**The Northern Trust Company**
**Economic Research Department**

# Positive Economic Commentary

*"The economics of what is, rather than what you might like it to be."*

**50 South LaSalle Street, Chicago, Illinois 60675**

Web Page -- http://www.northerntrust.com (See Economic Research)
Paul Kasriel (312)-444-4145 Fax (312)-444-4132

This week's commentary is a detailed presentation about the unbalanced status of U.S. economy and investment implications of the inevitable consequences of rebalancing.

***Paul L. Kasriel, Director of Economic Research (plk1@ntrs.com)***


# INVESTMENT IMPLICATIONS OF THE INEVITABLE REBALANCING OF THE U.S. ECONOMY

# OR

# MAKING LEMONADE OUT OF LEMONS

Comments By

**PAUL L. KASRIEL**

Sr. Vice President & Director of Economic Research

The Northern Trust Company

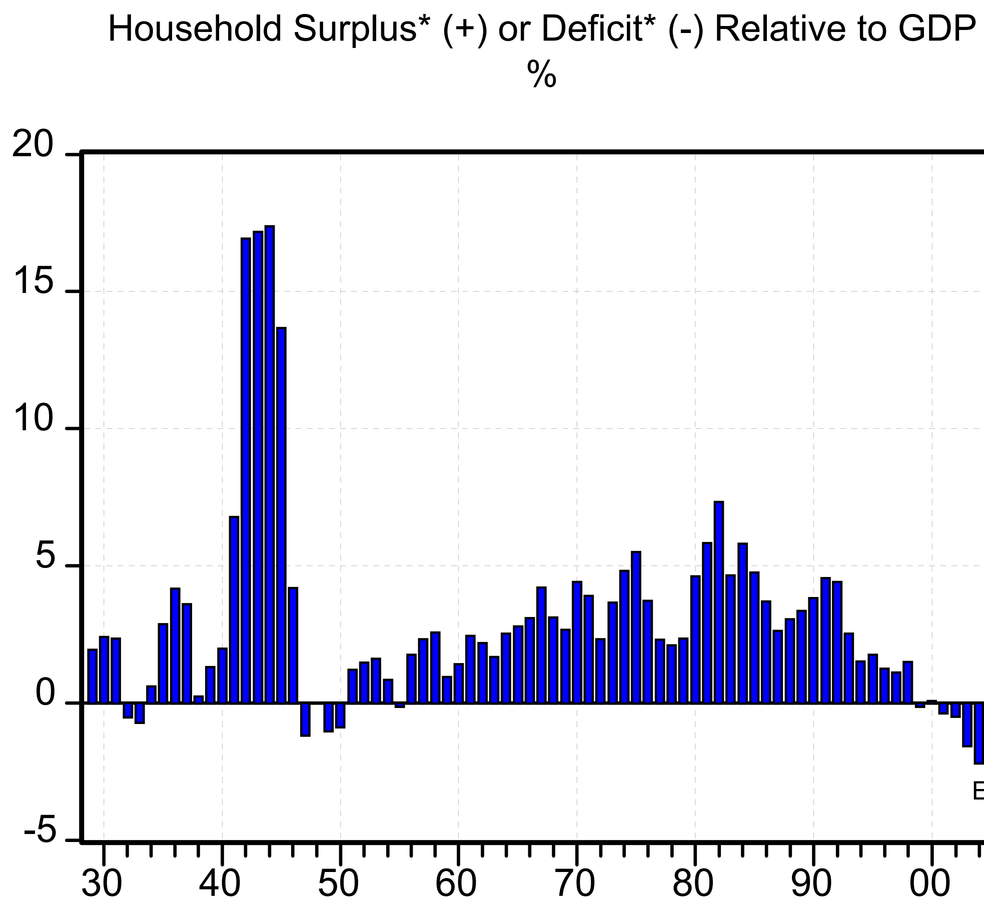
October 2004

Northern Trust

# THE U.S. ECONOMY IS FUNDAMENTALLY UNBALANCED

- EXCESSIVE HOUSEHOLD SPENDING AND BORROWING
- EXCESSIVE GOVERNMENT SPENDING AND BORROWING
- TOO LITTLE BUSINESS CAPITAL SPENDING
- EXCESSIVE FOREIGN CENTRAL BANK FINANCING OF U.S. NET DEFICIT

# HOUSEHOLDS USUALLY RUN SURPLUSES, BUT THEY ARE NOW RUNNING BIGGER *DEFICITS* THAN THEY DID RIGHT AFTER WWII



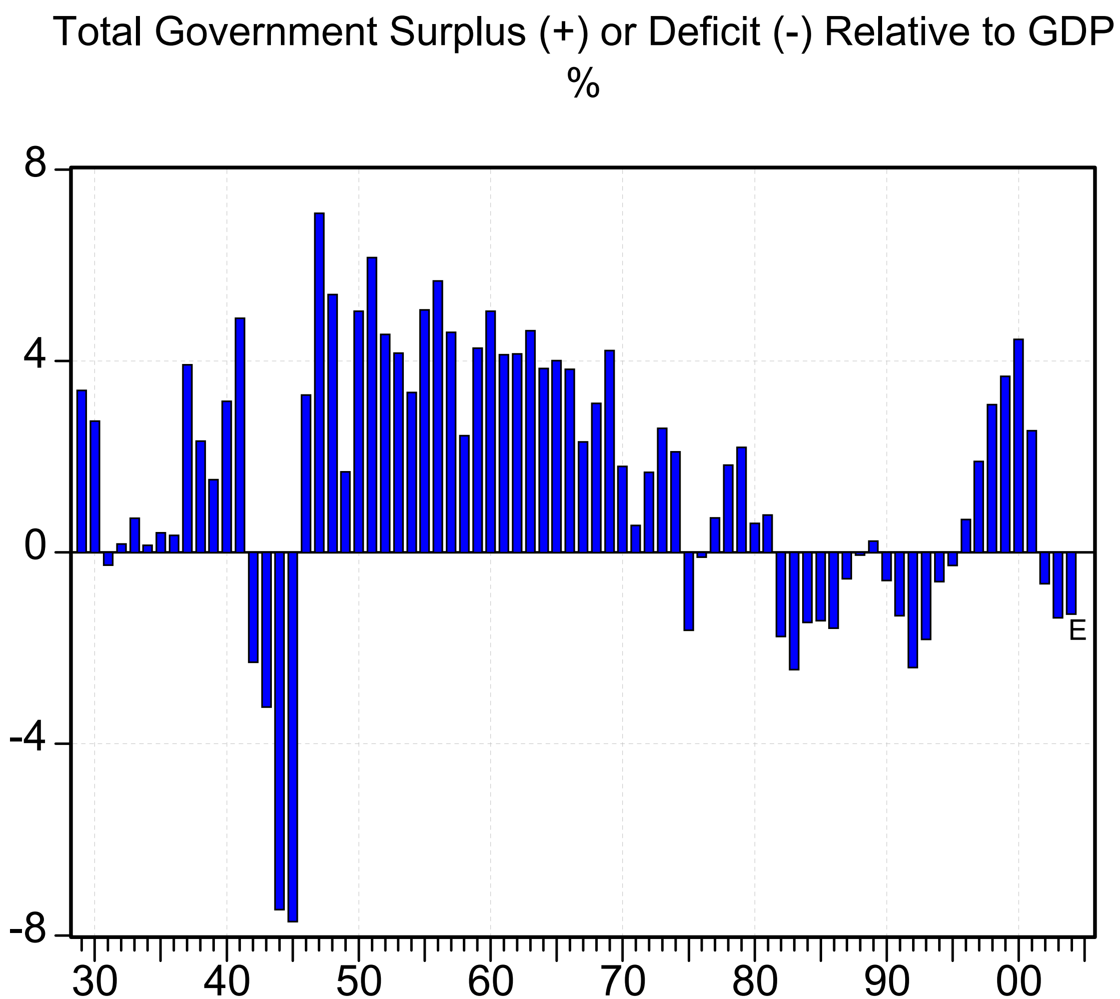

* Disposable Personal Income minus sum of expenditures on Consumption and Residential Investment

