

DAILY GLOBAL  
COMMENTARY

Northern Trust  
Global Economic Research  
50 South LaSalle  
Chicago, Illinois 60603  
northerntrust.com

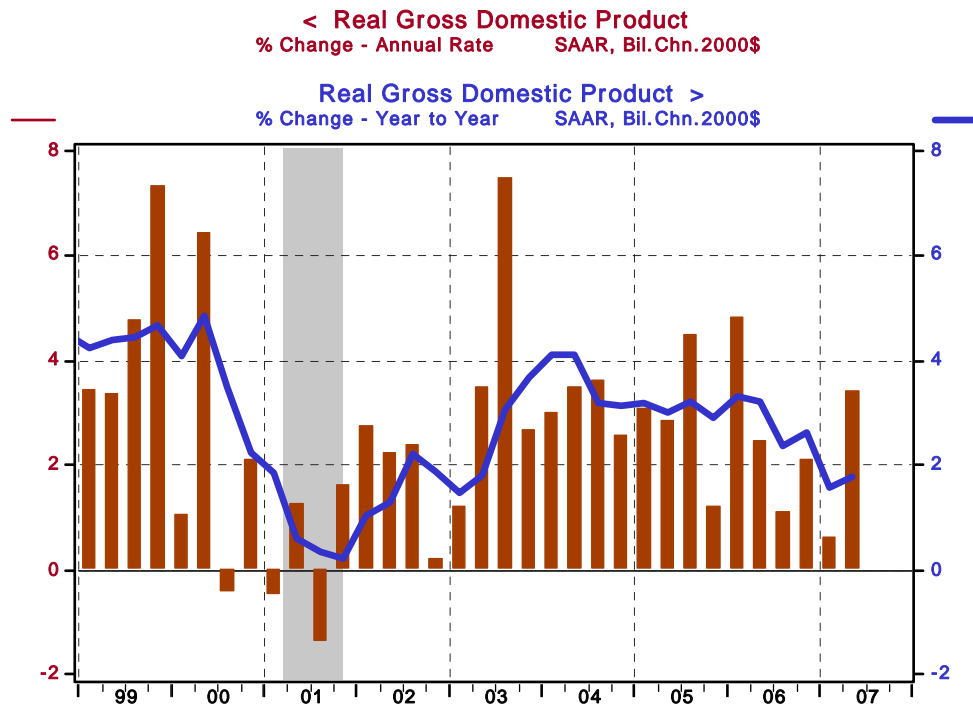
Asha Bangalore  
agb3@ntrs.com

## Rebound in GDP Growth Likely Temporary

July 27, 2007

Real gross domestic product of the U.S. economy grew at an annual rate of 3.4% in the second quarter after a 0.6% increase in the first quarter. This report included revisions of earlier estimates of GDP going back to the first quarter of 2004. The main conclusion from the revisions is that GDP grew at a slower pace during 2004-2006 than previously estimated. (Details of revisions are discussed at the end of these comments.)

Chart 1



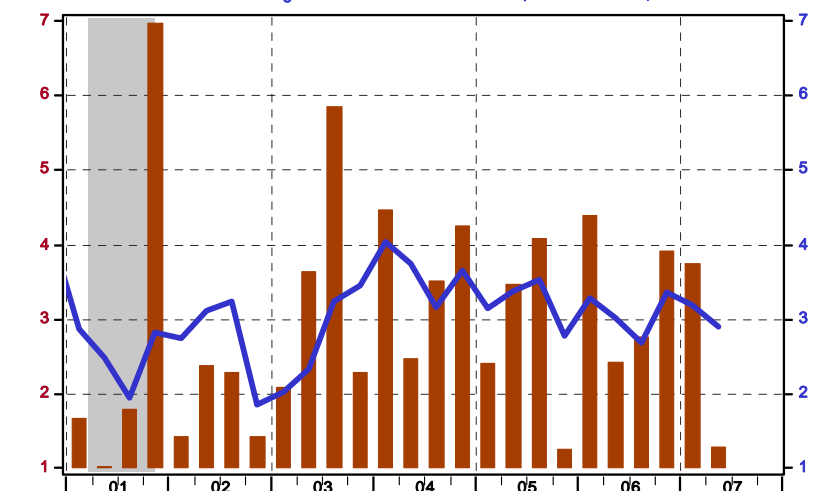
Source: Bureau of Economic Analysis /Haver Analytics

