

DAILY GLOBAL
COMMENTARY

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Factory Sector Has Been in Slump during the Past Year

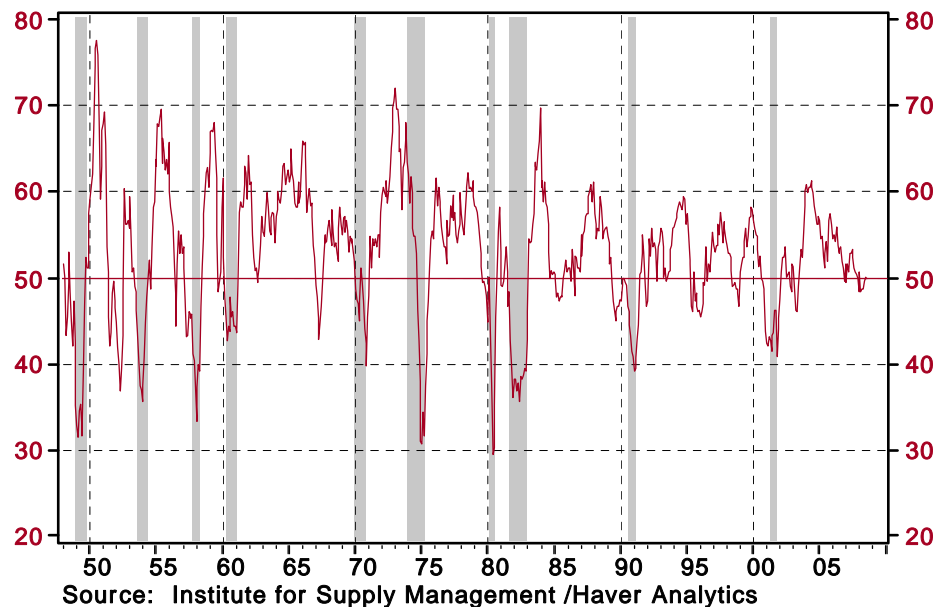
September 2, 2008

The ISM manufacturing composite index has moved between 50.7 and 48.4 since September 2007. During the twelve months ended August 2008, this index posted readings above 50.0 for six months, ranging between a high of 50.7 in January 2008 and a low of 50.0 in October 2007 and July 2008. During the six months in which it held below 50.0, it has hovered between 48.4 and 49.9. In other words, the composite index suggests that the factory sector has been moving around insignificant growth and contraction for a period of twelve months. The composite index for August is 49.9.

Chart 1

ISM Manufacturing: PMI Composite Index

SA, 50+=Increasing



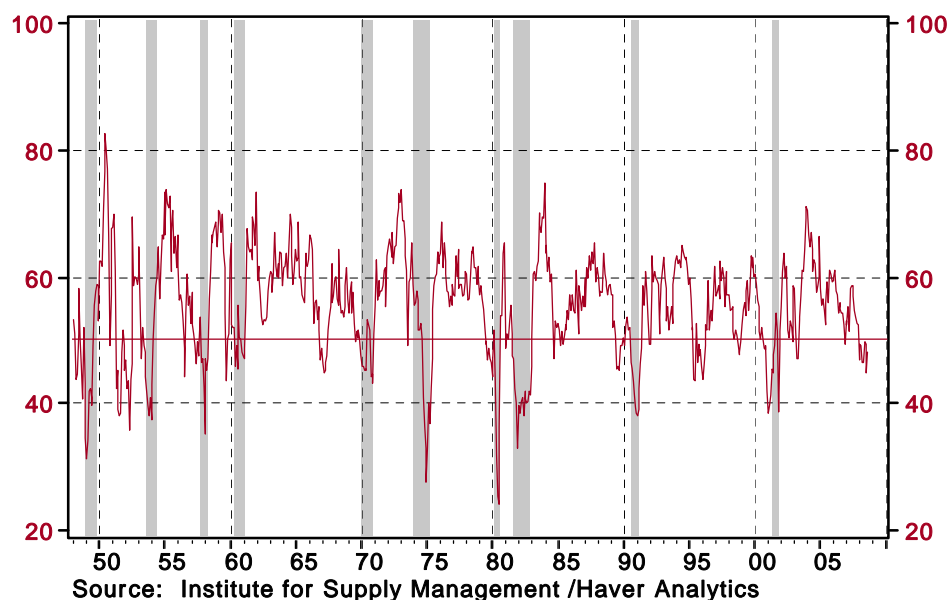
The new orders index, a leading indicator, rose to 48.3 from 45.0 in July. This index has held below 50.0 for nine straight months. Going back in time, with the exception of 1951-52, 1966-67, 1995-96 (see chart 2), the economy has been in a recession when the new orders index held below 50.0 for an extended period. Inflationary concerns and rising interest rates affected the factory sector after the post-war boom in 1951. During the 1966-67 period, the economy skirted around recession and the Fed was easing monetary policy. In the 1995-95 episode, the Fed began lowering the federal funds rate in July 1995 following a large dose of monetary policy tightening in 1994. This period marked the successful soft-landing event of the Greenspan Fed. If history is our guide, it appears that the new orders index from the ISM survey is sending an important message.

