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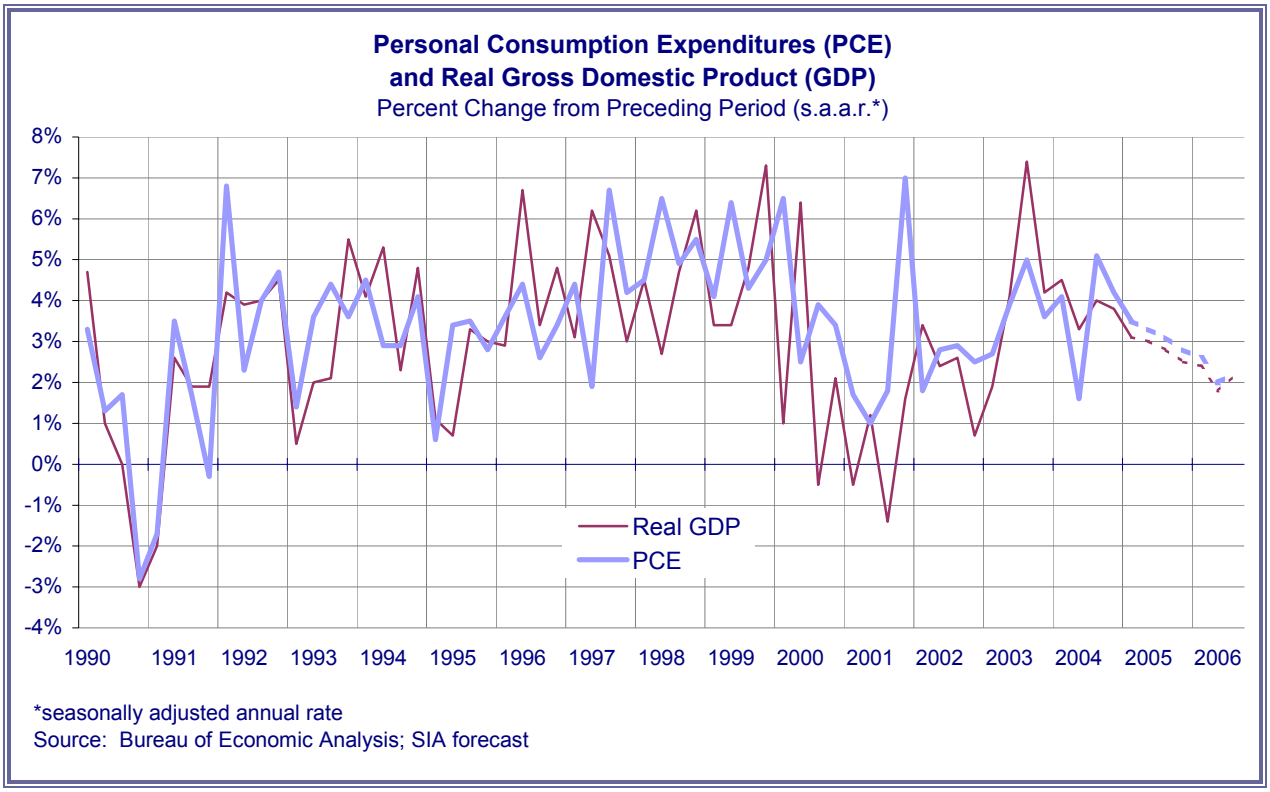
Summary

Real economic growth remains strong, but is losing momentum. Inflation, while still moderate, is picking up. Monetary policy, though belatedly and gradually tightening, appears to have fallen "behind the curve" and attempts to "jawbone" longer-term yields higher appear unsuccessful. Sizable and still growing imbalances that are not being addressed by policymakers present a risk to the forecasts.

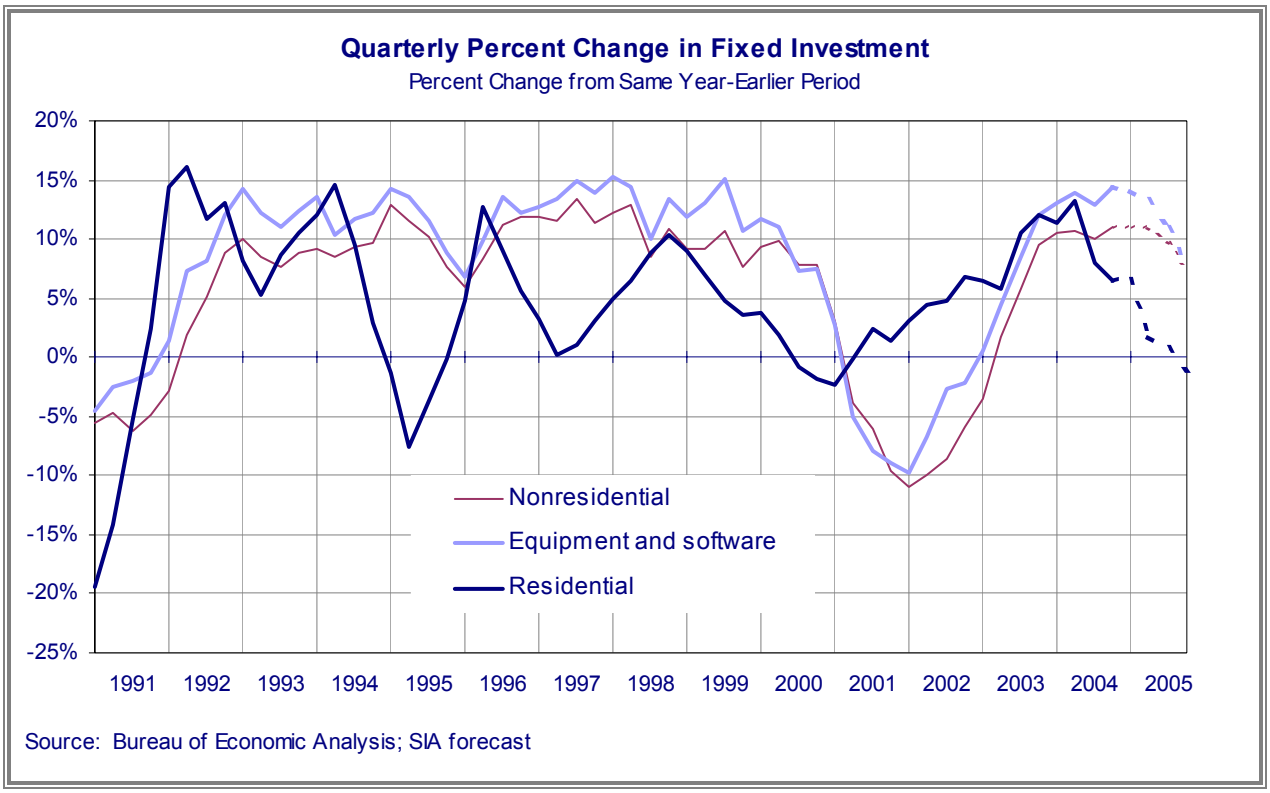
Recent Economic Activity: Still Strong But Losing Momentum

Despite less robust consumer spending and a larger than anticipated current account deficit, real gross domestic product (GDP)[1] increased at an annual rate of 3.1% in the first quarter of 2005, down from 3.8% in 4Q'04 and 4.0% in 3Q'04, but equal to the 3.1% average of the last 30 years. The deceleration in real GDP growth in each of the last two quarters largely reflects acceleration in import growth and slower growth of consumer spending and business investment that were only partly offset by an upturn in private inventory investment and exports. Personal consumption spending grew 3.5% in 1Q'05, down from 4.2% percent in 4Q'04, supported by continued gains in disposable income and wealth effects from still rising housing prices. Imports grew at a 14.7% annualized rate in 1Q'05, up from an already rapid pace of 11.4% in 4Q'04. Government spending rose 0.6% in 1Q'05, while residential fixed investment continued to grow, up 5.7%, as housing prices rapidly escalated.



[1] The output of goods and services produced by labor and property located in the United States expressed in "real" or inflation-adjusted terms. 2Q'05 estimates are those of SIA.

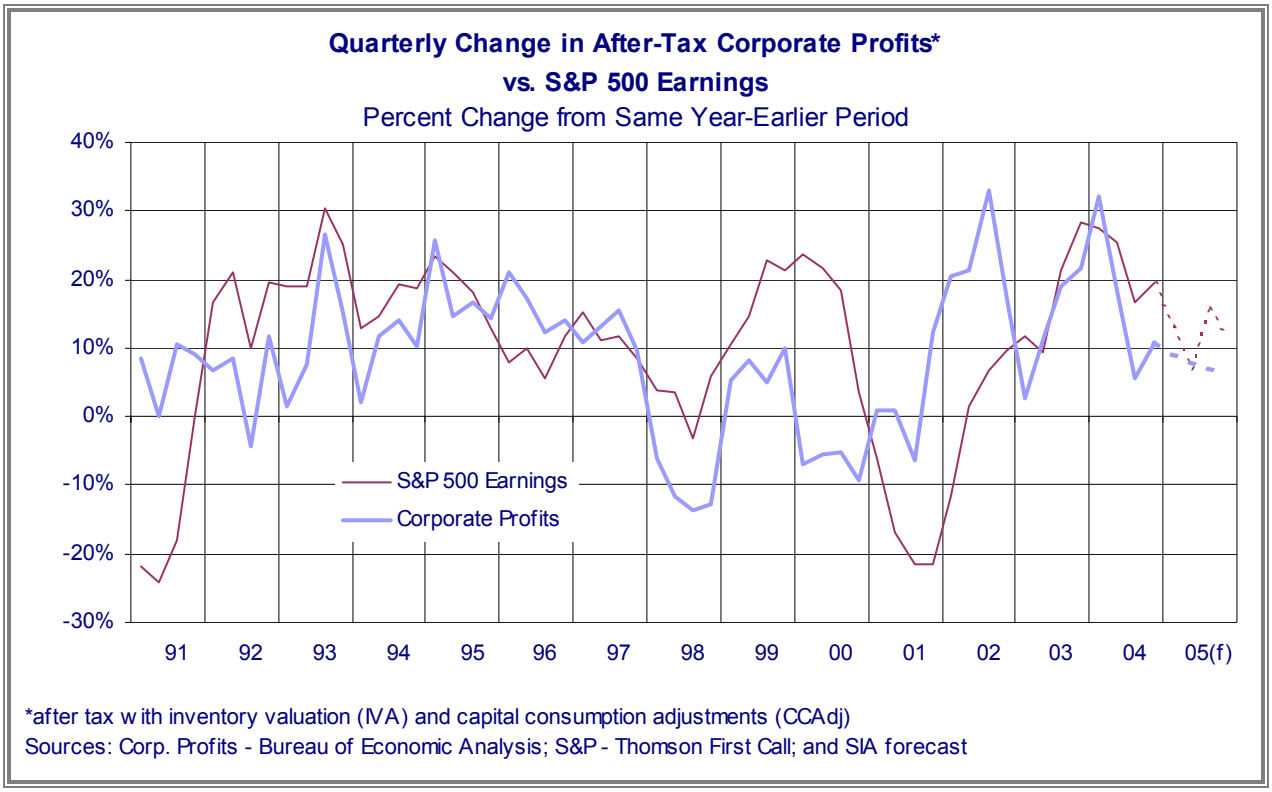
The growth of business equipment spending slowed in 1Q'05, well below expectations that saw this sector providing "a good bit of forward momentum"[2] to the economy. Business fixed investment spending rose 4.7% in real terms in 1Q'05. The expiration at end-year of the special tax incentives for equipment spending, which powered 14.5% growth in 4Q'04, appears to have had an impact.



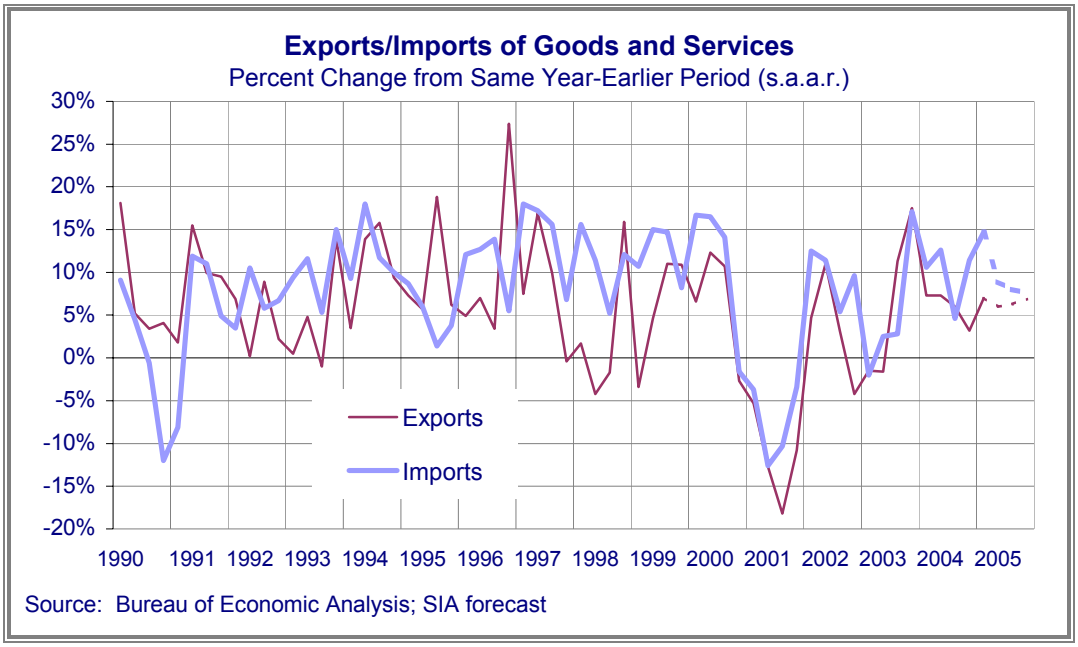
Corporate profits,[3] which rose 16.8% and 15.7%, respectively in 2003 and 2004, grew at more modest rates in 1Q'05, with two thirds of listed firms exceeding expectations. Also contributing to growth was the change in private inventories, which added a half percentage point to the change in real GDP in 4Q'04, and 1.2 percentage points in 1Q'05.

[2] Remarks by Federal Reserve Governor Donald L. Kohn at the 2005 Conference of Twelfth District Directors, Federal Reserve Bank of San Francisco, San Francisco, California, April 14, 2005. http://www.federalreserve.gov/boarddocs/speeches/2005/200504142/default.htm.

[3] Profit from current production or corporate profits with inventory valuation and capital consumption adjustments. In 2004, the difference between the increase in profits by this measure and the increase in profits before tax (which rose 12.7% in 2004, compared with an increase of 15.4% in 2003) was mainly due to the effects of the *Job Creation and Worker Assistance Act of 2002* and the *Jobs and Growth Tax Relief Reconciliation Act of 2003*, which allowed accelerated depreciation and lowered before-tax profits. The Acts did not affect profits from current production, because this measure does not depend on the depreciation-accounting practices used for federal income tax purposes. (See Gross Domestic Product: Fourth Quarter 2004 (Final), Corporate Profits: Fourth Quarter 2004, Bureau of Economic Analysis Release 05-12, March 30, 2005). After-tax profits reached a record $973 billion at seasonally adjusted annual rates in 4Q'04, an increase of 12.5% from the preceding quarter, the fastest surge since 2001.



Unfortunately, the deterioration in the current account deficit during 1Q'05 more than offset the contribution to growth provided by the increase in business and residential investment spending. The trade deficit, the principal component of the current account shortfall, reached a monthly record of $61 billion in February. Imports were 58% larger than exports and continue to grow more than twice as quickly.

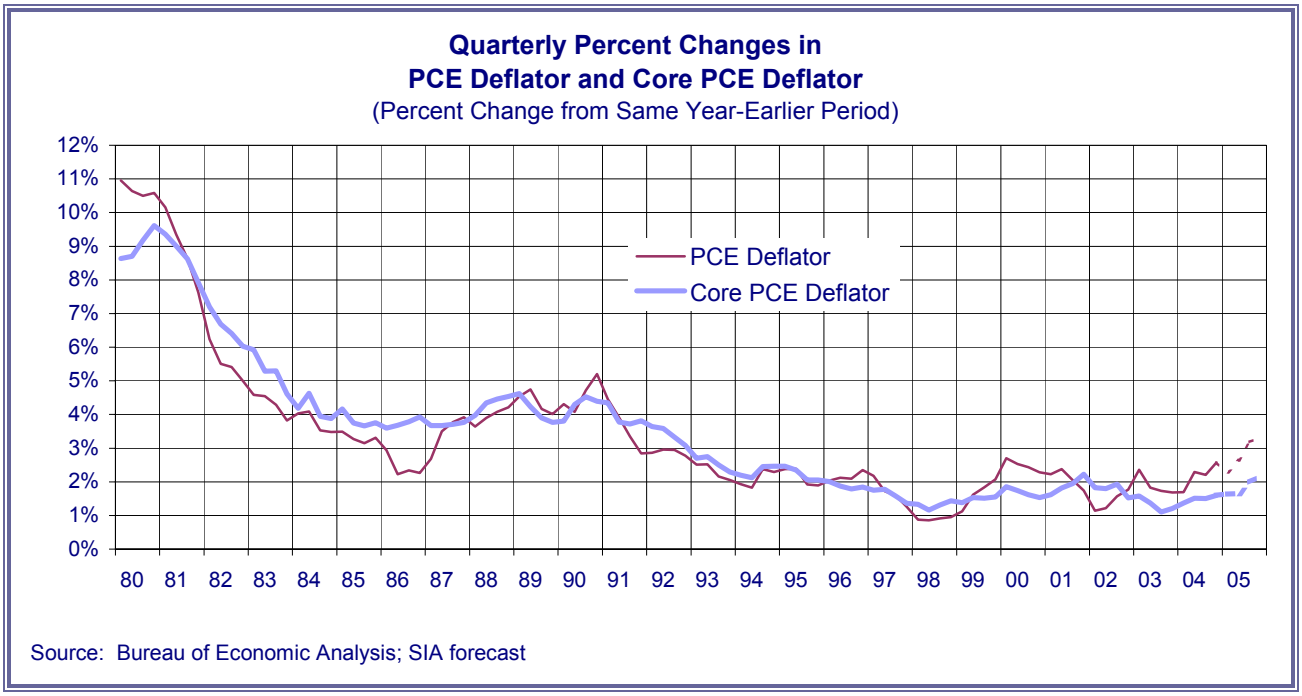


As a result, the expansion of the current account deficit shaved an estimated 1.49 percentage points from annualized real GDP growth in 1Q'05, compared to 1.35 percentage points in 4Q'04. In 2004, the current account deficit increased by $135 billion to $666 billion,[4] an amount equal to nearly 6% of GDP. This year, the shortfall could be $100 billion dollars higher than last year's outcome.

[4] By contrast, the comparable measure in GDP accounts, net exports of goods and services, reached a deficit of $674.8 billion at an annual rate in 4Q'04, which was equal to 5.6% of GDP of $11,994 billion current dollars. Just a year earlier, in 4Q'03, the shortfall was $502.8 billion, equal to 4.5% of GDP.

Inflation: Still Modest But Rising

Inflation has clearly picked up, albeit only modestly and from relatively low levels, both in 2004 and thus far in 2005. During 1Q'05, consumer prices[5] increased at a seasonally adjusted annual rate (s.a.a.r.) of 4.3%, up from an increase of 3.3% for all of 2004, and in March, they were 3.1% higher than year-earlier levels. Much of the increase (three-eighths of the total) reflects higher energy prices, which rose 16.6% in 2004, before increasing at a 21.1% (s.a.a.r.) in the first three months of this year. Excluding volatile food and energy prices, consumer prices increased 3.3% (s.a.a.r.) in 1Q'05, compared to a 2.2% increase for all of last year. Most categories of the index showed a faster rate of increase in the first quarter of 2005 than in 2004, with about 70% of the acceleration in the core rate of inflation attributed to large increases in the index for shelter – up 4.4% (s.a.a.r.) in the first quarter of this year after increasing 2.7% in 2004. Much of the acceleration in this category, in turn, came from a rebound in hotel room charges. Although most other categories of the consumer price index advanced at a faster pace, apparel and medical care also contributed importantly to the uptick in inflation.



The more closely watched measures of inflation, the personal consumption expenditure (PCE) price index and core PCE price index, appear better behaved, at least showing surprisingly modest increases in February. Annualized rates of increase in both the PCE and core PCE indexes had fluctuated between 1.4% and 1.6% over the past year, before rising 2.7% and 1.7%, respectively, in 4Q'04. But in February 2005, and for 1Q'05 as a whole these indexes only inched up and stood at 2.3% and 1.6%, respectively, above year-earlier levels. In March, inflation is reaccelerated, before slowing again in early April.

Businesses seem to have regained some long-lost "pricing-power" and increasingly during March passed through rising prices for energy, other primary commodities and higher import costs reflecting past dollar declines. Some relief may be in sight, however. Oil prices may well have seen a near-term peak during the first week of April before trending lower in response to reduced estimates of global demand and U.S. crude inventories reaching three-year highs in early April. This should limit gasoline price increases in May and June and help keep longer-term inflationary expectations in check. The March University of Michigan's Survey of Consumers showed short-term expectations of inflation jumped to 4.0% from 3.3%, while long-term expectations increased to 3.3% from 3.1% the month before. Financial market participants have responded to the data, suggesting the potential for greater inflation pressures by extending the anticipated length of the series of gradual interest rate increases from end-summer to end-year.[6]

[5] Figures cited are for the Consumer Price Index for All Urban Consumers (CPI-U).

[6] Op. cit. 3, p. 6.

Monetary Policy: Falling Behind the Curve

In February, the Federal Reserve Board for the first time published its forecast for inflation over the next two years rather than one,[7] and at its February Federal Open Market Committee (FOMC) meeting participants discussed the idea of explicitly setting an inflation target, something other central banks have done for some time but which the Fed has long resisted. FOMC participants[8] projected the core PCE index will increase between 1.5% and 1.75% both this year and next, roughly unchanged from the 1.6% increase in 2004. In March, however, the core PCE index is believed to have risen at a faster pace and is already at the top of this forecast range. More details of these forecasts are immediately below.

