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DAILY GLOBAL
COMMENTARY

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Bernanke Sticks to Essence of January FOMC Statement

February 14, 2007

Inflation, the housing market, and overall economic growth are the three major issues the Fed is focused on. Chairman Bernanke reiterated the essence of the January FOMC policy statement -- inflation is the Fed's primary concern. The hawkish posture of the FOMC was visible in several parts of the testimony. Here are the excerpts that highlight the Fed's focus on inflation:

- "Readings on core inflation--that is, inflation excluding the prices of food and energy--have improved modestly in recent months. Nevertheless, the core inflation rate remains somewhat elevated."
- "The monthly data are noisy, however, and it will consequently be some time before we can be confident that underlying inflation is moderating as anticipated."
- "Thus, the high level of resource utilization remains an important upside risk to continued progress on inflation."
- "The FOMC has continued to view the risk that inflation will not moderate as expected as the predominant policy concern."

The Fed remains bothered by the housing market and the ripple effects of the downturn. The objective view based on incoming data runs as follows:

- "The principal source of the ongoing moderation has been a substantial cooling in the housing market, which has led to a marked slowdown in the pace of residential construction. However, the weakness in housing market activity and the slower appreciation of house prices do not seem to have spilled over to any significant extent to other sectors of the economy."
- "Some tentative signs of stabilization have recently appeared in the housing market: New and existing home sales have flattened out in recent months, mortgage applications have picked up, and some surveys find that homebuyers' sentiment has improved."

The more worrisome side of the issue emerges in these observations:

- "However, even if housing demand falls no further, weakness in residential investment is likely to continue to weigh on economic growth over the next few quarters as homebuilders seek to reduce their inventories of unsold homes to more-comfortable levels."
- "The projection for GDP growth in 2007 is slightly lower than our projection last July. This difference partly reflects an expectation of somewhat greater weakness in residential construction during the first part of this year than we anticipated last summer."

- "The risks to this outlook are significant. To the downside, the ultimate extent of the housing market correction is difficult to forecast and may prove greater than we anticipate. Similarly, spillover effects from developments in the housing market onto consumer spending and employment in housing-related industries may be more pronounced than expected."

The FOMC's forecast for 2007 and 2008 show small changes. Real GDP growth and unemployment rate are now revised down slightly from the July estimate. The prediction of core inflation was left unchanged.

FOMC's "Central tendency" Projections for 2007 and 2008

	2007	2008
Real Gross Domestic Product - Q4 to Q4	**2-1/2% - 3.0%**	**2-3/4% - 3.0%**
(July Forecast)	(3.0% - 3-1/4%)	
Unemployment rate - Q4	**4-1/2% - 4-3/4%**	**4-1/2% - 4-3/4%**
(July Forecast)	(4-1/2% -5.0%)	
Core Inflation	**2.0% - 2-1/4%**	**1-3/4% - 2.0%**
(PCE price index less food and energy)		
(July Forecast)	(2.0% - 2-1/4%)	

Retail Sales Were Soft In January

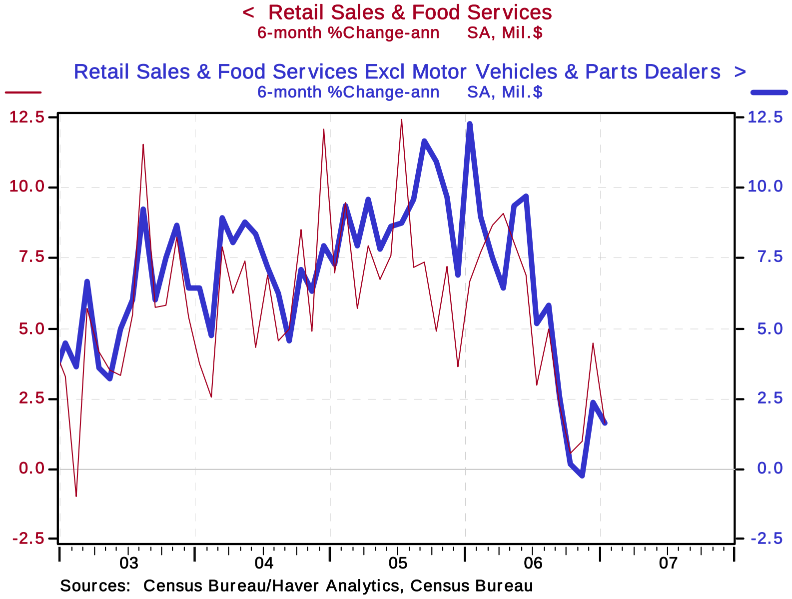
Retail sales held steady in January after an upwardly revised 1.2% increase in the prior month. Auto sales fell 1.3% but unit auto sales were nearly unchanged. Lower prices brought down gasoline sales 0.7% and the food services component dropped 0.7%. Purchases of furniture (+0.8%), building materials (+0.8%) and apparel (+1.0%) advanced and offset the declining components of retail sales.

