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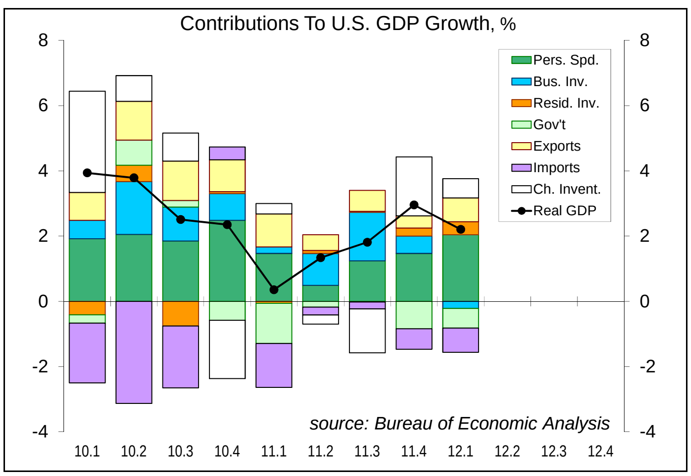
Monthly Economic Outlook

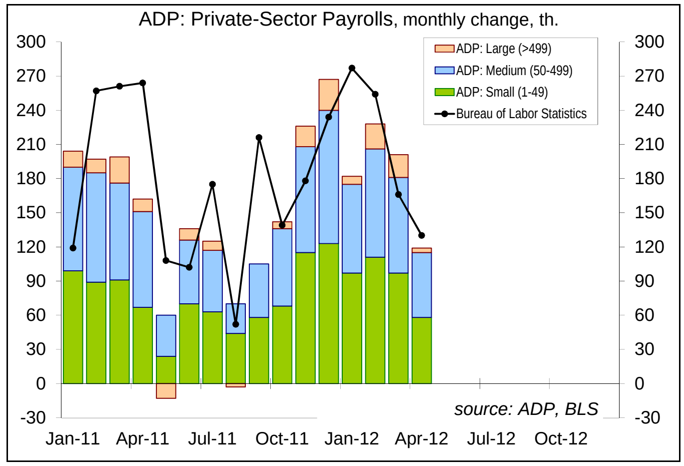
More of the Same

- *Recent economic data have remained consistent with a moderate pace of economic growth in the near term.*
- *Europe has become, once again, a key concern for U.S. investors. The impact on U.S. exports is expected to be moderate, but there's significant fear of financial contagion. Uncertainty (about what will happen) is expected to remain high and it will be a long time until the crisis is fully resolved.*
- *Monetary policy should remain highly accommodative, but further asset purchases (QE3) would depend on a more substantial deterioration in the economic outlook. The "fiscal cliff" is getting more attention, but lawmakers are unlikely to act until after the November elections.*

Real GDP rose at a 2.2% annual rate in the advance estimate for 1Q12. That figure will be revised (and revised again), but the story is unlikely to change much. Consumer spending, which accounts for roughly 70% of GDP, rose at a 2.9% pace, boosted by strength in motor vehicle sales (which were helped by mild weather). Business fixed investment fell at a 2.1% pace, with weakness concentrated in structures (odd, given the mild weather). Spending on equipment and software was mixed, but up modestly overall – disappointing, given the strength in corporate profits (a traditional driver of capital spending). Residential construction added 0.4 percentage point to GDP growth, reflecting a positive impact from the unusually mild winter. Inventories rose at a faster pace (perhaps unintentional), adding to overall growth.



Government remained a drag, subtracting 0.6 percentage point from overall GDP growth, matching the average pace of decline of the five previous quarters. Normally, government consumption and investment would be adding about 0.2 or 0.3 percentage points to GDP, which helps explain why the recovery from recession has remained relatively slow.

