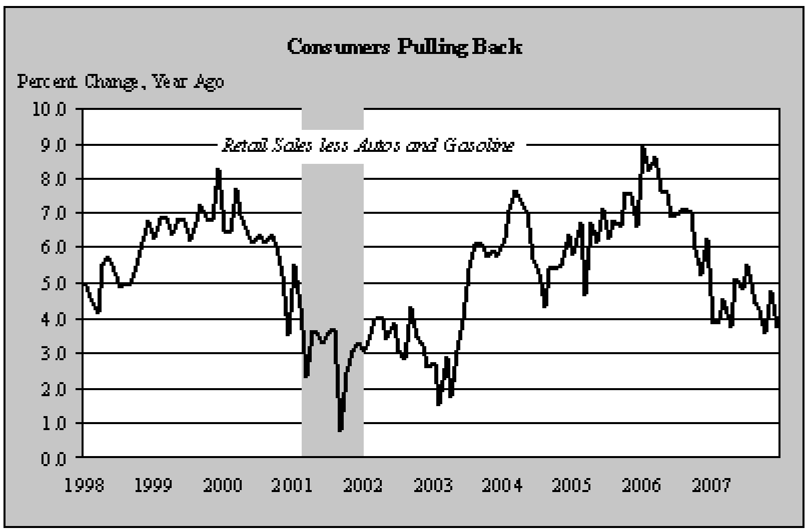
WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 18, 2008

FINANCIAL INDICATORS				
INTEREST RATES	January 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.85%	3.09%	2.97%	5.13%
6-month Treasury bill	2.84	3.06	3.33	5.16
3-month LIBOR	3.89	4.26	4.86	5.36
2-year Treasury note	2.35	2.57	3.18	4.92
5-year Treasury note	2.84	3.05	3.57	4.78
10-year Treasury note	3.63	3.79	4.16	4.78
30-year Treasury bond	4.28	4.38	4.58	4.86
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.16	3.25	3.38	3.77
10-Year	3.72	3.78	3.90	3.99
30-Year	4.47	4.52	4.68	4.49
30-year fixed mortgage rate	5.69	5.87	6.14	6.23
15-year fixed mortgage rate	5.21	5.43	5.79	5.98
1-year adjustable rate	5.26	5.37	5.51	5.51
STOCK MARKET				
Dow Jones Industrials	12099.30	12606.30	13450.65	12565.53
S&P 500	1325.19	1401.02	1484.46	1430.50
NASDAQ	2340.02	2439.94	2691.99	2451.31
Commodities				
Gold ($ per troy ounce)	884.90	898.00	815.40	636.40
Oil ($ per barrel) - Crude Futures (NYMerc)	90.56	92.70	93.21	51.87
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (Dec) - % change	-0.4	1.0	0.0	0.4
Industrial Production (Dec) - % change	0.0	0.3	-0.5	0.1
Capacity Utilization (Dec) - Percent	81.4	81.6	81.4	81.8
Producer Price Index(Dec) - % change	-0.1	3.2	0.1	0.6
Consumer Price Index(Dec) - % change	0.3	0.8	0.3	0.3
Core CPI (Dec) - % change	0.2	0.3	0.2	0.2
Housing Starts (Dec) - units in 000s	1008	1173	1274	1226
Building Permits (Dec) - units in 000s	1068	1162	1170	1229

As the books are being closed on 2007, the incoming data for December portray a bleak final chapter to the year. What's more, the new year's opening act is not thrilling audiences, either on Wall Street, Washington or on Main Street. Indeed, Wall Street is giving a decided thumbs down on what it is seeing so far, with the stock market turning in one of the most horrific performances during the opening three weeks than in any year since the 1930s. Since the plunge in home values has already made a serious dent in household wealth, a bear market in equities would further aggravate the mood on Main Street, punishing the stock portfolios of aging baby boomers. Needless to say, this is not a fertile climate for consumer spending, the major pillar that has kept the expansion on track during the past year.

Whether or not the combination of falling home values and sinking stock prices is mainly to blame, there is little question that households are reining in their spending propensities. Among the hefty package of data releases for December to come out this week, the most damaging for growth prospects were the retail sales figures. It's no secret that analysts were braced for a disappointing report, based on such anecdotal evidence as weak chain store sales and heavy price discounting just to get customers into stores. But the actual result turned out to be far worse than expected. In December, retail sales slumped by 0.4 percent, the biggest drop in six months and about double what analysts had been forecasting. True, that follows a brisk 1 percent increase in November, which included an early Thanksgiving that pushed more holiday shopping days into that month. But the initial estimates for both November and October were revised down, casting a dimmer light on consumer spending for the fourth quarter.

