First Quarter 2008 Performance Review and Outlook

The economy grew .6% in real terms during the first quarter of 2008 based on preliminary announcement by the Bureau of Economic Analysis. First quarter growth almost matched the .58% revised growth of the fourth quarter of 2007. The two back-to-back quarters of anemic growth are not likely to be the end of the slowdown. The housing sector remains weak and financial institutions have yet to repair balance sheets from the damage sparked by declining housing values. Current unemployment of 5% does not reflect the fundamental weakness in the labor market where hiring is slowing and wage gains are modest. Consumers face uncertain job prospects, declining home equity values, rapidly rising energy prices, higher food prices, strict credit conditions, and low levels of confidence for the future. Slower consumer spending limits the growth potential of the economy. Business investment is not likely to pick up the slack, especially with the large inventory accumulation of the first quarter. Government spending will pick up as rebate checks are spent in the second quarter, but this one-time stimulus is not likely to carry much momentum into the last two quarters of 2008. Trade will turn to a positive factor for growth as the weaker dollar and slow domestic economy lead to fewer imports.

Inflation remains moderate, even with rapidly rising energy prices and upward pressure from food and commodities. Moderate wage growth and rising productivity have kept labor costs down. Weak consumer spending will keep aggregate demand in check. Going forward, there are reasons to be worried about inflation pressures. The weak value of the dollar and rising import prices feed domestic inflation and allow domestic producers to increase prices. There is little evidence of high energy prices feeding into core product prices at this point, but spillover effects from higher oil prices may develop. The combined effects of Fed policy to bring down short-term interest rates and fiscal policy moves to stimulate the economy through deficit spending may lead to an inflation bias over time.

Consumer, business, and investor pessimism presents an important obstacle to improved growth. Sentiment index data and consumer surveys paint a picture of low and downward trending confidence in employment, inflation, and economic activity. While the depth of this economic slowdown to date is much less than in past recessions, sentiment data reflect lower levels of confidence today than in those prior periods. To some extent, improved sentiment must be part of any recovery from the current economic slowdown.

Economic growth in the final two quarters of 2008 will be modest (around 1%) as financial institutions repair balance sheets and homeowners work out mortgage obligations. Housing and durable goods sectors are not likely to improve much in the remainder of this year. The more important issue will be the extent to which the fundamental problems initiated by the housing sector spillover to other sectors. Consumer credit now finances a disproportionate amount of spending, making it possible for the same credit default issues to emerge in other credit markets. Inflation is likely to remain under control but will edge above the year over year 2.5% target for core measures. Baseline measures, including volatile energy and food components, are likely to be in the 3.5% neighborhood. Further easing by the Fed through lower Fed Fund targets is not likely. The current target of 2% already offers negative real interest rates to borrowers. More specific changes in regulation and capital formation guidelines are likely.

Just How Bad is the Slowdown?

Economic performance in the first quarter of 2008 can be placed in perspective by comparing quarterly performance over the past year. The first sign of serious economic problems with housing occurred at the end of the second quarter of 2007. Most economists estimate that housing alone cost the economy 1.2% GDP growth. Subsequent problems in the subprime market and asset values of financial institutions created additional drags on the economy, both directly and indirectly through higher risk aversion and pessimism in the economy. Table 1 illustrates the quarterly performance of the economy in key areas. Growth declined significantly in the last two quarters but remained positive. Inflation remained in check based on the implicit price deflator and corporate after-tax profits have no clear trend. While a slowdown is evident, economic performance has not yet reached a severe contraction.

