WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 11, 2008

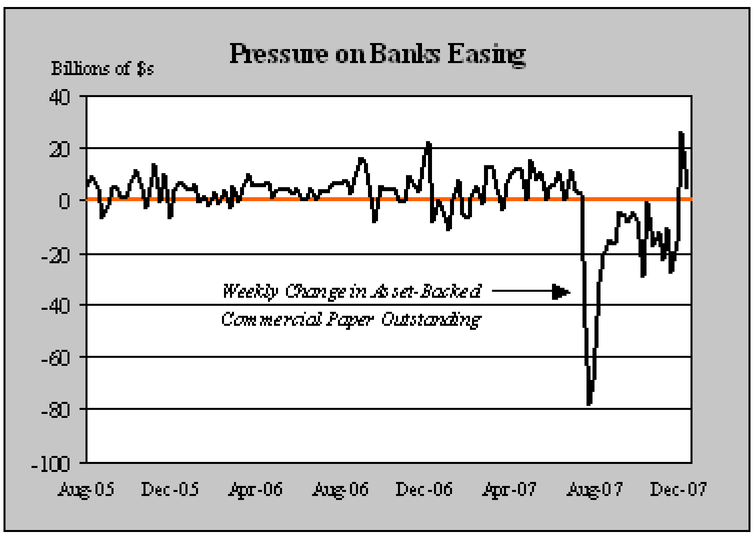
FINANCIAL INDICATORS				
INTEREST RATES	January 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.09%	3.19%	2.87%	5.08%
6-month Treasury bill	3.06	3.21	3.26	5.14
3-month LIBOR	4.26	4.62	4.97	5.36
2-year Treasury note	2.57	2.73	3.30	4.88
5-year Treasury note	3.05	3.17	3.63	4.76
10-year Treasury note	3.79	3.86	4.24	4.77
30-year Treasury bond	4.38	4.36	4.66	4.86
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.25	3.36	3.38	3.72
10-Year	3.78	3.86	3.90	3.94
30-Year	4.52	4.64	4.68	4.44
30-year fixed mortgage rate	5.87	6.07	6.11	6.21
15-year fixed mortgage rate	5.43	5.68	5.78	5.96
1-year adjustable rate	5.37	5.47	5.50	5.44
STOCK MARKET				
Dow Jones Industrials	12606.30	12800.18	13339.85	12556.08
S&P 500	1401.02	1411.63	1467.95	1430.73
NASDAQ	2439.94	2504.65	2635.74	2502.82
Commodities				
Gold ($ per troy ounce)	898.00	865.70	798.00	627.10
Oil ($ per barrel) - Crude Futures (NYMerc)	92.70	97.73	91.35	52.85
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Credit (Nov) - change in $Mlns	15449.3	2022.5	5305.9	11243.0
Trade Deficit (Nov) - mlns of $s	63118	57768	57118	58946

While it was not a robust week for data, the financial markets digested a bucketful of headlines that portrays an ominous future for the economy. According to a Wall Street Journal survey, economists now see a much higher risk of recession than a few months ago, Fed chairman Bernanke publicly acknowledged the numerous downside risks facing the economy, which could lead to “substantive” interest rate cuts, Washington insiders, including the Presidential hopefuls, are talking about fiscal measures that might be needed to stimulate growth, and the ongoing housing meltdown is taking an ever-greater toll on households and financial institutions, with no end in sight..

Clearly, these headlines are providing investors with a bad case of nerves, as evidenced by the volatile stock and bond market performance so far in this young year. No doubt, the downturn in stock prices would have been considerably worse if not for the surprisingly dramatic remarks by Bernanke this week that the Fed stands ready to take more aggressive action to stave off a recession. His comments came after weeks of criticism from Wall Street analysts that the chairman was being too timid in response to the unfolding crisis in the housing and credit markets that is threatening to put a stranglehold on growth. In his speech before a forum on Wednesday, the chairman gave short shrift to inflation concerns – which had tempered the Fed’s actions to this point – and emphasized the deterioration of economic conditions.

The question now is not whether the Fed will cut rates again at its next meeting scheduled for January 30-31 – a half-percentage point reduction is widely expected – but whether it comes in time to reverse the debilitating forces dragging down the economy. Even so, the pending cut will likely be just another installment in a series of moves that should continue through at least the middle of the year. Most economists expect that the federal funds rate, currently at 4.25 percent, will be slashed to 3 percent or so before all is said and done. Even that might not be enough if the turmoil in the credit markets, which is dampening the ability of financial institutions to lend funds to households and businesses, does not subside. Few things are more threatening to growth than a classic credit crunch, which drains the lifeblood from the economy.

