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The Global Economic and
Strategy Weekly
July 14, 1999

20 pgs

Goldman Sachs

Global Economics Website
Economics Research from the GS Financial Workbench[SM] at https://www.gs.com

The Global Economic and Strategy Weekly

Global Liquidity: Strong But Peaking?

Strategy

- Global liquidity has expanded rapidly on the back of the lower interest rates and aggressive central bank actions that accompanied the emerging market crisis last year.

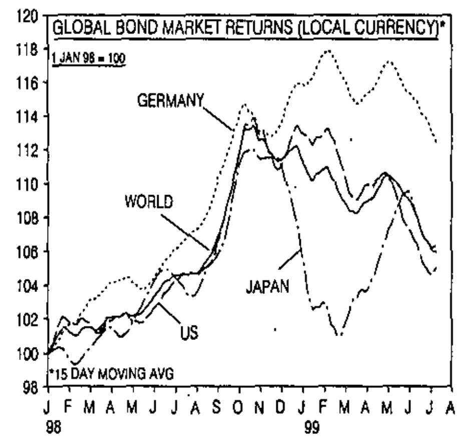
- In fact the surge in liquidity has been one of the fastest we have witnessed in recent memory.

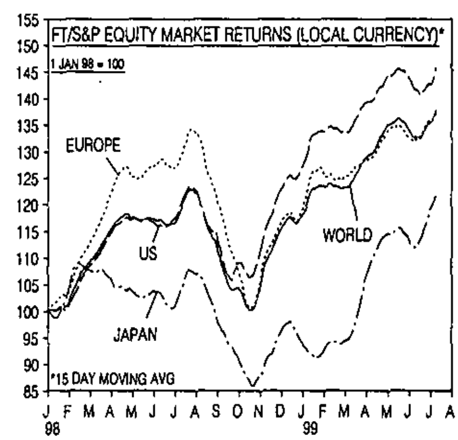
- We have devised some liquidity measures which have shown some correlation with equity market performance in the past. The recent robust growth of our liquidity indicators is certainly consistent with the current strength of equities in the face of the bond market sell off.

- But liquidity growth is slowing. The combination of much more moderate money supply growth in the US and Japan along with a pick up in global growth indicates liquidity expansion is rapidly moving back to its long run average levels.

- If last year's liquidity boost has supported equities in the face of the bond market sell off, then that support is ending.

- With equity valuations versus bonds looking stretched, we expect bonds to enjoy a period of outperformance versus stocks.





Neil Williams (Strategy)

Issue No: 99/27
14th July 1999

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Goldman Sachs

Global Economics Website
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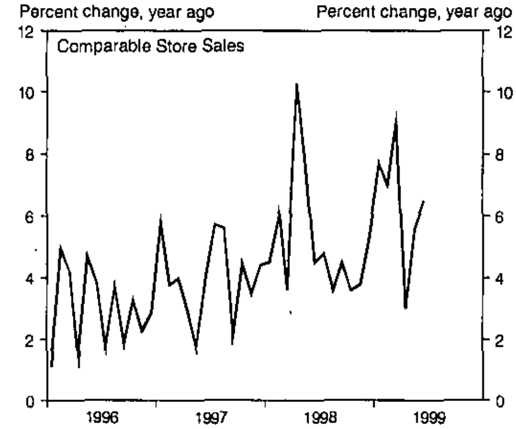
U.S. Economics Analyst

What's Up with U.S. Productivity?

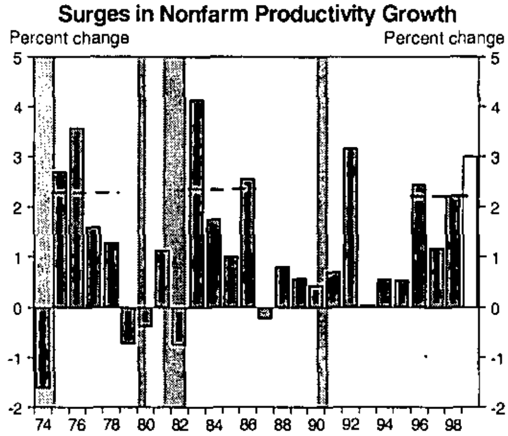
- In a week featuring very little fresh data, the few bits that were published suggest that the U.S. economy retains strong momentum at mid-year. For example, the Goldman Sachs Retail Index of year-to-year sales gains was 6.5% in June, up from 5.6% in May. Auto sales also were brisk in June, edging down only slightly from May's extremely high level.
- With demand and output rising rapidly, U.S. firms continue to post strong productivity gains. We now think that output per hour will rise 3% in 1999, the largest gain since 1992.
- Although this marks the fourth year of strong productivity growth, averaging 2.2%, it is still premature to conclude that the long-term trend has risen materially. Twice before since the early 1970s, when the productivity trend is widely recognized to have sagged, we have seen four-year spurts like the current one in the context of strong growth in demand and output.
- The main difference between this latest surge and its predecessors is that the productivity gains have occurred much deeper in the business expansion. Thus, whereas earlier surges have resulted mainly from putting idle resources to work, this one has relied on heavy investment in capital equipment to enhance the output per hour of labor resources already in use.
- The extent to which the productivity trend has changed can only be judged when the economy slows. If, as we expect, such a slowdown is a protracted affair, then a payback to the current surge is quite likely.

Goldman Sachs Retail Index Maintains Momentum



Source: Goldman Sachs.

Surges in Nonfarm Productivity Growth



Note: Dashed lines show 4-year averages.
Source: Department of Labor. Our estimates.

Trade Recommendations

- We would establish a spread position, going long the January '00 federal funds contract and going short the December '99 federal funds contract (currently at a spread of +13 basis points), with a target of 0 basis points and a stop on a close above 20 basis points.

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Issue No: 99/27
July 9, 1999

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U.S. Economics Analyst

Goldman Sachs

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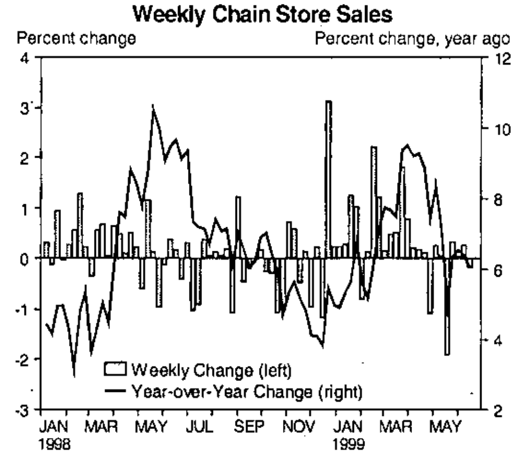
How Much Tightening by the Fed?

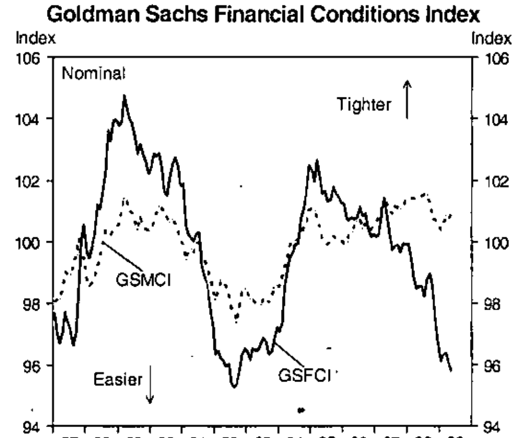
- The economy may be slowing slightly. The weekly chain-store sale reports have softened, and durable goods orders in May would have been flat but for large gains in the volatile defense and aircraft groups.
- But this is much too little, too late. A 25-basis-point tightening by the FOMC is nearly certain on June 30. In fact, Fed officials are likely to keep the directive biased toward tightening (and disclose that decision) in order to signal that this first move may not be the last.
- At the same time, Fed officials are unlikely to tighten monetary policy aggressively anytime soon. After all, the primary motivation is one of fine-tuning. The strength of the economy helps to confirm that financial conditions are accommodative. This indicates that monetary policy is not currently in the neutral to slightly restrictive setting that central bankers desire.
- However, more aggressive actions in 2000 cannot be ruled out. By then, inflation may be drifting higher and the nascent recovery in foreign economies may be more entrenched. At that point, pressures will increase on Fed officials to make monetary policy restrictive.
- Our forecast calls for 50 basis points of tightening this year and another 50 basis points in 2000. Although we are quite comfortable that Fed officials will not be aggressive this year, we are much less certain about the outlook in 2000. An examination of scenarios using the Taylor Rule suggests a wide range of possible federal funds rate targets 18 months from now, ranging between 4% and 7½%.

Weekly Chain Store Sales



Source: Mitsubishi Bank/Wertheim Schroder.

Goldman Sachs Financial Conditions Index



Source: Goldman Sachs.

Trade Recommendations

- Our long position in September T-bond futures was stopped out at 114.02 (initiated at 114.25). Although we believe the current sell-off is overdone, we would stay on the sidelines for the time being.

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Issue No: 99/25
June 25, 1999

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The Global Economic and Strategy Weekly June 30, 1999

20pgs

Goldman Sachs

GS Global Economics Website
Economics Research from the GS Financial Workbench[SM] at https://www.gs.com

The Global Economic and Strategy Weekly

The Start of Something Small

World Economy

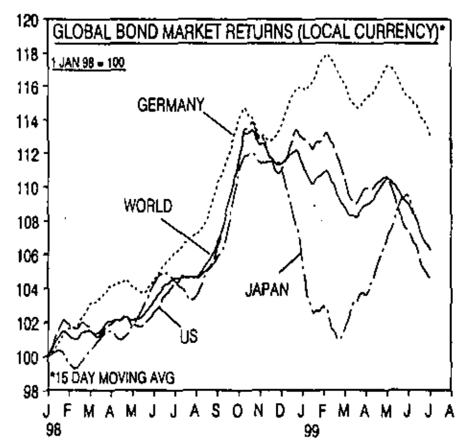
- The rise in the Fed funds rate was in line with expectations and represents the first increase in interest rates by a G3 central bank for more than two years. A further 25bp rise is likely at the August FOMC meeting. The outlook for rates next year is more uncertain. We expect 50bp of increase in 2000, taking rates to 5.75%.

- A larger increase in rates may ultimately prove necessary to slow the US economy to a sustainable rate. But monetary conditions in the main industrialised countries are broadly neutral and there seems little need for an aggressive tightening in global monetary policy.

- Despite the neutral monetary conditions, markets have become more pessimistic about short rates during recent weeks in each of the three major blocs – the US, Euroland and the Japan. Expectations about short rates are now overly pessimistic in each of these blocs.

- The deterioration in short rate sentiment has helped push up bond yields. But yields are now significantly above fair value even allowing for more pessimistic interest rate expectations. Therefore, some of the increase in rates represents a rise in the inflation risk premium.

- The key factor in the outlook for short rates and inflation is growth in the main industrialised countries and the output gap. There is pressure on resources in the US but elsewhere in the G7 there is spare capacity. We have updated our model linking inflation to the output gap in the G7 countries. The model suggests that inflation is very unlikely to rise significantly given the extent of spare capacity.



- A big part of this slack comes from recent sluggish growth in Japan. The strong Q1 GDP and indications of stronger private sector demand raise the possibility of continued stronger growth, which could eat into this spare capacity.

- Consumer spending holds the key to this prospect. Stronger growth in Japan requires a sustained recovery in consumption. Although this is something of a wild card in the prospects for the world economy, it is unlikely during the next two years. Therefore, the persistence of a global output gap should keep a lid on inflation pressures. In turn, the likely tightening in monetary policy should remain within expectations and risk premia should decline a little in time.

Gavyn Davies, Martin Brookes (Global Economy), Neil Williams (Strategy)

Issue No: 99/25
30th June 1999

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The Global Economic and Strategy Weekly June 23, 1999

20pgs

Goldman Sachs

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The Global Economic and Strategy Weekly

Stronger Growth: Which Equity Markets?

Strategy

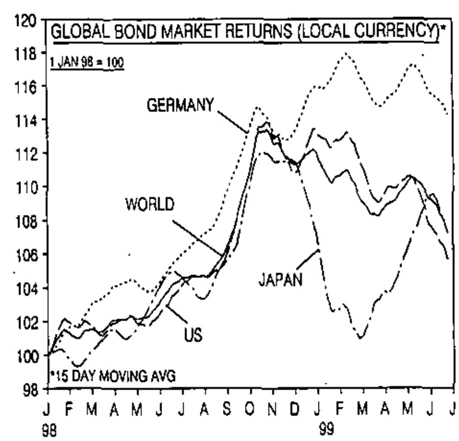
- Global growth is picking up. Stronger global growth favours some regional equity markets more than others. In addition, variations in regional growth will impact relative market performance. This note summaries a simple framework for assessing the importance of global and regional growth for relative equity market performance.

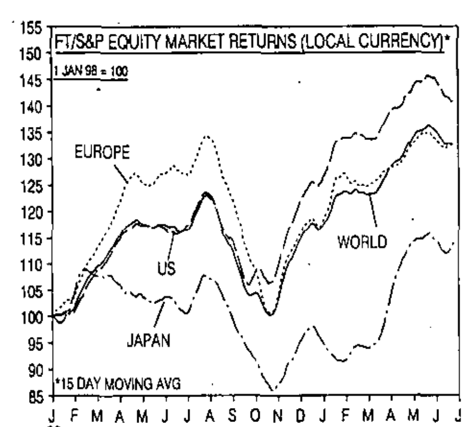
- Using a statistical model, we find that over the last 25 years differences in regional business cycles have been more important than changes in the overall growth rate of the global economy in determining the relative performance of regional equity markets.

- Stronger global growth tends to favour Japan, Canada and Europe (ex UK) over the US and the UK.

- In terms of our views on regional growth 'surprises' we see most scope for positive surprises from Continental Europe and the emerging markets. We remain quite pessimistic on the Japanese economic outlook.

- Pulling together the model's results with our views on global and regional growth we believe that our current recommended asset allocation - overweight Europe (ex UK) and the emerging markets versus the US and the UK is appropriate. Japan is the major uncertainty but our negative stance on domestic recovery leaves us neutrally weighted towards Japanese equities.





Neil Williams (Strategy)

Issue No: 99/24
23rd June 1999

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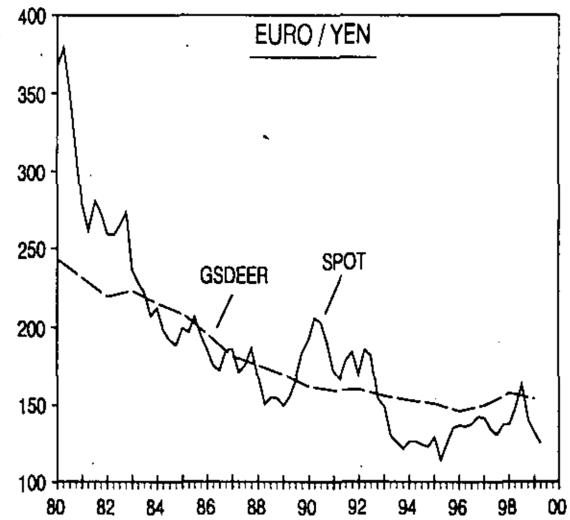
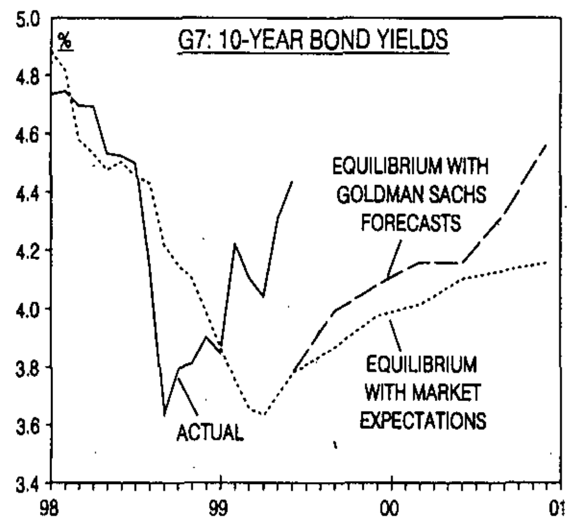
The Weekly Analyst

EUR/JPY Intervention. A First!

- The FX section discusses the BOJ's intervention in EUR/JPY, an historic event in the markets, as it is the first time a G3 central bank has intervened in a key 'cross rate'.
- We think that the BOJ's move is sensible, not least as EUR/JPY is about 20% undervalued, compared to $/JPY being fairly valued, and because most Japanese Government reserves are held in Dollars.
- We discuss the latest trends in US external trade and the Q1 current account, both of which are better than we expected.
- We also discuss the SEK again, suggesting that a move beyond our 8.60 forecast against the Euro could temporarily occur.
- In addition, we include a further discussion of the PLN.
- On bonds, we expect the Fed to tighten 50bp by year-end but this is fully priced in to the market. Moreover, there is a significant risk premium at the long-end of the curve. Hence we see some scope for a modest relief rally in US Treasuries.
- We indicated last week that a move back toward a more neutral US-European stance is appropriate for now. We would not shift to favour the US at this stage, however, firstly because we doubt that there is much room for US bond yields to fall and, secondly, because European bond markets remain better protected against renewed US interest rate jitters.
- Longer-term risks for global bond yields are skewed to the upside, reflecting both the underlying momentum of the US economy and an improvement in the outlook for global growth. A more favourable global backdrop would make it less easy to finance the US current account deficit and could weigh both on the Dollar and on Treasuries.





Trading Recommendations

- Go long EUR/$ on a 1 day close above 1.0575.
- Re-buy EUR/JPY with 2-day stops below ¥125.0
- See inside for other FX views.
- Hold longs in Sep UST, lower target from 121 to 118, raise stop-level from 113 to 114-16 (currently 115-00, initiated at 114-26).
- Roll Sep JGB shorts to #213 for a target of 1.88% yield, stop on a close below 1.65% (currently 1.70%).
- Close longs in 10-yr Gilts against Bunds (currently 76bp, opened at 81bp).

