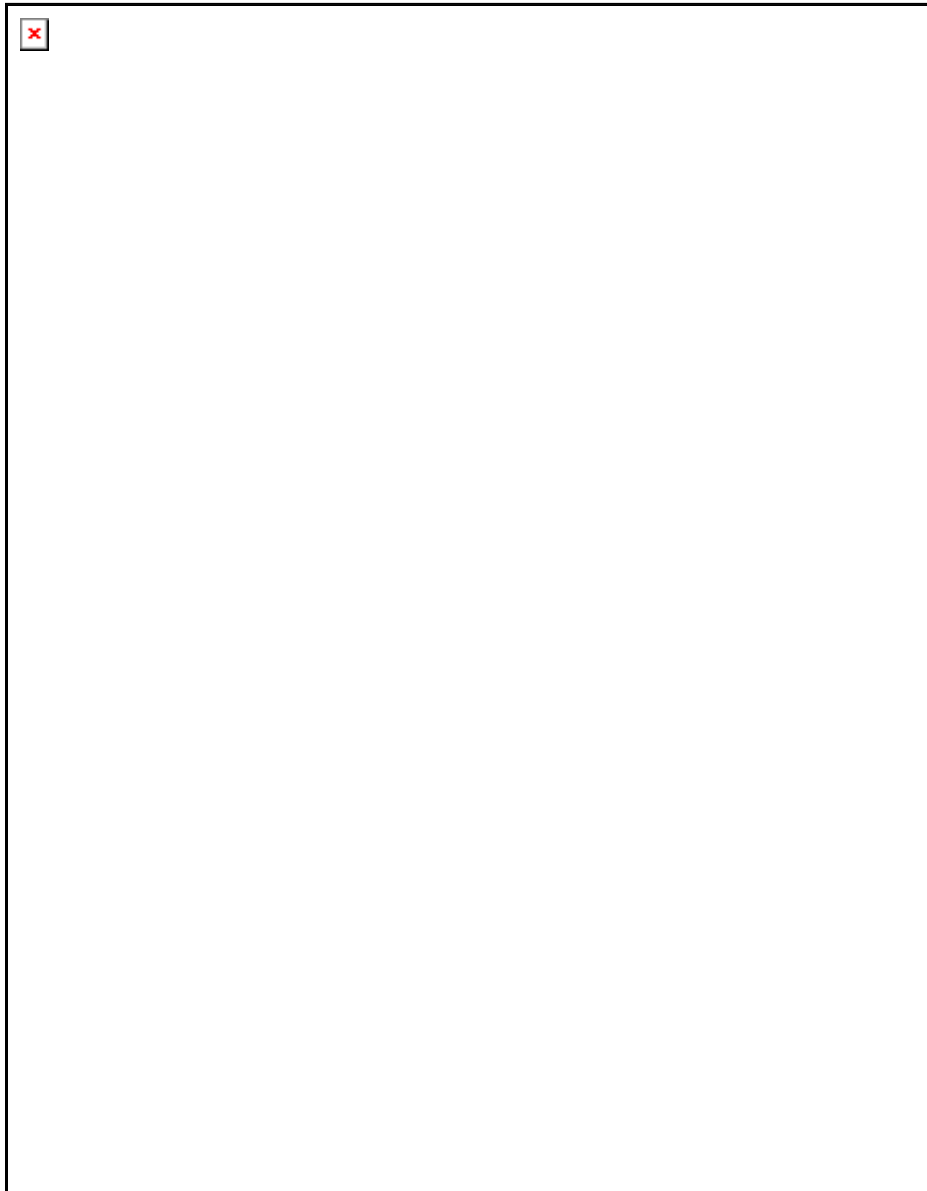


WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 4, 2007

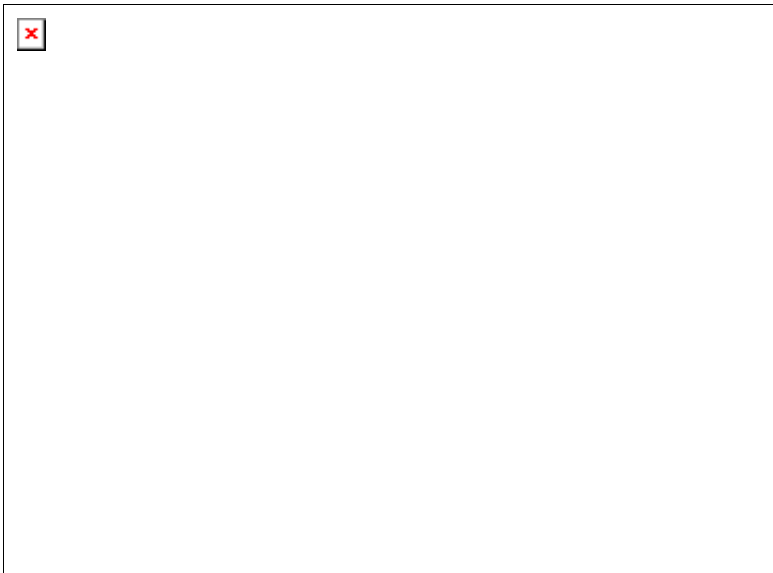
First the numbers, then the story

It was one of those good news/bad news weeks for the financial markets, although the good seemed to trump the bad, at least in the minds of investors. Since we have a reputation of being dismal scientists, we'll report the bad news first. Consumers, the linchpin of the economy's performance throughout the expansion, gave off signals that someone else may have to carry the mantle of leadership for a while. That may seem a bit contradictory, considering that household spending was the star performer in an otherwise lackluster first quarter. In last week's commentary, we noted that consumer outlays increased by a muscular 3.8 percent annual rate during the first three months of the year, even as the economy's overall growth rate slid to a paltry 1.3 percent, the slowest in four years.

The trouble is, households appeared to end the quarter on a downbeat note. According to the Commerce Department's monthly follow-up figures on income and outlays, released this week, personal consumption recorded a tepid 0.3 percent nominal gain in March, the slowest pace since last November.

What's more, after adjusting for the increase in prices, as measured by the PCE deflator, real outlays actually fell by 0.2 percent during the month, the first outright drop since last August. In other words, the economy is not receiving any forward momentum from consumers going into the second quarter. Indeed, the level of real expenditures in March stood 0.2 below the first quarter average, just about assuring that second-quarter spending will come in considerably weaker than the increase posted in the first quarter. Small wonder that the consensus of economists project another quarter of lackluster GDP growth in the April-June period.

To make matters worse, the job market that generates the much-needed income to support spending is also showing signs of fatigue. In Friday's jobs report, the Labor Department reported that nonfarm payrolls increased by only 88 thousand in April, the smallest increase since November 2004 and even weaker than the scaled-down forecast held