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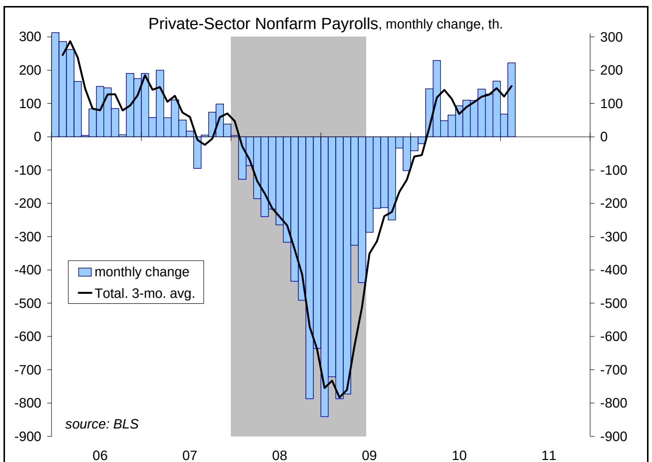
Monthly Economic Outlook

The Threat From Higher Oil Prices

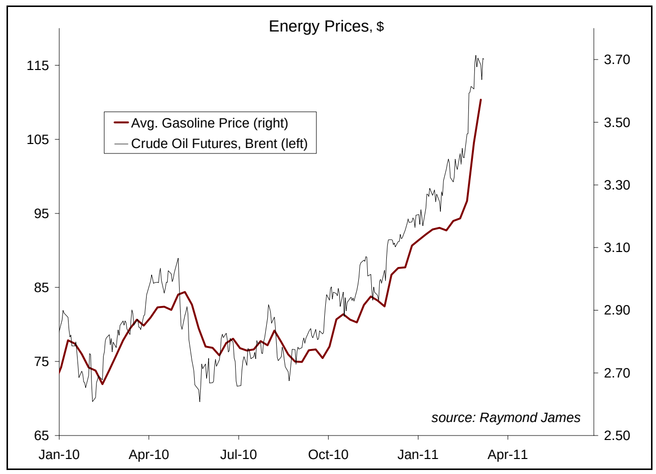
- *The economic outlook improved further in early 2011. A few headwinds (lingering problems in housing, strains in state and local government budgets) were expected to restrain the pace of the recovery, but new hiring and increased bank lending were poised to deliver positive momentum for growth.*
- *The recent rise in oil prices poses threats to the outlooks for growth and inflation. To date, the increase in gasoline prices will reduce the pace of growth somewhat, but should not lead to a recession. Inflation will be higher in the near term, but core inflation is likely to be up only moderately in 2011.*
- *The Federal Reserve will closely watch the impact of oil prices on inflation expectations. As long as inflation expectations remain well-anchored, higher oil prices are unlikely to force the Fed to tighten monetary policy.*

Private-sector payrolls rose by 220,000 in February, vs. a weather-restrained +68,000 in January. Taken together, private-sector payrolls averaged a 145,000 gain in the first two months of the year – good, but not great.



State and local government payrolls fell another 30,000 in February, averaging a 20,000 monthly decline over the last 12 months (normally, this sector would be adding 20,000 jobs per month). A third of the $800 billion federal fiscal stimulus was aid to the states and that will be going away soon. Austerity measures may lead to a sharper rate of government job losses in the months ahead (not enough to push the economy into recession, but this will dampen the overall rate of job growth).

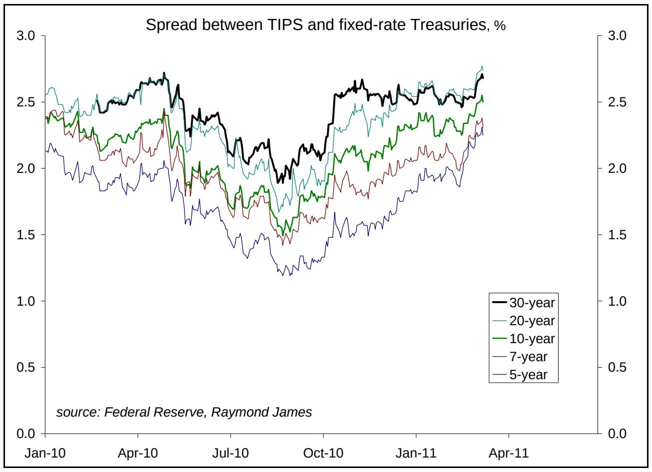
The unemployment rate fell to 8.9% in February, down from 9.8% in November. However, the decrease overstates the improvement in labor market conditions (due partly to shifts in labor force participation). The employment-population ratio, a better measure of slack in the labor market, rose to 58.4% in February (vs. 58.2% in November), down slightly from a year ago (58.5%) and well below pre-recession levels (around 63%).



