

WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 6, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	April 6	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.03%	5.03%	5.08%	4.68%
6-month Treasury bill	5.09	5.06	5.13	4.86
3-month LIBOR	5.35	5.35	5.34	4.98
2-year Treasury note	4.72	4.58	4.67	4.90
5-year Treasury note	4.65	4.54	4.55	4.91
10-year Treasury note	4.76	4.65	4.59	4.98
30-year Treasury bond	4.92	4.84	4.72	5.06
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.71	3.72	3.67	3.76
10-Year	3.99	3.97	3.87	4.10
30-Year	4.51	4.47	4.35	4.59
30-year fixed mortgage rate	6.17	6.16	6.14	6.43
15-year fixed mortgage rate	5.87	5.86	5.86	6.10
1-year adjustable rate	5.44	5.43	5.47	5.57
STOCK MARKET				
Dow Jones Industrial	12560.20	12354.35	12276.32	11120.04
S&P 500	1443.76	1420.85	1402.85	1295.50
NASDAQ	2471.34	2421.64	2387.55	2339.02
Commodities				
Gold (\$)- 100 OZ	679.40	669.00	649.70	593.00
Oil (\$ per barrel) - Crude Futures (NYMEX)	68.24	68.10	59.95	67.41
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs
ISM Manufacturing Index (March)	50.9	52.3	49.3	50.8
ISM Service-Sector Index (March)	52.4	54.3	59.0	56.4
Change in Nonfarm Payrolls (Mar) - 000s	180	113	162	164
Unemployment Rate (March) - Percent	4.4	4.5	4.6	4.5
Average Hourly Earnings (Mar) - % change	0.3	0.4	0.2	0.4

Depending on your perspective, the downshifting of economic growth over the past year represents either a welcome transition that will wring out inflationary pressures, or the late innings of an expansion that is poised to meet a painful end. The optimists, of course, subscribe to the former perspective, noting that the slowdown in growth is precisely what the Federal Reserve had been counting on to extend the life of the expansion. True, the adjustment came sooner and has been more severe than the Fed had expected, as the economy turned in three consecutive quarters of below-trend growth through the end of last year. More than likely, that string was extended into the first quarter of this year, and most economists expect another quarter of under-3 percent growth in the second quarter as well.

But few cyclical expansions are able to transition smoothly from its early turbo-charged state to a more moderate sustainable pace. Once pent-up demand is satisfied, easy credit and low interest rates work their magic in stimulating debt-financed spending, and businesses ramp up investment to meet growing

output needs, the seeds for the slowdown are planted. That's because the Fed doesn't sit idly by as these growth forces eventually strain the economy's productive capacity, igniting inflation embers. Before that point is reached, the policy makers start to take away the punch bowl, raising rates to cool off demand and create some slack in the economy. More often than not, the Fed overextends itself, pulling the rate-hiking trigger too aggressively. That, coupled with the economy's normal lagged response to rate increases, pushes the growth pendulum too far to the downside, launching a sequence of events that stifles the expansion.

To be sure, the Fed has become much better at reading the economic tea leaves, probing with the interest-rate lever instead of over-navigating as was customary in the past. During the 1990s, the Greenspan-led Fed was able to stop the tightening process in time when cyclical forces threatened to reach a boil in 1994. After short-circuiting nascent inflation pressures, the policy makers responded quickly to the growth slowdown in 1995 by cutting rates and refueling the expansion that ultimately continued for another five years. In 1999, it was not as lucky, as the rate-hiking campaign started too late to prevent the speculative excesses that were clearly building, particularly in the stock market. When the dot.com boom turned to a bust in 2000 and capital spending collapsed along with stock market, Greenspan could do little to stop the economic house of cards from tumbling into recessionary waters.

