



CAPITAL CONNECTIONS

Economic Supplement

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The Fed: Short-Term Rates Left Unchanged, Outlook Neutral

Central bankers left the benchmark overnight bank-lending rate at a 40-year low of 1.75 percent when the Federal Open Market Committee last met March 19. Committee members indicated the economy is recovering from a recession that started in March of last year. It was the second time the Fed's policy-setting Open Market Committee has decided to hold rates steady after 11 consecutive rate reductions in 2001.

Nevertheless, the Fed did take a step toward the first interest-rate increase in almost a year by dropping the view that weak growth is the biggest threat to the U.S. economy. The Fed's outlook toward future interest rate changes is no longer leaning toward pre-emptive monetary policy measures to circumvent a weakening economy, but rather its outlook is currently neutral.

The FOMC is next scheduled to meet May 7. Wall Street economists do not expect the Fed to make any changes to short-term rates until the second half of 2002.

Economic Rebound Surprises Economists

The economy's speedy rebound from recession has surprised economists and Federal Reserve officials. Gross domestic product (GDP) expanded at a faster-than-expected annual rate of 1.7 percent in the final three months of last year. The economy is likely to grow at a 4.2-percent rate through March, according to a recent survey of Wall Street economists by Bloomberg News.

In another report, manufacturing activity increased in January and February for the first time in 18 months, according to the Institute of Supply Management's factory index. The index jumped to 54.7 in February from a reading of 49.9 in January. The manufacturing report provided evidence that the sector has recovered from a slump that began in August 2000 and dragged the rest of the economy into recession last year. Separate reports showing increases in consumer spending, personal income and construction have added to further consumer optimism in the general economy. The economy added jobs in February for the first time since July 2001—lowering the unemployment rate for a second straight month.

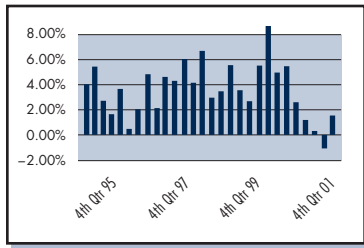
The consumer price index rose 0.2 percent in February, matching the previous increase and leaving prices just 1.1 percent above where they were 12 months earlier—indicating that, for the most part, inflation remains benign, according to the Labor Department.

Key Interest Rates

On March 29, 2002

FEDERAL FUNDS RATE	3-MONTH LIBOR	BANK PRIME RATE
1.75%	2.03%	4.75%

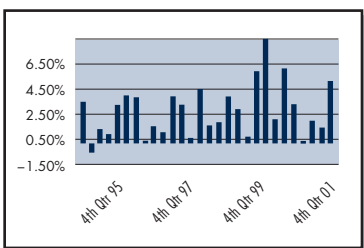
GROSS DOMESTIC PRODUCT *On March 28, 2002*



- The U.S. economy expanded in the fourth quarter at a revised 1.7-percent annual rate, which is the fastest in a year and a prelude to first-quarter growth, according to the Commerce Department.

- Fourth-quarter gross domestic product, the value of all goods and services produced, was driven by consumer and military spending that surged after the terrorist attacks of September 11.
- The economy is likely to grow at a 4.2-percent rate through March, according to a recent survey by Bloomberg News.

GDP INFLATION MEASURES *On March 28, 2002*



- The GDP price deflator, a broad measure of inflation tied to the GDP report, fell at a 0.1-percent pace in the fourth quarter.

- The personal consumption expenditure (PCE) price index rose at a 6.1-percent annual pace in the fourth quarter—up from a revised 1 percent boost reported for the third quarter.

