

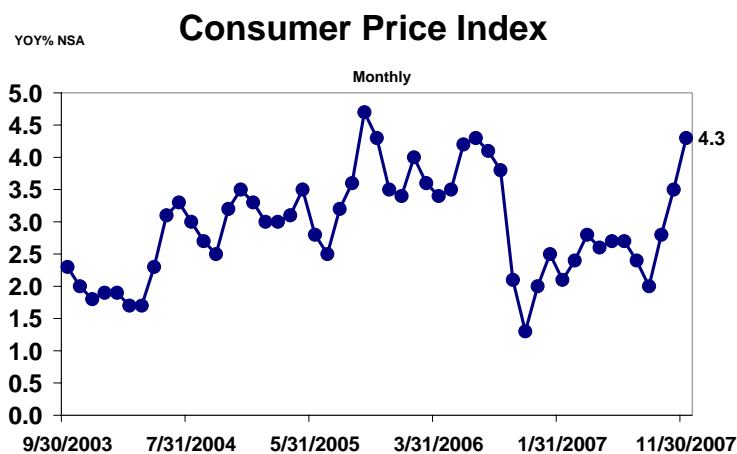
Date	Indicator	For	Estimate	Consensus*	Previous Period
Jan. 15	Retail Sales	December	0.1%	0.1%	1.2%
Jan. 15	Producer Price Index	December	-0.3%	0.1%	3.2%
Jan. 15	Empire Manufacturing Index	January	12.0	10.0	10.3
Jan. 15	Business Inventories	November	0.5%	0.4%	0.1%
Jan. 16	Consumer Price Index	December	0.2%	0.2%	0.8%
Jan. 16	Industrial Production	December	-0.4%	-0.1%	0.3%
Jan. 16	Capacity Utilization	December	81.0%	81.4%	81.5%
Jan. 16	NAHB/Wells Fargo Housing Index	January	20	NA	19
Jan. 17	Housing Starts	December	1.170M	1.170M	1.187M
Jan. 17	Initial Jobless Claims	Jan. 12	330K	NA	322K
Jan. 17	Philadelphia Manufacturing Index	January	UNCH	-2.0	-5.7
Jan. 18	University of Michigan Sentiment Index	January	76.0	74.8	75.5
Jan. 18	Leading Economic Indicators Index	December	UNCH	-0.1%	-0.4%

\*Consensus from Action Economics

## It is Hard to Imagine What Markets Are Hoping For

Markets continue to push the Federal Reserve to lower the Federal Funds rate as if any further lowering would bring back the U.S. housing market or increase the demand for U.S.-made automobiles. They even speculate that a lowering of the

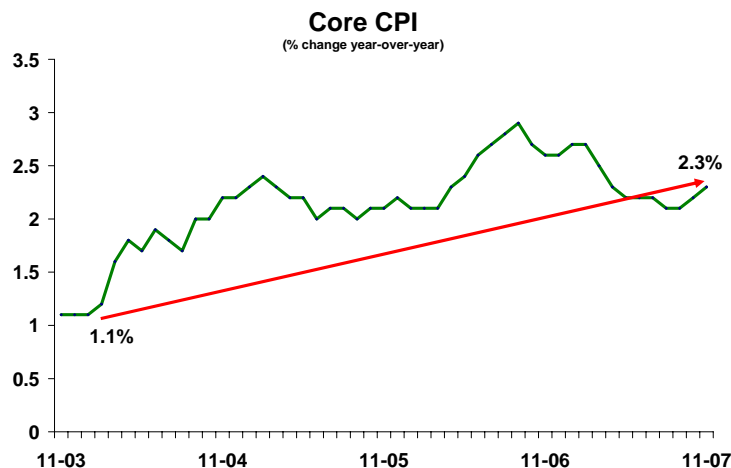
Federal Funds rate at this time to, let's say, 2%, will have no effect on inflation because the U.S. economy is so weak that inflation can never increase under that environment. The argument is that we already had the Federal Funds rate at 1% during a full year and inflation barely budged. All of these assumptions would be true if we were facing the world environment of the late 1990s and early 2000s. However, today's environment is completely different. Commodity prices, including petroleum and food, are at all-time highs, and nothing seems to indicate that those prices are going to go down any time soon. In fact, the U.S. Federal Reserve has to be very happy that inflationary expectations have remained so subdued even in this high commodity price environment. But, can we assume that this environment



Source: Bureau of Labor Statistics

will remain like this forever?

