Second Quarter 2008 Outlook and Review

Advanced estimates show that the economy's GDP grew at a 1.9% annual rate in the second quarter of 2008 following a revised growth rate of .9% in the first quarter. For the past year, GDP grew 1.8%, which is well below a target rate of 3% for sustainable growth. Recently revised data from the 2004 through 2007 period provide a 2.6% growth in real GDP. While the revised growth rate of -0.14 for the fourth quarter of 2007 is not consistent with a technical definition of recession, the economy is clearly mired in a very slow growth mode. Unemployment increased to 5.7% as labor markets weakened, but the unemployment rate is a lagging indicator and is normally much higher in a severe downturn or recession. Inflation continues to loom on the horizon as food, energy, and energy related price growth exceed targets. Foreign products are more expensive with the weaker dollar, and consumers have reduced imports. It remains to be seen if the positive boost to the economy from improved trade will be enough to keep the economy going until financial markets and housing markets work through the credit debacle.

Consumer confidence and leading economic indicators are sinking, even though July provided a respite from the plunge of earlier months. The Fed appears to be at the end of its interest rate cuts with a 2% Fed Fund rate. Even with negative real interest rates for bank borrowers there are limits to the influence of lower short term rates on longer term investment decisions. Worse yet, recent minutes of the Fed's Open Market Committee suggest that the balance of Fed attention is shifting to inflation away from the economic slowdown. A stronger dollar and lower inflation may now dominate the Fed's radar with higher interest rates as a target later in 2008.

For the remainder of 2008 the economy is likely to grow at a 2.5% rate with continued concerns for the stability of financial markets. Additional federal regulation of financial markets linked to increased efforts to work through defaults and bankruptcies will take time to restore confidence, allow liquidity, and return to more normal credit markets. Interest rates are likely to move up in response to higher expected inflation and higher credit risk premiums. The federal budget deficit will continue to grow and limit many of the fiscal initiatives that any new President of the U.S. may want to implement.

Is the Fed Out of the Picture for Stimulating Growth?

The minutes from the FOMC's meeting on June 24 and 25 show a picture of uncertainty with respect to the future course of Monetary Policy. Slow growth remained the most likely near term scenario but rising inflation created concerns for any additional easing. Growth in the first half of the year was clearly positive and out of the recession zone, but the economy remained soft. The consensus was that downside risks to growth had faded somewhat since the previous meeting, but that the risks "remained tilted to the downside." "At the same time, however, the near-term outlook for inflation had deteriorated.” Given all of this, the FOMC voted to hold the fed funds rate target at 2%. The minutes say that "members believed that the next change in the stance of policy could well be an increase in the funds rate."

Considering the inability of the Fed to support a continuation of an expansionary monetary policy, the chosen position is to sit on the fence. The FOMC held the target rate at 2% and is likely to stay with this position for the rest of this year and into 2009. The FOMC expects further weakness in the near term, but then an improvement. As long as this plays out, monetary policy will not change. If growth close to the sustainable rate of 3% takes hold in the first half of 2009, the Fed will begin to aggressively raise rates in an effort to hold off inflation.

Housing – A Hard Lesson in Reality- Prices Don’t Always Go Up

The collapse of the housing market continues to be a drag on the economy both directly and indirectly. Residential construction fell at an annual rate of 16% in the second quarter. The rate of decline in housing values and construction continues to moderate, but the bottom is not yet in sight. Falling real estate values and increased defaults and delinquencies have not yet fully filtered completely through the financial markets. Investment banks took the first financial market hits that are now threatening the existence of monoline insurers, banks, and major real estate mortgage programs like Freddie Mae and Freddie Mac. After showing signs of improving, financial market conditions have taken a turn for the worse. Facilitated by the troubles at Fannie and Freddie, equity markets were very volatile in July. Liquidity remains tight even with low interest rates as banks remain reluctant to lend to one another. Activity at the Fed’s lending facilities remains strong—an indication that banks need liquidity.

The lack of mortgage credit and the weak job market continue to impede stronger home sales. Even though policymakers are working hard to shore up the housing market and instill confidence in the financial markets, the housing market will not fully bottom out until mid-2009, with the risks to the outlook stacked on the downside.

Household credit quality is likely to get measurably worse into 2009. Nothing seems to be going right for household financing. Employment is falling, house and stock prices are lower, gasoline prices remain high even with recent reductions, major financial institutions are shaky, and consumers are as pessimistic as they have been in a quarter century. Lower wealth in the form of home equity, less available credit, and high debt and financial obligations are likely to push consumers toward saving and debt repayment rather than borrowing and spending. Government spending will continue to pick up some of the slack but it is difficult to see investment and international trade making up for soft consumer spending.

