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Economic Research

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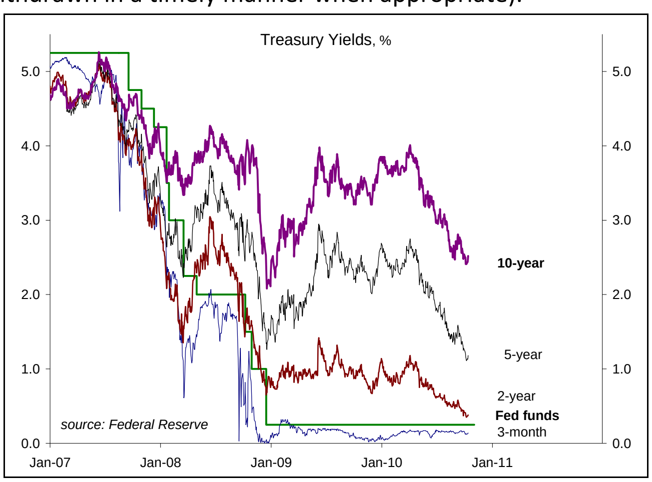
October 14, 2010

Monthly Economic Outlook

More Fed Accommodation On The Way

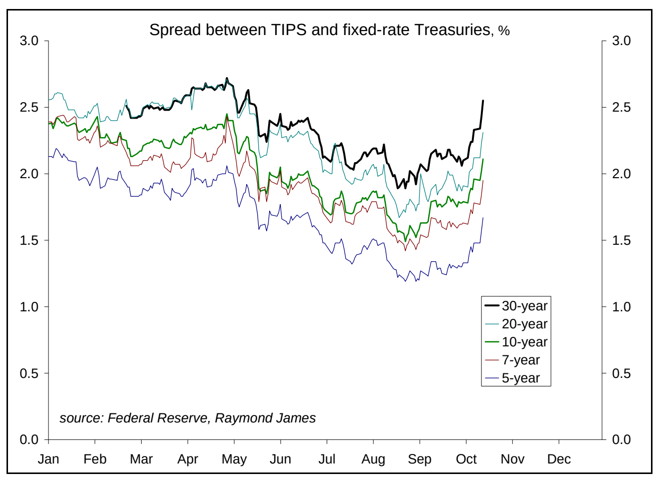
- *Recent data have continued to suggest positive but subpar economic growth in the near term.*
- *In its September 21 policy statement, the Federal Open Market Committee indicated that growth, while likely to remain positive, was too slow and that inflation was too low.*
- *Recent comments by senior Fed officials suggest that the FOMC is likely to announce plans for further purchases of long-term Treasury securities at the November 2-3 policy meeting.*

In its September policy statement, the FOMC indicated that *"the pace of economic recovery is likely to be modest in the near term,"* and *"measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability."* The FOMC wrote that it was *"prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."* At the time, Fed officials seemed unclear on whether the potential benefits of more "credit easing" (direct asset purchases by the Fed) would outweigh the potential costs. The Fed bought $1.25 trillion in mortgage-backed securities and agency debt and $300 billion in Treasuries during the financial crisis. Those efforts were very effective when the financial system and the economy were under severe duress, but might be less helpful now that the financial sector appears to be functioning in a "more normal" manner. Lacking much experience with such efforts, the Fed has limited ability to gauge the resulting impact and a further expansion of the balance sheet could undermine the Fed's credibility (although the Fed remains confident that accommodation can be withdrawn in a timely manner when appropriate).



