Northern Trust

DAILY GLOBAL COMMENTARY

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House Prices, the Wealth Effect and the Cash-in-Hand Effect

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House prices are collapsing, which means that homeowners' equity in their houses is plunging. According to Federal Reserve flow-of-funds data, homeowners' equity dropped by $399 billion quarter-to-quarter in Q1:2008 and $880 billion year-over-year – both record absolute declines (see Chart 1). The drop in homeowners' equity contributed significantly to the $1.7 trillion decline in household net worth in the first quarter (see Chart 2).

Chart 1

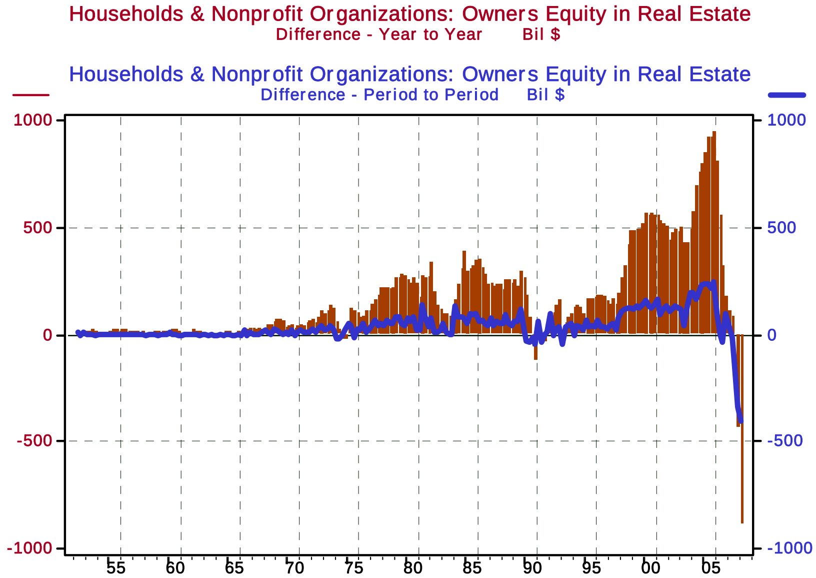
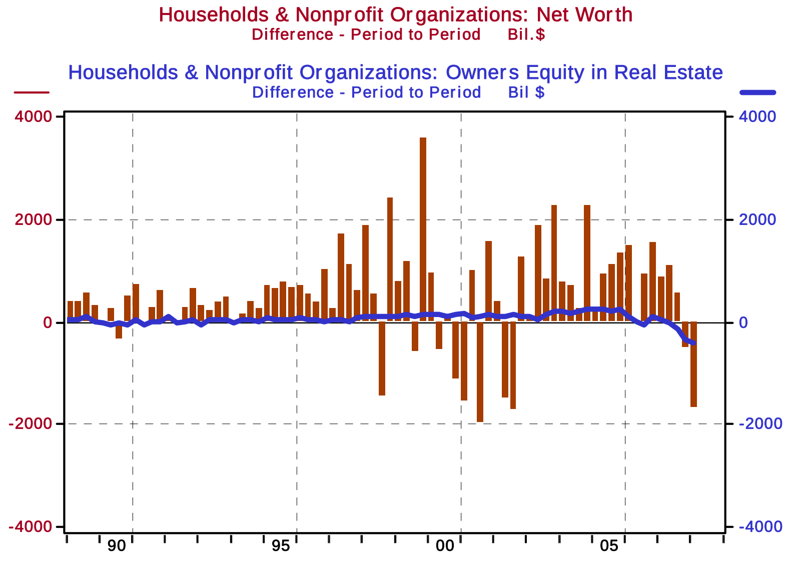


