

WEEK IN
REVIEW

July 16 – July 20, 2007

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Central Bank Policies

Chairman Bernanke's report about monetary policy and the state of the economy was largely a reiteration of the June **Fed** policy statement. The most significant part of Bernanke's testimony was the comment about inflation: *"With the level of resource utilization relatively high and with a sustained moderation in inflation pressures yet to be convincingly demonstrated, the FOMC has consistently stated that upside risks to inflation are its predominant policy concern."*

In the semi-annual testimony, the Chairman presents the FOMC's forecasts for economic growth, inflation, and unemployment. Revisions to GDP and inflation projections for 2007 and 2008 show slower GDP growth but unchanged inflation readings compared with the February 2007 forecast, which suggests that *potential* GDP of the economy is now viewed to be marginally lower – about ¼% to 3/8% -- than the implication in the Fed's February 2007 projection. The Fed's current forecast for 2007 implies real GDP growth averaging between 2.75% and 3.1% in the last three quarters of the year. Our forecast is for annualized growth of 2.0% over the last three quarters of the year with the Blue Chip consensus coming into close to the Fed's, not surprisingly, at 2.8%.

The FOMC remains cautious about the housing market, with Bernanke noting that *"declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time."* About the subprime market, the Chairman noted that conditions have "deteriorated significantly" and that "rising delinquencies and foreclosures are creating personal, economic, and social distress for many homeowners and communities -- problems that likely will get worse before they get better."

In terms of monetary policy, Chairman Bernanke offered no hints about the possibility of a change in the federal funds rate. The Fed is likely to be on hold at the August 7 FOMC meeting. The housing market adjustment is being watched closely, consumer spending has clearly softened, and the consensus optimism about capital spending is not supported by data as yet. These factors and other risky features of the economy such as a financially stretched household sector strongly suggest that weakening economic conditions will trump the Fed's concern about core inflation. We continue to think that the FOMC will be induced to begin taking out some anti-recession insurance -- i.e., to begin cutting the fed funds rate-- at the October 31 FOMC meeting, the day on which the Commerce Department will release its first estimate of third-quarter GDP.

The **People's Bank of China** raised the 1-year deposit rate and 1-year lending rate 27 bps to 3.33% and 6.84%, respectively, effective as of June 21, making it as the fifth hike since April 2006. This move was expected, particularly after the growth rate of real GDP in the second quarter was announced as a hefty 11.9% increase, the largest in eleven years. At the same time, inflation in China stood at a 4.4% year-to-year gain in June. The message from these

data is that Chinese economy is overheated, with additional rate hikes very much likely in 2007.

Brazil's COPOM eased 50bp, but three out of seven members dissented in favor of a 25bp reduction. We think that stronger economic data and signs of a modest deterioration in inflation expectations will lead the committee to shift to 25bp moves starting in September, with the Selic rate expected to fall an additional 75bp to 10.5% by December.

CPI and PPI – June 2007

Core Inflation at Retail Level is Contained

The Consumer Price Index (CPI) rose 0.2% in June, after a 0.7% increase in May. The energy price index fell 0.5%, but food prices advanced 0.5% in June. Year-to-date, the CPI has risen at an annual rate of 5.0% versus a 2.5% increase in 2006. Lower prices for gasoline (-1.1%) in June, after a 28.6% jump in the three months ended May, helped to bring down the overall energy price index. The energy price index has moved up 27.8% in the first six months of the year accounting for 48.0% of the increase in the overall CPI. Food prices were up 0.5% in May compared with a 0.3% increase in May. The food price index has risen at an annual rate of 6.2% in the first-half of the year and contributed to about 17.0% of the increase in the overall CPI.

The core CPI rose 0.2% in June, following a 0.1% increase in May. The core CPI has risen at annual rate of 2.3% in the first and second quarters of 2007 compared with a 2.6% gain in 2006. On a year-to-year basis, the core CPI increased 2.22% in June, nearly matching the increase seen in May (+2.24%). Shelter costs rose 0.4% in June, reflecting a 2.5% increase in hotel prices, a 0.3% jump in rents and a 0.2% increase in owners' equivalent rent. Shelter costs (+4.2% in 2006), after being a major factor in the escalation of the core CPI in 2006, show a deceleration in first-half of 2007 (+3.4%). In addition to a moderation in shelter costs, lower apparel prices have helped to trimmed back the advance of the core CPI in 2007. Higher prices for used cars (+0.4%), airfares (+0.9%), medical care (+0.2%), and tobacco (+0.5%) were partly offset by lower prices for clothing (-0.6%) and unchanged prices for new cars.

