

DAILY GLOBAL
COMMENTARY

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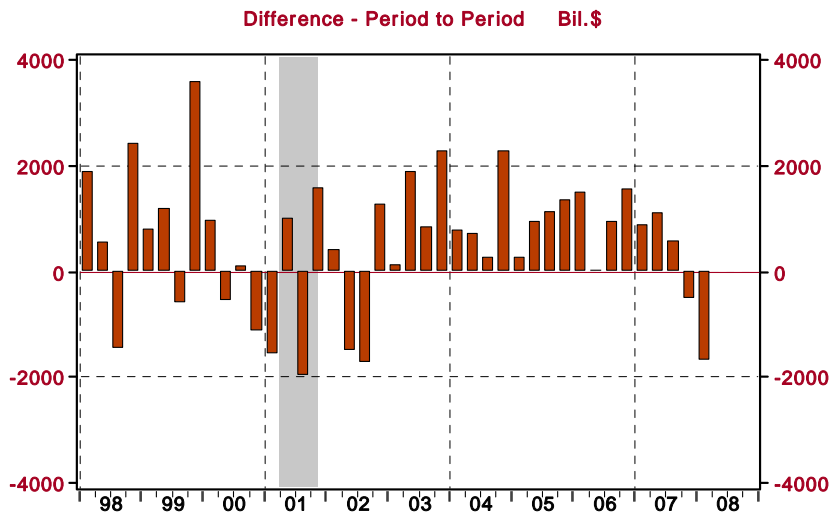
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Decline in Household Net Worth Raises Many Questions

June 5, 2008

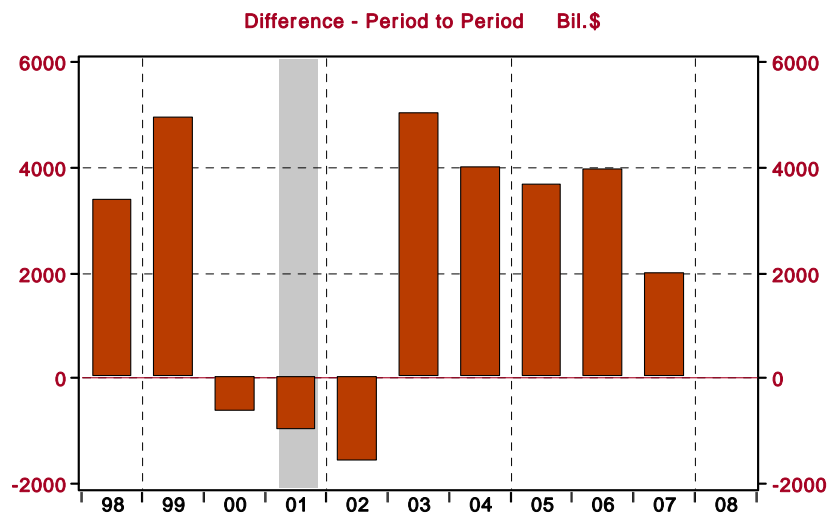
Household net worth fell \$1.696 trillion in the first quarter of 2008 after a \$0.529 trillion decline in the fourth quarter of 2007. The decline in net worth per se was expected but the size of the loss is significant and raises many questions.

Chart 1
Households & Nonprofit Organizations: Net Worth



The combined loss in net worth of households in the last two quarters -- \$2.226 trillion -- is 68% of the loss in net worth of households during 2000-2002 (see chart 2) and exceeds the loss in net worth recorded in 2001 (-\$1.01 trillion) and 2002 (-\$1.587 trillion).

