

WEEKLY ECONOMIC COMMENTARY – WEEK OF JUNE 15, 2012

FINANCIAL INDICATORS				
INTEREST RATES	June 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.09%	0.08%	0.08%	0.03%
6-month Treasury bill	0.14	0.13	0.14	0.09
3-month LIBOR	0.47	0.47	0.47	0.25
2-year Treasury note	0.27	0.27	0.29	0.37
5-year Treasury note	0.67	0.71	0.74	1.53
10-year Treasury note	1.57	1.63	1.71	2.95
30-year Treasury bond	2.69	2.74	2.80	4.21
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	0.88	0.80	0.82	1.27
10-Year	1.92	1.87	1.83	2.64
30-Year	3.13	3.21	3.12	4.26
30-year fixed mortgage rate				
	3.71	3.67	3.79	4.50
15-year fixed mortgage rate				
	2.98	2.94	3.04	3.67
1-year adjustable rate				
	2.78	2.79	2.78	2.97
STOCK MARKET				
Dow Jones Industrials	12767.17	12554.20	12369.40	12004.40
S&P 500	1342.83	1325.66	1295.22	1271.50
NASDAQ	2872.80	2858.42	2778.79	2616.48
Commodities				
Gold (\$ per troy ounce)	1626.50	1595.40	1591.20	1540.40
Oil (\$ per barrel) - Crude Futures (Nymex)	84.01	84.30	91.06	93.03
ECONOMIC INDICATOR (Month or Qtr)				
	Latest Month/Quarter	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Retail Sales (May) - % change	-0.2	-0.2	0.4	0.3
Consumer Price Index (May) - % change	-0.3	0.0	0.3	0.1
Core CPI (ex. Food & energy) - % change	0.2	0.2	0.2	0.2
Producer Price Index (May) - % change	-1.0	-0.2	0.0	-0.1
Industrial Production (May) - % change	-0.1	1.0	-0.5	0.4
Capacity Utilization (May) - Percent	79.0	79.2	78.5	78.8
Business Inventories (April) - % change	0.4	0.3	0.6	0.5

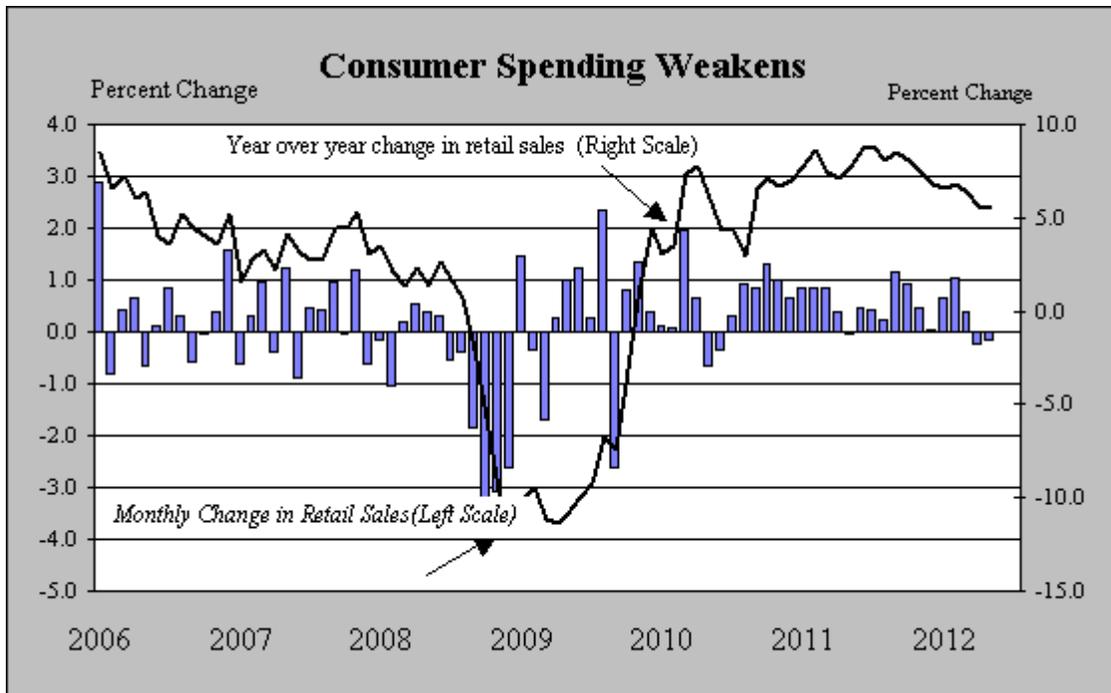
Greece, Spain and energy formed the trio of influences that had the biggest impact on economic data and the financial markets this week. Not to sound like a broken record, but the presence of this troika is indeed sounding like a broken record. Greece and Spain, of course, are part and parcel of the eurozone crisis that is in its fourth incarnation over the past few years. Energy developments, meanwhile, come and go like a fickle relative, sometimes bearing gifts and sometimes bringing grief to the broader economy. This time, the visit has been a pleasant one, as falling gasoline prices are providing households with a welcome infusion of discretionary cash.

