Northern Trust

U.S. ECONOMIC &
INTEREST RATE OUTLOOK

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

Paul L. Kasriel
Director of
Economic Research
312.444.4145
312.557.2675 fax
plk1@ntrs.com

Asha Bangalore
Economist
312.444.4146
312.557.2675 fax
agb3@ntrs.com

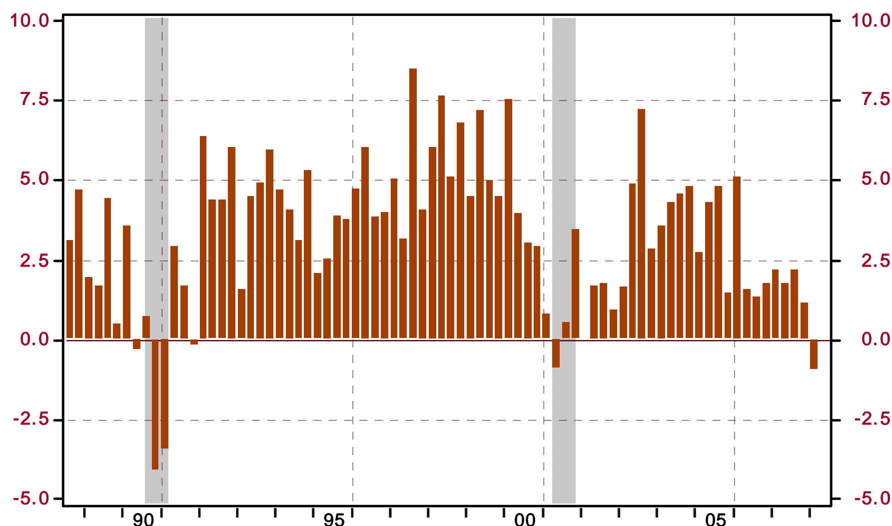
In the Eye of the Economic Hurricane

May 15, 2008

There seems to be sentiment developing that the U.S. has weathered the worst of the current cyclical economic storm and blue skies are ahead. We disagree. Any blue skies you see are likely to be short lived. The economy is in the relative calm of the eye of the business-cycle hurricane. The mortgage credit problems are not over. And credit problems in other sectors are just beginning as the housing recession spreads to the rest of the economy. When the economy recovers from the current recession, perhaps in the first half of 2009, that recovery is likely to be muted as financial institutions are still rebuilding their capital and, therefore, will not be able to extend much credit to the private sector.

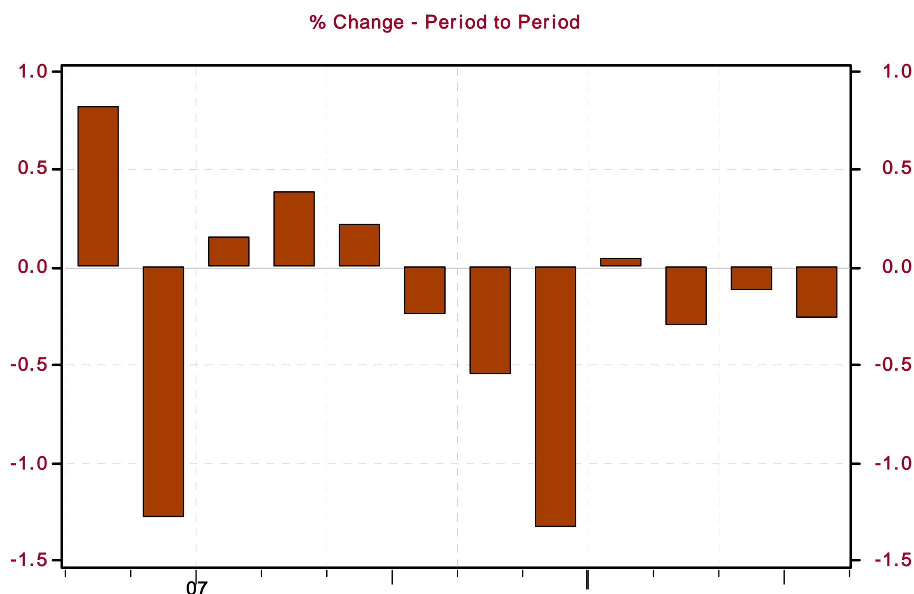
The plus-sign in front of the Commerce Department's preliminary estimate of the change in first-quarter real GDP was deceiving. Real final sales of domestic product, which is real GDP excluding the change in business inventories, contracted at an annual rate of 0.2% in the first quarter. Except for the negative impact of Hurricane Katrina in Q4:2005, this was the first decline in real final sales since the first quarter of 2002. Real *private* final domestic sales – i.e., the sum of personal consumption expenditures and private fixed investment expenditures – *contracted* at an annualized rate of 1.0% in the first quarter, which was the largest contraction since the fourth quarter of 1991 (see Chart 1). So, the housing recession is now spreading to consumer spending, business equipment spending and nonresidential construction spending.

