

WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 21, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	April 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.74%	4.69%	4.64%	2.91%
6-month Treasury bill	4.90	4.92	4.77	3.13
2-year Treasury note	4.89	4.95	4.71	3.60
5-year Treasury note	4.91	4.97	4.66	3.92
10-year Treasury note	5.01	5.05	4.67	4.25
30-year Treasury bond	5.09	5.11	4.69	4.58
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.82	3.77	3.62	3.26
10-Year	4.25	4.17	3.99	3.94
30-Year	4.67	4.64	4.53	4.63
30-year fixed mortgage rate				
	6.53	6.49	6.32	5.80
15-year fixed mortgage rate				
	6.17	6.14	5.97	5.36
1-year adjustable rate				
	5.63	5.61	5.41	4.26
STOCK MARKET				
Dow Jones Industrials	11347.45	11137.65	11279.97	10157.71
S&P 500	1311.28	1289.12	1302.95	1152.12
NASDAQ	2342.86	2326.11	2312.82	1932.19
Commodities				
Gold (\$) - 100 OZ	638.50	602.10	560.00	436.10
Oil (\$ per barrel) - Crude Futures (NYMerc)	75.17	69.45	64.27	55.39
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 (March) - 000s of units	1960	2126	2307	2095
Consumer Price Index (March) - % change	0.4	0.1	0.7	..1
Core CPI (March) - % change	0.3	0.1	0.2	0.2
Producer Price Index (March) - % change	0.5	-1.4	0.2	-0.1
Core PPI (March) - % change	0.1	0.3	0.4	0.1
Leading Economic Indicators (Mar.) - % ch	-0.1	-0.5	0.4	0.3

Is the perfect storm brewing? In recent weeks, the three major long-standing fears that could knock the economy off kilter have gathered force, and none looks likely to recede anytime soon. Energy prices are hitting new highs on an almost daily basis, with oil topping \$75 a barrel this week. The oil spike is reinforcing the spiral in other commodity prices, which have been on an accelerating upward track since late last year. Meanwhile, the highly vulnerable housing market continues to show signs of weakening, with builders belatedly listening to the weaker drumbeat of sales and curbing construction. Finally, the long-dormant bond market is sprouting wings, sending yields to levels not seen in four years and pushing up mortgage rates in the process.

While the financial markets are taking notice of these trends, they are not sure how to size them up. Stock prices turned in a

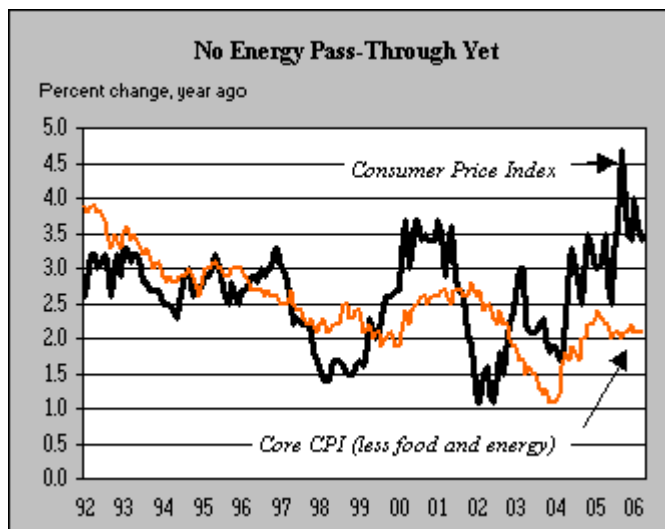
solid performance this week, propelled in part by favorable earnings reports. But just about every equity analyst commenting in the news media is voicing concerns about the above-mentioned headwinds. If not for the timely intervention of some important news concerning Federal Reserve policy, the three undercurrents behind the brewing storm might well have sank stock prices this week. But the markets are nothing if not forward-looking, and the Fed story held out a juicy carrot for investors to feast on.

