

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 6, 2008

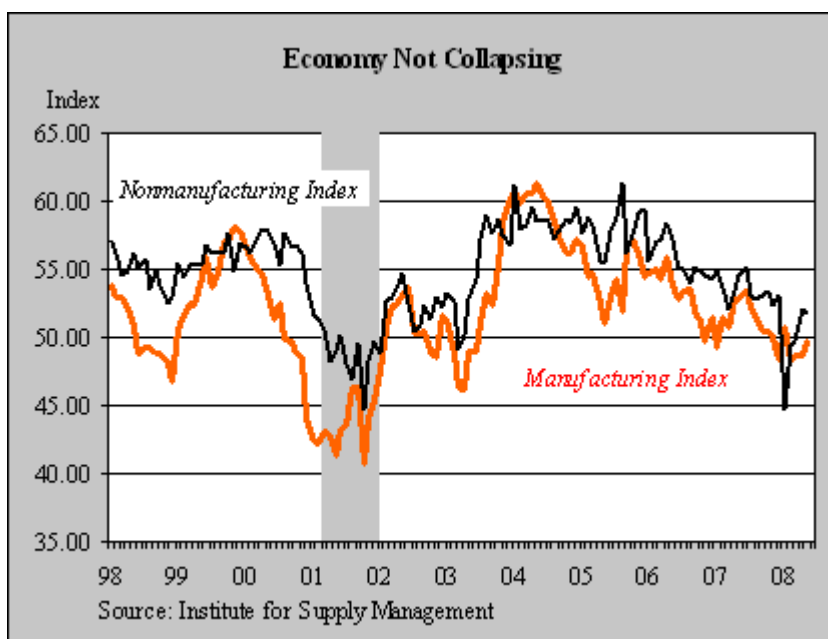
FINANCIAL INDICATORS				
INTEREST RATES	June 6	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.87%	1.89%	1.68%	4.77%
6-month Treasury bill	1.98	2.01	1.74	4.92
3-month LIBOR	2.70	2.68	2.68	5.36
2-year Treasury note	2.38	2.64	2.24	5.00
5-year Treasury note	3.19	3.41	2.96	5.05
10-year Treasury note	3.92	4.05	3.77	5.11
30-year Treasury bond	4.64	4.72	4.52	5.22
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.21	3.14	3.25	3.87
10-Year	2.96	3.87	4.02	4.11
30-Year	4.75	4.71	4.89	4.61
30-year fixed mortgage rate				
	6.09	6.08	6.05	6.53
15-year fixed mortgage rate				
	5.65	5.66	5.60	6.22
1-year adjustable rate				
	5.06	5.22	5.29	5.65
STOCK MARKET				
Dow Jones Industrial	12209.81	12638.32	12745.88	13424.39
S&P 500	1360.68	1400.38	1388.28	1507.67
NASDAQ	2474.56	2522.66	2445.52	2573.54
Commodities				
Gold (\$ per troy ounce)	899.00	891.50	885.80	650.30
Oil (\$ per barrel) - Crude Futures (NYMEX)	137.90	127.56	126.09	64.76
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (May) - Index	49.6	48.6	48.6	49.0
ISM Non-Manufacturing Index (May)	51.7	50.9	52.2	50.1
Nonfarm Payrolls (May) - change in 000s	-49	-28	-88	47
Unemployment Rate (May) - Percent	5.5	5.0	5.1	5.1
Average Hourly Earnings (May) - % change	0.3	0.1	0.3	0.3

Is the worst over? That's certainly not a question that would have been asked a few months ago, when the still-intensifying credit crisis and housing collapse raised the odds of a severe economic downturn. At the time, economists and other pundits were firmly convinced that the Fed had its work cut out for it, possibly slashing interest rates back to the ultra-low levels set in 2003 and 2004, when the economy was still fitfully emerging from the 2001 recession and deflation was more on the radar screen than inflation. But hardly anyone now is expecting the Fed to push the federal funds rate back to the 1 percent trough reached four years ago.

Instead, the consensus view is that the policy makers will keep the rate at its current 2 percent level at least through the June 29-30 FOMC meeting, and probably beyond. The futures market, in fact, had been pricing in more than a 50-50 chance that the next move will be to the upside, with the trigger pulled towards the end of the year. At least that was the bet until Friday's abysmal jobs report, which featured a meteoric jump in the unemployment rate. If the rate of joblessness continues on its upward path, reaching 6 percent within a few months, the odds of a rate hike anytime soon will diminish to slim or none. Still, while the jump in the jobless rate combined with another spike in oil prices rattled the financial markets on Friday, a slew of indicators released in recent weeks suggest that the economy is holding up better than expected.

