



The Northern Trust Company
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U.S. Economic and Interest Rate Outlook
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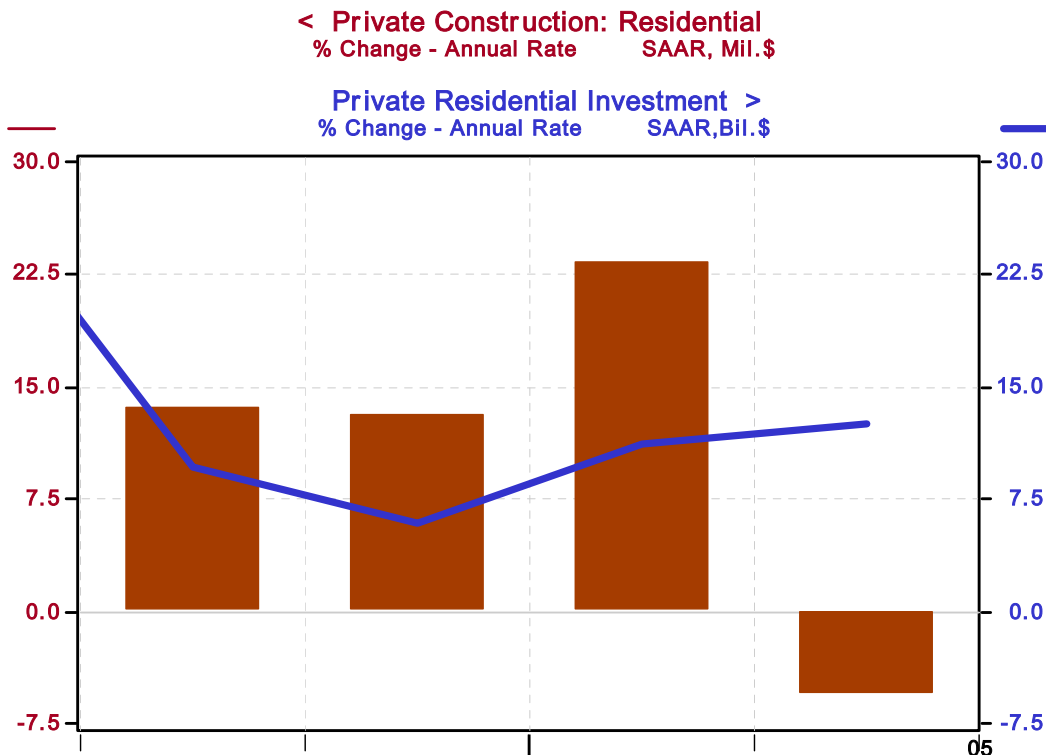
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Trust Your Compass

We already hinted at a major change in our forecast in our July 22nd weekly comment, "Greenspan Has Spoken, China Is Revaluing And I'm Reevaluating" http://www.northerntrust.com/library/econ_research/weekly/us/pc072205.pdf. As discussed in the July 22nd commentary, we no longer expect the FOMC to pause after its August 9th hike in the fed funds rate, which will bring its level up to 3.50%. Rather, we now expect the FOMC to push the funds rate up to 4.00% by the close of business on November 1st. And we have to admit that the BEA's first guesstimate of second quarter real GDP growth at 3.4% (annualized) was a bit stronger than our forecast, in part apparently due to real estate brokers' sales commissions. How else could a 5.7% annualized decline in nominal second-quarter residential construction expenditures result in a 12.6% annualized increase in nominal residential investment expenditures (see Chart 1)? Also, the shipments data for nondefense capital goods did not portend the strength estimated by BEA in second-quarter business equipment and software spending.

Chart 1



Sources: Census Bureau, Bureau of Economic Analysis /Haver Analytics

Thanks to Detroit's fire sale of light motor vehicles, we are required to significantly revise up our forecast for third quarter real GDP growth to 4.3% from last month's forecast of 3.2%. Car and truck sales drove June's personal consumption expenditures far above the second quarter average, putting the arithmetic wind at the back of third quarter consumption. Moreover, July's blowout month for Detroit also argues for stronger-than-we-had-expected third quarter consumption. And, of course, inventories, which knocked more than 2.3 points off second-quarter GDP growth, will likely be adding to GDP growth in the third quarter. But we believe that as the third quarter ends, GDP growth will be running out of gas. As a result, we have lowered our fourth-quarter GDP forecast to 2.8% annualized versus last month's forecast of 3.3%. With the new "actual" data reported and the changes to our quarterly forecasts, our new Q4/Q4 real GDP growth forecast for 2005 is 3.6% versus last month's 3.3%.

