

Global Indicators

U.S. Financial Markets
May 2006



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Monthly Financial Market Highlights

May 2006

- *The financial markets expect the Federal Reserve to increase overnight interest rates another ¼ of one percent to five percent at the Federal Open Market Committee's mid-May meeting and project another ¼ percent hike by fall.*
- *Long-term interest rates rise given increased expectations that rising oil prices are leading to purchasing power problems; inflation-adjusted rates also rise to encourage savings.*
- *The yield curve begins to slope upwards and corporate credit spreads decline as investors believe the economy has achieved the sustainable growth phase of the business cycle.*
- *The core rate of inflation derived from the Personal Consumption Expenditure Index increases by 1.8 percent over the past year; the rate is within the range preferred by several voting members of the central bank.*
- *Gold prices and oil prices jump in April trading as global demand improves and political tension surges within many regions of the world.*
- *Industrial production continues to increase and capacity utilization rates reach highest level in past six years.*
- *Purchasing managers contacted by the Institute for Supply Management report much higher cost of goods purchased and higher export orders.*
- *The equity markets continue to post solid gains even though price-earnings multiples assigned next year's earnings by investors falls below 15 times earnings.*
- *Consumer confidence approaches a four-year high as the U.S. economy continues to add several hundred thousand jobs each month.*
- *Retail sales and consumer spending exhibits erratic month-to-month performance but continue to support economic momentum.*
- *Construction spending remains strong as office vacancies decline and commercial real estate spending expected to pick up.*
- *A majority of Americans expect home prices to drop in next 12 months as long-term interest rates rise, adjustable-rate mortgages reset, energy prices jump and investors sell properties.*

Monthly Financial Market Trends May 2006

Central Bank Approaches “Neutral” Interest Rate *Base for Sustainable Growth Achieved*

The financial markets fully expect the Federal Open Market Committee (FOMC) to increase interest rates another ¼ of one percent at their mid-May meeting. The move will have lifted the federal funds interest rate from one percent to five percent over 16 consecutive meetings. The minutes from the March FOMC meeting show, “Most members thought that the end of the tightening was likely to be near, and some expressed concerns about the dangers of tightening too much given the lags in the effects of policy.” The financial future’s market assigns

over a 70 percent probability the Federal Reserve will increase rates another ¼ of one percent to 5.25 percent between late-June and fall. Federal Reserve Governor Donald Kohn recently indicated, “The economy is in transition to a sustainable pace of growth, in which case policy likely will be in transition too.” The equity markets have been buoyed by the expectation that overnight interest rates will soon remain stable with a level that should be considered neutral after five years of accommodation.

Table 1
Monthly Interest Rate Trends

Money Market (Three-month)	April 2006		March 2006	
	Rate	Spread	Rate	Spread
U.S. Treasury Bill	4.71%	0.00%	4.62%	0.00%
Commercial Paper	4.97%	0.26%	4.83%	0.21%
Certificate of Deposit	5.04%	0.33%	5.03%	0.41%
Capital Market (20 to 30 Years)				
U.S. Treasury Bond	5.18%	0.00%	4.88%	0.00%
Corporate Bond				
High-grade (Aa)	6.14%	0.96%	5.86%	0.98%
Medium-grade (Baa)	6.49%	1.31%	6.20%	1.32%
Low-grade (B)	8.10%	2.92%	8.00%	3.12%
Mortgage-backed Security				
Fannie Mae (FNMA)	6.04%	0.86%	5.85%	1.10%

Table 1 illustrates the monthly change in U.S. interest rates for key short-term money market, and long-term capital market instruments. Interest rates respond to shifts in the global supply of and demand for funds, and to perceptions of expected inflation. Interest rates

increased despite continued global commitment to U.S. debt. Foreign purchases of U.S. dollar-denominated securities increased by over 25 percent in February from January activity. Foreign central banks and other international investors snapped up U.S. \$87 billion of U.S.

Treasury debt, agency notes and corporate bonds. Such investment activity soon will be tested by recent declines in the value of the U.S. dollar. The dollar lost ½ of one percent this past month against the yen and over 2.5 percent against the euro. Interest rates will need to increase further should the foreign supply of funds decline relative to that required to fund domestic consumer demand and governmental deficits. The U.S. fiscal deficit was reported to be U.S. \$303 billion for the first six months of fiscal year 2006. The deficit is just U.S. \$8 billion above 2005 levels despite extra funds committed to Medicare's new drug program, military operations in the Middle-East, and rebuilding the Gulf Coast after last summer's hurricanes.

