

WEEKLY ECONOMIC COMMENTARY -- WEEK OF APRIL 27, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	April 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.92%	4.97%	5.03%	4.76%
6-month Treasury bill	5.02	5.04	5.06	4.71
3-month LIBOR	5.36	5.36	5.35	5.09
2-year Treasury note	4.66	4.65	4.58	4.86
5-year Treasury note	4.58	4.57	4.54	4.92
10-year Treasury note	4.69	4.67	4.65	5.06
30-year Treasury bond	4.88	4.85	4.84	5.17
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.76	3.74	3.72	3.81
10-Year	4.01	4.03	3.97	4.23
30-Year	4.49	4.55	4.47	4.66
30-year fixed mortgage rate	6.16	6.17	6.16	6.58
15-year fixed mortgage rate	5.87	5.89	5.86	6.21
1-year adjustable rate	5.43	5.45	5.43	5.68
STOCK MARKET				
Dow Jones Industrial	13120.94	12961.98	12354.35	11367.14
S&P 500	1494.07	1484.35	1420.85	1310.61
NASDAQ	2557.21	2526.39	2421.64	2322.57
Commodities				
Gold (\$)- 100 Oz	684.70	695.80	669.00	656.00
Oil (\$ per barrel) - Crude Futures (NYMEX)	68.41	63.38	68.10	71.88
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Existing Home Sales (March) - 000s	6120	6680	6440	6338
New Home Sales (March) - 000s	858	836	873	924
Durable Goods Orders (March) - % change	3.4	2.4	-8.8	-0.9
Nondef. Cap. Goods, ex. Air (Mar) - % ch	4.7	-2.3	-6.2	-0.8
Cons. Confidence Index (April) Conf. Bd	104.0	108.2	111.2	107.1
Real GDP (Q1) - % change, Saar	1.3	2.5	2.0	2.6
Employment Cost Index (Q1) - % change	0.8	0.9	0.9	0.8

Amid all the gloom and doom concerning the economy, highlighted by another subpar growth performance in the first quarter, the stock market just keeps rolling along seemingly without a care in the world. This week, the Dow Jones industrial average pierced a new high, leapfrogging the 13000 milestone on Wednesday, and the broader S&P 500 index edged ever closer to its all-time high of 1527, closing the week just a shade below that threshold. To be sure, it is not the first time that a disconnect between the performance of the economy and stock market has emerged – and it most certainly won't be the last. Nonetheless, the divide has left analysts scratching their heads for answers, and pundits are having a field day with all of the soul-searching.

We do not profess to have answers to the conundrum, but some time-honored reasons underpinning the stock-market's resistance is becoming increasingly apparent. For one, earnings drive equity prices, and the economy's subpar performance over the past year is not having a corresponding impact on the bottom line of corporations. Yes, profit growth has slowed from the persistent double-digit pace of the

past several years, and margins are narrowing, thanks to weaker productivity and rising labor costs. But neither the margin squeeze nor the earnings slowdown has been as pronounced as most analysts had expected. Indeed, first-quarter results are handily beating expectations across a wide swath of blue-chip companies, albeit the positive surprises are based on comparisons with scaled-down estimates.

Since it is not the economy that's propelling the gain in earnings, what is? One unsung hero has to be the earnings boost imparted by the dollar's weakness. Keep in mind that when the greenback declines relative to other currencies, earnings derived from overseas operations are worth more when translated back into dollars. For a variety of reasons, including primarily the nation's burgeoning trade deficit, the dollar has been sinking for the better part of five years, and has recently fallen to an all-time low against the euro. The currency's sinking spell this year has been exacerbated by expectations that the Fed will soon lower interest rates, even as foreign central banks are raising theirs. Relative interest rate movements have always been a magnet for global investor flows, and this time is no different. Investors are no doubt shifting some funds into higher yielding assets overseas, contributing to the dollar's weakness.

