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December 8, 2011

Monthly Economic Outlook

2012 – A Conditional Outlook

- *The economic fundamentals have been mixed, but generally positive in late 2011. Growth is expected to improve over the course of 2012, but there are some important caveats.*
- *It's likely that we'll soon see extensions of unemployment insurance benefits and the 2011 payroll tax reduction. If not, the outlook for consumer spending growth will be significantly weaker in the first half of the year. The November election will be important for the markets, but there is a lot of uncertainty about fiscal policy into early 2013.*
- *Europe is a significant risk to the outlook. There's still hope that policymakers can work it out, but strains have increased and the markets are suggesting that there's not a lot of time.*

First, a recap of 2011. The year began with some degree of optimism. Payroll taxes were cut, adding significantly to the take-home pay of the typical worker. However, the positive benefit of the payroll tax reduction was largely offset by the negative impact of higher gasoline prices. Starting the year at a little over $3 per gallon, the price of gasoline rose to over $4 by early May. Consumer spending slowed down in the spring and early summer, but picked up again as gasoline prices fell. Higher gasoline prices may also have dampened small business sentiment. New hiring by small firms picked up at the start of the year, but weakened in the spring and summer. Japan's earthquake and tsunami led to some supply-chain disruptions, which had a short-term negative impact. A showdown over the debt ceiling (an unnecessary and self-inflicted crisis) generated some market concerns in July and early August. However, after the debt ceiling was raised, market participant focused on fears of recession and the crisis in Europe. The Federal Reserve embarked on a maturity extension program (Operation Twist), selling short-term Treasuries out of its portfolio and buying longer-term Treasuries. Subsequent economic data were mixed, but sent a clear signal that the U.S. economy was not contracting as some had feared. Many firms appear to have underestimated the economy's strength heading into the second half of 2011, paring inventories. Real GDP rose at a 2.0% annual rate in the government's second estimate for 3Q11, but would have been at a 3.6% pace if not for the shift in inventories. A mild inventory rebuild is expected to add to growth in late 2011 or early 2012. Financial strains in Europe increased significantly in recent months, with borrowing costs rising in Italy, Spain, and France. Shifting sentiment about Europe added to U.S. stock market volatility and contributed to a flight to safety into U.S. Treasuries. Following a low inflation trend in 2010, core inflation picked up in 2011, but inflation is certainly not embedded in the labor market, which would be a more serious concern for Federal Reserve policymakers.

The economy continues to face headwinds and the risks are weighted to the downside, but GDP growth is likely to pick up in 2012. There is some pent-up demand in consumer durables. Replacement needs should continue to support growth in motor vehicle sales. Job growth is likely to step up somewhat, although should remain only moderately above a pace consistent with the growth of the working-age population.

The unemployment rate fell sharply in November, to 8.6%, from 9.0% in October and 9.8% a year earlier. That sound like a lot of improvement, but it's largely an illusion, as some individuals gave up looking for a job and are no longer counted as "unemployed." The employment-population ratio, the preferred measure of labor utilization, was little changed, at 58.5% in November, vs. 58.4 in October and 58.2% a year ago. There is still a large amount of slack in the labor market.

Corporate profits improved in 2011, helping to fuel strength in business fixed investment. Cash positions are generally strong, leaving businesses better positioned to absorb any moderate negative shocks that may come along. Manufacturing activity strengthened in early 2011, and the breadth of improvement was initially robust. Conditions were more mixed in the second half of the year. Factory sector activity is likely to be uneven in 2012, with some slowing in exports, but relative strength in domestic demand.

The housing sector disappointed in 2011. The spring sales season was soft and construction failed to rebound even modestly. Home prices drifted a bit lower, an ongoing problem for the large number of mortgage holders who are underwater. A further round of asset purchases from the Fed (mortgage-backed securities) could help, but wouldn't be a cure-all.

State and local government continued to contract in 2011, subtracting from overall job growth and reducing GDP growth. Tax revenues have continued to recover, which should help reduce budget pressures in 2012. However, while state and local government is expected to be less of a drag, the federal government is likely to be more of a negative.

