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Economic Research

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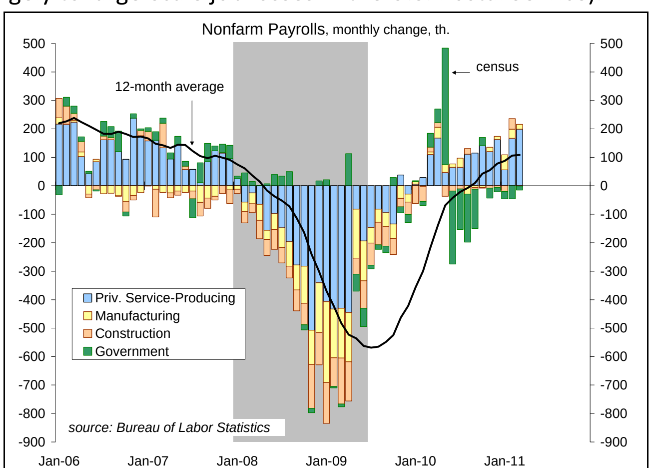
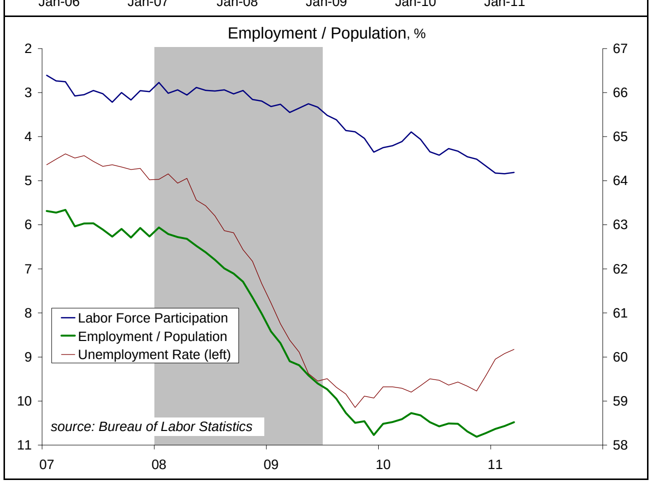
Monthly Economic Outlook

Recovery Continues, But With New Worries

- *The economy continued to advance in 1Q11, although the pace of underlying demand appeared to slow. Job growth has improved, as small and medium-sized firms have begun to hire.*
- *The rise in oil prices should dampen the pace of growth to some extent and boost consumer price inflation in the near term. A lot depends on what happens to oil prices from here, but to date, the economy appears unlikely to slip into recession.*
- *The Federal Reserve views inflationary pressure in food and energy prices as "transitional," but will watch the trends in underlying inflation and inflation expectations closely.*

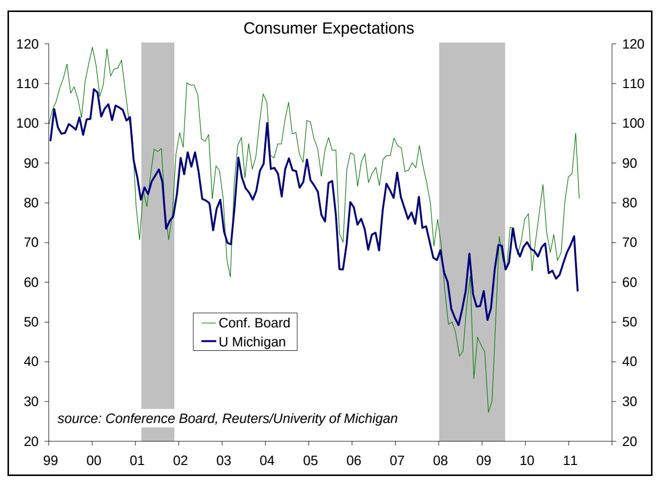
Private-sector payrolls rose by 230,000 in March, a 188,000 monthly average in 1Q11. Surveys suggest that hiring by small and medium-sized firms has begun to pick up in the last few months. State and local governments continue to shed jobs (down 282,000, or 1.6%, over the last 12 months). Ex-census workers, employment in the federal government rose by just 10,000, or 0.4%, over the 12 months ending in March (due largely to large-scale job losses in the U.S. Postal Service).





