NORTHERN TRUST GLOBAL ECONOMIC RESEARCH

The 2011 Economic Outlook:

Credit Given Where Credit Is Due

Paul L. Kasriel, Chief Economist
Phone: 312.444.4145
plk1@ntrs.com

January 2011

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US Economic and Interest Rate Outlook, January 2011

Economic Outlook:

- We are presenting the outlook this month in a PowerPoint (PDF) format.
- The forecasts of key economic variables and interest rates are in the usual tables following the respective slides with highlights of the forecast.
- There are some significant changes to key variables in this month's forecast compared with the November 2010 forecast (the last forecast update).
- With regard to 2010 real GDP growth, we now expect Q4/Q4 growth of 2.9% vs. 2.3% in the November forecast. Based on Q4:2010 available data, real GDP appears to be coming in at an annual rate of 3.6% rather than the 1.9% we were projecting in November. In addition, the Commerce Department revised up Q3:2010 real GDP growth from 2.0% to 2.6%.
- With regard to 2011 real GDP growth, we now expect Q4/Q4 growth of 3.3% vs. 3.0% in the November forecast. An upward revision of 2011 Q4/Q4 real consumption growth to 2.9% from 2.5% in November is the primary factor accounting for the upward revision to the real GDP growth forecast. We are more optimistic about 2011 real GDP growth primarily because QE2 implies that the Fed will be purchasing all of the additional Treasury debt issued in conjunction with the Obama-McConnell tax and unemployment insurance compromise. We currently see more upside risk to our 2011 real GDP growth forecast than downside risk.
- Consistent with the upward revision to our 2011 real GDP growth forecast, we also have lowered our forecast for the level of the unemployment rate and raised our forecast for the CPI inflation rate.

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US Economic and Interest Rate Outlook, January 2011 (Cont'd)

Table 1: US GDP, Inflation, and Unemployment Rate

	2009		2010				2011				Q4 to Q4 change			Annual change		
	09:3a	09:4a	10:1a	10:2a	10:3a	10:4f	11:1f	11:2f	11:3f	11:4f	2009a	2010f	2011f	2009a	2010f	2011f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	1.6	5.0	3.7	1.7	2.6	3.6	2.7	3.1	3.5	3.9	0.2	2.9	3.3	-2.6	2.9	3.0
CONSUMPTION EXPENDITURES	2.0	0.9	1.9	2.2	2.4	4.0	2.7	2.7	3.0	3.2	0.2	2.6	2.9	-1.2	1.7	3.0
BUSINESS INVESTMENT	-1.7	-1.4	7.8	17.2	10.0	7.9	5.4	8.2	9.5	10.3	-12.7	10.7	8.3	-17.1	5.8	8.5
RESIDENTIAL INVESTMENT	10.6	-0.8	-12.3	25.7	-27.3	-5.0	-1.5	-1.5	0.0	2.5	-13.4	-6.6	-0.1	-22.9	-3.5	-4.0
CHANGE IN INVENTORIES ('00 dlrs, bill)	-128.2	-36.7	44.1	68.8	121.4	121.7	126.7	136.7	147.7	160.7				-113.1*	89.0*	143.0*
GOVERNMENT	1.6	-1.4	-1.6	3.9	3.9	0.8	0.2	0.7	0.4	0.4	0.8	1.7	0.4	1.6	1.2	1.1
NET EXPORTS ('00 dlrs, bill.)	-390.8	-330.1	-338.4	-449.0	-505.0	-485.9	-480.4	-477.4	-474.8	-473.4				-363.0*	-444.6*	-476.5*
FINAL SALES	0.4	2.1	1.1	0.9	0.9	3.9	2.6	2.9	3.2	3.5	-0.3	1.7	3.0	-2.1	1.2	2.7
NOMINAL GROSS DOMESTIC PRODUCT	2.3	4.7	4.8	3.7	4.6	5.4	3.9	4.7	5.2	6.1	0.6	4.7	5.0	-1.7	4.0	4.7
GDP DEFLATOR - IMPLICIT (% change)	0.7	-0.3	1.1	2.0	2.0	1.8	1.2	1.5	1.7	2.2	0.4	1.7	1.6	0.9	1.0	1.6
CPI (% Change, 1982-84 = 100)	3.7	2.6	1.5	-0.7	1.5	2.0	1.4	1.7	1.9	2.4	1.5	1.1	1.9	-0.3	1.6	1.6
CIVILIAN UNEMPLOYMENT RATE (avg.)	9.6	10.0	9.7	9.7	9.6	9.8	9.9	9.7	9.3	8.8				9.3*	9.7*	9.4*

a=actual
f=forecast
*=annual average

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US Economic and Interest Rate Outlook, January 2011 (Cont'd)

Interest Rate Outlook:

- Our forecasts of the yield on the Treasury 10-year security last year resembled the behavior of loose cargo in the hold of a ship caught in a gale. For example, in our July forecast, we expected the yield to average 3.00% in Q4:2010 and 4.15% in Q4:2011. Then in November our 10-year yield forecast was 2.50% for Q4:2010 and 2.75% for Q4:2011. In fact, the Treasury 10-year yield ended up averaging 2.86% in Q4:2010. What confused us was the duration, or lack thereof, of any QE2 effect on bond yields. Our January 2011 forecast for the Treasury 10-year yield in Q4:2011 is 3.85%.

- With regard to the significant swings in our forecasts of the 10-year Treasury yield, one of our readers accused us of being dishonest in not alerting you to these forecast changes. Along with our current forecast, all of our prior forecasts are archived on our public website (northerntrust.com) for all of the world to view our forecasting failures along with our successes. So, although we may have been an errant forecaster of bond yields in 2010 (our 2009 Treasury 10-year yield and real GDP forecasts were the most accurate in the Chicago Fed's survey of economic forecasts), we reject the accusation of being dishonest.

