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That Second Half Thing

Two issues seem paramount for investors at this point of the cyclical rebound: (1) is the current performance of the economy 'as good as it gets,' in this economic cycle; (2) how fast will the Fed raise rates in its effort to

US Economic Forecast

	2003				2004				Q4/Q4			Ann. Avg		
	Q1	Q2	Q3	Q4	Q1	Q2e	Q3e	Q4e	03	04e	05e	03	04e	05e
Real GDP (q/q ann. rate)	2.0	3.1	8.2	4.1	4.4	4.5	3.5	3.5	4.3	4.0	3.7	3.1	4.6	3.7
Nominal GDP (q/q ann. rate)	4.3	4.2	10.0	5.7	7.2	7.6	6.2	5.6	6.0	6.6	5.9	4.8	6.9	6.0
CPI (y/y% of qtr. avg.)	2.9	2.2	2.2	1.9	1.8	2.6	2.8	3.2	1.9	3.2	2.4	2.3	2.6	2.6
Core CPI (y/y% of qtr. avg.)	1.8	1.5	1.3	1.2	1.3	1.8	2.1	2.4	1.2	2.4	2.4	1.5	1.9	2.5
Industrial Production (y/y%)	1.1	-1.0	-0.3	1.5	2.8	5.5	5.9	5.8	1.5	5.8	4.1	0.3	5.0	4.6
Unemployment Rate (avg.)	5.8	6.2	6.2	5.9	5.6	5.6	5.5	5.4				6.0	5.5	5.2
Fed Funds Rate (end of period)	1.25	1.00	1.00	1.00	1.00	1.00	1.50	2.00				1.00	2.00	3.50

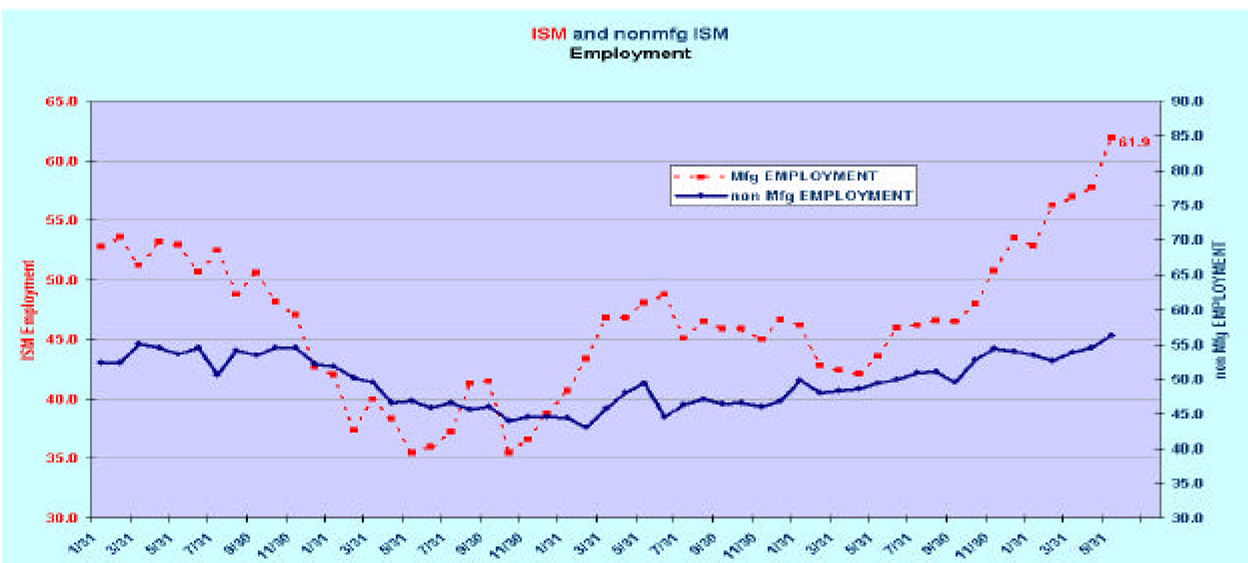
Source: Credit Suisse First Boston

bring the Federal Funds rate to a 'neutral setting?' (One can also phrase the question in terms of trying to determine what a 'neutral setting' might be, but at this stage, we think it is the timing of the increases over the course of the next six months that is the prime focus of investors).

