

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 25, 2005

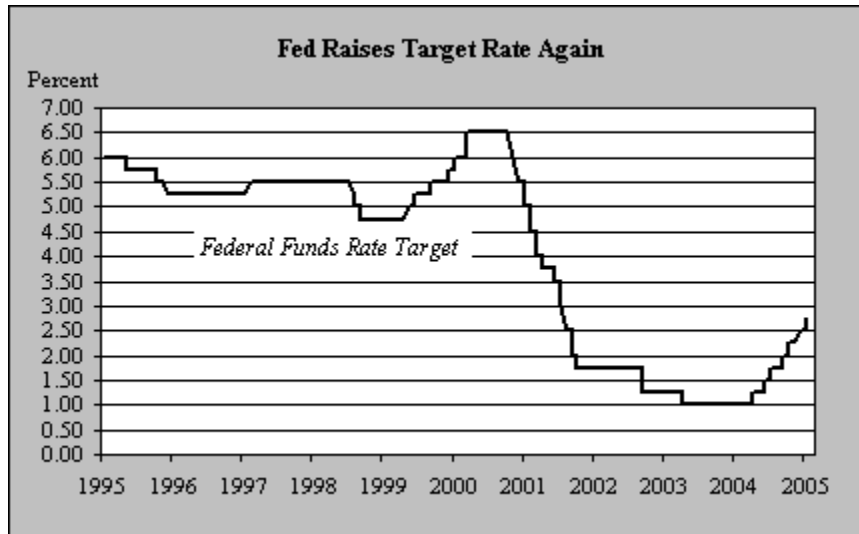
First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	March 25	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.82%	2.80%	2.73%	0.94%
6-month Treasury bill	3.14	3.10	2.94	0.99
2-year Treasury note	3.85	3.69	3.52	1.57
5-year Treasury note	4.30	4.16	3.89	2.78
10-year Treasury note	4.59	4.50	4.26	3.83
30-year Treasury bond	4.84	4.81	4.63	4.76
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.31	3.25	3.04	2.32
10-Year	3.99	3.91	3.67	3.49
30-Year	4.70	4.65	4.46	4.69
30-year fixed mortgage rate				
	6.01	5.95	5.69	5.4
15-year fixed mortgage rate				
	5.56	5.47	5.22	4.7
1-year adjustable rate				
	4.24	4.20	4.16	3.36
STOCK MARKET				
Dow Jones Industrials	10442.87	10629.67	10841.60	10212.97
S&P 500	1171.42	1189.65	1211.37	1108.03
NASDAQ	1991.06	2007.79	2065.40	1960.02
Commodities				
Gold (\$) - 100 OZ	425.00	439.80	436.20	423.2
Oil (\$ per barrel) - Crude Futures (NYMerc)	54.84	56.72	51.49	33.03
(Key Reports For Week of March 25)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Price Index (Feb) - % change	0.4	0.1	0.0	0.3
Producer Price Index (Feb) - % change	0.4	0.2	-0.3	0.5
New Home Sales (Feb) - 000s of units	1226	1121	1226	1210
Home Resales (Feb) - 000s of units	6790	6820	6810	6838
Durable Goods Orders (Feb) - % change	0.3	-1.1	1.5	0.5

They meet approximately ten times a year in roughly 4-6 week intervals, and when the Federal Reserve policy makers gather for these rate-setting sessions the financial community stops and listens. More often than not, the meetings have little consequence; that's particularly so when rates are left unchanged, which is frequently the case. Even when the Fed changes its benchmark federal funds rate, the impact is muted if the move was anticipated and perceived to be justified by economic conditions. Indeed, since the Fed embarked on its latest rate-hiking campaign last June, there have been six quarter-point increases prior to this week's, which hardly produced a ripple in the financial markets because they were well advertised in advance and widely accepted by investors and traders.

However, the response to this week's expected quarter-point increase broke that pattern, as bond yields jumped and stock prices tumbled following the meeting. It was not the increase itself -- which took the funds rate to 2.75 percent -- that produced the drama, but the wording of the policy statement accompanying the increase. For the first time in several years,

the Fed strongly indicated that the inflation genie was close to breaking out of the bottle, implying not only that more rate increases were likely -- which was also expected -- but that the size of future increases might be increased. Simply put, the markets could live with a "measured" pace of tightening because it symbolized a policy in control of economic forces that continue to evolve in a Goldilocks scenario. But with the Fed hinting that it may be falling behind the curve, and more gut-wrenching moves may be needed, investors and traders are suddenly threatened by a less predictable economic and financial environment -- and nothing is more disruptive than the prospect of uncertainty.