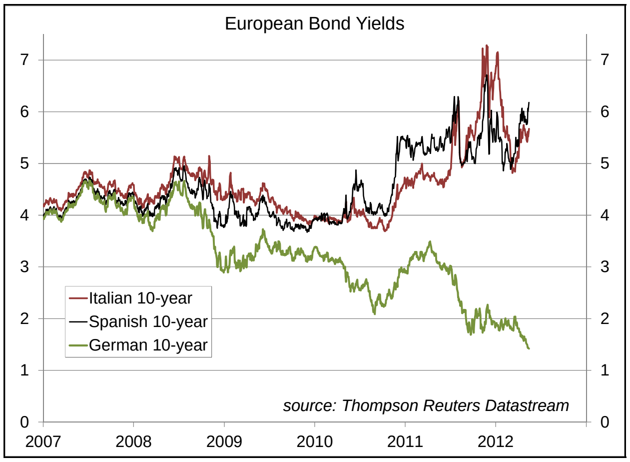


Job growth slowed in March and April, but that appears to reflect a return to more normal weather. The mild winter likely pulled forward seasonal job gains that would have occurred in March and April. Private-sector payrolls averaged a 207,000 monthly gain in the first four months of the year. We need about 120,000 jobs per month to absorb the growth in the working-age population. ADP, a payroll processing company, publishes its own estimates of private-sector payrolls. The ADP data and the official numbers from the Bureau of Labor Statistics differ from month to month, but tend to show similar results over time. Unlike the BLS figures, the ADP data have a breakout by size of firm. Recent figures have continued to show net gains for small and medium sized firms – a critical part of the recovery process – although April gains were somewhat smaller than earlier in the year. The BLS data have continued to show a contraction in government payrolls, reflecting strains in state and local budgets. However, the pace of government job losses has been slower than last year.

Moderately strong job growth has helped fuel aggregate income growth over the last year, but average wage gains have been restrained (average hourly earnings rose 1.8% over the 12 months ending in April) and inflation has reduced consumer purchasing power. Higher gasoline prices have been a significant constraint on consumer spending growth in the last month or two. Gasoline prices have been falling in recent weeks, but it will take some time before we see the impact.

The slowdown in business fixed investment is puzzling. Corporate profits remained strong in 1Q12, which would normally help fuel capital spending. However, firms also need to feel confident that demand for the goods and services they produce will continue to strengthen. Europe's troubles may have dampened U.S. business sentiment to some extent. However, built-in replacement needs should continue to support business investment in the quarters ahead.

Europe's crisis has been heating up again. Election results in Greece, France, and Germany signaled a public rejection of austerity efforts. Governments must work to reduce their budget deficits over the long run, but too much belt tightening too soon has weakened economic recoveries, making budget problems worse instead of better. The danger is the rejection of austerity may become too forceful, weakening prospects for long-term budget balance.



The second bailout of Greece was only a few months ago. Many thought that the country would be unable to live up to the imposed requirements. The odds that Greece will exit the euro have increased. However, the timing and the magnitude of adjustments it would have to make are unclear. Leaving the euro would be devastating for Greece's economy, but so would remaining in the monetary union. Beyond Greece, there are concerns about Europe's banks, particularly of those in Spain. The European Central Bank's Long-Term Refinancing Operations have reduced the chance of a near-term banking crisis, but haven't addressed the underlying problems. Europe needs growth, not austerity, in the short term.

Europe is expected to experience a mild recession, but activity has been mixed – substantially worse in the peripheral countries. Deterioration in financial conditions could worsen the European economy more than is currently expected. The risks are weighted to the downside. Investors should keep a close eye on long-term borrowing costs in Spain and Italy.

European weakness should have a negative impact on U.S. exports, but not enough to slow the U.S. economy significantly. The bigger concern would be financial contagion. The possibility of a failure of a large European bank creates counterparty risks, similar to what was experienced in the fall of 2008 (however, troubles here would likely be of nowhere near the same order of magnitude as in 2008).

Europe's problems have led to a flight to safety in German bunds and U.S. Treasuries. All else equal, low long-term interest rates should help the economic recovery. There has been much discussion of the possibility of a further round of asset purchases by the Fed (QE3). However, the goal of QE3 would be to reduce long-term interest rates – and long-term interest rates are already very low. In his press briefing following the April 24-25 Federal Open Market Committee meeting, Chairman Bernanke said that additional balance sheet actions *"remain very much on the table"* and the Fed is *"entirely prepared to act"* if necessary.

