

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 7, 2008

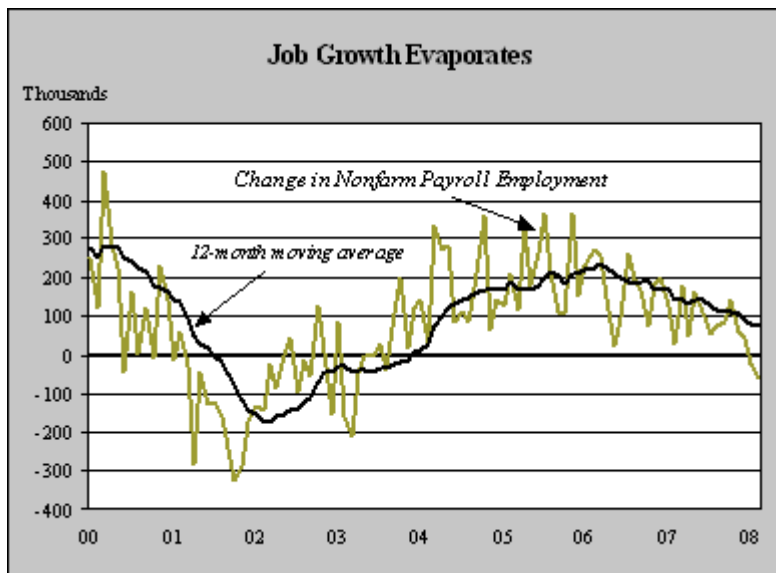
FINANCIAL INDICATORS				
INTEREST RATES	March 7	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.44%	1.84%	2.22%	5.08%
6-month Treasury bill	1.54	1.82	2.10	5.13
3-month LIBOR	2.94	3.06	3.09	5.34
2-year Treasury note	1.52	1.64	1.93	4.67
5-year Treasury note	2.44	2.49	2.68	4.55
10-year Treasury note	3.55	3.52	3.64	4.59
30-year Treasury bond	4.56	4.42	4.42	4.72
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.29	2.88	2.92	3.67
10-Year	4.07	3.67	3.63	3.87
30-Year	5.18	4.87	4.48	4.35
30-year fixed mortgage rate				
	6.03	6.24	5.67	6.14
15-year fixed mortgage rate				
	5.47	5.72	5.15	5.86
1-year adjustable rate				
	4.94	5.11	5.03	5.47
STOCK MARKET				
Dow Jones Industrial	11893.69	12266.39	12182.13	12276.32
S&P 500	1293.37	1330.63	1331.29	1402.85
NASDAQ	2212.49	2271.48	2304.85	2387.55
Commodities				
Gold (\$ per troy ounce)	974.20	975.00	923.70	649.70
Oil (\$ per barrel) - Crude Futures (NYMEX)	105.50	101.65	91.76	59.95
ECONOMIC INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (February)	48.3	50.7	48.4	49.7
ISM Non-manufacturing Index (February)	50.8	41.9	54.4	52.2
Construction Spending (Jan) - % change	-1.7	-1.3	-0.1	-0.6
Nonfarm Payrolls (February) - 000s	-62	-22	41	40
Unemployment Rate (February) - Percent	4.8	4.9	5.0	4.8

It may not be official, but it clearly is feeling more and more like a recession. Indeed, since last summer, the drumbeat of negative economic tidings has gotten consistently louder, undercutting the already-diminished hope that a recession can be avoided. The stomach-churning series of events started with the subprime-related credit upheaval last summer, followed by a deepening housing meltdown, weakening job and income prospects and deteriorating household balance sheets. The Federal Reserve and the administration are racing to stem the tide towards a full-blown recession, slashing interest rates and pumping tax rebates into household bank accounts.

But their efforts are being thwarted by eroding confidence in the financial markets. Investor dismay over the ability of institutions to preserve capital in the face of mounting losses on security holdings, both mortgage and nonmortgage-related, is sending stock prices tumbling and interest rates on non-Treasury debt higher. If the markets continue to crumble, the squeeze on institutional portfolios will intensify, forcing more of them to unload assets to raise capital. The heightened selling pressure, in turn, will reinforce the downward move in security prices, sustaining a vicious cycle that could severely crimp the availability of credit, choking off the economy's lifeblood. This is the makings of the so-called "adverse credit loop" that Fed chairman Bernanke alluded to last week, wherein deteriorating market conditions contribute to weaker economic activity, which intensifies the markets' turmoil and so on.

