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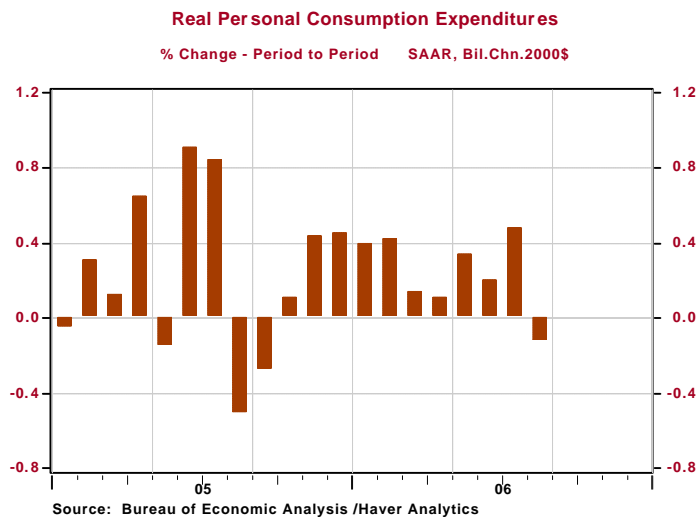
### Q3 Consumer Spending Lifted By Strength In July

September 29, 2006

Inflation adjusted consumer spending dropped 0.1% in August after a string of nine monthly gains. Declines in spending on durable goods (-1.3%), mainly cars and light trucks, and a drop in non-durable goods (-0.2%) led to an overall drop in consumer spending. Outlays on services rose 0.1% in August vs. a 0.3% jump in the prior month. The 0.5% increase in inflation adjusted spending in July gives a lift to overall consumer spending in the third quarter. The July-August average and a projected mild gain in September points to about a 3.0% increase in third quarter consumer spending compared with a 2.6% gain in the second quarter.

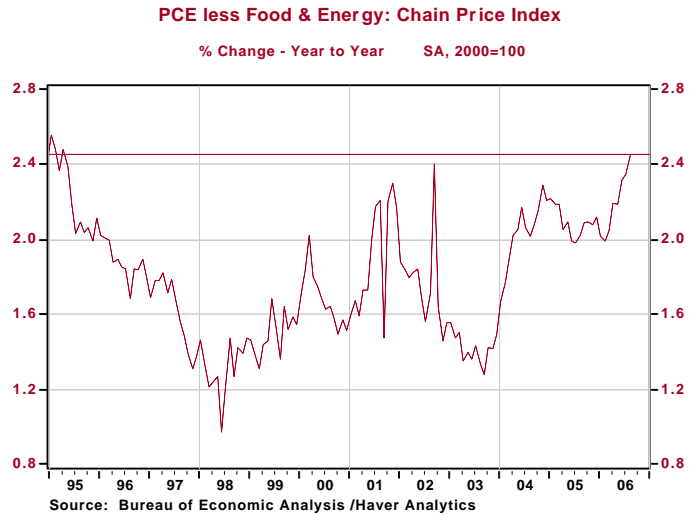
Personal saving as percent of disposable income was negative 0.5%. The saving rate is most likely to be negative in 2006 after a negative 0.4% average in 2005. Personal income increased 0.3% after a 0.5% gain in July. Wages and salaries rose only 0.1% in August after a 0.6% gain in the prior month.

Chart 1



The FOMC's preferred measure of inflation, the personal consumption expenditure chain price index excluding food and energy, rose 0.23% in August after a 0.14% increase in the prior month. The year-to-year increase in August is 2.45%, the largest gain since April 1995. The year-to-year trend of this inflation measure is above the Fed's comfort zone. The Fed is not likely to consider easing monetary policy until there are signs of moderation. The weak nature of incoming economic data suggests that we can be optimistic about an improvement in core inflation numbers.

