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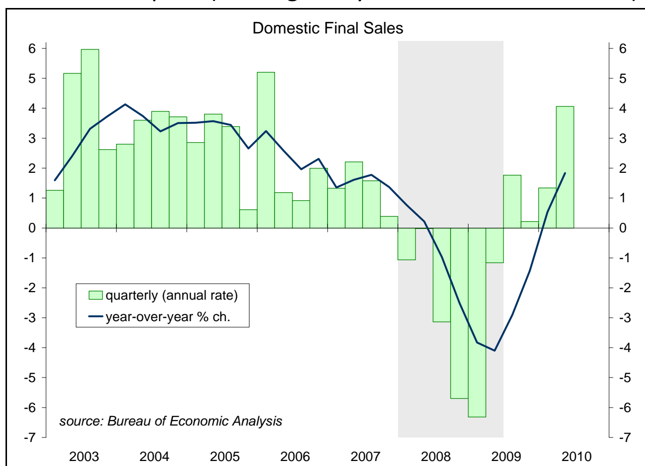
Monthly Economic Outlook

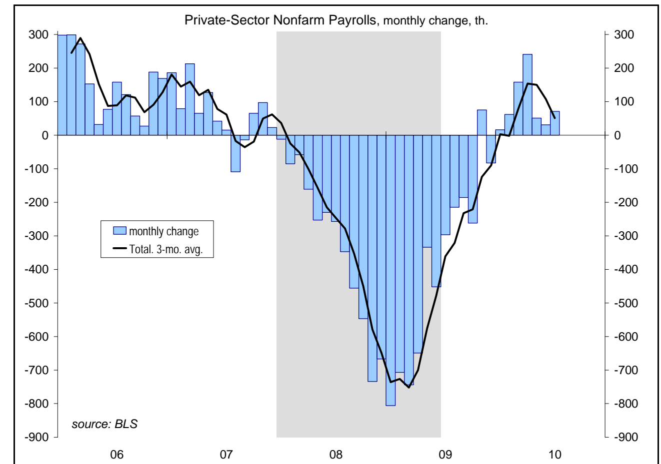
A Recovery at the Crossroads

- *Recent data continue to suggest positive economic growth, but at a more modest pace in the near term than seen earlier.*
- *A double dip is still not the most likely scenario, but downside risks to the growth outlook have increased.*
- *The Federal Reserve and Congress have recently taken modest stimulus efforts. The Fed is ready to do more if needed.*

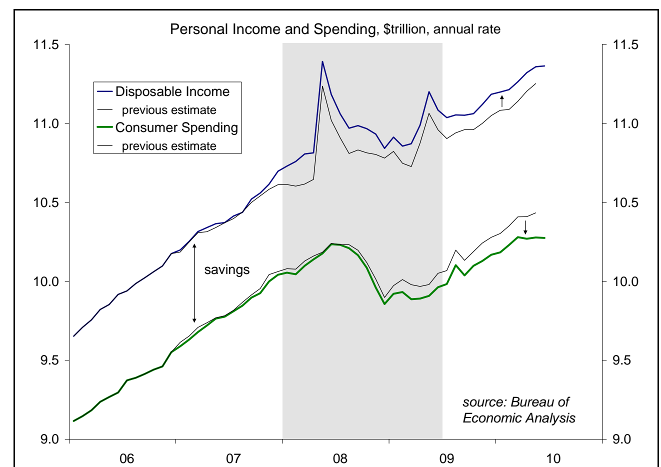
Real Gross Domestic Product rose at a 2.4% annual rate in the advance estimate for 2Q10 (vs. a revised +3.7% pace in 1Q10). Revisions to the GDP source data (most notably, June inventories and foreign trade) suggest that the first quarter growth estimate will be revised significantly lower (probably by more than a full percentage point). Yet, second quarter growth was not as weak as it seemed. Domestic Final Sales (GDP ex-inventories and net exports) rose at a 4.1% pace, the strongest since 1Q06. Consumer spending rose at a 1.6% annual rate (vs. +1.9% in 1Q10), relatively lackluster but still positive. Business fixed investment rose at a 17.0% annual rate, led by a 21.9% pace in spending on equipment and software (vs. +20.4% in 1Q10) – apparently supported by further improvement in corporate profits. There were two surprises. Residential fixed investment (homebuilding) and state & local government both expanded, a contrast to the anecdotal evidence (both are subject to revision). Inventories rose at a faster pace (although they should be revised down).



