

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 26, 2006

First the numbers, then the story

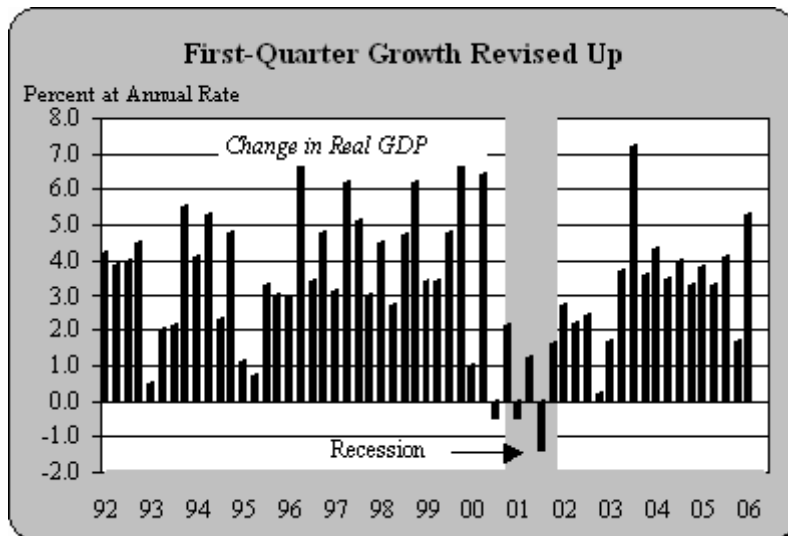
FINANCIAL INDICATORS				
INTEREST RATES	May 26	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.82%	4.81%	4.76%	2.95%
6-month Treasury bill	5.00	4.99	4.71	3.12
2-year Treasury note	4.94	4.96	4.86	3.64
5-year Treasury note	4.94	4.96	4.92	3.81
10-year Treasury note	5.05	5.06	5.06	4.07
30-year Treasury bond	5.16	5.14	5.17	4.43
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.79	3.82	3.81	3.15
10-Year	4.17	4.25	4.23	3.77
30-Year	4.58	4.63	4.66	4.49
30-year fixed mortgage rate				
	6.62	6.60	6.58	5.65
15-year fixed mortgage rate				
	6.23	6.20	6.21	5.21
1-year adjustable rate				
	5.61	5.62	5.68	4.21
STOCK MARKET				
Dow Jones Industrials	11278.61	11144.06	11367.14	10542.55
S&P 500	1280.16	1267.03	1310.61	1198.78
NASDAQ	2210.37	2193.88	2322.57	2075.73
Commodities				
Gold (\$) - 100 OZ	652.60	659.60	656.00	422.70
Oil (\$ per barrel) - Crude Futures (NYMerc)	71.38	68.53	71.88	51.85
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (April) - 000s of units	1198	1142	1020	1171
Existing Home Sales (April) -- 000s of units	6860	6900	6900	6818
Durable Goods Orders (April) - % change	-4.8	6.6	3.6	0.5
Personal Income (April) - % change	0.5	0.5	0.4	0.5
Personal Consumption (April) - % change	0.6	0.5	0.3	0.6
Personal Savings Rate (April) - percent	-1.6	-1.4	-1.3	-1.2

The financial markets heaved a collective sigh of relief this week as the economic data were not as terrible as feared. First, the economy did not reach an overheated state in the first quarter, as the upward revision in the GDP growth rate was less than expected. Second, while the housing market continues to weaken -- and flash some highly-worrisome signals -- it still remains a comfortable distance from falling into the quicksand. Finally, the latest inflation number did not support the notion that the Federal Reserve is falling behind the curve, requiring further rate hikes in late June and beyond.

To be sure, the psychological impact of these end-of-month data is much less potent than the employment and other figures released earlier in the month, which provide a more meaningful sense of the economy's performance. Still, for investors looking for confirmation of ingrained perceptions -- or reassurance that things aren't as bad as earlier data suggest -- they do serve a purpose. For example, the first-quarter GDP revision was eagerly anticipated by inflation hawks who believed that the economy was operating closer to full capacity than the earlier figures indicated. Recall that the advance report released a

month ago revealed a growth rate of 4.8 percent, stronger than the hurricane-depressed 1.7 percent pace in the fourth quarter of last year but not as sharp of a rebound as expected. Given more recent data, the consensus call was for an upward revision to about 6 percent, pushing the economy closer to the inflation edge.

However, the revised GDP data showed that the economy expanded at "only" a 5.3 percent pace in the first quarter. That's stronger than the original estimate but suggesting far less momentum heading into the second quarter than a 6 percent pace would have implied. Indeed, more current data reinforces the view that the economy is indeed heading for a "soft landing" during the second quarter, which would be just what the doctor ordered to relieve inflationary pressures while sustaining a healthy expansion. With the first month of the quarter now in the books, the economy is on a 2 1/2-3 percent growth track, a temporary pace that is clearly acceptable to the inflation-sensitive Federal Reserve. Of course, the Fed has to be careful not to get too much of what it wishes for. A sub-3 percent growth rate is entirely acceptable for a quarter or so to keep inflation pressures in check, but the risk is that the loss of momentum could feed on itself and lead to a stalling out of activity later in the year.



