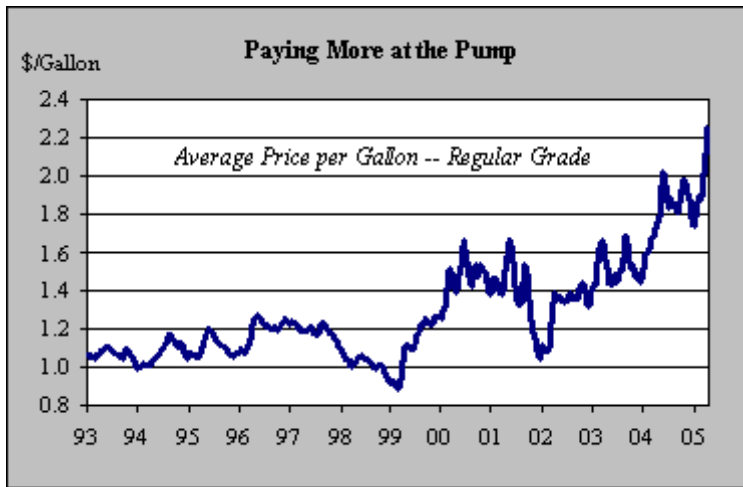


## WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 8, 2005

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	April 7	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.77%	2.72%	2.75%	0.93%
6-month Treasury bill	3.12	3.02	3.05	1.03
2-year Treasury note	3.75	3.73	3.71	1.86
5-year Treasury note	4.14	4.12	4.21	3.22
10-year Treasury note	4.48	4.45	4.54	4.19
30-year Treasury bond	4.76	4.72	4.81	5.03
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.34	3.35	3.17	2.7
10-Year	3.97	4.03	3.85	3.85
30-Year	4.63	4.70	4.64	4.9
30-year fixed mortgage rate	5.93	6.04	5.85	5.79
15-year fixed mortgage rate	5.48	5.58	5.38	5.12
1-year adjustable rate	4.23	4.33	4.24	3.65
STOCK MARKET				
Dow Jones Industrials	10461.34	10404.30	10774.36	10442.03
S&P 500	1181.20	1172.92	1200.08	1139.32
NASDAQ	1999.35	1984.81	2041.60	2052.88
Commodities				
Gold (\$) - 100 OZ	428.60	428.80	445.80	420.7
Oil (\$ per barrel) - Crude Futures (NYMerc)	53.32	57.27	54.43	34.54
(Key Reports For Week of April 8)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (Feb) - Mlns of \$s	5552	11626	7283	9165

Is it déjà vu all over again? With the peak driving season less than eight weeks away, gasoline prices are behaving much as they did last year at this time. In 2004, the average price of a regular gallon of unleaded gas jumped by 39 percent between the start of the year and the Memorial Day holiday, with about half of the rise occurring over the final eight weeks of the period. So far this year, the price at the pump has increased by 28 percent, as a gallon of regular unleaded gasoline hit a record \$2.24 this week. Industry experts are almost unanimous in the view that prices are heading higher in coming weeks, although the magnitude of the increase is open to question.



To be sure, Saudi Arabia's announcement that it would step up oil production provided some hope that the prospective increase would be mild. Indeed, crude quotes tumbled from a peak of over \$58 a barrel early in the week to \$53 on Friday. It's doubtful, however, that the reversal, even if sustained, will filter down to the retail level in time to provide much relief to motorists before the driving season starts. So the question is, will the parallel course of gasoline prices take as much of a bite out of consumer spending during the spring months as it did last year? Recall that in the second quarter of 2004, real consumer outlays increased by a paltry 1.6 percent, the slimmest gain since the 2001 recession and a precipitous slowdown from the muscular 4.1 percent increase in the first quarter. That consumer retrenchment -- producing the so-called soft patch -- raised questions about the sustainability of the recovery and delayed the Fed's first tightening move in its rate-hiking campaign until the end of June.

