

WEEKLY ECONOMIC COMMENTARY – WEEK OF JULY 19, 2010

FINANCIAL INDICATORS				
INTEREST RATES	July 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.15%	0.15%	0.09%	0.16%
6-month Treasury bill	0.18	0.19	0.16	0.27
3-month LIBOR	0.52	0.53	0.54	0.50
2-year Treasury note	0.58	0.62	0.71	0.99
5-year Treasury note	1.68	1.84	2.01	2.50
10-year Treasury note	2.93	3.06	3.22	3.65
30-year Treasury bond	3.94	4.04	4.15	4.54
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.48	1.56	1.77	1.86
10-Year	2.87	2.95	3.23	3.28
30-Year	4.38	4.38	4.47	4.79
30-year fixed mortgage rate	4.57	4.57	4.75	5.14
15-year fixed mortgage rate	4.06	4.07	4.20	4.63
1-year adjustable rate	3.74	3.75	3.82	4.76
STOCK MARKET				
Dow Jones Industrials	10098.35	10197.72	10450.64	8743.94
S&P 500	1065.09	1077.93	1117.51	940.38
NASDAQ	2179.68	2196.45	2309.80	1886.61
Commodities				
Gold (\$ per troy ounce)	1190.90	1210.00	1258.50	936.10
Oil (\$ per barrel) - Crude Futures (Nymex)	75.82	76.25	77.34	63.34
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (June) - % change	-0.5	-1.1	0.3	0.3
Industrial Production (June) - % change	0.1	1.3	0.3	0.5
Capacity Utilization (June) - Percent	74.1	74.1	73.1	73.1
Producer Price Index (June) - % change	-0.5	-0.3	-0.1	0.1
Consumer Price Index (June) - % change	-0.1	-0.2	0.1	0.0
Core CPI (June) - % change	0.2	0.1	0.0	0.1
Business Inventories (May) - % change	0.1	0.4	0.7	0.3

Prime Rate: 3.25%**1-Month LIBOR: 0.33688%**

If you live anywhere near the East Coast, where the heat and humidity have been oppressive for the past several weeks, you know that the “dog days of summer” have arrived. Even as we grumble about such

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cosmic events, we are reminded of the age-old refrain that everyone complains about the weather, but no one does anything about it. It would not be a stretch, in our view, to apply that message to the economy. Everyone's complaining, but no one is fixing it.

That, at least, would seem to be the paradox describing current conditions. Clearly, there is enough misery to complain about. The jobless rate remains intolerably high, with nearly half of the 15 million job-seekers out of work for at least 6 months. Not only is the economy expanding too slowly to bring meaningful relief, the recovery itself is showing some signs of fatigue. Making matters worse, the thrust from the fiscal and monetary steroids that have powered the recovery so far is fading, leaving a legacy of huge government debt and bailouts that underscore simmering public anger towards Washington. Ironically, that anger contains mixed emotions. Some feel Washington has not done enough, while others are convinced it should be doing more to alleviate the economy's woes.

Needless to say, both sides can present compelling arguments, reflecting the ambivalent currents buffeting the economy. Perhaps a more relevant issue, though, is whether policy makers even have the tools to breathe new life into the recovery. Clearly, another jolt of fiscal stimulus would provide a much-needed lift in aggregate demand, but that is unlikely to occur given the widespread aversion towards major spending initiatives that would further widen an already-huge budget deficit. That leaves monetary policy as the major lever to jump-start growth; but the question is, what more can the Fed do to accomplish that task? Within the Fed itself, there is some dissension over what direction policy should take.

That discord was revealed in the just-released minutes of the latest policy-setting meeting held in late June. In previous meetings, the discussion centered on how and when the Fed should implement an "exit" strategy from its ultra-easy policy in place since the financial crisis battered the economy in late 2008. With the financial system restored to reasonable health and a recovery underway since mid-2009, the Fed began to worry that it would overstay its welcome, setting the stage for another asset bubble or an inflation flare-up. These concerns garnered added support as the recovery gathered steam towards the end of last year and early this year, spurring the Fed as well as private forecasters to raise their growth outlook for 2010 and beyond. But, in the space of a few short months, perceptions of the economy have changed dramatically, reflecting a string of disappointing economic releases that once again resurrected fears the economy might be heading for a double-dip recession.

