably because they expect to find better situations elsewhere. This ratio climbed to 13.7% of unemployed persons last month, versus 11% in the third quarter of 1996, marking the steepest one-year rise since early 1988. To be sure, job quitters represent a smaller element of the unemployed now than they did in the latter stages of the prior business upswing, but after languishing for years their volume is now approaching the top quintile of observations over the past three decades.

Job Availability Index*



*Percentage of those saying jobs are plentiful less those viewing jobs as hard to get.
Source: The Conference Board.



Source: Department of Labor.

Source: Department of Labor.

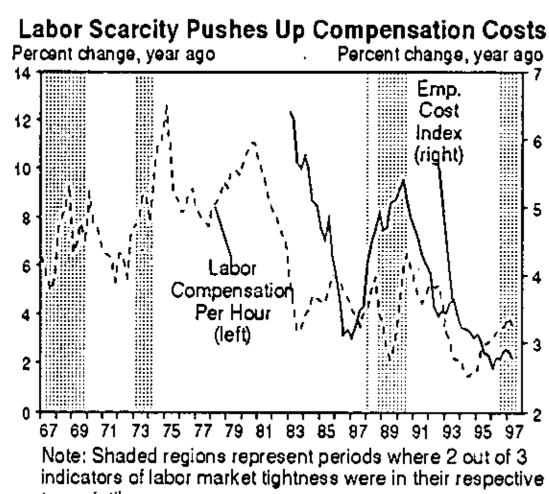
Joblessness among married persons can also be used as a yardstick for labor slack in the segment of the population with high educational attainment and job skills. This group over time has consistently had an unemployment rate that is both lower and less cyclically volatile in absolute terms than that experienced by other workers. Currently, the portion of married people in the labor force without jobs is just 2¾%, the lowest since early 1970 and well within the bottom one-fifth of the thirty-year data set. This would suggest that firms are likely to have considerable difficulty filling positions that require significant prior training or experience, which may force them to pad pay packages for recruitment efforts.

An Alternative to Traditional NAIRU Analysis

Many analysts have been perplexed by the lack of an appreciable pickup in labor compensation costs as the total unemployment rate has fallen below levels that had been experienced in prior business cycles. This has led some to abandon or temporarily suspend the concept of a non-accelerating inflation rate of unemployment ("NAIRU"), the downward piercing of which would be expected to create ripe conditions for higher wage and price inflation. Taken together, however, these other three indicators of labor utilization—consumer assessments of employment availability, the propensity to quit jobs, and joblessness for married persons—could serve as an alternative to the unemployment rate for the purpose of judging whether the labor market has moved into a posture that threatens a sustained labor cost upturn.

During the 1967-1996 interval, there were only three periods of any meaningful duration in which two of these three indicators were within the top quintile of market tightness at the same time: 1967-1969, February 1973-May 1974, and September 1988 through mid-1990. All of these episodes—which occurred at varying total unemployment rates—were marked by a significant and sustained labor compensation upswing, as measured by the Bureau of Labor Statistics' nonfarm business compensation costs index or, for the most recent occurrence, the employment cost index.

Thus, it is noteworthy that two of the three series—the married employment rate and the job availability index—crossed over into their respective top quintiles in the second quarter of 1996, and have advanced materially further since. For most of the past several years, by contrast, the portion of the unemployed who are job quitters was holding close to its historical average. This was taken as a sign that unusual insecurity about employment opportunities might be



Note: Shaded regions represent periods where 2 out of 3 indicators of labor market tightness were in their respective top quintiles.
Source: Department of Labor.

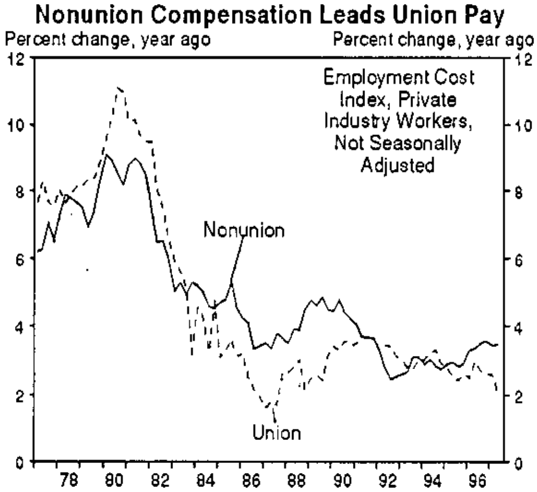
holding down workers' compensation demands. Over recent months, however, there has been a distinct rise in voluntary job leaving, which has brought this group within striking distance of its prior peak (14%-17%).