Contributors: Jim O'Neill, Andrew Bevan
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Issue No: 99/24
22nd June 1999

Goldman Sachs
Global Economics Website
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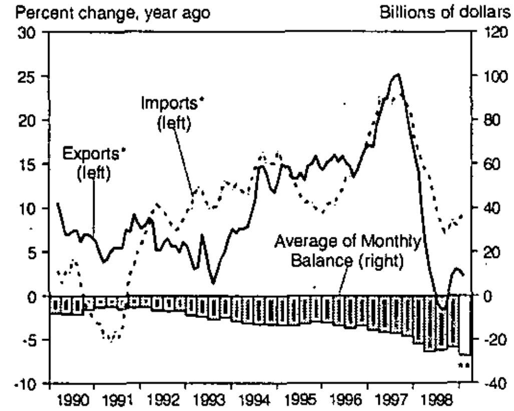
U.S. Economics Analyst

The Uphill Road for Profits

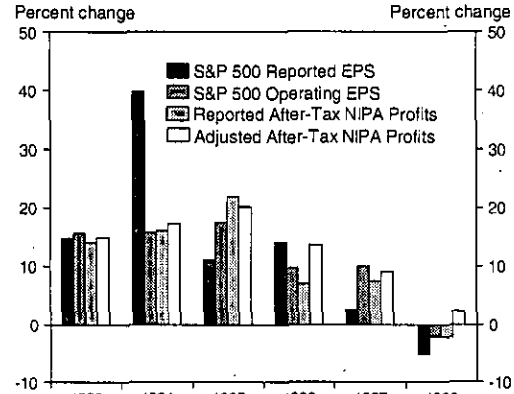
- The humongous $19.4-billion U.S. trade deficit reported for February neutralized the impact of sharp upward revisions to retail sales on our estimate for first-quarter growth, which remains at 3.8% (annualized).
- The fact that surging imports drove the increase in the trade deficit is consistent with the strength in domestic spending. So far, weekly retail sales data give no evidence that this strength has dissipated.
- Last year's hiatus in profit growth resulted from the increasing difficulty that U.S. firms faced in raising output prices. With compensation per hour trending higher in response to tight labor markets, productivity gains—while impressive —were not large enough to offset the widening gap between wage and price inflation.
- For the corporate sector as a whole, we see little prospect that these conditions will improve materially in 1999 despite a shift in inflation risks. Thus, after-tax earnings are expected to be about flat.
- However, companies in the S&P 500 should do better, mainly because their greater orientation toward manufacturing operations offers better prospects of both a narrowing of the wage/price inflation gap and productivity gains sufficiently large to fill this gap. Translation benefits from a weaker dollar and various special factors should also help. All in all, our Portfolio Strategy Group sees a 7% recovery in earnings per share for these firms following last year's 2.1% dip.

Real Merchandise Trade Balance



*3-month moving average **January/February average
Source: Department of Commerce.

A Hiatus in Profit Growth



Source: Department of Commerce, Standard and Poor's, Goldman Sachs.

Trade Recommendations

- Close out long January '09 TIPS/short nominal 10-year Treasury note (November '08 maturity) spread position (current spread is 133 basis points).
- Get short September Eurodollar futures at a price of 95.00 or higher (currently 94.885), with a target of 94.50, and a stop on close above 95.10.

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Issue No: 99/16
April 23, 1999

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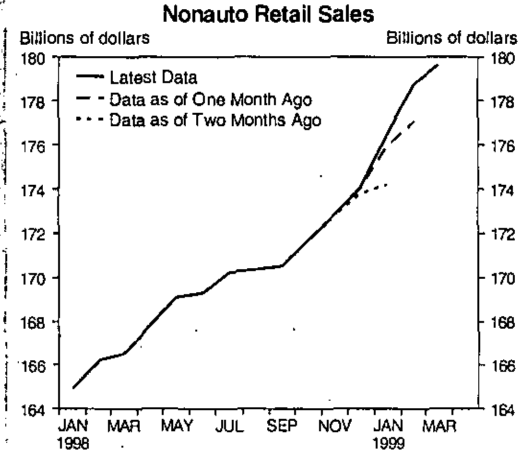
U.S. Economics Analyst

Modest Factory Upturn Could Quickly Absorb Slack

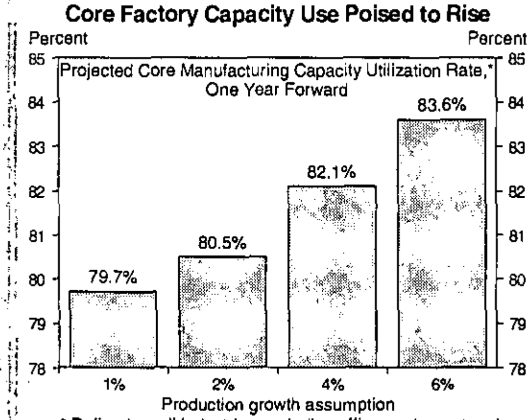
- The U.S. economy continues to charge ahead with no sign of generalized pickup in inflation. Although retail sales rose only 0.2% in March, sharp upward revisions make the quarterly increase in its core component (excluding motor vehicles and building materials) one of the largest on record in real terms. Housing activity also remained strong in March, suffering only slightly from an adverse swing in weather.
- While imports undoubtedly account for some of this strength in retail activity, it still implies that real GDP growth was even faster than our current 3.8% estimate—probably between 4% and 4½% at an annual rate. We will post a new figure once we see the February trade report.
- Consumer prices rose only 0.2% as the impact of the initial phase of the rebound in oil prices was offset by weakness in prices of food, motor vehicles, and apparel. Meanwhile, the Federal Reserve's industrial production index remained on an anemic growth path despite anecdotal indications of an improved trend in this sector.
- The lack of factory resource strains has been a key factor behind the weakness in unfinished goods prices, and it may also have played an important role in suppressing wage gains amid the ongoing squeeze on labor supplies. These conditions may be poised to change, however, in view of: (1) sharply lower Federal Reserve forecasts of manufacturing sector capacity growth and (2) improved potential for an output upswing given lean stockpiles and strong domestic demands for goods.
- Even a modest pickup in core factory production activity could generate a broad absorption of slack in this sector, which in turn might give rise to a firmer tone in goods pricing and, perhaps, less wage restraint.

Nonauto Retail Sales



Source: Department of Commerce.

Core Factory Capacity Use Poised to Rise



* Defined as all industries excluding office equipment and semiconductors and related electronic components.
Source: Federal Reserve Board. Our calculations.

Trade Recommendations

- Stay long the January '09 TIPS, and short the current nominal 10-year Treasury note (November '08 maturity), with a target for the yield spread at 160 basis points. Raise stop to a close below 100 basis points.

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Issue No: 99/15
April 16, 1999

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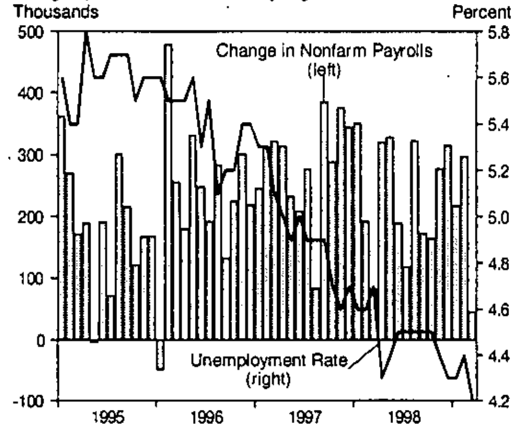
U.S. Economics Analyst

Medicare: Still the Most Intractable Entitlement Problem

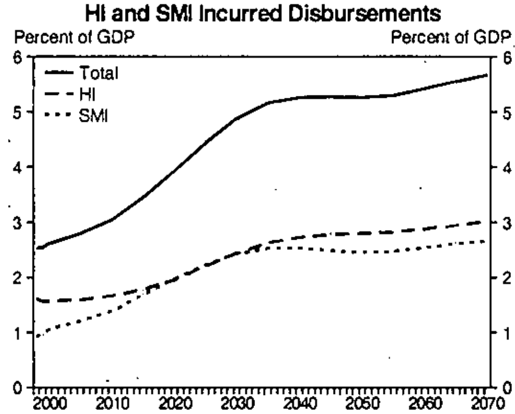
- The U.S. economy remains on a firm trajectory, with consumer and construction spending showing particular strength. Moreover, the persistence of strong domestic demand growth is helping bolster the manufacturing sector. The March NAPM index rose sharply. This foreshadows a recovery in manufacturing output.
- The weakness of payroll employment in March was weather related. Labor markets remain unusually tight as indicated by the decline in the unemployment rate to a cycle low of 4.2%. However, this has not yet caused significant wage pressure judging from the modest gains in average hourly earnings in recent months.
- The 1999 Medicare trustees report has pushed back the projected insolvency date of the hospital insurance trust fund to 2015, from 2008 a year ago. This will reinforce the inertia against structural reform of this entitlement program.
- Even though Medicare now appears to be solvent for longer, it remains the most intractable entitlement problem. That is because the mismatch between payroll tax receipts and expenditures grows rapidly after 2010 when the baby boom generation begins to retire in earnest.
- Ironically, deadlock on Medicare reform may be the best outcome for the bond market. A failure to agree on remedies could keep the budget surplus from being tapped for tax cuts and/or increased government spending. After all, the Democrats have already had success with the mantra, "save Social Security first." This may now be extended to the Medicare arena to frustrate those Republicans in Congress that still hope to cut taxes this year.

Payrolls Slow But Unemployment Hits New Low



Source: Department of Labor.

HI and SMI Incurred Disbursements



Note: Based on intermediate economic assumptions.
Source: 1999 Federal Supplementary Medical Insurance Trust Fund Report.

Trade Recommendations

- Continue to stay neutral.

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Issue No: 99/13
April 2, 1999

Goldman Sachs

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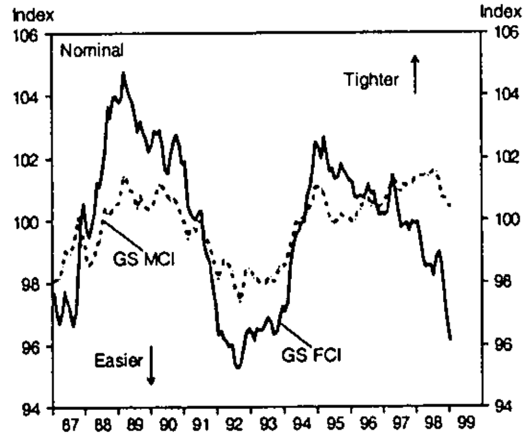
U.S. Economics Analyst

Our Views Have Changed

No Monetary Policy Easing This Year

- We are raising our GDP growth forecast for 1999 by about ½ percentage point on a fourth-quarter-to-fourth-quarter basis, to about 2¾%. This reflects firmer growth now, a sturdy equity market, which should help sustain spending, and the absence of significant contagion effects from Brazil to Mexico.
- As a consequence, we now expect Fed officials to keep monetary policy on hold throughout 1999. In fact, given the economy's momentum and the tautness of U.S. labor markets, the probability of tightening is now higher than of easing. With no Fed easing anticipated in 1999, any recovery in the bond market from the recent sell-off is likely to be much more muted than earlier anticipated.
- Chairman Greenspan offered relatively balanced policy testimony this week, indicating that Fed policy makers are not close to tightening credit. Official assessments of the non-inflationary growth trend may have moved up in response to recent brisk productivity increases, adding to the central bank's current preference for passivity.
- Signs of strength in U.S. spending, output, and labor demands remain widespread. Increased new and unfilled orders for most factory durable products have lifted manufacturing firms out of the doldrums while consumer optimism about job availability has hit a new multi-decade high, hinting at an early further decline in the unemployment rate.
- Congressional budgeting efforts are just getting underway, but all signs point to a push for sizable, multi-year tax reductions. This presents the potential for a fresh domestic demand stimulus from the fiscal realm as early as next fall.

Goldman Sachs Financial Conditions Index



Source: Goldman Sachs.

A Further Decline in Unemployment?

Source: Department of Labor. The Conference Board.

Trade Recommendations

- We would stay short the March '99 Treasury bond futures contract, lowering our stop to a close above 123.08 from 124.22 and lowering our target to 118.16 from 120.00.

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Issue No: 99/08
February 26, 1999

I. Weekly Wrapup

Economic and Market Overview

Downward pressure on U.S. bond prices has been relentless over recent days, pushing yields up to levels not seen since prior to last summer's credit market dislocations. This abrupt adjustment appears to reflect growing concerns that the economic expansion will not slow by much as the Fed remains strikingly passive in the face of broadly accommodative financial conditions.

Signs are proliferating that business activity was feverish around the turn of the year. Updated fourth-quarter real GDP estimates place the annualized growth rate at 6.1%, compared to the 5.6% advance figure, with the upward revision mainly due to higher exports, which resulted in a modest improvement in the net export deficit in the fourth quarter. This improvement, however, is likely to prove transitory. The trade accounts appear to suffer from seasonal adjustment problems. Temporary improvement in the fourth quarter has been a hallmark of the GDP data in recent years.

Spending has sustained a faster-than-normal pace in early 1999. To be sure, all of the 3.9% January surge in new orders for durable goods took place in the highly volatile aircraft and defense categories; other bookings actually slipped 0.1%. Yet, this means core durable goods orders last month retained all of the huge gains recorded over November and December, which in turn caused factory order backlogs to swell across a wide range of industries. Reflecting these developments, manufacturing firms are back in a growth mode, as suggested by the steep rise in the Chicago purchasing managers index for February, to 52.9%.

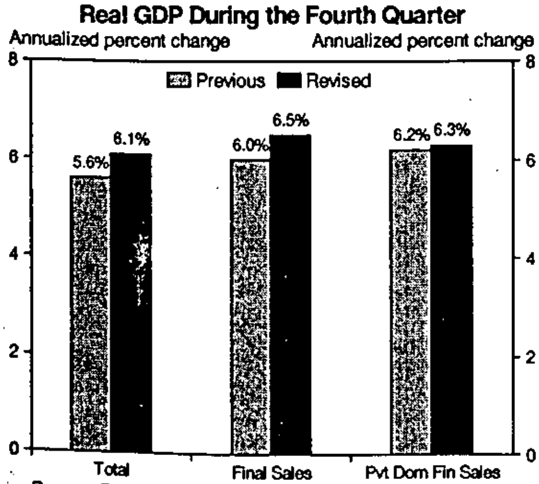
In another sign that the labor supply squeeze could be intensifying, household perceptions of job availability reached a new 31-year peak this month, according to the Conference Board's latest consumer survey. At +36.5%, the differential between respondents viewing jobs as plentiful versus hard to get during February was over four points higher than in any month of 1998, and appreciably above levels recorded in any previous year. As this series has displayed a clear negative historical correlation with unemployment, it provides another hint that the jobless rate may be declining still further.

Federal Reserve Policy

Chairman Greenspan, as expected, offered monetary policy views this week that were only slightly skewed toward the potential for a rise in the federal funds rate target. He said the FOMC perceives "considerable upside and downside risks to the economic outlook," and that "monetary policy must be ready to move quickly in either direction." External demand weakness and financial volatility remain the greatest threats to continued domestic expansion, while labor scarcity and related potential for additional wage acceleration poses an inflationary danger. With such large concerns weighing in opposite directions, Fed officials probably have a strong preference for patience and neutrality.

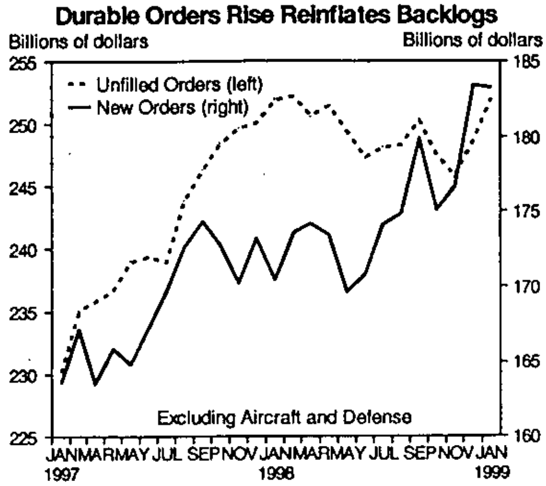
At the same time, a drift at the Fed toward more concern about excessive financial accommodation can be detected. Greenspan noted that the 75-basis-point easing last fall was designed to cushion the economy against then-prevailing financial market strains, and stated that, "The Federal Reserve must continue to evaluate . . . whether the full extent of the policy

Real GDP During the Fourth Quarter



Source: Department of Commerce.

Durable Orders Rise Reinflates Backlogs



Source: Department of Commerce.

easings . . . remains appropriate as those disturbances abate." This suggests an active debate is underway within the central bank as to whether some of those cuts should be unwound in the face of unexpectedly high spending trends. That said, the FOMC members do not betray a sense of urgency at this point, because they do not perceive much risk of an inflation pickup in the near term. That relaxed posture can be attributed largely to recent brisk productivity growth trends and more benign employment cost trends, which have suppressed gains in unit labor costs.

Fiscal and Political Developments

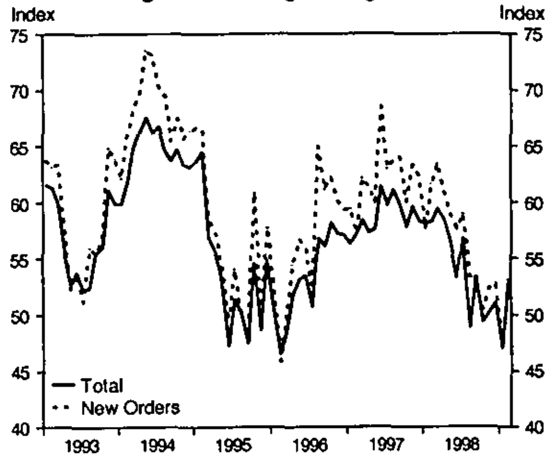
Republican congressional leaders are taking the very first steps toward framing their approach to the budget for fiscal 2000 and beyond. Senator Pete Domenici (R-New Mexico), the budget committee chairman, has offered a proposal to: (1) set aside the Social Security surplus for the next ten years, targeting it to marketable debt retirement, and (2) cut taxes by $787-$900 billion over the same period, with the abatements to "start out small and grow very, very large over time." The Domenici plan for a Social Security surplus "lockbox" has met with considerable GOP support, as it would likely neutralize Democrat opposition to the budget plan. At approximately $85 billion per year, the proposed tax reductions would amount to about 0.75% of projected GDP, a consequential amount of fiscal stimulus. This should be regarded as merely the opening shot of what will be a lengthy, partisan battle over fiscal priorities. Nevertheless, it is impressive that Senator Domenici, with his long record of budgetary caution, is willing to endorse such a magnitude of tax cuts, even on a graduated timetable.

Market Outlook and Comments on Value

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

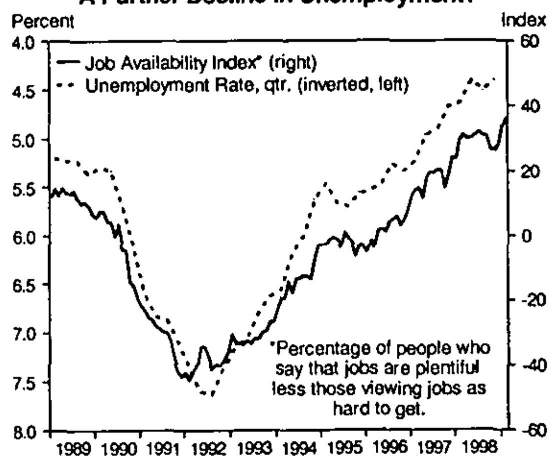
Although the risks are gradually becoming more evenly balanced, we would continue to stay short the March '99 Treasury bond futures contract until the market action itself helps to confirm that the sell-off is over. The next hurdle for the market is likely to be the February payroll employment report, which should show sturdy job gains and a further decline in the unemployment rate. We would lower the stop on the trade to a close above 123.08 from 124.22, and would also lower our target for closing out the trade to 118.16 from 120.00. In terms of the short end, fears about monetary policy tightening probably will intensify further. However, Fed officials are likely to remain patient. Thus, the most likely outcome is a further steepening of the Eurodollar futures yield curve.

