

WEEKLY ECONOMIC COMMENTARY -- WEEK OF January 7, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	January 7	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.31%	2.22%	2.24%	0.86%
6-month Treasury bill	2.63	2.58	2.43	0.96
2-year Treasury note	3.18	3.07	2.93	1.66
5-year Treasury note	3.71	3.61	3.53	3.05
10-year Treasury note	4.27	4.22	4.15	4.08
30-year Treasury bond	4.84	4.82	4.82	4.96
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.82	2.90	2.90	2.55
10-Year	3.72	3.78	3.83	3.73
30-Year	4.65	4.67	4.71	4.83
30-year fixed mortgage rate				
	5.77	5.81	5.71	5.87
15-year fixed mortgage rate				
	5.21	5.23	5.14	5.17
1-year adjustable rate				
	4.10	4.19	4.15	3.76
STOCK MARKET				
Dow Jones Industrials	10603.96	10783.01	10543.22	10458.89
S&P 500	1186.19	1211.92	1188.00	1121.86
NASDAQ	2088.61	2175.44	2128.07	2086.92
Commodities				
Gold (\$) - 100 OZ	419.00	438.40	435.80	426.80
Oil (\$ per barrel) - Crude Futures (NYMerc)	45.43	43.45	40.71	30.44
(Key Reports For Week of January 7)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (Dec.) - Index	58.6	57.8	56.8	58.8
Nonfarm Payrolls (Dec) - change in 000s	157	137	312	168
Unemployment Rate (Dec) - Percent	5.4	5.4	5.4	5.4

If "Employment Friday" is any indication, the old year rang out with neither a bang nor a whimper. The first Friday of the month, of course, is the day that the all-important employment figures are released -- and any surprise can shake up perceptions of the economy's performance. For financial markets that have seen too many surprises in recent months, the latest employment report thankfully came in well within expectations. Economists had expected a gain in non-farm payrolls of 150 - 175 thousand in December, and the actual number came in at 157 thousand. While a tad on the low side of the range, the previous estimates for October and November were revised up by 34 thousand jobs, more than compensating for the apparent softness in December.

On the negative side, the improving job market has yet to boost the bargaining power of workers. The gains in paychecks are still woefully anemic, with only a 0.1 percent gain in average hourly earnings reported for December. That's the third consecutive month of a slim 0.1 percent increase, resulting in an annualized growth rate of only 2.3 percent for the fourth quarter, down from 3.3 percent in the third quarter. Fortunately, employees put in longer hours in December, as the average work week posted a solid 0.4 percent increase during the month, resulting in a 2.1 percent annual gain for the quarter. Add to that an expected increase in productivity of roundly 2 percent, and the economy looks to have expanded by a 4 percent annual rate in the fourth quarter, about equaling the solid quarterly pace recorded for the year as a whole.

More importantly, the longer workweek combined with the increased number of jobs translates into a decent gain in weekly incomes. We have long argued that households cannot rely so heavily on tax cuts, rock-bottom interest rates and asset appreciation to sustain spending, which has been the case in recent years. With the last round of tax reductions behind us, interest rates on the rise and the housing market showing signs of leveling off, future consumption gains will be more heavily influenced by income generation. If the job market fails to generate stronger income growth in coming quarters, there is little question that consumer spending will slow, particularly since there is a growing realization that households need to shore up their skimpy savings.

To be sure, the miserly increase in hourly earnings in recent months indicates that there is still a considerable amount of slack in the labor market, which undercuts the leverage of workers to demand steeper pay raises. But with jobs being created at a respectable steady pace, that situation should change over time. As the expansion matures, corporations will be dipping into the pool of lesser skilled workers and productivity will taper off, a typical development in the mature stages of an upturn. This dynamic, in turn, leads to fatter pay raises for the more highly-skilled workers, something that is also typical as the recovery in the labor market gets longer in the tooth. One sign that this may be in the early stages of happening is that the number of workers voluntarily quitting their jobs is on the rise. In December, they increased for the second month in a row, lifting the number of job leavers about 15 percent higher than a year ago. As this trend gathers momentum, employers will be offering higher wages to retain and attract skilled workers.

