Northern Trust

DAILY GLOBAL COMMENTARY

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S&P 500 Corporate Profits Leave Little Recession Doubt

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Are we in a recession or are we not? The debate goes on. Take a look at the year-over-year change in operating profits of the S&P 500 corporations (see Chart 1). Profits have declined for three consecutive quarters through the first quarter of this year. Given reports of second-quarter profits to date and estimates of those corporate profits to be reported, it is a good bet that year-over-year profits will be down for four consecutive quarters. The data series in Chart 1 only goes back to the first quarter of 1989. But these limited data points suggest that the current behavior of corporate profits is signaling a recession. The data for year-over-year changes in reported S&P 500 profits (see Chart 2) start in the first quarter of 1965. The message is the same – current corporate profit behavior is consistent with past behavior in periods of recession.

Chart 1

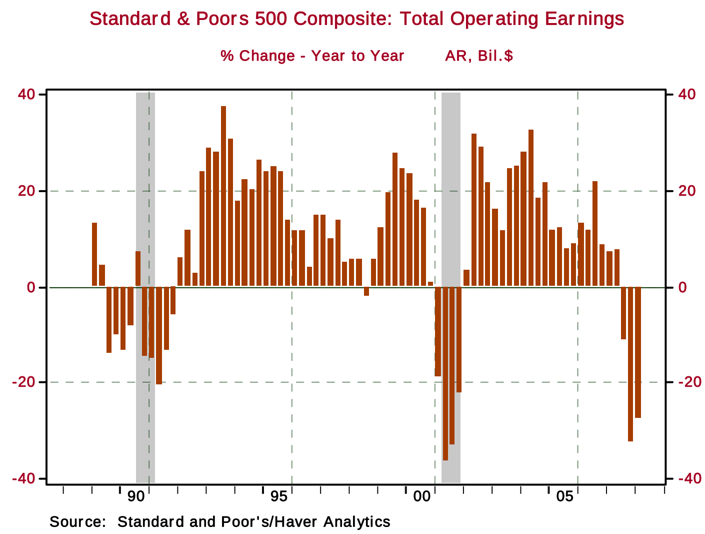
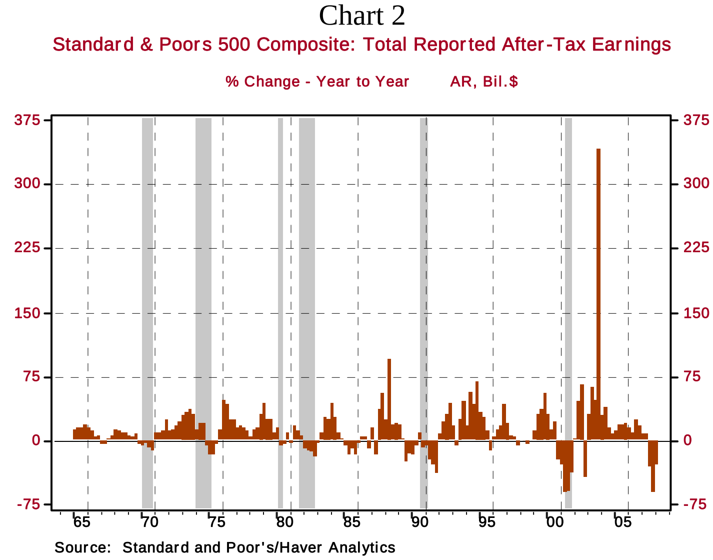


Chart 2



Now, the nice thing about corporate profit data is that they do not get revised as do a lot of other data that go into the recession decision. (I suppose that there might be an exception to this when it comes to the profit data associated with Fannie and Freddie!) With the S&P 500 profits data there is no debate as to whether the Commerce Department is using a correct measure of prices to deflate nominal data. If Ben Stein wants to continue arguing that the U.S. economy has not yet slipped into a recession, as he did in Sunday's *New York Times*, so be it. In the meantime, those who are paying attention to the behavior of corporate profits continue to win Ben Stein's money.