Chicago Purchasing Managers Index



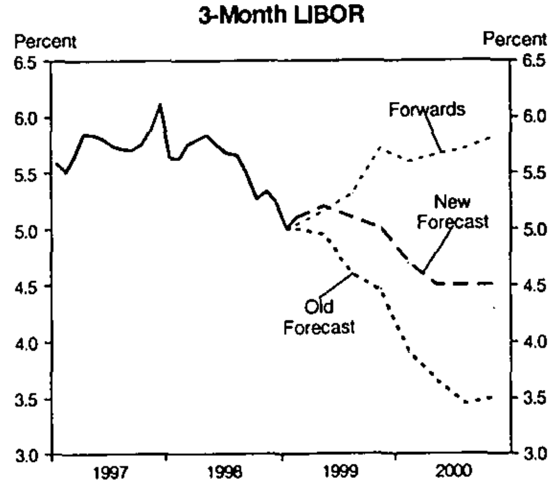
Source: Bishop Associates.

A Further Decline in Unemployment?



Source: Department of Labor. The Conference Board.

3-Month LIBOR



Source: International Financial Statistics. Bloomberg.

II. No Monetary Policy Easing This Year

We no longer expect monetary policy easing in 1999. This reflects the continued robustness of the economy and our assessment that monetary policy already appears to be sufficiently accommodative to sustain the expansion.

As a consequence of the economy's persistent strength, we have raised our real GDP forecast for 1999 by ½ percentage point to 2¾% from the fourth quarter of 1998 to the fourth quarter of 1999 (about 0.4 percentage points to 3.5% on a calendar-year basis). Real GDP growth should average about 3% in the first half and about 2½% (both annualized) in the second half of the year.

Our revised interest rate forecast is presented in the table below. Although the probability of a tightening of monetary policy is now higher than an easing, we expect that Fed officials will keep monetary policy on hold throughout 1999. We continue to show monetary easing in the first half of the year 2000, but we do not feel strongly about this. Finally, we have flattened out our bond yield forecast trajectory considerably. The recent bond market sell-off may run a bit further. Moreover, any rally thereafter is likely to be much more muted, given the absence of any drop in short-term interest rates in 1999. We will discuss the bond market outlook in more detail next week, when we unveil an updated GSWIRE model for the United States.

Why Easing Is No Longer Likely This Year

Our decision to revise our interest rate forecast and eliminate any monetary policy easing in 1999 is based upon a combination of factors: the economy's momentum and the implications of this strength for the tightness of U.S. labor markets, and the fact that our indicators of financial market conditions suggest that conditions are accommodative, not restrictive.

On the growth front, the economy remains much stronger than anticipated. Real GDP growth in the fourth quarter of 1998 has been revised up to a 6.1% annualized rate. Moreover, there is little evidence of any impending sharp slowdown in economic activity.

Revised Interest Rate Forecast

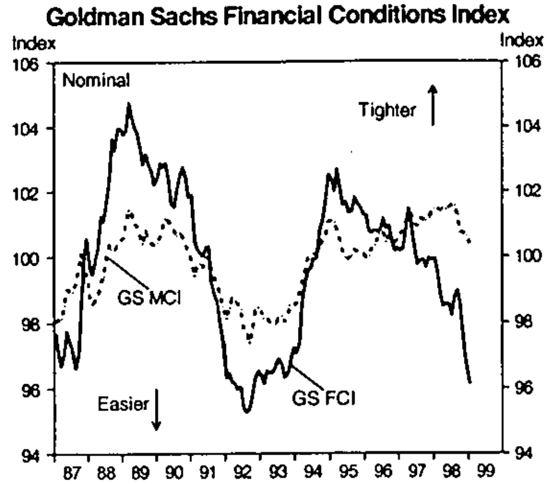
	1999				2000			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Fed Funds	4.75	4.75	4.75	4.75	4.50	4.25	4.25	4.25
3-Month LIBOR	5.10	5.20	5.10	5.00	4.70	4.50	4.50	4.50
2-Year Note	5.10	5.00	4.90	4.80	4.50	4.20	4.40	4.50
5-Year Note	5.20	5.05	5.00	4.90	4.70	4.50	4.65	4.80
10-Year Bond	5.30	5.10	5.00	4.90	4.80	4.70	4.80	4.90
30-Year Bond	5.60	5.40	5.30	5.20	5.10	5.00	5.10	5.20

In particular, both income and consumer spending growth exhibit rising trends on a year-over-year basis; payroll employment growth has risen back to its cycle highs on a six-month change basis, and consumer confidence has recovered from its autumn slide. Housing activity has reached a new cycle peak, which almost guarantees continued strength in consumer spending for awhile. As a consequence, labor markets are extraordinarily tight. For example, the four-week average of initial unemployment claims has declined to its lowest level in more than ten years. The unemployment rate is at its cycle low of 4.3% and households' assessment of labor market conditions as measured by the Conference Board is the most favorable in the history of the survey, which goes back to 1967.

With a slowdown still just a forecast, at a time that the monetary authorities want the growth pace to moderate because of the potential inflationary consequences of tight labor markets, Fed officials are nowhere near easing monetary policy. Monetary policy easing in 1999 would require a sharp slowdown that begins very soon and is sufficiently severe to push the unemployment rate up sharply. This seems unlikely in 1999 especially considering that the Y2K problem will stimulate economic activity toward the end of the year. Businesses are likely to build up inventories as insurance against supply disruptions caused by Y2K glitches.

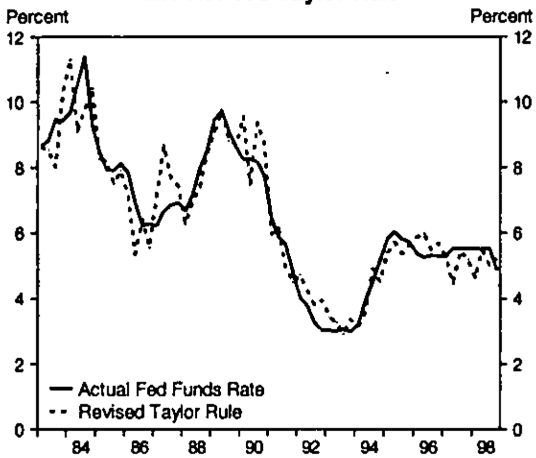
The notion of monetary policy easing is also contradicted by our Goldman Sachs Financial Conditions Index (GSFCI) and our revised Taylor Rule. The GSFCI, which includes short-term and long-term interest rates, the Goldman Sachs Trade-Weighted Dollar Index, and the S&P 500

Goldman Sachs Financial Conditions Index



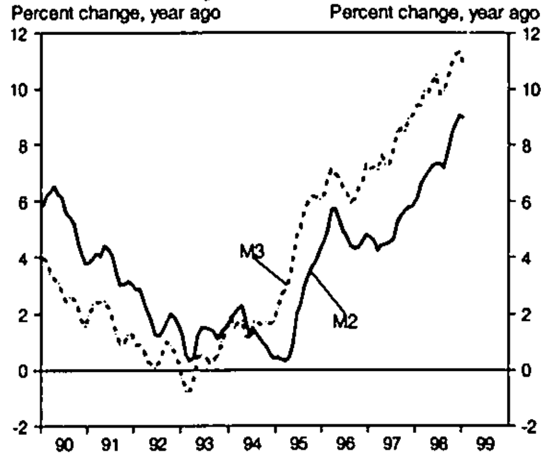
Source: Goldman Sachs.

The Revised Taylor Rule



Source: Federal Reserve Board. Goldman Sachs.

Monetary Growth Accelerates



Source: Federal Reserve Board.

price/earnings ratio as variables, has moved to its most accommodative reading since 1993. This is due to the 75 basis points of easing by Fed officials engineered last year, the decline in bond yields these rate cuts helped sustain, and the sharp rise in the price/earnings ratio as the stock market's appreciation has outstripped gains in earnings.

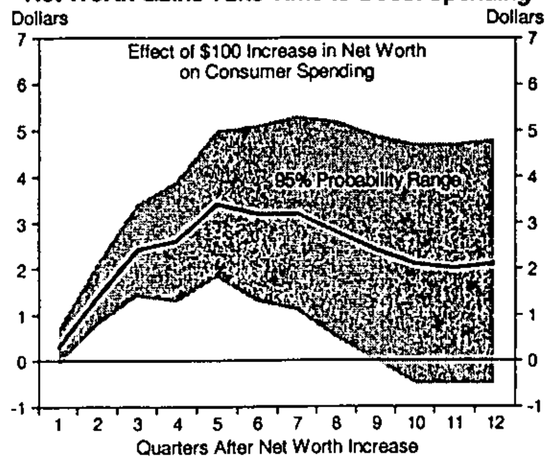
Our revised Taylor Rule sends the same message.[1] In our rendition of this rule, we use the index of leading indicators as a filter to allow the equilibrium real interest rate associated with monetary policy neutrality to fluctuate. Because the index has been strong recently, this has pushed the equilibrium real rate up to 3.6% currently. As a result, our revised Taylor Rule suggests that the federal funds rate target should be 5.2%, above the actual target of 4.75%.

In addition, the growth rates of the broad monetary aggregates and of household and corporate liabilities have climbed sharply. Over the past 12 months, M2 and M3 have risen 9.0% and 10.8%, respectively. Moreover, household and non-financial business liabilities have risen by 8.0% and 6.9%, respectively, over the past four quarters (through the third quarter of 1998). Although some of the climb in money supply growth is undoubtedly due to a shift in portfolio preferences (and thus has no strong inflationary implications), the fact that it has been accompanied by more rapid growth of private-sector debt suggests that it is another sign that financial market conditions may be too accommodative.

The thread running through both the performance of the economy and our indicators of financial market conditions is the U.S. equity market. Despite a paucity of earnings growth, the Wilshire 5000 index has climbed by 13.5% over the past year. This has boosted household net worth, excluding pension and insurance reserves, by more than $1 trillion, providing added impetus to consumer spending.

The stock market strength that has already occurred suggests that the degree of slowing in U.S. economic activity will be limited over the near term. That is because there are lags between stock market appreciation and its impact on consumer spending. Our work suggests that the impact of increases in net worth on household spending climbs gradually, reaching a peak after five quarters.[2] This implies that even if stocks stabilized at current levels, the equity market would still provide a positive impetus to the economy throughout 1999.

Net Worth Gains Take Time to Boost Spending

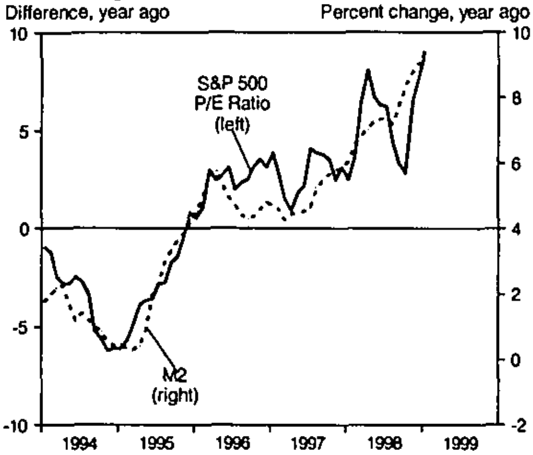


Source: Our calculations.

[1] See "Revitalizing the Taylor Rule," *U.S. Economics Analyst*, February 12, 1999.

[2] See "Wall St. and Main St. Intersect," *U.S. Economics Analyst*, November 6, 1998.

Change in P/E and Broad Money Growth



Source: Federal Reserve Board. Standard and Poor's.

The stock market strength also has an important role in the behavior of our indicators of financial market conditions. As shown in the chart on page 4, the Goldman Sachs Monetary Conditions Index, which does not include a stock market variable, is close to a neutral reading. But when stocks are added to the mix, the GSFCI reveals a clearly accommodative setting. Similarly, our revised Taylor Rule suggests that the Federal Reserve's target federal funds rate should be 5.2%. That is because the stock market has stimulated the economy and caused persistent strength in the index of leading economic indicators over the past few years. If the equity market were not strong, then the real equilibrium interest rate associated with monetary policy neutrality would be lower, implying a lower federal funds rate target.

Finally, we find that the growth rate of the monetary aggregates and the expansion of the price/earnings ratio is intertwined. As shown in the accompanying chart, M2 growth and changes in the price/earnings ratio of the S&P 500 index compared to a year ago have followed the same path in recent years. The causality here probably runs both ways. On the one hand, accommodative financial market conditions help to generate economic strength and rapid money growth, which pushes equity prices higher. On the other hand, higher stock prices boost the monetary aggregates by increasing the demand for money.

Why Doesn't the FOMC Tighten?

The arguments above suggest that Fed officials should be thinking hard about tightening monetary policy rather than easing. We agree, but we do not yet anticipate that the monetary authorities will tighten this year for two reasons. First, we do anticipate some slowdown in the growth pace. The pace of the equity market's advance has slowed somewhat. Thus, household spending should get less of a boost from stock market strength. In addition, capital spending growth should moderate in response to declines in capacity utilization rates. Finally, trade drag is likely to resume as Latin American economic activity contracts.

Second, Federal Reserve officials are also likely to be slow to tighten because the costs of waiting for more information are low given the absence of inflation pressure. Given the unsettled growth outlook abroad, the level of uncertainty is high. In this situation Fed officials are not going to take big risks with this expansion without clear cause.

In this regard, two recent developments have provided support for a patient approach. First, the fourth-quarter employment cost index report revealed a moderation of compensation and wage cost inflation. As a result, Fed officials are more amenable to the notion that the trade-off between the unemployment rate and wage inflation has become more favorable. The hope is that the positive inflation shocks of the past 18 months may have driven down inflationary expectations and that this has helped to restrain wage inflation. Given the absence of inflationary pressures, this implies that wage compensation trends could continue to be more restrained than expected. Second, productivity growth climbed in 1998, with non-farm labor productivity rising by 2.5%. Combined with only a slight pickup in labor cost trends, this held unit labor cost increases to a 1.6% annual rate, hardly much to be disturbed about. In this regard, future evidence that contradicts this evidence of a more favorable trade-off between wage inflation and unemployment and/or a sustained improvement in productivity growth would make monetary policy tightening more likely.

Chairman Greenspan's Humphrey-Hawkins testimony supports the notion that Fed officials are likely to be patient. Although there were a few phrases that implied a tightening might be more likely than an easing, the comments overall were quite balanced, with the Chairman at one point noting explicitly that "... monetary policy must be ready to move quickly in either direction . . . ." The most likely course is that Fed officials will discuss whether to tighten monetary policy at its next few meetings, possibly moving to an asymmetric directive biased toward tightening at the next FOMC meeting on March 30. But, in the end, caution will probably prevail and the FOMC will decide, as in much of 1996 and 1997, to wait for more information.

Bill Dudley

Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	'99 Feb	'99 Jan	'98 Dec	'98 Nov	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	–	245	298	277	246	226	Mar 5
Unemployment Rate (%)	–	4.3	4.3	4.4	4.4	4.5	
Index of Hours Worked (% ch)	–	0.0	0.3	-0.1	1.4	1.1	
Average Hourly Earnings (% ch)	–	0.5	0.3	0.3	3.9	4.0	
Producer Price Finished Goods Index (% ch)	–	0.5	0.4	-0.2	1.7	0.9	Mar 12
Excluding food and energy	–	-0.1	1.0	0.1	2.8	2.3	
Consumer Price Index (% ch)	–	0.1	0.1	0.2	1.6	1.6	Mar 18
Excluding food and energy (% ch)	–	0.1	0.3	0.1	2.2	2.3	
Retail Sales (% ch)	–	0.2	1.0	0.7	7.3	6.1	Mar 11
Excluding motor vehicles (% ch)	–	0.2	0.6	0.6	4.7	5.3	
Industrial Production (% ch)	–	0.0	0.2	-0.1	3.1	1.7	Mar 16
Manufacturing	–	0.1	0.1	0.2	4.8	2.2	
Capacity Utilization (%)	–	80.5	80.8	80.9	81.8	81.6	Mar 16
Manufacturing	–	79.6	79.9	80.1	80.1	80.6	
Housing Starts (annual rate, thousands)	–	1804	1738	1654	1681	1645	Mar 16
Single-family	–	1394	1378	1375	1327	1293	
Trade Balance (billions, monthly)	–	–	-13.8	-15.3	-14.8	-14.0	Mar 18
Merchandise	–	–	-20.3	-21.7	-21.2	-20.7	
Factory Orders (% ch)	–	–	2.3	0.4	7.6	2.6	Mar 4
Durable Goods	–	3.9	3.4	0.4	18.8	8.8	Mar 24
Personal Income (% ch)	–	–	0.5	0.4	5.1	5.1	Mar 1
Wages and Salaries	–	–	0.5	0.5	6.4	6.3	
Purchasing Managers' Index (%)	–	49.5	45.3	47.0	48.0	49.9	Mar 1
Consumer Sentiment U Mich (Feb 66=100)	108.1	103.9	100.5	102.7	102.3	104.2	Mar 26
Conference Board (1985=100)	132.1	128.9	126.7	126.4	128.6	131.3	Mar 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.

U.S. Calendar

Focus for the Week Ahead

- Job growth likely remained rapid during February, probably pushing the unemployment rate down to a new cyclical low. Taking account of a projected firm gain in average hourly earnings, the employment data should confirm a continued solid household earnings trend (March 5).
- Although a slight dip in the national purchasing managers index is anticipated, the level would nevertheless remain higher than in the autumn, implying a more stable factory environment (March 1).
- Personal consumption should have risen only slightly in January, due to a steep month-on-month drop in unit motor vehicle deliveries. In turn, that should have allowed some upturn in what lately has been a very depressed personal saving rate (March 1).
- The vast majority of the Conference Board's leading economic indicators posted increases last month, suggesting the composite index will register another hefty advance (March 2).

Economic Releases and Other Events

Date	Time	Indicator	Estimate GS	Estimate Consensus	Last Report
Mon Mar 1	8:30	Personal Income (Jan)	+0.6%	+0.4%	+0.5%
	8:30	Personal Consumption (Jan)	+0.1%	+0.2%	+0.8%
	10:00	National Purchasing Managers Index (Feb)	49.0%	49.8%	49.5%
	10:00	Construction Spending (Jan)	-0.8%	+0.5%	+1.7%
		Domestic Motor Vehicle Sales (Feb)	14.2M	13.8M	13.4M
ue Mar 2	10:00	New Home Sales (Jan)	-4.9%	-0.5%	-3.6%
	10:00	Leading Indicators (Jan)	+0.4%	+0.3%	+0.3%
Thu Mar 4	10:00	Factory Orders (Jan)	+1.9%	+0.4%	+2.3%
Fri Mar 5	8:30	Civilian Unemployment Rate (Feb)	4.2%	4.3%	4.3%
	8:30	Nonfarm Payroll Employment (Feb)	+250,000	+225,000	+245,000
	8:30	Average Hourly Earnings (Feb)	+0.4%	+0.3%	+0.5%
	3:00	Consumer Credit (Jan)	+$5.0 bn	+$5.6 bn	+$7.3 bn

- Treasury 1-Year Bill Auction (Tue, Mar 2)
- NAPM Non-Manufacturing Survey (Wed, Mar 3 – 10:00)
- Greenspan Testifies Before House Commerce Committee on Social Security (Wed, Mar 3 – 10:00)
- Chain-Store Sales Results (Thu, Mar 4)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3-month	5.2%	5.1%	4.7%
Forward	5.2	5.3	5.5
2 Year T-Note	5.0	4.9	4.5
Forward	5.2	5.3	5.4
10 Year T-Note	5.1	4.9	4.7
Forward	5.3	5.4	5.5

Key Numbers in the Business Outlook

	1998 Q4	1999 Q1E	1999 Q2E	1998	1999E
Real GDP	6.1%	3.5%	2.8%	3.9%	3.5%
Ind. Prod., Mfg.	4.8	1.5	3.4	4.2	2.3
CPI	1.7	2.0	1.8	1.6	1.9
After-Tax Profits*	7.2E	2.6	3.5	3.4E	1.6
Unemployment	4.4	4.2	4.2	4.5	4.3

* Excluding inventory profits; adjusted for depreciation distortions.

