

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 3, 2005

First the numbers, then the story

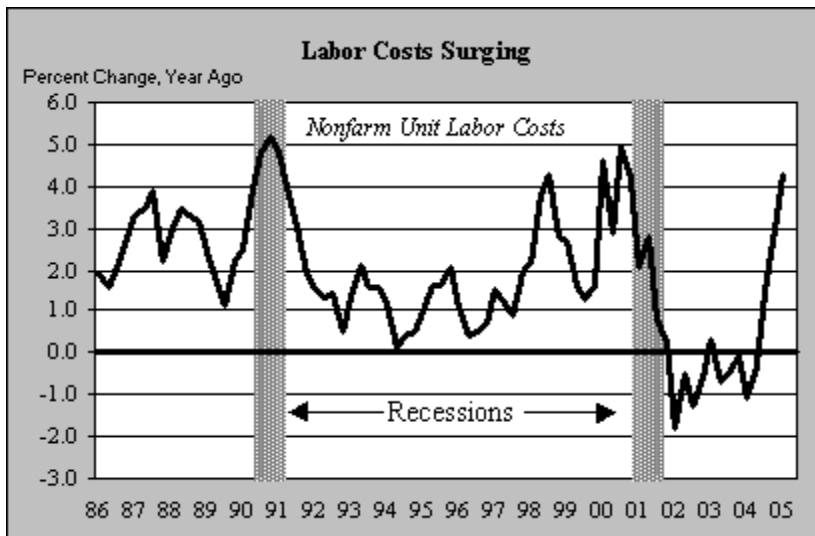
FINANCIAL INDICATORS				
INTEREST RATES	June 3	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.99%	2.95%	2.86%	1.19%
6-month Treasury bill	3.12	3.12	3.19	1.49
2-year Treasury note	3.57	3.64	3.72	2.69
5-year Treasury note	3.73	3.81	3.95	3.95
10-year Treasury note	3.98	4.07	4.26	4.77
30-year Treasury bond	4.29	4.43	4.63	5.46
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.13	3.15	3.16	3.29
10-Year	3.71	3.77	3.83	4.21
30-Year	4.43	4.49	4.56	5.2
30-year fixed mortgage rate				
	5.62	5.65	5.75	6.28
15-year fixed mortgage rate				
	5.20	5.21	5.31	5.63
1-year adjustable rate				
	4.26	4.21	4.22	3.98
STOCK MARKET				
Dow Jones Industrials	10460.97	10542.55	10345.40	10242.82
S&P 500	1196.02	1198.78	1171.35	1122.51
NASDAQ	2071.43	2075.73	1967.35	1978.62
Commodities				
Gold (\$) - 100 OZ	424.90	422.70	426.60	391.7
Oil (\$ per barrel) - Crude Futures (NYMerc)	55.03	51.85	50.96	38.03
(Key Reports For Week of June 3)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (May)	51.4	53.3	55.2	54.8
ISM Non-manufacturing Index (May)	58.5	61.7	63.1	61.0
Consumer Confidence Index (May)	102.2	97.5	103.0	102.5
Nonfarm Productivity(Q3) - % change	2.9	2.3	0.9	2.8
Nonfarm Payrolls (May) - change in 000s	78	274	122	176
Unemployment Rate (May) - Percent	5.1	5.2	5.2	5.2

If the past week is any indication, speculative activity in the financial markets is about to heat up considerably. Indeed, the bell for the opening round has already been rung. The first blow was thrown by Dallas Federal Reserve President Robert Fisher (a voting member of the Fed's rate-setting committee) who opined that the central bank is entering the eighth round of the tightening cycle, implying that the yearlong series of rate increases is nearing an end. Other Fed officials, however, disowned his comments,, and some observers even accused Fisher of making a "rookie" mistake of voicing an opinion not shared by the majority of his colleagues.

True to form, the financial markets seized on Fisher's comments and ran with it as far as it could. The bond bulls declared victory in the war on inflation and took long-term rates briefly down to levels not seen in more than a year, a move that will likely give the real-estate boom more legs. However, the skeptics were not to be denied, noting the improbability of the Fed

shifting course so abruptly after making the most hawkish statement about inflation following its May policy-setting meeting. Indeed, their skepticism seemed to be validated by mounting evidence of rising labor cost pressures, which spurs businesses to lift prices to maintain profit margins. A most conspicuous illustration of these pressures was revealed by the revised productivity numbers released by the Labor Department this week.

