

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 19, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.81%	4.82%	4.74%	2.88%
6-month Treasury bill	4.99	4.99	4.90	3.16
2-year Treasury note	4.96	5.00	4.89	3.66
5-year Treasury note	4.96	5.07	4.91	3.87
10-year Treasury note	5.06	5.19	5.01	4.12
30-year Treasury bond	5.14	5.30	5.09	4.44
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.82	3.81	3.82	3.15
10-Year	4.25	4.24	4.25	3.79
30-Year	4.63	4.60	4.67	4.55
30-year fixed mortgage rate				
	6.60	6.58	6.53	5.71
15-year fixed mortgage rate				
	6.20	6.17	6.17	5.27
1-year adjustable rate				
	5.62	5.62	5.63	4.26
STOCK MARKET				
Dow Jones Industrials	11144.06	11380.99	11347.45	10471.91
S&P 500	1267.03	1291.24	1311.28	1189.28
NASDAQ	2193.88	2243.78	2342.86	2046.42
Commodities				
Gold (\$) - 100 OZ	659.60	716.50	638.50	417.60
Oil (\$ per barrel) - Crude Futures (NYMerc)	68.53	72.04	75.17	47.50
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 (April) - 000s of units	1849	1996	2132	2063
Consumer Price Index (April) - % change	0.6	0.4	0.1	0.2
Core CPI (April) - % change	0.3	0.3	0.1	0.2
Producer Price Index (April) - % change	0.9	0.5	-1.4	0.1
Industrial Production (April) - % change	0.8	0.6	0.4	0.6
Capacity Utilization (April) - Percent	81.9	81.4	81.0	81.1

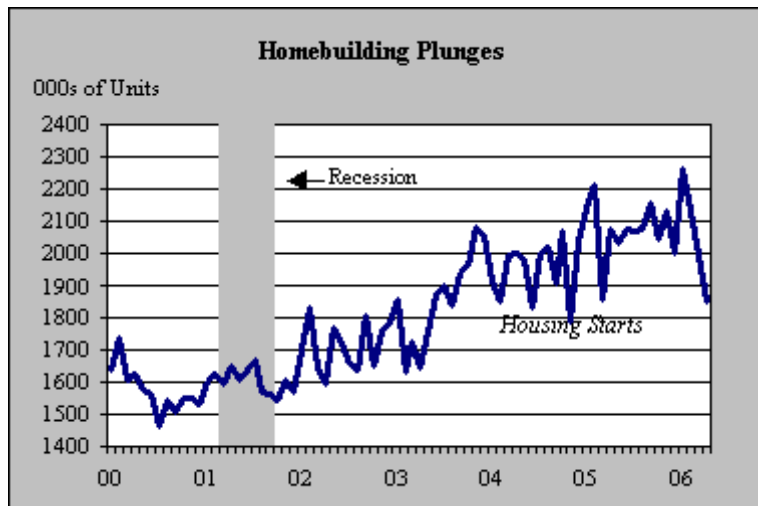
The dizzying ride on Wall Street this week mirrored the confusion generated by the week's batch of economic data. Things got off to a positive start for stocks and bonds when the numbers appeared to support the notion that the Federal Reserve would hit the pause button at its next meeting in late June. Wholesale prices for April came in on the weak side, revealing a tame inflation picture, and residential construction activity tumbled, reinforcing the escalating weakness in the housing market that the Fed is closely monitoring. But whatever uplift to bond and stock prices these early figures provided was abruptly reversed later in the week when fresh data on consumer prices spurred a sharp increase in inflation expectations and heightened the odds of another rate increase by the Fed. On Wednesday and Thursday, stock prices took a nerve-racking tumble, pushing the S&P 500 index to the lowest level since early February, before posting a modest increase on Friday.

Clearly, traders and investors are having a difficult time parsing the crosscurrents depicted by incoming data, something that is contributing to a spike in market volatility. That's particularly the case in the bond market, where prices and yields seem to

be moving irrationally. For example, despite the uptick in inflation and inflationary expectations this week, bond yields fell from a recent peak of over 5.20 percent to as low as 5.04 on Thursday. In a more rational environment, just the opposite would probably take place. One reason, perhaps, is that short-sellers are either getting squeezed or are covering positions because they perceive that bonds, at 5.20 percent, was oversold earlier in the week.