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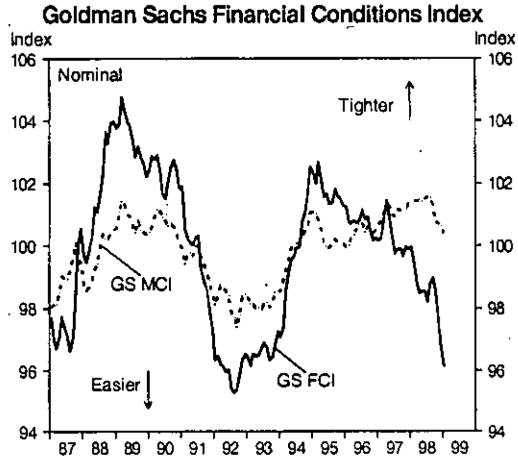
No Monetary Policy Easing This Year

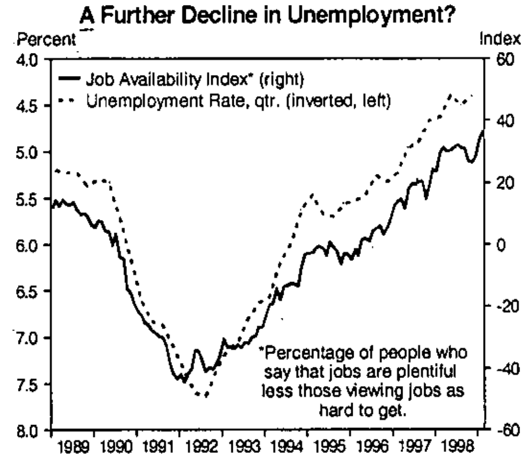
- We are raising our GDP growth forecast for 1999 by about ½ percentage point on a fourth-quarter-to-fourth-quarter basis, to about 2¾%. This reflects firmer growth now, a sturdy equity market, which should help sustain spending, and the absence of significant contagion effects from Brazil to Mexico.
- As a consequence, we now expect Fed officials to keep monetary policy on hold throughout 1999. In fact, given the economy's momentum and the tautness of U.S. labor markets, the probability of tightening is now higher than of easing. With no Fed easing anticipated in 1999, any recovery in the bond market from the recent sell-off is likely to be much more muted than earlier anticipated.
- Chairman Greenspan offered relatively balanced policy testimony this week, indicating that Fed policy makers are not close to tightening credit. Official assessments of the non-inflationary growth trend may have moved up in response to recent brisk productivity increases, adding to the central bank's current preference for passivity.
- Signs of strength in U.S. spending, output, and labor demands remain widespread. Increased new and unfilled orders for most factory durable products have lifted manufacturing firms out of the doldrums, while consumer optimism about job availability has hit a new multi-decade high, hinting at an early further decline in the unemployment rate.
- Congressional budgeting efforts are just getting underway, but all signs point to a push for sizable, multi-year tax reductions. This presents the potential for a fresh domestic demand stimulus from the fiscal realm as early as next fall.

Goldman Sachs Financial Conditions Index



Source: Goldman Sachs.

A Further Decline in Unemployment?



Source: Department of Labor. The Conference Board.

Trade Recommendations

- We would stay short the March '99 Treasury bond futures contract, lowering our stop to a close above 123.08 from 124.22 and lowering our target to 118.16 from 120.00.

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

Issue No: 99/08
February 26, 1999

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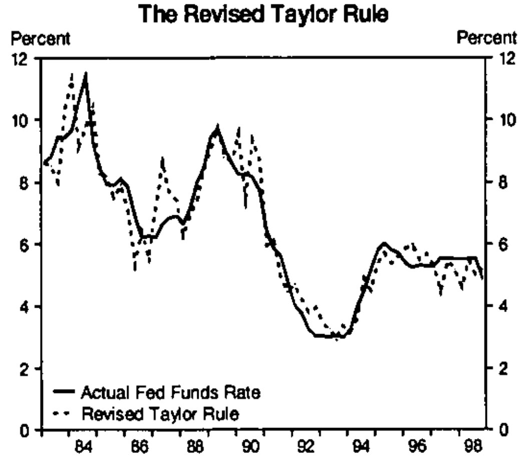
U.S. Economics Analyst

Revitalizing the Taylor Rule

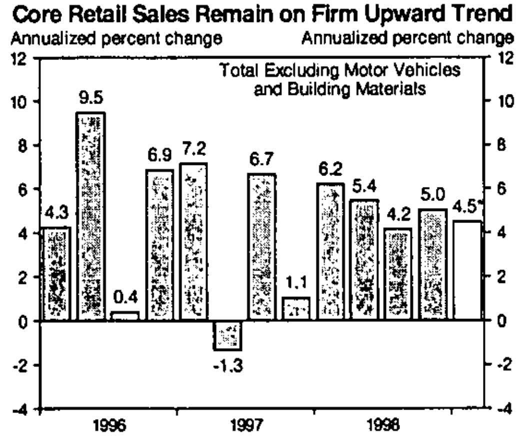
- The Taylor Rule has gone badly off-track in recent years. The problem has been the assumption that there is a constant equilibrium real federal funds rate associated with a neutral monetary policy.
- Using the index of leading economic indicators to construct a revised Taylor Rule with a time-varying equilibrium real rate improves the performance of the rule dramatically. It also implies that the equilibrium real rate is quite high now—over 3½%. This result is consistent with our Goldman Sachs Financial Conditions Index (GSFCI), which shows that financial conditions are currently accommodative.
- In the absence of forces that push inflation down or lower the equilibrium real interest rate associated with monetary policy neutrality, the revised Taylor Rule implies that monetary policy may ultimately have to be tightened. After all, the implied target rate from our revised Taylor Rule is currently 5.2% compared to an actual federal funds rate target of 4.75%.
- A quiet week of economic news indicates no significant change in the landscape. Although retail sales for January were a bit softer than generally anticipated, this was offset by upward revisions to December data. The labor market remains very tight, with initial unemployment claims drifting lower, and non-farm productivity rose sharply in the fourth-quarter, hardly surprising given the surge in real GDP growth.
- The end of the impeachment process is unlikely to be of much consequence for U.S. financial markets.

The Revised Taylor Rule



Source: Federal Reserve Board. Goldman Sachs.

Core Retail Sales Remain on Firm Upward Trend



* Represents January 1999 vs. 1998 Q4 average.
Source: Department of Commerce.

Trade Recommendations

- Stay short the March '99 Treasury bond futures contract, lowering our stop to a close above 124.22 from 126.16 previously, and maintaining a target of 120.00.

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Issue No: 99/06
February 12, 1999

I. Weekly Wrapup

Economic and Market Overview

Although retail spending rose just 0.2% during January, consumer demand for goods remains on a brisk upward trend. Excluding vehicles and building materials, retail outlays last month were 4.5% at an annual rate above the fourth-quarter average, which is squarely in line with the strong results recorded in the latter half of 1998. Considering the near absence of goods price inflation, essentially all of these nominal gains reflect an expansion of sales volumes. Thus, real personal consumption this quarter appears to be persisting at a well-above-average clip; we currently estimate that it will rise around 3½% annualized in the period. Sturdy demand at year-end depressed total business stockpiles of goods slightly and pushed down inventory-to-sales ratios across all distribution levels. Nonauto retail outlets have a particularly lean stock base, with the inventory-to-sales ratio down almost 3% from a year earlier to a new expansion low.

The long-running household spending spree has been fueled in large measure by rapid employment gains and a pickup in real wages. Judging from the weekly unemployment claims data, the labor market is still in robust condition. At 298,000, the four-week average of initial jobless insurance filings nearly matches the low point for this business cycle set last October, and the latest two weekly figures (294,000 and 281,000 for the weeks ending January 30 and February 6, respectively) are the lowest since mid-1997. The exceptionally low claims numbers hint that labor hoarding may be occurring, particularly in regions where unemployment is virtually non-existent and the adequacy of worker supplies represents a potential major constraint on the economy.

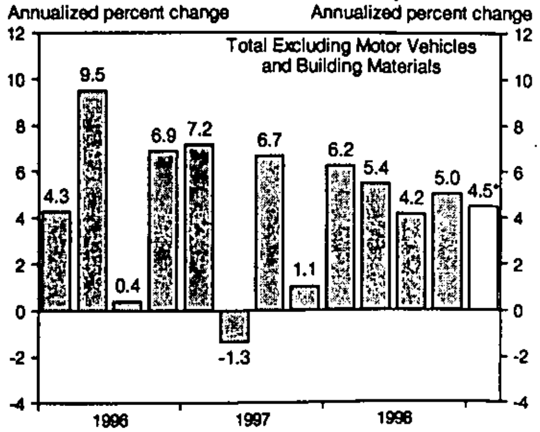
Rapid advances in productivity, however, have helped to bottle up inflationary cost pressures even as the labor market experiences unusual strains. Nonfarm business output per hour jumped 3.7% at an annual rate last quarter, which pulled the increase for all of 1998 up to 2.5%, versus 1.5% for the prior year. As a result, even though nominal labor compensation expenses have been slowly gaining momentum, on a per-unit basis labor costs have stayed very mild, rising just 1.5% in the latest four quarters.

The persistent strength of the economy has caused us to raise our first quarter real GDP growth forecast to 3.3% (annualized) from 2.7% previously.

Federal Reserve Policy

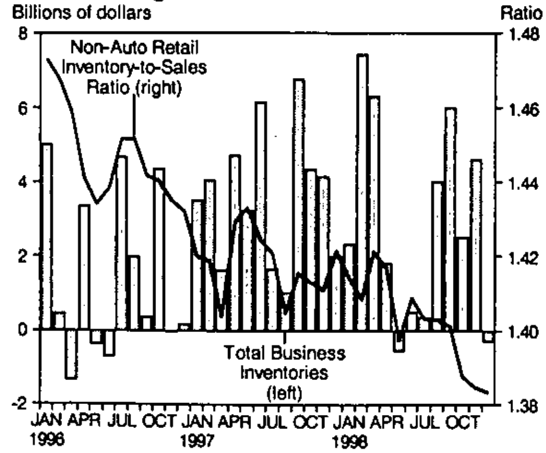
The latest data illustrate the competing influences on monetary policy that are likely to convince Federal Reserve officials to hold interest rates steady for some time. While the forward momentum in domestic demand remains very impressive and appears to be unsustainable, there are no signs that this is having inflationary consequences, as was highlighted by the favorable productivity and labor costs reports. Since central bankers are sticking with their three-year-old forecast that real GDP growth will move into a steady 2.0%-2.5% annual zone soon, they can and probably will remain reluctant to tighten credit as long as wage and price statistics do not suggest a firming. At the same time, no serious thought can be given to lowering rates when interest rate-sensitive demands are already extraordinarily high and private capital markets are back to nearly normal functioning. The danger in the near term for

Core Retail Sales Remain on Firm Upward Trend



* Represents January 1999 vs. 1998 Q4 average.
Source: Department of Commerce.

Sales Vigor Yields Leaner Stock Base



Source: Department of Commerce

financial markets is that Fed stability might come to be perceived as a sign of either complacency or a practical inability to act, with the consequence that risk premia in long-duration dollar assets could widen somewhat.

Fiscal and Political Developments

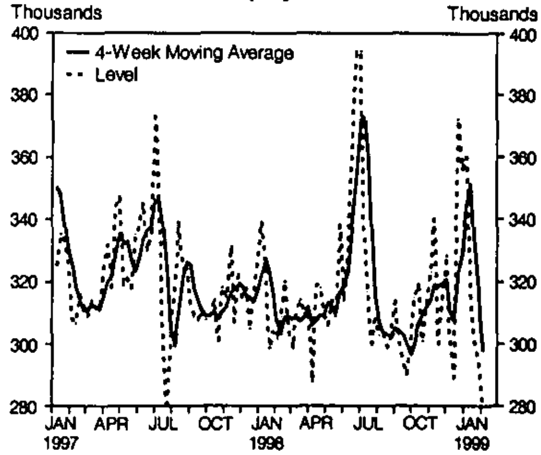
Now that the impeachment trial is over, and President Clinton has been allowed to remain in office, activity in Washington will shift back toward normal legislative and political concerns. Compromise between the parties will be difficult, but both the GOP Congress and the president are facing pressure to find agreement on some key agenda items, such as the budget and Social Security. Regarding the latter, there are reports that House Speaker Dennis Hastert (R-Illinois) might ask the president to sit down with him in an effort to set up a framework for dealing with the delicate subject of federal retirement reforms. That the Republican leader of the chamber that impeached President Clinton is mulling such an invitation reveals the degree to which Republicans recognize their hopes for tax reductions are dependent on some sort of Social Security compromise.

Market Outlook and Comments on Value

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

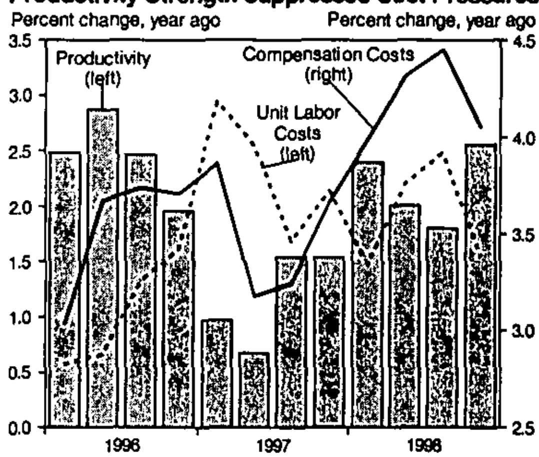
We would stick with our short March T-bond futures trade for awhile longer. First, the forthcoming producer price and consumer price reports should be sufficiently firm to cause the year-over-year inflation rates to tick higher for both measures. This may cause investors to conclude that inflation has bottomed and may make market participants more nervous about the wisdom of a stand-pat stance by the Federal Reserve. Second, investors are likely to be wary about Chairman Greenspan's Humphrey-Hawkins Testimony on February 23 and 24. At a minimum, the chairman is likely to say that the Fed could be forced to tighten eventually should the economy not slow from its current torrid rate. This could cause market sentiment to shift further in the direction that tightening is now more likely than easing. Third, with the impeachment process concluded, speculation about Treasury Secretary Rubin's departure could become more rampant. The bond risk premium could increase somewhat if Mr. Rubin were no longer in charge at the Treasury. Our target remains 120.00, but we would lower our stop to a close above 124.22 from 126.16 previously. Consistent with our negative stance on bonds, we have raised our 3-month forecast for 30-year Treasury bond yields to 5.6% from 5.4% previously.

Initial Unemployment Claims



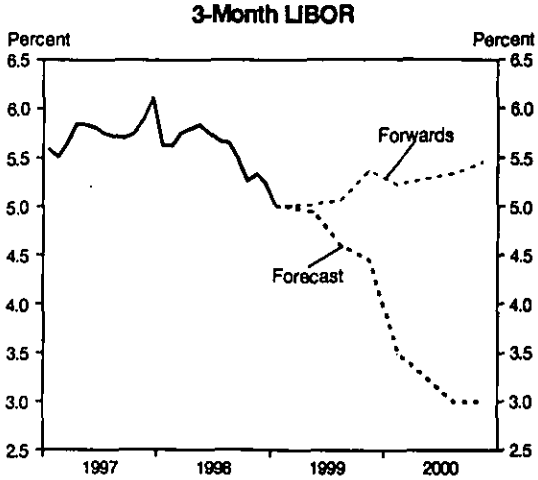
Source: Department of Labor.

Productivity Strength Suppresses Cost Pressures



Source: Department of Labor.

3-Month LIBOR



Source: International Financial Statistics. Bloomberg.

II. Revitalizing the Taylor Rule

The Taylor Rule, which has been used to approximate the reaction function of the Federal Open Market Committee in setting its federal funds rate target, is not performing well. The problem is the assumption that there is a stable equilibrium real interest rate associated with a neutral monetary policy.

One can revitalize the Taylor Rule by allowing the equilibrium real interest rate associated with neutrality to vary with changes in the index of leading economic indicators. Doing this, we find that the real equilibrium interest rate associated with a neutral monetary policy is currently about 3.6%. Our revised Taylor Rule implies a federal funds rate of 5.2%, somewhat above the actual target of 4.75%.

The Taylor Rule Goes Astray

Historically, the Taylor Rule has provided a good approximation to the reaction function used by Federal Reserve policymakers in setting monetary policy. The rule states that the Federal Open Market Committee sets its target federal funds rate equal to the equilibrium real interest rate associated with a neutral policy plus the expected inflation rate plus one-half of the difference between the actual inflation rate and the target inflation rate and one-half of the difference between actual output and potential output:

$$FFT = R + INFE + \tfrac{1}{2}(INF - INFT) + \tfrac{1}{2}(Y - YP)$$

Where	FFT	=	federal funds rate target
	R	=	real equilibrium federal funds rate associated with a neutral monetary policy
	INFE	=	expected inflation
	INF	=	actual inflation
	INFT	=	target inflation
	Y	=	actual output
	YP	=	potential output

To translate the Taylor Rule into an actual federal funds rate target, one has to make an assumption about the appropriate value for the equilibrium real federal funds rate. Generally, this has been assumed to be constant and equal to 2%—which is the average real federal funds rate over the 1960-1998 period.

Using actual inflation as a proxy for expected inflation and our own estimates for the GDP output gap, we can utilize the Taylor Rule to generate a predicted federal funds rate target. As can be seen in the accompanying chart, the Taylor Rule has gone off track. Although the correlation coefficient between the predicted and actual federal funds rate target is 0.60 between 1983 and 1998, the coefficient since 1992 is only 0.13.

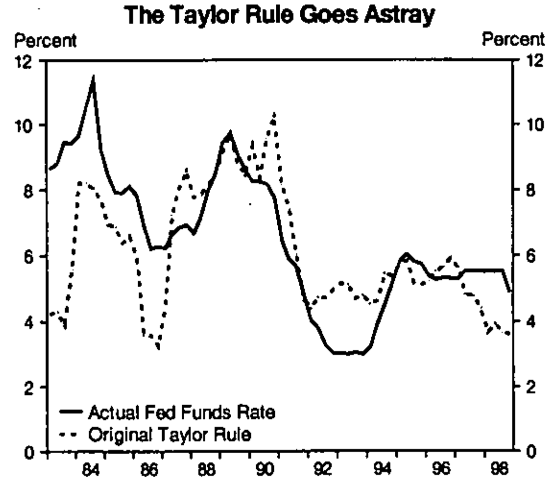
There are three potential explanations for this. First, the implicit weights assigned by Fed officials in meeting its inflation and output goals may be different than the 50% weights used in the Taylor Rule. For example, Fed officials could put more weight on fighting inflation than on keeping output close to its potential. Second, the Fed's reaction function may have shifted over time. For example, the weights might change depending on the stage of the business cycle. Third, the error might lie in the assumption of a constant equilibrium real federal funds rate consistent with a neutral monetary policy. If the equilibrium real interest rate is variable and the Fed policymakers implicitly understand this, then the assumption of a constant rate may cause the Taylor Rule to perform poorly.

