Northern Trust

DAILY GLOBAL
COMMENTARY

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3Q Labor Cost Data Point To Weak Profit Growth

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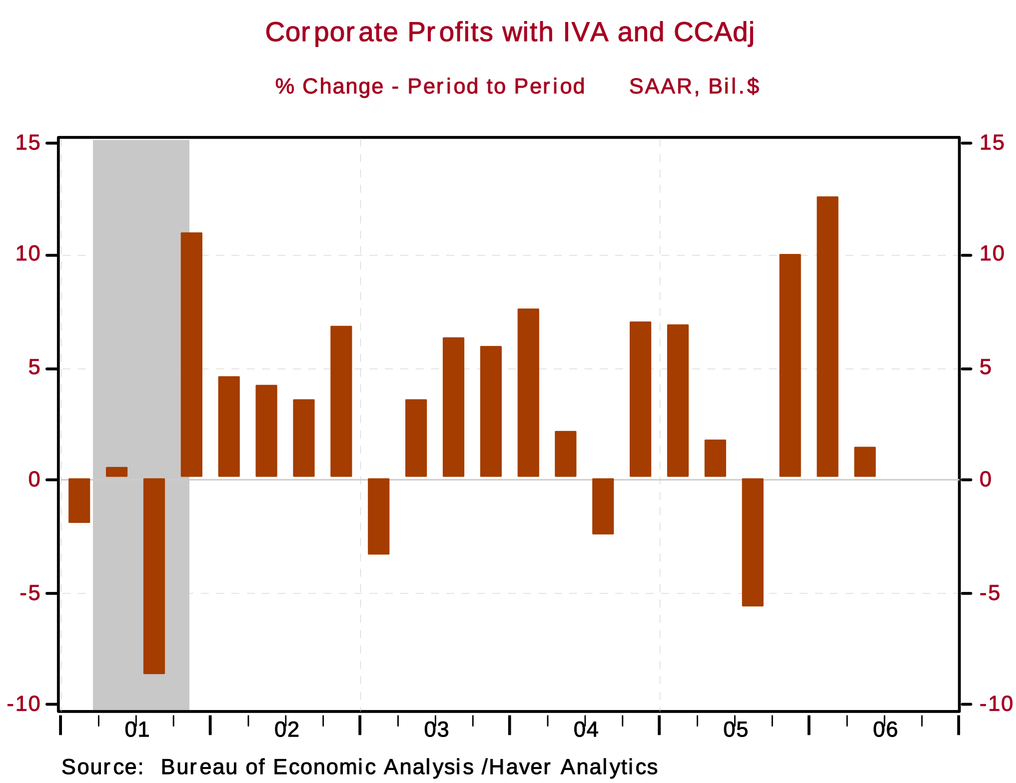
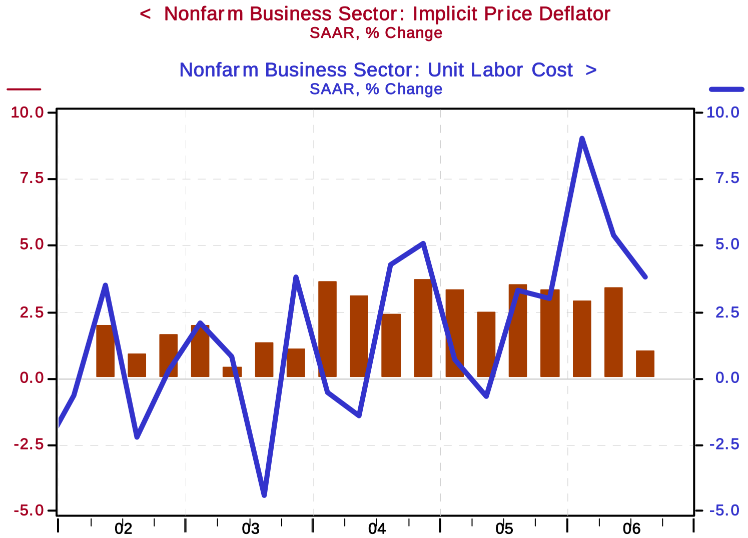
In addition to revisions to third-quarter GDP data, the Commerce Department will release its first estimate of third-quarter corporate profits tomorrow, November 29. As Chart 1 shows, quarter-to-quarter profit growth slowed sharply in the second quarter – to 1.45% from 12.60% in the first quarter. Based on third-quarter labor cost data, I suspect that third-quarter corporate profit growth, *measured sequentially*, will remain tepid, at best. On a year-over-year basis, however, corporate profit growth is likely to appear rosier given the Katrina-depressed profits in the third quarter of 2005.

