

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 16, 2008

FINANCIAL INDICATORS				
INTEREST RATES	May 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.84%	1.68%	1.36%	4.81%
6-month Treasury bill	1.90	1.74	1.66	4.96
3-month LIBOR	2.70	2.68	2.91	5.36
2-year Treasury note	2.44	2.24	2.14	4.82
5-year Treasury note	3.11	2.96	2.91	4.73
10-year Treasury note	3.85	3.77	3.72	4.81
30-year Treasury bond	4.58	4.52	4.51	4.96
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.16	3.25	3.10	3.76
10-Year	3.90	4.02	3.94	3.99
30-Year	4.79	4.89	4.90	4.48
30-year fixed mortgage rate				
	6.01	6.05	5.88	6.21
15-year fixed mortgage rate				
	5.60	5.60	5.40	5.92
1-year adjustable rate				
	5.18	5.29	5.10	5.48
STOCK MARKET				
Dow Jones Industrials	12986.80	12745.88	12849.36	13556.53
S&P 500	1425.35	1388.28	1390.33	1522.75
NASDAQ	2528.85	2445.52	2402.97	2558.45
Commodities				
Gold (\$ per troy ounce)	899.90	885.80	915.20	662.00
Oil (\$ per barrel) - Crude Futures (NYMEX)	126.66	126.09	116.77	64.94
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs
Retail Sales (April) - % change	-0.2	0.2	-0.5	0.1
Consumer Price Index (April) - % change	0.2	0.3	0.0	0.4
Core CPI (Ex Food and Energy) - % change	0.1	0.2	0.0	0.2
Industrial Production (April) - % change	-0.7	0.2	-0.7	-0.1
Capacity Utilization (April) - Percent	79.7	80.4	80.3	80.6
Business Inventories (March) - % change	0.1	0.6	1.0	0.5
Housing Starts (April) - 000s of units	1032	954	1107	1056

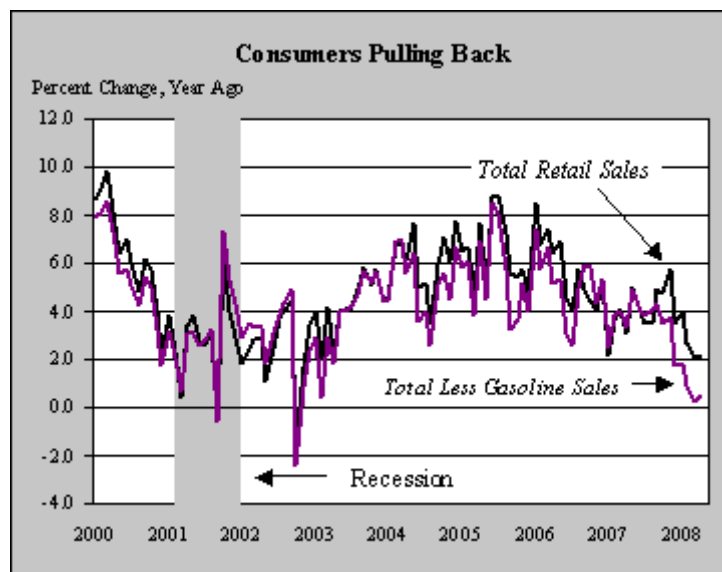
Remember the old Clairol advertising campaign that asked - "Does she or doesn't she?" We're reminded of that teasing question because it was meant to be unanswerable to the public at large (only the hairdresser knew). Likewise, the economy is posing an equally obtuse and highly debated question, namely is it or is it not in recession? This updated (and admittedly tortured) analogy comes to mind because the flow of incoming data appears designed to fool just about anyone trying to make sense of where the economy stands. Most pundits still believe we are either in or on the cusp of a recession. But no one, not even the nation's economic hairdresser, Ben Bernanke, can know for sure.

Take the latest figures on retail sales, which came in considerably stronger than expected during April. If the economy is heading for a downturn, households should be leading the way since they account for roughly 70 percent of total activity. But aside from slumping auto sales, which fell for the third consecutive month, the April sales figures suggest that consumer spending is hardly falling off a cliff. Nonauto sales jumped 0.5 percent during the month, the strongest increase since January, and the March total was revised up. With the job market deteriorating, soaring fuel and food prices gobbling up

discretionary incomes, slumping home prices vaporizing household wealth and confidence plunging to a 28-year low, what seems to be supporting spending?

