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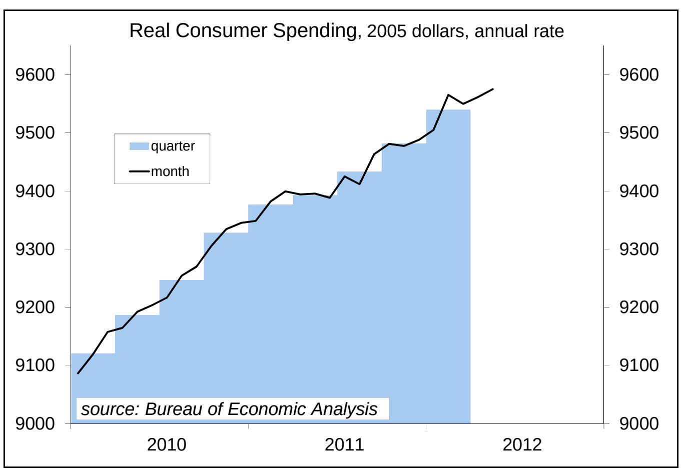
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **July 9, 2012**

Monthly Economic Outlook

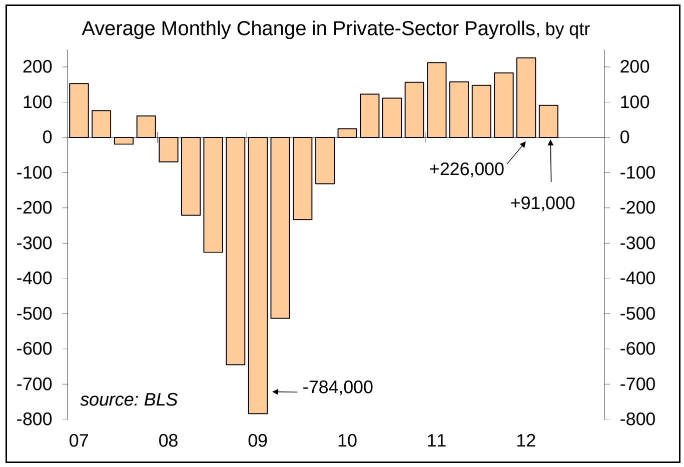
The Fed Responds to Downside Risks

- *Recent economic data have remained consistent with a moderate pace of economic growth in the near term.*
- *Europe and the fiscal cliff remain the two key uncertainties and the major downside risks to the growth outlook.*
- *Responding to these downside risks, the Federal Reserve extended Operation Twist through the end of the year. Officials are poised to do more, which may make QE3 a close call for the policy meeting later this month (decision due on August 1).*

Real GDP rose at a 1.9% annual rate in the third estimate for 1Q12. The second quarter pace is expected to be less than that. Real personal spending accounts for about 70% of GDP and figures for April and May suggested a 1.5% to 2.0% annual rate (vs. +2.5% in 1Q12). Some of the slowdown reflects a payback from a mild winter (which boosted spending in 1Q12), while some is likely the consequence of the earlier increase in gasoline prices. Gasoline prices have fallen, boosting consumer purchasing power in the near term. Average weekly earnings are now outpacing inflation. Bank credit to consumers, while still relatively tight, is gradually improving. Motor vehicle sales picked up in June after falling in May. Replacement needs should provide support to vehicle sales over the next several quarters. Still, a large percentage of homeowners with mortgages remain underwater (owing more than the home is worth), which will continue to restrain spending to some extent.



Job growth slowed significantly in the second quarter. An unusually mild winter lifted payroll figures in 1Q12, largely at the expense of softer numbers in 2Q12. Job growth over the first half of the year was not much different from the last half of 2011. However, worries about the election, the fiscal cliff, and Europe may prevent some firms from investing in new capital and hiring new workers over the near term. Payroll figures for July and August ought to provide a more accurate gauge of the pace of improvement in the labor market. The unemployment rate held steady at 8.2% in June. The employment/population ratio was unchanged at 58.6%, little changed over the last year, and well below the 63.0% average for 2007. The jobs data point to an economy that is growing fast enough to absorb the growth in the working-age population, but not enough to make up much of the ground that was lost in the labor market during the downturn.



The rate of private-sector job destruction remains relatively low. Hiring by small and medium-sized firms picked up in June and has been at a moderate pace over the last several months. However, some of the "softness" in payroll growth over recent quarters has been due to job losses in the public sector. The pace of job losses in state and local government has slowed relative to last year, but losses in federal government employment appear to be picking up (reflecting cutbacks in the U.S. Postal Service and a scaling back of military effort). The decrease in government jobs has a negative impact on consumer spending growth. The contraction in government has reduced GDP growth by about a full percentage point over the last couple of quarters. In other words, GDP would be growing at around 3% rather than 2% if the government sector were expanding modestly.

