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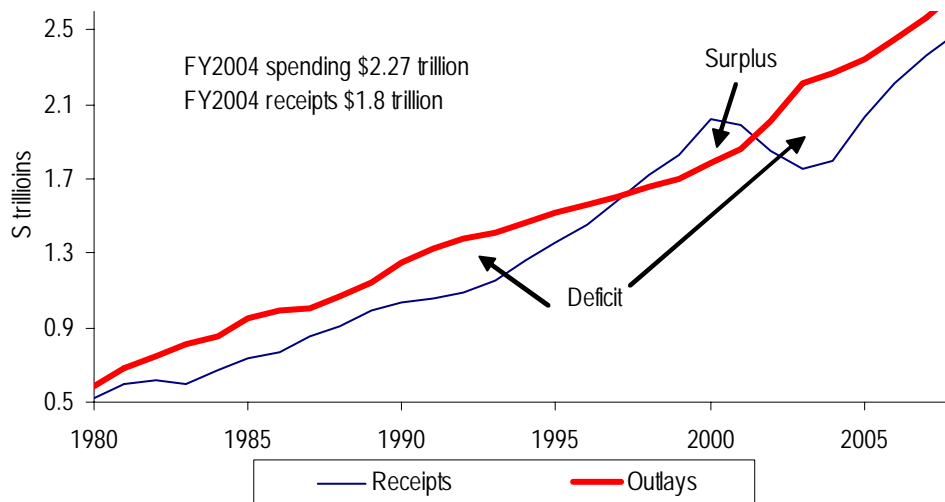
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Fiscal Deficit Growing Fast

The Administration raised its budget deficit estimates considerably for both FY2003 and FY2004 in its Mid-session review released on July 15.

- The Office of Management and Budget (OMB) now projects that the deficit will increase to \$455 billion in FY2003 ending in September, a big jump from the \$158 billion actual deficit in FY2002. OMB’s February estimate of the FY2003 deficit was \$304 billion.
- For FY2004, OMB raised its estimate to \$475 billion from \$307 billion in February. We expect the FY2004 estimate to go higher due to Iraq spending unless economic growth meets our above-consensus expectations.
- Of particular concern is the acceleration in the growth in government spending, and the further shift toward “mandatory spending”. OMB expects federal spending to hit \$2.27 trillion in FY2004.

Federal Government Receipts and Outlays

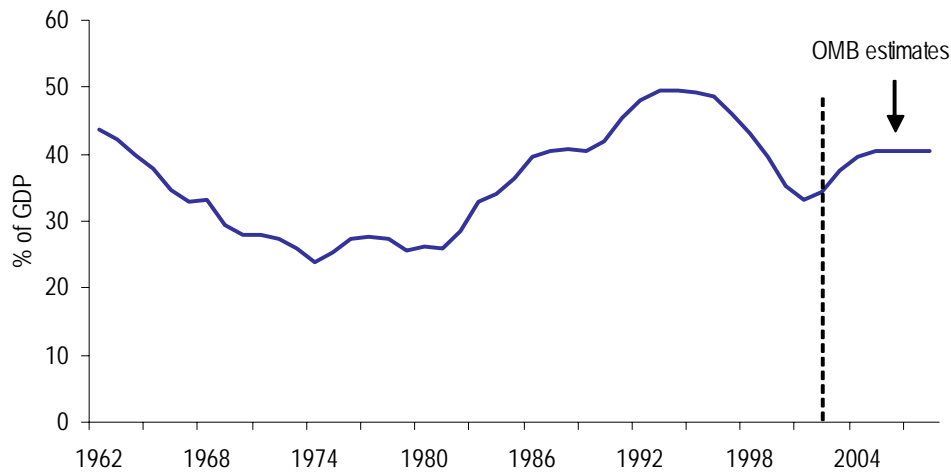


Source: Congressional Budget Office; OMB; Bear Stearns & Co., Inc.

We don't think the latest evidence of the increasing fiscal deficit will have much effect on the economy, the dollar, or financial markets. Deficits are expected during periods of sluggish economic growth, and are considered appropriate economic policy.

- As a percentage of GDP, the government's outstanding debt (marketable debt held by the public) is rising only modestly. It is projected to rise from 37.5% of GDP in FY2003 to a peak of 40.6% in FY2006. The debt/GDP ratio was lower in the 1970s, but that was the result of inflation driving tax revenues up faster than debt service costs, a temporary effect.

