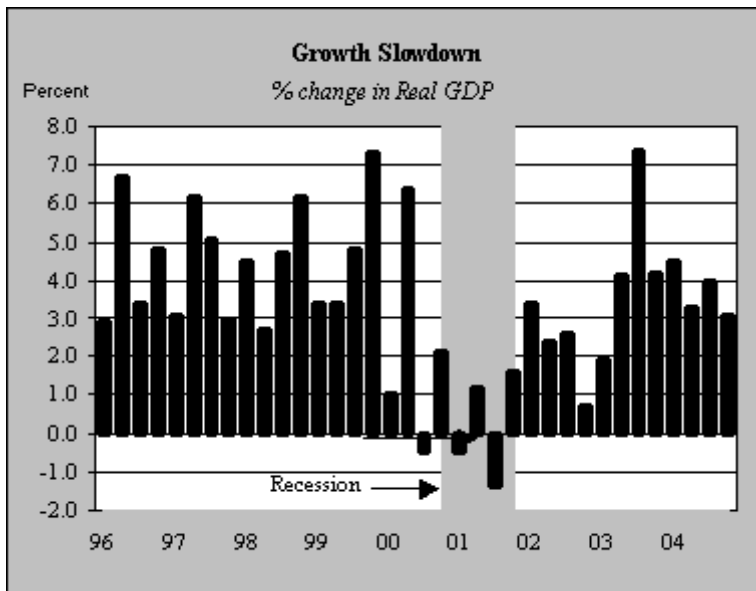


WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 28, 2005

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	January 28	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.45%	2.34%	2.22%	0.91%
6-month Treasury bill	2.70	2.65	2.58	0.99
2-year Treasury note	3.24	3.14	3.07	1.83
5-year Treasury note	3.68	3.64	3.61	3.15
10-year Treasury note	4.13	4.14	4.22	4.13
30-year Treasury bond	4.60	4.64	4.82	4.96
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.90	2.92	2.90	2.41
10-Year	3.73	3.73	3.78	3.63
30-Year	4.57	4.59	4.67	4.8
30-year fixed mortgage rate				
	5.66	5.67	5.81	5.68
15-year fixed mortgage rate				
	5.14	5.15	5.23	4.97
1-year adjustable rate				
	4.18	4.11	4.19	3.59
STOCK MARKET				
Dow Jones Industrials	10427.20	10392.49	10783.01	10488.07
S&P 500	1171.36	1167.87	1211.92	1131.13
NASDAQ	2035.83	2034.27	2175.44	2066.15
Commodities				
Gold (\$) - 100 OZ	428.60	427.30	438.40	402.9
Oil (\$ per barrel) - Crude Futures (NYMerc)	47.18	48.53	43.45	29.5
(Key Reports For Week of January 28)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Confidence (January) - Index	103.4	102.7	92.6	97.8
Existing Home Sales (Dec.) - 000s units	6690	6920	6760	6733
Durable Goods Orders (Dec) - % change	0.6	1.8	-1.0	0.7
Real GDP (Q4) - % change, Saar	3.1	4.0	3.3	4.4
Employment Cost Index (Q4) - % change	0.7	0.9	0.9	0.9

If the headlines on Friday morning were to be taken at face value, you would think that the economy was on the cusp of a recession. One after another, the business press shouted out the news that the "economy slowed" in the closing quarter of last year, with growth slipping to the lowest level in nearly two years. According to the Commerce Department's first take on GDP, the economy grew at "just" a 3.1 percent annual rate in the October-December period. That's down from 4.0 percent in the third quarter and the weakest performance since the first quarter of 2003, when the economy expanded by an anemic 1.1 percent pace. To punctuate the slowdown -- and add insult to injury -- the press releases reminded everyone that the growth rate was well below the consensus estimate held by economists, that much-maligned assemblage of soothsayers. In the interest or full disclosure, let it be known that our venerable crew had forecasted a growth rate closer to 4 percent than 3 percent -- a not inconsequential miss.

