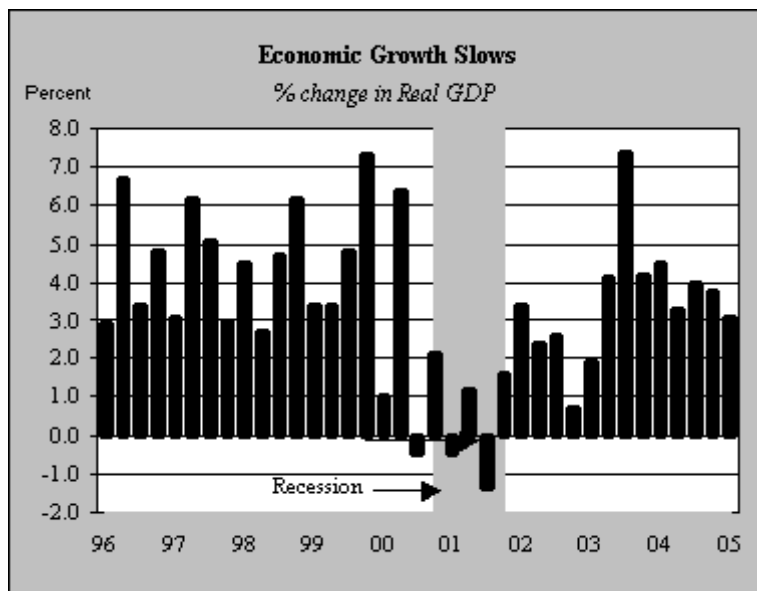


WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 29, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	April 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.89%	2.91%	2.72%	0.97%
6-month Treasury bill	3.18	3.13	3.02	1.15
2-year Treasury note	3.65	3.60	3.73	2.31
5-year Treasury note	3.90	3.92	4.12	3.61
10-year Treasury note	4.20	4.25	4.45	4.51
30-year Treasury bond	4.51	4.58	4.72	5.29
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.22	3.26	3.35	2.94
10-Year	3.90	3.94	4.03	4.08
30-Year	4.60	4.63	4.70	5.07
30-year fixed mortgage rate				
	5.78	5.80	6.04	6.01
15-year fixed mortgage rate				
	5.33	5.36	5.58	5.35
1-year adjustable rate				
	4.21	4.26	4.33	3.75
STOCK MARKET				
Dow Jones Industrials	10192.51	10157.71	10404.30	10225.57
S&P 500	1156.87	1152.12	1172.92	1107.26
NASDAQ	1921.65	1932.19	1984.81	1920.15
Commodities				
Gold (\$) - 100 OZ	435.50	436.10	428.80	387.5
Oil (\$ per barrel) - Crude Futures (NYMerc)	49.72	55.39	57.27	35.82
(Key Reports For Week of April 29)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Durable Goods Orders (March) - % change	-2.8	-0.2	-1.2	-0.3
New Home Sales (March) - 000s of units	1431	1275	1178	1268
Home Re-sales (March) - 000s of units	6890	6820	6820	6860
Real GDP (Q1) - % change, Saar	3.1	3.8	4.0	3.8
Employment Cost Index (Q1) - % change	0.7	0.8	0.9	0.9

The government's initial reading of the economy's first-quarter performance confirmed the widely-held view that we are indeed in the midst of a soft patch. According to the Commerce Department's figures, real GDP increased by an uninspiring 3.1 percent annual rate in the first quarter, the slowest in two years and a far cry from the muscular 4.4 percent increase in 2004. But it was not so much the reality of the highly-telegraphed soft patch that bothered the financial markets, which responded negatively to the numbers. After all, the economy had emerged unscathed from a similar pothole last year, and few expect the loss of momentum this time to extend into the second half of 2005.



