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Economic Research

Published by Raymond James & Associates

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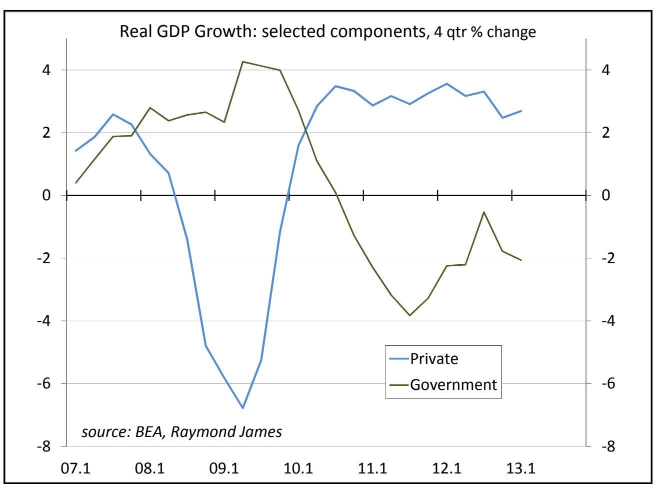
May 20, 2013

Monthly Economic Outlook

Moderate Growth in 2Q13, Better in the Second Half

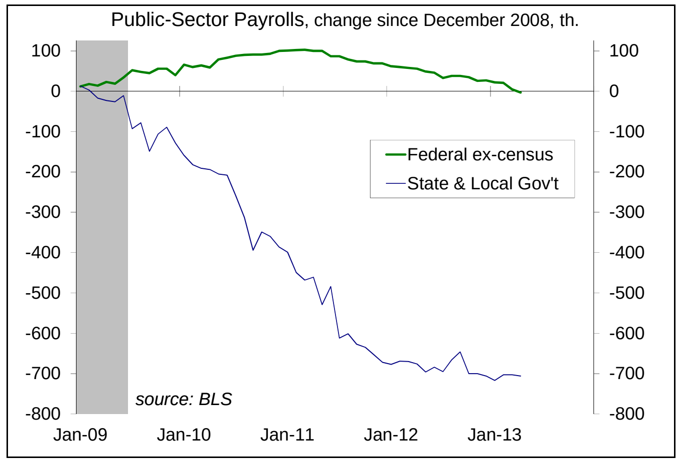
- *Recent economic data reports have been mixed, consistent with a moderate pace of growth in the near term.*
- *Job growth, while a bit uneven in recent months, has trended at a moderately strong pace – still far short of the "substantial improvement" that Federal Reserve officials are looking for.*
- *The Fed is still a long way from raising short-term interest rates. The current debate is about when to begin tapering the pace of asset purchases. Fed officials are uncomfortable with the asset purchase program, but the majority believes it has played an important role in the economic recovery.*

Real GDP rose at a 2.5% annual rate in the advance estimate for the first quarter. That figure will be revised a number of times, but the story isn't expected to change much. Consumer spending was stronger than anticipated at the start of the quarter. The two percentage point rise in the payroll tax did not appear to have had a major impact. However, that could be because many consumers were unaware that the tax had gone up (as many were unaware that the tax was lowered over the two previous years). Some reduced contributions to savings and retirement accounts, while others borrowed more to maintain spending levels. The top 20% of income earners, who account for about half of personal income and about half of consumer spending, have likely benefited from wealth gains in housing and equities. Spending in March was boosted partly by higher household energy consumption (cold weather). Consumer spending is expected to slow in 2Q13. Retail sales results for April were not as bad as feared, but far from strong.



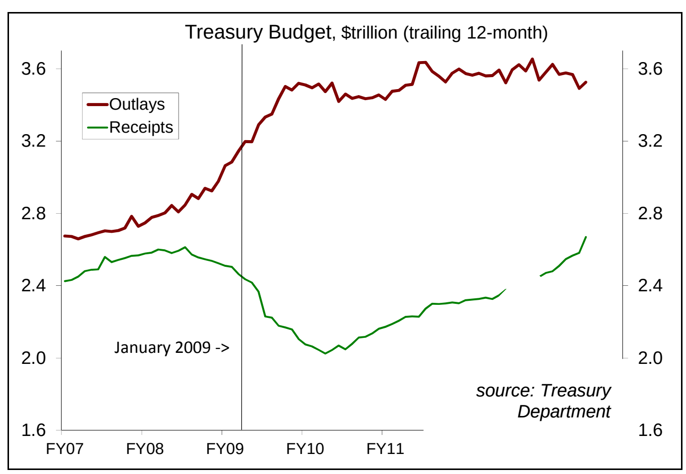
Real GDP Growth: selected components, 4 qtr % change