		2005		2006	
Indicator	2004 Actual	Range	Central Tendency	Range	Central Tendency
Change, fourth quarter to fourth quarter, in percent*					
Nominal GDP	6.20	5.00 – 6.00	5.50 – 5.75	5.00 – 5.75	5.00 – 5.50
Real GDP	3.70	3.50 – 4.00	3.75 – 4.00	3.25 – 3.75	3.50
PCE price index excluding food and energy	1.60	1.50 – 2.00	1.50 – 1.75	1.50 – 2.00	1.50 – 1.75
Average level, fourth quarter, in percent					
Civilian unemployment rate	5.40	5.00 – 5.50	5.25	5.00 – 5.25	5.00 – 5.25

* Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

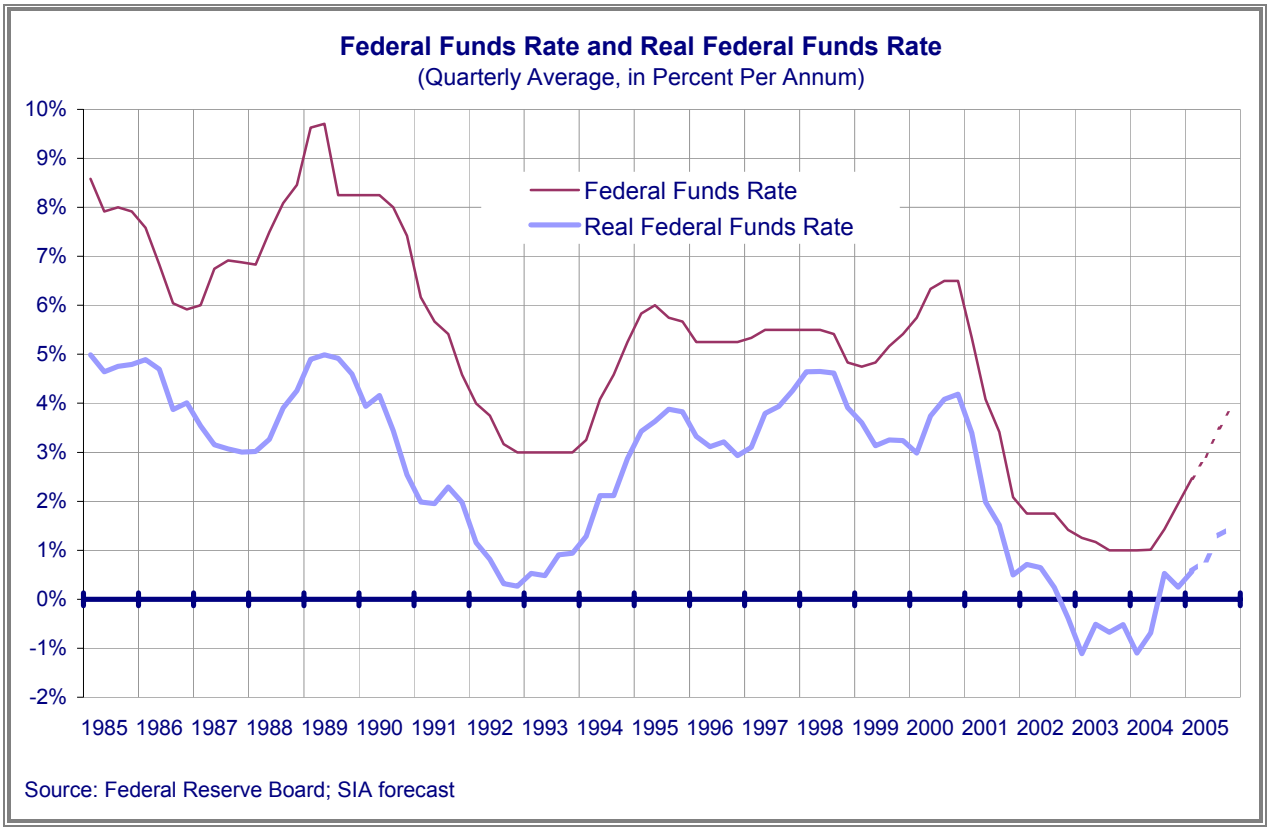
On March 22, the FOMC acknowledged stronger-than-expected price pressures during 1Q'05,[9] confirming concerns that members had hinted at over the previous month, and in the weeks that followed. The Committee promised vigilance, expressed confidence that the pickup in inflationary pressures will prove short-lived and easily contained, and raised its target for the federal funds rate by 25 basis points to 2¾%, the seventh consecutive quarter-point hike over the past nine months.

[7] Federal Reserve Board, Monetary Policy Report submitted to the Congress on February 16, 2005, Section 1, Monetary Policy and the Economic Outlook.

[8] The Federal Reserve Board and the Federal Reserve Bank presidents.

[9] Federal Reserve Press Release, FOMC statement and Board discount rate action, March 22, 2005.

Given that economic growth appears to be moderating and inflation remains within the target range (albeit near its top), the Fed is expected to maintain current policy, altering only the language of its statements. At least three more sequential quarter-point increases are expected to come at the May 3, June 28–29 and August 9 meetings, in order to lift the rate to 3.5%, a rate many consider the lower end of a "neutral" range, by the end of the summer. If inflationary expectations remain contained, expect the Fed to then "pause" briefly to gauge the effects of a year's worth of "measured withdrawal of monetary accommodation." If, as is more likely, inflation continues to inch higher across the summer, look for the Fed to continue with 25 basis point interest rate increases that will lift the target for the fed funds rate to 4.0% – 4.25% before year-end. Either way, we are closer to the end of this tightening cycle than the beginning.

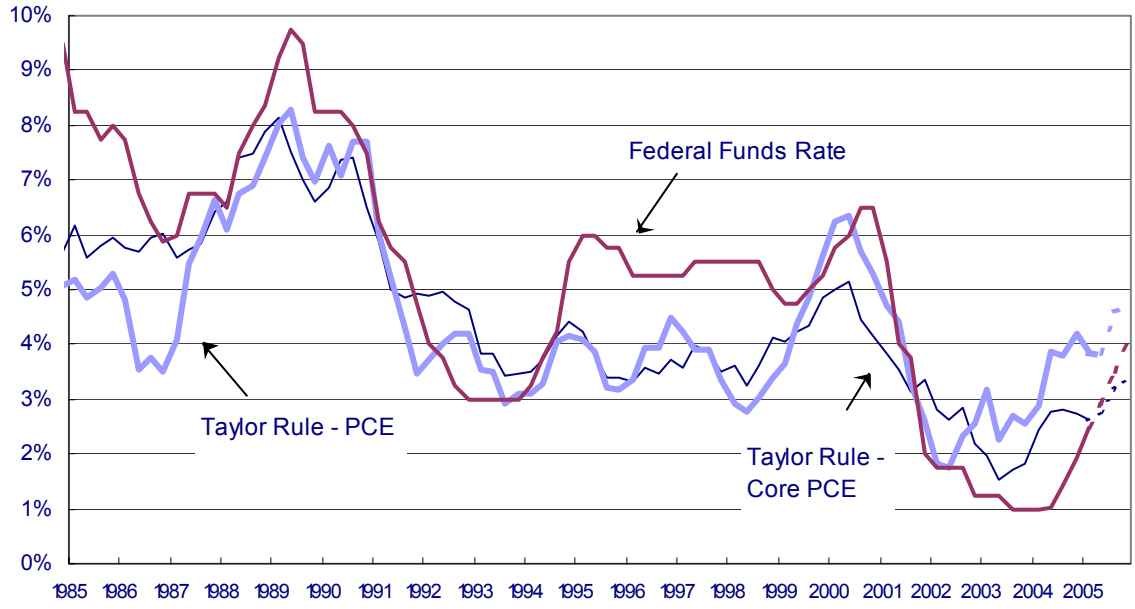


However, it appears that the Fed, thus far, has been slow to follow so-called "Taylor Rules"[10] in setting the target fed funds rate, inviting criticism that they are "behind the curve" and raising rates too slowly to fully contain inflation. One way to examine this issue is to apply Taylor Rules. A Taylor Rule is a guidepost (rather than a prescription) for monetary policy[11] that provides an indication where the fed funds rate should be in order to stabilize growth near its trend rate and control inflation over the long term. Although there are a number of ways to

[10] Taylor Rules are named after John Taylor, formerly Undersecretary of the Treasury who, twelve years ago as a Stanford University professor, claimed that adhering to a simple rule or strategy whereby the central bank sets the Federal Funds rate in response to two variable – deviation of inflation from a target rate and deviations of actual output in the economy from potential output, sometimes called the output gap, is a useful way to conduct monetary policy. The two arguments in the rule – inflation and the output gap – reflect the goals legislated for monetary policy, namely stabilizing real GDP around its trend growth in the short run and controlling inflation in the longer term. See John B. Taylor, "Discretion Versus Policy Rules in Practice," Carnegie-Rochester Conference Series on Public Policy 39, 1993, pp. 195-214. See also, Frank Fernandez, "Monetary Policy Outlook: Taylor Rules", *SIA Research Reports*, Vol. V., No. 5 (May 17, 2004), http://www.sia.com/research/pdf/RsrchRprtVol5-5.pdf.

[11] Charles T. Carlstrom and Timothy S. Fuerst, "The Taylor Rule: A Guidepost for Monetary Policy?" Federal Reserve Bank of Cleveland, July 2003.

state Taylor Rules, two simple forms of the rule, along with actual and forecast movements in the fed funds rate are shown in the chart below. What emerges from this calculation is revealing and has sparked a rising debate both within the Fed and outside of it. While some FOMC participants expect core inflation to remain subdued, others are concerned that the last few years of very low interest rates are starting to have an impact. Inflation risks have now shifted further to the upside, making it even more urgent that interest rates rise to at least 4% in the near term. In fact unless FOMC members are willing to accept inflation of 3% (as opposed to the target of 1.5%-1.75%), we are likely to see a fed funds rate of 5% sometime next year."[12]



Source: Federal Reserve, Bureau of Labor Statistics, Congressional Budget Office
'Taylor Rule - PCE' inflation is measured from the Personal Consumption Expenditures Chain Type Price Index, 4-quarter change. 'Taylor Rule - Core PCE' inflation is measured from the Core PCE Chain Type Price Index, 4-quarter change. The output gap is calculated as the percent deviation of potential GDP from Real GDP as measured by the CBO and BEA respectively.

Despite this, the Fed is unlikely to accelerate the process of tightening monetary conditions with a shift to 50 basis point (½ percentage point) increases. Given that growth already appears to be decelerating, fear of unsettling financial markets and precipitating a more pronounced slowdown in economic activity is expected to preclude such an aggressive course except under more dire circumstances than are likely to prevail, such as a marked acceleration in inflation and inflationary expectations. Financial market volatility, which has been exceptionally low during the past two years, has begun to rise and jumped sharply in mid-April, giving even more support to staying on a gradualist path.

The language of the Fed announcements is, however, expected to change. At the May 2004 FOMC meeting, the Committee revised its "assessment of risks" to indicate that the upside and downside risks for inflation had moved into balance and stated that monetary policy accommodation could "be removed at a pace that is likely to be measured." The measured language communicated its intention "to move toward a more neutral stance, though probably not at a rapid pace."[13] The Committee retained this language at the June meeting when it began

[12] Stephen Cecchetti, "The Inflation Update: March 2005", Brandeis University, April 20, 2005.

[13] Op. cit. 3, p. 3.

the first of seven quarter-point hikes in its target for the fed funds rate. Clearly the "assessment of risks" has changed to the upside, and has been "amended" in speeches by FOMC participants over the past month. The measured language might survive longer, for fear of unsettling housing and financial markets, but its days are numbered as well. Eliminating it would grant flexibility and make the Fed somewhat less predictable, which in turn might aid Mr. Greenspan in resolving his conundrum,[14] lifting the long end of the yield curve in the process.

Two months ago, Mr. Greenspan said, "for the moment, the broadly unanticipated behavior of world bond markets remains a conundrum."[15] The perplexing behavior in question has been long-term interest rates trending lower in recent months even as the Fed has raised the level of the target fed funds rate by 175 basis points. "This is contrary to experience, which suggests that, other things being equal, increasing short-term rates are normally accompanied by a rise in long-term yields."[16] However, it may be that this statement marked the beginning of a campaign by the Fed to talk up bond yields, including stirring inflation fears,[17] and Mr. Greenspan is less perplexed than some were led to believe by his statements. This and the jawboning that followed helped briefly lift the 10-year Treasury yield to a nine month high of 4.64% in mid-March. However, the 10-year Treasury yield fell back to 4.24% by mid-April, below where it was a year ago, 4.34%, and below where it was last June when the tightening cycle began.

Why are long-term interest rates so low? In the same testimony Mr. Greenspan offered a number of possible explanations of the forces underlying the current experience. For example, the fall in long-term rates since last June "may indicate market participants have marked down their view of economic growth going forward, perhaps because of the rise in oil prices." Another view attributes a combination of "subdued overall business demand for credit" with the "apparent eagerness of lenders, including foreign investors" (in particular, foreign central banks acquiring long-term U.S. Treasury securities) to provide financing. Later, Fed Governor Bernanke added the view that an increase in savings in emerging markets (particularly Asia) has created a savings glut that has been flowing to industrial countries (particularly the U.S.) and has kept long-term yields low.[18]

Domestic investors have also contributed to this trend. Attempts by mortgage investors to offset a decline in duration of holdings of mortgage-backed securities by purchasing longer-term securities[19] "may be yet another contributor to the recent downward pressure on longer-

[14] A conundrum is a word or thing of perplexing nature. It can also mean a riddle whose answer involves a pun or 16th-century university Latin slang for pedant, pedantic whim, word play, etc.

[15] Testimony of Chairman Alan Greenspan, Federal Reserve Board's Semiannual Monetary Policy Report to Congress, February 16, 2005, p. 5, http://www.federalreserve.gov/boarddocs/hh/2005/february/testimony.htm.

[16] Ibid. "The simple mathematics of the yield curve governs the relationship between short-term and long-term interest rates. Ten-year yields, for example, can be thought of as an average of ten consecutive one-year forward rates. A rise in the first-year forward rate, which correlates closely with the federal funds rate, would increase the yield on ten-year U.S. Treasury notes even if the more-distant forward rates remain unchanged. Historically, though, even these distant forward rates have tended to rise in association with monetary policy tightening. In the current episode, however, the more-distant forward rates declined at the same time that short-term rates were rising."

[17] Edward Yardeni, "Inflation Scare", Investment Strategy Weekly, Oak Associates, Ltd. March 14, 2005, www.yardeni.com/pub/a_050314.pdf.

[18] "The Global Saving Glut and the U.S. Current Account Deficit" Remarks by Federal Reserve Board Governor Ben S. Bernanke at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10, 2005.

[19] This is in apparent reference to a shift in the behavior of convexity hedging in the mortgage market. Convexity hedging refers to changes in the demand for longer-dated Treasuries as issuers of mortgage backed securities offset shifts in the duration of their portfolios due to changes in the prepayment of mortgages in reaction to swings in mortgage rates. See Mustafa Chowdhury and Marcus Hule, "Respect the Market: It has its Reasons for the Current Yield Curve Shape", The Bond Puzzle, Deutsche Bank Global Markets Research, March 18, 2005, pp. 28-31.

term yields. Strong demand for long-duration assets by pension funds, both to reduce the under-funded status of defined benefit pension plans[20] and in response to pension reform proposals announced in January 2005, is also offered as a partial, short-term explanation of the conundrum. Similarly transitory support for lower long-term interest rates comes the strategies being pursued by both fixed-income mutual fund managers and some hedge fund managers. Improving yield spreads, for example between U.S. and European government bonds, and risk spreads were noted and dismissed as inadequate technical explanations along with "glacially increasing globalization," but both appear to be supportive of lower long-term rates.

None of these factors fully explain why long-term interest rates are so low, but taken all together they do, at least adequately. But the coincidence of these factors is extraordinary and not likely to persist. As this rare alignment shifts, the yield curve will steepen. Higher inflationary expectations and increased uncertainty over the supply and demand for long-dated bonds should initiate the process. Expectations of how quickly the influence of each of these drivers of lower long-term rates diminishes will determine how fast and how much the curve will steepen. The glut of Asian savings is unlikely to dissipate soon, if at all. How much of it remains directed at dollar assets is the key question. Asian intervention in currency markets, which has been on a massive scale – nearly equal to the entire U.S. current account deficit over the past year – will continue, but in gradually diminishing amounts. The unwinding of fund managers, positions is likely to occur much sooner.

How much and how fast long-term rates might rise relative to short-term rates over the next year is of critical importance. Economic fundamentals and long-term historical averages suggest that a "neutral" 10-year rate and one consistent with stable inflation might be as much as 5.0%-5.5% today, a range that is 75-125 basis points higher than current long-term yields. However, only about half that adjustment is likely to take place this year, given the expected persistence of the drivers outlined above. Assuming the target fed funds rate rises at least another 100 basis points this year, the 10-year Treasury yields would be expected to rise to 5.5%-5.75% by year-end.

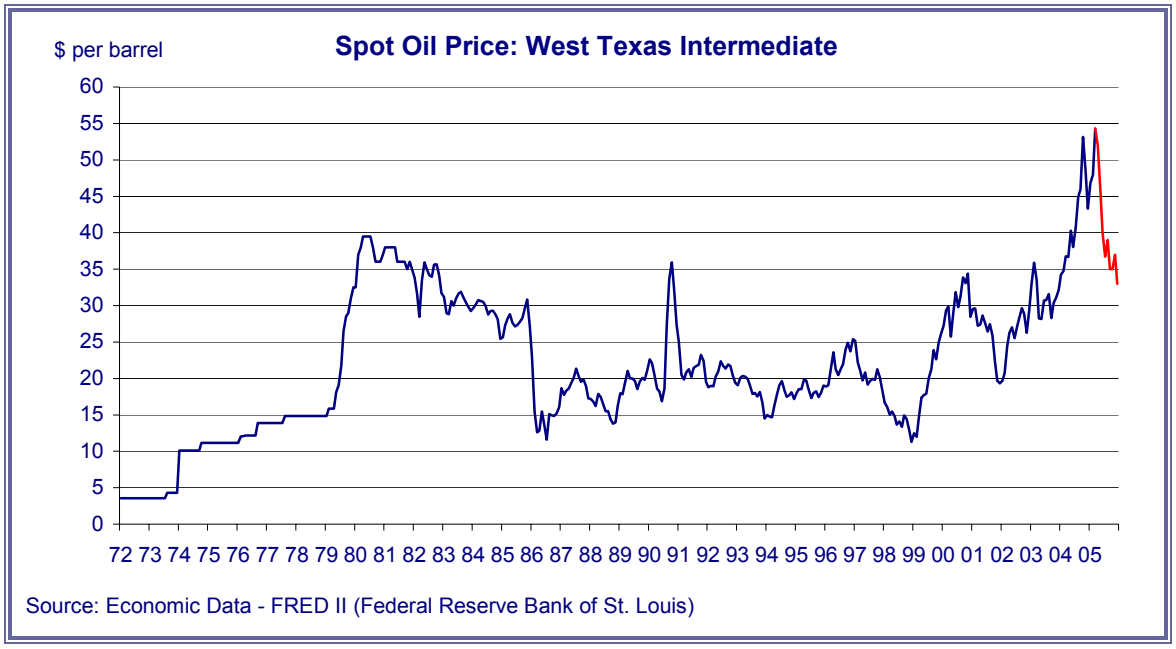
The Economic Outlook

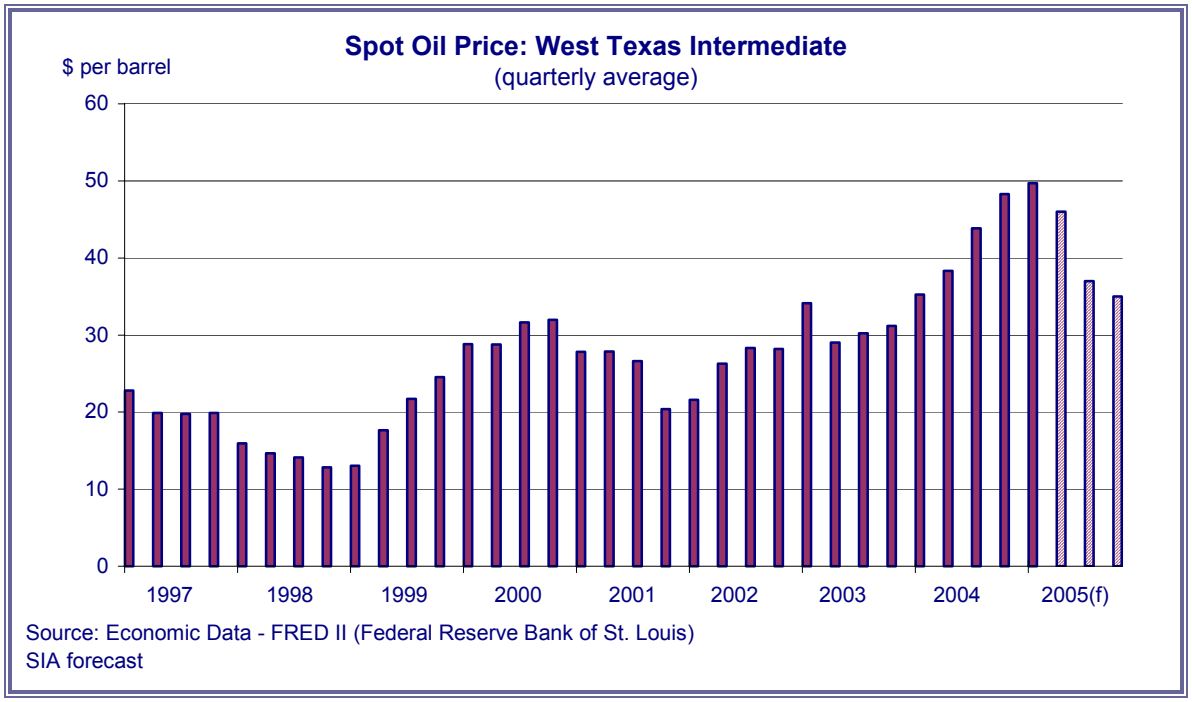
Although the U.S. economy performed well in the first three months of 2005, signs of slower growth appeared as the second quarter began. Retail sales were less than expected in March, and consumer sentiment weakened further in early April, falling to its lowest level in 18 months. In fact, excluding sales of autos, gasoline and construction materials, retail sales declined 0.3% in March. In April, even auto sales appear to be falling off. The weaker consumer data in part reflect no more than Easter falling in March rather than April this year, poor weather and the drag on spending of higher fuel prices. However, these signs, along with slower growth of consumer credit card debt and mortgage equity withdrawals, a sharp drop in housing starts, and weakening investor sentiment, could signal the start of a cyclical downturn. The Fed's most recent Beige Book (the informal survey by the Federal Reserve Banks of current economic conditions in their districts) showed most of the 12 Fed districts experienced a modest to strong increase in activity in the period from late February to early April, but retailers and tourism companies in two-thirds of the districts reported that "energy prices were already, or could soon be, dampening consumer demand."[21]

[20] Estimated at $600 billion in 2004.

[21] Federal Reserve Board, *Summary of Commentary on Current Economic Conditions by Federal Reserve District*, April 20, 2005. http://www.federalreserve.gov/fomc/beigebook/2005/20050420/default.htm.

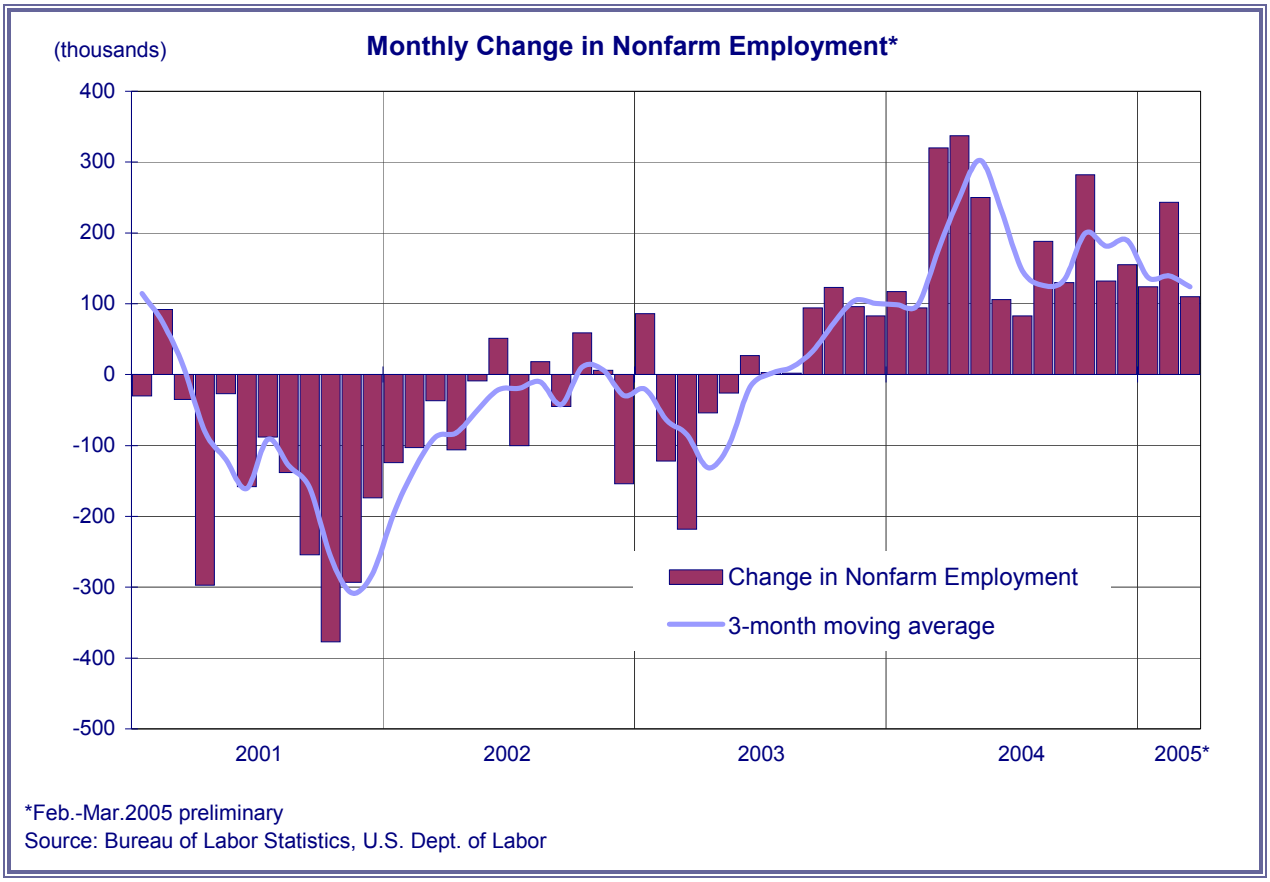
Higher oil prices, the fading of fiscal stimulus and the ongoing withdrawal of monetary accommodation will continue to restrain what is still above-average growth of consumer spending. In addition, slower growth, higher inflation, heightened insecurity over the adequacy of retirement savings, the impact of rising short-term interest rates on high levels of household debt and recent weakness in equity markets are encouraging more circumspect and risk-averse consumer and investor behavior. On a positive note, this appears to be aiding a partial recovery of historically low savings rates.[22] Thus far, it appears that what is taking shape in early 2005 is a moderate cyclical downturn: Not a "patch," soft or otherwise; not the first signs of stagflation; nor a prelude to outright recession.





