

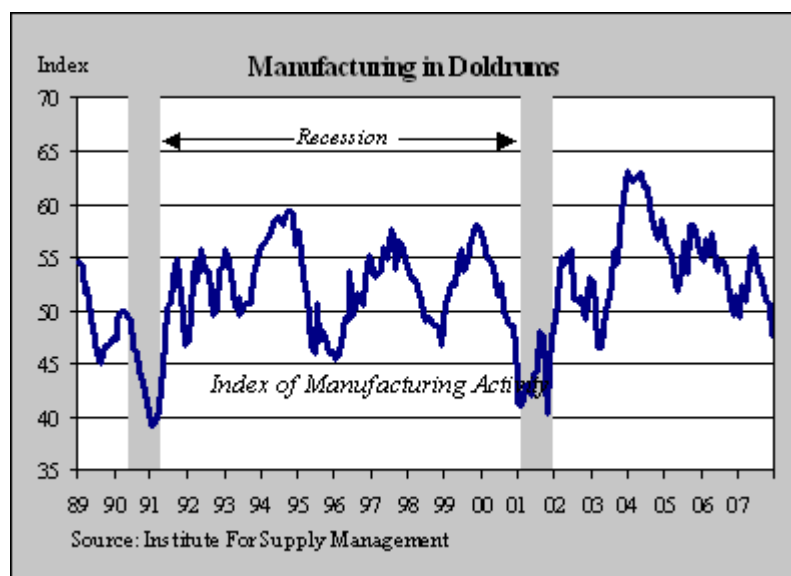
WEEKLY ECONOMIC COMMENTARY – WEEK OF JANUARY 4, 2008

FINANCIAL INDICATORS				
INTEREST RATES	January 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.19%	3.14%	3.05%	5.04%
6-month Treasury bill	3.21	3.42	3.25	5.08
3-month LIBOR	4.62	4.73	5.14	5.36
2-year Treasury note	2.73	3.10	3.10	4.76
5-year Treasury note	3.17	3.50	3.50	4.65
10-year Treasury note	3.86	4.08	4.11	4.65
30-year Treasury bond	4.36	4.50	4.57	4.74
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.36	3.39	3.41	3.70
10-Year	3.86	3.92	3.90	3.92
30-Year	4.64	4.70	4.62	4.39
30-year fixed mortgage rate				
	6.07	6.17	5.96	6.18
15-year fixed mortgage rate				
	5.68	5.79	5.65	5.94
1-year adjustable rate				
	5.47	5.53	5.46	5.42
STOCK MARKET				
Dow Jones Industrial	12800.18	13365.30	13625.58	12398.01
S&P 500	1411.63	1478.25	1504.66	1409.71
NASDAQ	2504.65	2674.46	2606.16	2434.25
Commodities				
Gold (\$ per troy ounce)	865.70	842.70	800.20	806.60
Oil (\$ per barrel) - Crude Futures (NYMEX)	97.73	95.99	88.32	56.15
INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (December)	47.7	50.8	50.9	51.4
ISM Non-Manufacturing Index (Dec)	53.9	54.1	55.8	55.0
Existing Home Sales (Nov) - 000s of units	5000	4980	5030	5333
Nonfarm Payrolls (Dec) - change in 000s	18	115	159	87
Unemployment Rate (Dec) - Percent	5.0	4.7	4.8	4.8

When the economy is downshifting as abruptly as it appears to be, the most rewarding game for optimists is to look for upside surprises. Unfortunately, those have been few and far between – at least over the closing month of last year. Since the stronger-than-expected consumer spending report for November came out, just about all of the news on the economy has been worse than expected. Households seem to have zippered up their wallets and purses in December, confirming fears that the holiday shopping season was lackluster at best. Businesses pared back orders for capital goods for two consecutive months, pointing to weaker investment outlays. And of course, there is no indication that the housing meltdown is nearing an end.

Simply put, the 4.4 percent average growth rate chalked up over the second and third quarters of 2007 is rapidly becoming a distant memory. If not for the resilience of consumers over the first two months of the closing quarter and the ongoing strength of exports, we might well be looking back at an economy that actually contracted in the October-December period. But the quarter's front-loaded strength in October and November likely produced a positive growth rate in the neighborhood of 1-2 percent. Unfortunately, it now appears that activity fell off of a cliff in December, and the economy will have to climb out of a rather deep hole to remain on a positive growth track in the opening quarter of the new year.

