

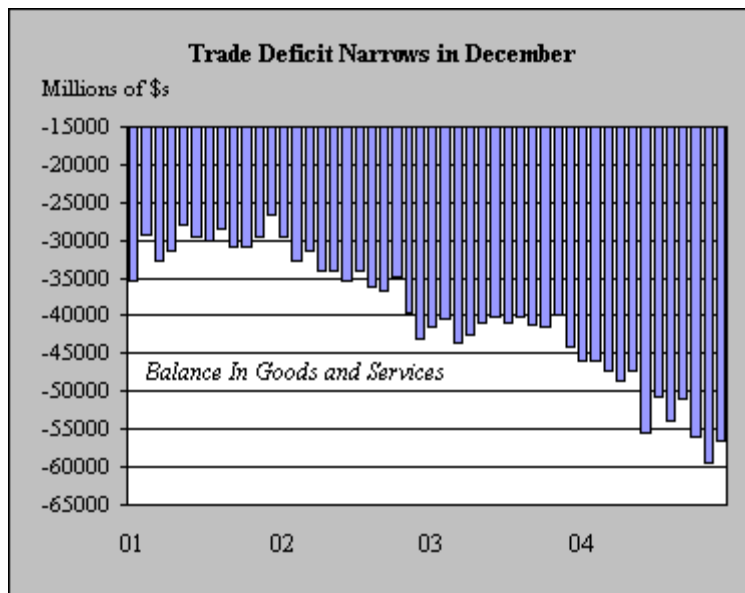
WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 11, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	February 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.54%	2.48%	2.36%	0.91%
6-month Treasury bill	2.81	2.74	2.66	0.97
2-year Treasury note	3.32	3.28	3.22	1.67
5-year Treasury note	3.69	3.67	3.71	3.01
10-year Treasury note	4.08	4.08	4.21	4.04
30-year Treasury bond	4.47	4.48	4.73	4.92
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.87	2.91	2.83	2.4
10-Year	3.59	3.65	3.73	3.61
30-Year	4.48	4.54	4.58	4.71
30-year fixed mortgage rate				
	5.57	5.63	5.74	5.66
15-year fixed mortgage rate				
	5.10	5.14	5.19	4.96
1-year adjustable rate				
	4.11	4.23	4.10	3.57
STOCK MARKET				
Dow Jones Industrials	10796.01	10716.13	10558.00	10627.85
S&P 500	1205.30	1203.03	1184.52	1145.81
NASDAQ	2076.66	2086.66	2087.91	2053.56
Commodities				
Gold (\$) - 100 OZ	422.00	416.20	423.30	410.8
Oil (\$ per barrel) - Crude Futures (NYMerc)	47.16	46.48	43.38	31.15
(Key Reports For Week of February 11)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (December) - Mlns of \$s	3116	1996	14077	8516
Trade Deficit (December) - mlns of \$s	56403	59333	56099	54577

Following last Friday's disappointing employment report, the economic news was somewhat more upbeat this week. True, there was nothing earth-shattering about the skimpy batch of data provided by the statisticians in Washington. But the year is young, and there is a natural tendency to accent the positive until events dictate otherwise. In this spirit, the markets drew encouragement from this week's reported drop in new claims for jobless benefits. The decline, to the lowest level in more than four years, was interpreted by some as evidence that the disappointing employment report for January may have been distorted by weather and other special factors.

Similarly, the markets' ongoing concern over the nation's burgeoning trade deficit was tempered by this week's report showing that the gap narrowed in December. Admittedly, nothing can obscure the mammoth \$617 billion deficit that the nation recorded for all of last year, accounting for an unprecedented 5.3 percent of GDP (and 5.7 percent in the fourth quarter). But after hitting a peak of \$59.3 billion in November, the deficit declined to \$56.4 billion in December, helped by a solid 3.2 percent gain in exports. Never mind that the December shortfall was still the second largest ever. To the optimists, the \$2.9 billion shrinkage during the month means that the worst is over, and at least we are in the right track going into 2005.