Nonfarm payrolls fell by 131,000 in July (following a 221,000 decline in June), reflecting a 143,000 decrease in temporary census jobs (that leaves 196,000 census jobs to be shed in the next couple of months). Private-sector payrolls advanced by 71,000, averaging a lackluster 51,000 gain over the last three months (vs. a 200,000 average from March and April). Facing budget strains, state and local governments shed another 48,000 jobs in July, down 169,000 since December. Temp-help payrolls, a leading indicator of new hiring, stalled in June and July (vs. a 45,000 average from October to May).



Personal income and spending figures flattened in June. Annual benchmark revisions showed higher income and lower spending over the last several months than was reported earlier. As a consequence, estimates of the personal savings rate for recent months were revised more than two percentage points higher than previously estimated (the May estimate went from 4.0% to 6.3%). The June estimate was 6.4% (vs. a 2.1% average in 2007). A further rise in the savings rate, while creating a better foundation for future spending growth, would make the overall economic recovery even more gradual. Consumer attitude measures remain relatively low, consistent with a near-term slowdown in consumer spending.



Models for forecasting recessions are generally signaling a very small probability of a renewed contraction. However, these models depend critically on the components used. The slope of the yield curve is the most consistent leading indicator of recession and recovery – but given the magnitude of the financial sector damage, it may not be sending the usual signals. The overall outlook is that the recovery will continue, albeit at a somewhat sluggish pace in the near term, but the downside risks to the growth outlook have increased.

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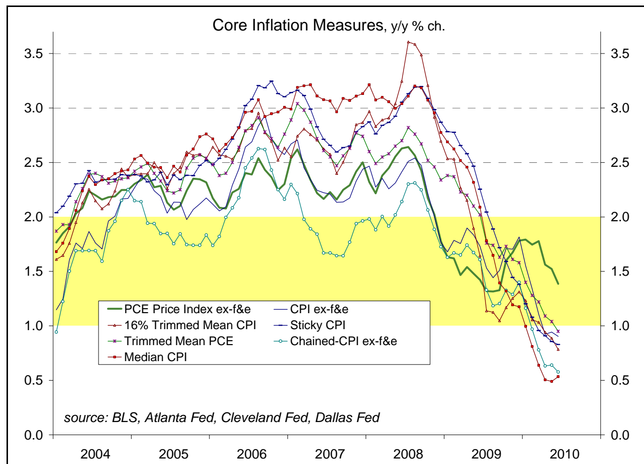
Much air and ink have been wasted in recent months fretting about the potential for higher inflation (the result of "excessive" fiscal and monetary policy). However, the current soft patch in growth raises the risk of deflation (a decline in the overall price level). Disinflation (a declining inflation rate) has been already apparent over the last several months. Core inflation gauges have been trending lower. Ex-food & energy, the Consumer Price Index rose 0.9% over the 12 months ending in June – a 0.6% annual rate in the first half of the year.



Most inflation models are based on some measure of the output gap (the unemployment rate or the difference between actual and potential GDP). As long as the output gap persists at a high enough level, inflation should be trending down. Hence, if economic growth remains sufficiently subpar, we could easily experience deflation – a frightening prospect. In deflation, consumers have no incentive to spend (since things will be cheaper next month) and businesses have no incentive to invest. Deflation paralyzes economic activity, leading to weaker growth and even more deflation – a downward spiral.

In the August 10 policy statement, the Federal Open Market Committee noted that *"the pace of economic recovery is likely to be more modest in the near term than had been anticipated."* Policymakers left short-term interest rates unchanged and repeated that *"economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period."* More importantly, the FOMC also voted to keep constant the level of its holdings of securities. The Fed said it would reinvest principal payments from agency debt and agency mortgage-backed securities in longer-term Treasuries. This is expected to total about $18 billion in the first month of operations. The decision, by itself, should not push long-term interest rates down by much (these rates are already very low), but the move was an important signal that the Fed stands ready to do more if needed. The fear for the financial markets is that more *is* likely to be needed.

On August 10, Congress passed (largely along party lines) and the president signed into law a $26 billion aid package to states and school districts to prevent the loss of thousands of teacher jobs. State budget pressures have led to higher taxes and cuts in government services, both of which have a contractionary impact on the economy. This latest move will help relieve some of the pressure in the short-term. The federal fiscal stimulus was successful in preventing a more significant economic meltdown, but it wasn't large enough to propel the recovery forward more significantly. That's unfortunate. The belief at the time was that the $787 billion stimulus package was as much as could be achieved (following the massive and unpopular bank rescue) and that more fiscal stimulus could be requested if needed. Well, more seems to be needed, but the political backdrop makes that nearly impossible to achieve. The limited scope for additional monetary and fiscal efforts, meanwhile, raises the risks that the current slow patch could develop into something more severe.

