

DAILY GLOBAL COMMENTARY

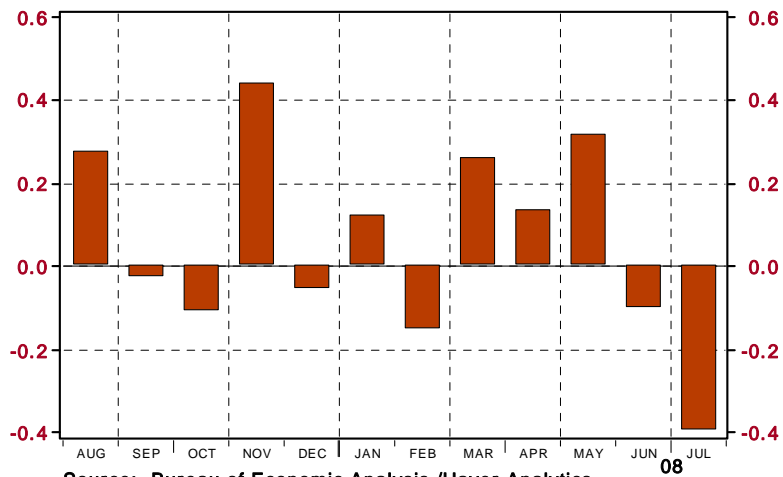
Northern Trust  
Global Economic Research  
50 South LaSalle  
Chicago, Illinois 60603  
northerntrust.com

Asha G. Bangalore  
agb3@ntrs.com

**Consumer Spending: Strong Likelihood of Decline in Q3**  
August 29, 2008

Nominal consumer spending increased 0.2% in July, following a 0.6% gain in June. However, inflation adjusted consumer spending fell 0.4% in July after a 0.1% decline in June.

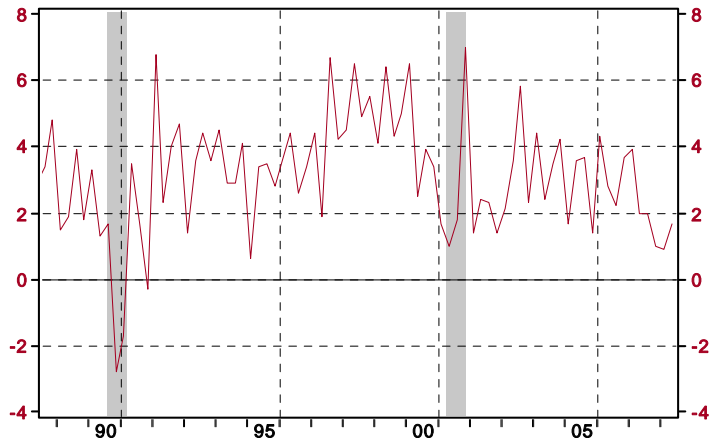
Chart 1  
**Real Personal Consumption Expenditures**  
% Change - Period to Period SAAR, Bil.Chn.2000\$



Source: Bureau of Economic Analysis /Haver Analytics

Consumer spending will have to advance in leaps and bounds in August and September for a *flat* reading in the third quarter. In other words, a decline in third quarter consumer spending is nearly certain. Assuming our forecast is accurate, this would be the first quarterly decline in consumer spending since fourth quarter of 1991 (see chart 2).