International Trade – Just How Much Can it Help?

Between 1996 and 2006, trade was a consistent drag on growth, shaving from 0.1 to 1.2 percentage points from growth in those years. The trade drag turned into a boost to growth adding 0.6 of a percentage point to growth in 2007. Trade was a key positive for the economy in the second quarter of 2008 making its largest contribution to growth since 1980. Record high oil prices remain an obstacle to improving the trade balance, but lower oil demand is starting to appear. Net exports added 2.4 % points to growth. Imports fell at an annualized rate of 7%, while exports rose 9%. The weak dollar played a large role in this improvement, as has strong global growth. With lower consumer spending and limits to government stimulation being likely going forward, continued contributions from trade to economic growth are important.

Global growth has so far generated strong demand for U.S. exports, particularly for manufactured goods. Added improvement in the U.S. balance of trade come from a lower value of a dollar, which makes U.S. export prices lower and import prices higher. The promising scenario for a boost in GDP from improved international trade requires continued economic growth abroad. Some major trading partners, notably the U.K., are experiencing economic slowdowns. On the other hand, a slowing domestic economy is restraining import growth. The U.S. economy is also expected to remain weak this year; so the trade balance may narrow further. The extent of the support for GDP from trade hinges on the strength of economic growth abroad.

Summary of Recent Economic Data

Production and Output – *Slow growth in all directions. Can it get any worse for housing and autos?*

- Real GDP increased 1.9% at an annualized rate in the second quarter. The consensus expectation called for 2.4% growth. Over the past year, real GDP increased 1.8%.

- Growth was 0.9% in the first quarter, revised downward from 1% last month. Trade and consumer spending were positives for growth, unlike the first quarter.

- Revisions to GDP show that output fell in the fourth quarter of 2007. Average annual growth from 2004 to 2007 was revised downward to 2.6%. This low growth rate represents an economy that is expanding, but at a slow rate below its potential.

- Trade was a key positive for the economy making its largest contribution to growth since 1980. Net exports added 2.4 % points to growth. Imports fell at an annualized rate of 7%, while exports rose 9%.

- A large drop in inventories placed a significant drag on GDP. Real final sales of domestic product, which is real GDP minus the change in inventories, increased 3.9% at an annualized rate in the second quarter. The change in inventories subtracted 1.9 percentage points from growth in the second quarter, the biggest drop in three years.

- Housing remains a drag on the economy, but with a smaller influence. Real investment in residential structures fell 16% at an annualized pace in the second quarter, the smallest decline in a year. The drop subtracted 0.6 of a percentage point from growth.

- Growth in real personal consumption expenditures increased 1.5% (annualized) in the second quarter, up from 0.9% growth in the first. Personal consumption expenditures added 1.1 percentage points to growth in the second quarter. Real spending on durable goods fell for the second straight quarter, the first time that has happened since 1990. Spending on nondurable goods bounced back after declining in the first quarter. Growth in spending on services slowed.

- Total real government spending rose 3% annualized in the second quarter, adding 0.7 of a percentage point to growth. Federal spending continues to grow, especially for defense. State and local government spending grew at a weaker pace after a decline in the first quarter.

- New orders for factory goods grew at a faster than expected pace of 1.7% in June. Nondurable manufacturer orders led the way with a 2.5% increase. Most of this increase occurred at petroleum refiners and chemical factories.

- For the second quarter, core capital goods orders increased 9.5% at an annual rate, about a percentage point less than the originally published estimate. Core capital (non-defense excluding aircraft) goods orders rose 1.2% in June and fell 0.3% in May, revised down from 1.4% and -0.1%, respectively.

- New orders for durable goods increased in June for the second consecutive month, contrary to expectations for a decline. A drop in civilian aircraft orders pulled down the new orders total. Outside of transportation, new orders were up 2%—the largest monthly increase since December 2007.

- Nondurable inventories surged 1.7%, the biggest increase since January. This was largely due to petroleum refinery inventories, which soared 9.1%.

- Inventories at factories rose 1%, the biggest increase since January. The inventory-to-sales ratio, which measures how many months it takes to deplete current inventories at the existing pace of sales, fell to 1.08 in May from an unrevised 1.09. The ratio stands at an all-time low. The durable I/S ratio ticked up by 1 basis point to 1.54 while the nondurable I/S ratio fell to a meager 0.76.

