

DAILY GLOBAL COMMENTARY

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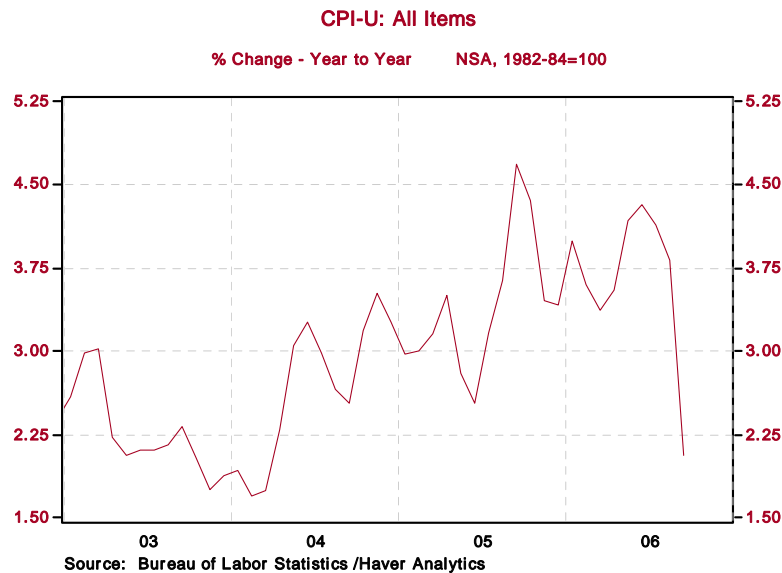
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Overall Inflation Contained, Core Distorted By Shelter Costs

October 18, 2006

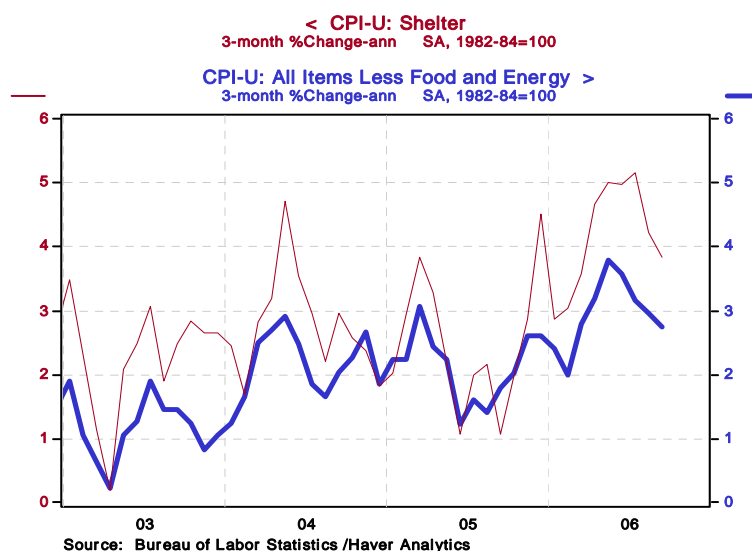
The Consumer Price Index (CPI) fell 0.5% in September putting the year-to-year increase at 2.1%. The recent high of the year-to-year increase in the CPI was 4.3% in June 2006. Lower energy prices have helped to bring down the all-items CPI. The energy price index fell 7.2% in September reflecting mostly lower prices for gasoline (-13.5%). Prices of natural gas and electricity advanced in September. In the first nine months of the year, the CPI has risen at an annual rate of 3.4% matching the increase seen in 2005. The index for energy, which advanced at annual rates of 21.8% and 23.8% in the first two quarters, declined at a 15.6% rate in the third quarter of 2006. Food prices advanced 0.3% in September, taking the year-to-date increase to an annual rate of 2.6% vs. a 2.3% gain in 2005. Higher prices of fruits and vegetables made up a large part of the increase in 2006.

Chart 1



The core CPI rose 0.2%, after posting similar gains in each of the two prior months. Although on a year-to-year basis the core CPI moved up 2.9%, the annualized change during the three-months ended September shows a deceleration of the core CPI to a 2.75% annualized increase vs. a 3.6% gain in the three-months ended May. During the first nine months of the year, the core CPI has risen at an annual rate of 3.0% compared with a 2.2% increase in all of 2005. According to the Labor Department, 80.0% of this acceleration was from the shelter component of the core CPI. The shelter price index has risen at an annual rate of 4.1% in the first nine months of the year after a 2.6% increase in 2005. The 1.9% increase in apparel prices in the first nine months of the year after a 1.1% drop in 2005 accounts for 18% of the increase in the core CPI.

