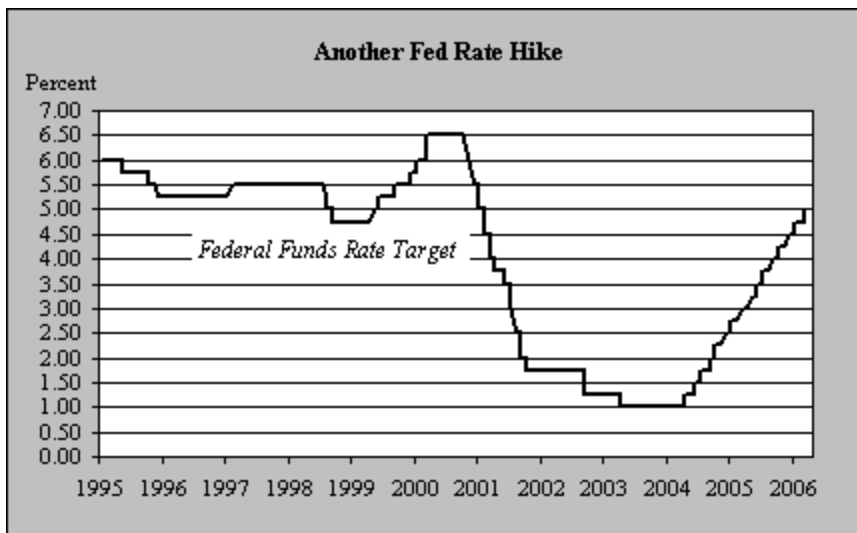


WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 12, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 12	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.82%	4.81%	4.69%	2.81%
6-month Treasury bill	4.99	4.98	4.92	3.12
2-year Treasury note	5.00	4.93	4.95	3.60
5-year Treasury note	5.07	4.98	4.97	3.82
10-year Treasury note	5.19	5.10	5.05	4.12
30-year Treasury bond	5.30	5.19	5.11	4.49
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.81	3.84	3.77	3.23
10-Year	4.24	4.27	4.17	3.84
30-Year	4.60	4.64	4.64	4.58
30-year fixed mortgage rate				
	6.58	6.59	6.49	5.77
15-year fixed mortgage rate				
	6.17	6.22	6.14	5.33
1-year adjustable rate				
	5.62	5.67	5.61	4.23
STOCK MARKET				
Dow Jones Industrials	11380.99	11577.74	11137.65	10140.12
S&P 500	1291.24	1325.76	1289.12	1154.05
NASDAQ	2243.78	2432.67	2326.11	1976.80
Commodities				
Gold (\$) - 100 OZ	716.50	683.70	602.10	420.40
Oil (\$ per barrel) - Crude Futures (NYMerc)	72.04	70.19	69.45	48.67
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 (April) - % change	0.5	0.6	-0.8	0.7
Retail ex. Auto Sales (April) - % change	0.7	0.5	-0.2	0.6
Business Inventories (March) - % change	0.7	0.1	0.6	0.5
Trade Deficit (March) - millions of \$s	62000	65643	68587	65600
Consumer Sentiment Index (early May)	79.0	87.4	88.9	87.5

