



In this week's issue, we'll examine the implications for the US Treasury yield curve in the remainder of this year and find out if our underlying thesis on long-term structural productivity is accurate. We look forward to this week's production reports for a better read on the manufacturing sector's soft patch as well as the May employment report. We expect nonfarm payroll at only 125,000 and an unchanged unemployment rate of 5.2%.

Higher Structural Productivity and Its Implications for the Yield Curve

The effects of a higher structural rate of productivity growth for this decade include inflation, unit labor costs, growth, short- and long-term interest rates, and the shape of the yield curve. We discussed this in our February 4 issue entitled "Productivity Plateaus at New Structural Level, Requiring Fewer New Jobs." That issue explored the recent news headlines on decelerating productivity growth and rising labor costs.

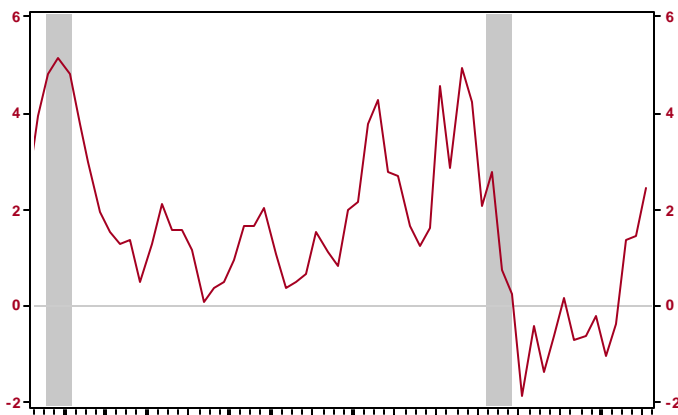
We said, "Productivity is decelerating from its very rapid pace of the last three years — 4.3% in 2003, 4.5% in 2004, and 4% thus far in 2005 — when severe cost-cutting pressures forced companies to figure out how to use the technology they bought at the end of the 1990s to become more efficient and productive. We doubt very much that this process is over; therefore we believe it is premature to conclude that high productivity gains are behind us. We have believed since late 1999 that productivity would plateau in the 2.5%–3% range during this decade."

This week's upward revision to Q1 GDP from 3.1% to 3.5% — and its consequent revisions to wages and salaries in the personal income component of GDP for Q4 — implies that growth and underlying productivity is trending higher. Once per quarter, the Bureau of Economic Analysis (BEA) incorporates more complete data on payrolls and wages from the unemployment insurance data, otherwise known as the ES202 data. This week's GDP report incorporates this information and shows a very large upward revision for Q4 to 10.4%. This implies that income growth was much stronger in Q4, which helps explain why Q1 personal consumption stayed strong in the face of high oil and gasoline prices. We have long argued that wealth is a driver of consumption, whether it comes from rising asset prices of stocks and bonds or a home. In this case, much of the upward revision to personal income came from more jobs, higher wages, and capital gains.

Unfortunately, we cannot dissect the weightings of each of these in the revision. Either there were more nonfarm payroll jobs created in Q4 or higher wages (or both). If it was the former, there are implications for productivity growth. As we mentioned in early February, we believe job growth in 2005 will amount to 2.1 million new jobs, or 150,000–175,000 new jobs per month. Already in Q1 2005, average monthly nonfarm payroll growth is 190,000. April's outsized gain of 274,000 implies smaller gains for May and June. We are forecasting a gain of 125,000 for May nonfarm payrolls and an unchanged unemployment rate of 5.2%. We see average hourly earnings rising 0.3%.

Nonfarm Business Sector: Unit Labor Cost

% Change - Year to Year SA, 1992=100



Source: Bureau of Labor Statistics /Haver Analytics

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As a result of these revisions, we are convinced that our underlying thesis is accurate: Productivity in this decade will not decelerate and plateau at 2.5% — as cost efficiencies and new Internet technology continue to be implemented and as creativity in this area soars, it will be that much higher. In our February piece we concluded that the range for this decade would be 2.5%–3%, but we also mused about the underlying rate trending above 3% for a sustained period of time. The

accompanying chart shows the sharp deceleration in productivity. This week the BEA will release productivity figures for Q1 2005 as well as a revision to Q4 2004. Our best guess is that the trend rate you see on the chart will turn upward toward 3%. We believe this is where the new sustainable rate will be over the next several years.

This conclusion basically hearkens back to our long-run growth thesis put forth in an issue we wrote in May 2000, entitled “Deflationary Boom Now or After Recession.” In that issue we forecast that growth in this decade would average 4%–5%, inflation as measured by the CPI would stay at 2%–3%, and low-level interest rates would be permanent. Our 2005 outlook piece also spelled out that this year would be the transition year in which this thesis would prove true. We are now witnessing the unfolding of these events. As we have mentioned many times before, it is impossible for inflation to accelerate as a result of all the structural changes in the US and global economy in

the last two decades. These changes have produced open global borders for trading and capital movements. In this environment, inflationary pressures cannot brew long term. The Fed's actions in the last year consist largely of moving the federal funds rate from 1% to neutral. In a speech to the Economic Club of New York last week, Greenspan said that the concept of neutral is nebulous. We have determined — based on the current performance of inflation as measured by the CPI, GDP deflator, and PCE deflator — that the Fed must stop raising interest rates at 3.5%.