Chart 1



Consumer spending appears to be off to a weak start in the second quarter. Retail sales adjusted for the goods component of the CPI fell by 0.3% in April, marking the sixth decline in real retail sales in the past seven months (see Chart 2).

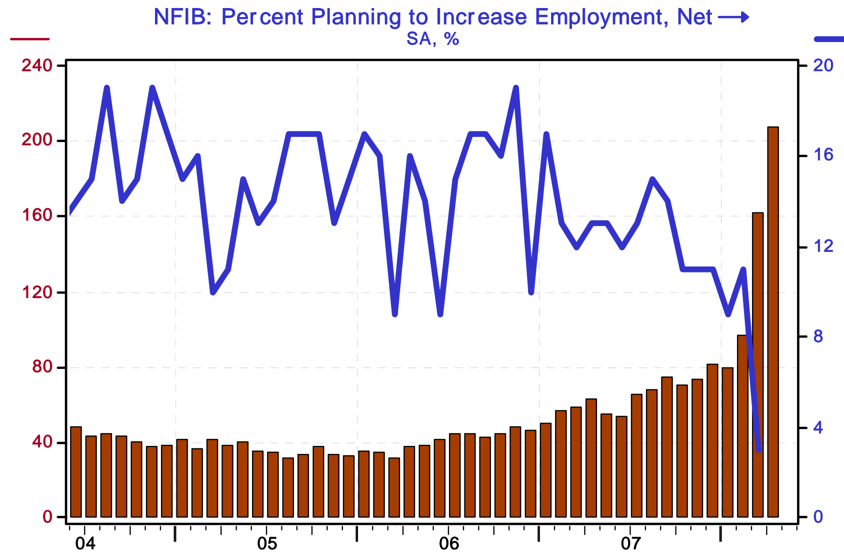
Chart 2



It is no wonder that growth in consumer spending is slowing significantly. For starters, the labor market is now in a recession. Nonfarm payrolls have contracted in each of the first four months of this year for a cumulative decline of 260,000. But this "headline" decline, as ominous as it is, probably understates the contraction in nonfarm payrolls because of the so-called birth/death adjustment the Bureau of Labor Statistics (BLS) makes to seasonally-unadjusted private nonfarm payrolls each month. Businesses, typically smaller ones, are "born" and "die" each month. Some of the small businesses are not yet included in the sample of establishments the BLS surveys each month. Therefore, the BLS estimates each month the net number of jobs created by the birth and death of these smaller businesses. In the 12 months ended April, the BLS reported that nonfarm payrolls increased by 381,000. However, the birth/death adjustment has added 787,000 new nonfarm payroll jobs in this 12-month period. So, net of the birth/death adjustment, nonfarm payrolls would have *declined* by 406,000. In the 12 months ended April, the birth/death adjustment accounted for almost *207*% if the change in nonfarm payrolls. As Chart 3 shows, starting late in 2007 as significantly fewer small business operators reported plans to increase their employment, the birth/death adjustment began accounting for ever higher proportions of 12-month nonfarm payroll increases. Thus, headline nonfarm payroll data of late appear to be overstating employment increases.

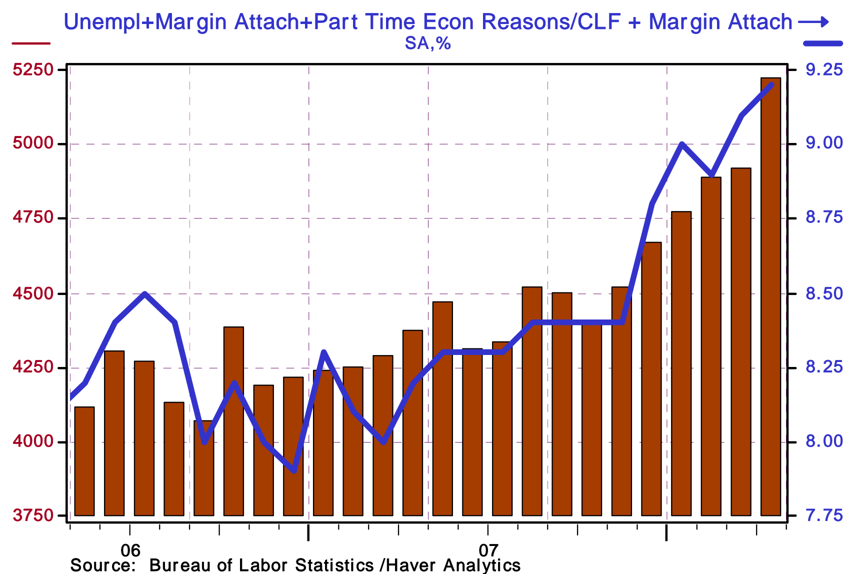
The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence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

Chart 3



Although the unemployment rate dipped to 5.0% in April from 5.1% in March, much of this improvement appears to have been related to a sharp increase in part-time employment. A broader measure of labor utilization, which includes those who are employed part time, continued to rise in April to a cycle high of 9.2% (see Chart 4).

