

WEEK IN  
REVIEW

October 15 – October 19, 2007

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## Federal Reserve Policy Is Most Likely to Favor Considerations of Growth

**Bernanke's Speeches:** There were no hints about the precise course of monetary policy in Chairman Bernanke's speech of October 15. It is nearly certain the Fed will need to lower the federal funds rate soon, but the timing remains uncertain. In his speech, Bernanke justified the 50 basis point cut in the funds rate as follows: (1) To offset the tightening credit conditions following the financial crisis and (2) from a risk management perspective of policy making doing more early would prevent some of the likely adverse effects of the financial market crisis. The FOMC was willing to accept the inflationary consequences of the aggressive move because slowing economic conditions were anticipated to keep inflation contained. He also expressed the Committee's willingness to reverse the policy action if inflation presented a problem. Elaborating about inflation, rising oil and commodity prices and a weak dollar were cited as likely suspects. In his opinion, available data pointed to "continued moderate increase in consumer prices." He reiterated that the FOMC is following developments related to inflation closely. The spillover from the housing market to consumer and business spending was deemed as not evident yet and too soon to assess. However, the housing market crisis was viewed to be a "significant drag" on the broader economy. This morning Bernanke noted that "intuition suggests that stronger action by the central bank may be warranted to prevent particularly costly outcomes." There remarks were made in a broader context of implementing monetary policy in general.

A lack of economic momentum going into the fourth quarter and sharp declines in profit growth gleaned from third quarter earnings reports, particularly in the financial sector, are factors supporting expectations of a lower federal funds rate at the October 31 meeting. There is a large degree of skepticism about the Master-Liquidity Enhancement Conduit that is being explored. Doubts about the viability of this venture raise the probability of the Fed having to lower the federal funds rate to ensure smooth functioning of financial markets. On the other side of the coin, the coast is not clear on the inflation front and the Fed is uncomfortable because a continued weakness of dollar and higher energy prices are inflationary.

**Federal funds rate call:** The October 31 call for federal funds rate is close. The futures market is expecting a lower federal funds rate at this meeting. If the Consumer Confidence Index drops, if there is a significant deterioration of housing market (large drop in homes sales during September, larger inventories of unsold homes compared with August, and a sharp drop in home prices), if the details of GDP report (to be published on October 31, prior to FOMC policy decision), point to noticeably soft business capital spending then the risk management approach would dictate a lower federal funds rate, with inflation/dollar issues taking a back seat. On the other hand, if economic data between now and October are mixed, money and capital market credit-risk spreads narrow (the table below shows that these spreads widened in the latest week), then FOMC can postpone the next monetary policy move to a later date with the weak dollar and necessity to gather more information as factors explaining the reason for standing pat. In sum, if the FOMC sees recession as imminent, a lower federal funds rate is assured on October 31.

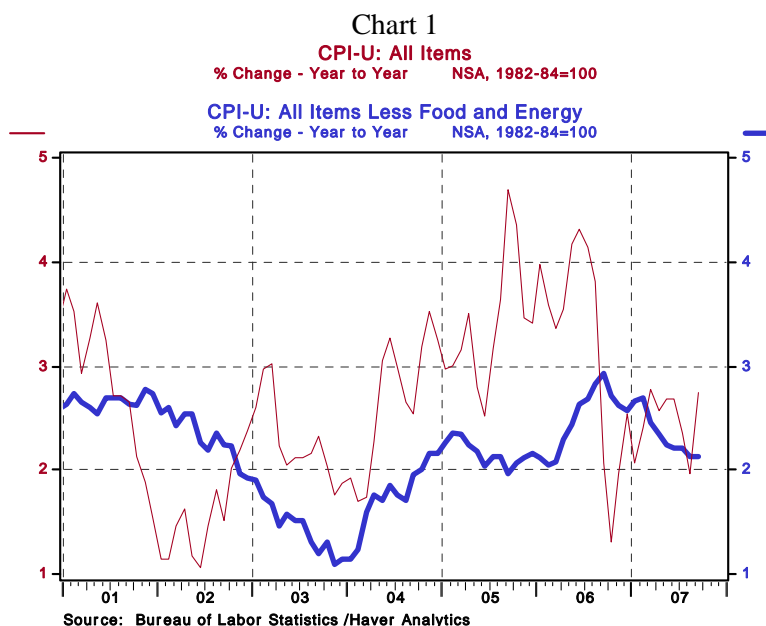
In other news, the IMF expects the global economy to grow at a 4.9% pace in 2008 vs. a 5.2% increase in 2007. The U.S. economy is predicted to grow at an annual rate of 1.9% in 2007 and 2008, a markdown of nearly 1 percentage point in 2008 from the earlier forecast. The balance of risks is on the downside. Inflation is being seen as a greater problem in the emerging markets due to higher food and energy prices.