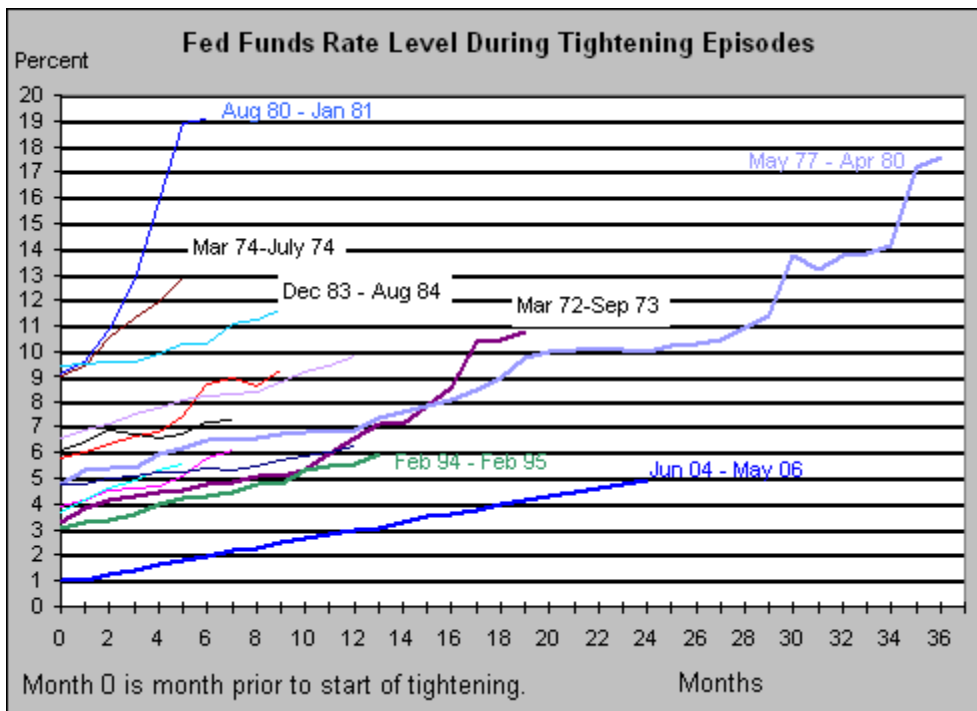
About a nanosecond after the Federal Reserve completed its policy meeting this week, a new round of watchful waiting and fevered speculation took hold in the financial markets. If the recent past is any indication, this new chapter should provide unsettling reading for the legions of Fed watchers and anxious investors. Just about the only expected note sounded at the meeting was the Fed's decision to hike the federal funds rate another quarter-point to 5 percent, the 16th consecutive increase in as many meetings dating back to June 2004. The action was widely anticipated and hardly drew a response in the financial markets, except to prompt a corresponding increase in the prime rate by the major banks.



What sent the markets into a new round of speculation was the much discussed post-meeting statement, which is avidly monitored by Fed watchers for clues about the central bank's intentions going forward. Unfortunately for those looking for closure, the statement was as open-ended as ever. With slight modification, the phrase "some further policy firming may yet be needed to address inflation risks" was retained, with only the word "yet" added to the verbiage. To those hoping the Fed would signify that the two-year rate-hiking campaign was ending, the retention of this phrase was a huge disappointment. But as we noted last week, policymakers are striving for as much flexibility as needed, which means that it must wean the markets off of the comfortable mentality of knowing exactly what it intends to do from one meeting to the next. This, the post-meeting statement did with utmost flair, claiming that "the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information."

In other words, the Fed may or may not hike rates again at its next meeting on June 28-29, and whatever happens then is not necessarily the final word. If no action is taken, it may simply be because the policymakers choose to pause and assess economic developments before making its next move. There is nothing unusual about such a strategy. Indeed, the staircase pattern of consecutive increases in each and every meeting over the past two years has been the exception, not the rule. The Fed usually pauses and reflects during policy cycles, whether moving rates up or down, often moving to the sidelines for several months before changing rates again. The fact that it has stayed on such a consistent course this time reflects the unusual nature of the current policy cycle.

Recall, that when the Fed embarked on its current rate-hiking campaign, the federal funds rate was at an historic low of 1 percent aimed at thwarting what was perceived to be an imminent deflationary threat, much as the one that has hobbled Japan for more than a decade. The initial strategy was to pump-prime the economic engine as aggressively as possible. But when the recovery gained traction two years ago, the Fed began to remove the unprecedented monetary stimulus that was no longer perceived to be necessary. Since the process started from such a low rate level, the road ahead was long and predictable, and conducted in measured quarter-point increments. Indeed, because so much ground had to be made up before the expressed goal of "neutrality" was reached, the policy-firming cycle has been one of the longest on record. As the chart below shows, of the twelve previous tightening campaigns, only the 1977-1980 episode lasted longer than the current one. As can also be seen, the Fed paused -- and even reversed course -- several times before finally bringing that campaign to an end. A similar stop-and-go pattern is visible in several of the other tightening cycles as well.



