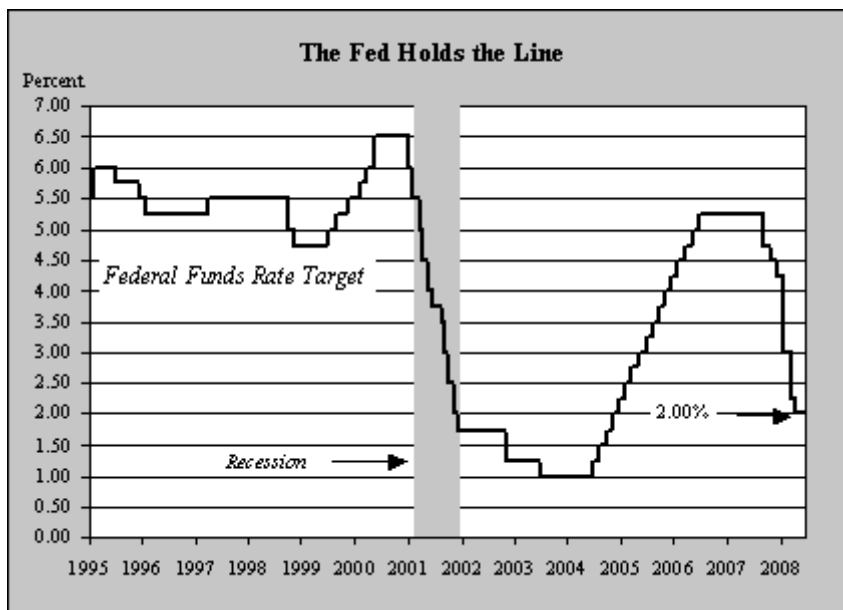


WEEKLY ECONOMIC COMMENTARY -- WEEK OF JUNE 27, 2008

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 Industrials	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/ Months 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 Federal Reserve finds itself in that unenviable position of being “damned if they do, and damned if they don’t”. Hence, it comes as no surprise that its decision to keep interest rates unchanged at the latest policy-setting meeting this week met with criticism from both sides of the aisle. On the one side are those who believe that another round of rate cuts is clearly needed. They argue, with some compelling support, that the economy remains in a highly fragile state, buoyed mostly by \$107 billion in tax rebates whose impact will soon fade and be overwhelmed by the depressing influence of surging food and fuel costs as well as a deteriorating job market. What’s more, the financial markets are still under considerable stress from extensive loan writeoffs and an erosion of capital that is stifling credit flows. While another cut in rates would not remedy these ailments, it might lessen the pain somewhat and perhaps bolster confidence in the economy’s future prospects.



On the other side of the aisle, however, are critics who are equally as adamant in their belief that the Fed should be increasing rates. Their argument also has some pillars of support. The biggest threat to the economy, they argue, is the debilitating rise in inflation, which has been running at an annual rate of over 4 percent since last fall, the longest stretch above that threshold since the early 1990s. What's more, the main driver behind the inflation pickup, escalating energy prices, is still gathering force and will likely push the headline inflation rate above 5 percent in coming months. True, the surge in food and fuel prices has not led to a broad acceleration in prices on other goods and services. But households purchase food and fuel on a daily basis and their higher prices are leading to a pickup in inflation expectations, something that is hard to reverse once they become entrenched.

So what's the beleaguered Fed to do? Essentially, it took the middle road, straddling a thin line between appeasing the hawks and the doves (taking a page, perhaps, from the presidential aspirants). To be sure, the decision to keep the federal funds rate unchanged for the first time since the credit crisis reached a boiling point last September came as no surprise to the financial markets. But investors were somewhat chagrined that the policy makers didn't provide firmer guidance as to what the next move might be. Going into this week's meeting, most expected the Fed to emphasize the inflation threat, hinting that a rate increase was more likely than a rate cut in coming months. While the post-meeting statement did acknowledge that upside risks to inflation and inflation expectations had increased, it also flatly noted that the policy committee expected "inflation to moderate later this year and next year."

