Northern Trust

DAILY GLOBAL COMMENTARY

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

Asha G. Bangalore
agb3@ntrs.com

Minutes of January FOMC Meeting – Implicit Inflation Target Included

February 18, 2009

The FOMC is more bearish about the economy, as shown in table 1, compared with the forecast published in October 2008. The U.S. economy is predicted to contract in 2009 (-1.3% to -0.5%) on a Q4-to-Q4 basis. The unemployment rate is predicted to advance higher than previously predicted and the inflation is expected to hold below the level seen in the October forecast. The direction of revisions to the Fed's projections is not a surprise given the nature of the economic reports of recent months. In fact, the minutes indicate that participants "generally expected that the recovery would be unusually gradual and prolonged."

The Fed introduced a new component in its forecast – longer run forecasts for real GDP, inflation, and unemployment rate. The inflation forecast appears to be a proxy for an official inflation target. The longer-run forecasts are the Fed's view about steady state economic growth, full employment, and price stability of the U.S. economy. In light of the anxiety about a possible entrenched deflationary environment, the longer-run projection about inflation is included to influence inflation expectations. All participants were of the opinion that there are downside risks to the growth forecast and the "inflation outlook was either balanced or tilted to the downside." In terms of calendar years, the longer-run forecast appears to be roughly estimates for 5-6 years down the road.

Table 1. Economic projections of Federal Reserve Governors and Reserve Bank presidents, January 2009

Percent

Variable	Central tendency[1]				Range[2]			
	2009	2010	2011	Longer Run	2009	2010	2011	Longer Run
Change in real GDP	-1.3 to -0.5	2.5 to 3.3	3.8 to 5.0	2.5 to 2.7	-2.5 to 0.2	1.5 to 4.5	2.3 to 5.5	2.4 to 3.0
October projection	-0.2 to 1.1	2.3 to 3.2	2.8 to 3.6	n.a.	-1.0 to 1.8	1.5 to 4.5	2.0 to 5.0	n.a.
Unemployment rate	8.5 to 8.8	8.0 to 8.3	6.7 to 7.5	4.8 to 5.0	8.0 to 9.2	7.0 to 9.2	5.5 to 8.0	4.5 to 5.5
October projection	7.1 to 7.6	6.5 to 7.3	5.5 to 6.6	n.a.	6.6 to 8.0	5.5 to 8.0	4.9 to 7.3	n.a.
PCE inflation	0.3 to 1.0	1.0 to 1.5	0.9 to 1.7	1.7 to 2.0	-0.5 to 1.5	0.7 to 1.8	0.2 to 2.1	1.5 to 2.0
October projection	1.3 to 2.0	1.4 to 1.8	1.4 to 1.7	n.a.	1.0 to 2.2	1.1 to 1.9	0.8 to 1.8	n.a.
Core PCE inflation[3]	0.9 to 1.1	0.8 to 1.5	0.7 to 1.5		0.6 to 1.5	0.4 to 1.7	0.0 to 1.8	
October projection	1.5 to 2.0	1.3 to 1.8	1.3 to 1.7		1.3 to 2.1	1.1 to 1.9	0.8 to 1.8	

NOTE: Projections of change in real gross domestic product (GDP) and of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The October projections were made in conjunction with the FOMC meeting on October 28-29, 2008.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation are not collected.

Source - Minutes of January 27-28 FOMC Meeting, Pg. 17

The FOMC discussed the possibility of introducing quantitative guidelines or targets for a monetary aggregate because it would provide information to anchor inflation expectations. There were mixed opinions about the usefulness of this policy and it appears that skeptics prevailed because the size and composition of the Fed's balance sheet should respond to the demands of the economic situation which may not always be consistent with the single quantitative target.

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.

