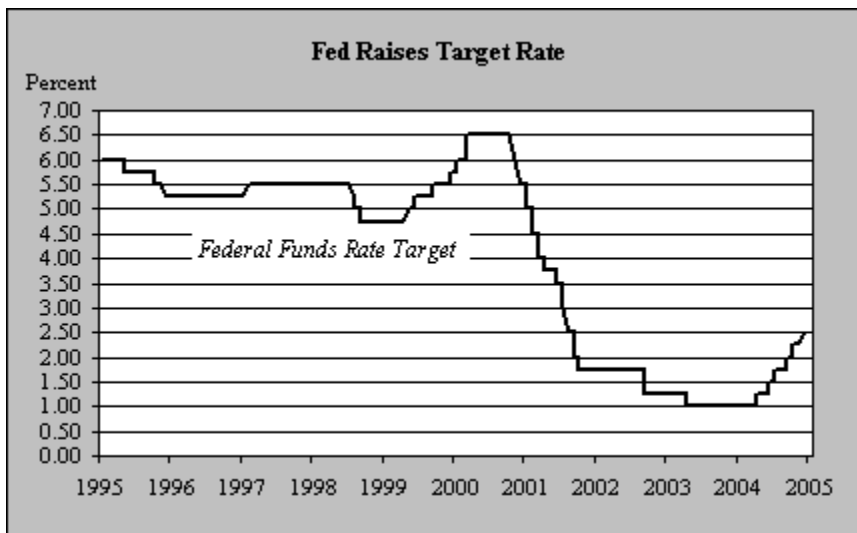


WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 4, 2005

First the numbers, then the story

| FINANCIAL INDICATORS | | | | |
|--|-------------------|--------------------|-------------------------|-----------------------------------|
| INTEREST RATES | February 4 | Week Ago | Month Ago | Year Ago |
| 3-month Treasury bill | 2.48% | 2.45% | 2.31% | 0.92% |
| 6-month Treasury bill | 2.74 | 2.70 | 2.63 | 1 |
| 2-year Treasury note | 3.28 | 3.24 | 3.18 | 1.75 |
| 5-year Treasury note | 3.67 | 3.68 | 3.71 | 3.08 |
| 10-year Treasury note | 4.08 | 4.13 | 4.27 | 4.08 |
| 30-year Treasury bond | 4.48 | 4.60 | 4.84 | 4.92 |
| Tax-Exempt Revenue Bonds (Triple-A) | | | | |
| 5-Year | 2.91 | 2.90 | 2.82 | 2.47 |
| 10-Year | 3.65 | 3.73 | 3.72 | 3.68 |
| 30-Year | 4.54 | 4.57 | 4.65 | 4.78 |
| 30-year fixed mortgage rate | | | | |
| | 5.63 | 5.66 | 5.77 | 5.72 |
| 15-year fixed mortgage rate | | | | |
| | 5.14 | 5.14 | 5.21 | 5.03 |
| 1-year adjustable rate | | | | |
| | 4.23 | 4.18 | 4.10 | 3.61 |
| STOCK MARKET | | | | |
| Dow Jones Industrials | 10716.13 | 10427.20 | 10603.96 | 10593.03 |
| S&P 500 | 1203.03 | 1171.36 | 1186.19 | 1142.76 |
| NASDAQ | 2086.66 | 2035.83 | 2088.61 | 2064.01 |
| Commodities | | | | |
| Gold (\$) - 100 OZ | 416.20 | 428.60 | 419.00 | 404.2 |
| Oil (\$ per barrel) - Crude Futures (NYMerc) | 46.48 | 47.18 | 45.43 | 29.32 |
| (Key Reports For Week of February 4) | | | | |
| INDICATOR (Latest Month/Quarter) | Current Month/Qtr | Previous Month/Qtr | Two-Months/ Qtrs Ago | Average-Past 6 Months or Qtrs. |
| ISM Manufacturing Index (January) | 56.4 | 57.3 | 57.6 | 57.9 |
| ISM Nonmanufacturing Index (January) | 59.2 | 63.9 | 61.9 | 59.9 |
| Nonfarm Productivity (Q4) - % change | 0.8 | 1.8 | 3.9 | |
| nonfarm payrolls (January) - 000s change | 146 | 133 | 132 | 169 |
| Unemployment Rate (January) - Percent | 5.2 | 5.4 | 5.4 | 5.4 |

With perhaps the lone exception of the venerable groundhog, Punxsutawney Phil, hardly anyone was surprised by the Federal Reserve's decision to hike interest rates by another quarter point this week. Sure, there was some speculation surrounding the policy-setting meeting that ended on Wednesday. But the conjecture focused mostly what the Fed would say after the meeting, not what it would do. In particular, some analysts thought that the post-meeting statement would omit the infamous phrase: "policy accommodation can be removed at a pace that is likely to be measured", which has been issued regularly since the rate-hiking campaign began last June. As expected, the phrase was retained, firmly indicating that more hikes are on the way.



