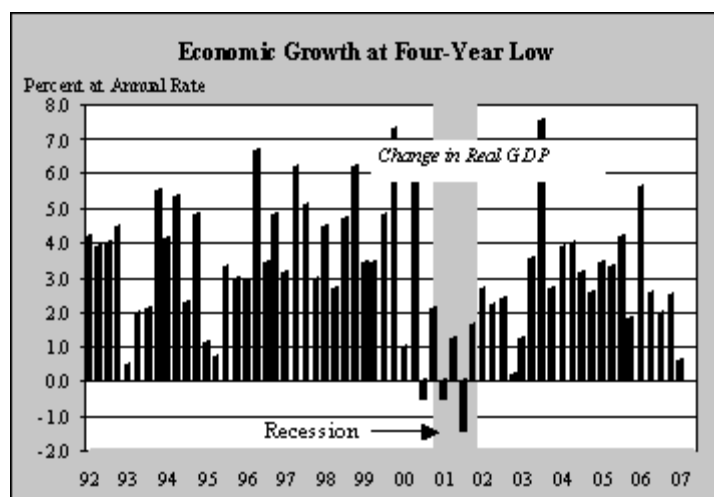


WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 1, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	June 1	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.87%	4.86%	4.87%	4.80%
6-month Treasury bill	4.97	4.96	5.01	5.00
3-month LIBOR	5.36	5.36	5.36	5.22
2-year Treasury note	4.97	4.86	4.67	4.91
5-year Treasury note	4.92	4.79	4.55	4.90
10-year Treasury note	4.95	4.86	4.64	4.99
30-year Treasury bond	5.06	5.00	4.81	5.10
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.82	3.81	3.76	3.76
10-Year	4.03	4.05	3.98	4.16
30-Year	4.55	4.55	4.46	4.57
30-year fixed mortgage rate	6.42	6.37	6.16	6.67
15-year fixed mortgage rate	6.12	6.06	5.87	6.26
1-year adjustable rate	5.57	5.64	5.42	5.68
STOCK MARKET				
Dow Jones Industrial	13668.11	13507.28	13264.62	11247.87
S&P 500	1536.34	1515.73	1505.62	1288.22
NASDAQ	2613.92	2557.19	2572.15	2219.41
Commodities				
Gold (\$ per troy ounce)	676.90	655.30	689.70	642.60
Oil (\$ per barrel) - Crude Futures (NYMEX)	65.08	65.20	61.93	72.33
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Confidence (May) - Index	108.0	106.3	108.2	109.0
Revised GDP(Q1) -- % change	0.6	2.5	2.0	2.5
Nonfarm Payrolls (May) - change in 000s	157	80	175	150
Unemployment Rate (May) - Percent	4.5	4.5	4.4	4.5
Average Hourly Earnings (May) - % change	0.3	0.2	0.3	0.3
ISM Manufacturing Index (May) - Index	55.0	54.7	50.9	52.3
Personal Income (April) - % change	-0.1	0.8	0.6	0.6
Personal Consumption (April) - % change	0.5	0.4	0.7	0.6

When it comes to economic data, it is often best to ignore the headlines and focus on the details. That principle readily applies to this week's batch of key numbers, starting with the revised first-quarter GDP report released early in the week. The initial growth estimate of 1.3 percent for the period was revised down, an adjustment widely expected due to information released after the initial estimate was made a month ago. Still, the downward revision – to 0.6 percent – was slightly greater than expected, and brought the economy closest to a stall speed since the fourth quarter of 2002, when a puny 0.2 percent gain in GDP was reported. Recall that was barely a year removed from the 2001 recession when the economy was still facing the stiff headwinds of a moribund stock market, corporate accounting scandals and debilitating job losses. If not for the swift and aggressive rate-slashing policy by the Fed and massive tax cuts by the administration, the nascent recovery might never have gotten legs.



But the downshifting in the headline GDP growth rate in the latest quarter hardly calls for the type of pump-priming that was desperately needed four years ago. As noted above, the devil is in the details. Indeed, parsing through the revisions, one could easily wonder if the weaker headline number actually masks stronger underpinnings than were present when the initial estimate was made a month ago. After all, the biggest contributor by far to the revision was a steep downward adjustment to business inventories. Originally reported to have risen by \$14.8 billion, the new estimates reveal that businesses slashed inventories by \$4.5 billion during the period, a swing of \$19.3 billion that more than accounted for the total \$17.4 billion downward revision in real GDP.

