RAYMOND JAMES

Economic Research

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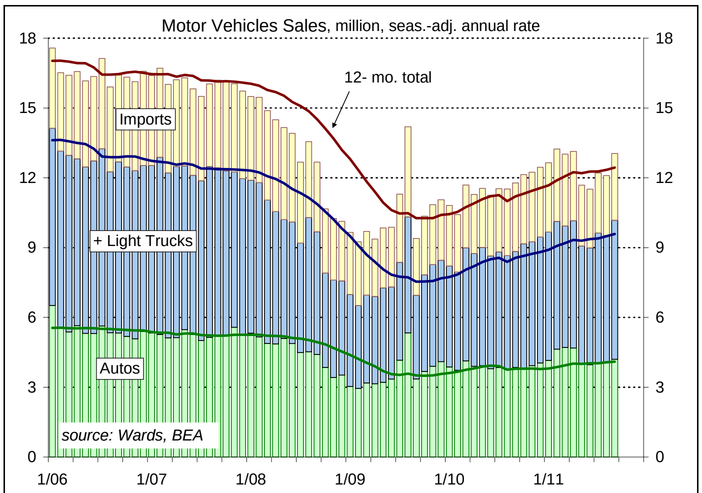
Monthly Economic Outlook

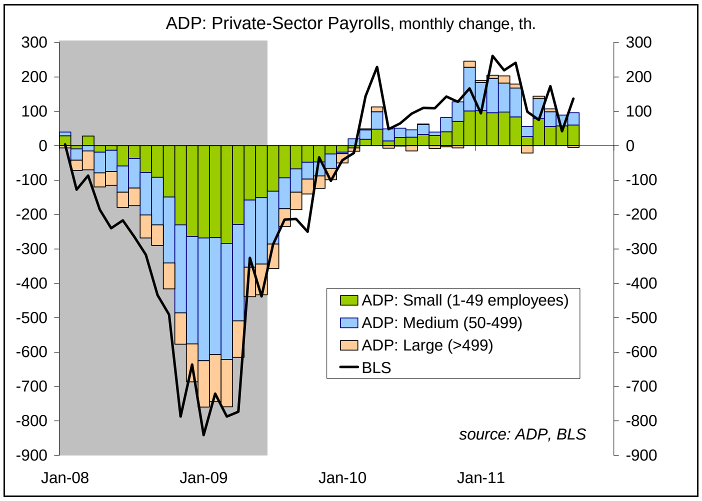
Muddling Along

- *Recent data reports continue to suggest positive, mixed, but subpar, economic growth in the near term.*
- *The Federal Reserve's maturity extension program has pushed long-term interest rates lower, which should help support the economy into early 2012. Fiscal policy is set to become a more significant drag on growth next year.*
- *European leaders have pledged to come up with a concrete plan, by the end of October, to shore up the region's banks and to help stabilize the euro-zone. If the plan is deemed sufficient, a major uncertainty for U.S. investors will be reduced.*

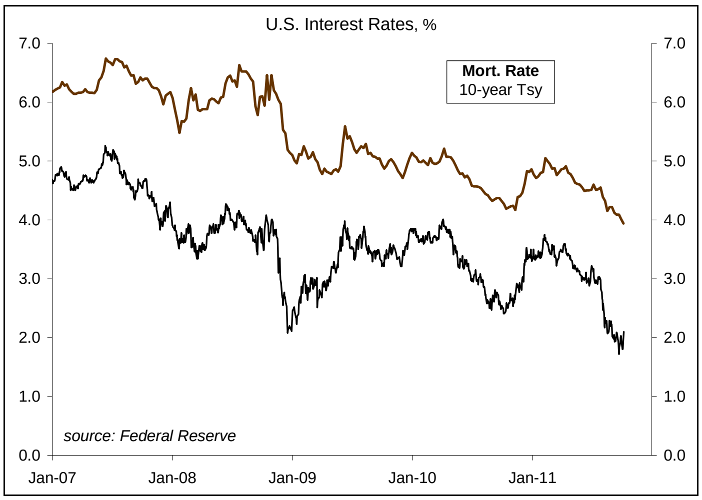
Real GDP growth rose at a 1.3% annual rate in the government's 3rd estimate for 2Q11 (revised from +1.0% in the 2nd estimate). Recent economic data releases have been consistent with a pace of GDP growth of 1% to 2% in 3Q11 (advance estimate due October 27). Results have been uneven across and within sectors. Manufacturing activity has generally improved, but orders and production have varied by industry. Consumer spending continues to advance, with some retailers faring better than others. Vehicle sales picked up last month.



