Northern Trust

WEEK IN REVIEW

October 9 – October 12, 2007

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul L. Kasriel
plk1@ntrs.com

Asha Bangalore
agb3@ntrs.com

Federal Reserve Policy – Keep Options Open in *Uncertain* Circumstances

The Fed is expected to ease monetary policy in the months ahead but the timing is not certain. The nature of incoming data points to the Fed standing pat at the October meeting. It is conceivable they could act in October and not wait until December, but the probability for a December rate cut is stronger given the nature of the Census Bureau's report on September retail sales and employment data.

During the week, President Yellen of San Francisco and William Poole of the St.Louis Fed spoke and the Fed published the minutes of the September 18 FOMC meeting. Starting with Fed rhetoric, according to President Yellen the September 18 FOMC decision to lower the federal funds rate 50 basis points was "a forward-looking and preemptive approach to policy. The policy move was not primarily a reaction to data in hand at the time of the meeting. Under the circumstances, available information on spending and output mainly reflected conditions before the financial disruptions began and was therefore less informative than under normal conditions about the appropriate stance of policy." She also noted that it is "inherently difficult to assess the stance of policy that is needed to ensure that the economy would grow at a moderate pace given ***uncertainties*** about financial developments and their impact on the economy." President Yellen also noted that monetary policy was probably restrictive even before the September 18 action.

President Poole presented a more optimistic view and noted that "although there is a substantial distance to go, restoration of normal spreads and trading activity appears to be under way, and we can be confident that in time the market will straighten out the problems. We do not know, however, how much time will be required for us to be able to say that the current episode is over." Uncertainty is a prominent theme in recent speeches of Fed officials including Governor Kohn's speech of October 5.

In Governor Kohn's opinion we "should view these forecasts even more skeptically than usual. The FOMC emphasized the considerable ***uncertainty*** in the outlook. As I noted earlier, we do not know how financial markets will evolve, and we do not know how households and businesses will respond to financial developments. Naturally, these types of ***uncertainties*** are greatest when markets are behaving abnormally. The recovery from the problems of the early 1990s was prolonged because banks had to rebuild capital; the rebound from the market crisis of 1998 was swifter, helped along by higher productivity growth and the rise in the stock market that accompanied the optimism about high-tech profits. We will need to be nimble in adjusting policy to promote growth and price stability."

The minutes of the September 18 FOMC meeting were significantly more bearish about the economy compared with the minutes of the August 7 FOMC meeting. **Here are highlights of the minutes pertaining to revision of the staff forecast:**

- The staff forecast for the fourth quarter of 2007 has been lowered because of the financial market turbulence.

- The minutes did not specify the magnitude of the mark down, but the forecast for 2008 is trimmed down.
- The forecast includes a modest increase in the unemployment rate. The official semi-annual forecast published in July showed a 4-3/4% unemployment rate as the central tendency compared with 4-1/2% -4-3/4% unemployment rate for 2007. The jobless rate in September was 4.7%.
- Residential investment expenditures are predicted to add to GDP only in the middle of 2008. In other words, declines in residential investment expenditures are expected in the second-half of 2007 and first-half of 2008.
- Businesses are predicted to "scale back capital spending."
- Economy is expected to grow below potential in 2008. "GDP was projected to firm in 2009 to a pace a bit above the rate of growth of its potential."
- Core PCE inflation was trimmed down and headline PCE inflation was expected to slow in 2008 and 2009

The minutes indicated that the FOMC regards the "outlook for economic activity as characterized by particularly high ***uncertainty***, with risks to growth skewed to the downside." There were mixed opinions about how much the current financial shock will affect the economy. Financial conditions were seen as "still fragile and that further adverse credit market developments could well increase the downside risks to the economy." Contrary to the staff forecast, members of the FOMC were more optimistic about business capital spending and expect investment to "remain healthy in coming quarters." The FOMC has changed its view about inflation since the August meeting. It now sees the "inflation situation to have improved slightly and judged that it was no longer appropriate to indicate that a sustained moderation in inflation pressures has yet to be shown. But, they agreed that "some inflation risks remain."

The minutes excluded any type of explicit guidance about the timing of the next federal funds rate cut. But, it was noted that "given the heightened ***uncertainty*** about the economic outlook, the Committee decided to refrain from providing an explicit assessment of the balance of risks, as such a characterization could give the mistaken impression that the Committee was more certain about the economic outlook than was in fact the case. Future actions would depend on how economic prospects were affected by evolving market developments and by other factors."

