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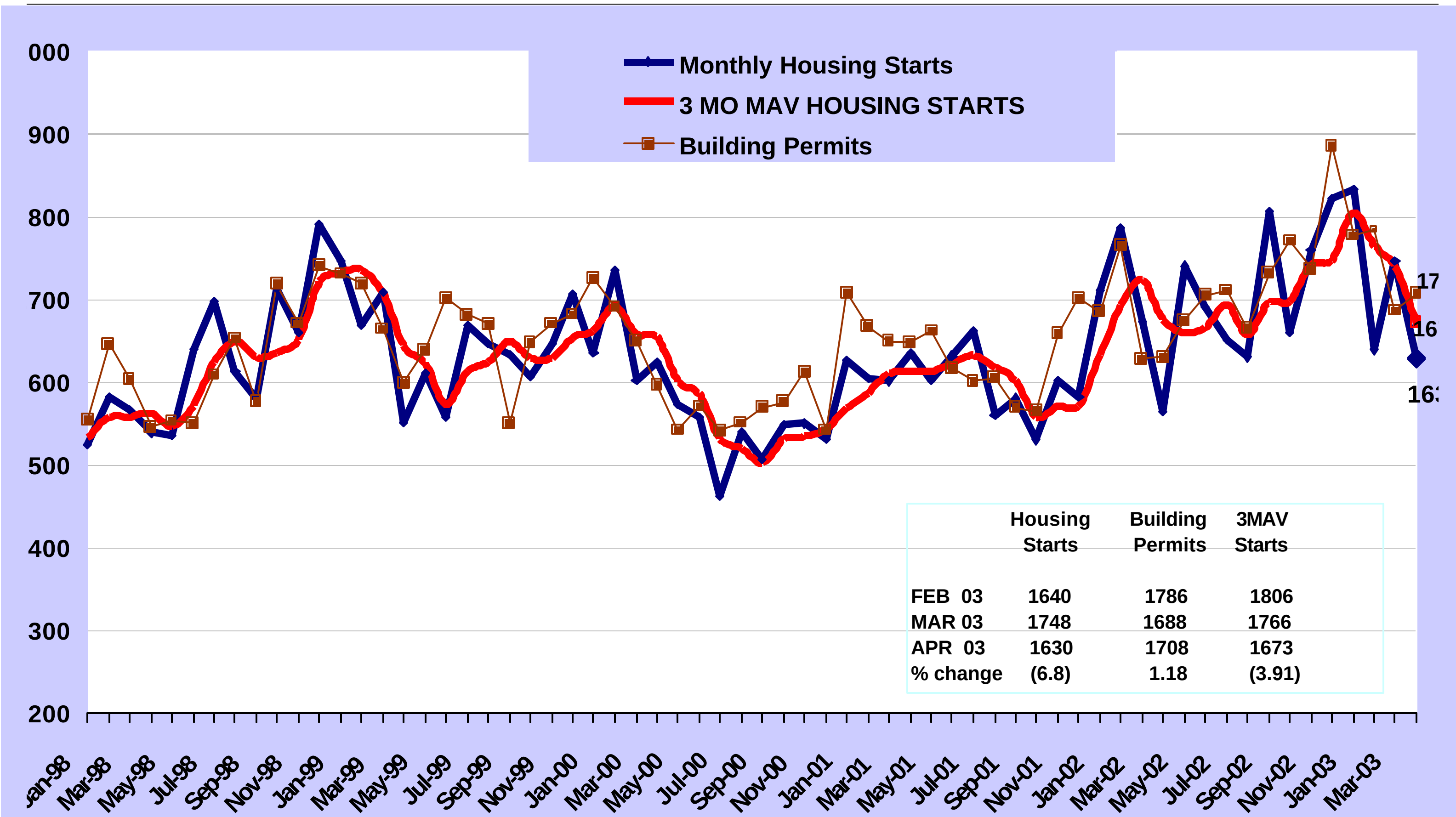
Housing, Business Surveys, Consumer Sentiment, Deflation: some real negatives



Housing Boom about to Bust?

It can't last forever, so it is said. The Housing Boom (or Bubble) may be fading, particularly if you look at the **three-month moving average of housing starts**. Still, much of that fade is in the multi-family segment with a drop of 21.7% in the past month. Single family starts have dropped, but by much smaller percentage (-3.0%).

