WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 2, 2007

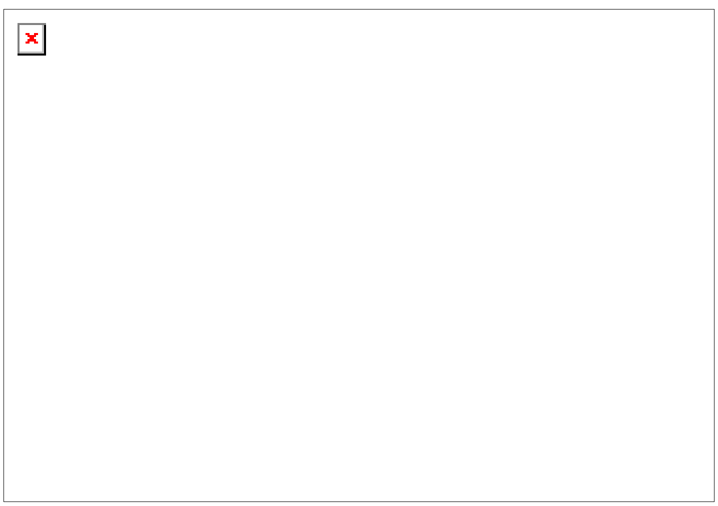
First the numbers, then the story

This week's tumultuous performance of the financial markets brought to life the old cliché "be careful what you wish for." For some time now, pundits have bemoaned the lack of volatility in stock and bond prices that has prevailed for the past several years. Their concern is that such a benign climate fosters complacency and undue risk-taking among investors, setting them up for a rude awakening if the markets are suddenly afflicted by an unexpected shock. Well, the shock waves hit the markets with a vengeance this week, resurrecting the long lost and much lamented volatility in spades.

To be sure, neither the equity-market setback on Tuesday nor the wild intraday swings over the remainder of the week measured up to past episodes of turbulence, dating back to October 1987 and spanning the days following the 9/11 terrorist attacks. Still, Tuesday's 3.3 percent drop in the Dow Industrials was the first daily correction in excess of 2 percent since March 2003, which marked the longest stretch of relative stability since the 1950s. With the slide continuing towards the end of the week, there was clearly a palpable sense of unease among investors as the weekend approached. Is the past week's performance the tip of the iceberg, or an isolated incident in an otherwise benign market environment that is still underpinned by positive economic fundamentals?

Clearly, no respectable analyst would venture an answer that question with absolute certainty. Investor psychology is swayed by a multitude of factors that are difficult, if not impossible, to identify. On the surface, the trigger setting off the latest turbulence does not seem particularly compelling. First was the 9 percent drop in Chinese stock prices that rippled throughout Europe's bourses before hitting the U.S. This was followed by some relatively innocuous remarks of former Fed Chairman Greenspan, which were wildly hyped in the financial press. Against this backdrop, the week's spate of new economic data initially gave the impression that the U.S. economy was much weaker than generally perceived. Given the mounting publicity over the problems in the subprime mortgage market and the ongoing housing slump, the markets were no doubt more vulnerable to the confluence of bad news this week than in some time.

Whether this "wake-up" call, as some analysts have described it, morphs into a self-reinforcing bearish sentiment that has a more pronounced and lasting effect on the market remains to be seen. Our sense is that if it does, it will have to be corroborated by economic fundamentals. And, despite some downbeat reports on the economy this past week, it is still far from apparent that the expansion is in jeopardy of expiring. True, the headline-grabbing number of the week – the revised GDP growth rate for the fourth quarter – set the tone for the suddenly more dire perception of the economy's health. Instead of staging a robust 3.5 percent increase for the period as reported a month ago, the revised GDP report showed that the economy only advanced by a 2.2 percent pace, a tad above the tepid 2 percent increase posted in the third quarter and well under the long-run trend of 3 percent.

