The Energizer Bunny Is in Dire Need of a Battery Re-Charge  
November 19, 2007

With the 3.9% “first print” of annualized real gross domestic product (GDP) growth for the third quarter and expectations that the “second print” will be close to 5%, some have compared the U.S. economy to the Energizer Bunny. Well, we believe the Bunny’s recent sprint has drained its battery and it is on the verge slowing to a crawl, if not actually falling over backwards. That is, we believe real GDP over the five quarters ended fourth quarter 2008 will grow at a compound annual rate of just 1.6%. And even that slow growth is dependent on a Fed battery recharge of about 100 basis points. For the record, we have scaled back our real GDP growth forecast for 2008 from last month’s 2.0% on a fourth quarter-to-fourth quarter basis to 1.7%. And we have lowered our terminal federal funds rate forecast from 4.25% to 3.50%.

Just as past performance of a mutual fund is no guarantee of future performance, the same holds true for GDP growth. There are numerous examples of when real GDP growth was strong just before it wasn’t anymore. Charts 1 through 5 illustrate this point.

Chart 1

Real Gross Domestic Product
% Change - Annual Rate  SAAR, Bil.Chn.2000$
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The principal reason we believe strong third-quarter real GDP growth will give way to fourth-quarter growth of only 1.3% is an expected sharp slowing in the growth of real personal consumption expenditures (PCE). For the third quarter as a whole, real PCE increased at a respectable annual rate of 3.0% (which is likely to be revised lower). However, PCE growth ran out of juice in September, growing at an annual rate of 1.0%. And if October retail sales are any indication, real consumer spending weakened further. Adjusted with the Consumer Price Index (CPI) for consumer goods, October retail sales contracted at an annual rate of 1.65%. With their home ATMs now draining funds rather than being topped up – that is, with house prices and home equity now declining – households seem to be opting to spend a little less of their after-tax incomes on baubles, a behavior quite common before the onset of recessions (see Chart 6).

Chart 6

Perhaps households know or sense something about the current employment situation that the Bureau of Labor Statistics (BLS) Establishment (nonfarm payroll) Survey bean counters don’t. The part of the Conference Board’s Consumer Confidence report that relates directly to current employment conditions – the percent of respondents reporting that jobs are plentiful minus the percent reporting that jobs are hard to get – headed south pronto in October, something that typically happens several months prior to the onset of recessions (see Chart 7). As an aside, Gail Fosler, the Conference Board’s president, either does not look at her organization’s survey results or does not believe them inasmuch as, according to the
November Wall Street Journal survey of economists, Ms. Fosler is placing the probability of a recession occurring in the next 12 months at zero – garnisht.

Likewise, from the Household Survey of employment, the number individuals telling the BLS they are employed in relation to the number who are old enough and fit enough to be employed is falling (see Chart 7). Declines in this employment-to-population ratio also tend to be a leading indicator of the onset of recessions.

Another measure of the strength or weakness of the labor market provided by households is how many household members line up each month for unemployment insurance checks – i.e., continuing unemployment insurance claims. Chart 8 shows that in October 2007, 5.2% more folks were in the unemployment insurance lines than in October 2006 – the highest percent increase in this cycle. Notice from Chart 8 that sustained year-over-year increases in continuing unemployment claims tend to be the precursor of recessions.

Chart 7
Although reports from households are that the employment situation has taken a significant turn for the worse, those bean counters in the Establishment Survey division of the BLS keep assuming there is a rash of hiring by start-up businesses, although already-existing small businesses are less than enthusiastic about expanding their operations now (see Chart 9). In the 12 months ended October 2007, the BLS claims that about 1.6 million nonfarm jobs were created, 1.1 million of which are assumed to have come from start-up-business hiring (see Chart 10). So, according to the BLS, 69% of the nonfarm jobs created in the 12 months ended October 2007 were due to a statistical adjustment. In the 12 months ended October 2006, this statistical adjustment accounted for 44% of nonfarm job creation, and in the 12 months ended March 2006, only 30%. The Establishment Survey nonfarm employment count strains credulity and does not corroborate the message being sent by households themselves.
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As mentioned above, households tend to spend a little less of their after-tax income, that is, they increase their saving rate, just before the economy enters a recession. Households collectively sense economic problems ahead, whereas economists collectively are the last to know. This economic unease on the part of households is reflected in sharp declines in consumer confidence. As Chart 11 shows, measures of consumer confidence from two of the major surveys of such, the Conference Board’s and the University of Michigan’s, show that confidence has sunk to levels below those that prevailed just prior to the past two recessions.

