

WEEK IN
REVIEW

October 22 – October 26, 2007

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Federal Reserve Policy - Risk Management Approach Points to Lower Federal Funds Rate

The FOMC meeting of October 30-31 is most likely to end with a 25 basis point cut in the federal funds rate to 4.50%. Recent Fed rhetoric has focused on the risk management approach of monetary policy. The main idea of this strategy is that the Fed may need to be preemptive in order to prevent the worst possible scenario from taking place even if the odds of this occurrence are low. This approach raises the probability of a cut in the federal funds rate at the close of the October 31 meeting. The nature of incoming data is also supportive of this prediction. The dollar is the wildcard that could result in the Fed standing pat. But, at the current time, the possibility of a recession and stress in financial markets trump all other issues.

Table 1 - Indicators of Market Stress

	7/17/07	8/17/07	8/24/07	8/31/07	9/7/07	9/14/07	9/21/07	9/28/07
3-month Libor less 3-month U.S. Treasury bill	54	185	138	171	177	175	156	151
3-month Commercial Paper less 3-month U.S Treasury bill	43	161	117	152	152	154	120	120
Merrill Lynch junk bond yield less 10-year U.S. Treasury note yield	320	442	431	454	465	454	409	408

Table 1 (contd) - Indicators of Market Stress

	10/5/07	10/12/07	10/19/07	10/26/07	High 2007	Low 2007
3-month Libor less 3-month U.S. Treasury bill	135	113	140	115	241.50 8/20/2007	31.00 2/20/2007
3-month Commercial Paper less 3-month U.S Treasury bill	109	93	117	98	215.00 8/20/2007	17.00 2/22/2007
Merrill Lynch junk bond yield less 10-year U.S. Treasury note yield	399	382	429	433 25-Oct	471.40 9/10/07	266.90 6/12/07

Housing Market Update – September 2007

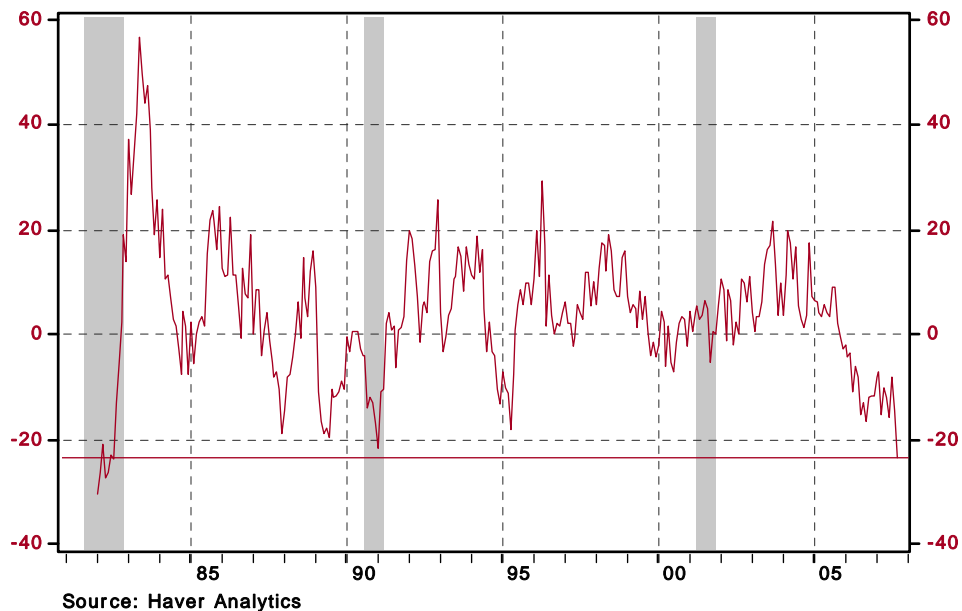
The housing market is at the center of macroeconomic policy discussions with the Fed being particularly sensitive to developments in this sector. The latest reports from the housing market (see details of home sales in September) indicate further deterioration which raises the possibility of more vulnerable financial markets if there is no rapid stabilization in the market, at the least.

Combined sales of new and existing homes fell 23.5% in September, the largest drop since early-1982 (see Chart 1). Sales of new and existing homes appeared to be stabilizing in the early months of 2007 with single-digit year-to-year declines, but the situation in recent months has changed significantly.