by Street economists, which clustered around a 100 thousand estimate. In sharp contrast to the robust March tally, a soft hue pervaded virtually every key component of the latest report. The unemployment rate edged up a notch, to 4.5 percent from 4.4 percent, and the average hourly earnings of workers increased by only 0.2 percent, about one-third less than the average monthly gain over the previous year.



To be sure, monthly gyrations in the payroll numbers can give off misleading signals. But two of the past three months have shown gains of less than 100 thousand, which makes the April change more than just an outlier. So far this year, nonfarm payrolls have increased by an average of 129 thousand a month, a significant slowing from the 189 thousand average monthly gain in 2006. Meanwhile, the tepid 0.2 percent increase in hourly earnings during the month lowered the annual gain to 3.7 percent from 4 percent in the twelve months through March. At the end of 2006, workers were enjoying annual pay increases of 4.3 percent. Parsing through the latest monthly report, most of the weakness showed up in the expected sectors, with manufacturing and construction jobs posting losses. Also, for the second month in a row, financial institutions pared workers from payrolls, which may reflect a growing impact from the subprime mortgage meltdown. The one downside surprise during the month was a sharp 26 thousand drop among retail workers; but that may have been an artifact of an early Easter, which boosted jobs in March and caused a reversal in April.

No doubt, with little slack in the job market and labor cost pressures driving up inflation concerns, a slowdown in job growth is not entirely unwelcome. The question is, will the slowdown become so acute as to undercut the income gains that is now the foundation for consumer spending, given the bursting of

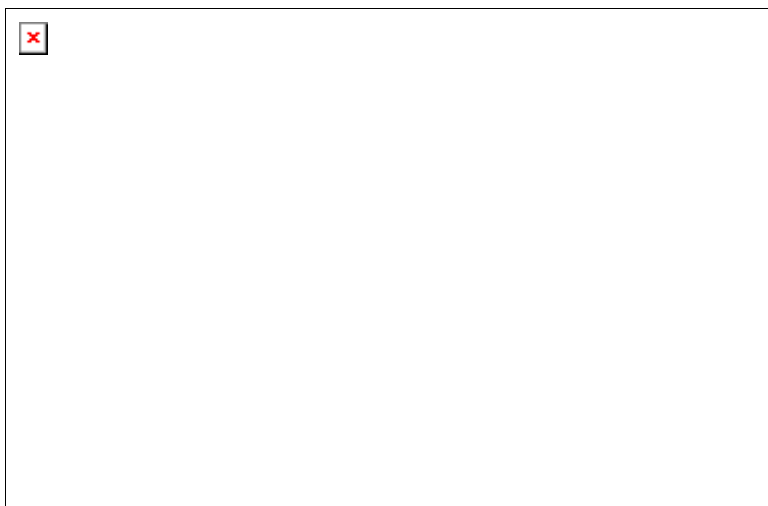
the housing bubble. Just as important, will slowing job growth finally move the Fed off the sidelines, bringing about a rate cut aimed at jump-starting growth? Based on past policy responses to a weakening job market, it usually takes at least a 0.3 percentage point increase in the unemployment rate before the Fed sees the need for action.

