

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 25, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	May 25	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.86%	4.81%	4.92%	4.82%
6-month Treasury bill	4.96	4.96	5.02	5.00
3-month LIBOR	5.36	5.36	5.36	5.18
2-year Treasury note	4.86	4.82	4.66	4.94
5-year Treasury note	4.79	4.73	4.58	4.94
10-year Treasury note	4.86	4.81	4.69	5.05
30-year Treasury bond	5.00	4.96	4.88	5.16
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.81	3.76	3.76	3.79
10-Year	4.05	3.99	4.01	4.17
30-Year	4.55	4.48	4.49	4.58
30-year fixed mortgage rate				
15-year fixed mortgage rate	6.06	5.92	5.87	6.23
1-year adjustable rate	5.64	5.48	5.43	5.61
STOCK MARKET				
Dow Jones Industrial	13507.28	13556.53	13120.94	11278.61
S&P 500	1515.73	1522.75	1494.07	1280.16
NASDAQ	2557.19	2558.45	2557.21	2210.37
Commodities				
Gold (\$ per troy ounce)	655.30	662.00	664.70	652.60
Oil (\$ per barrel) - Crude Futures (NYMEX)	65.20	64.94	68.41	71.38
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Durable Goods Orders (April) - % change	0.6	5.0	0.5	0.6
Nondefense Cap. Goods less Air - % change	1.2	4.4	-2.4	-0.2
New Home Sales (April) - 000s of units	981	844	856	930
Existing Home Sales (April) - 000s of units	5990	6150	6680	6297

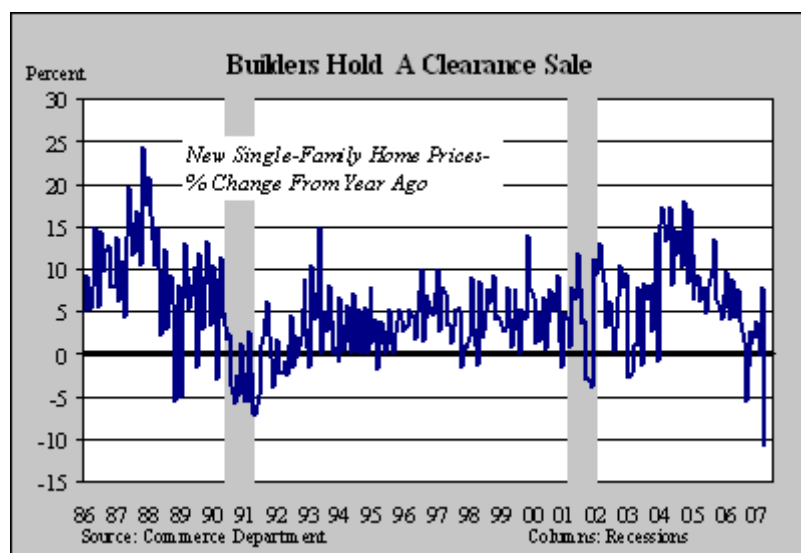
The stock market hit a bump in the road this week, as the blue-chip Dow Jones Industrial average slipped after setting a seemingly endless string of record-setting highs this year. Oddly enough, the setback occurred despite some promising economic news regarding housing and capital spending, two sectors accounting for the biggest unknowns in the outlook. Perhaps it was another case of “good news is bad news” syndrome for the financial markets, reminiscent of the days of yore when inflation loomed as an unappealing alternative to slow growth. The essence of this syndrome is that good news on the economy – a.k.a., stronger-than-expected growth – means higher inflation and, hence, higher interest rates or, at least in this case, less chance that the Fed will cut rates any time soon.

To be sure, it was not just economic news that rattled the markets this week. The departed Federal Reserve Chairman, Alan Greenspan, appears to have played a role as well, hinting that the high-flying Chinese stock market was vulnerable to a “dramatic contraction.” Understandably, cynics wonder if Greenspan is showing his hypocritical side, since he stayed mostly silent during the dot.com frenzy that propelled the U.S. stock market to dizzying heights during the late 1990s. But even that experience pales relative to what China’s benchmark equity index, the CSI 300, is doing -- skyrocketing by 92 percent

this year after more than doubling in 2006.

Recall that it was the 9.2 percent plunge in China's stock market on February 27 that sent shock waves through the global markets, including in the U.S. That plunge turned out to be a one-day wonder, as equity prices in both China and in the U.S. quickly recovered, setting the stage for the aforementioned string of record highs that subsequently took place. Clearly, in an environment where global markets are highly interconnected, ignoring what happens overseas can be hazardous to your financial health. Nor is it just a matter of a few billionaire hedge fund investors losing their shirts. Keep in mind that the 13 percent gain in stock prices over the past year has shored up household balance sheets at a critical time, as fatter equity portfolios more than offset the erosion in net worth associated with sagging home values.