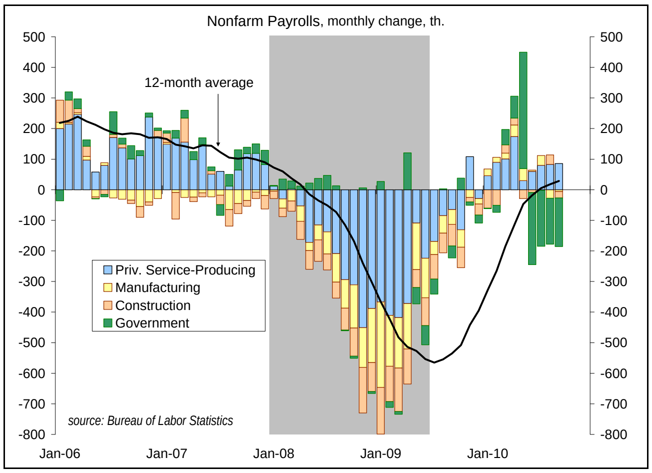
The Fed is still working out the mechanics and communication strategies of further accommodation. Unlike the first round, when the Fed announced large-scale purchases over many months, the Fed is expected to announce smaller purchases over shorter periods. Another option is for the Fed to announce a target for the 10-year Treasury note yield. The advantage of this strategy would be that the market would do most of the Fed's heavy lifting, moving toward the target even before the Fed begins its purchases. The Fed could announce an inflation target or make a longer-term commitment to keep short-term rates at very low levels (more than "an extended period"). These strategies have advantages and disadvantage, but the details should be worked out by November 3.

Unlike most other central banks, the Federal Reserve does not have an explicit inflation target. However, over the years, Fed officials have suggested an implicit comfort range of 1% to 2% (concentrated more at 1.5% to 2.0%). The path of inflation is seen as driven largely by two factors, a measure of the output gap (such as the difference between actual and potential GDP or the unemployment rate) and inflation expectations. Excess capacity (an economy operating well below its potential) puts downward pressure on inflation. Inflation expectations act as an anchor. If actual inflation trends below inflation expectations for a long enough period, inflation expectations will decline – and that appears to have been the case for most of this year. A decline in short-term inflation expectations boosts real interest rates, dampening aggregate demand. Conversely, an increase in inflation expectations lowers short-term real interest rates, stimulating the economy. The near-term goal of the Fed is therefore to boost inflation expectations, but not excessively.



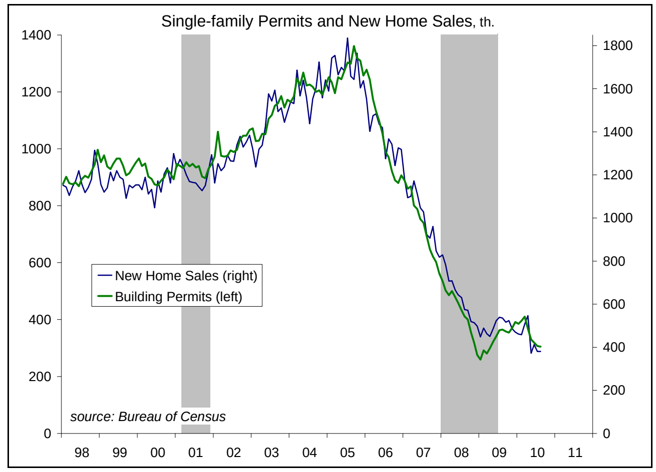
The spread between the yields on Treasury Inflation-Protected Securities (TIPS) and fixed rate Treasuries, provides a rough gauge of inflation expectations. These spreads have risen as Fed officials have suggested a greater likelihood of further asset purchases. However, one needs to be careful here. An increase in purchases of Treasury securities, without a corresponding increase in TIPS, would lead to wider spreads. A key gauge of inflation expectations would become unreliable.

Meanwhile, the economy appears likely to grow at a positive, but subpar, rate for the next few quarters, limited by a continuation of existing headwinds (lingering problems in residential and commercial real estate, tight credit, strains in state and local government budgets). The Bush tax cuts are set to expire at the end of this year, and Congress will not act on taxes until after the November 2 elections. There is some chance that some or all of the Bush tax cuts could be extended, but the uncertainty is not helpful. Furthermore, the federal fiscal stimulus will ramp down next year, acting as a drag on overall economic growth. On the positive side, financial conditions are better than they were before the recession. Corporate profits have generally been strong, helping to fuel business spending on equipment and software.