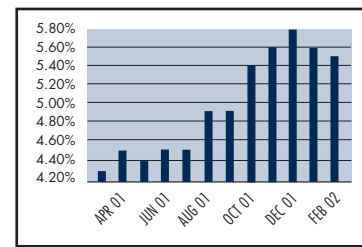
U.S. PRODUCTIVITY *On March 7, 2002*

- U.S. productivity grew almost five times faster in the final quarter of 2001 than it did in the third quarter—a sign the economy has room to recover without triggering higher prices, according to the Labor Department.
- Non-farm labor productivity, a measure of how much work an employee performs in an hour, rose at a 5.2-percent annual rate, faster than the 3.5-percent pace initially reported in February. In the third quarter of last year, productivity grew by a revised 1.1 percent.
- Federal Reserve Chairman Alan Greenspan indicated that growth in productivity will help hold labor costs in check and result in rising profit margins even with inflation remaining low.

TRADE DEFICIT *On March 19, 2002*

The Commerce Department reported that the U.S. trade deficit widened more than expected in January as a growing economy led to increased imports of oil (albeit at relatively higher cost), consumer goods and machinery. The \$28.5 billion gap followed a \$24.7 billion shortfall in December, the Commerce Department said.

Labor Market: Unemployment Falls in Feb.



Surprisingly good news came out of the employment sector last month when the Labor Department announced a decrease in the unemployment rate to 5.5 percent in February

while the U.S. economy added jobs for the first time in seven months. Airlines, construction, retailers and government agencies all posted payroll increases.

This is a really rapid turnaround considering unemployment numbers usually lag behind a recovering recession. Economists were originally expecting the unemployment rate to top out above 6 percent in early summer. Analysts, however, are beginning to revise that outlook downward.

EMPLOYMENT REPORT *On March 8, 2002*

- Unemployment unexpectedly fell to 5.5 percent in February from 5.6 percent in January. Economists expect unemployment to be 5.6 percent in March.
- Payrolls increased by 66,000 jobs last month—the first increase in seven months. January's payroll declined by 126,000 jobs.
- Analysts were projecting the unemployment would rise to 5.8 percent in February and the job market would remain flat. Job losses at factories were the smallest in more than a year, while construction jobs rose yet again.

EMPLOYMENT COST INDEX *On March 8, 2002*

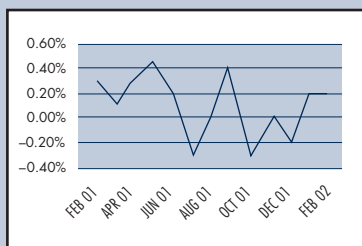
- The employment cost index, the government's best measure of how workers are compensated, rose 0.9 percent in the fourth quarter of 2001 after a 1.0 percent increase in the third quarter.
- Wages and salaries increased 0.8 percent during the final quarter of 2001, identical to the change in the third quarter. At the same time, benefit costs rose 1.2 percent in the fourth quarter.

Inflation: Unexpected Increases, But No Alarm Bells

Inflation unexpectedly jumped in February, causing some investors to be concerned about a pre-emptive Federal Reserve hike in the targeted federal funds rate in order to curb inflation. Even with increases for both the PPI and CPI, however, many economists played down the inflation threat, citing the up-tick in prices to one-time pricing anomalies in tobacco products and apparel.

In their meeting minutes, Federal Reserve officials noted the absence of inflationary pressures—a trend unlikely to change in the near term. Future rate increases are less likely to be driven by resurgent inflation than the need to restore the overnight bank rate from unusually low levels. Even though there may be signs of a turnaround in manufacturing, there is still no pricing power in the economy yet.

PRODUCER PRICE INDEX *On March 15, 2002*

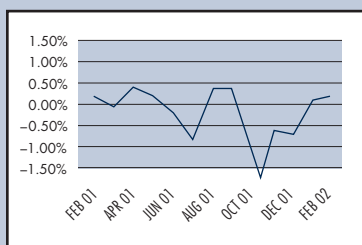


- Prices paid to U.S. factories, farmers and other producers rose 0.2 percent in February, led by increases for food and gasoline. Prices excluding food and energy were unchanged—a sign

the rebounding economy has yet to aggregate inflation.

- Even with signs of a turnaround in manufacturing—as evidenced by a surge in industrial production—there still remains no pricing power in the economy. Economic analysts had expected increases of 0.2 percent in the total index and 0.1 percent in the core, according to a median of estimates in a Bloomberg News survey.