**Table 1 Indicators of Market Stress (basis points)**

	7/17/07	8/17/07	8/24/07	9/14/07	9/21/07	9/28/07	10/5/07	10/12/07	10/19/07	High 2007	Low 2007
3-month Libor less 3-month U.S. Treasury bill	54	185	138	175	156	151	135	113	139	241.50 8/20/2007	31.00 2/20/2007
3-month Commercial Paper less 3-month U.S Treasury bill	43	161	117	154	120	120	109	93	118	215.00 8/20/2007	17.00 2/22/2007
Merrill Lynch junk bond yield less 10-year U.S. Treasury note yield	320	442	431	454	409	408	399	382	417 10/18/07	471.40 9/10/07	266.90 6/12/07

### Consumer Price Index – September 2007

After being relatively benign in the previous four months, the increase in the CPI flared up in September, increasing 0.3% month-to-month and 2.8% year-over-year. In August, the year-over-year increase was only 2.0%. After having fallen for three consecutive months, the energy component of the CPI increased 0.3% in September. Food prices continued their steady monthly increases, rising 0.5% in September. Unless there is a sharp drop in energy prices, year-over-year increases in the CPI are likely to climb even higher as energy prices now are considerably higher than they were in the fourth quarter of last year.



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The core CPI, which excludes food and energy components, increased by 0.2% in September, close to what has been doing on a monthly basis all year. On a year-over-year basis, the core CPI was up 2.1% in September, the same as in August. The biggest upside threat to core consumer inflation comes from the weaker dollar. The rate of increase in the prices of imported consumer goods is now trending higher. Although it doubtful that retailers will be able to pass through their higher costs of goods sold given the weak consumer demand in the coming quarters, the risk is that they will try to.

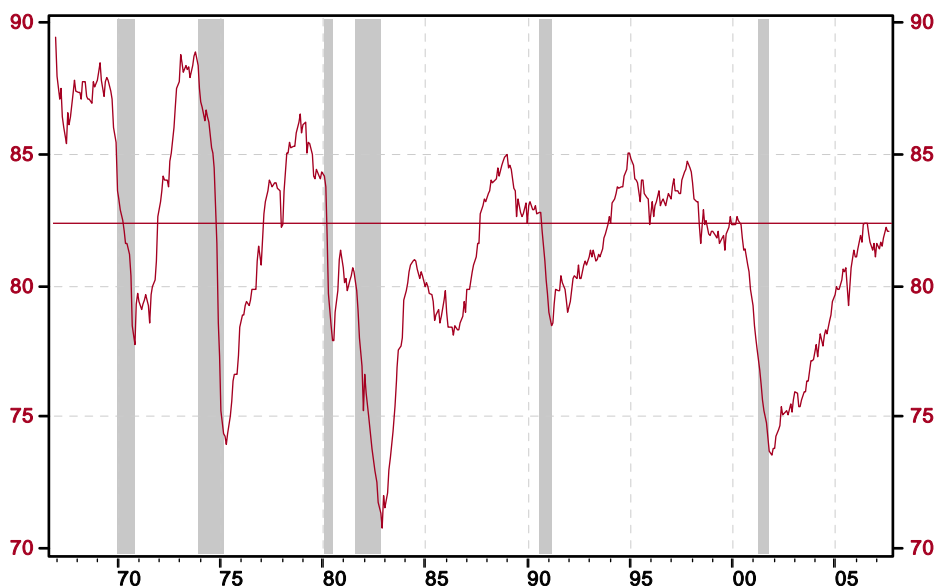
### Industrial Production – September 2007

