STATE OF THE ECONOMY
2004 Outlook

Introduction

Economic conditions continued to strengthen in the fourth quarter of 2003, enabling the economy to show improved performance on a year-over-year basis from 2002. Major geopolitical risks and uncertainties regarding Iraq served to suppress demand in the fourth quarter of 2002 and first quarter of 2003, with real gross domestic product (GDP) increasing by only 1.3% and 2.0%, respectively. Despite the military action in Iraq during the second quarter, GDP showed signs of improvement with an increase of 3.1% during the quarter. The economy rebounded significantly during the second half of 2003 following the swift execution of military action in Iraq that deposed the regime of Saddam Hussein, with GDP increasing by 8.2% and 4.0% in the third and fourth quarters, respectively.

To be sure, robust economic activity was sustained by improvements in consumer confidence following the war in Iraq, which prompted continued strength in consumer spending during the second half of the year, as well as the impact of the Jobs and Growth Tax Relief Reconciliation Act of 2003. The lower withholding schedules and rebate checks may have supported increased consumer spending by increasing aggregate household cash flow during the second half of the year. In addition, monetary policy remained accommodative with few signs of any inflationary pressures. Generally improved economic conditions following two years of subpar growth prompted a strengthening in business investment and productivity. As a result, for the full year real GDP increased by 3.1% in 2003 from 2002 as compared to a 2.2% annual increase in 2002. From the fourth quarter of 2002 to the fourth quarter of 2003, real GDP increased by 4.3%, compared to an increase of 2.8% during 2002. With continued optimism among consumers as well as improved financial performance throughout corporate America, conditions are favorable for the economy to experience solid gains in 2004.

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Gross Domestic Product

According to advance estimates[1] released by the Bureau of Economic Analysis (BEA), real GDP increased at an annual rate of 4.0% in the fourth quarter of 2003, following an increase of 8.2% in the third quarter[2]. Growth in the fourth quarter was due primarily to significant increases in exports and continued strength in personal consumption expenditures and residential fixed investment, although the latter factors grew at a more subdued rate than in the previous quarter.

Personal consumption expenditures increased by 2.6% in the fourth quarter, which was weaker than the 6.9% increase in the third quarter. Growth in purchases of durable goods decelerated significantly in the fourth quarter to 0.9% as compared to the 28% increase in the third quarter. This slowdown in purchases of durable goods is the result of a 10.7% decline in automobile sales in the fourth quarter, as a result of fewer factory incentives for buyers, following a 34.8% surge in the third quarter during which manufacturers and dealers offered generous incentives in order to draw down their inventories of 2003 models.

Personal consumption expenditures of nondurable goods increased by 4.4% in the fourth quarter, slightly lower than the 7.3% increase during the third quarter. However, the increase is likely due to modest increases in holiday retail sales during the fourth quarter and last two weeks of the year. According to The Beige Book from the Federal Reserve Board released on January 14, 2004, the twelve Districts reported that “holiday retail sales were generally upbeat across the country” with modest year-over-year sales growth.

According to the BEA, residential fixed investment increased by 10.6% in the fourth quarter as compared to a 21.9% increase in the third quarter, attesting to the continued strength in the housing markets. Building permits for privately-owned housing units increased 3.3% in December to 1,924,000 at a seasonally adjusted annual rate from the November level of 1,863,000. For the full year 2003, privately-owned housing units authorized by building

[1] The BEA press release on January 30, 2004 states the following with respect to advance estimates: The Bureau emphasized that the fourth-quarter “advance” estimates are based on source data that are incomplete or subject to further revision by the source agency. The fourth quarter “preliminary” estimates, based on more comprehensive data, will be released on February 27, 2004.
[2] Quarterly data is expressed at a seasonally adjusted annual rate. Real estimates are in chained (2000) dollars.

permits increased by 6.3% over 2002. Housing starts increased 1.7% in December to 2,088,000 from 2,054,000 in November. December's figures represent a 15% increase on a year-over-year basis. Housing starts for 2003 increased by 8.4% from 2002 on a year-over-year basis[3]. The ongoing strength of the real estate market was most likely aided, in part, by continued accommodative monetary policy by the Federal Reserve. With interest rates at multi-decade lows, mortgage rates were favorable for consumers seeking homeownership. Thirty-year conventional mortgages from the Federal Home Loan Mortgage Corp.[4] fell steadily during the first half of the year to a low of 5.23% for June from roughly 6% at the beginning of the year. Mortgage rates, however, trended up slightly during the third and fourth quarters to 5.88% for December. This upward trend is most likely a result of expectations of the future direction of long-term interest rates.