Chart 1



Here's the explanation. Chart 2 shows that in 2006, unit labor costs in the nonfarm business sector are now consistently growing faster than the prices nonfarm businesses receive for their goods and services. It can be shown algebraically that growth in the implicit price deflator for nonfarm business output minus growth in nonfarm business labor unit costs is equivalent to the gross revenues of nonfarm businesses minus their total labor costs.

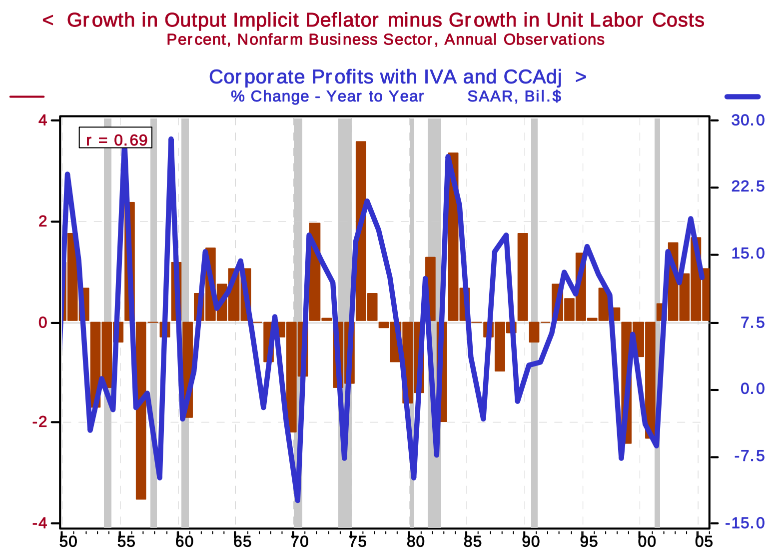
Chart 2



Source: Bureau of Labor Statistics /Haver Analytics

Because labor costs account for the majority of production costs in the United States, rising growth in labor costs relative to the growth in total revenues would be expected to have a negative impact on corporate profits. And, in fact, this is exactly what the historical record shows, as demonstrated in Chart 3. Using annual average data, the contemporaneous correlation between these two series is 0.69 out of a possible 1.00. With unit labor costs rising relative to selling prices and with sales volumes slowing, it is difficult to see how corporate profit growth in the near-term can be very strong. And if profit growth slows, where will corporations get the funds to continue "retiring" equity at a record pace – a factor supporting share prices and household deficit pending?

Chart 3



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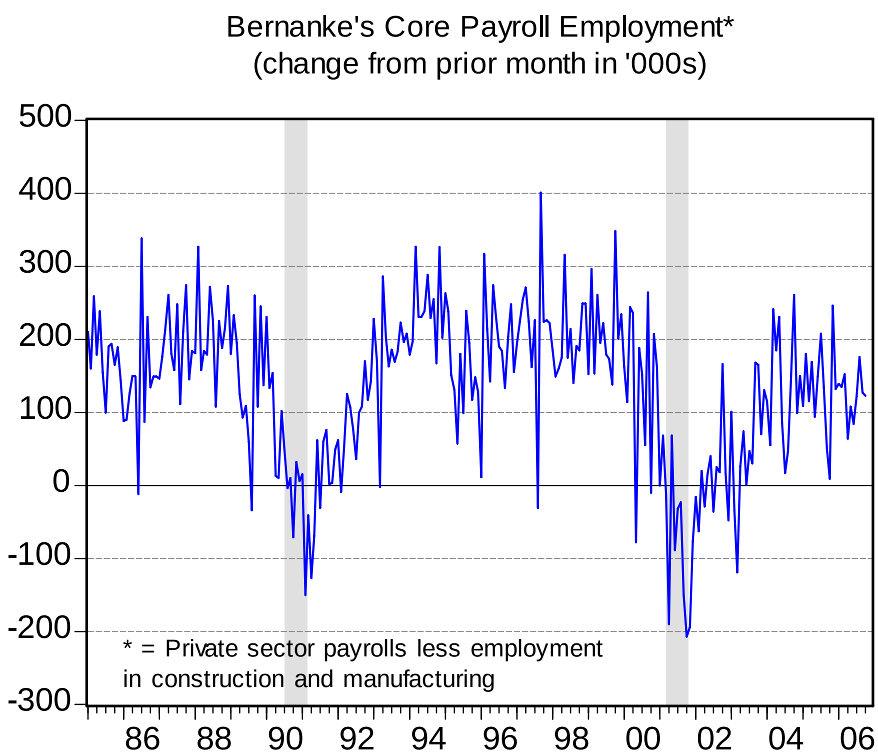
Mr. Bernanke Plays It Safe

