

US Quarterly Economic Update

Analysis by RBS Group Economics and
RBS Greenwich Capital

Economic Overview

The balancing act of remarkably stable GDP growth (between 3.3% and 4.3% annualized) for eight consecutive quarters ended in the fourth quarter, when activity sagged to a 1.6% clip. The slump reflected several factors. First, real consumer spending advanced at an anemic pace (1.2% annualized) mainly due to the spike in energy prices before and after the hurricanes.

Outlays dropped sharply in real terms in both August and September. There was an equally dramatic rebound in November and December, once energy prices pulled back, but it occurred too late to rescue the Q4 average. Second, the trade gap swelled, as the U.S. was forced to import energy supplies (not only crude oil but also gasoline and other refined petroleum products as well as natural gas) to compensate for damaged capacity in the Gulf region. Third, federal government spending plunged by 7% annualized, almost entirely retracing the third quarter surge (the bulk of both moves occurred in defense outlays). Finally, the gain in business investment in equipment and software was surprisingly soft, with the Commerce Department estimating a puzzling drop in aircraft deliveries. **Data released since late February point to another upward revision to the Q4 figure, though the growth rate will probably still fall short of 2% (perhaps around 1.9%).**

Most of the factors that dampened the economy in the fourth quarter likely reversed in the first quarter. The 0.9% and 0.7% gains in real consumer spending in November and December respectively suggest that a sharp acceleration in consumption for Q1 was essentially baked in the cake before the three-month period even began. The 0.4% real advance in January further underpins a robust result (we look for 5½% real growth in PCE in Q1). The trade gap may have stabilized in real terms, as Gulf-area production and refining facilities are mostly back on line. Government spending may also have normalized, and the growth in business investment likely returned to prior trends. In all, **GDP could advance by 6% annualized in the first quarter, which would leave the average for the past two quarters between 3½% and 4%, i.e. squarely within the range that has prevailed since late 2003.**

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As a result of the sustained above-trend pace of increase in activity, **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 near or even at full employment. Capacity utilization rates have recovered rapidly from multi-decade lows and, after a hurricane-related dip, reached their long-term averages by the end of last year, indicating no slack in physical capacity. If, as RBS expects, the economy continues to advance at an above-trend pace for much of 2006, especially in the first half of the year, then inflation pressures in the economy should finally begin to accumulate.

Strong Spending

Consumer spending performed better than feared in the wake of the hurricanes, and has remained solid so far this year. Expenditures in real terms fell sharply in August and September and were flat in October but surged in November and December, when energy prices gave back their hurricane-related jumps and auto sales returned to normal. Retail sales exploded in January, as warm weather boosted shopper traffic and the proliferation of gift cards extended the holiday season past New Year's Day, and pulled back somewhat in February. Retail sales excluding autos and gasoline have risen by 7.8% over the past 12 months.

Yet, many analysts continue to argue vehemently that the consumer sector is about to roll over, a refrain that has been constant for at least two years running. In contrast, RBS believes that, with faster income gains and moderating energy prices likely to offset any negative ripple effects of a moderation in home prices, the consumer should continue to spend at roughly the same pace as has been seen over the past several years.

Housing demand is indeed moderating, but construction activity appears to be merely leveling off, as builders still have to work through extremely large backlogs, and home prices were still increasing at a torrid pace late last year.

Over time, a cooling in the housing sector, reflecting less accommodative monetary policy, will be a diminishing stimulus to the consumer, but the data up to now argue against the notion that this process will be quick and dramatic.

Labor: Full Employment?

Meanwhile, the business sector has posted surprisingly robust results since the hurricanes as well, as ISM survey figures, durable goods orders, and industrial production figures all indicate that corporate America has weathered the shock from Katrina and Rita. Similar to consumers, business leaders' confidence dipped in the wake of the energy price spike but has bounced, based on various surveys. Industrial production has recovered most of the hurricane-related losses and many unaffected sectors have been strong as well. Core capital good orders have increased at an 11½% pace over the past three months, and nondefense capital goods shipments have been even stronger, surging by over 12% in the past 12 months. Thus, the puzzling slowdown in business investment in the fourth quarter, the bulk of which was concentrated in transportation equipment, will likely prove temporary.

