Northern Trust

U.S. ECONOMIC & INTEREST RATE OUTLOOK

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Greece, Portugal and Spain Are the Least of Our Economic/Financial Challenges

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After hitting a cycle high of 1217.28 on April 23, 2010, the S&P 500 stock market index fell by 10.65% in the following 20 trading days. The media would have you believe that the ongoing "official" correction in the U.S. equities market is all about the southern member states of the Euro-zone – Greece, Portugal and Spain (GPS). Although concern about the economically-weak and highly-indebted Euro-zone states have played a role in the U.S. equities market correction, we think there is more to the correction than GPS. Moreover, we believe that the problems of these challenged Euro-zone members will not have a significant effect on U.S. or global economic activity in the foreseeable future. China might, but not Greece, Portugal and Spain.

Let's put things into perspective. Greece accounted for 0.6% of global GDP in 2008 in nominal U.S. dollars. GPS, combined, accounted for only 3.8% of global GDP in 2008. In contrast, China accounted for 7.7% of global GDP in 2008. Brazil, India and China (BIC), combined, accounted for 12.6% of global GDP in 2008. In the five years ended 2007, the year before the global economy slumped into recession, the combined real GDP of GPS grew at a compound annual growth of 3.3%. In this same period, the combined real GDP of BIC grew at a compound annual growth of 8.9%. We would submit to you that the economic/financial situations in BIC are a lot more important with regard to global economic activity than the economic/financial situations in GPS.

And we would further submit to you that the economic/financial situations in BIC are a lot more important with regard to the U.S. economy than are the economic/financial situations of GPS. The level of U.S. nominal exports of goods in March 2010 was $22.4 billion above the March 2009 level. The March-over-March increase in exports to all of Europe accounted for 7.6% of the increase in total U.S. exports. The increase in exports to Asia ex-Japan and South America accounted for 44.3% of the increase in U.S. exports. Again, what is happening economically in BIC is more important for the U.S. economy than what is happening in GPS.

Now, has anything been going on in China that might be of some concern to the global economy? You bet. On Tuesday, May 4th, it was reported that the Chinese manufacturers purchasing managers index slipped to its lowest reading in six months. China, in addition to being a large exporter, also is a large importer of raw materials and semi-finished goods. If the Chinese manufacturing sector were slowing down, that could have a major negative impact on the economies of its suppliers. It is interesting that on May 3rd, the U.S. S&P 500 stock price index rose 1.3%. On Tuesday, May 4th, after the announcement of the decline in the Chinese purchasing managers index, the S&P 500 index fell 2.4%. The media's explanation for the

May 4th decline in the U.S. stock market was uncertainty about the Greece's problems. But, to the best of my knowledge, there was no change in uncertainty about Greece's problems between the close of the U.S. stock market on May 3rd and its close on May 4th. There was, however, a change in the uncertainty about the near-term prospects for the Chinese economy – a change for the worse. Perhaps this is why New York copper futures prices were down 3.5% on May 4th after having been down 1.8% on May 3rd. On May 10th, the Chinese government announced that CPI was continuing to trend higher, increasing 2.8% on a year-over-year basis in April 2010 compared with a drop of 1.5% in April 2009. In late April, the Chinese government also announced that real estate prices continued to climb. The Chinese economic authorities have been taking actions in recent months to slow down bank lending in order to damp down inflationary pressures in terms of goods/services prices as well as real estate prices. The historical record with regard to a managed deflation of asset prices is not too encouraging. Often, it becomes *unmanageable* with the pace of real economic activity slowing significantly. Thus, global investors would have reason to be nervous about the value of their portfolios with such an important economy such as China experiencing rising goods/services price inflation as well as asset-price inflation. Another important economy, that of India, also is experiencing a run-up in CPI inflation. As a result, the Reserve Bank of India has increased its repo rate by 50 basis points since February. We would submit that the restrictive economic policies being pursued in China and India could have a much more adverse effect on the U.S. economy and the U.S. stock market than the goings on in Greece, Portugal and Spain.

