

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 25, 2005

*First the numbers, then the story*

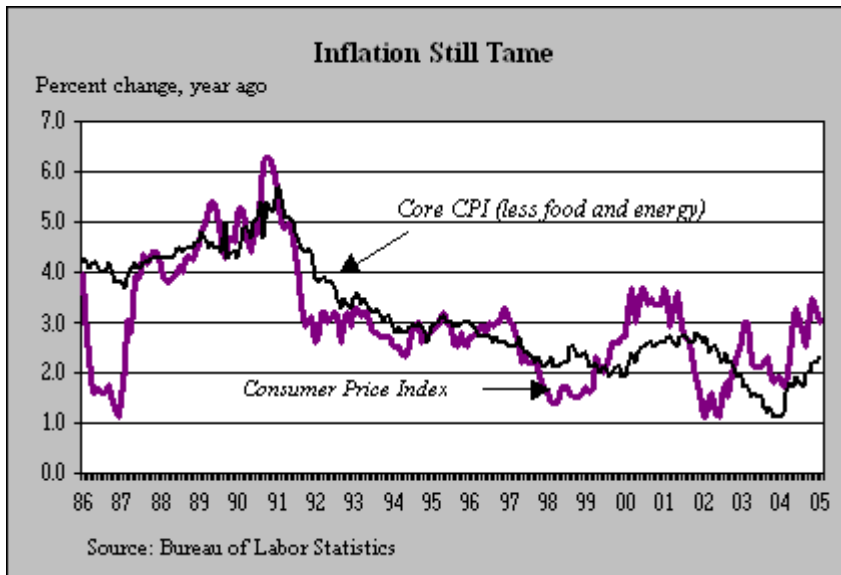
FINANCIAL INDICATORS				
INTEREST RATES	February 25	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.73%	2.59%	2.45%	0.94%
6-month Treasury bill	2.94	2.89	2.70	1.00
2-year Treasury note	3.52	3.43	3.24	1.64
5-year Treasury note	3.89	3.86	3.68	2.94
10-year Treasury note	4.26	4.27	4.13	3.97
30-year Treasury bond	4.63	4.65	4.60	4.84
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.04	2.89	2.90	2.29
10-Year	3.67	3.55	3.73	3.48
30-Year	4.46	4.42	4.57	4.71
30-year fixed mortgage rate				
	5.69	5.62	5.66	5.58
15-year fixed mortgage rate				
	5.22	5.14	5.14	4.89
1-year adjustable rate				
	4.16	4.15	4.18	3.50
STOCK MARKET				
Dow Jones Industrials	10841.60	10785.22	10427.20	10583.92
S&P 500	1211.37	1201.59	1171.36	1144.94
NASDAQ	2065.40	2058.62	2035.83	2029.82
Commodities				
Gold (\$) - 100 OZ	436.20	428.90	428.60	396.8
Oil (\$ per barrel) - Crude Futures (NYMerc)	51.49	48.50	47.18	32.4
(Key Reports For Week of February 25)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Confidence Index (February)	104.0	105.1	102.7	99.0
Durable Goods Orders (Jan.) - % change	-0.9	1.4	2.0	0.3
Consumer Price Index (Jan.) % change	0.1	0.0	0.3	0.2
Core CPI (January) - % change	0.2	0.2	0.2	0.2
Home Resales (January) - 000s of units	6800	6810	6980	6830
Revised GDP (Q4) - % change, SAAR	3.8	4.0	3.3	4.5

The whiffing sound of inflation that resonated so loudly in the financial markets last week morphed into a whisper this week. To be sure, no one denies that there is a decided "whiff" of inflation in the air. It's just that the smelling salts needed to revive shocked investors after last week's alarming report of skyrocketing wholesale prices turned out to be totally unnecessary in light of this week's tame reading on retail prices. Nonetheless, the debate between the inflation hawks and the inflation doves is far from settled. The contradictory data merely adds coals to a fire that will almost surely become more inflamed as the economic expansion continues.

Indeed, the huge gap between the 0.8 percent surge in the core producer price index for January reported last week and the skimpy 0.2 percent increase in the core CPI released this week is virtually unprecedented since comparable data have been collected beginning in 1974. Only once before -- in July 1980 -- have wholesale prices increased so much faster than retail

prices. To the doves, the big divide simply means that companies are not able to pass on their higher costs to consumers, which supports the notion that the highly-competitive, globally integrated U.S. economy is much less vulnerable to inflationary pressures than in the past. To the hawks, it's just a question of when the pass-through will materialize and by how much.

