

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 2, 2006

*First the numbers, then the story*

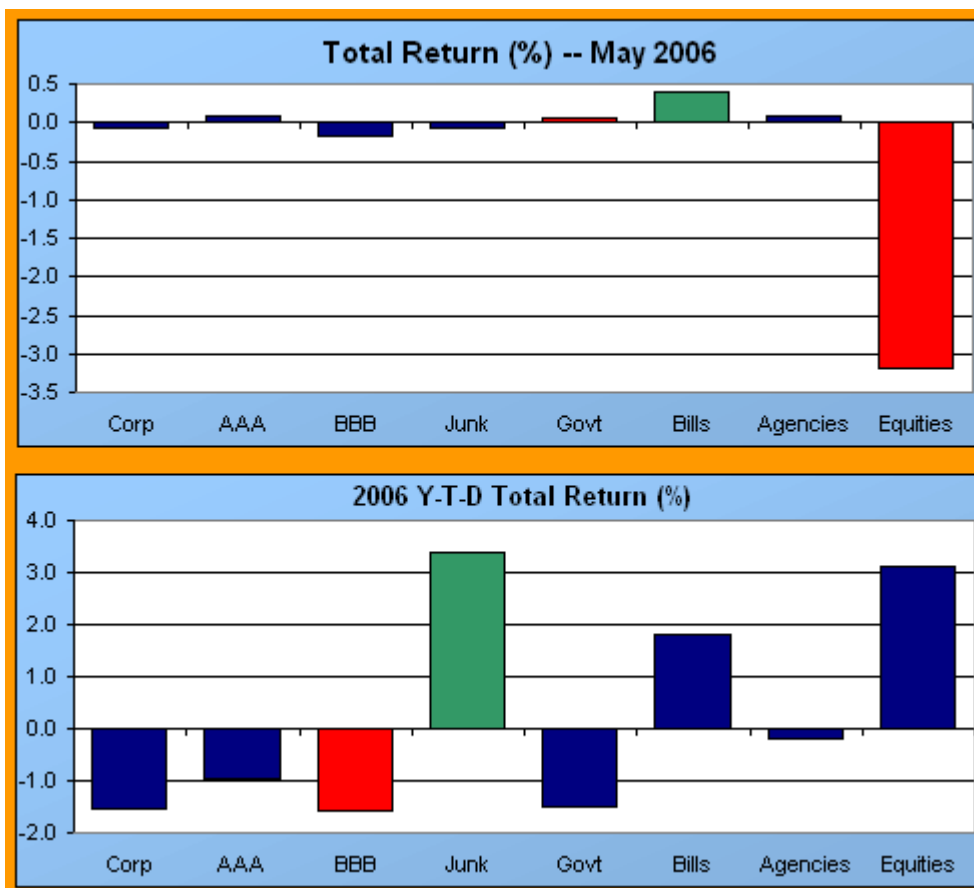
FINANCIAL INDICATORS				
INTEREST RATES	June 2	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.80%	4.82%	4.81%	2.99%
6-month Treasury bill	5.00	5.00	4.98	3.12
2-year Treasury note	4.91	4.94	4.93	3.57
5-year Treasury note	4.90	4.94	4.98	3.73
10-year Treasury note	4.99	5.05	5.10	3.98
30-year Treasury bond	5.10	5.16	5.19	4.29
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.76	3.79	3.84	3.13
10-Year	4.16	4.17	4.27	3.71
30-Year	4.57	4.58	4.64	4.43
30-year fixed mortgage rate				
	6.67	6.62	6.59	5.62
15-year fixed mortgage rate				
	6.26	6.23	6.22	5.20
1-year adjustable rate				
	5.68	5.61	5.67	4.26
STOCK MARKET				
Dow Jones Industrials	11247.87	11278.61	11577.74	10460.97
S&P 500	1288.22	1280.16	1325.76	1196.02
NASDAQ	2219.41	2210.37	2432.67	2071.43
Commodities				
Gold (\$) - 100 OZ	642.60	652.60	683.70	424.90
Oil (\$ per barrel) - Crude Futures (NYMerc)	72.33	71.38	70.19	55.03
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturers Index (May) - Index	54.4	57.3	55.2	55.7
Consumer Confidence (May) - Index	103.2	109.8	107.5	105.6
Nonfarm Payrolls (May) - change in 000s	75	126	175	146
Unemployment Rate (May) - Percent	4.6	4.7	4.7	4.7
Average Hourly Earnings (May) - % change	0.1	0.6	0.2	0.3

