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

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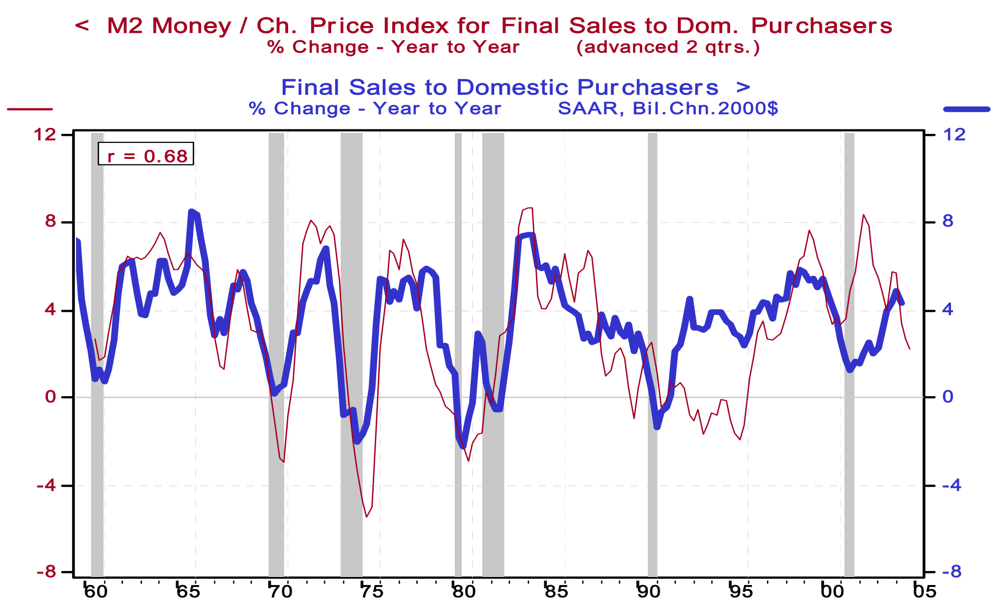
Phase One Of Fed Tightening Is Nearing An End

Although the U.S. economy is by no means on the edge of recession, its growth has moderated sooner than we had anticipated. For that reason, we have significantly revised our Fed policy outlook. We now are forecasting that the Fed will take a hiatus from raising the funds rate after two more 25 basis point hikes – one at the September 21 FOMC meeting and another one (51%-49% probability split) at the November 10 meeting. After that, the Fed is expected to hold the funds rate steady until the end of June 2005. In our August forecast, we had the funds rate at 2-1/4% at the end of this December and at 3-1/4% at the end of June 2005. The latest year-over-year-change in the "core" price index of consumer personal expenditures – the Fed's favored inflation measure – is 1-1/2%. We do not see it moving much from this magnitude between now and year-end. The Fed feels uncomfortable at this stage of the cycle without some positive spread between the funds rate and this measure of inflation. Over the past 44 years, this spread has averaged about 250 basis points, which would imply a fed funds rate of 4% under current conditions. The Fed has no intention of establishing a 250 basis point spread anytime soon. Rather, it will be content to get the funds rate 25 basis points to 50 basis points above its inflation measure, and then pause.

