WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 20, 2005

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 20	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.88%	2.81%	2.91%	1.02%
6-month Treasury bill	3.16	3.12	3.13	1.37
2-year Treasury note	3.66	3.60	3.60	2.55
5-year Treasury note	3.87	3.82	3.92	3.9
10-year Treasury note	4.12	4.12	4.25	4.75
30-year Treasury bond	4.44	4.49	4.58	5.46
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.15	3.23	3.26	3.43
10-Year	3.79	3.84	3.94	4.37
30-Year	4.55	4.58	4.63	5.24
30-year fixed mortgage rate	5.71	5.77	5.80	6.3
15-year fixed mortgage rate	5.27	5.33	5.36	5.67
1-year adjustable rate	4.26	4.23	4.26	3.99
			1.54	2.31
STOCK MARKET				
Dow Jones Industrials	10471.91	10140.12	10157.71	9966.74
S&P 500	1189.28	1154.05	1152.12	1003.59
NASDAQ	2046.42	1976.80	1932.19	1912.09
Commodities				
Gold ($)- 100 OZ		420.40	436.10	384.9
Oil ($ per barrel) - Crude Futures (NYMerc)		48.67	55.39	38.46

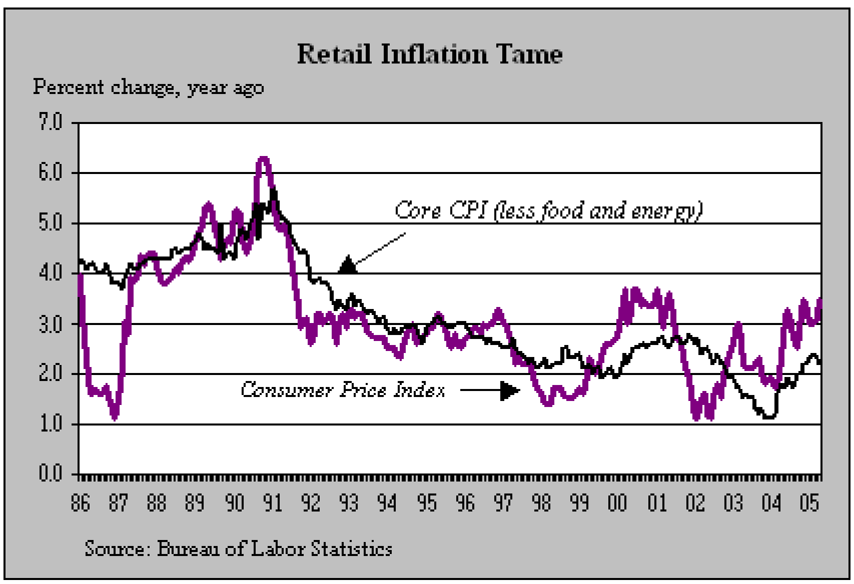
	(Key Reports For Week of May 20)			
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (April) - 000s of units	2038.0	1836.0	2228.0	2025.0
Industrial Production (April) - % change	-0.2	0.1	0.5	0.2
Producer Price Index (April) - % change	0.6	0.7	0.4	0.4
Core PPI (April) - % change	0.3	0.1	0.1	0.3
Consumer Price Index (April) - % change	0.5	0.6	0.4	0.3
Core CPI (April) - % change	0.0	0.4	0.3	0.2

The stagflation concerns that permeated the financial markets a few months ago are fading almost as quickly as they emerged. Recall that virtually all of the March data revealed an economy that was limping into the second quarter with an uncertain gait. This fading growth backdrop was summarily encapsulated by the government's GDP report, released in late April, which revealed an economy that slowed to a 3.1 percent annual rate in the first quarter, the weakest increase in two years and off significantly from the 4.4 percent pace recorded in 2004. Meanwhile, the growth slowdown coincided with a broad array of inflation indicators, led by soaring energy and other commodity prices, that strongly pointed to increasing price pressures throughout the economy. Slowing growth and rising inflation are two sides of the stagflation pincers that seemed to be closing in on an ever-jittery financial markets, and posing the ultimate dilemma for the Federal Reserve seeking the proper balance of stimulus and restraint to apply to the economy.

But in the past month or so, the pincers have been loosening their grip on both the economy and financial markets, and the wonder now is what all the fuss was about. In contrast to the weak March numbers, virtually all of the April data have come in above expectations, most dramatically in the form of a strong rebound in job creation and retail sales. What's more, upward revisions put additional muscle on the initially-weak March readings, and the surprising fall in the trade deficit that month will almost certainly result in an upward adjustment in the first-quarter GDP figures when they are released on May 26. The consensus is that the second reading will put the growth rate at 3.6 percent, but some economists estimate that the pace could be revised up to 4 percent. Simply put, the "stag" has been taken out of the stagflation equation, leaving the inflation component as the major source of concern. Or is it?

