



U.S. ECONOMIC & INTEREST RATE OUTLOOK

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Recession Now – Putting Our Forecast Where Our Mouth Has Been

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Since early January, the senior co-author of this commentary has been on the chicken-and-peas circuit telling audiences we were of the opinion that the U.S. economy had entered a recession. With a short break in our magical mystery tour and with a new laptop up and running (the old one crashed), we finally have the time to tell the rest of you – **the U.S. economy has entered a period that will most likely be declared a recession** by the National Bureau of Economic Research (NBER).

Ever since the first quarter of 2007, our recession warning indicator has been emitting the “R”-signal, albeit rather weakly at first (see Chart 1). In our December 2007 economic forecast update ([Probing the Probabilities of a 2008 Recession](#)), we mentioned that Probit analysis estimated a 65% probability of recession based on the fourth quarter readings of the Kasriel Recession Warning Indicator. After publishing our December update, the Institute for Supply Management reported that its manufacturing new orders index has averaged 48.2 in the two months ended January 2008 – the lowest since the spring of 2003, when the invasion of Iraq was 24/7 on CNN. The Bureau of Labor Statistics reported a sharp increase in the unemployment rate from 4.668% in November 2007 to 4.975.0% in December 2007 and 4.925% in January 2008. The Census Bureau reported weak December retail sales – down 0.4% from November. In fact, the percentage change in November-December nominal retail sales was the weakest since November-December 2001. The Federal Reserve Bank of Chicago National Activity Index, one of the most comprehensive coincident-indicator measures around, dropped to an average reading of *minus* 0.67 in the fourth quarter of 2007, which, when rounded, is right at the recession threshold. This index has been in negative territory for six consecutive quarters (see Chart 2). And, lastly, the Commerce Department’s first guesstimate of fourth-quarter 2007 real Gross Domestic Product (GDP) growth was a paltry 0.6% -- a sharp deceleration from the third quarter’s growth rate of 4.9%. So much for momentum forecasting!



Chart 1
Kasriel Recession Warning Indicator

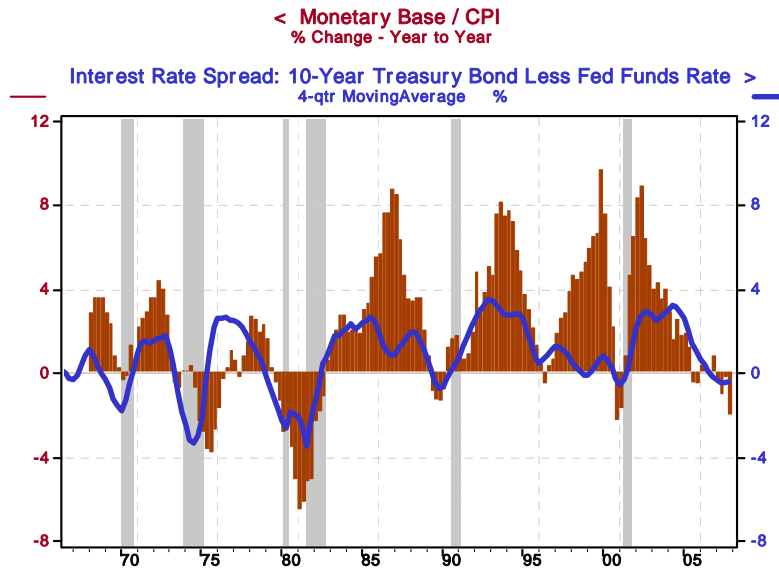
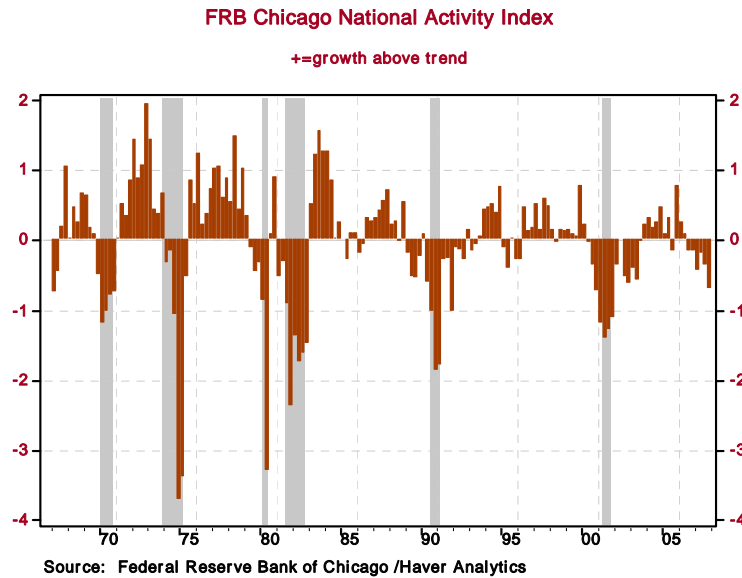