The Federal Reserve reported that industrial production (IP) in September increased by only 0.1% after being flat in August. The 3.9% annualized growth in Q3 IP (versus 3.6% in Q2) was “front-loaded” with the 0.6% month-to-month increase in July. Capacity utilization (CAPU) was unchanged in September from August at 82.1%. In this cycle, the peak CAPU occurred in July and August 2006 at 82.1%. The average CAPU over the 1972 through 2006 period was 81.0%. As Chart 2 shows, the peak CAPU in this cycle was the lowest cyclical peak in the 1967 through 2007 period. There may be other reasons why corporations would want to embark on increased capital spending programs now, but constrained capacity is *not* one of them.

Chart 2

#### Capacity Utilization: Industry

SA, Percent of Capacity



Source: Federal Reserve Board /Haver Analytics

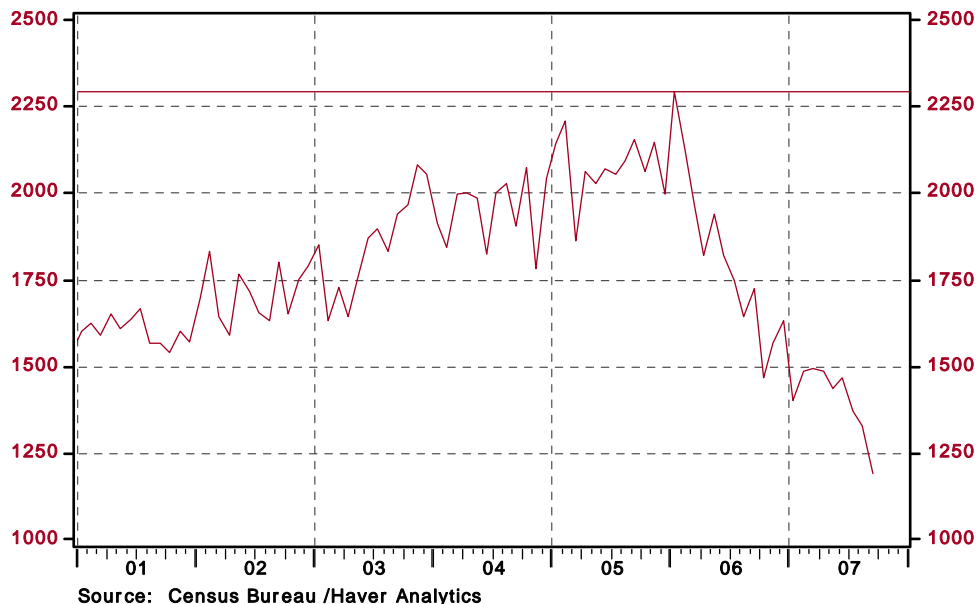
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## Housing Starts – September 2007

Total housing starts plunged 10.3% in September to an annualized rate of 1.191 million units – the lowest level of starts since March 1993. Whereas much of the weakness in starts had been concentrated in the single-family segment of the home-building market, it was the multi-family segment that took it on the chin in September. Multi-family starts fell 34.3% in September whereas single-family starts were down only 1.7%. Housing starts are down 48% from the peak in January 2006 (see chart 3). In terms of permits, the September declines were more evenly distributed – multi-family permits down 7.7% month-to-month in September and single-family permits down 7.1%. Single-family construction is much easier to turn off or on in response to changing demand conditions than is multi-family construction. Given the expectations of weak housing demand as far as the eye can see and given the glut of empty condos around the country, my bet is that the September weakness in multi-family starts will become the norm over the next 12 months.

