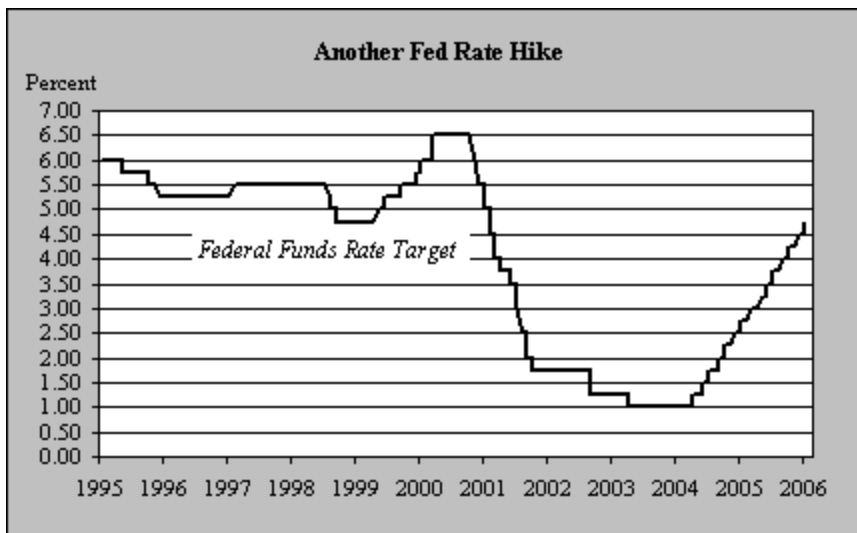


WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 31, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	March 31	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.60%	4.64%	4.60%	2.72%
6-month Treasury bill	4.81	4.77	4.75	3.02
2-year Treasury note	4.82	4.71	4.75	3.73
5-year Treasury note	4.81	4.66	4.71	4.12
10-year Treasury note	4.85	4.67	4.68	4.45
30-year Treasury bond	4.89	4.69	4.66	4.72
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.69	3.62	3.56	3.35
10-Year	4.03	3.99	3.92	4.03
30-Year	4.56	4.53	4.45	4.70
30-year fixed mortgage rate				
	6.35	6.32	6.24	6.04
15-year fixed mortgage rate				
	6.00	5.97	5.89	5.58
1-year adjustable rate				
	5.51	5.41	5.34	4.33
STOCK MARKET				
Dow Jones Industrials	11109.32	11279.97	11021.59	10404.30
S&P 500	1294.83	1302.95	1287.23	1172.92
NASDAQ	2339.79	2312.82	2302.60	1984.81
Commodities				
Gold (\$) - 100 OZ	582.00	560.00	566.90	428.80
Oil (\$ per barrel) - Crude Futures (NYMerc)	66.41	64.27	63.67	57.27
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Confidence Index (March)	107.2	102.7	106.8	100.7
Personal Incomes (March) - % change	0.3	0.7	0.5	0.9
Personal Spending (March) - % change	0.1	0.8	0.7	0.5

There was no "big bang" from the Federal Reserve this week, much to the consternation of monetary thrill-seekers hoping that the new Fed chief, Ben Bernanke, would issue a more provocative statement after Tuesday's much-anticipated policy meeting. Instead, the policy statement repeated almost verbatim the previous post-meeting directive, and could easily have been authored by the now-departed chairman Greenspan. Nonetheless, the statement did provoke some controversy -- and criticism among many analysts -- by retaining the phrase ... " some further policy firming may be needed". Simply put, the statement quashed speculation that the central bank was ready to hit the pause button in its rate-hiking campaign that has included quarter-point increases in the federal funds rate at each of the past fifteen meetings, including this week's boost to 4.75 percent.

