



This week's series of unexpected events proved that volatility lives on ad infinitum in the fixed-income markets. From the Fed's mishap with their FOMC statement and the Treasury's surprise announcement of a 30-year bond to the downgrading to junk status of the two major US auto companies, the markets zigged and zagged in turmoil. No one ever said the US economy's transition to the "flat world" described by Thomas Friedman would be easy. In fact, it's awfully painful.

America's Painful Transition to a Flat World

We have completed our reading of Thomas L. Friedman's latest book, *The World Is Flat: a Brief History of the Twenty-first Century*, and this week's string of unexpected events in the capital markets reminded us just how painful transition really is. If you've been considering reading it, we strongly suggest it. The titles of the first two chapters just about say it all: "While I Was Sleeping" and "The Ten Forces that Flattened the World." The book begins with the fall of the Berlin Wall in 1989 and covers the birth of the Internet and its ramifications on the global economy. It is well worth a read. This week's events reminded us that those who can accept gut-wrenching change will survive the transition and those who fight it will not.

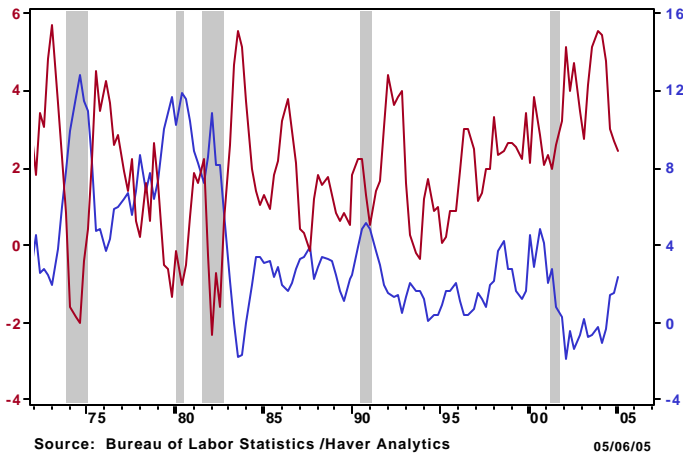
Fixed-income participants — most of whom were expecting long-term interest rates to return to 5% at some point this year, based on the notion that growth would moderate with lower productivity and higher inflation — have been taken for a ride. Growth does seem to be moderating a bit, but the market is still trying to determine whether it's a soft patch or lower trend. (We say it's only a soft patch.) Productivity is not slowing as much as expected, and the long end of the yield curve is telling us inflation is not a problem. These facts have kept ten-year yields moving steadily below 4.5%, a problem even the Fed is having difficulty with. How does the Federal Reserve stop speculation in certain asset classes and segments of the economy if long rates don't cooperate and move higher? The answer to that question this week was to re-issue the long bond. While the Fed would prefer to let speculative bubbles burst on their own, it cannot do so at the risk of destabilizing the capital markets. Thus Greenspan's comments on risk transfer and financial stability at the Federal Reserve Bank of Chicago's conference were particularly apropos this week.

Such is a fact of life in the flat world. Growth stays relatively high along with productivity while interest rates — both short and long — stay quiescent and any potential inflationary pressures are held at bay. This can be frustrating for those who believe the economy must return to a 1970s-style environment. These market participants should read Friedman's book to understand the deep and profound changes that have taken place and how they have affected the behavior of US capital markets.

Considering all the headlines in the financial press heralding the start of stagflation, it's easy to see that transition to a new way of thinking and a new model of the global economy does not come easily. Changing patterns of thought is one of the most difficult things for human beings to do. Stagflation is an outdated economic concept that has no place in the global economy of the 21st century. (Please see our latest Bloomberg column, "1970s Stagflation? Not a Reality," at www.bloomberg.com.)

Nonfarm Business Sector: Output Per Hour/All Persons
 % Change - Year to Year SA, 1992=100

Nonfarm Business Sector: Unit Labor Cost
 % Change - Year to Year SA, 1992=100

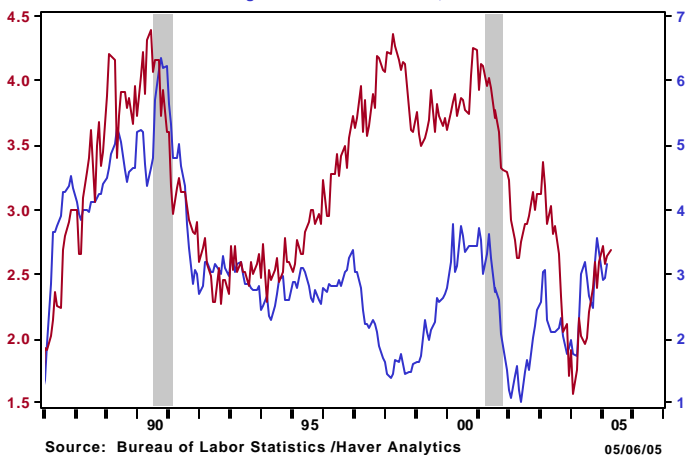


Source: Bureau of Labor Statistics /Haver Analytics 05/06/05

over-year advance in Friday's average hourly earnings report or the 2.2% rise in year-over-year unit labor costs. While headlines say that such a rise is endemic of brewing inflationary pressures, we maintain that this couldn't be further from the truth. The flat world simply won't permit it. Unit labor costs have come out of their long slump from 2001 to 2004, when companies driven by lagging sales were forced to cut their principal cost: labor. Now, with both domestic and international demand relatively robust, they can afford to lift wages a bit to attract ideal job candidates. This is good news, not bad news. Rising wages in the current environment cannot and will not translate into higher consumer price inflation because of intense competition. Barring unforeseen protectionist pressures, both unit labor costs and inflation will remain quiescent. So this is just more evidence of how the flat world is changing the paradigm of how we view the economy. It's time to accept it.

