

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 16, 2006

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	June 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.86%	4.87%	4.81%	2.97%
6-month Treasury bill	5.18	5.06	4.99	3.21
2-year Treasury note	5.16	5.00	4.96	3.70
5-year Treasury note	5.10	4.93	4.96	3.86
10-year Treasury note	5.13	4.97	5.06	4.07
30-year Treasury bond	5.17	5.02	5.14	4.36
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.77	3.75	3.82	3.14
10-Year	4.13	4.14	4.25	3.71
30-Year	4.54	4.54	4.63	4.41
30-year fixed mortgage rate				
	6.63	6.62	6.60	5.63
15-year fixed mortgage rate				
	6.25	6.23	6.20	5.22
1-year adjustable rate				
	5.66	5.63	5.62	4.25
STOCK MARKET				
Dow Jones Industrials	11014.55	10891.92	11144.06	10623.07
S&P 500	1251.54	1252.30	1267.03	1216.96
NASDAQ	2129.95	2135.06	2193.88	2090.11
Commodities				
Gold (\$) - 100 OZ	583.80	605.50	659.60	439.60
Oil (\$ per barrel) - Crude Futures (NYMerc)	69.83	71.63	68.53	58.47
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 (May) - % change	0.1	0.8	0.7	0.7
Consumer Price Index (May) - % change	0.4	0.6	0.4	0.3
Core CPI (May) - % change	0.3	0.3	0.3	0.2
Producer Price Index (May) - % change	0.2	0.9	0.5	0.2
Industrial Production (May) - % change	0.1	0.8	0.5	0.4
Capacity Utilization (May) - Percent	81.7	81.9	81.4	81.3
Business Inventories (April) - % change	0.4	0.7	0.1	0.5

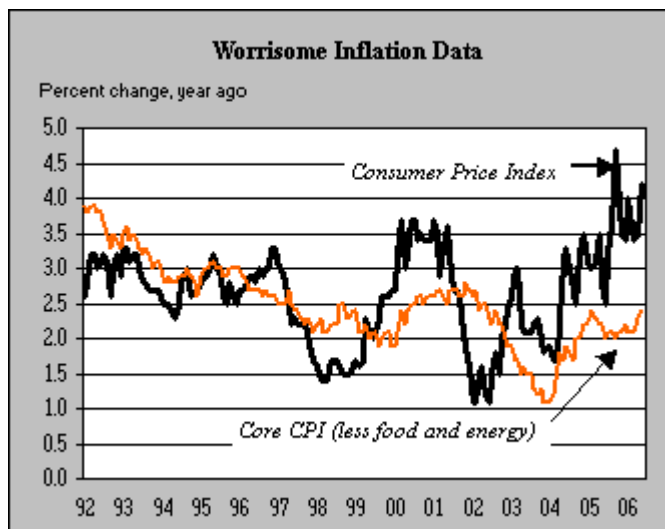
Is the inflation genie out of the bottle? That's the question financial markets and Federal Reserve policymakers are grappling with, as recent data indicate that price pressures are building. No doubt, heightened inflation fears have played a major role sparking the gut-wrenching drop in equity prices over the past month. Only the substantial mid-week rally kept the market "correction" from reaching double-digit territory for the Dow Industrials and S & P 500 indices. The tech-laden Nasdaq composite was not so lucky, dropping nearly 12 percent before the mid-week rebound. Presumably, tech players are not as faint-hearted as stodgy blue-chip investors and, hence, were more psychologically equipped to handle the slide. We suspect, however, that even they were shaken up by the market's turmoil in recent weeks.

More to the point is that volatility is likely to continue buffeting the market in the period ahead. That's because the inflation controversy is only starting to gain traction. Recall that the markets were prepared for some inflation pickup, as Federal

Reserve officials had repeatedly warned that some transitory increase was likely, reflecting past strength in the economy, years of excessive monetary stimulus and some pass-through of escalating energy costs to the prices of other goods and services. But the inflation bump was not considered to be overly worrisome, since it would soon recede with the expected slowing in economic growth. As long as inflation expectations remained "anchored", the Fed hinted that it would not necessarily tighten policy further, noting correctly that the prospective slowdown would contain inflation pressures.

But recently, the Fed appears to have changed its tune, as policymakers have been issuing hawkish comments almost relentlessly. Not surprisingly, the markets have become more sensitive to inflation data, sensing that the Fed is now more responsive to current trends than to the prospective impact of a slowing economy. Fed chairman Bernanke, whether deliberately or not, deflated some of the market's heightened inflation concerns with his mildly encouraging remarks on Wednesday, noting that inflation expectations appear to have subsided over the past month. His comments helped spark the huge stock-market rally on Wednesday and Thursday, but did not eradicate the newfound conviction among investors that the Fed is now almost certainly prepared to hike rates again on June 29 -- and perhaps again on August 8.

