Northern Trust

U.S. ECONOMIC &
INTEREST RATE OUTLOOK

No Growth Yet, But the Worst is Over

May 22, 2009

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Economic Developments

Real GDP contracted at annualized rates of 6.3% and 6.1%, respectively in Q4:2008 and Q1:2009. These rates of contraction would appear to be the largest that are likely to occur before real economic growth commences in Q4:2009. After having contracted in the second half of 2008, real personal consumption expenditures grew at an annual rate of 2.2% in Q1:2009. Although we expect that real consumption will resume its contraction in the second and third quarters of this year before posting growth again in the fourth quarter, the worst seems to be over for consumer spending. While overall nominal retail sales declined by 0.4% in April, total nominal chain store sales increased by 0.6%. With more autos and trucks being scrapped than new ones being produced, it is highly likely that the bottom of motor vehicle sales has been reached.

Sales and production activity in the residential real estate market appear to be bottoming out in large part because of increased affordability. The ratio of house prices to per-capita disposable personal income hit a record high in Q3:2005 only to fall to a record low in Q1:2009 (see Chart 1). Mortgage rates for the purchase of existing single-family homes are at a record low (see Chart 1). As a result of this increased house-purchase affordability, both new and existing home sales appear to be near a bottom (see Chart 2). Starts of single-family homes also appear to have bottomed (see Chart 3). Although house prices continue to fall, their rate of descent appears to have slowed (see Chart 4).

Chart 1

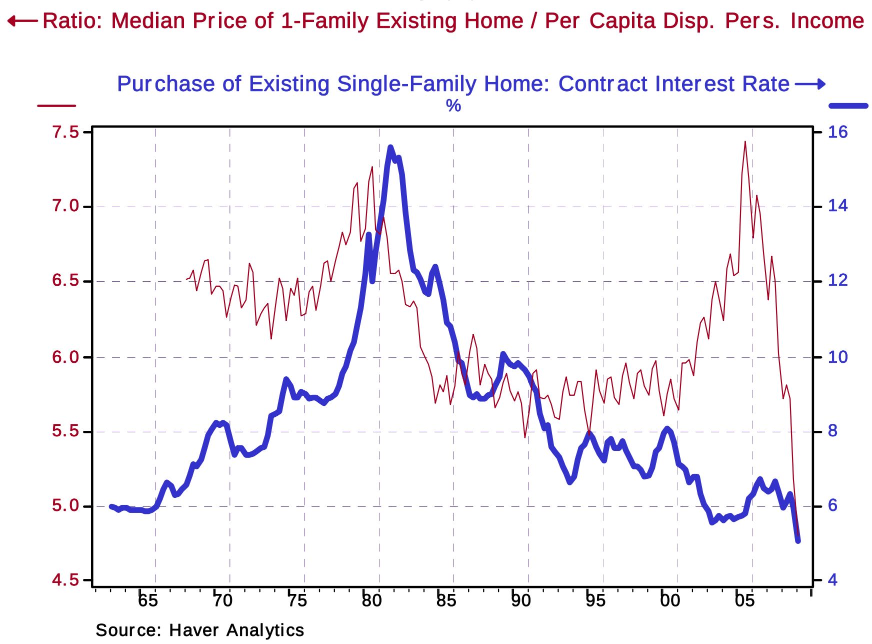

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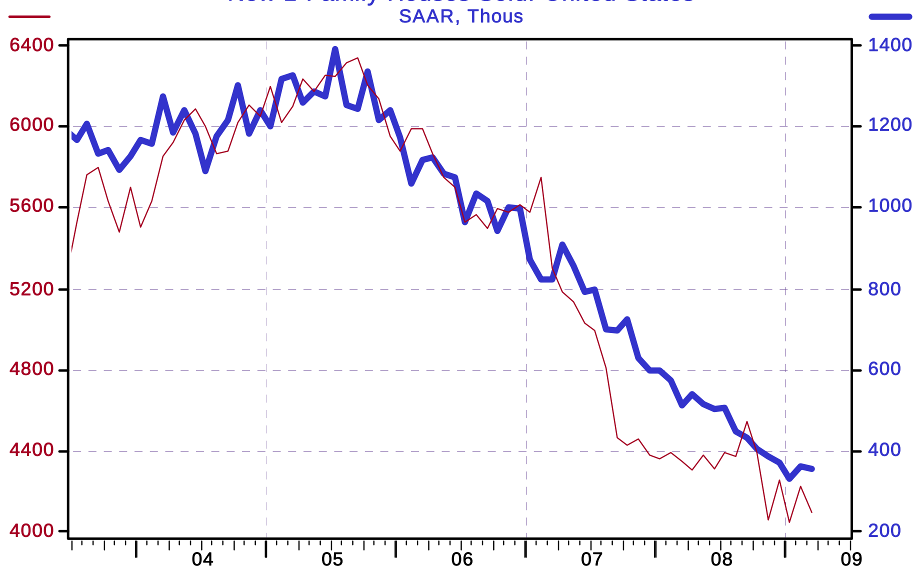
Chart 2

