



## Insights from Northern Trust

### Commentary from David Murdock, Western Region Managing Director

**August 16, 2010**

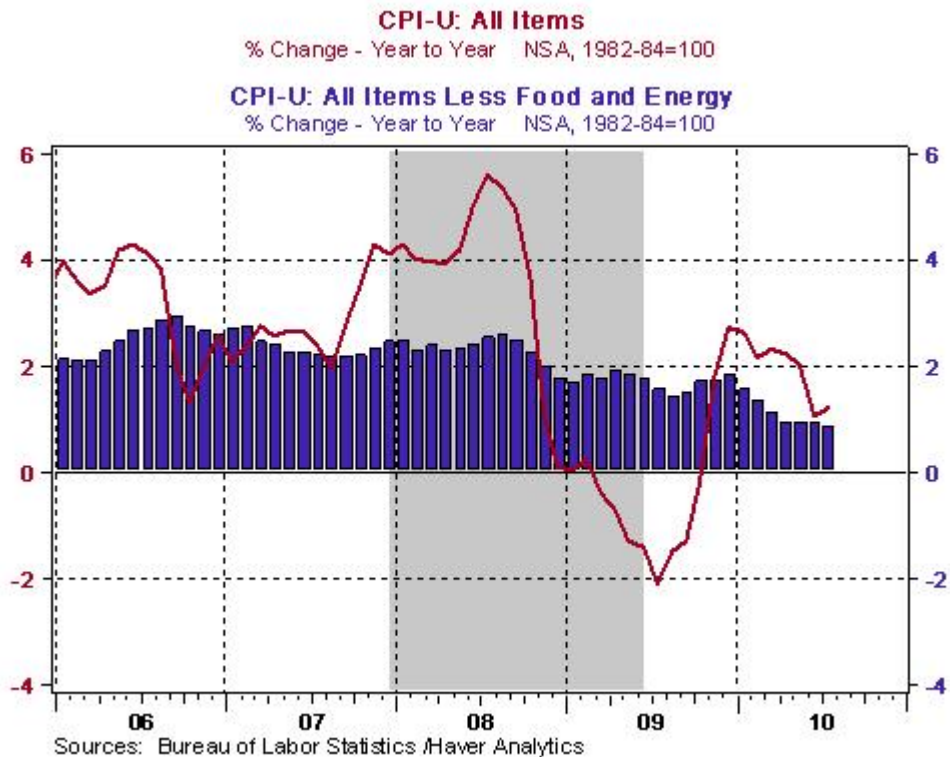
Mortgage rates continued their descent last week as Freddie Mac reported that the average 30-year fixed-rate mortgage was 4.44%, marking the lowest point since it began tracking rates in 1971. Additionally, yields on government Treasuries drifted lower by week's end, with the 10-year note yielding 2.68% and the two-year bill at 0.513%, a record low. However, it was neither record-low mortgage rates nor interest rates getting attention last week; it was the low inflation rate that grabbed headlines, with many speculating it might be headed lower.

Friday's U.S. consumer price index (CPI) reading rose from the previous month to 0.3% in July, while the year-over-year change excluding food and energy held steady at 0.9% for the fourth straight month. Without the effects of rounding, this would be the lowest reading since 1961. Should future prices trend lower, deflation worries will only continue to increase in magnitude and frequency. As a case in point, during the quarterly earnings call from Safeway, management for the grocery store owner/operator used the word "deflation" 57 times.

While dropping prices are good for consumers, they are usually bad for businesses and the economy in general. The longer prices edge lower, the bigger the change in consumer and business behavior. As corporate profits subsequently drop, managers tend to lay off more workers and cut spending. Consumers, expecting lower prices in the future, pull back on buying discretionary goods, magnifying the vicious cycle. Manufacturers will pressure suppliers to lower their prices and this, in turn, will have rippling effects throughout the economy and financial markets.

However, as shown in the following graph, annual inflation continues to remain well above negative rates although it has trended lower this year. Last week after the Federal Reserve concluded its scheduled meeting, it offered a more downbeat assessment of the domestic economy, citing disappointing data, particularly in the jobs market. Regarding inflation, the Fed commented that while inflation is expected to remain subdued for some time, longer-term inflation expectations remain stable. In addition to keeping the benchmark federal funds rate at current levels, the committee also stated its intention to use maturing mortgage-backed security proceeds to purchase additional longer-term Treasury bonds. While not the quantitative easing many had been expecting, this action will maintain the size of the Fed's balance sheet at \$2.3 billion and thus avoid any unintentional tightening while helping to support price stability.

