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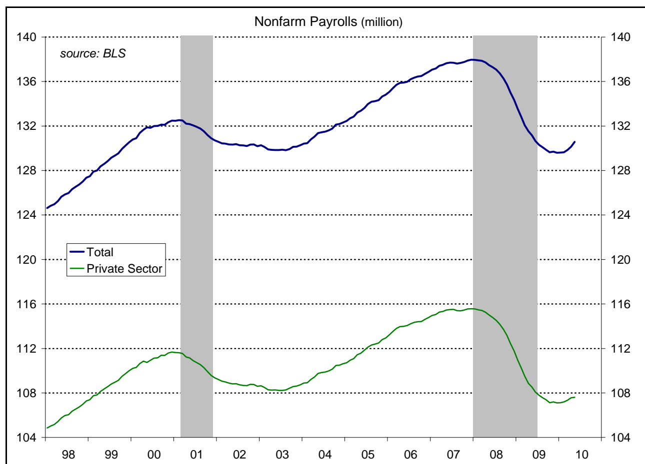
Monthly Economic Outlook

Still A Moderate Recovery

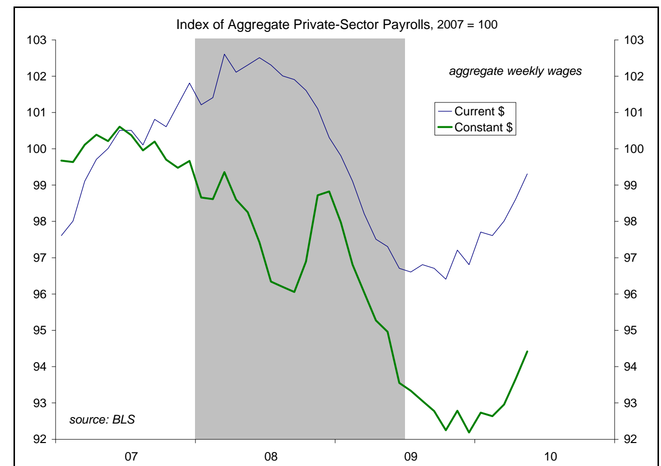
- *The economic recovery continued in May, but with a lackluster increase in private-sector jobs. The economy faces a number of headwinds in the near term, but a double dip recession appears unlikely.*
- *Core inflation figures have continued to trend lower.*
- *Federal Reserve policymakers are likely to keep short-term interest rates low well into 2011. The government's fiscal policy is expected to be less supportive at the federal level, and contractionary at the state and local level.*

Real Gross Domestic Product rose at a 3.0% annual rate in the 2nd estimate for 1Q10 – down from 3.2% in the advance estimate, but the story didn't change much. The recovery has been transitioning to a more sustainable path. That is, GDP growth in the second half of 2009 was supported largely by the government's fiscal stimulus and a shift in inventories. Growth in 2010 has been based more on improvement in underlying demand – consumer spending and business fixed investment.



While real GDP growth of 3% or so would be considered good in normal times, it's relatively disappointing given the depth of the economic downturn and the large number of jobs lost over the last two years. We need to see much stronger GDP growth to reduce the unemployment rate significantly. Nonfarm payrolls rose by 431,000 in the initial estimate for May, but 411,000 of those jobs were temporary workers hired for the 2010 census. Private-sector payrolls rose by a disappointing 41,000. However, that followed much stronger gains in March (+158,000) and April (+218,000) – the three-month average was +139,000, which is good, but not great (consistent with a moderate economic recovery). Weather effects may have shifted into April some job gains that would have occurred in May. The May jobs report showed some softness in construction and retail, but declines followed gains in March and April. State and local governments shed 22,000 jobs, apparently reflecting the impact of budget strains.

There were a number of positive elements in the May Employment Report. Manufacturing payrolls continued to rise. Temp-help employment advanced further and average weekly hours increased – both are traditional signs of a pickup in job growth ahead. Average weekly earnings rose 0.6%, up 2.8% y/y. The index of aggregate private-sector payrolls, a measure of total wage income, rose 0.7% in May, a 3.0% increase since October. Higher energy prices reduced the consumer's purchasing power last year, but declines in energy costs are expected to add to real income growth in the near term, providing important support for consumer spending growth.