Chart 11

Another reason we believe real economic growth is set to slow significantly is that third quarter growth received a sizeable boost – 0.36 percentage points – from inventory accumulation, something likely to reverse in the quarters ahead. According to the advance estimate of third-quarter real GDP, $11.9 billion of the $15.7 billion increase in business inventories were in motor vehicles. Some of this buildup in motor vehicle inventories might have been in anticipation of a lengthy United Auto Workers strike. The strike was short, light motor vehicle sales have fallen in four of the past five months, and auto producers are once again offering large price incentives. Therefore, it is a good bet that if motor vehicle inventories increase further in the fourth quarter, it will be because of weak sales, not increased production. In fact, the October Industrial Production report showed the third consecutive monthly decline of motor vehicle and parts output.

Speaking of the October Industrial Production report, the Federal Reserve, the originators of these statistics, reported that excluding motor vehicles and parts, manufacturing output fell 0.34% in the month. It appears that businesses may be attempting to pare their inventories in anticipation of slower demand for their products. Data suggesting that inventories are getting...
uncomfortably high were contained in the October manufacturing report from the Institute for Supply Management. To wit, the customer-inventories-too-high index reached 54, its highest level since the last recession (see Chart 12). Moreover, the ratio of inventories to new orders is on the rise (see also Chart 12).

The housing recession also seems to be spreading to another important sector of the economy – state and local governments. State and local government spending accounts for about 11% of real GDP and is about 1.7 times as large as direct federal government expenditures for goods and services. A number of states are reporting that their tax revenue growth is coming in below plan. California’s governor has instructed the state’s agencies to draw up plans for a 10% reduction in spending.

Exports contributed 1.79 percentage points to third-quarter real GDP growth – the largest quarterly contribution since the fourth quarter 2003. Although we believe exports will be the relative star performer of the U.S. economy in 2008, we are not convinced export growth will be as strong as the consensus believes. Recent data from some of the large developed economies show private domestic demand slowing. For example, in both Japan and Germany, new domestic machinery/manufacturing orders contracted in September on a year-over-year basis (see Chart 13). In Japan, both consumers and businesses are getting more pessimistic about the economic outlook (see Chart 14). Similarly, consumer and business confidence is waning across Europe (see Chart 15). Thus, although the weakening U.S. dollar will aid in chumming up demand for U.S. exports, weakening domestic demand abroad will provide a strong counterforce.
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The U.S. housing recession is unlikely to end until late 2008, if then. The excess supply of houses for sale remains large (see Chart 16). This increasing excess supply of homes for sale is putting extreme downward pressure on home prices. For example, as shown in Chart 17, the year-over-year decline in the median price of an existing single-family home was 4.93% -- the largest year-over-year decline in the history of the series, which dates back to January 1968. According to data compiled by Merrill Lynch, $683 billion of nonprime mortgages will be subject to interest rate resets from the end of the second quarter 2007 through the end of the fourth quarter 2008. A large number of these mortgages are likely to end up in foreclosure.

In the November 19 edition of Barron’s, Randall Forsyth cites a recent Bear Stearns study predicting that foreclosures will be running at an annual rate of 1.8 million units in the fourth quarter 2008, compared with 600,000 in 2006 (Up and Down Wall Street – Barron’s Online). To put this estimated foreclosure rate in perspective, the Census Bureau estimates that there were 2.1 million vacant housing units for sale in the U.S. in the third quarter. As our friend Michael Nicolleti has pointed out to us, there are few real estate sellers more motivated than creditors that have taken back properties in foreclosure. Thus, home price declines will likely accelerate in 2008 as foreclosures mount. In turn, falling home prices will erode the equity that households have been extracting from their abodes to help fund their unusual and record spending deficits in recent years.

Falling home prices also will erode the value of the collateral underlying outstanding mortgage-backed securities, which will lead to more problems on Wall Street. If you own residential real estate in Greenwich, Connecticut, where a lot of mortgage-backed- securities

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alchemists reside, you might want to think about selling it now because the financial sector layoffs are likely to mushroom in 2008 (see Chart 18).

Chart 16

**Total Single-Family Homes*: Inventory/Sales Ratio**

*Combined new and existing

Chart 17

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All of this brings us to the expected response from the Federal Reserve. The Federal Open Market Committee (FOMC) reluctantly cut its federal funds interest rate target an additional 25 basis points to 4.50% at its October 31 meeting. We say “reluctantly” because one voting member, Thomas Hoenig, president of the Kansas City Fed, dissented from the majority vote,

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preferring to hold the funds rate constant at 4.75%. At least one nonvoting FOMC, Charles Plosser, president of the Philadelphia Fed, indicated that he was not in favor of the October 31 cut.