Chart 2



Shelter costs increased 0.3% in September inclusive of a 0.4% increase in rent and a 0.3% gain in owner’s equivalent rent. Prices of passenger cars dropped 0.1%, apparel prices increased 0.6%, and health care costs rose 0.3% during September.

CONSUMER PRICE INDEX – SEPTEMBER 2006

	% change prior month	annualized change			% change		
		year-to-date	3 mo. ago	6 mo. ago	Sep-06 yoy	Sep-05 yoy	Dec-05 yoy
CPI - ALL ITEMS	-0.5	3.4	0.8	2.9	2.1	4.7	3.4
CORE - ALL ITEMS LESS FOOD & ENERGY (77.4)*	0.2	3.0	2.7	3.2	2.9	2.0	2.2
CPI ALL ITEMS LESS ENERGY (91.3)	0.2	2.9	2.8	3.1	2.9	2.0	2.2
FOOD (13.9)	0.3	2.6	3.5	2.6	2.5	2.5	2.3
ENERGY (8.69)	-7.2	8.3	-15.6	2.2	-4.3	34.8	17.1
SHELTER (32.26)	0.3	4.1	3.8	4.4	4.2	1.9	2.6
COMMODITIES (40.79)	-1.7	3.1	-3.1	2.0	-0.7	6.9	2.7
COMMODITIES LESS FOOD & ENERGY (22.31)	-0.1	0.8	0.0	0.4	0.5	0.6	0.2
SERVICES (59.2)	0.4	3.7	3.9	3.7	4.1	3.2	3.8
SERVICES LESS ENERGY SERVICES (55.05)	0.3	3.9	3.8	4.2	3.9	2.5	2.9

* - Figures in parentheses denote the relative importance of each category in the CPI.

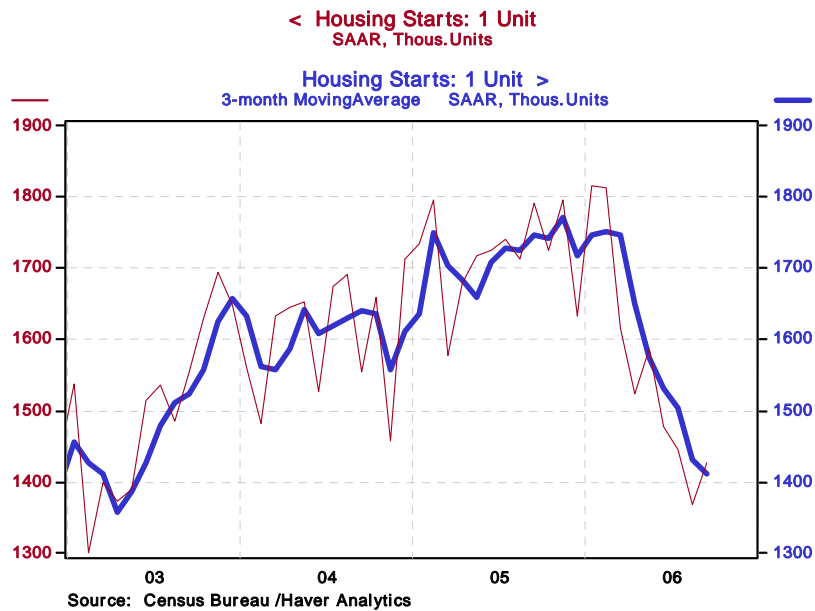
Conclusion – The October 24 monetary policy decision of an unchanged federal funds rate at 5.25% is nearly certain. The deceleration of the overall CPI and core CPI and the nature of other incoming data are supportive of this forecast. Recent Fed rhetoric has focused on inflation in the inflation vs. growth debate by necessity. William Poole of the Federal Reserve Bank of St. Louis, a hawkish member of the FOMC, recently said he regarded the policy outlook as “roughly symmetrical.” In other words, the probability of rate cut is roughly equal to the probability of a rate hike. The Fed needs a combination of continued weakening economic conditions and a decelerating trend of core inflation to lower the federal funds rate, which should occur in the months ahead. As shown in Chart 2, core CPI is heading in the right direction.