Financial Times of October 10 also echoed the "**uncertainty**" theme in two articles (FT.com / World - Corporate America racked by uncertainty and FT.com / Comment & analysis - The quest for a clear direction.) According to the latter article fifty percent of the top 120 business leaders in the U.S. responded that they would leave capital spending unchanged, twenty five percent indicated they would cut payrolls, and retailers are supposedly taking a cautious approach to inventories for the holiday season. In sum, uncertainty is the flavor of the season.

Table 1 Indicators of Market Stress (basis points)

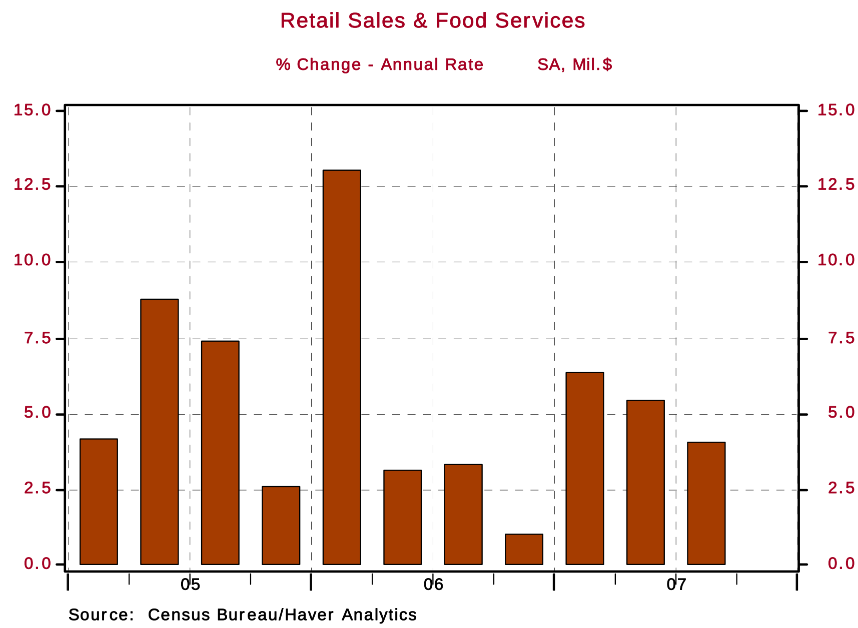
	7/17/07	8/17/07	8/24/07	8/31/07	9/7/07	9/14/07	9/21/07	9/28/07	10/5/07	10/12/07	High 2007	Low 2007
3-month Libor less 3-month U.S. Treasury bill	54	185	138	171	177	175	156	151	135	114	**241.50** 8/20/2007	**31.00** 2/20/2007
3-month Commercial Paper less 3-month U.S Treasury bill	43	161	117	152	152	154	120	120	109	107 10/11/07	**215.00** 8/20/2007	**17.00** 2/22/2007
Merrill Lynch junk bond yield less 10-year U.S. Treasury note yield	320	442	431	454	465	454	409	408	399	386 10/11/07	**471.40** 9/10/07	**266.90** 6/12/07

Retail Sales – September 2007

September Retail Sales: Gasoline Prices Exaggerate Headlines, Other Items Were Less Impressive

Retail sales increased 0.6% in September after a 0.3% gain in the prior month. Excluding the 2.0% jump in gasoline sales and 1.2% increase in auto sales, retail sales moved up 0.2% in September after a 0.1% drop in August. The increase in gasoline sales reflects higher prices. Unit auto sales, which matters for consumer spending in the GDP report, were nearly flat in September and declined in the third quarter (15.9 million units vs. 16.1 million units in Q2). In the third quarter, total nominal retail sales rose at an annual rate of 4.0% compared with a 5.4% increase in the second quarter (see chart 1). Also, on a year-to-year basis (see table 2 and chart 2), retail sales are decelerating. In September 2007, total retail sales rose 2.9% compared with a 4.9% gain in September 2006.