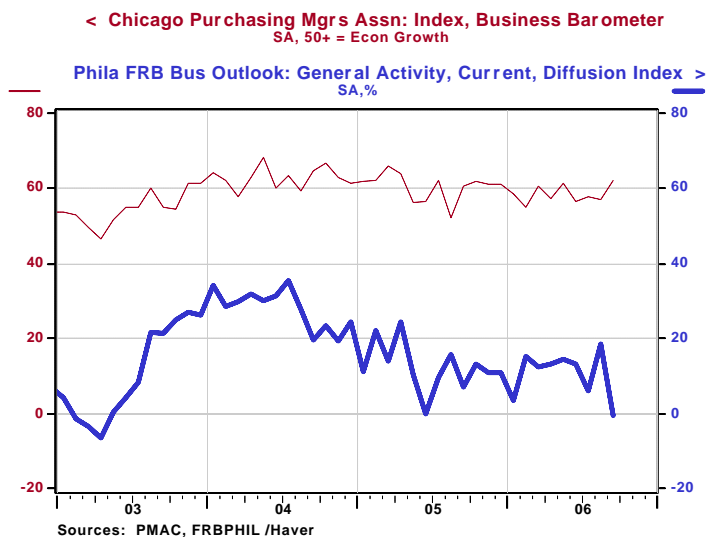
Chart 2



### Element of Surprise in Chicago Purchasing Managers Survey

The Chicago Purchasing Managers Index rose to 62.1 in September, a five-point increase from the prior month. Indexes tracking production (67.4, up 5.7 points) and new orders (67.3, up 7.7 points) posted a sharp improvement while the employment (50.8, down 4.3 points) index fell.

Chart 3



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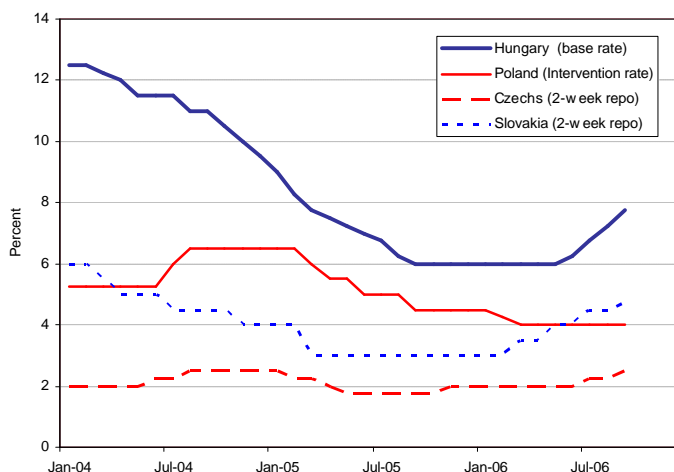
The Federal Reserve Bank of Philadelphia's factory survey for September showed a noticeable deterioration in factory conditions which resulted in a big rally in the bond market. To resolve the controversy we need to wait for the National ISM factory survey to be published on October 2.

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## Central Europe's Central Banks Respond to Deteriorating Inflation and Fiscal Outlooks

The central banks of Hungary, Slovakia, and the Czech Republic all hiked their policy interest rates this week, citing concerns about the inflationary impacts of higher domestic demand, high (and volatile) utility prices, and fiscal loosening. The central bank of Poland kept its rates unchanged, as it is not yet facing the same inflation concerns as its neighbors – but it does face a similarly-volatile domestic political scene, a fact that could yet undermine the zloty, and is likely to be in a tightening mode by early 2007. In fact, the confluence of risk factors in the region could bring increasing volatility to markets that have been the darling of investors since the expansion of the European Union two years ago.