At the same time that Greece has been getting headlines, financial sector regulation legislation had been winding its way through the U.S. Senate. Elements of this legislation are thought to have a significant adverse effect on some large U.S. financial institutions. Do you not think that this might have played a role in the correction of the U.S. stock market? This might help explain why the S&P stock index for financials was down 12.3% in the 20 trading days ended May 21 while the S&P stock index for industrials was down a bit less, by 10.5%. By the way, legislation pertaining to the regulation and taxation of financial institutions is being proposed in the European Union, too. This might have played a role in the decline of European financial sector equities above and beyond concerns about GPS.

Then there is that slick problem in the Gulf of Mexico. It is likely to cost BP *beaucoup* bucks to clean it all up and compensate those whose incomes have been impaired because of the externality BP imposed on them. And don't you think that the profits of the offshore oil drillers could be hurt by likely more stringent environmental regulations? Perhaps this might have more to do with the 10.9% April 20 through May 21 decline in the ETF for oil exploration corporations (XOP) than GPS.

It has been alleged in the past week that the North Koreans torpedoed a South Korean naval vessel operating in international waters. The South Korean ship sank and 46 South Korean sailors perished as a result. Sabers on both sides of the 38th parallel are rattling. Don't you think that if an armed conflict were to break out on the Korean peninsula it would cause some concern among global investors? More concern than if Greece had to restructure its debt?

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The dollar has appreciated markedly vs. the euro due to the problems of GPS. All else the same, when U.S. multinational corporations translate their *euro*-denominated earnings back into U.S. dollars, their *dolla*r-denominated earnings will be negatively affected. True, this is a case of “money illusion.” But stock jockeys often suffer from all kinds of illusions.

Lastly, the S&P 500 stock price index as of April 23rd was up almost 80% from its March 9th, 2009 low. With the consensus forecast of real GDP growth of only 3.2% this year and 3.1% in 2011, is it realistic to expect the S&P 500 stock price index to stay on its 80% growth trajectory?

But let’s assume, for the sake of argument, that the problems of GPS have been the major cause of the correction in global stock markets. What are the probabilities that the problems of these economies will continue to plague global stock markets? We would say, quite low. Here is why. GPS have been promised by other Euro-zone members and the IMF up to 860 billion of euro loans, if necessary. This represents 59% of the combined 2009 nominal GDP of GPS. In addition, the European Central Bank (ECB) will accept the sovereign debt of these troubled economies as collateral for loans to Euro-zone banks in need of funding. The Federal Reserve has re-opened its emergency currency swap line to the ECB so that Euro-zone banks are able to obtain from the ECB dollar funding that they might need. Lastly, the ECB has begun purchasing in the open market sovereign debt of GPS. In effect, the ECB has taken on again its legitimate function of lender of last resort to Euro-zone banks. This implies that U.S. banks with exposure to Euro-zone banks are unlikely to incur any losses as result of the problems currently being experienced by GPS. In sum, we believe the Euro-zone crisis is largely over due to the aggressive actions taken by the member states of the Euro-zone and the ECB.

Although investors are forward looking, let’s take a look in the rear-view mirror to see how the U.S. economy was performing before the “Greek tragedy” became all the rage. One of the broadest measures of the *current* state of the U.S. economy is the Chicago Fed National Activity Index (CFNAI). The CFNAI is a weighted average of 85 existing monthly indicators of economic activity drawn from five broad categories: 1) output and income 2) employment, unemployment and hours 3) personal consumption, housing starts and sales 4) manufacturing and trade sales and 5) inventories and orders. This index is constructed to have an average value of zero and a standard deviation of one. Because

economic activity tends toward trend growth rate over time, a positive index corresponds to growth above trend and a negative index corresponds to growth below trend. Chart 1 shows the behavior of the CFNAI through April of this year. The April 2010 reading of

+ 0.29 is the highest reading of the CFNAI since December 2006. So, the U.S. economy had a good bit of forward momentum before encountering the Greek tempest.

