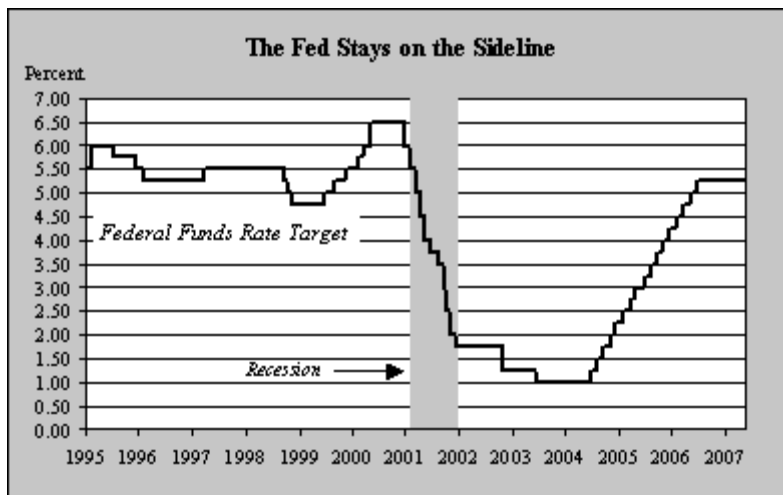


WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 29, 2007

First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	June 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.67%	4.71%	4.87%	4.98%
6-month Treasury bill	4.74	4.95	4.97	5.23
3-month LIBOR	5.36	5.36	5.36	5.45
2-year Treasury note	4.87	4.91	4.97	5.15
5-year Treasury note	4.93	5.01	4.92	5.10
10-year Treasury note	5.03	5.14	4.95	5.14
30-year Treasury bond	5.13	5.25	5.06	5.19
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	4.05	4.09	3.82	3.99
10-Year	4.32	4.33	4.03	4.28
30-Year	4.75	4.75	4.55	4.65
30-year fixed mortgage rate				
	6.67	6.69	6.42	6.78
15-year fixed mortgage rate				
	6.34	6.37	6.12	6.43
1-year adjustable rate				
	5.65	5.66	5.57	5.82
STOCK MARKET				
Dow Jones Industrials	13408.62	13360.26	13668.11	11190.22
S&P 500	1503.35	1502.63	1536.34	1270.20
NASDAQ	2803.23	2588.96	2613.92	2172.09
Commodities				
Gold (\$ per troy ounce)	650.90	657.00	676.90	618.30
Oil (\$ per barrel) - Crude Futures (NYMEX)	70.68	69.14	65.08	73.95
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (May)- 000s of units	915	930	827	904
Existing Home Sales (May) -000s of units	5990	6010	6150	6257
Durable Goods Orders (May) - % change	-2.8	1.1	5.1	-0.1
Consumer Confidence Index (June)	103.9	108.5	106.3	108.0
Personal Income (May) - % change	0.4	-0.2	0.8	0.6
Personal Consumption (May) - % change	0.5	0.5	0.4	0.6

As is customary when a policy-setting meeting is held, the Federal Reserve garnered the lion's share of attention in the financial markets this week. Since the central bank, as expected, left its target short-term interest rate unchanged at 5.25 percent – where it has been for just about a year – it might be tempting to ask what all the fuss is about. The answer, of course, is that investors are less interested in action than in words these days. Accordingly, all eyes were on the post-meeting statement, seeking nuances in language that would provide any clue as to what the next rate move might be and when it might occur.



Given the economy's lackluster performance in the first quarter – slogging to a near-stagnant 0.7 percent growth rate – the tamer inflation readings this year and the ongoing housing slump that does not seem to be nearing an end, one would think that a pending rate cut was a slam-dunk prospect. The reality, however, is anything but. Indeed, there are just as many pundits expecting the next move to be a rate increase as there are those expecting a rate cut. Nonetheless, both camps are outnumbered by economists who believe the Fed will stay on the sidelines for the balance of the year, waiting perhaps for nature to take its course.