What appears to be seeping into market psychology is the resurrection of the infamous stagflation concept that played havoc with the economy and financial markets in the 1970s. This notion describes an economy that is growing more slowly than its potential even as inflation increases. To a certain extent, the first-quarter data would seem to encapsulate this unhappy mix of growth and inflation. The 3.1 percent increase in GDP was below the economy's potential growth rate, which is generally considered to be about 3.5 percent. Meanwhile, most of the broad inflation numbers as depicted by the so-called GDP deflators increased in the first quarter. The most conspicuous acceleration was in Fed chairman Greenspan favorite measure, the personal consumption price deflator less food and energy items -- the core PCE -- which shot up by 2.2 percent. That's the fastest quarterly increase since the fourth quarter of 2001, and up from 1.7 percent in the fourth quarter of last year. Even more alarming, the overall GDP deflator, including prices paid by businesses, governments as well as consumers, accelerated to a 3.2 percent annual rate, the sharpest rise in 12 years.

It's quite possible that the stagflation notion will linger, and even gain more adherents in coming months. A closer look at the first-quarter GDP data reveals some elements that suggest growth in the second quarter will also come in below par. For example, businesses accumulated \$80.2 billion of inventories in the first quarter, which exceeded last year's buildup by more than 75 percent and contributed fully 1.2 percentage points to the first-quarter's growth rate. If this stockpiling of merchandise were done voluntarily in anticipation of stronger consumer demand, the ramifications for future growth would be more positive than negative. But by all accounts, a big chunk of the increase-- especially in autos -- was involuntary, which suggests some pullback in orders and production in the months ahead. Detroit has already announced cutbacks in production plans to bring inventories more in line with sales.

For another, the rise in oil prices has apparently taken a big bite out of consumer discretionary purchases, and is likely to remain a curbing force for at least a while longer. Indeed, the oil drag will be considerably larger in the second quarter than it was in the first, as most of the rise in gasoline prices has taken place since early March. And, with overseas economies outside of Asia suffering even more of a slowdown than the U.S., the gaping current account deficit, which siphoned 1.5 percentage points from GDP in the first quarter, is not likely to narrow anytime soon. Finally, businesses are still striving to pass-through higher energy costs to consumers; to the extent they are successful, the inflation measures will continue to flare-up even as economic growth slows.

On the surface, therefore, the stagflation story may well gain some credibility as the second quarter unfolds. That said, it is highly unlikely the economy will be mired in anything like the quagmire that existed in the late 1970s and early 1980s, when inflation and unemployment rates ran as high as 13 percent. True, oil was a big catalyst behind the economy's woes then, just as it is today. But the 1970s oil shock was mainly supply-driven, precipitated by OPEC cutbacks, which had a severe psychological as well as fundamental impact on the economy. The latest oil spike, in contrast, is primarily the result of stronger demand, particularly from China, and oil producing nations are ramping up output as much as possible to meet global energy needs. Even so, the U.S. economy is far less vulnerable to higher energy prices now than it was in the 1970s, as the amount of oil and gas required to produce a unit of output has been slashed by more than 50 percent over the past thirty years.

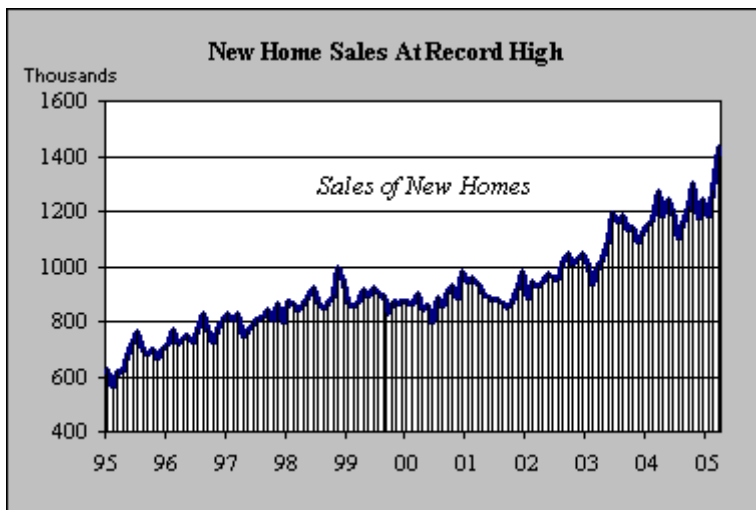
To be sure, should oil prices skyrocket to the level of the 1970s and early 1980s in real terms -- about \$90 in today's dollars --

the economic impact would still be palpable, perhaps even bringing on a recession. But given the recent behavior of the oil market, that does not seem likely. Indeed, the sensitivity of oil prices to slower global growth may already be showing up, as crude quotes plunged below the \$50 psychological threshold this week from a recent peak of over \$58. If prices at the pump follow suit, the consumer drag may end much more quickly than is now envisioned. As it is, households are holding up quite well despite absorbing higher energy bills.