Payroll gains averaged 165,000 per month in 2005, slightly less than the 2004 pace of 175,000 per month. However, the deceleration was due to Hurricane Katrina, which likely cost the economy around 300,000 jobs in September and October. Some lost jobs were recovered by the end of the year, but a significant amount of posthurricane hiring is likely in 2006, which means that job growth should be somewhat above trend this year. In any case, a variety of indicators suggest that the underlying pace of job growth remains strong. Payrolls have advanced by 228,000 per month after October. Initial unemployment claims, though volatile around the turn of the year, have been running below last year's pace. Anecdotal and survey evidence (including the Manpower poll of hiring plans for Q2, the Monster.com tally of Internet job postings, the NFIB small business index, the latest Beige Book, and recent newswire stories) point to stable or possibly even building labor demand. Meanwhile, the unemployment rate plunged in January to 4.7%, the lowest reading since July 2001, before inching up to 4.8% in February. In addition, **measures of labor force growth and employment gains from the household survey**

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increased substantially in 2005, though the pace moderated after Katrina. The labor force participation rate, which set a 16-year low in March, has hovered within a narrow range for several years and is still noticeably below readings that have historically been consistent with full employment. As a result, **despite the sub-5% jobless rate, it appears that the employment-to-population ratio may be just short of a level that would be consistent with full employment.**

The core PCE deflator has been running around the 2% mark, the often-cited upper end of the Fed's comfort zone, since before the FOMC began tightening in mid-2004. The 12-month advance actually slowed from a peak of 2.3% late in 2004 to 1.8% in January. The core CPI steadily accelerated from a low of 1.1% at the end of 2003 to a peak of 2.4% last March before pulling back somewhat (2.1% in February). 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. This process seems likely to gain momentum in 2006 as labor and product markets tighten. Still, core inflation should increase only gradually. **RBS looks for the 12-month increase in the core PCE deflator to pick up to around 2½% in 2006, enough to convince the Fed to move policy to an outright restrictive stance.**

Near-term Fed View

The FOMC tightened by 25 BP on March 28 and made surprisingly few changes to the statement. Most importantly, the Committee repeated that "some further policy firming may be needed," which conveyed the message that the Fed believed in late March that it will need to raise rates again. **RBS expects the Fed to tighten by 25 BP again at the May 10 FOMC meeting, which would be the 16th consecutive rate hike, a view that is almost fully priced in the fed funds futures market.**

Longer-Term Outlook

The stunning slowdown in GDP growth in Q4, sparked in large part by Hurricane Katrina, should be essentially offset by an explosive gain in Q1, leaving the two-quarter average in line with the prior underlying pace. Looking further ahead, RBS believes that activity will advance at an above-trend rate for much of 2006, especially in the first half of the year, as our empirical work suggests that the neutral funds rate may be in the 4½% to 5% range, so that policy will not move to a restrictive stance until at least mid-2006.

Meanwhile, consensus estimates have projected (both before and after Katrina) that growth will be noticeably cooler in 2006. 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 latest Blue Chip consensus forecast calls for increases in real GDP of 3.4% next year), while RBS's outlook would push the economy beyond its potential, creating upward pressure on wages and prices. As a result, **we expect the Fed to tighten by 25 BP in May, which would bring the funds rate to the top end of the neutral range (our span of 4½% to 5% and the Fed's 4% to 5% zone).**

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 this year, taking the funds rate to 5.50%.** Financial markets have priced in additional rate moves in recent months, with the Eurodollar and fed funds futures strips now pointing to the Fed stopping at (or more precisely just above) 5%. Thus, **our call of a 5% funds rate by mid-2006 is essentially conventional wisdom now, but our 5.50% call by year-end remains more aggressive than the consensus view.** ■

