THE BOND MARKET ASSOCIATION

EconomicOutlook

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The Economic Outlook: The Recovery Is Underway, but Significant Risks Remain

The Bond Market Association's Economic Advisory Committee predicts in its mid-year forecast that the U.S. economic recovery which began early this year will continue, driven by slowly increasing business investment, stimulative government fiscal policy and sustained consumer spending. GDP growth was higher in the first quarter of 2002 than the committee had previously anticipated, and that growth is expected to carry through into the rest of 2002 and 2003.

The committee is evenly split on the question of whether the Federal Reserve will tighten monetary policy in the second half of 2002. Of those who expect a tightening this year, most anticipate a 25 basis point increase in the federal funds rate at the November or December Federal Open Market Committee meeting. Of those who do not expect a tightening this year, most look for the Fed to raise short-term interest rates in the first or second quarter of 2003.

Forecast

The Committee expects GDP to grow by 3.8 percent in 2002 and 3.7 percent in 2003, measured fourth quarter to fourth quarter.[1] Inflation is expected to remain modest, with consumer prices rising 2.3 percent in 2002 and 2.6 percent in 2003. The Committee expects a turnaround in business investment, with growth forecast to begin in the second quarter of 2002 and continue into 2003, albeit at a slower pace than in some previous recoveries. That would follow five consecutive quarters of reduction in nonresidential fixed investment, or investment spending by businesses. Capital spending by businesses is important for sustained and robust economic growth. The Committee also foresees a sharp turnaround in the federal government's fiscal position, with projections for budget deficits of $150 and $160 billion in fiscal years 2002 and 2003, respectively. A significant majority of committee members forecast budget deficits well into the decade, and many believe the size of the deficit could approach $200 billion. The sources of the deficit—lower taxes and higher spending—will have the short-term effect of spurring GDP growth. Conversely, deficits can hamper growth by raising interest rates and discouraging investment, especially if government debt grows persistently.

[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 data table are the medians of the 21 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)	1.2	**2.7**	**3.5**
Real GDP (4Q - 4Q)	0.5	**3.8**	**3.7**
CPI (yr - to - yr)	2.8	**1.6**	**2.4**
CPI (4Q - 4Q)	1.9	**2.3**	**2.6**
Personal Consumption	3.1	**3.2**	**3.0**
Nonresidential Fixed Investment	-3.2	**-5.3**	**5.6**
Housing Starts (millions)	1.6	**1.7**	**1.6**
Real State & Local Gov't. Spending	4.0	**3.5**	**2.0**
Merchandise Trade Deficit (billions current $)	426	**460**	**498**
New Home Sales (millions units)	0.9	**0.9**	**0.9**
Existing Home Sales (millions units)	5.2	**5.5**	**5.2**
Unemployment Rate (cal. yr. avg.)	4.8	**5.9**	**5.7**
Federal Budget Surplus (FY, billions of $)	+127	**-150**	**-160**

Quarter-to-Quarter % Changes in Annual Rates

	2002				2003			
	I	II	III	IV	I	II	III	IV
Real GDP	6.1	**2.4**	**3.2**	**3.4**	**3.8**	**3.8**	**3.6**	**3.5**
CPI	1.4	**3.5**	**2.0**	**2.2**	**2.4**	**2.4**	**2.5**	**2.6**
Personal Consumption	3.3	**2.3**	**3.0**	**3.0**	**3.2**	**3.2**	**3.0**	**3.0**
Nonresidential Fixed Investment	-6.2	**2.0**	**3.5**	**4.8**	**6.1**	**6.4**	**7.6**	**7.0**

Interest Rates

(monthly average %)	Sept. 02	Dec. 02	Mar. 03	June 03	Sept. 03
Fed Funds	**1.75**	**2.00**	**2.40**	**2.75**	**3.00**
2 Year Treasury Note	**2.98**	**3.35**	**3.70**	**4.00**	**4.15**
10 Year Treasury Note	**5.00**	**5.10**	**5.30**	**5.50**	**5.65**
30 Year Fixed-Rate Home Mortgages	**6.80**	**6.90**	**7.03**	**7.08**	**7.25**
Municipals (Bond Buyer GO Index)	**5.15**	**5.25**	**5.28**	**5.28**	**5.33**
Moody's Corporate Bond Index (A rated)	**7.05**	**7.05**	**7.05**	**7.20**	**7.43**

