

DAILY GLOBAL
COMMENTARY

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Chairman Bernanke's Testimony – Expected Important Shift in Emphasis

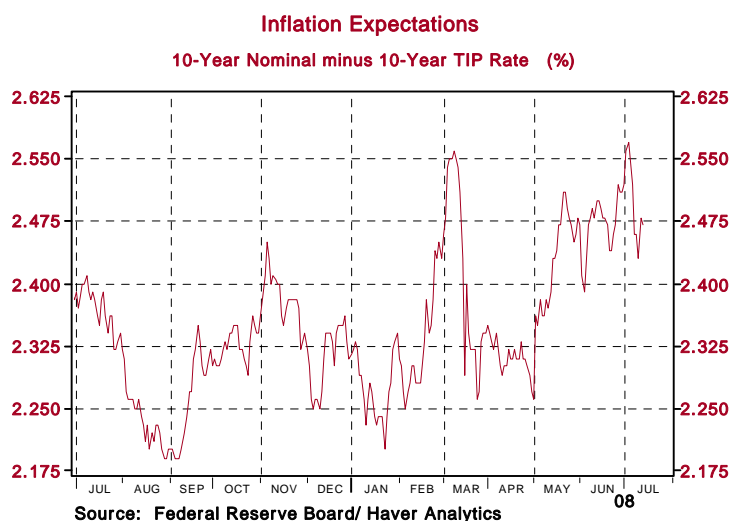
July 15, 2008

The June 25 monetary policy and recent rhetoric of Fed officials left a sense that inflation had taken precedence over growth in the inflation-growth debate. Chairman Bernanke's remarks today have moved the focus back to economic growth in the inflation-growth debate. That said, inflation is still a serious concern.

In particular, he noted that “the possibility of higher energy prices, tighter credit conditions, and a still-deeper contraction in housing markets all represent significant downside risks to the outlook for growth.” He also added that FOMC participants indicated that “considerable uncertainty surrounded their outlook for economic growth and viewed the risks to their forecasts as skewed to the downside.” These remarks about growth and financial market conditions highlight that growth is the predominant concern, for now.

With regard to inflation, Bernanke noted that the Fed is focused on preventing higher inflation expectations from being embedded in the “wage-price setting process,” which would then translate in to a rise in actual inflation over the longer term. He also mentioned that “a critical responsibility of monetary policy makers is to prevent the process from taking hold.” Bernanke's comments on inflation also included these observations: “Although the inflationary effect of rising oil and agricultural commodity prices is evident in the retail prices of energy and food, the extent to which the high prices of oil and other raw materials have been passed through to the prices of non-energy, non-food finished goods and services seems thus far to have been limited. But with businesses facing persistently higher input prices, they may attempt to pass through such costs into prices of final goods and services more aggressively than they have so far.” The above comments imply that the Fed officials remain concerned about inflation but by a measure that is less severe than what their rhetoric suggested in the past month. In sum, the tone of the testimony leans more toward growth as the primary concern, while inflation is important but marginally lower in rank compared with growth. Inflation expectations (see chart 1) have declined 10bps slightly since the recent high of 2.57% on July 3 (see chart 1).

Chart 1



The forecasts of the FOMC show slightly stronger growth in 2008, with predictions for 2009 and 2010 unchanged from the April 2008 forecast. The unemployment rate for 2008 was unchanged but it is estimated to be higher in 2009 and 2010 compared with the forecasts published in April. Overall inflation for 2008 was raised higher, while predictions for 2009 and 2010 were virtually unchanged. Core inflation estimates for 2008 was left unchanged, with forecasts for 2009 and 2010 raised by one-tenth (see table 1).

Table 1. Economic projections of Federal Reserve Governors and Reserve Bank presidents, June 2008

Percent

Variable	2008	2009	2010
Central tendency¹			
Change in real GDP	1.0 to 1.6	2.0 to 2.8	2.5 to 3.0
April projection	0.3 to 1.2	2.0 to 2.8	2.6 to 3.1
Unemployment rate	5.5 to 5.7	5.3 to 5.8	5.0 to 5.6
April projection	5.5 to 5.7	5.2 to 5.7	4.9 to 5.5
PCE inflation	3.8 to 4.2	2.0 to 2.3	1.8 to 2.0
April projection	3.1 to 3.4	1.9 to 2.3	1.8 to 2.0
Core PCE inflation	2.2 to 2.4	2.0 to 2.2	1.8 to 2.0
April projection	2.2 to 2.4	1.9 to 2.1	1.7 to 1.9