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Chart 1

FRB Chicago National Activity Index

+=growth above trend

Source: Federal Reserve Bank of Chicago /Haver Analytics

It is true that the Conference Board's Leading Economic Indicators index (LEI) declined by 0.1% in April – its first decline since March 2009. Although a sharp decline in building permits in April played a large role in bringing about the decline in the LEI, what concerns me more is the ongoing contraction in the price-adjusted M2 money supply. Chart 2 shows that after surging right after the Lehman Brothers failure, the year-over-year percent change in the CPI-adjusted M2 money supply began trending lower and has contracted in three of the past four months ended April. Although this trend contraction in the price-adjusted money supply might not preclude growth in real economic activity, it is unlikely that growth will be robust. And *this* is why we have been forecasting somewhat slower real GDP growth in the next several quarters – *not* because of Greece.

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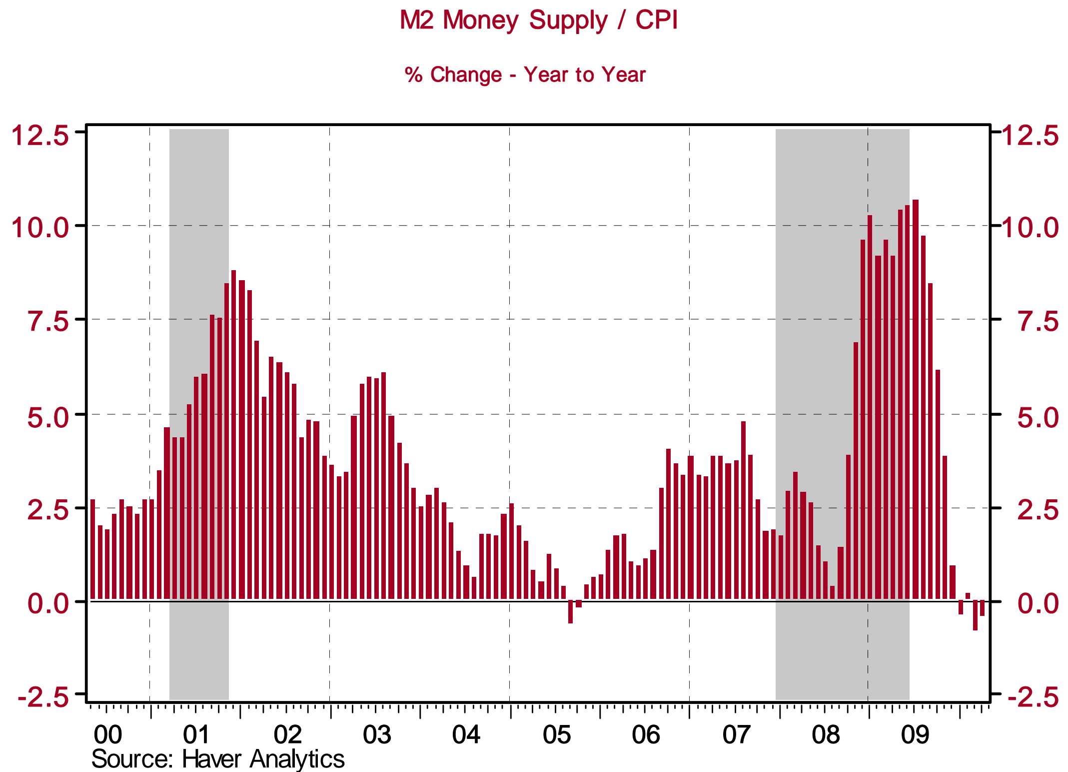
Chart 2



While on the subject of money supply growth, in *nominal* terms, both the U.S. and Euro-zone money supplies are growing very slowly. As shown in Chart 3, in the 12 months ended April, the U.S. M2 nominal money supply has grown at an annualized rate of 1.75%. In the 12 months ended March, the Euro-zone M2 nominal money supply has grown at an annualized rate of 1.48% (see Chart 3). Milton Friedman taught us that inflation is everywhere and always a monetary phenomenon. That is, for inflation to increase and be sustained at a higher rate, the money supply held by the nonbank public has to persistently grow at relatively high rates. We doubt that 12-month annualized growth in nominal money supply growth of 1.48% or 1.75% would have worried Friedman from an inflationary perspective – from a real growth perspective, perhaps, but not from an inflationary perspective.

