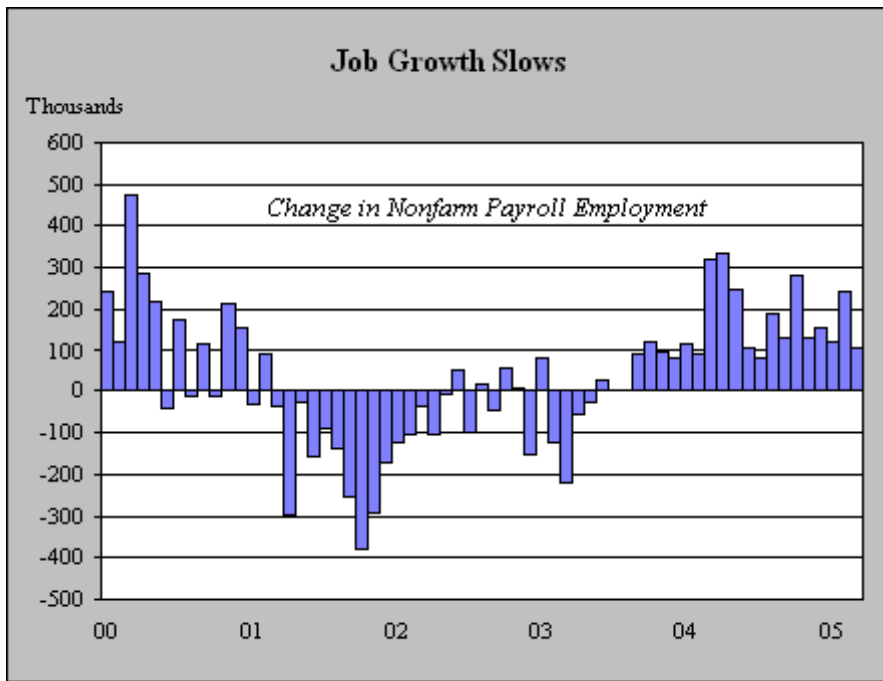


WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 1, 2005

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	April 1	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.72%	2.82%	2.75%	0.94%
6-month Treasury bill	3.02	3.14	2.99	1.02
2-year Treasury note	3.73	3.85	3.56	1.85
5-year Treasury note	4.12	4.30	3.96	3.14
10-year Treasury note	4.45	4.59	4.31	4.15
30-year Treasury bond	4.72	4.84	4.65	4.98
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.35	3.31	3.14	2.52
10-Year	1.03	3.99	3.81	3.67
30-Year	4.70	4.70	4.60	4.75
30-year fixed mortgage rate				
	6.04	6.01	5.79	5.52
15-year fixed mortgage rate				
	5.58	5.56	5.33	4.84
1-year adjustable rate				
	4.33	4.24	4.14	3.46
STOCK MARKET				
Dow Jones Industrials	10404.30	10442.87	10940.55	10470.59
S&P 500	1172.92	1171.42	1222.12	1141.81
NASDAQ	1984.81	1991.06	2070.61	2057.17
Commodities				
Gold (\$) - 100 OZ	428.80	425.00	435.20	422.5
Oil (\$ per barrel) - Crude Futures (NYMerc)	57.27	54.84	53.78	32.37
(Key Reports For Week of April 1)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Confidence Index (March)	102.4	104.4	105.1	100.0
Personal Income (February) - % change	0.3	-2.5	3.7	0.5
Personal Expenditures (Feb) - % change	0.5	0.1	0.9	0.5
Change in nonfarm Payrolls (March) - 000s	110	243	124	174
Unemployment Rate ( March) - Percent	5.2	5.4	5.2	5.4

Although it was a day for pranksters, the government's April 1 employment report was no joke. Yet, the financial markets were fooled once again, as the pumped-up expectations of job growth were unceremoniously deflated by the latest report. Instead of an expected increase of 225 thousand jobs, the economy generated a much tamer increase of 110 thousand in March, the smallest since last July. To add insult to injury, the previous month's muscular increase of 262 thousand jobs, which set the tone for the heightened expectations, was revised down to a 243 thousand gain. Needless to say, investors responded in a bewildered fashion. In the hour or so following the report's release, stock prices and market interest rates moved all of the lot; at the end of the day, stocks turned decidedly lower and bond yields slipped.



