Northern Trust

U.S. ECONOMIC &
INTEREST RATE OUTLOOK

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No Recession in Sight – If You Are Nearsighted

October 12, 2007

In an op-ed commentary in the October 9 edition of *The Wall Street Journal*, Mickey Levy, Bank of America's chief economist, made the case against the U.S. economy slipping into a recession through 2008 (No Recession in Sight - WSJ.com). The principal elements of his case are that because of relatively strong balance sheets, U.S. corporations "are unlikely to significantly alter their hiring and investment behavior, [c]onsumer spending is supported by rising incomes, [e]xports are strong, [a]nd monetary policy is consistent with sustained growth in domestic demand." We are not as confident about the U.S. economy escaping a recession as is Mr. Levy.

Let's start with the venerable U.S. consumer. The Conference Board categorizes nonfarm payrolls and personal income as *coincident* indicators, *not leading* indicators. In the latest edition of the Federal Reserve Bank of St. Louis *Review*, staff economist Kevin L. Kliesen presents compelling evidence that employment does *not* predict *future* economic activity with much accuracy (How Well Does Employment Predict Output?), thus validating the Conference Board's decision to categorize nonfarm payrolls as a coincident indicator. So, just because households might be experiencing income growth from employment today, this is no guarantee they will continue to spend as high a percentage of that income as they have in the past.

Even if employment were a leading indicator, we would be skeptical of the validity of recent nonfarm payroll data. Each month the Bureau of Labor Statistics (BLS) makes an adjustment to unadjusted private nonfarm payrolls in an effort to estimate how many new jobs are being created by start-up businesses not yet included in its monthly sample of business establishments. This estimate has come to be known as the birth/death adjustment. In the 12 months ended September, the birth/death adjustment accounted for 79.3% of the increase in private nonfarm payrolls compared to only 32.8% in the 12 months ended March 2006 (see Chart 1). With economic growth having slowed in the past year, one has to wonder why so many new businesses have *allegedly* been started and have accounted for almost 80% of private sector nonfarm employment growth. Another BLS measure of private nonfarm employment, which is obtained from surveys of households rather than business establishments, is unadulterated with respect to birth/death adjustments although it has its own shortcomings. In the 12 months ended September, private nonfarm employment measured in the household survey has increased only 0.9% versus the 1.2% from the establishment survey (see Chart 2). In sum, employment growth and personal income growth may not be as strong as the official data have portrayed it to be.

Chart 1

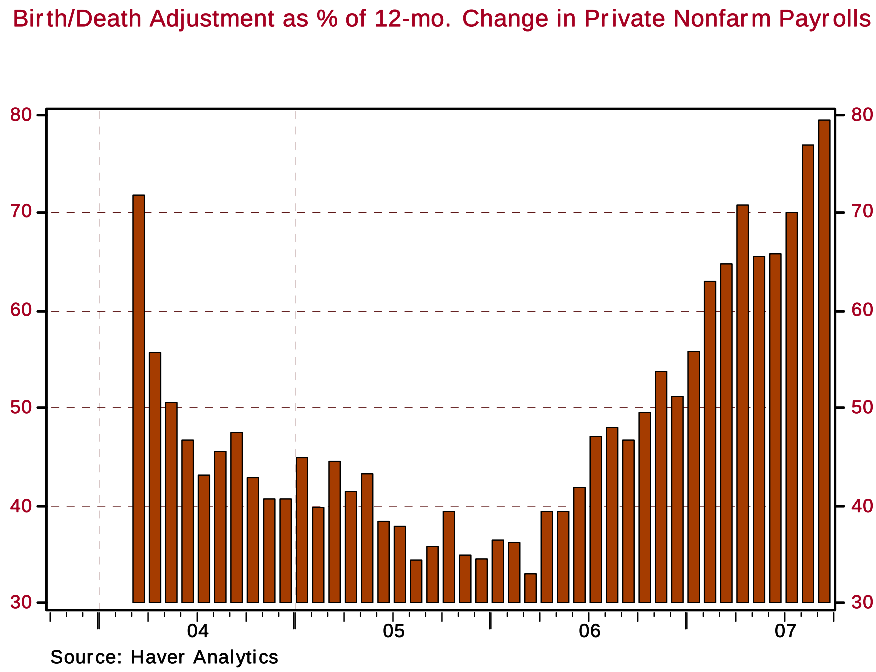
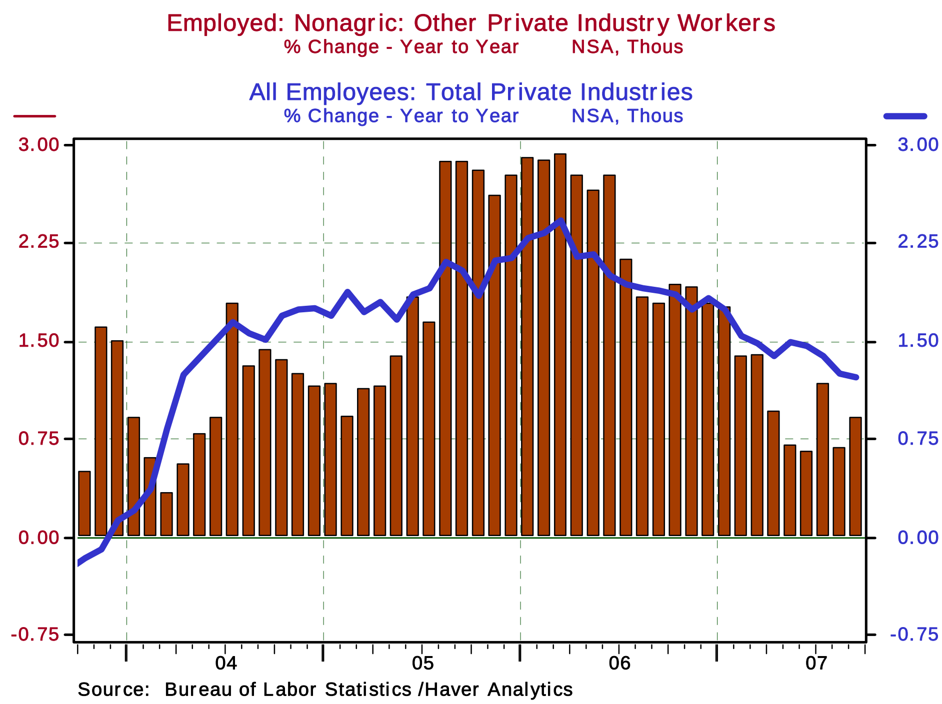


Chart 2



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With home mortgages having increased relative to total nonfinancial debt by almost 10 percentage points in the past 10 years (see Chart 3), and with the rapid increase in mortgage securitization, it stands to reason that there have been a lot of jobs and income created on Wall Street in connection with the recent housing bubble. The housing bubble has burst and therefore the growth in mortgage originations and securitizations is slowing. Quite naturally, then, one would expect job growth in the financial sector to slow. To wit, according to the Challenger, Gray & Christmas, Inc. employment survey, almost 60,000 more pink slips were issued by financial companies in the third quarter versus a year ago (see Chart 4). If we had residential real estate in the Greenwich, Connecticut area that we planned to sell within the next several years, we would put it on the market right now because Wall Street is sure to shed many more jobs in the next year.