Growth in business fixed investment is expected to be mixed, but generally positive in the near term, supported by a rebound in corporate profits and some improvement in economic expectations. Commercial real estate tends to lag in the economic cycle, continuing to contract as the overall economy begins to improve. Spending on business structures is likely to remain negative in the near term. Business spending on equipment and software should continue to improve.

Business credit conditions are likely to remain split. Large firms have been able to raise funds in the bond market and have also been increasingly able to borrow from large banks. Bank credit to small firms remains tight. Bank lending practices to small firms have changed through the financial crisis – banks are back to looking at balance sheets and cash flows, rather than simply lending based on a credit score. In addition, the demand for small business loans has been weak, as these firms see excess capacity and are not particularly enthused about the near-term economic outlook. While there have been some reports of a gradual increase in sales, many of these firms are "riding it out, waiting for their competition to go under." The weakness in lending to small business is a growing concern for the Federal Reserve and other officials in Washington. Small firms, those with less than 50 employees, accounted for a third of net job growth in the two previous economic expansions. They're not generating many jobs currently.

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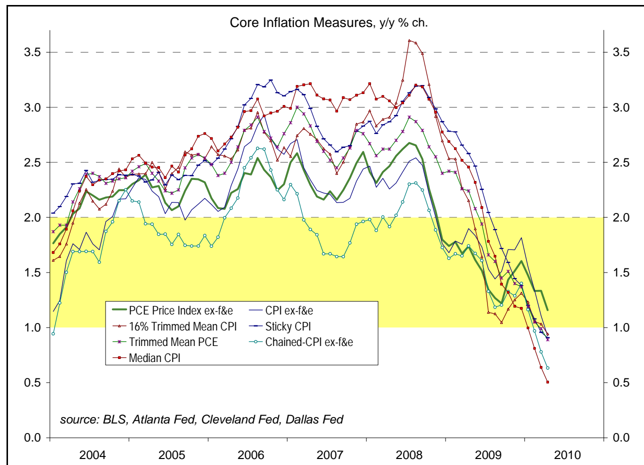
Tight credit for small business is one near-term restraint on economic growth, but there are headwinds. While the federal fiscal stimulus has helped support the economic recovery and prevented more substantial weakness in the labor market over the last year, state and local governments have countered some of that impact (reducing real GDP by 0.3% in 4Q09 and by 0.5% in 1Q10). Budget constraints are expected to lead to reduced government services and higher taxes at the state and local level over the next several quarters. In addition, the Bush tax cuts are set to expire at the end of the year.



Many investors have worried (unjustifiably) that the Fed's accommodative policy and wide federal budget deficit will lead to higher inflation. In contrast, measures of core inflation (which gauge the underlying trend in overall inflation) have been trending lower. Outright deflation, a sustained decline in the overall price level, is seen as unlikely, but low core inflation is likely to continue for some time. There is a large amount of slack in the economy and the pace of growth is unlikely to put much upward pressure on inflation anytime soon.

Should the underlying trend in inflation continue to trend lower, the Fed could respond with another round of quantitative easing (purchasing long-term Treasuries outright). It's not something the Fed would like to do, but it's a tool that could be employed if the economic recovery begins to falter. Some of the Fed's district bank presidents have been more vocal in their views that monetary policy needs to be tightened sooner rather than later. However, that's still very much a minority opinion among Fed policymakers. If, indeed, the Fed begins to raise short-term interest rates in the first half of 2011, as the consensus view of private economists seems to expect, such a move would be made largely to set monetary policy on a path toward more normal conditions – not a message that growth is excessive or that higher inflation is seen as a more immediate threat. In any case, any increase in short-term interest rates is several months away at the earliest.

The biggest risk to the economic outlook would be a policy mistake (either the Fed raises rates too soon or taxes are raised too early). Fed Chairman Bernanke is an expert on the Great Depression – so the Fed is unlikely to repeat the mistakes of the past. However, there is a growing populist movement to "do something about the federal budget deficit." While well-intentioned, that view is just wrong – at least in the intermediate term. Raising taxes or cutting government spending is contractionary – that is, economic growth would be weaker than it would be otherwise. It's possible that the recovery could withstand a moderate tax increase, but restraining growth with unemployment so high would be foolish. The budget deficit will decline as the economy recovers, although lawmakers will still face a long-term structural deficit. It's important that they come up with a credible plan to reduce the deficit, but acting too soon risks endangering the recovery and delaying improvement in the job market.

