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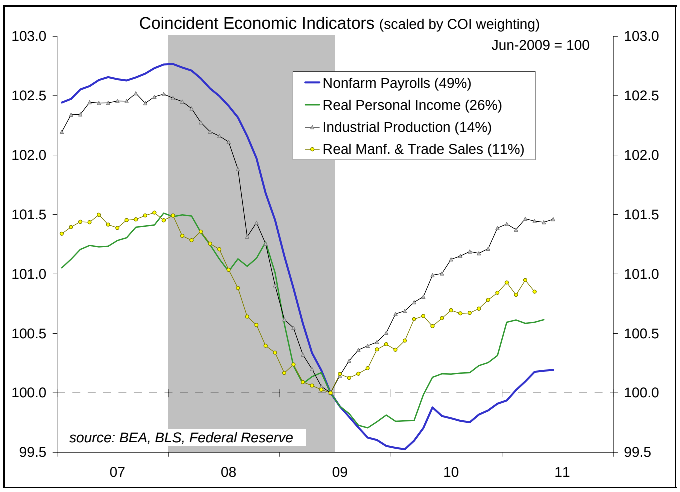
Monthly Economic Outlook

Slower Growth, More Uncertainty

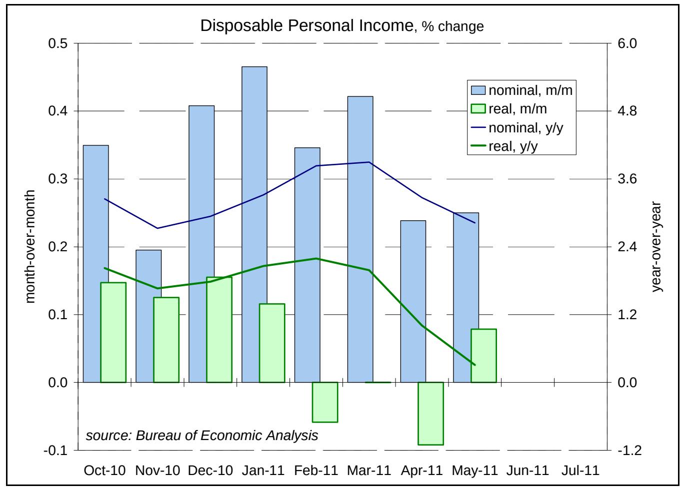
- *Recent data reports have remained consistent with a subpar rate of growth in the near term. Growth is still expected to pick up in 2H11, but the risks are tilted to the downside.*
- *Difficulties in raising the debt ceiling have generated some anxieties for investors, but a completed budget deal would likely be taken well by the financial markets.*
- *Federal Reserve policy is expected to remain on hold. Fiscal policy will become more contractionary.*

Real GDP growth appears to have risen at an annual rate of around 1.5% in 2Q11. However, we still don't have a complete picture for the quarter, and changes in inventories and foreign trade can swing quarterly growth figures around significantly. In addition, the government will include benchmark revisions with the advance GDP estimate (due July 29). Income and spending data through May showed inflation-adjusted consumer spending (70% of GDP) at less than a 1% annual rate (although these figures are subject to revision).