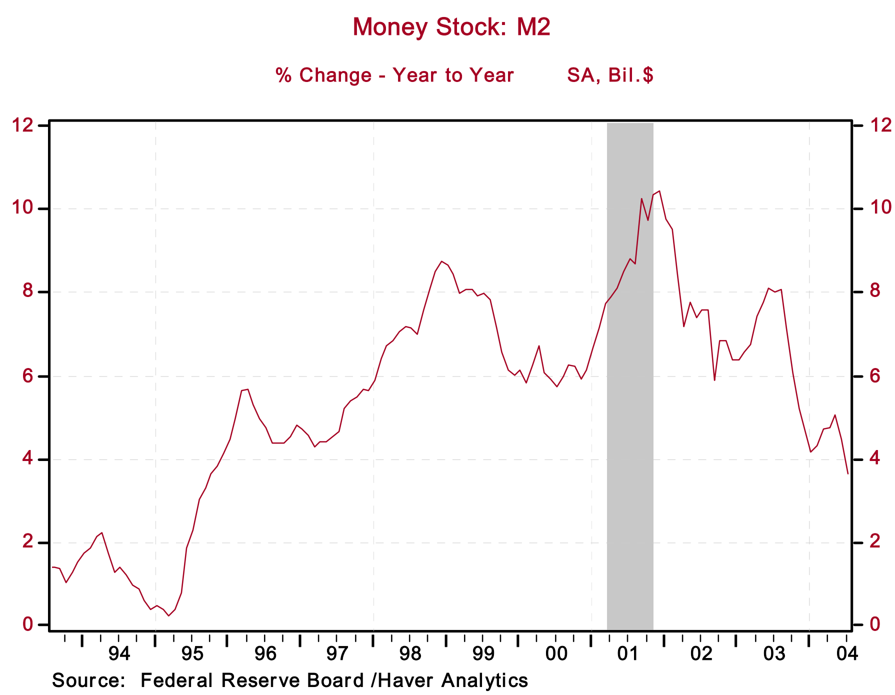
Chart 1



Why the change in our forecast? Chart 1, below, speaks volumes. We simply can no longer ignore the message being sent by the price-adjusted M2 money supply. On a year-over-year basis, growth in the M2 money supply deflated by the price index for domestic final demand has tailed off to just 2.2% in the second quarter of this year -- the lowest since 1995. Although real M2 growth may not be as good a leading indicator of domestic demand as it used to be in terms of point estimates, it still is a very good leading indicator of changes in growth trends of domestic demand. And the signal being sent by real M2 is loud and clear – growth in real domestic demand will be slowing over the next couple of quarters.

Weaker real M2 growth could be occurring because inflation is rising faster. And, in fact, inflation has picked up this year. But what is more telling to us about the potential for weaker domestic demand ahead is the slowdown in *nominal* M2 growth. Chart 2 shows that in July, the year-over-year percent change in nominal M2 had slipped to 3.6% -- again, the slowest since 1995.

Chart 2



This slower growth in nominal M2 suggests a weakening in nominal credit demand. One area where credit demand apparently has slowed is residential mortgages. Chart 3 shows that versus a year ago, growth in mortgage applications for the purchase of a home (rather than for refinancing) has fallen significantly. It is instructive in looking at how much the housing-affordability index plunged in recent months in the face of only an 84 basis point increase in 30-year fixed-rate mortgage interest rates between March and June (see Chart 4). With mortgage rates having fallen again, we could expect a stronger rebound in housing affordability and, thus, mortgage-credit demand.

