



U.S. ECONOMIC & INTEREST RATE OUTLOOK

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The Recession Continues

June 11, 2008

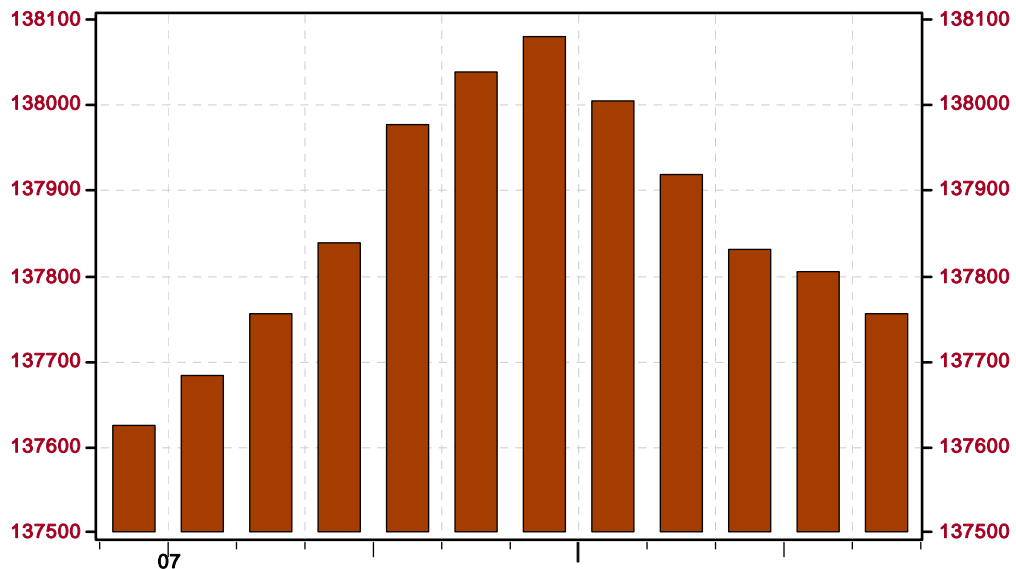
Real GDP annualized growth for the first quarter was revised up from its advance estimate of 0.6% to 0.9% in its preliminary estimate – a relatively insignificant revision. The major revisions were to imports and to business inventories. Annualized growth in imports was revised from +2.5% to -2.6%. Lower imports, all else the same, increase GDP. The change in business inventories was revised from +\$1.8 billion to -\$14.4 billion. A reduction in inventories, all else the same, decreases GDP. It would appear that some of the reduction in inventories was a result of reduced imports.

Despite the marginally positive real GDP growth in the first quarter, we continue to believe that the economy has entered a recession. The basis of this belief is that all four of the components of the index of Coincident Economic Indicators – nonfarm payrolls, real personal income less transfer payments, industrial production and real business sales – appear to have peaked (see Charts 1-4).

