

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 15, 2005

*First the numbers, then the story*

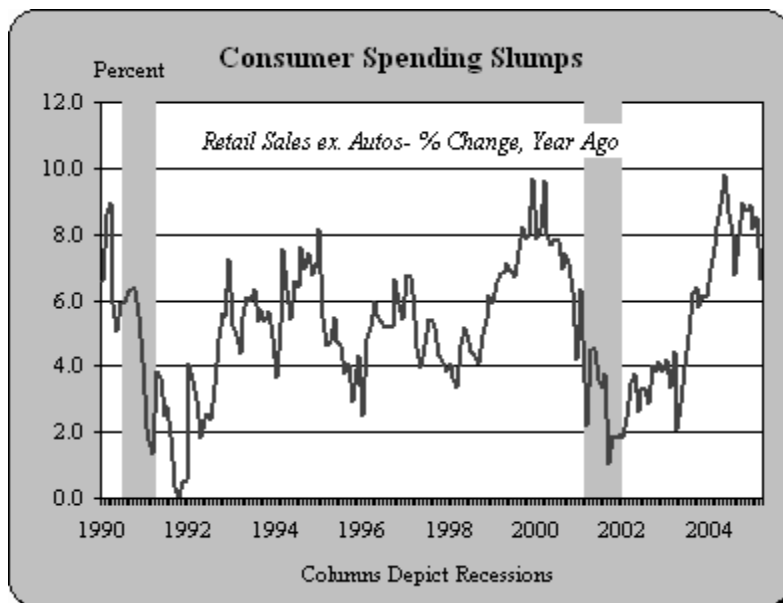
FINANCIAL INDICATORS				
INTEREST RATES	April 15	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.77%	2.77%	2.80%	0.93%
6-month Treasury bill	3.09	3.12	3.10	1.07
2-year Treasury note	3.49	3.75	3.69	1.98
5-year Treasury note	3.87	4.14	4.16	3.36
10-year Treasury note	4.24	4.48	4.50	4.34
30-year Treasury bond	4.59	4.76	4.81	5.17
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.30	3.34	3.25	2.8
10-Year	3.97	3.97	3.91	3.98
30-Year	4.62	4.63	4.65	5
30-year fixed mortgage rate				
	5.91	5.93	5.95	5.89
15-year fixed mortgage rate				
	5.46	5.48	5.47	5.23
1-year adjustable rate				
	4.30	4.23	4.20	3.69
STOCK MARKET				
Dow Jones Industrials	10087.51	10461.34	10629.67	10451.97
S&P 500	1142.62	1181.20	1189.65	1134.61
NASDAQ	1908.15	1999.35	2007.79	1995.74
Commodities				
Gold (\$) - 100 OZ	426.40	428.60	439.80	401.63
Oil (\$ per barrel) - Crude Futures (NYMerc)	50.49	53.32	56.72	35.19
(Key Reports For Week of April 15)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (March) - % change	0.3	0.5	0.1	0.5
Trade deficit (February) - mlns of \$s	61036	58504	55744	56963
Business Inventories (Feb) - % change	0.5	0.9	0.2	0.5
Industrial Production (March) - % change	0.3	0.2	0.0	0.6
Manufacturing Prod. (March) - % change	-0.1	0.3	0.3	0.6

Did someone say "soft patch"? That phrase, which so resonated with policy makers and investors precisely a year ago, is once again making headlines -- and capturing the attention of the financial markets. Indeed, stock prices were battered this past week, setting new lows for the year and adding another layer of angst to shareholders who might also have had to write a hefty check to Uncle Sam on Friday, the April 15 tax deadline. To be sure, concerns about the first-quarter earnings season are weighing on the equity markets, punctuated by a disappointing report issued by IBM. But company and even industry-specific profit shortfalls can be overlooked by investors if they are heartened by an encouraging economic outlook. Unfortunately, the recent batch of economic data is creating just the opposite sentiment.

Indeed, it was only a few short weeks ago that the general reading on the economy was highly upbeat. Consumers were spending more aggressively than expected, business capital spending was on a tear and job growth was accelerating, all pointing to a muscular 4 - 4.5 percent annual growth rate for GDP in the first quarter. But that was then. More recently, the

two pillars of the economy's strength -- jobs and consumer spending -- have weakened considerably. Two weeks ago, it was the employment report that shook up perceptions, as companies added less than half as many workers to payrolls as expected during March. With job growth slowing in the midst of sharply climbing oil prices, the economy suddenly faced headwinds that were not on the radar screen earlier in the year. The overriding fear was that heavily-indebted households would not garner the income gains needed to absorb higher energy bills and debt-servicing charges while still maintaining spending at the robust pace of earlier in the year.

