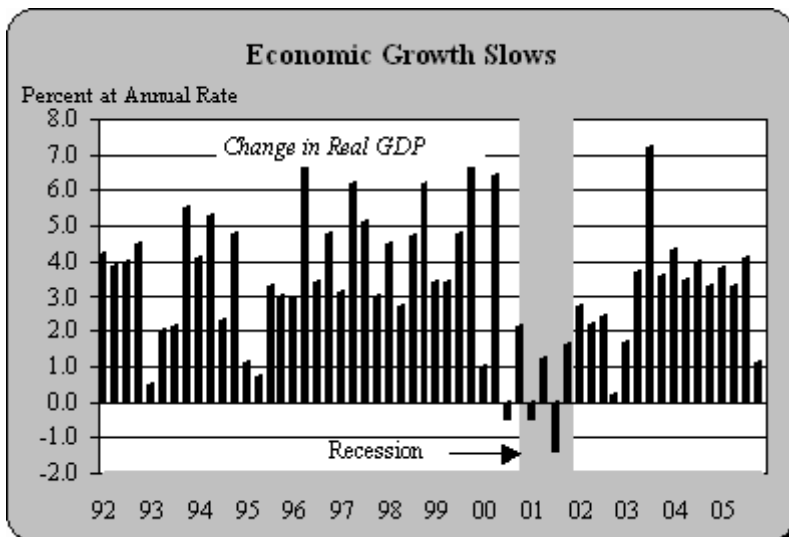


## WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 27, 2006

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	January 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.44%	4.35%	3.99%	2.45%
6-month Treasury bill	4.55	4.46	4.22	2.70
2-year Treasury note	4.49	4.35	4.41	3.24
5-year Treasury note	4.44	4.29	4.35	3.68
10-year Treasury note	4.51	4.35	4.39	4.13
30-year Treasury bond	4.69	4.52	4.61	4.60
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.44	3.44	3.52	2.90
10-Year	3.86	3.87	3.98	3.73
30-Year	4.44	4.45	4.50	4.57
30-year fixed mortgage rate				
	6.12	6.10	6.22	5.66
15-year fixed mortgage rate				
	5.70	5.67	5.76	5.14
1-year adjustable rate				
	5.20	5.18	5.15	4.18
STOCK MARKET				
Dow Jones Industrials	10907.21	10667.39	10717.50	10427.20
S&P 500	1283.72	1261.49	1248.29	1171.36
NASDAQ	2304.23	2247.70	2205.32	2035.83
Commodities				
Gold (\$) - 100 OZ	558.50	554.00	513.00	428.60
Oil (\$ per barrel) - Crude Futures (NYMerc)	67.76	68.48	61.06	47.18
(Key Reports For Week of January 27)				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Existing Home Sales (December) - 000s	6600	7000	7090	7068
New Home Sales (December) - 000s	1269	1233	1358	1292
Durable Goods Orders (Dec) - % change	1.3	5.4	3.1	1.0
GDP (Q4) - % change, SAAR	1.1	4.1	3.3	3.3

To no one's surprise, the economy downshifted abruptly in the final months of 2005. However, the extent of the slowdown raised eyebrows in the forecasting community, as it was far more severe than just about anyone expected. The consensus, including us, looked for growth to decelerate to the 2-3 percent range from a 4.1 percent pace in the third quarter. Instead, the Government's figures, released Friday morning, revealed that real gross domestic product slowed to just a 1.1 percent annual rate in the fourth quarter. Not only is that the slimmest increase in three years, it breaks a string of 10 consecutive quarterly gains in excess of 3 percent, the longest such streak since the 13 that ended in the second quarter of 1986.



The sharper-than-expected slowdown immediately raised speculation about a number of hot-button issues. Will it persuade the Federal Reserve to hit the pause button in its rate-hiking campaign? Is the economy heading for rougher waters than expected, perhaps nearing the end of the four-year-old expansion? Are higher energy prices, heavy debt loads and fears of a collapse of the real-estate bubble finally proving too much for the economy to bear? No doubt, voices on both sides of these issues will be heard loudly and clearly over the next several days, generating confusion over the economy's fate and heightening volatility in the financial markets.

Like most everyone else, we were surprised by the severity of the slowdown, but we continue to believe that the economy has solid underpinnings and will rebound nicely in the current quarter. That's not to downplay the growth obstacles that clearly remain on the radar screen, some of which have actually become more formidable than we thought a few months ago. Energy prices, for example, are not receding as much as expected last fall, when crude quotes appeared to be falling well below hurricane-inflated levels. At last look, oil prices remained stubbornly near \$70 a barrel, thanks to ongoing geopolitical tensions that received a fresh jolt with this week's surprising Palestinian election results. Higher energy bills, the functional equivalent of a tax increase, constitute a major depressant on consumer spending, which is already being weighed down by heavy debt burdens, a cooling real-estate market, and a woefully inadequate personal savings rate.

