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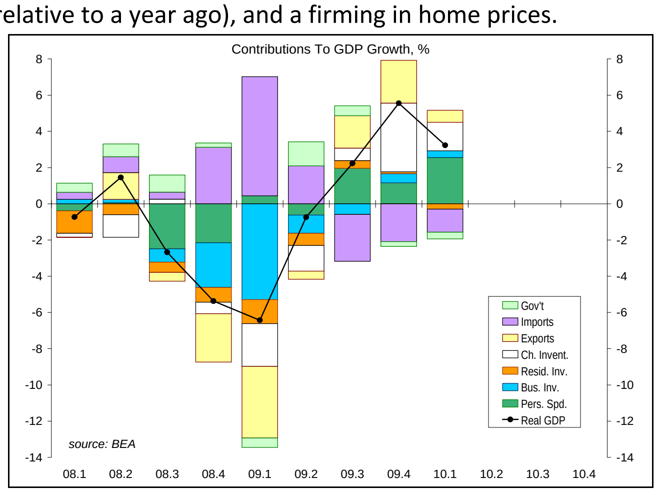
Monthly Economic Outlook

Headwinds and New Worries

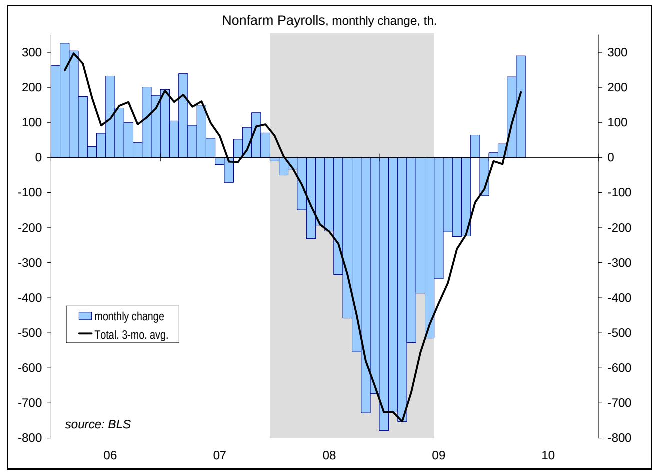
- *The recovery has progressed further in April, with private-sector job growth finally picking up.*
- *A number of headwinds remain in the near term and some further hurdles lie ahead. A greater European debt crisis would have a mixed impact on the U.S. economy.*
- *Federal Reserve policymakers are likely to keep short-term interest rates low well into 2011.*

Real GDP rose at a 3.2% annual rate in the advance estimate for 1Q10. The GDP report seemed to have something for everyone. Pessimists could argue that growth would have been just 1.6% if you exclude the shift in inventories. Inventories swung from a moderate decline in 4Q09 to a moderate increase in 1Q10 (the *change* in GDP contributes to the *level* of GDP, the *change in the change* in inventories adds to GDP *growth*). Spending on business structures fell at a 14.0% pace, residential fixed investment (homebuilding) fell 10.9%, and state and local government expenditures dipped 3.8%. Optimists can point to strong gains in consumer spending (a 3.6% annual rate, vs. +1.6% in 4Q09) and in business spending on equipment and software (+13.4%). Imports rose (a sign of strength in the domestic economy), but subtracted from the headline GDP figure. Part of the increase in consumer spending was accomplished through a drop in the savings rate (to 2.7% in March, vs. 4.0% in December). That may reflect a fading of consumer fears, a stronger stock market (relative to a year ago), and a firming in home prices.



Nonfarm payrolls rose by 290,000 in April, with 66,000 of that gain due to hiring for the 2010 census. Private-sector payrolls advanced by 231,000, following a +118,000 average for February and March. Job gains were relatively widespread in April. The unemployment rate rose to 9.9% (from 9.7% in March), but the increase was due to a jump in labor force participation. Typically, many people will return to the workforce as the job market begins to recovery.