But geopolitical events are by far the most important influence moving markets these days, as investors and traders nervously await the outcome of Greek parliamentary elections this weekend. Since the results won't be known until late Sunday evening, the global markets could be in for a tumultuous opening on Monday. The vote is seen as a referendum on whether Greece remains in the single currency bloc, linked to the euro, and is spurring a good deal of confusion and anxiety both within and outside Greece itself. Greek citizens apparently want to stay in the eurozone, but reject the harsh austerity measures that come with the privilege, which has sent the economy into a deep downward spiral. Aside from the initial tremors that the Greek vote could inject into the markets, there is the broader – and more worrisome – issue of what a Greek departure from the euro would mean for the global economy.

Clearly, the contagion effects are already palpable, with Spain and Italy being spurned by investors who fear that these governments, like Greece, will not be able to honor their debts without even larger bailouts than Greece needs to stay afloat. Indeed, not even the huge \$100 billion (125 billion euros) in funds provided by Europe to rescue Spanish banks this week quelled investor anxiety that the eurozone is teetering on the precipice of a wrenching breakup. Yields on government bonds of both Spain and Italy soared after the bailout package was announced, with the 10-year yield in Spain briefly rising above 7 percent for the first time since the euro was established. Needless to say, capital is flowing to safer investments, with the U.S. being the main beneficiary. Although figures documenting this trend are only available with a lag of several months, the Treasury Department revealed on Friday that foreign holdings of U.S. Treasury debt rose to a new record high of \$5.16 trillion in April. There should be little doubt that the inflow of capital has since accelerated.

The increased foreign demand, of course, is contributing to lower interest rates in the U.S., as the 10-year Treasury yield has fallen by about half-percentage point since early April. But the sovereign debt crisis is not the only reason for the downward move. While the U.S. economy and financial system are in better shape than Europe, conditions here are nonetheless faltering. Labor conditions have taken a turn for the worse over the past two months, incomes are barely keeping up with inflation, companies are ramping down production and inflation is receding, thanks to steeply falling gasoline prices. These economic fundamentals are a time-honored recipe for lower interest rates, which is only being reinforced by fears over Europe's travails.

This week's spate of data provided more evidence of this softening trend. Consumers, the backbone of the economy, are showing more reluctance to spend. Retail sales in May fell by 0.2 percent for the second consecutive month, the first back-to-back decline since May/June 2010. But the 2010 retrenchment followed two monthly increases that were twice as strong as the ones preceding the latest setback. Prior to 2010, the last episode of consecutive declines occurred during the depth of the Great Recession. Simply put, households are showing every sign of fatigue, having drawn down savings to support consumption in anticipation of fatter payrolls that so far has been slow to materialize. Worse, the average household is still digging out of the deep financial hole dug during financial crisis and housing bust. According to the dispiriting report issued by the Federal Reserve this week, the median net worth of households plunged by nearly 40 percent between 2007 and 2010, with homeowners suffering the biggest losses.



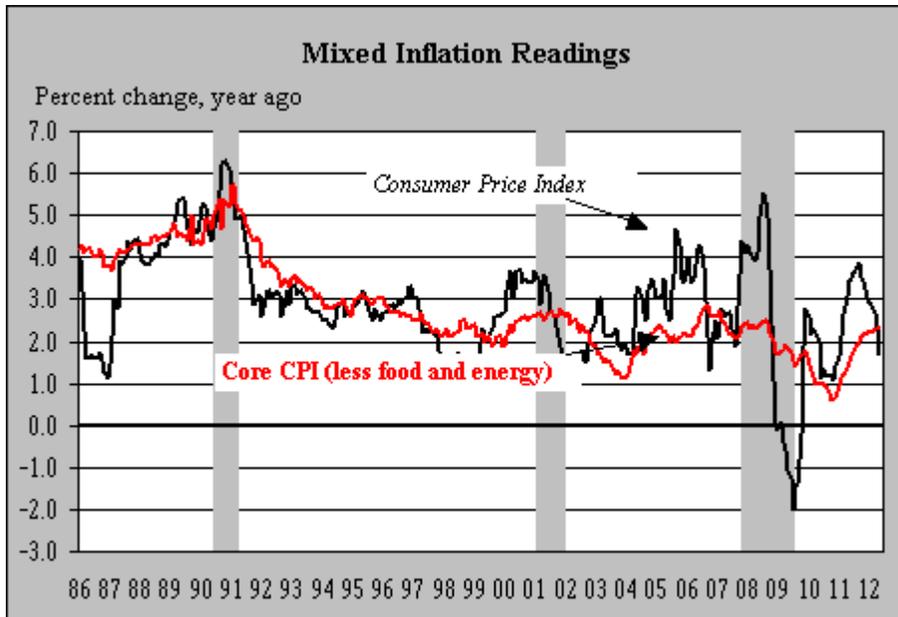
To be sure, the headline decline in retail sales overstates the weakness in spending, both in terms of magnitude and distribution. Overall, the dollar amount of purchases at retail establishments fell by \$691 million during the month, but the entire amount – plus some – reflected a \$998 plunge in sales at gasoline service stations. Hence, by one crude measure, retail sales excluding gasoline purchases actually posted a modest increase in May. Nor was that just a one-month phenomenon. Gasoline sales also fell in April, by \$646 million, bringing the two-month decline to about \$1.6 billion. That just about equaled the two-month fall in total retail sales, so by one simplistic yardstick it can be claimed that the entire setback in sales has been confined to gasoline stations over the past two months.