←Existing 1-Family Home Sales: United States
SAAR, Thous

New 1-Family Houses Sold: United States→
SAAR, Thous



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

Chart 3

Housing Starts: 1 Unit

SAAR, Thous.Units

Source: Census Bureau /Haver Analytics

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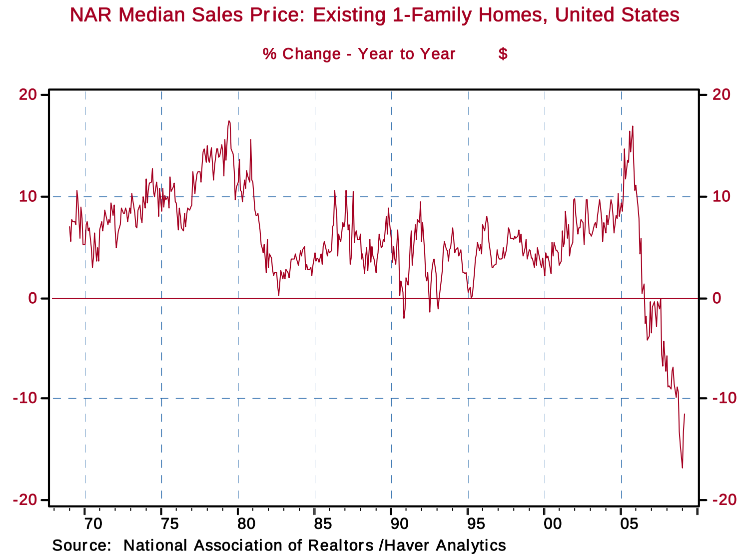
Chart 4



Just as housing sector activity appears to be bottoming out, so too, does the manufacturing sector. The new orders index if the ISM Manufacturing Survey reached a trough of 23.1 in December 2008 and had climbed to 47.2 by April 2009 (see Chart 5). Recently, the month-to-month rate of decline in production workers in the manufacturing sector has slowed and in April, the factory workweek increased for the first time since July 2008 (see Chart 6). Some of this improvement in the manufacturing sector is likely to be temporarily reversed due to the shutdown of Chrysler during its reorganization and the announced longer-than-usual shutdown of GM production this summer. But fourth-quarter manufacturing activity should receive an artificially-large boost as production resumes at both Chrysler and GM.

