



The Northern Trust Company
Economic Research Department
U.S. Economic and Interest Rate Outlook
50 South LaSalle Street, Chicago, Illinois 60675

<http://www.northerntrust.com> (See Economic Research)

Paul Kasriel (312)-444-4145 Fax (312)-444-4132

October 8, 2004

Leading Indicators Signaling Moderating Economic Growth Trend

Greenspan's "soft patch" apparently was not as soft as we were led to believe. The Bureau of Economic Analysis (BEA), the official counter of the GDP beans, revised up its estimate of second quarter real economic growth from 2.8% to 3.3%. A few days later, this same BEA revised up July price-adjusted personal consumption expenditures from 0.8% to 1.1%. That revision made all the difference in the world for our estimate of third-quarter real consumer spending. Last month, we expected third-quarter real consumer spending to grow at an annualized rate of 2.7%. But now, with the upward revision to July, we now expect third-quarter real consumer spending to grow an annualized 4.2%. And because construction and business equipment spending also are coming in stronger than expected, we have boosted our forecast of third-quarter real GDP growth from 3.5% to 4.4%.

But we do not believe that this above-trend economic growth rate will be sustained. Why not? Because *leading* indicators, especially *the* Leading Economic Indicators (LEI) index, are signaling a slowdown ahead, as shown in Chart 1. We expect the bulk of the slowdown to occur in consumer spending. As shown in Chart 2, growth in disposable personal income is slowing, in part because of the waning effects of the initial stimulus from recent prior tax cuts. Also, the boost to consumer spending from cash-out mortgage refinancing also is waning. Chart 3 shows that although mortgage applications for refinancing have started to move up, they remain low in relation to their surge in the summer of 2003. Chart 4 shows why the refi response to the recent decline in mortgage interest rates has been weak. The yield on a 30-year fixed rate mortgage today is only 5 basis points below its year-ago level; the yield on a 5-year balloon mortgage is 60 basis points higher. Thus, there is little or no rate advantage to refinance now.

