

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 1, 2008

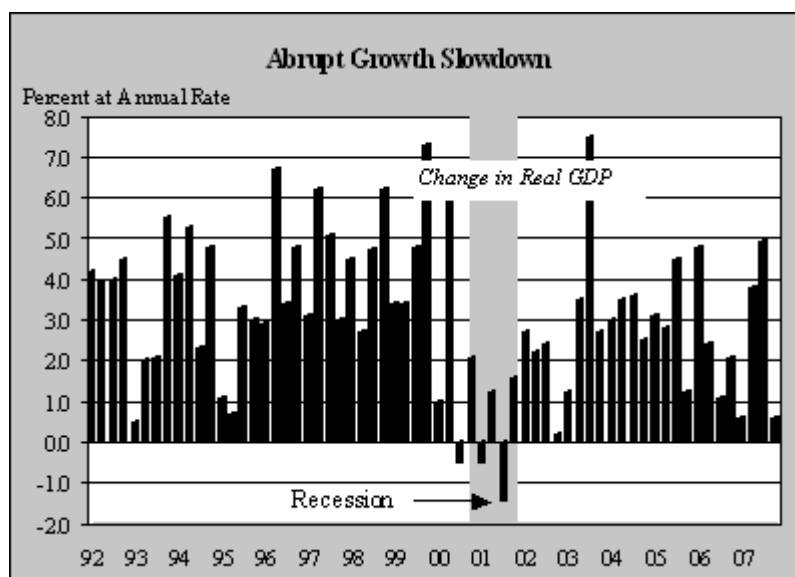
FINANCIAL INDICATORS				
INTEREST RATES	February 1	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.08%	2.25%	3.19%	3.19%
6-month Treasury bill	2.13	2.36	3.21	3.21
3-month LIBOR	3.10	3.31	4.62	4.62
2-year Treasury note	2.07	2.17	2.73	2.73
5-year Treasury note	2.75	2.76	3.17	3.17
10-year Treasury note	3.59	3.55	3.86	3.86
30-year Treasury bond	4.31	4.26	4.36	4.36
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.93	3.01	3.36	3.36
10-Year	3.60	3.60	3.86	3.86
30-Year	4.49	4.44	4.64	4.64
30-year fixed mortgage rate				
	5.68	5.48	6.07	6.07
15-year fixed mortgage rate				
	5.17	4.95	5.68	5.68
1-year adjustable rate				
	5.05	4.99	5.47	5.47
STOCK MARKET				
Dow Jones Industrial	12743.19	12207.17	12800.18	12800.18
S&P 500	1395.41	1330.61	1411.63	1411.63
NASDAQ	2413.36	2326.20	2504.65	2504.65
Commodities				
Gold (\$ per troy ounce)	910.00	914.60	865.70	865.70
Oil (\$ per barrel) - Crude Futures (NYMEX)	89.44	90.90	97.73	97.73
ECONOMIC INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Real GDP (Q4) - % change, Saar	0.6	4.9	3.8	2.2
Durable Goods Orders (Dec) - % change	5.2	0.5	-0.5	0.8
New Home Sales (Dec) - % change	604	634	725	692
Personal Income (Dec) - % change	0.5	0.4	0.2	0.4
Personal Expenditures (Dec) - % change	0.2	1.0	0.3	0.5
Nonfarm Payrolls (Jan) - change in 000s	-17	82	60	70
Unemployment Rate	4.9	5.0	4.7	4.8

For months now, the Cassandras have asserted that the economy is on the precipice of a recession, if not already in one. The problem is, they didn't have enough figures to back up that claim. Now supporting data are pouring in, giving heft to their argument and reasons for policymakers to accelerate their pump-priming efforts. Certainly, the Federal Reserve is wasting no time. Following up on last week's emergency interest-rate cut of 75 basis points it added another half-point reduction in the federal funds rate at its regularly scheduled meeting this week. The swift 1.25-percentage point rate reduction over an eight-day span marks the most aggressive easing move since the central bank formally began targeting the federal funds rate in the early 1980s. Nor are the politicians dragging their feet. This week, the Senate is trying to cobble together an even more ambitious fiscal stimulus bill than the one passed by the House last week. Some differences between the two plans will have to be ironed out before a final version is sent to the White House; but given the attention-grabbing recession headlines that are resonating ever more loudly, the haggling will likely be short and sweet, as any delay could risk the wrath of voter backlash in an election year.

