

WEEKLY ECONOMIC COMMENTARY -- WEEK OF FEBRUARY 29, 2008

FINANCIAL INDICATORS				
INTEREST RATES	February 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.84%	2.19%	2.08%	5.10%
6-month Treasury bill	1.82	2.13	2.13	5.06
3-month LIBOR	3.06	3.08	3.10	5.35
2-year Treasury note	1.64	2.05	2.07	4.53
5-year Treasury note	2.49	2.86	2.75	4.44
10-year Treasury note	3.52	3.81	3.59	4.50
30-year Treasury bond	4.42	4.58	4.31	4.64
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	2.88	2.86	2.93	3.71
10-Year	3.67	3.62	3.60	3.94
30-Year	4.87	4.76	4.49	4.36
30-year fixed mortgage rate				
	6.24	6.04	5.68	6.18
15-year fixed mortgage rate				
	5.72	5.64	5.17	5.92
1-year adjustable rate				
	5.11	4.98	5.05	5.49
STOCK MARKET				
Dow Jones Industrial	12266.39	12381.02	12743.19	12114.10
S&P 500	1330.63	1353.11	1395.41	1387.17
NASDAQ	2271.48	2307.35	2413.36	2368.00
Commodities				
Gold (\$ per troy ounce)	975.00	946.80	910.00	644.60
Oil (\$ per barrel) - Crude Futures (NYMerc)	101.65	99.13	89.44	61.62
ECONOMIC INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Durable Goods Orders (Jan) - % change	-5.3	4.4	0.5	-1.3
Producer Price Index (Jan) - % change	1.0	-0.3	2.6	0.6
Consumer Confidence Index (Feb) - Con Bd	75.0	87.3	90.6	89.3
Consumer sentiment Index (Feb) - U of M	70.8	78.4	75.5	77.5
New Home Sales (Jan) - 000s of units	588	605	630	657
Existing Home Sales (Jan) - 000s of units	4890	4890	5020	5045
Personal Income (Jan) - % change	0.3	0.5	0.3	0.4
Personal Outlays (Jan) - % change	0.4	0.3	0.9	0.4

Although the financial markets digested a bucketful of economic data this week, all eyes were focused on Fed chairman Bernanke's semiannual report on the economic outlook, which he dutifully presented to Congress this past Wednesday and Thursday. Understandably, his comments were not particularly inspiring to legislators seeking reelection, nor did they provide much encouragement to the financial markets. Indeed, in the Q & A session following his prepared testimony, Bernanke drolly remarked to a questioner ... "Senator, I realize my testimony wasn't the most cheerful thing you'll hear today."

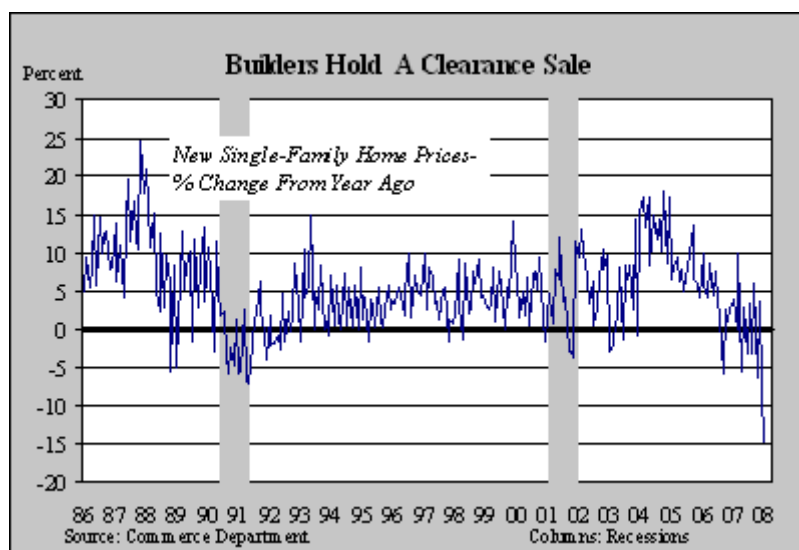
Essentially, the Chairman fleshed out the outlook already outlined in the minutes of the last FOMC meeting held on January 30-31, which we discussed in some detail in last week's commentary. Suffice it to say that Bernanke's testimony did not attempt to burnish the previously reported outlook with soothing promises. The bottom line is that conditions are grim and the Fed admits to facing some formidable headwinds in its efforts to steer the economy in the right direction. Make no mistake, the chairman's primary focus is on stimulating growth, which he acknowledges is under severe downward pressures from an ongoing housing collapse and tightening credit conditions. If anything, the risk is to the downside should housing conditions worsen more than anticipated and the credit spigot for

