WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 10, 2006

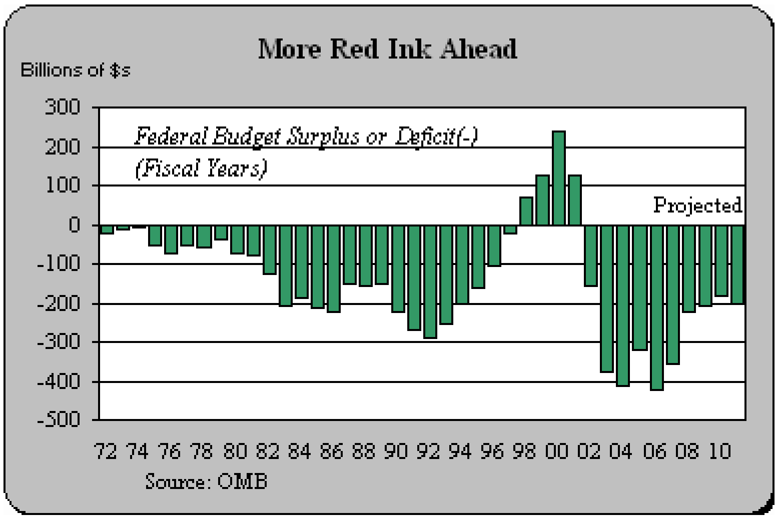
First the numbers -- then the story

FINANCIAL INDICATORS				
INTEREST RATES	February 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.53%	4.46%	4.32%	2.54%
6-month Treasury bill	4.69	4.62	4.42	2.81
2-year Treasury note	4.68	4.57	4.33	3.32
5-year Treasury note	4.58	4.48	4.28	3.69
10-year Treasury note	4.58	4.53	4.35	4.08
30-year Treasury bond	4.55	4.63	4.52	4.47
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.54	3.52	3.48	2.87
10-Year	3.94	3.91	3.91	3.59
30-Year	4.48	4.48	4.47	4.48
30-year fixed mortgage rate	6.24	6.23	6.15	5.57
15-year fixed mortgage rate	5.83	5.81	5.71	5.10
1-year adjustable rate	5.34	5.33	5.15	4.11
STOCK MARKET				
Dow Jones Industrials	10919.05	10793.62	10959.87	10796.01
S&P 500	1266.99	1264.03	1287.61	1205.30
NASDAQ	2261.88	2262.58	2317.04	2076.66
Commodities				
Gold ($)- 100 0Z	5538.00	571.30	557.00	422.00
Oil ($ per barrel) - Crude Futures (NYMerc)	61.84	65.37	63.92	47.16
	(Key Reports For Week of February 10)			
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (December) - mlns of $s	3349	568	-7232	4177
Trade Deficit (December) - mlns of $s	65676	64694	677909	63406

Welcome back you old bat. No, we are not alluding to Bela Legosi's legendary depiction of the blood-sucking vampire. Like that movie of a bygone era, the object in question has also been absent from the scene for quite a long time. As anyone who is even remotely involved with the bond market knows, what we are referring to is the resurrection of the heretofore bellwether 30-year Treasury bond, which the government auctioned off this week for the first time since August 15, 2001. The 4 1/2 year hiatus since the last bond sale was the result of a deliberate Treasury strategy announced on October 31 of that year, appropriately referred to as the "Halloween surprise" (and, hence, our tortured vampire metaphor).

Recall that when the Treasury decided to discontinue offering the long bond -- after including it regularly in its quarterly financing operations since 1977 -- the world was quite different from what it is today. In 2001, the government had run large budget surpluses for four consecutive years, the longest string in more than seven decades. With the budget expected to stay in the black for years to come, the debt managers decided that the need to raise funds through bond sales was no longer necessary. What cemented the decision was cost. At the time, the yield on 30-year Treasury bonds stood at 5.30 percent, which made it far more expensive than issuing 5-year notes at 3.7 percent, 2-year notes at 2.6 percent or borrowing short-term funds in the bill sector at 2 percent. With the economy mired in a recession and the Federal Reserve about to embark on an aggressive rate-slashing campaign that would ultimately lower short-term rates to the lowest level in forty years, the debt managers understandably deemed it prudent not to lock in borrowing costs at the prevailing level of bond yields for the next thirty years.

