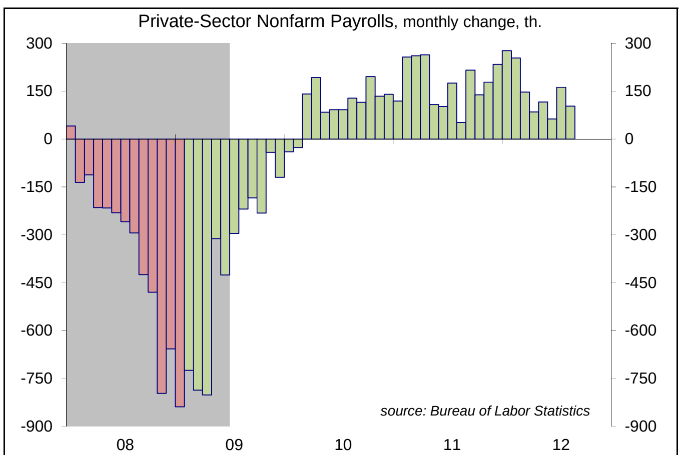
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **September 18, 2012**

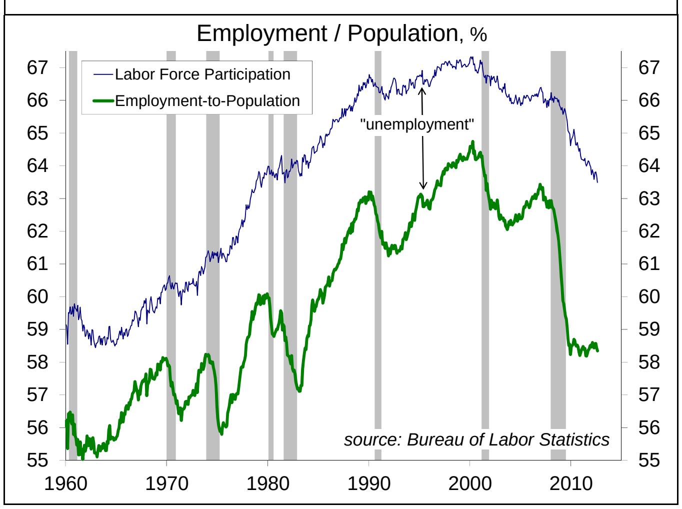
Monthly Economic Outlook

The Fed Does What It Can

- *Recent economic figures have remained mixed, consistent with a moderate pace of growth in the near term.*
- *The recovery is expected to continue, but faces a number of headwinds and some significant downside risks.*
- *Citing the lack of substantial improvement in the labor market, the Federal Reserve took further steps to support growth and promised to do more if needed.*

In his recent Jackson Hole speech, Fed Chairman Bernanke said that *"the stagnation in the labor market is a grave concern."* The economy appears to be in a moderate recovery, but *"it isn't growing fast enough to make significant progress reducing the unemployment rate."* Private-sector payrolls have averaged a 139,000 monthly gain in 2012 (down from 153,000 per month in 2011). That's roughly in line with the growth of the working-age population, enough to keep the unemployment rate steady over time. However, we've also continued to shed government jobs (-11,600 per month).





The unemployment rate has come down (from 10.0% in October 2009, to 8.1% in August). However, most of that is due to a decrease in labor force participation. Some of the decline in labor force participation is related to the aging of the population, but most appears to be due to discouraged workers (as people exhaust their unemployment insurance benefits they tend to give up looking and are no longer officially counted as "unemployed"). The employment/population ratio has been little changed over the last three years (also consistent with the view that we're treading water in the job market, but not recouping jobs lost during the downturn).

On September 13, the Federal Open Market Committee took steps to address the lackluster job market and to support economic growth. The key points:

1) The FOMC extended its forward guidance. That is, it indicated that economic conditions are expected to warrant exceptionally low levels of the federal funds rate to mid-2015 (vs. the previous *"late 2014"*). Long-term interest rates are a series of short-term interest rates, so the announcement should put downward pressure on long-term rates.

2) Accommodative policy will remain in place *"for a considerable time after the economy strengthens."* That is, the Fed won't start tightening monetary policy on the first signs of better growth. This statement should also help put downward pressure on long-term rates.