The impressive pickup in economic growth in the second quarter is a temporary event for the following reasons. Firstly, consumer spending grew at a 1.3% pace in the second quarter, after a revised 3.8% average gain in the prior two quarters. The sustained drop in home prices has resulted in a significant reduction of mortgage equity withdrawal which is the main reason for the weakness in consumer spending. Going forward, there is little reason to believe this will change in the second half of 2007.

Chart 2

< Real Personal Consumption Expenditures  
 % Change - Annual Rate SAAR, Bil. Chn. 2000\$

Real Personal Consumption Expenditures >  
 % Change - Year to Year SAAR, Bil. Chn. 2000\$



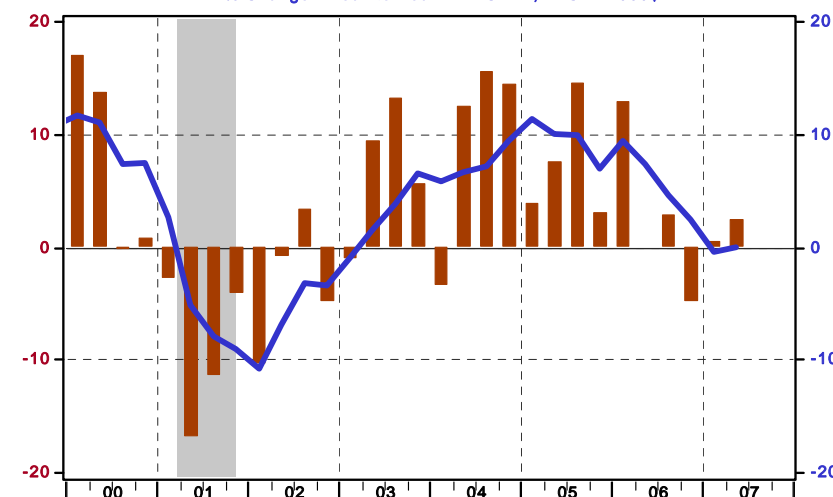
Source: Bureau of Economic Analysis /Haver Analytics

Secondly, capital spending grew at an anemic pace of 2.3% in the second quarter, following a 0.3% increase in the first quarter and a 4.9% drop in the fourth quarter. The current deceleration in consumer spending and projected trend of consumer spending has and will continue to deter businesses from undertaking capital expansion. In addition, a deceleration in the growth of profits is holding back capital outlays (see chart 3).

Chart 3

< Real Private Nonresidential Investment: Equipment & Software  
 % Change - Annual Rate SAAR, Bil. Chn. 2000\$

Real Private Nonresidential Investment: Equipment & Software >  
 % Change - Year to Year SAAR, Bil. Chn. 2000\$