Housing starts hit successive peaks beginning in May 2002, and have followed a saw tooth pattern at least until the "high" for this round---the record January 2003 level of 1,834,000 starts. Since then, Starts have dropped some 200,000, but at 1,630,000, Starts are above the "lows" of October 2001 and April 2002. During that period, the Starts series achieved higher "lows" and higher "highs." Since the peak in January 2003, the data appear to be showing a downward pattern with lower highs and lower lows. Clear? Not quite. New permits may have rebounded and the mortgage market is triggering more refinance. Will this be reflected in New Home Sales and increasing Starts? Hard to tell, but a whiff of caution flows from these data. Further new home sales will clearly be subject to a potential further deterioration in the labor market. Earlier this week, initial unemployment claims were reduced while continuing claims rose markedly. That is a divergent pregnant with change, but which moves? The weekly claims data starts back up or the continuing claims begins to level

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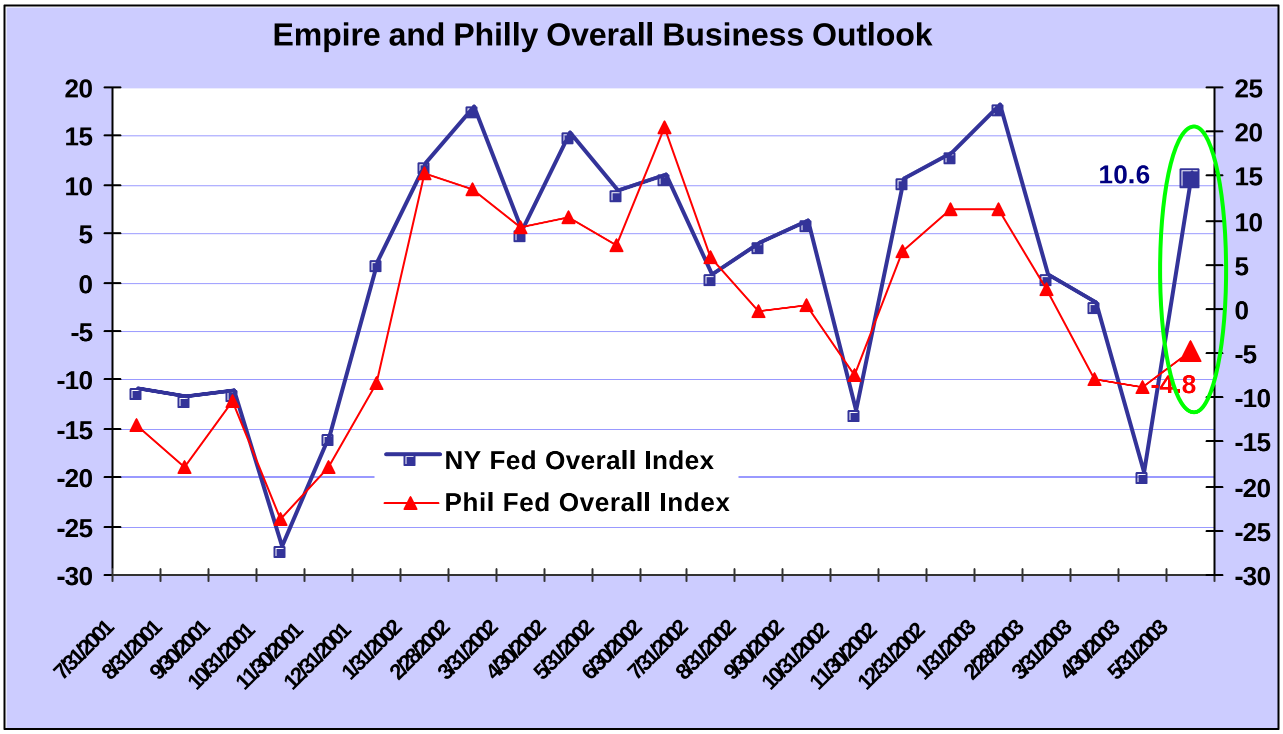
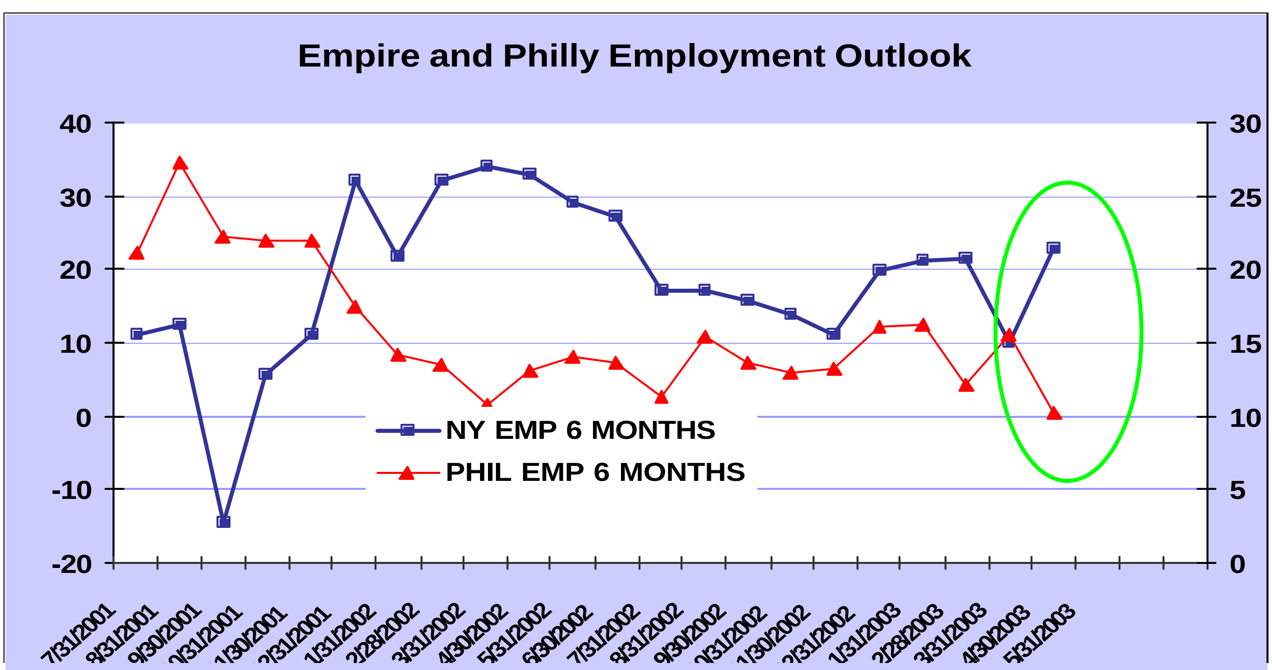
off.

