Northern Trust

U.S. ECONOMIC & INTEREST RATE OUTLOOK

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Base Case vs. Checkmate

July 14, 2008

Our base case economic scenario is that the U.S. economy entered a recession in early 2008, will remain in a mild recession throughout 2008 and will begin to experience an anemic recovery in the first half of 2009. The base case includes a sharp deceleration in inflation in the not-too-distant future as energy prices stabilize and then retreat due to a slowdown in the growth of global demand for energy. The Federal Reserve will maintain the federal funds rate at 2% through the first half of 2009. In the second half of 2009, when economic growth picks up enough to stop the upward trend in the unemployment rate, the Fed will start raising the funds rate.

Our risk case scenario is that the U.S. dollar begins to fall precipitously coinciding with a rise in Treasury bond yields. U.S. inflation does *not* moderate because of the depreciation in the dollar. As a result, the Federal Reserve is forced to raise the funds rate even in the face of a rising U.S. unemployment rate. This would be "checkmate" for the U.S. economy, turning a relatively mild recession into a severe one. Why might the dollar dive? Because the U.S. Treasury is forced to issue more debt in order to recapitalize either Fannie/Freddie/ the Federal Home Loan Bank System/FDIC, and the rest of the world balks at being the buyer of last resort for U.S. government debt. As this is being written on Friday, July 11, a hint of this is happening. Rumors are swirling that the U.S. Treasury will have to recapitalize Fannie Mae and Freddie Mac. Rather than resulting in the usual flight-to-quality bid for U.S. Treasury securities, yields on Treasury coupon securities are rising and the dollar is falling. Another factor that could precipitate a further sharp decline in the dollar might be the severing of the pegs that foreign monetary authorities have maintained between their currencies and the U.S. dollar. The byproduct of these pegs has been upward pressure on the inflation rates in these foreign economies. If these monetary authorities can no longer tolerate this imported inflation and sever their currency pegs to the dollar, the dollar would likely go into a tailspin.

But let's stick with the less-severe base case. Before we get into this, allow us to get one thing off our chests – the issue of whether the economy has entered a recession. As we have said until we are blue in the face, the National Bureau of Economic Research (NBER), the nonprofit organization that makes business cycle peak and trough calls, has no strict definition of what constitutes the onset of a recession. Although most recessions do include two consecutive quarters of contracting real Gross Domestic Product (GDP), not all do. The NBER concentrates on the behavior of the four components of the Conference Board's coincident indicators – nonfarm payrolls, real personal income less government transfer payments, industrial production and real manufacturing and trade sales. The NBER is looking for definitive peaks in these variables, not necessarily all of them. Because these data are subject to revisions and because with only the passage of time can one determine whether a definitive peak has been established, the NBER does not make a recession call until months after the business cycle has peaked. For example, the March 2001 peak was not announced to be the peak until November 26, 2001; the July 1990 peak was not declared one until April 21, 1991. What we do know now is that all of the four coincident indicators are off their hitherto cycle highs, pending revisions to the data (see Charts 1 – 4). In addition, monthly estimates of real

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GDP made by a private economic forecasting firm, Macroeconomic Advisers, suggest that real GDP peaked in January this year (see Chart 5). Now, there could be a miraculous strong recovery in general economic activity that would render these apparent peaks as "false" peaks, but as we will argue below, this is unlikely.