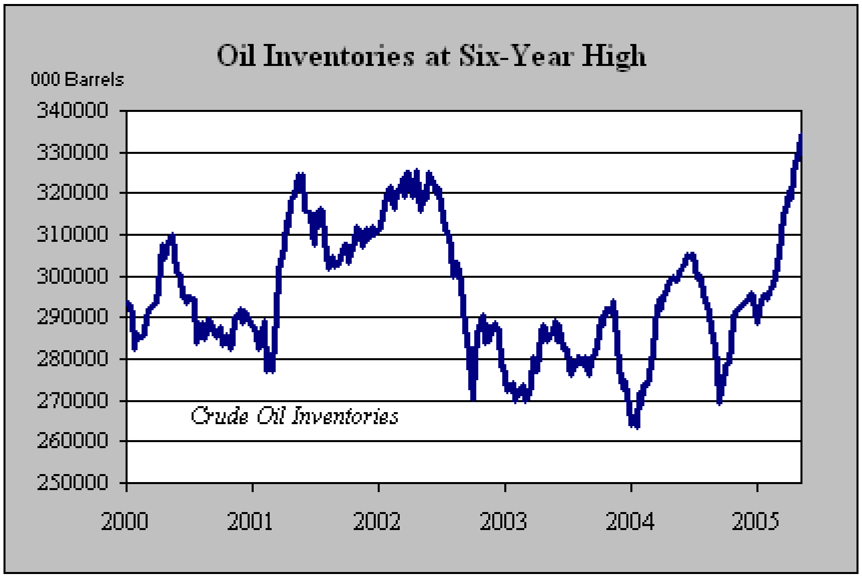
Most remarkably, the inflation component now also seems to be fading. This turnabout is particularly puzzling since economic logic would seem to point in just the opposite direction. After all, if the job market is gaining traction and consumer spending is picking up momentum, as the latest data suggest, the most likely result should be an escalation in labor costs pressures and greater pricing power on the part of merchants. Yet, neither seems to be happening. Indeed, if this week's report on consumer prices is any indication, retail inflation receded markedly in April. Outside of the volatile food and energy components, the so-called core consumer price index actually showed no gain during the month, the first time this has happened since November 2003. Recall that in 2003, the primary fear was that prices were increasing too slowly, and the Federal Reserve was still moving to combat the threat of deflation.

That flat reading in April lowered the 12-month increase in the core CPI to 2.2 percent from 2.3 percent in March and the nearby peak of 2.4 percent in February. Simply put, the road towards a 3 percent inflation rate that many pundits thought was inevitable a few months ago has been derailed, at least for now. What contributed to heightened inflation expectations was the perception that companies were being pressured to pass on rising labor and energy costs to consumers, and they would strive to do so as long as they were successful. But the wage-price pressure is far from reaching the boiling point. True, hourly earnings did post a respectable gain in April, along with the strong jobs increase, boosting the increase over the past year to 2.7 percent from a 52-week low of 2 percent. But the stronger growth in output that is likely to print with the revised GDP report means that productivity is growing faster than originally thought. With more output being spread over the same number of hours worked, unit labor costs are also being scaled back, thus diluting the impact of higher labor compensation and reducing the pressure to pass on labor costs to consumers.



Significantly, the tame reading for the core CPI in April is a strong sign that the climb in energy prices is not feeding through into other prices. This had been a growing concern in previous months as the core index crept upward amid what seemed to be a sharp cyclical fall-off in productivity. But not only is the productivity picture much improved, the energy spiral may now be starting to unwind, a pattern that is eerily reminiscent of last year when gasoline prices peaked just prior to the summer driving season. A month or so ago, the oil market seemed to have nowhere to go but up, as the price of a barrel of crude hovered in the upper end of the $55 - $60 range, refining capacity in the U.S. was thought to be nonexistent, and the clamor for the administration to open the spigot of its petroleum reserve was growing louder. With China's energy needs escalating along with its rapidly expanding economy, thoughts of a spike above $60 a barrel were rampant.

A month later, however, the energy situation seems much less menacing. Instead of climbing north of $60, crude prices have been receding for nearly a month and have recently broken decisively below the $50 threshold, ending at slightly above $47 on Friday. How much of the reversal can be attributed to the unwinding of speculative activity that led to bloated prices in the first place remains to be seen. But some clear improvement in the fundamentals underpinning the oil market is no doubt taking place. The most dramatic change can be seen in the storage tanks, which are filling up to the brim. According to the Energy Information Administration (EIA), crude stocks have increased by 45 million barrels since the end of last year and are at the highest level in almost six years. The last time inventories were this high, crude oil was selling for about $10 a barrel and the price at the pump was less than $1 a gallon for regular unleaded gasoline.



