

DAILY GLOBAL
COMMENTARY

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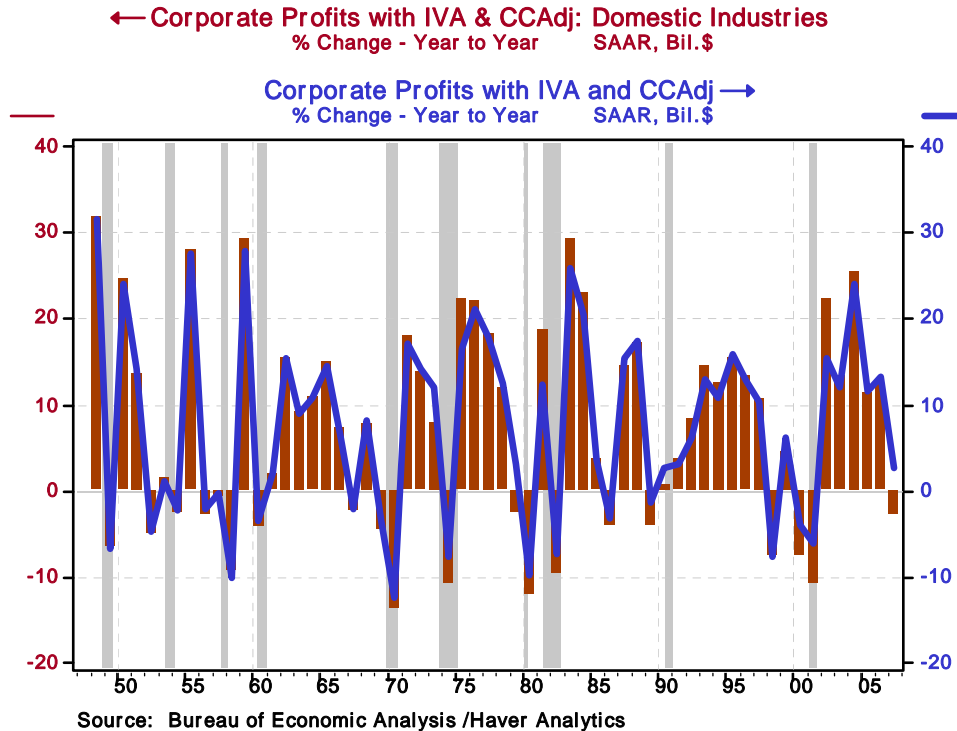
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A Profits Recession

March 27, 2008

With today's release of "final" (until revised yet again) Q4:2007 GDP, the Commerce Department also issued its estimate of Q4 corporate profits. The profits data are not encouraging. Chart 1 contains year-over-year percent changes in annual averages of both *total* before-tax corporate profits from current production (the Commerce Department's equivalent of operating profits) and *domestically-generated* before-tax profits. The total profits data includes profits earned by U.S. corporations earned from foreign operations. With the dollar having fallen in 2007, profits from foreign operations get "inflated" when translated back into dollars. That is, when the dollar is falling versus other currencies, say the euro, then one euro of profits means more dollars of profits. Total profit growth, including earnings from overseas operations, grew at 2.7% in 2007 versus 13.2% in 2006. The 2007 total profit growth was the slowest since 2001, when the economy was in an official recession. Profits from domestic operations *contracted* by 3.0% in 2007 – the first contraction, again, since 2001. As Merrill Lynch economist, David Rosenberg, has pointed out, U.S. corporate hiring and U.S. corporate capital spending depend on U.S. generated profits, not profits generated overseas.