Exchange Rates

(monthly average)	Sept. 02	Dec. 02	Mar. 03	June 03	Sept. 03
Yen/Dollar	**120**	**120**	**120**	**120**	**120**
Dollar/Euro	**1.00**	**1.00**	**1.00**	**1.00**	**1.03**

U.S. Department of Commerce Bureau of Economic Analysis has amended methods for calculating certain economic benchmarks. New statistics will be released on July 31, 2002. Actual figures in this table are based on old methodology.

The committee forecasts an increase in both short- and long-term interest rates over the next five quarters. The federal funds rate is projected to rise to 3.0 percent by September 2003. The yield on the 10-year Treasury note is expected to rise by approximately one percentage point to 5.65 percent by next September. Home mortgage rates and yields on municipal and corporate bonds are also expected to increase, but by lesser amounts. Higher mortgage rates are not expected to dampen home sales significantly. The Committee expects the dollar to remain relatively flat against both the Euro and the Yen over the next five quarters, despite a projection for an increasing merchandise trade deficit.

There was an unusually wide dispersion among the committee's responses to key questions, reflecting the considerable uncertainty in economic forecasting in the current environment. Forecasts for real GDP growth in 2002 ranged from 2.4 percent to 4.7 percent. Forecasts for second quarter growth in business investment ranged from -3.6 percent to 5.1 percent.

The Post-September 11 Economy

Most committee members believe the U.S. has largely recovered from the immediate economic consequences of the September 11 terrorist attacks, although some effects remain. Some industries, particularly travel and tourism, are still suffering from reduced demand. Moreover, some committee members have cited a lingering uncertainty among consumers and businesses regarding the threat of future attacks, which is limiting investment and spending and hampering the recovery. Conversely, the public sector's increased spending on defense and security has a direct, stimulative effect on the economy.

On the question of consumer spending, a majority of committee members believe consumers are not over-extended and that consumer spending can continue to grow, though not accelerate. Many on the committee share the sentiment that consumer spending can no longer be expected to drive the economic recovery. Sustained growth will depend on increased business investment and more hiring. The committee forecasts an average unemployment rate of 5.9 percent in 2002, falling to 5.7 percent in 2003. Most committee members expect labor productivity to rise over the coming quarters at rates comparable to those in the 1990s.

Threats to the Recovery

Committee members cited several threats to a continued recovery. First among them is continued poor stock market performance. Most on the committee believe that corporate governance and accounting scandals are eroding investor confidence and keeping stock prices low. This in turn is dampening growth through the reverse "wealth effect"—reduced consumer spending due to depressed asset prices—and by increasing capital costs for businesses that want to invest. Most committee members also cited the risk of further terrorist attacks or an erosion of confidence associated with military actions as potential threats to the recovery. Other risk factors cited by committee members include persistent weak economic performance in other countries; a collapse of the dollar or an unwillingness of foreign investors to hold dollar assets; a significant downturn in the residential real estate market; and increased energy prices brought about by political or military developments in the Middle East. A majority of committee members believe energy prices will remain stable over the near term. Several cited energy price volatility as a concern that will persist until Middle East tensions subside. Price inflation is not a major concern for most committee members.

The Bond Market Association Economic Advisory Committee consists of the following members:

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WASHINGTON OFFICE: 1399 New York Avenue, NW, Washington, DC 20005-4711 202.434.8400
NEW YORK OFFICE: 40 Broad Street, New York, NY 10004-2373 212.440.9400
EUROPEAN OFFICE: St. Michael's House, 1 George Yard, London EC3V 9DH 44.20.77 43 93 00
www.bondmarkets.com