

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 9, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	June 9	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.87%	4.80%	4.82%	3.00%
6-month Treasury bill	5.06	5.00	4.99	3.13
2-year Treasury note	5.00	4.91	5.00	3.69
5-year Treasury note	4.93	4.90	5.07	3.84
10-year Treasury note	4.97	4.99	5.19	4.05
30-year Treasury bond	5.02	5.10	5.30	4.32
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.75	3.76	3.81	3.10
10-Year	4.14	4.16	4.24	3.66
30-Year	4.54	4.57	4.60	4.39
30-year fixed mortgage rate				
	6.62	6.67	6.58	5.56
15-year fixed mortgage rate				
	6.23	6.26	6.17	5.14
1-year adjustable rate				
	5.63	5.68	5.62	4.21
STOCK MARKET				
Dow Jones Industrials	10891.92	11247.87	11380.99	10512.63
S&P 500	1252.30	1288.22	1291.24	1198.11
NASDAQ	2135.06	2219.41	2243.78	2063.05
Commodities				
Gold (\$) - 100 OZ	605.50	642.60	716.50	429.00
Oil (\$ per barrel) - Crude Futures (NYMerc)	71.63	72.33	72.04	53.54
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (April) - mlns of \$\$s	10613.0	1409.0	3718.0	4513.0
Trade Deficit (April) - blns of \$\$s	63.4	61.9	62.7	63.7

Since it's only the first week of the month, it is still too early to proclaim that the stock market is entering a "June swoon", a designation aptly earned in years past. Still, the ugly dive in equity prices during the past week -- the steepest one-week drop in more than a year and extending a dismal performance in May -- is unsettling to say the least. Even more disturbing is that the market's churning behavior does not seem to reflect any abrupt change in underlying economic fundamentals. It may be trite, but it's still true that the \$12 trillion juggernaut which is the U.S. economy simply does not shift gears on the dime. What does fluctuate precipitously, however, are perceptions, and there is little question that investor apprehension has replaced optimism as the driving force behind portfolio decisions.

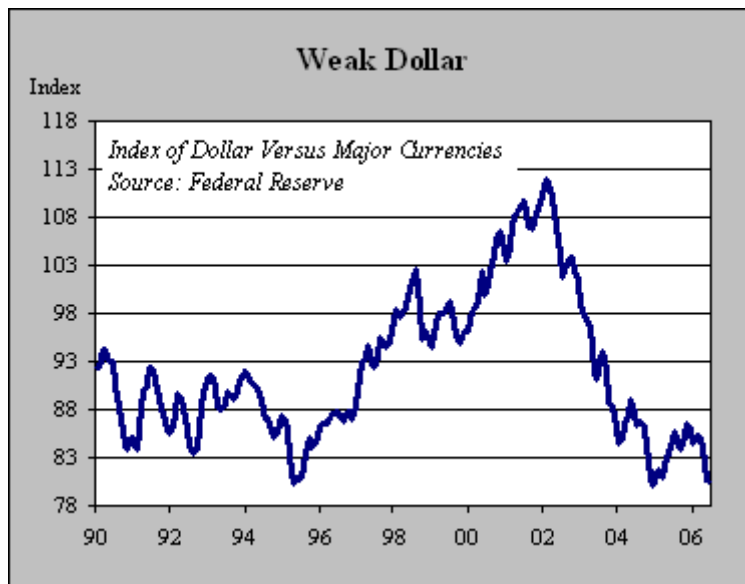
Interestingly, it was not a major geopolitical event that served as the catalyst for the recent turmoil, even though one did occur. Indeed, news of the death of Abu Musab al-Zarqawi, the al-Qaida leader in Iraq, hardly caused a ripple, perhaps because of the ambivalent sentiment it invoked among investors. While the elimination of a major source of insurgency in that country -- causing the loss of many lives, both among American troops and Iraqi civilians -- should be viewed as a positive development, it may also spur a backlash of retaliatory violence that would further inflame geopolitical tensions. Only time will tell how the event plays out. More to the point is that the source of the markets' recent turbulence appears to be totally homegrown. Specifically, what stirred the pot the most this week were comments, which almost seemed orchestrated, by a litany of Federal Reserve officials that strongly suggested another rate hike was in the cards at the June 29-

29 policy meeting.

Fed chairman, Ben Bernanke, led the parade on Monday with his comments at an International Monetary Conference in Washington, DC. The main takeaway from his remarks is that the Fed is not "comfortable" with the current pace of inflation, which is above acceptable levels and requires a vigilant stance to keep it under control. His position was reiterated throughout the week by a bevy of other central bank officials, including the nominee for Vice Chairman, Don Kohn, at his confirmation hearings on Thursday. The hawkish tone sounded by the Fed had an immediate impact on market perceptions. Thanks to weaker incoming economic data, including last week's employment report, investors had increasingly thought that the Fed would stand pat at its next meeting later this month. Now, however, the markets' are pricing in much higher odds of another rate hike, sending investors scurrying for recession-proof havens, something that drove Treasury bond yields below the 5 percent barrier again.

