

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 24, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	March 24	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.64%	4.62%	4.59%	2.82%
6-month Treasury bill	4.77	4.77	4.72	3.14
2-year Treasury note	4.71	4.64	4.72	3.85
5-year Treasury note	4.66	4.62	4.64	4.30
10-year Treasury note	4.67	4.67	4.58	4.59
30-year Treasury bond	4.69	4.72	4.53	4.84
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.62	3.66	3.56	3.31
10-Year	3.99	4.00	3.95	3.99
30-Year	4.53	4.53	4.45	4.70
30-year fixed mortgage rate				
	6.32	6.34	6.26	6.01
15-year fixed mortgage rate				
	5.97	5.98	5.89	5.56
1-year adjustable rate				
	5.41	5.37	5.32	4.24
STOCK MARKET				
Dow Jones Industrials	11279.97	11279.65	11061.85	10442.87
S&P 500	1302.95	1307.25	1289.43	1171.42
NASDAQ	2312.82	2306.48	2287.04	1991.06
Commodities				
Gold (\$) - 100 OZ	560.00	554.50	561.00	425.00
Oil (\$ per barrel) - Crude Futures (NYMerc)	64.27	62.82	62.91	54.84
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Leading Economic Indicators (Feb) - % ch.	-0.2	0.5	0.3	0.2
Producer Price Index (February) - % change	-1.4	0.2	0.6	0.2
Core PPI (February) - % change	0.3	0.4	0.1	0.1
Existing Home Sales (Feb) - 000s of units	6910	6570	6750	6918
New Home Sales (Feb) - 000s of units	1060	1207	1275	1232
Durable Goods Orders (Feb) - % change	2.6	-8.9	2.5	0.4

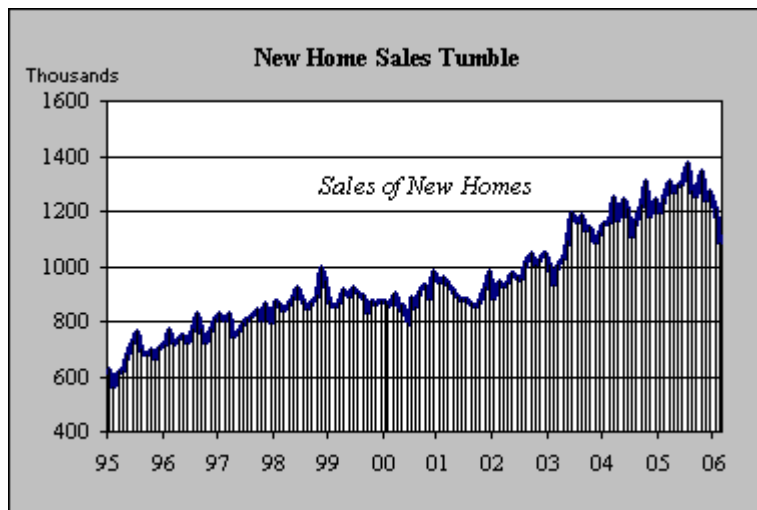
The national obsession over how the housing industry is holding up under the barrage of Federal Reserve rate increases and the recent upward climb in mortgage rates is highly understandable. Residential real estate has been a key driving force behind the last two years of the expansion, providing consumers with a vast reservoir of new wealth to sustain spending and contributing far more heft to job creation and economic growth relative to its size in the overall economy. In his semi-annual testimony before Congress, the newly-installed Federal Reserve chairman, Ben Bernanke, noted several risks facing the economy this year. While the chairman continues to feel that inflation looms as the larger threat, he along with most of his central bank colleagues are well aware of the downside risk that a weakening housing market poses for the economy.

Not surprisingly, therefore, all eyes were on two eagerly-awaited housing reports this week, not only for the information they provide about the industry itself but also for possible clues about Fed policy. After all, Bernanke is assuming that the housing

market will cool off gradually, not collapse, and its withdrawal as a major growth force will be offset by strength elsewhere in the economy, most notably capital spending and solid job creation, which will boost income. That assumption underscores the Fed's generally upbeat assessment of the economy this year, and its bias to lean against inflationary pressures, making at least one more rate increase at next week's policy-setting committee a virtual certainty. However, any sign that the housing market is indeed on the verge of a more serious downturn than assumed could well put policy on hold following the expected March 28 rate increase.