What may also be having an influence is the notion that if the Fed continues to tighten the monetary screws, the economy will indeed slow considerably in the second half of the year, if not before. Interestingly, it was only a few short months ago that market pundits as well as Fed officials were telling us to downplay the traditional forecasting significance of a flat yield curve, as long-term rates were being held down by such special factors as heavy foreign purchases and a savings glut overseas. However, with foreign buying of Treasuries slowing considerably recently, the renewed flattening of the yield curve this week may possibly be sending the correct message -- namely, that the economy is poised to slow markedly in coming months.

If that turns out to be the case -- a big if, given the time-tested resilience of the economy -- the most likely catalyst will be a sharp housing correction, which Fed chief Bernanke has identified as the biggest downside risk facing the economy. Certainly, recent data support the argument that the real-estate market is on the precipice of a hard landing. Sales of both new and existing homes have been sliding for several months, prices are weakening -- down more than 2 percent on new home sales compared to a year ago -- inventories of unsold homes are bulging and mortgage applications for home purchases are falling sharply. Now the builders are getting into the act, slashing construction of new homes at a faster pace than industry experts expected. In April, housing starts plunged by 7.5 percent to an annual pace of 1.849 million units, far below the consensus forecast of 1.950 units.



To be sure, some payback from the warm-weather-induced strength in homebuilding activity during the first quarter -- when starts averaged a record 2.131 units -- was to be expected. But builders have been pulling back now for three consecutive months, and the retrenchment is starting to become eye-opening. The 3-month slide, for example, translates into an annualized rate of 56 percent, the steepest such plunge since 1991. What's more, the near-term outlook is anything but encouraging. Permits for new construction have also declined for three consecutive months, falling to the lowest level since February 2004 in April. Given this backdrop, it is not surprising that builders are feeling gloomy. Indeed, the sentiment index compiled by the National Association of Home Builders slumped to an 11-year low last month, largely reflecting the shrinking volume of traffic by potential home-buyers.

That shrinkage has much to do with the budget pinch being felt by households. Although home prices are weakening, they are still lofty by historically standards. What's more, mortgage interest rates hit 6.60 percent this week, a four-year high and up nearly a full percentage over the past year. Combine expensive homes with ever-rising mortgage payments, and more and more house-hunters are finding that they don't have enough income to afford the cost of a median-priced home. In point of fact, the housing affordability index as compiled by the National Association of Realtors has fallen to a fourteen year low. With budgets being further squeezed by spiraling gasoline prices -- estimated to siphon about \$75 billion from incomes in the second quarter alone -- and weakening real estate values providing households with less housing wealth to convert into cash, there is little reason to be optimistic about housing activity in the near future.

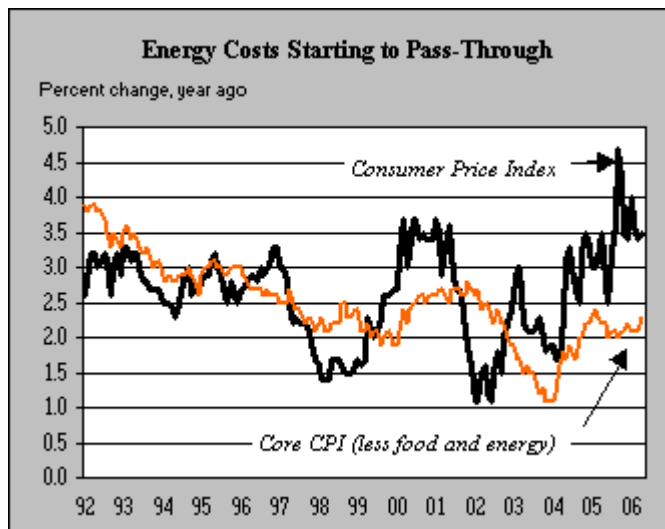
That said, it's important to keep in mind that a softening housing market is not unexpected. Unless it spirals out of control into an outright crash -- something that even Robert Shiller, the Yale University perennial bear doesn't expect -- the economy

is not likely to be brought to its knees. Even with the array of depressing statistics on sales, construction and sentiment, none other than Fed chairman Bernanke observed this week that the emerging housing weakness is unfolding in an orderly fashion. To us, that's a clear signal the Fed is still more concerned about inflation risks than a sharp housing-induced slowdown. Even if the June 29/29 FOMC meeting results in a pause after 16 consecutive rate increases, a 17th hike should not be ruled out in the August or September meeting.

