

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 13, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.81%	2.86%	2.77%	0.98%
6-month Treasury bill	3.12	3.19	3.09	1.33
2-year Treasury note	3.60	3.72	3.49	2.54
5-year Treasury note	3.82	3.95	3.87	3.9
10-year Treasury note	4.12	4.26	4.24	4.77
30-year Treasury bond	4.49	4.63	4.59	5.49
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.23	3.16	3.30	3.44
10-Year	3.84	3.83	3.97	4.43
30-Year	4.58	4.56	4.62	5.24
30-year fixed mortgage rate				
	5.77	5.75	5.91	6.34
15-year fixed mortgage rate				
	5.33	5.31	5.46	5.72
1-year adjustable rate				
	4.23	4.22	4.30	3.9
STOCK MARKET				
Dow Jones Industrials	10140.12	10345.40	10087.51	1012.87
S&P 500	1154.05	1171.35	1142.62	1095.66
NASDAQ	1976.80	1967.35	1908.15	1904.25
Commodities				
Gold (\$) - 100 OZ	420.40	426.60	426.40	377.1
Oil (\$ per barrel) - Crude Futures (NYMerc)	48.67	50.96	50.49	39.39
(Key Reports For Week of May 13)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (April) - % change	1.4	0.4	0.7	0.6
Retail Sales ex. Autos (April) - % change	1.1	0.2	0.7	0.6
Trade Deficit (March) - mlns of \$s	54986	60570	58504	57518
Business Inventories (March) - % change	0.4	0.5	0.9	0.6

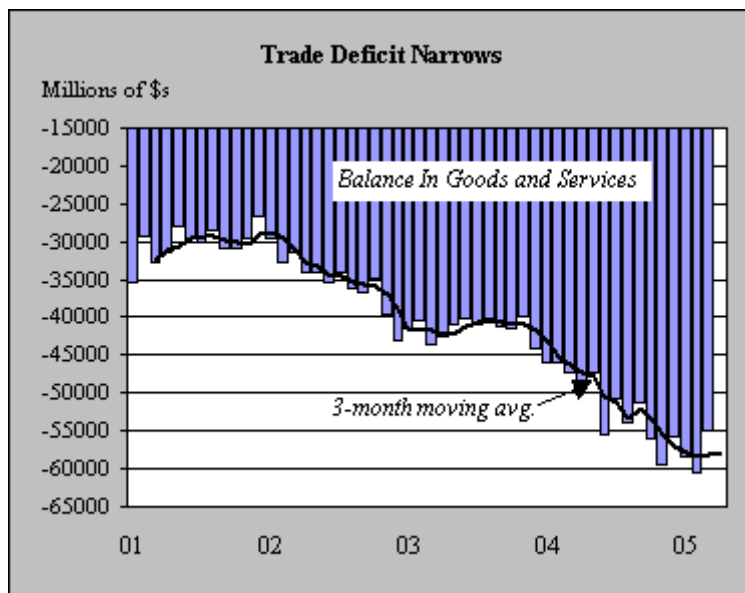
In the blink of an eye, it appears that all of the hoopla over the soft patch is now history. Not only are the incoming numbers for April negating the softness described in the March data, they are obliterating them. What's more, every new bit of information is being accompanied by a revised reading showing more strength in the old figures. This was the case with last week's strong jobs report for April, and was repeated in this week's retail sales report. Add to the mix a drastic shrinkage in the trade deficit for March, also reported this week, and whatever incipient softness in the first quarter that was thought to be in place a few weeks ago does not seem to be carrying over into the second quarter.

To be sure, the monthly figures can be notoriously volatile. They are especially vulnerable to capricious influences during March and April due to rapid weather changes and the timing of the Easter holiday. In all likelihood, the original March numbers overstated the economy's underlying weakness and the incoming April data exaggerates the economy's strength. Averaging out the two months provides a better perspective, and reveals an economy that is growing at about its potential growth rate of 3.5 percent or perhaps somewhat better. That's enough to remove the stag from the stagflation story, albeit the

inflation component is still an open question.

Indeed, the poster child for the so-called soft-patch -- the weak 3.1 percent growth rate in first-quarter GDP reported last month -- has put on some muscle, thanks to revised and new data since the report came out. The steroid most responsible for beefing up the figure is the latest reading on the trade deficit, which originally was calculated to have subtracted 1.49 percentage points from GDP during the period. But when the original tabulation was made, the Commerce Department only had hard numbers for January and February, forcing it to estimate the March tally. As it turns out, the estimate was far too high. The statisticians assumed that the monthly figure would not materially change the quarterly deficit estimate, but the March trade gap took an unexpected nosedive, shrinking by the sharpest amount in three years.