Producer Price Index – June 2007

The Producer Price Index (PPI) of Finished Goods fell 0.2% in June reflecting lower prices for food (-0.8%) and energy (-1.1%). Year-to-date, the PPI has risen at an annual rate of 6.4% vs. a 1.1% increase in all of 2006. Higher prices for food and energy accounted for a large part of the upward trend of the wholesale price index in the first six months of 2007.

The 0.3% jump in the core PPI of finished goods, which excludes food and energy prices, was mostly due to higher prices of passenger cars (+1.4%) and light trucks (+1.0%). Excluding the prices of these two items, the core PPI posted a more muted increase in June. Hefty incentives are being offered to move cars out of dealerships and these offers are likely to be sweetened more to lure consumers in the months ahead. Therefore, prospects of further gains in car prices are poor.

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Housing Starts – June 2007

Near Term Recovery of Housing Market Not in Sight

Starts of new homes increased 2.3% in June, after posting declines in April and May. The strength in housing starts in June was entirely due to a 12.5% increase in construction of multi-family homes. Construction of new single-family homes edged down 0.2% in June following a 3.5% drop in May. On a regional basis, housing starts fell in the Northeast (-2.4%) and Midwest (-3.7%) but rose in the South (+2.4%) and West (+8.9%).

On a quarterly-average basis, starts of new homes are down 21.8% from a year ago. Housing completions dropped at annual rate of 34.6% in the second quarter after a 37.1% decline in the first quarter. Housing completions track the residential investment expenditures component of GDP closely. Based on the second quarter pace of the decline in housing completions, residential investment expenditures should post a significant drop in the second quarter following a 15.8% annualized decline in the first quarter. The 7.5% drop in permit issuance in June suggests that outlook for near term construction of new homes is poor. All said, an immediate recovery of the housing market is clearly not in sight.

The Housing Market Index (HMI) of the National Association of Home Builders dropped 4 points to 24 in July, the lowest mark since January 1991 and the third lowest reading in the history of the survey. The index tracking traffic of prospective buyers fell 3 points to 19, the lowest since January 1991 when the index stood at 17. Home builders are notably glum about home sales in the next six months, with the index measuring outlook for sales six months ahead dropping 5 points to 34, the lowest reading since January 1991.

Industrial Production – June 2007

Industrial production – Increase Largely a Temporary Event

Industrial production increased 0.5% in June following a downwardly revised 0.1% drop in May. Factory production rose 0.6% in June versus a steady reading in May. Output at the nation's utilities moved up 0.3% during June after a 1.6% decline in the prior month. For the quarter, industrial production increased 2.9% compared with a 1.1% gain in the first quarter. Total capacity utilization stands at 81.7% in June, which is slightly above the long-term average of 81.0%.

Factory production advanced 0.6% in June, which translates into a quarterly annualized gain of 3.4% in the second quarter compared with a 0.8% annualized increase in the first quarter. The operating rate of the factory sector moved up to 80.3% after a 79.9% mark in May. Motor vehicles and parts (+2.5%) accounted for a large part of the increase in factory production during June. Excluding this component, factory output rose 0.4% in June, after an unchanged reading in May. In the second quarter, auto production was up at an annual rate of 13.3% after posting declines in each of the three prior quarters. This sharp increase in production of motor vehicles is likely to sit in dealer inventories because consumers are pulling back on spending. Light motor vehicle sales slowed to an annual rate of 15.6 million units in June compared with an average sales pace of 16.3 million in the three months ended May. J.D. Power has

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estimated that sales in the first half of July are about 20% below year-ago. Unless there is a surge in the second half of this month, July car and truck sales could decline for the seventh consecutive month.

