

DAILY GLOBAL  
COMMENTARY

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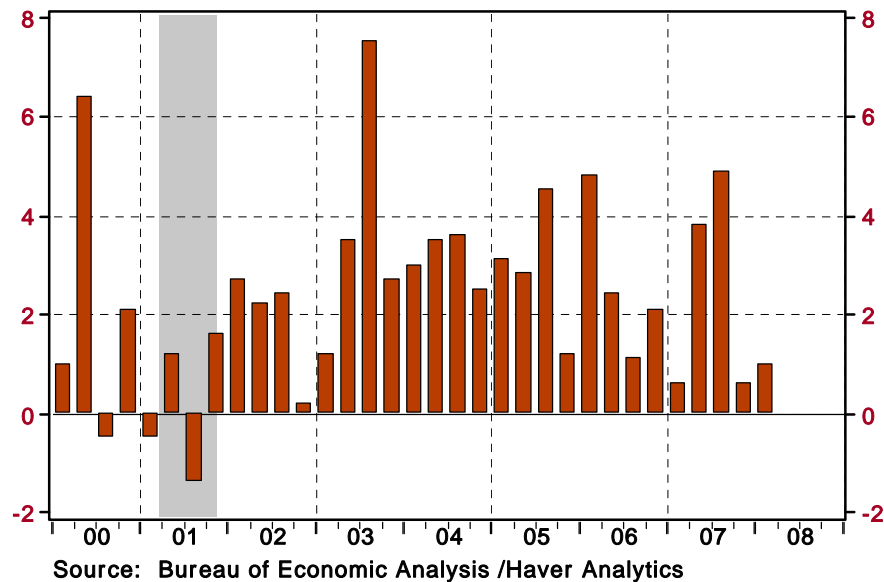
## Economic Reports Should Help Settle Debate about the U.S. Economy

July 30, 2008

In the next two days, four market moving economic reports -- GDP, Employment, ISM Manufacturing Survey, and auto sales -- are scheduled for publication. The advance estimate of second quarter GDP will be published on July 31. The economy is predicted to have grown at an annual rate of 1.5% in the second quarter, after gains of 0.6% and 1.0% in the fourth quarter of 2007 and the first quarter of 2008. The fiscal stimulus package lifted consumer spending in the second quarter and gave an overall boost to GDP. The market consensus is a 2.4% annualized increase in real GDP in the second quarter. The Bureau of Economic Analysis will publish revisions of GDP estimates for the period 2005-Q1 to 2008-Q1. The revisions and the details of the second quarter GDP report should be market movers. The headline reading for the second quarter will be impressive but the weak underlying fundamentals of the economy and the fact that the fiscal stimulus is a one-off event support forecasts of weak economic growth in the quarters ahead.

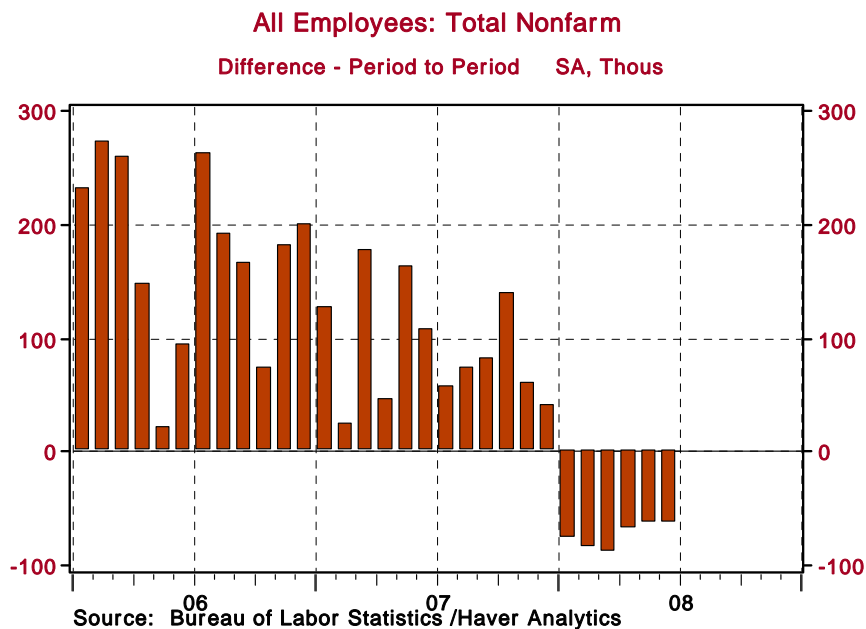
Chart 1

### Real Gross Domestic Product SAAR, %Chg



The employment report, ISM survey and auto sales reports will be available on August 1. Payroll employment is predicted to have fallen 75,000 in July after a loss of 62,000 in June. A drop in payroll employment in July will mark the seventh consecutive monthly decline.

