



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

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

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

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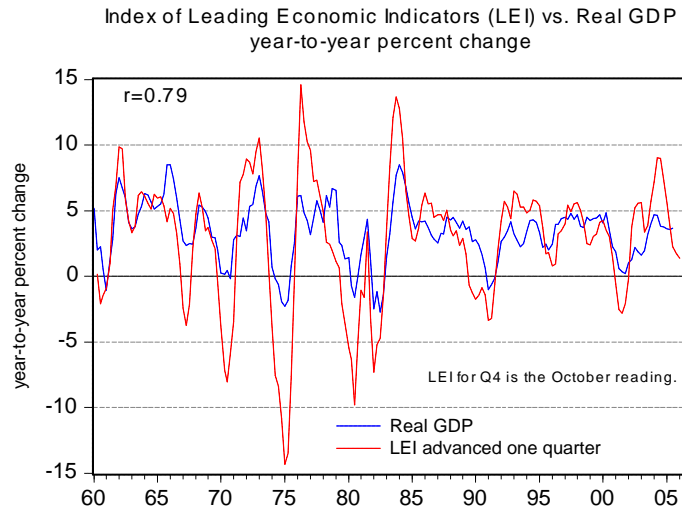
### **Why Wouldn't The Fed Want To Stop At 4-1/2%**

We continue to think that the Fed will pause in its interest rate hikes at 4-1/2%. The reasons for this are that economic growth will be slowing significantly, starting in the fourth quarter of this year, and that inflation will be moderating. Under these conditions and recognizing that recent Fed interest rate increases have not yet had their major impact on economic activity and inflation, why would the FOMC want to push the funds rate higher than 4-1/2%? Moreover, although outgoing Fed Chairman Greenspan has little practical use for the concept of a "neutral" fed funds rate, there is some evidence that incoming Fed Chairman Bernanke does. And the circumstantial evidence is that a 4-1/2% fed funds rate would be neutral, if not restrictive, under one of Bernanke's criteria of fed funds rate neutrality.

How can we say that economic growth is slowing after quarter-to-quarter annualized growth of 4.3% in real GDP in the third stanza? Because we recognize that a lot of that third-quarter strength occurred in July and petered out thereafter. Real personal consumption expenditures, which accounted for almost three percentage points of third-quarter real GDP growth, grew at an annualized pace of 4.2%. But all of that consumption growth occurred in July. Real consumer expenditures fell in both August and September and increased by only 0.1% in October. In order for real consumption expenditures to be just *flat* in the fourth quarter vs. the third, they would have to grow 0.5% in November and December. Although that is what we are forecasting, in all candor, we think that even flat real consumer spending in the fourth quarter is optimistic. With consumption accounting for about 70% of GDP, it is the closest thing to a slam dunk in economic forecasting that real GDP growth in the fourth quarter will fall well short of third-quarter growth. In our estimation, the shortfall in growth will be 1.3 percentage points.

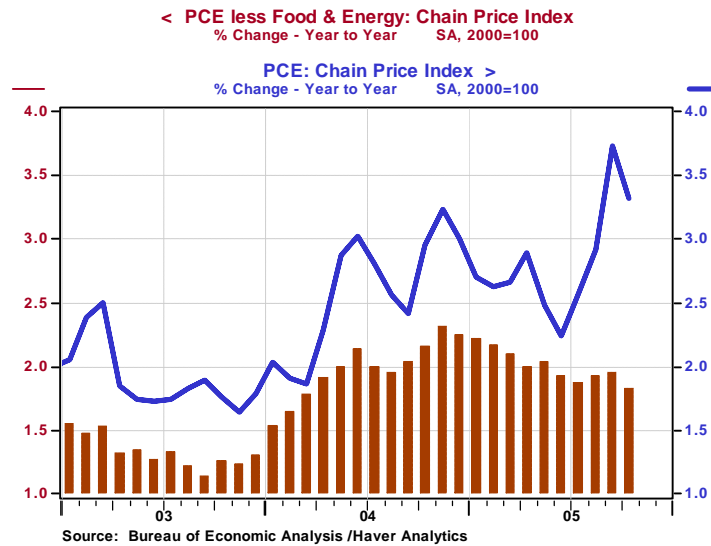
One quarter of slower growth, of course, could be just a temporary "soft patch." (In our view, Bernanke is a better economist than Greenspan but will fall short of his predecessor in phrasemaking.) But, as implied in Chart 1, the Conference Board's index of Leading Economic Indicators is signaling a sustained slowdown in real GDP growth going forward. On a Q4/Q4 basis, real GDP grew at 3.8% in 2004. We see it moderating to 3.6% in 2005 and to 3.0% in 2006. Over the past 60 years, the compound annualized growth in real GDP has been 3.4%. Making a conservative estimate of underlying productivity growth at 2-1/2% and assuming labor force growth of 1%, potential real GDP growth would be somewhere close to 3-1/2%. So our forecast of 3.0% real GDP growth in 2006 would put it below both its long-term trend and a conservative estimate of potential. This implies a rise in the unemployment rate in 2006. Why would the Fed want to keep raising the funds rate unless inflation were threatening to stay at its current elevated level?

