RAYMOND JAMES

Economic Research

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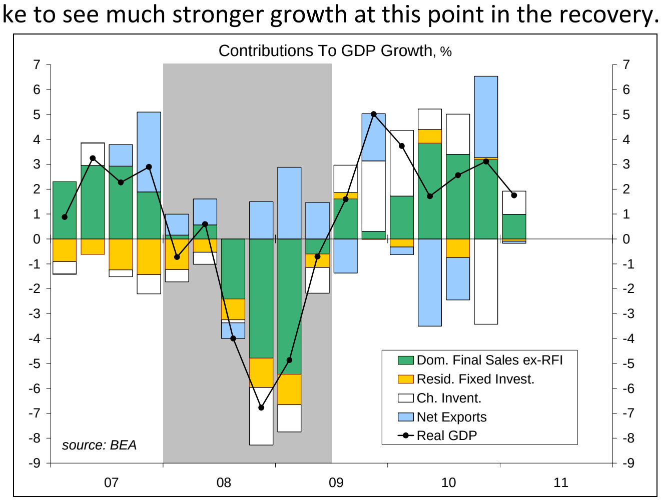
Monthly Economic Outlook

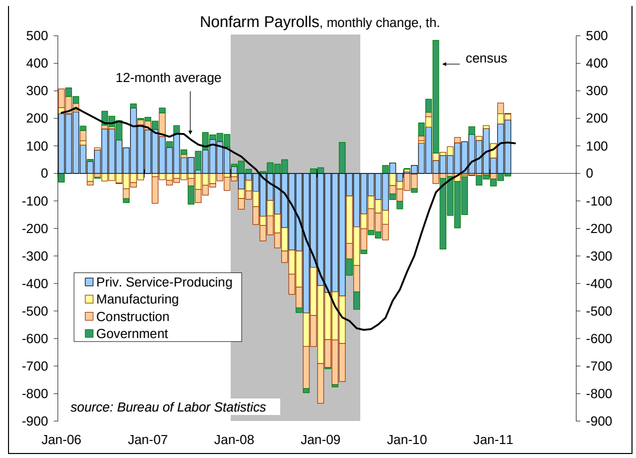
The Gasoline Price Impact

- *Energy prices are always a wildcard in the economic outlook. This year's rise in gasoline prices will dampen consumer spending growth in the near term, but the impact, which shows up with a lag, is unlikely to lead to a recession.*
- *Higher energy prices tend to have a transitory impact on consumer price inflation. The key is whether there will be second-round effects: higher core inflation, higher wage increases, and higher inflation expectations.*
- *The Federal Reserve is expected to keep monetary policy steady, leaving the federal funds rate target unchanged and keeping the size of the balance level after long-scale asset purchases (LSAP) end in June. At some point, the Fed will begin the process of normalizing monetary policy, but not soon.*

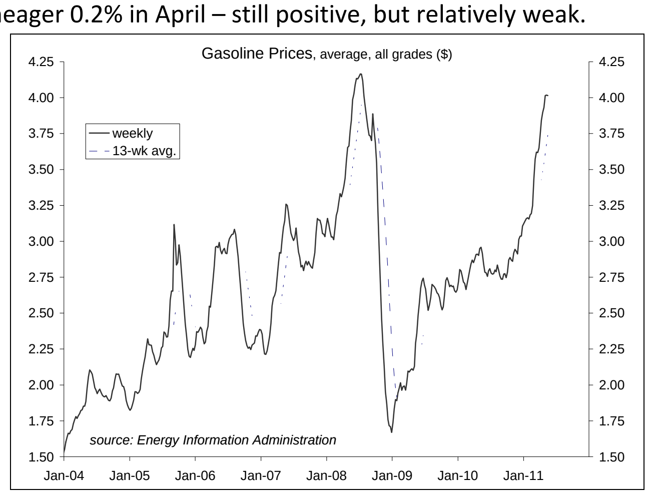
Real GDP rose at a 1.8% annual rate in the advance estimate for 1Q11, down from 3.1% in 4Q10. Consumer spending slowed to a 2.7% pace, vs. 4.0% – not great, but not bad either. Business fixed investment was mixed, as an 11.6% pace in spending on equipment and software offset a 21.7% rate of decline in business structures. A 5.2% drop in government expenditures subtracted 1.1 percentage points from GDP growth, with a little more than half of that in defense (which can be choppy from quarter to quarter) and the rest in state and local government (which is generally contracting). Inventory growth picked up, adding 0.9 percentage point to GDP growth. In short, it wasn't a bad quarter, although we'd like to see much stronger growth at this point in the recovery.