Clearly, the Fed could not turn a blind eye to the latest report on consumer inflation, which overruled the previously-released tame reading in the wholesale price report. As expected, headline consumer prices shot up by 0.6 percent in April, following a hefty 0.4 percent increase in March. The April gain reflected an outsized 3.9 percent spike in energy costs, three times larger than the 1.3 percent increase in April. The April gain in the overall CPI brought the annual increase to 3.6 percent, up from 3.5 percent in March but well off the torrid 4.7 percent post-Katrina surge reached last fall. Energy prices are still rising, but not as rapidly as they were following the hurricane disruptions last year. Hence, the modest slowdown in the headline inflation pace.

But it is not the energy-related increase in the CPI that's worrying the Fed, or stirring the angst of the inflation hawks. For nearly a year, the primary debate on Wall Street and in the Fed's boardroom has been whether -- and when -- the escalation in energy costs would feed through into other goods and services. Advocates on both sides of the debate have weighed in heavily with their opinions, and both present compelling arguments. For the most part, however, the inflation doves have been supported by the incoming data, which show little or no pass-through of energy prices into the core inflation metric. To them, that's just further evidence that in an age of globalization, strong productivity growth and with an Internet-empowered consumer able to surf the Web for price differentials on just about any product or service, the forces of disinflation are just too powerful for spiraling oil prices to overcome. If anything, higher energy costs are primarily deflationary, as they cut deeply into incomes that are already being held in check by cost-conscious businesses seeking to stifle the growth in labor compensation.

However, the inflation-phobes that don't buy into that argument are now flexing their muscles. While core inflation has been well contained, they point out that it is only a question of time before the energy pass-through as well as other cyclical forces finally conspire to put upward pressure on the general level of prices. As evidence, they can now point to back-to-back months of core CPI increases that exceeded expectations. In April, the core rose 0.3 percent, following March's similar gain, which marked the first time in over two years that core inflation has topped 0.2 percent for two consecutive months. To find the third time this has happened, it would be necessary to turn the calendar back to January/February 2001. Just as significantly, the annual rate of increase in the core CPI returned to the 2.3 percent pace last touched in March of 2005, well above the 2 percent upper limit that the Fed feels comfortable with.



Clearly, the above-consensus increase in the core CPI ignited market jitters this week, and was the main factor causing the tumble in stock prices. But the inflation doves are sticking to their guns, claiming that the devil is in the details. Sifting through the CPI report, what they find is that the core CPI is being unduly influenced by speedier increases in housing costs, which account for 40 percent of the index. And the reason housing costs are going up is because of rising rents, as people who can no longer afford a home are switching to the rental market, increasing demand for this form of shelter. What's more, the supply of rental units has been reduced due to the widespread conversion of apartments into condominiums in recent years. Simply put, the doves argue that this not a fundamental increase in inflationary pressures, but rather a consequence of

the Fed-induced increase in interest rates, which is artificially boosting rents by creating weakness in the housing market.

Whether the Federal Reserve buys that argument remains to be seen. Keep in mind that there are still a number of key reports bearing on the inflation landscape that will be released prior to the June 28 meeting, including a full round of monthly data on employment (and, by proxy, labor costs), consumer prices and housing, providing further details on the extent of weakness in this all-important sector. The Fed is also monitoring the sectors that are expected to offset the housing weakness, including capital spending and exports, which continue to show considerable strength. Indeed, the industrial side of the economy is continuing to recover strongly, powered by output gains in high-tech equipment related to the muscular increases in capital spending. With industrial production staging a solid 0.8 percent increase in April, factories are using an ever-increasing fraction of available capacity. In April, the industrial operating rate rose to a near six-year high of 81.9 percent. Since Bernanke has cited the high level of resource utilization as a major source of inflation pressure, we would like to see more evidence that demand is slowing enough to relieve these pressures before betting the Fed will pause in its rate-hiking campaign.

