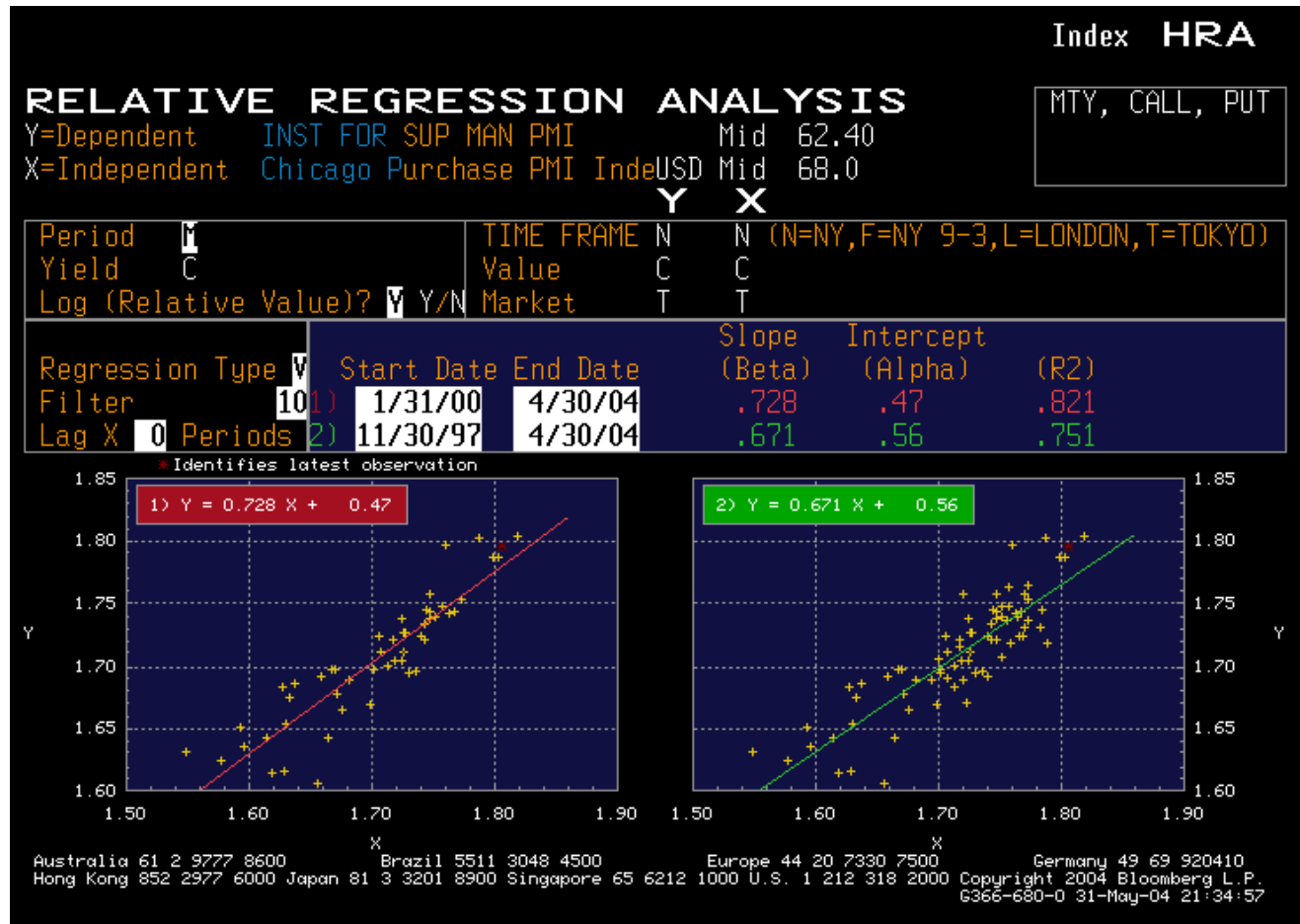




Where are we going, if anywhere?