With headwinds fading, real GDP growth this year would likely have been in the 3.5% to 4.0% range. However, tighter fiscal policy (the payroll tax increase and sequester cuts in spending) is likely to subtract about 1.5 percentage points from growth. Tighter fiscal policy has been a significant impediment to the recovery, subtracting 0.6 percentage point per year from GDP growth over the last 10 quarters. About half of that reflects a contraction in state and local government. However, tax receipts are improving as the economy recovers. Strains in state and local government budgets will be less severe in the quarters ahead. However, job losses in the federal government are set to increase. Already, federal government payrolls are lower than they were at the start of the Obama administration.



Public-Sector Payrolls, change since December 2008, th.

The large deficits of a few years ago were due largely to the recession (an increase in recession-related spending, a drop in tax receipts). Federal spending is now trending flat or slightly lower (down 0.6% y/y for the first seven months of FY13). Tax receipts have picked up (up 15.9% y/y for the first seven months of FY13). The Congressional Budget Office has lowered its projection of the current fiscal year deficit by about $200 billion relative to projections made just three months ago, and is now expected to be just 4.0% of GDP. About half of the recent improvement is due to payments from Fannie Mae and Freddie Mac, which aren't expected to recur. However, the longer-term budget outlook has also improved.



Treasury Budget, $trillion (trailing 12-month)

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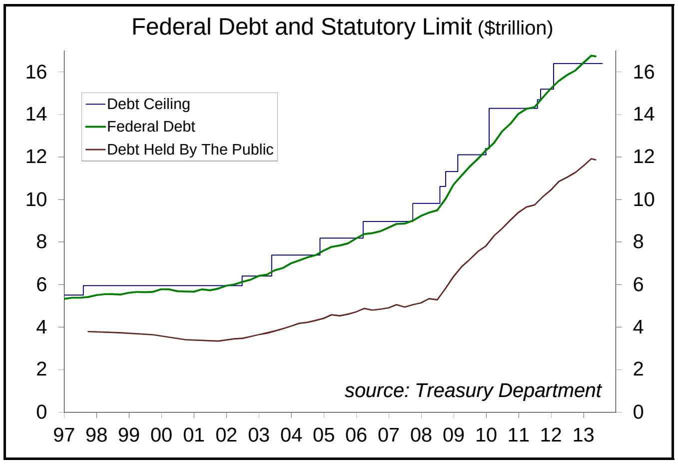
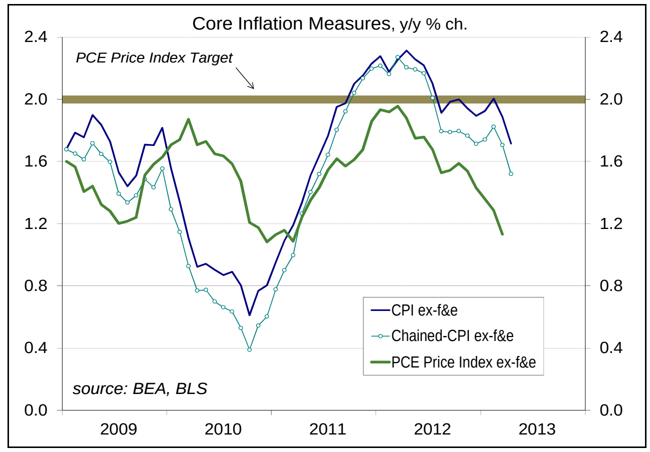


Recall that the federal debt ceiling was breached on December 31, 2012. The fiscal cliff deal waved the debt limit through February 15, and later extended that to May 19. The debt ceiling is now back in place. However, following the April budget surplus, Treasury appears to have enough maneuvering ability to fund the government through late July. We could see a showdown over the debt ceiling this summer (remember, the House and Senate typically take off the month of August). However, lawmakers are aware that the public is dissatisfied with "government by crisis" and business leaders largely blamed Congress for the heightened level of economic uncertainty ahead of the fiscal cliff deal late last year.

