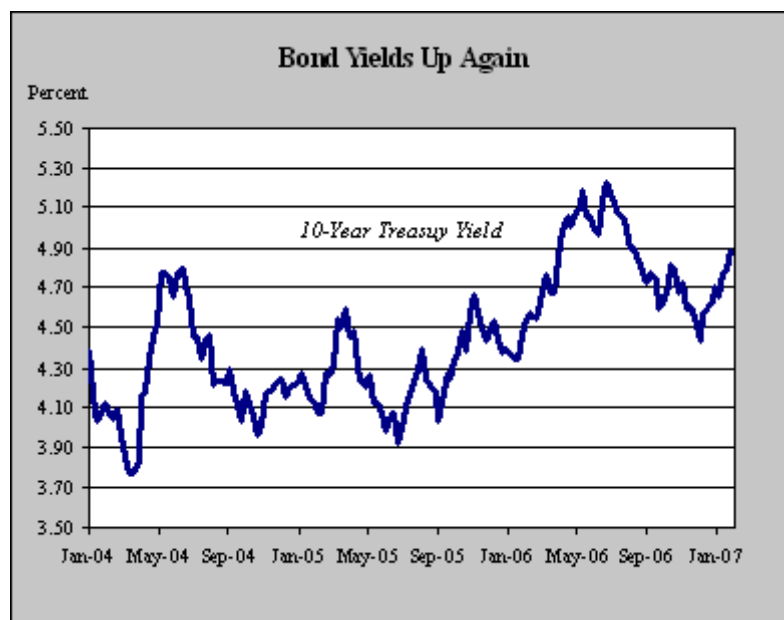


## WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 26, 2007

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	January 26	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.13%	5.13%	5.01%	4.44%
6-month Treasury bill	5.17	5.16	5.08	4.55
3-month LIBOR	5.36	5.36	5.36	4.61
2-year Treasury note	4.97	4.92	4.81	4.49
5-year Treasury note	4.86	4.78	4.69	4.44
10-year Treasury note	4.88	4.78	4.70	4.51
30-year Treasury bond	4.97	4.86	4.81	4.69
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.78	3.77	3.69	3.44
10-Year	4.00	3.99	3.91	3.86
30-Year	4.51	4.49	4.38	4.44
30-year fixed mortgage rate				
15-year fixed mortgage rate	6.25	6.23	6.18	6.12
1-year adjustable rate	5.98	5.98	5.93	5.70
	5.49	5.51	5.47	5.20
STOCK MARKET				
Dow Jones Industrial	12487.02	12565.53	12463.15	10907.21
S&P 500	1422.19	1430.50	1418.30	1283.72
NASDAQ	2435.49	2451.31	2415.29	2304.23
Commodities				
Gold (\$)- 100 Oz	651.60	636.40	638.60	558.50
Oil (\$ per barrel) - Crude Futures (NYMEX)	55.47	51.87	60.94	67.76
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Leading Economic Indicators (Dec) - % ch	0.3	0.0	-0.1	0.0
Existing Home Sales (Dec) - 000s of units	6220	6270	6240	6262
New Home Sales (Dec) - 000s of units	1120	1069	995	1031
Durable Goods Orders (Dec) - % change	3.1	2.2	-8.1	0.5
Nondefense Cap Goods less Air - % change	2.4	-1.0	-4.0	0.4

It's been a rough week in the bond market as the 10-year Treasury yield spiked up to 4.88 percent on Friday, the highest since last August. The rate has increased in seven of the past eight weeks, stamping it as a genuine bear market. At the start of the move, the bellwether issue traded nearly a half-percent lower, at 4.43 percent. But as hefty as the runup has been, it's not the first time that the bond bears have taken hold of the market in recent years. As the chart shows, since the end of the deflation scare in 2003, the 10-year yield has increased by at least 50 basis points five times, only to see most, if not all, of the increase rescinded in subsequent months.



