

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 18, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	March 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.80%	2.75%	2.59%	0.93%
6-month Treasury bill	3.10	3.05	2.89	1
2-year Treasury note	3.69	3.71	3.43	1.51
5-year Treasury note	4.16	4.21	3.86	2.73
10-year Treasury note	4.50	4.54	4.27	3.77
30-year Treasury bond	4.81	4.81	4.65	4.71
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.25	3.17	2.89	2.21
10-Year	3.91	3.85	3.55	3.41
30-Year	4.65	4.64	4.42	4.68
30-year fixed mortgage rate				
	5.95	5.85	5.62	5.38
15-year fixed mortgage rate				
	5.47	5.38	5.14	4.69
1-year adjustable rate				
	4.20	4.24	4.15	3.39
STOCK MARKET				
Dow Jones Industrials	10629.67	10774.36	10785.22	10186.6
S&P 500	1189.65	1200.08	1201.59	1109.74
NASDAQ	2007.79	2041.60	2058.62	1940.47
Commodities				
Gold (\$) - 100 OZ	439.80	445.80	428.90	412.7
Oil (\$ per barrel) - Crude Futures (NYMerc)	56.72	54.43	48.50	34.36
(Key Reports For Week of March 18)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (February) - % change	0.5	0.3	1.3	0.8
Housing Starts (February) - 000s of units	2195	2183	2056	2035
Industrial Production (Feb) - % change	0.3	0.1	0.8	0.6
Capacity Utilization Rate (February)	79.4	79.2	79.1	78.8
Business Inventories (January) - % change	0.9	0.2	1.1	0.6

With the spring season beginning this weekend, it's only appropriate that the latest batch of economic data would provide more reason for hope than despair. Consumers continue to open their wallets and spend at a robust pace, companies are ramping up production and building inventories in anticipation of future demand strength, and housing activity remains on the torrid pace that has defied expectations over the past several months. Clearly, the economy is still riding a considerable wave of momentum that will likely result in another quarter of above-trend growth in the January-March period.

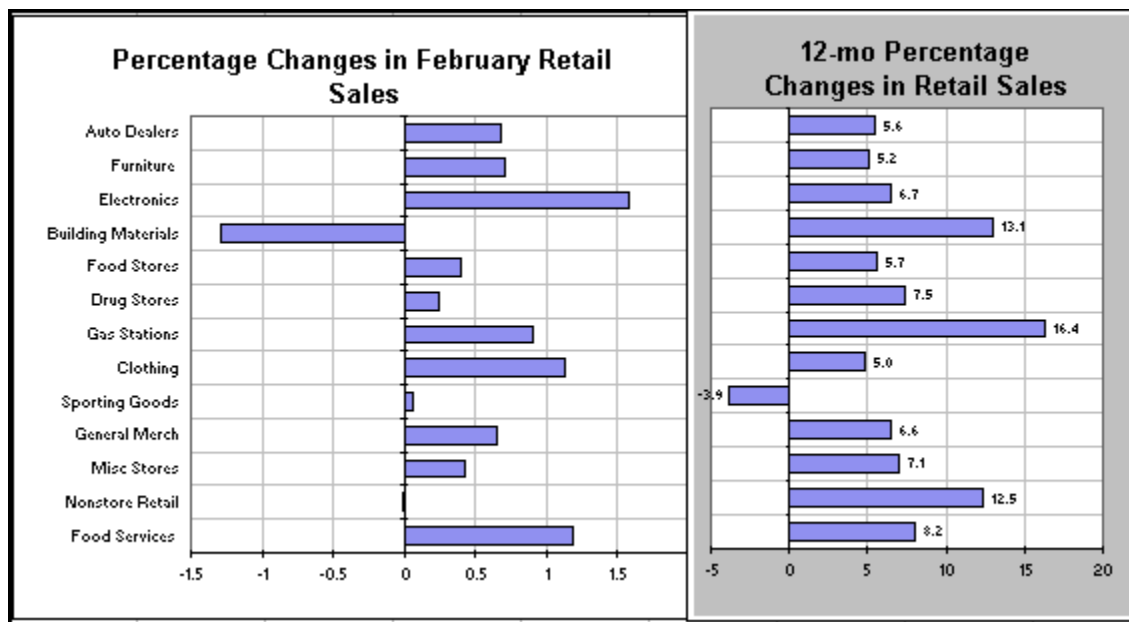
To be sure, a number of dark clouds continue to linger over the economic landscape, which threaten to bring an end to the good times. The relentless climb in the price of oil is perhaps the darkest of all looming threats, as it portends a big hit to consumer purchasing power in coming months. Some experts predict that gasoline prices could hit \$2.40 a gallon by Memorial Day, the start of the driving season, and siphon off as much as \$50 billion from discretionary incomes. That's the functional equivalent of a sizeable tax increase, something that could well crimp consumer spending over the summer

months. Meanwhile, the U.S. continues to plunge deeper into red ink on its international accounts, as the broadest measure of trade and investment flows -- the current account balance -- revealed a sharp deterioration in last year's fourth quarter, requiring an enormous inflow of foreign capital to finance the gap. This unsustainable trend has potentially highly disruptive implications for the dollar and interest rates, as well as to the overall economy.