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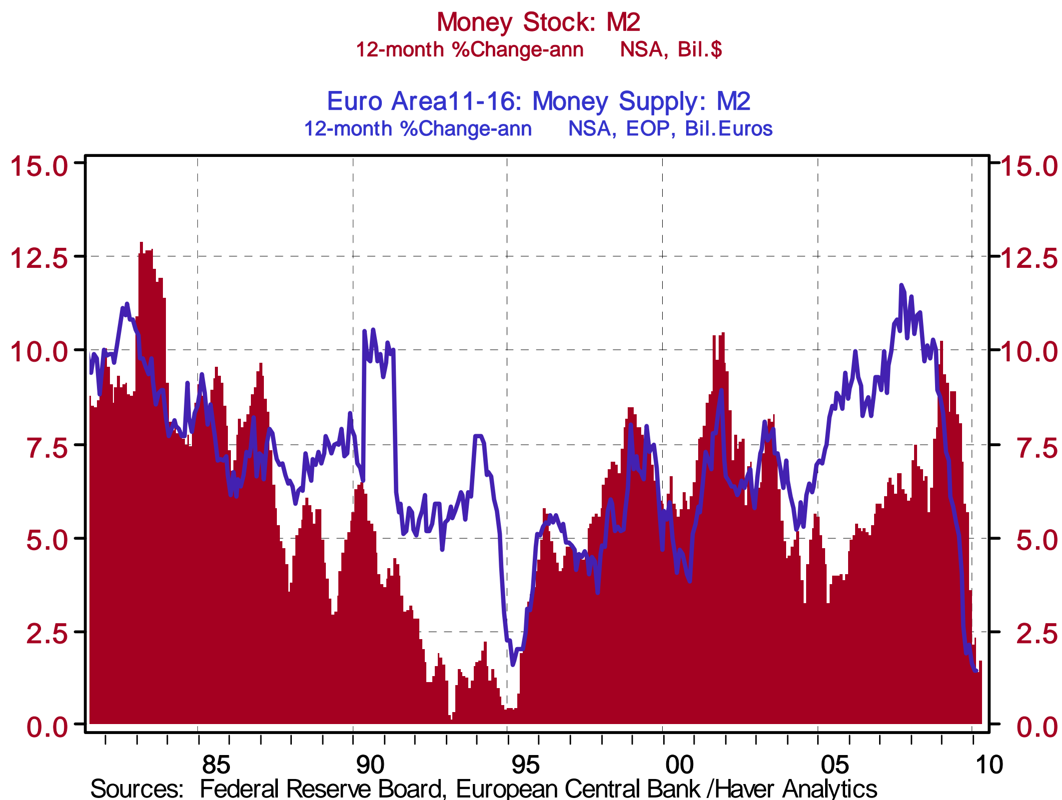
Chart 3



The behavior of the money supply is important with regard to *future* inflation. As much as central bankers intellectually understand that they have to make policy decisions *today* that will have an impact on inflation *tomorrow*, often emotion takes over and what is happening to inflation *today* will have an effect on their policy decisions *today*. Currently there is no "emotional" conflict for the Fed. Inflation in the U.S. *today* is not a clear and present danger, as shown in Chart 4. In the 12 months ended April, the CPI is up a relatively benign 2.2% and is trending lower since its 2.7% increase in the 12 months ended December 2009. The FRB 16% trimmed-mean CPI is constructed by "throwing out" each month's most volatile components (which can vary from month to month). Specifically, the 8% of the components with the largest percentage increases and the 8% of the components with the smallest percentage increases (or largest percentage decreases) are excluded from the calculation of the CPI – hence the term, 16% trimmed-mean. In the 12 months ended April, the trimmed-mean CPI had increased by only 0.9% and is trending lower. The upshot of the current behavior of inflation and the future behavior implied by current money supply growth is that the Fed can keep its policy interest rates at their current low levels for an extended period of time in order