Chart 1

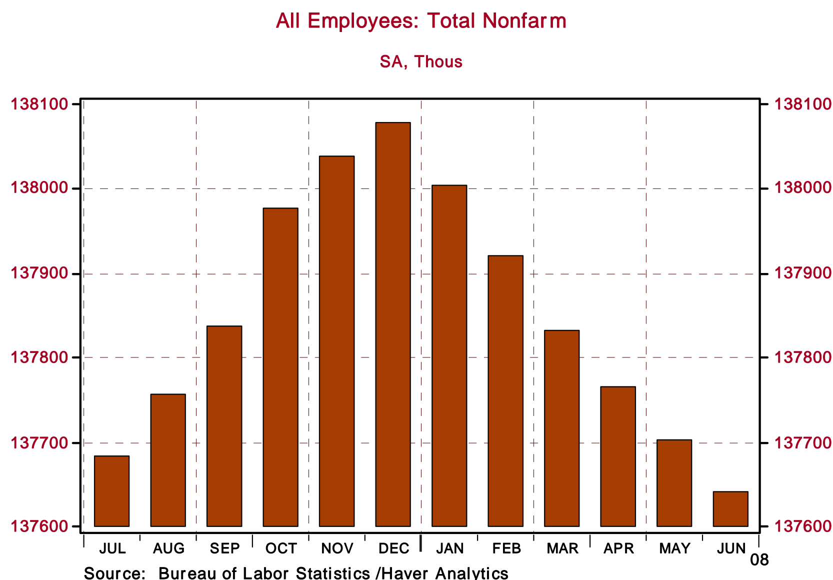

Chart 2

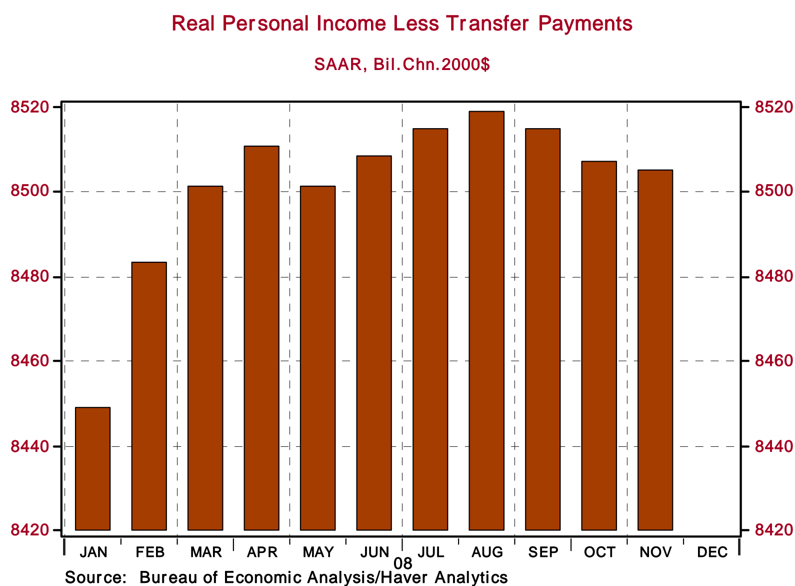

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Chart 3

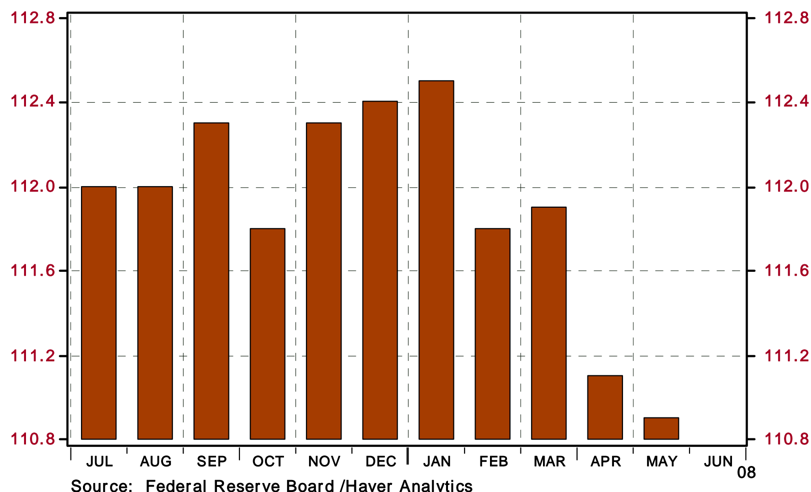

Chart 4

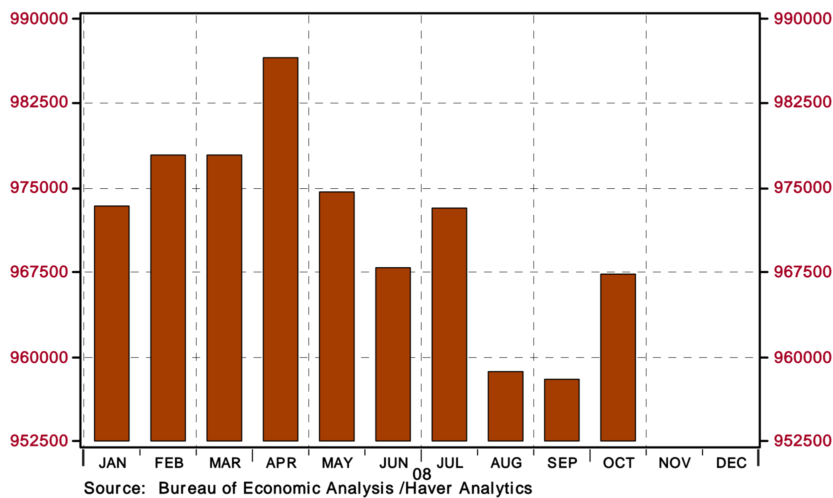

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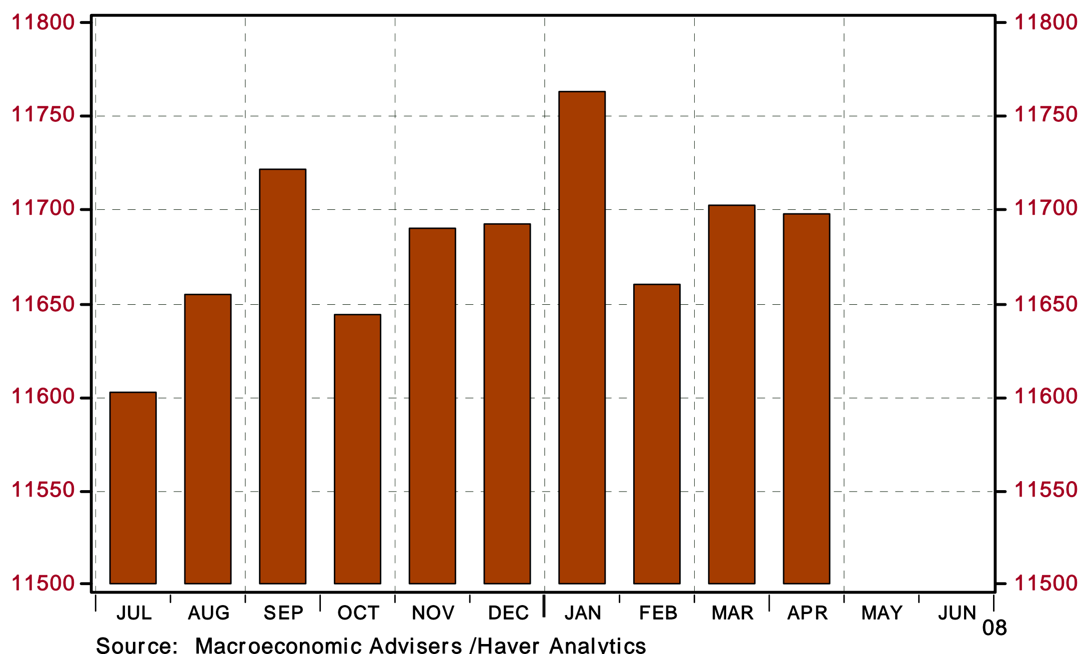
Chart 5



We want to make one more point about the recession debate that seems to be occurring. Some of the recession deniers are the very analysts who at midyear 2007 were forecasting that the Fed's next policy move would be to raise the federal funds rate from its then level of 5.25%. Some of these forecasters were predicting a 6.00% federal funds rate by the end of 2007. Some thought that Treasury bond yields were headed higher. And some were bullish on the U.S. stock market. Whether or not the NBER ultimately determines that the U.S. economy entered a recession in early 2008, these recession deniers were dead wrong about what really counts for investors – the direction of interest rates and the stock market.