Chart 2
Households & Nonprofit Organizations: Net Worth

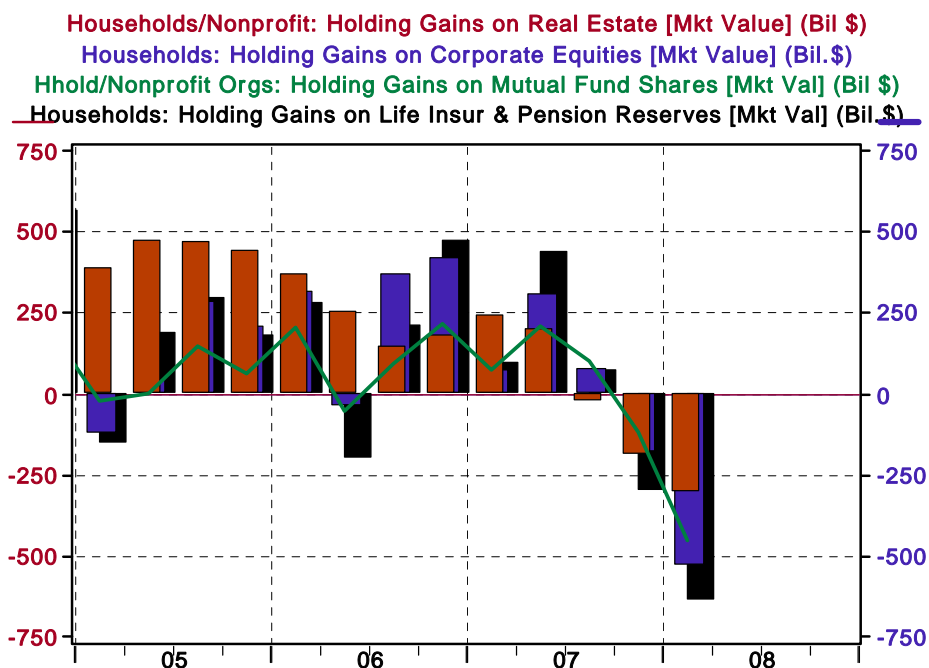


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The pertinent questions are – (1) Does the sharp drop in net worth of households in the first suggest we may be underestimating the likely weakness in consumer spending in the quarters ahead? (2) What is the risk and implication of larger declines in net worth during the next few quarters? The Case-Shiller Home Price Index declined 14.4% in March on a year-to-year basis. The large inventory of unsold homes in April points to additional declines in home prices and net worth of households if there is no offset from other asset classes.

In the fourth quarter of 2007, real estate losses made up 36% of the total drop in net worth of households, accounting for the largest loss by asset class. Losses from holding equities accounted for 34% of the decline in net worth in the fourth quarter of 2007. By contrast, loss in net worth of households from real estate holdings was 17.9% of the decline in the first quarter, with corporate equities (31.4%), mutual funds and shares (26.7%), and life insurance and pension reserves (37.8%) bearing the larger share.

Chart 3

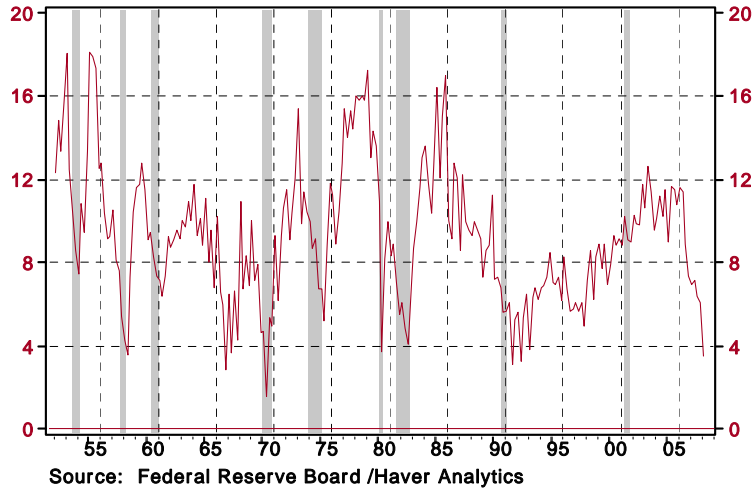


Household Borrowing Shows Sharp Downward Trend

Total household borrowing grew only 3.5% in the first quarter of 2008, the lowest since the first quarter of 1993 (see chart 4). A sharp reduction in mortgage debt has played a big role in bringing down the growth of debt.

