

WEEKLY ECONOMIC COMMENTARY - WEEK OF MAY 18, 2007

First the numbers, then the story

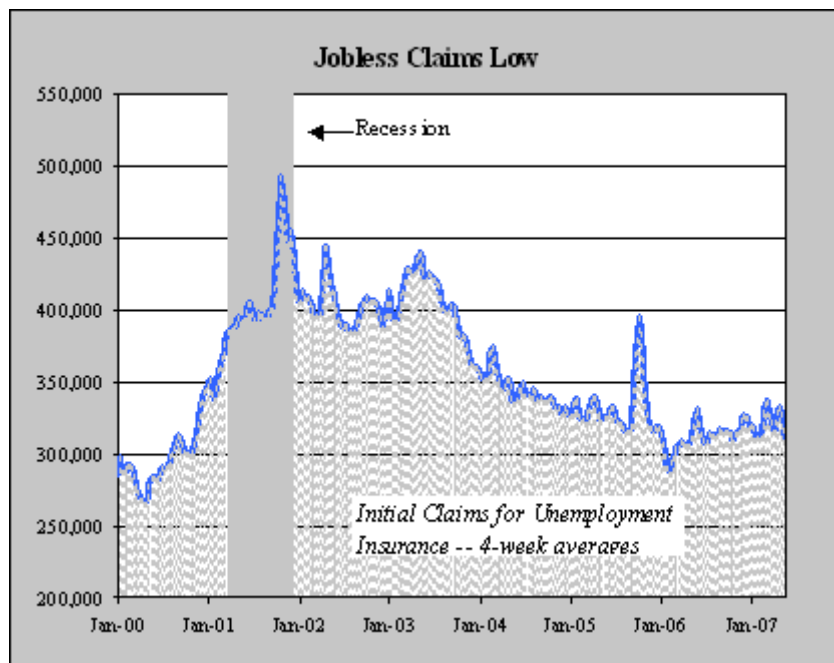
FINANCIAL INDICATORS				
INTEREST RATES	May 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.81%	4.84%	4.97%	4.81%
6-month Treasury bill	4.96	4.98	5.04	4.99
3-month LIBOR	5.36	5.36	5.36	5.17
2-year Treasury note	4.82	4.71	4.65	4.96
5-year Treasury note	4.73	4.58	4.57	4.96
10-year Treasury note	4.81	4.68	4.67	5.06
30-year Treasury bond	4.96	4.85	4.85	5.14
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.76	3.74	3.74	3.82
10-Year	3.99	3.98	4.03	4.25
30-Year	4.48	4.47	4.55	4.63
30-year fixed mortgage rate	6.21	6.15	6.17	6.60
15-year fixed mortgage rate	5.92	5.87	5.89	6.20
1-year adjustable rate	5.48	5.48	5.45	5.62
STOCK MARKET				
Dow Jones Industrial	13556.53	13326.22	12961.98	11144.06
S&P 500	1522.75	1505.85	1484.35	1267.03
NASDAQ	2558.45	2562.10	2526.39	2193.88
Commodities				
Gold (\$ per troy ounce)	662.00	672.30	695.80	659.60
Oil (\$ per barrel) - Crude Futures (NYMEX)	64.94	66.83	63.38	68.53
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (April) - 000s of units	1528	1491	1487	1517
Housing Permits (April) - 000s of units	1429	1569	1541	1543
Consumer Price Index (April) - % change	0.4	0.6	0.4	0.3
Core CPI, excl. Food & Energy (Apr.) - % ch.	0.2	0.1	0.2	0.2
Industrial Production (April) - % change	0.7	-0.3	0.8	0.2
Capacity Utilization (April) - Percent	81.6	81.2	81.6	81.4

Are we there yet? For anyone taking a long trip with children in the back seat, that may sound like a familiar, if annoying, refrain. But children aren't the only ones repeatedly asking that question. Many economic pessimists are also wondering when the economy will finally arrive at that long-awaited destination known as a recession. After all, with the housing slump sapping growth for more than a year, business investment failing to pick up the slack and consumers showing signs of fatigue, the expansion would seem to be perilously close to running out of fuel. Speaking of fuel, climbing gasoline prices, now approaching an historic record in inflation-adjusted dollars, puts another weight on the economy's shoulders that some feel could be the final brake stalling the growth engine.

But like the energizer bunny, the driver keeps going and going, leading us to wonder what fumes the economic machine is running on. Take the manufacturing sector, which was left for dead some months ago as the housing slump tightened its grip on producers of construction machinery, cement makers and other goods used by homebuilders and ancillary industries. And, indeed, the housing downturn did take a toll on the industrial sector, as virtually all key measures of factory activity slumped from mid-2006

market. One of the more perplexing issues facing policy makers is why the marked slowdown in economic growth over the past year has not produced a corresponding weakening in job creation.. Although the net increase in nonfarm payrolls has downshifted this year, the slowdown has been much less than would be suggested by the economy's sluggish performance. What's more, the unemployment rate continues to hover at the lowest level in seven years. What seems to be happening is that the economic slowdown is discouraging companies from hiring new workers, but not encouraging them to fire existing workers.

