

WEEKLY ECONOMIC COMMENTARY -- JUNE 8, 2007

First the numbers, then the story

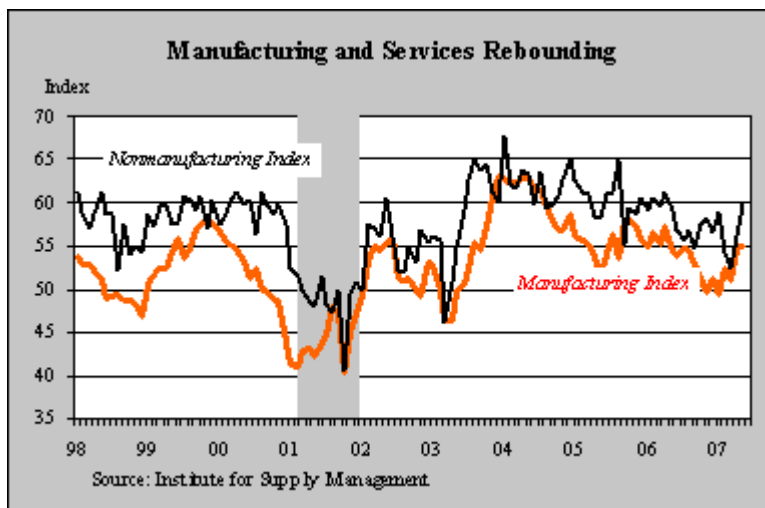
FINANCIAL INDICATORS				
INTEREST RATES	June 8	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.77%	4.87%	4.84%	4.87%
6-month Treasury bill	4.92	4.97	4.98	5.06
3-month LIBOR	5.36	5.36	5.36	5.25
2-year Treasury note	5.00	4.97	4.71	5.00
5-year Treasury note	5.05	4.92	4.58	4.93
10-year Treasury note	5.11	4.95	4.68	4.97
30-year Treasury bond	5.22	5.06	4.85	5.02
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.87	3.82	3.74	3.75
10-Year	4.11	4.03	3.98	4.14
30-Year	4.61	4.55	4.47	4.54
30-year fixed mortgage rate	6.53	6.42	6.15	6.62
15-year fixed mortgage rate	6.22	6.12	5.87	6.23
1-year adjustable rate	5.65	5.57	5.48	5.63
STOCK MARKET				
Dow Jones Industrials	13424.39	13668.11	13326.22	10891.92
S&P 500	1507.67	1536.34	1505.85	1252.30
NASDAQ	2573.54	2613.92	2562.10	2135.06
Commodities				
Gold (\$ per troy ounce)	650.30	676.90	672.30	605.50
Oil (\$ per barrel) - Crude Futures (NYMEX)	64.76	65.08	66.83	71.63
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Non-Manufacturing Index (May)	59.7	56.0	52.4	56.4
Consumer Credit (April) - chng. \$bilns	2599	14007	5548	9189
Trade Deficit (April) - Mlns of \$s	58495	62390	57598	39008

Will success spoil the stock market? After all, the sharp slowdown in economic growth during the first quarter did little to impede the remarkable gain in stock prices in recent months. Now amidst strong signs that the economy has turned the corner and growth is poised to accelerate, the stock market is taking it on the chin, absorbing a sharp three-day meltdown this week. Clearly, it would be as much of a mistake to attribute the market's rally to a weak economy as it would to blame the latest setback on signs of strength. Yet there is an obvious disconnect between Main Street and Wall Street that has analysts scratching their collective heads.

No doubt, a major impetus propelling stock price higher for much of this year had been the expectation that the Federal Reserve would soon cut interest rates to revive growth. Given the events of recent weeks, however, that catalyst has been taken off the table, at least for the foreseeable future. Indeed, the positive thrust from a prospective decline in rates has been quickly transformed into a negative influence. This week, bond yields surged above the 5 percent threshold, ending up at 5.11 percent. That's the highest level since last August, and up by more than 60 basis points since mid-May. The yield backup, which partly reflects a shift in perceptions regarding Fed policy, clearly contributed to the stock-market's slide this week.

Whether the turmoil will turn out to be a temporary hiccup for the market or a more serious correction remains to be seen. Friday's rebound in equity prices is a hopeful sign that the turbulence is subsiding. But the economic backdrop appears to be undergoing a seismic shift from a few months ago, and its full impact on both the stock and bond markets is uncertain at best. With each new economic report it is becoming increasingly clear that the economy is rebounding from the first-quarter slide, which saw growth weaken to a near-stagnant pace of 0.6 percent. Even the sparse data releases this week reinforced that notion, spurring economists to mark up their growth forecasts for the second quarter, which now hovers around 2.5 percent.