Fixing the Taylor Rule

The problem with the Taylor Rule does not lie in the assumption of equal weighting between the Fed's inflation and output goals. Instead, most of the difficulty stems from the assumption of a constant equilibrium real interest rate.

Allowing the weights to deviate from 50% does not improve the performance of the Taylor Rule much. Over the 1983-1998 period, the weights that would minimize the tracking error of the Taylor Rule (minimizing the mean squared error) are 0.35 for inflation and 0.65 for the output gap. Using these weights, the improvement in the fit is slight. For example, the mean absolute error only shrinks to 132 basis points from 138 basis points.

The Taylor Rule Goes Astray



Source: Federal Reserve Board. Goldman Sachs.

Taylor Rule Accuracy (1983-1998)

	Mean Absolute Error (basis points)	Correlation Coefficient
Standard Rule	138	0.60
Allowing Fixed Weight to Differ from 0.5	132	0.61
Allowing Weights to Vary Each Year	90	0.85
Revised Rule with Leading Indicators	57	0.95

Source: Our calculations.

As one might expect, allowing the weights to shift each year to whatever values minimize the tracking error in that year improves the fit by a much greater amount. The mean absolute error shrinks to 90 basis points. When one plots these optimal weights, one sees a shift away from the emphasis on inflation that prevailed during the early 1980s. This suggests that a shift in the reaction function of the Federal Open Market Committee may have occurred over time.

However, this is not a very satisfying way of improving the performance of the Taylor Rule because there is no way of knowing *ex ante* how the weights will shift each year. Thus, allowing variable weights provides little help in using the Taylor Rule in a predictive capacity.

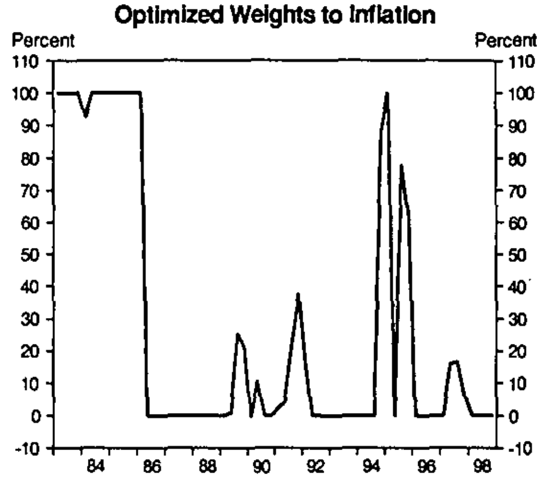
Similarly, allowing flexibility in the equilibrium real interest rate is only interesting if we can provide sufficient structure and intuition to avoid a tautological outcome. Consider that if we let the real equilibrium federal funds rate vary freely with no restrictions, we could make the Taylor Rule fit perfectly. The equilibrium real rate would be whatever level was necessary for the Taylor Rule prediction to equal the actual rate. This clearly would not be a very exciting conclusion.

As it turns out, we can do quite a bit better than this by using the index of leading economic indicators to provide the structure for changes in the equilibrium real interest.[1] We do this in three steps: (1) calculate the error terms between the actual federal funds rate target and that predicted by the Taylor Rule using a 2% equilibrium real interest rate; (2) regress the year-over-year change in the index of leading economic indicators against these error terms; and (3) use this equation to estimate a revised Taylor Rule. From the revised Taylor Rule we can then solve for the equilibrium real rate, which adjusts to changes in the growth rate of the index of leading economic indicators.

As can be seen in the accompanying chart, our revised Taylor Rule, which incorporates the information contained in the leading index, does a much better job in describing the federal funds rate target chosen by the Federal Open Market Committee. The mean absolute error of the forecast shrinks to 57 basis points from 138 basis points for the standard Taylor Rule formulation. This demonstrates that Fed officials pay attention to forward-looking activity variables in setting interest rates even after taking their output gap and inflation targets into consideration, and this strongly implies that the equilibrium real interest rate associated with a neutral monetary policy is not constant.

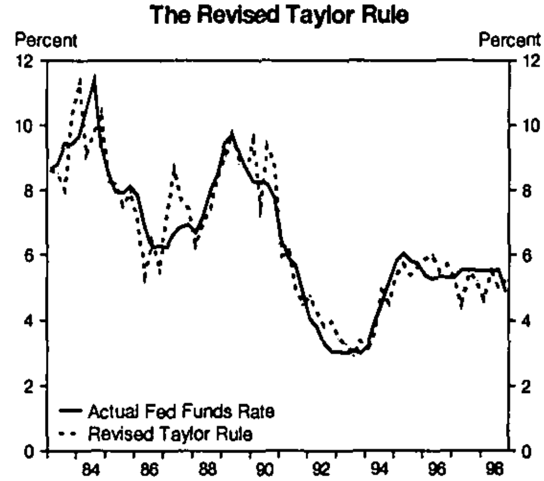
Intuitively, the behavior of the index of leading economic indicators matters because it provides the

Optimized Weights to Inflation



Source: Goldman Sachs.

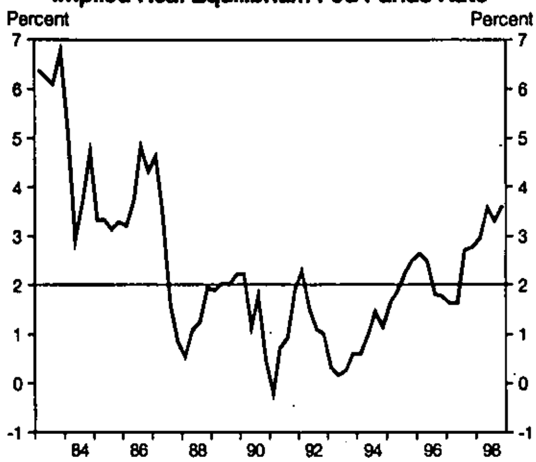
The Revised Taylor Rule



Source: Federal Reserve Board. Goldman Sachs.

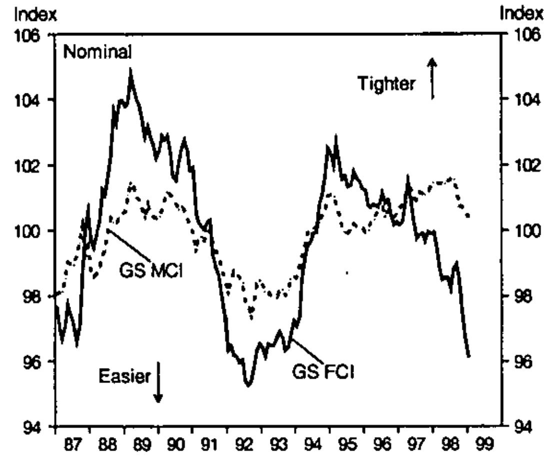
[1] In principle, one could use other macroeconomic variables. But the leading index has particular intuitive appeal for two reasons: (1) It is forward looking; and (2) it summarizes a plethora of real and financial variables into a single summary measure.

Implied Real Equilibrium Fed Funds Rate



Source: Goldman Sachs.

Goldman Sachs Financial Conditions Index



Source: Goldman Sachs.

FOMC with information about the current level of the equilibrium real interest rate associated with neutrality. For example, if the leading indicators are surging at a time that the real federal funds rate target is already above 2%, this strongly suggests that the neutral rate may be even higher. Under such circumstances, the FOMC will need to raise its target federal funds rate to keep the gap between the target and its estimate of the equilibrium real rate unchanged. If it did not do so, then it would be implicitly loosening monetary policy. The FOMC's goal is to keep the gap between the actual real federal funds rate and the equilibrium rate constant given the output and inflation gaps. If its estimate of the equilibrium real rate changes, then this should also result in changes to the actual target rate.

Our revised Taylor Rule implies that the real equilibrium interest rate varies over time. Solving for the real equilibrium interest rate embodied in our revised Taylor Rule estimates, we find that the equilibrium real interest rate has been both higher and lower than the 2% standard embodied in the simple Taylor Rule formulation. In the early 1980s, real interest rates were high because fiscal policy was stimulative. In the early 1990s, real rates were low because the economy was fighting the headwinds of a damaged financial system. And, finally, real rates are high currently because the stock market is boosting economic activity as the wealth effect stimulates consumption and as the lower cost of equity capital stimulates investment.

These results are consistent with our earlier work in which we constructed a financial conditions index. As shown in the accompanying chart, the Goldman Sachs Financial Conditions Index (GSFCI), which includes the S&P 500 price/earnings ratio as a variable (in addition to short- and long-term interest rates and the Goldman Sachs Trade-Weighted Dollar Index), is much more accommodative than the Goldman Sachs Monetary Conditions Index (GSMCI), which does not. The current reading of the GSFCI implies a robust economy. This is consistent with strength in the leading index of economic indicators and a higher equilibrium real federal funds rate.

Market Implications

The revised Taylor Rule strongly suggests that the equilibrium real rate consistent with a neutral monetary policy is substantially higher than 2%. If this is true, then the outlook for the U.S. bond market is not favorable unless there are economic shocks (such as trade drag generated from weakness in Latin American activity) that either lower the equilibrium real interest rate or the expected inflation rate. It also suggests that real yields on Treasury Inflation Protection Securities (TIPS) are likely to remain elevated. After all, if the real short-term interest rate associated with a neutral monetary policy is more than 3%, then TIPS yielding 3.7% in real terms are not particularly attractive on an absolute basis, even though they may be attractive relative to nominal Treasury securities of comparable maturities.

Our revised Taylor Rule also suggests that the pace of economic activity over the next few quarters could have important implications for the monetary policy outlook. If the economy keeps growing fast, then Fed officials may revise upwards their estimates of the equilibrium real rate consistent with neutrality. Under such circumstances, the result could be a tightening of monetary policy even in the absence of renewed inflationary pressures.

Bill Dudley

Key U.S. Economic Data

	Latest Monthly Data '99 Jan	'98 Dec	'98 Nov	'98 Oct	6 Mo Trend	12 Mo Trend	Next Release
Nonfarm Payrolls (ch. thousands)	245	298	277	164	246	226	Mar 5
Unemployment Rate (%)	4.3	4.3	4.4	4.5	4.4	4.5	
Index of Hours Worked (% ch)	0.0	0.3	-0.1	0.6	1.4	1.1.	
Average Hourly Earnings (% ch)	0.5	0.3	0.3	0.2	3.9	4.0	
Producer Price Finished Goods Index (% ch)	–	0.4	-0.2	0.2	1.1	-0.2	Feb 18
Excluding food and energy	–	1.0	0.1	0.1	3.5	2.4	
Consumer Price Index (% ch)	–	0.1	0.2	0.2	1.8	1.6	Feb 19
Excluding food and energy (% ch)	–	0.3	0.2	0.2	2.4	2.5	
Retail Sales (% ch)	0.2	1.0	0.7	1.2	7.3	6.1	Mar 11
Excluding motor vehicles (% ch)	0.2	0.6	0.6	0.7	4.7	5.3	
Industrial Production (% ch)	–	0.2	-0.1	0.5	3.3	1.9	Feb 17
Manufacturing	–	0.2	0.1	0.8	4.6	2.3	
Capacity Utilization (%)	–	80.9	81.0	81.4	81.3	81.9	Feb 17
Manufacturing	–	79.9	80.1	80.4	80.2	80.9	
Housing Starts (annual rate, thousands)	–	1720	1662	1693	1662	1618	Feb 17
Single-family	–	1357	1367	1291	1304	1274	
Trade Balance (billions, monthly)	–	–	-15.5	-13.6	-14.9	-13.7	Feb 19
Merchandise	–	–	-21.9	-20.2	-21.2	-20.3	
Factory Orders (% ch)	–	2.3	0.4	-1.7	7.6	2.6	Mar 4
Durable Goods	–	3.1	0.4	-2.2	13.6	5.6	Feb 25
Personal Income (% ch)	–	0.5	0.4	0.4	5.1	5.1	Mar 1
Wages and Salaries	–	0.5	0.5	0.6	6.4	6.3	
Purchasing Managers' Index (%)	49.5	45.3	47.0	48.4	48.0	49.9	Mar 1
Consumer Sentiment U Mich (Feb 66=100)	103.9	100.5	102.7	97.4	101.6	104.4	Feb 26
Conference Board (1985=100)	127.6	126.7	126.4	119.3	126.6	131.6	Feb 23

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.

U.S. Calendar

Focus for the Week Ahead

- Housing starts probably declined last month, as the weather and temperatures returned to more normal winter patterns (February 17).
- Industrial production for January is likely to be restrained by a sharp drop in mining output. The manufacturing sector is should to register a moderate advance (February 17).
- Producer prices and consumer prices are apt to advance moderately, with tobacco prices again contributing. Apparel prices are likely to be firm at the retail level reflecting strong sales and less promotional activity. The pace of inflation on a year-over-year basis should increase for both indices (February 18 and 19).
- The trade deficit is likely to narrow somewhat, aided by a big jump in aircraft exports and a drop in the price of oil, which will cut into the dollar value of oil imports (February 19).

Economic Releases and Other Events

Date	Time	Indicator	Estimate GS	Estimate Consensus	Last Report
Wed Feb 17	8:30	Housing Starts (Jan)	-4.0%	-2.9%	+3.5%
	9:15	Industrial Production (Jan)	+0.1%	0.0%	+0.2%
	9:15	Capacity Utilization (Jan)	80.6%	80.6%	80.9%
Thu Feb 18	8:30	Producer Price Index (Jan)	+0.2%	+0.2%	+0.4%
		Excluding Food & Energy	+0.1%	+0.1%	+1.0%
	10:00	Philadelphia Fed Survey (Feb)	+10.0%	+10.5%	+12.4%
Fri Feb 19	8:30	Consumer Price Index (Jan)	+0.2%	+0.2%	+0.1%
		Excluding Food & Energy	+0.2%	+0.2%	+0.3%
	8:30	Trade Balance (Dec)	-$14.8 bn	-$15.7 bn	-$15.5 bn

- Home Builders' Survey (Tue, Feb 16)
- Kansas City Fed Survey (Wed, Feb 17 – 11:00)
- Treasury Announces 2-Year Note (Wed, Feb 17 – 2:30)
- Import & Export Prices (Wed, Feb 17 – 10:00)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.0%	5.0%	4.5%
Forward	5.0	5.1	5.3
2 Year T-Note	4.8	4.6	4.2
Forward	4.9	5.0	5.1
10 Yr T-Note	5.3	5.0	4.4
Forward	5.0	5.1	5.2

Key Numbers in the Business Outlook

	1998 Q4	1999 Q1E	1999 Q2E	1998	1999E
Real GDP	5.6%	3.3%	2.2%	3.9%	3.1%
Ind. Prod., Mfg.	5.1	2.3	2.7	4.2	2.2
CPI	1.9	2.0	1.9	1.6	1.9
After-Tax Profits*	5.9E	1.6	2.8	3.1E	-0.6
Unemployment	4.4	4.3	4.4	4.5	4.4

* Excluding inventory profits; adjusted for depreciation distortions.

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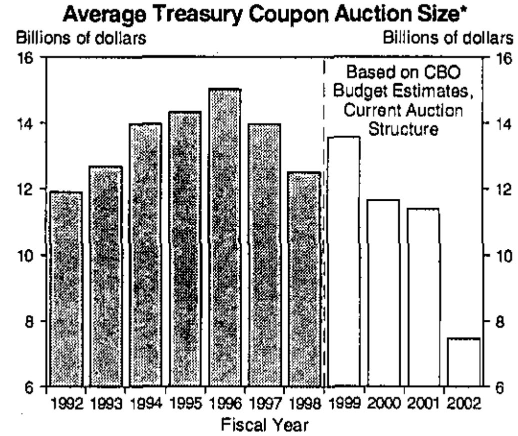
U.S. Economics Analyst

Renewed Pressures For Treasury Funding Reforms

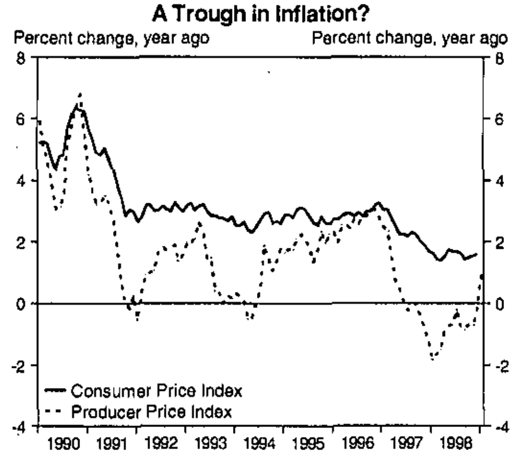
- Projections of sustained high budget surpluses are putting pressure on the Treasury to reconfigure its funding patterns once again. The result should be a substantial cut in the frequency of coupon securities auctions by autumn.
- Longer term, if the surpluses persist, even more aggressive steps will have to be taken. In particular, we recommend that the Treasury actively push Congress to enact legislation to eliminate the accounting barriers to the Treasury's purchase of outstanding debt. This would both reduce long-term interest costs and enhance the overall efficiency of the U.S. government securities market.
- If the Treasury goes this route, a regularized reverse-auction framework probably would work best by maximizing the breadth of investor participation and by reducing uncertainties about the regularity and magnitude of such a debt repurchase program.
- The economic news continues to paint a picture of robust domestic demand but a weak industrial sector. Labor market conditions continue to tighten, with the four-week moving average of initial unemployment claims hitting a 10-year low in the latest week. The narrowing of the trade deficit in December suggests that fourth-quarter real GDP growth will be revised upward to more than a 6% annualized rate.
- The inflation news remains good. The big gain in the overall producer price index was due to special factors. However, on a year-over-year basis inflation rates appear to have bottomed.

Average Treasury Coupon Auction Size*



* Excludes inflation-protection securities.
Source: Congressional Budget Office. Our estimates.

A Trough in Inflation?



Source: Department of Labor.

Trade Recommendations

- Stay short the March '99 Treasury bond futures contract, maintaining a stop on a close above 124.22, and a target of 120.00.

