

WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 8, 2008

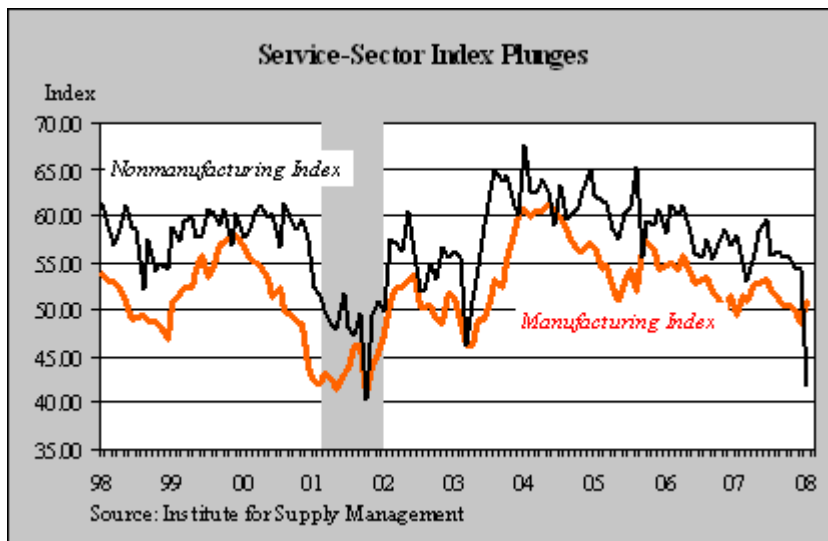
FINANCIAL INDICATORS				
INTEREST RATES	February 8	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.22%	2.08%	3.09%	5.14%
6-month Treasury bill	2.10	2.13	3.06	5.15
3-month LIBOR	3.09	3.10	4.26	5.36
2-year Treasury note	1.93	2.07	2.57	4.90
5-year Treasury note	2.68	2.75	3.05	4.77
10-year Treasury note	3.64	3.59	3.79	4.78
30-year Treasury bond	4.42	4.31	4.38	4.87
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.92	2.93	3.25	3.77
10-Year	3.63	3.60	3.78	4.00
30-Year	4.48	4.49	4.52	4.51
30-year fixed mortgage rate				
	5.67	5.68	5.87	6.28
15-year fixed mortgage rate				
	5.15	5.17	5.43	6.02
1-year adjustable rate				
	5.03	5.05	5.37	5.49
STOCK MARKET				
Dow Jones Industrials	12182.13	12743.19	12606.30	12580.83
S&P 500	1331.29	1395.41	1401.02	1438.06
NASDAQ	2304.85	2413.36	2439.94	2459.82
Commodities				
Gold (\$ per troy ounce)	923.70	910.00	898.00	671.30
Oil (\$ per barrel) - Crude Futures (NYMEX)	91.76	89.44	92.70	59.79
ECONOMIC INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Nonmanufacturing Index (January)	44.6	52.9	52.0	53.1
Nonfarm Productivity (Q4) - % change	1.8	6.0	2.2	1.6
Unit Labor Costs (Q4) - % change	1.0	3.0	4.2	3.2
Consumer Credit (Dec) - mlrs of \$	4501	17054	5573	11643

It's early in the year, but if the performance of the stock market so far in 2008 is any indication, one of the more reliable predictors of stock prices is about to go awry. With an accuracy rate of more than 80 percent, whenever a team from the original National Football League triumphed in the Super Bowl, stock prices rose for the year, and vice versa if one of the "upstarts" won. With the Giants – an original NFL stalwart—improbable victory last Sunday, the stars should be aligned for a winning year on Wall Street. Problem is, Main Street is being left out of this huddle, and a Hail Mary pass may be necessary to rescue the economy from slipping into a recession. While an economic downturn doesn't preordain a losing year in the stock market, it clearly injects a pessimistic attitude in the minds of investors, if only because a downward spiral in economic activity shoots the legs out from under profits.

It is no coincidence the stock market has started the year with one of its worst performances in the post-depression era amid ever-widening speculation that the economy is in the early throes of a recession. While it will take at least several months, if not longer, before enough data are available to either support or refute that speculation, the batch available over the last few weeks reveals an economy skating on thin ice, at best. True, market participants did not receive much in the way of new information this past week that would bolster the recession case. The one "hard" data release, however, was a doozy – the index of non-manufacturing activity compiled by the Institute for Supply Management. Indeed, what the Institute gave with one hand last week, it took with the other this week.

In the previous week, the ISM released its manufacturing index, which showed unexpected strength, jumping from 48.4 to 50.7 in January – a five-month high. That increase seemed to corroborate an earlier government report of strong durable goods orders for December, suggesting that the goods-producing sector of the economy, outside of housing-related industries, had firmer underpinnings than thought.

