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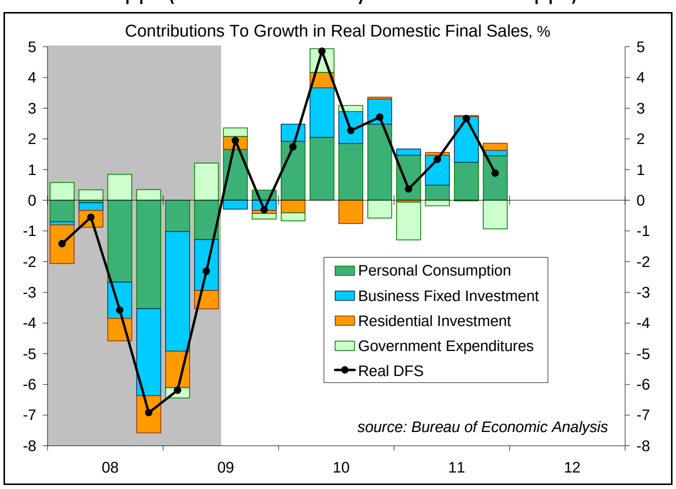
Monthly Economic Outlook

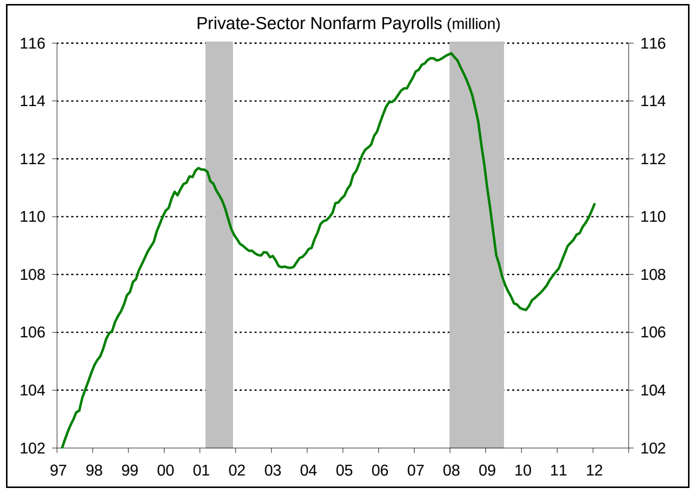
Growth in the Spring

- *Recent data continue to suggest moderate economic growth in the near term. Some figures were likely aided by unusually mild weather in December and January.*
- *Federal Reserve officials do not expect to raise short-term interest rates until late 2014, although they are divided on when to hike and how fast. The Fed formally adopted a 2% target for inflation and a soft target (5.2% to 6.0%) for the unemployment rate. However, this does not change how monetary policy will be conducted.*
- *European troubles continue, although the ECB's liquidity efforts appear to have headed off a broader banking crisis. The bigger concern for the U.S. economy will be fiscal policy in 2013 – and we may not get any clarity until after the election.*

Real GDP rose at a 2.8% annual rate in the advance estimate for 4Q11 (note: this figure will be revised, and revised again). Consumer spending rose at a 2.0% pace, rising faster than disposable income (+0.8%, vs. -0.5% in 2Q11 and -1.9% in 3Q11). Business fixed investment rose a disappointing 1.7% (vs. +15.7% in the third quarter). Inventories picked up, adding 1.9 percentage points to overall GDP growth. Domestic Final Sales (GDP less net exports and the change in inventories), a measure of underlying domestic demand, rose at a weak 0.9% annual rate in 4Q11, up just 1.3% from a year earlier. Government subtracted 0.9 percentage point from 4Q11 GDP, mostly in defense, but state and local government subtracted another 0.3 ppt (where it normally would add 0.2 ppt).



Nonfarm payrolls fell by 2.689 million in January – that is, before seasonal adjustment. Adjusted, payrolls rose by 243,000 (a three-month average gain of 201,000), reflecting unusually mild weather. The household survey data showed that 206,000 individuals were unable to work due to adverse weather, vs. a 425,000 average over the five previous Januarys (note: these figures are not directly comparable to the payroll data – these are two separate surveys – but it gives you an idea of the impact of mild weather). Fewer seasonal layoffs are a good thing, but it's not the same as actual job gains. Data for the spring hiring season (February to June) will present a clearer picture of the labor market. On a positive note, bank credit to small businesses is gradually easing, and there are signs that these firms have stepped up their hiring. Annual benchmark revisions showed a 2.926 million increase in nonfarm payrolls since January 2010, or an average of about 120,000 per month – that's roughly the pace needed to absorb the growth in the working-age population, but not enough to recoup the millions of jobs lost during the economic downturn.

