Northern Trust

U.S. ECONOMIC &
INTEREST RATE OUTLOOK

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## Second Quarter Rebound, Third Quarter Relapse, Fourth Quarter Rate Cut?

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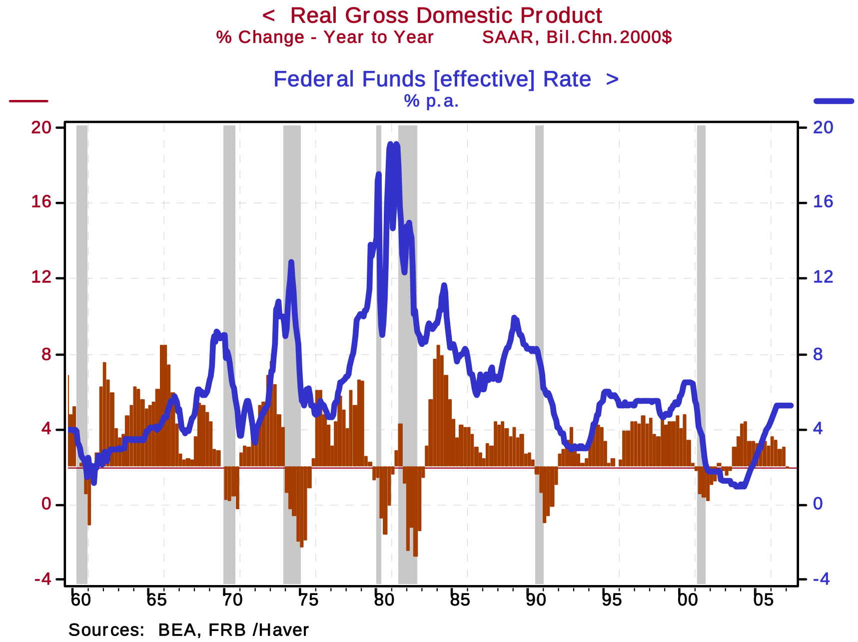
Yes, there does seem to be some rebound in real Gross Domestic Product (GDP) growth in the second quarter from the first quarter's annualized pace of 0.7%. But we suspect that the consensus is overly optimistic about headline real GDP growth in the second quarter, and the Federal Reserve might be a touch concerned about the composition of this modest rebound. According to the latest *Blue Chip Economic Indicators* survey, the average forecast of second-quarter real GDP growth among the 50 top U.S. forecasters is 3.0%. We think it will be closer to 2.7%. Moreover, we expect that the annualized growth in real consumer spending will slow to 1.7% in the second quarter versus 4.2% in the first quarter. The question is whether this significant slowing in the growth of consumer spending is a one-off event or something more long-lasting. If the latter, then businesses will be reluctant to engage in much spending for new plant and equipment or to build higher inventories in coming quarters. We hold the view that the second-quarter slowdown in the growth of consumer spending will persist during the second half this year. As such, we see real GDP growth after the modest second-quarter rebound *relapsing* into weaker growth in the second half – around 1.7% at an annual rate versus the *Blue Chip* consensus forecast of 2.7%. This relapse, along with moderation in inflation, especially excluding food and energy prices, could induce the Federal Reserve to take out some anti-recession insurance in the fourth quarter in the form of interest rate cuts.

As we have said before and is shown in Chart 1, Federal Reserve interest rates cuts appear to be a necessary but not sufficient condition for sustained rebounds in economic growth from the low year-over-year rate of 1.9% experienced in the first quarter. In the late-1960s, the mid-1980s and 1995, weak real GDP growth-but not as weak as now-precipitated some Federal Reserve interest rate cuts, and real GDP growth recovered. At other times, indicated by the gray shaded areas, weak real GDP growth also precipitated Federal Reserve interest rate cuts, but apparently they were too little, too late inasmuch as real GDP growth weakened to the point of contraction. In other words, a recession set in.