True, the news that oil prices spiked higher again on Friday undoubtedly added a degree of havoc to the markets' action, as did a separate report on manufacturers that depicted a sharp pickup in price pressures. But investors are first and foremost concerned about where the economy is heading, and the latest jobs report injected a note of skepticism into the prevailing view. No longer is it a slam-dunk that the economy is building on last year's momentum, with a strengthening job market pushing up labor costs and igniting an unwanted increase in inflation. Such a view implied that the Federal Reserve might very well have to step up its rate hiking campaign, perhaps accelerating the increases from quarter- point to half- point increments to stave off inflationary pressures.

Instead, the much weaker than expected growth in jobs last month now raises the possibility that the economy is losing momentum, which casts an entirely different light on interest-rate prospects. In recent months, the surprise has been that the economy had weathered the climb in energy prices so easily, staging a robust 4.4 percent growth rate last year and probably sustaining that pace through this year's first quarter. It would be premature at this point to mark down the first-quarter's estimate, as the correlation between monthly job gains and economic growth is anything but precise. Indeed, based on the consumer spending figures for January and February as well as the available gauges of business investment outlays, there is still a good chance that first-quarter's growth will print close to the 4 percent consensus forecast.

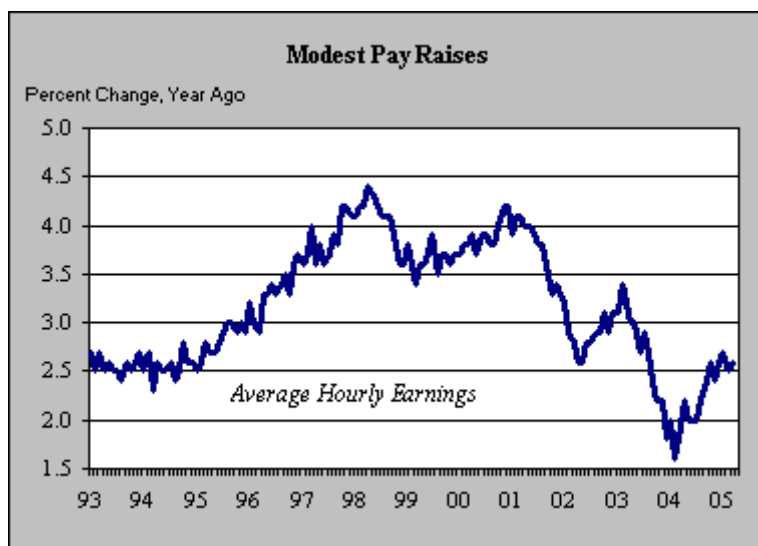
More importantly, though, is what the hiring slowdown in March implies going forward. Keep in mind that the climb in energy prices last year slashed the growth in consumer spending by 50 percent in the second quarter, bringing on the so-called "soft patch" that garnered headlines for a period of time. Recall also that the job market, while recovering, still lagged the pace of previous recoveries, underpinning John Kerry's contention that the economy was experiencing a jobless recovery akin to the 1990s to bolster his presidential aspirations. Business leaders were, in fact, quite outspoken about how the spike in oil prices made them more cautious about expanding payrolls. Their concern was that rising energy costs was siphoning off cash flow and squeezing household budgets, which could provoke a long-lasting slowdown in consumer spending.

The question now is, are businesses once again holding back on their hiring plans in response to the persistent climb in oil prices, which topped \$57 a barrel on Friday, reversing a brief slide to the \$54 level earlier in the week. Again, a one-month reading is not a reliable guide of what's to come. But what also weighed heavily on the minds of investors on Friday was a report by the Institute for Supply Management revealing that manufacturers paid steeply higher prices for supplies last month, as the prices paid component of the manufacturers' index spiked up to 73.0 from 65.5 the previous month. It was this report, coming shortly after the employment data, that whipsawed the bond market. Initially, bond yields fell sharply on the news of a weak gain in jobs because it diffused inflation concerns and suggested that the Fed might think twice about stepping up its rate-hiking strategy. The spike in the ISM price index, however, brought inflation concerns back to the forefront, knocking the feet out from both the bond as well as the stock market. However, by the day's end, the disinflationary implications of the jobs report won out, and the 10-year Treasury yield slid to 4.45 percent, well under its recent high of 4.60 percent.