Chart 1

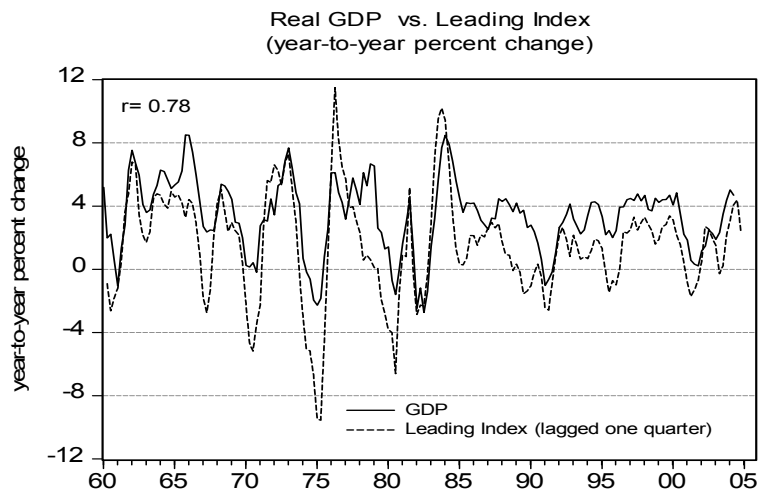


Chart 2

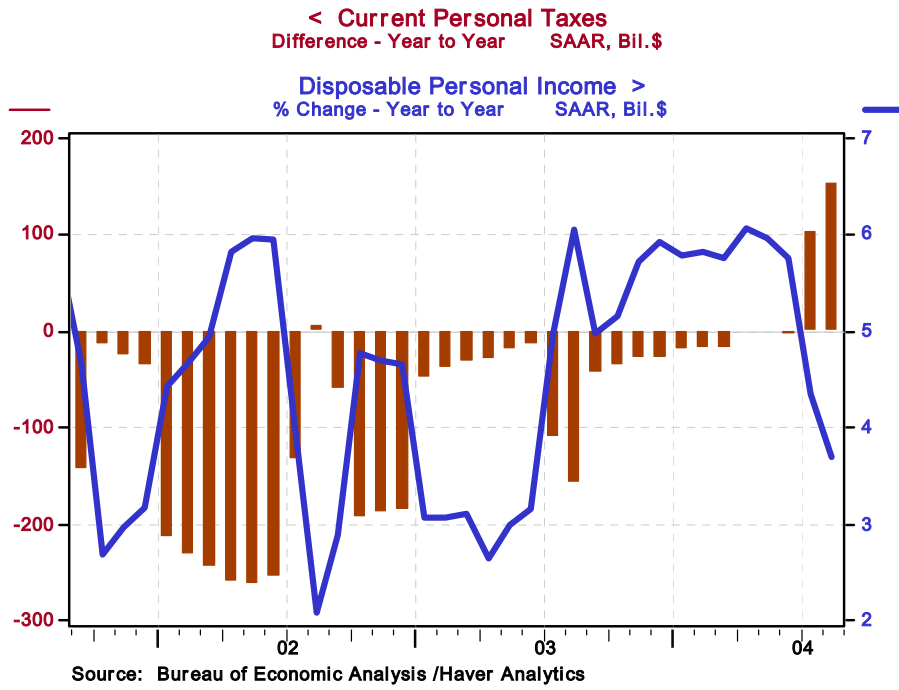
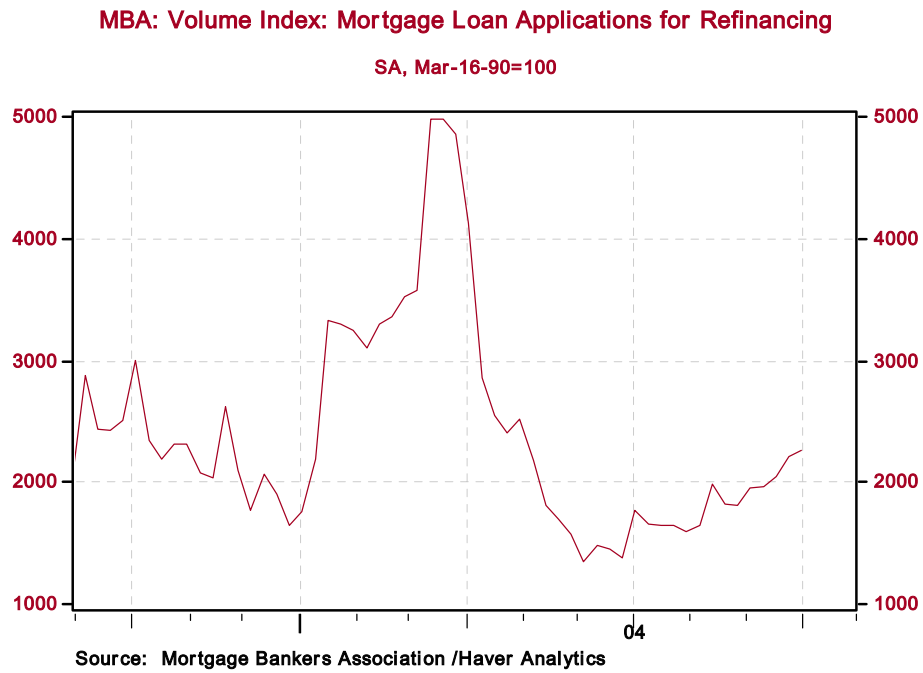
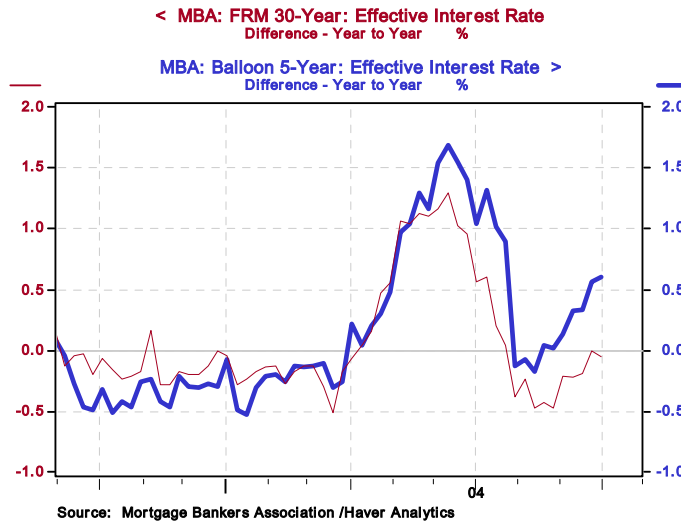


