

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 13, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	January 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.32%	4.20%	3.92%	2.36%
6-month Treasury bill	4.42	4.38	4.29	2.66
2-year Treasury note	4.33	4.35	4.35	3.22
5-year Treasury note	4.28	4.31	4.36	3.71
10-year Treasury note	4.35	4.37	4.44	4.21
30-year Treasury bond	4.52	4.56	4.65	4.73
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.48	3.48	3.57	2.83
10-Year	3.91	3.91	4.03	3.73
30-Year	4.47	4.48	4.56	4.58
30-year fixed mortgage rate				
	6.15	6.21	6.30	5.74
15-year fixed mortgage rate				
	5.71	5.76	5.85	5.19
1-year adjustable rate				
	5.15	5.16	5.15	4.10
STOCK MARKET				
Dow Jones Industrials	10959.87	10959.31	10875.59	10558.00
S&P 500	1287.61	1285.45	1267.32	1184.52
NASDAQ	2317.04	2305.62	2252.48	2087.91
Commodities				
Gold (\$) - 100 OZ	557.00	541.30	505.40	423.30
Oil (\$ per barrel) - Crude Futures (NYMerc)	63.92	64.21	58.06	43.38
(Key Reports For Week of January 13)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (November) - mlns of \$s	-649	-8404	4966	5067
Trade Deficit (November) - mlns of \$s	64207	68127	65995	62426
Producer Price Index (December) - % ch.	0.9	-0.7	0.7	0.7
Core PPI (December) - % change	0.1	0.1	-0.3	0.1
Retail Sales (December) - % change	0.7	0.8	0.2	0.3
Retail less Auto Sales (Dec) - % change	0.2	-0.4	0.7	0.6

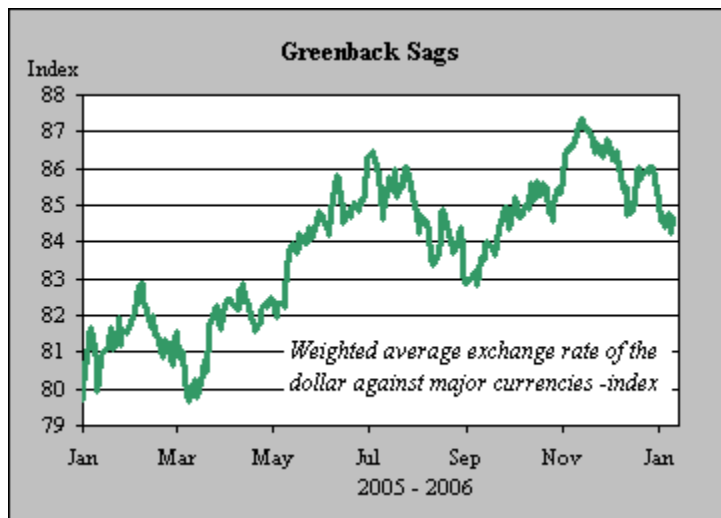
With the change at the Federal Reserve helm looming ever closer, the financial markets are showing little concern about the leadership skills of the incoming chairman, Ben Bernanke. We have no reason to feel any different from the consensus on this matter. Indeed, by all accounts, the presumptive chairman has all of the professional and intellectual qualifications to do a good job. Hopefully, the changeover that begins on February 1 will be more tranquil than the one that the outgoing chief experienced. Recall that two months after Greenspan took office in August 1987, the stock market suffered the sharpest one-day collapse since the Great Depression, raising fears of a potential economic calamity. Greenspan, of course, quickly quelled those fears, injecting a massive amount of liquidity into the system while offering assurances to the nation that the Fed stood ready to do whatever might be necessary to keep the economy afloat.

Having dealt successfully with this first crisis, Greenspan steered the economy admirably throughout most of his succeeding

eighteen years in office, which included a series of such disruptive events as an Asian financial crisis, another stock market collapse, corporate accounting scandals, the terrorist attacks, spiraling energy prices and two recessions. Indeed, thanks largely to his predecessor's efforts, Bernanke should be stepping into a much more stable and hospitable climate, one in which his early decisions will not be of a "make or break" variety. Yes, the interest rate decision at his first policy-setting meeting in March will be a close call -- the financial community is about evenly split over whether another increase will be necessary. But a quarter-point increase, even if not justified, should not materially alter the economy's growth and inflation prospects. Besides, any mistake can readily be corrected at subsequent meetings.