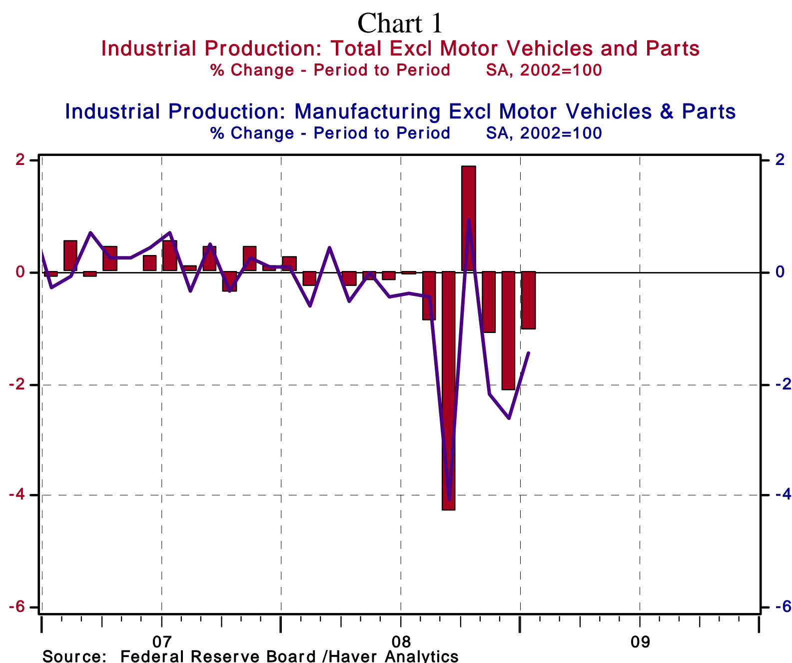
The FOMC members anticipate "that a gradual recovery in U.S. economic activity would begin in the third or fourth quarter" of 2009. Fiscal stimulus is being viewed "as a necessary and important complement to the steps the Federal Reserve and other agencies were taking and that it would foster economic recovery."

In a speech hours before the publication of the minutes of the January FOMC meeting, Chairman Bernanke spoke about the Fed's forecast and indicated that "the longer-term projections of inflation may be interpreted as the rate of inflation that FOMC participants see as most consistent with the dual mandate given to it by the Congress." Chairman Bernanke also explained the credit exposure of the Fed and concluded that credit risk of the Fed is extremely low.

Industrial Production Plunges, Factory Operating Rate at Record Low in January

Industrial production fell 1.8% in January, following a downwardly revised 2.4% drop in the prior month. If utilities production had not advanced at a rapid clip of 2.7%, the headline would have been weaker. The 23.4% decline in auto production from extended shutdowns of auto plants subtracted more than one percentage-point from the change in industrial production. Manufacturing output fell 2.5% in January; excluding autos, factory production dropped 1.4%, which is indicative of widespread weakness in the factory sector.

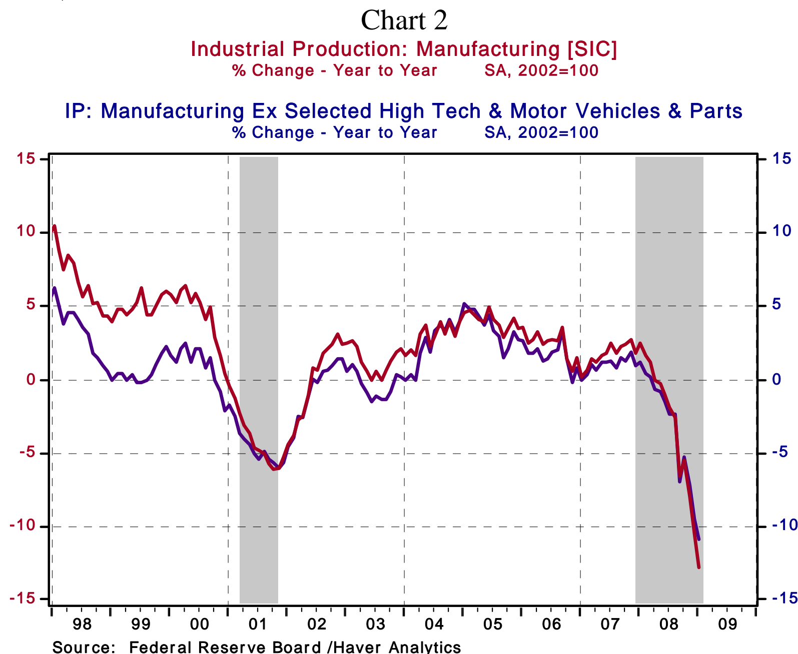
Chart 1



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.

