

WEEKLY ECONOMIC COMMENTARY – WEEK OF JUNE 20, 2008

FINANCIAL INDICATORS				
INTEREST RATES	June 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.66%	1.88%	1.89%	4.67%
6-month Treasury bill	2.12	2.22	2.01	4.74
3-month LIBOR	2.79	2.80	2.68	5.36
2-year Treasury note	2.63	2.88	2.64	4.87
5-year Treasury note	3.35	3.58	3.41	4.93
10-year Treasury note	3.97	4.16	4.05	5.03
30-year Treasury bond	4.52	4.72	4.72	5.13
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.55	3.59	3.14	4.05
10-Year	4.23	4.12	3.87	4.32
30-Year	5.06	4.89	4.71	4.75
30-year fixed mortgage rate				
	6.45	6.42	6.08	6.67
15-year fixed mortgage rate				
	6.04	6.02	5.66	6.34
1-year adjustable rate				
	5.27	5.19	5.22	5.65
STOCK MARKET				
Dow Jones Industrial	11346.51	11842.12	12638.32	13408.62
S&P 500	1278.38	1317.88	1400.38	1503.35
NASDAQ	2315.63	2406.09	2522.66	2803.23
Commodities				
Gold (\$ per troy ounce)	931.20	903.70	891.50	650.90
Oil (\$ per barrel) - Crude Futures (NYMEX)	140.86	134.62	127.56	70.68
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (May) - 000s of units	512	525	501	551
Existing Home Sales (May) - 000s of units	4,990	4,890	4,940	4,938
Durable Goods Orders (May) - % change	0.0	-1.0	-0.2	-0.1
Consumer Confidence (June) - Index	50.4	58.1	62.8	66.8
Personal Income (May) - % change	1.9	0.3	0.3	0.6
Personal Consumption (May) - % change	0.8	0.4	0.5	0.4

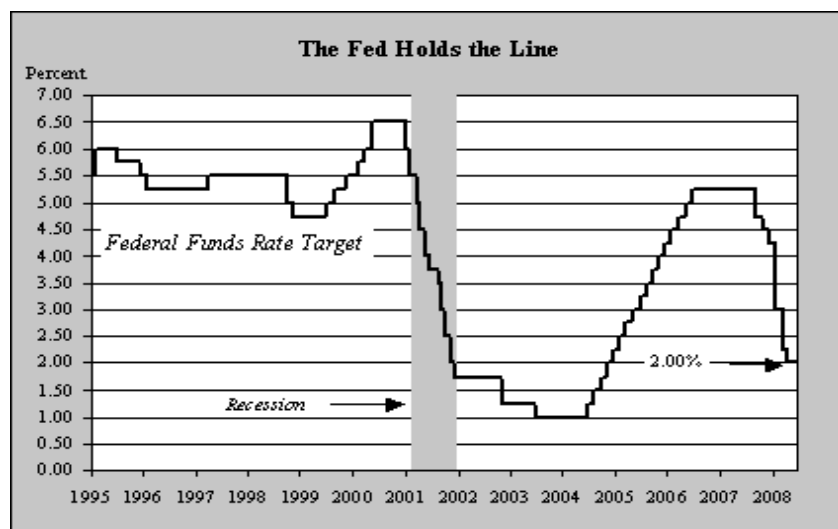
The drumbeat of inflation fears is growing louder, even as the forces that are supposed to suppress it are getting stronger. This is putting the Fed in an unenviable position, but the conundrum it faces is being shared on a global scale. In recent weeks, we have heard some feisty anti-inflation rhetoric from central bankers around the world, the loudest coming from Jean-Claude Trichet, president of the European Central Bank, who recently hinted that a rate increase could come as soon as July. This week, the chorus of hawkish statements reverberated through Canada, South Korea, China, India and England. Not surprisingly, these inflation worries are pushing the "stag" component of stagflation further into the background.

Indeed, the ECB is not alone in its intimations that a rate hike may be necessary to prevent price increases from racing out of control. Among the finger-waggers is none other than America's own central bank, led by Ben Bernanke, who famously asserted on June 9 that he would "strongly resist an erosion of long-term inflation expectations". That comment, echoed by a litany of other Fed officials, has sent market interest rates sharply higher, particularly on the Treasury two-year note, which is highly sensitive to policy expectations. Those expectations have clearly tilted away from a policy that would stimulate growth to one that is poised to curb inflation. The futures market has priced in a near-100

percent chance that the Fed will raise interest rates before the end of the year.

To be sure, there are scant signs yet that long-term inflation expectations are becoming "unanchored", which is the Fed's biggest fear. But the trend is becoming unnerving to Fed officials, as household surveys are showing some pickup in inflation worries and the credit markets are starting to price in a higher inflation premium on Treasury securities. Needless to say, the primary culprit behind the upward tilt in inflation expectations is the relentless increase in fuel, food and other commodity prices, which is grabbing headlines and understandably having an impact on public psychology. To date, the surge in commodity prices has not materially spilled over into the prices of other goods and services, at least not on the retail level. As reported last week, the core CPI, which excludes food and energy, edged up by a still-acceptable 0.2 percent in May, leaving the annual rate of increase well within the 2.1-2.5 percent range in effect for more than a year.