That's not to say that the central bank won't pause at some point if the economy hits a soft patch, or if some unforeseen event occurs that justifies a wait and see strategy for a while. Such a pause is typical of tightening cycles, and occurred at least once during each of the last two rate-hiking campaigns in 1994 and 1999. But the objective is clear. The Fed is anxious to bring the federal funds rate up to a "neutral" level, one that neither encourages nor hinders economic growth. No one is sure just what that target level is, but it is generally agreed that it has to reside at some comfortable margin over the inflation rate. Even with the latest increase to 2.50 percent, the funds rate is just barely above inflation, meaning that real short-term financing costs are still effectively zero.

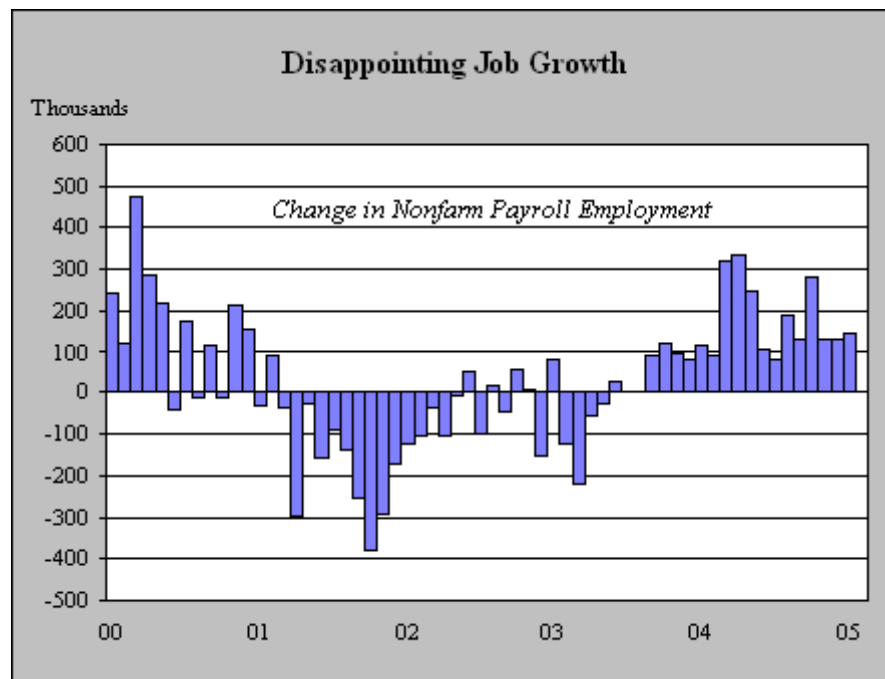
Whether the end of the tightening cycle occurs at 3 1/2 or 5 percent, or even higher, remains to be seen. Market analysts will be eagerly anticipating Chairman Greenspan's semi-annual congressional testimony on February 18 for some further insight into his thinking. While the tightening cycle so far is running according to script, it is surprising in at least one respect. Ordinarily, the Fed steps on the monetary brakes when the economy is gathering momentum and the inflation embers are heating up. This is not the economic backdrop that is currently shaping policy. As noted last week, the economy downshifted in the fourth quarter to a 3.1 percent growth rate from 4.0 percent in the previous quarter, and the major inflation barometers are throwing off benign signals. The consensus forecast among economists is that growth this year will be slower than the 4.4 percent pace recorded for all of 2004. Even the Fed is forecasting a slower growth rate in 2005 and continues to state that "inflation remains well contained".

Instead, it appears that Greenspan and Company is worried that by keeping interest rates at super-low levels, it is encouraging speculation in the housing and financial markets. Indeed, that sentiment was expressed in the minutes of the December 14 policy-setting meeting, indicating that the Fed is raising rates as much to ward off the creation of speculative bubbles as it is to keep inflation at bay. It's an open question as to whether the housing market is still in a runaway state or cooling off. The anecdotal evidence conveyed by the multitude of newspaper stories, cocktail party chatter and real-estate postings is that the housing boom is flying high, with competitive bidding sending prices sharply upward. But official numbers tell a different story, one that shows budding weakness in sales and construction as well as mounting inventories of unsold homes.

The fate of the real estate market is of no small consequence. Throughout the recovery, consumer spending has been supported mightily by the astonishing appreciation in home values, which has enabled households to cash in their expanding equity positions either through refinancings or by selling their homes at a substantially higher price than was originally paid. The growing wealth positions, reinforced by the revitalized stock market over the past two years, has encouraged consumers to spend virtually every penny of earned incomes, as the personal savings rate slid to a postwar low of 1 percent last year. If the wealth effect from housing is now vanishing, consumers will need to rely more on income generation to sustain spending going forward. Indeed, this is precisely what the policy makers were hoping for with the aggressively stimulative policies in place over the past several years.