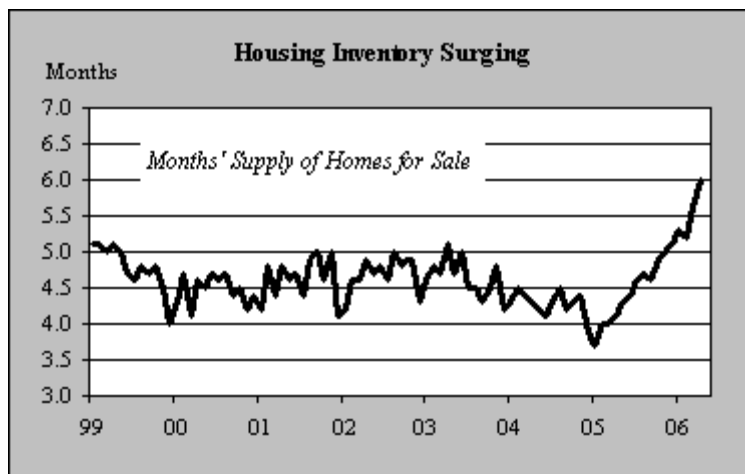
That's not a likely prospect, in our view, unless households buckle under the pressure of rising interest rates, sky-high energy costs and a weakening housing market. Clearly, consumers -- who have been the bedrock of the expansion so far -- have sustained their spending habits by dipping ever deeper into personal savings and eating into the equity of their rising real estate holdings. That, however, is becoming a less viable option. According to Friday's latest income and spending report for April, households continued to spend every penny of their earnings, and then some, requiring them to deplete savings even more than they have over the past year. For example, despite a relatively healthy 0.5 percent increase in personal incomes during the month, personal outlays advanced by an even-stronger 0.6 percent pace. As a result, the personal savings rate fell to a negative 1.6 percent, the twelfth time in the past thirteen months that this rate has been in negative territory.

Similarly, while consumers have been able to compensate for their savings shortfall by tapping into their housing equity, that too is becoming a less viable source of spending power. For one, the cost of borrowing against housing equity has risen significantly over the past year, particularly for those taking out home equity loans that are linked to the bank prime lending rate. The prime rate, following in lockstep with the Federal Reserve-induced hikes in the federal funds rate, is up by 4 percentage points over the past two years, and the more recent rise in bond yields has kicked up fixed mortgage rates as well. In the latest week, the 30-year fixed rate stood at 6.62 percent, a four-year high and up a full percentage point from a year ago. For many households whose budgets are already stretched by spiraling energy costs and higher debt levels, the increase in borrowing costs makes the conversion of housing equity into spendable funds virtually prohibitive.

Second, the appreciation in housing equity is rapidly disappearing, withdrawing the extra collateral that households have come to rely on for borrowing purposes. This, of course, is directly related to the growing imbalance in the real estate market, where construction has raced ahead of sales and homeowners have put more houses on the market than can be accommodated by demand. The good news is that demand has not fallen off a cliff -- as predicted by some of the bubble-conscious doomsayers -- at least not yet. True, home sales are well off their peaks of last year -- with the volume of transactions in both the new and existing housing markets down by 5.7 percent compared to a year ago. But the slide, which began from extraordinary high levels, appears to be slowing, and new-home sales actually rose in both March and April.

The bad news is that the supply of homes for sale is soaring through the roof. In the market for new homes, for example, an unprecedented 558 thousand units are for sale, up 27 percent over the past year. That may overstate the imbalance somewhat, since more than 100 thousand of these units haven't been started yet, and builders may just decide to postpone breaking ground until demand catches up with supply. Another incentive to hold back is that sales prices are not keeping up with construction costs. In April the median price of a new home sold stood only 0.9 percent higher than twelve months earlier, a marked comedown from the 13.6 percent appreciation that was typical as recently as last September.

