

Quarterly Economic Update

Analysis by RBS Group Economics and
RBS Greenwich Capital

Fed Policy Monitor

The economy has held up surprisingly well in the wake of three major hurricanes this season, Katrina, Rita, and Wilma. The direct physical disruptions, especially from Katrina, turned out to be less of a negative for economic activity than anticipated, as precautionary buying and charitable donations of necessities appeared to offset any loss of consumer demand due to the dislocation of a significant number of households, primarily in the New Orleans area.

The more important issue for the economy has been the spike in energy prices. However, with the notable exception of natural gas, energy prices have been moderating in recent weeks. In particular, prices for gasoline, which represents more than half of the average household's energy budget, have dropped precipitously since early October and are currently at their lowest levels since early July.

Business activity has also been robust since Katrina, as the manufacturing sector has more than survived the energy cost spike and supply disruptions, with orders and shipments outside of the energy industry actually accelerating, based on the ISM and various regional surveys.

The other half of the hurricane impact on the economy is the inflation picture. It is probably still too soon to know yet whether the bulge in commodity prices will cause a significant acceleration in core consumer prices, though anecdotal

reports are beginning to filter in suggesting that some firms are beginning to more aggressively test the waters. In any case, **inflation risks have undoubtedly risen, and the economy, after working through the headwinds caused by Katrina, Rita, and Wilma, should enjoy a period of tailwinds generated by falling energy prices and reconstruction efforts, mostly in the first half of 2006.**

GDP growth over the past eight quarters has been remarkably stable, fluctuating within a narrow band of 3.3% and 4.3%, and has been consistently at or above trend since the summer of 2003. As a result, the economy has absorbed the bulk of the slack in labor and product markets that had developed during the recession and subsequent sub-par recovery early in the decade. The unemployment rate and labor force participation rate as well as the flow of anecdotal reports on labor markets suggest that the economy is nearing at full employment. Similarly, capacity utilization rates have recovered rapidly from multi-decade lows and, after a

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New Fed Strategy

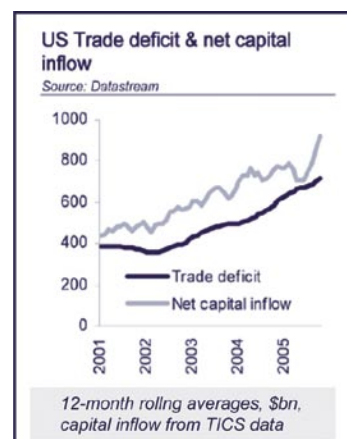
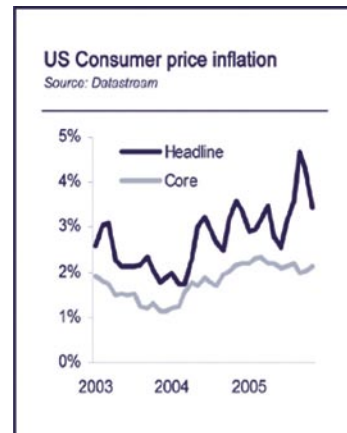
The Federal Reserve raised rates once more, but the tone of its policy statement shifted significantly. Underlying inflation ticked-up in November and the industrial sector strengthened, while the trade gap reached another all time high in October.

The Fed's decision to raise interest rates by another quarter point to 4.25% was no surprise, but the accompanying statement raised a few eyebrows. Policymakers no longer characterized the level of interest rates as stimulating economic activity. Many analysts will no doubt leap to the conclusion that the end of the rate hiking cycle is just around the corner - but don't count on it. Later in the statement the Fed makes clear that, "further measured policy firming is likely to be needed." Indeed, the amount of forward momentum in the economy and signs of rising inflation point to several more rate hikes ahead. Nevertheless, the Fed's change in tone has come earlier than we had expected and there is a risk that interest rates will peak at a lower level than previously anticipated, although market expectations of a peak of 4.5% are likely to prove wide of the mark. Incoming data releases will be more crucial than ever in determining the future course of interest rates – especially the inflation gauges.

