

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 14, 2005

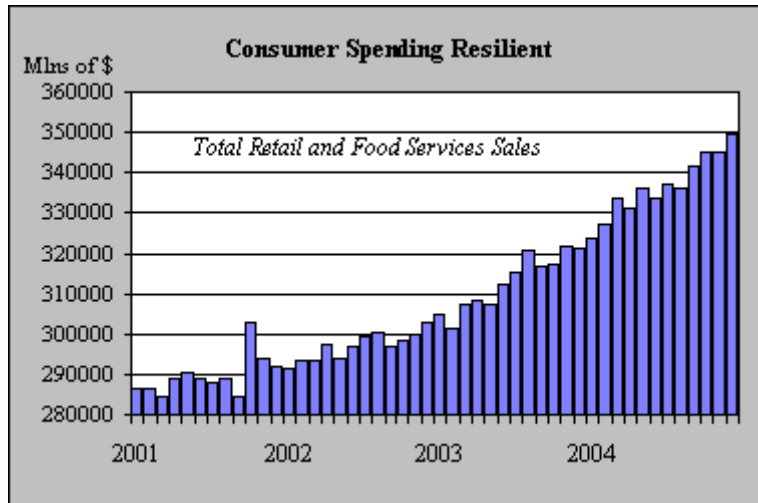
First the numbers, then the story

| FINANCIAL INDICATORS | | | | |
|--|-------------------|--------------------|-------------------------|-----------------------------------|
| INTEREST RATES | January 14 | Week Ago | Month Ago | Year Ago |
| 3-month Treasury bill | 2.36% | 2.31% | 2.19% | 0.88% |
| 6-month Treasury bill | 2.66 | 2.63 | 2.47 | 0.96 |
| 2-year Treasury note | 3.22 | 3.18 | 3.01 | 1.67 |
| 5-year Treasury note | 3.71 | 3.71 | 3.59 | 3.06 |
| 10-year Treasury note | 4.21 | 4.27 | 4.20 | 4.03 |
| 30-year Treasury bond | 4.73 | 4.84 | 4.83 | 4.89 |
| Tax-Exempt Revenue Bonds (Triple-A) | | | | |
| 5-Year | 2.83 | 2.82 | 2.87 | 2.3 |
| 10-Year | 3.73 | 3.72 | 3.72 | 3.52 |
| 30-Year | 4.58 | 4.65 | 4.66 | 4.76 |
| 30-year fixed mortgage rate | | | | |
| | 5.74 | 5.77 | 5.68 | 5.66 |
| 15-year fixed mortgage rate | | | | |
| | 5.19 | 5.21 | 5.11 | 4.97 |
| 1-year adjustable rate | | | | |
| | 4.10 | 4.10 | 4.18 | 3.62 |
| STOCK MARKET | | | | |
| Dow Jones Industrials | 10558.00 | 10603.96 | 10649.92 | 10600.51 |
| S&P 500 | 1184.52 | 1186.19 | 1194.22 | 1139.83 |
| NASDAQ | 2087.91 | 2088.61 | 2135.20 | 2140.46 |
| Commodities | | | | |
| Gold (\$) - 100 OZ | 423.30 | 419.00 | 443.10 | 407 |
| Oil (\$ per barrel) - Crude Futures (NYMerc) | 43.38 | 45.43 | 46.28 | 30.76 |
| (Key Reports For Week of January 14) | | | | |
| INDICATOR (Latest Month/Quarter) | Current Month/Qtr | Previous Month/Qtr | Two-Months/ Qtrs Ago | Average-Past 6 Months or Qtrs. |
| Retail Sales (December) - % change | 1.2 | 0.1 | 1.0 | 0.8 |
| Industrial Production (Dec) - % change | 0.8 | 0.2 | 0.8 | 0.6 |
| Producer Price Index (Dec) - % change | -0.7 | 0.5 | 1.7 | 0.3 |
| Core PPI (December) - % change | 0.1 | 0.2 | 0.3 | 0.2 |
| Trade Deficit (November) - mlns of \$s | 60297 | 56004 | 50925 | 54497 |
| Installment Credit (November) - mlns of \$s | -8701.3 | 9535.3 | 17031.5 | 6222.0 |

Sooner or later, claim the majority of economists, consumers will rein in their profligate ways. And, since consumer spending accounts for 70 percent of total economic activity, the impact will resonate throughout the economy. The dynamic is nothing mysterious. When households curb shopping, inventories build up involuntarily on the shelves of retailers, who then cut back orders from suppliers. The suppliers of goods, in turn, curtail production, leading to increased layoffs and reduced incomes, which further crimps demand. The circular loop continues until the downward spiral produces some policy-inducing catalyst that jump-starts the cycle back in the positive direction.