Nonfarm payrolls rose more than expected in September, boosted partly by the return of 45,000 workers who were on strike in August. Private-sector payrolls have averaged a 105,000 monthly gain over the last five months, vs. +204,000 in the first four months of the year (we need about 130,000 per month to keep pace with the growth in the working-age population, and 250,000 to 300,000 per month for a few years to regain the jobs lost during the recession). State and local government payrolls fell by 33,000, down 615,000 since December 2008 (with more than a third of that decline in education). The ADP estimates show continued job gains at small and medium-sized firms, but at a slower pace than earlier in the year. Large-scale job losses are still relatively limited.

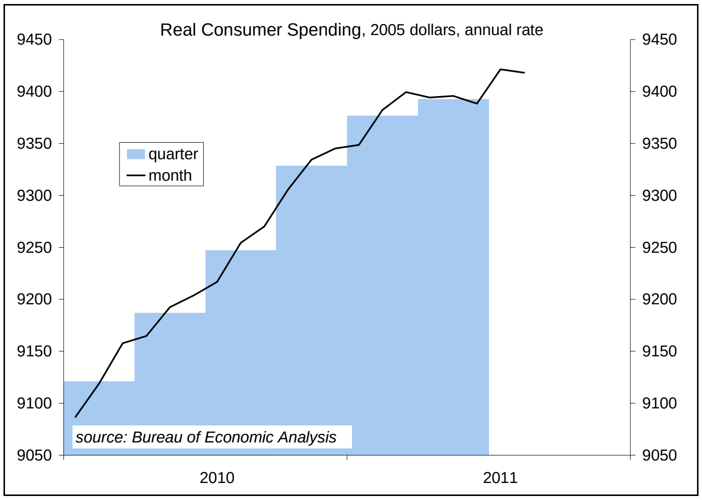


At the September 20-21 Federal Open Market Committee meeting, Fed policymakers took steps to lower long-term interest rates. In its maturity extension program ("operation twist"), the Fed will buy $400 billion in Treasuries with maturities of 6 – 30 years, by the end of June 2012, and sell an equal amount of Treasuries with maturities of 3 years or less from its asset holdings. To support the housing sector, the FOMC also voted to reinvest principal payments in its holdings of mortgage-backed securities (MBS) and agency debt into MBS. The size of the program was larger than anticipated, with a greater-than-expected shift out the curve (29% of the purchases will be in the 20-30 year maturity range).



The housing sector, at this point, can use all the help it can get. The spring selling season was a major disappointment and residential construction activity has been trending about flat. A large fraction of mortgage holders (22.5% in 2Q11, according to CoreLogic) remain upside down, owing more than the home is worth, with high portions (near 50%) in some areas.

Housing contributes to a wealth effect in consumer spending. The extraction of home equity helped fuel spending growth in the previous decade, but the household sector is currently paying down mortgage debt. There is also a stock market wealth effect on spending, but stock ownership is not as broad as home ownership, particularly among the middle class. The household sector has continued to pay down credit card debt. Bank credit to consumers has improved and bank loans to consumers are on the rise.



Higher gasoline prices restrained disposable income growth and, in turn, consumer spending growth in recent months. Gasoline prices have fallen significantly from the highs (more than $4 per gallon) of early May, which should provide some relief for the consumer. However, the positive impact of a given gasoline price decline tends to be smaller than the negative impact of a corresponding increase in gasoline prices (in other words, the impact on consumer spending is asymmetrical) and shows up with a lag. The drop in gasoline prices is likely to have a more positive impact later this year.

Fiscal policy remains a major uncertainty in the 2012 outlook. With no change in course, a fiscal tightening appears set to subtract around 2% from GDP growth next year. The president's job package, if passed in its entirety, would add roughly 2.5% to GDP, turning a 2%-of-GDP drag into a 0.5%-of-GDP addition. However, the jobs package appears to have stalled. It's an election year, so some of the elements in the package could make it through Congress. In particular, the extension of the payroll tax cut is critical for the consumer spending outlook next year (note that the president proposed an expansion, not just an extension, of the payroll tax cut for consumers, and offered reductions in the portion of payroll taxes paid by businesses). A major sticking point is how to pay for the plan. There is resistance from both parties on raising taxes and eliminating tax loopholes and subsidies.

