DAILY GLOBAL COMMENTARY

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Asha G. Bangalore
agb3@ntrs.com

FOMC Meeting: Growth Is the Predominant Concern

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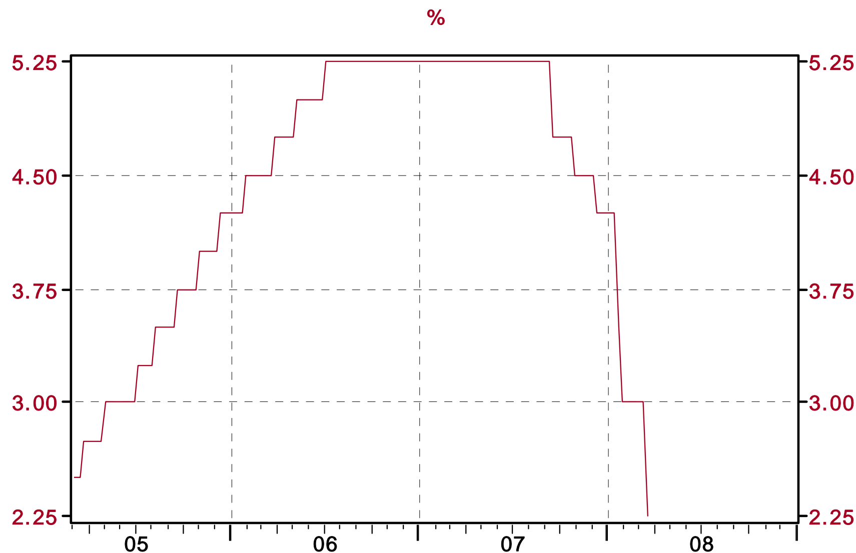
The FOMC lowered the federal funds rate and discount rate 75 bps to 2.25% and 2.50%, respectively. Fed Presidents Plosser and Fisher dissented and would have preferred less aggressive action. The Fed has lowered the federal funds rate from 5.25% to 2.25% in a six-month period, which works out to a 600 bps cut on an annualized basis. By contrast, the Fed raised the federal funds rate from 1.00% to 5.25% at a slower pace and extended the tightening cycle over a two-year period. The Fed's concern about financial market stress and economic growth are the main reasons for today's move.

Chart 1



The statement indicated that the slowing of consumer spending, soft labor market, financial market stress and the deepening of the housing market contraction are factors affecting economic growth which justifies the aggressive move. At the same time, the discussion about inflation was more extensive than in the prior three policy statements. Inflation expectations, as measured by the difference between the nominal 10-year U.S. Treasury note yield and the 10-year inflation protected security, was 2.56% on March 10, up from a low of 2.20% on January 23. Inflation expectations declined to 2.29% on March 17 and will probably close around 2.45% today. The fact that core consumer prices are off their lows, the import price index excluding petroleum continues to advance, and the dollar is posting new record lows everyday are factors increasing the uncertainty about inflation. The most telling aspect of the Fed's remarks today is that of the statements between December 11 and March 18, today's statement was the most concerned about inflation and yet the Fed lowered the federal funds rate 75bps, which leads one to conclude that were inflation more contained, the Fed would have moved more aggressively. Despite the tough stance about inflation, there is an element of optimism about the moderation of inflation in the

