WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 27, 2005

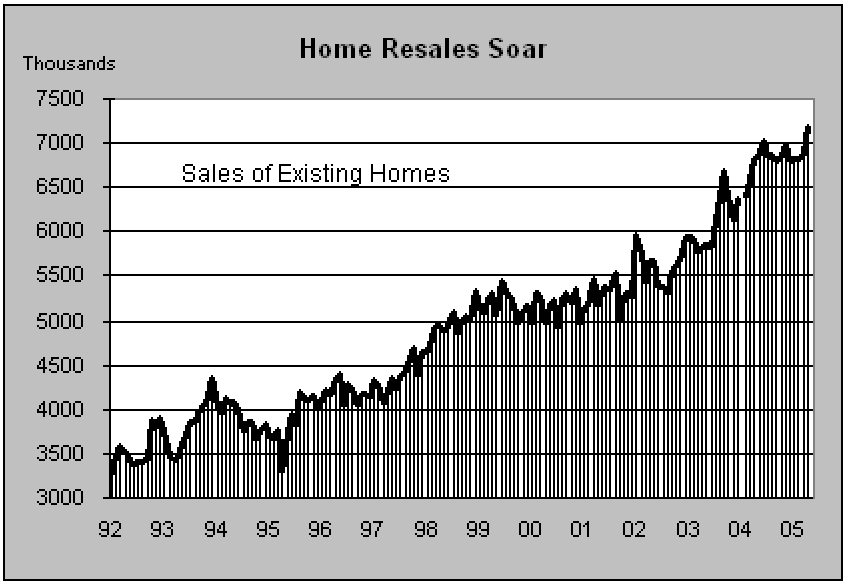
First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.95%	2.88%	2.89%	1.06%
6-month Treasury bill	3.12	3.16	3.18	1.38
2-year Treasury note	3.64	3.66	3.65	2.53
5-year Treasury note	3.81	3.87	3.90	3.79
10-year Treasury note	4.07	4.12	4.20	4.65
30-year Treasury bond	4.43	4.44	4.51	5.34
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.15	3.15	3.22	3.33
10-Year	3.77	3.79	3.90	4.23
30-Year	4.49	4.55	4.60	5.17
30-year fixed mortgage rate	5.65	5.71	5.78	6.32
15-year fixed mortgage rate	5.21	5.27	5.33	5.69
1-year adjustable rate	4.21	4.26	4.21	3.87
			1.57	2.45
STOCK MARKET				
Dow Jones Industrials	10542.55	10471.91	10192.51	10188.45
S&P 500	1198.78	1189.28	1156.87	1120.64
NASDAQ	2075.73	2046.42	1921.65	1986.74
Commodities				
Gold ($)- 100 OZ	422.70	417.60	435.50	394.9
Oil ($ per barrel) - Crude Futures (NYMerc)	51.85	47.50	49.72	38.85
	(Key Reports For Week of May 27)			
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (April) - 000s of units	1316	1313	1256	1250
Existing Home Sales (April) - 000s of units	7180.0	6870.0	6820.0	6913.0
Durable Goods Orders (April) - % change	1.9	-1.6	-0.1	0.4
Revised GDP (Q1) - % change, Saar	3.5	3.8	4.0	3.9
Personal Income (April) - % change	0.7	0.5	0.5	0.7
Personal Consumption (April) - % change	0.6	0.9	0.7	0.6

Six years ago, the cocktail banter was all about the stock-market bubble that was swelling portfolios and capturing the imagination of the American public. Today, of course, it is the hot real estate market that is grabbing headlines and generating both ecstasy and angst among homeowners and policy makers. Indeed, we googled the phrase "housing bubble" this morning and received 2.36 million hits, a sure sign of the public's fascination with a subject that has simultaneously become sexy and ominous. The seductive aspect of the issue is the enormous wealth being generated by an appreciating asset held by more than two-thirds of households. The ominous side is the question of what happens to the economy if the appreciation stops or, more dangerously, morphs into a collapse, much like the stock-market bubble did five years ago.

