

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 7, 2006

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	April 7	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.68%	4.60%	4.61%	2.77%
6-month Treasury bill	4.86	4.81	4.78	3.12
2-year Treasury note	4.90	4.82	4.73	3.75
5-year Treasury note	4.91	4.81	4.77	4.14
10-year Treasury note	4.98	4.85	4.76	4.48
30-year Treasury bond	5.06	4.89	4.75	4.76
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.76	3.69	3.64	3.34
10-Year	4.10	4.03	3.99	3.97
30-Year	4.59	4.56	4.49	4.63
30-year fixed mortgage rate				
	6.43	6.35	6.37	5.93
15-year fixed mortgage rate				
	6.10	6.00	6.00	5.48
1-year adjustable rate				
	5.57	5.51	5.45	4.23
STOCK MARKET				
Dow Jones Industrials	11120.04	11109.32	11076.34	10461.34
S&P 500	1295.50	1294.83	1281.58	1181.20
NASDAQ	2339.02	2339.79	2262.04	1999.35
Commodities				
Gold (\$) - 100 OZ	593.00	582.00	542.50	428.60
Oil (\$ per barrel) - Crude Futures (NYMerc)	67.41	66.41	59.96	53.32
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (March)	55.2	56.7	54.8	56.3
ISM Non-manufacturing Index (March)	60.5	60.1	56.8	59.5
Construction Spending (March) - % change	0.8	0.4	1.9	0.9
Nonfarm Payrolls (March) - 000s	211	225	154	188
Unemployment Rate (March) - Percent	4.7	4.8	4.7	4.8

With the Bush administration's poll numbers sinking as fast as Barry Bonds' fan base, the latest news on the employment front may be just the juice needed to pump up spirits in the White House. To be sure, it will be difficult, if not impossible, to deflect the public's attention away from the woes in Iraq, a divisive immigration bill, the skullduggery of lobbyists, sky-high gasoline prices and other matters that Americans associate with the administration shortcomings. But if there is one potent steroid that can lift public opinion about the government, it is a positive reading on the job market. This week, the Labor Department stepped up to the plate in a timely fashion.

In its latest reading, delivered on Friday morning, the department reported that the economy generated a muscular 211 thousand net new jobs in March, a reading that was in line with expectations but notable for several reasons. First, it builds on the healthy job-creation numbers reported for January and February, bringing the increase for the first quarter to 590 thousand. That's up from 536 thousand in the fourth quarter of last year, and is the strongest first-quarter gain since 2000. Second, it belies that notion that the economy is losing momentum after receiving a jolt of energy from a weather-related



closing. The latest month's increase brings the 12-month gain to 3.4 percent, just a tad below February's 3.5 percent increase, which was the peak for the cycle. It should be noted, moreover, that these initial estimates are often revised; February's 0.4 percent increase was originally reported to be 0.3 percent last month, so the March advance may turn out to be higher as well when the April employment figures are reported next month.



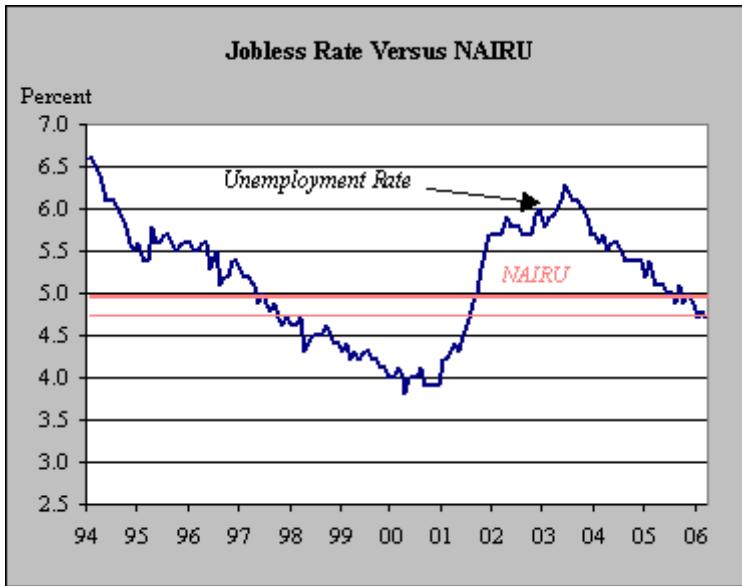
That's particularly the case since the job market is as tight as it's been in more than four and a half years. In March, the unemployment rate slid to 4.7 percent from 4.8 percent in February, marking the lowest level of joblessness since August 2001. Actually, the rate is a smidgen lower due to rounding. Taken to its third decimal, unemployment actually stood at 4.654 percent of the labor force, just five-thousandths of a point away from being reported as 4.6 percent. Had that been the case, the psychological impact of the employment report on the financial markets might have been considerably greater, as a drop in the jobless rate from 4.8 percent to 4.6 percent would convey the impression that businesses are frantically snatching workers out of the woodworks -- and willing to bid up wages to meet staffing needs.

