

WEEKLY ECONOMIC COMMENTARY – WEEK OF JUNE 13, 2008

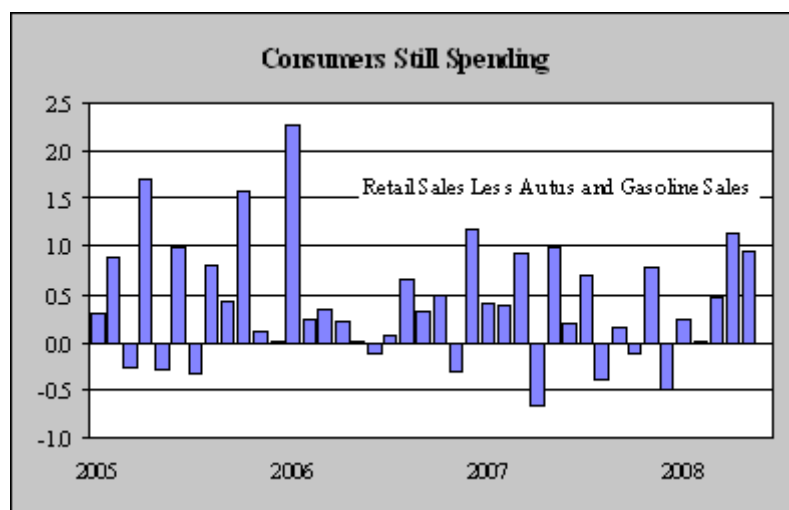
FINANCIAL INDICATORS				
INTEREST RATES	June 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.97%	1.87%	1.84%	4.55%
6-month Treasury bill	2.29	1.98	1.90	4.85
3-month LIBOR	2.81	2.70	2.70	5.36
2-year Treasury note	3.04	2.38	2.44	5.02
5-year Treasury note	3.73	3.19	3.11	5.08
10-year Treasury note	4.26	3.92	3.85	5.16
30-year Treasury bond	4.79	4.64	4.58	5.26
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.23	3.21	3.16	4.01
10-Year	4.01	2.96	3.90	4.25
30-Year	4.80	4.75	4.79	4.73
30-year fixed mortgage rate				
	6.32	6.09	6.01	6.74
15-year fixed mortgage rate				
	5.93	5.65	5.60	6.43
1-year adjustable rate				
	5.09	5.06	5.18	5.75
STOCK MARKET				
Dow Jones Industrial	12307.35	12209.81	12986.80	13639.40
S&P 500	1360.03	1360.68	1425.35	1532.90
NASDAQ	2454.30	2474.56	2528.85	2626.71
Commodities				
Gold (\$ per troy ounce)	873.10	899.00	899.90	658.70
Oil (\$ per barrel) - Crude Futures (NYMEX)	134.81	137.90	126.66	68.00
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Trade Deficit (April) - mns of \$s	60900	56491	60572	58879
Retail Sales (May) - % change	1.0	0.4	0.5	0.2
Business Inventories (April) - % change	0.5	0.2	0.4	0.5
Consumer Price Index (May) - % change	0.6	0.2	0.3	0.3
Core CPI (excl. Food & Energy) - % change	2.0	0.1	0.2	0.2

Spend your rebates here! Economists greeted those ubiquitous signs and ads, which seemed to pop up everywhere in recent months, with scorn and derision. And for good reason. By all accounts, households should be in no mood to spend their highly anticipated largesse from Washington. Besieged with a mountain of debt, sparse savings, a housing-deflating wealth shrinkage, soaring gasoline bills and faced with a weakening job market, the American consumer would seem more inclined to be frugal than spend-thrifty. But households have demonstrated an ornery streak throughout the expansion, and this week's reading on their spending habits during May once again highlighted a stubborn refusal to zipper up their wallets.

According to the Commerce Department, retail sales increased by more than double expectations last month, and the previous estimates for March and April were revised up significantly. Hence, not only will the first quarter's consumer spending pace be adjusted upward again in the next GDP report, but if the advance estimates for April and May hold up, the second quarter will be riding considerably more momentum than thought possible a few weeks ago. Indeed, many respected forecasters had penciled in a negative quarter for the period, adding statistical heft to the argument that the economy had slipped into recession waters.