That said, the major pillars of the economy's strength over the past year show little sign of wilting. Households, for one, are picking up where they left off last year, spending at a much faster pace than had been expected. In February, retail sales posted a respectable gain of 0.5 percent, but what made the advance even more impressive was that it came off of a higher base than had previously been estimated. That's because the January level of sales was revised up by 0.6 percent, transforming an originally-estimated decline of 0.3 percent into a gain of 0.3 percent. The February gain was helped by a rebound in auto sales, which benefited from more lucrative sales incentives than in January. But even excluding the volatile auto sector, the strength in sales was broadly based.

Indeed, just about all of the 13 major sales categories compiled by the Commerce Department increased last month, paced by electronics, clothing and food service establishments. The only notable decline was in building materials, but that appears to be an aberration when viewed against the strong gains posted over the past twelve months (see chart). The sharp increase in sales of apparel followed an even stronger increase in January, which may reflect the cashing in of the increasingly-popular holiday-related gift cards.

Furniture stores also enjoyed another impressive gain in sales in February, benefiting no doubt from the ongoing torrid pace of home sales. Surprisingly, gas station sales rose by a less-than-stellar 0.9 percent during the month, weaker than January's 1.9 percent jump, despite an increase in the price of gasoline to an average of \$1.91 a gallon from \$1.83 in January.



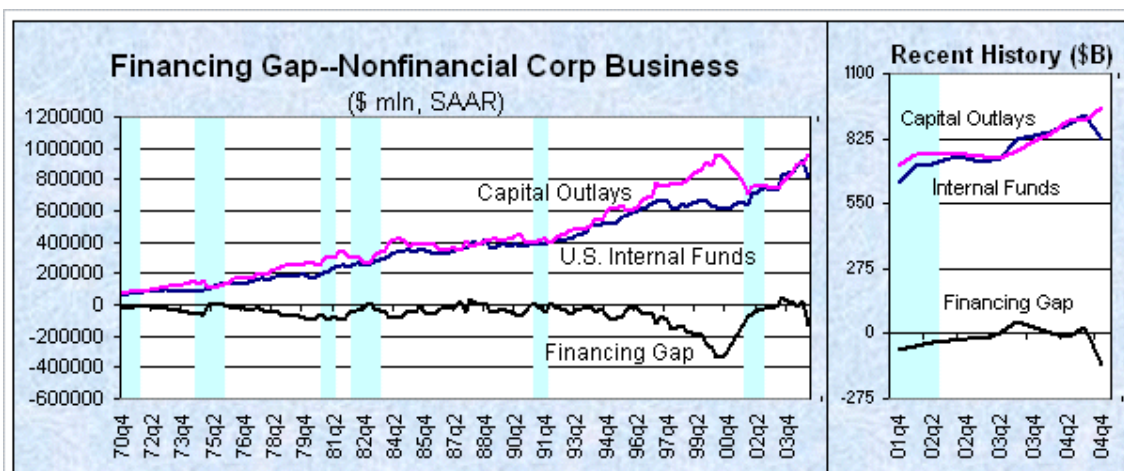
With soaring energy prices pinching incomes, savings in short supply and the economy not generating as many jobs as in past expansions, the sustained muscular spending by consumers is something of a conundrum. But the Federal Reserve provided compelling documentation as to why households have been so resilient. Simply put, according to the latest flow of funds data through the fourth quarter of last year, total net worth of American households marched irresistibly higher in 2004. In the final three months of the year, net worth surged by \$1.94 trillion, more than triple the \$572 billion increase in the third quarter, reaching a new record high of \$48.5 trillion. During the period, household wealth benefited from both an impressive rally in the stock market as well as continued hefty gains in real estate values.

Indeed, stock portfolios, including mutual fund holdings, swelled by about \$850 billion, while real estate values appreciated by \$393 billion in the fourth quarter. The overall gain in financial wealth -- the ninth consecutive quarterly gain -- lifted net worth to 546.6 percent of disposable incomes from 538.5 percent in the third quarter. Clearly, many households view these assets as a replacement for the shrinking fraction of savings they have put aside in recent years. Just as important, the latest flow of funds data provide evidence that the recovery in the wealth lost in the bursting of the stock market bubble is more than complete. Unfortunately, as the tepid performance of the stock market so far this year suggests, additional significant gains in household net worth are less certain. As such, the "wealth effect" may provide less support for consumer spending in

2005 than it did in 2003 and 2004.