Source: http://www.federalreserve.gov/boarddocs/hh/2008/july/0708mpr_part4.htm

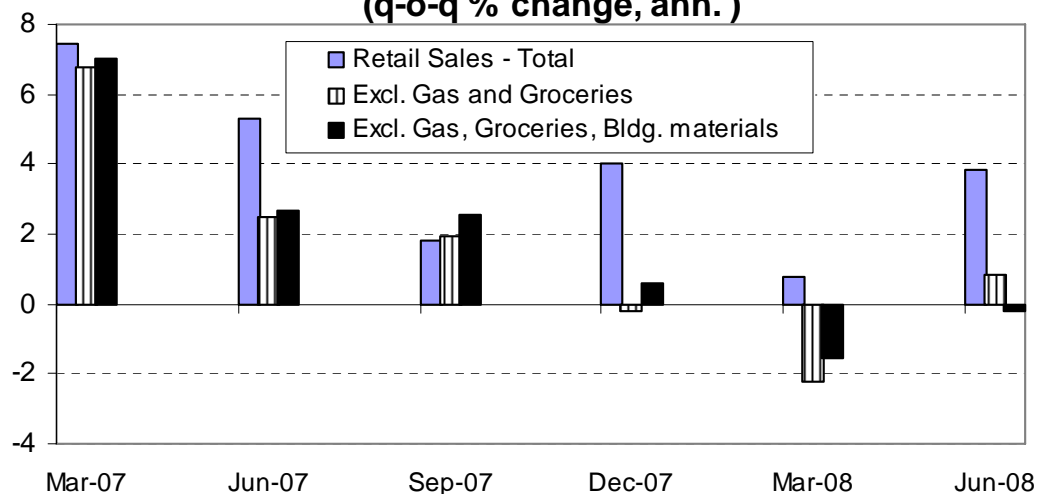
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Note: Projections of change in real gross domestic product (GDP) and of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy.

June Retail Sales Weaker than Headline Number

Retail sales edged up 0.1% in June after a 0.8% increase the prior month. Excluding autos, retail sales rose 0.8% vs. a 1.2% increase in May. This appears impressive, but after excluding gasoline (+4.7%) and purchases at grocery stores (+0.6%), retail sales declined 0.7%. Also, retail sales less gasoline, sales at grocery stores, and building materials fell 0.7% in June. Auto sales data from the retail sales report is not included in consumer spending estimates but unit auto sales are pertinent. Unit auto sales dropped to an annual rate of 13.6 million units in June following a 14.3 million sales mark in May. These three estimates of consumer spending indicate that consumer spending was weaker than the implied strength of the headline number in June. The other details of the report show that furniture (-1.4%) and building materials sales (-0.9%) fell in June, while that of apparel (+0.6%) and general merchandise (+0.4%) advanced.

Chart 2
Retail Sales
(q-o-q % change, ann.)



In the second quarter, retail sales increased 3.8% compared with a 0.8% gain in the first quarter. However, excluding purchases at grocery stores and that of gasoline, both inflated due to higher prices, retail sales moved up only 0.9% in the second quarter after a 2.3% drop in the first quarter. Excluding gasoline, building materials and purchases at grocery stores, retail sales fell at an annual rate of 0.2% following 1.5% decline in the first quarter. Unit auto sales fell at an annual rate of 26.6% in the second quarter vs. a 20% drop in the first quarter. Therefore, food and energy purchases mask the true strength in consumer spending in the second quarter. After the CPI report

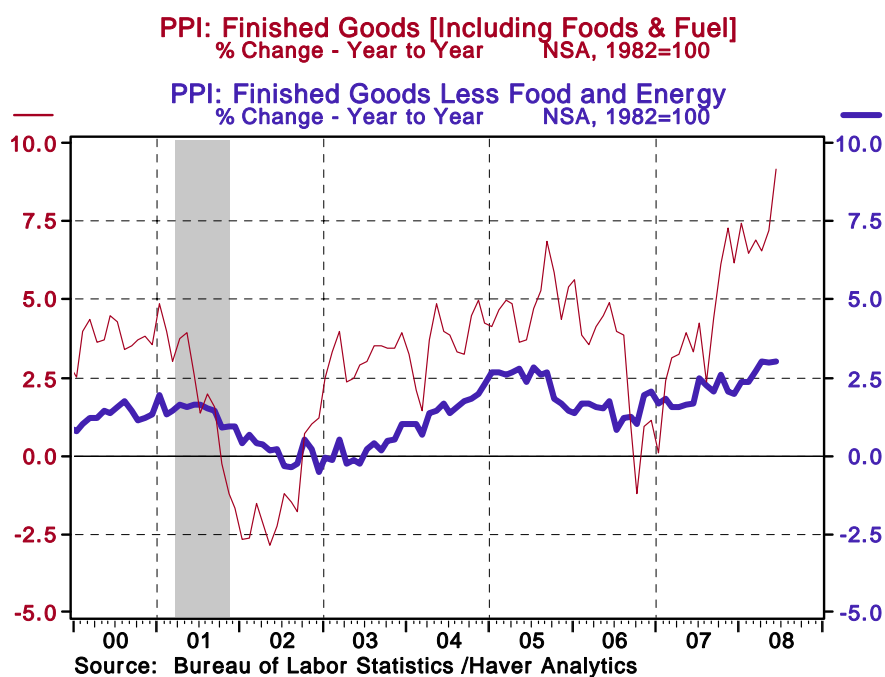
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is published tomorrow, we will be able to assess the inflation adjusted performance of retail sales in the second quarter.

