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

Quote of the month. “Innovation distinguishes between a leader and a follower.” – Steve Jobs

The month in brief. Thanks to the Federal Reserve’s intervention, August was not as bad as it could have been. Believe it or not, after all the ups and downs, it was practically a flat month. On the morning of August 1st, the Dow opened at 13,472.84, and it closed August 31st at 13,357.74. But in the interim, the markets endured all kinds of financial dramas.

The shock wave from the credit crunch spread, and the Fed took action. Its decisions to cut the key discount lending rate and pump tens of billions of dollars in temporary funds into banks heartened investors shaken by troubles at Countrywide Financial, Washington Mutual, American Home Mortgage, and Bear Stearns Co., which started the month with a disturbing asterisk on its A+ credit rating courtesy of Standard & Poor’s.

The housing sector showed no definitive sign of a rebound. Jobless claims data showed fewer-than-expected new jobs in July (92,000) and a notable jump in jobless claims (a 9,000 increase) during the last week of August. The Conference Board’s closely watched Consumer Confidence Index retreated from its notably high July reading.

An eventful August concluded with Fed Chairman Ben Bernanke’s relatively uneventful but reassuring remarks at the Federal Reserve Bank of Kansas City’s annual economic symposium in Jackson Hole, WY, and a plan from President Bush to help bail out homeowners impacted by adjustable-rate mortgages.

Domestic economic health. Many analysts now believe the 3Q and 4Q GDP will not match the (newly revised) 4.0% reading of the second quarter; in fact, some believe the 4Q GDP will be below 2%. August saw a rise in jobless claims, weak existing home sales, and a dip in the Consumer Confidence Index –dismaying signals to those worried about the R-word. As the cost of

borrowing increased during August, the Fed conceded that risks to growth had “increased appreciably.” Unemployment claims hit their highest level since April at the end of August (334,000, with the four-week moving average at 324,500), as builders and lenders trimmed payrolls. As Moody’s Economy.com senior economist Zoltan Pozsar explained to Bloomberg News, “Business psyche is being more and more affected by what’s been going on in the credit markets. If this [layoff trend] continues for the next few weeks, it’ll definitely be a sign that hiring is being affected by the credit market problems.”

Global economic health. The European Central Bank, the Bank of England and the Bank of Japan elected to keep interest rates unchanged during August. But at the start of the month, ECB president Jean-Claude Trichet stated that the bank was “strongly vigilant” on inflation, noting “a progressive reappraisal of risks in a number of markets.” During 2Q 2007, the economies of countries sharing the euro grew at a 2.5% pace.

Japan’s economy crawled through the second quarter, growing only 0.5%; its trade surplus narrowed 21% in July, largely due to a slowdown auto exports. The now-decade-long deflation in its economy persisted, reaffirmed by declines in consumer prices, spending and industrial production. In late August, the Bank of Japan kept its key interest rate at 0.50%. The government of the People’s Republic of China reported that foreign investment in the P.R.C. had increased nearly 13% in the first seven months of 2007. China’s consumer price inflation hit a 10-year high in July (5.6%, 15.4% for food prices), while retail sales expanded at the fastest pace since 2004. India’s economy exceeded expectations, growing 9.3% in 2Q 2007. Its rupee has been Asia’s best-performing currency this year.

World financial markets. On August 7th, BNP Paribas SA, France’s biggest bank, suspended a trio of

funds that had invested in U.S. subprime mortgages, halting withdrawals because it couldn't "fairly" value the funds' holdings. (Two of those three funds resumed trading on August 30th, with only minor declines in asset value.) The news sent European stocks reeling. On August 10th, European stocks tilted into the red for the year, as the region's major indexes witnessed the biggest one-day drop since 2003. As the Fed injected funds into the U.S. banking system, the European Central Bank and the Bank of Japan followed suit, respectively pouring 155 billion euros and 1 trillion yen into money markets. Then, in late August, European and Asian indexes rallied as fears over the U.S. mortgage sector eased and markets recovered from the global correction.

Most Asian banks had little exposure to U.S. subprime loans, but Asian markets were as volatile as usual. Hong Kong's Hang Seng index had another turbulent month, climbing above 23,000 to start August, then diving to just above 20,000 on August 18th, then climbing 6% in one day (August 20th) following a historic decision to allow Chinese citizens to invest in Hong Kong stocks. In the P.R.C., the People's Bank of China hiked lending rates August 21st for the fourth time in 2007 to 7%. The next day, China's benchmark CSI 300 stock index broke the landmark 5000 barrier. The CSI 300 has risen more than 140% this year.

Commodities markets. How did gold and silver do in August? During the Dow's descent in the first half of the month, silver prices sank 16% and gold prices 4.4%. Uncertain U.S. economic data caused investors to retreat to the safety of the dollar, which began to recover against other currencies late in August. But as energy prices rose and the dollar weakened, gold futures concluded the month near \$675 per ounce while silver ended the month near \$12 per ounce.

On August 1st, crude oil prices hit \$78.77 per barrel on the New York Mercantile Exchange. Energy Secretary Sam Bodman all but begged for OPEC to ramp up production, claiming that these record high oil prices were putting the American economy in a "danger zone". At the end of August, prices were near \$74 per barrel. A weak 2Q and 3Q economy might effectively reduce demand for oil and gasoline among U.S. consumers.

Housing & interest rates. No turnaround in sight. The data available was dismaying. New home construction reached a 10-year low in July, and the National Association of Realtors reported residential sales falling in 41 states during 2Q 2007, with one-third of metropolitan areas surveyed seeing price declines.

American Home Mortgage laid off 90% of its employees, and Countrywide borrowed in order to fund loans. The two bright spots: a brief dip in home mortgage rates (30-year FRMs averaged 6.59% nationally at mid-month) and an anomalous jump in new home sales (which rose 2.8% in July).

At month's end, President Bush outlined a plan to

improve the Federal Housing Administration mortgage program to permit homeowners with adjustable-rate mortgages (and good credit) to refinance using FHA insurance. He pledged to work with Congress to reform the tax code so that borrowers might restructure loans, but stated that he did not favor "direct grants to homeowners."

Major indexes. How did the wildest August in years ultimately affect the big indexes? See below.

% Change	1-Month	Y-T-D
DJIA	-0.86	+6.69
NASDAQ	-0.32	+6.50
S&P 500	+0.006	+3.80

Source: CNNMoney.com, 8/31/07

September outlook. Many economists now expect an interest rate cut. The question is when it will happen.

The Fed's next policy meeting occurs on September 18th, but some analysts feel the rate cut should be delayed until October. They argue that the Fed's August moves have been sufficient, and that there are other measures it can take. But in a *USA Today* survey published August 22nd, only 11 out of 37 economists polled said they expected no change in interest rates for the rest of 2007.

In his August 31st speech, Fed Chairman Ben Bernanke indicated that the Fed "would act as needed," and most economists expect a rate cut of a quarter-percent or half-percent in September, which might prompt the ECB and the Bank of Japan to consider interest rate cuts as well. (In the short term, the ECB's governing council meets on September 6th, and appears poised to hike rates above the current 4.0% to 4.25%.)

Some September reports of interest for your calendar: July construction spending (9/4), July pending home sales (9/5), August retail sales, business inventories and industrial production (9/14), the Fed policy statement (9/18), August CPI, core CPI and August housing starts (9/19), August existing home sales and September consumer confidence (9/25), August new home sales (9/27), and finally August personal income, personal spending and core PCE inflation (9/28).

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