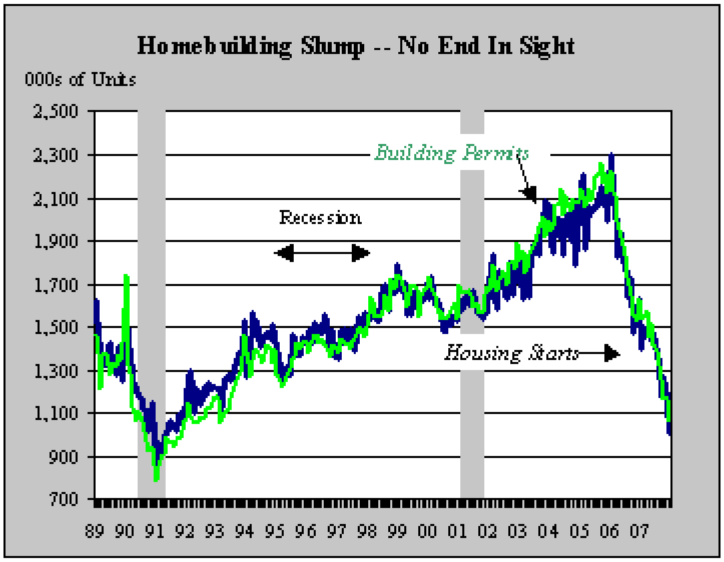
For the period as a whole, retail sales did post a larger increase than in the third quarter – 4.8 percent versus 3.7 percent. But the step-up was entirely an artifact of higher gasoline prices, which bloated the fourth-quarter numbers. If gasoline sales are stripped away, retail sales were flat during the fourth quarter, the weakest showing in more than two years. Throw out volatile auto sales as well, and the results are even bleaker. As the chart shows, sales outside of auto dealerships and service stations are running at close to the weakest annual pace since 2003, when the economy was still fitfully emerging from the 2001 recession. In fact, it was not until the Fed slashed short-term rates to historically low levels and the government's two-stage package of fiscal stimulus, including a tax rebate and a temporary boost in jobless benefits, kicked in that consumer spending finally started to flex the muscle which propelled the expansion into higher gear.



Not only are households cutting back on overall expenditures, the shift in how they are allocating their budgets reflects emerging strains being imposed by spiraling gasoline and food prices, sinking home values and increased interest payments on debt obligations that have grown enormously in recent years. Simply put, consumers are spending more on the essentials and curtailing discretionary expenditures. That transition was strikingly apparent in December, as outlays for food and health care products each increased by 0.7 percent, even as overall retail sales sagged by 0.4 percent. Meanwhile, spending for clothing and sporting goods plunged by 2 percent. While stores that cater to upper-income groups are also reporting slower sales, it is clear that consumers on the lower rung of the income ladder are feeling most of the budgetary strains.

Needless to say, the rush in Washington to cobble together a fiscal stimulus package aimed at short-circuiting a recession would be most effective if it is designed mainly to benefit the low and middle-income groups. The logic behind this is obvious and why it has usually been the hallmark of most previous plans to jump-start the economy: put money in the hands of folks who are most likely to spend it quickly. Clearly, those households who are now forced to allocate a larger fraction of their budgets to gasoline and food purchases as well as to medical expenses will not be stashing away the extra cash from tax rebates into their bank accounts. True, there is the argument that some households will use the tax refunds to repay debt; but that too would act as a stimulus by curtailing the surge in defaults and foreclosures, which is the source of much of the turmoil wreaking havoc in the credit markets. To the extent that tax refunds help households make timely debt-servicing payments, they would help ease the unfolding credit squeeze that is arguably the major threat to the economy.

That said, it is not clear what can be done to jump-start the housing market, which continues to spiral downward and pull the economy's growth rate down with it. If there is any silver lining to the latest dismal housing starts report, it is that the aggressive retrenchment by builders is stemming the rise in inventories of unsold homes. But the cutbacks needed to accomplish that goal has been nothing short of astonishing. In December, for example, housing starts plunged by another 14 percent from November to an annual rate of 1.006 million units – a level not seen since May 1991. The December level of starts was a whopping 38 percent lower than a year earlier and 56 percent below the peak reached in January 2006.



Hence, contrary to the wishful hope that the housing drag was nearing an end, its impact on overall growth is destined to widened further in coming months. Certainly, homebuilders have no intention of stepping up the pace of construction in the near future. Along with the latest monthly drop in starts, building permits – a leading indicator of construction activity – also fell by a disconcerting 8 percent in December to the lowest level since March 1993. Given the evidence to date, the decline in residential outlays in the fourth quarter will take at least as large a bite out of the economy's growth rate as the 1 percentage point haircut seen in the third quarter. More important, that drag is now poised to deepen in the first quarter, and probably the second as well.

Whether or not the drag will be sufficient to tilt the economy from expansion to contraction over the first half of the year is a close call at this point. The consensus of Blue Chip economists places growth at around 1.5 percent over the next two quarters, so there is not a big margin for error. Again, it is not just the direct drag coming from the expected decline in residential outlays that will be the tipping point. Of more importance will be the indirect effects stemming from how households react to the continued shrinkage in housing equity that is sure to occur as home prices undergo further declines. With foreclosures continuing to increase, more homes are being added to the mountain of unsold stock already on the market, which only reinforces the downward pressure on prices. Industry analysts are predicting another 10-15 percent house-price deflation on top of the 5-10 percent already in place since the market peaked more than a year ago. That would wipe out another \$2-\$3 trillion in wealth from household balance sheets, rivaling the wealth destruction that followed the stock-market bust in 2000.

