

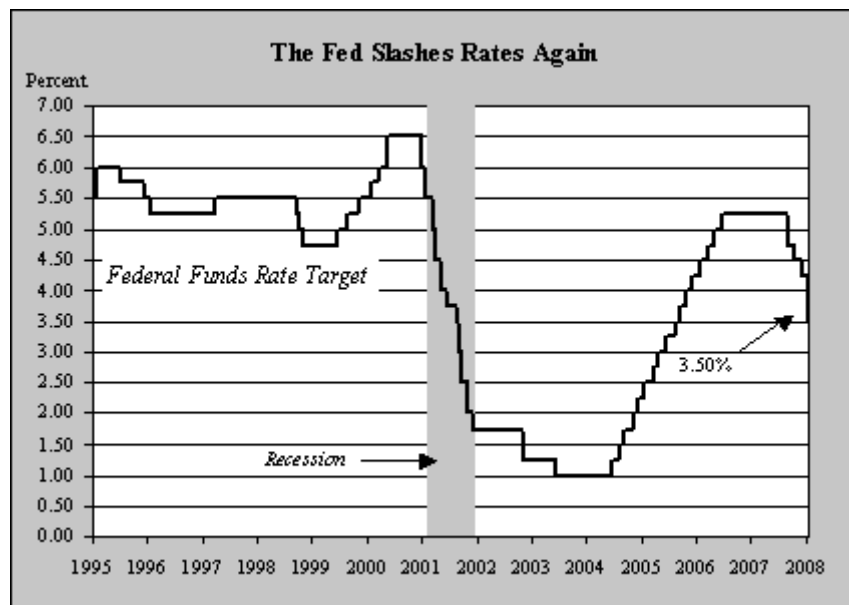
WEEKLY ECONOMIC COMMENTARY – WEEK OF JANUARY 25, 2008

FINANCIAL INDICATORS				
INTEREST RATES	January 25	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.25%	2.85%	3.14%	5.13%
6-month Treasury bill	2.36	2.84	3.42	5.17
3-month LIBOR	3.31	3.89	4.73	5.36
2-year Treasury note	2.17	2.35	3.10	4.97
5-year Treasury note	2.76	2.84	3.50	4.86
10-year Treasury note	3.55	3.63	4.08	4.88
30-year Treasury bond	4.26	4.28	4.50	4.97
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.01	3.16	3.39	3.78
10-Year	3.60	3.72	3.92	4.00
30-Year	4.44	4.47	4.70	4.51
30-year fixed mortgage rate	5.48	5.69	6.17	6.25
15-year fixed mortgage rate	4.95	5.21	5.79	5.98
1-year adjustable rate	4.99	5.26	5.53	5.49
STOCK MARKET				
Dow Jones Industrials	12207.17	12099.30	13365.30	12487.02
S&P 500	1330.61	1325.19	1478.25	1422.19
NASDAQ	2326.20	2340.02	2674.46	2435.49
Commodities				
Gold (\$ per troy ounce)	914.60	884.90	842.70	651.60
Oil (\$ per barrel) - Crude Futures (NYMEX)	90.90	90.56	95.99	55.47
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Existing Home Sales (Dec) – 000s of units	4890	5000	4980	5100

This time, they are not taking any chances. The “they” of course are the not-always-so-vigilant policymakers who frequently drag their feet when it comes to grappling with an unfolding crisis. That’s because economic upheavals, such as the one now unfolding, are rarely easy to understand and a poorly designed policy response can cause more problems than it solves. The tendency for the monetary policy makers is to deliberate, forge a consensus and then gradually implement measures that lean against the prevailing wind deemed responsible for blowing the economy off kilter. Washington, in turn, follows a similar game plan, but usually gets caught up in partisan bickering that results in an ill-formed response, which comes too late to do any good. More often than not, they actually do more harm than good.

But the current housing-stoked crisis is like no other, exposing the global economy to a mountain of toxic loans and securities whose ill effects are resonating throughout the world’s financial markets. Whether the crisis is being fueled by media hype, which some skeptics claim, or has fundamental roots in a dysfunctional economy is something that can be debated for years on end. But the turmoil in the financial markets, including the stomach-churning plunge in stock prices so far this year, has injected a sense of urgency in the minds of policy makers that hadn’t existed to this point. The Fed uncharacteristically took a decisive and bold strike, slashing short-term interest rates by 75 basis points this week without waiting for its regularly scheduled policy-setting meeting next week. In the process, it shrugged off the inflation concerns that had constrained its actions since it began easing policy last

September.



