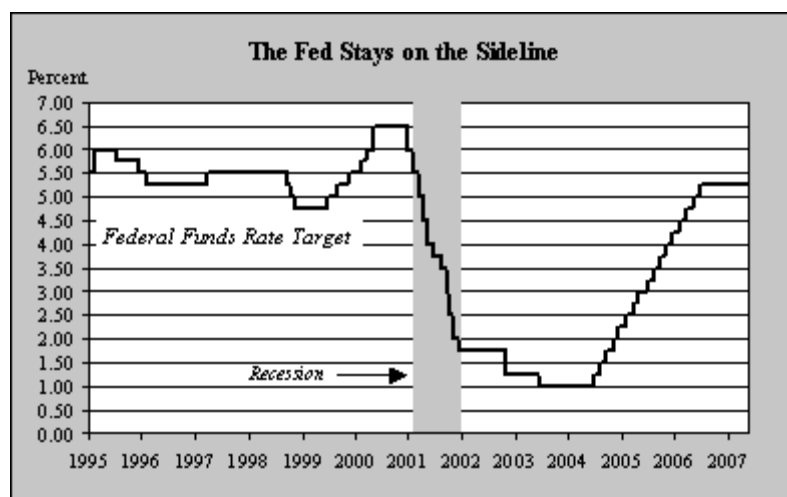


WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 11, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.84%	4.87%	5.00%	4.82%
6-month Treasury bill	4.98	5.01	5.08	4.99
3-month LIBOR	5.36	5.36	5.36	5.16
2-year Treasury note	4.71	4.67	4.76	5.00
5-year Treasury note	4.58	4.55	4.69	5.07
10-year Treasury note	4.68	4.64	4.76	5.19
30-year Treasury bond	4.85	4.81	4.93	5.30
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.74	3.76	3.75	3.81
10-Year	3.98	3.98	4.04	4.24
30-Year	4.47	4.46	4.56	4.80
30-year fixed mortgage rate	6.15	6.16	6.22	6.58
15-year fixed mortgage rate	5.87	5.87	5.90	6.17
1-year adjustable rate	5.48	5.42	5.47	5.62
STOCK MARKET				
Dow Jones Industrial	13326.22	13264.62	12612.13	11380.99
S&P 500	1505.85	1505.62	1452.85	1291.24
NASDAQ	2562.10	2572.15	2491.24	2243.78
Commodities				
Gold (\$ per troy ounce)	672.30	689.70	689.90	716.50
Oil (\$ per barrel) - Crude Futures (NYMEX)	66.83	61.93	68.63	72.04
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (March) - Mths of \$s	13461	5560	8415	8650
Trade Deficit (March) - Mths of \$s	63891	57893	58877	59876
Retail Sales (April) - % change	-0.2	1.0	0.6	0.5
Producer Price Index (April) - % change	0.7	1.0	1.3	0.8
Core Producer Price Index (April) - % ch.	0.0	0.0	0.4	0.3
Business Inventories (March) - % change	-0.1	0.2	0.2	0.1

If, as they say in sports, timing is everything, the Federal Reserve may seem a bit out of sync with the economy. To be sure, it's decision on Wednesday to keep the federal funds rate unchanged at 5.25 percent for the seventh consecutive time surprised no one. Even the post-meeting statement stirred little excitement in the financial markets, essentially repeating most of what was said following the previous policy meeting in March. Yet, if an economic observer from outer space dropped in and took a look at unfolding events, it might well wonder what Ben Bernanke and his colleagues are waiting for.



After all, the economy just logged its weakest quarter in four years, with growth slowing to a 1.3 percent annual rate in the January-March period. The job-creating engine downshifted abruptly in April, reinforcing the slowing trend underway since the start of the year. Housing remains in a severe slump, and the subprime mortgage meltdown may be setting the stage for a second down-leg of the yearlong plunge in activity. Consumer budgets are increasingly squeezed by spiking gasoline prices, heavy debt burdens and looming resets on adjustable rate mortgage loans. Nor is the second quarter starting out any better. Just one day after the Fed's decision to keep rates unchanged, major chain and department stores reported dismal sales results for April.