Chart 1



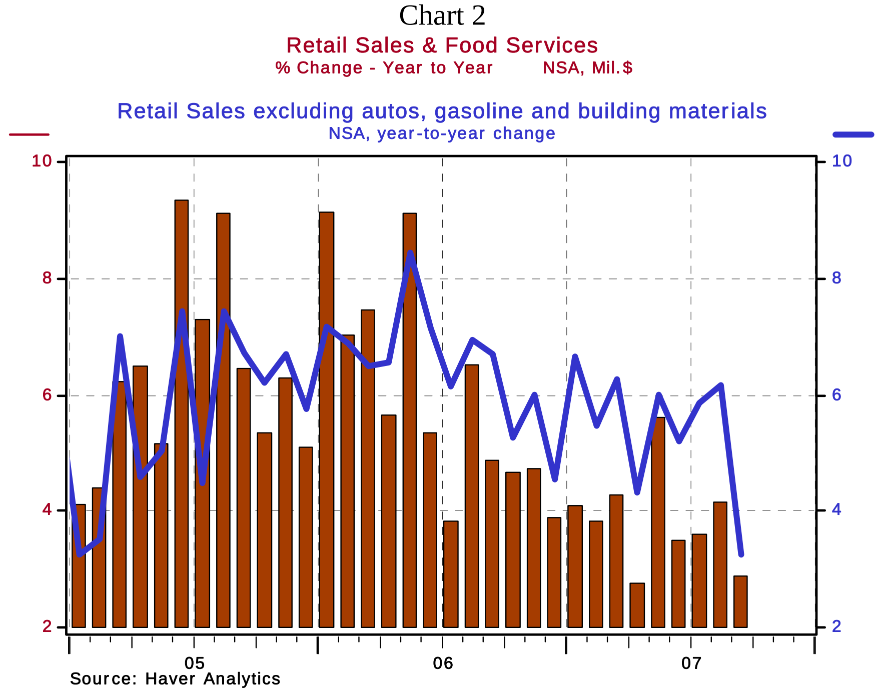
In September, sales of apparel (-0.4%), furniture (-0.6%), and general merchandise fell (-0.1%). Purchases of building materials rose 0.1% in September following a 1.3% drop in the prior month. Sales of building materials dropped at an annual rate of 1.2% in the third quarter vs. a 4.9% increase in the second quarter. Excluding sales of building materials, (which are a part of residential investment expenditures) autos, and gasoline, *nominal* retail sales advanced at an annual rate of 5.8% vs. a 5.4% increase in the second quarter. Inflation adjusted retail sales excluding sales of building materials, autos, and gasoline rose at an annual rate of 3.0% in the second quarter. Assuming a 0.2% increase in the CPI excluding energy for September results also in a 3.0% annualized increase. In other words, consumer spending on goods is holding on at a soft level but has not deteriorated, as yet.

Table 2 Retail Sales – September 2007

	July	August	September	07:Q2	07:Q3
				quarterly change SAAR	
Total Retail Sales & Food Service, % m-o-m	**0.6**	**0.3**	**0.6**	**5.4**	**4.0**
% change y-o-y	3.6	4.2	2.9		
Ex-auto, % m-o-m	**0.7**	**-0.4**	**0.4**	**7.7**	**4.0**
% change y-o-y	4.8	4.3	3.3		
Ex- autos and gas % m-o-m	**0.8**	**-0.1**	**0.2**	**5.3**	**5.0**
% change y-o-y	5.6	5.3	2.7		
Exc. Bldg. mat., auto, gas, % m-o-m	**0.8**	**0.0**	**0.2**	**5.4**	**5.8**
% change y-o-y	6.0	6.3	3.3		

There is insufficient evidence from the timeliest of economic indicators to justify another cut in the federal funds rate on October 31. The nature of incoming economic data allows the Fed to watch and wait.

Chart 2



The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

International Trade – August 2007

Export growth in July and August helped to trim trade deficit but outlook is less promising going forward

The trade deficit narrowed to $57.6 billion in August from $59.0 billion in the prior month. Imports of goods and services fell 0.4% in August, while exports of goods and services advanced 0.4%. Exports of goods and services have now grown for six straight months. The main message of the July-August trade numbers is that an improvement in the trade deficit will add to GDP growth. However, there is good chance that soft growth of other components of domestic spending, such as consumer spending, capital spending, and government spending, will be offsets to the strength in exports. The weakness in imports reflects softer growth in domestic demand compared with the earlier quarters.

