

DAILY GLOBAL  
COMMENTARY

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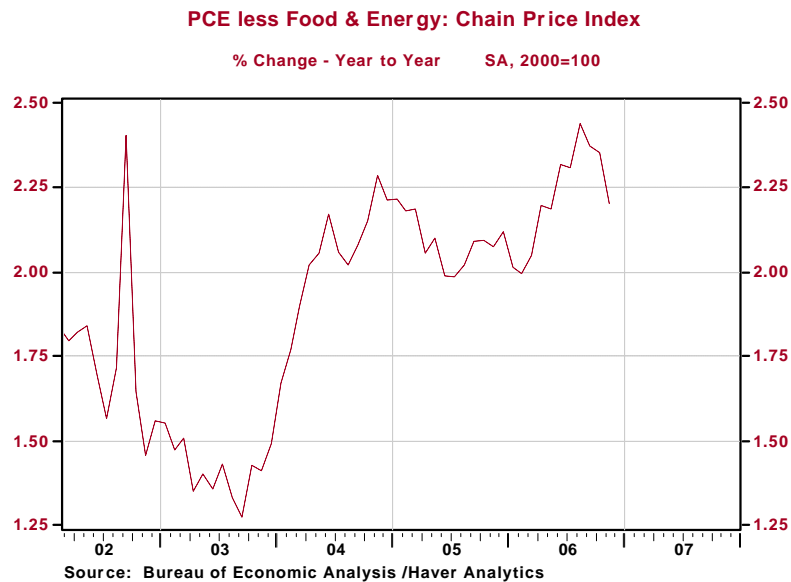
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## Inflation Still the Predominant Concern, But Recognition of Risk of Weak Growth Has Emerged

January 3, 2007

The minutes of the December 12 FOMC meeting suggest that inflation is the predominant concern in the inflation-growth debate. This is justified because the FOMC did not have the latest data about core inflation. The personal consumption expenditure price index excluding food and energy -- the Fed's preferred measure on core inflation -- rose 2.2% in November on a year-to-year basis, down from a peak of 2.44% in August. As chart 1 illustrates, core inflation has most likely peaked. Given the projection of slower economic growth in the first-half of 2007, it is plausible to expect further moderation in core inflation. The upcoming FOMC debate on January 30 and 31 is most likely to have quite a different tone given the nature of incoming data.

Chart 1



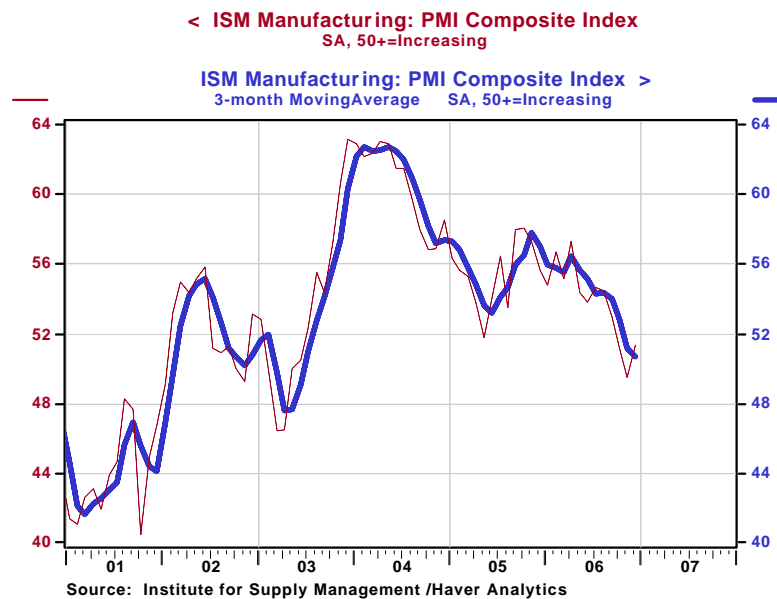
The minutes noted that “economic activity in the second half of this year was probably a touch softer than had been expected at the time of the October meeting.” It is also noteworthy that members of the FOMC remarked that “the subdued tone of some incoming indicators meant that the downside risks to economic growth in the near term had increased a little and become more broadly based than previously thought.” Also, “one member did not favor language that referenced only the possibility of additional policy firming and believed that although risks of inflation remained the predominant concern, the statement should emphasize that policy could be adjusted in either direction depending on the evolution of the outlook for inflation and economic growth.” A shift to complete acknowledgement of the risk of weak economic growth as the predominant concern should not be surprising in the January policy statement.

