

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 21, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	January 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.34%	2.36%	2.18%	0.88%
6-month Treasury bill	2.65	2.66	2.52	0.95
2-year Treasury note	3.14	3.22	2.99	1.66
5-year Treasury note	3.64	3.71	3.57	3.06
10-year Treasury note	4.14	4.21	4.21	4.07
30-year Treasury bond	4.64	4.73	4.84	4.95
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.92	2.83	2.90	2.27
10-Year	3.73	3.73	3.78	3.48
30-Year	4.59	4.58	4.65	4.75
30-year fixed mortgage rate				
	5.67	5.74	5.75	5.64
15-year fixed mortgage rate				
	5.15	5.19	5.18	4.95
1-year adjustable rate				
	4.11	4.10	4.17	3.56
STOCK MARKET				
Dow Jones Industrials	10392.49	10558.00	10827.12	10568.29
S&P 500	1167.87	1184.52	1210.13	1141.55
NASDAQ	2034.27	2087.91	2160.62	2123.87
Commodities				
Gold (\$) - 100 OZ	427.30	423.30	442.90	408
Oil (\$ per barrel) - Crude Futures (NYMerc)	48.53	43.38	44.18	30.86
(Key Reports For Week of January 21)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Price Index (Dec) - % change	-0.1	0.2	0.6	0.2
Core CPI (December) - % change	0.2	0.2	0.2	0.2
Housing Starts (December) - 000s of units	2004	1807	2065	1964
Leading Eco. Indicators (Dec) - % change	0.2	0.3	-0.3	-0.1

Much has been said and written about how the Federal Reserve prevented the economy from sinking into a deep hole following the stock-market collapse in early 2000, the terrorist attacks on September 11, the corporate accounting scandals in 2002 and the energy crises last year. Without recounting the details, suffice it to say that the timely and aggressive rate-slashing campaign begun at the cusp of the 2001 recession was critical to keep consumers in a spending mode, which moderated the severity of the recession and underpinned the economy's recovery over the past three years. Not only have consumers responded to the lowest interest rates in more than 40-years, borrowing huge amounts of debt to finance home purchases, autos and other durable goods, they benefited immensely from a revitalized housing market that sent real-estate values skyrocketing. The huge capital appreciation -- itself a product of low mortgage rates --boosted household wealth, providing the equity collateral and additional purchasing power to support consumption, even as paychecks sagged because of a slow recovery in jobs.

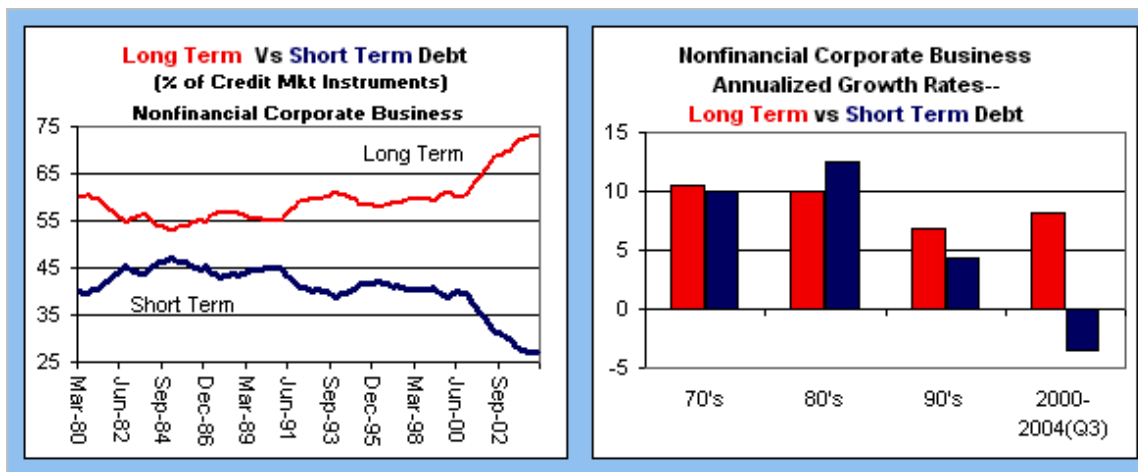
Admittedly, the interest-rate spur to consumer spending has generated a huge debt load for households, which some feel will

be a drag on future spending, particularly with the Fed now striving to restore interest rates to some "normal" level. But households are not as vulnerable to rising rates as might be expected because most of the loans taken out in recent years carry fixed rates over a set period. What's more, the exceptionally low mortgage rates in recent years has produced a refinancing boom of unprecedented proportions that has enabled millions of homeowners to lower their debt-servicing charges. And, while a growing fraction of loan applications last year was in adjustable rate mortgages, a sizeable percentage of those loans are in hybrid form, wherein a fixed rate is set for several years before floating in response to changing market rates. Even the pure floating rate loans have caps that limit upward adjustments to 2 percentage points a year in most cases.

