

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 15, 2007

*First the numbers, then the story*

FINANCIAL INDICATORS				
INTEREST RATES	June 15	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.55%	4.77%	4.81%	4.86%
6-month Treasury bill	4.85	4.92	4.96	5.18
3-month LIBOR	5.36	5.36	5.36	5.28
2-year Treasury note	5.02	5.00	4.82	5.16
5-year Treasury note	5.08	5.05	4.73	5.10
10-year Treasury note	5.16	5.11	4.81	5.13
30-year Treasury bond	5.26	5.22	4.96	5.17
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	4.01	3.87	3.76	3.77
10-Year	4.25	4.11	3.99	4.13
30-Year	4.73	4.61	4.48	4.54
30-year fixed mortgage rate				
	6.74	6.53	6.21	6.63
15-year fixed mortgage rate				
	6.43	6.22	5.92	6.25
1-year adjustable rate				
	5.75	5.65	5.48	5.66
STOCK MARKET				
Dow Jones Industrials	13639.40	13424.39	13556.53	11014.55
S&P 500	1532.90	1507.67	1522.75	1251.54
NASDAQ	2626.71	2573.54	2558.45	2129.95
Commodities				
Gold (\$ per troy ounce)	658.70	650.30	662.00	583.80
Oil (\$ per barrel) - Crude Futures (NYMEX)	68.00	64.76	64.94	69.83
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (May) - % change	1.4	-0.1	1.0	0.7
Business Inventories (April) - % change	0.4	0.0	0.2	0.2
Producer Price Index (May) - % change	0.9	0.7	1.0	0.7
Consumer Price Index (May) - % change	0.7	0.4	0.6	0.4
Core CPI (May) - % change	0.1	0.2	0.1	0.2
Industrial Production (May) - % change	0.0	0.4	-0.3	0.2

One reason that former Fed Chairman Greenspan received accolades during his years at the helm was the way he handled the economy during the 1990s. Recall that during the latter half of that decade, the economy's growth engine was going full tilt, spurred by a capital-spending boom and surging stock-market wealth that underpinned strong consumer spending. At the time, many inflation hawks were calling for the Fed to hike interest rates to tamp down growth in order to stave off inflationary pressures. But Greenspan recognized that strong growth and stable inflation can coexist, given the right set of conditions. His patience paid off, allowing the economy to enjoy the longest and strongest noninflationary expansion in modern history. Only late in the decade when overheating conditions became more apparent did the Fed tighten policy, leading to the mild recession in 2001 that was caused as much by the dot-com bust and capital-spending retrenchment as by policy actions.

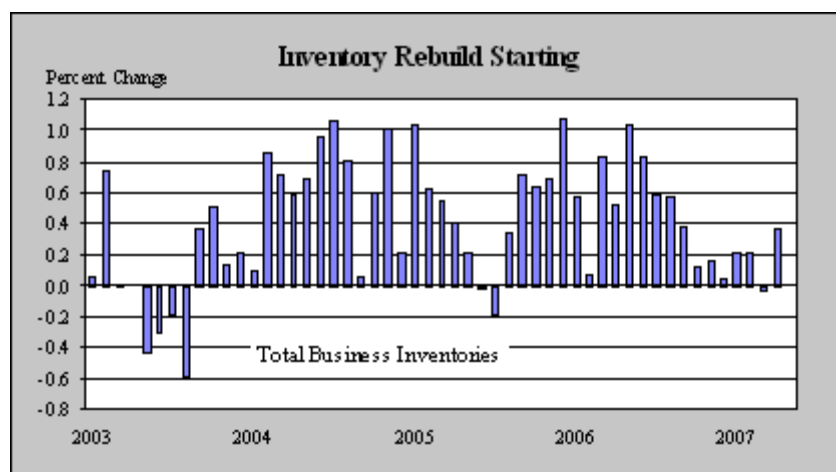
Today's economy is far removed from the turbo-charged growth scenario of the 1990s. Nonetheless, some common fears are being expressed, which may be seeping into market psychology. While no one is calling for an imminent Fed tightening, the economy's growth engine is clearly running on more cylinders than was the case a few months ago. Historically, stronger growth brings out the bond bears. That was the case in 1996, when the 10-year Treasury yield spiked by more than a percentage point, reaching 7 percent in early 1997, and is a pattern that has been repeated several times during the current expansion, including the past several weeks. The latest uptrend has seen the bond yield surge by about 70 basis points in less than a month, reaching a recent five-year high of 5.26 percent before receding to the current 5.16 percent.

