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DAILY GLOBAL COMMENTARY

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The FOMC Finds Itself in a Tight Spot

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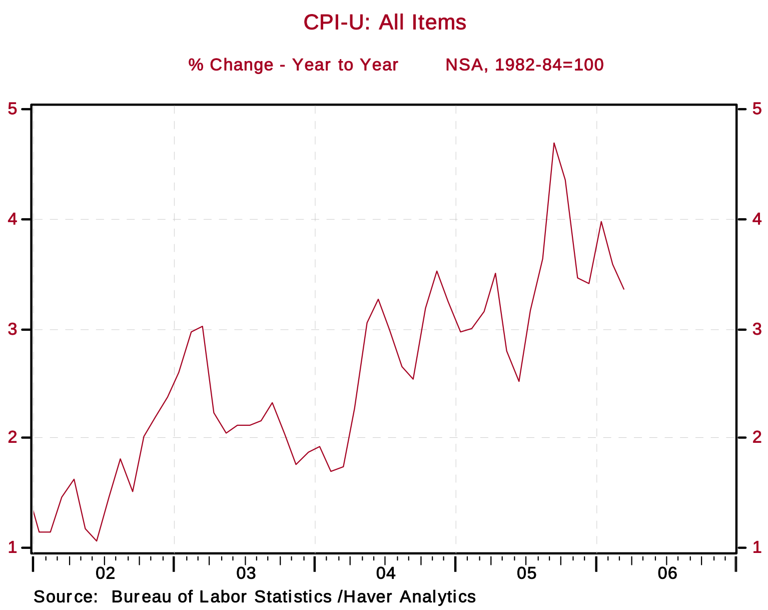
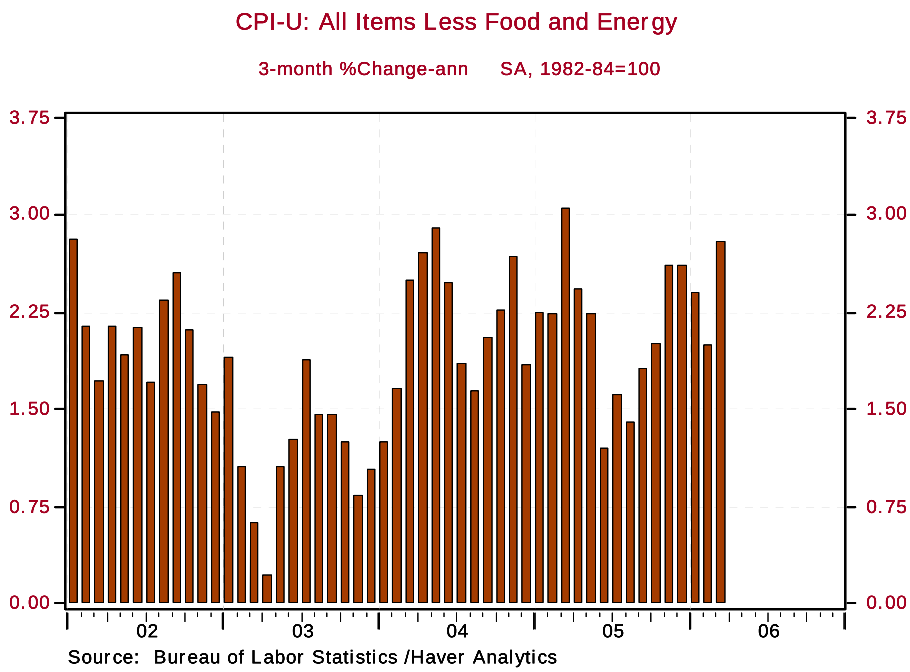
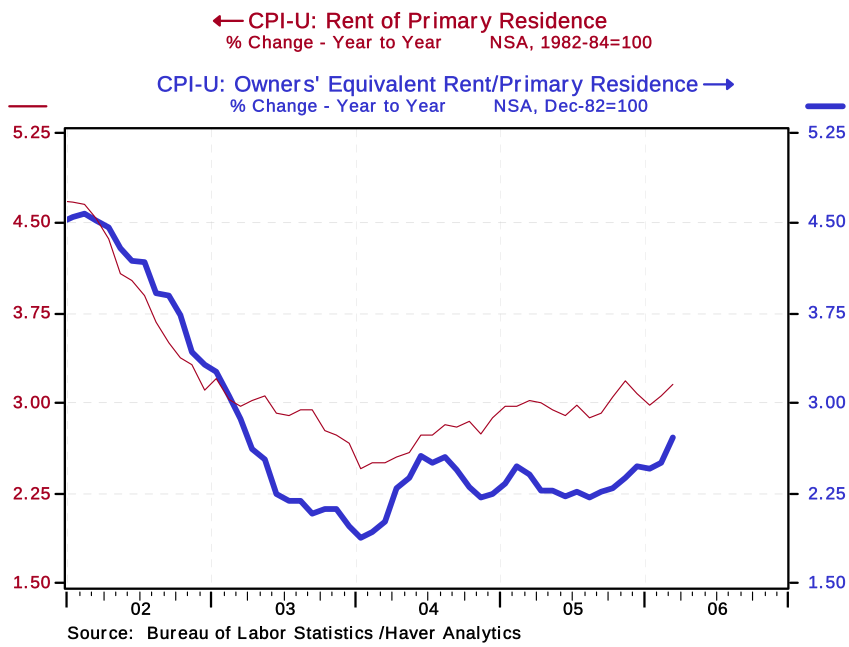
The Consumer Price Index (CPI) rose 0.4% in March after a 0.1% increase in February. Higher prices of gasoline and clothing and an increase in shelter costs were the main culprits. Year-to-date, the CPI has risen at an annual rate of 4.3% vs. a 3.4% increase in 2005. The energy price index moved up 1.3% in March compared with a 1.2% drop in the prior month. The 3.6% jump in gasoline prices more than offset declines in prices of natural gas and heating oil. Gasoline prices in April suggest that the energy price index is most likely to raise the overall CPI once again. The food price index rose 0.1% in March, matching the increase seen in February.