Chart 5

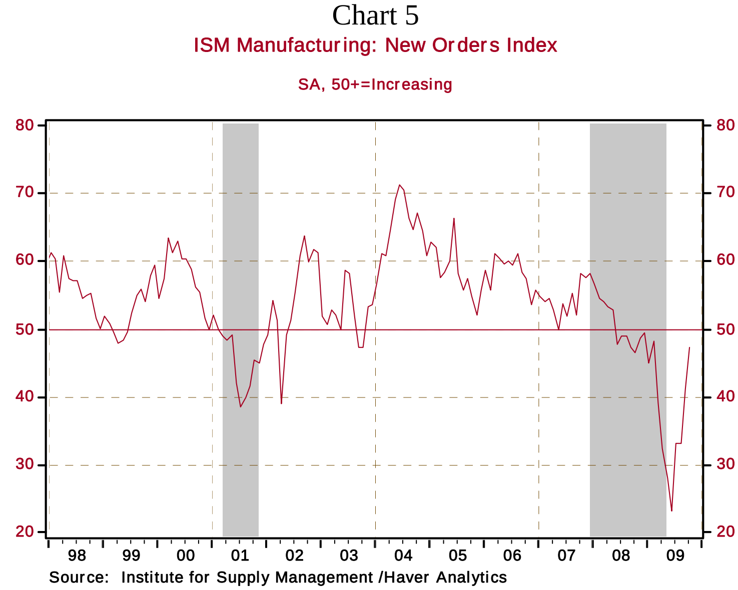
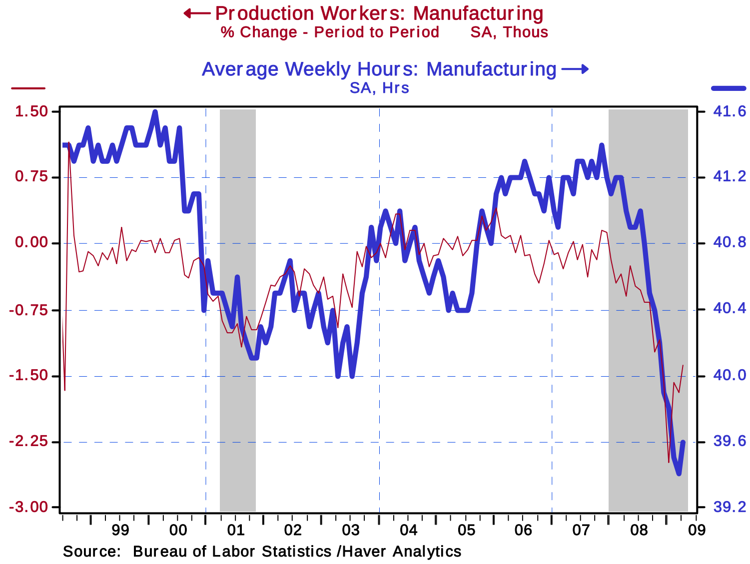
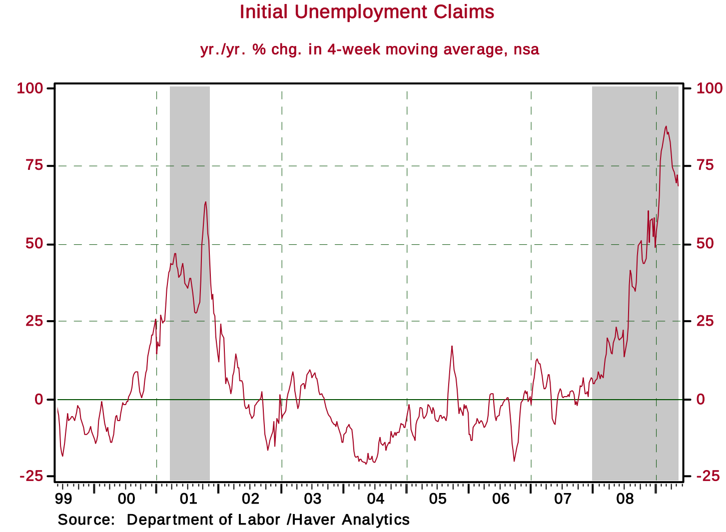


Chart 6



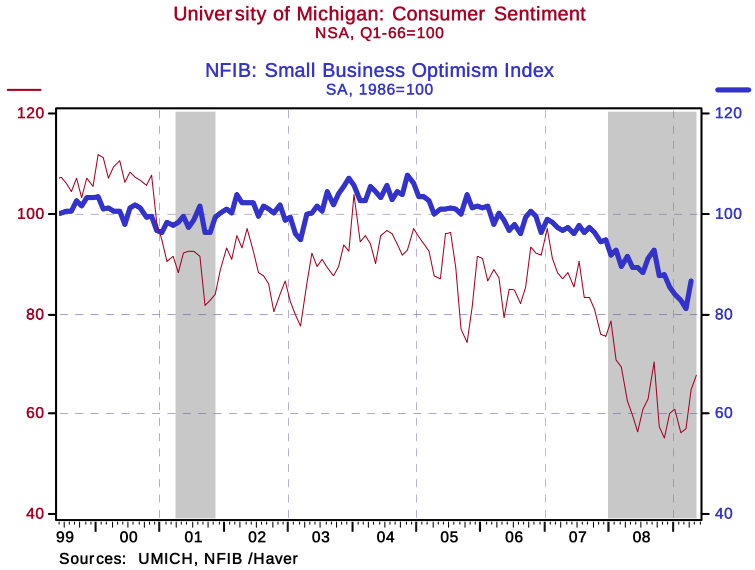
With regard to the labor market, there is tentative information that the worst may be over. To wit, it appears that new or initial unemployment insurance claims may have peaked in March. The year-over-year percent change in new claims has fallen significantly in recent weeks (see Chart 7). Again, the temporary production shutdowns associated with Chrysler and GM will provide some setbacks in this apparent downward trend in initial jobless claims. Moreover, although new claims for unemployment insurance may be slowing, it will take months before those already receiving unemployment insurance are re-employed. New entrants to the labor force, who are not eligible to receive unemployment insurance, also will not become employed for months. As a result, we expect the unemployment *rate* to trend higher from April's 8.9% level, reaching 10.1% by December 2009. The unemployment rate is unlikely to begin to move lower until the second half of 2010.