- We do not expect the Fed to raise any of its policy interest rates until early 2012. Given our assessment of upside risk to our 2011 real GDP forecast, however, we also would assign increased risk to an earlier Fed move on policy interest rates.

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US Economic and Interest Rate Outlook, January 2011 (Cont'd)

Table 2: Outlook for Interest Rates

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	**09:3a**	**09:4a**	**10:1a**	**10:2a**	**10:3a**	**10:4f**	**11:1f**	**11:2f**	**11:3f**	**11:4f**	**2009a**	**2010f**	**2011f**
Federal Funds	0.16	0.12	0.13	0.19	0.19	0.20	0.20	0.20	0.20	0.20	0.16	0.18	0.20
2-yr. Treasury Note	1.03	0.87	0.92	0.87	0.62	0.65	0.65	0.75	0.95	1.25	0.96	0.76	0.90
10-yr. Treasury Note	3.52	3.46	3.72	3.49	2.79	2.90	3.40	3.50	3.65	3.85	3.26	3.22	3.60

a = actual

f = forecast

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Preview of Takeaways

- The pace of economic activity is expected to accelerate in 2011 on a Q4/Q4 basis largely because of increased growth in credit created by monetary financial institutions.
- Housing and state/local governments are sectors that will remain a drag on economic growth.
- Exports are and likely will remain a star performer of the U.S. economy.
- Inflation, while remaining low in absolute terms, is expected to increase modestly.
- Money market interest rates are anticipated to remain near current levels because the Fed is not expected to raise its policy interest rates in 2011.
- Bond yields are expected to drift higher as *real* bond interest rates continue to "normalize".
- The principal upside risk to economic growth and interest rates is that private monetary financial institutions sharply increase their credit creation.
- The principal downside risk to economic growth and interest rates is that Chinese economic growth decelerates sharply.
- Federal budgetary issues are not a near-term threat to economic growth, but are a long-term threat.

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In the four quarters ended Q4:2009, monetary financial institution (MFI) credit *contracted* for only the second time in the post-WII era and by a record 4.7%.

Monetary Financial Institution* Credit

% Change - Year to Year *Federal Reserve, Commercial Banks, S&Ls

15 10 5 0 -5

55 60 65 70 75 80 85 90 95 00 05 10

Source: Haver Analytics

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Why the emphasis on monetary financial institution credit?

- One reason is theoretical.
- The other reason is empirical.

The theoretical importance of monetary financial institution credit:

- When the Federal Reserve purchases a security in the open market or makes a loan to a financial institution, it creates credit figuratively "out of thin air".
- Although an individual commercial bank or savings & loan cannot create credit "out of thin air", the commercial banking and S&L *systems* can.
- Although the Federal Reserve is not constrained in the amount of credit it can create, private monetary financial institution *systems* are limited in the amount of credit they can create by the amount of "seed" money or cash reserves provided by the Federal Reserve.
- **The unique quality of monetary financial institution credit is that no other entity need cut back on its current spending as the recipients of this credit increase their spending on goods, services and assets.**
- Credit extended by non-monetary financial institutions is, with one exception, merely a transfer of purchasing power from the ultimate lender to the ultimate borrower. On net, there is no new purchasing power created, rather there is a change in the distribution of spending with the ultimate lenders' current spending falling and the borrowers' current spending increasing by the same amount.

The empirical importance of monetary financial institution credit:

- There is a relatively high correlation, 0.58 out of a possible 1.00, between percentage changes in monetary financial institution credit and nominal GDP.

Monetary Financial Institution* Credit
% Change - Year to Year *Federal Reserve, Commercial Banks, S&Ls

Gross Domestic Product
% Change - Year to Year SAAR, Bil.$

r = 0.58

15
10
5
0
-5

65 70 75 80 85 90 95 00 05 10

Source: Haver Analytics

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Since the collapse of Lehman at the end of Q3:2008, the Fed has been the primary source of any increases in MFI credit.

Total Monetary Financial Institution Credit: yr.-over-yr. chg. $Bill.
Federal Reserve Credit: yr.-over-yr. chg. $Bill.
Prvt. Monetary Financial Institution Credit: yr.-over-yr. chg. $Bill.

1600
1200
800
400
0
-400
-800

08
09
10

Source: Haver Analytics

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Fed Quantitative Easing (QE) – What is it?

- QE implies that the Fed implements monetary policy with an emphasis on expanding the *quantity* of credit it creates, primarily through the purchase of securities in the open market.

- Because the emphasis is on the *quantity* of Fed credit created, *not* the *price* of Fed credit, in implementing QE, the type of securities (Treasury or MBS) the Fed purchases or the maturity of securities (T-bills or T-bonds) the Fed purchases is of secondary importance.

