

DAILY GLOBAL
COMMENTARY

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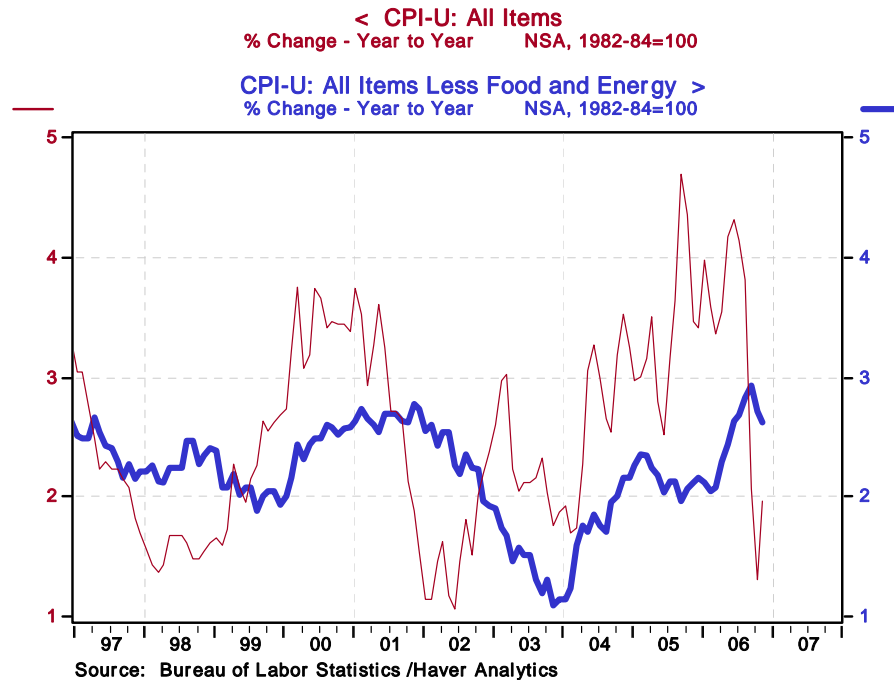
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Noteworthy Moderation of Core Inflation

December 15, 2006

The Consumer Price Index (CPI) held steady in November after two monthly declines. A drop in prices of food, energy, and other core items led to the benign inflation numbers in November. On a year-over-year basis, the CPI moved up only 2.0% compared with a 2.5% increase in 2005. The energy price index dropped 0.2% in November, translating into a year-to-date decline of 1.6%, after a 17.5% increase in 2005. Food prices have risen 2.4% in the first eleven months of the year vs. a 2.3% increase in 2005.