So far, the Fed's actions have had mixed results, at best. While short-term borrowing costs linked to the federal funds rate has been lowered by a full percentage point since September, the positive boost this would otherwise impart to growth has been offset by tightening lending standards that have diminished the availability of credit, particularly to households. On the positive side, however, the Fed's efforts to pump up bank balance sheets by providing liquidity through the discount window and its special Term Auction Facility (TAF) seems to be having some success. The spread between the rate banks pay on overnight borrowing and Treasury yields have narrowed considerably in recent weeks, and the huge volume of off-balance sheet assets that banks have been forced to take on their books, which absorbs capital, is waning. One sign of the latter: for the first time since August, outstanding asset-backed commercial paper – which is issued to finance these off-balance sheet assets – has increased for two consecutive weeks.



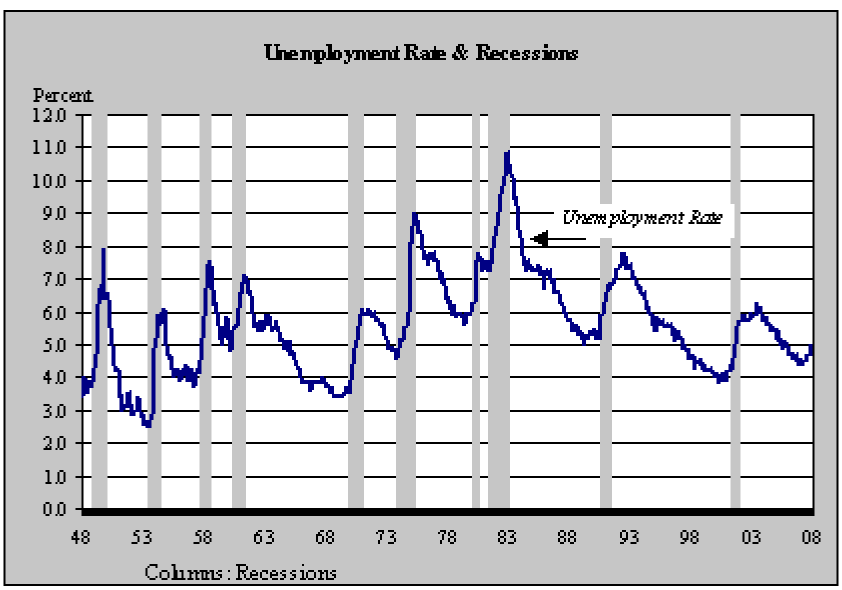
But the strains on the balance sheets of banks and other institutions are increasingly associated with a weakening economy, reflecting the growing inability of households to meet payments on the mountain of debt incurred in recent years. The surge in mortgage delinquencies has been well documented for some time, as homeowners are having trouble handling the jump in adjustable-rate resets on loans that they thought could easily be refinanced as the value of their homes increased. When the home-price appreciation boom ended last summer and properties started to lose value, it was inevitable that subprime borrowers would find themselves in over their heads, resulting in missed payments and an eventual rise in defaults. This is a problem that the lenders, regulators and policy makers are strenuously trying to devise remedies for that could hopefully pave the way for some compromise, enabling borrowers to meet payments and stay in their homes while limiting the avalanche of loan write-offs that is decimating the balance sheets of lenders.

What's more, it is not just lower income households with subprime mortgages that are having trouble meeting payments. Even the more affluent borrowers are feeling the strain, something that became strikingly apparent this week when American Express reported an increase in delinquencies among its cardholders in the fourth quarter. Nor is AMEX alone among the purveyors catering to the well-heeled.

The stock of Tiffany's took a big hit on Friday when the company reported soft sales during November and December. Indeed, the list of financially-strapped consumers also includes customers of AT&T, which announced that it cut off service to an increasing number of households who failed to meet monthly bills. Simply put, consumers in all income groups appear to be experiencing a budgetary squeeze that portends weaker spending and slower growth for the overall economy over the immediate future.

The question is, are we heading for a growth slowdown or an outright recession? As Bernanke noted in the question and answer session following his formal comments on Wednesday, that question is difficult, if not impossible to answer largely because even the most astute number crunchers can't identify a recession until after it gets underway. He should know, as he was once a member of the officially-recognized committee responsible for dating the turning points in the business cycle, and that team of experts failed to recognize the 2001 downturn for some time after its onset. That said, it's clear that Bernanke's heightened concern regarding a recession reflects the appearance of several signposts that have traditionally pointed towards a recession. Indeed, some financial yardsticks were in evidence throughout most of last year, including an inverted yield curve that many economists had long based their doomsday forecasts on.

But the most compelling evidence to date, at least the one that has the most influence on the Fed's thinking, stemmed from last week's employment report, which contained a sharp 0.3 percent increase in the jobless rate. Ordinarily, an increase of that magnitude in the past was followed by a recession within a few months. But the December spike to 5.0 percent stretched the cumulative increase to 0.6 percentage point from the 4.4 percent low reached last March. That's already greater than the 0.5 percent average increase that ushered in past postwar recessions. What's more, during the 10 postwar cycles, a recession began on average 7.8 months after the jobless rate started to climb from its low. By this metric, December marked the eighth month since the 4.4 percent low point was reached, supporting the case of those who believe the economy has already slipped into a recession.

