

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MARCH 21, 2008

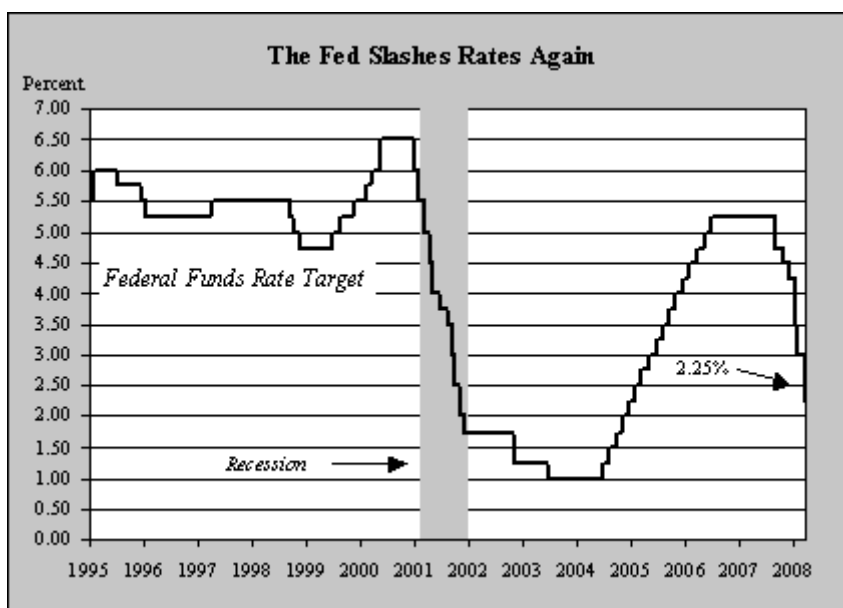
FINANCIAL INDICATORS				
INTEREST RATES	March 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.61%	1.16%	2.19%	5.05%
6-month Treasury bill	1.19	1.30	2.13	5.09
3-month LIBOR	2.61	2.76	3.08	5.35
2-year Treasury note	1.59	1.45	2.05	4.60
5-year Treasury note	2.37	2.37	2.86	4.51
10-year Treasury note	3.33	3.43	3.81	4.61
30-year Treasury bond	4.17	4.36	4.58	4.80
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.04	3.10	2.86	3.67
10-Year	4.05	4.02	3.62	3.87
30-Year	5.16	4.03	4.76	4.36
30-year fixed mortgage rate				
	5.87	6.13	6.04	6.16
15-year fixed mortgage rate				
	5.27	5.60	5.64	5.90
1-year adjustable rate				
	5.15	5.14	4.98	5.40
STOCK MARKET				
Dow Jones Industrial	12361.32	11951.09	12381.02	12481.01
S&P 500	2258.11	1218.14	1353.11	1436.11
NASDAQ	1329.51	221.249	2307.35	2456.18
Commodities				
Gold (\$ per troy ounce)	920.00	999.50	946.80	657.30
Oil (\$ per barrel) - Crude Futures (NYMEX)	101.84	110.05	99.13	62.28
ECONOMIC INDICATOR (Latest Month/Quarter)				
	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (February) - 000s of units	1065	1071	1000	1128
Building Permits (February) - 000s of units	978	1061	1080	1119
Producer Price Index (February) - % change	0.3	1.0	-0.3	0.8
Industrial Production (February) - % change	-0.5	0.1	0.2	-0.1
Capacity Utilization (February) - Percent	80.9	81.5	81.5	81.5
Leading Eco. Indicators (Feb) - % change	-0.3	-0.4	-0.1	-0.3

Investors hopefully had their seat belts fastened, as the financial markets took one of the most turbulent roller coaster rides in recent memories this week. Over three successive days, the Dow Jones industrial average soared more than 400 points, gave up more than 300 of the gain, and then rallied for more than 250 points on the final day of the holiday-shortened week. Other stock indexes followed a similar dizzying path and, like the Dow, wound up on the plus side for the week as a whole. Nonetheless, it was nip and tuck as to whether the week would end up on the positive side of the ledger, as market participants digested an array of developments that teetered between catastrophe and ecstasy.

The catastrophe was averted when investors awoke on Monday morning to discover that a proactive Federal Reserve helped prevent the collapse of Bear Stearns, Wall Street's fifth largest investment firm. By providing the necessary financing, the Fed facilitated the takeover of the beleaguered company by JP Morgan Chase. Although the move has generated a considerable amount of controversy, particularly around the moral hazard issue, there is no question that the Fed's move was the right one, considering the potential consequences that might have resulted from a failure of an institution the size of Bear Stearns. Although not particularly gargantuan in terms of assets, the company was the counterparty to \$10 trillion in over-the-counter swaps; failure to honor these contracts could have sent tremors

throughout the market for derivatives, perhaps seizing up the global financial system. Simply put, the downside risks to the financial markets and the economy of benign neglect dwarfs any positive ramifications of letting the company go under.

