

## WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 22, 2008

FINANCIAL INDICATORS				
INTEREST RATES	February 22	Week Ago	Month Ago	Year Ago
3-month Treasury bill	2.19%	2.19%	2.25%	5.17%
6-month Treasury bill	2.13	2.07	2.36	5.15
3-month LIBOR	3.08	3.07	3.31	5.36
2-year Treasury note	2.05	1.91	2.17	4.80
5-year Treasury note	2.86	2.76	2.76	4.66
10-year Treasury note	3.81	3.77	3.55	4.67
30-year Treasury bond	4.58	4.58	4.26	4.78
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.86	2.88	3.01	3.73
10-Year	3.62	3.61	3.60	3.96
30-Year	4.76	4.59	4.44	4.45
30-year fixed mortgage rate	6.04	5.72	5.48	6.22
15-year fixed mortgage rate	5.64	5.25	4.95	5.97
1-year adjustable rate	4.98	5.00	4.99	5.49
STOCK MARKET				
Dow Jones Industrials	12381.02	12348.21	12207.17	12653.17
S&P 500	1353.11	1349.99	1330.61	1451.84
NASDAQ	2307.35	2321.80	2326.20	2517.02
Commodities				
Gold (\$ per troy ounce)	946.80	906.00	914.60	686.70
Oil (\$ per barrel) - Crude Futures (NYMEX)	99.13	95.66	90.90	61.14
ECONOMIC INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (January) - 000s of units	1012.0	1004.0	1178.0	1166.0
Housing Permits (January) - 000s of units	1048.0	1080.0	1162.0	1174.0
Consumer Price Index (Jan.) - % change	0.4	0.4	0.9	0.4
Core CPI (January) - % change	0.3	0.2	0.2	0.2

Besides John McCain, rumors are rampant that another comeback kid is in the house: Stagflation. For those with short memories, that nasty designation applies to a condition that was all too prevalent during the 1970s and early 1980s when the economy featured the twin evils of tepid growth, highlighted by rising unemployment, and virulent inflation. At one time or another during this period, both the unemployment rate and the inflation rate visited double-digit levels. It took the courage of the then Fed chairman, Paul Volcker, to brake this cycle by shooting a third visitor to those nosebleed heights, short-term interest rates, which finally punctured the inflation spiral. Unfortunately, it also ushered in the harshest recession in the postwar period during the early 1980s.

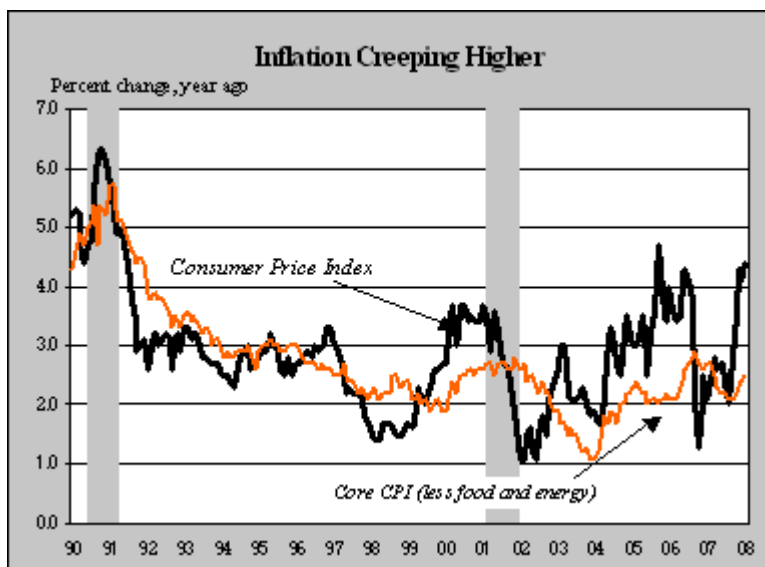
But Volcker's determination eventually paid off, as it restored credibility in the Fed's commitment to low inflation. Once that credibility was established, the financial markets also gained confidence that the dollar's integrity would be maintained. Accordingly, interest rates – both short and long – embarked on a long downward course, paralleling the disinflationary environment that unfolded over the next two decades. That, in turn, set the stage for the long and robust expansions in the 1980s and 1990s, which continued into the new millennium. One sign of how far from the hyper-inflation climate (by U.S. standards) the economy traveled; by 2003, the biggest fear was that the nation was perilously close to

suffering a bout of deflation.

