

WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 23, 2008

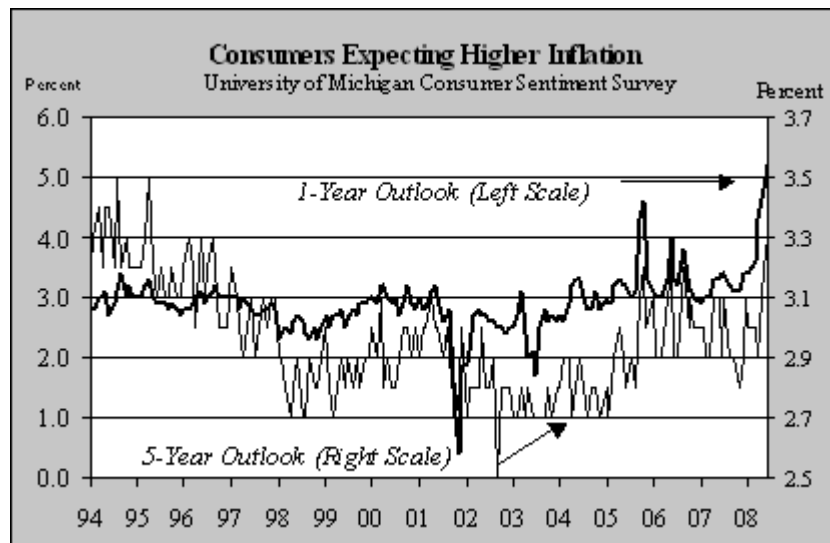
FINANCIAL INDICATORS				
INTEREST RATES	May 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.85%	1.84%	1.37%	4.86%
6-month Treasury bill	1.92	1.90	1.71	4.96
3-month LIBOR	2.65	2.70	2.91	5.36
2-year Treasury note	2.43	2.44	2.42	4.86
5-year Treasury note	3.13	3.11	3.18	4.79
10-year Treasury note	3.84	3.85	3.87	4.86
30-year Treasury bond	4.57	4.58	4.59	5.00
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.13	3.16	3.12	3.81
10-Year	3.86	3.90	3.93	4.05
30-Year	4.70	4.79	4.88	4.55
30-year fixed mortgage rate				
	5.98	6.01	6.03	6.37
15-year fixed mortgage rate				
	5.55	5.60	5.62	6.06
1-year adjustable rate				
	5.24	5.18	5.29	5.64
STOCK MARKET				
Dow Jones Industrials	12479.63	12986.80	12891.86	13507.28
S&P 500	1375.93	1425.35	1397.84	1515.73
NASDAQ	2444.67	2528.85	2422.93	2557.19
Commodities				
Gold (\$ per troy ounce)	925.80	899.90	889.70	655.30
Oil (\$ per barrel) - Crude Futures (NYMEX)	131.82	126.66	118.58	65.20
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Producer Price Index (April) - % change	0.2	1.1	0.3	0.8
Core Producer Prices (Apr.) - % change	0.4	0.2	0.5	0.7
Index of Leading Indicators (April) - % ch.	0.1	0.1	-0.3	0.2
Existing Home Sales (April) - 000s	4890	4940	5030	4940

Not since the 1970s has the Fed had to walk as delicate a tightrope as it is now. True, there are as many differences as there are similarities between today's environment and that of some three decades ago, when stagflation was the catchword of the day. But the parallels with that bygone era are striking - soaring oil prices, high consumer anxiety and sluggish economic growth - and they are having a significant influence on Fed policy. That influence is starkly evident in the minutes of the April 29-30 policy-setting meeting, released this week.

What the minutes made clear was that the Fed's task of navigating between the inflation-inducing surge in oil prices and the growth-dampening influence of a collapsing housing market and related credit crisis is fraught with dissension and uncertainty. The financial markets pounced on the main takeaway from the minutes, namely that the Fed is not likely to cut rates any further in the months ahead. Indeed, sentiment in the futures market took a turn in the other direction, pricing in greater odds that the next move will be to increase rates - probably before the end of the year. That, along with the persistent spike in oil prices to nosebleed heights topping \$130 a barrel abruptly reversed a solid two-month rally in the stock market, as the major equity indexes suffered their worst weekly loss since early February.

