Northern Trust

U.S. ECONOMIC & INTEREST RATE OUTLOOK

When the U.S. "Catches a Cold", So Does the Rest of the World

August 15, 2008

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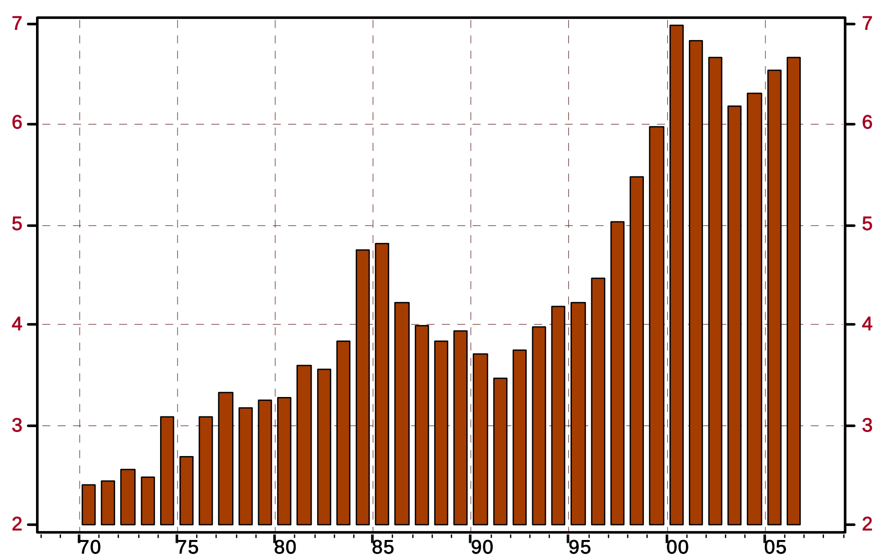
In the past 18 months, the CNBC/WSJ op-ed happy-talking heads have consistently been wrong. Remember the "containment" argument. No, we are not talking about George Kennan's Cold War strategy, although it might be getting dusted off given recent events in the Caucasuses. No, we are referring to the notion that problems in the sub-prime sector of the mortgage market would cause little or no harm to the financial system or the real economy as a whole. Another popular Pollyanna principle was a variation on the containment (or Las Vegas) hypothesis – namely, what happens in the U.S. economy stays in the U.S. economy, otherwise known as decoupling.

We have warned *ad nauseam* about the perils of buying into the containment myth. Now, we want to scribble a bit about the decoupling myth. We never understood how there could be as much economic globalization but that a recession in the largest economy would leave the rest-of-the-world's economies relatively unscathed. Consider that U.S. nominal imports of goods and services were 6.6% of the rest of the world's nominal GDP in 2006, up from 4.5% 10 years earlier in 1996 (see Chart 1). Now that U.S. imports are contracting in real terms, both year over year and quarter to quarter (see Chart 2), wouldn't you think that this would be having a negative impact on economic growth in the rest of the world?

Chart 1

U.S. Nominal Imports as % of Rest of the World's Nominal GDP



Source: Haver Analytics

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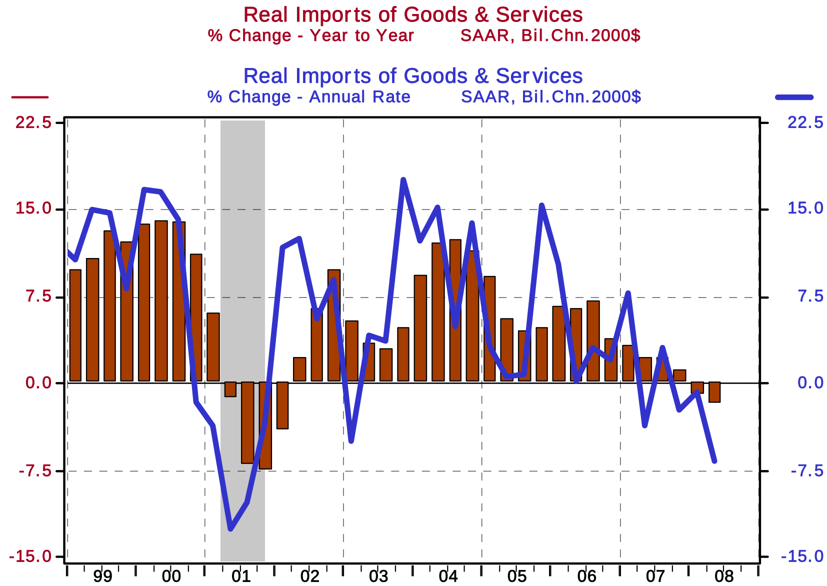
Chart 2