Table 1. Quarterly Performance of the Economy

Series	I Quarter '08	IV Quarter '07	III Quarter '07	II Quarter '07	I Quarter '07
Real GDP growth (Annual %)	0.6	0.58	4.91	3.82	0.60
Implicit Price Deflator (Annual %)	2.58	2.41	1.03	2.63	4.23
Corp. Profits After Tax (% change quarter ago)		1.08	-2.16	5.73	1.98

Source: Bureau of Economic Analysis

Table 2 shows more specific information about inflation. Given the shocks of higher oil prices and rising prices for commodities, inflation is relatively tame. For example, a CPI increase of .2% per month is an annual inflation rate of about 2.4% (2.6% compounded). There is no pressure on prices from labor, illustrated by the low employment cost index data in Table 2. Using a simple average, the annual % change in employment costs for the last four quarters is only 3.2%, which would be around 1.2% when labor productivity of about 2% is deducted.

Table 2. Monthly Inflation

Series	May '08	Apr. '08	Mar. '08	Feb. '08	Jan. '08
Consumer Price Index (m/m%)		0.2	0.3	0.0	0.4
Core CPI (m/m%)		0.1	0.2	0.0	0.3
PCE (m.m%)			0.3	0.1	0.3
Core PCE (m/m%)			0.2	0.1	0.2
PPI Finished Goods (m/m%)			1.1	0.3	1.0
Core PPI (m/m%)			0.2	0.5	0.4
Employment Cost Index (% change in index)	0.7	0.8	0.8	0.9	3.3

Source: Bureau of Labor Statistics

Unemployment rates through April in Table 3 do not correspond to what we expect to see in a severe downturn. Normally we see unemployment approaching double digits during a full blown recession. The 5% unemployment rate is close to what many would argue to be full employment. However, we do not expect reductions in weekly hours worked to occur when unemployment rates are as low as they are now. Table 3 shows relatively low unemployment data but weaknesses in the labor market also appear with declining work week hours along with low wage and salary increases.

Table 3 also shows relatively low personal income growth (an average of .4% per month would be an annual increase of 4.8% using simple arithmetic averaging). The lack of wage pressure and declining hours worked both suggest a weak labor market even though the unemployment rates do not suggest such a weakness.

Table 3 Monthly Unemployment and Labor Market Data

Series	May '08	Apr. '08	Mar. '08	Feb.'08	Jan. '08
Unemployment Rate (%)		5	5.1	4.8	4.9%
Aggregate Weekly Hours (m/m%)		-0.4	0.3	-0.1	-0.4
Personal Income (m/.m%)			0.3	0.5	0.3
Wages and Salaries (m/m%)			0.5	0.3	0.6

Source: Bureau of Labor Statistics and Bureau of Economic Analysis

In Table 4 the weakness in production and manufacturing is clearly developing with significant declines in autos and durable goods, which is in line with early stages of a recession. Table 4 shows that the weaknesses in housing and financial institutions are now clearly spilling over into manufacturing. This second round of problems is likely to develop more fully later in 2008. Weak income growth and pessimism both discourage consumer purchases of durable goods and vehicles. Table 4 shows the pattern of weak durable good orders, declining vehicle sales, lower capacity utilization, and weakness in retail sales.

Table 4. Production, Manufacturing, and Inventory

Series	May '08	Apr. '08	Mar. '08	Feb. '08	Jan. '08
Industrial Production (m/m%)		-0.7	0.2	-0.7	0.1
Manufacturing (m/m%)		-0.8	0.0	-0.7	0.0
Durable Good Orders (m.m%)			-0.3	-0.9	-4.4
Inventory/Sales Ratio			1.27	1.28	1.27
Auto & Light Truck (m/m%)		-4.6	-1.31	0	-5.5
Capacity Utilization (%)		79.7	80.4	80.3	81.0
Retail Sales (m/m%)		-0.2	0.2	-0.5	0.6

Source: Census Bureau and Federal Reserve Board

Key interest rate data appear in Table 5. The successive reductions in the Fed Fund target have brought the rate to 2%. With inflation of 2.5%, this makes the real rate negative. There is little room left for Fed easing through rate reductions and liquidity availability. The data in Table 5 also show that Fed reductions in the short term rates have little impact on longer term rates. Rates on 10-year notes show no relationship with the Fed Fund target rates. Longer term rates reflect expected inflation, risk aversion, and liquidity concerns that are not immediately affected by Fed policies. Further easing by the Fed is not likely to affect longer term rates and longer term decisions on investment.