- Vehicle sales in July fell to 12.5 million units on a seasonally adjusted annual basis, following sales of 13.6 million units in June. The last time sales were as low as they were in July was during the recession of the early 1990s. The main drag came from sales of SUVs, vans, and pickup trucks. Vehicle sales were off 13% in July from a year ago.

- Chain store sales increased 1.2% in the week ending July 26 according to the ICSC. This healthy gain followed four consecutive small gains and was the largest weekly gain since early June. However, year-over-year growth increased only slightly to 2.6% as sales were up strongly in the comparable week last year.

- The Chicago Fed national activity index increased to -0.6 in June from a downwardly revised -1.06 in May. The three-month moving average, used to smooth out volatility, rose to -0.93 from -1.08. This marks the 11th straight month that the CFNAI has been negative.

- Industrial production rose 0.5% in June, a strong showing after May's 0.2% decline. Total manufacturing production rose 0.2%, but outside of motor vehicle manufacturing, output fell 0.1%.

- Capacity utilization increased from 79.6% to 79.9%, the first increase of 2008. Manufacturing capacity utilization was unchanged at 77.6%.

Labor and Unemployment – *Labor markets weaken but the data don't show the pain.*

- The unemployment rate increased to 5.7% in July. The labor force increased but the number of unemployed increased at a slightly faster pace. The unemployment rate is the highest since March of 2004. Nevertheless, it remains well below an unemployment rate expected in a recession. The unemployment rate tends to be a lagging economic indicator for the economy, reflecting prior economic activity.

- Payroll employment declined less than expected in July, but continued a trend of seven consecutive months of decline. Payrolls fell by 51,000 in July following revised declines of 51,000 in June, and 47,000 in May.

- Average hourly earnings increased by 0.33% in July, keeping pace with prior months.

- The average workweek fell to 33.6 hours. The shorter workweek means that average weekly earnings are falling faster on a year-over-year basis than are average hourly earnings.

- The number of part time workers increased 1.4 million during the past 12 months. The economy lost 463,000 jobs since the beginning of the year, or 66,000 per month on average.

- Employer costs rose 0.7% in the second quarter, matching the gain of the first quarter. Wages and salaries increased 0.7%, while benefit costs increased 0.6%. These increases extend the moderation in labor compensation, a trend that is expected to persist throughout the remainder of the year.

- Total compensation rose 2.6% on a seasonally adjusted annual basis in the second quarter, down from 3% in the first quarter.
- Benefits advanced 0.6% in the second quarter following a similar gain in the first quarter. On an annualized basis, benefits increased by 2.3%. Compared with one year ago, benefits were up 2.8% versus 3.5% in the previous quarter.
- Initial claims for unemployment insurance rose to 448,000 in the week ending July 26, compared with the previous week's 404,000. The increase puts claims at their highest point since 2003. This increase in initial claims overstates the weakness in the labor market, as the government's recently extended unemployment benefits.

Personal Income – *Rebates offer a short perk but temporary transfers provide modest boosts to spending.*

- Personal income inched up 0.1% in June after rising 1.8% in May. Income growth appears lower since tax rebates counted as transfer income. Excluding the tax rebate effect, personal income rose 0.3% in June relative to 0.4% May.
- Disposable income fell 1.9% in total, though this reversed only a small portion of the 5.7% gain in May.
- Tax rebates of $27.9 billion in June followed distributions of $48.1 billion in May and $1.9 billion in April. The Bureau of Economic Analysis treats these distributions as reduced tax payments when they go to taxpayers and as transfer payments when they exceed the income tax liability of the recipient. As a result, transfer income increased by $149.4 billion in June, $179.6 billion in May, and $7.8 billion in April. Tax payments were reduced by $185 billion, $397.5 billion and $15.5 billion, respectively.
- Reduced tax payments are continuing to lift the saving rate. At 2.5%, it was the third highest since 2003.
- The saving rate fell by nearly half from May's level. Nonetheless, it remains inflated by tax rebates, which consumers are only gradually spending. After averaging 0.3% in the first quarter, the saving rate jumped to 2.6% in the second quarter.