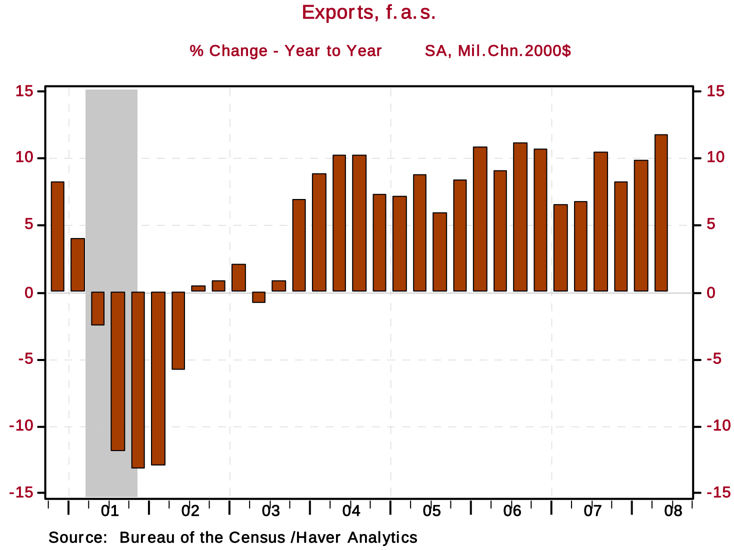
Source: Bureau of Economic Analysis /Haver Analytics

If you answered "yes" to our question you are correct. Japan just reported that its economy contracted at an annual rate of 2.4% in the second quarter with Japanese real exports contracting at an annual rate of 8.9%. The preliminary estimate of second-quarter real GDP for the euro-zone has the economy contracting at an annual rate of 0.8%, with industrial production contracting at an annual rate of 2.4%. The Canadian economy contracted in real terms at an annualized rate of 0.35% in the first quarter with real exports contracting by 4.1% – the third consecutive quarter in which real exports declined. The consensus is that the UK economy is on the eve of contraction. The Danish economy was contracting as of the first quarter as was the New Zealand economy. In sum, the developed economies are, at the very least, teetering on recession.

Given that a large amount of developing economies' exports is destined for developed economies, growth in developing economies is being adversely affected by the slowdown in growth in the developed world. For example, Mainland China's export volumes slowed to 5.9% year over year in June 2008 vs. 17.5% year over year in June 2007. In reaction to this deceleration in export growth, China's year-over-year growth in industrial production slowed to 14.7% in July vs. 18.0% in July 2007. Despite still high inflation, Chinese government economic officials have made statements in recent weeks to the effect that policies will be oriented toward stimulating economic growth rather than fighting inflation. The Singaporean economy, which we had the great pleasure in visiting last month, is experiencing a sharp slowdown in growth. On a year-over-year basis, Singaporean real GDP grew by only 2.1% in the second quarter of this year vs. 9.1% in the second quarter of 2007.

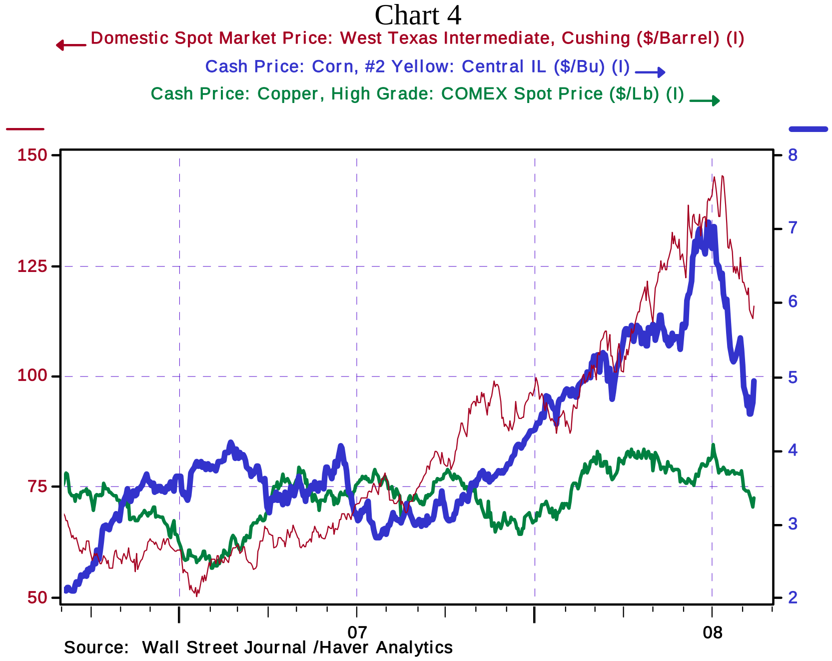
We believe that the slower growth now being experienced by the rest of the world will diminish somewhat the rest of the world's appetite for U.S. exports. Thus, U.S. real goods-export growth of 11.7% year over year in the second quarter (see Chart 3) may be the high-water mark for some time.

