



U.S. ECONOMIC & INTEREST RATE OUTLOOK

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The Fed Probably *Thinks* It Is On Hold for All of 2007

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We don't. We continue to believe that the Federal Reserve's next move is to cut the federal funds rate. However, the first interest rate cut now appears likely later in the year, perhaps on August 7, than we had been forecasting in recent months. The trigger for the Fed to decrease the federal funds rate will be the combination of lower inflation *and* persistent below-potential economic growth.

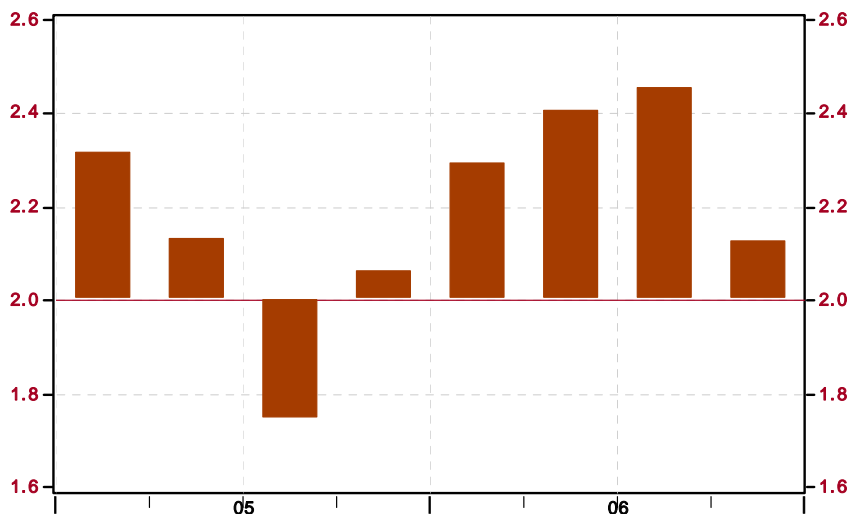
Despite the stronger-than-expected 3.5% annualized real Gross Domestic Product (GDP) growth in last year's fourth quarter, 2006 second-half growth slowed to an annualized 2.71% from 4.1% in the first half. And we believe that some of the strength in the fourth quarter was due to milder-than-normal weather. As temperatures return to more seasonal levels and as the recession in the housing sector slowly "infects" the rest of the economy, growth will moderate further.

Core consumer inflation, i.e., inflation excluding its volatile energy and food elements, is decelerating toward the 2.0% upper bound of the Fed's "comfort zone." As shown in Chart 1, core consumer inflation ran at an annual rate of 2.41% in the two quarters ended Q2:2006 then decelerated to 2.13% in the two quarters ended Q4:2006. On the inflation front, too, we expect the recession in housing will play a role in guiding the Fed to some second-half 2007 interest rate cuts.