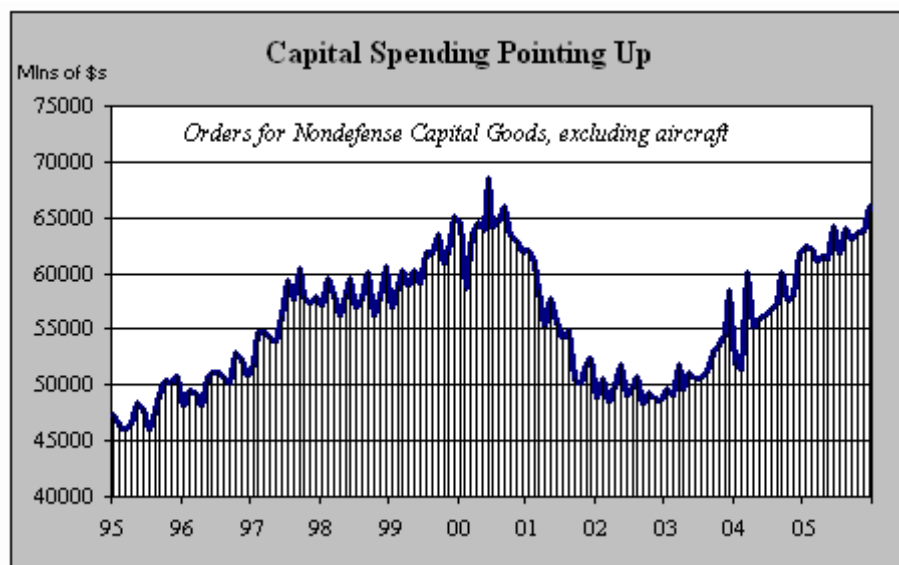
Nonetheless, elevated energy prices have been around for three years, and they have not brought consumers to their knees yet. With household fundamentals improving, the odds of a consumer meltdown in 2006 are becoming even slimmer, in our view. To be sure, an examination of the fourth-quarter GDP results show that consumers were the major impetus behind the slowdown. Real spending collapsed to a 1.1 percent growth rate from 4.1 percent in the third quarter, accounting for about 70 percent of the GDP slowdown. But the consumer retrenchment was front-loaded in the early part of the quarter, and largely confined to auto purchases. Outside of the auto sector, households were not nearly as frugal as the headline number suggest.

Outlays on services, for example, increased at a 3.2 percent pace in the fourth quarter, barely changed from the 3.3 percent increase in the third quarter. Nondurable purchases, meanwhile, rose at a 5.1 percent annual rate, which was actually stronger than the third-quarter's 3.5 percent gain. The main culprit, of course, lies with durable goods, which plunged by 17.5 percent during the period, following a 9.3 percent increase in the third quarter. Not surprisingly, autos were the big-ticket item that consumers shunned the most in the year's closing quarter. But even here, the quarterly change is somewhat misleading, as the biggest tumble occurred in October when auto makers stopped offering the generous employee discounts to the public that bolstered sales in August and September. In October, sales of autos and light trucks fell to a 14.7 million annual rate, the smallest volume since August 1998. Since then, Detroit has reinstated discount programs and sales have climbed back, reaching 15.7 million in November and 17.2 million in December. With auto sales starting the new year substantially above the average for the fourth quarter, there is little question that consumer spending will post a significantly stronger increase in the first quarter, perhaps as much as 3.5 percent. That alone would give the economy a significant lift during the period.

What's more, there were elements of the fourth-quarter slowdown that look highly suspicious, which could lead to upward revisions when the second GDP reading is taken next month. The most conspicuous item that jumped out at us was the much smaller-than-expected increase in business investment, which amounted to a nondescript 2.8 percent. That was far weaker than the 8.5 percent gain in the third quarter and less than half the expected increase. However, this GDP component just doesn't square with the trend observed in the monthly data. Just this week, for example, the Commerce Department released data on durable goods orders and shipments, which suggested a much stronger increase in capital spending than shown by the

investment figures in the GDP accounts.

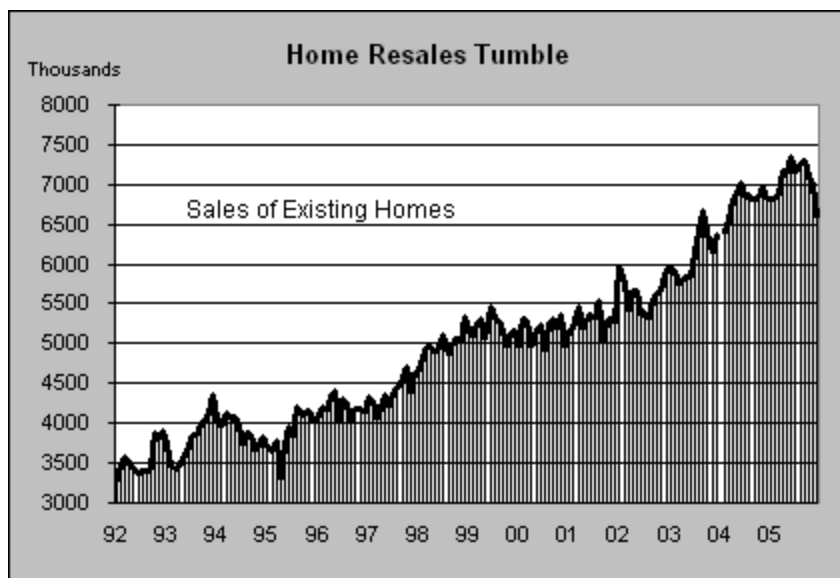
Indeed, shipments of nondefense capital goods less aircraft -- a proxy for capital spending -- leaped by 14.9 percent in the fourth quarter while output of capital goods, as reflected in last week's industrial production report, jumped by 19.5 percent. These figures strongly suggest that the preliminary fourth-quarter estimate of investment spending will be revised upward in the next GDP tally. What's more, capital-spending prospects ended the year on a high note. According to the monthly bookings data, new orders for capital goods less aircraft jumped by 3.5 percent in December, and the total stood an annualized 9.6 percent above the fourth quarter average. That points to a lot of forward momentum heading into 2005. Hence, both consumer spending and business investment are expected to rebound strongly in the first quarter.