Unfortunately, as has been the case for much of the data released in recent months, the housing reports provided a mixed message. Sales of existing homes unexpectedly jumped in February, reversing a five-month downtrend, but sales of newly-built homes fell by the largest amount in nearly nine years. No doubt, these divergent trends will just prolong speculation about housing conditions, but it's important to keep in mind that there are far fewer actual transactions made during the winter than in the warmer months. The numbers that are released, therefore, are subject to greater fluctuations when they are blown up by the seasonal adjustment factors. We suspect that the numbers have been particularly distorted by the unusual weather patterns this winter, including the record warm temperatures in January that probably inflated existing homes sales in February. Keep in mind that the sale of an existing home is recorded when the deal is closed, which may reflect a contract signed a month earlier. Hence, the February sales strength was probably influenced by January's warm weather.

Based on just about every other housing indicator, however, it's hard to deny that the market is at least cooling off. Not only are new home sales -- which are recorded at the time a contract is signed and, hence, a better indicator of current conditions -- tapering off rapidly, loan applications for home purchases have also been declining for some months. Meanwhile, the inventory of unsold homes has reached multi-year highs and home prices are leveling off, if not declining outright. For the first time since December 2003, the median sales price on new homes fell below its year earlier level in February, posting a drop of 2.9 percent to \$230,400. That may be an aberration, reflecting a changing mix of home sales, and prices in the existing home market are still higher than a year ago to the tune of 10.6 percent. But at \$209,000 in February, the median price on home resales is the lowest since last May, and the year-over-year margin of increases is shrinking. In October, for example, it stood at 16.6 percent.

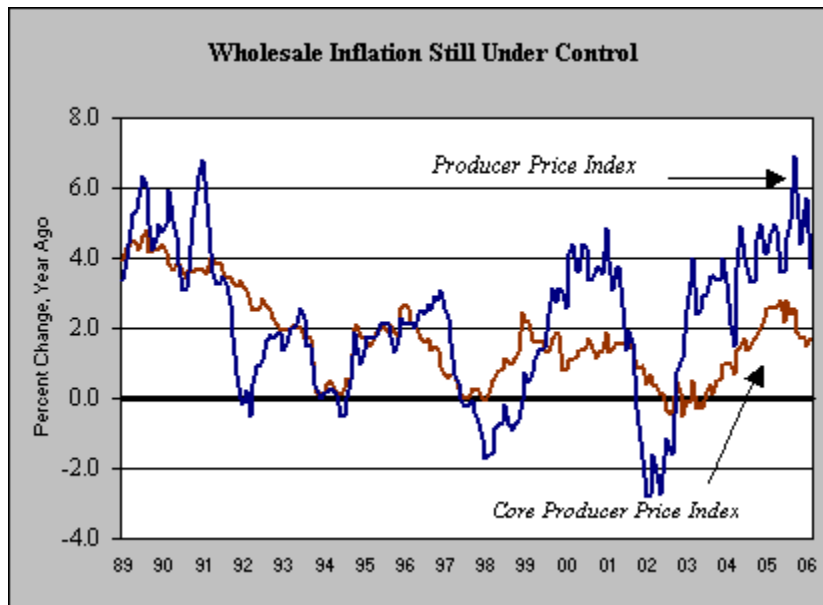


At the very least, therefore, households are no longer sitting on a rapidly appreciating asset that is generating the wealth and equity buildup so voraciously tapped into in recent years to sustain spending. Will the removal of this wealth boost to consumption be enough to keep the Fed from lifting rates beyond next week's expected hike? Only time will tell, of course, since the mantra now espoused by Fed officials is that future moves will be "data dependent". Between March 28 and May 10, the date of the following policy meeting, there will be two more employment reports, which clearly have a far greater influence on the Fed's thinking than just about anything else. But there is no doubt that the housing market is playing a major role in the decision making process. Just consider the amount of space devoted to the subject by various central bank officials.

Recently, for example, Boston Fed president Cathy Minehan offered the following perspective: "It makes sense to worry about the potential impact on overall GDP growth of a combination of a reduction in housing construction and a decline in household wealth. The Bank's baseline forecast takes what might be seen as a rather conservative perspective here. We see construction diminishing somewhat and real estate prices flattening, not declining, and those assumptions are built into the solid GDP growth rate I referred to earlier," said Minehan. But in the same speech later on, she conceded that "clearly, however, we could be wrong on the magnitudes. Real estate prices could actually decline (though this has never happened for

the nation as a whole at least on a nominal basis) and construction activity could retrench more than we expect. And rising mortgage rates could impede consumption more than our forecast predicts." In a separate speech, Fed Vice Chairman Roger Ferguson also acknowledged that "the possibility remains that the recent run-up in prices may be greater than can be justified by the fundamentals and that increases in house prices may moderate or undergo a sharper adjustment."