Oil prices surged in late February and early March. The price of WTI (West Texas Intermediate) rose to a little over $100 per barrel. However, Brent, which is more of a "global" price of oil, rose to over $115. Normally, the two tend to move together, kept close by paper arbitrage. However, in recent weeks an unusual physical-based price discrepancy has emerged. Supply into Cushing, Oklahoma (the price settlement point for WTI) is relatively high. However, geopolitical disruptions in the Middle East and North Africa pushed Brent higher. The price of oil in tankers is driven more by Brent and the concentration of refineries on the Gulf Coast makes Brent the relevant price for gasoline. Gasoline prices have risen sharply in the last few weeks and the futures market suggests even higher prices in the near term (note that retail gasoline prices typically rise about 18% from February to March).

The economic impact of higher gasoline prices depends on not just the magnitude, but also on the duration of the increase. Short-term spikes, such after Hurricane Katrina, normally have little lasting effect. However, a sustained increase will dampen the pace of economic growth. Spending more to fill their tanks, consumers will have less money to spend on other things.

What about the inflationary impact of higher oil prices? Consumer price inflation is typically modeled as a function of inflation expectations, a measure of the output gap (the unemployment rate or the difference between actual and potential GDP), and the price of oil. Higher oil prices will boost headline inflation in the near term. If sustained, higher oil prices will feed through to the underlying inflation trend (raising the cost of transporting goods, increasing the costs of plastics and other materials), and if inflation expectations rise, inflation becomes more entrenched. Inflation expectations had drifted lower in the spring and summer last year, but rebounded as Fed officials began talking about additional asset purchases. More recently, the higher price of oil has led to a relatively modest increase in long-term inflation expectations.



In the 1970s, the OPEC oil shock quickly fed through to wage inflation (many labor contracts were tied to the CPI). Inflation became embedded in the labor market. In contrast, we've had a number of oil price increases over the last ten years and they now tend to be more of a negative for growth than a catalyst for a higher trend in underlying inflation.

European Central Bank President Trichet recently signaled that the ECB will soon raise short-term interest rates. However, the inflation dynamic in Europe is a lot different than in the U.S. Higher oil prices will not, by themselves, lead the Federal Reserve to tighten monetary policy. However, if inflation expectations were to rise more significantly, the Fed could begin to tighten sooner rather than later. Most likely, the Fed will complete is asset purchase program on schedule (at the end of June) and continue to reinvest principal payments in its mortgage portfolio into long-term Treasuries for a while longer. There's no need to hit the brakes, but the Fed will need to take the foot off the gas pedal at some point. This "normalization" of monetary policy is likely to start in the first half of 2012. However, Fed action will depend critically on the evolution of the outlooks for growth and inflation.

Strong growth in corporate profits, lean inventories, the payroll tax cut, and easier credit should contribute positive momentum to economic growth in the near term. However, housing issues and problems with state and local government budgets will act as a restraint (in addition, payroll taxes are set to rise in 2012). The price of oil is always a wildcard in the economic outlook. If the recent increase sticks, we may see 0.5 to 1.0 percentage point shaved from GDP growth (a 2.5% to 3.5% range instead of the consensus view of 3.5% to 4.0% growth seen a month ago). A more substantial increase (say to $130) would dampen growth even more and could lead to stagflation (more sluggish growth and higher inflation).

There is one more danger in the near term. The current Continuing Resolution to fund the government expires on March 18. The two political parties are far apart on spending cuts for the remainder of the fiscal year and there is a possibility of a government shutdown. That would not be helpful. The government will also have to raise the debt ceiling within the next month or two. The government *will not* default on its debt, but the threat could be disruptive for the markets.