As it is, the markets did not take too kindly to the inflation message behind the latest employment report. After initially trading up on Friday morning, stock prices abruptly changed course and moved sharply lower heading into the weekend. Likewise, the inflation-phobic bond market did a double-take after the numbers were released, pushing long-term yields up to the highest level in nearly four years. At the close of trading on Friday, the 10-year Treasury bond yield stood just a sliver below 5 percent, a threshold last exceeded on June 11, 2002. In other words, following a prolonged period of resistance to the Fed's persistent rate hikes, the unwinding of the "conundrum" in the bond market seems to be finally underway.

No doubt, fears of higher inflation and continued Federal Reserve rate hikes -- fueled by the latest jobs report -- are the primary forces behind the climb in bond yields. But they are not the only forces. Just as strong foreign purchases of Treasury securities have been instrumental in keeping rates down in recent years, the opposite may be taking place now. Overseas purchases of Treasury coupons decelerated late last year to \$18.3 billion in December from a \$29 billion monthly average in 2005. These purchases then dropped abruptly in January to \$4.4 billion and, so, the combined activity in December and January represents a precipitous decline from trend. If overseas investors continue to back away from the Treasury coupon market or, even worse, liquidate Treasury holdings, the conundrum will quickly fade from memory, and be replaced by much more profound worries.

That said, barring large-scale foreign liquidations, which do not seem likely, domestic considerations will be the primary movers in the financial markets, and the interplay between growth and inflation expectations will take center stage in coming months. Clearly, the latest employment report tilts perceptions towards the higher inflation camp. For one, it provides more ammunition for the policy hawks who now expect the Fed to definitely hike rates for the 16<sup>th</sup> consecutive time on May 10 and are giving higher odds of another increase -- to 5 1/4 percent -- at the June meeting. For another, it gives more credibility to the inflation worriers, who understandably are deeply influenced by the resource utilization argument cited by numerous Federal Reserve officials, including chairman Bernanke.

What the argument posits is simply that as more workers are absorbed into the ranks of the employed, companies are forced to bid up wages to attract new employees amidst a shrinking pool of available labor. What's more, they may find it necessary to give existing workers higher pay just to prevent them from leaving for more attractive jobs elsewhere. As wages are bid up, the inclination to lift prices becomes greater, as companies strive to protect profit margins. Just when this wage-based increase in inflation pressure gains traction is not easy to identify. But the Fed has a notion of what it considers to be the non-accelerating inflation rate of unemployment (NAIRU), i.e. a range that is consistent with a stable inflation rate. Currently, it deems this range to be 4.75 - 5 percent, which means that the March unemployment rate has already pierced the lower acceptable band of the range.



As always, however, the devil is in the details. Despite the persistent drop in the jobless rate, most inflation measures remain benign. Some, in fact, even reveal a deceleration of inflation pressures. As the chart also shows, the jobless rate fell significantly below NAIRU in the 1990s without spurring a meaningful inflation pickup. The Fed, nonetheless, moved to tighten policy when the rate fell to 4.3 percent in mid-1999, eventually sliding all the way to 3.8 percent in early 2000. By May of that year, the funds rate had been ratcheted up to 6.5 percent from 4.75 percent ten months earlier and, less than a year later, the economy had fallen into a recession. While history does not always repeat, it usually rhymes. With a new poet laureate at the helm of the Fed, the next few verses will not be easy to write.