Chart 3

Trade Balance: Goods and Services, BOP Basis

SA, Mil.$

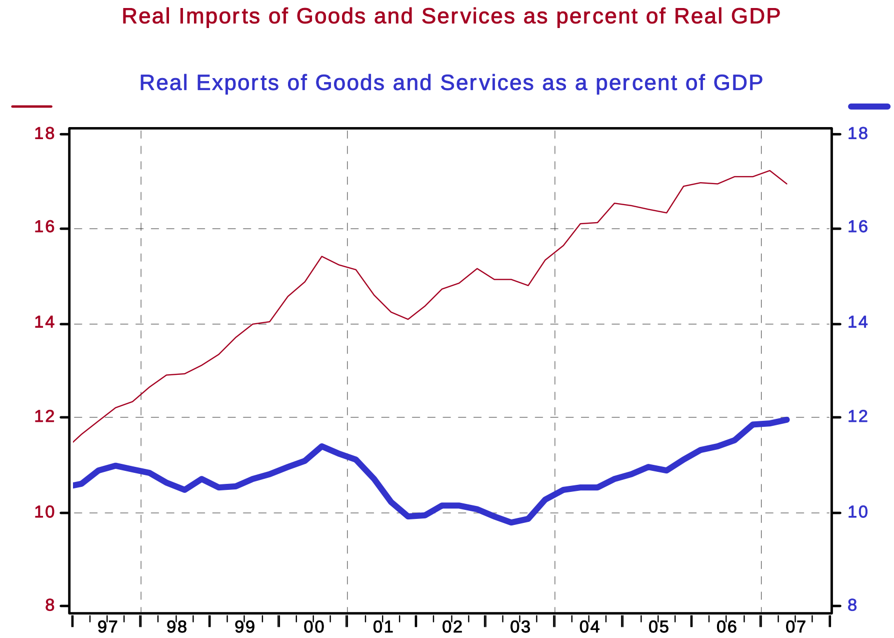
Source: Census Bureau /Haver Analytics

International Trade in Goods and Services – August 2007

	Trade Balance		Exports (m-o-m % change)		Imports (m-o-m % change)	
	Goods & Services	Goods	Goods & Services	Goods - 2000$	Goods & Services	Goods - 2000$
Feb-07	-57.9	-65.5	-1.5	-2.7	-0.6	-0.5
Mar-07	-62.7	-70.7	2.6	2.7	4.4	3.4
Apr-07	-58.6	-67.3	0.2	-0.7	-2.0	-3.5
May-07	-59.6	-68.5	2.5	2.5	2.3	1.2
Jun-07	-59.4	-68.4	1.3	0.9	0.8	0.8
Jul-07	-59.0	-67.8	2.7	3.7	1.7	0.6
Aug-07	-57.6	-66.6	0.4	0.2	-0.4	-0.6

Exports of goods and services have provided a lift to GDP growth in the past four years, with inflation adjusted exports now accounting for 12.0% of GDP, a two percentage point improvement since mid-2003. The share of imports has started to wane, with imports making up nearly 17.0% of GDP (see chart 4) in the second quarter after readings higher than 17.0% in the prior three quarters. The weakness of the dollar and strength in economic growth among the nation's trading partners are factors boosting growth in exports.

Chart 4



Source: Haver Analytics

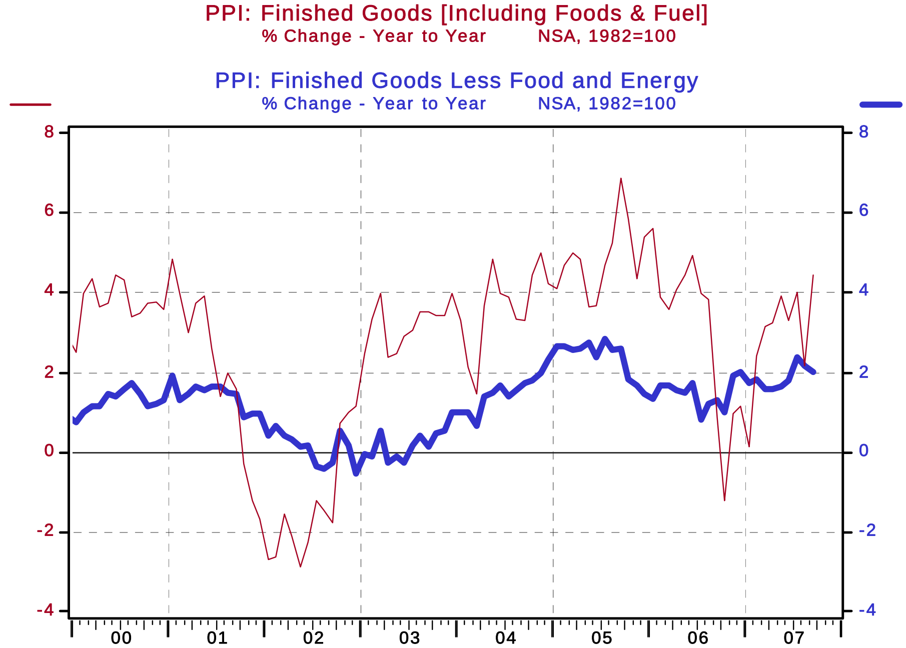
Optimistic projections of exports may be exaggerated because growth in the Euro Area has slowed and the Japanese economy contracted in the second quarter.

