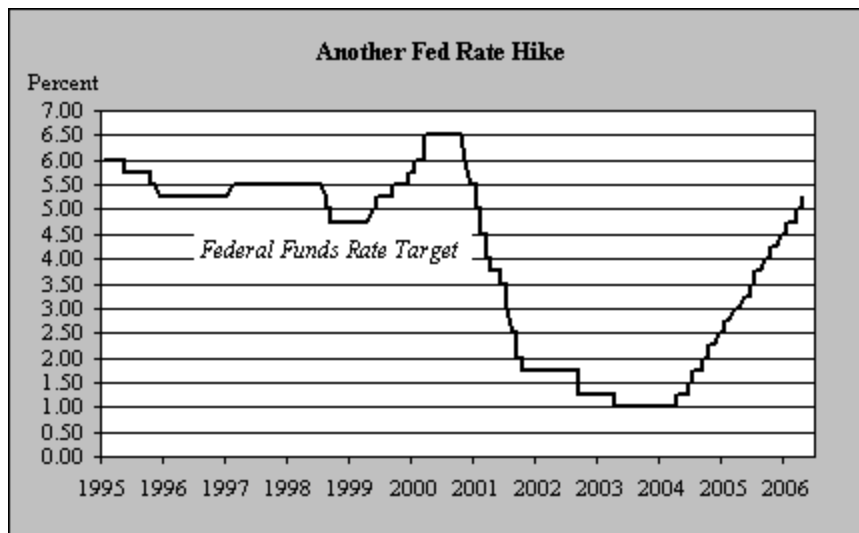


WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 30, 2006

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	June 30	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.98%	4.95%	4.80%	3.16%
6-month Treasury bill	5.23	5.26	5.00	3.36
2-year Treasury note	5.15	5.26	4.91	3.74
5-year Treasury note	5.10	5.20	4.90	3.83
10-year Treasury note	5.14	5.22	4.99	4.04
30-year Treasury bond	5.19	5.25	5.10	4.30
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.99	3.91	3.76	3.10
10-Year	4.28	4.19	4.16	3.71
30-Year	4.65	4.55	4.57	4.39
30-year fixed mortgage rate				
	6.78	6.71	6.67	5.53
15-year fixed mortgage rate				
	6.43	6.36	6.26	5.12
1-year adjustable rate				
	5.82	5.75	5.68	4.24
STOCK MARKET				
Dow Jones Industrials	11150.22	10989.09	11247.87	10303.44
S&P 500	1270.20	1244.51	1288.22	1194.44
NASDAQ	2172.09	2121.47	2219.41	2057.37
Commodities				
Gold (\$) - 100 OZ	618.30	586.50	642.60	429.30
Oil (\$ per barrel) - Crude Futures (NYMerc)	73.95	70.87	72.33	59.00
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 (May) - 000s of units	1234	1180	1114	1166
Existing Home Sales (May) - 000s of units	6670	6750	6900	6757
Consumer Confidence (June) - Index	105.7	104.7	109.6	106.2
Personal Income (June) - % change	0.4	0.7	0.4	0.5
Personal Outlays (June) - % change	0.4	0.7	0.5	0.6

If actions speak louder than words, the message conveyed at the Fed's rate-setting meeting this week came across loud and clear. By hiking short-term rates another quarter-point to 5.25 percent -- the seventeenth consecutive increase during the tightening cycle -- the central bank is saying through its actions that it intends to remain firmly on the inflation-fighting track, despite the clear slowing in economic growth. But as is usually the case, the pen turned out to be mightier than the sword, and it was the statement accompanying the Fed's action that had more of an impact on the financial markets than the act itself.