Inflation data for November suggest that price pressures are starting to build, albeit gradually. The next few readings are likely to be crucial for the inflation outlook as businesses think about their pricing strategy for the year ahead. Signs that past increases in energy costs are feeding through to the retail prices of goods and services would help ensure the Fed keeps on the tightening track through much of next year.

Industrial production continued to accelerate in November after the hurricane-related disruptions seen in previous months. Output increased at a 2.8% year-on-year rate, up from 2.3% in October and 1.7% in September. Capacity utilization increased to 80.2% in November, almost reaching the 80.3% level prevailing before the hurricanes struck and close to the long-term average of 81%. Given that the Fed flagged "increases in resource utilization" as an upside risk to inflation in its statement, the combination of the rise in underlying inflation and higher-than-expected capacity utilization figures should keep the Fed on edge about the price outlook.

Analysts had been expecting the trade deficit to narrow by around \$3 billion during the month in October, but instead it widened by that amount, reaching a new monthly record of \$68.9 billion, up from \$66 billion in September. The dollar didn't suffer too much, however, as data from the U.S. Treasury Department showed that the U.S. is having no trouble attracting the financing it needs. Foreign investors purchased a whopping \$107 billion (net) of U.S. assets in September, more than sufficient to cover the trade gap. Nevertheless, these outsized trade deficits leave the dollar vulnerable to shifts in investor sentiment – if the appetite for U.S. assets wanes, the dollar could weaken sharply. ■



hurricane-related dip, should bounce back shortly to within striking distance of their long-term averages.

As a result, **RBS looks for GDP growth to remain close to 4% in the fourth quarter, with around half of the advance stemming from a swing in inventory investment. Looking ahead, lower energy prices should propel GDP gains above 4% in the first half of the year.**

Consumer spending has performed better than feared in the wake of the hurricanes. Excluding autos and gasoline, retail sales jumped by 0.8% in August, 0.8% in September, and 1.1% in October, well above the previous prevailing trend. Still, in light of the sharp hike in energy prices and the drop-off in auto sales after an incentive-induced spike in June and July, expenditures in real terms fell in August and September and were close to flat in October. **The consumer sector has probably already passed through its worst period and should improve considerably.** However, the quarterly data will lag the underlying situation, in that a weak fourth quarter reading is essentially baked in the cake, given the low launching point for the period.

Meanwhile, the business sector has posted surprisingly robust results since the hurricanes, as ISM survey figures, durable goods orders, and the third quarter earnings statements all indicate that corporate America has weathered the shock from Katrina and Rita. However, similar to consumers, business leaders' confidence has dipped in the wake of the energy price spike, and it is not out of the question that caution could lead to a retrenchment in corporate spending. However, for now, RBS looks for continued healthy advances in business outlays.

The 2005 monthly average payroll gain through August of 195,000 exceeds the 2005 pace of 183,000. Moreover, a variety of indicators confirm that, prior to Katrina, hiring was strong. Initial unemployment claims were running lower than last year's range from mid-June through the end of August. Anecdotal and survey evidence (including jobless claims, the Manpower poll of hiring plans for Q4, the Monster.com tally of Internet job postings, the NFIB small business index, the Beige Book, and recent newswire stories) point to ongoing demand for workers since the hurricanes. Thus, payroll gains will probably pick up again going forward, reflecting the recovery of the 200,000 to 300,000 jobs lost from the hurricane and added hiring for rebuilding on top of a robust trend.

The core PCE deflator has been running essentially at or above the 2% mark, the often-cited upper end of the Fed's comfort zone, since before the FOMC began tightening in mid-2004. The year-over-year advance actually slowed from a peak of 2.3% in late 2004 to 1.9% in July but ticked back up to 2.0% in August and September. In contrast, the core CPI steadily accelerated from a low of 1.1% at the end of 2003 to a peak of 2.4% in March before pulling back somewhat this summer (the September reading fell to 2.0%, but the gauge ticked up to 2.1% in October).

