

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 5, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	January 5	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.04%	5.01%	4.95%	3.99%
6-month Treasury bill	5.08	5.08	5.06	4.22
3-month LIBOR	5.36	5.36	5.36	4.51
2-year Treasury note	4.76	4.81	4.68	4.41
5-year Treasury note	4.65	4.69	4.53	4.35
10-year Treasury note	4.65	4.70	4.56	4.39
30-year Treasury bond	4.74	4.81	4.66	4.61
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.70	3.69	3.51	3.52
10-Year	3.92	3.91	3.74	3.98
30-Year	4.39	4.38	4.21	4.50
30-year fixed mortgage rate	6.18	6.18	6.11	6.22
15-year fixed mortgage rate	5.94	5.93	5.84	5.76
1-year adjustable rate	5.42	5.47	5.43	5.15
STOCK MARKET				
Dow Jones Industrials	12398.01	12463.15	12307.49	10717.50
S&P 500	1409.71	1418.30	1407.29	1248.29
NASDAQ	2434.25	2415.29	2437.36	2205.32
Commodities				
Gold (\$)- 100 OZ	606.60	638.60	628.60	513.00
Oil (\$ per barrel) - Crude Futures (NYMerc)	56.15	60.94	62.08	61.06
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index(December)	51.4	49.5	51.2	52.4
ISM Non-Manufacturing Index(December)	57.1	58.9	57.1	56.3
Non-Farm Payrolls (Dec) - Change in 000s	167	154	86	161
Average Hourly Earnings (Dec) - % Change	0.5	0.3	0.4	0.3
Unemployment Rate (Dec) - Percent	4.5	4.5	4.4	4.5

Much as was the case in the closing weeks of 2006, the financial markets started the new year digesting fresh data pointing to both strength and weakness for the U.S. economy. Recall that during most of the just-completed fourth quarter, fears the economy was vulnerable to a looming housing-led correction escalated. That prospect was dramatically foreshadowed by the headline numbers, which traced the sharp slowdown that had already taken place. After rising by a sturdy 5.6 percent annual rate in the first quarter, real GDP posted a growth rate of 2.6 percent in the second quarter before slowing to just 2.0 percent in the third quarter. Another notch down would have brought the economy's growth rate perilously close to stagnation, where even a modest shock could tip it into the recessionary quicksand.

But just as the ship appeared to be sinking, the endgame was short-circuited by surprisingly stronger data. Yes, the housing meltdown dried up a vast reservoir of purchasing power, as home equity became an indispensable source of funds for households to tap into in recent years. But even as home values were shrinking in the fourth quarter, surging equity portfolios, thanks to the robust gains in stock prices, bolstered household balance sheets. Simply put, the stock market's rally offset much, if not all, of the negative wealth effect associated with the housing correction, cushioning the blow that was supposed to

bring down consumer spending.

Indeed, as 2006 drew to a close, it became readily apparent that households were not about to run for the hills. Consumer spending held up quite well over the holiday shopping season, prompting economists to revise up their fourth-quarter growth estimates, which now center around 2 ½ - 3 percent. Still, there was enough evidence to nourish recession fears as well as the growing conviction of pessimists that the Federal Reserve would need to cut interest rates as early as the spring of 2007 to sustain the expansion. For one, the direct and indirect effects of the housing correction were expected to become more severe in coming months, leading to broader layoffs, slower income growth and weaker confidence – all growth-retarding influences. Second, the domestic auto industry remained in the grips of its own recession, struggling with high inventories and the ongoing shift in consumer preferences towards foreign models. (For all of 2006, domestic auto sales were the lowest since 1993.) Scheduled production cutbacks in Detroit threatened to accelerate layoffs throughout the manufacturing sector, reflecting the growing impact of the cutbacks on the extended chain of companies that supply parts and materials to automakers.

As the calendar page turned to 2007, the prevailing view was that the twin recessions in housing and autos would weigh heavily on growth, but the economy has enough offsetting strengths to keep the expansion going. This is a portrait of the seductive soft landing that so enamored the financial markets during most of 2006, although cracks in the solidarity among investors began to appear in December. As the chart shows, all major financial asset classes generated positive returns for investors last year, with stocks leading the way. The Russell 3000 stock index closed out the year with five consecutive monthly gains, lifting the yearly return (including price appreciation and dividends) to 15.8 percent, more than double the 6.2 percent return in 2005. But the performance in the fixed income markets was not too shabby either. Led by junk bonds, which returned 11.6 percent, all bond categories turned in a stronger performance last year than the year before, despite an upward spike in bond yields over the first half of 2006.



