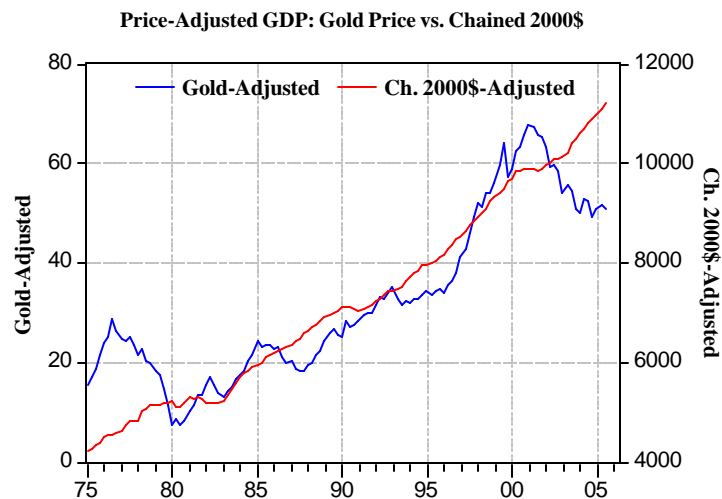




Gold-Price Adjusted, We're Still In A Recession

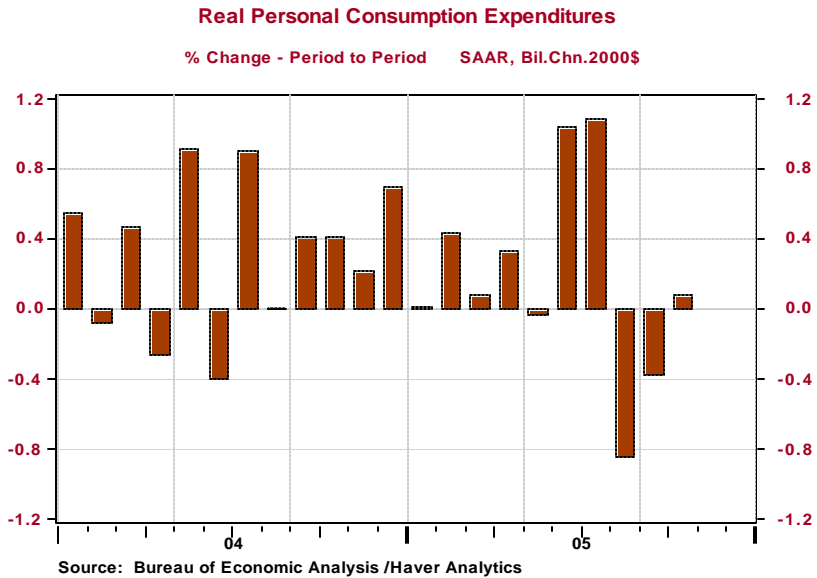
On the op-ed page of the December 1 edition of the *WSJ*, Michael Darda argues that the proper deflator when discussing *real* economic variables is the price of gold. I have great sympathy for his argument. And, as the chart below shows, if we use the price of gold as the deflator rather than the Commerce Department's deflator of chained 2000 dollars, it looks as though the U.S. economy still is in a recession despite the touted supply-side tax cuts we have had since 2001. Thanks for the tip, Mr. Darda!



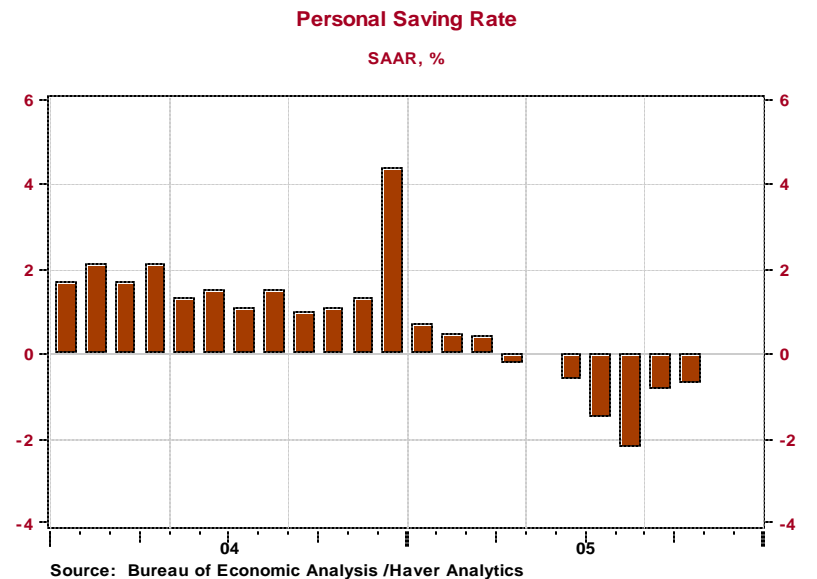
Paul Kasriel (plk1@ntrs.com)