To be sure, the trade deficit also imparted more of a drag on growth than originally estimated, reflecting a stronger increase in imports. But that accelerated increase is simply a function of stronger consumer demands for products made overseas. On this score, consumer spending was revised up, from an already sturdy growth rate of 3.8 percent to a rock-solid 4.4 percent. Indeed, the main takeaway from the revised first-quarter number is not that the economy performed more poorly during the period – as the headline slowdown suggests – but rather that final demands came in stronger than companies were prepared for, leaving them with leaner cupboards of merchandise going forward. With inventories lean, both new orders and production should pick up, something that is already evident in recent data. The ISM index of manufacturing activity, for example, jumped to 55.0 in May from 54.7 in April and 50.9 two months earlier. Powering the rise, the new orders index and the production index both increased to the highest levels in over a year, while the inventory index slid to 46.1 from 47.5 two months earlier.

As a result, the tepid 0.6 percent growth rate in the first quarter should mark the low point of the economic slowdown underway during the past year. The question is, how much of a rebound can reasonably be expected. After all, the major catalyst of the slowdown, housing, has hardly been defused. Despite some mixed readings on home sales and production recently, the forward-looking indicators are overwhelming pointing to further weakness in the months ahead. Inventories of unsold homes remain historically high, prices are still weakening, mortgage-lending standards are tightening and homebuilders' sentiment keeps on sinking. The latest barometer of future sales of existing homes, the pending home-sales index released on Friday, also depicts a sluggish housing market over the near term.

But while the housing drag is far from exhausted, at least it is not intensifying. In the first quarter, for example, residential spending subtracted .87 percentage point from the economy's growth rate compared to the 1.21 and 1.20 percentage point haircuts in the fourth and third quarters of 2006, respectively. Meanwhile, steep price concessions by builders are coaxing buyers back to the new-home market, indicating that the slide in construction activity will moderate in the months ahead. Simply put, a smaller drag from residential spending would allow growth to bounce back in coming quarters. If, as expected,

businesses start to replenish inventories, that alone should impart a major lift to GDP. Indeed, the inventory drawdown during the past two quarters has sliced more than 1 percentage point from overall growth, equaling the drag from residential spending. Hence, if companies just keep their stockpiles of merchandise at their current levels this quarter, that alone would boost the growth rate by 1 percentage point.

But for the economy to rebound, it is absolutely imperative that businesses step up spending on inventories and capital goods, even as the housing drag abates in coming quarters. The reason: the 70 percent of the economy represented by consumer spending cannot be expected to provide as much oomph to growth going forward. With gasoline prices piercing new highs at the onset of the driving season and climbing food prices also squeezing budgets, it would be unreasonable to expect households to increase spending anywhere near the upwardly-revised 4.4 percent first-quarter pace. If sustained for the rest of the year, that would actually exceed the peak 3.9 percent full-year growth rate for the expansion registered in 2004. That said, pessimists have been predicting a sharp consumer retrenchment ever since the housing downturn became entrenched more than a year ago. Yet, households have proven to be stubbornly resistant to these predictions, with temporary setbacks quickly followed by solid rebounds.

We have no compelling arguments against a slowdown in consumer spending, only with the severity of the retrenchment that the pessimists expect. At the start of the second quarter, many doomsayers were looking for a consumer spending gain of less than 1 percent for the period, as the first quarter ended on a sluggish note for retailers and the job-creating engine seemed to be ratcheting down sharply. But once again, the fundamentals that appeared to be eroding are proving to be surprisingly resilient. According to the monthly income and spending report released on Friday, households reopened their wallets and purses in April, stepping up outlays by a solid 0.5 percent during the month. On a real, inflation-adjusted basis, which is used to calculate the real GDP data, personal consumption increased by 0.2 percent, which puts it 1.5 percent above the first-quarter average. Barring an unlikely collapse in May and June, there is now a strong probability that real PCE will increase by about 2.5 percent in the second quarter – well below that of the first quarter, but a respectable showing nonetheless.

