

WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 13, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	April 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.00%	5.03%	5.02%	4.69%
6-month Treasury bill	5.08	5.09	5.12	4.92
3-month LIBOR	5.36	5.35	5.35	5.01
2-year Treasury note	4.76	4.72	4.59	4.95
5-year Treasury note	4.69	4.65	4.47	4.97
10-year Treasury note	4.76	4.76	4.55	5.05
30-year Treasury bond	4.93	4.92	4.70	5.11
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.75	3.71	3.64	3.77
10-Year	4.04	3.99	3.85	4.17
30-Year	4.56	4.51	4.34	4.64
30-year fixed mortgage rate	6.22	6.17	6.14	6.49
15-year fixed mortgage rate	5.90	5.87	5.88	6.14
1-year adjustable rate	5.47	5.44	5.42	5.61
STOCK MARKET				
Dow Jones Industrials	12612.13	12560.20	12110.41	11137.65
S&P 500	1452.85	1443.76	1386.95	1289.12
NASDAQ	2491.24	2471.34	2372.66	2326.11
Commodities				
Gold (\$)- 100 OZ	689.90	679.40	652.80	602.10
Oil (\$ per barrel) - Crude Futures (NYMerc)	68.63	68.24	60.30	69.45
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Producer Price Index(March) - % change	1.0	1.3	-0.6	0.4
Core PPI (March) - % change	0.0	0.4	0.2	0.2
Trade Deficit (February) - mths of \$s	58436	58877	61453	60085

We hate to write economic commentaries on Friday the thirteenth. It's hard enough dealing with bad luck on an ordinary day, but when the cosmic ill winds are also blowing in, the odds of not getting things right are greater than ever. That said, we have long worn the label of dismal scientists, so perhaps we should be comfortable with the omens associated with this infamous day. One thing is becoming ever-more apparent: our crowd does not lack esteemed colleagues. Among our compatriots are none other than former Fed chairman Alan Greenspan, who recently opined that the odds of a recession this year have increased considerably, as well as former Treasury Secretary (and departed president of Harvard) Larry Summers, who more or less supported that view in a televised interview on a business program this week.

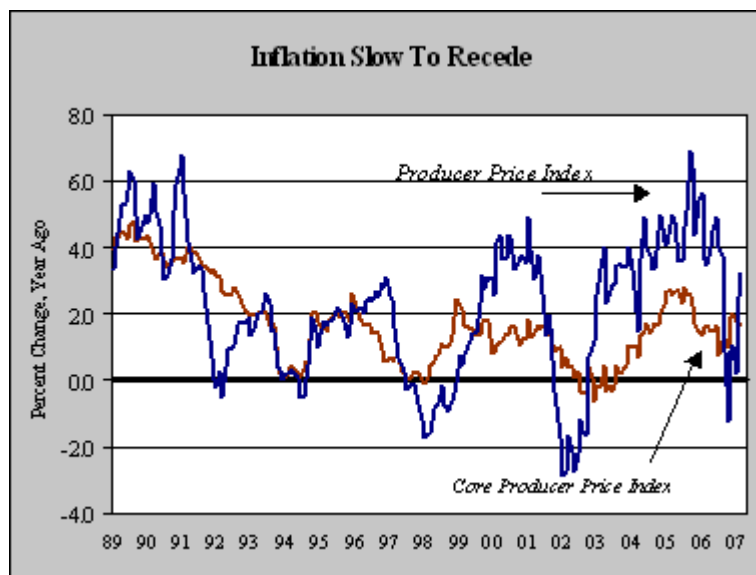
It's not entirely clear if Ben Bernanke, the current Fed chief, and his policy cohorts are also card-carrying members of the dismal persuasion, but they certainly did little to cheer up the financial markets this week. Still, stock investors sounded a decidedly upbeat note on their own, sending share prices solidly higher during the period. On the surface, the Fed's contribution to the week's aura would appear

to border on the positive. After all, the minutes of the March 21 policy-setting meeting, released this week, reiterated the message conveyed in the post-meeting statement, namely that the economy was not heading for hell in a handbasket. For the downtrodden folks worrying that the housing slump was about to bring down the economic house of cards, that should indeed be a positive thought.

