

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 30, 2007

First the numbers, then the story

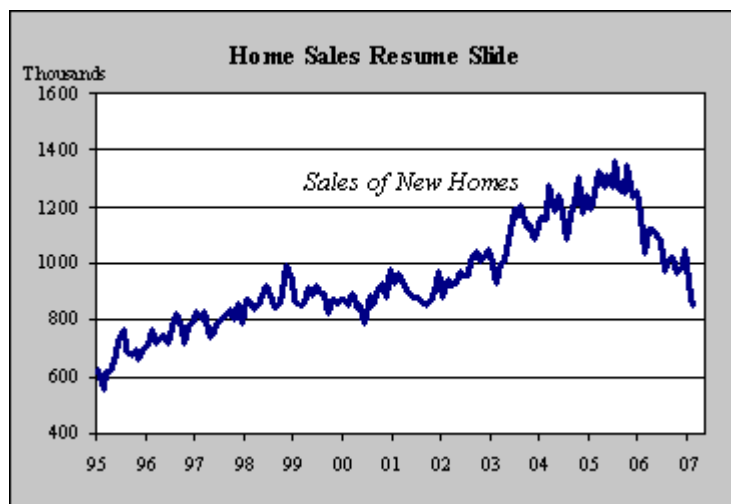
FINANCIAL INDICATORS				
INTEREST RATES	March 30	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.03%	5.05%	5.17%	4.60%
6-month Treasury bill	5.06	5.09	5.15	4.81
3-month LIBOR	5.35	5.35	5.36	4.95
2-year Treasury note	4.58	4.60	4.80	4.82
5-year Treasury note	4.54	4.51	4.66	4.81
10-year Treasury note	4.65	4.61	4.67	4.85
30-year Treasury bond	4.84	4.80	4.78	4.89
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.72	3.67	3.73	3.69
10-Year	3.97	3.87	3.96	4.03
30-Year	4.47	4.36	4.45	4.56
30-year fixed mortgage rate	6.16	6.16	6.22	6.35
15-year fixed mortgage rate	5.86	5.90	5.97	6.00
1-year adjustable rate	5.43	5.40	5.49	5.51
STOCK MARKET				
Dow Jones Industrials	12354.35	12481.01	12653.17	11109.32
S&P 500	1420.85	1436.11	1451.84	1294.83
NASDAQ	2421.64	2456.18	2517.02	2339.79
Commodities				
Gold (\$)- 100 Oz	669.00	657.30	686.70	582.00
Oil (\$ per barrel) - Crude Futures (NYMEX)	68.10	62.28	61.14	66.41
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (February) - 000s	848	880	1047	959
Median Sales Price (February) - \$s	250000	243200	241200	241933
Durable Goods Orders (Feb) - % change	2.5	-9.3	3.5	0.1
Revised GDP(Q4) - % change	2.5	2.0	2.6	3.1
Consumer Confidence Index (March)	107.2	111.2	110.2	108.2
Personal Income (Feb) - % change	0.6	1.0	0.5	0.5
Personal Consumption (Feb) - % change	0.6	0.5	0.7	0.4

We don't mean to sound repetitive, but with each passing week the downside risks to the economy are becoming more and more apparent. This week's reports on new home sales and capital goods orders simply reinforce that perception.. To be sure, Fed chairman Bernanke put on a brave face in his Congressional testimony on Wednesday, reiterating the official view that the economy should forge ahead at a moderate pace this year and probably accelerate in the second half when the housing drag is expected to wane. But even he acknowledges that the housing correction could be deeper than expected, and its ripple effects could impose more damage to the broad economy than is currently envisioned. And, for the first time, Bernanke is revealing doubts about whether capital spending will be strong enough to cushion the blow from the housing drag.

Still, the Fed chief retained the main message conveyed in last week's post-FOMC policy statement,

namely that the predominant risk facing the economy continues to be that inflation does not moderate as much or as quickly as anticipated. Simply put, Bernanke sounded an ambivalent theme in his testimony, and the financial markets reacted accordingly – negatively at first, but recovering somewhat thereafter. No doubt, the markets are responding to a host of concerns besides economic ambiguities. Chief among them is the growing tensions between Iran and Britain, which brings geopolitical uncertainties back into the forefront. It also shines the spotlight again on oil prices, which spiked to over \$65 a barrel this week. Not only does that elevate inflation pressures, it poses another obstacle for households to overcome, reinforcing the psychological hit coming from a rapidly deteriorating housing market.

