

WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 28, 2006

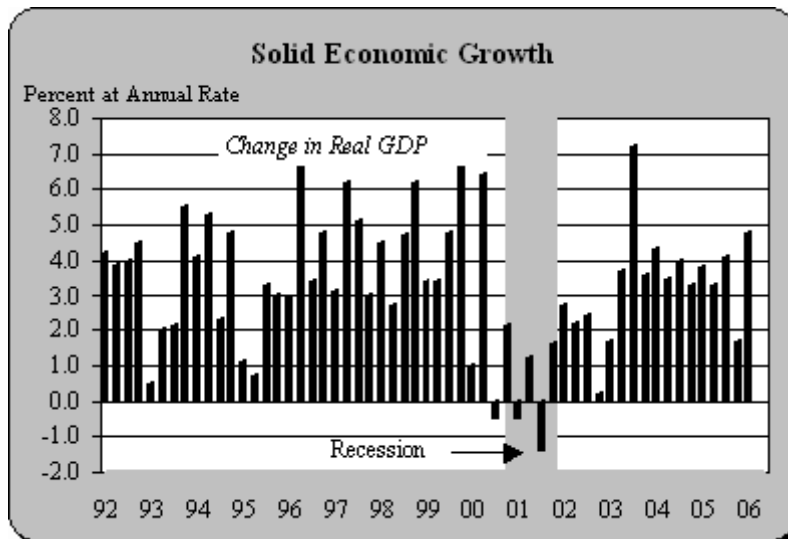
*First the numbers, then the story*

| FINANCIAL INDICATORS                         |                   |                    |                         |                                   |
|--|-------------------|--------------------|-------------------------|-----------------------------------|
| INTEREST RATES                               | April 28          | Week Ago           | Month Ago               | Year Ago                          |
| 3-month Treasury bill                        | 4.76%             | 4.74%              | 4.60%                   | 2.89%                             |
| 6-month Treasury bill                        | 4.71              | 4.90               | 4.81                    | 3.18                              |
| 2-year Treasury note                         | 4.86              | 4.89               | 4.82                    | 3.65                              |
| 5-year Treasury note                         | 4.92              | 4.91               | 4.81                    | 3.90                              |
| 10-year Treasury note                        | 5.06              | 5.01               | 4.85                    | 4.20                              |
| 30-year Treasury bond                        | 5.17              | 5.09               | 4.89                    | 4.51                              |
| Tax-Exempt Revenue Bonds (Triple-A)          |                   |                    |                         |                                   |
| 5-Year                                       | 3.81              | 3.82               | 3.69                    | 3.22                              |
| 10-Year                                      | 4.23              | 4.25               | 4.03                    | 3.90                              |
| 30-Year                                      | 4.66              | 4.67               | 4.56                    | 4.60                              |
| 30-year fixed mortgage rate                  |                   |                    |                         |                                   |
|  | 6.58              | 6.53               | 6.35                    | 5.78                              |
| 15-year fixed mortgage rate                  |                   |                    |                         |                                   |
|  | 6.21              | 6.17               | 6.00                    | 5.33                              |
| 1-year adjustable rate                       |                   |                    |                         |                                   |
|  | 5.68              | 5.63               | 5.51                    | 4.21                              |
| STOCK MARKET                                 |                   |                    |                         |                                   |
| Dow Jones Industrials                        | 11367.14          | 11347.45           | 11109.32                | 10192.51                          |
| S&P 500                                      | 1310.61           | 1311.28            | 1294.83                 | 1156.87                           |
| NASDAQ                                       | 2322.57           | 2342.86            | 2339.79                 | 1921.65                           |
| Commodities                                  |                   |                    |                         |                                   |
| Gold (\$) - 100 OZ                           | 656.00            | 638.50             | 582.00                  | 435.50                            |
| Oil (\$ per barrel) - Crude Futures (NYMerc) | 71.88             | 75.17              | 66.41                   | 49.72                             |
| KEY ECONOMIC INDICATORS                      |                   |                    |                         |                                   |
| INDICATOR (Latest Month/Quarter)             | Current Month/Qtr | Previous Month/Qtr | Two-Months/<br>Qtrs Ago | Average-Past 6<br>Months or Qtrs. |
| Durable Goods Orders (March) - % change      | 6.1               | 3.4                | -8.9                    | 1.9                               |
| New Home Sales (March) - 000s of units       | 1213              | 1066               | 1197                    | 1221                              |
| Existing Home Sales (Mar) - 000s of units    | 6920              | 6900               | 6570                    | 6870                              |
| Consumer Confidence (April) - Index          | 109.6             | 107.5              | 102.7                   | 104.8                             |
| Real GDP (Q1) - Percent Change, Saar         | 4.8               | 1.7                | 4.1                     | 3.5                               |