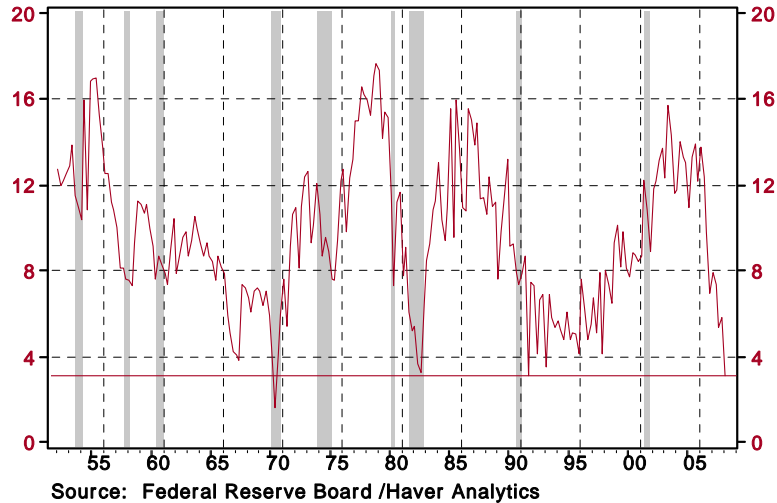
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Chart 4
Households: Liabilities: Credit Market Debt Growth
 SAAR, %



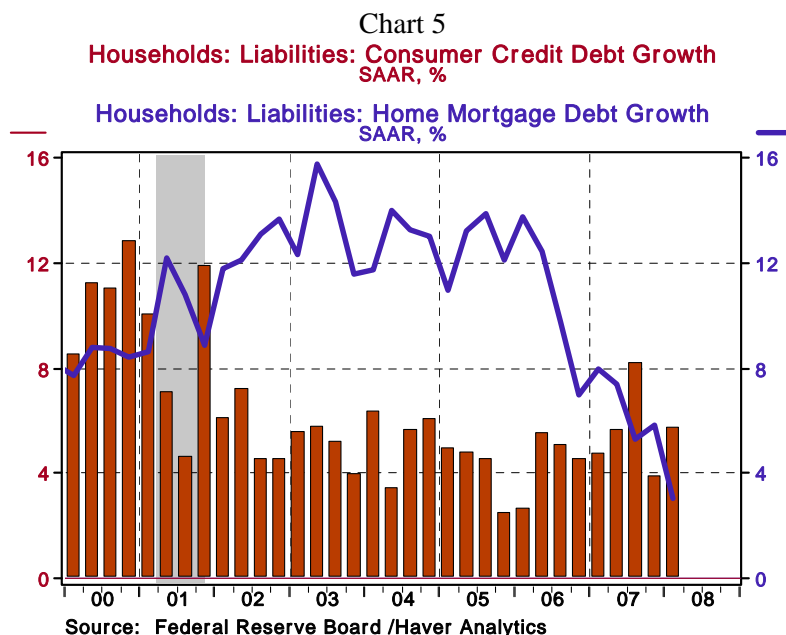
Mortgage debt of households grew at an annual rate of 3.05% in the first quarter, the smallest increase since the second quarter of 1970 (see chart 5). One should not be surprised about this, given the housing market crisis that is underway.

Chart 5
Households: Liabilities: Home Mortgage Debt Growth
 SAAR, %



But, it is worth noting that non-mortgage debt of consumers grew at annual rate of 5.72% in the first quarter, up from 3.89% in the fourth quarter. In 2005, non-mortgage debt of consumers increased only 4.1%, followed by a 4.4% gain in 2006 and a 5.6% pace in 2007.