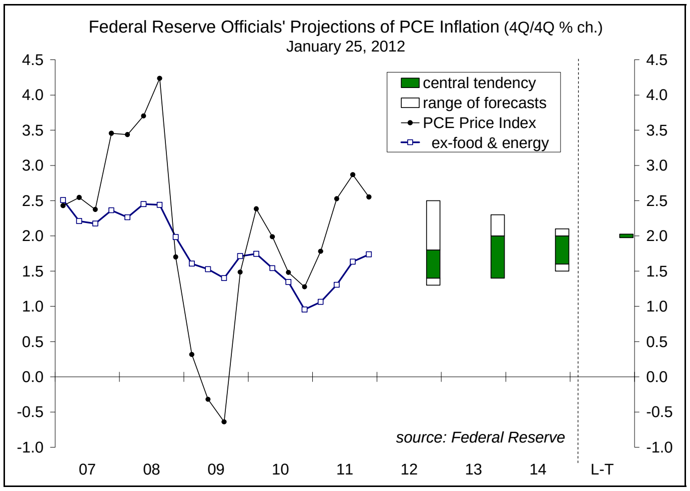


The unemployment rate fell to 8.3% in January, down from 9.1% a year ago. It had peaked at a little over 10% in October 2009. However, the employment/population ratio held steady at 58.5% in January, little changed over the last two years. Many workers stop looking for job when their unemployment insurance benefits expire, exiting the labor force.

Consumer credit picked up sharply in November and December, largely reflecting stronger motor vehicle sales. Mild weather may have helped vehicle sales, but replacement needs should continue to fuel improvement over the months ahead. Private-sector wages and salaries rose at a 5.0% annual rate in 4Q11, while government wage incomes edged down 0.1%. The fourth quarter also experienced a decline in farm income and a drop in interest income. A 3.6% cost-of-living adjustment in Social Security payments will add to income growth in 1Q12.

Housing remains a continued headwind for the household sector. Home prices remain soft, leaving many mortgage holders underwater (owing more than their home is worth). The spring housing season is likely to show some improvement, but it may be disappointing relative to expectations.

The Fed has long operated with an implicit inflation target and on January 25, made this explicit (a 2.0% annual rate of increase in the PCE Price Index). Many central banks have an inflation target, but the Fed has a dual mandate (price stability and maximum sustainable employment). The maximum level of employment is determined by a number of factors, which can vary over time and may not be directly measureable. However, the Fed currently estimates that the longer-run normal rate of unemployment is between 5.2% and 6.0%.



As some point, the Fed may find itself missing on both targets, but will use *"a balanced approach"* in moving back to target. Chairman Bernanke indicated that the Fed's adoption of a dual targeting system does not mean that the Fed will tolerate higher inflation in the short term in order to push the unemployment rate down. Moreover, the Fed chairman stressed that the announcement of long-term goals should not be interpreted as indicating any change in how the Fed conducts monetary policy. Rather, *"its purpose is to increase the transparency and predictability of policy."*

Four times per year, the Fed releases senior officials' projections of growth, unemployment, and inflation. Following its recent policy meeting, the Fed also began publishing projections of the federal funds target rate. The officials (the five Federal Reserve Board governors and 12 Fed district bank presidents) generally expect that economic conditions will warrant an exceptionally low federal funds target rate through late 2014 (previously, it was through mid-2013). However, officials differed in their expectations for the timing of the Fed's first rate hike and how fast it will move. Long term, Fed officials expect a 4.0% to 4.5% federal funds rate, but the expectations for 4Q14 ranged from 0.25% to 2.75%. Of course, monetary policy will depend on the evolution of the economy and where inflation and employment stand relative to their targets. The Fed expects inflation to remain at or below target in the near term, suggesting some room for further accommodation. A number of officials continue to talk about the possibility of purchasing mortgage-backed securities, although it's unclear whether the Fed will pull the trigger anytime soon. We will get more information on the Fed's outlook in the next few weeks, when Chairman Bernanke presents the Fed's Monetary Policy Report to Congress.