Chart 3



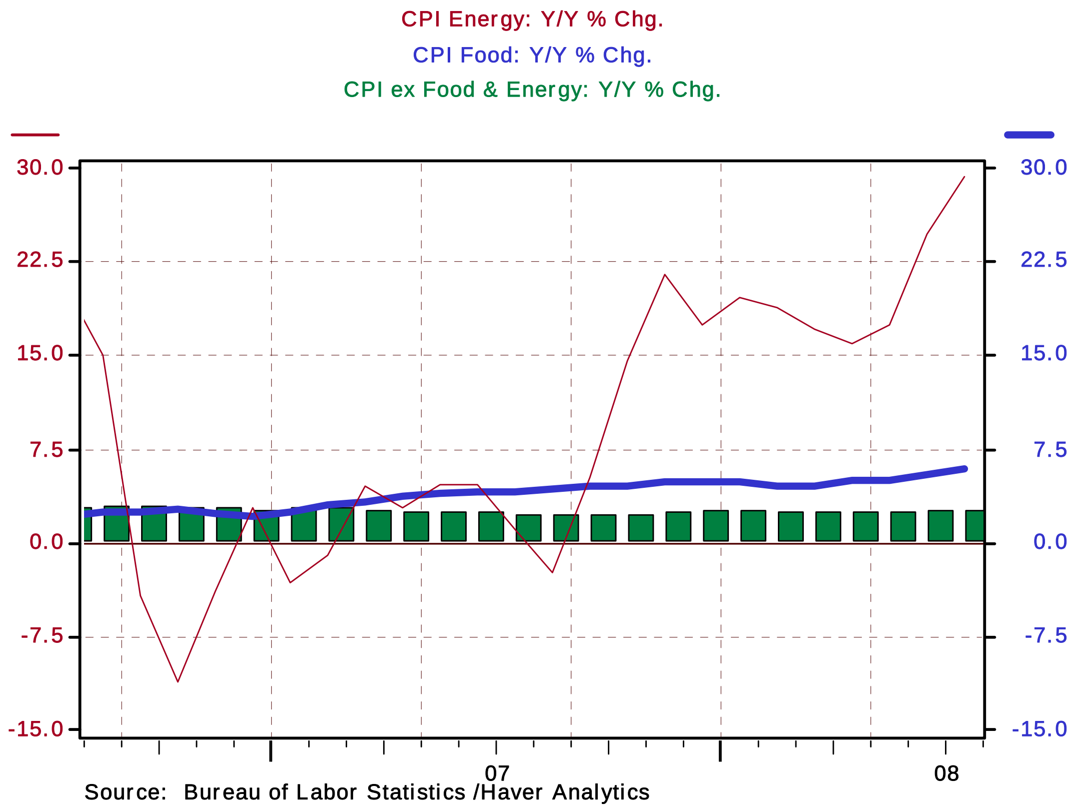
More importantly, we have believed that the global slowdown in economic growth would bring down escalating commodity prices – especially industrial commodity prices, which are cyclically sensitive. Commodity prices now appear to be responding to the global slowing in economic growth. As Chart 4 shows, in recent weeks there has been a sharp drop in the prices of the three "Cs" – crude oil, corn and copper. We believe the declines in the prices of crude oil and copper are being dominated now by weaker global demand rather than increased supply. Thus, we view these commodity price declines as a *symptom* of weaker global economic growth, *not a cause* of stronger future growth.