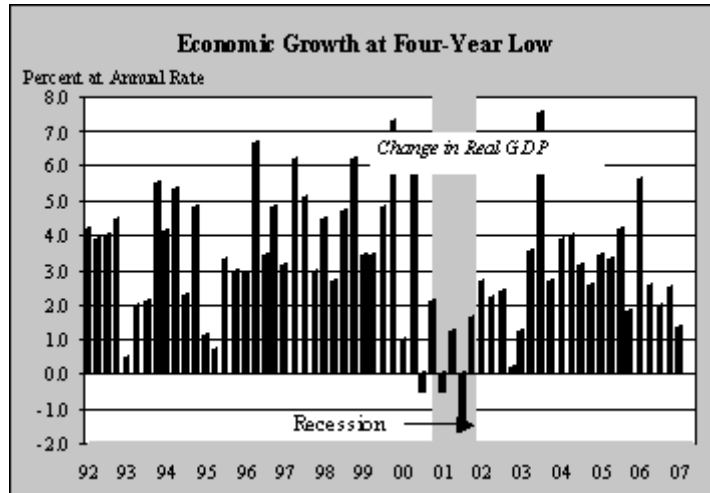
While it is true that the U.S. is more insular than most other economies, with foreign trade accounting for a smaller fraction of economic activity, most major corporations derive a substantial part of their earnings from overseas. And, it is these corporations that are reporting the surprisingly sturdy earnings results. A case in point is the favorable profits reported this week by GE, highlighted by the fact that 49 percent of its revenues stem from overseas operations. Simply put, even as demand may be lackluster in the U.S., sales to foreign consumers are booming. That should come as no surprise as the subpar performance in the U.S. masks muscular growth overseas. In its widely respected semiannual global outlook, the IMF recently upped its forecast for global growth this year, even as it downgraded growth prospects in the U.S. due to the housing recession. For the first time in six years, the agency expects growth in Europe to exceed that of the U.S. this year.

Not only does stronger global growth boost earnings for U.S. multi-national corporations, it helps cushion the weakness in domestic activity, particularly in the housing sector, by generating stronger exports. That's clearly been a growth-stimulating influence over the past year, although swelling oil-imports have prevented any material improvement in the trade deficit from taking place. Nonetheless, exports have been one of the few recent pillars supporting growth in the U.S. While real exports slipped in the first quarter after posting an outsized 10.6 percent gain in the fourth quarter, the modest payback hardly obscures the contribution made to the economy's performance during the period. Over the last two quarters, for example, real exports accounted for 1 percentage point of the 1.9 percent average growth rate in real GDP, almost fully offsetting the 1.09 percentage point drag from the housing downturn.

Nonetheless, it would be a mistake to count primarily on foreign demand to propel corporate earnings and economic growth going forward. For one, foreign central banks, as already noted, are lifting interest rates to stave off inflation, which is more of a concern overseas than it is to the Fed at the present time. The ECB and the central banks in England, Japan and even China are all in a tightening mode that eventually will slow growth in their respective markets, curbing demand for U.S. goods. More disturbingly, the rising tide of protectionist sentiment in the U.S. Congress could lead to tariffs and other barriers that would impede foreign trade, an unfortunate consequence of our ballooning deficit with China. Such an event could well have more far-reaching economic consequences – provoking retaliatory actions from overseas governments – that might ultimately produce more harm than good.

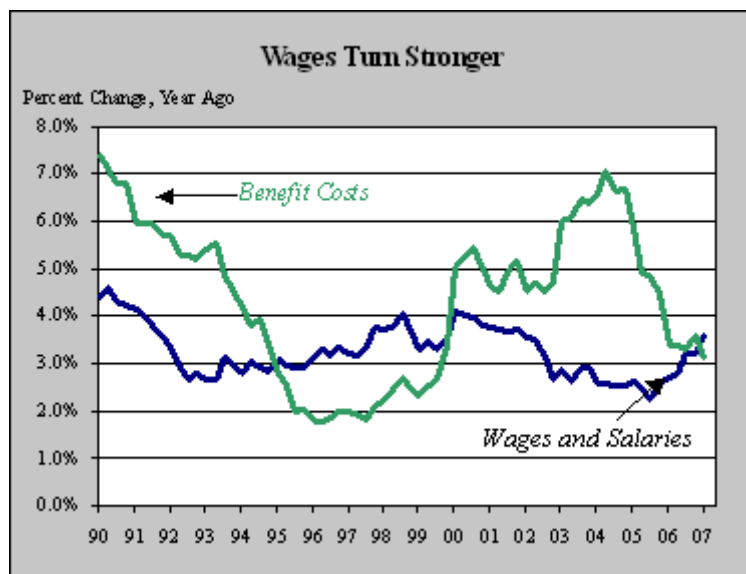
In looking ahead, the primary growth driver for the U.S. economy has always been – and will continue to be – American consumers, who account for 70 percent of overall activity. That link has never been more apparent than in the first quarter, when the economy would have slipped into recessionary

quicksand if not for the continued and surprisingly persistent ability of households to step up outlays. True, the headline-grabbing feature of the first-quarter GDP report, released Friday morning, is that the economy slowed to a crawl, registering a four-year-low growth rate of 1.3 percent. But the slowdown masks ongoing strength in consumer spending, which increased by a hearty 3.8 percent annual rate during the period. That's well above trend and stronger than even the 3.3 percent average quarterly gain staged during the 21 previous quarters of the current expansion.