Chart 1

All Employees: Total Nonfarm

SA, Thous

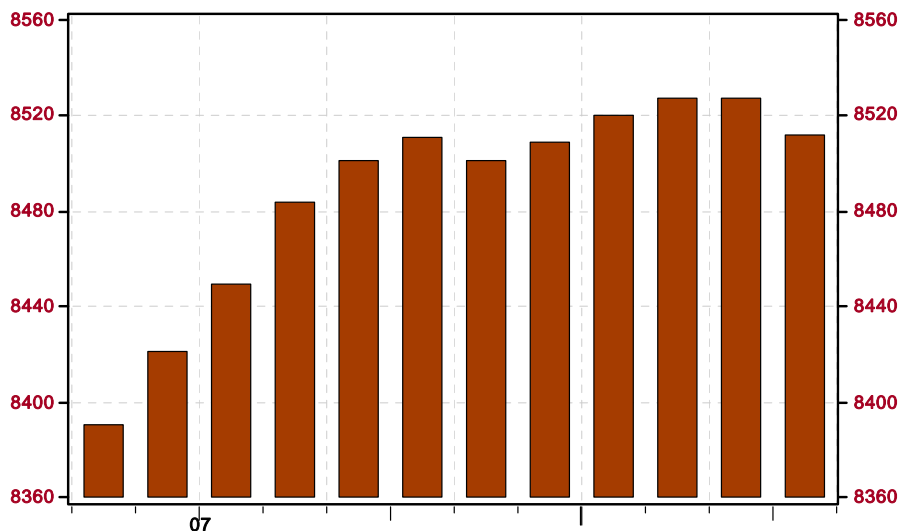


Source: Bureau of Labor Statistics /Haver Analytics



Chart 2
Real Personal Income Less Transfer Payments

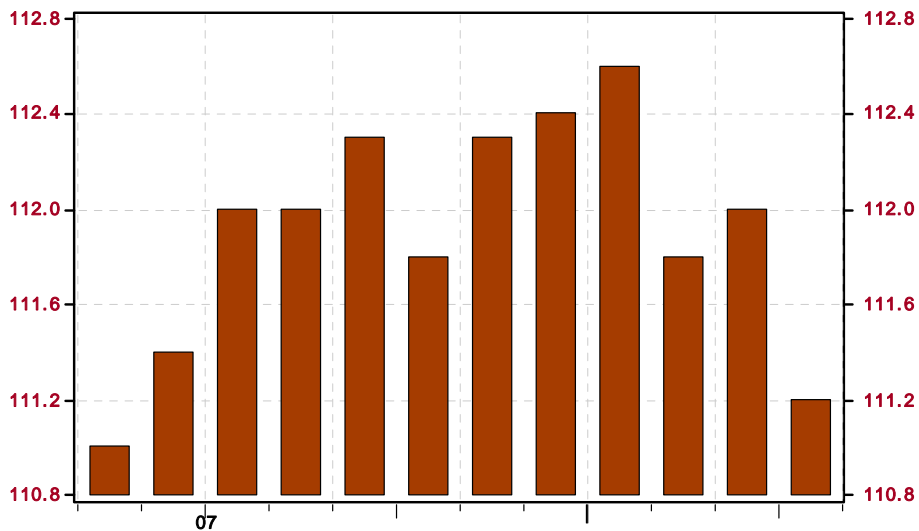
SAAR, Bil. Chn. 2000\$



Source: Bureau of Economic Analysis/Haver Analytics

Chart 3
Industrial Production Index

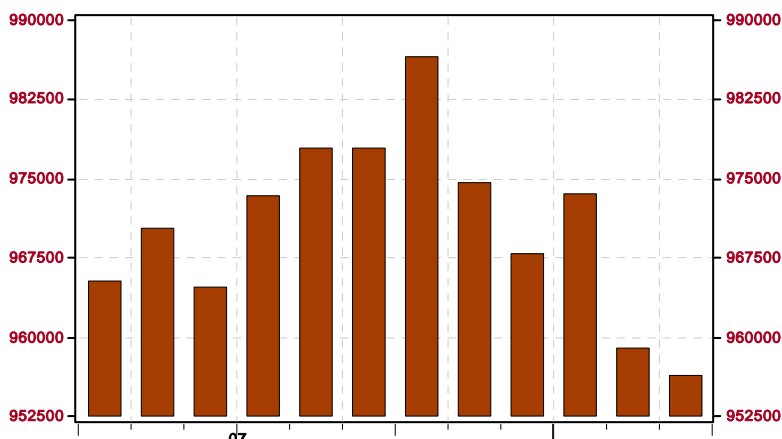
SA, 2002=100



Source: Federal Reserve Board /Haver Analytics

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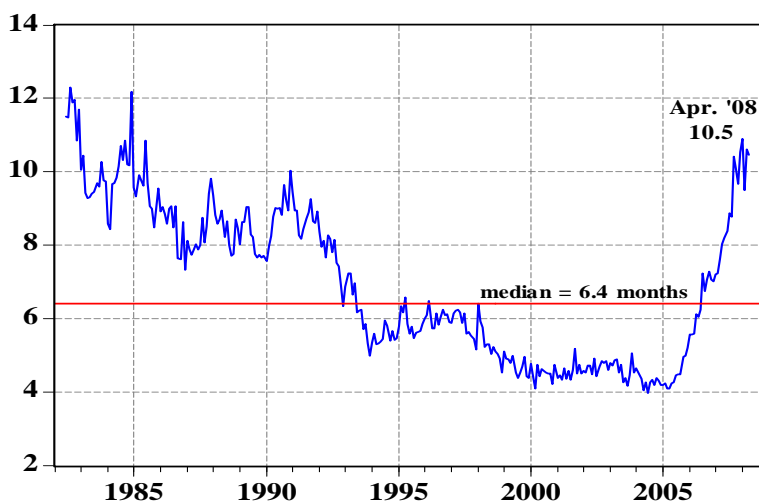
Chart 4
Real Manufacturing & Trade Sales: All Industries
 SA, Mil.Chn.2000\$



Source: Bureau of Economic Analysis /Haver Analytics

Housing starts increased marginally in April due to the multi-family component. New home sales also were reported to have increased in April. However, it would be premature to suggest that the housing recession is near a bottom inasmuch as there remains an elevated inventory-to-sales ratio for combined new and existing single-family homes (see Chart 5). This excess supply of houses continues to put downward pressure on home prices. As shown in Chart 6, the Case-Shiller house price index for 20 metro areas fell by 14.35% in March 2008 vs. March 2007. The March 2008 level of this house price index has fallen back approximately to where it was in October 2004.

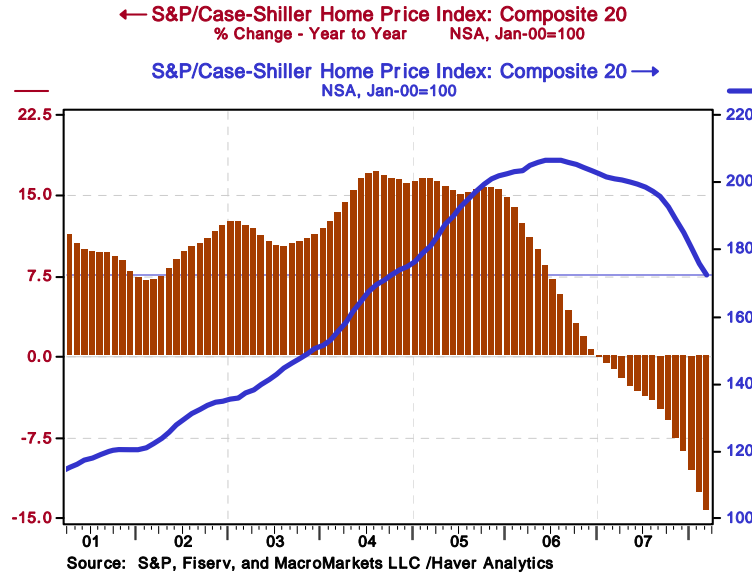
Chart 5
Total Single-Family Homes*: Inventory/Sales Ratio
 months' supply