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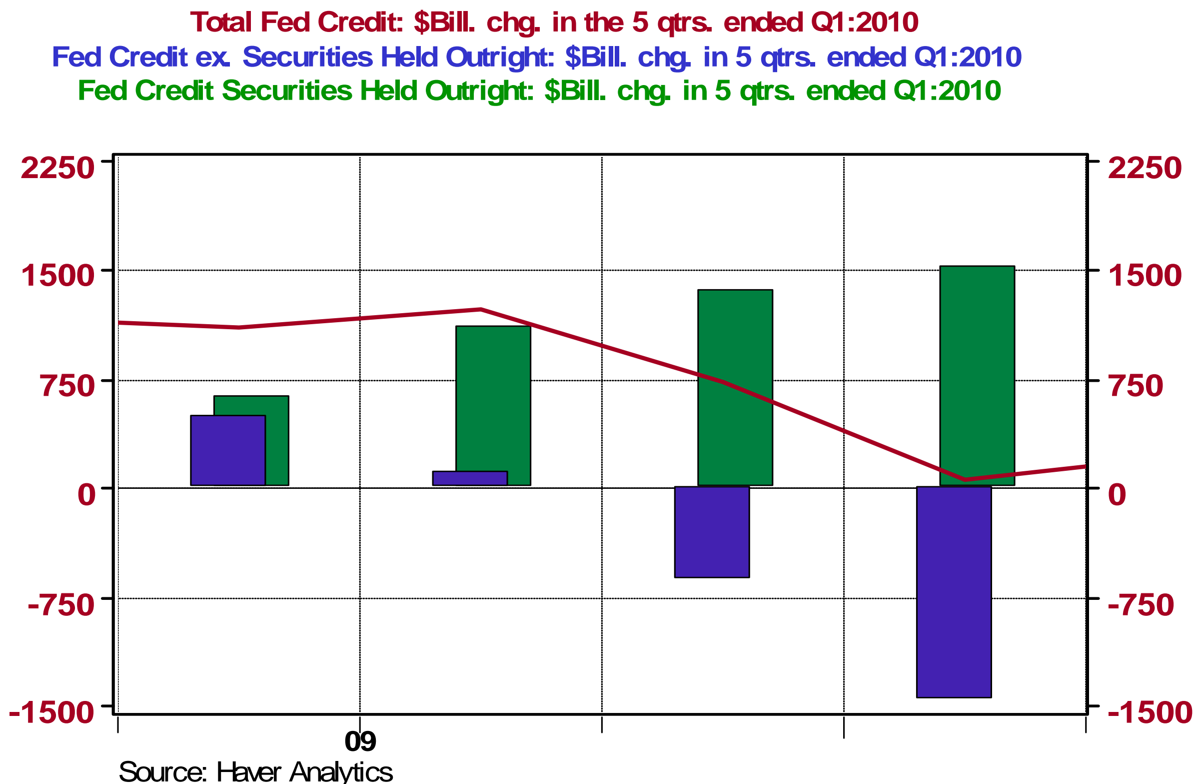
An Analysis of the Fed's QE Policy Immediately After the Lehman Collapse

- "QE1" commenced at the end of November 2008 and terminated in March 2010, approximately five quarters in duration.
- The net change in Fed outright holdings of securities during QE1 was an increase of $1.52 trillion.
- But, the net change in other elements of Fed credit during QE1 was a *decrease* of $1.45 trillion.
- Thus, the net change in *total* Fed credit during QE1 was an increase of only $70 billion.



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With only a $70 billion net increase in Fed credit during QE1 and with a net *decrease* of $384 billion in private MFI credit, *total* MFI credit during QE1 *decreased* a net $314 billion.

Sounds more like quantitative tightening!

Total MFI Credit: $Bill. chg. in the 5 qtrs. ended Q1:2010
Total Fed Credit: $Bill. chg. in the 5 qtrs. ended Q1:2010
Private MFI Credit: $Bill. chg. in the 5 qtrs. ended Q1:2010

1600
1200
800
400
0
-400
-800

09

Source: Haver Analytics

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Any reason to believe that QE2 will result in a net increase in MFI credit?

- The Fed announced that QE2 will tentatively entail the purchase of $600 billion of Treasury coupon securities between November 2010 and June 2011.
- In the eight months since the end of QE1 (March 2010), "other" Fed credit has contracted only a net $34 billion and commercial bank credit has *increased* a net $286 billion.
- Thus, it appears as though during QE2 Fed credit will increase nearly dollar-for-dollar with Fed purchases of securities and that private MFIs will not be a large drag on total MFI credit, perhaps even a plus.

