

DAILY GLOBAL  
COMMENTARY

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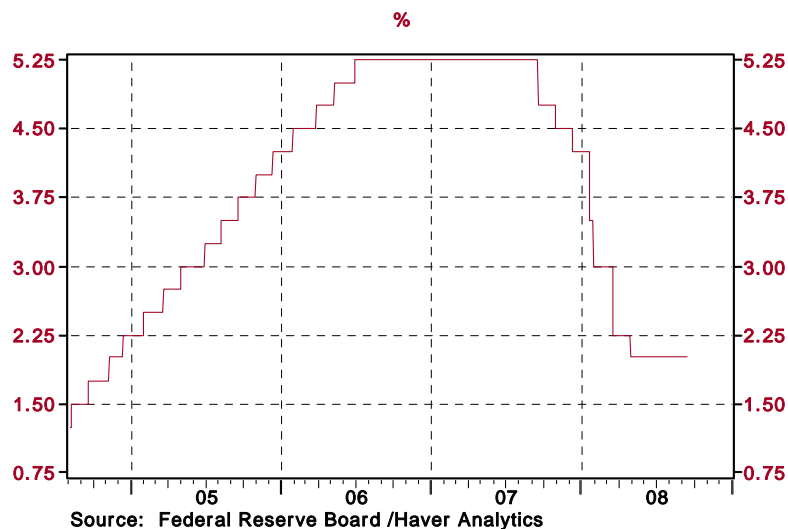
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## FOMC Holds Federal Funds Rate Steady

September 16, 2008

The Fed held the federal funds rate steady at 2.00% today, September 16, after three dramatic market moving events on September 15 -- Lehman Brother's bankruptcy, the sale of Merrill Lynch, and the shaky status of AIG. It was a unanimous vote to hold the funds rate unchanged, in stark comparison to prior meetings in 2008 which always included a dissent. The fact that the Fed widened the range of securities considered eligible for borrowing at the fund before today's meeting but left the federal funds rate unchanged suggests that it views the federal funds rate as appropriate to promote growth and sees financial market issues as a matter of inadequate liquidity. As of this writing, equity markets viewed this action in positive light, with equity prices and the dollar rallying.

Chart 1  
Federal Open Market Committee: Fed Funds Target Rate



The policy statement shows a shift to a neutral intermeeting bias, with the risk of higher inflation and weaker economic growth placed on equal footing.

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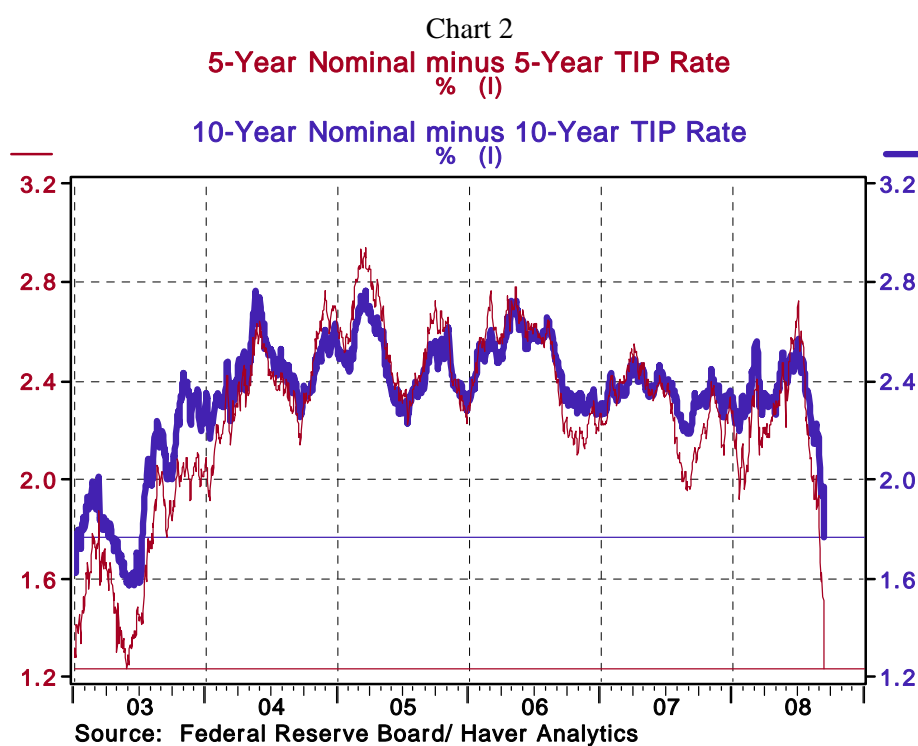
*“The downside risks to growth and the upside risks to inflation are both of significant concern to the Committee.”*