This is what markets seem to be assuming, that higher commodity prices will never affect inflation or inflationary expectations and that the Federal Reserve could lower interest rates without worrying about future inflation. However, my contention is that the Federal Reserve's job is to worry about inflation, even if inflation has still not been affected by the surge in commodity prices. But let me bring an analogy to what is happening today. Do we still remember that we are in this housing mess today because we assumed that interest rates would remain low forever? This is what markets were expecting several years ago, and is the



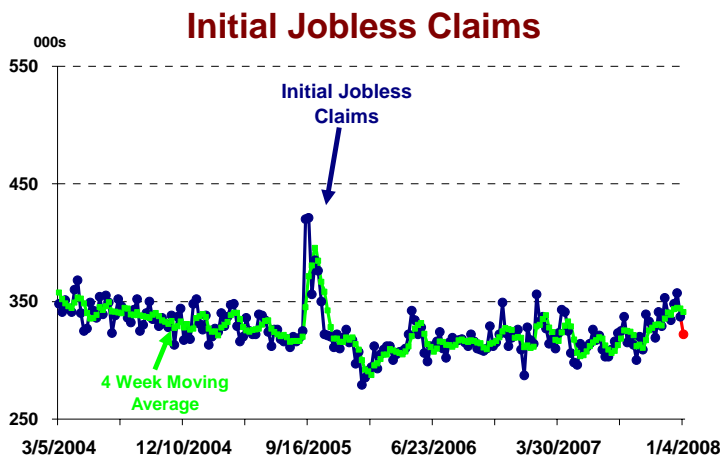
reason why we made so many investments mistakes. Are we ready to make the same mistake with inflation? Are we ready to say what many said about the business cycle during the 1990s when a host of “influential” economists argued that the business cycle was dead? Are we, or the Federal Reserve, ready to say that inflation is a thing of the past? If this is the case, we are in for a seriously rude awakening. And I believe that this is one of the biggest risks for the U.S. economy during this year.

Let’s say that the Federal Reserve lowers the Federal Funds rate to 2%, does this mean that we are going to start buying homes and U.S. automobiles again? The reason why nobody is willing to buy a home today is not that interest rates are too high; the reason is that *home prices* are too high. Nobody will want to buy a home today when they know that if they wait they could get the home for a large discount. This means that it does not matter what the interest rate is on mortgages; nobody is buying. And thus, it does not matter what the Federal Reserve does with the Federal Funds rate.

And I actually believe the Federal Reserve knows this. They are well aware of the ineffectiveness of the Federal Funds rate to help bring back the U.S. housing market and/or the U.S. auto sector. Thus, I still believe that many of the Federal Reserve Governors are going to be reluctant to lower the Federal Funds rate even if they ultimately go ahead with a decrease in the rate on January 30<sup>th</sup>.

### Is the Labor Slowdown Over?

One of my favorite weekly series is the initial unemployment claims series, and that series had been trending up since October in a clear indication that the U.S. job market was weakening. And as I have been arguing all along, a weakening of the labor market was going to weaken the U.S. economy as it was going to affect the strength of domestic consumption. However, during the last two weeks this series has been going the way of the R-word, but not the “R” word everybody is talking about, the “R” word of “Recovery.” Of course, those who want to keep lobbying the Fed to be more aggressive in lowering the Federal Funds rate are using all kinds of excuses to dismiss this latest turnaround in the initial unemployment

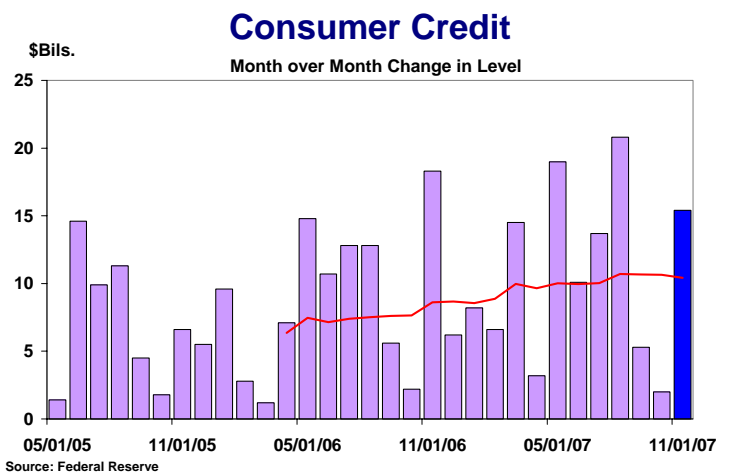


Source: Department of Labor

that even the credit crunch, which has been affecting the U.S. economy since August of last year, has had limited effect on consumer credit in the sense that consumers with good credit have continued to have access to relatively cheap credit. Only those consumers with bad credit have really suffered the effects of the credit crunch. Thus, it is not impossible to think that a recovery in economic activity is closer than many think. Having said this, don’t count on this recovery being a strong one, or for the U.S. economy to start growing at rates higher than 2.0%, unless we get to the point where the housing market comes back to life. And that event is at least a year away.

claims series, and I agree that it may be too early to call for a “Recovery” in the labor market. However, recoveries “do” start at some point, and I see no reason why we may not be facing a recovery in the U.S. labor market today.

