

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 4, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	March 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.75%	2.73%	2.48%	0.95%
6-month Treasury bill	2.99	2.94	2.74	0.98
2-year Treasury note	3.56	3.52	3.28	1.56
5-year Treasury note	3.96	3.89	3.67	2.8
10-year Treasury note	4.31	4.26	4.08	3.85
30-year Treasury bond	4.65	4.63	4.48	4.76
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.14	3.04	2.91	2.3
10-Year	3.81	3.67	3.65	3.52
30-Year	4.60	4.46	4.54	4.72
30-year fixed mortgage rate				
	5.79	5.69	5.63	5.59
15-year fixed mortgage rate				
	5.33	5.22	5.14	4.88
1-year adjustable rate				
	4.14	4.16	4.23	3.47
STOCK MARKET				
Dow Jones Industrials	10940.55	10841.60	10716.13	10595.55
S&P 500	1222.12	1211.37	1203.03	1156.86
NASDAQ	2070.61	2065.40	2086.66	2047.63
Commodities				
Gold (\$) - 100 OZ	435.20	436.20	416.20	401.6
Oil (\$ per barrel) - Crude Futures (NYMerc)	53.78	51.49	46.48	33.31
(Key Reports For Week of March 4)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (January) - 000s of units	1106	1216	1153	1192
ISM Manufacturing Index (February)	55.3	56.4	57.3	57.2
ISM Non-manufacturing Index (February)	59.8	59.2	63.9	60.1
Personal Income (January) - % change	-2.3	3.7	0.4	0.5
Nonfarm Payroll change (February) - 000s	262	132	155	182
Unemployment Rate (February)	5.4	5.2	5.2	5.3

The job market lit a fire under the financial markets on Friday, as companies ramped up hiring on a broader scale than expected in February. For stock investors, the employment report was indeed good news, as it reflected economic strength and continued healthy growth in profits. Bond investors also saw encouraging signs in the report, as the increase in jobs, while impressive, hardly put a strain on the labor force and, hence, did little to stir up inflation fears. Simply put, the Labor Department could not have provided the markets with a better way to end a trying week.

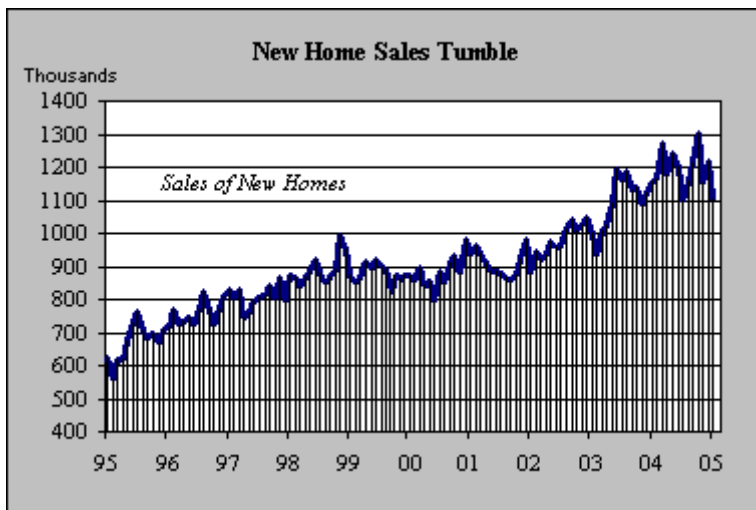
Indeed, with oil prices briefly surging past \$55 a barrel, signs of topping out in housing activity and a warning by Fed chairman Greenspan that the huge budget deficits could lead to economic stagnation, the week had sounded a mostly downbeat note until Friday. That all changed with news that the economy generated 262 thousand new jobs last month, the strongest increase since last October and about 40 thousand more than what had been expected on Wall Street. To be sure,

the employment rate -- actually slipped to a 12-year low of 62.3 percent in February. What this means, of course, is that the labor market is hardly tight enough to encourage larger pay demands by workers, something that would likely ignite fears of a wage-price spiral. In point of fact, the sturdy gain in jobs last month produced virtually no incremental pay raises, as average hourly earnings remained unchanged from January's level of \$15.90. While that follows a respectable 0.3 percent increase in January, the 12-month increase in hourly earnings slipped back to 2.5 percent from 2.7 percent, just barely keeping up with inflation and hardly enough to provoke the Fed into a more aggressive response.