*Combined new and existing

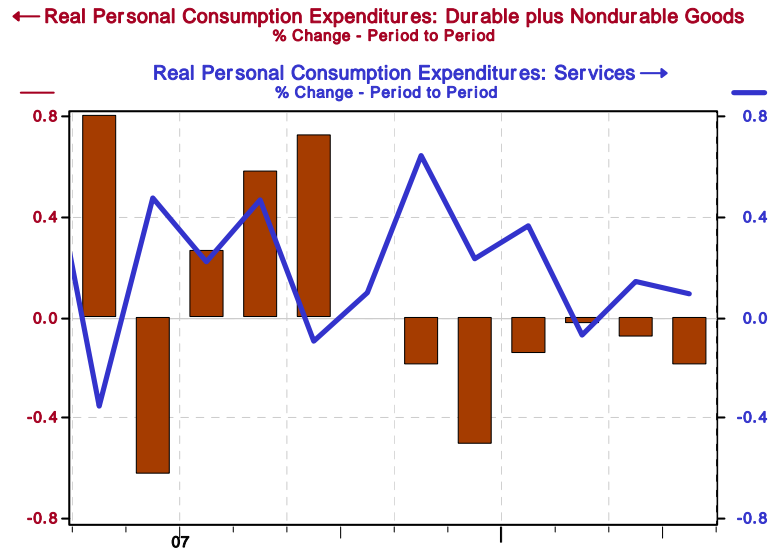
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Chart 6



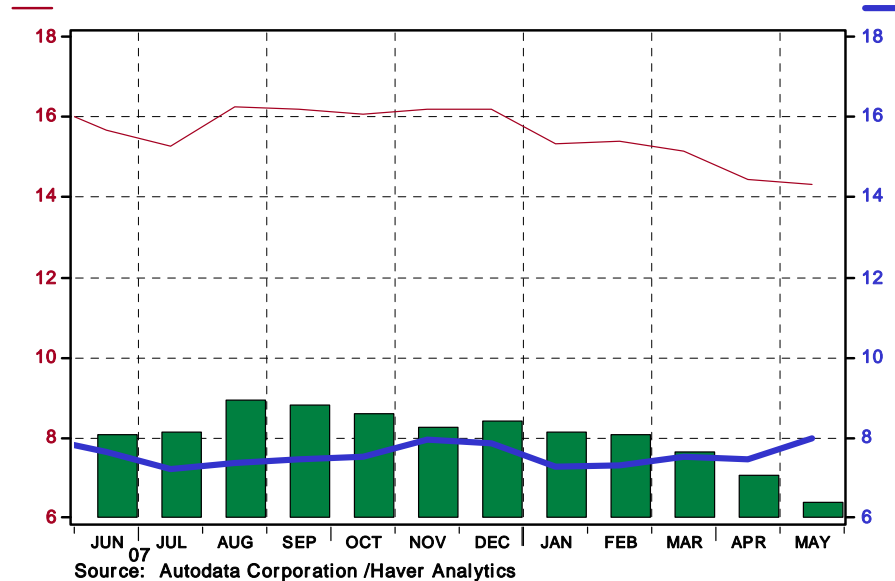
Consumer spending continues to weaken due to the fallout from the housing recession and elevated energy prices. Real personal consumption expenditures were flat in April vs. March. What is boosting real personal consumption in recent months are expenditures on consumer services, which includes the implicit rent on owner-occupied housing. As Chart 7 shows, real personal expenditures on consumer goods have contracted for six consecutive months. Especially hard hit has been the sales of motor vehicles. The annualized unit sales rate of light motor vehicles slowed to 14.3 million in May – the slowest sales rate since July 1998. As Chart 8 shows, a sharp weakening in truck and SUV sales, in part because of the increased price of gasoline, is largely responsible for the sluggish sales in total light motor vehicles in recent months.

Chart 7



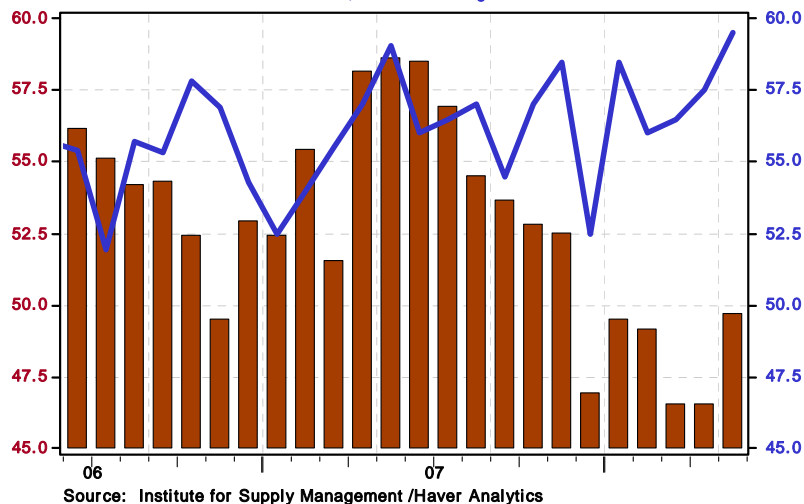
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Chart 8
Total Light Vehicle Retail Sales (Imported+Domestic) (SAAR, Mil. Units)
Total Car Retail Sales (Imported+Domestic) (SAAR, Mil. Units)
Total Light Truck Retail Sales (Imported+Domestic) (SAAR, Mil. Units)