Now, back to the base case. The housing market remains in a recession (see Chart 6). This recession is taking its toll on employment (see Chart 7). The housing recession is taking its toll on house prices and homeowners' equity in their houses (see Charts 8 and 9). Lastly, the decline in homeowners' equity in conjunction with tightening mortgage lending terms has significantly slowed mortgage equity withdrawal to 1.1% of disposable personal income, the lowest ratio since the first quarter 1996 (see Chart 10).

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Chart 6

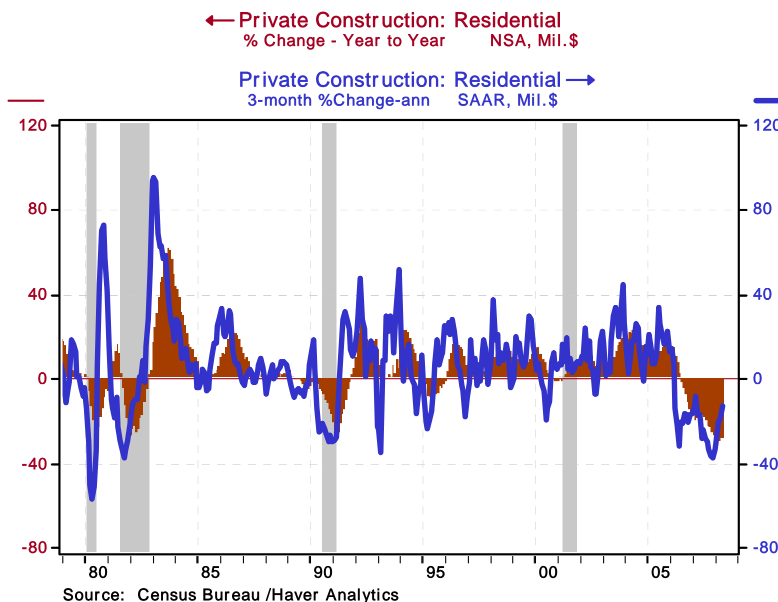

Chart 7

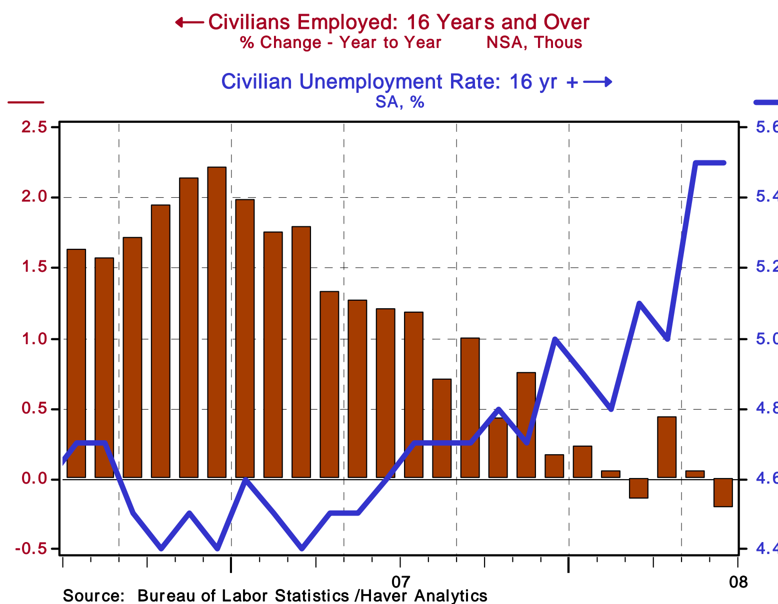