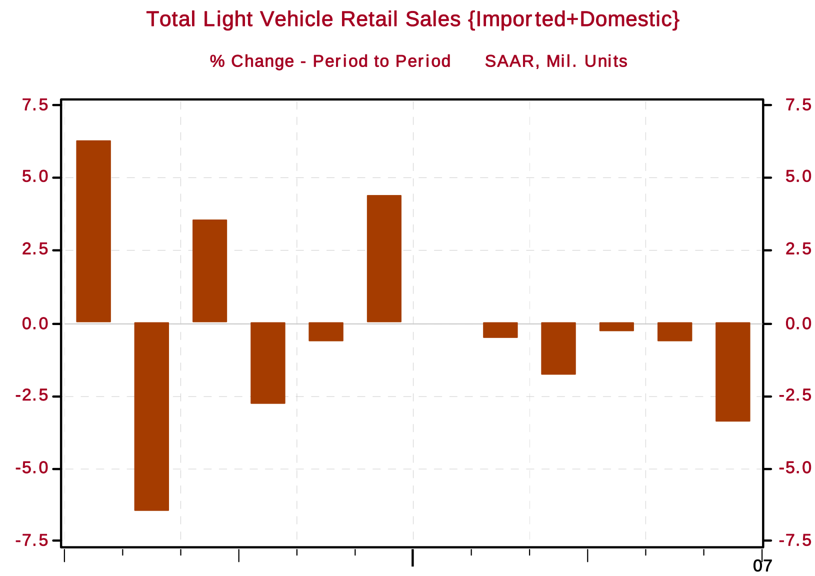
We wish there had been some instances when year-over-year real GDP growth had slowed to 2% or less and the Federal Reserve had *not* engineered declines in the federal funds rate. Then we would have a better test of the "immaculate recovery" hypothesis that the consensus of economic forecasters and the Federal Reserve have embraced. But we don't have such a case. Perhaps it will be different this time. Perhaps some exogenous event other than an easing of Federal Reserve policy will spark a sustained economic rebound. But we will go with percentages and forecast that this will not transpire.

Chart 1




We have been waiting for the tentacles of the housing recession to begin strangling the U.S. consumer. To-date second-quarter data suggest that the strangulation process might have started. Unit sales of light motor vehicles have declined month-to-month in each of the first six months of this year (see Chart 2). On a quarterly average basis, unit sales of light motor vehicles *contracted* at an annual rate of 12.7% in the second quarter.

Chart 2

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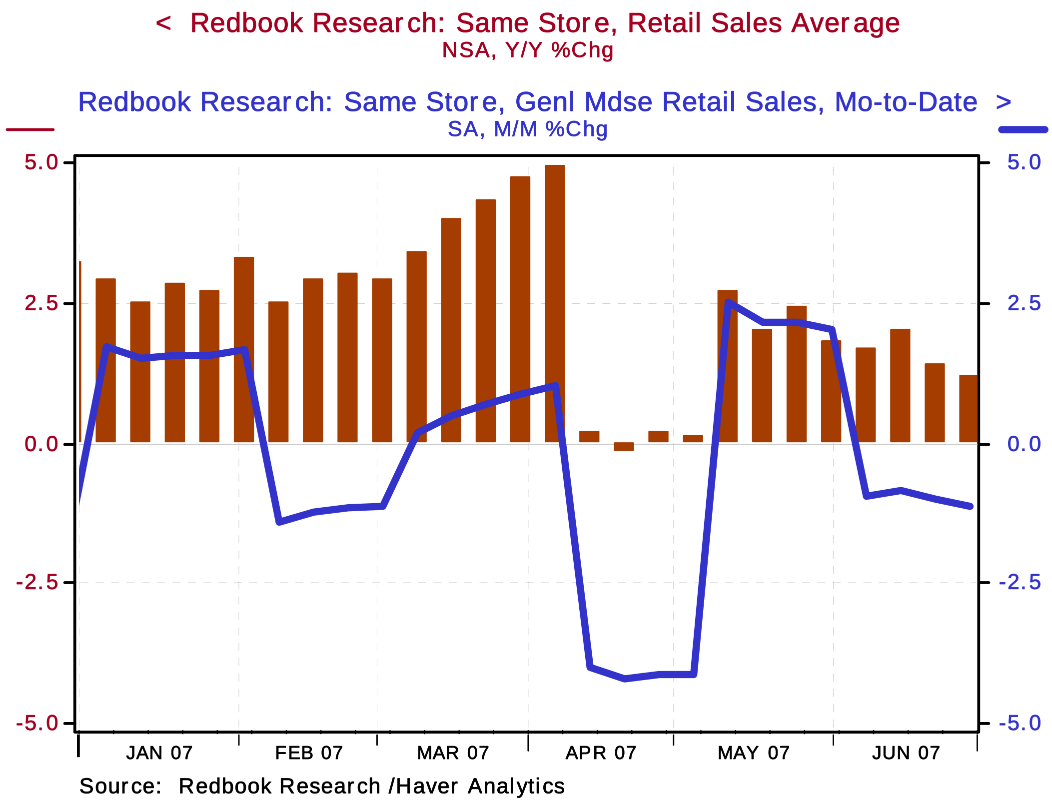
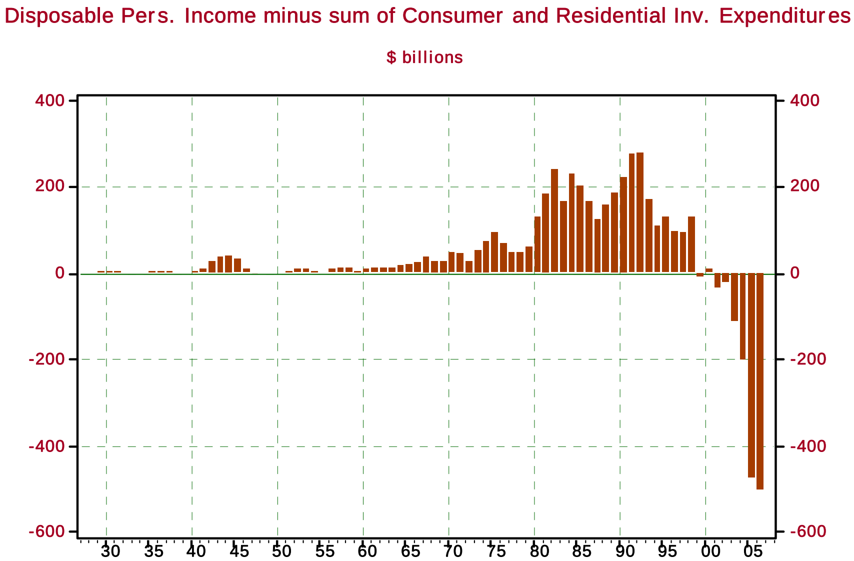
And it is not just motor vehicle sales that have stalled. Sales of other consumer discretionary goods also have weakened of late. Recently, big-box retailers such as Best Buy and Circuit City reported softer sales and revised down their guidance regarding future sales. Similarly, Bed Bath & Beyond said its sales had slowed. A number of the national restaurant chains have seen a slowdown in patronage. Corroborating these reports, the Johnson-Redbook weekly survey of chain store sales showed weakness in June both on a year-over-year and month-to-month basis (see Chart 3).