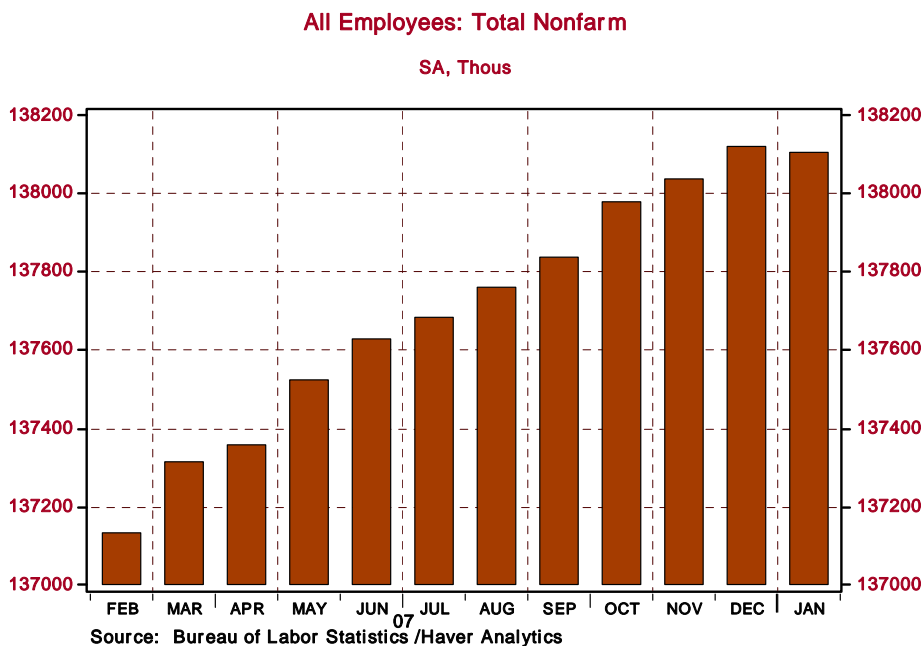
Chart 2



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As we discussed in our December 2007 forecast update, the NBER looks to the behavior of four variables to determine business cycle peaks and troughs: nonfarm payrolls, industrial production, real personal income less transfer payments, and real business sales. The recent behaviors of these four variables are shown in Charts 3, 4, 5 and 6. All four variables are down from recent peaks. With the 17,000 decline in January 2008 nonfarm payrolls, this variable may have peaked in December 2007. Both industrial production and real personal income appear to have peaked in September 2007. Real business sales appear to have peaked in October 2007. Because these data get revised many times – because only time will tell if the recent *apparent* peaks in these variables are, in fact, *actual* peaks – the NBER is likely not to tell us the economy entered a recession in late 2007 or early 2008 until the economic recovery has begun. Unlike the NBER, we as forecasters do not have the luxury of waiting to tell you until it is crystal clear that the economy has entered a recession. Our bet is that the U.S. economy has entered a recession. Moreover, we have been alerting you to the high probability of this event for more than a year now as evidenced by our much-lower-than-consensus real GDP forecasts. To paraphrase Casey Stengel – you can look it up in the monthly Blue Chip economic forecast survey results.