The payroll tax reduction is currently set to expire at the end of 2011. In addition, unemployment insurance benefits may not be extended. If neither is extended, consumer spending growth would be substantially slower in the first half of the year. We are heading into an election year, so it seems likely that Congress will be able to work out an extension of the payroll tax reduction. An extension of unemployment insurance benefits is less clear. While these benefits do tend to discourage people from taking a job, they also provide good bang-for-the-buck (albeit more defense than offense). The money is spent and stimulus is plowed back into the economy.

The fiscal policy outlook at the end of 2012 is more problematic. At this point, the Bush tax cuts are set to expire. In addition, automatic spending cuts (related to the failure of the super committee) are set to begin in 2013 (although Congress may find a way to wriggle out of that). We're set for another showdown over the federal budget deficit, most likely after the election. It's an election year, so not much action is expected out of Congress in 2012. Market participants will be focused on the race for the White House, and the president will set the tone on enforcement of existing regulations in 2013 and beyond. However, any new legislation will depend on what happens in the Senate. Democrats currently hold a majority in the Senate, and we could see of a shift of control to the Republicans, but without a filibuster-proof 60 seat majority it's difficult to get anything through. Gridlock was good in the 1990s. By the end of the decade, we ended up with budget surpluses. However, in the current environment, stuff has to get done. Congress may not support the economy if needed.

The European financial crisis has continued to escalate, without a clear resolution in sight. The risks to the global economy are huge. European leaders remain focused on reducing budget deficits rather than promoting economic growth and the European Central Bank has refused to take on the role of lender of last resort. The crisis has exposed problems inherent in the euro zone's construction. There is no broad fiscal authority. There's also nothing to prevent a run on a country. As investors doubt Italy's ability to make good on its debt, they'll require higher interest rates to roll over existing debt. However, the higher borrowing costs add to financial strains, generating even less incentive to invest, and so on. The ECB needs to take a much larger role, but is reluctant to do so. Efforts to promote liquidity are welcome, but they do nothing to get to the heart of the matter. Eventually, the ECB will have to come to the rescue – hopefully, before it is not too late.

Global financial crises are often begun by countries borrowing in currencies that they don't control. In this case countries outside the euro zone, such as the UK, have significantly lower borrowing costs. If Italy, Spain, or Greece had their own currency, they could simply devalue, take their lumps, and work their way out. Wedded to the euro, there's no path to recovery. There is some chance that one or more countries may exit the euro, or that the whole system will collapse. There is no road map here, no exit plan. For the U.S., a meltdown in Europe would hit exporters. Europe appears to be near or already in a recession. The bigger concern is the potential financial disruptions. U.S. banks may have limited exposure to Europe's sovereign debt, but the big banks here have significant relationships with the big banks of Europe. European banks doing business in the U.S. are said to be already tightening credit, as they repatriate capital. Domestic banks may step into the void, increasing their lending in the U.S., but we could see some return of counterparty fears and generally unsettled financial market conditions.

The projections in the forecast table are relatively optimistic, even a bit hopeful. However, the outlook is conditional on what happens with fiscal policy (payroll taxes and unemployment insurance benefits) in the next few weeks and what happens in Europe beyond that. There is still hope for Europe, but it's not looking good. A more substantial meltdown would have a significant impact on the U.S. economy and long-term interest rates. Inflation is expected to be moderate in 2012, but we could see a return of deflationary pressures if Europe weakens more substantially. Much as in 2011, perceptions about the strength of the U.S. economy and about the euro zone's fate are likely to vary over time, contributing to a high level of financial market volatility. Once again, it's going to be a challenging year for investors.

