Northern Trust

DAILY GLOBAL
COMMENTARY

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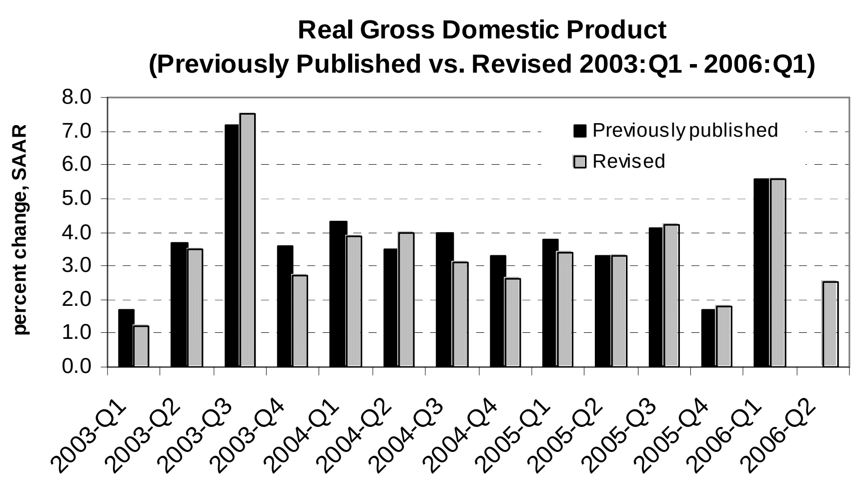
Evidence of Significant Slowing Strengthens Case for August Pause

July 28, 2006

The U.S. economy slowed to a 2.5% pace in the second quarter after a robust 5.6% increase in the first quarter. The impact of 425 basis points of Fed interest rate hikes is now clearly visible. Today's report also included revisions of GDP estimates going back to the first quarter of 2003. The most noteworthy aspect of this revision is that "the expansion that followed the 2001 downturn is slightly milder than previously estimated. From the cyclical trough of GDP in the third quarter of 2001 to the first quarter of 2006, the revised estimates show that real GDP increased at an average annual rate of 3.1 percent; the previously published estimates showed an average increase of 3.3 percent." Given how much monetary and fiscal policy stimulus administered to the economy in the early part of this cycle, growth of 3.1% is positively puny. Be that as it may, the withdrawal of Fed stimulus suggests to us that economic growth over the remainder of this year will be, at best, as anemic as it was in the second quarter. The FOMC's implicit forecast is a bit more optimistic than ours, but not much. Under these circumstances, it would be a surprise to us, and belatedly to the market, too, if the Fed were to raise the federal funds rate on August 8.

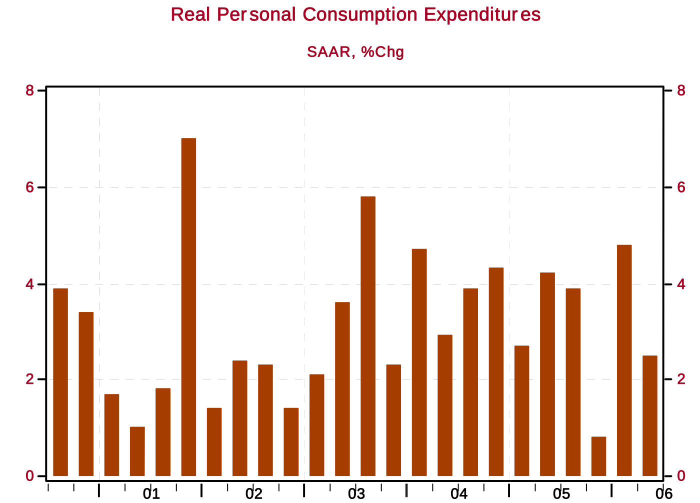
Chart 1



The sharp deceleration in consumer spending to a 2.5% annualized increase in the second quarter from a revised 4.8% pace in the first quarter, 1.0% decline in equipment and software spending vs. a 15.6% jump in the first quarter, a drop in residential investment expenditures, and deceleration in growth of exports and government spending were the reasons for slower growth of GDP in the second quarter.

