

WEEKLY ECONOMIC COMMENTARY – WEEK OF MAY 30, 2008

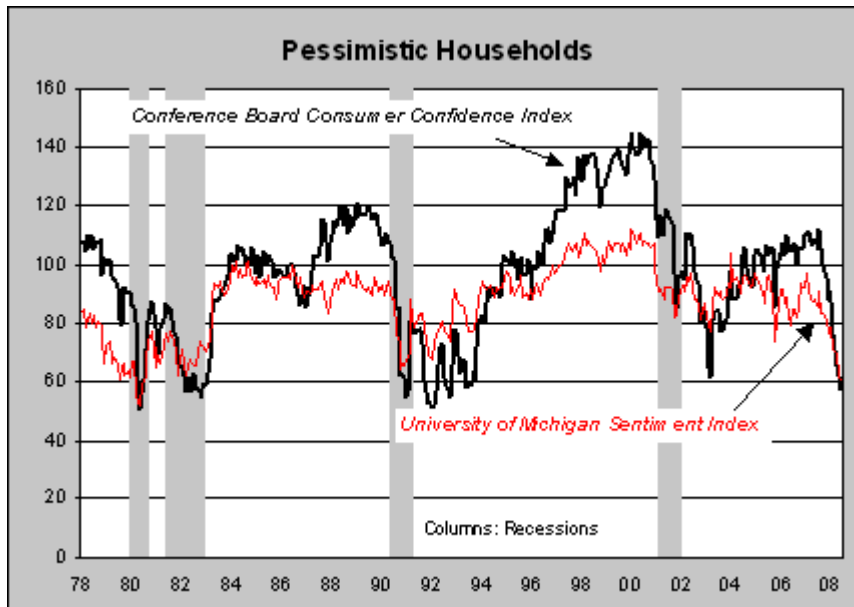
INTEREST RATES	May 30	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.89%	1.85%	1.49%	4.87%
6-month Treasury bill	2.01	1.92	1.69	4.97
3-month LIBOR	2.68	2.65	2.77	5.36
2-year Treasury note	2.64	2.43	2.45	4.97
5-year Treasury note	3.41	3.13	3.17	4.92
10-year Treasury note	4.05	3.84	3.86	4.95
30-year Treasury bond	4.72	4.57	4.58	5.06
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.14	3.13	3.20	3.82
10-Year	3.87	3.86	4.03	4.03
30-Year	4.71	4.70	4.90	4.55
30-year fixed mortgage rate				
	6.08	5.98	6.06	6.42
15-year fixed mortgage rate				
	5.66	5.55	5.59	6.12
1-year adjustable rate				
	5.22	5.24	5.29	5.57
STOCK MARKET				
Dow Jones Industrials	12638.32	12479.63	13058.20	13668.11
S&P 500	1400.38	1375.93	1413.90	1536.34
NASDAQ	2522.66	2444.67	2476.99	2613.92
Commodities				
Gold (\$ per troy ounce)	891.50	925.80	858.00	676.90
Oil (\$ per barrel) - Crude Futures (NYMerc)	127.56	131.82	116.29	65.08
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (April) - 000s of units	526.0	509.0	572.0	572.0
Consumer Confidence (May) - Index	57.2	62.3	65.9	73.3
Durable Goods Orders (April) - % change	-0.5	-0.3	1.1	-0.1
Personal Income (April) - % change	0.2	0.4	0.5	0.3
Personal Outlays (April) - % change	0.2	0.4	0.1	0.4

With gas prices approaching a national average of \$4 a gallon, home prices still plummeting and credit harder to get, households can be excused for feeling ornery. After all, it cost almost \$80 to fill up Old Bessie at the pump, which certainly takes the fun out of driving the family to an amusement park. Nor is it all that pleasant to stay home and be constantly reminded that your property is losing value by the day. Not only does that deflate any sense of financial well-being, it also erodes the equity that can be extracted to support spending. The latter, of course, would still be sustained if paychecks were rising. But like the other spirit-dampening forces, the job market is weakening and further undermining household purchasing power.

Given these powerful headwinds, it comes as no surprise that the mood of households is sinking like the Titanic. According to the Conference Board, consumer confidence sank to a 16-year low in May, reinforcing the dismal attitude conveyed by the University of Michigan Survey. Nor are consumers upbeat regarding the future. The expectations component of the Conference Board's index, which measures attitudes about conditions six months down the road, declined to the lowest level since 1973. Not coincidentally, back then households were also hammered by spiraling energy prices, a key feature of the "stagflation" environment that engulfed the nation for a good part of the ensuing decade.

