

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 6, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	January 6	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.20%	3.99%	3.93%	2.18%
6-month Treasury bill	4.38	4.22	4.27	2.52
2-year Treasury note	4.35	4.41	4.32	2.99
5-year Treasury note	4.31	4.35	4.33	3.57
10-year Treasury note	4.37	4.39	4.43	4.21
30-year Treasury bond	4.56	4.61	4.66	4.84
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.48	3.52	3.55	2.9
10-Year	3.91	3.98	4.02	3.78
30-Year	4.48	4.50	4.57	4.65
30-year fixed mortgage rate				
	6.21	6.22	6.28	5.75
15-year fixed mortgage rate				
	5.76	5.76	5.81	5.18
1-year adjustable rate				
	5.16	5.15	5.14	4.17
STOCK MARKET				
Dow Jones Industrials	10959.31	10717.50	10931.62	10827.12
S&P 500	1285.45	1248.29	1268.25	1210.13
NASDAQ	2305.62	2205.32	2263.01	2160.62
Commodities				
Gold (\$) - 100 OZ	541.30	513.00	492.90	442.9
Oil (\$ per barrel) - Crude Futures (NYMerc)	64.21	61.06	58.71	44.18
(Key Reports For Week of January 6)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (December)	54.2	58.1	59.1	56.8
ISM Non-Manufacturing Index (December)	59.8	58.5	60.0	59.5
Nonfarm Payrolls (December) - 000s	108.0	305.0	25.0	147.0
Unemployment Rate (December) - Percent	4.9	5.0	5.0	5.0

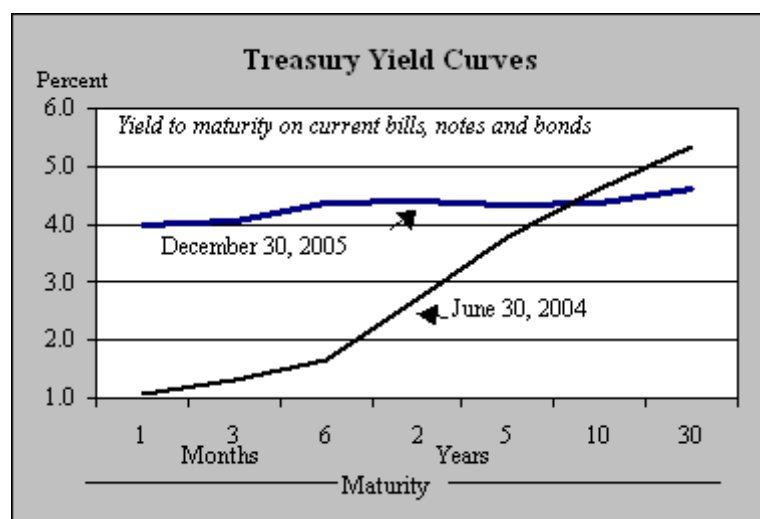
If the opening week of 2006 is a prelude of what's to come, it will be a happy year for investors. Both stock and bonds posted respectable gains during the week, spurred on by expectations that the Federal Reserve is nearing the end of its rate-hiking campaign. The notorious inverted yield curve that cast a pall over the markets towards the end of 2005 also unwound, defusing for the moment the lively debate over whether the economy is heading for a recession in the not-to-distant future. That debate will surely heat up in the wake of Friday's somewhat disappointing employment report and the media hoopla over what appears to have been a lackluster season for holiday sales.

Despite the market's upbeat tone this week, there is little question that the year ahead is fraught with uncertainties. On the policy front, Alan Greenspan will be leaving his post as Fed Chairman on January 31, and his presumptive successor, Ben Bernanke, has yet to demonstrate his leadership skills during what will likely be a more difficult policy-making environment than the one in place over the past several years. Greenspan's mission over the first six years of the new millennium has been obvious, and he transmitted it to the financial markets in the most open display of transparency on record. Following the 2001

recession, the terrorists attacks, deflationary fears and sluggish economic recovery, the clear policy mandate was to right the economic ship through massive doses of monetary stimulus that pushed short-term interest rates to the rock-bottom level of 1 percent, where it remained until the middle of 2004.

