

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 2, 2007

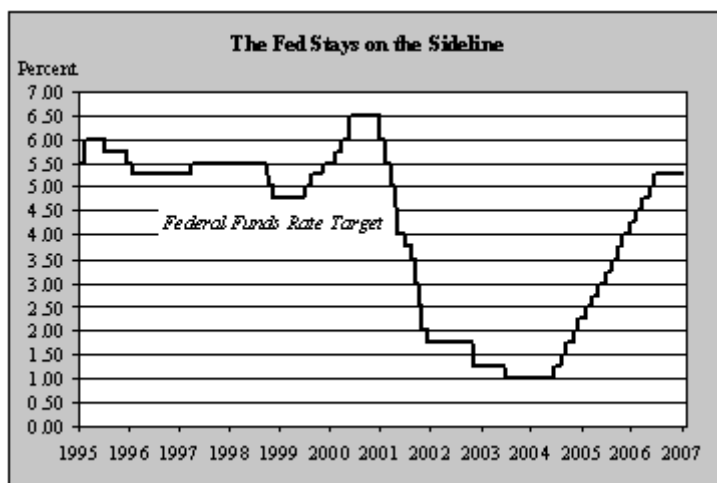
*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	February 2	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.13%	5.13%	5.04%	4.46%
6-month Treasury bill	5.15	5.17	5.08	4.62
3-month LIBOR	5.36	5.36	5.36	4.64
2-year Treasury note	4.93	4.97	4.76	4.57
5-year Treasury note	4.83	4.86	4.65	4.48
10-year Treasury note	4.82	4.88	4.65	4.53
30-year Treasury bond	4.92	4.97	4.74	4.63
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.77	3.78	3.70	3.52
10-Year	4.00	4.00	3.92	3.91
30-Year	4.51	4.51	4.39	4.48
30-year fixed mortgage rate				
15-year fixed mortgage rate	6.34	6.25	6.18	6.23
1-year adjustable rate	6.06	5.98	5.94	5.81
STOCK MARKET				
Dow Jones Industrials	12653.49	12487.02	12398.01	10793.62
S&P 500	1448.39	1422.19	1409.71	1264.03
NASDAQ	2475.88	2435.49	2434.25	2262.58
Commodities				
Gold (\$)- 100 Oz	652.70	651.60	606.60	571.30
Oil (\$ per barrel) - Crude Futures (NYMEX)	59.10	55.47	56.15	65.37
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Real GDP (Q4) - % change, Saar	3.5	2.0	2.6	3.3
ISM Manufacturing Index (Dec) - Index	49.3	51.4	49.9	51.5
Personal Income (Dec) - % change	0.5	0.3	0.3	0.5
Personal Consumption (Dec) - % change	0.7	0.5	0.3	0.4
Nonfarm Payrolls (January) - ch. in 000s	111	206	196	168
Unemployment Rate (January) - Percent	4.6	4.5	4.5	4.6
Average Hourly Earnings (Jan) - % change	0.2	0.4	0.3	0.3

Did someone hear Goldilocks knocking on the door? It might be another fairy tale in the making, but the economy is clearly making sounds that would sooth any bear's porridge. Not only is growth recovering nicely from the two-quarter slowdown staged in the middle of 2006, but inflation is moderating. Simply put, conditions appear to be neither too hot nor too cold, but just right for the denizens of both Wall Street and Main Street. As well, the policy makers are buying into the script, opening a new chapter of what is shaping up to be a long period of keeping out of harm's way.

At least that's the clear message conveyed at this week's rate-setting meeting held on January 31. To be sure, no one expected the Fed to alter its interest-rate stance, and it complied by keeping its target federal funds rate unchanged at 5 ¼ percent for the fifth consecutive meeting. Instead, attention was focused on what the Fed would say after the meeting, which analysts eagerly dissect for hints of what the next move might be. For the most part, the post-meeting statement couldn't be friendlier to the financial markets. Mimicking the Goldilocks scenario, the policymakers took note of the fact that the

economy is obviously in better shape than a few months ago, when the housing slump was still in full swing and posing a major threat to the expansion. In the official statement, the Fed noted that “recent indicators have suggested somewhat firmer economic growth, and some tentative signs of stabilization have appeared in the housing market.”