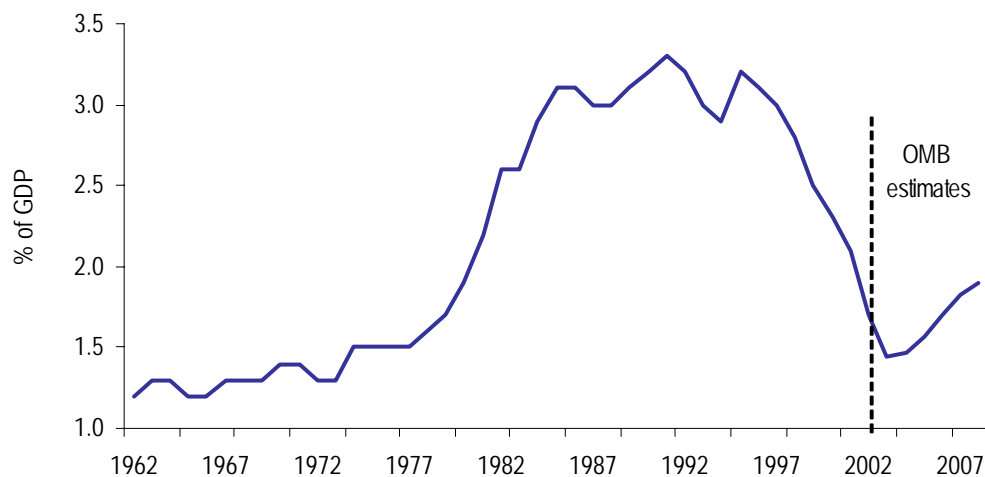
U.S. Government Debt Held by the Public



Source: Congressional Budget Office; OMB; Bear Stearns & Co., Inc.

- At under 40%, the U.S. debt/GDP ratio is among the lowest in the industrial world. The corresponding net debt-to-GDP ratios in Germany and France are above 40%, while Japan's is nearly 70% (with gross debt/GDP now above 140%).
- Importantly, the U.S. government's debt service cost stays at a relatively low level. We think this is a fair measure of the burden of the federal government's debt on the economy.

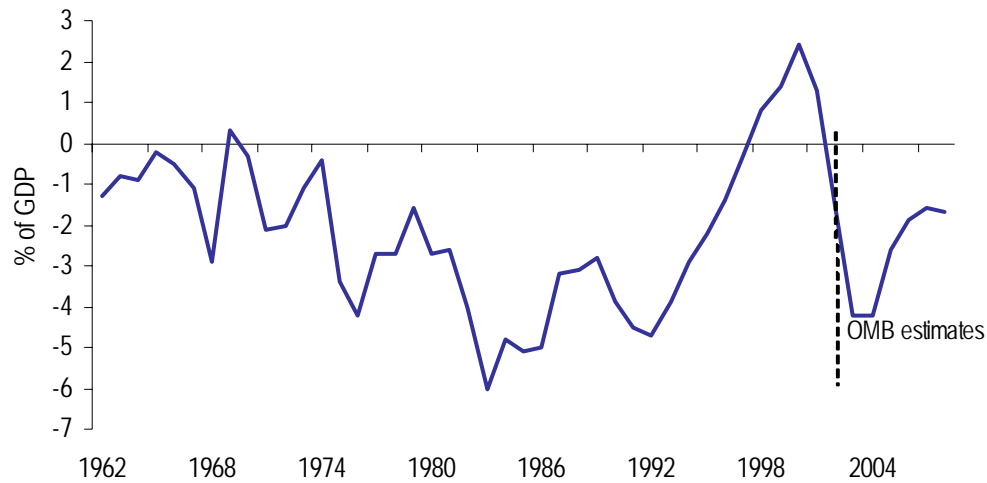
Federal government interest payments



Source: CBO; OMB; Bear Stearns & Co., Inc.

- The FY2003 deficit is expected to be 4.2% of GDP. The deficit expanded to a bigger portion of GDP after the 1982 recession (record 6% of GDP deficit in FY1983) and after the 1990-1991 recession.

U.S. Government Deficit



Source: CBO; OMB; Bear Stearns & Co., Inc.

Deficits and Interest Rates

We don't expect the substantial increase in the fiscal deficit to have much impact on interest rates or bond yields -- those are rising primarily due to the stronger growth outlook. Despite constant media assertions to the contrary, we don't think there's much connection between fiscal deficits and interest rates or much credible documentation of a strong connection. This is especially true given the U.S.'s low debt/GDP ratio.