3) The Fed launched a third Large-Scale Asset Purchase program (what most people call "QE3"). The Fed will purchase $40 billion per month in agency mortgage-backed securities. This program will be open-ended (no set ending date – in contrast to QE1 and QE2, where the Fed specified an amount it would purchase over a certain time frame).

4) The Fed promised to do more if needed. Operation Twist (where the Fed is buying about $45 billion per month in long-term Treasuries financed by selling a similar amount of short-term Treasuries from its portfolio) will finish at the end of the year, but the Fed is likely to buy more after that.

5) In his press briefing, Fed Chairman Bernanke said that monetary policy can't do everything, but the Fed is obliged to do what it can to help support economic growth.

6) The labor market is the key. Bernanke said that the Fed wants to see "substantial improvement" in the labor market outlook. He declined to define that precisely. However, he said that the Fed is not going to rush to tighten policy after one or two strong months of labor market data.

7) The Fed will not be trading higher inflation for lower unemployment. Fed officials are still projecting that inflation will remain at or below the 2% target.

The extended forward guidance and the open-ended nature of the QE3 were meant to persuade consumers, businesses, and the financial markets that monetary policy will remain very accommodative for a long period. However, the markets appear to be a bit confused following the Fed's recent actions. How long will QE3 last? What happens at the end of the year? Will the Maturity Extension Program (Operation Twist) be extended again? Or will QE3 purchases be increased? The Fed has placed its emphasis on the labor market, but what constitutes "sustainable improvement?" Is it like the old definition of pornography ("we know it when we see it")?

The financial markets signaled greater fear of inflation following the FOMC statement. Treasury yields initially moved higher. The dollar weakened. Commodity prices jumped. A number of economists have called for the Fed to pursue a policy of somewhat higher inflation for a period of time (for example 3% to 4% for one or two years) to further reduce inflation-adjusted interest rates. However, the Fed is having none of that. The battle for credibility on price stability (which the Fed defines as a 2% annual rate in the PCE Price Index) was hard-fought, and officials are not about to let that slip away. The seven Federal Reserve Governors and 12 Fed district bank presidents updated their economic projections at last week's policy meeting. Inflation was generally expected to remain at or below the 2% target through 2015. While inflation is always a monetary phenomenon, its transmission is observed through pressures in resource markets. The large amount of slack in the economy, particularly the labor market (which is the widest channel for inflation pressures), suggests that inflation is unlikely to be a problem anytime soon. In his press briefing, Bernanke said that the Fed is fully committed to both sides of its dual mandate and *"has the will to act at the appropriate time to avoid any emerging threat to price stability."*

How do large-scale asset purchases work? Essentially, just like cuts in the overnight lending rate. The goal is to encourage bank lending. However, QE3 also works through other channels, such as mortgage rates, corporate bond rates, and prices of assets (home prices and equities). It is not going to solve the unemployment problem by itself, but according to Bernanke, *"it does have enough force to help nudge the economy in the right direction."*

The U.S. economy will continue to face a number of headwinds in the near term, including slower global growth, tight credit for some borrowers, and fiscal contractions at all levels of government. Gasoline prices, which fell from early April to early July, rebounded in the last two months, but may have begun to fall again. The housing market is improving, but residential construction activity is unlikely to add more than a few tenths of a percentage point to GDP growth over the near term. The bigger concerns are the downside risks, including the debt ceiling and the fiscal cliff. The election is far from over. However, at this point, the key battleground states are leaning more toward Obama and a divided federal government in 2013. The financial markets seem complacent that scheduled tax increases will be deferred, but that's unclear. The current debt ceiling is expected to be reached by the end of the year. Treasury can take evasive action to keep the government running into the first few months of 2013. However, negotiations on the debt ceiling may be entangled with the efforts to avoid the full brunt of the fiscal cliff.

Meanwhile, Europe appears to be a bit less shaky. The European Central Bank indicated that it would conduct Outright Monetary Transactions to address dislocations in the government bond market (specifically, it will purchase Spanish and Italian bonds to push their yields lower). That's not monetary stimulus (as in QE3), but it should help.