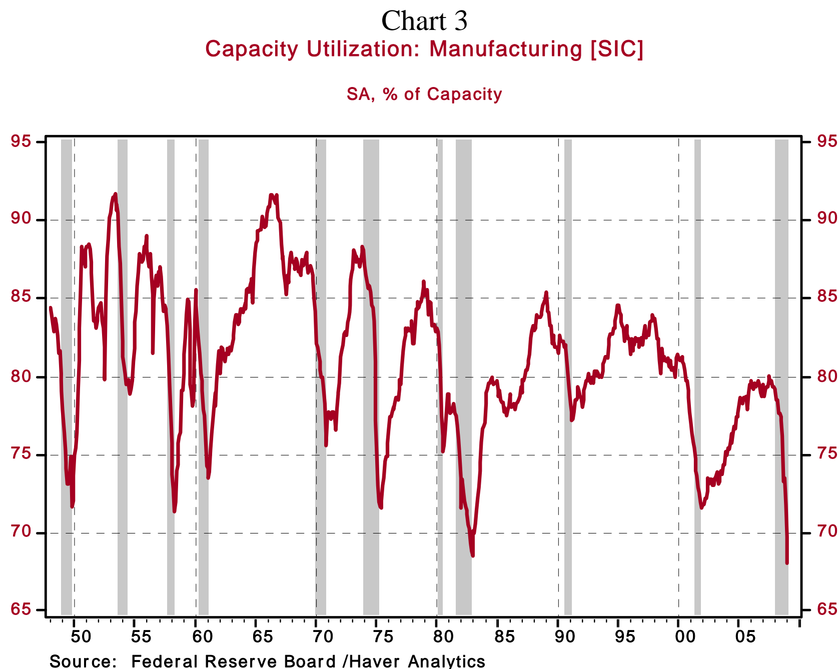
On a year-to-year basis, factory production fell 12.9% and excluding autos it declined 10.8% in January (see chart 2).

Chart 2



The operating rate of the factory sector was down 1.7% percentage-points to 68%, the lowest since record keeping began in 1948.

Chart 3



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.

High-tech production dropped 3.2% in January, putting the year-to-year decline at 12.8%, the largest decline for the cycle and it now matches the drop seen in the 2001 recession (see chart 4).