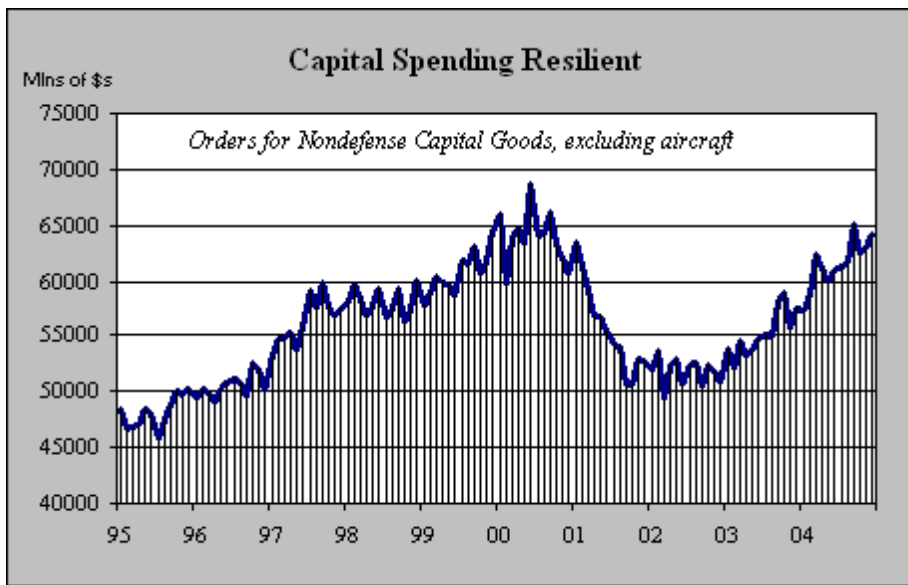


True enough. But as they say, the devil is in the details. And, what the details tell us is that the economy is far from a comatose state. Take consumer spending, the driving force that propels 70 percent of total economic activity. During the period, households increased their real outlays on goods and services by a 4.6 percent annual rate. While that's slower than the hearty 5.1 percent pace in the third quarter, it is hardly a weak showing. In fact, the 4.6 percent gain is stronger than in 10 of the 13 quarters that transpired since the economy emerged from the 2001 recession. Even more impressive is that consumers continued to step up their expenditures without the aid of the artificial stimulants that had boosted purchasing power in most of those quarters. These included two rounds of large tax cuts, an unprecedented mortgage refinancing boom and an aggressive rate-cutting campaign by the Federal Reserve that sent interest rates to their lowest level in more than 40 years.

Nor for that matter, could business spending be considered disappointing last quarter. Like consumers, businesses also tapered off their investment outlays, as nonresidential fixed investment rose by 10.3 percent compared to 13.0 percent in the third quarter. But the double-digit gain is nothing to sneeze at, particularly in a business environment that still has more than enough spare capacity to accommodate demand. That's probably the reason why outlays on structures actually fell by 4.1 percent during the quarter, reflecting an ongoing soft spot that is likely to hang around for a while longer. But capital spending for equipment and software staged another robust increase of 14.9 percent, extending a powerful recovery that has lasted through seven consecutive quarters following the 1999-2002 capital-spending bust.

Admittedly, the fourth quarter increase in capital spending received a boost from tax incentives that expired at the end of last year. Since some outlays were undoubtedly pushed forward to take advantage of the tax break, a slower pace of spending is probable early this year. But companies are not likely to drastically shrink their capex budgets. With strong competitive pressure to hold the line on pricing and labor costs rising, the push to sustain productivity is as strong as ever. That means spending on machinery, software and other high-tech gear designed to improve efficiency and lower production costs should continue to remain on solid ground going forward.

Indeed, that's the message provided by recent reports on durable goods orders -- advance bookings for goods having a life of three years or longer -- which posted a respectable 0.8 percent increase in December following a sturdy 1.8 percent gain the previous month. More significant was the strength in orders for nondefense capital goods, excluding the volatile aircraft sector, which is a good indicator of future capital spending. In December, these bookings increased by a hefty 1.8 percent after a 0.9 percent gain in November. Even allowing for month-to-month volatility in this series, the average 1.4 percent increase in core capital goods orders in November and December handily exceeded the 0.8 average monthly gain over the previous eight months. Keep in mind also that the latest data on bookings were not affected by the tax incentives, as the equipment purchased had to be in use by the end of the year to qualify for the bonus depreciation write-off. Simply put, the resilient capital spending plans reflect what companies perceive to be an ongoing need for new equipment and technology enhancements that will enable them to meet growing demand and compete effectively in a highly-competitive global marketplace.



So if consumer and businesses continue to flex their spending muscles, what caused the economy to decelerate so sharply last quarter? The culprit, not surprisingly, lies with our international accounts, which have been dragging down growth for some time. The simple matter is that we are importing far more goods than we are exporting, and these imports enter into the calculations of economic growth as a negative influence. In the fourth quarter, the current account deficit -- recorded as net exports of goods and services in the GDP accounts -- widened to a whopping \$632 billion, nearly \$50 billion greater than the already-huge \$583 billion in the third quarter. This widening, in turn, subtracted fully 1.73 percentage points from the GDP growth rate in the period. In other words, had the current account deficit just held steady in the fourth quarter, the economy would have expanded by a robust 4.8 percent.

Unfortunately, the trade deficit will continue to drag down growth for a while longer, despite the dollar weakness that has been underway for nearly three years. With imports exceeding exports by nearly 60 percent, our sales of goods and services overseas would have to grow by at least half again as fast as imports. That's a formidable task under any circumstances, but it is made even more difficult because U.S. is still expanding at a faster pace than virtually all of its main trading partners. The exception, of course, is China, which continued to post an eye-opening 9.5 percent growth rate in the fourth quarter. But the Chinese government has shown no willingness to stop pegging its currency to the dollar, thus preventing market forces from correcting the huge and growing surplus with the U.S. This remains one of the more intractable problems confronting the administration, which is likely to feel the heat of intensified protectionist sentiment from manufacturers and labor groups that are most directly affected by the growing trade imbalance with China.