Chart 1

PCE less Food & Energy: Chain Price Index

2-qtr %Change-ann SA, 2000=100



Source: Bureau of Economic Analysis /Haver Analytics

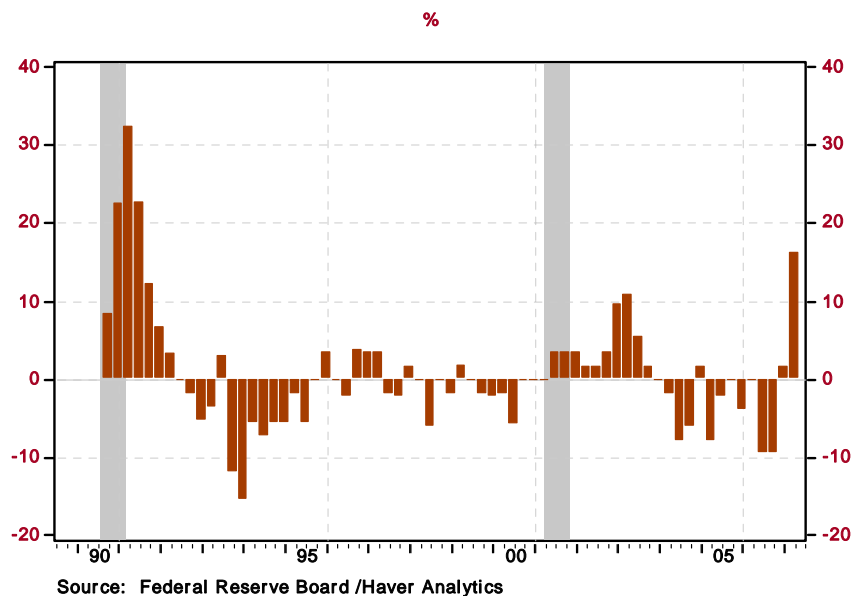


We believe that the bottom of the current housing recession lies quarters ahead. An average post-WWII era housing recession entails about a 25% peak-to-trough decline in real residential investment expenditures. As of the fourth quarter of 2006, these expenditures were down about 13% from their Q3:2005 peak. So, unless this is a milder-than-average housing recession, the trough lies ahead.

As winter temperatures return to normal or colder-than normal levels, both housing construction and sales activity are likely to weaken again, dousing talk that the housing recession is over. Moreover, *effective* housing affordability is likely to fall as federal and state financial regulators clamp down on “exotic” mortgage products as well as the mortgage market itself. In the past couple of months a number of exotic mortgage lenders and brokers have closed their doors as intermediate buyers/securitizers of this product have pulled back. The Fed’s latest survey of bank lending standards shows a sharp rise in the number of banks tightening their lending standards for residential mortgages (see Chart 2). In other words, credit conditions in the mortgage market are tightening.

Chart 2

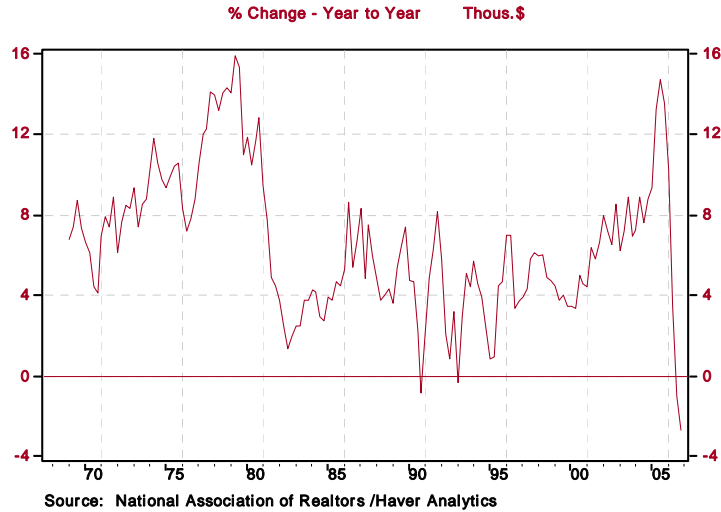
FRB Sr Off Survey: Banks Tightening Standards for Mtges to Individuals



The housing recession will moderate growth in consumer spending in two ways. First, the weakening in housing prices will slow the growth in home equity – an important source of funding for consumer spending in recent years. Chart 3 shows in quarterly observations the year-over-year decline in the median price of existing single-family homes was 2.7% in Q4:2006 – a record decline. Moreover, the rate of descent, or the second derivative of the decline in house prices, also was a record.

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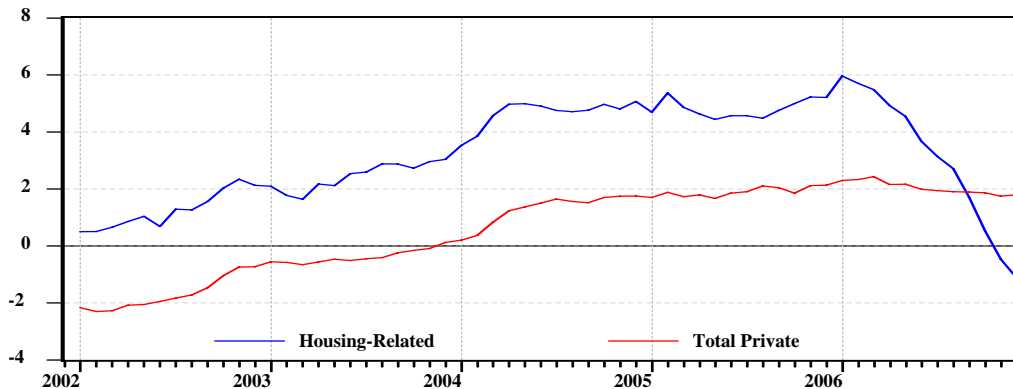
Chart 3
NAR Median Sales Price: Existing 1-Family Homes