What happened was not something new, but the release of the minutes of the last policy-setting meeting held three weeks ago. Recall that the initial policy statement after that meeting sent shivers through the financial markets because it strongly suggested that the Fed was not finished with its rate-hiking campaign, claiming that some further policy firming was probably needed. But the minutes of that March 28 meeting, released this week, revealed a much bigger split among the committee members than implied by the terse post-meeting statement. Some members actually expressed the concern that policy tightening may go too far, and most believed that "the end of the tightening process was likely to be near". On the inflation front, participants noted that "underlying inflation was not in the process of moving higher" and "some meeting participants expressed surprise at how little of the previous rise in energy prices appeared to have passed through into core inflation measures."

The release of the minutes defused fears that the Fed was staying on the tightening road without a compass, giving temporary support to the beleaguered bond market. After spiking above 5 percent for the first time since June 2002 last week, the 10-year Treasury yield slipped back below the 5 handle for a brief period. But the dip didn't last long, despite confirming public statements from some influential Federal Reserve members, including the San Francisco Fed President Janet Yellen who explicitly stated that "enough has been done by now". Simply put, investors had every reason to believe that the Fed would stop after the next hike on May 10, leaving the federal funds rate at 5 percent. But the "one and done" prospect became less certain as the week progressed, thanks to some unsettling price data, which sent the bellwether bond yield back above the 5 percent threshold again.

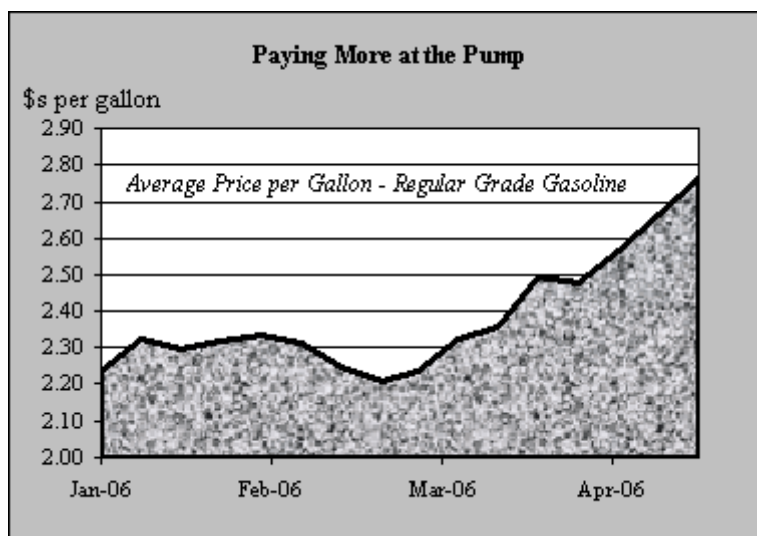
To be sure, the inflation picture didn't suddenly deteriorate out of the blue. In fact, the markets were encouraged earlier in the week when the government released its wholesale price report showing a miniscule 0.1 percent rise in the core component of the producer price index, the segment that excludes volatile food and energy items. If anything, that just corroborated the Fed's observation that energy prices were not seeping through into the broader economy. But the PPI tracks prices on the goods leaving the factory floor, not the products and services purchased by consumers. Unfortunately, the Consumer Price Index, which tracks the latter, did not provide as much of a soothing message as did the wholesale price report. Instead, the core CPI shot up by 0.3 percent, matching the biggest increase since November 2001. More than anything, it was that report that turned the bond market around, sending the 10-year yield back above 5 percent.

The inflation environment remains one of the more perplexing issues facing investors and policymakers. Time and again, the monthly wiggles produced surprises both on the upside as well as the downside, presenting an ambiguous message to the markets. As a result, the inflation hawks and doves must then put these monthly outliers into a broader context to support their arguments. For example, even after the March 0.3 percent spike, the 12-month gain in the core CPI still looks relatively benign, increasing by the same 2.1 percent as the previous month and well within the long-standing range of 1.7 percent and 2.4 percent in effect for the past several years. Not surprisingly, the doves point to this longer-term perspective to justify their comforting message that inflation remains more of a threat than a reality.



