

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 14, 2008

| FINANCIAL INDICATORS | | | | |
|---|-------------------|--------------------|----------------------|--------------------------------|
| INTEREST RATES | March 14 | Week Ago | Month Ago | Year Ago |
| 3-month Treasury bill | 1.16% | 1.44% | 2.19% | 5.02% |
| 6-month Treasury bill | 1.30 | 1.54 | 2.07 | 5.12 |
| 3-month LIBOR | 2.76 | 2.94 | 3.07 | 5.35 |
| 2-year Treasury note | 1.45 | 1.52 | 1.91 | 4.59 |
| 5-year Treasury note | 2.37 | 2.44 | 2.76 | 4.47 |
| 10-year Treasury note | 3.43 | 3.55 | 3.77 | 4.55 |
| 30-year Treasury bond | 4.36 | 4.56 | 4.58 | 4.70 |
| Tax-Exempt Revenue Bonds (Triple-A) | | | | |
| 5-Year | 3.10 | 3.29 | 2.88 | 3.64 |
| 10-Year | 4.02 | 4.07 | 3.61 | 3.85 |
| 30-Year | 4.03 | 5.18 | 4.59 | 4.34 |
| 30-year fixed mortgage rate | 6.13 | 6.03 | 5.72 | 6.14 |
| 15-year fixed mortgage rate | 5.60 | 5.47 | 5.25 | 5.88 |
| 1-year adjustable rate | 5.14 | 4.94 | 5.00 | 5.42 |
| STOCK MARKET | | | | |
| Dow Jones Industrials | 11951.09 | 11893.69 | 12348.21 | 12110.41 |
| S&P 500 | 1218.14 | 1293.37 | 1349.99 | 1386.95 |
| NASDAQ | 2212.49 | 2212.49 | 2321.80 | 2372.66 |
| Commodities | | | | |
| Gold (\$ per troy ounce) | 999.50 | 974.20 | 906.00 | 652.80 |
| Oil (\$ per barrel) - Crude Futures (NYMEX) | 110.05 | 105.50 | 95.66 | 80.30 |
| ECONOMIC INDICATOR (Latest Month/Quarter) | | | | |
| | Current Month/Qtr | Previous Month/Qtr | Two-Months/ Qtrs Ago | Average-Past 6 Months or Qtrs. |
| Retail Sales (February) - % change | -0.6 | 0.4 | -0.7 | 0.1 |
| Retail ex autos (February) - % change | -0.2 | 0.5 | -0.5 | 0.3 |
| Trade Deficit (January) - Millions of \$ | 58200 | 57856 | 62410 | 58288 |
| Business Inventories (January) - % change | 0.8 | 0.7 | 0.4 | 0.5 |
| Consumer Price Index (Feb) - % change | 0.0 | 0.4 | 0.4 | 0.4 |
| Core CPI (Excl food & energy) - % change | 0.0 | 0.3 | 0.2 | 0.2 |

Economists tend to be a suspicious bunch, so it is understandable that a cautiously upbeat report on the credit crisis by Standard and Poor's this week was greeted with a fair amount of skepticism. The report -- which sparked a modest stock-market rally on Thursday -- indicated that an end to the massive loan write-offs at financial institutions was in sight, even though the total magnitude of the loan losses will turn out to be about \$20 billion higher than estimated a few months ago, reaching a staggering \$285 billion on subprime mortgages. While the markets rallied on the news, there was hardly a consensus on Wall Street that a return to normalcy was just around the corner.

Nonetheless, hope springs eternal, and it was hope - not reality - that gave the biggest lift to the markets early this week. The most significant boost was provided by the Federal Reserve, which is stepping up its efforts to alleviate the crisis by pumping as much liquidity into beleaguered financial institutions as needed, with promises to do even more if conditions warrant it. The latest broad effort, unveiled on March 11, is an expansion of its securities lending facility, in which the Fed is offering to lend as much as \$200 billion of its high quality Treasury securities to primary dealers for a term of 28 days, not just

