

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 20,2006

First the numbers, then the story

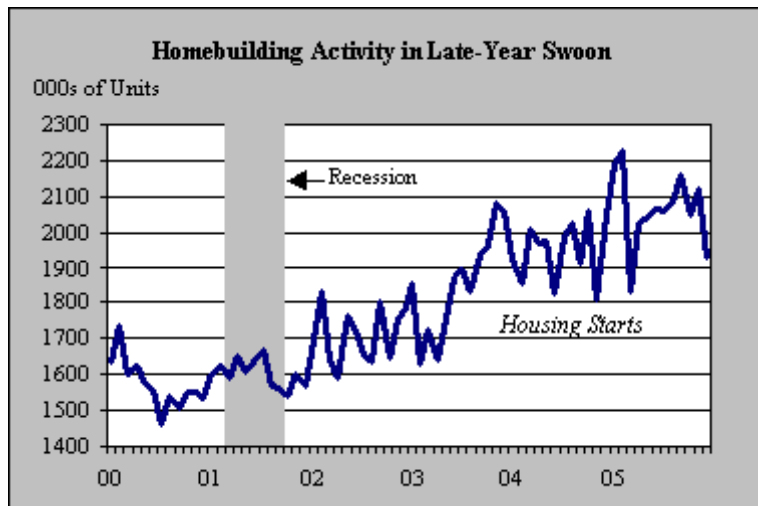
FINANCIAL INDICATORS				
INTEREST RATES	January 20	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.35%	4.32%	3.98%	2.34%
6-month Treasury bill	4.46	4.42	4.31	2.65
2-year Treasury note	4.35	4.33	4.36	3.14
5-year Treasury note	4.29	4.28	4.31	3.64
10-year Treasury note	4.35	4.35	4.37	4.14
30-year Treasury bond	4.52	4.52	4.55	4.64
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.44	3.48	3.56	2.92
10-Year	3.87	3.91	4.02	3.73
30-Year	4.45	4.47	4.54	4.59
30-year fixed mortgage rate				
	6.10	6.15	6.26	5.67
15-year fixed mortgage rate				
	5.67	5.71	5.79	5.15
1-year adjustable rate				
	5.18	5.15	5.22	4.11
STOCK MARKET				
Dow Jones Industrials	10667.39	10959.87	10883.27	10392.49
S&P 500	1261.49	1287.61	1268.66	1167.87
NASDAQ	2247.70	2317.04	2249.42	2034.27
Commodities				
Gold (\$) - 100 OZ	554.00	557.00	505.50	427.30
Oil (\$ per barrel) - Crude Futures (NYMerc)	68.48	63.92	58.43	48.53
(Key Reports For Week of January 20)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Industrial Production (December) - % chg	0.6	0.8	1.0	0.2
Capacity Utilization (December) - Percent	80.7	80.3	79.8	80.0
Housing Starts (December) - 000s of units	1933	2121	2051	2068
Consumer Price Index (December) - % chg	-0.1	-0.6	0.2	0.3
Core CPI (December) - % change	0.2	0.2	0.2	0.2

When the government releases its GDP report on January 27, we will have a preliminary reading on just how sharply the economy slowed in last year's fourth quarter. Most forecasts put the growth rate in the 1 to 3 percent range, which would mark the first quarter of below-trend growth in nearly three years (i.e., under 3 percent, which is presumed to be the economy's noninflationary growth potential). As the wide range of forecasts suggests, there is still a good deal of uncertainty about the extent of the slowdown; but the composition of the slowdown is following the expected path, at least according to monthly data already received.

There is little question, for example, that the major impetus behind the downshifting in activity is coming from the consumer side. Both the monthly auto and retail sales reports indicate that consumer spending braked to a screeching halt in the closing months of the year, with most estimates placing the real growth rate in personal consumption outlays at slightly north of zero. With consumers accounting for about 70 percent of total GDP, that alone is enough to substantially drag down the headline

growth number from the third-quarter's 4.1 percent pace. Similarly, residential construction activity came off the boil in the fourth quarter, and all signs point to a continuation of the slackening pace in the months ahead. As far as its contribution to the slowing trend, the housing pullback is nothing to sneeze at. In 2005, residential outlays accounted for about 15 percent of the increase in real GDP, three times its relative size in the overall economy.