	2Q09	3Q09	4Q09	1Q10	**2Q10**	**3Q10**	**4Q10**	**1Q11**	**2Q11**	**3Q11**	2009	**2010**	**2011**
GDP (↓ *contributions*)	-0.7	2.2	5.6	3.0	**2.5**	**2.5**	**2.4**	**2.5**	**2.7**	**3.4**	-2.4	**3.0**	**2.7**
consumer durables	*-0.4*	*1.4*	*0.0*	*0.9*	***1.1***	***0.4***	***0.3***	***0.3***	***0.3***	***0.4***	*-0.3*	***0.6***	***0.4***
nondurables & services	*-0.2*	*0.6*	*1.1*	*1.6*	***1.2***	***1.7***	***1.7***	***1.6***	***1.6***	***1.8***	*-0.1*	***1.2***	***1.6***
bus. fixed investment	*-1.0*	*-0.6*	*0.5*	*0.3*	***0.5***	***0.5***	***0.5***	***0.5***	***0.6***	***0.7***	*-2.2*	***0.2***	***0.5***
residential investment	*-0.7*	*0.4*	*0.1*	*-0.3*	***0.3***	***0.4***	***0.3***	***0.3***	***0.4***	***0.4***	*-0.7*	***0.1***	***0.3***
government	*1.3*	*0.6*	*-0.3*	*-0.4*	***-0.3***	***-0.3***	***-0.2***	***-0.2***	***-0.1***	***0.1***	*0.4*	***-0.1***	***-0.1***
Domestic Final Sales	-0.9	2.3	1.4	2.0	**2.8**	**2.7**	**2.6**	**2.5**	**2.7**	**3.4**	-2.8	**2.0**	**2.8**
exports	*-0.5*	*1.8*	*2.4*	*0.8*	***0.7***	***0.6***	***0.7***	***0.7***	***0.7***	***0.7***	*-1.2*	***1.1***	***0.7***
imports	*2.1*	*-2.6*	*-2.1*	*-1.5*	***-1.1***	***-0.9***	***-0.9***	***-0.7***	***-0.8***	***-0.8***	*2.2*	***-1.3***	***-0.8***
Final Sales	0.7	1.5	1.7	1.4	**2.4**	**2.4**	**2.4**	**2.4**	**2.7**	**3.3**	-1.7	**2.8**	**2.8**
ch. in bus. inventories	*-1.4*	*0.7*	*3.8*	*1.7*	***0.1***	***0.1***	***0.1***	***0.1***	***0.0***	***0.0***	*-0.7*	***1.1***	***0.1***
Unemployment, %	9.3	9.7	10.0	9.7	**9.8**	**9.8**	**9.7**	**9.6**	**9.6**	**9.4**	9.3	**9.7**	**9.4**
NF Payrolls, monthly, th.	-477	-261	-90	87	**200**	**35**	**115**	**100**	**135**	**170**	-395	**109**	**148**
Cons. Price Index (3 mo)	3.7	2.5	2.5	0.9	**-0.4**	**1.7**	**1.7**	**1.7**	**1.7**	**1.8**	2.8	**1.0**	**1.8**
excl. food & energy	2.2	1.4	1.3	-0.2	**0.9**	**1.2**	**1.3**	**1.4**	**1.4**	**1.5**	1.8	**0.8**	**1.5**
PCE Price Index (q/q)	1.4	2.6	2.5	1.5	**0.6**	**1.4**	**1.6**	**1.6**	**1.6**	**1.6**	0.2	**1.6**	**1.5**
excl. food & energy	2.0	1.2	1.8	0.6	**1.0**	**1.2**	**1.2**	**1.3**	**1.3**	**1.4**	1.5	**1.2**	**1.3**
Fed Funds Rate, %	0.18	0.15	0.12	0.13	**0.21**	**0.24**	**0.25**	**0.25**	**0.27**	**0.67**	0.16	**0.21**	**0.60**
3-month T-Bill, (bond-eq.)	0.2	0.2	0.1	0.1	**0.1**	**0.2**	**0.3**	**0.3**	**0.4**	**0.9**	0.2	**0.2**	**0.8**
2-year Treasury Note	1.0	1.0	0.9	0.9	**0.8**	**1.1**	**1.6**	**1.9**	**2.2**	**2.5**	1.0	**1.1**	**2.3**
10-year Treasury Note	3.3	3.5	3.5	3.7	**3.4**	**3.5**	**3.6**	**3.7**	**3.9**	**4.0**	3.3	**3.6**	**3.9**

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