

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 10, 2006

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	March 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.61%	4.60%	4.53%	2.75%
6-month Treasury bill	4.78	4.75	4.69	3.05
2-year Treasury note	4.73	4.75	4.68	3.71
5-year Treasury note	4.77	4.71	4.58	4.21
10-year Treasury note	4.76	4.68	4.58	4.54
30-year Treasury bond	4.75	4.66	4.55	4.81
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.64	3.56	3.54	3.17
10-Year	3.99	3.92	3.94	3.85
30-Year	4.49	4.45	4.48	4.64
30-year fixed mortgage rate				
	6.37	6.24	6.24	5.85
15-year fixed mortgage rate				
	6.00	5.89	5.83	5.38
1-year adjustable rate				
	5.45	5.34	5.34	4.24
STOCK MARKET				
Dow Jones Industrials	11076.34	11021.59	10919.05	10774.36
S&P 500	1281.58	1287.23	1266.99	1200.08
NASDAQ	2262.04	2302.60	2261.88	2041.60
Commodities				
Gold (\$) - 100 OZ	542.50	566.90	553.80	445.80
Oil (\$ per barrel) - Crude Futures (NYMerc)	59.96	63.67	61.84	54.43
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (January) - mlns of \$s	3937	3422	-89	2762
Trade Deficit (January) - mlns of \$s	68513	65074	64462	64989
Nonfarm Payrolls (February) - chng in 000s	243	170	145	166
Unemployment Rate (February) - Percent	4.8	4.7	4.9	4.9
Average Hourly Earnings (Feb) - % change	0.3	0.4	0.4	0.3

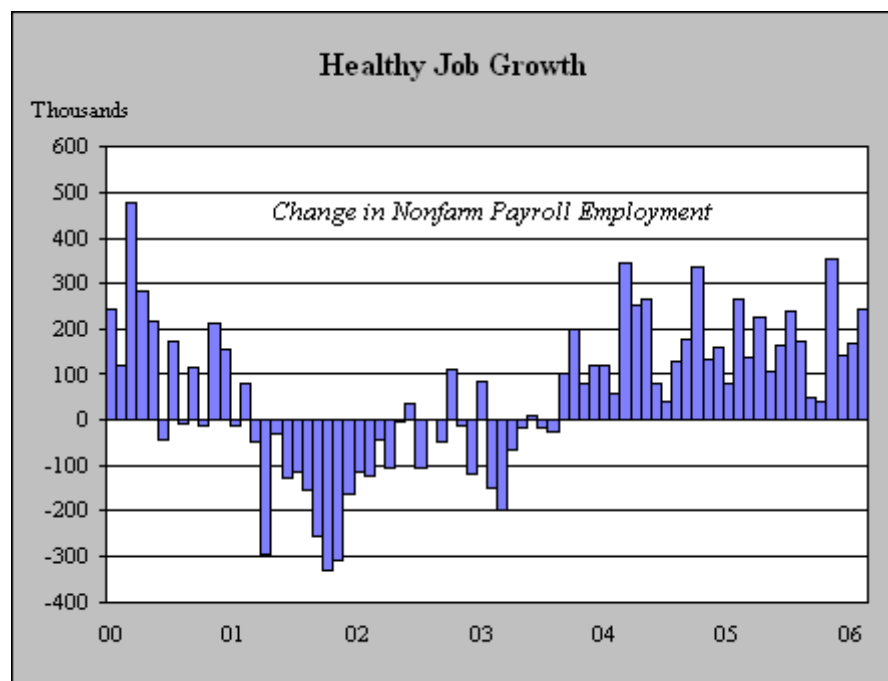
One after another, the world's central banks are falling into line, ending a long period of excessive monetary accommodation designed to recharge the global growth engine. America's Federal Reserve, of course, has led the charge, initiating the first of fourteen consecutive quarter-point rate increases in June 2004 that boosted the federal-funds rate from 1 percent to the current 4.50 percent level. At least one more hike is widely expected on March 28, and the financial markets are priced for another increase by the summer, which would bring the key policy rate to 5 percent. Until recently, the Fed has traveled the rate-hiking trail alone -- and for good reason. Simply put, the U.S. economy has expanded at a far stronger pace than other industrialized nations, resulting in greater inflation risks and a more urgent need to bring demand and supply into better balance.

But other central banks are now following in the Fed's footsteps. Thanks to an upsurge in growth in Europe and Japan -- which may actually expand at a faster pace than the U.S. this year -- monetary officials overseas are starting to rein in the

turbo-charged infusion of liquidity that has been the policy norm for several years. The European Central Bank (the ECB) took its first move in December, when it lifted its key policy rate from 2 to 2 1/4 percent, and followed up with another increase to 2.5 percent on March 2. This week, Japan added its stamp of approval to the liquidity-removal process, ending a five-year-old policy of "quantitative easing", which essentially flooded banks with funds to shore up their balance sheets and to guard against the debilitating deflation threat of the past decade. While the BOJ has not yet abandoned its long-standing "zero interest rate" policy (ZIRP), the removal of liquidity is widely regarded as a prelude to a rate hike later this year.

