Outlook for the Economy- First Quarter 2010

Real GDP rose at an annualized 3.2% rate in the first quarter of 2010, according to the advance estimate from the Bureau of Economic Analysis. Real GDP grew 5.6% in the fourth quarter of 2009 and has now increased for three straight quarters, offering confirmation that the recession ended last year. Consumer spending and business inventories both provided large positive gains in the first quarter. Consumer spending was driven by a pent-up demand but consumer fundamentals remain weak. With the unemployment rate moving back up to 9.9% and little growth in income, consumers are not able to sustain the type of robust spending normally seen in this stage of an expansion. Increased labor productivity with slow wage growth has enhanced profitability that will help increasing hiring, but risk aversion remains high. The latest sovereign debt crisis in Europe rekindled market fear and raised concerns over financial institutions holding massive amounts of country debt. Bailouts for banking institutions have now shifted from a concern over bad mortgages to bad sovereign debt. A potential silver lining is a low and manageable level of inflation. While specific prices, like oil, rise there is not enough demand across the board for a general increase in price levels. The absence of inflation allows the Fed to continue its easy money policy for the rest of the year.

The stimulation provided by the federal government is slowly fading and state and local budget cuts mean that overall government spending will be a negative for economic growth throughout 2010. Business investment in equipment and software remains a bright spot and will continue to expand as profitability improves, but business construction spending continues to decline because of excess space. Housing conditions are improving and mortgage rates remain low, but there is a long way to go before housing recovers fully.

The economy will expand over the next few quarters, but growth will be slow as the boost from inventories fades and job creation slowly makes a dent in the eight million plus jobs lost in the downturn. A lack of inflation pressure will provide room for continued monetary stimulus. The federal deficit will continue to rise as a new bailout for Fannie Mae and Freddie Mac takes shape and potential bailouts of state and local governments materialize. Interest rates at the longer term end of the yield curve should ease upward while Fed policies keep short term rates low. However, the expected increases in interest rates in the second half of 2010 will be less than expected as private sector demand develops more slowly. Corporate profitability will be good as low costs of labor continue in leaner restructured firms.

Inventory-Led Growth has Limits

The U.S. economy continues to expand but stronger consumer fundamentals are needed for a sustained recovery. The dependence on the inventory cycle for growth raises concerns about the near term. Inventories accounted for half the first quarter's growth and more than half in the previous quarter’s growth. With demand picking up, businesses are finally adding to their inventories. However, what matters for GDP growth is the “change in the change in inventories”, which is likely to be much smaller in the near term once higher inventory levels are set. Inventories will be a positive for near-term growth, but the contribution will be much smaller.

Consumer spending was a large positive for growth in the first quarter as consumers released some pent-up demand. However, with the labor market still soft and incomes barely growing, consumer spending should provide only small gains through most of this year until the labor market takes a decisive turn for the better late in 2010. The federal stimulus continues to provide a lift, but that is declining, and state and local budget cuts mean that overall government spending will be a negative for economic growth throughout 2010. Business investment in equipment and software remains a bright spot and will continue to expand as profitability improves, but business construction spending continues to decline because of excess space.

Near-term growth will weaken from its current pace set in the fourth quarter of 2009 and first quarter of 2010. Growth over the next three quarters is likely to be enough to keep pace with an expanding labor force. Unemployed and underemployed workers will move back into the labor force as the job market slowly improves. Job creation is not likely to keep pace with the strong first quarter performance. Even so, the unemployment rate should rise to 10% toward the end of this year as the higher labor participation rate overshadows new job creation. The best hope for a more normal recovery will be in 2011 if the housing market comes back around, larger job gains occur, the global economy expands, and credit flows improve. Under these conditions pent up demand and a healthy consumer may allow a more typical expansion. There are a lot of “ifs” in this scenario and many economists see a much longer time frame before a true expansion can occur. The biggest drags on confidence center on the intended and unintended consequences of proposed and enacted reforms of healthcare, financial regulation, environmental protection, and immigration.

Greece – Short Term Relief and Long Term Dilemma

When the potential for default on country debt of Greece increased the markets jumped on the fear factor by lowering equity values. The key concern is that there are a number of EU countries just behind Greece in terms of a serious inability to service massive debt. The ratio of debt to GDP in Greece, Spain, Portugal, and Italy is not sustainable. A default by Greece would serve as a contagion across EU countries. The markets recently rallied when the EU and the IMF structured a €750 billion bailout along with a continued commitment to support the debt of other

EU countries. The short term relief felt by the market due to the bailout plan translates to a dodged bullet - but the gun is still loaded. For now, country debt held by global financial institutions appears to hold its value. The cancer that was bad mortgage debt held by financial institutions now includes bad country debt.