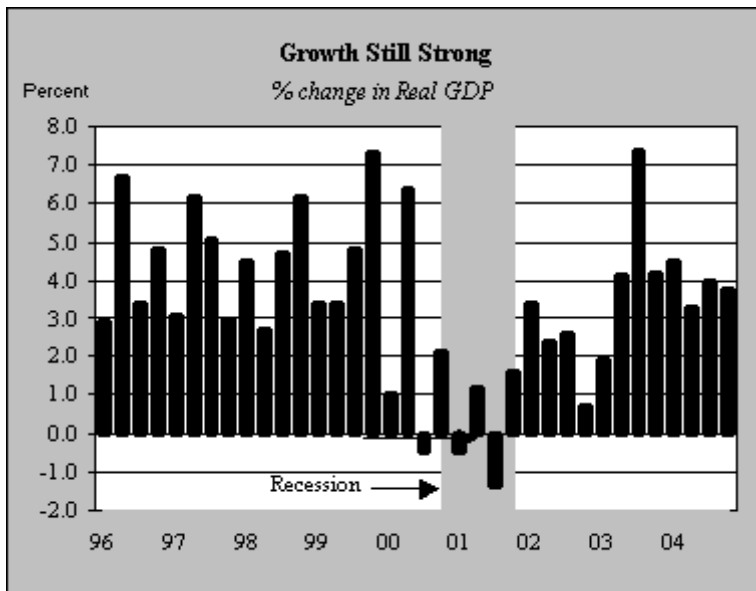
We admit that there are compelling arguments on both sides of the debate. Nonetheless, in all likelihood the wholesale numbers overstate the inflation case while the CPI data understate it. The 0.8 percent jump in the core PPI was probably a one-off event, as it dwarfed all other monthly readings observed in more than five years. But this week's 0.2 percent nudging up in the core CPI extends a string of muted increases that may well be defying time. Even with the tame monthly increase, core retail prices are running 2.3 percent ahead of a year earlier, which is more than double the pace of twelve months ago and the highest annual rate since August 2002. Nor for that matter, are consumers resisting all cost pass-throughs. Cigarette prices jumped by 2 percent in January, reflecting what the bean counters in Washington describe as "the pass through of a wholesale price increase, decreased discounting, and selected state tax increases." It appears that even the most price-conscious consumer needs a tobacco fix regardless of the cost.



What's more, the forward-looking indicators point to somewhat higher inflation in the months ahead. Clearly, the dollar's three-year slide is pushing up import prices, which are now rising at a 3.5 percent pace (excluding petroleum prices), the fastest in more than a decade. Not only does this feed directly into the cost of imported products -- which account for almost 20 percent of all consumer goods purchases -- but it provides domestic companies with more leeway to raise their own prices. True, foreign companies are trying to hold the line on price increases in the U.S. in an attempt to remain competitive with their rivals here. However, as Fed chairman Greenspan noted, there is a limit as to how much of the dollar's decline they are willing to absorb through lower profits.

Second, while the still-slow recovery in jobs is limiting wage increases, the slowdown in productivity growth is proceeding in true cyclical fashion. Even with the restraint on worker earnings, labor compensation is increasing at a faster rate than productivity, pushing up unit labor costs. Like the dilemma facing foreign producers, U.S. companies are absorbing as much as the cost increases as they can in deference to competitive pressures. But with the dollar depreciation lessening these pressures somewhat, and excess industrial capacity being whittled down, companies have regained some pricing power and are expected to exercise as much of this newfound muscle as they can.

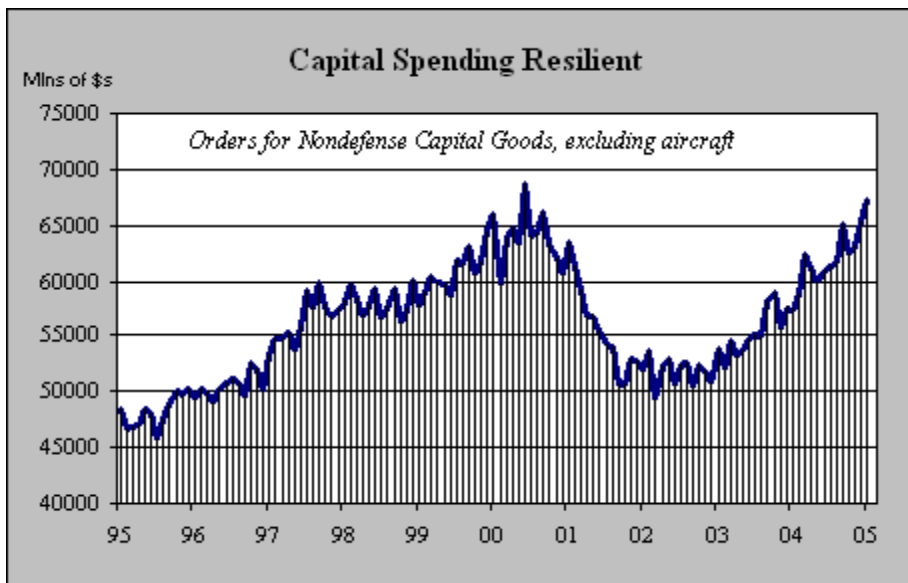
That's particularly the case if the economy continues to expand at the sturdy pace that it has over the past year. Indeed, according to the Commerce Department second look at fourth-quarter GDP, activity in the final three months of 2004 was considerably stronger than originally thought. The revised data (there is still another revision, albeit it will be much smaller, next month) show that the economy grew at a 3.8 percent rate during the period, well above the original estimate of 3.1 percent. The news was not really surprising because the data released after the initial GDP tally suggested that an upward revision would be forthcoming. In particular, a stronger net export position was foreshadowed by the sharp improvement in December's trade deficit and the undoing of a statistical mishap by Canadian statisticians who undercounted U.S. exports to Canada in November.