	3Q09	4Q09	1Q10	2Q10	**3Q10**	**4Q10**	**1Q11**	**2Q11**	**3Q11**	**4Q11**	2009	**2010**	**2011**
GDP (↓ *contributions*)	1.6	5.0	3.7	2.4	**1.8**	**1.8**	**2.1**	**2.5**	**3.0**	**3.2**	-2.6	**2.8**	**2.3**
consumer durables	*1.4*	*-0.1*	*0.6*	*0.5*	***0.2***	***0.2***	***0.2***	***0.3***	***0.3***	***0.3***	*-0.3*	***0.4***	***0.3***
nondurables & services	*0.1*	*0.8*	*1.7*	*0.6*	***1.5***	***1.5***	***1.5***	***1.5***	***1.6***	***1.7***	*-0.5*	***0.7***	***1.5***
bus. fixed investment	*-0.1*	*-0.1*	*0.7*	*1.5*	***0.5***	***0.5***	***0.5***	***0.6***	***0.7***	***0.7***	*-2.0*	***0.5***	***0.6***
residential investment	*0.3*	*0.0*	*-0.3*	*0.6*	***0.1***	***0.1***	***0.2***	***0.3***	***0.4***	***0.4***	*-0.7*	***0.0***	***0.3***
government	*0.3*	*-0.3*	*-0.3*	*0.9*	***-0.3***	***-0.2***	***-0.2***	***-0.1***	***0.1***	***0.2***	*0.3*	***0.1***	***-0.1***
Domestic Final Sales	1.8	0.2	1.3	4.1	**2.1**	**2.1**	**2.2**	**2.6**	**3.1**	**3.3**	-3.2	**1.7**	**2.5**
exports	*1.3*	*2.6*	*1.3*	*1.2*	***0.7***	***0.7***	***0.7***	***0.7***	***0.7***	***0.7***	*-1.2*	***1.3***	***0.7***
imports	*-2.7*	*-0.7*	*-1.6*	*-4.0*	***-0.7***	***-0.9***	***-0.7***	***-0.8***	***-0.8***	***-0.8***	*2.3*	***-1.7***	***-1.0***
Final Sales	0.4	2.1	1.1	1.3	**2.0**	**1.9**	**2.2**	**2.5**	**3.0**	**3.2**	-2.0	**2.7**	**2.5**
ch. in bus. inventories	*1.1*	*2.8*	*2.6*	*1.1*	***-0.2***	***-0.1***	***0.0***	***0.0***	***0.0***	***0.0***	*-0.6*	***1.4***	***0.0***
Unemployment, %	9.7	10.0	9.7	9.7	**9.6**	**9.6**	**9.6**	**9.5**	**9.3**	**9.3**	9.3	**9.6**	**9.4**
NF Payrolls, monthly, th.	-261	-90	87	175	**-24**	**103**	**100**	**135**	**170**	**185**	-395	**85**	**148**
Cons. Price Index (3 mo)	2.5	2.5	0.9	-0.8	**1.5**	**1.4**	**1.5**	**1.6**	**1.7**	**1.8**	2.8	**0.6**	**1.6**
excl. food & energy	1.4	1.3	-0.2	1.1	**1.2**	**1.3**	**1.4**	**1.4**	**1.5**	**1.6**	1.8	**0.9**	**1.5**
PCE Price Index (q/q)	2.9	2.7	2.1	0.1	**0.6**	**1.5**	**1.5**	**1.6**	**1.6**	**1.6**	0.2	**1.7**	**1.3**
excl. food & energy	1.5	2.1	1.2	1.1	**1.0**	**1.2**	**1.3**	**1.3**	**1.4**	**1.4**	1.5	**1.4**	**1.3**
Fed Funds Rate, %	0.15	0.12	0.13	0.19	**0.18**	**0.19**	**0.20**	**0.24**	**0.33**	**0.90**	0.16	**0.17**	**0.42**
3-month T-Bill, (bond-eq.)	0.2	0.1	0.1	0.1	**0.2**	**0.2**	**0.2**	**0.3**	**0.5**	**1.1**	0.2	**0.1**	**0.5**
2-year Treasury Note	1.0	0.9	0.9	0.9	**0.5**	**0.8**	**1.4**	**1.9**	**2.2**	**2.4**	1.0	**0.8**	**2.0**
10-year Treasury Note	3.5	3.5	3.7	3.5	**2.8**	**3.0**	**3.2**	**3.5**	**3.9**	**4.0**	3.3	**3.2**	**3.7**

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