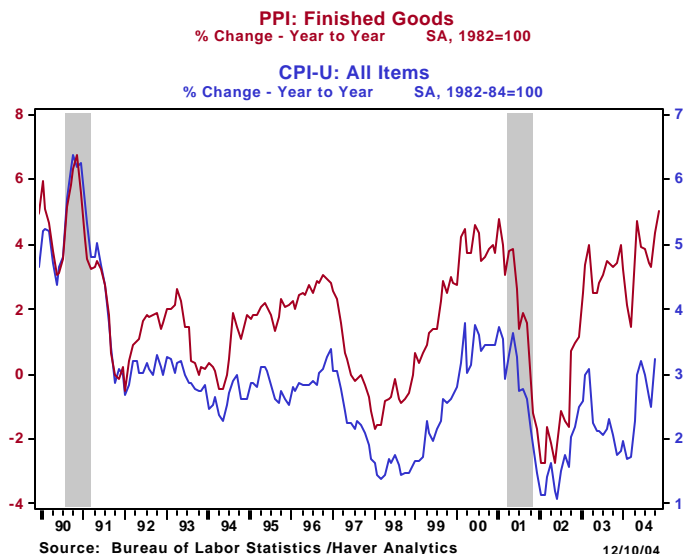




The US economy has reached the economic nirvana that we predicted in 2000 would unfold in this decade as the Internet has grown and made the economy stronger and more efficient. High real rates of GDP growth and productivity as well as low inflation and interest rates are the result. For 2005, we forecast 4.5%–5% GDP growth, 3% productivity, 5.2% unemployment, 2.5% CPI, 3% Fed funds, and 4%–4.5% long rates.

2005 Economic Outlook: Where Is the Pessimism Coming From? Only the Economists Know for Sure

As 2004 draws to a close and analysts, strategists, and economists alike peer into the future, they sometimes do so with hesitation and great trepidation. Being the analytical types that they are, they realize how tenuous forecasting can be. They begin to imagine all sorts of obstacles that might derail their predictions or even unforeseen shocks that could throw off the entire year. For whatever reason, 2004 happens to be one of those years when peering into the future seems to be particularly fraught with pessimism. The United States is running very large twin deficits (both trade and federal), its currency is sliding slowly toward a ten-year low on a trade-weighted basis, and job growth has been difficult to come by. While the war in Iraq lumbers on, the first-term presidential cabinet leaves and the second one is slowly appointed, the full-scale economic roadmap for the next four years has yet to be announced. There is talk of Social Security reform, an ownership society, and a revamping of social programs. All this change produces anxiety for some, and that's what makes the financial markets so jittery.

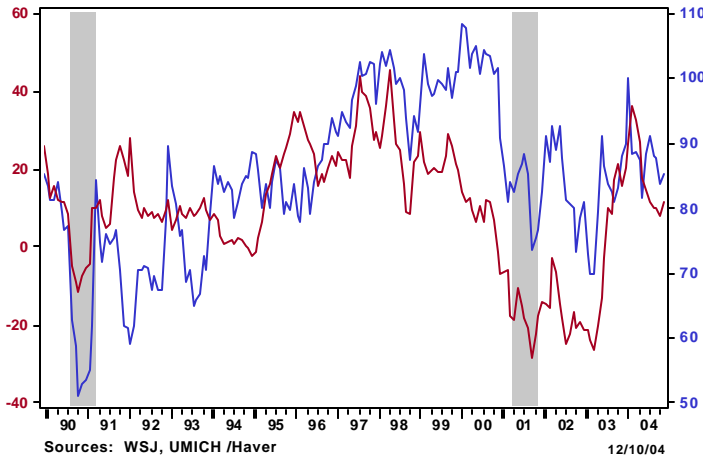


We don't see things quite the same way, but of course that is not unusual. In December 2000, we clearly stated that the forecast for 2001 was recession. In 2003, we stated that the forecast for 2004 was 5% real growth. The consensus forecast for 2005 GDP growth is 3.8% and has just been lowered to 3.6%. Our forecast is GDP of 4.5%–5%. The consensus expects an acceleration in inflation well above 3%, while we expect CPI to peak here at year-end to about 3.5% and then decelerate back to 2.5% next year.

