

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 17, 2006

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	March 17	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.62%	4.61%	4.54%	2.80%
6-month Treasury bill	4.77	4.78	4.67	3.10
2-year Treasury note	4.64	4.73	4.66	3.69
5-year Treasury note	4.62	4.77	4.55	4.16
10-year Treasury note	4.67	4.76	4.54	4.50
30-year Treasury bond	4.72	4.75	4.51	4.81
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.66	3.64	3.54	3.25
10-Year	4.00	3.99	3.97	3.91
30-Year	4.53	4.49	4.45	4.65
30-year fixed mortgage rate				
	6.34	6.37	6.28	5.95
15-year fixed mortgage rate				
	5.98	6.00	5.91	5.47
1-year adjustable rate				
	5.37	5.45	5.36	4.20
STOCK MARKET				
Dow Jones Industrials	11279.65	11076.34	11115.32	10629.67
S&P 500	1307.25	1281.58	1287.24	1189.65
NASDAQ	2306.48	2262.04	2282.36	2007.79
Commodities				
Gold (\$) - 100 OZ	554.50	542.50	554.10	439.80
Oil (\$ per barrel) - Crude Futures (NYMerc)	62.82	59.96	59.88	56.72
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (February) - 000s of units	2120	2303	1989	2127
Consumer Price Index (Feb) - % change	0.1	0.7	-0.1	0.2
Core CPI (February) - % change	0.1	0.2	0.1	0.2
Retail Sales (February) - % change	-1.3	2.9	0.3	0.5
Industrial Production (February) - % change	0.7	-0.3	1.0	0.4

Policy makers couldn't be more pleased with the economic data released this week. Indeed, the Federal Reserve probably heaved a sigh of relief that last week's strong employment report didn't presage a torrent of additional data showing an economy racing ahead at a breakneck pace. As it is, inflation fears have started to escalate, fueled by the apparent strength of the economy's performance. These fears, in turn, have been primarily responsible for the upward drift in bond yields over the past month or so. The 10-year Treasury yield, for example, climbed from a low of 4.53 percent in late February to 4.77 percent by the start of this week. What's more, in the immediate aftermath of the jobs report, speculation about Fed policy turned more hawkish; instead of one or at most two more rate increases, the financial markets were pricing in a higher probability of a third hike, which would lift the federal funds rate up to 5 1/4 percent from its current 4.50 percent level.

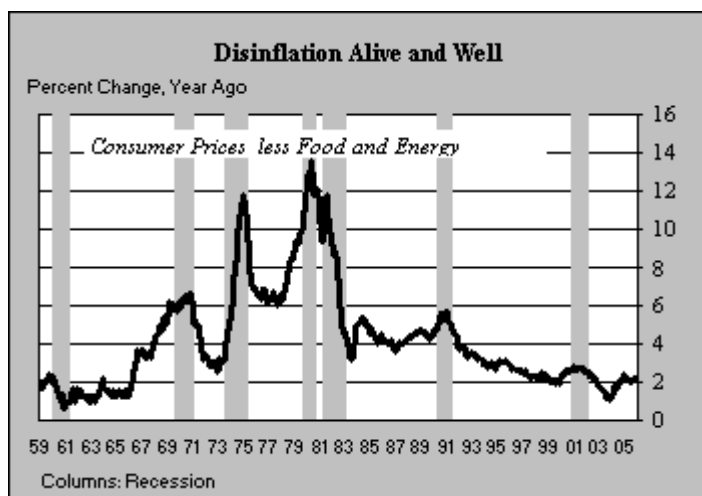
But a raft of "softer" economic data this week stifled, at least temporarily, the upsurge in inflation fears. Not surprisingly, the list was highlighted by the most interest-rate sensitive sector of the economy -- housing -- although highly scrutinized

consumers also showed signs of pulling in their horns. Then there was the most direct manifestation of inflation of all the yardsticks, the headline-grabbing consumer price index, which was just the balm that the doctor ordered to sooth inflamed market psychology. Not only did the CPI fail to confirm a buildup in inflationary pressures, it actually suggested that inflation was easing. Needless to say, the markets responded enthusiastically to the news. The bond yield, which seemed to be on a steady climb towards 5 percent, fell by a sizeable 10 basis points on Thursday to 4.64 percent -- the largest one-day drop in months -- before edging back up to 4.67 percent by the end of the week.