Chart 3



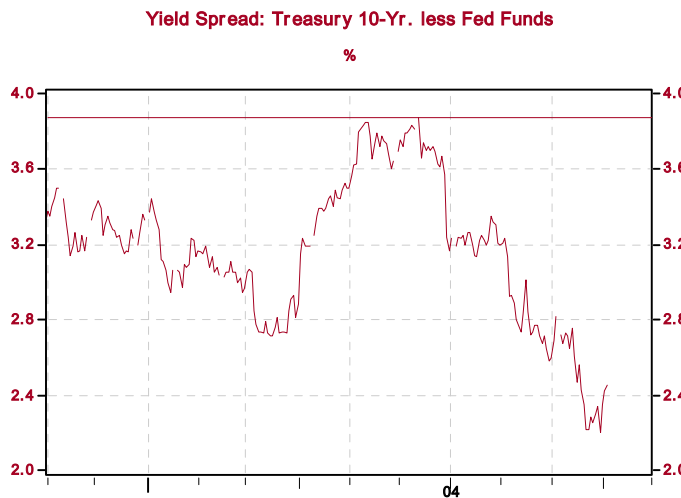
The information herein is based on sources which The Northern Trust Company believes to be reliable, but we cannot warrant its accuracy or completeness. Such information is subject to change and is not intended to influence your investment decisions.

Chart 4



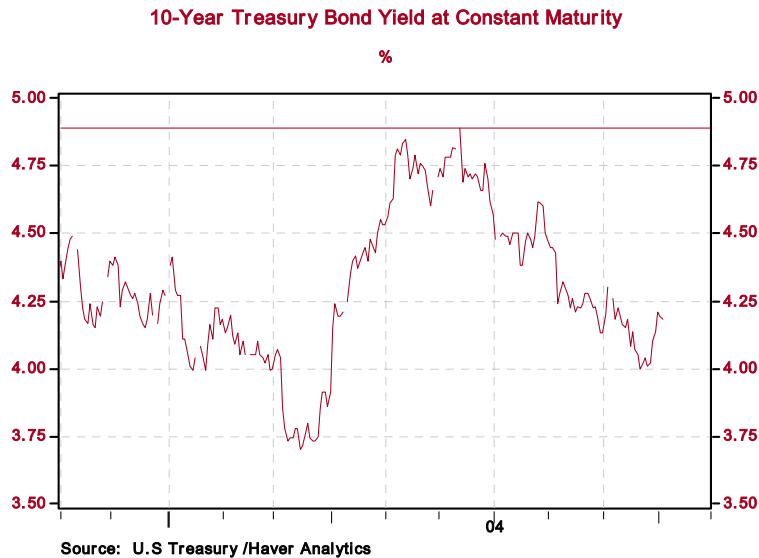
One component of the LEI index that is signaling a slowdown in real economic growth is the yield spread between the Treasury 10-year security and fed funds. As shown in Chart 5, this spread has narrowed from 3.87 percentage points on June 14 to about 2.50 percentage points today. Although it is not unusual for this spread to narrow as the Fed begins to hike the funds rate, it is unusual *how* the spread narrowed. Usually, when the Fed begins to raise the funds rate, the spread narrows with the 10-year yield *rising* – but rising less than the funds rate. Typically, it is not until late in the Fed’s rate-increase cycle does the yield on the 10-year Treasury begin to fall. This time, however, *early* in the Fed’s rate-hike cycle, the yield on the 10-year Treasury started to fall *absolutely*, not just relative to the funds rate. As shown in Chart 6, the yield on the 10-year Treasury fell from a recent high of 4.89% on June 14 to a recent low of 4.00% on September 22.