Chart 3

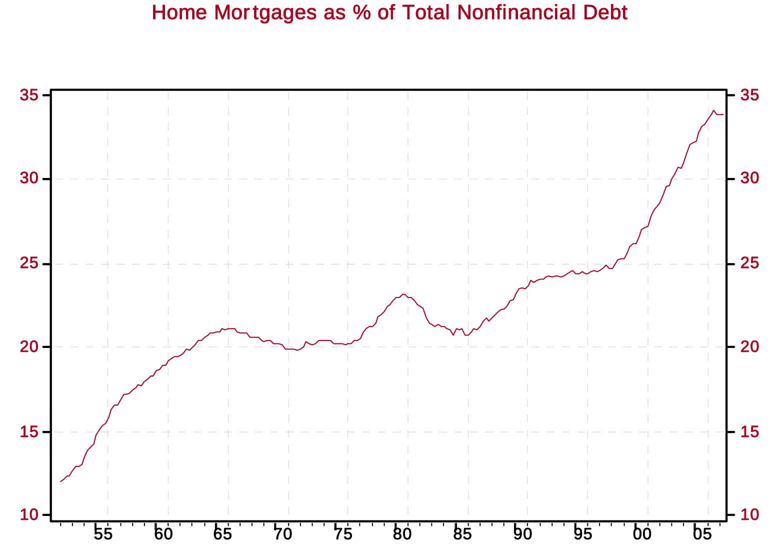
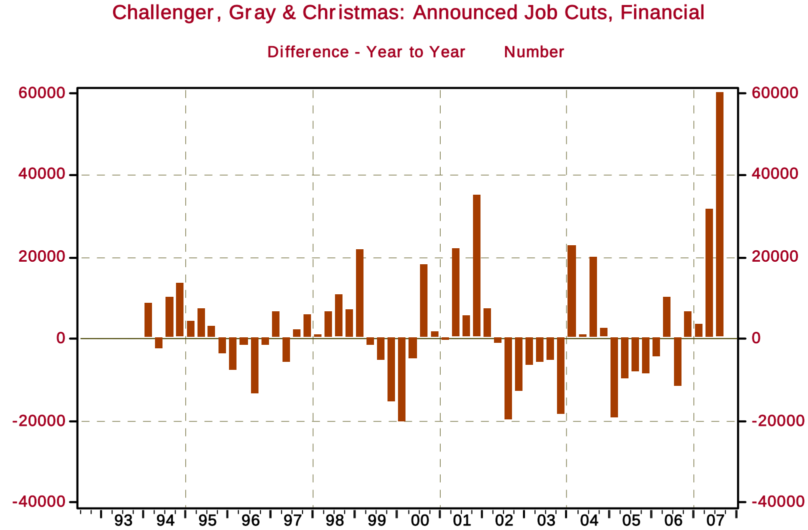


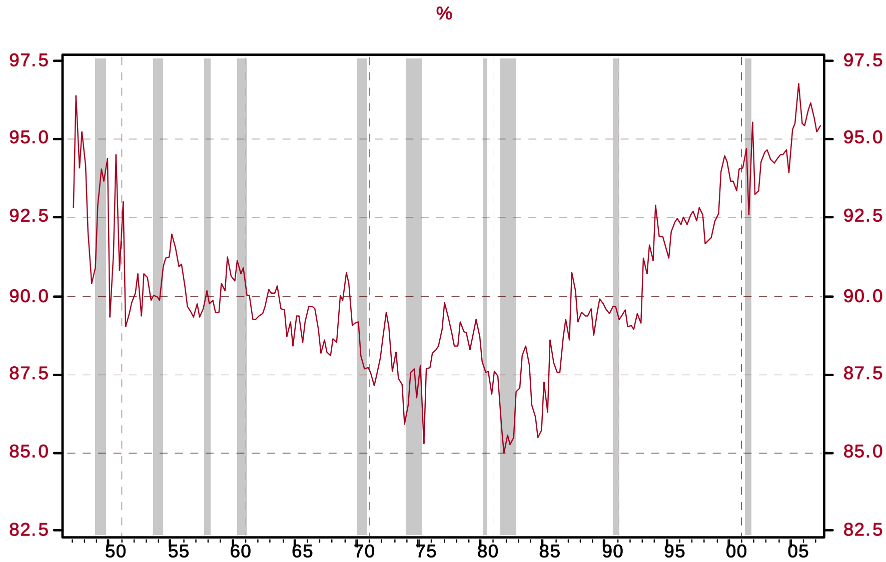
Chart 4



Households already are spending on consumer goods and services the highest percentage of their real after-tax income since just after the end of World War II (see Chart 5), a time when there was considerable pent-up demand and household balance sheets were in considerably better shape than they are now (see Charts 6 and 7).

Chart 5

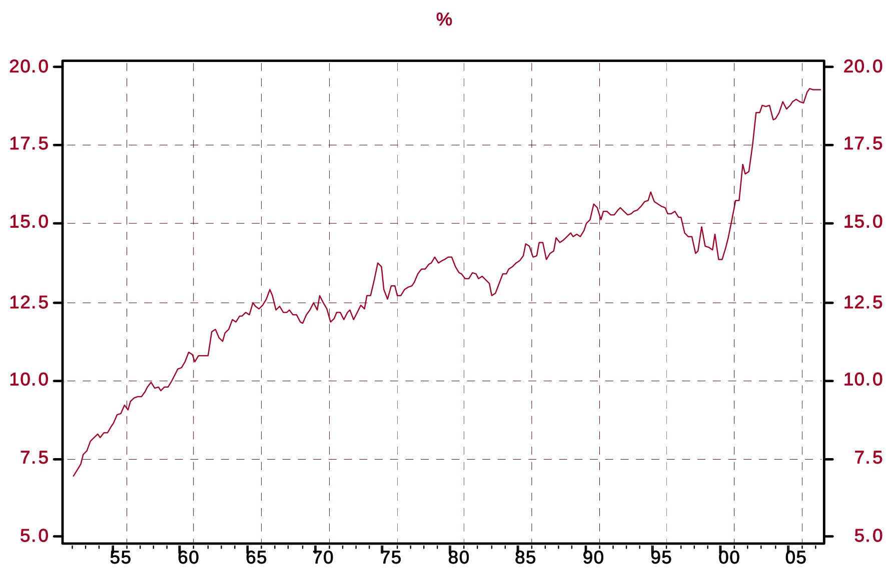
Real Personal Consumption Expenditures / Real Disposable Personal Income