Retail Sales – January 2007

	November	December	January	06:Q4	07:Q1
				quarterly change SAAR	
Total Retail Sales & Food Service, % m-o-m	**0.4**	**1.2**	**0.0**	**0.3**	**3.8**
% change y-o-y	4.7	3.9	4.3		
Ex-auto, % m-o-m	**0.6**	**1.3**	**0.3**	**-1.1**	**5.6**
% change y-o-y	4.8	4.5	5		
Ex- autos and gas % m-o-m	**0.4**	**1.0**	**0.5**	**3.8**	**5.0**
% change y-o-y	5.5	4.7	5.8		
Exc. Bldg. mat., auto, gas, % m-o-m	**0.3**	**1.0**	**0.4**	**5.1**	**4.9**
% change y-o-y	6.1	5.2	6.6		
* -annualized change based on Jan. data					

Retail sales (see chart 1) show a distinct moderation in pace during the last six months. The FOMC is, for now, of the opinion that the ripple effects of the housing market recession are contained, particularly with respect to consumer spending. This may have to be revised in the months ahead as additional evidence becomes available.

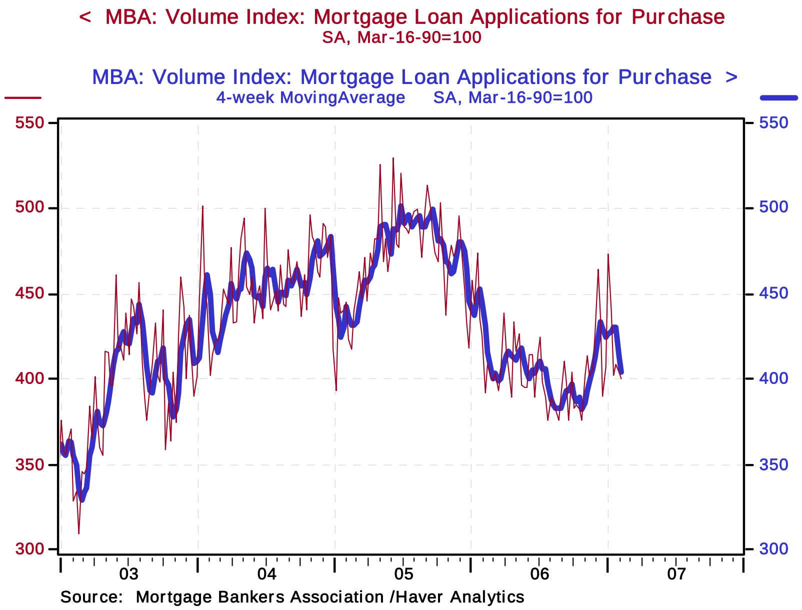
Chart 1



Distortion from Warm Weather Is Fading

The Mortgage Purchase Index dropped to 400.7 during the week ended February 9, marking the fourth weekly decline in the pas five weeks. The gains in the Purchase Index seen in November, December and early-January were partly due to poor seasonal adjustment and the warmer-than-typical weather conditions. The Mortgage Refinance Index moved up to 2031.7 from 1943.4 in the previous week.