Chart 1

Combined Sales of New and Existing Single-Family Homes

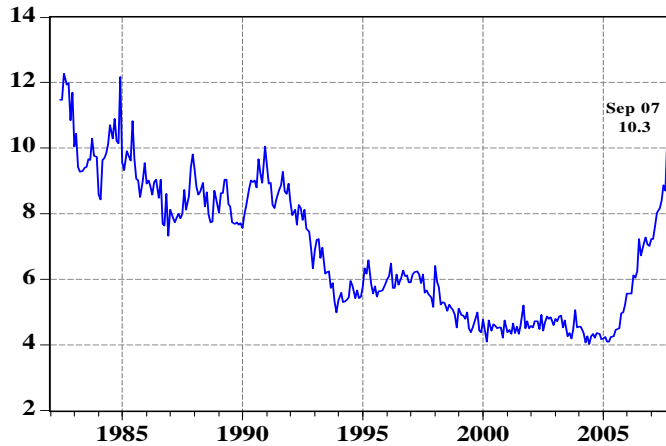
year-to-year change



Excess supply in the housing market continues to climb (see Chart 2) which points to continued declines in home prices. The unfortunate confluence of factors such as growing inventories of unsold homes, tightening mortgage standards, and weak employment conditions is working to restrain home sales, with no improvement in sight.

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Chart 2
Total Single-Family Homes*: Inventory/Sales Ratio
months' supply

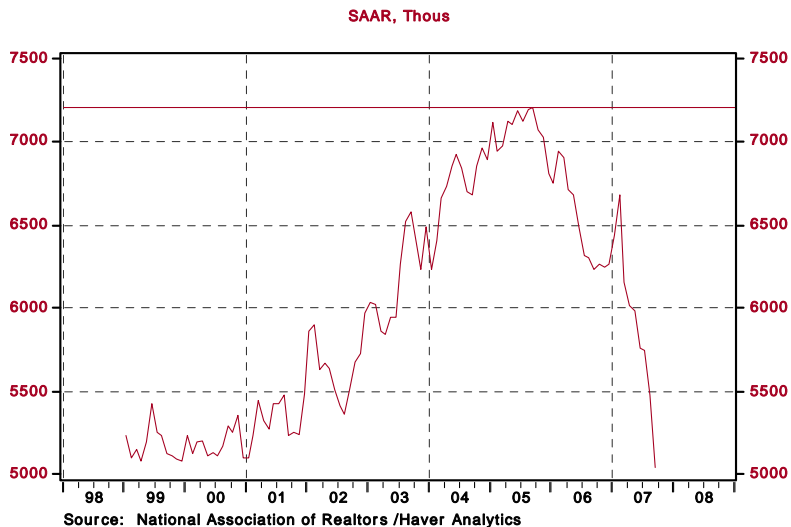


*Combined new and existing

Existing Home Sales - September 2007

Sales of all existing homes fell 8.0% to an annual rate of 5.04 million units. Sales of all existing homes are at the lowest level since 1999 when the National Association of Realtors began publication of combined sales of single-family homes and condos. Sales of existing homes are down 30.0% from the peak seen in September 2005. The news from the housing market is gloomy – prices continue to decline, the number of months to sell has risen to a troubling level. The spillover from the housing market weakness should become more visible in the months ahead.