Q4 Consumer Spending – A Flat Performance Is An Optimistic Estimate

Nominal consumer spending increased 0.2% in October, following a 0.5% gain in the prior month. However, inflation adjusted consumer spending increased only 0.1% in October, after declining in both September (-0.4%) and August (-0.9%). The October reading sets up a weak trajectory for the fourth quarter. Inflation adjusted consumer spending will have to average close to 0.5% in the November-December period to yield a flat reading of inflation adjusted consumer spending in the fourth quarter. It will be a tall order to expect robust consumer spending in the fourth quarter. The final tally of auto sales for November is expected a little after this edition of comments is published today. Given the renewal of incentives in November for auto purchases, auto sales numbers could provide a lift.



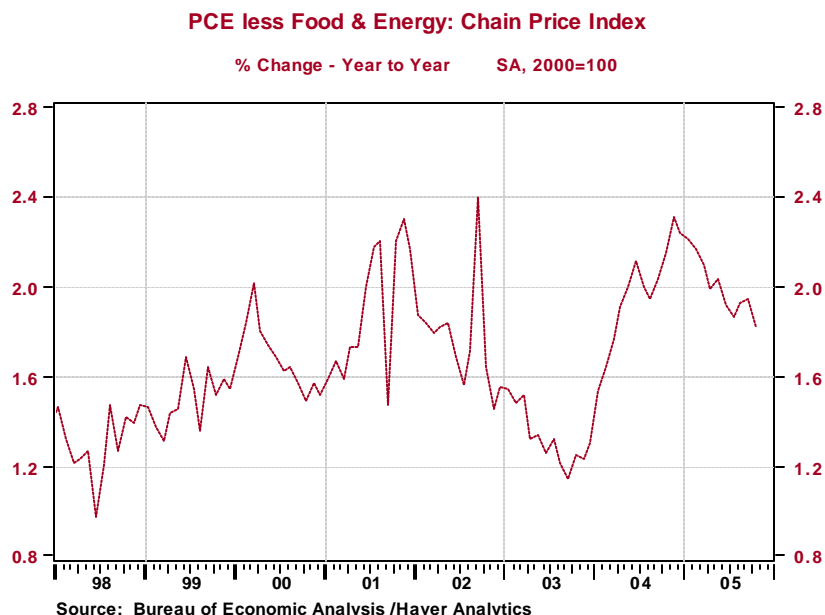
Personal saving as a percentage of disposable personal income was a negative 0.7% during October, compared with a negative 0.8% in September. Negative personal saving occurs when personal outlays exceed disposable personal income. Saving from current income may be near zero or negative when outlays are financed by borrowing (inclusive of borrowing financed through credit cards or home equity loans), by selling investments or other assets, or by using savings from previous periods. With the exception of a steady reading in May, personal saving as percent of disposable income has been negative during each month in the April-October period.



The 0.4% increase in personal income in October follows a 1.7% jump in September and a 1.0% drop in August. According to the BEA, personal income data for the August-October period contain distortions that are related to the impact from Hurricanes Katrina, Rita, and Wilma. Rental income and proprietors' income were reduced at annual rate of about \$10 billion in October, by about \$5 billion in September, and by about \$240 billion in August to reflect the uninsured losses of residential and business property.