Construction Spending – *Sinking residential construction sets the pace.*

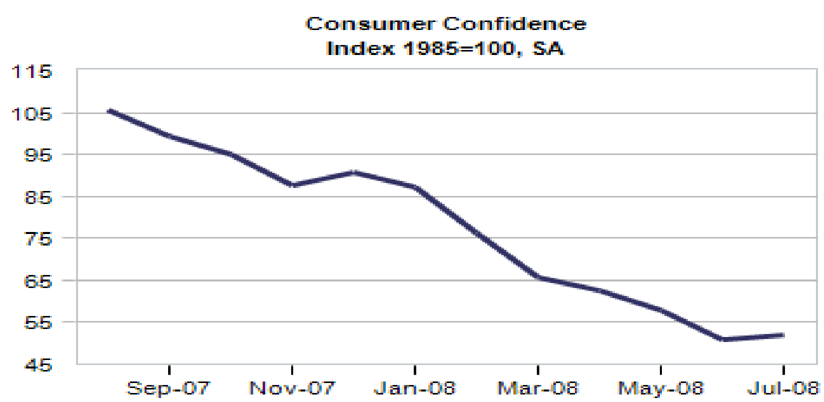
- Construction spending fell by 0.4% from May to June, which is in line with expectations. Construction spending in the first half of 2008 was 5.4% below the total for the first six months of 2007. Most of the decline in June's construction spending occurred in private residential construction while nonresidential construction also started to slow.

- Private residential construction remains the biggest drag on total construction activity. Not only has residential construction decreased steadily since January, but it is down by 26.4% from its June 2007 totals, a figure that indicates the true extent of the U.S. housing correction.

Sentiment and Confidence Surveys – *About as bad as it gets but July offered a small uptick.*

- The Conference Board index of consumer confidence increased slightly in July, rising to 51.9 from June's 51.0 (revised from 50.4). The expectations component of the index posted the largest gain of 1.7 points. An illustration of the index movement appears below.

Conference Board Index of Consumer Confidence



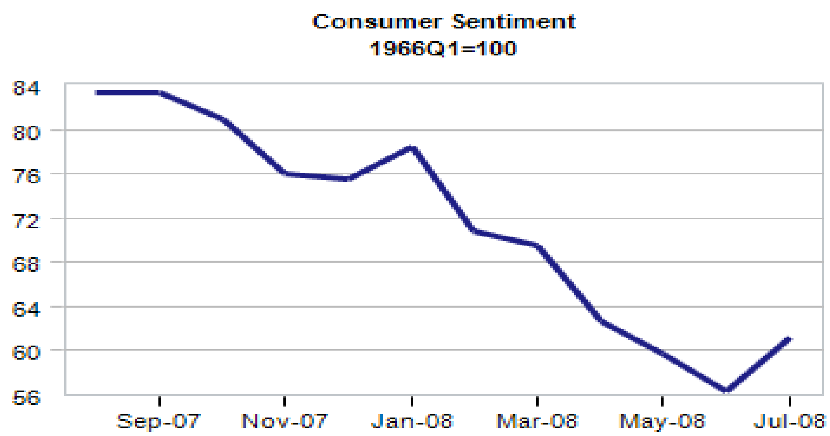
- Confidence rebounded in July from its 16-year low, but not by much. Lower gasoline prices and rebates appear to be more important to households than labor conditions.

- Inflationary expectations of respondents inched down while consumers became more optimistic about the stock market. More consumers expect interest rates to rise next year.

- The list of drags on confidence include a weak labor market; uncertain energy prices; weakness and volatility in equity markets; falling house prices; high food price inflation; reduced credit availability; and stretched household finances.

- The University of Michigan consumer sentiment index jumped in late July as lower energy prices improved consumer opinions. This same pattern occurs in the Consumer Confidence Index. The index came in at 61.2, up from the preliminary reading of 56.6 and June's 56.4. The current conditions component posted the larger increase compared with June. An illustration of the Michigan Consumer Sentiment Index over time appears below.

University of Michigan Consumer Sentiment Survey

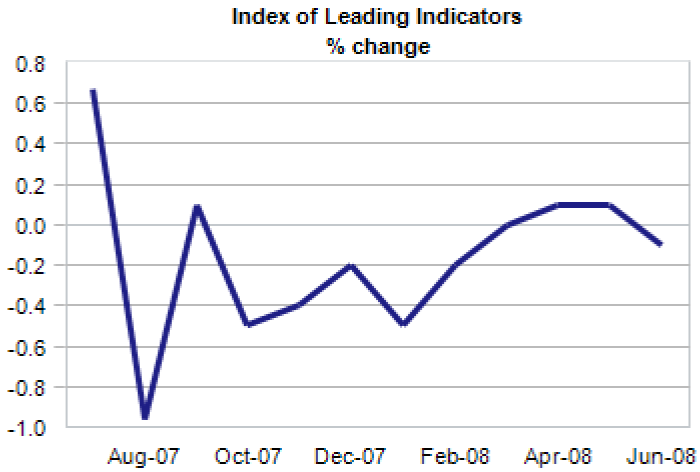


- Inflation expectations by consumers are high but are now easing. One-year expectations were unchanged from June's 5.1% and down from the 5.3% reported in the preliminary release two weeks ago. In May, they reached 5.2%, their highest level since 1982. Five-year expectations declined to 3.2%, from 3.4% in June and early July, which was the highest since 1996.