Chart 2  
**Real Personal Consumption Expenditures**  
SAAR, %Chg



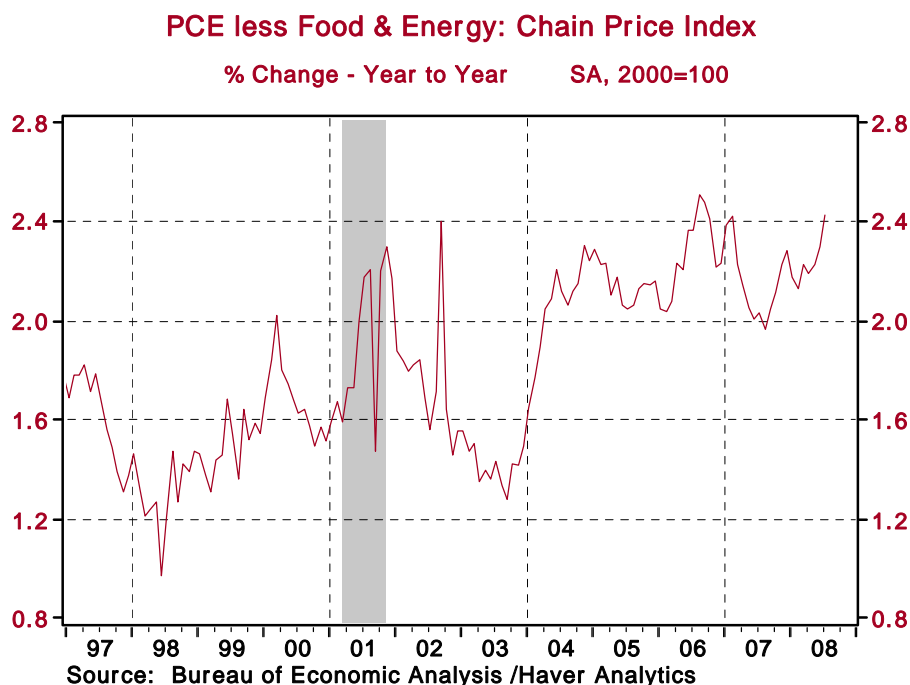
Source: Bureau of Economic Analysis /Haver Analytics

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If consumer spending posts a decline, it should not be surprising to see a minus sign attached to change in GDP during the third quarter. Our forecast earlier in the month was a steady reading for real GDP in the third quarter. We have yet to finish our forecast for September, but there is a good chance that this may change.

In July, inflation adjusted purchases of durables (-1.6%) and non-durables (-0.9%) dropped and outlays of services held steady. The personal consumption expenditure price index moved up 0.6% in July and the core personal consumption expenditure price index excluding food and energy rose 0.3%. On a year-to-year basis, the core personal consumption expenditure price index increased 2.43% in July, which is higher than the 2.0% comfort level of the Fed. Additional weakening of economic conditions in the months ahead should translate into a moderation of core inflation.

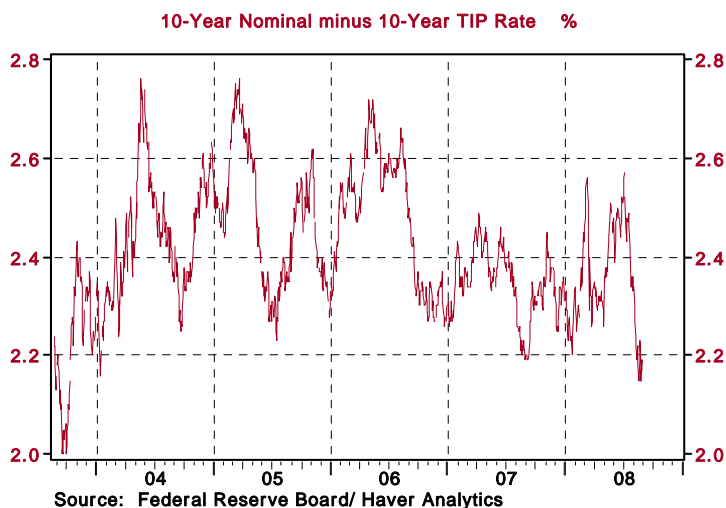
Chart 3



The good news is that inflation expectations do not pose a threat, with the spread between nominal 10-year U.S. Treasury note and the 10-year TIP at 217 bps as of August 28, down from 257 bps as of July 3.

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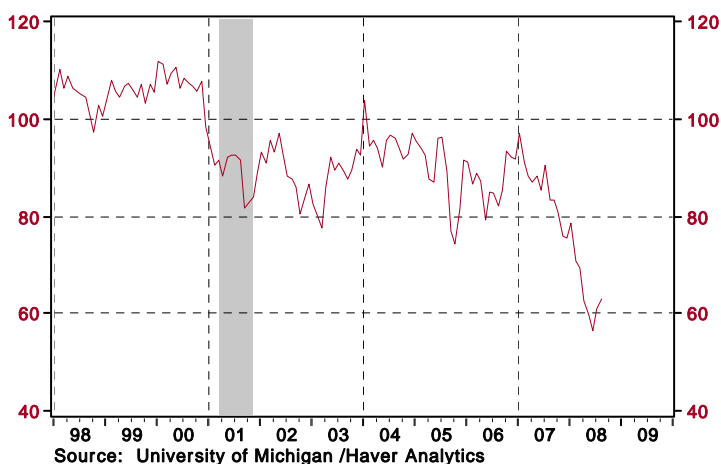
Chart 4  
Inflation Expectations