With the ugly CPI data released during the week, this conviction received even more support. What got the most attention was not the above-trend 0.4 percent increase in the overall index, which was in line with expectations and lifted the annual inflation rate to an unseemly 4.2 percent in May from 3.5 percent the previous month. The headline number, as everyone knows by now, is being unduly influenced by spiraling energy costs, which rose by 2.4 percent (not annualized) during the month. What the markets are focusing on is to what extent higher energy costs are being passed through into other prices. The bigger the pass-through, the greater the perception that inflationary pressures are gaining traction in the broader economy.



The barometer that the markets follow to gauge the pass-through effect is the so-called core CPI, which excludes energy and food prices. In both March and April, the core increased by 0.3 percent, which is widely considered to be above the Fed's comfort zone and appears to have been the catalyst for much of the recent hawkish comments by Fed officials. The hope was that the May increase would come in at 0.2 percent, or better still, 0.1 percent, thus giving some hope that inflation was subsiding and undermining the case for another rate hike. Unfortunately, that was not to be. During the month, the core CPI spiked up by another 0.3 percent, marking the first time in more than eleven years that this measure has increased by more than 0.2 percent for three consecutive months. More than anything, this cemented the conviction that the Fed had no choice but to pull the rate-hiking trigger again on June 29.

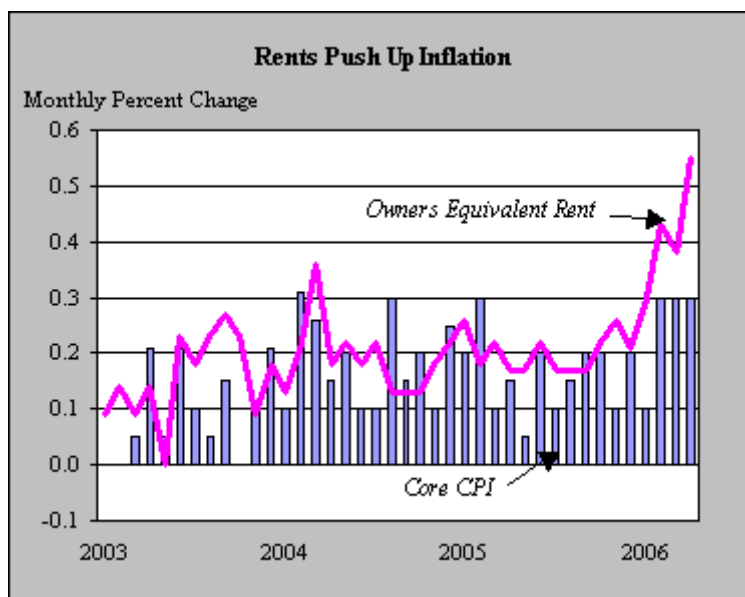
We concur that the Fed will move again, if only to retain credibility in its inflation fight. Keep in mind that chairman Bernanke has only been on the job for a little over four months, and there's still a contingent that suspects he is "soft" on inflation. That perception stems from his "helicopter" speech delivered several years ago in which he famously noted that the Fed can always throw dollars from the sky to prevent an outbreak of deflation, which was considered a threat in 2003. We doubt that the perception has any validity, given Bernanke's stated preference for inflation targeting as a policy strategy and the fact that he has already spearheaded two rate increases since assuming the reins from Alan Greenspan on February 1. Nonetheless, perceptions move markets, and any sign that the Fed is falling behind the inflation curve would probably have negative consequences, particularly in the bond market.

That said, it is important to note that the rise in the core price measure does not reflect an acceleration in inflation among a

broad array of non-energy goods and services. Instead, the recent increase has been heavily influenced by a surge in the cost of housing, most notably the component known as the "owners equivalent rent". The OER, which accounts for about 30 percent of the core CPI, has been used since 1983 to measure housing costs. This measure does not include the actual out-of-pocket costs of owning a home, such as mortgage payments, real estate taxes and maintenance costs; these were included prior to 1983 but were dropped by the government statisticians because it was felt that wide swings in mortgage rates (as well as rapidly-climbing home prices) distorted the underlying inflation rate. What the OER does is measure what homeowners would receive in rent if they rented out their home instead of living in it.

For the most part, the OER measure has been less volatile than the previous "cash-flow" basis for measuring housing costs. Yet, it does have a number of limitations, statistical and otherwise, that can create a highly misleading picture of actual housing costs and can distort the inflation measures. For one, because of a quirk in the way utility costs are accounted for, a drop in natural gas and electricity prices results in a faster increase in OER. For another, the accuracy of estimating what an owner can receive in rent is questionable. The problem here is simply related to sampling errors, i.e., finding rental units in the same neighborhoods as the owner-occupied units, and finding units with similar attributes, such as number of bedrooms, baths, view, etc. Finally, and perhaps most significantly, is that rents seem to bear a perverse correlation with actual conditions in the housing market. For example, when home prices and mortgage rates climb rapidly, homeownership becomes unaffordable for a larger fraction of the population, which increases the demand for rental units. Hence, even as home sales weaken, and prices level off, the increased demand for apartments pushes up rents.

