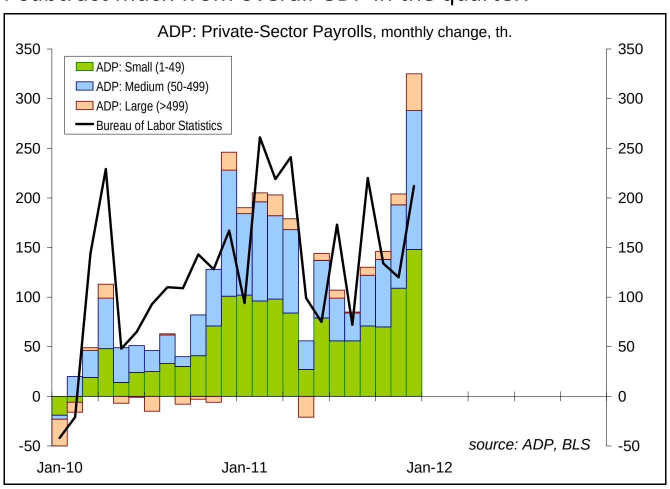
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **January 17, 2012**

Monthly Economic Outlook

Moderate Growth in 2012, but Worries About 2013

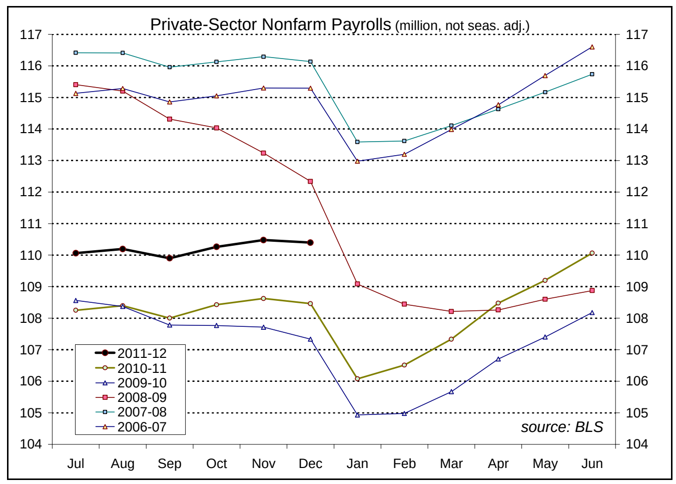
- *Economic growth appears to have remained moderate in late 2011. Inflation pressures have receded.*
- *Moderate growth is expected to continue in 2012, but Europe will remain a major concern for investors.*
- *The Federal Reserve is expected to keep monetary policy steady in the near term, but could undertake another round of asset purchases ("QE3," in mortgage-backed securities) if warranted. The Fed will soon begin publishing projections of the appropriate federal funds target rates.*

The advance estimate of 4Q11 real GDP growth will be reported on January 27. There's always a lot of uncertainty in the initial GDP estimate. We're missing December figures on foreign trade and inventories, which can whip the numbers around from quarter to quarter. Early estimates range from 2.5% to 3.5%. Consumer spending appears likely to have risen at a moderately strong pace, helped by gains in motor vehicle sales. Holiday retail sales were a bit disappointing relative to expectations, and spending was partly fueled by dipping into savings in the last several months of the year, but consumer spending momentum should carry through to the first part of this year. Corporate profits and cash flows have remained strong, helping to fuel business fixed investment. However, trends in new orders and shipments of capital equipment were a bit soft in October and November. Inventory growth slowed in 3Q11, generating expectations of a moderate re-build in 4Q11 and 1Q12, and figures for October and November were consistent with that view. Foreign trade looks unlikely to add or subtract much from overall GDP in the quarter.



The labor market strengthened in December, with nonfarm payrolls rising by 200,000 (we need about 120,000 or so to absorb the growth in the working-age population). December figures may have been helped by favorable weather (note that prior to seasonal adjustment, payrolls fell by 219,000). Private-sector payrolls averaged a 155,000 monthly gain in the last half of 2011. State and local government continued to shed jobs – down 618,000 since December 2008 (although the drag in government jobs should decrease as state and local tax revenues continue to recover from the recession). Note that the payroll survey data will undergo annual benchmark revisions on February 3, which are expected to raise the March 2011 level of payrolls by about 192,000 (or 0.1%).