CONSUMER PRICE INDEX *On March 15, 2002*



- Consumer prices rose in February at the same pace as January, and first-time claims for unemployment benefits fell, suggesting the economy is picking up speed as inflation stays tame.

- While the overall consumer price index rose as expected, the so-called core consumer price index, which excludes food and energy, increased at a larger-than-expected 0.3 percent, following January's 0.2-percent increase. Core prices generally carry more weight because energy and food prices are volatile.

- Initially, stock prices fell and bond yields rose after the CPI announcement. Even so, many financial market analysts are expecting a moderately paced recovery with relatively little buildup of inflationary pressures.

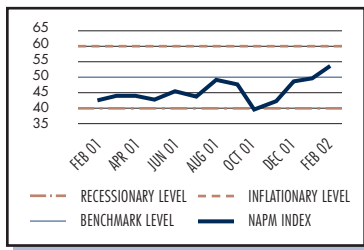
Industrial Sector: Recovery Evident

U.S. industrial production rose in February for a second straight month, a sign manufacturing is starting to recover from an 18-month slump. The 0.4-percent increase in production at the nation's factories, mines and utilities was the largest since June 2000, according the Federal Reserve. It was the first back-to-back increase since August-September 2000.

According to Bloomberg News, manufacturers including General Motors Corp. are starting to increase production to meet demand after businesses reduced inventories in the fourth quarter of last year at a record pace. In another report, the Institute for Supply Management's factory index, commonly referred to as NAPM, rocketed to 54.7 in February from a revised 49.9 in January.

- **Industrial production (3/15)** rose 0.4 percent in February and continued to increase for a second consecutive month, following a revised 0.2-percent gain in January.
- **Capacity utilization (3/15)**, which measures the extent to which capital stock in the production of goods is being used in the economy, fell slightly in February to a revised 74.8 percent. Capacity utilization was measured at a revised 74.5 percent in January.
- **Orders for durable goods (3/26)**, excluding aircraft and other transportation equipment, unexpectedly dropped 1.3 percent in February to \$124.1 billion in orders, following a revised 0.2-percent rise in January, according to the Commerce Department.
- **Factory orders (3/6)** rose 1.6 percent in January for goods other than military hardware, following a 0.7-percent rise in December, according to the Commerce Department.
- **Construction spending (4/1)** rose 1.1 percent in February to \$879.4 billion following a revised 0.8 percent increase in January. The increase was led by work on new housing, which may underpin an economy emerging from recession, according to the Commerce Department.

NATIONAL ASSOCIATION OF PURCHASING MANAGERS INDEX *On March 1, 2002*



- Manufacturing in the U.S. grew in February for the first time in 19 months, a sign the recession that began a year ago may have run its course.

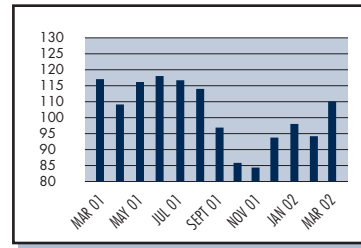
- The Institute for Supply Management's factory index rose to 54.7 in February from a revised 49.9 in January. A reading above 50 signals an economic expansion. The last time the index exceeded 50 was July 2000.
- Manufacturing appears to be bottoming out, and that is very good for the economy, according to Richard Clarida, assistant Treasury secretary for economic policy.

Housing: Record Numbers Posted

The housing numbers for February remained positive across all sections of the market. Although housing is very important to the overall economy, most economists don't expect this data to boost overall economic growth relative to other previous economic quarters. Unlike in previous recessions, the housing market never really weakened. Home-building and related home purchases helped limit the severity of the recession that started last March and saw near record-low mortgage rates.