Food and Energy Remain Culprits, Core Is Also Troubling, But Pass Through Is Limited

The Producer Price Index (PPI) for Finished Goods increased 1.8% in June, reflecting higher food and energy prices. The energy price index moved up 6.0% and the food price index rose 1.5%. The core PPI increased 0.2%, putting the year-to-year gain at 3.0%, compared with a 2.0% gain in 2007. The upward trend of wholesale prices is troubling.

Chart 3



At the earlier stages of production, intermediate goods price have also advanced rapidly (see table below). However, complete pass through of higher prices is not occurring. The evidence so far is that firms are unable to pass on the higher costs incurred by way of higher retail prices (see chart 4).

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Producer Price Index – June 2008

	% change	annualized % change		% change		
	prior month	3 mo. ago	6 mo. ago	Jun-08 yoy	Jun-07 yoy	Dec-07 yoy
PPI - FINISHED GOODS						
ALL ITEMS	1.8	14.1	12.4	9.2	3.3	6.2
CORE - ALL ITEMS LESS FOOD & ENERGY	0.2	3.7	4.5	3.0	1.7	2.0
FOOD	1.5	9.6	9.8	8.3	6.5	7.6
ENERGY	6.0	51.9	38.1	27.0	5.1	17.8
CAPITAL EQUIPMENT	0.3	3.2	3.8	2.5	1.6	1.4
PPI - INTERMEDIATE GOODS						
ALL ITEMS	2.1	26.8	22.5	14.5	3.6	7.1
CORE	1.3	19.3	14.8	8.4	2.6	3.3
PPI - CRUDE GOODS						
ALL ITEMS	3.7	70.1	74.0	45.5	15.5	19.8
CORE	-0.2	63.4	61.3	33.0	10.2	15.6

Chart 4

Ratio: CPI for Goods / PPI for Finished Consumer Goods



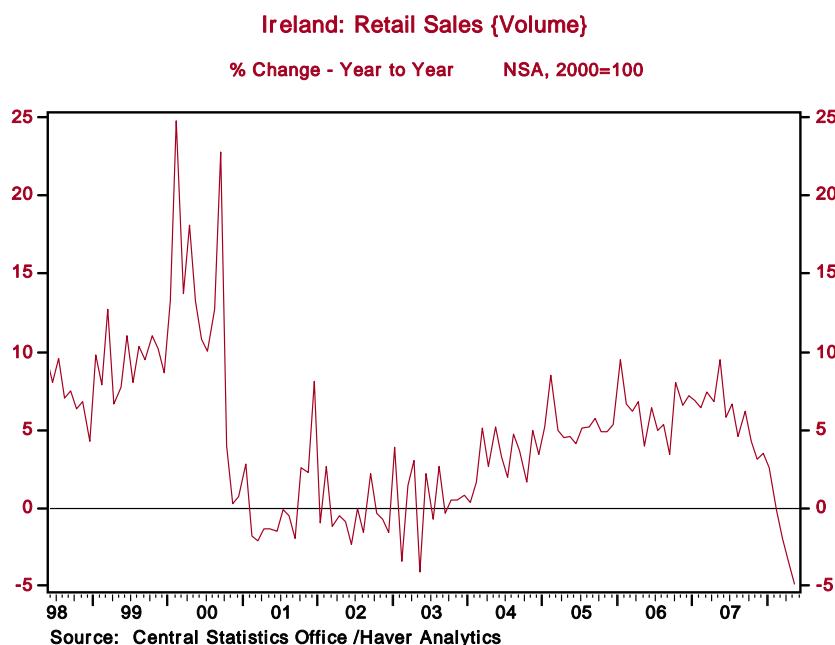
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Ireland: Hangover Time

Today's headline out of Ireland will add to fears that the decade-long economic boom is ending with a recession. The volume of retail sales fell 1.1% on the month and plunged 4.8% on the year in May, the fourth consecutive monthly fall and the sharpest annual drop since 1987.