Chart 2



The unemployment rate during July is predicted to have risen to 5.6% from 5.5% in June. The cycle low was 4.4% in March 2007 (The jobless rate in October and December of 2006 was also 4.4%).

Chart 3

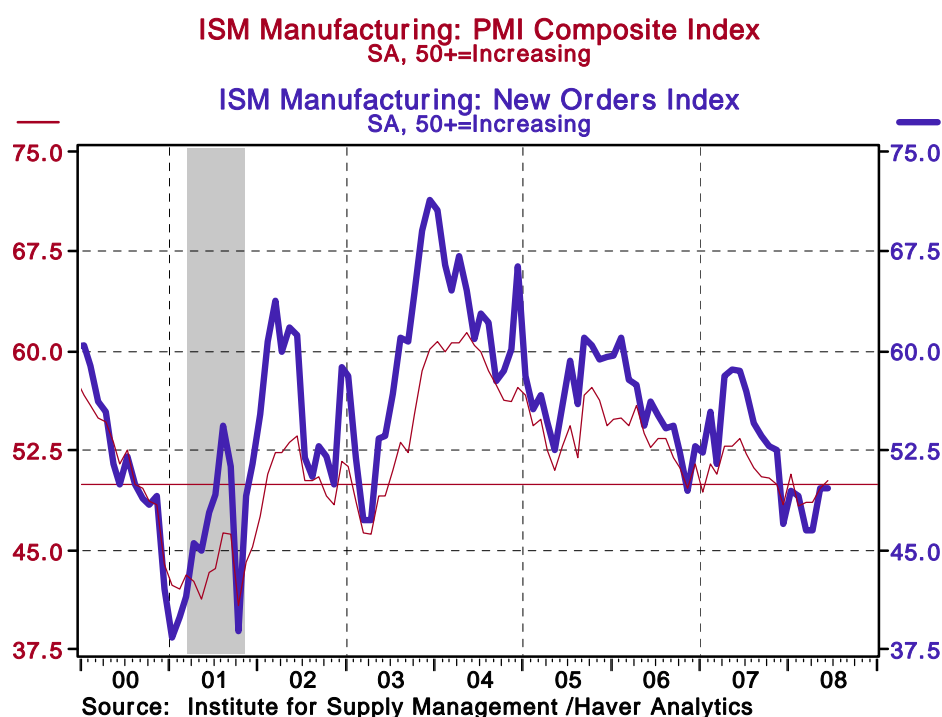


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The Greenspan Fed accomplished a soft-landing in 1995. The unemployment rate rose to 5.8% in April 1995 from 5.4% in March 1995, but soon headed down to 5.5% by October 1995. By contrast, for the optimists who maintain the economy is not experiencing a recession, the unemployment rate has climbed over one percentage point in recent months and payrolls have dropped for seven months. Payroll employment in 1995 fell 16,000 in the month of April and posted gains in the remaining eleven months. In other words, the labor market picture shows a stark difference from when a soft landing was achieved in 1995.

The market consensus of the composite ISM Manufacturing Index is 49.2, down from 50.2 in June. The composite index has held above 50.0 for two out of the first six months of the year, but the new orders index has remained below 50.0 in each of the six months ended June. Readings above 50.0 denote an expansion of activity and vice versa. Growth in exports, stemming from a weak dollar, has helped to maintain activity in the factory sector.

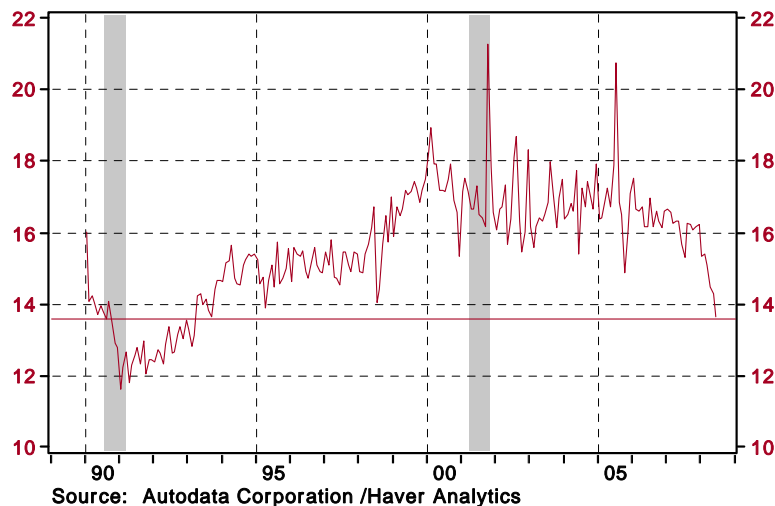
Chart 4



Financial markets are likely to pay more than usual attention to auto sales data. Auto purchases dropped to an annual rate of 13.6 million units in June, the lowest since March 1993. Sales of autos fell at an annual rate of 26.7% in the second quarter, a big negative for second quarter GDP growth.

