

DAILY GLOBAL COMMENTARY

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Why Buy Treasuries When You Will Be Able to Buy Fed/Treasury-Guaranteed GSEs?

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On Sunday, July 13, the Federal Reserve Board voted to give Fannie Mae and Freddie Mac access to the discount window at the Federal Reserve Bank of New York. This action effectively transforms a perceived implicit guarantee of Fannie and Freddie liabilities into an explicit guarantee. If Fannie or Freddie should have any problem funding their activities, they can now tap the New York Fed's discount window facility for funds. Also on July 13, the Treasury asked Congress for authority to increase its line of credit to the two government sponsored enterprises (GSEs) by an unspecified amount from the current \$2.25 billion already in place for each. Also, the Treasury asked Congress for authority to inject capital into the two GSEs. My bet is that Congress will grant the Treasury the authority to increase its line of credit and to inject capital into the two GSEs by a sufficient amount that will effectively guarantee to liabilities of the two. My bet also is that the Treasury will not have to actually lend a dime to Fannie or Freddie when the authority is granted. And I suspect that Fannie and Freddie will not feel the need to avail themselves of the Federal Reserve's discount window generosity. Why? Because, as mentioned above, an implicit guarantee of these GSEs' is now an explicit guarantee. Once fixed-income investors know this, they will have no credit-risk qualms about buying Fannie's and Freddie's paper.

That was painless, wasn't it? Or was it? Now that Fannie's and Freddie's paper is guaranteed by the Fed and is likely to be guaranteed by the Treasury shortly, if you were inclined to buy Treasury securities, why not buy a near-perfect substitute that is paying a slightly higher yield? In short, the yields on Treasury securities are likely to be higher *than they otherwise would be* as investors switch out of Treasuries into GSE paper. This means that the Treasury's debt service costs going forward also will be higher than they otherwise would be. And, this means that the current or future tax burden on U.S. taxpayers will be higher than it otherwise would be. As I have said on more than one occasion, there is no such thing as a free bailout. Some entity will pay.

I don't know what will happen to Fannie and Freddie's stockholders, although I do have some opinions as a taxpayer as to what I would want. To the degree that the Fed and the Treasury are guaranteeing their debt, Fannie and Freddie stockholders benefit. If Fannie and Freddie are more highly regulated, which will reduce their profitability even in "good times" and if Fannie and Freddie will be required to hold more capital to reduce their 68-to-1 leverage ratio, then new equity issued to the private sector will entail a high cost. Who wants to invest in a company whose profitability will be restrained? In this case, the dilution that current Fannie and Freddie stockholders will bear will be a bear. Presumably, if the Treasury were to inject capital into these GSEs, political pressure also would dictate that current Fannie and Freddie stockholders bear a high dilution price.

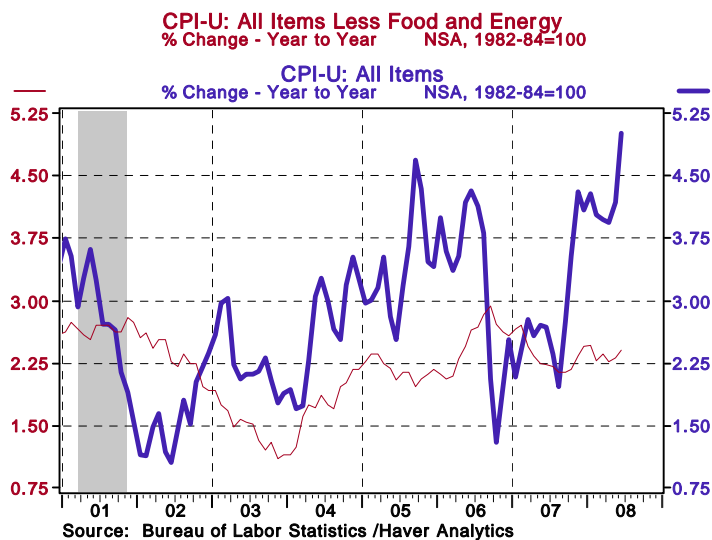
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Inflation is a Problem, Corporate Profits Likely to Take a Hit

That inflation is problem is an old story now. The Consumer Price Index (CPI) shot up 1.1% in June, putting the year-to-year increase as a hefty 5.0%, largest since March 1990. The energy