The core CPI excluding food and energy increased 0.3% in March, after benign gains ranging between 0.1% and 0.2% in the September – February period. According to the BLS, in March, shelter (+0.4%) and apparel (+1.0%) accounted for 70.0% of the increase in the core CPI. Excluding food and energy, the core CPI rose at annual rate of 2.8% in the three months ended March, following a 2.2% gain in all of 2005. The BLS also noted "while most categories advanced at a faster rate in the first quarter of 2006 than in all of 2005, about two-thirds of the acceleration was accounted for by a larger increase in the index for shelter--up at a 3.6 % in the first quarter after increasing 2.6% in all of 2005."



We need to watch the owner's equivalent rent and rent of primary residence components of shelter costs which are showing an upward trend. Owner's equivalent rent rose 0.4% in March, after a 0.3% increase in February and a 0.2% gain in January. Adjustments for utilities play a role in the computation of this component in addition to rental prices. The value of landlord provided utilities is subtracted from rent to obtain the "pure rent" measure of owner's equivalent rent. In situations of rising natural gas prices a larger amount is subtracted to estimate pure rent vs. situations when natural gas prices are falling. The recent decline in natural gas prices could explain to some degree the upward trend of owner's equivalent rent. In addition, the upward trend of the rent component of shelter costs also contributed to higher owner's equivalent rent. Higher rents reflect demand pressures on rental property as rising mortgage rates could have priced out otherwise eligible potential home owners. The rent index moved up 0.4% in March after a 0.3% gain in February and a 0.1% increase in January.



The 1.0% jump in apparel prices in March is partly due to poor seasonal adjustment. Although apparel prices are seasonally adjusted, data indicate that there is tendency for the apparel price index to post sharp increases in March when spring fashions are introduced. Therefore, the jump in the apparel price index during March should be partly discounted. Other price changes of importance are higher prices for medical care (+0.4%), increases in airfares (+1.1% in March, after gains of 1.2% in January and February), and a0.1% drop in the price index of new cars.