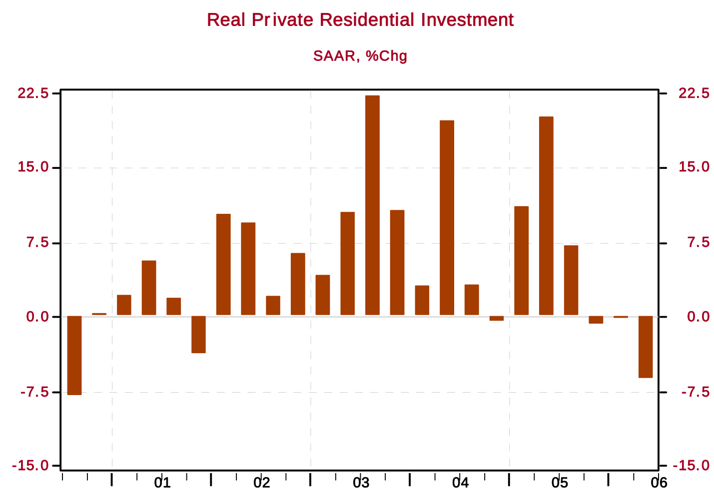
The softness in the second quarter consumer spending reflects a 0.5% drop in outlays of durable goods vs. a 19.8% increase in the first quarter. Although attractive incentives are available for purchases of autos, it appears that auto sales rose only slightly in July. The financially strapped consumer is expected to show restraint in the rest of 2006.

Chart 2



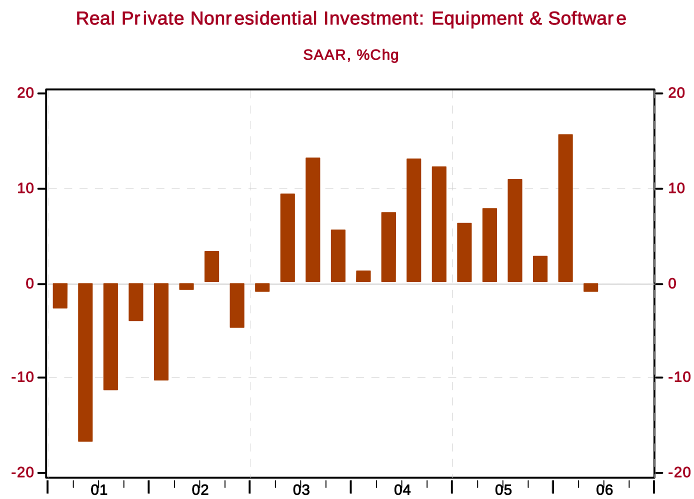
The 6.3% drop in residential investment expenditures marks the third quarterly decline in residential investment expenditures and it is largest of the three. The sharp increase in inventories of unsold homes, both existing and new, strongly suggests a continuation of the recession in residential investment, a.k.a. housing.

Chart 3



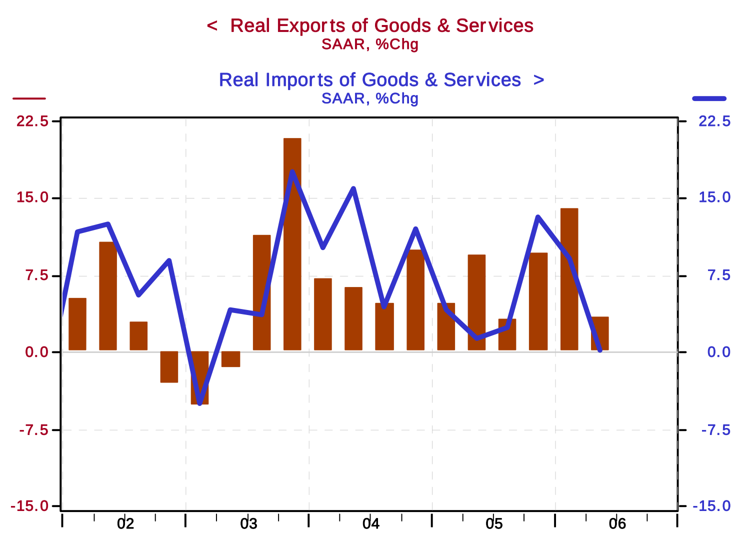
The overflowing coffers of corporations, which, according to conventional wisdom, were expected to "take the baton" from the slowing household sector, apparently dropped it. That is, equipment and software spending fell 1.0% in the second quarter vs. a 15.6% gain in the first quarter. Could it be that businesses actually try to identify customers for their wares before engaging in capital spending?