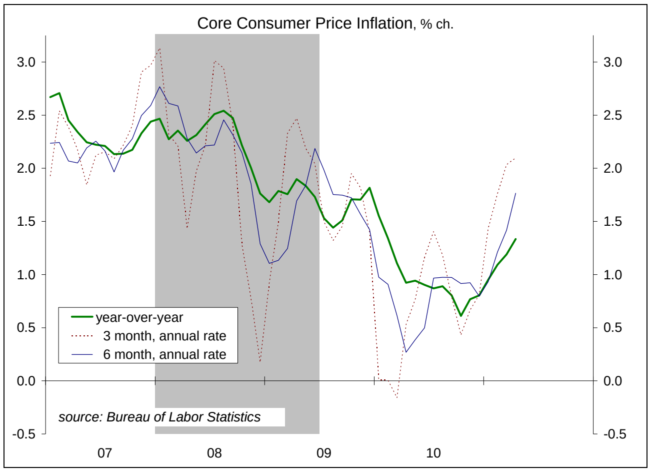
Private-sector job growth remained strong into the early spring, rising by 268,000 and averaging 253,000 per month over the last three months (vs. +130,000 in the three months before that, a pace comparable to the growth in the working-age population). Job destruction continues to trend at a relatively low level and there are signs that hiring has picked up for small and medium-sized firms (which typically account for a majority of job creation during an economic expansion). State and local government lost another 22,000 jobs in April, down by 467,000 since December 2008. Remember, about a third of the $800 billion federal fiscal stimulus was aid to the states. Job losses would have been more severe if not for that support – however, that support is going away. The unemployment rate rebounded to 9.0% in April, vs. 8.8% in March and 9.8% in November. However, there's always some level of statistical noise in the unemployment rate (the reported figure is accurate to ±0.2%), but recent readings appear to have become more unreliable. The employment-to-population ratio, a better measure of labor utilization, has been little changed over the last year.



The average retail price of gasoline rose to over $4 per gallon the first two weeks of early May. The recent correction in commodity prices points to some relief in the near term (perhaps 25 or 30 cents lower). The impact of higher gasoline prices arrives with a lag (the 13-week average is a good gauge) and there is growing anecdotal evidence of downward pressure on discretionary spending. Ex-gasoline, retail sales rose a meager 0.2% in April – still positive, but relatively weak.



Slower consumer spending growth may, in turn, have a detrimental effect on manufacturing activity. Manufacturing output fell 0.4% in April, the first decline in ten months, reflecting supply-chain disruptions related to Japan's earthquake/tsunami. Ex-autos, factory output rose just 0.2%.



Higher gasoline prices have led overall consumer price inflation higher in recent months. The headline CPI rose 3.2% in the 12 months ending in April, a 5.9% annual rate in the first four months of 2011 (vs. +1.5% in 2010). Core inflation is also higher, running at a 2.1% annual rate in the last four months (vs. +0.8% in 2010). That's not a bad thing. Real interest rates are what matter in the economy. Somewhat higher inflation means lower real rates, which are stimulative for growth. Commodity price increases have contributed to pipeline inflation pressures in goods, but the flow-through to the consumer level remains limited. Importantly, high gasoline prices have not led to a significant rise in inflation expectations. Surveys of economists and consumers, as well as market-based measures such as the spread between TIPS and fixed-rate Treasuries, show moderate long-term inflation expectations.

The Fed's commitment to keep the federal funds rate target at a exceptionally low levels for *"an extended period"* remains conditional on a high level of slack (especially in the labor market), a moderate trend in core inflation, and contained inflation expectations. If the outlook for these conditions changes, the Fed will be more likely to alter monetary policy. In his initial post-FOMC press briefing, Fed Chairman Bernanke signaled that the Fed's large-scale asset purchases will end un-tapered in June. The Fed will continue to reinvest maturing securities into long-term Treasuries (about $35 billion per month) for the foreseeable future, but will begin the process of policy normalization at some point – most likely in early 2012, but that depends on the evolution of the economic outlook over the next several months.

The federal government breached the debt ceiling ($14.3 trillion) on May 16. Through the use of creative accounting (borrowing internally from government retirement funds, etc.) the government can continue to function until early August. The bond market appears complacent about the possibility that the government will default, largely because the debt ceiling *has* to be raised. We've been in this situation a number of times. One party thinks it has the other over a barrel, but in the end, the debt ceiling must be raised. The consequences of not doing so would be severe – and nobody wants to get blamed for that. The wide deficits in recent years has been due largely to the recession (some narrowing is expected as the economy improves). More recently December's tax agreement added to the deficit (projections of the 2011 deficit by the nonpartisan Congressional Budget Office's went from $1.07 trillion in August 2010 to $1.48 trillion in January 2011). The real problem is long term and it's centered in Medicare.