Since then, policy decisions have been guided by a different set of circumstances, but the moves have been just as predictable and transparent. Essentially, the Fed has been responding to a mending economy and energy-driven inflation concerns that spurred it to bring about a more normal rate environment. The normalization process has been slow and gradual, but persistent. More to the point, each step of the way was telegraphed in advance, providing the financial markets with the assurance that short-term rates would increase in measured quarter-point increments until all policy accommodation was removed from the system. That transparency and guidance allowed the markets to adjust smoothly to the changing rate environment, knowing full well that no policy surprises were in store. But 325 basis points of rate increases over eighteen months have now brought policy into the neutral zone -- and future rate moves are no longer a slum-dunk.

Yes, another rate increase on January 31 -- the last meeting presided over by the departing Greenspan -- is widely expected, which would bring the federal funds rate up to 4.50 percent. But when Bernanke takes over the helm, policy will no longer be accommodative, and it's questionable if the economy can withstand further rate increases. Indeed, there is already some debate over whether the Fed has gone too far, setting the stage for a marked slowdown in growth at best, or a recession at worst. That debate is embedded in the yield curve, which inverted slightly between the two-year and ten-year maturities at the end of last year. Such an inversion has preceded each of the past six recessions, and fears that another downturn may recur in 2006 cast a pall over the markets in the waning weeks of 2005.



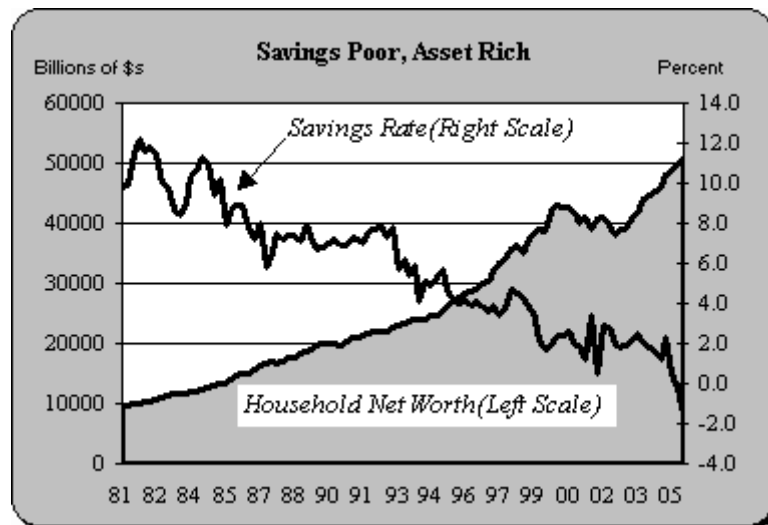
As noted earlier, the mild inversion has unwound this week, as the yield on 2-year Treasury securities slipped fractionally below that on the 10-year issue on Thursday and Friday. We were never in the camp that bought into the yield-curve recession signal, nor were the vast majority of economists who continue to believe that the economy will turn in another respectable year in 2006, although one that will grow more slowly than last. Still, the Fed is not immune from making mistakes; indeed, the economy has often succumbed to policy overshoots in the past, resulting in long periods of sub-par growth if not outright recessions. While we don't believe that it is in a particularly vulnerable position today, it would be foolhardy to deny the possibility that the slowdown in growth now underway could morph into something more severe. The point is, the Fed no longer has the luxury of putting policy on cruise control, as has been the case in recent years when the economic imperatives were clear. With the economy buffeted by conflicting forces, and its course more uncertain than in the recent past, the new chairman will have some difficult decisions to make, which may or may not be consistent with market expectations.

Clearly, the tea leaves will be particularly difficult to read over the first half of the year. Consumers have already downshifted gears, increasing spending at the slowest pace since the last recession during the fourth quarter. It's even possible that real consumption declined, which would be the first quarterly fall in fourteen years. The slump in auto sales early in the period accounted for most of the drag, but the quarter did not exactly end with a head of steam. After a promising start around the Thanksgiving holiday, retailers now report that sales growth during the remainder of the holiday season was lackluster at best, with Wal-Mart bemoaning that results came in at the low end of expectations. To be sure, a temporary setback for a quarter, especially after a long period of robust spending patterns, is not by itself a particularly worrisome development. It is the underlying reasons for the slowdown and what they imply going forward that matter.