Short-term money market interest rates increased marginally in April after jumping over 60 basis points in the first quarter of 2006. By contrast, long-term bond yields increased by 30 basis points in the past month's trading given mounting concerns for higher inflation and reactions to heightened global political tension. Oil prices jumped over 11 percent in April while gold prices shot up another nine percent. Gross domestic product (GDP) for the fourth quarter of

2005 was again revised upwards to 1.7 percent from the anemic 1.1 percent initially reported. Economic forecasters project GDP will range between 4.5 and 5.0 percent in the first quarter of 2006 and then increase by a lesser annual rate of about three percent during the last two quarters of the year. Stable growth will result if weakness developing in the housing market is offset by incremental business investment and additional export activity.

Table 1 also illustrates the monthly shift in interest rate spreads; a spread reflects the difference in yield between a corporate or agency security and a U.S. Treasury instrument of comparable maturity. Interest rate spreads change in response to perceptions of and tolerance for risk by investors and traders. Credit spreads for most securities except commercial paper declined in April. Capital market credit spreads decreased for all grades of corporate bonds as investors seek higher yields from corporate notes given the expectation that the central bank has achieved the interest rate required to attain modest inflation and sustainable growth. Confidence is returning to the market.

Table 2
Monthly Interest Rate Spread Trends

Spread	April 2006	March 2006
Yield Curve	0.26%	0.08%
Medium-grade Corporate	0.35%	0.34%
Low-grade Corporate	1.96%	2.14%
Inflation	2.61%	2.48%

Source: *The Wall Street Journal* and *Merrill Lynch Indices*

Several interest rate spread relationships, to include the yield curve spread, corporate bond credit spreads, and the U.S. Treasury Note/Treasury Inflation-protected Security spread provide information that may be used to project future economic conditions, and to confirm recently-released information about trends within the U.S. economy. Although

individual indicators provide false indications of strength or weakness, the composite spreads provide a reasonable representation of market expectations. Table 2 illustrates the monthly trend for each of the interest rate spreads.

- **Yield Curve Spread** -- The yield curve provides a graphical relationship between

the yield and the remaining term of a U.S. Treasury security. The yield curve spread is defined as the difference in yield between ten-year U.S. Treasury notes and three-month U.S. Treasury bills. The slope of the yield curve partly reflects expectations of interest rates in the future. The yield curve spread has plunged from almost 200 basis points in 2004 to very low levels as of 2006. The spread increased from eight basis points as of the end of March to 26 basis points by the end of April. The yield curve spread remains much lower than the historical average, which has approximated 180 basis points over the past several decades. There is little expectation that interest rates will continue to rise given the flatness of the yield curve. Based on historical experience, the modest upward sloping yield curve suggests a 20 percent chance of a recession occurring in the United States during the next twelve months. A recession is only likely if the housing market contracts quickly and consumers reduce spending and save for future needs. Higher long-term interest rates adversely affect the housing market and higher inflation-adjusted interest rates encourage saving. One reason the inverted yield curve has previously correctly signaled a recession has been the tendency of the Federal Reserve to overshoot and raise short-term interest rates too much in an attempt to control inflation; the excessive monetary tightening precipitates a subsequent recession.

- **Corporate Credit Spreads** -- The corporate credit spread reflects the difference in yield between corporate securities of comparable maturity but different asset quality. The low-grade corporate bond spread provides an especially good gauge of the market's perception of and tolerance for credit risk in the market. The yield spread between low-grade (e.g., BB, B and CCC credit ratings) and high-grade (e.g., AAA and AA ratings) corporate debt declined by another 20 basis points in April trading. The corporate bond spread decreases when traders believe the economy will continue to expand and investors are willing to accept more default risk to obtain higher portfolio returns. Given the still flat yield curve, investors

must be willing to take on very long-term debt (e.g., 40 to 60 year hybrid corporate bonds) or low-grade debt to significantly enhance yield. Meanwhile, the spread between medium-grade (e.g., A and BBB ratings) and high-grade corporate bonds was basically unchanged during April and remains a low 35 basis points.