There is still widespread optimism that the economy will continue to recovery. However, higher gasoline prices will be a restraint on growth in the near term and the level of uncertainty in the economic outlook remains very high.

	2Q10	3Q10	4Q10	1Q11	**2Q11**	**3Q11**	**4Q11**	**1Q12**	**2Q12**	**3Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	1.7	2.6	3.1	1.8	**2.7**	**2.6**	**3.0**	**2.6**	**3.0**	**3.4**	2.9	**2.5**	**2.9**
consumer durables	*0.5*	*0.5*	*1.5*	*0.8*	***0.3***	***0.4***	***0.4***	***0.1***	***0.2***	***0.4***	*0.5*	***0.7***	***0.3***
nondurables & services	*1.1*	*1.1*	*1.4*	*1.1*	***1.2***	***1.6***	***1.7***	***1.3***	***1.5***	***1.8***	*0.7*	***1.3***	***1.5***
bus. fixed investment	*1.5*	*0.9*	*0.7*	*0.2*	***0.5***	***0.7***	***0.8***	***0.9***	***0.9***	***0.8***	*0.5*	***0.6***	***0.8***
residential investment	*0.6*	*-0.8*	*0.1*	*-0.1*	***0.1***	***0.3***	***0.3***	***0.1***	***0.2***	***0.4***	*-0.1*	***0.0***	***0.2***
government	*0.8*	*0.8*	*-0.3*	*-1.1*	***0.2***	***-0.2***	***-0.2***	***0.0***	***0.1***	***0.2***	*0.2*	***-0.2***	***0.0***
Domestic Final Sales	4.3	2.6	3.2	0.9	**2.4**	**2.8**	**3.0**	**2.4**	**2.9**	**3.5**	1.9	**2.4**	**2.9**
exports	*1.1*	*0.8*	*1.1*	*0.6*	***0.7***	***0.7***	***0.7***	***0.7***	***0.7***	***0.7***	*1.3*	***0.8***	***0.7***
imports	*-4.6*	*-2.5*	*2.2*	*-0.7*	***-0.6***	***-0.7***	***-0.7***	***-0.6***	***-0.7***	***-0.8***	*-1.8*	***-0.6***	***-0.7***
Final Sales	0.9	0.9	6.7	0.8	**2.5**	**2.8**	**3.0**	**2.6**	**2.9**	**3.4**	2.9	**2.5**	**2.9**
ch. in bus. inventories	*0.8*	*1.6*	*-3.4*	*0.9*	***0.2***	***-0.2***	***0.0***	***0.0***	***0.0***	***0.0***	*1.4*	***-0.2***	***0.0***
Unemployment, %	9.6	9.6	9.6	8.9	**8.8**	**8.6**	**8.4**	**8.2**	**8.1**	**7.9**	9.6	**8.7**	**8.0**
NF Payrolls, monthly, th.	181	-46	139	175	**210**	**170**	**175**	**170**	**190**	**195**	78	**182**	**186**
Cons. Price Index (3 mo)	-1.4	2.9	3.3	6.1	**2.4**	**1.3**	**1.7**	**1.7**	**1.8**	**1.8**	1.5	**2.9**	**1.8**
excl. food & energy	1.2	0.8	0.8	2.0	**1.5**	**1.2**	**1.3**	**1.4**	**1.5**	**1.6**	0.8	**1.5**	**1.6**
PCE Price Index (q/q)	0.0	0.8	1.7	3.8	**3.5**	**1.4**	**1.6**	**1.6**	**1.7**	**1.7**	1.7	**2.3**	**1.7**
excl. food & energy	1.0	0.5	0.4	1.5	**1.5**	**1.2**	**1.3**	**1.5**	**1.5**	**1.6**	1.3	**1.1**	**1.5**
Fed Funds Rate, %	0.19	0.19	0.19	0.16	**0.10**	**0.18**	**0.23**	**0.29**	**0.52**	**0.78**	0.18	**0.17**	**0.66**
3-month T-Bill, (bond-eq.)	0.1	0.2	0.1	0.1	**0.0**	**0.1**	**0.2**	**0.4**	**0.7**	**0.9**	0.1	**0.1**	**0.8**
2-year Treasury Note	0.9	0.5	0.5	0.7	**0.6**	**1.0**	**1.4**	**1.7**	**2.0**	**2.1**	0.7	**0.9**	**2.0**
10-year Treasury Note	3.5	2.8	2.9	3.5	**3.3**	**3.6**	**3.8**	**3.8**	**4.0**	**4.1**	3.2	**3.5**	**4.0**

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