Are we in for a repeat performance, or is this the start of a bigger upward move in long-term interest rates, which would send mortgage rates spiraling higher and squash hopes that the housing correction is nearing an end? We are far from prescient on this issue, but can offer some useful observations that may shed some light on the unfolding drama. First, the reaction of the stock market to the bond-market's woes is interesting. The first leg of the rise in bond yields didn't seem to faze stock investors. Indeed, equity prices extended the year-end rally through the first three weeks of this year, largely because the increase in bond yields was viewed as a sign that the housing slump was not leading the economy into a recession. That's good news for the stock market, as a pending recession would clearly hammer profits, which has enjoyed a remarkable string of double-digit growth.

But the second leg of the yield increase has taken on negative connotations for equity investors, spurring the market sell-off on Thursday and Friday. As always, the stock market casts a wary eye on an economy that may be growing too rapidly, primarily because it threatens to bring on a less friendly policy environment. In the current instance, perceptions that the Federal Reserve stands ready to cut rates to resuscitate growth if necessary or, at most, stay on the sidelines while the economy establishes its footing has long dominated market psychology, allowing stock prices to flourish over the past several months. Now, however, perceptions are undergoing a palpable shift. Not only is a rate cut being priced out of the market, a possible rate increase is being priced in. That's clearly bad news for equity investors, as a policy tightening threatens to bring about the same endgame – i.e., weaker growth or, worse, an outright recession – that would ultimately stifle the increase in profits.

Clearly, a return to a rate-hiking strategy by the Fed is still a remote prospect, but there is little question that both the bond and stock markets have been unnerved by the resilience the economy has displayed over the past month. Virtually every key economic statistic has exceeded expectations, obliterating earlier fears that the economy was perilously close to sliding into a recession. But what seemed to be a flashpoint sending bond yields higher this week was gathering evidence that the housing correction – long considered to be the major drag that would choke off the expansion – was nearing an end. True, sales of existing homes fell again in December, capping a year in which sales suffered the largest drop since 1982. But instead of causing hand ringing among the bond bears, this week's report generated more positive than negative spin for the housing market.

For one, pundits were quick to note that despite the sharp sales drop last year, the annual total was still

the third highest on record, and followed a record year in 2005. For another, the sales drop was overshadowed by a significant reduction in inventories of unsold homes. At the December sales pace, it would take only 6.8 months to deplete the stock, the lowest in six months and off sharply from the 7.4 months' supply in October. What's more, the median price of homes sold during the month was the same as a year ago, ending four months of year-over-year declines, something that has never happened before in the history of this series. Keep in mind that the economic bears – those warning that the housing slump would bring on a recession – have long asserted that a plunge in home prices would have a devastating impact on household wealth, causing a sharp spending retrenchment. If home prices are now stabilizing, that warning becomes more of a hollow threat than a looming prospect.

Nor are developments in the market for new homes bringing any solace to the doomsayers. One valid claim by the housing bears is that the resale market is not a reliable measure of current housing developments because it registers a sale at closing and, hence, reflects buyer interest of several months ago. A more relevant yardstick in their eyes is the report on new-home sales, which are counted when a deposit is made and a contract is signed. But instead of showing weakness, this week's report on new homes sales provided even more evidence that the housing market is stabilizing than was the case with the existing home sales report. Not only did sales prices hold firm in December and inventories of unsold homes worked down, as in the resale market, actual sales rose by 4.2 percent during the month to the highest level since last April. The temptation, of course, is to distrust the sales numbers because anecdotal evidence suggests that homebuyers are increasingly canceling their contracts, resulting in much weaker actual sales. That may be the case, but the November sales total was actually revised higher in the December report, which dilutes that argument somewhat.



No doubt, the surprising strength shown in recent housing reports has been a key factor behind the shifting perceptions in the financial markets with regards to Fed policy. After all, if the housing slump is not gaining traction, the "downside risks" to the broader economy posed by the slumping housing market that Fed officials have frequently alluded to must seem less urgent than before. Hence, there's no compelling reason to expect a preemptive cut in interest rates to stave off a housing-led recession. As we have noted in recent commentaries, recession fears and expectations of a Fed rate cut reached a high note two or three months ago, when it was thought the economy would end 2006 on a weak note and limp into the new year in need of some monetary stimulus. Instead, the consensus of economists now expects that the economy turned in a sturdy growth rate in the fourth quarter, which should be validated by the GDP report released on January 31.

