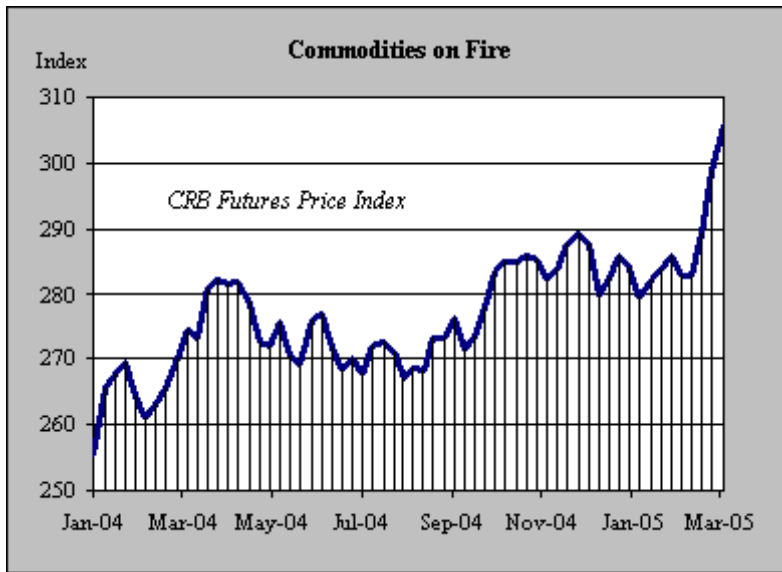


WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 11, 2005

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	March 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.75%	2.75%	2.54%	0.95%
6-month Treasury bill	3.05	2.99	2.81	0.99
2-year Treasury note	3.71	3.56	3.32	1.52
5-year Treasury note	4.21	3.96	3.69	2.73
10-year Treasury note	4.54	4.31	4.08	3.77
30-year Treasury bond	4.81	4.65	4.47	4.72
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.17	3.14	2.87	2.2
10-Year	3.85	3.81	3.59	3.39
30-Year	4.64	4.60	4.48	4.63
30-year fixed mortgage rate				
	5.85	5.79	5.57	5.41
15-year fixed mortgage rate				
	5.38	5.33	5.10	4.69
1-year adjustable rate				
	4.24	4.14	4.11	3.41
STOCK MARKET				
Dow Jones Industrials	10774.36	10940.55	10796.01	10240.08
S&P 500	1200.08	1222.12	1205.30	1120.57
NASDAQ	2041.60	2070.61	2076.66	1984.73
Commodities				
Gold (\$) - 100 OZ	445.80	435.20	422.00	395.6
Oil (\$ per barrel) - Crude Futures (NYMerc)	54.43	53.78	47.16	32.84
(Key Reports For Week of March 11)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Trade Deficit (January) -- mlns of \$s	58280	55744	59415	55746

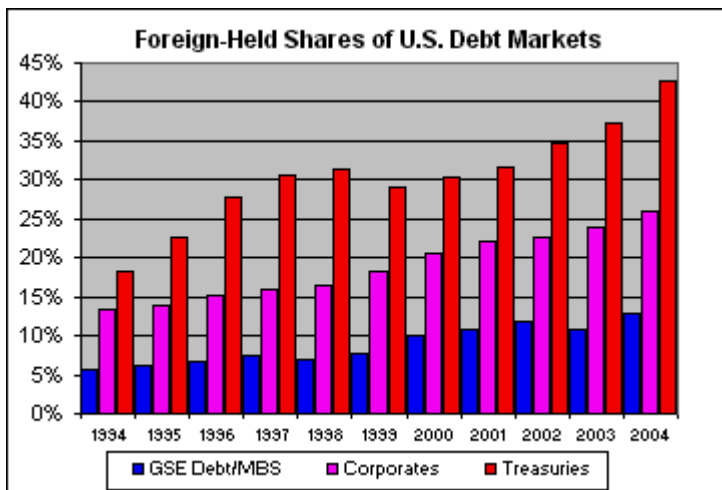
The euphoria generated by last week's Goldilocks employment report -- describing an economy that is neither too hot or too cold -- evaporated this week amidst a swirl of long-standing concerns that once again captured headlines. Oil topped the list of worries, as spiraling crude quotes has sent gasoline prices above \$2 a gallon, threatening to take a big chunk out of consumer purchasing power during the upcoming driving season. At the same time, high oil prices put a sharper focus on the inflation debate, which is being inflamed by climbing commodity prices in general. Not surprisingly, the prospect of an oil-induced slowdown in consumer spending combined with higher inflation spurred a negative reaction in the financial markets over the past week.