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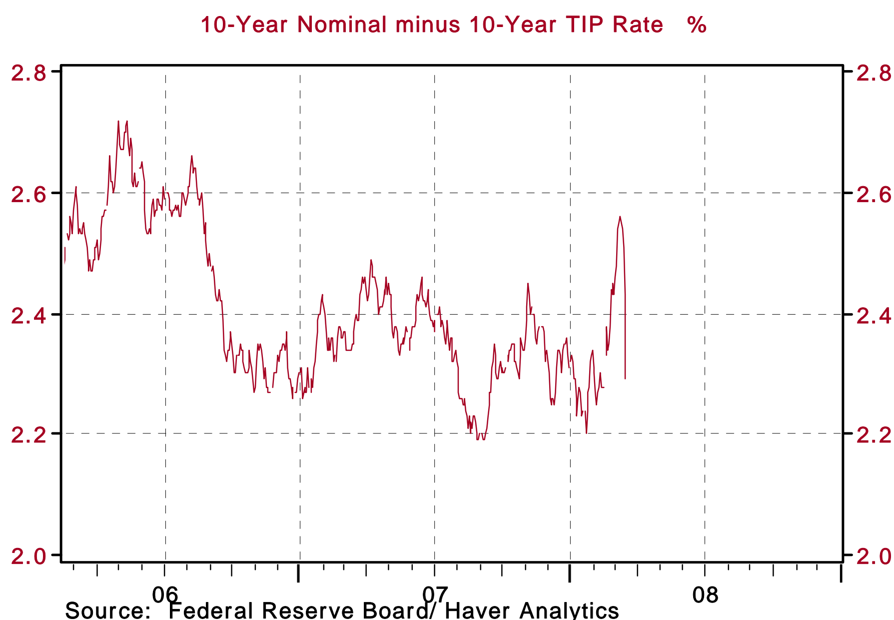
statement because the Fed expects energy and other commodity prices to stabilize and pressures on resource utilization to diminish. The unemployment rate and capacity utilization rate of the factory sector are heading in the desired direction of resource utilization that will be supportive of lower inflationary pressures.

Chart 2



Paul L. Kasriel
plk1@ntrs.com

The Fed's Various New Credit Facilities Are Potentially Effective Complements to Interest Rate Policy

Starting in mid December 2007, the Fed began introducing new facilities through which depository institutions and primary securities dealers could obtain fed funds or U.S. Treasury securities collateral. The purpose of these new facilities is to relieve liquidity pressures in the money and capital markets, augmenting the reductions in the fed funds rate implemented by the Fed.

In mid December 2007, the Fed introduced the Term Auction Facility (TAF), effectively a term repo facility that allows all U.S. depository institutions that are required to hold reserves at the Fed and are in good financial standing to bid for term fed funds from the Fed. Any collateral that is eligible to be presented at the Fed's discount window, which runs the gamut from U.S. Treasury securities to commercial/industrial loans, also is eligible to be posted by depository institutions. Despite reductions in the fed funds rate, other unsecured interbank lending interest rates, such as LIBOR, were not declining in tandem, suggesting liquidity and/or counterparty-risk issues. Chart 3 shows that after the establishment of the TAF, money market conditions have returned to more normal relationships.

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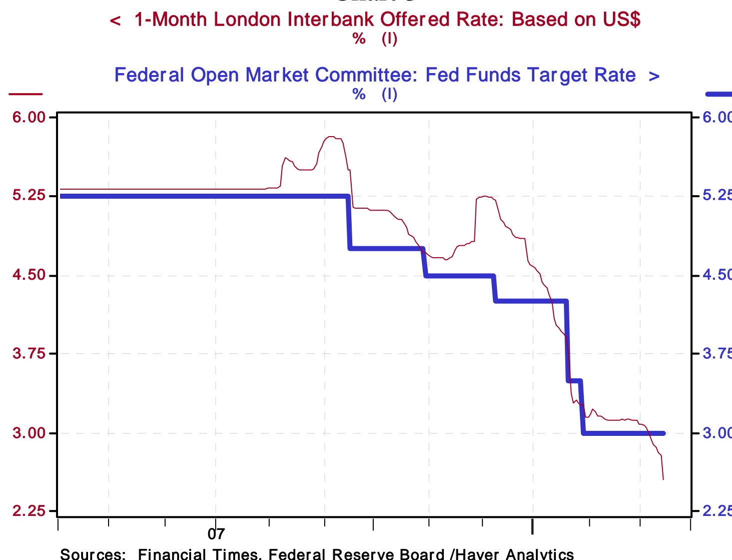
Chart 3



Although liquidity issues with regard to short-term unsecured interbank lending appear to have been resolved by TAF, liquidity and/or credit-quality issues with regard to mortgage-related securities remain. This is demonstrated in Charts 4 and 5 in which the yields on long-term mortgage-related securities are compared with the yield on the 10-year Treasury security. Whereas in the spring of 2007, the yield spread between direct FNMA 10-year debt and U.S. Treasury 10-year debt was about 40 basis points. In recent days, that yield spread has widened out to around 110 basis points. Similarly, in the spring of 2007, the yield spread between the rate on 15-year home mortgages and the rate on the 10-year Treasury security was in the range of 70 to 80 basis points. Early last week, the spread skyrocketed to 150 basis points, only to return to Earth yesterday.