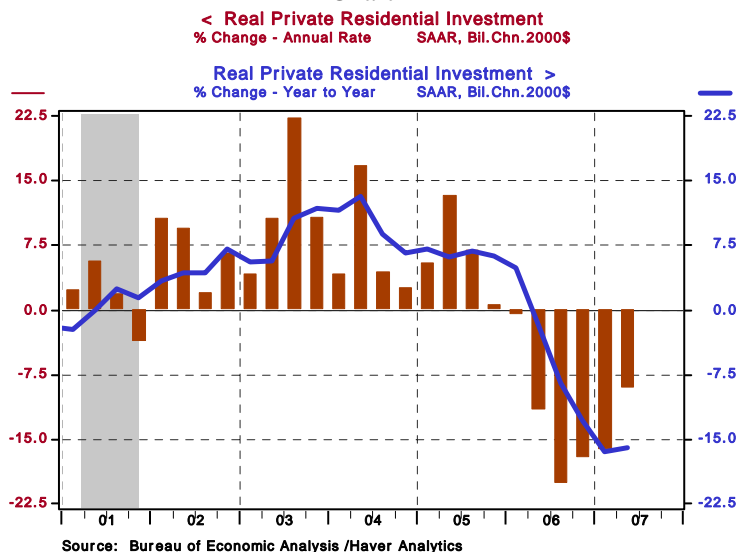


Source: Bureau of Economic Analysis /Haver Analytics

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Thirdly, residential investment expenditures fell at an annual rate of 9.6% in the second quarter, the sixth consecutive quarterly decline. There is a first quarterly reading that shows some moderation in the pace of decline after four quarters of double-digit reductions in outlays of residential investment expenditures. Is this the beginning of a turnaround? It is doubtful because mortgage lending standards are tighter now compared with the 2004-2006 period when extremely lenient mortgage underwriting led to the boom in residential investment expenditure and the contagion from the debacle in the sub-prime mortgage market is more widespread than previously thought. Essentially, the excess supply in the housing market needs to be worked off before this sector recovers. The timeline for this adjustment is the big unknown factor.

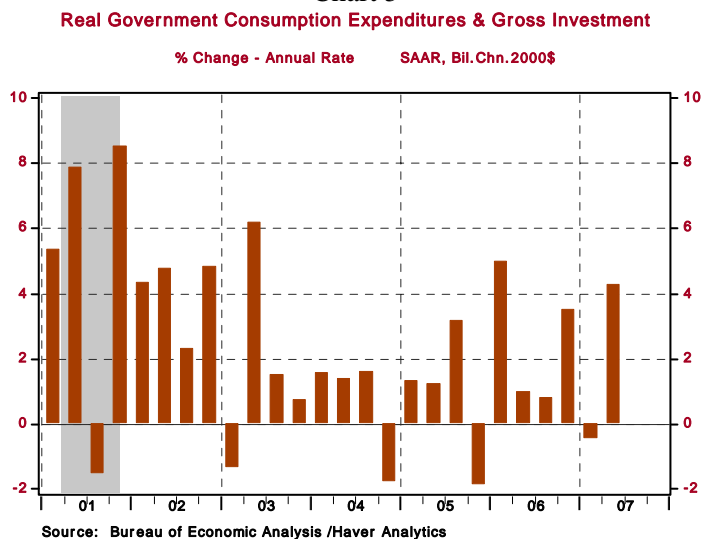
Chart 4



Source: Bureau of Economic Analysis /Haver Analytics

Fourthly, government spending grew at an annual rate of 4.6% in the second quarter after a 0.5% contraction in the previous quarter. A large part of this came from a 9.4% gain in defense expenditures. A repetition of this robust growth in government spending is doubtful.

Chart 5

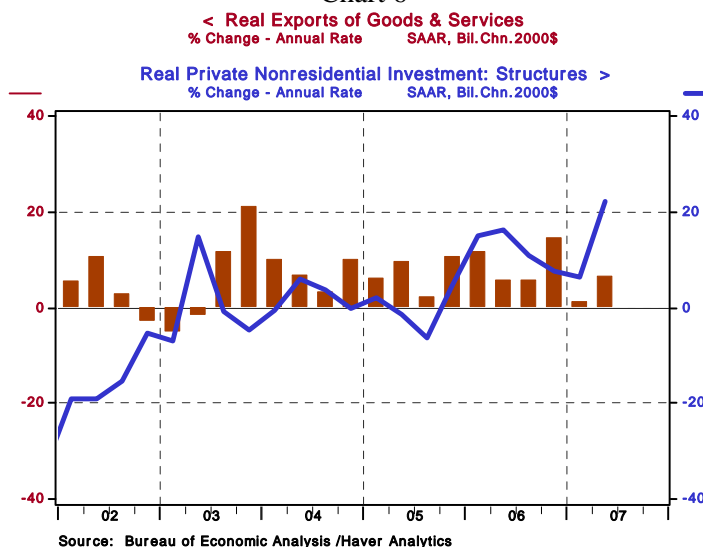


Source: Bureau of Economic Analysis /Haver Analytics

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Offsetting these likely setbacks in spending is a likely increase in non-residential structures and exports. Non-residential structures rose at annual rate of 22.1% in the second quarter. Power and communication (+43.1%) and mining exploration, shafts, and wells (+47.9%) were the main contributors for this noticeable increase in outlays within the structures component. Continued strength in the oil-related industries is plausible, albeit probably not at the second quarter pace. Exports advanced at an annual rate of 6.4% in the second quarter following a 1.1% increase in the first quarter. The economic strength of the nation's trading partners points to a positive contribution from exports to GDP in the quarters ahead.

