THE BOND MARKET ASSOCIATION

EconomicOutlook

December 9, 2002

The Economic Outlook: Recovery to Continue; Inflation, Interest Rates Remain Moderate

The Bond Market Association's Economic Advisory Committee forecasts continued moderate economic growth in 2003, brought about by sustained consumer spending, low interest rates and, most important, growth in business investment. Inflation will continue to be modest. However, if business investment fails to accelerate or if continued shocks to the economy—such as a potential long-term military conflict with Iraq—cannot be absorbed, growth will be threatened.

The vast majority of committee members believe the current round of accommodative monetary policy, initiated by the Federal Reserve in 2001, has come to an end. Most members believe the Fed will take no action on December 10, 2002, and that a bias towards monetary tightening will emerge in 2003 as the economy grows.

Forecast

The committee forecasts real GDP growth of 2.8 percent in 2002 and 3.4 percent in 2003, measured fourth quarter to fourth quarter.[1] No committee member is forecasting a return to negative growth conditions in 2003. Inflation is projected to remain modest, with the CPI increasing 2.3 percent in both 2002 and 2003. Business investment is expected to begin growing in the fourth quarter of 2002 after eight consecutive quarters of negative growth. Overall, nonresidential fixed investment is expected to fall by 5.6 percent in 2002, and grow by 3.5 percent in 2003. Growth in personal consumption is projected to increase 3.0 percent in 2002 before falling slightly to 2.6 percent in 2003.

The committee expects interest rates to rise modestly in 2003. The Federal Funds rate is projected to remain flat at 1.25 percent for the first half of 2003 before increasing to 2.0 percent by the end of the year. The 10-year Treasury note is expected to hover near 4.0 percent in late 2002 and the first quarter of 2003, and rise gradually to near 5.0 percent by the end of next year. The committee also forecasts an increase in the federal government's budget deficit. For fiscal year 2003, which runs October 1, 2002 through September 30, 2003, the deficit is projected to grow to $220 billion. Most committee members expect the deficit to grow only slightly larger than the projected 2003 level in the coming years. However, few members believe the federal government will return to a balanced budget before

[1] All growth rates are inflation-adjusted, and annual comparisons are measured from fourth quarter to fourth quarter. The forecasts discussed in the text and appearing in the accompanying table are the medians of the 19 individual members' submissions.

The Bond Market Association Economic Advisory Committee Forecast

(Inflation adjusted year-over-year percentage change unless otherwise specified. Forecast numbers appear in **bold**.)

	2001	2002	2003
Real GDP(yr - to - yr)	0.3	**2.4**	**2.8**
Real GDP (4Q - 4Q)	0.1	**2.8**	**3.4**
CPI (yr - to - yr)	2.8	**1.6**	**2.2**
CPI (4Q - 4Q)	1.9	**2.3**	**2.3**
Personal Consumption	2.5	**3.0**	**2.6**
Nonresidential Fixed Investment	-5.2	**-5.6**	**3.5**
Housing Starts (millions)	1.6	**1.7**	**1.6**
Real State & Local Gov't. Spending	3.1	**2.7**	**1.7**
Merchandise Trade Deficit (billions current $)	434	**473**	**512**
New Home Sales (millions units)	0.9	**1.0**	**0.9**
Existing Home Sales (millions units)	5.3	**5.5**	**5.3**
Unemployment Rate (cal. yr. avg.)	4.8	**5.8**	**5.8**
Federal Budget Surplus (FY, billions of $)	+127	-159	**-220**

Quarter-to-Quarter % Changes in Annual Rates

	2002				2003			
	I	II	III	IV	I	II	III	IV
Real GDP	5.0	1.3	4.0	**1.0**	**2.5**	**3.4**	**3.5**	**3.5**
CPI	1.4	3.4	1.9	**2.5**	**2.4**	**2.3**	**2.3**	**1.9**
Personal Consumption	3.1	1.8	4.1	**0.9**	**2.6**	**3.0**	**2.9**	**3.0**
Nonresidential Fixed Investment	-5.8	-2.4	-0.7	**0.6**	**3.8**	**5.2**	**6.4**	**7.9**

Interest Rates

(monthly average %)	Dec. 02	Mar. 03	June 03	Sept. 03	Dec. 03
Fed Funds	**1.25**	**1.25**	**1.25**	**1.50**	**2.00**
2 Year Treasury Note	**1.93**	**2.00**	**2.25**	**2.75**	**3.25**
10 Year Treasury Note	**4.10**	**4.15**	**4.50**	**4.70**	**4.93**
30 Year Fixed-Rate Home Mortgages	**6.00**	**6.05**	**6.18**	**6.40**	**6.80**
Municipals (Bond Buyer GO Index)	**4.80**	**4.80**	**4.80**	**5.10**	**5.40**
Moody's Corporate Bond Index (A rated)	**6.30**	**6.45**	**6.50**	**6.70**	**6.88**

Exchange Rates

(monthly average)	Dec. 02	Mar. 03	June 03	Sept. 03	Dec. 03
Yen/Dollar	**123**	**125**	**126**	**128**	**130**
Dollar/Euro	**1.00**	**1.00**	**1.02**	**1.03**	**1.04**

late in the decade. Most members believe a fiscal policy focused on a short-term economic stimulus is appropriate under the current conditions.