Looking ahead, robust domestic demand would make consumers somewhat less price sensitive and thus allow businesses to gain more pricing power, a process which appears to have been slowly but surely occurring for some time. In any case, firms would love to pass along more of their heightened input costs. Still, core inflation should increase only gradually. **RBS looks for the core PCE deflator to increase by close to 2% for the 12 months of 2005, at the top of the Fed's desired range but not enough to provoke the FOMC to step up the pace of tightening, and to pick up further, perhaps to around 2 1/2%, in 2006.**

Near-Term Fed View:

The FOMC tightened by 25 BP on November 1 and left the key elements of the statement essentially unchanged. By retaining the ideas that policy is accommodative and that the accommodation will likely be removed at a measured pace, the Committee presumably wanted to signal that it foresees additional rate hikes as necessary just to get policy back to a neutral stance.

Longer-Term Outlook:

Despite Hurricane Katrina, real GDP growth accelerated to 3.8% in Q3 (probably even higher when the revised figures are released) and RBS believes it should remain in the 4% vicinity in Q4 and pick up somewhat further in the first half of 2006.

Meanwhile, consensus estimates have projected (both before and after Katrina) that activity will be noticeably cooler. The difference between these two views is critical, since the mainstream forecast corresponds to a pace that is no better than the potential growth rate (the Blue Chip consensus forecast calls for increases in real GDP of 3.5% for 2005 and 3.3% for 2006).

In contrast, RBS looks for real GDP to rise at a pace that is fast enough to erode the remaining slack in resources, which has already been diminished greatly. As a result, **we expect the Fed to tighten by 25 BP at each of the next several FOMC meetings.** Fed Policy Monitor continued from page 5 RBS's empirical work suggests that the neutral rate may be in the 4 1/2% to 5% range, so that even if the Fed continues to tighten, policy should remain accommodative until at least early 2006. Furthermore, given the prospect of above-trend growth, tightening labor

and product markets, and thus building inflation pressures, the Fed will, in our view, likely have to take policy to a modestly restrictive stance in 2006. After the recent rally in fixed income markets, the Eurodollar strip has essentially taken out almost all odds of Fed tightening beyond 4.50% (there is basically no spread between the March 2006 and December 2006 contracts). Thus, **our call of a 5% funds rate by mid-2006 and remains sharply more aggressive than the consensus view.** ■

The table below sorts developments according to how they might rate on a Fed policy scale. The factors that are most critical are in bold face.

