Northern Trust

DAILY GLOBAL COMMENTARY

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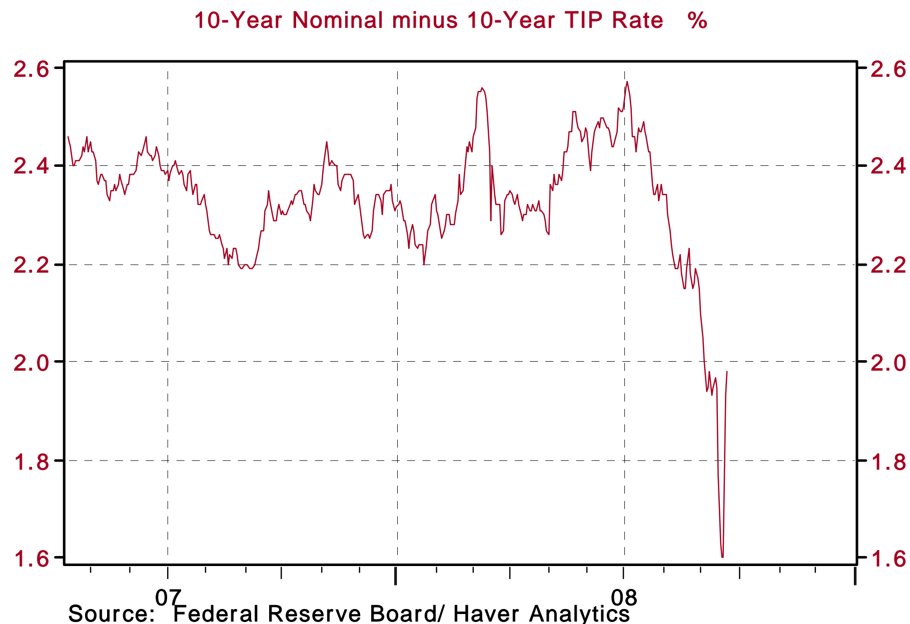
Paulson Plan Gets a Hostile Reception in Congress, Stagflation Fear Is Not Justified

September 23, 2008

The Paulson rescue package is at the front and center of the debate of how to contain the crisis underway. Treasury Secretary and Chairman Bernanke testified today about the need to hasten the passage of the Treasury plan. The details are trickling in gradually. Paulson and Bernanke stressed the necessity to take swift action. The questions raised before and during the testimony clearly underscore the strong dissatisfaction of Congress with the size and many aspects of the proposal. It is most likely that a compromise will emerge. The main goal of the plan is to buy illiquid assets and promote recapitalization of financial institutions, stop home foreclosures, and ease the credit crunch.

In the meanwhile, let us examine a hypothetical situation, the probability of which is high. Assume Congress passes a modified Paulson package, implying a larger federal budget deficit. The economy is working through a recession, although it is not officially announced yet. The Fed has adopted a neutral stance in the inflation-growth debate. And there is talk about the possibility of stagflation, and the market response to the Paulson plan has generally been pessimistic with sharp gains in inflation expectations, oil prices, and a weaker dollar. Inflation expectations, as measured by the difference between the 10-year U.S Treasury note yield and the 10-year TIP rate (see chart 1), shot up on September 22. Inflation expectations rose to 198 bps on September 22 (data points stop at 9/22 in chart 1) from a low of 160 bps on September 17 and 18. As of this writing, inflation expectations were down about 15 bps from September 22.

Chart 1



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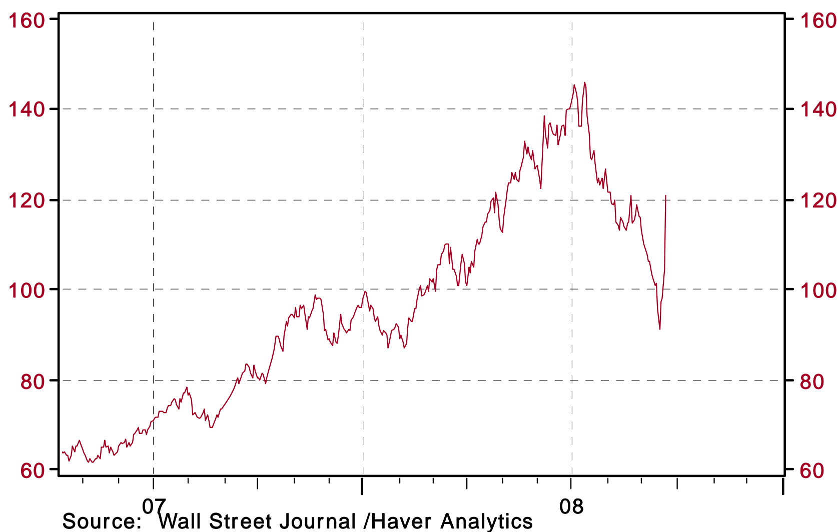
The sharp 32.6% increase in oil prices on September 22 vs. a low of $91.15 on September 16 is one of the reasons cited by predictors of stagflation. Crude oil was trading a tad over $100 as of this writing (data points stop at 9/22 in chart 2).

Chart 2



The trade-weighted dollar at 74.07 on September 22 reflects a decline from 77.06 on September 11, another factor that is seen as inflationary, and a possible larger deficit could reduce the attractiveness of U.S. investment.