Table 5. Financial Markets

Series	May '08	Apr. '08	Mar. '08	Feb. '08	Jan. '08
Fed Fund Target (%)	2.00	2.24	2.64	3.00	4.25
10-Year Note (%)	3.85	3.67	3.51	3.74	3.9

Sources: Federal Reserve Board and Bureau of Economic Analysis

The slowdown has not yet reached severe proportions, but the data suggest that subsequent rounds of the slowdown are yet to materialize. The last two quarters are significantly below the 2.9% average GDP growth experienced since the 1991 recession. A likely scenario is another two quarters of GDP growth that hovers around 1% as the economy adjusts to oil shocks and consumers repair their financial conditions. A shallow and prolonged downturn seems more likely than the short and violent recessions that are more typical of a business cycle.

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Summary of Recent Economic Data

GDP – Very Weak Growth – Problems Likely to Continue

- Advance estimates by the Bureau Economic Analysis reported an anemic 0.6% annualized GDP growth rate during the first quarter of 2008. The first quarter of 2008 nearly matched the dismal .58% real growth rate in the fourth quarter of 2007. While the first quarter GDP growth rate is barely above zero, it exceeded the .2% growth rate expected by the consensus forecast.

- Compared to the fourth quarter of 2007, inventory accumulation offered a stimulus to the economy in the first quarter of 2008. Stronger imports, weak nonresidential construction, and weak growth in consumer spending offset the boost from inventory growth.

- On a year over year basis ending after the first quarter of 2008, real GDP increased by 2.5%, below potential growth targets in the 2.75% to 3% range.

- Housing continued to be a drag on growth. Real investment in residential structures fell 27% on an annual basis in the first quarter following a decline of 25% in the fourth quarter. Contraction in residential investment now extends to nine straight quarters. Analysts estimate that residential investment contraction subtracted 1.2% from GDP growth in the first quarter alone.

Production and Manufacturing – Durable Goods are Tanking

- New orders for durable goods fell .3% in March following a .9% decline in February and 4.4% decline in January. Durable goods fell at an 8.5% annualized rate in the first quarter of 2008. New orders were largely help back by the drop in motor vehicle orders. Increases in defense and civilian aircraft orders did not offset the negative effect vehicle sales had on the transportation component of durable goods. Outside transportation, new orders for durable goods increased 1.5% with an increase of .2% in shipments.

- Unfilled orders and inventories of durable goods increased in March. Inventories increased 1.1% in March. The inventory to shipment ratio continues to move up and is now at its highest level since the final month of the last recession in 2001. Such a large

inventory to shipment ratio has a negative effect on durable good manufacturing going into the second half of 2008.

- Business investment, excluding inventories, fell 2.5% in the first quarter. The first quarter decline represents the first decline in business investment since the fourth quarter of 2006.

- The Chicago Purchasing Managers' Index (PMI) reached 48.3 in April following readings of 48.2 in March, 44.5 in February, and 51.5 in January. A PMI less than 50 signals contraction in manufacturing. The PMI index data suggest a continued contraction in the manufacturing sector.

- The ISM manufacturing index held steady at 48.6 in April. The index slipped below the contraction benchmark of 50 in February but stabilized somewhat in April. The ISM index levels are consistent with a contraction but are not necessarily in a recession zone. For example, the ISM index averaged 43.3 in the 2001 downturn compared to the 49.2 index average in the first quarter of 2008.

- Construction spending fell 1.1% in March following gains of .4% in February and a decline of 0.4% in January. Total construction spending is 3.4% lower than one year ago.

- Factory orders for manufactured goods increased 1.4% in March following a decline of 1.9% in February and a 1.1% increase in January.