In other words, it's all about the risks and the worst-case scenario for housing is potentially a lot worse than the worst-case scenario for inflation. That's why we do not fall into the camp of those who increasingly believe that the Fed will not only move on May 10, lifting the federal funds rate to 5 percent from next week's expected level of 4.75 percent, but go all the way to 5 1/2 percent by the summer. For that to occur, there would have to be more clear-cut evidence that inflationary pressures are percolating to the surface than is the case now. True, most inflation indicators are at the upper end of the Fed's comfort range, which will keep the Fed's bias towards tightening. Nor did this week's wholesale price report do anything to discourage that perception, as the core component of the producer price index -- a leading indicator of prices on the retail level -- increased by a faster-than-expected 0.3 percent in February, following a 0.4 percent spike in January. That nudged the 12-month increase up to 1.7 percent from 1.5 percent in January, although the headline PPI inflation rate receded from 5.7 percent to 3.7 percent thanks to a sharp drop in energy prices, which have since been reversed.



But there are few signs that higher wholesale prices -- or climbing energy prices for that matter -- are being passed on to consumers. Indeed, consumer price inflation, as measured by the core CPI, has actually decelerated to a 2 percent pace over the past three months from a recent peak of 2.6 percent. A similar picture is portrayed by the core personal consumption deflator, which is the Fed's favorite inflation barometer. Granted, the inflation statistics tend to be lagging indicators, and the absence of price pressures so far reflects strong productivity growth and an excess of spare productive capacity that are no longer as potent as they were in the past. Indeed, the forecast of continued sturdy growth, even as resource utilization is climbing, is a key reason the Fed is keeping its finger on the rate-hiking trigger.

But there is another compelling reason to believe that the Fed will probe cautiously before pushing rates above so-called neutral level. Keep in mind that this expansion has relied more heavily on borrowing than any before it, which may render it more vulnerable to higher interest rates than is currently believed. Since the last recession, for example, total debt incurred by nonfinancial sectors has increased by \$7.5 trillion, dwarfing the \$2.6 trillion increase in nominal gross domestic product. Put another way, it has required \$2.87 of additional borrowing to squeeze out a \$1 increase in GDP. Only during the 1980s has the economy been as remotely dependent on debt to fuel growth, and that expansion generated \$2.32 for each \$1 increment in GDP. The end result of this borrowing frenzy, of course, is that the economy is left with an exceptionally high debt burden. At the start of this year, debt outstanding represented 206 percent of GDP, 26 percentage points higher than at the end of the 1980s expansion, which was also considered astronomically high and, at the time, raised dire warnings.



The hot-button issue of the day is whether the heavily-indebted household sector will be able to absorb much higher interest rates on the mountain of debt they have accumulated over the years. Until recently, the burden of servicing debt has been kept down by the rock-bottom level of short-term interest rates, which has encouraged households to borrow more short-term funds than they normally would to keep monthly payments at reasonable levels. But that started to change when the Fed embarked on its rate-hiking campaign in the middle of 2004, and the ratio of monthly debt payments to disposable incomes has ratcheted to new highs, surpassing the previous peak reached in 1989. With rates still rising, the debt-servicing burden will surely increase further this year.

A major question is how well prepared are the legions of people with adjustable rate mortgages for the looming jump in payments that is due to take place this year. Recall that an unusually high fraction of home loans taken out in recent years has been of the adjustable rate variety, as borrowers took advantage of the much lower initial rate on these loans relative to the traditional 30-year fixed-rate mortgage. However, the spread between these two loans has narrowed dramatically over the past year, reflecting the Fed-induced climb in short-term rates and relatively stable bond market environment. As a result, many of these ARMs will be repriced at much higher levels in coming months. Indeed, the higher payments on these loans as well as on credit card balances will drain as much as \$50-75 billion from incomes this year, which could make a significant dent in discretionary purchases.

Simply put, a weakening housing market is not the only threat to the economy. The Fed also must be mindful of the huge debt burden weighing on households that could become a crushing drag on spending if rates are pushed too high. There is no way of knowing just what the breaking point is, of course, and there's good reason to believe that the income boost provided by a strengthening job market will enable households to grow out of their debt burdens over time. But the economy is in uncharted waters with regards to the mountain of debt built up in recent years, and the consequences of the Fed overshooting the mark is probably more far-reaching than ever before. We suspect that the ninth inning of this rate-hiking cycle is not far away.