This week provided ample evidence of the uphill climb the economy faces. Leading the way, the Institute for Supply Management reported on Wednesday that its index of manufacturing activity plunged by an unsightly 3.1 points in December, the sharpest decline in more than 4-1/2 years. The drop left the index, at 47.7, below the 50 threshold that demarcates expansion from contraction for the industrial sector. What's more, the internal details of the index points to more dismal readings in coming months. For example, the new orders component fell by nearly seven points to 45.7, which is the lowest level since late 2001 when the economy was just emerging from a recession. Indeed, only 15 percent of companies reported higher bookings for the month, a percentage that is usually associated with recessions.



Although the ISM report quickly heightened speculation that a recession was just around the bend, if not already upon us, it is still premature to declare the end of the six-year-old expansion. For one, the ISM manufacturing index has pierced the 50 mark on the downside several times over the past decade without leading to a recession. More often than not, a sub-50 reading to around the current level has been associated with a sharp slowdown in growth, much as is underway now, rather than an outright contraction. As the chart shows, there have been three instances when the index fell below December's 47.7 level without a recession taking place – the mid-cycle slowdown in 1995, the aftermath of the 1998 Asian financial crises, and the 2003 period following the onset of the Iraq war. In a statement accompanying the report, the ISM noted that the December reading of the index is consistent with a 1.8 percent increase in real GDP, which is spot on with the consensus forecast for the fourth quarter.

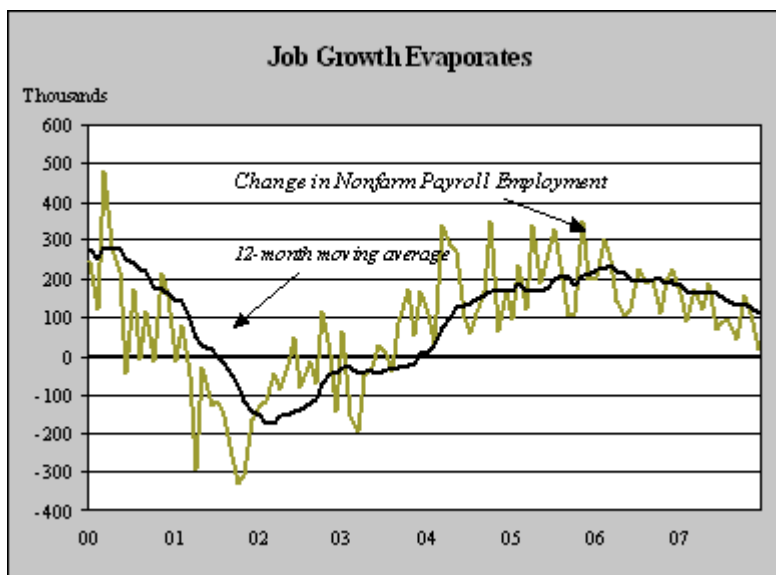
For another, the manufacturing sector has been steadily losing heft relative to the overall economy, both in terms of generating jobs and as a share of total economic output. Of far more importance is the ever-growing services sector, where activity is decidedly slowing but is far from comatose. In a companion report, issued on Friday, the ISM released its index for service-sector activity, and the reading contrasted markedly with the manufacturing index. Indeed, the December non-manufacturing index was virtually unchanged from November – 53.9 versus 54.1 – remaining comfortably above the 50 threshold. Still, the service sector is not immune to the headwinds that are buffeting manufacturing companies, particularly those associated with the beleaguered housing sector. Hence, among the weaker components of the ISM non-manufacturing index are real estate firms and finance and insurance companies, where the subprime quagmire is decimating balance sheets and spurring huge layoffs.

What the ISM readings portray is a snapshot of an economy that limped out of the old year on tired legs with little energy to stage a meaningful rebound at the start of the new year. Consumers are being

hammered not only by a housing crisis but also by spiraling energy costs, highlighted by this week's brief spurt in crude oil prices above \$100 a barrel. Although oil prices retreated to about \$98 a barrel towards the end of the week, that was still nearly twice as high as a year ago. With the upcoming surge in subprime mortgage resets in coming months, the additional drag on incomes from higher fuel and gasoline costs is another obstacle to a consumer sector that is already staggering.