Perhaps households are following the path of Wile E. Coyote, who famously stays aloft after running off a cliff until realizing there is no ground supporting him and gravity takes over. Following this scenario, consumers may well be relying more on credit cards and spending their rebate checks in advance to sustain living standards, only to retrench after these sources are exhausted. Only time will tell. That said, while the April sales figures were somewhat stronger than expected, they should not be viewed as strong enough to keep the economy out of a recession. Indeed, total retail sales in April stood only 2 percent above the level of a year ago. Since inflation has been running well above that pace, real spending has actually declined.

What's more, about 75 percent of that 2 percent increase has been spent at gasoline stations, reflecting the increased cost of filling up at the pump. Over the past twelve months, retail sales less gasoline purchases rose just 0.5 percent. Not only is this even further behind the inflation rate, as the chart shows the pace of both total sales and sales excluding gasoline is consistent with the trend observed during the last recession. Interestingly, many analysts are surprised that the skyrocketing cost of energy - with crude oil surging to over \$127 a barrel this week and gas prices topping \$4 a gallon in many parts of the country - has not had a more immediate impact on consumer spending, as was the case during the oil shocks in the 1970s that ushered in two of the harshest recessions of the post-war period. One possible reason is that back in the 1970s, drivers generally had to pay cash at the service stations, which instantly depleted their wallets of purchasing power. Today, of course, plastic is commonly used to purchase gas, so the ultimate impact on budgets is delayed until the credit card bills are received in the mail. Not surprisingly, the delinquency rate on credit cards is rising sharply.

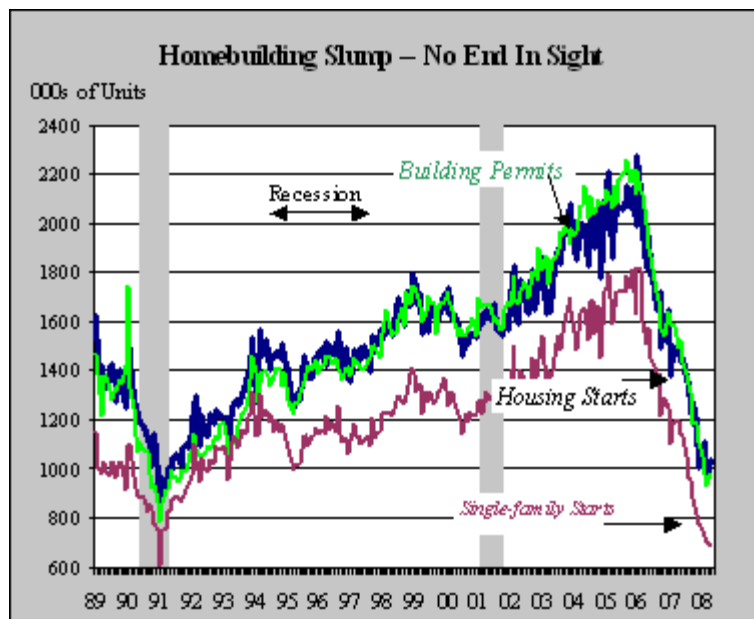


We suspect that aggressive promotions by department stores as well as consumers spending in anticipation of their rebate checks gave retail sales a temporary lift in April. It's doubtful, however, that this will be enough to jump-start the economic engine onto a sustainable recovery path. For that to occur, the headwinds tamping down growth would have to fade considerably more than they have. By all accounts, the Federal Reserve is pulling out all stops to arrest the credit crisis that is one of the most powerful growth-retarding forces dragging down the economy. But as discussed last week, the latest survey of bank lending officers shows that banks are hardly opening up the credit spigot, but are instead dramatically tightening lending standards for households and businesses. Small wonder that Fed chief Ben Bernanke continues to urge banks to raise as much capital as possible to shore up balance sheets.

While some progress has been made on this front - facilitated in part by the Fed's unprecedented efforts to provide banks and other institutions with much-needed liquidity - there is still a long way to go before credit conditions are restored to normal.

