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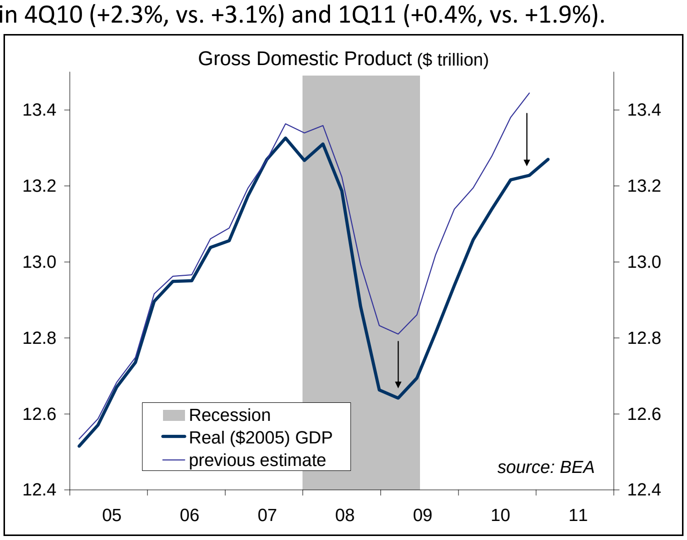
Monthly Economic Outlook

Fear And Uncertainty

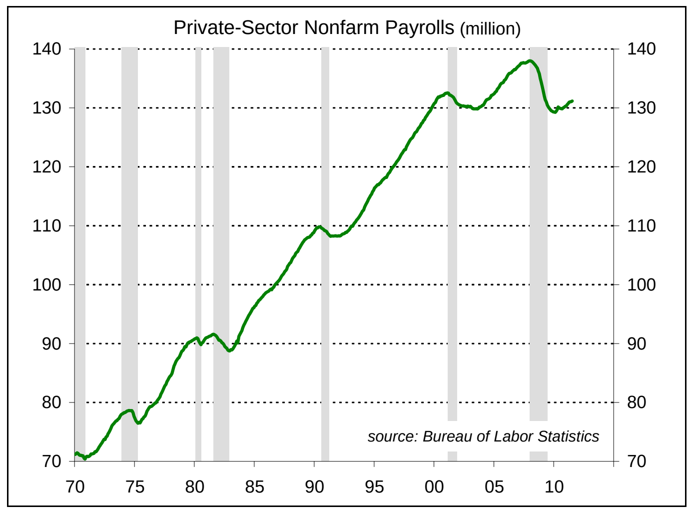
- *With the debt ceiling nonsense behind us, investors have focused on worries that the U.S. economy may slide back into recession and on concerns that Europe's sovereign debt crisis could evolve into an international banking crisis.*
- *Recent data reports have suggested a subpar rate of economic growth in the near term, not a recession. Risks to the growth outlook are tilted to the downside and gasoline prices will be a major wildcard in the second half of the year.*
- *Policy prescriptions remain limited. The Fed is unlikely to undertake another round of asset purchases (QE3) anytime soon. Fiscal policy has been tightening, but there are likely to be some efforts to provide support into 2012.*

Real GDP growth rose at a 1.3% annual rate in the government's advance estimate for 2Q11. The second quarter growth figure will be revised a couple of times, but the story is unlikely to change much. Consumer spending slowed to a crawl in 2Q11, as higher food and energy prices offset gains in disposable income. Business fixed investment rose at a moderate pace. Defense spending rebounded from the first quarter's dip, but other government spending subtracted 0.6 percentage point from overall growth. Japan's disaster had an impact on U.S. growth. Excluding motor vehicle production, real GDP would have risen at a 2.2% pace in 2Q11 (advance estimate). Annual benchmark revisions showed a sharper decline in GDP during the recession and slower rates of growth in 4Q10 (+2.3%, vs. +3.1%) and 1Q11 (+0.4%, vs. +1.9%).



