

DAILY GLOBAL
COMMENTARY

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Q2 Real GDP Growth Forecast: Chicago Fed at 2.7%; Consensus at 3.2%

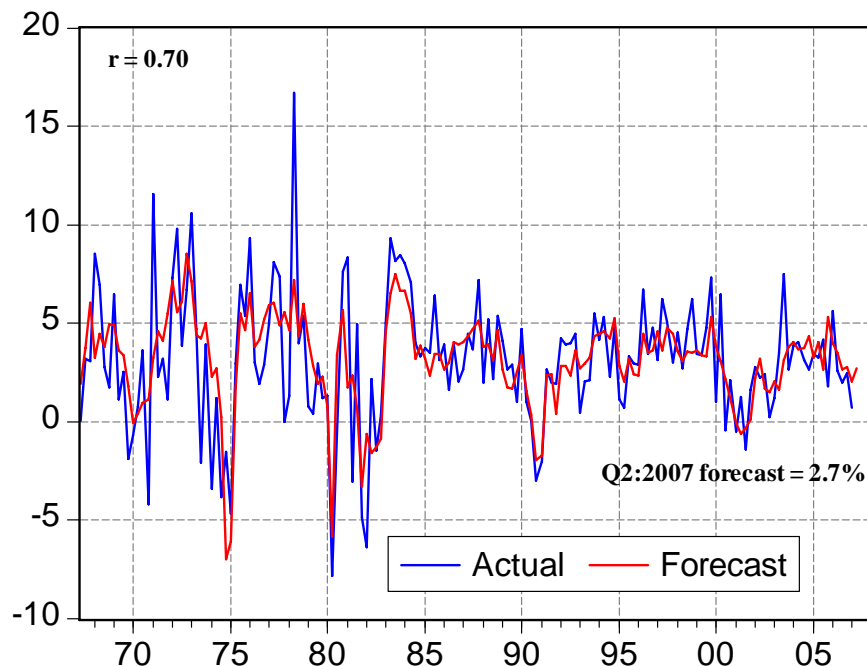
July 23, 2007

Of course, the Chicago Fed does not release to the public its GDP forecasts. But it does publish an index called the National Activity Index (NAI), which is, in effect, a darned good coincident indicator of real GDP growth. The NAI is a weighted average of 85 existing monthly indicators of economic activity drawn from five broad categories:

1) output and income 2) employment, unemployment and hours 3) personal consumption, housing starts and sales 4) manufacturing and trade sales and 5) inventories and orders. Using an ordinary least-squares regression with the NAI as the independent variable, one can obtain a forecast of quarter-to-quarter annualized real GDP growth. The chart below shows actual real GDP growth versus real GDP growth forecast by the NAI. The correlation between the two series is 0.70 – not bad for Federal Reserve work. The NAI forecast for second-quarter real GDP growth, the Commerce Department's first guesstimate of which will be released this Friday, is 2.7%. The consensus forecast is 3.2%. The low forecast in the consensus survey is 2.7%. Any ideas whose that might be? Check out the [U.S. Economic & Interest Rate Outlook July 10, 2007](#).

Chart 1

Real GDP: Actual vs. Forecast* qtr./qtr. annualized percent

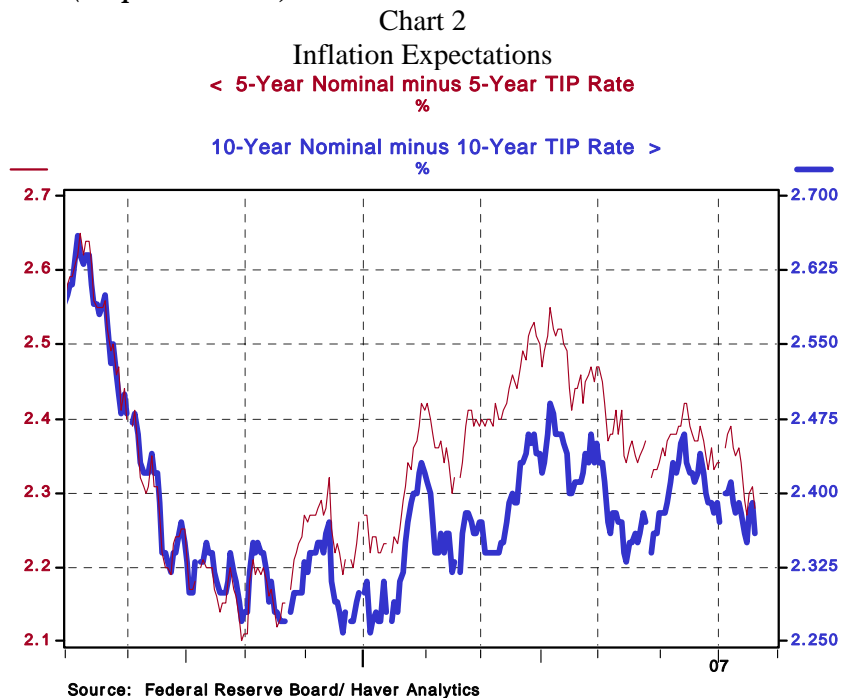


*** Forecast is based on ordinary least-squares regression with a constant and Chicago Fed National Activity Index as independent variable.**

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Inflation Expectations: Tolerance Threshold is Tough

The minutes of the June 27-28 meeting and Chairman Bernanke's testimony contain a strong message about inflation as the predominant risk in the near term. The view presented in June is more specific and tougher compared to the stance communicated in May. The message in June was: *“While total inflation was expected to slow toward the pace of core inflation over time, a number of participants noted that recent elevated readings posed some risk of a deterioration in inflation expectations. On this point, several participants cited the uptick in forward measures of inflation compensation over the intermeeting period derived from Treasury inflation-indexed securities. However, a portion of this increase might be attributed to technical factors, and survey measures of long-term inflation expectations had held steady over recent weeks. Nonetheless, several participants emphasized that holding long-run inflation expectations at or below current levels would likely be necessary for core inflation to moderate as expected over coming quarters.”* (Emphasis added)



From chart 2, it is clear that inflation expectations have not crossed into territory that calls for alarm. Nevertheless, the FOMC remains more than mindful of inflation expectations. The minutes of the May FOMC meeting indicate a more general view about inflation expectations: *“Most participants expected core inflation to moderate gradually, fostered in part by stable inflation expectations and a likely deceleration in shelter costs. Some participants also expected the anticipated slight easing of pressures on resources to help nudge inflation lower, although others felt that small movements in resource utilization were unlikely to have discernible effects on inflation. All participants agreed that the risks around the anticipated moderation in inflation were to the upside; and some noted that a failure of inflation to moderate could entail significant costs particularly if it led to an upward drift in inflation expectations.”* (Emphasis added)

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