Not surprisingly, the Fed lowered its forecast at the latest meeting. As the graphic shows, the Fed staff cut about 0.2 percent from the expected GDP growth rate for 2010 and now sees a higher unemployment rate next year than it did in its last forecast in April. The projection for inflation was also ratcheted down a notch in conjunction with the weaker growth forecast. What's more, about half of the monetary officials saw the risks to the forecasts tilted to the downside, reflecting more restrictive financial conditions associated with the recent sovereign debt crisis. That, they felt, had increased risk aversion among investors, thus potentially restricting the availability of credit. The ongoing weakness in commercial real estate was also cited as a factor in downgrading the growth outlook.

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Variable	Central tendency ¹			
	2010	2011	2012	Longer run
Change in real GDP.	3.0 to 3.5	3.5 to 4.2	3.5 to 4.5	2.5 to 2.8
April projection.	3.2 to 3.7	3.4 to 4.5	3.5 to 4.5	2.5 to 2.8
Unemployment rate.	9.2 to 9.5	8.3 to 8.7	7.1 to 7.5	5.0 to 5.3
April projection.	9.1 to 9.5	8.1 to 8.5	6.6 to 7.5	5.0 to 5.3
PCE inflation.	1.0 to 1.1	1.1 to 1.6	1.0 to 1.7	1.7 to 2.0
April projection.	1.2 to 1.5	1.1 to 1.9	1.2 to 2.0	1.7 to 2.0
Core PCE inflation ³	0.8 to 1.0	0.9 to 1.3	1.0 to 1.5	
April projection.	0.9 to 1.2	1.0 to 1.5	1.2 to 1.6	

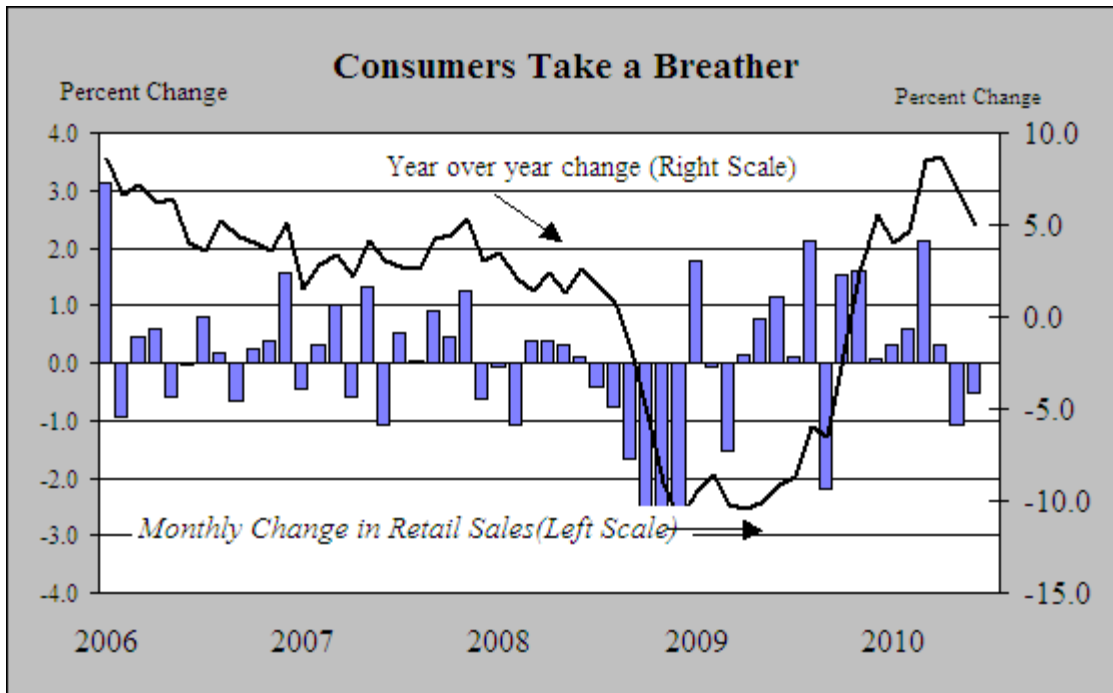
Hence, rather than focusing solely on an exit strategy, the Fed injected another twist on possible future direction of policy. Specifically, it noted that it might be prudent to consider the possibility of more monetary stimulus should economic conditions deteriorate further. In its own verbiage ...”members noted that in addition to continuing to develop and test instruments to exit from the period of unusually accommodative monetary policy, the Committee would need to consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably.” To be sure, the current softer economic outlook and uncomfortably low inflation were not enough to prompt the Committee to consider renewed easing measures at this time. Still, “Members agreed that some change to the statement's characterization of the economic and financial situation were necessary.”