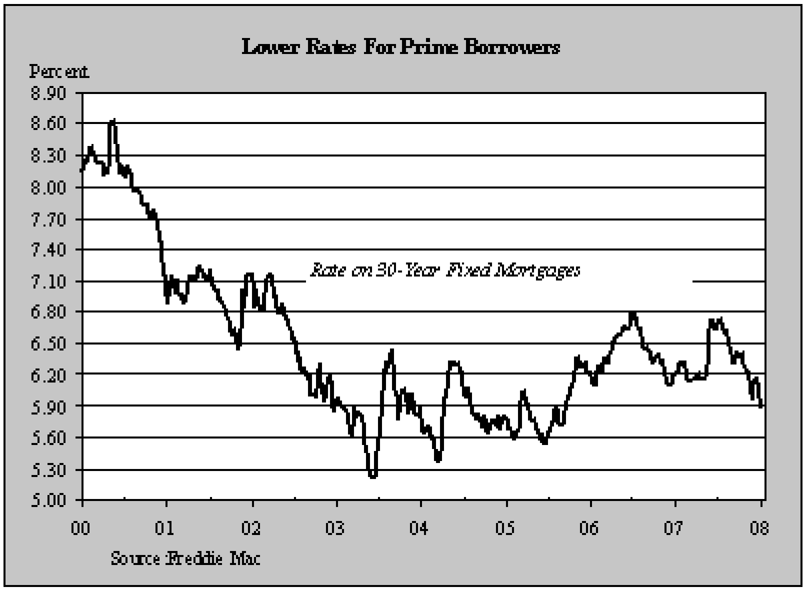


To be sure, a case can also be made that even with the 0.6 percent increase, the unemployment rate at 5.0 percent is still low by historical standards. While that's certainly true, particularly over the past 35 years, it is also important to note that seven of the ten postwar recession started when the jobless rate was about 5 percent or less. As the chart shows, the rate stood at 4.4 percent at the onset of the 2001 recession, which began in April. By the end of the year, it had shot up to 5.7 percent on the way to a peak of 6.3 percent. Indeed, many economists believe that the unemployment rate actually understates the weakness in the labor market, citing the low labor force participation rate that may reflect a large pool of available workers who simply stopped looking for a job.

That said, it is no secret that the low unemployment rate has been a major reason the Federal Reserve has been slow to respond to the unfolding weakness in the economy. Time and again, policy makers have warned that tight labor market conditions can potentially generate ever larger wage increases, greater price pressures and heightened inflationary expectations, a confluence that is a recipe for a potent inflation flare-up. At the same time, Bernanke has noted that as long as job market conditions remain healthy, workers should enjoy steady wage gains that would support continued gains in consumption. Clearly, with the December jobs report, that is no longer the case. Not only did the unemployment rate spike higher, indicating more slack – and, hence, less wage pressure – in the labor market, the number of workers put on payrolls virtually ground to a halt.

Needless to say, the stagnation in payrolls short-circuits the income generation needed to support spending. At the same time, it makes it even more difficult for households to meet their debt obligations, which is at the crux of the mounting turmoil in the credit markets. Add in the relentless climb in food and energy prices that sap discretionary purchasing power, and the recipe for a sharp consumer retrenchment is put in place. Clearly, this is a vicious cycle that the Fed is now moving to counter, and its success is anything but assured. Once a recession psychology seeps into the spending and investing decisions of households and businesses, further interest rate cuts amount to “pushing on a string” until the cycle runs its course. That’s why discussions regarding fiscal intervention is suddenly heating up, with many economists advocating some temporary measures – such as tax breaks for lower income groups and more liberal unemployment benefits – that would quickly enter the spending stream.

To be sure, the economy may well be in better shape than is indicated by all of the current speculation regarding a recession. It would not be the first time during the six-year expansion that the economic data turned almost universally bad for a month or so, only to turn more upbeat in subsequent months. The turmoil following the invasion of Iraq in 2003 and Hurricane Katrina in 2005 are just two cases in point. Although discouraged by the slew of events in recent weeks, we are not ready to throw in the towel on the expansion. That prospect would materialize if the credit market crisis escalates and chokes off funds for credit worthy borrowers. So far, however, that does not seem to be the case. Consumers still have access to credit card debt, as shown by the robust 11.3 percent increase in installment borrowing in November, as well as to conventional mortgages at reasonable rates. Indeed, according to the latest weekly survey by Freddie Mac, the 30-year fixed rate on conventional conforming mortgages fell by 20 basis points to 5.87 percent, the lowest level in more than two years. This has led to an encouraging, if modest, increase in applications for refinancing loans, which suggest that lower rates can indeed work its magic if the conditions are right. That said, more rate cuts will be needed for the magic to blossom into a truly uplifting experience for the economy.


Lower Rates For Prime Borrowers
Percent
8.90
8.60
8.30
8.00
7.70
7.40
7.10
6.80
6.50
6.20
5.90
5.60
5.30
5.00
Rate on 30-Year Fixed Mortgages
00
01
02
03
04
05
06
07
08
Source: Freddie Mac