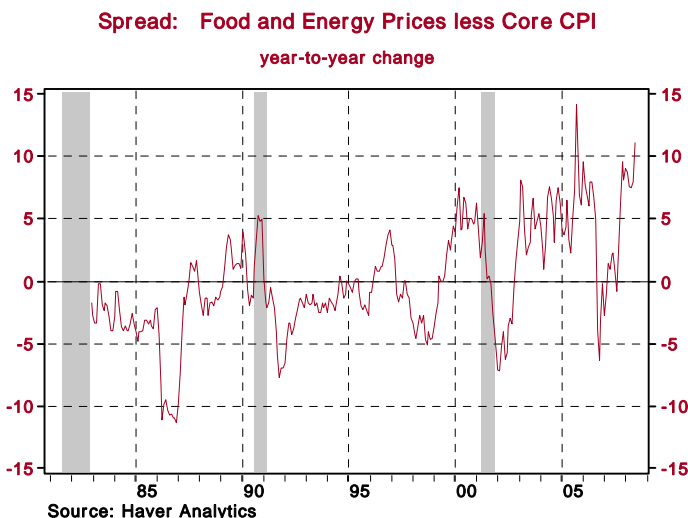
price index moved up 6.6% and food prices advanced 0.8% in June. The core CPI, which excludes food and energy, was up 0.3% in June, the largest monthly increase since January.

Chart 1



From chart 2 we can infer that food and energy prices are galloping to new heights and far ahead of core consumer prices. The year-to-year change in the combined food and energy price index exceeded the year-to-year change in the core CPI by 11.1% in June (see chart 2). Policy makers cannot institute large increases in interest rates to contain inflation because this action destabilizes the economy. At the moment, central banks can only hope that weakening aggregate demand conditions will tame inflation, which is what the Fed expects.

Chart 2

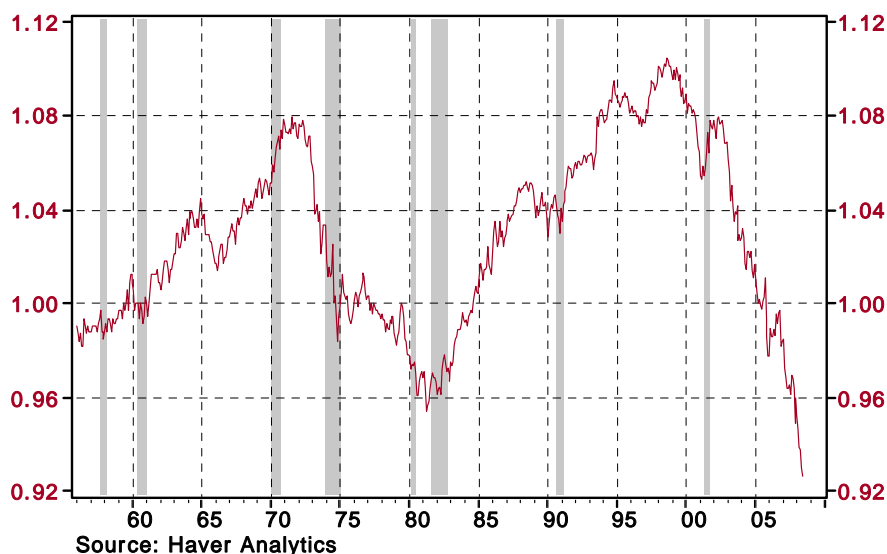


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At the same time, the steep increases in consumer prices have an important bearing on corporate profits. If firms can pass the higher costs of production, profit margins will not be squeezed. Is this occurring? Unfortunately, it is not the case. Chart 3 illustrates the ratio of consumer prices and wholesale prices. The declining trend of this ratio points to margin compression. Chairman Bernanke mentioned in his testimony that firms may attempt to pass through the rising costs into prices of final goods and services and the Fed should be wary of higher inflation expectations becoming embedded in wages and prices. We are of the opinion that firms may not succeed in passing through higher prices in the current weak economic environment.