Chairman Bernanke played it safe today and left the FOMC uncommitted to a change from its current stance about monetary policy. Once again, Bernanke noted that the risk of higher inflation is troubling and he gave a secondary role to weakening economic conditions. In other words, Bernanke's remarks represent no change in the Fed's view about the near term path of monetary policy despite recent developments that suggest that weak economic conditions warrant a lowering of the federal funds rate. The main conclusion of today's speech is that the FOMC will decide on December 12 if it needs to change its view about the economy.

Moving on to other details of his speech that beg comments: (1) "Private employers in industries outside of manufacturing and construction added nearly 125,000 workers to their payrolls last month, following an average increase of 140,000 jobs per month during the preceding three months." Construction and manufacturing are cyclically sensitive sectors. Mr. Bernanke strips out these components to give us a new "core payroll employment series." We will track these numbers going forward. Housing and housing-related employment has provided the bulk of payroll employment prior to the Fed's tightening actions. As chart 4 shows the Bernanke core payroll data are largely coincident. The Fed needs a leading indicator to be preemptive in its actions. (Shaded region denotes recession in chart 4)

Chart 4



(2). "To date there is little evidence that the weakness in housing markets is spilling over more broadly to consumer spending or aggregate employment. If these trends continue, growth in real activity might return to a pace that could intensify upward pressures on resource utilization." The

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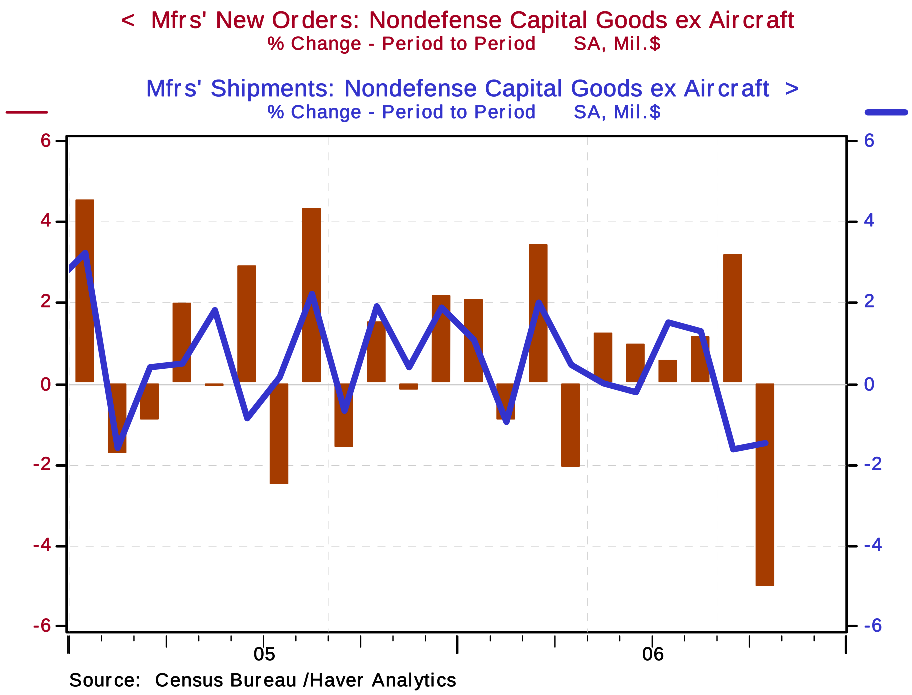
Fed needs to see additional spillover effects before changing course of monetary policy. There should be additional evidence supporting doves on the FOMC in coming months. Chairman Bernanke presented a hawkish outlook but the federal funds futures market voted otherwise. The March federal funds rate contract closed indicting a higher probability of an ease in March 2007 compared with the close yesterday.