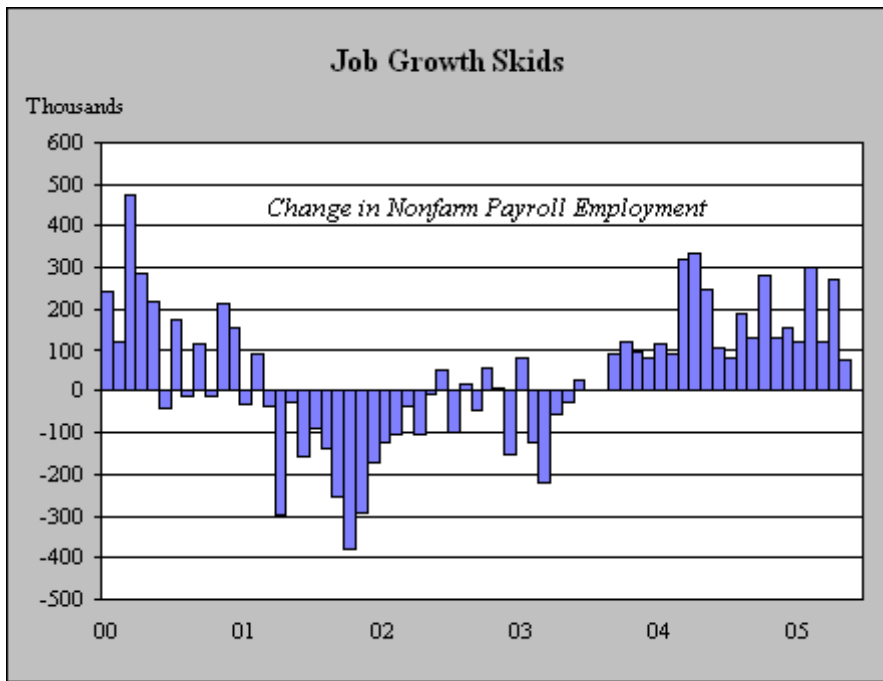
As expected, productivity for companies outside of the farm sector was revised up from 2.6 percent to 2.9 percent in the first quarter, reflecting the upward revision in the economy's growth rate depicted in the government's GDP data last week. But the productivity revision paled in comparison to the upward adjustment in labor compensation over the past two quarters. As a result, it is costing non-farm businesses a hefty dollar to turn out an additional unit of output, a fact shown by the eye-popping rise in unit labor costs in the following chart. Over the past four quarters, unit labor costs have increased by 4.3 percent, the fastest pace in more than four years. What's more, with hours worked up by more than a 3 percent annual rate in April and May, it looks like productivity is poised to slow significantly in the second quarter, unless GDP stages an unlikely growth rate in excess of the first-quarter's 3.5 pace. That means unit labor costs will also continue on its upward trend.



Of course, the climb in labor costs will only translate into higher inflation if businesses can pass on the costs to its customers. This is where the opponents of the inflation hawks enter the ring and give the speculators more ammunition to spar with. For one, the sharp increase in worker compensation, especially the whopping upward revision in last year's fourth quarter, may not reflect tightening labor market conditions that would ordinarily compel companies to pay higher wage rates to attract workers. Rather, it seems that the surge in the fourth quarter, and to a lesser extent the first quarter, represented a bulge in year-end bonuses and other incentive payments (particularly in the real-estate and financial services industries) which are more one-time events instead of an ongoing trend. If that's the case, the climb in unit labor costs should slow in coming quarters as the increase in labor compensation more closely mirrors the demand for and supply of workers.

In fact, the latest Conference Board survey of business executives reveal a very cautious approach to budgeting for salary increases. The executives canvassed expect to give workers a salary increase of 3.5 percent in 2006, precisely the same as this year and the third consecutive year of holding pay raises below 4 percent. Clearly, this conservative approach to salary budgets does not reflect a mind-set that anticipates a growing shortage of labor. Nor, for that matter, does it reflect an overwhelming urgency on the part of businesses to beef up their staffing needs. That may have seemed to have been the case last month, when the Labor Department revealed an outsized 274 thousand increase in payrolls for April, which convinced just about everyone that the job-creating engine had finally shifted into overdrive.

But that mind-set was turned on its head this week. Just as the April surge in hiring was nearly double expectations, the May increase in non-farm payrolls, reported this week, was about half of what the consensus on Wall Street had predicted. During the month, the economy generated a disappointing 78 thousand net new jobs, the smallest increase since August 2003, which greatly deflated the ebullience associated with the previous month's big gain. Simply put, the statisticians in Washington continue to send mixed signals as to the economy's underlying strength, printing strong reports one month followed by disappointing follow-ups the next. And, just as we cautioned not to read too much into the April numbers, we are offering the same advice for the May data.