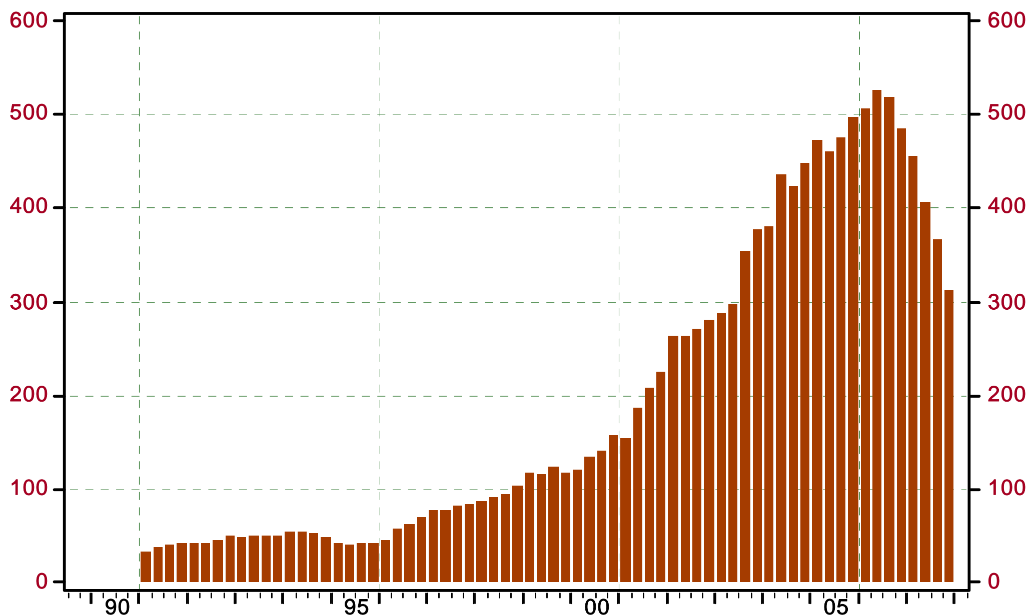
Chart 4



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.

Another factor depressing consumer spending is the loss of borrowing power resulting from the decline in home equity. It was reported on April 29 that the Case-Shiller house price index for 20 major metropolitan areas fell 2.66% month-to-month in February. Applying that percentage decline in house prices to the fourth-quarter value of $20,154.7 billion for household residential real estate from the Fed's flow-of-funds data yields a *decline of $536 billion* in that value. Now, this is a very rough approximation for at least two reasons. Firstly, the Case-Shiller price index is for only 20 metropolitan areas, not the whole country. So, the Case-Shiller index captures the decline in house prices in the Manhattan, New York area but not the Manhattan, Kansas area. Second, the value of residential real estate in the Fed's flow-of-funds accounts is based on the OFHEO house price index. But even with these qualifications, we are confident that in February there was very large *monthly* decline in collateral value that households could borrow against. And borrowing against it, households were in this past cycle. At its peak in 2006, home mortgage equity withdrawal was running at an annual rate of over $500 billion (see Chart 5), which was about 6% of disposable personal income. Given the persistence of excess housing inventory (see Chart 6), home prices and, therefore, home equity, are likely to keep falling for the foreseeable future. Lastly, even if one has home equity to withdraw, it is considerably more difficult to obtain home financing with which to extract that equity inasmuch as banks continue to tighten their lending terms on residential mortgages (see Chart 7).

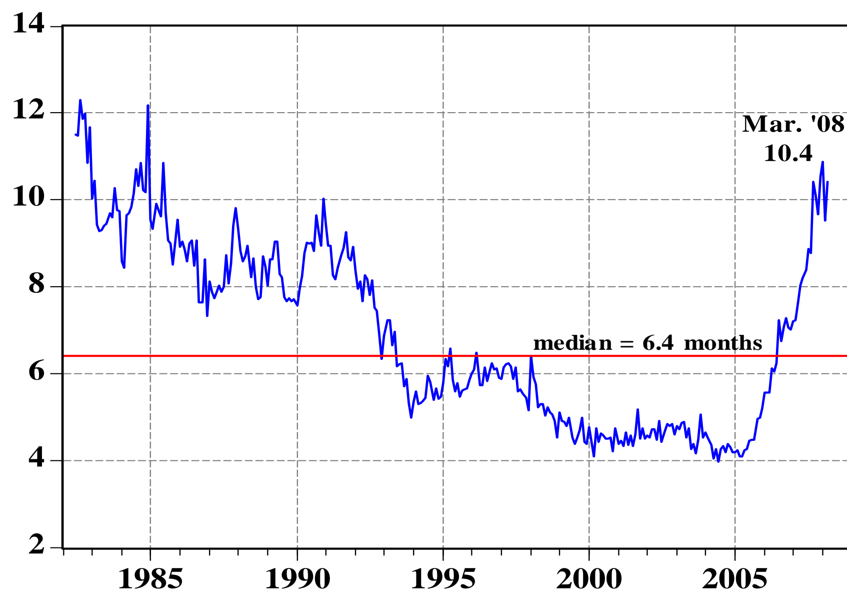
Chart 5



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.