Make no mistake. None of the data portray a picture of economic health. But collectively, they suggest that the slowdown is not morphing into a severe recession - an understandable fear sparked by the headline-grabbing housing collapse and credit-market turmoil. For example, the manufacturing sector continues to be battered by a housing slump and a steep downturn in auto sales that is shutting down auto production. But strong exports are providing a solid buffer to these headwinds, and demand for productivity-enhancing machinery and equipment is sustaining investment spending. Hence, the index of manufacturing activity, as compiled by the Institute for Supply Management, edged up by a point in May - a stronger than expected reading - reaching 49.6. That's still a shade below the 50 threshold, indicating a still-contracting sector, but the direction and the internal dynamics of the index point to stabilization, not an industrial sector that is falling off a cliff.

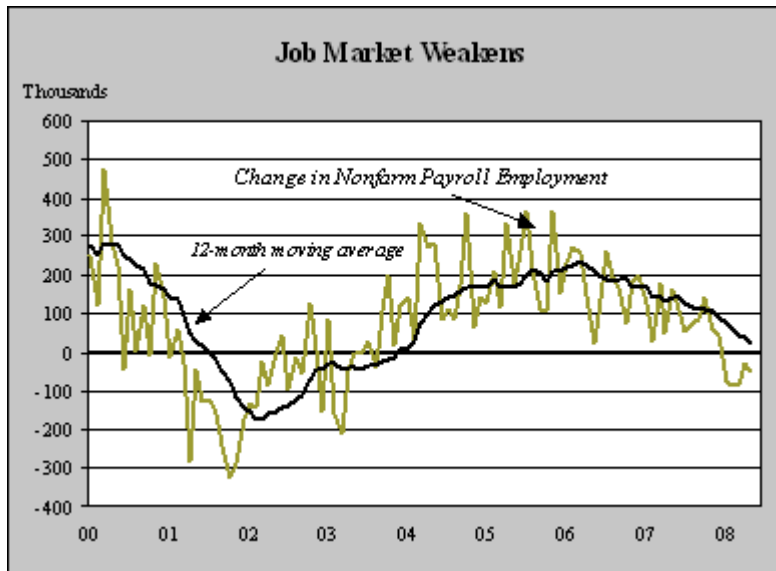
Likewise, the much broader - accounting for more than 60 percent of total economic activity - service sector is holding up quite well. The companion ISM index of non-manufacturing activity released this week showed an expansionary reading of 51.7 in May. This index has recouped most of the sharp drop incurred earlier in the year, and has remained above the 50 threshold for the second consecutive month. The most disturbing aspect of both the manufacturing and service-sector readings compiled by the ISM is the worrisome surge in prices that businesses are paying for supplies and materials. While this bodes poorly for profit margins - adding to downside risks facing the economy - it also spices up the inflation debate, spurring expectations that the Fed may rescind its rate cuts later this year.



Simply put, the Fed is being pulled in opposite directions, reflecting the conflicting goals inherent in its dual mandate of sustaining maximum employment and stable prices. Needless to say, expectations as to the next policy move will fluctuate according to perceptions of the relative risks of inflation versus growth. With the economy showing signs of stabilizing in recent weeks, inflation risks gained the upper hand, pointing to an end of the Fed's easing cycle. This week's reports from retailers indicating that shoppers spent more of their rebate checks in May than expected reinforced the perception that the economy is holding its own. Households received about half of the \$108 billion in rebates in May, and the remainder should be disbursed by early next month. If the May response by consumers extends into June and July, the economy should avoid an outright contraction in GDP in both the second and third quarters, adding fuel to the debate as to whether or not a recession is actually unfolding.

But if Friday's jobs report is any indication, it would be a mistake to count out the recession scenario.

Keep in mind that most economists believe the rebate checks will provide only a temporary boost to spending, not a sustainable thrust that will rejuvenate the expansion. Once the rebates are spent, households will revert to a spending pattern that is consistent with job and income prospects as well as how their balance sheets are shaping up. On both counts, the future does not look promising. First the jobs and income picture. According to Friday's Labor Department report, workers took it on the chin last month. Nonfarm payrolls fell by 49 thousand, marking the fifth consecutive monthly decline. In the private sector, the string of job losses extended to six months. The economy has never avoided a recession when the job market has eroded as much as it has since late last year.



But it was not the loss of jobs alone that heightened recession fears on Friday. In fact, the 49 thousand drop in nonfarm payrolls was slightly less than expected and was actually milder than the 69 thousand average decline over the previous four months. What sparked fear and confusion about the economy's fate - and brought immediate calls for a second fiscal stimulus package from Barney Frank - was the surge in the unemployment rate. The 0.5 percent jump to 5.5 percent was the sharpest monthly increase in 22 years, and lifted the jobless rate to its highest level since October 2004. The rate has now increased by 1.1 percentage points from its 4.4 percent low set last March, and an increase of this magnitude has always been associated with a recession.