We have been reluctant to roll out our first forecast for 2006 GDP growth until there was more clarity as to what the FOMC would do in the second half of 2005. Now that the FOMC has strongly suggested that it is intent on pushing the fed funds rate up to at least 4%, we are ready to take a stab at 2006 economic growth. Because we believe that monetary policy is approximately "neutral" under current conditions at 3-1/4% to 3-1/2%, logic dictates that we believe that the FOMC would be on the restrictive side of neutral if it pushes the fed funds rate up to 4%. As a result, we now see 4Q/4Q real GDP growth in 2006 at 2-1/2% in round numbers. Given our view that potential real GDP growth is about 3-1/2%, the slowdown in economic growth we are forecasting for 2006 would be consistent with a rise in the unemployment rate. With consumer inflation also expected to moderate in 2006, we are forecasting that the post-Greenspan FOMC will start cutting the fed funds rate by midyear 2006. We do not now foresee more than two cuts of 25 basis points each. In other words, these funds rate cuts would be more of a fine-tuning move rather than a major cyclical change in monetary policy.

Now for some comments in reference to the title of this month's essay, "Trust Your Compass." If you are sailing in the middle of Lake Michigan and hope to reach a specific destination, you need to rely on your compass to guide you to that destination. It is not unusual for sailors to second guess their compasses. But more often than not, the compass is correct and sailors' intuitions are wrong. Similarly, it is easy for economic forecasters to doubt their "compasses," especially when incoming data are at odds with their compasses. But for economic forecasters to abandon their compasses and rely on recent data to guide their forecasts is really to abandon forecasting.

As we mentioned above, the BEA's advance estimate for second-quarter real GDP growth was stronger than we expected and we have revised upward our third-quarter forecast of GDP growth. But we continue to believe that FOMC policy is pushing the economy on a course toward slower growth ahead. Why are we so reluctant to abandon this forecast of slower economic growth when recent growth has been stronger than we expected? For starters, recent economic growth is not a particularly good *leading* indicator of *future* growth. To demonstrate this, we ran a little experiment. We used real GDP growth *lagged* two quarters to "explain" real GDP growth in a current quarter. Then, we added two of our favorite FOMC-policy-related *leading* indicators to see what happened to the statistical significance of lagged real GDP growth as well as the explanatory power of the regression. Not surprisingly to us, the coefficient on lagged real GDP growth became statistically *insignificant* when the two FOMC-related independent variables were added to the regression and the explanatory power, or the adjusted R-squared of the regression increased by a large amount (from 0.037 to 0.241). The results of these two regressions are reported below.

Dependent Variable: RGDPQQ

Method: Least Squares

Date: 08/04/05 Time: 20:50

Sample(adjusted): 1959:4 2005:2

Included observations: 183 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
	t			
RGDPQQ(-2)	0.204813	0.071606	2.860293	0.0047
C	2.709846	0.355011	7.633140	0.0000
R-squared	0.043246	Mean dependent		3.41262
		var		3
Adjusted R-squared	0.037960	S.D. dependent var		3.53419
				8
S.E. of regression	3.466471	Akaike info criterion		5.33502
				0
Sum squared resid	2174.972	Schwarz criterion		5.37009
				6
Log likelihood	-	F-statistic		8.18127
	486.1543			8
Durbin-Watson stat	1.560800	Prob(F-statistic)		0.00473
				0

