

WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 22, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	April 22	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.91%	2.77%	2.82%	0.97%
6-month Treasury bill	3.13	3.09	3.14	1.17
2-year Treasury note	3.60	3.49	3.85	2.22
5-year Treasury note	3.92	3.87	4.30	3.56
10-year Treasury note	4.25	4.24	4.59	4.46
30-year Treasury bond	4.58	4.59	4.84	5.24
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.26	3.30	3.31	2.75
10-Year	3.94	3.97	3.99	3.93
30-Year	4.63	4.62	4.70	4.98
30-year fixed mortgage rate				
	5.80	5.91	6.01	5.94
15-year fixed mortgage rate				
	5.36	5.46	5.56	5.25
1-year adjustable rate				
	4.26	4.30	4.24	3.69
STOCK MARKET				
Dow Jones Industrials	10157.71	10087.51	10442.87	10472.84
S&P 500	1152.12	1142.62	1171.42	1140.6
NASDAQ	1932.19	1908.15	1991.06	2049.77
Commodities				
Gold (\$) - 100 OZ	436.10	426.40	425.00	395.7
Oil (\$ per barrel) - Crude Futures (NYMerc)	55.39	50.49	54.84	34.86
(Key Reports For Week of April 22)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Price Index (March) - % change	0.6	0.4	0.1	0.3
Core CPI (March) - % change	0.4	0.3	0.2	0.3
Producer Price Index (March) - % change	0.7	0.4	0.3	0.5
Housing Starts (March) - 000s of units	1837	2229	2189	2030

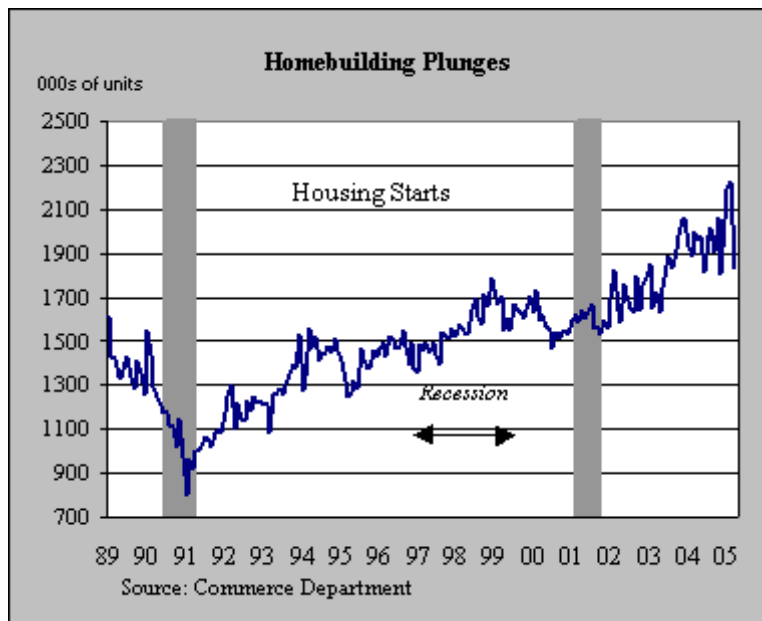
We are not psychologists, but it sure seems that the economy and financial markets are exhibiting extreme bipolar behavioral tendencies. It was hardly more than a month ago that the economy appeared to be barreling along, extending the torrid 4.7 percent growth rate recorded over the second half of last year, and more than justifying the Federal Reserve's intention to stave off inflation through a steady diet of interest-rate increases. The financial markets were fully in sync with the Fed's efforts, not only condoning the increases but also speculating when the baby steps of quarter-point hikes would be replaced by more aggressive action. But that was then.

Within the past month, the swirl of events has shifted dramatically. Instead of gaining momentum, virtually every key economic report has come in weaker than expected -- employment, retail sales, manufacturing output and, this week, housing starts. The reports covered activity for March, indicating a stunning loss of momentum heading into the second quarter. Suddenly, the talk is all about another soft patch, reminiscent of last spring when the economy also downshifted markedly between the first and second quarters. And, as was the case then, the main culprit behind the economic malaise is the climb in

oil prices, which has pushed energy-related costs up by nearly 30 percent so far this year and is expected to boost household energy bills by an annual rate of close to \$60 billion over the first half of the year.