The resulting composite picture is one of unusually scarce labor resources and, importantly, a substantially heightened awareness of this condition within the working population. The possible consequences of such tight supply circumstances were illustrated by the outcome of the recent strike by the Teamsters union against United Parcel Service, in which the wage, benefit, and job security settlement terms were very close to what the union had demanded. Not only did the company have trouble finding replacements for its striking drivers, but the strikers were able to supplement their incomes during the two-week outage by signing on with temporary employment service firms, which have had a large backlog of unfilled positions.

Low Union Membership Not Grounds For Comfort

If labor shortages have reached severe dimensions, as suggested by the foregoing analysis, then the long pattern of stable compensation gains is increasingly vulnerable to an upside breakout. Such a trend change could develop slowly and purely through the passage of time, as employers are squeezed into granting bigger real pay increases to retain and attract workers. That is what happened in 1988-1990, as the employment cost index gradually climbed from around 4% to 5½% per annum. Even more worrying, though, is the enhanced potential in this environment for an unanticipated jump in prices of major commodities to have a swift impact on labor costs, as occurred when food and energy quotes soared in 1973-1974.

Nonunion Compensation Leads Union Pay



Source: Department of Labor.

There is little or no comfort to be taken from the fact that union membership in the private sector is far lower now than in the earlier periods of labor scarcity. Normally, it is the non-union portion of the labor force that leads the way in determining changes in the pace of total wage and benefit cost growth. This is true in large part because collective bargaining agreements tend to have multi-year terms, so that it takes longer for a majority of workers covered by those pacts to be affected by shifts in labor market conditions. In fact, the pattern of late has been to extend the length of these contracts; for example, the new UPS contract with the Teamsters covers the next four years, compared to three years in the prior deal.

Employment Cost Index Report Takes Center Stage

It will be crucial, therefore, to stay alert in coming months for signs that wage and benefit costs are gaining momentum. The next major information in this regard will arrive on October 28, when the Department of Labor releases employment cost index statistics from the third quarter. Should that report provide signs of faster compensation gains, particularly in the non-union private sector, it could provide the trigger for Federal Reserve officials to move toward a materially more restrictive monetary policy stance.

John Youngdahl

Key U.S. Economic Data

	Latest Monthly Data '97 Aug	'97 Jul	'97 Jun	'97 May	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. Thousands)	49	365	222	163	218	207	Oct 3
Unemployment Rate (%)	4.9	4.8	5.0	4.8	4.9	5.1	
Index of Hours Worked (% ch)	0.4	-0.2	0.4	0.3	1.1	2.7	
Average Hourly Earnings (% ch)	0.4	0.1	0.3	0.4	3.2	3.6	
Producer price finished goods index (% ch)	0.3	-0.1	-0.1	-0.3	-1.8	0.1	Oct 10
Excluding food and energy	0.1	-0.1	0.1	-0.3	-0.6	0.0	
Consumer price index (% ch)	--	0.2	0.1	0.1	1.5	2.2	Sep 16
Excluding food and energy (% ch)	--	0.2	0.1	0.2	2.5	2.4	
Retail sales (% ch)	0.4	0.9	0.7	-0.3	0.6	5.2	Oct 15
Excluding motor vehicles (% ch)	0.3	0.6	0.5	0.0	1.4	4.9	
Industrial Production (% ch)	--	0.2	0.3	0.0	3.5	3.7	Sep 16
Manufacturing	--	0.1	0.3	0.1	3.5	3.8	
Capacity utilization (%)	--	83.1	82.3	83.3	83.4	83.3	Sep 16
Manufacturing	--	82.1	82.3	82.4	82.4	82.4	
Housing Starts (annual rate, thousands)	--	1447	1447	1402	1469	1452	Sep 17
Single-family	--	1141	1111	1098	1144	1135	
Trade balance (billions, monthly)	--	--	-8.2	-9.5	-9.3	-9.5	Sep 18
Merchandise	--	--	-15.0	-16.4	-16.1	-16.4	
Factory Orders (% ch)	--	0.2	1.7	-0.5	7.0	4.7	Oct 2
Durable Goods	--	-0.3	2.9	-0.4	13.0	6.1	Sep 25
Personal Income (% ch)	--	0.1	0.6	0.3	6.2	5.4	Sep 29
Wages and Salaries	--	0.0	0.8	0.3	6.2	5.9	
Purchasing Managers' Index (%)	56.8	58.6	55.7	57.1	56.2	54.2	Oct 1
Consumer Sentiment U Mich (Feb 66=100)	104.4	107.1	104.5	103.2	103.4	100.4	Sep 26
Conference Board (1985=100)	129.1	126.5	129.9	127.9	125.0	119.2	Sep 30

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

©1997 Goldman, Sachs & Co. All rights reserved.

