

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 10, 2005

*First the numbers, then the story*

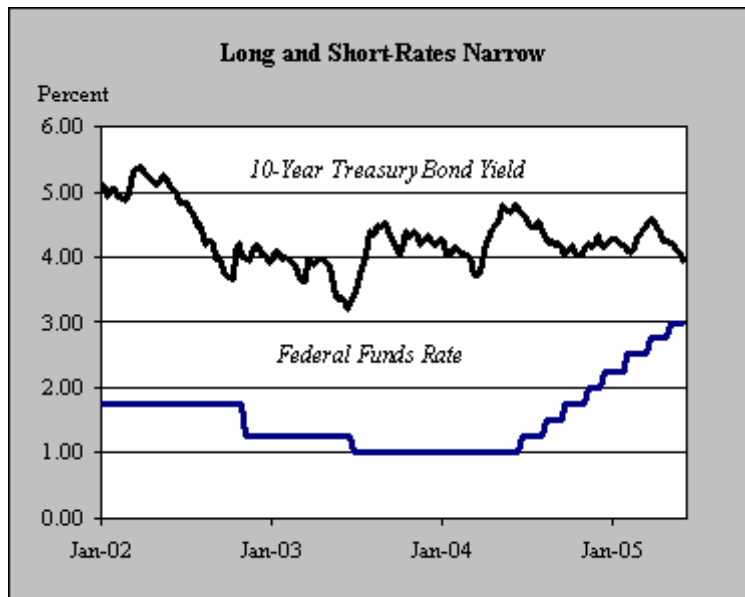
FINANCIAL INDICATORS				
INTEREST RATES	June 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.00%	2.99%	2.81%	1.28%
6-month Treasury bill	3.13	3.12	3.12	1.64
2-year Treasury note	3.69	3.57	3.60	2.80
5-year Treasury note	3.84	3.73	3.82	4.06
10-year Treasury note	4.05	3.98	4.12	4.80
30-year Treasury bond	4.32	4.29	4.49	5.47
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.10	3.13	3.23	3.34
10-Year	3.66	3.71	3.84	4.26
30-Year	4.39	4.43	4.58	5.24
30-year fixed mortgage rate				
	5.56	5.62	5.77	6.30
15-year fixed mortgage rate				
	5.14	5.20	5.33	5.67
1-year adjustable rate				
	4.21	4.26	4.23	4.14
STOCK MARKET				
Dow Jones Industrials	10512.63	10460.97	10140.12	10410.1
S&P 500	1198.11	1196.02	1154.05	1199.87
NASDAQ	2063.05	2071.43	1976.80	1999.87
Commodities				
Gold (\$) - 100 OZ	429.00	424.90	420.40	386.6
Oil (\$ per barrel) - Crude Futures (NYMerc)	53.54	55.03	48.67	38.28
(Key Reports For Week of June 10)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (April) - mlns of \$\$s	1263.8	6856.4	5927.3	5583.0
Trade Deficit (April) - Millions of \$\$s	56962.0	53562.0	60117.0	57062.0

The much-anticipated appearance of Fed Chairman Greenspan before the Joint Economic Committee took center stage this week, and the end-result was anything but momentous. Perhaps the most surprising development was what didn't happen; to wit, no one on the Committee asked Greenspan what inning of the rate-hiking ballgame we were in. The question would seem to be a natural follow-up to the comments made last week by Dallas Fed president Fisher, in which he claimed that the central bank was in the eighth inning of the process. We can only conclude that either Fisher's comments did not resonate in Congress, or they were sufficiently repudiated beforehand by analysts and other Fed officials.

Nonetheless, the question was unnecessary, as the Chairman clearly indicated that the ballgame is far from over. In his closing comments, he reaffirmed the Fed's intention to remove policy accommodation at a measured pace, reflecting the perception that the "U.S. economy appears to be on a reasonably firm footing...". And, while he noted that underlying inflation appeared to be well contained, there is little question that the Fed remains more concerned about a flare-up in inflation than a recession. Simply put, the JEC testimony did little to derail the prevailing expectation that another quarter-point rate hike will take place at the next policy-setting meeting on June 29-30, and at least one more will follow later in the summer. Beyond that, there is a range of opinion, with the majority looking for the Fed to pause at some point in the fall.

Most agree, however, that the endgame will not be reached until the funds rate is brought up to the 4 percent level, perhaps in early 2006.

Although Greenspan's trip to the Hill was ostensibly to present an economic outlook, most of the testimony was devoted to the two major issues of the day: the so-called interest rate "conundrum" and the housing bubble. The conundrum has baffled investors as well as the Fed chairman for some time, and continues to garner a wide array of explanations. At the heart of the issue is the mysterious behavior of long-term interest rates, which declined by about 80 basis points over the past year, even as the Fed has hiked its benchmark short-term interest rate from 1 percent to 3 percent. As Greenspan put it, this divergence is unprecedented in recent history. While he recognizes the possible reasons for the atypical movement in bond yields, none of them is viewed as particularly persuasive, something that was more elaborately discussed in a speech made earlier in the week to a monetary conference in Beijing.



As noted in the Beijing speech, perhaps the most compelling argument is that the bond market is signaling a slowdown in economic growth, which implies lower inflation and an impending move towards monetary ease. But Greenspan noted that if this were the case, bond yields would have increased when the economy showed clear signs of accelerating at various times over the past year. However, except for a brief spike in March, that has generally not been the case. Another widely-held explanation for the decline in bond yields is that foreign central banks are pouring funds into U.S. Treasury bonds to boost the dollar's exchange rate, thus increasing the export competitiveness of foreign goods in the global marketplace. But if that were the case, then the absence of central bank buying elsewhere in the world would have pushed up foreign bond yields. In point of fact, however, bond yields in most other developed capital markets have fallen more steeply than in the U.S., and in many cases are even lower than they are here.

Greenspan also dismissed two other explanations for the decline in U.S. bond yields -- the disinflationary impact of globalization and the growing demand for long-term securities by pension funds to accommodate aging baby boomers as they near retirement. Both of these trends, however, have been ongoing for some time and should already have been incorporated into the yield structure by forward-looking bond investors. As the Fed chief noted in his Beijing speech, "world demographic trends are hardly news". So, it appears the "conundrum" remains a formidable unresolved issue, which the Fed can only hope doesn't mask some underlying macroeconomic force that could undermine its policy goals.

Indeed, rather than signal economic weakness, the prevailing notion seems to be that low bond yields, by stimulating economic growth, will only provoke the Fed to remain on its rate-hiking course. Nowhere is this stimulus more apparent than in the real estate market, which Greenspan also discussed at length in his testimony. The basic theme sounded by the chairman was that the housing market appeared to be frothy in some local areas, but there is no sign of a systemic speculative binge that is causing a nationwide housing bubble. As he noted many times in the past, speculation in the housing market is not as easily conducted as it is in the financial markets because of the high transaction costs involved -- such as commissions and closing costs. For the most part, where speculative activity exists it is mainly in the market for second homes, those purchased as vacation destinations or for investment purposes. Unlike owner-occupied properties, these homes are more readily purchased and sold because the transaction does not force the owners to move from place to place.



If we are correct about housing retaining most, if not all, of its value, the much-improved financial condition of households will continue to provide some support to consumer spending. In the first quarter, household net worth increased by another \$327 billion, following an outsized \$2.1 trillion increase in the previous quarter. At a record \$48.8 trillion, households have seen their net worth climb by \$9.4 trillion since mid-2003. That's a lot of spending power and a formidable cushion to withstand a tapering off of the real-estate boom.

