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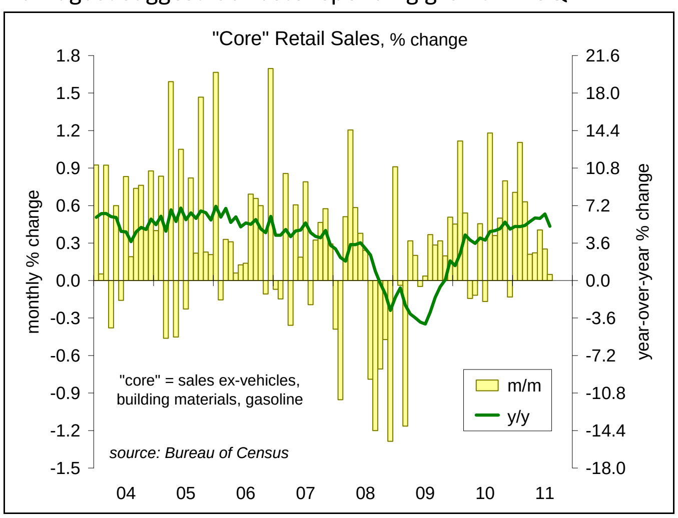
**September 14, 2011**

**Monthly Economic Outlook**

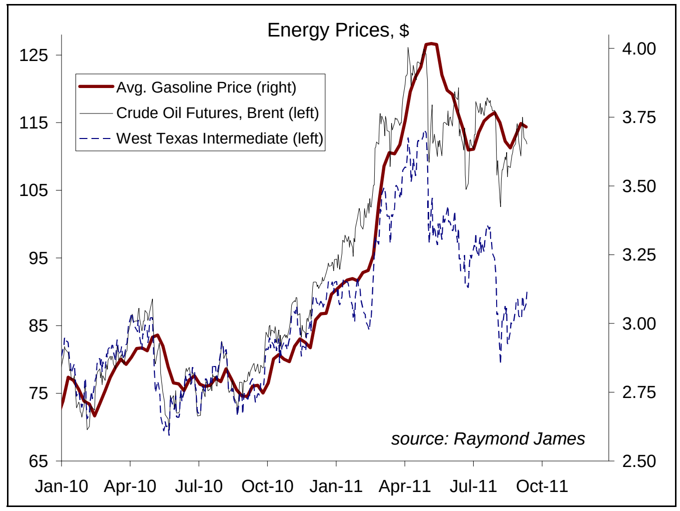
## More Strains

- *Recent data continue to suggest a subpar rate of economic growth in the near term (positive, but below potential). Risks to the growth outlook remain weighted to the downside.*
- *The 2012 growth outlook depends on monetary and fiscal policy. Fiscal stimulus (the jobs package) would help prevent a significant fiscal drag next year. The balance of Fed comments suggests more monetary accommodation is on its way.*
- *Worries about Europe's debt crisis remain an important factor for U.S. investors. The next few weeks will be critical.*

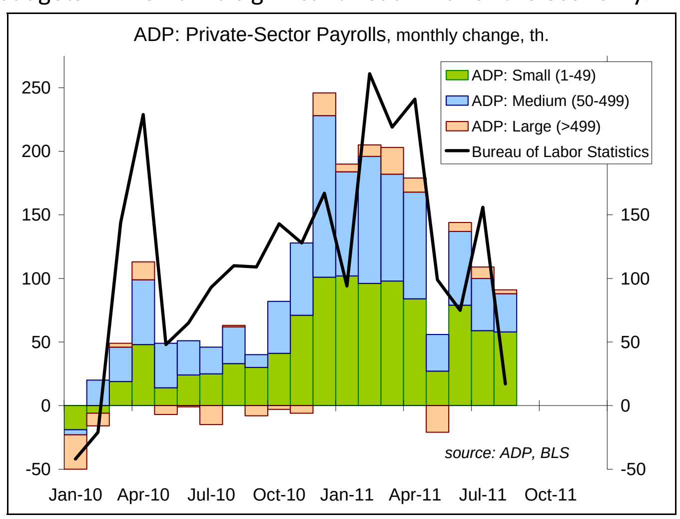
Real GDP growth rose at a 1.0% annual rate in the government's 2nd estimate for 2Q11 (revised from +1.3% in the advance estimate). The story didn't change much. The pace of consumer spending growth was meager (a 0.4% annual rate, vs. +2.1% in 1Q11 and +3.6% in 4Q10). Business fixed investment was moderate. A rebound in defense spending (which had dipped in 1Q11) added to the GDP growth total, but not enough to offset declines elsewhere in government (which subtracted 0.7 percentage points). Retail sales figures for July and August suggest lackluster spending growth in 3Q11.