Chart 4



Net exports narrowed to $627.1 billion quarter from $635.6 billion in the first quarter. Although exports showed slower growth, imports were very nearly steady in the second quarter as U.S. domestic demand slowed sharply. The strength seen among the trading partners of the U.S. economy supports expectations of net exports making a positive contribution to GDP over the rest of 2006. Bear in mind, however, that U.S. consumers account for 30% of non-U.S. global GDP. So, as American households curtail their spending, with a lag, foreign GDP growth will be negatively affected.

Chart 5



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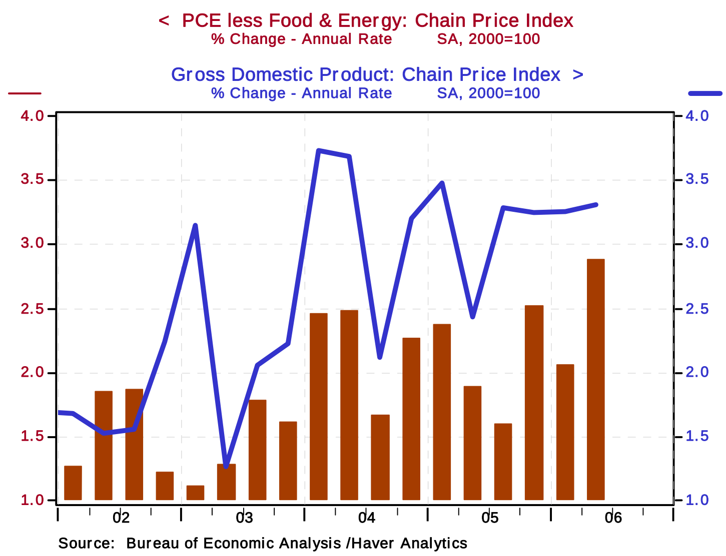
The $52.6 billion increase in business inventories added 0.4% second-quarter real GDP. In the face of rapidly decelerating domestic final demand, this build-up in inventories is likely to retard production in the quarters ahead.

The chain price index of personal consumption expenditures excluding food and energy advanced at an annual rate of 2.9% in the second quarter, which is far above the Fed's comfort zone. However, the Fed's forecast shows a moderation in core inflation in 2007. And Fed Chairman Bernanke indicated that he expected further moderation in inflation in 2008. This expected slowdown in inflation by the Fed is premised on the forecast of weaker aggregate demand going forward. Although a lot of market talking heads might not realize it, the Fed knows that inflation is a lagging economic process. So, although not happy about the second quarter's 2.9% rate of core consumer inflation, the weaker-than-consensus second-quarter real GDP growth gives the Fed some confidence to be patient in letting below-potential GDP growth gradually bring down inflation.

Chart 6



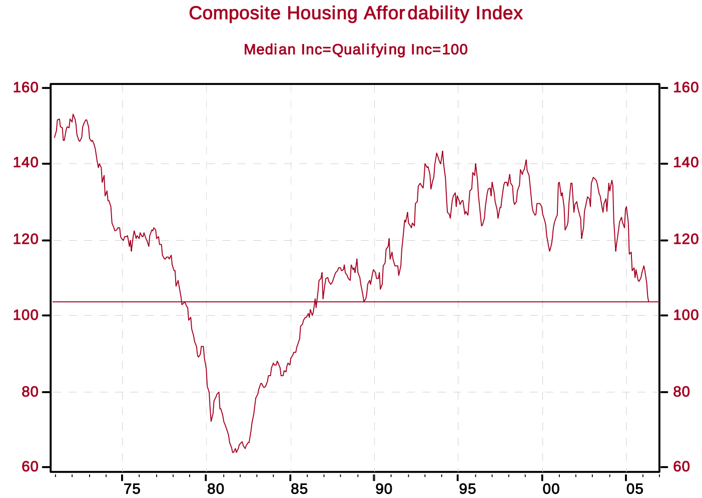
REAL GROSS DOMESTIC PRODUCT – ADVANCE ESTIMATE 2006:Q2