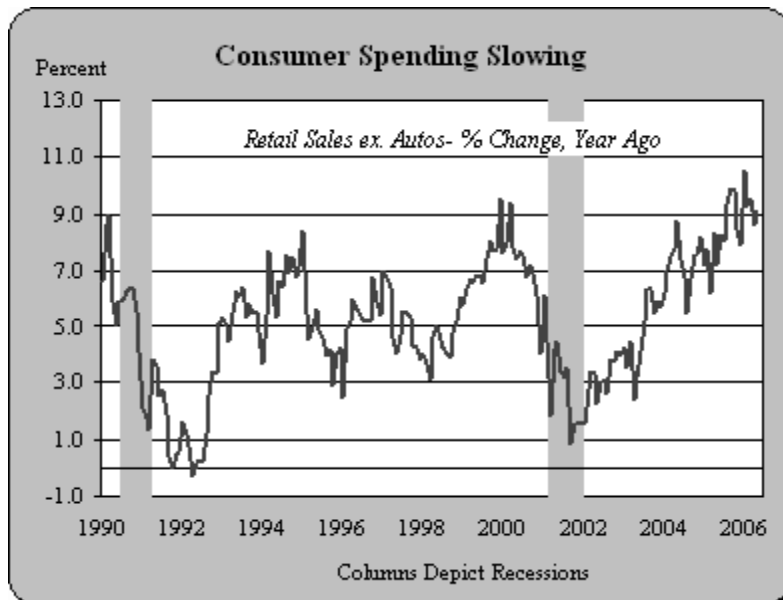
That perverse relationship has been accentuated by the sluggish pace of apartment construction in recent years and by the ever-increasing trend of apartment conversions into condominiums, particularly in such key markets as New York. As a result, the home ownership component of the core CPI has recently started to climb rapidly. In May, the OER jumped by 0.6, the steepest increase since August 1990. What's more, in the aforementioned tight New York City real-estate market, the rental component surged by 1 percent, following an eye-popping 1.3 percent in April. Just how much of an influence has this had on the overall inflation measure? If the OER is excluded, the core CPI would have increased by only 0.1 percent in May, not 0.3 percent. Over the past year, this stripped-down version of the consumer price index has increased by 1.9 percent. Except for the deflationary scare in 2003, this measure has been hovering around 2 percent since 1997, so there is no problem here. Simply put, the real question is whether the Fed should base its policy decisions on the movements of the core CPI, which is being skewed by soaring rents in New York City.



To be sure, the Fed is well aware of the statistical distortions and other measurement problems inherent in the consumer price index. But as we noted earlier, perceptions and credibility are the key notions to consider at this juncture. The markets are fully priced for another rate hike on June 29, and the Fed is likely to respond to market expectations, lest it lose the credibility that it is committed to keeping inflation in check. Of course, nothing is cast in stone yet. There are two weeks of housing statistics yet to be released before the late-June meeting. If the housing data show much more weakness than expected, the Fed may decide to reconsider its move, given that housing wealth is such a key component of household net worth.

But barring signs of a housing collapse, there is no reason to believe that the economy is heading for anything more than a soft landing, which is just what the Fed would like to see. In May, retail sales edged up by only 0.1 percent, but that comes on

the heels of an upwardly revised increase of 0.8 percent in April (originally estimated at 0.5 percent). As expected, the biggest drag came from a slump in auto dealer sales, which fell by 1.6 percent during the month. Excluding autos, retailers saw their revenues increase by a healthier 0.5 percent. However, that increase overstates consumer spending, as virtually all of it was due to rising gasoline sales, reflecting higher prices at the pump. Excluding gasoline, retail sales fell 0.1 percent last month, after rising 0.3 percent in April. Clearly, the trend over the past two months represents a slower pace of spending compared to the first quarter, when real consumer outlays increased by a sturdy 5.2 percent. It appears that the first quarter jump not only reflected a rebound from the hurricane-depressed levels of the fourth quarter, but also borrowed strength from the spring quarter as well. Recall that sales earlier in the year were buoyed by exceptionally warm weather.



We suspect that real consumer spending will increase at about half the first-quarter pace, thus cutting the growth in GDP from 5.3 percent to a tad under 3 percent in the current quarter. Considering the high cost of energy, a cooling housing market and several more rate hikes by the Fed, that's not a bad performance. What remains to be seen is whether slower growth will also bring down inflation expectations and provide the Fed with the necessary cover to move to the sidelines after the June 28/29 policy-setting meeting. If the Fed is to avoid inducing the next recession, it needs to halt the tightening process before a deceleration in the economy and inflation become too obvious. That is the lesson from history, and it is critically important that the policymakers leverage their considerable understanding of the lags between monetary policy, the economy and inflation to get the timing right.