Chart 3

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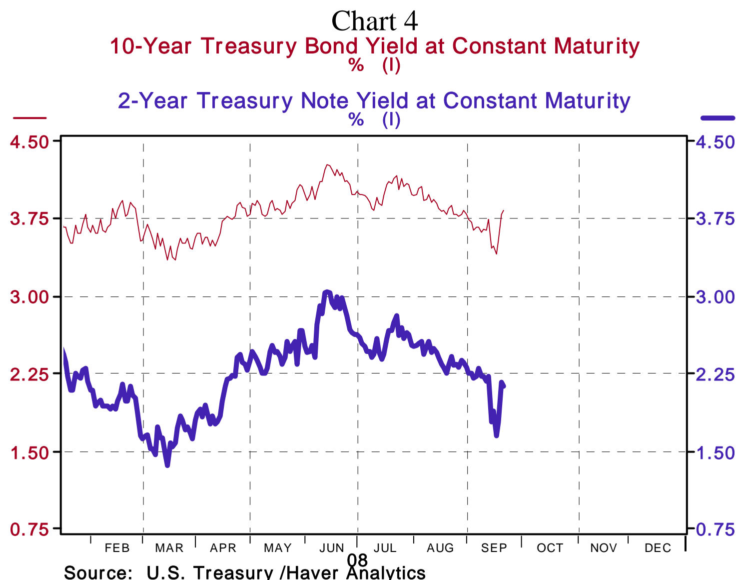
The interest rate impact of the likely large deficit has already emerged with the 2-year and 10-year Treasury note yields climbing to 2.13% and 3.83%, respectively, on September 22 vs. 1.64% and 3.41% on September 17, respectively. Today these rates were trading around 2.08% and 3.84%, respectively. (Data points stop at September 22 on chart 4.)

Chart 4



However, the credit crunch underway indicates that economic growth will continue to slow and the unemployment rate should head north of the 6.1% rate seen in August. It is challenging to imagine a scenario of rising inflation in the near term in an environment of weakening economic conditions exemplified by a rising unemployment rate, deceleration in the growth rate of personal income, and a credit crunch.

Chart 5

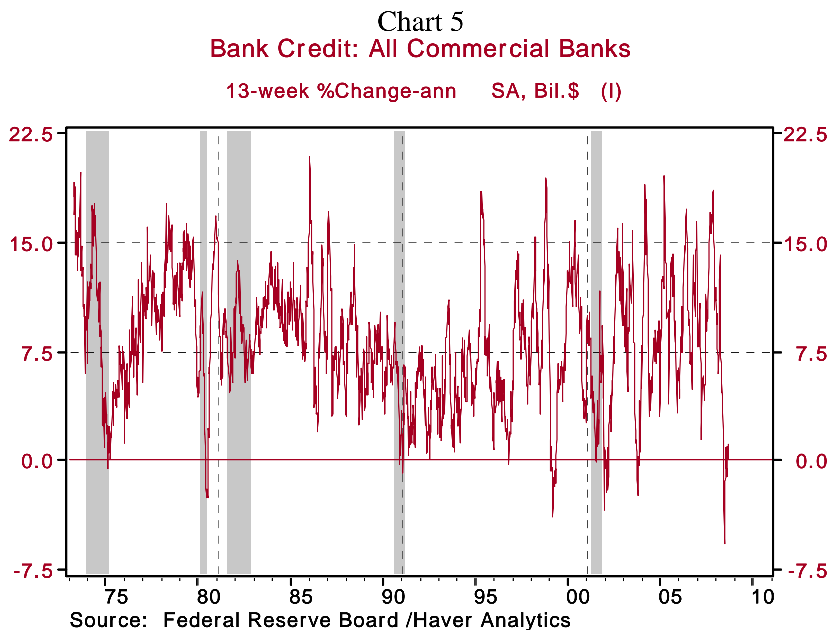


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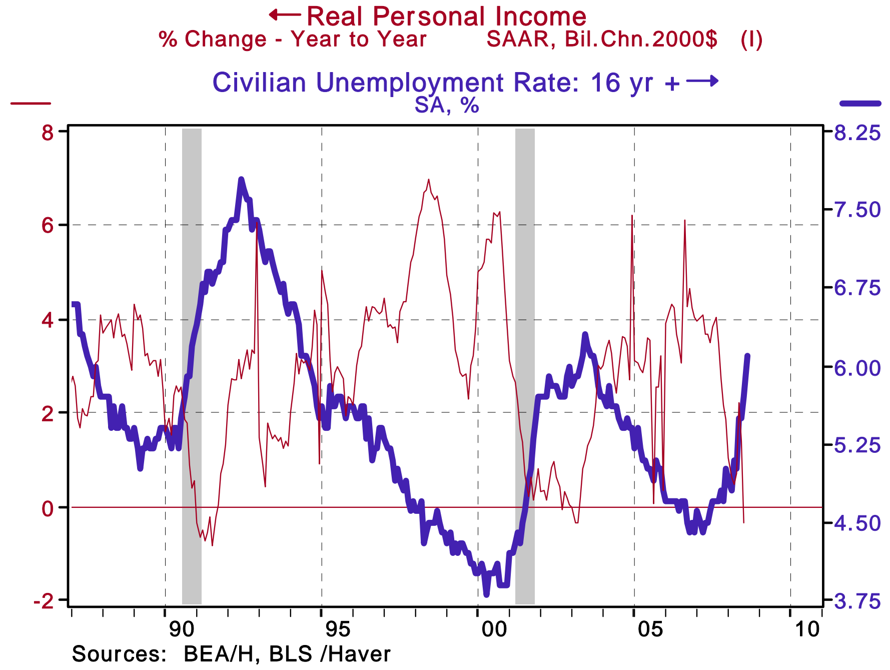
Chart 6



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