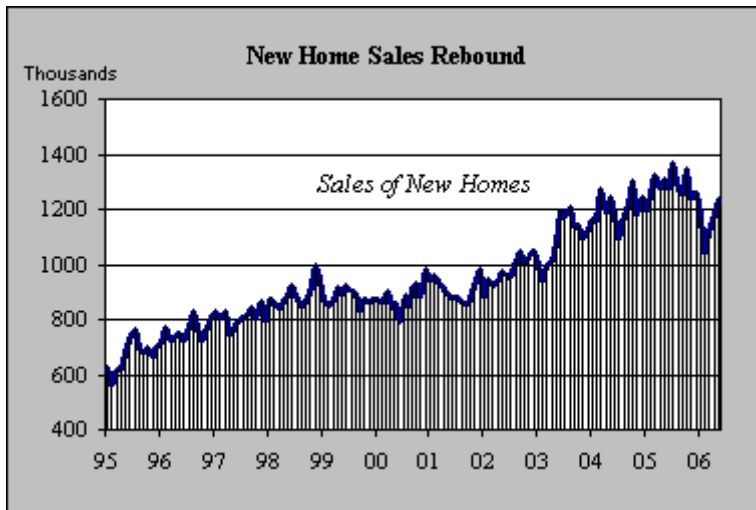


Indeed, virtually everyone expected the Fed to pull the rate-hiking trigger again this week, so the move came as no surprise. What the forward-looking markets want to know is not only what the Fed is doing, but what it intends to do in the future. After all, monetary officials have been rattling their sabers for the better part of the past month, issuing hawkish comments about the necessity of curbing inflation at the expense of growth. These comments, in turn, understandably made investors increasingly nervous that the central bank -- headed by a new chairman eager to establish his inflation-fighting credentials -- would go too far, ultimately choking off the expansion. Hence, the markets' braced for the policy statement accompanying this week's meeting, fearing hawkish language that would suggest more rate hikes were on the way.

Instead, the Fed put on a soothing cap, issuing a nuanced statement that calmed market fears and sent stock prices to their biggest one-day gain in more than three years. To be sure, inflation concerns were clearly evident in the Fed's statement, which noted that "Readings on core inflation have been elevated in recent months" and that "... the high level of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures." But whereas these concerns received top billing in previous policy statements, the Fed this time carved out a more prominent space for the economic slowdown that is now underway. Indeed, immediately after opening with the expected rate-hike announcement, the statement continued with ""Recent indicators suggest that economic growth is moderating from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices." Only then came the inflation warnings.

Clearly, the toned-down language of the statement does not preclude further rate increases. In fact, the Fed left its options open, indicating that another increase should not be ruled out. But importantly, it couched the likelihood of future increases in hypothetical terms, noting that "The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." That's a far cry from what the policy statement said at the previous meeting on May 10, to wit: "The Committee judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information." Our reading is that the statement was softened enough to build a case for a pause in the rate-tightening cycle. Clearly, that notion is being shared in the financial markets, as the futures markets is now pricing in a much lower probability of a rate increase at the next meeting on August 8 than it did in the days before this week's meeting.

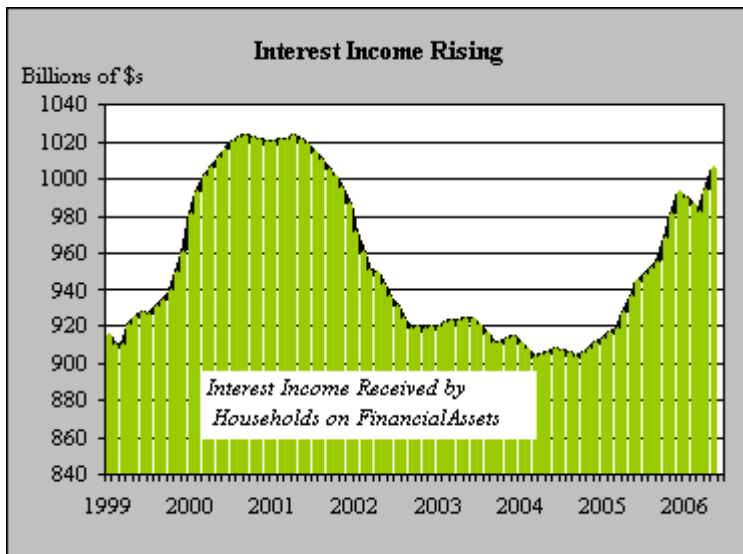
Simply put, the decision at the next meeting will depend heavily on how sharply the economy is slowing and whether another rate increase would bring it precariously close to a tipping point. With the futures market placing the odds at about 50-50 for another hike, investors obviously feel that it's a close call and will be closely monitoring incoming data as rigorously as will the Fed. As we noted last week, the housing market in particular will be receiving a lot of scrutiny, given its outsized impact on the economy in recent years. And, as the data on starts indicated last week, the latest statistics on home sales and prices are portraying somewhat of a mixed picture for this key sector. Sales of new homes unexpectedly rose again in May, marking the third consecutive increase following sharp declines in January and February. In contrast, sales in the larger existing-home market slipped during the month, although the decline was much milder than expected.



What the housing picture continues to portray is an orderly weakening in the real estate market. Fears of a dramatic bursting of a bubble that would vaporize wealth for millions of homeowners and completely deflate an important contributor to economic growth simply are not being borne out. That said, it's important not to be too encouraged by the apparent resilience shown by some of the housing data. If there is one overriding trend that is a significant leading indicator for this key industry, it is the bulging inventory of unsold homes, which points to weaker construction activity and home prices. In both the new- and existing-home markets, that trend is unmistakable, having risen to multi-year highs. The climb in the new-home market suggests that bigger price breaks are in the offing for first-time buyers, as builders are loath to keep cash-draining houses on the market for long. In the existing home market, the implications of rising inventories are somewhat different, and may not be as foreboding as is the case in the new-home market. Many sellers may be just testing the market, putting their homes up for sale and leaving them there until their asking price is met. Homebuilders, however, cannot tie up their cash indefinitely, and will slash prices if necessary, or slash new construction because of financing restraints.