Chart 6

Total Single-Family Homes*: Inventory/Sales Ratio
months' supply

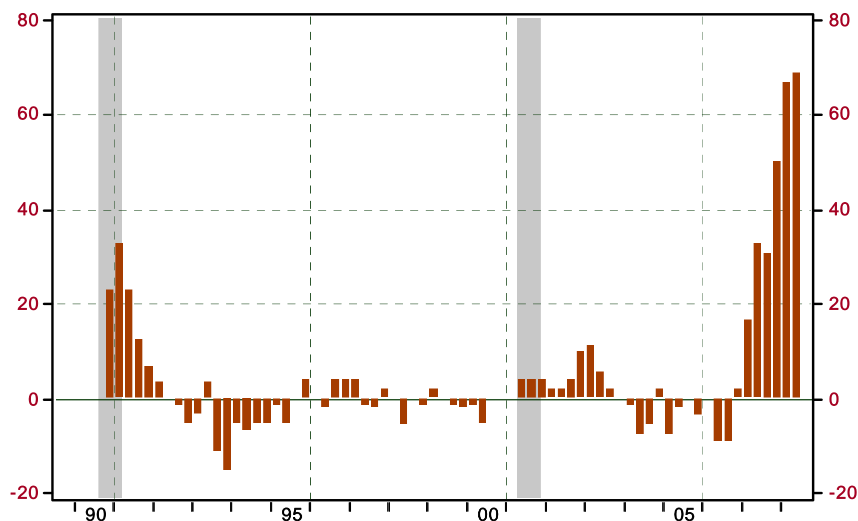


***Combined new and existing**

Chart 7

FRB Sr Loan Survey: Res Mortgages: Net Share, Banks Tightening

Haver Est, %

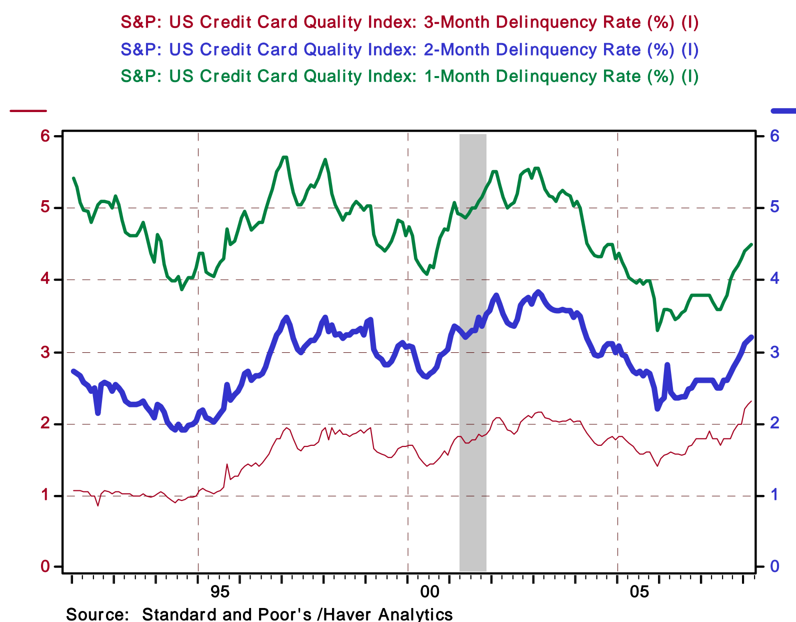


Source: Federal Reserve Board /Haver Analytics

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.

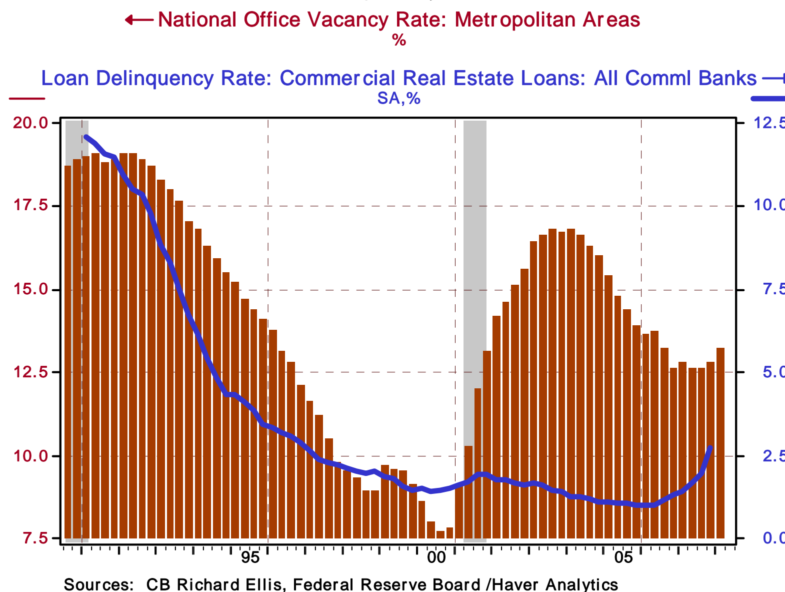
While the problems in the residential mortgage market will persist for some time, problems are now beginning to develop in other classes of credit. The rising unemployment rate is undoubtedly responsible, in part, for the increasing delinquency rates on credit card debt (see Chart 8).

