

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 5, 2006

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	May 5	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.81%	4.76%	4.68%	2.86%
6-month Treasury bill	4.98	4.71	4.86	3.19
2-year Treasury note	4.93	4.86	4.90	3.72
5-year Treasury note	4.98	4.92	4.91	3.95
10-year Treasury note	5.10	5.06	4.98	4.26
30-year Treasury bond	5.19	5.17	5.06	4.63
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.84	3.81	3.76	3.16
10-Year	4.27	4.23	4.10	3.83
30-Year	4.64	4.66	4.59	4.56
30-year fixed mortgage rate				
	6.59	6.58	6.43	5.75
15-year fixed mortgage rate				
	6.22	6.21	6.10	5.31
1-year adjustable rate				
	5.67	5.68	5.57	4.22
STOCK MARKET				
Dow Jones Industrials	11577.74	11367.14	11120.04	10345.40
S&P 500	1325.76	1310.61	1295.50	1171.35
NASDAQ	2432.67	2322.57	2339.02	1967.35
Commodities				
Gold (\$) - 100 OZ	683.70	656.00	593.00	426.60
Oil (\$ per barrel) - Crude Futures (NYMerc)	70.19	71.88	67.41	50.96
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 (April) - Index	57.3	55.2	56.7	56.2
ISM Service Sector Index (April) - Index	63.0	60.5	60.1	60
Personal Income (March) - % change	0.5	0.3	0.7	0.5
Personal Outlays (March) - % change	0.6	0.2	0.9	0.5
Nonfarm Productivity (Q1) - % change	2.4	2.5	3.1	2.7
Nonfarm Payrolls (April) - 000s change	138	200	200	199
Unemployment Rate (April) - Percent	4.7	4.7	4.8	4.8

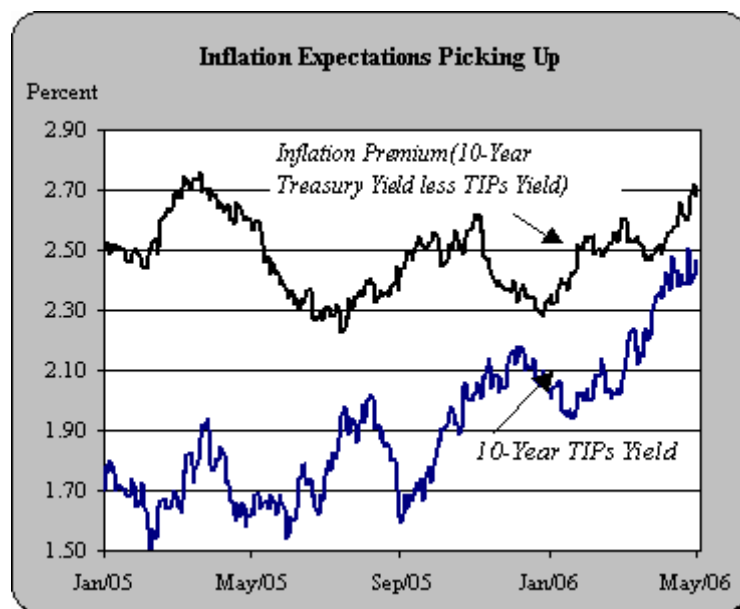
There is nothing more confusing -- or unsettling -- to the financial markets than the release of data that economists describe as a "mixed blessing". Unfortunately, the latest batch of data is about as ambivalent as it gets, feeding into the markets' angst. Even more unnerving, investors are having to cope with gyrating perceptions about Fed policy, something that is being aided and abetted by the Fed chairman himself. Recall that in his congressional testimony last month, Bernanke had strongly hinted that the policy-setting committee was about to hit the pause button in its two-year old rate-hiking campaign. Most market participants interpreted this to mean that the next rate hike, widely expected at the May 10 meeting, would be the last, fully embracing the "one and done" notion.

But that notion came under attack this week, when it was reported that Bernanke thought his congressional comments were misinterpreted by the financial community. Simply put, the chairman made it clear that a pause does not necessarily mean an

end to rate increases, only that the Fed may stop temporarily to assess the interplay between growing inflationary pressures on the one hand and emerging weakness in the housing market on the other. If the former gets the upper hand, the rate-hiking campaign could well resume later this year, perhaps as soon as the August meeting. Confusing? Perhaps, but Bernanke is trying to convey the message that policy decisions will be flexible going forward, dependent on incoming data. In point of fact, he had expressed this sentiment before, most notably in the very same testimony that hinted at an impending pause. The problem is, over the past three years the markets have become accustomed to receiving clear guidance from the Fed regarding its interest-rate intentions, and this newfound absence of certainty is hitting a discordant note among investors.