August 5, 2008:

*“Although downside risks to growth remain, the upside risks to inflation are also of significant concern to the Committee.”*

However, the language and tone of the first paragraph leans toward greater concern about growth in the inflation-growth debate. The statement duly noted that financial market stress “has increased significantly” and “labor markets have weakened further.” The statement listed three factors – tight credit conditions, the ongoing housing contraction, and some slowing in export growth – that are likely to hold back economic activity. “Slowing export growth” was included in this statement, which is consistent with the nature of economic reports from abroad.

The still worrisome statement about inflation is puzzling because it cites higher energy and commodity prices, which have now dropped noticeably. The exclusion of elevated inflation expectations is justified given the recent decline in inflation expectations (see chart 2).



Although industrial production fell 1.1% in August and the capacity utilization rate is now at 78.7, similar readings were last reported in October of 2004 (see chart 3), and the unemployment rate in August was 6.1%, the policy statement continues to hold that the outlook for inflation is “highly uncertain.” There is a contradiction here because the policy statement also notes that “the Committee expects inflation to moderate later this year and next year.” Is it too early to note that inflation is less of a threat than previously thought, given that the CPI report, published earlier in the morning, showed a 5.4% year-to-year increase and a 2.54% year-to-year gain in the core CPI? At the end of the day, the key to economic recovery is credit expansion, which is unlikely to occur in the near term.

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Chart 3  
**Capacity Utilization: Industry**  
 SA, Percent of Capacity

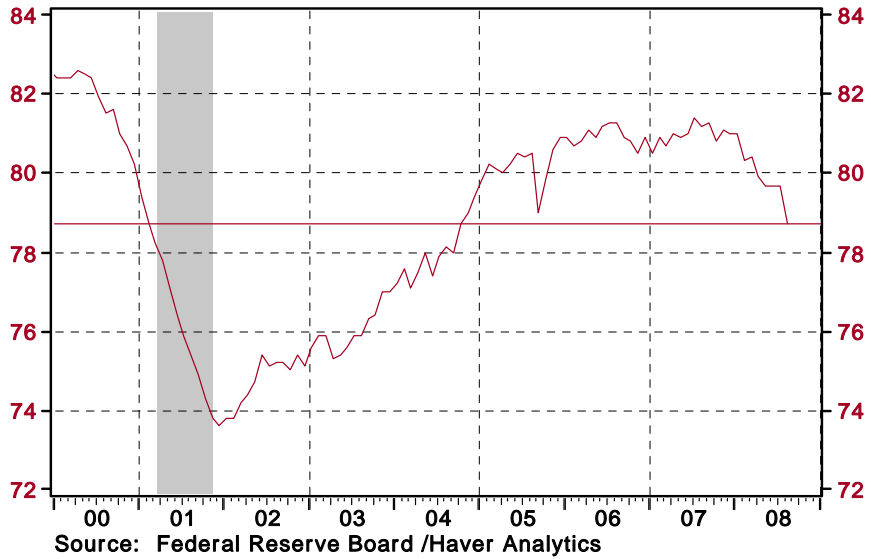
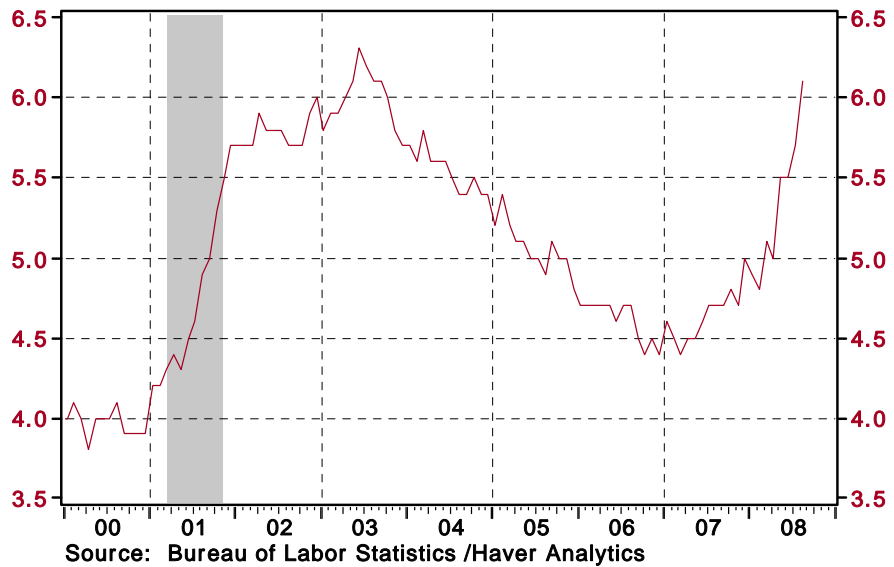