But that was then. Thanks to massive tax cuts, a war on terror that would bloat defense and homeland security spending, ever-growing entitlement outlays, a recession as well as a stock-market collapse that decimated tax revenues, the 1998-2001 surpluses would be gone in the blink of an eye. By fiscal 2002, the government was once again in familiar territory, incurring a $158 billion deficit that would balloon over the next three years, culminating in a record $423 billion gap estimated for the current fiscal year. The administration's latest budget, released this week, promises little relief going forward. Although the numbers sparked controversy as soon as they came off the press, one thing is certain: the Treasury will be operating in the red as far as the eye can see -- and it will need to borrow heaps of funds to finance the deficits.



What's more, the interest-rate environment today is far less receptive to borrowing funds in the short-term markets than it was in 2001, when the Treasury decided to suspend its bond offering. True, the strategy of lowering borrowing costs by raising an increasing fraction of funds in the shorter-term markets was successful until 2004, thanks to the wide spread between long and short-term interest rates that the Fed engineered over the period. But what the Fed giveth, it has since taken away. With the fourteen rate hikes implemented since June 2004, the Greenspan-led Fed has pushed short-term rates up by 3.75 percentage points. As a result, it is now more expensive to borrow short-term than long-term funds -- a condition encapsulated by the so-called yield-curve inversion. As of Friday's close of trading, for example, the yield on the 2-year Treasury note stood at 4.68 percent compared to 4.58 percent and 4.55 percent on 10-year and 30-year issues, respectively.

What's more, with the emphasis on shorter-term borrowing in recent years, the average maturity of the Treasury's outstanding debt has, not surprisingly, also shortened considerably. As a result, the Treasury now has to come to the market more frequently just to refinance the expanding volume of maturing debt. In the current quarter, for example, the debt managers are expected to raise a record $188 billion in the financial markets -- quite a tidy sum -- to refinance maturing debt and raise new funds. Given this backdrop, the decision to re-offer the 30-year bond makes sense if only to arrest the relentless shortening in the average maturity of outstanding debt and to curb the frequency of Treasury trips to the market. But there is another compelling reason for the government to resurrect the 30-year bond.

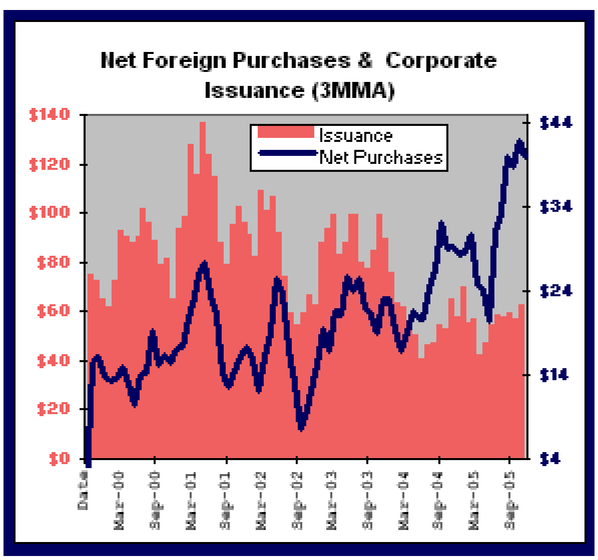
Simply put, while the Fed was jacking up short-term rates, bond yields hardly budged. Indeed, the 30-year bond is actually 75 basis points lower than it was in June 2004, when the first rate hike was put into effect. While the reasons bond yields have not increased throughout the rate-hiking campaign are the subject of heated debate, there is one indisputable fact: in its absence, the long bond has grown fonder in the hearts of investors. Reflecting the pent-up demand that the 4 1/2-year hiatus has generated, the reception for this week's 30-year bond auction was exceptional, drawing unprecedented demands from both domestic and foreign investors. The usual major participants, the primary dealers that are obligated to bid in these auctions, wound up with a paltry 34.4 percent of the $14 billion offer. By comparison, the average dealer takedown in long bond auctions has historically been closer to 70 percent.