All this serves as an informative backdrop to the raft of domestic and international news buffeting the financial markets over the past several weeks. In the U.S., the theme has been evolving for some time, and recent events have merely reinforced the tale. Unlike other industrialized nations, the U.S. has been expanding at an above-trend pace for the past two years, whittling down the slack in the labor and product markets in the process. With demand outstripping the growth in the supply of labor and productive capacity, the fear is that inflation will soon rear its ugly head, setting in motion a string of policy and market responses that have historically brought the economy to its knees. The latest in a series of economic reports corroborating the growing imbalance between demand and supply was the February employment report released on Friday.

During the month, the economy generated a hefty 243 thousand nonfarm jobs, following gains of 170 thousand in January and 145 thousand in December. The February increase can hardly be considered a blockbuster event, particularly since it contains some catch-up job creation that should have been captured in January, when exceptionally warm weather boosted economic activity and hiring. Additionally, government payrolls were swelled by the reopening of educational facilities shut down last fall by the devastating hurricanes that ravaged the Gulf states, most notably Tulane University. Still, even stripped of short-term weather and other aberrations, the latest employment report portrays a solid labor market that is on track to generate annual gains of about 2 - 2 1/4 million jobs, about the same as in 2004 and 2005.

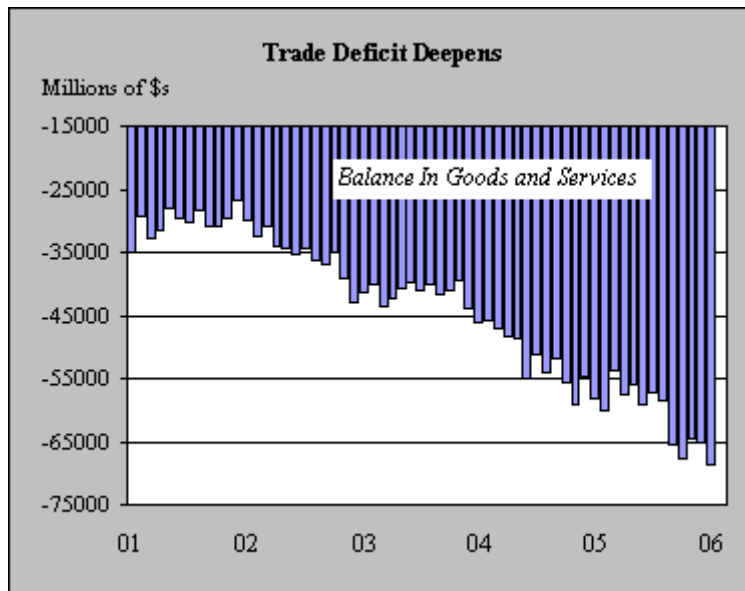


With the pace of job creation exceeding the growth in the labor force, the unemployment rate has fallen from a peak of 6.3 percent in mid-2003 to 4.8 percent in February, a tad higher than January's near five-year low of 4.7 percent. Whether the unemployment rate is below the level that is consistent with wage and price stability is open to debate, but there is little question that much of the slack in the labor force has been used up. Looking through the lens of the Federal Reserve, a tighter labor market is a sure-fire sign that wage pressures are at risk of heating up, igniting the inflation embers that keeps the Fed's finger on the rate-hiking trigger.

To be sure, the persistent fall in the jobless rate has been exceedingly slow to light the wage-price spiral that has typically occurred in the past. Many reasons have been offered for the delay, and many experts genuinely believe that historical precedents don't apply at the current time. For one, the dramatic weakening of union power over the past several decades has greatly undermined the bargaining power of workers, giving companies the upper hand in the wage-setting process. For another, labor's bargaining leverage was much stronger in a closed economy, wherein most goods consumed in the U.S. were produced by American companies using domestic workers. But globalization has dramatically altered that dynamic, as U.S.

manufacturers are now faced with a rising tide of low-priced imports, forcing them to clamp down on labor costs to maintain competitive prices. Where labor became too expensive, companies simply shifted operations overseas or outsourced job functions to cheaper workers in developing countries.

Small wonder, therefore, that protectionist sentiment has escalated in the U.S., with the drumbeat of worker backlash pounding larger with each month of rising trade deficits. The report this week that the deficit grew \$3.5 billion to a record \$68.5 billion in January provided more ammunition to the protectionists, particularly since most of them blame China -- the biggest source of our deficit -- for unfairly rigging competition by keeping its currency artificially low. Of course, the China-bashers ignore the fact that U.S. consumers save billions of dollars a year thanks to low-priced Chinese imports, which boosts purchasing power and offsets some of the wages lost to globalization. Confusing matters even more is the firestorm over the Dubai ports issue, which further politicizes the flow of capital across international borders.