That fear became more of a reality this week with the government's second key release of the month -- retail sales. What the report showed was that consumers indeed decided to take a breather in March, lifting spending by a tepid 0.3 percent, much weaker than expected. Moreover, the month's increase reflected an incentive-induced boost in auto purchases and a price-fueled spike in gasoline service-station sales. Take out those components, and retail sales actually slipped by 0.1 percent in March, marking the first such drop in almost a year. As a result, it appears that higher gasoline prices and interest rates may be taking a toll on households, prompting them to pull back on discretionary spending, much as was the case last spring. Not surprisingly, the most discretionary of all such items -- clothing as well as sales at department stores and food service outlets -- fell sharply last month.

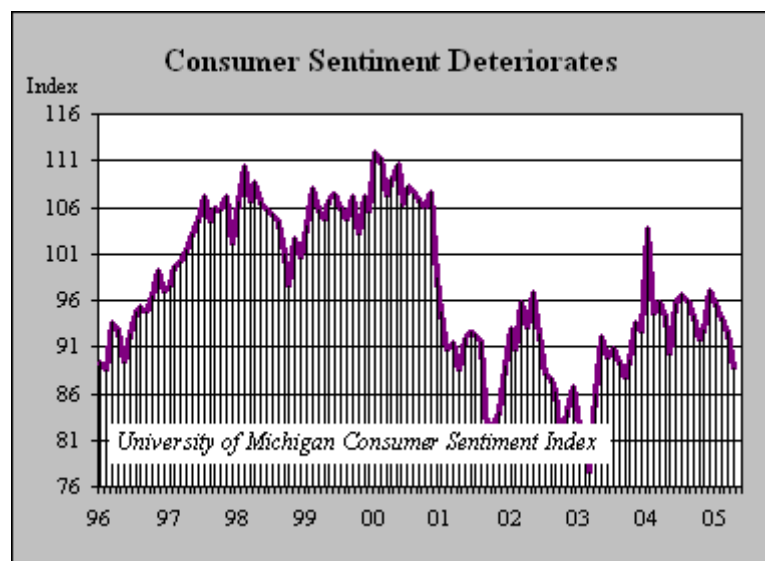


Other data released this week reinforced perceptions of a slowing economy. The trade deficit leaped sharply to a new record in February, factory output fell in March for the first time since last September and the University of Michigan reported a sharper than expected decline in household sentiment in early April. Even before these releases, economists were marking down their first-quarter growth forecasts. The more optimistic 4.5 percent target now seems like a pipe dream; some analysts even see the growth rate coming in below 3 percent. A consensus is still in the process of forming, but estimates seem to be coalescing around 3.25- 3.5 percent. That's not bad, but definitely a downward shift in expectations from a few weeks ago. More to the point is that the economy appears to have suffered an astonishing loss of momentum heading into the second quarter.

The question is, how long will the slowdown last? Last year, the soft patch was a fairly quick and dirty affair, induced primarily by the swift climb in oil prices. After a brief pullback in the spring, consumer spending rebounded vigorously over the second half of the year. A number of factors ignited the recovery, including stronger job gains, low mortgage rates and the wealth boost derived from surging home prices and a powerful late-year rally in the stock market, fueled by strong profits. Clearly, such a perfect storm of events is not likely to happen again. Indeed, household wealth has taken a big hit so far this year due to the slide in stock prices, and the unexpected weakness in the job market is once again creating anxiety among workers over employment and income prospects.

The University of Michigan's latest household survey vividly captures these negative influences. Its sentiment index for early April plunged to 88.7 from 92.6 in March. If the preliminary decline is sustained for the month as a whole, it would mark the fifth consecutive drop and produce the lowest reading since September 2003. In other words, consumer sentiment is now even more pessimistic than it was just prior to the onset of last year's soft patch. According to the Michigan analysts, the reasons for the downbeat attitude cover a wide range of issues; topping the list, not surprisingly, is the high price of oil, followed by deteriorating job prospects, higher inflation and rising interest rates. If this barometer of consumer psychology is

an indicator of things to come, the economy may indeed fall into a soft patch that could be at least as severe as last year's.