Simply put, the Fed continues to put faith in the time-honored dynamic that a slowing economy will eventually curb inflationary pressures. In a sense, the FOMC reinforced its commitment to this notion. In the previous policy meeting, the Fed stated that it expects inflation to "moderate in coming quarters." But the sustained upward movement in food and fuel prices plus the increase in inflation expectations just about renders that impossible. Rather than taking a tougher stance in response to the higher inflation pace that is destined over the next quarter or two, the Fed opted to push out the timetable several more quarters to allow the slowing growth dynamic to work through the system. The bottom line is that the odds of a rate increase, which had very high in the weeks leading up to the latest meeting, have been lowered somewhat. Although the consensus still expects a rate hike before the end of the year, the Fed gave little inclination that it would follow through.

Clearly, the Fed's middle-of-the-road stance reflects the mounting crosscurrents that are buffeting the economy, with a highly uncertain outcome. First and foremost is the astonishing run-up in oil prices,

which surpassed \$140 a barrel this week, sending shock waves through the financial markets as well as the real economy. The growth-retarding impact of the oil-price surge is palpable. Automakers are shutting plants, laying off workers and seeing their stock prices plunge to the lowest levels since the 1970s. While this industry is perhaps most directly impacted by the spike in oil and gasoline prices, which is clobbering vehicle sales, it is not alone. Companies of all stripes are dealing with higher energy costs in a myriad of ways. Those suffering a profits squeeze are responding much like the auto companies, scaling down operations and laying off workers.

Nor is the pressure coming from just the cost side. The climb in fuel prices is eating into household incomes, crimping purchases of all discretionary items, not just cars. As a result, companies facing weaker demands from consumers are also cutting back, and the associated loss of jobs and incomes is adding to the financial stress of households. As debt defaults climb, the daisy chain of negative consequences spreads to the financial sector, where institutions are struggling to retain capital. Their efforts are meeting with mixed success, but the end result is that credit flows are being restrained. In short, the surge in oil prices is having deep and broad deflationary consequences for the economy.

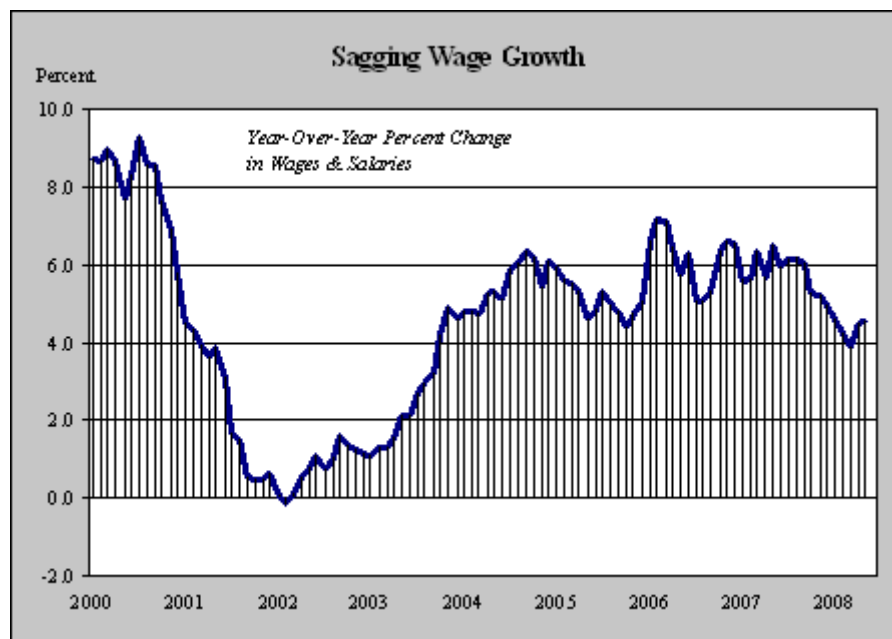
But the inflationary influence of spiraling oil and other commodity prices cannot be ignored by the Fed. Aside from lifting inflationary expectations, a wide array of companies are boosting prices to cover higher costs, especially those benefiting from strong export demand. Major chemical and steel companies are cases in point, as they have successfully posted price increases of as much as 50 percent in recent months. Other industries are probing with uncertain results. Airlines have tacked on fees for extra luggage and are now considering charging passengers according to their weight (gulp!). But these additional revenues fall far short of what is needed to cover higher fuel costs, and the industry is downsizing mightily, something that has already led to an abrupt decline in aircraft orders.