Chart 1

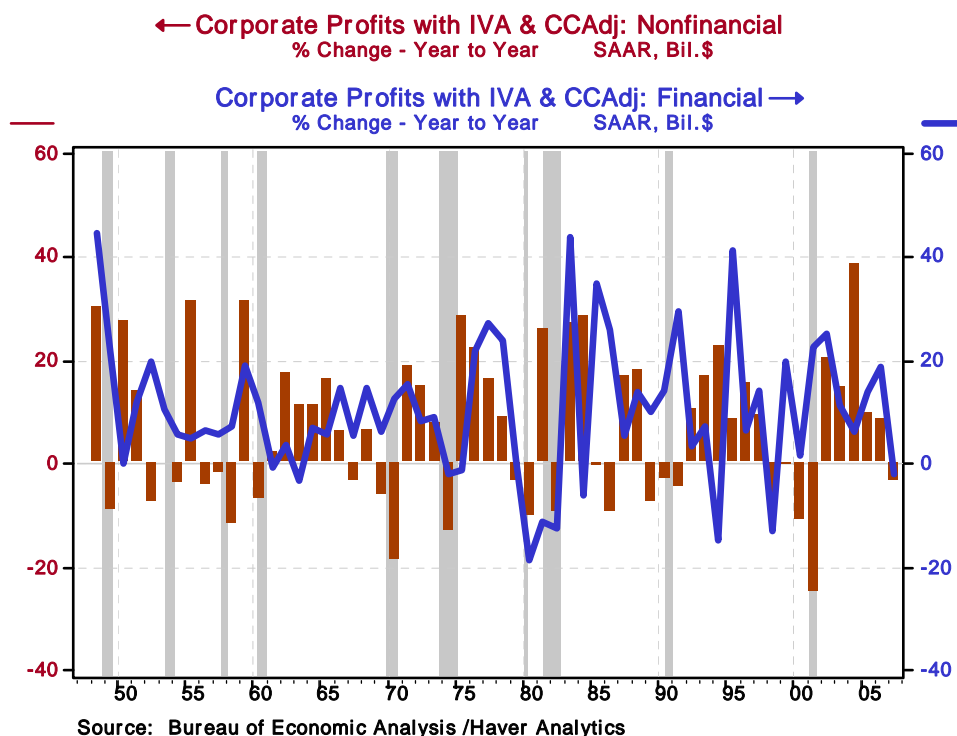


There has been some talk that the recent weakness in corporate profits is due to the problems being encountered by the financial sector. Excluding the financial sector, everything is rosy. Is

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this an extension of core inflation – in this case, take out the things that are going down? Did these same “analysts” who now want to exclude the financial sector also exclude it when financial profits were soaring? Well, it really does not matter. As Chart 2 shows, *both* financial sector as well as nonfinancial sector profits *fell* in 2007. Nonfinancial sector profits fell 3.7% in 2007, the first decline since 2001. Financial sector profits fell 1.8% in 2007, the first decline since 1998.

Chart 2



The weak growth in 2007 total U.S. corporate profits and the contraction in 2007 U.S. domestically-generated profits have negative implications not only for 2008 U.S. hiring and capital spending, but also for 2008 corporate stock buybacks. Chart 3 shows the “net retirement” of U.S. domestically-issued corporate equities. In 2007, U.S. corporations retired a record net \$677 billion of their own equities. Had this gargantuan amount of securities not been demanded by corporations themselves, would the U.S. stock market have seen an increase in value in 2007? With profits now contracting, how will corporations continue to reduce the supply of their equities? Borrow to fund share buybacks? Perhaps. But Chart 4 shows that with credit now being more appropriately priced, it will cost corporations more to borrow.