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Recovery of Housing Starts Is Tentative

Starts of new homes increased 5.9% in September to an annual rate of 1.772 million units, with single-family and multi-family units posting gains of 4.3% and 12.7%, respectively. A single-month's improvement is not an implication of an immediate turnaround in housing activity. Several months of gains in starts and sales are essential to declare the weakness in this sector is a matter of history. On a regional basis, housing starts rose in the South (+14%) and Midwest (+3.4%) but declined in the Northeast (-14.1%) and West (-2.2%). Permits to construct new houses fell 6.3% in September, marking the eighth consecutive monthly drop.

Chart 3



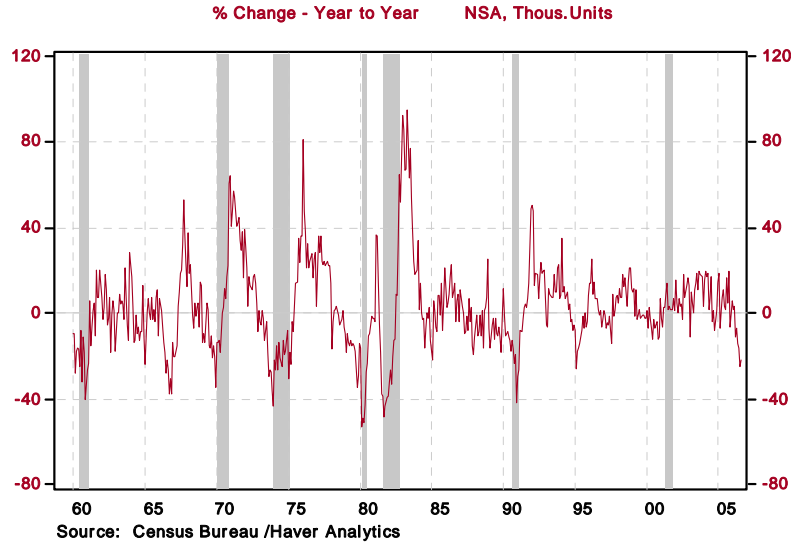
Looking back, starts of single-family units have declined close to 40% on a year-to-year basis during recessions (see chart 4). In the soft-landing episode of 1995, starts of single-family homes fell 14.0% before a recovery was in place.

In other related housing market news, the Mortgage Purchase Index of the Mortgage Bankers Association was nearly steady at 384.7 during the week ended October 13 vs. 383.3 in the prior week. The Mortgage Refinance Index fell 98.8 points to 1758.2 during the same week.

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Chart 4

Housing Starts: 1 Unit



Housing Starts

	<u>Total</u> <u>(mil. units)</u>	<u>% change from</u> <u>previous month</u>	<u>Single-family</u> <u>(mil. units)</u>	<u>% change from</u> <u>previous month</u>	<u>Multi-family</u> <u>(mil. units)</u>	<u>% change from</u> <u>previous month</u>
Apr-06	1.832	-7.1	1.524	-5.6	0.308	-13.7
May-06	1.953	6.6	1.587	4.1	0.366	18.8
Jun-06	1.833	-6.1	1.478	-6.9	0.355	-3.0
Jul-06	1.760	-4.0	1.445	-2.2	0.315	-11.3
Aug-06	1.674	-4.9	1.367	-5.4	0.307	-2.5
Sep-06	1.772	5.9	1.426	4.3	0.346	12.7

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Bank of England To Hike on November 9, But What Happens in 2007?

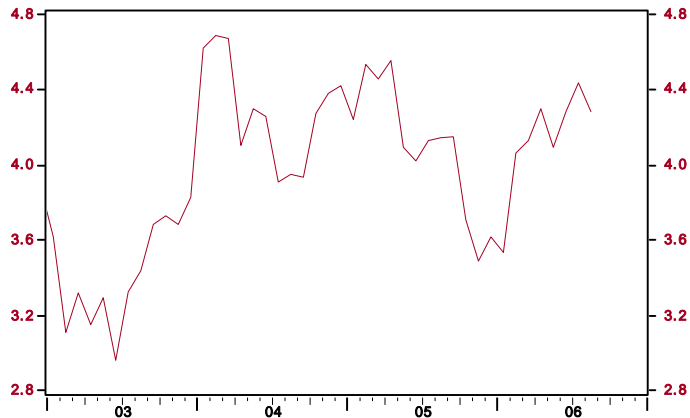
The latest crop of data out of the UK supports the assumption that the Bank of England’s Monetary Policy Committee (MPC) will be hiking the repo rate to 5.0% on November 9. The key question, of course, is whether that will be the last such tightening at this stage in the cycle, or whether one or two additional hikes will be needed next year. At this point, the best we can do is invoke the usual economist’s mantra – watch the data. In particular, watch the inflation, housing market, and labor market data over the next couple of months.

