

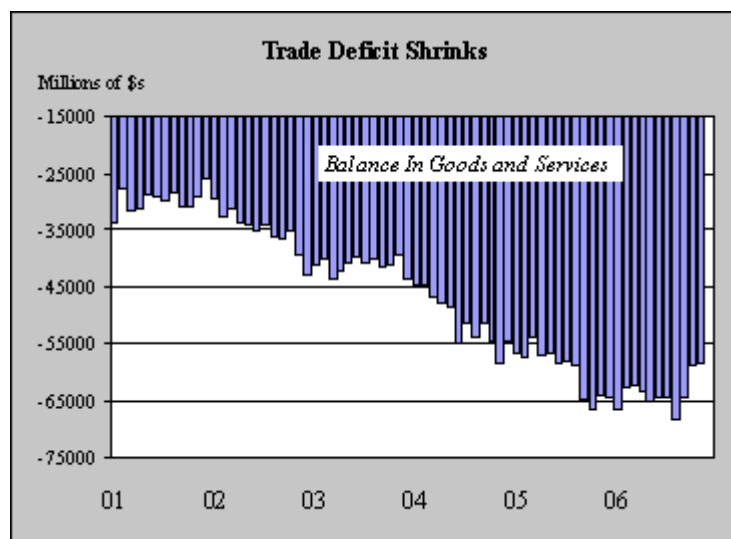
WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 12, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	January 12	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.08%	5.04%	4.90%	4.32%
6-month Treasury bill	5.14	5.08	5.05	4.42
3-month LIBOR	5.36	5.36	5.37	4.55
2-year Treasury note	4.88	4.76	4.72	4.33
5-year Treasury note	4.76	4.65	4.57	4.28
10-year Treasury note	4.77	4.65	4.59	4.35
30-year Treasury bond	4.86	4.74	4.72	4.52
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.72	3.70	3.58	3.48
10-Year	3.94	3.92	3.82	3.91
30-Year	4.44	4.39	4.28	4.47
30-year fixed mortgage rate	6.21	6.18	6.12	6.15
15-year fixed mortgage rate	5.96	5.94	5.86	5.71
1-year adjustable rate	5.44	5.42	5.45	5.15
STOCK MARKET				
Dow Jones Industrial	12556.08	12398.01	12445.52	10959.87
S&P 500	1430.73	1409.71	1427.09	1287.61
NASDAQ	2502.82	2434.25	2457.20	2317.04
Commodities				
Gold (\$)- 100 Oz	627.10	606.60	618.80	557.00
Oil (\$ per barrel) - Crude Futures (NYMEX)	12.85	56.15	63.33	63.92
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (Nov) - Mlns of \$	12333	-1255	3729	9253
Trade Deficit (Nov) - Mlns of \$	58233	58804	64239	63146
Retail Sales (December) - % change	0.9	0.6	-0.2	0.3

With Friday's release of a strong retail sales report for December, the evidence continues to mount that the economy entered the new year on a solid footing. As noted last week, workers found jobs plentiful last month and enjoyed fatter pay packages to boot. That combination portends healthy income gains going forward and solid support for continued sturdy spending gains. What's more, plunging oil and natural gas prices are imparting an extra boost to household buying power, reinforcing the positive employment and income fundamentals.

In addition to the late-week revelation of consumer shopping habits, another report released earlier in the week indicated that the economy's engine was firing on more cylinders last quarter than thought only a few weeks ago. Thanks to escalating growth among our major trading partners – which is igniting higher inflation expectations and induced at least one central bank, the Bank of England, to hike interest rates this week – American companies are selling more goods and services overseas, bringing about a marked reduction in our trade deficit. According to the latest Commerce Department estimate, the gap between imports and exports, which had been steadily rising throughout the expansion, narrowed again in November, following a significant shrinkage in October. The \$571 million reduction in November brought the trade deficit to \$58.2 billion, the lowest since July of 2005.