Job growth is an essential element in a sustainable economic recovery. We've come a long way over the last year, but we'll need to see monthly payroll growth average 250,000 to 300,000 for six years or so to push the unemployment rate back to 5.5%. Strong job growth certainly is within the realm of possibility, but while there are some continued headwinds in the near term, more substantial hurdles may lie ahead



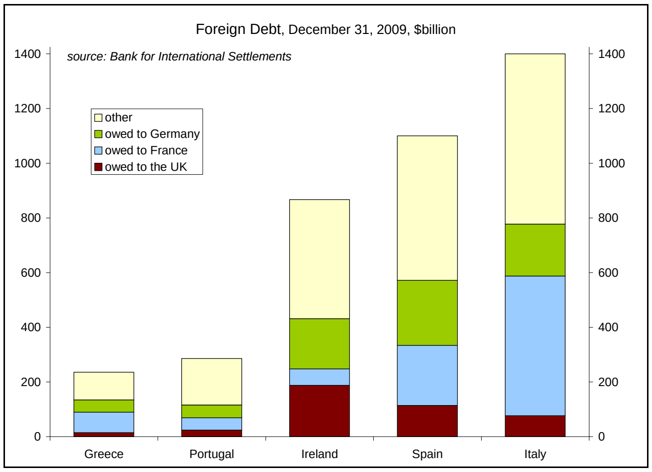
Credit is still tight, particularly for small firms. The Fed's April survey of senior loan officers showed that credit standards were little changed over the first quarter, but there was still some tightening of terms for consumer and business loans. Most of the banks that eased some lending policies were large banks. Terms on commercial and industrial loans for small firms were generally tightened further. Large firms have been able to borrow in the corporate bond market and from large banks. The tightness in credit for small firms is a concern since these firms typically account for a fair amount of job growth during an expansion. Credit should loosen up over time, but it will take a while.

State and local budget strains have led to some tax increases and cuts in services (both weaken the recovery). The situation isn't going to get much better right away, but there is some evidence that tax revenues have started to recover. Part of the fiscal stimulus was aid to the states, but it wasn't enough to offset these pressures. Budget conditions may remain tight as the fiscal stimulus ramps down into 2011.

Residential and commercial real estate problems will continue, although the drag should decrease over time. Conditions are likely to vary considerably around the country.

The Bush tax cuts are set to sunset at the end of the year. Congress does not have to do anything to raise taxes. It will take a bipartisan effort *not* to raise taxes. Unfortunately, it's an election year and we've all seen how well the two parties can work together. Raising taxes in a fledging recovery is a bad idea, but some compromise may be possible.

The Greek credit crisis has been simmering for a number of months. Following the rating downgrades of the sovereign debt of Greece, Portugal, and Spain, the crisis has grown to epic proportions. The European Union and the International Monetary Fund have finalized an aid package for Greece and the country has agreed to sharp austerity moves (raising taxes and cutting government wages and pensions). The main worry is contagion. Public protests in Greece haven't helped investor confidence. As a percentage of GDP, debt problems in Portugal and Spain are less severe than in Greece, but they are serious enough. Ireland has already undertaken austerity measures on its own. Still, a contagion to these countries would spell broader problems for European banks.



The impact on the U.S. of a European debt crisis would be mixed, but mostly negative. U.S. firms would face tougher competition from their European counterparts and those doing business in Europe would see weaker demand and a loss in earnings on the currency translation. However, a flight to safety has already reduced long-term Treasury yields.

What about the U.S. debt situation? The federal budget deficit has ballooned due to the recession and two large spending programs (the bank rescue and the fiscal stimulus). Tax revenues have already begun to improve, due to improvement in the economy, and banks have been repaying TARP funds. The bigger worry is what happens 10 to 20 years out and the worst of the problem is concentrated in Medicare. Tough choices on taxes and entitlement spending lie ahead. Lawmakers should come up with a credible plan to reduce the deficit over the next several years, but there's no need to attack the deficit in the early stages of an economic recovery.

In its April 28 policy statement, the Federal Open Market Committee repeated that economic conditions are likely to warrant an exceptionally low federal funds rate for *"an extended period."* That outlook remains predicated on a low level of resource utilization (an elevated unemployment rate and low capacity utilization), a low underlying trend in inflation, and well-anchored inflation expectations. The future outlook for these conditions is not expected to change dramatically anytime soon. In fact, most measures of core inflation have been trending lower recently. Outright deflation, an extended decline in the overall price level, seems unlikely, but a low inflation trend gives the Fed less room to maneuver in a crisis. The Fed has ended most of the special liquidity programs put forth during the economic crisis and an unwinding of the balance sheet is a long-term goal. However, given the inflation outlook, there's no pressing need for the Fed to hike rates.

The stock market is a leading indicator, but an imprecise one. Earnings results have been strong, but the market appears to have gotten a bit ahead of itself given the moderate economic outlook. Some correction was probably in order, and the Greek debt crisis has provided a good excuse. The road to a full economic recovery will be long, but we're on our way.