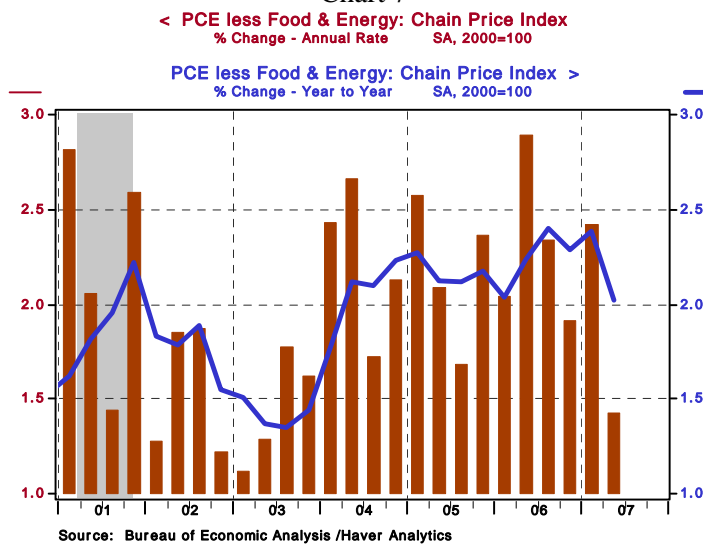
Chart 6



Source: Bureau of Economic Analysis /Haver Analytics

Overall inflation increased at annual rate of 2.7% in the second quarter following 4.2% in the first quarter. The core personal consumption expenditure price index excluding food and energy rose at annual rate of only 1.4% in the second quarter vs. a 2.4% gain in the first quarter. Core inflation appears less of a problem than what is implied in Fed rhetoric.

Chart 7



Source: Bureau of Economic Analysis /Haver Analytics

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

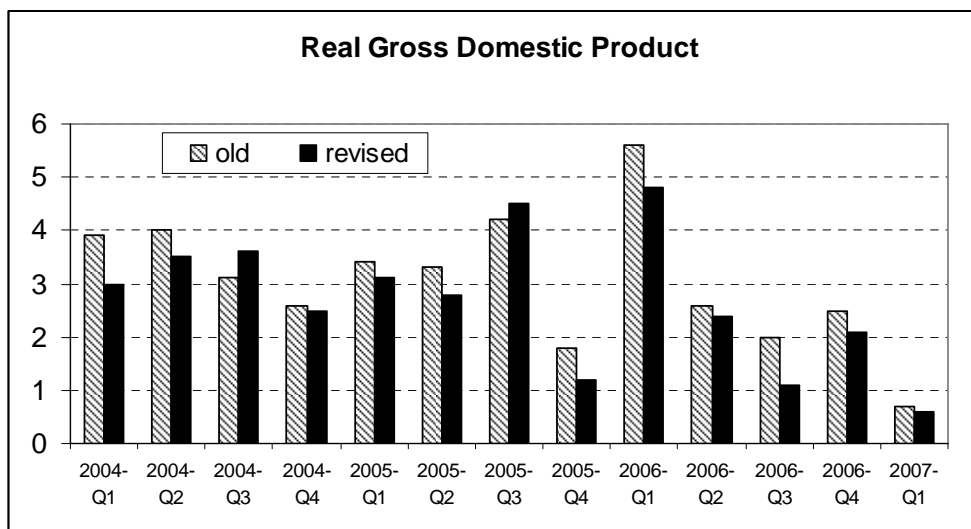
Revisions of GDP data show that real GDP grew much more slowly than earlier estimates during 2004-2006. The change in real GDP growth from the preceding year was revised down for all 3 years: from 3.9% to 3.6% for 2004, from 3.2% to 3.1% for 2005, and from 3.3% to 2.9% for 2006.

