

## WEEK IN REVIEW

January 20-23, 2009

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### FOMC Meeting – January 27-28

The policy statement will be the first following the zero interest rate policy adopted at the last meeting. The explicit hint about the Fed's future course of action in the December 16, 2008 policy statement read as:

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*"The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time."*

We will be paying close attention to whether the Fed will retain or rephrase this part of the policy statement. With regard to the Fed's views about economic growth and inflation, we are curious to read how the following description will be modified. We do not expect radical modifications of the entire policy statement.

*"Since the Committee's last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further."*

*"Meanwhile, inflationary pressures have diminished appreciably. In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate further in coming quarters."*

### Watching Credit Market Spreads

Financial authorities are working on a new banking entity, Aggregator Bank, to address the problem of toxic assets on balance sheets of banks. Essentially, this is a conduit to thaw credit markets and invigorate the credit machine. In this context, an update of credit spreads is instructive. At the short-end, the 3-month Libor less 3-month T bill spread was around 108 bps as of this writing, up from a low of 98 bps on December 15. Considerable progress has been made compared with the highs posted in late-2008, but the recent widening of the spread warrants watching.

Chart 1  
 Spread: 3-Month Libor less 3-Month Treasury Bill Rate

(1)



In the commercial paper market, the spread between A2/P2 paper (more risky) and AA paper (less risky) was 179 bps on January 22 vs. a low of 129 bps on January 21. Again, progress from the high in December has occurred after the Fed commenced supporting this market.

Chart 2  
 Spread: A2/P2 Non-financial Comm. Paper Minus AA Nonfinancial Comm Paper

30-day Maturity



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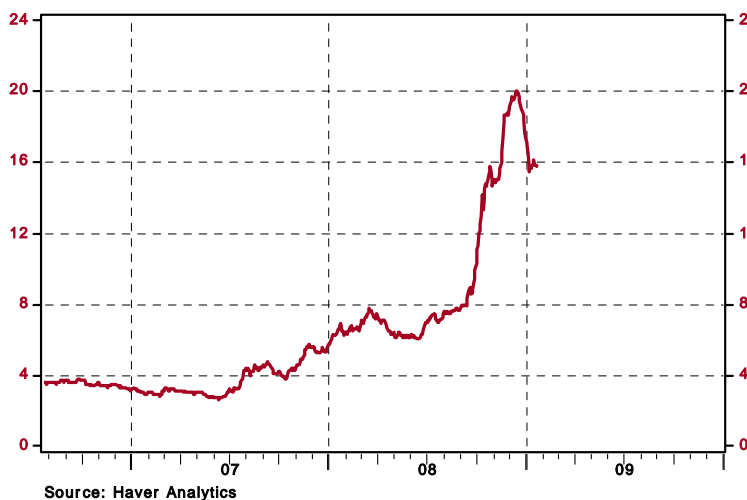
Corporate bond spreads have narrowed significantly, with the spread between the Moody's Baa yield and the 10-year Treasury note yield at 558 bps, down from a high of 611 bps on December 16, 2008.

**Chart 3**  
**Moody's Baa less 10-year U.S. Treasury Note Yield**  
 percent



At the far end of the risk spectrum, the spread between junk bond yields and the 10-year Treasury note yield was 15.76% on January 21, down from 20.05% on December 12, 2008. In sum, these charts indicate that progress is visible but plenty more narrowing of spreads is necessary to declare the coast is clear.

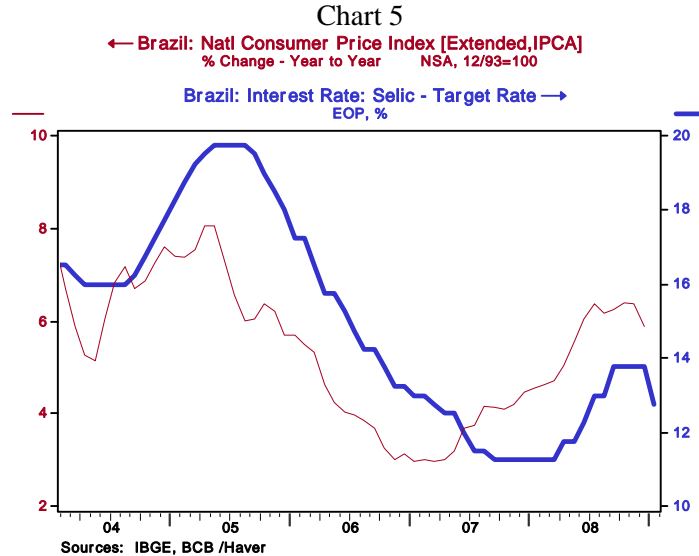
**Chart 4**  
**Merril Lynch Junk Bond yield less 10-year Treasury Note yield**  
 percent