Chart 5



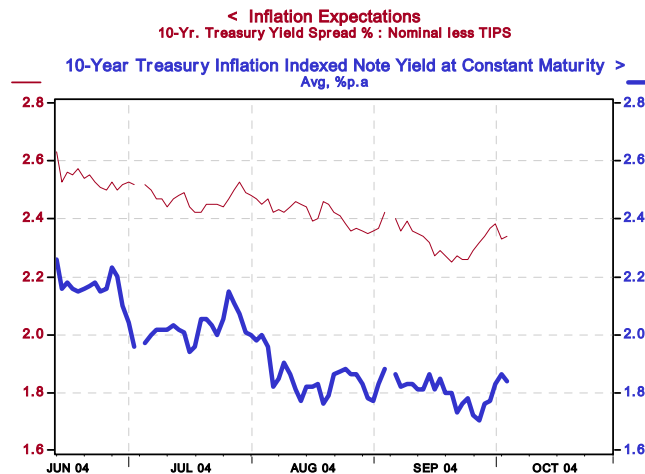
The information herein is based on sources which The Northern Trust Company believes to be reliable, but we cannot warrant its accuracy or completeness. Such information is subject to change and is not intended to influence your investment decisions.

Chart 6



This recent absolute decline in the Treasury 10-year yield reinforces our view that the pace of economic activity is set to moderate. What accounted for the decline in the nominal yield on the Treasury 10-year – lower inflation expectations or a lower real 10-year rate? The answer is both. As Chart 7 shows, between June 14 and September 29, 10-year inflation expectations narrowed from 2.63% to 2.32%, or 31 basis points. In that same period, the yield on the 10-year Treasury TIPS, or the real yield, fell from 2.26% to 1.70% -- 56 basis points. If the Fed has acquired a lot of credibility as an inflation fighter, it would not be so surprising that *nominal* bond yields would fall because of reduced inflation expectations as the Fed hiked the real funds rate. But why would *real* bond yields would be falling? We believe that it might be related to a declining expected real return on capital in the U.S., which would be a sign of slower economic growth ahead.

Chart 7



The information herein is based on sources which The Northern Trust Company believes to be reliable, but we cannot warrant its accuracy or completeness. Such information is subject to change and is not intended to influence your investment decisions.

In our September forecast update, we expected the Fed to hike rates by 25 basis points at both the September 21 and November 10 FOMC meetings. Then we believed that the Fed would pause in its interest rate increases until the end of June 2005. Of course, the Fed did raise the funds rate by 25 basis points on September 21. And we continue to believe that it will raise the funds rate another 25 basis points on November 10. But with the upward revision by the BEA to second-quarter real GDP growth and our upward revision to forecast third-quarter growth, we are less certain of a Fed rate-hike pause after the November 10 FOMC meeting. Yes, we are forecasting a significant deceleration in real GDP growth between the third and fourth quarters – 4.4% to 2.7%. And, as we mentioned above, inflation *expectations* have fallen. But given data-reporting lags and our belief that the Fed pays little attention to leading indicators, it may not be sure of the fourth-quarter slowdown by the December 14 FOMC meeting. For this reason, we are penciling in another 25 basis point funds rate increase at the Fed’s annual holiday gift-exchange meeting. Then the pause.

Paul L. Kasriel, Director of Economic Research (plk1@ntrs.com)
Asha G. Bangalore, Economist (agb3@ntrs.com)

THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
October 2004

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2003		2004				2005				Q4/Q4 change			annual change		
	03:3a	03:4a	04:1a	04:2a	04:3f	04:4f	05:1f	05:2f	05:3f	05:4f	2003a	2004f	2005f	2003a	2004f	2005f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	7.4	4.2	4.5	3.3	4.4	2.7	3.5	3.5	3.7	3.1	4.4	3.7	3.5	3.0	4.4	3.4
CONSUMPTION EXPENDITURES	5.0	3.6	4.1	1.6	4.2	2.5	3.0	3.2	3.0	2.7	3.8	3.1	3.0	3.3	3.5	3.0
BUSINESS INVESTMENT	15.7	11.0	4.2	12.5	12.4	6.3	6.4	5.8	7.0	5.9	9.4	8.8	6.3	3.3	10.0	7.4
RESIDENTIAL INVESTMENT	22.4	9.6	5.0	16.5	4.5	7.4	3.0	2.5	1.5	0.0	12.0	8.2	1.7	8.8	10.3	4.3
CHANGE IN INVENTORIES ('96 dlrs, bill)	-3.5	8.6	40.0	61.1	60.0	55.0	58.0	63.0	69.0	71.0				-0.8*	54.0*	65.2*
GOVERNMENT	0.1	1.6	2.5	2.2	3.0	3.0	2.5	2.5	2.5	2.5	2.2	2.7	2.5	2.8	2.4	2.6
NET EXPORTS (Cha.'96 dlrs, bill.)	-508.7	-528.3	-550.1	-580.3	-600.3	-615.3	-620.4	-625.2	-627.1	-626.6				-518.5*	-586.5*	-624.8*
FINAL SALES	6.8	4.0	3.3	2.7	4.5	2.9	3.4	3.4	3.4	3.5	4.5	3.3	3.3	3.1	3.9	3.4
NOMINAL GROSS DOMESTIC PRODUCT	8.8	5.7	7.4	6.6	6.1	4.8	6.2	6.2	6.4	5.9	6.2	6.2	6.2	4.9	6.6	6.0
GDP DEFLATOR - IMPLICIT (% change)	1.3	1.4	3.3	4.4	1.7	2.1	2.6	2.6	2.6	2.7	1.7	2.4	2.6	1.8	2.1	2.4
CPI (% Change, 1982-84 = 100)	2.3	0.7	3.6	4.7	2.0	2.4	2.9	2.9	2.9	3.0	1.9	3.2	2.9	2.3	2.6	2.8
CIVILIAN UNEMPLOYMENT RATE (avg.)	6.1	5.9	5.6	5.6	5.5	5.6	5.5	5.4	5.3	5.4				6.0*	5.6*	5.4*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

SPECIFIC INTEREST RATES	Quarterly Average										Annual Average		
	03:3a	03:4a	04:1a	04:2a	04:3a	04:4f	05:1f	05:2f	05:3f	05:4f	2003a	2004f	2005f
Bank Prime	4.00	4.00	4.00	4.00	4.42	4.95	5.25	5.25	5.65	6.20	4.12	4.34	5.59
Federal Funds	1.02	1.00	1.00	1.01	1.43	1.95	2.25	2.25	2.65	3.20	1.13	1.35	2.59
3-mo Neg. CD (Sec. Mkt)	1.07	1.10	1.05	1.25	1.70	2.10	2.30	2.35	2.80	3.35	1.15	1.53	2.70
3-mo. LIBOR	1.13	1.17	1.12	1.30	1.75	2.15	2.35	2.40	2.85	3.40	1.22	1.58	2.75
3-mo. Treasury Bill (discount basis)	0.93	0.92	0.92	1.08	1.49	1.80	2.00	2.05	2.50	3.05	1.01	1.32	2.40
2-yr. Treasury Note	1.68	1.86	1.69	2.45	2.56	2.70	2.80	2.85	3.35	3.60	1.65	2.35	3.15
5-yr. Treasury Note	3.14	3.25	2.99	3.72	3.51	3.50	3.60	3.60	3.95	4.05	2.97	3.43	3.80
10-yr. Treasury Note	4.23	4.29	4.02	4.60	4.30	4.30	4.30	4.50	4.80	5.00	4.02	4.31	4.65
Moody's AAA Corporate	5.70	5.66	5.46	5.93	5.64	5.65	5.65	5.75	5.90	6.10	5.67	5.67	5.85
Bond Buyer Index	4.92	4.76	4.52	4.98	4.71	4.70	4.70	4.80	4.95	5.10	4.75	4.73	4.89

a = actual
f = forecast

The information herein is based on sources which The Northern Trust Company believes to be reliable, but we cannot warrant its accuracy or completeness. Such information is subject to change and is not intended to influence your investment decisions.