

WEEKLY ECONOMIC COMMENTARY – WEEK OF JULY 23, 2010

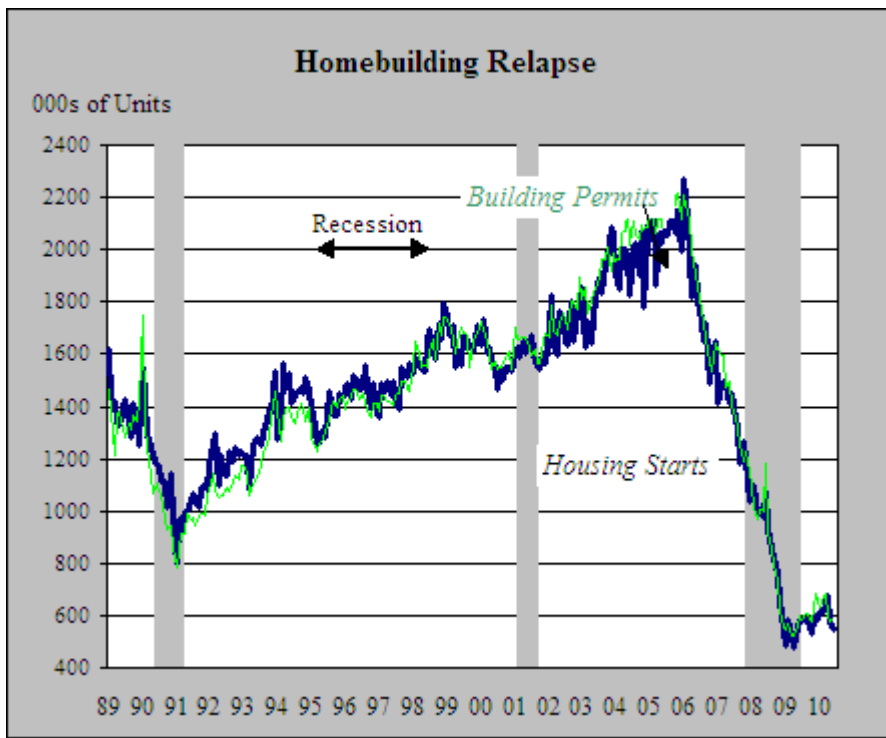
FINANCIAL INDICATORS				
INTEREST RATES	July 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.15%	0.15%	0.13%	0.18%
6-month Treasury bill	0.19	0.18	0.19	0.27
3-month LIBOR	0.49	0.52	0.53	0.50
2-year Treasury note	0.58	0.58	0.65	1.00
5-year Treasury note	1.72	1.68	1.89	2.53
10-year Treasury note	2.99	2.93	3.10	3.66
30-year Treasury bond	4.01	3.94	4.06	4.55
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.40	1.48	1.76	1.87
10-Year	2.81	2.87	3.18	3.28
30-Year	4.37	4.38	4.45	4.82
30-year fixed mortgage rate				
	4.56	4.57	4.69	5.20
15-year fixed mortgage rate				
	4.03	4.06	4.13	4.68
1-year adjustable rate				
	3.70	3.74	3.77	4.77
STOCK MARKET				
Dow Jones Industrials	10424.62	10098.35	10143.81	9093.24
S&P 500	1102.66	1065.09	1076.36	979.26
NASDAQ	2269.47	2179.68	2223.48	1965.96
Commodities				
Gold (\$ per troy ounce)	1186.50	1190.90	1255.40	952.20
Oil (\$ per barrel) - Crude Futures (Nymex)	79.97	75.82	79.04	68.01
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/ Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (June) - 000s of units	549	578	679	610
Sales of Existing Homes (June) - 000s	5370	5660	5790	5373

Big Ben climbed the steps of Capitol Hill this week to deliver his semiannual report on monetary policy to Congress. The Federal Reserve Chief provided few surprises, as his comments generally echoed the sentiments conveyed in the minutes of the latest policy-setting meeting, held on June 22-23, that were released last week. Still, like the old E. F. Hutton commercial, when the head of the central bank speaks, everyone listens. So it comes as no surprise that the testimony garnered most of the headlines this week, and had ripple effects in the financial markets.

