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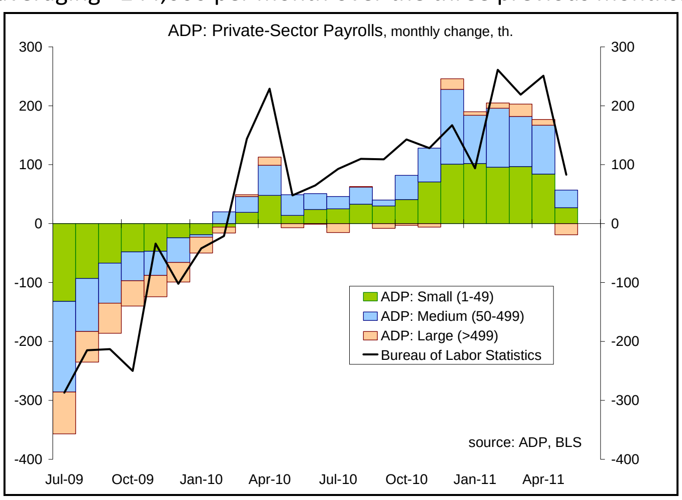
Monthly Economic Outlook

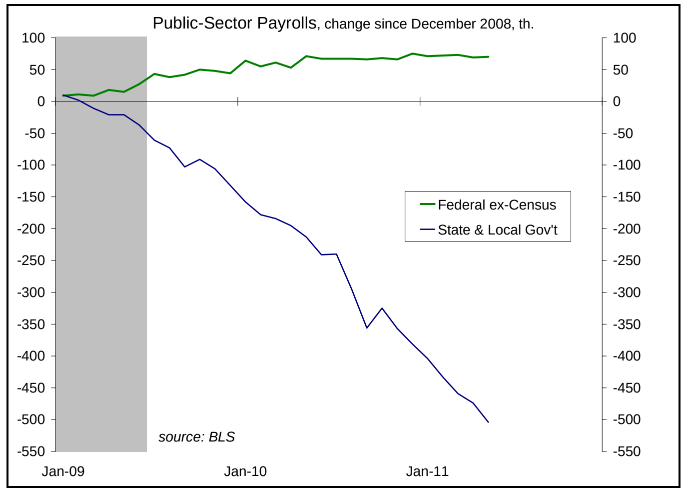
Slow Patch, Temporary Or Not?

- *The broad range of economic data reports has signaled a slowing in the pace of growth in the near term.*
- *Weighing the positive and negative forces at work on the economy, growth is likely to pick up in the second half of the year. However, risks appear to be tilted to the downside and there is little scope for further monetary or fiscal stimulus.*
- *The Federal Reserve is expected to complete its large-scale asset purchase program this month (QE2), but will continue to reinvest maturing securities into Treasuries. There is a high bar for the Fed to do another round of asset purchases (QE3).*

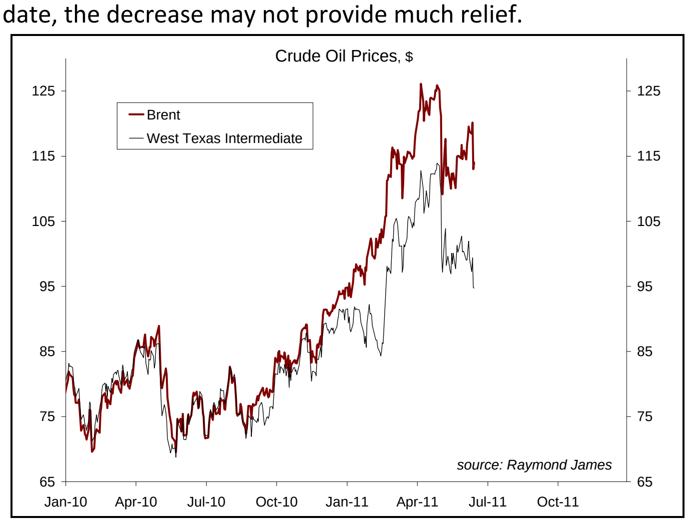
Real GDP rose at a 1.8% annual rate in 1Q11, according to the Bureau of Economic Analysis' 2nd estimate (same as the advance estimate). A decrease in government spending subtracted 1.1 percentage points from GDP growth, with a little more than half of that drag due to a drop in defense (which is often choppy from quarter to quarter) and the rest due to contraction in state and local government. Consumer spending growth slowed to a 2.2% annual rate (down from +4.0% in 4Q11). Nonfarm payrolls slowed in May, rising just 54,000 in the initial estimate, held back by a 30,000 decrease in state and local government. Private-sector jobs rose by 83,000, after averaging +244,000 per month over the three previous months.