While this is a time-honored dynamic that has regularly underpinned economic cycles in the U.S., it has been conspicuously absent for more than a decade. Indeed, the last time real consumer spending fell for a more than two consecutive months was in the first quarter of 1991, which ushered in the recession of that year. In the subsequent 53 quarters, households have

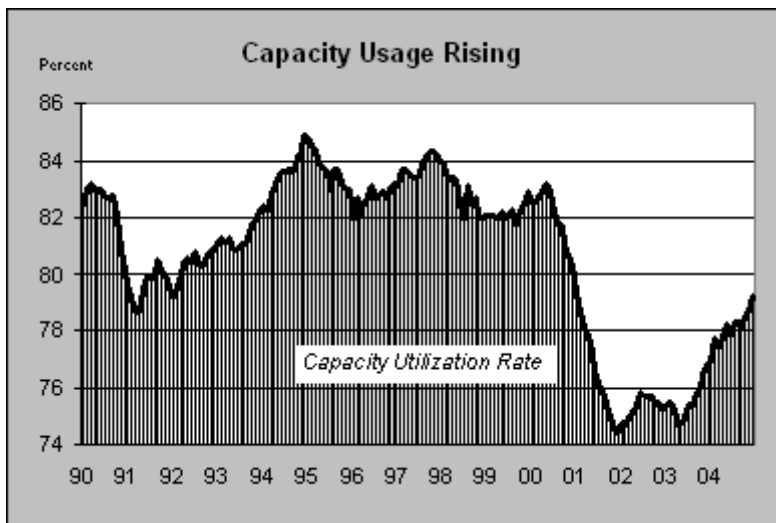
increased spending continuously, a string that is not only remarkable for its length but because it continued throughout the 2001 recession, something that has never happened before. By all accounts, that string remained unbroken through the fourth quarter of last year. According to the Commerce Department, retail sales leaped by a surprisingly strong 1.2 percent in December, capping a sturdy 10.3 percent gain for the fourth quarter.



Although retail sales are reported in nominal terms, and omit all-important spending on services, there is little question that real consumer spending on total goods and services staged another solid gain during the fourth quarter. In all likelihood, the annual rate of increase came in close to 4 percent, which supported a GDP growth rate of 3 1/2- 4 percent. In other words, as has been the case throughout the year, consumers were the linchpin driving the economy to a strong finish, and are poised to carry it through the early part of 2005. Keep in mind that the December increase in retail sales does not capture the bulk of the spending that is yet to come when households redeem their holiday gift cards, which are becoming an ever-growing component of holiday sales. We suspect that these cash-ins will impart a nice boost to retail sales in January as well.

Not surprisingly, the sustained strength in consumer spending has kept factories humming. Industrial production in December surged by 0.8 percent, about double expectations, lifting the gain for the quarter to a sizeable 4.1 percent. True, as was the case for retail sales, the auto industry contributed importantly to the strength in the figures. Thanks to the restoration of generous incentives in December, auto sales jumped sharply higher during the month. Similarly, despite high inventories of unsold vehicles -- which spurred the industry to step up their sales incentives -- automakers inexplicably increased output last month. We suspect that the auto industry is poised for a sharp retrenchment at some point early in the new year, which is the major drag looming over the economy in the near term. But both sales and production showed solid gains outside of the auto sector, suggesting that Detroit's woes will not spill over into the general economy to any great extent.

To be sure, the Federal Reserve is acutely aware that the resilient spending pace by consumers is eroding the slack in the economy's spare capacity, thus heightening inflation prospects. The December jump in production, for example, pushed up the operating rate at factories, mines and utilities to 79.2 percent, up 2.4 points from a year earlier, and only 1.9 points below the 1972-2000 average. Typically, a utilization rate in the 80 or 81 percent area is associated with an economy that is operating at or near full capacity, which is the threshold for accelerating inflation. As we approach that range, the Fed has more ammunition to bring short-term rates up to a neutral level, one that neither promotes nor subtracts from growth. The next step will likely be taken at the Fed's policy-setting meeting on February 1-2, lifting the federal-funds rate by another quarter point to 2.50 percent. As we have noted before, the Fed is probing for an elusive target in its search for neutrality, but the consensus view is that at least several more quarter-point increases are in store before the end of 2005.