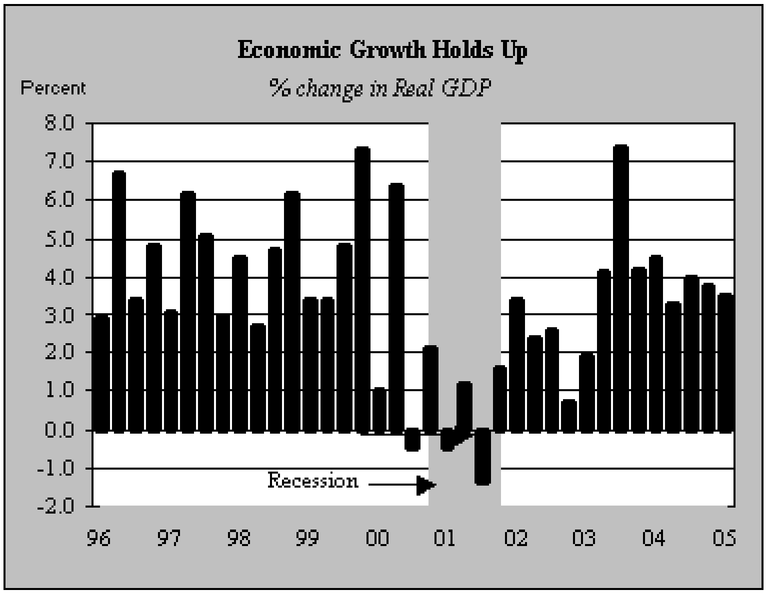
As for the seductive side, it may well be said that a man's home is his castle, but these days it has also become his piggy bank. According to Freddie Mac, the housing agency, more than $712 billion of equity has been extracted from residential real estate over the past four years through a combination of mortgage refinancing and taking out of second mortgages. How important has this extraction been for consumer spending? Consider that the funds obtained by tapping into home equity exceeded the increase in wages and salaries over the period. In other words, the housing boom has been a formidable source of purchasing power for the majority of households.

And, if recent data are any indication, the piggy bank is still overflowing. According to this week's report by the National Association of Realtors, the median price of an existing single-family home hit a record $203,800 in April, a whopping 15.1 percent higher than a year earlier. Nor has the sizzling price appreciation deterred buyers. During the month, sales of existing homes, including coops and condos, surged to a record annual rate of 7.18 million units, up 4.5 percent from March and 5.7 percent from a year ago. While homes listed for sale have also increased, there are few signs of a budding oversupply. Indeed, at the current sales pace, the available inventory would be taken off the market in 4.2 months, which is on the low side of the historical range.



To be sure, re-sales of existing homes are not entirely indicative of current trends in the housing market. That's because these sales numbers are based on closings of transactions initiated months earlier when conditions may or may not have been different. A more immediate indication can be gleaned from sales of new homes, which are recorded at the time a deposit is made and, hence, are more reflective of current conditions. But even here, the signs point to strength. According to the Commerce Department, new-home sales also rose to a new record high in April, hitting 1.316 million units. However, the new-home market is not as frothy as the re-sale market for existing homes, as median prices of new homes only increased by 3.7 percent over the past year to $230,800.

Granted, the wealth effect on consumer spending is difficult to measure, and the funds extracted from housing equity are used for a myriad of purposes, not just spending. This is similar to the situation in the late 1990s, when analysts could only speculate as to how much swollen stock portfolios and capital gains were boosting consumer demand. But the government's latest GDP data provides one indication of the disproportionate impact that housing is having on the economy. As expected, the latest figures, released this week, show that the economy grew at a faster pace than originally estimated -- 3.5 percent versus 3.1 percent -- in the first quarter. Also as expected, the major reason for the upward revision was that the U.S. trade deficit -- which detracts from growth -- was smaller than originally thought.