The latest monthly report on housing starts corroborates the cooling off taking place in the homebuilding industry. According to the Commerce Department, homebuilders broke ground on 8.9 percent fewer homes in December, dragging the total down to a 1.93 million unit annual rate. That's the first time in nine months that starts slipped below the 2 million mark, and it lowered the fourth quarter's average 3.1 percent below that of the third quarter. To some analysts, the December drop not only signals the end of the real-estate boom, it is also another sign that the sky is about to fall in this all-important sector. After all, home-price appreciation is slowing, sales are weakening, the stock of unsold homes is climbing rapidly and mortgage applications are sliding. While all this is true, it's still a leap to conclude that the housing market is on the verge of collapse.



For one thing, it would be a mistake to read too much into recent housing numbers. Keep in mind that in the winter months, sales and starts are generally much smaller than they are at most other times of the year. Hence, the data are blown up by seasonal factors to make them statistically comparable with the spring, summer and fall months. With a smaller sample size, anything unusual that affects a single month has an outsized impact on the seasonally adjusted data. We suspect that such seasonal distortions probably magnified the monthly changes in the fourth quarter. For example, the November starts number was likely exaggerated on the strong side by the unusually warm weather during that month. Similarly, the weather was unusually cold and wet in December, which probably magnified that month's decline. A better gauge of underlying trends would be an average for the November/December period. Such a smoothing of the two weather-related months reveals a starts figure of 2.03 million units, still weaker than earlier in the year, but not dramatically so.

For another, building permits, while down 4.4 percent in December remained above the level of starts for the tenth consecutive month. Indeed, permits are only a slight 0.6 percent below the level of a year ago, suggesting that any near-term slowdown in housing construction will be modest. Simply put, let's wait a few more months before subscribing to the "Chicken Little" scenario in the housing market. That said, it's certainly not premature to conclude that the bloom is off the real-estate rose, and housing will not provide anything near the forward thrust to the economy that it has in recent years. With regards to the housing support, we are not only alluding to the dollars spent by builders on construction supplies and the wages paid to construction workers. While, as noted above, such expenditures have made an outsized contribution to growth, the impact that housing inflation has had on consumer wealth has been an even greater influence.

According to Federal Reserve calculations, consumers have extracted more than \$400 billion a year in equity from their homes over the past four years, and that figure is estimated to have climbed to about \$600 billion in 2005. Last year's extraction exceeded the increase in wages and salaries, and encouraged households to forego saving anything out of their paychecks. But with the appreciation in home prices slowing -- and even declining in the hottest markets -- and home sales weakening, it's clear that homeowners will not be tapping into the housing well to support their buying habits as aggressively as they have so far during the expansion. With the evaporation of this important revenue source, there is little question that consumer spending will suffer in the months, if not year, ahead.

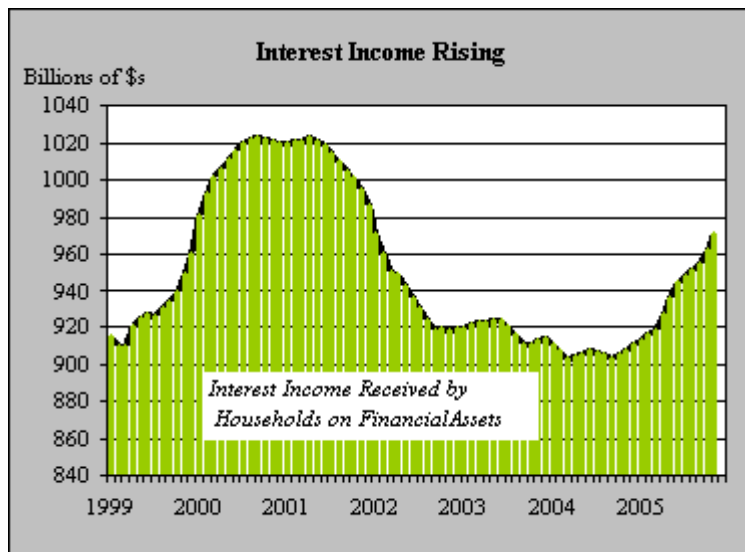
But how much of a consumer slowdown can reasonably be expected due to the withdrawal of the so-called wealth effect?