Then there is the powerful drag coming from the housing depression, which continues to assault the economy on several fronts. The most direct impact stems from the striking curtailment in spending on residential construction. Not only has this curtailment subtracted from the economy's growth rate for nine consecutive quarters, its impact is growing. In each of the past two quarters, declining residential construction outlays has siphoned 1.25 percentage points off of GDP, up from an average haircut of 0.92 percentage points over the nine-quarter interval. Given that the economy's growth rate has slowed to 0.6 percent over the past two quarters from a nine-quarter average of 2.3 percent, the outsized influence of the housing drag on the economy's performance is even more striking.

Unfortunately, that negative influence is not destined to fade anytime soon. True, like the retail sales data, the April figures on housing construction gave a stronger impression than expected. But the strength was solely in the headline number, not in the details. Overall, housing starts leaped a surprising 8.2 percent in April, but the entire increase was in multifamily buildings, which tend to be very volatile from month to month. The 36 percent increase in apartment construction last month merely reversed a 35 percent drop in March. The far more important single-family sector continued to languish, as starts there slumped by another 1.7 percent following a 2.5 percent drop in March. It was the twelfth consecutive monthly decline in this series, bringing the total to the second lowest level since the 1981/82 recession.



If there is one encouraging note in the data, building permits - an indicator of future construction - rose 4.9 percent, including a 4 percent rise in single-family permits. But before waxing enthusiastic that builders are finally preparing to ramp up construction, it should be noted that the April increase was concentrated in just one region - the Midwest. Moreover, it follows a dispiriting 3.9 percent drop in March and stands a full 35 percent below the level of a year ago. With inventories of single-family homes at 470 thousand units compared to a normal 350 thousand, it would take well over a year at the current sales pace to bring about an equilibrium in the housing market. Simply put, don't look for homebuilders to start breaking ground for more construction in the foreseeable future.

At the same time, don't expect the housing drag on the economy's growth rate to shrink from the 1.25 percentage point slice it has taken over the past two quarters. Keep in mind that residential construction outlays - the housing component of GDP - lags housing starts by two to three quarters. That's simply because it takes about eight months to complete a home after the actual start. Accordingly, outlays on construction materials, labor and other inputs are spread out over time, so the fall in starts in any given month sets in motion a prolonged period of lower spending. With single-family starts - which require more labor and material outlays per unit than multifamily starts - still declining through April, the aftershocks will be felt at least through the second and third quarters.

These aftershocks, of course, also include the secondary effects on household behavior stemming from the slide in home prices. The huge overhang of unsold homes will not only suppress construction activity for some time, it will also exert further downward pressures on sales prices. While the carnage so far has been substantial - with home prices falling between 10-15 percent over the past year depending on the measure used - many industry experts expect at least that much more of a drop before the real estate market stabilizes. With the total value of owner-occupied residential properties at \$20.1 trillion at the end of last year, that portends another \$2 trillion hit to household wealth. By itself, that would be expected to provoke some spending pullback, although the magnitude of the negative wealth effect is open to debate. But the pullback is being compounded by the increased difficulty of obtaining mortgage credit, which prevents homeowners from extracting some of their shrinking housing equity for spending purposes.

To be sure, the litany of proposed legislative measures in the pipeline aimed at relieving the mortgage burden of households should help, assuming some form of relief is put into effect soon. To the extent that they limit foreclosures and lower debt-servicing payments, both the housing market and household purchasing power would receive a boost. The longer it takes for signs of stability in housing to materialize, however, the greater the odds that the economy slips into a recession. For one, so much of the turmoil in the credit market is linked to the housing-induced losses in mortgage-related securities that continue to wreak havoc on bank balance sheets. For another, the longer the economy exhibits signs of weakness and vulnerability to external shocks, the more inclined are businesses to scale back operations.

As it is, industrial companies are rushing to catch up with the falloff in demand, slashing production and new orders, a possible prelude to larger payroll reductions than those already taken over the past four months. In contrast to this week's data on retail sales and overall housing starts, which surprised on the upside, the Federal reserve also reported a much sharper decline in industrial production last month than had been expected. With the sizeable 0.7 percent production cutback reported for April, the year-over-year increase has been lowered to just 0.2 percent. As the chart shows, when the growth in production has slid to that point, the economy was usually in or on the cusp of a recession. As we noted at the outset, no one can be sure if the nation has entered a recession, and the incoming batch of data is not imparting much clarity to the economic landscape. We suspect that conflicting data will be the order of the day over the next several months. Stay tuned.