Of course, that fear came and went with the resurgence of growth in 2004, sparked by aggressive Federal Reserve easing under chairman Greenspan and nourished by an unprecedented housing boom that has now ended in a veil of tears for the financial markets and the economy. Now the Fed, under its new chairman Ben S. Bernanke, is frantically striving to right the ship, stepping hard on the monetary accelerator and slashing interest rates by 2 ¼ percentage points since last September, with more cuts almost certainly in store. The Fed's actions put it more ahead of the curve than it was during the last housing meltdown heading into the 1990-91 recession. Then, the Fed cut its short-term interest rate target by 2 percentage points by the time the downturn ended (although more cuts came during the early recovery stage). This time, the cuts have already exceeded 2 percentage points, presumably before the much-heralded recession has even started.

But even as policy makers are focusing on preventing a recession, their efforts are being complicated by an unsettling upturn in inflation. Hence, the reemergence of the stagflation rumors, which are resonating ever more loudly in the business press and even receiving some acceptance among Fed officials. Indeed, the last two rate cuts have met with internal opposition at the Fed, as a different voting member dissented in each of the two meetings, fearing that another rate reduction would fan inflation expectations. While this sentiment clearly does not have enough support to override the growth-boosting inclination of the majority, it is receiving support from incoming data.

This week's Commerce Department's report on consumer prices, for example, provided a dramatic illustration of why inflation fears are starting to resonate more broadly. In January, the overall consumer price index increased by 0.4 percent, lifting the annual rate to a disturbing 4.4 percent. That's the second highest CPI inflation rate since early 1991, topped only by the 4.7 percent pace briefly hit in September 2005, when Hurricane Katrina-related disruptions along the Gulf Coast sent oil prices skyrocketing. To be sure, the current spike is also largely driven by oil as well as that other volatile component subject to extraneous influences, food. Stripped of energy and food, however, the so-called core CPI is moving in the wrong direction. The 0.3 percent increase in January was a tad above expectations, but even small excesses take on greater significance when inflation worries are on the rise.



What's more, the core CPI isn't exactly dormant. With January's 0.3 percent increase, the annual rate has risen to 2.5 percent, up from a recent low of 2.1 percent. Since that low was reached last August/September, the annual rate of core inflation has increased by 0.1 percentage point per month,

edging towards the 2.9 percent peak hit in September 2006. The core inflation rate has not reached 3 percent since 1996, and in all likelihood will remain below that handle in coming months. However, if the upward trend continues, there's little question that inflation alarms will ring more loudly in the financial markets, bringing out the bond vigilantes and reining in the Fed's headlong pursuit of reviving economic activity. As it is, the latest CPI report has already provoked some pundits to assert that the next rate cut on March 18 will be smaller than had been planned. The consensus on Wall Street still expects a half-point reduction in the federal funds rate, but this vocal minority now believes a more modest quarter-point haircut will be taken.

That said, it is hard to believe that the Fed would allow the recent behavior of inflation data to interfere with its ongoing efforts to revive growth and provide as much liquidity as needed to restore normal functioning of the credit markets. The Fed's focus is clearly set on short-circuiting a self-reinforcing pattern that, if sustained, would land the economy in recessionary quicksand before long. That focus was clearly evident in the just-released minutes of the FOMC meeting held on January 30-31, when the last 50 point rate cut was put into effect. Although the minutes gave considerable mention to the dissenting vote by Dallas Fed president Fisher and devoted two paragraphs to the "disappointing inflation data" in recent months, the top line concern of the committee was squarely on the deteriorating credit markets and the potential damage that a cutting off of the lending spigot would have on the economy.

Indeed, the headline-grabbing aspect of the minutes was the revelation that the FOMC feared an "adverse feedback loop", wherein tightening credit conditions would weaken economic activity, which, in turn, would feed back into still tighter credit conditions. This vicious cycle is the mirror image of the self-reinforcing inflation dynamic that in the past had been the adverse feedback loop. The inflation feedback contained a wage-push element wherein higher inflation encouraged workers to demand steeper pay raises which, in turn, provoked companies to impose still higher prices to offset rising labor costs. This cost-push inflation cycle was virulently unfolding in the 1970s until, as noted earlier, chairman Volcker intervened by stepping hard on the monetary brakes, sending interest rates spiraling until the inflation psychology was broken

But today's inflation environment is a far cry from what prevailed in the 1970s, and the Fed is well aware of that. The only shared catalyst behind the price increases during the two periods is oil, which skyrocketed then as well as now, albeit for different reasons. But whereas the core inflation rate shot up to double-digit territory in the 1970s, the surge in oil prices this time has not filtered through to other goods and services, as evidenced by the failure of the core inflation rate to pierce the 3 percent level. One reason, of course, is that unlike the 1970s, wage pressures have been virtually nonexistent in recent years and, in fact, are now receding along with the weakening labor market. That's why the FOMC remains adamant in its view that inflation will taper off in a lagged response to the slowdown in economic growth, which, it hopes, will not descend into a recession.