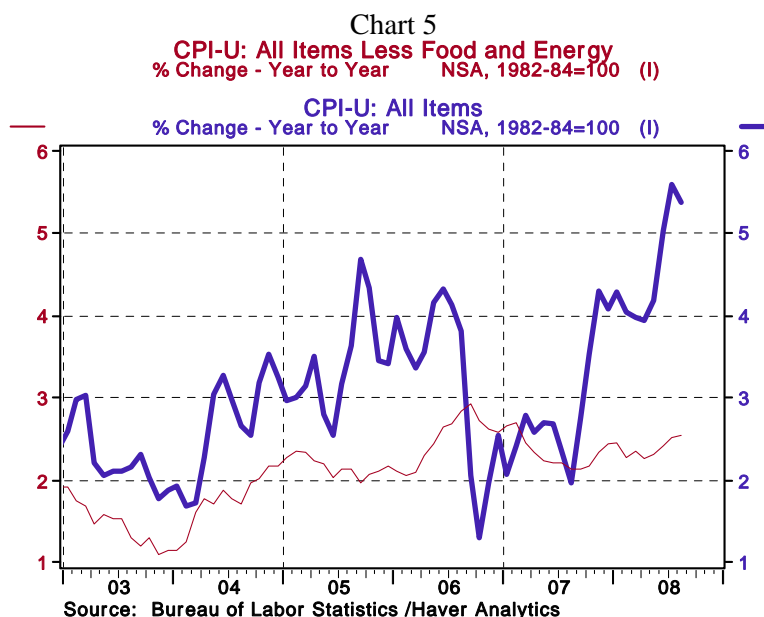
Chart 4  
**Civilian Unemployment Rate: 16 yr +**  
 SA, %



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## Consumer Price Index – August 2008

The Consumer Price Index (CPI) fell 0.1% in August, after a string of three significant monthly gains. On a year-to-year basis, the CPI has moved up 5.4% in August compared with a 4.1% increase in all of 2007. During the three months ended August, the CPI has risen at an annual rate of 7.2% vs. a 10.6% gain during the three months ended July. The 3.1% drop in energy prices reflects a 4.2% drop in gasoline prices, lower prices for natural gas and heating oil but higher prices for electricity. The food price index moved up 0.6%, putting the year-to-date gain at 7.5%. In 2007, food prices rose 4.9%, after a 2.1% increase in 2006.



Excluding food and energy, the core CPI rose 0.3% in August, translating to a 2.54% year-to-year gain vs. a 2.44% increase in 2007. In August, prices of clothes advanced 0.5%, car prices fell 0.6%, airfares increased 1.6%, while the shelter index moved up only 0.1%, and recreation costs rose 0.5%. The financial market crisis underway and a significantly weak economy point to a noticeable moderation of inflation in the months ahead.