E= average of Q1 and Q2 in 2004



Northern Trust

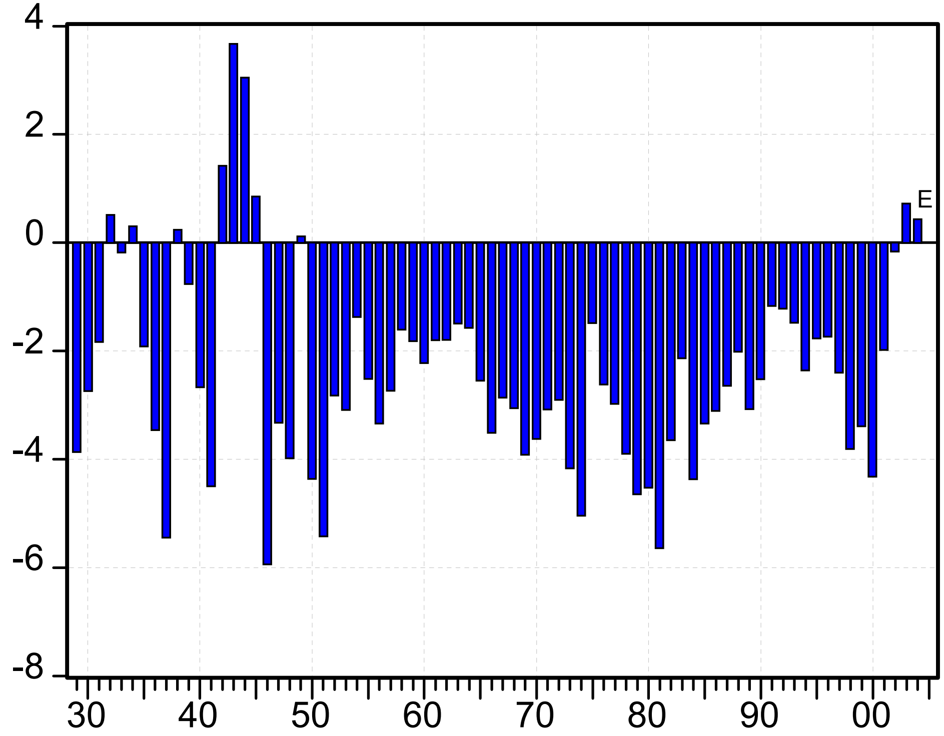
# LESS SURPRISINGLY, THE COMBINED U.S. GOVERNMENT SECTOR ALSO IS RUNNING A DEFICIT




E= average of Q1 and Q2 in 2004

# BUT CORPORATIONS, WHICH USUALLY ARE IN DEFICIT, ARE NOW RUNNING THEIR BIGGEST *SURPLUSES* SINCE THE WWII YEARS

Corporate Surplus* (+) or Deficit* (-) Relative to GDP
%



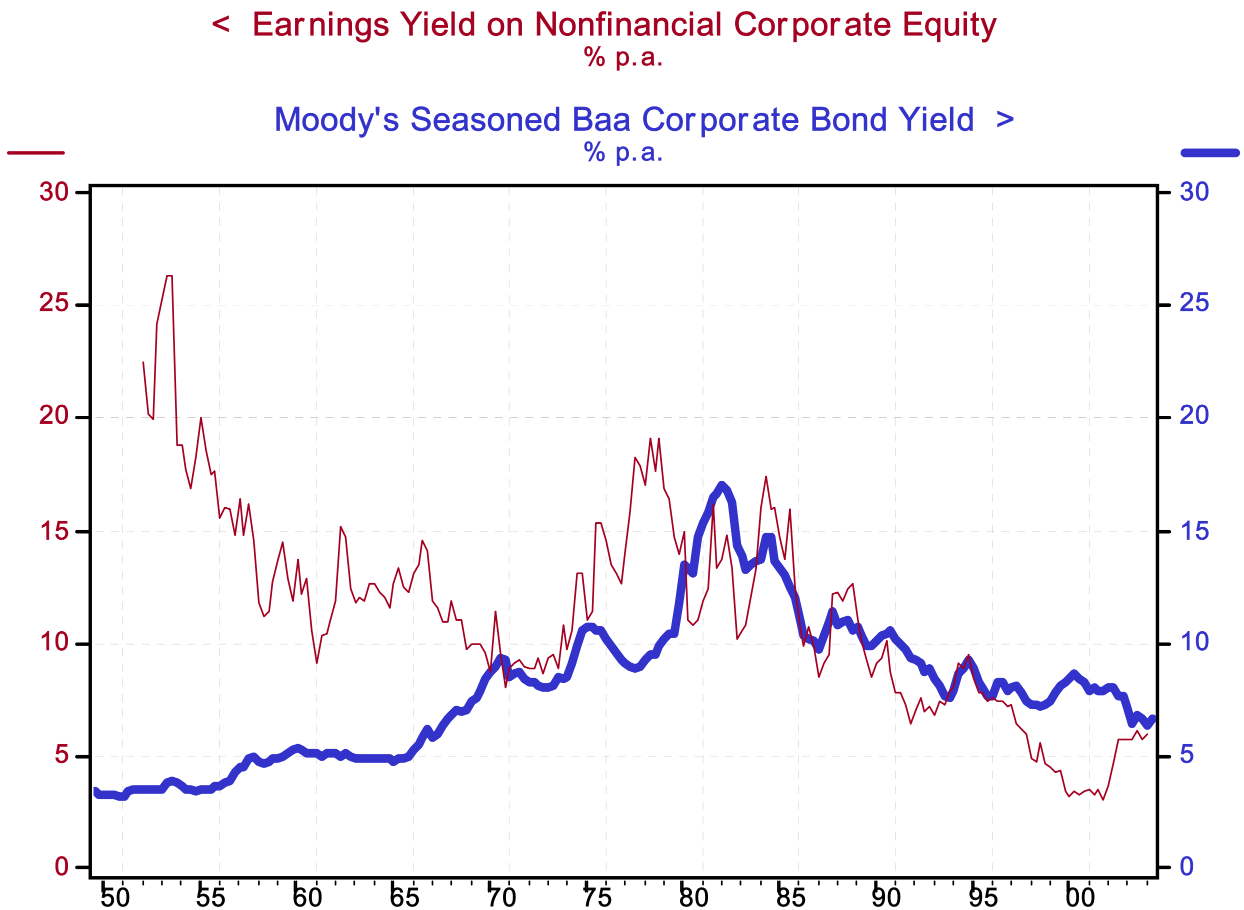

* Cash flow minus sum of nonresidential fixed investment expenditures and change in business inventories

E= Average of Q1 and Q2 in 2004



Northern Trust

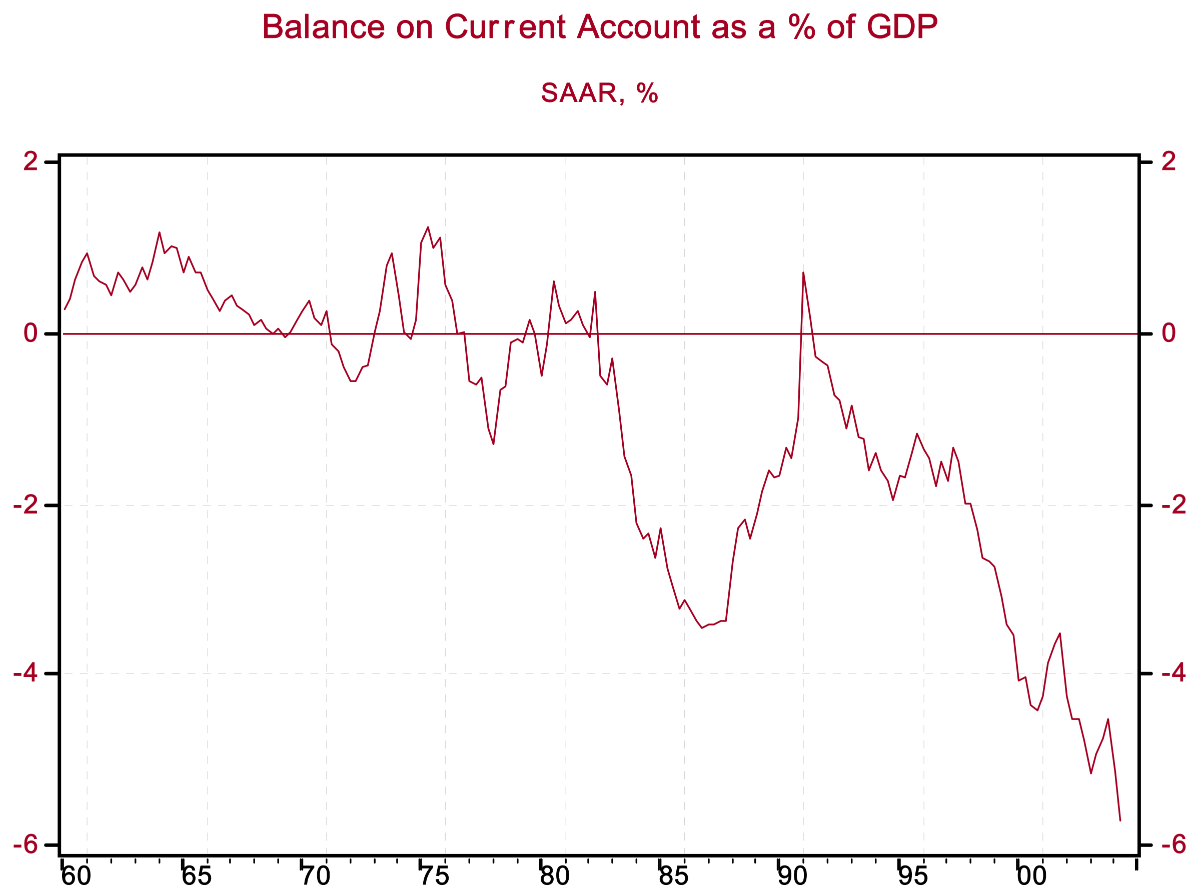
# BY THE WAY, THE FACT THAT CORPORATIONS ARE RUNNING SURPLUSES IN THE FACE OF LOW COSTS OF CAPITAL SUGGESTS THAT THE EXPECTED RETURN ON CAPITAL IS LOW






