WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 15, 2008

FINANCIAL INDICATORS				
INTEREST RATES	February 15	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.19%	2.22%	2.85%	5.16%
6-month Treasury bill	2.07	2.10	2.84	5.14
3-month LIBOR	3.07	3.09	3.89	5.36
2-year Treasury note	1.91	1.93	2.35	4.83
5-year Treasury note	2.76	2.68	2.84	4.68
10-year Treasury note	3.77	3.64	3.63	4.69
30-year Treasury bond	4.58	4.42	4.28	4.79
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.88	2.92	3.16	3.74
10-Year	3.61	3.63	3.72	3.98
30-Year	4.59	4.48	4.47	4.47
30-year fixed mortgage rate	5.72	5.67	5.69	6.30
15-year fixed mortgage rate	5.25	5.15	5.21	6.03
1-year adjustable rate	5.00	5.03	5.26	5.52
STOCK MARKET				
Dow Jones Industrials	12348.21	12182.13	12099.30	12767.57
S&P 500	1349.99	1331.29	1325.19	1455.54
NASDAQ	2321.80	2304.85	2340.02	2496.31
Commodities				
Gold ($ per troy ounce)	906.00	923.70	884.90	673.10
Oil ($ per barrel) - Crude Futures (NYMerc)	95.66	91.76	90.56	59.26
ECONOMIC INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (January) - % change	0.3	-0.4	0.0	0.3
Retail Sales ex Autos (January) - % change	0.3	-0.3	1.5	0.3
Trade Deficit (December) - mlns of $s	58759	63117	58048	58986
Business Inventories (December) - % chnge	0.6	0.4	0.1	0.4
Industrial Production (January) - % change	0.1	0.1	0.4	0.0

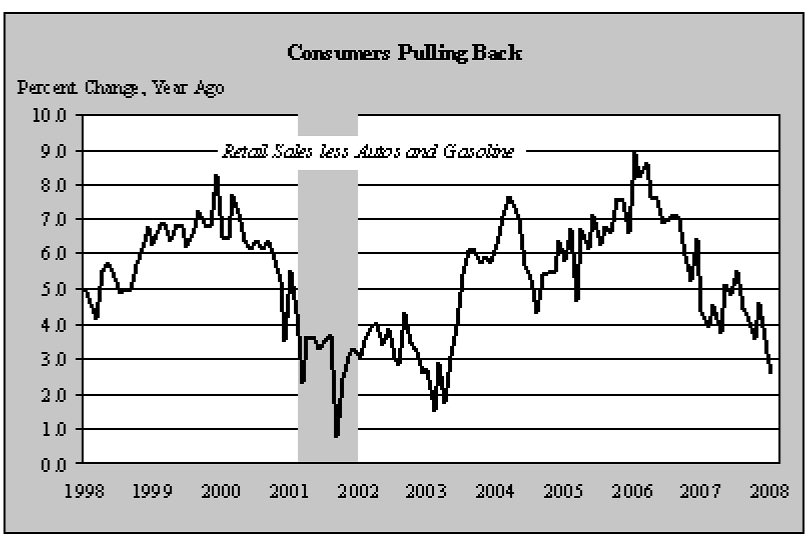
A funny thing happened on the way to a recession – the economy's main engine, consumers, sputtered back to life in January. The spending CPR may only breathe temporary energy into the waning expansion, but its presence provided some encouragement to the rapidly shrinking group of observers who still believe a recession can be avoided. Among those cautious optimists are Fed chairman Bernanke and Treasury Secretary Paulson, both of whom trekked up to Capitol Hill this week to give testimony before the Senate Banking Committee. Unfortunately, their comments did little to uplift the sourpusses in the financial markets who short-circuited a tidy 3-day equity rally on Thursday and Friday, sending the broad indexes into another tailspin, although the retained a slight gain for the week as a whole.

The comments by Bernanke clearly received more attention by market participants, who always parse the chairman's prose for clues as to what the next policy move might be. Actually, there is little suspense with regards to that issue, as just about everyone who earns a paycheck on Wall Street is firmly convinced that another rate cut, probably of a half point, is baked in the cake at the next meeting on March 18, if not sooner. What the Street is still not certain of, however, is whether the policy makers see some light at the end of the tunnel and whether Bernanke would provide some evidence that the worst is behind us. Unfortunately, Bernanke's testimony was anything but uplifting, which is why the markets sank in despair immediately after digesting his comments.

Yes, the Fed chairman – as well as Treasury Secretary Paulson – did present a base case forecast that the economy would skirt a recession this year. But policy makers never forecast a recession, which would be a tacit admission of failure on their part, so their comments should be viewed with a healthy dose of skepticism. What was more disturbing to market participants was the chairman's admission that the economy has more downside risks than thought a few months ago, thanks to the ever-deepening housing slide and tightening of credit conditions brought on by mounting write-offs at financial institutions. Since the Fed's earlier forecast had already painted a pretty grim picture of economic activity during the first half of the year, the chairman's downgrade in his testimony is as close to a recession forecast as you can get. Not surprisingly, the tide of opinion is shifting in that direction as well, as the survey of economists puts the odds of a cyclical downturn at just about 50-50. Less than a month ago, most economists thought that a recession could be avoided.