While it is true that the U.S. manufacturing sector is contracting, as shown by the latest ISM-manufacturing index, the service sector continues to expand. This means that the overall U.S. economy continues to move along. It is true that the strength of this recovery will be very weak, but I believe the worst is over and behind us. It is clear



Source: Federal Reserve

# Major Economic Indicators

January 11, 2008

Economic Data	History								Forecast				Q4 to Q4 % Chg or Annual Average			
	2006.1	2006.2	2006.3	2006.4	2007.1	2007.2	2007.3	2007.4	2008.1	2008.2	2008.3	2008.4	2005	2006	2007	2008
Real GDP*	4.8	2.4	1.1	2.1	0.6	3.8	4.9	1.7	1.3	2.1	1.9	1.9	2.9	2.6	2.7	1.8
Personal Consumption Expenditures*	4.4	2.4	2.8	3.9	3.7	1.4	2.7	2.5	1.4	2.0	2.1	2.1	2.8	3.4	2.6	1.9
Private Housing Starts (000s units)	2,127	1,861	1,704	1,555	1,460	1,464	1,304	1,152	1,101	1,094	1,096	1,096	2,073	1,812	1,345	1,097
Vehicle Sales (mill. Units, annualized)	16.9	16.3	16.6	16.3	16.4	16.0	15.9	16.0	15.8	15.8	15.8	15.8	16.9	16.5	16.1	15.8
Nonfarm Payroll Employment (mil.)	135.4	135.9	136.4	137.0	137.4	137.9	138.1	138.4	138.6	138.9	139.2	139.5	133.7	136.2	138.0	139.0
Unemployment rate	4.7	4.7	4.7	4.5	4.5	4.5	4.6	4.7	5.1	5.2	5.3	5.3	5.1	4.6	4.6	5.2
CPI* (percent)	1.9	5.0	3.1	-2.1	3.8	6.0	1.9	3.5	4.0	2.4	2.3	2.1	3.7	1.9	3.8	2.7
PPI* (percent)	-0.1	3.7	0.7	-3.1	6.7	10.0	1.1	3.3	3.1	1.7	1.5	1.4	5.2	0.3	5.2	1.9
Compensation Per Hour*	12.9	-1.4	0.6	11.2	5.9	1.0	4.2	4.6	4.7	4.5	4.3	4.1	3.7	5.8	3.9	4.4
Productivity*	2.5	0.8	-1.6	1.8	0.7	2.2	6.3	3.0	2.5	2.2	2.2	2.1	2.1	0.9	3.1	2.3

\*Quarterly Data Percent Change At Annual rate; Annual Data Q4 to Q4 % Chg.

Financial Data	History								Month-to-Date	Current	Forecast (monthly)							
	2007.07	2007.08	2007.09	2007.10	2007.11	2007.12	2008.01	1/11/2008	2008.02	2008.03	2008.04	2008.05	2008.06	2008.07	2008.08	2008.09		
S & P 500	1,521	1,455	1,496	1,540	1,461	1,480	1,424	1,406										
Dow Jones Industrial Average	13,673	13,240	13,548	13,901	13,182	13,414	12,872	12,677										
NASDAQ	2,655	2,539	2,633	2,780	2,658	2,664	2,526	2,460										
Federal Funds Rate	5.24	4.53	4.89	4.62	4.36	4.04	4.10	4.25	3.75	3.50	3.25	3.25	3.25	3.25	3.25	3.25		
Treasury-3 Month Bills (yield)	4.96	4.32	4.00	4.00	3.34	3.08	3.25	3.13	3.20	3.20	3.20	3.20	3.20	3.20	3.20	3.20		
Treasury-10 Year Notes (yield)	5.01	4.67	4.52	4.53	4.15	4.10	3.90	3.82	4.00	4.10	4.15	4.20	4.25	4.30	4.35	4.40		
Prime Rate	8.25	8.25	8.03	7.74	7.50	7.32	7.25	7.25	6.75	6.50	6.25	6.25	6.25	6.25	6.25	6.25		
Libor 3-Mo. U.S. Dollar	5.36	5.48	5.49	5.15	4.96	4.97	4.53	4.26	4.40	4.15	3.90	3.90	3.90	3.90	3.90	3.90		
Mortgage-15 Year (yield)	6.36	6.25	6.05	6.05	5.87	5.75	5.65	5.43	5.70	5.80	5.85	5.90	5.95	6.00	6.05	6.10		
Mortgage-Adjustable (yield)	5.70	5.65	5.70	5.67	5.49	5.49	5.46	5.37	5.43	5.53	5.58	5.63	5.68	5.73	5.78	5.83		
Mortgage-30 Year (yield)	6.69	6.59	6.39	6.38	6.22	6.09	6.05	5.87	6.07	6.17	6.22	6.27	6.32	6.37	6.42	6.47		
GNMA (yield)	5.71	5.64	5.51	5.36	5.25	5.27	5.15	5.10	5.17	5.27	5.32	5.37	5.42	5.47	5.52	5.57		
BAA Corporate (yield)	6.65	6.65	6.59	6.48	6.40	6.65	6.49	6.49	6.46	6.56	6.61	6.66	6.71	6.76	6.81	6.86		

Source: Wells Fargo Economics, Macroeconomic Advisers, Bloomberg, Federal Reserve