Chart 4

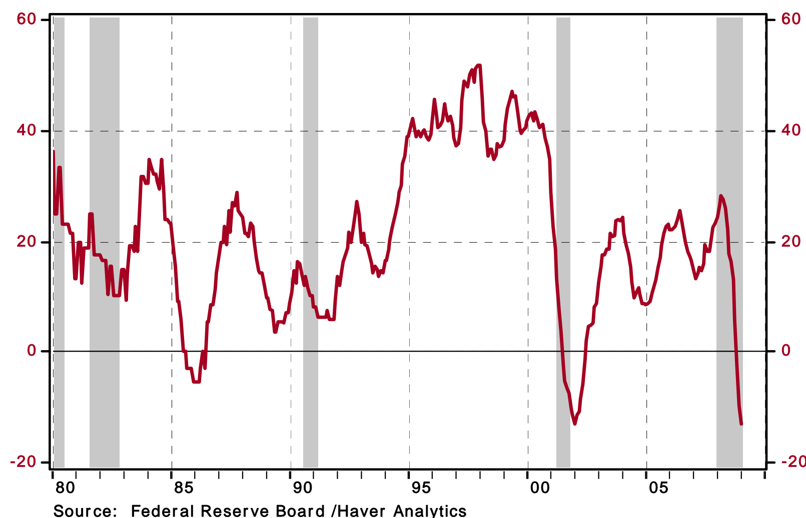


Table 2 Industrial Production

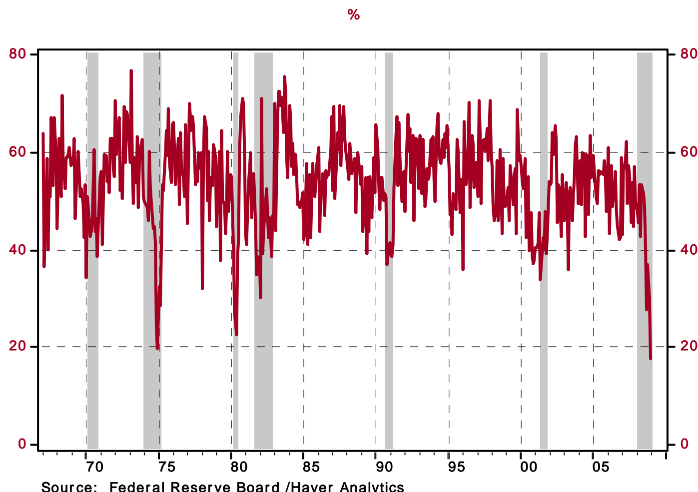
	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08	Jan-09
Industrial Production*	-1.3	-4.1	1.6	-1.2	-2.4	-1.8
Total Capacity Utilization	78.3	75.0	76.1	75.2	73.3	72.0
Manufacturing output*	-1.1	-3.8	0.6	-2.2	-2.9	-2.5
Man. Capacity Utilization	76.2	73.2	73.6	71.9	69.7	68.0
Capacity Utilization ex. High-tech industries	76.1	73.1	73.6	72.1	70.1	68.4
High-tech industries - output*	-0.8	-1.2	-2.9	-6.1	-6.2	-3.2
Manufact. Ex high-tech output*	-1.1	-3.9	0.8	-2.0	-2.7	-2.5

* - percent change from prior month

The broad-based weakness in factory production is visible in the diffusion index (The diffusion index is calculated as the percentage of the 255 component industries that increased over the indicated span plus one-half the percentage that were unchanged.) which was 17.78 in January, the lowest on record.

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 5



Construction of New Homes at New Record Low

Construction of new homes fell to a record low of 466,000 in January, which is down 79.5% from the peak in January 2006. The 16.8% drop in housing starts during January reflects a 12.2% decline in starts of new single-family homes and a 27.9% decline in starts of multi-family homes. The grim news has a positive aspect because in an environment of a rising inventory of unsold new homes (12.9-month supply, record high in December 2008) a reduction in the construction of new homes is necessary to reduce the supply of new homes and bring about stability in the housing market.

Chart 6

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.

Other details of the housing starts report:

Starts of new homes fell in all regions of the nation, with the Northeast recording the largest drop (-42.9%) and the West posting the smallest decline (-6.4%). Declines in the Midwest (-29.3%) and South (-12.8%) ranked in the middle.

The year-to-year decline in starts of single-family homes was 54.6% in January, the largest drop on record and now surpasses the 52.9% year-to-year decline recorded in March 1980.

The number of permits issued for new single-family units fell 4.8% to an annual rate of 521,000, reflecting an 8.0% drop in permits for new single-family homes and a 1.6% increase in permits for new multi-family units.

Tables 3 and 4 present the performance of housing starts and permits across business cycles.