As a result of this strong demand, the 30-year bond sold for an average yield of 4.53 percent. Not only is that far less than the 5.52 percent the Treasury paid on its last 30-year bond auction in August 2001, it is the lowest yield ever in the auctions going back to 1977. To be sure, the government would have fared even better had it came to the market with this issue back in mid-2003, when deflation fears pushed Treasury bond yields about 1.5 percentage points below where they are now. But at the time, short-term rates were 3.50 percentage points lower, and the magnitude of the budget-deficit problem had not yet come fully into focus.

Also not known until the last couple of years is the enormous appetite that has developed for longer-dated bonds by pension funds and other financial institutions. Part of that appetite simply reflects a shift away from riskier assets -- a legacy of the stock-market woes from 2000 to 2003 -- as well as a response to the tougher regulatory climate that evolved out of the accounting scandals of that period. But just as important is that pension funds and life insurance companies have an acute need for longer-dated assets with a certain income stream to match their liabilities associated with the burgeoning retirement population that is poised to get underway with the aging of the baby boomers. In short, the bond is back at just the right time, and the Treasury will have ample opportunity to sell it, given the steep financing requirements that lie ahead. Hence, its announcement that it will sell between $20-$30 billion of 30-year bonds this year hardly upset investors, who are likely eagerly awaiting the next auction, scheduled for August.

Of course, the government is not the only borrower in town, and the perennial question that arises in times of heavy deficit financing is how will other seekers of borrowed funds be affected. The answer, so far, is hardly at all. Indeed, corporations have been filling the void created by the Treasury's suspension of 30-year bond sales quite successfully, and continue to actively raise funds in the longer maturity segment of the market. Just this week, Verizon re-issued a 30-year bond, and the $500 million add-on was oversubscribed threefold. Meanwhile, the spread between corporate and Treasury yields -- which would normally widen if Treasury debt was "crowding out" private debt -- actually narrowed this week, and remains at the historically slim margin that emerged in 2005.

Here too, the heavy demand from institutions is playing a major role. But these days, it is impossible to gauge the strength in demand for either corporate or government issues without taking foreign investors into account. The reason: foreign funds have displaced domestic financial institutions as the largest source of new lending in the Treasury and corporate securities markets. And their presence is growing by leaps and bounds. In the year through last November, overseas investors snapped up $353 billion of corporate bonds and $288 billion of Treasury securities. While the Treasury has to tap domestic as well as foreign sources to finance its deficit, corporations are easily meeting all of its needs from abroad. As the chart shows, foreign purchases of corporate securities have exceeded the volume of new corporate issuance by a wide margin for nearly two years. Needless to say, this huge inflow has contributed importantly to the narrow spread between corporate and Treasury yields.



But one group of borrowers that may be getting squeezed is the household sector. Unlike the Treasury and corporations, consumers do not have direct access to the securities markets or to foreign investors. As a result, they cannot circumvent the surging level of short-term financing costs as readily as can those borrowers, making credit card borrowing and home equity loans much more expensive. Not surprisingly, households have cut back sharply on both of those types of loans in recent months. Home equity lending has tumbled like a stone, and installment borrowing virtually grounded to a halt in last year's fourth quarter. This, of course, is just what the Fed wanted to accomplish by hiking short-term rates, hoping to cool off consumer demand before inflation heats up.

However, there is an important leakage in the Fed's strategy, which may thwart the cooling-off process. With long-term rates remaining low, households have had continued access to cheap financing in the mortgage market. One result of this access is that they can refinance old loans with larger mortgages, using the extra proceeds from these so-called cash-out refinancings to support spending. According to just-released figures from Freddie Mac -- the large housing agency -- such cash-out refinancing, accounting for 80 percent of the total, increased to $70.3 billion in the fourth quarter from $67.2 billion in the third quarter, bringing the total for all of 2005 to $243 billion. That's a hefty supplement to incomes, which will likely spill over into the spending stream in early 2006. However, that may be a last-gap supplement, as the mortgages refinanced in the fourth quarter were based on homes that had appreciated by a record 27 percent since the original loans were taken out. That's not likely to be repeated this year, as the housing market is already cooling off and refinancing activity has fallen significantly in recent months. Freddie Mac expects cash-out refinancings to fall to $117 billion in 2006, less than half last year's volume. That's one of the reasons consumer spending is expected to moderate this year, curbing the economy's growth rate. Of course, a slowing economy will also cut into tax collections, potentially widening the government's deficit further -- and kicking up the Treasury's financing needs in the process. As we said at the outset -- welcome back you old bat!