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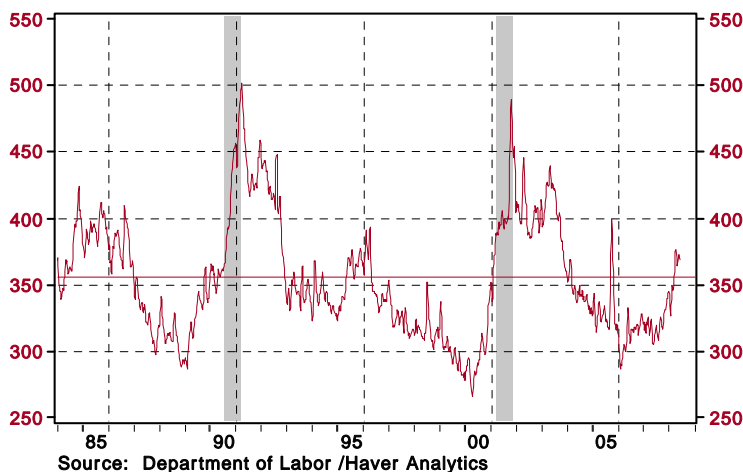


Jobless Claims – Upward Trend Remains in Place

Initial jobless claims fell 18,000 to 357,000 during the week ended May 31. The 4-week moving average (368,500 latest reading) has held above 356,000 for twelve straight weeks. The current level of the 4-week moving average is comparable to the reading associated with the onset of both the 1990 and 2001 recessions.

Chart 6

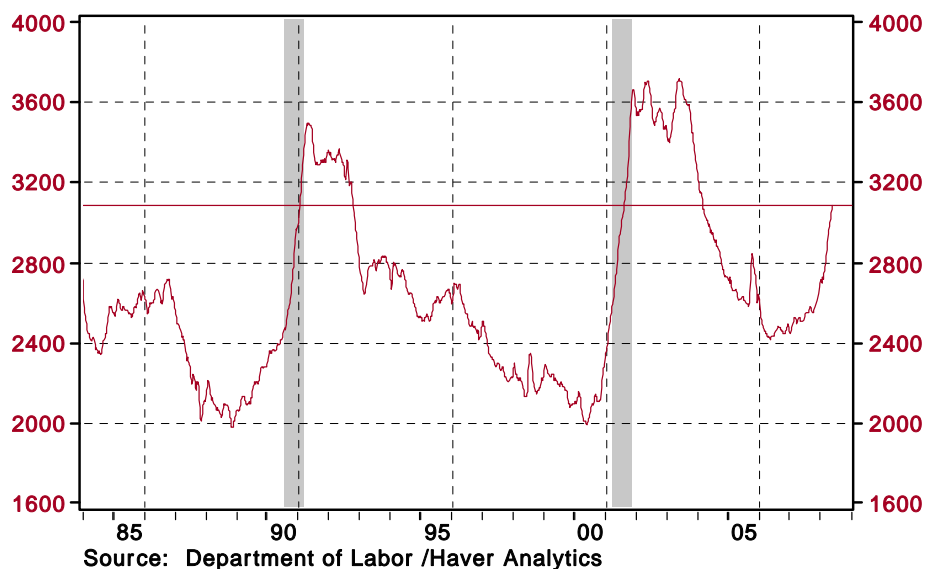
Unemployment Insurance: Initial Claims, 4-Week Moving Average SA,Thous



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Continuing claims, which lag initial claims by one week, dropped by 16,000 to 3.093 million. The current 4-week moving average of continuing claims (3.086 million, see chart 7) matches readings seen in the midst of the prior two recessions. The insured unemployment rate was unchanged at 2.3%. Although both initial and continuing claims declined, one week's reading is inadequate to offset the message of weak hiring conditions. Tomorrow's employment report for May will offer additional insight about the labor market.

