

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 9, 2007

First the numbers, then the story

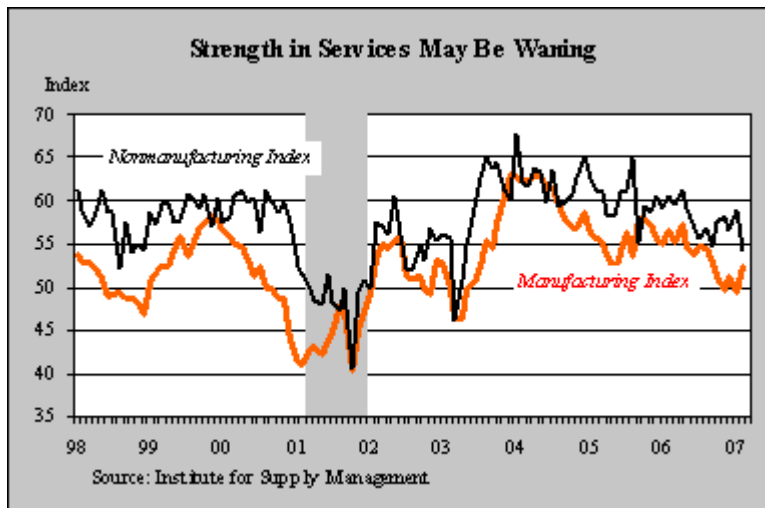
| FINANCIAL INDICATORS | | | | |
|---------------------------------------------|-------------------|--------------------|----------------------|--------------------------------|
| INTEREST RATES | March 9 | Week Ago | Month Ago | Year Ago |
| 3-month Treasury bill | 5.08% | 5.10% | 5.14% | 4.61% |
| 6-month Treasury bill | 5.13 | 5.06 | 5.15 | 4.78 |
| 3-month LIBOR | 5.34 | 5.35 | 5.36 | 4.83 |
| 2-year Treasury note | 4.67 | 4.53 | 4.90 | 4.73 |
| 5-year Treasury note | 4.55 | 4.44 | 4.77 | 4.77 |
| 10-year Treasury note | 4.59 | 4.50 | 4.78 | 4.76 |
| 30-year Treasury bond | 4.72 | 4.64 | 4.87 | 4.75 |
| Tax-Exempt Revenue Bonds (Triple-A) | | | | |
| 5-Year | 3.67 | 3.71 | 3.77 | 3.64 |
| 10-Year | 3.87 | 3.94 | 4.00 | 3.99 |
| 30-Year | 4.35 | 4.36 | 4.51 | 4.49 |
| 30-year fixed mortgage rate | | | | |
| | 6.14 | 6.18 | 6.28 | 6.37 |
| 15-year fixed mortgage rate | | | | |
| | 5.86 | 5.92 | 6.02 | 6.00 |
| 1-year adjustable rate | | | | |
| | 5.47 | 5.49 | 5.49 | 5.45 |
| STOCK MARKET | | | | |
| Dow Jones Industrials | 12276.32 | 12114.10 | 12580.83 | 11076.34 |
| S&P 500 | 1402.85 | 1387.17 | 1438.06 | 1281.58 |
| NASDAQ | 2387.55 | 2368.00 | 2459.82 | 2262.04 |
| Commodities | | | | |
| Gold (\$)- 100 Oz | 649.70 | 644.60 | 671.30 | 542.50 |
| Oil (\$ per barrel) - Crude Futures (NYMEX) | 59.95 | 61.62 | 59.79 | 59.96 |
| KEY ECONOMIC INDICATORS | | | | |
| INDICATOR (Latest Month/Quarter) | Current Month/Qtr | Previous Month/Qtr | Two-Months/ Qtrs Ago | Average-Past 6 Months or Qtrs. |
| ISM Nonmanufacturing Index (Feb) - Index | 54.3 | 59.0 | 56.7 | 56.7 |
| Consumer Credit (January) - mths of \$s | 6443 | 5011 | 20504 | 8325 |
| Nonfarm Productivity (Q4 rev.) - % change | 1.6 | -0.5 | 1.2 | 1.5 |
| Nonfarm Payrolls (Feb) - change in 000s | 97 | 146 | 226 | 162 |
| Unemployment Rate (Feb) - Percent | 4.5 | 4.6 | 4.5 | 4.5 |
| Average Hourly Earnings (Feb) - % change | 0.4 | 0.2 | 0.5 | 0.3 |

There's no doubt that the financial markets are in the cross hairs of conflicting developments. Wild swings in foreign stock prices are shaking up investor complacency, reinforcing the anxiety that is already elevated by the ever-growing questions surrounding the subprime mortgage market. Additionally, Federal Reserve presidents – past and present – are issuing opposing messages, with the former chief, Alan Greenspan, warning of a possible recession later this year in contrast to the outlook of the current chairman, Ben Bernanke, which is for moderate and, likely, reaccelerating growth going forward. Adding to market confusion, the economic data are portraying anything but a uniform picture.