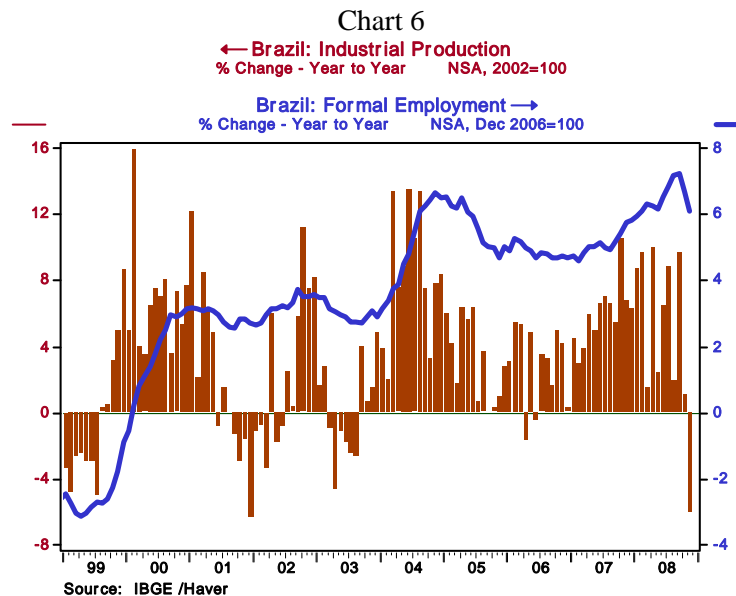
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## Brazil: 100 is the New 75

In a surprise to the majority of forecasters, Brazil's central bank lowered its benchmark rate by a larger-than-expected 100bps on Wednesday after an official vote of 5-3 (the three voted for a 75 bp cut), bringing the overnight Selic rate down to 12.75%. This move was justified after a subdued inflation reading for December, but the committee's main reason for the move was a significant deterioration in domestic conditions.



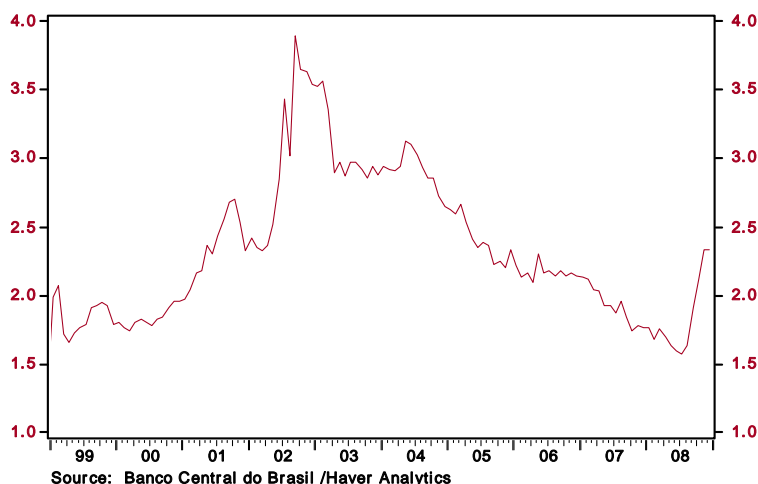
Industrial production registered a poor November, down 6.2% y-o-y, reflecting weak demand for its exports, which have been a main driver of the economy in recent years. Additionally, more than 650,000 formal jobs were lost in the month of November, signaling an inevitable drop in still-resilient consumer spending in the months to come.



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And what is the source of all this domestic deterioration? Risk aversion. Once thought to be impervious to the global credit crisis, the economy has been suffering ever since that mother-of-all bank collapses – Lehman Brothers. As a result, investment has slowed to a near standstill, trade finance has become largely unattainable, and the Real has plunged some 34% against the dollar since its most recent peak. Investors in the developed world have fled these riskier emerging markets, and thus, the economy is seizing up because of the combination of lack of financing and external demand. Over the next few months, expect these external factors to have a more marked effect on domestic activity (i.e. plummeting consumer spending).

Chart 7  
**Brazil: Foreign Exchange Rate: Commercial, Bid**  
 EOP, Reals/US\$



With two additional months of data at its next meeting on March 10-11, the monetary policy committee may have an even firmer foundation on which to justify a large reduction in its main policy rate. Given the extremes of the times, and the fact that the Real firmed after the cut (signaling a positive reception of deeper rate cuts by FX markets), we would venture to say that 100 is the new 75. In other words, expect to be surprised at how rapidly the Selic is lowered.