The pattern of excessive government spending financed by country debt is not going away anytime soon. The austerity measures necessary to reverse the situation will be very unpopular in affected countries and will slow any recovery from the global recession. And, the trend of growing deficits based on entitlement "promises" is not unique to Europe. Even the U.S. has now reached a debt to GDP ratio in excess of 65% and will soon approach the same ratio that the markets believed to be unsustainable in Greece. Any plan to reverse the trend in country finance will require changing expectations for government spending and higher taxes. This combination is a formula for slower growth at a time when economies are trying to pull out of recessions. Long run solutions are needed, but for now the only known remedy is austerity and temporary bailouts.

Summary of Economic Data

GDP Growth and Production – *The economy is growing but at a slow pace for the early stages of a recovery. Industrial output and the value of shipments suggest that U.S. manufacturing is recovering. Productivity gains have accelerated, holding hiring in check. Even though capacity utilization is increasing, there is still a glut of capacity.*

- Real GDP grew 3.2% at an annualized pace in the first quarter of 2010 following more robust 5.6% increase in the fourth quarter of 2009. Table 1 summarizes GDP growth since the third quarter of 2008. On a year-ago basis, real GDP rose 2.5% in the first quarter. This is the largest year-over-year gain since the third quarter of 2007.

- Consumer spending and private inventory investment were the major contributors to growth. Trade and government spending were drags on the economy.

Table 1. Real GDP Growth – Third Quarter 2008 through First Quarter 2010

	I Q 2010	*IV Q 2009*	*III Q 2009*	*II Q 2009*	*I Q 2009*	*IV Q 2008*	*III Q 2008*
Real GDP Growth	3.2	5.6	2.2	-0.7	-6.4	-5.4	-2.7

Source: Bureau of Economic Analysis

- Construction spending for March was higher than expected, coming in 0.2% above the revised February total. Private construction spending fell 0.9% below February totals, as residential construction led the decline with a 1.1% drop from February. The decline in private construction spending was overcome by the growth in public sector spending.

- Industrial production increased 0.1% in March, the smallest of nine consecutive monthly gain.

- Overall manufacturing shipments rose nearly 9% in value since their peak in the second quarter of 2009. Although different industries hit bottom at various times, most hit cyclical lows for shipments around the middle of last year.

- New orders bottomed out at the end of the first quarter of 2009 and have increased 12% since that time.

- Unfilled orders fell until the end of last year and have since grown slowly.

- Overall, physical production increased over 5% in this early expansion. Interestingly, measured by physical production instead of values, durable goods have gained 8%, compared with 3% for nondurables.

- Since the cyclical low, the Federal Reserve's overall capacity utilization rate has increased by over 4 percentage points, to 73% in February. This rise has not yet strained capacity and leaves a lot of room for a recovery of the 12-percentage point peak-to-trough decline.
- Excess capacity exists across the board. The durable goods capacity utilization rate is only 63% and the nondurables industry is only 75%.

- Nondurable goods production has less excess capacity (utilization rate exceeding 75%). All nondurables-producing industries other than printing and textiles have utilization rates exceeding 70%. In petroleum products more than 80% of available capacity is in use, suggesting that there is some pricing power.

Labor Market and Employment Costs - *The labor market is in a slow transition and it is not expected to show significant improvement until the second half of this year. Even as new jobs are added, the unemployment rate is likely to rise since increases in labor force participation offsets higher new job growth. The considerable labor market slack is enabling employers to keep a line on wage increases.*

- In terms of increased number of jobs, the labor market had its best month in three years in April. The increase of 290,000 in nonfarm employment was higher than expected. Even so, the increased labor force participation rate led to an increase in the unemployment rate to 9.9%. Table 2 summarizes monthly employment data since September of 2009.

- Revisions to the number of jobs created in the past months and April's surge in private employment suggest that firms are adding resources to meet strong demand growth. The unemployment rate rose and average hourly earnings stalled, but an increase in the workweek helped power a rise in household labor income.

- The change in total nonfarm employment for February was revised from -14,000 to 39,000, and the change for March was revised from 162,000 to 230,000.