Dependent Variable: RGDPQQ

Method: Least Squares

Date: 08/04/05 Time: 17:13

Sample(adjusted): 1959:4 2005:2

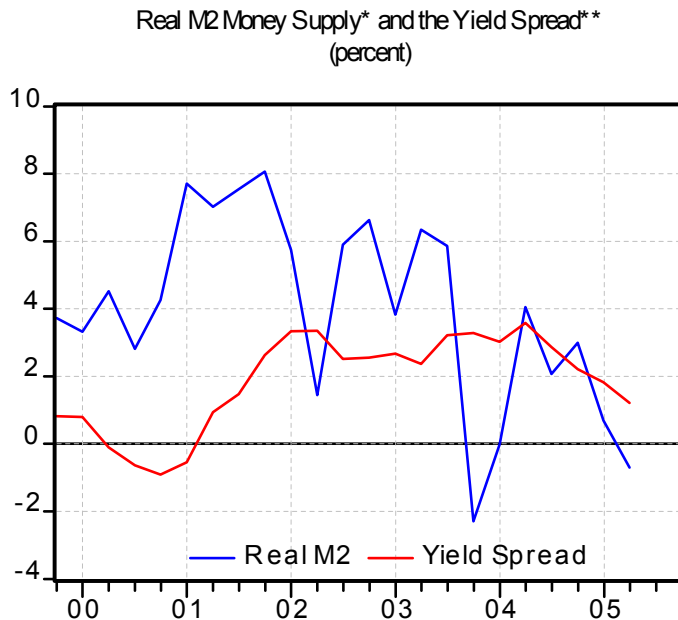
Included observations: 183 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
	t			
RGDPQQ(-2)	0.054857	0.067037	0.818311	0.4143
C	1.778707	0.346502	5.133324	0.0000
RM2QQ(-2)	0.271774	0.065731	4.134670	0.0001
T10FF(-2)	0.634918	0.148216	4.283742	0.0000
R-squared	0.253943	Mean dependent		3.41262
		var		3
Adjusted R-squared	0.241439	S.D. dependent var		3.53419
				8
S.E. of regression	3.078124	Akaike info criterion		5.10813
				3
Sum squared resid	1695.998	Schwarz criterion		5.17828
				6
Log likelihood	-	F-statistic		20.3093
	463.3942			5
Durbin-Watson stat	1.856715	Prob(F-statistic)		0.00000
				0

where RGDPQQ is quarter-to-quarter annualized real GDP growth, C is a constant, RM2QQ is quarter-to-quarter annualized real M2 money supply growth, T10FF is the quarterly average spread between the yield on the Treasury 10-year bond and the federal funds rate and (-2) indicates that the variable is lagged two quarters.

So, recent real GDP growth is *not* a good indicator of future real GDP growth. But the behavior of real M2 growth and the Treasury bond yield – fed funds rate spread *do* provide some useful information about future real GDP growth. Chart 2 shows the recent behavior of these two leading indicators. Real M2 growth has gone from 4.1% annualized growth in 2004:Q2 to 0.7% annualized *contraction* in Q2:2005. The yield spread has gone from 3.59 percentage points in 2004:Q2 to 1.22 percentage points in 2005:Q2. In other words, both of leading indicators, which are related to FOMC policy, are signaling a moderation in economic growth ahead. If the FOMC continues to push up the fed funds rate, it is likely that real M2 will contract more and the yield spread will narrow more.