But companies are coming under increasing pressure to lift prices more aggressively from a number of sources. The airlines are the most visible of the price-hiking group, given the huge role that the cost of fuel plays in their cost structure. However, they are not alone, as other industries are also being squeezed by the rising cost of raw materials and supplies, a rise that is reinforced by spiraling prices on imported goods associated with the steep decline in the dollar. These cost pressures are showing up in the latest figures on wholesale prices, the last stop before reaching retail cash registers. In May, the producer price index jumped 1.4 percent, lifting the increase over the past year to a whopping 7.2 percent. As expected, energy prices are leading the way up, but they are no longer being as contained as they are on the consumer level. As the chart shows, the core producer price index has posted a 12-month increase of 3 percent for the past two months, the steepest annual pace since 1991. What's more, cost pressures further down the production pipeline - the intermediate and crude stages of production - are increasing even faster.



The question, of course, is whether companies will be able to pass on these increased costs to consumers in the form of higher prices. This is where the rubber meets the road, and will determine what action the policy makers will ultimately need to take. Clearly, companies are desperately trying to recoup higher costs to protect margins whenever they can. Airlines, truckers and other transportation companies are imposing surcharges to cover higher fuel bills, and financial institutions are lifting fees on ATM usage to give a few examples of how price increases are being cloaked from consumers. But these efforts are still narrowly focused and haven't yet permeated the broader spectrum of goods and services that enter into the consumer price index.

The reason is simple: with the job market deteriorating, income growth slowing and household budgets increasingly squeezed by the rising cost of food and energy, consumers will resist price increases on virtually all discretionary purchases. Hence, companies striving to put through price increases risk the loss of sales in a market environment that is already being weighed down by powerful macro headwinds. This counterbalancing force to rising commodity prices is inherent in the Fed's long-standing conviction that a slowing economy would prevent companies from passing on higher costs to consumers. So far, that scenario is unfolding as planned.

Indeed, a key element of the Fed's forecast for a moderation in inflation is that a slowing economy would open up slack in the product and labor markets. That's a time-honored cyclical dynamic that never fails to curb price pressures. In the labor market, the extent of slack or tightness has always been a question of measurement. For most of the past four years, the unemployment rate has hovered well below the level that has traditionally defined full employment conditions. Yet, that barometer of labor market tightness has been viewed with a good deal of skepticism because the fraction of the adult population considered part of the labor force has also been unusually low. A broader measure, including working age folks that dropped out of the labor force for a variety of reasons, would indicate a much looser labor market. It would also be consistent with the much slower increase in incomes during the recent expansion compared to past cyclical standards.

Yet even the narrowly-defined unemployment rate is no longer indicating a tight labor market, as this measure has shot up to 5.5 percent in May, well above the 4.4 percent low of the expansion. Along with the slack opening up in the labor market, companies are now operating with more spare capacity than any time in 3 ½ years. Thanks to back-to-back monthly declines in industrial production, operating rates in the industrial sector slipped to 79.4 percent in May, the lowest since December 2004. On average, factories, mines and utilities in the U.S. have collectively used 81 percent of its capacity over the past 35 years, so the current usage is comfortably below what can reasonably be expected to lead to bottlenecks, delivery delays and other production logjams typically associated with rising prices.



Simply put, the fundamental underpinnings for a sustained upsurge in inflation - i.e. rising labor costs and companies operating at full capacity - are nonexistent. So why is the Fed worried? Clearly, it boils down to the interplay between surging commodity prices and expectations. If households and businesses believe that the spiral in commodity prices will lead to a permanent increase in the inflation rate, they will act accordingly - consumers will accelerate purchases to beat price increases, workers will demand higher wages to compensate for lost purchasing power and companies will raise prices to cover higher labor costs. Clearly, this inflation dynamic is no where to be found in the current environment, but the

Fed does not want to plant the seeds for it to flourish by keeping policy too easy.

The question therefore is whether interest rates are being kept too low for too long that would ultimately validate the upward tilt in inflation expectations that are gradually seeping into the public's mind-set. Unfortunately, it's almost impossible to ascertain what is an appropriate level of interest rates at any given time, particularly when the economy is buffeted by the conflicting forces of high inflation and sluggish growth. Relative to the 4.1 percent headline inflation rate, including food and energy prices, the current federal funds rate of 2 percent is still expansionary. Relative to the core inflation rate, however, it is closer to neutral. From this perspective, it is understandable that the financial markets are pricing in a rate hiking bias in its forecast, or at least assuming that the rate-slashing campaign is over.

But from the perspective of a slowing economy that is only months removed from a credit-market meltdown and is still being battered by a housing collapse, it may make sense for the Fed to remain as accommodative as possible. Indeed, the deflating of the housing bubble is continuing with a vengeance, as builders scaled back groundbreaking on new home construction by another 3.3 percent in May, more than reversing a flukish bounce in April. At an annual rate of 975 thousand units, housing starts are at their lowest levels since 1991, and signs of a near-term pickup are no where to be found. Building permits are also only a notch above their lowest level in eighteen years. Since residential investment outlays lag housing starts by 2-3 quarters, it's virtually certain that housing will continue to be a drag on economic growth through at least the remainder of the year.

If there is any hope for the beleaguered housing industry, it is that the historical record of past housing downturns indicates an end is near. This is the sixth major housing slump since the mid-1960s, and the slide in housing starts has just about equaled the average decline experienced over the previous five. From its peak in January 2006, starts have fallen by 57.1 percent, just shy of the 58.2 percent peak-to-trough average drop over the previous five downturns. But the bad news is that the current episode still has a ways to go to match the extended 6-year homebuilding slump that ended in January 1991, with starts sliding by 64.7 percent before hitting a low of 798 thousand units. By all accounts, the current housing slump is shaping up to be at least as harsh as that one, which should encourage the Fed to be ever so cautious about adding further stress to this highly rate-sensitive sector.