Chart 3

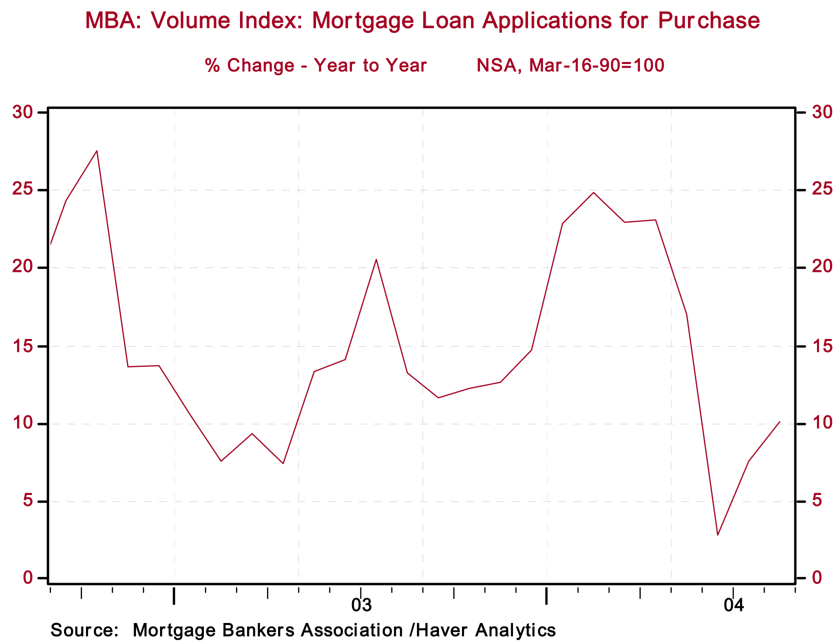
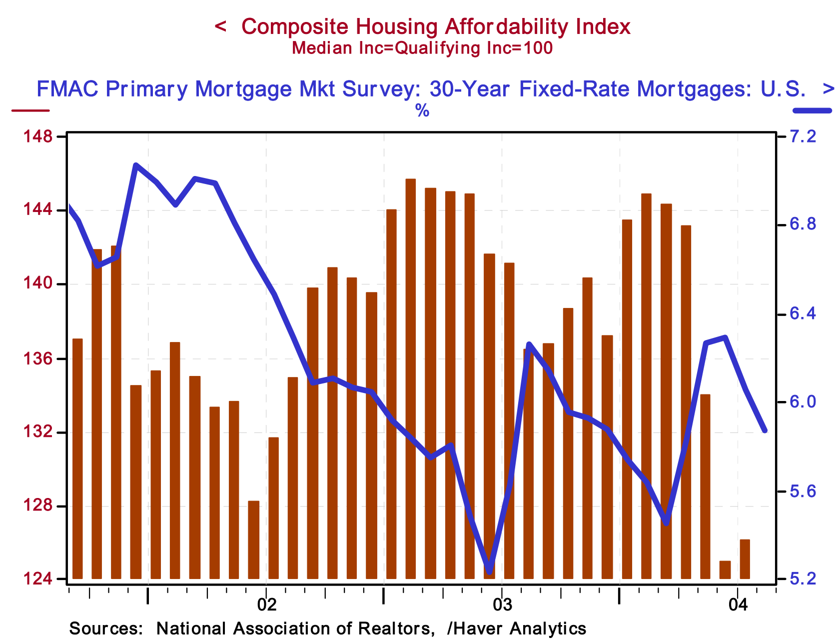
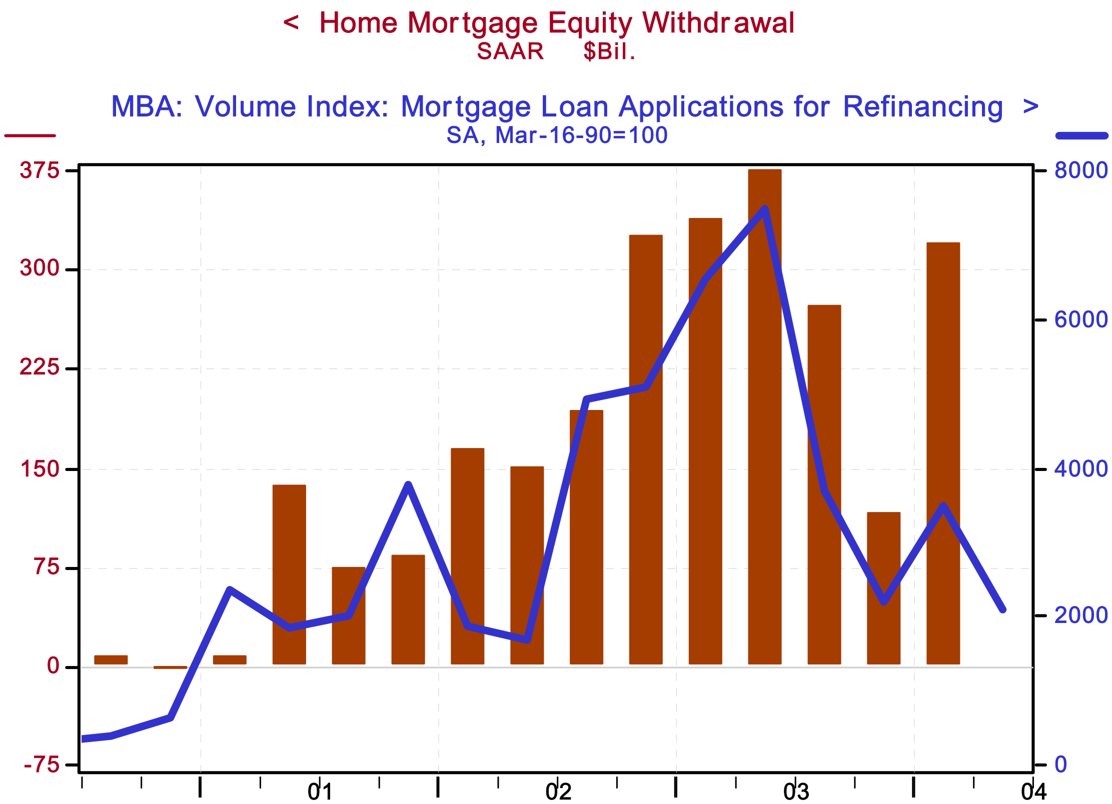