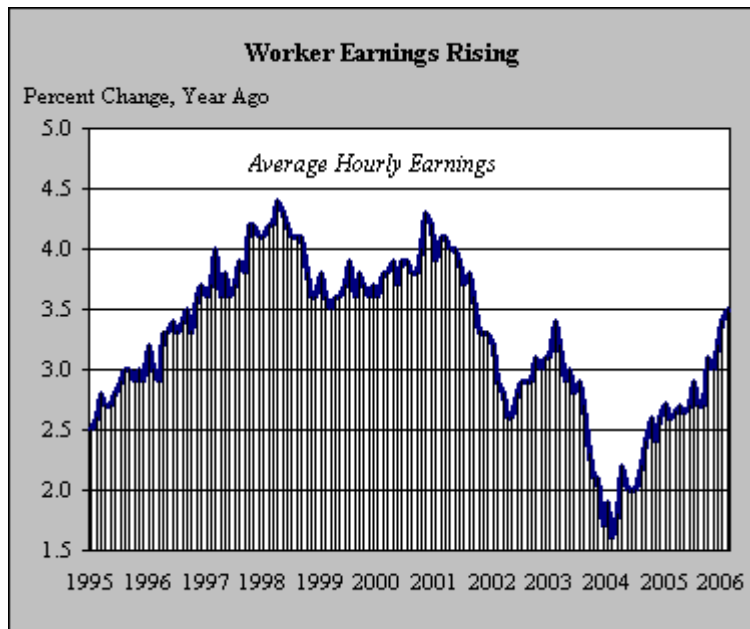
Just how the tensions over the trade deficit play out in the political arena remains to be seen. But the link between the growing imbalance in our international accounts and the emerging policy moves among the world's central banks is clear. There is little question that the revival in growth in Europe and Japan would not occur without the ongoing insatiable appetite for imports by American consumers. But while exports to the U.S. may have been the primary growth catalyst, these economies are now benefiting from strengthening domestic demand as well, which underscores the move by the ECB and BOJ to start removing excess liquidity from the system.

The turn in the global liquidity cycle may have important implications for the U.S. For one, strengthening domestic demand overseas means that less savings will be available to invest in foreign assets, including U.S. securities. For another, rising interest rates in Europe and Japan should attract funds that otherwise might flow to the U.S., intensifying the competition for a shrinking pool of foreign capital. Simply put, in order to borrow the funds needed to finance an ever-growing trade deficit, the U.S. will have to sweeten the prospective returns to foreign investors, resulting in higher interest rates. It is probably no coincidence that the month-long upward climb in U.S. bond yields received another boost this week, pushing the 10-year Treasury yield to its highest level in nearly two years.

That said, interest rate movements in the U.S. are still determined primarily by domestic developments, and the latest upturn is largely a product of the economy's performance. As we noted earlier, the U.S. has been riding an above-trend growth wave for more than two years, removing virtually all of the slack from the product and labor markets. Admittedly, the legitimacy surrounding the officially-reported jobless rate can be argued, but most experts agree that the economy is running as close to a fully-employed state as possible without generating inflationary pressures. The fact that globalization and other factors, such as strong productivity growth, have kept a lid on inflation so far has tempered, but not dissuaded, the Federal Reserve from trying to dampen the growth in demand down to the economy's growth potential.

While the increase in jobs during February is not, by itself, a headline inflation threat, it is enough to keep the Fed on inflation alert. One reason is the growing evidence that wage pressures are building, something that is closely monitored by monetary officials. In February, average hourly earnings rose by 0.3 percent, building on the 0.4 percent gain posted in January. Compared to a year ago, this metric is now up by 3.5 percent, the strongest pace since September 2001.

Significantly, workers in the goods producing-sector -- who are most directly affected by global competition -- saw their wages rise by just 2.2 percent over the twelve month period. It is in the more insulated services-sector that workers are reaping the benefits, as hourly pay there is up by 3.9 percent.



To be sure, a 3.5 percent increase in wages is not particularly disconcerting, since businesses can offset most of the increase through productivity gains, which continued to run at a 2.5 percent annual rate through last year's fourth quarter. What concerns the Fed is the prospect that inflationary expectations will gradually seep into the wage and pricing mechanism, with workers demanding higher pay to offset expected inflation and companies granting the increases in anticipation of charging higher prices. That's the hallmark of a wage-price spiral that has characterized past inflationary episodes, which provoked much harsher Fed-induced rate increases than would be necessary if the spiral were nipped in the bud. To date, inflationary expectations have been kept in check, at least according to most surveys of households and business executives, keeping alive the hope that the Fed is nearing the end of the tightening cycle. But another month or two of strong employment and wage data could drastically alter that perception, inflaming the inflation hawks and alarming the bond bears. Stay tuned.