consumers and businesses narrows further than it already has. The number one priority is to short-circuit a recession, making another rate reduction at the March 18 FOMC meeting a virtual certainty.

Yet, Bernanke acknowledges that the road ahead will be rougher than it was going into the 2001 recession. For one, the weak link this time is the consumer, whose expenditures account for 70 percent of total economic activity, not the much-smaller business sector that was the primary catalyst behind the previous downturn. The problems weighing on households are more pervasive and potentially more damaging to the broad economy than were the issues facing corporations in 2000, which were corrected when the capacity overhang from the excessive capital-spending boom of the late 1990s disappeared and healthy balance sheets were restored. For households coping with declining home values, low savings, huge debt burdens a weakening job market, and soaring energy and food costs, the headwinds are not only powerful they have an uncertain time horizon.

Not surprisingly, Bernanke noted that the ongoing slide in the real estate market is the primary source of concern. Not only is the housing collapse turning out to be much more severe than anticipated, the real estate malaise is spreading to the nonresidential sector, which had been one of the few positive forces propelling the economy forward last year. But it is the residential sector that is sounding the loudest alarm bells, and the news on this front continues to be dismal. This week's twin reports from the government and National Association of Realtors on home sales once again revealed that potential home buyers are remaining on strike, either in anticipation of further price declines or because mortgage loans are unavailable or too expensive. For homeowners looking to sell, as well as those staying put but consider their homes as a primary retirement asset, this wealth-eroding situation is undermining financial security and sapping the willingness to spend for legions of households.

Just how much erosion in housing wealth is taking place depends on the yardstick used to measure price trends. While they differ in magnitude, they all point in the same direction – down. The median price of a new home sold in January, for example, declined 15 percent compared to a year ago, the biggest annual drop on record since the Commerce Department started collecting price data in 1964. Other measures also depict record declines, although their history is much shorter. One of the most widely followed of these is the S&P/Case-Shiller home-price index. The composite for 10 major metropolitan areas posted a record 9.8 percent year-over-year drop in December, with declines spread over all of the 10 areas. Interestingly, according to the National Association of Realtors, the median down payment on a home purchase made last year was 9 percent, down from 20 percent in 1989. What this means is that the price decline last year wiped out the entire equity for 6.3 million households who purchased a new or existing home during the year. Small wonder that an increasing number of owners are turning over the keys of their newly-purchased homes to banks instead of paying down a mortgage that exceeds the value of the house.