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Chart 5  
**Total Light Vehicle Retail Sales {Imported+Domestic}**  
 SAAR, Mil. Units



Charts 1-5 speak for themselves. Economic data showing additional weakness in demand will strengthen expectations of the Fed standing pat for several months. Among participants of the Blue Chip Economic Indicators survey only 54.5% predict the economy is in a recession or will enter one in 2008. These reports will play a role in the FOMC’s deliberations on August 5 and influence the tone and language of the policy statement.

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### Surging Central European Currencies: Running Out of Steam?

The three major currencies of central Europe have appreciated strongly against the euro so far this year, boosted to varying degrees by rising interest rates, strong economic growth, and positive investor sentiment – the latter buoyed by the final confirmation that Slovakia will adopt the euro next January. However, there are some preliminary signs that the region’s strong growth rates are about to slow. Interest rates may be at their peak in Poland and Hungary, and a rate cut may be in the cards in the Czech Republic. All of which suggests that the Polish zloty, Czech koruna, and Hungarian forint may also have peaked for now.

With Euro-zone membership coming up next January, Slovakia’s central bank is focused on keeping its policy rate level with the ECB’s refi rate. As a result, the bank yesterday left its two-week repo rate unchanged at 4.25% and will follow any subsequent ECB moves in the run-up to January 1. In the Big Three, however, the picture is more complicated. All three have been hit by a surge in inflation thanks to rocketing food and fuel prices. June’s (EU-harmonized) annual rate came in at 6.7% in Hungary and in the Czech Republic, and at 4.6% in Poland. Currency appreciation has helped to restrain import price pressures somewhat in all three countries, but the Hungarian and Polish central banks remain biased toward tightening. However, the Czech central bank has shifted to a more dovish stance, and may even lower its policy rate next week.

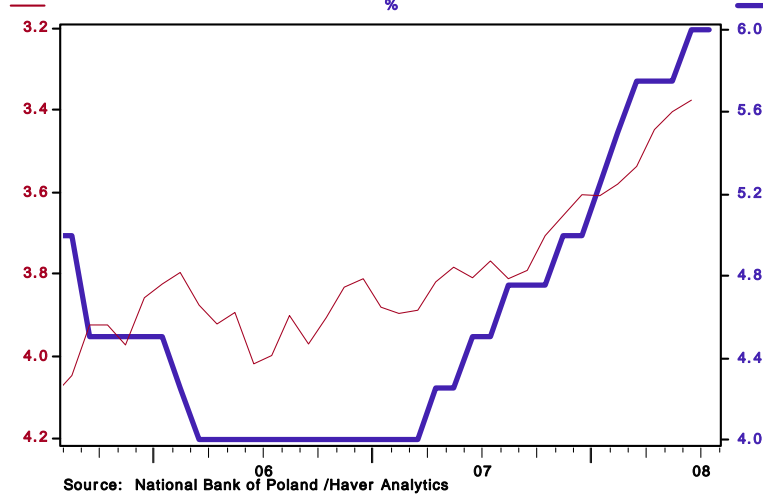
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Chart 6