While the uncertain policy environment has not particularly roiled the stock market -- which continued on its march towards all-time highs this week -- it has clearly dented any sense of complacency in the bond market. Indeed, the upward trend in bond yields this year has remained firmly intact in recent weeks, with the 10-year Treasury hitting a recent high of 5.15 percent compared to a low of 4.34 percent in mid-January. No doubt, uncertainty about monetary policy has contributed to the rise, as has the ratcheting up of short-term yields, which has lured funds out of the bond market. But until recently, the biggest catalyst has been the robust pace of economic growth, creating an environment that typically pushes up real interest rates. In such an environment, both businesses and households are more than willing to incur higher real borrowing costs in anticipation of greater returns from investment spending and increasing real wages.

In recent weeks, however, the upward trend in bond yields appears to be drawing more support from a long-dormant factor -- an increase in inflation expectations. True, the shift in forces behind the rise in long-term interest rates is always difficult to measure. But a widely followed gauge of inflation expectations is the difference between the market yield on Treasury issues, which contains both a real and inflation component, and the real yield on Treasury Inflation Indexed Securities (TIPs), which is paid regardless of the inflation rate. Between mid-January and early April, when the market yield on 10-year Treasuries rose from 4.34 percent to 4.97 percent, more than 90 percent of the rise was in the real component, which shot up by 58 basis points. Over the past two weeks, however, virtually the entire climb has been in the inflation component, as the TIPs yield has traded within a narrow band of just under 2.50 percent.



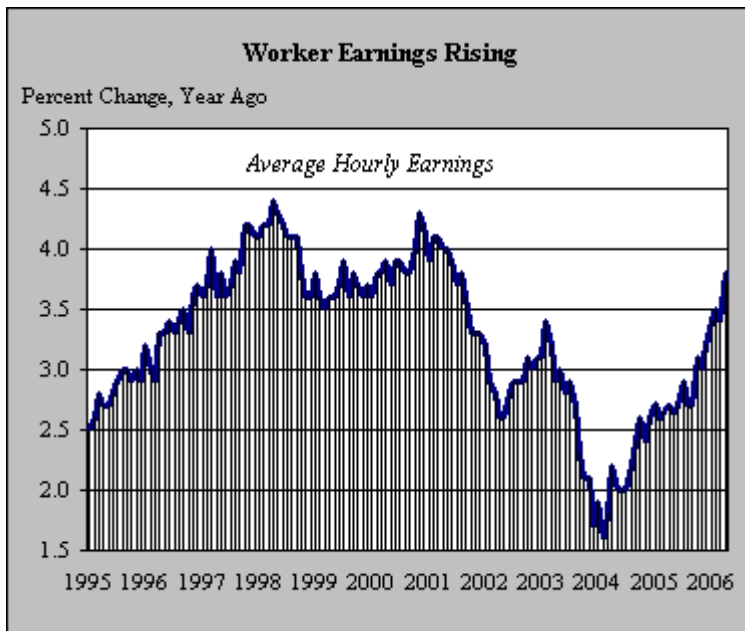
Just why the inflation hawks have started to flex their muscles in the bond market is subject to debate. Some claim that Bernanke's testimony played a role, igniting the ire of bond vigilantes who believe that any halt to the rate-hiking process would be premature given the economy's strong growth and high level of resource utilization. Others put some blame on the recent weakening of the dollar, which threatens to boost import prices and provides cover for domestic companies to raise their prices. Adding to the mix is the recent uptick in some inflation measures that market analysts monitor closely, not only for their broad inflation implications but also for their likely influence on Federal Reserve policy.

For example, it is a well known fact that the favorite inflation gauge of the Fed is the personal consumption deflator, excluding food and energy prices. This so-called core PCE deflator has been well behaved for some time, edging down from a 2.31 percent annual rate of increase reached in December 2004 to comfortably within the Fed's target range of 1.75-2.0 percent over the past several months. However, in March the deflator spiked up by a larger than expected 0.3 percent, and lifted the annual gain to 2 percent, which is at the upper limit of the Fed's comfort zone. What's more, the government

released two other reports this week, which undoubtedly heightened inflation expectations in the bond market, even as they provided good news in other respects -- the unsettling mixed blessing alluded to earlier.

First, the Bureau of Labor Statistics revealed that companies continued to turn in a remarkable productivity performance, squeezing 3.2 percent more output per hour worked out of employees during the first quarter. With the economy more than four years into an expansion, productivity growth in excess of 3 percent is a stunning accomplishment and provides companies with additional revenues to pay workers higher wages. That's the good news. The bad news is that the first-quarter increase in productivity was accompanied by an even greater increase in labor compensation, which surged by 5.7 percent. Combining the two yields a 2.5 percent increase in unit labor costs, following a 3 percent gain in the previous quarter. True, the year-on-year increase remains a relatively benign 1.4 percent, which companies can readily absorb into their historically wide profit margins, but a few more increases of this magnitude would clearly make them more eager to pass on these costs to consumers.