Similarly, the abrupt shift in the economy's growth prospects has altered market thinking regarding Fed policy. The consensus view earlier in the year that the Fed would soon have to lower rates to prevent a housing recession from spreading to the broader economy has all but disintegrated. Now the consensus is that the Fed will stay on hold for the balance of the year, and there is even a smattering of opinion that the next move will be to raise rates sometime next year. No doubt, at some point the Bernanke-led Fed will be fending off critics, much like his predecessor did in the late 1990s. But that's a story for later in the year or, more likely, for 2008. What matters now is whether the current Fed chief is as adept as Greenspan was in interpreting unfolding economic forces.

At issue is whether the growth rebound now underway is just a transitory blip, propelled by temporary catalysts that will be replaced by more fundamental weakness later in the year. If there was any question that the economy has emerged Phoenix-like from the tepid 0.6 percent growth rate in the first quarter, it is being extinguished by the incoming batch of data. What's more, economists are marking up their forecasts for the second quarter with virtually every new data point. A month ago, the perception was that there would be a modest rebound, perhaps to a 1.5-2.0 percent pace, if only because the housing drag was moderating and exports would provide a lift. That passive outlook has since been replaced by more aggressive markups, reflecting new data that have consistently exceeded expectations. The list is comprehensive, including job growth, consumer spending, capital goods orders and inventory restocking. After parsing through the list, economists are now looking for a second-quarter growth rate of at least 3 percent, and more than a handful are penciling in a 4 percent handle for the period.

Nonetheless, the biggest lift to the economy for the current quarter is coming from a moderation of forces that dragged down growth in the first quarter. Heading the list is inventories, which knocked off almost a percentage point from the increase in GDP during the January-March period. Actually, the housing-led slowdown last year had already induced companies to turn much more cautious towards inventory management. In the fourth quarter, for example, inventory liquidations sliced 1.2 percentage points from the growth rate, as purchasing managers understandably feared that the housing meltdown would undermine consumer spending, leaving them with a mountain of unwanted merchandise.

But after a prolonged period of caution, inventory stockpiles have become lean and mean, even as final demand has held up better than expected. As a result, companies are now replenishing their depleted stocks. In April, businesses increased inventories by 0.4 percent, the largest build since last September. The difference is that the buildup last year was largely involuntary, whereas the current increase is part of a deliberate strategy. In any event, the absence of further drawdowns in stockpiles will remove a drag from GDP that has averaged more than a percentage point over the past two quarters. As we noted earlier, that lessened drag will impart a significant growth boost in the second quarter.



To be sure, some of the inventory rebuilding is an artifact of circumstances that are not related to economic fundamentals. This is particularly the case in the auto industry, where the volume of unsold vehicles has been reduced considerably, thanks to steep production cutbacks during the second half of last year. As a result, domestic light vehicle inventories at the end of May totaled a seasonally adjusted 2.648 million units, the lowest level since the spring of 2002. Although that draw down only restores the inventory to sales ratio to a level that is consistent with historical patterns, automakers are ramping up production schedules considerably in the second and third quarters. Given high gas prices and a general environment that is not conducive to a spurt in auto sales, one has to wonder why Detroit is boosting assemblies so aggressively. One answer is simply that auto companies are planning ahead of union negotiations scheduled for September, and the possibility that a strike may occur. If they have a buffer of inventories when contract negotiations begin, the bargaining power of management is enhanced. In any event, the muscular second-quarter production schedules could add as much as 0.9 percentage point to GDP during the period.

Similarly, the trade deficit was a major negative in the first quarter, knocking down the growth rate by a full percentage point. That drag too is about to disappear, as evidenced by the marked narrowing in the gap during April and the ongoing momentum in global growth that is boosting U.S. exports. Taken together, the lessening of the growth-sapping influences coming from inventory draw downs and trade deficits during the first quarter should alone account for close to 2 percentage points of the expected bounce-back in GDP during the current quarter. An accurate accounting of the housing drag for the period is difficult to make at this point, but it does appear that the worst damage has already been done. After slicing 1.20 percentage point from GDP in the third and fourth quarters of last year, the bite from residential spending moderated to 0.87 percentage points in the first quarter, suggesting that the tide has turned.

But as noted earlier, economists are not marking up their growth forecasts solely because the previous drags are moderating. Indeed, one lesson learned from the past is that if inventory rebuilding is based on unrealistic demand expectations, the strategy could result in a veil of tears. If the inventory buildup is not ratified by consumer purchases, for example, companies will again be stuck with unsold merchandise, leading to a pullback in new orders and subsequent production cutbacks. But what economists are also coming to realize is that it is foolhardy to underestimate consumers, who have repeatedly proven to be more resilient than underlying fundamentals would suggest. That pattern is again showing up, and is no doubt the final straw inducing forecasters to mark up their growth outlook for the current quarter.

Yes, consumers are reining in expenditures somewhat, but that is only to be expected after stepping up



months, this inflation gauge has slipped to an annual rate of only 1.6 percent, which is comfortably within the Fed's 1-2 percent preferred range. This trend is just another reason to expect the Fed to remain in a holding pattern for the foreseeable future.