Unlike last year, there are few concerns that the oil spike will bring the economy to its knees. Recent surveys indicate that economists are mildly marking down their growth forecasts for the rest of the year, but none expects the expansion to abort unless oil soars into the \$80-\$90 range. There are a number of reasons for the more confident outlook this time. For one, the economy has gained enough traction to overcome higher oil prices; early last year, the growth engine was still sputtering, thanks to a lackluster job market and still-wavering consumer and business confidence. For another, consumers and businesses have become more accustomed to the higher price of oil, incorporating it into their budget and spending plans.

Indeed, the ability to adjust to higher oil prices is key to the more confident outlook this year. Along with modest pay raises, more than 2 million workers have been added to payrolls over the past twelve months, spurring faster income growth. In the year through February, the latest date available, wages and salaries increased by 5.5 percent, substantially stronger than the 4.3 percent growth rate a year earlier. True, that's still a disappointing pace compared to the comparable stage of past expansions, but households are supplementing incomes by tapping into their housing wealth, which has appreciated enormously in recent years. Nor has the sizeable increase in mortgage borrowing diluted the value of housing equity. In the fourth quarter of last year, homeowners retained a 56.1 percent equity position in their real estate, precisely the same as a year earlier and actually up from a recent low of 55.4 in the third quarter of 2003.



No doubt, the housing boom will not last forever, and the seven rate increases by the Fed since last June have already made it more expensive to tap into home equity. Not only has refinancing activity fallen sharply in March and early April, housing prices appear to be slowing in many regions of the country. What's more, more than half of all mortgage applications in recent weeks have been for variable-rate loans, a potential drag on household income as these rates adjust higher in coming months. In all likelihood, the impact of higher energy bills and debt-servicing charges will take a toll on consumers. But as long as oil prices do not skyrocket from current levels, households should be better equipped to sustain spending than they were last year.

Indeed, one major difference this year is that the Fed views the oil spike as more of a threat to inflation than to growth. As a result, the climb in oil prices is more likely to accelerate the rate increases than delay them, as was the case last year. This notion was given further credibility by Fed governor Poole on Thursday, when he commented that "...the biggest unknown is whether the inflation pressures, which are pretty obvious, are sort of a temporary thing...or whether a bigger inflation risk is ahead of us," and added that "...should we see evidence that we are getting into a more fundamental inflation problem, which as I say is not my best guess, then you are going to see the Federal Reserve act more vigorously."

Paradoxically, this week's \$5 a barrel plunge in crude oil prices provided little relief to the bond market, which, like the Fed, had viewed the oil spike as primarily an inflation threat. Reflecting this view, the bond vigilantes drove the yield on the Treasury's 10-year bond to over 4.60 percent in late March from about 4 percent in early February. However, after some weaker than expected economic data, particularly last week's disappointing employment report, the focus shifted to the possible damage that the oil spike might be having on the economy. As a result, the bond yield had slipped to as low as 4.43 percent last week. But with oil quotes tumbling this week and posing less of a threat to the economy, the bond vigilantes once again resurfaced, buoyed by strengthening growth prospects. On Friday, the Treasury yield pushed back up to 4.50 percent, ending the trading session at 4.48 percent