Chart 3



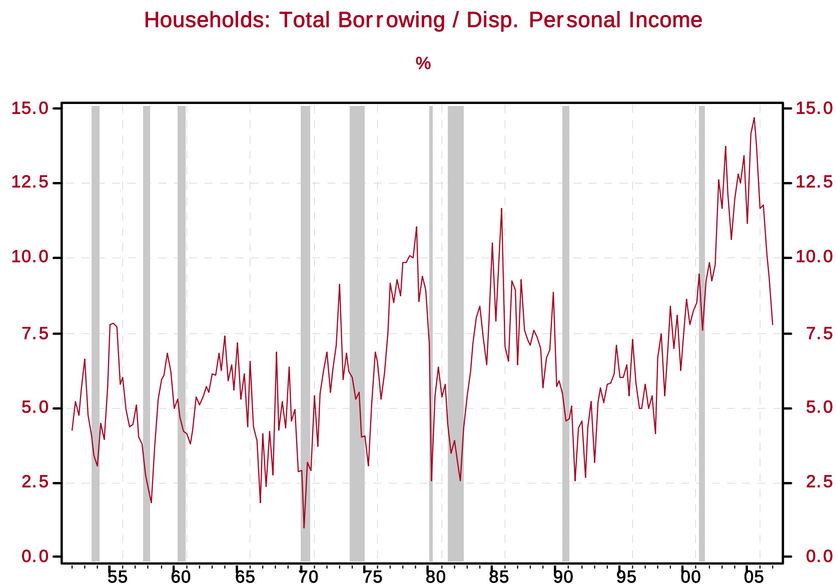

In 2006, households ran a deficit of about $506 billion. The way we calculate this deficit is to subtract from disposable, or after-tax, personal income the sum of expenditures on consumer goods and services and residential investment (essentially, the value added in the housing sector, which is largely due to new residential construction and brokers' commissions on the sale of existing homes). From 1929 through 2006, there only have been 13 years in which households ran a deficit, according to our definition (see Chart 4). Two of those deficit years occurred during the Great Depression of the 1930s, four of those deficit years occurred shortly after the end of World War II and the remaining seven years occurred starting in 1999. (In 2000, households ran a small surplus.)

