

WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 9, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	February 9	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.14%	5.13%	5.08%	4.53%
6-month Treasury bill	5.15	5.15	5.14	4.69
3-month LIBOR	5.36	5.36	5.36	4.69
2-year Treasury note	4.90	4.93	4.88	4.68
5-year Treasury note	4.77	4.83	4.76	4.58
10-year Treasury note	4.78	4.82	4.77	4.58
30-year Treasury bond	4.87	4.92	4.86	4.55
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.77	3.77	3.72	3.54
10-Year	4.00	4.00	3.94	3.94
30-Year	4.51	4.51	4.44	4.48
30-year fixed mortgage rate	6.28	6.34	6.21	6.24
15-year fixed mortgage rate	6.02	6.06	5.96	5.83
1-year adjustable rate	5.49	5.54	5.44	5.34
STOCK MARKET				
Dow Jones Industrials	12580.83	12653.49	12556.08	10919.05
S&P 500	1438.06	1448.39	1430.73	1266.99
NASDAQ	2439.82	2475.88	2502.82	2261.88
Commodities				
Gold (\$)- 100 Oz	671.30	652.70	627.10	553.80
Oil (\$ per barrel) - Crude Futures (NYMEX)	59.79	59.10	52.85	61.84
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Non-manufacturing Index (Jan)	59.0	56.7	58.3	57.2
Nonfarm Productivity (Q4) - % change	3.0	-0.1	1.2	2.1
Unit Labor Costs (Q4) - % change	1.7	3.2	-2.4	3.0
Consumer Credit (Dec) - Ch. In Mlns of \$	6007	13658	2344	9073

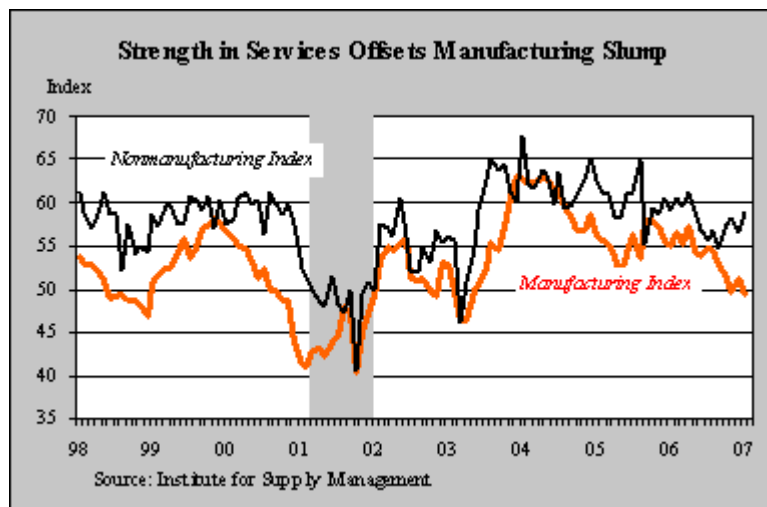
Given the crosscurrents that continue to buffet the economy and the sharp division of opinion among economists as to what the Fed's next move will be, the financial markets are eagerly anticipating Fed chairman Ben Bernanke's congressional appearance next week, when he will deliver the central Bank's semi-annual monetary policy report. No doubt, pundits will over-interpret every nuance of the chairman's testimony, holding out the potential for a turbulent week in the markets. That said, we do not expect Bernanke to substantially alter the Fed's underlying message that has been in place for some time. More than likely, he will reaffirm the theme that the U.S. economy is transitioning from a period of above-trend growth to a more sustainable trend and that core inflation continues to moderate, although upside risks to the inflation outlook persist.

The chairman will first testify before the Senate Banking Committee on Wednesday, February 14 at 10AM EST. On the following day, Thursday, February 15, he will present the identical testimony before the House Financial Services Committee at 10AM EST. However, there will be a twist to the House appearance, as that chamber will hold an unusual second day of testimony on Friday, February 16, to hear from expert economists on the Fed's report. We're pleased that the politicians are given the

denizens of the oft-maligned economic community a chance to vent their displeasure – or sing the praises – for the job policymakers are doing.

One thing the dismal scientists can't dispute is that the fabled soft landing is occurring even as the chairman prepares his remarks. Although real GDP strengthened to a 3.5% seasonally adjusted annualized rate in the final quarter of 2006, economic growth in the previous two quarters was sub-par at best, coming in at 2% and 2.6%, in Q3 and Q2, respectively. We suspect that the economy will gravitate back to the slower growth rates in the first half of 2007, as the housing drag will continue to weigh on aggregate economic activity and the growth-boosting impact of the unusually warm weather and plunge in oil prices fades. In fact, the Q4 2006 growth rate of 3.5% might be revised substantially lower in the next GDP report, scheduled for release on February 28. That's because the level of December wholesale inventories less autos, reported Thursday, which is the source data for the wholesale inventory component of GDP, came in sharply below the level assumed by the bean counters in their initial GDP report. The shortfall is a considerable \$24.8 billion, which alone would shave about 0.8-percentage point off of the fourth-quarter's growth rate.