Simply put, policy makers, as well as private forecasters are worried about the sustainability of the recovery. And, after weeks observing the swirl of hand-wringing, the financial markets may also be taking notice. Recently, stock prices have rallied, riding a wave of high expectations about corporate earnings. But this week, the euphoria concerning profits faded, overshadowed by doubts that revenue growth can be sustained in the midst of weakening demand fundamentals. What’s more, some earnings reports did not quite meet expectations, something that always has an amplified effect on market psychology when broad macro events turn negative, which has certainly been the case recently. Virtually every economic report released this past week sounded a downbeat note.

Perhaps most discouraging was the weak Retail Sales report which, next to the jobs report, is probably the most closely-watched barometer of the economy’s health. That’s because household spending is the linchpin of economic activity, accounting for about two-thirds of GDP. Hence, wither goes consumer spending, so goes the recovery. What the latest retail sales report for June strongly suggests is that pent-up demand has been satisfied and there is little, outside of Apple’s iPhones, that is stirring the appetite of consumers to rush out and buy something. Overall, retail sales slipped 0.5% last month, following a 1.1% drop in May – the first back-to-back monthly decline in retail sales in over a year. More than anything, the downshifting in consumer spending corroborates the notion that the economy has hit a speed bump in recent months. With the May/June results, retail sales in the second quarter increased by a 4.1% pace, precisely half the 8.2% increase registered in the first quarter and well below the 7.5% growth rate in the fourth quarter of last year.

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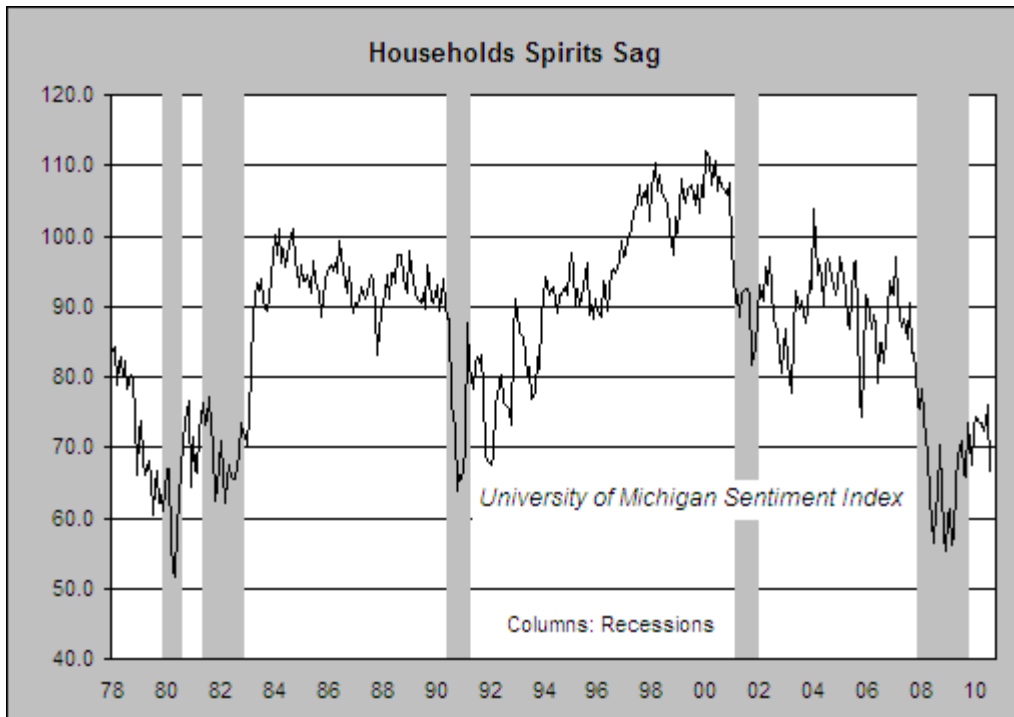