A legitimate question, therefore, is where will the purchasing power to support consumption come from if wages are being held in check? To answer that question, it is important to distinguish between the growth in aggregate versus individual paychecks. While it is true that the compensation of average workers is growing only grudgingly, more workers are drawing paychecks thanks to the pickup in job creation. Hence, total wages and salaries of all workers combined are rising at an accelerating rate, underpinning the purchasing power of households. For example, in the summer of 2003, just before the economy started generating new jobs, wages and salaries were growing at a 3 percent pace. By January of this year, the pace had nearly doubled to 5.8 percent.

Simply put, the February jobs report supplements other recent indicators that depict an economy with a good deal of momentum so far this year. Consumers are playing a big role in sustaining this momentum. Although auto sales in February turned out to be disappointing, that followed a robust selling rate in January. Significantly, retailers are reporting sizeable revenue gains during the month, building on the previous month's healthy performance. All told, households are on track to boost real outlays by close to 4 percent during the first quarter, which would impart a solid contribution to GDP growth. Nor are businesses lagging behind consumers. As noted last week, capital spending is increasing at the fastest pace since the late 1990s, with investments in structures and old-line equipment joining high-tech gear in the advance. The opening up of capital budgets as well as the increased hiring pace is consistent with the optimism being expressed by corporate chieftains, something that clearly showed up in the latest Business Roundtable survey of CEOs.

If there is one looming soft spot, however, it is in the red-hot housing sector, where some cracks are starting to materialize. New home sales in January tumbled by a sharp 9.2 percent, pushing them 15.4 percent below the peak sales pace set last October. By itself, this would not be too worrisome, as sales remain lofty by historical standards. But the astonishing runup in real estate prices seem to be ebbing, fueling the debate about whether a bubbly housing market is about to be punctured. The new home sales report, for example, revealed that the median price of homes sold had plunged by 13 percent in January to the lowest level in more than two years.



To be sure, this is a fickle number, and a one-month drop does not make a trend. But other disturbing indicators cannot be overlooked. The OFHEO also reported this week that the rate of home price appreciation slowed considerably in the fourth quarter of last year -- to an annual rate of 6.77 percent from 19.17 percent in the third period. Additionally, builders are seeing a sizeable pickup in unsold homes, hinting that some construction setback may be in the offing. In January, the inventory of homes awaiting sale rose by 15 thousand to a new record high of 438 thousand. If this overhang remains for a period of time, further downward pressure on selling prices can be expected. Keep in mind that that it is not just homebuilders that would suffer if the remarkable strength in the real estate sector evaporates. The appreciation in home values in recent years has made a powerful contribution to the increase in household net worth. Needless to say, it has also been a major source of support to consumer spending.

Still, the housing market at most is exhibiting some cracks, not fissures that threaten to shake the foundation down to its core. By all accounts, some regions are overstocked with pricey homes that will undoubtedly suffer some correction. But a widespread meltdown does not appear likely, given the still low level of mortgage rates, the easy access to mortgage credit and the improving job market that is nurturing stronger income growth. Unless these fundamental influences deteriorate abruptly, the probable scenario is that home prices will rust, not bust. In other words, households may not enjoy the kind of appreciation in home values that has played such an important role in their improving net worth position in recent years. But a wealth destruction brought on by a collapse in real estate values does not seem to be in the cards.

What's more, if the recent strength in the stock market continues, household net worth will receive a sizable lift from equity portfolios, thus compensating for the leveling off in housing appreciation. In our monthly roundup of relative asset performance, stock holders enjoyed the best total return last month, as rising yields in the investment-grade bond market resulted in negative returns for bond investors. The strong performance of stocks in February did not compensate for the weakness in January, and, hence, equity returns were negative over the first two months of the year. However, with the broad stock indices hitting multi-year highs at the end of this week, helped by the positive jobs report, equity returns are taking the leadership mantle for the year. If the cyclical forces play out as they normally do -- with profits deriving strength from a maturing expansion and interest rates rising in response to inflationary expectations as well as a tighter Fed policy -- the current pattern of asset performance should continue. But as we have seen, this cycle has been anything but normal, which argues against making big bets on any single asset class.