- Private services added 166,000 jobs in April, including 26,000 in temporary help services. Temporary employment is up by 35% at an annual rate over the past six months, signaling a shift toward more labor demand.

Table 2. Unemployment Rate and Workforce Data – September 2009 through March 2010

	Apr. 2010	Mar. 2010	Feb. 2010	Jan. 2010	Dec. 2009	Nov. 2009	Oct. 2009	Sep. 2009
Unemployment Rate (%)	**9.9**	9.7	9.7	9.7	10.0	10.0	10.1	9.8
Average Workweek (Hours)	**33.4**	33.3	33.1	33.3	33.2	33.2	33.0	33.1
Labor Force Participation Rate (%)	**65.2**	64.9	64.8	64.7	64.6	64.9	65.0	65.1
Average hourly earnings, % change	**0.3**	-0.1	0.1	0.3	0.3	0.1	0.4	0.1
Average workweek, hrs	**33.4**	33.3	33.2	33.3	33.2	33.2	33.0	33.1

Source: Bureau of Labor Statistics

- Over the past year, average hourly earnings increased by only 1.8%.

- At 20 weeks, the median duration of unemployment is the highest on record. A large proportion of unemployed workers have been out of work for long periods of time, making it more difficult to get them back into the labor market.

- Employer costs rose 0.6% in the first quarter of 2010. Growth was driven by a 1.1% expansion of benefits—the smaller of the two components of the index. Wages and salaries, the larger component, added 0.4%, down slightly from the prior period. Even though employer costs picked up in the first quarter, the growth in the current quarter is still consistent with the overall trend of slow wage growth throughout the year. Table 3 summarizes the percentage change in the employer cost index since the third quarter of 2008.

Table 3. Employer Cost Index – Third Quarter 2008 through First Quarter 2010

	I Q 2010	*IV Q 2009*	*III Q 2009*	*II Q 2009*	*I Q 2009*	*IV Q 2008*	*III Q 2008*
% Change in Employer Cost Index	0.6	0.4	0.4	0.4	0.4	0.4	0.6

Source: Bureau of Labor Statistics

- Wage growth is likely to be constrained by a weak labor market as payrolls are still 8.2 million below their 2007 peak. Even without natural growth in the labor market, it will take over two years to replace the lost jobs even with the robust job growth experienced in April.

- Initial claims for unemployment insurance decreased by 11,000 to 448,000 for the week ending April 24. Initial claims have declined in two consecutive weeks following an Easter-related bump higher. Continuing claims decreased by 18,000 to 4.645 million for the week ending April 17.

- Initial claims for unemployment insurance decreased to 448,000 for the week ending April 24 from 459,000. This brings the four-week moving average to 462,500, from 461,000 previously.

- The labor market is slowly improving but initial claims will need to be in the 350,000 to 400,000 range for the labor market to stabilize.

- Productivity growth for the fourth quarter of 2009 was revised upward to 6.9% compared to the 6.2% growth in the preliminary release. The revision was due to a larger gain in output and a smaller increase in aggregate hours. Profits will increase as productivity growth is strong, inflationary pressures remain low, and labor costs remain low. Table 4 provides a summary of productivity, compensation, and unit labor costs since the third quarter of 2008.

Table 4. Productivity and Unit Labor Costs

	IV Q 2009	*III Q 2009*	*II Q 2009*	*I Q 2009*	*IV Q 2008*	*III Q 2008*
Output Per Hour	6.9	7.8	7.6	0.9	2.2	1.1
Compensation per Hour	0.6	-0.4	7.7	-4.2	4.5	6.0
Unit Labor Costs	-5.9	-7.6	0.1	-5.0	2.2	4.9

Source: Bureau of Labor Statistics

- From the fourth quarter of 2008 to the fourth quarter of 2009, unit labor costs fell 4.7%. This is the largest year-over-year decline in the history of the series, going back to 1948.

Consumer Credit – *consumers pay off debt*

- Consumer credit fell 5.6% at an annualized rate in February. Revolving credit led the decline, falling at an annualized rate of 12.3%. Consumer borrowing is not likely to pick up until income growth and job creation accelerates.

- Nonrevolving credit balances also declined in February, falling at a 1.6% annualized rate.

- Consumer credit outstanding increased by $2 billion in March to a total of $2.451 trillion, but this was only the second monthly increase over the past 12 months. Consumer credit balances have been steady so far this year after falling throughout 2009.