[22] The sizable gains in consumer spending of recent years have been accompanied by a drop in the personal savings rate to an average of only 1% in 2004, which is low relative to the nearly 7% average over the past three decades. Our forecast is for the personal savings rate to average 1.8% in 2005 and 2.3% in 2006.

While "growth has been sufficient to continue eroding slack in labor and product markets"[23] it may not be true for much longer as the pace of activity slows. Weekly jobless claims had inched up, before an unexpected fall in early April. While this last observation may be due to nothing more than poor seasonal adjustment, payroll data is weaker. Total nonfarm payroll employment rose by 110,000 in March, down from an average monthly increase of 183,000 in 2004. The average monthly job gain for 1Q'05 was 159,000, less than the average of 190,000 in 4Q'04. The unemployment rate fell 0.2 percentage point to 5.2% in March, but the improvement largely reflected stagnant labor force participation growth. Growth of both capacity utilization and industrial production, which spurted in 4Q'04, slowed in 1Q'05, falling back to the pace seen in 3Q'04. Industrial production rose at an annual rate of 3.6% in 1Q'05 following growth of 4.5% in 4Q'04, and in March stood 3.9% above year-earlier levels. The capacity utilization rate edged up only 0.1 percentage point to 79.4 percent in March, a rate still 1.6 percentage points below its 1972-2004 average. Further evidence of weakness came from the latest monthly Empire State Manufacturing survey, which showed a drop in the performance of U.S. industry to the lowest level in two years.



Increases in oil prices and the fed funds rate have preceded each of the five recessions that have occurred in the last 35 years. High oil prices, rising interest rates and an expanding current account deficit is expected to trim real GDP growth to 3.0% in 2Q'05 from an annualized rate of 3.1% in 1Q'05. Business fixed investment, while still robust in the first half of 2005, is expected to expand at less than half the pace recorded in the second half of last year. Growth of corporate profits is expected to slow to the mid single-digit range after two years of double-digit growth as sales decline across the course of the year.

[23] Op. cit. 3.

Real GDP: Percent Change from Preceding Period
at seasonally adjusted annual rates (s.a.a.r.)

					2003		2004				2005 (f)			
	2002	2003	2004	2005	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
GDP	1.9	3.0	4.4	3.3	7.4	4.2	4.5	3.3	4.0	3.8	3.1	3.0	2.8	2.5
Personal Consumption Expenditures (PCE)	3.1	3.3	3.8	3.6	5.0	3.6	4.1	1.6	5.1	4.2	3.5	3.3	3.1	2.8
—Durables	6.5	7.4	6.7	3.8	16.5	3.9	2.2	-0.3	17.2	3.9	0.0	3.2	2.5	2.1
—Nondurables	2.6	3.7	4.6	4.1	6.9	5.1	6.7	0.1	4.7	5.9	4.9	3.2	3.0	2.6
—Services	2.6	2.2	2.8	3.3	1.9	2.8	3.3	2.7	3.0	3.4	3.6	3.4	3.4	3.0
Business Investment	-8.9	3.3	10.6	8.8	15.7	11.0	4.2	12.5	13.0	14.5	4.7	7.4	7.0	5.4
—Structures	-17.8	-5.6	1.4	2.1	-1.3	7.9	-7.6	6.9	-1.1	2.1	-2.6	6.6	6.0	1.6
—Equipment and Software	-5.5	6.4	13.6	10.7	21.7	12.0	8.0	14.2	17.5	18.4	6.9	7.6	7.1	5.8
Housing	4.8	8.8	9.7	2.7	22.4	9.6	5.0	16.5	1.6	3.4	5.7	0.0	-2.1	-3.5
Exports	-2.3	1.9	8.6	5.9	11.3	17.5	7.3	7.3	6.0	3.2	7.0	6.0	6.3	6.9
Imports	3.4	4.4	9.9	10.3	2.8	17.1	10.6	12.6	4.6	11.4	14.7	8.9	8.0	7.6
Government	4.4	2.8	1.9	1.6	0.1	1.6	2.5	2.2	0.7	0.9	0.6	2.9	2.9	2.6
—Federal	7.5	6.6	4.7	2.9	-3.3	4.8	7.1	2.7	4.8	1.2	0.6	3.9	5.5	5.4
—State and Local	2.8	0.7	0.4	0.8	2.2	-0.1	0.0	1.9	-1.7	0.6	0.5	2.3	1.3	1.0
Inflation (percent change from preceding period, s.a.a.r.)														
—GDP deflator	1.7	1.8	2.2	2.8	1.4	1.6	2.8	3.2	1.4	2.3	3.2	3.2	3.4	3.0
—PCE deflator	1.4	1.9	2.2	2.6	1.6	1.2	3.3	3.1	1.3	2.7	2.1	3.4	3.4	3.2
—PCE (excl. food & fuel) deflator	1.7	1.9	1.5	1.9	0.9	1.3	2.1	1.7	0.9	1.7	2.2	2.1	2.2	2.5
Other Indicators														
Real change in Private Inventories*	11.7	-0.8	45.7	16.0	-3.5	8.6	40.0	61.1	39.5	47.2	80.2	2.0	2.0	0.0
Net Exports	-472.1	-518.5	-583.7	-692.7	-508.7	-528.3	-550.1	-580.3	-583.2	-621.1	-663.2	-685.5	-703.6	-718.6

*billions of chained (2000) dollars

Source: BEA; SIA forecast

Growth in the housing market is expected to halt in 2Q'05. Investors, rather than occupants of property, have been responsible for an increasing share of new mortgages and housing starts in recent months, and have enjoyed strong new home sales in 1Q'05. But developers may find themselves with unwanted inventories if the pace of final sales slows and new housing starts decline in 2Q'05 and beyond. Higher mortgage rates in the second half of this year, as the long end of the yield curve belatedly begins to rise, should continue to depress residential fixed income and demand for construction materials.

Consumer spending growth is slowing as higher fuel bills reduce discretionary spending and, along with rising interest rates, discourage purchases of consumer durables. Real growth of personal consumption expenditures is expected to fall to 3.3% in 2Q'05, down from a rate of 3.5% in 1Q'05, continuing a pattern of sequential quarterly declines that is expected to extend into 2006. Consumer and investor confidence will likely weaken as job growth slows and wealth effects diminish.

This cyclical downturn is expected to extend through the second half of this year and into 2006. Real GDP growth is expected to decelerate to an annualized rate of 2.8% in the third quarter and 2.5% in the final three months of this year. For 2005 as a whole, real GDP growth is expected to fall to 3.3% from 4.4% in 2004, before slipping further to 2.5% in 2006.

Risks to the Forecast: The Costs of Inaction

This relatively benign forecast assumes that the yawning fiscal and external imbalances in the U.S. economy can be corrected without serious mishap and that growing concerns over speculative excess in housing prices and prospects for an extended period of high oil prices prove to be overstated. "Although the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness to do much about it."[24] Current trends indicate that the external imbalances will continue to expand.

For a "soft landing" to occur, several courageous assumptions need to be made. First, that China and other continental Asian economies will loosen their currency pegs and permit a substantial exchange rate appreciation against the U.S. dollar and that they can do so without substantial disruption of the global economy. This doesn't seem likely in the near term. Most market participants anticipate that China will revalue the renminbi over the next year, but only marginally, on the order of 5%. This is well below the range of 20% to 40% that most observers believe is necessary to impact the U.S. trade deficit with these Asian countries. Korea is seen as most likely to begin diversification of reserve accumulation away from the U.S. dollar, with Japan seen as least likely.

Japanese and E.U. officials need to move promptly and aggressively to boost domestic demand and address structural impediments to growth. This too seems unlikely. Real growth in Japan is expected to fall to only 0.8% in 2005, with a return to recession a possibility, while growth in Europe is expected to fall in the range of 1.5%-1.75%. Despite the reduced prospects for growth, there are no indications that any stimulus will be forthcoming. U.S. officials need to return to some semblance of fiscal discipline, honoring commitments to halve the federal budget deficit, but seem to be moving in the opposite direction. U.S. consumers need to curb their surging appetite for imports and the steady rise of household indebtedness. Oil prices are unlikely to retreat significantly from current levels around $50 a barrel, while housing price inflation appears increasingly unsustainable. If these trends continue, the cyclical downturn we are just entering is expected to be much less gradual than the forecast set forth above and a number of systemic threats could arise. Unfortunately that old maxim "what can be left to later, usually is – and then, alas it is too late"[25] still seems to apply.

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[24] Paul A. Volker, "An Economy on Thin Ice" *Washington Post*, Sunday, April 10, 2005, p. B07. http://www.washingtonpost.com/wp-dyn/articles/A38725-2005Apr8.html.

[25] Ibid.

PRIME BROKERAGE: OF PRIME IMPORTANCE TO THE SECURITIES INDUSTRY

Prime brokerage activity is a relatively new, but increasingly important, group of business lines provided by securities firms and banks. The rapid growth of prime brokerage has been driven mainly by the explosive growth of hedge funds, as well as changes in the types of trading strategies employed by hedge funds and other active traders, which benefit from the use of prime brokers. Such styles include long-short equity, convertible arbitrage and event-driven investing. Prime brokers intersect with the most active traders in the markets and with some of the most highly leveraged segments of the hedge fund world. Prime brokerage areas such as securities lending and financing have become important to securities firms' profitability, and the multifaceted relationships prime brokers have with their clients have become the basis of new developments in risk monitoring and management, as well as advances in technology and communications. With the advent of a great deal of press coverage and debate over the role of prime brokers, it is important to understand what prime brokerage is, trends that impact the prime brokerage market, and its prospects for the future.

What is Prime Brokerage?

Prime brokerage is a relatively new activity developed by several major U.S. broker-dealers in the late 1980s and early 1990s to service their growing hedge fund clientele. The genesis of prime brokerage service is the development of the prime brokerage agreement, which allows a broker-dealer to provide ***clearing***,[1] ***settlement*** and ***custody*** services for a client regardless of where that client executed the securities transaction.[2] Other services provided by prime brokers may include, but are not limited to, ***margin lending***, ***securities lending***, ***recordkeeping*** and ***performance reporting, risk management systems, direct market access*** and ***capital introduction***. Some prime brokers specialize in hedge fund start-ups and offer additional services, for example, such as operational support, office space and trading technology.

While the U.S. prime brokerage market is dominated by three firms that account for up to 65% of the prime brokerage market[3], there are at least a dozen firms offering some or all prime brokerage services. Prime brokerage has also expanded beyond its original focus on U.S. equities to include similar services in the areas of fixed income, foreign exchange and derivative products, as well as expanding into European and Asian markets and to offshore clients. Depending on the jurisdiction, the prime brokerage services might look more or less like that which is provided in the U.S. market, or the services offered might be tailored to particular foreign markets.

At its most elemental level, prime brokerage agreements allow clients to execute trades with any broker that has an agreement in place with the client's prime broker. By having a small number of firms responsible for clearing, settling and holding its positions, a client may arrange for financing or securities lending more easily and on more favorable terms than would be possible if trades had to be cleared by each executing counterparty. An example of a prime brokerage transaction of a U.S. equity trade is provided below.

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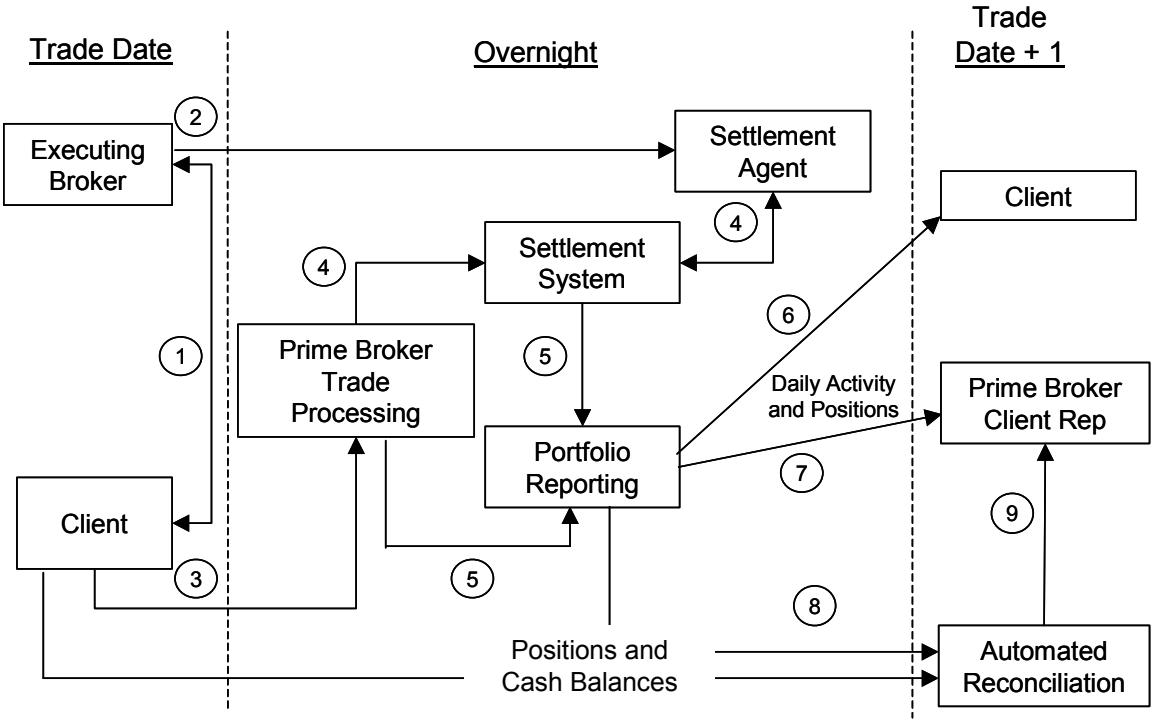
[1] Terms highlighted in ***bold blue italics*** are defined in the glossary at the end of this piece.

[2] In 1994 the Securities and Exchange Commission issued a no-action letter to the chairman of the SIA Prime Broker Committee granting an exemption to rules governing how broker-dealers could provide their customers with credit, allowing one broker, the prime broker, to settle transactions on behalf of its client with multiple executing brokers. See standard account forms at www.sia.com/standard_forms/pdf/prime.pdf and www.sia.com/standard_forms/pdf/primeclg.pdf.

[3] As measured by their clients' assets under management, Brad Hintz, "The Power of Prime Brokerage," Bernstein Research Call, February 24, 2005, p. 6.

Trade Example: U.S. Equity Buy/Sell[4]

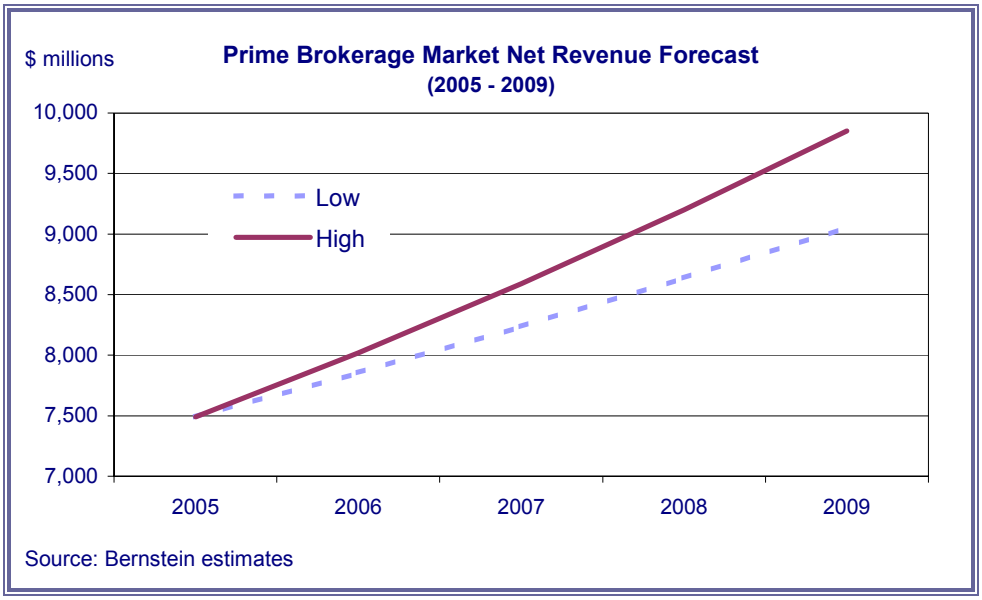


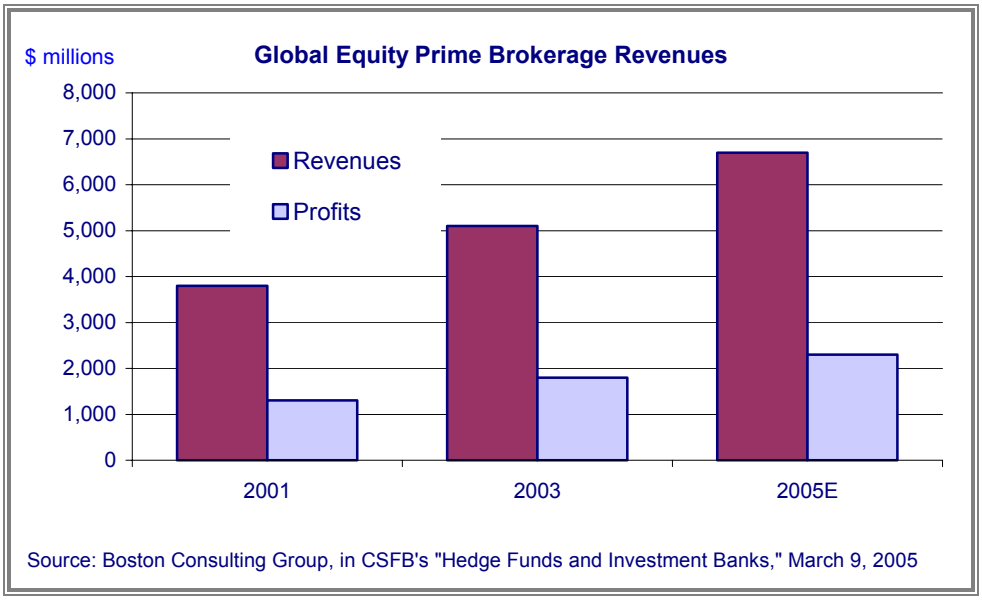
1. The Client places an order with an Executing Broker.
2. The Executing Broker submits the trade to the Settlement Agent.
3. The Client communicates the executed trade to the Prime Broker, which processes the trade through its own system.
4. The processed trade is submitted to the Settlement System with settlement instructions to a Settlement Agent (for example, DTC) vs. Executing Broker. The Settlement Agent does an automated overnight match of instructions and sends back data on matched and unmatched trades.
5. Trade information is processed and submitted to Portfolio Reporting provided by the Prime Broker.
6. The Prime Broker feeds trade and position data to the Client (directly or through portfolio reports).
7. The Prime Broker produces reports for the prime broker client representative and operations liaison.
8. The position and cash balances are reconciled between the Client and the Prime Broker through prime broker's system.
9. The Prime Broker sends the Client a report of any breaks (discrepancies) between the Prime Broker's and the Client's records.

[4] This example of a prime broker transaction is drawn from the Website of a major U.S. prime broker.

How Important is Prime Brokerage to Securities Firms?

According to several recent surveys, hedge funds are a significant driver of securities firms' revenue. One analyst recently estimated that investment banks' hedge fund-related revenues reached $25 billion, or 14% of global investment banking revenue, in 2004, of which $6 billion was ascribed to prime brokerage.[5] That estimate was echoed by the Boston Consulting Group, which recently opined that investment banks' prime brokerage revenue was $6.5 billion last year, up 15% from 2003.[6] Another report estimated that prime brokerage revenue would approach $7.5 billion in 2005 and grow at a compounded annual rate of 5% – 7% through 2009 (see graphs below).[7] While prime brokerage revenues may represent a small percent of the total, they include business lines in growth sectors of the industry with relatively high profit margins.

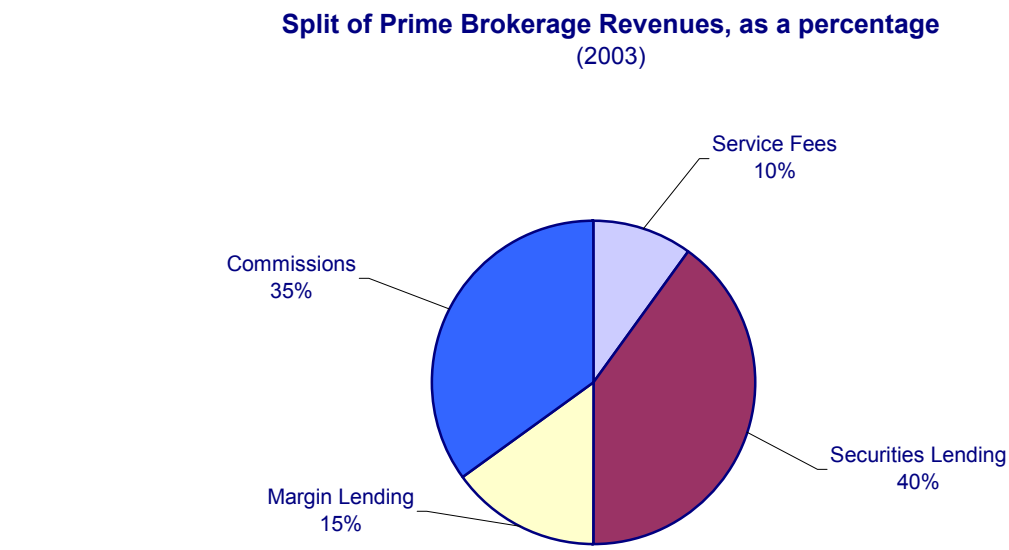




[5] Mark Rubenstein, "Hedge Funds and Investment Banks," Credit Suisse First Boston Equity Research, March 9, 2005, p. 1.

[6] As quoted in Michael Peltz, "Banks, Ogling $1 Trillion in Hedge Funds, Boost Prime Brokerage," Bloomberg (to be published in *Bloomberg Markets*, May 2005).

