Northern Trust

U.S. ECONOMIC & INTEREST RATE OUTLOOK

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul L. Kasriel
Director of
Economic Research
312.444.4145
312.557.2675 fax
plk1@ntrs.com

Asha Bangalore
Economist
312.444.4146
312.557.2675 fax
agb3@ntrs.com

Will The Markets And The WSJ Let Ben Be Ben?

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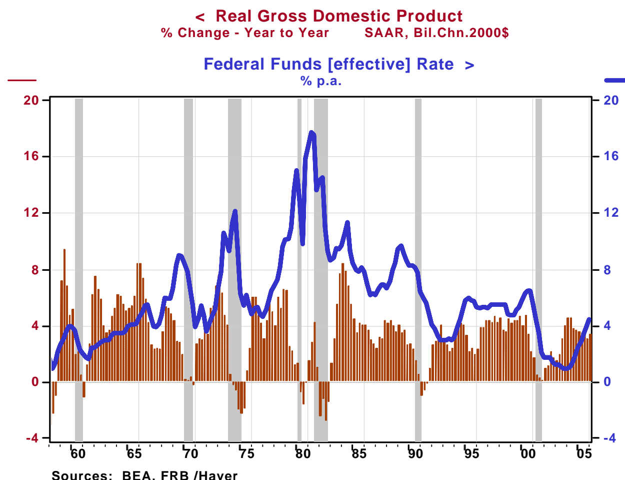
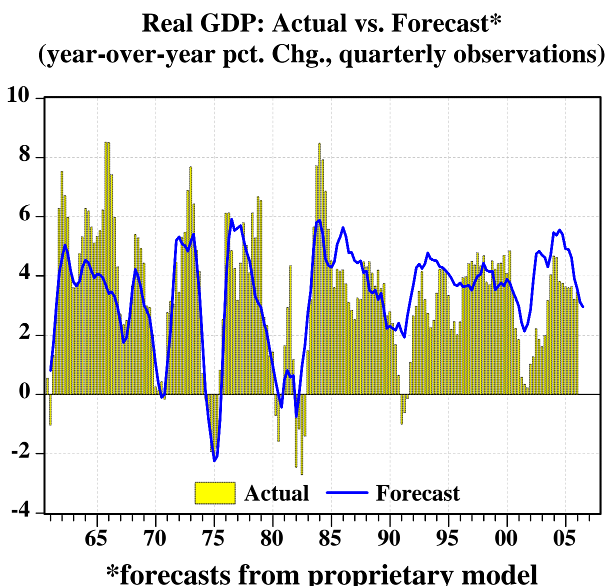
Let me begin by saying that I thought Ben Bernanke communicated uncommonly clearly for a Fed chairman in his prepared testimony before the Joint Economic Committee on April 27. I heard Chairman Bernanke saying in so many words: (1) that there were important lagged effects of past Fed policy actions, (2) that the Fed's consensus forecast for economic growth, *which attempts to incorporate these lagged effects*, was signaling a moderation in economic growth to a rate approximately equal to perceived potential, (3) that the FOMC wanted to *temporarily* pause in the not-too-distant future to see whether incoming data were consistent with its forecast and (4) post-pause-FOMC actions would be a function of whether incoming data conformed to the Fed's forecast. What was less straightforward, but what *I interpreted* to be implicit in Bernanke's testimony was that although near-term upside risks to inflation existed, given that inflation historically has been a *lagging* economic process and given that the FOMC's forecast is for excess aggregate demand pressures to be moderating, the Fed's *intermediate*-run forecast is for relatively benign inflation. Does this imply that Fed Chairman Bernanke and his colleagues are "doves" on consumer-price (as opposed to asset-price inflation) inflation? I don't think so. Rather, I believe that the FOMC is uncharacteristically attempting to make policy based on a *forecast* that suggests moderating inflation. I say "uncharacteristically" because, with the rare exceptions of 1967 and 1995, the post-war history of the Fed has been to continue raising interest rates until *coincident* indicators demonstrate beyond a shadow of a doubt that aggregate demand growth *has* slowed significantly, thereby creating expectations that inflation will follow suit (see Chart 1). Of course, the Fed's forecast could turn out to be grossly incorrect, in which case, after a *temporary* pause in funds-rate hikes, the FOMC might have to become more aggressive in raising interest rates.