Chart 3

Ratio: CPI for Goods/PPI for Finished Consumer Goods

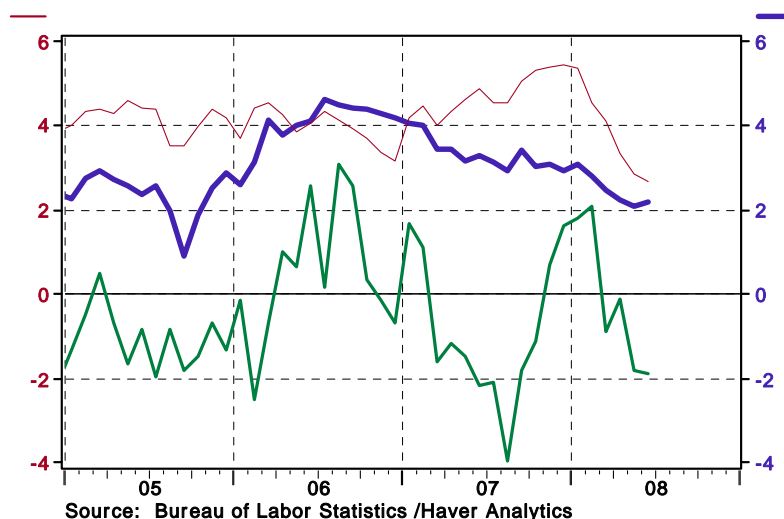


Other Highlights from the CPI report: The all items CPI has risen 5.5% in the first six months of the year compared with a 4.1% increase in 2007. The energy price index has risen 29.1% in the January-June period, accounting for about half of the gain in overall consumer prices. The 6.8% jump in the food price index is responsible for one-sixth of the overall gain in consumer prices in the first six months of year. The core CPI has advanced at an annualized rate of 2.3% in the first six months of 2008 compared with a 2.4% December/December increase in 2007. A deceleration of medical and shelter costs and a decline in apparel prices helped to trim the advance of the core CPI.

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Chart 4

Medical care prices, year-to-year change
 Shelter costs, year-to-year change
 Apparel Prices, year-to-year change



In June, shelter costs rose 0.3%, with the owners' equivalent rent and rent moving up 0.3% and 0.4%, respectively. Prices of news cars fell 0.3%, apparel costs declined 0.1%, medical care costs advanced only 0.2% and airfares rose 4.5%.

Consumer Price Index – June 2008

	% change	annualized % change		% change		
	prior month	3 mo. ago	6 mo. ago	Jun-08 yoy	Jun-07 yoy	Dec-07 yoy
CPI - ALL ITEMS	1.1	7.9	5.5	5.0	2.7	4.1
CORE - ALL ITEMS LESS FOOD & ENERGY (76.47)*	0.3	2.5	2.3	2.4	2.2	2.4
CPI ALL ITEMS LESS ENERGY (91.3)	0.4	3.4	3.0	2.9	2.5	2.8
FOOD (13.83)	0.8	8.5	6.8	5.3	4.1	4.9
ENERGY (9.69)	6.6	53.6	29.1	24.7	4.6	17.4
SHELTER (32.6)	0.3	2.3	2.2	2.5	3.8	3.1
COMMODITIES (41.27)	1.9	12.0	7.2	6.9	1.6	5.2
COMMODITIES LESS FOOD & ENERGY (21.6)	0.1	-0.1	-0.1	0.2	-0.8	0.1
SERVICES (58.7)	0.5	5.1	4.3	3.7	3.4	3.3
SERVICES LESS ENERGY SERVICES (54.87)	0.4	3.6	3.2	3.3	3.4	3.3
FRB CLEVELAND MEDIAN CPI	0.4	3.2	3.1	3.1	3.1	3.1

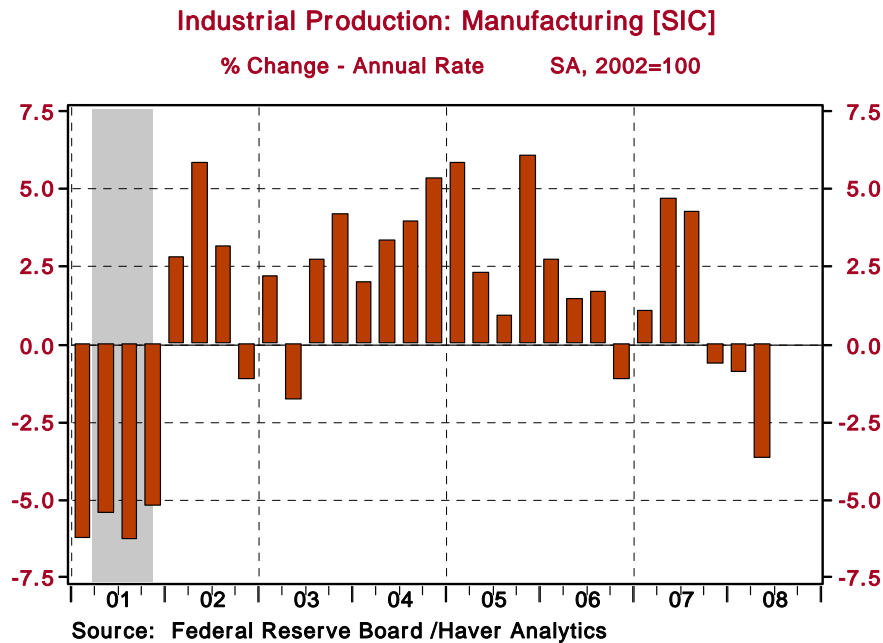
Conclusion – As mentioned earlier, the Fed expects weakening economic conditions to help contain inflation in the months ahead. Chairman Bernanke's testimony suggested that the Fed is on hold, for now. The Fed is a tight spot and the best it can do in the months ahead is to help stabilize financial market conditions, with one of the prerequisites for this being an accommodative stance and not tightening financial conditions given the backdrop of a housing market recession, a credit crunch, and weak real consumer spending.

