

WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 18, 2005

First the numbers -- then the story

FINANCIAL INDICATORS				
INTEREST RATES	February 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.59%	2.54%	2.34%	0.93%
6-month Treasury bill	2.89	2.81	2.65	1
2-year Treasury note	3.43	3.32	3.14	1.71
5-year Treasury note	3.86	3.69	3.64	3.07
10-year Treasury note	4.27	4.08	4.14	4.09
30-year Treasury bond	4.65	4.47	4.64	4.95
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.89	2.87	2.92	2.32
10-Year	3.55	3.59	3.73	3.53
30-Year	4.42	4.48	4.59	4.71
30-year fixed mortgage rate				
	5.62	5.57	5.67	5.58
15-year fixed mortgage rate				
	5.14	5.10	5.15	4.87
1-year adjustable rate				
	4.15	4.11	4.11	3.53
STOCK MARKET				
Dow Jones Industrials	10785.22	10796.01	10392.49	10619.03
S&P 500	1201.59	1205.30	1167.87	1144.11
NASDAQ	2058.62	2076.66	2034.27	2037.93
Commodities				
Gold (\$) - 100 OZ	428.90	422.00	427.30	398
Oil (\$ per barrel) - Crude Futures (NYMerc)	48.50	47.16	48.53	31.22
(Key Reports For Week of February 18)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (January) - % change	-0.3	1.1	0.0	0.5
Housing Starts (January) - 000s of units	2159	2063	1805	2001
Industrial Production (January) - % change	0.0	0.7	0.1	0.2
Business Inventories (December) - % ch	0.2	1.1	0.4	0.6
Producer Price Index (January) - % change	0.3	-0.3	0.7	0.4
Core PPI (January) - % change	0.8	0.2	0.2	0.4

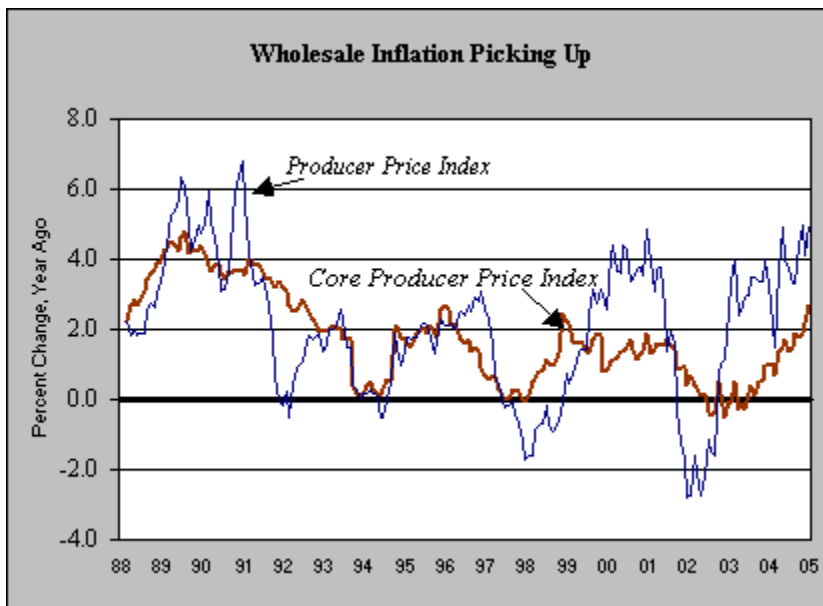
It doesn't exactly rank up there with "irrational exuberance", but the description of the bond market's behavior as a "conundrum" by Fed chairman Greenspan is receiving the kind of attention-grabbing status as that infamous remark did back in 1996. We are referring, of course, to the Fed chief's semi-annual congressional testimony this week, in which he was at a loss to explain the decline in long-term interest rates over the past seven months despite six rate hikes by the Fed during the period. Not that he didn't try, but all of the explanations proffered just didn't quite cut the mustard, in his view. For example, the notion held by the bond optimists that the decline in bond yields is simply a harbinger of a weaker economy doesn't square with the simultaneous narrowing of credit spreads or the stronger stock market, both indicators of impending economic vigor.