Chart 7
Continuing Claims: 4-Week Moving Average
 SA, Thous



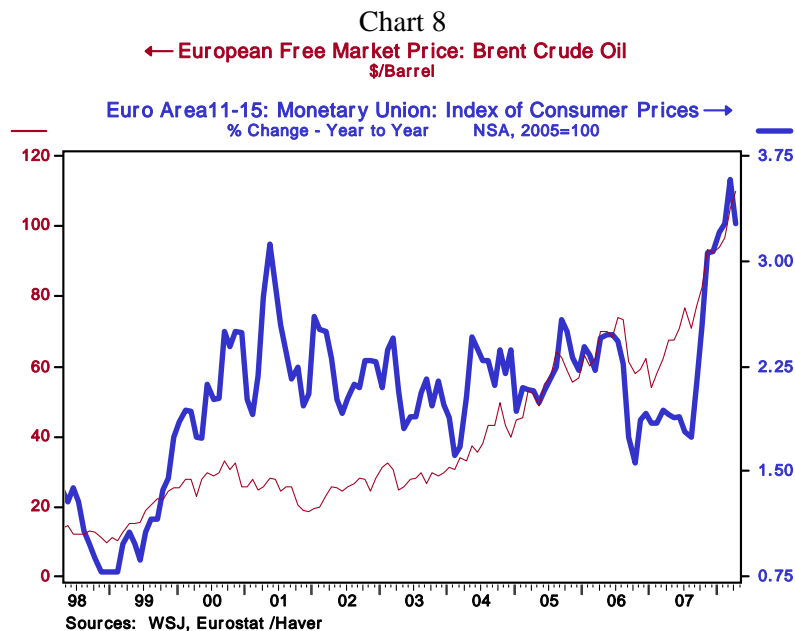
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European Central Bank Sounds Hawkish Tone at Its Ten-Year Anniversary

As expected, the European Central Bank (ECB) left its refi rate at 4.0% again this morning. What was not expected was the hawkish tone of the subsequent statement and the press briefing from President Trichet. He noted that the Governing Council had a “deep discussion” (trans: “fierce debate”?) and remains “in a state of heightened alertness.” Some members apparently wanted a rate hike this month but the consensus was to hold. The President then noted that the Council may decide to make “a small hike” at the July 3 meeting in order to anchor inflation expectations. The statement emphasized that risks to prices remain clearly on the upside and have increased further. And, Trichet reiterated that the bank’s mandate is to ensure medium-term price stability, which means firmly anchoring inflation expectations. The euro promptly firmed anew.

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Today's policy meeting took place against the backdrop of the ECB's ten year anniversary. Back on June 1, 1998, annual inflation in the eleven countries joining the Euro-zone was running at just 1.4%, a barrel of Brent crude cost \$15.60, and 3-month Euribor stood at 3.575%. While the 2000-2001 period brought a spike in inflation and market rates, the rest of the decade was fairly predictable policy-wise as price increases moved pretty much hand-in-hand with growth.



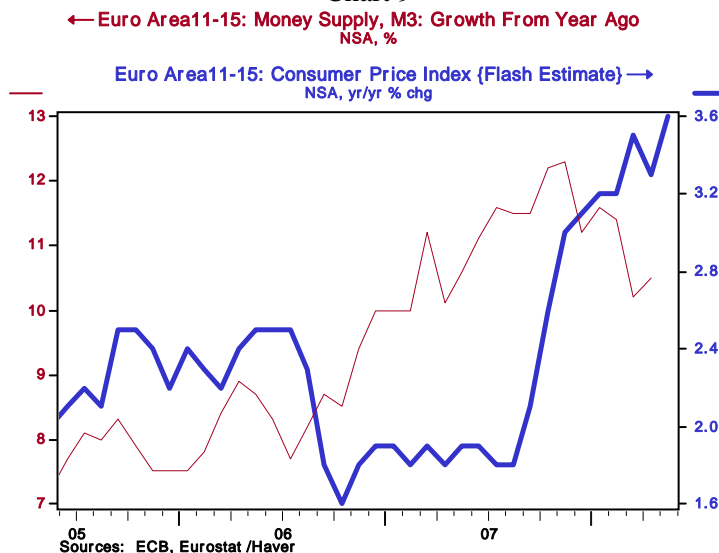
Today's ECB faces a much more challenging world. Inflation is rising, the interbank market is still struggling, and the macroeconomic impacts of the US slowdown and global financial turmoil are now coming home to roost. Inflation in the 15-member 'zone climbed to 3.6% in May, Brent crude stands at \$128pb, and 3-month Euribor today hit 4.864%, the highest so far this year. On the plus side, today's ECB policy-making has clarity, coherence, and credibility, all of which were sorely lacking a decade ago.

