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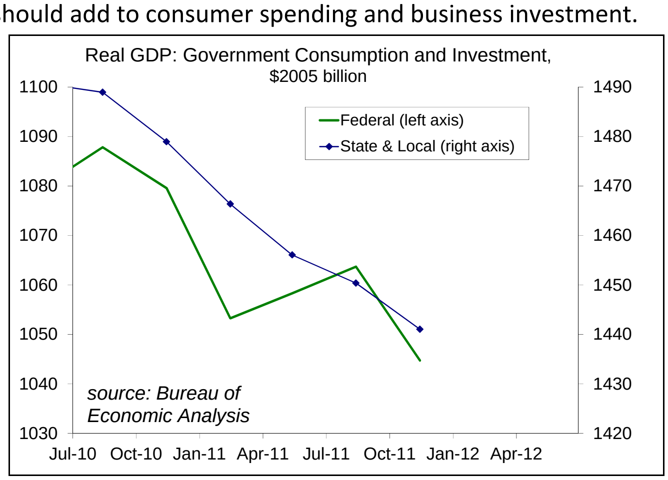
Monthly Economic Outlook

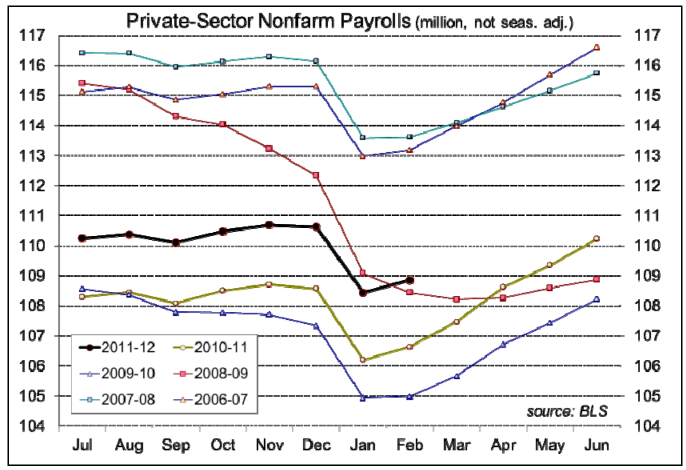
A Few Unanswered Questions

- *Recent data, while mixed, continue to suggest moderate economic growth in the near term. Job growth has picked up.*
- *An unusually mild winter has helped boost overall economic activity, but may have pulled forward seasonal gains that would have occurred in March and April. Higher gasoline prices threated to dampen consumer spending and business hiring.*
- *Further monetary policy stimulus (QE3) appears to be less likely, dependent on a faltering in the recovery or inflation staying well below the Fed's target. The Fed is likely to retain its conditional commitment to keep short-term interest rates exceptionally low into late 2014.*

Real GDP rose at a 3.0% annual rate in the 2nd estimate for 4Q11 (up from +2.8% in the advance estimate). Fourth quarter growth was boosted by a faster pace of inventory accumulation and held back by a decline in government consumption and investment. Consumer spending and business fixed investment rose moderately (annual rates of 2.1% and 2.8%, respectively). Personal income and spending figures through January suggest a considerable lack of momentum in inflation-adjusted consumer spending into early 2012. Real spending was reported flat for November, December, and January. Barring revisions or a sharp rise in February and March, the monthly arithmetic works out a subpar quarterly rate for 1Q12 (well below 2%). Remember that consumer spending accounts for about 70% of Gross Domestic Product. In addition, shipments of nondefense capital goods, while choppy, have exhibited a weakening trend in the last few months. Hence, business fixed investment may not be especially strong. However, unit motor vehicle sales were strong in January and February, which should add to consumer spending and business investment.