The 2Q11 slowdown in consumer spending growth was due to two factors: high gasoline prices, and Japan's disaster (which reduced motor vehicle sales). Disposable income rose 2.5% from December to July, but just 0.5% adjusting for inflation. Gasoline rose to over $4 per gallon in early May, a serious strain for household budgets. West Texas Intermediate has fallen to a level normally consistent with retail gasoline prices of a little over $3 per gallon. However, Brent and WTI have diverged this year and gasoline prices are driven more off of Brent (since most refineries are located on the Gulf Coast). Hence, there has been little relief for the consumer. Moreover, reductions in gasoline prices typically do not benefit consumer spending as much as comparable increases hurt.

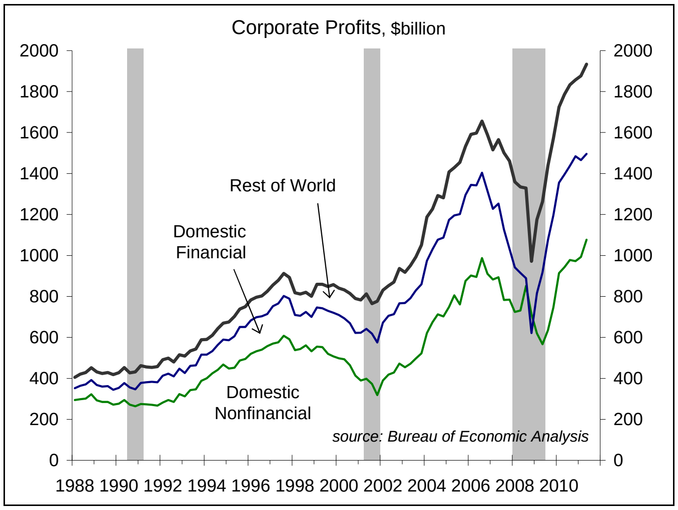



Nonfarm payrolls rose by 17,000 in August, but would have risen by 62,000 if not for the strike at Verizon. Accounting for the strike effect, private-sector payrolls averaged a 98,000 monthly gain for May through August, vs. a 204,000 average in the first four months of the year. State and local government payrolls have averaged a 40,000 monthly decline over the last three months – down 640,000 since December 2008 (in contrast, federal government payrolls have risen 41,000 over that same time). Austerity in state and local government budgets will remain a significant headwind for the economy.




Small and medium-size firms typically account for most of the job creation during an economic expansion. These firms remain credit constrained and have generally not seen an increase in the demand for the goods and services they produce (which is the biggest factor in hiring). ADP payroll estimates suggested a significant increase in hiring earlier this year, but the pace slowed in the last few months. High gasoline prices and debt ceiling uncertainty likely had some impact.

A downturn in domestic nonfinancial corporate profits has often preceded recessions. In contrast, corporate profits hit a record high in the second quarter. Cash positions are strong and debt service burdens are low (thanks, in part, to low borrowing costs), which limits the strains of a short-term slowdown in overall growth. Corporate profits do not lead to new hiring, but are a key driver of capital spending. Business investment in equipment and software has continued to improve, making up nearly all of the ground lost during the recession. Investment in business structures, on the other hand, remains far below pre-recession levels.




The two-tier recovery is likely to continue. Corporations are generally doing well. Profits can continue to improve in a period of subpar economic growth. Small businesses, which usually lead in recoveries, are constrained. Upper-income households are doing okay. Middle class households are struggling to keep up, reflecting a soft job market and the impact of higher food and energy prices. Nationally, more than one out of five residential mortgages is underwater.

The economy will continue to face headwinds in the next few quarters. The contraction in state and local government remains a significant drag on the overall economy. Food and energy prices are expected to fall back somewhat, but a lot of the economic damage (in terms of constraints on consumer spending) is likely baked in at this point. Residential housing is not expected to get much better anytime soon.

The economic outlook into 2012 depends on monetary and fiscal policy. Federal Reserve officials appear to be split on whether to add to monetary policy accommodation in the near term, but the majority view at the Fed is to do more. At the September 20-21 policy meeting, Fed officials will debate the possible costs and benefits of available tools. This meeting could result in a lengthening in the maturity of the Fed's assets or another round of asset purchases ("QE3").

As it stands now, federal fiscal policy is set to subtract at least 1.5 percentage points from GDP growth in 2012 as the federal fiscal stimulus fades. President Obama's jobs plan, if passed in its entirety, would probably add a full percentage point to growth next year. Most likely, only a portion of the package will make it through Congress.