If the financial markets have a propensity to climb a wall of worry, they clearly faced a steep incline this week. First, the Federal Reserve released the minutes of its May 10 policy meeting, which revealed a much more hawkish sentiment than portrayed by the summary post-meeting policy statement. Although the policy makers decided to hike the federal funds rate by another quarter-point at the meeting -- the sixteenth consecutive increase -- the decision was not made without some internal discussion about a possible half-point increase. True, some members wanted no change at all, but the fact that a half-point increase was even considered marked the first time since the tightening campaign got underway two years ago that anything more than a quarter-point hike was contemplated.

The Fed's unexpected hawkish sentiment mirrored its greater concern over inflation, which received more attention at the May 10 policy-setting confab than in previous meetings. And, not surprisingly, the markets sold off on the news, believing that the Fed was now more inclined to hike rates further, if not at the next meeting in June, then in subsequent months. The release of the minutes came on the last day of May, and put a punctuation mark on an array of concerns that hammered stock

prices over the final two weeks of the month. In addition to heightened inflation concerns and ever-increasing anxiety over sky-high gasoline prices, geopolitical factors also weighed heavily on investor psychology, particularly mounting tensions over Iran's nuclear ambitions. Whenever uncertainty gains traction in the financial markets, investors tend to flee to safe assets, such as Treasury and agency securities.

Their response to the uncertain environment last month was no exception. Although equity investors started the month in a bullish mode, they turned sour as the period progressed and became downright bearish towards risky assets in general over the final two weeks. As the chart shows, equities turned in sharply negative returns last month, with other riskier assets, such as lower-rated corporate bonds, also losing value. Conversely, Treasury and agency debt provided investors with positive returns, with the shortest maturities sporting the biggest gains. As always, however, the markets can deviate from course over a short-term period, and the monthly snapshot of relative asset returns does not necessarily provide an accurate view of the bigger picture. Over the first five months of the year, for example, riskier assets have provided investors with much fatter returns than have Treasury and agency securities. Indeed, junk bonds and equities have been stellar performers throughout most of the year, returning more than 3 percent through the end of May compared to negative returns on most fixed-income assets. The exception to the latter, of course, are Treasury bills, which provided investors with a positive return thanks to the increase in money market yields associated with the Fed's rate-hiking campaign.



While the reversal of fortune for equities last month may be just a temporary interruption of previous trends, there is little question that uncertainty and volatility go hand in hand, and the financial markets are facing more uncertainty now than they have at just about any time over the past three years. Leaving aside the growing geopolitical tensions, the domestic economy itself contains enough crosscurrents to make any expert waver. The heightened inflation concerns expressed by the policy makers at the May 10 meeting reflected both hard and anecdotal evidence, including rising labor costs associated with a tightening job market, a weakening dollar and the growing pressure on companies to pass on rising energy costs to consumers. Inflationary expectations, always a focus of attention of the Fed, have also crept higher, something that shows up in recent consumer surveys as well as in a popular bond market measure -- the spread between market yields and inflation-adjusted rates in the TIPS market.

