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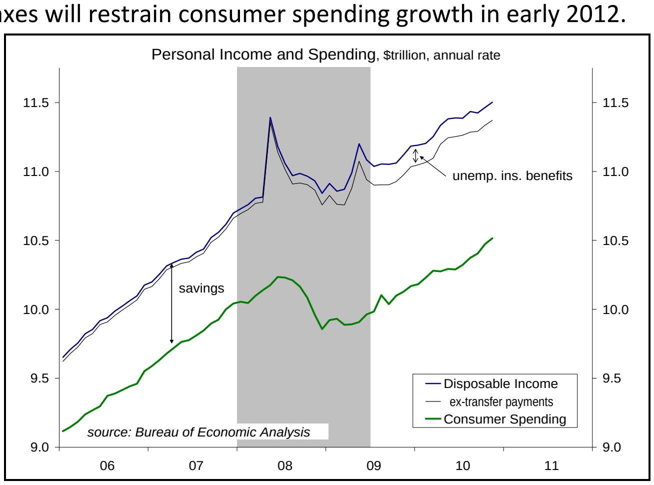
**Monthly Economic Outlook**

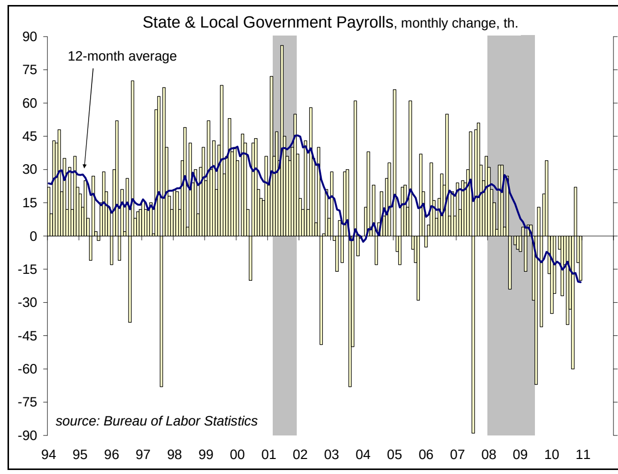
## More Of The Same

- *The economy ended 2010 on a strong note. Real consumer spending is likely to have grown at an annual rate of more than 4%. A slower pace of inventory accumulation will subtract from 4Q10 GDP growth, but a drop in imports will add to growth.*
- *The economy still faces a number of headwinds in early 2011, including lingering problems in residential real estate, strains in state and local government budgets, and higher gasoline prices. These headwinds aren't going to push us into a recession, but they will limit the pace of growth to some extent.*
- *The Federal Reserve is widely expected to complete its $600 billion asset purchase program by the end of June. While there's some chance that the Fed could end up buying more later on, such action is not expected. Eventually, policymakers will take the foot off the gas pedal, but not anytime soon.*

The holiday shopping season was strong, but mixed – a bit disappointing relative to lofty expectations, but consistent with solid growth in the overall economy. Inflation-adjusted consumer spending (70% of Gross Domestic Product) should post a strong gain for 4Q10 (the advance estimate of GDP growth will be released on January 28). Some of the improvement in spending appears to have been due to a drop in the savings rate. The December tax-cut agreement included a 2% reduction in the employee-paid potion of payroll taxes. For a household making $70,000 per year in wages and salaries, this reduction will result in an extra $117 per month in take-home pay, which should further support spending growth in the near term. However, higher gasoline prices will limit the impact to some extent, especially for lower-income households. Moreover, the reduction in payroll taxes only lasts a year – unless extended, the corresponding rebound in payroll taxes will restrain consumer spending growth in early 2012.

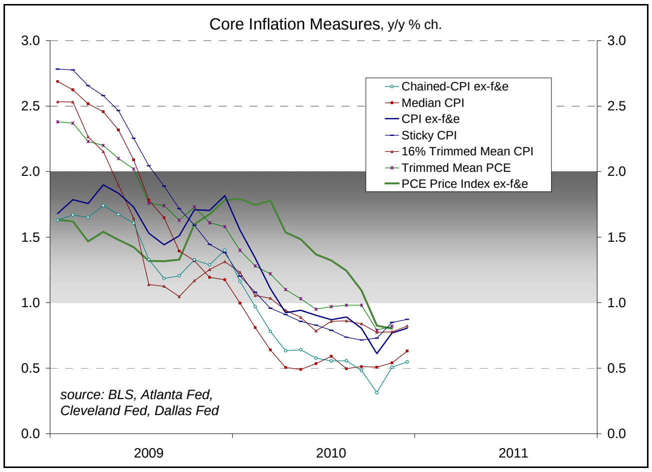



The pace of job growth was moderate in 4Q10. Private-sector payrolls (which are subject to revision next month) averaged a 128,000 gain in 4Q10, roughly what's needed to absorb the growth in the working-age population (hence, keeping the unemployment rate roughly steady over time). Job destruction appears to be very low. Announcements of corporate layoff intentions in 2010 were the lowest since 1997. The problem in the labor market has been a lack of new hiring. We normally look to small and medium-size (generally newer) businesses to account for much of the job creation during an expansion. Bank credit remains very tight for small firms, but should loosen up over time. However, many small firms with good credit do not want to take on additional financial obligations until they're certain that demand will be strong.