Northern Trust

# BECAUSE THE COMBINED DEFICITS OF THE HOUSEHOLD AND GOVERNMENT SECTORS EXCEED THE SURPLUS OF THE CORPORATE SECTOR, BY IMPLICATION , WE ARE RUNNING A LARGE DEFICIT WITH THE REST OF THE WORLD TO THE TUNE OF $665 BILLION



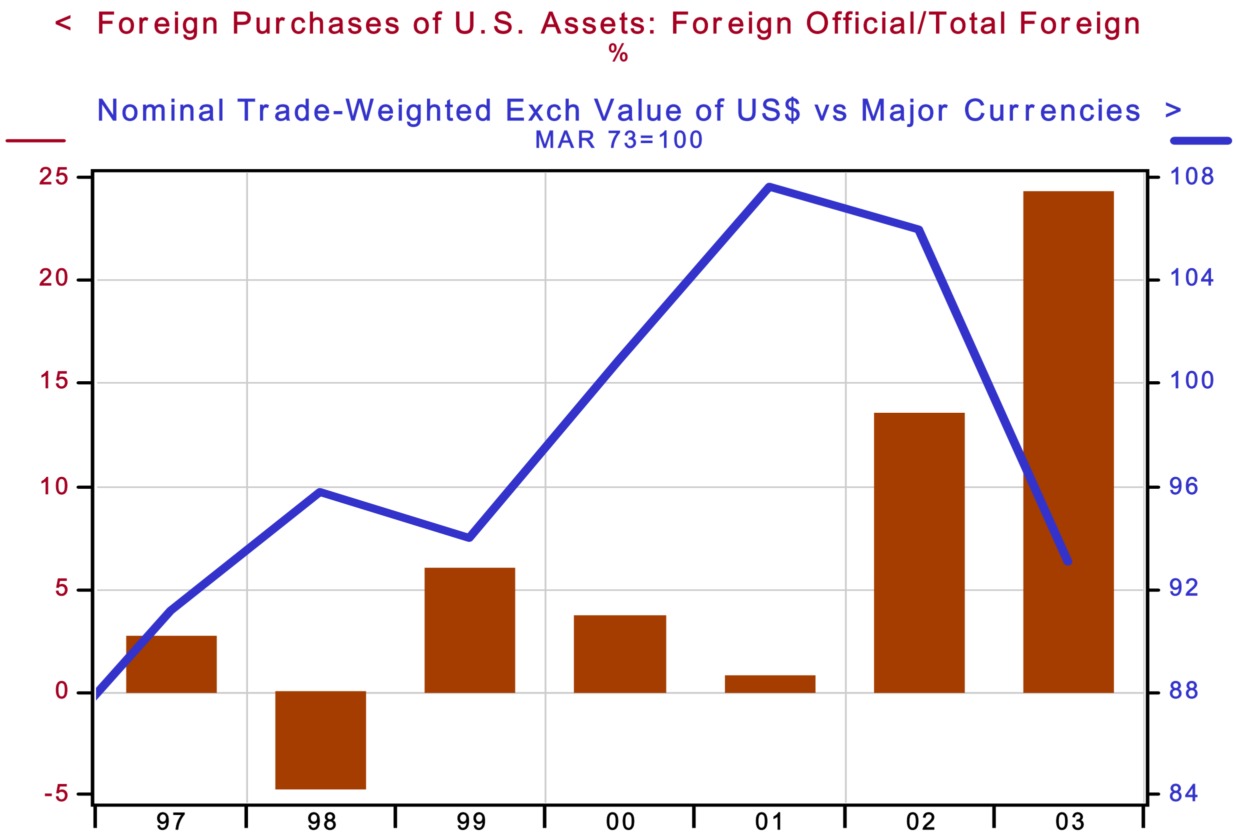



Northern Trust

## HOW LONG WILL THE REST OF THE WORLD KEEP SENDING US $1.8 BILLION A DAY SO THAT WE CAN KEEP BUYING SUVs, McMANSIONS AND CRUISE MISSILES?

- IF A CORPORATION USED MOST OF ITS STOCK AND BOND SALES PROCEEDS TO THROW EMPLOYEE PARTIES, WOULD NOT INVESTORS SOUR ON IT?
- BECAUSE ALL OF OUR FOREIGN DEBT IS DENOMINATED IN DOLLARS, MIGHT WE NOT TRY TO “PRINT” OUR WAY OUT OF THIS?

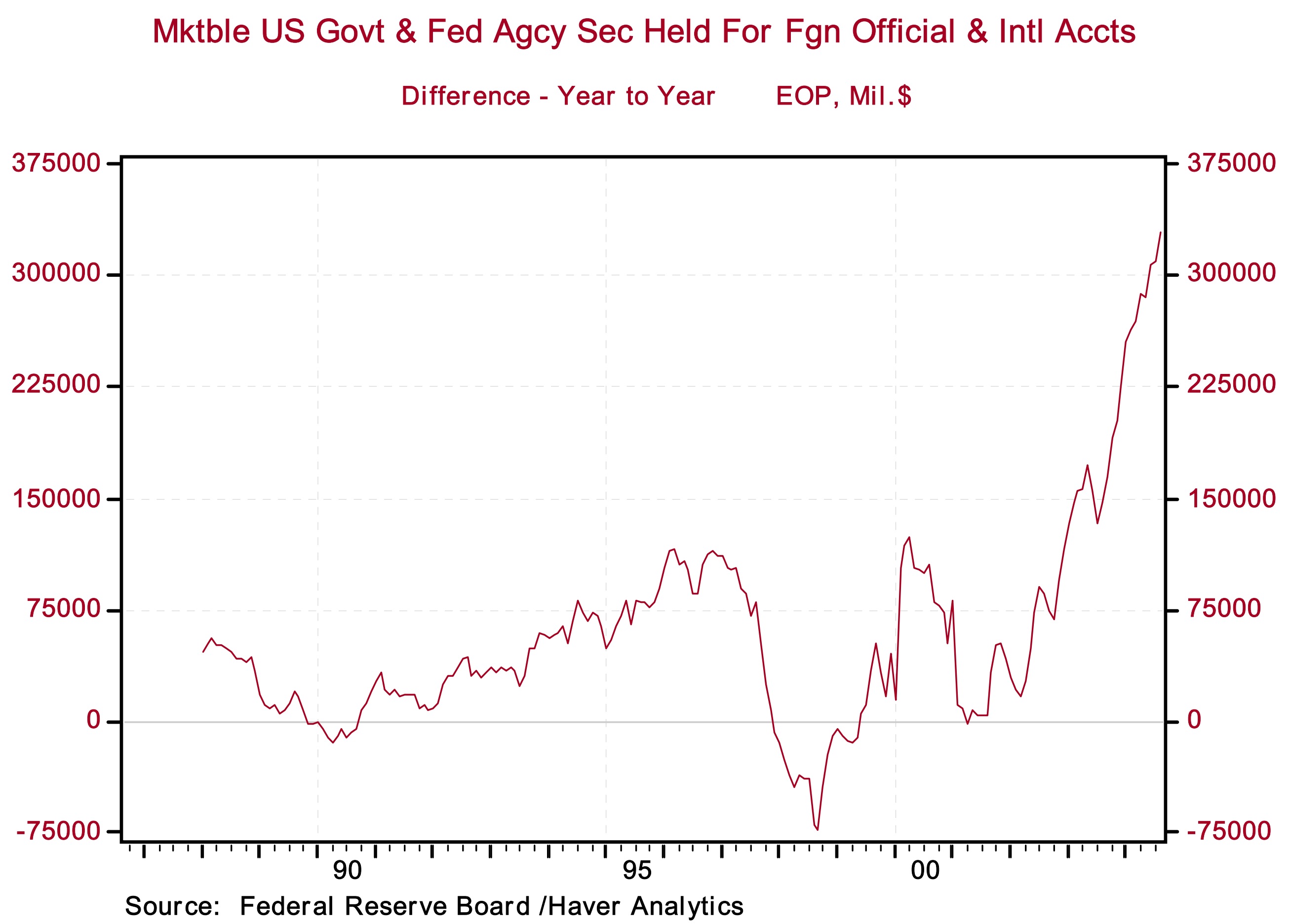
# IT APPEARS AS THOUGH *PRIVATE* FOREIGN INVESTORS *ARE* GETTING WARY OF BEING PAID IN DOLLARS WITH DIMINISHING PURCHASING POWER, BUT NOT FOREIGN *OFFICIAL* INVESTORS