While companies may well be responding to the rise in energy and commodities prices, there may be other reasons for the sudden pullback in job growth. Chief among them is the wave of mergers and acquisitions that has taken place over the past six months, which typically results in widespread downsizing as companies consolidate overlapping departments and operations. Another factor that may be retarding job growth is simply a growing mismatch between job openings and the skills among unemployed workers to fill the available positions. In other words, companies are still willing to hire workers, but cannot find enough of them to meet their requirements. The fact that the labor force participation rate remains at historically low levels may offer some support for this notion.

Indeed, if people are staying out of the labor force in larger numbers for whatever reason, it raises another intriguing possibility, something that the Federal Reserve Bank of Atlanta has recently presented in its quarterly review. Simply put, a smaller workforce means that it takes less of an increase in jobs to reduce the unemployment rate. Indeed, the Atlanta Fed opines that as little as 93 thousand net new jobs a month can lower the unemployment rate, a pace that is far removed from the roughly 150 thousand often cited as needed to keep the jobless rate from rising. Not coincidentally, despite the tepid job growth in March, the unemployment rate slid to 5.2 percent from 5.4 percent in February, equaling the lowest level since September of 2001. The unemployment rate, of course, is derived from a separate survey than the one that tabulates the increase in workers collecting paychecks. Still, the low rate is frequently alluded to by analysts who claim that there is less slack in the job market than is generally perceived.

The problem with this line of reasoning is that workers have not seen an increase in their bargaining power, something that would ordinarily happen in a tightening labor market. Yes, average hourly earnings increased by 0.3 percent in March, which was slightly stronger than expected. But that comes on the heels of tepid 0.1 percent increase in February, leaving workers with only a 2.6 percent gain over the past 12 months. That's a far cry from the pace of the 1990s, and barely keeps up with inflation, although there has been a gradual improvement over the past year. Nonetheless, for inflation to take hold, it must be corroborated by rising labor costs, which accounts for 70 percent of business expenses. There is very little in the earnings data that would support this view.



Our sense is that the surprising March slowdown in job growth probably exaggerates underlying trends, just as the February jump was an outlier on the upside. The 175 thousand average for the two months is probably more consistent with the economy's performance. If sustained, that would imply an increase of 2.1 million over the course of a year, which is roughly equal to the 2.2 million net new jobs generated in 2004. The question, of course, is will that pace be sustained. Given such formidable obstacles as climbing energy costs and a tightening Federal Reserve policy, the odds favor some slowing in economic growth, if not in the current quarter than over the second half of the year. On the surface, that would seem to point to a slower pace of job creation as the year progresses.

On the plus side, however, is the cyclical slowing in productivity that is already well underway. What this means is that it takes more workers to turn out a given unit of product, so that a growth slowdown will not necessarily produce a corresponding pullback in hiring. This is a tug of war that will play out in the months to come, and perceptions over the strength of the job market will wax and wane according to the ebb and flow of the monthly job reports. We suspect that the productivity factor will have the upper hand, keeping employment growth on the high side of expectations. Even so, wage pressures should not build to the boiling point, igniting an inflationary outbreak. Companies are showing no indication of abandoning the vigilant cost controls they have exercised over the past several years, and are likely to redouble their efforts

to contain labor costs in the face of rising costs elsewhere.

As a result, the volatility that struck the financial markets on Friday may well be a precursor of what's in store on a more frequent basis. Clearly, strong job reports from time to time will heighten inflationary expectations and spur speculation about a more stringent Fed tightening. Just the opposite can be expected when the jobs data come in weaker than expected. The Fed itself noted that future policy moves will be more data dependent than in the recent past, when the main objective has been to remove the excessive liquidity in the economy. That's still the ongoing motive. But in the blink of an eye after the latest employment report, the vocal calls for a more aggressive rate hike at the upcoming policy meeting has been silenced. Indeed, some whispers that the tightening cycle is nearing an end is starting to be heard.

Needless to say, just what scenario unfolds will have a profound impact on relative returns. As our monthly roundup of key financial asset classes indicates, March was not a good month for the more speculative investors, as holders of lower-rated bonds and stocks suffered the biggest losses, which was a recurring theme for the entire first quarter. Just about the only winner was that most risk-averse of all assets -- Treasury bills. Based on the market's performance on April 1, it continues to be no laughing matter for the risk-takers.