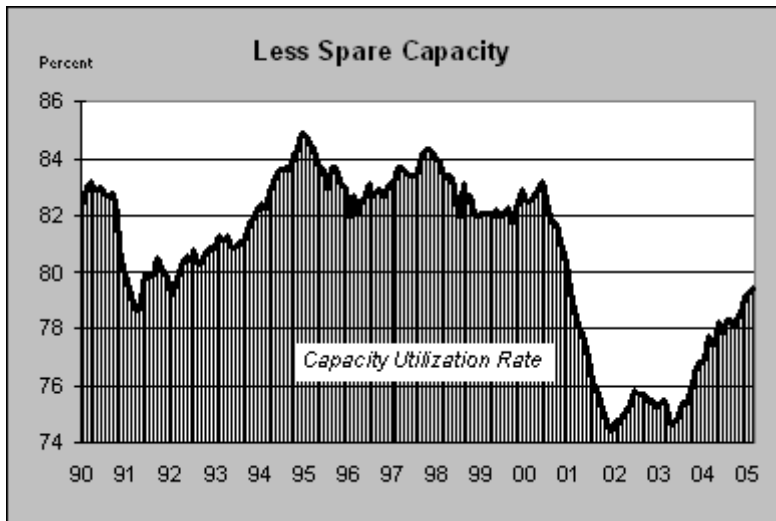
That's why it is imperative for the recent revival in job creation to continue, which would generate the much-needed pickup in income growth to sustain consumption. By all accounts, the portents are good. According to the latest Manpower survey, businesses plan to expand hiring in the second quarter of this year, which would be consistent with the more upbeat attitude expressed by CEOs in other recent surveys, including the Business Roundtable. Of course, these surveys merely reflect intentions, not deeds, and plans can easily be thwarted if conditions change. But just the fact that business sentiment has become more upbeat is a decided change from the overly cautious attitude that Fed Chairman Greenspan claims has been the major reason for the lackluster pace of job creation during the expansion.

As evidence of this caution, the Fed chief often points to the fact that corporations had allowed cash from surging profits to pile up rather than disbursing them on new investments, which would normally be the case. In six of the seven quarters prior to the fourth quarter of last year, internal funds of nonfinancial corporations exceeded capital outlays, which was the longest string of financing surpluses since the early 1960s. According to Greenspan, that spending shortfall reflected primarily corporate hesitancy and risk aversion more than other factors, such as a lack of investment opportunities. But if the latest flow of funds data is any indication, that hesitancy has about evaporated. In the fourth quarter, companies spent \$133 billion more on new investments than they took in through internal funds, the largest financing gap since the second quarter of 2001.



To be sure, the return of the financing gap may reflect a boost to investment outlays related to favorable depreciation rules in the tax code that expired at the end of last year. But recent data indicate that the increase in such outlays is continuing, despite less favorable tax treatment. That's clearly supported by the strength in advance bookings for capital goods as well as in shipments for January. Indeed, just as they plan to step up hiring, business executives also stated their intention to boost capital budgets in recent surveys. The latest data suggest that, so far at least, they are honoring these intentions. Of course, if the energy spiral takes more steam out of consumer spending than is now envisioned, these plans could change and usher in another soft spot as both consumer and business spending weakens.

But business executives have less reason to respond as abruptly to a consumer slowdown as they did a year ago, when the previous oil spike had caused a brief retrenchment in capital outlays. One reason: corporate America is operating with far less spare capacity than was the case then. Thanks to steady production gains, including a 0.3 percent increase in February, operating rates have pushed relentlessly higher, reaching 79.4 percent of capacity last month. That's more than 2.5 percentage points higher than at the start of last year, and the loftiest utilization rate since December 2000. With so much slack used up, and given the long lead time required to put new plant and equipment in place, companies are likely to focus more on future capacity needs than worry over a brief slowdown in demand.



What's more, the increase in utilization rates is another development that the Federal Reserve is clearly monitoring as a potential inflation source. While still comfortably below the 81-82 percent threshold usually associated with production bottlenecks that typically stir up inflation, that point is rapidly drawing closer. At the current production rate, it could well be reached before the end of the year. And, given the six month lag with which changes in policy affect the economy, the Fed may well take that prospect into consideration at its next policy setting meeting scheduled for this week. Few expect Greenspan and Company to depart from its strategy of hiking rates by quarter point increments at this confab, but speculation is mounting that a more aggressive move is not too far off. Stay tuned.