As expected, Bernanke reiterated the notion that the downside risks to the outlook have increased in recent months, but that the recovery should stay on a moderate growth track. Perhaps the most interesting part of the testimony had to do with what measures the policy makers would take if economic conditions deteriorated by more than expected. For those waiting for him to say something about a possible double-dip recession, the chairman refused to go there in his prepared remarks. Instead, Bernanke offered the usual blanket statement that the Fed is “prepared to take further policy actions if necessary.” But in the question

and answer period after the prepared script was read, he did offer a few specifics that had been mentioned at various times in the past.

At the outset, he acknowledged that the conventional measures to jump start growth have been just about exhausted. That's comes as no surprise, since the federal funds rate, the main policy tool, has been lowered to near zero and the banking system has already been flooded with as much liquidity to make loans as any time in history. To this end, the Fed has more than doubled the size of its balance sheet since the financial crisis hit in the fall of 2008 to over \$2 trillion. Roughly half of the assets consists of mortgage-related securities, reflecting the primary objective of keeping the housing market afloat. Given the ongoing sorry state of the real estate market, with residential housing starts sliding again in June to just a tad over the record low reached last October, skepticism over the success of this strategy is understandably running high.

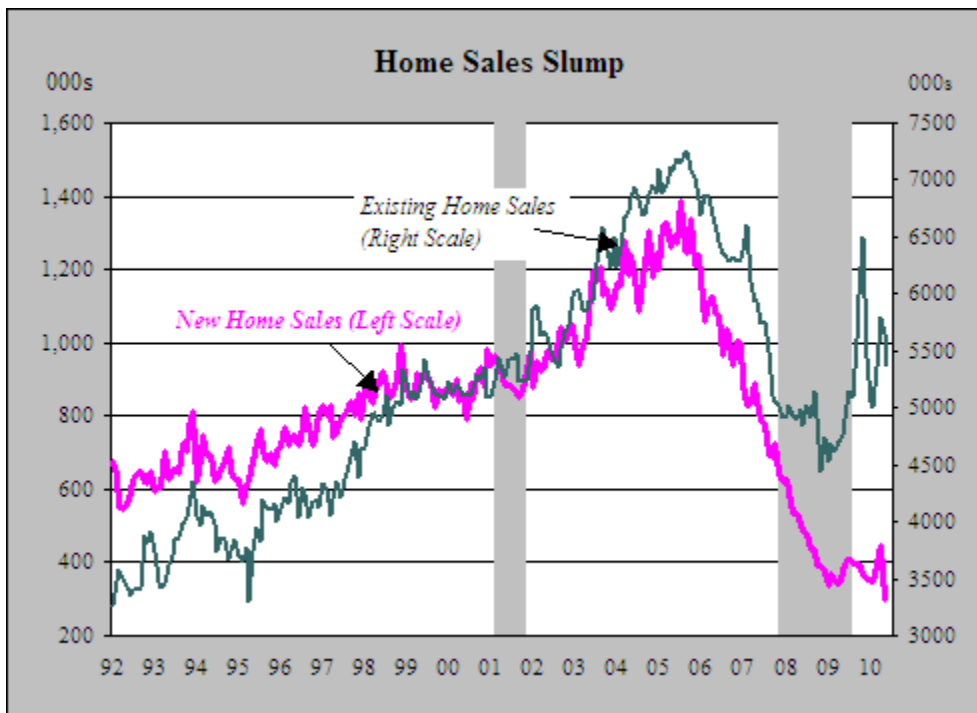


Unfortunately, the Fed finds itself in much the same defensive position as the administration, whose \$787 billion stimulus bill still gets “no respect”. The White House, of course, has vigorously championed the success of the bill, asserting that things would have been considerably worse without the fiscal stimulus. We agree with that assessment, although turning a negative into a positive is tough to do, and it clearly does not resonate with the 14.6 million jobless workers, 6.8 million who have been without a paycheck for at least six months. Likewise, the Fed can justifiably claim credit for its role in preventing a financial crisis from morphing into an outright calamity that would have brought the nation closer to a 1930s type depression. Nonetheless, while the financial system has stabilized, bank loans are still declining and many creditworthy borrowers, particularly small businesses, cannot obtain financing.