Mortgage equity withdrawal (MEW) reached a record-high annualized pace of \$730 billion in Q3:2005 and slowed to \$215 billion in Q3:2006, the latest data available. With housing prices declining, MEW is likely to slow even more as home equity increases at a much slower rate. Thus, one of the funding sources of household deficit spending is drying up.

But job growth is picking up, which will offset the negative effect on consumer spending from slower MEW, right? Wrong! Job growth is slowing as housing-related jobs *contract*, as shown in Chart 4. As builders complete houses already under construction, they will begin to lay off even more workers. Why don't we think builders will start a lot of new construction? Because they are walking away from options on land. Mortgage lenders and brokers will begin to lay off more employees as the housing market continues to languish. Once a real estate broker, always a real estate broker. But that doesn't mean real estate brokers will generate much in commissions as sales and prices remain soft.

Chart 4
Private Sector Employment Growth: Housing-Related vs. Total Private
 yr./yr. percent change



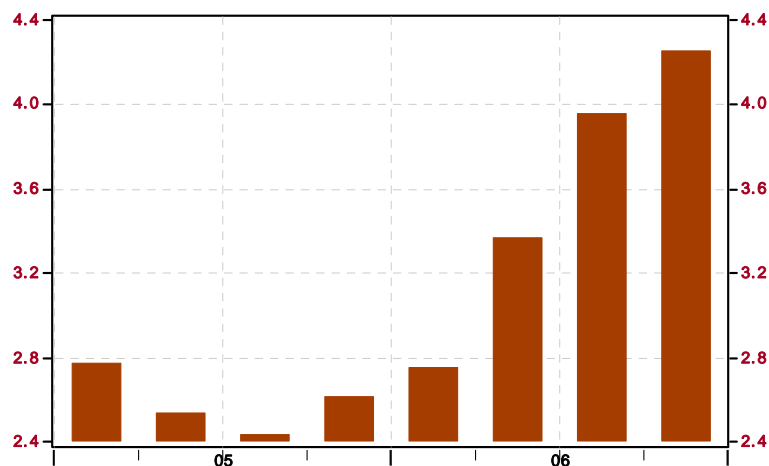
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The continuing recession in housing will moderate core inflation. One of the major factors driving up core inflation has been accelerating rent of shelter, as shown in Chart 5. But with a record number of houses and condos unoccupied or vacant (see Chart 6), the rate of increase in rents is likely to moderate in 2007.