If consumers finally throw in the towel and decide to abandon their spendthrift ways, the stage would be set for an economic contraction. Indeed, that prospect has been in the works for more than a year, ever since the housing collapse started to gain traction. But time and again, households defied predictions, proving to be more resilient shoppers than conventional wisdom would indicate. Although the reasons for their resilience are still not fully understood, there has been one compelling positive force that offered the best explanation. Amidst all the crosscurrents that buffeted households, the one constant positive has been a relatively healthy job market. As long as consumers receive a paycheck and modest raises that keep up with inflation, their willingness to spend despite sagging home values, tightening credit, and higher energy costs has remained intact.

But all that may be changing if the latest employment report is any indication. On Friday, the Commerce Department delivered a bombshell to the financial markets, revealing that the U.S. economy generated a skimpy 18 thousand net new jobs in December, the smallest increase in more than four years. To make matters worse, the unemployment rate jumped to a two-year high of 5 percent from 4.7 percent in November. Wall Street had been forecasting a rise in nonfarm payrolls of roundly 70 thousand and an uptick in the jobless rate to 4.8 percent, so the employment report was a disappointment on both fronts. To say that the financial markets reacted poorly to the report would be an understatement. Stock prices, already reeling from the weak ISM manufacturing report and \$100 a barrel oil, took an abrupt nosedive on Friday, with the Dow Industrials plunging by more than two hundred fifty points on Friday, closing out a dismal week that saw the Dow fall by 4.2 percent.



No matter how the December jobs report is sliced and diced, it is hard to come up with anything positive. The weakness was broadly based, as only 48.2 percent of industries in the private sector expanded payrolls, the lowest fraction since September 2003 and down from 52.2 percent in November. Still, the usual culprits were the biggest drag on the job market last month, with construction companies, manufacturers and financial services firms all shedding workers. These companies, of course, are the most directly impacted by the housing collapse and they continue to suffer the pain. But ominously, the housing drag is spreading more broadly to other industries, as evidenced by the low fraction of

companies adding jobs. Retailers also shrunk their workforces, a sign that the holiday shopping season did not meet expectations.

What's more, the overall job total was buoyed by government hiring, which resulted in 31 thousand additional public servants on payrolls. The private sector, in turn, shed 13 thousand workers, the first decline since July 2003, underscoring the weakening dynamic of the economy. If the "trend is your friend" in the stock market, it is clearly the enemy in the job market. With December's abysmal growth in jobs, the average monthly increase in private sector employment during the closing quarter of the year sank to 61 thousand from 78 thousand in the three months ending November. For all of 2007, the economy generated an average of 111 thousand jobs a month compared to 189 thousand in 2006.

If there is any silver lining in the latest jobs report, it is that it should pave the way for the Fed to cut interest rates without any hesitation either at or before the next scheduled policy-setting meeting at the end of this month. Indeed, the futures market is pricing in a near-certainty that the central bank will trim the federal funds rate by another 25 basis points, and the odds of a more aggressive 50 basis point cut has risen to about 50-50. But the Fed has been revealing a defiant side that has to be considered somewhat disturbing, given the mounting evidence that the economy is hanging by an increasingly frayed thread. Although the minutes of the last meeting on December 11 did acknowledge the growing risk that the weakening housing sector and deterioration of credit market conditions poses to the expansion, it continued to express concern over the inflationary implications of rising food and energy prices. In other words, instead of revealing to the markets a strong sense of direction for monetary policy, which is definitely needed to bolster investor confidence, the Fed is displaying a waffling attitude, reflecting dissension within its ranks. That indecisiveness may turn out to be highly unfortunate, not only for the markets but for the economy in general.

No doubt, the latest jobs report may instill more of a sense of urgency into the Fed's thinking. Keep in mind that policy makers, while pointing to oil and commodity prices, have always believed that the tight labor market posed the biggest inflation threat, facilitating a pickup in wages that would feed through into higher prices. The one caveat that mitigated this concern was the corresponding belief that a slowing economy would free up labor resources, lessening the pressure on wages. Until recently, that belief has gone unfulfilled, as the jobless rate continue to hover near historically low levels. But the December increase to 5 percent may change that perception. While 5 percent is still low by historical levels, it is at the top end of what has long been considered the range of unemployment consistent with stable inflation. Another monthly uptick comparable to December's and the Fed concern may well shift abruptly from inflation to recession. Stay tuned.