Chart 1



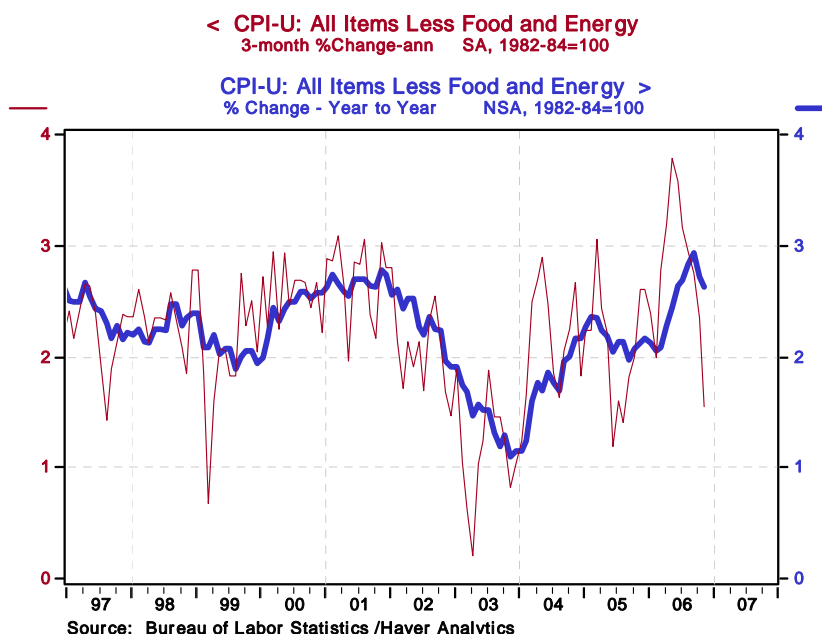
Consumer Price Index – November 2006

	% change prior month	annualized change			% change		
		year-to-date	3 mo. ago	6 mo. ago	Nov-06 yoy	Nov-05 yoy	Dec-05 yoy
CPI - ALL ITEMS	0.0	2.2	-3.9	-0.2	2.0	3.5	3.4
CORE - ALL ITEMS LESS FOOD & ENERGY (77.4)*	0.0	2.6	1.6	2.3	2.6	2.1	2.2
CPI ALL ITEMS LESS ENERGY (91.3)	0.0	2.6	1.8	2.4	2.5	2.1	2.2
FOOD (13.9)	-0.1	2.4	2.3	2.9	2.3	2.2	2.3
ENERGY (8.69)	-0.2	-1.6	-44.9	-22.4	-3.8	18.3	17.1
SHELTER (32.26)	0.4	4.2	4.4	4.3	4.2	2.5	2.6
COMMODITIES (40.79)	-0.4	0.5	-13.4	-5.1	0.2	2.7	2.7
COMMODITIES LESS FOOD & ENERGY (22.31)	-0.4	-0.2	-3.1	-1.3	-0.1	0.1	0.2
SERVICES (59.2)	0.3	3.4	3.0	3.3	3.2	4.0	3.8
SERVICES LESS ENERGY SERVICES (55.05)	0.2	3.8	3.5	3.7	3.7	2.9	2.9
FRB CLEVELAND MEDIAN CPI	0.3	3.8	3.4	3.8	3.7	2.4	2.5

The steady reading of the core CPI in November follows a 0.1% increase in October. In the first eleven months of the year, the core CPI has risen 2.6% compared with a 2.2% increase in 2005. In November, within shelter, the indexes for rent, for owners' equivalent rent, and for lodging away from home rose 0.4, 0.3, and 1.0 percent, respectively. The core personal consumption expenditure price index excluding food and energy has a lower weight for shelter, which implies that this core price index would most likely show a moderating trend also. Outside of shelter, most other components of core CPI were non-threatening. Prices of new cars dropped 0.7% and that of used cars fell 1.4%. Airfares declined 4.8% and apparel prices dropped 0.3%. Offsetting these price declines were higher prices for medical care, education, and recreation.

Conclusion -- Core inflation is moving in the desired direction. As mentioned earlier the core personal consumption expenditure price index excluding food and energy, the Fed's preferred price measure should show a similar moderation. The doves of the FOMC should have a stronger voice at the January 30-31 FOMC meeting to press for a modification of the current hawkish statement given the current soft momentum of the U.S. economy. We expect the Fed to sound the first formal warning bell about a shift in policy to a neutral stance at the close of the January FOMC meeting.