Table 3 Housing Starts across Business Cycles ('000's units)

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	Jan-09	466	Jan-09	347	-79.50%	-80.97%

Table 4 Permit Extensions across Business Cycles ('000s units)

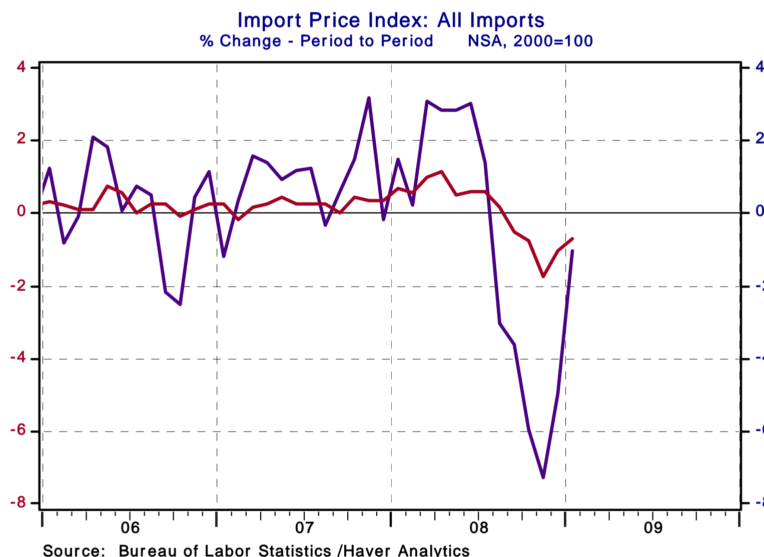
Recession	Peak - Housing Permits				Trough - Housing Permits				Change - Peak to Trough	
	Date	Total Permits	Date	Single-family	Date	Total Permits	Date	Single-family	Total Permits	Single-family
Apr. 60-Feb. 61	Jan-60	1092	Feb-60	868	Oct-60	972	Feb-61	673	-10.99%	-22.47%
Dec. 69-Nov.70	Feb-69	1495	Sep-68	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	Jan-09	521	Jan-09	335	-76.98%	-81.37%

Import Prices – January 2009

The Import Price Index of the U.S. fell 1.1% in January, marking the sixth consecutive monthly decline. Excluding petroleum, import prices fell 0.8%, also the sixth monthly decline. It is noteworthy that the pace of decline of these two price indexes is considerably smaller than in the earlier months. Excluding fuels the import price index declined 0.7%, the fifth straight monthly drop. On a year-to-year basis, the import price index excluding fuel was down 0.3%, the first such event in the last seven years. The main message is that import prices are not problematic now, but the trend bears watching (see chart 7).

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 7



Bryan J. Crowe
bjc5@ntrs.com

MXN Under Fire

Mirror, mirror on the wall, what is the most troubled cross of them all? Well, it's actually the Russian ruble. But in recent weeks, there has been another victim to join the most battered currency club – the Mexican peso.

Since the implosion of Lehman Brothers (September), risk appetite has packed up and left town – for all asset classes, including currencies – and Mexico's peso is no exception. This is reflected in the chart below with the MXN trading below 11/$ for most of 2008, up until – you guessed it – September. At that point, investors became so risk averse that you couldn't get them to bet on the World Series. The peso at around 13/$ felt a bit more comfortable for the time being because the data flow from south of the border was actually pretty resilient.

But like the rest of the world, things became evident over time. Data release after data release spelled disaster for the US-dependent economy, and the peso came under severe downward pressure with each fresh batch of bad news. After trading under 14/$ for the remainder of 2008, the new year ushered in a whole new panic attack for investors. Immediately, the MXN began trading over 14/$, then over 14.25/$, then up to 14.5/$. Once 14.5/$ was breached (end of Jan., horizontal reference on chart), the government and central bank began to worry. Not only does a weaker currency have inflationary consequences, but this was starting to look a little like a speculative attack.