The astonishing aspect of the sustained resilience of consumers is that it is ongoing without the aid of a housing boom, which had augmented consumption growth by about 1 percentage point from 2003 through 2005. So, the \$64 million question is, where is the source of household purchasing power coming from? Clearly not from home equity withdrawals, which has virtually evaporated in the face of slumping sales and tightening lending standards, nor from appreciating housing values, which had bloated household wealth and, hence, the incentive to forego savings out of current incomes. The answer, of course, is the still-strong job market that is providing consumers with fatter paychecks and the cash flow to keep merchant registers ringing. Indeed, that trend was amply documented again on Friday, when the government released its employment cost index, a comprehensive picture of labor compensation that includes wages and salaries as well as benefit payments.

During the first quarter, the Labor Department reported that the overall ECI increased by 0.8 percent, lifting the index 3.5 percent above the level of a year earlier. But it was the composition of the increase that raised eyebrows, as the quarterly change by itself came in close to expectations. In particular, the wage and salary component jumped by 1.1 percent, boosting the annual gain to 3.6 percent, the strongest since the fourth quarter of 2001. What held down the overall index was a marked deceleration in benefit costs, which eked out a scant 0.1 percent increase in the first quarter, slicing the annual gain to 3.1 percent – less than half the pace observed as recently as two years ago. It's unclear why growth in benefits has been slowing so much, given the rise in medical care costs. One factor may be the ongoing efforts of companies to successfully offload the cost of health care onto the shoulders of workers, who are assuming a greater share of premiums. Another is simply that employees are contributing less to pension plans, thanks to the roaring stock market, which is enabling companies to meet their funding requirements without having to pony up additional cash.



Unfortunately, the flip side of the escalation in worker pay is that it keeps inflation fears alive at the Federal Reserve, short-circuiting the rate cuts that many believe will be necessary to sustain the expansion. In point of fact, the GDP report on Friday contained some disturbing inflation trends, including a sizable 4 percent increase in the overall deflator, a major leap from the 1.6 percent increase in the fourth quarter of last year. Even the Fed's preferred gauge, the core personal consumption deflator, which includes all consumer purchases except food and energy products, moved higher. The core PCE registered a 2.2 percent increase in the first quarter, up from 1.8 percent in the fourth quarter. More significantly, this key inflation yardstick remains stuck above the Fed's 1-2 percent tolerance range, defying expectations that it would recede along with the deceleration in economic growth. While the annual increase has receded from the 2.4 percent peak set in the third quarter of last year, the move has been far too slow for the Fed's satisfaction, and there is some question whether it will fall within the Fed's comfort zone in the second quarter.

That perception may change when the core PCE for March is released next week along with the personal income and expenditure report for the month. The math derived from the quarterly GDP figure suggests that the monthly change in March will show a much more benign reading, perhaps coming in flat with February. If that's the case, the Fed will have more leeway to ease policy if the slow growth in the first quarter persists at the same, or similar, rate in the second. That would especially be the case if the slowdown is accompanied by the long-awaited retrenchment in employment growth, pushing up the unemployment rate. Historically, the Fed has been loath to cut interest rates until tangible evidence of a weaker labor market surfaces, usually marked by at least a 0.3 percent increase in the jobless rate. As of April, the rate remained at a historical low of 4.4 percent, which is also the low point for the business cycle. So it would take at least several months of sluggish payroll gains for this rate to increase by that much, and even that might not push the Fed off the sidelines if inflation remains above its tolerance range.

To be sure, the doomsayers are convinced that joblessness will surge in coming months as the lagged effects of the housing meltdown send construction workers to the unemployment lines in droves. That may very well be the case. Still, the lags are certainly taking longer to play out than expected, causing some analysts to wonder if these workers are successfully selling their skills elsewhere instead of falling off of payrolls. One sector that can readily absorb laid-off residential hard hats is the nonresidential sector, where they can be used to put up factories, office buildings and shopping malls. In this regard, it may be significant to point out that the downturn in nonresidential investment in last year's fourth

quarter was reversed in the first quarter, as outlays on both structures as well as equipment and software increased during the period. What's particularly encouraging was the 1.9 percent increase in equipment and software spending, which may indicate that the long slump in capital spending may be coming to an end. Indeed, companies stepped up their orders for capital equipment in March, following two months of declines. It will take more than a one-month turnaround to erase fears that the unexpected slump in capital spending is over, but the March jump in bookings has to be considered a pleasant surprise. If businesses step up investment outlays, economic growth should recover nicely in the second quarter, sustaining the increase in job and incomes and offsetting much of the housing drag.