When all was said and done, however, more was said than done. At the end of the day, there are just as many questions about the economy's underlying strength and inflation prospects as there were a month ago. Nor has the policy picture come into clearer focus. About the only sure bet is that the rate-setting committee will boost the funds rate a quarter point to 4.75 percent when it meets on March 27-28. Beyond that, the crystal ball remains as murky as ever, with the odds favoring another hike to 5 percent on May 10 if the consensus forecast of the economy's performance in the first quarter materializes. The key word is "if", as the Fed has explicitly said that future policy decisions will be more data dependent than it has been over the past 20 months, when the only mission has been to remove the excessive monetary stimulus from economy.

Still, the latest batch of data takes the edge off of the more hawkish tendencies embraced by the financial markets in recent weeks. Given all of the rhetoric emanating from Fed officials and Wall Street pundits over how the high level of resource utilization is pushing the economy precariously close to an inflation outbreak, the consumer price report this week was clearly a pleasant surprise. First, the overall CPI only inched up by 0.1 percent in February, defusing the eye-opening 0.7 percent jump in January. The smaller increase lowered the 12-month gain to 3.6 percent from the 4 percent pace in the previous month. To be sure, the moderation in the headline CPI was widely expected, as the energy spike in January unwound in February. Retail energy prices fell by 1.2 percent last month, following a 5 percent jump in January. But what surprised -- and calmed -- the markets was the so-called core component of the consumer price index, which excludes the volatile food and energy items. Core inflation had been expected to rise by 0.2 percent during the month, but it registered an increase of just 0.1 percent, leaving the 12-month increase through February at 2.1 percent, the same as January.

What's more, the core inflation component has increased at an annual rate of 2 percent over the past three months, suggesting that the direction of this key barometer is down, not up. If that's the case, and the 2.4 percent inflation rate reached last February is the high water mark for the cycle, it would match the lowest cyclical peak in more than forty-five years, dating back to October 1959 when core inflation peaked out at 2.4 percent. Interestingly, back then, the 10-year Treasury yield peaked out at about 4.70 percent -- not far from the recent level -- which raises the question of whether the current low level of bond yields is really a "conundrum" at all, or simply an accurate reflection of underlying fundamentals. Keep in mind though that in October 1959, the economy was in the last legs of an expansion, just five months away from slipping into a debilitating recession that would undercut inflationary pressures.



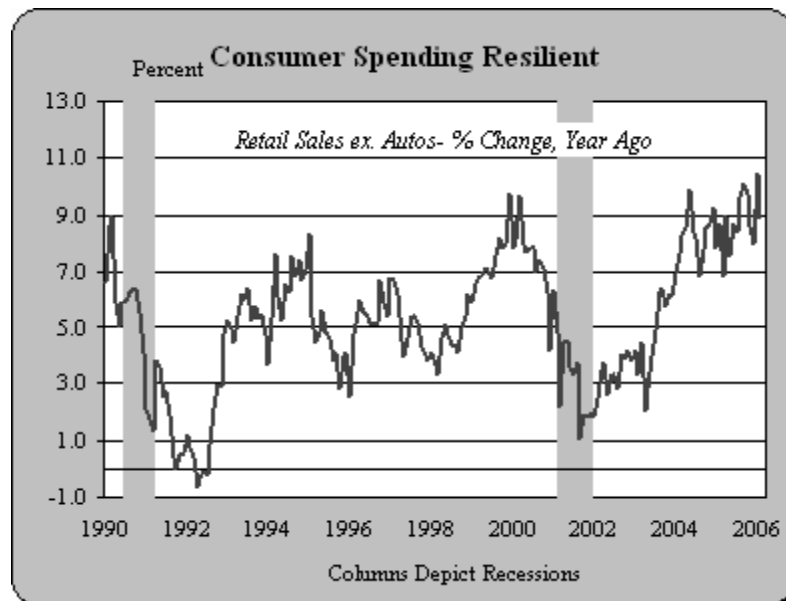
Today's economy is in far different shape than it was then. Although the expansion is now moving into an advanced stage -- more than four years removed from the 2001 recession -- it is hardly running out of steam. The primary reason that inflation has remained so tame in this cycle is that secular disinflationary forces have overwhelmed the cyclical forces that would normally rev up the inflation engine. These include the technology-driven surge in productivity and the pervasive impact of globalization that has undercut the pricing power of corporate America. But following more than two years of above-trend growth that has greatly whittled down -- if not eliminated -- spare capacity in the labor and product markets, which had contributed to the tame inflation environment, the Fed is understandably concerned that the cyclical forces may be on the

verge of gaining the upper hand.