With fiscal policy in contractionary mode, monetary policy will continue to do the heavy lifting in the recovery. For the financial markets, the key issue is when the Fed will begin to taper the rate of asset purchases (unlike QE1 and QE2, QE3 is open-ended). Fed policymakers have a qualitative threshold for QE3 (*"substantial improvement"* in the labor market), but could reduce asset purchases on signs of excessive risk-taking.

Job market indicators have continued to suggest improvement, but the labor market is far from where the Fed wants it to be. Growth in nonfarm payrolls has been mixed in recent months, but the trend is moderately strong. Hiring rates and quit rates are trending somewhat higher, but are still much lower than what one would expect to see in a strong job market.



The large amount of slack in the economy, especially the labor market, should continue to restrain inflation pressures over the near term. The soft global economy has put downward pressure on commodity prices. Measures of consumer prices have trended lower in recent months.

Economic recoveries are usually uneven across time and across sectors of the economy. Consumer spending growth appears to have slowed, but that should prove to be temporary. Manufacturing gauges have been weak recently, suggesting a modest contraction in factory output. The stock market, perhaps willing to look ahead to better growth in the quarters ahead, has reacted positively to favorable economic figures, but has largely ignored the weaker data.

	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	2012	2013	2014
GDP (↓ *contributions*)	1.3	3.1	0.4	2.5	1.3	2.2	2.7	2.8	3.0	3.0	2.2	1.9	2.7
consumer durables	0.0	0.7	1.0	0.6	0.2	0.3	0.3	0.3	0.3	0.3	0.6	0.5	0.3
nondurables & services	1.1	0.5	0.3	1.6	0.8	1.2	1.5	1.5	1.5	1.5	0.7	1.0	1.4
bus. fixed investment	0.4	-0.2	1.3	0.2	0.5	0.7	0.9	0.9	0.9	0.9	0.8	0.5	0.8
residential investment	0.2	0.3	0.4	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.3
government	-0.1	0.8	-1.4	-0.8	-0.3	-0.3	-0.2	-0.1	0.0	0.0	-0.3	-0.5	-0.1
Domestic Final Sales	1.4	1.9	1.5	1.9	1.7	2.4	2.7	2.9	3.0	3.1	2.0	1.9	2.8
exports	0.7	0.3	-0.4	0.4	0.3	0.2	0.4	0.5	0.5	0.6	0.5	0.2	0.4
imports	-0.5	0.1	0.7	-0.9	-0.4	-0.4	-0.5	-0.6	-0.6	-0.7	-0.4	-0.3	-0.6
Final Sales	1.7	2.4	1.9	1.5	1.6	2.2	2.6	2.8	2.9	3.0	1.9	1.8	2.6
ch. in bus. inventories	-0.5	0.7	-1.5	1.0	-0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Unemployment, %	8.2	8.0	7.8	7.7	7.5	7.3	7.2	7.0	6.9	6.8	8.1	7.4	6.9
NF Payrolls, monthly, th.	108	152	209	206	160	165	180	190	200	200	183	178	200
Cons. Price Index (q/q)	1.0	2.1	2.2	1.4	-0.6	1.8	1.9	1.9	1.9	2.0	2.1	1.3	1.7
excl. food & energy	2.4	1.6	1.7	2.1	1.3	1.7	1.8	1.8	1.8	1.9	2.1	1.7	1.8
PCE Price Index (q/q)	0.7	1.6	1.6	0.9	-0.2	1.7	1.8	1.8	1.8	1.9	1.8	1.1	1.7
excl. food & energy	1.7	1.1	1.0	1.2	1.1	1.6	1.6	1.7	1.7	1.7	1.7	1.2	1.7
Fed Funds Rate, %	0.16	0.15	0.16	0.14	0.14	0.15	0.16	0.17	0.18	0.19	0.14	0.15	0.19
3-month T-Bill, (bond-eq.)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.2
2-year Treasury Note	0.3	0.3	0.3	0.3	0.2	0.3	0.5	0.7	0.8	1.0	0.3	0.3	0.9
10-year Treasury Note	1.8	1.6	1.7	2.0	1.8	1.9	2.0	2.1	2.2	2.2	1.8	1.9	2.2

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