Indeed, Greenspan left the distinct impression that the bond market was in bubble-like territory. More to the point, he gave every indication that the Fed would continue on its rate-hiking campaign, stating that the federal funds rate was still relatively low. Just what the target for the rate is, however, remains unclear, reflecting a somewhat ambiguous presentation of the economic outlook. On the one hand, the Fed is forecasting stronger growth in 2005 than it did last year, but it also believes that inflation remains "well anchored". Critically, Greenspan took note of the disappointing pace of job creation, noting that employers continue to remain overly cautious about taking on new workers. Hence, the outlook for employment growth was trimmed somewhat.

All in all, the major takeaway from Greenspan's testimony is that the markets should expect at least several more rate hikes in the months ahead. Once the funds rate, currently at 2.5 percent, moves above the 3 percent level, it will be approaching the neutral range that is the expressed goal of the policy makers -- i.e. the level at which policy is neither stimulating nor curbing economic growth. Historically, the rate has averaged 2.5 percent above the core inflation rate, which currently stands at 2.2 percent. That implies the Fed still has a ways to go before reaching neutrality, but Greenspan noted that the concept of a neutral rate is constantly changing; hence, historical averages should not be viewed as a reliable yardstick of what is appropriate for current conditions.

Unlike the impact of the "irrational exuberance" comment, which briefly shook up the stock market in 1996, Greenspan's comments were hardly earth-shattering this time. Bond yields did edge higher after his remarks, but what really got the attention of the bond community was Friday's wholesale inflation report. Nothing will bring the bond vigilantes out of the woodworks faster than a whiff of accelerating inflation. Until now, their ire had been held in check by the relatively benign behavior of the major price indexes. That's particularly so in the case of the core personal consumption deflator, Greenspan's favorite inflation measure, which has actually decelerated in recent months. Even the core CPI, which increased to 2.2 percent at the end of last year from 1.1 percent a year earlier, remains well within the range of the past five years. Besides, the Fed was not happy with a 1.1 percent pace of consumer inflation, which bordered on the deflationary threshold that prompted it to embark on the most aggressive rate reductions in the postwar period.

However, the inflation meter dialed up a notch this week when the Labor Department reported a surprising 0.8 percent jump in the core producer price index for January, the biggest increase since December 1998. Only a drop in food and energy prices kept the overall PPI to a smaller increase of 0.3 percent. But it is the core that analysts take more seriously, since it presumably is more sensitive to economic fundamentals, whereas food and energy products tend to march to their own special drummer, such as weather or supply shocks. True, a major contingent of analysts pooh-poohed the January jump in the core PPI, claiming that a one-month spike does not make a trend. What's more, the overall increase was highlighted by outsized jumps in the "sin" categories of tobacco, alcohol and autos.



But their protestations do not completely ring true. Yes, those items did show unusually large increases, but even excluding them would have resulted in a sizeable 0.6 percent increase for the month. In other words, there was a broad-based acceleration in wholesale prices in January. What's more, pressures were felt further down the production chain. In the intermediate stage of production, core prices shot up by 0.8 percent, and lifted the year over year increase to 8.5 percent.

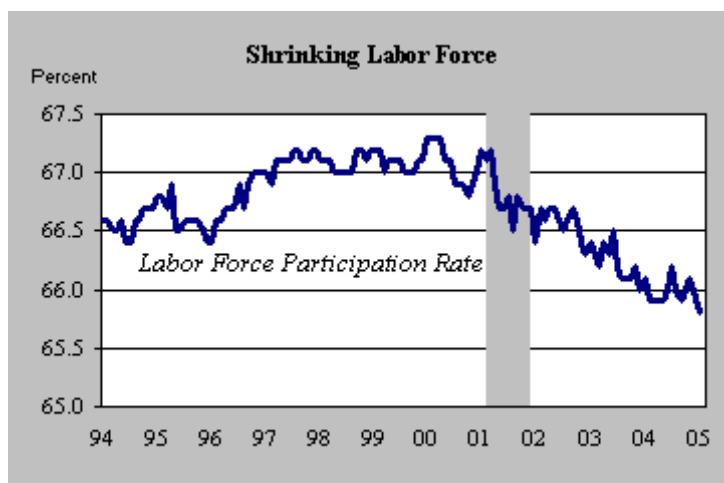
That's the fastest pace since September 1981. Only on the crude level of the supply chain do things look modestly better. There, the core PPI is "only" up by 13 percent compared to a year ago. Believe it or not, that's a sharp slowdown from the 28.3 percent pace that was unfolding last October.

