



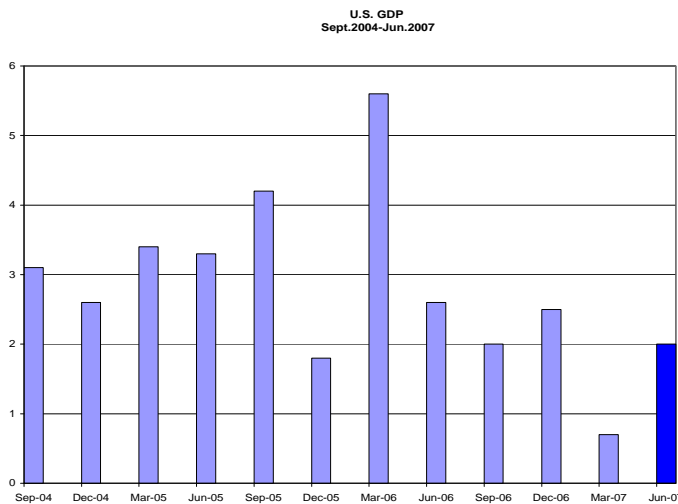
Quarterly Economic Report – 2nd Quarter 2007 (June)

The Good, The Bad and The Ugly

After a stumbling start in the first quarter of 2007, the US economy rebounded in the second quarter of the year which ended June 30th. Economic activity, as measured by GDP, only grew at a .7% pace in the first quarter. That pace returned to a more “trend” like level of between 2-2.5%, which is still below the average of the last 12 quarters, but feels a lot better to businesses and consumers than the snail’s pace of Q1. We are not seeing forward growth accelerating much beyond that pace but we do see divergence within sectors of the economy, hence the good, bad and ugly outlooks.

“THE GOOD”

Overall, the core rate of commodity inflation remains low. Recently, we have seen a new spike in Crude Oil prices as demand for refined products (gasoline, jet fuel, petrochemicals, etc.) has grown faster than expected while at the same time refinery capacity utilization has been curtailed by mechanical and weather related problems at sites around the nation. But with producers unable to pass along higher energy costs due to global competition, wholesale prices excluding food and energy have increased an average of less than .2% per month since the beginning of the year. Consumers have fared equally as well, with CPI’s core rate only rising at the same pace of less than .2% and retail demand for products whose costs are rising shifting to alternative, lower priced items in many cases.



With Q2 growth estimated at 2% or higher the economy has almost returned to “trend” level-the average for the last 3 years.

As long as commodity based inflation remains in check it allows the US Federal Reserve Bank to maintain a “wait and see” attitude and keep monetary policy unchanged.

“THE BAD”

Amidst the soft economy of Q1 hopes rose for an easing of monetary policy by the US Federal Reserve sometime near the end of 2007. These hopes were dashed when the Open Market Committee announced that their inflation concern was not solely commodity based but rather based on a tightening labor market and the high level of “resource utilization”. Simply put, resource utilization means that there are not enough workers to fill existing jobs while new jobs are being created by economic growth. This can cause an inflationary wage-price spiral that is extremely difficult for the FOMC to contain. Commodity based inflation can usually be reined in by moderately slowing the economy through gradually tightening monetary policy. This, in turn, gradually slows final demand. It also eliminates pricing power and drops prices back down.

A wage-price spiral is very different.

Company A has a pool of skilled workers and is doing well. They are doing so well, in fact, that their biggest competitor Company B decides to build a new plant next door. In order to hire skilled workers (all of whom work at Company A) they offer a higher salary and/or better benefits. Company A then has a choice. They can let the workers go and hire new ones (which requires time and training-all of which costs money) or they can match or exceed the offer Company B is making. If they choose that course of action, their fixed costs now increase and they have no choice other than raise the price of the goods they produce. This ‘domino effect’ through the economy is so broad based the only thing the Fed can do is hike rates hard and fast and slow things down much quicker. That puts people out of work along with other detrimental and is the last thing the FOMC wants to have to do.

FedSpeak has moved into the subject of job creation and the shrinking US labor force. With unemployment at 4.5% there is very little “slack” in the jobs market from the Fed’s viewpoint. They have said they would be “preemptive” in tightening policy *if* the jobs market continues to put pressure on labor costs. Upon hearing this, the bond market promptly discounted the likelihood of any Fed easing near term and yields rose across the curve anywhere from 25-30 basis points. The adjectives and verbs used by the Fed become very critical as the markets look for direction.

“THE UGLY”

When the housing market began its current contraction about a year ago it was initially deemed a healthy situation that would get rid of some of the excesses in the industry. What has become more and more clear, however, is that the depth of the excess was far greater than originally believed and that there may still be a considerable way to go before the industry stabilizes itself.

The “sub-prime” lending market, which is a catch all phrase for non-traditional home lending, based itself on the belief that the appreciation of housing prices would continue to exceed the costs of financing and allow homeowners to borrow more and more using their homes as collateral. As prices are now retreating in both the new and existing home sales indices, the rates of defaults, foreclosures and personal bankruptcies have soared. Many of the mortgage finance companies who wrote the underlying loans have had to shut their doors and several large investment banking firms have seen billion dollar portfolios lose 10-15% of their underlying asset value. All this has put a huge damper on housing and housing related activity. Since this sector is believed to account for as much as one third of all GDP related activities it will probably be a drag on the economy not just for the rest of 2007 but most of 2008. It may very well be a reason why the FOMC would not tighten monetary policy further as the “measured pace” of rate increases during 2004-2006 was probably one of the contributors of the housing and mortgage markets imbalance.

With the first half of 2007 now behind us we have seen a wide range of varying and conflicting economic data. When we blend the good, the bad and the ugly and then throw in global geopolitical problems, some curveballs we may get from Mother Nature and the outlook for a new US President in 2008 it will definitely get more interesting before the year rides off into the sunset.