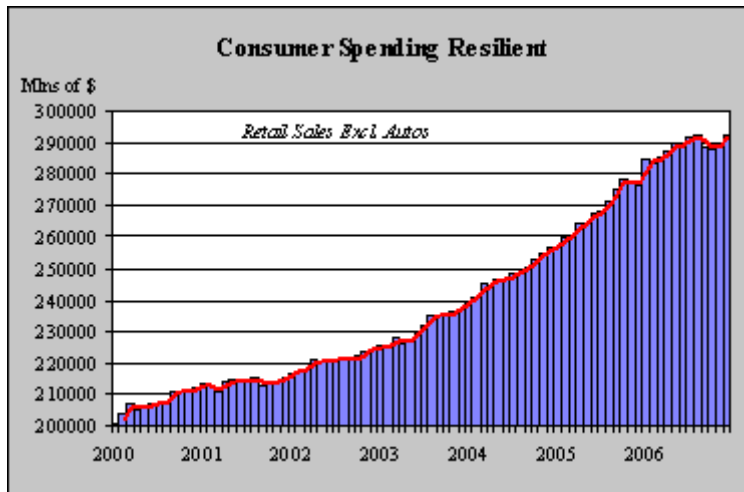
To be sure, sliding oil prices helped, reducing the dollar cost of petroleum imports. Also, non-oil imports flattened, reflecting the attempt by U.S. retailers to reduce bloated inventories, much of which is brought in from overseas. But the real story for the month was the strength in exports, which grew by a solid 0.9 percent in November, boosting the volume 13.3 percent above the year-earlier level. While foreign shipments of civilian aircraft surged, the strength in exports during the month was broadly based, including muscular increases in sales of industrial supplies, other capital goods and non-auto consumer products. Simply put, the long-awaited contribution to U.S. growth from strengthening exports is well underway; not only is the global economy picking up speed, but three years of dollar weakening has made U.S. goods more competitive with foreign-made products.

While December's numbers on foreign trade have yet to be released, it's almost certain that the real trade deficit declined in the fourth quarter, providing another offset to the drag from the housing correction. More to the point is that the housing drag has so far not spread materially beyond the housing sector. For sure, the jury is still out on the ultimate knock-on effects that the weakening residential real estate market will have on households. As documented in earlier commentaries, there is little question that homeowners have tapped liberally into their housing equity to support spending in recent years. Not only have they extracted equity through refinancings and second mortgages, the rapid appreciation of home prices has made homeowners feel wealthier, and hence more willing to spend an ever-higher fraction of their paychecks. It is no coincidence that the personal savings rate has been negative for a record 20 consecutive months during the real-estate boom, as households simply felt that their retirement goals were being adequately funded by appreciating home values.

It comes as no surprise therefore that the bursting of the housing bubble would foster the perception that households will behave just the opposite way during the housing meltdown than they did during the real-estate boom. Instead of feeling wealthier, the sagging housing market should induce a sense of caution among households, whose major asset is no longer contributing to retirement nest eggs. With home prices falling, homeowners should feel poorer, not wealthier; and with the equity cushion embedded in housing values shrinking, they are being deprived of a major source of funds that had previously supported spending. In short, most forecasters had long assumed that the housing correction would have serious knock-on effects on consumer spending, resulting in an economic slowdown that would soon require Federal Reserve rate cuts to resuscitate growth.

But a funny thing is happening on the way to the apocalypse. Instead of retrenching, households are displaying a stubborn resilience in their spending habits that is confounding the Cassandras. The latest

example of this defiance is the December retail sales report, released on Friday. Based on the somewhat gloomy results given out by the major chain stores in recent weeks – signaling a disappointing holiday shopping season – the consensus had expected a tepid increase in retail sales for December, something in the neighborhood of 0.7 percent for total sales and 0.5 percent for non-auto sales. But these grinch-like numbers were greatly surpassed, as total retail sales increased by 0.9 percent and non-auto sales surged by 1 percent, more than double the consensus estimates. Yes, the original sales estimates for October and November were revised down a tad, but the overall gain for the final quarter of the year can only be seen as impressive by any standard.



What's more, the gain in real terms will look even more impressive when the final calculations are in. The greatest beneficiaries of consumer spending in December, for example, were the retailers selling electronics, who enjoyed a sales spike of 3 percent during the month. Keep in mind that prices of flat-panel plasma and LCD televisions have been dropping like a stone in recent months, which means that the huge sales gains for these sets will look even larger when converted into real dollars. Since real retail sales track closely with the real personal consumption component of GDP, we suspect that overall economic growth in the fourth quarter received a sizeable boost from household spending, resulting in a growth rate of roundly 3 percent. That would be a hefty step up from the 2 percent pace of the second quarter, and hardly a sign that the Federal Reserve would need to provide more stimulus through lower interest rates to keep the expansion on track. What's more, when the \$25-30 billion of gift cards purchased in December are redeemed this month, a significant oomph to January retail sales will be provided, giving the economy a good head of steam as 2007 gets underway.