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Chart 3

Corporate Equities: Net Issuance of U.S. Corporations

\$billions

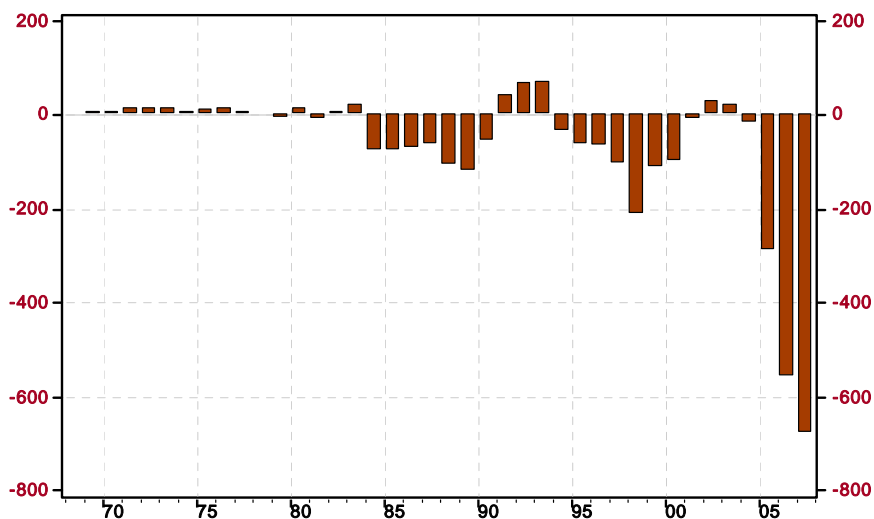
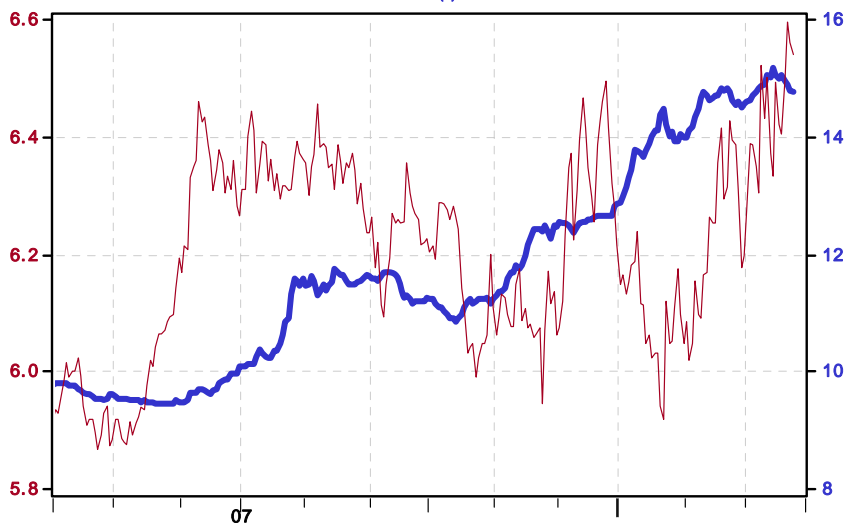


Chart 4

← Merrill Lynch Corporate Bonds: BBB Rated: Yield to Maturity % (l)