Conclusion – The March CPI data eliminate doubts, if any, about a 25 bps increase of the federal funds rate to 5.00% on May 10. The path of monetary policy after the May meeting is more challenging to project. The minutes of the March 28 FOMC meeting reveal that the FOMC is concerned about core inflation and inflation expectations. Today's core inflation number favors the hawks in the FOMC. The Fed is in a tight spot because it has to weigh the costs of tightening further, based on a lagging indicator such as inflation, to maintain its credibility vs. the benefit of pausing and possibly enabling a soft landing, based on signals of a leading indicator, such as housing. Incoming housing information -- housing starts, permits, and homebuilders survey results -- and sales and inventories of new and existing homes point to a significant loss of momentum in this market. The housing market has a wide reach in the current expansion where the direct and indirect effects have been significant. The dollar is an additional factor to consider in this tightrope walk. Therefore, the June call for the Fed is more complex than the decision to raise the federal funds rate a few months ago. Recent Fed rhetoric (Kohn, Hoenig, Yellen and minutes of the March 28 FOMC meeting) suggests that the FOMC has been inclined toward pausing after the May 10 hike. The futures market indicates a lower probability for a June hike in the federal funds rate today compared with the estimates seen earlier in the month. The Fed Board staff's forecast calls for some upward drift in core inflation this year, then moderation in 2007. Today's March CPI data are not in conflict with that forecast. Assuming that the April and May core CPI and PCE price index increase are less than March's and assuming that the housing data in the coming months show continued weakening, then we think the FOMC will pause at funds rate target level of 5%. But make no mistake about it; the Fed is walking a policy tightrope now. If there is a net below, it is a long way down.

HIGHLIGHTS OF THE CONSUMER PRICE INDEX – MARCH 2006

	% change	annualized change		% change	
	prior month	3 mo. ago	6 mo. ago	year ago	y-o-y '05**
CPI - ALL ITEMS	0.4	4.3	1.2	3.4	3.4
CORE - ALL ITEMS LESS FOOD & ENERGY (77.4)*	0.3	2.8	2.7	2.1	2.2
CPI ALL ITEMS LESS ENERGY (91.3)	0.2	2.6	2.7	2.2	2.2
FOOD (13.9)	0.1	2.5	2.5	2.6	2.3
ENERGY (8.69)	1.3	21.8	-10.8	17.3	17.1
SHELTER (32.26)	0.4	3.6	4.0	2.5	2.6
COMMODITIES (40.79)	0.6	5.3	-3.2	2.9	2.7
COMMODITIES LESS FOOD & ENERGY (22.31)	0.3	1.4	0.6	0.3	0.2
SERVICES (59.2)	0.2	3.6	4.5	3.8	3.8
SERVICES LESS ENERGY SERVICES (55.05)	0.3	3.4	3.7	2.8	2.9
FRB CLEVELAND MEDIAN CPI	0.4	3.7	3.1	2.7	2.5

** - Dec.-to-Dec.

* - Figures in parentheses denote the relative importance of each category in the CPI.

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BoE Minutes Confirm Wait and See Stance

The minutes of the Bank of England's Monetary Policy Committee (MPC) meeting on April 6, released this morning, confirm the widespread view that UK interest rates are unlikely to shift over the next few months. What is not clear – either to the MPC members or to the markets – is just where the economy and interest rates are headed, once we get into the closing months of this year.

As widely expected, only one member of the Committee voted for a rate change two weeks ago, with noted dove Stephen Nickell (who retires from the MPC after the May meeting) arguing once again for a 25bp cut. Nickell still fears that considerable slack in the economy, combined with the effect of higher energy prices on consumption, could push inflation below target.

The other members still see upside risks to prices from higher energy costs, noting that inflation expectations have been picking up in recent surveys. Indeed, the latest survey update from the BoE, released yesterday, showed median expectations for the rate of inflation over the coming year at 2.7%, up from 2.6% the previous month and the highest level since comparable records began six years ago.

Overall the minutes conclude that, allowing for erratic movements, the economy and consumer spending have been growing at roughly trend levels over the last couple of quarters. The members noted that there is little evidence of a slowdown in the housing market and that asset prices should support consumer demand going forward. The conclusion is that inflation remains close to the 2.0% target with some upside risks in the near term related to recent increases in energy prices.

With oil prices scaling new heights, it will be interesting to see if some of the members get more vocal about the risk that soaring utility bills could encourage inflationary pay demands, although there is no evidence of this yet.

So, it's rates on hold and watch the data, starting with March CPI tomorrow and retail sales on April 24. Preliminary Q1 GDP is due for release on April 26 with the GFK consumer confidence indicator on the 28th. March mortgage lending and credit data come out May 4, the same day as the next BoE rates decision.