The hawks, of course, take a different perspective. While the 12-month increase looks stable, this longer-term perspective masks some underlying upward momentum. For example, the core CPI has increased at a 2.70 percent annual rate over the past six months and at a 2.79 percent pace over the past three months. By this reckoning, the energy pass-through is taking hold and it is only a question of time before the broad price indices start to turn ugly on just about any basis. Indeed, the broad consensus among economists is that by the second half of the year, the core CPI will be rising at a 2.4 percent annual rate, which is still low by historical standards but not something that can be viewed with impunity. That's particularly the case in light of the leading inflation indicators, which continue to argue against complacency. Most significantly, the low unemployment rate and continuing strength in job creation portend rising wage pressures down the road, and the high rate of capacity usage points to delivery delays and bottlenecks usually associated with upward price movements.

The tug of war between the inflation hawks and doves will probably not be resolved anytime soon, setting the stage for more volatility in the financial markets. Perhaps the biggest flashpoint is the ongoing oil-price spiral, which some analysts are saying could go to the \$100 mark before all is said and done. The perplexing aspect of the issue is that neither policymakers nor investors quite know whether the oil surge is inflationary or deflationary. Clearly, the inflation impact is visible at the pump, where drivers are already paying more than \$3 a gallon in many parts of the nation, and certain industries, such as trucking, airlines and chemical manufacturers are passing on higher fuel bills to customers. Should the passthrough effect spread to a broader array of industries, and begin to have more of an impact on inflation expectations than is currently the case, the inflation debate will quickly end in favor of the hawks.



But the deflationary argument of the energy spiral cannot be dismissed out of hand. With gasoline prices already 60 cents a gallon higher than a year ago, and the peak driving season only weeks away from starting, the pain from higher energy bills will only escalate. If oil prices stabilize at current levels -- a big if -- households will be diverting about \$75 billion more towards energy costs in coming months than last year, which accounts for a sizable chunk of disposable incomes. With the personal savings rate negative and budget-strapped consumers coping with record debt burdens, there is a fairly high chance that this diversion will curb discretionary spending this summer and fall. At the moment, the Fed is publicly taking a diplomatic position on how the energy issue will play out, stating that the inflationary impact will be transitory and the economy will only slow to a sustainable pace in coming quarters.

If the Fed's view is correct, the optimism surrounding the release of the minutes this week would certainly be justified. Whether the "one and done" scenario plays out according to script, or the endgame still has another inning to go, the light at the end of the rate-hiking tunnel would be clearly within sight. But it is hard to subscribe to this goldilocks scenario when there are so many chapters still waiting to be written. The oil act, for example, is far from complete, as questions about the geopolitical arena still abound, particularly regarding Iran's nuclear ambitions and how the Western world responds to it. Industry experts are divided over how high oil prices can go, but the consensus view is that if the climb proceeds gradually, the economy can withstand another \$10 or even \$20 a barrel increase. That, of course, remains to be seen.

Then there is the question of housing, which Fed officials always refer to as a conditional element in presenting an outlook. Keep in mind that energy prices spiked in both 2004 and 2005 without bringing consumers or the overall economy to its knees. The primary reason is that the booming real-estate market had been a potent offset, providing households with a vast reservoir of equity wealth to tap into to sustain purchases. But with house prices softening, that's no longer the case, as equity withdrawals have fallen significantly this year. And, with mortgage rates up -- both for ARMs and conventional fixed-rate

mortgages -- refinancing activity has also plunged, removing another resource for consumers to rely on.

Now, homebuilders are getting into the act. Following months of weakening sales and surging inventories of unsold homes, builders are finally following the path paved by domestic automakers -- slashing production to conform with a shrinking market. In March, housing starts fell for the second consecutive month, bringing the two-month decline to a whopping 15.6 percent. With permits for future construction also down, and the sentiment index of homebuilders sliding, it would seem that the near-term prospects for this industry are dim indeed. The question is, how much of a retrenchment is in store for this vital sector? If it just falls back to earth, and then consolidates until demand and supply are brought back into balance, the economic impact should not be particularly severe. If, however, the much-feared real-estate collapse is in the cards, all bets are off. Our sense is that housing is in the beginning stages of a long-overdue correction, but not one that will be severe or long enough to derail the economy. Still, given the Fed's sensitivity to the industry, the extent of the correction should go a long way towards determining when the rate-hiking campaign will end.