If there is one sector of the economy that is exhibiting signs of stabilization, it is manufacturing. The new orders index increased in the May manufacturing Institute for Supply Management report. As shown in Chart 9, new orders for exports appear to have played a major role in the May rebound in total new manufacturing orders.

Chart 9
← ISM Manufacturing: New Orders Index
SA, 50+=Increasing
ISM Manufacturing: New Export Orders Index →
SA, 50+=Increasing



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Despite high food and energy prices, year-over-year growth in the CPI for all items, although uncomfortably high, is moderating (see Chart 10). As mentioned at the outset, the Federal Reserve is concerned that a further weakening in the dollar would lead to further increases in the rate of change in the prices of imported goods. Chart 11 shows that import prices of consumer goods have been increasing at a faster pace in recent months. Perhaps as a result of this, the CPI for goods excluding food and energy is now beginning to post year-over-year increases. Although these CPI increases are still quite small, in 2007, the CPI for consumer goods ex food and energy was *falling*.

Chart 10
CPI-U: All Items

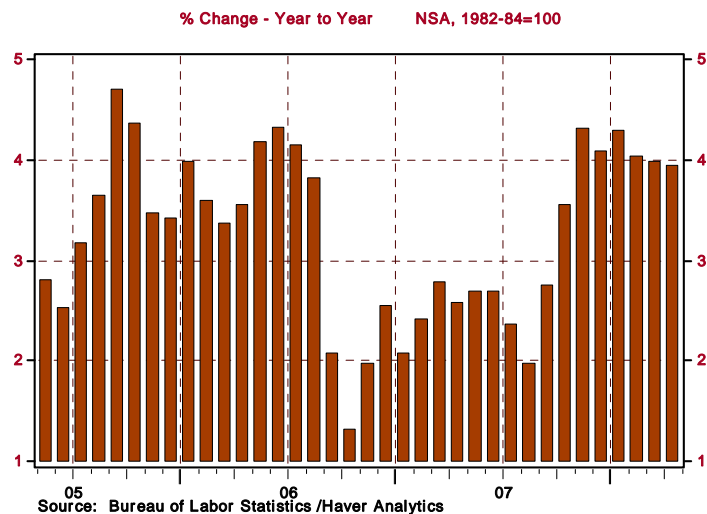
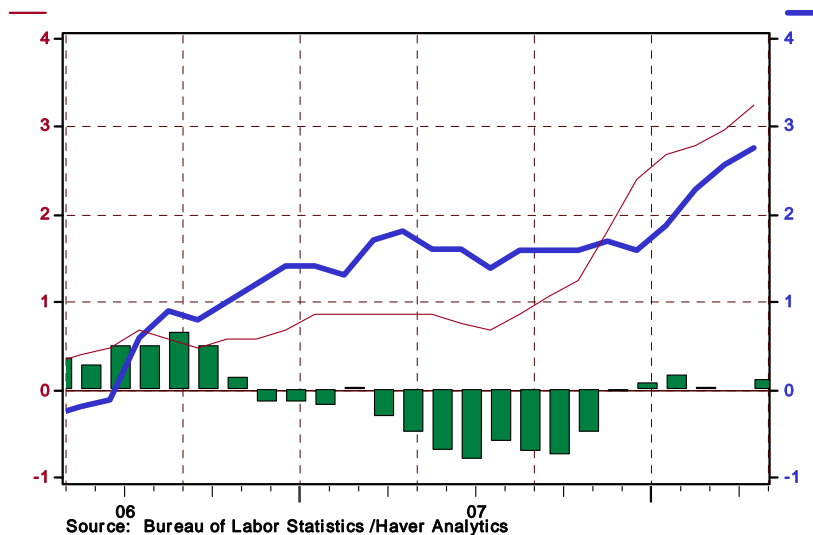


Chart 11

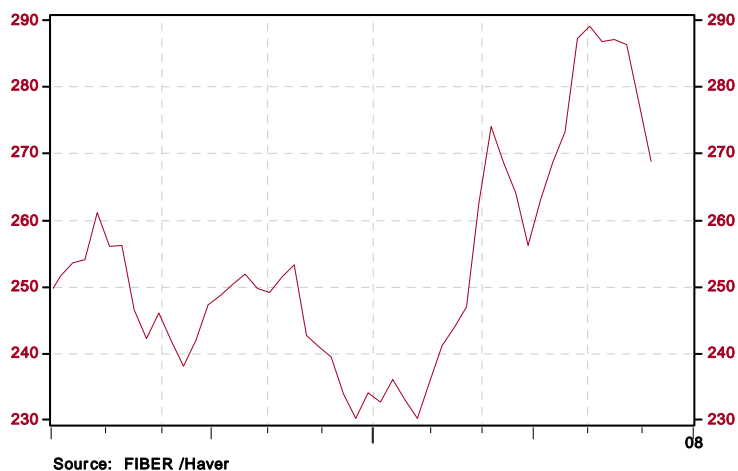
Import Prices: Autos, y/y% chg.
Import Prices: Consumer Goods ex Autos, y/y% chg.
CPI: Goods ex Food and Energy, y/y% chg.