Although the Cassandras would appear to have the upper hand in the ongoing debate about the economy's health, their recession claims are not universally accepted. Indeed, a vocal group of economists believe that the economy is not in as dire shape as the headline figures suggest. What's more, they argue that the policymakers are overreacting to events, igniting the embers under an already simmering inflation environment. Some believe that the Fed is reacting primarily to financial market turmoil, not to fundamental economic developments. Indeed, the January plunge in stock prices was the worst for that month since 1990, as measured by the S&P 500 index.

To be sure, this is not the first time that the Fed is accused of being either behind or ahead of the curve. That time-honored controversy is a permanent feature of economic debates during turning points in the business cycle. When that point is reached, incoming data tend to be ambiguous. During the tail end of an expansion, for example, it is not unusual to see an increasing number of economic indicators flashing weakness, even as inflation shows signs of heating up. The Fed has to determine which is the biggest risk to the economy and calibrate its policy levers accordingly. In the current environment, there is little question that the recession risks are outweighing inflation risks, which is why the Fed has been largely applauded for its aggressive moves in recent weeks. Even so, the Cassandras are claiming that the moves are too little too late to avert a recession, and the only hope now is to limit the severity and length of the impending downturn. That, in turn, will require still more rate cuts, beginning with the Fed's next meeting on March 18.

Clearly, the markets agree that another rate cut will be forthcoming on that date, if only because incoming data strongly suggest the economy is teetering on the brink of a recession. Two key economic reports this week highlight that impression. On Wednesday, the Commerce Department released its advance GDP report, providing a preliminary reading on how the economy performed in the closing quarter of 2007. In a nutshell, the results were not good, portraying an economic engine that almost stalled out. During the period, real GDP squeezed out a gain of just 0.6 percent, the smallest since the fourth quarter of 2002 when the economy was still fitfully emerging from the 2001 recession. Adding gloom to the broad picture is that consumer spending – accounting for 70 percent of GDP – clearly lost momentum towards the end of the period, suggesting that the economy may actually have been contracting as the calendar turned to 2008.



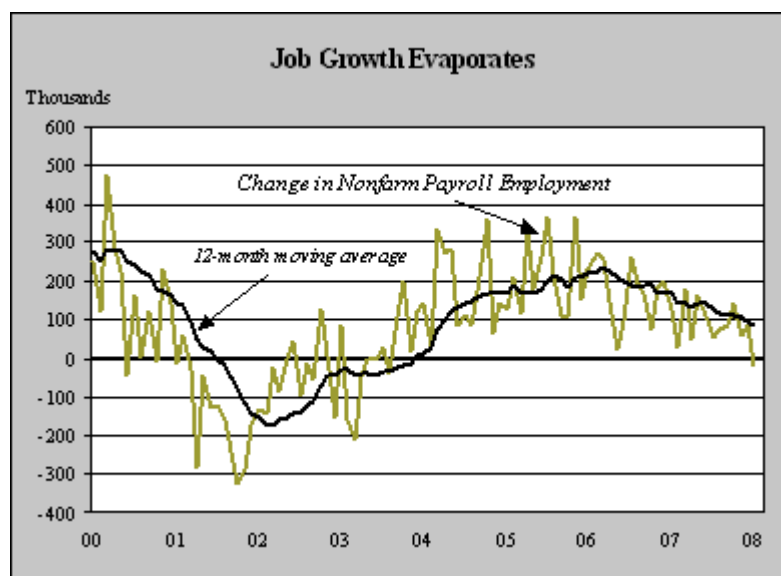
While the abrupt downshifting in GDP growth is understandably raising recession alarms, a good case can be made that the economy is not as weak as the headline slowdown suggests. As usual, the devil is in the details, and a few noteworthy aspects of the GDP report are worth exploring. Yes, the housing meltdown continued to weigh heavily on the overall numbers, as residential outlays plunged by an astonishing 24 percent during the period. That alone sliced 1.2 percentage points from the economy's growth rate, the eighth consecutive quarter that residential activity has dragged down GDP. With no end in sight for the housing slump, there is little question that this sector will continue to be a formidable negative force over at least the next several quarters, if not for the entire year.