Chart 1



We think inflation is more likely to trend lower in 2006 than trend higher. The year-over-year percent change in the Personal Consumption Expenditure (PCE) chain price index was 1.8% in October 2003. In October 2005, the year-over-year percent change in the PCE price index had risen to 3.3% -- an increase of 1.5 percentage points. The year-over-year percent increase in the PCE price index *excluding* its food and energy components, the "core" PCE price index, was 1.3%. In October of 2005, the core PCE price index had risen to 1.8% -- an increase of 0.5 percentage points. So, the spike in energy has been the primary contributor to the recent acceleration in consumer inflation. Moreover, as shown in Chart 2, core consumer inflation peaked in November 2004 at 2.3% and has been trending lower ever since.

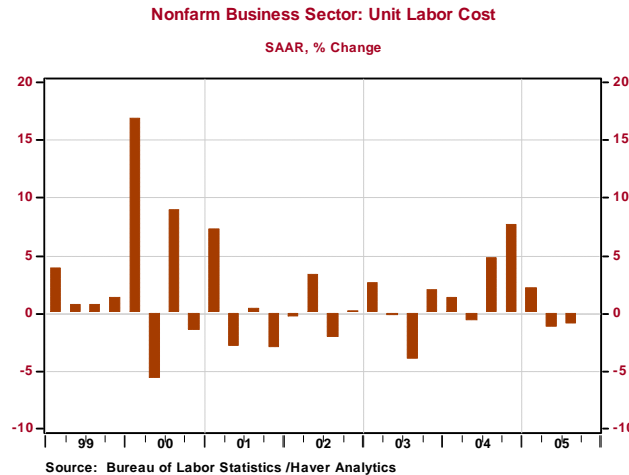
Chart 2



Rightly or wrongly, the Fed has placed an emphasis on labor costs as a source of inflationary pressures. Is the labor market signaling higher inflation ahead? Hardly. After flaring up in the second half of 2004, growth in unit labor costs has settled down in 2005, with costs actually contracting in both the second and third quarters, as shown in Chart 3. So, with energy prices stabilizing, at the least, with core consumer inflation already trending lower, with labor costs

behaving benignly and with aggregate demand in the process of moderating, which would relieve inflationary pressures, why would the Fed want to push the funds rate above 4-1/2%?

Chart 3



Why are we fixated on a 4-1/2% fed funds rate? Firstly, the Fed has embraced policy signaling. That is, the Fed now likes to tell market participants what it is planning to do with the funds rate one-to-two FOMC meetings ahead. Because the Fed has not yet signaled a halt in its interest rate increases, we have to assume that it intends to raise the fed funds rate at least another 25 to 50 basis points. Secondly, a 4-1/2% fed funds rate would be about at the long-term average relationship to core PCE inflation. That long-term average relationship is 250 basis points. At the current reading of core consumer inflation of 1.8%, 4-1/2% fed funds rate would be 270 basis points higher, but that would give the Fed a little anti-inflation insurance.

Lastly, and this is related to one of Bernanke's apparent criteria of neutrality, a 4-1/2% fed funds rate would likely result in flat or slightly inverted yield curve. As this is being written, the 10-year Treasury security is trading at a yield of 4.52%. If our forecast of economic activity and inflation is close to the mark, another 50 basis points of increase in the fed funds rate at the very least would leave the Treasury 10-year yield around 4-1/2% and could easily result in a decline in its yield. Over the past 50 years, the average spread between the Treasury 10-year yield and the fed funds rate has been about 90 basis points. Econometric analysis conducted by the late Robert Laurent, who did the seminal work on the yield curve as a leading indicator, suggested that a 90 basis point spread was consistent with 3.5% real GDP growth going forward. So, a zero spread or a slightly negative spread (i.e., an inverted yield curve) would, in our view, be on the restrictive side of neutral (hence our below-consensus forecast).

What does all this have to do with Bernanke's view of the neutral level of the fed funds rate? We would refer you to a passage from a speech given by Bernanke on March 8, 2005:

**The funds rate will have reached an appropriate and sustainable level when, first, the outlook is consistent with the Committee's economic goals and, second, the slope of the term structure of interest rates is approximately normal, as best as can be determined. With this definition in mind, one can search for indications of where the "neutral" funds rate is likely to be at a given point in time.** [emphasis added]

This statement by Bernanke shows that on March 8, at least, he, unlike his predecessor Greenspan, found the shape of the yield curve a useful leading indicator of economic activity. If Bernanke still believes this on March 28, 2006, the first FOMC meeting he will chair, and if the yield curve is flat, as we think it will be, then Bernanke is likely to conclude that a 4-1/2% fed funds rate is *at least* neutral and maybe even a little restrictive.