Due to higher inflation, others expect the Fed to raise rates more rapidly in '05, while we expect them to plod along, raising rates in 25 bps intervals so as not to disrupt growth in a disinflationary environment and leaving the Federal funds rate close to 3% by year-end. Our two favorite leading indicators — the

Stock Price Index: Standard & Poor's 500 Composite
 % Change - Year to Year 1941-43=10

University of Michigan: Consumer Expectations
 NSA, Q1-66=100



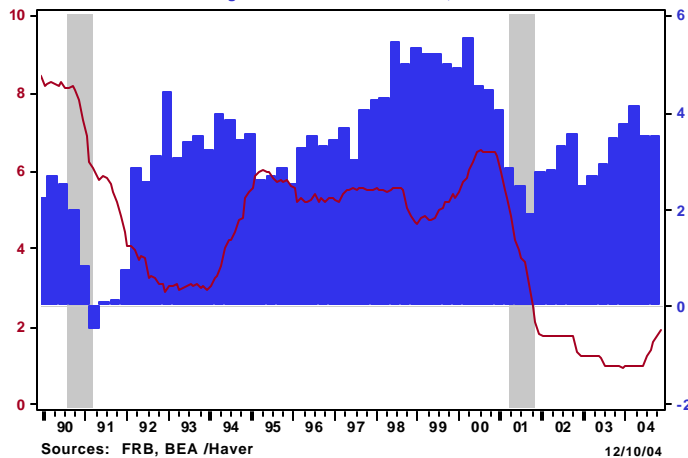
S&P 500 and the University of Michigan Consumer Expectations Index — both suggest that the recovery is well intact going into its fourth year. These two indicators perform exceptionally well around business cycle turning points. In the middle of an expansion, their guidance is less stellar. Both expectations and the S&P have subsided from peak levels in 2004, and some believe that these indicators as well as others signal a dramatic slowing of growth and possibly even another recession. Our forecast couldn't be farther from this extreme.

As for the composition of GDP growth next year, we expect personal consumption expenditures (PCE) to grow at 3.5% in spite of rising short-term

interest rates. What was most impressive about consumption growth this year was that higher oil prices didn't do more damage. In 2004, PCE will have grown close to 4% in a year when oil prices reached \$55 per barrel. As oil prices move closer to \$40 a barrel and stay there for most of next year, we still expect consumption to grow at 3.5%.

Federal Funds [effective] Rate
 % p.a.

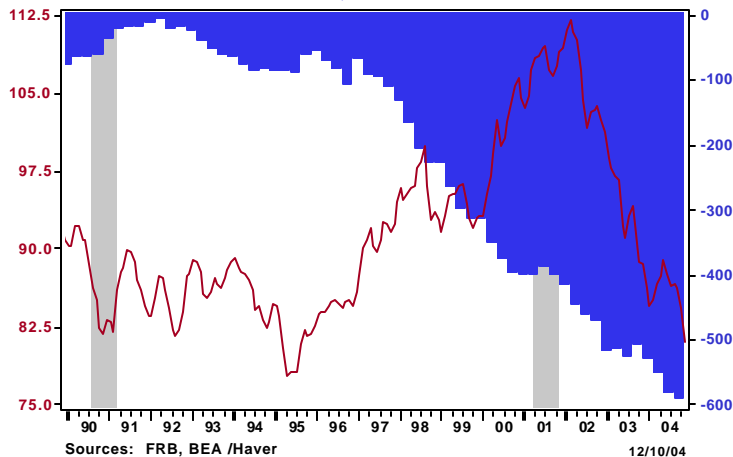
Real Personal Consumption Expenditures
 % Change - Year to Year SAAR, Bil.Chn.2000\$



Others believe a large housing bubble hangs over the economy just waiting to burst as both short- and long-term interest rates rise. We believe that housing will continue to grow at a strong rate next year as demographic factors exert a more powerful impact on growth. While there may very well be pockets of speculation in housing (and we have observed several of them firsthand), it is far from true that the entire housing market is in a bubble. By lowering interest rates and using housing stock to keep the economy going during a capital bust, Fed Chairman Alan Greenspan successfully negotiated the economy through a difficult time. Higher interest rates in 2005 will moderate "housing exuberance," but longer-term structural factors and wealth creation will keep the housing sector robust.