Bank Credit: All Commercial Banks
8-month Change SA, Bil.$

Fed Credit ex Outright Holdings of Securities
8-month Change NSA, Bil.$

400, 200, 0, -200, -400, -600, -800

JAN FEB MAR APR MAY JUN JUL AUG SEP OCT NOV DEC
10

Source: Haver Analytics

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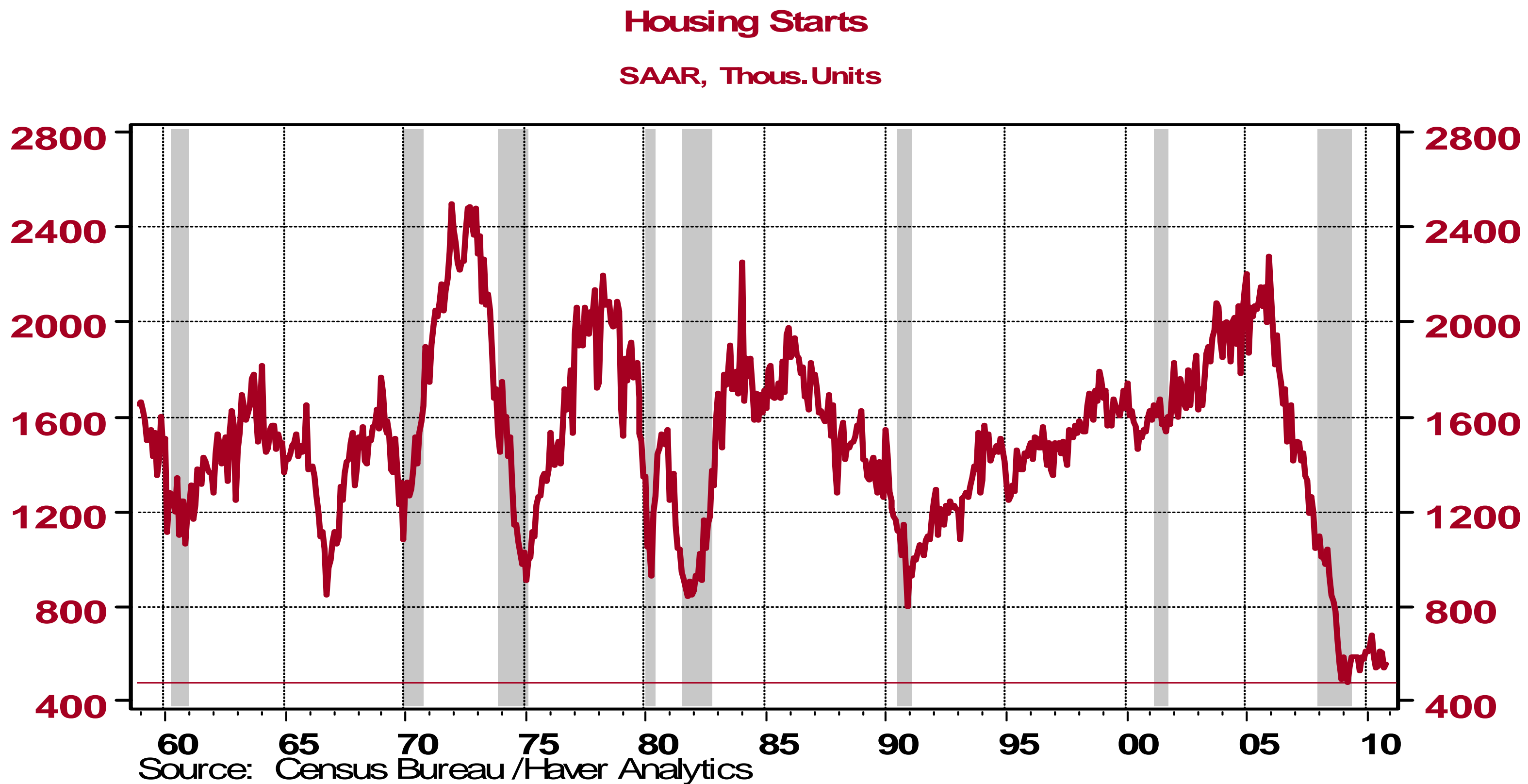
A lack of MFI credit creation is not the only factor that has been restraining the pace of economic growth.

- Housing typically is the first sector to sprint ahead at the beginning of an economic recovery.
- In this recovery, housing appears to have gotten winded at the first curve in the track.



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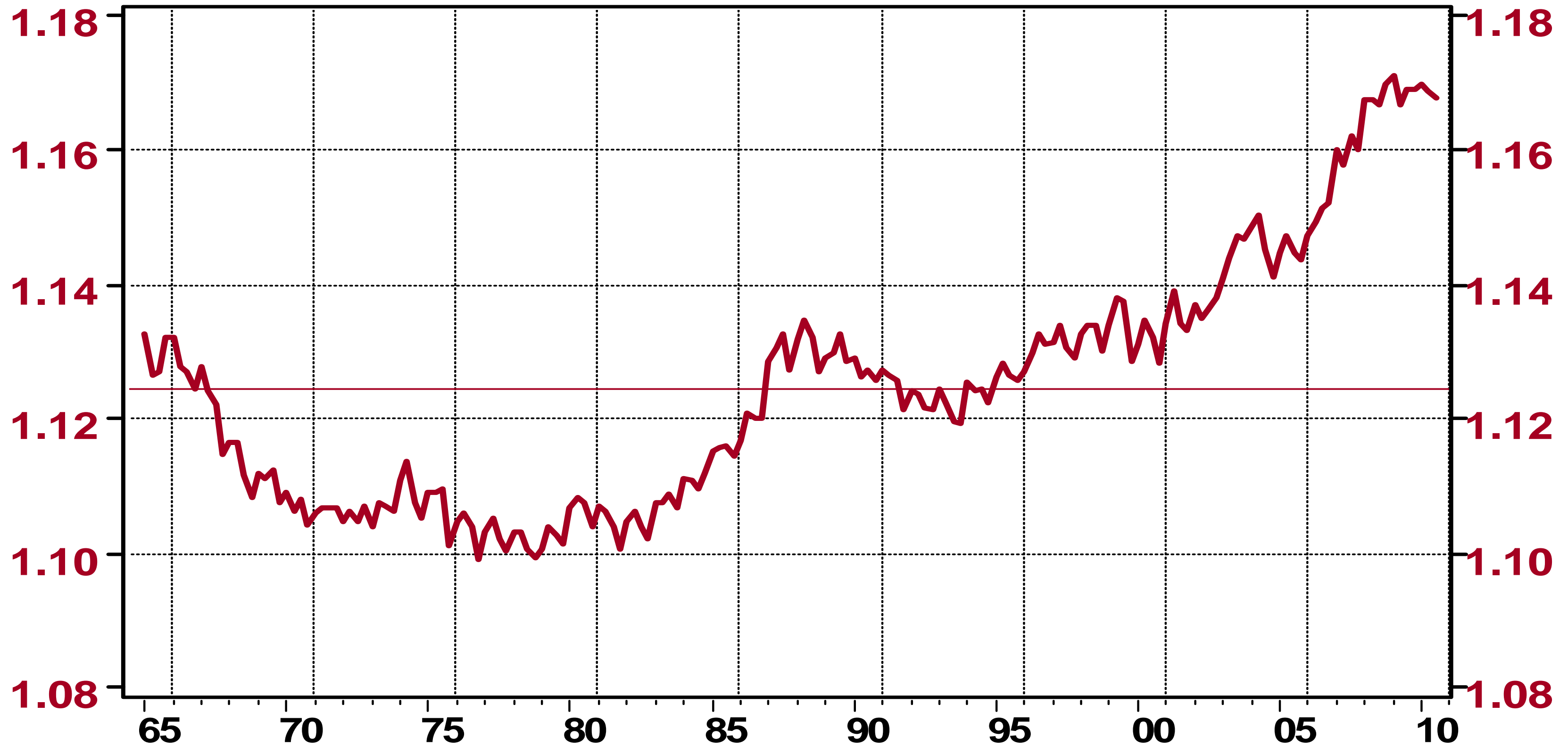
Why build new houses and apartments when we have a near record number of dwelling units relative to households?