In 2010, the level of job losses trended relatively low (a cynic would say that they simply ran out of people to fire). The main problem in the labor market was a lack of new hiring. Corporate profits had improved, but while increased profits are supportive of business fixed investment, they don't necessarily lead to new hiring. In fact, one of the reasons that profits were up is that firms had held the line on labor expenses, doing more with fewer people. We normally look to small to medium-sized firms to account for much of the job creation in an expansion. Data suggest that such new hiring began to pick up late last year. Small firms have been reluctant to expand, largely because they haven't seen a significant increase in demand for the goods and services they produce. However, tight credit has also been a constraint. Bank credit for business borrowers is still relatively tight, but has gotten easier.



Higher gasoline prices reduced real wage income growth in recent months. Better job growth and a reduction in payroll taxes added to disposable income this year. However, higher prices of food and gasoline prices sapped consumer purchasing power. High gasoline prices may also have been a factor in the apparent slowing in the labor market in May. The impact of higher gasoline prices arrives with a lag and falls unevenly across the income scale. Upper income households are generally doing well (the top 20% of income earners account for about half of personal income and about half of consumer spending). However, middle class households are struggling, as evidenced by recent signs of softness in discretionary spending. Gasoline prices have been edging down in recent weeks, but to date, the decrease may not provide much relief.

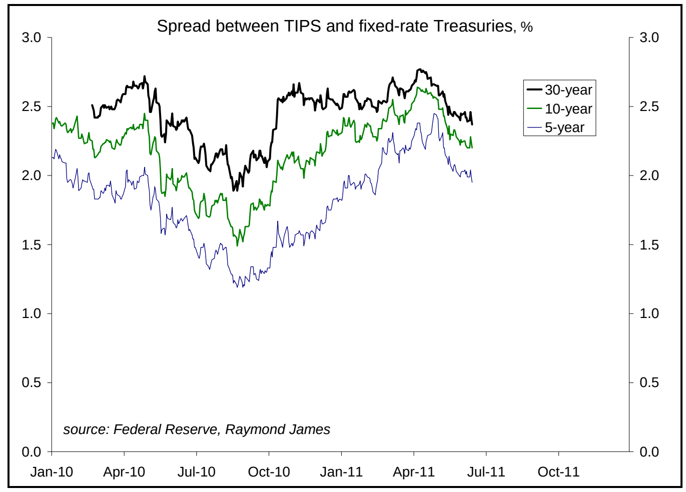


There are other headwinds besides gasoline and the fiscal contraction in state and local government. Home prices have continued to trend lower, leaving many mortgage holders underwater, owing more than the home is worth. Most of these borrowers will continue to make mortgage payments, hoping that home prices will eventually recover. However, some will face difficulties (due to the loss of a job, divorce, etc.) and perhaps walk away. Following signs of stronger economic growth late last year and improved job growth this year, the spring housing season has been a major disappointment. Residential construction activity is bouncing around the bottom at historically low levels. Moreover, there appears to be little chance that home sales will increase significantly anytime soon.

So what's the good news? Oil prices may continue to decline. We could get some resolution on the Libyan situation and we may see somewhat slower demand growth from China and other countries. There is a speculative element in oil, which was partly wrung out last month. Japan's disaster led to supply-chain disruptions in autos. We should see a rebound in auto output in 3Q11. Credit remains readily available to large firms (which can borrow in the corporate bond market or from the major banks). Bank lending to small and medium-sized firms will be a key factor in the second half economic outlook. Most likely, bank lending to small firms will continue to expand and these smaller firms will continue to hire. However, there is considerable uncertainty as to how things will unfold.

Lawmakers have made progress on negotiations to raise the debt ceiling, but are still relatively far apart. At some point, the two sides will agree to whatever they can and move on. Ultimately, the debt ceiling will be raised because it *must* be raised. A default would be catastrophic for the U.S. financial system, and the leaders in Washington understand this. At issue in current negotiations is how much of a down payment we'll see on spending reductions. Cutting too much spending too soon would risk damaging the economic recovery.

