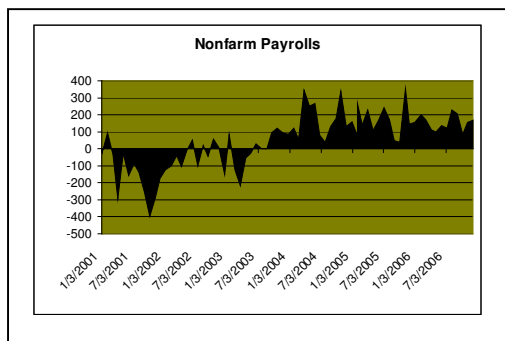




Quarterly Economic Report – 4th Quarter 2006 (December)

A New Year and an Old Forecast

The questions for the new quarter is the same one with which we left 2006 and that is how much underlying strength is there in this economy, and, is there significant inflation lurking in the shadows? As to the strength issue, economists can make sound arguments for either a weakening economy or underlying strength. Those arguing for weakness can look conveniently to manufacturing and housing for support. Those arguing strength can point to employment and the consumer. Those waiting for inflation need only look at commodity prices and oil to bolster their position and those against point out we haven't seen it.



Without question the economy has slowed from booming and bustling 2005.

Year-over-year comparisons throughout 2006 made the economy look perhaps weaker than reality. The USA is not going to be the provider of autos to the world in the coming decade.

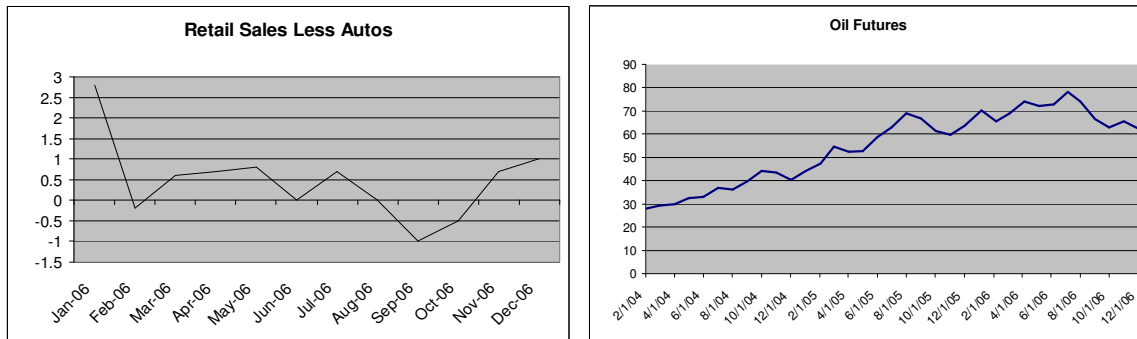
Major layoffs in the auto manufacturing area not only heralded severe blue collar unemployment problems in the upper Midwest but indicated an ever growing awareness that the US GM is just about to pass the #1 mantra to Toyota, Ford is in disarray, and Nissan and Kia are claiming substantial market shares. However, despite the severe layoffs in Detroit and other auto manufacturing areas these are localized problems and have to be absorbed locally. More frightening is the overall position of US manufacturing until developing countries experience their own wage pressures.

Another area of concern is the housing sector which for several months has clearly shown a slowdown from the red hot markets in 2003-2005. One could reasonably ask however just how that super-heated market could continue. Housing was fueled by mortgage and interest rates at historical lows. Money was cheap and the economy was strong. Homebuyers had confidence that their jobs would continue and jumped into home ownership at record rates. As they worked on personalizing their homes the Home Depot's of the world boomed as did Bed Bath & Beyond. Eventually however the *American* consumer has to rest. Higher interest rates have slowed the market but so has the overhang in housing inventories built by opportunistic home buyers during the same period. It will take awhile to work through this housing inventory as it does to take to work through any inventory. That is why we call it a business cycle!

Both the manufacturing and housing markets exhibited unexpected strength in December. Outside of autos durable goods (new orders for large items) rose 3.1% and although skewed by

airplane orders even the core were up a substantial 2.4%. This will not make up for the quarter's poor showing which was done the most in 3 years. In housing also December new sales were up 4.8% for an annual rate of 1.12 million units due partially to warm weather. A longer period review will be necessary to see how inventories and incentives are really pointing to extended weakness.

The confidence that helped fuel the housing boom (or forth as Greenspan so accurately described it) has not dropped as much as would be expected if one thinks that the economy is about to falter or fall. People have confidence when they are getting a pay check, when they think their job will continue, when they can still afford their necessities and a few niceties. This is a strong showing with so many rallying against current military actions. Consumers did their best at Christmas to buy beyond their means and the retailers enjoyed a healthy season.



The inflation threat is a real one also. Oil has fallen to \$50 a barrel in January but it peaked at \$ 78.10 in July 2006 and held above \$60 a barrel for all of 2006. Other commodities such as copper, lumber and aluminum also saw major increases and as those still high prices must work through the manufacturing cycle which could in turn spike inflation considerably. With red-hot competition worldwide it has been difficult for manufacturers to pass through their costs but some may have to take a lead from the airlines and pass through increases. Such a move would force the Fed to act and raise rates.

The shaky positions of housing and manufacturing contrast with an overall strength in the economy that continues to exceed expectations. Consumer spending (shown above) and job growth may well balance the slowdown. Federal Reserve members are hoping that moderate growth in other areas will override the housing slump. In addition the slow down may cool the inflation built up by commodities and housing prices. If the balance holds the Federal Reserve will be able to hold short term rates at 5.25%. The futures markets are betting 9 out of ten that the rates are in hold until at least mid-year.

As we start 2007 the economic picture is blurry but an underlying strength appears to be winning over inflation threats and component weakness. If the Federal Reserve stays on hold we may even see a more normally shaped yield curve (with higher longer term rates) based more on market activity. As rates rise globally, international funds may flow out of the US raising longer rates. As expectations of rate cuts decrease and investors feel more comfortable with a non-booming but stable economy we could easily see that long awaited fly-by as opposed to the nay-sayers hard landing.