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FINANCIAL FUTURES & OPTIONS

111 RIVER STREET, 11TH FLOOR, HOBOKEN, NJ 07030

TEL (201) 626-1000 FAX (201) 626-1577

Web Site: www.mizuhosecurities.com

Prices of Treasury securities and their related futures instruments finished with small mixed changes this past week. Earlier in the week, Treasury prices were supported by the flight-quality-bid that continued to exist for U.S. Treasury securities due to fears of a breakdown in the credit derivatives market spilling over from the previous week. However, these fears eased toward the end of week partly in response to an announcement by Fitch Ratings Agency that, although it downgraded Ford Motor Credit by one notch to BBB, it "views it as unlikely that Ford would be downgraded to non-investment grade in 2005." As a result, automotive sector bonds reversed direction, helping to stabilize credit fears at the same time. Meanwhile, the economic data released was mixed. Most notable were the April price reports. While the total PPI (+0.6%) and CPI (+0.5%) both continued to feel the impact of another large jump in energy prices, the core components turned out to be mixed. The core PPI increased by a larger-than-expected 0.3%, boosted by rebounds in passenger car and light truck prices and a sizable increase in tobacco prices. In contrast, the core CPI surprised market participants by remaining unchanged, held back by paybacks in lodging away from home and apparel prices (the same two components behind the previous month's outsized 0.4% increase). Most important, on a year-over-year basis, the core PPI remained unchanged at +2.6%, while the core CPI eased to +2.2%.

Insight into the coming weeks' economic highlights. Over the next two weeks, market participants will receive the latest economic releases highlighting inflation, manufacturing activity, consumer and capital spending, and employment. Most relevant will be the May employment report (Friday, June 3). We anticipate that the seesaw pattern witnessed in payroll gains during the first four months of 2005 likely continued in May, with total nonfarm payrolls increasing 175,000, down from the weather-induced 274,000 surge registered in April. While weather conditions across the U.S. during late April and early May turned out to be much drier than usual, they also proved to be much cooler than average, likely stifling some typical spring hiring. Of note, construction employment should ease slightly in May from its recent breakneck pace. Similarly, leisure and hospitality employment is also likely to slow from last month's sharp jump. Potentially offsetting some of the expected slowdown in payroll gains could be another upward revision to the previous months' data. Based on historical data, the BLS has reported net cumulative upward revisions to the March and April employment figures in 9 out of the past 10 years. Meanwhile, the employment rate will likely stay unchanged at 5.2%; however, the risk of a small increase is not out of the question as discouraged workers continue to re-enter the workforce. Recall that last month the unemployment rate was able to hold steady, as a surge of new entrants was successfully absorbed directly into the employed labor pool. Also attracting market participants' attention over the next two weeks will be the CAPM (Tuesday, May 31) and ISM (Wednesday, June 1) manufacturing surveys. In contrast to the New York and Philadelphia Feds' regional surveys, we anticipate that the Chicago and National surveys will indicate that manufacturing activity continued to expand at a pace similar to that reported in April. This would be a welcome improvement for the ISM's headline index, which has declined for the past five consecutive months. Turning toward the consumer, although unit motor vehicles sales (Wednesday, June 1) are expected to have slowed slightly in May from the strong sales pace registered in April, they are still expected to remain at a relatively lofty sales pace of 16.7 million. Additionally, chains store sales are expected to snap back from April's post-Easter holiday-related weakness, with year-over-year sales expected to increase 3.0% in May. The April durable goods report (Wednesday, May 25), which highlights non-residential fixed investment, will also be watched closely as market participants gauge how capital spending started out the second quarter following the slowdown witnessed in the first quarter. Lastly, market participants will pay close attention to the price deflators contained in the April personal income and outlays report (Friday, May 27), specifically the core PCE deflator, the Fed's preferred measure of inflation. Recall that last month's year-over-year growth rate in the core PCE deflator edged higher to 1.7%.

May 3 FOMC minutes to provide additional guidance into Fed thinking. The Federal Reserve will release the minutes of its May 3 FOMC meeting on Tuesday, May 24. Since the May 3 meeting, the number of public appearances by Fed policymakers highlighting current economic condition and/or monetary policy has been significantly less than usual. As a result, market participants have been provided with little additional guidance into the Fed's stance on recent economic developments and policy inclinations during the current lengthy inter-meeting period. Of the few Fed members that did make public appearances, St. Louis Fed President Poole noted that the Fed members will continue to determine if the recent rapid price increases are a "temporary blip" or a "more fundamental inflation problem;" whether the "recent moderation in economic growth is likely to persist;" and at what point monetary policy will be "sufficient to maintain long-run price stability." Additionally, Dallas Fed President Fisher reinforced that "The FOMC's job is to keep a steady hand and not be carried away by noise or the tendency of markets to have significant mood swings." Overall, we believe that, similar to the March 22 FOMC minutes, policymakers will remain optimistic regarding the economic outlook, while also reiterating that future inflation should remain relatively low. Recall that the Fed's March 22 minutes proved to be significantly less hawkish on inflation than market participants had feared.

May 20, 2005

We wish our readers a happy holiday.

Due to the Memorial Day holiday, the next issue of the Mizuho Letter will be published June 3, 2005.

Glenn Haberbush, Economist (201) 626-1181

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