Clearly, policy makers are responding more urgently to the unfolding crisis, which is dominating the headlines and reinforcing the grim mood on Wall Street as well as on Main Street. Indeed, speculation that the economy has already slipped into a recession reached a feverish pitch on Friday with the government's release of its latest employment report. The report provided more dismal tidings for households, whose financial well-being is being undermined by sinking home values, soaring debt burdens and budget-draining spikes in energy and food costs. With their assets under siege and savings already at rock-bottom levels, households must rely heavily on income growth to sustain consumption. Unfortunately, that final bastion of hope is also falling by the wayside.

According to the government's reading, the economy lost jobs at the fastest rate in February than any time since March 2003, when it was still fitfully emerging from a recession. During the month, employers slashed 63 thousand workers from payrolls, following a 22 thousand cutback in February. What's more, if not for a solid increase in government hiring, the overall decline would have been much worse. That's because the private sector experienced a 101 thousand shrinkage in jobs, the third consecutive monthly drop totaling 141 thousand workers. Even more troubling is that the reported numbers may understate the actual weakness in the job market. Keep in mind that the Labor Department cannot possibly canvass every business establishment in the nation to arrive at its payroll estimate. Instead, its monthly survey covers a very small fraction of companies, accounting for about one-third of the workforce, and blows up this sample with what is known as a "Birth/Deaths Model". This model makes an assumption about how many net new businesses were created during the month, and how many new jobs were generated as a result of this estimated figure.



While the Birth/Deaths methodology has improved in recent years, most economists believe that it still is a highly imperfect measure of jobs when the economy is going through a transition phase - either downshifting to slower growth or upshifting to faster growth. During the downshifting phase, the model tends to overestimate the number of new business formations and, hence, new jobs, and vice versa during the strengthening growth phase. Unquestionably, the economy has been going through the downshifting phase for the better part of the past year, which strongly suggest that the reported jobs number is exaggerating the growth in payrolls. Indeed, over the past twelve months, the Labor Department reports that the number of jobs in the private sector has increased by 552 thousand. Yet its actual sample of 300 thousand business establishments shows a decline of 216 thousand jobs at those companies during the period. In other words, all of the growth in jobs and then some (768 thousand in total) is the result of an estimate made through the Birth/Death model.

In an economy that has downshifted so rapidly since last summer, it is highly unlikely the pace of new business formations has been as strong as that assumed by the Birth/Death model. When the final tally is made (based on actually unemployment insurance records) the result will almost surely show a weaker job market than what is now being reported. Nor for that matter should the slight drop in the unemployment rate reported for February - to 4.8 percent from 4.9 percent in January - be construed as a sign of strength. The jobless rate - which is derived from a separate survey of households - reflects a huge drop in the labor force that more than offset the decline in actual employment. Simply put, the number of people who stopped looking for work increased dramatically during the month, a sign that jobs are harder to get, which reduced the labor force participation rate from 66.1 percent to 65.9 percent. If more evidence that jobs are hard to come by is needed, just look at the number of workers who were forced to take part-time jobs during February because they couldn't secure full-time positions. That number shot up by 769 thousand to 8.884 million - the highest level in more than five years.

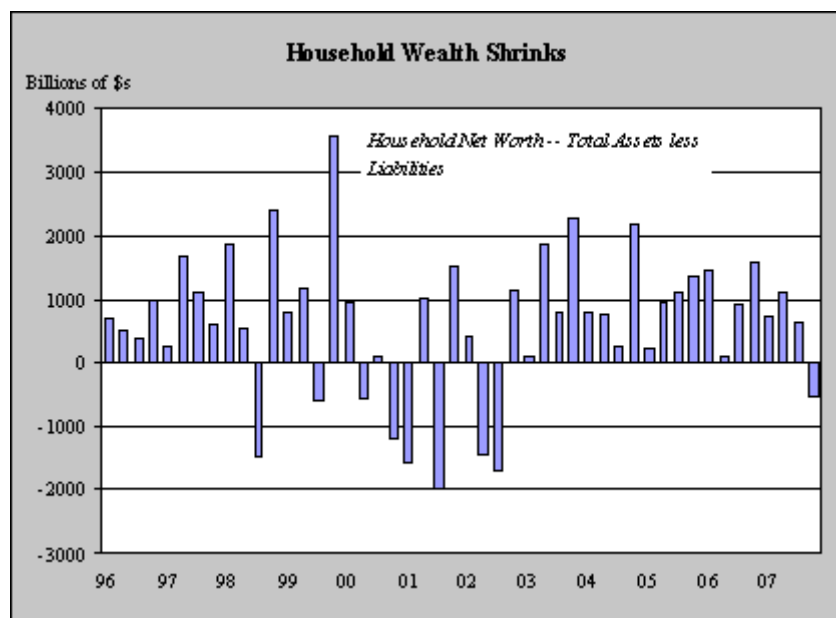
Not surprisingly, the dismal jobs report strengthened expectations on Wall Street that the Fed will move, and move aggressively, to reduce interest rates at its next meeting on March 18. Prior to the jobs report on Friday, the odds favored a 50 basis point cut in the federal funds rate to 2 ½ percent. Following the report, the futures market priced in a stronger probability of a 75 basis point cut, with some expectation that the move could occur before the scheduled March 18 meeting. That may happen if turmoil in the financial markets escalates to the point of panic in the coming week, which at this writing is not happening. Additionally, just minutes before the jobs report was released, the Federal Reserve announced it would take fresh steps to prevent a seizing up in the credit market by raising the amount of money it will auction to banks through its recently-created term auction facility (TAF). The Fed said it would increase the size of its March 10 and 24 auctions to \$50 billion each. The auctions had been slated for \$30 billion each and Fed officials said if need be they plan even bigger amounts for future auctions. Also, starting Friday, the Fed said that it would begin a series of repurchase transactions expected to reach \$100 billion.