Many investors are concerned about the municipal bond market. Strains in state and local government budgets led to a 250,000 drop in payrolls in 2010. Tax revenues are rebounding, but generally remain far short of pre-recession levels. A third of the federal fiscal stimulus was aid to the states (and 70% of that was in healthcare and education – funds allocated with no future commitment to get budgets in order). This federal support will go away in 2011. The pace of job declines in state and local government (about 20,000 per month in 2010) may double in 2011 (as a point of comparison, we'd normally be adding about 20,000 jobs per month, somewhat less than would be justified by population growth). That's not enough to push us into a recession, but it's not going to help the recovery.

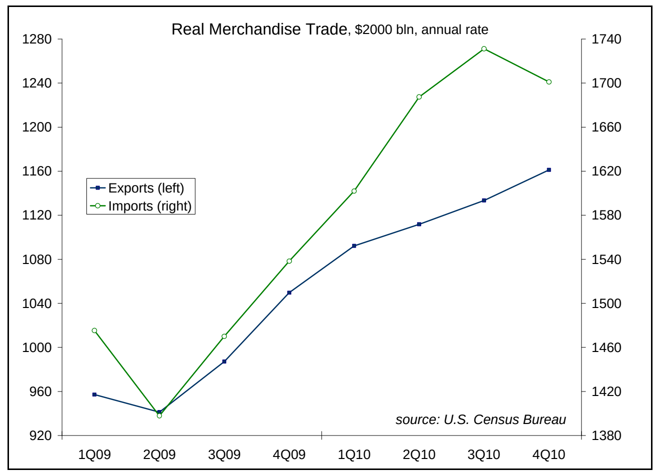
Municipal securities and loans totaled $2.857 trillion at the end of 3Q10, roughly a quarter of the size of the corporate bond market. About $1.06 trillion in muni debt is held directly by the household sector, but there are also sizeable holdings in commercial banks ($229 billion), insurance companies ($448 billion), money market funds ($332 billion) and mutual funds ($532.8 billion). There are likely to be problems (delayed payments, etc.) in some areas. However, the threat of large-scale defaults is not credible. There is some possibility of a panic, but it's difficult to predict something like that. At some point, the government would likely step in to support the muni market, but we are a long way from that now.




The Consumer Price Index rose 1.5% in the 12 months ending in December, up just 0.8% ex-food & energy. One goal of the Fed's asset purchase program was to generate a little more inflation (the Fed's implicit target is around 2%). Growth is likely to be strong enough to keep inflation from trending lower in 2011, but a sharp rise in the underlying trend is unlikely. Labor cost increases are muted and productivity growth appears to have remained strong. Commodity prices are elevated, but there is still a limited ability for firms to pass higher costs along (moreover, 60.2% of the CPI is services).

Energy prices are always a wildcard in the economic outlook. Gasoline prices edged higher in early 2011, with the 13-week average now over $3 per gallon – a level which appears to have been a more noticeable restraint on consumer spending growth in recent years. Some of the recent boost in oil prices may be short-term, a function of colder weather. Unlike the 1970s, when oil price shocks translated quickly into higher wage inflation, oil price increases over the last decade have been associated more with slower economic growth that with a higher trend in underlying inflation.

The Federal Reserve is widely expected to complete its current asset purchase program ($600 billion from November 2010 to June 2011). One channel of both fiscal and monetary policy stimulus is the role of confidence building. While attitudes regarding policy efforts are always going to be mixed to some extent, criticism in recent years has been widespread and vocal – and counterproductive. The Fed has been more communicative. For example, Chairman Bernanke has made a number of efforts to explain technical issues and the Fed's rationale for its asset purchase program. However, that message has not been received clearly. Granted, the vast majority of American's could not tell the difference between monetary and fiscal policy and there has been a general loss of confidence in policymakers during the downturn. Confidence in the Fed should improve as economic growth picks up.