Source: Haver Analytics

Chart 6

Households: Total Liabilities / Market Value of Total Assets



Source: Haver Analytics

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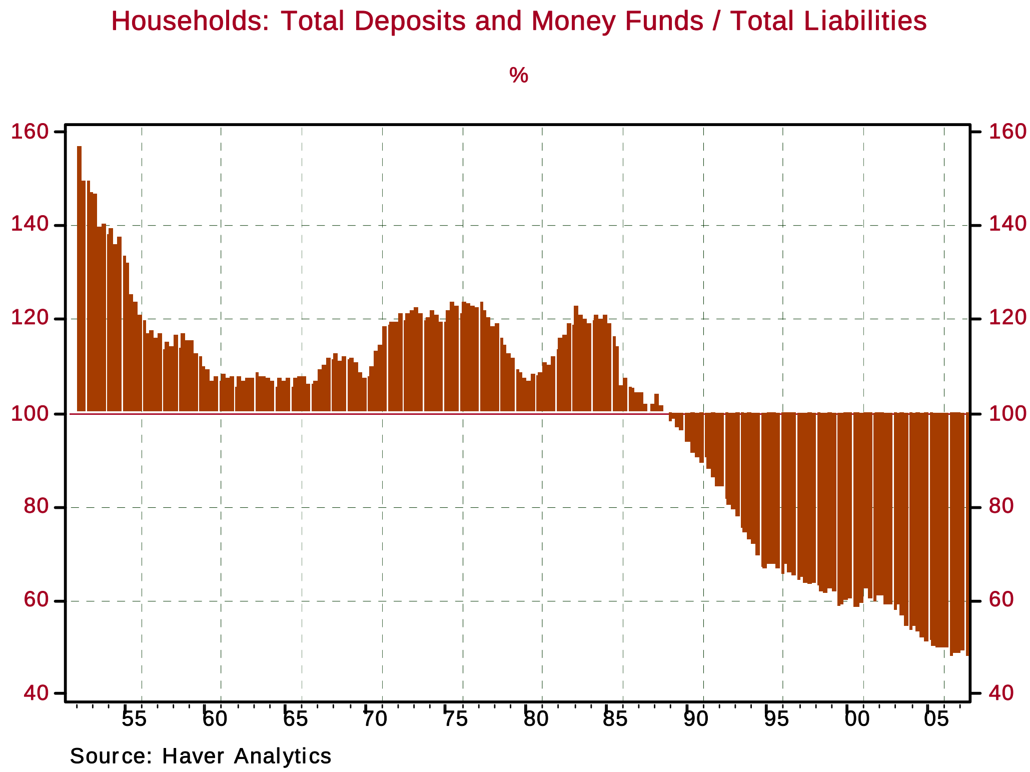
Chart 7



We have argued elsewhere (Wall Street and Main Street Are Joined at the Hip) that easy, cheap access to home mortgage credit has encouraged and enabled households to increase their consumption expenditures relative to their after-tax income. Annual holding gains on owner-occupied residential real estate relative to household after-tax income went from nil in 1990 to a record 21.6% in 2005 (see Chart 8). By 2006, households were extracting equity from their homes at an annual rate of more than $500 billion (see Chart 9). This equity extraction allowed households to go on a spending spree. Now home equity is falling and mortgage underwriting terms have become more stringent. As a result, this source of funding for consumer spending is drying up. Perhaps this is why Harley-Davidson, Inc. has reported stalled domestic sales and Brunswick Corporation's recreational marine division is dead in the water. So how much of the slowdown in September chain-store retail sales really was due to the hot weather versus the cold housing market?

Chart 8

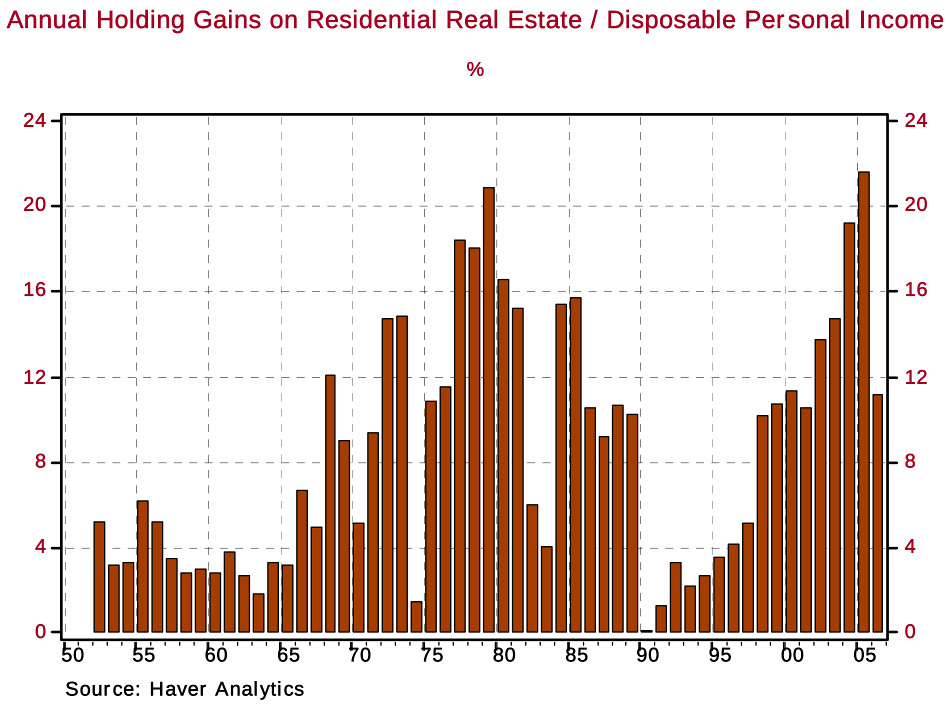
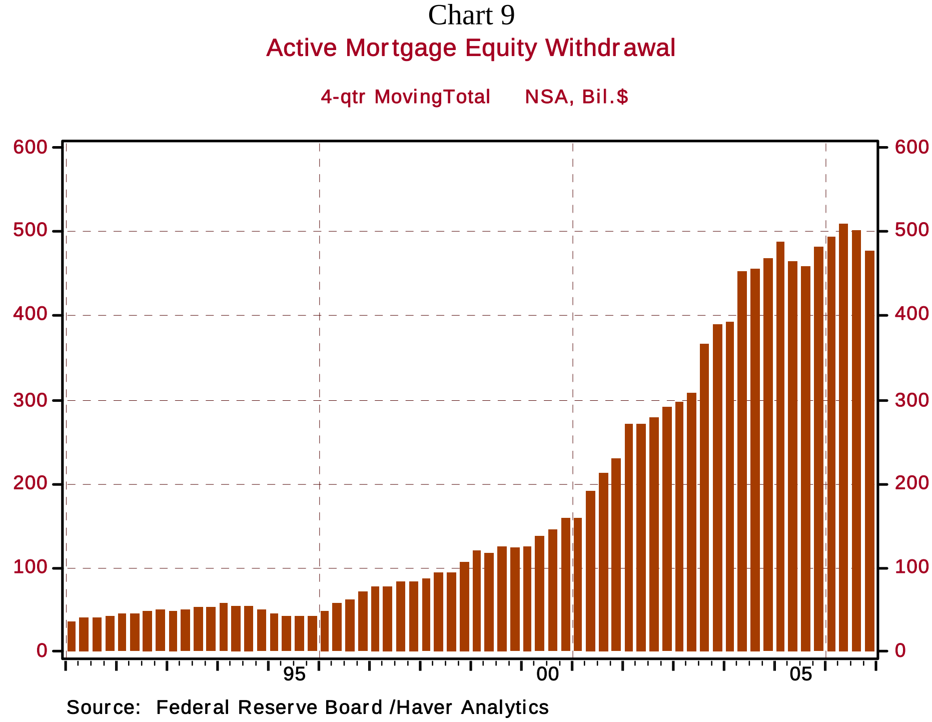


Chart 9



Now let's turn to one division of the cavalry that is supposed to rescue the U.S. economy from a recession – U.S. corporations. Yes, their balance sheets are in good shape (see Chart 10). And yes, their profits are high relative to nominal gross domestic product (GDP), as shown in Chart 11. But despite prior strong profit growth in this cycle, real business capital spending growth has been relatively cautious and already is starting to trend lower (see Chart 12). Corporate profit growth has slowed significantly in the past year (see Chart 13). In fact, U.S. corporate profits derived from domestic nonfinancial activities are now *contracting* on a year-over-year basis (see Chart 14). These profits account for about 50% of total U.S. corporate profits.