	4Q10	1Q11	2Q11	3Q11	**4Q11**	**1Q12**	**2Q12**	**3Q12**	**4Q12**	2010	**2011**	**2012**	**2013**
GDP (↓ *contributions*)	2.3	0.4	1.3	2.0	**2.8**	**2.4**	**2.7**	**2.8**	**3.0**	3.0	**1.7**	**2.5**	**2.9**
consumer durables	*1.2*	*0.9*	*-0.4*	*0.4*	***0.8***	***0.3***	***0.3***	***0.3***	***0.4***	*0.5*	***0.6***	***0.4***	***0.3***
nondurables & services	*1.3*	*0.6*	*0.9*	*1.3*	***1.1***	***1.3***	***1.6***	***1.6***	***1.7***	*0.9*	***1.0***	***1.4***	***1.6***
bus. fixed investment	*0.8*	*0.2*	*0.9*	*1.4*	***0.6***	***0.8***	***0.8***	***0.8***	***0.9***	*0.4*	***0.8***	***0.9***	***0.8***
residential investment	*0.1*	*-0.1*	*0.1*	*0.0*	***0.0***	***0.1***	***0.2***	***0.2***	***0.2***	*-0.1*	***0.0***	***0.1***	***0.2***
government	*-0.6*	*-1.2*	*-0.2*	*0.0*	***-0.3***	***-0.4***	***-0.4***	***-0.3***	***-0.1***	*0.1*	***-0.4***	***-0.3***	***0.0***
Domestic Final Sales	2.7	0.4	1.3	3.0	**2.3**	**2.1**	**2.6**	**2.8**	**3.0**	1.9	**2.0**	**2.5**	**2.8**
exports	*1.0*	*1.0*	*0.5*	*0.6*	***0.4***	***0.3***	***0.4***	***0.5***	***0.6***	*1.3*	***0.9***	***0.4***	***0.6***
imports	*0.4*	*-1.4*	*-0.2*	*-0.1*	***-0.4***	***-0.5***	***-0.6***	***-0.6***	***-0.6***	*-1.8*	***-0.8***	***-0.4***	***-0.6***
Final Sales	4.2	0.0	1.6	3.6	**2.3**	**2.0**	**2.4**	**2.7**	**3.0**	2.8	**2.0**	**2.4**	**2.7**
ch. in bus. inventories	*-1.8*	*0.3*	*-0.3*	*-1.6*	***0.5***	***0.4***	***0.3***	***0.0***	***0.0***	*1.6*	***-0.3***	***0.0***	***0.0***
Unemployment, %	9.6	8.9	9.1	9.1	**8.8**	**8.5**	**8.4**	**8.3**	**8.2**	9.6	**9.0**	**8.4**	**7.9**
NF Payrolls, monthly, th.	139	166	97	147	**115**	**115**	**140**	**155**	**165**	78	**131**	**144**	**176**
Cons. Price Index (3 mo)	3.3	6.1	1.5	4.8	**0.7**	**1.9**	**1.9**	**2.0**	**2.1**	1.4	**3.3**	**2.0**	**2.1**
excl. food & energy	0.8	2.0	2.9	2.1	**1.7**	**2.1**	**2.1**	**2.0**	**2.0**	0.7	**2.2**	**2.0**	**2.0**
PCE Price Index (q/q)	1.9	3.9	3.3	2.3	**1.2**	**1.7**	**1.8**	**1.9**	**2.0**	1.8	**2.5**	**1.8**	**2.0**
excl. food & energy	0.7	1.6	2.3	2.0	**1.2**	**1.9**	**1.9**	**1.9**	**1.9**	1.4	**1.4**	**1.8**	**1.9**
Fed Funds Rate, %	0.19	0.16	0.09	0.08	**0.08**	**0.10**	**0.12**	**0.18**	**0.20**	0.18	**0.10**	**0.15**	**0.39**
3-month T-Bill, (bond-eq.)	0.1	0.1	0.0	0.0	**0.0**	**0.0**	**0.0**	**0.1**	**0.1**	0.1	**0.0**	**0.1**	**0.4**
2-year Treasury Note	0.5	0.7	0.6	0.3	**0.3**	**0.3**	**0.5**	**0.7**	**0.9**	0.7	**0.5**	**0.6**	**1.2**
10-year Treasury Note	2.9	3.5	3.2	2.4	**2.1**	**2.1**	**2.2**	**2.3**	**2.4**	3.2	**2.8**	**2.2**	**2.7**

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