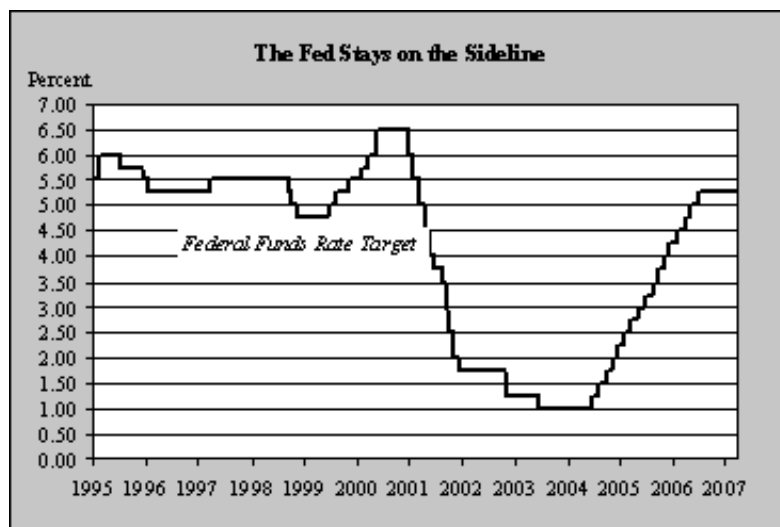


WEEKLY ECONOMIC COMMENTARY - WEEK OF MARCH 23, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	March 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.05%	5.02%	5.17%	4.64%
6-month Treasury bill	5.09	5.12	5.15	4.77
3-month LIBOR	5.35	5.35	5.36	4.92
2-year Treasury note	4.60	4.59	4.80	4.71
5-year Treasury note	4.51	4.47	4.66	4.66
10-year Treasury note	4.61	4.55	4.67	4.67
30-year Treasury bond	4.80	4.70	4.78	4.69
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.67	3.64	3.73	3.62
10-Year	3.87	3.85	3.96	3.99
30-Year	4.36	4.34	4.45	4.53
30-year fixed mortgage rate				
	6.16	6.14	6.22	6.32
15-year fixed mortgage rate				
	5.90	5.88	5.97	5.97
1-year adjustable rate				
	5.40	5.42	5.49	5.41
STOCK MARKET				
Dow Jones Industrials	12481.01	12110.41	12653.17	11279.97
S&P 500	1436.11	1386.95	1451.84	1302.95
NASDAQ	2456.18	2372.66	2517.02	2312.82
Commodities				
Gold (\$)- 100 Oz	657.30	652.80	686.70	560.00
Oil(\$ per barrel) - Crude Futures (NYMEX)	62.28	60.30	61.14	64.27
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (Feb) - 000s of units	1525	1399	1633	1554
Building Permits (Feb) - 000s of units	1532	1571	1613	1570
Leading Indicators (Feb) - % change	-0.5	-0.3	0.7	0.0
Existing Home Sales (Feb) - 000s of units	6690	6440	6270	6298
Median Home Prices (Feb) - \$s	212800	210900	221600	217067

The Federal Reserve sparked a major stock market rally this week, although there is some question as to whether its actions justified the heightened euphoria. What ignited the rally, of course, was the Fed's policy-setting meeting on Tuesday and Wednesday, which, as expected, didn't result in any interest-rate change. The federal funds rate was left untouched at 5.25 percent for the sixth consecutive meeting, dating back to last June. But as we discussed last week, it was not deeds but words that galvanized traders and investors.



Simply put, the spotlight focused on whether or not the Fed would soften its anti-inflation stance in the statement issued after the meeting, something that would set the stage for a possible rate cut in the foreseeable future. While expectations were about evenly split as to whether it would or would not, the odds that it would soften its anti-inflation rhetoric increased in recent weeks owing to the economy's continuing subpar performance and the ongoing housing correction that has lately been exacerbated by the headline-grabbing woes in the subprime mortgage market. Well the Fed did alter the language in its statement, taking out a key phrase from past meetings that alluded to ... "the extent and timing of any additional firming that may be needed ...". It was that omission that launched the rally, as it was widely perceived as a shift in Fed thinking towards a more neutral stance, with growth and inflation risks receiving equal priority.