But housing's bite on the GDP data was widely expected. What leaps out as the most unexpected aspect of the GDP report was the collective decision of businesses to pare inventories. Indeed, the shift from inventory accumulations in the third quarter to an outright contraction in the fourth slashed 1.25 percentage points from the economy's growth rate, an even bigger haircut than the housing drag. One can argue that this is a positive development for the economy going forward, as businesses are now in a lean and mean inventory position to deal with future demand surprises. Hence, companies will not be forced to cut back production as much as they otherwise would if customer demand is weaker than expected. Conversely, if demand comes in on the strong side, the lean inventory positions could lead to a rebound in orders and a production spurt.

What the inventory liquidations mean is that the slowdown in overall GDP exaggerates the weakness in final demand for goods and services. In fact, real final demand posted a respectable 1.9 percent increase in the fourth quarter, led by a solid 7.5 percent increase in business investment spending. Even consumers made a significant contribution, increasing by 2.0 percent, despite fading out during the final month of the year. That fade-out may be a prelude to a dismal first quarter, if December's weak showing is followed by a spending cutback in January. But another way to look at December is that consumers did not give back any of the outsized 1 percent spending burst they powered in November. As a result, while real consumer spending in December was unchanged from November, it stood a half-percentage point above the fourth quarter average. That means there is some positive momentum heading into 2008, and even modest spending gains by consumers would keep the economy on a positive growth track during the first quarter.

The question, of course, is whether households can stay the course in coming months, given the powerful headwinds that they face. One obstacle that would be virtually impossible to overcome is a sudden turn for the worse in the labor market. With home values sinking like a stone, energy costs spiraling and debt burdens weighing heavily on budgets, the most critical factor that will sustain spending is continued growth in jobs, providing households with the necessary incomes to pay bills. Unfortunately, the news on that front is hardly encouraging. In fact, Friday's jobs report by the Labor Department provided additional fuel for the Cassandras who assert that the economy is on the brink of a recession.

Again, the headline story tells the most striking tale. For the first time in more than four years, the economy lost jobs in January, as nonfarm payrolls shrank by 17 thousand workers. This was a shock to analysts, who were looking for an increase of roundly 75 thousand during the month. Some of the sting from this disappointing report was eased by an upward revision to the December jobs number, which now shows a gain of 80 thousand instead of an initial estimate of a puny 18 thousand increase. But the November increase was revised down from a 115 thousand gain to a 60 thousand increase, so the revisions for the two months only added a net of 19 thousand jobs to the originally reported figures. More important is the trend, which is depicting a sharp slowing in employment growth. Over the past three months, payroll gains have averaged 42 thousand a month, down sharply from the six-month average of 70 thousand a month. For all of 2007, companies added 95 thousand a month to payrolls.



Unlike the GDP report, most of the details in the January jobs report corroborated the weakness in the headline number. The fall-off in net hiring was spread broadly throughout most major sectors, with the cyclically sensitive industries and those related to housing suffering the biggest declines. As has been the case for some time now, the job-creating engine is receiving almost all of its fuel from education and health services, which continued to provide support to the job market in January. Otherwise, the labor market during the month provided grim reading. The workweek was cut back, pay raises were trimmed – average hourly earnings rose by just 0.2 percent compared to 0.4 percent in December – and the percentage of private companies adding workers fell to the lowest level since August 2003.

Just about the only positive news in the labor market last month was that the unemployment rate, which is derived from a separate survey than the payroll numbers, dipped slightly, from 5 percent to 4.9 percent. But this is considered to be statistically insignificant and should not sugarcoat what is otherwise a dismal jobs report. If the payroll trend continues on the trajectory established over the past three months, the unemployment rate will surely increase well beyond December's 5 percent peak. Should that turn out to be the case, there will be little further debate as to whether or not the economy has fallen into a recession.

More than anything, the dismal jobs report justifies the Fed's aggressive rate-slashing moves over the past two weeks, and solidifies expectations that another cut, probably of a half-percentage point, will be put in place at its next meeting on March 18. It's a close call as to whether the Fed's actions, together with the impending fiscal stimulus, come in time to avert a recession. One encouraging trend: lower interest rates are spurring households to refinance mortgages again, something that could lower debt servicing burdens and free up some cash for spending in coming months. As the chart shows, applications for refinancings have surged to a 4-½ year high in recent weeks, and mortgage rates should remain low for some time. Our sense is that the economy will just barely tread above water over the next quarter or two, but will receive enough strength from capital spending and exports to stay out of a recession. By the second half of the year, the monetary stimulus should be working its cyclical magic and growth should move back towards trend. Indeed, don't be surprised if the Fed starts to remove some of its stimulus before the year's end, when the voice of the inflation hawks starts to be heard.