Indeed, this sentiment is captured in the Fed's latest economic forecast, which will be presented in more detail at Bernanke's semiannual monetary policy testimony before congress next week. As the summary table shows, the Fed raised its inflation outlook for the current year from its previous forecast last October. But whereas in last October's forecast, the core inflation rate was expected to hold steady between 2008 and 2009, it is now projected to decline. The reason, of course, is that the Fed also sharply lowered its growth forecast for this year, taking down the expected GDP growth rate by half -percentage point. At the same time, it also lifted its forecast of the unemployment rate by almost a half-percentage point, both for this year and next. The combination of weaker growth and higher unemployment is a sure recipe, in the Fed's mind, of reduced wage pressure and, hence, tame inflation going forward.

<b>Economic Projections of Federal Reserve Governors and Reserve Bank Presidents</b>			
	<b>2008</b>	<b>2009</b>	<b>2010</b>
<b>Central Tendency</b>			
<i>Growth of real GDP</i>	<i>1.3 to 2.0</i>	<i>2.1 to 2.7</i>	<i>2.5 to 3.0</i>
October projections	1.8 to 2.5	2.3 to 2.7	2.5 to 2.6
<i>Unemployment rate</i>	<i>5.2 to 5.3</i>	<i>5.0 to 5.3</i>	<i>4.9 to 5.1</i>
October projections	4.8 to 4.9	4.8 to 4.9	4.7 to 4.9
<i>PCE inflation</i>	<i>2.1 to 2.4</i>	<i>1.7 to 2.0</i>	<i>1.7 to 2.0</i>
October projections	1.8 to 2.1	1.7 to 2.0	1.6 to 1.9
<i>Core PCE inflation</i>	<i>2.0 to 2.2</i>	<i>1.7 to 2.0</i>	<i>1.7 to 1.9</i>
October projections	1.7 to 1.9	1.7 to 1.9	1.6 to 1.9
<b>Range</b>			
Growth of real GDP	1.0 to 2.2	1.8 to 3.2	2.2 to 3.2
October projections	1.6 to 2.6	2.0 to 2.8	2.2 to 2.7
Unemployment rate	5.0 to 5.5	4.9 to 5.7	4.7 to 5.4
October projections	4.6 to 5.0	4.6 to 5.0	4.6 to 5.0
PCE inflation	2.0 to 2.8	1.7 to 2.3	1.5 to 2.0
October projections	1.7 to 2.3	1.5 to 2.2	1.5 to 2.0
Core PCE inflation	1.9 to 2.3	1.7 to 2.2	1.4 to 2.0
October projections	1.7 to 2.0	1.5 to 2.0	1.5 to 2.0

What's more, the incoming batch of data since the January 30-31 meeting has only deepened the Fed's recession fears. Not only were the dismal jobs numbers that came out the following week enough to send tremors throughout the financial markets, but the latest confidence surveys reveal a more pessimistic mood among households than any time since the early 1990s. If consumers scale back real outlays during the first quarter, it would be the first contraction from this key sector since 1991. Keep in mind that the economy has never averted recession in the past fifty years when consumers retrenched for at least one quarter, so it's understandable that the Fed is more worried about a downturn than an inflation outbreak.

Of course, no discussion of recession risks is complete without mentioning housing, which continues to be the biggest direct as well as indirect drag on the economy. On this front, the latest data offer no relief. Yes, total housing starts edged up by 0.4 percent in January. But some bounce from the steep 15 percent plunge in December was expected. What's more, the January bounce was entirely noise, as it reflected a whopping 22.3 percent jump in multi-family starts following a 39.2 percent slide in December. The more important single-family starts figure showed another drop, the tenth in a row and both starts and permits for single-family homes continued to drop like a stone. Based on the selling pace for single-family homes in December, the last month available, it will take at least 20 months for the inventory of unsold and vacant houses on the market to be whittled down to normal levels. If there is one light at the end of the tunnel, it is that the National Association of Homebuilders said their sentiment index moved up ever so slightly for the second consecutive month. That's largely a reflection of the Fed's efforts to lower rates, which only points again to another reduction next month.