This material is for your private information, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material may, from time to time, have long or short positions in, and buy or sell, the securities, or derivatives (including options) thereof, of companies mentioned herein. No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means, or (ii) redistributed without Goldman, Sachs & Co.'s prior written consent.

This material has been issued by Goldman, Sachs & Co. and/or one of its affiliates and has been approved by Goldman Sachs International, which is regulated by The Securities and Futures Authority, in connection with its distribution in the United Kingdom and by Goldman Sachs Canada in connection with its distribution in Canada. This material is distributed in Hong Kong by Goldman Sachs (Asia) L.L.C.; and in Japan by Goldman Sachs (Japan) Ltd. This material is not for distribution in the United Kingdom to private customers, as that term is defined under the rules of The Securities and Futures Authority; and any investments, including any convertible bonds or derivatives, mentioned in this material will not be made available by us to any such private customer. Neither Goldman, Sachs & Co. nor its representative in Seoul, Korea, is licensed to engage in the securities business in the Republic of Korea. Goldman Sachs International and its non-U.S. affiliates may, to the extent permitted under applicable law, have acted upon or used this research, to the extent it relates to non-U.S. issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk.

Further information on any of the securities mentioned in this material may be obtained upon request, and for this purpose persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan, or at its London branch office at 133 Fleet Street, and persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 3 Garden Road. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

U.S. Calendar

Focus for the Week Ahead

- Consumer prices should have risen a bit more rapidly in August, boosted by higher gasoline prices. But the core reading should remain moderate (September 16).
- The growth rate of business inventories in July is likely to have moderated significantly due mainly to the earlier-reported drop of 0.6% in wholesale inventories (September 16).
- Industrial production probably rose sharply in August, partly due to a rebound in motor vehicle output. The advance should push the industrial capacity utilization rate higher (September 16).
- The Fed's beige book report is likely to indicate a pickup in consumer spending. Investors should scrutinize the report for evidence whether labor market tightness is leading to a rise in wage pressures (September 17).
- A wider trade deficit for July is anticipated, owing mainly to a pickup in the import growth rate. Exports, however, should remain on a fairly firm track, judging by the strength reported in factory shipments (September 18).

Economic Releases and Other Events

			Estimate		
Date	Time	Indicator	GS	Consensus	Last Report
Tue Sep 16	8:30	Consumer Price Index (Aug)	+0.3%	+0.3%	+0.2%
		Excluding Food & Energy	+0.2%	+0.2%	+0.2%
	8:30	Business Inventories (Jul)	+0.2%	+0.3%	+0.7%
	9:15	Industrial Production (Aug)	+0.7%	+0.5%	+0.2%
	9:15	Capacity Utilization (Aug)	83.4%	83.3%	83.1%
Wed Sep 17	8:30	Housing Starts (Aug)	+2.0%	+0.9%	0.0%
Thu Sep 18	8:30	Trade Balance (Jul)	-$9.0 Bil	-$9.5 Bil	-$8.2 Bil
	10:00	Philadelphia Fed Survey (Sep)	20.0%	n.a.	24.3%

- Import & Export Prices (Wed, Sep 17 - 10:00)
- Fed "Beige Book" (Wed, Sep 17 - 2:00)
- Treasury Announces 2- and 5-Year Notes (Wed, Sep 17 - 2:30)
- G7 Meeting in Hong Kong (Sat, Sep 20)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	6.1%	6.4%	6.7%
Forward	5.9	6.0	6.3
2 Yr T-Note	6.2	6.4	6.7
Forward	6.1	6.2	6.3
10 Yr T-Note	6.4	6.5	6.8
Forward	6.4	6.5	6.5

Key Numbers in the Business Outlook

	1997				
	Q2	Q3E	Q4E	1997E	1998E
Real GDP	3.6%	2.7%	3.3%	3.8%	3.1%
Ind. Prod., Mfg.	3.7	2.5	4.3	4.4	4.8
CPI	1.1	1.8	2.2	2.3	2.6
After-Tax Profits*	8.7	5.9	3.6	6.9	2.4
Unemployment	4.9	4.8	4.7	4.9	4.4

* Excluding inventory profits; adjusted for depreciation distortions.