Chart 8



The rising unemployment rate also is contributing to the bottoming out in the office vacancy rate. In turn, this is causing some increase in the delinquency rate on commercial real estate (see Chart 9).

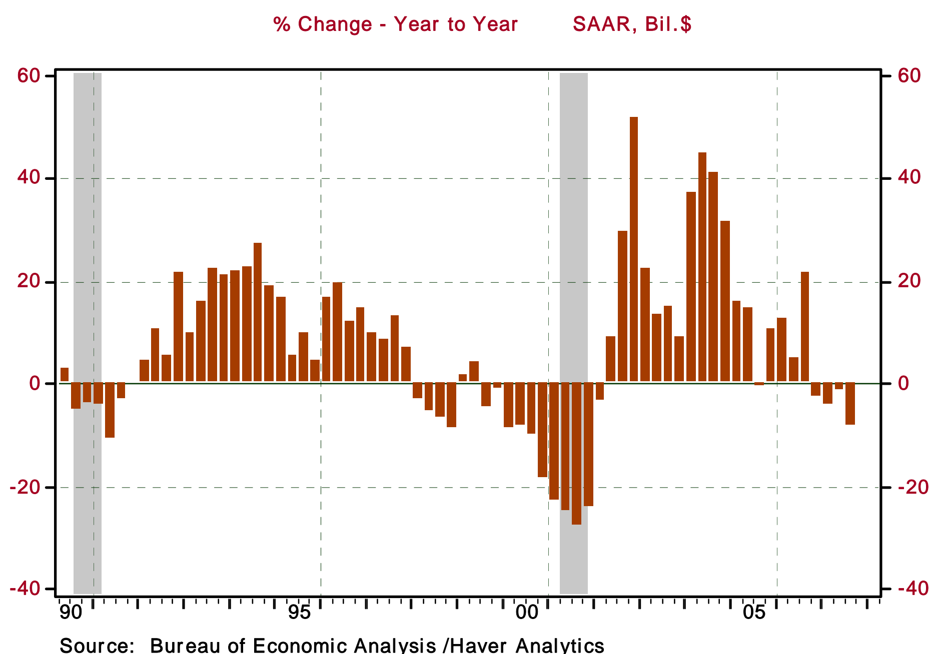
Chart 9



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.

According to Commerce Department estimates, profits of nonfinancial corporations were contracting in 2007 (see Chart 10). With real economic activity projected by us to contract in 2008 on a fourth-quarter-to-fourth-quarter basis, corporate sales volumes will suffer this year. Profit margins are likely to be squeezed as businesses will not be able to pass through the full amount of their higher commodity costs due to weak final demand. Thus, the outlook for nonfinancial corporate profit growth in 2008 remains dim. In turn, corporate bond defaults will be rising this year.

Chart 10

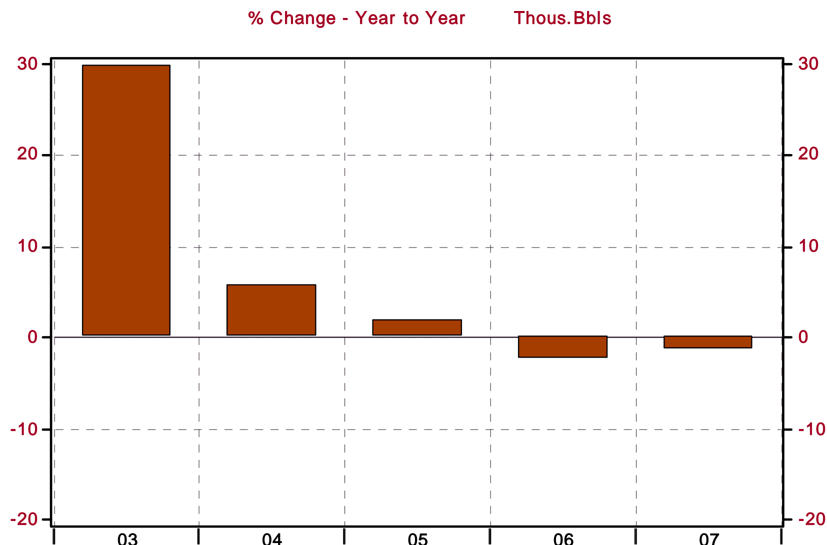


In sum, the spreading of the housing recession to other parts of the economy is now beginning to cause problems in other sectors of the credit markets. Thus, financial institutions will continue to see their capital erode throughout 2008. At the same time, financial institutions will be urged to or required to hold more capital by their regulators. This capital "squeeze" will prevent robust credit creation and will, therefore, prevent a robust economic recovery.

