WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 3, 2006

First the numbers, then the story

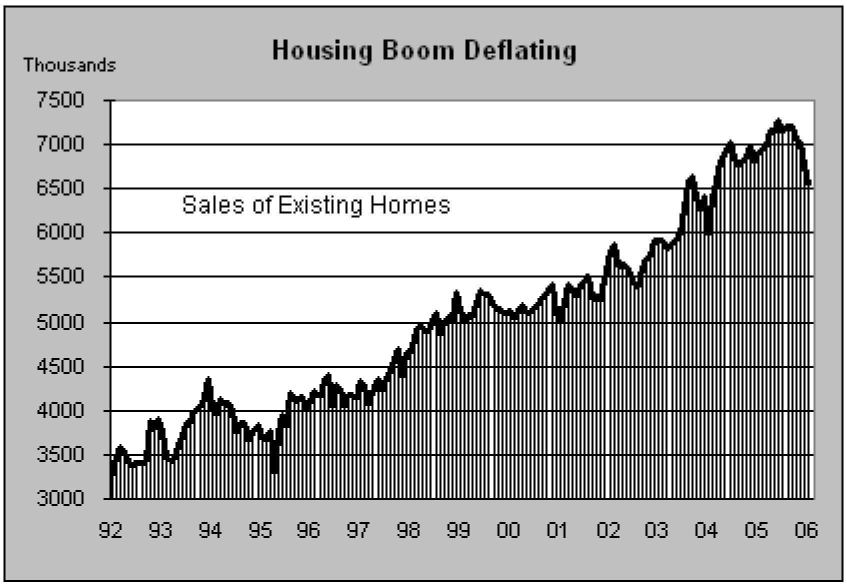
FINANCIAL INDICATORS				
INTEREST RATES	March 3	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.60%	4.59%	4.46%	2.75%
6-month Treasury bill	4.75	4.72	4.62	2.99
2-year Treasury note	4.75	4.72	4.57	3.56
5-year Treasury note	4.71	4.64	4.48	3.96
10-year Treasury note	4.68	4.58	4.53	4.31
30-year Treasury bond	4.66	4.53	4.63	4.65
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.56	3.56	3.52	3.14
10-Year	3.92	3.95	3.91	3.81
30-Year	4.45	4.45	4.48	4.60
30-year fixed mortgage rate	6.24	6.26	6.23	5.79
15-year fixed mortgage rate	5.89	5.89	5.81	5.33
1-year adjustable rate	5.34	5.32	5.33	4.14
STOCK MARKET				
Dow Jones Industrials	11021.59	11061.85	10793.62	10940.55
S&P 500	1287.23	1289.43	1264.03	1222.12
NASDAQ	2302.60	2287.04	2262.58	2070.61
Commodities				
Gold ($)- 100 0Z	566.90	561.00	571.30	435.20
Oil ($ per barrel) - Crude Futures (NYMerc)	63.67	62.91	65.37	53.78

KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (January) - 000s of units	1233	1298	1251	1275
Existing Home Sales (Jan) - 000s of units	6560	6750	7030	6967
ISM Manufacturing Index (January) - Index	56.7	54.8	55.6	56.8
Consumer Confidence (February) - Index	101.7	106.8	103.8	97.2
Personal Income (January) - % change	0.7	0.5	0.3	0.5
Personal Outlays (January) - % change	0.9	0.7	0.5	0.4

Even though the economy is poised to turn in a rip-snorting performance in the first quarter, an uneasy tone continues to permeate discussions about growth prospects. One reason is the widespread perception that the economy's fate is heavily dependent on the housing industry. That's not surprising considering the outsized contribution that housing has made to the expansion over the past several years. During the 2003-2005 period, for example, direct expenditures on residential structures accounted for 13.3 percent of the growth in GDP, more than twice the size that such spending represents in the overall economy.

But the direct spending contribution only tells a small part of the story. Thanks to the real estate boom, construction payrolls expanded at a far stronger pace than most other segments of the labor force -- and those workers so not include the army of real-estate brokers and other white-collar employees hired by financial institutions that participate in the mortgage-lending process. Then there are the ancillary industries that benefit from the housing boom, including those that provide home furnishings, appliances, remodeling products and services, as well as moving companies that help folks make the transition from their old homes to newly-purchased ones. Finally, there is the so-called "wealth effect" that enables homeowners to cash out equity from their vastly appreciated properties through mortgage refinancings and second mortgages, which can be used for spending purposes. All told, it is estimated that fully one-quarter of the economy's growth rate over the past three years has been derived from the real-estate frenzy in all of its forms.