### New vs. Old Estimates of GDP Growth

	2004		2005		2006	
	Old	Revised	Old	Revised	Old	Revised
Annual Average	3.9	3.6	3.2	3.1	3.3	2.9
Q4/Q4	3.4	3.1	3.1	2.9	3.1	2.6

From the cyclical trough of GDP in the third quarter of 2001 to the first quarter of 2007, the revised estimates show that real GDP increased at an average annual rate of 2.7% vs. the previously published estimates of a 2.9% increase.

Chart 8



**Conclusion** – We expect real GDP growth to slow in the second-half of the year to about 1-3/4%. If this forecast is accurate, the economy would have recorded seven quarters of sub-par growth resulting from a 425 bps increase in the federal funds rate. If the federal funds rate were held steady at 5.25% it is likely that soft growth will change to a decline in economic activity. There is ample evidence now for the Fed to press the gas pedal and revive economic activity. However, Fed rhetoric shows an unwillingness to ease monetary policy. We predict that by the October 31 FOMC meeting, as the evidence of a relapse of weak economic activity is reported in the Commerce Department's release of its advance estimate of third quarter GDP, the Fed will be more concerned about the prospects of a near-term recession than rising inflation.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

## Real Gross Domestic Product 2007:Q2 Advance Estimate

	Levels (Billions of chained 2000 dollars)			Percent Change (SAAR)		
	06:4 Final	07:1 Final	07:2 Advance	From 06:3 to 06:4	From 06:4 to 07:1	From 07:1 to 07:2
GDP	11395.5	11412.6	11507.9	2.1	0.6	3.4
CONSUMPTION	8141.2	8215.7	8241.4	3.9	3.7	1.3
DURABLE GOODS	1197.6	1223.2	1228.2	3.9	8.8	1.6
NONDURABLE GOODS	2368.8	2386.6	2381.8	4.3	3.0	-0.8
SERVICES	4595.5	4630.7	4655.9	3.7	3.1	2.2
INVESTMENT	1856.2	1816.9	1831.0	-14.1	-8.2	3.1
FIXED INVESTMENT	1835.5	1815.2	1825.0	-7.1	-4.4	2.2
NONRESIDENTIAL	1314.8	1321.7	1347.6	-1.4	2.1	8.1
STRUCTURES	278.3	282.6	297.1	7.4	6.4	22.1
EQUIPMENT & SOFTWARE	1044.4	1045.3	1051.2	-4.9	0.3	2.3
RESIDENTIAL	529.4	506.3	494.2	-17.2	-16.3	-9.3
CHG. BUS. INVENT.	17.4	0.1	3.6			
NET EXPORTS	-597.3	-612.1	-577.9			
EXPORTS	1350.9	1354.7	1375.9	14.3	1.1	6.4
IMPORTS	1948.2	1966.8	1953.7	1.6	3.9	-2.6
GOVERNMENT (Cons. & Invest.)	1997.2	1994.7	2015.6	3.5	-0.5	4.2
FEDERAL	752.3	740.2	752.3	7.3	-6.3	6.7
DEFENSE	505.8	491.6	502.8	16.9	-10.8	9.5
OTHER	246.1	248.4	249.2	-10.0	3.8	1.3
STATE AND LOCAL	1244.9	1254.2	1263.1	1.3	3.0	2.9
DISP. PERS. INC.	8510.7	8633.0	8616.1	6.2	5.9	-0.8
FINAL SALES	11375.8	11411.6	11502.7	3.5	1.3	3.2
FINAL SALES TO DOM. PURCHASERS	11967.3	12017.4	12075.2	2.1	1.7	1.9
PRICE DEFLATORS:						
GDP CHAIN TYPE	117.5	118.8	119.5	1.7	4.2	2.7
GDP EX. FOOD & ENERGY				2.4	3.3	1.7
PCE CHAIN TYPE	115.1	116.1	117.4	-0.9	3.5	4.3
PCE EX. FOOD & ENERGY	113.1	113.7	114.1	1.9	2.4	1.4

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

## The Past Year's Stock Market Rally Has *Not* Been Economically Driven

What accounts for the 18.4% increase in the S&P 500 stock price index in the 12 months ended June 2007? Was it profit growth? Hardly. The Commerce Department's National Income and Product Accounts (NIPA) measure of corporate profits adjusted for prices (the GDP chain price index) shows the year-over-year change at *minus* 0.8% as of Q1:2007, the latest data available (see Chart 9). In nominal terms, year-over-year NIPA profit growth was only 2.1% in Q1:2007 vs. 10.1% in Q1:2006 (see Chart 10).