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Chart 8

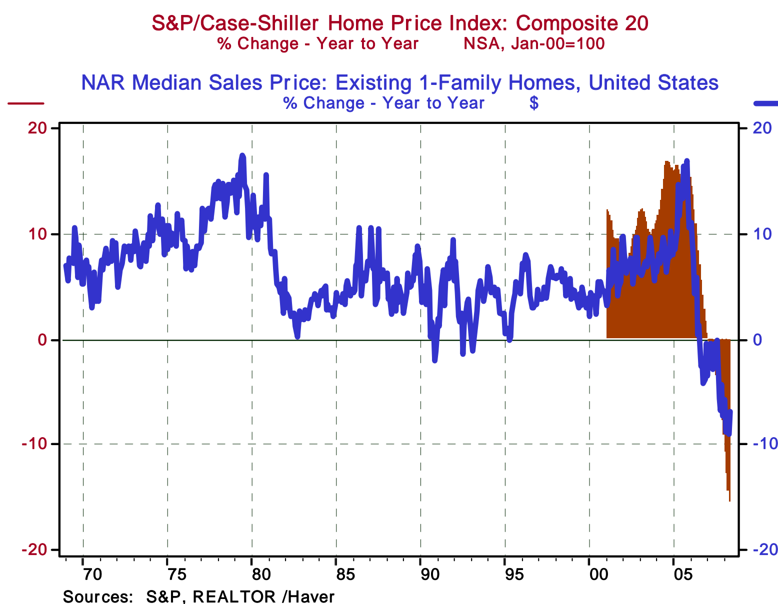

Chart 9

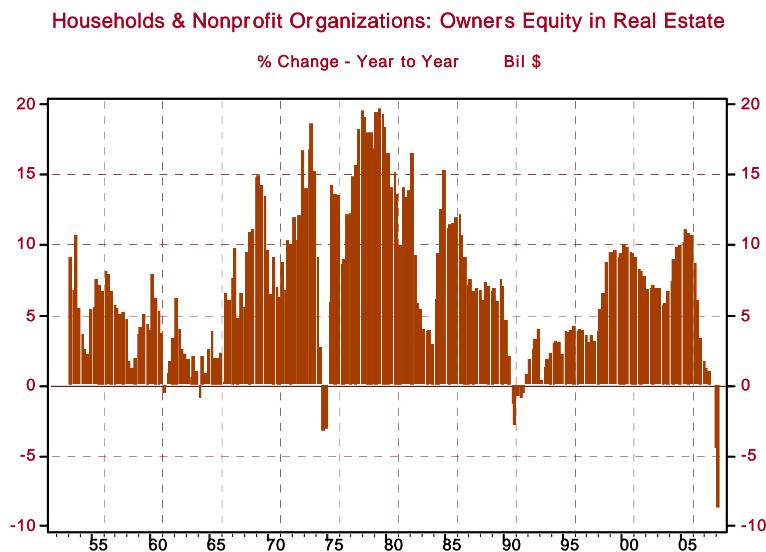

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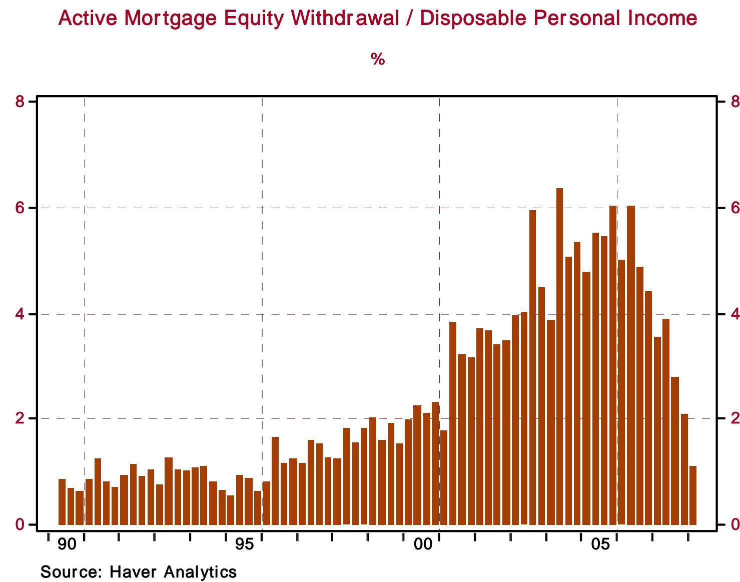
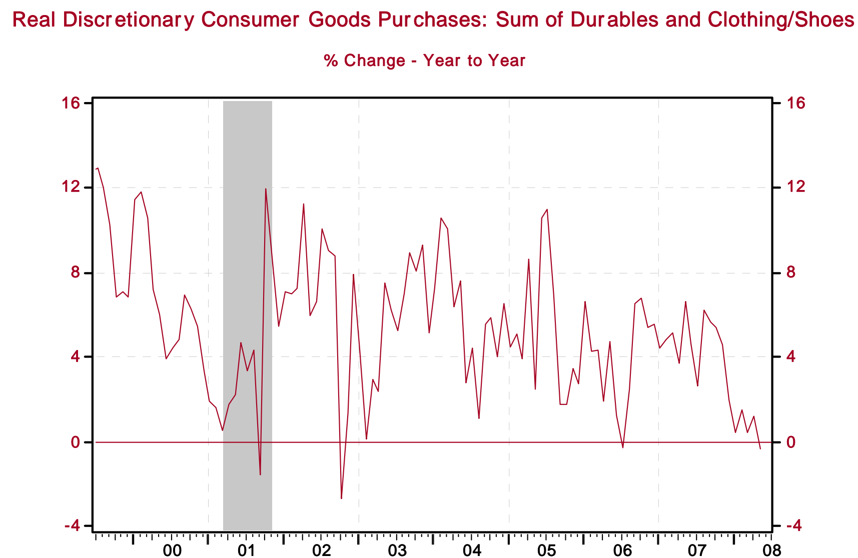
Chart 10



The deterioration in the labor market and the dramatic slowing in mortgage equity withdrawal has put a crimp in real spending on discretionary consumer goods – durable goods plus apparel/shoes. On a year-over-year basis, this aggregate of real discretionary consumer goods purchases *contracted* by 0.37% in May – its weakest performance since October 2002 (see Chart 11).

