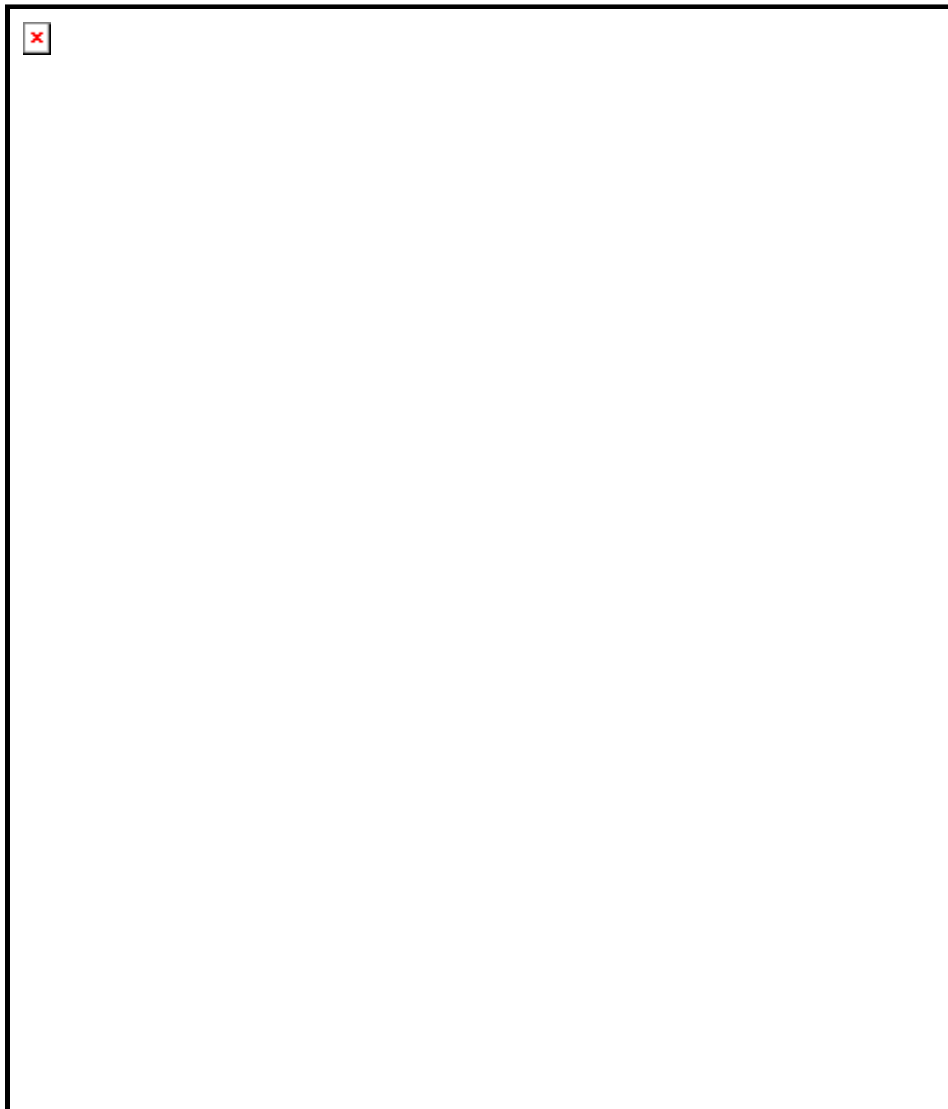
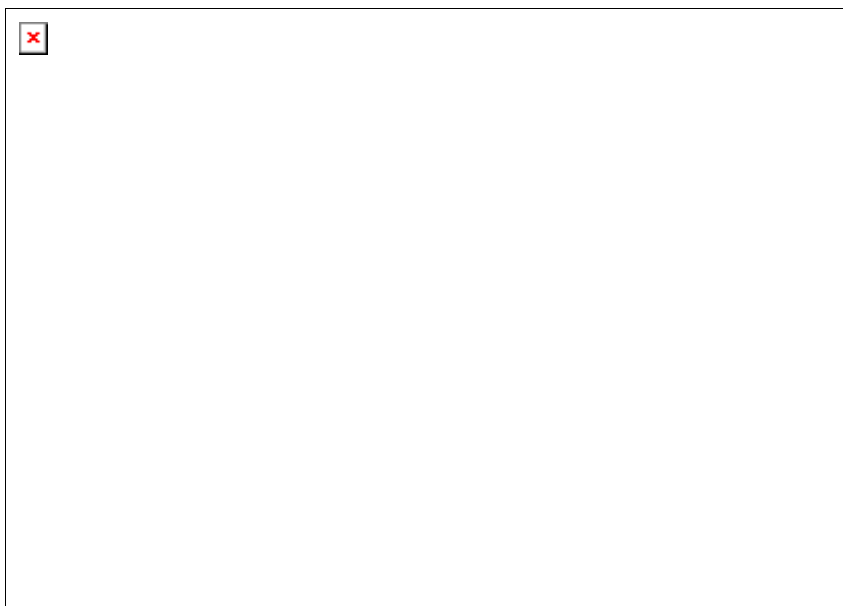


## WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 2, 2008



Harry Truman used to criticize two-armed economists for their inability to express a decisive opinion. Good thing he isn't around today to witness the Federal Reserve's ambivalent reading of the economic landscape. On the one hand, the Fed is asserting that the economy is in dire straits and will respond "as needed" to promote growth by cutting interest rates further. On the other hand, the Fed is wary of escalating inflation pressures, hinting that it will abandon its rate-slashing campaign if these pressures intensify and the economy seems sturdy enough to operate on its own two feet.

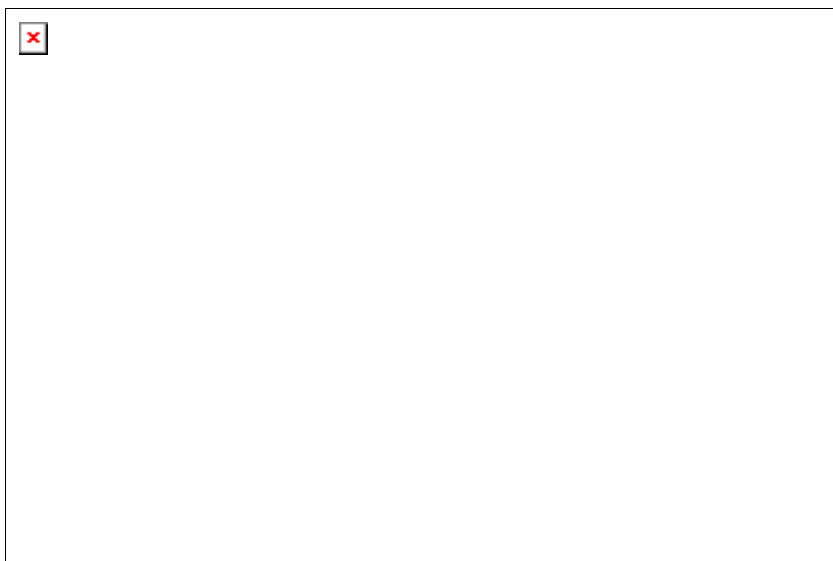
Either the Fed is trying to please everyone, or it simply has trouble reading the tea leaves. With all due deference to Harry, we both understand and sympathize with the Fed's plight. The economy is indeed treading water, even as inflation is rearing its ugly head. This is a confluence of unfortunate events that does not lend itself to easy policy fixes. Still, the fact that the Fed, as expected, lowered its target federal funds rate again at this week's policy meeting suggests it is more concerned over the economy's frailties than the inflation threat. But it also suggested in the formal statement following the meeting that the quarter-point reduction taken this week may be the last for a while. At least that's the message gleaned from the army of analysts whose job it is to parse the language contained in these post-meeting statements, which, as Mr. Truman would surely attest, is hardly a model of clarity.



