

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 6, 2005

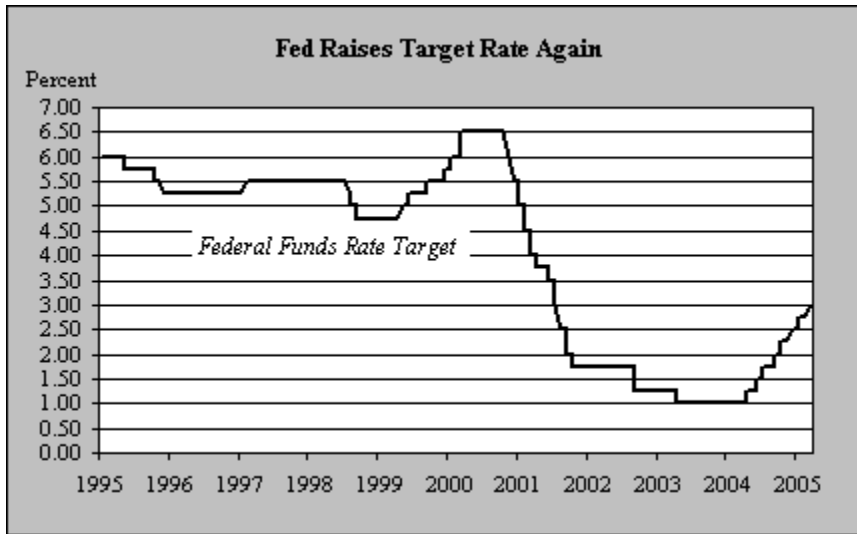
First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 6	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.86%	2.89%	2.77%	0.93%
6-month Treasury bill	3.19	3.18	3.12	1.03
2-year Treasury note	3.72	3.65	3.75	1.86
5-year Treasury note	3.95	3.90	4.14	3.22
10-year Treasury note	4.26	4.20	4.48	4.19
30-year Treasury bond	4.63	4.51	4.76	5.03
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.16	3.22	3.34	2.7
10-Year	3.83	3.90	3.97	3.85
30-Year	4.56	4.60	4.63	4.9
30-year fixed mortgage rate				
	5.75	5.78	5.93	5.79
15-year fixed mortgage rate				
	5.31	5.33	5.48	5.12
1-year adjustable rate				
	4.22	4.21	4.23	3.65
STOCK MARKET				
Dow Jones Industrials	10345.40	10192.51	10461.34	10442.03
S&P 500	1171.35	1156.87	1181.20	1139.32
NASDAQ	1967.35	1921.65	1999.35	2052.88
Commodities				
Gold (\$) - 100 OZ	426.60	435.50	428.60	420.7
Oil (\$ per barrel) - Crude Futures (NYMerc)	50.96	49.72	53.32	34.54
(Key Reports For Week of May 6)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (April) - Index	53.3	55.2	55.3	55.8
ISM Non-Manufacturing Index (April)	61.7	63.1	59.8	61.5
Nonfarm Payrolls (April) - Change in 000s	274	146	300	189
Unemployment Rate (April)	5.2	5.2	5.4	5.3
Nonfarm Productivity (Q1) - % change	2.6	2.1	1.3	2.8

Don't you just love it when a venerable institution such as the Federal Reserve makes an embarrassing gaffe, like leaving out an important sentence in its official policy statement? That's what happened in the aftermath of this week's policy-setting meeting. The omitted verbiage ... "Longer-term inflation expectations remain well contained" was duly inserted in a revised statement that a red-faced Fed issued about 1 1/2 hours after the original one. We just hope that the person responsible for "copying and pasting" from one Word document to another doesn't sit on the decision-making committee.

Nonetheless, after causing a brief spate of financial-market turbulence -- and a bushful of losses for some hedge funds and professional traders -- the gaffe had little net effect on financial asset prices. Nor did it alter the course of events at the Fed, or the thinking of policy makers. At the end of the day, the benchmark federal-funds rate was hiked for the eighth time since last June; the quarter-point increase to 3 percent was both widely expected and generally condoned by investors. And, despite the belated insertion of the misplaced sentence -- which had been dutifully inscribed in past policy statements -- the message