Chart 4



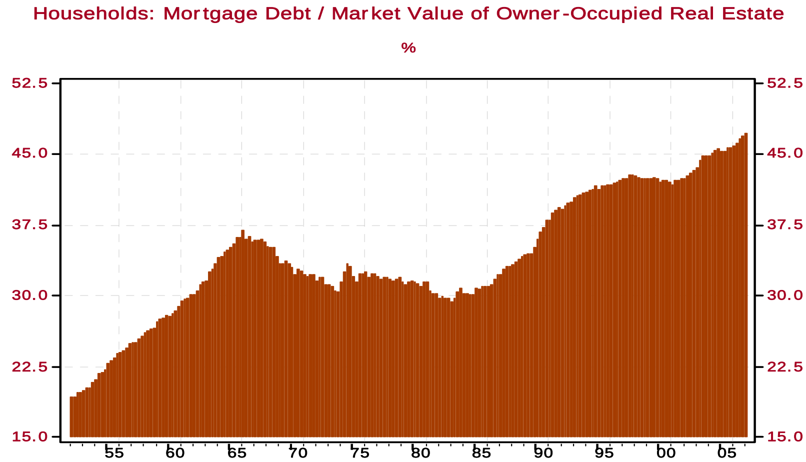

There are two ways households can spend more than they earn or produce. One way is to fund their deficit by borrowing. The other way is to sell assets to an entity outside the household sector. As Chart 5 shows, households certainly have increased their borrowing in recent years. In fact, household borrowing – the *change* in their debt, not the total amount outstanding -- reached a record high 14.7% of disposable (after-tax) personal income (DPI) in the third quarter 2005. Since then, household borrowing has fallen sharply to only 7.8% of DPI in the first quarter 2007.

Chart 5



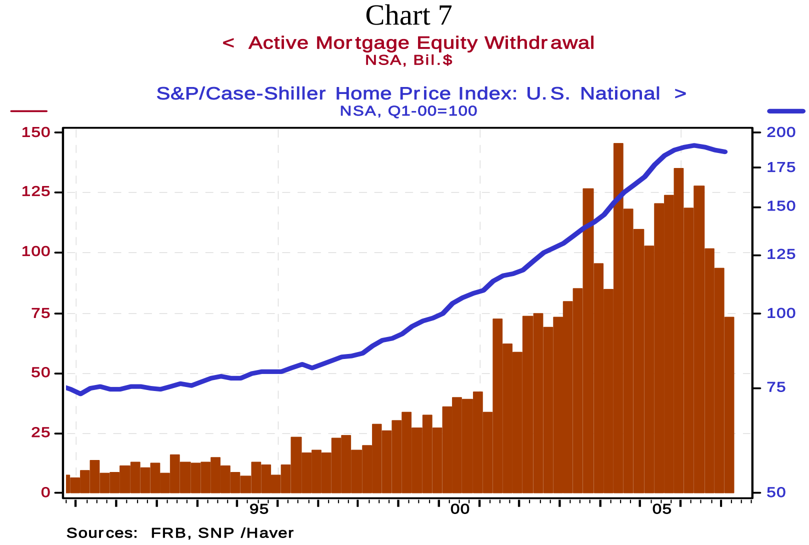
Of course, with the recent housing boom, a lot of household borrowing was incurred to finance the purchases of homes. But Chart 6 shows that mortgage-related borrowing relative to the market value of residential real estate reached a record-high 47.3% in the first quarter 2007.

Chart 6




In addition to smaller relative down payments on home purchases in the latest housing cycle, another factor leading to the record leverage in housing was the extraction of equity of rapidly appreciating residential real estate to fund consumer spending and home improvements. This is called mortgage equity withdrawal (MEW). *Active* MEW is defined as mortgage equity withdrawal consisting of refinancing and home equity borrowing. As Chart 7 shows, active Mew took off in 2001 in rough coincidence with housing values. But as home prices began to fall and mortgage lending terms tightened, active Mew slowed significantly. To wit, in the first quarter 2007, active MEW only was $73.7 billion versus $119.2 billion four quarters earlier. With excess supply still hanging over the housing market, home prices are expected to fall more, causing active MEW to continue its recent lower trend, thereby depressing consumer spending.