But the sharp reaction in the market may have overstated the Fed's intent. True, it removed the contentious signal that the next move will more likely be a rate hike than a cut, something that the economic doomsayers have long called for. To think that the Fed has become an outright dove, however, poised to step on the rate-slashing accelerator at the first convenient moment would probably be a stretch. Indeed, a closer examination of the statement clearly shows that the policymakers still perceive inflation to be the major risk facing the economy. While it removed the aforementioned phrase with one hand, it bolstered this perception with the other by reiterating that "the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected."

In other words, the bias in the Fed's stance remains tilted towards curbing inflation rather than stimulating growth. Nonetheless, Bernanke and Company did downgrade their growth forecast, acknowledging that the housing correction is "ongoing" rather than "stabilizing" as described in the previous months' statement. That's a significant concession, in our view, but does it increase the probability that the next move will be a rate cut? Certainly, the futures market thinks so, as manifested by the fed funds futures contract, which immediately priced in a much higher chance of a rate cut by the end of the year. Our sense is that what the policy makers are attempting to do is give themselves as much flexibility as possible to respond to incoming economic data.

Clearly, the Fed is frustrated that inflation has not receded as fast as it anticipated. Indeed, key inflation measures not only remain above unofficial target ranges, they have actually accelerated in recent months. Meanwhile, the economy has slogged along at a weaker pace than expected, not only because of the housing drag but also due to the inexplicable weakness in business capital spending. In a sense, therefore, the Fed finds itself caught between the proverbial rock and hard place. If it continues to lean against the inflation tide by keeping interest rates too high, it risks pushing the economy closer to a

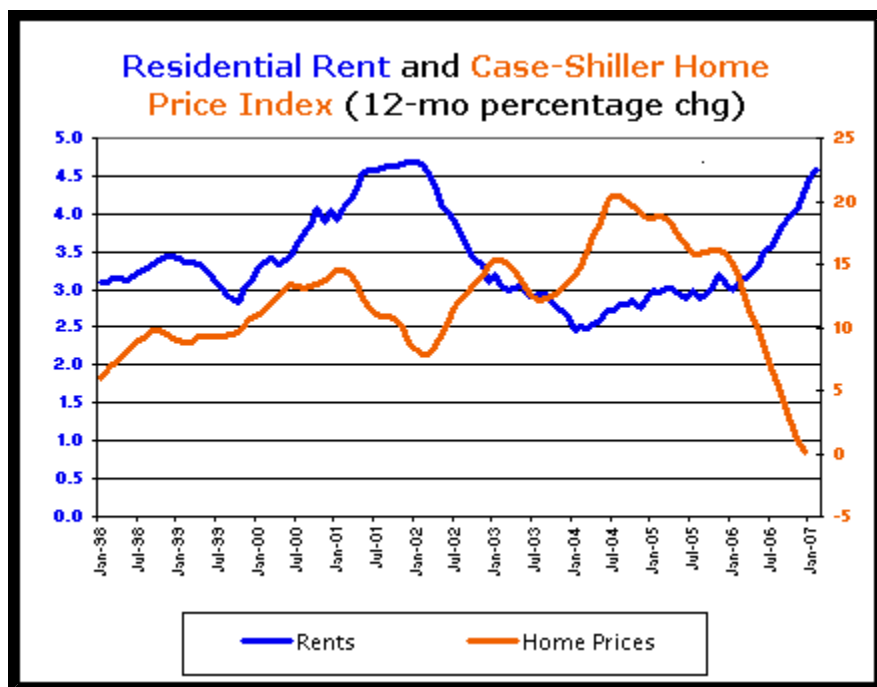
recession. Conversely, if it eases up on the inflation fight to revitalize growth, it risks igniting inflation embers that might require even harsher rate-hiking moves later on.

Complicating matters even more is that inflation, as we noted last week, is a lagging indicator. Hence, the Fed also has to take into account the prospect that the inflation rate will subside in coming months in response to the economic slowdown that has been underway for the past several quarters. Clearly, the Fed is aware of this lagging relationship, which probably explains why it has been so patient in tolerating an inflation rate that has remained above its comfort zone for so long – almost three years in fact. But there is also a nagging sense of unease among many policy officials that by continuing to tolerate an elevated inflation rate, they run the risk of embedding higher inflationary expectations into household and business decisions. Once this occurs, it becomes much harder to root inflation out of the system, as both actual and expected inflation have to be reigned in. That may require a more painful policy prescription in the future than would be the case with a dose of preventive medicine now.

