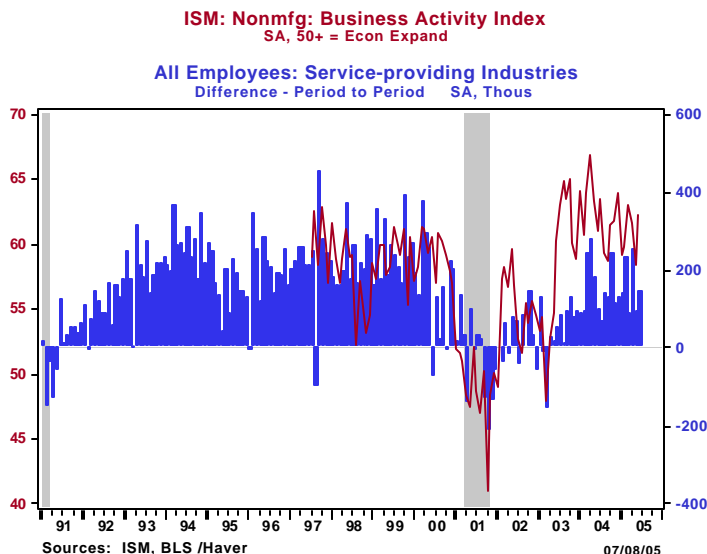




Market participants have been reluctant to acknowledge that manufacturing activity has ceased to be a good leading indicator of overall US economic growth. Instead, they should watch service-sector activity. Job growth as measured in the 5% unemployment rate indicates that our forecast of 4% growth for 2005 is intact, as is quiescent inflation and low short- and long-term interest rates.

Highly Productive Service Sector Drives US Economy

Once again, it's been another zigzag week for the US financial markets, as market participants try to grapple with the reality of an economy whose manufacturing sector has moderated and whose service sector is taking off. This is the nature of the once again newly restructured US economy, which in this first decade of the new millennium, in the post-bubble environment, is stronger than ever, buffeted by the winds of ever greater productivity and more wealth creation. What a glorious environment to live in ... assuming one can accept little job security, portable pensions and healthcare benefits, long hours, and constant change. *This is the nature of work in the 21st century.* Of course, some will say that only highly skilled white-collar workers are benefiting in this environment, but this is only partly true. Of course, the more education workers have, the more likely they'll garner a higher status and presumably a higher salary. However, these workers are now just as likely (if not more so) to lose their jobs due to outsourcing, insourcing, or downsizing. Lifetime employment does not exist, not even in the public sector.

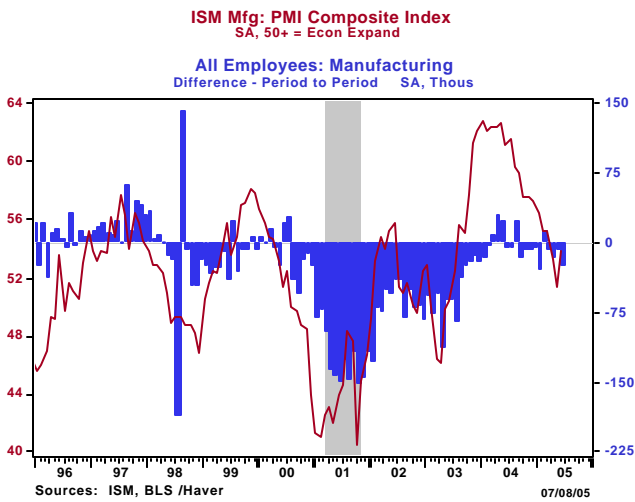


The more service-sector growth and job creation, the more homes sold or built and the more purchases made for those homes. All this activity also generates more blue-collar jobs and lower-paying service-sector jobs. The problem is that the higher cost of living ends up hurting those who have not accumulated assets. Asset accumulation is the key to surviving in today's capitalism, regardless of socio-economic class. As the accompanying graph shows, the ISM Non-Manufacturing Index is burgeoning along at levels higher now than during the Internet boom of the 1990s. This is impressive and it's a quantitative assessment of the statements above. More and more, the highly productive service sector is driving US growth.