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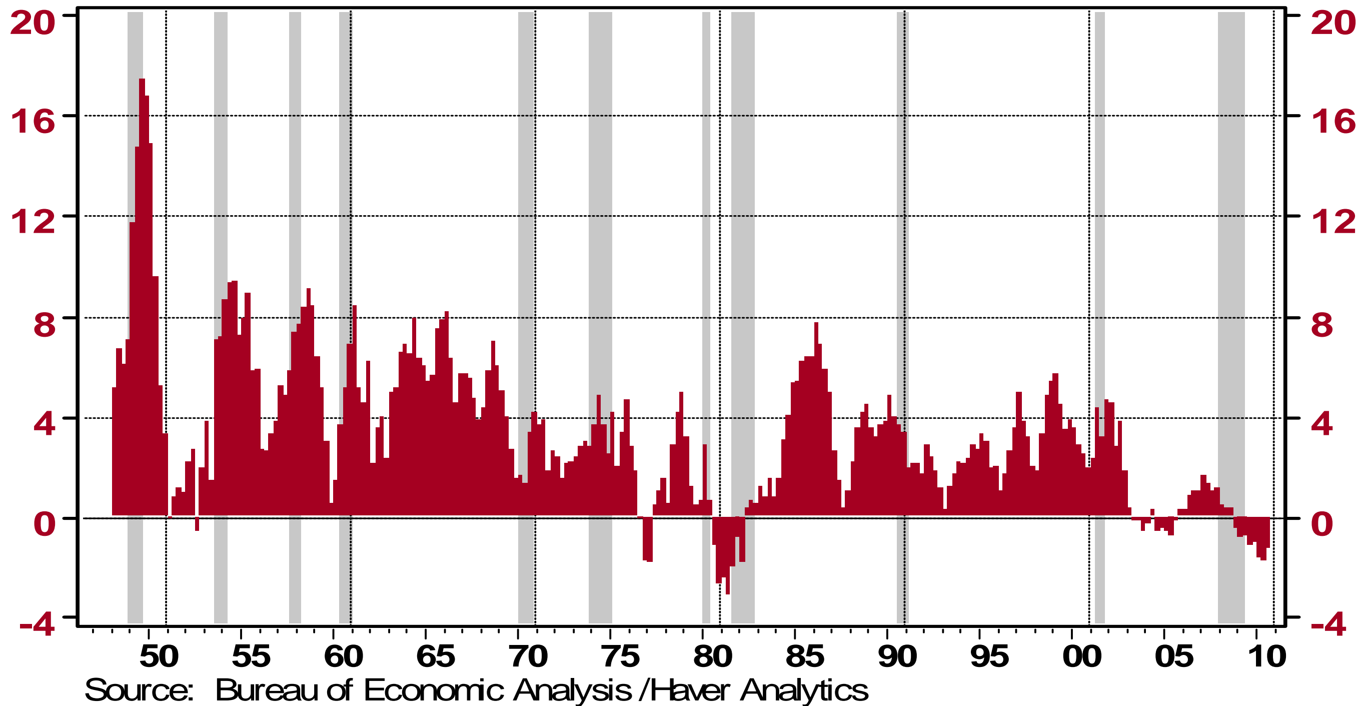
State & local government budgetary challenges remain a headwind related to aggregate demand for goods and services.

- It is unusual for real state & local government expenditures to contract on a year-over-year basis, much less still be contracting well into an economic recovery.
- Not only do state & local governments face challenges with regard to their operating budgets, but, as important, with regard to underfunded public employee retirement benefit plans.