There have been two dark clouds hanging over the stock market in the last couple of months. One has been a fear of recession. The other is Europe. Recent economic data should dispel the notion that we are currently in a recession. We continue to face some important headwinds into 2012 and the risks are predominately to the downside, but the economy is not falling off a cliff (it's more like "running in place").

We're now a year and a half into Europe's debt crisis, but tensions have risen rapidly in recent weeks. Until now, the leadership has responded with strong rhetoric and weak promises ("a plan to have a plan"), but not much action. However, German Chancellor Angela Merkel and French President Nicolas Sarkozy have said that they will have a plan, by the end of October, to shore up Europe's banks and stabilize the euro-zone. Investors expect something big – and will be disappointed if the plan merely pushes action down the road. The risks are huge. For the U.S., a banking crisis in Europe would almost certainly do less damage than our financial crisis of three years ago, but it would have a similar sort of flavor. Even with a plan, worries about Europe may linger.

	3Q10	4Q10	1Q11	2Q11	**3Q11**	**4Q11**	**1Q12**	**2Q12**	**3Q12**	**4Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	2.5	2.3	0.4	1.3	**1.3**	**1.6**	**1.9**	**2.3**	**2.5**	**2.6**	3.0	**1.6**	**1.9**
consumer durables	*0.6*	*1.2*	*0.9*	*-0.4*	***0.5***	***0.2***	***0.2***	***0.2***	***0.3***	***0.3***	*0.5*	***0.5***	***0.2***
nondurables & services	*1.2*	*1.3*	*0.6*	*0.9*	***0.9***	***1.1***	***1.2***	***1.4***	***1.6***	***1.6***	*0.9*	***1.0***	***1.2***
bus. fixed investment	*1.0*	*0.8*	*0.2*	*0.9*	***0.7***	***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***	***-0.4***	***-0.3***	*0.1*	***-0.5***	***-0.4***
Domestic Final Sales	2.3	2.7	0.4	1.3	**1.7**	**1.6**	**1.7**	**2.1**	**2.5**	**2.6**	1.9	**1.8**	**1.9**
exports	*1.2*	*1.0*	*1.0*	*0.5*	***0.7***	***0.4***	***0.5***	***0.6***	***0.6***	***0.6***	*1.3*	***0.9***	***0.5***
imports	*-1.9*	*0.4*	*-1.4*	*-0.2*	***-0.4***	***-0.4***	***-0.5***	***-0.6***	***-0.6***	***-0.6***	*-1.8*	***-0.8***	***-0.5***
Final Sales	1.7	4.2	0.0	1.6	**2.0**	**1.5**	**1.8**	**2.1**	**2.5**	**2.6**	2.8	**1.8**	**1.8**
ch. in bus. inventories	*0.9*	*-1.8*	*0.3*	*-0.3*	***-0.6***	***0.1***	***0.1***	***0.2***	***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	96	**100**	**110**	**135**	**150**	**155**	78	**115**	**138**
Cons. Price Index (3 mo)	2.9	3.3	6.1	1.5	**4.4**	**1.8**	**1.9**	**1.9**	**2.0**	**2.1**	1.4	**3.5**	**2.0**
excl. food & energy	0.8	0.8	2.0	2.9	**2.5**	**2.1**	**2.1**	**2.1**	**2.0**	**2.0**	0.7	**2.4**	**2.0**
PCE Price Index (q/q)	1.0	1.9	3.9	3.3	**2.3**	**1.9**	**1.8**	**1.8**	**1.9**	**2.0**	1.8	**2.5**	**2.0**
excl. food & energy	0.8	0.7	1.6	2.3	**2.1**	**1.8**	**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	0.08	**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	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	0.1	**0.1**	**0.0**
2-year Treasury Note	0.5	0.5	0.7	0.6	0.3	**0.1**	**0.4**	**0.6**	**0.8**	**1.0**	0.7	**0.4**	**0.7**
10-year Treasury Note	2.8	2.9	3.5	3.2	2.4	**2.1**	**2.2**	**2.3**	**2.4**	**2.5**	3.2	**2.8**	**2.3**

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