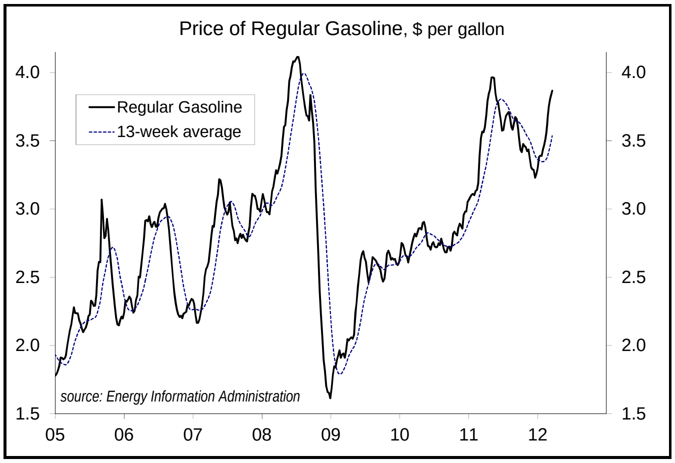
Government subtracted an average of 0.6 percentage point from GDP growth over the last five quarters, split mostly between defense spending and state and local government. Budget strains in state and local government have contributed to job losses over the last few years. Some of these strains may be decreasing as tax receipts recover. However, military spending is set to decline further and significant cuts in federal spending are slated for 2013. These spending cuts combined with scheduled tax increases would be about a 4% drag on GDP growth in 2013. However, we are likely to see some (if not most) of the fiscal policy tightening pushed out after the election in November (presumably, with the election out of the way, the two parties have less incentive to posture and more incentive to compromise and get things done – we'll see).



This winter has been unusually mild. As a consequence, many of the recent economic data reports may reflect a temporary weather impact. In the job market, weather often shifts activity from one month to the next. In this case, mild weather may have pulled into January and February seasonal gains that would have normally occurred in March and April. The Labor Department reported that the number of individuals unable to work during the survey weeks in January and February were well below the average of the last ten years. In addition, the impact of mild weather is often exaggerated by the seasonal adjustment. The worst of the recession hit in the first quarter of 2009, which may have perturbed the pattern used to seasonally adjust the job market data, making recent payroll numbers appear somewhat stronger than they would be otherwise. None of this means that the economy is weak, but it does suggest that recent strength may be overstated to some extent. The bigger test will come in the economic data reports for March, April, and May.

The retail price of gasoline has risen about 20% since mid-December. As it approaches $4 per gallon, inflation-adjusted consumer spending is likely to slow further. The 13-week average is a good gauge of the timing of the impact on the consumer (that is, it usually shows up with a lag).

Of course, the impact of higher gasoline prices on the economy depends on how high gasoline prices go and how long they stay high. Last year, the increase in gasoline prices dampened the pace of consumer spending considerably in late spring and early summer. A retreat in gasoline prices brought only moderate relief in the final part of last year.



Increased U.S. production has been a positive story, but one overshadowed by concerns about the Middle East. Recent developments in Syria and Iraq have likely already been factored in, but the market is looking at increased risks in the near term. Somewhat slower global growth and a tapping of strategic oil reserves (in the U.S. and abroad) could put some downward pressure on oil prices in the near term.

Note that, for the Consumer Price Index, the seasonal adjustment factors in a 15% rise in retail gasoline prices between February and May. Adjusted, gasoline prices are expected to rise in March, but may not head much higher in April and May. However, the lagged impact of previous gasoline price increases will matter for consumer spending. One should watch the March retail sales figures closely.

The relative strength in the recent economic data has reduced the market odds that the Federal Reserve will come through with a further round of asset purchases (QE3). The minutes of the January 24-25 Federal Open Market Committee meeting noted that *"a few FOMC members"* felt that economic conditions could warrant additional asset purchases before long, while *"other members"* felt that such action would depend on a loss of momentum in the recovery or if inflation seemed likely to otherwise trend below its 2% target over the medium term. There's nothing in the recent data that would suggest that the Fed is close to pulling the trigger on QE3, but while seemingly less likely, it's not off the table completely.