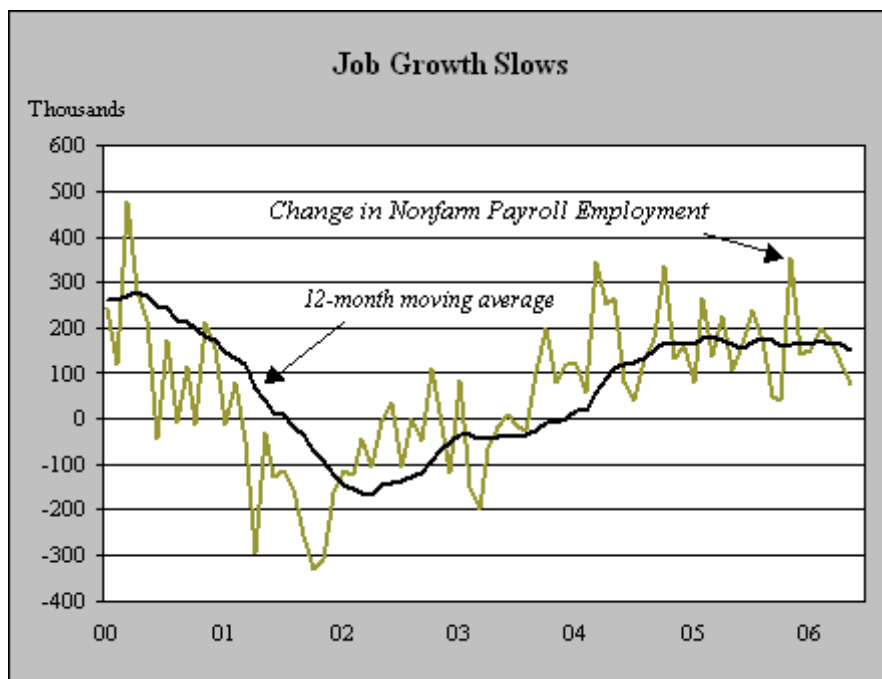
But what seemed so evident three weeks ago, appeared less obvious in the first two days of June -- providing the markets with another opportunity to abruptly shift gears. In particular, new data show that not only is the inflation threat greatly

overrated, but the economy may be in the midst of a sharper slowdown than the Fed would like to see. The new information, in turn, provides a more compelling case for the policy makers to ease up on the tightening brakes, making a rate hike at the June 28-29 meeting less likely. Since perceptions drive the market, the response to this turn of events has been quick and decisive. At the end of trading on Friday, the 10-year Treasury bond yield had slipped below 5 percent, down almost a quarter of a percent from its recent high reached in mid-May. Equity prices, however, turned in a mixed performance, surging on reduced expectations of another rate hike in late June but then slipping on Friday in response to weaker economic data than expected. While stock investors are cheered by the prospect of a rate pause, they are just as likely to be chagrined by a severe economic slowdown that would crimp profit prospects.

The first indication that inflation concerns may be overblown came earlier in the week, when the Commerce Department released revised productivity figures for the first quarter. As expected, productivity growth was adjusted upward, reflecting the upward revision in GDP for the period released last week. But the estimate for labor compensation was also revised down. That, together with the stronger productivity gain, translated into a marked reduction in unit labor costs. Since a major source of inflation concern at the Fed -- and in the bond market -- is related to rising worker pay, the more benign reading on first-quarter productivity and unit labor costs took some of the steam out of the recent increase in inflationary expectations.

What's more, the latest jobs report, released Friday morning, was particularly jolting to the inflation hawks who have persistently claimed that the ever-increasing fraction of resource utilization is a sure-fire prelude to escalating inflation pressures. No doubt, many of them will retain this conviction since Friday's jobs report revealed another downtick in the unemployment rate to a near five-year low of 4.6 percent in May. But this number is derived from a smaller sample of households that most economists believe is a less credible reflection of job conditions than the payroll count derived from a larger sample of business establishments. What the so-called establishment survey reveals is that the economy generated a much smaller increase in jobs last month than expected. Indeed, the shortfall was more than just a statistical quirk, as the monthly increase in payrolls was less than half of the consensus forecast on Wall Street.