Instead of an expected figure of about \$61.5 billion, the latest trade report, released this week, revealed that the deficit plunged by \$5.5 billion in March to \$54.99 billion. This drove the number-crunchers back to the drawing board, as the deficit clearly subtracted much less from GDP than was originally thought. To be sure, there are offsets to consider before a final estimate can be made. For example, there is a link between the trade deficit and inventories, which surged by \$80.2 billion in the first quarter, adding 1.2 percentage point to GDP. A good chunk of the inventory buildup consists of imported goods, so if imports were less than originally estimated there is a good chance that inventories were lower as well, thus removing some of their contribution to growth.

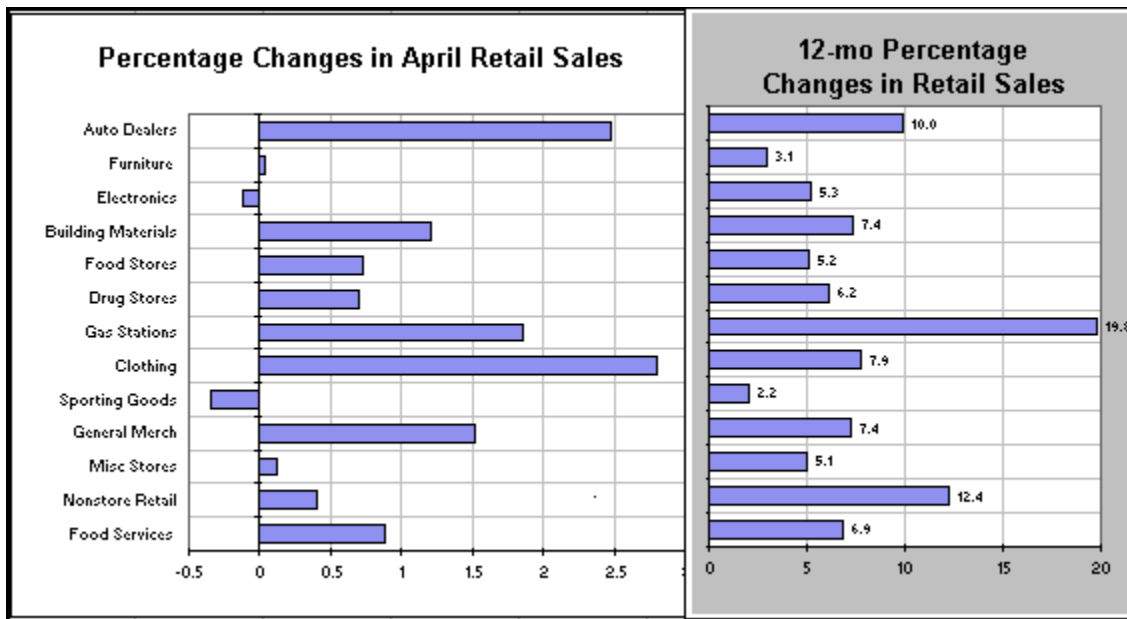


As it turns out, Friday's report on inventories for March did show less of an inventory buildup than was assumed in the initial GDP estimate. But the shortfall only accounted for about a third of the drop in imports; hence, it should not materially water down the upward revision to the first-quarter growth rate that is scheduled to be released on May 26. The consensus of economists now expects that the new number will show a growth rate of close to 4 percent instead of 3.1 percent. If that's the case, the slowdown hardly qualifies as a soft patch that generated so much concern and uncertainty in the financial markets over the past month. Just a few weeks ago, the markets were pricing in a possible pause in the Federal Reserve's rate-hiking campaign sometime this summer. Now, the speculation is whether the Fed will accelerate its tightening strategy to cool off inflationary pressures.

This shift in sentiment closely parallels the radical shift in consumer behavior that appears to be taken place. A month ago, the fear was that consumers were running out of steam, beset by higher energy prices, sluggish job growth and lagging incomes. The tepid increase in March retail sales corroborated that notion. But, like the jobs report last week, the government unleashed a retail sales report this week that both revised up the February and March gain and showed an astonishing increase for April that was nearly twice as big as the consensus estimate. During the month, sales surged by 1.4 percent, powered by an incentive-laden boost in auto sales. But the auto-buying binge was only part of the story, as sales of just about everything else also staged impressive gains.

Indeed, non-auto sales jumped by 1.1 percent, also about double expectations, following a weak 0.2 percent increase (revised from 0.1 percent) in March and an upwardly revised 0.7 percent gain in February. Yes, a price-driven 1.9 percent increase in gasoline sales contributed to the overall strength. But contrary to conventional wisdom, the increased cost of filling up at the pump did not deter households from purchasing other products. Sales were stepped up for general merchandise, clothing, and

at eating and drinking establishments, all areas that were weak in March. Since these purchases tend to be heavily influenced by weather, we are inclined to believe that climatic as well as the early Easter played a role in the April sales strength.