Exports of goods and services, increasing by 19.1% as compared to a 9.9% increase in the third quarter, was the largest contributor to the increase in real GDP in the fourth quarter of 2003. For the full year, exports increased by 1.9%, as compared to a decrease of 2.4% in 2002. The improvement in exports was due to the weakness of the dollar during the second half of the year. At the end of 2002, the dollar/sterling ($/£) exchange rate stood at $1.61 with a dollar/euro ($/€) and yen/dollar (¥/$) exchange rate of $1.05 and ¥119, respectively[5]. By the beginning of the fourth quarter, the dollar had weakened to $1.66/£, $1.15/€ and ¥112 as a result of concerns over America's growing current account deficit, which had increased from -$510.2 billion for the twelve months prior to the end of the first quarter to -$528.7 billion for the twelve months prior to the end of the second quarter. By the end of the third quarter, the current account deficit had increased to -$541.7 billion for the prior twelve months. This, in conjunction with concerns over its impact on long-term interest rates and a soaring fiscal budget deficit, further weakened the dollar during the fourth quarter to $1.78/£, $1.25/€ and ¥107. At the end of the fourth quarter, the dollar had fallen by roughly 11% against the pound sterling, 18% against the euro, and 11% against the yen on a year-over-year basis. The weakness of the dollar would be expected to narrow the current account deficit, as U.S. exports become relatively cheaper to foreigners. This would, in turn, be expected to result in improvements in the domestic manufacturing sector, as

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[3] From the January 21, 2004 New Residential Construction in December 2003 joint press release of the U.S. Department of Commerce/U.S. Census Bureau and the U.S. Department of Housing & Urban Development.
[4] Data from www.economagic.com
[5] Source: *The Economist*

manufacturers increased production to satisfy the increased demand for exported goods.

Federal government consumption expenditures increased by 0.7% in the fourth quarter. This is lower than the 23.5% increase during the second quarter, due to a 41.9% increase in national defense spending in relation to military action in Iraq. Following the end of major combat in Iraq, national defense spending fell by 1.3% in the third quarter. This was offset, however, by a 6.5% increase in nondefense spending, which contributed to the lower 1.2% increase in federal government consumption expenditures. Third quarter growth in federal government consumption expenditures is still nearly twice the increase as that during the fourth quarter. For the fourth quarter, national defense spending increased by 1.8%, offsetting a 1.6% decline in nondefense spending.

Following a buildup of inventories during the fourth quarter of 2002 and first quarter of 2003, private businesses allowed stocks of inventories to be drawn down by $4.5 billion and $9.1 billion in the second and third quarter, respectively. During the fourth quarter, private businesses began to increase inventories to replenish supplies drawn down during the second and third quarters. As a result, private inventories increased by $6.1 billion in the fourth quarter. This added 0.61% to the fourth quarter increase in GDP.

The Federal Reserve

In its effort to stimulate the economy and provide a solid foundation for the economic recovery, the Federal Reserve continued its accommodative monetary policy throughout 2003. At its June 25, 2003 meeting, the Federal Open Market Committee (FOMC) lowered the federal funds rate by twenty-five basis points to 1%. The FOMC believed that its accommodative monetary policy and robust productivity growth were providing ongoing support for economic activity. The rate reduction was implemented to provide further support for the economy, which the FOMC expected to improve over time. The federal funds rate would remain unchanged for the remainder of the year.

However, the FOMC continued to maintain a position that “an unwelcome substantial fall in inflation exceeds that of a pickup in inflation from its already low level.” This was partly the basis for concerns that the economy could have begun exhibiting deflationary trends, which may have had an adverse impact upon the strength of economic activity. The FOMC maintained this position at its subsequent meeting on August 12, 2003 and added that "the risk of inflation becoming undesirably low is likely to be the predominate concern for the foreseeable future." Despite this, the FOMC believed that its accommodative monetary policy could be maintained for a considerable period. The FOMC maintained this view at its September 16, 2003 and October 28, 2003 meetings, leaving rates unchanged.