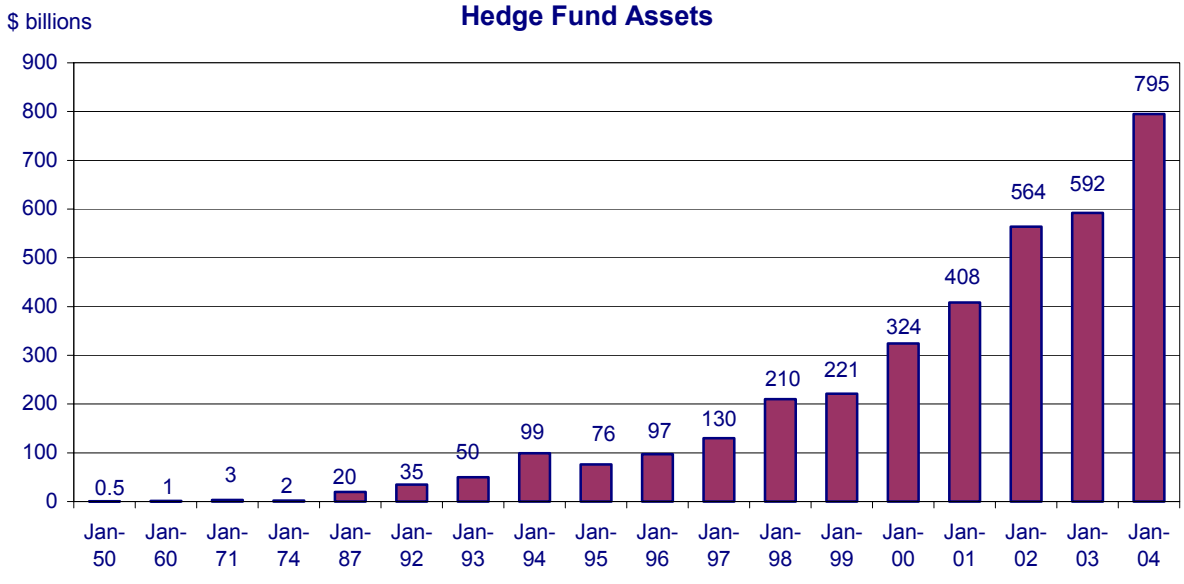
[7] Hintz, p. 2.



Source: BCG, in CSFB's "Hedge Funds and Investment Banks," March 9, 2005

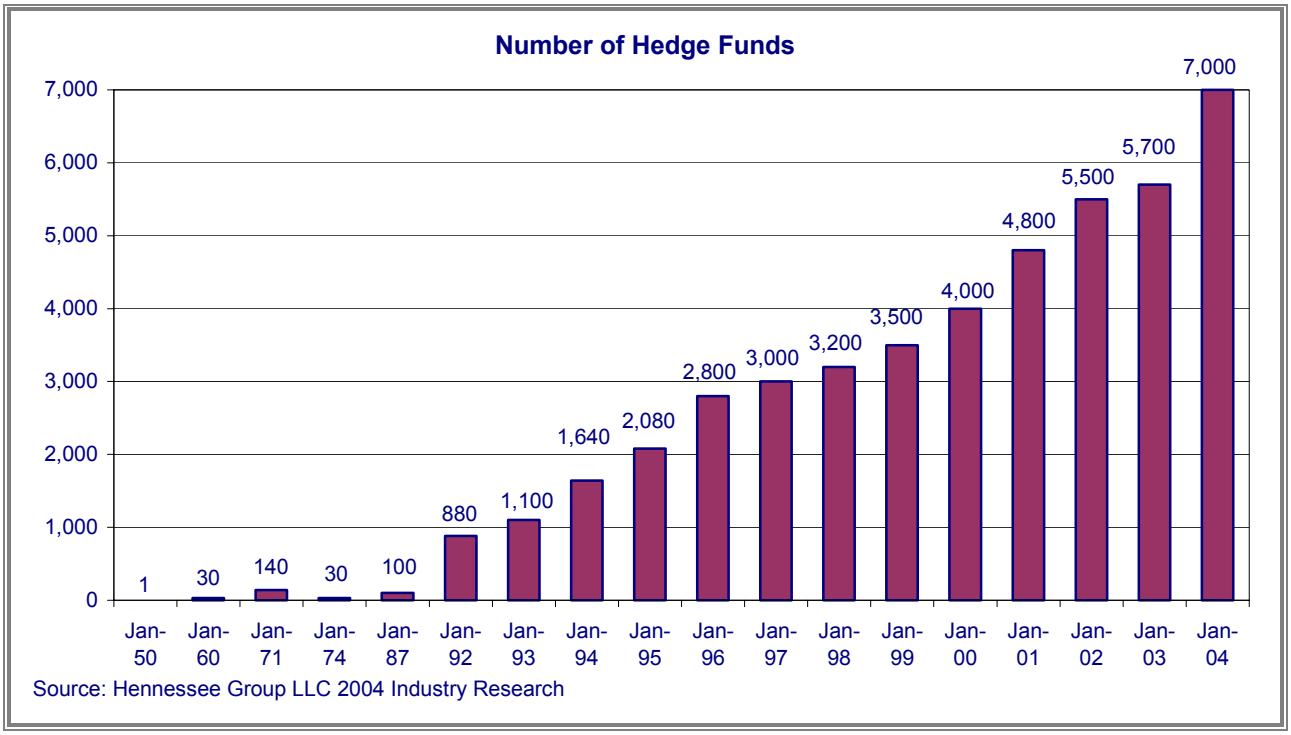
What Trends Are Driving the Growth of Prime Brokerage?

The main trend driving the growth of the prime brokerage business is the phenomenal growth in both the number of hedge funds and the amount of assets under hedge fund management (see graphs below).[8]



Source: Hennessee Group LLC 2004 Industry Research

[8] See also "The State of Hedge Funds," by Kyle L Brandon, *SIA Research Reports*, Vol. 5, No. 11 (September 20, 2004), http://www.sia.com/research/pdf/RsrchRprtVol5-10.pdf.



Measuring hedge funds by assets under management does not tell the whole story, however. Hedge funds, especially those with active trading styles, are often leveraged, which increases their purchasing (and selling) power. Hedge funds also make very good clients generally speaking because they are active in many areas of investing, often in cutting-edge areas, which help brokers develop expertise in new, higher-margin business lines. Hedge funds reportedly account for:

- 40-50% of the daily turnover of the New York and London Stock Exchanges;
- 70% of the total trading volume of convertible bonds;
- 20-30% of the credit default swap (CDS) market;
- 82% of the U.S. distressed debt market and almost a third of the U.S speculative-grade debt market; and,
- 70% of all US trading volume in exchange-traded funds.[9]

In addition to hedge funds, several other types of clients use prime brokerage services, such as family offices, pension funds, university endowments and other governmental or state entities. Such clients' investments may be self-directed, in the case of entities that have in-house investment management, or may be in the form of managed accounts that are managed externally by a hedge fund or other manager.

[9] Rubenstein, p. 5.

What are the Current Challenges?

Competitive Forces

Prime brokers are assailed on all sides by competitive forces – not the least of which arise from their own clients. More and more established hedge funds are routinely using several prime brokers to lessen their dependence on any one firm and to take advantage of the strengths of a variety of service providers. According to one observer, while it used to be common for hedge funds to use one or maybe two prime brokers, now they are using a third or fourth prime broker, especially when the hedge fund is active internationally and needs to borrow securities in a variety of markets.[10] This is also true of hedge funds that are active in a variety of asset classes. Larger clients (those with assets under management of more than $1 billion) reported using more than four prime brokers. This is, on average, over twice as many prime brokers as used by those under $1 billion (just under two prime brokers) and three times more than those under $100 million (on average 1.3 prime brokers).[11] Prime brokers are competing for business based on many factors, but certainly included is pressure from clients that may play one firm off another to drive their own costs down.

However, prime brokers, especially the largest, are not without competitive resources. It is no small task to change prime brokers. It is a costly, arduous task that is not without risk. Further, not all prime brokers can provide all services equally well. Prime brokers compete on more than price: service quality and expertise are held to be of equal or greater value. According to a recent survey, clients are very discerning of the service levels offered by prime brokers. While there are three firms that dominate the prime brokerage market, there are at least another ten that are ranked highly in one or more service areas, depending on both the size (in terms of assets under management) of the client and its investment strategy,[12] and surveys show that in terms of customer satisfaction, the market is wide open.[13]

Barriers to Entry

Significant barriers to entry in the prime brokerage arena give leading firms an advantage over newcomers. Perhaps the highest barrier is the cost of technology and infrastructure. It is estimated that leading or aspire-to-be-leading full-service prime brokerages "invest upwards of $100 million in their prime brokerage offerings and technology annually."[14] That estimate doesn't take into account what start-up investment amounts might look like today. Granted, a great deal of that investment benefits other areas of the firm, nevertheless, it is an impressive number, and only the largest global firms compete on that level.

Other barriers to entry include expertise, both in terms of personnel and the institution itself. Firms that traditionally place great emphasis on certain areas such as operations, clearing for others, client custody, trading and sophisticated structuring, for example, would already have many pieces of the prime brokerage puzzle in place. Another important barrier would be existing relationships with potential prime brokerage clients like hedge funds. Without existing client relationships there would be no point in building a full-scale prime brokerage business.

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[10] Josh Friedlander, "Upstarts Battle for Prime Brokerage Share," *IDD*, January 31, 2005, p. 10.

[11] "2004 Prime Brokerage Survey," *Global Custodian*, Spring 2004, p. 127.

[12] Ibid, p. 128.

[13] "2005 Prime Brokerage Survey," *Global Custodian*, Spring 2005, p. 136.

[14] Hintz, p. 3

Despite these significant barriers, the leading prime brokers are not protected from competition on all fronts. Some of the most profitable pieces of the prime brokerage business are securities lending and the provision of leverage, which can be provided without the massive investment necessary to become a full-service prime broker. ***Synthetic prime brokerage*** is a term used to describe the provision of many such services without the operational structure of a prime broker. It is an alternative way for clients to take leveraged long and short positions, and it has become more and more prevalent, especially in Europe.[15] Instead of executing all aspects of such trades separately,[16] the entire transaction would be structured as a ***total return swap*** or other derivative contract, such as ***cash-for-difference contract*** (***CFD***), that replicates the desired position. Each firm may have a different name for such services and structure them in slightly different ways, which makes synthetic prime brokerage more difficult to define and track than classic prime brokerage.

Regulatory Hurdles

Compliance with more numerous and increasingly complex regulations has proven to be a significant draw on the resources of prime brokers. One such example is the role prime brokers are expected to play in the new ***short selling*** regulatory scheme known as Regulation SHO.[17] Reg SHO, among its several areas of new regulation, deals with the issue of failed trades and the need to ***locate borrows*** before initiating short positions. Because prime brokers' clients make up a significant portion of short sellers, regulators would like to have prime brokers track and enforce Reg SHO's locate requirements, although it is not clear that prime brokers have such a capability.

Some regulations arose in response to past problems. For example, the 1998 collapse of a major hedge fund, Long Term Capital Management (LTCM), and the potential for systemic damage that the experience highlighted, prompted the formation of industry groups which came up with recommendations to improve risk management practices, especially as they relate to hedge fund counterparty exposures.[18] Subsequently, hedge fund counterparties, in particular prime brokers, have put into place more comprehensive risk management policies and procedures thereby reducing the risk of future meltdowns due to lack of information on true counterparty exposures. Another example is provided by the failure of MJK in 2001, the aftermath of which led to greater transparency of whom executing and prime brokers represent on transactions.

Recently, there has been some commentary concerning the relationship between prime brokers and their hedge fund clients (in particular their highly leveraged hedge fund clients) and risks that might not be captured by current risk management systems. As an example, New York Federal Reserve President Timothy Geithner noted that financial firms have many exposures to hedge fund counterparties "including those related to prime brokerage and counterparty credit extensions, proprietary investments in hedge funds, the provision of structured hedge fund

[15] See Jay Eden, "How Synthetic Brokering Became the Real Deal," *ISF Magazine*, December 2004.

[16] In order to do complex trades involving margin and/or securities lending, different types of accounts would have to be opened, and the prime broker would have to provide, at least, clearing, settlement, custody, financing and/or securities lending.

[17] Regulation SHO, adopted by the SEC on June 23, 2004, provides a new regulatory framework governing the short selling of securities. For further information, please see http://www.sec.gov/rules/final/34-50103.htm for the rule itself; http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm for answers to frequently asked questions; and, http://www.sec.gov/spotlight/keyregshoissues.htm for the SEC's description of key points about Reg SHO.

[18] One of the leading groups was the Counterparty Risk Management Policy Group (CRMPG), which was recently reinstated as CRMPG II to examine new developments in the area.

products, and the offering of external fund of funds and in-house managed hedge funds as investment products, among other things."[19]

To allay these concerns prime brokers must ensure that their risk management systems, policies, and procedures prevent leveraged clients from becoming "too" leveraged. Prime brokers must balance the desire to do as much business as possible with the requirement to stay within prudent exposure and leverage limits, and maintain supervisory practices that ensure that risks are properly managed. Regulators, on the other hand, should avoid pushing prime brokers into the role of police, and should be mindful that prime brokers do not often see all sides of their clients' transactions and cannot monitor or influence their clients in aspects of their business that they cannot see.

What are the Future Prospects?

The prime brokerage business is expected to grow along with the growth of its client base and increasing use of prime brokerage services by firms that didn't use them previously. Established prime brokers will enter new business areas as demand increases away from traditional securities investing to alternative investments. In another direction, prime brokerage will continue to grow in overseas markets, expand in terms of financing opportunities (***cross margining***), and develop new technologies and operation capabilities (***straight-through processing***). Overseas markets should prove a fertile field for new clients and new business areas. Prime brokerage was originally designed for U.S. equity clients, but has a promising future in both Europe and Asia.

New entries in the prime brokerage space will continue to utilize synthetic products to allow them to offer prime brokerage-like products without the expense of building up full-fledged prime brokerage infrastructure. Some aspiring participants may follow the example of a large European bank that acquired an existing prime brokerage operation whole, allowing it to enter the full-service prime brokerage business without the time lag of starting from scratch. Not all major global banks currently have fully developed prime brokerage offerings, however. While some such institutions have proclaimed that it is too late to get into full service prime brokerage (with the attendant start-up costs and time) the attraction of the business and the tight relationships it generates with high quality clients make jumping in with both feet irresistible.

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[19] Timothy F. Geithner, "Hedge Funds and Their Implications for the Financial System." Speech given on November 17, 2004 at the National Conference on the Securities Industry presented by the AICPA and the Financial Management Division of the Securities Industry Association, New York City (http://www.newyorkfed.org/newsevents/speeches/2004/gei041117.html).

Glossary of Terms*

Capital introduction: Prime brokers provide introductions between their investing clients and their investment management clients. Most prime brokers are very careful to ensure that they are not seen to be selling hedge funds to their clients, and in fact are not directly remunerated for any actual investing that might take place subsequent to such introductions.

Cash-for-difference contract (***CFD***): A derivative contract (a contract that derives its value from the value of something else) whereby the synthetic provider (SP) buys (or short sells) financial instruments on behalf of a client. The SP pays (or receives) the difference between the purchase price and the price at the end of the contract, depending on the economic performance of the position.

Clearing: In the context of prime brokerage, clearing refers to the prime broker confirming the client's transactions with client's counterparties, and reporting and cleaning up discrepancies between the client and its counterparties.

Cross margining: Some, but not all, prime brokers assess a client's risk profile and ability to borrow looking at its entire portfolio across products and legal entities. Cross margining is an area under development as prime brokers wrestle with legal issues and their own systems capabilities.

Custody: The prime broker holds the clients assets, as well as monitors for corporate actions such as dividend and proxy-related activities.

Direct market access: The prime broker may provide a client with access to its electronic trading platform, either through its own or the client's order management system. This is a particularly important service for clients that rely on high volume and/or rapid trading styles.

Locate borrows: According to Reg SHO, a broker-dealer must have reasonable grounds to believe that a security can be borrowed before effecting a short sale (with limited exceptions).[20] A short seller is required to locate shares to borrow before selling short. This is a particularly important requirement for shares that are difficult to borrow.

Margin lending: The prime broker may lend funds to a client using the client's assets in its custody as collateral.

Performance reporting: The prime broker provides consolidated reporting on cash, securities and other financial products trading and settlement, often in electronic or even web-based interactive format. Reporting of client hedge fund's net asset value may also be provided.

Record keeping: The prime broker may keep a client's official books and records, especially in the case of a start up or smaller hedge fund that does not have its own operations or accounting in-house.

* Definitions were drawn from a number of sources, including prime brokers' own descriptions of the services they offer, Web-based reference sites and articles quoted in the research piece.

[20] See http://www.sec.gov/spotlight/keyregshoissues.htm.

Risk management systems: The prime broker provides use of its own risk management system to its client.

Settlement: The prime broker arranges for the payment (receipt) of funds and receipt (deliver) of financial instruments between the prime broker's client and the client's trading counterparties.

Securities lending: The prime broker lends (or arranges for the loan) of securities that the client has sold short. The brokerage firm may own the securities being lent, or it may source them from another of its clients (under a securities lending agreement with that client), or the broker may go into the market and borrow the securities from another firm.

Short selling: The selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short. Ordinarily, traders must borrow a stock, or determine that it can be borrowed, before they sell it short.

Straight-through processing (***STP***): The seamless integration of systems and processes to automate the trade process from end-to-end trade execution, confirmation and settlement without the need for manual intervention or the re-keying of data. Broadly, STP encompasses the streamlining of operational infrastructure – front, middle and back offices – of all securities industry participants.

Synthetic prime brokerage (also known as prime brokerage substitute products): The prime broker provides prime brokerage services, such as securities or margin lending, to a client with a derivative instrument such as a ***total return swap*** or ***cash-for-difference contract***. Such derivatives replicate the economic position of being long or short a position without the custody, clearing or settlement operational requirements. Using such custom-made over-the-counter financial products, a financial institution that lacks the infrastructure necessary to provide full service prime brokerage services can still participate in prime brokerage's lucrative business areas of providing leverage and securities lending.

Total return swap: A derivative contract whereby the swap buyer receives the cash flow generated by a reference asset/position and pays an amount determined by an agreed upon reference rate. At maturity, the reference asset or position is revalued and payment is made, with all the risk of the value of the reference asset/position borne by the swap buyer.

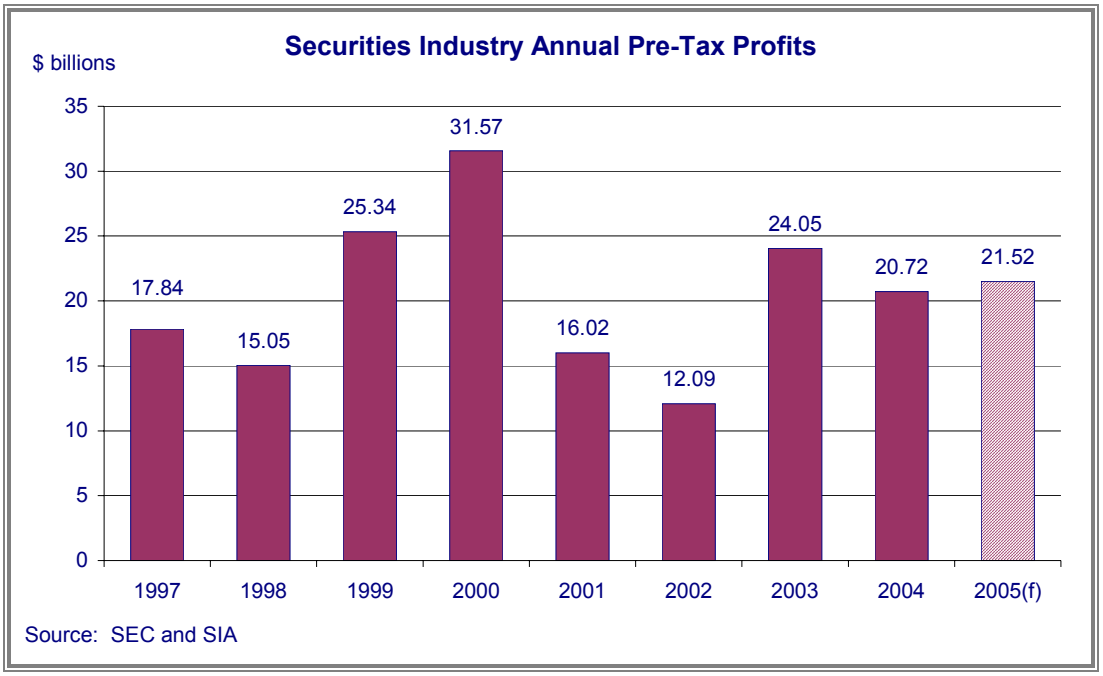
SECURITIES INDUSTRY PROFITABILITY UPDATE: FINAL 2004 RESULTS AND DETAILED 2005 FORECASTS

Final 2004 Results: Fourth Quarter Results Prove To Be Stronger Than Expected

Fourth quarter results were better than expected, marking a robust close to the year.[1] Industry profits (pre-tax net income) reached $6.75 billion, or a 99.0% increase from 3Q'04 results, as both revenues and expenses showed double-digit rates of increase. Gross revenues jumped 23.6% over the quarter to reach $68.6 billion, a 24.9% increase on a year-on-year basis. Total expenses increased 18.6% to $61.8 billion, and were up 28.2% from 4Q'03 levels.

2004: A 'U-Shaped' Year

Full year 2004 pre-tax profits came in at $20.7 billion. This 'bottom-line result' is 13.9% below 2003's performance, but up 71.3% from 2002, the trough of the industry downturn, and 29.4% greater than in 2001. With $7.6 billion of pre-tax net income in 1Q'04, the year was off to a very strong start. The first quarter was essentially a continuation of the very strong results, particularly in trading gains, which marked 2003. However, results tailed off dramatically in the second and third quarters of 2004, with net income dropping by 60.7% and then by a further 13.7% respectively. The mid-year slump was attributable to both a weakening of investor sentiment and a decline in issuer activity. The final quarter of last year marked a return to strong profitability. This 'U-shaped' pattern of quarterly results for 2004 shows, among other things, how volatile securities industry profits can be. Average quarterly pre-tax earnings were $5.2 billion last year, but individual quarterly results were widely dispersed around that mean.



[1] Industry financial data in this report is for all NASD- and NYSE-reporting broker-dealers. This article is excerpted from the forthcoming issue of *Securities Industry Trends*. The January edition of *SIA Research Reports*, Vol. VI, No. 1 (January 25, 2005), available at http://www.sia.com/research/pdf/RsrchRprtVol6-1.pdf, sets out estimates for 4Q'04 and discussed the outlook for 2005. A more detailed analysis of trends driving profitability in the securities industry by business line was published in the February edition of *Securities Industry Trends*, Vol. XXX, No. 1 (February 28, 2005). Subscription details are available at http://www.sia.com/research/html/securities_industrytrends.html.

Individual Business Line Results

One of the most important and positive aspects of 4Q'04's strong performance was the robustness of the industry's recovery from the market's trough in 2002. It had been expected that overall 2004 results would be down from 2003's results, which were driven by extraordinary **trading gains**. The final results show that, while trading gains did indeed decline over the year, dropping by 23.5% compared to 2003's result, other business lines took up the slack.

Underwriting had a very strong fourth quarter, increasing by 25.7% from third quarter levels, driven by a pickup in the equity underwriting cycle, which in turn was led by a revived initial public offering (IPO) market.[2] The first quarter of 2004 was also strong, and both quarters saw total primary market revenues top the $5 billion mark, the two strongest quarterly results since 2000. Weaker second and third quarters for equity issuance meant that full-year 2004 underwriting revenues were up 11.2% on 2003.