Chart 4



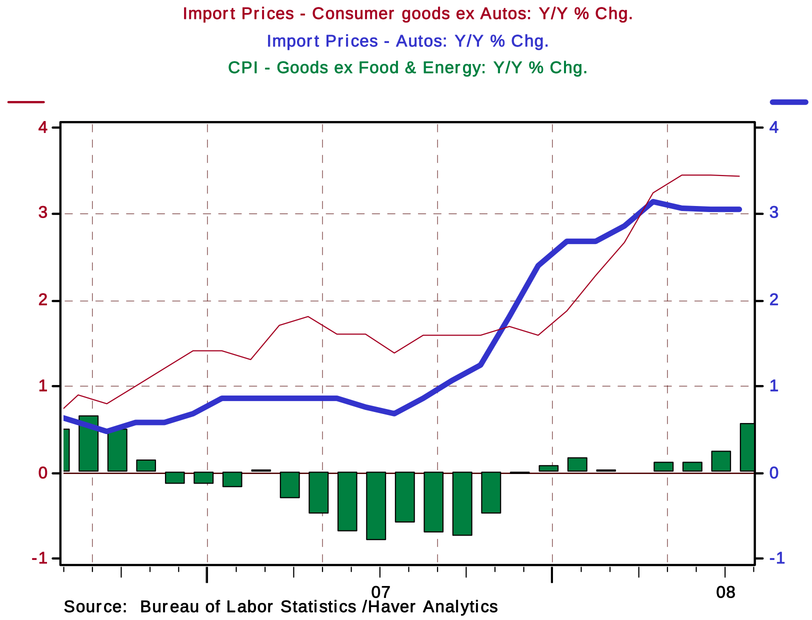
The recent drop in commodity prices brings us to the subject of consumer inflation. Year-over-year growth in the CPI has been accelerating in the past year, reaching a cycle-high year-over-year increase of 5.6% in July. Chart 5 shows that the recent acceleration in CPI growth has been dominated by price increases for energy and, to a lesser extent, food. Barring a renewed sustained increase in the prices of energy and raw agricultural products, “headline” consumer inflation is likely to decelerate sharply as the year draws to an end. We would bet that over the next 18 months, the month-to-month increases in the headline CPI will be well below July’s 0.8%.

Chart 5



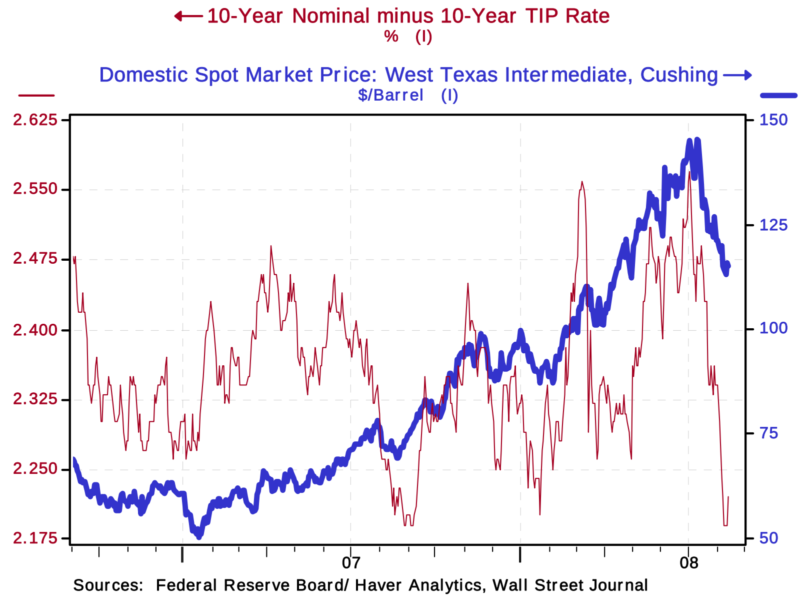
To a much lesser extent, import prices of non food and energy products appear to have put some upward pressure on some elements in the CPI (see Chart 6). But with the dollar appearing to stabilize due to economic weakness abroad, the rate of increase in import prices is likely to slow later this year. This, too, will relieve inflationary pressures in the U.S.

Chart 6



We have some good company in our expectation that U.S. inflation is headed lower – the market for inflation expectations. As crude oil prices have fallen into a well in recent weeks, so has the spread between the yield on a 10-year Treasury security with *no* inflation protection minus the yield on a 10-year Treasury security with inflation protection – the yield on a 10-year TIPS. This yield spread represents a market-based measure of 10-year inflation expectations. As shown in Chart 7, this spread has collapsed from 2.57% on July 3 to 2.22% as of August 14.