Indeed, not only is growth for the fourth quarter likely to exceed expectations of a few months ago,

projections for the current quarter are also being revised higher, something that might put the final nail in the rate-cutting coffin. One reason the economy will sport a healthy growth rate this quarter is more statistical than real. In football, it is said that momentum – affectionately known as Big Mo – is like having an extra player on the field, giving the team a shot of adrenaline which enables it to more easily overcome resistance. In economics, Big Mo is also a propellant, but more of a statistical nature. When calculating how fast the economy is expanding, for example, extra weight is given to how high the starting point is. If the previous quarter ended strongly, the starting point for the next quarter is higher, imparting the arithmetical equivalent of a momentum boost for the period.

Following the fourth quarter's strong showing, 2007 began at a much higher point than was expected, providing a faster start to the first quarter's growth rate. What's more, the launching pad may get another lift from the growing importance of gift cards in holiday shopping patterns. These cards are not counted in retail sales until they are redeemed, which means that sales could get as much of a \$25 billion boost in January when most redemptions occur. Simply put, the economy is off to a running start in the first quarter, which will give the period's growth rate a big statistical lift even if activity levels off in February and March. With the bond market already spooked by the heady growth rate expected for the fourth quarter, it would seem that the bond bears will have an even greater influence as evidence of the first quarter's performance becomes apparent.

To be sure, it is not the custom of investors to make judgments through a rear view mirror. The bond market is nothing if not forward-looking, and if the perception that the economy's forward momentum is fading as the quarter progresses, the impetus behind the latest upward move in bond yields should also fade. That's the dynamic that underlined the pendulum swings in recent years, and it could well be repeated this year. Indeed, the stalwart bond bulls are expecting just that to happen. Their argument is that the exceptionally warm weather in December and early January as well as the plunge in energy costs have contributed importantly to the housing market's surprising strength and to the ebullience in consumer spending. With weather returning to normal and energy costs stabilizing, those catalysts will no longer come into play, allowing the fundamental weaknesses that spurred the growth slowdown in the second and third quarters of last year to reassert themselves. Accordingly, much as was the case over the past two years, the bulls are firmly convinced that the bond market pendulum will once again swing in their favor, repeating the pattern observed in recent years.

Our sense is that the economy is not as strong as the recent numbers indicate, nor is the outlook as bleak as the pessimists think. No doubt, growth will slow from its recent heady pace, as the housing correction still has a ways to go, despite the promising data contained in recent reports. Even if the worst of the housing downturn is behind us, there are lagged effects on employment and sales of housing-related goods and services that have yet to unfold. What's more, the 50 basis point backup in bond yields will push up mortgage rates as well, to some extent offsetting the recent home-price declines that have increased housing affordability for a swath of first-time buyers. To be sure, mortgage rates are far from levels that would cripple sales, but another quarter or half point up might be enough to produce another sales slump in the spring, particularly if potential homebuyers become anxious about the economy's overall health.

While we do not think that a Federal Reserve rate hike is in the cards, the odds of cut have clearly diminished in our view. At this point, it appears that consumers are becoming more confident about job and income prospects, and will remain a positive force for growth, although less so than they were when the housing market was booming. In all likelihood, the business sector holds the key to the near-term outlook. Capital spending came in below expectations over the second half of last year, particularly given the robust increase in profits and sharp reduction in spare plant capacity. It's unclear why that occurred, although it does seem that the spike in energy prices and fears consumers would retrench much more sharply than they did played a role in turning company CEOs more cautious. However, this

week's report on bookings suggests that their caution may be dissipating. Following two monthly declines, new orders for nondefense capital goods less aircraft – a proxy for capital spending – turned up by 2.4 percent. If this is a sign that the long delayed increase in business investment spending is finally coming on stream, an important buffer to the housing weakness and expected slowdown in consumer spending will have been ignited. Only time will tell, but we would bet that the interest rate jitters that have permeated the markets in recent weeks will be hanging around for a while longer.