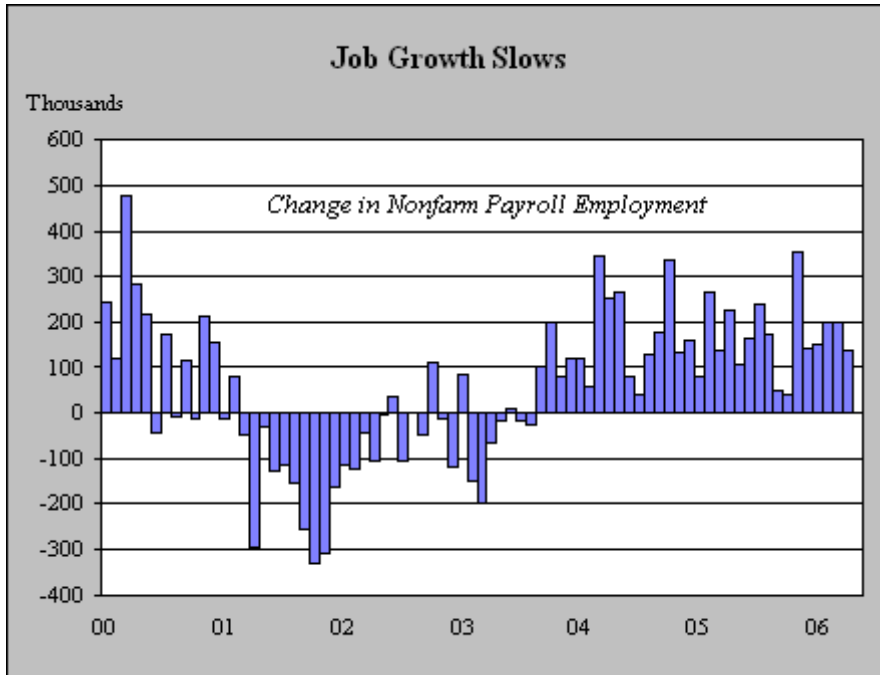
And, while the surge in labor compensation covered by the productivity report is for the first quarter, the April data on hourly earnings indicate that the trend is continuing into the current quarter as well. According to the second important government report this week -- describing conditions in the job market -- average hourly earnings jumped by a much larger-than-expected 0.5 percent last month, lifting the gain over the past year to 3.8 percent -- the strongest annual increase since August 2001. Together with a sizeable 0.5 percent increase in hours worked, employees enjoyed a hefty improvement in weekly paychecks. Indeed, the 0.8 percent jump in average weekly earnings in April was the largest since July 1997. So, to the extent that worker compensation is linked to inflation, the bond vigilantes indeed have reason to push up the inflation premium in the bond market.



But the wage-price link is not nearly as firm as was the case in years past, when the U.S. economy was largely a closed one, allowing companies to more easily pass on labor costs without fearing a loss of customers to imports. That, of course, is no longer the case, thanks to the deep penetration made in U.S. markets by foreign rivals. The globalization process has also enabled companies to outsource production and tap into a vast global labor pool to fend off militant wage demands by U.S. workers. And, with profits posting solid first-quarter gains, companies are still in a good position to absorb much of the increase in labor costs without raising prices.

What's more, chairman Bernanke as well as several other Fed officials, have said that they expect -- and would tolerate -- a transitory increase in inflation, recognizing that such a bulge would reflect past strength in the economy. The key point here though is that the increase is considered transitory only as long as economic growth slows towards a trend-like pace consistent with stable inflation. With the labor and product markets extremely tight by such conventional measures as the jobless rate and capacity utilization, that means a slowing in the pace of company hiring and a restoration of a better balance between demand and supply in the product market. That brings us to the good news in the latest employment report, which stirred the inflation pot by revealing the outsized jump in hourly earnings. If slower hiring is needed to cap the increase in labor costs, the April report has to be considered encouraging to the inflation doves.

While the unemployment rate in April remained at the five-year low of 4.7 percent reached in March, the number of new jobs created during the month fell precipitously from February and March -- to 138 thousand from 200 thousand in each of the previous two months. What's more, the initial estimates for February and March were revised down by cumulative 36 thousand. The April jobs growth was significantly less than the 200 thousand expected by the consensus on Wall Street, and gave a modest lift to the bond market, as the 10-year Treasury yield slipped to 5.10 percent on Friday. Except for the hurricane-depressed job figures last September and October, the April increase in payrolls was the slimmest since January 2005.



To be sure, the relatively sluggish pace of job creation in April should not be viewed as a sure sign that the economic engine has downshifted significantly. Most other numbers for the month so far are much more upbeat, including chain store sales and the considerable strength in manufacturing and service sector activity reported by the Institute for Supply Management this week. Moreover, a 138 thousand increase in jobs is perfectly within the 125-150 thousand range that is consistent with the growth in the labor force, which is not too hot or too cold. If that hiring pace is maintained, the labor market would not get any tighter, providing the Fed with hope that the recent climb in labor costs will be short-circuited. If, however, the April slowdown in job creation was a fluke, the May 10 hike in the funds rate will not be the last -- and may not even be followed by a pause.