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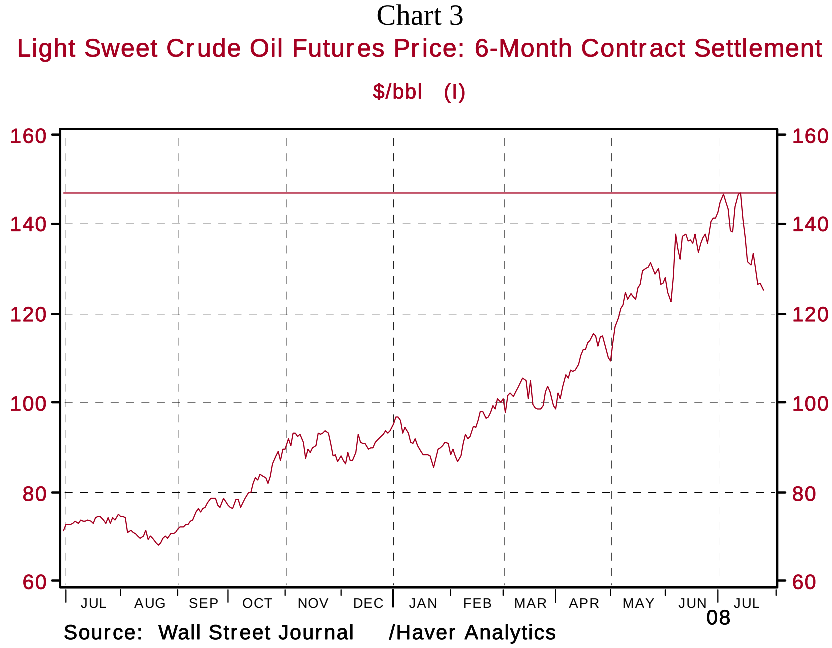
Recent Market Developments Supportive of Forecast Calling For Fed on Hold

The FOMC meeting of August 5 is widely expected to conclude with the federal funds rate unchanged at 2.00%. The federal funds futures markets has priced in a higher federal funds rate by the end of the year. Fed Presidents Plosser and Fisher continue to present a hawkish stance about inflation. The tone of Chairman Bernanke's testimony of July 15 leaned toward "economic growth" as the major priority in the inflation-growth debate, despite the extensive remarks about the importance of containing inflation and inflation expectations. Recent market developments suggest that the Fed has room to watch and wait before considering a higher federal funds rate in the near tem as the market expects.

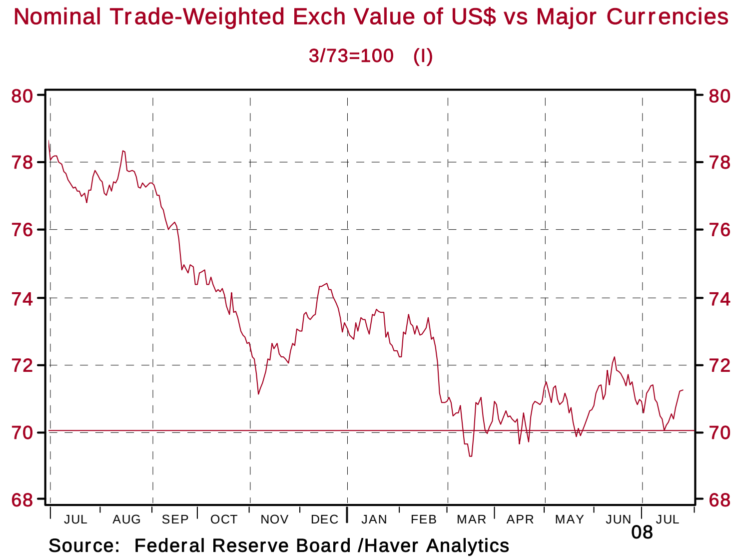
First, oil prices have declined nearly 15% from their highs on July 14 (see chart 3)