Fed Rates Developments

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 appears poised to rebound sharply in Q1, perhaps by around 6%, which would bring the 2-quarter avg. in line with prior trends Real domestic demand (GDP minus inventories and trade) has expanded at an average annual pace of more than 4% over the past 11 quarters 	<ul style="list-style-type: none"> Real GDP slowed to a 1.6% pace in Q4, the softest performance in 3 years, due to hurricane-related output losses and the impact of the resulting spike in energy prices 	
Consumer	<ul style="list-style-type: none"> Real PCE may surge by close to 5 1/2% annualized in Q1 after a soft Q4 advance of 1.2% Despite a pullback in Feb., the surge in retail sales in Jan. means that the two-month average gain was 0.8% overall and 1.1% ex-autos The net-worth-to-disposable-income ratio surged in 2005 and is at its highest level in history with the exception of the equity-bubble era of the late 1990s 	<ul style="list-style-type: none"> Energy costs represent a drag for the consumer, as gasoline prices have jumped in Mar. and home heating bills have been much larger than a year ago Retail sales fell back in Feb. by 1.3% after exploding in Jan. by 2.9% Unit auto sales slipped to a 16.5 mil. unit pace in Feb., the softest performance since Nov. 	
Housing	<ul style="list-style-type: none"> Existing home sales rebounded in Feb. to 6.91 mil. units, only 4% off of last summer's all-time record Housing starts fell in Feb. but to a still-high level of 2.120 mil. units, well above the 2005 average The OFHEO home price index jumped by 14.6% over the 4 quarters ending in June, the steepest appreciation since 1979, and barely slowed in Q3 and Q4 (to annualized rates of 12.6% and 11.4% respectively) 	<ul style="list-style-type: none"> New home sales plunged in Feb. to 1.080 mil. units, the lowest level since 2003, and the months' supply of new homes for sale soared to a 10-year high There is increasing anecdotal evidence that housing demand has cooled noticeably from the unsustainable pace seen last year 30-year fixed mortgage rates have risen by almost 80 BP since early July. Even so, mortgage applications for refinancing have inched up after falling in Dec. to the lowest pace since Apr. 2002. 	
Capital Spending	<ul style="list-style-type: none"> Business purchases of equipment and software advanced at an annualized pace of at least 8% for 7 straight quarters before cooling in Q4, but a resumption of the prior trend seems likely in 2006 Corporate operating profits rose by 15.7% over the past 4 quarters (21.8% excluding the effects of hurricanes) Nondefense capital goods orders excluding aircraft have been choppy from month to month but rose 5% over the past 12 mos. and at an 11 1/2% annualized pace since Nov. 	<ul style="list-style-type: none"> Business investment in nonresidential structures has advanced at less than a 1% annualized pace in the 4 qtrs. of 2005 	
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 added over 1 1/2 pctg. pts. to GDP growth in Q4 		
Manufacturing	<ul style="list-style-type: none"> The ISM factory index jumped to 56.7 in Feb., a level traditionally consistent with 5% GDP growth Excluding autos, factory output rebounded by 2.0% in Oct., 1.3% in Nov., 0.6% in Dec., and 0.6% in Jan. before moderating to a 0.1% gain in Feb. The factory operating rate moved above its long-run avg. in Nov. (Feb. 80.4%) 		
Employment	<ul style="list-style-type: none"> The jobless rate fell to 4.7% in Jan., the lowest reading since July 2001, but retreated to 4.8% in Feb. Payroll growth averaged 228K from Nov. through Feb. after sub-par hiring in Sep. and Oct. due to Hurricane Katrina The household survey measure of employment has increased by over 220K per mo. since the end of 2004, and the employment-to-population ratio (62.9% in Feb.) has moved close to a level consistent with full employment 		
Inflation	<ul style="list-style-type: none"> Core PCE deflator has been running close to the key 2% mark on a year-over-year basis for almost 2 years Hurricanes Katrina and Rita exacerbated energy price pressures and may make it easier for firms to pass along higher input costs to their customers, though pass-through effects so far appear to have been limited. 	<ul style="list-style-type: none"> Core inflation has been benign. The 12-month gain in the core PCE deflator slipped to 1.8% in Jan., down from 2.2% at the end of 2004. In contrast, the core CPI ended 2005 up 2.2%, identical to 2004's gain, but ticked down to 2.1% in Jan. and Feb. After a brief spike in the wake of Hurricane Katrina, market and survey measures of inflation expectations have returned to historically benign levels 	
Other	<ul style="list-style-type: none"> Surging income tax receipts confirm economic strength and led to a sharp narrowing in the FY2005 budget deficit to \$318 bil. Continued robust revenues suggest no worse than minimal widening in the gap in FY2006, in contrast to most forecasts 		
Notes, quotes.	<ul style="list-style-type: none"> 3/28 FOMC Statement: "The Committee judges that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance." Moskowitz: "Even with the funds rate in the range of neutral, further changes in policy may be appropriate." (3/7) Guyton: "My sense is that, by a lot of measures, credit conditions are quite favorable and quite accommodative at this point, despite 350 BP of federal funds target rate increases." (MNI, 3/20) corresponding to price stability." (10/18) 	<ul style="list-style-type: none"> Minehan: "We see construction diminishing somewhat and real estate prices flattening, not declining. Clearly, however, we could be wrong on the magnitudes, [and that may be a] downside risk to growth." (3/20) • Yellen: "We do need to be careful about overshooting." (3/13) 	

RBS In the Press

Forbes FORTUNE

● **Forbes Magazine** has listed The Royal Bank of Scotland as #14 among The World's Biggest Public Companies, ranked on a composite score for sales, profits, assets and market value in its April cover story. In past issues, Forbes has also included RBS on its A List, Forbes 2000 list and named its CEO, Fred Goodwin as Global Businessman of the Year for 2002.

● The current **Fortune 500** issue features a special corporate aircraft section that includes commentary from Marc Pauhus, National Sales Manager for RBS Asset Finance. In past issues, **Fortune** has ranked RBS among the World's Most Admired Companies and #53 in the Global Fortune 500. ■

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