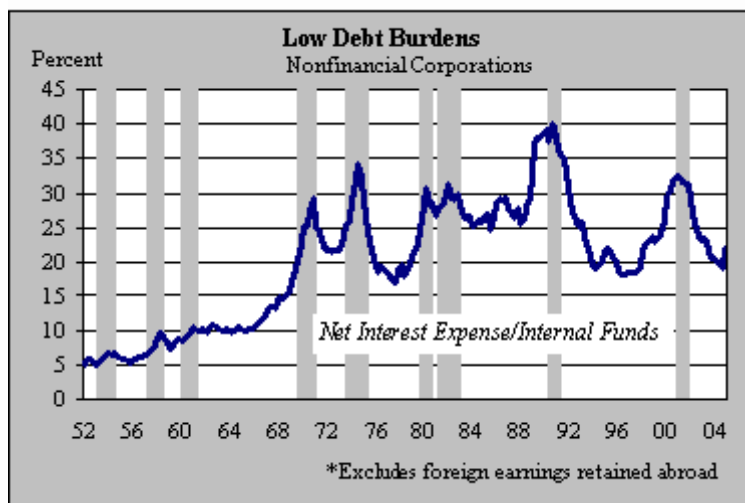
Simply put, the consensus view is that economic growth will not be severely damaged by the latest climb in oil prices, unless the climb turns out to be much steeper and longer than is currently envisioned. That puts the focus squarely on inflation, and how the Federal Reserve is likely to react in coming months. Despite last week's disappointing employment report, most economists still expect the Fed to lift its target federal funds rate at each of the next several policy-setting meetings, although they disagree about the size of the increases. Since the next meeting on May 3 is just before the April employment report is released, the odds are that the Fed will keep to its measured pace of quarter-point increments. However, if the weakness in the last jobs report turns out to be an aberration and the April report shows a much stronger pace of job creation, speculation will surely mount for a larger rate hike at the next meeting on June 29-30. Keep in mind that the Fed has never gone through an entire tightening cycle without pushing through at least one half-point rate increase.

Once the federal funds rate moves above 3 percent, which should be the case by late June, the markets will likely focus on how well a heavily-leveraged economy will be able to withstand higher interest rates. Clearly, the housing market will be among the first to suffer, as is usually the case in this highly rate-sensitive sector. Even here, however, the impact is likely to be milder than in past cycles, if only because mortgage rates should not climb to the prohibitively high levels that in the past had choked off home sales and construction. Perhaps a bigger threat would occur if home prices collapsed, making a big dent in household wealth and dragging down consumer spending. While nothing can be ruled out, the more likely scenario is that

home values will rust, not bust, and household balance sheets will not be severely impaired.

The key, of course, is that businesses retain confidence in the economy and continue to expand payrolls as well as investment spending. Until recently, consumers have done most of the heavy lifting in keeping the expansion going. But now, a normal cyclical rotation should be kicking in, with businesses taking the mantle from households. By all accounts, this rotation has already begun, as capital spending has been picking up momentum over the past year. A critical influence jump-starting the process was the ability of businesses to repair their balance sheets, after suffering a particularly gruesome profit squeeze during the last recession.

Not only have profits rebounded, they have done so with a vengeance. According to the latest Commerce Department's figures, earnings from current production surged by 15.7 percent in 2004, following an even sturdier 16.8 percent increase in 2003. These back-to-back gains provided nonfinancial corporations with more than enough internal funds to finance capital spending, and still build up a respectable cash hoard. Meanwhile, thanks to a receptive bond market and low interest rates, companies refinanced a huge amount of high-yielding debt and replaced short-term loans with longer-term bonds at rock-bottom rates. One result, companies have done an extremely good job of insulating themselves from the Federal Reserve's rate hiking actions.



Indeed, as the chart shows, the debt-servicing burden of nonfinancial corporations -- interest payments as a percent of cash flow -- is considerably below the peak levels reached during the 2001 recession. The current ratio stands at 22 percent compared to a high of 32.5 percent in the first quarter of 2001. And with long-term debt accounting for an outsized 73.3 percent of total outstanding obligations, up from 60.7 percent at the start of the recession, the rate hikes by the Fed are affecting a relatively small fraction of corporate liabilities. In short, while higher oil bills and interest rates may well impinge on consumer spending in coming months, businesses are in much better financial shape to weather both; hence, they should take the lead in propelling the economy forward over the rest of the year. As is usually the case when a business cycle shifts from a recovery to an expansion stage, economic growth tends to slow. That will probably occur this time as well over the second half of the year, but unless the oil crisis deepens or the Federal Reserve overreacts to perceived inflation threats, the expansion should remain intact and proceed at a healthy pace going into 2006.