The press release following its December 9, 2003 meeting indicated some shift in the FOMC's position:

> *The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. However, with inflation quite low and resource use slack, the Committee believes that policy accommodation can be maintained for a considerable period.*

The FOMC remained optimistic regarding the positive impact of its accommodative monetary policy upon the economy. The press release also stated:

> *The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period confirms that output is expanding briskly, and the labor market appears to be improving modestly. Increases in core consumer prices are muted and expected to remain low.*

The Federal Reserve Beige Book[6] released on November 26, 2003 and January 14, 2004 confirmed the continued strengthening of economic activity in the fourth quarter, though the pace of growth varied among the twelve Districts[7]. Most Districts indicated stronger year-over-year retail sales and results for the holidays. Favorable weather throughout several Districts aided the tourism industry, with most contacts indicating improvements among

[6] The press release on November 26, 2003 states the following: This document summarizes comments received from businesses and other contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials.
[7] The Twelve Districts of the Federal Reserve system include: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

leisure travelers and increased optimism for international visitors to the United States as a result of the weak dollar. The weakness of the dollar, which resulted in an increase in exports in the fourth quarter, prompted improvements in manufacturing activity throughout most of the Districts. Residential real estate activity remained strong throughout the nation, as confirmed by data from the Census Bureau and Department of Housing & Urban Development. Labor markets showed some improvements with contacts noting reduced redundancies and modest hiring. As a result of continued excess capacity in labor markets, there were few signs of wage pressures though health care costs continued to increase.

Consumer Confidence

Consumer confidence, though slightly dented by the uncertainty prior to military action in Iraq, rebounded during the second half of the year, as the pace of economic activity strengthened and boosted optimism among consumers. The Conference Board's Consumer Confidence Index[8] ended June at 83.5 with the Expectations Index ending the first half at 96.4. Weakness in the labor markets as well as continued expectations for weak job growth prompted a fall in the indices during the third quarter, with the Consumer Confidence and Expectations Indices ending September at 77.0 and 88.5, respectively[9].

The pace of GDP growth in the third quarter as well as improvements in labor markets, manufacturing activity, and rising exports boosted consumer confidence in the fourth quarter. The Consumer Confidence Index reached its highest level since 2002 in November, ending the month at 92.5; the index retreated slightly in December to 91.3, still well above the level of earlier in the year. The Expectations Index surged to 102.9 in December, signaling significant improvement in consumer expectations for economic activity in the first half of 2004. Though concerns over the labor markets persisted, consumers anticipated some improvements in the first half of 2004 in conjunction with increased economic activity with 21.7% of those surveyed expecting more jobs to become available in the next six months as of December. This was a marked improvement from November when 18.5% expected more jobs to become available in the next six months.

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[8] www.conference-board.org

[9] The December 30, 2003 press release by the Conference Board states: "The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. The monthly survey is conducted for The Conference Board by NFO WorldGroup. NFO is one of TNS group of companies."

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The Business Sector

Improvements in economic activity were further evident in noticeable gains in the business sector during the fourth quarter. Industrial production increased by 0.6% in September at a seasonally adjusted rate followed by increases of 0.4%, 1.0% and 0.1% in October, November, and December. For the fourth quarter, industrial production increased at an annual rate of 6.2%. On a year-over-year basis, industrial production increased by 2.3%. Capacity utilization showed some improvement in the fourth quarter as well, increasing from 74.9% in September to 75.8% in November and December. Manufacturing capacity utilization increased from 73.6% in September to 74.5% in December[10]. These improvements in industrial production and capacity utilization are most likely a result of increased activity resulting from the surge in exports during the fourth quarter due to the slide in the dollar's value relative to other currencies.

The Department of Commerce, Census Bureau's Manufacturers' Shipments, Inventories, and Order for December 2003 industrial report confirms the increase in manufacturing activity during the fourth quarter. New orders increased 1.1% in December to $342.4 billion, the highest level since December 2000 on a seasonally adjusted basis. This compares to a 0.9% decline in November and a 2.4% increase in October. For the fourth quarter, new orders increased roughly 2.6%. For the full year, new orders increased by 3.9% through December. Shipments increased for four consecutive months from $337.5 billion in September to $346.5 billion in December, the highest level since February 2001, representing a 2.7% increase for the fourth quarter. For December shipments increased 1.5%, following increases of 0.5% in November and 0.7% in October. Shipments increased 2.7% on a year-over-year basis.