## Highlights from U.S. Economic Reports

### Housing Starts – June 2008

#### New Record Low for Housing Starts

Starts of new homes fell 15.5% in December to an annual rate of 550,000. The annual average of new homes started in 2008 is 902,000, the lowest on record. Starts of new single-family homes dropped 13.5% to an annual rate of 398,000, the lowest on record (see chart 8).

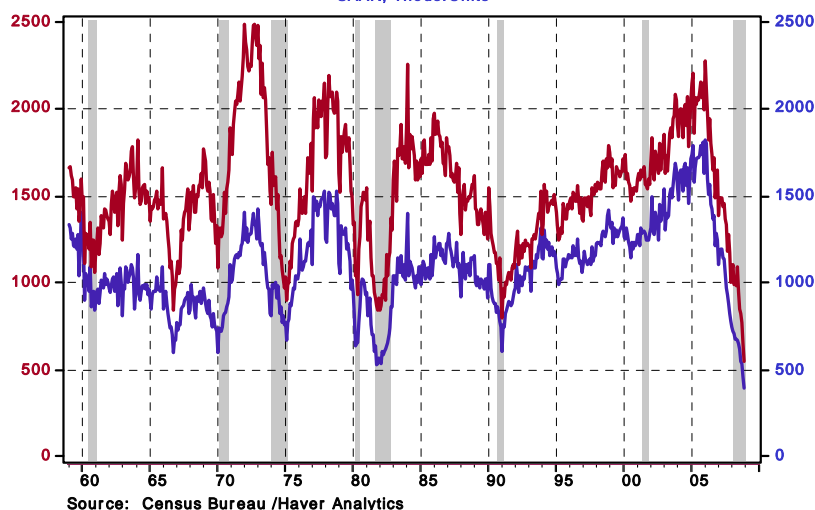
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Chart 8  
**Housing Starts**  
 SAAR, Thous. Units

**Housing Starts: 1 Unit**  
 SAAR, Thous. Units



The peak-to-trough decline in housing starts, both total and single-family, is the largest on record since record keeping began for these series in 1959 (see table 1). The duration of the weakness in home construction (peak was in January 2006 – December 2008) is also the longest on record.

**Table 1 Housing Starts across Business Cycles**

Recession	Peak - Housing Starts				Trough - Housing Starts				Change - Peak to Trough	
	Date	Total Starts	Date	Single-family	Date	Total Starts	Date	Single-family	Total Starts	Single-family
Apr. 60-Feb. 61	Feb-59	1667	Jan-59	1336	Dec-60	1063	Dec-60	841	-36.23%	-37.05%
Dec. 69-Nov.70	Jan-69	1769	Jan-69	967	Jan-70	1085	Jan-70	596	-38.67%	-38.37%
Nov. 73-Mar.75	Oct-72	2485	Sep-72	1399	Feb-75	904	Feb-75	667	-63.62%	-52.32%
Jan.80-Jul. 80	Apr-78	2197	Apr-78	1517	May-80	927	Mar-80	633	-57.81%	-58.27%
Jul.81-Nov. 82	Jan-81	1547	Sep-80	1019	Jan-82	843	Oct-81	523	-45.51%	-48.68%
Jul. 90-Mar.91	Jan-89	1621	Jan-89	1149	Jan-91	798	Jan-91	604	-50.77%	-47.43%
Mar. 01-Nov. 01	Feb-00	1737	Dec-99	1375	Oct-01	1540	Oct-01	1240	-11.34%	-9.82%
Current cycle	Jan-06	2273	Jan-06	1823	Dec-08	550	Dec-08	398	-75.80%	-78.17%

On a regional basis, there is a faint glimmer of hope in the Northeast because starts of new homes rose 12.7% in December, inclusive of a nearly 18.0% increase in single-family starts. Additional monthly gains will be necessary to confirm that home construction has turned the corner in this part of the nation. Housing starts posted declines in the other regions of the nation. The small 2.2% drop of housing starts in the West is also noteworthy compared with double-digit declines in the Midwest (-24.53%) and South (-22.2%).