- **Inflation Spread** -- The popular price indices illustrate **historical** price trends. The consumer price index has increased 3.4 percent over the past year. The financial markets can be interpreted to identify **future** inflation expectations by focusing on the difference between the nominal yield for 10-year U.S. Treasury notes, which were used to derive the U.S. Treasury yield curve spread, and the real rate for 10-year Treasury Inflation-protected securities. The inflation spread increased by more than 10 basis points during April after rising by more than 20 basis points in the first three months of 2006. The financial markets project average annual inflation of approximately 2.6 percent over the next decade, which is less than recently experienced but more than projected earlier in the year. Although the U.S. dollar had appreciated against other currencies earlier in the year, it lost value during April. The cost of imported goods increases when the U.S. dollar loses value and exporters have more of an opportunity to increase the price of their goods given the less expensive dollar cost of exports.

Strong global demand and political tension within oil-producing regions of the world from South America to Africa to the Mid-east has sent the price of oil up over ten percent in the past month to prices above \$70 per barrel. Even though turmoil and the still bloody insurrection in Iraq have not subsided, President Bush and other global leaders are directing military and economic pressures against Iran as the later country develops a nuclear threat. One international problem occurs before an existing crisis is resolved. Political anxiety, coupled with rising prices of oil and other commodities, has increased demand for gold, which now trades well above \$600 an ounce. The U.S. financial markets do not appear to be troubled much by

the international domain. The markets are concerned that inflation will accelerate. However, the lower credit spreads and more steeply sloped yield curve both suggest investors

Core Rates of Inflation Remain Benign

Despite the rapid recent rise in the cost of oil, the popular price indices remain well behaved.

- The inflation measure derived from the Personal Consumption Expenditure (PCE) Index was unchanged in February. Over the past year, prices from the PCE have increased 2.9%. The core rate of PCE inflation increased .1% in February and a modest 1.8% during the last year. The core rate of inflation backs out volatile energy and food costs. Selected voting members of the FOMC prefer to focus on the core rate of inflation derived from the PCE when judging purchasing power problems. Several of the voting members of the FOMC prefer the inflation gauge to range between 1% and 2%.
- The industrial materials price index compiled by JOC-ECRI declined 1.4% in March but is 3.2% above year-earlier levels.
- Producer prices jumped .5% in March and have increased 3.5% during the last 12 months. Core producer prices increased .1%

Industrial Production and Capacity Utilization Rates Increase

Business Investment Remains Strong

The monthly index compiled by the Institute for Supply Management for the manufacturing sector declined marginally in March to 55.2 from 56.7 posted in February. Despite the monthly decline, it is important to note that a reading above "50" suggests sector expansion. The index has now been above "50" for 34 consecutive months. The purchasing managers were especially optimistic regarding new export orders received during the month. Other indicators show strength.

- Industrial production increased .6% in March and is 3.6% higher than a year ago. The business equipment sector gained .8% in the month and is 10.9% above year-earlier levels.

remain generally upbeat about economic prospects.

and are just 1.7% higher than a year ago.

- Consumer prices increased .4% in March and have risen 3.4% during the past year. Core consumer prices increased a worrisome .3% during the month of March and are 2.1% above year-earlier levels.
- Purchasing managers surveyed by the Institute for Supply Management in March noted a large increase in prices for goods and services purchased.

Inflation will begin to creep into core prices if the unemployment rate continues to decline and capacity utilization rates continue to rise. The central bank has not only increased interest rates almost four percent during the past several years, it has restricted the growth of money. After allowing the broad money supply, M2, to increase at annual rates well in excess of eight percent between 2001 and 2003, the Federal Reserve has more recently controlled liquidity within the market. M2 increased by 4.5 percent over the past year.

- The capacity utilization rate at the nation's factories, utilities and mines increased .3% in March to 81.3%. The utilization rate is the highest posted in the past six years.
- Vacancies in office buildings declined to 14.1% in the first quarter of 2006 relative to 14.7% posted in the final quarter of 2005. Office vacancies are under 10% in Washington, DC, New York City and parts of California.

Economic momentum requires continued support from the industrial sector and commercial real estate construction.