Central European Policy Rates

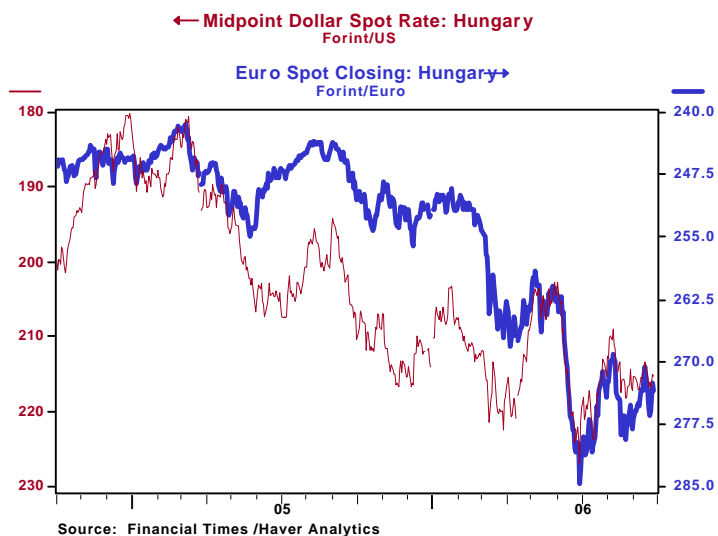


The week started with a 50bp rate hike from the National Bank of Hungary on Monday, citing its determination to defeat inflation after anti-government rallies over the previous week triggered a fall in the forint, and the bank said that more hikes may be needed. As we have noted before (most recently on September 20: Hungary: All Eyes On The Streets – And On The Central Bank) Hungary is one of the emerging markets that is most vulnerable to an adverse shift in investor

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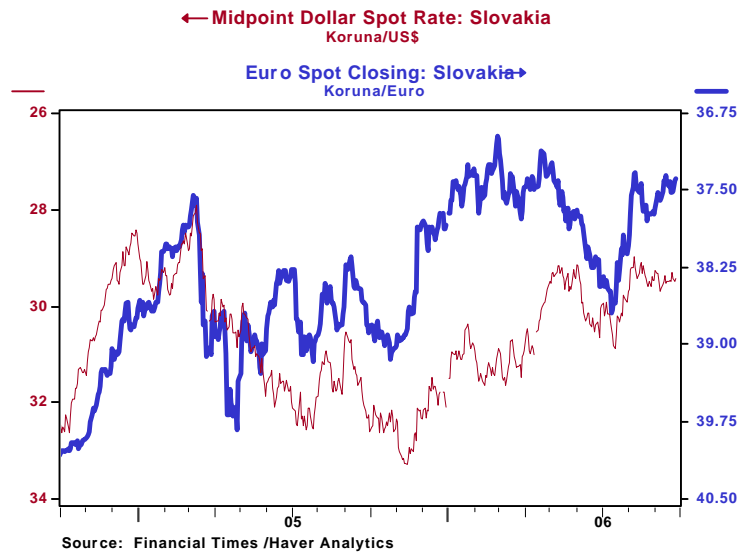
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sentiment, thanks to its hefty current account and fiscal deficits. Because foreign investors hold a large chunk of Hungarian state bonds and treasury bills, any large-scale sell-off in Hungarian assets could quickly accelerate into a rout. And, because foreign-currency denominated loans (mainly euro and Swiss franc) account for nearly 50% of all credits to non-financial corporations and 60% of all long-term household borrowing, a slide in the currency would have a particularly painful impact on the wider economy and on the local banking sector. There are already signs that the economy is starting to slow, and the combination of planned tax hikes to correct the runaway fiscal deficit and higher interest rates to curb inflation will further squelch domestic consumption.