Still, there is little question that the cooling housing market is having broad effects on the economy, something that was explicitly noted in the Fed's policy statement. For one, builders are already cutting back on construction activity, paring new hiring in the process. In the twelve months through February of this year, for example, construction payrolls expanded by an average of 27 thousand a month. Over the past three months, the average monthly increase has been cut to 6 thousand. For another, the slower appreciation in home prices together with the increase in mortgage rates has curtailed the volume of equity cash-outs through refinancings and home equity loans. The withdrawal of housing equity has been a key element behind the sustained increase in consumer spending over the past two years, enabling households to spend far beyond their means.

Indeed, the gap between the growth in spending and in paychecks continued to prevail in May, according to Commerce Department figures released on Friday. While total personal incomes rose in step with the 0.4 percent increase in total personal outlays, that was only because households are enjoying stellar increases in interest receipts and in dividends. Interest from financial assets jumped by \$10.8 billion during the month, accounting for nearly a third of the increase in total personal incomes. That's quite a contribution for a component that only comprises 9.4 percent of total income. In contrast, wages and salaries -- the main determinant of spending-- were flat last month, the first time they haven't increased since the aftermath of the hurricanes last November. No doubt, the recent slowing in employment together with company vigilance over labor costs is keeping households from making greater strides on the earnings front.



With wages stagnant and the housing market cooling, it should come as no surprise that consumer spending is also fading from the robust 5.1 percent pace in the first quarter. Indeed, virtually the entire 0.4 percent increase in personal outlays in May was eaten up by rising prices, as the personal consumption deflator rose by a similar 0.4 percent. Hence, real spending edged up by a puny 0.1 percent during the month, after rising by a tepid 0.2 percent in April. As a result, consumer spending over the first two months of the quarter is running at an annual rate of about 2 percent, which if extended through June would be less than half the increase posted in the first quarter. Since such spending accounts for nearly 70 percent of total economic activity, a slowdown of this magnitude would clearly slash the growth rate in real GDP as well, bringing it noticeably below the 3 percent threshold that is regarded as the noninflationary speed limit.

Would the Fed respond to a sub-3 percent growth rate and move to the sidelines on August 8? Possibly, but the more important consideration will be what the incoming monthly data show. If the quarter ended weakly and the third quarter started on an even softer note, the stage for a pause would certainly be put in place. In this regard, the Fed will have two more months of some key economic data to consider -- the most important being the June and July employment reports. If the slowdown in hiring underway in recent months continues and the jobless rate edges higher, a major factor underscoring the Fed's inflation concern -- rising labor costs -- will be defused, making a pause in the rate-hiking cycle that much more likely. Keep in mind that policymakers have constantly referred to high resource utilization as the major inflation threat, and an unwinding of a perceived tight labor market would go a long way towards defusing that threat.

What's more, given the less hawkish tone sounded in the latest policy statement, the Fed may be somewhat forgiving of uncomfortable inflation numbers if the economic slowdown persists. To be sure, the central bank's patience would be one of degree and not open-ended. Any sign that inflation expectations were heating up along with actual inflation would probably force the Fed's hand, despite a slowing economy. But as the latest policy statement indicated, as long as economic conditions have the potential to "sustain inflation pressures" and not "add to inflation pressures" which was emphasized in the previous policy statement, the Fed appears willing to be patient and wait for slowing growth to work its anti-inflation magic.

Bernanke and his colleagues are also well aware that a statistical quirk in the way housing costs are measured is largely responsible for the recent acceleration in the consumer price index. That's one of the reasons the Fed prefers to watch another inflation barometer, the core personal consumption deflator as a more meaningful indicator of price trends. The core PCE deflator, which excludes food and energy prices, measures housing costs the same way as do the folks who compile the CPI. The difference is that the housing component carries a much smaller weight in the deflator than in the CPI and, hence, has a smaller influence on its movement. Not surprisingly, the core PCE deflator has been increasing more slowly than the core CPI over the past year -- 2.1 percent versus 2.4 percent. In Friday's income and spending report for May, the core PCE deflator increased by a relatively tame 0.2 percent, the same as the previous month, compared to three monthly increases of 0.3 percent in the CPI. Even so, the core PCE deflator is running slightly above the Fed's stated 1 - 2 percent comfort zone, so it would be mistake to be too complacent about a pause in the rate-hiking cycle on August 8.