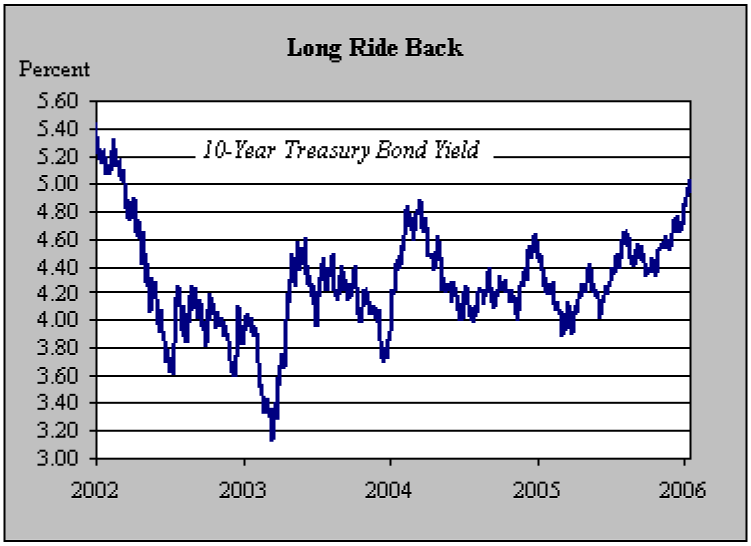
WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 14, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	April 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.69%	4.68%	4.62%	2.77%
6-month Treasury bill	4.92	4.86	4.77	3.09
2-year Treasury note	4.95	4.90	4.64	3.49
5-year Treasury note	4.97	4.91	4.62	3.87
10-year Treasury note	5.05	4.98	4.67	4.24
30-year Treasury bond	5.11	5.06	4.72	4.59
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.77	3.76	3.66	3.30
10-Year	4.17	4.10	4.00	3.97
30-Year	4.64	4.59	4.53	4.62
30-year fixed mortgage rate	6.49	6.43	6.34	5.91
15-year fixed mortgage rate	6.14	6.10	5.98	5.46
1-year adjustable rate	5.61	5.57	5.37	4.30
STOCK MARKET				
Dow Jones Industrials	11137.65	11120.04	11279.65	10087.51
S&P 500	1289.12	1295.50	1307.25	1142.62
NASDAQ	2326.11	2339.02	2306.48	1908.15
Commodities				
Gold ($)- 100 0Z	602.10	593.00	554.50	426.40
Oil ($ per barrel) - Crude Futures (NYMerc)	69.45	67.41	62.82	50.49
	KEY ECONOMIC INDICATORS			
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (March) - % change	0.6	-0.8	3.0	0.7
Univ. Of Mich. Sentiment Index (April)	89.2	88.9	86.7	88.2
Industrial Production (March) - % change	0.6	0.5	-0.4	0.6
Capacity Utilization (March) - Percent	81.3	81.0	80.7	80.8
Trade Deficit (February) - Mlns of $s	65742	68587	65074	66214
Business Inventories (February) - %	0.0	0.6	0.8	0.5

It's taken awhile, but the bond market seems to be finally joining the parade. To be sure, investors have driven up long-term interest rates several times during the current expansion, only to backtrack when it appeared that economic and technical considerations didn't justify higher yields. This time, however, previous ceilings have been pierced, and the upward march seems to have solid underpinnings. That, at least, is the implication derived from the widespread media coverage of the latest move in bond-land going into the long holiday weekend.

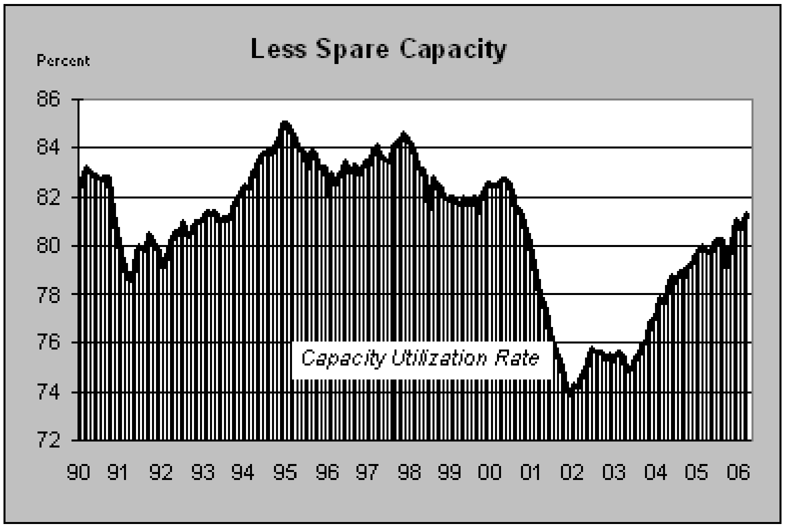
What sparked the headline-grabbing interest in bond yields is the fact that for the first time since June 2002, the 10-year Treasury yield pierced the 5 percent threshold, closing at 5.05 percent on Thursday. That's a climb of more than 60 basis points from the year-end level of 4.39 percent. What makes the story even more compelling is that the increase exceeds the rise in shorter-term rates, unwinding the negative yield curve that has clouded the economic outlook for the past several months. In mid February, the 2-year note yield, at 4.66 percent, topped the 10-year by 12 basis points, an inversion that many analysts associated with an impending sharp slowdown in economic growth, if not a recession. However, at the end of the latest week, the 2-year rate, at 4.95 percent, stood a comfortable 10 basis points under the 10-year yield.