Chart 3



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Chart 4

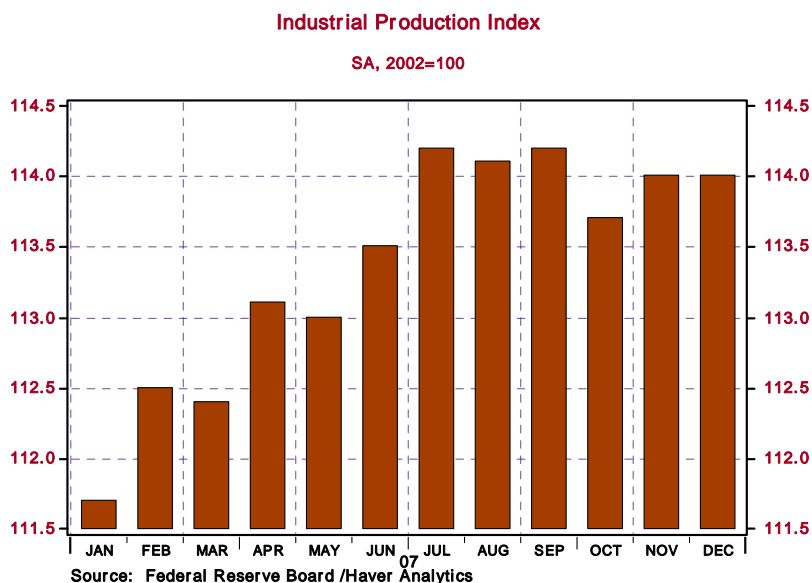
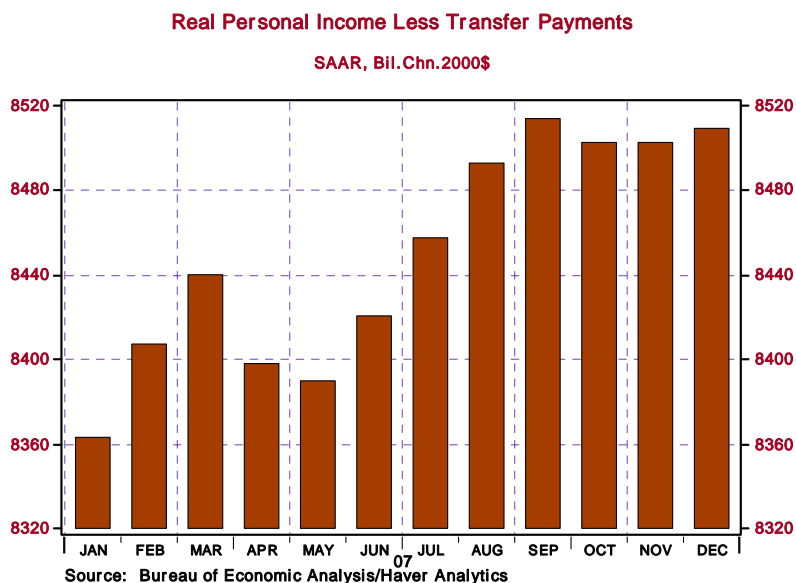