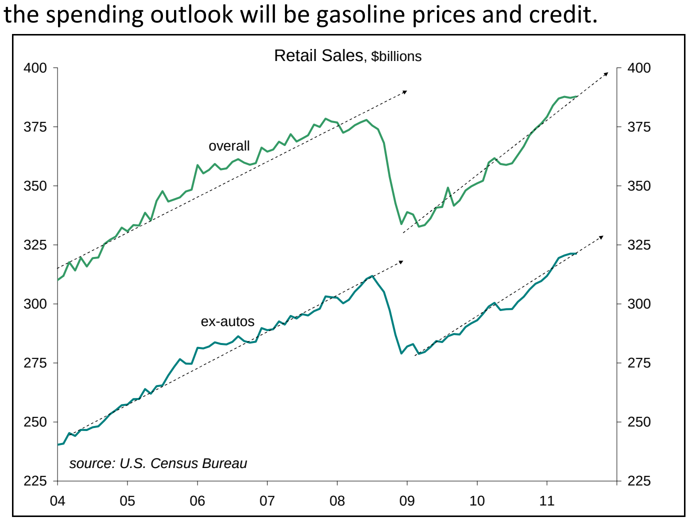


Coincident economic indicators have softened in recent months, consistent with a slower rate of economic growth, but not a contraction. Leading economic indicators, including the slope of the yield curve and money supply growth, suggest that growth is likely to remain positive in the near term. Private-sector job growth was strong in the spring (payrolls averaged a 240,000 monthly gain for February, March, and April – we need about 130,000 per month to absorb the growth in the working-age population), but slowed in May and June (averaging just 65,000). The recent slowing in jobs may partly be explained by the weather, which likely shifted seasonal gains into the early spring. However, high gasoline prices may have dampened business confidence and limited new hiring. State and local government continues to shed jobs at a rapid pace (averaging a 27,500 monthly drop in the first half of the year).

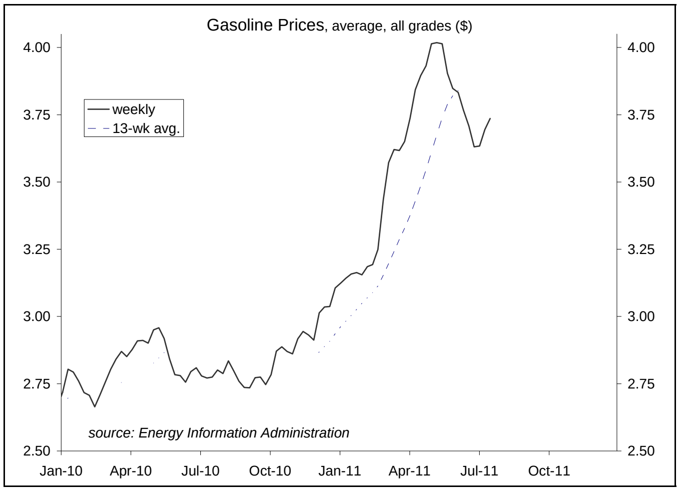
Job and wage growth, along with this year's cut in payroll taxes, boosted disposable income by 1.7% in the first five months of 2011. Aggregate wage and salary income for private-sector industries rose 3.6% in the 12 months ending in May (government wage and salary income was down 0.7% y/y, partly reflecting the added income from last year's census workers). However, higher gasoline prices have washed away the added purchasing power. Real disposable income was essentially unchanged from December to May, providing little support for consumer spending growth.



Retail sales were sluggish in May and June, but this softness followed relatively strong gains in the first quarter. Consumers appear to have become more cautious recently and have limited their discretionary spending. Households have continued to pay down mortgage debt, but consumer credit has begun to pick up (and no, that's not a bad thing). Home prices have continued to decline, limiting any wealth effect on consumer spending growth. Looking ahead, the key factors in the spending outlook will be gasoline prices and credit.



Gasoline prices have fallen from their peak in early May, but the level has remained relatively high and has edged up in the last few weeks. The 13-week average, which is just past its peak, provides a good measure of the impact of higher gasoline prices on the consumer. By this measure, one shouldn't expect to see much relief for the consumer in the near term.



Corporate profits have generally remained strong, providing support for business fixed investment. However, the economy continues to face a number of headwinds that are expected to limit the pace of growth in the remainder of the year. These headwinds include lingering problems in the housing sector, contractionary policy in state and local government, and a fading federal fiscal stimulus. Delays in raising the federal debt ceiling have generated some anxiety for investors. However, there still appears to be a great deal of confidence that a deal will be struck. That's because the consequence of a debt default would be catastrophic to the economy and to the financial markets – so it's difficult to imagine that lawmakers won't do the right thing in the end.

The credit rating agencies have threatened to downgrade the credit rating of U.S. debt, due to concerns about a possible default and the long-term debt outlook. Lawmakers do have to address the long-term budget situation, but this is a separate issue from the debt ceiling. Holding the credit quality of the U.S. government hostage is poor tactics – and always has been.

The minutes of the June 21-22 Federal Open Market Committee, as well as Chairman Bernanke's monetary policy testimony, suggest a balanced policy outlook. The Fed could do another round of asset purchases (what most people would call "QE3") if conditions warrant. The Fed could also tighten policy sooner rather than later if appropriate. However, the bar for QE3 is very high (we would need to see signs of an economic contraction and a renewed threat of deflation) and Fed officials do not appear likely to start raising interest rates anytime soon.