Producer Price Index – September 2007

Energy and Food Prices Lift Wholesale Price Index in September

The Producer Price Index (PPI) for Finished Goods rose 1.1% in September after a 1.4% gain in August. The 4.1% jump in energy prices and 1.5% increase in food prices were the reasons for most of the gain in wholesale prices during September. Based on available information, energy prices are unlikely to show a large gain in October. The widespread increase in food prices is most likely to show a moderate increase in October. In the three months ended September, the PPI for finished goods rose at an annual rate of 1.4% vs. a 6.0% gain in the prior three-month period, with energy prices being the main reason for the deceleration. By contrast, food prices rose at an annual rate of 4.7% in the three months ended September after declining 2.1% in the prior three-month period.

Chart 5



Source: Bureau of Labor Statistics /Haver Analytics

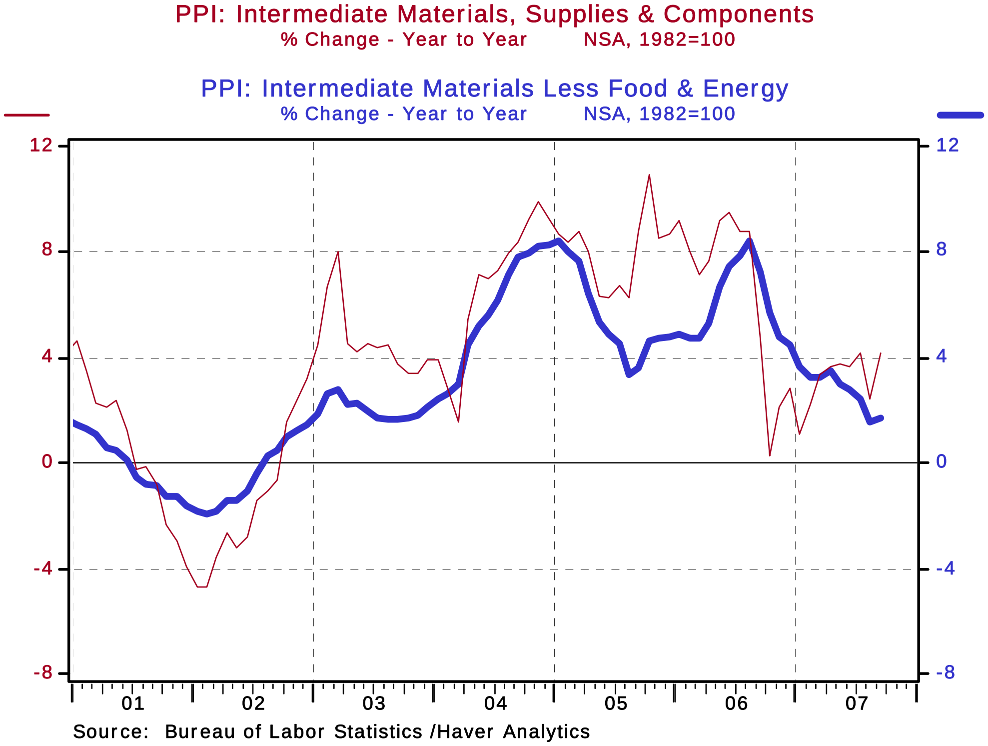
The core PPI for finished goods, which excludes food and energy, increased only 0.1% in September compared with a 0.2% gain in August. This puts the year-to-year gain at 2.0%, down from the recent high of a 2.4% gain in July. The core PPI for finished goods, which excludes food and energy, rose at annual rate of 1.5% in the three months ended September compared with a 2.5% gain in the prior three-month period. In September, lower prices for cars (-1.8%) and light trucks (-0.5%) offset gains in higher prices for cigarettes, pharmaceutical preparations, alcoholic beverages, household furniture, newspaper circulation, and book publishing