Merrill Lynch High Yield Corporates: Rated: CCC & Lower: Yield to Maturity →



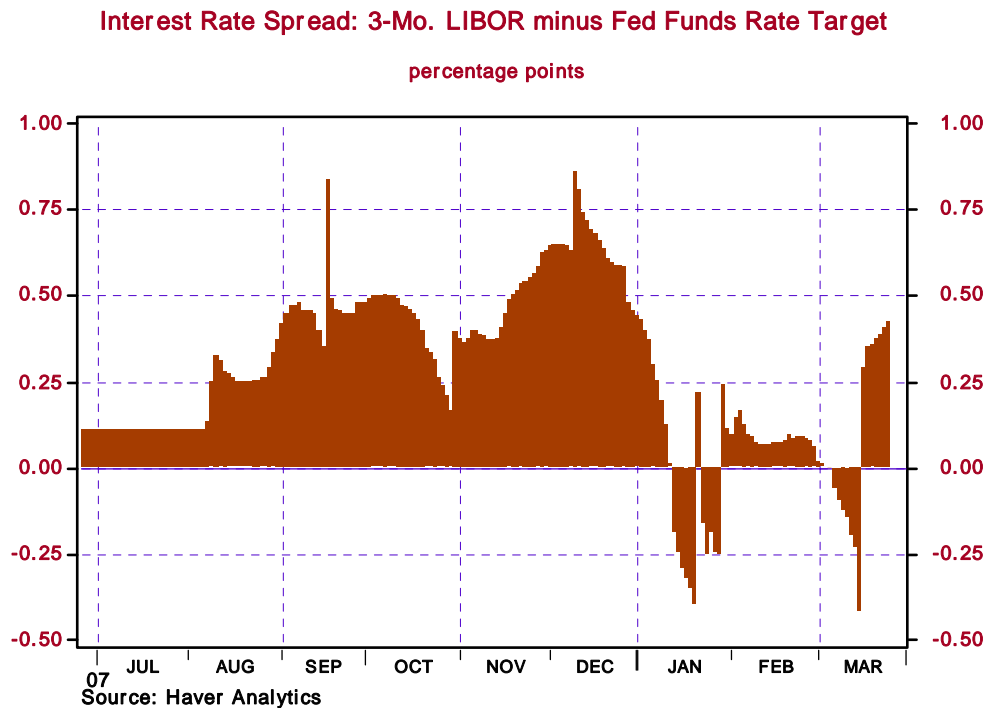
Source: Merrill Lynch /Haver Analytics

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Time to Reform TAF?

The Term Auction Facility (TAF) that the Fed initiated in mid December of last year was a stroke of genius. In recent days, however, it seems to be failing to accomplish what it was designed to do – bring interbank lending rates into line with the Fed’s funds rate target. This is illustrated in Chart 5 below. When the interbank lending market seized up in August of last year, the spread between the 3-month LIBOR rate and the fed funds target rate widened significantly. After the TAF was initiated in mid December, this spread began to narrow and even turned negative on some occasions, probably because of expectations of future declines in the fed funds rate target. But the spread has widened out again in recent days to an extent certainly not justified by expectations of fed funds rate target levels in the next three months.

Chart 5



As the following table, prepared by Asha Bangalore, shows, the TAF auctions have been oversubscribed. Moreover, in the last auction on March 24, the rate at which these term funds were lent was 11.5 basis points above the discount rate. There is an obvious excess demand for funds from the TAF.

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Details of Term Auction Facility

Auction Date	TAF Amount (\$ billions)	Stop-out-rate (percent)	Primary credit rate	Total propositions submitted (\$ billions)	Bid/cover ratio	Number of bidders
3/24/08	50.00	2.615	2.500	88.869	1.78	88
3/10/2008	50.00	2.800	3.500	92.595	1.85	82
2/25/2008	30.00	3.080	3.500	67.958	2.27	72
2/11/2008	30.00	3.010	3.500	58.400	1.95	66
1/28/2008	30.00	3.123	4.000	37.452	1.25	52
1/14/2008	30.00	3.950	4.750	55.526	1.85	56
12/20/2007	20.00	4.670	4.750	57.664	2.88	73
12/14/2007	20.00	4.650	4.750	61.553	3.08	93

Source - <http://www.federalreserve.gov/monetarypolicy/taf.htm>

The Fed could grope around by trying to find the “correct” size of TAF auctions that would bring other interbank loan rates back in line with the funds rate target. But why guess? Why not eliminate TAF and let depository institutions and primary dealers both access overnight funds from the Fed at the target funds rate? But might not that lead to an excess of funds in the financial system that would cause the funds rate to trade below the Fed’s target? It sure could. But the second part of my proposal would be for the Fed to stand ready to *borrow* from depository institutions at its funds rate target. If the funds rate were to slip below its target, depository institutions and primary dealers could lend to the *Fed* at the target funds rate rather than lending to a private counter party at the lower rate. The Fed could take the same collateral in these new market-initiated reserve injection/drainage operations as it does in the TAF auctions, taking *appropriate* haircuts on non-U.S. Treasury securities collateral. If the Fed were borrowing from depository institutions and primary dealers, it could offer Treasury collateral to the lenders.