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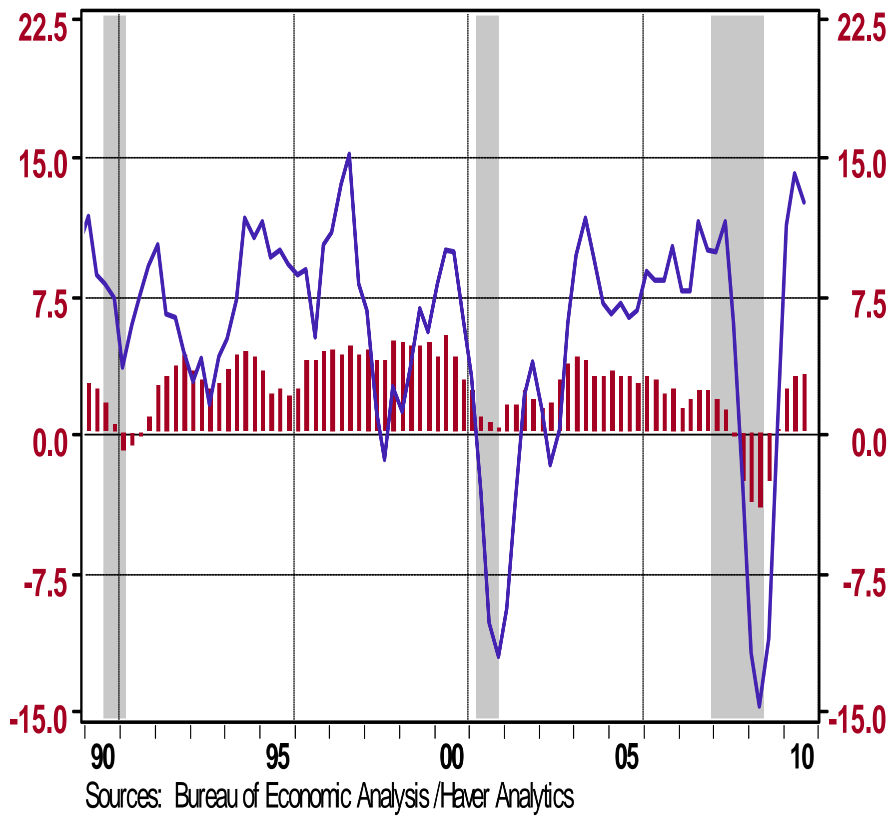
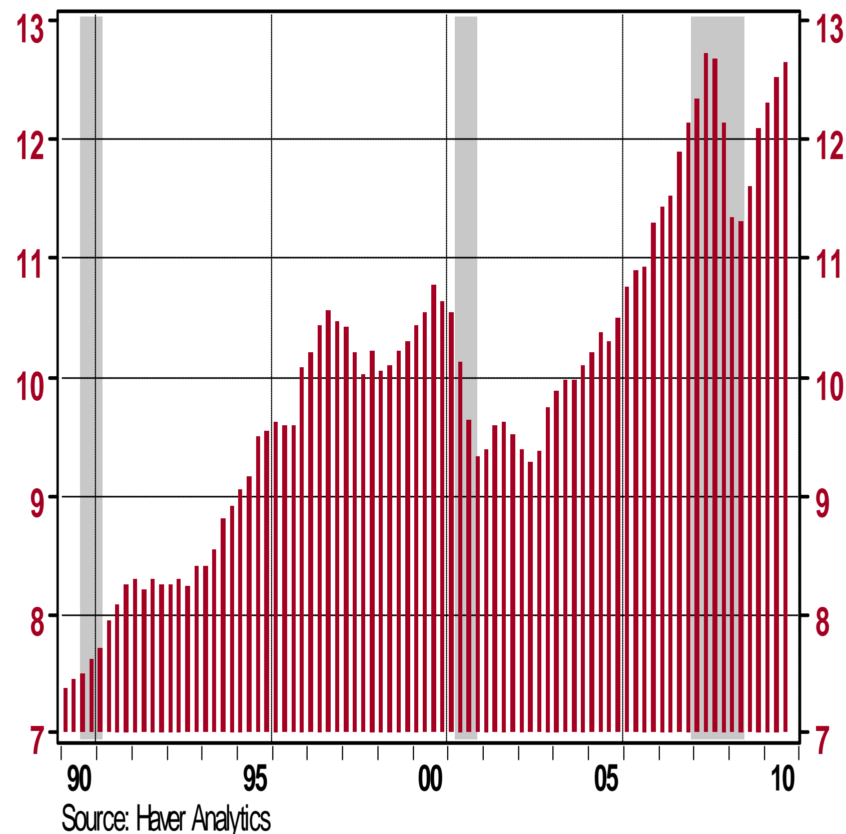
U.S. exports have rebounded sharply in the recent recovery.



Sources: Bureau of Economic Analysis /Haver Analytics



Source: Haver Analytics

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Emerging markets have been and are likely to continue to be a key driver of U.S. exports.

- Assuming continued relatively strong economic growth in the developing economies, discretionary incomes will be rising for hundreds of millions of households.
- This will provide export opportunities for U.S.in the areas of agricultural, health-care technology/pharmaceuticals, infrastructure, fast food, retailing and entertainment.

U.S. Goods Exports: Pacific Rim ex Japan plus South America as a % of Total

12-month moving average

Source: Haver Analytics

Although inflation expectations have drifted up in recent weeks, the bond market is relatively sanguine about the inflation outlook.

Should it be sanguine?

5-Year Nominal minus 5-Year TIP Rate
%

CPI-U: All Items
% Change - Year to Year NSA, 1982-84=100

	03	04	05	06	07	08	09	10

Y-axis (left and right): 6, 4, 2, 0, -2, -4

Sources: FRB, BLS /Haver

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Yes, if the leading relationship between MFI credit growth and consumer inflation is any guide.

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Bond yields are likely to drift higher in 2011 and thereafter.

- When QE2 was first hinted at in the late summer of 2010, the inflation-expectations component of the Treasury 10-yr. yield began moving up.
- The bond market's inflation expectations are likely to drift marginally higher in 2011.
- After the November 2010 midterm election, the real bond yield began moving higher in anticipation of higher Treasury borrowing resulting from the extension of the Bush 43 tax rates.
- With real economic growth expected to accelerate in 2011 and Fed interest rate hikes anticipated in early 2012, the real bond yield is expected to drift higher toward its average level of 1.86% of the past 11 years.

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The biggest upside risk to 2011 economic growth and interest rate levels is that private monetary financial institutions rapidly begin transforming their almost $1 trillion of excess “cash” into loans and securities.

Adjusted Excess Reserves of Depository Institutions

NSA, Bil.$

1200
1000
800
600
400
200
0

30 35 40 45 50 55 60 65 70 75 80 85 90 95 00 05 10

Source: Federal Reserve Board /Haver Analytics

A unexpected sharp deceleration in Chinese economic growth is the biggest downside risk to 2011 U.S. economic growth.

Although China is major global exporter, it also is becoming a major importer as well, and, thus, a global economic locomotive.

Merchandise Imports: Chinese as a % of U.S.