Chart 7



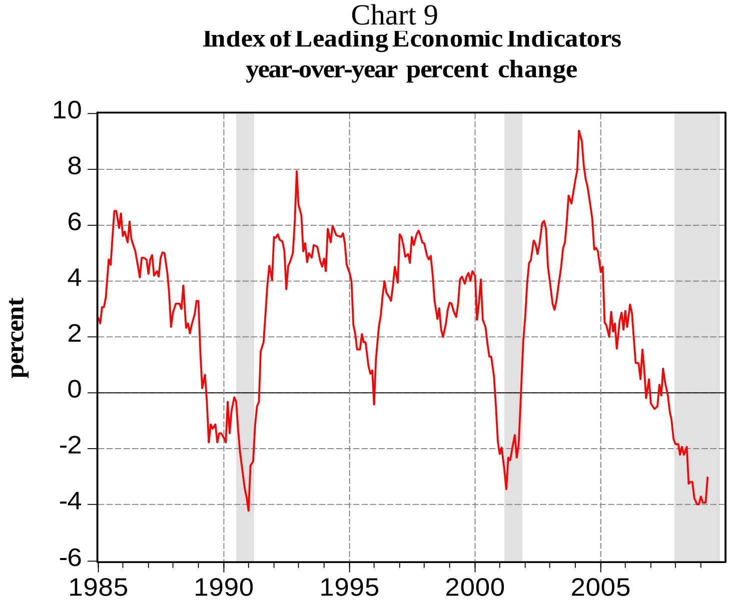
Although we do not place much weight on sentiment measures – household or business – as *leading* indicators, we note that both consumer and small business sentiment have improved of late (see Chart 8).

Chart 8



Perhaps the best summarizing statistic for the economic outlook is the index of Leading Economic Indicators (LEI). The year-over-year percent change in this index does a good job of identifying turning points in the overall economy. As Chart 9 shows, the year-over-year change in the LEI appears to have reversed from a declining to a rising trend. Again, the message is that although an outright economic recovery still lies ahead, the worst of the recession is likely behind us.

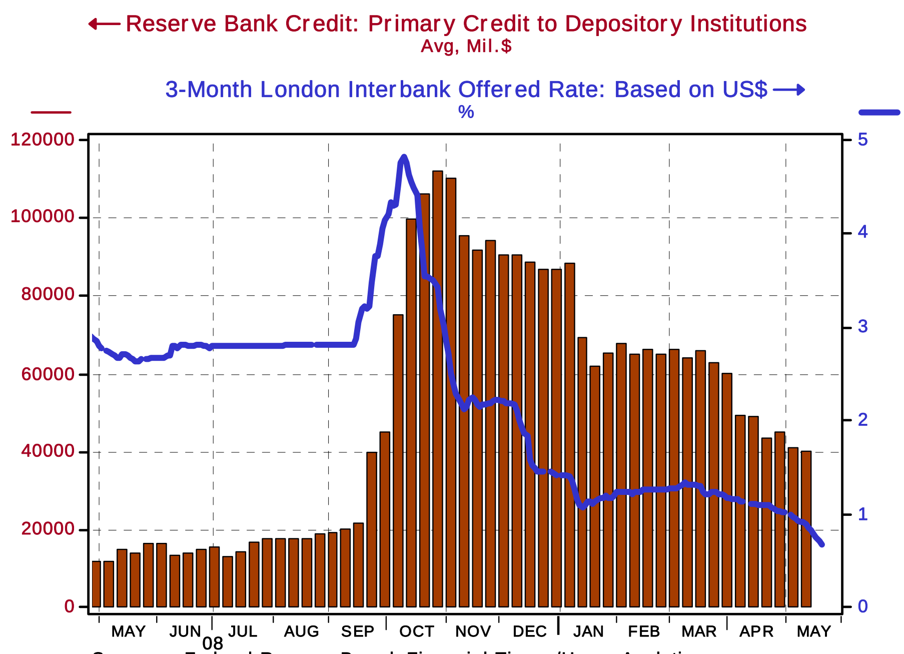
Chart 9



Credit Market Developments

There are definitive indications of a thaw now occurring in the previously frozen credit markets. Nowhere is this more evident than in the interbank lending market. As Chart 10 shows, 3-month Libor has fallen below 0.70% in recent days from the 1-1/4% level that prevailed earlier in the year. At the same time that Libor has been falling, discount window borrowings from the Fed also have been declining (see Chart 10). Taken together, these two events suggest that interbank lending is beginning to pick up again.

Chart 10



Sources: Federal Reserve Board, Financial Times /Haver Analytics

Perceived credit default risk appears to be moderating. This is evidenced by declines in absolute yield levels on high-yield corporate bonds as well as investment grade financial corporation bonds (see Chart 11). Likewise, yields on securities backed by credit card and auto loan receivables are declining (see Chart 12) despite a sharp increase in delinquency and charge-off rates on consumer debt (see Chart 13). This once again illustrates the forward-looking nature of financial markets. That is, today's market prices incorporate tomorrow's expected events. So, a lot of the credit problems that are surfacing currently were previously anticipated by market participants.