	1Q10	2Q10	3Q10	4Q10	**1Q11**	**2Q11**	**3Q11**	**4Q11**	**1Q12**	**2Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	3.7	1.7	2.6	2.8	**1.8**	**3.2**	**3.2**	**3.2**	**2.8**	**3.1**	2.9	**2.6**	**3.1**
consumer durables	*0.6*	*0.5*	*0.5*	*1.4*	***0.6***	***0.4***	***0.4***	***0.4***	***0.2***	***0.3***	*0.5*	***0.7***	***0.3***
nondurables & services	*0.7*	*1.1*	*1.1*	*1.4*	***1.2***	***1.3***	***1.6***	***1.7***	***1.4***	***1.6***	*0.7*	***1.5***	***1.6***
bus. fixed investment	*0.7*	*1.5*	*0.9*	*0.5*	***0.7***	***0.8***	***0.9***	***0.9***	***0.9***	***0.9***	*0.5*	***0.8***	***0.8***
residential investment	*-0.3*	*0.6*	*-0.8*	*0.1*	***0.2***	***0.3***	***0.3***	***0.3***	***0.1***	***0.2***	*-0.1*	***0.1***	***0.2***
government	*-0.3*	*0.8*	*0.8*	*-0.3*	***-0.2***	***-0.2***	***-0.2***	***-0.1***	***0.0***	***0.1***	*0.2*	***0.0***	***0.0***
Domestic Final Sales	1.3	4.3	2.6	3.1	**2.5**	**2.6**	**3.0**	**3.2**	**2.6**	**3.1**	1.9	**2.9**	**3.0**
exports	*1.3*	*1.1*	*0.8*	*1.2*	***1.4***	***0.7***	***0.7***	***0.7***	***0.7***	***0.7***	*1.3*	***1.0***	***0.7***
imports	*-1.6*	*-4.6*	*-2.5*	*2.2*	***-3.0***	***-0.6***	***-0.7***	***-0.7***	***-0.6***	***-0.8***	*-1.8*	***-1.2***	***-0.7***
Final Sales	1.1	0.9	0.9	6.7	**0.9**	**2.8**	**3.1**	**3.2**	**2.8**	**3.1**	2.9	**2.8**	**2.9**
ch. in bus. inventories	*2.6*	*0.8*	*1.6*	*-3.7*	***0.9***	***0.4***	***0.1***	***0.0***	***0.0***	***0.0***	*1.4*	***-0.1***	***0.1***
Unemployment, %	9.7	9.6	9.6	9.6	**9.0**	**8.8**	**8.6**	**8.5**	**8.4**	**8.2**	9.6	**8.7**	**8.2**
NF Payrolls, monthly, th.	39	181	-46	139	**150**	**180**	**180**	**175**	**170**	**190**	76	**171**	**186**
Cons. Price Index (3 mo)	0.7	-1.4	2.9	3.3	**4.5**	**1.1**	**1.6**	**1.7**	**1.7**	**1.8**	1.5	**2.2**	**1.8**
excl. food & energy	-0.1	1.2	0.8	0.8	**1.6**	**1.0**	**1.1**	**1.3**	**1.4**	**1.5**	0.8	**1.3**	**1.6**
PCE Price Index (q/q)	2.1	0.0	0.8	1.8	**3.1**	**1.9**	**1.5**	**1.6**	**1.6**	**1.7**	1.7	**1.9**	**1.6**
excl. food & energy	1.2	1.0	0.5	0.4	**1.1**	**1.2**	**1.2**	**1.3**	**1.5**	**1.5**	1.3	**1.0**	**1.4**
Fed Funds Rate, %	0.13	0.19	0.19	0.19	**0.16**	**0.18**	**0.20**	**0.24**	**0.38**	**0.82**	0.18	**0.20**	**1.01**
3-month T-Bill, (bond-eq.)	0.1	0.1	0.2	0.1	**0.1**	**0.2**	**0.2**	**0.3**	**0.4**	**0.9**	0.1	**0.2**	**1.0**
2-year Treasury Note	0.9	0.9	0.5	0.5	**0.7**	**1.0**	**1.5**	**1.8**	**2.1**	**2.2**	0.7	**1.2**	**2.2**
10-year Treasury Note	3.7	3.5	2.8	2.9	**3.5**	**3.6**	**3.7**	**3.9**	**3.9**	**4.1**	3.2	**3.7**	**4.1**

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