Chart 4

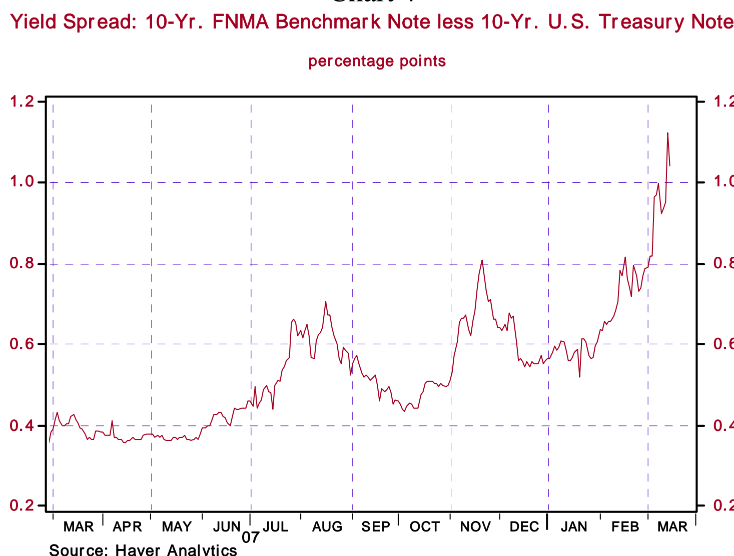


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Chart 5

In order to address these liquidity and credit-quality issues in the market for investment-grade mortgage-related debt, the Fed established two new facilities for primary securities dealers in recent days – the Term Securities Lending Facility (TSLC) and the Primary Dealer Credit Facility (PDCF). The TSLC allows dealers to bid for U.S. Treasury securities on loan from the Fed in exchange for high-quality mortgage-related securities. The TSLC does not inject new reserves (fed funds) into the financial system, but does allow primary dealers to exchange less liquid securities for the most liquid, U.S. Treasury securities. In turn, the primary dealers can easily borrow using these Treasury securities as collateral.

The PDCF is, in effect, a discount window for primary dealers. Dealers can borrow fed funds from the Fed at a penalty over the fed funds rate target. That penalty currently is 25 basis points. Primary dealers can post as collateral against their borrowing of fed funds from the PDCF in addition to Treasury and agency securities, investment grade corporate, municipal, mortgage-backed and asset-backed securities.

The TSLC and the PDCF would be expected to increase the liquidity in securities markets related to mortgages inasmuch as dealers know that they can easily borrow against this collateral from the Fed. With added liquidity in the markets for mortgage-related securities, mortgage interest rates would be expected to move lower now relative to comparable maturity Treasury yields. Moreover, with the establishment of PDCF, the likelihood that liquidity issues would morph into solvency issues for dealer/brokers would be diminished.

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Asha G. Bangalore
agb3@ntrs.com

Housing Starts – Single-Family Units Post Largest Cyclical Decline on Record

Construction of new homes declined 0.6% to an annual rate of 1.065 million units in February. Starts of homes have now fallen 53.5% from the peak reading of 2.292 million in January 2006. The 14.4 % increase in multi-family starts held back the overall decline in housing starts. Single-family starts fell 6.7% to an annual rate of 707,000 in February 2008, which is the lowest since January of 1991 (see chart 6). Starts of single-family homes have dropped 61.5% from the peak in January 2006 (1.837 million units), the largest cyclical drop since reporting began for this series. There should be additional declines in the months ahead because the bottom of the housing market crisis is not here yet.