Producer Price Index – September 2007

	% change	annualized % change			% change		
	prior month	year-to-date	3 mo. ago	6 mo. ago	Sep-07 yoy	Sep-06 yoy	Dec-06 yoy
PPI - FINISHED GOODS							
ALL ITEMS	1.1	4.7	1.4	3.7	4.4	0.9	1.1
CORE - ALL ITEMS LESS FOOD & ENERGY	0.1	2.0	1.5	2.0	2.0	1.3	2.0
FOOD	1.5	6.7	4.7	1.2	5.7	2.2	1.7
ENERGY	4.1	11.4	-1.5	12.1	10.6	-1.8	-2.0
CAPITAL EQUIPMENT	-0.1	1.4	0.3	1.2	1.6	1.5	2.3
PPI - INTERMEDIATE GOODS							
ALL ITEMS	0.4	5.0	-0.7	4.8	4.2	4.7	2.8
CORE	0.1	2.8	-0.5	3.4	1.7	7.2	4.5
PPI - CRUDE GOODS							
ALL ITEMS	0.1	9.5	-6.6	2.5	11.4	-8.2	-4.7
CORE	1.6	21.6	12.4	6.0	13.9	20.7	17.0

The intermediate goods price index moved up 0.4% and the core intermediate goods price index inched up 0.1% during September. Pipeline price pressures are nearly absent. The core intermediate goods price index rose 1.7% from a year ago, representing a deceleration from the recent peak of an 8.4% year-to-year increase in August 2006.

Chart 6



Jobless Claims – September 2007

Jobless Claims Contradict Anecdotal Reports

Initial jobless claims fell 12,000 to 308,000 during the week ended October 6. The four-week moving average at 310,250 is the lowest since late July. Continuing claims, which lag initial claims by one week, fell 15,000 to 2.521 million and the insured unemployment rate was unchanged at 1.9%. The decline in initial jobless claims in three out of the last five weeks is puzzling because an upward trend in initial claims was expected following reductions in payroll announced after the financial crisis.

Next Week's Highlights:

1. **Industrial production** [Oct. 16] **–** The steady manufacturing man-hours index for September points to a 0.1% increase in factory production. The operating rate is projected to have held steady at 82.2% in September. **Consensus:** +0.3% ; Capacity Utilization: 82.2

2. **Consumer Price Index** [Oct. 19] **–** A 0.2% increase in the CPI is predicted for September, reflecting higher food and energy prices. The core CPI is expected to match the 0.2% advance seen in August. On a year-to-year basis, the core CPI was up 2.1% in August. **Consensus:** +0.2%, core CPI +0.2%.

3. **Housing Starts** [Oct. 19] **–** Anecdotal reports continue to indicate a lack of demand for homes. Permit extensions for new homes fell 4.8% in August which is indicative of a reduction in housing starts. Starts of new homes are predicted to have fallen to an annual rate of 1.20 million in September vs. 1.331 million in August. **Consensus:** 1.288 million

4. **Leading Indicators** [Oct. 20] **–** Interest rate spread made a negative contribution and the manufacturing workweek was unchanged in September. Initial jobless claims, stock prices, consumer expectations, vendor deliveries, and real money supply made positive contributions. The net impact is a gain in the leading index (+0.4%) in September after a 0.6% drop in August. **Consensus:** +0.4%

Other reports – Empire State Manufacturing survey [Oct. 15], NAHB Survey [Oct. 16], Beige Book [Oct. 17], Philadelphia Fed Survey [Oct. 18].

Key Interest Rates

	10/12/2007 14:33	1-wk. change, bps	4-wk. change, bps	1-yr. change, bps
3-month Libor	5.22	-2	-43	-15
2-year U.S. Treasury note yield	4.22	14	17	-65
10-year U.S. Treasury note yield	4.69	4	22	-12

