

WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 20, 2007

First the numbers, then the story

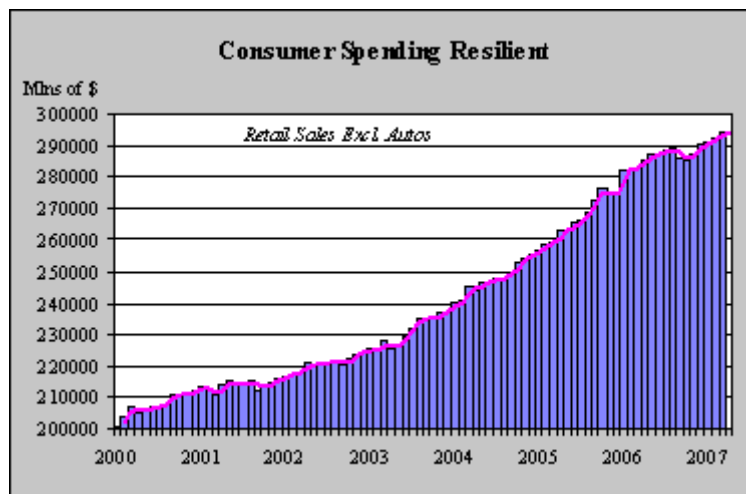
| FINANCIAL INDICATORS | | | | |
|--|-------------------|--------------------|----------------------|--------------------------------|
| INTEREST RATES | April 20 | Week Ago | Month Ago | Year Ago |
| 3-month Treasury bill | 4.97% | 5.00% | 5.05% | 4.74% |
| 6-month Treasury bill | 5.04 | 5.08 | 5.09 | 4.90 |
| 3-month LIBOR | 5.36 | 5.36 | 5.35 | 5.06 |
| 2-year Treasury note | 4.65 | 4.76 | 4.60 | 4.89 |
| 5-year Treasury note | 4.57 | 4.69 | 4.51 | 4.91 |
| 10-year Treasury note | 4.67 | 4.76 | 4.61 | 5.01 |
| 30-year Treasury bond | 4.85 | 4.93 | 4.80 | 5.09 |
| Tax-Exempt Revenue Bonds (Triple-A) | | | | |
| 5-Year | 3.74 | 3.75 | 3.67 | 3.82 |
| 10-Year | 4.03 | 4.04 | 3.87 | 4.25 |
| 30-Year | 4.55 | 4.56 | 4.36 | 4.67 |
| 30-year fixed mortgage rate | | | | |
| | 6.17 | 6.22 | 6.16 | 6.53 |
| 15-year fixed mortgage rate | | | | |
| | 5.89 | 5.90 | 5.90 | 6.17 |
| 1-year adjustable rate | | | | |
| | 5.45 | 5.47 | 5.40 | 5.63 |
| STOCK MARKET | | | | |
| Dow Jones Industrials | 12961.98 | 12612.13 | 12481.01 | 11347.45 |
| S&P 500 | 1484.35 | 1452.85 | 1436.11 | 1311.28 |
| NASDAQ | 2526.39 | 2491.24 | 2456.18 | 2342.86 |
| Commodities | | | | |
| Gold (\$) - 100 Oz | 695.80 | 689.90 | 657.30 | 638.50 |
| Oil (\$ per barrel) - Crude Futures (NYMerc) | 63.38 | 68.63 | 62.28 | 75.17 |
| KEY ECONOMIC INDICATORS | | | | |
| INDICATOR (Latest Month/Quarter) | Current Month/Qtr | Previous Month/Qtr | Two-Months/ Qtrs Ago | Average-Past 6 Months or Qtrs. |
| Industrial Production (March) - % change | -0.2 | 0.8 | -0.4 | 0.0 |
| Capacity Utilization (March) - Percent | 81.4 | 81.6 | 81.1 | 81.5 |
| Retail Sales (March) - % change | 0.7 | 0.5 | -0.8 | 0.4 |
| Housing Starts (March) - 000s of units | 1518 | 1506 | 1399 | 1517 |
| Housing Permits (March) - 000s of units | 1544 | 1532 | 1571 | 1554 |
| Consumer Price Index (March) - % change | 0.6 | 0.4 | 0.2 | 0.2 |
| Core CPI (Ex Food & Energy) - % change | 0.1 | 0.2 | 0.3 | 0.2 |
| Leading Indicators (March) - % change | 0.1 | -0.6 | -0.3 | 0.0 |

Waiting for the housing slump to take a toll on consumers is getting more and more like waiting for Godot – that elusive character in Samuel Beckett’s play who never showed up. For the past year, economic doomsayers have been proclaiming that sooner or later, the destruction in homeowner wealth brought on by the housing downturn and the plunge in home equity withdrawals will cause consumers to zipper up their wallets and purses. Their persistence in adhering to this view is understandable. After all, the real estate boom from 2002 through 2005 imparted a major boost to consumer spending for a host of reasons, adding as much as a percentage point to the real growth in outlays. First, appreciating home values made households feel wealthier, thus boosting their inclination to save less out of current incomes and spend more. Second, with income growth lagging behind cyclical standards for most of the period, households supplemented their purchasing power by withdrawing a big chunk of their bloated

housing equity through refinancings and second mortgages.