Commissions and fees from trading activity picked up 17.0% in 4Q'04, relative to the preceding quarter, in line with forecasts, led by sharply higher activity in institutional and individual equity accounts. For all of 2004, commission and fee income was 4.6% above 2003 levels.

Mutual fund sales revenues and **asset management fees** also finished 2004 broadly in line with expectations, up respectively 10.0% and 8.8% over 3Q'04. The improved performance was thanks to both strong net new cash inflows into all types of funds in the fourth quarter and higher valuations on the assets held in funds as market indices moved higher. These results meant that full-year mutual fund sales revenues were up 15.2% over 2003, and asset management fees were 16.2% higher.

Many of the strongest sources of growth in recent years have been in businesses that are reported in the '**other revenues related to the securities business**' line. They include mergers and acquisitions (M&A) and prime brokerage.[3] As the hedge fund sector has grown, both in terms of capitalization and quantity of trading activity, it has proven an increasingly lucrative revenue source for broker-dealers. Coincidentally, the M&A cycle turned up in 2004, following a long lull. Both of these factors drove this line item to $22.3 billion in revenues in 4Q'04, well above expectations, and an increase of 29% from 3Q'04 and 61% higher than 4Q'03. For all of last year, this revenue line item rose 24.5% from 2003 totals.

On the expense side of the ledger, **compensation** remains the single largest expense item. Fourth quarter 2004 compensation costs jumped 16.6% to $21.7 billion. This reflects the accrual of bonus pools, which were paid out in early 2005. Thanks in part to strong investment banking performances in the first and fourth quarters of 2004 and still impressive proprietary trading gains, variable compensation rose sharply in 2004. The compensation ratio for the year, an important measure of cost control, edged up slightly to 46.6%, up from 45.3% in the previous year. Compensation expense for the whole of 2004 totaled $83.2 billion, up 8.4% on 2003.

Interest expense rose in 2004 by 35.0%, reflecting, largely, the rapid rise in overnight borrowing rates. These rates closely track the Federal Funds rate, which more than doubled from 1% at the beginning of the year to 2.25% by year-end. The increase in interest expense also reflects

[2] See *Securities Industry Trends*, Vol. XXX, No. 1 (February 28 2005), op. cit. for more details.

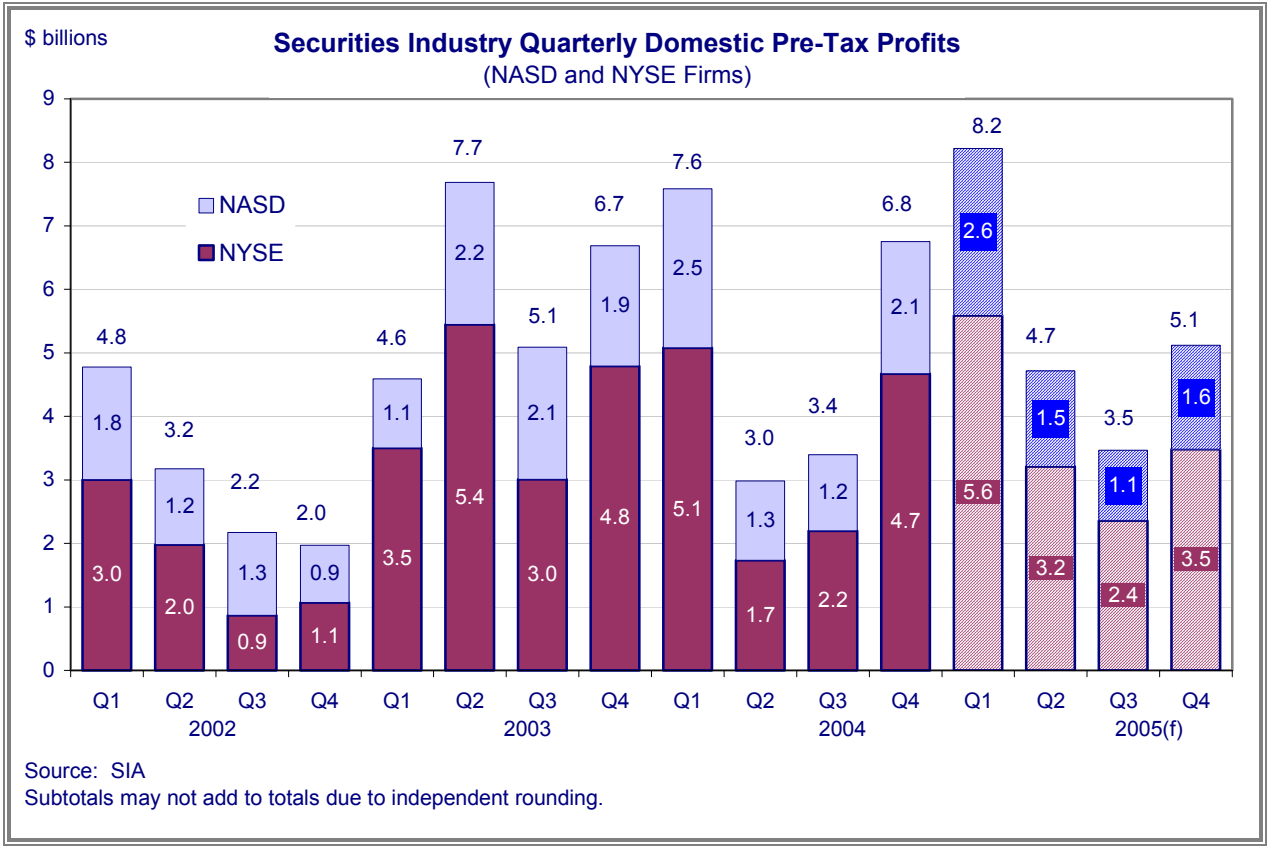
[3] See page 16 of this issue of *Research Reports* for an article discussing prime brokerage in depth.

increased customer demand for credit both from business lines that are in a cyclical upswing, such as M&A (where acquirers often leverage up to make an acquisition) and those that are in secular growth mode (such as prime brokerage units extending margin to the rapidly expanding number of hedge funds). Another factor was a pattern of trading desks taking on greater leverage in their market positions during a period of relatively low market volatility.

Detailed 2005 Forecasts: Same Location, Different Route

Overall, we expect 2005 to deliver a performance resembling 2004 both in terms of the level of full-year profits and the quarterly distribution of those profits. However, we expect 2005 to be driven by a changing business mix. In essence, we expect this year to proceed at roughly the same pace and to end up in broadly the same place as 2004, but to arrive there by a different route.

For our first detailed forecast for 2005, we anticipate overall pre-tax net income of $21.5 billion, compared to the $20.7 billion result for 2004. We have reduced our profit forecast for the industry by $0.5 billion compared to our preliminary forecast of $22.0 billion in January, because of signs of weakness in the broader economy and indications of somewhat slower market conditions than had been initially expected.



Source: SIA
Subtotals may not add to totals due to independent rounding.

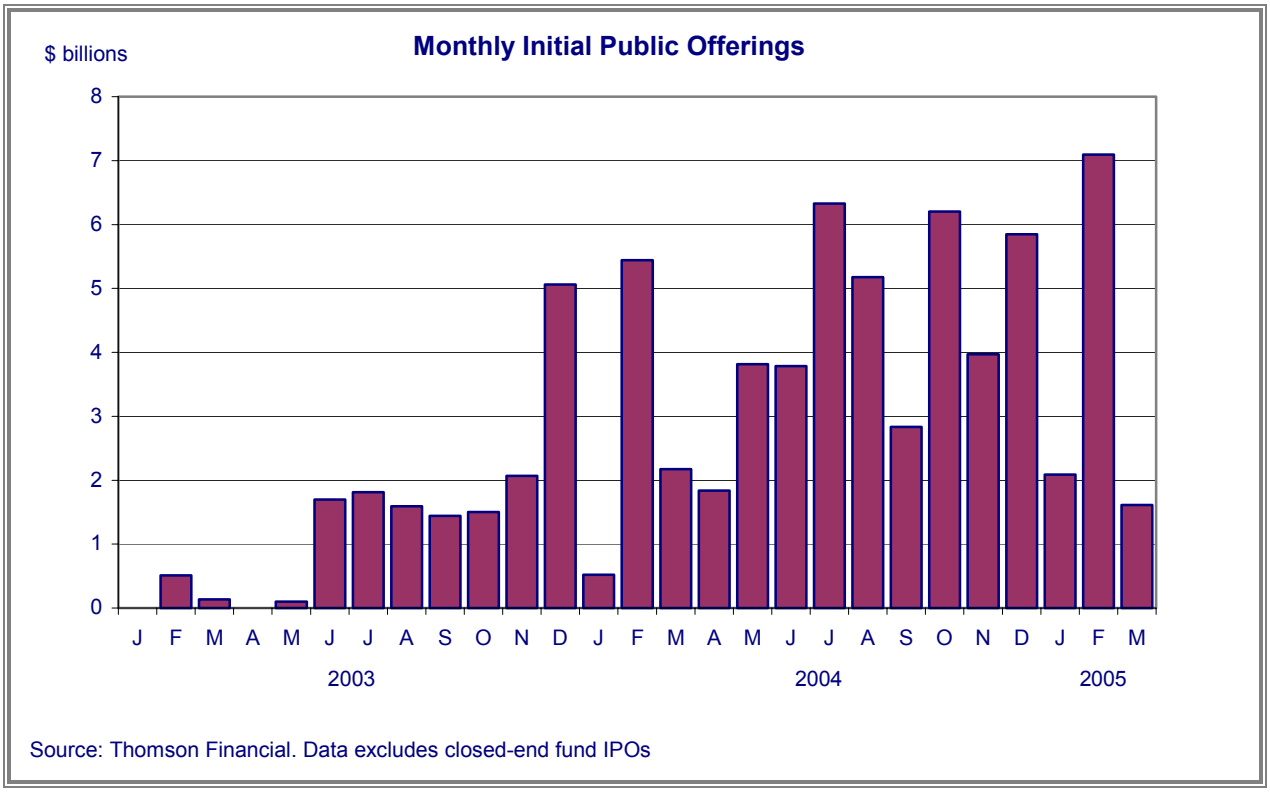
Underwriting

We are somewhat cautious about the equity side of the underwriting business in 2005. The equity capital markets business rebounded and had a very strong year in 2004, with total volumes only marginally below 2000's record. But weaker volume in 1Q'05 reflected the relatively slow pipeline going into the year, with $42.7 billion of equity underwritten, a result

that was down 9.1% on 4Q'04 and – more significantly – down 37.6% on the equivalent period a year earlier. This suggests that 2005 will not represent a linear continuation of 2004's growth rate in this market.

Looking further forward into the year, conditions in equity markets, while not adverse, seem less benign than they did three months back. The market backlog – a forward-looking indicator of likely volume in the weeks and months ahead – traditionally tends to build into the middle of the year as companies seek financing. There has been little build-up over the course of 1Q'05 and into 2Q'05, however, with the backlog currently at the same level as February 2005, and down 19.9% on a year earlier.

A somewhat brighter star in the investment-banking firmament is the market for IPOs. U.S. IPO volume for 1Q'05 was $10.8 billion, down 32.6% on 4Q'04, but in a neatly symmetrical fashion up 32.6% from the same period a year ago. As the chart below shows, the market was also rather volatile, with February's volume the highest since the 2000 IPO bubble, but with a precipitous 77% decline in March volume. In other words, the IPO market is still strong, but more erratic than anticipated.

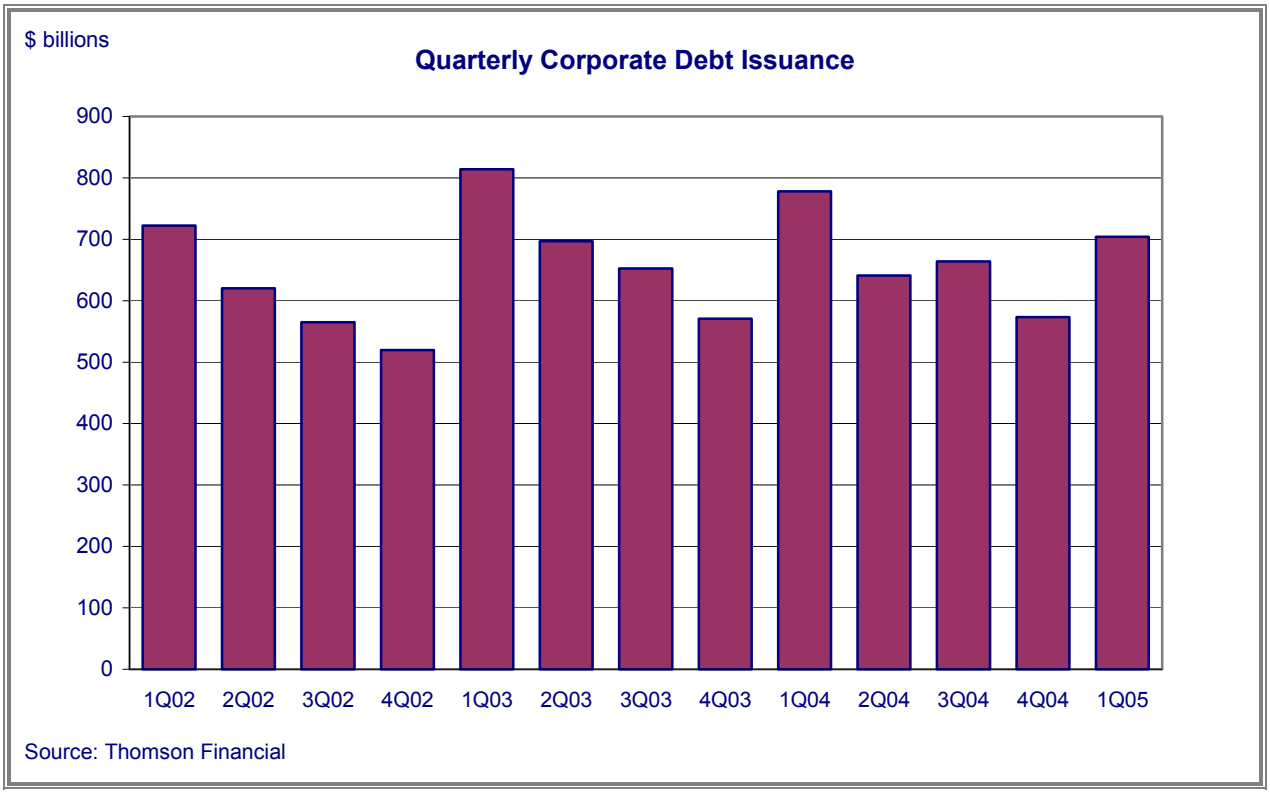


Bearing in mind this balance of factors, we forecast that 1Q'05 equity underwriting results will be up on 4Q'04 by approximately 13%, but will then weaken into the second and third quarters, followed by a pick-up in 4Q'05.

The corporate bond underwriting market ended 2004 down 2.9% from 2003's total, at $2.7 trillion in issuance. Revenues were supported by a record year in high-yield issuance, which is a higher risk and higher margin product for underwriters. We expect that debt underwriting will struggle to generate revenues at 2004 levels, given the upturn in the interest rate cycle, and

deteriorating conditions in the high-yield credit market. Recent market events have also increased risk and uncertainty.

In terms of revenue generation, early indications suggest a decline for the quarter of approximately 15%.[4] However, 1Q'05 corporate debt underwriting volumes were unexpectedly strong, with $704 billion of issuance. This result is up 22.8% from 4Q'04, and also above 3Q'04 and 2Q'04 totals, although down 9.5% on a year earlier. 1Q'05 also saw reduced levels of high-yield debt issuance, down 30% from 4Q'04 to $30.5 billion.[5]



We estimate that overall underwriting revenue levels were up 3-5% in 1Q'05 on a sequential quarterly basis to $5.5 billion, on the back of sustained equity issuance and higher than expected corporate debt issuance. However, the headwinds that both equity and debt markets are likely to face as we move into the second and third quarters – though with some support likely from the IPO market – mean that we expect revenues to deteriorate, dropping 20-25% in 2Q'05, and then a further 5-10% in 3Q'05. We expect a modest recovery in 4Q'05, though not on the scale of the final quarter of 2004, as bankers work to bring deals to market before the year-end.

Trading Gains

Trading gains are harder to forecast because, unlike primary capital markets, asset management or M&A activities, the state of the business is not reflected in easily-available information on the underlying market (such as issuance levels, assets under management or deal volume). Moreover, trading gains display significantly more volatility than other business lines.

[4] Source: Dealogic

[5] Source: Thomson Financial

However, of the public firms that have published 1Q'05 results almost all reported extremely strong trading or principal gains[6], with a couple of firms seeing trading gains at nearly double 4Q'04 levels. This suggests that overall 1Q'05 trading gains will be similarly strong, coming in at levels last seen in early 2001. We forecast 1Q'05 revenues in this line of $8.9 billion, or 25% above 4Q'04 levels. However, we would then expect gains to return to more normal levels in 2Q'05 and 3Q'05, although still at levels exceeding 3Q'04, the low point of 2004.

Commissions

Commission rates continued to decline in 2004, albeit at a slower rate than in the past. At the same time, though, there has been higher average daily ticket volume, with an increase in 2004 of 12.7% compared to 2003. This trend has persisted into the first quarter of 2005, with market indicators suggesting that high levels of client trading activity in recent months buoyed broker-dealers' commissions during 1Q'05. These indicators include:

- Daily average ticket volume processed through the clearing and settlement machinery increased by 11.0% over the quarter; and,
- Daily average share volume on the principal stock markets (NYSE, Amex and NASDAQ) increased by 7.3% over the quarter.

We expect this rise in trading activity to continue into mid-year, as market volatility rises after a two-year lull, leading investors to move in and out of the market more frequently, either to take positions on short-term price movements or to implement volatility-based trading strategies (such as index arbitrage trades). Both will tend to increase broker-dealer commission flows. As a result, we forecast a 3.0% increase in total commission revenues in 1Q'05. Offsetting this trend, however, is the recent weakness in equity markets, which is likely to leave many retail and institutional investors sitting on the sidelines later in the year, reducing commission levels.

Mutual Fund Sales Revenue and Asset Management Fees

We set out in an earlier report looking ahead into 2005 that we expected strong headwinds to impede further progress in the investment management business, both for the revenues from mutual fund sales and fees for assets under management.[7] We noted that both the competitive and macroeconomic environments were unwelcoming, and that there has been a secular decline in overall fee levels that fund companies can charge. We concluded that with slowing corporate earnings growth and rising interest rates, significant advances in market indices were unlikely, despite the apparent buoyancy at the time of the broader economy.

As we move into the second quarter, these expectations have been borne out. Long-term mutual fund assets were up only 0.9% at the end of February compared to end-4Q'04, although 6.5% higher than a year previously, thanks to the rally in equity markets in 4Q'04. As a result, we estimate 1Q'05 asset management fees were largely unchanged on 4Q'04 figures.[8]

Mutual fund sales volumes, despite this malign backdrop, actually appeared remarkably robust in 1Q'05. Net new cash flow into equity mutual funds for the first two months of 2005 was up by 2.4% compared to the last two months of 4Q'04, although down by more than half from the

[6] Principal gains include investment gains, which tend to be only a small share of overall gains

[7] See *Securities Industry Trends*, Vol. XXX, No. 1 (February 28 2005), op. cit.

[8] Data in this section sourced from Investment Company Institute, www.ici.org/stats/mf/.

first two months of 2004, when very strong inflows were recorded. But this drop was more than balanced out by strong flows into hybrid and bond funds. Although margins are lower on fixed income fund sales, these flows will still provide support for sales revenues. Overall, for all long-term mutual funds,[9] net new cash flow in the first two months of 2005 was 20.8% above levels for the last two months of 2004. Given the changing product mix in mutual fund sales – and particularly the declines in equity product sales - we expect overall results for this revenue line item in 1Q'05 to remain broadly flat.

As we move into 2Q'05 and 3Q'05, the outlook deteriorates. With the major market indices lower year-to-date, we expect both net mutual fund inflows to slow, and assets under management to decline. We expect mutual fund sales to drop significantly in 2Q'05 – in the order of 10% – with a further (if smaller) decline in 3Q'05, before recovering somewhat towards year-end. For asset management fees, we anticipate a similar, but less volatile pattern, with fees dropping 7% into 2Q'05 before stabilizing in the second half of the year.

Other Revenues Related to the Securities Industry

The businesses covered in this reporting line include some that are increasingly important to the industry, including M&A advisory fees, prime brokerage services for hedge funds and fees for tailored structured transactions for clients.

M&A deals appear, on initial estimates, to be up by 10% in 1Q'05. The M&A market is driven by various factors, including the overall business environment, funding costs, and concerns about creditworthiness or rating prospects of potential targets. Most of these factors are currently benign. We forecast that M&A deals will top $1 trillion in 2005, an increase of 20% over 2004's tally of $834 billion of deals completed. Year-to-date, this forecast looks to be well on track, with $300.6 billion in deals announced, 18.5% more than the $253.7 billion announced over the same timeframe in 2004.[10]

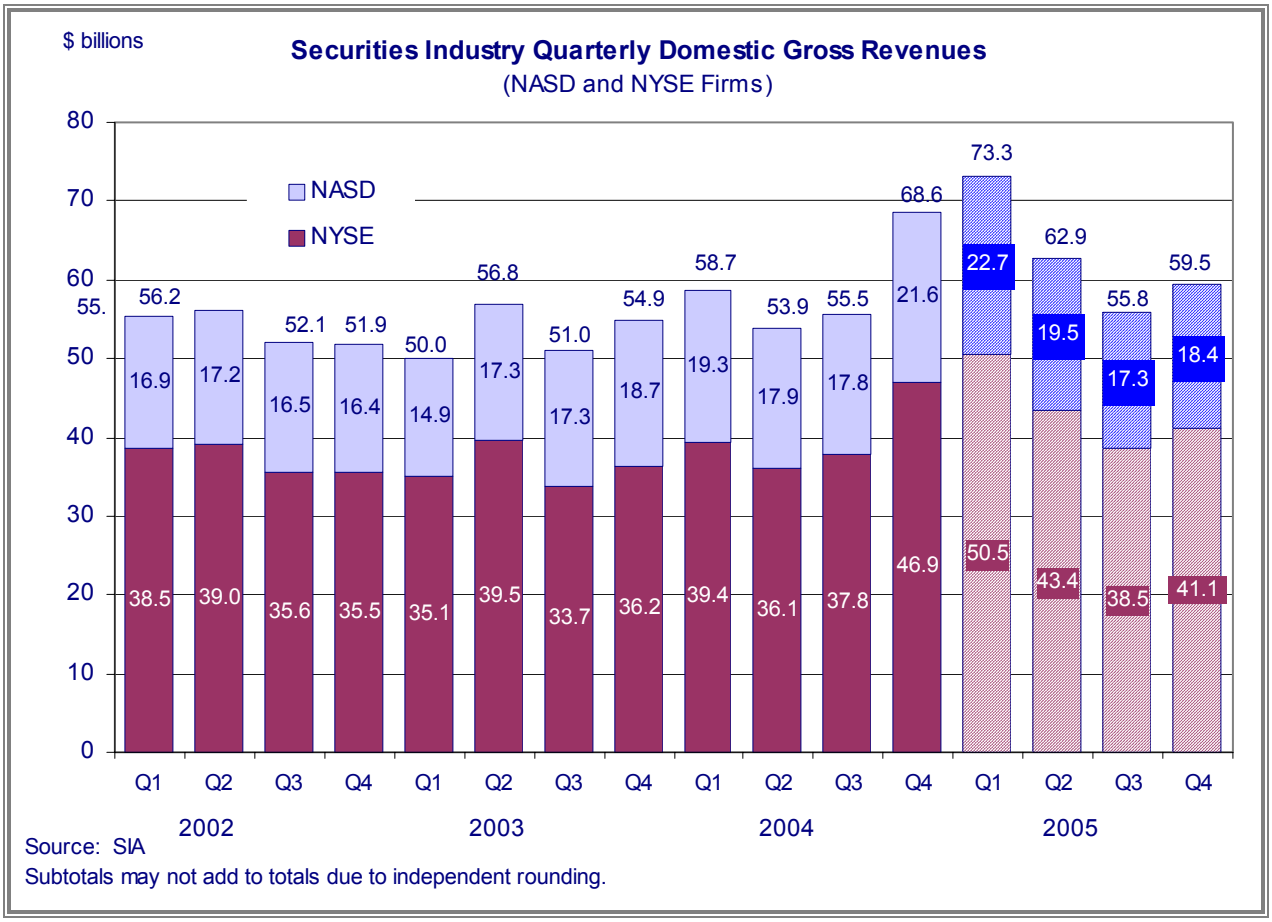
Data is harder to come by for prime brokerage, where hedge funds generate margin, stock-lending fees and other revenues for broker-dealers. But given their growing size and the fact that hedge fund trading intensity is likely to have increased as a result of recent increases in market volatility, we expect a significant pick-up in prime brokerage revenues in the first half of the year, in the order of 10%-20%, followed by slower growth in the second half.