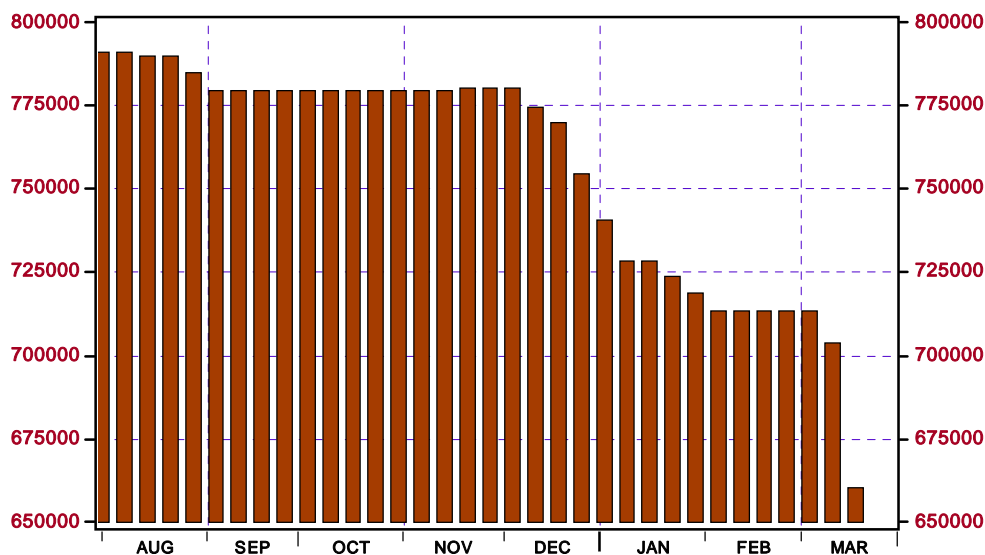
There is another issue that has gained attention of late – the Fed’s running down of its U.S. Treasury securities holdings. As shown in Chart 6 below, the Federal Reserve’s portfolio of U.S. Treasury securities has gone down from \$790.8 billion on August 8, 2007 to \$660.5 billion on March 20, 2008 -- a decline of \$130.3 billion. If the Fed were to continue injecting reserves into the banking system in exchange for non-Treasury collateral, it might run out of Treasury collateral with which to drain reserves in order to prevent the funds rate from falling below its target. A solution to this, which might require some new legislation, would be for the Treasury to issue marketable securities directly to the Fed in exchange for some of the additional non-Treasury collateral that the Fed was acquiring through its reserve-injection operations.

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Chart 6

All Fed Res Banks: Assets: U.S. Treasury Securities held Outright

EOP, Mil.\$ (I)



Source: Federal Reserve Board /Haver Analytics

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2007:Q4 GDP Unchanged, Weaker Economic Conditions Are Expected in Q1

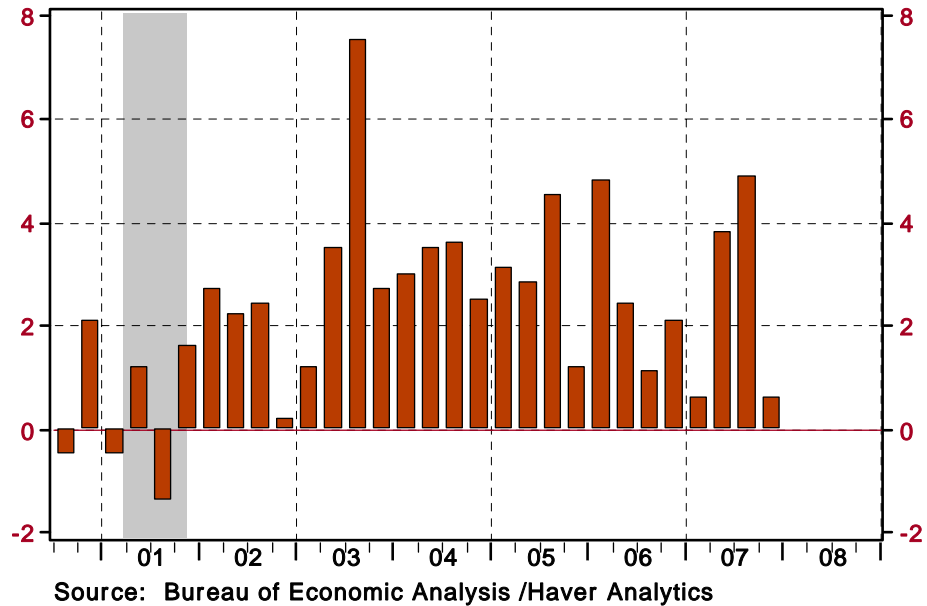
Real gross domestic product grew at an annual rate of 0.6% in the fourth quarter of 2007, which is unchanged from the preliminary estimate. Upward revisions of consumer spending (+2.3% vs. 1.9% in preliminary report), exports (+6.5% vs. +4.8% in preliminary report), imports (-1.4% vs. -1.9% in preliminary report) matched the downward revisions of structures (+12.4% vs. +14.7% in preliminary report), equipment and software spending (+3.1% vs. +3.3% in preliminary report), inventories (-\$18.3 billion vs. -10.1 billion in preliminary report) and government outlays (+2.0% vs. +2.2% in preliminary report) to leave the headline unchanged. Estimates of inflation, both overall and core, were revised down slightly.