Chart 5

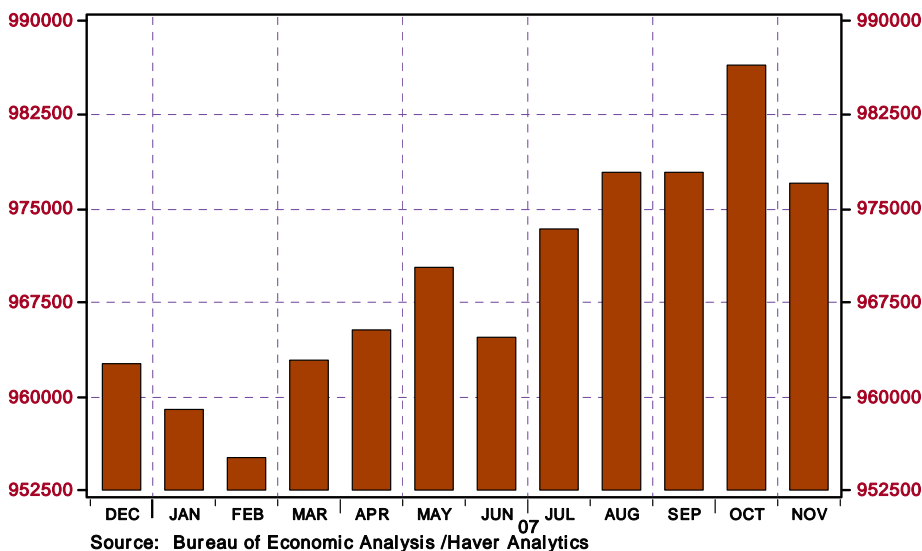


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Chart 6

Real Manufacturing & Trade Sales: All Industries

SA, Mil.Chn.2000\$

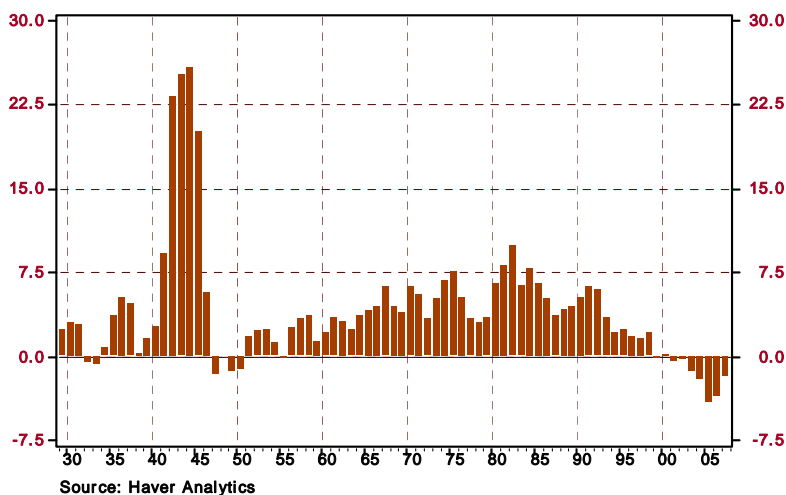


Unlike the 2001 recession, this recession will be dominated by weakness in household spending. We define household spending as the sum of Personal Consumption Expenditures (PCE) and Residential Investment Expenditures (RIE). RIE essentially is the value added in housing – new construction, including improvements, and the brokerage commissions generated from home sales. A proxy for household surpluses or deficits is obtained by subtracting the sum of PCE and RIE from after-tax or Disposable Personal Income (DPI). If the remainder is positive, i.e., total household spending is less than DPI, then households are running a surplus – they are net providers of funds to the rest of the economy. If the remainder is negative, households are running a deficit – they are net receivers of funds from the rest of the economy. If households are spending more than they are earning after taxes, by definition they are borrowing from and/or selling assets to the rest of the economy. Chart 7 shows annual household surpluses and deficits as a percent of DPI from 1929 through 2007.

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Chart 7

Household Surplus (+) / Deficit (-) as % of Disposable Personal Income



Until 1999, there had been only six years in which households ran deficits. Two of those deficit years – 1932 and 1933 – are not difficult to explain. The economy was in the grip of the Great Depression. Households were borrowing or selling the furniture just to survive. During the 1940s, households ran record surpluses relative to DPI. This is not difficult to explain. The bulk of goods and services produced in the economy were for the war effort. So, there was little that households could buy, *legally*. A large part of DPI was used to purchase war bonds. After WWII, households wanted to replace the consumer durables that had depreciated during the war and they wanted houses. Moreover, households’ balance sheets were in great shape due to their high surpluses during the war years. So, households ran deficits in 1947, 1949 and 1950. Households also ran a deficit in 1955. This is more difficult to explain. The only explanation we can come up with is that the Kasriel family bought a new Ford that year.

