WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 23, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	June 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.95%	4.86%	4.82%	3.08%
6-month Treasury bill	5.26	5.18	5.00	3.26
2-year Treasury note	5.26	5.16	4.94	3.58
5-year Treasury note	5.20	5.10	4.94	3.70
10-year Treasury note	5.22	5.13	5.05	3.92
30-year Treasury bond	5.25	5.17	5.16	4.22
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.91	3.77	3.79	3.10
10-Year	4.19	4.13	4.17	3.68
30-Year	4.55	4.54	4.58	4.38
30-year fixed mortgage rate	6.71	6.63	6.62	5.57
15-year fixed mortgage rate	6.36	6.25	6.23	5.16
1-year adjustable rate	5.75	5.66	5.61	4.23
STOCK MARKET				
Dow Jones Industrials	10989.09	11014.55	11278.61	10297.84
S&P 500	1244.51	1251.54	1280.16	1191.57
NASDAQ	2121.47	2129.95	2210.37	2053.27
Commodities				
Gold ($)- 100 OZ	586.50	583.80	652.60	441.60
Oil ($ per barrel) - Crude Futures (NYMerc)	70.87	69.83	71.38	59.84

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 (May) - 000s of units	1957.0	1863.0	1972.0	2032.0
Leading Economic Indicators (May) - Index	137.9	138.7	138.9	138.6
Durable Goods Orders (May) - % change	-0.3	-4.7	6.0	-0.3
Nondef. Cap. Gds Orders (May) - % change	1.0	-1.9	3.4	1.0

It was another topsy-turvy week on Wall Street, as stock and bond prices continue to be buffeted by uncertainty over monetary policy -- stoked by conflicting inflation news -- mixed earnings results, and another whiff of fraudulent trading practices by a major hedge fund. There was nothing particularly startling on the economic front that would alter perceptions of the economy's near-term direction, and certainly nothing that would discourage the near certain expectation of another rate hike at the conclusion of the Fed's policy meeting on June 29. Indeed, the futures market is already pricing in higher odds of another rate increase in August, and some pundits are looking for the federal funds rate to rise from the current 5 percent level to 6 percent before the end of the year.

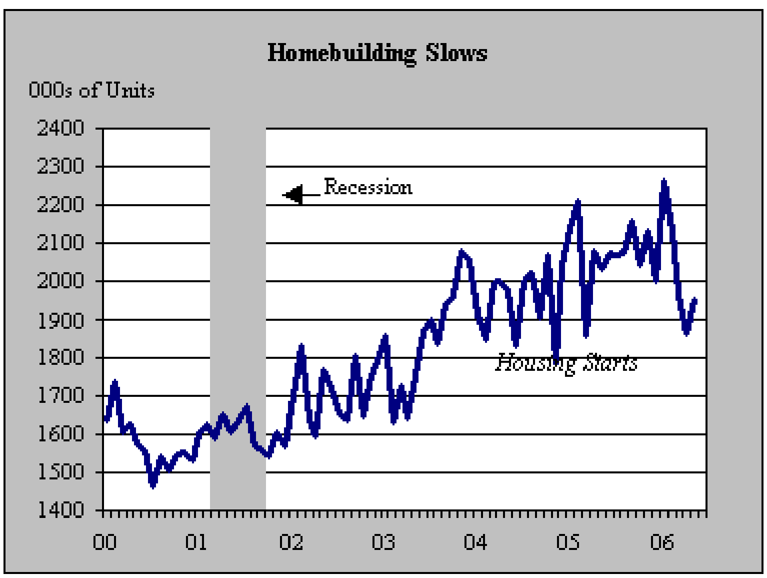
Whether or not the Fed stays on such an aggressive course remains to be seen. But the volatility that has emerged as an unpleasant fact of life for most investors this year seems to be here to stay, at least for a while longer. That's a common feature of the late stage of a business expansion when speculation swirls over whether or not the Fed is poised to overdo the tightening cycle, sending the economy into a recession. As an aside, if the small -- but vocal-- group of forecasters expecting a 6 percent funds rate by the end of the year turns out to be correct, then policy would only be a tad less tight in nominal terms than it was in June 2000, when the funds rate topped out at 6.5 percent. Recall that less than nine months later, the economy had entered a recession, something that clearly is not lost on the cynics who feel that another policy mishap is just around the corner.