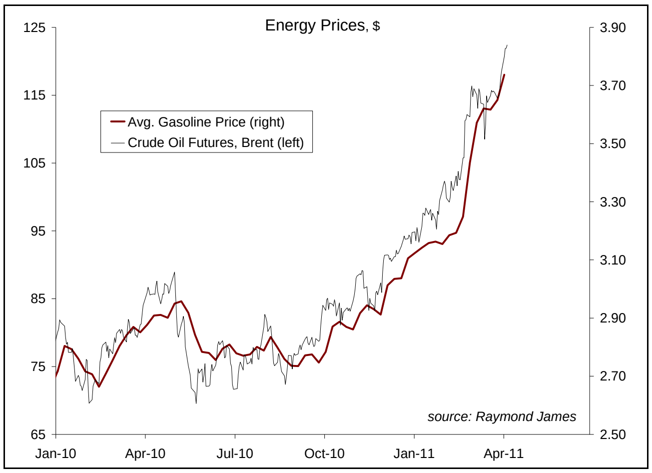
The employment rate continued to fall in March (to 8.8%, vs. 9.8% in November). However, part of the recent decline has been due to a decrease in labor force participation (many give up looking for a job once unemployment insurance benefits expire and are therefore no longer officially counted as "unemployed"). The employment-population ratio, a better measures of capacity utilization in the labor market has shown more modest improvement (up slightly in the last few months, but little changed compared to a year ago).

Personal income and spending figures through February suggest that real consumer spending (70% of GDP) rose at about a 1.5% annual rate in 1Q11, down from a 4.0% pace in 4Q10. It's not unusual to see some slowing following a strong quarter, these data are subject to revision, and weather was certainly a factor in some areas of the country, but these figures do not reflect the surge in gasoline prices in late March and early April. The impact of higher gasoline prices depends on the magnitude and duration of the increase. To date, the rise in gasoline prices does not appear to be large enough to force the economy into a recession, but it does mean that economic growth will be slower than it would be otherwise. In early February, the broad consensus was that GDP growth would probably be around 3.5% to 4.0% this year. At this point, growth of 2.5% to 3.0% seems more likely – but much will depend on whether oil prices rise, fall, or flatten out from here. The impact of higher gasoline prices falls more heavily on low- and middle-income households (offsetting much, if not all, of the benefit of this year's reduction in payroll taxes) and typically shows up with a lag. Anecdotal evidence suggests that discretionary spending is under pressure. In the near term, investors should pay close attention to signs of softer growth. Consumer attitude measures have already fallen sharply.



Note that while the price of West Texas Intermediate has hit $110 per barrel, Brent has risen to more than $122. Brent, is more representative of the global price of oil and is a bigger factor in the price of gasoline.

Higher food and energy prices have put upward pressure on consumer price inflation. However, food and energy prices have a tendency to flatten out or retreat after sharp increases. For example, drought conditions can boost grain prices, but the weather doesn't remain extreme for extended periods. Moreover, higher prices encourage more planting, and the increased supply will eventually bring prices back down. In general, it takes a huge increase in commodity prices to have much of an effect at the consumer level (remember, 60% of the CPI is services), but oil prices are the exception. Oil prices have a broader impact on the economy than most commodity prices. The key issue is whether higher oil prices will boost the underlying inflation trend and lift inflation expectations.



Core inflation fell in 2010. Recent figures suggest a firming into early 2011. Short-term inflation expectations have risen, but long-term inflation expectations are up only slightly. There is no sign that high gasoline prices are boosting wage inflation. Average hourly earnings were flat in March, up just 1.7% from a year ago. We may see wage inflation in some skilled labor positions, but labor slack should keep wage increases low.