	Levels (Billions of chained 2000 dollars)			Percent Change (SAAR)		
	05:4 Final	06:1 Final	06:2 Advance	From 05:3 to 05:4	From 05:4 to 06:1	From 06:1 to 06:2
GDP	11163.8	11316.4	11385.3	1.8	5.6	2.5
CONSUMPTION	7910.2	8003.8	8053.0	0.8	4.8	2.5
DURABLE GOODS	1137.9	1190.5	1189.1	-12.3	19.8	-0.5
NONDURABLE GOODS	2309.6	2342.8	2352.4	3.9	5.9	1.7
SERVICES	4476.7	4494.5	4533.2	2.0	1.6	3.5
INVESTMENT	1927.0	1963.6	1971.7	16.2	7.8	1.7
FIXED INVESTMENT	1877.3	1914.6	1911.1	2.8	8.2	-0.7
NONRESIDENTIAL	1248.2	1288.8	1297.5	5.2	13.7	2.7
STRUCTURES	254.2	259.6	267.5	12.0	8.7	12.7
EQUIPMENT & SOFTWARE	1007.6	1044.8	1042.2	2.8	15.6	-1.0
RESIDENTIAL	618.9	618.5	608.5	-0.9	-0.3	-6.3
CHG. BUS. INVENT.	43.5	41.2	52.6			
NET EXPORTS	-636.6	-636.6	-627.1			
EXPORTS	1228.4	1269.3	1279.6	9.6	14.0	3.3
IMPORTS	1865.0	1905.9	1906.7	13.2	9.1	0.2
GOVERNMENT (Cons. & Invest.)	1963.5	1987.1	1990.0	-1.1	4.9	0.6
FEDERAL	729.6	745.1	738.7	-4.6	8.8	-3.4
DEFENSE	481.4	491.8	490.5	-9.9	8.9	-1.0
OTHER	248.0	253.1	248.0	7.1	8.5	-7.8
STATE AND LOCAL	1233.7	1242.0	1251.1	1.0	2.7	3.0
DISP. PERS. INC.	8183.3	8217.4	8237.5	5.5	1.7	1.0
FINAL SALES	11115.5	11269.0	11326.4	-0.3	5.6	2.1
FINAL SALES TO DOM. PURCHASERS	11744.6	11898.7	11946.9	0.7	5.4	1.6
PRICE DEFLATORS:						
GDP CHAIN TYPE	114.0	115.0	115.9	3.3	3.3	3.3
GDP EX. FOOD & ENERGY				3.3	3.1	3.0
PCE CHAIN TYPE	112.9	113.4	114.6	2.9	2.0	4.1
PCE EX. FOOD & ENERGY	110.4	111.0	111.8	2.5	2.1	2.9

Housing Affordability Plunges In June

The Housing Affordability Index (HAI) fell to 103.7 in June from 105.1 in May. This is the lowest since August 1986. There is abundant evidence of more than slowing conditions in the housing market – declining sales of homes, deceleration in prices, rising inventories, and a downward trend in the HAI. The mounting evidence is strengthening the case for a pause on August 8, as mentioned earlier.

Chart 7



Labor Costs Advance, Albeit Gradually

The Employment Cost Index (ECI) rose 0.9% in the second quarter, putting the year-to-year increase to 3.0%. The wage and salary component has risen 2.8% on a year-to-year basis from a low of 2.3% in the third quarter of 2005. The benefit component of the ECI has stabilized at 3.4% on a year-to-year basis, after posting a decelerating trend for nearly two years. Fed rhetoric suggests that the Fed is mindful of inflationary pressures but the focus is shifting toward maintaining growth in the inflation vs. growth debate.

Chart 8