Table 3
Monthly Equity Market Trends
(Standard and Poor's 500)

	April 2006	March 2006
Index	1,309.9	1,272.7
Price-earnings Ratio		
Trailing Year	18.1x	18.6x
Next Year	14.9x	15.2x
Dividend Yield	1.77%	1.79%

Source: *Business Week* and *Standard and Poor's Corporation*

The equity market continues to rally in 2006. The broad-based Standard & Poor's 500 Index increased 2.9 percent during April trading; the Index is 13.6 percent higher than a year ago despite higher interest rates. The price-earnings multiple assigned by investors for next year's earnings has declined from 15.2 times earnings

at the end of March to 14.9 times earnings as of the end of April. The market had assigned a price-earnings ratio of over 16 times at the end of 2005. Investors assign lower price-earnings ratios when not as confident of corporate earnings growth.

Consumer Confidence Returns with Job Growth

Consumer confidence as measured by the Conference Board increased in March after declining in February. Confidence is near a four-year high. The proportion of respondents listing the economy as "good" increased from 26.4 percent in February to 28.3 percent in March while those who think the economy is "bad" declined from 15.4 percent to 14.7 percent. Approximately 18.0 percent of those polled believe business conditions will "improve" compared to 9.9 percent who project "worse" conditions over the next half-year. The more optimistic confidence can be traced to job growth.

- The U.S. economy added another 211,000 new jobs in March. The job growth reduced the unemployment rate by .1% to 4.7%. The United States has created over 2.1 million jobs in the last year. Much of the growth has occurred in construction, retail, finance, education, health care and government.

- Personal income increased .3% in February while disposable income increased .2% and spending increased by just .1%. During the past year, disposable income has increased 2.2% compared to 3.2% growth in spending. The saving rate in the U.S. remains negative and is minus .5% of disposable income.
- The large retail chains reported lackluster March results. Retail sales at stores open at least one year increased by a lethargic 1.9% in March. Costco reported sales growth of 7.0% while the Gap's sales plummeted 13.0%. The chains blamed a late Easter date as part of the reason for mediocre results.
- Retail sales improved .6% in March and are 7.9% higher than 2005.

It is still uncertain how household spending will hold up if a reverse wealth effect develops from declining home values.

Long-term mortgage rates have increased about ½ of one percent in 2006. Fixed-rate mortgages now yield about 6.75 percent. The housing market is beginning to show stress from very lofty levels experienced over the past three years.

- Home starts fell 7.8% in March to 1.96 million annualized unit starts. Despite the decline, housing starts are 6.9% above year-earlier levels.
- Construction spending increased .8% in February; residential spending increased 1.3% as builders must increasingly offer incentives and discounts to move properties built on a speculative basis. Residential spending has increased 7.1% over the past year.

Summary

Selected members of the FOMC believe the U.S. economy is in transition between the expansion phase of the business cycle and sustainable growth phase. Monetary policy has moved from accommodation to neutrality. The economy continues to add hundreds of thousands of new positions each month and the unemployment rate is well under five percent. Jobs provide consumers the ability to spend and maintain economic momentum. Consumer confidence is near a four-year high. Capacity utilization rates are well above 80 percent. Common stock prices are up more than 13 percent over the last year. Corporate credit spreads are low and declining while the yield curve is again upward sloping; both market indicators are consistent with investor optimism.

There are risks to the economy. Consumers are fearful that home prices will decline and burst the long-developing housing bubble. Gold and oil prices have increased quickly in response to

- According to a recent survey by Experian-Gallup, approximately 70% of U.S. consumers believe a national housing bubble will burst and home prices collapse within the next year.
- Commercial real estate spending increased .8% in February and is now 9.6% above year-earlier levels. As office vacancy rates decline, commercial construction should continue to improve.

High home prices have allowed mortgagors an opportunity to turn real estate wealth into liquid assets by refinancing or taking out a home equity loan. In contrast to financial asset bubbles, homes also provide shelter for consumers and are less likely to precipitate a major reduction in consumer spending if and when home prices stagnate or decline.

global demand, rising international political tension and preliminary evidence of inflationary pressure on core prices. Purchasing power pressures will increase further if the U.S. dollar continues to depreciate against key trading-partner currencies. Retail sales have proved erratic on a month-to-month basis. The household savings rate is still negative. As long as the housing market cools, but does not collapse, and industrial production expands modestly given a weaker dollar and encouraging global demand, sustainable growth will be achieved in the United States for the foreseeable future. However, the market is not sufficiently robust to withstand a “disturbance,” such as \$100 per barrel oil caused by acts of terrorism domestically or within oil-producing nations. Analysts must monitor the housing market, inflation indices, and the business equipment sector to gauge the likelihood of enjoying a long period of sustainable growth versus the risks of a contraction.

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