But it is also worthwhile to examine if the comfort zone established for inflation by the Fed is reasonable in today's economic environment. Unofficially, the range is 1-2 percent, established several years ago when the major threat to the economy was deflation. The 1 percent lower bound was deemed as insurance against deflation, while the 2 percent upper limit was considered reasonable to allow for an upward bias inherent in the price measures, such as price increases that do not take into account quality improvements. In short, a 1-2 percent increase in inflation, as currently measured, was consistent with the Fed's notions of price stability in a normal economic environment.

No doubt, if inflation were running considerably above the upper end of the range, there would be little question that a policy tilting towards restraint would be the appropriate stance. But what if, as is currently the case, the inflation rate is hovering just a quarter of a percent or so above the Fed's comfort zone, even as the economy is running well below its trend rate. Under these circumstances, it is understandable to wonder if the comfort range of 1-2 percent is too rigid and arbitrary. Many experts believe it is. The crux of their argument is that the range should be widened to allow for some of the obvious distortions in the price measures that are boosting perceived inflation above actual inflation. In the current instance, the major distortion is the way housing costs are measured in the CPI and other price indexes, including the Fed's preferred gauge, the core personal consumption deflator.

Essentially, the Labor Department uses rents as a proxy for owner-occupied housing costs, called the Owners Equivalent Rent (OER). Instead of measuring actual cash flows associated with purchasing and owning a home, such as mortgage rates, real estate taxes or home prices, it measures the "opportunity cost" of living in one's home. That opportunity cost is defined as the rent a person would receive if someone else lived in his or her home. For a while, this was considered to be a reasonable proxy of housing costs, since rents and home prices tended to move together. However, in recent years, their paths have diverged markedly, with rising home prices accompanied by slower rent increases, and vice versa. Why? There are several explanations, but the most accepted one is simply that when home prices are falling, prospective occupants would rather rent than buy a home in anticipation of continued price declines. That behavior, in turn, boosts the demand for rental units and leads to an increase in rents. Just the opposite happens when home prices are rising, as was the case from 2002-2005.



To make matters worse, the OER plays an outsized role in the price indexes, accounting for 30 percent of the core consumer price index. Indeed, the acceleration in the core CPI over the past year has been very much dominated by the OER. In the twelve months ending in February 2007, for example, the core CPI has increased from an annual rate of 2.1 percent to 2.7 percent, well above the Fed's comfort zone. However, of that 0.6 percent acceleration, the OER has contributed fully 0.5 percent. In other words, excluding the housing component, the core inflation rate has remained essentially unchanged at a rate well within the Fed's comfort zone. Yet the rise in the OER is really an artifact of falling home prices, which is clearly a deflationary event.

The point is, if the Fed continues to target the distorted price measures as a guide to policy, it could well be keeping rates too high. Perversely, an overly tight policy would serve to further weaken the housing market, causing a continued drop in home prices, which would have the effect of boosting rents and, hence, the core consumer inflation rate. This is a vicious bind that could end in a veil of tears for the economy. No doubt, the Fed is well aware of the distortions in the price indexes, and is taking them into account when formulating policy decisions. However, the financial markets react to statistical data, revealing the ups and downs in the inflation rate, and may not be sympathetic to Fed moves that run counter to these movements. Hence, should the Fed decide to ease because of a weak economy when the core inflation rate is increasing, due largely to rising rents, the bond vigilantes may well strike with a vengeance, sending long-term interest rates sharply higher.

At this juncture, it does not seem that the OER influence on inflation will moderate in the immediate future. Home prices continue to slide, reflecting increasing levels of inventories for both new and existing homes. What's more, rising foreclosures are effectively adding to unsold homes while reinforcing the demand for rental units, as dispossessed households need a place to live. These trends were highlighted in Friday's report of existing home sales. In February, inventories rose to a 6.7 months' supply of sales, up from 5.2 months a year ago, while median prices continued to fall below levels of a year ago. On the bright side, sales did bounce up for the second consecutive month. The rebound may have been related primarily to the unusually warm weather in December and January, when the contracts for the units sold were signed. Whether the housing market is stabilizing or sinking even further because of the subprime woes is something that will have a critical influence on both economic growth as well as

the published inflation rate. Clearly, the Federal Reserve will have to sift through a complicated set of conflicting data in coming months. Hopefully, they will come to the right conclusions.

