

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 16, 2007

First the numbers, then the story

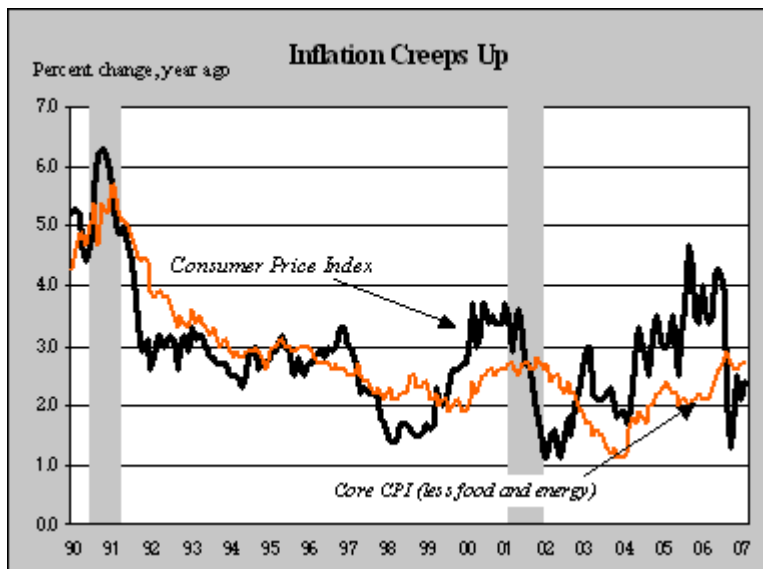
FINANCIAL INDICATORS				
INTEREST RATES	March 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.02%	5.08%	5.16%	4.62%
6-month Treasury bill	5.12	5.13	5.14	4.77
3-month LIBOR	5.35	5.34	5.36	4.88
2-year Treasury note	4.59	4.67	4.83	4.64
5-year Treasury note	4.47	4.55	4.68	4.62
10-year Treasury note	4.55	4.59	4.69	4.67
30-year Treasury bond	4.70	4.72	4.79	4.72
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.64	3.67	3.74	3.66
10-Year	3.85	3.87	3.98	4.00
30-Year	4.34	4.35	4.47	4.53
30-year fixed mortgage rate				
	6.14	6.14	6.30	6.34
15-year fixed mortgage rate				
	5.88	5.86	6.03	5.98
1-year adjustable rate				
	5.42	5.47	5.52	5.37
STOCK MARKET				
Dow Jones Industrials	12110.41	12276.32	12787.57	11279.65
S&P 500	1386.95	1402.85	1455.54	1307.25
NASDAQ	2372.66	2387.55	2496.31	2306.48
Commodities				
Gold (\$)- 100 OZ	652.80	649.70	673.10	554.50
Oil (\$ per barrel) - Crude Futures (NYMEX)	60.30	59.95	59.26	62.82
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (February) - % change	0.1	0.0	1.2	0.1
Consumer Price Index (Feb) - % change	0.4	0.2	0.4	0.0
Core CPI (February) - % change	0.2	0.3	0.1	0.2
Producer Price Index (Feb) - % change	1.3	-0.6	0.9	0.1
Business Inventories (Jan) - % change	0.2	0.0	0.2	0.3
Industrial Production (Feb) - % change	1.0	-0.3	0.8	0.1
Capacity Utilization (Feb) - Percent	82.0	81.2	81.8	81.8

With the Federal Reserve's policy-setting meeting scheduled for next week, all eyes will be on the post-meeting statement. No one expects the policy makers to change its short-term interest rate target from the 5.25 percent in effect since last June. But there is some speculation that the language in the statement could shift to a less hawkish tone, de-emphasizing the inflation threat and elevating the growth risks that seem to be growing. What underpins this speculation, of course, is the mounting problems in the subprime mortgage market, which are increasingly being perceived as an added weight on the already-sagging housing market.

As they say, however, timing is everything, and the latest round of price data should discourage the Fed from giving any appearance of easing up on the inflation fight. The wholesale price report, released on Thursday, was bad enough, revealing an outsized 1.3 percent jump in the finished goods index for February, more than double the consensus estimate. While food and energy prices were responsible for most of the increase, as expected, the core index that excludes those items also increased by about

double the consensus forecast, rising by 0.3 percent. Investors shrugged off the unseemly rise in wholesale prices, expecting a milder report on consumer prices to tame inflation hawks. For the most part, their hopes were met, as both the headline consumer price index and the core CPI, released on Friday, came in about as expected, rising by 0.4 percent and 0.2 percent, respectively, for February.