## Mixed Economic News Is the Rule Recently

On the bullish side, the ISM manufacturing survey for December shows a small rebound in activity. Mortgage applications posted a minor recovery, but its level is not encouraging. On the bearish side, residential construction spending remains weak and the ADP employment report showed a net loss of jobs in December. Despite a few bullish economic reports, the economy in the near term is most likely to show a tepid performance and the Fed's next move is to lower the federal funds rate.

The ISM manufacturing survey results for December indicate a small improvement with the Purchasing Managers' Index (PMI) moving up to 51.4 in December after a 49.5 mark in November. Indexes tracking production, new orders, employment, and supplier deliveries advanced in December. Indexes tracking exports and imports showed slower growth in December compared with November. The important message is that the nation's factory sector appears resilient. The FOMC will need to see additional monthly gains to fully confirm that a meaningful factory sector recovery is underway. The PMI has dropped in eight out of twelve months of 2006 and the fourth quarter average is the lowest since the second quarter of 2003.

Chart 2



Responses cited in the survey point to continued weakness in furniture and related industries (a 10% drop in production is being projected for first half of 2007), slowing conditions in the chemical products sector, but strong demand for computer and electronic products and transportation equipment were also noted. A recovery is reported in the automotive sector after flat/down conditions in the prior few months.

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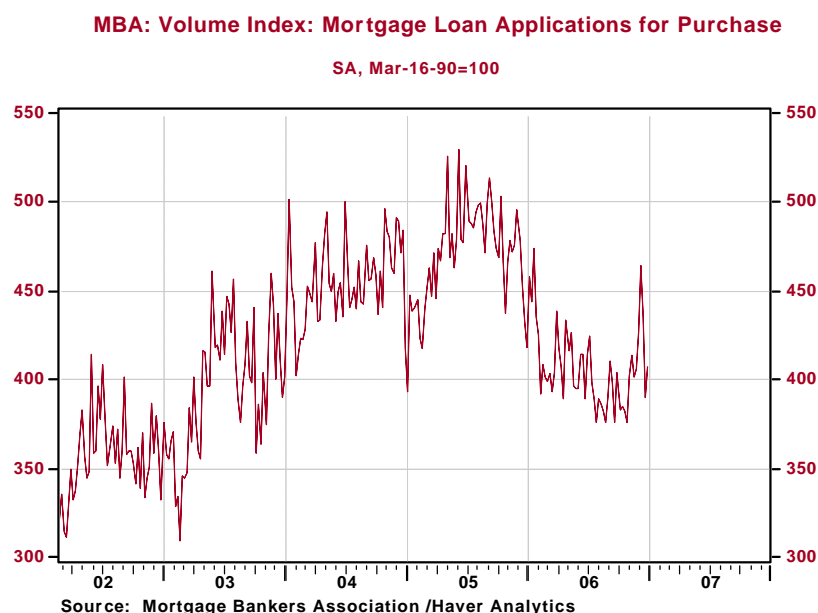
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### ISM Manufacturing Survey – December 2006

	<u>Jul-2006</u>	<u>Aug-2006</u>	<u>Sep-2006</u>	<u>Oct-2006</u>	<u>Nov-2006</u>	<u>Dec-2006</u>
<b>Composite Index</b>	54.7	54.5	52.9	51.2	49.5	<b>51.4</b>
<b>New Orders</b>	56.1	54.2	54.2	52.1	48.7	<b>52.1</b>
<b>Production</b>	57.6	56.6	56.1	51.9	48.5	<b>51.8</b>
<b>Employment</b>	50.7	54.0	49.4	50.8	49.2	<b>49.7</b>
<b>Vendor Deliveries</b>	55.4	55.0	54.1	50.2	52.8	<b>53.4</b>
<b>Inventories</b>	50.5	50.2	46.4	49.4	49.7	<b>48.4</b>
<b>Prices</b>	78.5	73.0	61.0	47.0	53.5	<b>47.5</b>
<b>Backlog of Orders</b>	50.5	51.5	46.5	44.5	46.5	<b>45.0</b>
<b>New Export Orders</b>	51.9	55.7	55.3	57.8	56.9	<b>54.3</b>
<b>Imports</b>	57.5	54.0	56.0	57.0	56.5	<b>55.5</b>

The housing sector remains in a recession despite the recent reports of improving sales of both new and existing homes during November. Anecdotal reports continue to point to weak demand conditions. The Mortgage Bankers Association’s Mortgage Purchase Index rose to 406.9 from a low of 390.2. The latest reading is well below the 463.8 mark reported for the week ended December 8. The blip in the early December numbers of the mortgage purchase index appears to be temporary, additional confirmation like the factory survey report will be necessary for the FOMC to declare that a noteworthy improvements are underway.