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February 19, 1999
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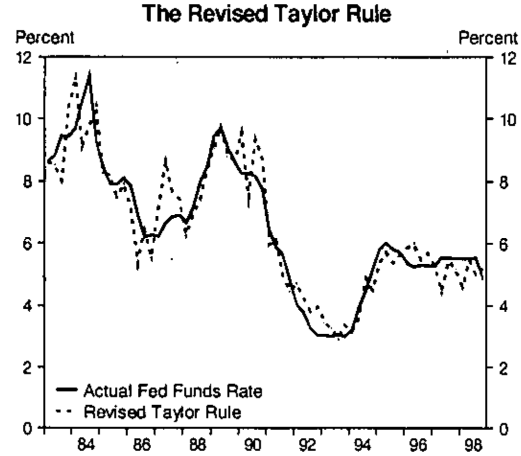
U.S. Economics Analyst

Revitalizing the Taylor Rule

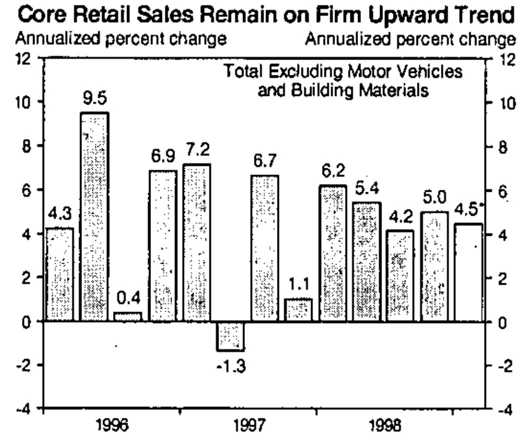
- The Taylor Rule has gone badly off-track in recent years. The problem has been the assumption that there is a constant equilibrium real federal funds rate associated with a neutral monetary policy.
- Using the index of leading economic indicators to construct a revised Taylor Rule with a time-varying equilibrium real rate improves the performance of the rule dramatically. It also implies that the equilibrium real rate is quite high now—over 3½%. This result is consistent with our Goldman Sachs Financial Conditions Index (GSFCI), which shows that financial conditions are currently accommodative.
- In the absence of forces that push inflation down or lower the equilibrium real interest rate associated with monetary policy neutrality, the revised Taylor Rule implies that monetary policy may ultimately have to be tightened. After all, the implied target rate from our revised Taylor Rule is currently 5.2% compared to an actual federal funds rate target of 4.75%.
- A quiet week of economic news indicates no significant change in the landscape. Although retail sales for January were a bit softer than generally anticipated, this was offset by upward revisions to December data. The labor market remains very tight, with initial unemployment claims drifting lower, and non-farm productivity rose sharply in the fourth-quarter, hardly surprising given the surge in real GDP growth.
- The end of the impeachment process is unlikely to be of much consequence for U.S. financial markets.

The Revised Taylor Rule



Source: Federal Reserve Board. Goldman Sachs.

Core Retail Sales Remain on Firm Upward Trend



* Represents January 1999 vs. 1998 Q4 average.
Source: Department of Commerce.

Trade Recommendations

- Stay short the March '99 Treasury bond futures contract, lowering our stop to a close above 124.22 from 126.16 previously, and maintaining a target of 120.00.

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Issue No: 99/06
February 12, 1999

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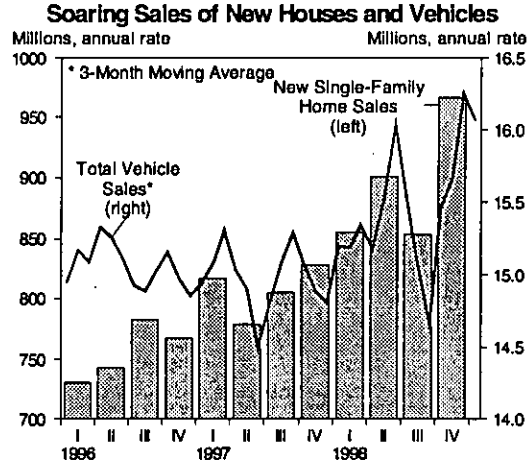
Brazil: Probably Only a Small Effect on U.S. Growth

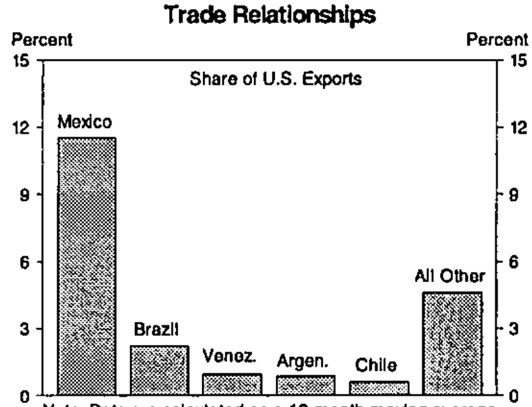
- U.S. consumers clearly did not make any New Year's resolutions about thrift, as reports on car sales and business at major retail chains in January were quite strong. With home sales also hitting all-time highs late last year, the momentum of domestic demand remains unabated.
- This momentum is providing a lift to the U.S. manufacturing sector. Orders were up sharply in December, and the NAPM composite index bounced in January, bringing it into closer alignment with other survey data.
- January's job report likewise indicates little, if any, slowing in hiring trends, while the tight labor market has pushed average hourly earnings growth back up to 4%. Thus, the strength in consumer income that has fueled spending is set to continue.
- Based on all of these indications, our estimate of 2.7% annualized growth for the first quarter now looks too low. A figure in the 3%-3½% range seems more appropriate; we will make a more specific adjustment when we review the entire forecast in the February *Pocket Chartroom*.
- Against all of this domestic strength, the impact of the devaluation of the Brazilian Real may well be obscured. Based on the experience of earlier episodes (Mexico in 1994-1995 and Asia in 1997-1998), as well as the parameters of the latest shock, we conclude that its impact will be about ¼% of U.S. GDP. Because Brazil is a small trading partner (2.2% of exports), the potential for a much bigger effect depends on contagion into Mexico and/or the U.S. stock market, neither of which has happened so far.

Soaring Sales of New Houses and Vehicles



Source: Department of Commerce.

Mexico Dominates U.S./Latin America Trade Relationships



Note: Data are calculated on a 12-month moving average ending in November 1998.
Source: Department of Commerce.

Trade Recommendations

- Stay short March '99 T-bond futures (currently 124.20); lower target to 120.00 and lower the stop to a close above 126.16.
- Close out the Eurodollar "millennium butterfly" position (long December '99 Euros vs. a combined short in September '99 and March '00 contracts), at the current level of 23 basis points.

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February 5, 1999

I. Weekly Wrapup

Economic and Market Overview

Bond yields have risen sharply over the past week, responding to a consistent pattern of strength in the economic news. All signs indicate that a rebound in U.S. factory output is now underway. An unexpected 1.2% jump in nondurable goods bookings pushed total factory orders up 2.3% in December, while manufacturing inventories plunged 0.9%, the biggest monthly drop in over seven years. This combination of firmer goods demand and leaner stocks helps to explain the sharp rise in the NAPM composite index for January to 49.5%, the high since last June. New export orders in particular showed surprising strength, climbing to 49.8%, a 13-month peak. This caused the export-import orders differential to move into positive territory, which suggests that the drag on U.S. growth from Asian weakness had dissipated by the turn of the year. Any negative trade shock from recent developments in Brazil, however, has not yet been reflected in these data.

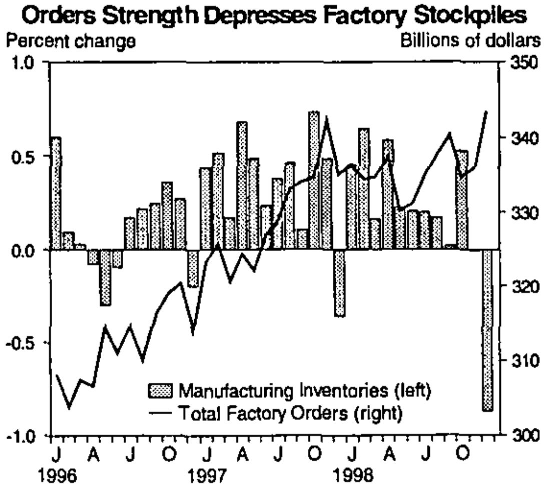
Household income and expenditures have remained on unusually solid growth paths. Personal income rose 0.5% in December, and the 0.5% gain for wages and salaries extended a prior trend of approximately 6% annual current-dollar increases. This translates to real growth of about 5% per year in core earnings. The explosion in real income has fostered robust increases in real personal spending (+0.7% during December) and has encouraged an extraordinary pace of demand for homes and other durable items. Sales of new single-family dwellings soared to an annual rate of 967,000 last quarter, far above the previous record, while the average selling rate for new motor vehicles also scaled new heights.

In most respects, January's job report confirms the indications from other data that the U.S. economy is growing at an above-trend rate. Even amid less hospitable weather conditions, nonfarm payrolls rose 245,000 last month, including a further 15,000 rise in construction workers. Moreover, the unemployment rate stayed low, at 4.3%, despite an 800,000 rise in the labor force, and hourly earnings rose 0.5%, bringing the 6- and 12-month wage trends back to about 4% at an annual rate. Although workweeks and indexes of hours worked were soft, this may have been due to unseasonably nasty weather during the survey week. On balance, it appears that our 2.7% estimate for real GDP growth in the first quarter is probably too low.

Federal Reserve Policy

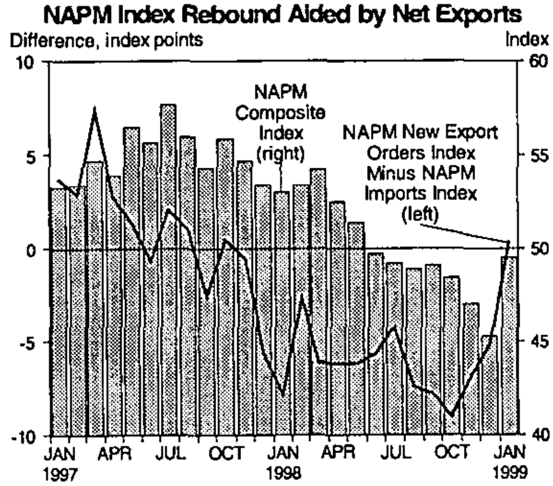
Although Fed officials very likely did not adopt a formal bias toward possible future tightening at their meeting this week, the broad, remarkable strength of recent statistical reports on domestic economic conditions has clearly raised formidable barriers to even the contemplation of easing anytime soon. By their own models of monetary policy transmission, central bankers should be expecting that the three late-1998 rate cuts will not have their full effect on aggregate domestic demand for some time. That is somewhat worrisome, considering that consumption growth is already far above long-term averages and shows no evidence of slackening. Moreover, the rapid pace of new home sales and existing house turnover last quarter suggests the potential for an extended further period of vigorous housing-related outlays. If by late March it appears that GDP growth has remained brisk through the winter months, then it will be tough for the FOMC to justify maintaining an

Orders Strength Depresses Factory Stockpiles



Source: Department of Commerce.

NAPM Index Rebound Aided by Net Exports



Source: National Association of Purchasing Management.

officially even-handed approach to future rate changes.

Fiscal and Political Developments

One year before the earliest presidential selection caucuses and primaries, the field of contestants for the 2000 White House race is coming into sharper focus. This week, House Minority Leader Richard Gephardt (D-MO) formally declined to make a run, preferring instead to lead his party's effort to recapture the lower chamber of the Congress. That seems to leave Vice President Albert Gore and former New Jersey Senator Bill Bradley as the main and perhaps sole contenders for the Democratic nomination.

On the Republican side, former Vice President Dan Quayle and conservative activist Gary Bauer have both thrown their hats into the ring. At this point, the main uncertainty for the GOP is whether Texas Governor George W. Bush, son of the former president, will heed calls to jump into the race. Because he could quickly acquire the necessary huge financial resources, and would likely attract high-level political talent (perhaps including some from his father's former team), Governor Bush currently looms as the most formidable threat to the Democrats. That said, he has not yet been tested at the national level, and history is littered with examples of early front-runners who stumbled badly under the intense pressure of an actual campaign.

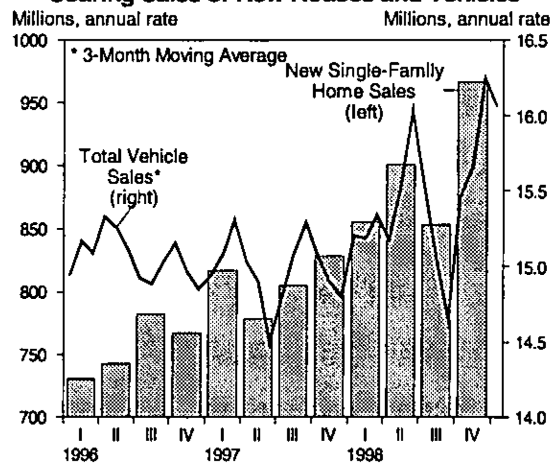
Market Outlook and Comments on Value

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

We advise sticking with a short position in Treasury bond futures (currently 124.20), with the price target lowered to 120.00 and stops brought down as well, to a close above 126.16. While the bond market may pause following its recent steep sell-off, the risks remain skewed toward higher yields in the near term. The economy is growing at an unsustainable rate, yet senior Fed officials apparently will be very slow to move toward restraint. In this environment, the bond market in effect may be called upon to serve as the primary brake on excessive expansion. Additionally, the bottoming of oil prices suggests that year-on-year headline inflation changes may turn upward.

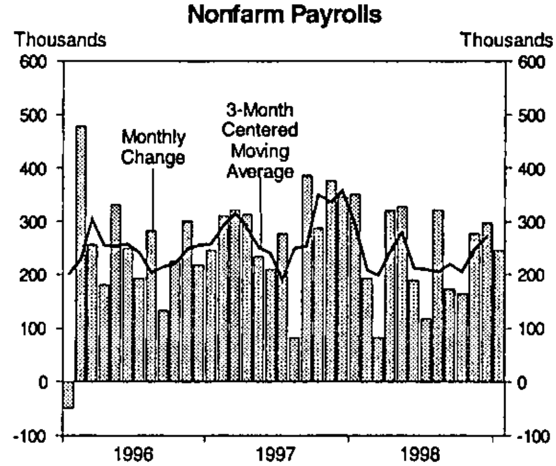
We recommend closing the Eurodollar "millennium butterfly" spread trade, in which we were long the December '99 Euro against a combined short in the September '99 and March '00 Euros, now that the price has moved down to 23 basis points, fairly close to what had been our target.

Soaring Sales of New Houses and Vehicles



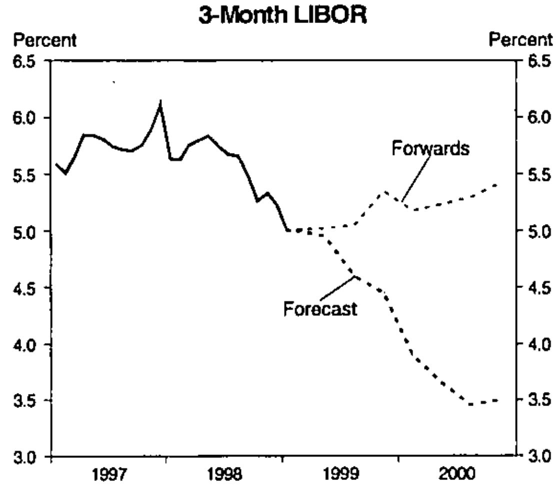
Source: Department of Commerce.

Nonfarm Payrolls



Source: Department of Labor.

3-Month LIBOR



Source: International Financial Statistics, Bloomberg.

II. Brazil: Probably Only a Small Effect on U.S. Growth

For the third time in less than five years, the U.S. economy faces the prospect of a setback in foreign trade, this time in the wake of last month's devaluation of the Brazilian Real. In the two earlier episodes (Mexico in 1995 and Asia in 1997-1998), sharp cutbacks in demand from the afflicted regions precipitated a significant slowing in the growth of U.S. factory output. However, the rest of the U.S. economy suffered very little in 1995, and most of that slowdown can be attributed to the 300-basis-point tightening in monetary policy in 1994 and early 1995. In the 1998 episode, the U.S. economy outside manufacturing actually benefited from lower interest rates and lower inflation, as illustrated by the fact that growth in real GDP was the same as in 1997 (3.9%) despite the factory slowdown.

Will the latest shock coming from Brazil go the way of these other two, or will it inflict more damage to the U.S. expansion? The simple answer is that the recession now getting underway in Brazil is unlikely to impart a significant drag on U.S. growth unless weakness spreads into Mexico or the U.S. stock market. Since neither of these seems likely, we are not reducing our U.S. growth outlook at this time. In fact, persistently stronger-than-expected domestic demand suggests that U.S. growth is more likely to surprise us on the strong side in coming months.

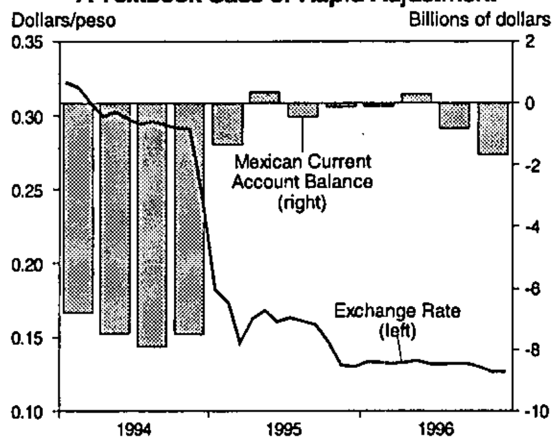
Past Shocks from Mexico and Asia

In the past five years, the U.S. economy has experienced two external shocks in which export demand fell as significant trading partners or blocs underwent sharp current account adjustments. In both cases, U.S. manufacturers experienced a sharp slowdown in demand growth, to the point where they laid off workers in large quantities, but the rest of the economy held up very well.

Mexico's devaluation of the peso in December 1994 triggered the first episode. In the wake of this devaluation, which cumulated to about 50% within three months, Mexico's $30-billion current account deficit virtually disappeared in 1995, as shown in the chart above. U.S. business firms, who supply the overwhelming portion of Mexico's imports (about 70% in 1994), quickly felt the effect, as the U.S. trade balance in goods and services with Mexico swung from a $1-billion surplus to a $19-billion deficit. This $20-billion loss of business was worth slightly more than ¼% of U.S. GDP at the time.

In theory, this figure understates the full impact on U.S. growth for two reasons. (1) It excludes the

The 1994-1995 Mexican Peso Crisis: A Textbook Case of Rapid Adjustment



Source: Banco de Mexico. Goldman Sachs.

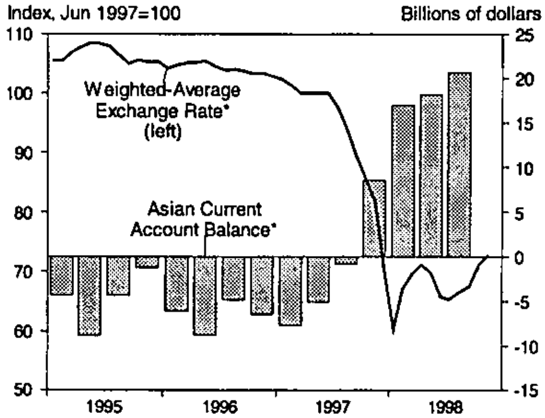
effect of contagion to other Latin American countries. (2) It also excludes any knock-on "multiplier" effect resulting from the impact of job and income loss on domestic demand. However, neither factor appears to have been important.

Contagion had no impact on U.S. trade whatsoever. In fact, the U.S. balance with other countries in Latin America actually improved by $6.2 billion between 1994 and 1995, providing a mild offset to the setback with Mexico.