Specifically, economists were looking for nonfarm companies to add about 180 thousand workers to their payrolls in May, modestly higher than the weak showing in April, but not strong enough to intensify wage pressures. However, instead of a number that is neither too hot nor too cold, the Labor Department revealed that the economy generated a tepid 75 thousand increase in jobs last month, the smallest monthly increase since last fall, when the job market was battered by Hurricanes Katrina and Rita. What's more, the original payroll gains estimated for the previous two months were revised down, from 138 thousand to 126 thousand in April and from 200 thousand to 175 thousand in March.

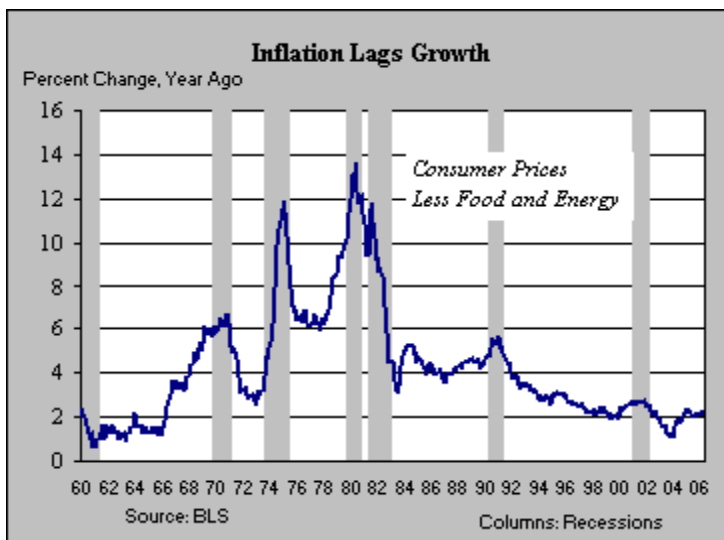


Simply put, it appears that the tightening up of the labor market is evaporating rapidly -- perhaps too rapidly. Over the past year, job growth has averaged only 158 thousand a month, which is far from a sizzling pace, and just barely consistent with the growth in the labor force. But over the past three months, the average increase has dipped to 125 thousand, which if sustained should lead to an increase in the unemployment rate. Most discouraging is that the weak job market in May

permeated just about all major sectors, paced by cutbacks in construction, manufacturing and retail establishments. Not surprisingly, worker paychecks saw much slimmer gains during the month, as average hourly earnings edged up by a meager 0.1 percent.

Needless to say, to a Fed that has explicitly stated future policy decisions will be data-dependent, these latest job figures weigh in on the side of a pause at its next meeting. To be sure, there are still a number of important reports to ponder before the June 28-29 meeting. Even if the Fed does move to the sidelines then it does not necessary mean that the rate-hiking cycle has come to an end. A resumption of stronger growth and a pickup in hiring over the second half of the year could well inflame inflation concerns again and cause the central bank to continue stepping on the monetary brakes. However, the Fed is mindful of the risks of responding too aggressively to incoming data, which complicates the task of predicting policy moves.

The biggest risk is that the Fed misjudges a prospective pickup in the inflation readings over the next month or two and decides to hike rates despite evidence of a slowing economy. Historically, inflation is a notoriously lagging indicator of growth, peaking after a slowdown gets underway. As the chart shows, core inflation has peaked out after the onset of every recession in the past forty-five years. This history suggests that the recent -- and prospective -- pickup in some inflation measures should not by themselves be overly alarming. Indeed, if the Fed responds too aggressively to current price movements, it could well aggravate a cyclical slowdown and drive the economy into a recession.



Clearly, the new Fed chairman, Ben Bernanke, like his predecessor Alan Greenspan, has great respect for historical relationships and is not likely to act irresponsibly to incoming data. In fact, Bernanke has already noted the probability that the economy will experience a "transitory" increase in inflation, reflecting the pass-through of higher energy costs and the economy's robust growth in the recent past that is now fading. As we noted last week, our sense is that the Fed will not hike rates at its June 28-29 meeting, but issue a statement that reaffirms its inflation-fighting commitment. This week's jobs report makes that prospect more likely, in our view.