For a brief time, there was some hope that the housing drag was actually beginning to fade, as both housing starts and sales of existing homes showed surprising strength in February. But the uptick in starts was more a weather-related bounce than anything, since building permits for future construction continued to decline. What's more homebuilders are expressing deep despair over conditions, marking down forecasts and warning of an earnings squeeze that is hammering their stock prices. Meanwhile, the encouraging report on existing home sales reflects closings of contracts signed several months ago, before the subprime mortgage meltdown closed the credit spigot for this important group of homebuyers. A more accurate reading on current conditions can be gleaned from the report on new home sales, and this week's reading provided by the Commerce Department is hardly encouraging.



If anything, the dispiriting 3.9 percent drop in new home sales during February may mark the next leg down in the housing market, one that could yet be more precipitous than the Fed would like to see. The February drop, which followed sharp downward revisions in sales for the previous two months, lowered the monthly selling rate to 848 thousand, the lowest since August 2000. More important, sales are falling at a faster pace than builders are cutting production, which will keep the inventory of unsold homes at their lofty levels. Simply put, builders still have their work cut out for them. Even assuming that sales level out in coming months, it will take several quarters of pared-down construction activity before inventories are restored to more tolerable levels. Over the last half of 2006, the decline in residential construction sliced 1- $\frac{1}{4}$ percentage points from the economy's growth rate, and it looks like that drag will persist throughout the first half of this year.

Moreover, there is a lag between housing starts and employment in the construction industry. It takes about six months to build a home, so the hardhats that were hired at the start of the building process will find themselves out of a job when the project is completed. This means, of course, that the unemployment toll among construction workers and those in related industries that supply parts and materials to the homebuilding sector will be climbing for some time. Just how severe a bite into the

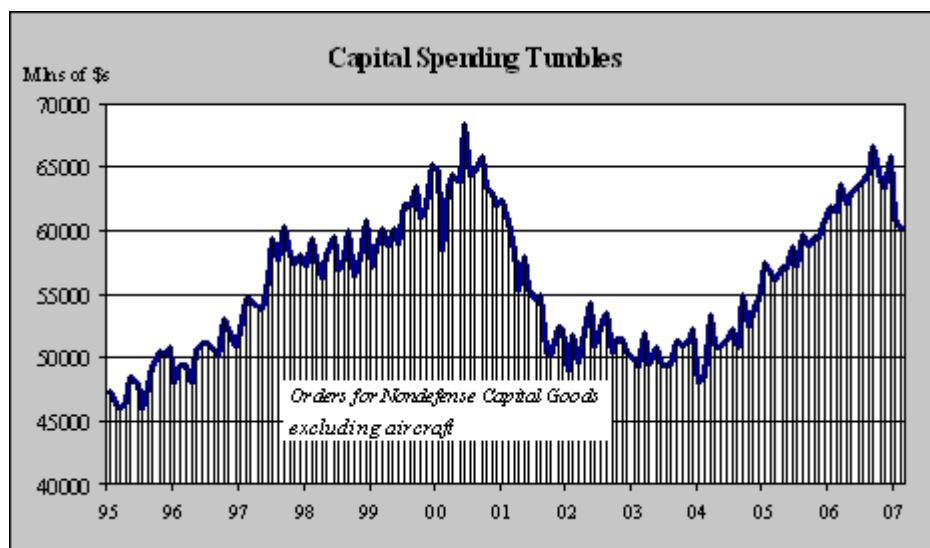
overall job market this takes remains to be seen, as many of these laid-off workers will presumably find work elsewhere. One alternative, of course, is the nonresidential sector, where the construction of commercial offices, factories and shopping centers has, until recently, been quite strong. Indeed, business investment in general has long been viewed as a prospective bulwark against the housing drag, not only absorbing laid-off workers but also replacing the growth haircut caused by the drop in residential spending. That offset, however, has fallen far short of expectations, and the future does not look too encouraging.

Indeed, following more than two years of solid increases, investment spending has slowed considerably over the final three quarters of 2006. From the second through the fourth quarters of last year, the growth rate in nonresidential outlays averaged 3.8 percent, less than half the 7.7 percent average gains over the previous eight quarters. To make matters worse, the final quarter of last year witnessed the first outright decline in investment spending in nearly four years, paced by a sharp 4.8 percent retrenchment in outlays for capital goods. On the positive side, spending on structures – offices, factories, shopping centers and the like – continued to expand, although just barely, during the period, suggesting that high operating rates is still a powerful incentive to add capacity. Indeed, the fourth-quarter slowdown in spending on structures may have been an aberration as these outlays picked up again in January and February of this year.

