



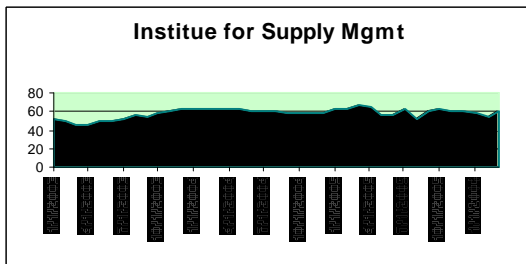
Quarterly Economic Report – 1st Quarter 2006

Inflation Watch

It came as no surprise that the Fed hiked overnight rates in March to 4.75%. What was a surprise was that there was no change in the message or its delivery. In his first meeting as Chairman, Ben Bernanke, was a wildcard but the soft rhetoric after the meeting sounded like pure-Greenspan-speak. The Committee downplayed the deep GDP decline in 4Q and saw strong 1Q growth although they admitted that the growth is "likely to moderate to a sustainable pace." They clearly want to focus and contain inflation risk. They are data dependent and will watch inflation signals, the pace of demand, and resource use closely which will add to volatility.

The message remained the same because the situation fundamentals remained the same. We have strong global growth, high energy and commodity prices which threaten inflation, and strong employment which points to wage pressure. All these factors make for a Fed willing to hike rates to stave off inflation. With few changes the risks also remain the same: geopolitical events, elections, possible avian pandemics, and soaring energy costs. That has the bond market on the defensive until it definitely sees a softer economy and has rates slowly moving up. (At this point the futures markets see a 93% chance of a move to 5.00% in May and 34% for July's move to 5.25%).

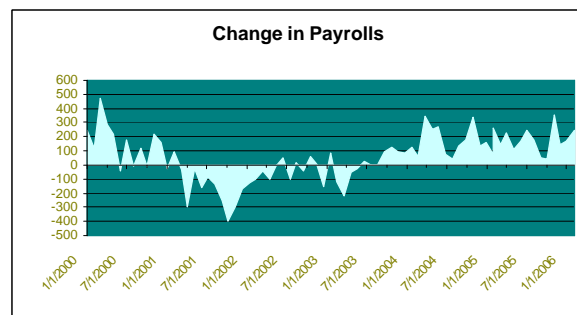
The continuing strength in **business** is clear. Inventories are their highest since 8/04 and have enjoyed a 34 month expansion. Manufacturing in 1Q was its highest in 2 years. The service industry, which is 90% of the economy, is strong from a pickup in government and commercial building. Corporate profits are up



sharply (21.3% YOY) after the hurricanes. The increasing M&A activity in 1Q shows business putting those dollars to work. The biggest threats to business lie perhaps in health care costs and wage pressure with global market growth a close third. Even in housing the slow-down in residential work is being replaced by commercial building activity.

As for the **consumer**, their insatiable hunger for material goods waned slightly in 1Q but the wealth effect is still there from refinancing, and, spending is on track for a solid annual 4.7% rate pace. The decline in the last quarter was due almost entirely to less auto sales which took 1.9% off the annual GDP. Slower retail sales are also blamed on a late Easter. The slower demand is consistent with Fed hikes but gains in employment will continue the trend that has consumer spending outpacing personal income.

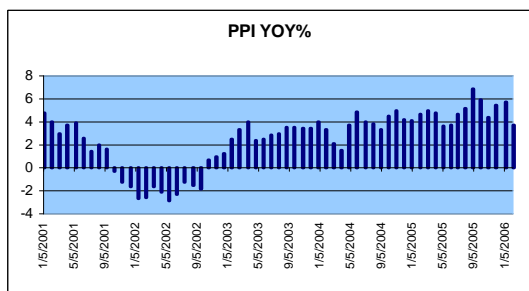
Currently the US sits basically at full **employment** levels and this influences consumer expectations and actions - it is also a major factor in **inflation**. Inflation will continue therefore to be a major review point for the Federal Reserve. With the unemployment rate at 4.7% and the work week holding at 33.8 workers are confident in their jobs and prospects. Even in the face of dangerous isolationism in Washington, foreign owned auto makers are expanding adding 3,000 employees in 2005 (Kia/Hyundai). A strong economy forces business owners to add workers and causes wage pressures to mount. Labor has been paid