Using these assumptions, and noting the strength in other components of the 'Other Revenues Related to the Securities Business,' such as structured transactions, we expect that overall growth in this business line will be in the order of 15% in 2005 compared to 2004. As with other business lines, market conditions and the broader macroeconomic outlook indicate a slowdown in the middle part of the year. We forecast a drop of 10% in 2Q'05 from 1Q'05, and then a further but smaller decline in 3Q'05.

The forecast for securities industry gross revenues in 2005 is $251.4 billion. This would be 6.2% higher than 2004 gross revenues, and significantly above 2003's and 2002's results, but 8.3% below record 2001 levels.

[9] Fee levels are significantly lower on money-market funds, and while a useful indicator of market sentiment are not factored into our forecasting analysis.

[10] *Investment Dealers' Digest*. data as of 04/11/05



Compensation Expense

Turning to the expenses side, compensation expense will remain the largest cost center for broker-dealers in 2005. Several factors affect our forecast for compensation expense in 2005, including:

- Our projection that overall industry headcount will increase by 3.0%-3.5% over year-end levels in 2004;
- Our expectation that aggregate industry wage inflation is likely to track U.S. averages in 2005, but that bonus payouts are likely to grow more rapidly; and,
- Changing personnel composition in the industry suggests a higher proportion of industry workers are likely to be compensated for performance, supporting our view that bonuses are likely to experience an uptick in 2005.[11]

[11] See "Employment Trends in the Securities Industry: Winners and Losers as Employment Recovers," *SIA Research Reports* Vol. VI, No. 3 (April 6 2005), http://www.sia.com/research/pdf/RsrchRprtVol6-3.pdf.

In total, we forecast total compensation in 2005 to reach $88.5 billion. This would be a 6.4% increase on 2004. In terms of the distribution of these payouts over the four quarters, we expect to see a spike in 1Q'05, as bonuses are paid out and the year gets off to a strong start. There is likely to be weakness in the middle part of the year, reflecting lower production payouts in a weaker mutual fund sales environment, and we forecast that 4Q'05 will end stronger, as firms accrue bonus pools for the 2005-6 bonus season.

Occupancy Costs, IT and Capital Spending

The drop in industry profits from 2001 to 2003 was reflected in wide-ranging cost-cutting initiatives. Occupancy costs, information technology (IT) spending and new capital investment were hit particularly hard. The total expenses in the 'communications expense' and 'occupancy and equipment costs' categories were cut by 14.5% in 2002, and by a further 8.9% in 2003. This two-year period is sometimes referred to as the IT 'freeze and squeeze.'

In 2004, spending in these categories leveled off at almost exactly 2003 levels. In 2005, with two years of solid profitability booked, occupancy and capital spending constraints are being lifted, and higher spending is expected this year. In all, we expect an aggregate increase in these expense areas in the order of 2%, rising to $11.4 billion from $11.1 billion.

Interest Expense

The other major cost item is interest expense. As we noted earlier, interest expense picked up significantly in 2004 as a result of several factors. Going into 2005, we expect interest expense to continue to rise, but at a slower rate than in 2004. The greater levels of volatility seen in secondary markets may result in a slower rate of expansion of leverage in proprietary-trading positions. Growth of credit to hedge funds is expected to slow. Balancing this out somewhat is the greater use of the balance sheet to support corporate finance activities. In particular, several of the large M&A deals seen so far this year and demand for credit in leveraged buy-out transactions should support continued growth in interest expense. More significantly, on the macro side, it seems likely that short-term interest rates will head further north than the 3.5% consensus foreseen a few months back, with many commentators expecting fed funds to breach 4% by end-2005. *Ceteris paribus*, this will also lead to greater levels of interest expense.

Our forecast for total securities industry expenses in 2005 is $229.9 billion, 6.4% higher than 2004's total of $216.0 billion. With gross revenues forecast to be $251.4 billion, this would generate $21.5 billion of pre-tax net income in 2005.

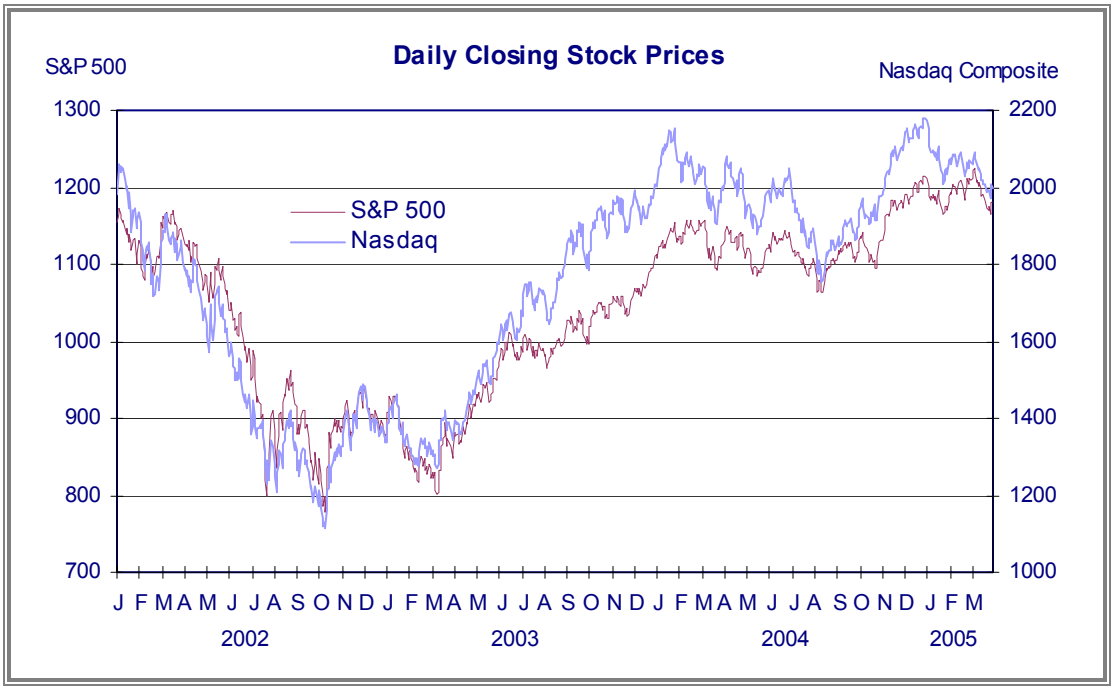
Rob Mills
Vice President and Director, Industry Research

MONTHLY STATISTICAL REVIEW AND FIRST QUARTER WRAP-UP

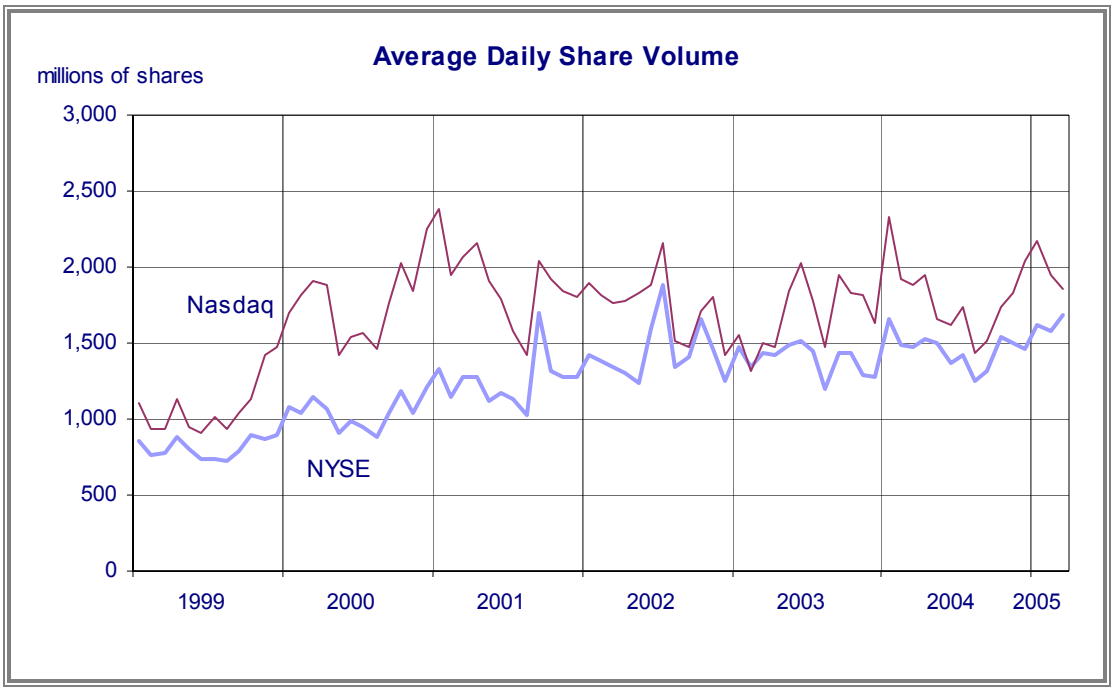
U.S. Equity Market Activity

Stock Prices – The U.S. stock market rally in the closing months of 2004 proved to be short-lived, as the three major indices registered losses in the first quarter of 2005. After a difficult January, the Dow Jones Industrial Average and the S&P 500 Index rebounded to fresh 3 ½ year highs by early March, buoyed in part by increased merger activity and some strong corporate earnings reports. However, the indices retreated through the remainder of the month as another spike in oil prices, rising interest rates, and intensified inflationary fears sparked concern about the outlook for the economy and corporate profits. Current forecasts call for year-over-year earnings growth for S&P 500 companies to decelerate to 13% in the first quarter of 2005, down from 20% growth in last year's final quarter. All told, the DJIA shed 2.4% in March to close at 10,503.76 and the S&P 500 fell 1.9% to 1,180.59. Meanwhile, the NASDAQ Composite Index dropped 2.6% to end March at 1,999.23.

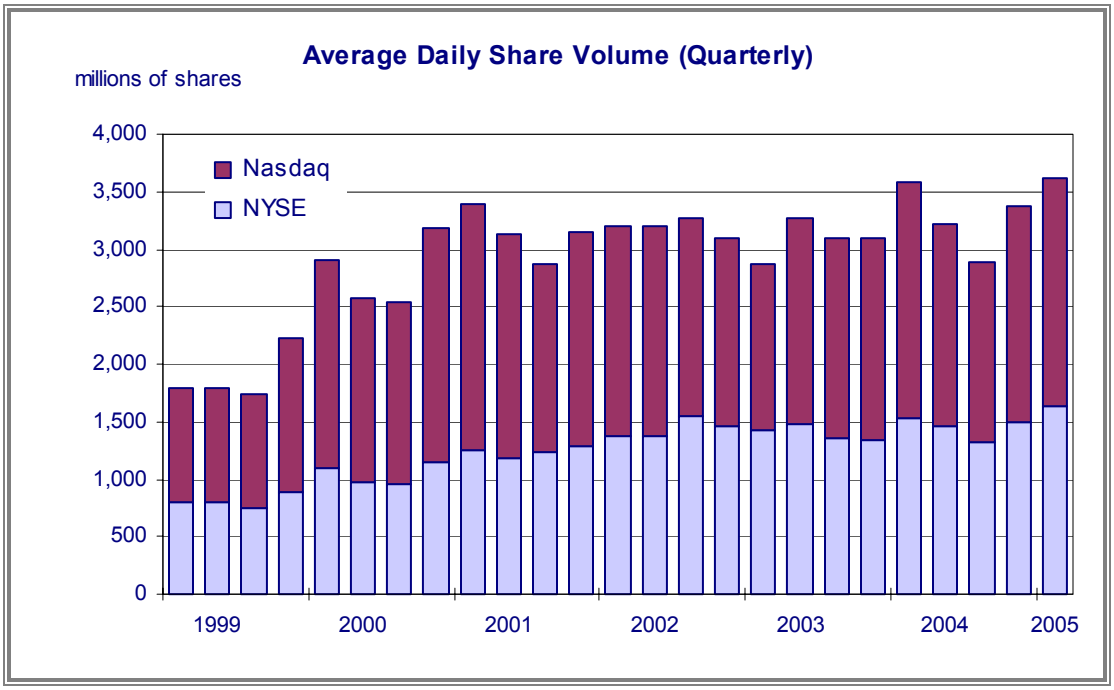
For the first three months of this year, the S&P 500 and DJIA were both down 2.6%, while the NASDAQ declined 8.1% mainly due to weakness in technology stocks. These quarterly results marked NASDAQ's worst quarterly performance since the third quarter of 2002, the S&P 500's worst quarterly showing in two years, and the DJIA's third consecutive first-quarter downturn.



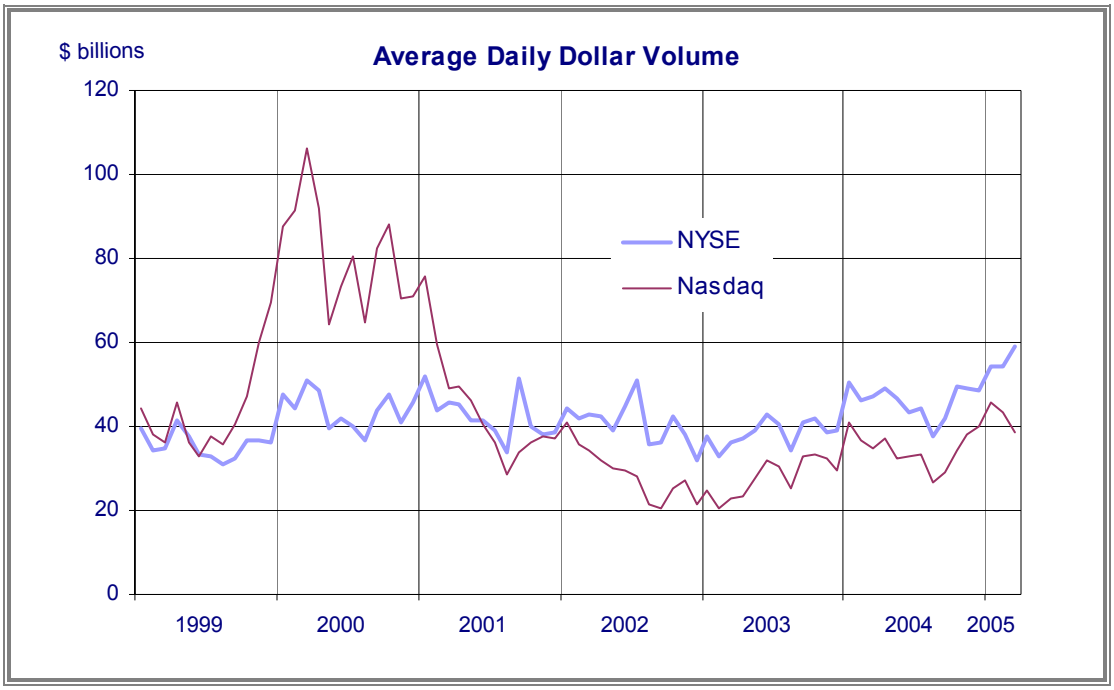
Share Volume – Average daily share volume on the New York Stock Exchange remained strong throughout the first three months of 2005. In March, NYSE volume rose 6.6% from February's level to 1.68 billion shares daily. That lifted volume in the first quarter to a record 1.63 billion shares daily, up 8.6% from fourth quarter 2004 levels and 5.9% above volume levels reached in the same year-earlier period.



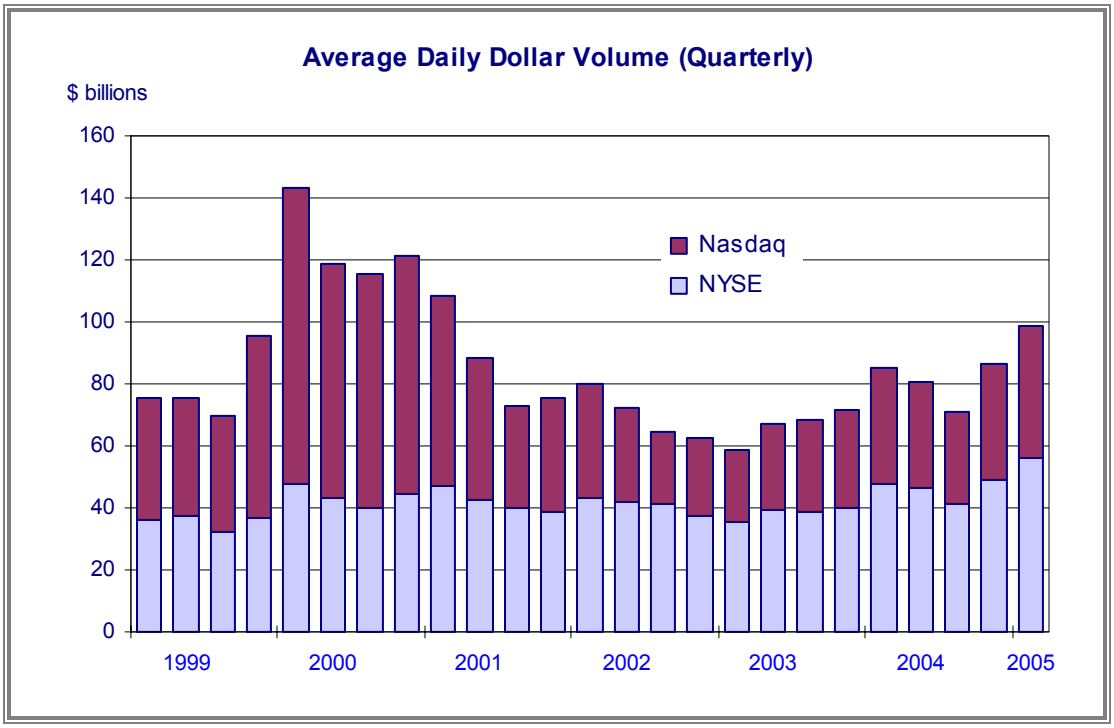
NASDAQ volume also was heavy throughout 1Q'05, despite easing somewhat over the past two months. After surging in January to 2.17 billion shares daily, NASDAQ average daily share volume slipped 5.2% from February's level to 1.85 billion in March. For the quarter overall, NASDAQ share volume averaged 1.99 billion daily. This is 6.3% higher than in 4Q'04, but still shy of the 2.04 billion daily average for the first three months of last year.



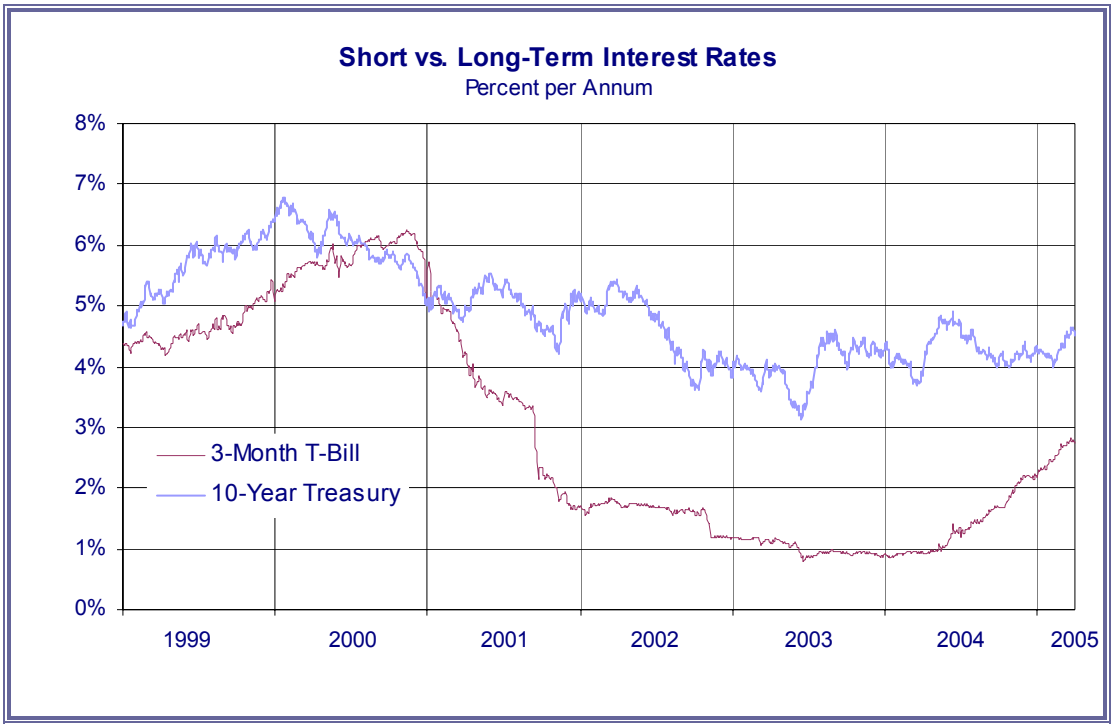
Dollar Volume – Heightened trading activity, along with a rise in the average price per share traded, drove NYSE average daily dollar volume to record levels in the first quarter. It climbed for the third consecutive month to $59.1 billion in March, an 8.4% increase over $54.5 billion in February. That lifted the first quarter average to $56.0 billion daily, eclipsing the previous record of $49.0 billion daily set in 4Q'04 and 16.9% above levels in the same year-earlier period.



The value of trading in NASDAQ stocks also increased in 1Q'05 from 2004 levels, as increased trading activity offset the retreat in NASDAQ stock prices. After rising for five consecutive months to $45.5 billion daily in January, NASDAQ dollar volume fell back for the second straight month to $38.8 billion daily in March. First quarter average daily dollar volume of $42.4 billion was nonetheless 13.1% ahead of fourth-quarter 2004's pace and 13.6% above first-quarter 2004 levels.

