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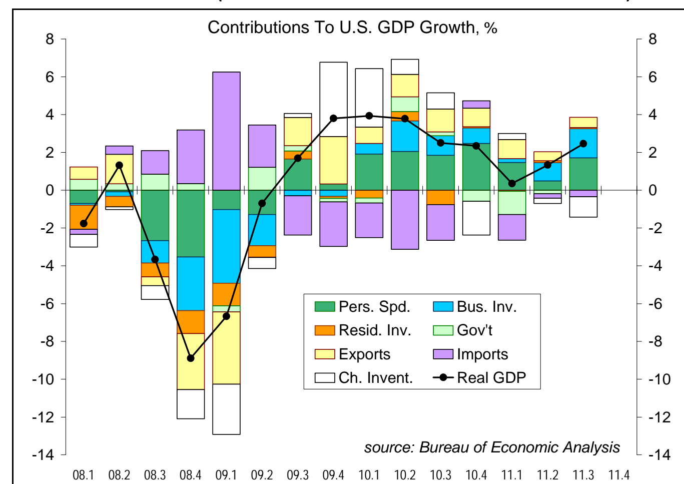
November 9, 2011

Monthly Economic Outlook

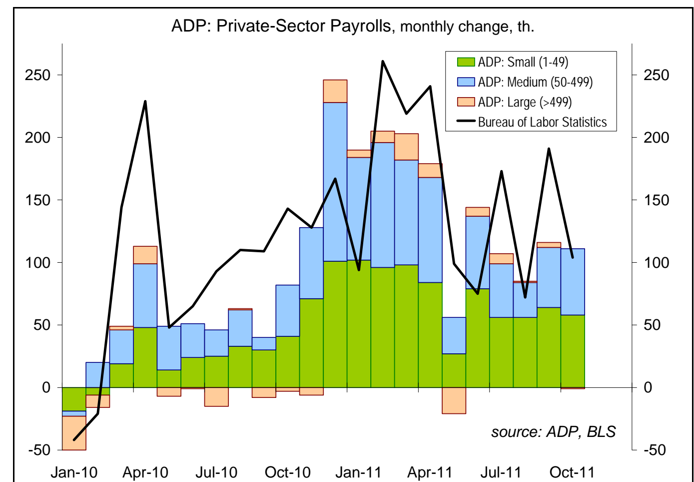
Momma Mia!

- *Recent data reports continue to suggest moderate growth in the near term. The economy continues to face a number of headwinds and will be subject to some downside risks.*
- *The Federal Reserve made no changes at the November 1-2 policy meeting, but is poised to do more if deemed necessary.*
- *Most financial market participants have focused recently on the situation in Greece. However, Italy is quickly becoming a much bigger worry, representing a major downside risk.*

Real GDP rose at a 2.5% annual rate in the advance estimate for 3Q11, up 1.6% from a year ago. Consumer spending rose at a 2.4% pace in the quarter, but that was fueled by a drop in the savings rate (inflation-adjusted disposable income fell at a 1.7% annual rate, following +0.6% in 2Q11). These figures have a tendency to get revised significantly, but taken at face value, they do not provide much encouragement. Business fixed investment, on the other hand, stormed ahead at a 16.3% annual rate, apparently fueled by strength in corporate profits. A slower pace of inventory accumulation subtracted 1.1 percentage points from overall growth, but paves the way for a modest rebuild in 4Q11 or early 2012. Real Final Sales (GDP less net exports and the change in inventories), a measure of domestic demand, rose at a 3.2% annual rate (vs. +1.3% in 2Q11 and +0.4% in 1Q11).