The ECB and its President apparently have decided that their best course is to stick firmly to the bank's mandate of maintaining price stability. Trichet himself set the tone at a speech this past weekend, when he warned that bad management of the oil crisis back in the 1970s (large wage rises and low interest rates) seriously hurt the economy. He concluded by warning that the errors of the past must not be repeated.

As noted, Euro-zone headline inflation jumped to 3.6% in May. The pace of M3 money supply growth (something the Council is known to watch closely), which appeared to be on a downward trend in recent months, nudged back up to 10.6% in April from 10.1% in March. As Trichet pointed out today, while this probably overstates the underlying pace of monetary expansion thanks to financial market upheavals, the underlying rate of money and credit growth remains strong.

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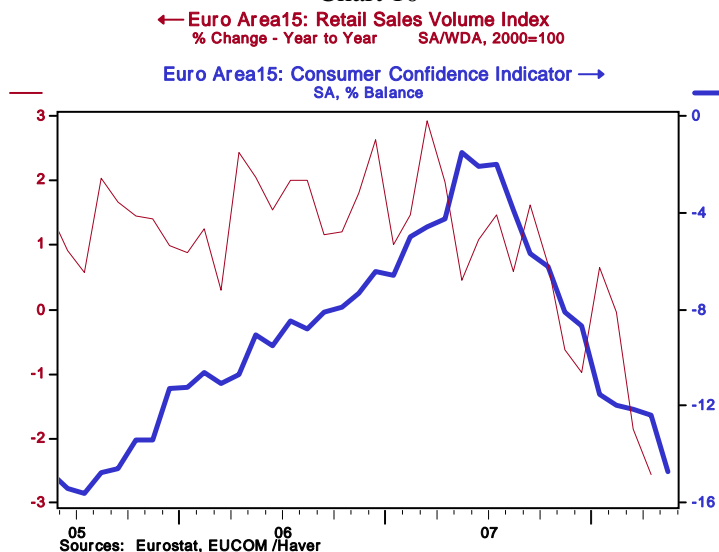
Chart 9




Add in better-than-expected GDP growth in Q1 – up 0.8% on the quarter and 2.2% on the year – and the case for a July rate hike looks clear. Except, of course, that forward-looking data point to much slower growth for the ‘zone as a whole in Q2, while the outlook for some countries is downright gloomy.

Retail sales across the 15 ‘zone countries fell 0.6% m-o-m and 2.9% y-o-y in April (-0.9% and -2.3%, respectively, in March) as increasingly-expensive oil and food hit consumers’ purchasing power. The European Commission’s economic sentiment survey for May showed consumer confidence hit its lowest level since September 2005 although overall sentiment did at least stabilize and inflation expectations continue to hover around the same level as last summer.

Chart 10



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Euro-zone services PMI slipped closer to contraction in May, coming in at 50.6 from 52.0 in April, and took a particularly sharp hit in France, while Italy saw services PMI contract for the third straight month and Spain for the fifth. Industrial new orders for the Euro-zone were much weaker than expected in March, shrinking 1.0% on the month and 2.5% on the year. And, today came the news that manufacturing orders in powerhouse Germany slipped 1.8% on the month in April as capital goods orders from other Euro-zone states dropped 9.0% – a reflection perhaps of rapid cooling in the likes of Spain and Ireland.

So, what are the odds of a July rate hike? The ECB’s mandate is to keep inflation “below but close to 2%” in the medium term. That qualifier allows some wiggle-room – the Council can say that current conditions are temporary and prices will come back toward target in the “medium-term” and can define that however it sees fit. For now, our hunch is that the Council will continue to talk tough but the consensus to stand pat will prevail. As always, though, watch the data.

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