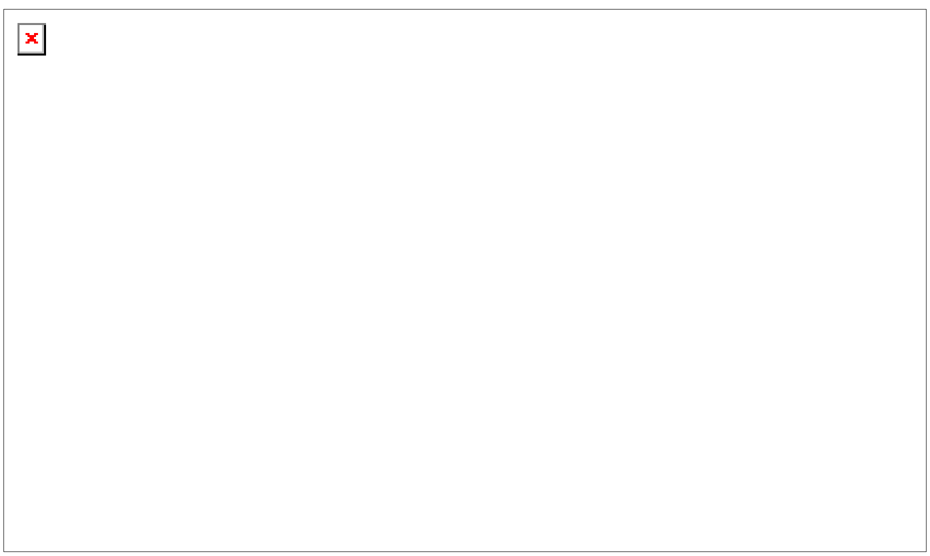


About half of the downward revision was attributed to an inventory adjustment. In the earlier estimate, it was thought that businesses had accumulated \$35.3 billion in inventories, but the revised tally put the stockpiling of merchandise at a much lower \$17.3 billion. That \$18 billion differential accounted for the lion's share of the \$35 billion reduction in the second GDP count. For the most part, there was little surprise over this downward adjustment, as it was clearly telegraphed by the monthly inventory data that preceded the GDP report. Indeed, the lower level of inventories can be viewed as a positive influence going forward. It's no secret that uncomfortably high inventories have been a drag on production in recent months; to the extent they have been brought down to more manageable levels, the stage may be set for a production rebound in coming months, imparting oomph to a faltering economy.

But more worrisome than the inventory overhang, which may or may not still be a problem, is the possibility that that a key expected growth driver – capital spending – is downshifting to a crawl. After the $18 billion downward revision to inventories, the second biggest adjustment to the GDP figures was a $6.8 bullion haircut in business investment outlays. As a result, nonresidential fixed investment actually fell by 2.4 percent in the fourth quarter, the first decline since the first quarter of 2003. Not only did outlays on equipment and software fall, as was the case prior to the revision, spending on structures also declined, which reversed the small increase recorded in the first estimate of GDP.

We assume that the fall in spending for structures – factories, office towers and other commercial buildings – was an aberration, given the low office vacancy rates and high level of capacity utilization, notwithstanding the production cutbacks over the second half of last year. What is of more concern is the retrenchment in spending on capital equipment and software, which may indicate that business executives have turned more cautious about growth prospects. If that's the case, their caution is bound to lead to budget cutbacks in other areas as well, most notably for payrolls. That's an element a faltering economy can ill afford to absorb, as a sharp slowing in job creation would cut into income gains and consumer spending.

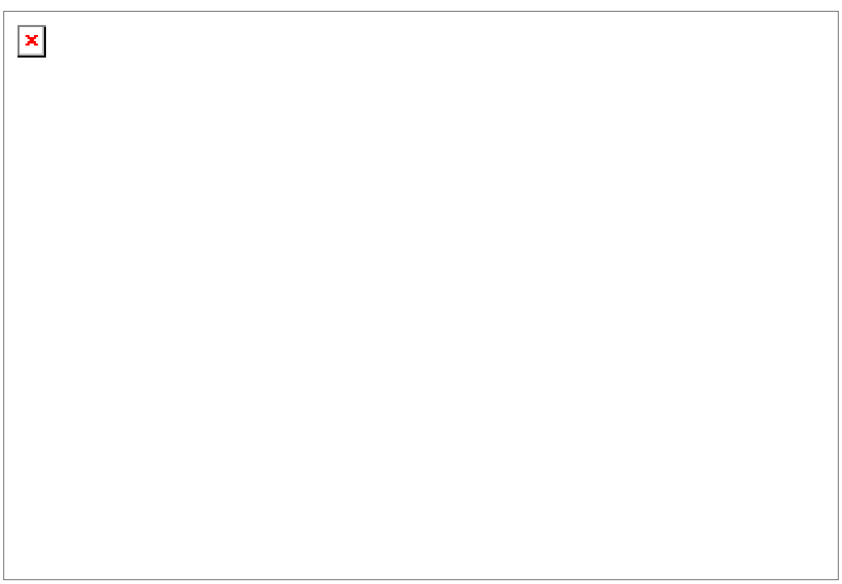
Significantly, the fourth-quarter weakness in capital spending spilled over into the new year. Among the downbeat economic reports this past week, shipments of nondefense capital goods less aircraft, which is the source data for capital spending in the GDP accounts, plunged by 2.7 percent in January, a larger drop than the 0.8 percent decline in December. As a result of the latest slide, the level of shipments in January stood a whopping 9.7 percent below the fourth-quarter average, which imparts a sizeable downward risk to first-quarter capital spending. Nor is a quick turnaround likely, as new orders for these goods – a reliable forward-looking indicator of actual spending – plummeted by 6 percent in January, the third decline in the past four months.