So now that the Fed has told us not to take anything for granted, the task at hand will be to monitor incoming economic data and determine if inflation risks continue to outweigh the growth risks, which are dominated by the income-draining effect of soaring energy prices and a weakening housing market. If recent data are any indication, the job will not be easy. What the Fed is hoping for -- and expecting according to the latest policy statement -- is for growth to taper off to a more sustainable pace, one that matches the economy's long-run growth potential. That pace -- generally perceived to be around 3 percent or slightly stronger -- would prevent demand from continuing to outstrip supply and, hence, halt the buildup of pressures in the labor and product markets. Although core inflation has remained benign, the high level of resource utilization is clearly the major reason that the Fed still perceives inflation risks to be a major threat to the economy.

Indeed, inflation concerns are being increasingly manifested in a number of ways. Bond yields have spiked sharply higher, with the 10-year Treasury rising another 9 basis points to 5.19 percent on Friday. The bond bears are buying inflation protection by loading up on Treasury TIPs, reducing their yields and widening the breakeven point between the nominal rate on Treasury issues and the TIPs yield. This differential -- a proxy for inflation expectations in the bond market -- has increased to 2.75 percent this week, testing the highs not seen since 1997. The dollar continued to sag against major currencies this week, extending the 5 percent drop since April and heightening the prospect of higher import prices. The price of gold -- a traditional inflation hedge-- remained on its astonishing upward ride, reaching \$725/ounce before correcting to \$711 on Friday. Finally, the upward spiral in commodity prices, fueled as much from booming global demand as from speculative activity, continues unabated.

Adding to these inflation signs, the U.S. economy -- now well into its fifth year of expansion -- is just coming off one of the strongest quarterly growth spurts of the upturn. Indeed, the 4.8 percent preliminary estimate for the first quarter's GDP growth rate is almost certain to be revised sharply higher when the new numbers are released on May 25. The upward revision -- which could easily approach 6 percent -- reflects more recent data that were not available when the initial estimate was made. These include March figures on construction, inventories and the trade balance, which showed a much narrower deficit than expected during the final month of the quarter according to a Commerce Department report released on Friday. While the whopping \$3.6 billion reduction in the March trade gap reflected some temporary forces that will be reversed in coming months, it does reveal the steadily growing strength in exports, which topped the year ago level by a solid 11.6 percent. If the U.S. is to climb out of the deep deficit hole that is spurring a huge dependency on foreign loans to finance it, the growth in exports must be sustained. At the same time, of course, American consumers need to reduce their insatiable appetite for foreign goods, something that should be aided by the recent weakness in the dollar, which makes foreign products more expensive.

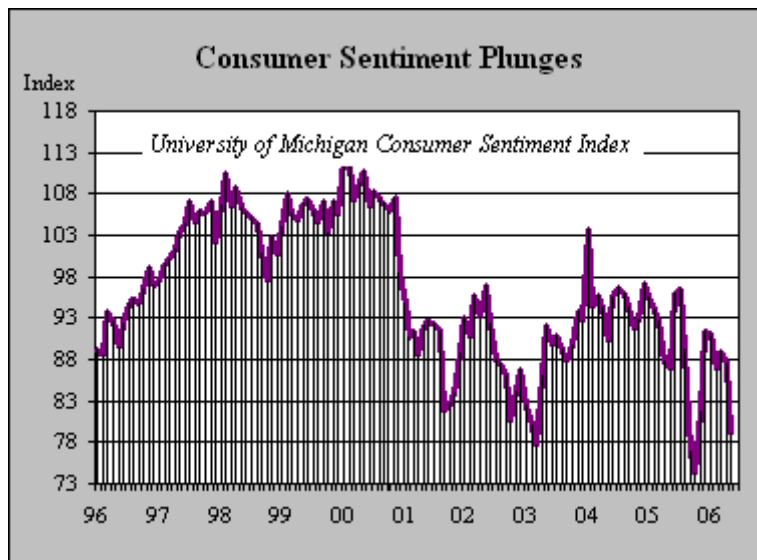
Nonetheless, the upward revision in the first-quarter's growth rate should not obscure the fact we are now well into the second quarter, and it is current as well as the future flow of data that will determine the course of Fed policy. One thing is sure: the U.S. economy is slowing dramatically from the 5.5 - 6.0 percent pace of the first quarter; only the extent of the