- The total inventory to sales ratio reached 1.27 in March, which is the highest reading since 2003. The manufacturing inventory to sales ratio remained unchanged at 1.27 while the wholesaler ratio declined to 1.09 from 1.11. The retail ratio declined to 1.47 from 1.48. Overall, inventories are relatively high, suggesting weaker new manufacturing in the second quarter of 2008.

- Nonfarm business productivity grew 2.2% in the first quarter of 2008 compared to a 1.8% increase in the fourth quarter of 2007. From the first quarter of 2007 to the first quarter of 2008, productivity grew 3.2%. Even with the weak economy, productivity gains continue to prevent inflation pressures from the labor market.

- According to the Philadelphia Fed survey of manufacturers, the economy is in a recessionary zone with respect to factory operations. The survey results improved in May but the index has been negative for six consecutive months. Factories are getting help from increased trade exports but slower domestic spending and weak business confidence continue to weigh down manufacturing.

- Industrial production fell .7% in April, well below expectations. By comparison, industrial production increased .2% in March, fell .7% in February, and gained .1% in January. While there was little change in industrial production in the second half of 2007 and only a modest decline in the first quarter of 2008, April's report suggests significant impacts on production from the weak economy are likely to develop into 2008.

- Capacity utilization for the industrial sector as a whole fell to 79.7% in April from 80.4% in March. April marks the firs utilization rate below 80 since 2005.

Inflation – Better than Expected

- The overall GDP price index increased at a 2.6% annual rate in the first quarter of 2008. The index increased 2.4% in the fourth quarter of 2007.

- The personal consumption expenditure price index (PCE) increased at a 3.5% annual rate in the first quarter compared to a 3.9% increase in the fourth quarter. The core PCE, which is the Fed's preferred measure of inflationary pressure in the economy, increased at a 2.2% annual rate in the first quarter.

- The consumer price index (CPI) increased 0.2% in April following a 0.3% increase for March, a flat February, and .4% increase in January. On a year-over-year basis, the core CPI increased 2.3%. Both the core CPI and the baseline CPI are below consensus estimates, suggesting that inflation is slowing. There is no evidence that high energy prices are spilling over into the core CPI. The Fed will keep a watchful eye on inflation data and is likely to pause with after the most recent Fed Fund target reduction to 2%. The slow economy appears to be keeping inflation in check for the near term and allows some added room for fiscal stimulation.

- Producer prices increased 1.1% in March following increases of 0.3% in February and 1% in January. The core PPI rose .2% in March, .5% in February, and .4% in January. The sharp increase in the PPI over the first quarter of 2008 came from higher food and energy prices. The core PPI is more docile.. In general, inflation is higher at the earlier stages of processing than for finished goods, suggesting that substantial price pressure remains in the system. This pressure need not result in dramatic CPI increases as long as demand for finished goods remains weak.

- Wages and salaries increased .8% for the fourth consecutive quarter. On an annual basis, wages and salaries are up 3.4%. After subtracting productivity gains from wage and salary increases, the wage component of inflation is modest.

- The market's five year-forward 5-year inflation expectations are 2.44%, which has been steady over the last month. The level of inflation expectations are about the same as the 2006-2007 average. This gauge represents a relatively low level of market expectations for inflation.

Consumer Spending and Sales – Weaker Spending Throughout the Year

- Personal income rose .3% in March following gains of .5% in February and .3% in January.

- Consumer credit increased by $15.3 billion in March and increased at a 7.2% annualized rate. The increased use of credit in March is the second largest increase in the past seven months. By definition, consumer credit excludes mortgages or loans secured by real estate. Revolving credit contributed most to the increase in March. The data illustrate that consumers continue to use credit cards to maintain spending during weak labor markets, slow income growth, and asset value reductions. Increased consumer credit helps sustain spending during the downturn but it also causes an erosion of credit quality.