Chart 10

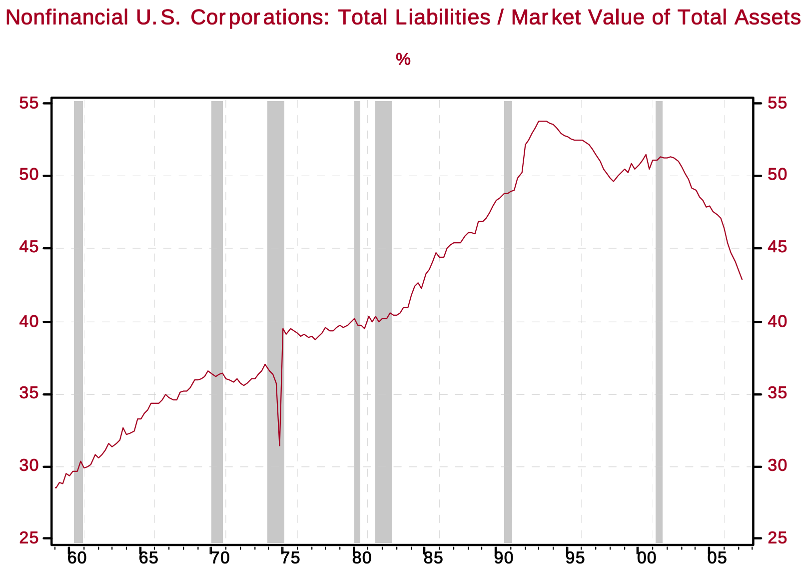


Chart 11

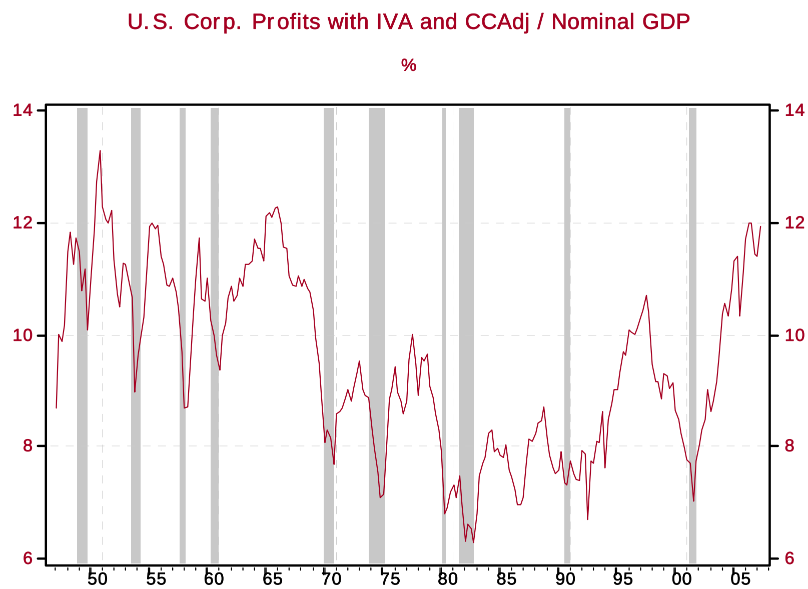


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Chart 12

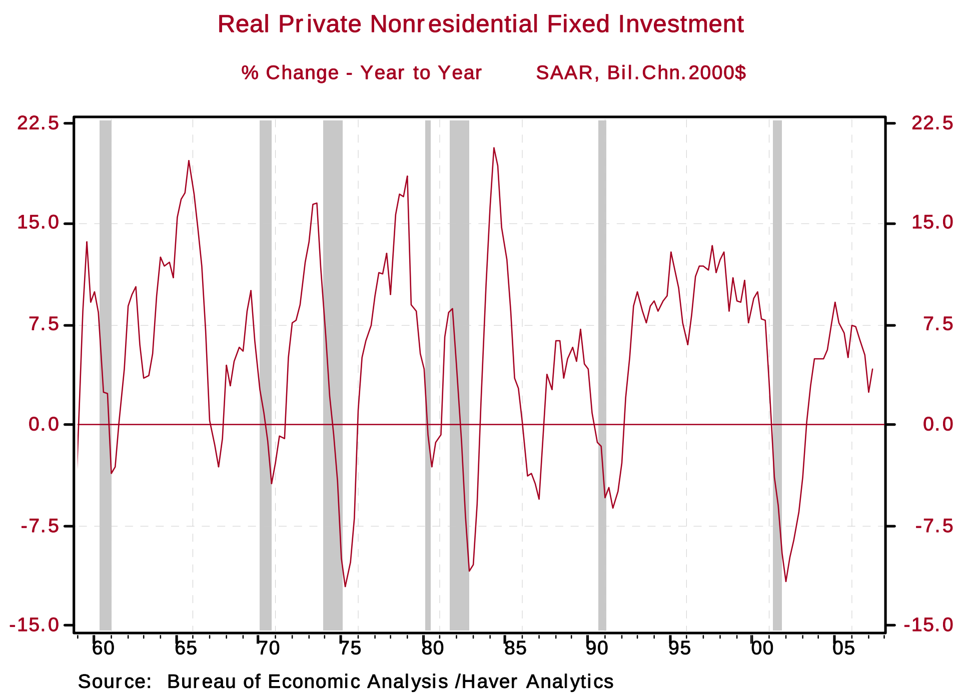

Chart 13

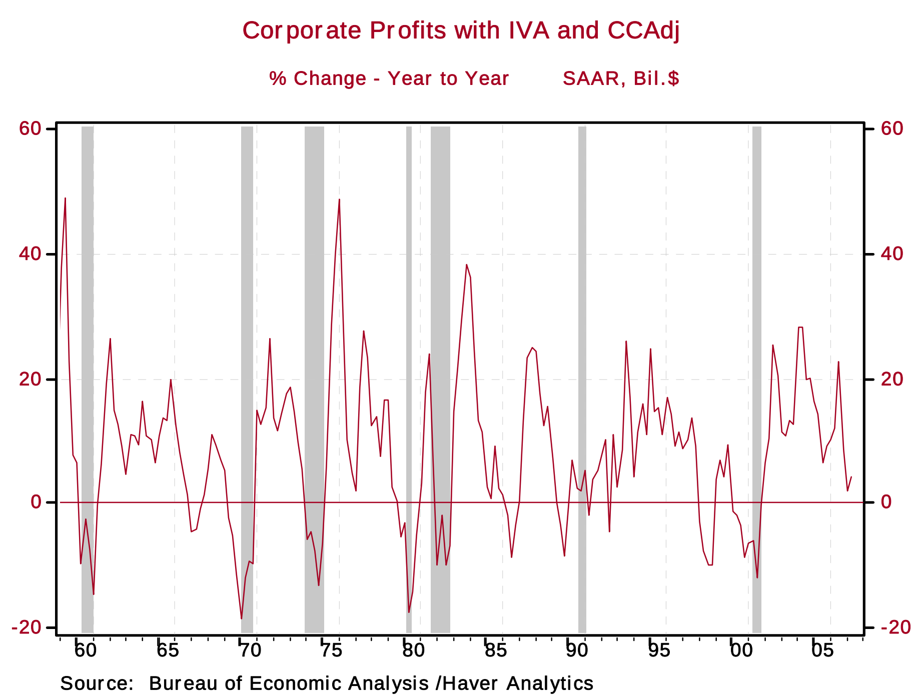

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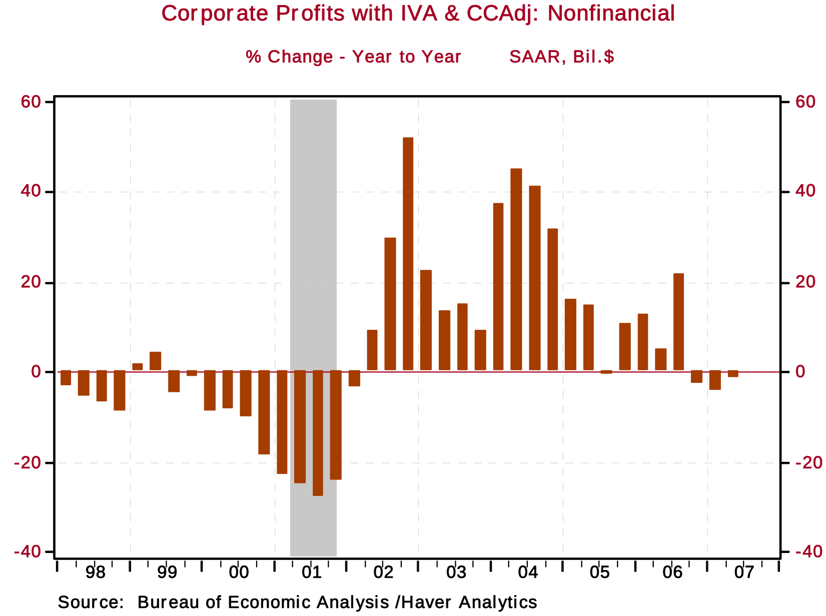
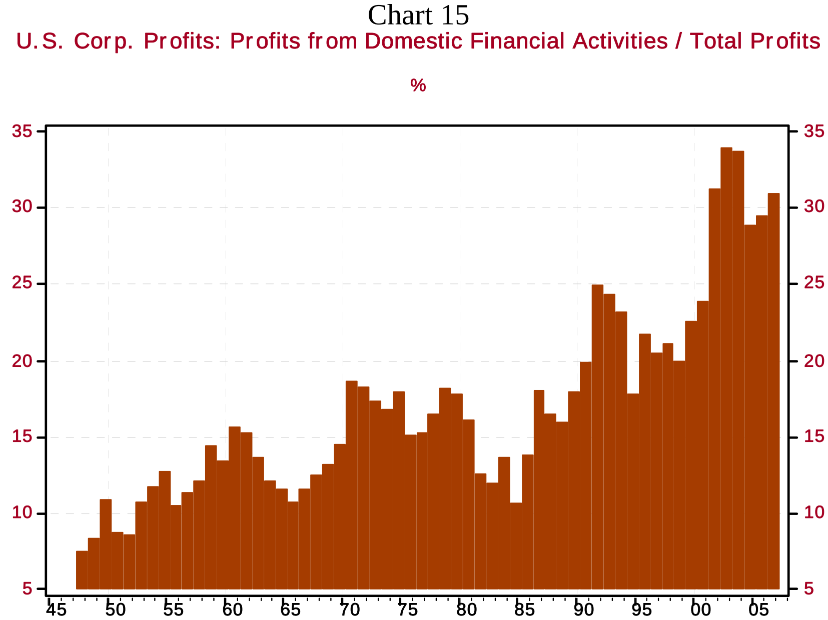
Chart 14



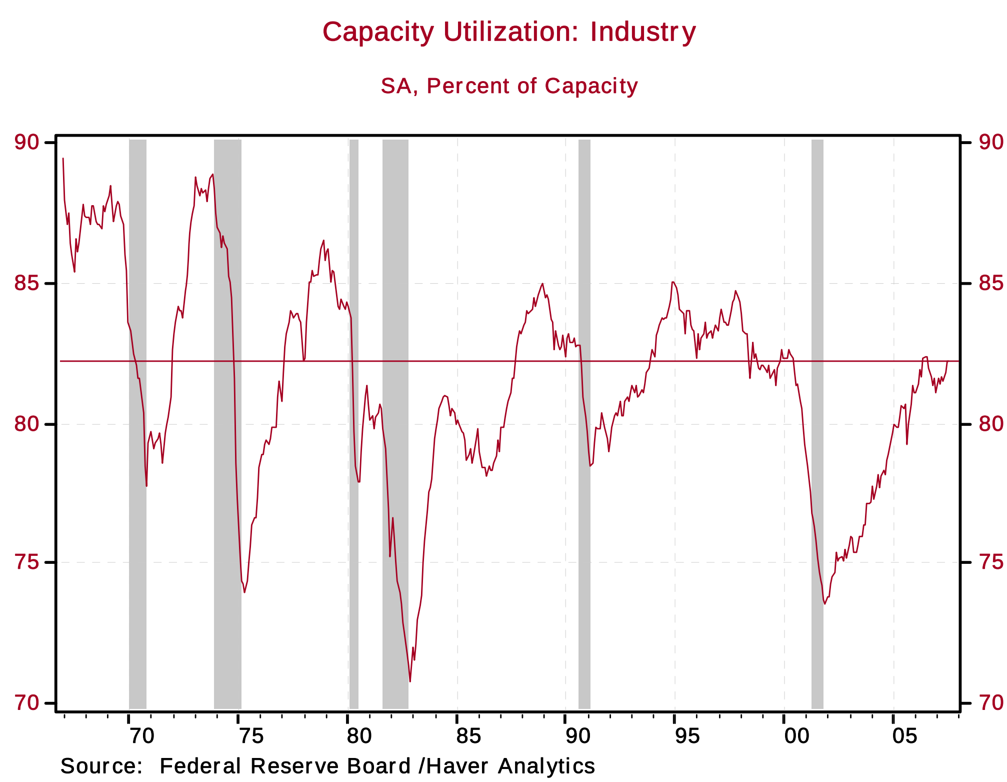
Starting in 1991, the U.S. financial sector began contributing more and more to total U.S. corporate profits as our universities began matriculating relatively more *financial* engineers (modern day alchemists?) compared to *mechanical* engineers (see Chart 15). In 2006, profits from domestic financial activities accounted for 31% of total U.S. corporate profits versus 20% in 1990. Do you think there has been a year-over-year, 60,000-person increase in layoff announcements in the financial sector in the third quarter because financial sector profits are continuing to do well? How long will it be before financial sector profits join nonfinancial sector profits in contraction?