	- (Tightening Direction)	Neutral (Policy on Hold)	+ (Easing Direction)
GDP	<ul style="list-style-type: none"> • Real GDP growth advanced at an above-trend pace of 3.8% in Q3, despite the effects of Hurricanes Katrina and Rita • Real domestic demand (GDP minus inventories and trade) has expanded at an average annual pace of 4.3% over the past 10 quarters 		
Consumer Sector	<ul style="list-style-type: none"> • Retail sales excluding autos and gasoline jumped by 0.8% in Aug. and Sep. and 1.1% in Oct., despite the spike in energy prices • Chain store sales have been surprisingly healthy since Hurricane Katrina • Gasoline prices have plunged in late Oct. and early Nov., reaching 4-mo. lows, and are down over 25% from their peak 	<ul style="list-style-type: none"> • Gasoline prices spiked from July through early Oct., curtailing household purchasing power • Unit auto sales plunged in Oct. (14.7 mil. units annualized), the worst result since 1998, but a new round of incentives suggests a rebound by year-end • Consumer attitude indices plummeted in Sep. and Oct. The U. of Michigan measure plunged to its worst reading since 1992 (74.2) in Oct. before rebounding in early Nov. (79.9), and the Conference Board index fell by 20 points from Aug. to Oct. (to 85.0). 	
Housing Sector	<ul style="list-style-type: none"> • Existing home sales were flat in Sep. (7.28 mil. units a.r.), just shy of June's all-time high. Meanwhile, mortgage applications for purchase were steady near all-time highs from June through Sep. and, despite a dip in Oct., have barely softened since this summer • Housing starts have exceeded the 2 million unit mark for 10 of the last 11 months (2.014 mil. units a.r. in Oct.) • The OFHEO home price index jumped by 13.4% over the 4 quarters ending in June, the steepest appreciation since 1979 	<ul style="list-style-type: none"> • New home sales have eased somewhat from all-time highs in July (Sep. 1.22 mil. units a.r.) • 30-year fixed mortgage rates have risen by 84 BP since early July to 6.37%, the highest level in over 2 years. As a result, mortgage applications for refinancing in the week ended 11/11 (1702.4) fell to the lowest pace of 2005 • There is increasing anecdotal evidence that housing demand is beginning to moderate from the unsustainably strong pace seen earlier in the year 	
Capital Spending	<ul style="list-style-type: none"> • Business purchases of equipment and software have advanced at an annualized pace of at least 8% in each of the past 7 quarters through 2005 • Operating profits of domestic corporations rose by 16.8% over the past 4 quarters • Nondefense capital goods orders excluding aircraft have been choppy from month to month but rose at a 7% annualized clip in the 6 mos. through Sep. 	<ul style="list-style-type: none"> • Business investment in nonresidential structures is essentially unchanged in real terms since the end of last year 	
Foreign Sector	<ul style="list-style-type: none"> • Exports have been trending up since mid-2003, with merchandise exports up by more than 10% per year over past 2 years 	<ul style="list-style-type: none"> • Steep increases in imports since mid-2003 indicate that a substantial portion of growth in domestic demand is being filled by overseas producers 	
Inventories	<ul style="list-style-type: none"> • A return to a more normal pace of inventory accumulation after the Q2 and Q3 drawdowns will likely add noticeably to GDP growth in Q4 	<ul style="list-style-type: none"> • Inventory drawdowns subtracted 2.1 percentage points from Q2 GDP growth and 0.6% from Q3 	
Manufacturing	<ul style="list-style-type: none"> • After moderating in August, the ISM factory index jumped to 59.4 in Sep., the best reading in over a year, and held at 59.1 in Oct. • Factory output rebounded by 1.7% in Oct., mainly reflecting the return of striking machinists at Boeing. Further recovery from hurricane-damaged facilities in the Gulf region should boost production in coming months 	<ul style="list-style-type: none"> • The factory capacity utilization rate remains low by historical standards (the long-run average is 79.8%) but has risen by over 6 percentage pts. since May 2003 (79.0% in Oct.) • Despite a rise in Oct. caused by the end of the Boeing strike, manufacturing payrolls have fallen in 11 of the past 14 months 	
Employment	<ul style="list-style-type: none"> • The unemployment rate declined in Oct. to 5.0%, just above the lowest reading since Sep. 2001 • Payroll growth averaged 195K from Jan. through Aug., faster than 2004's 183K gain per month, before hurricane distortions stalled hiring • The household survey has registered vigorous increases in the labor force (1.9 million) and employment (2.5 million) over the past 8 months 		
Inflation	<ul style="list-style-type: none"> • Core PCE deflator has been running close to or above the key 2% mark on a year-over-year basis for over a year • Hurricane Katrina has exacerbated energy price pressures and may be making it easier for firms to pass along higher input costs to their customers. The core intermediate PPI has posted back-to-back 1.2% surges in Sep. and Oct., the largest monthly rise since 1980. 	<ul style="list-style-type: none"> • Core inflation has been benign since April, with the 12-month gain in the core PCE deflator hovering around 2%, down from 2.2% in 2004 	
Other	<ul style="list-style-type: none"> • Firming income tax receipts confirm economic strength and led to a smaller federal budget deficit in FY 2004 than previously expected (\$413 bil.) and to a sharp improvement in FY2005 to \$318 bil. 		
Notes, quotes,	<ul style="list-style-type: none"> • 11/1 FOMC Statement: "Monetary policy accommodation, coupled with and anecdotes robust underlying growth in productivity, is providing ongoing support to economic activity that will likely be augmented by planned rebuilding in the hurricane-affected areas." • Guyonn: "By most conventional measures, policy is still accommodative. So I believe the continued removal of that monetary accommodation is appropriate for now." (10/20) • Yellen: "The very notion that a neutral policy stance is appropriate is premised on the assumption that inflation is and will remain well-contained in a zone corresponding to price stability." (10/18) 	<ul style="list-style-type: none"> • Guyonn: "Clearly, the risks to inflation are elevated, but I believe price increases are likely transitory and will not significantly change the long-term inflation outlook." (10/20) 	