- **Housing starts (3/20)** were at 1.77 million, up 2.8 percent in February from January. Continued warm weather helped construction crews complete work they may have otherwise put off until spring, signaling a possible pullback in the numbers later this year.
- **Building permits (3/20)** to build new units, a precursor of activity, were up 2 percent in February after a 4-percent gain the year before.
- **Sales of existing family homes (3/25)** fell 2.8 percent in February, but the pace remained very strong with 5.88 million homes. Analysts were expecting a 5.54 million rate after a record 6.05 million pace in January.
- **New home sales (3/27)** rose 5.3 percent to an 875,000 annual rate in February after a temporary setback last month. Analysts had expected sales to rise to 890,000 homes at an annual rate. New homes account for 15 percent of all home sales.

Consumer Sector: Confidence Surges



Consumer confidence in the U.S. surged in March, increasing the likelihood that consumers will continue to fuel the economic recovery. The confidence index rose to 110.2 for the month, up from a 95 reading in

February. The month's index was the highest since August 2001, and the increase was the largest since the employment rebound from the last recession.

Consumer spending typically rises with consumer optimism, which has led major retailers such as Wal-Mart to predict a rise in sales of up to 10 percent in the coming month. Analysts had expected a confidence reading of 98—based on a survey of 51 forecasts in a Bloomberg News survey. Treasury securities and stocks rose after the report was published, suggesting investors are now more confident that corporate profits will improve and help push stock prices up.

- **Personal income (3/29)** rose 0.6 percent in February after rising 0.4 percent in January. This was the largest increase in 14 months. Analysts had expected a 0.5-percent increase this month.
- **Personal consumption (spending) (3/29)** data showed that shoppers are doing their part to help boost the economy. Consumer spending rose 0.6 percent in February following a 0.5-percent increase in January.
- **Retail sales (3/13)** increased 0.3 percent during the month of February, which was less than the 1.0-percent increase analysts had expected. Analysts believe the less-than-expected rise suggests consumers took a breather after spending in the fourth quarter at the fastest pace in three and a half years.

Looking Ahead: Positive and Gaining Momentum

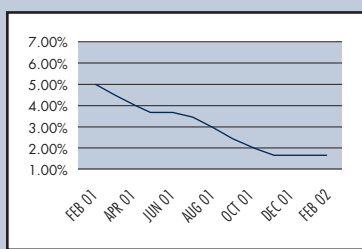
Consumer spending, industrial production and business investment have continued to be stronger than expected. Given this growth, economists are now predicting the economy could grow at a 5.5-percent or 6-percent annual rate in the first three months of this year.

Weak demand for goods and services during last year, particularly on the part of businesses, caused many firms in manufacturing and wholesale and retail trades to slash their inventories of unsold goods. The opposite effect is now occurring; many firms are in the process of halting that liquidation or beginning to rebuild their depleted stocks of unsold goods.

The economy's strength for the rest of this year will depend on increases in spending by consumers, businesses and governments.

- **Factory orders (4/2)** – Factory orders will be up 0.6 percent in February as the manufacturing sector continues to show signs of recovery.
- **Employment report (4/5)** – The key economic statistic of the week will likely be Friday's employment report which should, again, show an increase in hiring as the economy heats up, according to analysts on Wall Street.
- **FOMC meeting (5/7)** – Given the benign inflation report and reported price stability, forecasters expect the Fed to leave the overnight rate unchanged at 1.75 percent at the next FOMC meeting on May 7. There seems to be consensus among forecasters that the first tightening will occur at the FOMC's June 26 meeting.

Eye on the Fed



The Fed took its first step toward raising interest rates for the first time since May 2000 by dropping their view that weak growth is the biggest threat to the U.S. economy.

Strengthening economic data over the past few months prompted the Fed to leave the overnight bank-lending rate unchanged for the second consecutive time. The Fed stated that the overnight rate is "currently accommodative" which suggests they see rates as too low for the longer term, but are not quite ready to start raising rates.

Currently, the Federal Funds futures market sees the rate remaining unchanged until the Fed's June 26 meeting, where they are expected to raise the rate by 25 basis points. The Fed is expected to raise the overnight rate by 100 basis points by the end of this year.

