Northern Trust

U.S. ECONOMIC &
INTEREST RATE OUTLOOK

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Patient But Vigilant Fed

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Chairman Bernanke failed to offer broad hints about an imminent round of financial accommodation or an extension of Operation Twist (Maturity Extension Program) in his testimony on June 7. There were three key takeaways pertaining to the near term economic outlook from Bernanke's testimony and response to questions:

1. Economic growth "appears poised to continue at a moderate pace over coming quarters." The Fed's economic forecast, published as of April 25, exemplifies this view.

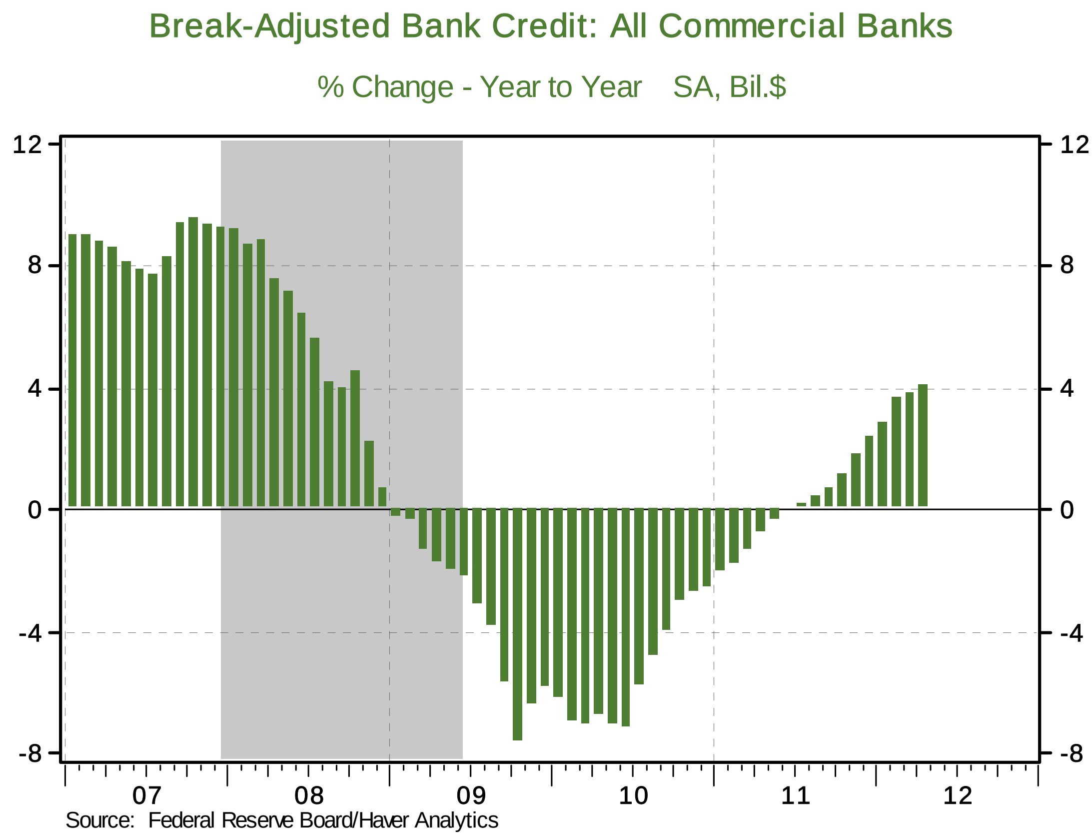
2. The main question is whether economic recovery will move forward sufficiently to register a meaningful decline in the unemployment rate.

3. The "Federal Reserve remains prepared to take action as needed to protect the U.S. economy in the event that financial stresses escalate."

Pulling these strands together, what we have is a patient but vigilant Fed. Also, Bernanke's remarks implied that pre-emptive action in response to the projected risk from the eurozone crisis is unlikely. The outcome of the June 17 elections in Greece will give the Fed only a partial sense of whether the situation in the eurozone will transmit a financial shock to the extent that new monetary policy easing will be necessary, as negotiations are likely to be underway at the time of the June 19-20 FOMC meeting.

