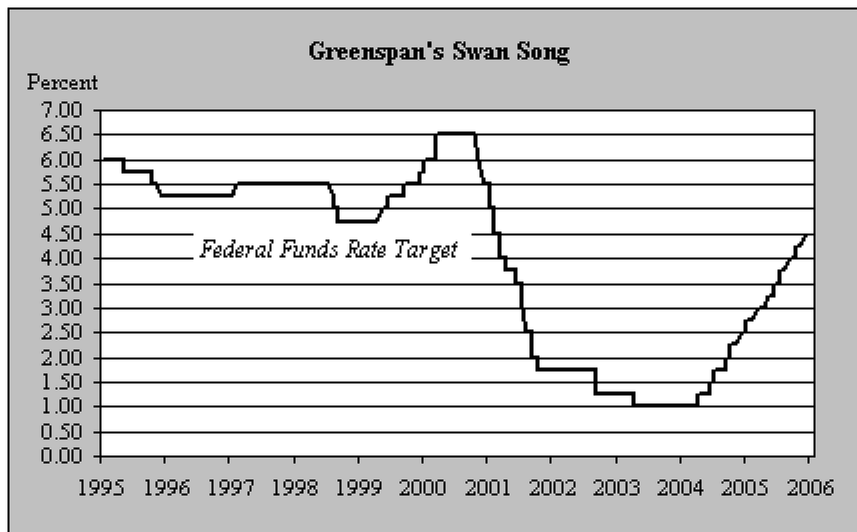
WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 3, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	February 3	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.46%	4.44%	4.20%	2.48%
6-month Treasury bill	4.62	4.55	4.38	2.74
2-year Treasury note	4.57	4.49	4.35	3.28
5-year Treasury note	4.48	4.44	4.31	3.67
10-year Treasury note	4.53	4.51	4.37	4.08
30-year Treasury bond	4.63	4.69	4.56	4.48
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.52	3.44	3.48	2.91
10-Year	3.91	3.86	3.91	3.65
30-Year	4.48	4.44	4.48	4.54
30-year fixed mortgage rate	6.23	6.12	6.21	5.63
15-year fixed mortgage rate	5.81	5.70	5.76	5.14
1-year adjustable rate	5.33	5.20	5.16	4.23
STOCK MARKET				
Dow Jones Industrials	10793.62	10907.21	10959.31	10716.13
S&P 500	1264.03	1283.72	1285.45	1203.03
NASDAQ	2262.58	2304.23	2305.62	2086.66
Commodities				
Gold ($)- 100 0Z	571.30	558.50	541.30	416.20
Oil ($ per barrel) - Crude Futures (NYMerc)	65.37	67.76	64.21	46.48

	(Key Reports For Week of February 3)			
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Personal Income (December) - % change	0.4	0.4	0.6	0.5
Personal Outlays (December) - % change	0.9	0.5	0.1	0.5
Consumer Confidence Index (January)	106.3	103.8	98.3	97.8
ISM Manufacturing Index (January)	54.8	55.6	57.3	56.2
Employment Cost Index (Q4)	0.8	0.8	0.7	0.8
Nonfarm Productivity (Q4) - % change	-0.6	4.5	2.1	2.2
Nonfarm Payrolls (January)-change in 000s	193	140	354	128
Unemployment Rate (January) - Percent	4.7	4.9	5.0	5.0

The Maestro conducted his last song this week, culminating an eighteen-year masterpiece with a final wave of his rate-hiking wand on January 31. To be sure, Greenspan's last act as the departing Fed chief may elicit a curtain call from the incoming chairman, Ben S. Bernanke, who was sworn in without much fanfare the following day. But Bernanke has a tough act to follow, and his leadership skills and acumen will be sorely tested in the months ahead. With the latest quarter-point increase in the federal funds rate to 4.50 percent, monetary policy is now squarely in the neutral zone, i.e., where it neither stimulates nor retards economic growth. From here on, the Fed's task will be much more challenging than it has been over the past year and a half.