Global Economic Data

	Real GDP SAAR, yoy %		CPI NSA, yoy%		Unemployment Rate %		year-ago	Central Bank Rate %		year-ago
United States	1.9	Q2-07	2.0	Aug-07	4.7	Sep-07	4.6	4.75	Aug-07	5.25
Euro-Area	2.5	Q2-07	1.7	Aug-07	6.9	Aug-07	7.8	4.00	Sep-07	3
Japan	1.7	Q2-07	-0.2	Aug-07	3.8	Aug-07	4.1	0.51	Sep-07	0.26
UK	3.1	Q2-07	1.7	Aug-07	2.6	Aug-07	2.9	5.75	Sep-07	4.75
Australia	4.3	Q2-07	2.1	Q2-07	4.2	Sep-07	4.7	6.5	Sep-07	6
Canada	2.5	Q2-07	1.7	Aug-07	5.9	Sep-07	6.4	4.5	Sep-07	4.25
China	11.9	Q2-07	6.7	Aug-07	4.1	Q2-07	4.2	2.12	Jul-07	2.06
India	9.3	Q2-07	7.3	Aug-07	--	--	--	6.00	Sep-07	6
New Zealand	3.8	Q2-07	2.0	Q2-07	3.6	Q2-07	3.6	8.25	Sep-07	7.25
Norway	3.7	Q2-07	-0.3	Aug-07	2.6	Q2-07	4.8	5	Sep-07	3
Singapore	8.7	Q2-07	3.0	Aug-07	2.3	Q2-07	3.2	2.23	Sep-07	3.35
South Korea	5.0	Q2-07	2.3	Sep-07	3.2	Aug-07	3.5	5.00	Sep-07	4.5
Sweden	3.2	Q2-07	2.2	Aug-07	5.5	Aug-07	6.8	3.75	Sep-07	2.5
Switzerland	2.8	Q2-07	0.7	Sep-07	2.6	Sep-07	3.2	2.79	Sep-07	1.81
Taiwan	5.0	Q2-07	2.9	Aug-07	3.9	Aug-07	3.9	3.25	Sep-07	2.63
Thailand	4.5	Q2-07	2.1	Sep-07	1.6	Aug-07	1.8	3.75	Sep-07	6.50

* UK - Claimant Count Unemployment Rate
* Thailand - GDP Non-Seasonally Adjusted
* EA-13, UK, Sweden - Harmonized Unemployment