Chart 11



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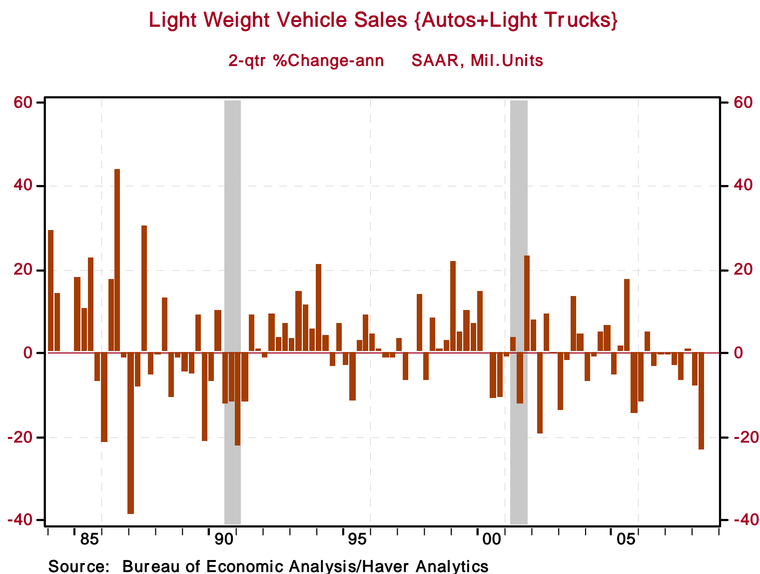
One sector of consumer discretionary spending that has been especially hard hit, for the reasons given above and because of the recent spike in gasoline prices, is motor vehicles. In the past two quarters, the annualized sales of light motor vehicles *contracted* by 23.6% -- the largest two-quarter contraction since the first quarter of 1987 (see Chart 12).

Chart 12



To the degree that the behavior of stock prices is an accurate forecaster of the future, then the future still looks pretty grim for retailers. Chart 13 shows that an index of retail stocks hit a new cycle low on July 11 (see Chart 13).

Chart 13

With the unemployment rate rising, retail activity slowing and manufacturing activity moderating, vacancy rates in the commercial real estate markets are moving up. And with

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higher vacancy rates come lower prices. Chart 14 shows that same-property sales of commercial real estate transactions are now occurring at falling prices. Not surprisingly, nonresidential building activity is slowing. Chart 15 shows that the year-over-year growth in nominal nonresidential construction expenditures has slowed from 22.8% in October 2007 to 12.5% in May 2008. Another measure of the developing weakness in nonresidential construction is the sharp drop-off in billings by architectural firms for commercial and industrial projects (see Chart 16).

Chart 14

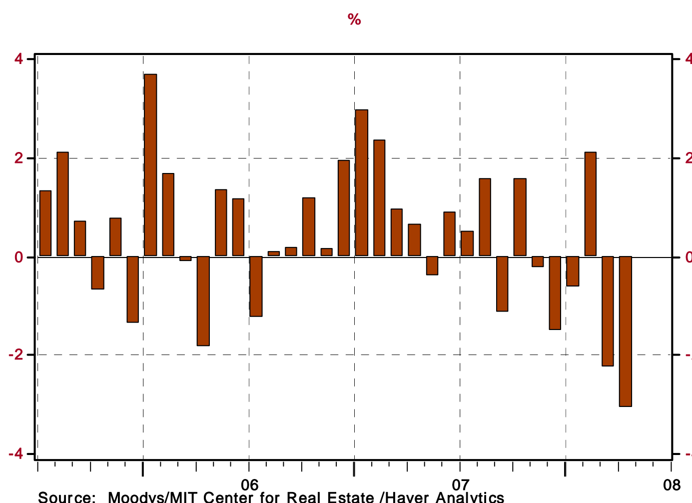

Chart 15

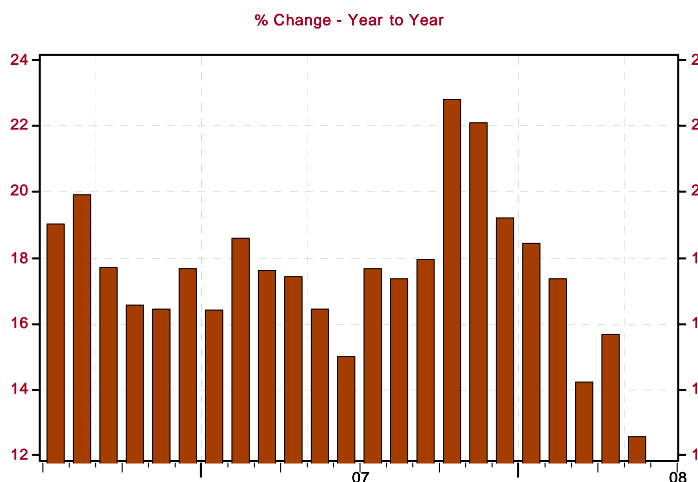

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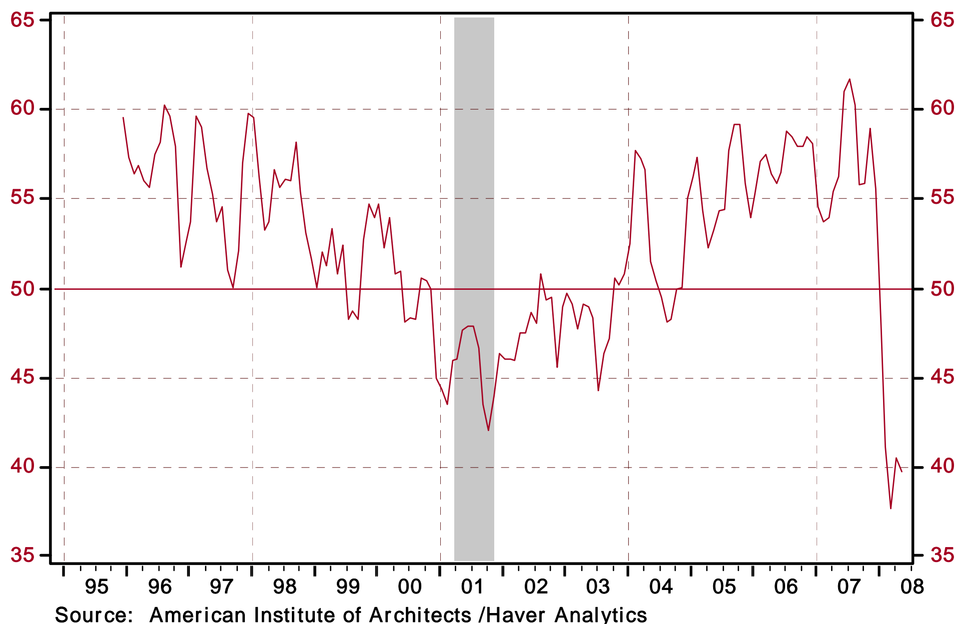
Chart 16



The next likely domino to fall is state and local government spending. State and local government tax revenues are now coming in below plan. Real state and local government spending represents approximately 11% of real GDP – only one percentage point less than exports – and is about 1.7 times as large as federal government spending in the GDP accounts. So, a slowdown in the growth of state and local government expenditures is of significance.