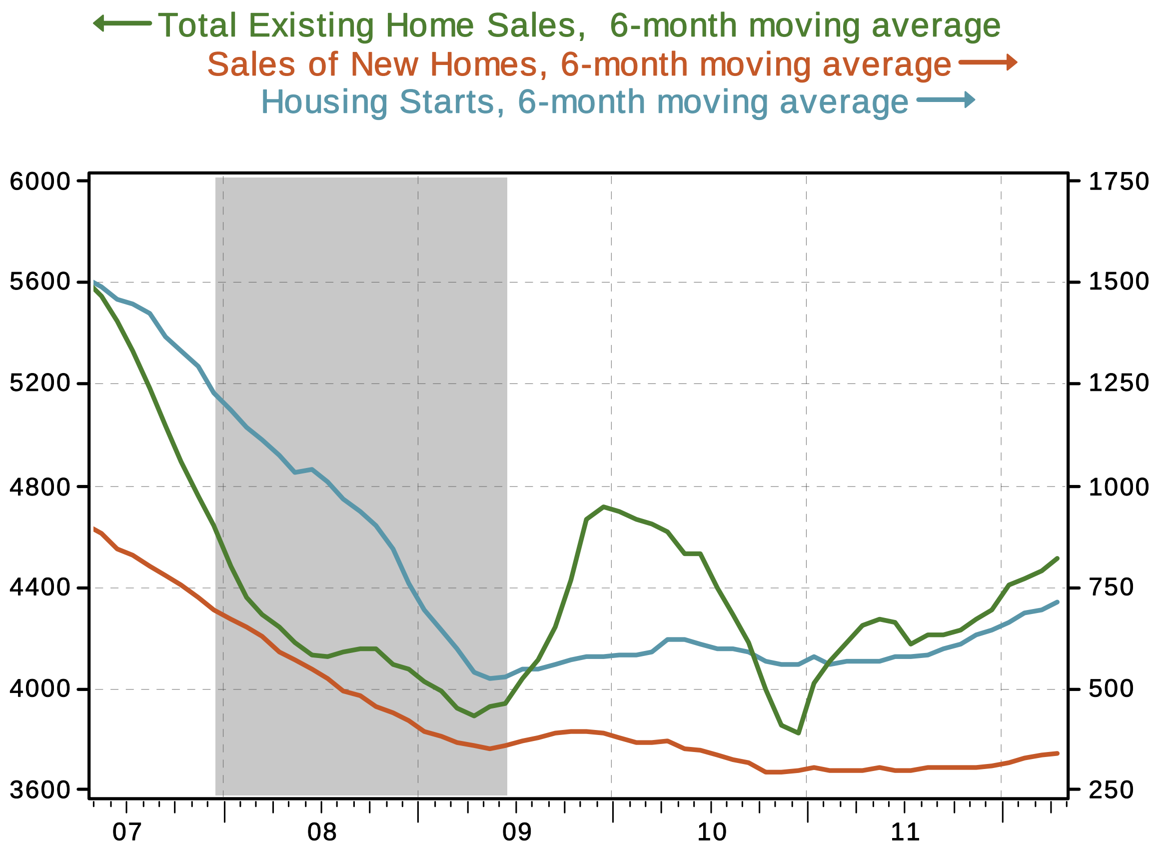
Narrowing focus on the future growth trajectory of the United States, there have been noteworthy positive developments that justify watching and waiting before the FOMC may need to take action. **First**, bank credit has continued to advance, with the year-to-year increase at 4.1% in April (see Chart 1). The raison d'etre for citing bank credit is its strong positive correlation with GDP as expounded in earlier commentaries. Unlike the eurozone, the revitalized banking sector in the United States will continue to function and support the performance of the economy in the quarters ahead.