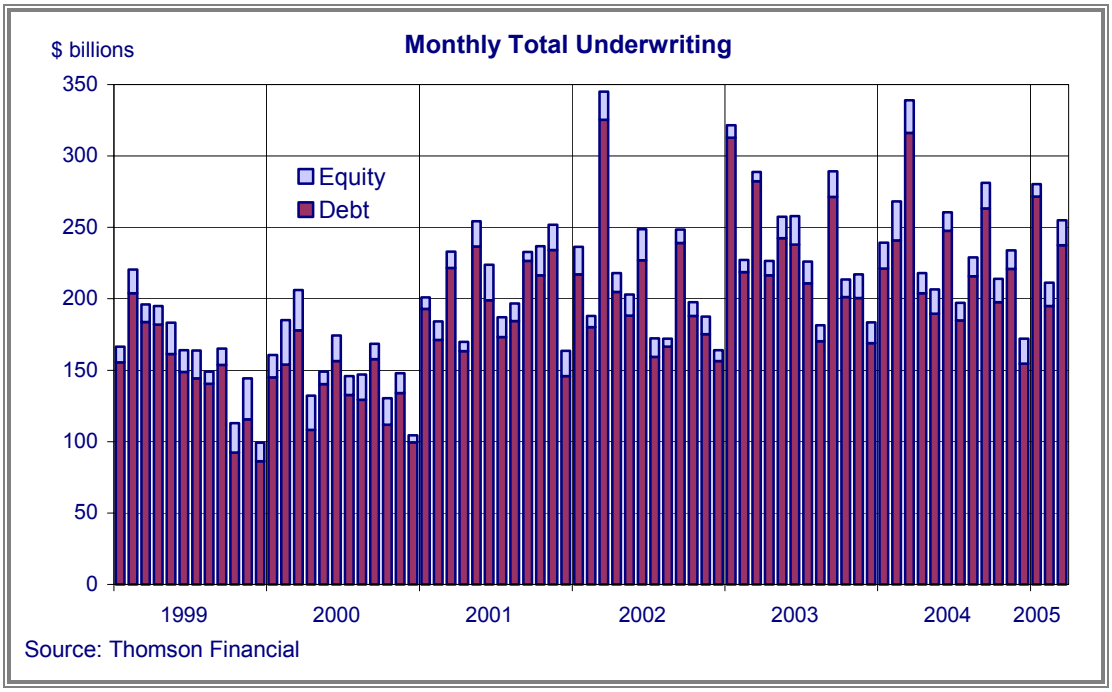


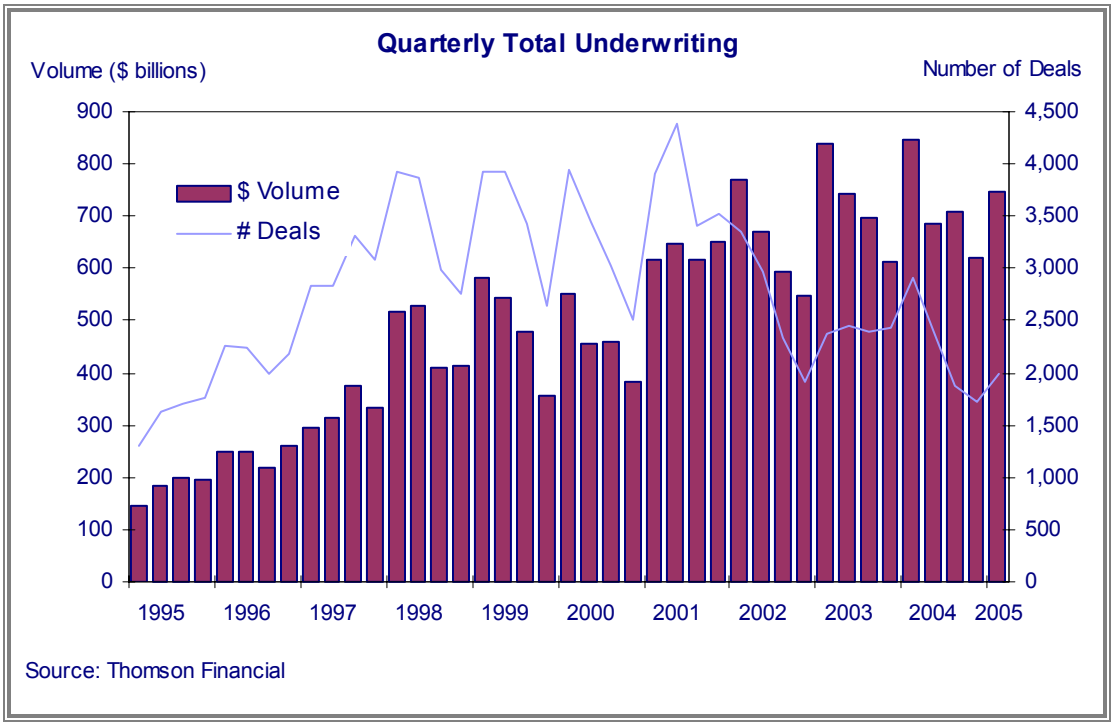
Interest Rates – Long-term interest rates headed lower through early February, with 10-year Treasury yields falling to a four-month low of 4.00% on February 9 from 4.24% at the start of the year. However, yields began to rise after Federal Reserve Chairman Alan Greenspan told Congress that the recent decline in long-term rates amid rising short-term interest rates was a "conundrum." Also driving yields higher was the Fed's unexpected comment on the build up of inflationary pressures in the statement that accompanied its quarter-point (25 basis points) increase in the federal funds rate to 2.75% on March 22. The 10-year Treasury yield hit a nine-month peak of 4.64% on March 28 and ended the quarter at 4.50%. With two quarter-point hikes in short-term rates by the Fed during the first quarter of 2005, yields on three-month Treasury bills increased to 2.73% by the end of March from 2.18% at year-end 2004.



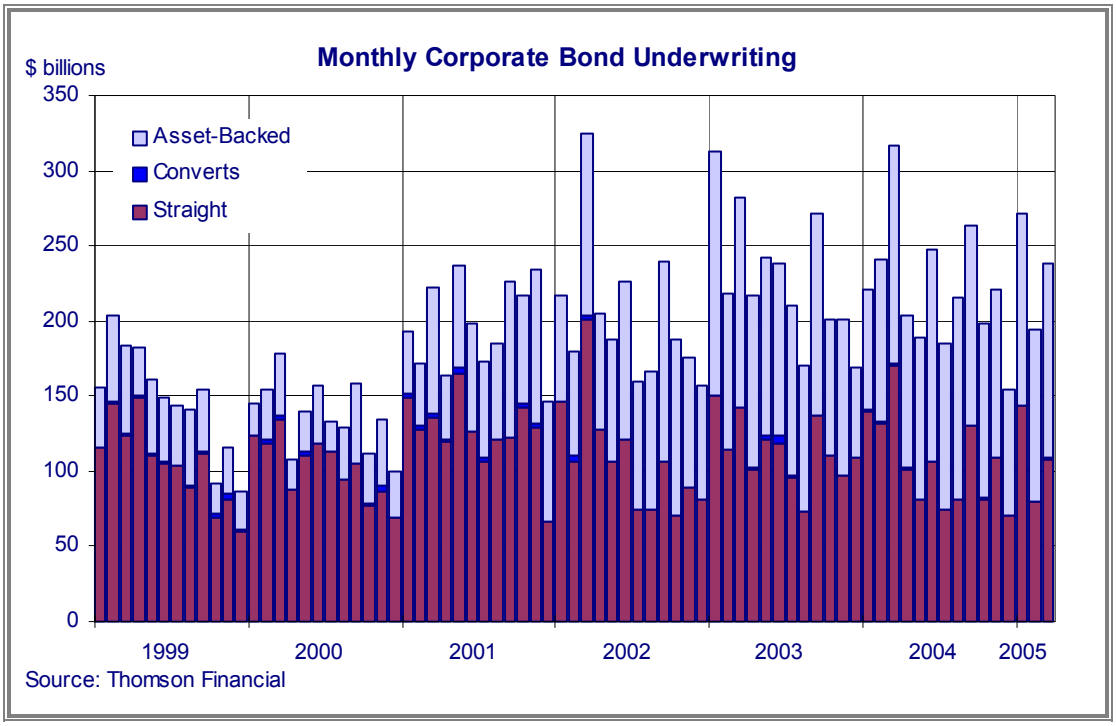
U.S. Underwriting Activity

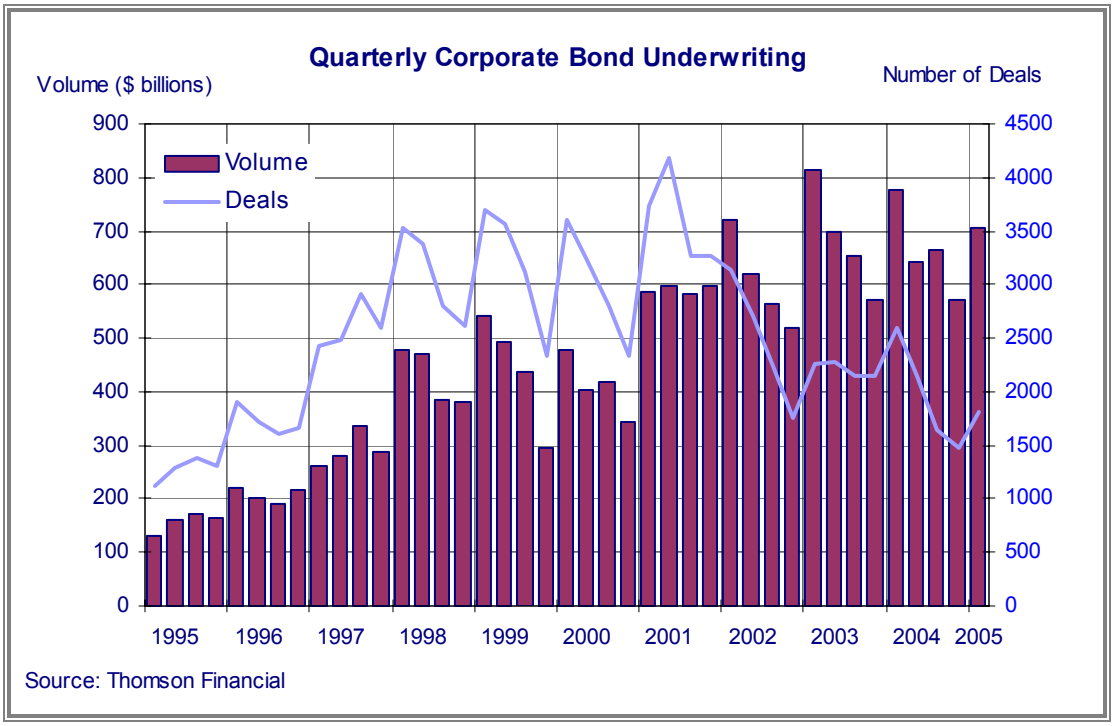
Total underwriting activity in the U.S. market surged 20.8% in March to $255.2 billion, reflecting increased new issuance of both corporate debt and equity. For the first quarter as a whole, underwriting activity totaled $746.6 billion, up 20.4% from $620.1 billion in the previous quarter, but off 11.8% from the record $846.5 billion set in the first quarter of 2004.



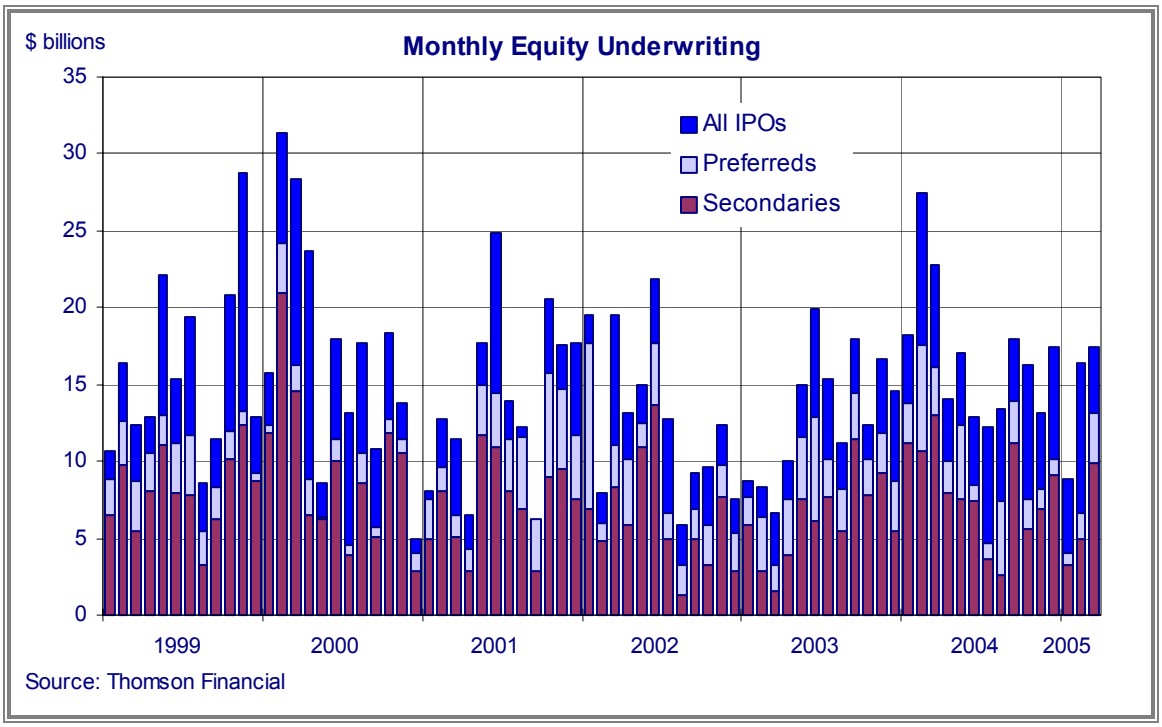


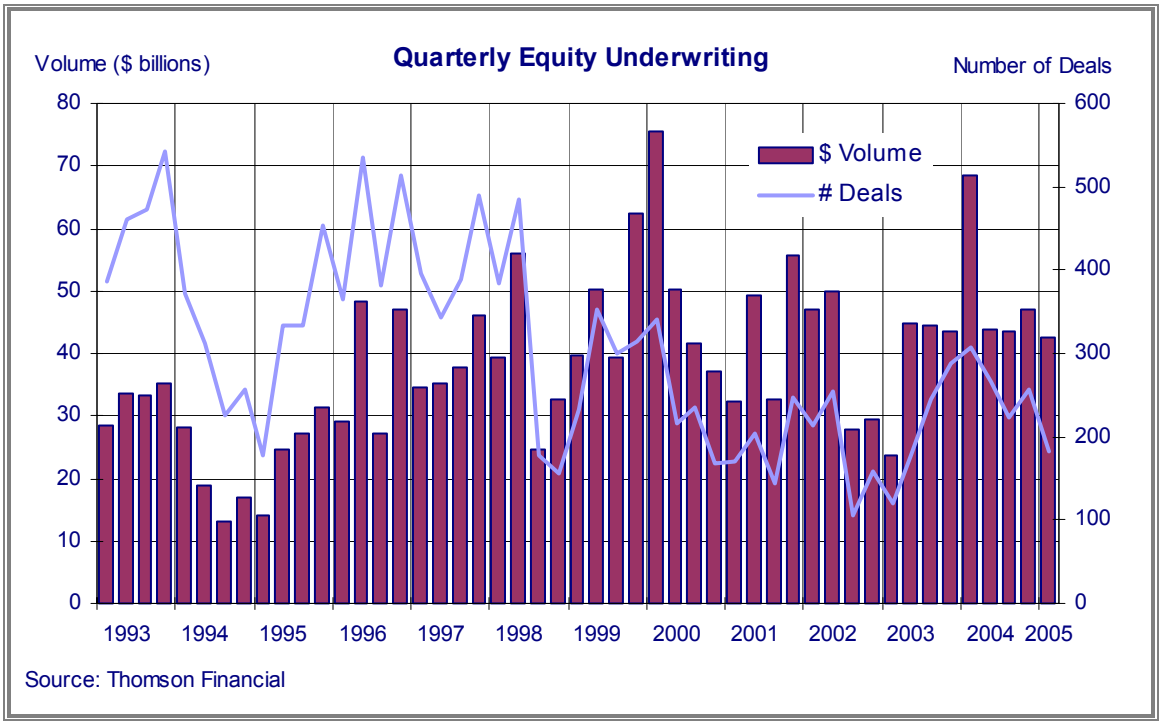
Corporate Bond Underwriting – Although interest rates have been rising lately, they still remained at attractive levels to corporate issuers. New issuance of corporate bonds totaled $704.0 billion in the first quarter of 2005, which was 22.8% above the $573.2 billion issued in the fourth quarter of 2004, but 9.5% below the $778.2 billion issued during this same time period last year. That decline from year-ago levels was due to a cutback in straight corporate debt offerings, which fell 25.0% to $331.8 billion in 1Q'05, from $442.0 billion in last year's comparable period.



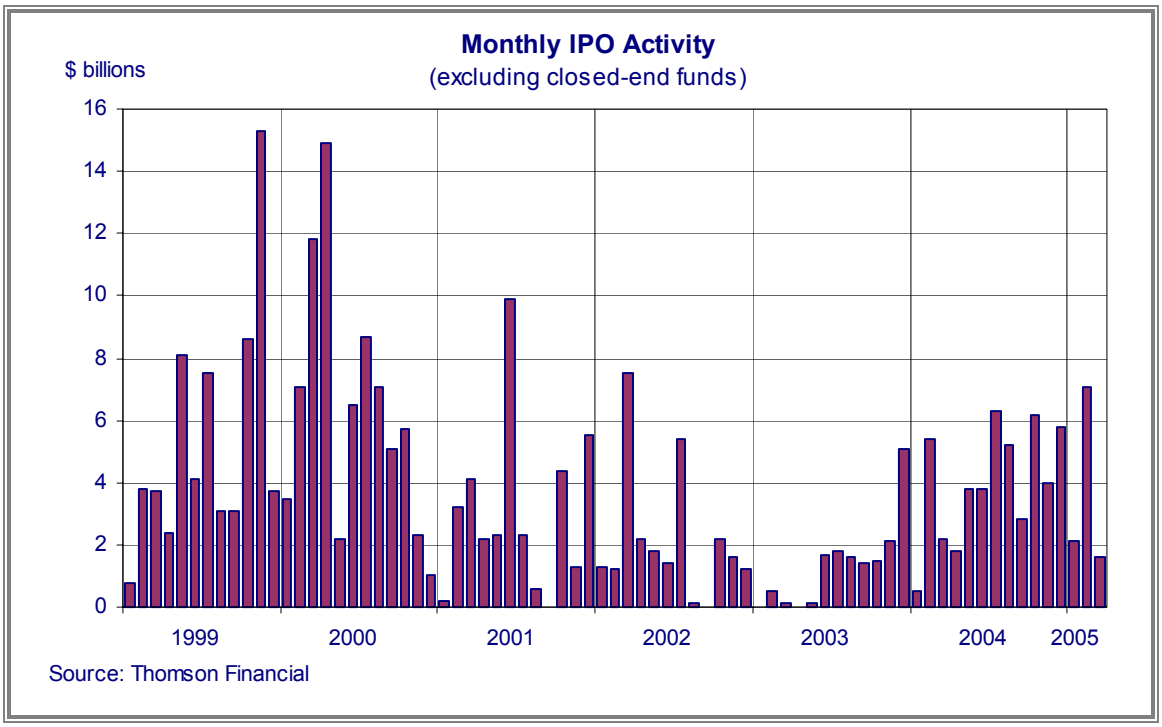


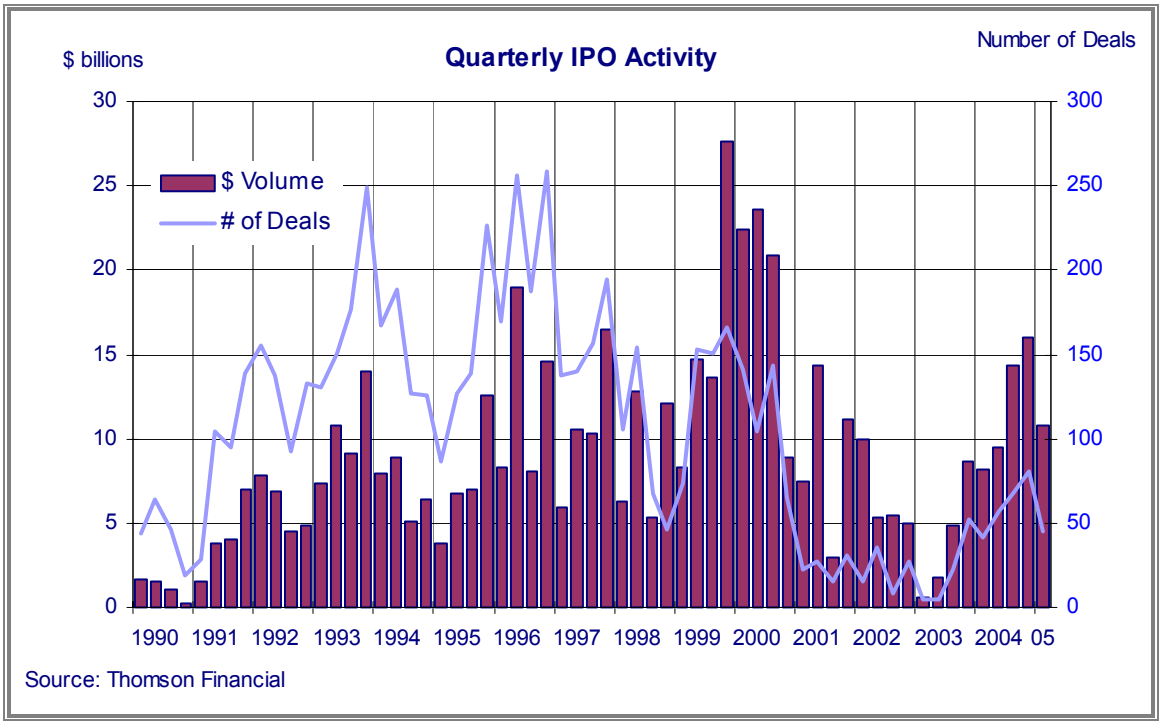
Equity Underwriting – The overall issuance volume of common and preferred stock by U.S. issuers fell in the first quarter of 2005 as the downturn in the stock market dampened investor enthusiasm. Despite steady monthly increases from $8.8 billion in January to $17.5 billion in March, first quarter volume of $42.7 billion stood 9.0% below fourth-quarter levels, and 37.6% lower than 1Q'04's elevated level of $68.4 billion.