Chart 7

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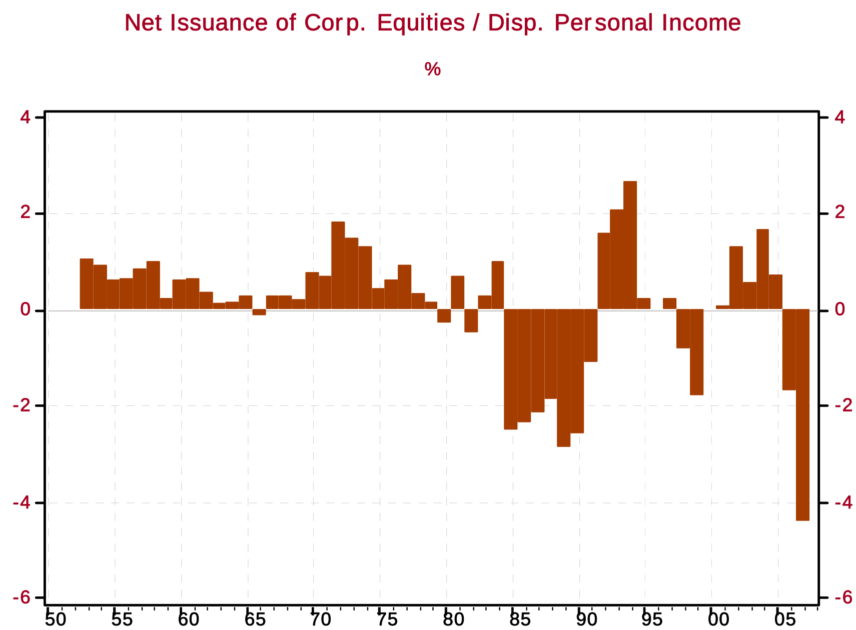
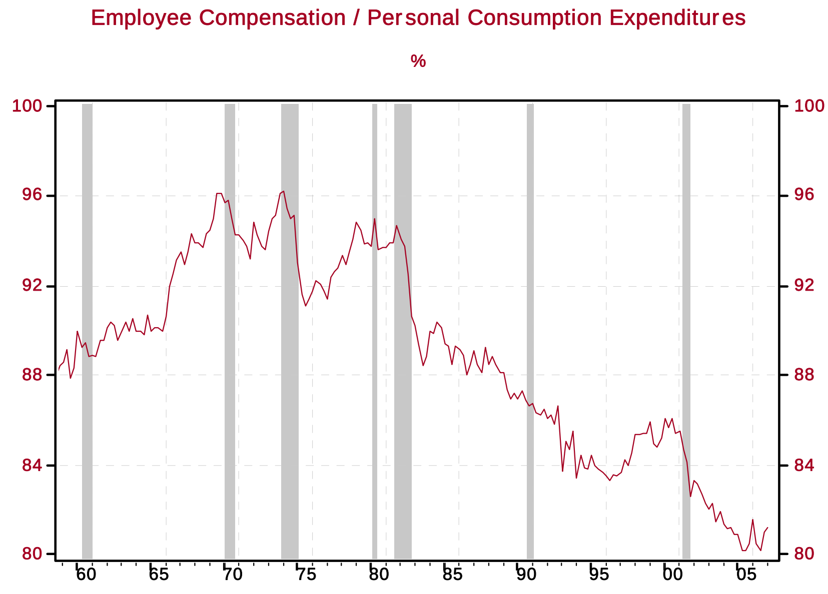
We mentioned that the other way households can fund their deficit spending is to sell assets to entities other than households. One asset that households have been selling is corporate equities. Chart 8 shows annual net equity issuance by corporations as a percent of DPI. In 2006, a record $415.2 billion of corporate equities were "retired," which represented a record 4.4% of DPI. Because foreign entities were net purchasers of U.S. equities, it had to be U.S. households who were the net sellers. Some of the equities were retired as a result of corporations buying back their own shares. Private equity transactions, which used to be referred to in less politically correct terms as leveraged buyouts, also played a big part in the recent retirement of corporate equities. In effect, corporations and private equity investors have played a large role of late in funding household deficit spending. With private equity borrowing becoming more expensive because of increased risk aversion in the capital markets, the retirement of corporate equities could slow, which would have a negative effect on consumer spending.