Economic growth is expected to be moderate in the near term. Headwinds should remain apparent, but the drag is likely to soften over time. Monetary policy should remain highly accommodative. However, fiscal policy is more uncertain. The expiration of the Bush-era tax cuts, the end of the 2% payroll tax reduction and government spending cuts would likely subtract more than 4% from GDP in 2013. Lawmakers are expected to move to postpone most of the pain, but we'll have to wait until after the election to see any action.

	1Q11	2Q11	3Q11	4Q11	1Q12	**2Q12**	**3Q12**	**4Q12**	**1Q13**	**2Q13**	2011	**2012**	**2013**
GDP (↓ *contributions*)	0.4	1.3	1.8	3.0	2.2	**2.1**	**2.4**	**3.0**	**2.2**	**2.6**	1.7	**2.3**	**2.6**
consumer durables	*0.9*	*-0.4*	*0.4*	*1.2*	*1.1*	***0.3***	***0.3***	***0.3***	***0.2***	***0.3***	*0.6*	***0.6***	***0.3***
nondurables & services	*0.6*	*0.9*	*0.8*	*0.3*	*0.9*	***1.4***	***1.5***	***1.6***	***1.2***	***1.4***	*0.9*	***1.0***	***1.4***
bus. fixed investment	*0.2*	*0.9*	*1.4*	*0.5*	*-0.2*	***0.8***	***0.9***	***0.9***	***0.6***	***0.7***	*0.8*	***0.6***	***0.8***
residential investment	*-0.1*	*0.1*	*0.0*	*0.3*	*0.4*	***0.1***	***0.2***	***0.2***	***0.0***	***0.2***	*0.0*	***0.2***	***0.1***
government	*-1.2*	*-0.2*	*0.0*	*-0.8*	*-0.6*	***-0.2***	***-0.2***	***0.0***	***0.0***	***0.0***	*-0.4*	***-0.4***	***0.0***
Domestic Final Sales	0.4	1.3	2.7	1.3	1.6	**2.4**	**2.7**	**3.0**	**2.0**	**2.5**	1.9	**2.1**	**2.6**
exports	*1.0*	*0.5*	*0.6*	*0.4*	*0.7*	***0.4***	***0.4***	***0.5***	***0.5***	***0.6***	*0.9*	***0.5***	***0.5***
imports	*-1.4*	*-0.2*	*-0.2*	*-0.6*	*-0.7*	***-0.5***	***-0.5***	***-0.5***	***-0.4***	***-0.5***	*-0.8*	***-0.5***	***-0.5***
Final Sales	0.0	1.6	3.2	1.1	1.6	**2.3**	**2.6**	**2.9**	**2.1**	**2.5**	1.9	**2.0**	**2.4**
ch. in bus. inventories	*0.3*	*-0.3*	*-1.4*	*1.8*	*0.6*	***-0.2***	***-0.2***	***0.0***	***0.0***	***0.0***	*-0.2*	***0.2***	***0.0***
Unemployment, %	9.0	9.1	9.1	8.7	8.2	**8.0**	**7.8**	**7.7**	**7.6**	**7.5**	9.0	**7.9**	**7.4**
NF Payrolls, monthly, th.	192	130	128	164	229	**155**	**165**	**160**	**155**	**170**	153	**177**	**175**
Cons. Price Index (q/q)	4.5	4.4	3.1	1.3	2.5	**2.3**	**1.8**	**2.0**	**2.1**	**2.1**	3.0	**2.3**	**2.1**
excl. food & energy	1.8	2.4	2.5	1.9	2.1	**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	2.4	**2.0**	**1.7**	**1.9**	**2.0**	**2.0**	2.5	**2.0**	**2.0**
excl. food & energy	1.6	2.3	2.1	1.3	2.1	**1.9**	**1.9**	**1.9**	**1.9**	**1.9**	1.4	**1.9**	**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**	**0.3**	**0.5**	**0.8**	**1.0**	0.5	**0.4**	**1.0**
10-year Treasury Note	3.5	3.2	2.4	2.0	2.0	**1.9**	**2.1**	**2.3**	**2.5**	**2.5**	2.8	**2.1**	**2.5**

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