Index of Leading Economic Indicators – June 2007

The Index of Leading Economic Indicators (LEI) fell 0.3% in June after a revised 0.2% increase in May. The LEI has dropped during four out of the last six months. On a year-to-year basis, the LEI declined 0.15% from a year ago in the second quarter after a 0.5% drop in the first quarter. Historically, negative year-to-year changes in the LEI are associated with weakening economic conditions. The U.S. economy grew at a 0.7% annual rate in the first quarter following three quarters of sub-par economic growth. The second quarter reading of the LEI suggests that a similar sub-par performance in the near term is likely in the quarters ahead.

Jobless Claims

Auto Industry Layoffs Could Be Distorting Jobless Claims Readings

Layoffs in the auto industry are typical at this time of the year as production is cut in order to retool for the next year's models. Thus, the seasonal adjustment factors for early July compensate for the "expected" sharp increase in layoffs. Seasonally-adjusted initial jobless claims fell 8,000 to 301,000 during the week ended July 7. It could be that because of previous large layoffs in the auto industry and some precautionary inventory building in anticipation of a possible mid-September UAW strike, auto-related layoffs this year are less than normal, which would boost the seasonally-adjusted data. Continuing claims, which lag initial claims by one week, rose 20,000 to 2.571 million and the insured unemployment rate held steady at 1.9%. For some time now, continuing claims for unemployment insurance have suggested a weaker labor market than have first-time claims. This could reflect employers' reluctance to fire existing staff because of uncertainty as to how long the weak economic environment will persist, but also a reluctance to hire new employees.

Next Week's Highlights:

1. **Existing Home Sales** [July 25] – Sales of existing homes are expected to decline in June for the fourth consecutive month. In May, existing home sales were down 10.1% from a year ago. **Consensus:** -2.3% to 5.85 million from 5.99 million in May.
2. **New Home Sales** [July 26] – The market is looking for a 2.7% drop in sales of new homes in June. Sales of new homes have dropped in four out of the last five months. **Consensus:** -2.7% to 890,000 from 915,000 homes in May.
3. **Durable Goods Orders** [July 26] – A rebound in orders of durable goods (+0.8%) is predicted for June. The headline number is likely to reflect a reversal in orders of

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aircraft which dropped in May and brought about a 2.4% decline in orders of durables.
Consensus: +2.0%

4. **Real GDP** [July 27] – Real GDP is predicted to have grown at an annual rate of 2.7% in the second quarter after a 0.7% increase in the first quarter. Consumer spending is predicted to have slowed to a 1.7% gain in the second quarter after a 4.2% increase in the first quarter. Positive contributions are likely from, business inventories, capital spending and outlays on structures. Residential investment expenditures are forecast to post the seventh quarterly drop. A small improvement of the trade gap is included in the forecast. **Consensus:** 3.2%.
5. **Other reports** – Beige Book [July 25] and Consumer Sentiment Index [July 27].

Key Interest Rates

	7/20/2007 12:25	1-wk. change, bps	4-wk. change, bps	1-yr. change, bps
3-month Libor	5.36	0	0	-13
2-year U.S. Treasury note yield	4.75	-19	-17	-33
10-year U.S. Treasury note yield	4.94	-17	-20	-11