Assessing the multiplier impact is more problematic because the peso devaluation occurred near the end of a 300-basis-point tightening in U.S. monetary policy, which also slowed the growth rate. However, the multiplier cannot have been much of a factor given that the unemployment rate held steady and growth in wage and salary payments actually accelerated in 1995 in the face of both events. Thus, we conclude that the overall dent in U.S. growth was not much different than the original ¼% hit to real GDP.

The second episode began with the devaluation of the Thai baht on July 2, 1997, which set off a round of devaluations in Asia during the second half of that year. By year-end, the currencies of seven countries in the area—Thailand, Malaysia, Indonesia, the Philippines, South Korea, Singapore, and Taiwan—were down about 40%, weighted by U.S. exports, as shown in the chart on the top of page 5. Although the current account adjustment for the region as a whole was not quite as abrupt, given the large number of countries involved, it does appear to have occurred fairly rapidly. By the third quarter of 1998, we reckon that the consolidated current account (netting out a rough estimate of intra-regional flows) for these

The 1997-1998 Asian Shock



Note: Countries include Indonesia, Malaysia, the Philippines, Thailand, Korea, Singapore, and Taiwan.
Source: Department of Commerce. IMF. Goldman Sachs.

nations was in surplus by about $80 billion and was in process of stabilizing, as also shown in the chart above. This compares to a deficit of about $25 billion in the year prior to the Thai baht devaluation. Thus, the Asian crisis appears to have imposed on the rest of the world a reduction in demand on the order of $100 billion (annualized) in a period of 15 months.

Based on typical shares of imports into the region, again netting out intraregional commerce, U.S. firms should have shouldered between 20% and 25% of this adjustment. The actual impact appears to have been toward the upper end of this range. Over the same 15-month period, the U.S. trade deficit with these nations rose $24.6 billion.

Relative to the size of the U.S. economy, this loss was almost identical to the one that occurred in 1995 —about 0.3% of GDP—as a much smaller U.S. exposure to the collapse in the region's imports offset a much larger current account adjustment.[1] The 1997-1998 experience was also similar in the sense that the U.S. response was confined to the manufacturing sector, as an exceptionally tight labor market short-circuited the multiplier. Meanwhile, the Asian crisis provided some offsets to its own damage on demand via its depressing effect on commodity prices and diversion of international capital flows, which reduced U.S. inflation and interest rates. In the end, the U.S. economy suffered no net damage. Growth in 1998 was the same as in 1997 on an annual average basis (3.9%) and actually slightly faster on a four-quarter change basis (4.1% during 1998 versus 3.6% as of mid-1997), which is a cleaner measure of conditions before and after the shock.

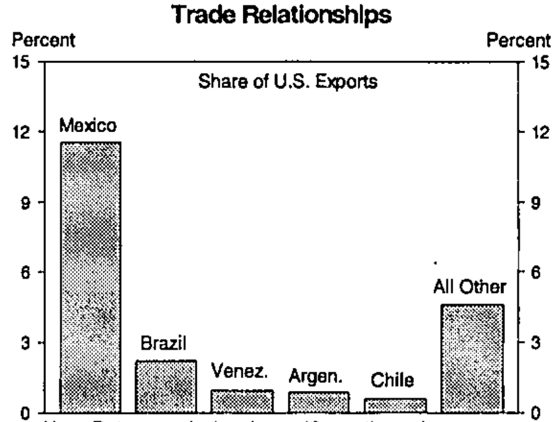
Implications for Brazil's Effect

What do these experiences imply about the probable effect on U.S. growth of the difficulties now besetting Brazil? In the context of the following observations, they suggest that these problems are unlikely to be the source of a material slowing in U.S. growth unless they prove to be contagious in one of two ways—either to Mexico's economy or to the U.S. equity market.

- **Brazil is a small trading partner of the United States.** It has been commonplace to observe in the context of the Real devaluation that Latin America buys about one-fifth (20.8%) of U.S. merchandise exports. However, Brazil accounts for only about one-tenth (2.2%) of this business, much less than either Mexico in 1994 (10%) or Asia in mid-1997 (about 17%). Assuming a comparable share for exports of services, Brazil consumes only about ¼% of U.S. GDP. Thus, the U.S. economy would suffer only a trivial setback if weakness following the devaluation of the Real were confined to Brazil.

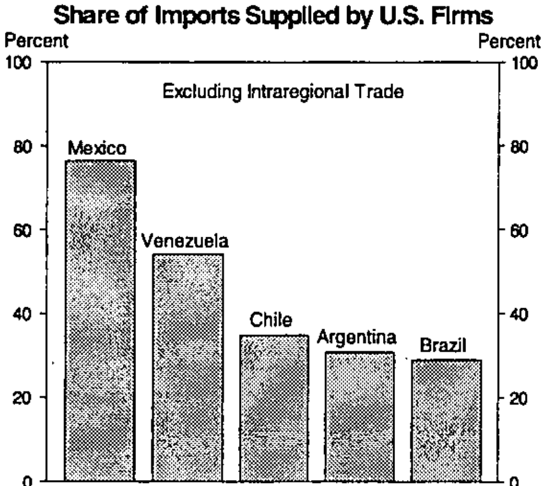
- **Mexico is by far the dominant market for U.S. exports in the region.** Of course, weakness is not likely to be confined to Brazil. Our emerging markets team has estimated that Latin America as a whole would suffer a mild recession in the wake of the Real devaluation and experience a current account adjustment of about $50 billion more than previously thought in the process. However, where this weakness occurs is of crucial importance insofar as its effects on U.S. trade are concerned. As shown in the chart below, Mexico buys more than half of the U.S.

Mexico Dominates U.S./Latin America Trade Relationships



Note: Data are calculated on a 12-month moving average ending in November 1998.
Source: Department of Commerce.

[1] Note that these figures exclude Japan and China. Over the same period, the U.S. trade deficit with these two nations rose $10.5 billion apiece. If these adjustments are counted as part of the shock, then it would be slightly more than ½% of GDP.



exports to the region, while none of the other countries buy as much as 5% (1% of total U.S. exports). Thus, in terms of impact on U.S. trade, contagion into Mexico is the key issue.

- **Mexico's importance is also underscored by the pattern of U.S. shares of imports into the region.** As is apparent in the foregoing analysis, these shares are important as a gauge of how automatically U.S. firms will suffer from a correction in the current account deficit of a trading partner. As shown in the chart above, Mexico stands apart from most other countries in Latin America in this respect. In the 12 months to November 1998, U.S. firms supplied more than three-quarters of Mexico's imports, whereas the U.S. share of imports into most other key Latin American countries was only about 30% to 35% after netting out intraregional trade.

- **However, Mexico is not apt to bear the brunt of contagion from Brazil.** This is an outgrowth of the preceding two points, which emphasize the fact that the Mexican economy is more closely tied to the U.S. economy than to its Latin American counterparts. Thus, while the outlook for most other economies in South America has deteriorated significantly in the wake of the Real devaluation, our emerging markets group still foresees moderate growth in Mexico, on the order of 2½% to 3% in 1999. Thus, the U.S. share of the $50-billion Latin American current account adjustment is likely to converge toward the lower end of the range shown in the chart above—a trade hit again in the vicinity of ¼% of GDP.

- **The recent performance of the peso and the Mexican stock market bolsters the case for only minimal contagion to Mexico.** Given that Mexico's trade linkages are primarily with the United States, contagion from Brazil to Mexico will occur mainly via disruptions in financial markets. Thus, it is reassuring that the peso is currently trading about where it was prior to the widening of the Real bands on January 13 (10.1 pesos to the dollar). Meanwhile, the Mexican stock market has risen 23% in local currency terms, and only slightly less in dollar terms.

- **The other possible avenue of contagion is via the U.S. equity market.** In essence, the Real crisis has replaced the Asian currency crisis as the main opponent of domestic demand in the tug-of-war for U.S. growth. The foregoing points suggest that the shock from Latin America is unlikely to have a much different outcome on the U.S. trade balance. Could it "win" the tug-of-war by undermining the strength in stock prices that has been so central to the strength in U.S. domestic demand?

- **However, this avenue also appears unlikely.** To ascertain the prospects for contagion via the U.S. stock market, we asked our industry analysts about the exposures to Brazil and Latin America of the industries and companies they follow. The results of this survey are to be published in a separate report, but the key finding is that exposures in the region are quite modest overall. This is consistent with the market's subdued response to the crisis thus far, and it suggests that any impact on U.S. growth via this channel will require a significant further deterioration in the outlook for Latin America.

In summary, we see no reason to reduce our forecast of U.S. growth at the present time on account of the developments in Brazil and their implications for growth in the region. To the contrary, incoming data on a wide variety of fronts strongly suggest that growth in U.S. domestic demand is remaining robust for longer than we had anticipated, as discussed more fully in the weekly wrap-up on page two. Thus, it remains the case that U.S. growth is more likely to exceed our expectations for domestic reasons than to fall short for foreign reasons, at least in the near term.

Bill Dudley **Ed McKelvey**

Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	'99 Jan	'98 Dec	'98 Nov	'98 Oct	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	245	298	277	164	246	226	Mar 5
Unemployment Rate (%)	4.3	4.3	4.4	4.5	4.4	4.5	
Index of Hours Worked (% ch)	0.0	0.3	-0.1	0.6	1.4	1.1	
Average Hourly Earnings (% ch)	0.5	0.3	0.3	0.2	3.9	4.0	
Producer Price Finished Goods Index (% ch)	--	0.4	-0.2	0.2	1.1	-0.2	Feb 18
Excluding food and energy	--	1.0	0.1	0.1	3.5	2.4	
Consumer Price Index (% ch)	--	0.1	0.2	0.2	1.8	1.6	Feb 19
Excluding food and energy (% ch)	--	0.3	0.2	0.2	2.4	2.5	
Retail Sales (% ch)	--	0.9	0.6	1.2	5.1	6.7	Feb 11
Excluding motor vehicles (% ch)	--	0.4	0.6	0.7	4.9	6.2	
Industrial Production (% ch)	--	0.2	-0.1	0.5	3.3	1.9	Feb 17
Manufacturing	--	0.2	0.1	0.8	4.6	2.3	
Capacity Utilization (%)	--	80.9	81.0	81.4	81.3	81.9	Feb 17
Manufacturing	--	79.9	80.1	80.4	80.2	80.9	
Housing Starts (annual rate, thousands)	--	1720	1662	1693	1662	1618	Feb 17
Single-family	--	1357	1367	1291	1304	1274	
Trade Balance (billions, monthly)	--	--	-15.5	-13.6	-14.9	-13.7	Feb 19
Merchandise	--	--	-21.9	-20.2	-21.2	-20.3	
Factory Orders (% ch)	--	2.3	0.4	-1.7	7.6	2.6	Mar 4
Durable Goods	--	3.1	0.4	-2.2	13.6	5.6	Feb 25
Personal Income (% ch)	--	0.5	0.4	0.4	5.1	5.1	Mar 1
Wages and Salaries	--	0.5	0.5	0.6	6.4	6.3	
Purchasing Managers' Index (%)	49.5	45.3	47.0	48.4	48.0	49.9	Mar 1
Consumer Sentiment U Mich (Feb 66=100)	103.9	100.5	102.7	97.4	101.6	104.4	Feb 12
Conference Board (1985=100)	127.6	126.7	126.4	119.3	126.6	131.6	Feb 23

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.

U.S. Calendar

Focus for the Week Ahead

- A decline in the seasonally-adjusted unit vehicle sales volume last month from very high levels should have weighed down the total dollar amount of retail expenditures. Spending other than for cars and trucks, however, will likely post a respectable gain, judging from the strong year-to-year rise in our own Goldman Sachs Retail Index (February 11).
- The exceptionally large (6.4% annualized) increase in nonfarm output embedded in the fourth-quarter GDP report implies a sharp further increase in labor productivity at year-end (February 9).
- Preliminary data for December show a large drop in manufacturers' inventories at year-end. This, coupled with a probable significant drawdown of retail vehicle stocks, implies an overall reduction in business inventories (February 12).

Economic Releases and Other Events

Date	Time	Indicator	Estimate GS	Estimate Consensus	Last Report
Tue Feb 9	10:00	Nonfarm Productivity (Q4—Preliminary)	+4.5%	+4.1%	+3.0%
Thu Feb 11	8:30	Retail Sales (Jan)	-0.1%	+0.1%	+0.9%
		Excluding Autos	+0.3%	+0.4%	+0.4%
Fri Feb 12	8:30	Business Inventories (Dec)	-0.3%	+0.2%	+0.4%

- Richmond Fed Survey (Tue, Feb 9 – 10:00)
- Treasury 5-Year Note Auction (Tue, Feb 9)
- Wholesale Trade (Wed, Feb 10 – 10:00)
- Treasury 10-Year Note Auction (Wed, Feb 10)
- Greenspan Testifies Before House Banking Committee on Financial Services Reform (Thu, Feb 11)
- Treasury 30-Year Bond Auction (Thu, Feb 11)
- Atlanta Fed Survey (Fri, Feb 12 – 9:00)
- U. of Michigan Consumer Sentiment—Preliminary (Fri, Feb 12 – 10:00)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.0%	5.0%	4.5%
Forward	5.0	5.0	5.2
2 Year T-Note	4.8	4.6	4.2
Forward	4.8	4.9	5.0
10 Yr T-Note	5.1	4.8	4.4
Forward	5.0	5.0	5.1

Key Numbers in the Business Outlook

	1998 Q4	1999 Q1E	1999 Q2E	1998	1999E
Real GDP	5.6%	2.7%	2.2%	3.9%	3.0%
Ind. Prod., Mfg.	5.1	4.1	2.4	4.2	2.6
CPI	1.9	2.1	1.6	1.6	1.8
After-Tax Profits*	6.2E	4.0	4.8	3.1E	1.0
Unemployment	4.4	4.4	4.4	4.5	4.5

* Excluding inventory profits; adjusted for depreciation distortions.

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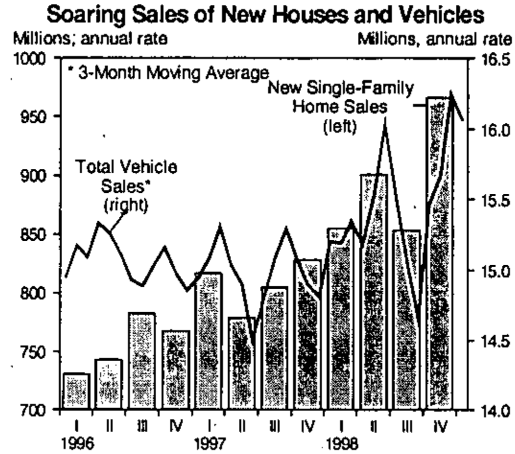
Goldman Sachs

U.S. Economics Analyst

Brazil: Probably Only a Small Effect on U.S. Growth

- U.S. consumers clearly did not make any New Year's resolutions about thrift, as reports on car sales and business at major retail chains in January were quite strong. With home sales also hitting all-time highs late last year, the momentum of domestic demand remains unabated.
- This momentum is providing a lift to the U.S. manufacturing sector. Orders were up sharply in December, and the NAPM composite index bounced in January, bringing it into closer alignment with other survey data.
- January's job report likewise indicates little, if any, slowing in hiring trends, while the tight labor market has pushed average hourly earnings growth back up to 4%. Thus, the strength in consumer income that has fueled spending is set to continue.
- Based on all of these indications, our estimate of 2.7% annualized growth for the first quarter now looks too low. A figure in the 3%-3½% range seems more appropriate; we will make a more specific adjustment when we review the entire forecast in the February *Pocket Chartroom.*
- Against all of this domestic strength, the impact of the devaluation of the Brazilian Real may well be obscured. Based on the experience of earlier episodes (Mexico in 1994-1995 and Asia in 1997-1998), as well as the parameters of the latest shock, we conclude that its impact will be about ¼% of U.S. GDP. Because Brazil is a small trading partner (2.2% of exports), the potential for a much bigger effect depends on contagion into Mexico and/or the U.S. stock market, neither of which has happened so far.

Soaring Sales of New Houses and Vehicles



Source: Department of Commerce.

Mexico Dominates U.S./Latin America Trade Relationships

Note: Data are calculated on a 12-month moving average ending in November 1998.
Source: Department of Commerce.

Trade Recommendations

- Stay short March '99 T-bond futures (currently 124.20); lower target to 120.00 and lower the stop to a close above 126.16.
- Close out the Eurodollar "millennium butterfly" position (long December '99 Euros vs. a combined short in September '99 and March '00 contracts), at the current level of 23 basis points.

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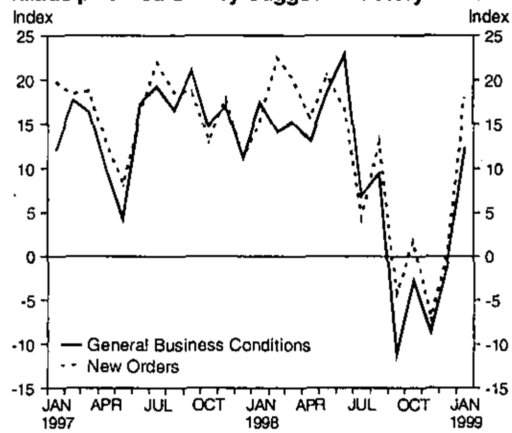
Goldman Sachs

U.S. Economics Analyst

Y2K Fears Will Boost Growth, but Rate Spike Is Unlikely

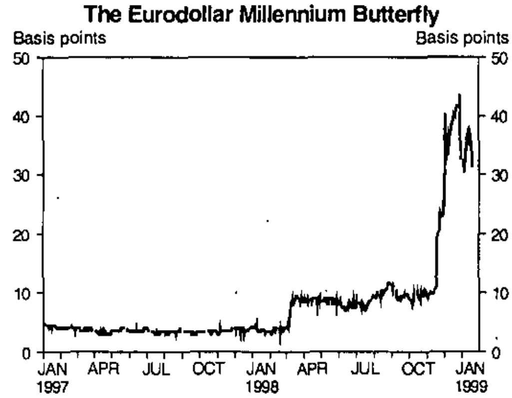
- The possibility of tax cuts in 1999 has increased for three reasons: (1) Budget surplus projections continue to rise, suggesting that sufficient funds are available to put Social Security on a sounder footing and cut income taxes; (2) as a result, President Clinton no longer proposes to use the entire surplus to fix Social Security; and (3) the Republicans are united on this issue, with Senator Domenici now favoring across-the-board cuts in personal income taxes.
- Chairman Greenspan's testimony indicates that monetary policy is locked on hold for the foreseeable future. Although the Chairman would like equity prices to stop rising fast, he shows no inclination to tighten for that purpose.
- The economy remains vibrant, with strength in housing starts in December and the Fed's "beige book" report indicating "solid growth." Moreover, there are signs that the strength of the domestic economy is beginning to prop up the ailing manufacturing sector.
- Fears of Y2K disruptions should generate precautionary behavior, including a buildup of materials and supplies inventories by manufacturers and an increase in financial liquidity by households and businesses.
- This inventory building is likely to boost real GDP growth significantly in the fourth quarter of 1999. However, the desire for greater financial liquidity is not likely to cause a spike in short-term interest rates because the Federal Reserve will supply sufficient liquidity to keep the federal funds rate stable. Instead, increased demand for "safe" assets should result in lower interest rates on Treasury bills and coupons maturing shortly after year-end.