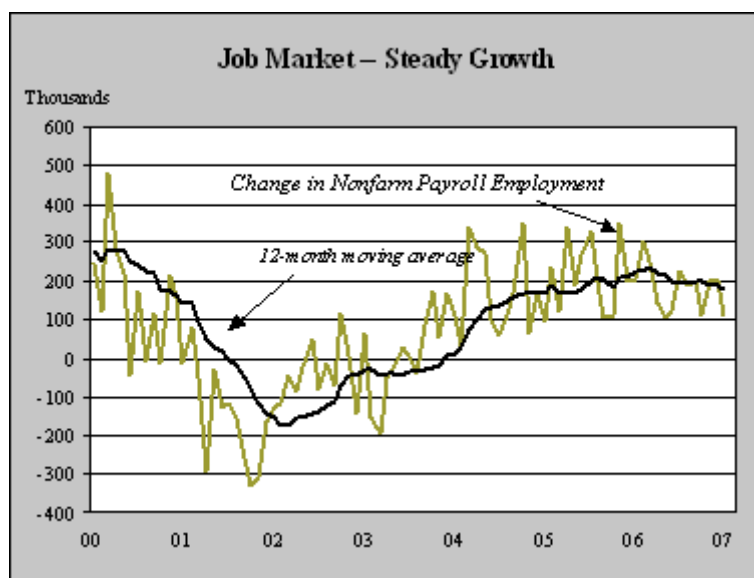


On the surface, the acknowledgement of a stronger economy would ordinarily be interpreted as a hawkish sign by the financial markets, suggesting that higher rates might be needed to stave off inflationary pressures. But while the Fed reaffirmed that “some inflation risks remain” it temporized its comments by removing any reference to the pass-through effect of oil prices and striking the phrase “have been elevated” from readings on core inflation contained in previous statements. But it did retain the thought that “readings on core inflation have improved modestly in recent months and inflation pressures seem likely to moderate over time.” In other words, the picture being portrayed by the policy makers is one of moderately improving growth and receding inflation – an economy that is neither too hot nor too cold, but just right.

Not surprisingly, the Fed’s post-meeting statement was sweet music for the financial markets, propelling both bond and stock prices higher on Wednesday and Thursday. With growth recovering and inflation receding, the economy is clearly experiencing a sweet spot that allows the Fed to go on cruise control for the foreseeable future. No doubt, the pundits will continue to debate the wisdom of a do-nothing strategy, as some would prefer a preemptive strike to prevent bad things from happening. The problem is, there is no agreement over what that “bad” thing might be. At this juncture, the analytic community is virtually split down the middle over what direction the economy is taking. About half believe that future prospects are bleak, reflecting the still-unfolding drag from the housing correction that will become more apparent when the temporary growth-boosting forces dissipate. The other half sees the future in a much different light, expecting higher inflation to result from a rebounding economy that has successfully eluded the harsh effects of a now-stabilizing housing market.

In all likelihood, that split in perceptions also permeates the Fed’s thinking, validating its decision to stay on the sidelines until the crystal ball comes into clearer focus. Although the forecasting community may disagree over the economy’s future direction, there is widespread agreement that the greater risk is a policy mistake on the part of the central bank. That’s the major reason the financial markets responded so favorably to indications that policy will remain on hold for the foreseeable future – a manifestation of the “no foul, no harm” syndrome. Clearly, incoming data continue to support the notion that no interference is necessary at this time. The economy is humming along quite nicely and inflationary pressures appear to be bottled up, despite the “high resource utilization” in the product and labor markets that the Fed continues to see as a potential inflation catalyst.

Indeed, the labor market provides a vivid snapshot of the positive blend of forces coursing through the economy. On Friday, the government released its latest jobs report for January that portrays Goldilocks in all of her grandeur. During the month, the economy generated 111 thousand net new jobs, a moderate pace that came in somewhat below expectations. But that shortfall should be taken with a grain of salt, as there has been a persistent tendency to revise up initially reported figures the following month. For example, 81 thousand more workers were added to the payroll count originally reported for November and December, marking the eighth consecutive month that the job numbers have been revised higher. In light of the suspect nature of original estimates, it's best to look at the new figures in a broader time perspective, averaging them in with the past two or three months.



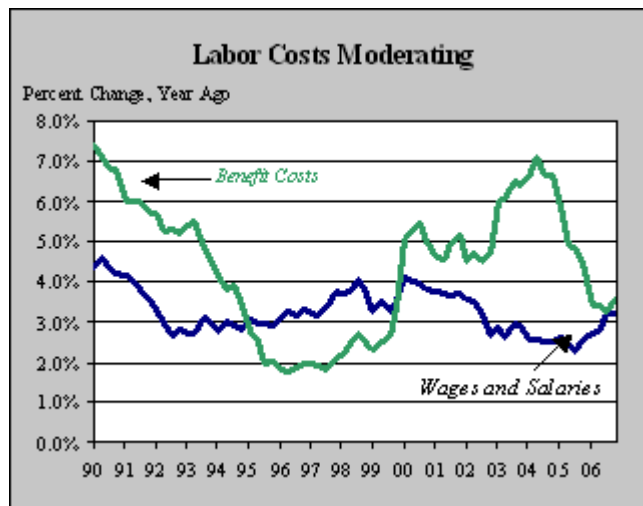
On this basis, it's steady-as-she goes. Over the past three months, for example, nonfarm payrolls have increased on average by 171 thousand a month, almost spot-on with the 179 thousand average monthly increase over the past year. In other words, the job market is neither accelerating nor weakening, but providing just enough workplace opportunities to accommodate the increase in the labor force. True, the unemployment rate ticked up from 4.4 percent to 4.5 percent, the first increase in 6 months. But the jobless rate stood at 4.7 percent at the start of last year, and the current level is firmly within the range that the Fed considers to be full employment. By this measure, of course, the inflation bears would seem to have a compelling argument for the Fed to remain vigilant in the inflation fight. After all, a tight labor market, which is clearly the case now, heightens the risk that wages will start to heat up, putting pressure on businesses to pass on higher labor costs to consumers.