But for income growth to take up the slack created by a leveling off in real estate values, the labor market must show far more strength than it has to date. If Friday's much-anticipated employment report is any indication, a hiring boom is still a long ways from replacing the real-estate boom. Indeed, companies appeared to start the new year on a tepid note, expanding payrolls by only 146 thousand workers in January. That's considerably weaker than expected, and represents a much slower pace of job creation than in 2004, when employers expanded payrolls by an average of 183 thousand a month. What's more, the increases for the previous two months were revised down, and the January gain did not generate much in the way of extra

earnings for workers. Average hourly earnings edged up by 0.2 percent, less than inflation, during the month, which brought the twelve-month increase to 2.6 percent, where it's been virtually stuck for the past four months.



Admittedly, the optimists can turn to some positive elements in the January employment report. In particular, the jobless rate fell from 5.4 percent to 5.2 percent, the lowest in four years. The primary reason for the drop is that fewer people were in the labor force seeking jobs, as the labor participation rate fell to 65.8 percent from 66 percent in December. This is contrary to normal cyclical patterns. Typically, as a recovery matures and generates stronger demands for workers, new entrants to the labor force come out of the woodworks -- previously discouraged workers, housewives seeking second incomes, new retirees and students who might forego a degree because of perceived good job opportunities. As a result, the labor force participation rate tends to increase, which can actually cause the jobless rate to rise for a while until the new entrants to the workforce are absorbed.

Indeed, for a while, it looked like the typical pattern was unfolding. As the job market heated up last spring, discouraged workers returned to the labor force and the participation rate increased from 65.9 percent to 66.2 percent. But that was the high point for the year, and the January rate of 65.8 percent is the lowest since this measure was reconstituted back in 1994. Given that the job market is improving, albeit by a disappointingly slow pace, it is hard to explain the drop in the participation rate. Government officials are putting a positive spin on this development. A representative from the Council of Economic Advisors appeared on a business news program on Friday citing the willingness of housewives to stay at home because of their growing confidence in the labor market, suggesting that they can find a job anytime they want to. Another plausible explanation is that young people recognize the value of a degree and are increasingly deciding to stay in school. That argument would seem to have support in the numbers, as the participation rate among 16-19 year olds took a particularly sharp drop in January.

We are more than willing to give the January employment report a pass, if only because volatile weather conditions make it a notoriously bad month to gauge job market conditions. But what makes the January tepid gain in jobs so disappointing is that it comes on the heels of a sharp slowdown in productivity growth. In the fourth quarter, productivity among nonfarm corporations increased by only 0.8 percent, the slowest pace since the first quarter of 2001, a recession year. Recall that a commonly made argument for the lackluster pace of job creation during the recovery is that companies have relied on the astonishing gains in productivity to generate output. This suggests that once productivity tapers off, companies will have to hire more workers to satisfy customer demands. Well, the productivity slowdown is here, but the hiring response is not.

The question is whether the burst of hiring will be coming with a lag, or whether companies will instead compensate for the slowdown in worker efficiency by stressing more cost-cutting. This will be a key question going forward, but the rash of mergers and acquisitions being transacted -- the latest blockbuster being the proposed Procter and Gamble acquisition of Gillette -- indicates that corporations may be using this vehicle as a means of achieving greater cost efficiencies to retain a competitive edge. Since M&A activity is usually accompanied by large-scale layoffs, this is not a particularly good omen for

future job growth.

That said, the financial markets were clearly not overly discouraged by the latest spate of economic indicators. Both bond and stock prices rallied strongly following Friday's employment report, probably for different reasons. The bond crowd was obviously pleased by the moderate pace of job growth, as it implies less wage and price pressures than otherwise. It also hints at the possibility that the Federal Reserve may go a little slower on the road towards neutrality than if the labor market was heating up. We doubt that the employment report will change the thinking of the Fed at this time, but a few more months of similar reports might have an impact. Equity investors, in turn, may also have been encouraged by what the jobs report means for wage and, hence, cost pressures. The lower these pressures, the greater the odds of retaining healthy profit margins; as it is, the market derived some strength this week from earnings reports that are coming in better than expected.

With the stock market turning in the first solid weekly gain for the year, it is poised to reverse a disappointing performance in January, should it remain strong over the rest of February. The bond market, in turn, is continuing to reward investors and defy all expectations. In our monthly roundup of relative asset performance, total returns in the bond market handily exceeded those in the stock market last month, as the major equity indexes took a sharp fall in January. As the chart shows, stocks were the big winners last year, but fixed-income securities did not perform too shabbily. How the rest of this year shapes up will depend in large part on how successful the Fed is in manipulating the policy levers.