	1Q09	2Q09	3Q09	4Q09	1Q10	**2Q10**	**3Q10**	**4Q10**	**1Q11**	**2Q11**	2009	**2010**	**2011**
GDP (↓ *contributions*)	-6.4	-0.7	2.2	5.6	3.2	**2.7**	**2.7**	**2.9**	**2.6**	**3.0**	-2.4	**3.1**	**2.9**
consumer durables	*0.3*	*-0.4*	*1.4*	*0.0*	*0.8*	***0.3***	***0.3***	***0.3***	***0.1***	***0.3***	*-0.3*	***0.5***	***0.3***
nondurables & services	*0.2*	*-0.2*	*0.6*	*1.1*	*1.8*	***1.5***	***1.6***	***1.7***	***1.5***	***1.6***	*-0.1*	***1.3***	***1.6***
bus. fixed investment	*-5.3*	*-1.0*	*-0.6*	*0.5*	*0.4*	***0.5***	***0.5***	***0.5***	***0.5***	***0.6***	*-2.2*	***0.2***	***0.5***
residential investment	*-1.3*	*-0.7*	*0.4*	*0.1*	*-0.3*	***0.3***	***0.3***	***0.4***	***0.3***	***0.4***	*-0.7*	***0.1***	***0.4***
government	*-0.5*	*1.3*	*0.6*	*-0.3*	*-0.4*	***-0.3***	***-0.2***	***-0.2***	***-0.1***	***-0.1***	*0.4*	***-0.1***	***-0.1***
Domestic Final Sales	-6.4	-0.9	2.3	1.4	2.2	**2.4**	**2.6**	**2.7**	**2.3**	**2.8**	-2.8	**2.0**	**2.7**
exports	*-4.0*	*-0.5*	*1.8*	*2.4*	*1.1*	***0.9***	***0.7***	***0.8***	***0.8***	***0.8***	*-1.2*	***1.2***	***0.8***
imports	*6.6*	*2.1*	*-2.6*	*-2.1*	*-1.4*	***-1.1***	***-0.9***	***-0.9***	***-0.7***	***-0.8***	*2.2*	***-1.3***	***-0.8***
Final Sales	-4.1	0.7	1.5	1.7	1.6	**2.2**	**2.4**	**2.6**	**2.4**	**2.9**	-1.7	**2.8**	**2.9**
ch. in bus. inventories	*-2.4*	*-1.4*	*0.7*	*3.8*	*1.6*	***0.5***	***0.3***	***0.3***	***0.2***	***0.1***	*-0.7*	***1.2***	***0.2***
Unemployment, %	8.2	9.3	9.7	10.0	9.7	**9.8**	**9.8**	**9.6**	**9.5**	**9.4**	9.3	**9.7**	**9.2**
NF Payrolls, monthly, th.	-753	-477	-261	-90	94	**230**	**70**	**110**	**100**	**135**	-395	**126**	**148**
Cons. Price Index (3 mo)	2.5	3.7	2.5	2.5	0.9	**1.8**	**1.7**	**1.7**	**1.8**	**1.8**	2.7	**1.5**	**1.8**
excl. food & energy	2.3	2.2	1.4	1.3	-0.2	**1.4**	**1.2**	**1.3**	**1.4**	**1.4**	1.8	**0.9**	**1.5**
PCE Price Index (q/q)	-1.5	1.4	2.6	2.5	1.5	**1.4**	**1.6**	**1.6**	**1.6**	**1.7**	0.2	**1.8**	**1.6**
excl. food & energy	1.1	2.0	1.2	1.8	0.6	**1.1**	**1.3**	**1.4**	**1.4**	**1.4**	1.5	**1.2**	**1.4**
Fed Funds Rate, %	0.19	0.18	0.15	0.12	0.13	**0.21**	**0.24**	**0.25**	**0.29**	**0.70**	0.16	**0.21**	**0.97**
3-month T-Bill, (bond-eq.)	0.2	0.2	0.2	0.1	0.1	**0.2**	**0.3**	**0.3**	**0.4**	**0.8**	0.2	**0.2**	**1.0**
2-year Treasury Note	0.9	1.0	1.0	0.9	0.9	**1.0**	**1.6**	**2.1**	**2.3**	**2.5**	1.0	**1.4**	**2.6**
10-year Treasury Note	2.7	3.3	3.5	3.5	3.7	**3.6**	**3.8**	**3.9**	**4.0**	**4.1**	3.3	**3.7**	**4.1**

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