Chart 5

PCE: Housing Services: Chain Price Index

% Change - Year to Year SA, 2000=100

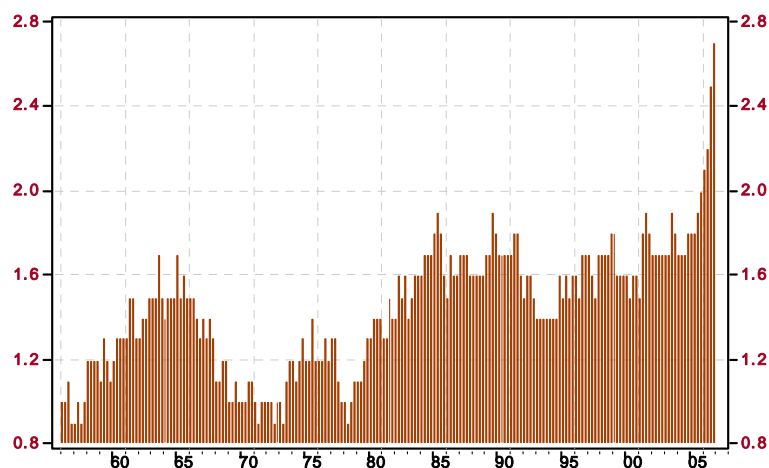


Source: Bureau of Economic Analysis /Haver Analytics

Chart 6

Homeowner Vacancy Rate: United States

%



Source: Census Bureau /Haver Analytics

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In sum, we expect core inflation to moderate in 2007 as the pace of rent increases moderates. We believe the housing recession will start to negatively affect consumer spending this year through slower employment growth and slower MEW. Thus, we are forecasting real economic growth of less than 2-1/4% over the first three quarters of 2007. This below-potential growth will put upward pressure on the unemployment rate. The combination of moderating core inflation and a rising unemployment rate will induce the Fed to commence dropping the federal funds rate in the second half of this year.

**Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy*

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**THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
February 2007**

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2006				2007				Q4-to-Q4 change			Annual change		
	06:1a	06:2a	06:3a	06:4a	07:1f	07:2f	07:3f	07:4f	2005a	2006a	2007f	2005a	2006a	2007f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	5.6	2.6	2.0	3.5	2.6	1.7	2.2	2.8	3.1	3.4	2.3	3.2	3.4	2.5
CONSUMPTION EXPENDITURES	4.8	2.6	2.8	4.4	3.3	2.2	2.3	2.5	2.9	3.7	2.6	3.5	3.2	3.0
BUSINESS INVESTMENT	13.7	4.4	10.0	-0.4	11.3	3.0	3.8	4.9	5.6	6.8	5.7	6.8	7.4	5.5
RESIDENTIAL INVESTMENT	-0.3	-11.1	-18.7	-19.2	-18.0	-13.0	-6.0	0.0	9.0	-12.6	-9.5	8.6	-4.2	-14.6
CHANGE IN INVENTORIES ('00 dlrs, bill)	41.2	53.7	55.4	35.3	28.6	24.6	24.6	26.6				19.7*	46.4*	26.1*
GOVERNMENT	4.9	0.8	1.7	3.7	1.7	2.2	2.2	2.2	1.2	2.8	2.1	0.9	2.1	2.2
NET EXPORTS ('00 dlrs, bill.)	-636.6	-624.2	-628.8	-581.4	-571.1	-560.8	-554.6	-549.0				-619.2*	-617.8*	-558.8*
FINAL SALES	5.6	2.1	1.9	4.2	3.1	1.8	2.2	2.8	3.2	3.5	2.5	3.5	3.1	2.7
NOMINAL GROSS DOMESTIC PRODUCT	9.0	5.9	3.9	5.0	5.5	3.7	3.9	4.3	6.4	5.9	4.3	6.3	6.4	4.6
GDP DEFLATOR - IMPLICIT (% change)	3.3	3.3	1.9	1.5	2.8	2.0	1.7	1.4	3.1	2.5	2.0	3.0	2.9	2.1
CPI (% Change, 1982-84 = 100)	2.2	5.0	2.9	-2.2	3.1	2.3	2.0	1.7	3.7	2.0	2.3	3.4	3.2	1.8
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.7	4.6	4.7	4.5	4.6	4.8	4.9	5.0				5.1*	4.6*	4.8*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

SPECIFIC INTEREST RATES	Quarterly Average								Annual Average		
	06:1a	06:2a	06:3a	06:4a	07:1f	07:2f	07:3f	07:4f	2005a	2006a	2007f
Federal Funds	4.46	4.90	5.25	5.25	5.25	5.25	5.05	4.60	3.21	4.96	5.04
3-mo. LIBOR	4.76	5.21	5.43	5.37	5.35	5.35	5.00	4.55	3.56	5.19	5.06
2-yr. Treasury Note	4.60	4.99	4.93	4.74	4.90	4.75	4.55	4.45	3.85	4.82	4.66
10-yr. Treasury Note	4.57	5.07	4.90	4.63	4.75	4.65	4.45	4.45	4.29	4.79	4.58

a = actual
f = forecast

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