Permits to build new homes fell 10.4% in December to an annual rate of 549,000, reflecting fewer permits issued for single-family units (-12.3%). Much like housing starts, permits issued for new homes have fallen sharply from the peak set in September 2005 such that the December readings are at new record lows (table 2). The large inventory of unsold new

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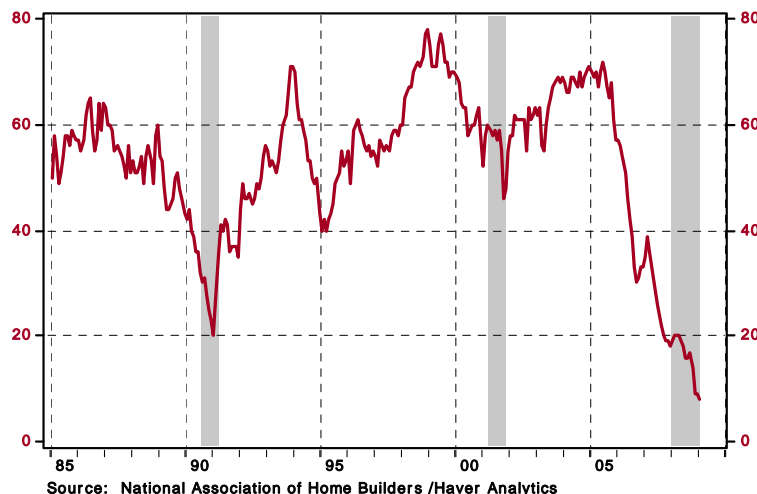
homes and the weakness in hiring implies that a pickup in home construction is most likely to reverse only later in the year as economic conditions improve.

**Table 2 Housing Permits across Business Cycles**

Recession	Peak - Housing Permits				Trough - Housing Permits				Change - Peak to Trough	
	Date	Total Permits	Date	Single-family	Date	Total Permits	Date	Single-family	Total Permits	Single-family
Apr. 60-Feb. 61	Jan-60	1092	Feb-60	868	Oct-60	972	Feb-61	673	-10.99%	-22.47%
Dec. 69-Nov.70	Feb-69	1495	Sep-68	738	Jan-70	1062	Jan-70	486	-28.96%	-34.15%
Nov. 73-Mar.75	Dec-72	2419	Oct-72	1150	Mar-75	709	Jan-75	527	-70.69%	-54.17%
Jan.80-Jul. 80	Jun-78	1983	Apr-78	1279	Apr-80	808	Apr-80	476	-59.25%	-62.78%
Jul.81-Nov. 82	Sep-80	1484	Sep-80	881	Oct-81	731	Oct-81	401	-50.74%	-54.48%
Jul. 90-Mar.91	Jan-90	1748	Jan-90	989	Jan-91	786	Jan-91	587	-55.03%	-40.65%
Mar. 01-Nov. 01	Jan-00	1727	Jan-00	1277	Sep-01	1565	Oct-01	1185	-9.38%	-7.20%
Current cycle	Sep-05	2263	Sep-05	1798	Dec-08	549	Dec-08	363	-75.74%	-79.81%

In related news, the Housing Market Index (HMI) of the National Association of Home Builders fell to 8.0 in January 2009 from 9.0 in December 2008. Before the onset of the current recession, the record low for the HMI was 20.0 during the 1990-91 recession (see chart 9). The question now is: What is the low for the HMI? The answer is unknown, but we can say that the severity of the housing market situation grows in leaps and bounds everyday.

**Chart 9**  
**Home Builders: Housing Market Index (Composite)**  
 SA, All Good = 100



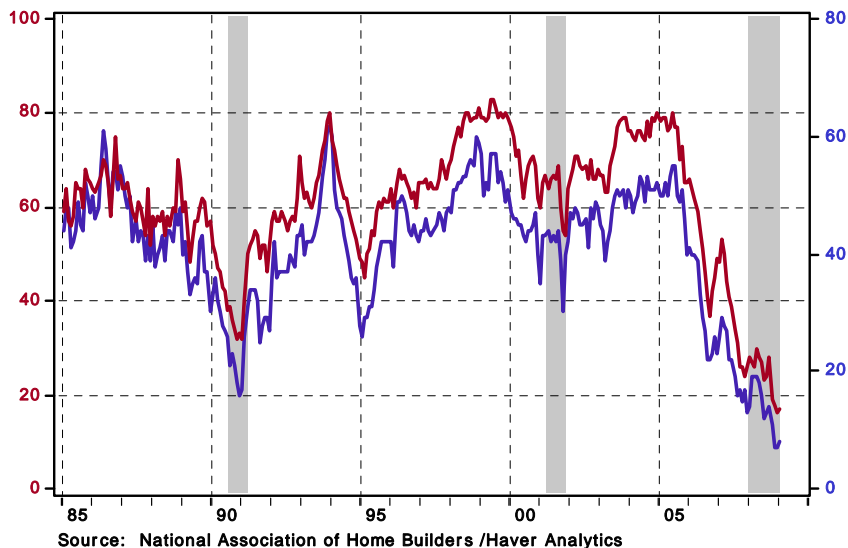
Among the sub-categories that make up the HMI, small gains of the indexes tracking sales in the next six months (17 vs. 16 in December) and traffic of prospective buyers (8.0 vs. 7.0 in December) are encouraging. On a regional basis, the HMI held steady in the Midwest (6.0) and advanced in the South (11.0 vs. 10 in December) but fell in the Northeast (10 vs. 11 in December) and West (4.0 vs. 7.0 in December).