The 4Q10 GDP growth forecast has been revised sharply higher from a month ago. Part of that improvement reflects continued strength in consumer spending, but much of the increase is due to higher exports and a drop in imports (which, although a sign of weakness, adds to GDP growth).

| | 4Q09 | 1Q10 | 2Q10 | 3Q10 | **4Q10** | **1Q11** | **2Q11** | **3Q11** | **4Q11** | 2009 | **2010** | **2011** | **2012** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP (↓ *contributions*) | 5.0 | 3.7 | 1.7 | 2.6 | **5.0** | **3.0** | **3.2** | **3.5** | **3.5** | -2.6 | **3.0** | **3.4** | **3.3** |
| *consumer durables* | *-0.1* | *0.6* | *0.5* | *0.5* | ***1.5*** | ***0.3*** | ***0.4*** | ***0.4*** | ***0.4*** | *-0.3* | ***0.5*** | ***0.7*** | ***0.3*** |
| *nondurables & services* | *0.8* | *0.7* | *1.1* | *1.1* | ***1.5*** | ***1.9*** | ***1.7*** | ***1.8*** | ***1.7*** | *-0.5* | ***0.7*** | ***1.6*** | ***1.7*** |
| *bus. fixed investment* | *-0.1* | *0.7* | *1.5* | *0.9* | ***0.5*** | ***0.7*** | ***0.9*** | ***0.9*** | ***0.8*** | *-2.0* | ***0.5*** | ***0.8*** | ***0.9*** |
| *residential investment* | *0.0* | *-0.3* | *0.6* | *-0.8* | ***0.2*** | ***0.2*** | ***0.3*** | ***0.4*** | ***0.3*** | *-0.7* | ***-0.1*** | ***0.1*** | ***0.3*** |
| *government* | *-0.3* | *-0.3* | *0.8* | *0.8* | ***0.1*** | ***-0.2*** | ***-0.1*** | ***0.1*** | ***0.2*** | *0.3* | ***0.2*** | ***0.1*** | ***0.1*** |
| Domestic Final Sales | 0.2 | 1.3 | 4.3 | 2.6 | **3.8** | **3.3** | **3.1** | **3.6** | **3.5** | -3.2 | **2.0** | **3.4** | **3.3** |
| *exports* | *2.6* | *1.3* | *1.1* | *0.8* | ***1.4*** | ***0.7*** | ***0.7*** | ***0.7*** | ***0.7*** | *-1.2* | ***1.4*** | ***0.9*** | ***0.7*** |
| *imports* | *-0.7* | *-1.6* | *-4.6* | *-2.5* | ***1.2*** | ***-0.7*** | ***-0.6*** | ***-0.7*** | ***-0.7*** | *2.3* | ***-1.9*** | ***-0.8*** | ***-0.7*** |
| Final Sales | 2.1 | 1.1 | 0.9 | 0.9 | **6.4** | **3.3** | **3.3** | **3.6** | **3.5** | -2.0 | **3.0** | **3.4** | **3.2** |
| *ch. in bus. inventories* | *2.8* | *2.6* | *0.8* | *1.6* | ***-1.4*** | ***-0.3*** | ***-0.1*** | ***-0.1*** | ***0.0*** | *-0.6* | ***1.5*** | ***-0.1*** | ***0.0*** |
| Unemployment, % | 10.0 | 9.7 | 9.6 | 9.6 | 9.6 | **9.5** | **9.4** | **9.3** | **9.0** | 9.3 | 9.6 | **9.3** | **8.3** |
| NF Payrolls, monthly, th. | -90 | 87 | 190 | -30 | 128 | **145** | **170** | **185** | **200** | -395 | 94 | **175** | **221** |
| Cons. Price Index (3 mo) | 2.5 | 0.9 | -1.5 | 2.7 | **3.5** | **1.3** | **1.5** | **1.6** | **1.7** | 2.8 | **1.5** | **1.5** | **1.8** |
| excl. food & energy | 1.3 | -0.2 | 1.3 | 0.7 | **0.7** | **0.8** | **1.0** | **1.1** | **1.3** | 1.8 | **0.8** | **1.1** | **1.6** |
| PCE Price Index (q/q) | 2.7 | 2.1 | 0.0 | 0.8 | **1.6** | **1.8** | **1.5** | **1.6** | **1.6** | 0.2 | **1.7** | **1.4** | **1.6** |
| excl. food & energy | 2.0 | 1.2 | 1.0 | 0.5 | **0.4** | **0.9** | **1.0** | **1.2** | **1.3** | 1.5 | **1.3** | **0.9** | **1.4** |
| Fed Funds Rate, % | 0.12 | 0.13 | 0.19 | 0.19 | 0.19 | **0.20** | **0.24** | **0.25** | **0.25** | 0.16 | 0.18 | **0.23** | **1.01** |
| 3-month T-Bill, (bond-eq.) | 0.1 | 0.1 | 0.1 | 0.2 | 0.1 | **0.1** | **0.2** | **0.2** | **0.3** | 0.2 | 0.1 | **0.2** | **1.1** |
| 2-year Treasury Note | 0.9 | 0.9 | 0.9 | 0.5 | 0.5 | **0.6** | **1.2** | **1.6** | **2.0** | 1.0 | 0.7 | **1.3** | **2.2** |
| 10-year Treasury Note | 3.5 | 3.7 | 3.5 | 2.8 | 2.9 | **3.3** | **3.4** | **3.5** | **3.7** | 3.3 | 3.2 | **3.4** | **4.0** |

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