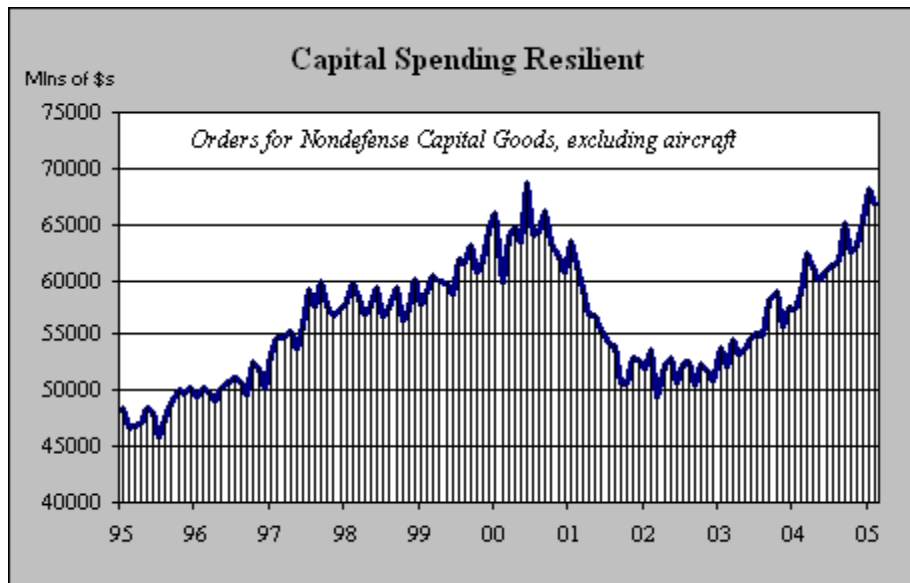
To be sure, the official policy statement retained the reference to a "measured" pace of tightening. But the tone of the statement was decidedly more hawkish than previous ones. The most glaring example was the phrase "... pressures on inflation have picked up in recent months, and pricing power is more evident". True, it was also noted that "... inflation and long-term inflation expectations remain contained", but that was followed by the caveat that the benign inflation outlook was contingent on "appropriate policy actions". In other words, the Fed is saying that it may have to step on the monetary brakes more forcefully to keep the inflation genie from breaking out. Some analysts believe that the reference to a "measured" pace of tightening was retained as a compromise to appease some of the doves on the committee; others believe that the Fed took a half step towards removing the phrase at the next meeting. We will have a better handle on the dialogue that went on during the meeting when the full minutes are released in early April.

Nonetheless, it would not be surprising if Greenspan and his colleagues want investors to start *thinking* that a half-point increase is possible at one or more of the upcoming meetings. It is no secret that the chairman is befuddled by the fact that long-term interest rates hadn't budged following the first six federal-funds rate hikes; in fact, until recently, bond yields were actually below the level that prevailed when the first hike was taken last June. In a recent testimony, Greenspan alluded to this dichotomy as a "conundrum", implying that the impact of the Fed's tightening moves was being neutralized by low long-term rates. But that conundrum is now being addressed by the bond vigilantes. At the end of this week, the bellwether 10-year Treasury yield, at 4.59 percent, had finally moved above the pre-tightening level, having risen by more than half a percent over the past month.

Hence, it is not the Fed itself that is shaking up the market, but a confluence of events that has unfolded in recent weeks, whose meaning has been ratified by the latest policy statement. In essence, the economy has performed at a much higher level than was generally expected at the start of the year that, when combined with surging oil-led commodity prices, has ignited inflationary expectations. Recall that as the year began, the consensus forecast was that the economy would cool off from the above-trend 4.4 percent growth rate set in 2004. Underscoring this forecast was an expected pullback in business capital spending following the expiration of a tax incentive that boosted such spending at the end of last year. Consumers, too, were expected to take a breather, reflecting a historically low savings rate, high debt burdens and rising borrowing costs, particularly on mortgage loans.

But the reality has hardly matched expectations. Based on the numbers available so far for January and February, the economy could well match last year's growth rate during the first quarter. One reason is that the linchpin behind the slowing forecast, the pullback in capital spending, is not falling into place. Yes, this week's figures on bookings and shipments for nondefense capital goods -- a proxy for such spending -- fell by 2.1 percent and 2.6 percent, respectively. But the payback was very modest when viewed alongside of the robust gains posted in previous months. In the three months including February, orders rose at a muscular annual rate of 24.5 percent and shipments are up by 17.2 percent. Assuming there hasn't

been a collapse in March, capital spending is on track to expand by a hearty double-digit pace again in the first quarter, with only a modest slowing in the spring quarter.



Nor have consumers shown any inclination to curb spending, despite the above-mentioned retarding forces. Buoyed by a strengthening job market, they have stayed the course in January and February, shopping at the same high-powered pace as they did last year. Just as important as the increase in job growth, the real estate boom continues to bolster household wealth, thus offsetting the shrinking savings rate. That was again evident in this week's data on new home sales, which soared by a much stronger-than-expected 9.4 percent in February to an annual rate of 1.226 million units. The February level is the fourth highest ever, and not far below the all-time high of 1.304 set in October of last year. Importantly, the strength in sales is sustaining the rapid climb in residential prices. In February, the median price of a new home surged to a new record of \$230,700 from \$210,400 in January.

