

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 22, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	June 22	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.71%	4.55%	4.88%	4.95%
6-month Treasury bill	4.95	4.85	4.96	5.26
3-month LIBOR	5.36	5.36	5.36	5.36
2-year Treasury note	4.91	5.02	4.86	5.26
5-year Treasury note	5.01	5.08	4.79	5.20
10-year Treasury note	5.14	5.16	4.86	5.22
30-year Treasury bond	5.25	5.26	5.00	5.25
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	4.09	4.01	3.81	3.91
10-Year	4.33	4.25	4.05	4.19
30-Year	4.75	4.73	4.55	4.55
30-year fixed mortgage rate				
	6.69	6.74	6.37	6.71
15-year fixed mortgage rate				
	6.37	6.43	6.06	6.36
1-year adjustable rate				
	5.66	5.75	5.64	5.75
STOCK MARKET				
Dow Jones Industrial	13360.26	13639.40	13507.28	10969.09
S&P 500	1502.63	1532.90	1515.73	1244.51
NASDAQ	2588.96	2626.71	2557.19	2121.47
Commodities				
Gold (\$ per troy ounce)	657.00	658.70	655.30	586.50
Oil (\$ per barrel) - Crude Futures (NYMEX)	69.14	68.00	65.20	70.87
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (May) - 000s of units	1474	1506	1491	1498
Housing Permits (May) - 000s of units	1501	1457	1569	1544
Leading Indicators (May) - % change	0.3	-0.3	0.6	0.0

Just as it seemed that the turbulence in the bond market was subsiding, the wild ride resumed this week. Recall that the bellwether 10-year Treasury yield spiked up sharply over the first two weeks of the month, climbing from 4.88 percent on May 30 to a five-year intraday high of 5.33 percent on June 14, before ending the day at 5.22 percent. The yield then receded over the first two trading days of this week, closing Wednesday at 5.09 percent, suggesting that the rate spiral, like the ones that occurred in each of the past five years, would turn out to be another false alarm.



That may still turn out to be the case, but the downturn has at least been temporarily interrupted. Over the final three trading days of the week, the yield rebounded to as high as 5.22 percent and ended on Friday at 5.14 percent, about midway between the closing high and low of the latest episode. As is the case in the stock market – which is undergoing its own wild ride – it is difficult, if not impossible, to trace the proximate causes of abrupt shifts in bond yields. Investor psychology is influenced by the interplay of many factors, some irrational and some rooted in reality that do not become apparent until well after the events occur.

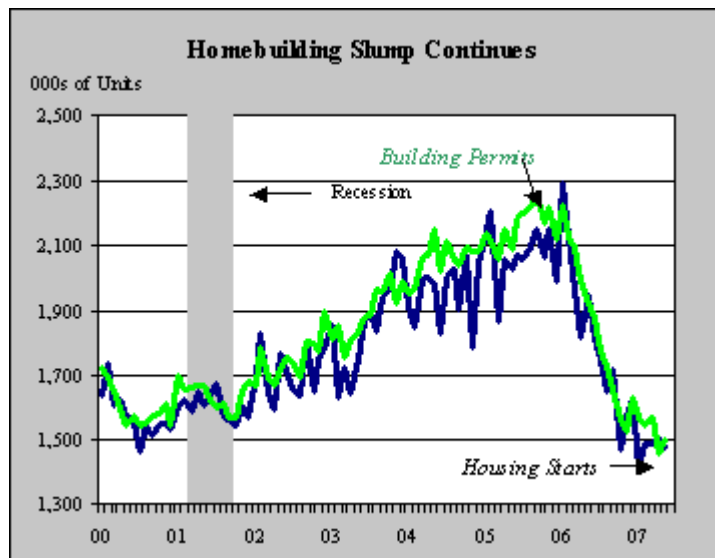
Ordinarily, long-term interest rates are primarily influenced by inflationary expectations. However, it does not appear that inflation concerns – the usual horse that the bond vigilantes hitch onto – are responsible for the latest yield backup. Indeed, except for food and energy prices, inflation has been receding in recent months; the main debate now is whether the Federal Reserve will drop its reference to “elevated inflation pressures” as still being the primary risk in its policy statement following its meeting next week. Nor are the markets pricing in a higher inflation premium, as the spread between nominal and inflation-indexed bonds have barely widened during the current yield spiral.

Instead, the yield climb reflects a combination of other forces. The most likely candidate is the stronger growth outlook now embedded in market expectations. Not only is this more muscular forecast being supported by the slew of economic data reported in recent weeks, it is manifested by the aforementioned composition of the yield backup, virtually all of which has been in the real yield. Since stronger growth promises a higher rate of return on investment, borrowers are willing to pay a higher real rate on debt obligations. But market pundits also cite other factors that may be playing an equally large role in the bond market. These include waning foreign demand for dollar-based assets – perhaps reflected in China’s reduced participation in the Treasury’s latest sale of 10-year notes – and institutional hedging actions associated with changing mortgage market conditions, the so-called mortgage convexity trade.

Be that as it may, the argument that the yield backup contains the seeds of its own destruction is always front and center, and this time it has more than a fair share of credibility due to the fragile state of the housing market. Keep in mind that mortgage rates are closely linked to the 10-year Treasury yield, and the increase in the latter has produced the expected response in the mortgage market. During the past month, the 30-year fixed rate on conventional mortgage loans has increased by more than half-percentage point, pushing an ever-larger segment of potential home buyers out of the market. Not only does that impose another direct hit on the housing sector, it raises the bar for homeowners to refinance existing loans. Indeed, according to Wall Street analysts specializing in mortgage-backed securities, virtually all outstanding mortgage loans used as collateral for these securities are “unrefinanceable” at

current rates.