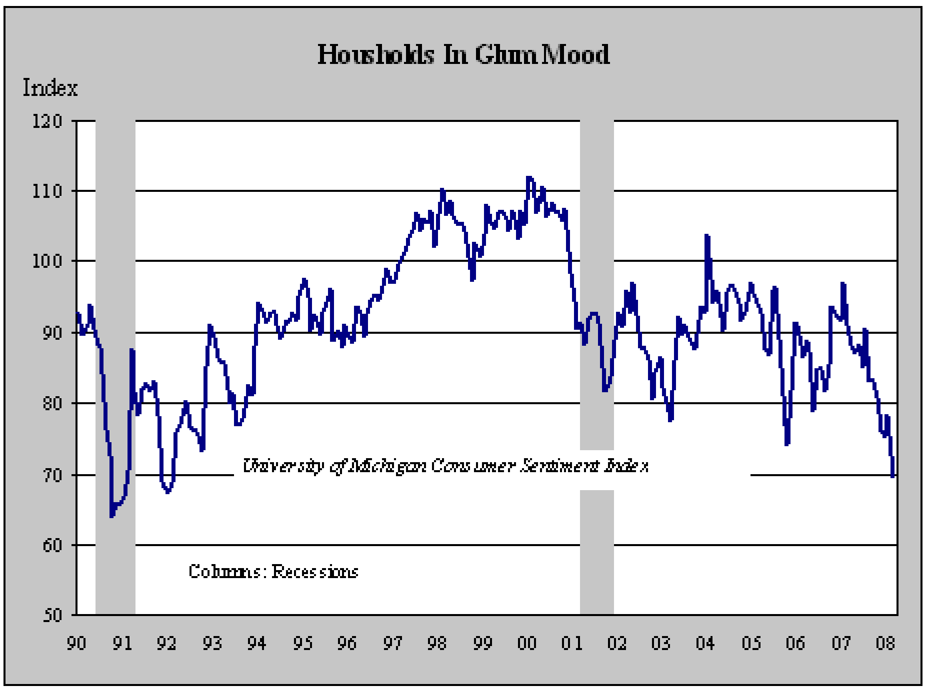
What upped the recession odds in recent weeks was the growing perception that consumers would not be able to withstand the powerful housing-related headwinds that are now joined by a deteriorating job market. With last month's dismal employment report showing the first contraction in payrolls in more than four years, the most important remaining pillar of support for consumer spending – worker paychecks – has come under siege, setting the stage for the first consumer-led recession since 1990-91. Keep in mind though that on numerous occasions during the six-year old expansion, rumors of the death of consumers have surfaced, only to turn out premature when households proved to be far more resilient than expected. With this week's report that retail sales in January unexpectedly increased by a modest 0.3 percent, a glimmer of hope emerged that households would once again buck the odds.

But the retail sales figure only provided a mild dose of optimism that was quickly overshadowed by Bernanke's downbeat testimony. What's more, the one-month bounce hardly changes the overall contour of consumer spending, which is decidedly on a downward slope. That's particularly the case when volatile auto sales and high-priced gasoline purchases are stripped away. As the chart shows, the remaining 70 percent of retail sales, after posting a 0.3 percent decline in December and no change in January, are sinking like a stone. Compared to a year ago, these sales show an increase of only 2.6 percent, a gain that hasn't been as weak since the middle of 2003, when the economy was still fitfully emerging from the 2001 recession. Indeed, if the pace slows as much over the next two months as the last two, consumer spending would be tracking a path similar to the 2001 recession.



Keep in mind, however, that consumer spending never contracted during the 2001 recession, which was a unique event in business cycle history. Instead, it was the collapse of business investment, a fallout from the overzealous capacity expansion during the 1990s capital-spending frenzy and the ensuing dot-com bust, that was the main catalyst behind that downturn. While capital spending is clearly weakening now, it is hardly on the verge of a similar-sized meltdown. Hence, consumer spending would have to show a much deeper slide than was the case in 2001 to bring the economy to its knees. Whether the housing collapse can do what the stock-market collapse failed to accomplish in 2001 – send consumers into hibernation – remains to be seen.