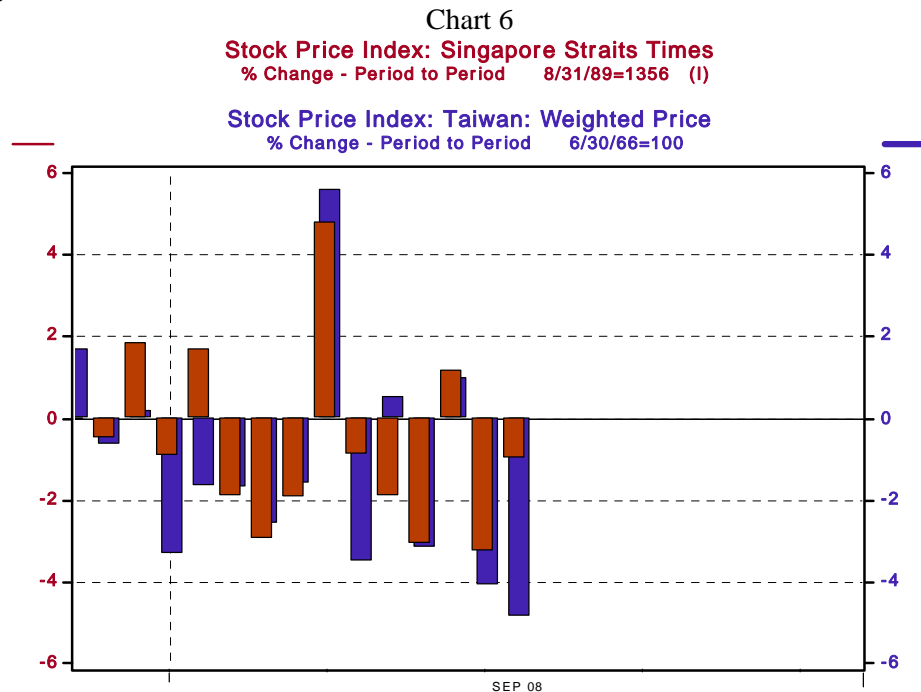
## Consumer Price Index – August 2008

	% change	annualized % change			% change		
	prior month	year-to-date	3 mo. ago	6 mo. ago	Aug-08 yoy	Aug-07 yoy	Dec-07 yoy
CPI - ALL ITEMS	-0.1	5.1	7.2	6.0	5.4	2.0	4.1
CORE - ALL ITEMS LESS FOOD & ENERGY (76.47)*	0.2	2.5	3.4	2.6	2.5	2.1	2.4
CPI ALL ITEMS LESS ENERGY (91.3)	0.3	3.3	4.4	3.4	3.1	2.4	2.8
FOOD (13.83)	0.6	7.5	9.6	7.8	6.1	4.3	4.9
ENERGY (9.69)	-3.1	22.4	32.9	30.6	27.2	-2.5	17.4
SHELTER (32.6)	0.1	2.0	2.4	2.0	2.4	3.4	3.1
COMMODITIES (41.27)	-0.5	6.4	10.4	7.9	7.3	0.2	5.2
COMMODITIES LESS FOOD & ENERGY (21.6)	0.1	0.7	2.5	0.8	0.6	-0.7	0.1
SERVICES (58.7)	0.1	4.3	4.8	4.7	4.1	3.2	3.3
SERVICES LESS ENERGY SERVICES (54.87)	0.2	3.2	3.8	3.4	3.3	3.2	3.3
FRB CLEVELAND MEDIAN CPI	0.3	3.3	3.8	3.5	3.3	2.9	3.1

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## Asia: When the US Sneezes, Who Will Catch A Cold?

Perhaps it was good fortune, but a few of the Asian markets were closed for a public holiday on Monday, and therefore missed the first wave of equity sell-offs. But now that the rest of the markets are open for business, everyone has had a chance to react to events in the US financial sector. Not surprisingly, the major Asian exchanges sold off big time on their first day of business. However, for those bourses that were open on Monday and have had a second day to process everything, the response is much more telling. In particular, Singapore and Taiwan exemplify this.



Source: Wall Street Journal/Financial Times /Haver Analytics

Just as both indexes were up over 4% on September 8 when the word got out about the Fannie Mae and Freddie Mac bailouts, they also dove over 3% with the Lehman Brothers/Merrill Lynch news. However, Taiwan went into a sharper sell-off mode the next day in both instances, where Singapore had a more moderated trading day. We find this quite telling not only about equity performance in general, but how the financial sectors are perceived and how the situation in the US will impact Asia.