From our lens, the Fed will need to talk tough to keep inflation expectations in check, but its bark will turn out to be worse than its bite. There is just too much at risk to lift rates any time soon. Besides, higher rates would do little, if anything, to curb the climb in oil and other commodity prices, which are driven mostly by forces outside of the Fed's control. True, higher rates might arrest the downtrend in the dollar, which has arguably contributed to the rise in oil prices. But the Fed rarely adjusts policy to influence the dollar, particularly if it conflicts with domestic objectives. By and large, dollar policy falls under the jurisdiction of the Treasury Department, which continues to publicly advocate a strong U.S. currency but treats the greenback's free-fall with benign neglect.

Before the Fed can even consider lifting interest rates, the economy would have to show tangible signs of surviving the powerful headwinds that are depressing growth. Yes, the inflation hawks can cite some recent numbers that show more strength than expected. The latest is this week's report on consumer spending, which revealed a sizeable 0.8 percent increase in May, the biggest monthly gain since last November. Fueling the spending burst, personal incomes also jumped by a whopping 1.9 percent during the month, the sharpest gain since the post-Katrina bounce in October 2005. But both the income and spending gains were largely an artifact of the Economic Stimulus Act of 2008, which is dispensing \$108 billion of rebate checks to individual taxpayers. These payments began on April 28 and will continue to fatten household bank accounts on a weekly basis through mid-July.

Nearly half of the rebates were disbursed in May, which clearly impacted household income and spending during the month. The stimulus checks, for example, accounted for about half of the increase in incomes, which would have otherwise increased by a much more modest 0.4 percent. Indeed, labor generated incomes -wages and salaries - advanced by a relatively weak 0.3 percent, following an outright contraction of 0.1 percent in April. Over the past year, wages and salaries have increased by 4.6 percent, nearly one-third less than the 6.5 percent growth rate at this time last year. While households may go on a temporary spending binge with their rebate checks, their sustainable consumption patterns

will reflect the growth in paychecks. With the labor market still shedding jobs, the outlook on this score does not look promising.



Hence, we suspect that the spending lift provided by the rebates will expire as soon as the last check is mailed out on July 11, as the headwinds facing households remain firmly in place. Consumers are suffering from a negative wealth effect as both home values and equity prices are in decline. There are no personal savings to fall back on to support spending. The labor market has weakened, which along with the housing depression and soaring food and energy prices has undermined consumer confidence. And, as already noted, the rising price of food and energy has cut into spending on discretionary items. Indeed, fully half of the 0.8 percent increase in consumption during May was due to higher prices, as the personal consumption deflator rose by 0.4 percent.

On the surface, the May personal income and spending data support the Fed's decision to hold policy steady at its latest meeting. However, it is hard to imagine that spending will be sustained at anywhere near its current pace beyond July, given the weakened state of the job market, the ongoing plunge in housing values and a renewed slide in stock prices (including a nasty tumble this week), all of which is eviscerating household confidence. This week's report by the Conference Board confirmed the dismal mood of the public, as its confidence index slid nearly 8 points in June to 50.4, the fifth lowest reading on record. More importantly, the expectations component of the index fell to a record low, suggesting that households believe the economy will be stuck in low gear for some time to come. That's not an environment conducive to a sustained increase in spending.