Keep in mind though, that the statement is not always a reliable barometer of future Fed actions. Recall that back in October, the Fed also indicated that it would hit the pause button, following two rate cuts, noting that the balance of risks between recession and inflation was roughly even. At the time Bernanke and his colleagues thought that the subprime debacle, which surfaced in August, would be "contained" and the monetary stimulus already provided would propel the economy on its merry way. Of course, nothing could be further from the truth. The summer turmoil in the credit markets caused by the early subprime revelations was just the tip of the iceberg of what was to come. As the massive mortgage-related losses at financial institutions escalated towards the end of the year, it became apparent that the seeds for a severe credit crisis were being sown.

By then, the Fed had no choice but to continue with its rate-slashing campaign. What's more, it augmented its pump-priming efforts with huge liquidity infusions to beleaguered institutions in order to avoid a complete closing of the credit spigot. Since the turn of the year, the federal funds rate has been lowered by another 225 basis points to its current 2 percent level and the liquidity injections have continued. On Friday, for example, the Fed revealed that it expanded its term lending facilities and currency swap arrangements with the European Central Bank aimed at bolstering the global liquidity squeeze that is afflicting banks here and abroad. That said, it is unlikely that the Fed's latest nuanced shift in policy expressed in the post-meeting statement will be as far off the mark as was the October shift.

True, the dark clouds overhanging the economy and the credit markets continue to paint a gloomy landscape. Friday morning's long-anticipated employment report revealed that the economy continued to shed jobs in April, although the financial markets were cheered that the losses were less than expected. During the month, nonfarm companies pared 20 thousand workers from payrolls, far less than the roundly 85 thousand projected on Wall Street. Additionally, the unemployment rate posted a surprising dip to 5 percent from 5.1 percent in March. These headline-grabbing numbers ignited a "relief" rally on Wall Street and kept alive the notion that the worst of the economy's troubles may be behind us. From a policy perspective, it also supported the argument that the Fed should move to the sidelines, as the economy may not need any more stimulus to put it back on a positive growth track.



To be sure, the financial markets are forward looking, and Friday's rally extended a solid upturn in stock prices during April, which turned in the strongest monthly showing in four years. Likewise, the credit markets are showing strong signs of mending. Spreads between lower quality securities and Treasury yields have narrowed significantly over the past several weeks, the premium banks charge each other for short-term funds, as reflected in the London interbank offering rate (Libor), has shrunk relative to the federal funds rate set by the Fed, and the bond market has become somewhat more receptive to new corporate offerings, which increased sharply last month. These positive indicators strongly suggest that investors see more silver linings in the dark clouds than do the folks on Main Street. Indeed, while economists may still disagree over the recession issue, John and Jane Q Public are not; according to latest surveys, 8 of 10 households believe the economy is firmly mired in its eleventh post-war recession.

The April jobs report confirms that perception. Although milder than expected, the nation has never averted a recession when the labor market has deteriorated as much as it has since the start of the year. The 20 thousand loss of nonfarm jobs was the fourth decline in a row, and the losses in the private sector were stretched to five consecutive months. As expected, the weakness was concentrated among the usual suspects, with losses in the construction, manufacturing and retail sectors accounting for the lion's share of the payroll reduction. For construction workers, the news just gets worse and worse. During the month, the building trades purged 60 thousand jobs, following declines of 46 thousand and 44 thousand in February and March. It was the 10th consecutive month in which hard hats were thrown onto the unemployment lines; what's more, the layoffs are extending beyond the moribund residential sector to the commercial sector as well.