But the very same message that might inspire positive feelings for some contains a disturbing sidebar that also dilutes its positive impact. Simply put, the strong implication of the Fed's upbeat assessment of the economy is that no rate cuts are in the offing, at least in the foreseeable future. It may take some time for this thought to sink in, but it's the third time over the past month that the chairman has repeated it for all investors to hear – including the March 21 policy statement, in congressional testimony the following week and now in the minutes of the March 21 FOMC meeting. To be fair, Bernanke and his colleagues are not 100 percent sure if the economy will soon pull out of its prolonged housing-induced slump, which is why they took out their previous explicit guidance that “additional firming may be needed” from the last policy statement.

What Bernanke is simply trying to accomplish is give himself and his policy cohorts the flexibility to ease if economic conditions worsen, something that might shock the markets if the explicit tightening bias were still in place. But as one pundit aptly put it this week, the markets decided to focus on what was taken out of the official policy statement instead of what was left in. And the retained phraseology combined with ensuing remarks since the March 21 meeting clearly indicates that the Fed considers inflation, not weak growth, as the predominant risk facing the economy. More specifically, the Fed is more worried that inflation will not recede as fast or as much as it would like than that it will accelerate.

In that regard, the latest inflation gauge released this week is not overly encouraging. For March, the wholesale price index jumped by 1 percent, following an outsized 1.3 percent spike in February. The latest increase lifted the annual gain to 3.2 percent, the highest since last August. True, the March increase, like the previous month, was heavily influenced by energy and food prices, which surged by 3.6 and 7.8 percent respectively during the month. Excluding those volatility components, the so-called core producer price index was unchanged, which was actually a better reading than what the markets had expected. For the 12-months through March, the core PPI increased by 1.7 percent, which is about double the pace of the cycle low reached last summer, but well off the cyclical high of 2.8 percent set in 2005.



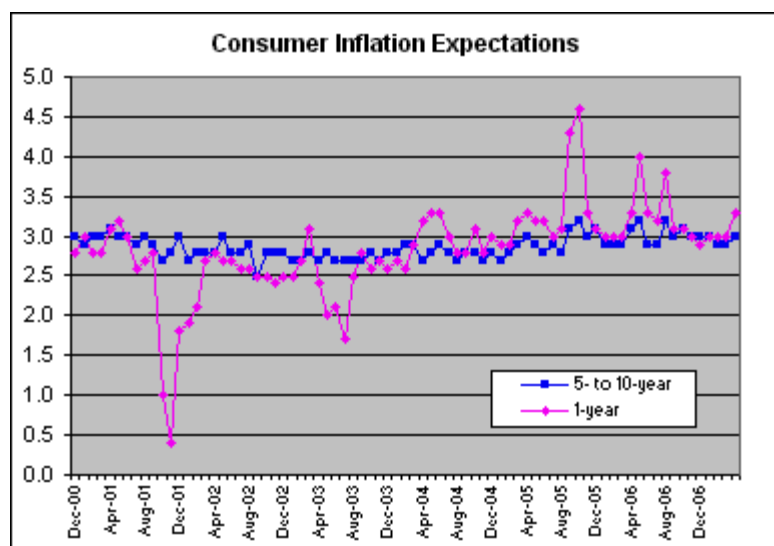
To be sure, the Fed does not pay much attention to wholesale prices, largely because they do not include prices in the more comprehensive service sector that have a greater influence on consumer budgets. Hence, the trend in retail prices, whether measured by the consumer price index or by the Fed's preferred gauge the core personal consumption deflator, has more of a bearing on policy decisions as well as on the financial markets. It is not surprising, therefore, that the unchanged reading in the core PPI for March barely caused an iota of excitement in the bond pits, where yields on Treasury bonds actually edged up after the wholesale price report came out. It could be that traders are simply waiting for confirmation from the CPI, due out next week, showing that inflation is under control before reacting positively.