Chart 2

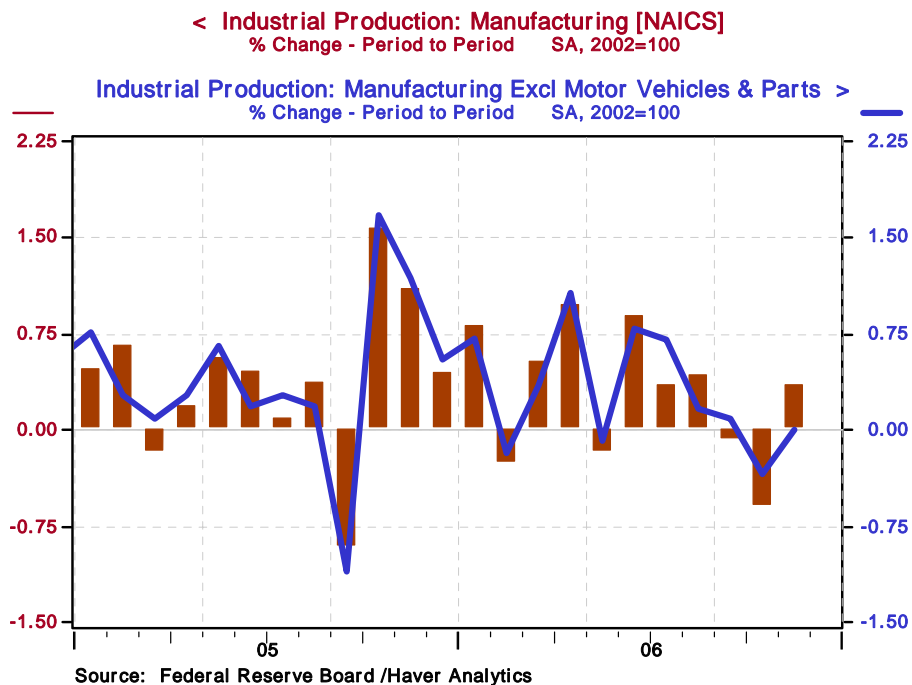


Auto Production Boosts Factory Output

Industrial production increased 0.2% in November following a downward revision to the earlier estimate of activity in October (0.0 vs. minus 0.2%). Factory production rose 0.3% mainly due to auto production. Excluding motor vehicles and parts, factory output held steady in November after a 0.4% drop in the prior month.

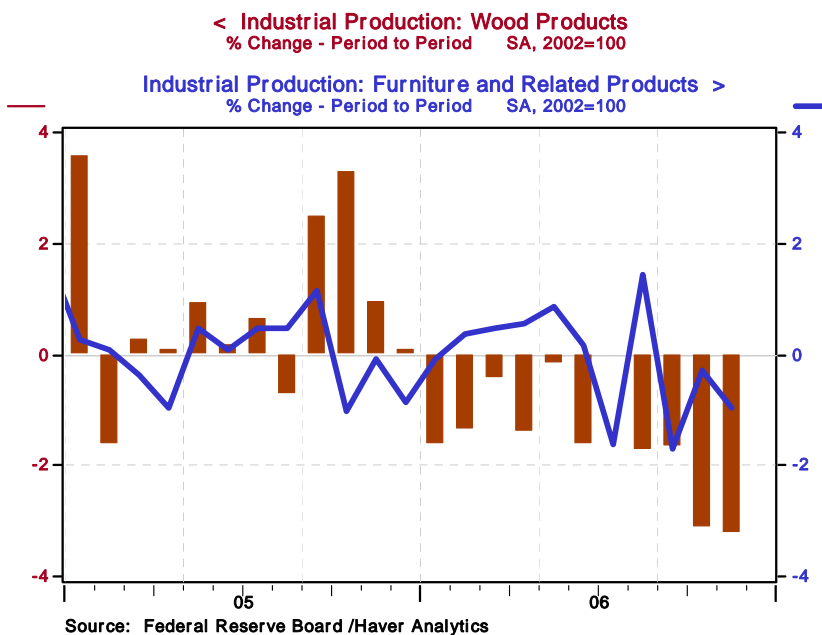
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Chart 3



Production in the housing related industries continue to post declines. The wood products components posted the eleventh consecutive decline and furniture production fell 1.0%