Indeed, for the first time since March the 10-year Treasury yield fell below the 2-year yield, restoring the infamous negative yield curve that many believe portends a sharp slowdown in economic growth. While the flattening of the curve has been the subject of discussion and debate for more than a year, there is more of a conviction this time that the inversion augurs slower growth. For one, the Fed itself acknowledges that the economy is going through a "transition" phase from rapid to slower growth, largely due to the drags imposed by higher energy prices and a weakening housing market. For another, the debate last year was complicated by the global liquidity argument, which simply states that long-term rates are being held down by a surplus of foreign savings being funneled into the U.S. bond market. Largely reflecting those inflows, the U.S. dollar, which had been sliding for two years, reversed course and moved solidly higher last year.

But the global liquidity argument became somewhat less compelling this year for a number of reasons. Not only is economic growth overseas picking up, the resurgence is being fueled by domestic demand, which is sopping up excess savings. Additionally, the yield advantage of investing in the U.S. is narrowing, as the strengthening economies have prompted foreign central banks to flex their inflation-fighting muscles. This week alone, the European Central Bank hiked the benchmark short-term rate by a quarter-point, and another increase is widely expected in July. Meanwhile, central banks in India, Korea, Turkey, Denmark and South Africa all lifted rates this week. Hence, after last year's rebound, the dollar's slide resumed this year, falling persistently against all major currencies. While the slide was interrupted this week by the al-Zarqawi slaying, which spurred a typical safe-haven flight to the greenback, the macro global theme echoed by the actions of foreign central banks remains firmly intact.



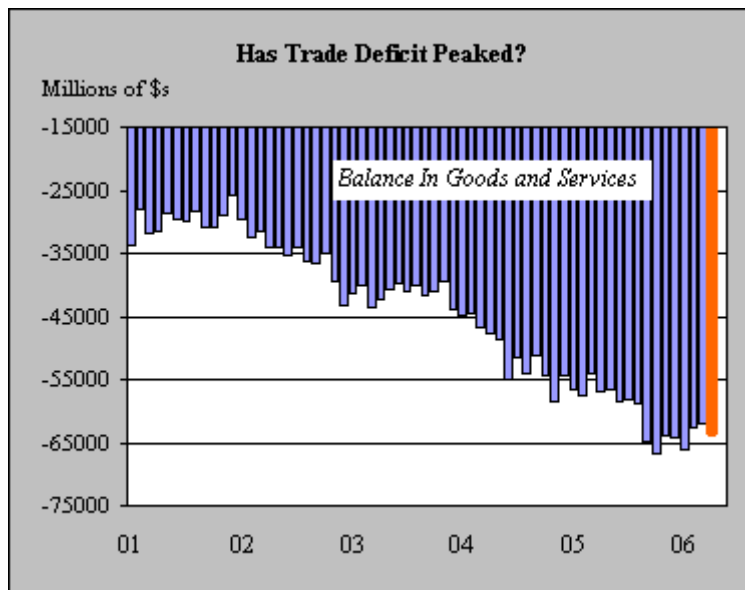
Interestingly, the renewed weakness of the dollar, should it continue, will only complicate the Fed's policy decisions, as it reinforces other influences that are heightening inflation concerns. A weak dollar, of course, makes foreign goods more expensive, even as higher import prices give domestic manufacturers cover to lift their prices. No doubt, the Fed's hawkish statements this week helped -- whether deliberately or not -- to stabilize the dollar. What will be interesting to see is what kind of a "dollar policy" the incoming Treasury Secretary, Henry Paulson, will espouse. U.S. policy on the dollar, of course falls within the domain of the Treasury Department, not the Fed, although the Treasury utilizes the Fed to act as its agent in the event that the Treasury Secretary deems foreign exchange intervention to be necessary.

The U.S. adopted a strong dollar policy during the Clinton administration under Secretaries Rubin and Summers. Whether or not this policy is still in force is a matter of debate at least in part because the concept is nebulous and subject to interpretation. Recall that former Treasury Secretary O'Neill got himself into hot water when he observed that the administration was not "pursuing...a policy of a strong dollar. In my opinion, a strong dollar is the result of a strong economy." He later clarified his position by indicating that he supported a strong dollar and that there "was no change in policy" from the Rubin-Summers era. The current outgoing Treasury Secretary Snow defined his concept of a "strong dollar policy" as being a situation where investors have "confidence in your currency, you want them to see a currency as a good medium of exchange." Secretary Snow was correct in the sense that the dollar will be strong if there is investor confidence in the U.S., but confidence is a consequence of a variety of factors, including policy initiatives.