This lack of credit creation also would be expected to temper the rate of inflation going forward. We continue to expect energy prices to recede as growth in the global demand for it slows. Indeed, U.S. demand for physical volumes of imported energy products has been contracting for about two years (see Chart 11). With the Japanese economy stalled out, the UK economy flirting with a recession and the Eurozone economy slowing, the global demand for energy is bound to slow. There is no way the developing world's real economic growth, and, thus, its energy-demand growth can continue at its recent pace with real economic growth in the developed world slowing significantly.

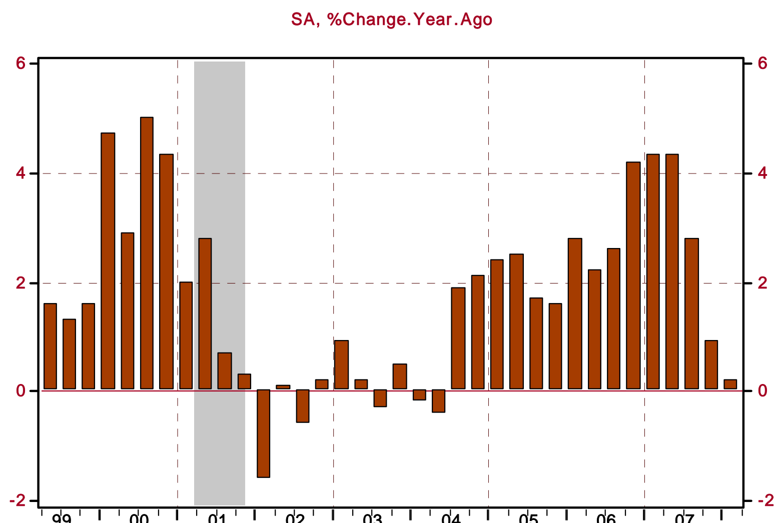
The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence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

Chart 11



If industrial commodity prices should continue to increase, we believe that consumer demand will be so weak that businesses will not be able to pass through much of their higher commodities input prices, as mentioned above. And for all you labor cost-push theorists, there is not much in the way of labor costs to push through into higher selling prices. As Chart 12 shows, on a year-over-year basis, nonfarm business unit labor costs were up a scant 0.2% in the first quarter.

Chart 12

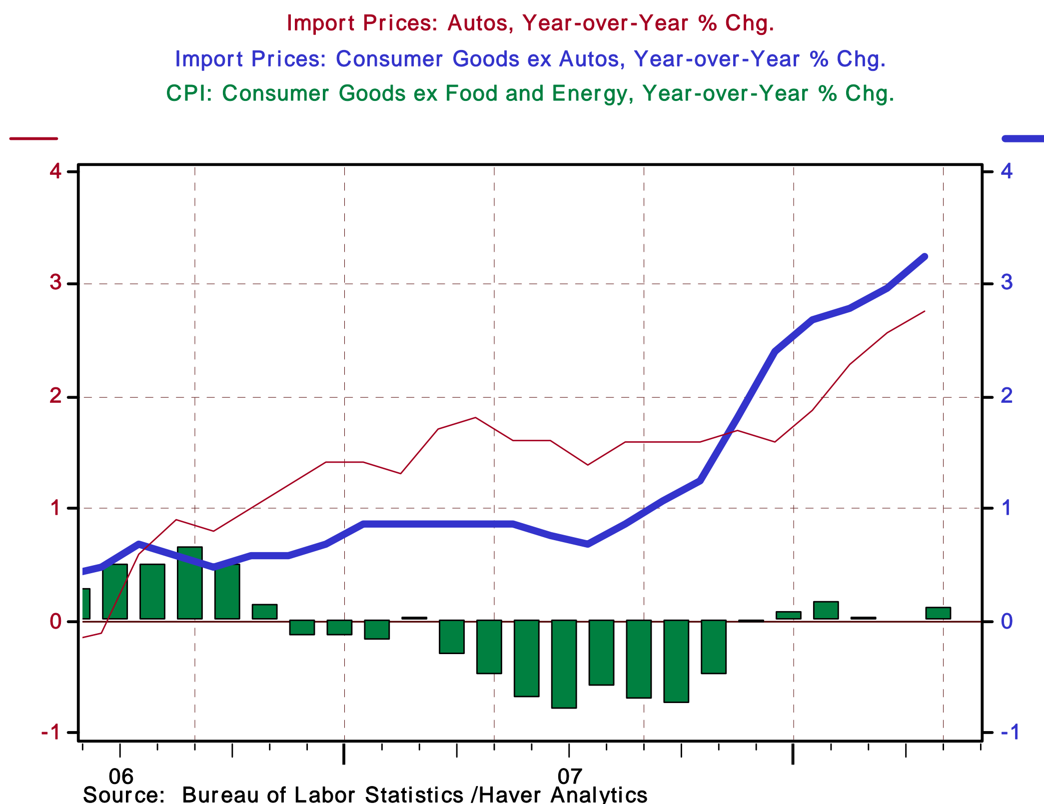


The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence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

Although our base case is for a moderation in consumer inflation for all items as well as the "core," there remain some upside risks. In March, the federal funds rate target of 2.25% was 175 basis points *under* the year-over-year increase in the all-items CPI of 4.00%. This suggests that the Fed is playing with inflationary "matches." When the interest rate structure adjusted for inflation enters negative territory, the public has an incentive to borrow and spend, which will put upward pressure on inflation. As we noted above, lenders are reluctant to extend credit now, but the danger lurks.