Chart 1



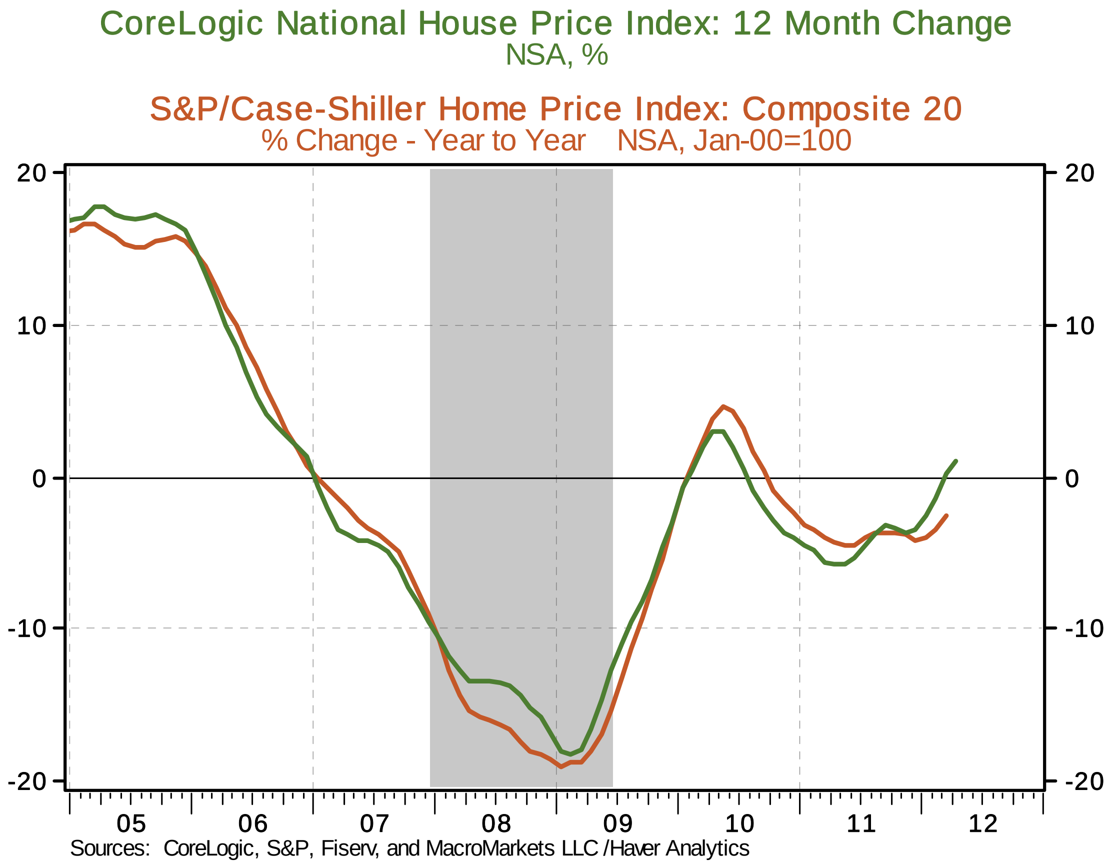
Second, the housing market shows more than noticeable signs of improvement. Sales of both existing and new homes have moved up, albeit at a gradual pace in recent months. Construction of new homes also shows a small upward trend in the past six months (see Chart 2). Price indexes of homes have also stabilized (see Chart 3). The CoreLogic Home Price Index rose 1.1% from a year ago in April, the second consecutive monthly increase since January 2007, excluding the brief gains posted when the first-time home buyer program was in place. The inventory-sales ratio of both existing and new homes are below the historical median and the percentage of distressed properties that make up existing home sales have dropped by a large measure (28% of existing homes sales were foreclosures and short sales in April versus 37% in April 2011). In sum, the overall picture of the housing market has undergone a significant positive transformation in recent months. That said, housing sector woes have not vanished, as yet.