Chart 1



Although we are undoubtedly using a different forecasting model than is the Fed – ours includes proven leading indicators such as real M2 growth – our general conclusions about the near-term behavior of economic growth appear to be congruent with that of the FOMC. Namely, we also expect a moderation in economic growth. Chart 2 shows the year-over-year forecast of real GDP growth generated by our proprietary model along with actual real GDP growth. Based on the advance estimate by the BEA, year-over-year real GDP growth was 3.5% in 2006:Q1. Our model projects year-over-year real GDP growth moderating further to 3.0% by 2006:Q3.

Chart 2



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We are not "strict constructionists" when it comes to forecasts. That is, we look to our model for guidance but reserve the right to use some judgment, too. So, our quarter-to-quarter pattern of real GDP growth is somewhat different form that implied by our model. But the basic message is that we expect *continued* slowing in the trend rate of growth of real GDP.

How can that be when the BEA just reported that its first estimate of real GDP in 2006:1 puts quarter-to-quarter annualized growth at 4.8%? As we noted in our April 28 weekly commentary, "GDP Is A Terrific *Coincident* Indicator", there have been numerous occasions when a quarter of strong real GDP growth has been the prelude to a series of quarters of considerably weaker growth. One such occasion was 1994:Q4, when quarter-to-quarter annualized real GDP was clocked at 4.8%. Annualized real GDP growth in the subsequent five quarters was 1.1%, 0.7%, 3.3%, 3.0% and 2.9%. The reason we bring up this particular occasion is that we think that current economic environment bears some resemblance to this 1994-95 period. As you may recall, the Fed commenced an aggressive interest rate raising campaign in February 1994, ending it in February 1995 with a cumulative funds rate increase of 300 basis points. By July 1995, the Fed had reversed course and was cutting the funds rate as that weak real GDP growth we mentioned had caught its attention.

As we have discussed in previous commentaries, the winds of arithmetic were at the back of GDP growth in the first quarter. Let us explain. In December 2005, real Personal Consumption Expenditures (PCE) increased by 0.7%. This put the December level of PCE so far above the quarterly average PCE for 2005:Q4, that even if PCE had shown no growth in January, February and March of 2006, quarterly average real PCE would have grown at an annualized rate of 3.1% in 2006:Q1. The arithmetic winds have shifted in the second quarter of this year. Real PCE increased by only 0.2% in March, which puts its level not that far above the quarterly average for 2006:Q1. If PCE shows no growth in April, May and June, then quarterly average real PCE would grow at an annualized rate of only 0.8% in 2006:Q2.

Is there any evidence that second-quarter slowdown in economic growth is underway? In all candor, not as much as we expected. But there are some signs. Sales of new motor vehicles have been approximately flat for the three months ended April. Although both new and existing home sales were up in March, their trend is moving lower (see Chart 3). Housing starts fell sharply in March. And the stocks of homebuilders are in a significant downtrend. Housing historically has been the sector that buckled first as economic growth started to weaken. Because of the prominent role housing has played in this expansion –both in employment growth and consumer spending growth via mortgage equity withdrawal – we believe that a weakening housing sector will have even- larger-than-usual multiplier effects on the economy as a whole in the coming quarters. Initial jobless claims, a leading indicator of economic activity, are starting to trend higher (see Chart 4).