Underscoring the perception that the Fed has moved to the sidelines, the minutes acknowledged that the decision to cut the federal funds rate by 25 basis points at the meeting was a "close call". Two members

of the FOMC, in fact, voted for no change in rates, worrying that the cumulative 3.25 percentage point in cuts put in place since last September are sowing the seeds of runaway inflation. Of particular concern to the Fed hawks on the committee is the noticeable rise in inflation expectations that is starting to take hold. In the latest University of Michigan consumer sentiment survey, for example, household inflation expectations for the next twelve months jumped from 4.8 percent in April to 5.2 percent in early May, the highest since February 1982, when inflation was running at a disturbing 7.6 percent. No doubt, the jump in the 1-year outlook was skewed by the spike in oil prices that, if reversed, would likely bring down the near-term inflation forecast as rapidly as it increased it. But the long-term inflation outlook of households - from 5 to 10 years out - is also edging higher, reaching 3.3 percent in May, the highest level in more than a decade.



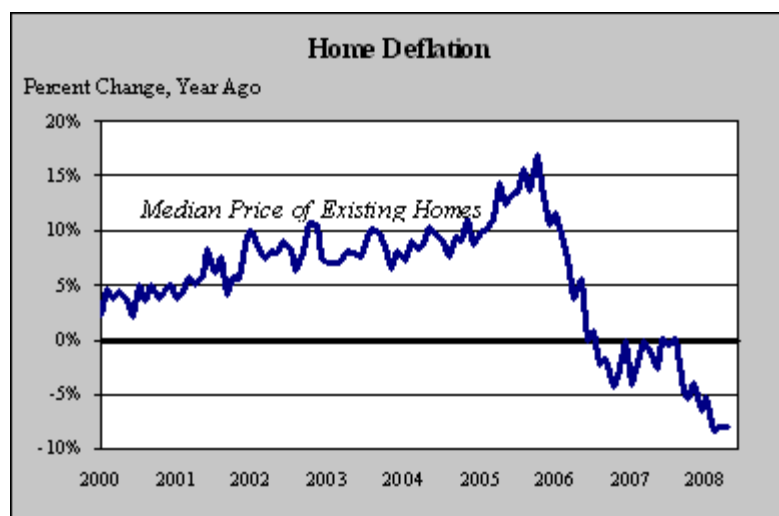
To be sure, the Fed has acknowledged the increased inflation threat several times throughout its eight-month rate-slashing campaign. But the dominant view has always been that moderating growth would ultimately tame price pressures and prevent higher oil prices from bleeding through to the broader price level. That perception is still held by the majority of Fed officials but with less conviction than before, largely due to the persistence of the oil-price surge, which is becoming embedded in household longer-term inflation expectations. As a result, the policy makers are being forced to make some concession with regards to the growth/inflation tradeoff. In the minutes, the Fed is now saying that it would require even more of an economic slowdown than is envisioned in the outlook to bring about another cut in rates.

That's no small concession, given that the Fed lowered its growth outlook for this year considerably compared to the forecast presented at the January meeting. As the table, extracted from the minutes, shows, the 2008 growth rate for GDP was lowered by roundly a full percentage point from the January forecast, and the unemployment rate was revised up by about 0.3 percentage point. Meanwhile, both the overall and core inflation rate were revised higher, with the overall rate bumped up by a full percentage point owing to the oil price spike during the three-month interval between FOMC meetings. Significantly, oil prices have increased by another \$20 a barrel since the April 29-30 meeting, which only solidifies the view that the Fed is unlikely to cut rates further unless the economy weakens considerably more than envisioned in the latest outlook

	(Percent)		
	2008	2009	2010
Central Tendency¹			
Growth of real GDP	0.3 to 1.2	2.0 to 2.8	2.6 to 3.1
<i>January projections</i>	<i>1.3 to 2.0</i>	<i>2.1 to 2.7</i>	<i>2.5 to 3.0</i>
Unemployment rate	5.5 to 5.7	5.2 to 5.7	4.9 to 5.5
<i>January projections</i>	<i>5.2 to 5.3</i>	<i>5.0 to 5.3</i>	<i>4.9 to 5.1</i>
PCE inflation	3.1 to 3.4	1.9 to 2.3	1.8 to 2.0
<i>January projections</i>	<i>2.1 to 2.4</i>	<i>1.7 to 2.0</i>	<i>1.7 to 2.0</i>
Core PCE inflation	2.2 to 2.4	1.9 to 2.1	1.7 to 1.9
<i>January projections</i>	<i>2.0 to 2.2</i>	<i>1.7 to 2.0</i>	<i>1.7 to 1.9</i>

From our lens, it appears that the Fed is willing to tolerate even a quarter of outright negative growth without pulling the rate-cutting trigger again. What would change their attitude is not just a quarterly contraction in GDP but a realization of the "adverse feedback loop" that seems to present the greatest downside risk to the economy. In this scenario, the credit crisis spawned by the housing meltdown creates more weakness in the economy, which, in turn, aggravates the credit crisis and sets in motion the vicious loop that sends the economy into a downward spiral. According to the latest minutes, Fed officials seem to believe that strains in the credit market have eased somewhat, thus reducing the risk that this adverse feedback loop will be set in motion. On this score, there is some justification for the Fed's optimism, as some of the extreme distortions in the credit market has unwound in recent months.