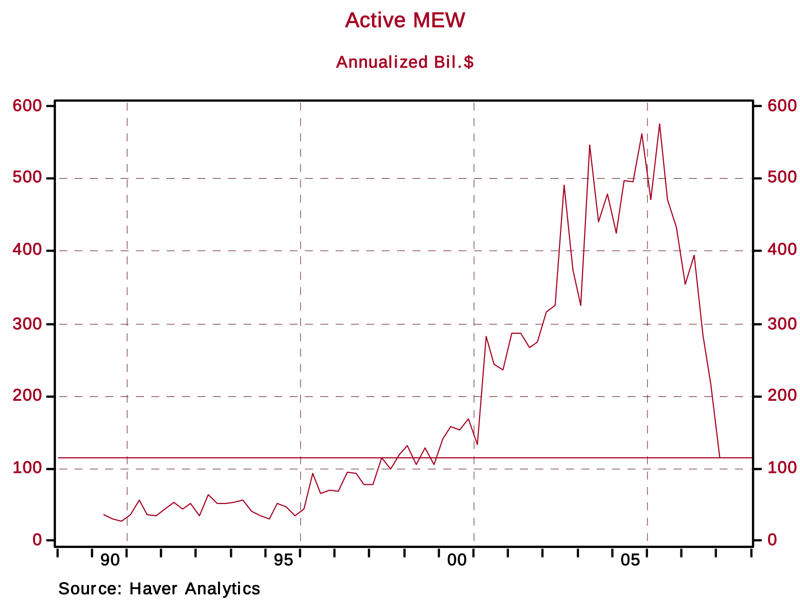
Chart 2



Economists refer to something called the "wealth" effect. It is hypothesized that households tend to spend relatively more of their income when their wealth is increasing and vice versa. Mind you, households do not have any more cash in hand to spend when the value of their stock portfolios or houses go up. They are just wealthier "on paper."

In this past cycle, it had become very easy for households to turn their increased "paper" housing wealth into actual cash by borrowing against their increased home equity. This borrowing is called mortgage equity withdrawal, or MEW. Active MEW can be defined as mortgage equity withdrawal consisting of refinancing and home equity borrowing. In contrast, inactive MEW consists of turnover. At an annualized rate, active MEW peaked at $576 billion in the second quarter of 2006. Active Mew has slowed to only $114 billion in the first quarter of this year – the smallest amount since the fourth quarter of 1999 (see Chart 3). There is no doubt in my mind that active MEW, which actually puts additional cash into the hands of households, played an important role in boosting consumer spending in this past expansion. And there is no doubt in my mind that the recent and likely continued decline in active MEW will play an important role in retarding consumer spending in this recession. Because it has been easier to borrow against the increased wealth in one's house than in one's stock portfolio, dollar-for-dollar, falling house prices will have a more important negative effect on household spending that will falling stock prices.

Chart 3



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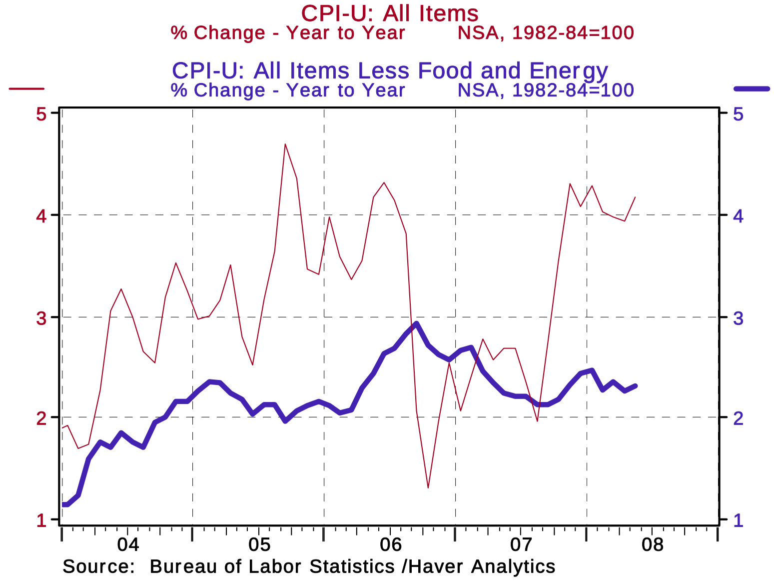
CPI Headline Justifies Hawkish Fed Rhetoric, but Action May Not Follow Just Yet