No doubt, had the January jobs report corroborated that notion by revealing a big jump in wages, the financial markets would have given back a big chunk of the gains made on Wednesday and Thursday. But that was hardly the case. Indeed, workers received a paltry 0.2 percent increase in average hourly pay during the month, half the average increase over the previous three months, putting the gain over the past year at 4.0 percent. In each of the previous two months, the 12-month increase in average hourly earnings stood at 4.2 percent, so it doesn't seem that the tight labor market is pushing up labor costs. What makes the January slim gain in pay even more impressive from an inflation-dampening standpoint is that it took place during a month when 10 states, including California, hiked the minimum wage. That knowledge prompted many economists to forecast an increase of as much as 0.5 percent in hourly earnings during the month, something that thankfully did not materialize.

Nor is it just the hourly earnings series that's pleasing the inflation doves. Keep in mind that the Labor

Department's tally of worker pay contained in the jobs report is subject to distortion because it does not compensate for changes in the composition of payrolls. Hence, if a larger fraction of job gains was among lower-paid workers, that would skew the average hourly increase downward, even though a typical worker might have received a larger percentage increase in wages than in the month before. Just the reverse would be true if higher-paid workers accounted for a larger fraction of payroll gains in any given month. But another, more comprehensive series put out by the Labor Department does adjust for this distortion, the quarterly Employment Cost Index, which includes both wages and salaries as well as benefit payments to workers. Earlier in the week, the ECI was released and, lo and behold, it validated the message conveyed by the average earnings series.

During the fourth quarter, the index increased by 0.8 percent, a slowing from the 1.0 percent and 0.9 percent increases posted in the third and second quarters, respectively. The wage component also increased by 0.8 percent, off from the 0.9 percent increase in each of the previous two quarters. That slowdown arrested the steady acceleration in the 12-month increase, which had shot up from 2.3 percent in mid-2005 to 3.2 percent in the third quarter of last year, where it remained in the fourth quarter. The benefit component of the index did creep up on a year-over-year basis, to 3.6 percent from 3.3 percent in the third quarter. But that's still a far cry from the out-of-control increases in benefit payments that companies were shelling out three years ago, when the 12-month increase topped out at 7 percent.



Simply put, the trend in labor costs is clearly not a source of inflationary pressures at this juncture. If the Fed's projection for growth to moderate over time pans out, there is little reason to expect cost-push pressures on prices to emerge. Indeed, the Fed has to be pleased with the way the inflation gauges are behaving. It's favorite barometer, the core personal consumption deflator, is decelerating, rising by only 2.1 percent in the fourth quarter compared to a year earlier versus a 2.2 percent increase in the third quarter. In December, the core PCE deflator edged up by only 0.1 percent after showing no increase in November. At the current pace, this inflation measure should fall into the Fed's comfort zone, pegged at 1-2 percent, by the spring. If it does, the pendulum in the forecasting community will no doubt tilt in favor of a rate-cut, as it would be highly unusual for the Fed to raise interest rates when inflation was receding.

But market psychology is just as heavily influenced by growth prospects as actual inflation data, which tend to reflect past strength or weaknesses in the economy. If the economy's recent strength has been propelled by such temporary factors as plunging oil prices and unusually warm weather in December and January, some payback can be expected in coming months. Oil prices have moved up from the lows of mid-January and weather conditions are returning to normal. The inflation doves are convinced that

once these influences are purged from the figures, the economy's growth rate will downshift markedly in the second and third quarters, imparting even more relief on the price front. In their view, that will inevitably prompt the Fed to cut rates to sustain the expansion. But the inflation hawks argue that the economy is forging ahead quite nicely despite the historically large drag from the housing and auto corrections. Once this drag evaporates, which they believe is already occurring, economic growth will escalate, tightening the product and labor markets to the point where inflationary pressures are bound to intensify. That, in turn, will prod the Fed into resuming its rate-hiking stance in effect until last June. For the time being, Goldilocks is the reigning influence in the financial markets but, as in the fairy tale, she is not destined to hang around forever. Stay tuned.