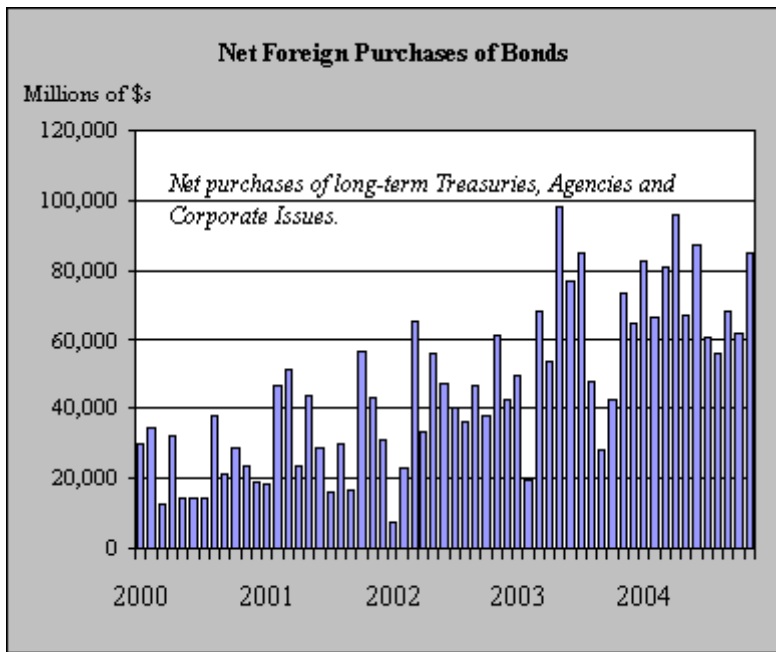
If that's the case, the dollar's three-year slide may finally be working its magic, making U.S. goods more attractive to overseas buyers. Indeed, the export increase in December was broadly based, including gains of 5.8 percent in capital goods, 7.1 percent in consumer goods and 4.1 percent in industrial supplies. But the December spike in exports follows several months of tepid growth, so we will have to see if the nascent strength is corroborated in coming months. More importantly, no improvement in the trade deficit can be accomplished unless imports are curbed. On the surface, the December figures provide some encouragement, as imports only edged up by a puny 0.1 percent, following a 1.6 percent increase in November.

But that slowing in imports was largely oil-related, reflecting a drop in the price of imported petroleum. What's more, there was a suspicious 5.3 percent drop in apparel imports, following a 3.2 percent decline in November. Odds are, this a temporary development that is related to the scheduled expiration of Chinese import quotas on clothing at the end of last year. With that restraint now removed, a burst of imports from China can be expected, something that is bound to fuel protectionist sentiment and ignite more outcries in the apparel industry, which has been bleeding jobs for years. The simple fact is that imports exceed exports by more than 50 percent, meaning that growth in exports needs to be at least half again as fast as the increase in imports for there to be any progress on the trade front.

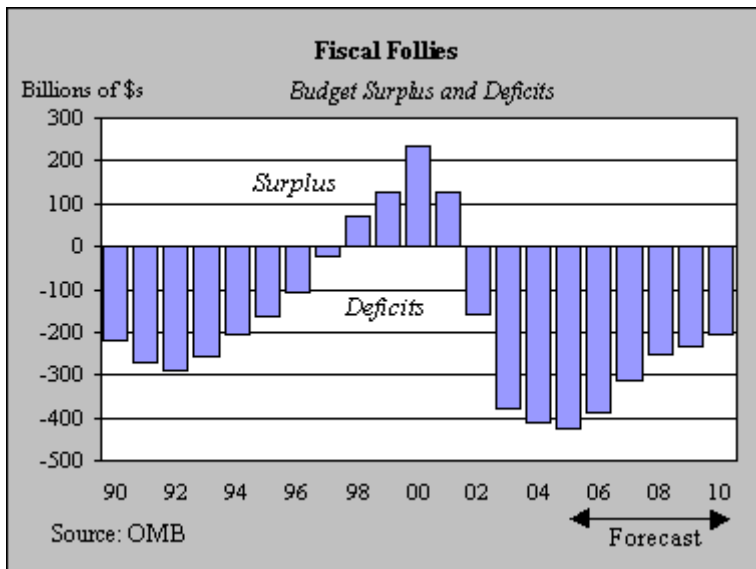
We suspect that some winnowing away at the deficit will begin this year, but progress will be gradual at best. Since almost the entire shortfall is in consumer goods, the key will be for households to rein in their purchases of imported products. To the extent that these imports are sensitive to changes in the dollar, the lagged impact of the greenback's decline over the past three years should help. Also, an expected decline in oil prices from last year's peak should contribute to a lower oil deficit. Keep in mind, that a narrowing of the current account deficit not only provides a boost to economic growth; it also reduces the dependence on foreign lenders to bridge the gap between imports and exports.