Chart 8



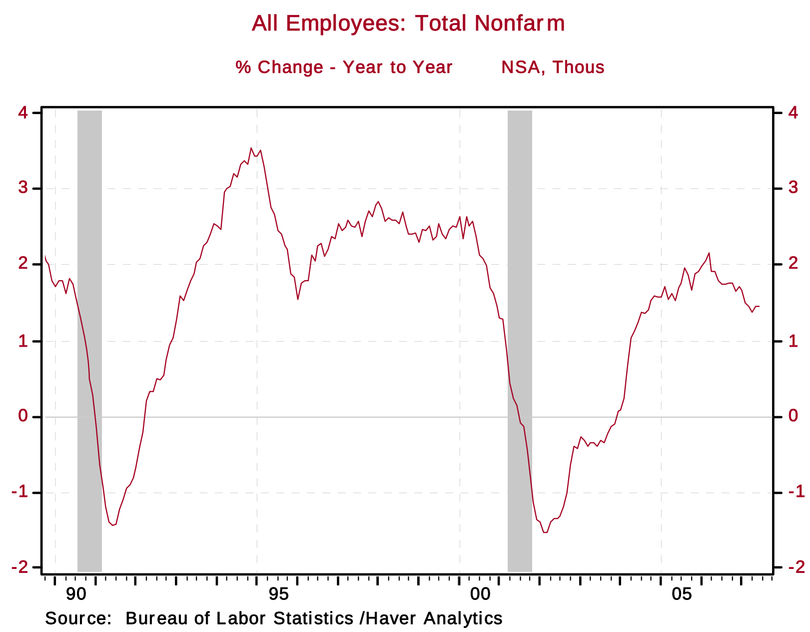

But won't employment and personal income growth support consumer spending? Not necessarily. For starters, the Conference Board, after examining the empirical evidence, has determined that employment and personal income historically have *not* been leading indicators, but *coincident* indicators. And because consumer spending represents such a large proportion of GDP (approximately 70%), it stands to reason that employment and personal incomes would not be a leading indicator of Personal Consumption Expenditures (PCE). As Chart 9 shows, just prior to most recessions since 1960, employee compensation tends to spike up relative to consumer spending. This is due to rising real rates of interest making saving more attractive, and/or some other event that makes households more cautious in their spending.

Chart 9



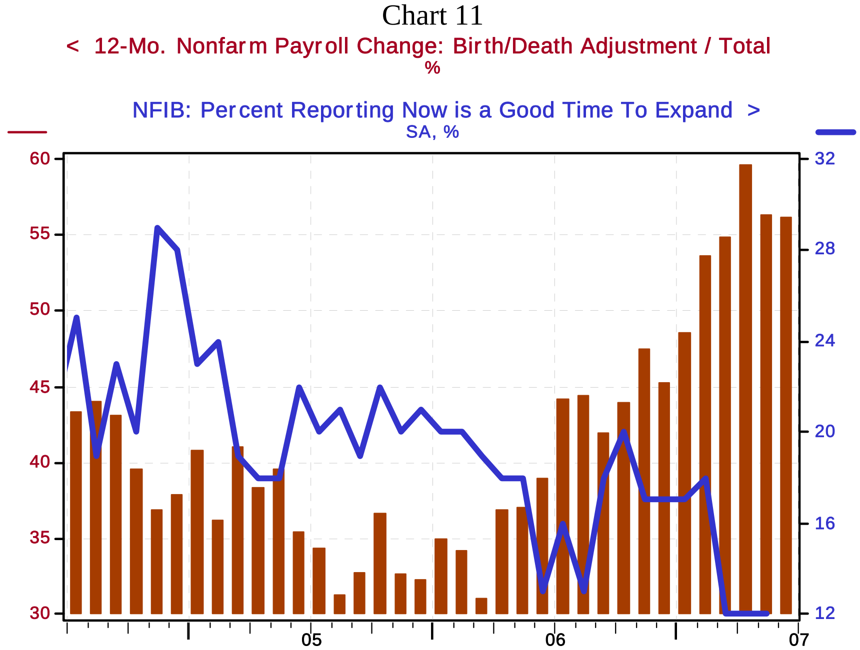

Although nonfarm payrolls continue to grow, the *rate* of growth has been trending lower since hitting a cyclical peak of 2.14% in March 2006 on a year-over-year basis (see Chart 10). This growth had slowed to only 1.45% in June 2007.