Chart 11

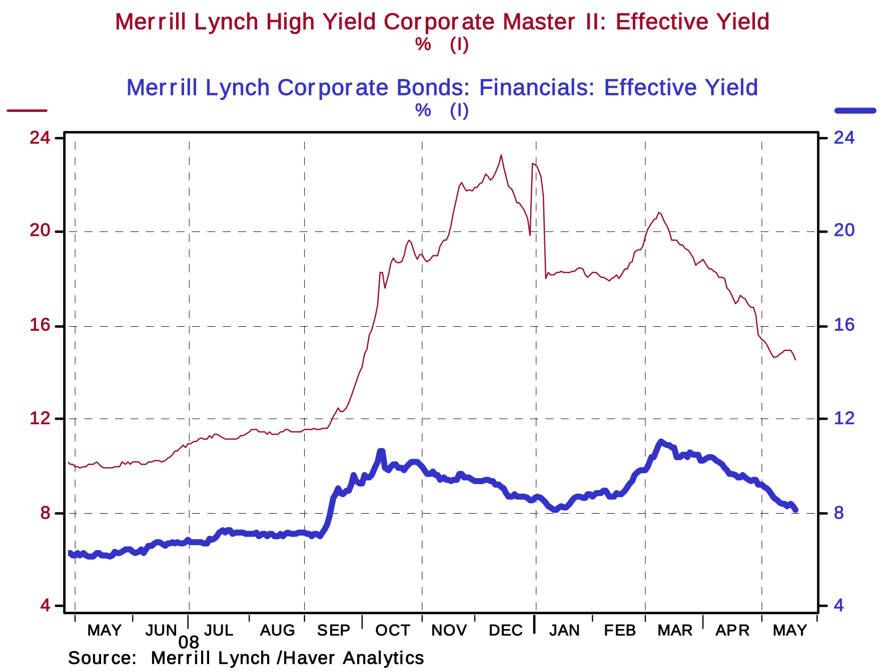


Chart 12

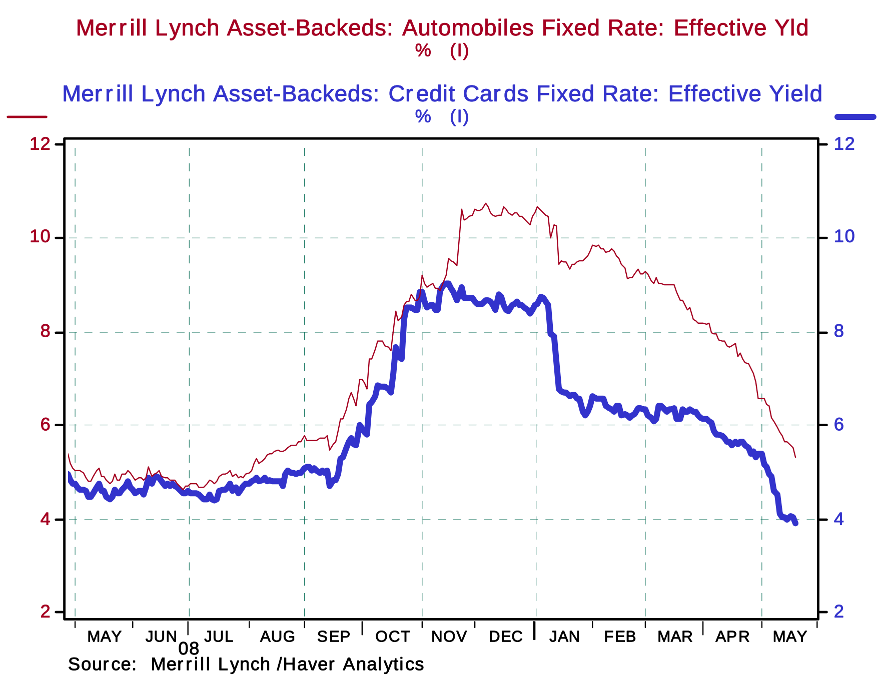
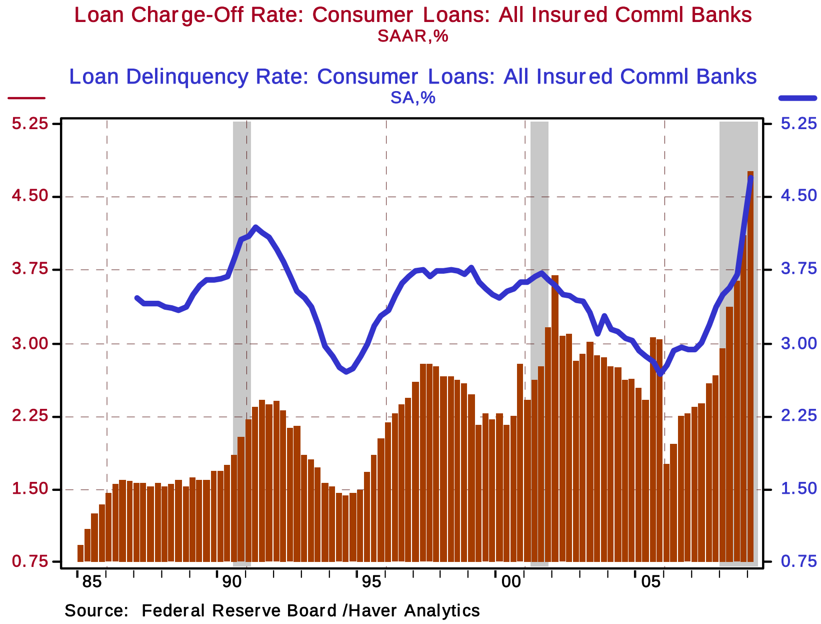
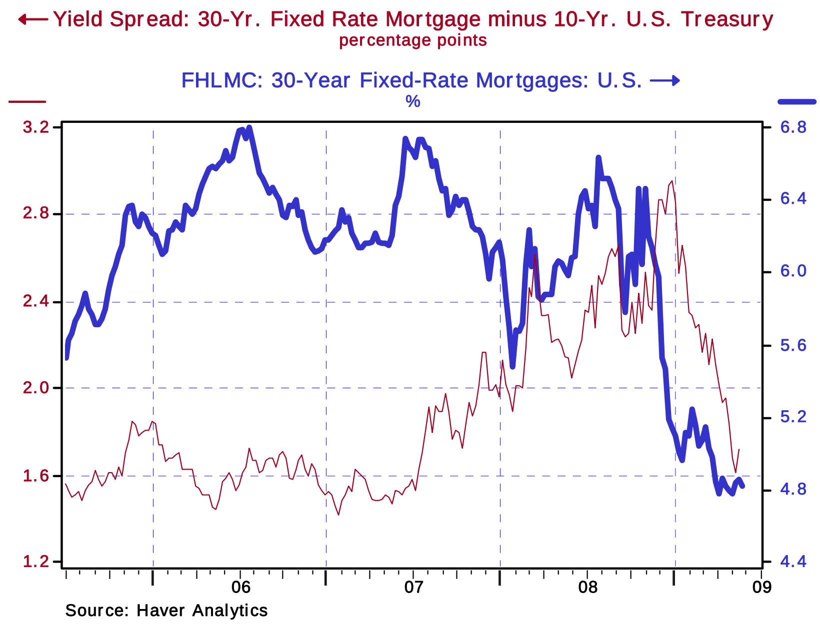


Chart 13



Another sector that is exhibiting signs of decreased default risk is the conventional residential mortgage market. Not only has the yield on the 30-year fixed rate mortgage fallen in absolute