With the downward revisions in GDP and the diminished near-term capital spending outlook, the economy takes on a much different look than it had a few weeks ago. Instead of ending 2006 on a firm footing and gaining momentum into the new year, as earlier data suggested, it now is perceived to be on much shakier ground and vulnerable to further downward pressures, particularly from a housing slump that continues to grab headlines. Much was made, for example, of the latest home sales report, which revealed a sharp 16.6 percent contraction in sales of newly-build homes in January to the lowest level since February 2003. The decline was far greater than expected and only heightens the prospect that homebuilders will continue to scale back construction in the months ahead, despite an encouraging improvement in builder sentiment last month reported by the National Homebuilders Association. While the January sales decline probably overstated the ongoing weakness in the housing sector, there is little question that the housing correction still has a ways to go.

That said, not all of the news last week was doom and gloom. Indeed, even as the capital-spending outlook was dialed down, manufacturing activity actually took a turn for the better, at least according to the purchasing managers of major companies. The Institute for Supply Management's index of manufacturing activity shot up by 3 points in January, jumping back above the 50 breakeven point that demarcates growth from contraction in the industrial sector. While automakers and producers of construction-related manufactured goods are clearly still in the doldrums, the bounce-back in the index suggests that weakness is not spreading and eroding the manufacturing base. What's more, even the housing sector received some positive news this week, as resales of existing homes rose 3 percent to an eight-month high in January.

Arguably, the existing home market is not as good of a barometer of housing conditions as is the new-home market, primarily because an existing home transaction is recorded at the time of closing, reflecting a sale made months earlier. Conversely new home sales are recorded when a contract is signed, which is more indicative of current conditions. Hence, the slump in new home sales should probably be given more weight than the rebound in existing home sales last month. However, speculation that the housing slump is bringing on a free-fall in home prices and vaporizing the value of a household's major asset is simply not true. One overlooked report this week was released by the Office of Federal Housing Oversight, which tracks the prices of repeat sales or refinancings of the same property over time. This series is a more reliable indicator of home price trends than that shown in the monthly home sales report, which is skewed by changes in the mix of homes being sold. As the chart shows, while the appreciation in home prices is clearly decelerating, it has not stopped – or fallen as is reported in the monthly sales figures. Indeed, the Ofheo figures show that home prices in the fourth quarter rose by an annual rate of 4.5 percent, which is actually stronger than the 4.1 percent gain recorded in the third quarter.



But the real test of the economy's strength going forward rests with the consumer. Despite the downward revision in the fourth quarter's growth rate, the sturdy increase originally reported for consumer spending during the period remained more or less intact, with the increase shaved from a muscular 4.4 percent to a still-robust 4.2 percent. If this spending resilience is retained, the inventory overhang that has constrained production and, perhaps, inhibited capital spending plans, will be speedily worked off, encouraging businesses to ramp up activity. So far, so good. In contrast to the downbeat report on capital goods orders, households enjoyed a solid 1.0 percent increase in personal incomes in January, the strongest in a year and more than double the 0.4 percent average increase over the previous six months. True, fat bonus payments to highly-paid executives inflated the January gain, but these hefty paychecks entered the spending stream, boosting real consumer outlays by 0.3 percent during the month. That lifted the January spending level a solid 2.9 percent above the fourth quarter average, indicating that consumers will impart almost as much strength to the economy's growth rate in the first quarter as they did in the last. As long as households keep on spending, the economy should be able to withstand the blow from the housing correction. More to the point, it is hard to believe that company executives would retain their recent cautious behavior in the face of a resilient consumer. Simply put, while the stock-market's turbulence may well continue in the weeks to come – and could eventually have a real impact on the economy – it does not appear to be justified by a widespread and pronounced weakening in economic fundamentals.