It is tempting to make too much of the wholesale price readings for January, and the bond market clearly reacted to the news. On Friday, the 10-year Treasury yield spiked up to 4.27 percent from 4.08 percent a week ago. That's still below the 4.5 percent rate in effect when the Fed started on its rate-hiking campaign last June, but the gap is closing. A few more weeks of this, and the "conundrum" will have been solved. Indeed, a few more bad inflation readings and the Fed will up the ante in its rate hikes, moving to half-point instead of quarter-point bump-ups. But it is far too early to make that assessment, and it is unlikely that the wholesale price report will have much, if any, influence on the Fed's near-term thinking.

A more important inflation gauge, as far as the Fed is concerned, will be released this coming week in the form of the consumer price index. If that also shows a surprisingly strong upward movement, the bond vigilantes will almost surely vent their angst even more forcefully, driving bond yields higher. But there has been a disconnect between wholesale and consumer prices movements for some time, and we would not be surprised to see it recur again in the CPI report. As Greenspan has noted several times, companies have wide enough profit margins to absorb higher wholesale prices without suffering much damage to the bottom line. That's particularly the case if the volume of sales compensates for narrower margins.

Besides, it is not easy to pass through higher material costs to consumers without losing sales. Households remain highly resistant to price increases -- just witness the ebb and flow of auto sales in response to the on-again, off-again pattern of incentives. Additionally, the ubiquitous Internet has empowered consumers to shop for the lowest prices on virtually all categories of goods and services as never before. For the Fed to become truly concerned about building inflationary tailwinds, two things would need to happen. First, the labor market would have to tighten enough to spur larger wage increases, something that has yet to occur. Second, the economy's resources would have to be stretched, which is far from the case.

True, the unemployment rate, at 5.2 percent in January, is well off its peak of 6.3 percent reached in mid 2003. But that hardly signifies a tight labor market, since much of the decline in the jobless rate reflects people dropping out of the labor force. After hitting a peak of 67.3 percent in early 2000, for example, the labor force participation rate -- the fraction of the adult population that is either working or looking for work -- has dropped to 65.8 percent in January, which is the lowest rate in over sixteen years. Simply put, there is a large and growing reservoir of potential workers that can be brought back into the labor force, which indicates that the labor market is not nearly as tight as the low unemployment rate suggests.



What's more, the economy has hardly used up the slack in its production facilities. Admittedly, this is not an easy concept to measure because some of the nation's productive capacity is obsolete. Nonetheless, the Federal Reserve estimates that industrial capacity is growing at about 1.2 percent a year, a fairly conservative estimate in our view, which translates into 0.1 percent per month. Hence, if production increases by more than that measly pace, capacity utilization will increase. But even that low threshold was not met in January, as industrial production was unchanged during the month, reflecting unusually warm weather that held back utility output and a cutback in auto assemblies as manufacturers are struggling to reduce bloated inventories.

As a result, the capacity utilization rate in January slipped back to 79 percent from 79.1 percent in December. As the chart shows, there is not nearly as much spare capacity as there was coming out of the recession in late 2001, when the CU rate stood at 74.4 percent. But the January rate is about 2 percentage points below the average for 1972-2004, and productivity is significantly higher today than it was in the 1970s and 1980s. Simply put, there is still a ways to go before the industrial sector experiences the kinds of bottlenecks in the production process that typically generates worrisome price pressures. The Federal Reserve, of course, will want to preempt inflation and, consequently, will monitor capacity usage closely, particularly if the dollar's decline sparks a big upsurge in manufacturing exports. As of now, however, the inflation environment remains sufficiently benign to keep the Fed's rate hikes at a "measured pace". Whether it is benign enough to stave off the bond vigilantes is another matter.