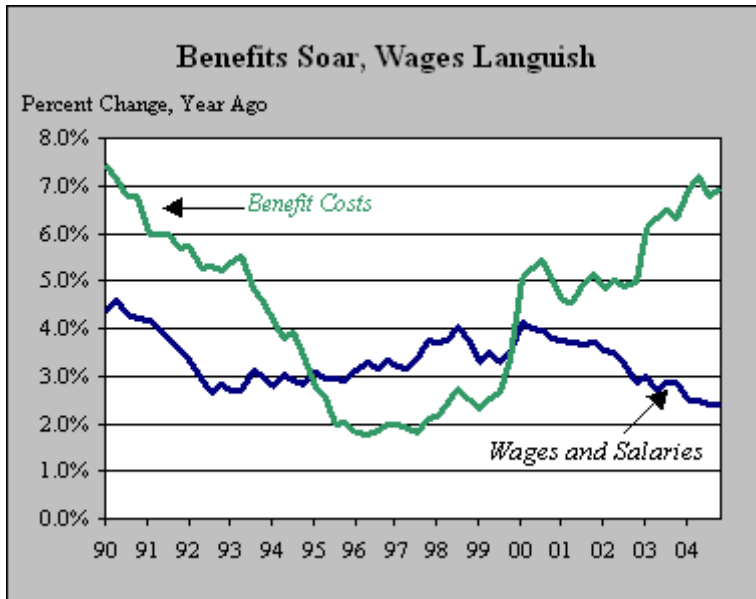
The point is that the U.S. economy is doing just fine, notwithstanding the headline slowing in GDP last quarter. Consumer spending is holding up well, business capital outlays remain on a solid growth trajectory and the strength in both of these key sectors are underpinned by solid fundamentals. What's more, there is a silver lining behind the growth slowdown in that it removes pressure on the Federal Reserve to accelerate its rate-hiking campaign, which is due to receive another quarter-point installment in the upcoming week. Indeed, wherever this pressure is coming from, it's not from the bond market, which is pleased as punch with the latest economic numbers. Not only did the pace of growth slide below the economy's perceived 3.5 percent long-term potential, but the key inflation components remained very much subdued.

For example, Alan Greenspan's favorite inflation barometer -- the core personal consumption deflator -- increased by a benign 1.5 percent in the fourth quarter, matching the increase for all of 2004. In 2003, this measure increased by 1.3 percent, and in 2002 it rose by 1.8 percent. So here we are entering the fourth year of expansion, and the inflation dragon remains firmly bottled up, at least according to this broad measure of consumer inflation. One reason Greenspan likes the PCE over other measures is that it reflects changing buying habits of consumers. The CPI, in contrast, measures price changes for a fixed basket of goods and services that may not reflect the propensity of consumers to substitute lower priced for more expensive products from quarter to quarter.

As we noted, the bond market couldn't be more pleased with data that depicted moderating growth and low inflation. At the end of the day, the bellwether 10-year Treasury yield fell all the way back to 4.13 percent after rising to 4.22 percent earlier in the week. The earlier rise was influenced by the renewed climb in oil prices as well as bloated estimates of the budget deficit by both the CBO and the White House, which portend some heavy Treasury financing needs in coming quarters. But

another reason for the improved sentiment in the bond market was the news that the rise in labor costs may also be moderating. With companies adding to payrolls at a faster clip and productivity slowing in recent quarters, the understandable concern is that labor cost pressures are building, which companies will strive to pass on to consumers.

Yet, according to the Labor Department's latest figures on employment costs, just the opposite is the case. True, benefit costs continue to soar, particularly pension contributions and health insurance, but companies are compensating by putting a greater squeeze on wages and salaries. In the fourth quarter, paychecks rose by a puny 0.4 percent, keeping the 12-month increase to only 2.4 percent. That matches the weakest annual increase in wages and salaries in 20 years. Hence, even with benefit costs increasing by a sturdy 1.4 percent -- and by a whopping 6.9 percent over the past twelve months -- the rise in total employment costs slowed to 0.7 percent in the fourth quarter from 0.9 percent in the third. The third quarter increase was the smallest since 1999.



To be fair, the decline in Treasury yields may not be entirely related to changing economic and inflation perceptions. With violence erupting ahead of the Iraqi elections this weekend, and possible oil-supply disruptions looming, there were undoubtedly some safe-haven bids bolstering Treasury prices. But safe-haven bids do not usually favor the longer maturities, which waters down this argument somewhat. The best guess is that the latest data have caused the bond vigilantes to retreat, while allowing the bond bulls their day in the sun. That dynamic could change abruptly next week when the government releases its all-important jobs report for January. More than anything, this report sets the tone for the economy for weeks to come and any surprise can profoundly alter perceptions in the financial markets. Stay tuned.