Chart 2



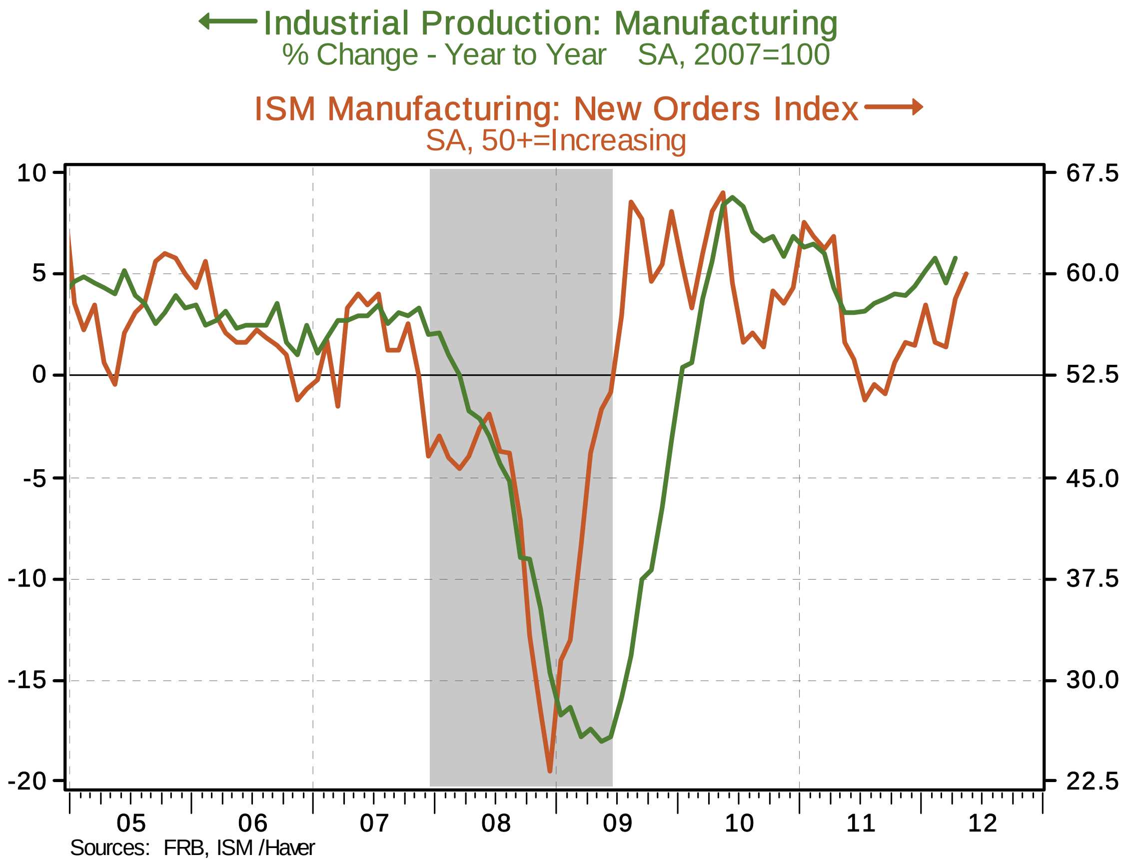
Sources: National Association of Realtors/Haver Analytics, Census Bureau