- Although confidence improved in the second half of July, it remains low. In June, the index was more than 4 points below its lowest level in the 1990 recession and well below its low for this decade. Confidence has not been that low since 1980.

- The Institute for Supply Management's manufacturing index inched slightly lower to 50 for July compared with June's 50.2. An index below 50 suggests an economic slowdown. Overall, the ISM index is consistent with a sluggish economy that has avoided a severe downturn.

- The Conference Board index of leading indicators fell 0.1% in June, following a downwardly revised 0.2% decline in May (previously +0.1%). The movement of the indicator series appears in the illustration below.



- After leveling out between January and May, the leading index is weakening again. The index is now at its lowest level since late-2004 and is negative once again.
- There were four positive contributors and six negative contributors to the index. Falling stock prices, higher unemployment claims, and a drop in the money supply subtracted three-quarters of a percentage point from growth in June.
- The six-month annualized leading indicator increased from -1.6% to -0.8%, its highest reading since September of last year.
- The Chicago Fed national activity index is a backward-looking indicator, and is more useful in gauging the overall economic picture of recent history through its compilation of a broad array of economic indicators. The CFNAI has been below the -0.7 threshold for the past seven months, and reflects recessionary economic conditions.

Inflation – *Food and energy spiral up but it could (and might) be worse.*

- The top-line CPI index for June finished 1.1% higher than in May and 4.9% higher than in June 2007, a higher than expected increase. Core inflation for the CPI also edged upward to 0.3% for the month and 2.4% for the year since June 2007. Most of the increase in top-line inflation came from a jump in energy prices, which finished 6.6% higher for the month and 24.7% higher after one year.
- The top-line CPI finished at 218.8 for June, an increase of 1.1% for the month and 4.9% from June 2007. The annualized rate of top-line CPI inflation was 7.9%.
- The core CPI finished at 215.6, an increase of 0.3% for June and 2.4% for the year since June 2007. The annualized rate of core CPI inflation was 2.5%.

- Core inflation continues to be dominated by rising services prices. The core services CPI increased by 0.3% for the month and 3.2% since June 2007. Annualized services inflation is now at 2.9%. By contrast, the U.S. economic downturn has sent the core goods CPI into deflation territory—a fall of 0.1% for the month, though prices are still 0.1% higher than one year ago.

- The CPI for urban wage earners finished at 215.2, a 1.2% jump from May and a 5.6% increase from June 2007. The higher jump compared with the standard CPI is almost entirely due to the larger share that transportation is taking up in wage earners' budgets.

- Energy prices increased by 6.6% from May to June and came in at 24.7%, higher than June 2007, in both cases a higher rate than in May. The rate of gasoline price inflation in June was 10.1% for the month and 32.8% compared with one year ago. The fuels and utilities component of housing costs increased by 1.8% for the month and was 12.2% higher than last year.

- Price increases among energy products have been dramatic over the past six months. Prices for finished energy products rose at a 38% rate during the first half of the year. A 6.0% increase in June was led by rapidly increasing prices for motor fuel, heating oil and natural gas.

- Energy price increases at earlier stages of processing have been even more dramatic. Prices for intermediate energy goods rose at a 49% rate during the first half of 2008, while prices for crude energy products rose at a 133% rate. In addition to rising prices for gasoline and diesel fuel, prices for residential heating oil, crude natural gas, and coal all saw large price increases during June.

- Food price inflation also edged up to 0.8% per month and 5.3% for the year. These summary numbers indicate that inflation cost pressures are increasing and may well push inflation beyond the Fed's comfort zone.

- The All Farm Products Index of Prices Received by Farmers rose 1.9% in July from a month earlier. The index has followed a steady upward trend since last fall.

- The farm price index is 16% higher than in July 2007. Food commodities prices were up 1.3% on the month and 17% for the year. The relatively small increase in prices seen in July was somewhat of a surprise considering that not all the flood damage was ascertained a month ago

- The July Index of Prices Paid by Farmers was up 1.1% this month from June and is 18% higher than a year ago.