This is the week when the true direction of economic policy may emerge. Tomorrow, we get construction spending and the ISM. The latter, in our view, may be the more critical number, but it is a very hard forecast to make. The Chicago PMA blowout should make us wary of an upside surprise, but Chicago is very influenced by auto production shifts and it might not carry on a national basis. Below is a regression in the logs of the ISM on the Chicago PMA. Reasonable fit and significant regression coefficient, but monthly predictability is dicey.



The consensus ISM top line is 61.5, a decline from 62.4 last month, but if the regression above held, we would get a positive improvement to something like 65! Earlier in May, it was hard to find any analyst who was that optimistic, given the 'mixed readings' from the Empire and the Philly surveys, but that is changing. Recent statements by some investment bank economists (e.g. JPM) point to the likelihood of readings in the 63+ range. What we will be paying particular attention to are New Orders and Employment (both current and future) because they may shed some light on likely Fed behavior going forward.

In particular, the employment series could alert us to the possibility of a much larger than anticipated payroll



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number (due Friday). The prices paid and prices received components will speak to the issue of whether inflation (slightly higher) is going to get more upward thrust. For the Fed, the issues will be employment and inflationary expectations. At this stage, with several months of better employment data and the prospects of better job data throughout the economy, we should begin to make some estimates as to how gradual the Fed can be going forward.

The Street has 25 basis points built in. Our view is that the 50 basis point possibility should not just be thrown out, even though it seems unlikely at this stage. However, some data are now showing a mild, but nonetheless positive acceleration in inflationary expectations. The Fed will have to watch much more carefully if this week's data indicates that "missing jobs" are no longer missing!

In addition, the monetary aggregates have been climbing in a pronounced way in recent months. The relevance of these data are whether the Bond Vigilantes beat the "behind the curve" tom-tom sufficiently to arouse concern at the FOMC's month-end meeting. Positive data points will make the noise louder and will invigorate those on the FOMC who believe that the risks lie to the upside (on prices and employment).

All of these data points will be viewed in the context of the widely-held notion that SH2004 will be weaker than FH2004. That is the conventional wisdom stemming from the evidence of slower consumption spending in QII04 and the uncalibrated impact of higher interest rates on housing; a China slowdown (or Hard Landing) and the escalated energy price spectrum. We note that the farther-out crude strips do show some weakness as compared to the current price, but the terrorist attack in Saudi Arabia last week and the poor response by Saudi forces (in letting three terrorists escape) has to heighten concerns for the promised increase in Saudi supplies. The peak in gasoline season is usually July 4th, just slightly more than a month away and there is evidence of heavier tanker bookings. It will be a race between current demands and future, increased supplies.

Finally, since we have been much more bearish than bullish on Tech, we have to take note of the rather impressive 10% rise in the SOX since 5/17/04. The Durable Goods numbers last week did show that there have been good order flows in the computer and communication equipment subcomponent series, but this has to be viewed in light of the very high volatility of these series. Our thought is that we might be seeing some of the investment demand that we expected in response to the accelerated depreciation allowances set to expire at the end of the year. In principle, we would expect that the elimination of this tax benefit should cause higher than normal spending investment spending, but investment spending by firms will also be related to what final consumption numbers turn out to be. If employment continues to rise, consumers will have more wage income to support better consumption even in the face of higher interest rates and perhaps continued high energy prices. That will be a spur to increased investment spending and perhaps to some inventory building.

The equity market seems to have sent us an alert these past two weeks. In spite of the continuing bad geopolitical news, markets rallied off their 200-day moving average lows. Now, we will have to determine whether it was just another false hope. At this stage, much hangs on this week's data and perhaps even more how the market intends to discount earnings going forward in the face of the expected increases in the Fed Funds rate. The real issue is not short term rates but whether the long end of the curve will rise further as a response to higher expected inflation and a steady withdrawal of very accommodative monetary policy.