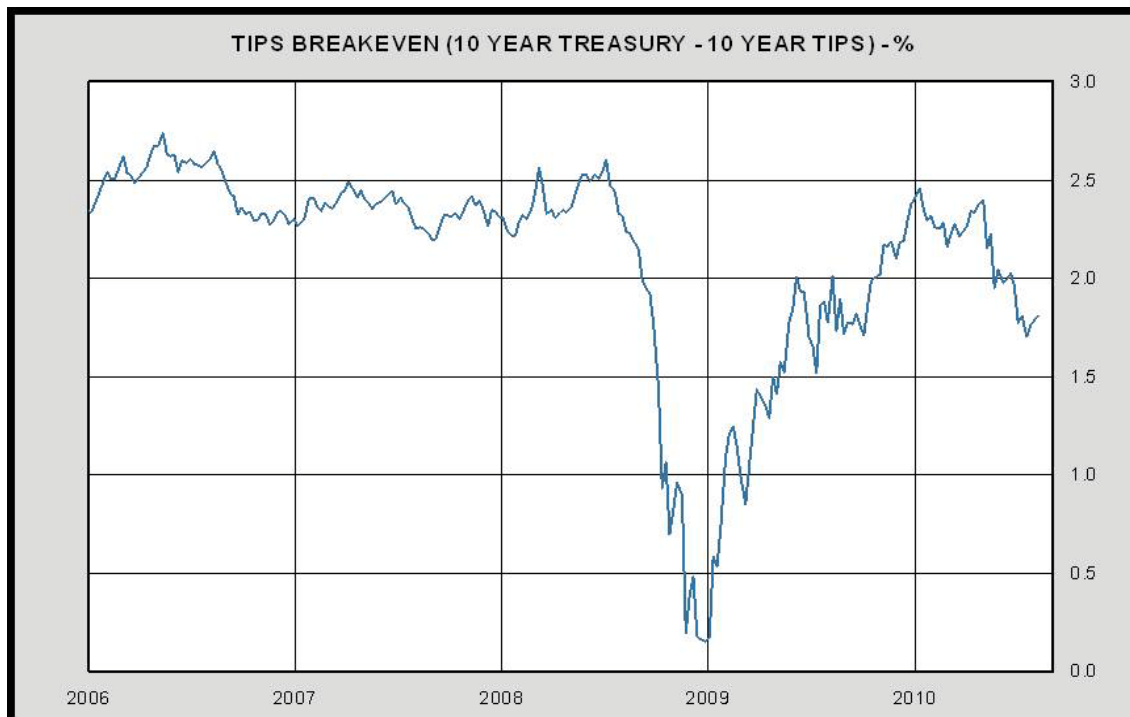




Deflation in its simplest definition can be explained by too little money being available in the hands of consumers. When cash is plentiful, people tend to buy without bargaining or with less worry on price. As a result, prices rise, which causes people to buy now before prices go even higher tomorrow. On the other hand, in a deflationary environment, cash is scarce and people tend to conserve that which is scarce. Thus people are reluctant to spend, and selling goods and services becomes difficult, prompting manufacturers to cut prices. Lower and lower prices finally inspire people to postpone purchases into the future when bargains might be had. Deflation punishes the spender, and while American consumers have been habitual spenders, the economic trauma of the Great Depression or recent illustrations of Japan's 15-year deflationary spiral are not yet distant memories in our minds.

If the public market then is concerned about deflation, the credit market appears less in agreement with that view. Based on recent pricing of Treasury Inflation-Protected Securities (TIPS), the five-year breakeven inflation rate for the United States is currently estimated at 1.3%, while 10-year expectations are priced at 1.7%. If correct, the economy might continue down a short-term path of disinflation but ultimately should stay above negative levels in the future.





Source: Bloomberg. Data as of 8/6/2010

Northern Trust currently is not forecasting a deflationary environment; however, we recognize the difficulties the Fed has in fighting deflation. With interest rates near zero, clearly this lever has been pulled to its fullest extent possible. Ben Bernanke in his now-famous 2002 speech stated the central bank would do whatever it can to prevent significant deflation in the United States by printing as many dollars as it needs.

The Fed is very keen to keep long-term inflation expectations in check and thus will continue to err on the side of easing and avoid potential deflation. While some argue that with policy rates near zero, Bernanke is left with little ammunition to fight a decline in inflation. However, he and the committee have considerable power remaining to stimulate aggregate demand for goods and services, including:

- Eliminating overnight crediting rates on bank reserves;
- Cutting the discount rate;
- Restarting and/or expanding the Term Asset-Backed Securities Loan Facility (TALF);
- Increasing purchases of government bonds and expanding the Fed's balance sheet;
- Stating a price-level target instead of its current inflation rate expectation;
- Cooperating with fiscal authorities to consider funding of tax cuts; and
- Implementing strategies that might encourage lower rates further out on the yield curve or strategies that might lower the value of the dollar.

As a result, Northern Trust fully anticipates that the Fed will keep monetary policy accommodative and interest rates low well into 2011, if not through all of next year. We continue to believe the Fed can provide additional liquidity measures and will act as necessary, yet the situation requires continual

monitoring. Because inflation tends to be a lagging economic indicator, should economic growth continue to moderate in the coming quarters, falling core CPI is likely. However, should activity not worsen materially from its current levels or even slightly improve, then a deep deflation scare is not likely, which continues to be our base-case scenario for portfolio construction.

David Murdock holds designations as a Certified Financial Planner<sup>®</sup>, a Chartered Life Underwriter, and a Certified Investment Management Analyst<sup>®</sup>, as well as received his MBA with honors from the University of Chicago Booth School of Business.

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