terms, but also relative to the yield on a 10-year Treasury security (see Chart 14). The yield differential between these two securities has almost returned to the range that prevailed before the 2007 onset of financial market turmoil.

Chart 14



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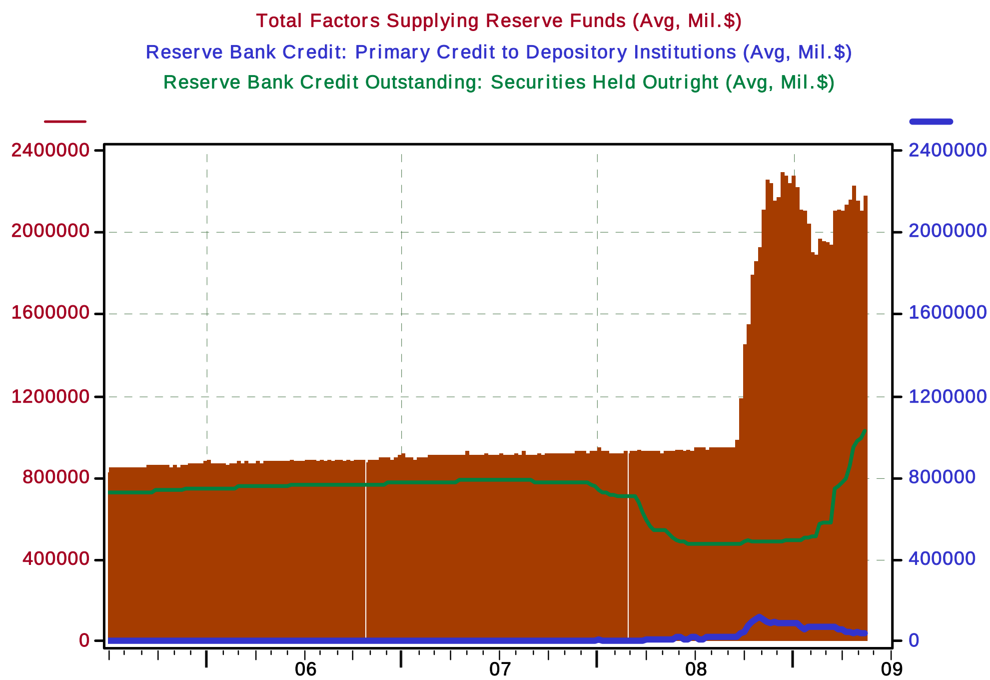
Outlook for Federal Reserve Monetary Policy