- Chain store sales increased 3.6% in April following a decline of .5% in March and 1.9% increase in January. Overall, sales in the first quarter are consistent with the prior two quarters. Tax rebates may help sales over the next two months but the general trend is for weak sales for the next two quarters.

- Total retail sales fell .2% in April following a 2% gain in March, a decline of .5% in February, and a .6% gain in January. Vehicle sales were responsible for the major declines in sales while building supply stores, electronics and appliance stores led the April growth.

- Vehicle sales slumped in April to an annual seasonally adjusted rate of 14.4 million units following 15.1 million units in March, 15.3 million units in February, and 15.3 million units in January. First quarter vehicle sales were 15.3 million units at the annual seasonally adjusted rate. The April sales number is the lowest since mid-1998. Most of the plunge in vehicle sales occurred in SUV and light truck sales as a reaction to high gas prices. The Big Three automakers had double-digit declines in sales compared to a year ago. Sales are likely to improve in the second half of 2008 only if consumers spend tax rebates, a gas tax holiday is declared, and if additional policies are implemented to protect homeowners.

- Nominal consumer spending increased .4% in March following a .1% gain in February and .4% increase in January. In real terms, spending was much more modest. Real spending in March represented a small 2% increase on a year-ago basis.

- The consumer saving rate fell to .2% in March following rates of .4% in February and 0% in January.

Unemployment and Labor – Better than Expected – Should get Worse

- The unemployment rate fell to 5% in April following rates of 5.1% in March, 4.8% in February, and 4.9% in January. On the surface, a 5% unemployment rate is not alarming and would be much higher in a normal recession.

- Payrolls fell by only 20,000 in April compared to expectations for 75,000 lost jobs. Job losses in March were 81,000 following losses of 83,000 in February and 76,000 in January. The economy has lost 60,000 jobs a month on average over the last six months. Many of these job losses come from housing or housing-related businesses. The

relatively low unemployment rates mask the movement of workers to part-time jobs and lower-paying service jobs.

- Job cuts over the last few quarters are moderate compared to prior recessions. For example, in the first six months of the 2001 recession, job cuts averaged 130,000 per month compared to job losses averaging 60,000 per month over the last six months.

- Since the beginning of the fourth quarter of 2007 the four-week moving average of initial claims for unemployment insurance shifted from 320,000 to the current level of 365,750. Continuing unemployment claims increased by 28,000 to a level of 3.06 million in April, which is the highest since 2004.

- Approximately 25% of the job cuts in April were in financial services, underscoring the industry's restructuring. In the remainder of 2008 we are likely to see weaker job numbers in other sectors and the secondary effects of the financial market failures spread.

- Employment costs increased .7% in the first quarter of 2008 compared to a .8% gain in the fourth quarter of 2007. The general trend of low employment cost increases should continue throughout 2008, helping to moderate inflation overall. The benefits component of the employment cost index increased only .6% in the first quarter. Low labor costs suggest weak labor markets and relatively low pressure for domestic wage-induced price increases.

- The recent Job Openings and Labor Turnover Survey (JOLTS) reported that the economy created 4.55 million jobs in March, but 4.4 million people left their jobs. The hiring rate has trended downward since the second half of 2006 but a corresponding decline in separation rates (layoffs as well as voluntary attrition) cushioned the blow on employment data.

- Hourly earnings rose only .1% in April following increases of .3% in the prior three months. These relatively low increases show no evidence that rising food and energy prices are affecting wages.

Sentiment and Confidence Indicators – Worse than they Should Be

- The Conference Board Index of consumer confidence fell to 62.3 in April from 65.9 in March. The index was 76.4 in February and 87.3 in January. The index stood at 110 one year ago and has been declining steadily since that date.