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Chart 10

HMI: Sales of New Single Fam Det Homes Index: Next 6 Mo  
SA, All Good=100

HMI: Traffic of Prospective Buyers of New Homes Index  
SA, All Good = 100



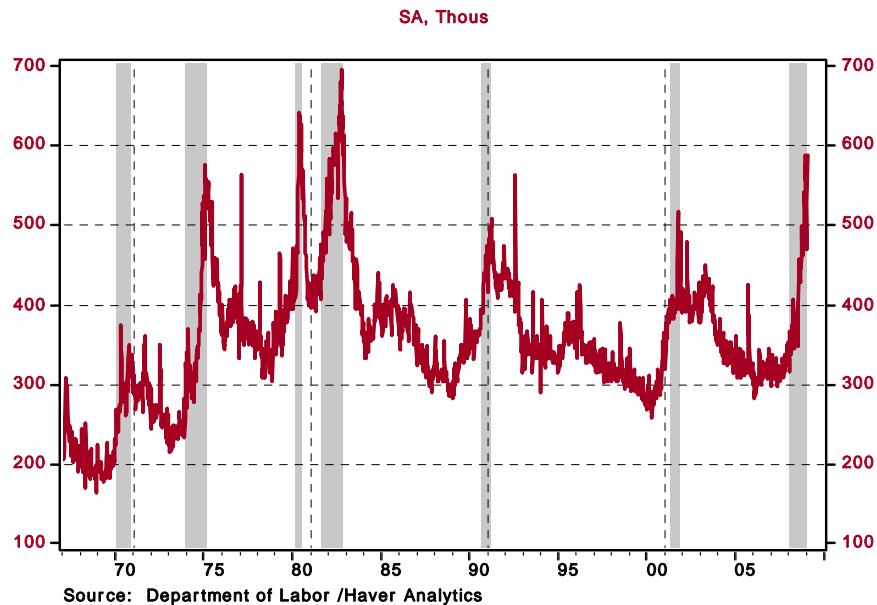
## Initial Jobless Claims

### Labor Market Situation Remains Grim

Initial jobless claims climbed back to 589,000 during the week ended January 17. The latest level reflects an increase of 119,000 claims in the last two weeks. Initial jobless claims declined by an identical number during the prior two weeks which contained holidays. These wide swings suggest a seasonal adjustment issue over the holidays. In any case, the main message is that the number of applicants filing for unemployment insurance is at a cycle high once again. Continuing claims, which lag initial claims by one week, advanced 97,000 to 4.607 million and the insured unemployment rate held steady at 3.4%.

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Chart 11  
Unemployment Insurance: Initial Claims, State Programs



## International Economic Highlights

### Japan: No Sale!

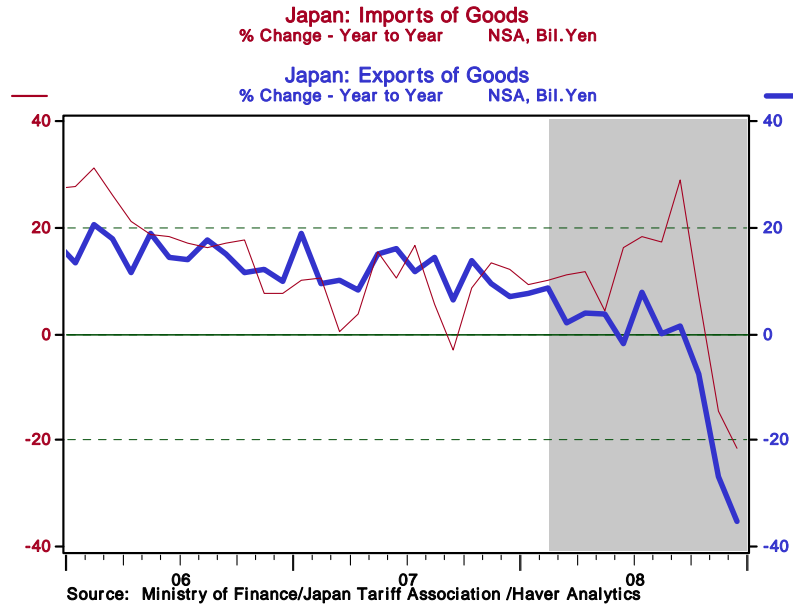
Two items of significance regarding the Japanese market hit the wire this morning – the end-year trade balance and the Bank of Japan (BoJ) policy meeting announcement. With the overnight call rate already down to 0.10%, another rate cut would hardly be a news-maker, but the state of Japan’s exports usually makes the front page. And unfortunately, the news was not good. Nobody expected the export market to make a miraculous turnaround, but some hope existed for less erosion in overseas sales or fewer imports, thereby supporting net exports. Neither occurred. December imports contracted by 21.5% on the year and were up by 7.9% for 2008 as a whole, but exports fared much worse, posting respective changes of -35.0% and -3.4%. This dragged the annual trade balance down to \$20.4 billion, a level not seen since 1983 and a far cry from the 2007 tally of \$92.1 billion.