We continue to believe that the Fed will probe more cautiously than what is implied by a 6 percent endpoint this year, but recognize that the new Fed chairman has the difficult task of convincing market players that he is not soft on inflation. Since Ben Bernanke has only been on the job for less than five months, he has not yet attained the credibility of his predecessor, Alan Greenspan, who instilled confidence that he could manipulate the policy levers to achieve the right balance between growth and inflation. Of course, even the maestro was fallible, having presided over two recessions and not perceiving that the 2001 downturn was underway until it had already started.

Much as was the case then, the Fed faces the daunting task of curbing inflation expectations, even as the economy transitions to slower growth. What complicates the task is that consumer expectations are shaped by current inflation trends, which are clearly increasing but historically lags the growth cycle. If the monetary brakes are applied too aggressively, the economy could downshift much more abruptly than is necessary to bring down the inflation rate. At most risk, of course, is the rate-sensitive housing sector, where a harsh correction would impose a considerably greater drag on the economy this time than it did five years ago. In the 1990s expansion, it was the stock-market bubble that underpinned growth, and the market collapse in 2000 was a major catalyst behind the ensuing recession. This time it is the real-estate bubble that has underpinned the expansion, and the fear is that a major housing correction could bring on a similar result.

So far, however, that fear is far from materializing. Yes, housing activity is cooling off, which should not be surprising given that mortgage rates are at four-year highs and housing affordability has sunk to eleven-year lows. But the slowdown is progressing in an orderly fashion, with nothing resembling a collapse gaining traction. Home sales are down about 5 - 10 percent from their highs of last year, but those highs reached historical proportions, and the haircut may reflect the removal of "froth" from the market. Sales for both new and existing homes are still comfortably above the solid levels of two-three years ago. Similarly, home prices have come off their peaks but are still above year-earlier levels, so bargain basement shopping in the real estate market remains a hope, not a reality for home-seekers.

Understandably, homebuilder stocks have been hit hard in recent months by the fear of a major real-estate correction. But homebuilders themselves are not exactly putting away their shovels and bulldozers. According to this week's Commerce Department report, groundbreaking for new homes actually increased in May, rising a surprising 5 percent to an annual rate of 1.957 million units. To be sure, that may have been a "dead cat bounce", as it followed a precipitous decline over the previous three months. But those declines, as is the case with sales, started from exceptionally lofty levels that reflected more speculative activity than would be justified by underlying fundamentals. At the current pace, starts are only a shade below the 2.07 million average pace for all of 2005.