Given the lopsided role that housing has played in the economy's performance, it is understandable that a real-estate collapse is widely feared as a possible death blow to the expansion. With the housing market cooling off, these fears have grabbed headlines on almost a daily basis. This week, the industry provided more ammunition for the worrywarts to spread their gloom and doom scenario. Despite mild weather in January, for example, sales of new homes slid 5 percent during the month to the lowest level in a year. At the January sales pace, the months' supply of unsold homes rose to the highest level since 1996, suggesting that homebuilders will soon curb new construction to prevent a housing glut from materializing. Nor are re-sales of existing homes, which account for about 85 percent of the residential market, faring any better. In January, re-sales fell for the fifth consecutive month, and the 2.8 percent drop brought the total to the lowest level since February 2004, down nearly 10 percent from the peak reached last June.



Clearly, these trends signal an end to the housing boom, which is not surprising in light of the fourteen consecutive short-term rate increases engineered by the Fed since June 2004, and the more modest upward movement in long-term mortgage rates over the past year. But it is one thing to note a cooling off in housing activity, and quite another to claim that an outright collapse is in the making. Indeed, the weakness seen in housing activity thus far is hardly compelling. Even following five months of declining sales, the number of existing homes sold in January stood only 5.5 percent below the average of last year's third quarter, which was the third strongest on record. More to the point, homeowners are not seeing their property values vanish into the night, causing a negative wealth effect that would stifle consumer spending.

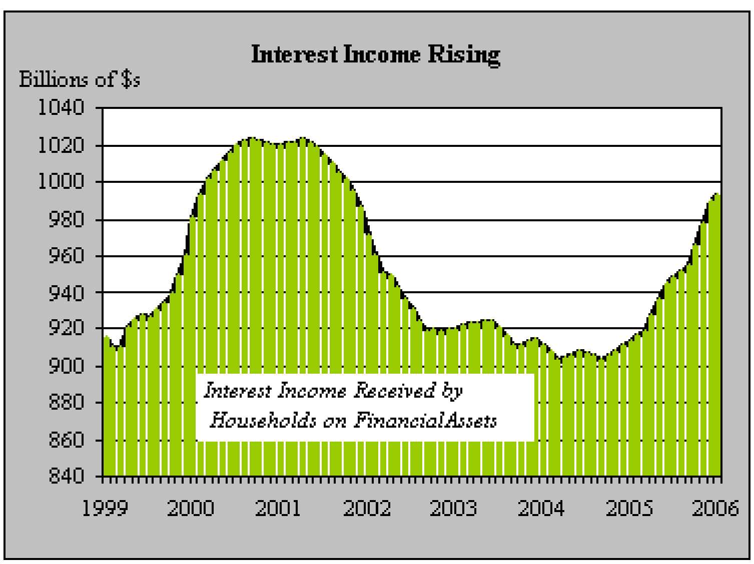
While the brouhaha over ever-soaring property values at cocktail parties may be lessening, hardly anyone is being impoverished by a slump in housing prices. Yes, homes are staying on the market longer, and prices have been reduced from listed quotes, particularly for the red-hot condo/coop market. In certain local markets, steep price declines have been noted, and erroneously interpreted by intrepid reporters as an early-warning sign of the much-feared real-estate collapse. But the reality is that on a nationwide basis, sellers are still fetching higher prices for their homes than were posted a year ago. In the twelve months through January, median sales prices in the existing and new-home markets were up 11.6 percent and 6.7 percent, respectively. True, these prices are skewed by the distribution of sales, which have recently consisted of more higher-priced homes as potential buyers in the lower-income groups are being increasingly priced out of the market.

But other figures that track home prices on a more consistent basis describe a similar theme in the housing market. The Office of Federal Housing Enterprise Oversight (OFHEO), for example, follows quarterly home price changes for repeat sales or refinancings on the same single-family homes over time, based on information provided by Fannie Mae and Freddie Mac, two giant housing agencies. This week, it provided data for last year's fourth quarter, and the reading is hardly descriptive of impending doom in the housing market. Yes, on a sequential basis, the appreciation is slowing. Compared to the third quarter, home prices rose by 2.9 percent, modestly slower than the 3.1 percent gain posted in the previous quarter. But compared to a year earlier, home prices staged a robust 13 percent increase, up from 12.6 percent registered in the third quarter, and just barely off of the record 14.2 percent jump posted in last year's second quarter. Simply put, while the bloom may be off the housing rose, the real-estate market is far from the point of bringing the economy to its knees. At most, the expansion will not be deriving the disproportionate positive thrust it enjoyed over the past several years from housing, which implies a 25 percent haircut from GDP growth going forward.