To be sure, the pullback in consumer spending last quarter was not entirely unexpected. Keep in mind that retail sales benefited from some temporary artificial props during the second half of last year as well as early this year, including the housing tax credit that boosted furnishings and other housing related products, the cash for clunkers program and rebates to consumers who purchased energy-efficient appliances. That said, the consumer retrenchment was somewhat greater than expected. And while retail sales do not line up dollar for dollar with the personal consumption component of GDP, the sales slowdown will almost certainly drag down the broader consumption figure. Hence, we suspect that real personal consumption in the second quarter will come in measurably slower than the 3 percent pace registered in the January-March period.

Does the consumer slowdown threaten to derail the recovery? Probably not, but it does not augur well for the immediate future. For one, the May/June slippage in retail spending means that there was no momentum heading into the third quarter. Indeed, retail sales in June totaled an annualized 3 percent below the second quarter average, so there will be a steep hill to climb over the next several months before this metric returns to a positive growth rate. For another, consumer confidence has taken a beating from a string of unsettling events, including the uncertainly arising from the European debt crisis, disappointing job figures, confusion over the direction and effectiveness of policy as well as new regulations, a slumping stock market and, to some extent, the negative aura associated with the Gulf oil spill. Despite the slip in sales, growth in sales is still positive and, at current levels, sits only about 5% below the peak levels of late 2007.

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As a result, the University of Michigan/Reuters consumer sentiment index plummeted in early July, falling a whopping 9.5 points to 66.5. The latest reading was the lowest in a year and is consistent with other anecdotal evidence that households are feeling less secure about economic prospects. Given the array of confidence-shattering news noted above, that comes as no surprise. However, a one-month plunge in confidence, though unsettling, should not be viewed as a death-knell for consumer spending, much less for the broader economic recovery. Not only does household confidence trace a jagged pattern, as the chart clearly demonstrates, it is not a very good predictor of actual spending. Some studies conclude that rather than being a harbinger of things to come, consumer confidence surveys tend to reflect household reactions to what has already transpired. Hence, they may be more of a lagging rather than a leading indicator of spending behavior.

That said, there is little question that the economy is entering a slowing stage of the recovery process, one that is engendering fear and concern about its sustainability. As we noted at the outset, the hands of the fiscal stewards of the economic ship are more or less tied by anti-deficit considerations, leaving the heavy lifting up to the Federal Reserve. But with short-term interest rates already at rock-bottom levels of near zero and the Fed's balance sheet already twice the size of a year ago, there is some question as to whether the Fed has any arrows left in its quiver. It clearly has no leeway on the rate front, unless it forces people to pay interest for the privilege of saving, thus bringing on a negative interest rate. Nor would further expanding its balance sheet bring tangible results, particularly since mortgage and long-term Treasury rates have already fallen to historical lows. The one Achilles Heel that we see as open to remedial action is the lack of credit availability to small businesses, which continues to be a significant problem. The Fed can more actively strive to reopen the credit spigot for these borrowers through a variety of means, including lending to them directly if necessary. Indeed, there is precedent for such action. Under Section 13 (3) of the Federal Reserve Act (and later, under Section 13 (b)) the Fed was given the authority to lend directly to individuals, partnerships and corporations "under unusual and exigent circumstances". It is this provision that authorized the Fed to lend to AIG and other private entities during the financial crisis. While we agree that it would be unwise for the Fed to engage in commercial banking activities for an extended period of

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time, we wonder if credit-starved small companies – who generate the bulk of new jobs during recoveries – are facing “unusual and exigent circumstances” that justify at least some temporary relief from above. We’ll see.

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