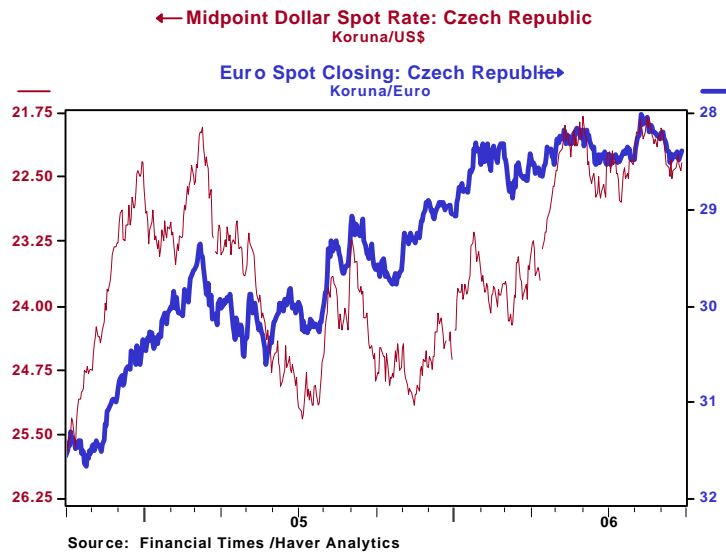


Next in line for a rate hike was Slovakia, where the central bank surprised the markets with a 25bp rate hike on Tuesday the 26<sup>th</sup>, noting its concern over persistent inflation risks from wage growth and the uncertainty over the trend in utility prices. As in Hungary, the bank warned that more hikes will be necessary. It has also been warning of late that rising inflation, combined with the more lax fiscal stance adopted by the populist government elected in June, are clouding Slovakia's chances of adopting the euro in 2009 as formally planned. Slovakia joined the ERM-2 euro-waiting room in November 2005, meaning that it is obliged to keep the koruna within a trading band around its central rate to the euro (effectively +/- 2.5%). ERM-2 membership may help to deter speculators looking for vulnerable regional currencies, but with a populist government installed in Bratislava and political risks growing in neighboring Hungary, Poland, and the Czech Republic, the Slovakian koruna could yet find itself caught in the regional backwash.

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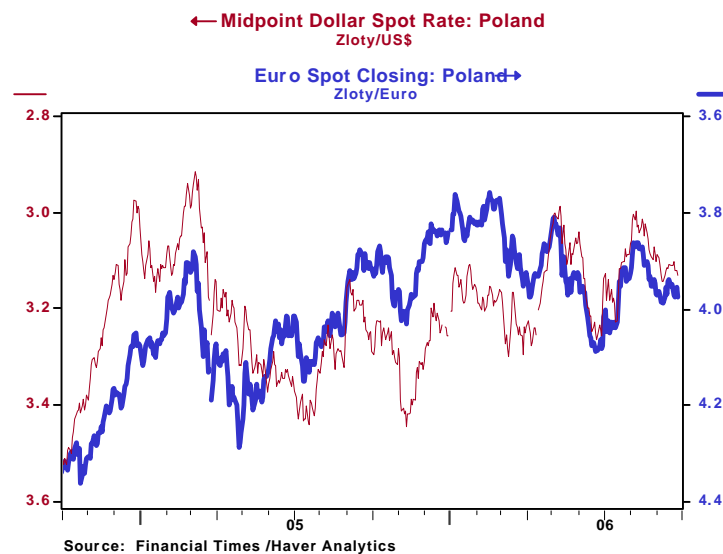


On Wednesday the 27<sup>th</sup> the Czech National Bank (CNB) also surprised the markets with a 25bp rate hike, and it also noted the inflationary impacts of accelerating domestic demand and a weaker currency. CNB members have also harshly criticized the expected widening of the fiscal deficit next year (the result of pre-election handouts), which would rule out adopting the euro in 2010 as currently planned. Meanwhile, after months of uncertainty, the June election has finally resulted in a weak minority cabinet that has little clout to push fiscal reforms – and that is anyway likely to lose a confidence vote next week, probably leading to a new election early next year. Such a prolonged period of political uncertainty is going to rattle market nerves.



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Finally, the National Bank of Poland (NBP) kept its policy rate unchanged on the 27<sup>th</sup>, as expected. With a manageable current account deficit, no broad-based lending boom, and investor inflows helping to support the zloty, the Polish inflation rate is under control for now, although the NBP has noted that rate hikes will be necessary come early 2007. And like its neighbors, Poland is also vulnerable to concerns about political and currency stability. While overall domestic credit expansion has not been particularly strong, about 26% of all private sector lending is in foreign currencies and as much as two-thirds of housing loans are foreign currency – mostly Swiss franc – denominated, leaving households particularly vulnerable to zloty depreciation. The free-floating zloty tends to drop on any adverse political news – both domestic and regional (particularly in Hungary). To date, the fact that Poland's fiscal deficit looks manageable (only 2.5% of GDP in 2005) has helped investors feel sanguine about the largest new-EU economy. However, a shift in EU-mandated accounting rules means that next year's deficit will look a lot higher than otherwise expected. Add the government's plans to increase spending on agriculture and welfare, and the 2007 deficit could push past 4.5% of GDP.



Meanwhile, there is also a sense of rising political crisis in Poland. Last week the Law and Justice Party (PiS), which leads the government coalition elected last September, kicked the second largest party out of the coalition, saying the left-wing populist Self Defense (Samoobrona) was making unreasonable budget demands. The remaining two parties have given themselves until October 10 to form a new coalition – and with questions also being raised about the tactics being used by PiS aides to woo deputies to join the coalition, the odds increasingly favor an early election.