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Chart 5



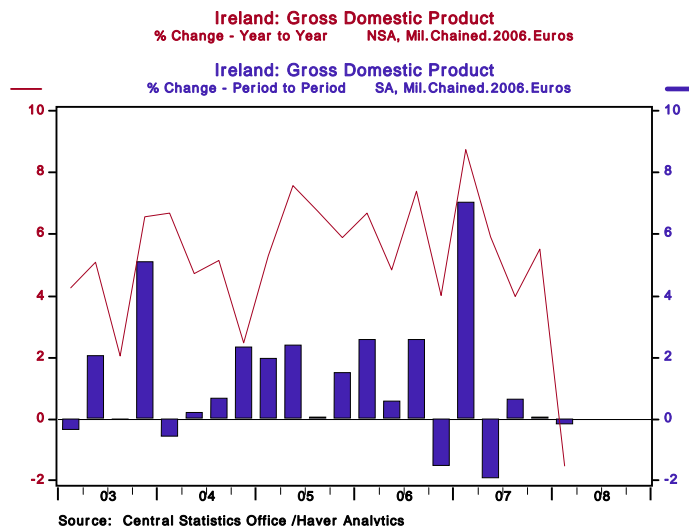
Ireland (like fellow-EU member Spain) is being hit by a double whammy. Domestic housing market woes are coinciding with global problems in the form of the credit crunch, rising food and oil prices, and the US and UK slowdowns. The drop in export demand is particularly harmful to such an open economy. The US is Ireland's largest market, taking about 20% of annual exports, with the UK a close second at around 18%.

After a decade-long boom, Ireland's economy began to slow over the course of last year as the housing market bubble began to deflate. House prices dropped for the 15th month in a row in May, with the annual decline at 9.5%. The risk of a US-style housing market slump is mitigated in part by the fact that demand for housing remains relatively robust thanks to the nation's demographics (a young population and generally-high rates of immigration). Growth in residential mortgage lending has slowed (to an annual rate of 11.1% in May, the weakest in 16 years) rather than reversed.

Nevertheless, the economy clearly is on the brink of a technical recession. Real GDP growth slipped 0.2% on the quarter in Q1, and was down 1.5% on the year. The government's official forecast sees real GDP growth at just 0.5% this year. Last week, Central Bank Governor Hurley warned that "growth prospects for the next 18 months or so are now significantly less favorable" and forecast 2008 growth of "significantly less than 1%".

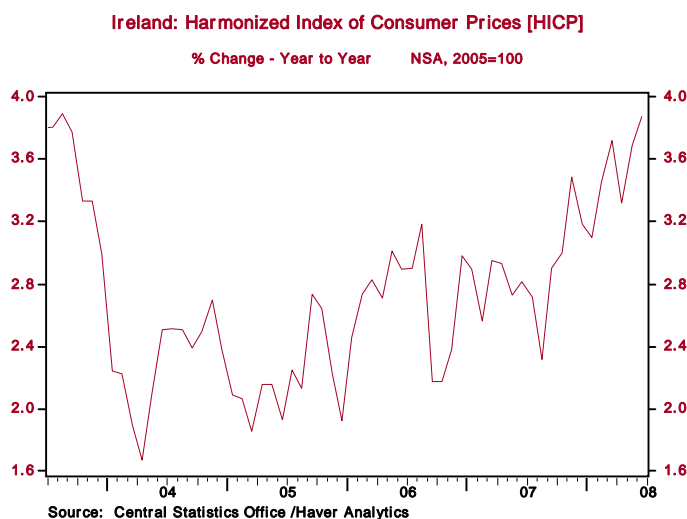
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Chart 6



Meanwhile, inflation is rising. The annual rate of EU-harmonized CPI hit 3.9% in June, the highest in nearly five years.

Chart 7



Yet for all the doom and gloom, the economy is in much better shape overall than at the time Ireland's last recession in the late 1980s. The government has some fiscal stimulus wiggle-room thanks to a series of annual budget surpluses and a ratio of public sector debt to GDP that is now one of the lowest in the EU. All told, it seems the decade-long party will culminate in a painful hangover, but one that should wear off by 2009.

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