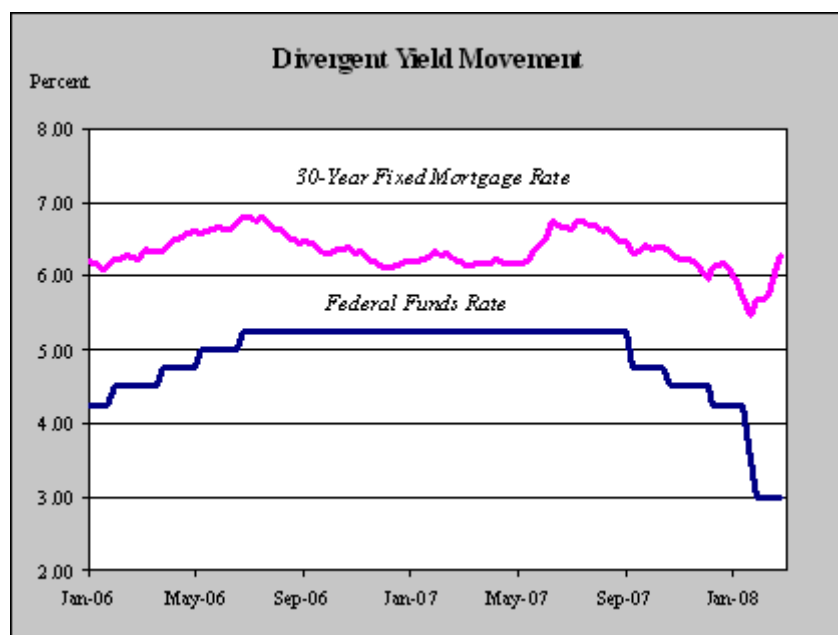
From a macro perspective, however, the Fed has the daunting task of preventing the destruction of home values from causing households to zipper up their wallets and purses. At the end of last year's third quarter, the value of owner-occupied real estate stood at \$21 trillion, so a 10 percent haircut in home values translates into a \$2.1 trillion hit to net worth. Making matters worse, there has been no compensating appreciation in other financial assets that would offset this erosion. Stock values declined in last year's fourth quarter, and it continues to slide downhill so far this year, no doubt facilitated by the housing-led weakening of the economy. Recall that the bursting of the last asset bubble – the stock-market collapse at the start of the decade – did not impair consumer spending much, in part because rising home values kept household balance sheets intact. That, together with the Fed's rate-slashing campaign and Washington's tax cuts helped make the 2001 recession one of the mildest on record.

But as Bernanke pointed out in his testimony this week, Washington does not have as much leeway to pump-prime the economy as it did heading into the 2001 recession, when the budget was solidly in the black. This time, the federal budget is going deeper into the red, thanks to sagging tax revenues associated with a weakening economy and housing market as well as rising expenditures due to higher Medicare, Social Security and defense needs. The recently-enacted \$168 billion stimulus bill will augment the red ink, even as its growth-boosting attributes are coming under question. Many pundits believe that the \$100 billion segment earmarked for tax rebates will do little to bolster spending, but will go instead towards paying down debt incurred by already over-leveraged households in recent years.

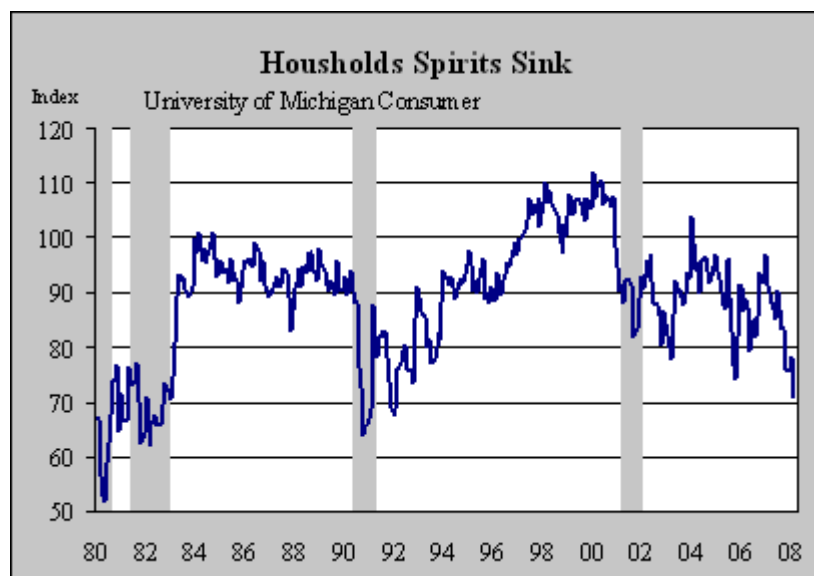
Bernanke also rightfully noted that the Fed's rate-slashing campaign now underway might not impart as much of a stimulant to the economy as it did during the previous downturn. For one, the positive impact of lower interest rates is being watered down by the reduced availability of credit, as banks have become much less willing to extend loans due to the erosion of their capital base stemming from rising defaults and portfolio write-downs of tainted mortgage-related securities. For another, the Fed's 2 ¼ percentage point reduction in its target for federal funds is not filtering through to other interest rates. In fact, the growing risk aversion of institutions is pushing up long-term interest rates on private obligations relative to Treasury securities. The spread between the yield on BBB-rated corporate securities and Treasuries, for example, is the widest since 2004, when corporate scandals and tarnished balance sheets also encouraged investors to place their funds in safe havens such as government securities.