	3Q11	4Q11	1Q12	2Q12	**3Q12**	**4Q12**	**1Q13**	**2Q13**	**3Q13**	**4Q13**	2011	**2012**	**2013**
GDP (↓ *contributions*)	1.3	4.1	2.0	1.7	**2.0**	**2.0**	**1.6**	**2.1**	**2.7**	**2.9**	1.8	**2.3**	**2.0**
consumer durables	*0.4*	*1.0*	*0.9*	*0.0*	***0.4***	***0.3***	***0.2***	***0.2***	***0.3***	***0.3***	*0.5*	***0.5***	***0.3***
nondurables & services	*0.8*	*0.5*	*0.9*	*1.2*	***1.2***	***1.2***	***1.1***	***1.2***	***1.4***	***1.4***	*1.3*	***0.9***	***1.2***
bus. fixed investment	*1.7*	*0.9*	*0.7*	*0.4*	***0.4***	***0.5***	***0.4***	***0.5***	***0.8***	***0.8***	*0.8*	***0.8***	***0.5***
residential investment	*0.0*	*0.3*	*0.4*	*0.2*	***0.4***	***0.3***	***0.2***	***0.1***	***0.2***	***0.3***	*0.0*	***0.3***	***0.2***
government	*-0.6*	*-0.4*	*-0.6*	*-0.2*	***-0.3***	***-0.3***	***-0.5***	***-0.2***	***0.0***	***0.0***	*-0.7*	***-0.4***	***-0.3***
Domestic Final Sales	2.2	2.1	2.2	1.6	**2.1**	**2.0**	**1.4**	**1.9**	**2.8**	**2.9**	1.9	**2.1**	**2.0**
exports	*0.8*	*0.2*	*0.6*	*0.8*	***0.3***	***0.4***	***0.5***	***0.6***	***0.6***	***0.6***	*0.9*	***0.5***	***0.5***
imports	*-0.8*	*-0.9*	*-0.5*	*-0.5*	***-0.2***	***-0.4***	***-0.4***	***-0.4***	***-0.7***	***-0.7***	*-0.8*	***-0.5***	***-0.4***
Final Sales	2.3	1.5	2.4	2.0	**2.2**	**2.0**	**1.5**	**2.0**	**2.7**	**2.8**	1.9	**2.0**	**1.8**
ch. in bus. inventories	*-1.1*	*2.5*	*-0.4*	*-0.3*	***-0.2***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	*-0.2*	***0.2***	***0.0***
Unemployment, %	9.1	8.7	8.2	8.2	**8.2**	**8.1**	**8.0**	**7.9**	**7.7**	**7.6**	9.0	**8.2**	**7.8**
NF Payrolls, monthly, th.	128	164	226	67	**115**	**130**	**110**	**135**	**170**	**175**	153	**134**	**148**
Cons. Price Index (q/q)	3.1	1.3	2.5	0.8	**1.7**	**2.2**	**1.8**	**1.9**	**1.9**	**2.0**	3.0	**1.9**	**1.9**
excl. food & energy	2.5	1.9	2.1	2.6	**1.5**	**1.7**	**1.8**	**1.8**	**1.9**	**2.0**	2.2	**2.0**	**1.9**
PCE Price Index (q/q)	2.3	1.1	2.5	0.7	**1.3**	**1.9**	**1.7**	**1.8**	**1.8**	**1.9**	2.4	**1.8**	**1.7**
excl. food & energy	1.9	1.3	2.2	1.8	**1.3**	**1.7**	**1.7**	**1.8**	**1.8**	**1.8**	1.4	**1.7**	**1.7**
Fed Funds Rate, %	0.08	0.08	0.10	0.16	**0.15**	**0.15**	**0.15**	**0.15**	**0.16**	**0.17**	0.10	**0.14**	**0.16**
3-month T-Bill, (bond-eq.)	0.0	0.0	0.1	0.1	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	0.1	**0.1**	**0.1**
2-year Treasury Note	0.3	0.3	0.3	0.3	**0.3**	**0.3**	**0.3**	**0.3**	**0.4**	**0.5**	0.5	**0.3**	**0.4**
10-year Treasury Note	2.4	2.0	2.0	1.8	**1.6**	**1.6**	**1.6**	**1.7**	**1.8**	**2.0**	2.8	**1.8**	**1.8**

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