Chart 3  
Housing Starts

SAAR, Thous. Units

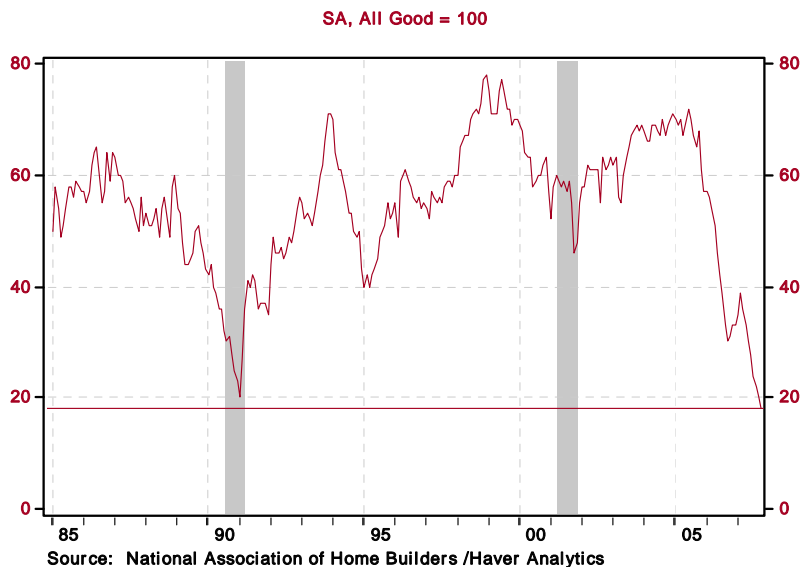


The National Association of Home Builders reported their index of housing demand conditions sank to its lowest level in the history of the series (see Chart 4). The overall index slipped to a reading of 18 in October (probably refers more to conditions in September) from 20 in September. To put an exclamation point on the Home Builders report, the CEO of Caterpillar said the current downturn in the housing market was the worst since World War II and was likely to weaken further next year.

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Chart 4  
Home Builders: Housing Market Index (Composite)



## Index of Leading Economic Indicators – September 2007

### Rebound of Index of Leading Economic Indicators Is Temporary

The Index of Leading Economic Indicators (LEI) rose 0.3% in September after a downwardly revised 0.8% drop in August. Of the ten components of the leading index, interest rate spread and building permits made negative contributions during September, both of which are also likely to make negative contributions in October. In addition, initial jobless claims and consumer expectations are predicted to join the group making negative contributions. The strength in September was from vendor performance, stock prices, orders of non-defense capital goods, and initial jobless claims, with real money supply, consumer expectations, and orders of consumer durables making smaller positive contributions. The manufacturing work week held steady in September. In the third quarter, the year-to-year change in the LEI was 0.4% after two negative readings in the first and second quarters of 2007. The main message is that there will be slow economic growth in the near term.

### Jobless Claims – Jobless Claims Send Worrisome Signal, Confirmation Necessary

Initial jobless claims rose 28,000 to 337,000 during the week ended October 13. This reading is the highest since April 14, 2007. Initial jobless have been bouncing around the 325,000 level for several months, with lows around 300,000. Additional readings of this nature will be necessary to confirm that a severe softening of labor market conditions is underway. Payroll employment data have already signaled that firms are expanding payrolls at a noticeably slower pace. Subsequent weekly readings of jobless claims will be followed closely to see if firms are beginning to pare payrolls, not just refrain from hiring.