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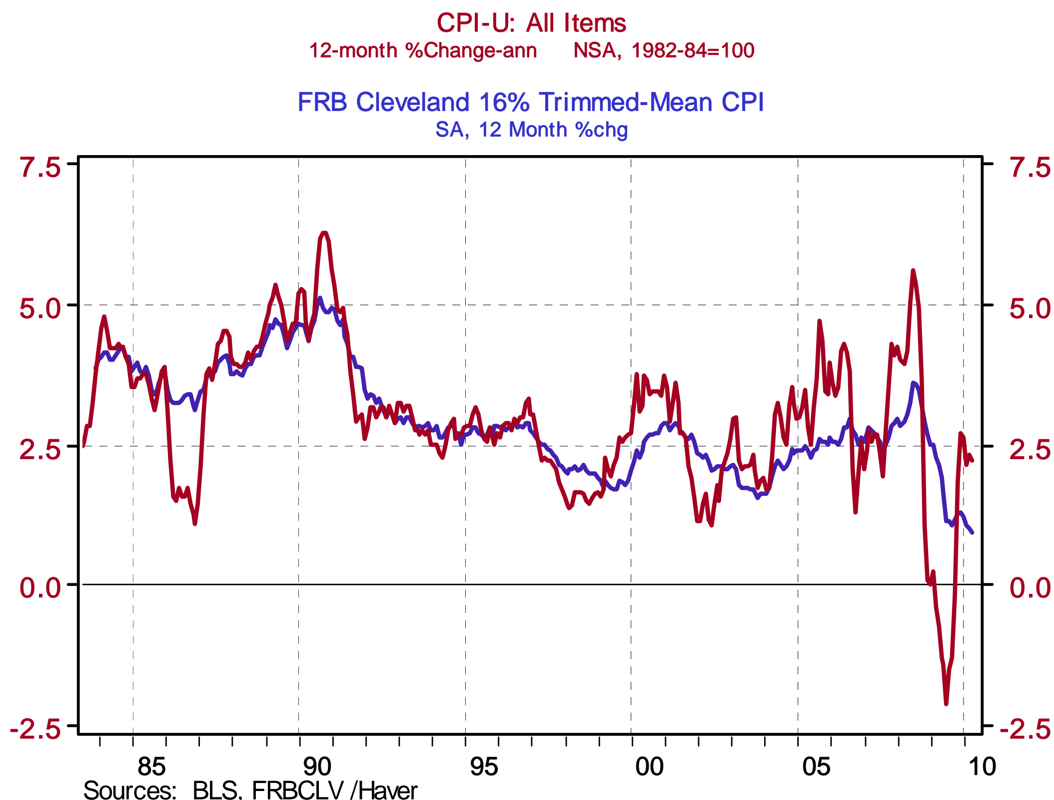
to evaluate the effects of the cross currents affecting the U.S. economic and financial environment.

Chart 4



In sum, the problems that GPS are currently enduring have undoubtedly had a negative effect on global financial markets and likely will have some negative effect on global economic activity. In fact, we have shaved a marginal amount off our forecast for U.S. export growth over the rest of this year. But we are skeptical that the travails of GPS account for as much disruption in the financial markets that the media have ascribed to it. Nor do we think the problems associated with GPS will derail the global economic recovery currently underway. In our view, the biggest threat to the continuation of the global economic recovery

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would be some policy mistake by the Chinese economic policymakers resulting in a rapid deflation of the Chinese real estate bubble, which, in turn, would reduce Chinese real GDP growth from approximately 12% back down to 6%. Barring this, do expect slower U.S. real GDP growth over the remainder of 2010 mainly because of continued restricted credit creation by private-sector financial institutions and secondarily because of marginally weaker export growth because of GPS. Do not, however, expect a "double-dip."