Whether or not the infusion of liquidity into the banking system prevents the credit spigot from closing remains to be seen. Banks may simply use the funds to strengthen balance sheets and remain tightfisted about lending to anyone but the Treasury, where the risk of default is nil. If that were the outcome, the Fed would, in effect, be pushing on the proverbial string, resulting in little net stimulus to the economy. We suspect, however, that the credit markets will not seize up to that extent, and the liquidity infusion plus the lower rates will have a modestly positive impact in the near term, with the effects growing later on in the summer and fall when the fiscal stimulus will also be kicking in. Keep in mind that monetary policy works with a lag of six to nine months and the first rate cuts only took effect last September, barely enough time for the positive ramifications to play out.

Meanwhile, policy makers must be troubled by the powerful headwinds that are buffeting already beleaguered households, which threaten to shut down spending as forcefully as would any credit crunch. The weakened state of the job market is only the last of a series of blows that are persistently undermining the ability and willingness of consumers to keep their wallets open. Not only is income growth slowing along with the downshifting of the job-creating engine, but households are now suffering an erosion in net worth, depriving them of another source of spendable funds. This week, the Federal Reserve issued its flow of funds report for the fourth quarter that, among other things, tracks changes in the balance sheets of households and businesses. Both experienced a setback in financial well-being, but the adverse turn in fortunes for households is particularly alarming because rising asset values had been the primary fuel sustaining spending in recent years. That's no longer the case.

According to the Fed's report, household net worth tumbled by \$533 billion in the fourth quarter, the first wealth erosion since the third quarter of 2002 when the stock-market bubble was still deflating. This time, of course, it is the housing bubble that is rapidly losing air and constituting the major drag on

household wealth positions. Indeed, a decline in home equity values accounted for \$287 billion of the drop in net worth, leaving households with less equity in their homes than they owe to the banks. At the end of the year, the equity stake of homeowners slipped to an all-time low of 47.9 percent. At the start of the decade, the percentage of equity Americans had in their homes stood at 57.8 percent. To be sure, the equity share of households has been on a declining trend throughout the postwar period, reflecting the willingness of households to take on ever-larger amounts of mortgage debt, which had become increasingly more affordable and accessible.



However, the shrinking equity positions now is the result of falling property values, even as homeowners have far fewer options to refinance their mortgage debt than they had in the past. As a result, debt is being serviced out of current income, which is already being squeezed by rising energy and food costs as well as smaller paychecks associated with the weakening job market. It is small wonder that home foreclosures surged to record levels in the fourth quarter, with more increases undoubtedly on the way. The tide may be slowed by the proliferation of programs designed to help borrowers stay current on their mortgages, but the fundamentals underpinning the debt-servicing capacity of households are anything but favorable. As foreclosures continue to grow, the stock of homes on the market will also swell, putting more downward pressure on prices.

Indeed, like the jobs numbers, the flow of funds report may actually understate the decline in home equity positions because the Fed bases its estimate of housing values on the price measure compiled by the OFHEO, which does not include mortgages greater than \$417 thousand. The more inclusive Case-Shiller index depicts a much steeper decline in home prices, and if that measure is used household net worth would have suffered a decline about three times as steep as that reported by the Fed for the fourth quarter. What's more, the first quarter is shaping up to be even worse, as household stock portfolios - valued at \$10.5 trillion - is on track for a 10-15 percent decline, at least through early March. At the very least, if the economy is not already in a recession, it is clearly feeling like one to a broad swath of households.