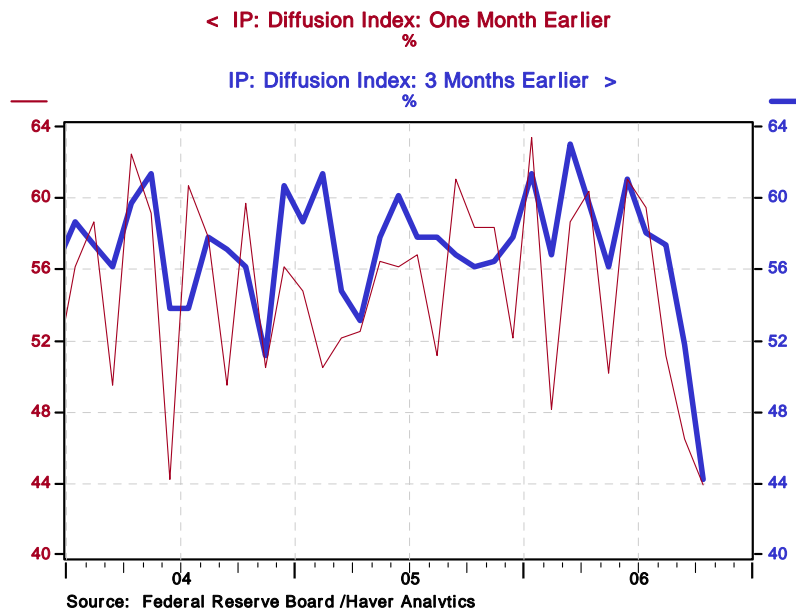
Chart 4



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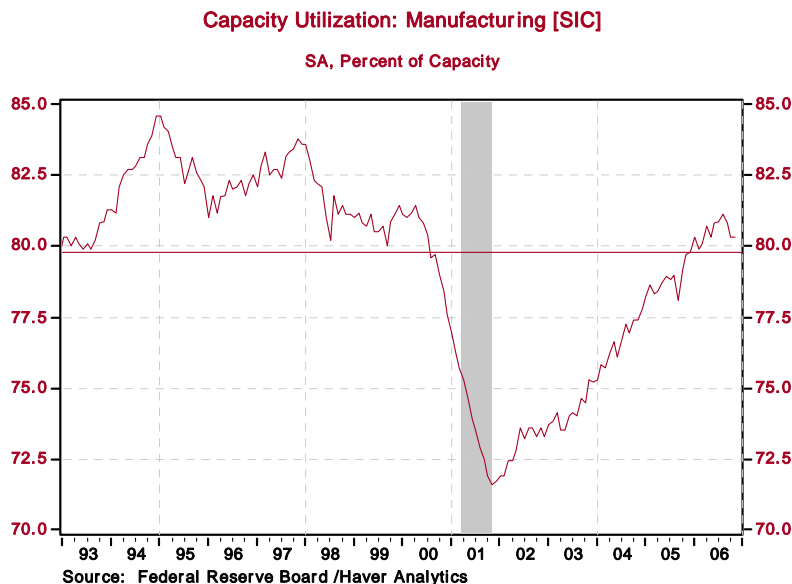
The 1-month and 3-month diffusion indexes of industrial production present a picture of noticeable weakness in the factory sector.

Chart 5



The operating rate of the factory sector was 80.3 in November compared with the long-term average (79.8). Although the operating rate is slightly higher than the long-term average, it appears to have peaked in the current cycle.

Chart 6



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Industrial Production – November 2006

	<u>Jul-06</u>	<u>Aug-06</u>	<u>Sep-06</u>	<u>Oct-06</u>	<u>Nov-06</u>
Industrial Production*	0.4	0.2	-0.4	0.0	0.2
Total Capacity Utilization	82.4	82.4	82.0	81.8	81.8
Manufacturing output*	0.4	0.4	-0.1	-0.5	0.3
Man. Capacity Utilization	80.9	81.1	80.8	80.3	80.3
Capacity Utilization ex. High-tech industries	81.3	81.4	81.1	80.4	80.4
High-tech industries - output*	1.7	2.5	3.1	1.8	2.2
Manufact. Ex high-tech output*	0.3	0.2	-0.3	-0.7	0.1