- With an increase of 1.6% for the month, the all-crop index is 32% higher than a year ago.

- Overall inflation, as measured by the consumer spending deflator, jumped 0.8% in June, the biggest increase since September 2005. Core prices rose 0.3%. Year-over-year inflation accelerated. Core inflation increased to 2.3% for the first time since December, while top-line inflation jumped to 4.1%, the highest inflation rate since 1991. On a market basis, core inflation increased to 2% and top-line inflation soared to 4.1%.

- The overall GDP price index increased 1.1% annualized in the second quarter, down sharply from a 2.6% increase in the second quarter.

- Consumer prices measured using the personal consumption expenditure price index rose 4.2% annualized in the second quarter, up from 3.6% in the first, in part due to higher energy prices. The Federal Reserve's preferred inflation measure, the core PCE deflator, which excludes food and energy prices, was up 2.1% in the second quarter, a slight slowing from 2.3% inflation in the first quarter.

- Producer prices for finished goods rose by a large 1.8% in June as expected, following a 1.4% increase in May. Inflation was led once again by large price increases among food and energy products. Excluding food and energy, prices for core finished producer goods rose by 0.2% for the second month in a row. Price increases slowed down at earlier stages of processing. Core prices for intermediate products rose by 1.3%, while core prices for crude materials fell by 0.2%.

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- The Federal Open Market Committee left interest rates unchanged at its June meeting. This is the first time since last summer's subprime financial shock that the Fed's central committee has met without cutting interest rates. The minutes from the June meeting, released last week, showed an increased concern about inflation, but rates hikes are not likely soon.

Housing – *Searching for a bottom but still sinking.*

- House prices declined in May. Both the 10-city and 20-city composite S&P/Case-Shiller house price indices posted record year-ago declines. The table below summarizes key housing price movements.

Case Shiller S&P Monthly Home Price Index

City	% Change one Year Ago	% Change one Month Ago	Peak Price Date	% Change from Peak
Boston	-6.2	1.0	Sep 2005	-12.1
Chicago	-9.4	-0.3	Sep 2006	-11.0
Denver	-4.8	1.0	Aug 2006	-7.5
Las Vegas	-28.4	-2.9	Aug 2006	-31.4
Los Angeles	-24.5	-1.9	Sep 2006	-27.5
Miami	-28.3	-3.6	Dec 2006	-31.2
New York	-7.9	-0.5	Jun 2006	-10.2
San Diego	-23.2	-1.4	Nov 2005	-28.9
San Francisco	-22.9	-1.2	May 2006	-25.5
Washington	-15.4	-1.0	May 2006	-20.6
Boston	-6.2	1.0	Sep 2005	-12.1

Source: S&P/Case-Shiller

- Every month so far this year, both the 10- and 20-city indices have recorded greater double-digit price declines from a year ago. Housing market problems continued to broaden: All 20 metropolitan areas reported year-ago price declines.

- The 20-city composite index lost 15.8% from May 2007, a record annual decline. However, like the 10-city index, the pace of monthly decline slowed in May, falling 0.9%. April's month-ago rate of decline was 1.3%.

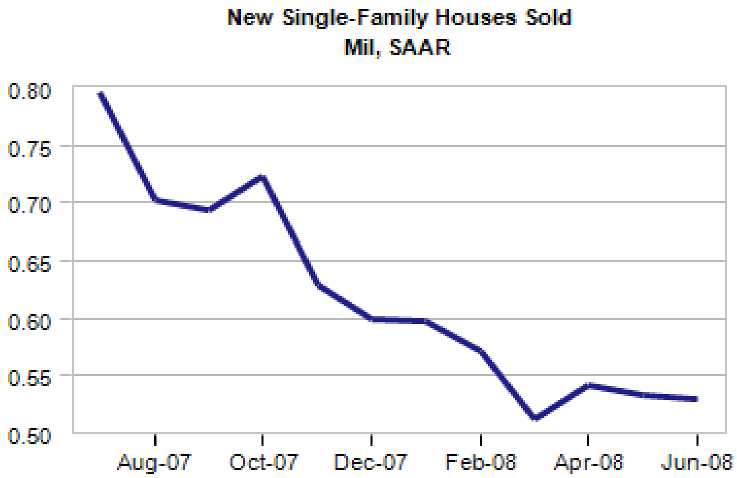
- Residential investment has now contracted for 10 straight quarters and is down 39% from its peak.

- With a large inventory of unsold homes and rising foreclosures in many markets, the national housing market will remain weak. Overall, house prices are not likely to stabilize until the second half of 2009.