But the goods-producing industries account for a small fraction of overall economic activity, and they would have to be going all-out to prevent the economy from sliding into a recession. They are not, and now the more inclusive services-sector that accounts for the lion's share of spending and employment may be sliding downhill – a much more ominous recession signal. According to the ISM's shocking report this week, the non-manufacturing business activity index plummeted to 41.9 in January from 54.4 the previous month. That was the steepest one-month decline ever for this series, and lowered the index well into the zone it inhabited in the 2001 recession. True, the series only extends back to 1997 and, hence, only spans one business cycle. But the importance of services in the overall economy is considerably larger now than in any previous recession, so a drop of this magnitude has to be considered an portentous signal.

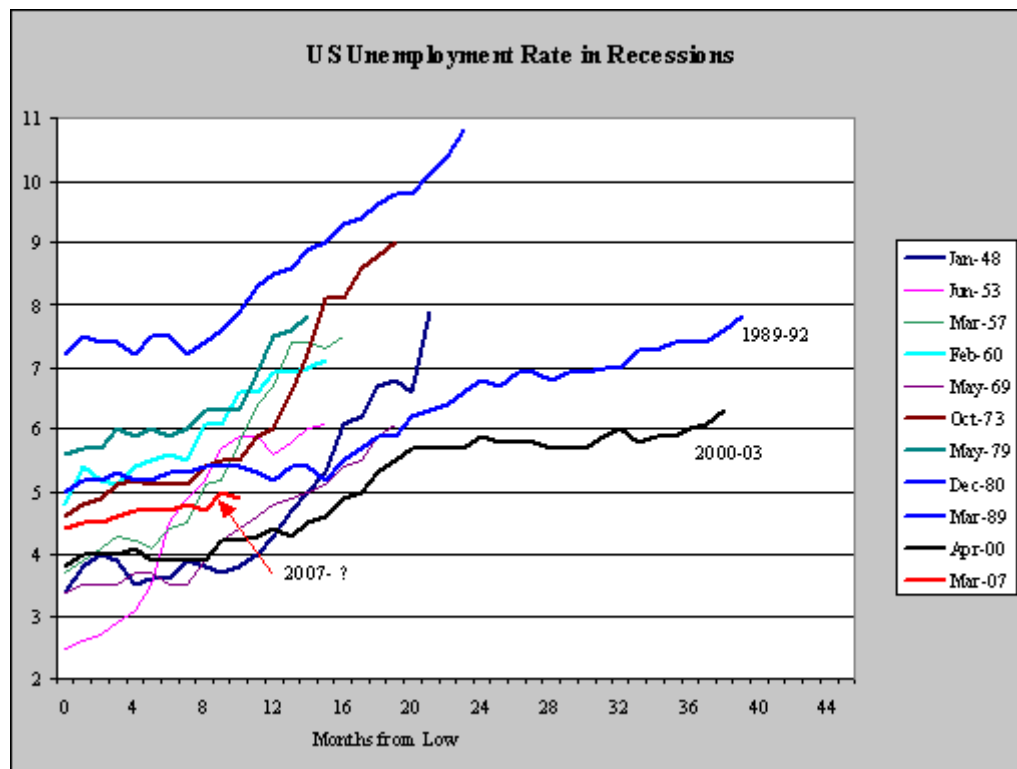


To be sure, whenever an economic series moves so dramatically in any given month – whether up or down – it's natural to take a wait-and-see attitude. In the case of the ISM index, there is another reason to be skeptical. A drop as precipitous as January's would usually be the result of some shock, such as an energy crisis, a natural disaster or war. In the current environment, the biggest external shock buffeting the economy is the headline-grabbing credit crisis. Surely, if companies in the services sector were suddenly denied access to funds, that would spark a pronounced slide in business similar to the one reported in January. But the first question asked to respondents in the ISM survey was "Is the turmoil in financial markets having any effect on your firm's ability to obtain regular or additional financing?" The answer: 85.4 percent said "No". Still, even discounting for some distortion, the scope and scale of the deterioration shown in the ISM survey is shocking, and certainly bolsters the case that the economy is flirting with recession tendencies.

One thing is sure: the Federal Reserve is not through cutting interest rates, despite Friday's Wall Street Journal report that some policy makers are getting increasingly concerned about inflation. If, indeed, the economy is either in or on the cusp of a recession, the unemployment lines are about to swell considerably, and that will take a higher priority in the collective minds of Fed officials than inflation. So, before asking how low interest rates will need to go, it might be useful to investigate how high

unemployment might rise. If the record of past recessions is any indication, the outlook for American workers is grim indeed. In fact, the rise in the unemployment rate from 4.4 percent last March to the 4.9 percent reached in January of this year would seem to be the first leg of a long journey that could climb to a peak of 7.5 percent before all is said and done.