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 8

Foreign Exchange Rate: Mexico

And what do you do during a speculative attack on your currency? You sell FX reserves. In the week ended Feb. 6, Mexico sold $1.06 billion from its foreign reserves to help the battered peso. While the markets responded favorably for a short time after each sale, over the course of the day the currency would eventually trade lower than before the government's dollar auction. The authorities seemed to forget that the market has an *extremely* short-term memory. Perhaps they also forgot to take heed of Russia's current nightmare situation. By selling reserves to protect its own currency, the Russian authorities, in effect, painted a bulls-eye on the ruble, and are moving ever closer to the situation faced in 1998, despite Putin's rock-solid rhetoric.

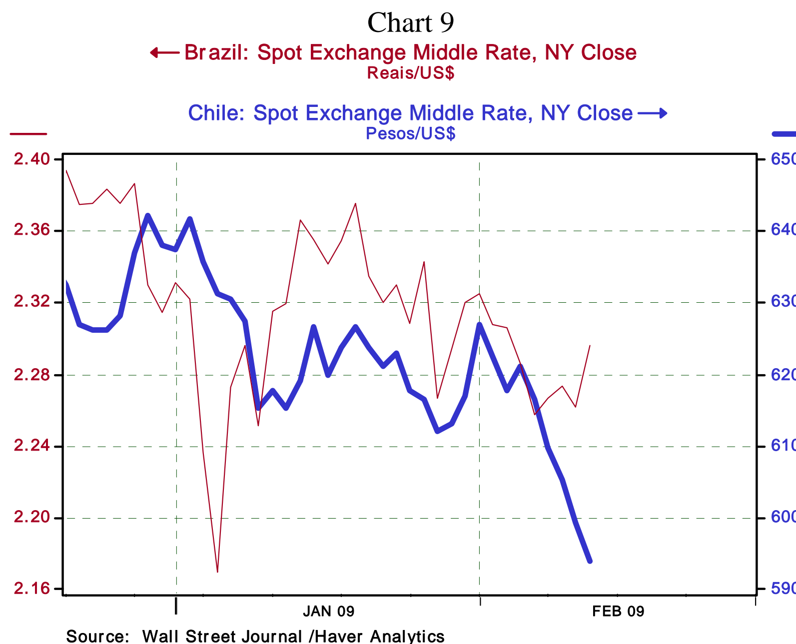
The real question is, did the Mexican authorities also put a price on the peso's head? After reaching an all-time high of 14.7165/$ in intra-day trading on February 17, it is tough to say no. Despite billions in reserve sales, the MXN continues to sink to record lows, so it appears as if the moves have been futile. Furthermore, Fitch mentioned on February 9 that due to the recent reserve reductions, Mexico is on watch for a downgrade – which sounds exactly like a bulls-eye.

The important thing for the authorities to remember here is that they cannot, under any circumstances, target a certain exchange rate. Targeting an exchange rate will result in the vicious cycle of throwing reserves at the market, time and time again, while seeking a conclusion that the market is not willing to accept. The market is going to go where it wants to, and fighting its urges will only lead to the loss of billions more reserves, which may in fact destabilize the economy faster than *not* intervening would. The peso will be undervalued in the short-term and the authorities should accept that. As the US and Mexican economies come back to life, the value will correct in the medium-term. There is no problem with smoothing volatility, but it seems as if 14.5/$ is the bank's magic number. And having a magic number is very bad indeed.

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.

If the central bank were observant, it could play hero in this mess. Instead of being worried about rate cuts fuelling inflation (the economy is going to contract in 2009, killing demand-side pressures), it should be thanking Brazil and Chile and any other Latin American country that has made a large cut for showing them the way. Brazil's most recent cut (Jan. 21) of 100 bps was followed by a rally in the Real that has still retained most of its gains. Likewise, Chile's first cut of the cycle (Jan. 8) of 100 bps had the same effect on its peso, as did the most recent monster 250 bp cut (Feb. 12). The take-away here is, markets are loving bigger-than-expected emerging rate cuts. So, Banxico, please help stimulate your sagging economy and save your nose-diving peso from freefall by giving us more than we expect on February 20.

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.