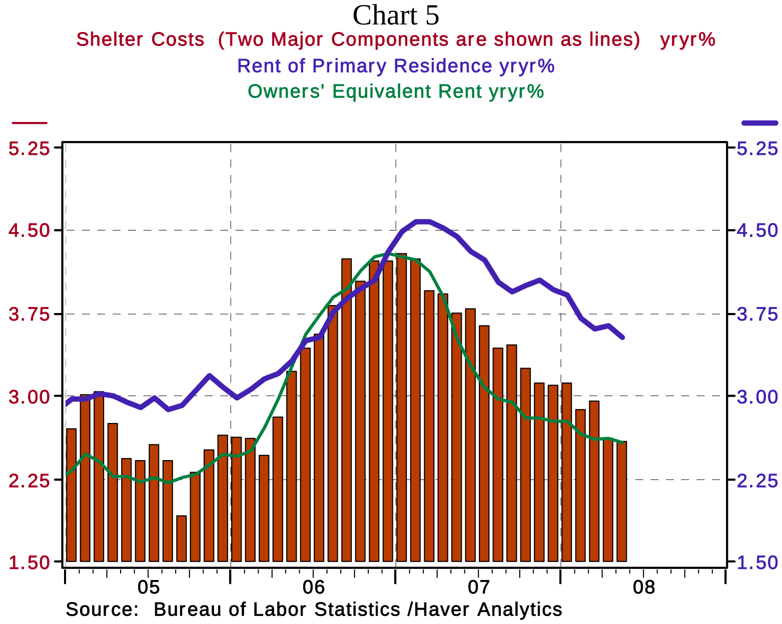
The Consumer Price Index (CPI) advanced 0.6% in May following a 0.2% increase in April. Year-to-date, the CPI has risen at an annual rate of 4.0% compared with a 4.1% increase in all of 2007. The energy price index moved up 4.4% and the food price index rose 0.3% in May.

Chart 4



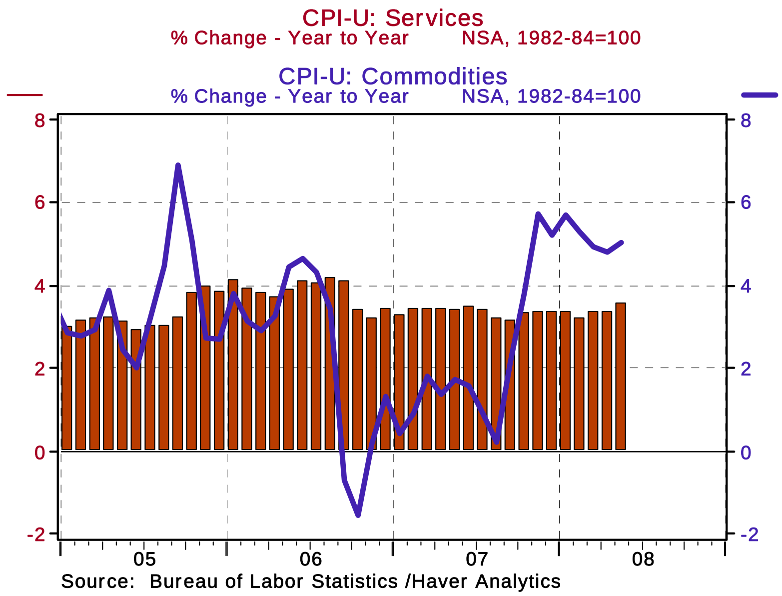
The core CPI, which excludes food and energy, increased 0.2% in May, putting the year-to-year gain at 2.31%, down from the recent high of a 2.47% jump in January. Among the core items, shelter costs (major components are rent of primary residence and owners' equivalent rent) were up only 0.2% in May. On a year-to-year basis, shelter costs show a significant deceleration (see chart 5), which reflects a drop in rental costs (due to the upward trend of vacant homes). The disparity in the pace of decline between rent of primary residence and owners' equivalent rent reflects the subtraction in utility costs from owners' equivalent rent in the calculation of this CPI component.