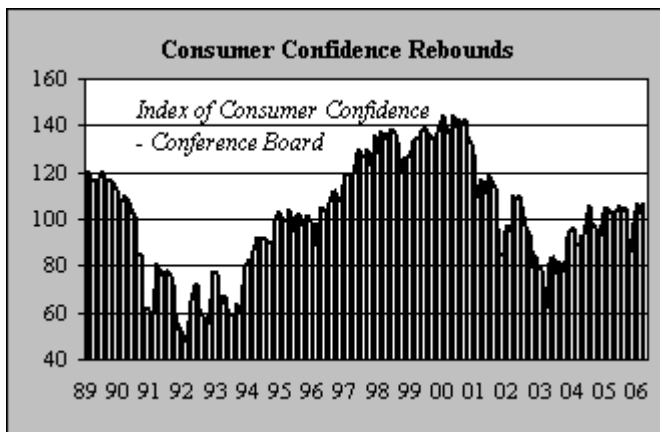


To be sure, the financial markets had priced in another increase to 5 percent at the next meeting on May 10. But many analysts hoped the Fed would provide some indication that the next increase would be the last, at least for a while. In the absence of such a carrot, speculation about continued rate hikes that would carry the funds rate north of 5 percent immediately gained traction, particularly after the Government released its revised fourth-quarter GDP report on Thursday. While the upward revision to growth -- from 1.6 percent to 1.7 percent -- hardly caused a ripple, the report contained a disturbing upward revision in a key inflation measure, the core personal consumption deflator, which the Fed closely monitors. The core PCE deflator now shows an annual rate of increase of 2.4 percent in the fourth quarter, up from the previous estimate of 2.1 percent. With the Fed explicitly worrying that elevated energy prices could soon infect the prices of other goods and services, that was not a comforting event. Among other consequences, it awakened the bond bears, who sent long-term yields in the Treasury market to their highest level in almost two years.

Towards the end of the week, however, the edge was taken off some of the more strident fears, and the markets settled down. The 10-year bond yield, which seemed to be heading towards a four-year high, slipped a bit and stock prices recovered from a knee-jerk slump following the Fed's meeting. In retrospect, the harsh immediate reaction to the Fed's policy statement was clearly overblown. Recall that Bernanke in his confirmation hearings before Congress had expressed a preference for policy continuity, not wanting to abruptly break from the generally successful strategy presided over by Greenspan. What's more, it's imperative for incoming Fed chairmen to establish their inflation-fighting credentials with Wall Street as soon as possible, and Bernanke probably wanted to adhere to that tradition. Indeed, given the new chairman's well-known preference for inflation-targeting, the retention of a mildly hawkish bias in the policy statement should have been anticipated.

That said, it is almost inevitable that questions about whether the Fed is on the verge of going too far in its rate-hiking campaign will arise, particularly in the face of an already-slowing housing market and a debt-laden consumer sector that may be highly vulnerable to another rate increase. No doubt, if the Fed retains the same forward-looking hawkish language after going to 5 percent, as expected, on May 10, these questions will proliferate. But one note of encouragement contained in the latest policy statement suggest that Bernanke will probe cautiously in coming months. In the only significant departure from past statements, the latest directive did say that economic growth... "appears likely to moderate to a more sustainable pace." In other words, the Fed is looking beyond the current rebound in activity, which is clearly being bolstered by some transitory forces, to a second half environment wherein growth returns to a more trend-like path. If that's the case, and inflation remains benign, a 5 percent federal funds rate could well be the last stop for this cycle.

Still, there is little indication yet that households are feeling overly pinched by the 375 basis points of rate increases since June 2004. Real consumer spending is on track to stage a solid 5 percent increase in the first quarter, following Friday's government release of its latest income and spending figures for February. The February increase in real PCE was only 0.1 percent, but that followed three torrid monthly gains averaging 0.6 percent. As a result, the average level over the first two months of the year stood 4.7 percent above the fourth quarter average, just about assuring an eye-popping quarterly increase even if March shows a flat result. What's more, household spirits continue to rebound from the depressed post-hurricane levels. According to the Conference Board, consumer confidence jumped 4.5 points in March, lifting it to the highest level since May 2002.



The Conference Board's survey was corroborated by the University of Michigan's consumer sentiment index, which also increased in March. More to the point, both surveys showed a strengthening in consumer buying plans in coming months, suggesting that March PCE will also increase. Also, they cast some doubt as to how much of a drag a weakening housing market will be on the economy. Yes, the leveling off in prices is curbing the wealth buildup that has boosted consumption so importantly in recent years, but it may also be bringing some new buyers into the market. Both surveys, for example, showed a pickup in home-buying plans, reflecting still-favorable mortgage rates and lower home prices, which are making a home purchase more affordable. These are surveys, of course, not actual transactions, which are showing a distinct falloff in new home sales. But they do suggest that there are willing buyers on the sidelines who are waiting to jump in if real-estate conditions cool off enough.