From 1956 through 1998, households ran surpluses. In 1999, they ran a small deficit, in 2000, a small surplus and from 2001 through 2007, deficits – and very large deficits at that in 2004, 2005 and 2006. Why did households start running deficits in recent years? A lot had to do with the low interest rate structure. Starting in 2001, inflation-adjusted money market yields were either very low or, in 2003 through 2005, *negative* (see Chart 8). There was, therefore, little incentive to save. Rather, real short-term interest rates were providing incentives to borrow and spend. From 2002 through 2005, the annual rate of appreciation in house prices was greater than the mortgage rate to finance the purchase of a house (see Chart 9). This positive differential had not existed since the late 1970s. So, the relatively low mortgage rates were encouraging households to borrow and buy houses. And borrow they did. Chart 10 shows that household borrowing relative to DPI hit a postwar record in 2006. Household

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deficits also can be funded by the sale of assets to other sectors. Chart 10 shows that households were big net sellers of corporate equities in 2001, 2006 and 2007. By the way, principal net buyers of these corporate equities were corporations themselves.

Chart 8

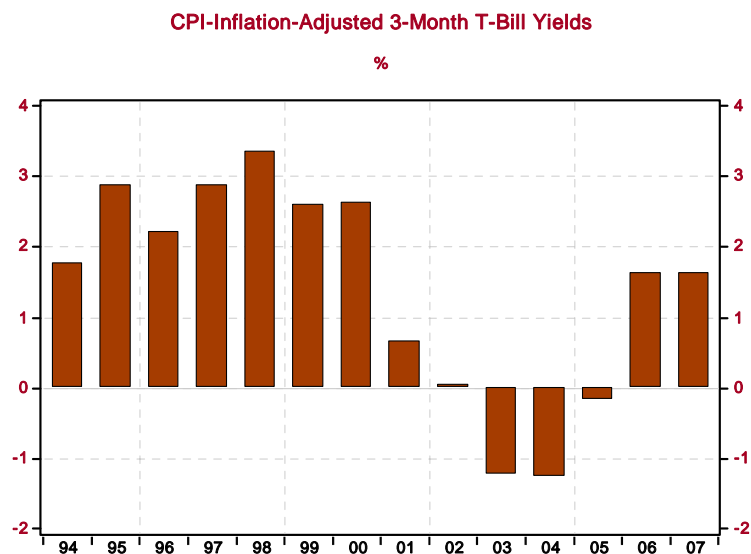
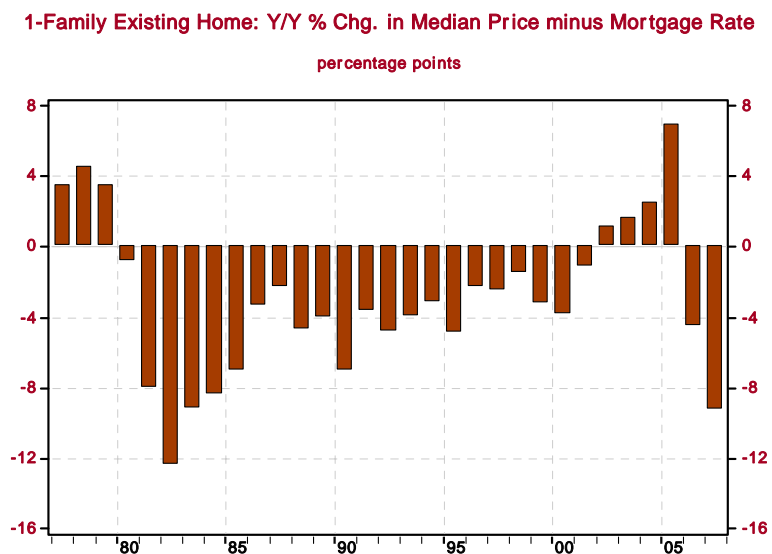