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Chart 3

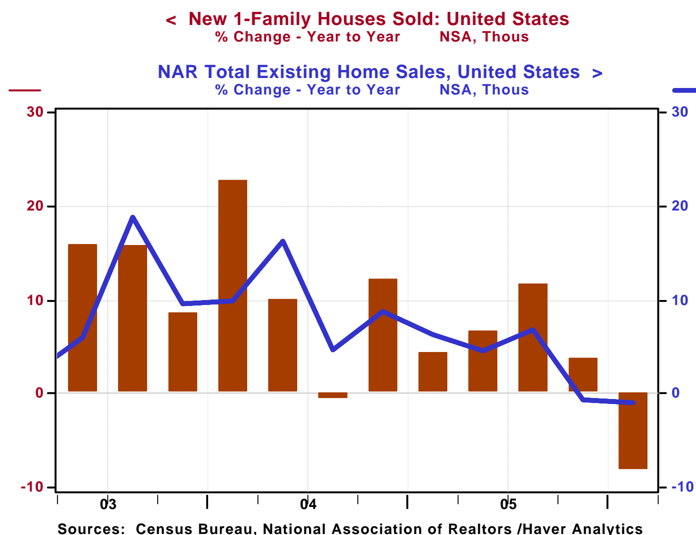
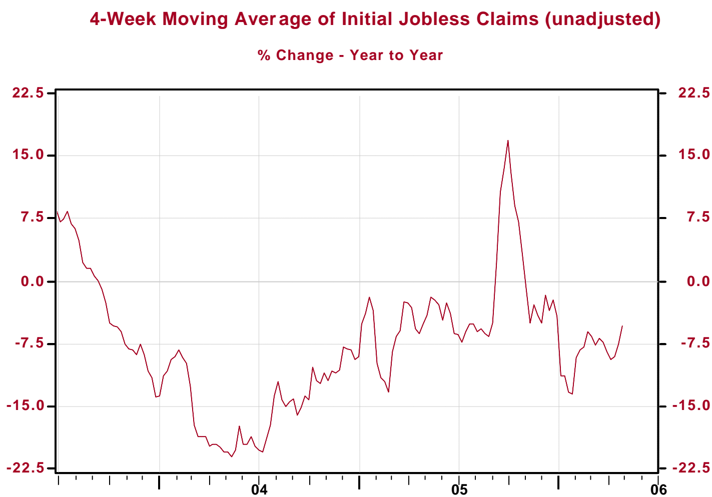


Chart 4



The short-term inflationary risks are skewed to the upside, largely because of recent surge in energy prices. As we discussed in a recent weekly commentary "Federal Reserve and Inflation Targeting – First Do No Harm", inflation is a monetary phenomenon with long lags between

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policy actions and the inflationary manifestations of those actions. In that same commentary we showed that the lagged monetary impulse is now toward disinflation. To those Marxists out there who believe that labor costs are a source of inflation, rest easy. One of the most comprehensive measures of labor compensation, the Employment Cost Index (ECI), is showing a slowing growth trend. If we calculate unit labor cost growth using the ECI as the measure of labor compensation as shown in Chart 5, we can see exceptionally benign effective labor compensation growth. The rate of change in non-fuel import prices is moderating (see Chart 6), although this could reverse course later this year or next year as a result of the resumed declining trend in the dollar.