Chart 5



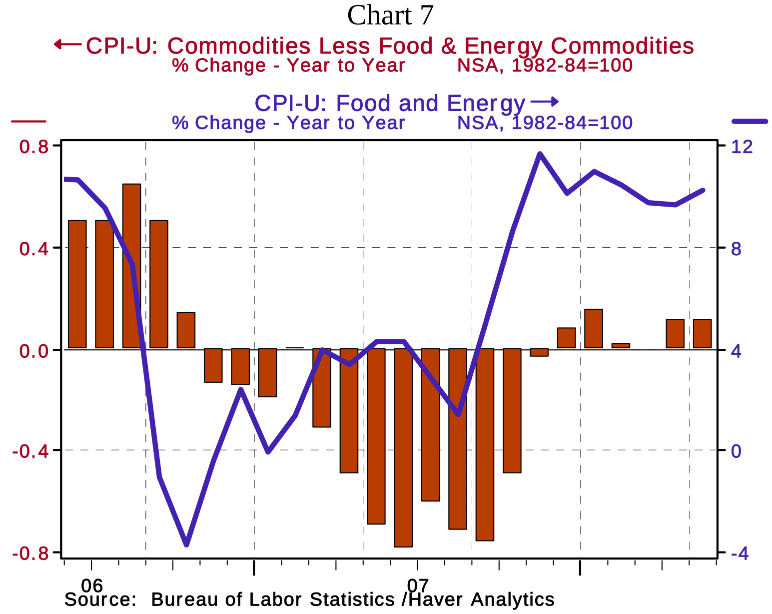
The commodities component of rose 0.9% in May, putting the year-to-year (seasonally unadjusted) gain at 5.1% compared with the steady behavior of the cost of overall services (see chart 6).

Chart 6



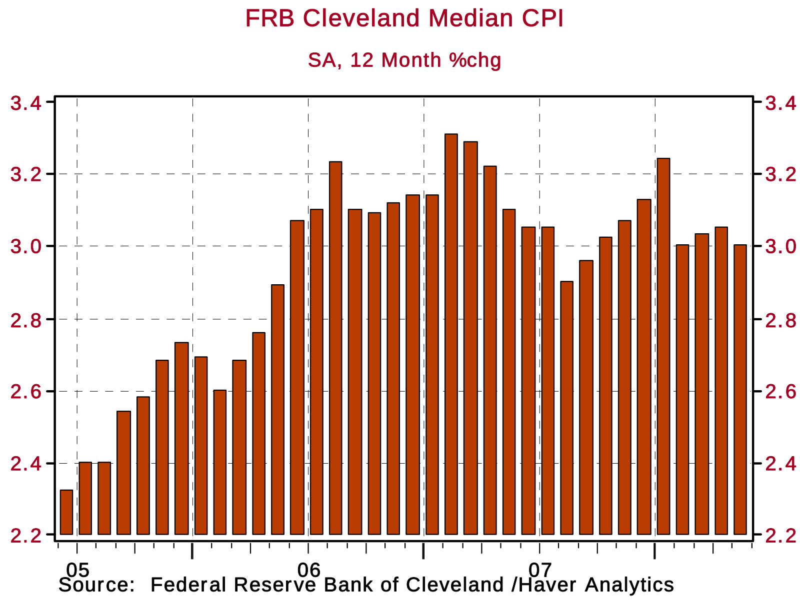
Within commodities, prices of food and energy are the two widely known items contributing to the advancing trend of commodity prices, with energy prices playing a larger role. Prices of commodities excluding food and energy have moved up slightly from an extended period of declining prices to show small gains (see chart 7). Commodities make up 41.3% of CPI, with food and energy accounting for nearly 24%, while services are 58.7% of CPI.