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

**THE NORTHERN TRUST COMPANY**  
**ECONOMIC RESEARCH DEPARTMENT**  
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**SELECTED BUSINESS INDICATORS**

**Table 1 US GDP, Inflation, and Unemployment Rate**

	2005				2006				Q4-to-Q4 change			Annual change		
	05:1a	05:2a	05:3a	05:4f	06:1a	06:2f	06:3f	06:4f	2004a	2005f	2006f	2004a	2005f	2006f
<b>REAL GROSS DOMESTIC PRODUCT</b> (% change from prior quarter )	3.8	3.3	4.3	3.0	3.3	3.3	2.7	2.7	3.8	3.6	3.0	4.2	3.6	3.3
CONSUMPTION EXPENDITURES	3.5	3.4	4.2	0.0	2.6	2.4	2.6	2.5	3.8	2.8	2.5	3.9	3.5	2.3
BUSINESS INVESTMENT	5.7	8.8	8.8	17.1	5.0	6.0	4.7	3.8	10.9	10.0	4.9	9.4	9.5	7.9
RESIDENTIAL INVESTMENT	9.5	10.8	8.4	4.0	5.0	5.0	-1.5	-1.0	6.6	8.1	1.8	10.3	7.4	4.3
CHANGE IN INVENTORIES ('00 dlrs, bill)	58.2	-1.7	-13.4	6.5	9.1	11.1	20.1	16.1				52.0*	12.4*	14.1*
GOVERNMENT	1.9	2.5	3.2	2.9	4.0	4.1	0.6	2.4	2.1	2.6	2.8	2.2	2.1	3.1
NET EXPORTS ('00 dlrs, bill.)	-645.4	-614.2	-621.3	-635.4	-640.3	-643.1	-643.6	-635.4				-601.3*	-629.1*	-640.6*
FINAL SALES	3.5	5.6	4.7	2.3	3.2	3.3	2.4	2.8	3.6	4.0	0.0	3.9	4.0	3.3
NOMINAL GROSS DOMESTIC PRODUCT	7.0	6.0	7.4	8.1	6.3	6.3	4.9	4.9	6.8	7.1	5.6	7.0	6.6	6.5
GDP DEFLATOR - IMPLICIT (% change)	3.0	2.6	3.0	5.0	2.9	2.9	2.1	2.1	2.9	3.4	2.5	2.6	2.8	3.1
CPI (% Change, 1982-84 = 100)	2.4	4.2	5.1	5.3	3.2	3.2	2.4	2.4	3.4	4.2	2.8	2.7	3.5	3.7
CIVILIAN UNEMPLOYMENT RATE (avg.)	5.3	5.1	5.0	5.0	5.1	5.1	5.2	5.4				5.5*	5.1*	5.2*

a=actual

f=forecast

\*=annual average

**Table 2 Outlook for Interest Rates**

SPECIFIC INTEREST RATES	Quarterly Average								Annual Average		
	05:1a	05:2a	05:3a	05:4f	06:1f	06:2f	06:3f	06:4f	2004a	2005f	2006f
Bank Prime	5.44	5.91	6.43	6.95	7.40	7.50	7.45	7.00	4.34	6.18	7.34
Federal Funds	2.47	2.94	3.46	3.95	4.40	4.50	4.45	4.00	1.35	3.21	4.34
3-mo Neg. CD (Sec. Mkt)	2.78	3.23	3.74	4.30	4.50	4.55	4.35	3.85	1.56	3.51	4.31
3-mo. LIBOR	2.84	3.28	3.77	4.30	4.55	4.60	4.40	3.90	1.62	3.55	4.36
3-mo. Treasury Bill (discount basis)	2.54	2.86	3.36	3.85	4.05	4.10	3.90	3.40	1.37	3.15	3.86
2-yr. Treasury Note	3.44	3.64	3.95	4.40	4.50	4.45	4.30	4.00	2.38	3.86	4.31
5-yr. Treasury Note	3.88	3.87	4.04	4.40	4.50	4.45	4.30	4.00	3.43	4.05	4.31
10-yr. Treasury Note	4.30	4.16	4.21	4.50	4.60	4.55	4.35	4.05	4.04	4.29	4.39
Moody's AAA Corporate	5.32	5.15	5.09	5.40	5.50	5.45	5.30	5.05	5.63	5.24	5.33
Bond Buyer Index	4.44	4.33	4.31	4.55	4.65	4.60	4.45	4.20	4.68	4.41	4.48

a = actual

f = forecast

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