As the year wound down, however, a key element of the soft landing scenario that nourished both stocks and bonds during the second half of 2006 became less of a given for bond investors. As it became apparent that consumer spending was holding up and the economy was further away from slipping into a recession than thought, the expectation that the Fed would cut interest rates sooner rather than later began to fade. Without a rate cut, a crucial variable that helped push bond yields below short-term yields over the second half of the year – creating the so-called negative yield curve – would be withdrawn from the equation. Not surprisingly, as the perception that the Fed might remain on hold longer than expected gained traction, bond yields moved up, resulting in negative returns for all bond classes except junk bonds (which have many equity characteristics) in December.

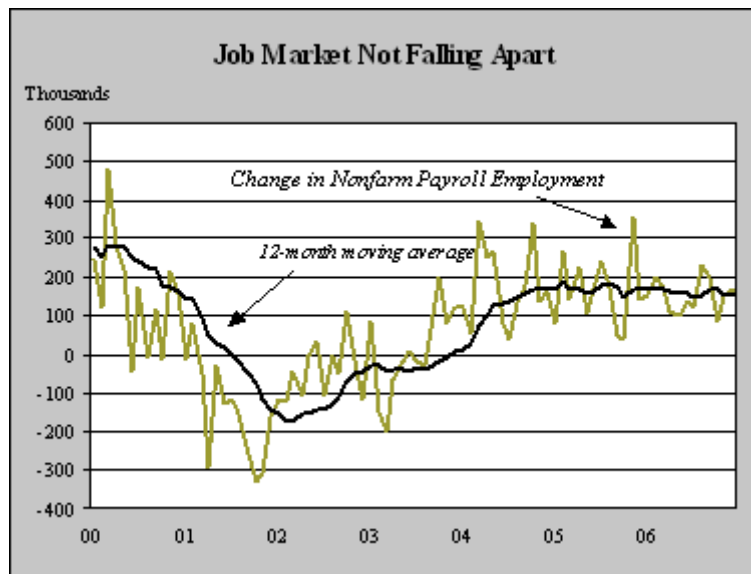
To be sure, stocks are not immune to what the Fed does. Like the bond market, equity investors were also cheered by the prospect of an imminent rate cut, as such a move would re-energize the growth drivers propelling the economy forward. Bond investors, however, view a Fed rate cut through a different lens, seeing the move as another sign the economic ship is sinking and inflation is ebbing, thus validating the message embedded in the negative yield curve. In and of itself, the failure of the Fed to lower rates is not discouraging to equity investors, as it implies the economy is strong enough to forge ahead on its own power. What is disturbing to the stock market, however, is the prospect that the Fed may have to raise rates to counter what it perceives as overly strong inflationary pressures. That, of course, would open the door to another policy mistake, reminiscent of those in the past that ultimately sent the economy into a tailspin.

Whether or not such a perception factored into the stock market's setback this week is open to debate. But after starting out the new year on the fence with regards to Fed policy, the markets ended up the week less convinced that the next move would be a rate cut. Significantly, the release of the minutes of the December 12 policy meeting on Thursday gave the impression that the Fed was moving towards a more neutral position about the economy. While the voting members still emphasized the risks of inflation, there was a growing sense of unease about the economy's underlying strength. For example, the minutes noted that "Several members judged that the subdued tone of some incoming indicators meant that the downside risks to economic growth in the near term had increased a little and become a bit more broadly based than previously thought."