Northern Trust

# IN THE PAST 12 MONTHS, FOREIGN OFFICIAL "INVESTORS" HAVE PURCHASED $330 BILLION OF U.S. GOVERNMENT AND AGENCY SECURITIES – ABOUT 50% OF OUR CURRENT ACCOUNT DEFICIT



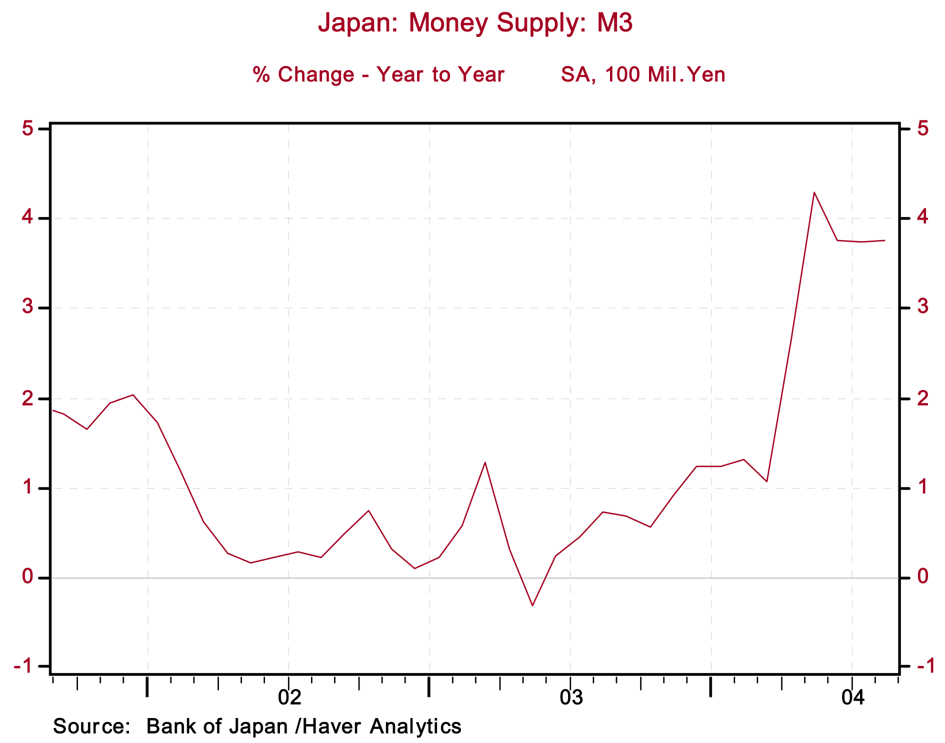



Northern Trust

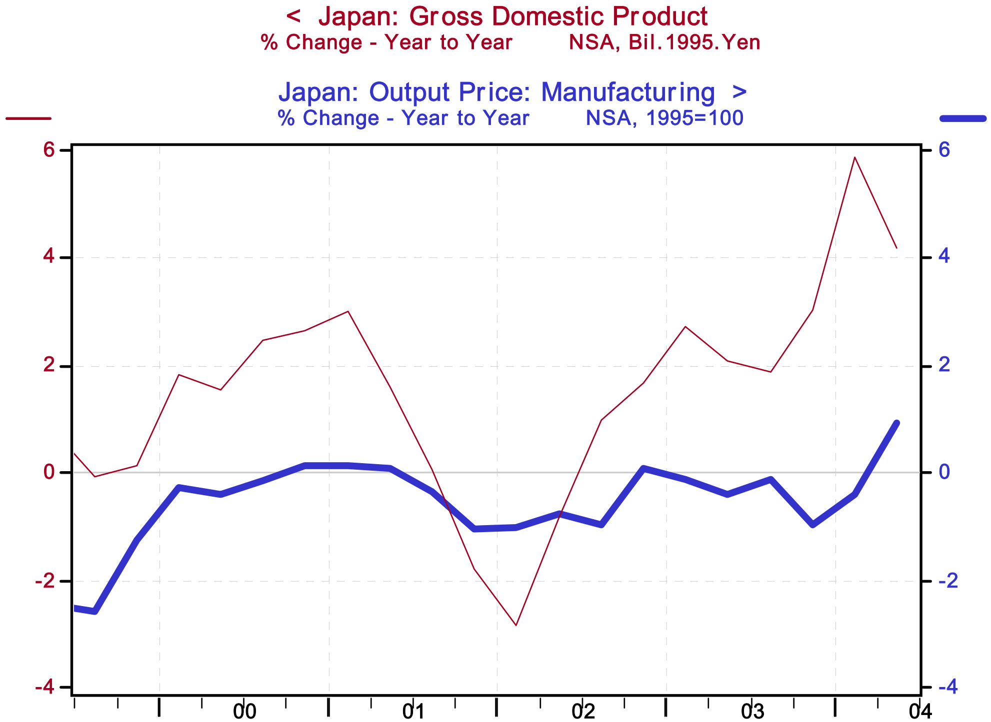

# WHAT MIGHT CURB FOREIGN OFFICIAL INVESTORS' APPETITE FOR DOLLAR ASSETS?

# PERHAPS WHEN THEY TIRE OF IMPORTING OUR INFLATION?

# WHERE DO THESE FOREIGN OFFICIAL INVESTORS – PREDOMINANTLY FOREIGN CENTRAL BANKS – GET THE FUNDS TO BUY DOLLAR ASSETS? THEY "PRINT" THEM!