Chart 4



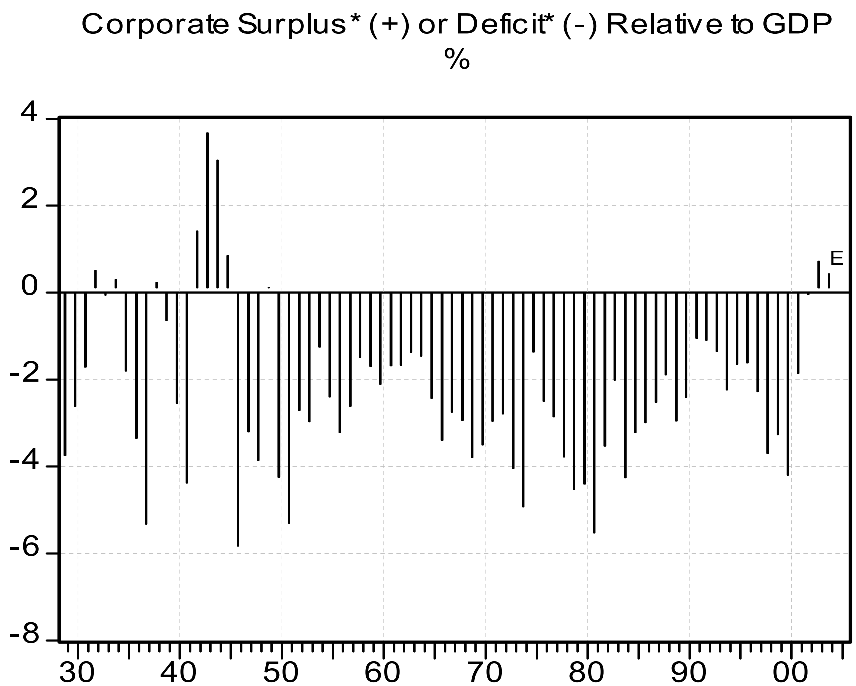
The rise in mortgage rates in the second quarter led to a sharp reduction in mortgage refinancing applications (see Chart 5). It is "cash-out" mortgage refinancing that leads to an increased demand for credit. The Fed has not published second quarter data necessary to calculate mortgage equity withdrawal, but given the decline in refinancing applications in the second quarter, it is highly likely that mortgage equity withdrawal in the second quarter dropped from its first-quarter annual rate of over $300 billion (see Chart 5). Again, this slowing in the demand for credit would go hand in hand with the slowing in the nominal money supply. It also highlights how dependent the economy is on ultra-low interest rates.