Chart 3
NAR Total Existing Home Sales, United States

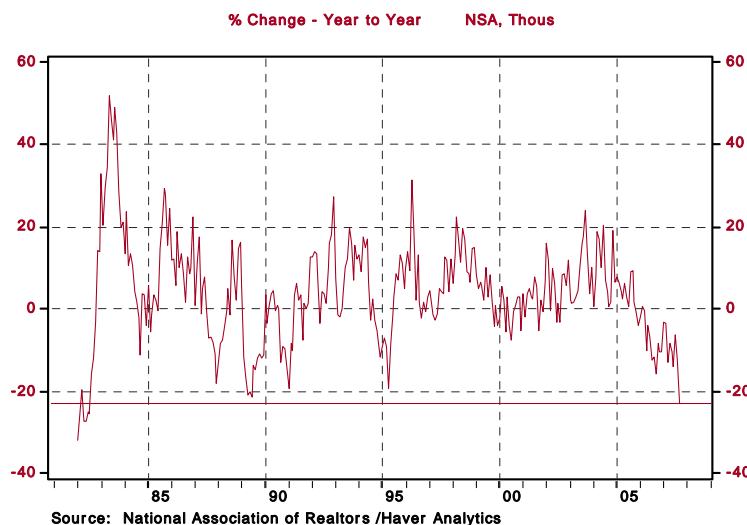


Source: National Association of Realtors /Haver Analytics

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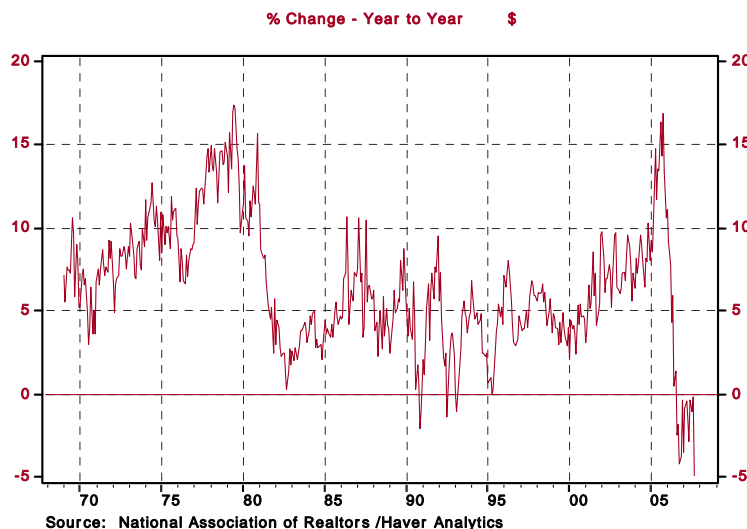
Sales of single-family existing homes dropped 8.6% to an annual rate of 4.38 million units. Purchases of single-family existing homes are down 30.1% from the peak reading of 6.30 million units in September 2005. In September, sales of existing single-family homes fell nearly 23.0% from a year ago, which is the largest decline since July 1982 (see chart 4). Sales of single-family existing homes fell in all four regions of the economy with the West (-12.0%) and Northeast (-11.1%) posting the larger declines compared with the Midwest (-7.9%) and South (-6.5%).

Chart 4
Existing 1-Family Home Sales: United States



The median price of a single-family existing home at \$210,200 is down 4.9% from a year ago. The September year-to-year decline in the median price of a single-family home is the largest on record (see chart 5).

Chart 5
NAR Median Sales Price: Existing 1-Family Homes, United States



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The number of months to sell an existing home at the current sales pace has risen to a 10.5-month mark in September, up from a 7.3-month reading in September 2006. The implication for home-owners who have moved before selling their previous residence is that the cost of bridge loans, if necessary, is burdensome and likely to result in a setback to consumer spending.

New Home Sales - September 2007

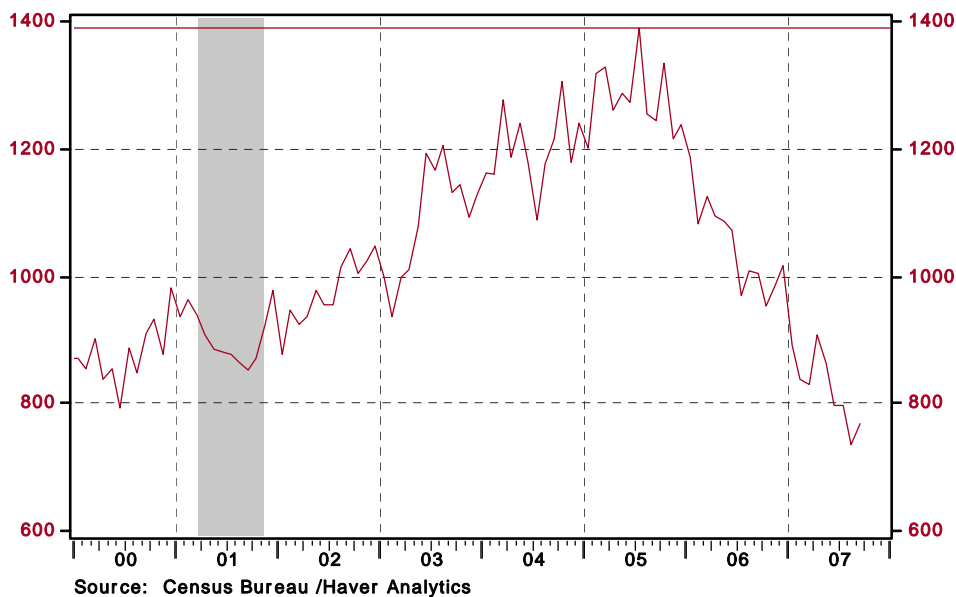
September New Home Sales – Gain Is Suspect and Subject to Revision