On the surface, all this would seem to beg for a more relaxed monetary policy aimed at jump-starting growth. But the Fed gave no sign that it is ready to move off its present stand-pat stance. Yes, it did give some lip service to the weakening economy, noting that "economic growth slowed in the first part of the year", a minor downgrade from its March 21 statement, which said that "recent indicators have been mixed." Simply put, Bernanke acknowledged the past, but didn't go beyond that. Instead, the policy committee adhered to its long-standing view that "the economy seems likely to expand at a moderate pace over coming quarters". More to the point, "the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected."

In other words, those looking for a rate cut in the immediate future will be sorely disappointed. It certainly won't happen at the next scheduled meeting in late June, and the latest statement reduces the odds that anything will occur at the following confab on August 7. If there is any hope that the economic bears can cling to, it is that the Fed's post-meeting statements are not always a good leading indicator of future actions. Take, for example, the sequence of events that transpired towards the end of the last tightening cycle seven years ago.

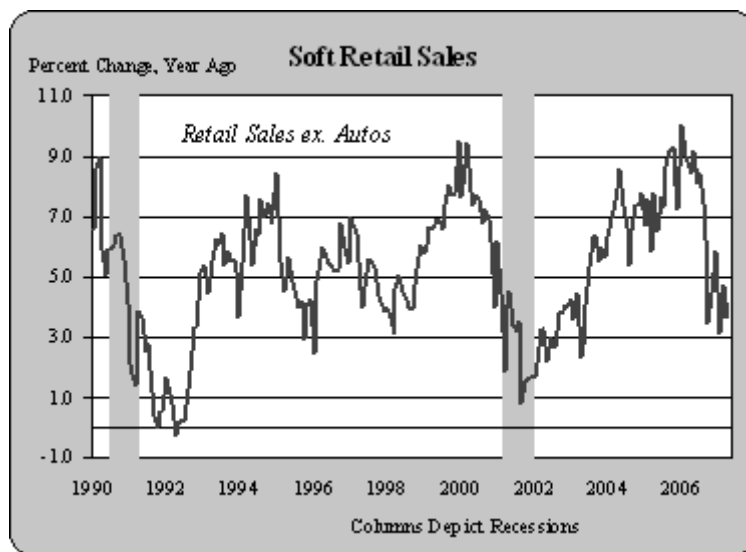
Following the final rate hike in May 2000, the Fed continued to sound hawkish over the next four meetings, emphasizing inflation risks over growth risks right through November of that year. But the following month, on December 19, it acknowledged that slowing growth posed the greater risk and, just two weeks later, it cut interest rates. What's more, the policy makers became so alarmed about the economy's weakening state, they didn't even wait for the next scheduled meeting to pull the trigger, as they cut rates as part of a rare inter-meeting move. In other words, in the space of six weeks, the Fed did a complete about face – from worrying overtly about inflation to cutting rates in an attempt to stave off a recession. By the time it saw the light, of course, it was too late to prevent the economy from falling into the recession that began in March, 2001.

Could history be repeating itself? Clearly, there are some similarities with late 2000 that should not be

ignored. Then, as now, a major asset bubble had been punctured, namely the stock market. This time, it is the housing market. But be careful not to carry the analogy too far. The stock-market collapse from early 2000 to early 2003 certainly aggravated a worsening situation, but it was not the catalyst that drove the economy into a recession. That impetus came from the business side, as capital spending plunged following the dot-com bust, which unmasked the excessive increase in investment that accompanied the high-tech boom of the late 1990s. Recall that consumer spending did not decline in any quarter during the recession, despite the stock-market collapse.

In the current environment, the housing collapse may yet portend a severe retrenchment in consumer spending that would bring down the economic house of cards. But so far, that has not occurred. True, there are signs that households are getting a bit fatigued after increasing their real outlays on goods and services for a record 61 consecutive quarters. As noted last week, consumption ended the first quarter on a downbeat note and this week's data on retail sales indicate that the second quarter is getting off to a lackluster start. The dismal results for April reported by major department and chain stores alluded to earlier provided the first inkling that retail outlets were suffering a case of the spring blahs. Friday's more complete retail sales report released by the Commerce Department confirmed that notion.