In public comments, the inflation views of Federal Reserve officials have varied. There is a long history of a hawkish tilt for some Fed districts (such as Richmond and Philadelphia). Comments from the presidents of these district banks tend to be more fearful of the possibility of higher inflation. They would generally rather tighten sooner than later. However, this is very much a minority view at the Fed. Most officials see the impact of higher food and energy prices as "transitory," with inflation determined largely by the amount of slack in the economy and by inflation expectations. Officials will closely watch the trends in core inflation and measures of inflation expectations. The Fed is widely expected to complete its $600 billion asset purchase program at the end of June, but will likely continue reinvesting principal payments in its mortgage portfolio into long-term Treasuries (keeping the size of the balance sheet unchanged). At some point, the Fed will have to start normalizing monetary policy (taking the foot of the accelerator, not stepping on the brake). Any future policy moves will depend on the outlook for growth and inflation, but short-term interest rates are likely to remain low into 2012.

Japan's earthquake/tsunami/nuclear tragedy has caused some disruptions in the supply chains for autos and electronics, but the impact on global economic growth is widely expected to be short-term. Japan should have little trouble in raising funds for rebuilding. There's no need for the country to sell its holdings of U.S. securities, but we could see less demand from Japan at future auctions of U.S. Treasury securities (but there's been little evidence of that so far).

As of this writing, we appear set for a shutdown of the federal government. Necessary operations will continue, but there will be disruptions to some services and delayed wage payments to federal workers (effectively costing the government more than if it weren't shut down). The economic impact should be limited. The government will not default, but there may be unwarranted concerns about U.S. debt.

	1Q10	2Q10	3Q10	4Q10	**1Q11**	**2Q11**	**3Q11**	**4Q11**	**1Q12**	**2Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	3.7	1.7	2.6	3.1	**1.6**	**3.2**	**3.2**	**3.2**	**2.8**	**3.1**	2.9	**2.6**	**3.1**
consumer durables	*0.6*	*0.5*	*0.5*	*1.5*	***0.5***	***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*	***0.6***	***1.3***	***1.6***	***1.7***	***1.4***	***1.6***	*0.7*	***1.2***	***1.6***
bus. fixed investment	*0.7*	*1.5*	*0.9*	*0.7*	***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	3.2	**1.8**	**2.6**	**3.0**	**3.2**	**2.6**	**3.1**	1.9	**2.7**	**3.0**
exports	*1.3*	*1.1*	*0.8*	*1.1*	***1.1***	***0.7***	***0.7***	***0.7***	***0.7***	***0.7***	*1.3*	***0.9***	***0.7***
imports	*-1.6*	*-4.6*	*-2.5*	*2.2*	***-2.2***	***-0.6***	***-0.7***	***-0.7***	***-0.6***	***-0.7***	*-1.8*	***-1.0***	***-0.7***
Final Sales	1.1	0.9	0.9	6.7	**0.7**	**2.8**	**3.1**	**3.2**	**2.8**	**3.1**	2.9	**2.7**	**2.9**
ch. in bus. inventories	*2.6*	*0.8*	*1.6*	*-3.4*	***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	**8.9**	**8.7**	**8.4**	**8.3**	**8.1**	**7.9**	9.6	**8.6**	**7.8**
NF Payrolls, monthly, th.	39	181	-46	139	**159**	**180**	**175**	**175**	**170**	**190**	78	**172**	**186**
Cons. Price Index (3 mo)	0.7	-1.4	2.9	3.3	**6.0**	**1.2**	**1.3**	**1.7**	**1.7**	**1.8**	1.5	**2.5**	**1.8**
excl. food & energy	-0.1	1.2	0.8	0.8	**2.0**	**1.2**	**1.2**	**1.3**	**1.4**	**1.5**	0.8	**1.4**	**1.6**
PCE Price Index (q/q)	2.1	0.0	0.8	1.7	**3.7**	**2.5**	**1.4**	**1.6**	**1.6**	**1.7**	1.7	**2.1**	**1.7**
excl. food & energy	1.2	1.0	0.5	0.4	**1.4**	**1.4**	**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	**0.19**	**1.01**
3-month T-Bill, (bond-eq.)	0.1	0.1	0.2	0.1	**0.1**	**0.1**	**0.1**	**0.2**	**0.4**	**0.9**	0.1	**0.1**	**1.0**
2-year Treasury Note	0.9	0.9	0.5	0.5	**0.7**	**0.9**	**1.2**	**1.6**	**1.9**	**2.1**	0.7	**1.1**	**2.1**
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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