As it turned out, the post-meeting statement provided encouragement for virtually all points of view. For those believing the next move in rates will be down, the Fed obliged by removing the hawkish comment that “core inflation remains elevated” contained in previous statements. Instead, it noted that ... “readings on core inflation have improved modestly in recent months.” That, however, did not assuage skeptics of the easing view because the statement also contained an important caveat. Specifically, the Fed asserted that ... “a sustained moderation in inflation pressures has yet to be convincingly demonstrated.”

Simply put, the Fed is standing by, linking future policy adjustments to “the evolution of the outlook for both inflation and economic growth, as implied by incoming information.” In other words, Ben Bernanke and his colleagues are still not sure where the key policy influences will take them. Their baseline forecast remains that the economy will expand at a moderate pace over coming quarters, and that the high level of resource utilization puts the risk of inflation on a higher level than the risk of a recession. This is the type of environment that understandably justifies a “wait-and-see” strategy, underscoring the majority view that the Fed will do nothing in the months and quarters immediately ahead.

Given the fickle nature of monthly data releases and the shifting nature of market psychology, there's little question that perceptions regarding the policy outlook will continue to swing widely in coming months. Indeed, the pendulum has already moved in both directions in recent weeks, courtesy of conflicting readings on the economy and inflation. Prior to this week, for example, the tide had turned more to the hawkish side, reflecting the emerging consensus on Wall Street that the economy had rebounded heartily from the first-quarter slowdown. Some economists even penciled in a 4 percent handle on the second-quarter's growth rate, influenced primarily by a major inventory swing from negative to positive and signs that businesses were finally shedding their caution with regards to capital spending. Their optimism was also fueled by the belief that the housing drag would moderate over time, allowing positive forces to propel the economy back to a trendlike growth track over the second half of the year.

Needless to say, that outlook contributed mightily to the spike in bond yields earlier in the month, which lifted the 10-year Treasury yield to an intra-day high of 5.33 percent. But once again, the pendulum has run into powerful headwinds that are now causing a swing back to the dovish camp. Not surprisingly, the catalyst for the latest move has come from the beleaguered housing sector, which is demonstrating once again how hard it is to reverse a longstanding trend. It may well turn out that the housing slump is in its late innings and its drag on the economy will lessen as the year progresses, a prospect embedded in the Fed's baseline forecast. But incoming data are hardly encouraging, and the turmoil in the subprime mortgage market, which is making it harder for prime borrowers to obtain a mortgage, puts another obstacle in the way of a near-term recovery.

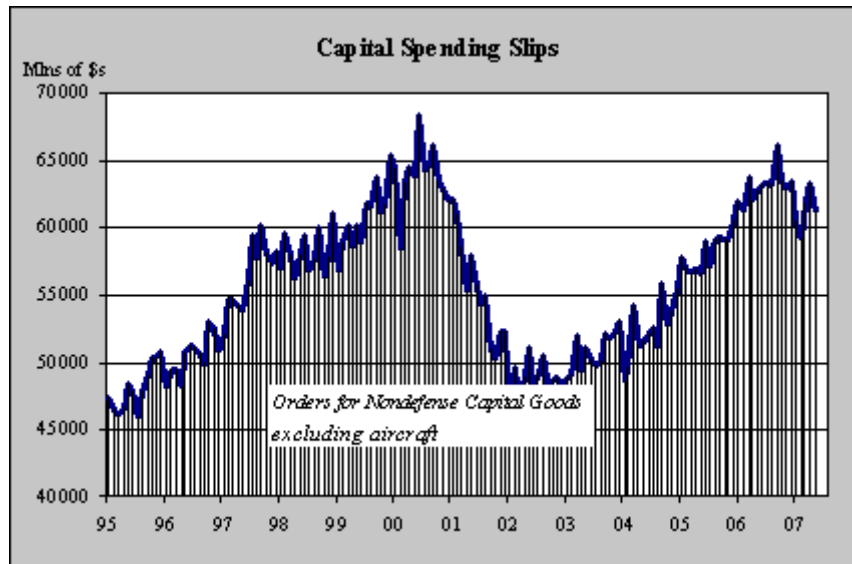
One thing is clear, the housing market will not stage a recovery until buyers return and the mountain of unsold homes that is discouraging new construction and depressing prices is whittled down to more tolerable levels. As of May, however, neither of those conditions was met. Home sales continued to fall last month, with the pace of existing home sales falling below 6 million units for the first time in four years. At the current sales pace, it would take 8.9 months to clear the market, a record high inventory/sales ratio that is pressuring sellers to lower prices. To be sure, sellers have the option to take their homes off the market until prices stabilize, which is undoubtedly occurring to some extent.