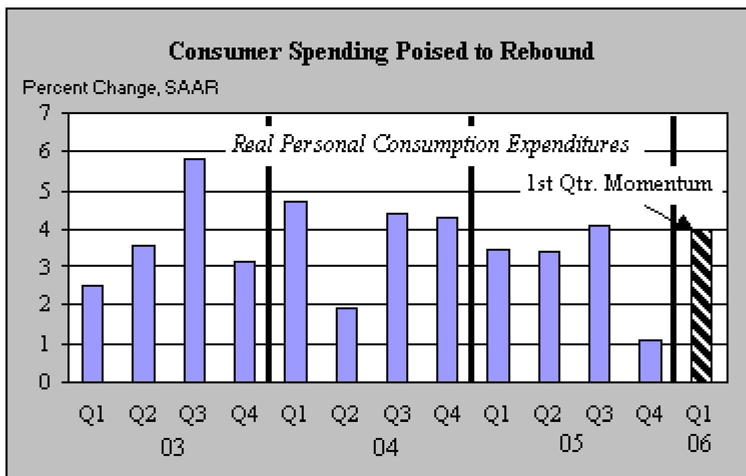
Indeed, for the most part, all of the 14 increases that the Fed implemented since June 2004, when the funds rate stood at a rock-bottom 1 percent, were no-brainers; the economy forged ahead at an above-trend pace, the 2002-2003 deflation threat had been vanquished, and slack in the product and labor markets has mostly evaporated, heightening inflation concerns. Simply put, the Fed's objective during this period was to wean the economy off of the excessive monetary stimulus that was clearly no longer needed to sustain growth. The financial markets generally agreed with that strategy and Main Street hardly suffered, as the economy enjoyed the most sustained period of above-trend growth since the mid-1980s.

Now, however, volatility has replaced growth as the overriding feature of the economic landscape. With volatility comes uncertainty, making the Fed's task more difficult. Hence, it comes as no surprise that for the first time since the tightening cycle began, the Fed altered its policy statement to reflect a greater degree of uncertainty as to what it might do going forward. Recall that in each of the previous thirteen meetings, the official statement accompanying the quarter-point rate hikes conveyed the clear impression that another increase was forthcoming. The message was embedded in the recurrent use of the phrase "some further measured policy firming is likely to be needed". In the January 31 official statement, however, that infamous phrase was subtly altered to read "some further policy firming may be needed". In other words, folks, the Fed may or may not raise rates again, depending on what the economic data reveal.

Last week, the markets leaned towards the view that, at most, one more rate hike was in the cards at the next policy meeting on March 28 -- the so-called "one and done" notion that became the catchphrase of the moment. Indeed, more than a small fraction of Street analysts believed that the Fed had already finished the job, and would now go into a pause mode. After all, the latest inflation numbers were benign -- actually subsiding with the topping out in energy prices -- the economy's major growth driver, the real estate market, was clearly cooling off, and economic growth downshifted abruptly in the fourth quarter. The last component of that trifecta was particularly compelling, as real GDP growth almost crawled to a halt, ringing in at just 1.1 percent -- the slowest pace since the fourth quarter of 2002 when the economy was still struggling out of the 2001 recession.

But as we discussed last week, the near-stalling out of the GDP data was largely illusory, as it was highly concentrated in the auto sector and front-loaded in October, when auto sales plunged to a six-year low. While housing activity clearly subsided throughout the period, all of the other key sectors picked up momentum as the year drew to a close, and leading indicators pointed to continued strength in early 2006. The reported fourth-quarter slowdown in business investment was especially vexing, as it was inconsistent with monthly capital-spending data that showed considerably more strength. More to the point is that both new capital goods orders and shipments posted strong increases in December, indicating solid forward momentum in investment spending at the start of the new year.

This week's data reinforced the perception that the economy will open the year on a robust note. In discussing the consumer-spending component of GDP last week, we took note of the fact that auto sales gradually recovered as the quarter progressed while other consumer purchases held up quite well. As it turns out, that description of household behavior was an understatement. According to the Commerce Department's monthly report on personal incomes and outlays released this week, consumer spending surged by 0.9 percent in December, the largest gain in six months. What's more, all of the gain was real, as the personal consumption deflator -- the broadest measure of consumer inflation -- was unchanged during the month. As a result, real consumer spending ended the year at a whopping 3.7 percent above the fourth quarter average.



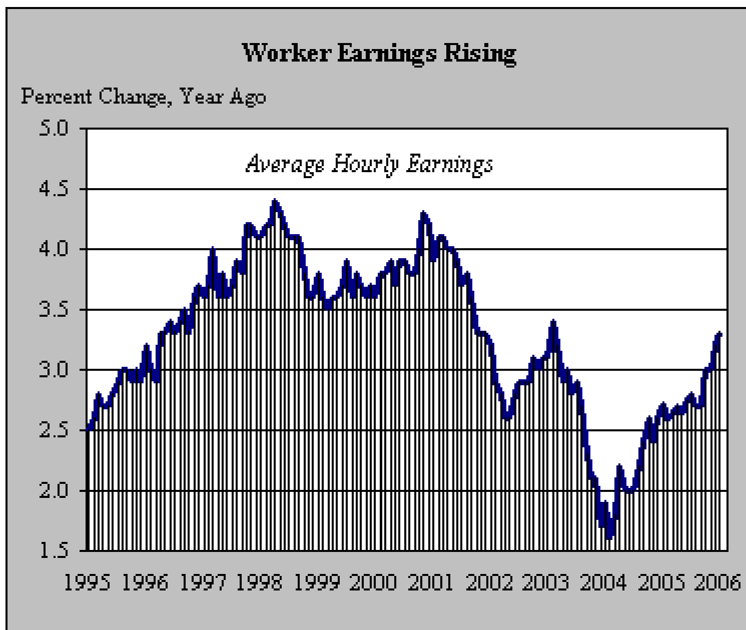
In other words, if consumer spending remained unchanged at December's level over the next three months, it would still register a solid 3.7 percent gain for the quarter, more than three times the fourth quarter's puny 1.1 percent increase. Since consumers account for some 70 percent of GDP, that alone would likely boost the economy's growth rate back close to the above-trend 4 percent average pace that prevailed in the two and a half years prior to the fourth quarter's slump to 1.1 percent. If, as is more likely, households increase their outlays by a modest 0.2 or 0.3 percent a month, the quarterly gain in real consumption would surge to over 5 percent, generating a corresponding increase in GDP. Indeed, economists were falling all over themselves this week to mark up their first-quarter growth forecasts, with some high-profile prognosticators looking for a gain of as much as 6 percent.