Chart 7



If we and the market are correct about a moderation in inflation, then pressure will be taken off the Fed to bump up the funds rate. And right now, the last thing the sputtering U.S. economy needs is a higher federal funds rate in that the effective cost of credit already is rising with a steady funds rate. This is illustrated by the results of the Fed's third-quarter survey of bank lending terms. As shown in Chart 8, banks are tightening their lending terms to businesses, both large and small. Banks are tightening their lending terms on real estate loans, both residential and commercial (see Chart 9). And banks are tightening their lending terms on consumer loans, including credit cards (see Chart 10).

Chart 8

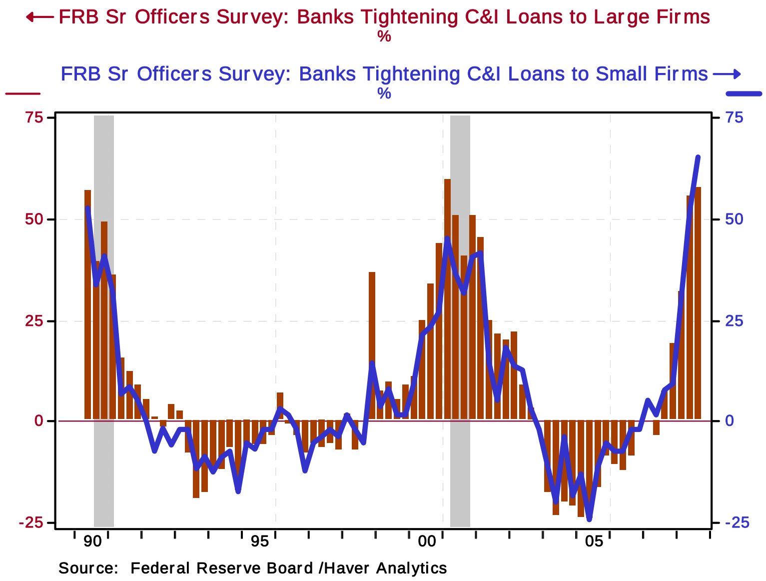


Chart 9

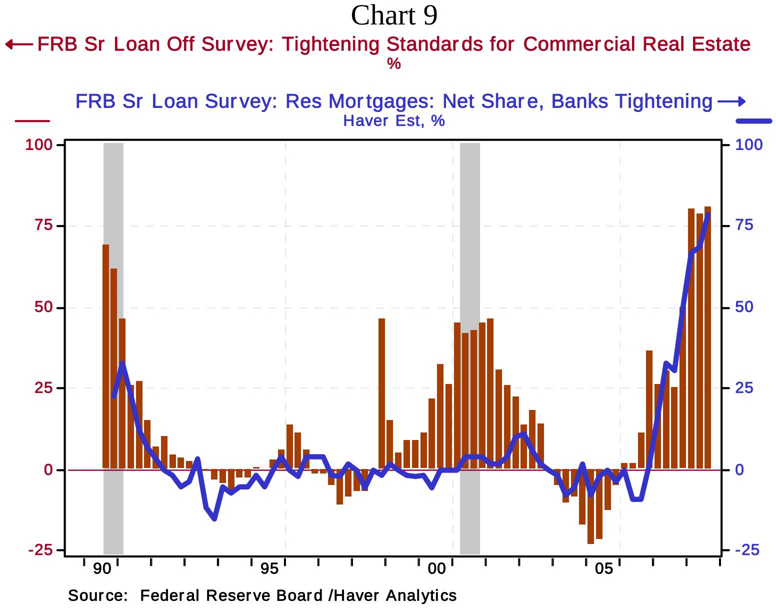
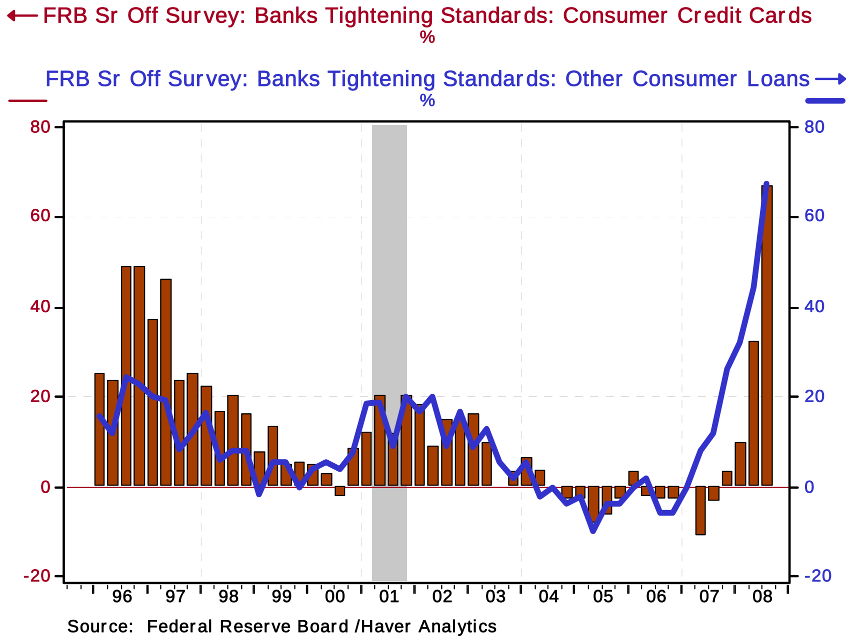
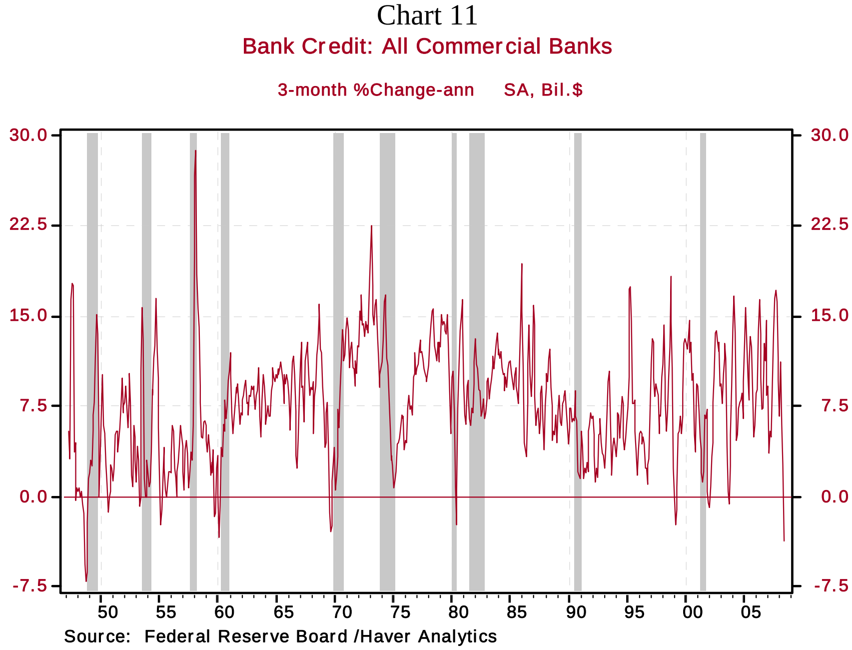


Chart 10



Not surprisingly, the manifestation of this tightening in lending terms is a slowdown in the amount of credit being created by the banking system. To wit, in the three months ended June, total bank credit – loans granted by and securities held by commercial banks – *contracted* at an annual rate of 3.72% -- the largest contraction since the 3 months ended November 1948 (see Chart 11).

Chart 11



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Quite naturally, if the asset side of the banking system's balance sheets is contracting, then the liabilities side also must be contracting. A component of banks' liabilities is their deposits. Although not contracting, growth in deposits at commercial banks has slowed sharply in recent months (see Chart 12). And, a component of the M2 money supply is part of banks' deposits. So, it comes as no surprise that there has been a sharp deceleration in the growth of the *nominal* M2 money supply. After soaring to an annualized growth rate of 13.20% in the three months ended March 2008, M2 growth has slowed to an annualized pace of only 2.42% in the three months ended July (see Chart 13).