But it is the sharp slowdown in spending on equipment and software that has been the biggest disappointment to the Fed and private forecasters. Capital spending can be a strong driving force behind a cyclical expansion, as evidenced by the torrid high-tech inspired boom of the late 1990s. That boom collapsed with the dot-com bust at the turn of the century, which played a big role ushering in the mild 2001 recession. Indeed, capital spending remained in the doldrums for two years following the bust, as companies focused on restoring shattered balance sheets and practiced capital discipline in the wake of the excesses of the 1990s. With stock prices also depressed for three years following the market collapse in early 2000, it became much more expensive for corporate treasurers to raise equity capital.

But the conditions for capital spending have improved by leaps and bounds in recent years. Profits have surged, providing corporate treasurers with ample cash flow to finance outlays, balance sheets have been restored to health, the cost of borrowing has remained low and the stock market has staged a powerful recovery. As a result, expectations ran high that the modest capital-spending recovery in 2004 and 2005 would gain momentum last year and continue into 2007, replacing the slack left by the housing correction. Unfortunately, these expectations have been sadly unfulfilled. As already noted, capital spending slowed dramatically as 2006 unfolded, culminating with the fourth-quarter outright decline, and recent figures point to continued weakness in the foreseeable future.

Most conspicuously, the government reported this week that new orders for nonmilitary capital goods, less volatile bookings for commercial aircraft, slid by another 1.2 percent in February, following a pronounced 7.4 percent drop in January. This series is considered to be a reliable gauge of future capital spending, indicating that the fourth-quarter retrenchment will not soon be followed by a major snapback. Indeed, the first quarter could well turn in another negative reading. While orders point to the future of spending, shipments reflect what is happening now, and capital-goods shipments in January and February averaged a whopping 9.8 percent below the fourth quarter average. It's not likely that March shipments will rebound enough to push the total into positive growth terrain. Fortunately, as mentioned above, spending on structures continued to increase in January and February, which should give a lift to total nonresidential fixed investment spending in the first quarter.



In light of the positive fundamentals that typically underscore capital spending, it is something of a mystery as to why CEOs are holding back. Clearly, the slowing economy is coloring their assessment of just how profitable new capital investments would be, particularly if the slowdown continues and, perhaps, morphs into a recession. Indeed, recent surveys do reveal a growing sense of caution among business leaders with regards to the economy's prospect. That caution is understandable given the uncertainty over how pronounced the housing downturn will turn out to be, and the potential ripple effect the downturn eventually has on consumer spending. If households feel significantly poorer because of the weakening housing market and decide to pull in their horns, companies would find themselves with more spare capacity, burgeoning inventories of unsold goods, and less incentive to purchase new capital equipment.

Clearly, businesses are casting a wary eye on households, and will likely continue to do so as long as housing conditions remain in a weakened state. This augurs for a sustained period of capital-spending discipline, something that could well benefit shareholders if corporate treasurers continue to use their cash inflows to buy back company stock. But they also run the risk of having inadequate productive resources to meet demand in the event of a growth surprise. It's one thing to cut back capital spending when these resources are being underutilized. It is quite another to be inadequately prepared for unexpected strength in demand when resource utilization is high, as is currently the case. In that instance, the risk is consumers will turn to rival companies – either domestically or abroad – to satisfy consumption, resulting in a loss of market share.

If there has been one consistent pattern throughout the expansion, it is that forecasts have repeatedly underestimated the resiliency of consumers. We suspect that may be happening again. The housing correction has been ongoing now for well over a year and, despite dire claims that the correction will bite deeply into consumer spending, there has been no discernible impact. To be sure, it may just be a matter of time before the roof does finally cave in, but we have learned from the mistake of second-guessing what drives households. Simply put, while changes in housing wealth influence spending decisions, ultimately it is jobs and incomes that play the more important roles. Both are holding up well so far, and it is no coincidence that consumers have stayed the course. This week's report on income and spending for February reaffirmed that trend, as both increased by a sturdy 0.6 percent during the month. During the first two months of the year, real consumer spending stood 3.2 percent above the fourth-quarter average. Assuming a modest 0.2 percent increase in March, the first-quarter increase in real outlays would come to a 3.7 percent annual rate. That's a tad under the sturdy 4.2 percent fourth-quarter gain, but on par with the increases posted throughout the expansion. Our sense is that if households

continue spending at anywhere close to this pace in the second quarter, businesses will reevaluate the adequacy of their capital stock and rev up spending plans to keep pace with demand. That, in turn, would give the economy a major lift over the second half of the year. With the financial markets apparently priced for a slowing economy and a probable Fed rate cut, it would be interesting to see how they would react to a growth surprise.