The new figures also show upward revisions in business investment spending and in inventory accumulations. Whether the stronger inventory buildup is a sign of economic strength or potential weakness depends on whether it is viewed as a voluntary or involuntary development. Our sense is that the buildup is more voluntary than involuntary since retail sales in November and December had previously been revised higher, suggesting that some companies had been caught short of merchandise and decided to stockpile goods to avoid losing potential sales. Similarly, the rationale behind the investment strength is somewhat murky, but also points to more strength than weakness.

For example, the growth in capital goods spending was revised up to a whopping 18 percent pace from an already-strong advance estimate of 14.9 percent. The fourth-quarter strength was generally expected because of a special tax break given to businesses that took possession of new equipment before the end of last year. What makes the upward revision suspicious is that there appears to have been a transfer of truck sales that had previously been counted as consumer spending into investment spending. The appropriate category for such sales has to do with whether the trucks are being purchased outright for personal use or whether they are leased. Leased vehicles by consumers are counted as business investment, not consumption, because they are owned by leasing companies. Not coincidentally, the upward revision in investment spending was accompanied by an almost corresponding downward revision in consumer durable goods purchases.

But it would be a mistake to view the strength in investment spending as purely a statistical aberration. By all accounts, capital spending is holding up far better than thought a few months ago. Keep in mind that the prevailing wisdom had been that such outlays would fall off sharply in the first quarter due largely to the expiration of the aforementioned tax break. So far, however, that script is hardly being followed -- at least if the January data on bookings and shipments are any indication. According to the Commerce Department, new orders for nondefense capital goods staged a solid 2.9 percent gain in January, the third sturdy monthly gain in a row. At \$67.2 billion, the volume of bookings has crept within 2 percent of the all-time high set in June of 2000, the tail end of the capital-spending boom of the late 1990s. What's more, shipments -- which are a good proxy of capital spending -- jumped 3.7 percent in January and are on track for a 22 percent gain in the first quarter.



True, the bookings and shipments data can be highly volatile, and are subject to large revisions from month to month. Even so, it is hard not to be impressed with the recent strength in investment spending, which at the very least hints at a much stronger first quarter than widely envisioned a few months ago. With consumer spending also holding up better than expected, economists are already revising up their forecasts for first-quarter GDP. Instead of slipping to a 2 1/2 percent pace that was broadly expected late last year, the consensus of forecasts is now moving closer to the 3.5 - 4 percent zone for the first three months of 2005. To be sure, economists are a fickle bunch, and if the numbers for February show a relapse from January's strength, look for some retracing of the optimism that is now being embraced by the forecasting community.

But if the strength holds up, the inflation hawks should gain the upper hand over the doves. The question is, when will the bond vigilantes join the party and start pushing up the still-meager inflation premium embedded in long-term interest rates. Following last week's outsized wholesale price increase, it seemed that they were making their presence felt, as the 10-year bond yield shot up to 4.27 percent from 4.08 percent at the end of the previous week. Clearly, however, the vigilantes, like the inflation hawks, were quieted by the benign consumer price report, and the 10-year bond yield held mostly steady this week. That stability, in turn, came despite the bearish rumor that Korea might be diversifying some of its foreign exchange reserves out of dollars, a rumor that was subsequently denied.

Just how the inflation story unfolds remains to be seen. But it appears that both the bond and stock markets are clinging to a Goldilocks scenario for the economy, one that embraces solid growth in a noninflationary environment. Not only are long-term rates still resisting upward pressure, but stock prices turned in a solid performance this week, reaching highs for the year. The economy may indeed be in a "sweet spot" that will allow the Federal Reserve to pursue its strategy of normalizing the federal funds rate, which foreshadows several more increases in coming months. We suspect, however, that as the rate heads north of 3 percent from its current 2.5 percent level, the free pass will end and something will start to give. Either the economy will slow and justify the inflation doves as well as the bond optimists, or bond yields will respond by backing up, reflecting a robust economy that will nurture inflationary forces and provoke the Fed into more aggressive actions. Stay tuned.