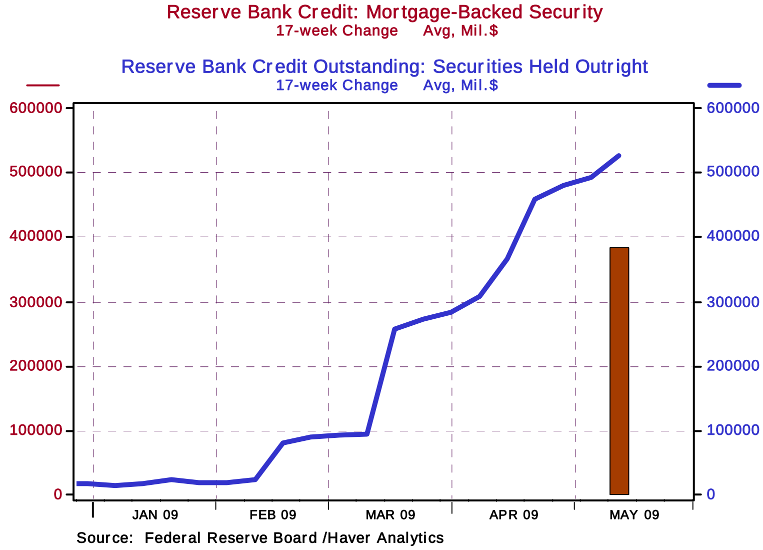
The FOMC continues to keep the federal funds rate between zero and ¼%. The Fed's balance sheet remains in the range of $2.1 trillion to $2.2 trillion with discount window borrowings declining and outright purchases of securities increasing (see Chart 15). In the 17 weeks ended May 13, the Fed increased its outright holdings of securities by approximately $528 billion, $383 billion of which were residential mortgaged-backed securities (see Chart 16). There was sentiment expressed by some FOMC members at the April 28-29 meeting to increase Fed outright purchases of securities above the additional $1.15 trillion that was authorized at the March 18 meeting. The Term Asset-Backed Securities Loan Facility (TALF) has increased marginally but, still at less than $16 billion outstanding loans, remains woefully short of its $1 trillion allocation. The Fed recently added commercial mortgage-backed securities as eligible collateral, which might increase participation. We continue to believe that the biggest obstacle to greater participation in this program is concern on the part of private investors that their profits might be clawed back by Congress. We view TALF as critical in restarting the flow of credit to the private nonfinancial system while the private financial system recapitalizes itself.

Chart 15



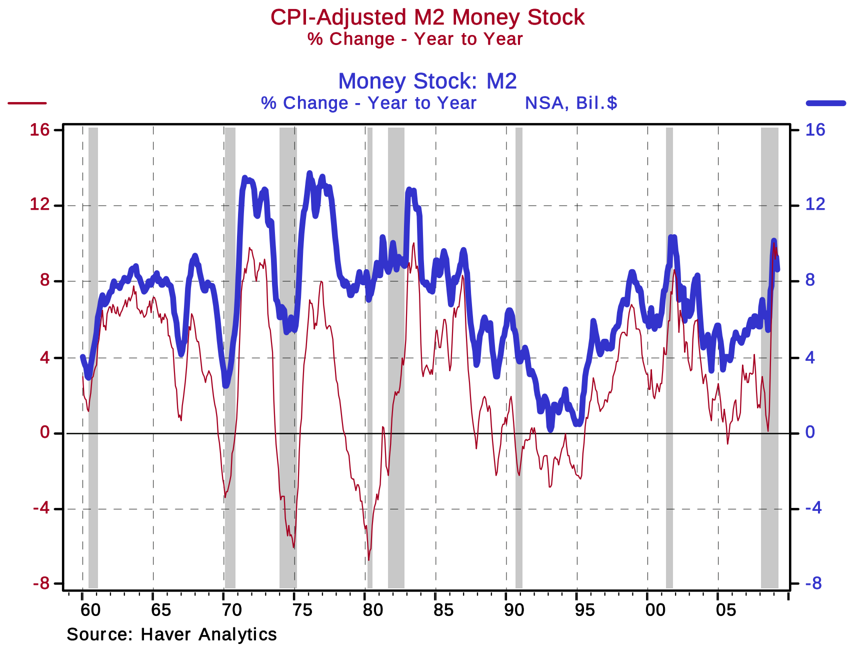
Source: Federal Reserve Board /Haver Analytics