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Chart 7

Real Gross Domestic Product

SAAR, %Chg



Incoming data for the first quarter support our forecast of drop in GDP in the first quarter. Equipment and software spending should be weak based on January and February data of shipments of non-defense capital goods excluding aircraft. Retail sales numbers and auto sales for January and February suggest that consumer spending could possibly post the first drop in consumer spending since fourth quarter of 1991. Construction expenditures and housing market information indicate a drop in residential investment expenditures.

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REAL GROSS DOMESTIC PRODUCT 2007:Q4 FINAL ESTIMATE

	(2000 chained dollars)				Percent Change (SAAR) from prior quarter			
	07:4 Final	07:4 Advance	07:4 Preliminary	07:4 Final	07:3	07:4 Adv	07:4 Prel.	07:4 Fin
GDP	11658.9	11677.4	11677.1	11675.7	4.9	0.6	0.6	0.6
CONSUMPTION	8302.2	8342.7	8341.3	8349.1	2.8	2.0	1.9	2.3
DURABLE GOODS	1241.9	1254.7	1249.0	1248.1	4.5	4.2	2.3	2.0
NONDURABLE GOODS	2396.8	2408.0	2405.1	2404.2	2.2	1.9	1.4	1.2
SERVICES	4689.5	4708.2	4713.6	4722.4	2.8	1.6	2.1	2.8
INVESTMENT	1859.9	1810.5	1799.1	1787.7	5.0	-10.2	-12.5	-14.6
FIXED INVESTMENT	1826.0	1814.1	1809.9	1807.5	-0.7	-2.6	-3.5	-4.0
NONRESIDENTIAL	1387.3	1412.7	1410.5	1407.8	9.3	7.5	6.9	6.0
STRUCTURES	311.1	322.7	321.9	320.3	16.4	15.8	14.7	12.4
EQUIPM. & SOFTWARE	1073.5	1083.4	1082.2	1081.7	6.2	3.8	3.3	3.1
RESIDENTIAL	463.3	432.7	430.8	430.9	-20.5	-23.9	-25.2	-25.2
CHG. BUS. INVENT.	30.6	-3.4	-10.1	-18.3				
NET EXPORTS	-533.1	-521.0	-506.8	-503.2				
EXPORTS	1441.2	1455.0	1458.2	1464.1	19.1	3.9	4.8	6.5
IMPORTS	1974.3	1975.9	1965.0	1967.3	4.4	0.3	-1.9	-1.4
GOVERNMENT (C & I)	2033.6	2046.7	2044.7	2043.4	3.8	2.6	2.2	2.0
FEDERAL	764.0	764.5	765.6	765.0	7.1	0.3	0.9	0.5
DEFENSE	513.9	513.1	513.5	513.2	10.1	-0.6	-0.3	-0.5
OTHER	249.6	251.0	251.7	251.4	1.1	2.2	3.4	2.8
STATE AND LOCAL	1269.6	1282.0	1279.0	1278.3	1.9	4.0	3.0	2.8
DISP. PERS. INC.	8702.6	8709.3	8686.2	8695.2	4.5	0.3	-0.3	0.1
FINAL SALES	11626.4	11681.3	11688.0	11695.2	4.0	1.9	2.1	2.4
GROSS DOMESTIC PURCHASE	12155.6	12198.4	12190.9	12194.6	2.5	1.4	1.2	1.3
PRICE DEFLATORS:								
GDP CHAIN TYPE	119.8	120.6	120.6	120.6	1.0	2.6	2.7	2.4
GDP EX. FOOD & ENERGY					1.7	2.4	2.4	2.1
PCE CHAIN TYPE	117.9	119.0	119.1	119.0	1.8	3.9	4.1	3.9
PCE EX. FOOD & ENERGY	114.7	115.5	115.4	115.4	2.0	2.7	2.7	2.5