But the sigh of relief associated with the takeover was only one of a series of mood enhancers that the Fed encouraged over a frantic three-day period. Along with the Bear Stearns transaction, the central bank flung open its lending window to a broader range of cash-strapped institutions, both banks and nonbanks, and followed up with another major interest-rate reduction at its scheduled policy-setting meeting on Tuesday. The rate cut, from 3 percent to 2.25 percent, was a quarter-point less than what many in the market had expected or hoped for. But while the smaller reduction may provide less of a growth thrust, it nonetheless served a useful purpose by appeasing the inflation hawks within the Fed and in the financial markets. Indeed, two voting members of the policy-setting committee dissented with Tuesday's decision, preferring a smaller reduction, while various market indicators, such as the inflation premium priced into the market for TIPs, had been signaling higher inflation for some time.



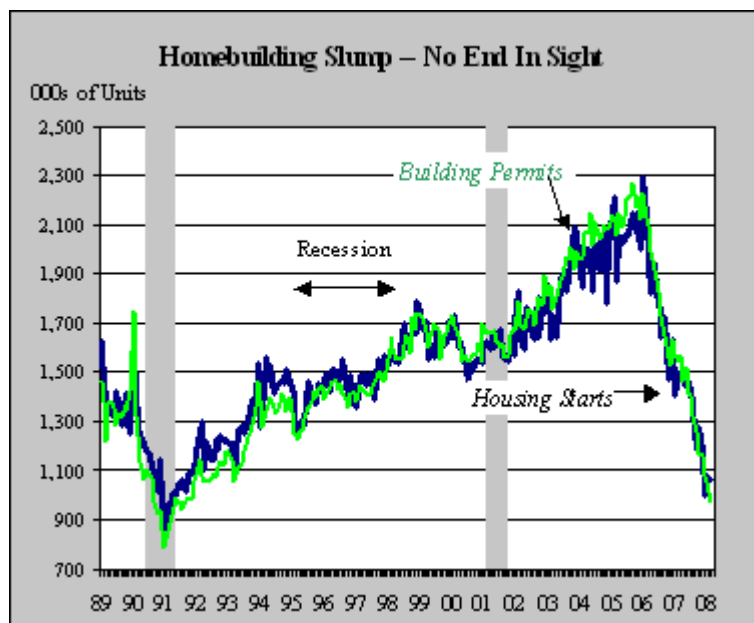
By throwing a bone to the inflation hawks, the Fed may also have broken the virulent rise in commodity prices, at least for a while. On Wednesday and Thursday, both oil and gold prices plunged along with many other raw material prices, resulting in the sharpest weekly downturn in the CRB commodities index in more than 50 years. It's unclear what exactly spurred the turnaround as market professionals have cited a number of causes. But the Fed's nod to inflation concerns - which was explicitly mentioned in the official statement following Tuesday's meeting - gave a boost to the dollar, which had been weakening for several years, with the slide accelerating in recent months. Most commodities, including oil, are priced in dollars, so the greenback's weakness forced commodity sellers to compensate by lifting prices. The dollar's rebound, at least temporarily, removed that catalyst behind the commodities spiral.

That said, the Fed left no doubt that its top priority is to prevent a financial meltdown and the "adverse feedback loop" it might impart to the economy. The Bear Stearns rescue was a critical component of that mission, as is the expanded lending facility the central bank is making available to cash-strapped institutions. If these measures do not soon restore a semblance of normalcy to the credit markets, rest assured more will be on the way; that includes another rate cut in April, which seems to an odds-on prospect in any event. Additionally, Washington is increasingly getting into the act. Indeed, this week's decision by the Office of Federal Housing Enterprise Oversight (Ofheo) to allow Fannie Mae and Freddie Mac to hold less capital against their assets may make a significant contribution to stabilizing

the housing market, as it could lead to an infusion of more than \$200 billion of new mortgage funds.

Nonetheless, it's doubtful if the increased capacity of these quasi-government agencies to purchase mortgages from banks and other lenders will get to the heart of the housing-related mortgage crisis. The reduction in capital requirements can do little to help borrowers afford their mortgages, which can't be refinanced because their homes are worth less than their mortgages. Our sense is that more aggressive intervention will be necessary. It may well be that the writing down of the principal of many of these "upside down" mortgage loans is the only way to prevent the mounting tide of foreclosures that is putting ever-more downward pressure on home prices and is aggravating the mortgage-market meltdown. There is no shortage of workable ideas to address the foreclosure crisis. In recent weeks, Representative Barney Frank and Senator Christopher Dodd have unveiled proposals. According to the Wall Street Journal, the White House is finally willing to entertain these ideas and Treasury officials are holding talks with aides to Rep. Frank.