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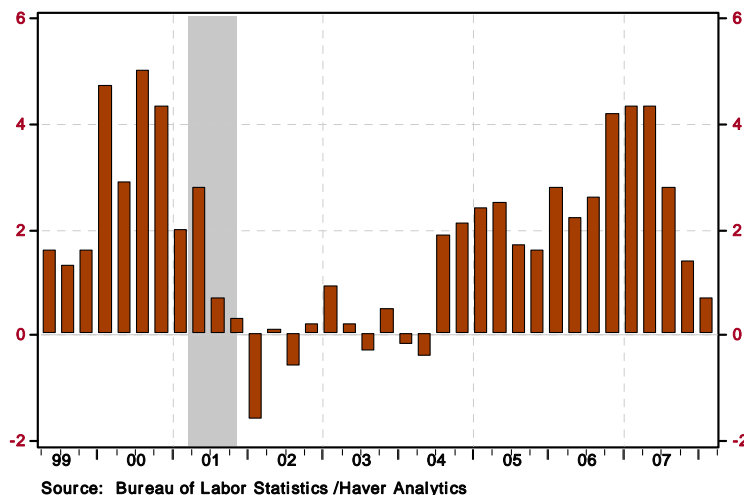
There are tentative indications that a slowing in global economic activity is beginning to weaken prices of industrial commodities. Chart 12 shows that industrial metals prices have broken down of late.

Chart 12
Industrial Materials Price Index: Metals
 Avg, 1990=100



Another encouraging sign for a moderation in inflation is the behavior of unit labor costs – labor compensation adjusted for productivity. On a year-over-year basis, growth in unit labor costs has been declining – up just 0.7% in the first quarter of this year (see Chart 13). Given our forecast of a further significant rise in the unemployment rate over the remainder of this year, growth in labor compensation would be expected to moderate. Thus, there appears to be little likelihood that unit labor costs will put upward pressure on inflation.

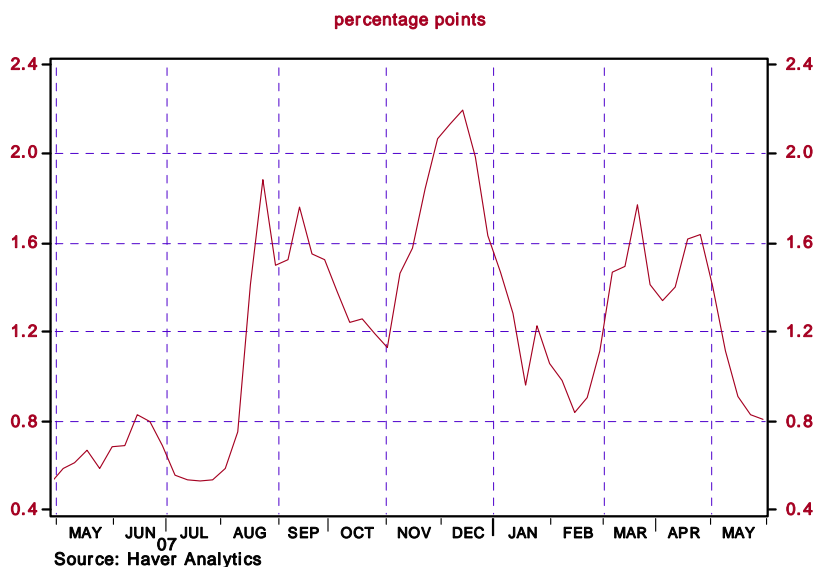
Chart 13
Nonfarm Business Sector: Unit Labor Cost
 SA, %Change.Year.Ago (I)



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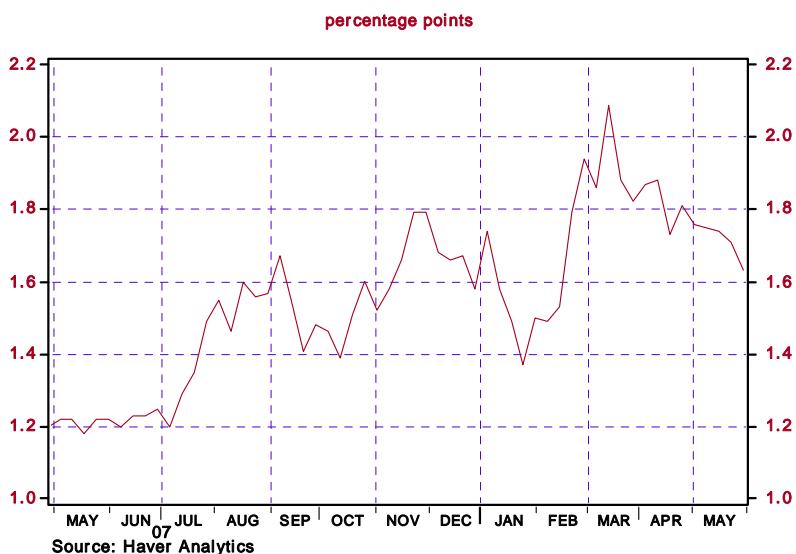
Liquidity conditions are improving and credit risk premia are being reduced in the fixed income markets. The interest spread between 3-month Libor and 3-month T-bills finished May at about 80 basis points – down considerably from the recent highs and only about 20 basis points higher than what is was at the end of May 2007 (see Chart 14).