Chart 6

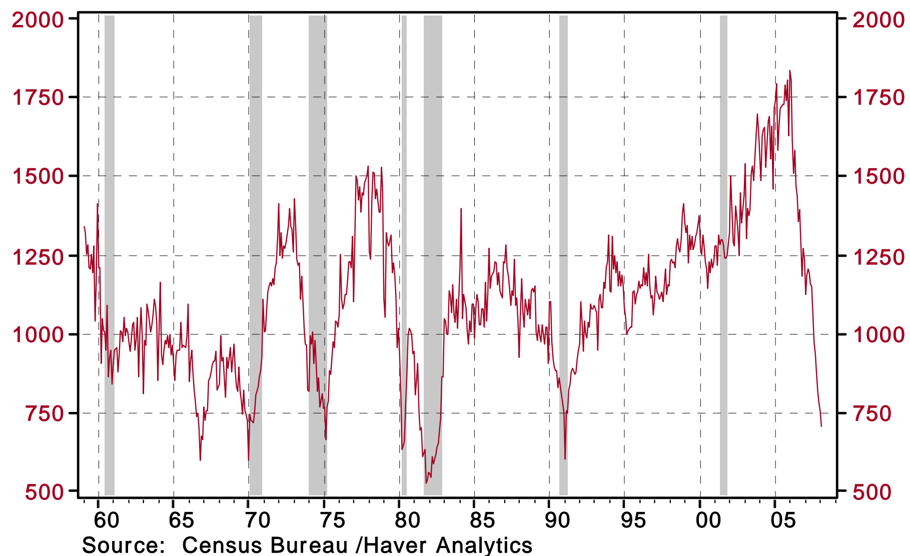

Table 1 Housing starts and business cycles

Recession	Peak				Trough				Change - Peak to Trough	
	Date	Total Starts	Date	Single-family	Date	Total Starts	Date	Single-family	Total Starts	Single-family
Apr. 60-Feb. 61	Feb-59	1667	Jan-59	1336	Dec-60	1063	Dec-60	841	-36.23%	-37.05%
Dec. 69-Nov.70	Jan-69	1769	Jan-69	967	Jan-70	1085	Jan-70	596	-38.67%	-38.37%
Nov. 73-Mar.75	Oct-72	2485	Sep-72	1399	Feb-75	904	Feb-75	667	-63.62%	-52.32%
Jan.80-Jul. 80	Apr-78	2197	Apr-78	1517	May-80	927	Mar-80	633	-57.81%	-58.27%
Jul.81-Nov. 82	Jan-81	1547	Sep-80	1019	Jan-82	843	Oct-81	523	-45.51%	-48.68%
Jul. 90-Mar.91	Jan-89	1621	Jan-89	1149	Jan-91	798	Jan-91	604	-50.77%	-47.43%
Mar. 01-Nov. 01	Feb-00	1737	Dec-99	1375	Oct-01	1540	Oct-01	1240	-11.34%	-9.82%
Current cycle	Jan-06	2292	Jan-06	1837	Feb-08	1065	Feb-08	707	-53.53%	-61.51%

On a regional basis, starts of new homes fell 27.7% in the Northeast, held steady in the Midwest, but rose in the South (+3.9%) and West (+5.1%).

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Permit extensions for new homes, often seen as a leading indicator, dropped 7.8% to an annual rate of 978,000 in February. Permits for building single-family homes declined 6.2% in February to an annual rate of 639,000. This is the largest monthly decline in the current cycle. Permits for single-family homes have fallen 64.5% from the peak level of 1.798 million in September 2005 (see chart 7).