- The MBA (mortgage broker association) market index finished the week at 420.8. The index shows a 14.1% decrease from the previous week, a decline of 11.9% from four weeks ago, and a decline by 30.7% from last year. The purchase index finished the week at 309.5, down by 7.8% from last week, down by 9.7% from four weeks ago, and down by 25.7% from last year.

- This week's decrease in applications fits in with expectations of continued house price deflation, which is consistent with the latest release of S&P Case-Shiller data. Both of the index city composites fell around 1% for May and from 15% to 17% compared with May 2007.

- Sales of new homes declined by 0.6% m/m in June to 530,000 annualized units, continuing a long trend of declines that resulting in a 33% decline from one year ago. The graph below illustrates new home sales changes over time.



Source: Census Bureau

- As with sales of existing homes, the quarterly new-home sales data indicate that the severity of the declines is easing. In the second quarter, new-home sales declined by an annualized 17% from the first quarter, compared with declines in the 40% range in the previous three quarters.

- Although sales are still falling, slower residential building is improving the inventory situation. The level of inventories has been descending nonstop for the last year, for a 22% y/y/ decline. The months of inventory has fallen from a cyclical peak of 11.2 in March to 10 in June—nearly double the norm, but an improvement nonetheless. The median number of months on the market, however, continues to climb and stands at a cyclical peak of 8.4 months.

- The median new-house price is firming, with a seasonally adjusted gain of 3% m/m. The median price is quite volatile however, and June's gain followed a 2% drop in May. On a y/y basis, the median price was down by 2% in June and 3% for the second quarter.

- Home sales were down to a new cyclical low. Sales dropped to 4.86 million annualized units in June, a month-over-month decline of 2.6% and a year-over-year decline of 15.5%. Sales of single-family homes fell by 3%. By contrast, condo sales increased by nearly 2%, the second consecutive monthly gain. For the second quarter, total sales declined by only an annualized 3% compared with a decline of more than 27% at this time last year.

- The months of available inventory picked up slightly in June to 11.1 months. Months of inventory have remained around this cyclical peak for the past three months. Single-family months of inventory are up to 11 months. A slight increase in single-family listings, combined with slower sales, was behind the increase in months of inventory. There are 12 months' worth of unsold condos on the market, down from a 14.2-month peak in April. The reduction in the condo inventory stems from a decline in the number of condos listed for sale. This decline is quite significant, down nearly 14% year over year.

- Housing permits for June were 1.091 million, an increase of 11.6% from May, but 23.9% lower than June 2007 permits. Of the new permits, single-family authorizations in June came in at 613,000, a drop of 3.5% from May single-family permits. Multifamily permits for June came in at 446,000.

- Housing starts for June totaled 1.066 million, an increase of 9.1% above May's totals but 26.9% below June 2007 housing starts. Single-family housing starts were 647,000, a decrease of 5.3% below May totals. Multifamily starts for June were approximately 400,000.

- Despite the good numbers this month, the key figure is still the totals for housing sales, which are now at 15% below May's level and nearly 30% below the housing market peak in the third quarter of 2005. Until financial markets and consumer finances recover sufficiently to increase the level of housing sales, residential construction will remain below its trend level even after it bottoms out later this year

- The Housing Market Index finished at 16, an 11% drop from June's value of 18 and a 33% drop from the July 2007 value of 24. Both the overall index and its components are currently at record lows.

- Prospective demand for homes as perceived by homebuilders has fallen to its lowest point yet because of the combination of falling home prices, reduced credit ratings, and tightening loan conditions. Loan conditions have worsened because of financial news in the past two weeks about the weakness of private banks and of Fannie Mae and Freddie Mac. Banks are trying to improve credit quality at any cost, further restricting the pool of prospective homebuyers.

Consumer Credit Conditions – *Delinquency is no longer reserved for juveniles. Is it possible that saving and paying down debt could enter into the American psyche?*

- Household credit quality eroded in the second quarter although rebate checks moderated the erosion. Dollar delinquency and default rates rose for most loan categories, although results were better on an account basis. Taking all household liabilities together, delinquency and default rates are now much higher than they were in the 2001 recession. Balance growth fell sharply in the quarter.

- Consumer credit totaled $2.571 trillion in May, an increase of $7.8 billion. Rapid growth of revolving credit accounted for most of this month's increase, while nonrevolving lines of credit increased more slowly.

- Credit quality deteriorated further in the second quarter as consumer finances were stretched and jobs continued to disappear.