Indeed, the heavy reliance on foreign capital to finance the trade deficit has been a lingering sore spot in the financial markets for some time. The fear, of course, is that overseas investors will at some point turn wary about holding too many dollar assets, particularly if the risk of a further dollar decline grows. The upshot of a foreign withdrawal of funds, or a boycott of new investments in U.S. securities, would be a spike in interest rates that could seriously damage growth prospects. To be sure, such an occurrence could well take place down the road if foreign investors lose confidence in dollar assets or perceive that the reward for investing in the U.S. is not worth the risk. That, however, is not suggested by the pattern of fund flows, or by the performance of the U.S. economy relative to other nations providing alternative investment opportunities.

According to the latest Treasury data, for example, net foreign purchases of U.S. securities totaled \$85.2 billion in November, more than \$20 billion above what was needed to finance the monthly trade deficit. In other words, overseas investors still see plenty of value in U.S. securities, which is underpinned by a growth rate that is significantly stronger than in Europe and Japan. What's more, dollar-denominated bonds offer higher interest rates than are available on foreign securities, notwithstanding the historically low level of yields that still prevail in the U.S. In short, there is little indication that foreign investors have either the inclination or the incentive to abandon the U.S. financial markets -- at least not to this point.



As we noted at the outset, the modest fall in the trade deficit in December provided some encouragement that we are heading in the right direction. Whether or not that turns out to be the case in coming quarters is open to legitimate debate. But the future of the trade deficit is not nearly as controversial as what's in store for the nation's other deficit -- the massive shortfall in the Federal budget. Like the trade deficit, the volume of red-ink being spilled in Washington is also at an unprecedented level, reaching \$413 billion in fiscal 2004. But if the administration's latest budget forecast released this week is to be believed, that too is poised to decline. After rising to \$425 billion in the current fiscal year, the budget deficit is slated to fall to \$389 billion in fiscal 2006 and continue on a downward path towards \$207 billion in 2010, thus fulfilling the President's pledge to halve the deficit in five years.



At the outset, two things need to be said. First, the budget proposals of the current President, as was the case with the budget proposals of his predecessors, are primarily political documents and, therefore, a mixture of fact and fancy. Also, because it is a political document, omissions are sometimes as, or even more, important than what is included. The trick is to be able to decipher the fact from the fancy, and also to understand when pieces do not add up because something is missing. Second, because the budgets are political documents, they tend to be presented in a very subjective way, rather than an objective way. As Harry Truman said, "if you cannot convince them, confuse them."

For example, one of the interesting subjective twists in the current budget is the preference of the administration to present

the deficit in terms of its relationship to GDP. This mode of presentation, of course, was not invented by this administration, but the inclination to diminish the significance of the massive deficits by viewing them as a percentage of GDP has been a clear theme of this administration.

Why would it do this? When viewed in this context, the worst is already behind us. Indeed, based on OMB projections, the deficit peaked at 3.6% of GDP in fiscal 2004 and will gradually decline to 1.3% by 2010, which would be strikingly low in an historical context.

But the odds of such an accomplishment are quite low, in the view of most fiscal experts. True, the current year's projected deficit of \$425 billion is not unrealistic; there are even lower forecasts among private economists. But again, it is those omissions that just don't add up. One of the biggest, of course, is the supplemental financing needed to fund ongoing operations in Iraq and Afghanistan, which is not included in the budget forecast beyond 2005 and is estimated to be at least \$70 billion a year. Then there are the transition costs involved with the President's much-hyped plan to privatize part of Social Security; these costs do not kick in for several years but they are massive in scope and if passed will add more than \$1 trillion to the cumulative deficits over the next decade. Simply put, to meet the ambitious deficit targets, either an unexpected burst of revenues would have to materialize, or the lawmakers would have to apply draconian cuts to other discretionary programs, which they are not likely to do. The budget saga is in its early stages, so expect a lot of pushing and shouting on Capitol Hill over the next four years. But the administration's ambitious budgetary proposals are just that -- proposals that may never see the light of day. Until and unless they are, the budget numbers should be viewed with a good deal of skepticism.