Fiscal policy is set to get a lot tighter in 2013. The fiscal cliff (the expiration of the Bush-era tax cuts, the end of the 2% payroll tax reduction, and scheduled spending cuts) would subtract about 4% from GDP growth in 2013, enough to push the U.S. economy into recession in the first half of the year. Most likely, we will see at least a partial extension of tax cuts and some softening in spending reductions no matter who is elected president. However, nothing is going to happen until after the election. If Obama is re-elected, negotiations can begin right away. If it's Romney, extending the Bush tax cuts will likely be the main priority after he is sworn in (January 20).

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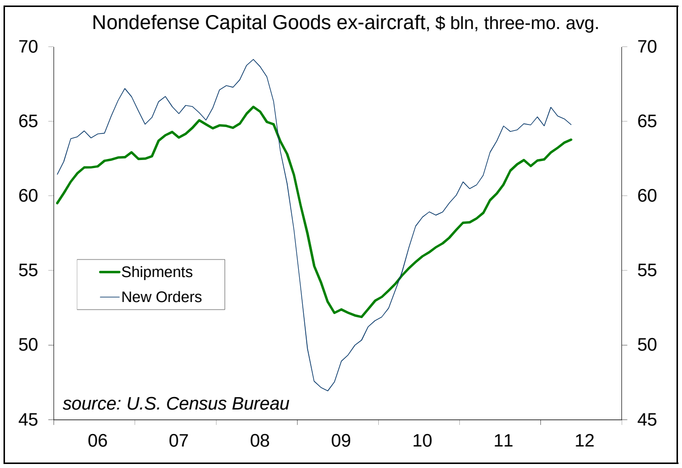
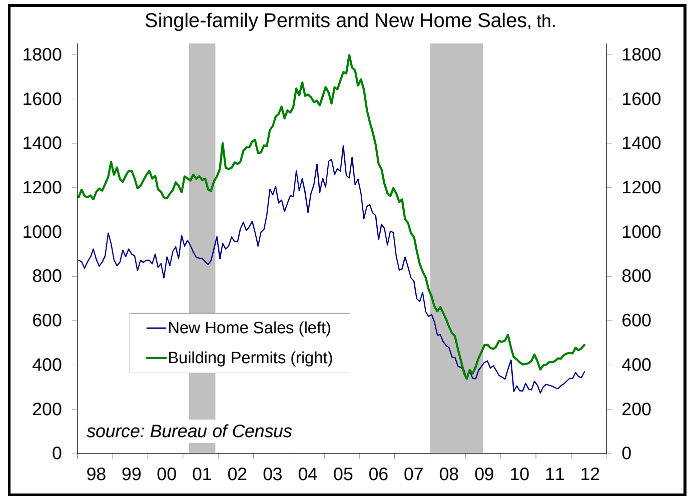
The budget deficit would improve significantly over time if the fiscal cliff is hit (at the expense of weaker economic activity in the short run). However, most of the can is expected to be kicked down the road, leaving a relatively large deficit in 2013. At this point, the market is not showing signs that large deficits are a problem. However, as with most other countries, the U.S. will have to reduce the deficit over the long term.

Market participants were encouraged by the results of the European summit in late June. However, doubts have quickly surfaced about the speed of change in Europe. Borrowing costs for Spain and Italy remain elevated. The European Central Bank lowered short-term interest rates by 25 basis points at its July meeting, but the markets wanted more.



Corporate profits in the U.S. were mixed in the first quarter, with gains in the domestic nonfinancial sector offsetting a drop in earnings from the rest of the world. This should help support business fixed investment, but uncertainty about the strength of the economy may dampen capital spending somewhat in the near term.

Manufacturing activity was more mixed, and generally flat, in June. Firms are reporting some weakness in orders from Europe. However, Europe's impact on U.S. exports is expected to be relatively limited (the bigger concern is the possible financial fallout of broader banking problems in Europe). Prices of oil and other commodities have generally fallen.



The housing sector appears to have turned the corner. Home sales and residential construction activity are up significantly from a year ago. However, the pace of recovery is likely to be gradual, adding only 0.2% to 0.3% to GDP on average over the next several quarters.