Nominal Trade-Weighted Exch Value of US\$ vs Major Currencies
 Mar-73=100

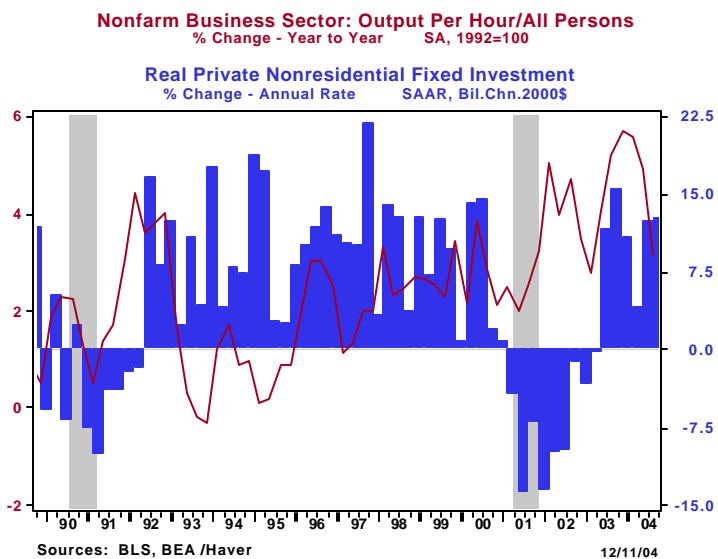
Real Net Exports of Goods & Services
 SAAR, Bil.Chn.2000\$



We believe capital spending in 2005 will continue to grow at double-digit rates. Considering the magnitude and length of the record post-WWII capital bust between 2000 and 2003 and the caution with which CEOs have approached long-term spending plans this year, we don't expect anything less than 10% growth in real nonresidential fixed investment in 2005. There is quite a bit of catching up to do, and even while some of that spending is making its way outside the

country to other cheaper destinations for manufacturing facilities, there is equally as much new current investment in domestic infrastructure, regardless of what the PC industry tells us on a quarterly basis about its backlog of orders. Some have questioned our enthusiasm, especially considering that the Bush administration's tax incentives are rolling off. We believe these incentives will be extended and expanded in the second term. The president's plan must ensure that all segments of the economy are making full use of Internet technology to become as efficient as possible in the globally interconnected economy. This includes the public sector and the healthcare industry in particular. We cannot afford to lag behind.

Since the late 1990s, we've talked about the full implementation and integration of the Internet taking place in this decade. We said that the efficiencies derived from the Internet would produce high real rates of GDP growth and productivity, with low inflation and consequently low interest rates.



This scenario is now in the process of unfolding and will continue for several more years. The first sign, and the most perplexing one for economists, was the lack of nonfarm payroll growth in 2004. While many analysts were busy trying to explain why large companies weren't hiring, small, medium, and large firms were busy adapting to this new environment. Large-company business models shifted to outsourcing and offshoring jobs, while domestic start-ups and existing firms expanded to meet the needs of their growing clientele, both in the United States and abroad. While the interconnected world was in the process of rapidly expanding, economists were left to explain how these inconsistencies could

co-exist: How could the dollar continue to weaken while both trade and current account deficits continued to expand? Could the United States continue to run a current account deficit in excess of 5% of GDP? Could the economy continue to grow at 4%+ growth with average nonfarm payroll growth of 150,000 to 200,000 jobs per year? How could commodity prices keep rising — with oil hitting all-time highs — without some negative repercussion on US consumer and business spending? Was oil really not that important in the interdependent world? Could global commodity prices continue to rise due to demand pressures from China without consequent cost-push inflation here in the United States? Could the Fed raise rates very gradually without fear of inflation?

These and many other questions are what make the study of the economy so fascinating. It is truly ever changing, transforming, and adapting to a new world, and that world is getting brighter every day as the global community adopts capitalism as its economic model. Innovations take time to make their impacts felt, and in the end, those who create have left the rest of us better off as long as we can adapt to a changed reality. In order to do so, we must be alert, ready to learn, and flexible.

A few weeks ago, we outlined our thoughts on how the president would reform our antiquated Social Security, healthcare, and education systems to bring them into line with the new economy. The period we are now entering — between 2004 and the end of the decade — will be one of great transformation. It is important to embrace the change.

At the Republican National Convention in August, the president said, “This changed world can be a time of great opportunity for all Americans. ... And government must take your side. Many of our most fundamental systems — the tax code, health coverage, pension plans, worker training — were created for the world of yesterday, not tomorrow. We will transform these systems. ...”

For the last year, the president has been hard at work with his team of experts to create a fundamentally new system. This plan will be unveiled in January. We await it with great anticipation and optimism.

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