Durable Goods Orders -- Weak October Data Set the Tone for Q4

Orders of durable goods fell 8.3% in October after a sharp 8.7% jump in the prior month. These wide swings in orders of durable goods reflect the large variation in orders of civilian aircraft (-44.5% in October vs. +198.2% in September) and defense items (-42.1% in October vs. +39.1% in September).

Chart 5

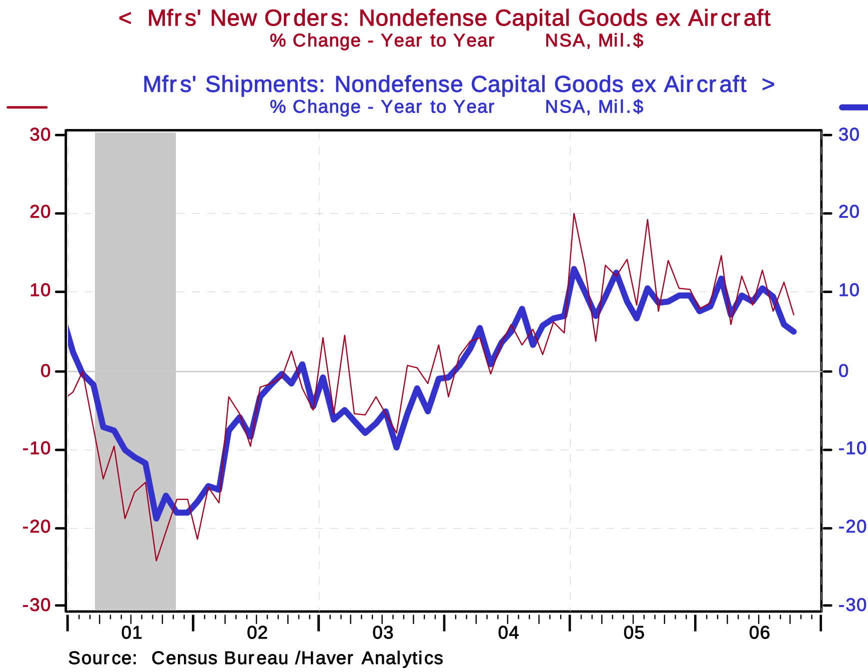


DURABLE GOODS ORDERS - % CHANGE M-M

DATE	TOTAL	DEFENSE	NON-DEFENSE CAPITAL GOODS	NON-DEFENSE CAPITAL GOODS EX-AIRCRAFT	COMPUTERS AND ELECTRONIC PRODUCTS
Apr-06	-4.7	-26.8	-6.5	-2.1	-11.2
May-06	0.3	-7.1	-2.0	1.3	-1.9
Jun-06	3.3	51.7	1.7	0.9	5.7
Jul-06	-2.8	-15.0	-0.9	0.6	4.1
Aug-06	0.0	9.1	-2.0	1.1	-2.1
Sep-06	8.7	39.7	24.7	3.2	2.3
Oct-06	-8.3	-42.1	-15.6	-5.1	-10.2

Orders and shipments of non-defense capital goods excluding aircraft have slowed in October (see chart 6). Bookings of non-defense capital goods excluding aircraft rose 7.2% on a year-to-year basis in October, the smallest increase since March 2005 excluding the 5.9% gain of April 2006. Shipments of non-defense capital goods excluding aircraft moved up 5.0% in October compared with a year ago reading, which is smallest increase since September 2004.