← POLAND: Exchange Rates  
Average, Zloty/Euro

Poland: Reverse Repo Rate →  
%

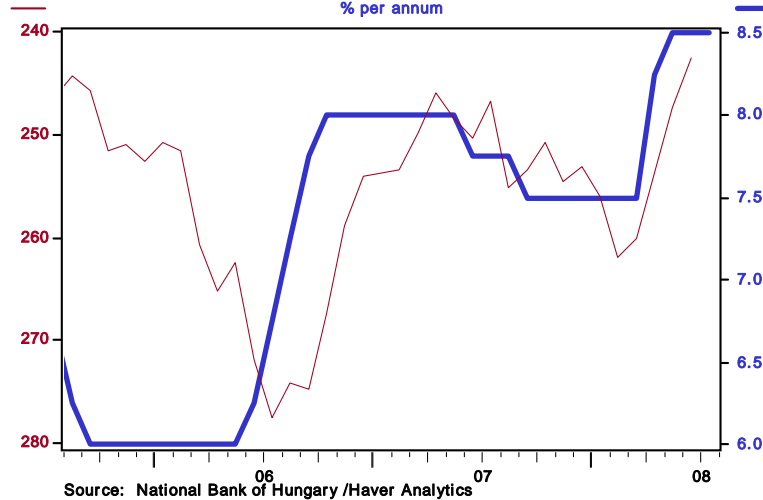


Having hiked by a total of 100bps since the start of the year, Poland's central bank today left its main interest rate on hold at 6.0% for the second consecutive month. Polish growth remains robust (with the finance ministry's latest forecast of real GDP growth at 5.5% this year) and while inflation is not as high as in Hungary or the Czech Republic, there are concerns that the zloty is masking the strength of domestic inflationary pressures. Today's statement from the Monetary Policy Council specifically noted that the bank stands ready to hike rates further if needed to bring inflation back to the 2.5% target.

Chart 7

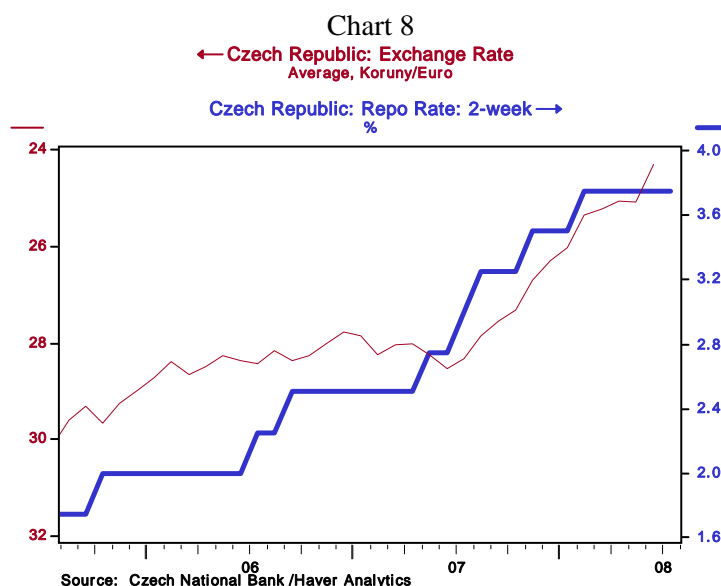
← Hungary: Exchange Rate: Euro  
Average, Forint/Euro

Hungary: Base Rate →  
% per annum



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Hungary's central bank has also hiked by a total of 100bps so far this year, but last week left its base rate at 8.5% for the second consecutive month, citing the anti-inflationary impact of the strong forint. However, the bank also said that it would hike again if needed to meet its 3.0% inflation target. Growth is weakest in Hungary, with the government forecasting just 2.4% real GDP growth this year, but sentiment has been boosted by the Slovak effect, by the announcement of a major auto sector investment project, and by an improvement in the fiscal accounts. (This year's budget deficit is now expected to come in around 3.6% of GDP, down from 5.5% last year and 9.2% in 2006.) Hungarian exports also seem to be holding their own. Still, grumbles about forint strength may get louder, particularly if Czech rates start to come down.



In contrast with the neighbors, the Czech Republic's central bank has raised rates only once this year – 25bps back in February – and its benchmark two-week repo rate of 3.75% remains below that of the ECB. Still, the perception of the koruna as a regional safe haven has made it among the world's best performing currencies against the euro and the dollar this year. However, signs of an economic slowdown are clearest in the Czech Republic, where exports have started to stagnate and the finance ministry has trimmed its GDP growth forecast for this year to 4.6% (vs. 6.6% in 2007). PM Topolanek has argued that the koruna's appreciation has outpaced productivity growth and so threatens the economy. Last week central bank Governor Tuma stated that the bank would stop discussing rate hikes and focus on whether to hold or cut at the August 7 meeting. He raised the concern that the currency's strength could push inflation below next year's target of 3.0%. Another member said today that the board may discuss a 50bps rate cut next week.

The Czech koruna has slipped about 4.5% over the past week as the markets have been convinced that a shift in strategy is imminent. Although July's inflation data (which will be released August 8 but doubtless made available to the August 7 board meeting) may seem to preclude a cut, the central bank is focused on the outlook for 2009. Assuming the bank's August inflation outlook shows the headline rate dropping next year, Czech interest rates likely are headed downward. However, it is unlikely that the Polish and Hungarian central banks will be in a rush to follow suit.

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