# BY SUPPORTING THE FUNDAMENTALLY WEAK DOLLAR, FOREIGN CENTRAL BANKS ARE REFLATING THEIR OWN ECONOMIES




Sources: Cabinet Office, Bank of Japan /Haver Analytics

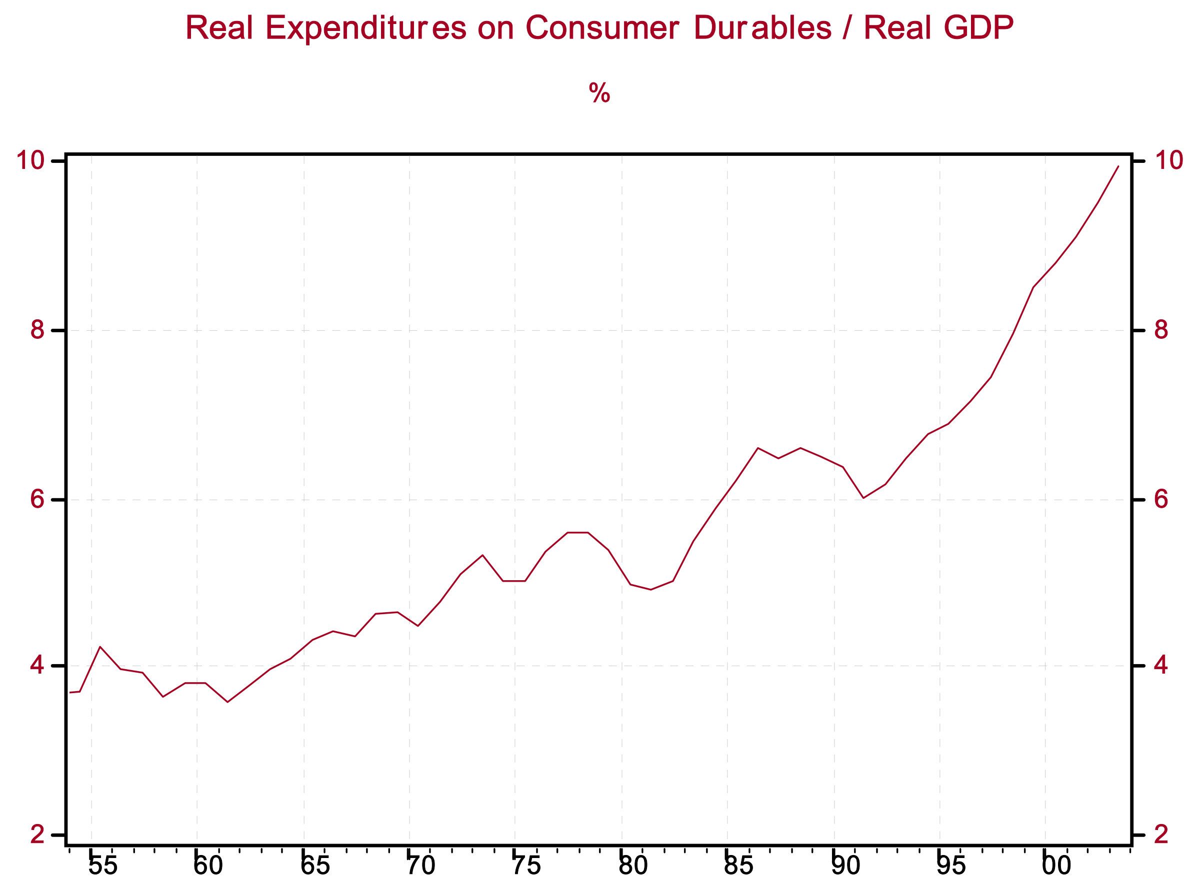
# WHEN THEIR ECONOMIES START TO OVERHEAT, FOREIGN CENTRAL BANKS WILL STOP SUPPORTING THE DOLLAR

- THE FALLING DOLLAR AND STRONG FOREIGN ECONOMIES WILL STIMULATE U.S. EXPORTS
- AS RELATIVELY MORE U.S. OUTPUT IS DEVOTED TO EXPORTS, UPWARD PRESSURE ON U.S. INFLATION WILL RESULT UNLESS DOMESTIC DEMAND IS CURBED
- THE FED WILL RESPOND TO THE DEVELOPING INFLATIONARY PRESSURES BY RAISING ITS POLICY INTEREST RATE
- HIGHER INTEREST RATES WILL PROVIDE THE MARKET INCENTIVE FOR U.S. HOUSEHOLDS TO CUT THEIR DEFICIT – THAT IS, INCREASE THEIR SAVING

# INVESTMENT IMPLICATIONS OF A SHARPLY DECLINING DOLLAR

- FOREIGN-CURRENCY DENOMINATED-ASSETS WILL HAVE THE "WIND AT THEIR BACK"
- U.S. INTEREST RATES WILL RISE
- U.S. OUTPUT AND CORPORATE PROFITS WILL SHIFT AWAY FROM INDUSTRIES RELATED TO INTEREST-SENSITIVE CONSUMER SPENDING, INCLUDING HOUSING, TOWARD THOSE THAT ARE EXPORT-ORIENTED
- BASIC MATERIALS PRICES WILL RISE

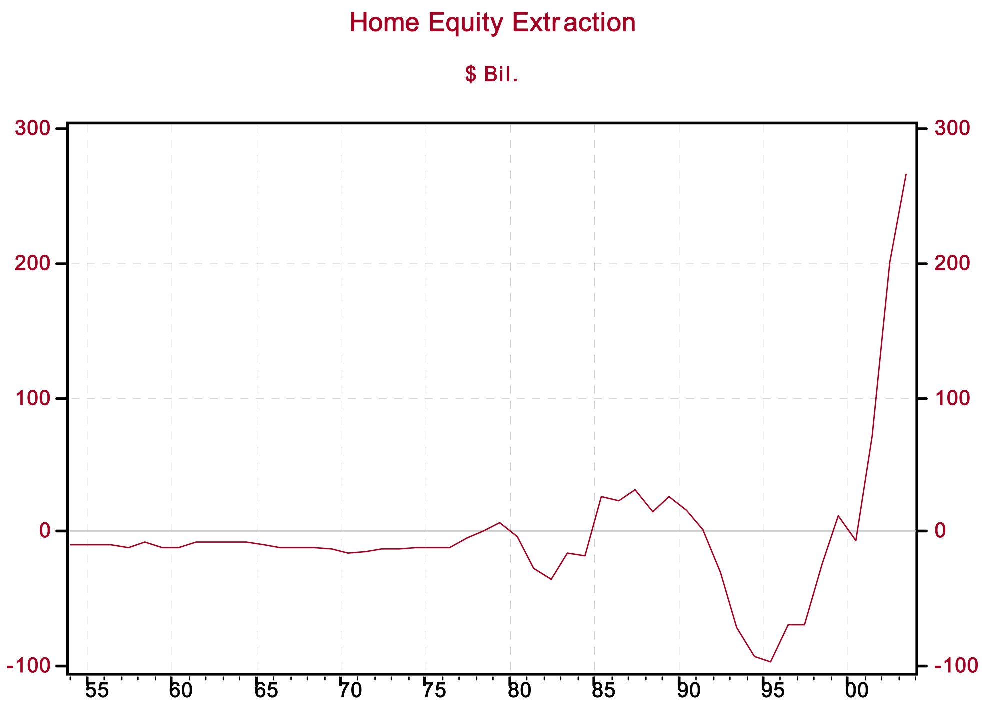
# SPENDING ON CONSUMER DURABLES HAS ACCELERATED IN RECENT YEARS






Northern Trust

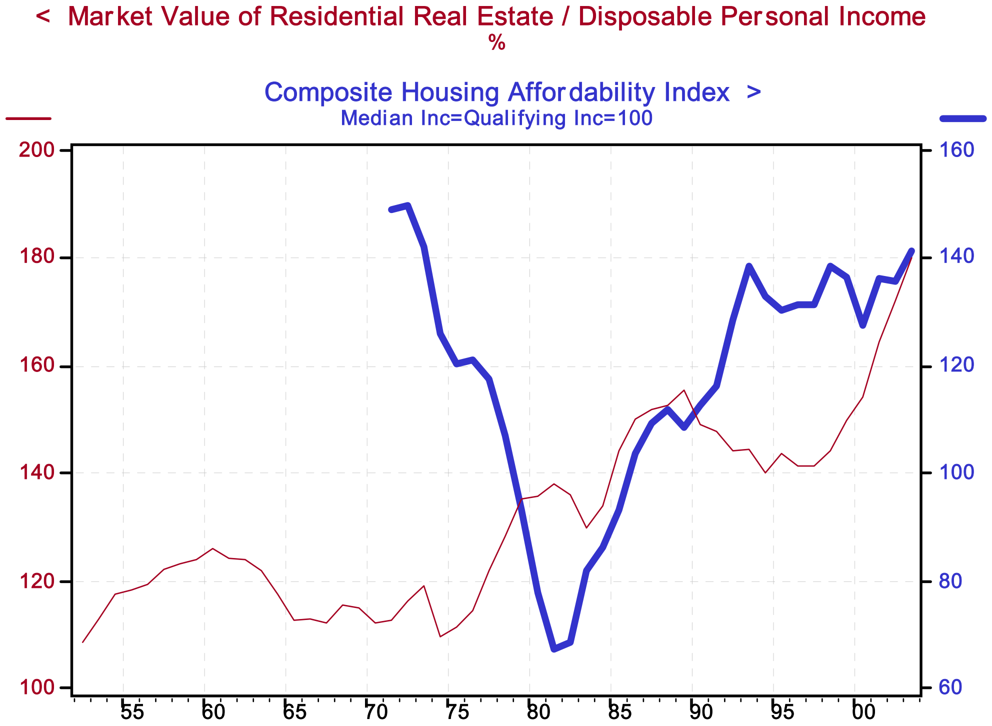
# THE ULTRA-LOW INTEREST RATES IN RECENT YEARS HAVE ENCOURAGED AND ALLOWED HOUSEHOLDS TO TAP THE EQUITY IN THEIR HOMES IN ORDER TO PURCHASE DURABLE GOODS