Europe remains a serious concern for investors. The markets are likely to swing back and forth, responding to mixed news – and the next few weeks will be critical. Near term, the key questions are whether there will be more support for Greece and whether governments will move to back the big banks. Fiscal and monetary policies have gone in the wrong direction this year. The European Central Bank raised short-term interest rate twice. As in the U.S., the European countries face clear long-term budget problems. However, austerity in the short-term has weakened their recoveries, doing little to relieve financial strains. Moreover, the euro system inherently has the potential for self-fulfilling runs against individual countries. The sovereign debt crisis could turn into a banking crisis, with some repercussions for the U.S. financial system.

| | 3Q10 | 4Q10 | 1Q11 | 2Q11 | **3Q11** | **4Q11** | **1Q12** | **2Q12** | **3Q12** | **4Q12** | 2010 | **2011** | **2012** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP (↓ *contributions*) | 2.5 | 2.3 | 0.4 | 1.0 | **1.3** | **1.8** | **2.0** | **2.3** | **2.7** | **2.8** | 3.0 | **1.5** | **2.0** |
| *consumer durables* | *0.6* | *1.2* | *0.9* | *-0.4* | ***0.4*** | ***0.2*** | ***0.2*** | ***0.2*** | ***0.3*** | ***0.3*** | *0.5* | ***0.5*** | ***0.2*** |
| *nondurables & services* | *1.2* | *1.3* | *0.6* | *0.7* | ***0.7*** | ***1.1*** | ***1.2*** | ***1.4*** | ***1.6*** | ***1.6*** | *0.9* | ***0.9*** | ***1.2*** |
| *bus. fixed investment* | *1.0* | *0.8* | *0.2* | *0.9* | ***0.6*** | ***0.7*** | ***0.7*** | ***0.8*** | ***0.8*** | ***0.8*** | *0.4* | ***0.7*** | ***0.7*** |
| *residential investment* | *-0.8* | *0.1* | *-0.1* | *0.1* | ***0.1*** | ***0.1*** | ***0.0*** | ***0.1*** | ***0.2*** | ***0.2*** | *-0.1* | ***0.0*** | ***0.1*** |
| *government* | *0.2* | *-0.6* | *-1.2* | *-0.2* | ***-0.5*** | ***-0.5*** | ***-0.4*** | ***-0.4*** | ***-0.3*** | ***-0.3*** | *0.1* | ***-0.5*** | ***-0.4*** |
| Domestic Final Sales | 2.3 | 2.7 | 0.4 | 1.1 | **1.3** | **1.6** | **1.8** | **2.2** | **2.6** | **2.7** | 1.9 | **1.7** | **1.9** |
| *exports* | *1.2* | *1.0* | *1.0* | *0.4* | ***0.8*** | ***0.6*** | ***0.7*** | ***0.8*** | ***0.8*** | ***0.8*** | *1.3* | ***0.9*** | ***0.7*** |
| *imports* | *-1.9* | *0.4* | *-1.4* | *-0.3* | ***-0.4*** | ***-0.4*** | ***-0.5*** | ***-0.6*** | ***-0.7*** | ***-0.7*** | *-1.8* | ***-0.8*** | ***-0.5*** |
| Final Sales | 1.7 | 4.2 | 0.0 | 1.2 | **1.7** | **1.7** | **2.0** | **2.3** | **2.7** | **2.8** | 2.8 | **1.7** | **1.8** |
| *ch. in bus. inventories* | *0.9* | *-1.8* | *0.3* | *-0.2* | ***-0.4*** | ***0.0*** | ***0.0*** | ***0.0*** | ***0.0*** | ***0.0*** | *1.6* | ***-0.2*** | ***0.0*** |
| Unemployment, % | 9.6 | 9.6 | 8.9 | 9.1 | **9.1** | **9.0** | **8.9** | **8.8** | **8.6** | **8.5** | 9.6 | **9.0** | **8.7** |
| NF Payrolls, monthly, th. | -46 | 139 | 166 | 97 | **50** | **100** | **110** | **135** | **150** | **155** | 78 | **103** | **138** |
| Cons. Price Index (3 mo) | 2.9 | 3.3 | 6.1 | 1.5 | **3.4** | **1.8** | **1.9** | **1.9** | **2.0** | **2.1** | 1.4 | **3.2** | **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 | 3.2 | **2.0** | **1.7** | **1.8** | **1.8** | **1.9** | **2.0** | 1.8 | **2.4** | **1.9** |
| excl. food & energy | 0.8 | 0.7 | 1.6 | 2.2 | **2.1** | **1.7** | **1.9** | **1.9** | **1.9** | **1.9** | 1.4 | **1.5** | **1.9** |
| Fed Funds Rate, % | 0.19 | 0.19 | 0.16 | 0.09 | **0.09** | **0.10** | **0.12** | **0.14** | **0.20** | **0.22** | 0.18 | **0.11** | **0.17** |
| 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** | **0.3** | **0.5** | **0.8** | **1.0** | **1.1** | 0.7 | **0.5** | **0.8** |
| 10-year Treasury Note | 2.8 | 2.9 | 3.5 | 3.2 | **2.4** | **2.4** | **2.6** | **2.8** | **3.2** | **3.4** | 3.2 | **2.9** | **3.0** |



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