Global Economic Data

	Real GDP		CPI		Unemployment Rate		Central Bank Rate	
	SAAR, yoy %		NSA, yoy%		%	year-ago	%	year-ago
United States	1.9	Q1-07	2.7	Jun-07	4.5	Jun-07	4.6	5.25 Jun-07 5.25
Euro-Area	3.1	Q1-07	1.9	Jun-07	7.0	May-07	7.9	4.00 Jun-07 2.75
Japan	2.7	Q1-07	0.0	May-07	3.8	May-07	4.1	0.51 Jun-07 0.04
UK	3.0	Q1-07	2.4	Jun-07	2.7	Jun-07	3.0	5.50 Jun-07 4.50
Australia	3.8	Q1-07	2.4	Q1-07	4.3	Jun-07	4.8	6.25 Jun-07 5.75
Canada	2.0	Q1-07	2.2	Jun-07	6.1	Jun-07	6.1	4.25 Jun-07 4.25
China	11.9	Q2-07	4.5	May-07	4.1	Q1-07	4.2	2.43 Apr-07 1.64
India	9.1	Q1-07	6.6	May-07	--	--	--	6.00 Jun-07 5.75
New Zealand	2.7	Q1-07	2.0	Q2-07	3.8	Q1-07	3.7	8.00 Jun-07 7.25
Norway	2.8	Q1-07	0.4	Jun-07	2.7	Q1-07	4.7	4.25 Jun-07 2.75
Singapore	6.2	Q1-07	1.1	May-07	2.9	Q1-07	3.4	2.25 Jun-07 3.10
South Korea	3.9	Q1-07	2.5	Jun-07	3.3	Jun-07	3.5	4.50 Jun-07 4.25
Sweden	3.3	Q1-07	1.9	Jun-07	5.8	May-07	7.0	3.50 Jun-07 2.25
Switzerland	2.4	Q1-07	0.6	Jun-07	2.8	Jun-07	3.4	2.70 Jun-07 1.52
Taiwan	4.3	Q1-07	0.0	Jun-07	4.0	May-07	3.9	3.13 Jun-07 2.50
Thailand	4.3	Q1-07	1.9	Jun-07	1.4	May-07	1.2	4.00 Jun-07 6.50

* UK - Claimant Count Unemployment Rate
* Thailand - GDP Non-Seasonally Adjusted
* EA-13, UK, Sweden - Harmonized Unemployment