Given the upside push to spending, it is not surprising that normally-positive economists would join the doomsayers in believing that the housing slump would drag down spending. But like their pessimistic brethren, they have been woefully disappointed by the results. True, spending growth has tailed off somewhat from the torrid 3.7 percent average pace of 2004 and 2005. But the dropoff was far smaller than the 1 percentage point boost attributed to the housing boom. Indeed, the 3.2 percent gain in real outlays last year was only a tad below the 3.5 percent average over the past fifteen years, which includes the turbocharged spending spree fueled by the dot-com boom of the late 1990s. And, despite warnings to the contrary, there are few signs of consumer fatigue showing up.

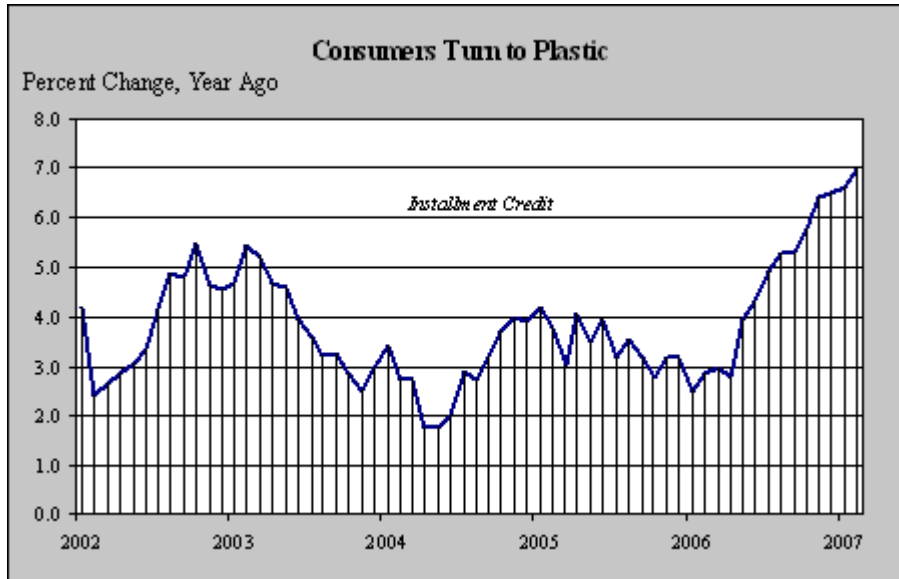
Based on latest retail sales data, consumers continued to shop heartily in the first quarter. Total sales rose 0.7 percent in March, following a 0.5 percent gain in February. Excluding volatile auto sales, the results were about the same, rising by an average of 0.6 percent over the two months. And, while rising gasoline prices last month gave the nominal reading a boost, a wide range of merchants benefited from consumer purchases, as total nonauto sales less gasoline purchases rose by 0.4 and 0.3 percent in March and February, respectively, which is spot on with the 0.3 percent average increase posted over the previous twelve months. The initial reading of GDP for the first quarter will be released next week, and we suspect that it will reveal a growth rate in real consumer outlays that will come close to the 3.2 percent gain registered last year.



Simply put, what the stubborn resilience of consumers tells us is that jobs and incomes trump changes in housing values and home equity withdrawals as the major drivers of consumer spending. While, as noted earlier, income growth has lagged cyclical norms during the first four years of the current expansion, that shortfall has been narrowing over the past year, thanks to sustained strength in the job market that has pushed the unemployment rate down to historical lows, thus giving workers more bargaining power. To be sure, households are not immune to the housing slump. Clearly, the incentive to draw savings down further because of accelerating housing wealth is no longer in play, as the flattening out in home prices means that retirement nest eggs can only expand by putting aside more out of incomes.

What's more, the mortgage meltdown and the tightening up of lending standards by financial institutions in general are reducing the availability of mortgage financing to a wide swath of homeowners. This poses a double threat to spending. Not only does it close the refinancing spigot that serves as the portal to home equity extraction, it forces borrowers to turn to more expensive forms of credit in order to sustain living standards. The major alternative to home equity loans, for example, are

credit cards, which carry much higher interest rates and are not tax-deductible to boot. The shift to plastic over the past six months or so is unmistakable. By February, consumer revolving debt was increasing by a 7 percent annual rate, double the pace of a year earlier and the fastest increase since the 2001 recession, when credit cards typically serve as a conduit for stress borrowing. Nor does this shift in borrowing habits fully tell the tale of financial stress that is yet to surface when billions of dollars in adjustable rate mortgages reset in coming months, lifting the debt burdens for millions of households.



So, it may well be that the economy will yet suffer a delayed reaction from the housing slump. Many analysts, in fact, think that the rubber will meet the road in the second quarter and are sharply marking down their consumer-spending forecast for the period. Their reasoning is derived not only from the housing spillover, but from the gyrations in gasoline prices as well. Keep in mind that fuel prices dropped sharply in last year's fourth quarter, saving households about \$90 billion in winter energy bills that undoubtedly helped buoy spending of other goods and services during the period as well as the early months of this year. But the rebound in oil prices in February and March coupled with the ongoing shortage in refinery capacity is destined to push gasoline prices back to last summer's \$3 a gallon pain threshold, siphoning off as much purchasing power as the drop in fuel prices over the winter bloated it. In combination with the housing-related drags, the higher cost of filling up at the pump could be the final straw that sends consumers into hibernation.