Nonfarm payrolls rose by 80,000 in October, while the two previous months were revised higher by a net 102,000. Payrolls have averaged a 125,000 monthly gain over the last 12 months, roughly consistent with the growth in the working-age population. Private-sector payrolls rose by 104,000 in October. State and local government payrolls fell by 22,000, down 613,000 since December 2008 (with nearly a third of that decline in education). The unemployment rate edged down to 9.0% in October, but much of the decline was teenagers and young adults, which suggests some possible issues with the seasonal adjustment. The employment-population ratio, a better measure of labor force utilization, edged up to 58.4%, little changed from 58.3% a year ago, and well below the 2007 average of 63.0%). In other words, we appear to be running in place, growing just enough to absorb the growth in the working-age population, but not enough to recover much of the ground lost during the downturn. Large-scale job losses remain limited. For some time, the main problem in the labor market has been a lackluster pace of job creation. Most of the job growth in an expansion will typically come from small, newer firms. The ADP estimates of private-sector payrolls have shown continued job gains at small and medium-sized firms in recent months, but at a slower pace than earlier in the year. The White House has proposed a number of initiatives to boost job growth, but there has been little action from Congress.



At the November 1-2 Federal Open Market Committee meeting, Fed policymakers made no changes in short-term interest rates, the asset maturity program ("operation twist"), the mortgage reinvestment program, or its communications policies, and the wording of the economic outlook was essentially the same as in the previous statement. However, in his post-meeting press conference, Chairman Bernanke indicated that the Fed was open to do more *"if appropriate."* The Fed had discussed a further round of asset purchases (most likely, centered in mortgage-backed securities to provide more support to the housing market) and the possible adoption of policy triggers (inflation, the unemployment rate). However, Fed officials had not reached any conclusions.

Treasury posted a $1.3 trillion budget deficit in FY11 (which ended in September), roughly 8.7% of GDP. Tax receipts continued to improve, up 6.5% from FY10 (but remained 10.4% below the FY07 peak). Outlays rose 4.2%.

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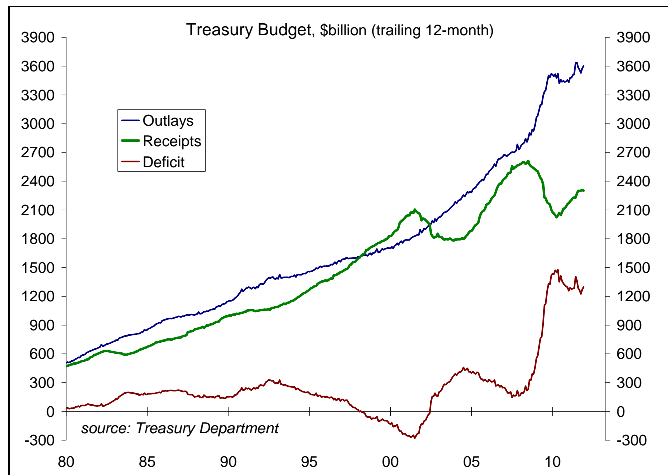
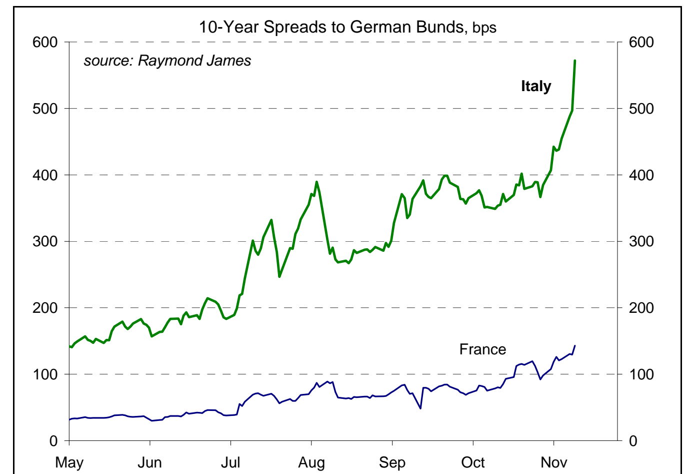
The Joint Select Committee on Deficit Reduction (aka the "super committee") is charged with issuing recommendations by November 23 to achieve at least $1.5 trillion in deficit reduction over 10 years. Those recommendations would be put to a simple up or down vote (no amendments, House blocks, or Senate filibusters) by December 23. If the super committee fails or if Congress does not approve the package, $1.2 trillion in deficit reduction would be automatically triggered, mostly in national security and other non-entitlement spending. Most Republicans have signed a pledge to never raise taxes (and most view the elimination of tax breaks as "a tax increase"). However, fear of large cuts in defense spending may give Republicans incentive to negotiate.