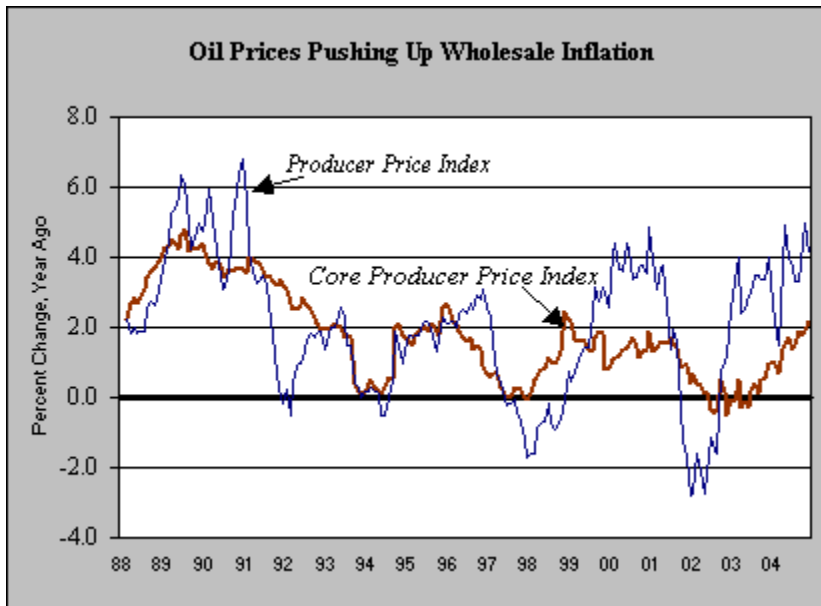


Indeed, the ongoing climb in interest rates, along with the historically low savings rate of households, underpin economists' forecasts that consumers are poised to rein in spending. However, the extent that higher rates take a toll on spending will depend in good measure on how longer-term interest rates respond to the Fed-induced upward march in short-term rates. So far, the response has hardly been in lockstep as the benchmark 10-year Treasury yield -- against which fixed mortgage rates are set -- has remained stubbornly low, hovering near the 4 1/4 percent level of a year ago. No doubt, at some point, long-term rates will buckle under the pressure of ever-climbing short-term rates, especially as the bond vigilantes take notice of the shrinking capacity in the economy. But it may require more of a rise to take the starch out of consumers than is generally perceived.

We took a look back at the last major increases -- 1993-94 and 1998-99 -- in long-term rates to assess the likely response of consumers. In the former period, the 10-year yield spiked up from a monthly average of 5.33 percent to 7.90 percent, and in the 1998-98 span it jumped from 4.50 to 6.66 percent. In both instances, the consumer response was long delayed and, ultimately, quite mild. Real personal consumption continued to strengthen through the first year of the bond-rate climb, accelerating from 3.3 percent in 1993 to 3.7 percent in 1994, and from an already sizzling 5.0 percent in 1998 to 5.1 percent in 1999. Only two years after the rate increase began did spending slow -- to 2.7 percent in 1995 and 4.1 percent in 2000. Simply put, it took more than a 200 basis point increase in long-term rates to finally put a crimp in consumer spending propensities.

At the current level of 4.22 percent, the 10-year yield would need to climb to about 6 1/2 percent to bring about a similar response. While that may yet occur at some point, even the most hawkish of forecasters do not envision a rise to much over 5 percent by the end of the year. The reason: despite the shrinkage of excess capacity, the omnipresent threat of higher oil prices and an improving labor market, there is far less gloom about inflation prospects than was the case during the earlier episodes of rising bond yields. That's largely because the Federal Reserve has build up a formidable cushion of inflation-fighting credibility and has become much more transparent in communicating its intentions to keep inflation under control. What's more, the economy has itself become less vulnerable to inflationary forces, thanks to intense competitive pressures stemming from globalization and the rapid advances in technology that have ratcheted up productivity growth.

Indeed, the Labor Department this week provided yet another reassuring measure of just how well inflation is being contained. On Friday, it was reported that wholesale prices plunged by 0.7 percent in December, the largest drop since April 2003. While the plunge was caused by a sharp tumble in energy prices, which has since been reversed, the core producer price increase edged up by a tiny 0.1 percent during the month. For the year as a whole, the overall PPI leaped by 4.1 percent, the steepest in 14 years. But the core index, which excludes volatile food and energy prices, rose by a much more modest 2.2 percent, indicating how little of the energy spike filtered through to other wholesale prices.



If anything, the resumed increase in oil prices this week -- pushing it up towards the \$50 a barrel level -- saps discretionary incomes and gives the pessimists another reason to expect a pullback in consumer spending. But that argument has been used often over the past year and is starting to lose some credibility. Yes, the brief consumer retrenchment during the second quarter was largely an oil-related phenomenon. But the oil spike then occurred against an uncertain job-market backdrop, as the recovery in employment growth following a three-year downtrend had only begun six months earlier. Now, the job market has been in a recovery mode for 17 months, and income growth is accelerating. Household confidence is riding a high tide, based largely on improving job prospects.

Just as significantly, the lesson over the past decade is that consumer spending, while clearly responsive to interest rates, energy prices and other external forces, is hugely influenced by how households feel about their financial situation. In this regard, there is much to cheer about. Household net worth has soared by \$8 trillion over the past two years, including a sturdy \$54.5 billion gain in the third quarter that pushed the total to a record high \$46.7 trillion. Unlike the sizzling rise in net worth in the 1990s that was propelled by the stock market boom, the current climb is largely related to soaring real estate values. Indeed, stock portfolios actually declined in the third quarter. But the stock market ended the year on a strong uptrend and even if real estate values leveled off, household net worth likely staged another strong advance in last year's fourth quarter.

Simply put, households started the new year on a good financial footing, which should cushion the impact of the Fed's rate-rising campaign as well as the higher home heating bills that consumers will be absorbing over the winter. As we noted at the outset, at some point consumers will pull in their horns. But with long-term yields remaining steady at near historically low levels, inflation not an immediate threat, balance sheets in good shape and the job market strengthening, there is little on the near-term horizon that poses a serious threat to the economy. Next week's numbers on consumer prices should reinforce the benign inflation environment that is coexisting with the solid advance in economic growth described by this week's retail sales and production numbers. Did anyone say that Goldilocks was knocking at the door?