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The personal consumption expenditure deflator rose 1.8% on a year-to-year basis in October vs. a 1.95% increase in September. Essentially, the FOMC should be less concerned about inflation because its favorite inflation measure signals a benign situation.



ISM Manufacturing Survey Suggests Moderation In Pace of Activity

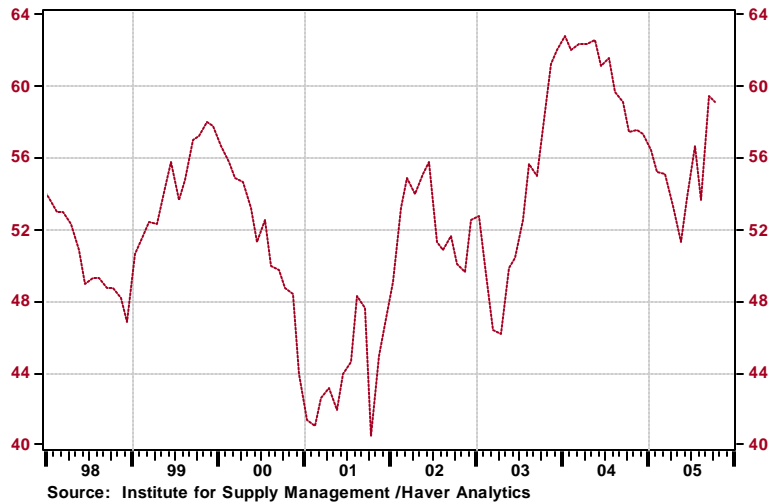
The November ISM manufacturing survey edged down to 58.1 from 59.1 in October. The main message is that the factory sector grew during November but at a slower pace than October. Indexes tracking production and new orders dropped but they continue to hold over 50.0, denoting an expansion in activity. However, a reduction in levels of these indexes in November point to a deceleration in the pace of operation. The pickup in the employment index implies increased hiring in November vs. October, the factory payrolls numbers of November (to be published tomorrow) will confirm or refute the signal from this reading. The 10-point drop in the price index reflects a reduction in oil prices.

ISM Manufacturing Survey – November 2005

	<u>Jul-2005</u>	<u>Aug-2005</u>	<u>Sep-2005</u>	<u>Oct-2005</u>	<u>Nov-05</u>
Composite Index	56.6	53.6	59.4	59.1	58.1
New Orders	60.6	56.4	63.8	61.7	59.8
Production	61.2	55.9	63.1	62.0	60.6
Employment	53.2	52.6	53.1	55.0	56.6
Vendor Deliveries	51.8	50.5	59.3	61.7	58.3
Inventories	47.5	45.7	49.6	48.1	49.3
Prices	48.5	62.5	78.0	84.0	74.0
Backlog of Orders	49.0	50.5	55.0	55.5	53.0
New Export Orders	55.9	53.3	56.9	54.8	59.2
Imports	54.7	53.4	53.4	58.2	54.1

ISM: Mfg: PMI Composite Index

SA, 50+ = Econ Expand

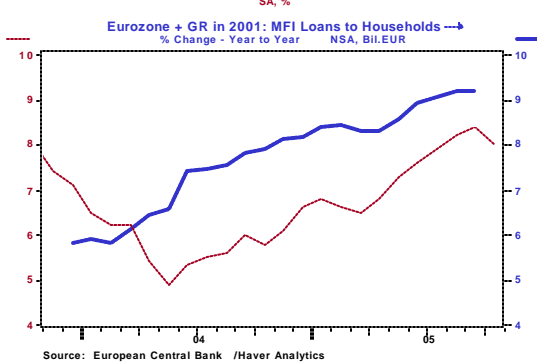


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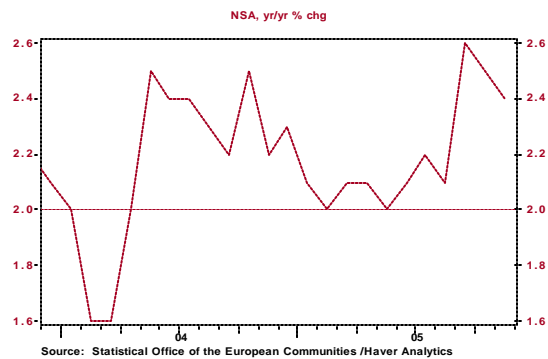
ECB Rate Hikes: Ripple Effects Felt To The East