Speaking of sagging home values, if the median sales price of newly built homes is any indication, the housing market experienced its biggest clearance sale on record during April. That, at least, is the message contained in the latest sales figures released by the government this week. During the month, prices plunged by 10.9 percent compared to a year earlier, the steepest drop in record. Clearly, the nosedive has to be taken with a grain of salt, as it reflected a major shift in the mix of homes sold towards lower priced regions, particularly in the South. But it is consistent with the notion that appreciating home values are no longer contributing to household wealth, as was the case during 2003 through 2005. The buildup in housing equity during that period supported a huge wave of refinancings and equity extraction that ultimately bolstered consumer spending.

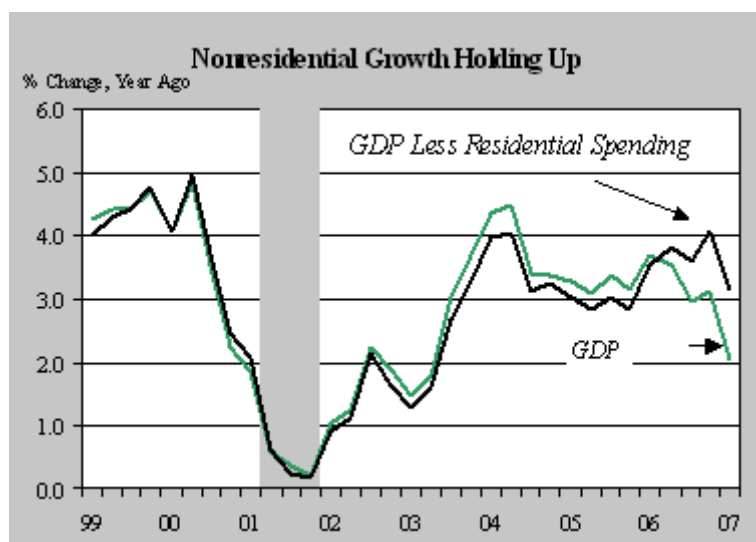


Nonetheless, the steep price concession by builders had its desired effect. Sales of new homes surged 16.2 percent in April, the biggest one-month jump in 14 years, a result that far exceeded expectations. The enthusiastic response to lower prices put a dent in the huge inventory overhang, lowering the months' supply of unsold homes to 6.5 months from 8.1 in March. Still, as was the case with the plunge in reported home prices, the surge in new-home sales should also be viewed with a grain of salt. First, the monthly figures are extremely volatile and are often revised substantially in subsequent months. What's more, the sales jump was not broadly based but concentrated in the South where, as already noted, homes are cheaper than in other regions. There may be another reason for the Southern splurge -- the return of flippers. A closer look at the data shows that most of the sales increase was for "units not started", instead of completed homes. This suggests that speculators are back in such areas as Florida, picking up spec units on the cheap and betting on a rebound in six months or so, the usual time it takes to build a new home.

In any event, it is probably highly premature to conclude that the housing market has stabilized, removing the major drag overhanging the economy. While the supply of unsold units did shrink modestly in April, it is still high by any standard. The 6.5 months supply is well above the 5 – 5.5 months that builders feel comfortable with. And if sales fall back in May, that inventory ratio will balloon once again. Keep in mind also that foreclosures are rising, although still far from crisis levels, which effectively adds to inventories when these foreclosed properties are thrown back on the market.

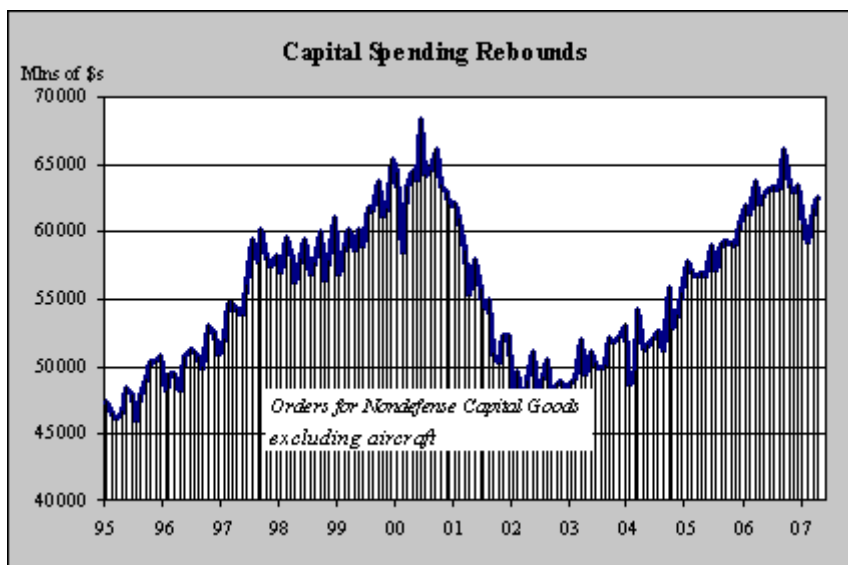
Perhaps the biggest gorilla in the housing closet is the extent by which lenders tighten their underwriting standards. So far, the harshest screening is for applicants seeking nontraditional loans, a natural response to the subprime mortgage meltdown. But if the tougher standards spread to the more credit-worthy borrowers, making it much more difficult for them to obtain mortgages, the life could be squeezed out of any nascent recovery in housing activity. This chapter in the long housing slump has not been written yet, but it is something to keep an eye on. Indeed, there are signs that tightening lending standards for nonprime borrowers are crimping sales in the secondary housing market. This should not be surprising since home builders finance a larger fraction of sales in the new-home market whereas financial institutions play a bigger role in the market for existing homes. More to the point, just one day after the bullish new home sales results were reported, the National Association of Realtors revealed that existing home sales fell by a larger amount than expected in April. If there was one consistent theme between the two markets, it is that home prices fell in both of them. The drop in median prices for existing homes was far more muted than it was in the new-home market, but the direction was the same, suggesting that prospective homebuyers need some incentive to get them back into the market.