Chart 6



In October, orders of all several categories of durable goods posted declines in orders as did shipments. In particular, shipments of non-defense capital goods excluding aircraft fell 1.5% following a 1.6% decline in the prior month. The level of shipments of non-defense capital goods excluding aircraft in October is below the third quarter average which bodes poorly for the quarterly performance. This category of shipments is the input used to compute the equipment and software spending component of GDP. Based on this information, equipment and software spending is not unlikely to make a positive contribution to real GDP growth in the fourth quarter.

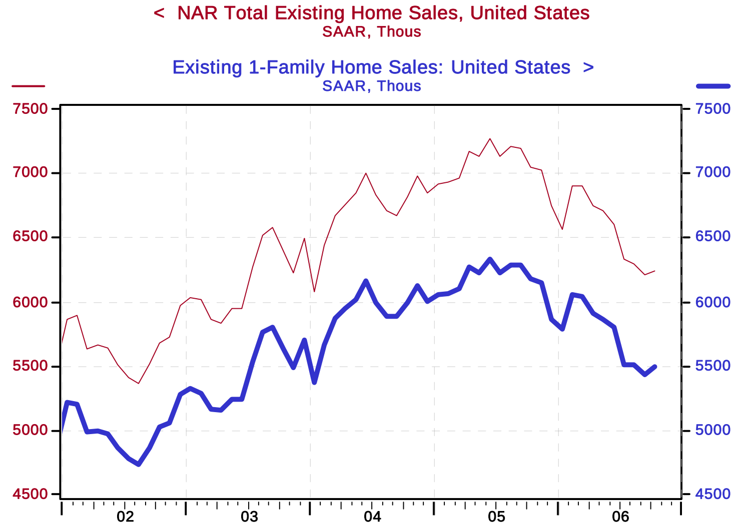
DURABLE GOODS SHIPMENTS- % CHANGE M-M

DATE	TOTAL	NON-DEFENSE CAPITAL CAPITAL GOODS	NON-DEFENSE CAPITAL GOODS EX-AIRCRAFT	COMPUTERS AND ELECTRONIC PRODUCTS
Apr-06	-1.2	-1.4	0.4	-1.2
May-06	3.0	2.1	0.0	1.6
Jun-06	0.2	-0.2	-0.2	-0.4
Jul-06	-1.3	0.6	1.5	1.3
Aug-06	2.1	2.0	1.3	1.0
Sep-06	-2.7	-0.3	-1.6	-3.6
Oct-06	0.6	-2.3	-1.5	1.1

Sales of Existing Homes Move up a Little Bit, But Prices Post Record Decline

Sales of all existing homes rose 0.5% to an annual rate of 6.24 million units. Sales of existing homes fell in the South (-1.2%) and Northeast (-2.9%), held steady in the Midwest,and rose 6.4% in the West. Sales of single-family existing homes rose 1.3% in October, the first monthly gain in the thirteen months ended October. On a year-to-year basis, sales of single-family existing homes dropped 1.1% in October, following a sharp 19.1% drop in September. The Pending Home Sales Index (PHSI) is indicative of actual home sales two months down the road. The September drop in the PHSI points to a likely decline in existing home sales in November.