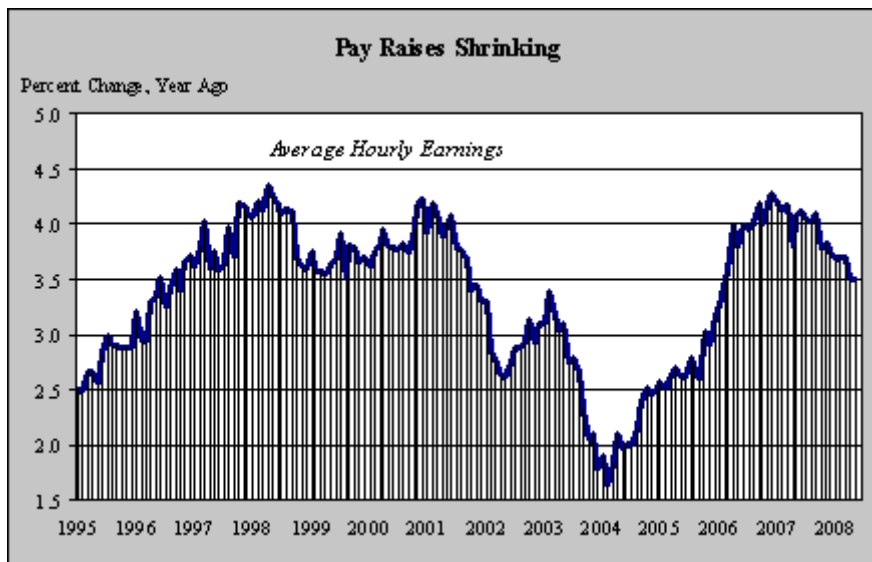
To be sure, most economists will tell you that the payroll data are more reflective of labor market trends than the unemployment rate, which is derived from a separate - and much smaller - survey of households. What's more, a closer look at the unemployment rate reveals that most of the increase was among teenagers, where the unemployment rate surged by 3 percentage points, and college-aged adults. The unemployment rate among 20-24 year olds increased from 8.9 to 10.4 percent and among the entire 16-24 year group it surged from 11 to 13 percent. Many skeptics claim that this is an aberration, related to a typical seasonal rush of students seeking summer jobs that were not appropriately captured by the seasonal adjustment factors. Since the survey period extended much later in the month than usual, that argument probably has some credibility.

But it would be a mistake to attribute the weak employment report entirely to a surge in school-age job seekers that either couldn't find work or fell through the statistical cracks. A lot of gainfully employed workers also lost their jobs. For example, a cursory analysis of state unemployment insurance records shows that job losers as a percentage of the labor force rose from 2.6 percent to 2.8 percent last month, accounting for one-half of the total unemployment rate. Given what we know about the economy - with huge layoffs in the auto, airlines, housing and financial services industries - it would be hard to believe

that the increase in the jobless rate is merely a statistical artifact related to a bulge in the unemployed student population. Yes, the half percentage point jump in May probably overstated the month's weakness. At the same time, however, the jobless rate held unaccountably steady over the previous four months, when payrolls were steadily declining. Hence, the jump in May could just as well have reflected a catching up of this statistic to where it should have been all along.

We suspect that the truth lies somewhere in the middle, but the trend is clear. The labor market is weakening, and the weakness is spreading to virtually all major categories of workers. Just about the only sector that is experiencing stronger job growth is health and education, where employment grew by 54 thousand in May following increases of 61 thousand and 44 thousand in April and March, respectively. But employment in this sector is responsive more to demographics than cyclical developments. Indeed, the pattern in recent decades is that job prospects in health and education tend to strengthen during recessions, providing a bulwark against job losses elsewhere. Hence, not only are the broad job trends following a typical recession pattern, so too are the internal dynamics of the workforce.

Whether or not the monthly employment figures overstate or understate the strength of the labor market, the bottom line for consumer spending is how fast paychecks are growing. On this score, the outlook is grim. Worker pay is just barely keeping up with inflation, as average hourly earnings have increased by 3.5 percent over the past year, including a 0.3 percent rise in May. With personal savings at rock bottom levels, and household wealth being eroded by sinking home prices, the pace of wage gains is not sufficient to keep households flocking to shopping centers and malls. Spending from the tax rebates may be the last gasp effort of consumers to maintain living standards, but that effort will fade unless the job market starts to pick up.



Simply put, the economy has displayed a remarkable degree of resilience in the face of powerful headwinds associated with the housing meltdown and credit crunch. But time may be running out if households do not have the wherewithal to sustain spending in the months ahead. The modest drop in payrolls in May is encouraging, which, along with some other recent positive readings, may suggest that the worst of the economy's malaise may be behind us. But the spike in joblessness tells another story entirely. Importantly, the astonishing \$11 surge in oil prices on Friday highlights the pressure being put on household budgets from escalating energy costs. The oil spike hammered the stock market, and the Dow Industrial average suffered a huge 394 point drop on Friday to end the week on a deeply sour note. If this downbeat sentiment carries into next week, we suspect that few pundits will be talking about when the Federal Reserve will be raising rates.