12-month moving average

70 60 50 40 30 20 10

96 97 98 99 00 01 02 03 04 05 06 07 08 09 10

Source: Haver Analytics

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The rapid growth in the Chinese money supply in 2009 is now generating higher Chinese consumer inflation …

China: M2: 12-Month Percent Change [-12]
%

China: Consumer Price Index
NSA, year/year % chg

r = 0.42

30.0
22.5
15.0
7.5
0.0
-7.5

97 98 99 00 01 02 03 04 05 06 07 08 09 10 11

Sources: PBC, CNBS /Haver

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… as well as land-price inflation.

China: Money Supply: M2 [-3]
% Change - Year to Year NSA, Bil.Yuan

China Land Transaction Price Index: Total
NSA, yr/yr % chg

Sources: PBC, CNBS /Haver

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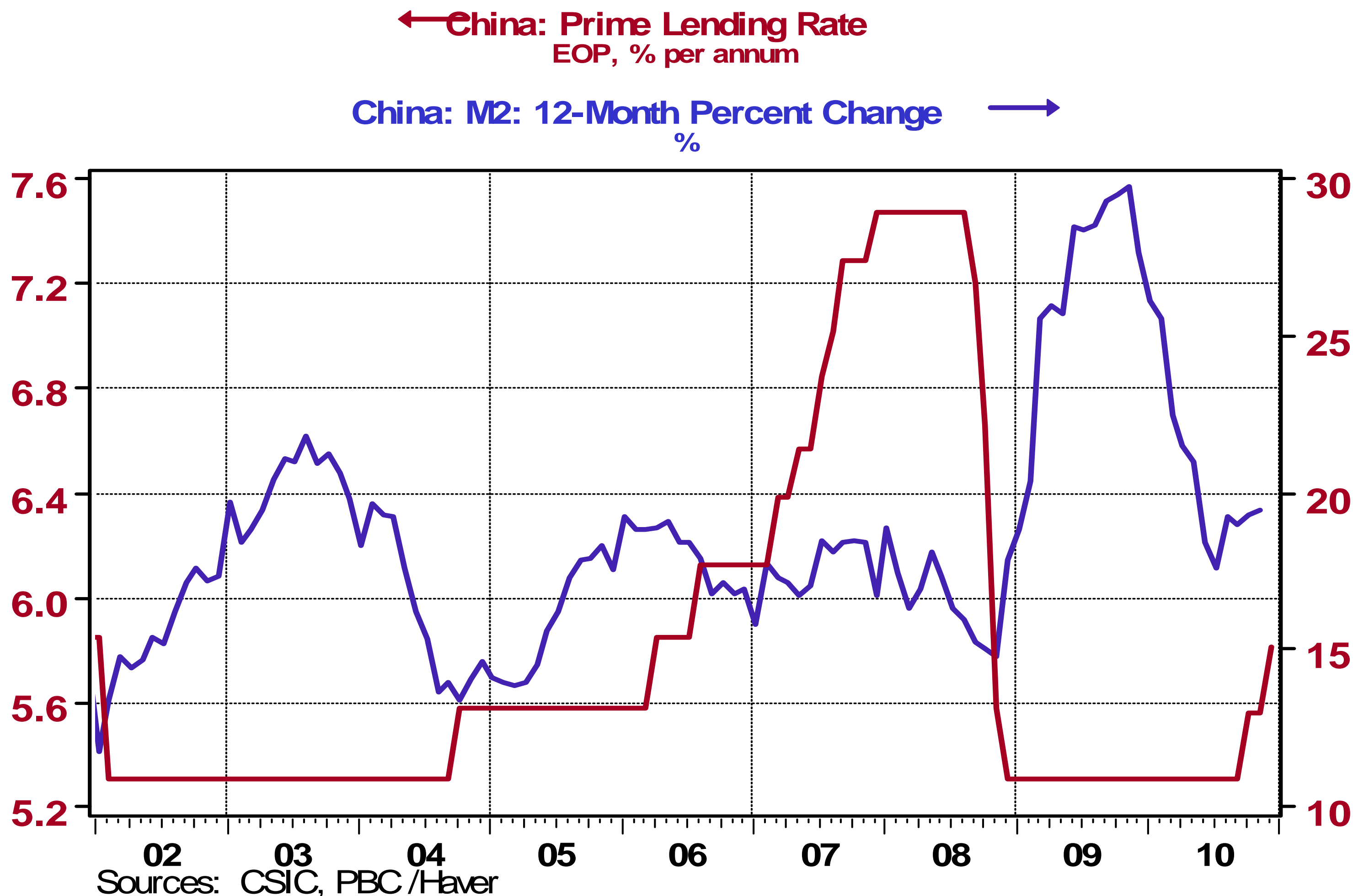
With the Chinese money supply already slowing, the PBOC needs to be careful to not raise interest rates too much.



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The U.S. Federal budget is more of a long-term headwind to economic growth than a short-term headwind.

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With an end to the $700 billion TARP expenditures and a slowdown in the growth of income “safety-net” expenditures, federal outlays are actually contracting.