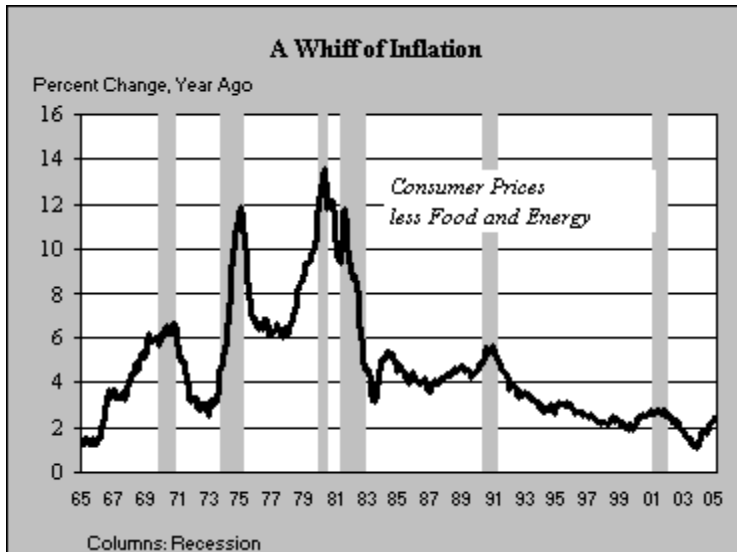
Not surprisingly, the sustained strength in home sales is generating lively discussions over how much of it stems from speculative activity. According to the National Association of Realtors, fully one-quarter of recent home sales is for investment purposes, as buyers are increasingly using the property to generate rental income or are simply betting that they can quickly flip the homes at higher prices. A front-page story in Friday's New York Times goes into great detail about how speculation in real estate has replaced the day-traders who captured headlines during the dot-com frenzy of the last 1990s. Indeed, this speculative type of activity has already been noted by Greenspan and is no doubt helping to tilt the Fed's thinking towards taking a harder policy line.

What may also be sustaining the demand for homes is the desire of prospective buyers to get into the market before mortgage rates go higher. Along with the month-long rise in Treasury yields, mortgage rates have also climbed markedly. In the latest week, the 30-year fixed rate nudged just past 6 percent, reaching the highest level since July. If that's the case, the recent bulge in home sales may just be a last-gap chapter in the frenzied real-estate saga. While there may be some element of that taking place, a 6 percent mortgage rate is not a particularly punishing force for sales, although it just about kills refinancing activity. Most industry experts believe that a big sales deterrent would only occur at the 7 percent level, which is not on the radar screen of most forecasts.

To be sure, neither the strength in the economy nor a hot real-estate market stirred the bond vigilantes last year as inflation and inflation expectations were suppressed by strong productivity gains, a lackluster labor market and intense global competition. What is now getting the attention of the bond bears as well as the Federal Reserve is that those inflation constraints are rapidly weakening. With companies stepping up the hiring pace, productivity growth is waning in true cyclical fashion, boosting unit labor costs. Meanwhile, the ongoing strength in the economy has eaten into much of the spare production capacity that eviscerated pricing power in recent years. Finally, with the dollar declining by about 30 percent against major currencies over the past three years, imports have become more expensive and constitute less of a restraint on domestic manufacturers to lift prices.

As a result, the Fed and the bond market are looking at much more threatening inflation numbers today than they were last year. True, climbing oil prices continue to have an outsized influence on the data, pushing up the consumer price index by 0.4

percent in February, the fastest increase in five months. But unlike last year, when oil prices did not filter through to other prices, companies are better able to pass through this cost, as well as rising labor expenses, to the general public. Hence, the so-called core consumer price index, which excludes volatile food and energy prices, rose by 0.3 percent last month, and now stands 2.4 percent higher than a year ago. That's the fastest 12-month increase since August 2002.



In the final analysis, it is real interest rates that influences economic activity. At 2.4 percent, the 12-month increase in the core CPI is up from a low of 1.1 percent at the start of 2004. That 1.3 percentage point rise offsets about 75 percent of the 1.75 percentage point boost in the federal funds rate since last June. Hence, the bite from the rise in real interest rates so far is hardly much of a growth deterrent, which gives the Fed more of an incentive to step up the pace in coming months. Whether it does so will depend largely on upcoming data, particularly the price data. If the core CPI comes out at 0.3 percent for two or more successive months, the odds greatly favor an abandonment of the measured pace of tightening, with the Fed hiking the funds rate by half percent instead of the quarter-point increments. It should also be noted that inflation is a lagging indicator that in the past has provoked the Fed into one too many rate hikes, choking off economic growth. This is the tightrope that Greenspan will be walking as he approaches retirement next January. Hopefully, he won't be leaving a sinking ship.