Today’s data hinted that the labor market may be softening. Average earnings growth slowed a tad more in August, rising 4.2% in the three months to August, compared with 4.4% in the three months to July.

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UK: Average Earnings Index: Whole Economy

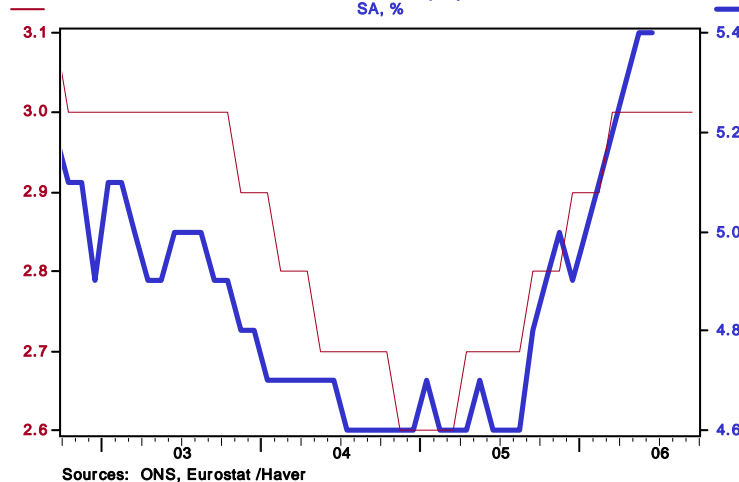
SA, 3-mo. average, % Change - Year to Year



The September claimant count unemployment level jumped to 962,000, the highest level since December 2001, although the jobless rate on this measure remained at 3.0%. According to the broader, internationally-comparable ILO unemployment measure, the August jobless rate rose to 5.5%. However, the hint of softening is not yet a trend.

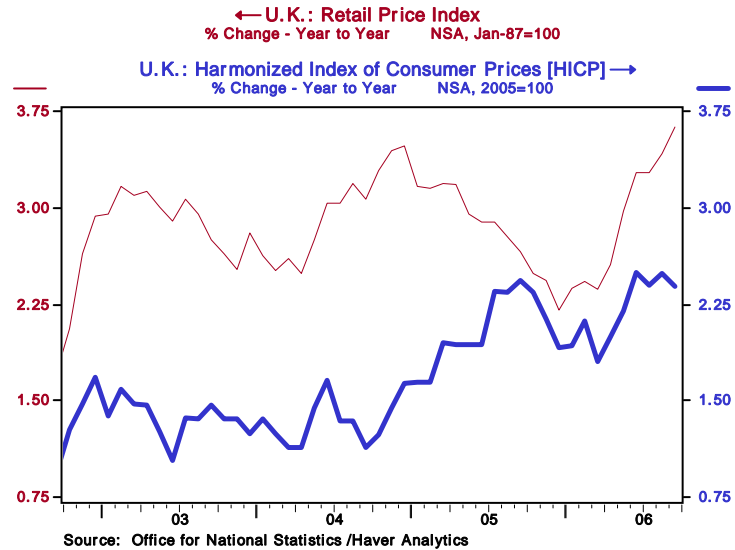
← U.K.: Unemployment: Claimant Count Rate
SA, %

U.K.: Harmonized Unemployment Rate →
SA, %



Yesterday’s headline EU-harmonized consumer price inflation for September didn’t look too bad, easing to 2.4% on the year as petrol prices came down. However, annual retail price inflation – the measure on which many UK pay deals are based – climbed to an eight-year high of 3.6%. This is the kind of number that will have the members of the MPC fretting about wage pressures.

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Today also saw the release of the minutes from the October 5 MPC meeting, at which two of the nine members voted for an immediate rate hike, arguing that consumption is strong and price pressures are picking up. The other members agreed with this assessment but worried that an unexpected hike would boost market expectations of further moves and so provide “an additional degree of tightening which was not required.”

Meanwhile, BoE Governor King continues to state that wage and cost pressures need to be monitored closely, that any dip in inflation at the end of Q3 is likely to prove temporary, and that policymakers need to look beyond short-term fluctuations in oil prices.

All told, there is little doubt that the Committee members anticipate a 25bp rate hike on November 9 – but plenty of doubt about where the economy and interest rates are headed in 2007.

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