Sales of new single-family homes rose 4.8% to 770,000 in September, following major revisions to sales estimates in the June-August period which amounted to a net downward revision of 167,000. Although there was a small increase in purchases of new homes in September, the level of home sales in September is far below the earlier estimate of home sales in August (795,000 original estimate vs. current estimate of 735,000). On a year-to-year basis, sales of new single-family homes are down 25.0% from a year ago and 45% lower than the peak sales mark of 1.389 million in July 2005. The increase in homes sales during September is suspect because major homebuilders such as Centex and Pulte and other minor builders announced losses this week, and reportedly wrote down billions dollars pertaining to the value of land they own and slashed down prices of homes.

Chart 6

New 1-Family Houses Sold: United States

SAAR, Thous



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Inventories of unsold homes are holding at a high level of 8.3 months, but down slightly from the 9.0-month reading of August. The number of completed homes for sale moved up 16.4% from a year ago, representing a significant improvement from readings that were upwards of 50% in late-2006. The seasonally unadjusted level of completed homes for sale was at a record high mark. The median price of a new single-family home increased 5.0% on a year-to-year basis to \$238,000 in September. The gain could be reflecting the fact the homes sold were in the West (+37.7%) where prices are higher than other regions, while home sales dropped in the other regions of the nation.

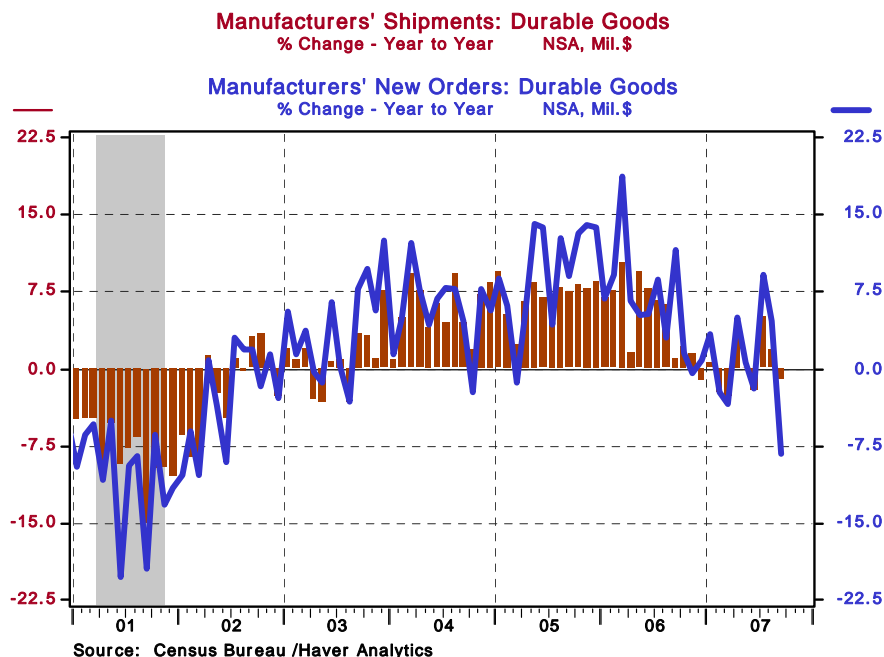
Durable Goods Orders – September 2007

Wilting Durable Goods Orders - Precursor of More to Come?

Durable goods orders fell 1.7% in September, following a 5.3% drop in the prior month. The 38.7% drop in orders of durable defense items was the major cause for the drop in durable goods orders. Excluding defense, bookings of durable goods increased only 0.7%. Orders of non-defense capital goods rose 4.4% in September after a 12.2% decline.

The more troubling issue is the fact that both orders (-8.4%) and shipments (-1.1%) of durable goods are weak on a year-to-year basis (see chart 7).