But that too would overstate the case, as the softness in spending was spread over a broad range of goods. Indeed, about half of the major retail categories in the Commerce Department’s report saw declines last month, including building materials and supplies, food and beverage stores, sporting goods and general merchandise stores, including Department stores. True, at least one of those categories, building material and supply stores (the Home Depots) may have been affected by the weather, as sales were pulled forward by the unusually warm weather earlier in the year. After rising by a sturdy 3.1 percent in the first quarter, sales at building material and supply stores fell in both April and May. We suspect that the weather effect has been completely cleansed in the May data and should not skew the figures in coming months.

But the big story in the retail sales report has to revolve around gasoline, where prices have been sinking rapidly. Since reaching a peak of \$3.88 a gallon in early April, the average price of regular conventional gasoline has fallen by about 40 cents, and all indications point to further declines in the weeks ahead. The average household purchases 1200 gallons of gasoline a year, so a 40-cent a gallon price break translates into \$480 in annual savings that can be used for other purchases. Put another way, American drivers are expected to pump around 133 gallons of gasoline this year. If the 40-cent drop stays intact for a full year that would inject the equivalent of a \$53 billion tax cut into the economy. Indeed, the gas savings may already be boosting consumption of discretionary goods. As noted, about half of the retail categories fell last month, but auto sales and purchases of home furnishing, apparel and electronics increased, all of which fall into the discretionary spending category.

Nor do just households benefit from lower gas prices. Businesses also reap some benefits from lower transportation costs and reduced prices on a wide array of supplies that are used in the production process. All this is by way of saying that swings in gasoline prices can have a significant impact on broader inflation

trends. The latest inflation report clearly reflects this causal effect. In June, the consumer price index fell by 0.3 percent, owing entirely to the decline in gasoline prices. While a gasoline-induced drop in the CPI has occurred several times in recent years, this was the largest monthly decline since December 2008, when deflationary forces were causing deep concerns among policy makers.



The fear of deflation is obviously not on the radar screen at the moment. As the chart shows, while the annual inflation rate has receded to 1.7 percent in May – the slowest in eighteen months – the core rate, which excludes volatile food and energy prices, has remained at a post-recession high of 2.3 percent, having posted increases of 0.2 in each of the past three months. However, the core inflation rate tends to lag the overall rate, as it takes time for swings in energy and other commodity prices to work through to the broader economy. Hence, the elevated core rate is still being influenced by the run-up in commodity prices that occurred earlier in the year. Like the headline CPI, the core inflation rate is likely to recede over the second half of the year, as the lagged effects of sliding oil and commodity prices filter through to the broader basket of goods and services.

Significantly, the financial markets are once again putting a positive spin on the latest spate of negative economic news, which included a decline in industrial production as well as weak retail sales this week. With the second quarter shaping up to be somewhat weaker than expected a few weeks ago, the hope is that the Federal Reserve will step in with more easing moves to help reinvigorate growth. That prospect may also have brightened by the improved inflation environment as well. The Fed's policy-setting committee meets next week and we suspect that there is a good chance it will find sufficient evidence the recovery could falter, and opt to take out a little insurance against decelerating growth and volatile financial markets. Hence, don't be surprised if the decision is made to extend and expand the Maturity Extension Program (MEP) -- so-called "Operation Twist" -- beyond the previously announced June 30 end. The contents of the Fed's portfolio still has a pocket of about \$200 billion of shorter-term holdings that could be sold to purchase longer-term Treasuries. The Committee could allot some or all of this to further maturity extension, which would ensure that rates remain lower than they would have otherwise. A little insurance is probably the safest course to take, giving the uncertain environment in coming weeks and months.

Industrial Production Slips