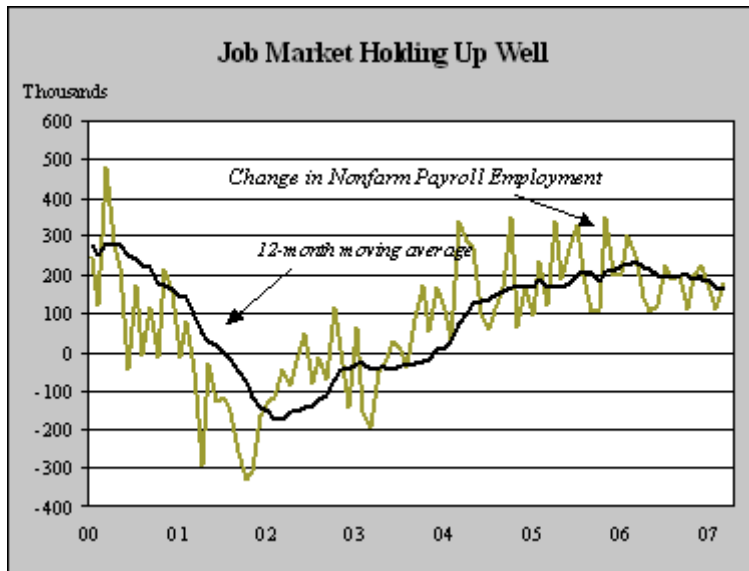
Now the question again is, has the Fed waited too long to right the economic ship? The optimists say no, believing that just enough growth-retarding moves were put in place to nip rising inflation pressures, but not so much that the growth engine is deprived of nourishment. True, the two-years of rate increases totaling 4.25 percentage points through last June have had a profound impact, particularly on the housing market. But it was the frenzied housing boom of recent years that, like the stock market of the late 1990s, represented the major speculative excess of the expansion, encouraging consumers to spend beyond their means and take on record debt burdens to sustain consumption habits. The goal of freeing the economy from its housing addiction was a primary focal point of the rate-hiking strategy.

Clearly, that goal has been accomplished – in spades. But the Pollyannas maintain that the prolonged housing slump underway over the past year is merely defusing an inflation catalyst and putting the economy on a necessary below-trend growth diet until inflationary forces have been purged from the system. How long the growth engine needs to cruise in second or third gear remains to be seen, but the positive view, one held by the current Fed chairman, is that the economy retains enough strength elsewhere to keep it out of a recession. Once the housing drag fades, the forces for growth should reemerge, propelling the expansion into a long and healthy life.

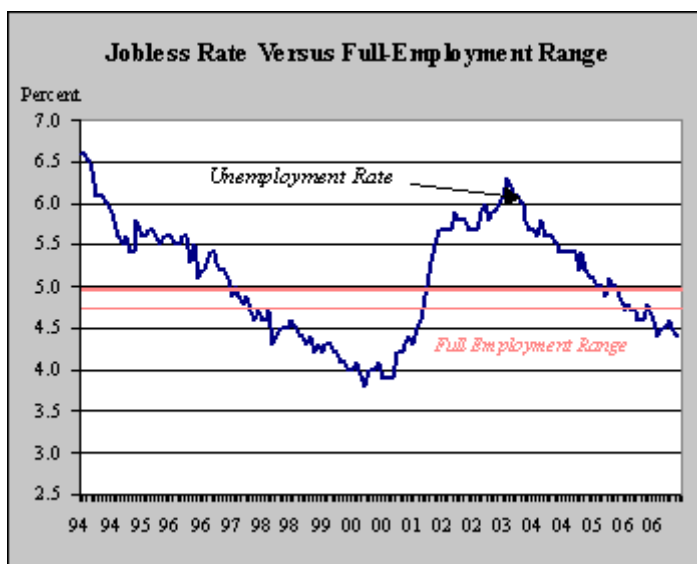
So far, the optimists seem to have it right. As Fed chairman Bernanke has repeatedly claimed, as long as households enjoy solid job and income gains, consumer spending – which accounts for 70 percent of economic activity – should provide the needed support to sustain the expansion. Clearly, with appreciating housing wealth no longer a source of purchasing power, as was the case during the first four years of the expansion, consumers would have to rely more heavily, if not entirely, on income gains to finance expenditures. A key question is whether the housing slump and its ripple effects would spread to the broader economy, discouraging businesses from expanding payrolls and depriving households with the very income growth critical to this somewhat rosy scenario.

Given the headline-grabbing downturn in housing activity and the associated meltdown in the subprime mortgage market, with its still uncertain ramifications, the performance of the job market has to be considered a pleasant surprise. While the job machine, like the overall economy, has certainly downshifted into a lower gear, it has hardly run out of gas as many forecasters had expected by now. What's more, the extent of the slowdown is open to question, as the government has consistently revised up its initial estimates of monthly job growth. In the latest holiday-shortened week, this pattern was once

again observed. On Friday, the Labor Department reported that the economy generated a sturdy 180 thousand new jobs in March, far more than the 150 thousand or so that had been expected on Wall Street.