Speaking of exports, they are one bright spot in the U.S. economy. On a year-over-year basis, growth in real exports of goods was 10.3% in May. But, as Chart 17 shows, year-over-year growth in real exports of goods appears to be capped at about 11% in this cycle. With growth in the rest of the developed world slowing, is it reasonable to expect still stronger growth in exports? Probably not. However, with the high cost of energy increasing transoceanic shipping costs, we might expect some shift back "home" in manufacturing activity from abroad to satisfy whatever domestic demand for goods there is.

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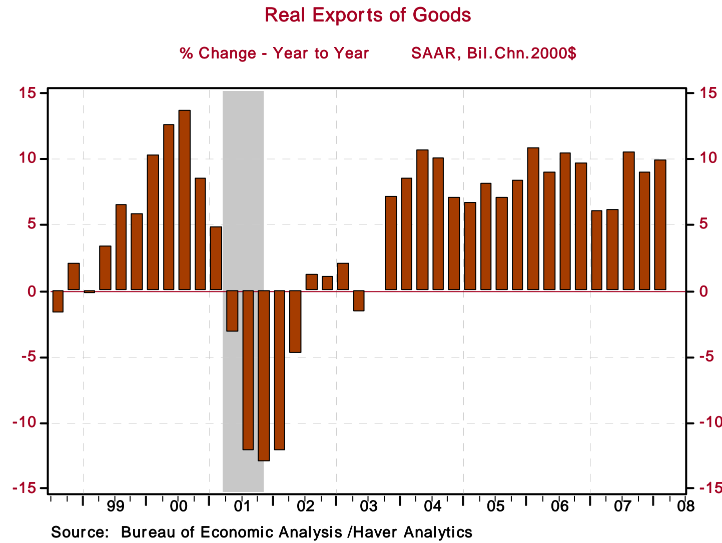
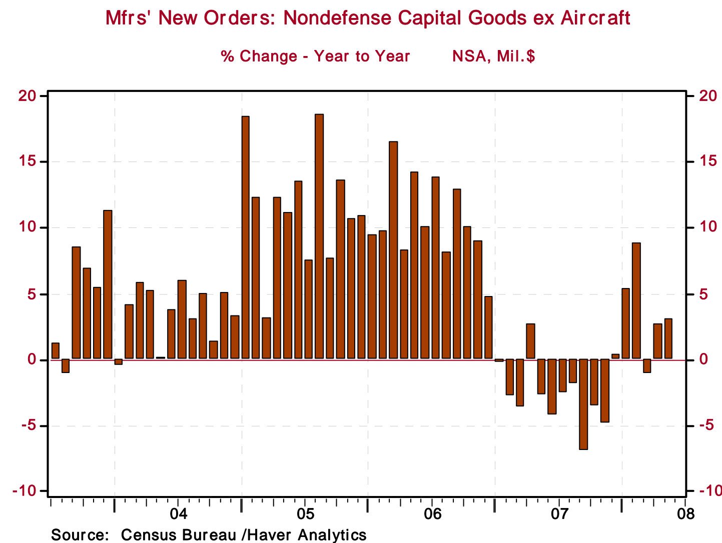
Chart 17



Another bright spot in the economy appears to be business capital spending. Although not exactly soaring, the year-over-year change in nondefense capital goods excluding aircraft has returned to positive territory after contracting for a number of months in 2007 (see Chart 18). Not surprisingly, new orders for oil/gas drilling and power transmission equipment are strong. More surprisingly, however, is the strength in new orders for construction equipment – perhaps export related. We believe that nondefense capital spending will weaken again as consumer spending fades after all of the tax rebate checks have been spent later this month.

Chart 18



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On a year-over-year basis, U.S. nonfinancial corporation profits generated from domestic operations have been contracting since the fourth quarter of 2006 (see Chart 19). With our forecast of contracting real GDP growth in the second half of this year followed by a muted recovery in 2009, unit sales growth for nonfinancial corporations is likely to be weak. Because of soft final demand, we believe that profit margins also will be squeezed as businesses find it difficult to pass on their higher commodity prices to consumers. This has been the case so far as the ratio of the Consumer Price Index (CPI) for goods to the Producer Price Index (PPI) for finished consumer goods has been falling (see Chart 20).