Europe appears to have moved into a recession, but one that is widely expected to be relatively mild. Higher oil prices and austerity measures are not going to help growth in the near term. The European Central Bank's liquidity injections into the banking system have significantly reduced the odds of a broader banking crisis, but Europe is far from out of the woods. With the ink of Greece's second bailout not even dry yet, it's widely expected that the country will need a third bailout before long. For U.S. investors, Europe may have moved to the back burner, but it's not off the stove entirely.

While the stock market has rallied around improved expectations for the economy, there are a number of key uncertainties. How much of the recent strength has been due to the weather, and will there be a "payback" in the data as we roll into spring? How high will gasoline prices go and how long will they stay elevated? Labor input has increased significantly, but the GDP components (personal spending and business investment) do not suggest that overall growth is especially strong. Is one of these stories wrong, or is productivity slowing (which would have an impact on corporate profit margins)? Bond yields will depend on the answers to these questions.

	1Q11	2Q11	3Q11	4Q11	**1Q12**	**2Q12**	**3Q12**	**4Q12**	**1Q13**	**2Q13**	2011	**2012**	**2013**
GDP (↓ *contributions*)	0.4	1.3	1.8	3.0	**1.2**	**2.0**	**2.6**	**3.0**	**1.9**	**2.7**	1.7	**2.1**	**2.6**
consumer durables	*0.9*	*-0.4*	*0.4*	*1.1*	***0.5***	***0.3***	***0.3***	***0.3***	***0.1***	***0.3***	*0.6*	***0.5***	***0.3***
nondurables & services	*0.6*	*0.9*	*0.8*	*0.4*	***0.5***	***1.4***	***1.5***	***1.6***	***1.0***	***1.4***	*0.9*	***0.9***	***1.4***
bus. fixed investment	*0.2*	*0.9*	*1.4*	*0.3*	***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*	*0.3*	***0.3***	***0.1***	***0.1***	***0.2***	***0.0***	***0.2***	*0.0*	***0.2***	***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	1.1	**2.0**	**2.4**	**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*	*-0.7*	***-1.0***	***-0.6***	***-0.6***	***-0.6***	***-0.4***	***-0.5***	*-0.8*	***-0.6***	***-0.6***
Final Sales	0.0	1.6	3.2	1.1	**1.4**	**2.2**	**2.6**	**3.0**	**1.9**	**2.6**	1.9	**2.0**	**2.3**
ch. in bus. inventories	*0.3*	*-0.3*	*-1.4*	*1.9*	***-0.2***	***-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	**8.2**	**8.1**	**7.9**	**7.8**	**7.7**	**7.6**	9.0	**8.0**	**7.5**
NF Payrolls, monthly, th.	192	130	128	164	**230**	**150**	**160**	**165**	**160**	**170**	153	**176**	**176**
Cons. Price Index (3 mo)	5.1	3.0	3.7	0.3	**3.5**	**1.9**	**2.0**	**2.1**	**2.1**	**2.1**	3.0	**2.4**	**2.1**
excl. food & energy	2.2	2.7	2.1	2.0	**2.2**	**2.1**	**2.0**	**2.0**	**2.0**	**2.0**	2.2	**2.1**	**2.0**
PCE Price Index (q/q)	3.9	3.3	2.3	1.2	**2.1**	**2.2**	**1.9**	**2.0**	**2.0**	**2.0**	2.5	**2.0**	**2.0**
excl. food & energy	1.6	2.3	2.1	1.3	**1.9**	**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	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	0.1	**0.1**	**0.3**
2-year Treasury Note	0.7	0.6	0.3	0.3	**0.3**	**0.3**	**0.5**	**0.6**	**0.8**	**1.1**	0.5	**0.4**	**1.1**
10-year Treasury Note	3.5	3.2	2.4	2.0	**2.0**	**2.2**	**2.3**	**2.4**	**2.6**	**2.6**	2.8	**2.2**	**2.7**

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