State of the Economy

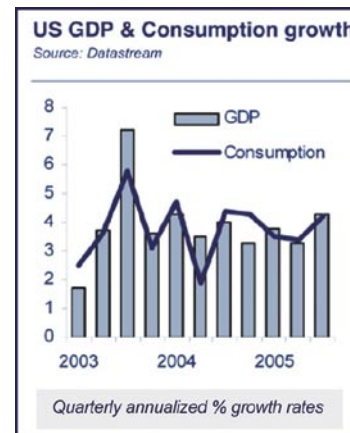
The flood of data releases pointed to an economy galloping ahead. Revised GDP data show that the economy came through the initial onslaught of Hurricane Katrina without missing a beat, while payroll figures and a key manufacturing survey suggest the economy maintained its forward momentum through Q4.

Data revisions show that the economy grew at a much more robust pace in the third quarter than first thought, expanding by 4.3% (quarter-on-quarter annualized) compared to the initial estimate of 3.8%. This performance is little short of astounding. Even though the economy was struck by hurricanes and energy prices surged, the economy still managed to notch up the second-best performance of the current expansion.

A swing in the inventory cycle should give a significant boost to growth. Firms have been drawing down inventories as they have struggled to keep up with domestic demand – as a result the inventory to sales ratio is at a record low. Anecdotal evidence points to significant stock rebuilding in Q4, which could potentially keep the overall GDP growth rate close to 4%. While the economy has this much momentum, gasoline prices are moderating steadily and with post-hurricane reconstruction due to ramp up in the quarters ahead, it is hard to believe the Federal Reserve is close to calling a time out in its rate hiking program.

The disruption caused by the Hurricanes has meant that it has been impossible to properly take the temperature of the labor market for several months, but the fog finally appears to be lifting and things are looking good. After increasing by just 17,000 in September and 44,000 in October, firms added a healthy 215,000 new positions in November. This figure is well above the 196,000 average monthly gain recorded in the January to August period. Job growth is likely to remain robust in the months ahead as the workers displaced by the hurricanes are gradually reabsorbed. The unemployment rate held steady at 5% - close to most estimates of full employment (the lowest rate consistent with stable inflation). The hourly wages moved up (to 3.2% YOY) which, along with sporadic reports of labor shortages in some regions for certain professions in the Beige Book, adds to the picture of a tightening labor market. This scenario provides yet another compelling reason for the Fed to keep moving interest rates steadily higher.

The ISM survey of manufacturing activity moderated in November, but at 58.1 remained at an elevated level, well above the 50 reading that indicates stable output (historically a reading of 58.1 has been associated with GDP growth of around 5.5%). The new orders and production sub-indices moderated, but continued to point to a robust pace of expansion. There were some reassuring signs on the inflation front for once. The index tracking prices paid by firms for their inputs moderated by ten percentage points, although at 74 it continued to signal that input costs were rising at a very rapid rate. Respondents' comments also suggest that firms are more sanguine about energy prices, on the whole stating that they were "concerned" rather than "worried" as in previous reports. For the Fed, the issue of paramount importance is whether the rapid input cost increases that we have seen in previous quarters will be passed along to consumer prices. The evidence from a recent Beige Book report suggests that it is becoming more of an issue, but that it is not yet pervasive. ■



Oil and Gas Index

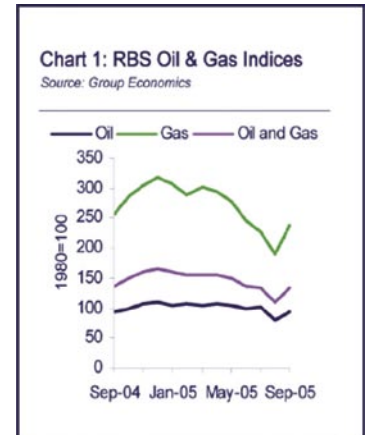
As expected, production of oil and natural gas rebounded strongly in September as most companies completed scheduled maintenance during the summer. However, despite an increase in the number of rotary rigs, operators have failed to increase production compared to one year ago. Although commodity prices have receded from recent all-time highs, the environment remains supportive for exploration, development and production.