Northern Trust

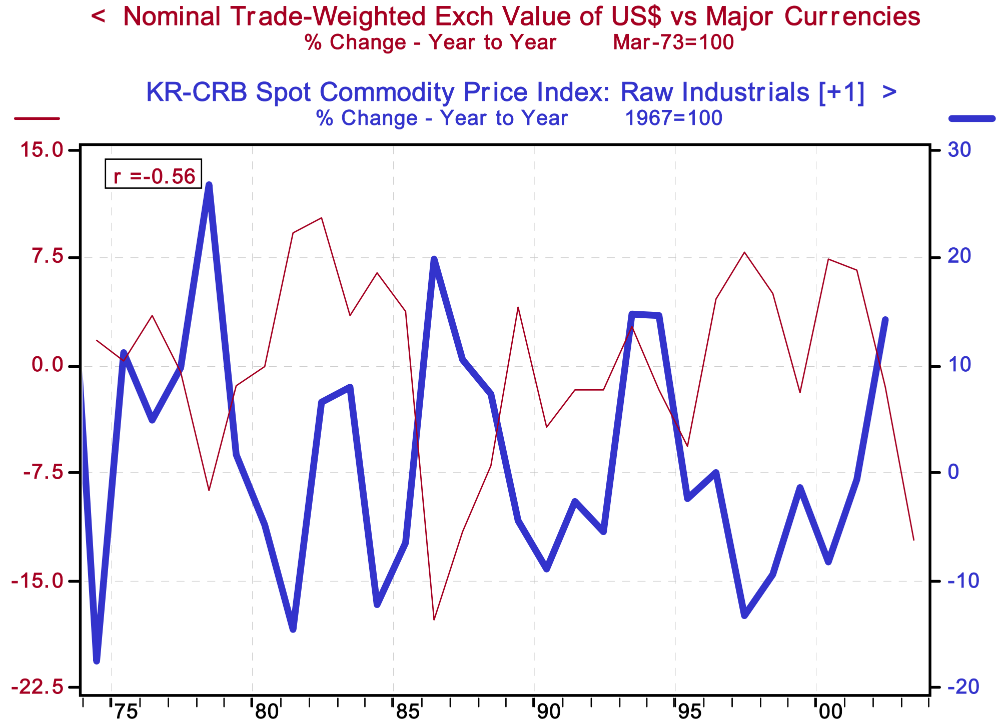
# RECENT ULTRA-LOW INTEREST RATES HAVE KEPT HOUSES VERY AFFORDABLE DESPITE THE HIGHEST RATIO OF HOME PRICES TO AFTER-TAX INCOME






Northern Trust

# A FALLING DOLLAR AND CONTINUED RAPID ECONOMIC DEVELOPMENT IN CHINA AND INDIA SHOULD BENEFIT BASIC MATERIALS INDUSTRIES




Sources: FRB, CRB /Haver

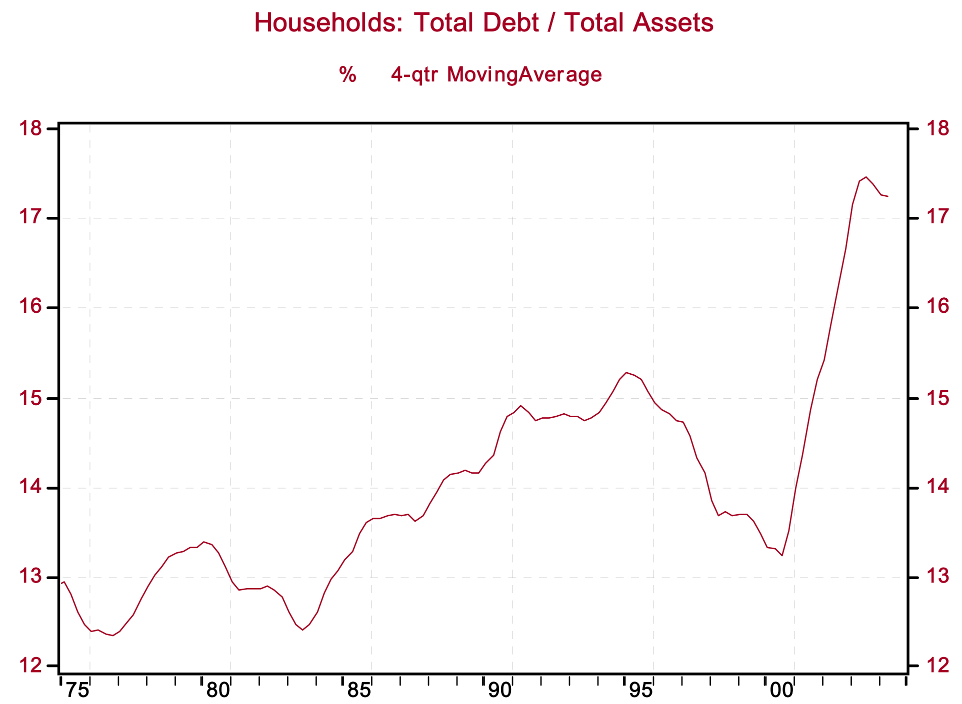


Northern Trust

## SOME SIGNIFICANT U.S. ECONOMIC RISKS TO A SHARPLY FALLING DOLLAR

- RESULTING HIGHER INTEREST RATES COULD "SHOCK" THE HIGHLY-INDEBTED HOUSEHOLD SECTOR
- RESULTING HIGHER INTEREST RATES COULD "SHOCK" AN EXPENSIVE HOUSING MARKET
- A "SHOCKED" HOUSING MARKET COULD SEVERELY DAMAGE THE BANKING SYSTEM

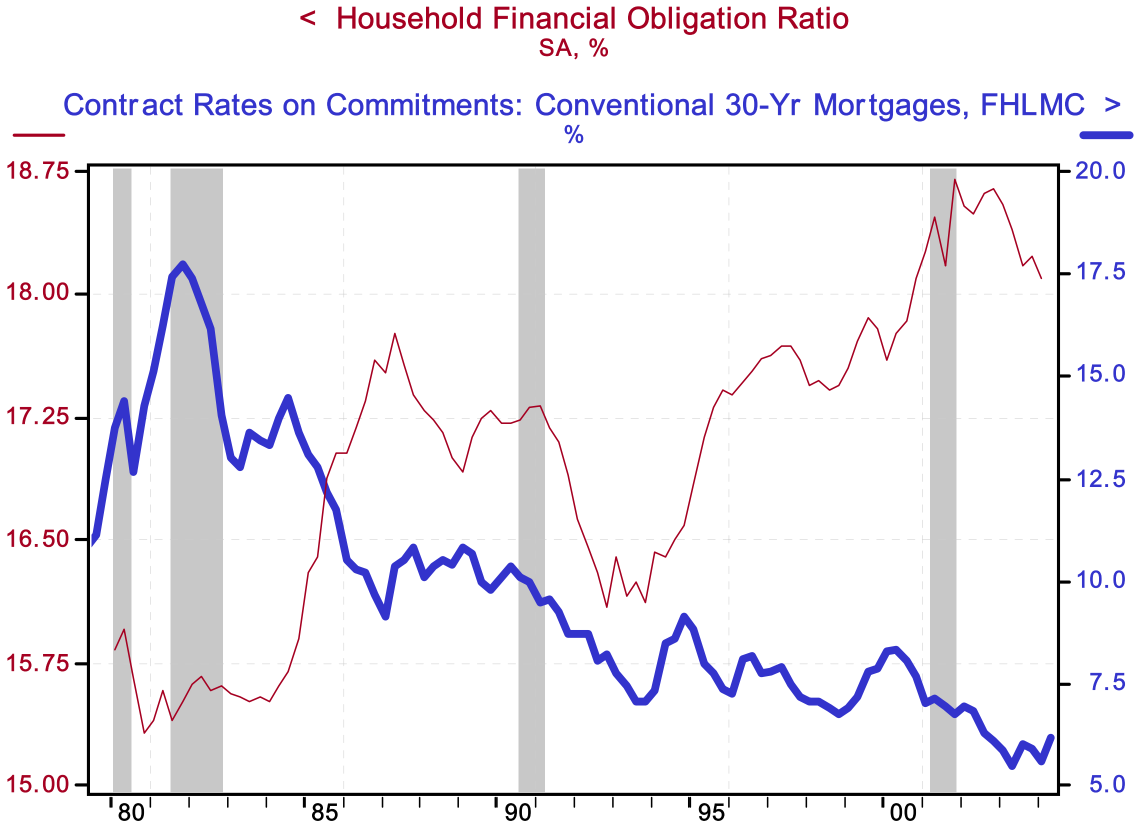
# HOUSEHOLD RELATIVE INDEBTEDNESS IS JUST OFF A POSTWAR HIGH