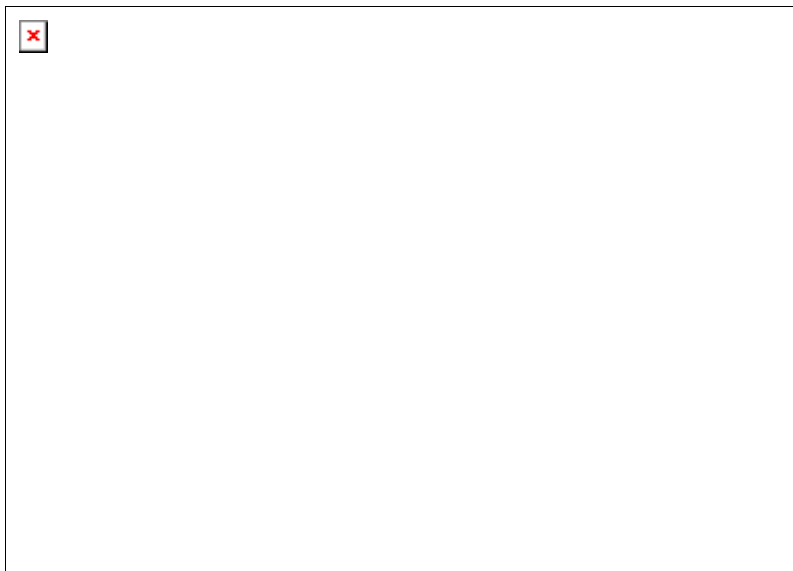
That said, the 20 thousand overall loss in nonfarm payroll jobs in April was considerably less than the 80 thousand average decline over the previous three months. In conjunction with the dip in the unemployment rate during the month, the complexion of the headline data clearly gives the impression that the severity of the downturn is lessening and the economy may well be on the path to recovery. Indeed, a surface reading of events suggest that even if the economy has slipped into a recession around the turn of the year - which seems to be the general consensus - it is starting on a much milder footing than past ones. As the chart shows, the 65 thousand average monthly drop in nonfarm payrolls this year is much less than the 121 and 123 thousand average that occurred during the first four months of the 2001 and 1990-91 recessions.

We agree that the job market may well hold up better than it did in prior recessions, if only because

companies are heading into the downturn with a much leaner workforce than they usually do. That's because hiring during the just-ended six-year expansion was also more conservative than in past expansions. Indeed, the 0.9 percent average annual increase in nonfarm payrolls during the six-year span was by far the smallest of the 10 previous expansions, which generated an average gain of 3.2 percent per year. With less bloat going into the recession, businesses have less fat to cut in the face of weakening demands. But we are far from convinced that the economy is on the path to recovery.

For one, the conservative hiring efforts during the expansion translated into much weaker income gains that is typical of periods of rising economic activity. In fact, virtually all of the income gains were eaten up by higher prices, particularly during the waning months of the expansion. Hence, following solid increases in 2006 and early 2007 when the unemployment rate fell to a cyclical low of 4.4 percent, by March of this year real average earnings of rank-and-file workers had fallen back to the level of December 2001, the first month of the expansion. In other words, some 80 percent of the workforce entered the recession having not enjoyed any increase in purchasing power over the previous six years. If the April payroll data are any indication, that situation has not changed. During the month, average hourly pay eked out a slim 0.1 percent increase, even as the number of hours worked during the month fell by .4 percent. Simply put, it looks like wages and salaries actually fell last month, something that does not bode well for consumer spending.

Which brings us to the last piece of the week's confusing batch of data. Like the relatively mild drop in the headline payroll count last month, the government earlier in the week also reported that the economy posted a modest 0.6 growth rate during the first quarter, matching the previous quarter's performance. A positive growth rate would seem to contradict the notion, subscribed to by most economists, that the recession began around the turn of the year. However, as Martin Feldstein - head of the NBER committee responsible for dating business cycles - expressed in some recent personal remarks, all of the growth occurred between quarters, which would have given the first-quarter's GDP tally a statistical boost. In his view, as well as others, the economy was significantly weaker towards the end of the quarter than at the beginning



We concur with that view, and note that the headline 0.6 percent growth rate masks some broad fundamental weaknesses that are likely carrying over into the second quarter. In fact, if not for an unwanted inventory buildup and the as-expected positive thrust from exports, the economy would already be in negative growth territory, not positive. Indeed, real final sales to domestic purchases did decline by 0.4 percent during the quarter, marking the first such decline since the 2001 recession. With

auto sales dropping like a stone in April and the housing drag showing no sign of easing up, we expect that GDP will stage an outright decline in the second quarter. At some point this summer, the tax rebates should give consumer spending a temporary boost, which again will make the headline reading on the economy's performance seem healthier than it actually is. But until the job market turns around and starts to generate a stronger growth in incomes, we don't think the economy is out of the woods. The Fed may pause to assess the impact of its past actions as well as the tax rebates, but it is premature to conclude that it is done helping to put the economy back on to the road to recovery.