Philadelphia Fed Survey Suggests Factory Rebound



Source: Federal Reserve Bank of Philadelphia.

The Eurodollar Millennium Butterfly



Note: Calculated as the December '99 Eurodollar futures yield minus the average of the September '99 Euro yield and March '00 Euro yield.
Source: Goldman Sachs.

Trade Recommendations

- We would stay long December '99 Eurodollar futures against a September '99/March '00 butterfly, with a target of 15 basis points and a stop on a close above 45 basis points.

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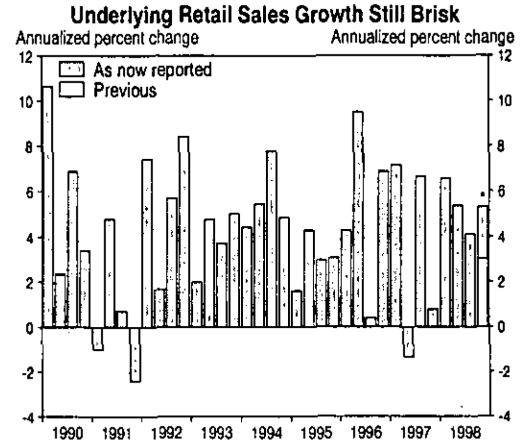
Imports: How Deep a Cushion?

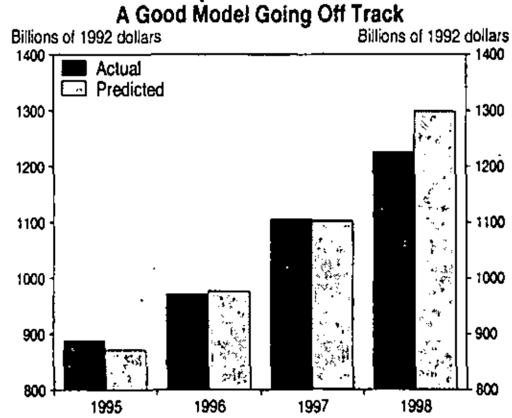
- The U.S. economy barreled into the holiday season on a strong, noninflationary growth track. Consumers continued to increase spending well ahead of income gains, judging from the latest data on retail sales and installment borrowing. Meanwhile, indexes of producer prices fell at all stages of production in November.
- Thus, our outlook for slower growth in 1999 remains very much a forecast, with little hard supporting data outside the factory sector. On a more anecdotal level, the latest Federal Reserve "beige book" summary of regional economic conditions detected a pattern of slower growth.
- If growth in domestic demand does slow, then reduced growth in imports is likely to cushion the effect on real GDP in 1999. Already, growth in real imports is falling well short of predictions based on historical relationships, with growth in real domestic demand, which is currently strong, and changes in the relative prices of imports and domestic goods and services, which are falling.
- An analysis of imports by major product type confirms that demand is the key driver of import growth. It also suggests that the import cushion will be bigger to the extent that the slowdown is tilted toward reduced demand for computers and other capital equipment, where the penetration by foreign products is deepest.
- However, because the United States is the prime locomotive for world growth, a material slowing in U.S. import growth would heighten the risk of a prolonged stagnation in the global economy, with attendant risks of reduced U.S. export growth down the road.

Underlying Retail Sales Growth Still Brisk



* Based on available data.
Source: Department of Commerce.

Import Forecasts: A Good Model Going Off Track



Note: 1998 values through Q3.
Source: Department of Commerce. Our calculations.

Trade Recommendations

- Buy 10-year Treasury Inflation-Protection Securities (TIPS) outright (current yield 3.81%) with a yield target of 3.50% and a stop on a close above 4.00%.

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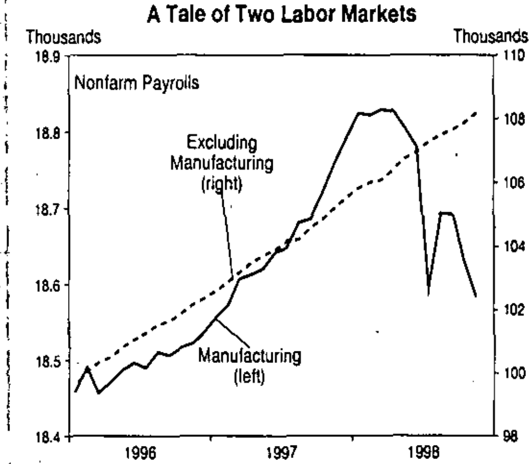
U.S. Economics Analyst

Reflections on the Turmoil in the Capital Markets

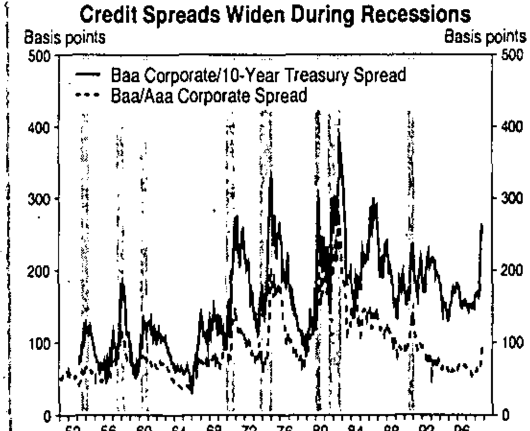
- November's employment report, which featured a drop in unemployment and a bounce-back in nonfarm payroll growth, confirms the strength in other recent reports. As a result, we have lifted our estimate of real GDP growth in the fourth quarter to 3.5% from 2.7%. However, we still expect growth to slow sharply during 1999, to 1.5% on a fourth-quarter-to-fourth-quarter basis.
- The U.S. growth story remains a tale of two economies, with the manufacturing sector shedding 47,000 jobs in November, purchasing agents reporting the weakest factory conditions since February 1996, and orders dropping in October.
- The sharp decline in oil prices should help contain inflationary pressures and boost the purchasing power of the U.S. consumer. At the same time, it exerts additional pressure on already battered oil-producing emerging economies, which could get recycled back to the United States.
- The lesson from recent capital market turmoil is that sharp adjustments are likely to occur more frequently than in the past. This reflects the fact that information is transmitted more rapidly in today's global capital market system whenever financial and economic shocks occur.
- Even so, the recent spasm in the capital markets is unlikely to have much impact on the economy's growth trajectory. The Federal Reserve's easing steps have helped pull down borrowing costs and settle markets, and banks and other financial intermediaries have acted as safety valves to accommodate borrowers temporarily shut out from the capital markets.

A Tale of Two Labor Markets



Source: Department of Labor.

Credit Spreads Widen During Recessions



Source: Federal Reserve Board. Moody's Investors Service.

Trade Recommendations

- We would remain neutral for now.

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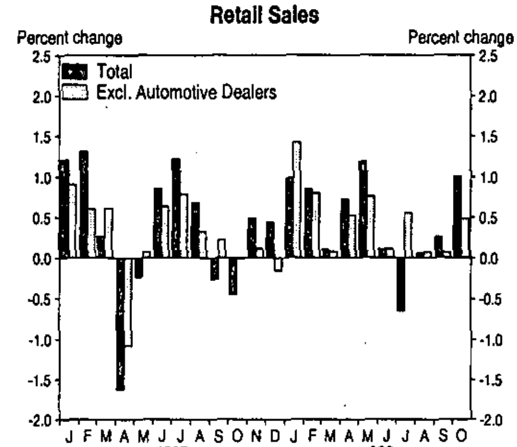
Goldman Sachs

U.S. Economics Analyst

Capital Spending: A Tale of Two Forces—Return v. Utilization

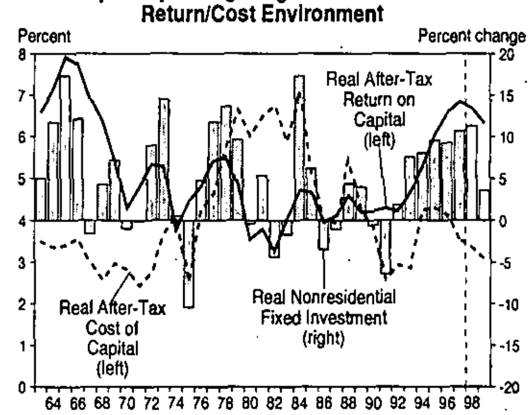
- The probabilities still tilt slightly in favor of a 25-basis-point cut in short-term interest rates at the November 17 FOMC meeting, mainly as an insurance policy to avoid a renewal of recent credit supply disruptions. If this does occur, the accompanying statement may signal heightened patience and a renewed focus on U.S. growth prospects as the key factor. If it does not, then Fed policy will probably stay on hold through year-end barring renewed market turmoil.
- Retail sales surged in October, led by auto sales but bolstered by widespread gains in other areas. Meanwhile, September's 1.2% jump in stocks at wholesale distributors foreshadows either an upward revision to last quarter's 3.3% real GDP growth rate or a persistently wide trade deficit. Although prices of finished goods rose more than expected in October, there is no evidence of pressure deep in the production pipeline.
- Capital spending in the 1990s has benefited from the favorable combination of a high and rising return on capital and a low cost of capital. As a result, its normal link with capacity utilization has broken down. However, signs that the rate of return on capital has peaked (including the persistent weakness in utilization) suggest that this link will reconnect over the next year or so.
- If growth in capital spending does slow, the initial effect may be more to contain the damage to the trade balance than to hurt GDP growth. However, in a world economy looking toward the United States to be the locomotive for growth, the weakness may eventually come home to roost via reduced exports.

Retail Sales



Source: Department of Commerce.

Capital Spending Surges in a Favorable Return/Cost Environment



Source: Federal Reserve Board. Department of Commerce. Standard and Poor's. Goldman Sachs.

Trade Recommendations

- Stay long December T-bond futures (currently 127.17), maintaining a target of 133.00, and moving the stop up to a close below 125.24.

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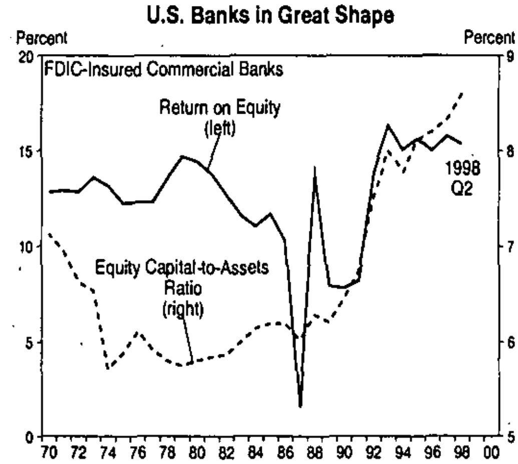
More Crimp Than Crunch

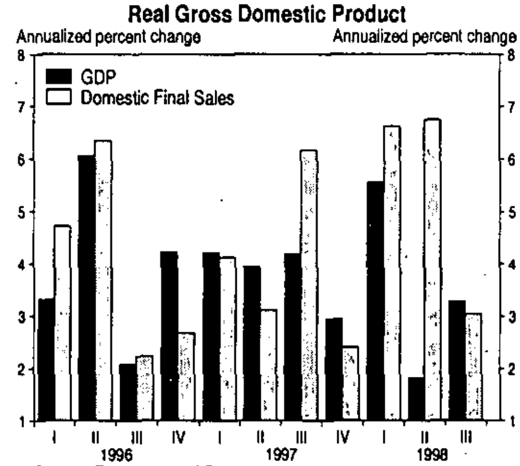
- Fears of a credit crunch appear overblown. For most borrowers, interest rates have declined despite the widening in credit spreads, and the problems have been confined mainly to the capital markets. The banking system is in excellent shape, in sharp contrast to its condition on the eve of the last economic downturn.
- The widening in credit spreads reflects both a deterioration in the economic outlook—an increased risk of recession—and the fact that the sharp change in the outlook caught many investors, who had underestimated the risks associated with credit products, "off-sides." They have responded by reducing their risk positions sharply.
- Even if the upward pressure on credit spreads were to subside, the U.S. economy remains vulnerable in several other respects. A slowdown in Latin America is likely to lead to further trade drag, consumption is vulnerable to a decline in equity prices given the depressed saving rate, and capital spending growth is likely to slow sharply because capacity utilization rates are declining.
- A sharp slowdown in economic activity remains more of a forecast than a reality. Real GDP growth advanced 3.3% at an annualized rate last quarter, led by strong gains in consumption; durable goods orders in September advanced sharply, with an especially large gain in nondefense capital goods orders, excluding aircraft; and compensation increases were greater than expected as the employment cost index rose by 1.0% in the third quarter. However, two signs that point to slower growth are also evident: Inventories rose much more quickly last quarter, and consumer confidence continues to sink.

U.S. Banks in Great Shape



Source: Federal Deposit Insurance Corporation. Our calculations.

Real Gross Domestic Product



Source: Department of Commerce.

Trade Recommendations

- Go long the December '98 bond futures contract (currently 129.03) and short the March '99 eurodollar futures contract (currently 95.585).

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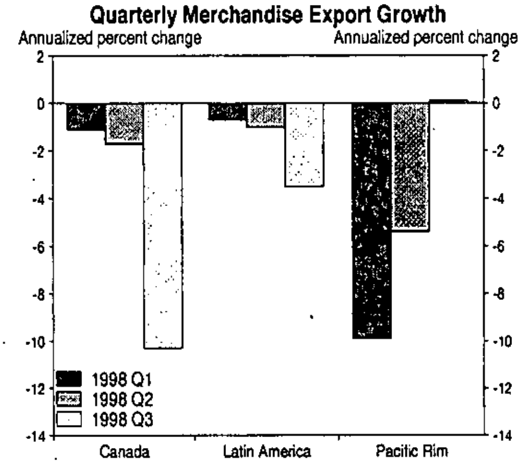
Goldman Sachs

U.S. Economics Analyst

Refinancing: Not Much Help for Growth . . . So Far

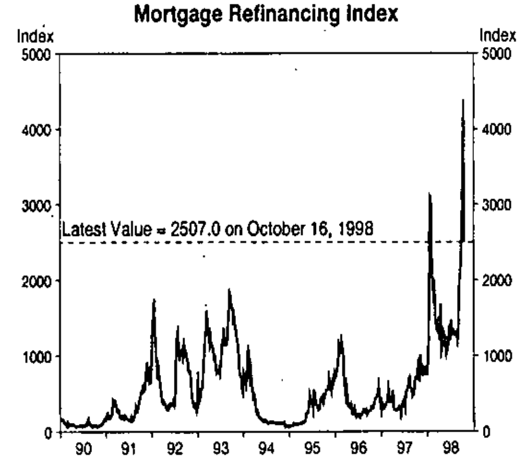
- Last week's pattern of weaker-than-expected news on U.S. economic activity continued with fresh readings on international trade and housing starts. The September setback in housing was mainly due to hurricanes and therefore not fundamental, but the same cannot be said for the trade deficit, which hit a new record in August. Underlying this rise is a disturbing shift in relative weakness from trade with Asia to trade with partners in the Western Hemisphere.
- Recent statements by Fed officials indicate that the October 15 easing was in response to a general worsening in credit availability rather than indicative of a specific unheralded problem. Although the equity market has surged in response, credit quality spreads remain quite wide, especially in the commercial paper market.
- A widening in spreads between mortgage rates and Treasury yields, coupled with an extremely flat yield curve, has prevented borrowers who are refinancing mortgages from realizing large cuts in interest expense. This, coupled with an already high level of household debt, suggests that the economy will not get the same type of boost from refinancing as it did in 1992-1993, despite a comparable volume of such activity.
- A shift in public opinion polls has eased the fears of some Democrats that they will suffer big losses in the mid-term congressional elections two weeks hence. However, bulging campaign coffers and the risk of low turnout still tilt the probabilities toward moderate GOP gains.

Quarterly Merchandise Export Growth



Source: Department of Commerce. Our calculations.

Mortgage Refinancing Index



Source: Mortgage Bankers Association of America.

Trade Recommendations

- Although we would stay neutral for the time being, we would look to buy long-term Treasury bonds should yields continue to drift higher.

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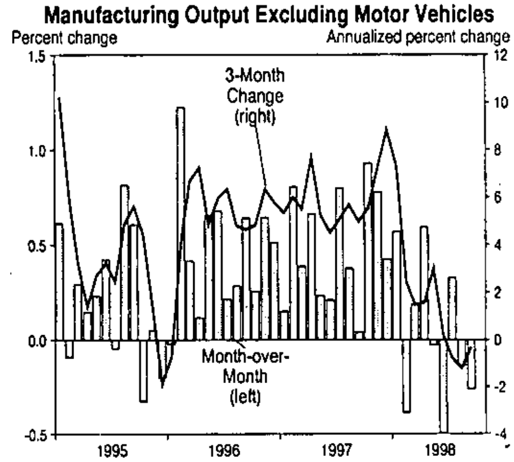
Goldman Sachs

U.S. Economics Analyst

Capital Spending Resting on Pillars of Salt

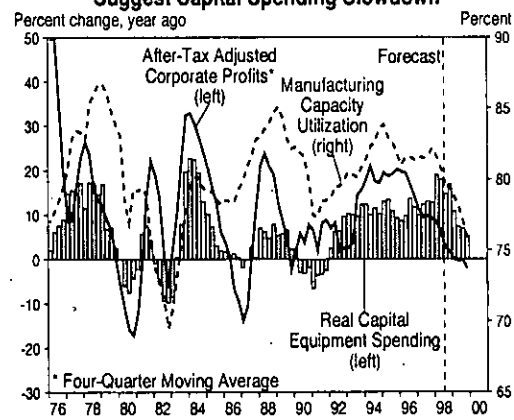
- The decision of Chairman Greenspan to cut the federal funds rate and discount rate between FOMC meetings indicates a growing concern with unsettled capital market conditions. Fed officials are undoubtedly disturbed by the increasing illiquidity evident not just in longer-dated fixed income assets, but also in money market instruments, including commercial paper. The Fed's action should help smooth the waters as it is a strong signal that the monetary authorities will do whatever it takes to provide liquidity and buttress the economy against the forces that are likely to lead to a substantial slowdown in 1999.
- The timing of future rate cuts depends critically on how successful this week's move is in calming financial markets. But regardless of how it is received, further rate moves are in the offing as the economy slows. The manufacturing sector in particular already appears quite weak. We reiterate our view that the federal funds rate will decline to around 4% before yearend 1999.
- Capital spending—which surged at over three times the overall rate of economic growth in the 1990s—is now resting on eroding pillars of salt. Deteriorating corporate profitability, falling exports, declining utilization rates, less accommodative financial conditions, and issues relating to the Y2K bug all point toward a capital spending slowdown in 1999.
- Comparisons of this decade's investment boom with the late 1920s or the Japanese bubble of the 1980s seem premature at this point, though they could gain more credence should a capital spending slowdown not materialize soon.

Manufacturing Output Excluding Motor Vehicles



Source: Federal Reserve Board.

Profits and Capacity Utilization Suggest Capital Spending Slowdown



Source: Department of Commerce, Federal Reserve Board.

Trade Recommendations

- We would stay neutral for the time being.

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Important disclosures appear on the inside back cover.