Business Survey Data

The data from the NY and Philly Fed surveys suggest that business expectations are still depressed. We interpret business projections for employment six months forward as indicating a depressive overhang. The divergence between the recent Empire State and Philadelphia Business Outlook is hard to calibrate, but they



did not reinforce one another, which would have been a more positive indicator of what Managers are likely to do on employment. We should not expect positive ISM data next week

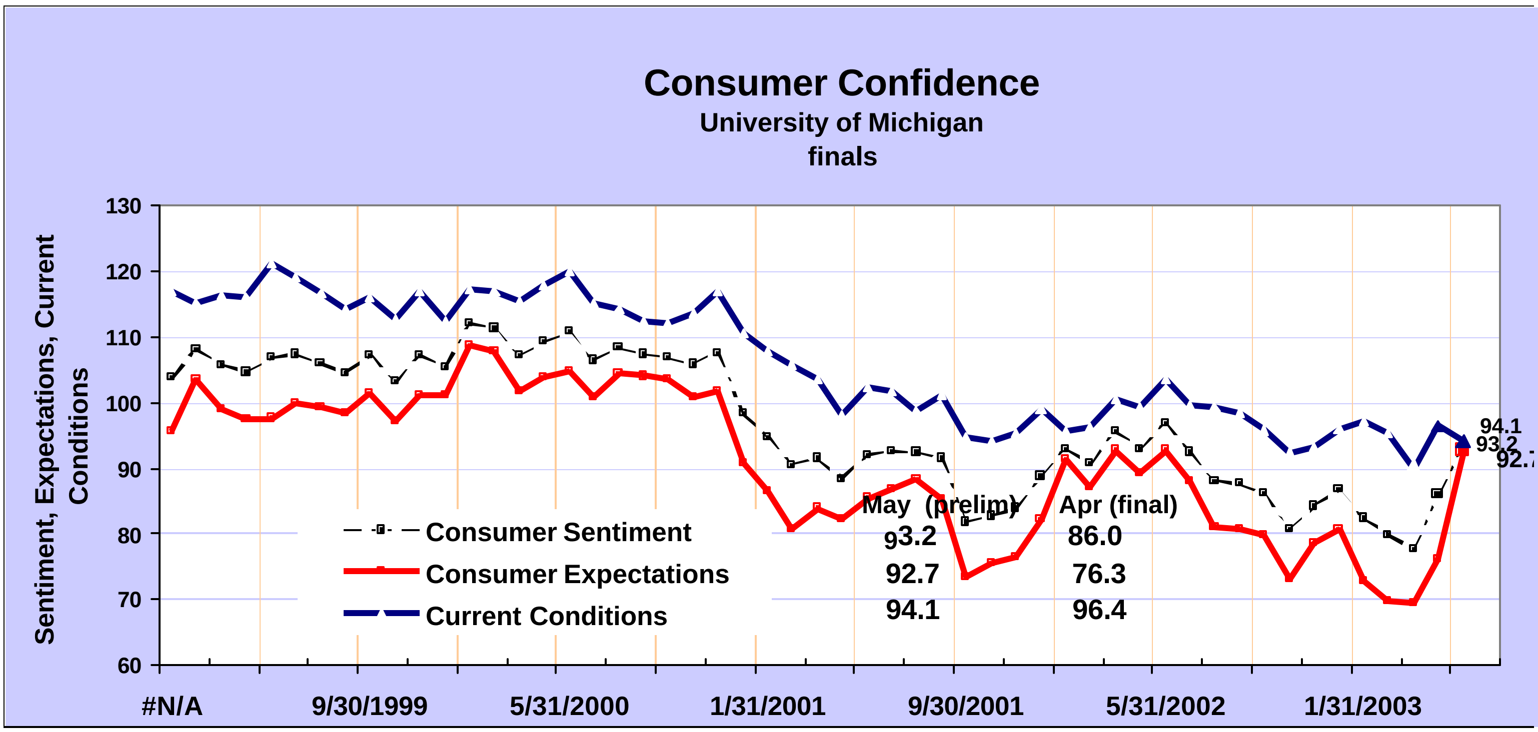


The divergence is worth some consideration. How much? We can't be sure, but we note that if optimism were far more prevalent in the business sector, there would be some reasons for optimism on the labor front. Since wage and salary income prospects drive the consumption of durables, including housing, we have some concerns. And, we think the Fed will have those same concerns.

The Fed and the Consumer

Where does this lead? Assuming the Fed sees the data as we have suggested, they will have to worry and may indeed take action at the June 24th meeting. The Fed Funds market suggests a high probability of another easing and there has been a notable flattening of the curve. That's good for mortgages, but it is unclear how it will affect swap spreads. They had narrowed sharply and its is possible that swap spreads won't widen---but it is not a foregone conclusion

The tax bill may be on the way to the Hill by the time the FOMC meets, but the impact of this front-loaded bill is unclear, at least in terms of immediate response. Retroactivity is a positive item, but whether the consumer