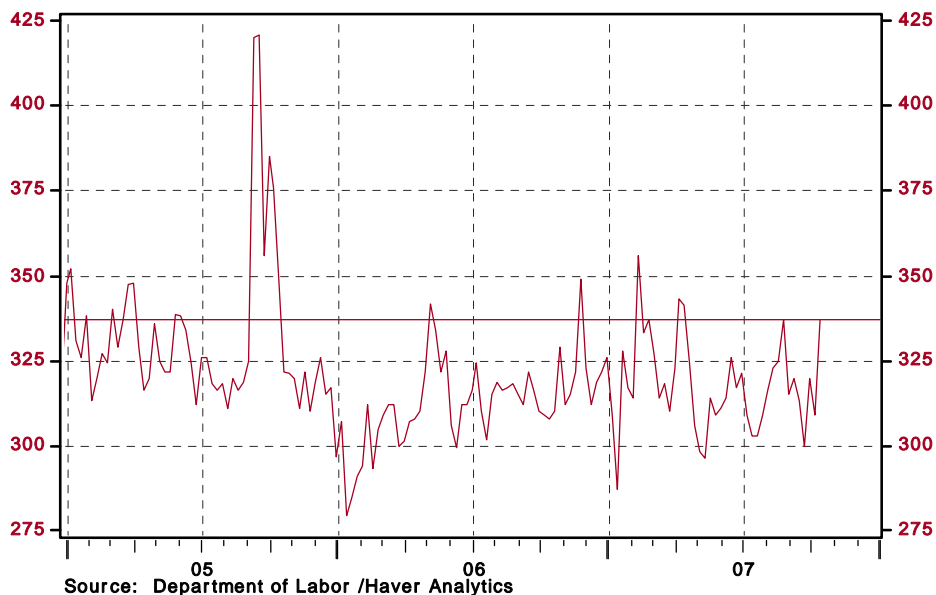
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Chart 5

Unemployment Insurance: Initial Claims, State Programs

SA, Thous



Next Week's Highlights:

1. **Existing Home Sales** [Oct. 24] – The consensus forecast is a 5.5% drop in sales of existing homes to 5.2 million units in September from an annual rate of 5.500 million units in August.
2. **Durable Goods Orders** [Oct. 25] – A decline in aircraft orders was the major reason for the 4.9% drop in orders of durable goods in August. A large reversal should not be surprising. The key is whether other components of durable goods will show a rebound after the weakness seen in August. **Consensus:** +1.0% vs. -4.9% in August.
3. **New Home Sales** [Oct. 25] – Reports from home builders continue to present a gloomy outlook for the housing market. The market forecast is a 2.5% drop in sales of new homes to 775,000 from 795,000 in August.
4. **Other reports** –University of Michigan Consumer Sentiment Index [Oct.26].

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## Key Interest Rates

	10/19/2007 13:17	1-wk. change, bps	4-wk. change, bps	1-yr. change, bps
3-month Libor	5.15	-7	-5	-22
2-year U.S. Treasury note yield	3.83	-40	-23	-104
10-year U.S. Treasury note yield	4.41	-29	-23	-38

## Global Economic Data

	Real GDP		CPI		Unemployment Rate		Central Bank Rate			
	SAAR, yoy %		NSA, yoy%		%	year-ago	%	year-ago		
United States	1.9	Q2-07	2.8	Aug-07	4.7	Sep-07	4.6	4.75	Aug-07	5.25
Euro-Area	2.5	Q2-07	2.1	Aug-07	6.9	Aug-07	7.8	4.00	Sep-07	3
Japan	1.7	Q2-07	-0.2	Aug-07	3.8	Aug-07	4.1	0.51	Sep-07	0.26
UK	3.1	Q2-07	1.7	Aug-07	2.6	Sep-07	3.0	5.75	Sep-07	4.75
Australia	4.3	Q2-07	2.1	Q2-07	4.2	Sep-07	4.7	6.5	Sep-07	6
Canada	2.5	Q2-07	2.5	Aug-07	5.9	Sep-07	6.4	4.5	Sep-07	4.25
China	11.9	Q2-07	6.7	Aug-07	4.1	Q2-07	4.2	2.12	Jul-07	2.06
India	9.3	Q2-07	7.3	Aug-07	--	--	--	6.00	Sep-07	6
New Zealand	3.8	Q2-07	1.8	Q2-07	3.6	Q2-07	3.6	8.25	Sep-07	7.25
Norway	3.7	Q2-07	-0.3	Aug-07	2.6	Q2-07	4.8	5	Sep-07	3
Singapore	8.7	Q2-07	3.0	Aug-07	2.3	Q2-07	3.2	2.23	Sep-07	3.35
South Korea	5.0	Q2-07	2.3	Sep-07	3.3	Sep-07	3.5	5.00	Sep-07	4.5
Sweden	3.2	Q2-07	2.2	Aug-07	6	Sep-07	6.6	3.75	Sep-07	2.5
Switzerland	2.8	Q2-07	0.7	Sep-07	2.6	Sep-07	3.2	2.79	Sep-07	1.81
Taiwan	5.0	Q2-07	2.9	Aug-07	3.9	Aug-07	3.9	3.25	Sep-07	2.63
Thailand	4.5	Q2-07	2.1	Sep-07	1.6	Aug-07	1.8	3.75	Sep-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