To be sure, the week was devoid of any significant economic news that would have provided an effective counterbalance to these negative influences. In the coming week, that void will be filled by an array of economic reports that could well lift investor spirits once again. Still, it would be foolhardy to ignore the broader forces that are gaining traction in the financial markets and could have an increasingly disruptive influence if not addressed at some point. The oil conundrum, for example, is symptomatic of the imbalances in the U.S. economy that continue to weigh heavily on the outlook for growth, the dollar, interest rates and asset values in general.

One of the most hotly debated imbalances is the stubborn propensity of the nation to live beyond its means, relying on foreign capital to replace a chronic shortfall of domestic savings. The swelling budget and trade deficits are perhaps the most vivid symbols of this imbalance, reinforced by households who are spending virtually every penny of earned incomes. As a result, the U.S. is sucking in increasing amounts of foreign funds to sustain its consumption habits, which is spurring an enormous increase in IOUs in the hands of overseas investors. For the most part, foreign funds are being channeled into government securities -- Treasuries and government-sponsored agencies -- although the corporate bond market is also a favorite destination for the inflows.

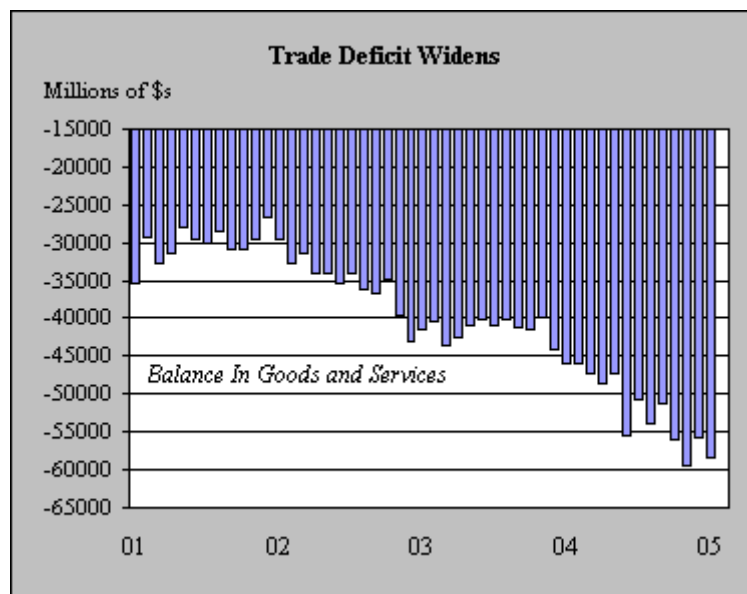
Just how important foreign investors have become in the U.S. financial markets is vividly portrayed in the following chart. According to the latest flow of funds data released by the Federal Reserve this week, foreign investors upped their holdings of Treasury securities by \$56.6 billion in the fourth quarter of 2004, lifting the foreign-held share of outstanding Treasuries to an eye-opening 42.8 percent by the end of the year. In addition, agency holdings increased by \$65.9 billion and corporate debt by \$82.2 billion, pushing the foreign-held share in those sectors to 25.9 percent and 12.8 percent, respectively. As the chart shows, foreign ownership of U.S. securities has increased exponentially over the past ten years.



What this means is that foreign investors have an increasingly important influence on the prices of government and corporate securities. As a result, any hint that they are becoming less enamoured with dollar-denominated assets is bound to send shivers through the debt markets. For one, a pullback in foreign purchases or, worse, outright sales would directly remove a major source of demand for these securities, thus putting downward pressures on prices. For another, a foreign withdrawal from the U.S. markets means that the greenback itself would come under downward pressure, spurring higher inflation and interest rates. Not surprisingly, the news that Japan's central bank -- the largest foreign holder of Treasury securities --was considering diversifying out of its dollar holdings created some havoc with the dollar and U.S. debt markets this week. The rumor was subsequently denied, but a similar story out of South Korea a few weeks earlier had a comparable disruptive influence, indicating how sensitive the markets have become to the whims of foreign investors.