Chart 3



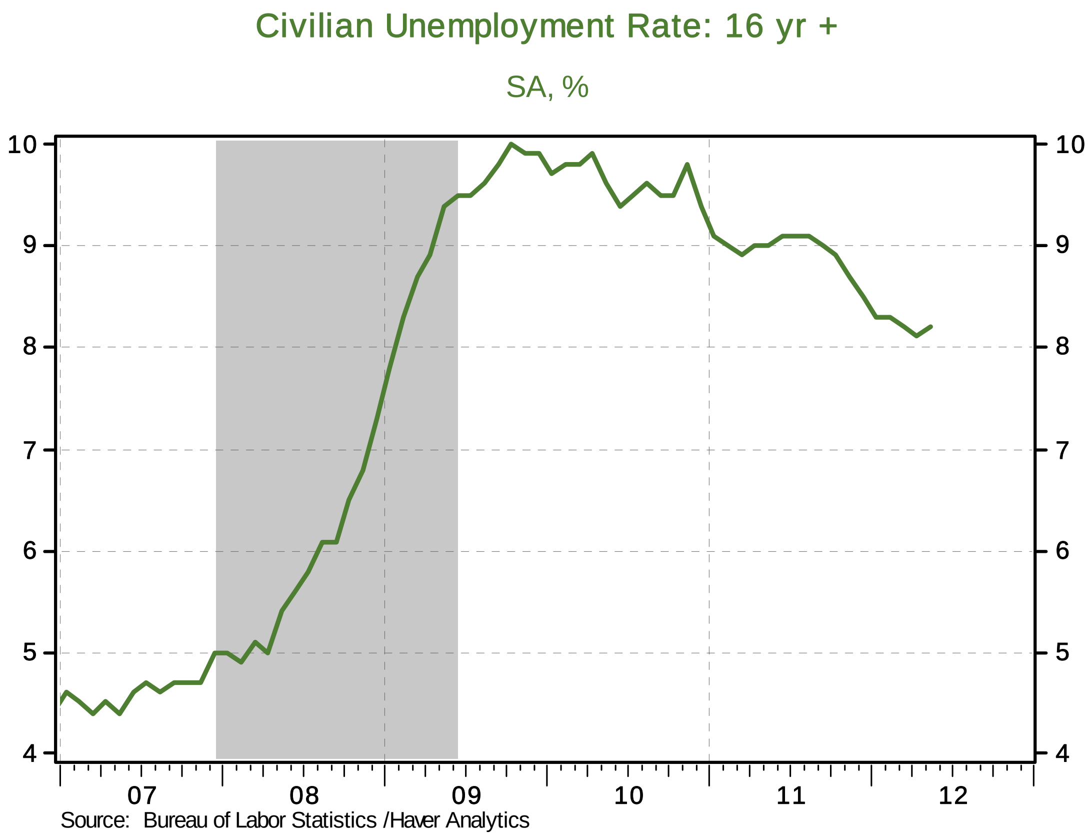
Third, the factory sector continues to show upward momentum. The ISM manufacturing survey results for May show a gain in the index measuring new orders (60.1), the highest since April 2011. Factory output moved up 5.7% from a year ago in April, matching the increase seen in February and the largest gain since March 2011.

Chart 4



Labor market reports of the last three months present a less bullish picture compared with improvements in the U.S. economy discussed above. The unemployment rate has held nearly steady between 8.1% and 8.2% in the March-May period, down slightly from 8.3% in the January-February months. Payrolls increased 226,000, on average in the first three months of the year, but slowed to an average gain of 73,000 in the April-May months. Initial jobless claims averaged 366,000 in the February-March period, rose to 384,000 in April and are tracking around 375,000 in May and early-June. Thus, the recent labor market data have been a source of serious concern. Nonetheless, firms are hiring, initial jobless claims have declined from the uptick in April, and seasonal adjustment issues could have distorted the latest hiring trend because of an unseasonably warm winter. Essentially, there is room to wait before Fed needs to provide support.