Chart 15



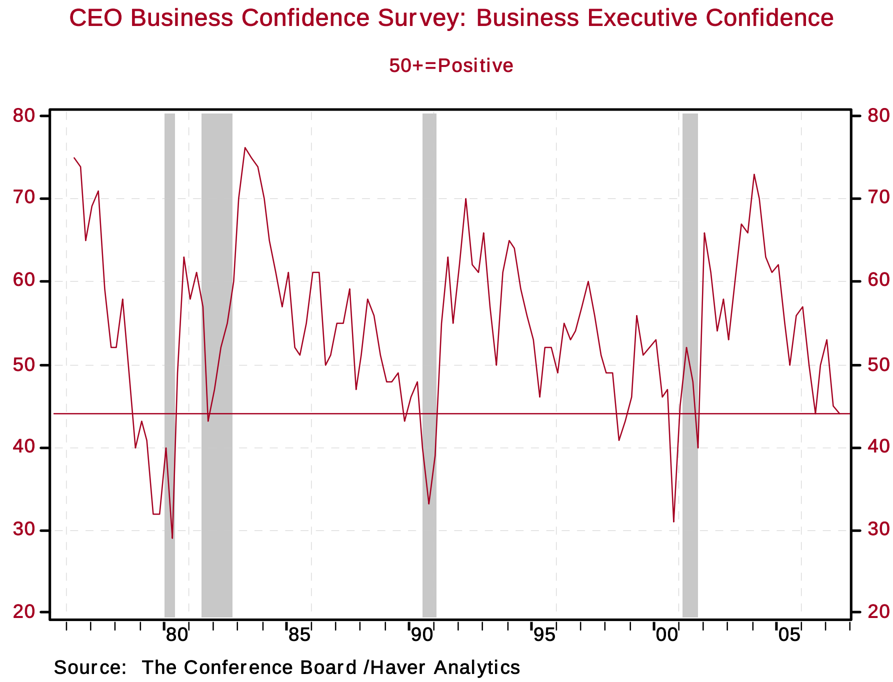
Business capital spending was not booming when corporate profit growth and household demand were strong. So why would it be expected to continue to grow when profit growth and household demand growth are slowing? Do corporations want to invest to expand their production capacity if demand for that production is slowing? For some analysis as to what motivates capital spending – profits versus household demand – see [Corporate Profits or Household Spending - Which Has Bigger Effect on Capex?]. We will give you a hint – household spending dominates. Last, with regard to capital spending, U.S. businesses are not exactly bursting at their productive seams, as evidenced by the rate of capacity utilization. As Chart 16 shows, the 82.2% capacity utilization rate in August was well below previous cycle peaks.

Chart 16



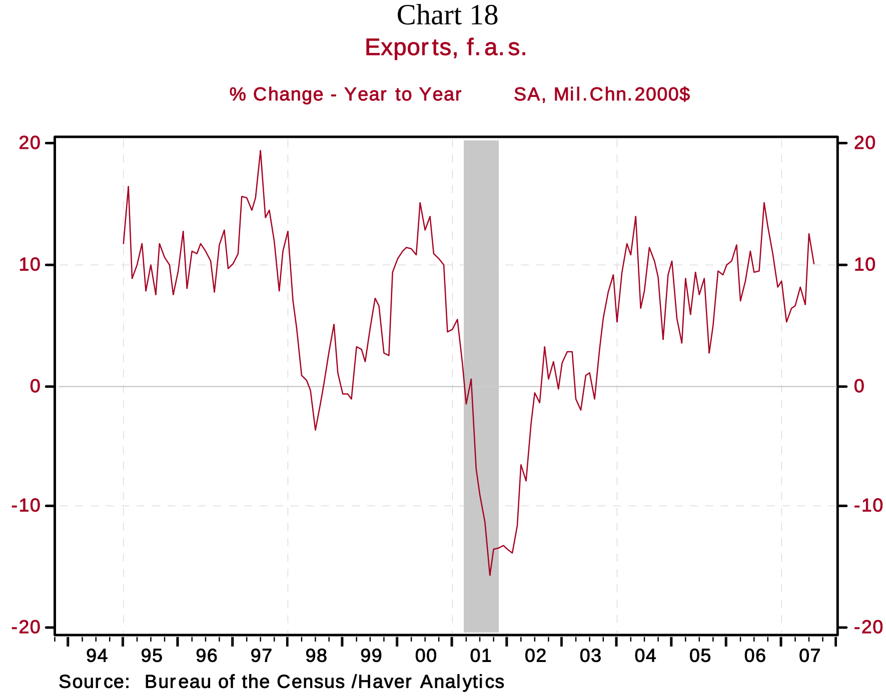
U.S. corporate CEOs do not appear as confident as Mr. Levy. In the latest Conference Board survey released on October 5, CEO confidence dropped to 44 – a level that ties the low for this cycle and is relatively low in an historical context (see Chart 17). With CEO confidence falling and profit growth slowing, do you think CEOs are going to countenance much new hiring? (I think I know why very few economists become CEOs.)

Chart 17



Now let's talk about the other division of the economic rescue cavalry: the rest of the world. Yes, real export growth has accelerated in 2007, but on a year-over-year basis it falls short of its high in 2006 (see Chart 18).

Chart 18



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Although economic growth in the rest of the world has been strong - up until recently, that is - a lot of this strength has resulted from the rest of the world exporting its production to the United States. But as Chart 19 shows, U.S. real import growth is stalling. This can't be good for the rest of the world's exports and economic growth. In addition, while the Federal Reserve kept its policy interest rate steady from June 2006 through August 2007, many central banks around the world were busy raising their policy interest rates. The lagged effects of these central bank interest rate hikes will soon start to slow growth in domestic demand in these economies. Two of the largest economies in the world – Japan's and the Euro Area's – slowed significantly in the second quarter. In fact, Japanese real GDP *contracted* (see Chart 20). In Japan and the Euro Area, both domestic demand and export growth have weakened (see Charts 21 and 22). This division of the economic cavalry may be too spent to prevent a U.S. recession.