Chart 14
Interest Rate Spread: 3-mo. Libor minus 3-mo. T-Bill



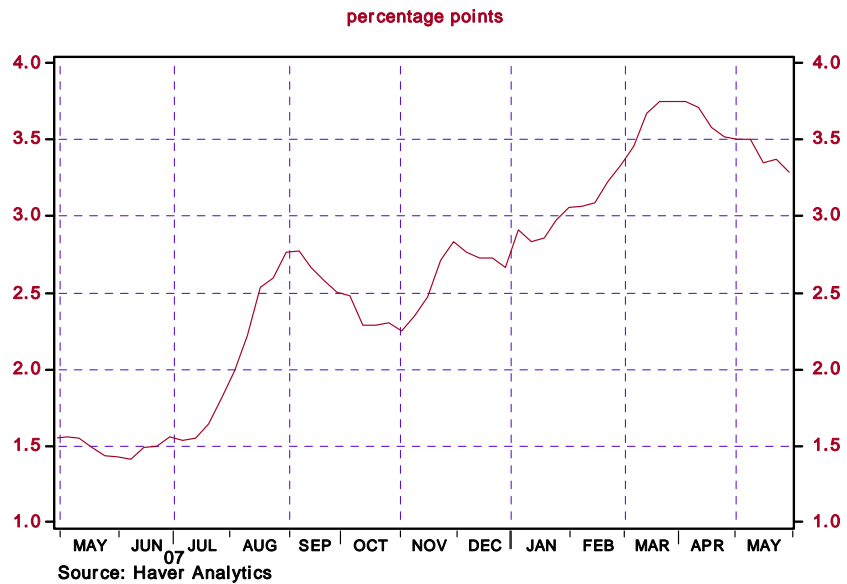
Yield spreads in the residential mortgage market are declining but remain elevated. This is illustrated in Chart 15 for conforming mortgages and Chart 16 for jumbo mortgages.

Chart 15
Yield Spread: 15-Yr. Freddie Mac Fixed Rate Mortgage minus 10-Yr. Treasury



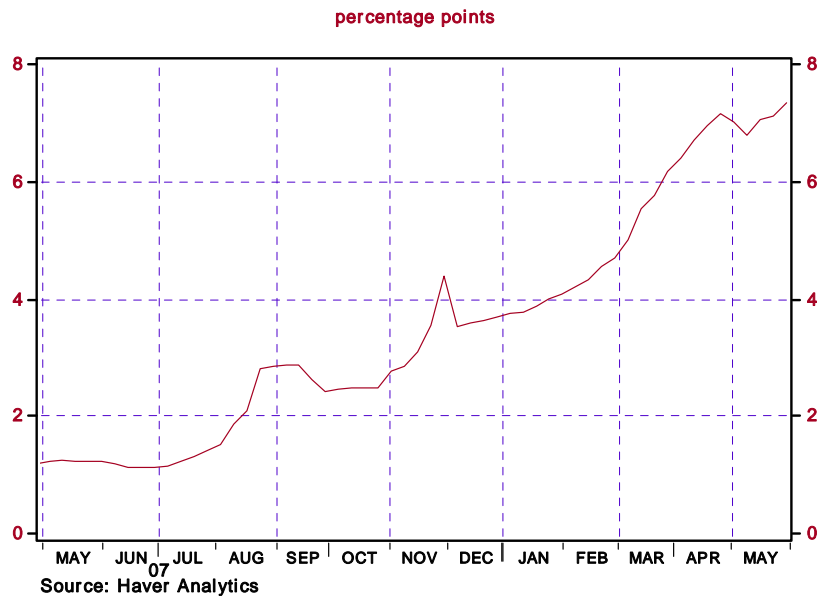
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Chart 16
Yield Spread: Jumbo Mortgage minus 10-Yr. Treasury