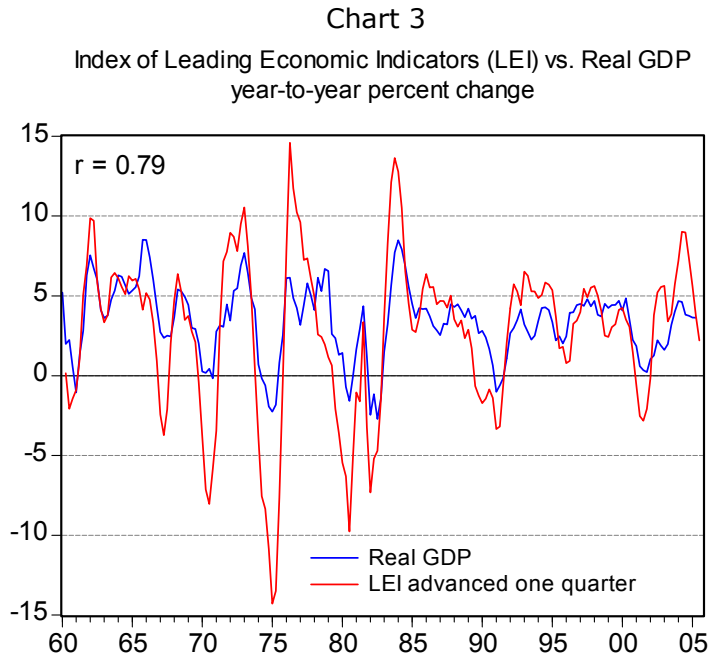
Chart 2



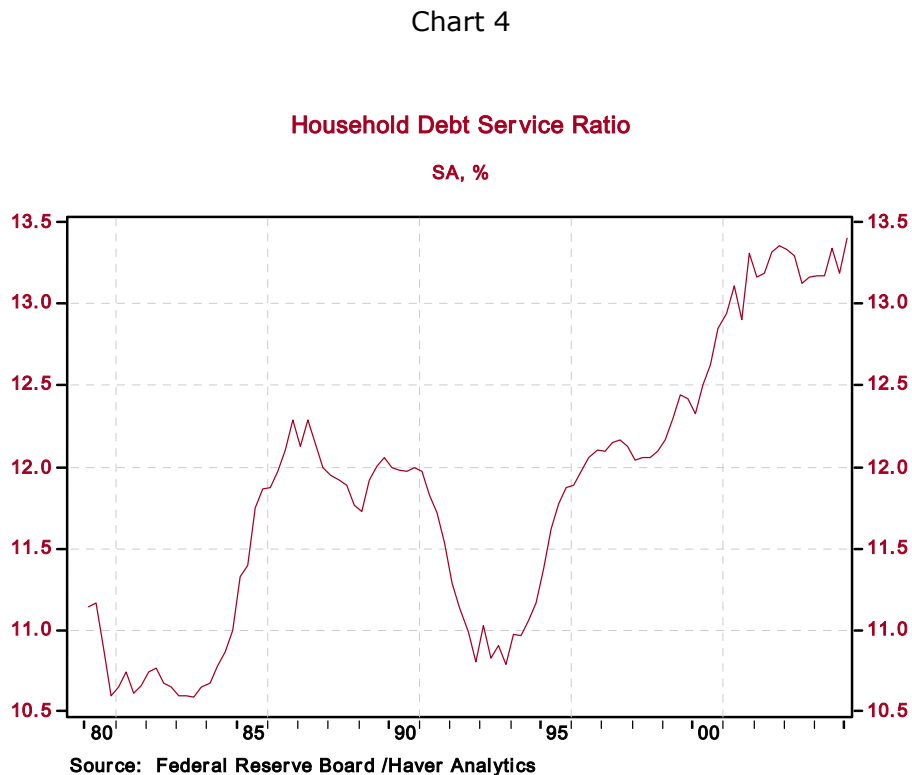
* quarter-to-quarter annualized percentage change in nominal M2 divided by GDP chain price index.

** quarterly average difference between 10-yr. Treasury bond yield and fed funds rate.

Because real M2 growth and the yield spread have been reliable leading indicators of economic growth over the past 45 years, it should come as no surprise that they are components of the Conference Board's index of Leading Economic Indicators (LEI). On a trend basis, the LEI has a good track record of foreshadowing real GDP growth, as shown in Chart 3. Over the past 45 years, the year-over-year percent change in the LEI (advanced by one quarter) has a correlation coefficient of 0.79 out of a maximum possible 1.00 with the year-over-year percent change in real GDP. Again, if the FOMC continues to push up the fed funds rate, there is the likelihood that two of the LEI's components, real M2 and the yield spread, will be behaving so as to bias downward LEI growth. This, then, is the compass that helps us plot our forecasting course.



There are other “navigational aids” that give us confidence that our compass is true. The household debt-service ratio calculated by the Federal Reserve is at a record high of 13.40% in the history of the series (see Chart 4). With the FOMC continuing to push short-term interest rates higher, this debt-service ratio is likely also to move still higher, which ultimately will curb household borrowing and spending.