12-Month Cumulative Total Federal Outlays

percent change from comparable year-ago month

Source: U.S. Treasury /Haver Analytics

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**Milton Friedman taught us that when the government spends it also taxes – either *explicitly today* or *implicitly tomorrow*.
So government spending is the real economic issue, not how the government funds its spending.**

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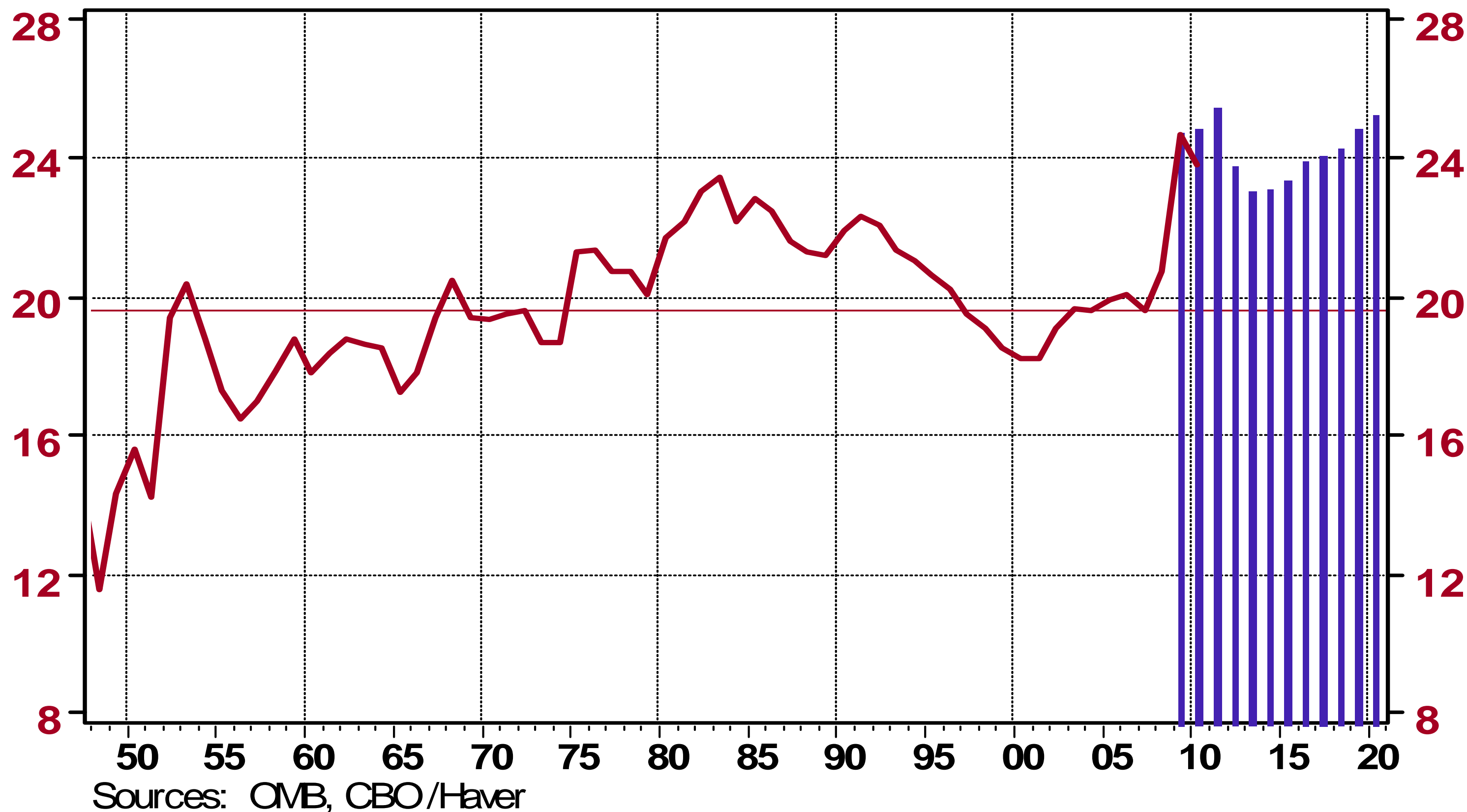
It is the projected "out year" spending, if it actually occurs, that could adversely affect real economic growth.



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What accounts for the bulk of this high “out year” federal government spending?

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Medicare, Medicaid, Social Security and interest on the debt.

Estimated Chg. in Mandatory Spending in 11 yrs. ended 2020, $Bill.
Estimated Chg. in Net Interest Payments in 11 yrs. ended 2020, $Bill.
Estimated Chg. in Discretionary Spending in 11 yrs. ended 2020, $Bill.

1200
1000
800
600
400
200
20

Sources: Congressional Budget Office /Haver Analytics

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- An increased amount of economically-productive resources would be used to care for U.S. retirees.
- Given the finite supply of economically-productive resources, other sectors of the economy would be deprived of the use of these resources.
- Investment in the state-of-the-art equipment/software and R&D by U.S. businesses would be curtailed, adversely affecting labor productivity.
- Resources would be curtailed for education, which will adversely affect the productivity of future workers.
- With current and future labor productivity growth adversely affected, the U.S. economy's long-run rate of growth would be adversely affected.

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Investment Implications of the 2011 Economic Outlook

- U.S. top-line corporate profit growth would be expected to be favorably affected by the faster growth in MFI credit and the resulting faster growth in both nominal and real GDP.
- Specific sectors such as agriculture, health-care technology/pharmaceuticals, infrastructure, global fast food, global retailing and entertainment would be expected to benefit from continued relatively strong economic growth in developing economies.
- Although U.S. money market interest rates are expected to remain steady and low as a result of the Fed delaying any policy interest rate increases until early 2012, longer-maturity interest rates are likely to drift higher because of stronger credit demand, a mild increase in the actual inflation rate and the expectation of Fed interest rate hikes in 2012.
- Relative to the U.S., foreign sovereign fixed income is likely to outperform in those economies where central government fiscal environments are more favorable and their currencies might be expected to appreciate relative to the U.S. dollar. Examples of such economies are Canada, Australia, Norway and South Korea.
- With the U.S. economy expected to grow faster in 2011 and with corporations holding large amounts of liquid assets, corporate bond default risk would be expected to diminish.
- In contrast, with the severe operating budgetary and public pension challenges being faced by state & local governments, municipal bond default risk would be expected to increase.

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