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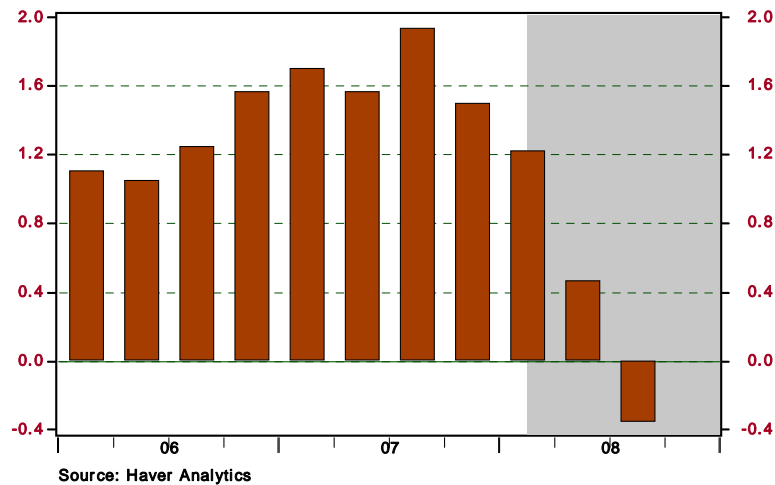
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Chart 12



To put that in perspective, net exports were 1.7% of GDP in 2007 – in 2008 this amount will barely reach 0.4%. Now consider that this collapse in trade all loaded into the tail-end of last year. This back-loading suggests that Japan’s Q4 GDP figure will be well beneath the sad Q3 tally of -0.5% on the quarter. We have said it before and we will say it again – our official forecast for Q4 GDP in Japan is ‘abysmal’.

Chart 13  
Net Exports as a % of GDP



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On a final note, while the BoJ did not cut the overnight rate, it took action in the form of accepting real estate investment trust (REIT) debt as collateral for market operations. By opening up this new category for BoJ operations, the central bank effectively salvaged a section of the economy struggling to secure funds. This measure also opened the possibility that other debt categories could be included as collateral in the future, giving debt markets something to be happy about in a year that so far has brought little joy.

The BoJ also downgraded its GDP and inflation outlooks dramatically, but this came as little surprise. The central bank now believes the current recession (which started in April 2008) will last for a full eight quarters, and a deflationary environment will persist into 2011. This is hardly an upbeat forecast, but we think it is the most forthright the BoJ has been in some time. And at least for the next few quarters, we believe the data will confirm this outlook.

### U.S Highlights for Next Week - FOMC Meeting January 27-28

1. **Leading Indicators** [Jan. 26] – **Consensus: -0.3%** vs. -0.4% in November
2. **Existing Sales** [Jan.26] –. **Consensus: 4.40 million** vs. 4.49 million in November.
3. **New Home Sales** [Jan. 29] –**Consensus: 400,000** vs. 407,000 in November.
4. **Durable Goods Orders** [Jan.29] –**Consensus: -2.0%** vs. -1.5% in November.
5. **Real GDP** [Jan. 30] – TNT: -4.5% **Consensus: -5.4% vs. -0.5 in Q3**

**Other reports** – Consumer Confidence [Jan. 27]. Consumer Sentiment Index, Employment Cost Index [Jan. 30]

### Key Interest Rates

	1/23/2009	1-wk. change, bps	4-wk. change, bps	1-yr. change, bps
3-month Libor	1.17	3	-29	-214
2-year U.S. Treasury note yield	0.81	8	-8	-142
10-year U.S. Treasury note yield	2.62	26	46	-99