Interestingly, May is the third consecutive month that the Conference Board's confidence gauge was

below the University of Michigan's index. Ordinarily, the Conference Board's index is higher, often much higher, and only slips below the University of Michigan index when the economy is already deep into a recession. As the chart shows, this has been a consistent pattern spanning the last four recessions. While history does not always repeat, it often rhymes. Many economists have been asserting for some time that the eleventh cyclical downturn of the postwar period is already underway, with the likely start back in December when fifty two consecutive months of nonfarm payroll growth came to an end.



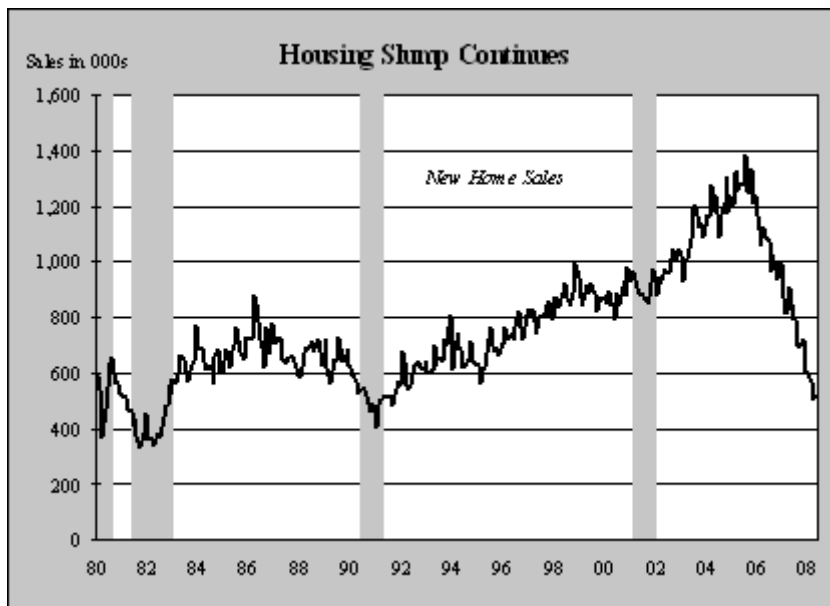
But the broad statistical support that would support the recession claim remains elusive. For example, real gross domestic product - the broadest measure of the economy's performance - continues to grow. Indeed, this week's release of revised figures for the first quarter shows that GDP actually staged a stronger increase than was originally reported a month ago - 0.9 percent versus 0.6 percent. The upward revision was widely expected based on new monthly data released since the original estimate was made. That's especially the case for the monthly trade data, which confirmed that net exports provided more lift to the economy than initially reported. The question is, can the nation's improving trade position provide enough oomph to keep the economy afloat, offsetting the drag from powerful domestic depressants.

No doubt, the forces underscoring the net export boost should remain in place for the remainder of the year. The weakening dollar has made U.S. goods cheaper in the global marketplace, reinforcing the strong demand associated with the still-robust growth rate among most of our trading partners. While the greenback has shown signs of stabilizing in recent weeks, and may even rally in coming months, the precipitous drop over the past several years has provided a considerable price advantage for American goods that should stimulate exports for some time to come. Still, the export boost will not be enough to offset the drag from domestic headwinds. Indeed, the trade bulwark is already fading.

For example, net exports contributed 1.28 percentage points to the economy's average growth rate in the second through fourth quarters of last year, more than offsetting the 0.98 percentage point drag coming from the plunge in residential spending. But the housing collapse has now gotten the better of that tradeoff. In the fourth quarter of 2007, the decline in residential outlays subtracted 1.25-percentage point from GDP, more than offsetting the 1.02 percentage point boost from net exports. In the just-reported revised first-quarter data, the tradeoff was skewed even further in favor of the housing drag. During the period, the growth haircut associated with declining residential outlays was 1.17 percentage points, dwarfing the 0.80 percentage point lift imparted by stronger net exports.