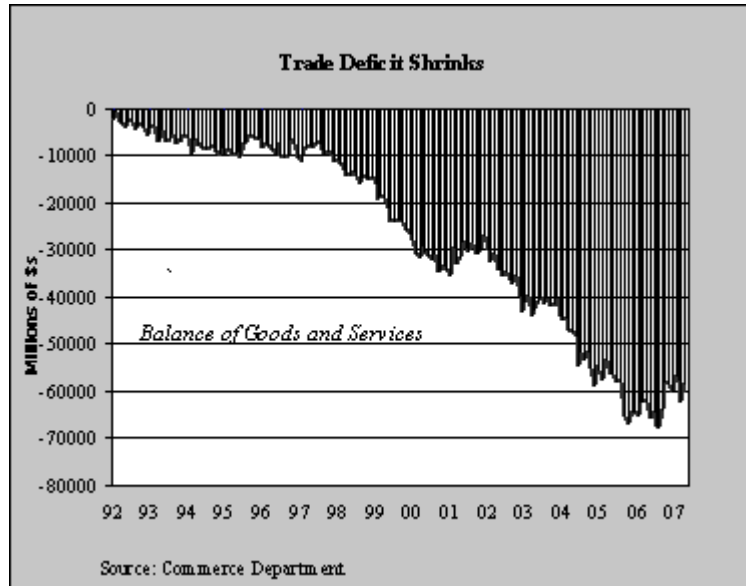
The Institute for Supply Management, for example, released its gauge of activity for the broad service sector of the economy this week. Like its manufacturing counterpart reported last week, the service-sector index has rebounded strongly in recent months. After hitting a cycle low of 52.4 in March, the ISM non-manufacturing index increased to 56.0 in April and jumped by another 3.7 points to 59.7 in May – the highest level in more than a year. The rebound has been broadly based, as most major components showed strength, including new orders, inventories and employment. Importantly, export orders continued to surge, leaping 18 points over the last two months. This lends further support to the notion that the U.S. economy is benefiting handsomely from strong growth overseas.



Indeed, the strength in global growth is contributing to the back up in bond yields. Not only does it stoke the demand for U.S. exports, thus boosting the increase in GDP, the robust advance in overseas economies is shrinking the pool of foreign savings that has flowed into the U.S. markets in recent years. Recall that none other than current Fed chief Bernanke had famously attributed the historically low level of bond yields reached in 2003 (before assuming the helm at the Fed) to a global savings glut. Well if foreign demand is sopping up those savings, that pool is rapidly drying up. Soon thereafter, former chairman Greenspan also chimed in with his “conundrum” theory in a somewhat different context, asserting that strong foreign demand for U.S. Treasury securities was responsible for keeping long-term rates low despite the 425 basis points of short-term rate hikes that he spearheaded between mid-2004 and mid-2006.

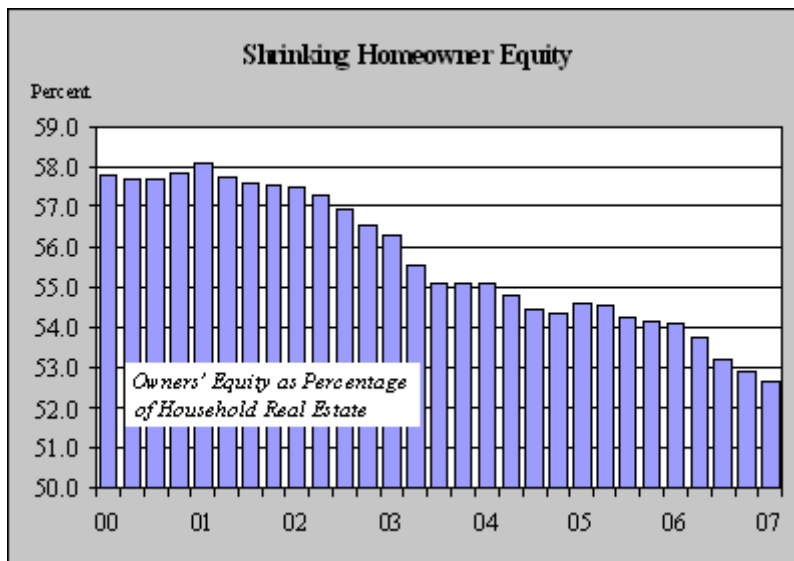
To be sure, the impetus to the U.S. economy imparted by foreign demand is limited by the fact that trade accounts for a relatively small fraction of overall activity. Still, on the margin it is important. The persistent widening of the trade deficit – financed by drawing heavily on the global savings glut – has subtracted an average 0.6 percentage point from annual GDP growth since 1998. That drag has diminished in recent years as the weakening dollar and accelerated growth of our trading partners stimulated exports even as slower growth in the U.S. has restrained the increase in imports. Last year,