Chart 2



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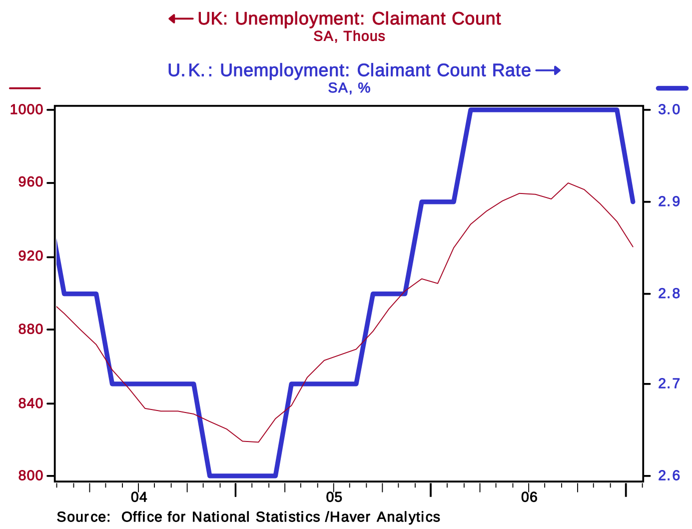
Bank of England Says One More Rate Hike Will Be Necessary

While there was mixed news in this morning's labor market data for December, the markets focused on the latest Bank of England (BoE) Quarterly Inflation Report which had one unambiguous message – interest rates will have to go up once more this cycle, if the BoE is to meet its inflation target.

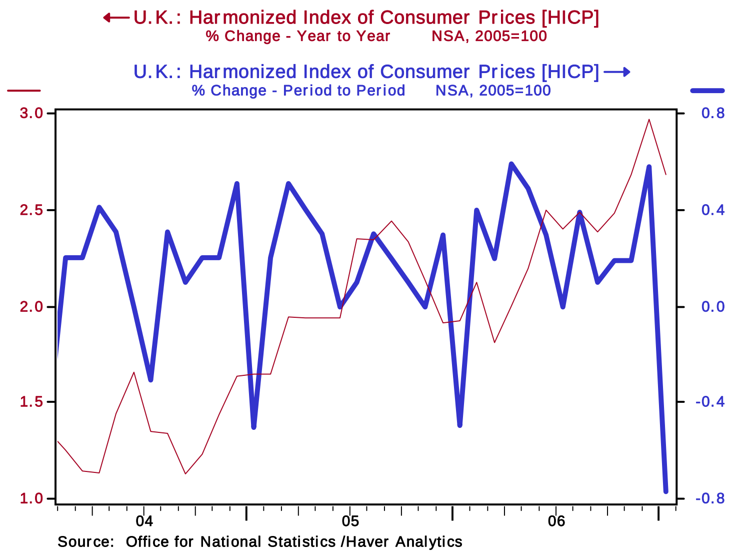
The report stated that inflation would fall to 2.0% in two years' time assuming one more hike in interest rates. If the repo rate stays at the current 5.25%, then inflation will overshoot the target. Governor King was equally unequivocal: "the path of interest rates assumed for this projection is about 25 basis points above current rates."

The governor noted that the inflation outlook over the coming year is "highly uncertain," citing shifts in domestic gas and electricity prices – which have recently fallen sharply – as well as concerns about fluctuations in global oil prices. He also hinted that the housing market may be on the verge of softening – which would be "a welcome development" – but warned that it is too early to tell whether or not wages will go up.

Data today showed that wages rose a less-than-expected 4.0% on the year in the October-December period, down slightly from 4.1% in the three months to November. On the other hand, claimant-count unemployment dropped by 13,500 last month, the largest monthly decline in nearly three years, taking the claimant-count jobless rate down to 2.9%. The EU-harmonized unemployment rate remained at 5.4% for the sixth consecutive month in December. The data generally support the BoE's Quarterly Inflation Report comment that the recent period of labor market loosening may be coming to an end.



Yesterday's inflation data showed that the annual pace of price increases dropped sharply from the 3.0% peak seen in December to just 2.7% in January, as consumer prices actually fell 0.8% on the month. The pull back was largely the result of falling fuel costs.



The only question now is *when* the BoE's Monetary Policy Committee (MPC) will take the repo rate up to 5.50%. January's rate hike was the result of a very close 5-4 vote. We will have to wait for the minutes of the February 8 policy meeting, which will be released February 21, to see whether the perspective of any of the members has started to shift. Given the closeness of the January vote, and the uncertainties about the near-term inflation and demand outlook, our best guess is that the Committee will not be tightening again until the May 10 meeting, but April 5 remains a possibility. The Minutes on February 21 should give some clues; otherwise it remains a case of "watch the data."