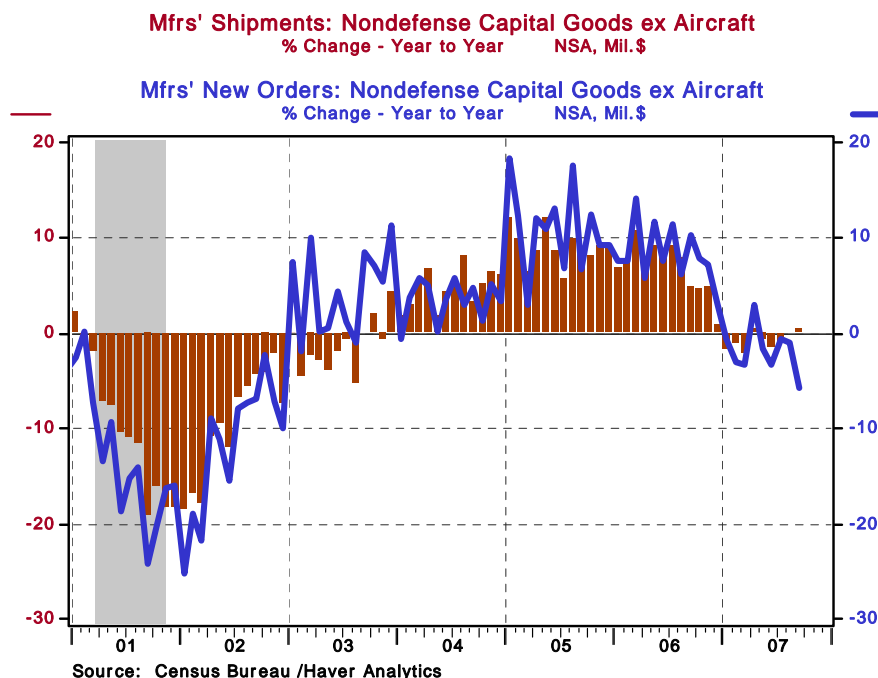
Chart 7



Orders and shipments of non-defense capital goods excluding aircraft, the less volatile component of durable goods, also send a similar message (see chart 8)

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Chart 8



Jobless Claims – Jobless Claims Send Worrisome Signal, Confirmation Necessary

Initial jobless claims fell 8,000 to 331,000 during the week ended October 20. Seasonally unadjusted initial jobless claims moved up 5.0% from a year ago, marking the seventh weekly reading that is positive in the past twelve weeks. Continuing claims, which lag initial claims by one week, rose 7,000 to 2.530 million and the insured unemployment rate held steady at 1.9%. The main message is that additional readings of initial jobless claims upwards of 320,000 should leave the markets and Fed more concerned about the already weak labor market.

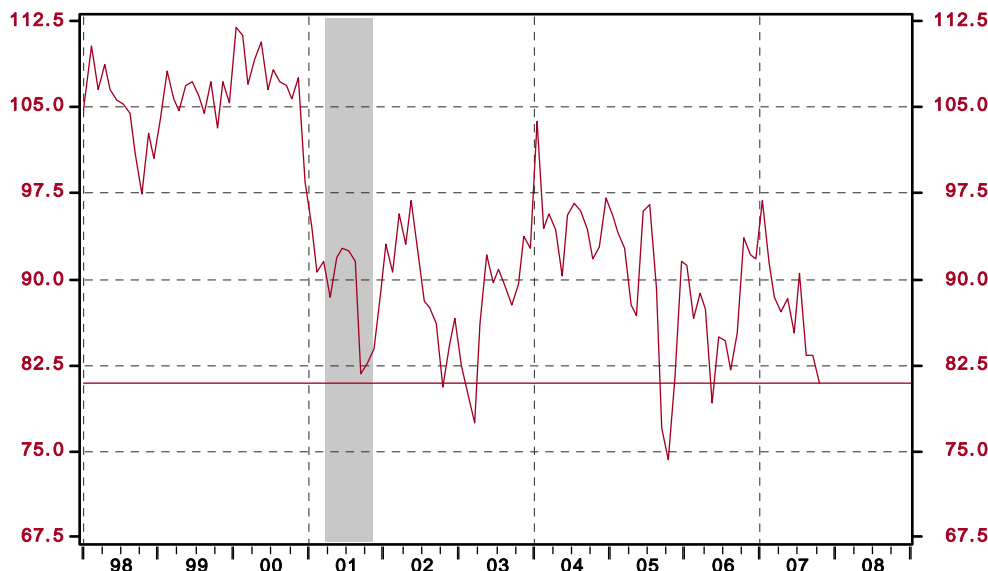
Consumer Sentiment Index – Worrisome Decline

The University of Michigan Consumer Sentiment Index fell to 80.9 in October from 83.4 in September. The preliminary reading for October was 82.0. The level of the index is below the low seen in the 2001 recession (excluding readings associated with the declaration of war in Iraq (March 2003), Hurricane Katrina (September - October 2005) and sharp gains in oil prices (May 2006). Oil prices have once again staged a sharp upward trend and the economy is significantly weaker now compared with 2006. The Current Economic Condition Index dropped to 97.6 (preliminary estimate was 98.2) from 97.9 in September. The Expectation Index declined to 70.1 from 74.1 in September.