Still, the bond folks may not have been too enamored with some of the details in the wholesale price report itself. For one, price pressures further down the pipeline were anything but dormant – even excluding food and energy products. Core crude goods prices, for example, surged by 7.7 percent in March, lifting the annual pace through the month to an eye-opening 24.6 percent. Further up the chain, things were a bit better, but nothing to write home about. In the 12-months through March, crude intermediate goods prices increased by 3.5 percent, well off recent peak rates, but not enough to translate into slower increases of finished goods in the wholesale price index.

More to the point, the Fed seems to be particularly concerned with grass-roots influences on inflation that continue to keep the issue on the front burner. For one, productivity is slowing, even as worker pay is rising. This combination is putting upward pressure on unit labor costs, something that is not likely to ease as long as the job market remains as tight as it is. It is somewhat of a mystery as to why unemployment remains so low with the economy slowing as much as it has over the past several quarters. It may be that companies are loath to lay off workers when there appears to be such a shortage of skilled help available. If that's the case, they will almost certainly cave in to rising labor cost pressure at some point, lest profit margins evaporate and shareholders revolt by selling company stock.

But if companies subscribe to the Fed's view that the economy will rebound later this year when the housing drag presumably fades, then they may be willing to absorb the hit of higher labor costs for a while, expecting to recoup costs by raising prices in a strengthening economy. That's the classic dynamic of a wage-price cycle that always scares the policy makers. Keep in mind that the mantra of former Fed chairman Greenspan, based on theories well grounded in economic literature, is that inflation is particularly difficult to root out of the system when it becomes ingrained in the decision making process of businesses and consumers. The stubborn pattern of retaining workers in a slowing economy may be an early reflection of that dynamic on the business side.

Just as significant is that inflationary expectations may also be seeping into household psychology, setting the stage for a possible double whammy facing the Fed. Recall that the logic behind excluding food and energy prices from inflation benchmarks in assessing price pressures is that those prices are influenced more by non-cyclical forces that are not under the control of monetary policy. That may well be true, but in point of fact households do purchase gasoline and heating fuel as well as food for consumption. While these items may constitute a smaller fraction of household budgets than they did a decade or two ago, thanks to rising incomes, they nonetheless factor into inflationary expectations. So far, households have been able to put aside inflation worries associated with rising food and energy prices, but that may be changing. In the University of Michigan's early-April canvas of consumer sentiment, released on Friday, inflationary expectations over the next year jumped to 3.3 percent from an expected inflation rate of 3 percent last month. That jump has not yet lifted longer-term inflationary expectations, a crucial influence on spending decisions, but if the short-term outlook stays elevated for several more months, it might well become more deeply ingrained in household psychology.



Given the array of indicators supporting inflation risks, it should not be surprising that the Fed is talking tough, dissuading the markets from thinking that a rate cut is on the way. While there is a vocal contingent firmly convinced the Fed's next move will be an interest-rate increase, not a reduction, we do not share that view at this time. What's important to realize is that by staying pat as the economy is slowing, policy is in effect getting tighter just by not easing. That's because in an environment where prospective returns from investing in new plant and equipment and other capital goods are shrinking, the cost of borrowing at the same interest rate becomes more onerous than before.

To many critics of the stand-pat strategy, that's a risky policy decision by the Fed. With the subprime mortgage meltdown sending housing activity deeper into the throes of a slump, the endgame from this powerful drag is anything but certain. Even if the economy is able to withstand the housing drag, it is also now facing another headwind that the Fed itself is beginning to acknowledge, namely an unexpected and still-ongoing weakening in capital spending. This, too, may merely be a temporary setback, reflecting an inventory overhang and the housing correction. But if it stems from a more fundamental reassessment of growth prospects by companies, the economic consequences could be more severe and lasting. What's more, it is not only domestic companies pulling back from capital spending. In an otherwise positive report showing a surprisingly large reduction in the trade deficit in February, capital goods exports fell by a sizeable 5.8 percent, the second decline in three months. In other words, foreign companies may also be scaling back capital spending plans in response to the U.S. slowdown. If that's the case, exports, a major source of past and expected strength for the U.S. economy, may also be fading. The bottom line: both inflation and slowing growth will be in the crosshairs of the Fed's looking glass for the next several months, and getting it right will not be easy – even on days other than Friday the thirteenth.