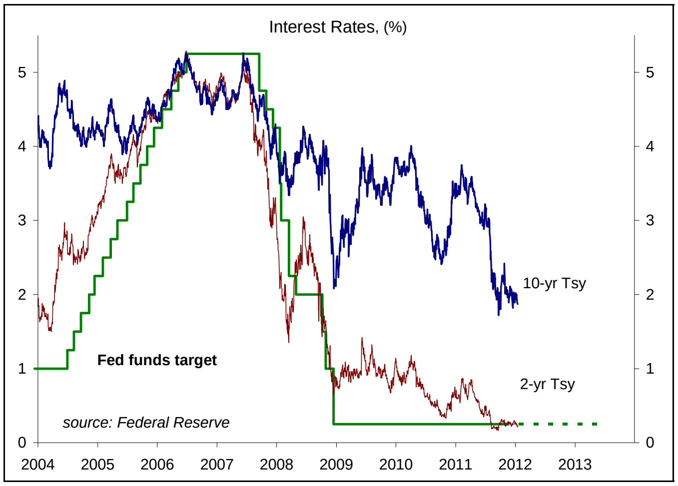
The ADP estimate of private-sector payrolls for December was much stronger than the official BLS figure. The ADP report breaks the numbers out by size of firm. Importantly, job growth appears to have picked up for small and medium-sized firms, which usually account for the bulk of new jobs during an economic expansion. On a cautionary note, improved hiring by smaller firms a year ago petered out in the spring, likely reflecting the negative impact of $4 gasoline.



Seasonal adjustment is a significant factor in the labor market data in December and January. Much has been made recently of the lower trend in claims for unemployment insurance benefits. Unadjusted claims run higher in the end of the year and spike as the new year gets underway. With the lower trend in adjusted claims in December, we may be seeing lower seasonal layoffs than usual. Unadjusted payrolls fall sharply each January, largely reflecting the end of the holiday shopping season. The bigger test for the labor market will come in the spring hiring season, between February and June.

Inflation-adjusted personal income drifted lower over the course of 2011, while spending picked up (after trending flat in the spring and early summer). Spending was fueled by a decrease in the savings rate, which fell from 5.2% in December 2010 to 3.5% in November. However, note that the income figures (and hence, savings rates) are subject to revision.

While the recent economic data have been generally better than expected, the evidence hasn't pointed to especially strong growth. The ISM Manufacturing Index, for example, has been consistent with expansion, but the breadth is soft (the same percentage of industries reporting growth as reporting contraction). The economy remains on a recovery path, but we still have a long way to go for a full recovery.



The bond market and the stock market have been telling different stories recently. Stocks have rallied in the last two months, largely as worries about a European meltdown have subsided and recession fears have faded. Yet, worries about Europe have helped push long-term Treasury yields to very low levels (the 10-year Treasury at 1.86%). The Fed has been buying through Operation Twist, and could end up buying more if policymakers decide to undertake another round of asset purchases ("QE3") – but that's not the whole story. There's still a strong demand for safe assets. Yields on five- to ten-year TIPS have been negative, meaning that investors are willing to lend money to the government at a rate below future inflation.

In the last few months of 2011, a number of Fed officials spoke about the possibility of the Fed buying mortgage-backed securities. The housing market has been a big disappointment for the Fed. At this point, the recovery was expected to be much further along. Moreover, the weak housing market has interfered with the transmission of monetary policy. The Fed recently released a white paper on housing, which puts the onus on lawmakers to aid the housing sector. However, not much is expected out of Congress in an election year. The minutes of the December 13 Federal Open Market Committee meeting showed that officials thought that *"current and prospective economic conditions could well warrant additional policy accommodation,"* but they believed that *"any additional actions would be more effective if accompanied by enhanced communication about the Committee's longer-run economic goals and policy framework."* The FOMC will make such enhancements at the January 24-25 policy meeting, when it begins releasing senior Fed officials' projections of the federal funds target rate. Putting two and two together, this implies that we could see another round of asset purchases. However, growth is not weak enough to force the Fed's hand.