Chart 5


Civilian Unemployment Rate: 16 yr +
SA, %
10
9
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4
07
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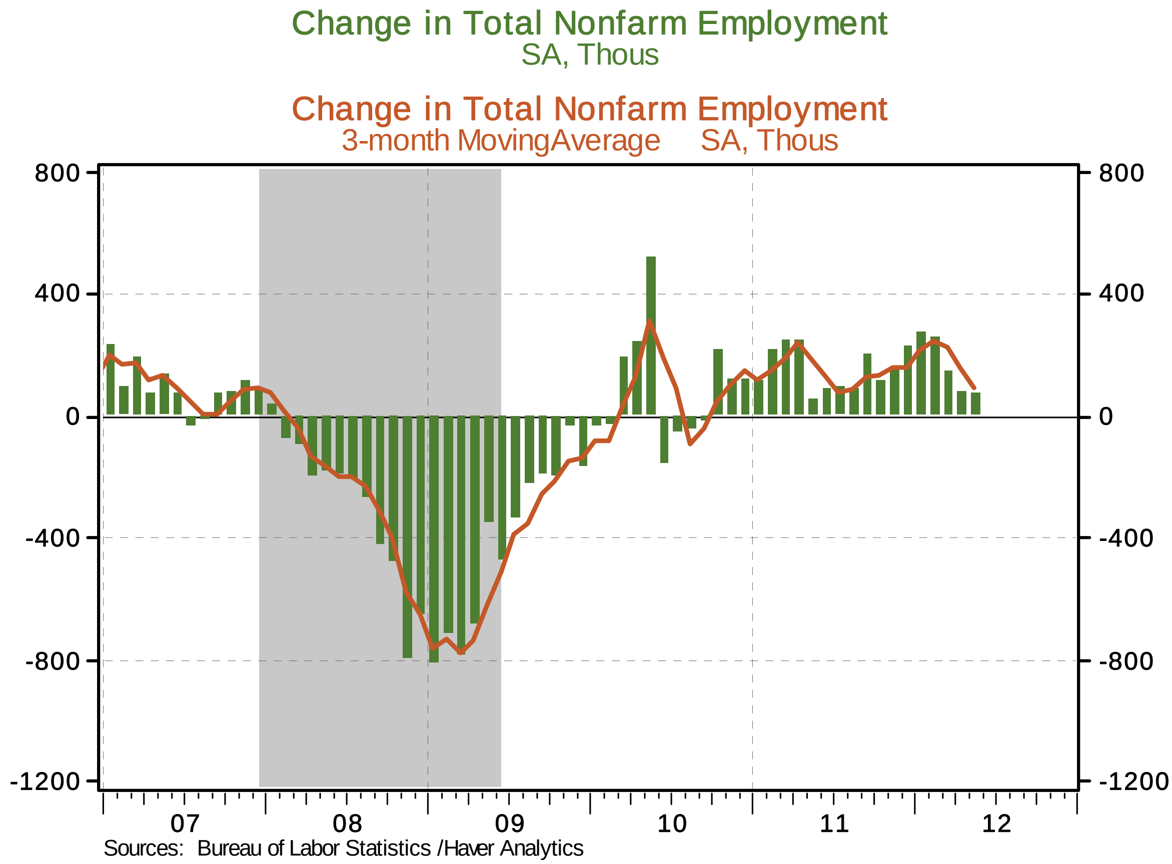
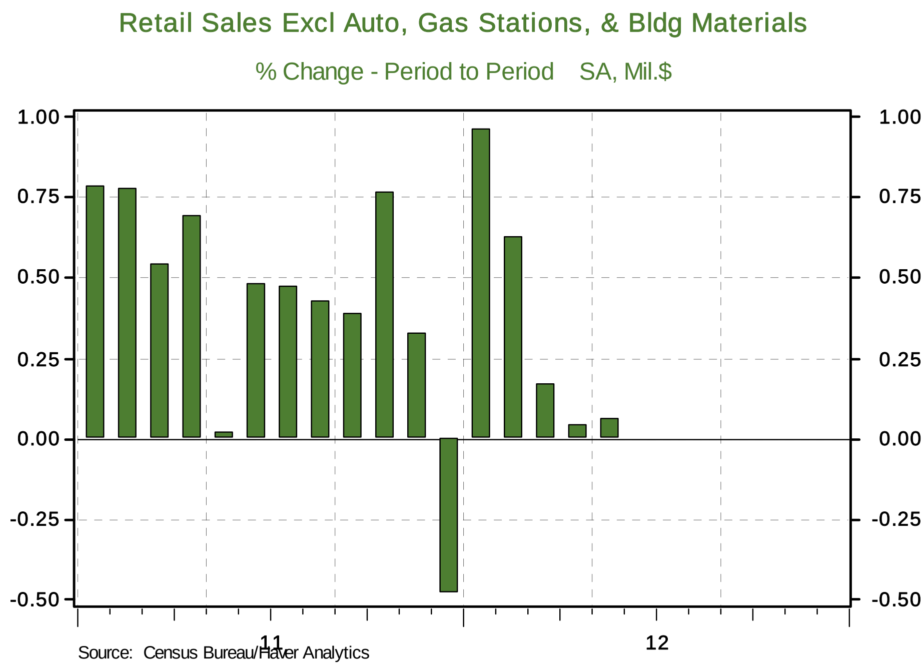
12
Source: Bureau of Labor Statistics /Haver Analytics