All told, there is a palpable sense of unease hovering over central Europe as we head into Q4. The region is not facing an Asian-style meltdown – much of the investor inflows supporting the currencies and the economies over the past couple of years have been in the form of direct investments in things like factories and bridges, rather than short-term speculative flows chasing

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higher yields. Nevertheless, the combination of political upheavals, looser fiscal policies, high levels of household foreign currency borrowing in the two largest markets, and rising inflation and rising interest rates, with the added factor of “regional contagion” fears, points to an increased risk of currency volatility over the coming months.

The country that would suffer the most from any adverse shift in confidence would be Hungary. However, any perception that euro adoption across central Europe is going to be delayed past 2010 could further undermine regional currencies and investor confidence heading into 2007. As we’ve often noted in the past, politics is at least as important as economic fundamentals, when it comes to emerging markets. This week, the region’s central banks tacitly acknowledged that fact.

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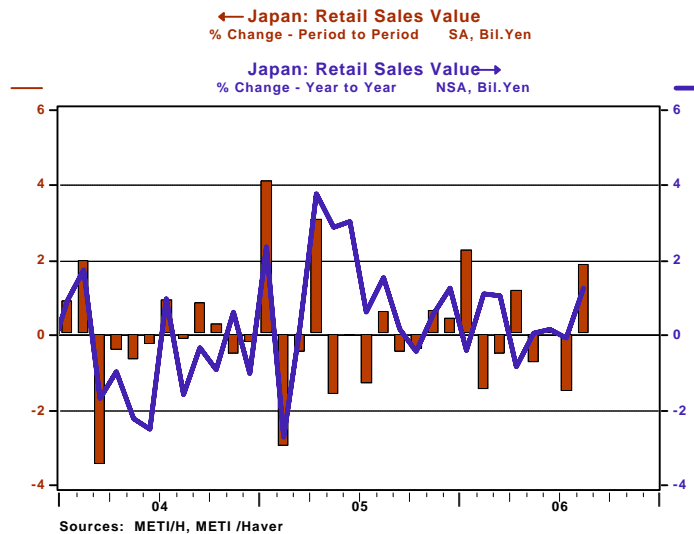
### **Japan: Indicators Ease Concerns About Slowdown – But Not About Inflation**

The end of the month is usually heavy with Japanese economic indicators, and September is no exception. Data on retail sales, consumer spending, unemployment, industrial production, housing and construction – all released within a 48-hour period – provided good evidence that the softer figures from July represented a mild breather rather than the first stages of a slowdown. We feel that the July lull was due in some part to the uncertainty surrounding the Bank of Japan’s (BoJ’s) elimination of the zero interest rate policy and that most – but not all – economic sectors went back to business as usual after the first rate hike in four years passed by uneventfully. However, a sharp rise in the CPI – while taken as a good sign that deflation has left – serves as a reminder that inflation has returned.

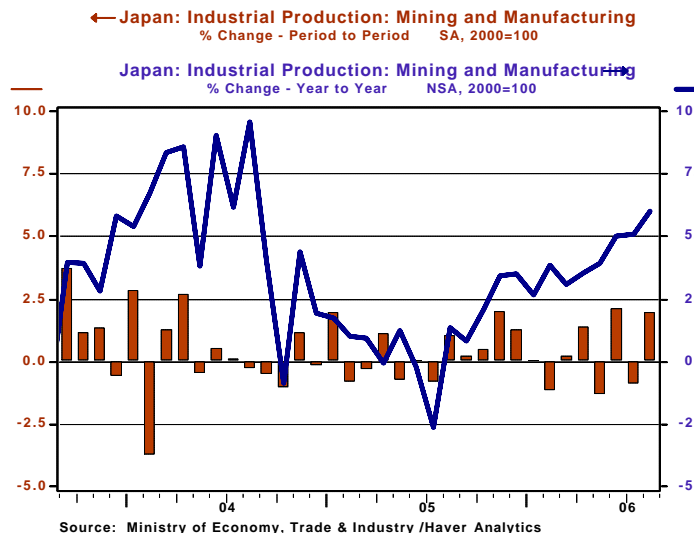
The first in this parade of reports was August retail sales, and the figures support the argument for a brief pause. Retail sales rose 1.9% on the month and 1.3% on the year on a value basis, well above consensus forecasts. Motor vehicle sales posted their largest monthly increase in over a year, and food sales posted their fourth increase in eight months. However, this did not dovetail at all with the report on August household spending, which dipped a real 0.6% on the month, dragging the year-over-year figure to -4.3% from -1.3% in July. The spending data were the most worrisome of the major releases today, and may weigh on sentiment over the near-term.