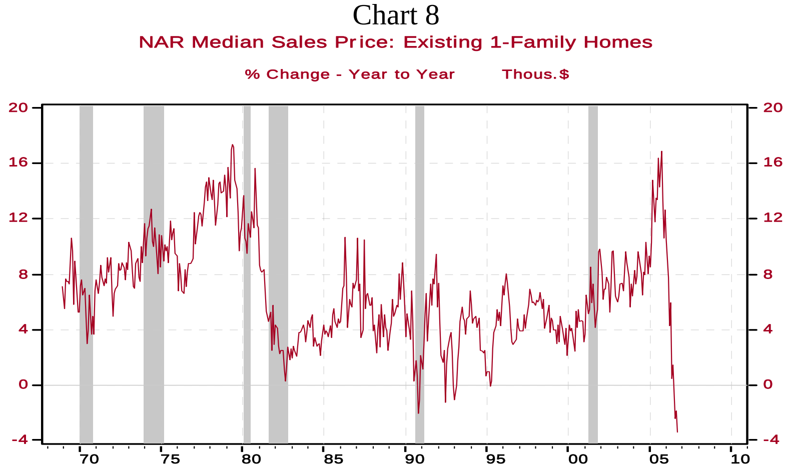
Chart 7



Source: National Association of Realtors /Haver Analytics

Sales of existing homes made a small dent in October partly due to lower prices. The median price of a single family home rose slightly in October to $221,300 vs. $221,100 in the prior month. However, on a year-to-year basis, the median price of an existing single-family home declined 3.5% in October, the largest drop recorded in the history of this series (see chart 8).

Chart 8



Source: National Association of Realtors /Haver Analytics

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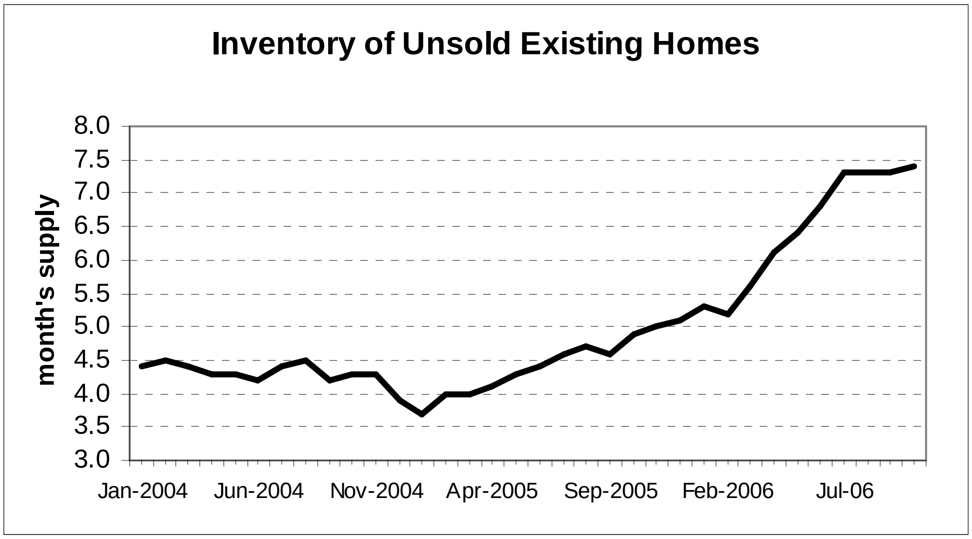
The inventory of unsold existing homes rose 51.0% from a yea ago to a 7.4 month supply in October. This rising inventory of unsold existing homes is troubling because it is indicative of further declines in prices of existing homes.

Chart 9



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Brazil: Nearing the end of the line?

Brazil's central bank has cut its benchmark lending rate, the Selic, by six percentage points over the past fourteen months to its lowest level in over two decades, 13.75%. Despite signs of a slight uptick in inflation, investors are eagerly waiting to see if the central bank will trim another 25-50 basis points off the overnight rate at tomorrow's conclusion of the two-day policy meeting,.

Rising food prices pushed up Brazil's monthly inflation, as measured by the government's IPCA-15 consumer price index, in the thirty days through November 13th (0.37%) compared to the month ended October 11th (0.29%). The rise in food prices has caused economists to increase their 2006 inflation estimates to 3.15%, but the average forecast for 2007 has remained steady at 4.1%. Both rates are below the central bank's targeted midpoint of 4.5%.

Growth forecasts are moderate for Latin America's largest economy, as low borrowing costs are expected to spur consumer spending, countering the effects of an export market that is struggling in the wake of a still-strong currency. Third-quarter GDP data will also be released tomorrow, which should support our forecast for a steady 3.0% expansion in 2006.

Benign inflation and sub-par growth forecasts support additional monetary easing in 2007. The pace of rate cuts, however, will undoubtedly slow as there are growing concerns that rising sugar prices (due to increased ethanol production), strong domestic demand, and a weakening currency (the real has fallen 1.3% this month) could translate into unexpected inflationary pressures.

The central bank's next policy meeting will be on January 23-24.