- Total credit increased at an annualized rate of 1% in March, while the sharp drop initially reported in February was revealed to be less severe after revisions. Steady growth in retail sales underpinned demand for revolving credit, even though many consumers are still reducing their credit card balances

Sentiment and Confidence - *confidence and sentiment are low for an expansion stage.*

- The University of Michigan consumer sentiment index fell 1.4% in April. The index has gone three months without an increase. The Michigan index shows no upward trend and remains in a range that has persisted for about a year. Monthly movements in the Michigan index appear in Table 5 below.

Table 5. University of Michigan – Monthly Consumer Sentiment Index

	Apr 10	Mar 10	Feb 10	Jan 10	Dec 09	Nov 09	Oct 09
Index	72.2	73.6	73.6	74.4	72.5	67.4	70.6
Change in the Index	-1.4	0.0	-0.8	1.9	5.1	-3.2	-2.9

Source: University of Michigan

- The Conference Board index of consumer confidence surged in April, but confidence remains very low. Improvement was widespread across survey questions, although the income outlook remains weak. Confidence remains mired at levels consistent with a recession. Monthly levels of the Conference Board's index appear in Table 6.

Table 6. Conference Board Index of Consumer Confidence – Monthly Index

	Apr 10	Mar 10	Feb 10	Jan 10	Dec 09	Nov 09	Oct 09
Index	57.9	52.3	46.4	56.5	53.6	50.6	48.7

Source: Conference Board

- The Conference Board index of leading indicators rose for a 12th consecutive month, increasing 1.4% in March. Since bottoming in March, the leading index gained an impressive 12%. The leading index was 11.9% higher on a year-ago basis. This is the fastest year-ago growth rate seen since the 1980s.

Inflation – *the economy remains too weak for inflation pressures.*

- Consumer prices measured using the personal consumption expenditure price index rose 1.5% annualized in the first quarter following a 2.5% increase in the fourth quarter. The core PCE deflator, which excludes food and energy prices, was up just 0.6% at an annualized rate in the first quarter, down from 1.8% inflation in the previous quarter.

- Based on the GDP price deflator, prices increased at a 0.9% annualized rate in the first quarter, after a 0.5% increase in the fourth quarter of last year. Table 7 shows annualized rate of change in the GDP deflator for each quarter since the third quarter of 2008.

Table 7. GDP Price Deflator – Third Quarter 2008 through First Quarter 2010

	I Q 2010	*IV Q 2009*	*III Q 2009*	*II Q 2009*	*I Q 2009*	*IV Q 2008*	*III Q 2008*
Implicit Price Deflator (annualized rate)	0.9	0.5	0.4	0.0	1.9	0.0	4.1

- The top-line CPI for urban consumers increased by 0.1% in March after a seasonal adjustment. Most of the increase was due to a high rate of increase in fruit and vegetable prices. The core CPI stayed level in March. Monthly data on the CPI and core CPI appear in Table 8.

Table 8. Consumer Price Index – Monthly and Year-Ago % Change

	Mar. 2010	**Feb. 2010**	**Jan. 2010**	**Dec. 2009**	**Nov. 2009**	**Oct. 2009**	**Sep. 2009**
Monthly CPI % Change	0.1	0.0	0.2	0.2	0.2	0.2	0.2
Monthly Core CPI % Change	0.0	0.1	-0.1	0.1	0.0	0.2	0.2
Year Ago CPI % Change	2.4	2.2	2.7	2.8	1.8	-0.2	-1.3
Year Ago Core CPI % Change	1.2	1.3	1.5	1.8	1.7	1.7	1.5

Source: Bureau of Labor Statistics

- The top-line CPI for urban consumers (CPI-U) for March came in at 217.6, a 0.1% increase from its revised February level and up by 2.4% from March 2009, before the seasonal adjustment.

- The core CPI for March came in at 221.1, holding steady from the previous month, and up by 1.2% from March 2009, before the seasonal adjustment.

- While some service prices like medical care and durable goods such as cars and trucks posted slight increases in price during March, overall inflation in core prices is still abnormally low and continues to point to a weak economy.

- Producer prices for finished goods rose 0.7% in March, some of it accountable by firming food prices which rose 2.4%. Table 9 shows the monthly and year ago changes in the producer price index for finished goods. Producer prices are higher on a year ago basis.

After stripping out food and energy, core prices for finished goods were up marginally by 0.1%. Core prices for intermediate goods as well as crude goods advanced in March.