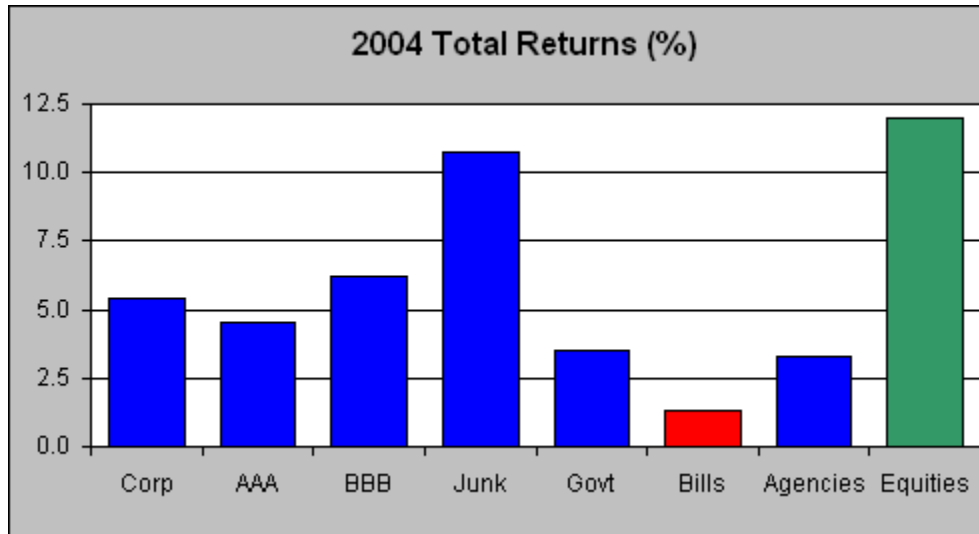
Nonetheless, it will take quite a while before the labor market can be described as "tight", which would lead to the kinds of wage increases that heighten inflation fears. Indeed, the financial markets got somewhat of a jolt this week upon the release of the minutes of the Fed's last policy-setting meeting on December 14. The minutes were much more hawkish about inflation than was suggested by the summary policy statement released on the day of the meeting. As a result, the perception that the Fed would step up its rate-hiking campaign, perhaps lifting the federal funds rate by 50 basis points instead of the 25-point increment that has been the norm so far, crept into market psychology, pushing up bond yields a bit and sending stock prices lower during the first week of the new year. If anything, the muted increase in hourly earnings contained in the December employment report should calm any fears that we are on the verge of an overheated labor market.

But make no mistake; the Fed will not be deterred from its tightening strategy, even if the pace of job growth weakens in coming months. One thing that was also made clear in the minutes is that the Fed is worried about promoting a speculative bubble in the housing and equity markets by keeping interest rates too low. How low is too low is still a question that economists are debating. The search for neutrality is an elusive quest, as no one is quite sure what level of short-term rates is consistent with a non-inflation growth trend. But the current 2.25 percent federal funds rate is generally viewed as being considerably below that neutral rate. Another hike, most likely a quarter-point, at the next meeting scheduled for February 1-2 is baked in the cake.

At the current juncture, we expect that the Fed will continue to raise the target on the federal funds rate in 25 basis point increments at most policy-setting meetings in 2005, bringing the funds rate to within a 3.5%-4% range by year-end 2005. As calendar 2005 progresses, the debate about quantifying what exactly constitutes the sought-after "neutral funds" rate will emerge as the focal point of the policy debate. This, of course, does not preclude --and possibly increases-- the possibility that the FOMC will decide to temporarily hold rates steady at one or more of the meetings as the "neutrality debate" is hashed out. Indeed, the policymakers may well pursue their goal of monetary neutrality more slowly at some point in the first half of the year due to a temporary slowdown in the economy that is primarily related to the well-publicized difficulties in the U.S. automobile industry.

However, any slowdown should be short-lived and followed by a return to solid and consistently strong economic growth over the second half of the year. If the job market holds up, as we expect, so too will consumer spending, providing the necessary support over the course of 2005. Meanwhile, corporations are flush with funds, thanks to robust profits that handily exceeded investment spending in recent years. Whether or not they will use more of their ample financial resources to pay down debt, repurchase shares, increase dividends or acquire other companies remains to be seen. But the rebound in investment spending last year should continue into this year, as companies strive to equip their facilities with productivity-enhancing equipment and software. The growth in investment spending may not be as strong as it was in 2004, but it should nonetheless be strong enough to support the economy's forward momentum.

While the economy likely to enjoy a growth rate in excess of its 3 percent trend rate, inflation will probably tick up during the course of 2005. More than anything, this will keep the Fed on its rate-hiking course and push up short-term rates. If past cyclical patterns are repeated, this means that the yield curve will continue to flatten, much as it has over the past year. Indeed, the compression between long and short-term rates was particularly sharp in 2004 as long-term interest rates held virtually unchanged even as the yield on the 2-year note increased by about 120 basis points. This compression, together with the low level of rates in general cut into the returns enjoyed by holders of government securities last year.



Indeed, a look at how major financial asset classes performed in 2004 confirms that the risk takers were the biggest winners during the year. Stocks, as measured by the Russell 3000 index, provided a total return of 12 percent while junk bonds came in strong second, generating a total return of 10.76 percent. Both of these riskier assets also outperformed in 2003 as well, returning 31 percent and 27 percent, respectively. Of course, the speculators took it on the chin in 2001 and 2002, so investors should always weigh the risk against prospective returns before making portfolio decisions.