Nonetheless, the new chairman is not exactly inheriting a Goldilocks environment that portends smooth sailing as far as the eye can see. The economy has turned in a solid performance over the past two years, largely because foreign investors have been willing to finance the profligate borrowing and spending habits of consumers through their heavy purchases of U.S. securities, which have been instrumental in keeping long-term interest rates far below where they otherwise would be. According to a recent Federal Reserve study, bond yields would be about 150 basis points higher if not for the massive inflow of foreign funds. These inflows, in turn, reflect the flip side of the unprecedented U.S. balance of payments deficit, which generates a flood of dollars overseas that foreign exporters have willingly recycled back into the U.S. securities' markets. This "virtuous" cycle, which has also helped contain inflation by propping up the dollar, can be sustained only as long as our trading partners are willing to accept the ever-growing volume of dollar-denominated assets at existing prices.

However, there are signs that the dollar's acceptance overseas may be waning. After a strong uptrend throughout most of 2005, the greenback has been slipping over the past several months, including a 1.6 percent slide against major currencies since the end of last year. The latest fall reverses a brief late-year rally and now leaves the dollar 3.6 percent below its peak level reached last November. Not coincidentally, the U.S. trade deficit hit a record \$68.1 billion in October, a whopping \$12.5 billion or 22.5 percent increase over the year-earlier shortfall. The deficit did shrink to \$64.2 billion in November, according to this week's government report; but some special factors contributed importantly to the surprising drop, including a one-time surge in civilian aircraft exports, reflecting the end of the Boeing strike, and a steep fall in energy imports, pulled down by falling crude oil prices. Oil prices have since reversed course, and it's unlikely that the spike in aircraft sales will be repeated anytime soon. For the fourth quarter as a whole, the trade deficit should easily set a new record high, pushing the current account gap -- which includes the surplus or deficit in investment flows -- to an unprecedented 6 percent of GDP.



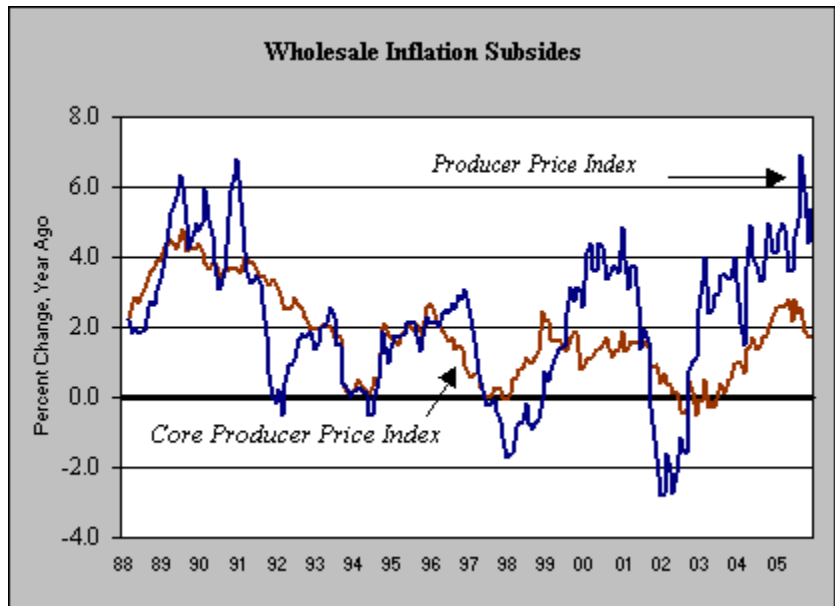
To be sure, the imbalance in our trade accounts is not the only factor influencing the dollar's movement, nor on the margin, is it necessarily the most important. Foreign investors are motivated by the profit incentive, just as are portfolio managers in the U.S. Hence, a strong catalyst behind the willingness to pour funds into the U.S. is the simple fact that the rewards of doing so have greatly exceeded those available overseas. That was not the case from 2002 through most of 2004 when the Fed was slashing interest rates to a rock-bottom 1 percent level and the dollar embarked on a modest, but persistent, declining trend. In such a low-rate environment, the relative return on U.S. securities vis-à-vis those available in overseas markets was hardly compelling. But the relative tide started to turn when the Fed initiated the first of thirteen interest-rate increases in June 2004 even as rates in Japan and Europe were kept at low levels by central banks striving to stimulate their languishing economies. With short-term rates up by 325 basis points, the yield differential between U.S. and foreign securities has widened considerably, providing overseas investors with an attractive lure for their funds.