Any hope that the housing drag would lessen over the next quarter or two is rapidly fading, thanks to the ongoing dismal reports from the industry. This week was no exception. First, the widely followed S&P/Case-Shiller house price index revealed that residential property values are declining at an accelerating pace. In the first quarter, prices in 20 metropolitan areas plunged 14.1 percent below the level of a year ago, the largest decline in the 20-year history of the index. The decline in values is as broadly based as it is deep, affecting nineteen of the twenty areas covered in the survey. Only one, Charlotte, North Carolina, managed to retain higher prices compared to a year ago, but even there the appreciation is rapidly evaporating. In March, Charlotte home values increased a mere 0.8 percent over the past twelve months, a sharp falloff from the 7.4 percent rate of appreciation over the twelve months ending March 2007.

At some point, prices will fall enough to coax homebuyers back into the market. That point, however, still hasn't been reached. True, the second housing report this week - for new home sales - did show a slight increase in April from the month before. But the slim 3 percent April gain still fell short of expectations because the March sales figure was revised down from 526 thousand to 509 thousand. If the March total were left alone, the April tally would have shown no gain. As it is, the sales pace is now running very close to the abysmally low levels reached during the last housing meltdown in 1990/91. In all likelihood, the news in the housing industry is destined to get worse before turning the corner.



For one, the inventory of unsold homes stands at a hefty 456 thousand units. While that is about 17 percent lower than the peak reached a year ago, it towers above the 300 thousand units considered normal for the industry. At the current sales pace, it would take 10.6 months to clear the market of unsold homes, the second longest since 1981. Looked at another way, the number of months that a median home stayed on the market before getting sold rose to 8 months in April from 7.5 months in March. That too was the longest since 1983. The longer it takes to sell a home, the greater the pressure on home builders to lower prices. Making matters worse, fully 40 percent of the new homes for sale in April consisted of completed homes, the highest share since the severe 1981/82 recession. Completed homes do not require further construction, which means that the workers involved in the building process are getting laid off. Just as important, those unsold completed homes are putting a severe financing strain on contractors, putting even more pressure on them to slash prices.

In this environment, it would be highly unlikely for builders to step up construction anytime soon, indicating that the retrenchment in residential outlays will continue in the quarters ahead, subtracting at

least as much as the roundly 1 percentage point from GDP as has been the case over the past year. What's more, when builders lower prices on new homes, the ripple effects are felt throughout the housing market, embracing existing homeowners who are struggling to sell their property. That's why industry experts believe the 14.1 percent home-price decline over the past twelve months still has a ways to go. Whether we are half way towards the bottom or slightly closer to the end is really a moot issue. The ongoing deflation in housing values is making a significant dent in household wealth, which will further undercut the waning support for consumer spending. Assuming the Case-Shiller measure accurately measures the loss in residential property values, households suffered a reduction in housing wealth of more than \$1 trillion in the first quarter.

That's a big bite out of assets, which also took a hit from declining stock values during the first quarter. So far in the second quarter, equities are up about 6 percent, offsetting a big chunk of the ongoing erosion in property values. But even if household assets have a neutral impact on spending decisions in the current quarter, it's doubtful that consumers will provide much, if any, lift to the economy during the period. Indeed, following a 1 percent unrevised increase in real consumption during the first quarter, consumer spending was essentially flat in April, according to Friday's income and spending report released by the Commerce Department. Both incomes and outlays increased 0.2 percent during the month, all of which was wiped out by higher prices. If not for the accelerated tax rebates sent out in April, the income side of the ledger would have fared considerably worse. That's because wages and salaries fell 0.2 percent, the first drop in a year, reflecting four months of net job losses that are poised to continue in the months ahead.

If there is any silver lining among the dark clouds overhanging the economy, it is that businesses are not retrenching as much as feared - at least not yet. Indeed, there are signs that the pullback in investment outlays may be nearing an end, setting the stage for a modest pickup over the second half of the year. A key gauge of future capital spending - nondefense capital goods orders less aircraft - jumped by 4.2 percent in April, only the third monthly gain in excess of 4 percent in nearly three years. Of course, the April jump follows three months of declines, so it would be premature to read too much into a one-month rebound. Still, the increase in new orders was accompanied by a solid increase in shipments, which now stand 2.3 percent above the first quarter average. Shipments are considered to be a good proxy for actual capital spending, so there's a chance that the 0.9 percent contraction in such spending during the first quarter will be reversed in the second. If that's the case, there is also a good chance that second-quarter GDP will register on the positive side of the ledger, further challenging the assertion that the economy is mired in a recession.