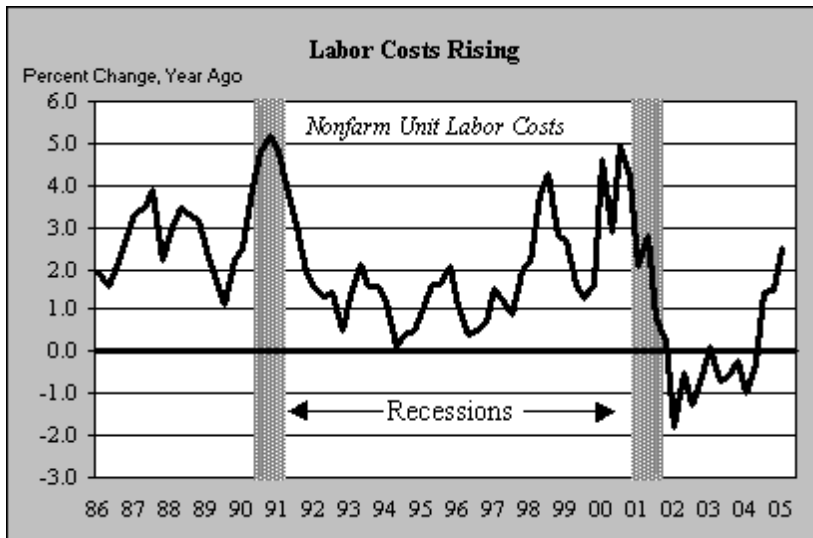
conveyed by the official missive was that more rate hikes are in store.



Yes, the party line about inflation expectations being contained was restored. But the Fed left little doubt that it thought the greater risk to the economy is higher inflation, not recession. Indeed, one phrase that was not carried over from the previous policy statement ... "the rise in energy prices has not notably fed through to core consumer prices" ... confirms that bias. The reason for dropping this key phrase is simply that the inflation landscape has changed in recent months. Core consumer prices, for example, are increasing at the fastest pace in more than two years, and other inflation measures are also perking up. Importantly, there are signs that labor costs are adding to these price pressures, a dynamic that until recently has been generally missing from the current business cycle.

To be sure, the data on labor costs can be misleading, as different figures frequently convey different messages. The monthly series on hourly earnings contained in the employment reports has been painting a weaker picture of labor costs than the more comprehensive quarterly employment cost index, which includes soaring benefit expenses paid by employers as well as wages. Last week, we saw that even the ECI moderated somewhat in the first quarter, thanks to a deceleration in the benefit component. However, another element that must be considered is productivity, which is a critical offset to labor compensation. Stronger productivity growth means that more output is generated per hour of work, which lowers unit labor costs, and vice versa.

According to this week's Labor Department's figures, worker productivity actually strengthened in the first quarter, but labor compensation increased even faster. During the period, the 4.8 percent increase in labor compensation among nonfarm workers exceeded the 2.6 percent gain in worker productivity, resulting in a 2.2 percent increase in unit labor costs. This marked the third consecutive quarterly increase in unit costs following two years of outright declines. The turnaround is particularly striking when seen on a year-over-year basis. Over the past twelve months, unit labor costs are up by 2.5 percent through the first quarter, the fastest pace since 2000, when the Fed pushed the funds rate to a cyclical high of 6.5 percent to stave off inflationary pressures.



Needless to say, the situation today is far different from what it was earlier in the decade. Even the Fed, with its clear bias towards keeping inflation in check recognizes that inflationary pressures are far from out of control. That point was driven home as recently as Thursday when, after a speech in Chicago on derivatives, Fed chairman Greenspan remarked that global forces are keeping inflation low. Greenspan also believes companies can readily absorb higher labor costs without boosting prices, thanks to fat profit margins that are close to postwar highs. Fed Governor Kohn recently supported this view, noting that "The margin of prices over unit labor costs is high by historical standards, and firms should be able to absorb some increases in labor costs without passing them on in prices." This does not sound like a Fed that is about to pull the rate-hiking trigger aggressively in response to the recent upcreep in inflation.

But the Fed is also not wavering from its long-standing contention that the economy will soon emerge from its soft patch and, hence, justify its goal of removing all monetary stimulus from the system. While some analysts feel that a funds rate of 3 percent is close to neutrality, the latest policy statement makes it clear that there is still a ways to go. The key phrase here is ... "the stance of monetary policy remains accommodative" -- a sure sign that the benchmark funds rate is still too low in the minds of policy makers. True, the statement also noted that... "policy accommodation can be removed at a pace that is likely to be measured" ... a highly controversial phrase that indicates future moves will continue to be in quarter-point increments. But Fed officials acknowledge that this phrase will not be retained forever, as it limits their flexibility to step up the rate hikes if deemed necessary without causing serious disruptions in the financial markets.

If Friday's employment report is any indication, the end-date for that phrase may be closer at hand than was thought a few weeks ago. What the report revealed was that job creation in April was far stronger than anyone had predicted. During the month, the economy generated an outsized 274 thousand new jobs, about 100 thousand more than economists had expected and nearly twice the March increase. What's more, both the March and February numbers were revised upward, by a collective total of 93 thousand jobs, which raises the question of just how soft the "soft patch" is. After all, monthly payrolls have risen on average by a solid 240 thousand over the past three months and by 211 thousand for the year to date. That's far and away enough to absorb the growth in the labor force and still reduce unemployment.