Not surprisingly, the speculation about monetary policy has also shifted. The earlier calls for a step-up in rate hikes have been quelled, and some are even questioning the wisdom of applying the monetary brakes continuously for as long as the eye can see. A fraction of advocates of the go-slow approach believe that the Fed would be wise to pause after its next expected hike on May 3 to see how much momentum has been lost. After all, if hiring plans are being scaled back and consumer spending is slowing, the last thing the economy needs is another growth impediment in the form of still higher borrowing costs. On the surface, this argument may have received timely support from the latest data on housing, the most interest-rate sensitive sector of the economy.

In March, housing starts suffered their biggest plunge since January 1991, dropping by an unsightly 17.6 percent. At 1.84 million units, the annual rate of new construction fell to the lowest level since last November. What's more, all major regions were affected, with the Midwest suffering an outsized 29.3 percent drop. But while the housing industry is tightly linked to financial conditions, it is highly unlikely that homebuilders decided to rein in construction plans because of a prospective rate-induced fall-off in housing demand. First of all, mortgage rates are well within the tight range in effect over the last year; indeed, the rate on 30-year fixed rate loans stood at 5.80 percent in the latest week, which is actually a tad lower than the 5.94 percent prevailing a year ago.



For another, homebuilders have little reason to cut back as dramatically as the latest data would suggest. Inventories of unsold homes are relatively low, prices are still rising, home-buying plans remain upbeat and, most importantly, actual sales of both new and existing homes continue to hover near historically high levels, at least through February. Finally, the March plunge in starts followed a muscular increase in February, suggesting that some weather-related influences played havoc with the figures. Perhaps the best way to interpret the wide swings is by averaging out the last two months. On this basis, starts in January and February averaged 2.033 units, 8 percent less than in the prior two months but still above the strong 2004 total of 1.952 units.

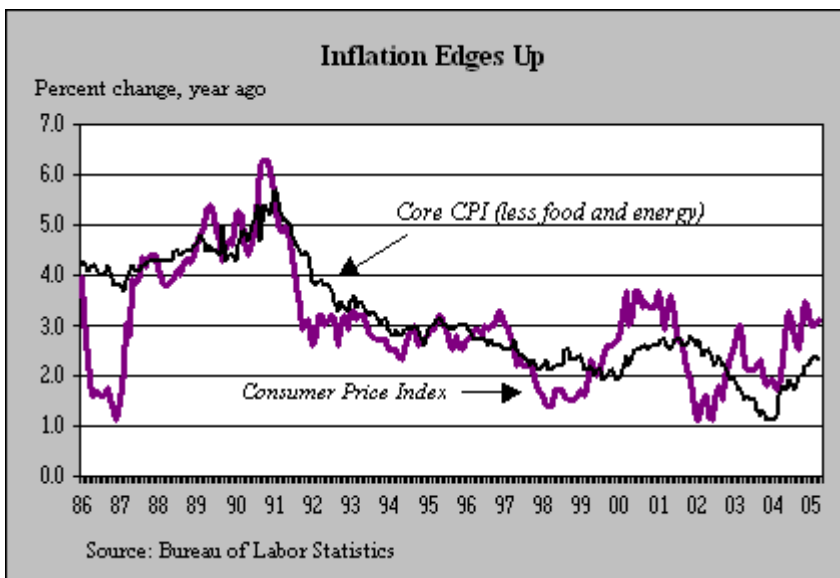
No doubt, the real-estate boom is fraying at the edges and the wealth boost from surging home values will not propel consumer spending as much this year as was the case in 2004. But unless there are clear signs that the housing boom is turning into an outright wealth-deflating bust, the Fed is not likely to alter its policy strategy in coming months. In all probability, the abrupt growth slowdown in March took the Fed by surprise and, hence, diminishes the odds that it will boost the federal funds rate by 50 instead of 25 basis points in the near future. But it is showing no indication of taking its foot off of the monetary brakes any time soon.

Simply put, Greenspan & Company will more than likely look through the current soft patch, believing that it is mainly oil-driven and will follow the same brief pattern as last year. Recall that after gasoline prices peaked late last spring, the economy quickly recovered and soared through the second half of 2004. In an April 14 speech, Fed governor Kohn emphasized the fact that the economy was on a sound footing and the Fed must be vigilant in guarding against building

inflation pressures. His remarks came after the weak employment and retail sales numbers were known, so this doesn't sound like a Fed that is about to be pushed to the sidelines by the current soft patch, at least not unless it extends beyond a quarter or so.