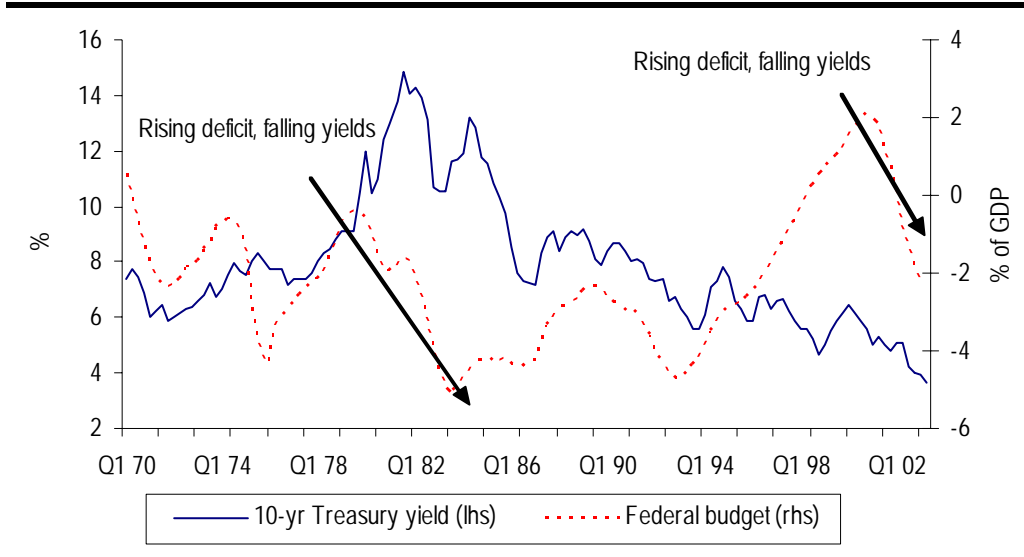
Bond yields primarily reflect growth and inflation expectations, and credit quality. As the U.S. reflation continues and economic growth accelerates, we expect Treasury bond yields, and then short-term interest rates, to move still higher in fits and starts.

Empirical data do not show a relationship between bond yields and the budget deficit.

- The yield on 10-year bonds fell throughout the 1980s, even as the fiscal deficit moved above 4% of GDP over a number of years.
- The August 1993 tax hike was followed by an increase in 10-year bond yields to nearly 8% by November 1994 from 5.5% when the tax hikes were passed.

- The 10-year yield rose to 6.7% by early 2000 from a low of 4.5% in late 1998, even as the budget was producing surpluses.
- Fiscal deficit estimates have been increasing for roughly two years. During that time, bond yields and interest rates moved to major new lows.

Treasury Note Yields and the Budget Deficit



Source: Datastream; Bear, Stearns & Co. Inc.

Comparing bond yields among developed countries turns up no discernable relationship between a country's fiscal deficit and its bond yield.

- Japan has a huge budget deficit (nearly 8% of GDP) and one of the world's largest national debts. Yet its overnight interest rate is 0% and its ten-year bond yield is 0.9% (versus 4% for the U.S.)

Sluggish economy and Iraq War

The continued sluggishness of the U.S. economy and the military action in Iraq are the primary factors behind the increased OMB deficit estimate.

- Per OMB estimates, the sluggish economy caused \$66 billion (44%) of the \$151 billion increase in the FY2003 deficit estimate, and \$95 billion (57%) of the \$168 billion FY2004 increase. OMB now expects real GDP in 2003 (Q4/Q4) to increase 2.8%, down from its 3.4% expectation in February. The 2.8% is roughly the Blue Chip consensus. We're at 3.0%.
- The costs of the military action in Iraq were not included in OMB's February budget estimates. In the current estimate, Operation Iraqi Freedom will add \$47 billion to FY2003 spending and \$20 billion to FY2004 spending.
- The OMB outlook for economic growth in 2004 is 3.7% Q4/Q4, compared with a 3.6% consensus. However, both we and the Fed are more optimistic. We expect real GDP growth of 4.1% in 2004 while the mid-point of the Fed's forecast is 4.25%.
- As growth accelerates, we expect tax receipts to increase. This should cause the deficit to stabilize and then to decline if economic growth continues and any sort of spending restraint emerges.