Contrary to conventional wisdom, the roof is not caving in on the housing market. Nor for that matter, is the sky falling on the overall economy. That's bad news for the bond bulls and inflation doves who were hoping these interrelated developments would eradicate inflation fears and push the Federal Reserve to the sidelines. But the bond hawks and inflation worriers have no reason to feel vindicated. While the apocalypse is not near, neither is the economy riding a wave of unbridled growth that will bring inflationary pressures to a boil and keep the Fed in play as far as the eye can see.

That's the message from the latest batch of economic data, which included readings on housing activity, business investment plans, consumer confidence and the most comprehensive snapshot of the economy's performance, the GDP report. Not surprisingly, the latter captured the most attention, largely because it quantified the growth rebound in the first quarter that had been widely discussed and expected for several months. During the period, real GDP expanded at a robust 4.8 percent annual rate, rebounding from the tepid 1.7 percent growth rate posted in the hurricane-battered fourth quarter of 2005. It was the strongest performance since the third quarter of 2003, and lifted the 12-month pace to 3.5 percent from 3.2 percent in the

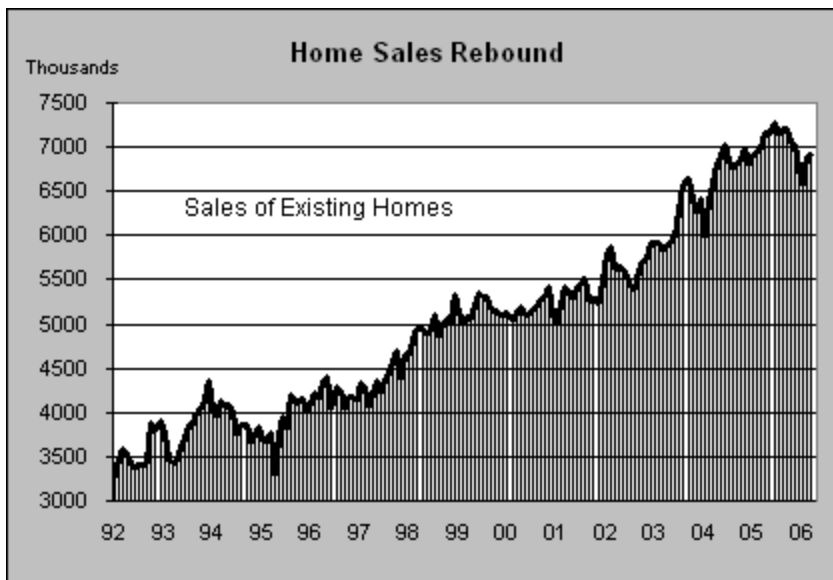
fourth quarter. It also marked the eleventh time in the last twelve quarters that growth has exceeded the 3 - 3/14 percent threshold, which is generally considered to be the maximum pace that can be sustained in a noninflationary environment.



As expected, consumer and business spending led the way last quarter, with personal consumption expenditures jumping by 5.5 percent following a puny 0.9 percent gain in the fourth quarter. Meanwhile, companies continue to add to their stock of capital goods and erect new structures at a pell-mell pace. In the first quarter, nonresidential fixed investment spending surged by 14.3 percent, the strongest gain since the second quarter of 2000, paced by an eye-opening 16.3 percent increase in outlays for equipment and software. But companies are also stepping up spending on new structures, which advanced at a solid 8.6 percent rate compared to 3.1 percent in the fourth quarter. Investment spending accounted for fully 30 percent of the increase in GDP during the period, about three times its relative size in the overall economy.