Job losses from the 2010 census are behind us. Private-sector payrolls rose by 64,000 in the initial estimate for September, a 77,000 average over the last three months (we need 120,000 to 130,000 to keep pace with the growth in the working-age population, +200,000 to +300,000 or more would be consistent with a strong economic recovery).

Economic recoveries often involve "chicken or egg" questions. Job growth leads to more consumer spending, more consumer spending leads to more job gains, and so on. There doesn't need to be a single driver to propel overall growth. Rather, improvement typically comes in fits and starts, uneven across sectors, but broadly over time. In a typical recession, consumers delay purchases of new cars and homes and businesses put off capital expenditures. Once the economy starts to improve, the pent-up demand slingshots the recovery. There is evidence of some pent-up demand in this cycle (seen largely in the technology sector). However, given the damage to the financial sector, the boost to overall economic growth should be relatively limited.



The developing mortgage foreclosure crisis is likely to add to the economic headwinds in the near term. Home construction and sales activity are already low – so while the news isn't helpful, the direct economic damage may be limited. However, we could see more significant financial sector difficulties as the crisis unfolds. With further fiscal stimulus extremely unlikely, Fed policy is the only game in town.

	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	2009	2010	2011
GDP (↓ *contributions*)	1.6	5.0	3.7	1.7	1.6	1.6	2.0	2.5	3.2	3.4	-2.6	2.6	2.2
consumer durables	1.4	-0.1	0.6	0.5	0.4	0.2	0.2	0.3	0.3	0.3	-0.3	0.4	0.3
nondurables & services	0.1	0.8	0.7	1.1	1.2	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	0.6	0.6	0.6	0.7	0.8	0.8	-2.0	0.5	0.7
residential investment	0.3	0.0	-0.3	0.6	-0.3	0.2	0.2	0.3	0.4	0.4	-0.7	0.0	0.2
government	0.3	-0.3	-0.3	0.8	0.0	-0.1	-0.2	-0.1	0.1	0.2	0.3	0.1	0.0
Domestic Final Sales	1.8	0.2	1.3	4.3	1.9	2.3	2.3	2.7	3.2	3.4	-3.2	1.8	2.6
exports	1.3	2.6	1.3	1.1	1.2	0.7	0.7	0.7	0.7	0.7	-1.2	1.4	0.8
imports	-2.7	-0.7	-1.6	-4.6	-1.8	-0.9	-0.7	-0.8	-0.8	-0.8	2.3	-1.9	-1.2
Final Sales	0.4	2.1	1.1	0.9	1.3	2.1	2.3	2.6	3.1	3.3	-2.0	2.8	2.5
ch. in bus. inventories	1.1	2.8	2.6	0.8	0.3	-0.5	-0.3	-0.1	0.0	0.0	-0.6	1.4	-0.1
Unemployment, %	9.7	10.0	9.7	9.7	9.6	9.7	9.6	9.5	9.3	9.1	9.3	9.7	9.4
NF Payrolls, monthly, th.	-261	-90	87	190	-73	85	95	135	170	180	-395	72	145
Cons. Price Index (3 mo)	2.5	2.5	0.9	-1.5	3.1	1.4	1.5	1.6	1.7	1.8	2.8	1.0	1.6
excl. food & energy	1.4	1.3	-0.2	1.3	1.1	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	0.19	0.19	0.20	0.24	0.25	0.41	0.16	0.18	0.28
3-month T-Bill, (bond-eq.)	0.2	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.4	0.2	0.1	0.3
2-year Treasury Note	1.0	0.9	0.9	0.9	0.5	0.5	1.2	1.8	2.1	2.3	1.0	0.7	1.8
10-year Treasury Note	3.5	3.5	3.7	3.5	2.8	2.3	2.4	2.9	3.5	3.7	3.3	3.1	3.1

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