More recently, however, relative interest rates and economic prospects have undergone a shift that may well extend the

dollar's recent slide. In December, the European Central Bank lifted its benchmark short-term interest rate for the first time in five years, reflecting solid evidence that the Continent, led by Germany, is finally enjoying an acceleration in growth after an extended period of lackluster activity. The ECB left rates unchanged at its last meeting, but most analysts expect another to be forthcoming soon, with a good chance of more to follow. Similarly, after many false starts over the past decade, Japan seems to be finally on a strong expansion track, erasing the deflation-induced need to maintain negative interest rates. In the U.S., however, the prospective policy environment has turned less hawkish. Yes, another quarter-point rate increase is expected on January 31, the last Fed meeting presided over by the outgoing chairman, but the odds of future increases have diminished considerably in recent weeks.

The first hint that the Fed was nearing the endgame of its rate-hiking campaign came with the release of the minutes of the December 13 FOMC meeting earlier this month. In particular, market perceptions were jolted by the phrase... " the number of additional firming steps required probably would not be large," which enhanced the notion that the Fed could well be done after the January 31 increase. What's more, the economy's performance since the release of the minutes did little to alter the view that additional rate increases would not be necessary. The December jobs report released last week, for example, contained numerous conflicting signals, but the headline number revealing a disappointing growth in payrolls corroborated the notion that the economy has downshifted towards the end of the year. We suspect that when the GDP report is released in late January, the numbers will indeed show that growth slowed considerably in the fourth quarter.

Meanwhile, this week's reports on inflation and retail sales also argue for a less aggressive Fed stance in the months ahead. On the inflation front, wholesale prices surged by a stronger-than-expected 0.9 percent in December, but the spike was entirely due to a 3.1 percent jump in energy prices. By contrast, the core producer price index, which excludes volatile food and energy prices, edged up by a milder-than-expected 0.1 percent, following a similarly small increase in November and an outright 0.3 percent decline in October. Hence, while the headline PPI accelerated to a twelve-month pace of 5.4 percent in December, compared to 4.2 percent a year ago, the core index decelerated to a 1.7 percent 12-month pace from 2.3 percent in December 2004.



Simply put, there is no sign yet that higher energy costs are being passed through into the broader market for goods and services, something that will likely be corroborated in next week's report on consumer prices. Nonetheless, the Fed is a forward-looking institution, and as long as consumer demand increasingly uses up spare capacity in the economy, it will assume that price pressures will ultimately build. For that reason, it's important to monitor spending on the retail level to gauge whether the gap between supply and demand is closing, and if so, how rapidly. On this score, the Fed may also derive some comfort from the latest tally on consumer spending habits.

According to the latest Commerce Department report, retail sales in December came in on the soft side. During the month, total sales rose by 0.7 percent and sales less autos increased by an unimpressive 0.2 percent. Prior to the release of the report, the market had been expecting increases of 0.9 percent and 0.4 percent, respectively. What's more, the numbers indicate that holiday sales were surprisingly weak, as purveyors of general merchandise, which includes traditional department stores, suffered a sales drop of 0.3 percent during the month. Based on the so-called control group that enters into the GDP

calculations -- i.e., sales excluding autos, building materials and gasoline -- it appears that real consumer spending increased by a very modest half a percent in the fourth quarter. That would be a far cry from the 3.5 percent average during the past four years, and off sharply from the 4.1 percent gain posted in the third quarter.

Does that mean the consumer is tapped out, and is poised to retrench until debt is paid down to more comfortable levels and depleted savings are replenished? On the surface, that would not seem far-fetched. After all, following years of borrowing heavily against the increased appreciation in home values, households have racked up a mountain of debt. In the third quarter, the share of disposable income earmarked for debt payments -- both interest and principal -- surged to an all-time high; with short-term rates up sharply, that figure will climb further in the fourth quarter. Indeed, there are signs that consumers may already be giving more attention to their balance sheets, as they paid down installment debt in both October and November, the first two-month decline since the early 1990s.



We suspect that the rise in short-term interest rates is curbing consumer borrowing somewhat, which should restrain spending in the months ahead. A cooling off in the housing market should also contribute to this trend. While solid business investment spending will take up part of the slack, the likelihood is that the economy will grow more slowly this year than in 2004. This prospect strongly suggests that the Fed is indeed near the end of the tightening cycle. Meanwhile, as we noted above, economic growth overseas is generally accelerating and rates are heading higher, a divergence that could make dollars less attractive to foreign investors. If that causes foreign investors to reduce their demand for dollar-denominated assets, it could lead to a back up in long-term interest rates just as the U.S. economy is weakening. This would not be a healthy recipe for economic growth, and could pose the first challenge for the new Fed chairman.