The Economy

There was widespread agreement among committee members that while moderate economic growth is likely in 2003, virtually all the risks to that forecast are on the downside. Perhaps the biggest risk cited by the committee is the possibility of a protracted military conflict in Iraq and additional terrorist attacks at home and abroad. A small majority of committee members believe a military engagement with Iraq is likely. Most of those members believe that such a conflict will likely take place in the first half of 2003, and that it will result in quick success for the U.S. and its allies. The economic consequences of such a scenario would likely be limited to volatility in energy and asset prices, with little effect on growth trends. However, if the war dragged on or if we experienced significant new terrorist attacks, the risks to growth would become significant.

A sharp drop in consumer spending is also cited by some committee members as a risk to growth. The Committee forecasts a drop in consumer spending for the fourth quarter of 2002, resulting mainly from a drop in demand for autos and other consumer durables. While we project continued increases in consumer spending through 2003, most members believe growth will be slower than in 2001 and 2002. The economy has already reaped the benefits of interest-rate-sensitive consumer demand for products like autos. Tax cuts and mortgage refinancings will continue to put cash in consumers pockets. This will likely be offset by increasing savings rates driven by low returns on investment assets. Most committee members do not believe U.S. consumers are over-extended, especially if employment and income grow. However, a tightening of credit to consumers would have a negative effect on overall consumer spending.

Another risk cited by committee members is continued weak corporate profitability. If corporate profits remain poor, corporations will not invest and hire, with negative implications for growth. This is not a likely scenario, however, as the committee forecasts growth in capital expenditures and a flat unemployment rate. We also note that business inventories have already started to exhibit growth. Most committee members do not believe that broad price deflation is a likely scenario, although most do believe that if deflation were to emerge, the consequences could be serious.

Summary

The main driver of growth in the current recovery has been the very accommodative monetary policy implemented by the Federal Reserve. Low interest rates have spurred consumer spending and have helped maintain growth in real estate values, two sectors which have contributed significantly to the overall economy. Low rates have also increased cash available to homeowners through mortgage refinancing. The economy has also been helped by stimulative fiscal policy and, in particular, tax cuts, which have helped sustain consumer spending. These stimulating factors have been offset by a "reverse wealth effect" brought about by poor stock market performance.

A sustained recovery will depend on growth in business investment—already evident and projected to grow—and improved corporate profitability. Assuming consumer spending continues to grow, business investment accelerates and interest rates remain low, we are likely to see moderate growth through 2003. Shocks to the economy—such as prolonged war with Iraq, a spike in producer prices, particularly energy, or more corporate scandals—could threaten that scenario.

William Dudley, Committee Chair, Goldman, Sachs & Co.
Richard B. Berner, Committee Co-Chair, Morgan Stanley & Co. Inc.
Frederick S. Breimyer, State Street Corporation
Scott J. Brown, Raymond James & Associates, Inc.
Stephen W. Gallagher, Société Générale
Maury Harris, UBS PaineWebber Inc.
Stuart Hoffman, PNC Capital Markets
Peter Hooper, Deutsche Bank Securities Inc.
Parul Jain, TIAA-CREF
Hugh Johnson, First Albany Corporation
Mickey Levy, Bank of America
John Lipsky and **Jim Glassman**, JP Morgan Chase & Co.
Christopher Low, First Tennessee Capital Markets
Michael Moran, Daiwa Securities
William Quan, Aubrey G. Lanston & Co., Inc
David H. Resler, Nomura Securities International, Inc.
Richard D. Rippe, Prudential Securities Inc.
John Ryding and **Conrad DeQuadros**, Bear, Stearns & Co. Inc.
Avery Shenfeld, CIBC World Markets
John E. Silvia, Wachovia Securities
Stephen D. Slifer and **Ethan Harris**, Lehman Brothers Inc.
Neal Soss, Credit Suisse First Boston Corp.
Stephen Stanley, Greenwich Capital Markets Inc.
Diane Swonk, Bank One
Gary Thayer, AG Edwards & Sons, Inc.
Brian S. Wesbury, Griffin, Kubik, Stephens & Thompson, Inc.
Henry Willmore, Barclays Capital

Michael Decker, Staff Advisor

The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally.

WASHINGTON OFFICE: 1399 New York Avenue, NW, Washington, DC 20005-4711 202.434.8400
NEW YORK OFFICE: 360 Madison Avenue, New York, NY 10017-7111 646.637.9200
EUROPEAN OFFICE: St. Michael's House, 1 George Yard, London EC3V 9DH 44.20.77 43 93 00
www.bondmarkets.com