Over the past two weeks, for example, the data seemed to support the view that a gathering storm was brewing, setting the stage for a sharper slowdown than expected. The ongoing housing slump showed no signs of abating, with the future looking even more foreboding as institutions tightened lending practices in the wake of the subprime mortgage quagmire. To be sure, sagging housing activity as well as a weak auto sector had been dragging down growth for a while. However, as long as the ripple effects were contained the prevailing view was that the economy would emerge relatively unscathed from the

experience.

But recent figures showing that capital spending was also faltering have suddenly cast doubt on that view, as business investment outlays had long been counted on to cushion the blow from the housing and auto drags. Indeed, the notion that the housing slump was having little or no effect on the rest of the economy received another hit early this week as the Institute for Supply Management's index of service sector activity staged a surprisingly large drop of nearly 5 points in February. That more than offset the positive implications of last week's ISM report showing a rebound in the manufacturing index for the same month. Since the service sector accounts for 80 percent of economic activity, any sustained weakness there would surely have a more profound impact on the economy's fundamental underpinnings, such as employment and incomes, than a modest manufacturing recovery.



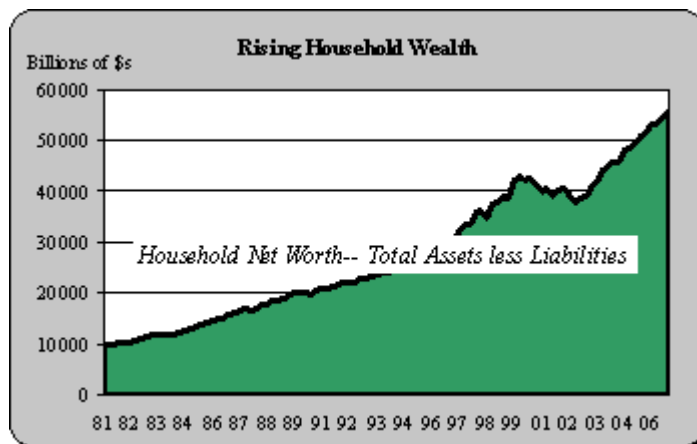
But just as economists were about to sharpen their pencils to mark down their forecasts, some stronger tailwinds started to blow through the growth sails. First and foremost were last week's encouraging signs that consumer spending was holding up well, supported by sturdy income gains. More than anything, that suggested households were not feeling as much pain from the housing correction as the pessimists were claiming. With real consumption standing nearly 2 percent above the fourth quarter average in January, even modest gains in February and March would put consumer spending on par with last quarter's 4.2 percent increase. At that pace, the inventory overhang that has contributed to the more cautious business sentiment would be worked off speedily, imparting a lift to production and eating into spare capacity. That, in turn, is a recipe for stronger capital spending, which would short-circuit the emerging weakness that has surfaced over the past several months.

The question is, how sustainable is the sturdy gains in consumer spending. The pessimists understandably believe that households are living on borrowed time, steadfastly resisting the wealth deflation caused by the housing correction until reality sinks in. This is a classic lagged response to unfolding events, reflecting a strong desire of consumers to sustain living standards for as long as possible. At some point, however, households assess the whole array of financial resources that determine their purchasing power – the value of their assets, debt burdens and income prospects – and start to behave more rationally. The problem with the pessimists' assertions is that when such an assessment is undertaken, the implications for spending are not nearly as negative as they make them out to be.

Yes, housing values have been coming under downward pressure, but the impact is more relative than absolute. As we noted last week, one of the more relevant measures of home prices compiled by the

Office of Federal Housing Management Oversight (Ofheo) – which tracks prices of the same homes involved in repeat sales or refinancings – showed that houses were still appreciating last quarter, albeit by sharply reduced rates than in the recent past. Critics of this series rightfully point out its flaws, including the fact that it only covers homes financed with Fannie Mae and FHLMC mortgages, which have accounted for a smaller fraction of the housing market in recent years and largely encompass the higher priced homes that are not as vulnerable to the correction as are the less-expensive ones.

While that may be the case, it would also be an exaggeration to claim that home values are undergoing a steep erosion that is severely damaging households balance sheets. Indeed, figures released by the Federal Reserve this week reveal that just the opposite is actually taking place. According to the Fed's flow of funds report for the fourth quarter, household net worth -- their total assets less liabilities -- grew by a sizeable \$1.4 trillion in the final months of the year, reaching an all-time high of \$55.6 trillion. True, homeowner equity barely increased during the period, accounting for just 3.2 percent of the net worth gain. That's in stark contrast to the outsized 40 percent contribution it provided over the past 3-½ years.