However, builders of new homes do not have that flexibility. And with new home sales down 16 percent so far this year compared to last year's average monthly selling rate, and transactions in May slipping another 1.6 percent from April, homebuilders are stuck with a huge 536 thousand unsold units. That's about 200 thousand above normal levels, which explains why builder sentiment has sunk to a 16-year low and residential construction is falling like a stone. Not surprisingly, home prices are sliding, something that shows up in the latest S&P/Case - Shiller home price index, which tracks prices based on the "repeat-sales method". This index fell 2.1 percent compared to a year earlier, a year-over-year decline not seen since October 1991.

So while the bite from the housing market may be lessening – a questionable assumption at this point – it is also quite clear that a bottom has not been reached. The question is, is there enough strength elsewhere to offset the housing drag and keep the economy on the moderate growth track that the Fed is expecting. One key source of strength is expected to come from business investment, which had been woefully disappointing over the past several quarters as company executives worried that the housing slump might sink the economy and undercut the need for more capacity. That concern, however, has gradually faded, reflecting the growing conviction that the housing slump was not spreading to the broad economy. Accordingly, capital spending recovered modestly in the first quarter and seemed to be picking up momentum in the second quarter.

But with the Commerce Department's latest reading on capital spending this week, the extent of the rebound is being brought into question. Following two months of hefty increases in March and April, new orders for nonmilitary capital goods, excluding aircraft, slipped 2.8 percent in May, a much weaker performance than had been expected by economists. What's more, shipments of these goods, which are used in the GDP calculations, also fell during the month, dipping by 0.2 percent. In the aftermath of this report, estimates for capital spending in the second quarter were scaled back, along with projections for GDP. The consensus view now is that the economy will deliver a growth rate of roundly 3 percent, a respectable snapback from the first-quarter's pace, but far removed from the 4 percent- plus estimate that occupied the high end of the bell curve a few weeks ago.



With housing still in the doldrums and the thrust from capital spending not as great as expected, the economic backdrop that fostered the spike in long-term yields earlier this month suddenly became more bond friendly. Accordingly, the 10-year Treasury yield backed off sharply this week, ending up at 5.03 percent on Friday, fully 10 basis points below last week's close and markedly below the 5.33 percent intra-day high reached earlier in the month. Reinforcing the bull move in bonds, a widely followed price measure that is also the Fed's preferred inflation gauge – the core personal consumption deflator – turned in a tamer reading than expected, rising by a mild 0.1 percent in May. That left the index just 1.9 percent above the level of a year ago, marginally under the Fed's implied 1 – 2 percent comfort zone.

The tame reading on the core PCE would appear to vindicate the Fed's assertion made in its post-meeting statement that "readings on core inflation have moderated in recent months". It's unlikely, however, that Bernanke and his colleagues have altered their view about inflation risks or the economic outlook – at least not on the basis of only one-month's data. Before the Fed would even consider a rate cut, the job market would have to deteriorate much more rapidly than has been the case so far this year, pushing the unemployment rate up closer to 5 percent from the current 4.5 percent level. Indeed, if next week's employment report shows a peppy job growth in June, market perceptions could once again shift on a dime. One interesting factoid to take into account: Since 1990, the number of months between policy reversals has ranged from 5 to 18 months with the average coming in at 12 months. It has now been 12 months since the Fed last adjusted monetary policy, and if it stays on the sidelines for the rest of the year the markets will be enjoying the longest period of policy stability in nearly two decades. Stay tuned.