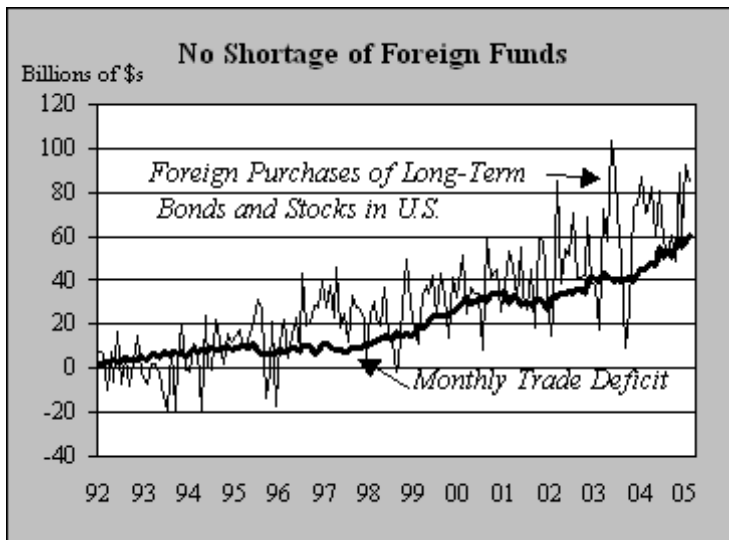


But it would be unwise to jump to such a conclusion, at least with the evidence on hand. Yes, the economy has lost some of its earlier momentum, and the more Pollyannaish forecasts asserted earlier in the year now seem farfetched. But it takes a powerful catalyst to drastically alter the direction of an \$11 trillion economy and no such dynamic has emerged to bring that about. If anything, the seeds for a revival in activity are already being sown. Oil prices have fallen sharply from a peak of over \$58 a barrel to about \$50 today, even slipping a buck or so below the \$50 threshold for a while this week. Meanwhile, the interest-rate threat to the real estate market has diminished somewhat, as the 30-year mortgage rate has fallen from 6.04 percent to 5.91 percent over the past two weeks. Based on the slide in Treasury bond yields, mortgage financing should become even less expensive in coming weeks.

Indeed, the bond market has enjoyed a remarkable rally in recent weeks, reflecting the abrupt shift in perceptions about the economy and the inflation outlook. A little over a month ago, the 10-year Treasury yield hit a peak of 4.63 percent, as bond investors fretted over rapid economic growth, rising inflation and expectations that the Federal Reserve would step up its pace of interest-rate hikes. But this hawkish attitude gradually began to evaporate as economic data came in weaker than expected, prompting the bond vigilantes to retreat. By this week, the doves took the mantle of leadership, pushing the bond yield down to 4.24 percent on Friday from 4.48 percent a week ago. That 24 basis point drop was the sharpest weekly fall in the bond yield since last August, and portends a corresponding slide in mortgage rates in coming weeks.

Interestingly, the fall in bond yields occurred in a week that saw another big jump in the trade deficit -- to a new record of \$61 billion in February from \$58.5 billion January. The deficit over the first two months of the year translates into a full-year gap of \$717 billion, which would be a full \$100 billion larger than the record annual deficit set last year. Keep in mind that the relentless climb in the trade deficit had been one of the biggest worries in the bond market, as investors feared that foreigners would demand stiff concessions to take on the huge increase in greenbacks flooding the currency markets. Any reduction in foreign willingness to expand their dollar holdings in line with the financing needs of the deficit or, worse, a collective decision to sell existing holdings of dollar assets could cause a spike in interest rates and/or a sharp dollar devaluation.

But despite these fears, foreign investors have shown little inclination to abandon dollar assets. Indeed, their appetite for U.S. securities remains as voracious as ever. True, foreign demand for U.S. equities fell in February, reflecting the stock market's dismal performance that month. But net purchases of notes and bonds remained strong, and combined inflows into the U.S. capital markets totaled a healthy \$84.5 billion in February, only modestly below January's eye-opening \$91 billion. More importantly, the two-month total of net purchases exceeded the trade deficit by a sizeable \$57.5 billion, which indicates that foreign investors are still more than willing to fill the void created by the lack of domestic saving in the U.S. Just how much the sustained foreign demand for U.S. bonds is contributing to the decline in long-term yields is debatable; but the threat to the bond market of a prospective foreign withdrawal has faded into the woodworks for the time being.



More than likely, the biggest influence behind the drop in bond yields -- and the plunge in stock prices this week -- is the downward ratcheting of growth expectations, reflecting the latest batch of weak economic data. Market psychology, however, can shift on the dime, and our sense is that the pendulum will once gain reverse as the economy stages a better performance over the second half of the year than is now anticipated by asset prices. Even with the March slowdown, consumer spending in the first quarter was fairly robust, increasing by about 3.5 percent. Barring an about-face in crude oil prices, the drag from higher gasoline prices that crimped spending in February and March should diminish in coming months, much as was the case last year.

What's more, it is doubtful that the disappointing employment report for March represented a fundamental shift in company hiring. With productivity waning and the economy still growing above its long-term trend rate, businesses will need to add at least as many workers as last year to meet customer demand. Moreover, companies have ample financial resources to satisfy staffing needs; profits are still growing, albeit at a slower pace than last year, and borrowing costs are still relatively low if external funds are needed. Nonetheless, the recent signs of economic sluggishness lowers the odds that the Federal Reserve will boost interest rates more aggressively at the May or June meetings. Of course, if the next two employment reports are stronger than expected, look for the Fed to step up its rate-hiking campaign over the summer months.