Northern Trust

# DESPITE THE LOWEST INTEREST RATES IN 40 YEARS, HOUSEHOLDS' REQUIRED MONTHLY PAYMENTS ARE HIGH RELATIVE TO THEIR INCOMES

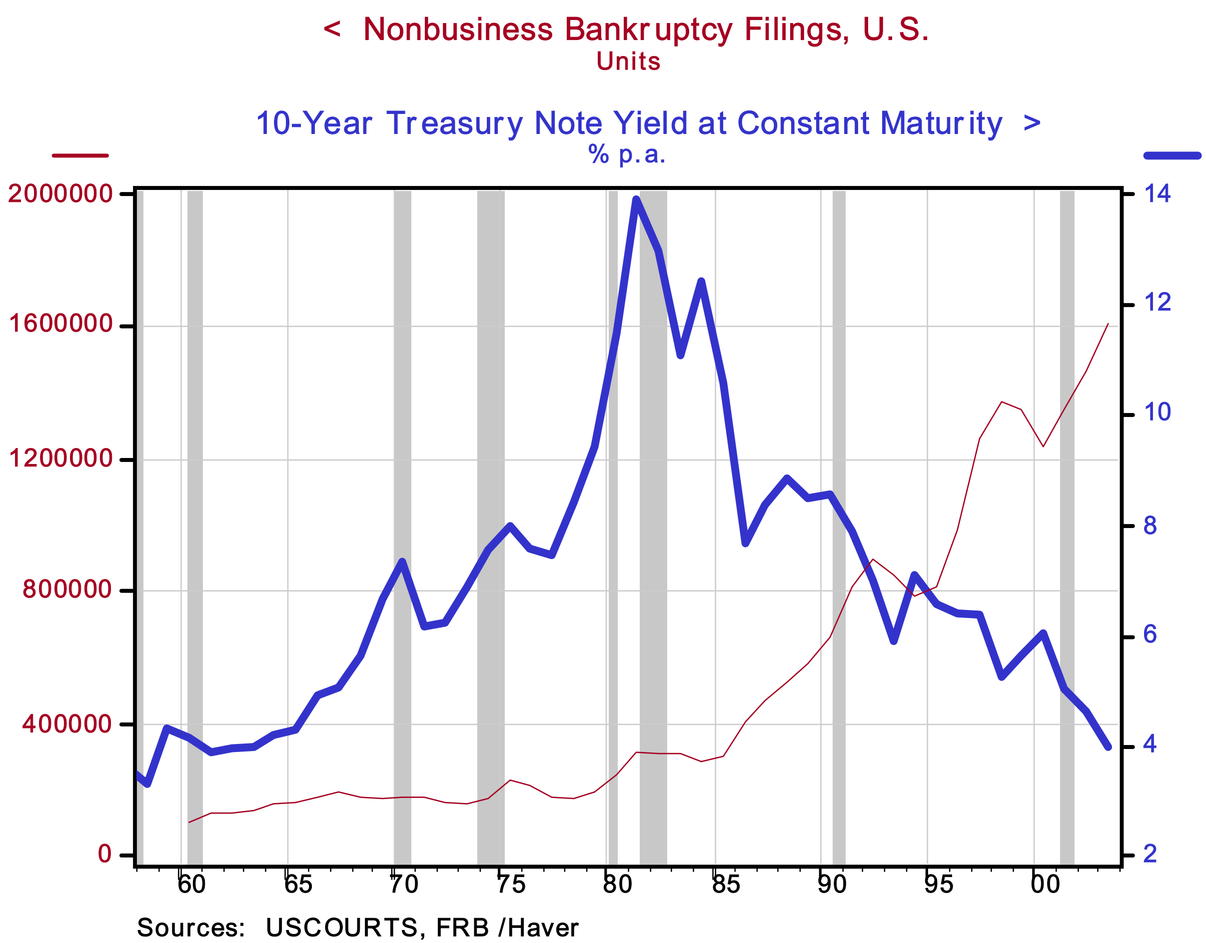


Source: Federal Reserve Board /Haver Analytics



Northern Trust

# DESPITE THE LOWEST INTEREST RATES IN 40 YEARS, PERSONAL BANKRUPTCY FILINGS ARE AT A RECORD HIGH

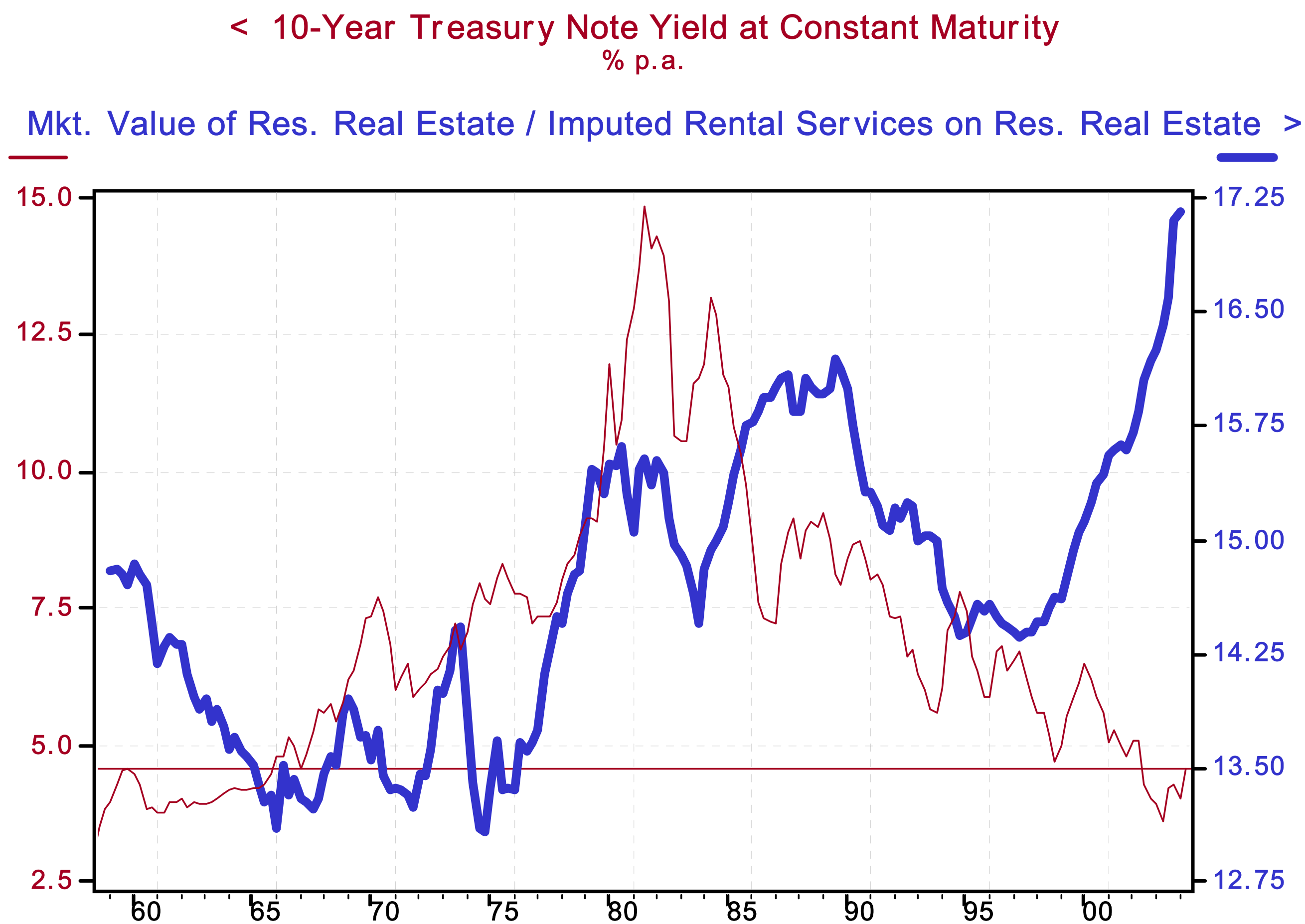





Northern Trust


# WOULD A SIGNIFICANT RISE IN INTEREST RATES DO GRAVE HARM TO AN "EXPENSIVE" HOUSING MARKET?

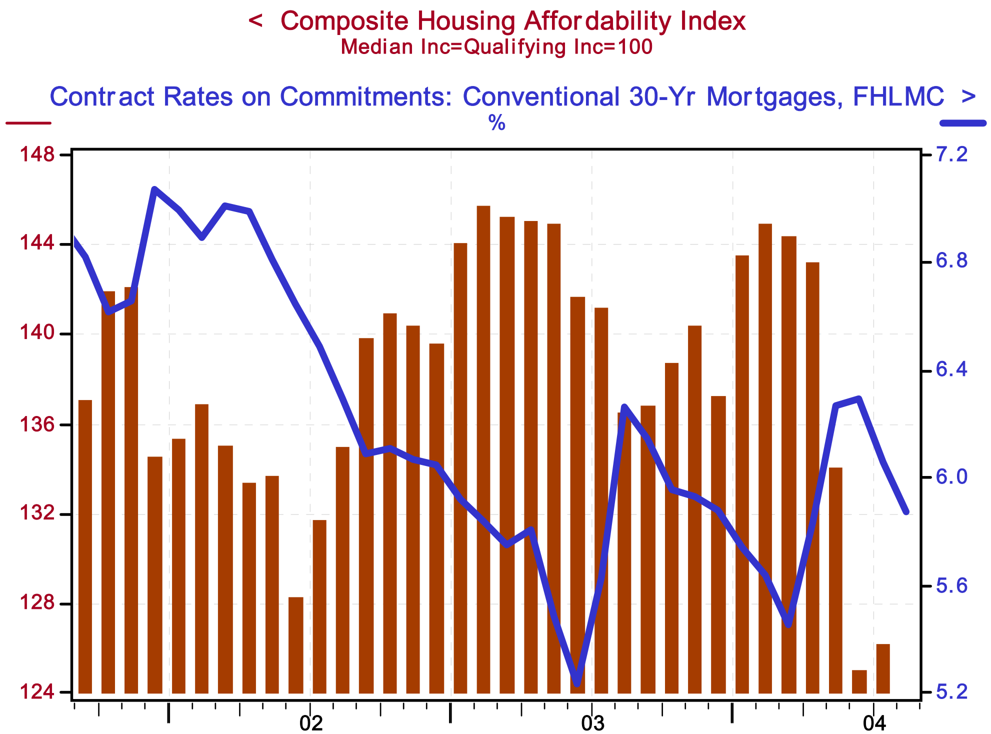
# THE “P/E” RATIO FOR HOUSING IS THE HIGHEST IN HISTORY






Northern Trust

# THE RECENT RELATIVELY MINOR RISE IN MORTGAGE RATES HAS LED TO A RELATIVELY LARGE DECLINE IN HOUSING AFFORDABILITY

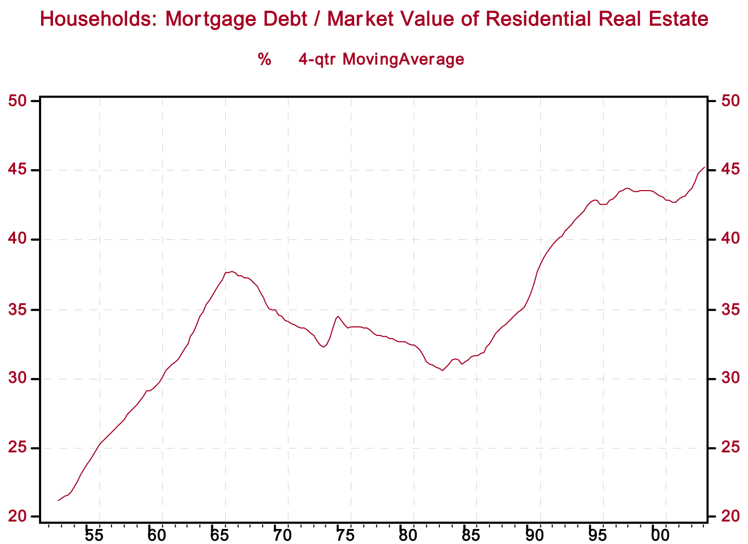


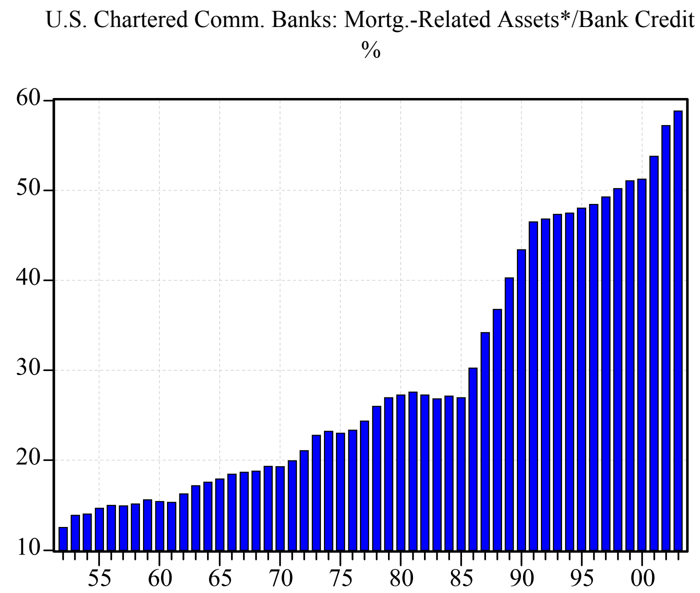

Sources: REALTOR, FRB /Haver



Northern Trust