Chart 5



Why are not businesses borrowing more? The pat answer is that they are so flush with cash that they do not need to. Chart 6 shows corporations' financial surpluses or deficits as a percent of nominal GDP since 1929. Typically, corporations are net demanders of funds, not net suppliers of funds. But in 2003 and in the first half of 2004, corporations have been running surpluses for the first time since World War II. With real interest rate now low and with price-to-earnings ratios on corporate equity high, the implication is that the cost of capital to corporations is low. So, why is Corporate America a net lender of funds to the household and government sectors of the economy? Our working hypothesis is that the expected return on capital in the U.S. is very low. Despite relatively low interest rates, then, money supply growth might be trending lower, in part, because the demand for credit from businesses is paltry due to a low expected return on capital.

Chart 6

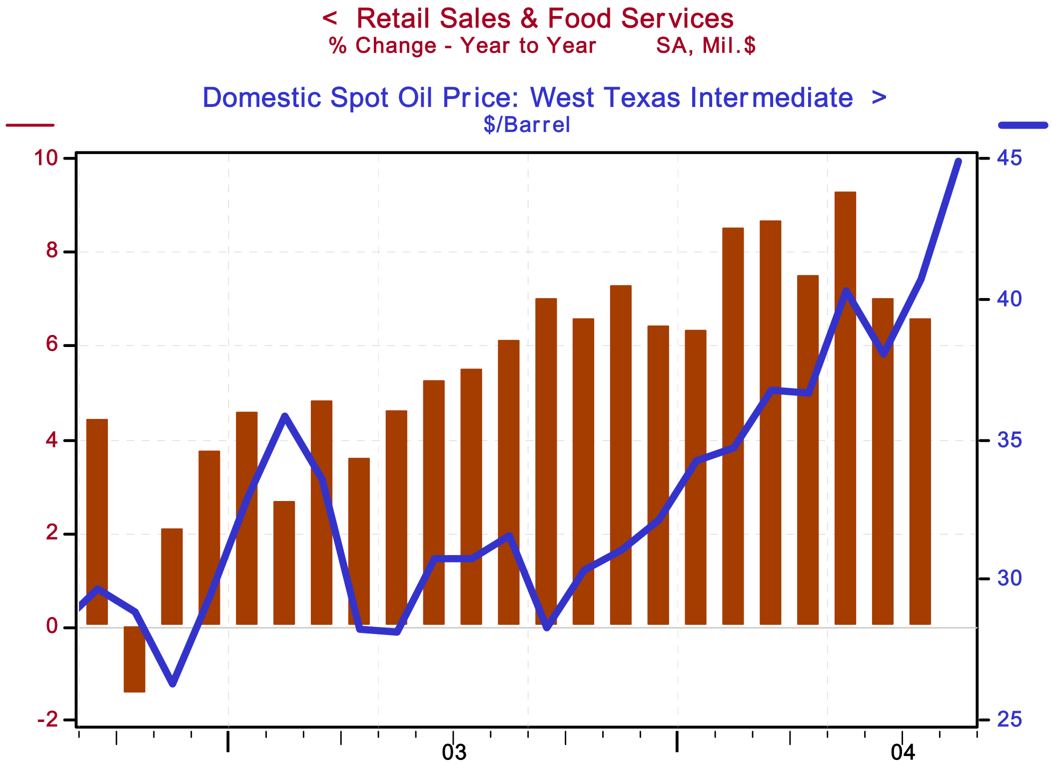


* Cash flow minus sum of nonresidential fixed investment expenditures and change in business inventories

E= Average of Q1 and Q2 in 2004

We expect real GDP growth in the third quarter to accelerate to 3.5% annualized from the second quarter's 2.8% rate. However, we are forecasting another deceleration to 3.2% in the fourth quarter as GM and Ford cut production to work off their bloated motor vehicle inventories. In the four quarters ended Q1:2004, real GDP grew an annualized 5.0%. Given the second quarter's 2.8% growth, we are forecasting annualized real GDP growth of 3.2% in the three quarters ended Q4:2004. The conventional wisdom is that this "soft patch" is the result of higher energy prices negatively affecting domestic consumer *demand*. Although we believe that higher energy prices might have had some negative implications for real economic growth emanating from supply-side constraints, we do not buy the demand-side arguments. As Chart 7 shows, *nominal* retail sales growth has slowed in the past two months. Higher energy prices would not be expected to lead to weaker *nominal* activity. If households spent more of their nominal income on energy products, leaving less to spend on non-energy products, their *nominal* purchases would *not* fall, just their *real* purchases.