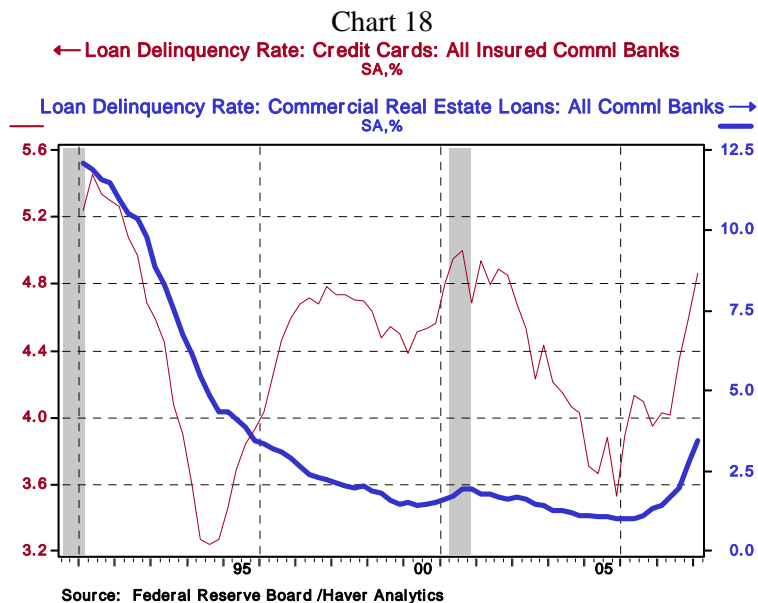
One debt instrument that continues to exhibit increasing credit risk is the asset-backed home equity loan. Yield spreads over Treasuries for this instrument continue to widen (see Chart 17).

Chart 17
Yield Spread: Asset-Backed Home Equity Loans minus 10-Yr. Treasury

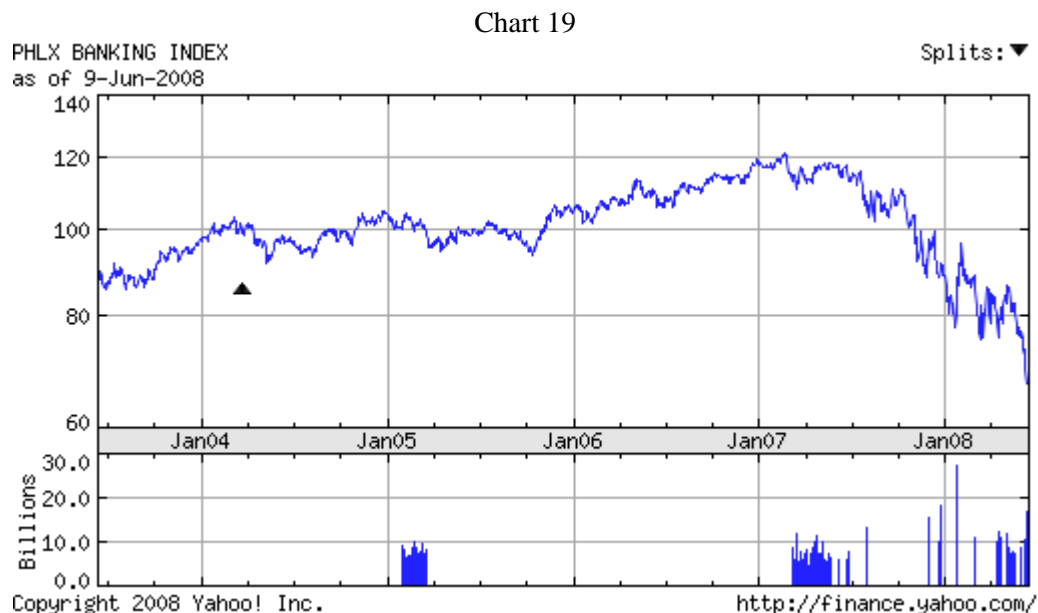


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It is interesting that credit risk premia are shrinking as delinquency rates are rising in debt categories other than residential mortgages. Chart 18 shows that delinquencies are rising on credit card and commercial real estate loans. Smaller commercial banks hold a high concentration of commercial real estate loans.

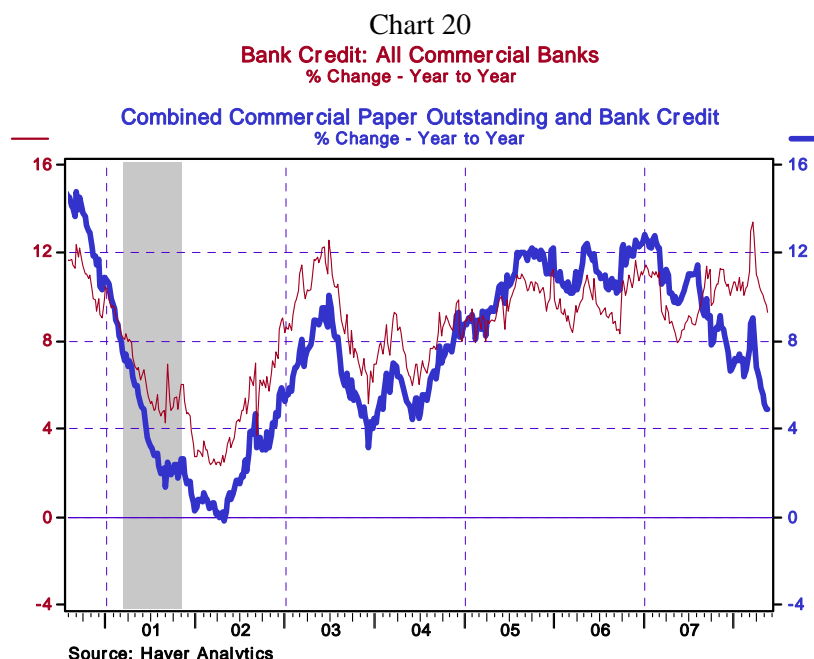


It also is interesting that credit risk premia are shrinking as an index of bank stocks is hitting new cycle lows (see Chart 19). We would have assumed that in the current environment, declining prices of bank stocks might be somehow related to continued credit problems with banks' earning assets.