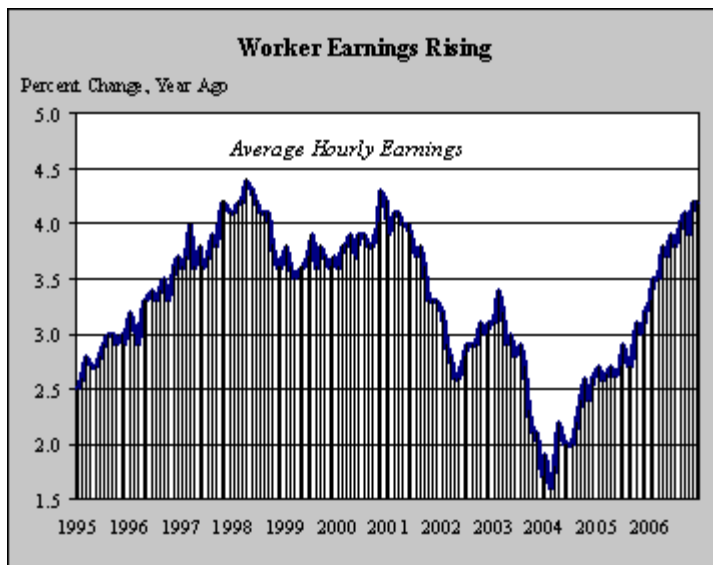
To several market analysts, this conditional statement implied that the Fed was edging closer towards issuing a more balanced policy statement after the next meeting, scheduled at the end of this month, which would pave the way for a possible rate cut in March. Those thoughts, however, vanished almost as quickly as they surfaced on Friday when – once again – the markets were whiplashed by stronger economic data than anticipated. What's more, the greater strength this time applied to the one facet of the economy that is considered to be the cornerstone of its performance, namely the job market. It's important to remember that households spent every penny of their incomes and then some over the past two years because the rapid appreciation in home values contributed to gains in their net worth positions. Hence, it was not necessary to put aside funds from weekly paychecks, as the real estate market was essentially fulfilling the savings goals for households.

However, with the bursting of the housing bubble, households now find themselves having to rely on current incomes to satisfy spending as well as their savings targets. Since that means a greater portion of paychecks needs to be put aside for savings, some spending would have to be deferred, if not abandoned, underscoring the case for a consumer retrenchment this year. To the pessimists, the housing correction together with the inevitable weakening in the job market constituted a double whammy for the economy, as sagging wealth as well as the shortfall in incomes were sure to bring on a severe consumer pullback. But for this scenario to play out, the job market would have to cooperate – and so far, just the opposite appears to be taking place.

Instead of ratcheting back on their hiring plans, companies are beefing up payrolls far more than expected. According to Friday's jobs report, nonfarm businesses added 167 thousand workers to payrolls, considerably more than the 115 thousand or so forecasted by economists. What's more, earlier estimates of job growth for October and November were revised up by a combined 29 thousand workers. Simply put, there is little sign that the job market is heading for hell in a handbasket, as the doomsayers assert. The 167 thousand employment gain in December was stronger than the 153 thousand average monthly increase during 2006, and more than enough to keep the jobless rate from moving up. Indeed, the jobless rate held steady at a low 4.5 percent in December, which is consistent with general notions of a fully-employed economy.



More to the point, the tight labor market combined with the still-robust demand for labor is having a predictable effect on income growth. In December, average hourly earnings jumped by 0.5 percent after an upwardly-revised 0.3 percent increase in November. Compared to a year ago, wages are up by 4.1 percent, an annual increase not seen since February 2001. Simply put, households headed into 2007 with incomes growing at a muscular pace, suggesting that paychecks should be fat enough to support both solid spending gains as well as some increase in savings. If indeed that turns out to be the case, the prospect that the Federal Reserve will be forced to jump-start growth by cutting interest rates anytime soon should recede into the woodworks.



We suspect that the pendulum of market sentiment will swing to the other extreme in coming weeks and months, as the economy shows more signs of strength than weakness and inflation concerns take center stage. For one, there is a rash of gift cards waiting to be spent this month, which will be reflected in robust retail sales for January. Last year, purchases of gift cards totaled \$25 billion, up 34 percent from the previous year and retail analysts expect that an even stronger increase occurred in December 2006. Second, the drop in oil prices and the unseasonably warm temperatures throughout the Northeast are slashing home heating bills, providing households with even more discretionary funds to spend. Finally, business capital spending, particularly for computers, should receive a significant, if temporary, boost from the introduction of the Vista operating system. If the housing correction also appears to be nearing an end – as some recent data tentatively suggest – the curtain could ring down on the doomsayers' conviction that the economy is poised for a recession. While it's far too early in the year to make such judgments, that won't stop the financial markets from jumping to conclusions. Be prepared for a bumpy ride in the weeks to come.