Lawmakers voted to extend the payroll tax reduction for the first two months of this year, but it's widely expected that the reduction will be extended for the full calendar year. That's good for this year's consumer spending outlook, but the payroll tax cut won't be extended indefinitely. Government spending cuts that resulted from the Super Committee's failure to reach a budget accord will not begin until 2013. The expirations of the payroll tax cut, unemployment insurance benefit extensions, and the Bush tax cuts imply a sizeable fiscal drag early next year. For investors, 2013 is some time away. Perceptions about U.S. economic growth and the situation in Europe are likely to vary over this year.

	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	2011	2012	2013
GDP (↓ *contributions*)	0.4	1.3	1.8	2.6	2.3	2.7	2.8	3.1	2.2	2.8	1.7	2.4	2.8
consumer durables	0.9	-0.4	0.4	0.8	0.3	0.3	0.3	0.4	0.2	0.3	0.6	0.4	0.3
nondurables & services	0.6	0.9	0.8	0.9	1.3	1.6	1.6	1.7	1.2	1.4	1.0	1.3	1.5
bus. fixed investment	0.2	0.9	1.4	0.7	0.8	0.8	0.8	0.9	0.6	0.7	0.8	0.9	0.8
residential investment	-0.1	0.1	0.0	0.1	0.1	0.1	0.2	0.2	0.0	0.2	0.0	0.1	0.1
government	-1.2	-0.2	0.0	-0.2	-0.4	-0.2	-0.2	0.0	0.0	0.1	-0.4	-0.2	0.0
Domestic Final Sales	0.4	1.3	2.7	2.3	2.0	2.7	2.8	3.1	2.0	2.7	1.9	2.4	2.7
exports	1.0	0.5	0.6	0.4	0.3	0.4	0.5	0.6	0.6	0.7	0.9	0.4	0.6
imports	-1.4	-0.2	-0.2	-0.4	-0.5	-0.6	-0.6	-0.6	-0.4	-0.5	-0.8	-0.5	-0.6
Final Sales	0.0	1.6	3.2	2.3	1.9	2.5	2.7	3.0	2.2	2.8	2.0	2.3	2.6
ch. in bus. inventories	0.3	-0.3	-1.4	0.3	0.4	0.2	0.0	0.0	0.0	0.0	-0.3	0.0	0.1
Unemployment, %	9.0	9.1	9.1	8.7	8.4	8.3	8.1	8.0	7.9	7.8	9.0	8.2	7.7
NF Payrolls, monthly, th.	166	97	147	137	115	140	155	165	160	170	137	144	176
Cons. Price Index (3 mo)	6.1	1.5	4.8	0.2	1.9	1.9	2.0	2.1	2.1	2.1	3.2	2.0	2.1
excl. food & energy	2.0	2.9	2.1	1.9	2.1	2.1	2.0	2.0	2.0	2.0	2.2	2.0	2.0
PCE Price Index (q/q)	3.9	3.3	2.3	0.7	1.5	1.8	1.9	2.0	2.0	2.0	2.4	1.7	2.0
excl. food & energy	1.6	2.3	2.1	0.9	1.8	1.9	1.9	1.9	1.9	1.9	1.4	1.7	1.9
Fed Funds Rate, %	0.16	0.09	0.08	0.08	0.10	0.12	0.18	0.20	0.21	0.23	0.10	0.15	0.39
3-month T-Bill, (bond-eq.)	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.1	0.1	0.4
2-year Treasury Note	0.7	0.6	0.3	0.3	0.3	0.5	0.7	0.9	1.0	1.2	0.5	0.6	1.2
10-year Treasury Note	3.5	3.2	2.4	2.0	2.0	2.2	2.3	2.4	2.5	2.6	2.8	2.2	2.7

International Headquarters:
The Raymond James Financial Center | 880 Carillon Parkway | St. Petersburg, Florida 33716 | 800-248-8863