# AT A TIME WHEN THE LOAN-TO-VALUE OF RESIDENTIAL REAL ESTATE IS AT A RECORD HIGH, BANKS' EXPOSURE TO THE HOUSING MARKET ALSO IS AT A RECORD HIGH




* includes mortgage pool and collateralized mortgage obligations, direct mortgages, and liabilities of gov't.-sponsored agencies.



Northern Trust

# WHAT MIGHT HAPPEN IF A SEVERE DECLINE IN THE HOUSING MARKET CAUSED REAL ESTATE VALUES TO FALL FOR THE FIRST TIME SINCE THE GREAT DEPRESSION?

- **HOUSEHOLD WEALTH WOULD DECLINE, PUTTING A CRIMP IN CONSUMER SPENDING**
- **THE RIPPLE EFFECT OF WEAKER CONSUMER SPENDING WOULD INCREASE UNEMPLOYMENT**
- **INCREASED UNEMPLOYMENT WOULD LEAD TO MORTGAGE DEFAULTS**
- **MORTGAGE DEFAULTS WOULD LEAD TO FURTHER DOWNWARD PRESSURE ON REAL ESTATE VALUES**
- **MORTGAGE LENDERS, INCLUDING BANKS, COULD SUFFER SIGNIFICANT LOSSES**


**BUT DON'T WORRY ABOUT THIS RISK CASE BECAUSE ALAN GREENSPAN HAS ASSURED US THAT THERE IS NO HOUSING MARKET BUBBLE**


# HAVE A NICE DAY

Northern Trust