



Quarterly Economic Report – 4th Quarter 2005

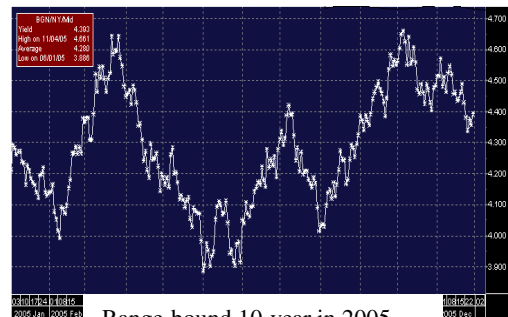
A Goldilocks Year: Not too hot, not too cold, just right.....

2005 was a challenging year of major events and strong trends and the feeling that we have survived and indeed prospered has left the markets with an optimistic blush to begin 2006.

The economy's strength in 2005 was great enough to shrug off horrific hurricanes, energy prices at historical highs, a bi-coastal housing frenzy, terrorist wars, a spiraling national debt, and a major changing of the Federal Reserve guard. Consumers saw inflation rise but kept on spending and retailers who dreaded the holiday season found it finished quite respectably. The consumer's ardor for automobiles did cool with the phase out of drastic incentives and although that cooling will present a slight drag on fourth quarter GDP we should see continuing moderate growth. Unemployment had fallen to a comfortable 4.9% by year's end and monthly averages showed solid hiring. This trend to hiring, without wage pressure, will be a key factor in determining how tight labor markets really are in our new productivity driven world.

A major mover in the 2005 economy was the housing sector which created value bubbles on both coasts and in between. Unlike the tech bubble of the 90's however this frenzy was better characterized by Greenspan as *froth* made up of thousands of bubbles and the fizzle is now slowing without a major pop. The increased equity value for homeowners has tended to balance the household debt which at \$11.4 trillion is up 55% since 2000. The consumer debt which is now 115% of all disposable income is nearly all mortgage debt and is broadly distributed. The most obvious danger here would come from a sharp drop in house prices which would curtail consumer spending. A fizzle rather than a pop should moderate that effect.

The steady, plodding growth of the economy was one factor that kept yields in the treasury markets range-bound all year. For 18 months the FOMC has moved consistently at each meeting and, it appears, those increases may continue. Fed Fund futures change daily but currently show a 96% chance of another increase in January (1/31), a 62% chance in March (3/28), and 90% in May (5/10) if the January hike is made. Yields held captive in a 75basis point range all 2005 created Mr. Greenspan's *ultimate conundrum*: what is keeping long



rates so low? The 10-year treasury started the year at 4.22% and meandered from 3.9% to 4.65% and even the equities did not break out to the upside until 2006. By year's end the curve was beginning to invert in some sectors creating a debate on its shape or possible inversion as a replacement for economic projections. The conundrum may continue. It is unlikely that a big bond rally, in price or yield, is imminent.

There are some trends that do appear likely for the coming 12 months.

- the Fed tightening will probably end by mid-2006,
- near term growth should be about 3-4% with most of it in inventory accumulation,
- housing should moderate allowing bubbles to fizzle out slowly for a soft landing,
- the employment market will tighten but the effect on wages will remain to be seen
- the consumer will be tempered by energy costs but the wealth effect of housing gains may offset their caution, and
- manufacturing should stay strong with orders and production mixed.

Another good bet is that Ben Bernanke will appear as a Greenspan clone at least for a year. Both men have similar views on monetary policy. The policy will not be restrictive and the goal should remain neutrality. The new FOMC may show less change than is feared but volatility from the change-over is inescapable. After 18 months of a consistent message, the different language of the new Chairman will inevitably cause indigestion and, therefore, volatility. The Committee appears prone to continue its weak consensus on increased rates but with an increasing focus on economic reports meeting to meeting. The minutes released in December convinced markets that the end was in sight, but, the minutes also hinted that “the economy was possibly producing in the neighborhood of its potential and the persistent strength in spending of late suggested that resource markets could tighten further and inflation pressures build” but “the number of additional firming steps required would probably not be large.” Regardless of the rhetoric it is important to remember that the Fed has two main goals: to stabilize prices and encourage sustainable employment. They must remain focused on energy costs, inflation expectations, and accelerated labor costs. They will be vigilant to changes and greater energy spikes will undoubtedly be dealt with quickly and aggressively by the FOMC.

Will 2006 be another Goldilocks year then? There are a number of significant factors which could interfere. Some of these factors have driven forecasts of an inverted curve and ‘an inevitable’ recession. Neither of these may be likely. At the end of the last two tightening cycles (‘94-95 and ‘99-00) we saw a bullish bond market lasting well into the next cycle as the markets expressed confidence that inflation was under control. But, rates are considerably lower this time around and the movement has to be constrained by that fact. How much value can even a stung-out bond bull find in a 30-year at 4%?

A second question hinges on whether foreigners will continue to buy our debt. Right now we buy oil and the dollars flow through oil producers right back to the US dollar as they buy our securities. Why? Because, despite our low rates, the US economy is the strongest in the world currently and our rates are higher than most. Investors flock to value and safety. There is a direct correlation between this foreign buying and our trade balance reflecting this recycling of dollars. In addition, the quasi-fixed link of several Asian currencies to the dollar makes it difficult for those countries not to support the dollar through continued buying. This hunger for USD securities should keep long yields low but as global economies improve oil money may also move away from our bonds lowering prices and raising yields. As money gradually moves from our market the dollar may also weaken which makes our long bonds even less attractive and accelerates the process. The heavy investment in US bonds may also be pushing the diversification limits of foreign portfolios. A shift in the dollar could force many re-evaluations overseas.

Perhaps a more important factor in international trade and its effect on our curve is the reactionary mood of the US Congress vis-à-vis China. The pending HB 1498 (the so-called “Chinese Currency Act of 2005”) would force the US to define the current currency stance by China as “manipulation” and bring large scale US intervention which can only raise tensions and hurt the dollar and our free trade thereby raising rates. The US certainly doesn’t need that with the same foreigners funding our debt. The Treasury asked for a hike in the debt ceiling to \$8.2 trillion in December (from \$5.9 billion in 2001). Until the economy generates enough itself to lower that debt, we need foreign buying.

Moderation in prices and a slight steepening in the long end should come even if foreign buying continues because of an increase in supply. In February, the Treasury will bring back the 30-year bond. The idea that it is back is as important as the volume added. Planned reforms in pensions will require more long securities but the anticipated \$30 billion in the 30-year treasury should take care of the pension needs. We have not had any treasury issuance past the 10-year since October 2001 creating an innate value in the scarce commodity and keeping yields low (prices high). This will begin to ease. Another supply factor will be moderation in housing. Less refinancing will lessen the asset-liability needs of long term mortgage portfolios.

There are at least as many good reasons for a slight steepening of the curve or a curve which remains relatively flat as one that inverts. Add those reasons to an economy that has good underlying strength and a recession generating inversion seems even less likely. We have enough dangers lurking to press rates down: terrorists, avian flu, and elections but none seem likely to stop a 4%-4.5% growth rate.