Chart 7



Sources: , Wall Street Journal /Haver Analytics

No, we are of the opinion that this is an economy that needs a steady diet of policy "steroids" administered to it or it gets flabby in a hurry. We already mentioned that businesses are not keen to splurge because of a low expected return on capital. Households, on the other hand, will spend every tax cut given to them and darned near every additional dollar of increased home equity they can borrow against at low interest rates. Well, as Chart 8 shows, the initial stimulus from recent years' tax cuts is over. Whereas corporations atypically are now running net surpluses, households are now atypically running net deficits, as shown in Chart 9 – the largest net deficits in 76 years! We showed you how housing affordability plunged with a small increase in mortgage interest rates. Chart 10 shows that households' required monthly payments relative to after-tax income are the highest in their 24-year history at the commencement of Fed interest rate hikes. Households may finally be "borrowed up." That is, they may not be able to borrow that extra dollar to spend in the face of higher interest rate on that extra dollar of borrowing. To repeat, strong demand growth in this economy is dependent on the continued supply of ultra-cheap credit. Once the Fed starts to raise the price of credit, household demand slows. This is why we expect the Fed to pause in its interest rate hikes at a funds rate level of 2% -- or perhaps even 1-3/4%. To keep raising rates beyond this level would risk a collapse in household spending.

Chart 8

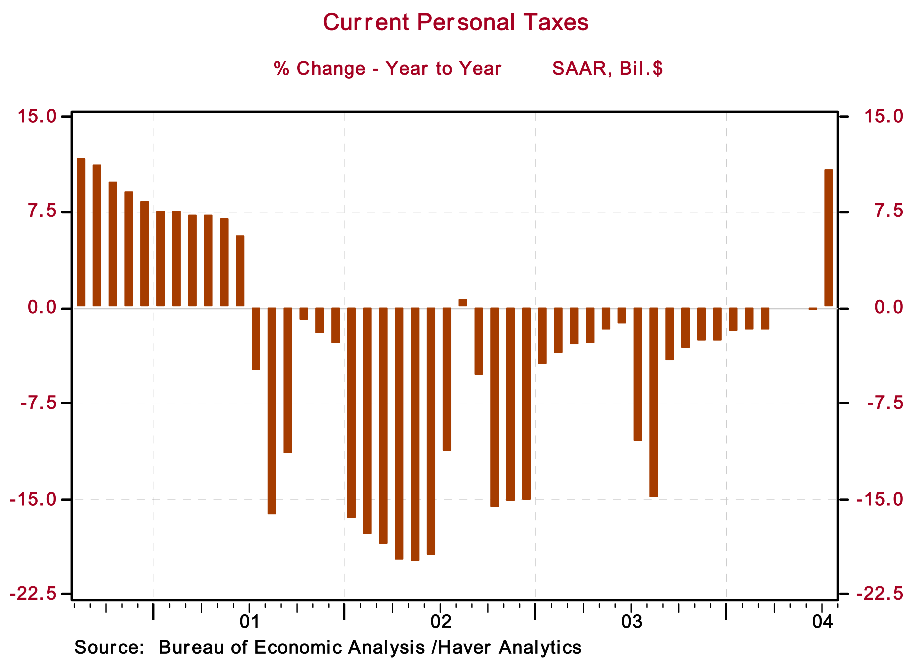
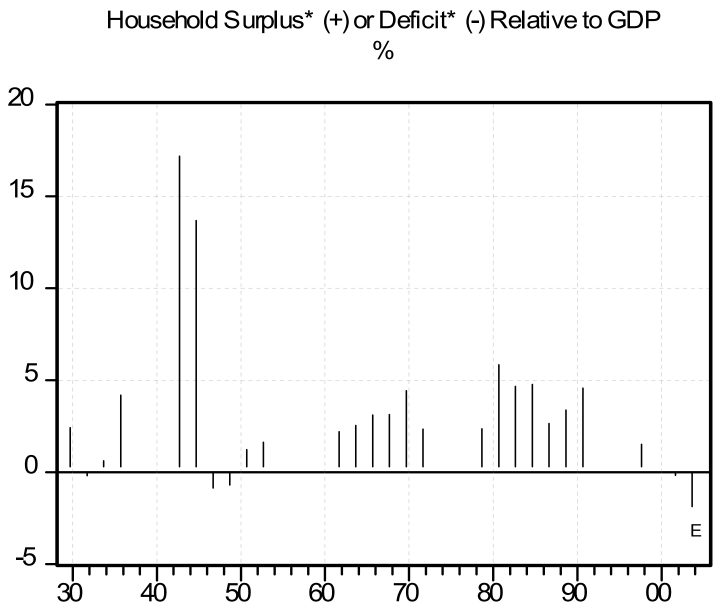