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Historical US Economic Data

	Jun-07	May-07	Apr-07	Mar-07	Feb-07	Jan-07	Dec-06	Nov-06	Oct-06	Sep-06	Aug-06	Jul-06
Payroll Employment (000)	132	190	122	175	90	162	226	196	109	198	186	222
% Change, Year Ago *	1.5	1.5	1.4	1.4	1.5	1.6	1.7	1.7	1.8	1.8	1.7	1.7
Unemployment Rate (%)	4.5	4.5	4.5	4.4	4.5	4.6	4.5	4.5	4.4	4.6	4.7	4.8
Avg. Hourly Earnings (% Chg.)	0.3	0.4	0.2	0.3	0.4	0.2	0.5	0.3	0.4	0.2	0.3	0.4
% Change, Year Ago	3.9	4.0	3.7	4.0	4.1	4.1	4.3	4.2	3.9	4.1	4.1	3.9
PPI (% Chg.)	-0.2	0.9	0.7	1.0	1.2	-0.6	0.7	1.6	-1.5	-1.1	0.4	-0.1
% Change, Year Ago *	3.3	4.1	3.2	3.2	2.4	0.1	1.1	0.9	-1.2	0.9	3.8	4.0
CPI (% Chg.)	0.2	0.7	0.4	0.6	0.4	0.2	0.4	0.0	-0.4	-0.5	0.3	0.4
% Change, Year Ago *	2.7	2.7	2.6	2.8	2.4	2.1	2.5	2.0	1.3	2.1	3.8	4.1
ISM Diffusion Index (%)	56.0	55.0	54.7	50.9	52.3	49.3	51.4	49.9	51.5	52.7	54.3	54.4
Industrial Production (% Chg.)	0.5	-0.1	0.4	-0.1	0.8	-0.5	0.6	-0.4	-0.2	-0.3	0.2	0.4
% Change, Year Ago	1.4	1.7	1.8	2.2	2.9	2.4	2.8	3.0	4.6	6.0	4.6	4.7
Capacity Utilization (%)	81.7	81.4	81.6	81.4	81.6	81.1	81.6	81.3	81.7	82.0	82.4	82.4
Nondefense Cap. Goods ex Aircraft												
- Orders (% Chg.)		-2.1	2.0	4.6	-2.4	-4.4	0.9	-1.0	-4.1	4.8	-0.2	0.1
% Change, Year Ago *		-2.3	2.9	-3.3	-3.0	-0.7	2.9	7.2	7.9	10.3	6.2	11.5
- Shipments (% Chg.)		0.1	0.9	1.6	0.6	-4.2	0.2	0.8	-1.2	-0.8	0.9	0.3
% Change, Year Ago *		-1.5	0.4	-2.3	-1.3	-1.8	0.8	4.7	4.6	4.7	7.8	9.0
Retail Sales (% Chg.)	-0.9	1.5	-0.3	1.0	0.6	0.0	1.1	0.3	0.0	-0.6	0.1	1.0
% Change, Year Ago	3.2	5.6	2.8	4.3	3.8	4.1	3.9	4.7	4.7	4.9	6.5	3.8
Real Personal Consumption (% Chg.)		0.1	0.2	-0.1	0.4	0.4	0.4	0.4	0.5	0.3	-0.1	0.4
% Change, Year Ago		3.1	3.4	3.3	3.5	3.6	3.5	3.6	3.7	3.2	2.7	2.3
Personal Income (% Chg.)		0.4	-0.2	0.8	0.7	1.1	0.5	0.4	0.6	0.5	0.4	0.5
% Change, Year Ago		6.1	5.8	6.1	5.8	5.7	5.9	5.9	5.7	5.7	8.3	5.9
New Home Sales (SAAR, mn)		0.92	0.93	0.83	0.84	0.89	1.02	0.99	0.95	1.00	1.01	0.97
% Change, Year Ago *		-16.7	-13.0	-26.9	-22.7	-25.8	-18.4	-17.4	-29.5	-19.2	-20.0	-29.1
Existing Home Sales (SAAR, mn)		5.99	6.01	6.15	6.68	6.44	6.27	6.25	6.27	6.23	6.31	6.32
% Change, Year Ago *		-10.1	-8.0	-12.6	-3.7	-3.2	-11.2	-10.9	-8.5	-16.0	-12.1	-12.3
Housing Starts (SAAR, mn)	1.47	1.43	1.49	1.49	1.49	1.40	1.63	1.57	1.47	1.72	1.65	1.75
% Change, Year Ago *	-19.8	-28.9	-15.5	-25.4	-28.9	-37.9	-17.4	-28.3	-27.6	-20.1	-23.5	-14.2
International Trade (Bils \$)		-60.0	-58.7	-62.4	-57.6	-56.8	-60.3	-58.5	-58.2	-64.1	-67.6	-67.6
	Q2-07	Q1-07	Q4-06	Q3-06	Q2-06	Q1-06	Q4-05	Q3-05	Q2-05	Q1-05	Q4-04	Q3-04
Real GDP, Chain Weighted, SAAR		0.7	2.5	2.0	2.6	5.6	1.8	4.2	3.3	3.4	2.6	3.1
% Change, Year Ago		1.9	3.1	3.0	3.5	3.7	3.1	3.4	3.1	3.3	3.4	3.4
Chain-Weighted Price Index, SAAR		4.2	1.7	1.9	3.3	3.3	3.3	3.3	2.4	3.5	3.2	2.1
% Change, Year Ago		2.8	2.5	2.9	3.3	3.1	3.1	3.1	2.8	3.1	3.2	2.9
Nominal GDP, SAAR		4.9	4.1	3.9	5.9	9.0	5.1	7.6	5.8	7.0	5.9	5.3
% Change, Year Ago		4.7	5.7	6.0	6.9	6.9	6.4	6.6	6.0	6.5	6.7	6.4
Employment Cost Index (%)		0.8	0.9	0.9	0.9	0.6	0.8	0.7	0.6	1.0	0.6	0.9
% Change, Year Ago		3.5	3.3	3.3	3.0	2.8	3.1	3.0	3.2	3.6	3.7	3.8
Productivity Nonfarm, SAAR		1.0	2.1	-0.5	1.2	3.5	-0.6	3.7	1.5	4.0	0.4	0.2
% Change, Year Ago		1.0	1.6	0.9	1.9	2.0	2.1	2.4	1.5	2.4	1.8	1.6
Unit Labor Costs, Nonfarm, SAAR		1.8	8.9	1.1	-2.5	9.1	3.0	3.0	-0.6	0.7	5.2	4.2
% Change, Year Ago		2.2	4.0	2.6	3.1	3.6	1.5	2.0	2.3	2.2	1.8	1.5
Source: Haver Analytics												
* NSA												

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