Chart 9  
Real Corporate Profits with IVA and CCAj  
% Change - Year to Year

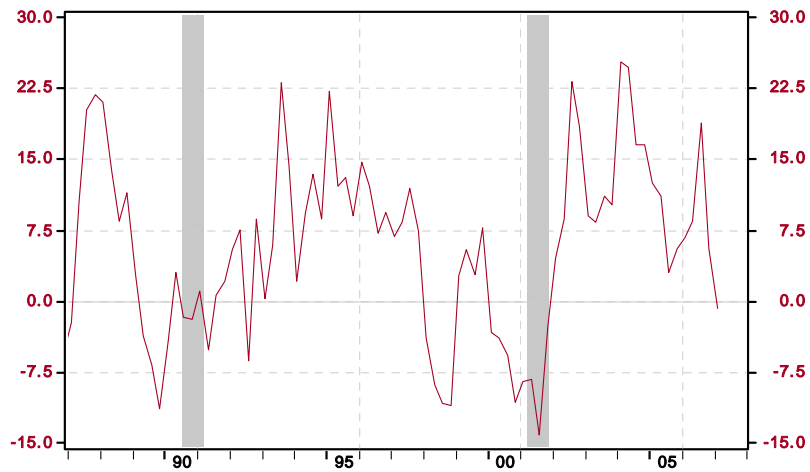
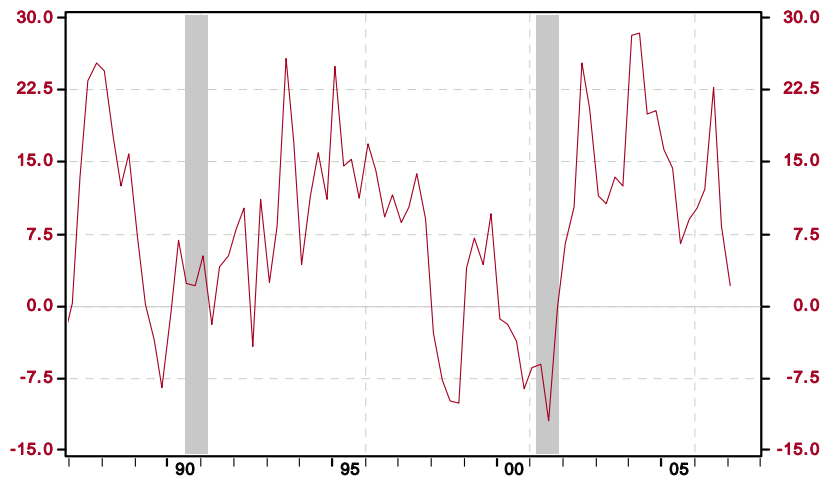


Chart 10  
Corporate Profits with IVA and CCAj  
% Change - Year to Year SAAR, Bil.\$