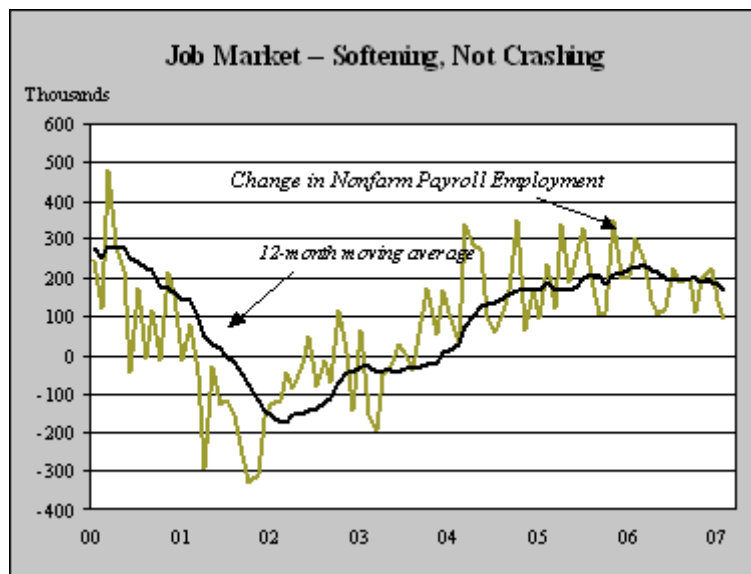


But households enjoyed a substantial increase in their portfolios of stocks and mutual funds, which increased by a combined \$422 billion during the fourth quarter. And that doesn't include the even larger indirect gains included in their pension fund holdings of equities. What's more, while spending has exceeded incomes for over a year, resulting in a negative personal savings rate, that doesn't mean households are depleting their liquid assets. On the contrary, holdings of deposits surged by a record \$226 billion in the fourth quarter, following a \$175 billion increase in the third. That two-quarter accumulation of deposits and liquid assets was by far the largest for a comparable period on record. Rather than being reckless with their finances, it appears that households are parking at least some portion of their home-equity cash-outs into conservative assets, building up a formidable rainy-day fund.

Indeed, the Fed's latest figures dramatically reveal how much households have been relying on assets rather than incomes to support spending. While the savings rate has turned negative, net worth as a percentage of disposable incomes has been rising consistently over the past four years. In the fourth quarter, the ratio moved up to 5.75 percent from 5.66 percent in the previous quarter and stood about a full percentage point higher than it was in the third quarter of 2002, just prior to the onset of the housing boom. Clearly, with the housing boom turning to bust, household balance sheets are vulnerable to the behavior of the stock market, which has turned much more erratic this year relative to the second half of 2006. But even with the 4 percent falloff from its peak in February, stock prices remain above the average of the fourth quarter. Simply put, the housing correction has yet to do serious damage to household balance sheets, which partly explains the ongoing resilience of spending.

Still, it would be foolhardy to assume that the stock market will continue to boost household portfolios going forward, and it is already clear that the real estate market is no longer making a positive contribution to net worth. What that means, of course, is households will have to rely more on income growth than asset gains to sustain spending. Needless to say, income prospects will be largely determined by the strength or weakness of the job market. For the majority of forecasters, this is where the rubber meets the road, which is why the monthly employment numbers garner so much attention in the business press. Unfortunately, the Labor Department's data have a tendency to create as much confusion as clarity.

One reason for the confusion is that it is becoming increasingly difficult to believe the initial estimate of monthly job changes released by the Labor Department. For whatever reason, these estimates have been revised by ever-larger amounts in subsequent months than has historically been the case. For example, this Friday's report revealed that companies added only 97 thousand jobs in February, which would make it the weakest month of job creation since January 2005. However, if past is prologue, the February number will be revised higher, as has been the case for virtually every month over the past year. In Friday's report, the Labor Department added 55 thousand payrolls to the December and January estimates made last month. As a result, the tepid 111 thousand gain in jobs originally reported for January – which set off recession signals in the financial markets – has been transformed into a more respectable 146 thousand increase. We suspect that the slim February gain will likewise get beefed up in the revised numbers released next month.



What's more, the February jobs report lends itself to multiple interpretations for other reasons as well. While the gain in payrolls was weak, the unemployment rate declined to 4.5 percent from 4.6 percent, reaffirming the tightness in the labor market that has driven wage rates higher. But the decline in the jobless rate was due less to strong corporate hiring than to a shrinkage in the labor force, reflecting a sharp drop in the number of people looking for work. Indeed, the number of workers who actually lost jobs rose last month. All in all, the latest jobs report provided at best a mixed picture of labor market trends, which will not give the financial markets a clear sense of direction that is desperately needed to calm the recent upsurge in volatility. Our sense is that the latest jobs report supports the notion that the economy is still transitioning to a slower growth phase, but is far from the brink of a recession. We suspect that several quarters of below-trend growth lie ahead, which should reduce nascent inflation pressures and allow the Fed to cut rates later on in the year if necessary. However, the jury is still out as to whether such action will in fact be needed.