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## Global Economic Data

	Real GDP		CPI		Unemployment Rate			Central Bank Rate		
	SAAR, yoy %		NSA, yoy%		%		year-ago	%		year-ago
United States	0.7	Q3-08	0.1	Nov-08	7.2	Dec-08	4.9	0.13	Nov-08	4.50
Euro-Area	0.6	Q3-08	1.6	Nov-08	7.8	Nov-08	7.2	2.50	Dec-08	4.00
Japan	-0.3	Q3-08	1.0	Nov-08	3.9	Nov-08	3.8	0.10	Dec-08	0.50
UK	0.3	Q3-08	3.1	Nov-08	3.6	Dec-08	2.5	2.00	Dec-08	5.50
Australia	1.9	Q3-08	5.0	Q3-08	4.5	Dec-08	4.2	4.25	Dec-08	6.75
Canada	0.5	Q3-08	1.2	Nov-08	6.6	Dec-08	6	1.50	Dec-08	4.25
China	6.8	Q4-08	0.0	Nov-08	4.2	Q4-08	4	1.14	Dec-08	1.89
India	7.6	Q3-08	10.4	Nov-08	--	--	--	5.00	Dec-08	6.00
New Zealand	-1.4	Q3-08	3.4	Q3-08	4.2	Q3-08	3.8	5.00	Dec-08	8.25
Norway	0.6	Q3-08	2.1	Nov-08	2.5	Q3-08	2.9	3.00	Dec-08	5.25
Singapore	-3.6	Q3-08	4.4	Nov-08	2.2	Q3-08	2.7	0.44	Dec-08	0.98
South Korea	-3.6	Q3-08	4.1	Dec-08	3.3	Dec-08	3.2	3.00	Dec-08	5.00
Sweden	0.3	Q3-08	0.9	Nov-08	6.8	Dec-08	6.0	2.00	Dec-08	4.00
Switzerland	1.7	Q3-08	0.7	Nov-08	2.8	Dec-08	2.6	0.66	Dec-08	2.76
Taiwan	-1.0	Q3-08	0.0	Dec-08	5.0	Dec-08	3.9	2.00	Dec-08	3.38
Thailand	4.1	Q3-08	0.4	Dec-08	1.1	Nov-08	1.4	3.25	Dec-08	3.75

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

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## Historical US Economic Data