Chart 12

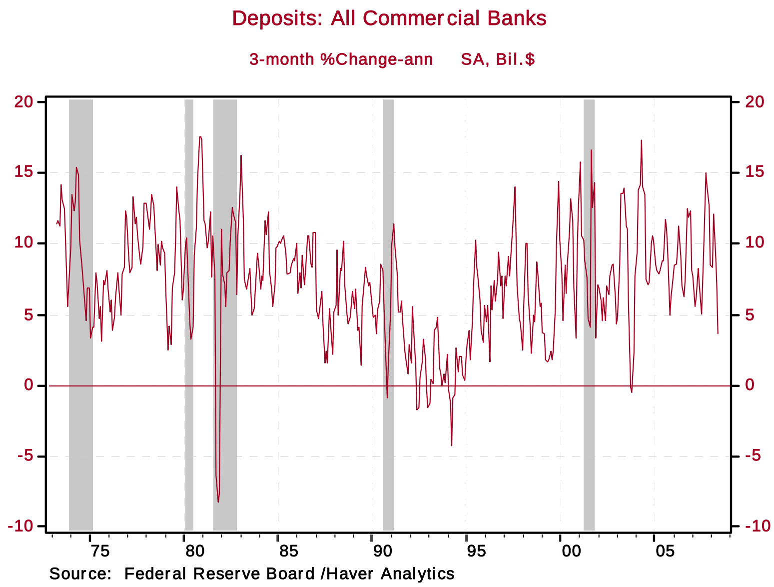
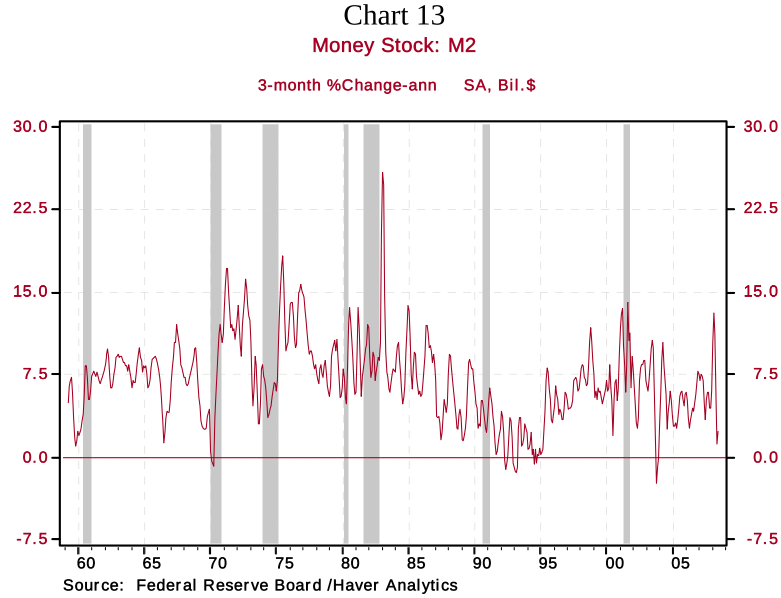
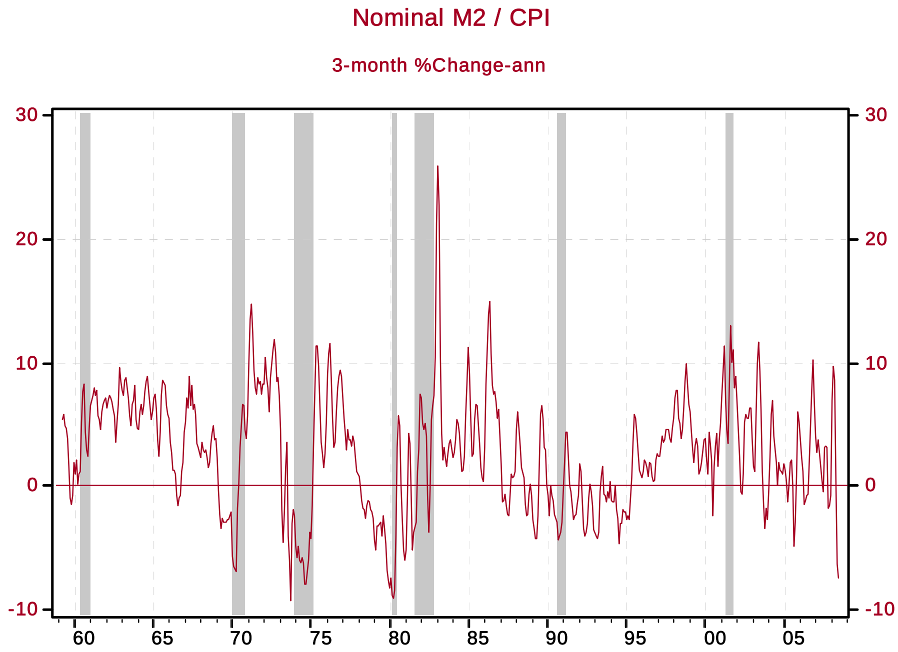


Chart 13



Nominal money supply growth has implications for price inflation. *Real*, or price-adjusted, money supply growth has implication for real aggregate demand growth. When we adjust the sharply slowing *nominal* M2 growth for the sharply accelerating CPI growth, we get a sharply *contracting real* M2 change. In the three months ended July, the CPI-adjusted M2 money stock has contracted at an annualized rate of 7.32% – the sharpest three-month contraction since early 1980 when credit controls were imposed on the U.S. economy and some households were cutting up their credit cards (see Chart 14).