Historical US Economic Data

	Sep-07	Aug-07	Jul-07	Jun-07	May-07	Apr-07	Mar-07	Feb-07	Jan-07	Dec-06	Nov-06	Oct-06
Payroll Employment (000)	110	89	93	69	188	122	175	90	162	226	196	109
% Change, Year Ago *	1.2	1.3	1.3	1.4	1.5	1.4	1.4	1.5	1.6	1.7	1.7	1.8
Unemployment Rate (%)	4.7	4.6	4.6	4.5	4.5	4.5	4.4	4.5	4.6	4.5	4.5	4.4
Avg. Hourly Earnings (% Chg.)	0.4	0.3	0.3	0.5	0.4	0.2	0.3	0.4	0.2	0.5	0.3	0.4
% Change, Year Ago	4.1	3.9	3.9	4.0	4.0	3.7	4.0	4.1	4.1	4.3	4.2	3.9
PPI (% Chg.)	1.1	-1.4	0.6	-0.1	0.7	0.9	1.0	1.2	-0.6	0.7	1.6	-1.5
% Change, Year Ago *	4.4	2.2	4.0	3.3	3.9	3.2	3.1	2.4	0.1	1.1	0.9	-1.2
CPI (% Chg.)		-0.1	0.1	0.2	0.7	0.4	0.6	0.4	0.2	0.4	0.0	-0.4
% Change, Year Ago *		2.0	2.4	2.7	2.7	2.6	2.8	2.4	2.1	2.5	2.0	1.3
ISM Diffusion Index (%)	52.0	52.9	53.8	56.0	55.0	54.7	50.9	52.3	49.3	51.4	49.9	51.5
Industrial Production (% Chg.)		0.2	0.5	0.6	-0.1	0.6	-0.1	0.8	-0.5	0.6	-0.4	-0.2
% Change, Year Ago		1.7	1.7	1.5	1.9	1.9	2.2	2.9	2.4	2.8	3.0	4.6
Capacity Utilization (%)		82.2	82.2	81.8	81.5	81.7	81.4	81.6	81.1	81.6	81.3	81.7
Nondefense Cap. Goods ex Aircraft												
- Orders (% Chg.)		-0.5	0.9	-0.2	-1.5	2.0	4.6	-2.4	-4.4	0.9	-1.0	-4.1
% Change, Year Ago *		-0.9	-0.7	-3.2	-1.6	2.9	-3.3	-3.0	-0.7	2.9	7.2	7.9
- Shipments (% Chg.)		1.0	0.0	-0.8	0.7	0.9	1.6	0.6	-4.2	0.2	0.8	-1.2
% Change, Year Ago *		-0.5	-1.2	-1.6	-0.9	0.4	-2.3	-1.3	-1.8	0.8	4.7	4.6
Retail Sales (% Chg.)	0.6	0.3	0.6	-0.8	1.6	-0.3	1.0	0.6	0.0	1.1	0.3	0.0
% Change, Year Ago	2.9	4.2	3.6	3.5	5.6	2.8	4.3	3.8	4.1	3.9	4.7	4.7
Real Personal Consumption (% Chg.)		0.6	0.3	0.1	0.1	0.3	-0.2	0.3	0.4	0.5	0.2	0.6
% Change, Year Ago		3.4	2.5	2.9	2.9	3.0	3.0	3.2	3.4	3.3	3.3	3.4
Personal Income (% Chg.)		0.3	0.5	0.5	0.5	0.0	0.8	0.8	0.9	0.8	0.4	0.6
% Change, Year Ago		6.8	6.8	6.3	6.7	6.4	6.8	6.3	5.8	6.1	6.0	5.9
New Home Sales (SAAR, mn)		0.80	0.87	0.84	0.86	0.91	0.83	0.84	0.89	1.02	0.99	0.95
% Change, Year Ago *		-22.7	-10.8	-22.4	-22.5	-17.0	-25.9	-22.7	-25.8	-18.4	-17.4	-29.5
Existing Home Sales (SAAR, mn)		5.50	5.75	5.76	5.98	6.01	6.15	6.68	6.44	6.27	6.25	6.27
% Change, Year Ago *		-11.9	-6.1	-13.4	-10.1	-8.0	-12.6	-3.7	-3.2	-11.2	-10.9	-8.5
Housing Starts (SAAR, mn)		1.33	1.37	1.47	1.44	1.49	1.49	1.49	1.40	1.63	1.57	1.47
% Change, Year Ago *		-18.8	-21.1	-19.0	-28.2	-15.5	-25.4	-28.9	-37.9	-17.4	-28.3	-27.6
International Trade (Bils $)		-57.6	-59.0	-59.4	-59.6	-58.6	-62.7	-57.9	-57.0	-60.3	-58.5	-58.2

	Q3-07	Q2-07	Q1-07	Q4-06	Q3-06	Q2-06	Q1-06	Q4-05	Q3-05	Q2-05	Q1-05	Q4-04
Real GDP, Chain Weighted, SAAR		3.8	0.6	2.1	1.1	2.4	4.8	1.2	4.5	2.8	3.1	2.5
% Change, Year Ago		1.9	1.5	2.6	2.4	3.2	3.3	2.9	3.2	3.0	3.2	3.1
Chain-Weighted Price Index, SAAR		2.6	4.2	1.7	2.4	3.5	3.4	3.5	3.5	2.6	3.9	3.2
% Change, Year Ago		2.7	2.9	2.7	3.2	3.5	3.2	3.4	3.3	3.0	3.3	3.2
Nominal GDP, SAAR		6.6	4.9	3.8	3.4	6.0	8.4	4.8	8.1	5.5	7.1	5.9
% Change, Year Ago		4.7	4.5	5.4	5.6	6.8	6.7	6.3	6.6	6.1	6.6	6.5
Employment Cost Index (%)		0.9	0.8	0.9	0.9	0.9	0.6	0.8	0.7	0.6	1.0	0.6
% Change, Year Ago		3.3	3.5	3.3	3.3	3.0	2.8	3.1	3.0	3.2	3.6	3.7
Productivity Nonfarm, SAAR		2.6	0.7	1.8	-1.6	0.8	2.5	-1.4	4.4	0.3	3.7	0.7
% Change, Year Ago		0.9	0.4	0.9	0.1	1.5	1.4	1.7	2.2	1.4	2.5	1.8
Unit Labor Costs, Nonfarm, SAAR		1.4	5.2	10.3	2.9	-1.0	4.6	4.1	1.3	1.2	-0.1	4.7
% Change, Year Ago		4.9	4.3	4.1	2.6	2.2	2.8	1.6	1.7	2.5	2.3	2.1

Source: Haver Analytics

* NSA