But the underlying source of the credit-market turmoil, the housing meltdown, is far from out of the woods. Indeed, this week's figures on home re-sales strongly indicates that the housing collapse is still in full swing. According to the National Association of Realtors, sales of existing homes fell by another 1 percent in April and, at an annual rate of 4.890 million units, stand almost 33 percent below the sales level of a year ago. And, if the inflation rate is a growing concern to the Fed, just the opposite problem is plaguing homeowners trying to sell their property. To them, the issue is severe deflation, as median prices of homes on the secondary market are plummeting like a stone. In March, the median sales price fell 8 percent from a year ago, close to the record 8.4 percent drop seen in February.



If there is an "adverse feedback loop", it is probably being felt more in the housing market than anywhere else. The dynamic here is a microcosm of the economy-wide loop feared by the Fed - but also includes an added dimension. Like the broader credit crisis afflicting virtually all households and businesses, the housing credit crunch is particularly acute, if only because it all started with the subprime debacle and the lion's share of the write-downs that are decimating the balance sheets of banks and other institutions stems from soured mortgage loans. Hence, the biggest squeeze on credit is occurring, not surprisingly, in the mortgage market. But the added dimension reinforcing the housing collapse is the adverse feedback loop linking buyers and sellers. Simply put, sellers are lowering prices in an effort to spur sales but buyers are staying out of the market in anticipation of still lower prices in the futures.

Hence, just as a galloping inflation environment encourages people to expect even higher prices, prompting a "buy in advance" type of behavior, the virulent deflation in the housing market is encouraging people to expect still lower prices and prompting a "wait-and-see" attitude. This tug-of-war will eventually end when an equilibrium price level -i.e., one that brings supply and demand into balance - is reached. But right now, the imbalance still greatly favors buyers. In April, the inventory of unsold homes stood at an unsightly 4.6 million units, which equals and 11.2 months supply of homes on the market at the current sales pace - a record. What's more, that mountain of inventory is destined to rise even further, even if sales stabilize at current levels. The reason: depending on who's counting, between 2-3 million homes are heading for foreclosure over the next year or two.

That's why it's vital for the housing bill currently wending its way through Congress to be passed in close to its current form. The bill, designed to potentially help as many as 500,000 homeowners who are struggling to avoid foreclosure, would be a least a first step in putting a floor under falling home prices and stabilizing the free-falling housing market. To be sure, the administration has taken steps to help ease stresses on struggling mortgage borrowers that have had some success, including relaxing eligibility standards for FHA loans. But these steps are not sufficient to deal with the scope of the subprime mortgage problem. The bill under negotiation in Congress would attempt to provide assistance to a broader array of distressed mortgage borrowers by providing up to \$300 billion in federally insured loans to refinance mortgages headed for foreclosure. The White House has threatened to veto the bill on the grounds that it would bail out borrowers who acted irresponsibly at taxpayers' expense that CBO estimates to in the ballpark of \$2 to \$3 billion.

This is a complicated issue. Opponents of government relief for mortgage borrowers in distress argue -- correctly in some cases-- that borrowers acted irresponsibly and need to bear the consequences of their

own actions. Therefore, they should not benefit from a bailout at taxpayer expense. Proponents of government intervention in the mortgage market argue --also correctly in many cases-- that this is a classic case of market failure and that many borrowers were victims of an under-supervised and poorly regulated mortgage market. By failing to supervise or regulate the mortgage market appropriately, the government bears significant responsibility for the subprime mess and, therefore, should provide financial assistance to borrowers who fell prey to widespread unscrupulous practices.

There is no perfect solution to this mess. Under any relief package, some irresponsible borrowers will benefit and some victimized borrowers will go without assistance. The objective should be to help as many of the latter as possible with an understanding that some of the former are going to slip through the cracks despite best intentions. At stake is more than just the moral hazard issue, as the increasing risks posed by the mounting tide of foreclosures are the root of the housing and credit-market stresses that threaten the health of the overall economy.