Then there is the suspicious decline in Federal Government spending during the fourth quarter, a period when hurricane rebuilding needs prompted Congress to appropriate an additional \$78 billion in funds to aid the hard-hit region. Whatever wasn't captured in the fourth-quarter spending figures will surely show up in the first quarter. Aside from the questionable accounting of government spending, it is hard to believe that Federal Defense spending actually fell in the fourth quarter, which the data show, given Afghanistan, Iraq and general Pentagon requirements to beef up military preparedness in an increasingly hostile geopolitical environment. If you don't believe that defense outlays will rebound in the first quarter, there's a bridge for sale that we are happy to show you. Indeed, with the Treasury set to borrow a record \$171 billion in the January-March period, the budget honchos are poised to open the spending spigots, unless they plan to squirrel away the proceeds for a rainy day.

To be sure, we don't mean to downplay the slowdown in overall economic activity that took place in the fourth quarter. Given the powerful headwinds that prevailed at the start of the period -- the devastation wrought by the hurricanes, the confidence-shock related to spiraling oil prices and the temporary removal of auto incentives -- there is little question that the economy faltered during the period. Indeed, in addition to these external shocks, the economy also received much less of a boost from housing, which was widely expected and likely ongoing. After increasing by 10.6 and 10.9 percent in the second and third quarters, residential outlays posted a slim 3.5 percent gain in the fourth quarter. While this downshifting is significant, it is probably an accurate reflection of what's happening in the housing market. Sales are slowing, unsold homes are becoming more plentiful and builders are scaling back construction plans.

But as we noted last week, we don't expect that housing activity is on the verge of collapsing. While the latest numbers do indicate a sharp slowing in virtually all phases of the residential real-estate market, the winter months are not the best time to gauge the overall health of the sector. In all likelihood, the slump in housing starts and home re-sales in December was exaggerated by special weather-related factors. Indeed, the housing numbers that were released this week provide a good example of how difficult it is to get a firm read on this market. Sales of existing homes tumbled by a larger-than-expected 5.7 percent in December and median prices fell during the month. But just as the housing postmortem was being written, the government reported on Friday that new home sales staged a surprising 2.9 percent jump during the month. We are just as skeptical about the strength in new home sales as we are about the weakness in existing home sales and construction. We suspect that housing is transitioning from red-hot to a cooling-off stage, but no collapse is imminent, not with fixed mortgage rates still hovering at historical lows of 6.1 percent in the latest week.



Simply put, we expect the first quarter's growth rate to show a solid rebound from the tepid fourth quarter reading, which in turn could be revised upward next month. It's possible that GDP could once again expand in the 4 percent plus neighborhood during the period, particularly if the fourth-quarter shortfall in capital spending and government outlays is fully recaptured in the first quarter. However, just as the economy is stronger than what was portrayed by the 1.1 percent showing last quarter, a rebound to 4 percent in the first quarter would likely be a temporary bulge that will fade in the spring months. A more reasonable expectation is for a growth rate hovering near 3 percent over the balance of 2006, with consumers pulling in their horns somewhat while capital spending and exports become more important growth drivers.

We suspect that the Fed will view the economy in much the same way, and not be dissuaded by the latest GDP numbers from pulling the rate-hiking trigger once again when it meets on January 31. Not only is it well aware of the distortions inherent in the fourth quarter GDP report, the slowdown in growth failed to bring about a corresponding fall in a key inflation index. Indeed, the inflation barometer that the Fed -- at least under outgoing chairman Greenspan -- placed the most reliance on actually moved higher in the fourth quarter, as the core personal consumption deflator, which excludes food and energy items, increased by an annual rate of 2.2 percent compared to 1.4 percent in the third quarter. With the Fed striving to keep inflation under 2 percent, that suggests the end of the rate-hiking campaign may not be as near as many expect. Still, the next policy-setting meeting following the one this Tuesday is about two-months away, giving the Fed plenty of time to digest incoming data, which will be ever-so crucial in the decision-making process.