Whether a backup of that magnitude would be enough to spur a policy ease this time remains to be seen. Keep in mind that the current 4.5 percent jobless rate is still within the zone of what is generally considered to be full employment, so it may well take a larger increase to, say, 5 percent or so to make the Fed pull the trigger. However, many analysts, including some within the Federal Reserve itself, wonder if the current low unemployment rate overstates the actual tightness in the labor market. If, in fact, there is more slack than meets the eye, the threshold for a rate cut may indeed be lower. Indeed, one factor holding down the unemployment rate in April was a massive 392 thousand drop in the number of people in the labor force, which slashed the labor force participation rate from 62 to 60 percent. If not for that drop, the jobless rate would have jumped to 4.7 percent, a sizeable 0.3 percent increase in just one month alone.

That said, it is far too early to conclude that the job market has turned soft enough to move the Fed off of its present stand-pat policy stance. As already noted, a slowdown in job growth is not exactly an unwelcome development, nor is it unexpected. Although the it has softened its anti-inflation rhetoric and expressed more concern about weak housing activity and slower growth, the Fed still views inflation as the primary threat to the economy. That assessment of risk may be subtly changed again at the FOMC meeting scheduled for next week, but it's doubtful that recession alarms will be sounded. For that to happen, there will have to be more signs that the housing correction and the attendant loss of construction jobs is spreading to the broader economy. Thus far, the contagion has been very modest, although the full extent of job losses among construction workers has yet to play out.

If, in fact, the economy's job engine has downshifted to a gear that generates 50-100 thousand net new positions a month for a while, that could be a safe and desirable cruising speed in the eyes of the Fed. One reason the downshifting is not ringing alarm bells is that it is occurring amidst other healthy signs for the economy. It's one thing when economic data are all pointing in the same direction—either strong or weak. It's quite another, however, when the signals are mixed. Then the message from any one indicator gets defused, which may be the case with the latest employment report. Simply put, what matters is the overall context surrounding the indicator. Had April's soft job number, for example, been reinforced by the week's other key indicators, perceptions about the economy's overall health would have been much more dour, particularly in the wake of the aforementioned slippage in March consumer spending and the tepid first-quarter GDP report. But that was not the case.

Instead, other key indicators this week revealed more strength in the economy than expected. An index of manufacturing activity compiled by the Institute for Supply Management, for example, jumped sharply in April to 54.7. That was nearly 4 points higher than consensus forecast, and reflected solid gains in new orders, production and order backlogs. It also revealed a cutback in customer inventories, which suggest that the inventory overhang that has been depressing output may be drawing to a close. Indeed, industry data show that auto dealers have whittled down unsold cars on their lots, which may mean they are poised to step up orders, something that could give a nice lift to the factory sector in coming months. Meanwhile, the much larger nonmanufacturing sector appears to be forging ahead. The ISM index for that category also staged a healthy 3.6 point increase to a higher than expected 56.0, reversing a string of two monthly declines.



Importantly, in both of the ISM indices, the inflation components remained elevated, largely reflecting higher energy and metals prices. The prices paid index in the manufacturing report jumped from 65.5 to 73.0, the highest since last August, when energy prices were also exerting upward pressures on the index and inflaming inflation fears. The point here is that other indicators are pointing to strength in the economy, thus defusing the implications of slowing growth in jobs and consumer spending. But just as significant is that the slowdown in jobs and spending should be viewed in the context of the Fed's still-elevated inflation concerns. To the extent that these concerns are lessened, the weaker job and spending numbers can be seen in a more positive light.

Indeed, that's precisely how the financial markets seem to be interpreting the latest batch of mixed signals. When we alluded to the good news/bad news composition of the data at the outset, the good news component has everything to do with the moderating inflationary implications associated with this week's data. In point of fact, the weekly package contained three distinct reports that pointed to a lower rate of inflation in coming months. The first was contained in the personal income and spending report, in which the core personal consumption deflator – the Fed's favorite inflation barometer – came in unchanged for the month of March, bringing the annual increase down to 2.1 percent from 2.4 percent in February. That's just a smidgeon above the Fed's 1-2 percent presumed tolerance range.

Then came news that nonfarm businesses in the first quarter were much more productive than thought, as productivity increased by 1.7 percent during the period. While that was weaker than the 2.1 percent increase in the fourth quarter, the slowdown was not as great as the deceleration in GDP, which slipped from 2.5 percent to 1.3 percent. In other words, a greater share of the economy's growth is being derived from improving productivity rather than labor inputs. That, in turn, is checking the rise in unit labor costs. Indeed, the slight 0.6 percent increase during the first quarter brought the twelve-month gain in unit labor costs to a modest 1.3 percent, the slowest in almost three years. Finally, the jobs report this week revealing the slower increase in hourly earnings provided further evidence that labor costs are being kept in check. Since labor accounts for the lion's share of business expenses, this has to be construed as a positive development for profits, even as it promises to keep inflation on a moderating track. Is it any wonder that the financial markets viewed the good news as trumping the bad news this week?