Message from Jobless Claims Is Unchanged

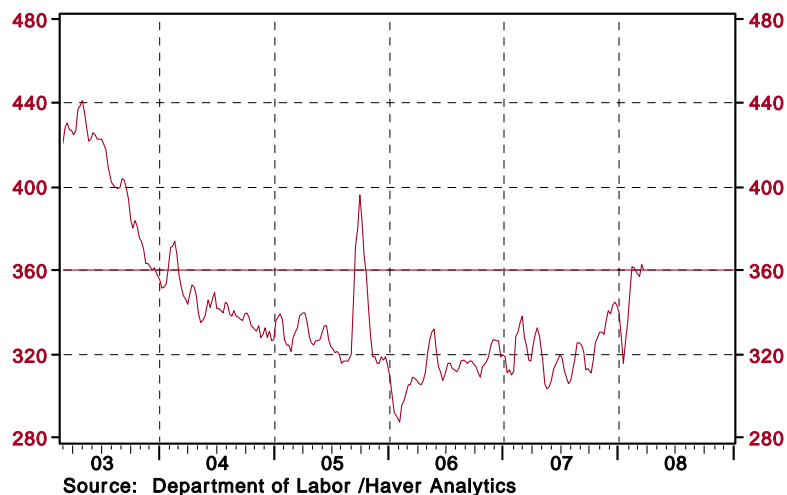
The message of weakness in hiring remains persistent. Initial jobless claims fell 6,000 to 366,000 during the week ended March 22. The four-week moving average is 360,250, slightly lower than the earlier but the highest since early-2004, excluding the Katrina-related jump.

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Chart 8

Unemployment Insurance: Initial Claims, 4-Week Moving Average

SA,Thous

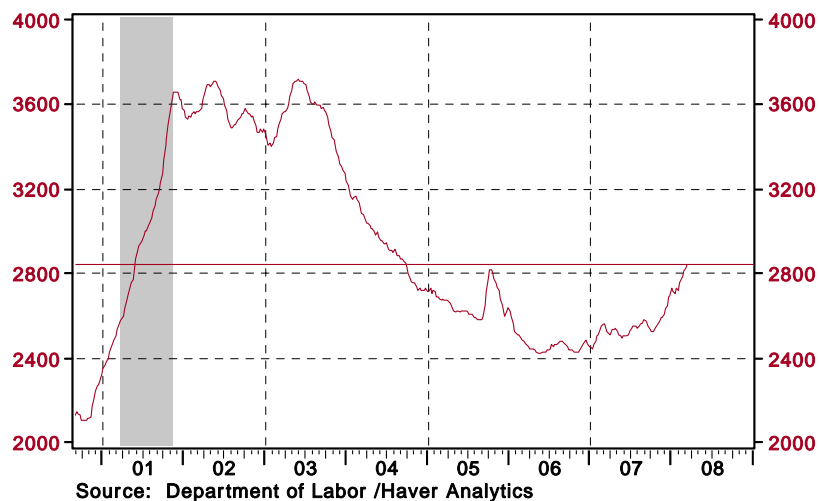


Continuing claims, which lag initial claims by one week, were down 5,000 to 2.845 million. The four-week moving average is the highest since September 25, 2004. The insured unemployment rate has held at 2.1% for five weeks (the previous week's estimate was revised down to 2.1% from 2.2%).

Chart 9

Insured Unemployment, State Programs: 4-Week Moving Average

SA, Thous



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