UPCOMING FOMC MEETINGS	WALL STREET EXPECTATIONS	FED OUTLOOK	FORECASTED FED FUNDS RATE
May 7, 2002	No Change	Neutral	1.75
June 26, 2002	+25	Tightening	2.00
August 13, 2002	+25	Tightening	2.25

Treasury Focus

The yields on U.S. Treasuries surged in March due to increasingly positive economic data that caught the market by surprise. The largest move in Treasuries occurred in early March when positive comments by Fed Chairman Alan Greenspan sparked a sell-off in government securities.

The yield curve flattened over the course of the month as short-term rates saw a larger rise than long-term rates. The yields on the two-year note rose 71 basis points, while the yield on the 30-year note rose 36 basis points. Investors continue to sell government debt to fund purchases of higher-yielding corporate bonds and equity securities.

Treasury Rates

MATURITY	SPOT RATES ON 3/1/2002	SPOT RATES ON 3/29/2002	SPREAD DIFFERENTIALS
2-Year	3.01%	3.71%	+70 Bp
5-Year	4.21%	4.80%	+59 Bp
10-Year	4.89%	5.39%	+50 Bp
30-Year	5.43%	5.79%	+36 Bp

MARKET MOVERS IN MARCH

- Treasury yields rose by more than 30 basis points across the curve in the first week of March as comments by Alan Greenspan and increasingly positive economic data caught the markets by surprise. Although corporate profits did not show any signs of a turnaround, the equity markets all rose in early March.
- The Treasury yield curve flattened slightly in mid-March as yields along the short end of the curve rose while the remainder of the curve was unchanged. Economic data continued to improve as initial jobless claims fell for the fifth time in six weeks and inflation remained in check.
- Treasury movement was relatively quiet in the final week of March due to the long holiday weekend. The short end of the curve moved down slightly, while the remainder was unchanged. All three stock indices posted losses for the final week of March.

Streetwatch: Wall Street Firms Forecast

Wall Street firms believe the economy will start to turn around in the second quarter of 2002, as many market indicators are starting to show signs of an economic recovery. On average, Wall Street firms predict a 2.5-percent annual growth rate by the second quarter of 2002.

Treasury yields are expected to continue rising throughout the year as investors sell off bonds and put their money to work in the equity markets.

Analysts also expect the Fed to begin raising the Fed funds rate by the third quarter of this year when they will adopt a tightening bias through the remainder of the year.



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Interest Rate Forecasts as Predicted by the Futures Market

On March 29, 2002

PERIOD	30-DAY FED FUNDS	2-YEAR T-NOTE	5-YEAR T-NOTE	10-YEAR T-NOTE	30-YEAR T-NOTE
Current	1.75%	3.71%	4.80%	5.39%	5.79%
Jun 02	1.76%	4.26%	5.16%	5.68%	6.14%
Sep 02	2.23%	4.47%	5.40%	5.83%	6.21%
Dec 02	3.20%	4.62%	5.47%	6.00%	6.28%

Energy Price Forecasts as Predicted by the Futures Market

On March 29, 2002

PERIOD	CRUDE OIL	HEATING OIL	HENRY HUB NATURAL GAS	PROPANE GAS	CINERGY ELECTRICITY	ENERGY ELECTRICITY	PJM ELECTRICITY
May 02	26.31	.6733	3.283	.4025	N/A	N/A	N/A
Jun 02	26.37	.6753	3.309	.4025	N/A	N/A	N/A
Jul 02	26.32	.6793	3.347	.4050	N/A	N/A	N/A
Aug 02	26.13	.6838	3.382	.4100	N/A	N/A	N/A
Sep 02	25.92	.6908	3.387	.4125	N/A	N/A	N/A
Oct 02	25.69	.6973	3.401	.4200	N/A	N/A	N/A

Stock Market Forecasts as Predicted by the Futures Market

On March 29, 2002

PERIOD	DOW JONES IND. AVG	NASDAQ 100	S&P
Current	10,403	1,845	1,147
Jun 02	10,374	1,459	1,149
Sep 02	10,396	1,469	1,152
Dec 02	10,436	1,479	1,158

CFC's finance experts can answer your questions about specific economic information. Contact:

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