Chart 19

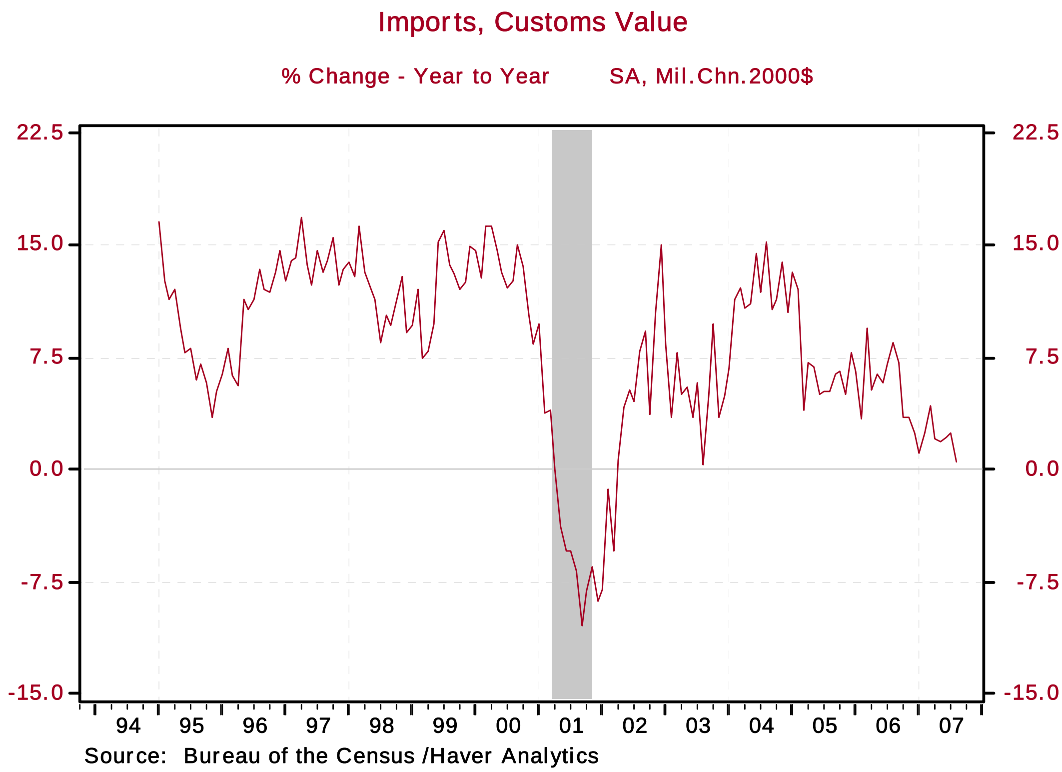


Chart 20

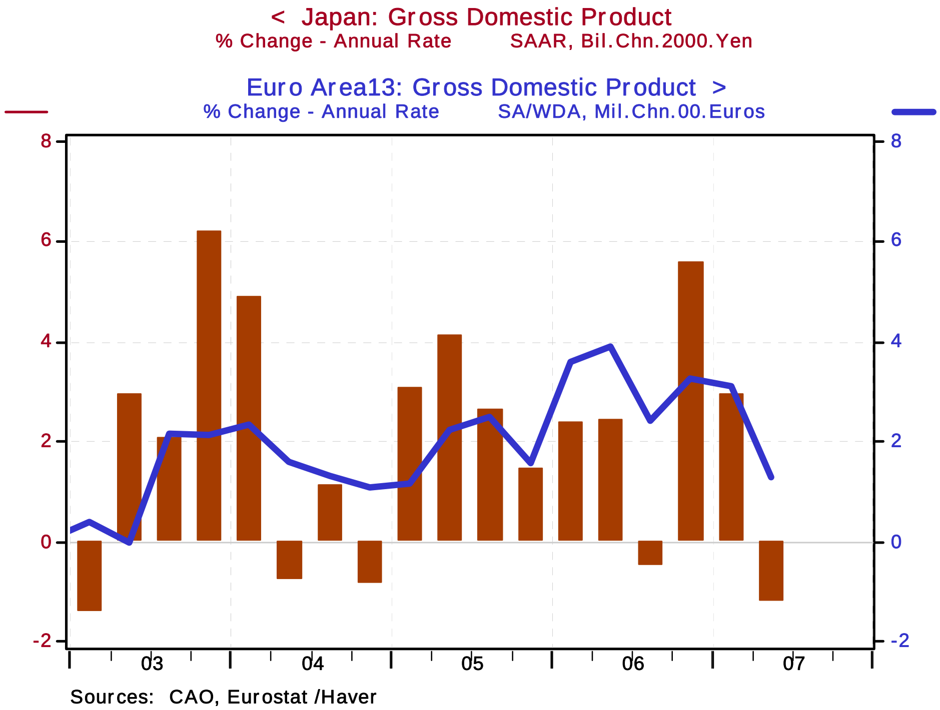


Chart 21

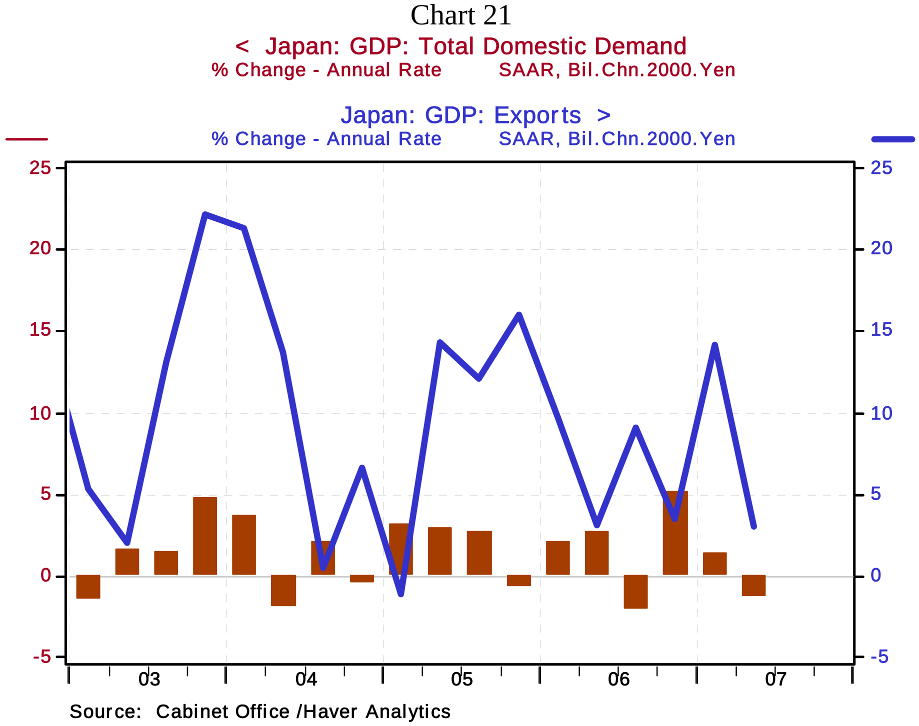
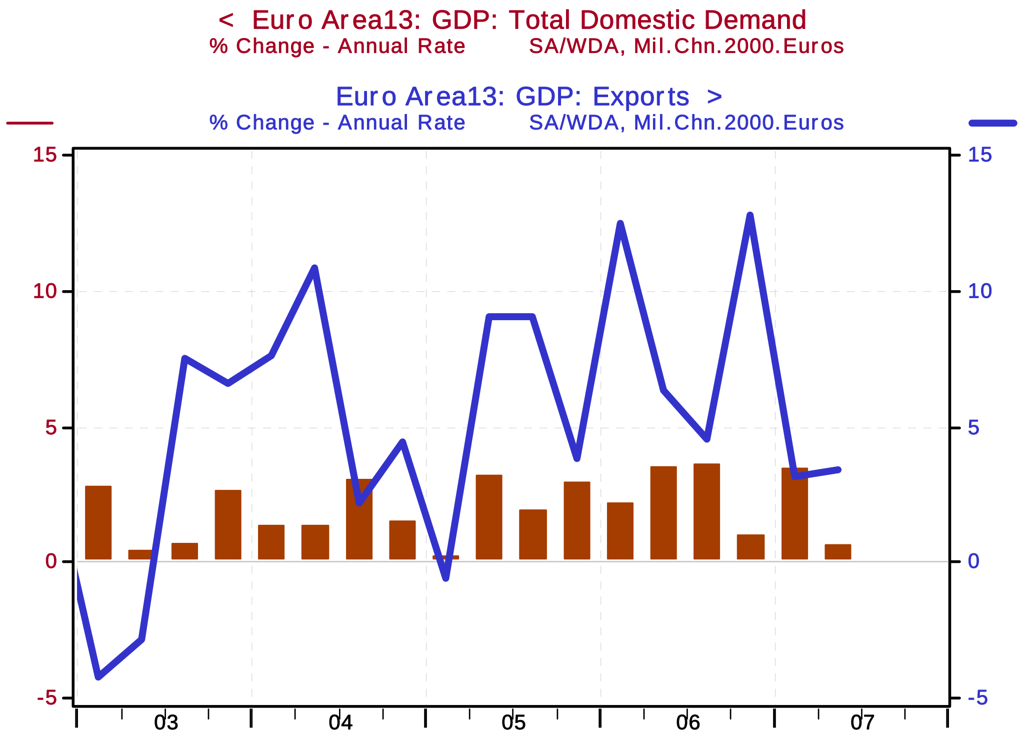