So, what more can the Fed do if economic conditions take a severe turn for the worse? Bernanke admits that unconventional options exist, but the Fed's staff has not thoroughly investigated all of the consequences they might entail. The three mentioned in his testimony include using language in policy statements that explicitly promise to keep short-term rates at exceptionally low levels beyond just the vague “extended period”, which is the current verbiage; lowering the rate it pays banks on excess reserves below the current quarter-percentage point in order to encourage more lending; and further expand its balance sheet beyond the \$2.1 trillion in assets currently held. All of these options have drawbacks, according to Bernanke, even as their benefits are not fully understood.

Clearly, the most stimulative of the options would be expanding the Fed's balance sheet, as that would directly inject more funds into the economy and, presumably, reduce long-term interest rates, which arguably has more of an economic impact than would lower short-term rates, which are already near zero. But the additional benefits that would be derived from lower long-term rates are dubious, at best, if households and businesses are unwilling to borrow. This is reminiscent of the adage "you can lead a horse to water, but you can't make it drink". Keep in mind that mortgage rates have already fallen quite substantially since the Fed started its mortgage-securities purchase program more than a year ago, reaching a multi-decade low of 4.57 percent this week. Yet mortgage applications to purchase a home remain exceptionally low and the demand for homes continue to sink.

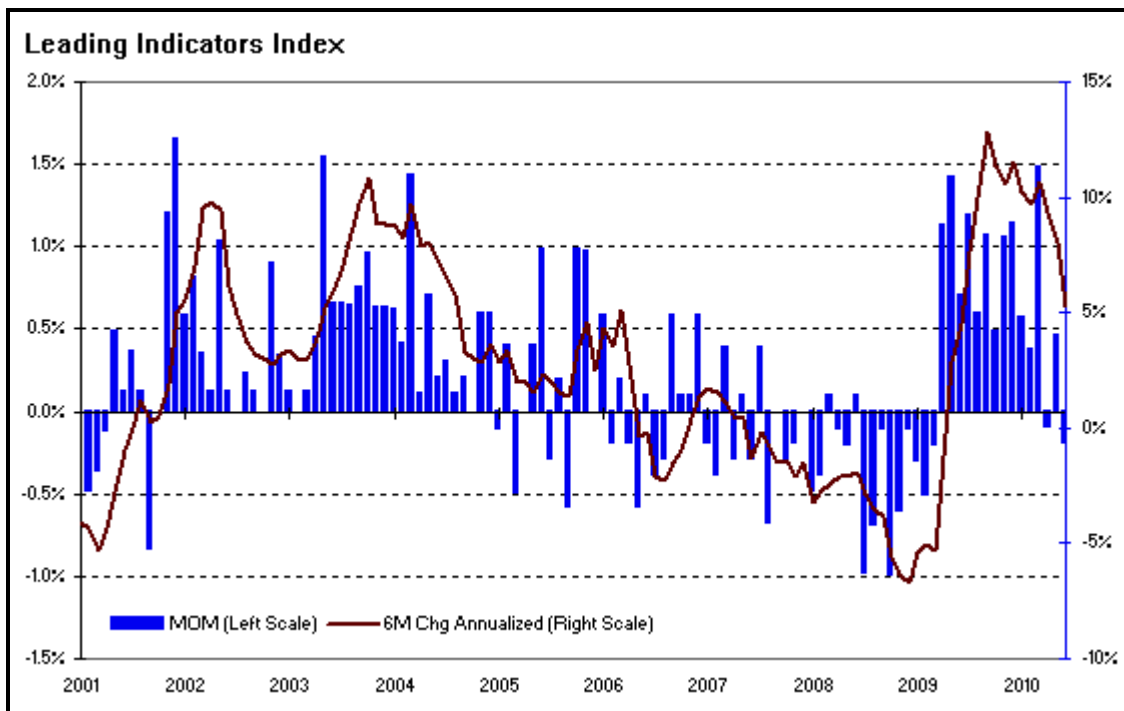
That was made abundantly clear again this week with the latest figures on sales of existing homes. In June, resales fell by another 5.1 percent, following a 2.2 percent drop in May. These declines occurred despite the boost provided by the homebuyer's tax credit, which expired in April but applies to transactions that were closed in June. The home resale figures, released by the National Association of Realtors, are for completed contracts, so they captured the effects of the tax credit. The good news is that total sales in June, at 5.37 million units, were still almost 10 percent above where they were a year ago. The bad news, based on the trend in mortgage applications and in the more forward-looking new home sales, is that the positive cushion is likely to be erased in coming months, as sales fall towards their 2010 lows.