While durable goods purchases stagnated in the first quarter that was mainly due to a decline in vehicle sales which had been pumped up by aggressive incentives late last year. Spending on other big-ticket items, such as furniture and housing-related equipment, continued to grow at a respectable pace. In fact, the 3.5 percent increase in total real consumer outlays, while down from 4.2 percent in the fourth quarter, was nothing to sneer at, at it exceeded the increases in 2002 and 2003 when consumers were still striving to satisfy pent-up demand left over from the 2001 recession. Granted, the first-quarter increase was largely front-loaded, reflecting strong consumer spending in January that gradually dissipated in February and March. Given that loss of momentum, consumer spending will more than likely show a smaller increase in the second quarter than in the first.

But if the oil drag diminishes, the momentum behind consumption should pick up over the summer months, leading to a stronger growth rate over the second half of the year. Indeed, the resilience in housing-related purchases in the first quarter may well be retained over the summer, giving the second-quarter much-needed support. That's because the housing market still refuses to roll over, notwithstanding dire predictions that the real-estate bubble is on the verge of collapse. Industry experts may be scratching their heads over the ongoing willingness of households to take on such a huge financial commitment as a home purchase in the face of a slowing economy and persistent Fed-induced rate hikes. But commit they are, as the latest housing data released this week reveal.

First, the National Association of Realtors reported that sales of existing homes in March posted a respectable 1 percent increase from an already near-record level in February. At 6.89 million units, sales stood only a tad below the all-time high of 7.02 million units reached last June. But the real shocker came from the Census Bureau, which reported that new-home sales soared 12.2 percent in March, hitting a new record high of 1.43 million units. This gain came as such a surprise and was so much of an outlier relative to both expectations and recent sales that it no doubt exaggerated the strength in home sales. Nonetheless, as we said, industry experts are searching for answers for this ebullient sales market, resulting in an abundance of theories. They range from the belief that households are substituting real estate for stocks as an investment vehicle to the simple notion that people are buying in advance of expected higher mortgage rates and house prices. Whatever the reason, the robust pace of home sales portends ongoing strength in purchases of furniture and other housing-related goods, such as appliances, carpeting and the like, over the near term..



If, as we expect, the economy recovers from its latest soft patch and hops back onto a faster growth track over the second half of the year, the stagnation component of the stagflation thesis will be erased. But what about the inflation component, which clearly accelerated in the first quarter? No doubt, the trend in inflation is up, something that is to be expected as an expansion matures and the slack in labor and product markets diminishes. But the trend is starting from a historically low base -- one that bordered on deflation less than two years ago -- and a 2 1/2 core inflation rate is hardly comparable to the double-digit increases seen in the 1970s. What's more, unlike the 1970s, the inflation embers are not being ignited by sharply rising labor costs.

Indeed, a key measure of labor costs released this week reveals that just the opposite may be taking place. According to the government's comprehensive Employment Cost Index, labor cost pressures actually receded in the first quarter, rising by just 0.7 percent compared to 0.8 percent in the previous quarter. Over the past 12-months, the ECI has increased by 3.5 percent, down from a 3.7 percent in 2004 and the slowest annual rate since the fourth quarter of 2002. Critically, the fastest-growing component of labor costs -- benefit payments, such as social security and health insurance premiums -- slowed considerably in the first quarter, rising 1.2 percent compared to 1.6 percent in the fourth quarter.



Assuming that productivity is running at or near its trend rate of 2.5 percent (the first quarter's figures will be released next week), unit labor costs would be rising at about 1.5 percent, hardly the raw material for an escalating inflation picture. Simply put, fears of a stagnating economy or of a sharp increase in inflation appear to be unfounded at this juncture. Nonetheless, the data will likely continue to highlight one or the other in coming months, stoking confusion and volatility in the financial markets. Once the economy recovers from its oil-driven soft patch, and the Federal Reserve has removed the excessive stimulus from the system, fears of stagflation should give way to more pleasant thoughts about a Goldilocks scenario.