Still, the April strength in consumer spending casts a different light on where the economy is heading in the second quarter. Before the April rebound, the consumer engine seemed like it would not provide any thrust to growth in the second quarter, as sales in March stood a puny 0.2 percent above the first-quarter average. With the April data in hand, that picture changes dramatically, as sales now stand a robust 4 percent above the first-quarter average. In other words, consumers are imparting a good deal of momentum to growth in the second quarter, undermining expectations that the soft patch would linger and infect the second quarter's reading as well. While that no longer seems to be the case, it is somewhat ironic that economists, according to a Wall Street Journal survey printed on Friday, are marking down their second-quarter growth forecasts by about a half percentage point.

Interestingly, the survey was taken after the blockbuster jobs report for April was known (but not the latest retail sales report), suggesting that they agree with our assessment that the April numbers likely overstate the economy's strength. The Fed is probably in accord with that perception as well, and will await the data for May before altering its current policy strategy of hiking interest rates in measured quarter-point increments. Understandably, the consensus among economists is that the economy still has some formidable hurdles to overcome, including still-high gasoline prices that may yet drag down consumer spending as we head into the peak driving season. Furthermore, the robust job growth in April is not consistent with consumer surveys, which reveal increased pessimism about job prospects.

Indeed, if things were that good in April, it certainly does not show up in the latest sentiment index compiled by the University of Michigan. In early May, the index that summarizes household attitudes with regards to present and future economic conditions fell to 85.3 from 87.7 in April. If that early-May number holds up for the rest of the month, it would mark the fifth consecutive drop and bring it to the lowest point in more than two years. What's more, the financial markets do not seem convinced that the economy is gaining as much traction as the April numbers suggest. If demand were improving as much as the retail sales data indicate, the stock market would be upping its earnings outlook, if only because of the enhanced pricing power that stronger sales permit. But stock prices have been trendless over the past month, and ended the week with a loud thud despite the more muscular economic readings.

Additionally, the bond market is hardly behaving like the economy was gaining traction and lighting the inflation embers. After hitting a high of 4.64 percent in late March, the 10-year Treasury yield has since fallen like a stone, ending this week at 4.12 percent, the lowest in three months. To be fair, however, the Treasury market is outperforming other sectors of the bond market for a variety of reasons that may or may not reflect underlying economic fundamentals. One thing is sure, a spate of unusual events in recent weeks has made investors much more risk averse, which clearly favors this high-quality asset. Most conspicuously, in a move that has caught the attention of even the most casual market watcher, Standard & Poor's downgraded the debt of both General Motors and Ford Motor Company to junk status.

Just why this has generated headlines is easy to understand, given the astonishing size of the debts involved. According to

S&P calculations, GM and Ford bonds totaling \$291.8 billion and \$161.3 billion, respectively, lead the pack of past "fallen angels" by a wide margin. No one else is even close, as the next largest debtor to suffer a downgrade to junk was WorldCom with \$30 billion outstanding. The following table strikingly reveals how much the GM and Ford totals tower over past "fallen angels". Granted, it's unlikely that the downgrades of the automakers will be contagious and spread throughout the corporate bond market. Nonetheless, investors are shifting funds from riskier assets to Treasuries, causing some widening out of quality yield spreads and depressing Treasury yields. The move so far has been relatively modest, leaving spreads still narrow in the context of the past several years. This suggests that investors remain generally confident that no major "accident" is about to occur. But for old-timers like us, it is hard to forget the old adage that "what's good for GM is good for America" -- as it implies that the reverse is true as well.

LEADING GLOBAL FALLEN ANGELS 1987 - 2005(YTD)						
Date	Company	From	To	Subsector	Country	Affected Debt (\$B)
5/5/05	General Motors Corp.	BBB-	BB	Automotive	U.S.	291.8
5/5/05	Ford Motor Co.	BBB-	BB+	Automotive	U.S.	161.3
5/10/02	WorldCom Inc.	BBB	BB	Telecom	U.S.	30.0
12/2/02	El Paso Corp.	BBB	BB	Utility	U.S.	21.2
2/7/91	Chrysler Corp.	BBB-	BB+	Automotive	U.S.	20.6
8/3/04	AT&T Corp.	BBB	BB+	Telecom	U.S.	17.0
8/14/02	Vivendi Universal S.A.	BBB-	BB	Media & Ent.	France	16.6
12/22/97	Korea Development Bank	BBB-	B+	Bank	Korea	13.8
11/28/01	Enron Corp.	BBB-	B-	Utility	U.S.	13.6
7/23/02	Williams Companies Inc.	BBB	BB+	Utility	U.S.	13.0
5/22/02	Qwest Communications Int'l	BBB-	BB+	Telecom	U.S.	12.9
1/16/01	Edison International	BBB-	CC	Utility	U.S.	11.3

Source: Standard & Poor's Global Fixed Income Research