Data from the Federal Reserve Beige Book indicating improved retail sales on a year-over-year basis is confirmed by the advance monthly sales for retail trade and food services in December 2003 released by the Department of Commerce[11]. In December, retail and food service sales increased 0.5%[12] to $325 billion. This represents a 6.7% increase over December 2002. Total sales in 2003 increased 5.6% on a year-over-year basis. For the fourth quarter, total

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[10] Industrial production data from the Federal Reserve's Industrial Production and Capacity Utilization statistical release from January 16, 2004.
[11] Press release from the Department of Commerce on January 15, 2004.
[12] Adjusted for seasonal, holiday, and trading day differences but not for price changes.

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sales increased 6.9% compared to the fourth quarter 2002. Total sales excluding motor vehicles and parts increased 0.1% in December from the prior month to $246.3 billion and 6.7% on a year-over-year basis from $230.7 billion. Total sales excluding motor vehicles and parts for 2003 increased 5.5% from 2002.

Preliminary productivity data released by the Department of Labor, Bureau of Labor Statistics[13] indicates that productivity in the business sector increased by 1.8% in the fourth quarter, compared to an 8.7% increase in the third quarter at a seasonally adjusted annual rate. For 2003, business productivity grew by 4.3%, slightly lower than the productivity growth of 4.8% in 2002 but nearly twice that of the 2.2% growth rate in 2001. Productivity in the nonfarm business sector increased 2.7% in the fourth quarter, slower than the 9.5% increase in the third quarter. On an annual basis, nonfarm business productivity increased by 4.2%, lower than the 4.9% rate in 2002 but twice that of the 2.1% rate in 2001. The significant improvements in manufacturing activity were accompanied by a productivity increase of 4.8% in the fourth quarter, resulting in a 4.3% increase in productivity for the sector for the year. Again, this is lower than the 6.8% productivity growth in 2002 but much higher than the 2.2% growth in 2001.

The available data regarding the business sector confirms the strength of the economic activity that manifested over the course of the year. Continued consumer optimism, an accommodative interest rate environment, strength in the equity markets and low inflation should continue to provide favorable conditions for businesses to generate strong performance in the coming months.

Inflation

Inflation remained tame throughout 2003 with the consumer price index (CPI) increasing at an annual rate of 1.9% for the year as compared to a 2.4% increase in 2002[14] on a seasonally adjusted basis. Food and beverage prices increased at an annual rate of 3.5% in 2003 compared to a 1.5% increase in 2002; food and beverage prices increased at the fastest rate since 1996, when prices increased by 4.2%. Energy prices experienced higher volatility throughout the year as a result of military action in Iraq with prices increasing by 6.9% for the year. This increase in energy prices, however, is lower than the

[13] Press release from February 5, 2004.
[14] Based on data from the Consumer Price Index: December 2003 press release on January 15, 2004 by the Bureau of Labor Statistics, United States Department of Labor.

10.7% increase in prices in 2002. Removing the food and energy indexes, the core CPI increased by an annual rate of 1.1% in 2003, compared to a 1.9% rise in 2002.

As a result of the relatively low level of inflation throughout the year, fears of deflation began to emerge during mid-year. Though the economy experienced a period of disinflation during the year, deflationary pressures never materialized, despite indications that the Federal Reserve believed there was the risk of a substantial, unwanted fall in inflation. Already low short-term interest rates caused concern that the Federal Reserve's traditional monetary policy instruments would be unable to combat deflationary pressures. With minimal inflation still present as well as continued strengthening in the economy, there does not appear to be a risk of deflation. In addition, prospects for a rapid and unexpected rise in inflation (in the absence of price shocks such as in the oil markets prompted by exogenous events) seem remote, particularly since the availability of capacity should enable manufacturing to increase markedly without triggering a rise in inflationary pressures in the economy.

Unemployment

Unemployment trended lower in the fourth quarter with the unemployment rate falling from 6.0% in October to 5.9% in November to 5.7% in December. For the fourth quarter, the unemployment rate averaged 5.9%, down slightly from the 6.2% and 6.1% average unemployment rates in the second and third quarters. This improving trend is most likely due to the increased economic activity during the second half of the year, which may have prompted many businesses to rehire employees who had previously been made redundant. Though total nonfarm payroll employment was virtually flat in December, increasing by only 1,000, payrolls increased by a total of 277,000 in the prior four months. Total nonfarm payroll employment averaged a seasonally adjusted 130,109,000 in the fourth quarter as compared to the 129,902,000 third quarter average. These increases in payroll employment are the result of employment gains in construction, professional services, and health care that slightly outweighed the losses in the retail and manufacturing sectors.