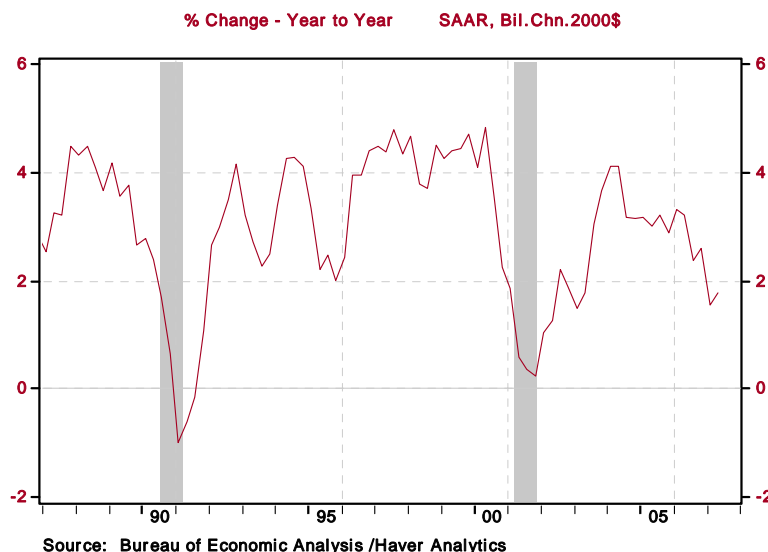


Source: Bureau of Economic Analysis /Haver Analytics

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

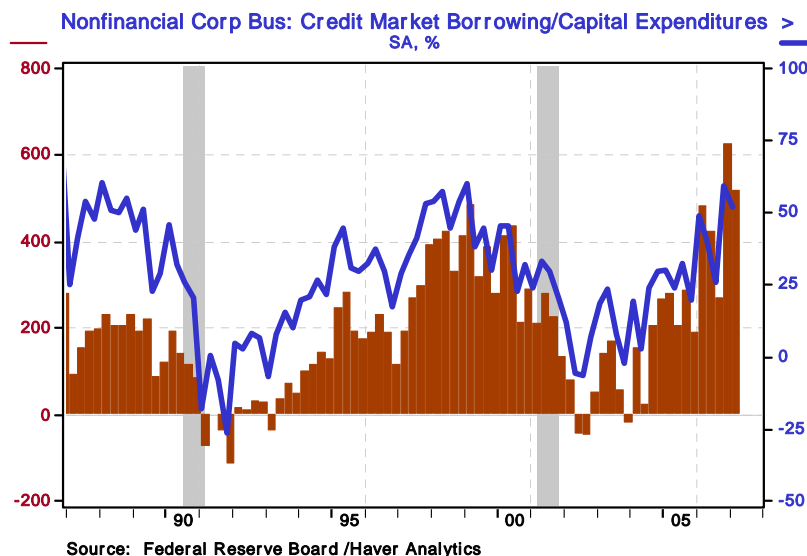
Real GDP growth has slowed significantly. On a year-over-year basis, real GDP was up only 1.8% in Q2:2007 vs. 3.2% in Q2:2006 (see Chart 11).

Chart 11  
Real Gross Domestic Product



So, what has been driving U.S. stock prices higher? Massive buybacks of their own stocks by corporations and massive amounts of corporate stocks being purchased by private equity syndicates in taking publicly-traded companies private. And what has been driving this massive “de-equitization”? Cheap credit. Chart 12 shows that non-financial corporate borrowing has picked up in absolute terms and in relative terms – relative to capital spending.

Chart 12  
< Nonfarm Nonfinancial Corp Bus: Liabs: Credit Market Instruments  
SAAR, Bil.\$



The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

But now, credit to fund de-equitization is getting more expensive. Since June 12, the yield spread between high yield (aka junk) bonds and 10-year U.S. Treasury securities has increased by 150 basis points (see Chart 13). Even with this recent widening, corporate credit-risk spreads still are relatively low (see Chart 14). But should they continue to widen, this de-equitization factor that has been driving up stock prices will wane.

Chart 13  
Yield Spread; Merrill Lynch High Yield Master II minus U.S. Treasury 10-Yr.  
percentage points



Chart 14  
Yield Spread; Merrill Lynch High Yield Master II minus U.S. Treasury 10-Yr.  
percentage points



The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Would a significant slowdown in de-equitization have a negative impact on U.S. aggregate demand? You bet it would. As I argued in my latest *The Econtrarian* ([Wealth Effect or Borrowing/Asset Sales Effect?](#)), households have been net sellers of corporate equities (to corporations and private equity entities), the proceeds of which have been helping to fund household deficits. With the mortgage credit market tightening, a significant slowing in de-equitization would be another nail in the coffin of household spending, which accounts for 75% of real GDP. Perhaps the feeble 0.6% quarter-to-quarter annualized growth in real household expenditures (sum of real personal consumption and residential investment expenditures) in Q2:2007 – the weakest since Q1:1995 – is the new reality (see Chart 15).

Chart 15  
**Real Household Spending: Sum of PCE and Residential Investment Expend.**  
 % Change - Annual Rate



The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.