Simply put, households are in fairly good financial shape, despite being heavily in debt. Interest and principal payments are taking a smaller share of incomes than was the case a few years ago, thanks to lower rates and stretched out maturities. Just as significant, asset values have increased at a faster pace than debt obligations, resulting in a big boost to household net worth. Indeed, the ratio of net worth to after-tax incomes is considerably higher than at any time over the past fifty years prior to the late 1990s, when irrational exuberance inflated the value of stock portfolios. The collapse of the stock market bubble vaporized more than \$5 trillion in equity values between 1999 and 2002, but a good portion of this lost wealth has been replaced since early 2003 as the market has recovered.

A lesser known but an equally impressive dynamic has occurred on the business side of the ledger due to the Fed's low-rate strategy in recent years. Just as the stock-market rose to irrational levels during the late 1990s, the speculative capacity expansion plans that businesses put in place during that period turned out to be far too ambitious in light of the drop-off in global demand that subsequently occurred. As a result, corporate America was left with an enormous amount of spare capacity that transformed a capital boom into a capital bust, which not only held back the recovery but contributed to the deflation threat that spurred the Fed into action in 2001. At the same time, bloated payrolls and high debt burdens contributed to a harsh squeeze on corporate profits and left balance sheets in disrepair.

Like households, corporations exploited the friendly financial environment created by the Fed and set out to put their financial houses in order. Among the main objectives were to lower debt-servicing burdens and provide protection against the eventual day that interest rates would once again resume climbing. On both counts, corporate debt managers have been enormously successful. For one, interest expense as a percentage of cash flow has been slashed by more than a third -- from over 32 percent in early 2001 to about 19 percent in last year's third quarter. For another, just as home mortgages were refinanced at a frenetic pace, corporations took advantage of low bond yields to refinance outstanding long-term debt. At the same time, they replaced variable short-term debt with longer-term liabilities with the objective of locking in the rock-bottom bond yields before rates head up again.



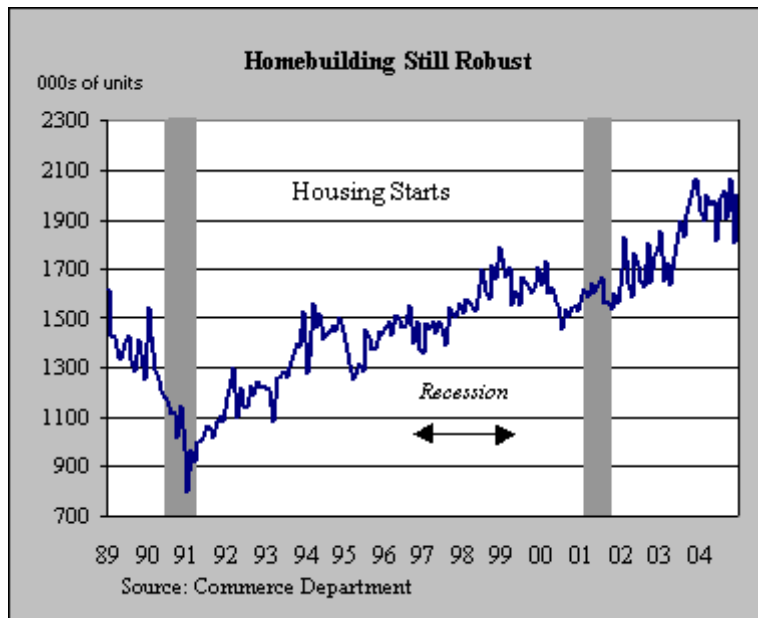
As the chart shows, corporate balance sheets look substantially different today as a result of the debt-management strategy in effect since the Fed began slashing rates in 2001. In particular, the "terming out" of debt liabilities has greatly boosted the percentage of long-term debt on corporate books. In last year's third quarter, almost 73 percent of credit market obligations owed by nonfinancial corporations constituted long-term debt. That's a far cry from the 60 percent share in the second quarter of 1999 or the recent low of 58 percent in the first quarter of 1996. Simply put, like the household sector, corporate managers have insulated themselves from rising bond yields when the turn eventually comes.