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Paul Kasriel is the recipient of the Lawrence R. Klein Award for Blue Chip Forecasting Accuracy

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THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
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SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2008		2009				2010				Q4 to Q4 Change			Annual Change		
	08:3a	08:4a	09:1a	09:2a	09:3a	09:4a	10:1a	10:2f	10:3f	10:4f	2008a	2009a	2010f	2008a	2009a	2010f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	-2.7	-5.4	-6.4	-0.7	2.2	5.6	3.2	2.5	2.2	2.8	-1.9	0.1	2.7	0.4	-2.4	3.0
CONSUMPTION EXPENDITURES	-3.5	-3.1	0.6	-0.9	2.8	1.6	3.6	2.8	2.0	2.3	-1.8	1.0	2.7	-0.2	-0.6	2.4
BUSINESS INVESTMENT	-6.1	-19.5	-39.2	-9.6	-5.9	5.3	4.1	0.9	2.3	4.5	-6.0	-14.1	2.9	1.6	-17.8	1.3
RESIDENTIAL INVESTMENT	-15.9	-23.2	-38.2	-23.3	18.9	3.8	-10.9	-4.0	2.5	5.0	-21.0	-12.6	-2.0	-22.9	-20.5	-1.8
CHANGE IN INVENTORIES ('00 dlrs, bill)	-29.7	-37.4	-113.9	-160.2	-139.2	-19.7	31.1	44.2	54.2	69.2				-25.9*	-108.3*	49.7*
GOVERNMENT	4.8	1.2	-2.6	6.7	2.6	-1.3	-1.8	0.3	0.6	0.4	3.1	1.3	-0.1	3.1	1.8	0.2
NET EXPORTS ('00 dlrs, bill.)	-479.2	-470.9	-386.5	-330.4	-357.4	-348.0	-367.0	-367.7	-363.6	-358.8				-494.3*	-355.6*	-364.3*
FINAL SALES	-2.9	-4.7	-4.1	0.7	1.5	1.7	1.6	1.7	1.9	2.4	-1.4	-0.1	1.9	0.8	-1.7	1.7
NOMINAL GROSS DOMESTIC PRODUCT	1.4	-5.4	-4.6	-0.8	2.6	6.1	4.1	4.1	2.9	4.0	0.1	0.7	3.9	2.6	-1.3	3.8
GDP DEFLATOR - IMPLICIT (% change)	4.1	0.0	1.9	1.7	3.5	2.4	1.3	0.4	1.7	1.8	2.0	0.7	1.2	2.1	1.2	0.8
CPI (% Change, 1982-84 = 100)	6.4	-9.2	-2.2	1.9	3.7	2.6	1.5	0.6	1.9	2.0	1.6	1.5	1.5	3.8	-0.3	1.9
CIVILIAN UNEMPLOYMENT RATE (avg.)	6.0	7.0	8.2	9.3	9.6	10.0	9.7	9.9	9.9	9.7				5.8*	9.3*	9.8*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	08:3a	08:4a	09:1a	09:2a	09:3a	09:4a	10:1a	10:2f	10:3f	10:4f	2008a	2009a	2010f
Federal Funds	1.94	0.51	0.18	0.18	0.16	0.12	0.13	0.20	0.20	0.25	1.93	0.16	0.20
2-yr. Treasury Note	2.36	1.21	0.91	1.01	1.03	0.87	0.92	0.90	0.95	1.05	2.00	0.96	0.95
10-yr. Treasury Note	3.86	3.25	2.74	3.31	3.52	3.46	3.72	3.50	3.45	3.75	3.67	3.26	3.60

a = actual
f = forecast