The question is, would lower mortgage rates promoted by the Fed turn that around? Probably not. Keep in mind that the major impact of the homebuyer's tax credit was to push forward sales that would have taken place anyway. Hence, the payback from those accelerated sales will be difficult to overcome, even if lower mortgage rates do, on the margin, ignite some sales that would not have occurred. And, if demand does not pick up from its current weak state, the housing market will continue to be clogged up with excess inventory that is being bloated by a persistent high foreclosure rate. The volume of unsold homes on the resale market rose 2.5 percent in June to 3.99 million, just a tad below its all-time high. The current unsold volume represents an 8.7-month supply at the current sales pace, which is poised to fall in coming months even as inventories should continue to rise. Hence, the supply overhang will continue to be a huge drag on the housing market. Under healthier housing conditions, a more normal supply of homes for sale would be around 6 months.

True, lower mortgage rates would increase housing affordability, thus expanding the universe of potential buyers. But to get the “horse to drink” will take more than just affordability; potential buyers need to feel secure that they will have the necessary incomes to handle a mortgage loan. That security, in turn, is closely linked to the job market and the health of the overall economy. Needless to say, the current environment is not exactly conducive to a high level of confidence as it is reeling from an onslaught of disappointing economic data, particularly on the jobs front. More than anything, the stream of bad news has undermined household sentiment, which could well lead to the type of negative behavior that would justify the downbeat perceptions regarding the economic outlook.

As it is, all signs are pointing to a slowdown in coming months. One metric that sums up that prospect is the index of leading economic indicators, released by the Conference Board this week. The index, a compilation of ten components that tend to lead economic activity, fell by 0.2 percent in June. It was the second decline in the past three months, led by weak readings in two job-related components – the average workweek and claims for unemployment benefits. Another component, the University of Michigan index of expectations, has already registered a steep decline for early July, so a meaningful drag on the LEI is already built in for the month. In all, the movement in the leading indicators is a strong signal that the economy has indeed hit a speed bump, and a slowdown is in store for the second half of the year.



That said, a slowdown is a far cry from a double-dip recession, which a vocal minority of forecasters still have on the radar screen. From our lens, that remains a long shot. Keep in mind that only once since the 1930s has the economy relapsed into a recession less than two years after exiting one. That was in July 1981, precisely one year into a recovery, which was brought on by a vigorous anti-inflationary Federal Reserve policy. Under the Paul Volker-led regime, the Fed hiked short-term rates up by more than 1000 basis points to almost 20 percent, thereby choking off economic growth. No such headwind is visible today that is powerful enough to snuff out the recovery.

Our sense is that the Bernanke-led Fed is prepared to oversee a slowdown, which it seems to view as almost inevitable. Based on the chairman’s public comments and from the minutes of the latest policy meeting, there does not appear to be a strong concern among the policy makers that the economy is vulnerable to a recessionary relapse. We concur with that assessment but are not very sanguine about what measures the Fed can take if that forecast turns out to be wrong. Bernanke has admitted that the Fed staff has not looked too closely into what could be done if another recession engulfs the economy, most likely

because that prospect is given a low probability. We would feel better if Big Ben would start the clock ticking on such a contingency, if only to provide assurance that the Fed would know what to do.