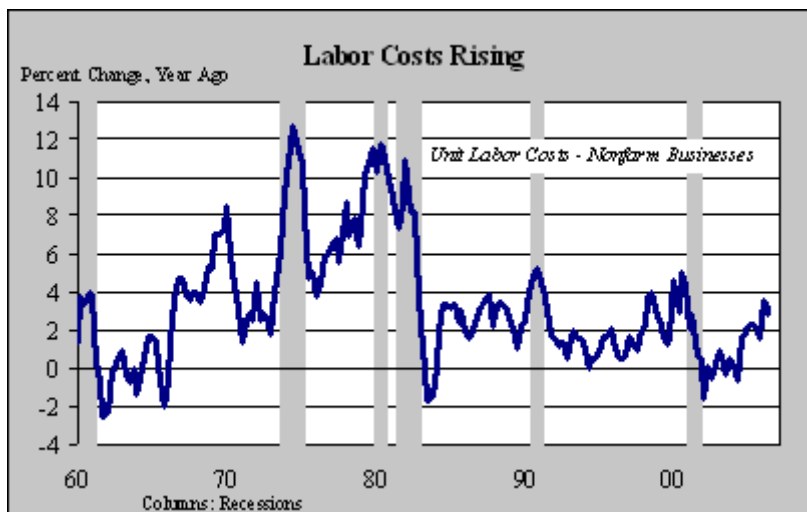
Indeed, inventory liquidations have been one of the more unheralded drags on the economy in recent months, prompting companies to sharply curtail production to bring stockpiles down to tolerable levels. That's particularly the case among manufacturers, as revealed in the purchasing managers index of manufacturing activity released last week. The Institute for Supply Management's index fell to 49.3 in January, the lowest since April 2003, largely reflecting a plunge to a five-year low in the inventory component. Non-manufacturing companies are also liquidating inventories, but the drag is not as acute as it is among manufacturers. In fact, the ISM index of service-sector activity, which constitutes about 80 percent of overall economic activity, actually posted a surprisingly strong increase in January, moving to a eight-month high.



Simply put, the final chapter on the economy's performance in last year's fourth quarter has yet to be written. In coming weeks, some key pages will be filled in, including data for December on the trade deficit and retail inventories, which will round out the overall inventory picture for the fourth quarter. As well, the retail control group, which serves as the basis for consumer spending estimates, is also expected to be revised. These pending points of information together with other data released since the first reading on GDP was released suggest that the revised numbers could paint a considerably weaker picture for the fourth quarter. Our back-of-the-envelope calculations indicate that as much as 1 percentage point could be shaved from the muscular 3.5 percent initial estimate for GDP when the second tally is made available on February 28.

What won't be revised is the clear moderating trend in inflation that is occurring alongside of the slowing economy. In December and November 2006, the core PCE deflator rose at a 2.2% pace compared to a year ago, which represent slightly lower readings than the string of 2.4% increases observed from August to October 2006. Similarly, we have seen disinflation occurring in the core CPI measure. In December and November 2006, core CPI was up 2.6% from a year ago, which is down from 2.7% in October 2006 and 2.9% in September 2006. Nevertheless, Fed chairman Bernanke is likely to reiterate that some inflation risks remain because even with the decelerating trend, current inflation readings still stand above the Fed's comfort zone.

No doubt, what the Fed chief is most concerned about is the potential upward pressure on prices coming from rising labor costs. There are two basic reasons behind this concern. First and foremost is the tight labor market, as reflected in the low 4.6 percent unemployment rate, which is pushing up wages. Second is the clear slowing in productivity growth, which is an essential offset to wage gains required to keep companies from raising prices. This week, the Labor Department reported that nonfarm productivity increased by only 2.1 percent in 2006, the weakest pace in nine years, despite a rebound to an annual rate of 3 percent in the fourth quarter. While the fourth-quarter rebound is encouraging on the surface, it will probably be revised down along with the expected downward revision in GDP that we noted earlier. With productivity slowing, the flip side is that the cost of producing a unit of output is rising. For all of 2006, unit labor costs surged by 3.2 percent, the steepest in six years. What's more, that number will likely be revised upward as a result of the expected scaled down adjustment in productivity growth.



