

## Focus on the Trend

**I**NCOMING ECONOMIC DATA IS volatile, sometimes conflicting and often subject to statistical distortions — whether related to the season, weather, holidays or simple randomness. As a result, initially reported figures are customarily revised. This reality explains the reason short-term economic and financial market forecasting is hazardous, and usually humbling.

Analysts must step back from weekly data and ascertain underlying patterns and trends. Market expectations and investment horizons, in turn, should be longer term, not trading oriented. Major turning points in the economy and financial markets are less frequent than the business media or short-term traders would have you believe.

The recent clamor over a loss of economic momentum is illustrative. The Commerce Department's advance real gross domestic product (GDP) estimate for the first quarter of 2005 (+3.1%) was disappointing, particularly because it suggested a slowdown in business investment and a substantial increase in inventories. This report, combined with softness in other indicators, led many economists to significantly lower their forecasts for growth for the remainder of the year.

Then came reports for the March balance of trade and April retail sales and employment. This data suggested that

Commerce's estimate for first-quarter GDP will be revised upward and any "soft spot" in current economic momentum would be brief and concentrated in manufacturing, which appears to be experiencing a mini-inventory cycle. Economists were forced to flip-flop and upwardly revised their growth forecasts.

Recent labor market indicators have been unquestionably strong. Nonfarm payrolls, for example, were estimated to have increased by 274,000 jobs in April and reports for the prior two months were revised upward by an additional 93,000 jobs.

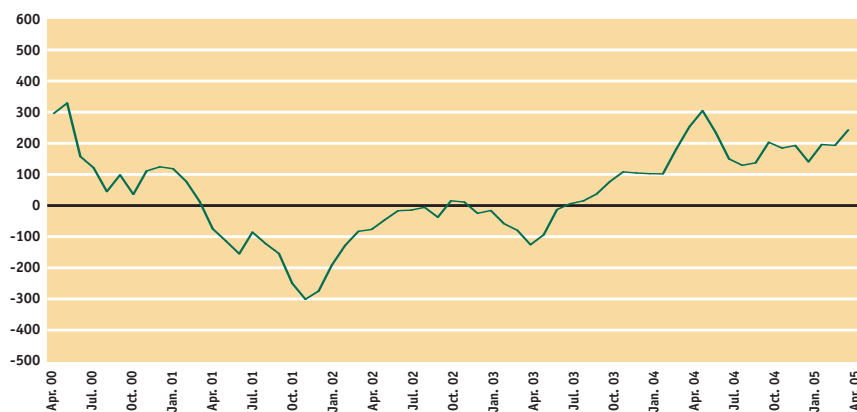
But the most startling piece of new data was the index of aggregate hours worked. This index combines the average work week and total private payroll jobs to measure total private labor input in the economy. The combination of an increase in the average workweek (from 33.7 to 33.9 hours) and 256,000 net new private jobs produced a 0.9% rise in this index — the fastest in eight years.

If the index of aggregate hours worked proves accurate, either productivity growth is collapsing or output growth will significantly exceed current expectations. GDP, for example, would be greater than 5% in the second quarter. This appears unlikely given current spending patterns, but it underscores the need to identify trends underlying headline data and place all data points in their appropriate context.

The Federal Reserve continued its measured pace of monetary tightening at its May meeting, where it increased the Federal funds rate by 25 basis points for the eighth consecutive time. The Fed is unlikely to change this policy path — particularly given that the economy is growing near, if not slightly above, its long-term potential, the strength in labor markets and continued concerns about "creeping" inflation. The market's expectation that the Fed funds rate will reach 3.75% by year end may prove conservative.

### NONFARM PAYROLLS JUMP IN APRIL

*In April, nonfarm payrolls were estimated to have increased by 274,000 jobs, and the totals from the previous two months have been revised upward by an additional 93,000 jobs.*



Left Axis: U.S. nonfarm payrolls three-month moving average (x1,000)  
Sources: Bloomberg, Bureau of Labor Statistics



Another reason the Fed tightening process may go further than anticipated is the continuing looseness of financial conditions. A weaker dollar, higher stock prices and lower bond yields have offset the impact of higher short-term interest rates. This may be changing marginally, but short-term rates will need to rise beyond current market expectations to tighten financial conditions significantly.

We expect long-term interest rates and credit spreads to eventually respond most to this continued tightening. The dollar can strengthen near-term because of increasing interest rate differentials and relative economic growth rates. (Europe, for example, continues to disappoint.)

But the United States' persistent current account deficit will limit this appreciation. Stocks, meanwhile, will be supported by record profits, free cash flow, higher dividends and share repurchases. First-quarter business performance strongly corroborates this view.

Interest rates, in contrast, must contend with growing inflationary concerns, driven particularly by pressure on labor resources. Unit labor costs are now rising. The Fed will need to engineer higher interest rates and wider credit spreads to contain these inflationary pressures.

*Orie L. Dudley Jr.*  
*Chief Investment Officer*

## INVESTMENT STRATEGY

### What Has Changed

- Financial markets responded to conflicting data reports uncertain as to whether the U.S. economy is slowing, experiencing a soft patch or poised to strengthen.
- Creeping inflation, strong first-quarter profits and better job growth firmed convictions that the Federal Reserve will continue raising rates at a "measured" pace.
- The Treasury announced it is considering resuming 30-year bond sales early next year, taking advantage of low interest rates.
- Protectionist sentiments are rising, and both the White House and Capitol Hill demanded that China loosen its fixed currency peg.

### Economy Continues to Grow Near Its Longer-Term Potential

- Retail sales and employment data exceeded expectations.
- Incoming data suggest any "soft spot" will be concentrated in manufacturing, which is experiencing a mini-inventory cycle.

### Neutral Portfolio Durations Recommended

- We expect the yield curve to further flatten.
- Correction in the high-yield market has prices now approaching fair value.
- Supply-driven pressure on municipal yields may ease by mid-year.

### Solid Economic Growth Outlook Favors Equities

- Stocks should regain momentum as economic growth becomes clearer.
- We favor large-cap domestic and international equities.

### International

- Economic growth in Europe and Japan continues to disappoint.
- While the decision will be political, economics suggest the time is right for a more flexible Chinese exchange rate.

### Conclusion

- Liquid reserves should be higher than normal as monetary tightening persists, but strong business performance argues stocks should remain the asset of choice in portfolio construction.

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