the drag was miniscule, slicing growth by a mere 0.02 percentage point. Although a surprising increase in the trade gap brought on a sharper 1-percentage point haircut in this year's first quarter, that development is in the process of being reversed. According to Friday's report on foreign trade, the U.S. deficit with the rest of the world narrowed sharply in April, to \$58.5 billion from \$62.4 billion in March. Hence, net exports are on track to deliver a positive thrust to GDP in the second quarter, and will likely be a positive influence for the year as a whole.



The sharp narrowing in April's trade deficit is one reason economists are marking up their growth forecasts for the second quarter, but it is not the only one. Business investment spending is also picking up, as indicated by recent gains in capital goods orders and the sustained strength in nonresidential construction spending. What's more, companies have worked off excess inventories and many will need to replenish stockpiles in coming months, something that will stimulate production and provide support to job growth. The latter, of course, is crucial to the more upbeat outlook on the economy. As welcome as the boost provided by investment spending and exports is, it would be wiped out if households sharply curtail their spending in the months ahead. In that regard, it's critical that the job market remains firm, generating the income needed to sustain consumer spending.

Indeed, the latest quarterly figures released by the Federal Reserve provides another illustration of just why fatter paychecks will be necessary to support consumption. Recall that households have relied heavily on their housing wealth to finance spending in recent years, extracting huge amounts of equity through refinancings and second mortgages. That source of funds, of course, has been rapidly disappearing, thanks to the housing correction, the sub-prime mortgage meltdown, tighter lending standards and increase in mortgage rates, particularly on adjustable-rate loans. But the latest flow of funds data by the Fed reveal another factor at work, namely the extent by which homeowners have drawn down their home equity cushion.



As the chart shows, despite the record increase in mortgage borrowing between 2004 and early 2006, homeowners retained most of the equity in their homes largely because housing values had increased almost as much as borrowing. But with the onset of the real-estate correction early last year, the appreciation in property values has slowed markedly, increasing by a mere 0.8 percent in the first quarter of this year. That's a drastic falloff from the average quarterly gain of 3 percent in 2004 and 2005, and the slimmest since the fourth quarter of 1995. Meanwhile, mortgage borrowing has also tailed off, but not by nearly as much. As a result, homeowners' equity as a percentage of property values has sunk to an all-time low of 52.7 percent in the first quarter, a shrinkage of more than five percentage points since 2001. At this rate, it won't be long before homeowners in the aggregate owe more on their homes than they own.

To an aging baby-boom population that has long relied on the buildup of housing wealth to fatten their retirement nest eggs, this has to be a rude wake-up call. What's more, millions of homeowners will be facing stiff resets on adjustable rate loans this year and next that will sharply increase debt-servicing burdens. To the extent that many may be forced to sell their homes to get out from under these burdens, the pressure on the housing market will only intensify, as more sellers will swell the supply of homes on the market. Keep in mind too that the back up in bond yields is pushing up mortgage rates. Industry experts believe that a 7 percent rate on conventional 30-year fixed-rate loans would be the final straw that chokes off demand, which would usher in the second – and fatal – leg of the housing downturn. While the rate is currently at 6.53 percent, it has increased by 38 basis points in three short weeks. Following the spurt in the 10-year Treasury bond yield this week, another rise of at least 10 basis points would seem to be baked in for mortgage rates next week.

In short, the crosscurrents buffeting the economic backdrop are intensifying. A major rebound in growth should be expected for the second quarter, thanks to stronger investment spending, an inventory rebuild and an improving net export position. Offsetting these strengths, however, the recent backup in mortgage rates imparts another obstacle that the housing market will have to overcome, possibly extending the housing downturn well into the second half of the year. As a result, it is unclear whether the growth rebound this quarter will be sustained over the second half of the year. Keep in mind that even if growth reaches 3 – 3 ½ percent during the period, the first-half pace would still average out to only about 2 percent. Given the headwinds facing consumers – heavy debt burdens, high gasoline prices, sagging housing wealth and higher interest rates -- it does not seem likely that momentum will be building heading into the second half of the year.