That's why the latest CPI reading will not prevent the next quarter-point rate hike, despite the encouraging message it sends about inflation. What the Fed is looking at is the underlying demand and supply forces that will shape pricing decisions, both in the labor and product markets. No doubt, it is taking notice of the pickup in hourly earnings shown by recent jobs reports, suggesting that wage inflation is gaining traction and forcing companies to pass on higher labor costs to consumers. At the same time, the Fed recognizes the shortcomings of the hourly earnings figures, which may be biased upward by the stronger increase in higher paying than lower paying jobs instead of reflecting a pickup in actual wage rates. But what counts from a macro perspective is the trend in total wages, regardless of the mix, since it is income generation that ultimately drives the demand for goods and services, which the Fed is trying to bring into better balance with the economy's productive capacity.

At first glance, this week's retail sales report indicates that the Fed is having some success on this front. In February, spending at retail establishments fell by a greater-than-expected 1.3 percent, dragged down by a large 4.6 percent drop in vehicle sales. But excluding autos, sales slipped by 0.4 percent with a broad range of purchases showing weakness, including clothing (-3.3 percent), furniture (-4.0 percent), electronics and appliances (-2.0 percent), gasoline (-1.6 percent) and department store sales (-1.4 percent). These declines more than offset pockets of strength, particularly for building materials, where sales jumped by 1.5 percent thanks largely to hurricane rebuilding efforts in the South and Gulf Coast. Clearly, the general softness in the sales numbers encouraged the expectation that the Fed is nearing the endgame of the rate-hiking campaign, reinforcing the positive tone in the bond market this week.

But it's questionable if the February softness in retail sales is the real deal. After all, the 1.3 percent decline comes on the heels of an upwardly revised 2.9 percent spike in January, which was heavily influenced by record warm weather related purchases that would ordinarily have occurred in February. In other words, some payback was to be expected, and the fact that the pullback was less than half the January gain is hardly a sign of a consumer retrenchment. Indeed, the 0.8 percent average gain for January and February was far stronger than the 0.5 percent average monthly increase seen in 2005, which the Fed had deemed too fast relative to the economy's output potential. As the chart shows, even with the February pullback, sales outside of the auto sector continue to exhibit a lot of forward momentum, standing a solid 8.9 percent above a year ago.



To be sure, just as the February slide in sales exaggerated the weakness in that month's consumer spending, so too should the high January/February average be viewed with some skepticism. Given the climb in short-term interest rates, the cooling off of the housing market and still-high gasoline prices -- which are projected by many experts to hit \$3 a gallon this summer -- the odds are that consumer spending will moderate as the year progresses. Keep in mind, too, that interest rates on a sizeable fraction of outstanding adjustable-rate mortgages will be re-set at higher levels in coming months, which could boost monthly payments by as much as fifty percent for many homeowners. While consumers have been surprisingly resilient in the face of strong headwinds in recent years, there is no guarantee that this will continue, particularly with a savings rate that has been negative for the first time since the Great Depression.

That said, the Fed probably remains in a Trumanesque "show me" state, and will want to see by how much -- and if --

households rein in their aggressive shopping habits. No doubt, policy deliberations will also focus heavily on housing, which many Fed watchers believe is the key barometer that will determine how high rates will be pushed. Indeed, Ben Bernanke pointed out in his recent semiannual testimony before Congress that one of the biggest downside risks facing the economy is the housing slowdown. What the chairman and private economists worry about is that the expected cooling off in the housing market will morph into something more severe, decimating accumulated wealth for millions of homeowners and dealing a potentially lethal blow to consumer spending.

Thus far, the cooling process seems to be unfolding in an orderly manner, particularly on the builders' side. According to the latest release by the Commerce Department, construction of new homes fell 7.9 percent in February, but that was less than expected given the outsized 15.9 surge in January, which boosted housing starts to 2.303 million units, the highest in more than 30 years. At over 2 million units, builders continued to break ground at a historically high pace in February, apparently oblivious to warnings that sales are about to crumble and leave them with a huge overstock of unsold homes. If that prospect materializes, they could well get burned, particularly since the pipeline of homes under construction continues to soar. For that reason, it is important to keep a watchful eye on home sales, which has been weakening, but so far not crumbling. Clearly, next week's reports on new and existing home sales will be eagerly awaited by the financial markets, and any big surprise could well shake things up.