Personal income fell 0.7% in July, after a 0.1% gain in June. Changes in income during both June and July reflect the impact of tax rebates. Excluding tax rebates personal income grew 0.5% in July and 0.3% in June. Excluding rebates real disposable fell 0.1% in July and 0.4% in June (Including rebates real disposable income fell 1.7% in July and 2.6% in June). Personal saving as a percent of disposable income was 1.2% in July, after a 2.5% reading in June (a distortion from tax rebates).

In related news, the University of Michigan Consumer Sentiment Index moved up in the final survey to 63.0 from 61.2 in June and 61.7 in the preliminary estimate. The Current Economic Conditions Index (71.0 vs. 73.1 in July) and the Expectations Index (57.9 vs. 53.5 in July) rose in August. The small improvement in consumer sentiment is not entirely significant given the weakening of labor market conditions.

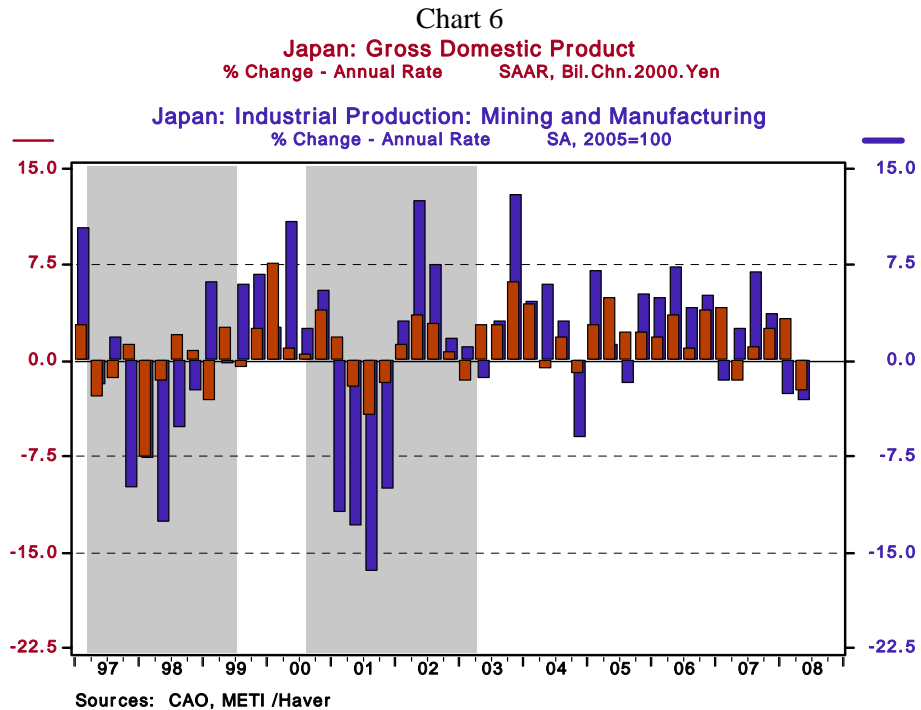
Chart 5  
University of Michigan: Consumer Sentiment  
NSA, Q1-66=100 (I)



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## Japan: The Response to the Upcoming Recession

Even though GDP has not contracted for the two consecutive quarters required, the world's second-largest economy is showing every sign of recession. A prolonged contraction in industrial production has been the main sign of recent recessions, and that seems to be the case as of today's release. The monthly figure for July production was surprisingly up on the month, but it is very likely that it will show another contraction for Q3 as a whole, and GDP will follow suit. Given this grim scenario, it is no surprise that the government took action. However, it would be hasty to call Tokyo's announced measures a 'stimulus' package.