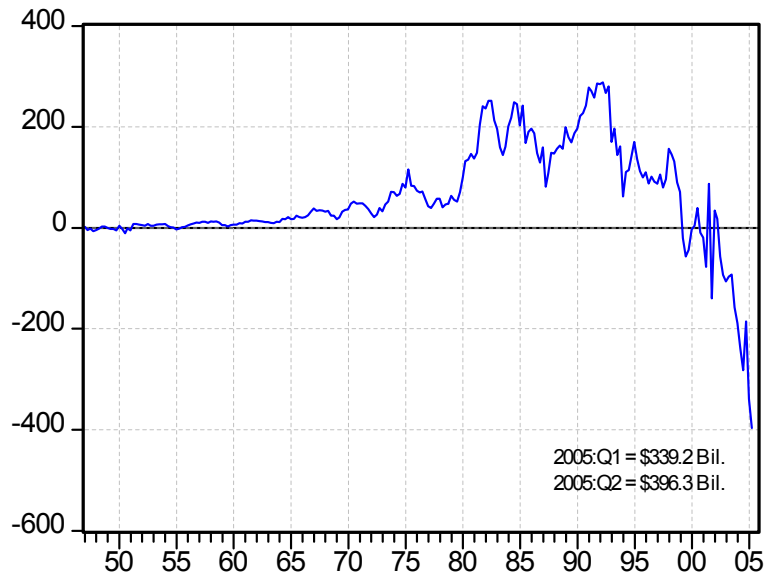


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Speaking of borrowing and spending, households did a record amount of it in the second quarter. Households' consumer goods/services and residential investment expenditures exceeded their after-tax income by a record \$396 billion in 2005:Q2 (see Chart 5). In order for households in the aggregate to spend more than they earn, they have to borrow from non-household entities and/or sell assets to non-household entities. Again, with the FOMC pushing up interest rates and with the household debt-service ratio at a record high, it would seem that households will have increased difficulty in running ever larger deficits.

Chart 5

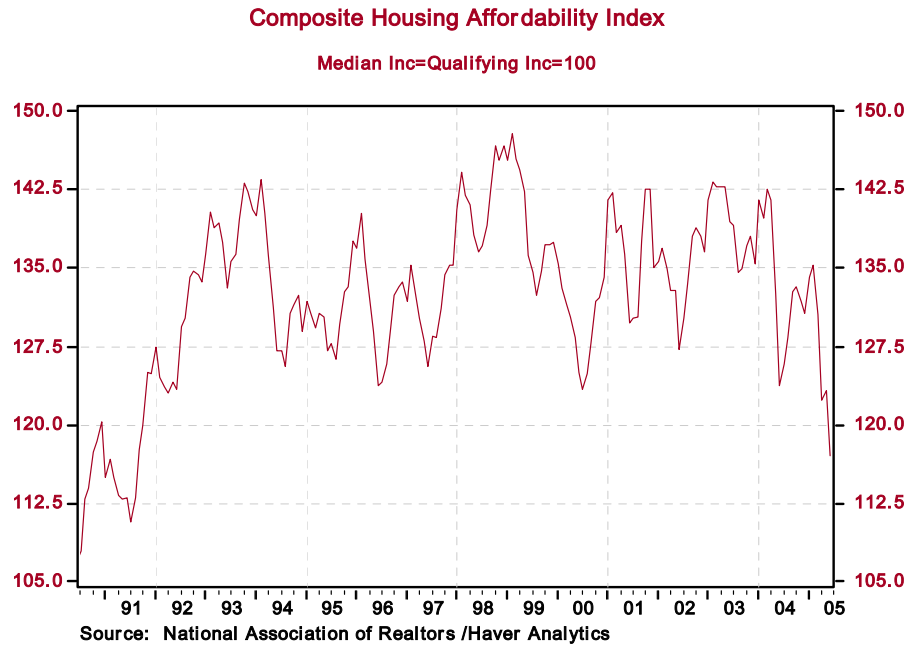
Household Surplus (+) or Deficit (-)*
\$ Bil. SAAR



* disposable personal income minus expenditures on consumer goods/services and residential investment

Housing directly and indirectly has provided much support to the current recovery/expansion. But as shown in Chart 6, housing affordability has been falling. In fact, affordability has fallen to its lowest level since August 1991. Again, with the FOMC continuing to push up short-term interest rates and with the market value of residential real estate at a record high in relation to after-tax income, housing affordability is likely to fall more. As a result, growth in residential construction and home sales would be expected to slow.

Chart 6



In sum, although recent data suggest that economic growth continues to head north, our compass says that it is headed in more southerly direction. Until the compass reading changes, we will continue to forecast accordingly.