Chart 3

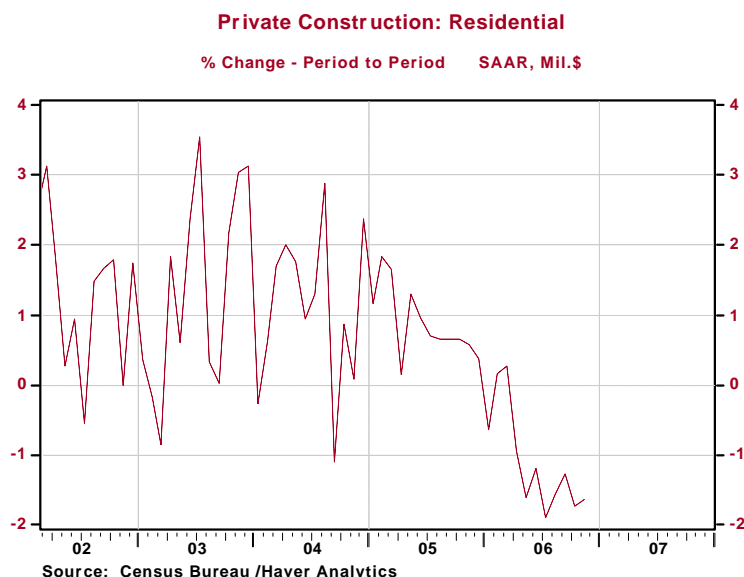


Construction outlays in the residential sector fell 1.6% in November, marking the eighth consecutive monthly decline (see chart 4). During the October-November period, residential construction expenditures have dropped at an annual rate of 14.6% after a 17.3% drop in the third

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quarter. This bodes poorly for residential investment expenditures in the fourth quarter GDP report. Residential investment expenditures dropped 18.7% in the third quarter, the fourth consecutive quarterly drop. On the positive side, construction expenditures in the non-residential sector (+1.4%) have risen in both October and November, implying a positive contribution to fourth quarter GDP. Non-residential structures grew at an annual rate of 15.7% in the third quarter.

Chart 4



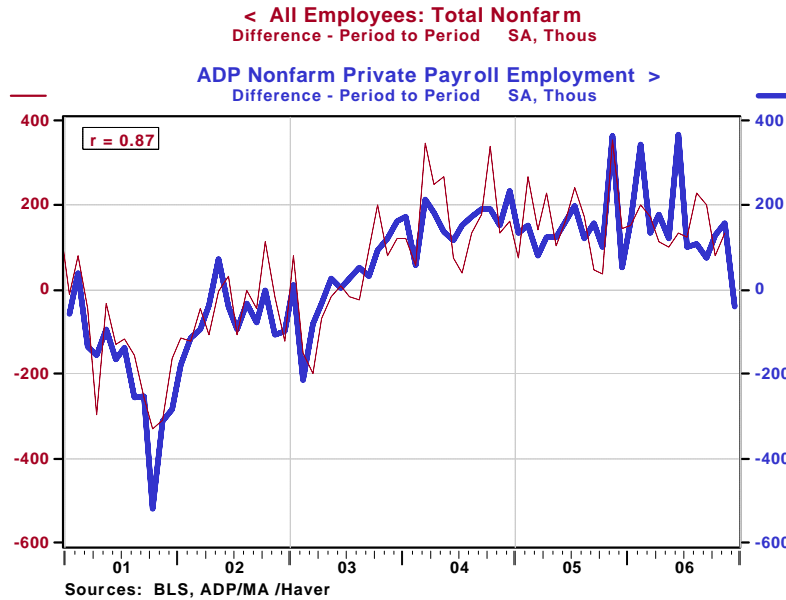
Construction Spending – (percent change from prior month)

	<u>Total</u>	<u>Private</u>	<u>Residential</u>	<u>Non-residential</u>	<u>Public</u>
May-2006	-0.4	-1.0	-1.6	0.5	1.5
Jun-2006	0.0	-0.2	-1.2	2.0	0.8
Jul-2006	-0.7	-0.7	-1.9	1.7	-0.8
Aug-2006	0.0	-0.1	-1.6	3.0	0.1
Sep-2006	-0.8	-1.0	-1.3	-0.5	0.1
Oct-2006	-0.3	-1.0	-1.7	0.5	1.9
<b>Nov-2006</b>	<b>-0.2</b>	<b>-0.6</b>	<b>-1.6</b>	<b>1.4</b>	<b>1.0</b>

Speaking about bearish indicators, the ADP employment report shows a loss of 40,000 jobs in December. These estimates are positively correlated to nonfarm payrolls (see chart 5). The official employment report on Friday will give us a complete take on the labor market situation.