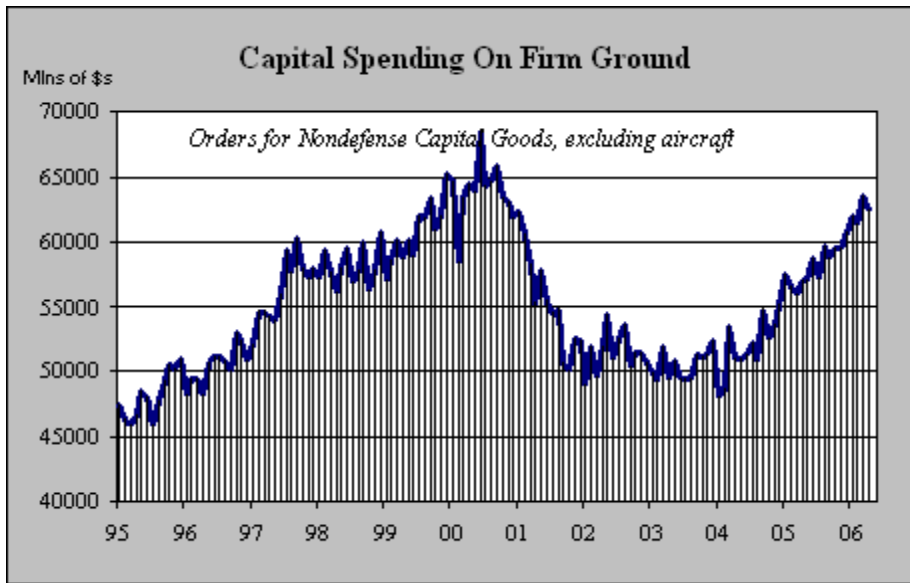
In the much larger resale market -- which accounts for more than 85 percent of all home sales nationwide -- the evidence of a withering housing boom is even more striking. True, prices here are rising faster than in the new-home market, as the median price stood 4.2 percent higher than a year ago in April. But that annual increase is off from a 16.8 percent appreciation rate reached last summer, and the growing excess of supply is much steeper than in the new home market. For example, there is an eye-opening 2,890,000 homes on the market with a "for sale" sign on the lawn, up a sizzling 33.2 percent from a year ago. At the current sales pace, that represents a 6-month supply, which is a worrisome 46.3 percent larger than twelve months earlier. Clearly, either prospective sellers will have to lower prices if they want to move, or take their homes off of the market and stay put until they can get their asking price. We suspect that the former is the more likely prospect, which further erodes the housing wealth that makes up the bulk of household net worth.



So, with savings depleted and the gains in housing wealth vanishing, where will consumers obtain the wherewithal to sustain spending? Two points are noteworthy in this regard. First, the incremental boost to consumer shopping provided by the real-estate boom is history. That, by itself, should remove about a half percentage point from the increase in consumer spending observed over the past two years. Second, households will have to rely more heavily on traditional sources of purchasing power, namely the growth in incomes through job creation and fatter paychecks. Fortunately, this transition from an asset and savings-dependent consumer to one whose purchasing habits are shaped by income growth appears to be firmly underway. Not only is the growth in total personal incomes rising at a solid clip, with April's 0.5 percent gain lifting the increase over the past year to a healthy 5.4 percent, the core wage and salary component that drives consumer spending is on a much stronger growth track. The 0.9 percent increase in wages and salaries matches the strongest monthly gain in nearly two years. What's more, paychecks have increased a muscular 7.7 percent annual rate over the first four months of the year.

With the job market strong and the unemployment rate hitting the lowest level in five years, we suspect that earnings will continue to expand at a healthy clip over the balance of the year, enabling households to both replenish savings and sustain consumption at a respectable pace. Granted, consumers will scale back from the 3.7 percent average spending increase posted in 2004 and 2005. The retrenchment during the current quarter should be particularly sharp, as the full brunt of the rise in gasoline prices is felt. At \$3 a gallon, it is estimated that energy costs will siphon as much as an annualized \$90 billion from disposable incomes during the spring months, and the toll may rise during the peak driving season in July and August. However, if the price at the pump steadies from here on out, a strong possibility, the incremental drag from filling up the tank will vanish, even as incomes continue to grow.

Hence, after this quarter's retrenchment, we expect consumer spending to return to a respectable 2 1/2 - 3 percent growth track in the second half of the year, which should be enough to support a 3 percent plus growth rate in GDP. That assumes businesses will continue to invest heavily in new capital equipment and structures, something they are showing every indication of doing. For example, despite a minor pullback of 1.7 percent in April, nondefense capital goods orders, less the volatile aircraft bookings, stood a healthy 9.4 percent above year-earlier levels. Over the first four months of the year, capital goods orders are up at an 8.7 percent annual rate, foreshadowing close to double-digit spending gains in coming quarters.



As we noted at the outset, the financial markets were relieved that the data this week showed neither an overheated economy or a collapsing housing market, fueling a modest stock market rally from Wednesday through Friday following two dismal down weeks. Perhaps the real relief was that a closely-watched inflation barometer, the core personal consumption deflator, didn't follow the lead of the core consumer price index, which rose by 0.3 percent in each of the last two months-- a pace that heightened inflation expectations shaped by monthly average increases of 0.2 percent since the last recession. Instead of also ratcheting higher, the core PCE deflator increased by the same 0.2 percent in April as in the previous month, which calmed fears that the Fed would pull the rate-hiking trigger at its June 28-29 meeting. It's still a close call as to whether another rate increase is coming at that time, but the Fed still has a full month of data to review before making that decision. Our early read is that the Fed will pause at the meeting and issue a strongly-worded statement indicating its firm commitment to contain inflation. Of course, upcoming data, particularly the pending jobs and consumer price reports, could force the Fed's hand in unexpected ways.