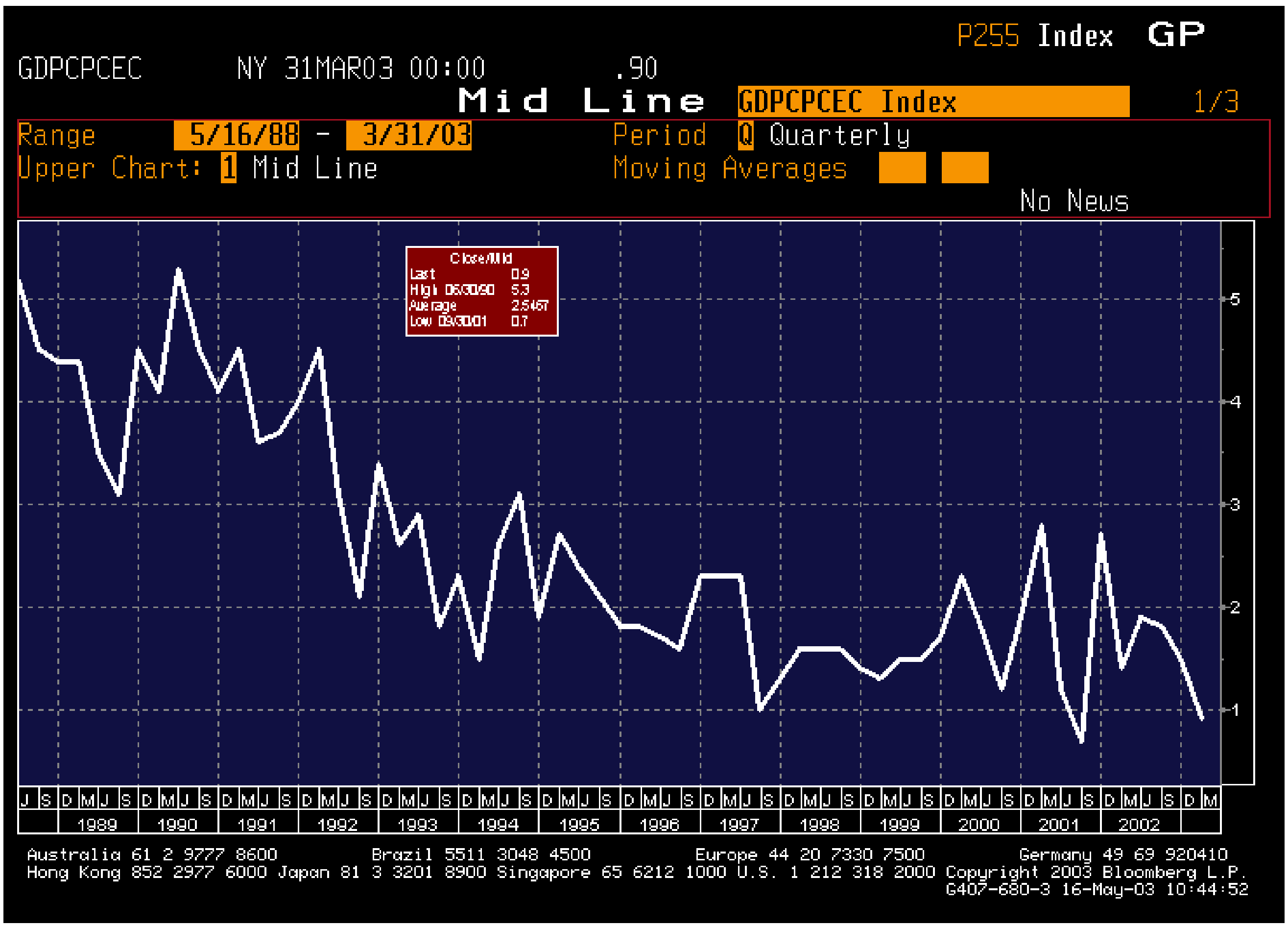


regards the 'sunset' technique that allows the bill to pass as giving rise to permanent income is not assured.

In our view, the consumer is the key to pulling out of this 'slow growth' period. The Fed has placed a huge bet that their policy moves will continue to stimulate the consumer, particularly in housing and in durables, until business spending begins to rise sharply. If the consumer hangs in, the business sector should respond. But, there have been notable declines in the growth rate of retail sales and that has to disturb the optimists. If one believes that a jump in forward expectations is a precursor to an improvement in retail sales, the University of Michigan preliminary survey is a positive indicator. We are suspicious of this bounce because the survey immediately followed the "official" end of the war. Current conditions actually fell surely reflecting the poor job market that faces the average consumer faces.

Inflation-Deflation

The bogey in all of this is the continuing threat of deflation. The Japanese experience haunts attitudes in the U.S. and that deflationary experience is one that the Fed will do its best to avoid. There appears to be a fair degree of momentum on the goods side. We saw it in the PPI yesterday, and there was a dramatic fall in top line CPI---largely reflecting a drop in oil and petroleum product prices. Core inflation was non-existent and if one believes that the quality factor is worth at least 1%, adjusting for quality take the Core into deflation territory. That has to worry the Fed. The Fed's chosen measure tries to incorporate more of the service sector by looking at the core personal consumption indicator. The most recent data is March but there will be another reading on May 29th. A sharp downtick will surely guarantee the Fed will act. Given the Fed's fear of deflation, the argument for a 50 basis point cut is also worth serious attention.



Equity Market Moves

With a near 20% rally in principal averages, clearly some portion of the equity market believes that the earnings pick up experienced by many corporations in QI can be projected forward. In our opinion, that forecast is conditional on the consumer not fading any further---maybe even beginning to show more life. A wing and a prayer was the famous lyric from WWII. In the war against deflation, that is where we are. The Wing is Monetary Policy (even unconventional moves). The Prayer is that the Japanese experience is not the relevant historical precedent.