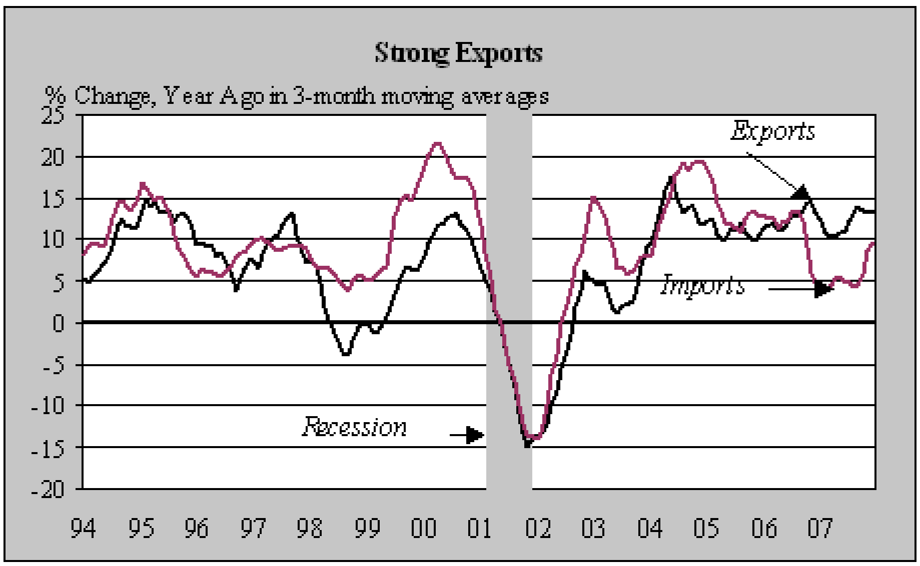
Certainly, If the consumer sentiment surveys are any indication, the housing meltdown is having a much more profound impact on household psychology than the bursting of the stock-market bubble did early in the decade. According to the University of Michigan Sentiment index, released on Friday, consumers are more downbeat now than they were during the 2001 recession. The preliminary February reading, at 69.6, is the lowest since February 1992. To be sure, sentiment readings are not a reliable barometer of future spending; research indicates that measures of confidence tend to be more a reflection of past events than a portent of the future. All things equal, however, the downbeat mood of consumers weighs in on the negative side of the ledger regarding spending prospects.



While there is no question that recession risks are greater now than was the case a few months ago, there are compelling reasons to remain cautiously optimistic the economy can stay on a positive growth track. For one, the Fed has responded much more aggressively to unfolding events today than it did going into past recessions. Currently, the federal funds rate stands at 3 percent compared to 5.5 percent at the start of the 2001 recession. Even in inflation-adjusted terms, the rate is considerably lower. When adjusted by the core personal consumption deflator – the Fed's preferred inflation gauge – the real federal funds rate stands at just under 2 percent versus 2.8 percent in April 2001. To be sure, the decline in the Fed's benchmark rate has not spread to all other rates – borrowing costs for many consumer, business and mortgage loans have actually risen in recent months. What's more, the stimulus provided by lower rates is being watered down by the reduction in credit availability for many borrowers, reflecting the deepening credit crisis.

But for the most part, the majority of creditworthy borrowers have access to lower-cost funds, even if the credit spigot has narrowed. What Bernanke and Paulson are counting on is that the effects of lower rates will be reinforced by the growth thrust expected from the $170 billion fiscal stimulus package just signed into law by the president. Even assuming households save a big chunk of the tax rebates that will be mailed out late in the second quarter, the spending stream should receive a nice boost in the third quarter, enough to lift economic growth by roundly 1 percent during the period. This would be consistent with Bernanke's broad outlook presented in this week's testimony, which assumes a pick up in activity in the second half of the year following a sluggish first-half performance.

For another, the economy continues to receive healthy support from foreign demand. That was again affirmed by this week's report of a $4.4 billion drop in the trade deficit during December, powered by a strong 1.5 percent gain in exports – the biggest increase in six months. For the year as a whole, the nation's trade deficit shrank by $47 billion, the first reduction in five years. Helped by the weakening dollar and continued strong growth among most of our trading partners, exports retained a strong underpinning throughout the year. True, global growth is slowing along with the U.S. economy, which will likely curb the pace of exports in 2008 compared to last year. But growth among most developing nations as well as in Europe and Japan is expected to outpace that in the U.S., which should underpin solid export growth this year. And with interest rates in the U.S. falling much faster than overseas, the dollar should remain low for a while longer, making U.S. merchandise attractive to foreign customers.



Finally, recessions are usually heavily influenced by inventory adjustments, which tend to amplify both the contracting as well as the expanding phases of business cycles. On the upside, when businesses are upbeat, inventory stockpiling accelerates, leading to strength in new bookings, production and employment. Just the opposite occurs when business confidence in economic prospects worsens, and inventories appear too high relative to prospective demand. Then, the inclination is to clear out excess merchandise, which leads to cutbacks in orders, production and eventually payrolls. These inventory swings have an outsized impact on the cyclical dynamic. For example, in the last six recessions since 1960, the fall from peak to trough in total economic output averaged 1.7 percent, with inventory corrections contributing 1.4 percentage points to the drop.

Fortunately, businesses have been highly disciplined in their inventory management throughout the current expansion. Hence, even with the slackening in final demand now underway, inventory stockpiles remain well within tolerable levels. Whether the absence of a sharp inventory correction – which often tipped the scales towards recessions in the past – helps keep the economy above water this time is questionable. But at the very least, if a recession looms – or has already started – it will not be aggravated by heavy inventory liquidations that would deepen the downturn. In a climate dominated by negative psychology laced with ominous forecasts, the cautious optimists have a few positive threads to cling to.