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Factory Sector – Third Quarterly Decline in Production

Industrial production moved up 0.5% in June after a 0.2% decline in the prior month. Under significantly weak economic conditions this readings is impressive. However, the details indicate that the headline exaggerates the underlying fundamentals. The 2.1% jump in production at utilities after a 2.4% drop in May helped to boost total industrial production. Factory production rose 0.2% after a steady reading in May. The 5.4% jump in auto production is suspect because demand for autos in June was at the lowest level since January 1993. This is probably a case of building inventories prior to shutdowns in the summer. Factory production edged down 0.1% in June after excluding autos,. In the second quarter, factory production fell at an annual rate of 3.7%. This is the third quarterly decline in factory production (see chart 5), with the latest quarterly drop as the largest in the current cycle.

Chart 5



Production of durable goods rose 0.7%, reflecting gains in output of motor vehicles and parts, wood products, primary metals, computer and electronic products, and aerospace and miscellaneous transportation equipment. The indexes for nonmetallic mineral products, fabricated metal products, machinery, furniture and related products, and miscellaneous manufacturing declined in June. The output of nondurable goods fell 0.3% after a nearly steady reading in May.

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Industrial Production – June 2008

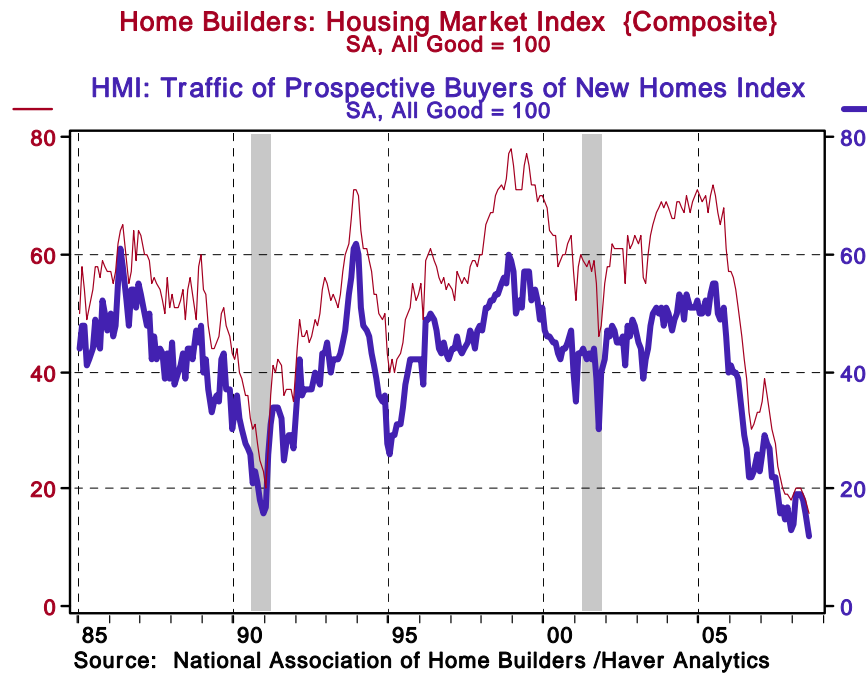
	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Industrial Production*	0.2	-0.4	0.1	-0.7	-0.2	0.5
Total Capacity Utilization	81.0	80.3	80.5	79.9	79.6	79.9
Manufacturing output*	0.0	-0.7	0.2	-0.9	-0.1	0.2
Man. Capacity Utilization	79.1	78.4	78.5	77.7	77.6	77.6
Capacity Utilization ex. High-tech industries	79.1	78.4	78.4	77.5	77.4	77.4
High-tech industries - output*	0.4	2.1	2.7	1.3	0.1	1.8
Manufact. Ex high-tech output*	0.0	-0.8	0.1	-1.0	-0.1	0.1

* - percent change from prior month

Housing Market Doldrums – End Is Not Here Yet

The National Association of Home Builders survey for July 2008 shows a grim picture of the housing market. The Housing Market Index fell to 16 from 18 in June. The July index is the lowest on record (see chart 6). The sub-indexes tracking current sales, sales in the next six months, and traffic of prospective buyers hit new lows. The message is that housing market conditions are yet to improve.

Chart 6



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