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Chart 9
University of Michigan: Consumer Sentiment

NSA, Q1-66=100



Source: University of Michigan /Haver Analytics

The Conference Board’s Consumer Confidence Index is scheduled to be published on October 30. Consumer sentiment indexes are not tied closely to consumer spending but it is included in the set of indicators the Fed watches closely. The policy statement accompanying the surprise Fed easing on January 3, 2001 the Fed noted that, “actions were taken in light of further weakening of sales and production, and in the context of lower consumer confidence, tight conditions in some segments of financial markets, and high energy prices sapping household and business purchasing power.” Several of these aspects of the economy are prevalent today.

Next Week’s Highlights: FOMC Meeting October 30-31

1. **Real GDP** [Oct. 31] – Real gross domestic product is predicted to have risen 2.0% in the third quarter following a 3.8% gain in the prior quarter. The **consensus forecast** is a 3.0% gain. Business capital spending and exports will be watched closely to establish if they provided a lift to overall growth.
2. **ISM Manufacturing Survey** [Nov. 1] – The market is looking for a small drop in the ISM manufacturing index to 51.8 in October from 52.0 in September. Indexes tracking new orders and production fell in September but held above 50.0 implying slower growth in September compared with August. The Federal Reserve Bank of Philadelphia’s factory survey showed declines in indexes tracking orders, production and the overall business index. **Consensus:** 51.8 vs. 52.0 in September.

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3. **Employment Report** [Nov. 2] – Payrolls are predicted to have increased 75,000 in October after a 110,000 increase in the prior month. Payroll employment increased 90,000 a month in the three months ended September compared with an average gain of 147,000 jobs in the first five months of 2007 and an average monthly gain of 186,000 jobs in 2006. The unemployment rate is expected to have risen to 4.8% in October from 4.7% in the prior month. **Consensus:** Unemployment rate: 4.7%. Payrolls: +85,000 vs. +110,000 in September.

Other reports – Consumer Confidence, Chicago PMI, construction spending, [Oct. 30] Auto Sales, Pending Home Sales Index, [Nov. 1], Factory orders [Nov.2].

Key Interest Rates

	10/26/2007 14:41	1-wk. change, bps	4-wk. change, bps	1-yr. change, bps
3-month Libor	4.98	-17	-25	-39
2-year U.S. Treasury note yield	3.76	-4	-21	-100
10-year U.S. Treasury note yield	4.39	-2	-20	-29

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	1.9	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	11.5	Q3-07	6.5	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	2.8	Aug-07	2.3	Q2-07	3.2	2.23	Sep-07	3.35
South Korea	5.1	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	Sep-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.)	0.4	-0.1	0.9	-0.2	-1.5	2.0	4.6	-2.4	-4.4	0.9	-1.0	-4.1
% Change, Year Ago *	-5.6	-1.0	-0.7	-3.2	-1.6	2.9	-3.3	-3.0	-0.7	2.9	7.2	7.9
- Shipments (% Chg.)	1.0	1.8	0.0	-0.8	0.7	0.9	1.6	0.6	-4.2	0.2	0.8	-1.2
% Change, Year Ago *	0.3	0.0	-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)	0.77	0.74	0.80	0.80	0.86	0.91	0.83	0.84	0.89	1.02	0.99	0.95
% Change, Year Ago *	-25.0	-28.4	-18.1	-25.5	-22.5	-17.0	-25.9	-22.7	-25.8	-18.4	-17.4	-29.5
Existing Home Sales (SAAR, mn)	5.04	5.48	5.75	5.76	5.98	6.01	6.15	6.68	6.44	6.27	6.25	6.27
% Change, Year Ago *	-22.7	-12.1	-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
	Q3-07	Q2-07	Q1-07	Q4-06	Q3-06	Q2-06	Q1-06	Q4-05	Q3-05	Q2-05	Q1-05	Q4-04
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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