Chart 7



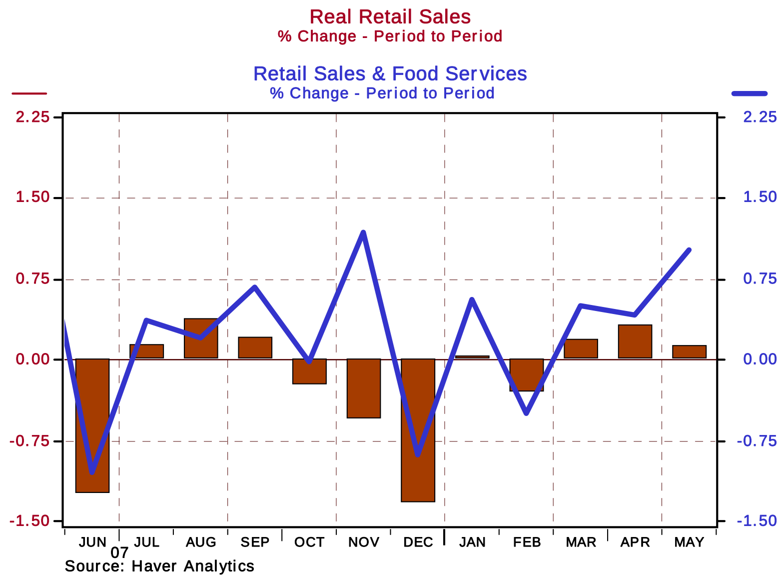
Energy prices are expected to stabilize in the months ahead, which should result in a less threatening inflationary situation. Also, the median CPI of the Federal Reserve Bank of Cleveland, which strips out outliers or high-noise components of the index, showed a 0.2% increase in May, putting the year-to-year gain at 3.0%, less inflationary than the 4.2% year-to-year gain of the CPI.

Chart 8



On June 12 there was a great deal of exuberance about the 1.0% jump in retail sales during May. This optimism needs a revision because inflation adjusted retail sales (using the commodities price index from the CPI report) shows that retail sales rose a meager **0.1%** (see chart 9) in May**.**

Chart 9



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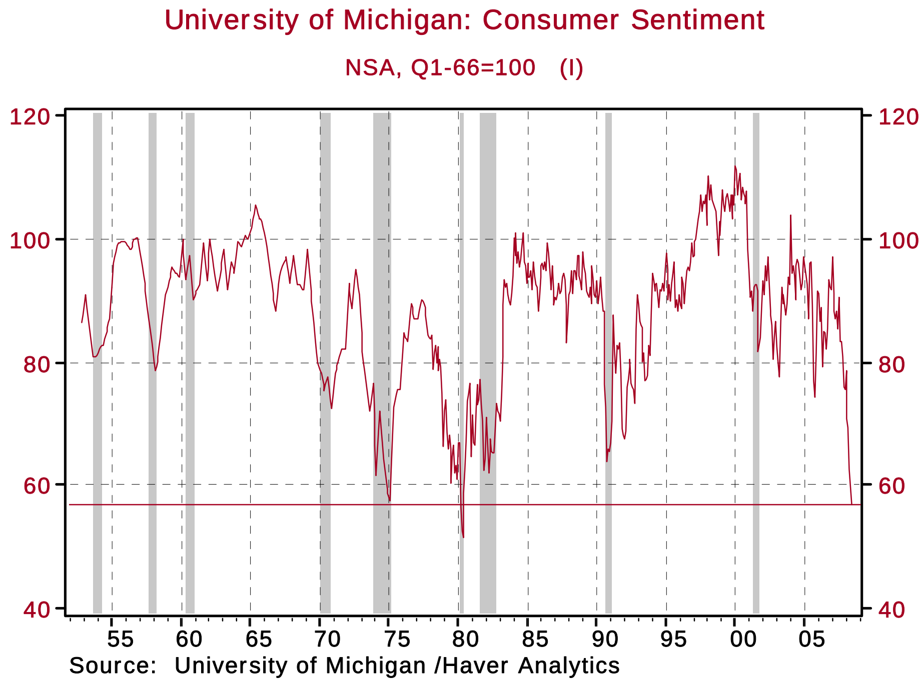
Also, consumers are downright blue inasmuch as the University of Michigan Consumer Sentiment Index fell to 56.7 in June from 59.8 in June, a new cycle low and the lowest since May 1980 (see chart 10).