But with the surprising 1 percent jump in retail sales in May and the upward revisions to March and April, which now show increases of 0.5 and 0.4 percent, respectively, it would take a lot of depressants elsewhere to push the economy into negative territory during the second quarter. Keep in mind that consumer spending accounts for more than two-thirds of total economic activity, and a cursory reading of the remaining one-third outside of housing does not yield enough weakness to bring that about. True, the retail sales data are not adjusted for inflation, and higher prices, particularly for food and energy, are gobbling up a big chunk of the dollars spent by consumers. But the remarkable aspect of the latest retail sales report is the breadth as well as the size of the spending gain.

For example, spending on everything except autos and gasoline increased by a solid 1.0 percent in May following a 1.1 percent gain in April - the sharpest two-month increase in more five years. This measure, along with another that strips out building materials, approximates the basket of goods used by the Commerce Department in calculating consumer spending for the GDP accounts. Barring a major setback in June, the gains made in April and May indicate that the pace of real consumer spending will reach 1 percent in the second quarter, enough to keep GDP on a solid growth track. Given the powerful headwinds noted at the outset that are buffeting households, the question is, what is fueling consumer purchasing power? The most obvious catalyst is that object of scorn and derision also highlighted at the outset, namely those rebate checks retailers hoped to siphon out of households wallets are soon as they were received.



Clearly, the rebates did have an effect. If households spent just 10 percent of the roughly \$55 billion mailed out in May, that alone would be enough to add more than 1 percent to the \$385 billion sales total at retail stores during the month. What's more, spending should receive at least as much of a lift from the remaining \$50 billion or so in rebates that will reach household bank accounts by early July. So, not only is the fiscal stimulus working its magic in the second quarter, it should also have a visible impact on the third, as the period will start off on a significantly higher spending base than would be the case without the rebate checks.

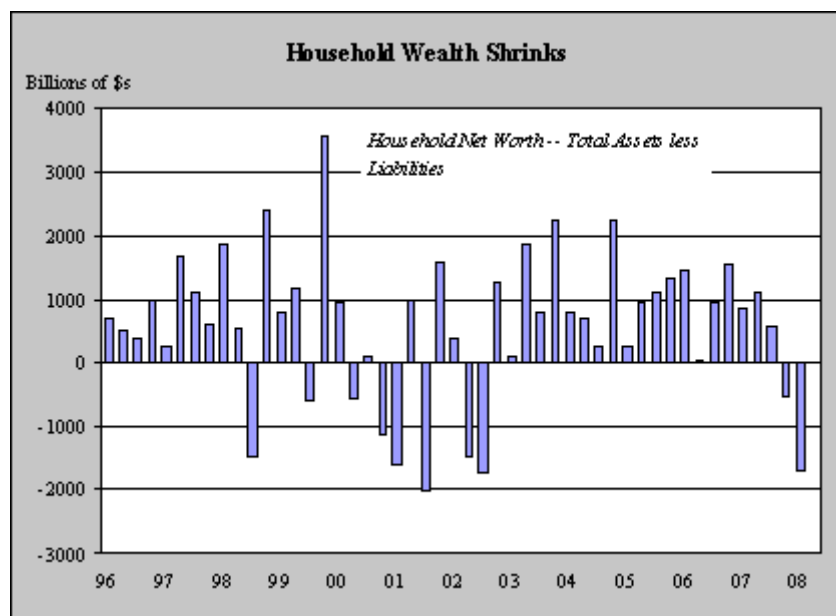
To be sure, many skeptics claim that the rebate checks are doing nothing more than shifting the deck chairs around on the Titanic - moving up growth into the second quarter while pushing out the inevitable weakness that is poised to occur in the second half of the year. After all, the rebates hardly change the fundamentals underpinning consumers and the broader economy. If we can make an analogy with the weather, the economy can be viewed as being in the eye of a hurricane. The front end hit with a vengeance as the housing collapse combined with the credit crunch coalesced quickly to short-circuit what had been several years of above-trend growth, producing two-quarters of near stagnation. The rebate checks and aggressive Federal Reserve action - in which short-term rates were slashed from 5.25

percent to 2 percent in a mere four month period - provided some clearing in the darkened economic skies, but the back end of the hurricane may yet hit hard.