The tamer consumer price reading injected a note of stability into the financial markets, although equity prices slipped again this week. But the CPI report was probably not enough to erase the Fed's lingering inflation concerns. With February's 0.2 percent increase, the core CPI is up by 2.7 percent compared to a year ago, the same annual rate as the previous month. That's about a quarter of a percentage point higher than what is perceived to be the Fed's comfort zone, and represents a significant acceleration from the 2.1 percent inflation rate of a year ago. In deference to Lucy's husband of yore, the Fed would have "lots of 'splaining" to do if it became less vigilant in the inflation fight.



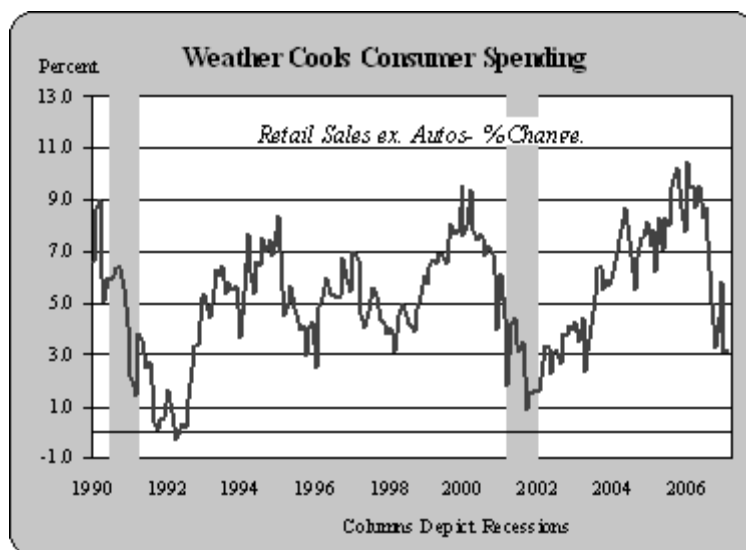
To be sure, the Fed would have a compelling argument to draw on if it chooses to adopt a less hawkish tone at its upcoming meeting. Historically, the consumer prices index, like other inflation measures, is a lagging indicator, responding months after the economy changes direction. Hence, inflation usually continues to rise after a recession begins and, conversely, continues to decline during the initial stages of a recovery. If the Fed waits for actual inflation to subside to its desired range, it may be too late to thwart recessionary forces from gaining traction. Simply put, the policy makers have to be forward looking when setting rates, calibrating their decisions based on where they see the economy in six or twelve months from now. Indeed, the semi-annual monetary report presented to Congress on February 14 clearly implied that the Fed expects inflation to subside over the course of this year and into 2008, reflecting the moderation in economic growth that it expects over the balance of the year.

The question, of course, is whether growth is slowing too much for the Fed's comfort, justifying a more balanced risk assessment in the upcoming post-meeting statement. A month or so ago, a shift in Fed thinking would have been ruled out, as the economy seemed to be picking up momentum, spurred largely by sturdy consumer spending. That perception, however, has since been eroding. Not only was growth in last year's fourth quarter revised down sharply from original estimates, the gathering problems in the subprime mortgage market may well be intensifying the housing downturn, leading to heightened ripple effects throughout the economy. Over the past several weeks, there has been ample debate in the media – and surely among policy officials – about this issue, and only time will tell if the broad economic damage caused by the mortgage meltdown is being exaggerated, as many believe.

Nonetheless, it is hard not to notice the implications of the subprime issue. The Mortgage Bankers Association just reported a record volume of foreclosures in the fourth quarter, fueled by an upsurge in homeowners defaulting on these nonconventional types of loans. Bank mortgage lending standards are tightening significantly, several high-profile institutions specializing in these loans are suffering severe balance sheet and liquidity problems, and the proliferation of foreclosure signs on lawns around the nation may be beginning to weigh on household psychology. Indeed, Friday's report by the University of Michigan that its index of consumer sentiment fell to a six-month low in early March partially reflects this impact. While rising gasoline prices are also contributing to a more sour mood, the mortgage meltdown is clearly being felt, as the people who expressed the most dissatisfaction with conditions are the upper income folks, those who are most likely to own a home.