Perhaps the most unfortunate victim of this flight to quality is the mortgage market, where interest rates have risen substantially in recent weeks. In fact, since the Fed's "emergency" rate cut of 75 basis points on January 22, which was followed by another 50 point reduction the following week, the national

average for 30-year fixed rate mortgages has increased from 5.48 percent to 6.27 percent in the latest week. In other words, a 1-1/4 percentage point reduction in the federal funds rate has been accompanied by an increase in mortgage rates of more than a three-quarters of a percentage point. That's clearly contrary to the Fed's intentions to arrest the housing slide by making homes more affordable through lower mortgage rates. One positive omen, however, is this week's approval by the government allowing Fannie Mae and Freddie Mac to purchase mortgage loans from institutions that exceed the previous conforming limit of \$417 thousand. That allows mortgage lenders to offload these heretofore-jumbo loans from their balance sheets, which should encourage lending to buyers of more expensive homes and lead to lower mortgage rates than would otherwise be the case.



At this juncture, the Fed is still not forecasting a recession, but sees the economy slogging along at a barely positive pace over the first half of the year, before picking up gradually going into 2009. The key to this scenario is the ability of households to sustain a positive spending pace this year, bucking the multitude of headwinds noted earlier. That outcome will not be easy to obtain, and the Fed will continue to provide as much support as needed to keep consumers in a shopping mood. As it is, household spirits have sunk to the lowest level since the early 1990s according to the University of Michigan's sentiment index for February. The Michigan reading paints a somewhat more dire picture than other surveys, such as that compiled by the Conference Board, but they all portray a fairly dispirited household.



To be sure, the connection between sentiment surveys and actual spending by households is not all that tight, so the policy makers will be paying more attention to what consumers do rather than how they feel. That said, they cannot be too encouraged by the latest spending figures released Friday by the Commerce Department. In January, households increased outlays on goods and services by 0.4 percent in January, a tad higher than expected. However, the entire increase was due to higher prices, as the personal consumption deflator also rose by 0.4 percent. Adjusted for prices, personal consumption – that 70 percent component of GDP – was flat for the month and stood a paltry 0.5 percentage point above the fourth-quarter average. Simply put, it would not take much of a setback in February and March to eliminate any positive contribution to growth coming from consumers in the first quarter.

Assuming that such a setback does not happen, the current reading for consumers suggest that the economy will eke out a small gain in the current quarter, probably just enough to keep the economy out of recession waters. We concur with that prospect as long as the credit crisis does not morph into a broadly-based credit crunch that squeezes the lifeblood out of economic activity. In his testimony this week, Bernanke acknowledged the downside risks associated with tightening credit conditions, and rattled the markets by asserting that he expects a few small banks to go under. That certainly did not cheer up risk-averse investors besieged by headlines depicting the financial woes of several high-profile institutions. Yet, it should be remembered that the credit crunch of the late 1980s and early 1990s featured the collapse of about 1600 savings and loans, a prospect that is far removed from the current environment.