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Economic Evaluation Group, Inc. Presents **Monthly Economic Update for October, 2007**

Quote of the month. “Only the shallow know themselves.” – Oscar Wilde

The month in brief. The big news, of course, was the Federal Reserve’s .5% interest rate cut on September 18th and the enormous rally that followed. The Dow Jones Industrial Average soared 335 points, the best one-day gain in five years. As the dollar sank to new lows against the euro, a fevered commodities rally began, lasting the rest of the month.

The stock markets had a positive month, but more than a few economists categorized the rate cut as a temporary shot of adrenaline, not a cure for the credit and housing sector problems plaguing the economy. Fed policy did appear to shift slightly (and necessarily) from keeping close watch over inflation to taking direct action against “significant market stress” (in the words of Fed Chairman Ben Bernanke).

There was no relief in the housing market, as the spreading credit crisis meant fewer buyers, lingering inventories and still-rising foreclosure rates.

Domestic economic health. The month started out with a surprise: against expectations, the economy had lost 4,000 jobs in August. Other August data betrayed signs of a weakening economy: retail sales (+0.3%) and industrial production (+0.2%) fell short of analysts’ expectations, and factory production decreased in August for the first time in six months. Throw in the gloom from the credit crisis and all signs pointed to a rate cut, with the Fed obliging.

As it happened, some positive indicators surfaced shortly after the rate cut: a mid-September unemployment report showed an unexpected decline

of 9,000 jobless claims, and consumer spending rose 0.6% in August with core consumer prices up only 0.1%. Core inflation has risen 1.8% over the last 12 months, within the Fed’s 1-2% target.

Global economic health. In the currency market, the euro gained 4.5% against the dollar during September, finishing the month at \$1.43; the pound gained 1.5% and the yen 0.8%, to the highest level against the dollar since June 2006.

The Eurostat, the Statistical Office of the European Communities, estimated Eurozone annual inflation at 2.1% for September, up from 1.7% for August. This was above the target of the European Central Bank. The ECB and the Bank of England are expected to hold interest rates on October 4 at 4% and 5.75%.

Japan’s trade surplus nearly quadrupled in August, thanks to enormous gains in exports to Europe and other Asian nations. India’s rupee registered its biggest monthly advance since April on speculation that India’s bullish stock market and thriving economy would attract increased foreign investment.

In late September, Goldman Sachs issued a report called *The Global Economy Hits a Crunch*, which forecast the chances of recession for Japan as “nearly two in three” and noted that “the mood in [global] financial markets is clearly darker, and the economic data in the developed world is showing signs of wear.” The data from Japan is certainly interesting: wages in Japan have fallen for eight straight months, consumer prices have dropped for seven straight months, the jobless rate unexpectedly rose last month, and the Bank of Japan’s benchmark interest rate is at 0.5%.

World financial markets. The Fed's rate cut – and hopes for more rate cuts – drove Asian stocks to a two-month high in September. The mid-month rally was also aided by soaring commodities prices. At month's end, Hong Kong's Hang Seng Index had topped 27,000 for the first time and benchmarks in China, Australia, India and Singapore had also reached new highs. (The Hang Seng has jumped 25% since August 20th in anticipation of China investors entering the city's equities markets.)

It was not a great month for European stocks. The U.K. FTSE 100 Index, Germany's DAX Index and others fell almost 2% on September 7th upon news of rising jobless claims in the U.S., and fears of a U.S. recession. Then the U.K. mortgage lender Northern Rock had to be rescued by the Bank of England on September 14th, which many investors saw as confirmation that the credit crisis in America had come to Europe. Things improved after the September 18th interest rate cut, but the weakening dollar and increasing borrowing costs meant a mediocre month and a poor third quarter.

Commodities markets. With the dollar so weak, a bull market emerged for commodities. Gold prices went up 10% in September. They broke the \$700 barrier at mid-month and ended the month with a major rally as prices hit their highest level since 1980 – futures for December delivery closed at \$750.00 an ounce September 28, after peaking at \$752.80. Silver prices went from well under \$12 an ounce to \$13.74 an ounce by month's end, shooting up 7.2% in the third week of the month alone.

Oil prices cracked ceiling after ceiling in September, ascending 3.1% during the second week of the month alone and hitting an all-time high of \$83.90 per barrel on September 20th, then pulling back to end the month at \$81.66 per barrel. Crude oil futures have posted gains every week since late August.

Housing & interest rates. It was a month when every story about the housing market seemed to contain the phrase, "the lowest level in ____." The August data was full of lows: the lowest number of new housing starts since 1995, the lowest level of new home sales since 2000 (sales down 8.3% for the month), and the lowest level of residential resales in five years, with the steepest month-over-month resale price drop since 1991. The National Association of Home Builders index of builder confidence fell to 20 for September, matching the lowest reading ever recorded.

We also received the latest (2Q) data from the Mortgage Bankers Association, noting an all-time high

of 0.65% of U.S. mortgageholders entering the foreclosure process. Mortgage rates dipped to four-month lows in mid-September but quickly rebounded, with 30-year FRMs averaging 6.42% as the month wrapped up. Countrywide Financial, America's leading mortgage lender, announced plans to cut up to 20% of its payroll by January 1st.

Major indexes. The indexes had a decent September and continued marching well into positive territory for the year. The month-ending numbers:

% Change	1-Month	Y-T-D
DJIA	+4.12	+10.30
NASDAQ	+3.89	+10.14
S&P 500	+3.46	+7.12

Source: CNNMoney.com, 9/28/07

October outlook. Does a major interest rate cut rejuvenate an ailing economy? Or does it merely distract Wall Street until the next jolt of reality? October may bring some kind of answer to those questions. While we just saw the best September for stocks since 1998, two unanswered questions still confront the economy – "how far will the credit crisis spread?" and "when will the housing slump end?"

Many 3Q earnings reports will be released beginning in mid-October; a Bloomberg survey is already indicating that 3Q profit margins among firms in the S&P 500 will rise at an average of 2.7% from a year earlier, as opposed to the double-digit year-over-year profit growth that many have enjoyed for the last 20 quarters.

Speaking of reports, here are some of the major economic releases coming in the next 30 days: August pending home sales (10/2), August factory orders (10/4), September jobless claims and wages (10/5), September retail sales (10/12), September housing starts, building permits and CPI (10/17), September durable goods orders and new home sales (9/25), consumer confidence (10/30), and construction spending and advance 3Q GDP (10/31).

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