	Sep-07	Aug-07	Jul-07	Jun-07	May-07	Apr-07	Mar-07	Feb-07	Jan-07	Dec-06	Nov-06	Oct-06
Payroll Employment (000)	110	89	93	69	188	122	175	90	162	226	196	109
% Change, Year Ago *	1.2	1.3	1.3	1.4	1.5	1.4	1.4	1.5	1.6	1.7	1.7	1.8
Unemployment Rate (%)	4.7	4.6	4.6	4.5	4.5	4.5	4.4	4.5	4.6	4.5	4.5	4.4
Avg. Hourly Earnings (% Chg.)	0.4	0.3	0.3	0.5	0.4	0.2	0.3	0.4	0.2	0.5	0.3	0.4
% Change, Year Ago	4.1	3.9	3.9	4.0	4.0	3.7	4.0	4.1	4.1	4.3	4.2	3.9
PPI (% Chg.)	1.1	-1.4	0.6	-0.1	0.7	0.9	1.0	1.2	-0.6	0.7	1.6	-1.5
% Change, Year Ago *	4.4	2.2	4.0	3.3	3.9	3.2	3.1	2.4	0.1	1.1	0.9	-1.2
CPI (% Chg.)	0.3	-0.1	0.1	0.2	0.7	0.4	0.6	0.4	0.2	0.4	0.0	-0.4
% Change, Year Ago *	2.8	2.0	2.4	2.7	2.7	2.6	2.8	2.4	2.1	2.5	2.0	1.3
ISM Diffusion Index (%)	52.0	52.9	53.8	56.0	55.0	54.7	50.9	52.3	49.3	51.4	49.9	51.5
Industrial Production (% Chg.)	0.1	0.0	0.6	0.5	-0.1	0.6	-0.1	0.8	-0.5	0.6	-0.4	-0.2
% Change, Year Ago	1.9	1.6	1.7	1.5	1.9	1.9	2.2	2.9	2.4	2.8	3.0	4.6
Capacity Utilization (%)	82.1	82.1	82.2	81.8	81.5	81.7	81.4	81.6	81.1	81.6	81.3	81.7
Nondefense Cap. Goods ex Aircraft												
- Orders (% Chg.)		-0.5	0.9	-0.2	-1.5	2.0	4.6	-2.4	-4.4	0.9	-1.0	-4.1
% Change, Year Ago *		-0.9	-0.7	-3.2	-1.6	2.9	-3.3	-3.0	-0.7	2.9	7.2	7.9
- Shipments (% Chg.)		1.0	0.0	-0.8	0.7	0.9	1.6	0.6	-4.2	0.2	0.8	-1.2
% Change, Year Ago *		-0.5	-1.2	-1.6	-0.9	0.4	-2.3	-1.3	-1.8	0.8	4.7	4.6
Retail Sales (% Chg.)	0.6	0.3	0.6	-0.8	1.6	-0.3	1.0	0.6	0.0	1.1	0.3	0.0
% Change, Year Ago	2.9	4.2	3.6	3.5	5.6	2.8	4.3	3.8	4.1	3.9	4.7	4.7
Real Personal Consumption (% Chg.)		0.6	0.3	0.1	0.1	0.3	-0.2	0.3	0.4	0.5	0.2	0.6
% Change, Year Ago		3.4	2.5	2.9	2.9	3.0	3.0	3.2	3.4	3.3	3.3	3.4
Personal Income (% Chg.)		0.3	0.5	0.5	0.5	0.0	0.8	0.8	0.9	0.8	0.4	0.6