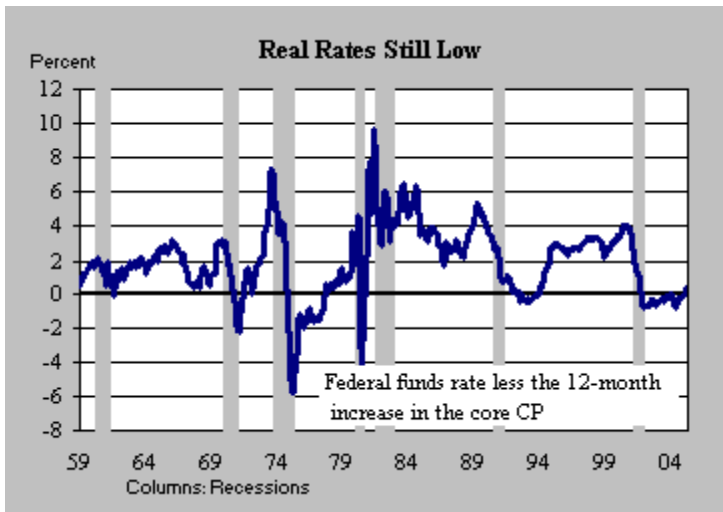
Indeed, the Fed continues to be more preoccupied by the inflation threat than with slowing growth prospects. In the latest Beige Book that summarizes regional economic conditions around the nation, the key point made was that businesses are increasingly able to pass along rising energy and other costs to consumers. It didn't take long for hard evidence of this increased pricing power to hit the headlines. This week, the government revealed that the consumer price index staged a much bigger increase in March than expected, rising by 0.6 percent, equaling the steepest rise since April 1999.

True, energy costs was the major driver, surging by 4 percent during the month. But that was expected and did little to influence inflation expectations. The major surprise was in the so-called core CPI, which excludes volatile food and energy items. Here, prices jumped by 0.4 percent, about double expectations and last exceeded way back in October 1992. On a 12-month basis, things do not look as bad, thanks to the soothing effect of moving averages, but as the chart shows the trend is decidedly up. What accounted for the ugly March numbers? Primarily the cost of lodging away from home, which shot up by a whopping 3.9 percent and women's apparel, which jumped by 0.8 percent.



Interestingly, the bond market, which tends to have a knee-jerk reaction to any bad news on the inflation front, hardly reacted to the latest CPI data. Indeed, the 10-year Treasury yield ended the week virtually unchanged from the previous week, at 4.24 percent, which remains considerably below the recent high of 4.64 percent. Quite possibly, the more forward-looking indicators are calming inflation fears. For example, pipeline inflation pressures actually diminished in March, as the core producer price index edged up by a smaller than expected 0.1 percent, the second consecutive tame monthly reading for this measure of wholesale prices. Just as importantly, the consumer price index is a lagging indicator of economic activity, and the soft patch may well be signaling a slower increase in the CPI in coming months.

Still, the Federal Reserve is not likely to buy into the "wait and see" approach to policy, at least not yet. Since last June, when the first of seven rate hikes was implemented, the federal funds rate has been lifted by a cumulative total of 1.75 percentage points. That may seem like a lot, but it just barely kept up with the increase in inflation over the period. As a result, the real funds rate -- the difference between the nominal funds rate and the core inflation rate -- has only recently turned from negative to positive, averaging just 0.3 percent in March.



Even if, as expected, the funds rate is lifted to 3 percent on May 3, the real rate would still be well below the 3-4 percent threshold that in the past has started to take a real bite out of the economy. Clearly, that's not a threshold the Fed is striving to meet, given the current slowdown and the economy's vulnerability to high energy prices. But with key inflation data flaring up and the probability that the soft patch will be brief and mild, expect the policy makers to stay on the rate-hiking path until the funds rate is brought up to a neutral level. Admittedly, that's an elusive target, which could range from 1 to 3 percent above the inflation rate. At a nominal 3 percent, however, there are still at least a few more hikes to go before the lower boundary of that range is hit.