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THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
August 2005

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2004		2005				2006		Q4-to-Q4 change			Annual change		
	04:3a	04:4a	05:1a	05:2a	05:3f	05:4f	06:1a	06:2f	2004a	2005f	2006f	2004a	2005f	2006f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	4.0	3.3	3.8	3.4	4.3	2.8	2.5	1.9	3.8	3.6	2.4	4.2	3.6	2.7
CONSUMPTION EXPENDITURES	4.4	4.3	3.5	3.3	3.5	2.5	2.5	2.5	3.8	3.2	2.6	3.9	3.6	2.7
BUSINESS INVESTMENT	11.8	10.4	5.7	9.0	10.7	4.2	6.4	4.6	10.9	7.4	4.4	9.4	8.9	5.7
RESIDENTIAL INVESTMENT	2.6	1.6	9.5	9.8	5.0	1.0	-2.0	-5.0	6.6	6.3	-1.8	10.3	6.5	-0.2
CHANGE IN INVENTORIES ('00 dlrs, bill)	50.4	50.1	58.2	-6.4	14.3	24.3	23.1	13.1				52.0*	22.6*	12.1*
GOVERNMENT	1.8	0.9	1.9	2.0	2.2	2.2	2.0	2.0	2.1	2.1	2.0	2.2	1.8	2.1
NET EXPORTS ('00 dlrs, bill.)	-606.5	-634.1	-645.4	-601.3	-625.1	-633.6	-638.5	-641.1				-601.3*	-626.4*	-638.5*
FINAL SALES	4.6	3.3	3.5	5.8	3.6	2.4	2.6	2.3	3.6	3.8	0.0	3.9	3.9	2.9
NOMINAL GROSS DOMESTIC PRODUCT	5.3	6.1	7.0	5.9	6.1	5.0	4.7	4.0	6.8	6.0	4.5	7.0	6.2	4.8
GDP DEFLATOR - IMPLICIT (% change)	1.3	2.7	3.0	2.4	1.7	2.1	2.1	2.0	2.9	2.3	2.0	2.6	2.5	2.0
CPI (% Change, 1982-84 = 100)	1.6	3.6	2.4	4.2	2.0	2.4	2.4	2.3	3.4	2.7	2.3	2.7	2.9	2.4
CIVILIAN UNEMPLOYMENT RATE (avg.)	5.4	5.4	5.3	5.1	5.0	5.2	5.4	5.5				5.5*	5.2*	5.5*

a=actual

f=forecast

*=annual average

Table 2 Outlook for Interest Rates

SPECIFIC INTEREST RATES	Quarterly Average										Annual Average		
	04:3a	04:4a	05:1a	05:2a	05:3f	05:4f	06:1f	06:2f	06:3f	06:4f	2004a	2005f	2006f
Bank Prime	4.42	4.94	5.44	5.92	6.40	6.90	7.00	7.00	6.60	6.50	4.34	6.17	6.78
Federal Funds	1.43	1.95	2.47	2.94	3.40	3.90	4.00	4.00	3.60	3.50	1.35	3.18	3.78
3-mo Neg. CD (Sec. Mkt)	1.70	2.25	2.78	3.20	3.60	4.05	4.05	3.95	3.55	3.50	1.56	3.41	3.76
3-mo.LIBOR	1.75	2.30	2.84	3.26	3.65	4.10	4.10	4.00	3.60	3.55	1.62	3.46	3.81
3-mo. Treasury Bill (discount basis)	1.49	2.01	2.54	2.87	3.25	3.70	3.70	3.60	3.20	3.15	1.37	3.09	3.41
2-yr. Treasury Note	2.56	2.81	3.44	3.66	4.00	4.25	4.15	4.00	3.70	3.65	2.38	3.84	3.88
5-yr. Treasury Note	3.51	3.49	3.88	3.90	4.10	4.30	4.20	4.05	3.85	3.90	3.43	4.05	4.00
10-yr. Treasury Note	4.30	4.17	4.30	4.16	4.25	4.15	4.00	3.90	3.85	3.95	4.27	4.21	3.93
Moody's AAA Corporate	5.64	5.49	5.32	5.16	5.15	5.05	4.95	4.90	4.85	4.90	5.63	5.17	4.90
Bond Buyer Index	4.71	4.50	4.44	4.32	4.45	4.35	4.20	4.10	4.05	4.15	4.68	4.39	4.13

a = actual

f = forecast

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