Chart 5

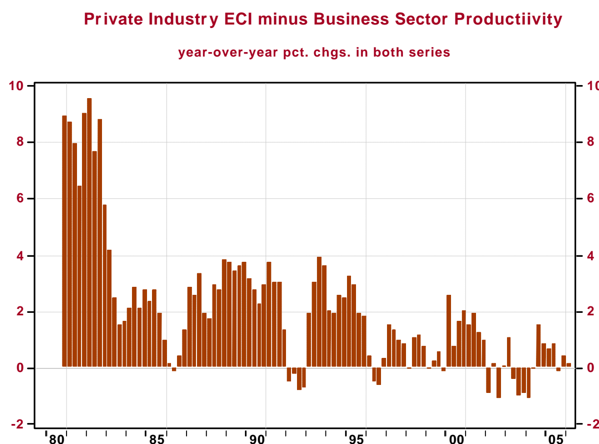

Chart 6

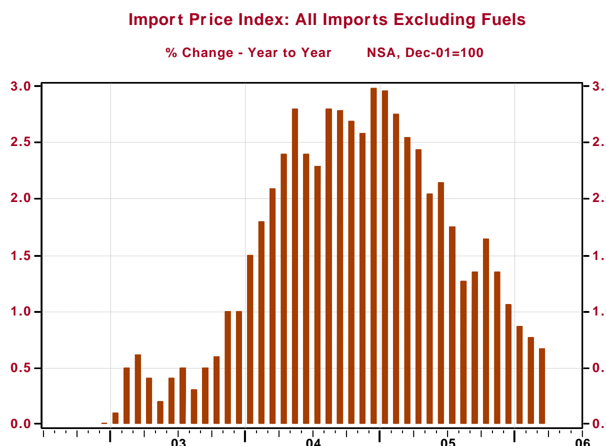

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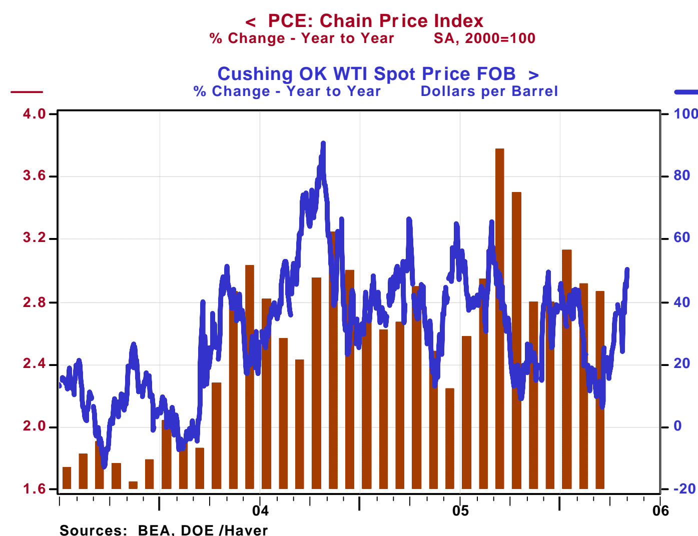
Chart 7 shows that the all-items PCE price inflation, based on year-over-year growth, peaked in September 2005 at 3.8%. The latest reading, March 2006, is 2.9%. With the recent flare-up in crude oil prices, we are likely to see a temporary uptick in the year-over-year percent increase in the PCE price index in the coming months. But, assuming oil prices stabilize or edge lower, the downward trend in this measure of inflation would be expected to be rejoined in the second half of this year.

Chart 7



So-called core consumer inflation appears to have peaked way back in November 200*4* at 2.3% (see Chart 8). The year-over-year reading for this past March did tick up to almost 2% – the upper limit of the FOMC's perceived range of tolerance. A near-term upside risk to core consumer inflation is the shelter component. During the housing boom, rent of shelter – both explicit and implicit – was held down as homeownership (the term is used advisedly) rates reached record highs. Now that the housing boom is cooling, demand for rental shelter is rising, putting some upward pressure on rents.

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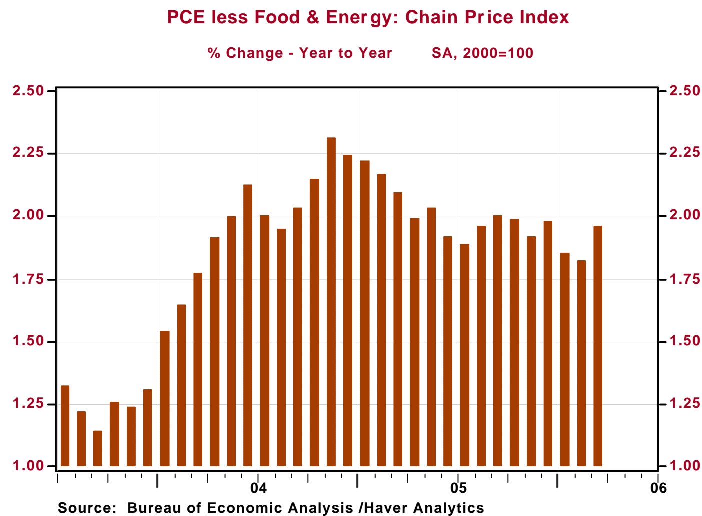
Chart 8



Putting it all together, we expect economic growth to slow to below potential – i.e., below 3-1/2% -- over the rest of the rest of the year. Below-potential economic growth implies a rising unemployment rate in the second half of the year. Overall inflation is likely to tick up in the next few months, but then resume a moderate downward trend later in the year. With regard to Fed policy, we do expect the FOMC to pause in its interest rate hikes after a 25 basis point increase in the fed funds rate at its May 10 meeting. Our base case is that the FOMC remains on hold until the December 12 meeting, at which time it begins some fine-tuning rate cuts.

The two major sources of risk to our forecast are Fed credibility and the dollar. Although we have found little relationship between measured consumer inflation and commodity prices "Commodity Prices and Consumer Prices -- Just The Facts, Ma'am", the recent parabolic rise in various commodity prices is unnerving to bond investors and to the editorial writers of *The Wall Street Journal*. Rising commodity prices are all the more unnerving to these groups when a new Fed chairman with the moniker, Helicopter Ben, has just been installed. We think that moniker is a bit unfair. At the time then Fed Governor Bernanke said that the Fed could figuratively drop money from a helicopter in order to forestall deflation, non other than the presumed keeper of price stability, Fed Chairman Greenspan, was conducting an anti-deflationary monetary policy. No one seems to question Greenspan's anti-inflation credentials, though they should. But Bernanke is tarred for mentioning an old University of Chicago economics department thought experiment at a time when his boss was contemplating implementing such a policy. Because of Bernanke's lack of price-stability credibility, unfair in our opinion, he might be forced to disregard his plan to conduct policy on the basis of forecasts and revert to the Fed tradition of reacting to the latest data. If so, The FOMC might

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not pause after a May 10 funds rate hike, but keep going. If so, the risk of a 2007 recession would escalate.