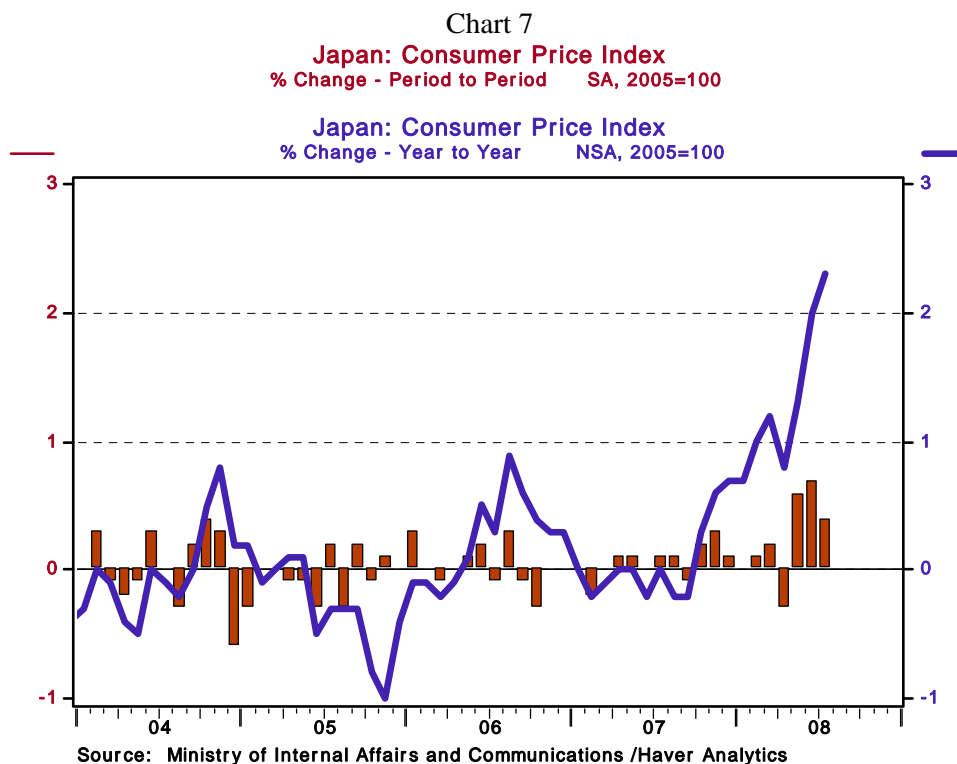


Today, the government announced an ¥11.7 trillion (\$107 billion) set of fiscal measures in response to the weakening economy (and likely to the ruling party's low approval ratings). As opposed to past financial packages, these actions will not aggravate the high government debt burden. Most of the support will be in the form of loan guarantees and other forms of small business assistance, with very little set aside for relief from sharply-rising consumer prices. Some tax cuts were promised as well, but details were thin and they would likely not be introduced until FY2009 (April-March). The strategy behind this fiscal package is to balance the need for economic stimulus with the government's goal of balancing the primary budget. In that context, reviews are mixed.

After years of stable or declining prices, July inflation rose to a decade-high 2.3% according to today's release. Real interest rates are now decidedly negative, and consumer sentiment has taken a significant hit. The fiscal stimulus package does nothing to remedy this situation until April 2009 at the earliest, and by that time the recession may have really sunk its teeth into the economy

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and deeper tax cuts would be required. The main beneficiaries of today's announcement will be small businesses struggling to stay open during such trying times. They will not have any additional incentive to expand operations or create jobs, but there will be some short-term financial padding that could prevent another round of bankruptcies and job losses.



As we said earlier, this is not a 'stimulus' package as much as it is a 'stabilization' package. It is not designed to spur future growth as much as it tries to contain the damage caused by the current economic slowdown. We do not expect a formal stimulus package to be announced until the FY2009 budget, and it is too early to speculate at its magnitude. The current government of PM Yasuo Fukuda may be so weak by that time that it is beholden to its junior coalition partner New Komeito, which has been pressing for low-income tax cuts and a number of costly, populist measures. A new administration may not fare much better, but a change of leadership may buy the ruling party a little time to possibly push through more aggressive measures.

The one thing that is almost certain is that the Bank of Japan (BoJ) will remain on the sidelines for the near-term. Normally, stagflation is a central banker's nightmare, but the BoJ can rest a little easier than most. As it is reluctant to cut interest rates and stimulate the economy in the face of rising prices, it can allow the government to do the easing through fiscal measures and state that rates will remain steady so the government's measures can take hold. We expect rates to remain steady throughout this year and well into 2009, and any surprise change in monetary policy would be a rate cut if the 'recession' deepens significantly over this quarter and next.

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