Crude oil prices continue to moderate. The front-month contract for the North American benchmark West Texas Intermediate fell to its lowest level since June in mid-November. Ample supplies and increased drilling activity have contributed to the recent fall. There has also been a response on the demand side although as prices have eased recently, this has supported a pick up in consumption such that it now stands up year-on-year.

The Royal Bank of Scotland's outlook for crude oil calls for further price moderation, as current trends continue. Commercial crude oil stocks have been replenished in the U.S. and continue to stand well above the five-year average for this time of the year. Moreover, the Strategic Petroleum Reserve has been filled to capacity, indicating that some spare capacity already exists in petroleum markets. The picture is similar throughout the OECD. Thus, it is hard to avoid the conclusion that crude supplies are plentiful.

Supply growth is unlikely to decelerate going forward, as investment in the exploration and development of new fields continues apace, promising even further production

gains. Baker Hughes reports that the number of rotary rigs operated outside North America increased by more than 7% between October 2004 and October 2005. In Britain, the rig count increased from 15 to 19 over the same period. However, it has been difficult for North Sea operators to leverage increased activity into higher output so far.



The severest upside risk to the outlook for petroleum markets is a short-term price spike in refined product prices, especially if the upcoming winter is severe. Middle distillates are particularly susceptible to a supply squeeze. Inventories here are in the lower end of the average just as seasonal demand is picking up and refining capacity remains tight. In the longer term, this problem ought to be rectified by additional refining capacity scheduled to be built in Asia and the Middle East.

Strength of the Dollar

Through mid-November, the dollar consolidated recent gains against major currencies, including Sterling, due to robust economic growth in the U.S. The solid performance has confirmed market expectations that the Federal Reserve will continue its gradual tightening of monetary policy, which will support the dollar. ■

Table 1 Oil and Gas Index Key Statistics							
	Daily Avg Oil Output (bpd)	Daily Avg Gas Output (mmcf/d)	Total Daily Avg Output (boe)	Monthly Brent Average \$ per barrel	Avg Daily Oil Value (£ million)	Provisional Total Avg Daily Value (£ million)	US\$/£
Sep-04	1,526,692	8,716	3,061,159	42.92	36.6	55.87	1.79
Oct-04	1,630,230	9,677	3,333,967	49.66	44.8	66.25	1.81
Nov-04	1,748,744	10,385	3,577,079	42.88	40.3	63.31	1.86
Dec-04	1,800,309	10,823	3,705,753	39.55	36.9	60.91	1.93
Jan-05	1,725,929	10,489	3,572,558	44.24	40.7	63.90	1.88
Feb-05	1,743,275	9,825	3,473,106	45.40	41.9	63.71	1.89
Mar-05	1,705,214	10,217	3,503,999	52.95	47.4	70.05	1.90
Apr-05	1,750,111	9,961	3,503,742	51.83	47.8	69.91	1.90
May-05	1,723,598	9,451	3,387,563	52.95	47.9	68.86	1.90
June-05	1,610,263	8,351	3,080,424	54.45	48.2	66.73	1.82
July-05	1,657,880	7,760	3,024,114	57.59	54.5	71.72	1.75
Aug-05	1,322,106	6,424	2,453,129	64.08	47.2	61.44	1.79
Sep-05	1,546,138	8,125	2,976,535	62.91	53.8	71.79	1.81

Notes: Gas prices are provisional and sourced from DTI's Quarterly Energy Prices. Oil & Gas output figures are provided by the operating companies and are subject to revision. All other figures from Datastream. Gas production figures from Shell estimated using average production movements for the past 12 months.

Source RBS Group Economics

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