Current performance, however, is not unambiguous…how should performance be measured? GDP growth? payroll growth; earnings growth

Employment/Payrolls

Until early this year, much of the focus was on this recovery and its "missing jobs." For the last quarter of 2003, payroll employment averaged nearly 60,000 per month. For the first four months of this year, this figure rose to about 217,000 per month and the Bloomberg consensus for tomorrow is 225,000. The "whisper number," however may be above 250,000. Certainly both the ISM and the non manufacturing ISM questions on employment suggested that firms are hiring at significantly higher rates than in QIII03 or early 2004.



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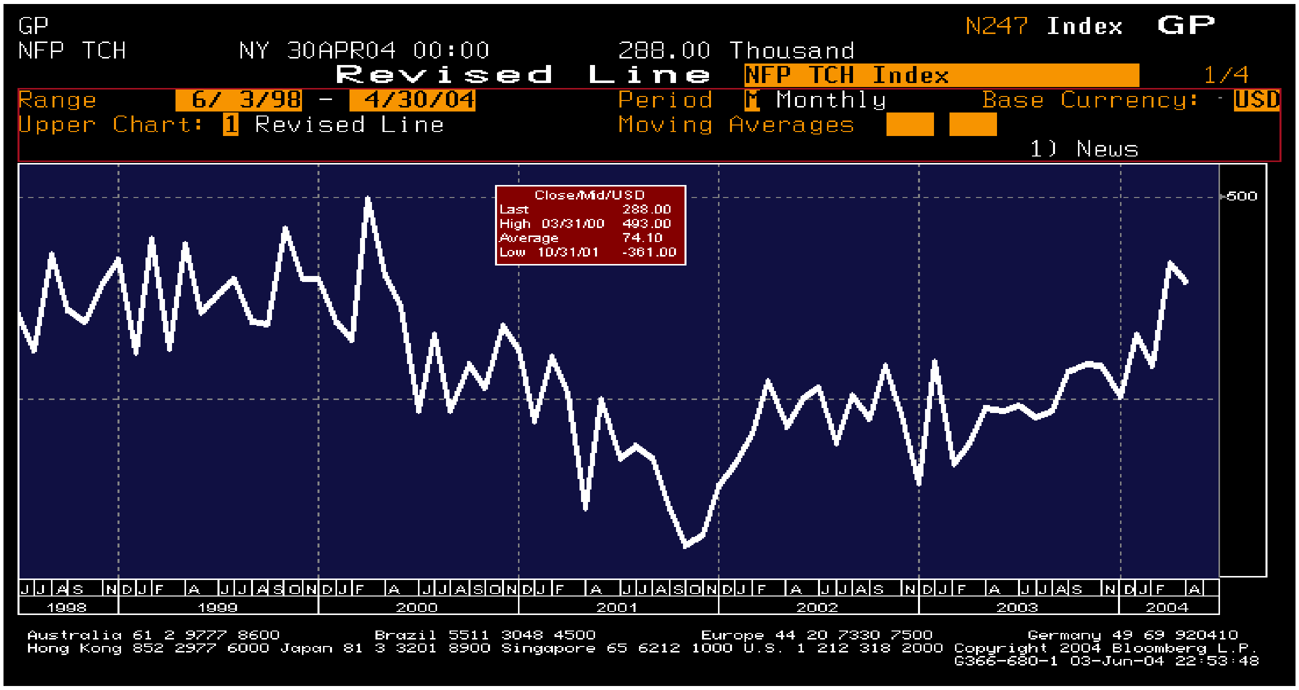
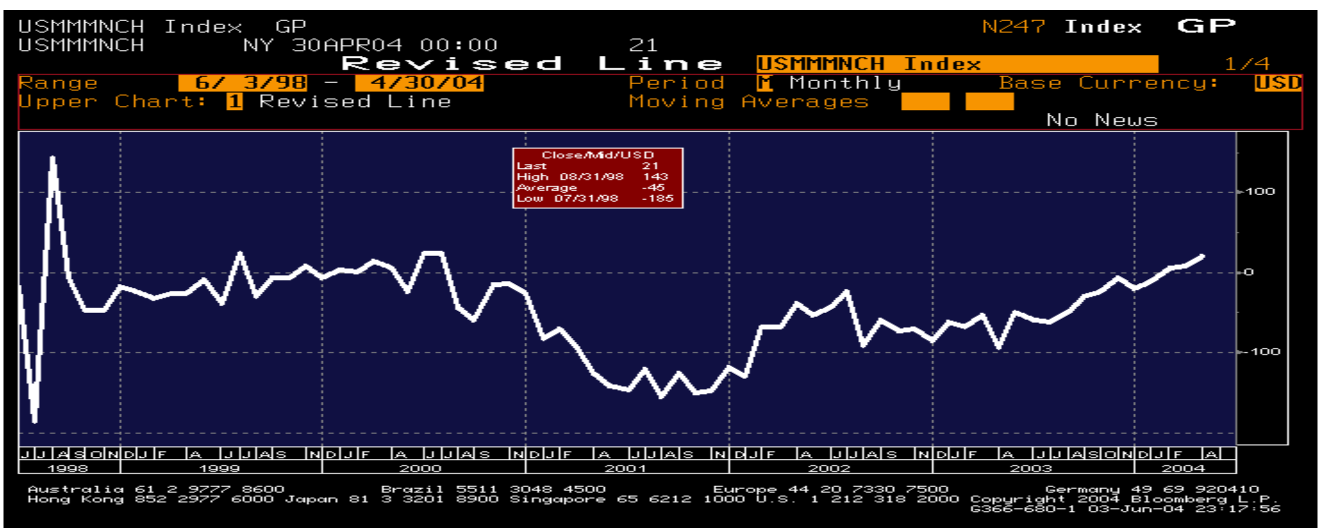