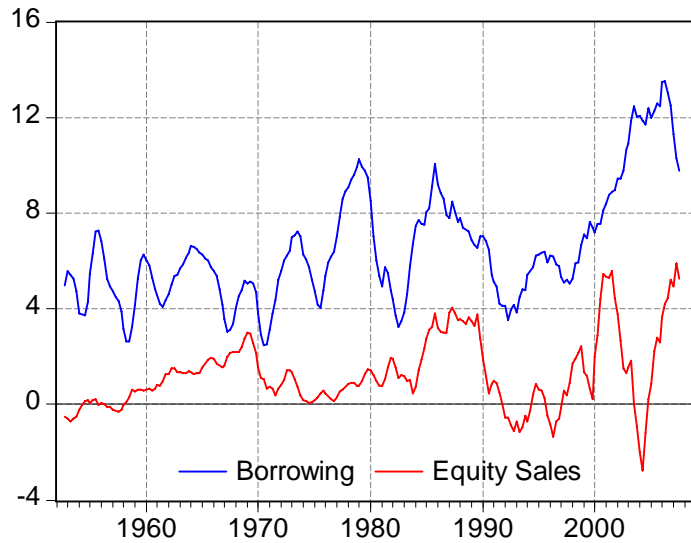
Chart 9



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Chart 10

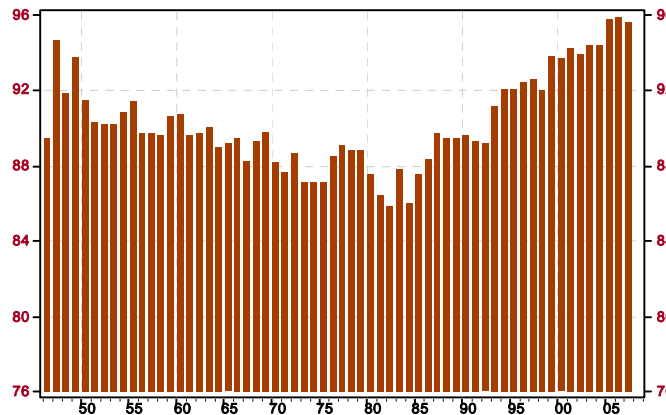
**Households: Borrowing and Net Sales of Corporate Equities
as % of Disposable Personal Income
4-qr. moving average**



Not all of the borrowing or asset sales were used to finance the purchases of or improvements in houses. Consumer spending relative to disposable personal income hit record post-WWII highs during this past economic expansion (see Chart 11).

Chart 11

PCE as % of DPI

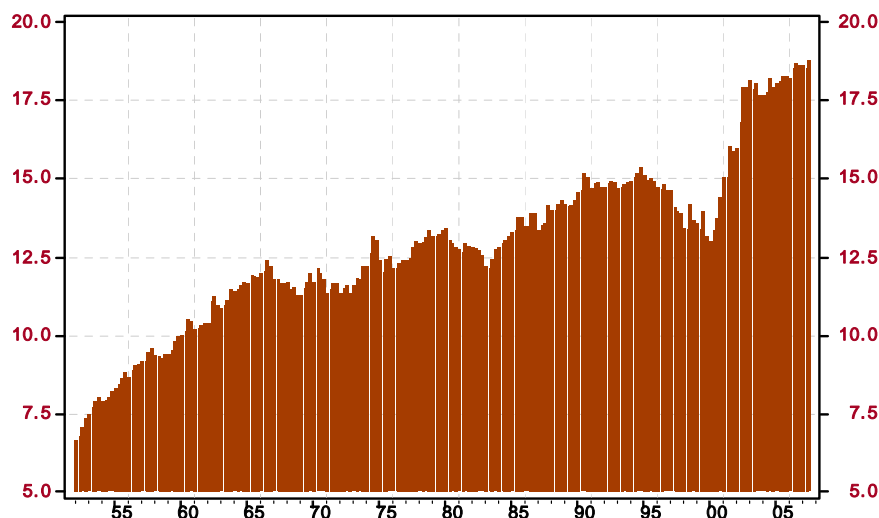


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Well, the party is ending. Home prices are falling, home foreclosures are soaring and mortgage lenders are requiring more than a pulse in order to qualify for a loan. So, household borrowing will be less available to fund household spending. And with corporate profits now contracting and corporate borrowing costs rising, the pace of corporate share buybacks and leveraged buyouts will slow, eroding another funding source of household deficits. Meanwhile, households are now experiencing their highest leverage ratios in the post-WII period (see Chart 12) and near their lowest liquidity ratios (see Chart 13). We repeat, this recession will be characterized by a retrenchment in household spending.