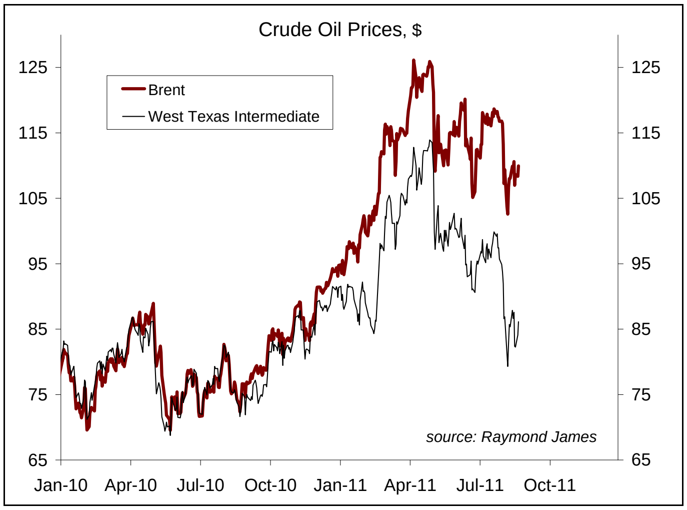
The labor market continued to improve in July. Nonfarm payrolls rose by 117,000 in the initial estimate (note: we need about 130,000 per month just to absorb the growth of the working-age population). Private-sector payrolls fared better, rising by 154,000 – a three-month average of 111,000 (vs. a +240,000 average for April, May, and June).

The unemployment rate edged down to 9.1% in July, vs. 9.2% in June and 9.5% a year earlier. However, the decrease was due largely to reduced labor force participation. To be officially counted as "unemployed," one has to be actively looking for a job (which is the same criterion for receiving unemployment insurance benefits). Many individuals will give up looking for a job once their unemployment insurance benefits run out (and even with the extension of unemployment insurance benefits, individuals remain limited to 99 weeks). Hence, the unemployment rate does not give an accurate picture. The employment-population ratio, a better measure of labor force utilization, indicates a somewhat weakening trend over the last several months. Job destruction has remained low, but appears to be picking up a bit. The debt ceiling debacle likely reduced the rate of new hiring in August.



The broad range of data released over the last several weeks continue to indicate that the economy is recovering, albeit gradually. There are no clear indications that the economy has entered a new recession. Models of recession odds are of limited use, since (until the recent recession) we've had only two minor recessions in recent decades. Moreover, the economy and financial systems are a lot different than 30 years ago. With those restrictions in mind, most of these models, as well as subjective judgment, suggest that the odds of entering a recession within the next 12 months may be 30% to 35% – not likely, but too high for comfort. The economy continues to face a number of headwinds, including lingering problems in the housing sector, contractions in state and local government, and a fading federal fiscal stimulus. The recovery is fragile and remains susceptible to negative shocks that might come along. Risks to the growth outlook are tilted to the downside. There does seem to be enough positive momentum to carry us through, but a lot depends on gasoline prices, the prospects for supportive policies, and developments abroad.

Crude oil prices have fallen from the peak in early April. However, Brent remains considerably higher than West Texas Intermediate (the spread between the two is roughly $24 per barrel, whereas the two have trended close together historically). Brent is the relevant driver of gasoline prices. A resolution to the situation in Libya, which may be at hand, could reduce the spread between Brent and WTI. A sharper decline in gasoline prices (say to below $3 per gallon) would provide an important boost for consumer spending growth.



Higher prices of food and energy lifted headline inflation in the first half of the year, but these should partially unwind in the second half of the year. Core inflation, which trended very low in 2010, picked up in the first half of the year. Commodity price pressures have generally moderated, but many firms are likely to pass along higher costs to the consumer. Apparel prices, which have risen mildly over the last several years, rose significantly in the last three months. Owner's equivalent rent, which accounts for about a fourth of the CPI and a third of the core CPI, rose 0.3% in July (vs. +0.3% for all of 2010).

There are no signs that inflation is feeding through to higher wages, which is the major difference between the current environment and the inflation shocks of the 1970s and early 1980s. However, the outlook is currently much different from a year ago, when inflation and inflation expectations were trending lower. That means that the Fed is less likely to undertake another round of asset purchases anytime soon. The Fed has a few other tools to support growth, including giving an explicit time frame for which short-term interest rates will remain exceptionally low (at the August 9 policy meeting the Federal Open Market Committee said conditions were likely to warrant low rates through the middle of 2013). The Fed could also lower the interest rate it pays on bank reserves (currently 0.25%) or lengthen the maturity of its portfolio. However, these efforts aren't going to provide a lot of support for economic growth in the near term.

Fiscal policy has already been contracting in state and local government. Federal fiscal policy has also turned negative. State and local government is shedding about 30,000 jobs per month (when it would normally be adding 25,000) and subtracted 0.4 percentage points from GDP growth in each of the last two quarters (when it would normally be adding about 0.2 percentage point). The federal fiscal stimulus is ramping down and will act as an increased drag on GDP growth in 2012. We're likely to see a number of policy proposals to support growth, such as extending this year's cut in payroll taxes. However, given, the sharp differences between the two parties and the misguided focus on near-term deficit reduction, the prospect for additional economic support aren't very strong.