We looked at the pattern of unemployment during each of the 10 recessions in the postwar period. As the chart shows, if the economy succumbs to a recession this year, the unemployment rate has a steep hill to climb. On average, the rate increased by 3.2 percentage points between the low and high for the cycle and the average amount of time it took to reach the high was 22 months. If the current cycle follows a similar path, the jobless rate will rise for about another year (well into the presidential election cycle) and peak out at 7.5 percent. Admittedly, the internal dynamics of the economy have changed over the course of the past 60 years as has the ability of policy makers to deal with recessions. More than likely, the jobless rate will not scale the heights seen in some earlier recessions, particularly the 10.8 percent peak reached in November 1982 when the Fed clamped down hard on the monetary brakes to quash virulent inflation.



However, even if the current experience is similar to that of the last two recessions, the outlook is not overly promising. Yes, the average of the two implies a lower peak unemployment rate of about 7 percent, but the journey would be considerably longer than in past cycles – nearly 40 months. While the last two recessions were much milder than the previous eight, the recovery phase was also weaker. Pundits refer to both post-recession episodes as the jobless recoveries for precisely that reason. What's more, there are strong similarities between the current episode and those of the last two. As now, the 2001 recession was preceded by the collapse of a bubble – the dot-com frenzy. And as is currently the case, a credit crisis was the catalyst behind the 1990-91 recession – the collapse of thousands of savings and loan associations, which ushered in a credit crunch that retarded the ensuing expansion.

Given the similar backdrop that the current experience shares with those of the last two recessions, the policy response to the 1990-91 and 2001 downturns might provide some insight into what the Fed will

do in coming months. With the federal funds rate target currently at 3.0% and widespread expectations that the FOMC will slash the target by another 1/2 percent to 2.50% at the March 18 meeting, the Fed would clearly run out of room to cut rates further if they are fighting a prolonged battle against a rising unemployment rate. In the 1990-1991 episode, the Federal Reserve had substantial leeway to reduce interest rates as the federal funds rate was near 10% in May 1989, which was subsequently reduced to 3% by September 1992, and that was over a period of three years. The Federal Reserve does not have that luxury now.

In 2001, the Federal Reserve cut rates fast and furiously, bringing the federal funds rate target from 6.50% to 1.75% by the end of that year. It then further reduced the funds rate to 1.0% in June 2003 and kept it there for over one year. To be sure, there is one major difference between today and the 2001 episode. In the period leading up to the final leg of the rate-slashing campaign in 2003, the major fear prodding the Fed on was deflation. That's clearly not the case now, as inflation continues to exceed the Fed's tolerance range even as it embarks on its pump-priming strategy. Indeed, as mentioned earlier, some Fed members fear the rate cuts may go too far, stoking the inflation embers that will be difficult to control down the road. Our sense is that this fear will have a braking effect on how aggressively the Fed cuts rates, but it will not stand in the way of further cuts if the unemployment rate follows the cyclical script written in the past. If, in fact, the inflation rate recedes as slack in the economy builds up over the course of the year – something the Fed is actually forecasting – we may well see the funds rate target revisit its 1 percent trough reached in 2003.

That said, it is still not a slam-dunk that the economy is heading into a recession. As we noted in a previous commentary, the half-percentage point rise in the unemployment rate so far has equaled the average increase that ushered in past recessions. But there has been at least two occasions, in 1963 and 1986, when the rate increased by that much without sparking a recession, so there is a chance that one can be avoided this time as well. Indeed, the consensus among economists is that the economy will just barely skirt a downturn, although they virtually all agree that the odds of a recession have increased significantly in recent months. One reason: the escalating credit crisis is spreading to all corners of the economy, threatening to choke off the lifeblood of the expansion.

That, at least, is the message conveyed by the Federal Reserve's latest survey of senior loan officers at banks. The January survey revealed that banks are tightening lending standards appreciably for virtually all borrowers – from households to businesses, large and small. Simply put, the credit noose is not just tightening around subprime mortgage applicants, but around the necks of prime mortgage borrowers as well as other consumers seeking loans. Likewise, commercial and industrial loans are tighter for large, middle-market and small firms. The latter could find themselves in a particular bind, as small companies tend to rely more heavily on banks for financing than their larger brethren.

One aspect of the Fed's survey we find especially troublesome is the clear tightening of credit conditions for commercial real estate developers. According to the latest tally, more than 80 percent of banks said they were restricting commercial real estate loans – the highest fraction ever for this series dating back to 1990. One of the pillars of the economy over the past year has been the strength in nonresidential construction spending, which has greatly cushioned the blow coming from the severe housing drag. In the fourth quarter, for example, business outlays on structures increased by a solid 15.8 percent annual rate, contributing more than half a percentage point to the economy's growth rate during the period. If that spending were squashed due to lack of financing, a key prop under the economy would be weakened considerably, giving another upward kick to the recession odds.