The other major risk to our forecast that we see would be a run on the dollar. If the FOMC were to pause in its interest rate hikes while the ECB and the BOJ were raising their policy interest rates, this could create downward pressure on the dollar. Moreover, with President Bush's declining approval rating in the polls, foreign investors could lose some confidence in the president's ability to govern. Do you remember the early 1970s? A run on the dollar could push inflation higher, which would require more aggressive FOMC rate hikes. Perhaps this scenario has a low probability of playing out, but in terms of Greenspan's risk analysis, the "cost" would be high.

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THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
May 2006

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2005				2006				Q4-to-Q4 change			Annual change		
	05:1a	05:2a	05:3a	05:4a	06:1a	06:2f	06:3f	06:4f	2004a	2005a	2006f	2004a	2005a	2006f
REAL GROSS DOMESTIC PRODUCT	3.8	3.3	4.1	1.7	4.8	3.0	2.5	2.5	3.8	3.2	3.2	4.2	3.5	3.3
(% change from prior quarter)														
CONSUMPTION EXPENDITURES	3.5	3.4	4.1	0.9	5.5	2.8	2.3	2.3	3.8	2.9	3.2	3.9	3.5	3.2
BUSINESS INVESTMENT	5.7	8.8	8.5	4.5	14.3	12.5	5.3	3.8	10.9	6.8	8.9	9.4	8.6	9.2
RESIDENTIAL INVESTMENT	9.5	10.8	7.3	2.8	2.6	-1.5	-3.0	-1.5	6.6	7.6	-0.9	10.3	7.1	1.9
CHANGE IN INVENTORIES ('00 dlrs, bill)	58.2	-1.7	-13.3	37.9	21.9	12.9	16.9	12.9				52.0*	20.3*	16.2*
GOVERNMENT	1.9	2.5	2.9	-0.8	3.9	2.8	2.0	2.4	2.1	1.6	2.8	2.2	1.8	2.2
NET EXPORTS ('00 dlrs, bill.)	-645.4	-614.2	-617.5	-655.2	-678.2	-687.1	-687.9	-679.8				-601.3*	-633.1*	-683.3*
FINAL SALES	3.5	5.6	4.6	-0.2	5.5	3.5	2.4	2.7	3.6	3.3	0.0	3.9	3.8	3.3
NOMINAL GROSS DOMESTIC PRODUCT	7.0	6.0	7.6	5.2	8.2	6.0	4.4	4.7	6.8	6.4	5.8	7.0	6.4	6.3
GDP DEFLATOR - IMPLICIT (% change)	3.0	2.6	3.3	3.5	1.9	2.9	1.8	2.1	2.9	3.1	2.5	2.6	2.8	2.9
CPI (% Change, 1982-84 = 100)	2.5	3.7	5.5	3.2	2.2	3.2	2.1	2.4	3.3	3.7	2.5	2.7	3.4	3.1
CIVILIAN UNEMPLOYMENT RATE (avg.)	5.2	5.1	5.0	4.9	4.7	4.8	5.0	5.2				5.5*	5.1*	4.9*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average								Annual Average		
SPECIFIC INTEREST RATES	05:1a	05:2a	05:3a	05:4a	06:1a	06:2f	06:3f	06:4f	2004a	2005a	2006f
Federal Funds	2.47	2.94	3.46	3.98	4.46	4.90	5.00	4.95	1.35	3.21	4.83
3-mo.LIBOR	2.84	3.28	3.77	4.34	4.76	5.10	5.10	4.90	1.62	3.56	4.97
2-yr. Treasury Note	3.44	3.64	3.95	4.36	4.60	4.95	4.85	4.70	2.38	3.85	4.78
10-yr. Treasury Note	4.30	4.16	4.21	4.49	4.57	5.10	5.10	4.90	4.04	4.29	4.92

a = actual
f = forecast

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