Today's 25bp interest rate hike from the ECB had been so well flagged by Governor Trichet and others that, despite being the first Euro-zone rate change in two and a half years, and the first rate increase in five, the markets didn't even blink. Indeed, one could be forgiven for wondering if anyone really cares about the ECB's monetary stance. Let's face it, the US Fed is still the only game in town as far as global markets are concerned. Even the outlook for the euro is more dependent on whether US interest rates continue to rise than on ECB moves per se. There is some conjecture about the pace of the ECB's newly-begun tightening cycle, but for now the markets seem to be accepting Trichet's comments about a gradual shift at face value. Expectations are for, at most, three more 25bp rate hikes from the ECB over the coming 12 months – although, with the amount of liquidity currently sloshing around in the Euro-zone, and inflation persistently above the 2% target, that assumption could well prove overly sanguine.

← Euro-zone + GR in 2001: ECB Money Supply, M3: Growth From Year Ago



Euro-zone + GR in 2001: Consumer Price Index (Flash Estimate)



However, there is one group that cares deeply about the ECB's shift in stance, and about the pace of future rate hikes, and that's the ten newer members of the EU. None of them are yet members of the Euro-zone, but seven have their currencies closely tied to the euro through the so-called ERM-2

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mechanism (the two-year Euro-zone waiting room). The greatest ripple effects from rising Euro-zone interest rates are likely to be felt by the three new EU members still outside the ERM-2 – the Czech Republic, Hungary, and Poland.

The impact on these three will be all the greater thanks to Slovakia's joining the ERM-2 late last week – a full year earlier than expected – in a bid to shield the Slovak crown from regional volatility and from any adverse effects from next year's elections. Bratislava's move gave an initial boost to the Czech crown, the Polish zloty, and the Hungarian forint, but this has already started to fade. Indeed, over the coming months investors are likely to distinguish more carefully between those currencies that are likely to adopt the euro over the next couple of years, and those still on the outside looking in.

Among the seven ERM-2 members, Estonia, Lithuania, and Slovenia aim to adopt the euro in 2007; Cyprus, Malta, and Latvia are shooting for 2008; and Slovakia officially is aiming for the beginning of 2009, although a 2008 date is feasible. These seven must keep a lid on inflation and simultaneously keep their currencies in a tight trading range against the euro. All but Slovakia have long been used to keeping their currencies closely aligned with the euro (in the case of the three Baltic nations, through a formal currency board arrangement) so adjusting to a new interest rate environment should pose no challenge.

The Czech Republic could well join the ERM-2 in late 2006 (rather than the late-2007 target it had previously anticipated). But, Hungary and Poland are far behind. In a world where ECB interest rates are in a rising trend, even a gentle one, this differentiation will become even more apparent.

The National Bank of Slovakia (NBS) is already in a hawkish mood, having warned in recent months that monetary conditions were getting too relaxed for the rapidly-growing economy. The jump in the crown in recent days effectively tightened monetary conditions enough to allow the NBS to keep its two-week repo rate at 3.0% at Tuesday's meeting (unchanged now for nine months), but the bank is likely to match the ECB's move within the next two months.