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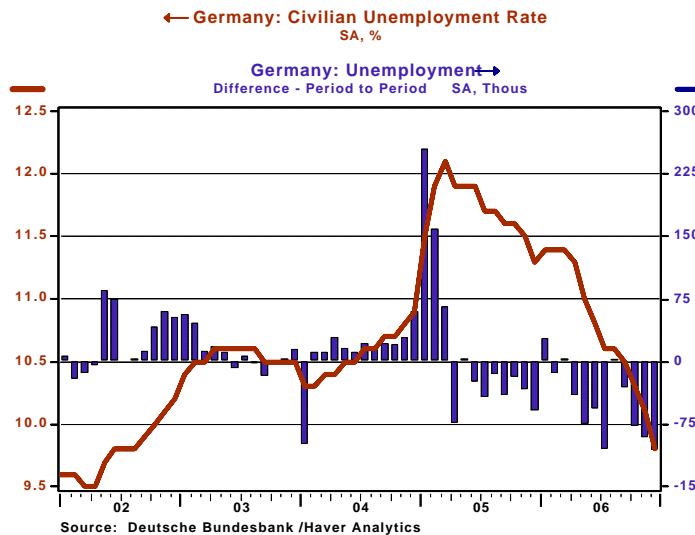
Chart 5



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### German Economy Looking Pretty Robust Heading Into 2007

Germany's seasonally-adjusted jobless total recorded its sharpest monthly fall in over 50 years last month, dropping by 108,000 from November – the ninth consecutive decline. This brought the adjusted unemployment rate down from 10.1% in November to 9.8% – the first time the politically-sensitive number has fallen below 10.0% since September 2002.



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There were some specific factors that explain part of this improvement. Relatively mild weather helped to ease the usual drop in employment at the start of winter (particularly in the construction industry). And, the introduction of a seasonal short-term working benefit, designed to avoid winter unemployment in weather-sensitive industries, also reduced the usual rise in (unadjusted) unemployment numbers. This implies that the level of labor market improvement in the next couple of months will be more muted. Even so, such a marked drop in the jobless number is impressive and is a further indication of the strength of the German economy heading into 2007. After a long period of sub-par growth, painful corporate restructuring and recent labor market reforms are finally having an impact.

Yesterday came the news that activity in the manufacturing sector strengthened to a six-month high in December, with the (seasonally-adjusted) Purchasing Managers' Index rising to 59.4 from 58.3 in November. The component output index climbed to 61.3 (59.1 in November) and the new orders index hit 61.0 (60.6 in November). Both domestic and foreign orders apparently rose on the month, with new export business up for the 41<sup>st</sup> consecutive month. Interestingly, the rate of inflation of average charges also picked up sharply, reaching its second-highest level since data were first collected in September 2002. Companies reportedly were encouraged to increase their output prices by strong demand, as well as by further inflation in average costs.

Back on December 20 we learned that German companies were feeling very optimistic heading into the New Year, with the Ifo business survey jumping to its highest level since 1991, and the forward-looking business expectations index rising for the third month in a row. (See [Daily Global Commentary, December 20: Germans Confident, Belgians More Cautious, Heading Into 2007](#).) However, on December 29 came the news that consumer sentiment is slipping, with the forward-looking GfK consumer climate indicator dropping from 9.2 for December to 8.7 for January, its first such fall in over a year. Consumers were rattled at the prospect of the three percentage point hike in the VAT rate that kicked in on January 1. It remains to be seen whether this concern actually translates into reduced consumer demand over the coming months, and if so, how far this impacts the corporate sector.

Meanwhile, data to watch for the rest of this month include November retail sales (Jan. 4-8) and industrial production (Jan. 9). More relevant for the 2007 outlook will be the January Ifo business survey (Jan. 25), the next GfK consumer sentiment survey (Jan. 26), and January's preliminary inflation data (sometime in the final week).