In reality, the U.S. has no choice but to wish, hope and pray for a strong dollar as the combination of current account and budget deficits could cause significant financial market and economic distress. The post-Rubin/Summers "policy" on the dollar has effectively been shaped by just such wishful thinking for a "strong dollar" as opposed to a coherent policy initiative. But neither O'Neill nor Snow could explain how the U.S. can purport to have a strong dollar policy when the U.S. continues to generate massive current account and budget deficits. Both Secretaries suffered in part because of an inability to credibly and convincingly enunciate a US policy on the dollar without the necessary policy initiatives that would support their case. Now the chore falls on the incoming Treasury Secretary Paulson. Mr. Paulson has the necessary experience, credentials and credibility for the task, but he will have to overcome the same obstacles posed by the persistently large twin deficits.

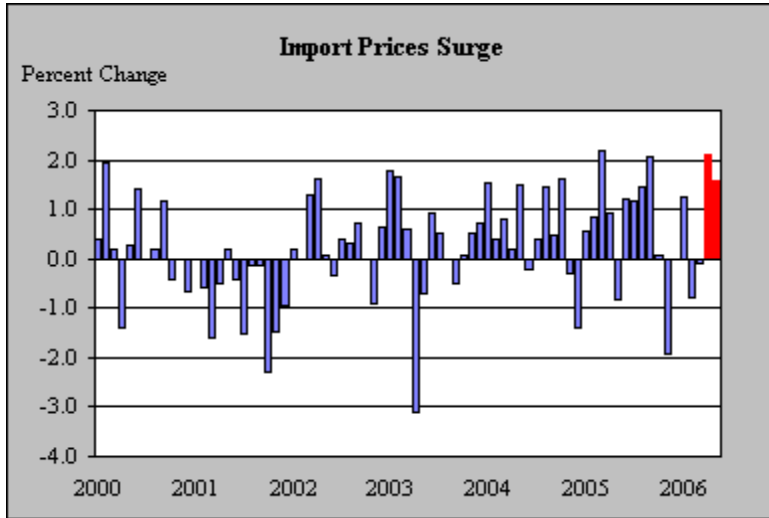
Fortunately, there are some signs that the global economic dynamic may ease the burden somewhat, particularly on the trade front. With global growth accelerating and the dollar weakening this year, exports have been growing at a double-digit rate and foreign demand for U.S. goods should remain strong over the balance of the year. Meanwhile, should the U.S. economy continue to "transition" to slower growth, the demand for foreign goods is likely to recede from the red-hot pace of recent years, reducing the growth in imports. That's a combination that will slow the growth in the trade deficit and, in time, actually bring about some shrinkage. We say it will take some time because exports would have to grow about 50 percent faster than imports to bring this about, given that the level of imports is currently 55 percent larger than exports.

By all accounts, that achievement is a ways off, but some progress is being made. According to Friday's trade report, the deficit for April came in about \$1.5 billion less than expected, although it did widen to \$63.4 billion from \$61.9 billion in March. Still, the shortfall over the past three months is significantly below the deficit of the previous five months, and well under the \$66.2 billion record high reached in January. Whether the January deficit represents the peak for the cycle remains to be seen, as volatile oil imports could once again surge if crude prices spike higher in coming months. Nonetheless, even if the deficit continues to increase this year, it is unlikely to even remotely climb as fast as last year's 17.2 percent jump. Any moderation in the deficit growth would be a welcome development for the dollar, and a more stable dollar would reduce import price inflation, making the Fed's inflation-fighting task less daunting.



Unfortunately, the progress on the trade front has so far not translated into a slowing of import prices. In a separate report, the Labor Department reported on Friday that the import price index surged by 1.6 percent in May, following a 2.1 percent jump

in April. That marked the strongest two-month increase since October 1990, squarely in the midst of the 1990-1991 recession. True, higher oil prices dominated the climb, surging 5.2 percent in May and an eye-opening 11.5 percent in April. But the weakening dollar filtered through to the prices of other imported goods. Indeed, excluding oil prices, the import price index still jumped by a worrisome 0.6 percent, much larger than expected and the steepest increase in seven months.



Simply put, the market spotlight shone intensely on inflation matters this week, adding sting to the hawkish comments made by Federal Reserve officials. While these comments clearly increase the odds that another rate hike will take place at the June 28-29 meeting, it is still not cast in stone. There are some key economic numbers due out before that meeting, including the widely-followed CPI measure in the coming week as well as retail sales, which will give a better sense of how well consumer spending is holding up. It may well be, as one noted journalist postulated this week, that Bernanke's hawkish comments were a carefully calculated message to lessen inflationary expectations. By playing a hawkish role, Bernanke hopes that words will make action unnecessary so he can orchestrate a soft landing for the economy without crashing into a recession. It won't be the first time that a Fed chief tried to "jawbone" the markets into thinking a certain way in order to achieve its objectives.