It is not surprising, therefore, that the homebuilders' sentiment index plunged to a sixteen year low this week, something that is clearly influencing their construction plans. According to the latest Commerce Department figures, housing starts slid 2.1 percent in May, to a 1.464 million pace. Actually, that was not as bad as expected, mostly because of a rebound in multifamily structures, which can be highly volatile. Single-family starts, which are more representative of the industry's woes, fell by a larger 3.4 percent. Still, both single-family and multifamily construction has been on a long slippery slope, with the former down 29 percent over the past year and the latter off by 16 percent. Nor should any quick rebound be expected anytime soon. While building permits did increase in May, all of the 3 percent gain was for multifamily structures, which as noted tend to be volatile. On a year-over-year basis, permits, like starts, are down substantially.

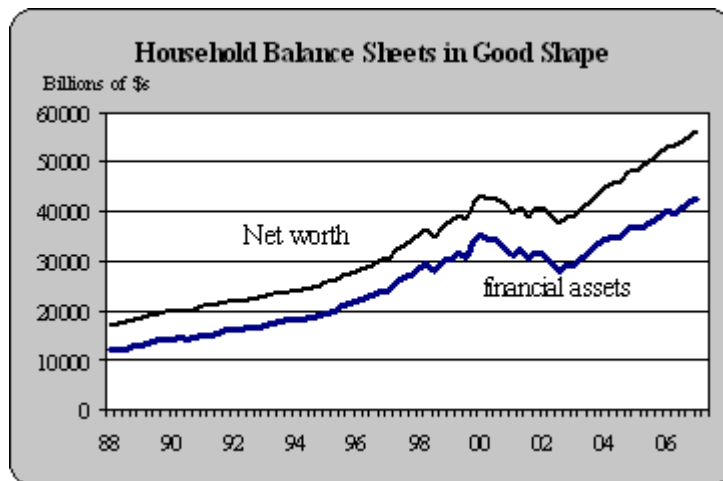


The jury is still out as to whether the worst of the housing slump is over, or whether the harshest direct and indirect effects are still to come. Clearly, higher interest rates are not helping matters and the tightening of credit standards associated with spreading subprime mortgage problems adds another burden for the housing sector to bear. With homebuilders still struggling to pare a huge backlog of unsold units, and potential buyers holding out for lower prices and other concessions, there is little question that the housing drag still has a ways to go. What's more, the employment fallout from the ongoing drop in homes under construction is still in the early innings. True, the official statistics may not capture the full extent of the number of construction jobs being lost because many workers in the industry are undocumented and, hence, are not counted in payroll surveys. But whether the jobs are above or underground, the lost paychecks will result in diminished purchasing power that will ultimately be transmitted to the spending stream.

Simply put, the endgame for the bond market will depend largely on how well consumer spending holds up. If the modest pullback in the second quarter is all that we can expect, the economy should continue to forge ahead impressively. A sturdy growth rebound during the period is already baked in, with companies striving to replenish depleted inventories, strong global growth boosting exports, capital spending posting modest gains and automakers expanding production ahead of contract negotiations with the UAW; the latter has already struck a strident note as management is seeking a \$30 an hour cut in worker pay. These powerful tailwinds should more than offset a modest pullback in consumer spending from an eye-opening pace in excess of 4 percent in each of the previous two quarters to what is shaping up as a near-3 percent increase in the current quarter.

But the markets are nothing if not forward-looking, and a second-quarter rebound in the GDP growth rate from a near-stagnant 0.6 percent pace in the first quarter to 3 ½-4 percent in the second is already priced in. What investors are focusing on now is whether momentum will carry through to the second half of the year, and what the future implies for monetary policy, interest rates and stock prices. With regards to the latter, equity investors took it on the chin this week, but the setback seems to be related more to external factors – such as congressional proposals to tax private equity firms at higher rates and the spreading subprime fallout, including the rumored collapse of a brokerage firm this week and the bailout of the mortgage hedge fund arm of another – than to fundamental economic underpinnings.

Nonetheless, the performance of the stock market bears close watching, if only because it has significant ramifications for consumer spending. There is little question that household wealth has taken a hit over the past year due to sagging property values that has eroded the largest asset in household balance sheets. But the loss of property values has been more than offset by the appreciation in stock prices, which has inflated the financial assets of household portfolios to the tune of \$2.5 trillion over the past year. As a result, household net worth has continued forge upward, climbing by another \$587 billion to a record \$56.2 trillion in the first quarter. Even with the setback this week, stock prices as measured by the broad Dow Jones Wilshire 5000 index is up nearly 6 percent so far this quarter, which translates into a \$600 billion gain in household equity portfolios.



Simply put, the stock market has been a powerful offset to the housing drag this year, enabling households to retain a comfortable sense of financial well-being even as home values have plummeted. As long as these two primary asset holdings do not deflate together, there is little reason to fear a sharp consumer retrenchment that would send the economy into a tailspin. Still, it would be foolhardy to expect the stock market rally over the first half of the year to be replicated in the second half, particularly with profits growth undergoing a normal cyclical slowdown. Hopefully, however, when the profits cycle turns negative, as it surely will, the housing downturn will have run its course.