During the month, sales at all retail outlets combined slipped 0.2 percent, a weaker showing that had been expected. And, while a sharper than expected 1 percent drop in auto sales led the way, consumers also cut back their purchases of clothing, building material and general merchandise. Although nonauto sales were flat during the month, that was only because higher gasoline prices pumped up sales at service stations. Excluding both autos and gasoline, retail sales fell 0.2 percent, the first decline since last May. If there is any surprise, it is that the higher cost of filling up at the pump didn't take a bigger bite out of other purchases. In fact, gasoline prices rose faster than gasoline sales, suggesting that motorists may be cutting back on driving. If so, the demand for gasoline may not be as inelastic as many believe.



Nonetheless, it would be premature to conclude that the soft retail sales reading for April is evidence that the housing slump is finally catching up to consumers, leading to a pronounced spending retrenchment that spells the end of the expansion. First, it should be noted that fickle weather and an early Easter holiday may have distorted the figures somewhat. The early Easter likely boosted sales in March, triggering a payback in April. Indeed, the March retail sales number was revised up, from an original estimate of a 0.7 percent increase to a gain of 1 percent. Averaging the two months together still yields a weak reading, but the impression is not as soft as that conveyed by the April figures alone.

Second, unusually wet and cold weather in early April undoubtedly suppressed sales of clothing and other apparel that would ordinarily receive a seasonal boost if normal weather conditions prevailed.

Simply put, we need to observe consumer behavior for another month or two before concluding that households are ready to throw in the towel. Clearly, the headwinds are formidable, and will no doubt slice the second-quarter gain in personal consumption to about half of the first quarter's pace. Consumers are not immune to the deflating wealth effects of the slide in home values, which erodes their sense of financial well-being. Nor are they immune to rising gasoline prices that eats into discretionary incomes, even as personal savings remains negative. But growing incomes is still supporting spending, and the seemingly unstoppable stock market rally is offsetting a big chunk of the wealth deflation caused by slumping home values. A sharp slowdown in the second quarter is in the cards, but an outright decline in consumer spending that accounts for more than two-thirds of GDP is far from assured.

The key to the severity and length of the current slowdown probably rests with businesses, much as was the case earlier in the decade. Capital spending has been a big disappointment over the past several quarters, falling far short of the increases that would ordinarily be indicated by the robust gains in profits, healthy balance sheets and high capacity utilization. It's unclear why this has occurred, but languishing confidence among CEOs that consumers will stay the course is probably having a major influence. On the positive side, however, the fact that corporations have taken such a disciplined approach to capital spending throughout the expansion means that they are not likely to slash spending budgets as radically as they did earlier in the decade. Indeed, the latest monthly rebound in capital goods orders may signal a modest acceleration in investment spending in the second quarter, which would offset some of the expected consumer retrenchment.

No doubt, the Fed is counting on businesses to contribute to the "moderate pace" of growth in coming quarters, as well as on a receding housing drag that would enable the economy to emerge from its doldrums over the second half of the year. If this scenario doesn't pan out and growth continues to slow from its already tepid pace, Bernanke may well set the stage for a rate cut at one of the upcoming policy meetings by rebalancing the risk assessment, citing more downside growth risks relative to upside inflation risks. Just when such a rebalancing act takes place will depend not only on the economy's real performance but also on inflation data, which lately have been moving closer to the Fed's desired range. The core personal consumption deflator – its preferred inflation gauge – was unchanged in March and stood just a tad over the 1-2 percent presumed target, at 2.1 percent. This week, the Labor Department provided another signal that inflation continues to moderate, reporting an unchanged reading for core wholesale prices in April, which excludes food and energy items, for the second month in a row. That's the first back-to-back decline in more than a year and brings the annual rate down to 1.5 percent. Clearly, this trend gives the Fed more leeway to cut rates if deemed necessary, but that decision is probably still at least several months away.