If the yield curve is to retain its positive slope going forward, the odds are that the latest climb in bond rates still has further to go. That's because the Federal Reserve is almost sure to hike its benchmark federal funds rate by another quarter-point on May 10, which is likely to boost other short-term rates as well. Moreover, the financial markets are increasingly pricing in another Fed hike at its June meeting, which will only sustain the upward pressure on bond yields. The question is, why now? After all, the bond market has resisted the Fed's rate-hiking strategy underway since June 2004 despite persistent above-trend growth and energy-induced inflation pressures. Has something new occurred that is finally ending the conundrum of low bond yields that has perplexed policy makers for so long?

We don't profess to know the definitive answer to this question, nor are we sure that the current climb in bond yields is hear to stay. More than likely, the current move reflects a cumulative wave of events that is taking a belated toll on the bond market. Keep in mind that it is only over the past several months that the Fed has cited the fuller utilization of resources as being a primary threat to inflation. With the economy staging a robust growth spurt in the first quarter -- estimated at about 5 percent -- that threat has become even more pronounced in the minds of bond investors. If they needed any reminder of the unfolding squeeze on productive resources, two events of the past week brought the message home. Last Friday's employment report, for one, provided a striking example of the possible shortage of labor that may be materializing, as the jobless rate slipped to 4.7 percent, matching the five-year low set in January. While evidence of a wage-based increase in inflation pressures remains scanty, the prospect of an acceleration in labor compensation has clearly become more credible as the pool of jobless workers dwindles.

For another, a Federal Reserve report this week reveals that the protracted rise in output is putting an ever-greater squeeze on industrial capacity. In March, the nation's factories, mines and utilities increased production by a solid 0.6 percent, following a 0.5 percent gain in February. With the latest increase, industrial companies are operating at 81.3 percent of capacity, the highest since September 2000. More important, the current capacity usage is slightly above the 80-81 percent range that is generally considered to be consistent with stable inflation, and is also marginally higher than the 1972-2005 average of 81.0 percent. If the utilization rate continues to rise, it is only a matter of time before bottlenecks and other glitches cause delivery delays and a shortage of merchandise that has traditionally sparked an inflation outbreak.



To be sure, the bond market has heard this "growth causes inflation" story before, without paying it much heed. One reason is that globally competitive forces are keeping a lid on pricing power, forcing U.S. companies to hold the line on labor costs. Another is that an unusually high proportion of the nation's output gains continues to come from productivity improvements, which usually fade much more quickly than it has at this stage of an expansion. While these countervailing forces are certainly present, they may be having less of an influence on bond investors because of the changed policy environment. Recall that even as the Fed was raising rates over the past twenty two months, it has done so in a predictable fashion, giving investors a sense of certainty and complacency as to what lies ahead. Until recently, the Fed's actions were viewed as long overdue and designed primarily to remove the excessive monetary stimulus that was no longer needed to thwart a deflation threat, which seemed imminent as recently as 2003.