Keep in mind that only a fraction of the home equity extraction was actually used for spending purposes. The major portion went into debt repayments or used to trade up into bigger, more expensive, homes that are not reflected in the consumer spending figures. We are already seeing the cutback in home sales, and the fading wealth boost to consumption will unfold in coming months. Fed studies suggest that the wealth effect accounted for about a quarter of the increase in consumer spending over the last two years. If the reverse holds true, a corresponding drag on consumption is not an unreasonable expectation. In other words, without any help from equity extraction, consumer spending could well increase at a 3 percent pace next year compared to about 4 percent over the past two years.

But the pessimists are looking for an even sharper pullback, as consumers will strive to rebuild depleted savings and higher interest rates will discourage borrowing. Both drags are likely to play out, at least over the first half of the year. But it's important not to lose sight of some positive influences that will more than offset the negative pull from a higher savings rate and borrowing costs. While it's true that a dollar increase in savings means a dollar less is being spent, it is only a zero-sum game if household income fails to increase. But that's hardly the case in an improving job market, which is expected to generate an average of about 200 thousand more payrolls a month in 2006. With the jobless rate already at a historically low 4.9 percent, it is not unreasonable to assume that companies will be giving more generous pay raises this year to attract and retain workers. In other words, both savings and spending can increase side by side as worker paychecks expand.

What's more, the Fed-induced rise in interest rates is a double-edged sword. Yes, it discourages people from borrowing against their credit cards and home equity lines, particularly with rates on these short-term loans 3.25 percent higher than they were eighteen months ago. But what the Fed takes away, it also gives back, and the folks holding savings accounts and other interest-yielding financial assets are reaping the rewards. While it may seem that these folks are a disappearing lot because of the negative savings rate, it's important to remember that 2005 was an unusual year. Indeed, households have been net savers in every other year since the Great Depression, putting aside an average of 4.25 percent of their paychecks since 1959. As recently as 1992, the savings rate was hovering near 9 percent.

As a result of decades of savings, households have accumulated far more assets than they owe to lenders. In the third quarter of last year, financial asset holdings totaled \$37.8 trillion, more than triple the \$11.4 trillion in liabilities. While only a fraction of those assets generate interest income that responds to Federal Reserve rate changes, it is not an insignificant amount. As the chart shows, since the middle of 2004, when the Fed started its rate-hiking campaign, interest income has been on a steady and accelerating upward trajectory. Over the twelve months through November, interest income increased by \$63 billion, and monthly increases have accelerated to a \$96 billion annual rate over the last two months. Simply put, even as higher rates are contributing to the cooling off in the housing market -- and the wealth-boost to consumption -- it is also padding the bank accounts of savers and providing an important revenue source for spending.



We suspect that the slowdown in consumer spending this year will materialize, as expected, but the retrenchment will not be as dramatic as believed by some of the more pessimistic forecasters. No doubt, when the fourth-quarter spending numbers are revealed in the upcoming GDP report, the pullback will appear to be quite pronounced and generate much speculation about where the economy is heading. There may even be calls for the Fed to think twice about pulling the rate-hiking trigger again on January 31, which is widely expected. But the Fed is aware that most of the slowdown in the closing months of last year reflected a slump in auto sales that was largely front-loaded at the beginning of the period. Non-auto sales posted a

respectable gain during the quarter, and there may well be a spike in January as consumers cash in their ever-more popular holiday gift cards.

What's more, there is still every reason to believe that strengthening business investment outlays will offset the slowdown in consumer spending and housing. Indeed, industrial companies expanded their output sharply in the closing months of last year, particularly for high-tech equipment, which is an essential component of the capital spending revival that is remaining firmly on track. With factory production up by 8.5 percent in the fourth quarter -- the strongest gain in six years -- the amount of spare capacity is rapidly being used up, providing another incentive for businesses to ramp up investment spending plans. Indeed, at 80.7 percent in December, industrial companies are utilizing the highest percentage of capacity in more than five years. That's still a tad below the level normally associated with bottlenecks and rising inflationary pressures. But it's a signal for the Fed to remain on alert, suggesting that its inclination will be to keep its finger on the rate-hiking trigger until -- and unless -- the fourth quarter's growth slowdown extends into the first half of this year.