The Fed extended Operation Twist to the end of this year, buying about $44.5 billion per month in Treasuries maturing in six to 30 years and selling Treasuries with maturities of three years or less. Having initially said that it would react to signs of a faltering recovery, the Fed appears to have adopted a risk-based policy framework – reacting not to signs of weakness, but to an increase in downside risks to the growth outlook.

	2Q11	3Q11	4Q11	1Q12	**2Q12**	**3Q12**	**4Q12**	**1Q13**	**2Q13**	**3Q13**	2011	**2012**	**2013**
GDP (↓ *contributions*)	1.3	1.8	3.0	1.9	**1.5**	**2.1**	**2.5**	**1.2**	**1.9**	**3.0**	1.7	**2.0**	**2.0**
consumer durables	*-0.4*	*0.4*	*1.2*	*1.0*	***-0.1***	***0.3***	***0.3***	***0.1***	***0.2***	***0.3***	*0.6*	***0.5***	***0.2***
nondurables & services	*0.9*	*0.8*	*0.3*	*0.7*	***1.4***	***1.5***	***1.6***	***1.0***	***1.2***	***1.6***	*0.9*	***0.9***	***1.4***
bus. fixed investment	*0.9*	*1.4*	*0.5*	*0.3*	***0.5***	***0.8***	***0.6***	***0.2***	***0.5***	***0.9***	*0.8*	***0.7***	***0.6***
residential investment	*0.1*	*0.0*	*0.3*	*0.4*	***0.3***	***0.3***	***0.3***	***0.1***	***0.1***	***0.2***	*0.0*	***0.3***	***0.2***
government	*-0.2*	*0.0*	*-0.8*	*-0.8*	***-0.2***	***-0.3***	***-0.2***	***-0.6***	***-0.3***	***0.0***	*-0.4*	***-0.5***	***-0.3***
Domestic Final Sales	1.3	2.7	1.3	1.6	**1.9**	**2.6**	**2.7**	**0.8**	**1.8**	**3.0**	1.9	**2.0**	**2.1**
exports	*0.5*	*0.6*	*0.4*	*0.6*	***0.4***	***0.3***	***0.4***	***0.5***	***0.6***	***0.6***	*0.9*	***0.5***	***0.5***
imports	*-0.2*	*-0.2*	*-0.6*	*-0.5*	***-0.5***	***-0.5***	***-0.6***	***-0.2***	***-0.4***	***-0.7***	*-0.8*	***-0.5***	***-0.5***
Final Sales	1.6	3.2	1.1	1.8	**1.8**	**2.4**	**2.5**	**1.1**	**1.9**	**2.9**	1.9	**1.9**	**1.9**
ch. in bus. inventories	*-0.3*	*-1.4*	*1.8*	*0.1*	***-0.3***	***-0.3***	***0.0***	***0.0***	***0.0***	***0.0***	*-0.2*	***0.1***	***0.0***
Unemployment, %	9.1	9.1	8.7	8.2	8.2	**8.1**	**7.9**	**7.9**	**7.7**	**7.6**	9.0	**8.1**	**7.7**
NF Payrolls, monthly, th.	130	128	164	226	75	**130**	**125**	**90**	**135**	**170**	153	**139**	**143**
Cons. Price Index (q/q)	4.4	3.1	1.3	2.5	**0.6**	**0.4**	**2.0**	**2.1**	**2.1**	**2.1**	3.0	**1.5**	**2.1**
excl. food & energy	2.4	2.5	1.9	2.1	**2.5**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	2.2	**2.2**	**2.0**
PCE Price Index (q/q)	3.3	2.3	1.2	2.6	**0.6**	**0.7**	**1.9**	**2.0**	**2.0**	**2.0**	2.5	**1.7**	**1.7**
excl. food & energy	2.3	2.1	1.3	2.3	**1.8**	**1.8**	**1.9**	**1.9**	**1.9**	**1.9**	1.4	**1.9**	**1.9**
Fed Funds Rate, %	0.09	0.08	0.08	0.10	0.16	**0.18**	**0.20**	**0.21**	**0.23**	**0.24**	0.10	**0.15**	**0.23**
3-month T-Bill, (bond-eq.)	0.0	0.0	0.0	0.1	0.1	**0.1**	**0.1**	**0.2**	**0.2**	**0.2**	0.1	**0.1**	**0.3**
2-year Treasury Note	0.6	0.3	0.3	0.3	0.3	**0.3**	**0.3**	**0.5**	**0.6**	**0.9**	0.5	**0.3**	**0.9**
10-year Treasury Note	3.2	2.4	2.0	2.0	1.8	**1.6**	**1.8**	**2.0**	**2.1**	**2.2**	2.8	**1.9**	**2.3**

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

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