Average Hourly Earnings: Total Private Industries
 % Change - Year to Year SA, \$/Hour

CPI-U: All Items
 % Change - Year to Year SA, 1982-84=100

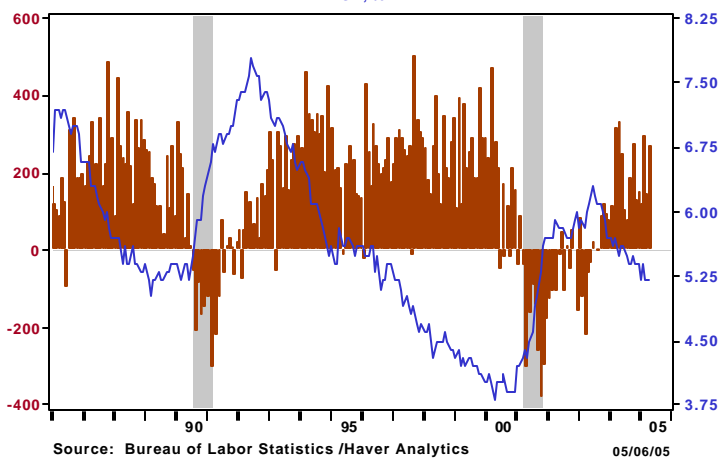


Source: Bureau of Labor Statistics /Haver Analytics 05/06/05

For this reason, we are not worried by the 2.7% year-over-year advance in Friday's average hourly earnings report or the 2.2% rise in year-over-year unit labor costs. While headlines say that such a rise is endemic of brewing inflationary pressures, we maintain that this couldn't be further from the truth. The flat world simply won't permit it. Unit labor costs have come out of their long slump from 2001 to 2004, when companies driven by lagging sales were forced to cut their principal cost: labor. Now, with both domestic and international demand relatively robust, they can afford to lift wages a bit to attract ideal job candidates. This is good news, not bad news. Rising wages in the current environment cannot and will not translate into higher consumer price inflation because of intense competition. Barring unforeseen protectionist pressures, both unit labor costs and inflation will remain quiescent. So this is just more evidence of how the flat world is changing the paradigm of how we view the economy. It's time to accept it.

All Employees: Total Nonfarm
 Difference - Period to Period SA, Thous

Civilian Unemployment Rate: 16 yr +
 SA, %



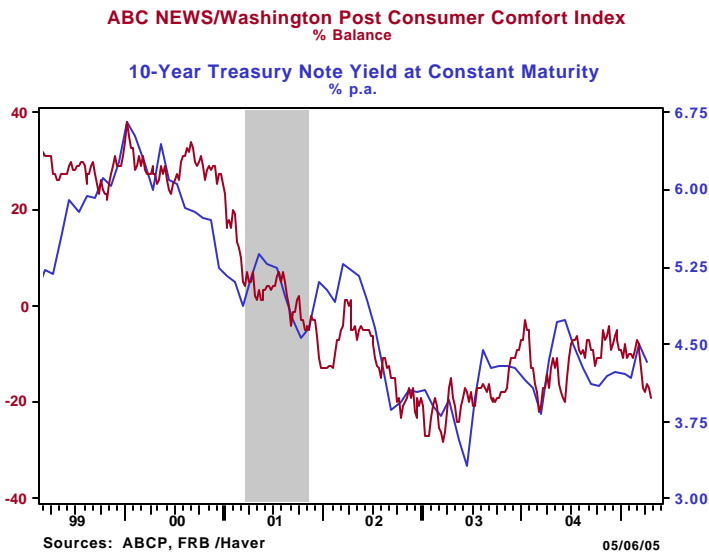
Source: Bureau of Labor Statistics /Haver Analytics 05/06/05

The April nonfarm payroll report was a surprise to the upside at 274,000 with upward revisions to both of the prior months. Strength in construction, business services, temporary jobs, and trade carried the number. The April figure was higher than the Q1 average of 190,000, but we don't believe this is the new trend rate. In 2005, nonfarm payrolls are likely to stay between 175,000 and 225,000 per month given the weak demographic picture in this decade.

The unemployment rate seems to have plateaued at 5.2%; we don't expect anything below 5% this year. Details of the report showed no sustained resumption in manufacturing job growth. While high-skilled manufacturing jobs are still a substantive part of the US labor force, lower-skilled jobs are going to destinations with cheaper production costs. We suspect that manufacturing jobs will show little growth in this cycle, another sign of the flat world. As we mentioned in our December 17 issue last year, "Ten Sources of New Job Growth for the Decade," much of the growth will come from business and professional services, construction, education, healthcare, and financial services. In order to

get these jobs, graduating seniors may have to pursue both college and graduate degrees. Working in a knowledge-based service economy requires a constant upgrading of skills to stay employed. It also provides ample opportunity for Internet-based business start-ups, which allow low cost of entry. These types of businesses will also be a major source of new job growth for the decade.

Late last year, we thought the yield on long-term US debt (the ten-year note) would stay confined to the 4%–4.5% range in 2005. In the first quarter, as economic data suggested a robust rate of growth, long-term yields moved above 4.5% anticipating higher inflation. In recent weeks, as data have portrayed a possible soft patch, yields have moved lower. This week's Consumer Comfort Index and the ten-year note yield portray what has happened during this time. As the soft patch evidences itself, the yield on long-term debt may move lower still. Once we clear this period (similar to June 2004), we are likely to see stronger growth and somewhat higher yields.



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