If a central bank engineers negative inflation-adjusted interest rates when other central banks are maintaining positive inflation-adjusted interest rates, the currency of the economy with negative inflation-adjusted interest rates will depreciate against the others, all else the same. And a depreciating currency usually is accompanied by higher inflation. There are signs that the depreciation of the dollar in recent years is inducing faster price increases of imported consumer goods and those faster import price increases are beginning to be passed on by retailers (see Chart 13). Although the dollar appears to have found some support in recent weeks, further reductions in the FOMC's federal funds rate target could lead to the greenback's renewed descent.

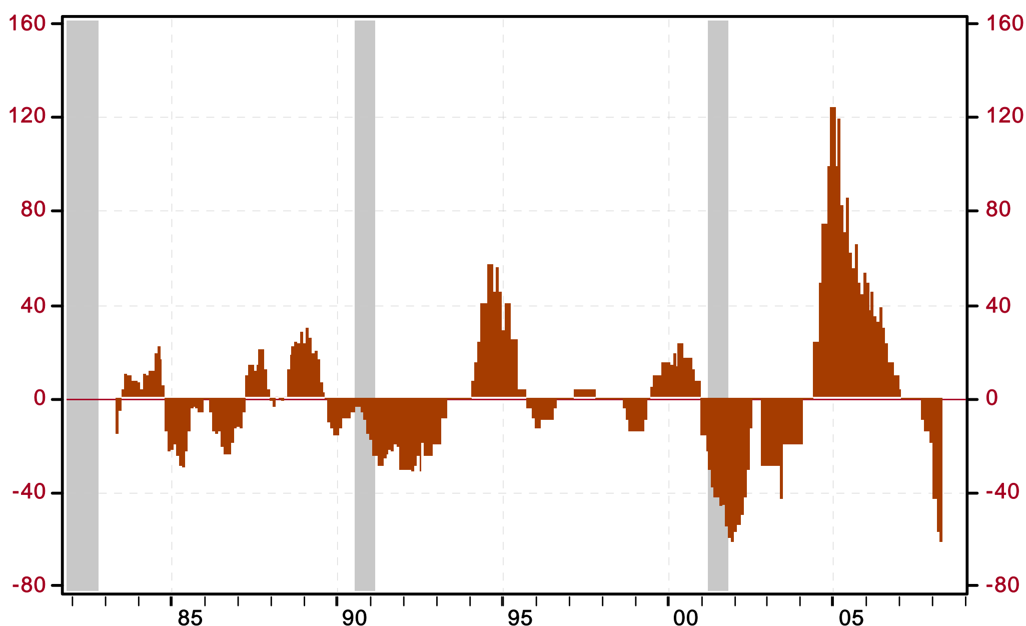
Chart 13



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.

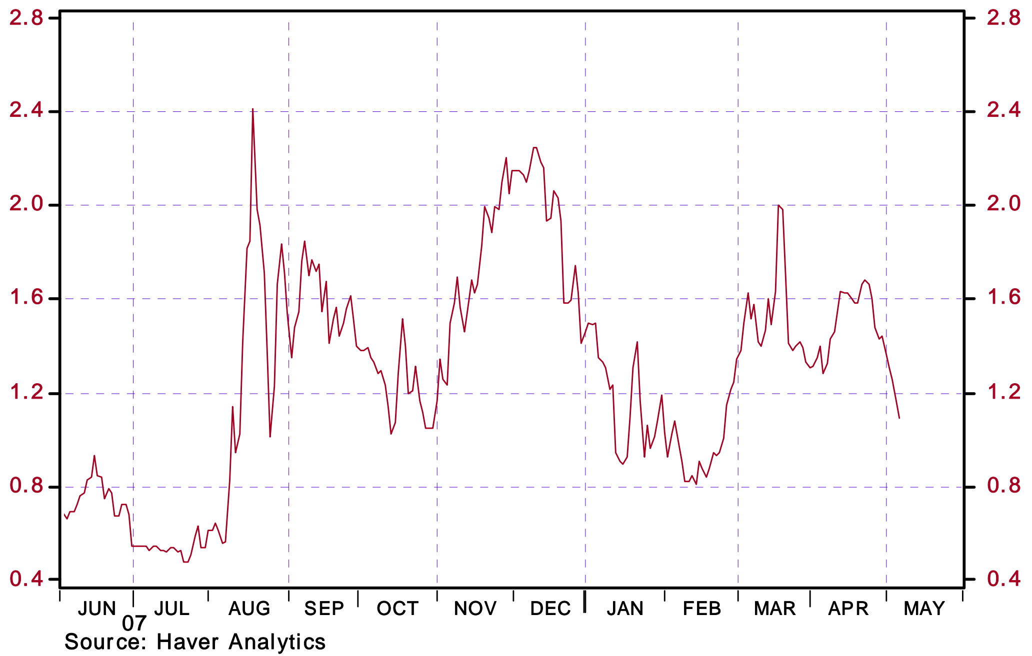
All of which leads to our forecast for the federal funds rate. The language of the statement accompanying the FOMC's April 30 interest-rate-reduction decision hinted that the committee would likely refrain from cutting its funds rate target at its next meeting on June 24-25. We take the FOMC at its word. In fact, as things now stand, we see the FOMC standing pat with regard to its federal funds rate target for the rest of the year. As mentioned above, the federal funds rate is significantly below the consumer inflation rate, which makes FOMC hawks uncomfortable. The FOMC has reduced the federal funds rate a cumulative 325 basis points in the space of only eight months. On a *percentage* basis, this represents a 61.9% decline in the federal funds rate target – historically, a very aggressive percentage reduction, as shown in Chart 14. The FOMC is well aware of the lagged impact of funds rate reductions on the economy. Moreover, the federal funds rate reductions along with the other actions the FOMC has taken appear to be reducing some of the liquidity/counterparty risk premia in the money markets (see Chart 15). Although we believe the FOMC is on hold for an extended period, if it were to change the funds rate over the remainder of the year, we would put the probabilities of a reduction in the rate much higher than the probabilities of an increase in the rate.