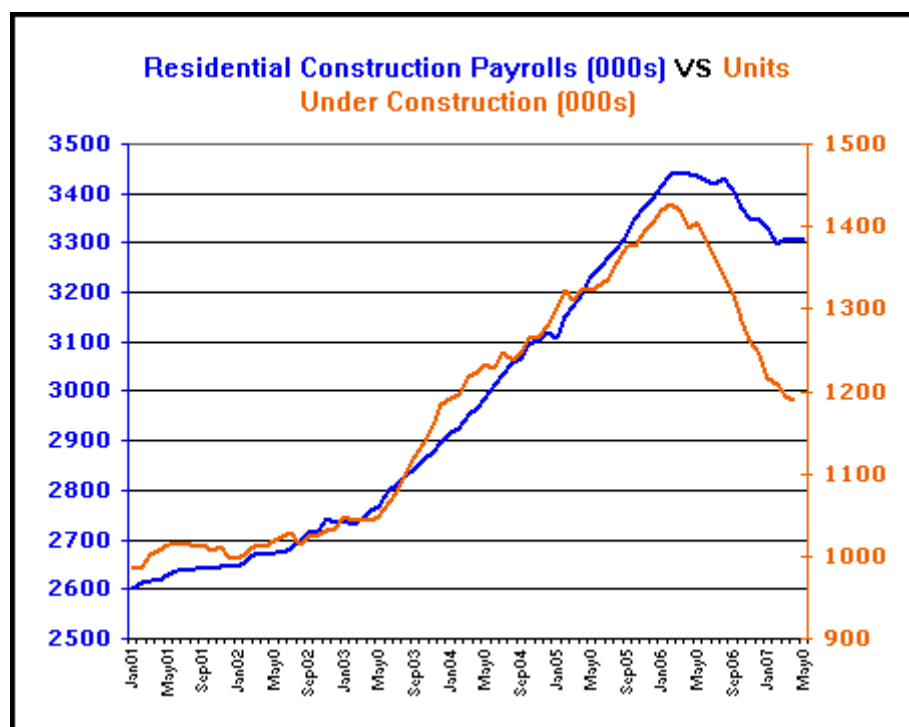
More important, the long-awaited collapse in business hiring remains more of a threat than reality. Yes, the trend rate in job growth is slowing, but that is to be expected at a mature stage of an expansion when labor resources are virtually fully utilized and the Fed is attempting to engineer enough slack in the job market to stave off an unwelcome outbreak of wage inflation. By all accounts, that objective is being accomplished. If anything, the Fed may still be disappointed with the lagged pace of the slowdown in the job market. That perception is in marked contrast to the thinking in effect following last month's report. Recall that in April, the pace of job creation slumped to 88 thousand during the month, which was the smallest increase since late 2004 and set off alarm bells about the sustainability of consumer spending. Well that view has once again been turned upside down this week, with the Labor Department's latest jobs report for May.

First, the job-creating engine cranked up again, generating a robust 158 thousand net new jobs in May, exceeding expectations and almost double the downwardly-revised 80 thousand April increase. Second, the low jobless rate, which policy makers constantly allude to as justifying their inflation vigilance, didn't budge, remaining at a near five-year low of 4.5 percent. Finally, wages continue to rise faster than inflation, as average hourly earnings increased by 0.3 percent during the month. Along with the increase in hours worked, that assures another month of fatter paychecks for workers, reinforcing the positive income fundamentals supporting consumer spending.



Once again, however, it is important to parse the details of the employment report, as these headline-grabbing components probably overstate the strength in the labor market. First, as already noted, even taking the numbers at face value, the trend is decelerating. Over the first five months of the year, the average gain in nonfarm payrolls has slipped to 134 thousand a month from 188 thousand in 2006. Second, the major areas of strength are coming from sectors that are showing strong secular growth, such as education and health care, which are not responsive to a cyclical weakening of economic growth. In other words, the Federal Reserve can do little to slow job growth in these sectors without choking off the expansion entirely.

Finally, the job numbers still contain an astonishing disconnect with reality in at least one respect. Despite the housing recession and obvious retrenchment of builders, residential construction employment remains highly resilient. In May, the total on payrolls hardly budged, even as the number of homes under construction continues to plummet. As the chart shows, the number of housing units under construction has fallen by 15 percent from a year ago while residential employment has fallen by only 4 percent. This disparity has been ongoing for some time, and there are no easy explanations for it. One possible reason is that many residential workers are finding jobs at commercial construction sites, but are still being classified as residential jobholders. To some extent, that may be happening, but it's doubtful that such switchovers and misclassifications account for the magnitude of the disparity in jobs versus the plunge in residential activity. We suspect that when more complete data are available in coming months, the head count among construction workers will show a much steeper decline than is now apparent in the payroll numbers.



When all is said and done, however, it certainly appears that the economy is holding up significantly better than the consensus of blue-chip economists thought a few months ago, and is clearly exceeding the downbeat expectations that many pessimists still adhere to. We suspect that the first quarter will mark the nadir of the growth slowdown, and the economy is poised for a modest rebound over the remainder of the year. Investors are increasingly pricing this perception into their valuation models, boosting stock prices in anticipation of healthy profits and lifting bond yields in response to a more inflation-vigilant Fed. Indeed, the benchmark 10-year Treasury yield has moved up by nearly half of a percentage point since mid-March and appears set to pierce the 5 percent threshold again for the first time since last summer. With mortgage rates linked to this yield, it remains to be seen if a corresponding increase in the cost of financing a home purchase intensifies the housing correction. If so, the housing drag would pose more of a growth obstacle to overcome, setting the stage for another reassessment of economic prospects around mid-year. Stay tuned.