Chart 10



Conclusion – Fed rhetoric will continue to lean on the hawkish side until the June 24-25 FOMC meeting. A 2.00% federal funds rate is the most likely case for the outcome of this meeting. The appreciation of the dollar since Bernanke's comments on June 9 suggests that open mouth policy is working. However, action might be necessary because talk tends to lose power if it is not backed by action eventually. Will the Fed tighten monetary policy in the absence of improving economic conditions to contain inflation and support the dollar? It is conceivable the Fed could engage in a one-off 25 basis point hike in the funds rate, which could not make a material difference on business activity because the Fed has taken radical preemptive action as an insurance against the possibility of a severe economic downturn and/or continued financial market disruptions. Given that the Fed has addressed the liquidity demands of strained financial conditions through the array of innovative programs and the exigencies of economic issues are less severe now, there is room for a solitary token action to reinforce credibility of the Fed as an inflation fighter. But, there is a distinctly stronger probability attached to the likelihood of an unchanged federal funds rate well into 2009 than the case of a slightly higher federal funds rate because the details of the CPI report suggest that inflation most likely will show a moderating trend soon and the weakness of the economy outweighs the threat of entrenched inflation. In other words, in our estimation, the Fed may *not* need to translate rhetoric into action given the fragile economic environment and the likelihood that inflation will be moderating in the second half of the year.

Consumer Price Index – May 2008

	% change	annualized % change			% change		
	prior month	year-to-date	3 mo. ago	6 mo. ago	May-08 yoy	May-07 yoy	Dec-07 yoy
CPI - ALL ITEMS	0.6	4.0	4.9	4.0	4.2	2.7	4.1
CORE - ALL ITEMS LESS FOOD & ENERGY (76.47)*	0.2	2.0	1.8	2.1	2.3	2.2	2.4
CPI ALL ITEMS LESS ENERGY (91.3)	0.2	2.6	2.5	2.6	2.7	2.5	2.8
FOOD (13.83)	0.3	6.3	6.2	5.4	5.1	3.9	4.9
ENERGY (9.69)	4.4	16.5	28.2	17.5	17.4	4.7	17.4
SHELTER (32.6)	0.2	1.8	1.6	2.1	2.6	3.8	3.1
COMMODITIES (41.27)	0.9	4.0	5.3	4.2	5.1	1.7	5.2
COMMODITIES LESS FOOD & ENERGY (21.6)	-0.1	-0.3	-0.9	-0.2	0.1	-0.7	0.1
SERVICES (58.7)	0.5	4.0	4.6	3.9	3.5	3.4	3.3
SERVICES LESS ENERGY SERVICES (54.87)	0.3	2.9	2.9	3.0	3.2	3.4	3.3
FRB CLEVELAND MEDIAN CPI	0.2	2.8	2.7	2.9	3.0	3.1	3.1

* - Figures in parentheses denote the relative importance of each category in the CPI.

Irish “No” Gives European Union a Nasty Headache

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The euro dipped this morning as news broke that Ireland’s voters rejected the EU Lisbon Treaty in yesterday’s national referendum. Although the Treaty’s fate has no direct economic impact on the EU, the resulting uncertainty will add to market anxiety over more pressing issues like rising inflation, oil price protests, and looming recessions in Spain and even Ireland. The “no” will certainly embolden euro-skeptics in other countries, and does present the EU with a significant political headache. The Lisbon Treaty – which replaces the EU constitution that was rejected by voters in France and Netherlands back in 2005 – is supposed to make the 27-member EU more effective and streamlined. It has to be ratified by all members, but Ireland is the only one to hold a national referendum. So far, 14 countries have approved the Treaty in parliamentary votes. A rejection from the generally pro-Europe Irish is also a political headache for the UK’s PM Brown. Already weakened politically, facing down calls for a similar popular referendum in the UK will further undermine the PM. The biggest headache of all is for Irish PM Cowen, who will be called to account by fellow EU leaders at next week’s summit. Re-negotiating the whole Treaty is off the table, and a re-run of 2001 – when Ireland rejected the Nice Treaty on EU expansion, then staged a second and successful referendum some months later – is unlikely this time around. For now, collective wisdom suggests the remaining 12 EU members will proceed with ratifying the Treaty, while the mandarins come up with a special solution for Ireland, perhaps a series of opt outs or assurances that can be put to the voters. The whole process will be a major distraction at a time of real economic and political challenges. And, whatever the solution, it will only add to the popular perception that EU leaders are oblivious to the concerns of ordinary voters.

Note: Daily Global Commentary will not be published June 16-18. Publication will resume on June 20, 2008.