Estimates of GDP growth have come down over the last several weeks and the level of uncertainty in the outlook has risen, but growth is expected to remain positive. One continuing worry is the possibility of a policy mistake. Bernanke is an expert on the Great Depression – so the Federal Reserve is unlikely to raise interest rates too soon. However, fiscal policy in state and local government is already contractionary, likely shaving more than half a percentage point from GDP growth in the near term, and the federal fiscal stimulus is ramping down, acting as a moderate drag on GDP growth. A debt deal that cuts spending too soon would dampen the pace of the recovery. An agreement that includes larger spending cuts later on might help business sentiment in the near term, but the main economic problem is clearly a lack of demand – not a lack of investment. The effects of Japan's earthquake and tsunami should have a short-term impact on inventories and production in the U.S. Lower gasoline prices would help support consumer spending growth, but they've stopped falling. Bank credit has begun to loosen up in recent months. It's critical that that trend continues.

	2Q10	3Q10	4Q10	1Q11	**2Q11**	**3Q11**	**4Q11**	**1Q12**	**2Q12**	**3Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	1.7	2.6	3.1	1.9	**1.5**	**2.5**	**2.9**	**2.8**	**3.1**	**3.4**	2.9	**2.3**	**2.9**
consumer durables	*0.5*	*0.5*	*1.5*	*0.7*	***-0.3***	***0.4***	***0.4***	***0.3***	***0.2***	***0.4***	*0.5*	***0.6***	***0.3***
nondurables & services	*1.1*	*1.1*	*1.4*	*0.8*	***0.8***	***1.5***	***1.7***	***1.6***	***1.7***	***1.8***	*0.7*	***1.1***	***1.6***
bus. fixed investment	*1.5*	*0.9*	*0.7*	*0.2*	***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*	*-1.2*	***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	0.5	**1.2**	**2.4**	**2.9**	**2.6**	**3.0**	**3.4**	1.9	**2.0**	**2.7**
exports	*1.1*	*0.8*	*1.1*	*1.0*	***1.0***	***0.8***	***0.9***	***0.9***	***0.9***	***0.9***	*1.3*	***0.9***	***0.9***
imports	*-4.6*	*-2.5*	*2.2*	*-0.8*	***0.2***	***-1.0***	***-0.8***	***-0.7***	***-0.8***	***-0.9***	*-1.8*	***-0.6***	***-0.8***
Final Sales	0.9	0.9	6.7	0.6	**2.3**	**2.3**	**2.9**	**2.8**	**3.1**	**3.4**	2.9	**2.2**	**2.9**
ch. in bus. inventories	*0.8*	*1.6*	*-3.4*	*1.3*	***-0.8***	***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	9.1	**8.8**	**8.7**	**8.5**	**8.3**	**8.1**	9.6	**8.9**	**8.2**
NF Payrolls, monthly, th.	181	-46	139	166	87	**140**	**160**	**170**	**180**	**195**	78	**138**	**184**
Cons. Price Index (3 mo)	-1.4	2.9	3.3	6.1	**2.0**	**1.2**	**1.7**	**1.7**	**1.8**	**1.8**	1.5	**2.8**	**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	3.9	**3.6**	**1.2**	**1.5**	**1.6**	**1.7**	**1.7**	1.7	**2.3**	**1.7**
excl. food & energy	1.0	0.5	0.4	1.6	**2.2**	**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	0.09	**0.17**	**0.22**	**0.25**	**0.32**	**0.58**	0.18	**0.16**	**0.51**
3-month T-Bill, (bond-eq.)	0.1	0.2	0.1	0.1	0.0	**0.1**	**0.2**	**0.3**	**0.4**	**0.6**	0.1	**0.1**	**0.6**
2-year Treasury Note	0.9	0.5	0.5	0.7	0.6	**0.5**	**0.8**	**1.1**	**1.6**	**1.8**	0.7	**0.6**	**1.6**
10-year Treasury Note	3.5	2.8	2.9	3.5	3.2	**3.1**	**3.3**	**3.5**	**3.7**	**3.9**	3.2	**3.3**	**3.8**

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