Chart 12

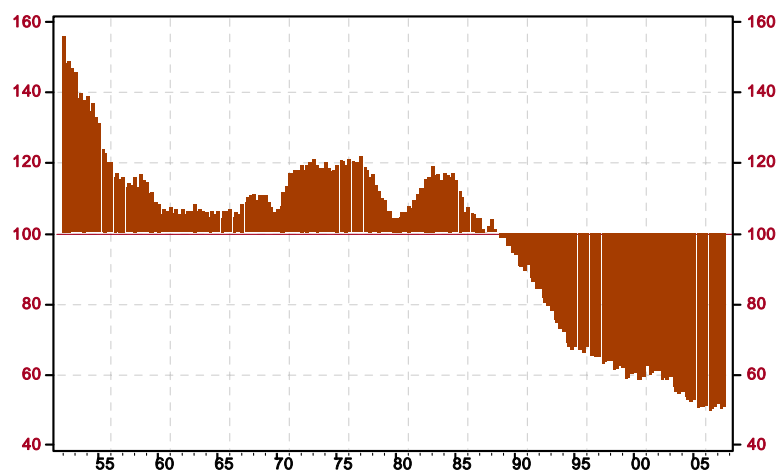
Households: Total Debt as % of Market Value of Total Assets



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Chart 13

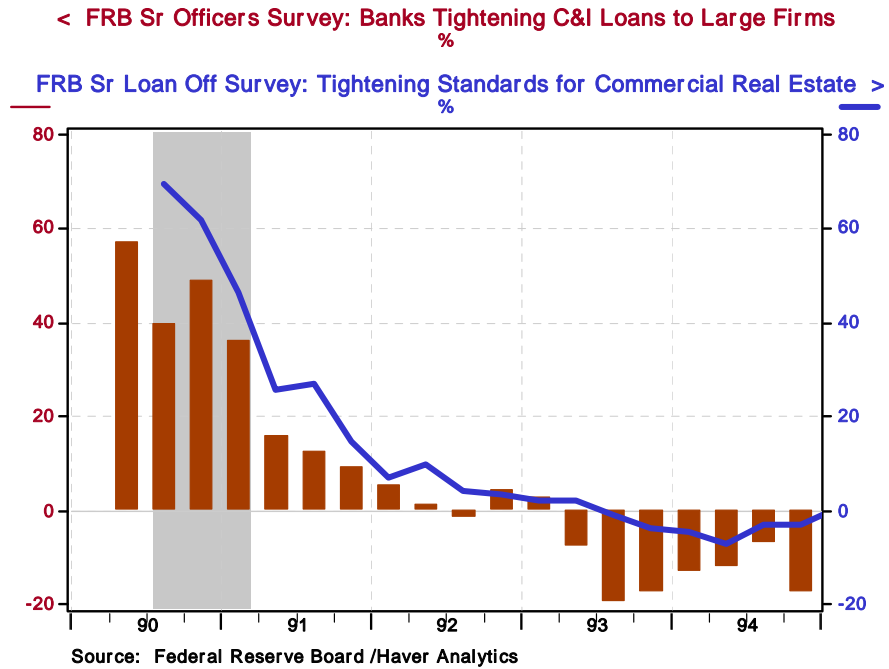
Households: Deposits and Money Funds as % of Total Liabilities



Although the Federal Reserve has been quite aggressive in reducing the fed funds rate and will likely continue to be aggressive, we expect an anemic recovery. Why? Because the financial sector is likely to incur some large losses in this downturn. The losses will not be confined to securities related to residential mortgages, but will involve credit card debt, auto loans, commercial mortgages and high-yield securities (known as junk bonds in a less politically-correct era). The financial sector, especially the banking system, is the transmission mechanism between the Federal Reserve and the private sector of the economy. If the financial transmission is not functioning properly, the Federal Reserve can mash on the monetary accelerator but little power gets transmitted to the “wheels” of the economy. Credit losses can lead to capital *inadequacy* of the financial system. Capital inadequacy means that the financial system cannot extend as much credit to the private sector as otherwise would be the case. So, even though the Federal Reserve is offering to extend credit to the financial system at relatively low interest rates, the financial system, because of capital inadequacy, cannot, in turn, extend as much credit to the private sector. This was the situation that prevailed in the United States after the economic recovery began in April 1991. The Federal Reserve continued to reduce the federal funds rate through September 1992 with little to show for it. It was not until the second half of 1993 that the financial sector had rebuilt its capital to the extent it could step up its lending to the private sector in earnest. That is when economic activity began to behave in a more normal cyclical fashion. So, a good “model” for the 2008 recession might be the 1990-1991 recession.