To be sure, Alan Greenspan and other Fed officials have put a positive spin on the increased participation of foreign investors in the U.S. markets. Greenspan noted that globalization has led to an integration of financial markets that has greatly facilitated the flow of funds across borders, thus making it less imperative for the U.S. to rely wholly on domestic savings. Fed Governor Bernanke has taken this logic a step further, in essence blaming the U.S. trade deficit on a huge savings surplus overseas. Simply put, foreigners are not spending enough to spur growth in their own economies and the U.S. is providing them with the most attractive savings vehicles to accommodate their frugal ways.

That may well be the case, but it is also clear that the growing U.S. trade imbalance with the rest of the world is putting the dollar on a slippery downward slope, aggravating inflationary pressures and contributing to the Fed's rate-hiking campaign. And, while Greenspan believes that corrective market forces -- i.e., a lower dollar -- will ultimately shrink the trade deficit, so far that has not been the case. That lack of progress was again demonstrated this week with the Commerce Department's latest report on January trade flows. What the report showed is that the gap between imports and exports widened sharply during the month, increasing by 4.5 percent to \$58.3 billion. The latest shortfall was the second highest on record, topped only by the \$59.4 billion deficit set last November.



With imports exceeding exports by more than 50 percent, the latter would have to increase at least that much faster to keep the deficit steady. Unfortunately, the relative growth rates are running in the opposite direction. Over the past twelve months, imports have shot up by 18.2 percent, dwarfing the respectable 13.6 percent gain in exports. Nor are the trends converging; in January, exports rose by a miniscule 0.4 percent while imports surged by 1.9 percent. The import strength received a sizable boost from the elimination of quotas on multi-fiber textiles, which spurred a flood of apparel imports from China (and a predictable outcry from textile manufacturers in the U.S.). However, even excluding the apparel factor, demand for foreign products, from autos to toys to electronics, is booming. What's more, the import increase in January occurred despite a drop in oil imports, reflecting a fall in crude oil prices that has since been reversed. Hence, the February figures will likely show a muscular rise in the oil import bill as well.

Meanwhile, exports have yet to benefit much from the sinking dollar, which is supposed to make U.S. goods cheaper to foreign buyers. The 13.5 percent annual increase in exports in January, while respectable, is barely higher than the 12.4 percent increase registered for all of 2004. Part of the lag is simply due to the sluggish growth in overseas markets, as parts of Europe and Japan stalled out in the closing quarter of last year. However, there is also anecdotal evidence that U.S.

companies are lifting selling prices on exports, thus diluting the sales boost that would otherwise come from the lower dollar. To the extent that is the case, the road towards trade balance will be considerably longer than if normal market forces were allowed to play out.

Ironically, the increase in the trade deficit in January, if sustained in February and March, may well detract from what is otherwise shaping up to be a fairly robust growth rate in the first quarter. Following the January report, some economists started marking down their first-quarter growth forecast by a half percentage point or so. By comparison, the widening of the current account deficit in the fourth quarter siphoned off 1.43 percentage point from that quarter's 3.8 percent pace. The issue is whether the import surge in January wound up in inventories, which may have been the case since wholesale inventories also rose by more than expected in January. If so, than any subtraction in growth due to a higher trade deficit would be offset by the positive contribution coming from inventory stockpiling.

That said, the sustained muscular demand for imports, even if it temporarily boosts inventories, reflects a healthy pace of economic growth in the U.S. Consumers are still shopping aggressively, despite low savings, and businesses are expanding payrolls as well as boosting capital spending. In other words, the forces that have propelled the Federal Reserve onto a rate-hiking track in the second half of last year remain well ensconced, and should continue to guide Fed thinking in the months ahead. At this juncture, the Fed continues to pursue monetary policy neutrality in measured steps and will continue to do so for at least the first half of the year. As St. Louis Fed President William Poole indicated this past week, at some point some development will trigger the "measured" language to be removed, but in the absence of some trigger, measured steps will remain the FOMC modus operandi.

We, like virtually every other economist, expect that the Fed is going to continue to boost the overnight lending rate by a quarter-point at least over the next three policy-setting meetings, which would take the federal funds rate up to 3 1/4 percent by mid-year. Whether or not policy will then be put on hold, as some think, to give the Fed time to assess the economy's response remains to be seen. A lot will depend on the data flow over the next several months, and how the financial markets behave. Significantly, longer-term market rates have, at long last, shown an inclination to follow the cyclical script, breaking above the top of long-standing ranges over the past week. With mortgage rates also up to a seven-month high and skyrocketing gasoline prices eating into discretionary incomes, the unanswered question is how well will consumers hold up. Any signs of faltering may well be the trigger that alters the Fed's path towards neutrality.