More recent data on household behavior suggest that such an outsized forecast is not so farfetched. Chain stores reported solid sales gains in January, thanks in part to the heavy redemption of the ever-more popular holiday gift cards. The unusually warm weather also played a role, not only by making it more inviting for shoppers to go to the malls, but by also reducing home heating requirements, thus leaving extra discretionary cash on the table for spending purposes. Add to the mix another increase in auto sales, and January is shaping up to be quite a muscular start to the new year. Even factoring in a weather-related drop-off in February as Mother Nature returns to normal, it seems that the economy's growth engine will accelerate sharply in the first quarter, posting a gain of at least 4 percent.

To be sure, nothing is cast in stone, and any number of external shocks -- from weather changes to energy price spikes to geopolitical disruptions -- could easily knock the strengthening trend askew before the quarter's end. But the "one and done" notion that circulated last week is now as passe as the fourth-quarter's GDP report.. Based on the behavior of the futures market, the odds have risen significantly that the Fed will raise rates at least two more times before calling it a day, with a 5 percent handle for the federal funds rate in sight. That perception received added support on Friday, with the release of the government's employment report, which admittedly contained more anomalies than clarification as to the underlying strength in the job market.

On the surface, the 193 thousand gain in payrolls in January portrayed a far weaker market than expected, as the consensus forecast was for an increase of at least 250 thousand. Some forecasters were looking for a blockbuster number, something north of 300 thousand, reflecting seasonal quirks, such as the unusually warm weather, which was expected to inflate construction jobs. Well the weather did play a role, as a big chunk of the January gain in jobs was concentrated in weather-sensitive industries, such as construction and in the leisure and hospitality grouping, which includes restaurants and bars. However, market pundits chose to downplay the significance of the headline weakness in job growth and focus instead on the upbeat elements of the employment report.

Of those, there were plenty indeed. First off, the January softness in payrolls was upstaged by steep upward revisions to the previous four monthly job gains, totaling a cumulative 124 thousand. When those revisions are factored in, the total number of workers drawing paychecks in January was actually higher than expected. But that's only part of the story. The unemployment rate, derived from a separate survey of households, tumbled from an already-low 4.9 percent to 4.7 percent, the lowest rate since April 2001. Given the Fed's explicit concern (reiterated by the new chairman Bernanke in a speech delivered months before taking office) about how the high rate of resource utilization poses an inflation threat, the latest unemployment number will obviously not sit too well with the policymakers at the next meeting. That's particularly the case since the employment report also revealed more upward pressure on wages. For the second month in a row, average hourly earnings increased by 0.4 percent, the first back-to-back reading of this magnitude since late 2000.



As the chart shows, this measure of worker earnings has been climbing steadily over the past two years, albeit from a disturbingly low level reached in late 2003. Still, the upward trend is palpable and reinforces the sharp increase in unit labor costs that occurred in the fourth quarter when productivity growth tumbled. There are many diehard pessimists who claim that the low unemployment rate exaggerates the tightness in the labor market because it masks the exodus of people from the labor force. They point to the low labor force participation rate -- currently at a near-cycle low of 66 percent -- as evidence of the large number of potential workers that are too discouraged to look for a job. While there may have been an element of truth to that view in the past, a more compelling reason for the low participation rate now is simply that more young people in the 18-24 age group are staying in school. We suspect that this in not an indication of discouragement, but rather an acknowledgment of the higher level of technical and informational skills required in the workplace. As evidence of this, just witness the fact that the jobless rate among college graduates is 2.1 percent compared to 4.4 percent and 7.7 percent among high school grads and dropouts, respectively. While there may be anomalies in the latest jobs report, the value of an education in today's workplace stands out as one indisputable reality.