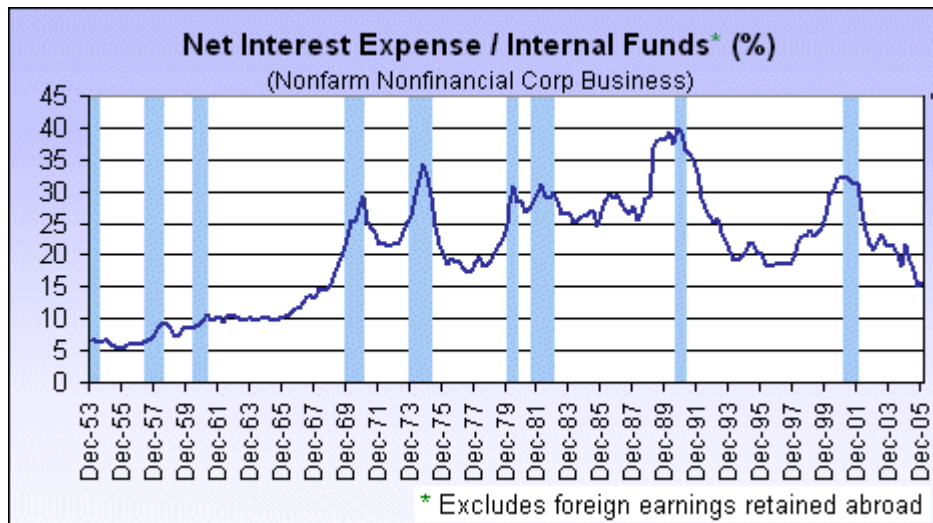
The jury is still out on that all-important issue. Even if housing holds its own this year, there is little question that consumers will not be tapping into their built-up equity as extensively as they have in recent years to support spending. With short-term rates nearly 4 percentage points higher than 22 months ago, it has become much more expensive to engage in equity-related borrowing. In fact, home equity loans at banks have fallen sharply in recent months, as has refinancing activity. With home sales weakening, spending on housing-related products should also feel the effects, although outlays on renovations and remodeling may pick up if more homeowners decide to stay put and create additional space and/or more elegant living quarters as compensation for not trading up.

The Fed, of course, is hoping that the vanishing housing support to growth will be gradual and replaced by strength elsewhere in the economy. The two prime candidates are exports and business investment, both of which continue to flash encouraging signals. With growth among our trading partners picking up -- Japan, in fact, could well register stronger growth than the U.S. this year -- the demand for U.S. goods and services is following suit, as evidenced by solid double-digit gains in exports. The problem, of course, is that imports are also racing ahead, bloating the current account deficit that now accounts for a record 7.5 percent of GDP. But the import strength reflects the insatiable appetite for overseas products by U.S. consumers, which should soon fade along with the expected slowdown in consumer spending over the balance of the year. If, as many currency analysts expect, the dollar also weakens in the foreign exchange markets, imports will become more expensive, contributing to the slowdown in demand for foreign products.

But the main prospective source of strength is expected to come from business investment, which has lagged behind consumer spending and continues to fall well short of the increases that typically unfold at this stage of an expansion. There are many reasons for the lag, dating back to the dot-com collapse in early 2000, which exposed a vast amount of overbuilding generated by the capital-spending frenzy of the late 1990s. The ensuing recession in 2001 and the demand-retarding forces associated with the stock-market collapse, a series of energy shocks and the raft of accounting scandals conspired to leave businesses with more spare capacity than can be profitably used, curbing the incentive to invest in new capital equipment for several years. However, three years of above-trend growth against a stagnant capital stock have gradually whittled down the bloat, and operating rates are now back to the levels prevailing prior to the last recession.

As a result, businesses have stepped up capital spending over past two years, although the increases have not been as strong as would be indicated by the resurgence in corporate profits during the period. Simply put, companies have held back committing the bulk of their cash inflows, both to clean up balance sheets and to reward investors with increased dividends. What's more, business executives have retained a good deal of caution because some of the above-noted headwinds continue to prevail. The sustained elevated level of energy prices, for example, is absorbing an outsized fraction of household incomes, which always threatens to stifle demand, particularly with households running a negative savings rate. What's more, with the Fed's rate hikes, financing costs have also increased, possibly undercutting capital-spending incentives.

Unlike households, however, the Fed's actions should have little, if any, deterring effect on business spending decisions. For one, companies still have access to funds in the bond markets at very favorable rates, thanks to the headline-grabbing "conundrum" in which long-term rates have remained relatively stable in the face of the steep climb in short-term rates. For another, internal cash flow is more than adequate to finance spending, as nonfinancial corporations have actually been enjoying an unprecedented financing surplus over the past three quarters. Finally, as the chart shows, interest expense is hardly an obstacle for corporations, as companies have sharply lowered the cost of servicing their debt by refinancing short-term loans into lower-cost longer-term liabilities. Indeed, you would have to go all the way back to 1968 to find a time when interest expenses accounted for as small a fraction of cash flow as they did in the fourth quarter of last year.



In short, the stage is set for businesses to step up capital spending and fill the void expected by the slowdown in consumer spending and housing. Spare capacity has been whittled down, profits and cash flow are robust, and financial conditions remain favorable. The only question is whether company executives believe future demand will be sufficiently strong to justify putting expansion plans into effect. That will depend in large part on how much of a drag the Fed's rate hikes will have on consumer spending. So far, the impact has been modest, which is just what the doctor ordered. But monetary policy affects the economy with a lag of six to nine months, meaning that the last 200 basis points of increases are only now beginning to exert their impact on activity. The risk of a policy overshoot grows with each rate hike, posing a significant challenge to the new Fed chairman in coming meetings.