Again, the outsized gain in GDP was widely expected, coming in within a hair of the 5 percent consensus forecast. Ordinarily, a growth of this magnitude would bring out the inflation hawks and cause the bond market vigilantes to price in an ever-tighter monetary policy aimed at keeping the lid on price pressures. But the general view is that the first-quarter strength is history and the economy is poised to slow dramatically in the months ahead, paced by a major housing correction and a prospective consumer retrenchment that is being exacerbated by surging fuel prices. Indeed, just about every respectable forecast is peppered with the caveat that the housing correction could be more severe than now envisioned, and that the savings-short, heavily-indebted households may react more negatively to the reduction in housing wealth than is built in to the more complacent forecasts.

That may still turn out to be the case. However, as we noted at the outset, it doesn't seem that the housing roof is about to cave in just yet. Indeed, the March data on sales in both the new and existing home markets suggest that just the opposite may be the case. Instead of extending the weakness observed in recent months, homebuyers responded to "For Sale" signs in aggressive fashion, snapping up 1.67 million more new and existing homes than in February. The sharpest gain was in the new-home market, where sales jumped to 1.213 million units, which more than reversed the previous month's plunge to 1.066 million units from the 1.197 million units sold in January. But resales of existing homes weren't too shabby, retaining all -- and then some -- of the February jump to 6.9 million units from 6.570 million in January. The March selling rate edged up another 0.2 percent to 6.920 million.



Unlike the GDP report, the strength in the housing market was a surprise, and cast doubt on the notion that the real estate bubble is about to collapse in a veil of tears. If the housing market doesn't buckle under, a major pillar of the economy's strength in recent years will remain more or less intact, giving ammunition to the inflation hawks who argue that more Fed tightening and still higher mortgage rates are necessary to bring growth down to an acceptable pace. But before getting too unnerved by the latest housing reports, it's important to delve beneath the headline numbers. What this shows is that the housing market may not be as vulnerable as some of the more dire forecasters had been predicting. But at the same time, it is not immune to the forces that are clearly cooling off this sector.

For one, it is taking far longer to sell a home than last year, resulting in a major buildup of unsold homes. In the resale market, total homes for sale surged 40 percent above year-ago levels and it would take 5.5 months to work off this inventory at the current sales pace, the highest months' supply since July 1998. Not surprisingly, sellers are cutting prices to sell their homes, as the median price on an existing home fell to \$218 thousand in March from a recent peak of \$229 thousand last June. That's still 7.4 percent above the year-earlier level, but the annualized increase reached 16.8 percent six months ago. At current prices, the annual change will be negative in two months. In the new home market, the cooling off is even more dramatic. While sales rose strongly -- and surprisingly -- in March, they stood 7.2 percent below the level of March 2005. And, at \$224,200, median prices are down nearly \$20 thousand from last October's peak; what's more, they are actually 2.2 percent below year-earlier levels.