- The University of Michigan Consumer Confidence Index fell 6.9 points in April from the March reading of 69.5. The index continues to slide from levels of 70.8 in February and 78.4 in January. April's index is the lowest since March of 1982. The short-run inflation expectations component of the index spiked with one-year inflation expectations reaching 4.8%. The dismal levels of confidence are more consistent with severe recessions than with current economic conditions. For example, the index is now almost a point and a

half below the lowest level in the 1990 recession. Confidence levels have not been this low since the aftermath of the 1981-1982 recession.

- The ABC News/Washington Post Consumer Comfort Index continued its downtrend reaching -47 in May. This low index level is associated with a severe downturn.

- The Conference Board's Consumer Confidence Index fell in January to 87.9 from 90.6 in December. Overall, the index remains low compared to levels of 112 reached earlier in 2007. Consumer confidence continues to spiral downward due to the combined effects of rising energy prices, weak and volatile equity markets, weak housing values, thin household finances, increased reliance on credit, and weak labor markets.

- Moody's Survey of Business Confidence reported a new record low. The survey results suggest a contraction in the U.S. and Europe while Asian and South America are expected to growth below long run potential.

Housing – Dismal Throughout 2008

- Existing home sales declined by 2% to 4.93 million annualized units. The decline in March represents a month-over-month decline of 2% and a year-over-year decline of 19%. Inventories increased in March to 9.9 months. According to the National Association of Realtors, housing prices are 8% lower than one year ago.

- New Home sales fell 8.5% in March following declines of 5.3% in February and .5% in January. Census Bureau data indicated that the median house price fell 13% from one year ago with inventory expanding to 11 months. Conditions in the new home market appear to be more severe than in the existing home market.

- The S&P/Case-Shiller Home Price Index based on a 10-city composite fell 2.9% in February and 2.3% in January. Over the past year the index fell 13.6%. The 20-city composite index fell 2.7% in February and 2.3% in January. Prices are down 12.7% over the past year for this index. Price declines have been most severe in the Las Vegas, Miami, Los Angeles, San Diego, and San Francisco markets.

- The HAHB Housing Market Index fell from 20 to 19 in May. The index was 28 one year ago. Buyers are constrained by strict lender requirements, larger down payments, and expectations for further declines in housing values, uncertain labor markets, and general lack of confidence in the economy.

International Interactions – Trade Should Add to Growth

- The nominal trade deficit in goods and services declined 5.7% in March. The deficit of $58.21 billion was $3.5 billion less than in February. The improved deficit is a consequence of declines in both imports and exports, with a larger decline in imports. The weaker dollar appears to have helped lower imports but weak income growth abroad

also decreased exports. The U.S. imported less oil volume but higher prices boosted expenditures on oil imports to $33.15 billion.

- Trade with China represents a little over 25% of the U.S. trade deficit. This imbalance is expected to improve very slowly as the yuan appreciates relative to the dollar.

- The trade deficit should improve as the weak domestic economy and higher prices of imports due to the weak dollar take a toll on imports. The lower value of the dollar should make exports more attractive. If global growth holds, U.S. exports will provide a stimulus to growth later in the year.

- U.S. import prices increased 1.8% in April following the 2.9% increase in March, .2% increase in February, and 1.5% increase in January. Import prices in April are 15.4% higher than one year ago, adding inflationary pressures. Much of the increased import price move came from higher oil prices.

- U.S. export prices increased .3% in April following increases of 1.5% in March, 1% increase in February, and 1.2% increase in January.

- The global economy remains stable so far compared to the financial crisis affecting the U.S. and European markets. Higher commodity prices may introduce a wave of protectionist policies that could lower wealth creation overall. Most of the sentiment in favor of such protection centers in Europe.

- Europe feels the impact of the U.S. financial debacle. European financial institutions find it hard to obtain short-term money. The “value” of structured securities on their balance sheets remains unclear. Central banks on both sides of the Atlantic are sorting out the values of assets and liabilities.

- Both China and India experienced slower growth in 2007 due to slower export growth and tighter domestic monetary conditions to keep inflation under control.