in many cases on increased productivity gains translated into profits for business and those productivity gains have to continue in order to fight a major business risk: health care costs. A recent Federal Reserve

study suggests that while the initial decline in the unemployment rate was cyclical (in the business cycle) boomers may keep employment participation down - and health costs up! If so, without continuing productivity gains, GDP could slow because of the slack in labor.

Productivity is a major element in inflation and since it is an element that has broadly and deeply influenced our growth over the last decade it bears a closer look. Productivity plays a large role in growth because it reduces business costs and provides for higher output at a lower cost. It affects inflation by lowering costs at all levels in the chain and thereby increases profits. This elusive element actually changes the entire financial asset process as it changes the cyclical and structural base of business and what it can produce. Productivity also normally reduces corporate debt and its structure. A Federal Reserve study recently looked at major periods during which changes in productivity cycled through our economy. Over the past 150 years, it showed that a productivity cycle usually lasts from 20-30 years and that most of the significant changes came at the end of the period as business found new uses for the new technology and became acclimated to the new technology for exploitation. This study pegged productivity gains at 1.5-2.5% from 1970-1990 and then saw a new wave of productivity beginning in 2000. The first wave was used primarily for gains in capital equipment used in production and manufacturing areas. These changes decreased costs but in general were narrow in their use and potential. However, the second wave seems to have a broader base and is focused on innovation and end-product application. Information on the technology becomes more available to business for application to consumer goods (ipod anyone?) and consumers incorporate these now trusted and understood products into their own use. We see the speed with which products change now in the current cycle (TVs, recorders, phones, etc.) and the almost daily innovations. Our current evolution in technology and productivity use has, in turn, changed whole industries (phones and cable), rewritten inventory basics (just-in-time management), and created a whole new approach to consumer information. In return the consumer has increased her bargaining position with the information available which further restrains price increases. Another side angle to this current productivity cycle, especially since it focuses on communications and information transfer, is its impact on global competition.



All of this leads us back to inflation which remains the key focus of the Fed. There is inflation in the system but it remains tame as yet. GDP price indexes increased 3.5% YOY and PPI has decreased since mid-2005. But, the wage pressures, nagging health care costs, and higher energy prices pose a continuing threat. Many people point to the **commodities** as an indication that inflation - or a disaster - is looming large on the horizon. Gold has hit over \$600 for the first time in 25 years and silver hit a 22 year high.

Copper and zinc have hit all-time highs and oil has averaged above \$62 for a year. Traditionally, gold and silver have been seen as repositories of value and their higher prices reflected tensions in geo-political and economic uncertainties. Commodities as havens from political and economic storms usually benefit from a weaker dollar as investors look for returns. This time there may be more to the story.

Many analysts feel that the increases in commodity prices are now due instead to funds flow and a herd mentality as much as the value/fear fundamentals. The markets may be reacting to an impending dislocation of assets as Asian savers (primarily Japanese) slow their savings rate as a result of a Japanese monetary policy change after 8 years. The US has been soaking up 2/3rds of global savings to finance our consumption and allowing Asian savers to finance our debt. A major change in policy will change our trade balances and rates globally. Combine this move with a dangerous move to US isolationism - perceived or real - as seen in the Dubai port machinations, and the US as well as its bond markets, could be put in serious jeopardy. Such a shift would naturally push investors to the benefits of hard assets (the commodities). But, the relative impact of media coverage regarding the enormous price gains and the popularity of the gold ETF which allows small investors to invest in gold has to have had a sizeable impact also. It is difficult to determine how "real" this move to real assets is or if speculators and short-term traders are over-inflating the prices. In either case, in the short term it raises serious inflationary pressures on producers using these commodities.