Likewise, Washington got its act together with almost breathless speed, forging a fiscal stimulus package of \$150 billion that is on a fast track to the president's desk. As is customary, some partisan bickering has surfaced, and the details may yet be fudged a bit before Mr. Bush pens his signature to a final bill. But the bickering should be short and swift; after all, it's an election year and neither party wants to be blamed for exacerbating an economic slowdown or, worse, a recession. In a sense, the current political environment is eerily similar to the period leading up to the 1992 election. Then, as now, voters shifted their attention from a war in Iraq to a sputtering economy. Although the first Iraq conflict, dubbed Operation Desert Storm, was hugely successful and popular (unlike the current prolonged involvement) the incumbent President Bush was defeated at the polls by Bill Clinton, who rode to victory on the mantra – "It's the economy stupid." Once again, the election results showed that pocketbook issues usually trump other areas of concern in the minds of voters, especially when those issues reach the point of high anxiety.

That's clearly the case now. The public's mood has darkened considerably, as household surveys place confidence at near recession levels. Business leaders are also in a funk, reflected in sinking readings contained in CEO confidence surveys. Finally, financial markets are hardly casting a vote of confidence with the way things are going. The aforementioned plunge in global stock prices this year has been punctuated by huge gyrations, including a welcome two-day rally this week that was aborted on Friday, which is the hallmark of investor confusion and uncertainty. As far as economists and market analysts are concerned, the future is as cloudy as it is ominous. Not only are they conflicted over the outlook, they are equally as odds with the wisdom and effectiveness of the policies put in place so far.

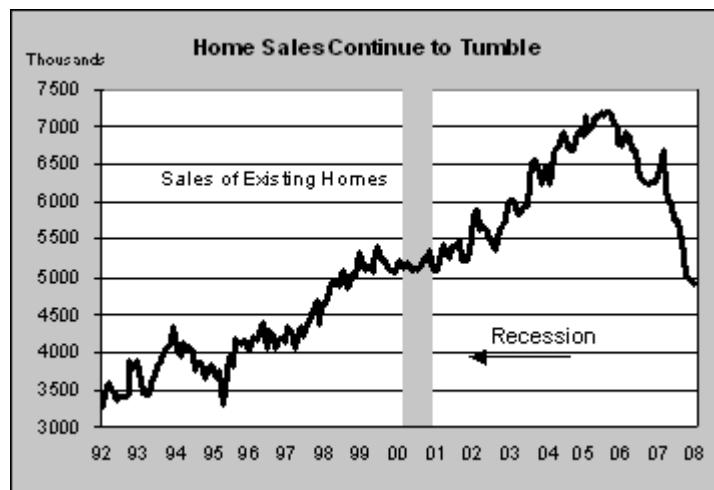
Indeed, there is a two-pronged debate regarding the Fed's strategy. The first part centers around the question of whether the Fed overreacted to the plunge in global stock prices this week, which seems to have been at least partially sparked by the unconscionable \$7.1 billion loss associated with a rogue trader's antics at the huge French bank, Society Generale. Fed critics argue that the central bank should not respond to market gyrations, but execute policy solely on the basis of changing economic and inflation fundamentals. The Fed, for its part, denies that it is responding directly to financial markets, but to the economic aftershocks that the financial turmoil can bring about. A corollary to this debate is the perception by some that the markets are exaggerating the real problems in the economy. To the extent this perception is accurate, the Fed may not only be overreacting to developments, but

unwittingly sowing the seeds for an inflation flare-up down the road.

The second prong of the debate focuses on what the Fed will do next week, when its regularly scheduled meeting takes place. There was virtually unanimous agreement prior to the emergency rate cut this week that the FOMC would approve a half-percentage point reduction in the federal funds rate at the meeting. Now the question is whether that move has been preempted by the emergency 75-basis point reduction this past week. The consensus on the Street is that another cut will take place, as the Fed is accelerating its growth-boosting strategy in the face of a more rapid deterioration in the economic outlook than had been expected. Still, there may be some dissent within the FOMC towards another rate cut, not only from the inflation hawks on the voting committee, but from those who might be sensitive to criticism that the Fed overreacted to financial market developments.