slowdown has yet to be determined. What complicates matters is that the first-quarter's strength was greatly exaggerated by the exceptionally warm weather early in the period, as well as the rebound from the hurricane-induced slump in last year's fourth quarter. The hurricane rebuilding impetus is already fading and should have little effect going forward. However, the weather-related payback seems to be unfolding as scripted, which makes it difficult to decipher the fundamental underpinnings of the economy.

For example, virtually all of the increase in retail sales in April was due to an outsized gain in gasoline station sales, reflecting a 4.6 percent jump in petroleum prices during the month. Retail sales, excluding sales at service stations, only edged up by a puny 0.1 percent. One reason for this weak showing is that sales at building materials stores slumped by 1.6 percent during the month, an unusually large drop during the spring. But this category showed unexpected strength in January when it leapt by 6.9 percent, owing to the unusually warm weather which spurred sales of remodeling and gardening supplies that tend to sell more briskly in the spring. Simply put, these purchases were pushed forward, contributing to the weak sales in April. Otherwise, retailers did not fare too badly. Indeed, core retail sales, excluding gasoline and autos, stood a hefty 7.4 percent above a year ago.

Still, there's no question that soaring gasoline costs are crimping budgets and stifling spending plans. With interest rates also spiking higher, an even heavier burden is weighing on households. That may be contributing to the sinking poll ratings of the administration, which is being criticized -- perhaps unfairly -- for the way it is handling the energy crisis, overshadowing the positive aspects of the economy's performance. More importantly, consumer psychology is taking a big hit, something that could translate into much weaker spending than is currently envisioned by policymakers. This is a big shift from recent experience, as consumer spirits have held up quite well under the strain of rising gasoline prices and interest rates.

But if the latest University of Michigan survey is any indication, households may be reaching the breaking point. In the early-May survey, the University's consumer sentiment index plunged to 79 from 87.4 in April. That was a much weaker reading than expected, as the consensus forecast was for the index to edge down to only 86.0. As the analysts at the University explained, consumer sentiment is the lowest it has been in more than a decade except for the brief readings associated with the special and temporary circumstances following Hurricane Katrina and the initial invasion of Iraq. Not surprisingly, the incessant spiral in oil prices is taking a big toll. Indeed, more consumers in the history of the survey said they were being hurt by high gasoline prices, and nearly half of the people surveyed expected their inflation-adjusted incomes to decline in coming months.



Needless to say, the slump in the sentiment index brought with it a sharp decline in consumer buying plans, particularly for durables, such as cars, and real estate. In fact, the fraction of households that said it was a good time to buy a home fell to the lowest level since December 1990. These are surveys, of course, not actual behavior, and survey results do not necessarily portend corresponding changes in spending behavior. In fact, studies show that confidence surveys tend to be more backward than forward-looking. Still, the Fed will have a hard time ignoring the sudden and abrupt downturn in consumer attitudes and the latest increase in long-term interest rates, which will reinforce the weakening trend in the housing market. In short, the latest batch of data would seem to support the notion that the Fed will pause at the next meeting in June. But there's many a slip between the cup and the lip, and the Fed still has another six weeks of data to absorb before having to make that decision. By late June, we should have a better read as to whether the April weakness in consumer behavior is just a temporary

payback from the first-quarter's weather-induced strength or something that is more fundamental in nature.