- According to data from CreditForecast.com, mortgage delinquency and default rates continued to rise in the second quarter. The dollar delinquency rate is nearly 250 basis points above its end-2005 low. Nonetheless, 30-day delinquencies fell in the second quarter and 60-day delinquencies increased only 4 basis points as consumer finances were strengthened by tax rebates.

- Defaults have also soared, up more than five-fold since the end of 2005. The second quarter contained the largest quarterly increase in the dollar default rate on record.

- Household credit quality has arguably never been worse. Household liabilities that are in delinquency and default totaled $775 billion at the end of June. This is equal to 7.5% of all liabilities. Just two years ago there were just over $300 billion in delinquent and defaulting loans accounting for only 3% of liabilities. The erosion in household quality is evident across all loan types and in nearly every corner of the country.

- Inflation was an important part of the story in June. Prices posted their largest increase in almost three years on a monthly basis, and annual inflation was the highest in 17 years. Energy price increases took a huge bite out of household income and spending, forcing consumers to cut back elsewhere.

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International Trade – *Just when trade looks more promising for growth the global economy may cool down.*

- The May trade deficit in goods and services narrowed by 1.2% to $59.8 billion, from a revised $60.5 billion deficit in April 2008. The consensus expected the deficit to widen to $62.1 billion.

- The trade deficit with China widened $0.8 billion to $21.0 billion as exports increased 16.4% and imports increased 6.7%.

- The trade deficit with the EU decreased $0.6 billion compared with a month ago to $7.9 billion in May.

- The trade deficit with Canada decreased $1.9 billion compared with a month earlier, reaching $5.4 billion.

- Imports of crude oil, not seasonally adjusted, amounted to $32.3 billion in May, compared with $30.1 billion in the previous month. The unit price of crude oil increased by $9.47 per barrel to $106.28 in May. The price in May 2007 was $59.37. Crude oil imports decreased from 388.1 million barrels in April, to 373.3 million barrels in May 2008, which was down from 427 million barrels in May 2007.

- The broad trade-weighted dollar increased a very modest 0.3% in June, its second consecutive gain. Still, the dollar is down over 7% on a year-ago basis. A weak dollar is a boon to exports and as a positive for the economy. The narrowing in the trade deficit helped ensure that the economy has not contracted, as measured by real GDP.

- The trade deficit narrowed unexpectedly in May following a widening in April. In May both imports and exports increased, but the increase in exports was greater than the increase in imports.

- Between 1996 and 2006, trade was a consistent drag on growth, shaving from 0.1 to 1.2 percentage points from growth in those years. The trade drag has turned into a boost to growth now; trade added 0.6 of a percentage point to growth in 2007. The weak dollar has played a large role in this improvement, as has strong global growth.

- Record high oil prices remain an obstacle to improving the trade balance, but lower oil demand is starting to appear. Also, imported goods are getting costlier, since the dollar has been weakening and is at historic lows against the euro and the Canadian dollar. This trend will put downward pressure on imports, while a cheaper dollar would boost exports. The combined effect would be a lower trade deficit.

- For the second consecutive month, the import price index rose 2.6%. May’s gain was revised higher to 2.6% (previously 2.3%). Import price gains were led by petroleum prices, which rose 7.4%. Nonpetroleum imports rose 0.9% compared with May’s 0.7%. Export prices were up 1% following a 0.4% increase in May. Import prices increased 35% annualized in the second quarter, the strongest since the inception of the series in 1982.

- Over the year, import prices are up 20.5%, the largest increase since the series was first published in 1982. Import prices were running 2% to 3% at this time last year.

- Petroleum prices continue to be the primary source of import price inflation. Prices for petroleum were up 7.4% over the month. Prices excluding petroleum rose 0.9%

compared with May’s 0.7% growth. The acceleration in nonpetroleum prices is bad news on the core inflation front.

- Import prices pose a growing threat to domestic inflation. Soaring global food and energy prices are the catalysts pushing import prices higher. Nevertheless, with the U.S. recession developing and import prices accelerating rapidly, talk may resurface that the U.S. is nearing a 1970s-type stagflation.

- Import prices will remain under pressure in the near term because of the lagged effects of a weaker dollar, rising Chinese import prices, and pass-through of higher energy costs. The important question for the inflation outlook is the extent to which higher prices for nonpetroleum imports are passed through to consumer prices. If the economy does not downshift further, businesses will be better able to pass along higher prices for imported goods. Today's report will keep inflation worries in the spotlight.

- Strong growth will be needed to offset a projected slowing in exports as the global economy weakens.

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