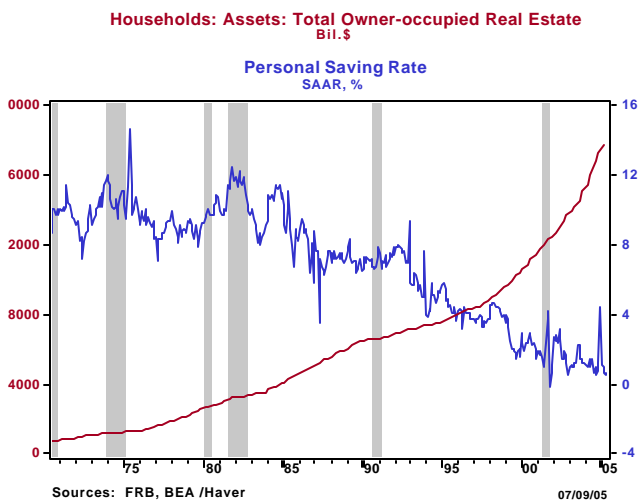
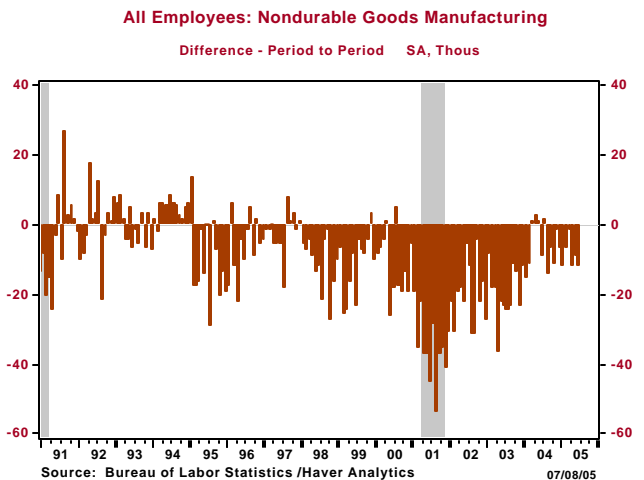
Also note the modest advance in service-providing payrolls during the last several years compared to the 1990s. While overall payroll growth has averaged 175,000 during the last two years, service-sector payrolls are averaging 200,000

— but this is well below the average service-sector payroll growth of 225,000–250,000 during the 1990s. This is the effect of productivity enhancements as businesses do more with fewer people, and it's another reason to teach asset accumulation so that when high-paying service-sector jobs are eliminated there are assets to fall back on. Of course, this is not the whole story: An increasingly cautious business attitude in the post-9/11 world is also contributing to less of a willingness on the part of major corporations to beef up staffs any more than is absolutely necessary. In most large corporations, workers complain of more work and fewer workers to do it.

These economic facts can be hard to accept, especially for those from the manufacturing sector, where job shrinkage is the buzzword of the day. Take a look at the grim economic reality of the US manufacturing sector pictured in the first two graphs below. There is virtually no new job creation to speak of even though the economy is growing near 4%. The recent decline in the ISM Index has pushed all kinds of alarms on Wall Street. Market participants are immediately on guard after taking just one look at the swift decline in the index, payrolls, and a variety of other measures of manufacturing activity. This is because, regardless of gravitating toward an economy that is 80% driven by the service sector, *most US economic data are still based on the manufacturing sector.* (What a business opportunity for someone who wants to measure service-sector activity!) Market participants need to keep one eye on the stream of manufacturing data and another on the realities of the world around them. In that real world, more people are buying or selling a house, pocketing a substantial investment gain, and using the proceeds for more travel and leisure, for moving to another (preferably less expensive) part of the country, or for starting a business. The deregulation of our capital markets has made much of this possible, and as a result wealth keeps on rising. As we mentioned in an issue late last year, the Federal Reserve flow of funds data showed that 2 million more millionaires were created