The Bad News - Accelerating spending growth

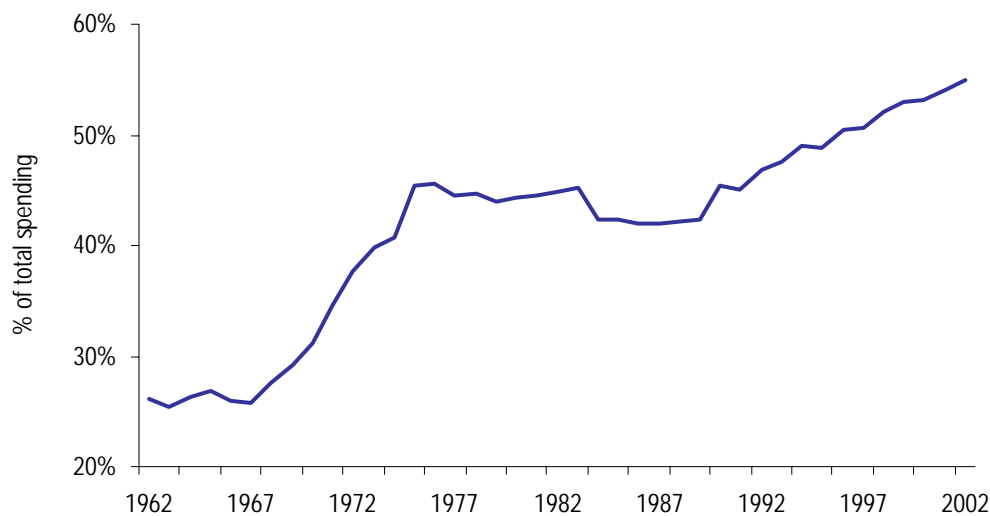
In our view, the key budget issue is the rate of growth of government spending. We think current and future spending is a better measure than deficits of the resources absorbed by the government.

- Total government spending rose 7.9% in nominal terms in FY2002.
- OMB now expects it to increase another 10% in FY2003.
- OMB's latest \$475 billion deficit estimate for FY2004 assumes a 3.8% decline in defense spending, holding the spending increase to 2.7%. We expect the FY2004 estimates to increase.

A big chunk of the spending problem is the growing share of government spending going to Social Security, Medicare, pensions, and other "mandatory spending." This spending does not require congressional approval and doesn't pass through the annual appropriations process.

- The addition of prescription drug benefits to Medicare would further increase the government's mandatory spending and would likely materially increase the growth rate of overall government spending.

Mandatory Federal Government Spending (as a share of the total)

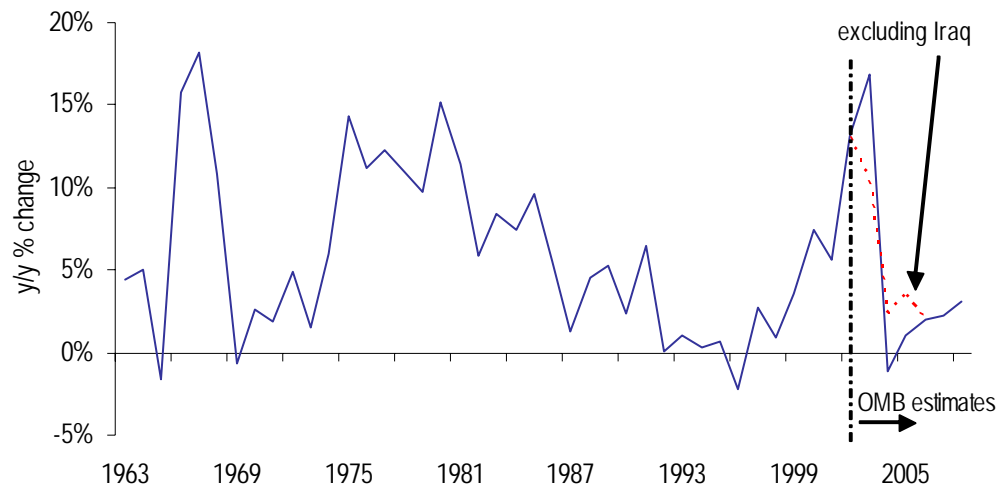


Source: CBO; Bear, Stearns & Co. Inc.

- The rest of government spending, called "discretionary spending", has accelerated sharply. It is an important cause of the recent increase in the deficit. In the past three fiscal years, discretionary spending has increased at an 8.7% annual rate after having risen at a 1.6% annual rate for the preceding 10 years.

- Even without the additional spending on the Iraq war, discretionary spending will grow quite rapidly in FY2003.

Growth in Discretionary Federal Government Spending



Source: CBO; OMB; Bear Stearns & Co., Inc.