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Chart 2

ISM Manufacturing: New Orders Index

SA, 50+=Increasing



ISM Manufacturing Survey – August 2008

	<u>Mar-2008</u>	<u>Apr-2008</u>	<u>May-2008</u>	<u>Jun-2008</u>	<u>Jul-2008</u>	<u>Aug-2008</u>
Composite Index	48.6	48.6	49.6	50.2	50.0	49.9
New Orders	46.5	46.5	49.7	49.6	45.0	48.3
Production	48.7	49.1	51.2	51.5	52.9	52.1
Employment	49.2	45.4	45.5	43.7	51.9	49.7
Vendor Deliveries	53.6	54.0	53.7	55.1	55.1	50.3
Inventories	44.9	48.1	48.0	51.2	45.0	49.3
Prices	83.5	84.5	87.0	91.5	88.5	77.0
Backlog of Orders	47.5	51.5	46.0	47.5	43.0	43.5
New Export Order:	56.5	57.5	59.5	58.5	54.0	57.0
Imports	45.0	48.0	49.5	46.0	46.5	48.5

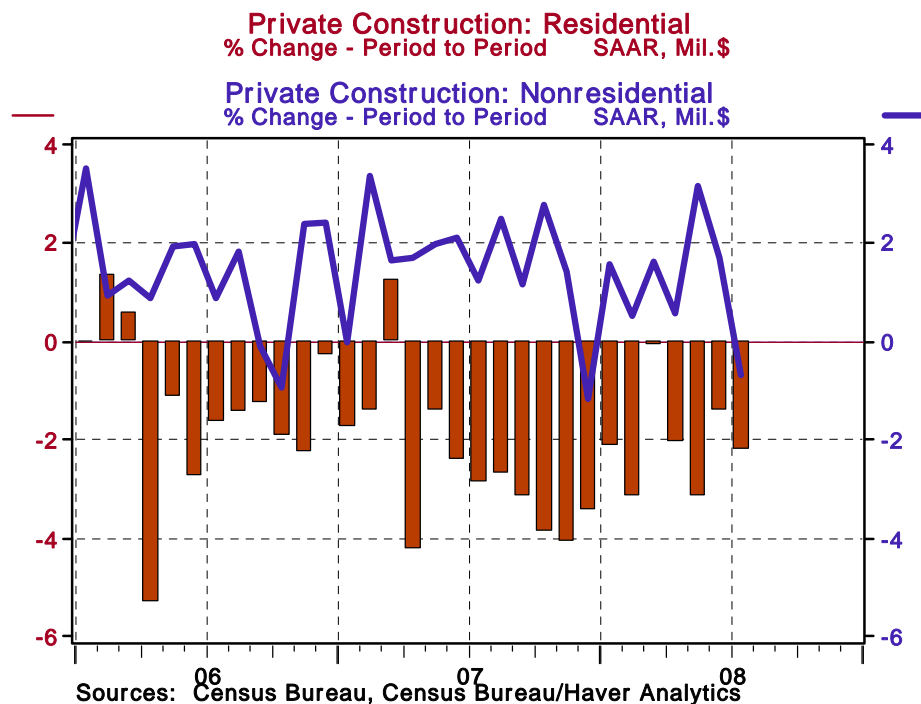
The recovery of the export orders index (57 vs. 54 in July) may have to be considered with care in light of the weak economic reports from abroad. The sharp drop of the price index in the last two months is noteworthy.

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Construction Outlays in Q3 Should Be Weak

Total construction spending fell 0.6% in July, reflecting a 1.4% drop in private sector construction outlays and a 1.4% gain in public sector spending. Both residential (-2.3%) and non-residential private construction expenditures (-0.7%) declined in July. The weakness was such that the July readings of these two categories of construction spending are lower than the quarterly average. With this arithmetical disadvantage, construction spending will have to gather large momentum in August and September to make a positive contribution to overall economic growth in the third quarter, which is unlikely.

Chart 3



Construction Outlays – July 2008 (percent change from prior month)

	Total	Private	Residential	Non-residential	Public
Mar-2008	1.4	0.8	-0.1	1.6	3.2
Apr-2008	-0.5	-0.8	-2.1	0.6	0.2
May-2008	0.3	0.1	-3.2	3.1	0.9
Jun-2008	0.3	0.2	-1.4	1.7	0.4
Jul-2008	-0.6	-1.4	-2.3	-0.7	1.4

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Australia: RBA Sides In Favor of Growth

Like most of the industrialized world, Australia has been facing rising prices and a waning economy. During this time, the Reserve Bank of Australia (RBA) has opted for containing consumer prices at the expense of growth, and its particularly assertive rate hikes during the past two years have placed interest rates among the highest in the G10. But now, after six months of a steady Official Cash Rate of 7.25%, the RBA is shifting to easing mode. Effective on September 3, the OCR will be 7.00%, with an accommodative bias. With inflation still on the rise, the change in monetary policy direction appears to be due to expectations that the worst has passed, or at least plateaued.