Chart 14



In sum, the U.S. recession has infected the rest of the world, which is slowing the demand for crude oil and other industrial commodities. The decline in crude oil prices suggests that U.S. inflation is set to moderate significantly over the remainder of this year and into next year. The worst for U.S. real GDP in this recession lies ahead. The Fed will not be raising the federal funds rate any time soon. Rather, it most likely will maintain the funds rate at its current level of 2% through the first half of 2009. If the Fed makes any changes to the funds rate, the changes will be to cut it, not raise it.

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

THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
August 2008

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2007		2008				2009				Q4 to Q4 Change			Annual Change		
	07:3a	07:4a	08:1a	08:2a	08:3f	08:4f	09:1f	09:2f	09:3f	09:4f	2007a	2008f	2009f	2007a	2008f	2009f
REAL GROSS DOMESTIC PRODUCT	4.8	-0.2	0.9	1.9	0.0	-1.2	-0.8	0.6	1.9	2.5	2.3	0.4	1.0	2.0	1.3	0.2
(% change from prior quarter)																
CONSUMPTION EXPENDITURES	2.0	1.0	0.9	1.5	-0.8	-1.5	-0.5	0.7	1.5	2.0	2.2	0.0	0.9	2.8	0.9	0.0
BUSINESS INVESTMENT	8.7	3.4	2.4	2.3	-7.3	-5.2	-4.5	-2.2	1.1	3.6	6.4	-2.0	-0.5	4.9	2.0	-3.0
RESIDENTIAL INVESTMENT	-20.6	-27.0	-25.1	-15.6	-10.0	-4.0	-2.0	0.0	3.0	5.0	-19.0	-14.0	1.5	-17.9	-19.5	-3.0
CHANGE IN INVENTORIES ('00 dlrs, bill)	16.0	-8.1	-10.2	-62.2	-29.6	-24.6	-21.2	-16.2	-6.2	3.8				-2.5*	-31.7*	-10.0*
GOVERNMENT	3.8	0.8	1.9	3.4	0.3	-0.4	-0.1	0.4	1.3	1.3	2.4	1.3	0.7	2.1	2.0	0.4
NET EXPORTS ('00 dlrs, bill.)	-511.8	-484.5	-462.0	-395.2	-372.7	-354.0	-351.0	-348.9	-348.7	-350.9				-546.5*	-396.0*	-349.9*
FINAL SALES	4.0	0.8	0.9	3.9	-1.2	-1.4	-0.9	0.4	1.5	2.2	2.5	0.5	0.8	2.4	1.6	0.0
NOMINAL GROSS DOMESTIC PRODUCT	6.4	2.3	3.5	3.0	4.7	0.8	0.2	2.0	3.6	4.4	4.9	3.0	2.6	4.8	3.7	2.1
GDP DEFLATOR - IMPLICIT (% change)	1.5	2.5	2.6	1.1	4.7	2.0	1.0	1.4	1.7	1.9	2.6	2.6	1.5	2.7	2.3	1.9
CPI (% Change, 1982-84 = 100)	2.8	5.0	4.3	5.0	8.0	2.3	1.3	1.7	2.0	2.2	4.0	4.9	1.8	2.9	4.7	2.8
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.7	4.8	4.9	5.3	5.7	6.0	6.2	6.4	6.6	6.4				4.6*	5.5*	6.4*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	07:3a	07:4a	08:1a	08:2a	08:3f	08:4f	09:1f	09:2f	09:3f	09:4f	2007a	2008f	2009f
Federal Funds	5.07	4.50	3.18	2.09	2.00	2.00	2.00	2.00	2.15	2.70	5.02	2.32	2.21
3-mo.LIBOR	5.45	5.03	3.26	2.75	2.75	2.40	2.25	2.25	2.40	2.90	5.30	2.79	2.45
2-yr. Treasury Note	4.38	3.48	2.02	2.42	2.45	2.30	2.25	2.30	2.55	3.00	4.36	2.30	2.53
10-yr. Treasury Note	4.73	4.26	3.66	3.89	3.90	3.60	3.50	3.60	3.80	4.10	4.63	3.76	3.75

a = actual
f = forecast