If companies were responding to the slowdown by stepping up firings, it would show up in the unemployment lines. But that's hardly been the case. Instead, initial applications for jobless benefits have stayed exceptionally low this year. In fact, the 5000-drop in filings in the latest week brought the total down to a four-month low. On a four-week moving average basis, which smoothes out weekly fluctuations, the number of applicants shrank to 305 thousand in the week of May 18, which is the lowest in more than a year. As the chart shows, the unemployment lines are far shorter than was the case during the 2001 recession. There is no easy explanation for this trend, but one compelling interpretation is that companies are simply holding on to workers longer because of a scarcity in many professions, particularly those that require more than just a modest skill level.



Whether that is also the case in the construction industry is unclear. Undoubtedly, many homebuilders fear that they will not be able to recapture laid-off workers when the next housing upturn occurs. But in fact, there may have been more firings of hardhats than the official data reveal. That's because this industry retains a higher proportion of undocumented workers than most others, workers who never show up in the Labor Department's monthly tally of nonfarm payrolls. These are likely to be the first workers to be laid off when business softens and, since they do not appear on official payroll records when they are working, they are not counted among the unemployed when they are fired. In other words, the ranks of unemployed construction workers may have swelled by much more than is recognized. This shadow trend not only obscures actual labor market trends, it may also be inflaming the immigration debate, as many of these undocumented workers are illegal immigrants. The headlines are filled with local skirmishes involving out-of-work hardhats visibly seeking jobs in hard-hit residential markets.

Significantly, a slew of recent data suggests that the low unemployment rate, as officially defined, is overstating the tightness in the labor market. Even the net change in nonfarm payrolls reported this year may exaggerate hiring trends, as the recent release of more comprehensive quarterly data based on state unemployment records indicate that there will be a downward revision of previously-reported nonfarm payroll data. If that's the case, there may well be more slack in the job market than is currently perceived, something that could sway the Federal Reserve to lean more towards a rate cut if the economy continues to languish at its slower pace. Keep in mind that a major reason the Fed is holding firm to its current stand-pat policy, and retaining an inflation bias in its official statements, is the belief that resource utilization is high, a code phrase that alludes mostly to the low unemployment rate. That, in turn, is keeping upward pressure on wages and labor costs, a major contributor to higher inflation. But if the official data overstate the labor market tightness, they may also overstate the decline in productivity and increase in unit labor costs.

Still, the burden of proof that the housing-led slowdown will gain traction in coming months and require rate-cutting measures to revive growth rests with the doomsayers. Their argument will only mobilize support at the Fed if signs of contagion to the rest of the economy multiply. While nascent signals are flashing more frequently, they have yet to reach alarming levels. Most economists, in fact, believe that the worst of the slowdown is now behind us, with the first-quarter's growth rate – expected to be revised down to below 1 percent—marking the low point for the cycle. Even the slumping housing sector may be showing signs of stabilizing. Mortgage loan applications have recently firmed, new home sales strengthened in March and sales in the much larger market for existing homes actually increased in the first quarter from the previous quarter.

True, the jury is still out on housing prospects. A wildcard in the mix is how lenders respond to the subprime mortgage meltdown. Financial institutions have tightened underwriting standards, but mainly for the less creditworthy borrowers. That may be the reason mortgage applications are rising; potential homebuyers may simply be filing multiple applications because they fear being rejected by a given lender. But if sales do not take another nosedive, the inventory of unsold homes may soon be brought down to manageable levels, fostering a quicker homebuilding recovery than is generally expected. As it is, the ballooning of unsold units appears to have been arrested. Since reaching a peak of 573 thousand last summer, the inventory of unsold single-family homes has slowly receded, hitting a low of 536 thousand this January before edging up to the March level of 545 thousand units.

To be sure, that is still a high 7.8 months supply on the market at the current sales pace, which does not exactly portend a quick rebound in homebuilding activity. Indeed, builders filed the fewest number of permits for new housing units in ten years in April. But at the same time, they also broke ground for more homes during the month, as starts jumped to a four-month high of 1.528 million housing units in April. That spike was likely an aberration, but it was the third consecutive monthly increase in starts, which does suggest that the long slump in housing construction may have bottomed out. If so, that tidal wave of layoffs may not occur as expected, keeping the recession-worriers asking “are we there yet?” for at least a while longer.