No doubt, the longer the housing meltdown continues, the greater the odds are that Washington will step in more broadly with some remedial measures. At this juncture, there is little reason to believe that the housing market is nearing the end of its historical collapse. This week, the Commerce Department gave its latest reading on residential construction activity, and the results were not encouraging. In February, builders broke ground for 1.012 million new housing units, 0.6 percent below the previous month. The only reason starts did not fall further is because of a bounce in the volatile multifamily sector, which may reflect unusually favorable weather conditions in certain regions of the nation. Single-family starts fell for the 10th consecutive month and, more importantly, building permits slipped below the 1 million mark for the first time since September 1991. Indeed, permits fell below the level of starts in February, pointing to more cutbacks by builders in the months immediately ahead.



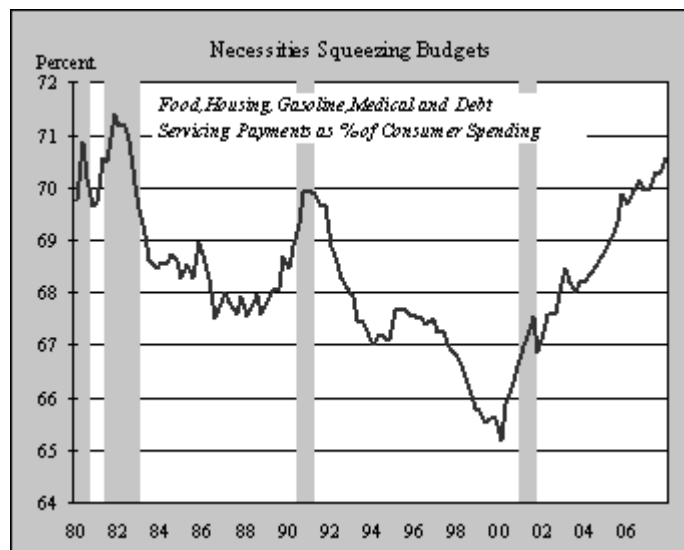
The bad news is that the drop in housing starts, as pronounced as it is, has made little headway towards reducing the overhang of unsold homes, as sales are falling almost as precipitously. At the current level of sales and starts, it would take about two years to work off the 200 thousand or so of excess inventories of unsold units. The good news is that the inventory overhang is shrinking, albeit slowly, suggesting that the biggest hit to the economy from the housing collapse is behind us. Make no mistake, the housing drag, which has diminished the economy's growth rate for a protracted nine consecutive quarters, is far from over. However, its direct impact should lessen in coming quarters, as should its

indirect effects on ancillary industries and construction payrolls.

If, as we suspect, the housing drag is about to become less pronounced, there is reason to hope that the national recession, which is arguably already underway, will be relatively brief and mild. To be sure, the National Bureau of Economic Research (NBER) - the widely recognized arbiter of business cycle dating - will not have enough information to formally confirm a recession until at least later this year. But the recession signals, including the deteriorating job market, the shockingly disappointing retail sales in February, and the fifth consecutive monthly decline in the leading economic indicators reported for February all suggest that a cyclical downturn has already begun.

That said, the traditional imbalances that amplified past cyclical downturns, such as a large inventory overhang and excess capacity, are not present now. Nor are businesses stuck with bloated payrolls that need to be sharply pared in the face of softer demand, as employment growth was modest throughout the expansion. While, as noted above, the housing meltdown still has a ways to go before hitting bottom, its economic damage should diminish in coming quarters. The key, as always, as to how severe and prolonged the recession turns out to be rests with the ability of households to recover from the powerful headwinds that are increasingly dampening spending propensities.

Indeed, the purchasing power of households is being pinched from both ends. Not only is the growth in paychecks slowing, thanks to the weakening job market, price increases on food, gasoline and other basic necessities are accelerating, leaving consumers with less spendable funds for discretionary purchases. In last year's fourth quarter, households earmarked almost 57 percent of their total expenditures for essentials - i.e., food, gasoline, housing and medical care - the highest fraction in fifteen years. And, if debt-servicing payments are thrown in, the fraction rises to over 70 percent, the highest since the early 1980s. Small wonder that discretionary purchases, like autos, are falling by the wayside. Can plasma TVs be far behind?



But the squeeze on household budgets would be greatly eased if mortgage market conditions improved, enabling homeowners to refinance at lower rates, and the spiral in food and energy prices is reversed. On these fronts, some promising omens emerged this week, with the prospective expansion of mortgage funds due to the reduction in capital requirements at Fannie Mae and Freddie Mac coupled with a sharp 33 basis point drop in the 15-year fixed mortgage rate to a six-week low. Additionally, a significant decline in crude oil prices this week is a hopeful sign that the escalating price of gasoline will be short-circuited before the peak driving season gets underway in a few months. Whether these promising

developments become more pervasive in the weeks ahead remains to be seen, but they will be closely monitored by policy makers whose task now is to determine how aggressive they need to be in righting a sinking economic ship.