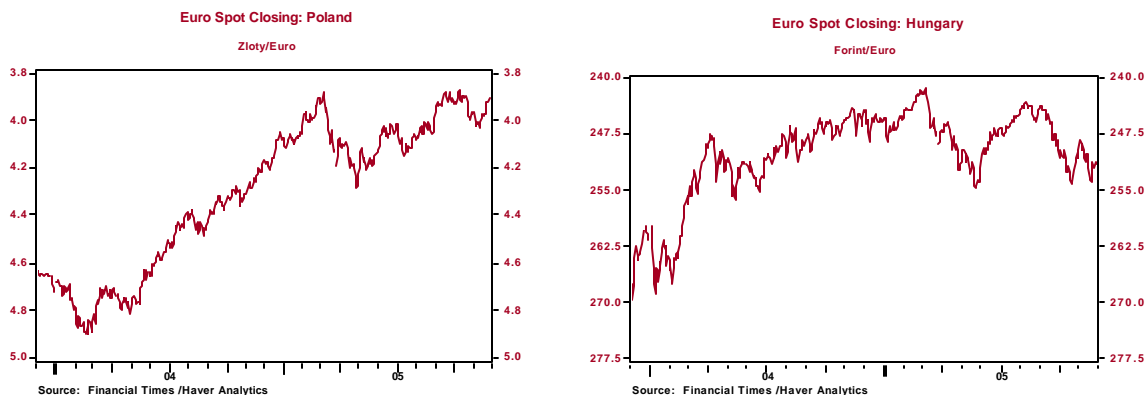
With headline inflation jumping sharply upward this year, the Czech National Bank (CNB) has already shifted to a tightening mode, raising its open market rate by 25bp to 2.00% in October, then pausing in November. The CNB is also anxious to avoid an interest rate differential with the Euro-zone, lest this trigger volatility in the crown. Currency volatility tends to filter quickly into inflation in the small and open Czech economy. So, another 25bp increase is likely at the CNB's December 22 meeting.

The pictures in Hungary and Poland, the biggest of the expansion ten countries, are more complicated. Budapest and Warsaw are starting to slip back in the economic restructuring and euro-convergence race. Retaining international investor interest is vitally important for these two, given their sizeable fiscal and current account deficits – particularly Hungary, which has just been warned by the European Commission to get its fiscal house in order, and which runs an annual current account deficit that's close to 10% of GDP. Over the course of 2006 an ECB tightening cycle, even a very gradual one, will add to the pressure on these two to continue to attract investors.

The National Bank of Poland (NBP) has cut interest rates by 200bp this year, but has left its main policy rate at 4.50% since August. The bank stood pat again yesterday, with evidence building that the economy is gradually accelerating. Still, at 3.7% year-over-year, Q3 GDP growth still lags that of its neighbors (6.2% in Slovakia, an estimated 5.0% in the Czech Republic, 4.5% in Hungary), and with inflation contained for now (1.6% in October), the NBP could do with some monetary room to maneuver. However, with ECB rates headed upward, and Slovakia and the Czech Republic following suit, Monetary Policy Council members have acknowledged recently that their room for maneuver "has narrowed to a minimum." An economy-stimulating rate cut could backfire by triggering an exodus of investors; a zloty-boosting rate hike could strangle the nascent domestic recovery.

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The situation in Hungary is even trickier. The National Bank of Hungary (NBH) has warned repeatedly in recent months that the rising fiscal deficit – expected to exceed 7.0% of GDP this year – combined with a hefty current account shortfall, could undermine the forint and jeopardize macroeconomic stability. Having slashed interest rates by a total of 6.5 percentage points since March 2004, the NBH has left its main policy rate at 6.0% since September. At this Monday's policy meeting the bank warned again that this recent stability was misleading, pointing out that "external conditions remain very volatile" and that an ECB rate hike "would be a significant event" for Hungary.



While the zloty's rising trend against the euro appears intact for now, there are signs that the forint is starting to weaken – a trend that is likely to be exacerbated by a more hawkish ECB. If the forint falls below HUF260 the NBH may feel it has no choice but to start raising interest rates again, even though headline inflation is expected to remain well below the bank's 3.0% medium-term target.

Finally, with rising interest rates making euro-denominated assets more attractive, the ECB's policy shift will also have ripple effects farther afield in EU-hopefuls Bulgaria and Romania, and longer-term hopefuls like Croatia. The closer Bulgaria gets to the Euro-zone, figuratively speaking, the more attractive it looks to investors. If Romania's accession date gets delayed to 2008 (as seems increasingly likely) then it becomes proportionately less attractive.

Given how far the ripples from an ECB policy shift now spread, it's no surprise that Governor Trichet signaled the change so clearly. Policy makers and investors in Warsaw, Prague, and Budapest – and even in Zagreb – should hope that he continues to do so.

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