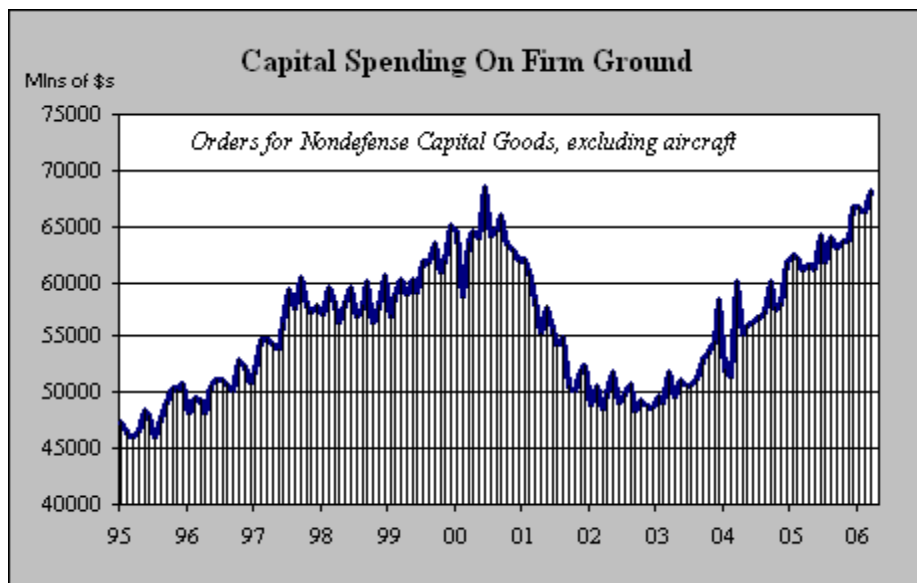
So, while a housing bust is far from underway, the industry has definitely lost its sizzle. If new mortgage applications and the surveys of realtors are any indication, activity will only soften further in coming months. If that's the case, consumers will not be drawing on appreciating housing wealth to support spending as extensively as they have in recent years. With the personal savings rate in negative territory and debt-servicing burdens getting heavier with each quarter-point increase in interest rates, there should be little question that households will be tightening their purse strings in coming months. Since consumer spending accounts for 70 percent of overall economic activity, the prospective slowdown in household purchases will be a major drag on GDP as the year progresses. The question is, how much of a drag should be expected, and does the economy have other strengths to draw on?

In our estimation, the drag will be potent but not fatal. To be sure, the latest spiral in energy prices will reinforce the drag on household purchasing power, perhaps slicing into discretionary spending to a far greater extent than it already has. But so far, the damage does not seem to be particularly severe, at least according to the latest Conference Board index of consumer confidence, which staged a sizeable increase for the second consecutive month in April, moving to a four-year high. Apparently, households are extremely confident that whatever hits they incur from higher gas prices and interest payments will be more than offset by the income gains associated with a strengthening labor market. Indeed, the percentage of respondents in the survey that claimed jobs were plentiful climbed to the highest level since August 2001. Whether that optimistic assessment is justified has yet to be determined, and will either be challenged or supported when next Friday's jobs report for April is released.

Assuming, as we do, that consumer spending slows to about half of the 5.5 percent pace registered in the first quarter, the economy will clearly need other sectors to compensate for that drop-off if it is to expand anywhere near its long-term trend

rate of 3 - 3 1/4 percent. From our lens, the most likely candidate continues to be the business sector, which remains committed to a productivity-inspired plan of boosting capital spending. That was clearly demonstrated in the first quarter's GDP report, but more to the point is that the quarter ended on a solid upbeat note.

According to a separate Commerce Department report on durable goods orders and shipments, businesses stepped up bookings and shipments of capital goods significantly in March, providing a considerable amount of forward momentum heading into the second quarter. New orders for nondefense capital goods less volatile aircraft orders -- a reliable leading indicator of capital spending -- leaped 3 percent in March, and stands a solid 6.7 percent above the first quarter average at an annual rate. In other words, all indications are that business investment will take up much of the slack left by consumers in the second quarter, cushioning the expected slowdown in GDP during the period.



But make no mistake, the economy is not likely to enjoy another quarter of 4.8 percent growth that it experienced in the first quarter for quite some time. The only question is whether it will slip below its sustainable trend rate, which would prompt the Federal Reserve to move to the sidelines. As we have noted frequently in recent commentaries, the May 10 move of another quarter-point in the funds rate looks like a done deal, if only because the financial markets already fully expect it. After that, however, all bets are off. The markets were encouraged by chairman Bernanke's congressional testimony this week, in which he strongly hinted that policy would be put on hold after the May 10 meeting. We concur with that assessment, but are less convinced that the next move will be to cut rates, which has been the Fed's strategy over the past two decades following tightening policies. This time, the Fed may decide to wait and see for a few months before deciding on its next move -- which could just as easily be another hike as a cut in rates. While the markets generally interpreted Bernanke's testimony to be relatively dovish this week, he made it quite clear that the tightening process may not be over. The following excerpt from that testimony says it all.... .."Of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings, and the Committee will not hesitate to act when it determines that doing so is needed to foster the achievement of the Federal Reserve's mandated objectives." Stay tuned.