Chart 16



Despite continued contraction in commercial bank credit, the broad money supply (M2), both in nominal and price-adjusted terms, continues to grow at a rapid rate (see Chart 17). Given extreme investor risk aversion and thus, an increased demand for money to hold (i.e., a decrease in monetary velocity), were it not for this increased *supply* of money, real economic activity would be even weaker than it is. The challenge for the Fed will be to anticipate when the demand for money begins to ebb so that it can begin to rein in the supply of money in order to prevent an undesired increase in the inflation rate.

Chart 17



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We continue to expect that the Fed will take no actions to begin draining liquidity from the financial system until the second half of 2010 at the earliest. The Fed will want to make sure that the recovery that we expect to commence in the fourth quarter of this year will be sustained. It is unlikely to feel confident of this until early in the second half of 2010.

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

THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
May 2009

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	08:2a	08:3a	08:4a	09:1a	09:2f	09:3f	09:4f	2007a	2008a	2009f	2007a	2008a	2009f
REAL GROSS DOMESTIC PRODUCT	4.8	-0.2	0.9	2.8	-0.5	-6.3	-6.1	-3.6	-1.9	2.5	2.3	-0.8	-2.3	2.0	1.1	-3.4
(% change from prior quarter)																
CONSUMPTION EXPENDITURES	2.0	1.0	0.9	1.2	-3.8	-4.3	2.2	-2.3	-1.5	2.0	2.2	-1.5	0.1	2.8	0.2	-1.2
BUSINESS INVESTMENT	8.7	3.4	2.4	2.5	-1.7	-21.7	-37.9	-22.1	-9.4	-4.9	6.4	-5.2	-19.7	4.9	1.6	-20.4
RESIDENTIAL INVESTMENT	-20.6	-27.0	-25.1	-13.3	-16.0	-22.8	-38.0	-16.0	-7.0	0.0	-19.0	-19.4	-16.6	-17.9	-20.8	-21.5
CHANGE IN INVENTORIES ('00 dlrs, bill)	16.0	-8.1	-10.2	-50.6	-29.6	-25.8	-103.7	-121.7	-136.7	-106.7				-2.5*	-29.1*	-117.2*
GOVERNMENT	3.8	0.8	1.9	3.9	5.8	1.3	-3.9	2.3	2.6	3.3	2.4	3.2	1.0	2.1	2.9	1.1
NET EXPORTS ('00 dlrs, bill.)	-511.8	-484.5	-462.0	-381.3	-353.1	-364.5	-308.4	-291.8	-284.2	-285.9				-546.5*	-390.2*	-292.6*
FINAL SALES	4.0	0.8	0.9	4.4	-1.3	-6.2	-3.4	-3.3	-1.4	1.4	2.5	-0.7	-1.7	2.4	1.4	-2.6
NOMINAL GROSS DOMESTIC PRODUCT	6.4	2.3	3.5	4.1	3.4	-5.8	-3.5	-3.1	-0.1	4.6	4.9	1.2	-0.6	4.8	3.3	-1.7
GDP DEFLATOR - IMPLICIT (% change)	1.5	2.5	2.6	1.3	3.9	0.6	2.9	0.5	1.8	2.0	2.6	2.1	1.8	2.7	2.2	1.8
CPI (% Change, 1982-84 = 100)	2.4	5.8	4.5	4.5	6.2	-8.3	-2.4	0.7	2.0	2.2	4.0	1.5	0.6	2.9	3.8	-0.7
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.7	4.8	4.9	5.4	6.1	6.9	8.1	9.1	9.7	10.0				4.6*	5.8*	9.2*

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	08:3a	08:4a	09:1a	09:2f	09:3f	09:4f	2007a	2008a	2009f
Federal Funds	5.07	4.50	3.18	2.09	1.94	0.51	0.18	0.18	0.20	0.20	5.02	1.93	0.19
2-yr. Treasury Note	4.38	3.48	2.02	2.42	2.36	1.21	0.91	0.90	0.90	0.95	4.36	2.00	0.91
10-yr. Treasury Note	4.73	4.26	3.66	3.89	3.86	3.25	2.74	3.20	3.30	3.35	4.63	3.67	3.15

a = actual
f = forecast