Our sense is that another cut will occur at the conclusion of the meeting on January 30, even though it would be but a scant 8 days removed from the emergency reduction. Based on scattered comments by Fed officials, the perception we get is that the policy makers would rather do too much than too little at this juncture. While they will not have any more economic data than what was available leading up to this week's emergency cut, the risk of standing pat is that it could undermine confidence and invoke a sense that the Fed is falling behind the curve. True, by cutting rates again the Fed runs the risk of igniting inflation concerns, something that is already being manifested by renewed weakness in the dollar and surging commodity prices, including a spike in gold to a record high this week. But given the sharp downgrading of the economic outlook by the Fed's staff, this is a risk that it seems willing to take. Besides, as Fed vice chair Kohn recently remarked, it can quickly revoke some of the rate cuts if the economy seems to be holding up better than perceived a few months from now. What's more, it would be easier to contain an inflation flare-up if caught early enough than to revive an economy being sucked down into a deepening recession.

One thing is clear: the housing meltdown that is the genesis of the economy's woes – and the catalyst of much of the turmoil in the financial markets – is showing no signs of abating. That was made abundantly evident in this week's release of existing home sales for December – the only significant economic report for the period. As expected, the secondary market for homes continues to dry up, with sales falling another 2.2 percent from November, resulting in a 12.8 percent drop for the full year. Not surprisingly, given the ongoing softness in demand, homeowners are being forced to mark down prices to make a sale. In December, the median price on an existing home sale fell \$300 below November's level, to \$208,400. Compared to a year earlier, prices show a drop of 6.0 percent, the steepest annual decline on record.



If there is one sliver lining in an otherwise dark housing cloud, it is that the number of “for sale” signs on lawns strewn across America is dwindling. In December, the inventory of homes for sale fell by 312 thousand to the lowest level since last March. But the supply on the market is still more than 50 percent above normal relative to the pace of sales, an imbalance that will likely take close to a year to work off. What’s more, the inventory of homes for sale is not a very accurate barometer of excess supply, at least in the secondary market. Keep in mind that many homeowners can simply take their homes off the market if they feel they are not getting a fair price, especially if they are not forced to sell. What this means, of course, is that once the sales market stabilizes, these homes will swell broker listings again, which will probably cap any upside to prices. Another price-dampening factor to watch is the flood of homes coming into the market as a result of surging foreclosures. Some of these may be hidden from published data, as many banks will hold foreclosure sales directly with buyers instead of listing the property with realtors.

Nor is it just homeowners that are being hurt by the sick housing market. Ever since the housing woes began to surface more than a year ago, economists have been talking about the contagion effects on the broader economy. Those effects have been surfacing in fits and starts before mushrooming into a full-fledged financial crisis. But a sector that has not garnered as many headlines regarding the pain it is feeling from the housing meltdown is state and local governments. Yet, the pain is palpable, as states and municipalities are on the receiving end of falling property tax revenues. According to figures released this week by Nelson A. Rockefeller Institute of Government, the growth in state tax revenues slid to 4.4 percent in nominal terms during the third quarter from 6.1 percent in the second quarter. In real terms – i.e., adjusted for legislative tax changes and inflation, revenues actually fell in the third quarter for the first time since 2003.

What’s more, the outlook for state budgets is grim. Earlier this week, the Center on Budget and Policy Priorities (CBPP) reported that 24 states project budget deficits for their fiscal 2009 years, which, for most states, begin on July 1. Of those states, 16 have estimated the deficits, which combined total \$30 to \$32 billion. Many of the states on the list include those that saw the best of the housing boom and are now experiencing the worst of the collapse, including California, Florida, Nevada, New York, New Jersey, Maryland, Virginia and Massachusetts. California's estimated budget shortfall accounts for \$14.5 billion, nearly half the total for those 16 states that have projected the size of their deficits. According to CBPP, another eight states expect deficits for 2009 but have yet to estimate the size, and another four states are projecting deficits in fiscal years beyond 2009. To make matters worse, the states got no real help from the stimulus package that's been agreed to by the Administration and Congressional leaders. Earlier this week, the National Governors Association asked that any stimulus package include \$12 billion in aid to the states, consisting of \$6 billion for Medicaid and \$6 billion in block grants. The governors also urged caution with any tax law changes that might result in cuts to state revenues, since many state tax codes are linked to comparable provisions at the federal level. The states appear to have lost that battle, as well. According to CBPP, the business tax breaks in the stimulus plan will cause states to lose at least another \$4.0 billion in receipts. Unlike the federal government, most states are required to balance their budgets. As a result, they have to respond to deficits with either tax increases or spending cuts. This will aggravate any slowing in the overall economy, all else equal.