Chart 19

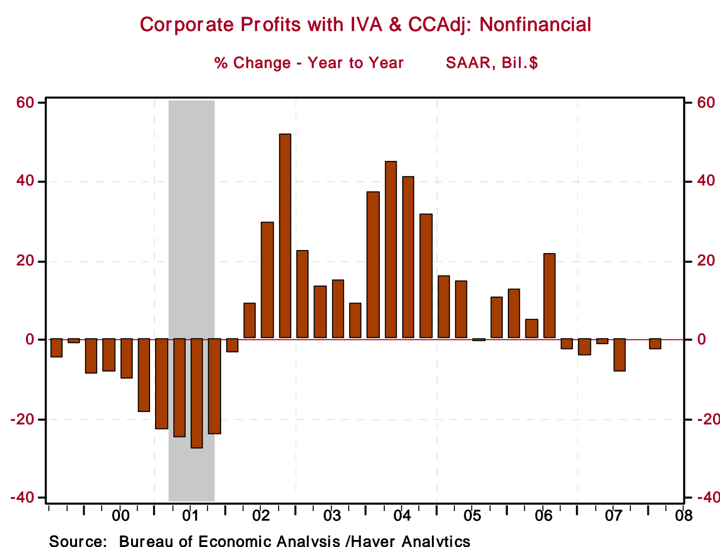
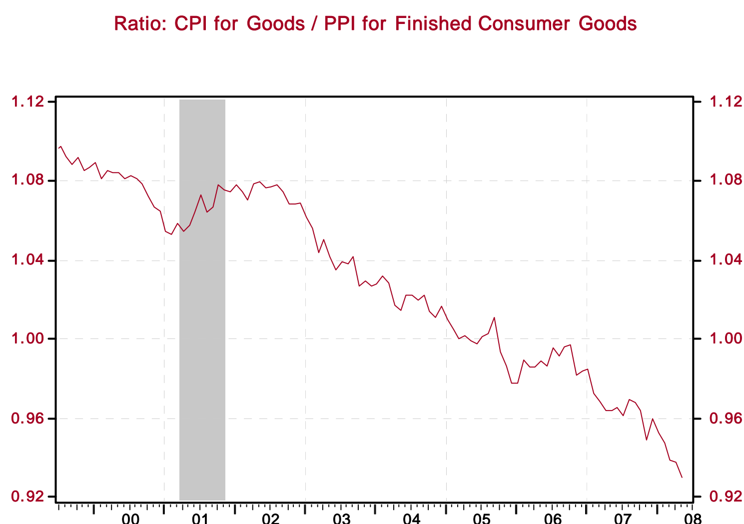


Chart 20



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Year-over-year U.S. financial corporation profits from domestic operations also are now contracting (see Chart 21). With house prices continuing to fall, losses on residential mortgage securities will continue. In addition, losses will start to mount on credit card debt, auto loan debt, commercial real estate debt and high-yield corporate debt. This will erode the capital of financial institutions at a time when the regulators are likely to require higher capital ratios. Thus, inadequate capital at financial institutions will retard their ability to extend new credit to the private sector. Concrete manifestation of this "credit crunch" can be seen in the recent behavior of commercial bank credit. On a three-month annualized basis, growth in U.S. commercial bank loans and securities soared to 17% last summer as banks were forced to take onto their balance sheets assets that had formally been financed with commercial paper in off-balance sheet entities. However, bank credit growth in recent months has collapsed. In the three months ended June, bank credit has *contracted* at an annualized rate of 5.8% -- the second largest contraction in bank credit in the history of the series, which began in January 1947 (see Chart 22). Given that assets equal liabilities plus net worth and given that the asset side of the banking system's balance sheet is contracting, we would expect that bank deposit growth – a component of the liability side – would be weakening. And, as shown in Chart 23, in the three months ended June, annualized growth in bank deposits has sharply decelerated to 1.5% after having skyrocketed to 15.1% in the three months ended October 2007.