	Dec-08	Nov-08	Oct-08	Sep-08	Aug-08	Jul-08	Jun-08	May-08	Apr-08	Mar-08	Feb-08	Jan-08
Payroll Employment (000)	-524	-584	-423	-403	-127	-67	-100	-47	-67	-88	-83	-76
% Change, Year Ago *	-1.9	-1.5	-1.0	-0.6	-0.2	-0.1	0.0	0.1	0.3	0.4	0.6	0.7
Unemployment Rate (%)	7.2	6.8	6.6	6.2	6.2	5.8	5.6	5.5	5.0	5.1	4.8	4.9
Avg. Hourly Earnings (% Chg.)	0.3	0.4	0.3	0.2	0.4	0.3	0.3	0.3	0.1	0.3	0.3	0.3
% Change, Year Ago	3.7	3.8	3.6	3.4	3.6	3.4	3.4	3.5	3.5	3.7	3.7	3.7
PPI (% Chg.)	-1.9	-2.2	-2.8	-0.4	-0.9	1.2	1.7	1.4	0.3	0.9	0.3	1.2
% Change, Year Ago *	-0.9	0.4	5.2	8.7	9.7	9.9	9.1	7.3	6.4	6.7	6.5	7.4
CPI (% Chg.)	-0.7	-1.7	-1.0	0.0	-0.1	0.8	1.1	0.6	0.2	0.3	0.0	0.4
% Change, Year Ago *	0.1	1.1	3.7	4.9	5.4	5.6	5.0	4.2	3.9	4.0	4.0	4.3
ISM Diffusion Index (%)	32.9	36.6	38.7	43.4	49.3	49.5	49.5	49.3	48.6	49.0	48.8	50.8
Industrial Production (% Chg.)	-2.0	-1.3	1.8	-4.2	-1.3	0.0	0.1	-0.2	-0.5	-0.2	-0.3	0.2
% Change, Year Ago	-7.8	-5.9	-4.2	-6.3	-1.9	-0.7	-0.1	0.2	0.4	1.5	1.6	2.5
Capacity Utilization (%)	73.6	75.2	76.3	75.0	78.3	79.4	79.6	79.6	79.9	80.4	80.7	81.0
Nondefense Cap. Goods ex Aircraft												
- Orders (% Chg.)		3.9	-6.7	-3.4	-2.3	0.3	1.6	-0.3	3.1	-1.0	-0.9	-0.8
% Change, Year Ago *		-6.2	-7.2	0.1	-0.2	6.6	3.4	3.4	2.6	-1.1	8.8	5.3
- Shipments (% Chg.)		-0.2	-3.7	1.7	-2.1	0.3	0.6	0.2	1.0	0.8	-1.3	-0.4
% Change, Year Ago *		-4.7	-2.2	2.7	-1.6	6.1	2.0	2.7	3.7	1.0	6.1	6.2
Retail Sales (% Chg.)	-2.7	-2.1	-3.4	-1.6	-0.7	-0.6	0.1	0.8	0.2	0.5	-0.5	-0.2
% Change, Year Ago	-7.9	-9.9	-4.0	0.1	-0.4	4.1	1.4	2.5	3.7	0.3	7.0	4.7
Real Personal Consumption (% Chg.)		0.6	-0.5	-0.5	-0.1	-0.6	-0.2	0.2	0.1	0.3	-0.2	0.1
% Change, Year Ago		-0.9	-1.0	-0.6	-0.2	0.2	1.1	1.4	1.3	1.5	1.2	1.7
Personal Income (% Chg.)		-0.2	0.1	0.0	0.3	-0.8	0.1	1.8	0.0	0.4	0.2	0.1
% Change, Year Ago		2.5	3.1	3.3	3.8	3.9	5.3	5.6	4.0	3.9	4.1	4.7
New Home Sales (SAAR, mn)		0.41	0.42	0.44	0.45	0.51	0.50	0.52	0.54	0.51	0.57	0.60
% Change, Year Ago *		-37.8	-42.1	-34.0	-36.7	-36.8	-38.4	-38.0	-41.0	-38.8	-29.4	-33.3
Existing Home Sales (SAAR, mn)		4.49	4.91	5.14	4.91	5.02	4.85	4.99	4.89	4.94	5.03	4.89
% Change, Year Ago *		-17.0	-1.9	6.8	-15.0	-11.3	-16.7	-16.3	-15.7	-22.5	-19.4	-23.2
Housing Starts (SAAR, mn)	0.55	0.65	0.77	0.82	0.85	0.95	1.09	0.98	1.00	0.99	1.11	1.06
% Change, Year Ago *	-46.2	-47.1	-40.7	-27.2	-37.0	-32.2	-25.6	-32.8	-34.0	-33.6	-24.0	-25.5
International Trade (Bils \$)		-40.4	-56.7	-56.6	-58.9	-61.1	-58.7	-60.0	-61.4	-57.0	-61.4	-58.7
	<b>Q4-08</b>	<b>Q3-08</b>	<b>Q2-08</b>	<b>Q1-08</b>	<b>Q4-07</b>	<b>Q3-07</b>	<b>Q2-07</b>	<b>Q1-07</b>	<b>Q4-06</b>	<b>Q3-06</b>	<b>Q2-06</b>	<b>Q1-06</b>
Real GDP, Chain Weighted, SAAR		-0.5	2.8	0.9	-0.2	4.8	4.8	0.0	1.5	0.8	2.7	4.8
% Change, Year Ago		0.7	2.1	2.5	2.3	2.8	1.8	1.3	2.4	2.4	3.2	3.1
Chain-Weighted Price Index, SAAR		3.9	1.1	2.6	2.8	1.5	2.0	4.1	2.2	2.8	2.7	3.5
% Change, Year Ago		2.6	2.0	2.3	2.6	2.5	2.8	2.9	2.8	3.2	3.5	3.4
Nominal GDP, SAAR		3.4	4.1	3.5	2.3	6.4	6.9	4.3	3.7	3.6	5.5	8.6
% Change, Year Ago		3.3	4.1	4.7	4.9	5.3	4.6	4.3	5.3	5.7	6.8	6.6
Employment Cost Index (%)		0.7	0.7	0.7	0.8	0.8	0.9	0.8	0.8	1.0	0.9	0.6
% Change, Year Ago		2.9	3.1	3.3	3.3	3.3	3.3	3.5	3.3	3.3	3.0	2.8
Productivity Nonfarm, SAAR		1.3	3.6	2.6	0.8	5.8	4.1	0.0	0.2	-2.1	1.8	2.5
% Change, Year Ago		2.1	3.2	3.3	2.7	2.5	0.5	0.0	0.6	0.3	1.7	1.3
Unit Labor Costs, Nonfarm, SAAR		2.8	-2.6	1.2	4.5	-2.4	-3.2	4.9	9.1	4.1	-1.1	2.6
% Change, Year Ago		1.4	0.1	0.0	0.9	2.0	3.7	4.2	3.6	2.6	2.2	2.9

Source: Haver Analytics

\* NSA

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