Worries about Europe have simmered down, as the ECB's injection of liquidity has reduced the odds of a full-scale banking crisis. Some have suggested that the ECB purchase large amounts of sovereign debt. The ECB has avoided that, but lending to the banks and having them buy sovereign debt produces a similar result. Many observers expect Greece to exit the euro and Europe to experience a mild recession. It will still be some time before the situation is resolved completely.

At this point, tighter fiscal policy is set to subtract roughly 4% from GDP in 2013. However, after November's election, we're likely to see some compromise to delay that.

	1Q11	2Q11	3Q11	4Q11	**1Q12**	**2Q12**	**3Q12**	**4Q12**	**1Q13**	**2Q13**	2011	**2012**	**2013**
GDP (↓ *contributions*)	0.4	1.3	1.8	2.8	**1.7**	**2.1**	**2.6**	**3.0**	**1.9**	**2.7**	1.7	**2.2**	**2.6**
consumer durables	*0.9*	*-0.4*	*0.4*	*1.1*	***0.2***	***0.3***	***0.3***	***0.3***	***0.1***	***0.3***	*0.6*	***0.4***	***0.3***
nondurables & services	*0.6*	*0.9*	*0.8*	*0.4*	***1.1***	***1.5***	***1.5***	***1.6***	***1.0***	***1.4***	*0.9*	***1.1***	***1.4***
bus. fixed investment	*0.2*	*0.9*	*1.4*	*0.2*	***0.8***	***0.8***	***0.9***	***0.9***	***0.6***	***0.7***	*0.8*	***0.8***	***0.8***
residential investment	*-0.1*	*0.1*	*0.0*	*0.2*	***0.1***	***0.1***	***0.1***	***0.2***	***0.0***	***0.2***	*0.0*	***0.1***	***0.1***
government	*-1.2*	*-0.2*	*0.0*	*-0.9*	***-0.2***	***-0.2***	***-0.2***	***0.0***	***0.0***	***0.0***	*-0.4*	***-0.3***	***0.0***
Domestic Final Sales	0.4	1.3	2.7	0.9	**2.0**	**2.5**	**2.6**	**3.0**	**1.7**	**2.5**	1.8	**2.1**	**2.5**
exports	*1.0*	*0.5*	*0.6*	*0.6*	***0.4***	***0.4***	***0.5***	***0.6***	***0.6***	***0.7***	*0.9*	***0.5***	***0.6***
imports	*-1.4*	*-0.2*	*-0.2*	*-0.8*	***-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	0.8	**2.0**	**2.3**	**2.6**	**3.0**	**1.9**	**2.6**	1.9	**2.0**	**2.4**
ch. in bus. inventories	*0.3*	*-0.3*	*-1.4*	*1.9*	***-0.3***	***-0.2***	***0.0***	***0.0***	***0.0***	***0.0***	*-0.2*	***0.1***	***0.0***
Unemployment, %	9.0	9.1	9.1	8.7	**8.3**	**8.2**	**8.0**	**7.9**	**7.8**	**7.7**	9.0	**8.1**	**7.6**
NF Payrolls, monthly, th.	192	130	128	157	**175**	**140**	**155**	**165**	**160**	**170**	152	**159**	**176**
Cons. Price Index (3 mo)	6.1	1.5	4.8	-0.4	**2.3**	**1.9**	**2.0**	**2.1**	**2.1**	**2.1**	3.2	**2.1**	**2.1**
excl. food & energy	2.0	2.9	2.1	1.8	**2.0**	**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	1.1	**1.8**	**1.9**	**1.9**	**1.9**	**1.9**	**1.9**	1.4	**1.8**	**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**	**0.23**
3-month T-Bill, (bond-eq.)	0.1	0.0	0.0	0.0	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	0.1	**0.1**	**0.3**
2-year Treasury Note	0.7	0.6	0.3	0.3	**0.3**	**0.4**	**0.5**	**0.7**	**0.8**	**1.0**	0.5	**0.5**	**1.1**
10-year Treasury Note	3.5	3.2	2.4	2.0	**2.0**	**2.1**	**2.3**	**2.4**	**2.4**	**2.5**	2.8	**2.2**	**2.6**

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