Chart 22



Source: Statistical Office of the European Communities /Haver Analytics

One sector of the economy that does not get much mention but accounted for 11% of real GDP in 2006 is state and local government spending. Growth in state/local tax revenues is being negatively affected by the recession in housing and the slowdown in the growth of overall economic activity. The Liscio Report, the preeminent source of information on state/local tax receipts, is purported (we can't afford a subscription) to have noted that in September just 45% of states met or exceeded their forecasted revenues – down from 57% in August. One of those states seeing its revenues come in below plan is a very important one, economically speaking – California. You will recall that California's residential real estate market has hit a bit of "soft patch," as Alan Greenspan might say. (As an aside, with Greenspan's book-peddling media blitz still going on, we are reminded of a country-western song entitled, "How Can I Miss You If You Won't Go Away?") So, any additional strength in exports perceived by Mr. Levy could be nullified by weakness in state and local government spending.

To be fair, we have not yet penciled in a recession in our forecast. But we have considerably less confidence, for the reasons discussed above, than Mr. Levy that the U.S. economy will be able to avoid a recession in 2008.

One final thought, since this is the monthly forecast update: We think the Federal Open Market Committee (FOMC) will stand pat on its federal funds rate target at its upcoming October 30-31 meeting. We believe that one of the reasons it chose the more aggressive, 50-basis-point fed funds rate target cut at its September 18 meeting was so it would not feel compelled to change the target rate as frequently. But because weak September chain-store retail sales are likely to be a harbinger of weak holiday retail sales, the FOMC will be moved to cut its federal funds rate target again at its December 11 meeting. In other words, no Halloween treat from Bernanke & Co., but an early holiday gift.

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy

THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
October 2007

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2006		2007				2008				Q4-t-Q4 change			Annual change		
	06:3a	06:4a	07:1a	07:2a	07:3f	07:4f	08:1f	08:2f	08:3f	08:4f	2006a	2007f	2008f	2006a	2007f	2008f
REAL GROSS DOMESTIC PRODUCT	1.1	2.1	0.6	3.8	2.0	1.5	1.6	2.0	2.2	2.4	2.6	2.0	2.0	2.9	1.9	2.0
(% change from prior quarter)																
CONSUMPTION EXPENDITURES	2.8	3.9	3.7	1.4	3.0	1.7	1.9	1.8	2.1	2.1	3.4	2.5	2.0	3.1	2.9	2.0
BUSINESS INVESTMENT	5.1	-1.4	2.1	11.0	2.0	3.2	2.8	3.4	3.3	5.6	5.2	4.5	3.8	6.6	3.6	3.6
RESIDENTIAL INVESTMENT	-20.4	-17.2	-16.3	-11.8	-15.0	-9.4	-5.8	-3.9	0.0	2.0	-12.8	-13.2	-2.0	-4.6	-15.4	-6.6
CHANGE IN INVENTORIES ('00 dlrs, bill)	53.9	17.4	0.1	5.8	1.4	-0.6	-1.2	-1.2	3.8	7.8				40.3*	1.7*	2.3*
GOVERNMENT	0.8	3.5	-0.5	4.1	2.1	2.2	1.4	1.4	1.4	1.4	2.5	1.9	1.4	1.8	1.8	1.8
NET EXPORTS ('00 dlrs, bill.)	-633.8	-597.3	-612.1	-573.9	-561.4	-556.0	-552.5	-540.9	-542.3	-547.1				-624.5*	-575.9*	-545.7*
FINAL SALES	1.0	3.5	1.3	3.3	2.2	1.6	1.6	2.0	2.0	2.2	3.0	2.2	0.0	2.8	2.3	2.0
NOMINAL GROSS DOMESTIC PRODUCT	3.4	3.8	4.9	6.6	3.5	2.7	2.8	3.4	3.6	4.0	5.4	4.4	3.5	6.1	4.6	3.4
GDP DEFLATOR - IMPLICIT (% change)	2.4	1.7	4.2	2.6	1.5	1.2	1.2	1.4	1.4	1.6	2.7	2.4	1.4	3.2	2.6	1.4
CPI (% Change, 1982-84 = 100)	3.1	-2.1	3.8	6.0	1.8	1.5	1.5	1.7	1.7	1.9	2.0	3.3	1.7	3.2	2.7	1.9
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.7	4.5	4.5	4.5	4.6	4.9	5.2	5.3	5.4	5.4				4.6*	4.6*	5.3*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	06:3a	06:4a	07:1a	07:2a	07:3f	07:4f	08:1f	08:2f	08:3f	08:4f	2006a	2007f	2008f
Federal Funds	5.25	5.25	5.26	5.25	5.05	4.70	4.35	4.25	4.25	4.25	4.96	5.06	4.28
3-mo.LIBOR	5.43	5.37	5.36	5.36	5.45	5.05	4.45	4.25	4.25	4.25	5.19	5.30	4.30
2-yr. Treasury Note	4.93	4.74	4.77	4.81	4.40	4.10	3.95	4.00	4.10	4.25	4.82	4.52	4.08
10-yr. Treasury Note	4.90	4.63	4.68	4.85	4.75	4.55	4.30	4.25	4.30	4.45	4.79	4.71	4.33

a = actual
f = forecast