To be sure, the behavior of bond yields has been a mystery to most forecasters for more than a year. At the start of 2004, the general view was that the maturing recovery, the withdrawal of monetary stimulus and nascent inflation pressures would exert upward pressure on long-term interest rates throughout the year. It was also widely agreed that the first victim of the

expected rise would be the housing sector, as mortgage rates are closely linked to the 10-year Treasury bond yield. Of course, except for a brief spurt in the spring, the much ballyhooed yield climb never materialized. By the end of the year, long-term rates were essentially unchanged from 12-months earlier, and homebuyers found mortgage borrowing to be as accessible and cheap as ever.

Hence, despite the long-anticipated retrenchment in housing activity, both sales and construction remained on a solid footing throughout most of the year. That resilience was highlighted again this week with the release of the latest monthly housing starts figures for December. After slumping in November due to poor weather conditions, the pace of new groundbreaking rebounded with a vengeance in the following month.

While it may have been weather-related bounce, there is no denying the sustained strength that the housing sector has displayed throughout the year, including the fourth quarter. For the year as a whole, housing starts came in just shy of that magical 2 million unit level -- 1.953 million units to be exact -- which is up 5.7 percent from the solid 1.848 million units started in 2003. The last year that starts topped the 2 million threshold was 1978.



In the latest week, mortgage rates slipped to 5.67 percent, almost precisely where it stood a year earlier and actually lower than the 5.84 percent average for all of 2004. Not surprisingly, mortgage applications, after dipping in December when mortgage rates hit a high of 5.81 percent, are once again on the rise. In the week ended January 14, purchase applications spiked up by 14 percent, and with rates lower in the following week another gain seems to be in the cards. While applications for refinancing also bounced up in the latest week, it is hard to imagine that another refinancing boom is on the way, as most eligible loans have already been refinanced. Still, until bond yields finally do embark on their long-awaited climb, it would be foolhardy to question the staying power of this remarkable housing market.

But the question that lingers in the minds of policy makers is whether or not the real estate market is in a bubble that, like the stock-market bubble of the late 1990s, can come to an unceremonious end. As we have noted before, real estate has become a key component of household net worth, regaining the lead from stocks as the most valuable asset held by households. With home prices appreciating at a rapid rate last year, consumers tapped into their growing equity positions to support consumption -- through home equity loans and refinancings. Meanwhile, the personal savings rate has shriveled to almost zero in the fourth quarter of last year as individuals opted to let the appreciation in their assets do the savings for them.

This is a dangerous trend that makes households vulnerable to a setback in asset values -- whether it is in stocks or real estate. With stocks losing ground for four consecutive weeks to start the new year and mounting signs that home prices have peaked, there is a strong probability that households will set aside a larger fraction of their paychecks in 2005. No doubt, higher interest rates would facilitate that movement, as the reward for postponing consumption would rise, as would the cost of financing goods through increased borrowing. Significantly, the Federal Reserve acknowledged at its December policy-setting meeting that speculation in the housing market may be brewing. Hence, its continued rate-hiking efforts will be as much to dampen such speculation as to restrain any buildup in inflationary pressures.

This is just another reason to expect the Fed to move again at its February 1-2 meeting, with a quarter point increase in the

benchmark federal funds rate widely expected. There has been some speculation, partly based on recent hawkish statements by a few Fed officials, that Greenspan and Company is poised to accelerate the rate-hiking campaign, putting through some half-point increases on the way to neutrality. That may well be the case if the economic data start heating up and inflation rears its ugly head more forcefully than it has. But the latest price data do not paint a picture of escalating inflation, at least not enough to provoke the Fed into a more aggressive tightening stance with so many questions still overhanging the economy. In December, the CPI fell by 0.1 percent due largely to falling energy prices, while the core CPI, which excludes food and energy items, edged up by 0.2 percent, equaling the increase in each of the previous two months. For the year through December, the core CPI rose 2.2 percent, which is close to the pace observed since 1997. To be sure, the Fed can move preemptively, much like it did in 1994 to stave off inflation before it begins by moving more aggressively. But in 1994, there was much less slack in the labor and product markets than is the case now, so the odds favor a "measured" pace of tightening for a while.