What the pessimists failed to take into account in assessing the impact of the housing correction on spending is that household wealth consists of more than just real estate. True, the appreciation in home values has been the major contributor to household net worth over the past three years. But in 2006, the driving force behind rising net worth shifted back to financial assets. For example, household net worth held in the form of real estate assets rose \$1.034 trillion during the first three quarters of 2006 while the value of financial assets increased by \$2.049 trillion over that period. In the third quarter alone, the value of household financial asset holdings rose by \$747 billion, thanks mainly to a surge in stock prices, compared to a puny \$15 billion appreciation in real estate equity. Clearly, the shift away from real estate to financial assets accelerated in the fourth quarter, as stock prices continued to rally while home values sagged.

To be sure, it would be foolhardy to assume that the housing correction will not ultimately have a more serious, if delayed, impact on consumer spending. Hardly any industry expert believes that the correction is over; the only question is how severe the next leg of the housing downturn will be. If, in

fact, home sellers have to slash prices much more radically in coming months to get buyers off the fence, the impact on homeowner confidence could be quite harsh, leading to a much more abrupt spending cutback than has taken place so far. That, it turn, could erode confidence among businesses, leading to delays if not the outright abandonment of investment and hiring plans. The net result could be a cascading of self-reinforcing events that ultimately chokes off the expansion. Needless to say, such a course of events would be damaging to profits and undercut the stock market rally that has boosted household equity portfolios and sustained the rise in net worth.

However, the temptation to believe that the “sky is falling” on the housing market should also be resisted. With each passing week, there are more hopeful signs that the housing correction is moving through its late innings, and the endgame will not be catastrophic for the economy. Indeed, industry analysts generally expect that the slide in home sales and prices will continue through the first half of 2007, but the worst of the downturn is behind us. That perception appears to be validated by the recent trend in home sales, which have held up better than expected. And while home prices continue to fall, they are coming off extremely inflated levels and are still about 50 percent higher than they were at the beginning of the real-estate bubble. To the pessimists, that only means prices still have a great deal further to go before hitting bottom. But to most analysts, that is not a realistic prospect, given the underlying fundamentals of the housing market.

Our sense is that the housing market is still in the process of unwinding the excesses seen in recent years, but the ongoing correction will not be severe enough or last long enough to derail the economy from the expansion track. If, in fact, the intensity of the correction is gradually fading, as many believe, the drag on the economy will also lessen, allowing the offsetting strengths to reassert themselves. Nonetheless, as we already noted it is far too early to make firm judgments about the fate of the housing downturn. That’s particularly the case in light of the murky data that tracks the industry’s performance. For example, data on new home sales do not account for cancellations of contracts, which have risen substantially in recent months and by some estimates affect nearly 30 percent of sales. If this trend is accurate, the home sales data greatly overstate the strength of the housing market, and the inventory of unsold homes is much higher than what is being reported by the official statistics.

But as they say, you work with the tools available, and the incoming crop of data on housing is more encouraging than discouraging. The most current available data on housing developments, besides anecdotal evidence from brokers and media reports, for example, are those provided by lenders on mortgage applications, presumably a reliable indicator of potential home sales. According to the Mortgage Bankers Association, the first week of January saw a major rebound in applications to purchase a home. Again, the rebound may be more illusory than real if many homebuyers applying for mortgages decide to renege on the sales contract, forfeiting the deposit and canceling the sale. What’s more, as the chart shows, the recent weekly trend has been quite volatile, with large gains in applications followed by equally large declines. But the year-long slide in applications seems to have hit bottom last fall and the trend since then is pointing more up than down. With mortgage rates still low and financial institutions eager to lend to creditworthy mortgage applicants, the only obstacle in the way of a stabilizing housing market would seem to be a sudden turn for the worse in the job market, which would short-circuit the recent uptrend in income growth. However, that is not what the latest job figures show, and there is no compelling reason for companies to cut back on hiring as long as consumers are spending and the global economy is expanding.