Chart 6



Consumer spending, another area of concern, grew at an annual rate of 2.7% in the first quarter, the strongest performance since the fourth quarter of 2010. Incoming data for the second quarter are less promising. Auto sales slipped in May to an annual rate of 13.8 million units from 14.4 million in April, putting the two-month average at 14.1 million versus 14.5 million in the first quarter. The April-May retail sales numbers excluding autos, gasoline, and building materials posted small gains (+0.1%). Based on retail sales numbers for the April-May period, consumer spending in the second quarter is likely to post a 1.9% annualized increase. Real GDP of the U.S economy is projected to grow 2.4% in 2012 on a Q4-to-Q4 basis, the unemployment rate is predicted to stand at 7.9% by year-end, and inflation is most likely to post a 2.0% gain. The current projections of the U.S. economy reflect small downward revisions from the May 2012 forecast. Growth at or above trend is necessary to bring about a significant reduction of the unemployment rate, which is likely to be visible in the final months of 2012 and carry on into 2013.

Chart 7



The main conclusion is that economic growth has not turned ***severely*** weak to beckon immediate assistance of the Fed. Headwinds from the eurozone are the biggest concern and the latest bailout of the Spanish banking system is an important step in the resolution of the eurozone crisis. The key assumption, for now, is that a financial tsunami from Europe is not likely and that a "muddle through scenario" will ***not*** knock the U.S from its expansion path.

THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
June 2012

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2011		2012				Q4 to Q4 change			Annual change		
	11:3a	11:4a	12:1a	12:2f	12:3f	12:4f	2010a	2011a	2012f	2010a	2011a	2012f
REAL GROSS DOMESTIC PRODUCT (% change, SAAR)												
Jun-2012	1.8	3.0	1.9	2.1	2.5	3.3	3.1	1.6	2.4	3.0	1.7	2.2
May-2012	1.8	3.0	2.2	2.5	2.7	3.5	3.1	1.6	2.7	3.0	1.7	2.4
CONSUMER PRICE INDEX (% change, ann. rate)												
Jun-2012	3.1	1.3	2.5	1.9	1.7	1.9	1.2	3.3	2.0	1.6	3.1	2.2
May-2012	3.1	1.3	2.5	2.5	1.7	1.9	1.2	3.3	2.2	1.6	3.1	2.3
CIVILIAN UNEMPLOYMENT RATE (avg.)												
Jun-2012	9.1	8.7	8.3	8.1	8.0	7.9				9.6*	9.0*	8.1*
May-2012	9.1	8.7	8.3	8.1	8.0	7.8				9.6*	9.0*	8.0*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average						Annual Average		
	11:3a	11:4a	12:1a	12:2f	12:3f	12:4f	2010a	2011a	2012f
Federal Funds									
Jun-2012	0.08	0.07	0.10	0.15	0.15	0.15	0.18	0.10	0.14
May-2012	0.08	0.07	0.10	0.10	0.10	0.10	0.18	0.11	0.10
2-yr. Treasury Note									
Jun-2012	0.28	0.28	0.29	0.25	0.25	0.25	0.70	0.46	0.27
May-2012	0.28	0.28	0.25	0.25	0.25	0.25	0.70	0.45	0.25
10-yr. Treasury Note									
Jun-2012	2.43	2.05	2.04	1.85	1.90	2.20	3.21	2.79	2.00
May-2012	2.43	2.05	2.04	2.05	2.20	2.50	3.21	2.80	2.20

a = actual
f = forecast