Chart 7

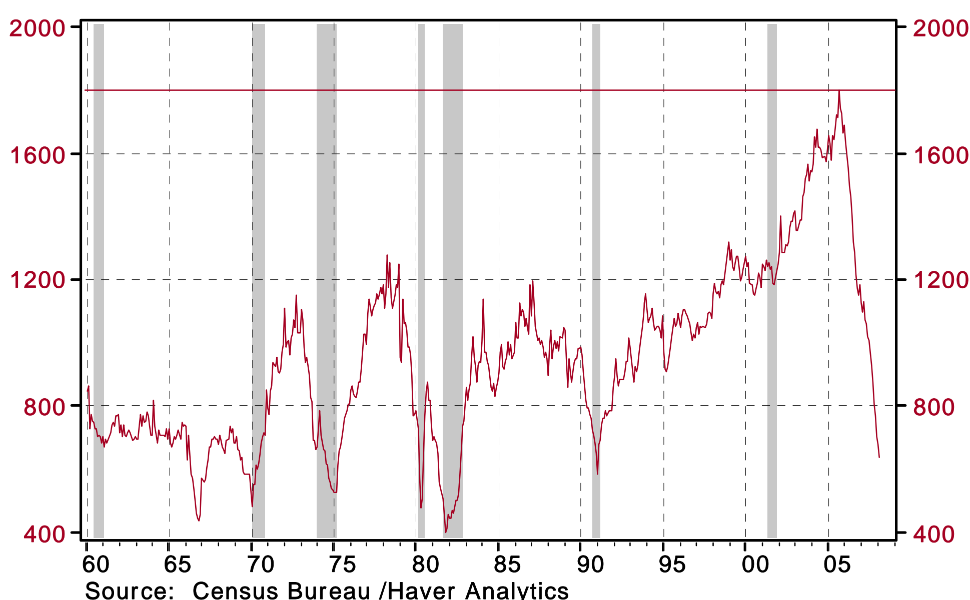

Table 2 Housing Starts – February 2008

	Total (mil. units)	% change from previous month	Single-family (mil. units)	% change from previous month	Multi-family (mil. units)	% change from previous month
Aug-07	1.347	-1.8	0.974	-7.9	0.373	19.2
Sep-07	1.182	-12.2	0.938	-3.7	0.244	-34.6
Oct-07	1.274	7.8	0.879	-6.3	0.395	61.9
Nov-07	1.178	-7.5	0.816	-7.2	0.362	-8.4
Dec-07	1.000	-15.1	0.782	-4.2	0.218	-39.8
Jan-08	1.071	7.1	0.758	-3.1	0.313	43.6
Feb-08	1.065	-0.6	0.707	-6.7	0.358	14.4

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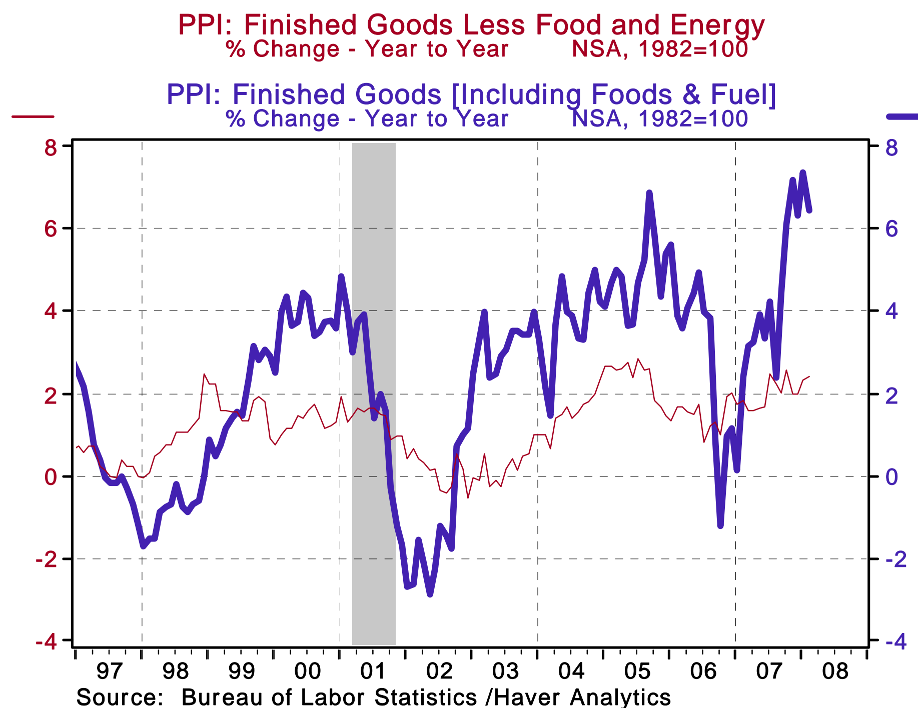
Core Wholesale Prices Continue to Advance

The Produce Price Index (PPI) for Finished Goods rose 0.3% in February, following a 1.0% jump in the prior month. Although food prices fell (-0.5%), the energy price index advanced 0.8% and core PPI, which excludes food and energy, increased 0.5%. On a year-to-year basis, the PPI for finished goods is up 6.4%, marking the fifth monthly reading that exceeds 6.0%. Energy prices have advanced 19.6% and food prices have risen 6.0% during past twelve months.