Chart 21

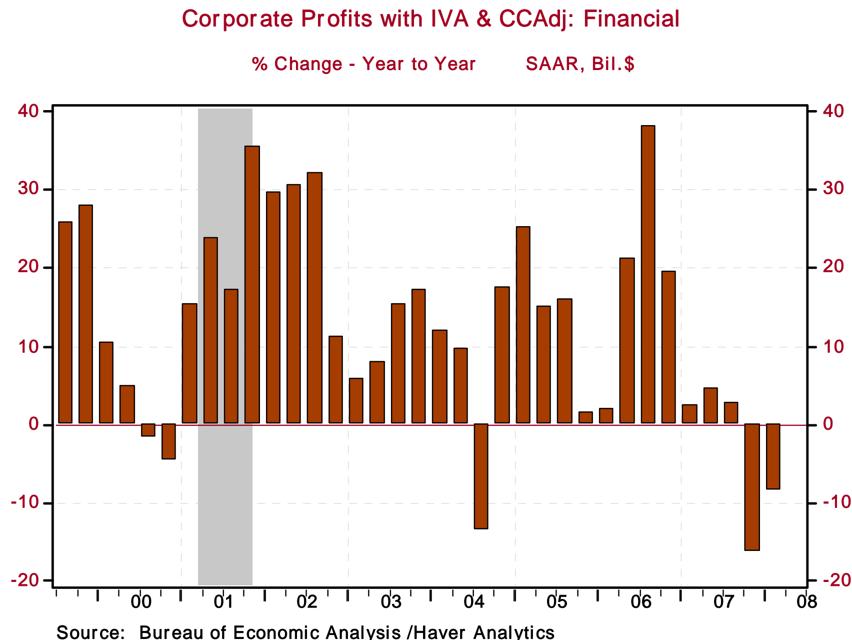

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Chart 22

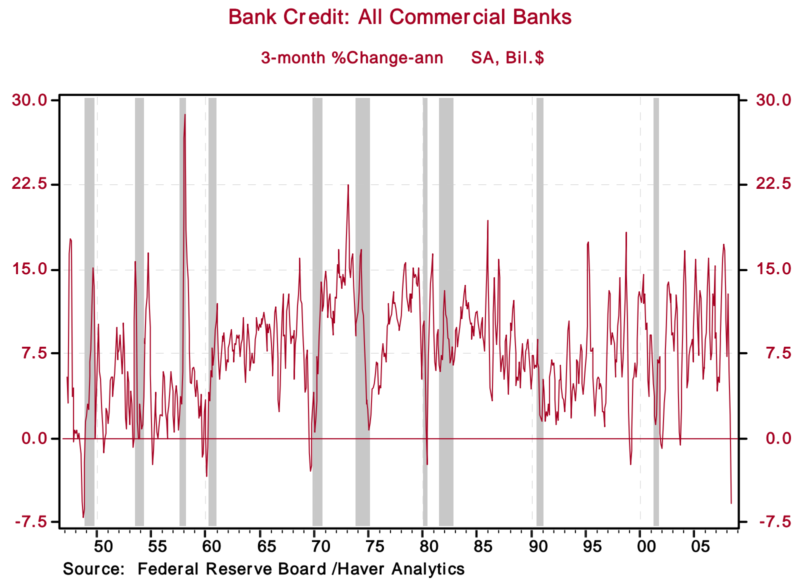
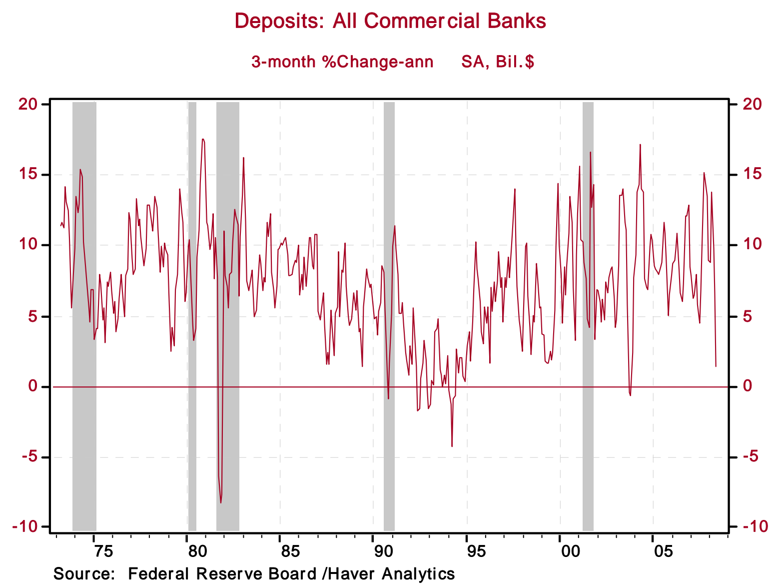


Chart 23



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In the early 1990s, U.S. commercial banks suffered from capital inadequacy and the U.S. economy suffered from bank credit inadequacy. Throughout the decade of the 1990s, Japanese banks suffered from capital inadequacy and the Japanese economy suffered from bank credit inadequacy. History is rhyming again.

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
July 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	4.9	0.6	1.0	1.5	-0.2	-0.7	0.1	0.8	2.0	2.5	2.5	0.4	1.4	2.2	1.4	0.5
(% change from prior quarter)																
CONSUMPTION EXPENDITURES	2.8	2.3	1.1	2.3	-0.5	-1.0	0.3	0.7	1.5	2.0	2.6	0.5	1.1	2.9	1.5	0.4
BUSINESS INVESTMENT	9.3	6.0	0.6	2.0	-3.4	-3.7	-1.8	-0.6	2.3	3.7	7.1	-1.2	0.9	4.7	2.7	-1.1
RESIDENTIAL INVESTMENT	-20.5	-25.2	-24.6	-17.0	-8.0	-4.0	0.0	2.0	3.0	5.0	-18.6	-13.8	2.5	-17.0	-19.0	-1.9
CHANGE IN INVENTORIES ('00 dlrs, bill)	30.6	-18.3	-19.6	-30.1	-21.1	-16.1	-12.7	-7.7	2.3	12.3				4.5*	-21.7*	-1.5*
GOVERNMENT	3.8	2.0	2.1	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 dlrs, bill.)	-533.1	-503.2	-480.2	-452.1	-429.9	-411.3	-408.6	-406.8	-406.9	-409.4				-555.6*	-443.4*	-407.9*
FINAL SALES	4.0	2.4	0.9	1.9	-0.5	-0.9	0.0	0.7	1.6	2.2	2.8	0.4	1.1	2.5	1.6	0.4
NOMINAL GROSS DOMESTIC PRODUCT	6.0	3.0	3.7	5.3	4.3	1.7	1.1	2.3	3.7	4.4	5.1	3.7	2.9	4.9	4.3	2.6
GDP DEFLATOR - IMPLICIT (% change)	1.0	2.4	2.7	3.7	4.5	2.4	1.0	1.4	1.7	1.9	2.6	3.3	1.5	2.7	2.8	2.1
CPI (% Change, 1982-84 = 100)	2.8	5.0	4.3	4.0	4.8	2.7	1.3	1.7	2.0	2.2	4.0	4.0	1.8	2.9	4.2	2.4
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.7	4.8	4.9	5.3	5.6	6.0	6.3	6.6	6.6	6.4				4.6*	5.5*	6.5*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	07:3a	07:4a	08:1a	08:2a	08:3f	08:4f	09:1f	09:2f	09:3f	09:4f	2007a	2008f	2009f
Federal Funds	5.07	4.50	3.18	2.09	2.00	2.00	2.00	2.00	2.15	2.70	5.02	2.32	2.21
3-mo.LIBOR	5.45	5.03	3.26	2.75	2.70	2.30	2.25	2.25	2.40	2.90	5.30	2.75	2.45
2-yr. Treasury Note	4.38	3.48	2.02	2.42	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	3.89	3.80	3.55	3.50	3.60	3.80	4.10	4.63	3.73	3.75

a = actual
f = forecast

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