- Excluding food and energy products, core prices for finished goods edged up 0.1% over the month and 0.9% on the year.

Table 9. Producer Prices for Finished Goods – Monthly and One Year Ago % Changes

	March 2010	Feb. 2010	Jan. 2010	Dec. 2009	Nov. 2009	Oct. 2009	Sept. 2009	Aug. 2009
Monthly % Change	0.7	-0.6	1.4	0.6	1.6	0.2	-0.5	1.5
Year Ago % Change	6.1	4.6	5.0	4.7	2.3	- 2.1	- 4.8	- 4.3

Source: Bureau of Labor Statistics

Housing – *prices are stabilizing but there is a long way to go.*

- Pending home sales ended higher in February, with an 8.2% gain over the level in January. The increase, which was the single largest percentage gain recorded since late 2001, brought the national index back up to a level of 97.6, on par with its level during December.

- On a year-ago basis, the 20-city composite house price index rose by 0.6% during the three months ending in February. This was the first year-ago gain recorded by the index since December 2006 and is a reflection of the improvement in house prices that occurred during the second half of last year. The 10-city composite increased by 1.43% on a year-ago basis in February.

- Sales of new homes increased by 26.9% in March. At an annualized 411,000 units, sales are back up to where they were last summer. Nevertheless, sales are still running far below the 2008 pace. First quarter sales fell at an annualized 14% rate below the fourth quarter of last year.

International – The *U.S. trade deficit gets worse. The focus is on global debt bailouts to prevent a crisis in country debt and insolvency of banks holding that debt. A correction of excessive spending and growing deficits must take place in exchange for bailouts from the IMF and Euro zone countries, but the transition will be unpopular at home.*

- Exports increased by less than 1% to $143.2 billion in February, while imports increased 1.7% to $182.9 billion.

- The trade deficit in goods widened 3.9% to $51.3 billion in February, while the trade surplus in services narrowed 6.8% to $11.6 billion. The real trade deficit widened 3.7%

to $42.5 billion in February, while real gross exports rose by less than 1% to $90.2 billion, and real gross imports rose 1.7% to $132.7 billion.

- Net imports of petroleum in February widened 1.6% to $22.9 billion, while both gross exports and gross imports of petroleum rose from January's level. Crude oil sold for an average of $76.42 per barrel in February, 2.3% lower than the January average of $78.22 per barrel.

- The trade deficit with Canada, the U.S.'s largest trading partner, narrowed 28.4% to $2.8 billion in February. The trade deficit with Mexico, the U.S.'s second largest export destination and third largest import source, widened 3.2% to $4.8 billion.

- The trade deficit with China narrowed 9.8% to $16.5 billion, and the trade deficit with Japan widened 28.3% to $4.3 billion.

- Fear of a contagion of sovereign debt default in the Euro zone, starting with Greece, prompted a recent bailout plan of €750 billion. The EU bailout designed to rescue euro zone economies in financial trouble should restore market confidence and prevent the Greek debt crisis from spreading across Europe. The required cuts in government spending and fiscal responsibility conditions necessary in the troubled countries will have other consequences that will slow EU growth. Domestic and political unrest from fiscal austerity in countries with entitlement expectations will also lead to uncertainty in global investing.

Fed Policy- *low inflation will allow the Fed to stand by the current policies of low short term rates and cheap liquidity for banks.*

- The Federal Open Market Committee announced a policy of "status quo." There are no immediate plans to target higher interest rates. The Fed will continue to provide liquidity through open market operations that buy government securities. The FOMC said it will keep the fed funds rate target in the 0% to 0.25% range. The wording in the FOMC minutes is unchanged from the committee's seven previous releases, going back to June 2009.

- FOMC minutes point to new information of further strengthening in the economy. The view on the labor market switched from "stabilizing" to "improving. Positive data included higher household spending, stronger business investment in equipment and software, a slight increase in housing starts, and better financial market conditions.

- On the negative side, the FOMC minutes reported a number of constraints on growth, including the high unemployment rate, weak income growth, reduced housing wealth, and tight credit. The statement noted that business investment in structures is falling, housing starts—while improving—are still very low, and businesses are still reluctant to hire.

- The FOMC report predicted a moderate recovery with a gradual return to higher levels of activity with price stability. This is the same view expressed in the two previous statements. There is little concern about inflation given the amount of slack in the economy.