Non-Farm Payrolls



Manufacturing Payrolls

Despite the shrill cry of "outsourcing," not only have non-farm payrolls grown, but a similar trend is showing up on the manufacturing side. The growth in these payroll numbers is occurring with record earnings improvements and rather contained unit labor costs. Nominal hourly compensation has been growing at between 4% and 6% (year over year on a quarterly basis) although real hourly compensation has not been truly brisk (2.8% for the business sector as a whole and only 2.7% for non-farm business, yoy on a quarterly basis). Real wages in manufacturing have grown 4.2% with the strongest gains in durable manufacturing.

Two trends are noticeable. First, the growth in real wages should be a support for consumption (critical for SH GDP performance) and secondly, final goods and intermediate goods prices are rising at an increasing rate. Initially, rising prices are consistent with reports of increased pricing power, and it probably has given business sufficient confidence to reach out and fill more employment on a permanent basis. The issue going forward will be the durability of the recovery in the labor market. Rising real incomes will be necessary to sustain consumption as the effects of both higher gasoline and fuel prices and rising interest rates begin to cut into household purchasing power. But, even if consumption has slowed somewhat, it appears that both real physical investment by business and some inventory building is occurring, both of which can contribute to a good second half performance for the economy.

Tomorrow, the Fed and Fed-Watchers get an important data point. The "survey" data suggest strong hiring. If that turns out to be the case, a more traditional "recovery" picture will be re-enforced. That will make the market focus more on the notion of "measured," (the new Fed mantra) and it will make the Fed become much more attentive to whether expectations of future inflation are going to rise more quickly.

The Bond Market has conceded the 25 basis point rise for month end…depending on the numbers tomorrow, we will see more and more questioning whether 25 basis points is enough to take the "measure" of recent increases in inflationary expectations.