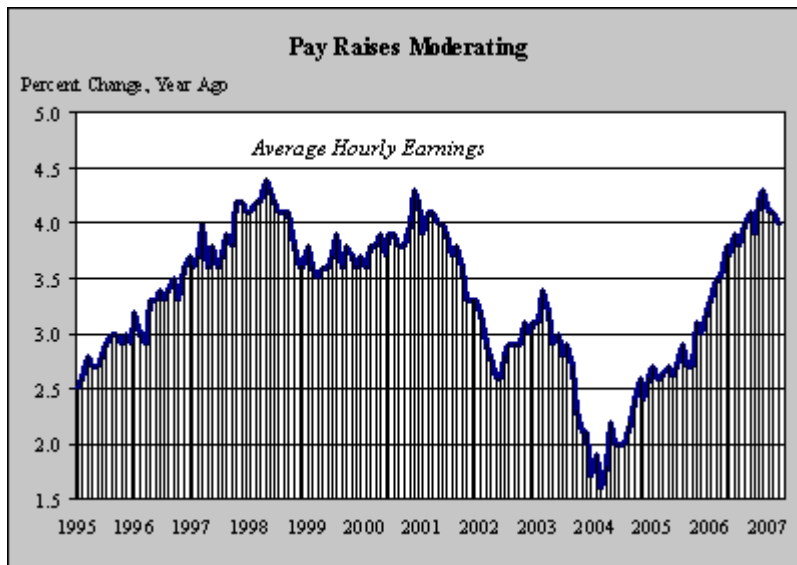


And, true to form, estimates from previous months were revised up – from 97 thousand to 113 thousand in February and from 146 thousand to 162 thousand in January. Over the past year, job growth has averaged 164 thousand a month, slipping to 151 thousand in the first quarter. That's well off the peak 12-month pace of 237 thousand reached a year ago; but if the economy were still producing that many jobs, the wage and price environment would be considerably more frightening than is currently the case. The reason: the job market is as tight as a drum, at least according to conventional measures of labor tightness. Although there is considerable debate on this issue, full employment is generally thought to exist when the unemployment rate falls to within a range of 4 ¾ and 5 percent.



In March, the jobless rate slipped a tenth of a percentage point to 4.4 percent, matching the six-year low reached last October. Simply put, when unemployment is driven down to such bare-bones levels, the fear is that companies will have to ratchet up wages to attract scarce workers. That, in turn, increases the pressure on employers to lift prices in order to protect profit margins. Nothing provokes the Federal

Reserve into a rate-hiking mode more than the threat of an escalating wage-price cycle, something that requires harsh measures to combat. But while wages have been creeping up, they have not jumped by as much as would be suggested by the low jobless rate. Indeed, the 0.3 percent increase in hourly earnings in March was spot on with the monthly average over the past year, and the 4 percent 12-month increase is actually down from the 4.3 percent peak hit at the end of last year.



It is not clear why wage increases are moderating in the face of a shrinking pool of available labor. One explanation may simply be that the forces of globalization are restraining the ability of workers to demand larger pay raises. Another is that measures of unemployment do not accurately reflect how tight the labor market actually is. Indeed, the labor force participation rate remains at historically low levels, suggesting that there may be a good deal of "hidden" slack that could be tapped into if the lure of higher earnings became strong enough to attract dropouts back to the workplace. The Federal Reserve itself is sufficiently suspicious of conventional jobless measures that it lowered the range of what it considers to be full employment to 4 ½ to 4 ¾ percent for next year.

On the surface, that suggests the Fed is being more tolerant of low unemployment and will not blindly pull the rate-hiking trigger just because historical thresholds have been reached. However, it's questionable how patient it will be. After all, despite speculation that the Fed has moved to a neutral policy stance at its March 21 FOMC meeting, chairman Bernanke has clearly asserted that inflation remains the predominant risk facing the economy, not weak growth. With both the inflation rate above the Fed's comfort level and the jobless rate below the threshold viewed as compatible with price stability, it may not be long before the inflation hawks start to get the upper hand in the bond market. Indeed, the bond vigilantes were out in full force following the jobs report on Friday, pushing the 10-year Treasury yield up to 4.76 percent, culminating a sizeable 11 basis point increase during the week.

Clearly, the latest jobs report lessens the odds that the growth slowdown will prod the Fed into cutting interest rates, as was widely expected a month or so ago when the major threat was that the housing slump would bring the economy to its knees. To be sure, the March employment data contained some weather-related quirks, including a jump in construction jobs that obviously conflicts with everything we know about the deteriorating housing market. Even so, it seems that the job market, like the consumer, is proving to be more resilient than the doomsayers have long been predicting. As long as that continues to be the case, fears that the housing slump will spread to the rest of the economy and choke off the expansion unless the Fed jumps in with rate-cutting preventive action will remain more a threat than a reality.