Though manufacturing lost roughly 516,000 jobs in 2003, the rate of job losses decreased throughout the year, with employment declining at a slower pace during the fourth quarter than the prior three quarters. This trend may be the result of increased manufacturing activity prompted by a fall in the dollar exchange rate that, as previously discussed, helped exports increase significantly during the second half of the year. Continued weakness of the dollar may result in continued export gains, as domestic products become less expensive to foreign consumers; this may, in turn, result in further deceleration of job losses or perhaps job creation in the manufacturing sector.

According to the Conference Board's Consumer Confidence Survey, consumers were rather pessimistic regarding the employment at the end of the third quarter with an increase in the number of consumers expecting fewer jobs to become available in the next six months. Consumers' appraisal of the current conditions regarding employment improved in both October and November, with those claiming jobs were hard to get falling from 33.8% to 29.6%, before reversing the trend in December with an increase to 32.6%. The employment outlook, however, seemed to improve during the fourth quarter with those anticipating more jobs to become available in the next six months increasing from 16.6% at the end of the third quarter to 21.7% at the end of the fourth quarter. This increased optimism is most likely the result of favorable economic conditions that have become apparent in consumers' minds as well as expectations for continued strong growth in the coming quarters.

Equity Markets

Improving economic conditions throughout the year ultimately resulted in improvements throughout the business sector and in corporate profits of many publicly-traded companies. In addition, corporate governance reforms and federal prosecution of corporate executives involved in numerous scandals began the process of healing that was so desperately needed for investors. These factors helped bolster investor confidence that had been dampened by major corporate scandals over the last two years (Tyco, Enron, Adelphi, etc.), conflicts of interest with Wall Street analysts and investments banks, and disappointing earnings resulting from weak economic performance. For the fourth quarter, approximately two-thirds of companies in the S&P 500 had reported earnings that beat expectations as of the date of this article[15]. In addition, more than twice as many companies had issued positive earnings guidance than in the past three quarters.

Improved financial performance stemming from more favorable economic performance as well as more favorable expectations regarding future earnings helped the major indices advance during the year. The Dow Jones Industrial

[15] Based on data from *The Financial Times*, "Companies say outlook is positive," February 2, 2004.

Average ended 2003 at roughly 10,454, up 25% from the year end 2002 level of 8,342. The S&P 500 advanced 26% from 880 at the end of 2002 to end 2003 at 1,112. The NASDAQ composite posted a gain of approximately 50%, ending 2003 at 2,003 compared to the 1,336 year end 2002 close. In the fourth quarter alone, the DJIA gained roughly 13%, the S&P 500 gained 12%, and the NASDAQ advanced 12%. The "wealth-effect" created by the improvements in the equity markets may have boosted investor confidence and contributed to the increased consumer spending that helped advance the economy during 2003. Sustained investor confidence, in the absence of any further corporate scandals, as well as continued strong corporate earnings would have a favorable impact upon the outlook for the equity markets in 2004.

Oil Prices

Oil prices rose in the first quarter as concerns over geopolitical tensions and military action in Iraq prompted concerns that Saddam Hussein would destroy Iraq's oil fields or those of neighboring Saudi Arabia and Kuwait or that other Arab nations would impose an embargo. These fears of oil supply disruptions prompted oil prices to an average $35.87 per barrel in February, though prices eased slightly in March to an average of $33.55. These prices were well above OPEC's targeted price range of $22-$28 per barrel[16].

Following the swift execution of military action in Iraq with no resulting damage to oil supplies, oil prices eased further in April and May to an average of $28.25 and $28.14, respectively. Prices generally trended higher during the remainder of the year, with the monthly average increasing to $32.15 for December. The increase during the second half of the year may be attributed to continued geopolitical tensions regarding nuclear programs in Iran and North Korea. In addition, continued domestic unrest in Venezuela, OPEC's third largest producer nation, regarding the efforts to recall President Hugo Chavez may also have prompted fears of oil supply disruptions.

At its December 4, 2003 meeting in Vienna[17], OPEC ministers concluded that the oil markets were well-supplied, despite increased oil demand estimates, and maintained their current production levels of 24.5 million barrels per day until further notice to allow continued replenishment of commercial oil stocks. OPEC noted that the dollar's weakness in foreign exchange markets had had an adverse impact upon the purchasing power of

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[16] Average oil prices from www.economagic.com.
[17] OPEC press release following the 128th (Extraordinary) Meeting of the OPEC Conference in Vienna, Austria on December 4, 2003.

the barrel and that continued production at current levels would most likely result in a supply over-hang in the second quarter of 2004, which would result in considerable downward pressure on prices. As such, ministers agreed to convene an extraordinary meeting in Algiers, Algeria on February 10, 2004 to discuss possible adjustments to production levels.