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Chart 14



**Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy*

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**THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
February 2008
SELECTED BUSINESS INDICATORS**

Table 1 US GDP, Inflation, and Unemployment Rate

	2007				2008				Q4-t-Q4 change			Annual change		
	07:1a	07:2a	07:3a	07:4a	08:1f	08:2f	08:3f	08:4f	2006a	2007f	2008f	2006a	2007f	2008f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	0.6	3.8	4.9	0.6	-0.7	-0.7	0.0	1.1	2.6	2.5	-0.1	2.9	2.2	0.7
CONSUMPTION EXPENDITURES	3.7	1.4	2.8	2.0	-0.6	-0.5	-0.2	1.0	3.4	2.5	-0.1	3.1	2.9	0.6
BUSINESS INVESTMENT	2.1	11.0	9.3	7.5	0.8	-0.7	-0.8	0.5	5.2	7.4	-0.1	6.6	4.8	3.1
RESIDENTIAL INVESTMENT	-16.3	-11.8	-20.5	-23.9	-18.0	-12.0	-5.0	0.0	-12.8	-18.3	-9.0	-4.6	-16.9	-15.6
CHANGE IN INVENTORIES ('00 dlrs, bill)	0.1	5.8	30.6	-3.4	-6.0	-12.0	-7.0	-3.0				40.3*	8.3*	7.0*
GOVERNMENT	-0.5	4.1	3.8	2.6	1.9	1.4	1.4	1.5	2.5	2.5	1.5	1.8	2.1	2.2
NET EXPORTS ('00 dlrs, bill.)	-612.1	-573.9	-533.1	-521.0	-508.0	-496.6	-491.8	-491.2				-624.5*	-560.0*	-496.9*
FINAL SALES	1.3	3.3	3.7	1.7	-0.6	-0.5	-0.2	1.0	3.0	2.7	0.0	2.8	2.5	0.9
NOMINAL GROSS DOMESTIC PRODUCT	4.9	6.6	6.0	3.2	2.3	0.5	1.1	2.5	5.4	5.1	1.6	6.1	4.9	2.7
GDP DEFLATOR - IMPLICIT (% change)	4.2	2.6	1.6	4.0	3.1	1.3	1.1	1.4	2.7	2.6	1.7	3.2	2.7	2.0
CPI (% Change, 1982-84 = 100)	3.8	6.0	1.9	4.3	3.4	1.6	1.4	1.7	2.0	4.0	2.0	3.2	2.9	2.8
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.5	4.5	4.7	4.8	5.1	5.6	6.0	6.3				4.6*	4.6*	5.7*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

SPECIFIC INTEREST RATES	Quarterly Average										Annual Average		
	06:3a	06:4a	07:1a	07:2a	07:3a	07:4a	08:1f	08:2f	08:3f	08:4f	2006a	2007a	2008f
Federal Funds	5.25	5.25	5.26	5.25	5.07	4.50	3.25	2.30	2.00	2.00	4.96	5.02	2.39
3-mo.LIBOR	5.43	5.37	5.36	5.36	5.45	5.03	3.15	2.20	2.05	2.05	5.19	5.30	2.36
2-yr. Treasury Note	4.93	4.74	4.77	4.81	4.38	3.48	2.20	2.00	2.05	2.15	4.82	4.36	2.10
10-yr. Treasury Note	4.90	4.63	4.68	4.85	4.73	4.26	3.60	3.30	3.25	3.35	4.79	4.63	3.38

a = actual
f = forecast

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