Chart 3



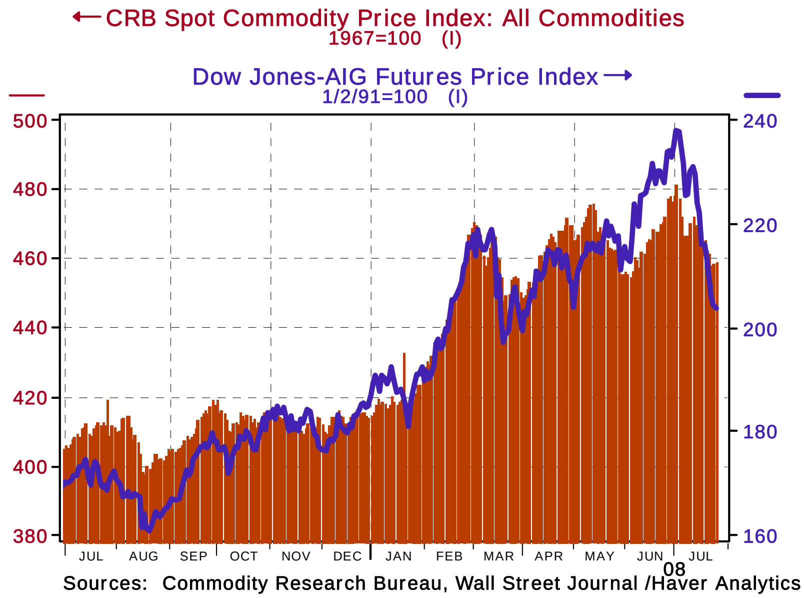
The trade-weighted dollar is trading at 72.68 today, up 3.78% from a low of 70.03 on July 15 (data points on chart end on July 25). If it closes above 72.229 today, it will be the highest reading since June 13.

Chart 4



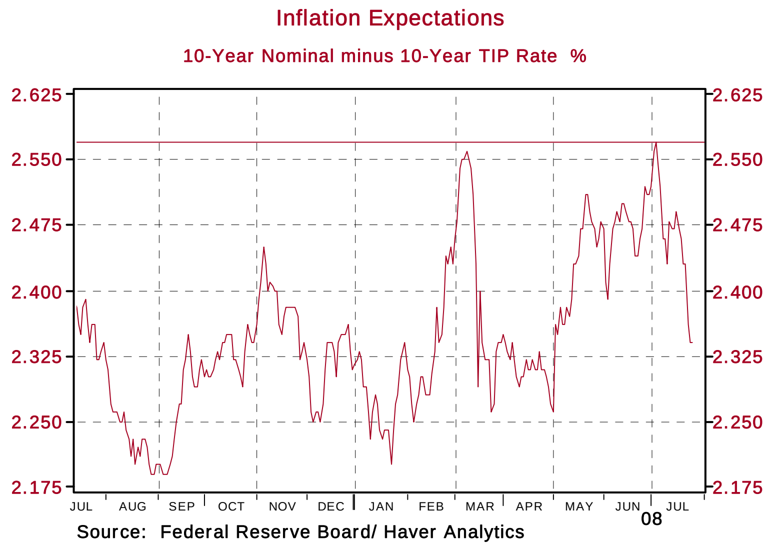
Commodity price indexes are trending down (see chart 5) after registering a peak on July 2. The CRB Spot Commodity Price Index (a composite of 29 different commodity prices, excludes oil) has dropped 4.5% since July 2. The Dow Jones-AIG Futures Price Index (prices of 20 commodities, includes oil) has fallen 14.4% from the peak reading on July 2.

Chart 5



Inflation expectations, as measured by the spread between the nominal 10-year U.S. Treasury note yield and the 10-year TIP note has dropped to 2.34% (7/25/08) from 2.57% (7/3/08), the highest since the current financial market crisis commenced in August 2007 (see chart 6).

Chart 6



The downward trend of oil prices and non-oil commodity prices and the mild upward trend of the dollar suggest reduced inflationary pressures. At the same time, the credit crunch is holding back economic activity. Loans of commercial banks for the purchase of homes, other consumer loans, and business loans contracted at an annual rate of 5.1% in the second quarter (see chart 7). Credit is the critical lubricant that keeps the economic engine running. Such a severe contraction translates into weak aggregate demand. The reduction in inflationary pressures and weak conditions of the economy both support expectations of an unchanged federal funds rate in the months ahead.

Chart 7