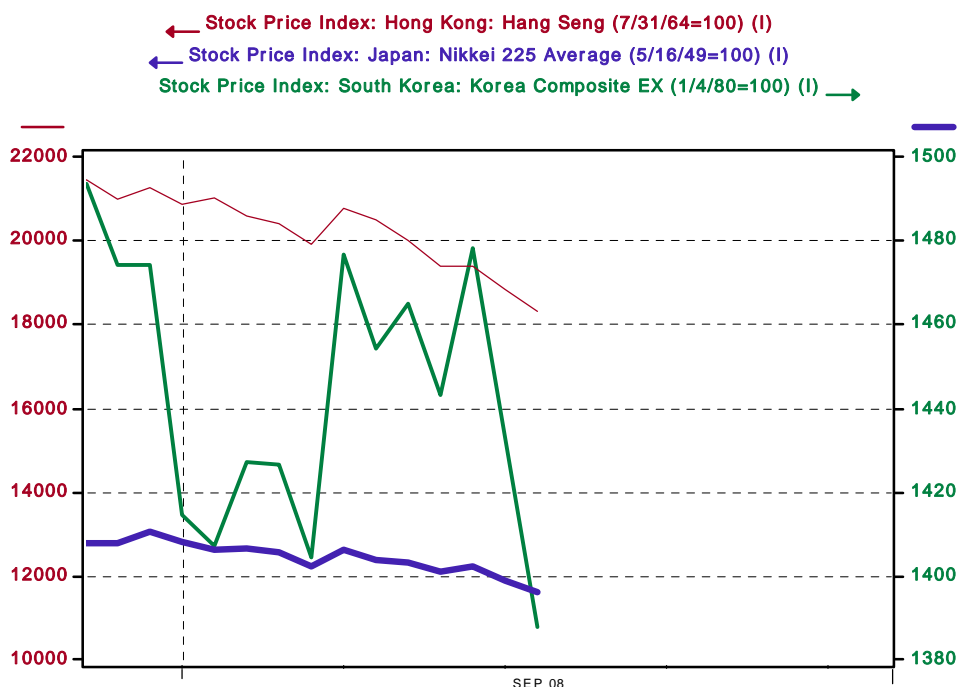
The news coming out of Singapore so far is that the major institutions are not reporting significant holdings in Lehman Brothers. While the state institutions will likely not reveal their positions immediately, it is believed that exposure is contained and will not have a drastic impact on future performance. This is not surprising, as the city-state's financial sector is deep, sophisticated and regarded as one of the better-regulated in all of Asia. Once the markets got over the reactionary selling and repositioning, Tuesday's trading had less volatility – presumably because there was still confidence that in the long-run, local banks would not end up bedridden from contagion from the US.

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Conversely, Taiwan continued its sell-off into Tuesday, and we are not particularly surprised. While the local banking system is quite large, it has some structural weaknesses that are hard to overlook. Non-performing loans are still an issue with Taiwanese banks, the regulatory environment has several shortcomings (particularly a lack of transparency), and the state has not divested itself from all institutions. So, when Taipei traders came to work Tuesday morning, they did not have the reassurances that their Singaporean counterparts possess. The central bank even recognized this, and cut reserve ratio requirements from 5.75% to 5.00% to add liquidity to the markets. Whether this is enough cold medicine to stave off the chills, however, is hard to say.

Other markets that were closed on Monday and deserve a good look are Japan, Hong Kong and South Korea. They all had their sell-offs today for their first business day of trading, as expected. Our concern is how tomorrow's performance will go, and what we can deduce from that data.

Chart 7



Source: Wall Street Journal/Financial Times /Haver Analytics

South Korea gives us pause, and not just because of Lehman Brothers (local banks held an estimated \$1.4 billion in Lehman assets). Korea has been rather volatile of late for several reasons – questions about the government's ability to tap capital markets, short-term liquidity concerns, and the stability of the depreciating won to name but a few. While none of these individual issues are a significant threat to near-term stability, in aggregate they are weighing heavily on market confidence. Now that US financial sector issues have joined the dog pile of bad news weighing on Korea's markets, we think that there might be some bad days ahead. If the KOSPI sells off tomorrow, it means that the markets have not found any reason to reclaim some confidence.

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Japan is already in a bind with negative GDP growth and decade-high inflation, but these have been priced into the markets already. The official word from Tokyo officials is that the US financial crisis will not have a significant impact on the Japanese financial system, and the Bank of Japan added ¥2.5 trillion (\$23.8 billion) into the market to maintain short-term stability. However, Japan's banking sector has not exactly reclaimed the market's confidence over the past several years of reform, and with the economy already on shaky ground it might take more than assuring words and a pile of yen to ease nervous traders. The Nikkei sold off 5% today on its first day of trading, so if there is some confidence that Japanese banks – which admittedly are in better shape than during the last recession – can ride this through, the trading day will be a non-event. But if the sell-off continues and market activity is high, the opinion is that Japan just caught the sniffles.

And as for Hong Kong, we feel it's in the same camp as Singapore, with a sound financial sector that can weather short-term turbulence. The Hong Kong Monetary Authority issued a statement today that HK banks had "insignificant" exposure to Lehman Brothers, citing a figure equal to 0.05% of total local bank assets. We do recognize that the economy is enduring some hard times, with GDP having contracted in Q2 and likely to do so again this quarter due to slowing global trade. However, we still feel that the banking sector's resiliency will carry the day and keep trader confidence high. It would not surprise us if trading on the Hang Seng was downright boring on Wednesday relative to recent activity.

Further down the spectrum of developing economies, the less-sophisticated markets are being thoroughly pummeled thanks to both low confidence and a general flight to quality. Until matters settle down in the US, which may not be too soon, safe havens from the US financial crisis will be few in Asia, and there is the possibility that second-round effects could stifle an early recovery.