Europe's sovereign debt crisis has moved to Spain and Italy. The ECB and European governments have been flat-footed and slow to respond, but should move to prevent a more significant crisis. There is some concern that banking problems in Europe could spread to the U.S. Fear and uncertainty are likely to stay with us for a while.

	3Q10	4Q10	1Q11	2Q11	**3Q11**	**4Q11**	**1Q12**	**2Q12**	**3Q12**	**4Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	2.5	2.3	0.4	1.3	**2.1**	**2.0**	**2.0**	**2.4**	**2.9**	**2.9**	3.0	**1.7**	**2.2**
consumer durables	*0.6*	*1.2*	*0.9*	*-0.4*	***0.5***	***0.3***	***0.3***	***0.3***	***0.4***	***0.4***	*0.5*	***0.6***	***0.3***
nondurables & services	*1.2*	*1.3*	*0.6*	*0.4*	***1.1***	***1.3***	***1.2***	***1.4***	***1.6***	***1.6***	*0.9*	***0.9***	***1.3***
bus. fixed investment	*1.0*	*0.8*	*0.2*	*0.6*	***0.8***	***0.6***	***0.7***	***0.8***	***0.8***	***0.8***	*0.4*	***0.7***	***0.7***
residential investment	*-0.8*	*0.1*	*-0.1*	*0.1*	***0.2***	***0.2***	***0.1***	***0.2***	***0.4***	***0.4***	*-0.1*	***0.0***	***0.2***
government	*0.2*	*-0.6*	*-1.2*	*-0.2*	***-0.5***	***-0.5***	***-0.5***	***-0.4***	***-0.3***	***-0.3***	*0.1*	***-0.5***	***-0.4***
Domestic Final Sales	2.3	2.7	0.4	0.5	**2.0**	**1.9**	**1.8**	**2.3**	**2.8**	**2.9**	1.9	**1.7**	**2.1**
exports	*1.2*	*1.0*	*1.0*	*0.8*	***0.6***	***0.7***	***0.7***	***0.8***	***0.8***	***0.8***	*1.3*	***0.9***	***0.7***
imports	*-1.9*	*0.4*	*-1.4*	*-0.2*	***-0.7***	***-0.7***	***-0.6***	***-0.7***	***-0.8***	***-0.8***	*-1.8*	***-0.9***	***-0.7***
Final Sales	1.7	4.2	0.0	1.1	**1.9**	**1.9**	**2.0**	**2.3**	**2.8**	**2.9**	2.8	**1.7**	**2.0**
ch. in bus. inventories	*0.9*	*-1.8*	*0.3*	*0.2*	***0.2***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	*1.6*	***0.0***	***0.1***
Unemployment, %	9.6	9.6	8.9	9.1	**9.1**	**9.0**	**8.9**	**8.7**	**8.5**	**8.4**	9.6	**9.0**	**8.6**
NF Payrolls, monthly, th.	-46	139	166	87	**120**	**140**	**145**	**150**	**165**	**170**	78	**128**	**158**
Cons. Price Index (3 mo)	2.9	3.3	6.1	1.5	**3.7**	**1.8**	**1.9**	**1.9**	**2.0**	**2.1**	1.4	**3.3**	**2.0**
excl. food & energy	0.8	0.8	2.0	2.9	**2.3**	**2.1**	**2.1**	**2.1**	**2.0**	**2.0**	0.7	**2.3**	**2.0**
PCE Price Index (q/q)	1.0	1.9	3.9	3.1	**1.5**	**1.6**	**1.8**	**1.8**	**1.9**	**2.0**	1.8	**2.4**	**1.8**
excl. food & energy	0.8	0.7	1.6	2.1	**1.8**	**1.7**	**1.9**	**1.9**	**1.9**	**1.9**	1.4	**1.4**	**1.9**
Fed Funds Rate, %	0.19	0.19	0.16	0.09	**0.09**	**0.15**	**0.17**	**0.18**	**0.20**	**0.22**	0.18	**0.12**	**0.19**
3-month T-Bill, (bond-eq.)	0.2	0.1	0.1	0.0	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	0.1	**0.1**	**0.1**
2-year Treasury Note	0.5	0.5	0.7	0.6	**0.3**	**0.4**	**0.6**	**0.9**	**1.0**	**1.1**	0.7	**0.5**	**0.9**
10-year Treasury Note	2.8	2.9	3.5	3.2	**2.5**	**2.6**	**3.0**	**3.3**	**3.5**	**3.7**	3.2	**2.9**	**3.3**

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