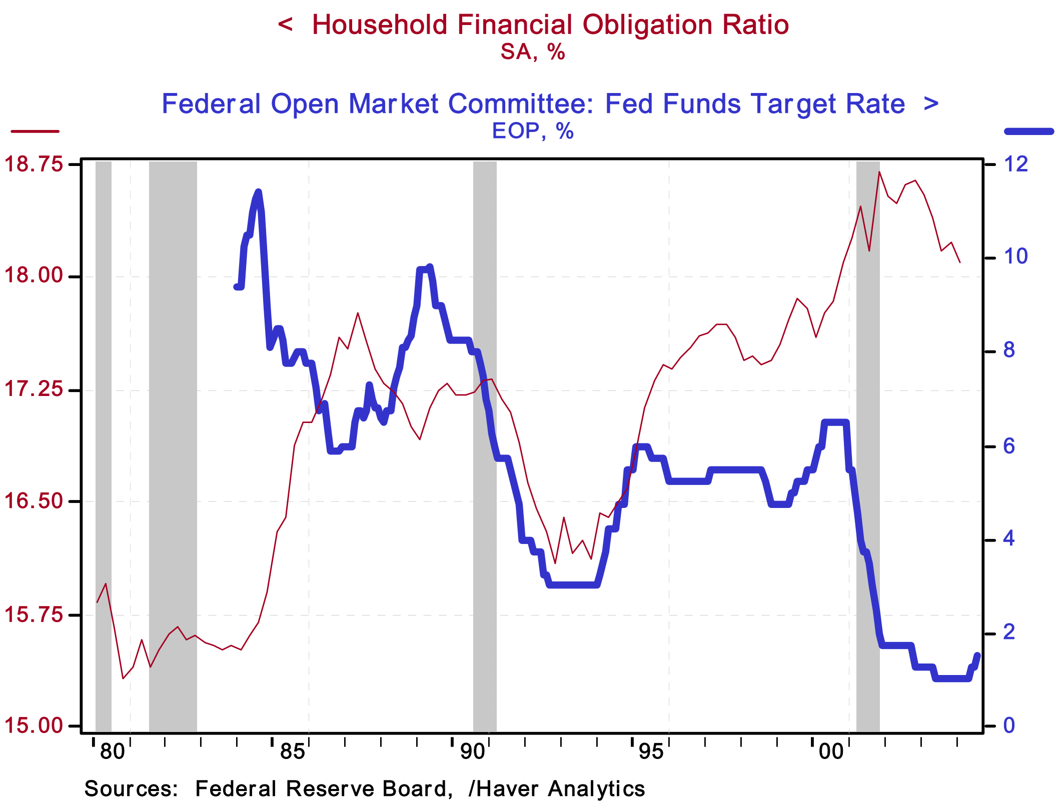
Chart 9



* Disposable Personal Income minus sum of expenditures on Consumption and Residential Investment