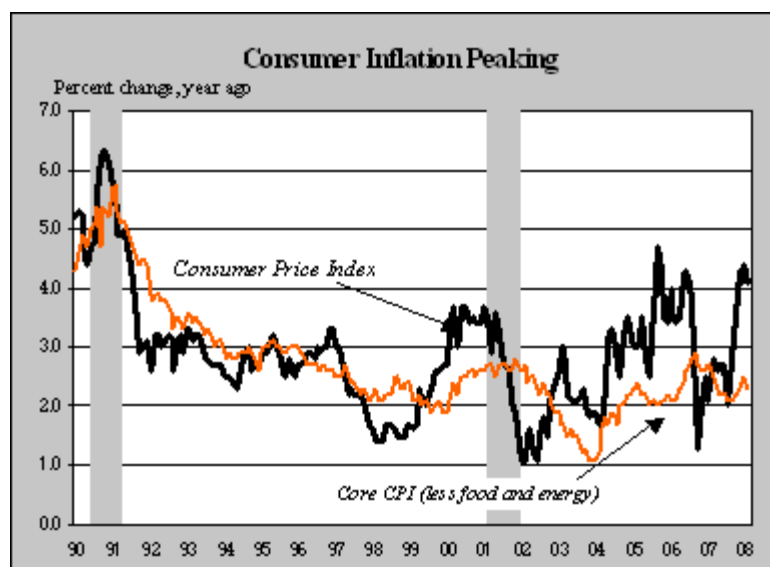
overnight as is usually the case. What's more, the program - called the Term Securities Lending Facility (TSLF) - enables the borrowing institutions to put up a wider array of collateral to secure the loans, including private-label residential mortgage-backed securities as well as agency-backed issues.

The inclusion of the private label MBS is the most significant element in the program, as these are the securities that have become toxic to investors, forcing institutions to hold them even as their values erode on an almost daily basis. By offering to take these securities off the books of financially-strapped institutions in exchange for more marketable Treasury securities - if only for a period of up to 28 days - the Fed is hoping to unfreeze assets of questionable value and enable these institutions to once again get back to the business of lending to households and businesses. Presumably, the institutions with the most dire funding problems - i.e. whose portfolios are loaded with illiquid, riskier assets like the tainted mortgage-backed securities - will be the major beneficiaries of the Fed's program.

Simply put, the expanded lending facility represents another attempt to restore confidence and credibility in the credit markets, which appears to be on the brink of seizing up. Whether or not it will work remains to be seen, but it is clear that the liquidity problems at financial institutions may be far more serious than generally perceived. That was made strikingly apparent by another bombshell that rocked the markets on Friday morning. Just minutes after trading began, news hit the wires that J.P. Morgan and the New York Fed was providing emergency loans to keep a major investment bank - Bear Stearns - afloat. Simply put, the environment is looking eerily similar to the brief but severe credit crunch that engulfed the financial markets in 1998, when the Russian debt default, the collapse in values of emerging market debt and the demise of a major hedge fund (Long-Term Capital Management) rocked the financial markets. At the time, at least one major investment bank, Lehman Brothers, was thought to be in serious financial straits, and many pundits questioned whether it could survive.

Of course, the markets emerged from that episode with the help of the Fed, which after all is the lender of last resort during such emergency situations. But just how much aid will be needed to restore confidence and liquidity to the credit markets this time is almost impossible to ascertain at this point, as is the potential damage to the overall economy that the credit crisis might cause - i.e., the adverse feedback loop that Fed chairman Bernanke has cited as a major risk. One thing is becoming increasingly clear: the Federal Reserve will be devoting all of its resources over the near term to minimize the downside risks to the economy, shunting inflation concerns to the sidelines for as long as necessary. That strategy, of course, doesn't sit well with the inflation hawks, who are alarmed by surging commodity prices, including oil, a plunging dollar and the potential inflation outburst that lurks down the road from an highly stimulative monetary policy that seems to be unfolding.

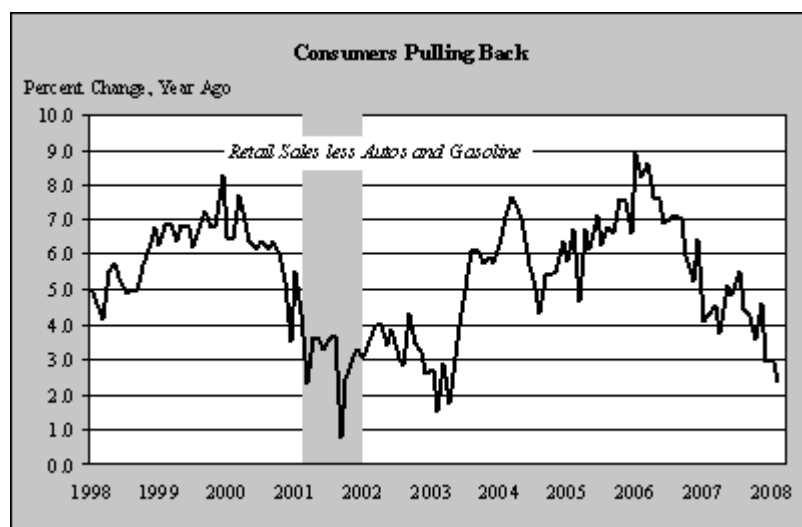
But while the inflation argument is being heard, it is also being muted by the urgency surrounding the deepening credit crisis and the growing perception among economists that the economy has entered a recession. What's more, the Fed's policy objective to bolster growth at the expense of tamer inflation is getting some support from incoming data. Indeed, just before the Bear Stearns bombshell hit the markets on Friday morning, stocks were buoyed by an exceptionally positive government report on consumer prices for the latest month. Contrary to expectations of a 0.3 percent increase in the CPI and 0.2 percent in the core index, the Bureau of Labor Statistics reported that both gauges actually come in unchanged during February - the first time that one or the other hasn't increased in a single month in nearly five years.