Some market participants are concerned that we may see another downgrade of U.S. government debt. Recall that Standard & Poor's August 5 lowering of its long-term credit rating for the U.S. was due to concerns about the political environment, not about the ability of the U.S. to repay its debt. Note also that the bond market really didn't care much. Treasury yields are a lot lower than they were in August.

Fears of recession have abated in the U.S. Recent data suggest an economy that is continuing to expand, although the pace is not especially strong. We will continue to face a number of headwinds into early 2012, including lingering problems in the housing sector and tighter fiscal policy.



In recent months, investors have been worried about the situation in Greece. However, Italy is quickly becoming a much bigger concern. Italy has exposed problems inherent in the construction of the euro zone. That is, as investors become increasingly worried about Italy's ability to repay its debt, borrowing costs rise, adding to financial strains and discouraging investors even more. Ten-year Italian bond yields have risen to a point where it is increasingly doubtful whether Italy will be able to service its debt. Europe's Financial Stability Fund is not a big enough to backstop Italy. In contrast to the U.S. Federal Reserve, the European Central Bank is not the lender of last resort in Europe. A meltdown in Italy would have serious repercussions for the big banks in Europe and the U.S. would likely suffer some financial contagion. U.S. exports would also be restrained by a European recession.

	3Q10	4Q10	1Q11	2Q11	3Q11	**4Q11**	**1Q12**	**2Q12**	**3Q12**	**4Q12**	2010	**2011**	**2012**
GDP (↓ *contributions*)	2.5	2.3	0.4	1.3	2.5	**2.0**	**2.1**	**2.4**	**2.5**	**2.6**	3.0	**1.8**	**2.2**
consumer durables	*0.6*	*1.2*	*0.9*	*-0.4*	*0.3*	***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*	*1.4*	***1.1***	***1.2***	***1.4***	***1.6***	***1.6***	*0.9*	***1.1***	***1.3***
bus. fixed investment	*1.0*	*0.8*	*0.2*	*0.9*	*1.5*	***0.7***	***0.7***	***0.8***	***0.8***	***0.8***	*0.4*	***0.8***	***0.9***
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*	*0.0*	***-0.4***	***-0.4***	***-0.4***	***-0.4***	***-0.3***	*0.1*	***-0.4***	***-0.3***
Domestic Final Sales	2.3	2.7	0.4	1.3	3.2	**1.7**	**1.7**	**2.1**	**2.5**	**2.6**	1.9	**2.0**	**2.1**
exports	*1.2*	*1.0*	*1.0*	*0.5*	*0.6*	***0.4***	***0.5***	***0.6***	***0.6***	***0.6***	*1.3*	***0.8***	***0.5***
imports	*-1.9*	*0.4*	*-1.4*	*-0.2*	*-0.3*	***-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	3.6	**1.7**	**1.8**	**2.1**	**2.5**	**2.6**	2.8	**2.0**	**2.1**
ch. in bus. inventories	*0.9*	*-1.8*	*0.3*	*-0.3*	*-1.1*	***0.3***	***0.3***	***0.3***	***0.0***	***0.0***	*1.6*	***-0.3***	***0.0***
Unemployment, %	9.6	9.6	8.9	9.1	9.1	**9.0**	**8.8**	**8.7**	**8.6**	**8.5**	9.6	**9.0**	**8.7**
NF Payrolls, monthly, th.	-46	139	166	97	130	**105**	**110**	**125**	**150**	**155**	78	**124**	**135**
Cons. Price Index (3 mo)	2.9	3.3	6.1	1.5	4.8	**1.6**	**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	2.1	**2.0**	**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	3.3	2.4	**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	**1.5**	**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	**0.08**	**0.10**	**0.12**	**0.18**	**0.20**	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	**0.3**	**0.3**	**0.5**	**0.7**	**0.9**	0.7	**0.4**	**0.6**
10-year Treasury Note	2.8	2.9	3.5	3.2	2.4	**2.1**	**2.1**	**2.2**	**2.3**	**2.4**	3.2	**2.8**	**2.3**

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