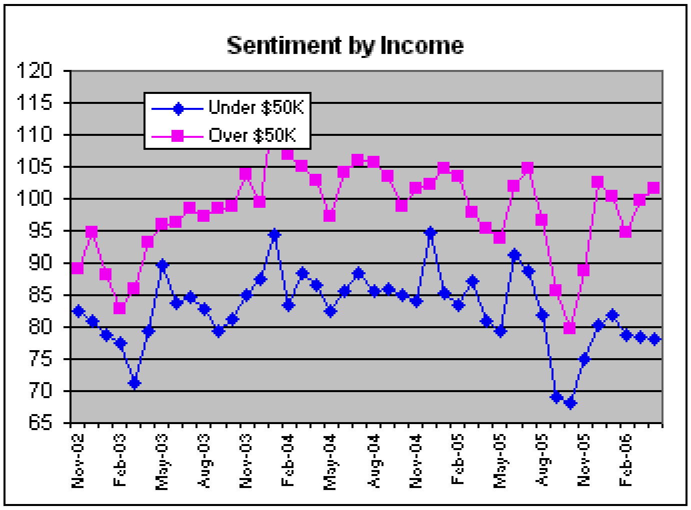
But the era of policy predictability has come to an end. The Fed has already removed any reference to "measured rate increases" from its lexicon of policy pronouncements and has muddied the waters with regards to future rate increases. Yes, another increase on May 10 seems to be a done deal, but even that was brought under a cloud this week by several Fed officials who claimed that they were merely expressing an inclination, not a commitment, to another hike at its last meeting on March 28. Making matters even more confusing, one Fed Governor this week strongly suggested that the Fed retains more of an anti-inflation bias but at the same time claimed that policy was in a "transition" phase, meaning that anything can happen depending on the message depicted by incoming data.

The point is that the bond market is no longer benefiting from a predictable policy environment that until recently has reduced the risk premium embedded in long-term yields. Instead, investors are facing a more uncertain future, which could include either a halt to rate hikes or steeper increases down the road. What this means is that yield movements will become much more sensitive to data points, presaging a higher degree of volatility going forward than has been the case until now. More to the point, the flow of data in recent months has raised perceptions of stronger growth, paced by a string of robust jobs reports and ongoing strength in consumer demand.

Indeed, it is the stubborn refusal of consumers to rein in their spending propensities that is fueling these growth perceptions. This week, for example, the nation's retailers reported a sturdy 0.6 percent increase in overall sales, and a 0.4 percent gain in nonauto sales, more than reversing a 0.3 percent drop in February. Simply put, the payback from January's weather-induced surge didn't last long, as consumers kept their wallets and purses open as the spring approached. For the first quarter as a whole, retail sales increased by a 13.4 percent annual rate, the strongest since the fourth quarter of 2001, when post-9/11 auto incentives sharply boosted spending. Nor for that matter do households seem poised to pull in their horns. According to the University of Michigan, consumer spirits continue to improve, as its preliminary sentiment index for April rose for the third consecutive month.

Clearly, households are being buoyed by the solid growth in jobs, which offers the hope of stronger income gains in the months ahead. Needless to say, fatter paychecks will be needed to offset the drag from a cooling housing market, which is undercutting the ability of households to tap into home equity to support spending. But the University of Michigan's survey exposes a curious rift in household sentiment that appears to be unfolding. First, while consumers are more confident about current conditions and job prospects -- and are increasing spending plans -- they are turning less confident about future prospects. That split is reflected in the divergent movement in the two major components of the sentiment index. On the one hand, the current conditions index rose to 111.1 in April from 109.1 in March, reaching the highest level since July of last year. In contrast, the expectations component slipped to 75.1 from 76.0 in March and a recent peak of 80.2 last December.

In other words, households are not so sure that the good times will continue, which casts some doubt over how willing they are to sustain spending at the current pace. An even more disturbing aspect of the Michigan survey is the growing rift in attitude that is opening up between people earning more than $50,000 and those with smaller paychecks. As the chart shows, sentiment among the higher earners is quite high, having rebounded strongly from last fall when the hurricane-induced energy price spiral sent household spirits into a nosedive. However, the lower income earners are not feeling nearly as frisky, as sentiment in this group has fallen for three consecutive months.



Clearly, it is the people earning smaller paychecks who are the most vulnerable to higher interest rates and the recent climb in gasoline prices, which the Energy Information Agency warns could hit $3 a gallon this summer. Simply put, a major segment of consumers is already experiencing a budget squeeze, and may well be forced to curb spending in coming months. What's more, the backup in bond yields is driving up mortgage rates as well, making a home purchase even less affordable for the marginal buyer. As a result, the recent strength in the data flow could just as easily morph into weakness, once again undercutting the justification for higher bond yields. That would be particularly be the case if inflationary pressures fail to intensify, further belying the fears surrounding the tight labor and product markets. Nonetheless, barring a more pronounced economic slowdown in the spring and summer months than is now envisioned, it's not likely that the bond market will completely retrace the recent pickup in yields -- at least in the near future.