We expect the Fed to raise rates by 25 bps at the next two meetings and stop at neutral. *Thus, we define neutral as 3.5%.* As much as the Taylor rule can be applied to determining the exact level of the nominal fed funds rate consistent with noninflationary growth, a neutral fed funds rate is still a nebulous concept.

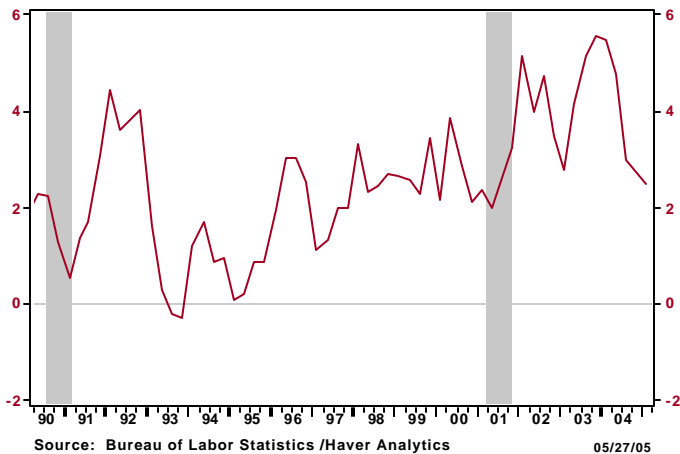
Note the accompanying chart, which shows the relationship between productivity and the yield curve (the ten-year to federal funds rate spread). If our thesis on productivity is correct and the trend rate is 3%, then the yield curve may also plateau in a range of 150–250 bps once the federal funds rate reaches neutral at 3.5%.

Of course, this leads us to a discussion of what the current nominal yield on the ten-year note is telling us at 4%. How can the interpretation be anything other than that productivity is higher, growth is stronger, and inflation is not an issue? Inflationary expectations embedded in

the long end of the yield curve are minimal. Note the chart on the next page, which shows the very long-term real yield on the ten-year note. What are we to conclude except that we have reached a sustained noninflationary rate of growth? As one economist colleague said, “The risks of inflation and deflation are now equally weighted.” This may be an extreme view as long as the US dollar remains the world's reserve currency. If inflation is no longer an issue, this implies that the back end of the yield curve is driven by “other factors” or exogenous events such as the Chinese purchases of US Treasuries, dislocations related to hedge fund events, and/or mortgage market dislocations. We have said before that this concept may be difficult for older traders of the capital

Nonfarm Business Sector: Output Per Hour/All Persons

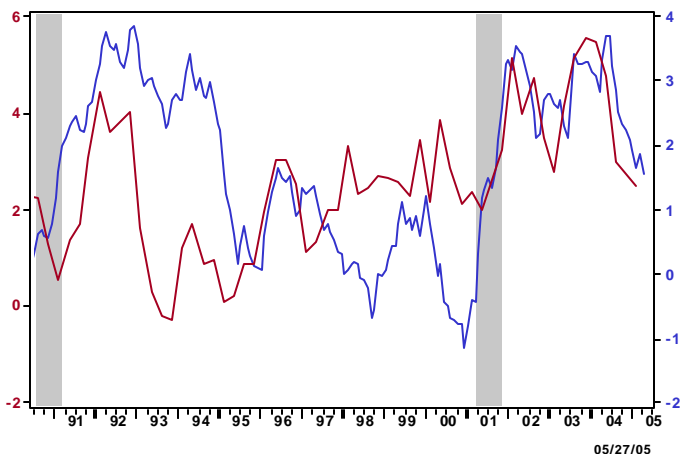
% Change - Year to Year SA, 1992=100



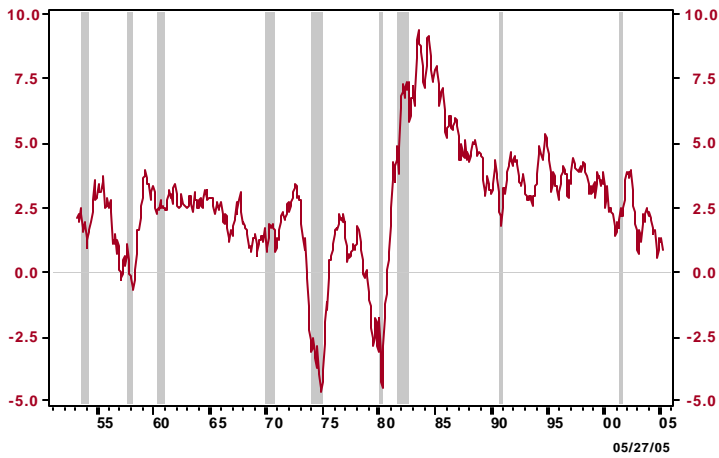
Nonfarm Business Sector: Output Per Hour/All Persons

% Change - Year to Year SA, 1992=100

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markets to grasp. It will be very hard to trade the long end of the yield curve when it stays confined to such a narrow range.

As for this week, we look forward to the Chicago PM and ISM reports for a more exact reading on the manufacturing sector. Consumer confidence, despite all the hand-wringing, is hanging on quite nicely, and productivity saves the day.

If our 2005 economic outlook of 4% growth, 2.7% CPI, 3% productivity, and a 3.5% peak in fed funds is correct, this implies a flattening out of the yield that traders and portfolio managers should plan for.

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