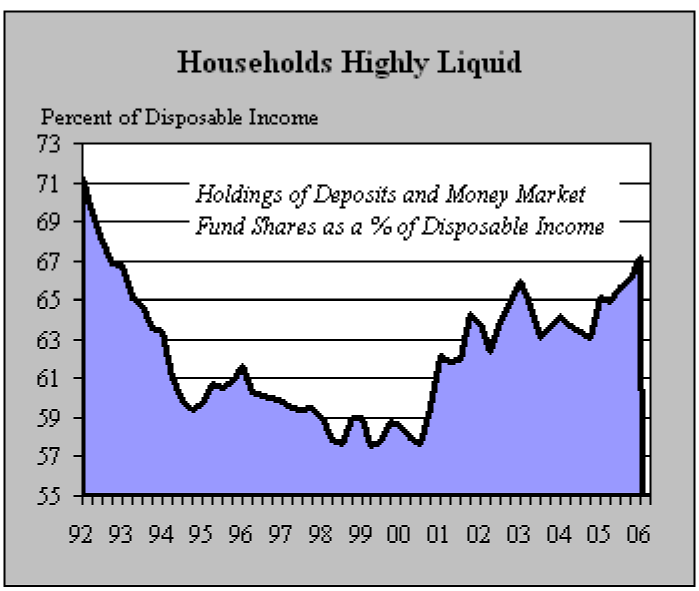


That's not to say that further construction declines aren't in the cards. They most certainly are, at least according to the trend in building permits, which slid another 2.7 percent in May to the lowest level since November 2003. By all accounts, the slowing in housing activity will probably continue throughout the balance of the year and into 2007 as well. But as long as the job market holds up and households can afford to make mortgage payments, it is unlikely that a housing collapse will take place. If the cooling off process continues in an orderly fashion, a major growth-catalyst will be removed from the expansion, facilitating the slowdown in overall economic activity that is already underway. At the same time, a weakening housing market, characterized by a leveling off in home prices nationwide and perhaps sizeable declines in some local markets, will undoubtedly make homeowners fell "poorer" than they did when prices were skyrocketing. But the impact of this negative "wealth effect" on consumer spending will likely be much less than is commonly feared.

It's true that a home is the single most important asset on household balance sheets, and the huge appreciation in home values in recent years has played a major role supporting consumer spending, enabling homeowners to cash-out their newfound equity by taking out second mortgages and home equity loans. But it would be a mistake to assume that households have little in the way of other assets to sustain consumption patterns in the event of a housing correction. Indeed, household net worth jumped by another $1.3 trillion in the first quarter, reaching a new record high of $53.3 trillion. What's more, only $233 million, or less than 20 percent of the gain, came from an increase in housing equity. . Most of the increase in household wealth took the form of increased holdings of stocks, mutual funds and other financial assets. Even when home prices were rising much faster last year, real estate provided a less important boost to net worth than other assets. Over the past twelve months, financial asset holdings of households increased by $3.2 trillion, more than double the $1.5 trillion increase in home equity.

Simply put, household balance sheets have benefited from gains in a broad array of assets, not just housing. Hence, while a weakening housing market would clearly remove a major growth catalyst that has underpinned consumer spending, its potential growth-depressing influence may be overstated. Homeowners still retain a sizable -- and expanding -- cushion of financial assets that can support outlays. What's more, they have hardly made a dent in their housing equity, as home price appreciation has kept pace with the increase in mortgage debt. At the end of the first quarter, for example, homeowners retained a 56.1 percent equity position in their homes, precisely the same as a year earlier.

To be sure, some argue that since financial assets have accounted for most of the gain in net worth in recent years, household balance sheets are increasingly vulnerable to a stock or bond market correction, which could vaporize wealth just a easily as would a severe housing correction. Indeed, the heightened market volatility this year alone could make consumers wary about the sustainability of their recent asset gains, making them less likely to spend as freely as they would under calmer market conditions. However, an overlooked fact is that the Fed-induced increase in short-term interest rates has encouraged households to load up on liquid assets. Since the end of 2004, holdings of deposits and money market funds have increased by more than $600 billion to $6.3 trillion. That's equal to 67 percent of aftertax incomes -- the highest in more than thirteen years -- providing households with a substantial buffer against a market correction.



Still, with household incomes growing at a supbar pace, energy costs taking an ever-larger share of disposable earnings and interest rates rising over the foreseeable future, there is little question that consumers will not be providing as much support to the expansion over the balance of the year. The Fed is well aware of that prospect, and is no doubt factoring it into their policy thinking, despite the hawkish comments being made by an onslaught of monetary officials in recent weeks. But Bernanke and his colleagues are likely to retain the conviction that inflation remains more of a risk than slower growth until -- and unless -- the squeeze on households translates into a more severe spending slowdown than now appears likely.

Indeed, businesses do not seem to be overly deterred by the impending weakness in consumer demand and are shoring up their expansion plans. In May, new orders for nondefense capital goods, excluding volatile aircraft orders, increased by a solid 1 percent, lifting the total a robust 10 percent above year-earlier levels. By all accounts, investment spending should compensate for a good part of the slack left by slowing consumer demand, advancing at a double-digit pace over the next several quarters. If that's the case, the economy should settle into a 3 percent growth rate, which is slightly under its noninflationary growth potential. Over time, that should relieve budding inflationary pressures -- and more importantly, inflationary expectations -- allowing the Fed to probe more cautiously towards an optimum rate level than the skeptics who fear an overshoot expect. It will be interesting to see how strident the policy statement accompanying next week's meeting will be -- and whether a tough-sounding message will be meant to assuage the inflation hawks or to signal continued rate hikes later this year.