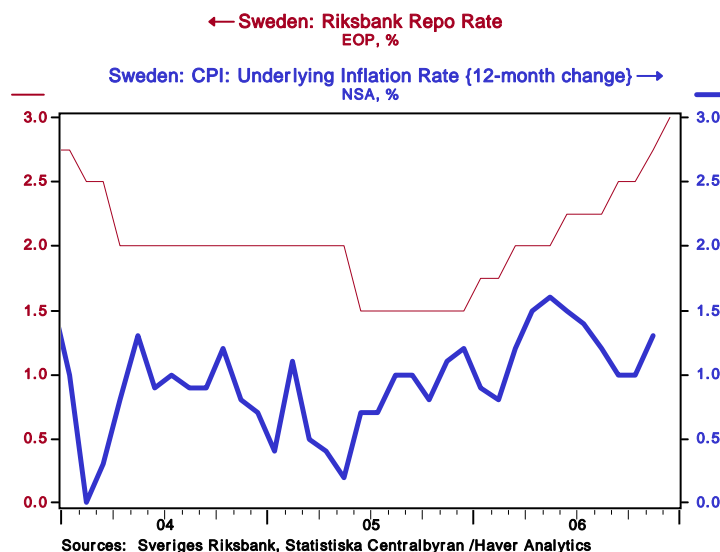
* - percent change from prior month

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Sweden's Riksbank Continues On Its Tightening Path

As expected, Sweden's Riksbank ended the year with its sixth consecutive rate hike today, taking the repo rate up 25bps to 3.00%. In making its announcement, the bank said: "It is reasonable to assume that the interest rate will need to be increased further, roughly in line with recent market expectations." This implies additional 25bps rate hikes at each of the next four policy meetings – in February, March, May, and June – putting the repo rate at 4.00% by mid-2007.

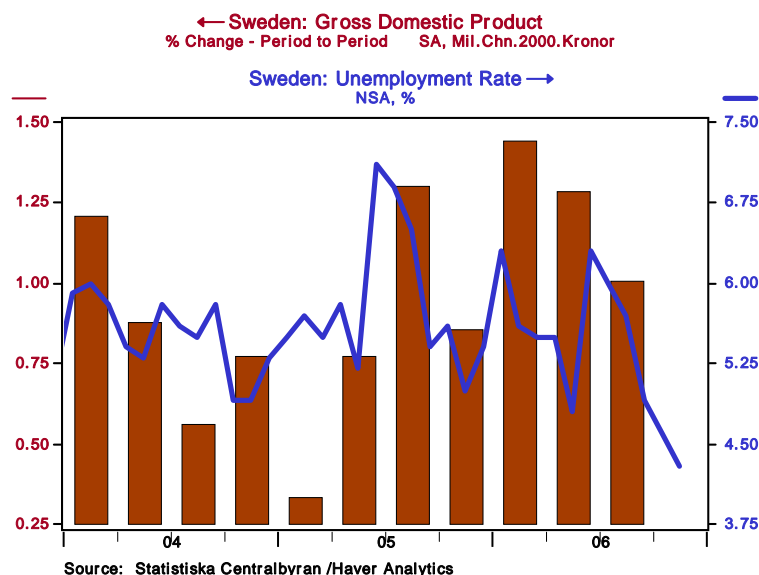
The central bank targets underlying inflation (UNDIX, ex-indirect taxes and interest rates) of 2.0% over a two-year forecast horizon. As we've noted before (see Daily Global Commentary, [October 26: Sweden's Riksbank Hikes Repo Rate Again](#)), although UNDIX remains well below this level – coming in at just 1.3% in November – the Riksbank is concerned with where inflation will be two years from now.



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The overall tone of the Riksbank's statement was quite measured. Yes, rates will need to keep edging upward, but at the same leisurely pace that we have seen over the past year. There is no need to be more aggressive. The bank noted continued strong economic activity, and warned it may lift its forecast for 2007 GDP from the 3.1% projected in October. It also noted fast credit growth and rising inflation, but went on to comment that the inflation forecast made back in October – annual average headline inflation of 1.3% in 2006 and 2.0% in 2007 – may need to be revised downward for the coming year, primarily as a result of lower energy prices.

Recent data certainly underline the view of a healthy economy. The unemployment rate fell for the fifth month in a row in November, dropping to 4.3% from 4.6% in October. And earlier this month came confirmation that while the pace of GDP growth eased a little in Q3, it remained robust – up 1.0% on the quarter and 4.4% on the year (+1.3% and +5.3%, respectively, in Q2).



Assuming this scenario continues, we can expect the repo rate to reach 4.0% in mid-2007 and stay there through the end of the year.

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