Since the economy has been expanding at an above-trend pace during most of the past three years, wringing virtually all of the excess capacity out of the product and labor markets, that's not entirely an unwelcome development in the eyes of policy makers. After all, the Federal Reserve's rate-hiking campaign is designed to cool off consumer demand, which has been the driving force powering the growth engine throughout the expansion. To the extent that a more temperate housing market curbs household spending propensities, it is viewed by Fed officials as an ally in the anti-inflation fight. That view may change, of course, if the housing market weakness morphs into something more serious and threatens to abruptly derail consumer spending. Indeed, many analysts believe that the Fed is monitoring the housing situation much more closely than in past cycles, and is using it as a guide to determine how high it can push up interest rates. If that's the case, a flattening housing market may be a good sign that the rate-hiking campaign is nearing an end.

But so far, the housing data are among the few indicators signaling a slowdown in growth, and not by enough to push the Fed to the sidelines yet. Keep in mind that households have tapped into their housing equity so extensively to support consumption largely because of the woefully slow recovery in incomes during the expansion. By all accounts, that appears to be changing, thanks to the tightening up in the labor market that has seen the jobless rate fall to a four and a half year-low of 4.7 percent in January. As a result, the increase in hourly earnings has started to accelerate, pushing up wage and income growth. In January, personal incomes posted a solid 0.7 percent increase, more than three times the average monthly gain in 2005. While some special factors boosted the income total for the month -- such as the cost-of-living increase for social security recipients and government workers -- wages and salaries in the private sector also staged a muscular 0.7 percent gain, handily outpacing the average 0.3 percent monthly increase in 2005.

If organic income growth is starting to pick up, households will not have to rely as much on their housing equity to sustain consumption. True, any reduction in real estate values that subtracts from housing wealth will make homeowners feel poorer. In turn, that will encourage households to replenish a sorely-depleted savings rate, which remained negative in January for the eighth time in the past ten months. But a healthy pickup in savings can be accomplished alongside of spending gains, if incomes are growing sufficiently. What's more, the rate-hikes by the Fed are having a positive side effect on incomes, even as they discourage borrowings. Since late last year, interest-income has increased by roundly $90 billion, most of which is plowed back into the savings vehicles that generated the gain.



Clearly, some pullback in consumer spending should be expected from the unsustainable pace of recent years. Indeed, after the blowout increase in January, retail sales sagged in February, as a record snowstorm along the Northeast and normally-cold weather replaced the unusually mild conditions that prevailed in January. The February slowdown won't be enough to dampen what looks like will be a hyperactive first-quarter, with consumer-led GDP growth topping a 5 percent pace. But as we noted last week, that's not the underlying trend, which is closer to the 3 - 31/4 percent growth rate averaged over the last two quarters, including the upwardly-revised 1.6 percent pace for last year's hurricane-battered fourth quarter.

The question of whether that trend-like pace can be sustained going forward in the face of a weakening housing market (not a bursting bubble) and slowing consumer spending will depend on how other components of the economy performs. To date, the much-heralded transition from consumers to businesses appears to be playing out according to script. The latest Business Roundtable survey of CEOs portrays a highly optimistic group of executives, who plan to step up capital spending and hiring over the next six months based on strong sales forecasts. The capital spending outlook is corroborated by incoming data on durable goods orders, which point to continued strong gains in outlays for short-lived capital goods that, together with software, have underpinned the rebound in business investment over the past two years.

Now, following several years of caution, the second shoe of the investment package looks ready to drop. Until recently, businesses have only grudgingly committed funds to new plants and other structures, thanks to the overcapacity built up during the go-go years of the 1990s, which lingered on after the dot-com bust and 2001 recession. The modest recovery in such spending beginning in late 2004 was arrested with the energy crisis and hurricanes in the summer of last year. But over the past six months, with industrial operating rates climbing to the highest level in more than five years, the need for expansion has become compelling, and companies are responding accordingly. As the chart shows, business spending on structures is on a strong growth track, posting an average annual gain of 12 percent over the last three months. Indeed, the nonresidential sector of the real-estate market may provide a respectable counter-weight to the sagging residential sector, further limiting the economic damage that might occur if the air continues to seep out of the housing balloon.