% Change, Year Ago		6.8	6.8	6.3	6.7	6.4	6.8	6.3	5.8	6.1	6.0	5.9
New Home Sales (SAAR, mn)		0.80	0.87	0.84	0.86	0.91	0.83	0.84	0.89	1.02	0.99	0.95
% Change, Year Ago *		-22.7	-10.8	-22.4	-22.5	-17.0	-25.9	-22.7	-25.8	-18.4	-17.4	-29.5
Existing Home Sales (SAAR, mn)		5.50	5.75	5.76	5.98	6.01	6.15	6.68	6.44	6.27	6.25	6.27
% Change, Year Ago *		-11.9	-6.1	-13.4	-10.1	-8.0	-12.6	-3.7	-3.2	-11.2	-10.9	-8.5
Housing Starts (SAAR, mn)	1.19	1.33	1.37	1.47	1.44	1.49	1.49	1.49	1.40	1.63	1.57	1.47
% Change, Year Ago *	-32.9	-18.7	-20.5	-19.0	-28.2	-15.5	-25.4	-28.9	-37.9	-17.4	-28.3	-27.6
International Trade (Bils \$)		-57.6	-59.0	-59.4	-59.6	-58.6	-62.7	-57.9	-57.0	-60.3	-58.5	-58.2
	<b>Q3-07</b>	<b>Q2-07</b>	<b>Q1-07</b>	<b>Q4-06</b>	<b>Q3-06</b>	<b>Q2-06</b>	<b>Q1-06</b>	<b>Q4-05</b>	<b>Q3-05</b>	<b>Q2-05</b>	<b>Q1-05</b>	<b>Q4-04</b>
Real GDP, Chain Weighted, SAAR		3.8	0.6	2.1	1.1	2.4	4.8	1.2	4.5	2.8	3.1	2.5
% Change, Year Ago		1.9	1.5	2.6	2.4	3.2	3.3	2.9	3.2	3.0	3.2	3.1
Chain-Weighted Price Index, SAAR		2.6	4.2	1.7	2.4	3.5	3.4	3.5	3.5	2.6	3.9	3.2
% Change, Year Ago		2.7	2.9	2.7	3.2	3.5	3.2	3.4	3.3	3.0	3.3	3.2
Nominal GDP, SAAR		6.6	4.9	3.8	3.4	6.0	8.4	4.8	8.1	5.5	7.1	5.9
% Change, Year Ago		4.7	4.5	5.4	5.6	6.8	6.7	6.3	6.6	6.1	6.6	6.5
Employment Cost Index (%)		0.9	0.8	0.9	0.9	0.9	0.6	0.8	0.7	0.6	1.0	0.6
% Change, Year Ago		3.3	3.5	3.3	3.3	3.0	2.8	3.1	3.0	3.2	3.6	3.7
Productivity Nonfarm, SAAR		2.6	0.7	1.8	-1.6	0.8	2.5	-1.4	4.4	0.3	3.7	0.7
% Change, Year Ago		0.9	0.4	0.9	0.1	1.5	1.4	1.7	2.2	1.4	2.5	1.8
Unit Labor Costs, Nonfarm, SAAR		1.4	5.2	10.3	2.9	-1.0	4.6	4.1	1.3	1.2	-0.1	4.7
% Change, Year Ago		4.9	4.3	4.1	2.6	2.2	2.8	1.6	1.7	2.5	2.3	2.1

Source: Haver Analytics

\* NSA

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