Chart 4

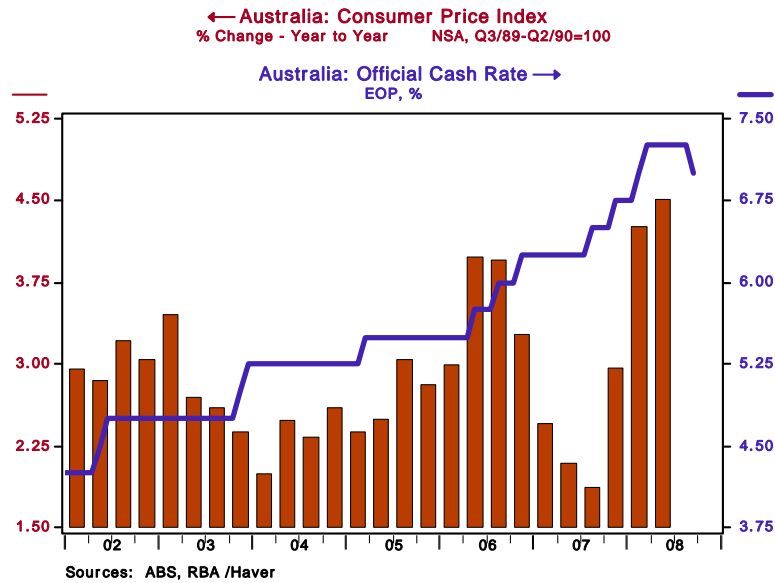
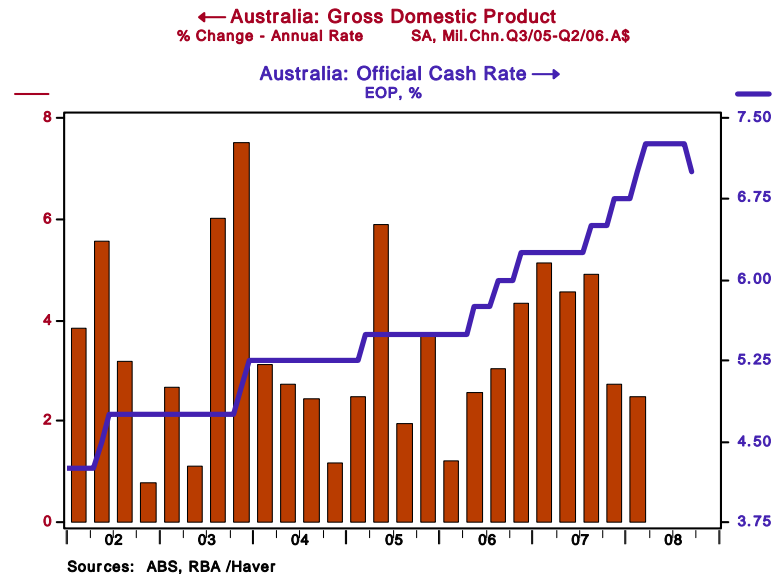


Chart 5



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The main shift in the RBA's thinking comes from a few neatly-packaged parts of the monthly statement released by Bank Governor Glenn Stevens. As these releases are largely boilerplate pieces, the substance comes in the one- or two-word changes to pivotal parts, or the addition of particularly choice phrases. Below are quotes from today's release, with key sections italicized and the verbiage from the previous month inserted in parenthesis:

"The evidence is that the *tight* (tightening in) financial conditions, in conjunction with other factors including *higher* (rising) fuel costs and lower asset values, have *exerted the needed restraint on* (restrained) demand"

"Surveys suggest a softening in business activity *and growth in production has slowed*. *Indicators of capacity utilisation, while still high, are declining and* (omitted) there have also been some (early) signs of an easing in labour market conditions."

The first quote suggests that the crisis criteria mentioned in August – tightening conditions, rising costs – have changed from active events to passive conditions by this month, and the impact they exerted on the economy has been priced into the equation as well. The second quote adds a few more qualifiers of an economic slowdown, suggesting that is where the RBA is now focused.

The statements about inflation were largely unchanged, mostly repeating that the CPI is only likely to moderate next year and fall into the RBA's target range of 2-3% by 2010. So, in balance, there is a greater concern about an economic slowdown in the near future – so much so that the RBA tipped in favor of a modest cut to the OCR, the first since 2001.

The Bank is likely to take a cautious approach to easing rates, perhaps only cutting once more this year by 25 bps. Not only does the RBA have to weigh the tradeoff between slowing growth and rising consumer prices, but there is also a concern that more aggressive easing could weaken the strong A\$, possibly triggering outflows of short-term foreign investment in high-yielding Aussie debt. A sharp, sudden fall in the A\$ would offer another round of imported inflation and undo all the work the RBA has put into avoiding a recession.