The federal fiscal stimulus is ramping down, and will act as a drag on GDP growth in 2012. We're already seeing fiscal contraction in state and local governments, which directly shaved 0.35 percentage points from GDP growth in the last two quarters (more than 0.50 percentage point if you account for a multiplier effect). Austerity makes sense for the long term, but it's bad policy in a fragile recovery. There are a number of things the government could do to support the economy and add jobs (including more aid to the states and infrastructure spending), but little appears to be politically feasible.



Will the recent slowing in growth lead to another round of asset purchases by the Fed? There's little chance of that. This is not August 2010, when the Fed was missing on both sides of its dual mandate. Core inflation figures have been trending at the upper end of the Fed's comfort level more recently. Much weaker growth and a renewed threat of deflation could prompt another round of asset purchases, but that's unlikely.

GDP growth is likely to improve in the second half of the year, but the level of uncertainty in the outlook is high.

	2Q10	3Q10	4Q10	1Q11	**2Q11**	**3Q11**	**4Q11**	**1Q12**	**2Q12**	**3Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	1.7	2.6	3.1	1.8	**2.0**	**2.1**	**2.9**	**2.8**	**3.1**	**3.4**	2.9	**2.3**	**2.9**
consumer durables	*0.5*	*0.5*	*1.5*	*0.8*	***-0.1***	***0.4***	***0.4***	***0.2***	***0.2***	***0.4***	*0.5*	***0.6***	***0.3***
nondurables & services	*1.1*	*1.1*	*1.4*	*0.9*	***1.2***	***1.6***	***1.7***	***1.6***	***1.7***	***1.8***	*0.7*	***1.2***	***1.6***
bus. fixed investment	*1.5*	*0.9*	*0.7*	*0.3*	***0.4***	***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***	***-0.3***	***-0.3***	***-0.2***	***0.0***	***0.1***	*0.2*	***-0.2***	***-0.1***
Domestic Final Sales	4.3	2.6	3.2	0.7	**1.8**	**2.6**	**2.9**	**2.6**	**3.0**	**3.4**	1.9	**2.3**	**2.8**
exports	*1.1*	*0.8*	*1.1*	*1.2*	***0.8***	***0.8***	***0.9***	***0.9***	***0.9***	***0.9***	*1.3*	***1.0***	***0.9***
imports	*-4.6*	*-2.5*	*2.2*	*-1.2*	***-0.2***	***-1.2***	***-0.8***	***-0.7***	***-0.8***	***-0.9***	*-1.8*	***-0.8***	***-0.8***
Final Sales	0.9	0.9	6.7	0.6	**2.4**	**2.3**	**2.9**	**2.8**	**3.1**	**3.4**	2.9	**2.4**	**2.8**
ch. in bus. inventories	*0.8*	*1.6*	*-3.4*	*1.2*	***-0.4***	***-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	**9.0**	**8.8**	**8.7**	**8.5**	**8.3**	**8.1**	9.6	**8.9**	**8.2**
NF Payrolls, monthly, th.	181	-46	139	166	**125**	**160**	**175**	**170**	**180**	**195**	78	**156**	**184**
Cons. Price Index (3 mo)	-1.4	2.9	3.3	6.1	**2.7**	**1.3**	**1.7**	**1.7**	**1.8**	**1.8**	1.5	**3.0**	**1.8**
excl. food & energy	1.2	0.8	0.8	2.0	**2.3**	**1.2**	**1.3**	**1.4**	**1.5**	**1.6**	0.8	**1.7**	**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	1.4	**1.9**	**1.4**	**1.3**	**1.5**	**1.5**	**1.6**	1.3	**1.2**	**1.5**
Fed Funds Rate, %	0.19	0.19	0.19	0.16	**0.10**	**0.17**	**0.22**	**0.28**	**0.45**	**0.78**	0.18	**0.16**	**0.64**
3-month T-Bill, (bond-eq.)	0.1	0.2	0.1	0.1	**0.0**	**0.1**	**0.2**	**0.4**	**0.6**	**0.9**	0.1	**0.1**	**0.8**
2-year Treasury Note	0.9	0.5	0.5	0.7	**0.6**	**0.9**	**1.3**	**1.6**	**1.9**	**2.1**	0.7	**0.9**	**1.9**
10-year Treasury Note	3.5	2.8	2.9	3.5	**3.2**	**3.5**	**3.7**	**3.7**	**3.9**	**4.0**	3.2	**3.4**	**3.9**

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