We suspect that the worst of the housing slump is behind us, but the drag on the economy is far from over. If that's a correct assessment, the first quarter sluggish growth rate in GDP – which is likely to be revised down from the initial estimate of 1.3 percent – will mark the low point for the current cycle. The key to the outlook is whether the rest of the economy remains on the relatively healthy growth track followed over the past year. On this point, it is noteworthy that virtually the entire slowdown in the economy's growth rate over the past year can be attributed to the direct effects of the housing slump. For example, in the year ending with the first quarter, real GDP expanded by 2.1 percent, down sharply from the 3.7 percent year-over-year growth rate ending with the first quarter of 2006. But take out residential investment spending, and the rest of the economy only slowed from 3.6 percent to 3.1 percent. Not only is the nonresidential slowdown much more subdued than it is for the overall economy, the 3.1 percent growth rate is only a tad below the 3.3 percent average over the past three years.



To be sure, the lagged effects of the housing slump on the broader economy have not fully played out, particularly with regards to the unemployment fallout that is sure to come. But assuming that the mortgage market does not experience a credit crunch due to the subprime meltdown, these effects should be contained. A critical variable is how chief executives perceive the likely outcome. There's little question that the housing-led deceleration in overall growth over the past year has led to some skepticism by corporate leaders over the sustainability of the expansion. Along with this skepticism, many companies put investment spending plans on the shelf, seeing little need to expand capacity until they get a clearer picture of how well final demand holds up. As a result, capital spending has fallen far below expectations, particularly since the housing downturn has gained traction beginning mid-way through last year.

But an encouraging sign has surfaced in recent months, which may point to a long-delayed pickup in capital spending. In particular, new orders for nondefense capital goods, less civilian aircraft, which is considered a reliable gauge of future spending, have increased for two consecutive months, with a 1.2 percent gain in April following a hefty 4.4 percent jump in March. This was the first back-to-back gain since last June/ July, which ushered in a string of five declines over the ensuing seven months. Although bookings for equipment used in the slumping housing as well as the auto industries led the way down, the weakness spread across virtually all capital-goods categories, reflecting a general unwillingness of companies to commit funds to expand or modernize operations.



What makes the rebound over the last two months so encouraging is that it has been accompanied by a pickup in capital-goods shipments, which are used in the GDP calculations for business spending on equipment and software. In April, the level of nondefense capital goods shipments less aircraft stood a solid 7.8 percent above the first quarter average. Unless the April gain is reversed in May and June, that means the pace of capital goods spending in the second quarter is on track to increase nearly four times faster than the tepid 1.9 percent increase registered in the first quarter. All else equal, such an increase would clearly boost the growth rate of GDP above the first-quarter's pace, giving credence to the notion that the low point of the slowdown occurred in the January-March period.

But returning to the assertion made at the outset, the financial markets may well interpret this as a good news is bad news story. The good news, of course, is that recent data suggest the economy is further removed from a recession than perceived by many a month or two ago. The bad news is that a revival of growth may be taking place before inflation slides into the Fed's comfort zone. As a result, a move towards an interest rate cut, which had been priced into the stock market, may not take place any time

soon – if at all this year. Should that perception gain more credibility on Wall Street in coming weeks and months, the market boost derived from an anticipated rate cut would be priced out of stocks, requiring some other catalyst to sustain the rally. Of course, there’s always the possibility that “bad news” will return, giving the market a reason to cheer. Keep your eyes on the housing market for clues.