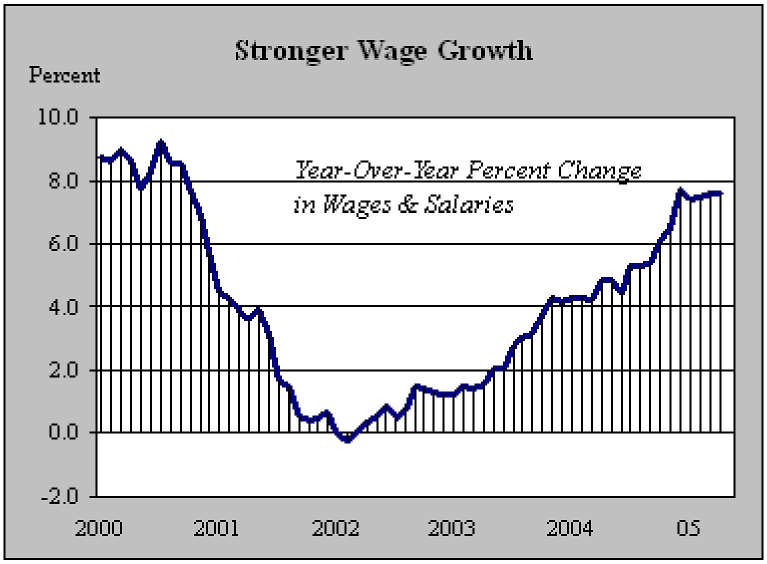


But the second largest revision was in residential investment, which increased by 8.8 percent in the new tabulations, a significant acceleration from the first estimate of a 5.7 percent gain. That might not seem overly important from a broader perspective since residential investment spending only accounts for 5.2 percent of GDP. Despite its diminutive relative size, however, residential outlays accounted for nearly 13 percent of the increase in GDP during the first quarter. Simply put, the housing sector is carrying almost three times its weight in driving the economy. Needless to say, this disproportionate impact on growth works both ways, which is why there is so much concern that the housing bubble might burst.

So is a housing bubble brewing or not? The jury is still out on this issue, but the University of Michigan's latest survey of households weighed in on the ominous side this week, saying that … "Whereas consumers could not resist the enticement of record low interest rates during the past few years, now consumers can not resist the temptation of buying homes in advance of expected increases in mortgage rates and home prices. Attitudes toward home buying conditions have recently displayed nearly all of the characteristics of earlier bouts of advance buying, a reaction that has typically generated economic busts following extended booms, acting to increase the amplitude of economic cycles." The report went on to say: "The best hope is that the current housing boom will be slowly extinguished by continuous increases in mortgage rates, although some price declines are likely on both coasts." To that, we say "amen" and are keeping our fingers crossed.

We agree with Fed chairman Greenspan's assessment that the housing market is showing some "froth" in selected regions, but it is not in the grips of a nationwide bubble built on highly speculative activity. Still, many analysts believe that the hot housing market is carrying the economy, and just a cooling off would impose a serious drag on growth. We would agree with that notion if the economy had no other underpinnings to derive strength from, which is not the case. Had the real estate market turned sour last year when households were still uncertain about job and income prospects, the impact might have been more severe. But the labor market has turned the corner, and paychecks are growing at a steadily increasing pace.

The government's latest tally on personal incomes provides a striking example of how consumers are benefiting from the improving job market. In April, wages and salaries -- the core component of personal incomes -- staged a solid 0.7 percent advance, more than double the March gain, lifting the annual increase to a robust 7.6 percent. A year ago, paychecks were growing at a more subdued 4.9 percent annual pace and workers were obtaining 2.2 percent increases in their hourly earnings. Now, hourly earnings are increasing by 2.7 percent and speeding up. Significantly, household incomes are going further in real terms, as the personal consumption deflator rose less in April than in March.



With real incomes growing, households presumably will not have to rely as much on appreciating housing wealth to support their spending habits. And, with inflation still within the Fed's comfort zone, the central bank can stay on the course of tightening policy at a "measured" pace. Clearly, Greenspan has little desire to bring the housing market to its knees or impose too much of a drag on the economy by overtightening policy. Indeed, the potential harm that steeply higher interest rates could cause to the economy has prompted an increasing number of analysts to ask if the Fed is near the end of the current tightening cycle. Our simple answer is no, for the time being.

If the Federal Reserve truly felt that the tightening cycle was soon coming to an end, it would likely tell us in no uncertain terms. We don't think the Fed would be vague about it. Since the central bank began to increase short-term interest rates last summer, it has been providing unambiguous guidance about its near-term rate intentions, that is to expect 1/4 percent increments in the federal funds rate target at each upcoming FOMC meeting. To date, we have not received any clear and direct public communication from Fed officials that they intend to stop raising rates soon.

For example, nowhere in the following recent public statements do the policy makers even remotely hint that the end of the tightening cycle is close.

"My personal view is that we've not yet reached a neutral policy stance," said Atlanta Fed president Guynn on May 25.

"We still have more ground to cover" in regards to interest rate increases, said Chicago Fed president Moskow on May 24.

"All members regarded the stance of policy as accommodative and judged that the current level of short-term rates remained too low to be consistent with sustainable growth and stable prices in the long run," said the minutes of the May 3 FOMC meeting which was released on May 24.

The Federal Reserve is simply telling us that its work is not finished and will continue to carry on as it has until it indicates otherwise. In other words, don't expect the next quarter-point increase at the upcoming policy-setting meeting on June 29-30 to be the last of this cycle, as some are suggesting. More than likely, the Fed will hike its benchmark short-term rate, now at 3 percent, to at least 3 3/4 percent before indicating a pause in its tightening campaign. Whether that takes some of the froth out of housing remains to be seen. But the economy seems to be strong enough to withstand both modestly higher rates as well as a less torrid real-estate market.