What the pessimists believe is that the negative influences present before the rebate checks were mailed out will soon reassert themselves once the temporary uplift to spending fades into the background. First among these influences is the surge in fuel prices, which is taking an ever-larger toll on household budgets negating obvious efforts to sustain living standards. Each \$1 rise in a gallon of gasoline translates into a \$120 billion hit to discretionary incomes over a year's time. So far this year, the price at the pump has already surged beyond that threshold, and the prospect of a decline much below the \$4 nationwide average reached last week is dim - at least in the near future. While households have become much more energy efficient compared to their usage during the oil crises of the 1970s and early 1980s, the fraction of spending devoted to fuel consumption has already doubled over the past year.

What's more, the surge in fuel costs will slam the productive capacity of the U.S. auto and aircraft industries in the second half of 2008. The Big Three have already pre-announced sharp production cutbacks in net motor vehicle output and U.S. airlines have announced cutbacks in aircraft orders, with attendant knock-on effects that will hammer the suppliers to these two key industries. Hence, industrial production will be further depressed by the retrenchment in orders for steel, rubber, plastic, aluminum and ancillary products used in the manufacturing of autos and aircrafts. Needless to say, these manufacturing companies will continue to trim payrolls, reinforcing the economy-wide job losses seen over the past five months. On Thursday, U.S. Airways announced that it would slash 1700 jobs and cut capacity by 8 percent in response to the growing fuel crisis.

The second influence that will weigh on household spending propensities is the ongoing housing depression that is showing no signs of letting up. Yes, the plunge in home sales may become less severe in coming months, thanks to improving affordability. But with the inventory of unsold homes still at a burdensome 10.6 months supply and surging foreclosures adding to the burgeoning list of homes for sale, the downside pressure on housing prices will persist for some time to come. That portends continuing erosion in household net worth, which has now shriveled to the tune of \$2.2 trillion over the last two quarters. Estimates vary as to the impact such a wealth erosion has on spending, but the latest studies indicate that about 5 cents of every dollar of evaporating net worth is pulled out of the spending stream. That would translate into a spending retrenchment of roughly \$100 billion, more than offsetting the boost imparted by the tax rebates.



Putting it all together, it is hard to visualize the Federal Reserve rescinding its interest rate cuts any time soon, despite the growing expectations on Wall Street that such a move is just around the corner. Indeed, the futures market is pricing in a rate hike as early as the August 5 policy-setting meeting, which would mark one of the fastest turnabouts in Fed policy ever. To be sure, monetary officials are doing nothing to discourage such speculation. That's particularly the case with Fed chairman Bernanke, who has sounded increasingly hawkish in recent public appearances. In a Boston speech on June 9, Bernanke was adamant in his conviction that the Fed would "strongly resist an erosion of longer-term inflation expectations, as an unanchoring of those expectations would be destabilizing for growth as well as for inflation." That speech was one of the most hawkish the chairman has delivered since taking office and was primarily responsible for sending market interest rates sharply higher over the past week, with the two-year Treasury yield jumping by more than half a percentage point.

No doubt, Bernanke as well as the other hawkish-sounding Fed officials are responding to the persistent increase in oil and other commodity prices as well as to the slide in the dollar, which has also contributed to the surge in headline inflation in recent months. From our lens, however, the purpose of these statements is to appease the inflation hawks and to keep inflation expectations in check. They are not a prelude to action, particularly rate-hiking actions, that would probably do more harm than good, given the still-fragile condition of the economy and financial markets. The Fed may feel emboldened by some recent upbeat economic data, but it is far from convinced that recession risks have been overwhelmed by the inflation risks.

Indeed, while consumers may be spending more than expected, they are hardly in an upbeat mood. According to the latest Reuters/University of Michigan sentiment survey, released Friday, household spirits have sunk to the lowest level since May 1980 in early June. Simply put, they may be spending their rebate checks, but households are clearly not happy doing it. They are deeply worried about future employment prospects, soaring gasoline bills and the contracting housing market. Of course, these spirit-dampening influences have been battering confidence for the better part of a year without producing a tangible spending response. But one wonders if the cumulative effects were about to take a toll until the rebate checks arrived. That question cannot be answered now, but it's unlikely that the Fed will take the chance of adding to household woes by hiking interest rates.