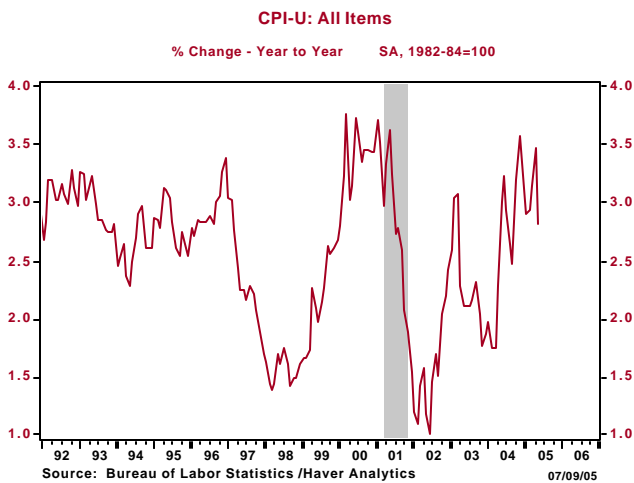


between 2002 and 2004. Much of this is due to the appreciation of real estate holdings. So while the national savings rate declines, the value of owner-occupied real estate appreciates. This is a store of wealth that has been making its way into the real economy as baby boomers liquidate primary residences and more money is freed up to be spent on other things, creating all kinds of service-sector jobs in places where they never existed before. As we mentioned in that same issue, there will be 10 million new jobs created in this decade: 2 million in construction, 2 million in financial services, 2 million in professional and business services, 2 million in education



and health services, and 2 million in leisure and hospitality. We are well on our way to this amount of job creation. According to the establishment survey, 3.4 million new jobs were created between June 2001 and June 2005 alone.

It's no wonder Wall Street keeps getting it wrong: With so much misplaced emphasis on manufacturing data, one is bound to get the forecast for GDP growth wrong along with the direction of the markets. We would be extremely careful about overemphasizing manufacturing data or listening to the doom and gloomers on slowing economic growth, more Fed tightening, and inflationary pressures. We continue to forecast 4% growth for 2005, 2.7% CPI, a 4%–4.5% ten-year note, and a peak in the federal funds rate at 3.5%. *Those who believe that the economy is collapsing and predict 2% real GDP growth and a 3.5% ten-year note by the end of this year need to take stock of the real-world economy, not just manufacturing statistics.*



This week we were confronted with inflation statistics, industrial production, and the trade balance. We look for inflation to remain quiescent. The overall CPI should show continued deceleration from its peak of 3.5%. Since higher oil prices are not making their way in a generalized fashion into goods prices, we don't expect higher inflation pressures to spook the Fed into more tightening. Once the market realizes this, it could be disappointed. Industrial production may surprise on the upside as ISM manufacturing did, and the trade balance is likely to continue to be large.

The recent terrorist attack in London prompted the press to ask us to comment on the extent to which such an event will further weaken European growth. With growth already weakening there, we see this as just another reason it may continue to moderate in the months ahead. Since the Italian economy is already in recession, more European central bank easing may be in store.

As for the US stock market, we stand by our original forecast made at the beginning of this year and presented at the annual forecast luncheon of the New York Society of Security Analysts. The S&P 500 will likely post only single-digit gains once again in 2005. For those anxious to get better returns, it would be wise to find a superb financial adviser who knows how to pick stocks. This may sound old-fashioned, but it is the tried and true method of investing.

Kathleen Camilli
 Camilli Economics, LLC
 917-363-3609
 kcamilli@camillieconomics.com
 www.camillieconomics.com

This report represents the individual views and opinions of Kathleen Camilli on the subjects discussed. It is not an offer to buy or sell any security or to participate in any investment or trading strategy. This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of those who receive it. Securities discussed in this report may not be suitable for all investors. Camilli Economics, LLC, and/or its principals may have or acquire an interest in securities named or referred to herein. Camilli Economics, LLC, recommends that investors independently evaluate particular strategies and investments and encourages investors to seek the advice of a financial adviser. Camilli Economics, LLC, makes every effort to use reliable, comprehensive information but makes no representation that the information received from third parties (government or private) is accurate or complete, nor does it undertake to update or revise this report at any time or for any reason. © Copyright 2005 Camilli Economics, LLC. All rights reserved.