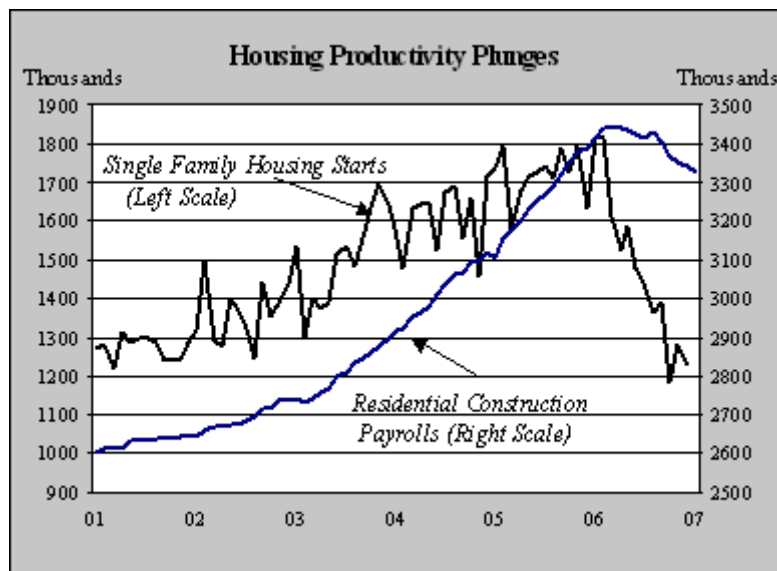
To be sure, the slowdown in productivity and rise in unit labor costs are time-honored cyclical patterns that typically occur at the mature stage of an expansion. After all, with five years of growth in the books and following three years of sturdy job gains, employers have to dig deeper into the labor pool to find qualified workers, and the deeper they dig the more difficult it is to find skilled workers who are as productive as the ones already on the job. Hence, at this point, it takes more workers to squeeze out an additional unit of output. Meanwhile, as the job market gets ever tighter, companies find themselves having to offer top dollar to lure additional workers into the fold. In the fourth quarter of last year, real compensation for workers on nonfarm payrolls surged by a 7.1 percent annual rate. Over the past forty-five years, that real pay increase has been exceeded in only three other quarters.

In all fairness, however, the fourth-quarter surge in compensation was probably heavily skewed by the huge year-end bonuses and stock option cash-outs that typically follow strong market rallies, which clearly took place last year. While a tightening job market is driving up worker pay, the rate of gain is not nearly as strong as the fourth quarter reading suggests. What's more, the slowdown in productivity

growth may not be as fundamentally ingrained as last year's numbers imply. Keep in mind that the tepid 2.1 percent productivity increase was not only the slowest in six years, but well below what many economists had come to believe was the long-term trend of about 2.5 percent. If the 2.1 percent pace is an accurate gauge of productivity and the trend is heading even lower going into 2007, that means the economy's potential noninflationary growth rate is also lower, giving the Fed less flexibility to lower interest rates when the economy slows. By the same token, a modest pickup in economic growth – to say 3 or 3 ½ percent – could prompt the Fed to pull the rate-hiking trigger much more quickly than it otherwise would.

However, the jury is still out with regards to the economy's underlying productivity trend. We suspect that the 2.1 percent reading last year overstates the decline that actually occurred, largely because it includes an outsized drop in productivity in the housing sector. Since the housing downturn started a year ago, single-family construction has plunged by 32 percent. Meanwhile, builders shed only 114 workers from payrolls, a drop of 2.5 percent over the same time span. In other words, it required a lot more workers to construct a dwelling unit last year, which translates into a huge loss of productivity. By some estimates, the housing downturn, together with the lagged employment response, may have contributed as much as two-thirds of a percentage point to the overall drop in nonfarm productivity last year. Hence, if not for the housing slump, productivity growth would have been closer to 3 percent than 2.1 percent last year.

If that's the case, we should see a marked improvement in 2007. One reason for the productivity squeeze in the housing sector is that builders do not lay off workers until a project is completed and future prospects are assessed. With housing completions now dropping sharply and building permits well below last year's average level, layoffs among the hardhats should start to rise dramatically, and could reach a half a million before all the damage is done. But if, as Bernanke has stated and some recent numbers confirm, the housing correction is moderating, the employment dropoff among construction workers will be greater than the ongoing slide in construction activity. That's the reverse of what happened in 2006, which suggests that a significant rebound in productivity is about to take place in the housing sector, something that should give a big lift to the overall nonfarm productivity trend in 2007.



Our sense is that the trend rate of productivity growth is closer to the 2.5 percent average seen over the past decade, and there will be a gradual improvement towards that pace during 2007. Assuming a labor

force growth rate of half a percentage point or so, that means the economy's growth potential is about 3 percent or slightly more. We believe that as long as growth remains below that threshold, inflationary pressures will continue to moderate and keep the Fed from pulling the rate-hiking trigger. At the same time, with housing showing signs of stabilizing and other sectors of the economy continuing to hold up, it does not seem that growth is on the precipice of slowing dramatically from the pace of recent quarters, provoking the Fed into a series of rate reductions. While Ben Bernanke may hint otherwise in his upcoming testimony, what this tells us is that the Fed will most likely stay on the sidelines for the foreseeable future