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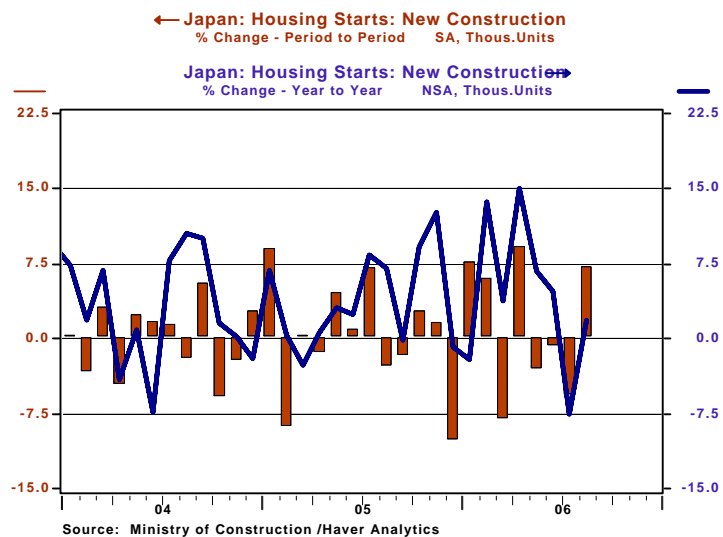
The August unemployment rate met expectations, holding at the previous month's 4.1%. The more telling figure was industrial production. A disappointing decline in July IP was a contributing factor to beliefs about a softening economy, but last month those losses were more than reversed. Headline production rose an adjusted 1.9% on the month and 6.0% on the year, both matching expectations of a firm rebound.



Housing starts and construction orders for last month were both well above expectations, easing for the moment concerns about the fragility of the real estate market. After an impressive five-month run of year-on-year growth in total housing starts, July posted a 7.5% decline that fell

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below a modest consensus forecast. In August, however, growth in total starts went back into positive territory by 1.8%. Construction orders for last month also rose in kind, posting a strong 10.3% increase from August 2005. It is a little more difficult to gauge how the Japanese homebuyer will respond to this new environment of (slowly) rising interest rates going forward. Despite good year-on-year numbers, monthly housing starts began declining on a month-over-month basis once the BoJ pushed forward with its higher interest rate program, so the sudden reversal last month was quite unexpected. This could be interpreted as the consumer's return to real estate after the current tightening cycle began without a hitch, but the Japanese property market is not that simple. For the near-term, however, the markets took the positive numbers well.



Oddly enough, Tokyo markets were also heartened by the latest CPI data. In August, consumer inflation rose by 0.6% on the month and 0.9% on the year – both figures higher than at any other time this decade. The mindset seems to be one of relief that deflation is no longer entrenched in the economy and that pricing power will grow during this recovery. This assumption may well be true, but it is not the only concept worth noting. The BoJ is taking cautious steps to raise interest rates without rattling the markets or stalling the economy, but if the buildup in price pressures may already be seeping through, a more aggressive monetary tightening might be required. Currently, we have the next 25-basis point rate hike penciled in for December, with a regimen of regular, modest increases spread throughout 2007. This, however, may be revised dramatically if the CPI continues to increase in this manner.

We remain convinced that Q3 will post a healthy performance as a whole, perhaps held back slightly due to the period of uncertainty that led up to the July rate hike. Looking into next month, the first report that grabs our attention is the release of the quarterly Tankan survey on October 2<sup>nd</sup>. This report on the short-term outlook for business is taken seriously by Tokyo markets, and will get the fourth quarter started off in a hurry. The next BoJ policy meeting will be on October 12-13, and there is not enough evidence to suggest a rate hike at that time.

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