Chart 14



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.

Chart 15



Paul Kasriel is the recipient of the Lawrence R. Klein Award for Blue Chip Forecasting Accuracy

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.

THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
May 2008

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2007				2008				Q4-t-Q4 change			Annual change		
	07:1a	07:2a	07:3a	07:4a	08:1a	08:2f	08:3f	08:4f	2006a	2007a	2008f	2006a	2007a	2008f
REAL GROSS DOMESTIC PRODUCT	0.6	3.8	4.9	0.6	0.6	-1.3	0.2	-0.2	2.6	2.5	-0.2	2.9	2.2	0.9
(% change from prior quarter)														
CONSUMPTION EXPENDITURES	3.7	1.4	2.8	2.3	1.0	-0.3	0.3	-0.3	3.4	2.6	0.2	3.1	2.9	1.1
BUSINESS INVESTMENT	2.1	11.0	9.3	6.0	-2.5	-3.3	-2.2	-1.5	5.2	7.1	-2.4	6.6	4.7	1.2
RESIDENTIAL INVESTMENT	-16.3	-11.8	-20.5	-25.2	-26.7	-15.0	-8.0	-4.0	-12.8	-18.6	-13.9	-4.6	-17.0	-19.2
CHANGE IN INVENTORIES ('00 dlrs, bill)	0.1	5.8	30.6	-18.3	1.8	-15.2	-7.2	-13.2				40.3*	4.5*	-8.5*
GOVERNMENT	-0.5	4.1	3.8	2.0	2.0	1.4	1.5	1.5	2.5	2.3	1.6	1.8	2.0	2.1
NET EXPORTS ('00 dlrs, bill.)	-612.1	-573.9	-533.1	-503.2	-495.9	-479.5	-474.5	-461.4				-624.5*	-555.6*	-477.8*
FINAL SALES	1.3	3.6	4.0	2.4	-0.2	-0.7	-0.1	0.0	3.0	2.8	0.0	2.8	2.5	1.0
NOMINAL GROSS DOMESTIC PRODUCT	4.9	6.6	6.0	3.0	3.2	0.8	1.8	1.3	5.4	5.1	1.8	6.1	4.9	3.0
GDP DEFLATOR - IMPLICIT (% change)	4.2	2.6	1.0	2.4	2.6	2.2	1.6	1.5	2.7	2.6	2.0	3.2	2.7	2.1
CPI (% Change, 1982-84 = 100)	3.7	4.6	2.8	5.0	4.3	2.5	1.9	1.8	2.0	4.0	2.6	3.2	2.9	3.5
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.5	4.5	4.7	4.8	4.9	5.2	5.6	6.1				4.6*	4.6*	5.5*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	06:3a	06:4a	07:1a	07:2a	07:3a	07:4a	08:1a	08:2f	08:3f	08:4f	2006a	2007a	2008f
Federal Funds	5.25	5.25	5.26	5.25	5.07	4.50	3.18	2.10	2.00	2.00	4.96	5.02	2.32
3-mo.LIBOR	5.43	5.37	5.36	5.36	5.45	5.03	3.26	2.70	2.30	2.10	5.19	5.30	2.59
2-yr. Treasury Note	4.93	4.74	4.77	4.81	4.38	3.48	2.02	2.25	2.15	2.15	4.82	4.36	2.14
10-yr. Treasury Note	4.90	4.63	4.68	4.85	4.73	4.26	3.66	3.75	3.60	3.50	4.79	4.63	3.63

a = actual
f = forecast

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.