Basically, the pessimists worry that that consumers are facing much higher energy bills that could sap discretionary spending for months to come, sending the economy into a soft patch that could extend well into the first half of 2006. While low and middle-income earners would most acutely feel this income drag, those in the somewhat higher echelons of the income scale also face a prospective squeeze on purchasing power by the cooling off of the housing market. It's no secret that households have been living well beyond their means for some time, as the personal savings rate has melted from positive to a negative 1.5 percent over the past three months. Instead of saving out of current incomes, consumers have turned their homes into veritable cash machines, extracting equity through second mortgages and home equity loans. With mortgage rates up, home-price appreciation leveling off and sales slowing, that source of spending power is drying up.

As a result, consumers will have to rely more on income growth to support spending, which just about assures a slower growth rate for consumption going forward. How much slower depends on whether households will also feel the need to replenish depleted savings -- and to what level. Any attempt to rebuild savings implies that spending will grow more slowly than incomes, siphoning even more momentum from the economy. But while the growth in consumer spending over the next six months or so will fall short of the 3.5 percent average increase recorded since the end of the recession, we doubt that the slowdown will be enough to choke off the expansion. Here's why.

For one, households still have a considerable reservoir of accumulated wealth to tap into. Even if the appreciation in home prices evaporates completely in 2006, household net worth stood at a record \$51.1 trillion in the third quarter of last year, up \$2.9 trillion from December 2004. Since the "wealth effect" supports consumer spending over several quarters, or even years, the wealth increase last year should continue to be a source of spending growth in 2006, even as the rate of increase in net worth slows along with the appreciation of real estate values. Keep in mind too that the refinancing boom, which is now fading rapidly, enabled millions of homeowners to permanently reduce their debt-servicing payments by shifting their high-rate mortgages into lower-rated loans. This reduction in monthly debt payments is the functional equivalent of a tax cut, which frees up cash that households can either spend or earmark for savings.



For another, households should start to feel the benefits of a strengthening job market. True, the latest employment report came as a shocking disappointment to many, as the pace of job creation in December was about half the 215 thousand expected. But we've learned to take a one-month surprise with a grain of salt. The December shortfall, reported Friday, is not the last word on the job market for the month, as future revisions could well cast the hiring pace in an entirely different light. Indeed, in the latest report, the November estimate for job growth, originally put at 215 thousand, was revised up to a whopping 305 thousand, the strongest gain since April 2004.

It's unclear why the preliminary estimate for December tailed off so sharply. One possibility could be the weather, which was considerably colder than normal in many parts of the nation. The Labor Department noted that weather was not a factor, but that's not what workers are saying. Indeed, according to the separate household survey, from which the unemployment rate is derived, the number of people who missed work due to the weather climbed to 253 thousand in December from 131 thousand in the same month a year earlier. In fact, looking at all past Decembers, the weather-related absentee list last month was the highest since 1985, and was the third highest on record, topped only in 1985 and 1977. Furthermore, the biggest shortfalls in job creation last month occurred in weather sensitive industries. Construction payrolls, for example, plunged by 92 thousand, after rising by 42 thousand in November and an average of 21 thousand a month during 2005.

Our suspicion is that the average hiring pace over the fourth quarter as a whole is a better measure of employment trends than the aberrational December reading. During the period, payrolls rose by 442 thousand, which is virtually the same as the third quarter's 438 thousand increase, but less than the 570 thousand average over the first two quarters of last year. The sharp slowing in payroll growth over the second half of the year was due entirely to Hurricanes Katrina and Rita, which cost the economy a couple of hundred thousand jobs that have yet to be recovered. But the hurricane rebuilding efforts are now in full swing, generating a pent-up demand for workers that will likely manifest itself in coming months. With the unemployment rate down to 4.9 percent in December, the labor market is growing increasingly tight, which bodes well for a pickup in wages and salaries. Indeed, that trend appears to be well underway, as hourly earnings in December increased 3.1 percent over a year ago, the strongest 12-month increase since March 2003.



No doubt, the Fed is looking closely at this development as a harbinger of future inflation, which is another reason to expect a rate hike on January 31. But if spending slows significantly because of higher heating bills and softness in the housing market, the new Fed chairman may well decide that the inflation threat is not worth risking a recession for and put the rate-hiking campaign on hold at the March meeting. At this point, it's a close call. But one thing is for sure, the Fed's actions can no longer be taken for granted, which should make for a lively debate -- and greater market volatility -- as new data flow from Washington's statistical mills. Stay tuned.