Chart 10



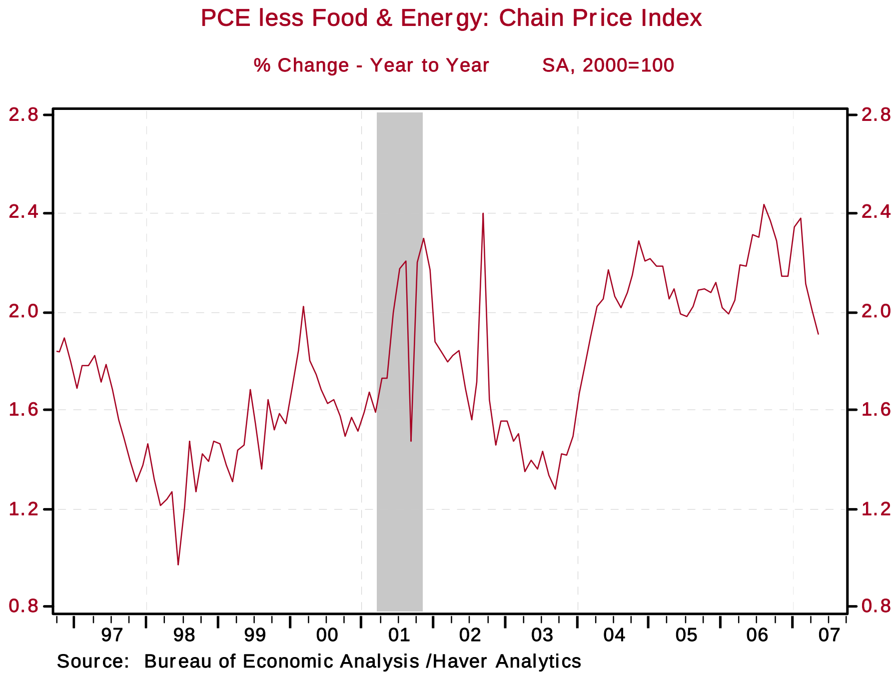
Moreover, as the growth in nonfarm payrolls has slowed, the *credulity* of even that slower growth has diminished because of the so-called "birth/death" adjustment. This is an adjustment made by the Bureau of Labor Statistics (BLS) each month to unadjusted private nonfarm payrolls to account for hiring and firing by smaller businesses that is not yet being picked up in the BLS monthly survey of employers. The birth/death adjustment does not consider what part of the business cycle the economy is in. One would think that if small businesses were reporting that now is not a good time to expand their operations, new business start-ups would be slowing. If this were not being considered in the birth/death adjustment to payrolls, this adjustment could be overstating the hiring by new small businesses. Chart 11 shows that as small businesses, in fact, have been reporting that now is not a good time to expand operations, the birth/death adjustment has been trending up as a percent of the 12-month change in unadjusted nonfarm payrolls. In the 12 months ended June 2007, the birth/death adjustment represented *56%* of the change in total nonfarm payrolls (*67%* of the change in private nonfarm payrolls). **In short, even the relatively slow growth in nonfarm payrolls of 1.45% in June is suspect. In reality, it might be much slower because of an upward bias emanating from the birth/death adjustment.** The birth/death adjustment might help the Federal Reserve resolve its latest conundrum – employment growth higher than what would be expected given weak real GDP growth.

Chart 11




The Federal Reserve continues to express its concern about inflation despite the fact that its assumed preferred measure of inflation, the PCE price index excluding food and energy prices, is now trending lower (see Chart 12). After reaching a cycle peak of 2.44% in August 2006, the year-over-year change in the "core" PCE price index slowed to 1.91% in May.

Chart 12




It is possible the Federal Reserve is becoming as concerned about the *overall* rate of inflation as it has been with the core, inasmuch as persistent increases in food and energy prices could begin to raise inflation *expectations* even if there is little pass-through to core prices. Our belief is that energy prices are currently being driven higher more by supply factors, such as civil unrest in Nigeria, than demand factors. We are not geo-political experts, so we cannot forecast when these supply-side factors will ease. But we do believe that some of the demand-side factors will argue for lower energy prices. The obvious demand-side factor we are forecasting is the continued below-potential growth in the U.S. economy. The less-obvious one is the forecasted slower non-U.S. economic growth we see coming toward the fourth quarter from past and future foreign central bank tightening of their monetary policies.

Regardless of what happens to energy prices in the second half this year, we believe real economic growth will be less than 2% at an annual rate because of persistent weakness in consumer spending. If the Federal Reserve cannot lower the federal funds rate because of higher food and energy prices, so be it. But if the Federal Reserve does not begin lowering the federal funds rate early in the fourth quarter, then our forecast of a 2008 economic rebound will be null and void. Rather, we would view the probabilities of the U.S. economy entering a recession in 2008 as rising significantly.

***Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy***

**THE NORTHERN TRUST COMPANY**
**ECONOMIC RESEARCH DEPARTMENT**
**July 2007**

# SELECTED BUSINESS INDICATORS

## Table 1 US GDP, Inflation, and Unemployment Rate

| | 2006 | | 2007 | | | | 2008 | | | | Q4-t-Q4 change | | | Annual change | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 06:3a | 06:4a | 07:1a | 07:2f | 07:3f | 07:4f | 08:1f | 08:2f | 08:3f | 08:4f | 2006a | 2007f | 2008f | 2006a | 2007f | 2008f |
| REAL GROSS DOMESTIC PRODUCT | 2.0 | 2.5 | 0.7 | 2.7 | 1.7 | 1.7 | 2.0 | 2.5 | 3.0 | 3.3 | 3.1 | 1.7 | 2.7 | 3.3 | 1.8 | 2.2 |
| (% change from prior quarter) | | | | | | | | | | | | | | | | |
| CONSUMPTION EXPENDITURES | 2.8 | 4.2 | 4.2 | 1.7 | 2.0 | 1.7 | 2.0 | 2.1 | 2.8 | 2.7 | 3.6 | 2.4 | 2.4 | 3.2 | 3.0 | 2.1 |
| BUSINESS INVESTMENT | 10.0 | -3.1 | 2.6 | 10.2 | 3.6 | 1.0 | 2.8 | 3.4 | 3.3 | 6.4 | 6.0 | 4.3 | 4.0 | 7.2 | 3.9 | 3.4 |
| RESIDENTIAL INVESTMENT | -18.7 | -19.8 | -15.8 | -10.0 | -8.0 | -2.0 | -0.5 | 1.5 | 3.0 | 5.5 | -12.8 | -9.1 | 2.4 | -4.2 | -13.9 | -1.2 |
| CHANGE IN INVENTORIES ('00 dlrs, bill) | 55.4 | 22.4 | -4.2 | 10.3 | 5.8 | 3.8 | 4.3 | 4.3 | 9.3 | 15.3 | | | | 43.2* | 3.9* | 8.3* |
| GOVERNMENT | 1.7 | 3.4 | 1.0 | 2.4 | 2.0 | 2.2 | 1.9 | 2.2 | 2.2 | 2.2 | 2.7 | 1.9 | 2.1 | 2.1 | 2.0 | 2.1 |
| NET EXPORTS ('00 dlrs, bill.) | -628.8 | -582.6 | -606.2 | -598.4 | -593.0 | -588.1 | -587.3 | -579.0 | -580.8 | -586.2 | | | | -618.0* | -596.4* | -583.3* |
| FINAL SALES | 1.9 | 3.7 | 1.7 | 2.3 | 1.8 | 1.8 | 2.0 | 2.5 | 2.8 | 3.0 | 3.3 | 1.9 | 0.0 | 3.1 | 2.2 | 2.2 |
| NOMINAL GROSS DOMESTIC PRODUCT | 3.9 | 4.1 | 4.9 | 8.5 | 3.7 | 3.1 | 3.2 | 3.9 | 4.4 | 4.9 | 5.7 | 5.0 | 4.1 | 6.3 | 5.1 | 4.0 |
| GDP DEFLATOR - IMPLICIT (% change) | 1.9 | 1.6 | 4.2 | 5.7 | 2.0 | 1.4 | 1.2 | 1.4 | 1.4 | 1.6 | 2.5 | 3.3 | 1.4 | 2.9 | 3.2 | 1.7 |
| CPI (% Change, 1982-84 = 100) | 3.1 | -2.1 | 3.8 | 6.0 | 2.3 | 1.7 | 1.5 | 1.7 | 1.7 | 1.9 | 2.0 | 3.4 | 1.7 | 3.2 | 2.7 | 2.0 |
| CIVILIAN UNEMPLOYMENT RATE (avg.) | 4.7 | 4.5 | 4.5 | 4.5 | 4.7 | 5.0 | 5.1 | 5.1 | 5.1 | 5.0 | | | | 4.6* | 4.7* | 5.1* |

a=actual
f=forecast
*=annual average

## Table 2 Outlook for Interest Rates

| | Quarterly Average | | | | | | | | | | Annual Average | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| SPECIFIC INTEREST RATES | 06:3a | 06:4a | 07:1a | 07:2a | 07:3f | 07:4f | 08:1f | 08:2f | 08:3f | 08:4f | 2006a | 2007f | 2008f |
| Federal Funds | 5.25 | 5.25 | 5.26 | 5.25 | 5.25 | 5.05 | 4.55 | 4.25 | 4.25 | 4.25 | 4.96 | 5.20 | 4.33 |
| 3-mo.LIBOR | 5.43 | 5.37 | 5.36 | 5.36 | 5.35 | 4.95 | 4.45 | 4.20 | 4.25 | 4.35 | 5.19 | 5.25 | 4.31 |
| 2-yr. Treasury Note | 4.93 | 4.74 | 4.77 | 4.81 | 4.95 | 4.70 | 4.40 | 4.20 | 4.25 | 4.35 | 4.82 | 4.81 | 4.30 |
| 10-yr. Treasury Note | 4.90 | 4.63 | 4.68 | 4.85 | 5.00 | 4.70 | 4.45 | 4.35 | 4.40 | 4.50 | 4.79 | 4.81 | 4.43 |

a = actual
f = forecast