Chart 8



The core PPI, which excludes food and energy, rose 0.5% in February, putting the year-to-year increase at 2.4%. The year-to-year change in the core PPI bottomed out at 0.8% in July 2006. The upward trend of the core PPI remains troublesome as does the overall wholesale price index. In February, higher prices for medicines, trucks, cars, alcoholic beverages, civilian aircraft, medical and surgical equipment, and communication related equipment helped to raise the core PPI.

At the earlier stages of production, the intermediate goods price index moved 0.8% and the core intermediate prices index was up 0.6%. The core intermediate price index rose 4.8% from a year ago, up from a cycle low 1.6% in August 2007. The overall and core crude goods price index advanced 3.7% and 3.3%, respectively, in February.

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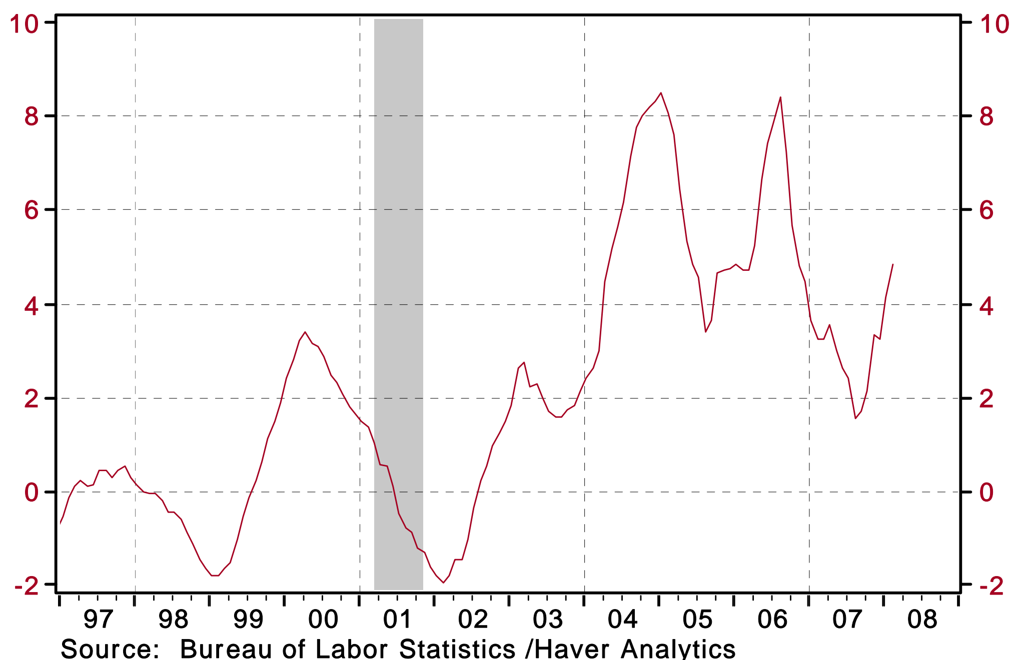
Chart 9



Producer Price Index – February 2008

	% change	annualized % change			% change		
	prior month	year-to-date	3 mo. ago	6 mo. ago	Feb-08 yoy	Feb-07 yoy	Dec-07 yoy
PPI - FINISHED GOODS							
ALL ITEMS	0.3	8.3	4.0	9.6	6.4	2.4	6.3
CORE - ALL ITEMS LESS FOOD & ENERGY	0.5	6.0	4.7	3.2	2.4	1.8	2.0
FOOD	-0.5	7.6	10.8	9.7	6.0	6.6	7.4
ENERGY	0.8	14.5	-3.1	28.7	19.6	-0.1	18.4
CAPITAL EQUIPMENT	0.5	5.7	4.1	2.7	1.9	2.1	1.3
PPI - INTERMEDIATE GOODS							
ALL ITEMS	0.8	13.6	7.9	11.7	8.8	2.2	6.8
CORE	0.6	9.1	6.0	5.4	4.8	3.2	3.3
PPI - CRUDE GOODS							
ALL ITEMS	3.7	43.6	33.1	48.8	24.6	7.7	20.6
CORE	3.3	53.7	34.4	26.4	20.6	18.6	16.8

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