Economic Outlook 2004

The Conference Board's Leading Economic Indicators increased 0.2% to 114.3 in December, following improvements of 0.5% in October and 0.2% in November[18]. For the six months ending in December, the LEI increased 2.1%. Since its low in March, the LEI increased by an annual rate of 4.7%. Seven of the ten indicators in the LEI increased in December (vendor performance, stock prices, building permits, average weekly initial claims for unemployment insurance [inverted], index of consumer expectations, manufacturers' new orders for nondefense capital goods, and manufacturers' new orders for consumer goods and materials), with only two of the indicators (real money supply and average weekly manufacturing hours) declining[19]. These improvements in the LEI coincide with strong GDP growth during the fourth quarter and generally improved economic conditions throughout the nation during that time.

Economic conditions should remain favorable during 2004 as a result of continued accommodative monetary policy, robust consumer spending and confidence, and further improvements in corporate profits that would most likely have a positive impact upon the equity markets. As a result, the United States economy should experience strong performance in 2004. Our expectations for the economy include:

- Real GDP growth of 3 ½% - 4%.

- Interest rates are likely to remain stable throughout the year. Excess capacity in manufacturing should accommodate strong growth throughout the year without stoking any inflationary pressures. Furthermore, given that 2004 is a presidential election year, the FOMC may be reluctant to initiate any aggressive policy changes. The FOMC, however, may increase the federal funds rate by 25 basis points around

[18] From The Conference Board's January 22, 2004 press release.
[19] The interest rate spread remained unchanged in December.

mid-year. Regardless of the timing, the most likely move in interest rates in the coming year is slightly higher.

- Inflation should remain tame in 2004 with the core CPI increasing by roughly 1 ½% - 2%.

- As the economy continues to strengthen and exhibit improved performance in various sectors, unemployment is likely to fall to under 5 ½% for the year.

- Given the pace of economic activity, business spending will most likely increase during 2004 as production increases in order to balance aggregate supply and demand for goods and services from both domestic and foreign consumers.

- Oil prices are likely to remain above OPEC's preferred price band of $22 to $28 per barrel, particularly if OPEC minister agree to a cut in production at its February 10, 2004 meeting in order to balance supply with the reduction in demand that is typical during the second quarter of the year. Continued unrest in Venezuela is likely to exert continued upward pressure on prices as well.

- Continued weakness of the dollar in foreign exchange markets should be favorable for further strong growth of exports. This would, ultimately, have a positive impact upon manufacturing, employment, and the economy at large.

On the other hand, there are a number of risks to the economy in 2004, which could have significant adverse impacts upon economic performance in 2004.

- An escalation in geopolitical tensions with North Korea and Iran regarding suspected nuclear weapons programs could have an unfavorable impact upon consumer confidence and temper economic growth much as the uncertainty regarding Iraq restrained growth during the fourth quarter of 2002 and the first quarter of 2003. It is likely, however, that President Bush's administration will focus on diplomatic negotiations this year prior to the elections in November.

- The presidential election in November may have some impact upon consumer and business confidence, given the uncertainty of the outcome. Given the elections, there is unlikely to be any major policy initiatives during the year. It is unlikely that the elections will have anything more than a marginal impact upon economic activity in 2004.

- An increase in interest rates by the FOMC may temper further gains in the equity markets, which could have a negative impact upon consumer confidence. It is unlikely, however, that this will be an issue, given that any rate increases are expected to be small.

Conclusion

Easing of geopolitical tensions during the first half of the year coupled with increases in consumer confidence and spending, a weaker dollar, improvements in the equity markets and a more favorable outlook for the economy promoted strong economic performance during the second half of 2003. In addition, the impact of the Jobs and Growth Tax Relief Reconciliation Act of 2003 provided more impetus for strengthening in consumer confidence and spending as a result of increased cash flow during the second half of the year. As economic activity strengthens in 2004, the labor markets should show modest improvements. With GDP growth increasing to 4.3% for 2003, significantly higher than that of 2002, conditions appear favorable for continued and sustained strong growth in 2004.

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