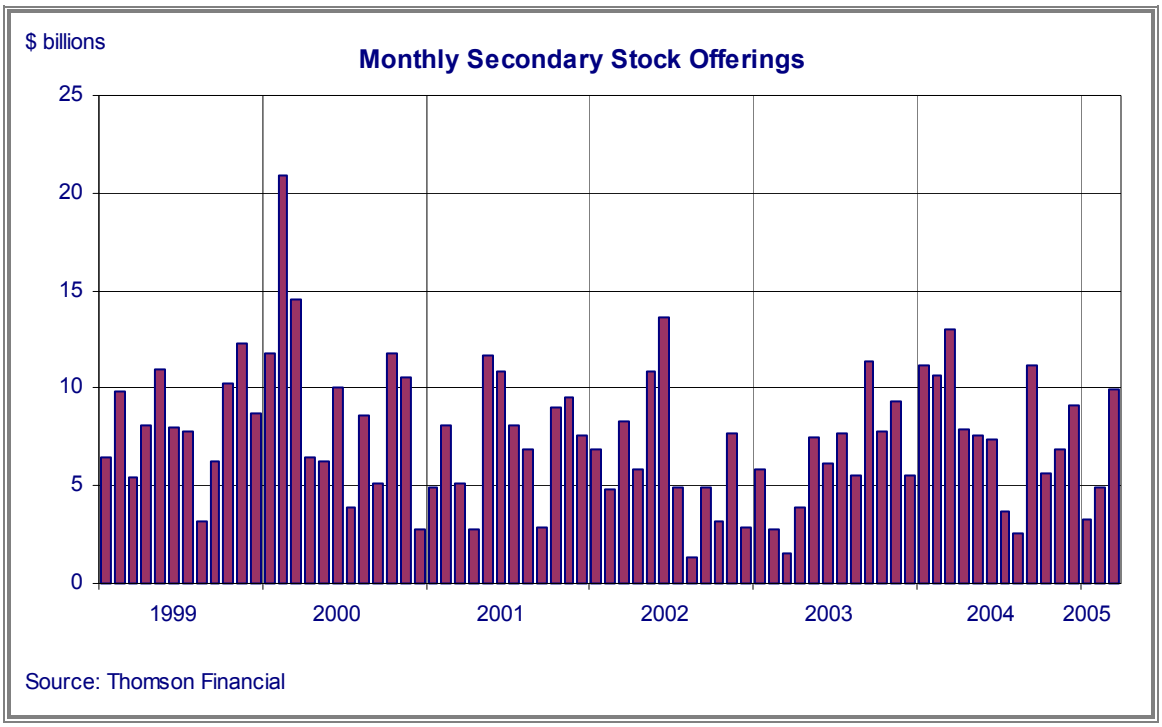


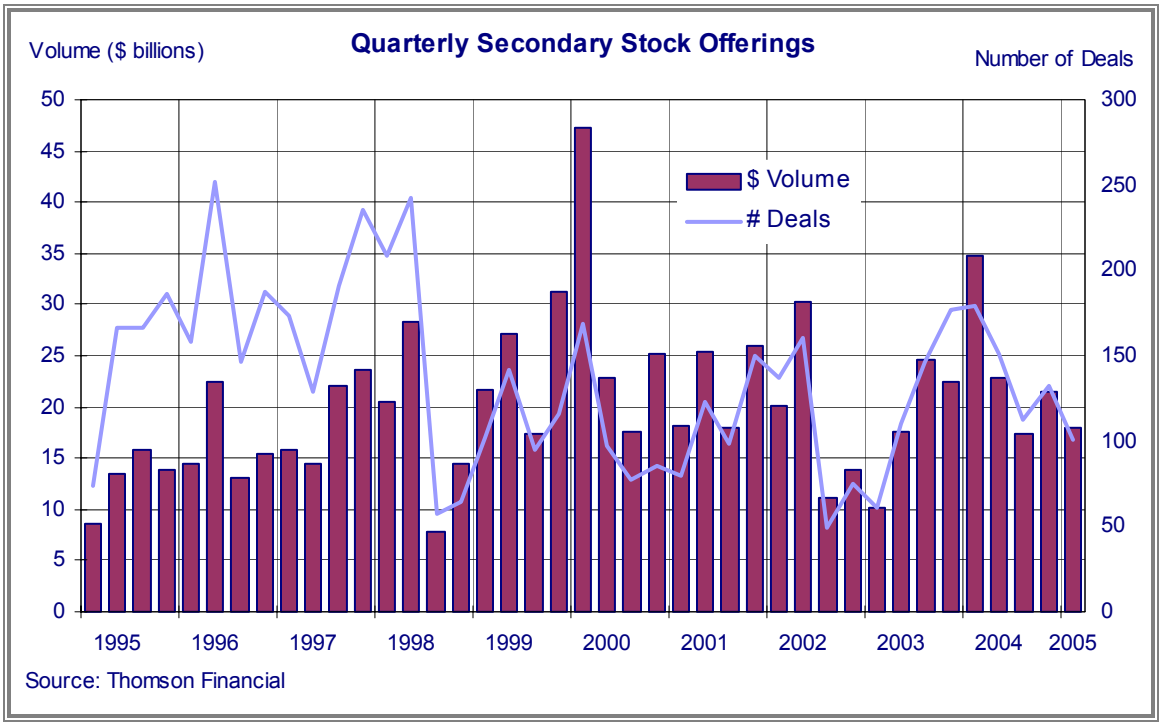
Initial Public Offerings (IPOs) – U.S. IPO activity waned in March, as the stock market weakened and some start-up companies that planned to go public chose to be acquired instead. After surging to a three-year high of $7.1 billion in February, IPO volume plunged to $1.6 billion in March, the lowest monthly total since last January. That brought the first quarter total to $10.8 billion. While that figure represents a 32.6% drop from $16.0 billion in the fourth quarter of 2004, it still stands 32.6% above the $8.1 billion posted in the first quarter of 2004.





Secondary offerings of common stock doubled in March from February's level to $9.9 billion. Despite the upward trend in monthly activity, volume during the first three months of 2005 fell to $18.0 billion, a 16.7% decline from $21.6 billion in the previous quarter, and a sharp 48.2% drop from the $34.8 billion posted in last year's first quarter.





Grace Toto
Vice President and Director, Statistics

U.S. CORPORATE UNDERWRITING ACTIVITY

(In $ Billions)

	Straight Corporate Debt	Con-vertible Debt	Asset-Backed Debt	TOTAL **DEBT**	Common Stock	Preferred Stock	TOTAL **EQUITY**	All IPOs	"True" IPOs	Secondaries	**TOTAL** UNDER-**WRITINGS**
1985	76.4	7.5	20.8	104.7	24.7	8.6	33.3	8.5	8.4	16.2	138.0
1986	149.8	10.1	67.8	227.7	43.2	13.9	57.1	22.3	18.1	20.9	284.8
1987	117.8	9.9	91.7	219.4	41.5	11.4	52.9	24.0	14.3	17.5	272.3
1988	120.3	3.1	113.8	237.2	29.7	7.6	37.3	23.6	5.7	6.1	274.5
1989	134.1	5.5	135.3	274.9	22.9	7.7	30.6	13.7	6.1	9.2	305.5
1990	107.7	4.7	176.1	288.4	19.2	4.7	23.9	10.1	4.5	9.0	312.3
1991	203.6	7.8	300.0	511.5	56.0	19.9	75.9	25.1	16.4	30.9	587.4
1992	319.8	7.1	427.0	753.8	72.5	29.3	101.8	39.6	24.1	32.9	855.7
1993	448.4	9.3	474.8	932.5	102.4	28.4	130.8	57.4	41.3	45.0	1,063.4
1994	381.2	4.8	253.5	639.5	61.4	15.5	76.9	33.7	28.3	27.7	716.4
1995	466.0	6.9	152.4	625.3	82.0	15.1	97.1	30.2	30.0	51.8	722.4
1996	564.8	9.3	252.9	827.0	115.5	36.5	151.9	50.0	49.9	65.5	979.0
1997	769.8	8.5	385.6	1,163.9	120.2	33.3	153.4	44.2	43.2	75.9	1,317.3
1998	1,142.5	6.3	566.8	1,715.6	115.0	37.8	152.7	43.7	36.6	71.2	1,868.3
1999	1,264.8	16.1	487.1	1,768.0	164.3	27.5	191.7	66.8	64.3	97.5	1,959.8
2000	1,236.2	17.0	393.4	1,646.6	189.1	15.4	204.5	76.1	75.8	112.9	1,851.0
2001	1,511.2	21.6	832.5	2,365.4	128.4	41.3	169.7	40.8	36.0	87.6	2,535.1
2002	1,303.2	8.6	1,115.4	2,427.2	116.4	37.6	154.0	41.2	25.8	75.2	2,581.1
2003	1,370.7	10.6	1,352.3	2,733.6	118.5	37.8	156.3	43.7	15.9	74.8	2,889.9
2004	1,278.4	5.5	1,372.3	2,656.2	169.6	33.2	202.7	72.8	47.9	96.7	2,859.0
2004											
Jan	139.4	1.4	80.3	221.1	15.6	2.6	18.2	4.4	0.5	11.2	239.2
Feb	132.2	0.7	108.1	240.9	20.5	6.9	27.4	9.8	5.4	10.7	268.2
Mar	170.5	0.6	145.2	316.2	19.8	3.1	22.8	6.7	2.2	13.0	339.1
Apr	101.6	0.3	101.9	203.9	12.0	2.1	14.1	4.1	1.8	7.9	218.0
May	81.4	0.1	108.1	189.6	12.2	4.8	17.0	4.6	3.8	7.6	206.6
June	107.0	0.0	140.6	247.6	11.8	1.0	12.9	4.5	3.8	7.4	260.5
July	74.2	0.0	110.7	184.9	11.2	1.0	12.2	7.5	6.3	3.7	197.1
Aug	81.0	0.0	134.7	215.7	8.6	4.8	13.4	6.0	5.2	2.6	229.1
Sept	130.5	0.6	132.1	263.2	15.2	2.7	17.9	4.0	2.8	11.2	281.1
Oct	81.0	1.1	115.6	197.7	14.4	1.9	16.3	8.8	6.2	5.6	214.0
Nov	108.7	0.4	111.7	220.9	11.8	1.3	13.1	5.0	4.0	6.9	234.0
Dec	70.9	0.3	83.5	154.6	16.5	1.0	17.5	7.4	5.8	9.1	172.1
2005											
Jan	143.1	0.2	128.2	271.5	8.1	0.7	8.8	4.9	2.1	3.3	280.3
Feb	80.3	0.0	114.6	194.9	14.7	1.7	16.4	9.8	7.1	4.9	211.2
Mar	108.4	0.5	128.7	237.6	14.3	3.2	17.5	4.4	1.6	9.9	255.2
YTD '04	442.0	2.6	333.5	778.2	55.8	12.6	68.4	21.0	8.1	34.8	846.5
YTD '05	331.8	0.7	371.5	704.0	37.1	5.5	42.7	19.1	10.8	18.0	746.6
% Change	-25.0%	-73.3%	11.4%	-9.5%	-33.5%	-56.0%	-37.6%	-9.0%	32.6%	-48.2%	-11.8%

Note: IPOs and secondaries are subsets of common stock. "True" IPOs exclude closed-end funds.
Source: Thomson Financial

MUNICIPAL BOND UNDERWRITINGS

(In $ Billions)

INTEREST RATES

(Averages)

	Compet. Rev. Bonds	Nego. Rev. Bonds	**TOTAL REVENUE BONDS**	Compet. G.O.s	Nego. G.O.s	**TOTAL G.O.s**	**TOTAL MUNICIPAL BONDS**	3-Mo. T Bills	10-Year Treasuries	SPREAD
1985	10.2	150.8	161.0	17.6	22.8	40.4	201.4	7.47	10.62	3.15
1986	10.0	92.6	102.6	23.1	22.6	45.7	148.3	5.97	7.68	1.71
1987	7.1	64.4	71.5	16.3	14.2	30.5	102.0	5.78	8.39	2.61
1988	7.6	78.1	85.7	19.2	12.7	31.9	117.6	6.67	8.85	2.18
1989	9.2	75.8	85.0	20.7	17.2	37.9	122.9	8.11	8.49	0.38
1990	7.6	78.4	86.0	22.7	17.5	40.2	126.2	7.50	8.55	1.05
1991	11.0	102.1	113.1	29.8	28.1	57.9	171.0	5.38	7.86	2.48
1992	12.5	139.0	151.6	32.5	49.0	81.5	233.1	3.43	7.01	3.58
1993	20.0	175.6	195.6	35.6	56.7	92.4	287.9	3.00	5.87	2.87
1994	15.0	89.2	104.2	34.5	23.2	57.7	161.9	4.25	7.09	2.84
1995	13.5	81.7	95.2	27.6	32.2	59.8	155.0	5.49	6.57	1.08
1996	15.6	100.1	115.7	31.3	33.2	64.5	180.2	5.01	6.44	1.43
1997	12.3	130.2	142.6	35.5	36.5	72.0	214.6	5.06	6.35	1.29
1998	21.4	165.6	187.0	43.7	49.0	92.8	279.8	4.78	5.26	0.48
1999	14.3	134.9	149.2	38.5	31.3	69.8	219.0	4.64	5.65	1.01
2000	13.6	116.2	129.7	35.0	29.3	64.3	194.0	5.82	6.03	0.21
2001	17.6	164.2	181.8	45.5	56.3	101.8	283.5	3.39	5.02	1.63
2002	19.5	210.5	230.0	52.3	73.1	125.4	355.4	1.60	4.61	3.01
2003	21.1	215.8	236.9	54.7	87.7	142.4	379.3	1.01	4.02	3.00
2004	17.2	209.8	227.1	51.5	77.7	129.2	356.3	1.37	4.27	2.90
2004										
Jan	0.7	10.4	11.1	3.6	5.7	9.3	20.4	0.88	4.15	3.27
Feb	1.0	13.0	14.1	4.8	7.7	12.5	26.5	0.93	4.08	3.15
Mar	2.7	19.7	22.4	5.6	10.5	16.1	38.5	0.94	3.83	2.89
Apr	1.0	18.1	19.0	3.5	8.2	11.8	30.8	0.94	4.35	3.41
May	1.4	28.0	29.5	3.1	4.7	7.8	37.2	1.02	4.72	3.70
June	1.3	24.0	25.3	4.5	5.4	9.8	35.1	1.27	4.73	3.46
July	1.8	14.6	16.5	5.1	3.7	8.9	25.3	1.33	4.50	3.17
Aug	0.6	15.5	16.1	4.0	7.6	11.6	27.7	1.48	4.28	2.80
Sept	1.7	13.2	14.9	5.3	4.8	10.1	25.0	1.65	4.13	2.48
Oct	2.4	17.7	20.0	5.3	6.5	11.8	31.9	1.76	4.10	2.34
Nov	1.1	17.2	18.3	2.3	4.6	6.8	25.1	2.07	4.19	2.12
Dec	1.5	18.5	20.0	4.5	8.3	12.7	32.7	2.19	4.23	2.04
2005										
Jan	1.0	11.5	12.5	3.6	6.7	10.3	22.7	2.33	4.22	1.89
Feb	1.5	15.8	17.3	4.5	9.2	13.6	30.9	2.54	4.17	1.63
Mar	1.2	22.8	24.0	7.0	12.7	19.6	43.6	2.74	4.50	1.76
YTD '04	4.5	43.1	47.6	14.0	23.9	37.9	85.5	0.92	4.02	3.10
YTD '05	3.6	50.1	53.7	15.0	28.5	43.5	97.3	2.54	4.30	1.76
% Change	-18.3%	16.1%	12.9%	7.7%	19.2%	15.0%	13.8%	176.7%	6.9%	-43.3%

Sources: Thomson Financial; Federal Reserve

	STOCK MARKET PERFORMANCE INDICES (End of Period)				STOCK MARKET VOLUME (Daily Avg., Mils. of Shs.)			VALUE TRADED (Daily Avg., $ Bils.)	
	Dow Jones Industrial Average	S&P 500	NYSE Composite	NASDAQ Composite	NYSE	AMEX	NASDAQ	NYSE	NASDAQ
1985	1,546.67	211.28	1,285.66	324.93	109.2	8.3	82.1	3.9	0.9
1986	1,895.95	242.17	1,465.31	348.83	141.0	11.8	113.6	5.4	1.5
1987	1,938.83	247.08	1,461.61	330.47	188.9	13.9	149.8	7.4	2.0
1988	2,168.57	277.72	1,652.25	381.38	161.5	9.9	122.8	5.4	1.4
1989	2,753.20	353.40	2,062.30	454.82	165.5	12.4	133.1	6.1	1.7
1990	2,633.66	330.22	1,908.45	373.84	156.8	13.2	131.9	5.2	1.8
1991	3,168.83	417.09	2,426.04	586.34	178.9	13.3	163.3	6.0	2.7
1992	3,301.11	435.71	2,539.92	676.95	202.3	14.2	190.8	6.9	3.5
1993	3,754.09	466.45	2,739.44	776.80	264.5	18.1	263.0	9.0	5.3
1994	3,834.44	459.27	2,653.37	751.96	291.4	17.9	295.1	9.7	5.8
1995	5,117.12	615.93	3,484.15	1,052.13	346.1	20.1	401.4	12.2	9.5
1996	6,448.27	740.74	4,148.07	1,291.03	412.0	22.1	543.7	16.0	13.0
1997	7,908.25	970.43	5,405.19	1,570.35	526.9	24.4	647.8	22.8	17.7
1998	9,181.43	1,229.23	6,299.93	2,192.69	673.6	28.9	801.7	29.0	22.9
1999	11,497.12	1,469.25	6,876.10	4,069.31	808.9	32.7	1,081.8	35.5	43.7
2000	10,786.85	1,320.28	6,945.57	2,470.52	1,041.6	52.9	1,757.0	43.9	80.9
2001	10,021.50	1,148.08	6,236.39	1,950.40	1,240.0	65.8	1,900.1	42.3	44.1
2002	8,341.63	879.82	5,000.00	1,335.51	1,441.0	63.7	1,752.8	40.9	28.8
2003	10,453.92	1,111.92	6,440.30	2,003.37	1,398.4	67.1	1,685.5	38.5	28.0
2004	10,783.01	1,211.92	7,250.06	2,175.44	1,456.7	65.6	1,801.3	46.1	34.6
2004									
Jan	10,488.07	1,131.13	6,551.63	2,066.15	1,663.1	83.5	2,331.7	50.3	40.9
Feb	10,583.92	1,144.94	6,692.37	2,029.82	1,481.2	75.6	1,917.2	46.3	36.5
Mar	10,357.70	1,126.21	6,599.06	1,994.22	1,477.5	77.3	1,880.6	47.1	34.9
Apr	10,225.57	1,107.30	6,439.42	1,920.15	1,524.7	78.3	1,950.8	49.0	37.3
May	10,188.45	1,120.68	6,484.72	1,986.74	1,500.0	72.1	1,663.6	46.9	32.3
June	10,435.48	1,140.84	6,602.99	2,047.79	1,371.4	57.4	1,623.3	43.5	32.9
July	10,139.71	1,101.72	6,403.15	1,887.36	1,418.1	54.1	1,734.8	44.1	33.2
Aug	10,173.92	1,104.24	6,454.22	1,838.10	1,243.5	49.9	1,431.0	37.7	26.7
Sept	10,080.27	1,114.58	6,570.25	1,896.84	1,322.2	52.7	1,510.7	41.8	29.1
Oct	10,027.47	1,130.20	6,692.71	1,974.99	1,543.5	61.3	1,730.7	49.5	34.5
Nov	10,428.02	1,173.82	7,005.72	2,096.81	1,494.4	68.5	1,827.6	49.0	38.0
Dec	10,783.01	1,211.92	7,250.06	2,175.44	1,463.3	63.3	2,042.2	48.4	39.9
2005									
Jan	10,489.94	1,181.27	7,089.83	2,062.41	1,618.4	62.5	2,172.3	54.1	45.5
Feb	10,766.23	1,203.60	7,321.23	2,051.72	1,578.2	62.7	1,950.2	54.5	43.2
Mar	10,503.76	1,180.59	7,167.53	1,999.23	1,682.6	66.7	1,849.0	59.1	38.8
YTD '04	10,357.70	1,126.21	6,599.06	1,994.22	1,538.5	78.8	2,037.3	47.9	37.3
YTD '05	10,503.76	1,180.59	7,167.53	1,999.23	1,629.0	64.1	1,986.5	56.0	42.4
% Change	1.4%	4.8%	8.6%	0.3%	5.9%	-18.7%	-2.5%	16.9%	13.6%

MUTUAL FUND ASSETS

($ Billions)

	Equity	Hybrid	Bond	Money Market	**TOTAL ASSETS**
1985	116.9	12.0	122.6	243.8	495.4
1986	161.4	18.8	243.3	292.2	715.7
1987	180.5	24.2	248.4	316.1	769.2
1988	194.7	21.1	255.7	338.0	809.4
1989	248.8	31.8	271.9	428.1	980.7
1990	239.5	36.1	291.3	498.3	1,065.2
1991	404.7	52.2	393.8	542.5	1,393.2
1992	514.1	78.0	504.2	546.2	1,642.5
1993	740.7	144.5	619.5	565.3	2,070.0
1994	852.8	164.5	527.1	611.0	2,155.4
1995	1,249.1	210.5	598.9	753.0	2,811.5
1996	1,726.1	252.9	645.4	901.8	3,526.3
1997	2,368.0	317.1	724.2	1,058.9	4,468.2
1998	2,978.2	364.7	830.6	1,351.7	5,525.2
1999	4,041.9	383.2	808.1	1,613.1	6,846.3
2000	3,962.0	346.3	811.1	1,845.2	6,964.7
2001	3,418.2	346.3	925.1	2,285.3	6,975.0
2002	2,667.0	327.4	1,124.9	2,272.0	6,391.3
2003	3,684.8	436.7	1,240.9	2,051.7	7,414.1
2004	4,384.1	519.3	1,290.3	1,913.2	8,106.9
2004					
Jan	3,804.2	440.7	1,256.6	2,032.1	7,533.7
Feb	3,893.5	452.7	1,267.2	2,015.2	7,628.6
Mar	3,885.1	455.7	1,277.7	2,006.8	7,625.4
Apr	3,811.3	452.5	1,245.7	1,964.2	7,473.7
May	3,855.0	457.1	1,223.3	1,974.6	7,510.0
June	3,948.0	467.0	1,220.9	1,954.3	7,590.3
July	3,796.9	462.4	1,229.2	1,953.6	7,442.2
Aug	3,804.1	469.9	1,253.4	1,944.5	7,471.8
Sept	3,916.5	479.0	1,263.9	1,903.6	7,563.0
Oct	3,994.1	487.4	1,277.8	1,891.4	7,650.7
Nov	4,222.3	504.5	1,276.5	1,920.2	7,923.5
Dec	4,384.1	519.3	1,290.3	1,913.2	8,106.9
2005					
Jan	4,289.2	516.7	1,302.0	1,892.9	8,000.8
Feb	4,416.4	529.1	1,304.3	1,874.7	8,124.5
YTD '04	3,893.5	452.7	1,267.2	2,015.2	7,628.6
YTD '05	4,416.4	529.1	1,304.3	1,874.7	8,124.5
% Change	13.4%	16.9%	2.9%	-7.0%	6.5%

MUTUAL FUND NET NEW CASH FLOW*

($ Billions)

	Equity	Hybrid	Bond	Money Market	**TOTAL**	Total Long-Term Funds
1985	8.5	1.9	63.2	-5.4	68.2	73.6
1986	21.7	5.6	102.6	33.9	163.8	129.9
1987	19.0	4.0	6.8	10.2	40.0	29.8
1988	-16.1	-2.5	-4.5	0.1	-23.0	-23.1
1989	5.8	4.2	-1.2	64.1	72.8	8.8
1990	12.8	2.2	6.2	23.2	44.4	21.2
1991	39.4	8.0	58.9	5.5	111.8	106.3
1992	78.9	21.8	71.0	-16.3	155.4	171.7
1993	129.4	39.4	73.3	-14.1	228.0	242.1
1994	118.9	20.9	-64.6	8.8	84.1	75.2
1995	127.6	5.3	-10.5	89.4	211.8	122.4
1996	216.9	12.3	2.8	89.4	321.3	232.0
1997	227.1	16.5	28.4	102.1	374.1	272.0
1998	157.0	10.2	74.6	235.3	477.1	241.8
1999	187.7	-12.4	-5.5	193.6	363.4	169.8
2000	309.4	-30.7	-49.8	159.6	388.6	228.9
2001	31.9	9.5	87.7	375.6	504.8	129.2
2002	-27.7	8.6	140.3	-46.7	74.5	121.2
2003	152.3	32.6	31.0	-258.5	-42.6	215.8
2004	177.7	42.6	-10.6	-156.8	52.9	209.7
2004						
Jan	43.0	5.4	-0.3	-19.5	28.7	48.2
Feb	26.2	5.0	1.5	-20.9	11.8	32.7
Mar	15.5	4.8	7.5	-9.1	18.6	27.7
Apr	23.0	4.6	-7.8	-44.3	-24.5	19.8
May	0.4	2.3	-16.2	8.6	-4.9	-13.5
June	10.0	2.4	-7.5	-21.3	-16.4	4.9
July	9.4	3.0	-1.2	-2.0	9.2	11.2
Aug	1.2	2.6	4.2	-10.3	-2.3	8.0
Sept	10.3	3.0	2.8	-42.4	-26.3	16.1
Oct	7.2	3.5	3.6	-14.1	0.1	14.2
Nov	21.4	4.1	2.0	26.5	54.0	27.6
Dec	10.2	1.9	0.8	-8.1	4.9	13.0
2005						
Jan	10.0	5.3	4.6	-27.5	-7.6	19.9
Feb	22.4	4.3	2.3	-20.1	9.0	29.1
YTD '04	69.1	10.5	1.3	-40.4	40.5	80.9
YTD '05	32.4	9.6	7.0	-47.6	1.4	49.0
% Change	-53.1%	-8.1%	446.9%	NM	-96.6%	-39.4%

* New sales (excluding reinvested dividends) minus redemptions, combined with net exchanges
Source: Investment Company Institute

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