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Although liquidity may be improving and credit risk may be receding, short-term credit creation is slowing. Bank credit growth remains relatively high, but this appears to be because commercial banks are taking on the credit formerly being provided via commercial paper issuance. Growth in the combined aggregate of commercial paper outstanding and bank credit has slowed sharply in recent months (see Chart 20).



The next scheduled FOMC meeting is June 24-25. Federal Reserve officials have given every indication that no change in the federal funds rate will be forthcoming at this meeting. With the federal funds rate now below the consumer inflation rate, the FOMC probably believes that monetary policy is quite accommodative. Moreover, a negative “real” federal funds rate has in the past been the catalyst for accelerating inflation. Under these circumstances, the FOMC is reluctant to reduce the nominal federal funds further. Yet, with economic growth expected to remain sluggish at best for several quarters ahead, the FOMC, hawkish “open mouth policy” notwithstanding, is likely to be reluctant to raise the federal funds rate. Our current forecast is for real GDP growth to contract through the end of 2008, with barely positive real GDP growth beginning in the first half of 2009. We also expect that inflation will begin to moderate significantly in the second half of 2008 as energy prices recede and price increases for consumer discretionary goods and services increase at a slower pace. As a result, we currently believe that the FOMC will maintain the federal funds rate at a level of 2.00% through the first half of 2009.

**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
June 2008
SELECTED BUSINESS INDICATORS**

Table 1 US GDP, Inflation, and Unemployment Rate

	2007		2008				2009				Q4 to Q4 Change			Annual Change		
	07:3a	07:4a	08:1a	08:2f	08:3f	08:4f	09:1f	09:2f	09:3f	09:4f	2007a	2008f	2009f	2007a	2008f	2009f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	4.9	0.6	0.9	-0.6	-0.1	-0.4	0.4	1.1	2.1	2.6	2.5	-0.1	1.5	2.2	1.0	0.6
CONSUMPTION EXPENDITURES	2.8	2.3	1.0	0.0	-0.5	-0.3	0.3	0.7	1.5	2.0	2.6	0.0	1.1	2.9	1.0	0.4
BUSINESS INVESTMENT	9.3	6.0	-0.2	-0.3	-1.5	-1.5	0.8	1.5	2.8	3.7	7.1	-0.9	2.2	4.7	2.5	0.6
RESIDENTIAL INVESTMENT	-20.5	-25.2	-25.5	-17.0	-8.0	-4.0	0.0	2.0	3.0	5.0	-18.6	-14.0	2.5	-17.0	-19.3	-1.9
CHANGE IN INVENTORIES ('00 dtrs, bill)	30.6	-18.3	-14.4	-29.7	-25.7	-25.7	-22.3	-17.3	-5.3	7.0				4.5*	-23.9*	-9.5*
GOVERNMENT	3.8	2.0	2.0	1.3	0.2	-0.4	-0.1	0.4	1.3	1.3	2.3	0.8	0.7	2.0	1.8	0.3
NET EXPORTS ('00 dtrs, bill.)	-533.1	-503.2	-480.2	-457.6	-435.6	-424.5	-421.8	-420.1	-420.3	-422.9				-555.6*	-449.3*	-421.3*
FINAL SALES	4.0	2.4	0.7	-0.1	-0.3	-0.4	0.3	0.9	1.7	2.2	2.8	0.0	1.3	2.5	1.3	0.5
NOMINAL GROSS DOMESTIC PRODUCT	6.0	3.0	3.5	2.2	2.7	1.6	1.5	2.5	3.9	4.5	5.1	2.5	3.1	4.9	3.4	2.4
GDP DEFLATOR - IMPLICIT (% change)	1.0	2.4	2.6	2.9	2.8	2.0	1.0	1.4	1.7	1.9	2.6	2.6	1.5	2.7	2.4	1.8
CPI (% Change, 1982-84 = 100)	2.8	5.0	4.3	3.2	3.1	2.3	1.3	1.7	2.0	2.2	4.0	3.2	1.8	2.9	3.8	2.1
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.7	4.8	4.9	5.3	5.6	6.0	6.3	6.5	6.5	6.3				4.6*	5.5*	6.4*

a=actual

f=forecast

*=annual average

Table 2 Outlook for Interest Rates

SPECIFIC INTEREST RATES	Quarterly Average										Annual Average		
	07:3a	07:4a	08:1a	08:2f	08:3f	08:4f	09:1a	09:2f	09:3f	09:4f	2007a	2008f	2009f
Federal Funds	5.07	4.50	3.18	2.10	2.00	2.00	2.00	2.00	2.20	2.75	5.02	2.32	2.24
3-mo.LIBOR	5.45	5.03	3.26	2.75	2.45	2.15	2.15	2.15	2.40	2.90	5.30	2.65	2.40
2-yr. Treasury Note	4.38	3.48	2.02	2.40	2.55	2.30	2.25	2.30	2.55	3.00	4.36	2.32	2.53
10-yr. Treasury Note	4.73	4.26	3.66	3.85	3.80	3.55	3.50	3.60	3.80	4.10	4.63	3.72	3.75

a = actual

f = forecast

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