E= average of Q1 and Q2 in 2004

Chart 10



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

THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
September 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	7.4	4.2	4.5	2.8	3.5	3.2	3.5	3.5	3.7	3.1	4.4	3.5	3.4	3.0	4.2	3.4
(% change from prior quarter)																
CONSUMPTION EXPENDITURES	5.0	3.6	4.1	1.6	2.7	2.7	3.0	3.2	3.0	2.7	3.8	2.8	3.0	3.3	3.4	2.8
BUSINESS INVESTMENT	15.7	11.0	4.2	12.1	11.2	6.1	6.4	5.8	7.0	5.9	9.4	8.3	6.3	3.3	9.8	7.2
RESIDENTIAL INVESTMENT	22.4	9.6	5.0	14.7	2.9	3.0	3.0	2.5	1.5	0.0	12.0	6.3	1.7	8.8	9.5	3.2
CHANGE IN INVENTORIES ('96 dlrs, bill)	-3.5	8.6	40.0	57.7	65.8	70.8	73.8	78.8	84.8	86.8				-0.8*	58.6*	81.0*
GOVERNMENT	0.1	1.6	2.5	2.4	3.0	3.3	2.5	2.5	2.5	2.5	2.2	2.8	2.5	2.8	2.4	2.7
NET EXPORTS (Cha.'96 dlrs, bill.)	-508.7	-528.3	-550.1	-588.7	-606.7	-616.2	-621.3	-626.1	-628.1	-627.6				-518.5*	-590.4*	-625.8*
FINAL SALES	6.8	4.0	3.3	2.3	3.3	3.1	3.4	3.4	3.4	3.5	4.5	2.9	3.3	3.1	3.7	3.2
NOMINAL GROSS DOMESTIC PRODUCT	8.8	5.7	7.4	6.1	5.5	5.5	6.2	6.2	6.4	5.9	6.2	6.1	6.2	4.9	6.5	6.0
GDP DEFLATOR - IMPLICIT (% change)	1.3	1.4	3.3	4.4	1.9	2.2	2.6	2.6	2.6	2.7	1.7	2.5	2.6	1.8	2.2	2.5
CPI (% Change, 1982-84 = 100)	2.3	0.7	3.6	4.7	2.2	2.5	2.9	2.9	2.9	3.0	1.9	3.2	2.9	2.3	2.7	2.9
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

	Quarterly Average										Annual Average		
SPECIFIC INTEREST RATES	03:3a	03:4a	04:1a	04:2a	04:3f	04:4f	05:1f	05:2f	05:3f	05:4f	2003a	2004f	2005f
Bank Prime	4.00	4.00	4.00	4.00	4.40	4.90	5.00	5.00	5.40	5.95	4.12	4.33	5.34
Federal Funds	1.02	1.00	1.00	1.01	1.40	1.90	2.00	2.00	2.40	2.95	1.13	1.33	2.34
3-mo Neg. CD (Sec. Mkt)	1.07	1.10	1.05	1.25	1.65	2.00	2.05	2.10	2.55	3.10	1.15	1.49	2.45
3-mo.LIBOR	1.13	1.17	1.12	1.30	1.70	2.05	2.10	2.15	2.60	3.15	1.22	1.54	2.50
3-mo. Treasury Bill (discount basis)	0.93	0.92	0.92	1.08	1.45	1.80	1.85	1.90	2.35	2.90	1.01	1.31	2.25
2-yr. Treasury Note	1.68	1.86	1.69	2.45	2.55	2.65	2.60	2.85	3.35	3.60	1.65	2.34	3.10
5-yr. Treasury Note	3.14	3.25	2.99	3.72	3.55	3.60	3.55	3.70	4.05	4.20	2.97	3.47	3.88
10-yr. Treasury Note	4.23	4.29	4.02	4.60	4.35	4.35	4.35	4.55	4.80	5.00	4.02	4.33	4.68
Moody's AAA Corporate	5.70	5.66	5.46	5.93	5.70	5.70	5.70	5.80	6.00	6.25	5.67	5.70	5.94
Bond Buyer Index	4.92	4.76	4.52	4.98	#N/A	4.75	4.75	4.90	5.05	5.20	4.75	#N/A	4.98

a = actual
f = forecast