If, in fact, the problems in the mortgage market are affecting consumer behavior, the Fed would no doubt have to reassess its risk bias and start to worry at least as much about growth as inflation. To the pessimists, this week's report on retail sales for the month of February only argues for such a reassessment. Consumer spending at retail outlets edged up by 0.1 percent during the month, thanks mainly to stronger sales at auto dealers and service stations, reflecting higher gasoline prices. But elsewhere, sales were weak. Excluding autos, sales slipped by 0.1 percent during the month, and the decline deepens to 0.3 percent if both autos and service stations are stripped from the total. The list of retail groupings showing weakness last month was broad, including sellers of clothing, building materials, furniture and general merchandise.

That said, the February weak showing at retailers comes with some qualifications. First and foremost is the weather. Recall that unusually warm weather boosted sales in December and January, setting the stage for some payback as cooler temperatures returned. That clearly occurred in February, as frigid conditions and storms affected many regions of the nation. Among the victims of this weather reversal were clothing outlets as well as building material and home improvement stores, although the latter are being more heavily affected by the housing downturn. Although it is hard to gauge the impact of weather on sales, some inferences can be drawn from last week's jobs report by the Labor Department. In the household survey, it was noted that more than half a million people could not get to work at some point during the month because of bad weather, the highest total in more than ten years -- since the blizzards of January 1996.



No doubt, some of those hemmed-in workers found it difficult to get to the malls, depressing the sales figures last month. One sign that purse strings were still being kept open: Internet and catalogue

shopping, which aren't influenced by the weather, jumped by 2.8 percent in February, nearly three times the average monthly gain during 2006. What's more, the so-called retail control group, which consists of sales less autos and building materials that enter into the GDP calculations for consumer spending, averaged nearly 2 percent above the fourth quarter average in January and February. Assuming a modest rebound in March, consumer spending remains on track for a 3 percent gain in the first quarter, enough to propel GDP solidly higher for the period.

To be sure, a 3 percent growth rate in consumer spending would still represent a slowdown from the fourth quarter's sturdy 4.2 percent pace. But it would be at least as strong as the middle two quarters of last year and hardly a sign of an economy running out of steam. What could be a wild card in the outlook – aside from the still-uncertain impact of the mortgage meltdown – is the looming drag on consumer purchasing power from another bout of rising gasoline prices, which is clearly underway. Recall that higher pump prices last summer siphoned about \$90 billion from disposable incomes, contributing to the pronounced growth slowdown in the third quarter. Another spiral of the magnitude seen then could aggravate the psychological damage inflicted on consumers by the housing correction, including the spirit-sapping impact of the sharp rise in mortgage foreclosures.

Many questions about the economy's health abound, and ammunition for opposing views on growth and inflation can easily be found among recent data. To us, the biggest disappointment with regards to growth prospects has been the unexpectedly weak capital spending by businesses in recent quarters, especially in light of the strong gain in profits and the excellent health of corporate balance sheets. If business spending continues to underperform in coming quarters, our sense is that the economy will experience more than just the "soft landing" that the Fed is hoping to bring about. But we are not ready to throw in the towel just yet. While leading indicators, such as durable goods bookings, point to sluggish near-term capital spending, it's not at all clear why this is happening, or how long it will last.

To the extent that businesses are holding back until excess inventories are worked off, setting the stage for a rebound in production that will eat into spare capacity, the wait may not be long. One encouraging sign was this week's report of a stronger-than-expected increase in industrial production for February. The 1 percent jump was the strongest in 15 months, lifting the capacity utilization rate to 82 percent from 81.2 percent in January. And while cold weather boosted utility output, manufacturers also revved up operations, lifting production by a solid 0.4 percent during the month. Most encouraging from the capital-spending standpoint, production of computers, semiconductor and communications equipment increased by a robust 3.2 percent following a sturdy 2.1 percent gain in January. The strength in output of high-tech gear may be an early sign that companies are poised to upgrade their plant facilities with productivity-enhancing equipment. That would not only add muscle to capital spending it also helps keep costs and, hence, inflation down, something that would make the Fed's job that much easier.