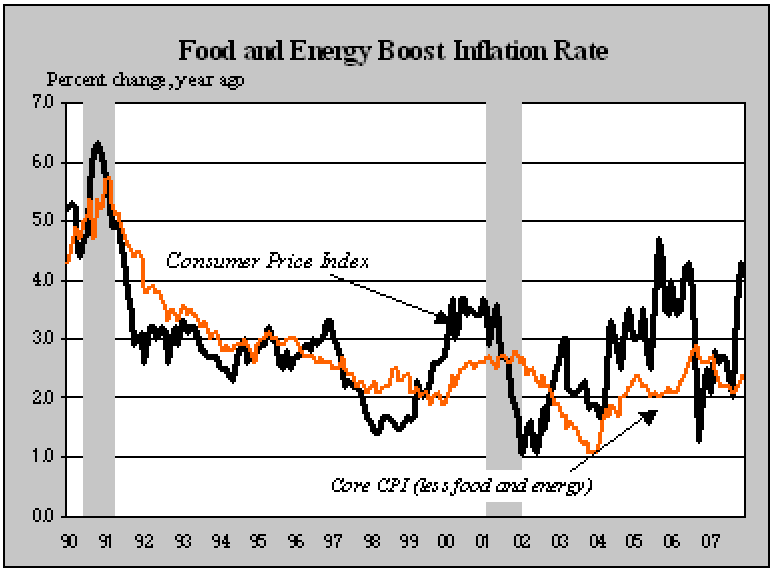
To be sure, consumers continued to expand spending despite the stock-market meltdown during the

2001 recession, a remarkable feat by itself. But that resilience can be attributed to a number of factors that aren't present in today's climate. For one, consumers were coming off an astonishing five-year bull market in equities that lifted household net worth by 72 percent, half again as large as the rise that accompanied the housing-led boom in recent years. For another, consumers had easy access to credit as the Fed was aggressively pumping liquidity into the financial system and lowering interest rates as fast as it can. to rock bottom levels. Indeed, the Fed is now getting much criticism for fueling the housing bubble that many feel was the result of an overly stimulative policy that stayed in place far beyond the point it was needed.

That said, the easy credit conditions that encouraged consumers to spend throughout the early years of the decade hardly exist today. True, the Federal Reserve is once again pumping in liquidity and embarking on a rate-slashing campaign. The 1 percentage point drop in the federal funds rate since September is only the initial installment of what's to come. By all accounts, at least another half-percentage point drop is expected at the Fed's next meeting on January 29-30, and the futures market is pricing in an even larger decline based on the rapid deterioration of the economic outlook. But it's questionable just how much the Fed's moves are helping consumers, as financial institutions are raising rates and tightening lending standards on everything from credit cards to auto loans to home-equity lines of credit. And while conventional fixed mortgage rates are plummeting along with Treasury bond yields, these rates only apply to conforming mortgages, i.e. those conventionally insured mortgages under $417 thousand that are eligible to be purchased by Fannie Mae and Freddie Mac. Rates on jumbo loans are actually increasing, and an increasing number of financial institutions are not even offering such loans because no secondary market for them exists.

So the question of whether the economy is on the precipice of an outright recession or merely heading for a "growth slowdown" as Ben Bernanke and Hank Paulson seem to believe is not something that can be answered unequivocally. Clearly, it's encouraging that the administration appears willing to work on a nonpartisan stimulus package with the Democrats, which increases the odds that something can be put in place quickly. While the $150 billion package being bandied about may not be timely or large enough to prevent a recession, it would at least help limit the severity of a downturn if one were to materialize. As Ben Bernanke noted in his congressional testimony this week, a stimulus plan of that magnitude would have a material impact on the economy over the second half of the year.

Bernanke, of course, would probably welcome some fiscal help in jump-starting the economy, if only because of the growing possibility that lower interest rates are not getting as much bang for the buck due to the reasons cited above, i.e. the offsetting influence of tighter lending standards by banks. One thing is becoming more obvious however; the Fed chairman is not letting inflation risks get in the way of future interest-rate cuts. This is a marked turnabout from a few months ago, when the latest inflation data might have been more of an obstacle to Fed easing. In December, the consumer price index increased by 0.3 percent, slightly higher than expected, lifting the increase for all of 2007 to 4.1 percent, the highest for a full calendar year since 1991. However, the acceleration was due entirely to higher food and energy prices, as the core CPI, which excludes those items, subsided to a 2.4 percent pace from 2.6 percent in 2006. Simply put, fears that higher food and energy prices would be passed through to the broader price level has not been validated; with the economy's weakened state, those fears should subside and pave the way for the Fed to do whatever is necessary to keep growth on track.


Food and Energy Boost Inflation Rate
Percent change, year ago
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Consumer Price Index
Core CPI (less food and energy)
90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07