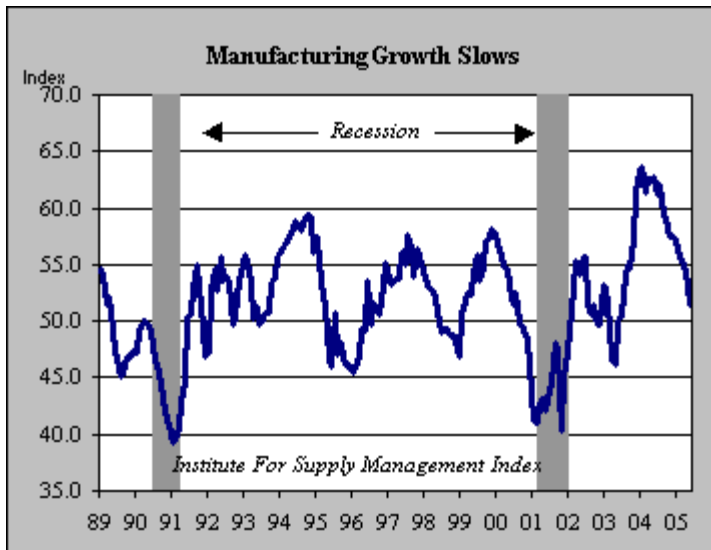


As always, whenever there is much volatility in the numbers, it is best to average out the extremes to gain a clearer picture of the trend. Hence, if the April and May changes are averaged, the net result is a gain of 176 thousand jobs a month. That's not materially different from the 186 thousand average gain over the prior 12 months (ending in March), the 3-month average of 182 thousand or the six month average of 186 thousand. In other words, the latest jobs report -- admittedly the key economic missive for the month -- does not signify that the sky is falling. Indeed, a closer look at the details suggest that the May report itself is not an unmitigated disaster, as the headlines will likely convey over the weekend.

For one, the unemployment rate actually slipped from 5.2 percent to 5.1 percent during the month, the lowest since September 2001. This metric, which is derived from the household survey rather than the company survey that produces the payroll numbers, mirrors other indicators that also suggest less slack in the labor force. For example, the employment/population ratio rose to a cycle high of 62.7 percent, the labor force participation rate inched up, and the length of time job-seekers were out of work fell to a near-cycle low of 18.8 weeks from 20 weeks in April. Finally, two of Alan Greenspan's favorite barometers of slack in the labor force turned stronger last month. The "pool of available labor" shrunk from 12.797 million in April to 12.375 million in May and the number of workers voluntarily quitting their jobs jumped from 847 thousand to 942 thousand last month. Greenspan would interpret the increase in the quit rate as a sign that workers feel more secure in their ability to find a new job.

So, what does the Fed do next? On the margin, the tide has probably shifted a bit away from the strong anti-inflation mentality that prevailed at the May 3 policy-setting meeting. After all, not only have the inflation data subsided from the worrisome flare-up that seemed to be underway during the spring, there is now some indication that the economy's growth engine may be downshifting once again. In addition to the sluggish gain in payrolls for May, the Institute of Supply Management revealed a marked slowing in both manufacturing and service-sector activity during the month.

Indeed, the ISM index of manufacturing activity moved lower for the sixth consecutive month, and the May reading, at 51.7 is just barely above the 50 threshold that separates growth from outright contraction. Significantly, the prices paid index plunged from 71 to 58, which is the steepest one-month drop since July 1973 and another indication that the run-up in commodity prices has ended. According to some studies, there is a close correlation between Federal Reserve rate actions and the ISM price movement. Granted, the weakness in manufacturing is heavily influenced by the travails of domestic automakers, which continue to suffer sales losses to Japanese nameplates and are forced to offer steep price discounts to move unsold inventories. The latest campaign of General Motors, offering all customers the same discount as GM employees, is just the most recent example of this. But Detroit is now moving more aggressively beyond pricing to pare inventories, as both GM and Ford announced significant production cuts in the third quarter.



Needless to say, these planned cuts will prolong the sluggishness in manufacturing. Not only does auto production account for a sizable proportion of overall industrial output, the actions of automakers have ripple effects throughout the production chain. Producers of steel, for example, are likely to feel the sting, as well as textile companies that provide the fabric for auto interiors, such as car seats. But the latest sign of economic slowing goes beyond the manufacturing sector. Just as the employment report revealed a slowdown in hiring in the service industries, so too has the ISM index of service-sector activity also ratcheted lower. About an hour after the jobs report was released on Friday morning, the ISM reported that its non-manufacturing index fell from 61.7 in April to 58.5 in May, the lowest level in two years.

Since services account for more than 80 percent of overall economic activity, the slowdown among service providers would seem to have a more profound influence on the Fed's thinking. Our sense, however, is that the policy makers will view the latest bump in the road as a transitory development, much as they did the so-called soft patch that appeared to be unfolding earlier in the year. Perhaps Alan Greenspan will provide us with some insight into the Fed's thinking next week. On Monday, Greenspan will give a speech to an international monetary conference at the Peninsula Palace, Beijing, via satellite and on Thursday the chairman will testify before the Joint Economic Committee on the Fed's economic outlook.

For all intents and purposes, another quarter-point rate increase is baked in at the next policy-setting meeting on June 29-30. Failure to do so would probably send the wrong message about what constitutes a neutral fed funds rate. But Fisher's comment that we are in the eighth inning in this tightening game will be put to the test shortly after that meeting when the next jobs report comes out. If the hiring slump in May is replicated in June, the Fed may well call a "time out" to assess whether a 3 1/4 percent funds rate is indeed having a more restrictive impact on a heavily-leveraged economy than desired. But if the economy is poised to stage a solid advance in the second half of the year, as most economists believe, the road to neutrality still has a ways to go.