To be sure, inflation is still running above the Fed's comfort zone, and the unchanged reading in the overall CPI in February does not capture the surge in gasoline prices towards the end of that month. With crude oil hitting new records so far this month - reaching a record \$110 a barrel this week - the headline CPI will likely take another upward turn in March. But the likelihood that higher oil prices will feed through to other goods and services is diminishing with each new statistic pointing to greater weakness in economic activity. Without the support from demand, companies will be hard pressed to pass on higher energy prices to consumers. By the same token, a languishing economy is forcing cutbacks in hiring and increases in layoffs, which short-circuits the ability of workers to command bigger pay raises. In the absence of wage pressures and consumer demand that would support higher prices, the ingredients for a sustained inflation spiral simply do not exist.

That's why Fed chair Bernanke can assert with a reasonable degree of confidence that inflation expectations remain well anchored. If anything, the spiraling cost of oil and gasoline is now having a more deflationary than inflationary impact on consumer behavior. In past episodes of rising energy prices that raised inflation expectations, consumers would step up purchases of goods and services in anticipation of still higher prices later on. Today, that attitude is hardly applicable, as higher energy costs are taking an ever-larger bite out of already stretched budgets. With households sitting on a rock-bottom savings rate, suffering a severe erosion in housing wealth and finding jobs harder to get, much less getting sizeable wage increases, they have no choice but to cut back on discretionary purchases as more of their disposable incomes is being siphoned off by higher energy costs.

That was made abundantly clear this week with the Commerce Department's latest retail sales report for February. During the month, retail merchants witnessed a 0.6 percent drop in receipts, a much weaker showing than had been expected. Even excluding the volatile auto sector, sales posted a 0.2 drop, and all purchases outside of autos and gasoline fell by 0.1 percent. Indeed, those purchases, which account for 70 percent of total retail sales, show a skimpy 2.4 percent gain compared to a year ago, the slimmest increase in nearly five years. While the weakness is permeating virtually all categories of consumer purchases, the February snapshot reveals just how dramatically the housing downturn is spreading to related industries. For example, furniture sales fell another 0.5 percent during the month, their fifth consecutive monthly drop, and the housing-sensitive building material sector suffered a 0.7 percent drop in sales, the sixth in the past seven months. Even sales of once high-flying plasma TVs are feeling the effects of pinched budgets, as electronic stores have seen customer traffic decline for three consecutive months.



Although retail establishments constitute less than one-half of total consumer expenditures - with service sector sales taking the lion's share - their weak showing is a strong indication that households are finally caving in to the powerful headwinds that have been blowing in since the housing downturn started to gain traction last year. In conjunction with weakening job prospects, income-draining energy costs and tighter credit conditions, the erosion in housing equity is now causing a retrenchment in consumer spending that makes it almost impossible for the economy to avoid a recession. Given the retail sales numbers for January and February, it now seems that real consumer outlays will post the first quarterly decline since 1991 in the current quarter. Since consumers account for about 70 percent of total economic activity, such a retrenchment would almost certainly be accompanied by a contraction in real GDP during the period.

In point of fact, the consensus among economists now is that a recession probably started late last year, perhaps in December, with the consumer retrenchment serving as the tipping point behind this newly forged perception. The widely recognized arbiter of business cycle dating, the National Bureau of Economic Research (NBER) will not, of course, have enough information to corroborate this opinion until at least later this year, if not beyond. But the policymakers have to react to emerging developments and the imperatives for more growth-boosting measures are clearly palpable. As recently as a month or so ago, the general perception was that the economy would be able to skirt a recession thanks primarily to strong exports and the need for companies to restock inventories that were deeply drawn down late last year.

But while export growth is still solid, the consumer setback has left companies with more inventories than was expected. Indeed, following a sizeable 0.7 percent gain in December, total business inventories shot up by another 0.8 percent in January - the largest back-to-back increases in more than two years. What's more, given the February decline in retail sales, inventories likely posted another sizeable increase last month, leaving many companies with unwanted merchandise. That will contribute to a cutback in new orders, which, in turn, will filter through to weaker production and possibly more layoffs, a sure-fire recipe for a snowballing economic downturn. In short, the Fed has its hands full. Not only must it cope with a headline-grabbing credit crisis and its potential "adverse feedback loop" to the real economy. Even absent these debilitating forces, the economy is on a slippery downward slope that will require some heroic and creative measures to arrest.