If, in fact, energy prices are destined to repeat the pattern of last year and head lower over the balance of 2005, another major source of inflation will be defused. And as was the case last year, lower energy prices will free up discretionary income for consumers, providing much needed relief for households whose earnings are treading water in real terms. Indeed, according to the Bureau of Labor Statistics, weekly earnings adjusted for inflation are running 0.3 percent below last year's level, despite a modest 0.2 percent increase in April. But if hourly earnings in May match the 0.3 percent gain in April and the workweek expands at even half the outsized 0.6 percent increase it posted last month, workers should enjoy the first increase in real earnings since last September. The increase, in fact, would be magnified depending on how much of the drop in crude oil prices filters through to the consumer level.

With inflationary pressures diminished and growth picking up, the nascent speculation that stagflation is gripping the economy should all but evaporate in the weeks ahead. Indeed, it would not be surprising if the Goldilocks scenario once again begins to capture the imagination of economic forecasters. But this is not the late 1990s, when the New Economy was enjoying a passionate love affair with the high-tech revolution that spurred huge advances in productivity and unleashed unbounded optimism in the financial markets. The Federal Reserve, for one, is not likely to be as patient as it was then, allowing the unemployment rate to drop below 4 percent and ignoring the warning signs that ultimately led to the biggest stock-market bubble -- and subsequent collapse -- in modern history.

Indeed, the Fed is grappling with conundrums in the bond market and trying to get a handle on a real estate market that may or may not be taking on bubble characteristics. Chairman Greenspan first acknowledged the bond market conundrum in February when the 10-year Treasury yield hovered just over 4 percent. At the time, the Fed had already pushed through six quarter-point increases in short-term rates beginning last June and yet the 10-year rate had fallen by more than a half-percentage point over the period. But the mystery of low bond yields soon faded as rising inflation expectations energized the bond bears who drove the rate up to over 4.60 percent by late March. Just as the pundits were predicting $60-$80 oil prices, the bears were convinced that bond yields were firmly on the road to 5 percent. Indeed, this view was in accord with the consensus of opinion held by economists at the start of the year.

But once again the best-laid plans went awry, as the path to higher bond yields has been abruptly reversed. After hitting the 4.60 percent plateau, the 10-year rate has since fallen like a stone and is now flirting with the 4 percent threshold that three months ago invoked Greenspan's conundrum remark. However, in February the most plausible explanation for low Treasury yields was that foreign central banks were gobbling up government securities, both to prevent the dollar from appreciating and to recycle the funds obtained from our burgeoning trade deficit. This time, there are other reasons to explain the slide in Treasury yields, including a safe-haven bid from investors fleeing the corporate market, which has been rattled by some highprofile ratings downgrades, most notably in the auto industry. Not coincidentally, quality yield spreads have widened out significantly in recent weeks. Additionally, the tame inflation data and the drop in oil prices have undoubtedly also contributed to the decline in the 10-year Treasury rate.

As a result, the yield curve has once again flattened, extending a pattern that is following a highly unusual script. While it is not unusual for the spread between long and short-term rates to narrow as an expansion matures, the flattening trend is typically the result of the Fed driving up short-term rates faster than the market drives up bond yields. This time, however, the bond bulls are throwing a monkey wrench in the process, pulling long-term rates lower as the Fed drives short-term rates higher. Hence, instead of foreshadowing slower growth -- and even an end to the expansion -- that is a signature feature of a flatter yield curve, the ramifications now are quite the opposite, as the decline in long-term rates is frustrating the Fed's efforts to remove stimulus from the economy.

The sector that is most effected by the atypical behavior of bond yields is the housing market, which continues to be nurtured by historically low mortgage rates. This week's report that housing starts in April rebounded from a brief slide in March, posting a solid 11 percent gain to 2.23 million units, is a sign that builders are not expecting the demand for residential properties to decline from its ongoing torrid pace anytime soon. That demand, in turn, is spurring double-digit gains in home prices, surging real-estate lending and concerns that the residential market is becoming overextended. Even Greenspan acknowledged this week that the housing market may be showing signs of "froth", a reversal of his earlier position wherein he maintained that appreciating home prices was not the result of speculative activity. Mindful of the stock-market bubble of the late 1990s, the ever-bounding housing market just provides the chairman with more ammunition to keep raising short-term rates, hoping that bond yields will soon follow and prevent the emergence of a full-fledged housing bubble.