The FOMC has indicated that it is disinclined to reduce its fed funds rate target at the upcoming December 11 meeting. It expects a significant deceleration in fourth-quarter real GDP growth. The FOMC argues that it took this growth slowdown into consideration in its decision to cut its federal funds rate target by a cumulative 75 basis points. The decline in the federal funds rate is not expected to have a significant positive effect on the pace of economic activity until sometime later in 2008. The FOMC believes that if it continues to cut the federal funds rate in reaction to near-term incoming weak economic data, it runs the risk of sowing the seeds of higher future inflation.

We take the FOMC at its word with respect to the December 11 meeting. But we believe the FOMC will resume paring its federal funds rate target at its January 29-30 meeting. Credit conditions have tightened despite the FOMC’s policy actions to date. According to Federal Reserve surveys, banks continue to tighten their lending terms in the residential mortgage market and now are beginning to tighten lending terms in the business loan and commercial mortgage markets. Credit-quality concerns have increased, as evidenced by the widening differential between the yield on junk bonds and the yield on a Treasury 10-year security (see Chart 19).

We believe the FOMC will need to cut the federal funds rate to about 3-1/2% by midyear 2008 if a recession is to be avoided. But will the FOMC have the latitude to cut its policy rate by

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another 100 basis points from its current level? Although various general price indexes that exclude food and energy prices remain relatively well behaved, the rate of increase is accelerating for those price indexes that do include food and energy prices. There are limits as to how much more increases in commodity prices domestic producers can absorb through reduced profit margins. Moreover, with the renewed decline in the foreign exchange value of the dollar, there are limits as to how much foreign producers can absorb through reduced profit margins from their foreign exchange losses. Thus, although the FOMC is likely to further cut the federal funds rate starting in early 2008, there is some question in our minds as to whether it will have the policy latitude to cut the funds rate sufficiently to avoid a recession next year.

*Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy*
### Table 1 US GDP, Inflation, and Unemployment Rate

<table>
<thead>
<tr>
<th>Series</th>
<th>2007</th>
<th>2008</th>
<th>Q4-t-Q4 change</th>
<th>Annual change</th>
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<td><strong>REAL GROSS DOMESTIC PRODUCT</strong></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>(% change from prior quarter)</td>
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<tr>
<td>Consumption Expenditures</td>
<td>3.7</td>
<td>1.4</td>
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<td>2.5</td>
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<tr>
<td>Business Investment</td>
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<td>1.1</td>
<td>2.8</td>
<td>3.2</td>
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<tr>
<td>Residential Investment</td>
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<td>-11.8</td>
<td>-10.0</td>
<td>-12.8</td>
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<td>Change in Inventories ('00 dlrs, bill)</td>
<td>0.1</td>
<td>5.8</td>
<td>-3.0</td>
<td>40.3*</td>
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<td>Government</td>
<td>-0.5</td>
<td>4.1</td>
<td>1.4</td>
<td>1.8</td>
</tr>
<tr>
<td>Net Exports ('00 dlrs, bill.)</td>
<td>-612.1</td>
<td>-573.9</td>
<td>-516.2</td>
<td>-624.5*</td>
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<td>Final Sales</td>
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<td>3.3</td>
<td>0.9</td>
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<tr>
<td>Nominal Gross Domestic Product</td>
<td>4.9</td>
<td>6.6</td>
<td>3.1</td>
<td>6.1</td>
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<td><strong>GDP DEFLATOR - IMPLICIT (% change)</strong></td>
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<tr>
<td>CPI (% Change, 1982-84 = 100)</td>
<td>4.2</td>
<td>2.6</td>
<td>2.4</td>
<td>2.7</td>
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<tr>
<td>Civilian Unemployment Rate (avg.)</td>
<td>4.5</td>
<td>4.5</td>
<td>5.0</td>
<td>4.6</td>
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* = annual average

**a** = actual
**f** = forecast

### Table 2 Outlook for Interest Rates

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<tr>
<th>Specific Interest Rates</th>
<th>Quarterly Average</th>
<th>Annual Average</th>
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<td>2-yr. Treasury Note</td>
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<tr>
<td>10-yr. Treasury Note</td>
<td>4.90</td>
<td>4.63</td>
</tr>
</tbody>
</table>

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