However, it should be pointed out that the repeated spikes in gasoline prices throughout most of the expansion have caused only temporary setbacks in consumer spending, all of which ended with impressive rebounds. We suspect that the sturdy pace of job creation and the acceleration in wages and salaries have played a big role in the ability of consumers to recover from these energy and others shocks during the period, and a compelling case can be made for a similar response this time as well. Not only are incomes still advancing at a healthy clip, thanks to the still-firm job market, the sterling performance of the stock market is offsetting much of the wealth deflation associated with weakening home prices. Household portfolios of stocks and mutual funds total \$10 trillion, the same as the value of housing equity, so on a net basis, total asset values are not being severely impaired by deflating housing wealth. Moreover, their equity portfolio does not include the trillions of dollars held indirectly as 401(k) and other retirement accounts managed by financial institutions. Just as a sagging housing market may make households feel poorer, gains in stock prices impart a more positive feeling about financial circumstances, keeping households in a spending mood.

The key to the sustainability of consumer spending, of course, is how well the job market holds up in the months ahead. If income growth is short-circuited because businesses decide to abruptly cut back on hiring, households would surely respond as the doomsayers have long expected them to. So far this year, companies have slowed the pace of hiring, but not enough to push up the unemployment rate and undermine the newfound bargaining power of labor. Indeed, it's unclear if the hiring slowdown is due to slower economic growth or to the lack of available labor with the skill sets required by prospective employers. Outside of the construction sector, where the labor pool is obviously enlarging, the anecdotal evidence of labor shortages continues to pile up.

But it's also clear that businesses are skeptical about how long consumers will stay the course, given the headwinds of the housing slump, rising debt burdens and, now, increasing gas prices. In its latest quarterly survey of CEOs, the Conference Board reported a decline in the percentage of business leaders who thought that economic conditions would improve over the next six months, as well as a drop in the fraction that plans to increase hiring. That uncertain sentiment is probably a key reason why investment spending has fallen far below expectations in recent quarters, as companies are reluctant to add capacity if prospective demand will not support higher output. More than anything, it is the shortfall in capital spending that is preventing the economy from growing at a trendlike pace in recent quarters. It is also raising the anxiety level at the Federal Reserve, which has cited lackluster investment as a major downside risk facing the economy this year.

Based on recent data for capital goods bookings and shipments, it's unlikely that economic growth received much, if any, lift from investment spending in the first quarter. But in one of the many disconnects that permeates the economic landscape (the other major one being the discrepancy between sluggish economic growth and strong employment gains), the weak investment spending figures contradicts the muscular gains in the production of industrial machinery and productivity-enhancing equipment, such as computers and semiconductor that is taking place. In recent months, for example, manufacturers have increased their output of machinery at a 20 percent annual rate and of computers and other electronic products at a similar pace. Simply put, someone is buying this gear to shore up productive capacity, and since it's not domestic companies, it must be coming from outside the U.S.

In point of fact, that's precisely what is happening. While the U.S. may be caught in the throes of a housing-led slowdown that may or may not last beyond mid-year, the global economy is barreling ahead, something that received headline-grabbing documentation in the latest IMF global outlook released a week ago. Even as the IMF cut its growth forecast for the U.S. from 2.9 percent to 2.2 percent for this year, it upped its outlook for just about everyone else, resulting in a sturdy global growth rate of 4.9 percent for 2007. The point here is that stronger growth in Japan, Europe and emerging market nations is spurring these countries to rev up capacity to meet demand, which requires spending on capital goods, including machinery and high tech gear from the U.S.

Indeed, exports by U.S. companies are turning out to be an important growth driver, reflecting the growing importance of foreign trade in the nation's economic fabric. Prior to 1970, for example, total U.S. trade with the rest of the world – i.e., exports plus imports – never accounted for more than 10 percent of gross domestic product. That fraction edged up ever so slightly over the next decade or so, but it has exploded since the mid-1980s. Currently, total transactions with foreign countries make up nearly 30 percent of the real output of goods and services in the U.S. Both imports and exports have doubled their shares of GDP over the past twenty years. Most significant is that a surge in exports in last year's fourth quarter just about offset the drag from housing and was the second largest contributor to overall growth, behind only consumer spending. With growth in China exploding by an 11 percent pace in the first quarter and the dollar weakening against most of our trading partners, there is every reason to believe that foreign sales of capital goods as well as other exports will continue to make a strong positive contribution to growth in the U.S. Just as important is that the revenues from these sales are

bolstering corporate earnings for major domestic manufacturers – witness the strong results reported by Caterpillar on Friday. Not only does that send positive shock waves through the equity markets, it provides U.S. companies with the cash flow to sustain hiring and spending. In terms of households purchasing power, these are two influences that constitute powerful offsets to the housing drag.

