

Economic and Market Points

April 11, 2011

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2011 Outlook

GDP GROWTH:
3.2%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

First, what happened in 2010?

- During the last three quarters of 2010, economic growth accelerated, in our opinion, due specifically to the wealth effects of the Fed's QE2 program and the tax law changes effected in December 2010. From the second quarter of 2010 to the fourth, domestic Gross Domestic Product (GDP) growth rates were 1.7 percent, 2.6 percent and 3.1 percent (full-year 2.7 percent).
- Personal consumption expenditure growth rates rose from 2.2-to-4.0 percent during the last three quarters of 2010 (full year 2.6 percent).
- Nonresidential fixed investment spending was robust for much of the year, ending at a 10.6 percent growth rate for all of 2010.
- Consumer Price Index (CPI) (core) was steady, ranging from 0.8-to-0.6 percent during the last three quarters of 2010. The Fed is targeting two percent core CPI levels. Headline CPI rose from -0.5 to +2.6 percent during the last three quarters of the year. It appears *headline* inflation is running at roughly a five percent annualized rate during the first quarter of 2011.
- Interest rates were reasonably flat for the last three quarters of last year.
- Real disposable income rose by 2.4 percent during 2010.

Where are we now? What has been happening lately?

- It appears first quarter GDP will be released at roughly 2.1 percent growth (as compared to 3.1 percent growth for Q4 2010). Prior to this report, many market pundits had increased their expected GDP growth rate to the *high-3s* level – now those levels are being reined in. Our outlook has been calling for an expected GDP growth rate of 2.9-to-3.5 percent for the year 2011. **We now feel comfortable narrowing that forecast to the 2.9-to-3.2 percent level.**
- These revisions are being driven by demand drags due to rising oil prices and fundamental uncertainties which are being exacerbated by events in Middle East and North Africa, Europe and Japan. Domestically, we have seen a series of disappointments regarding sales and pricing within the housing markets. Are we headed towards another dip in values? Consumer and business sentiment measures have been soft, which may be a reflection of a **lack of willingness to transact.**

- Personal consumption growth rates appear to have decelerated to the 1.5-to-2.0 percent level from the 3.0 percent range during the second half of 2010. Reflection of this significant lowering in consumption patterns can be seen in the recent consumer sentiment surveys. The latest Survey of Consumer Confidence came in at 63.4, down a whopping 8.6 points in one month. This volatile index is certainly showing signs of weakness. For the full 12 months, however, the index is still up.
- Nonresidential fixed investment growth rates are taking a breather. It appears this series may experience a decline in growth from the nine percent level to something around 2.0-to-3.0 percent. The CEO Confidence Survey was recently up 12 points and the Small Business Optimism Survey was up to 94.1, but still below the needed neutral state of 100. With this in mind, and the continued strong showing in corporate profits and huge cash-on-hand positions for many companies, we continue to believe capital spending plans remain robust.
- If we are correct in our assumption of GDP growth now registering 3.0 percent in 2011, we need to look at projected productivity gains to gauge potential improvement in the employment picture. We expect productivity to increase by a slightly lower rate than in 2010 (+1.8 percent versus +2.0 percent). Given the spread between productivity and GDP (with remainder being made up by increase in the employed workforce), we can gauge potential improvements in hiring plans. We may see an average job creation level of 150,000-to-200,000 jobs per month going forward, up from an average of 90,000 during the last number of months. However, we need to create 140,000 jobs per month to actually break even with population growth.
- Given the analysis, it is hard to understand why job creation will make a major upside move for much of this year. We expect the unemployment rate to remain in the "8s" for the remainder of the year, and depending on the denominator in the calculation, we may see the official unemployment rate *burp* back into the "9s."
- This will effect consumption and final demand. Expect lower-than-normal growth rates to prevail for much of the year for consumer final demand.
- Economic growth deceleration is now becoming the norm on a worldwide basis. Indeed, upwards of 10.0-to-12.0 percent of the world's economy is, or will probably soon be, back in recession. Japan, United Kingdom, other smaller European states and various countries in Africa are suffering this economic fate. This was not the case 60 days ago. Additionally, two of the world's economic growth engines (China and India) are attempting to engineer growth contractions, due to increasing concerns of rising inflationary pressures. It appears the world in general is experiencing a growth slowdown.
- Finally, domestic corporate profits should grow in the 7.0-to-10.0 percent range for 2011, given our newly revised GDP growth forecast.

What does this mean for interest rates, inflation and financial asset prices?

- **Inflation.** We believe Ben Bernanke will get his wish: Core inflation will probably accelerate throughout the year. We are forecasting core inflation in the 1.5-to-2.0 percent level by the end of 2011.
- **Interest rates** should rise, slowly. We expect the 10-year treasury to yield above 4.0 percent by the end of the year, with Fed Funds rate in the 0.2 percent level.

- **Stock values.** While QE2 is operative, we expect stock prices should remain firm. However, we believe due to weakening economic momentum on a worldwide scale being the rule of the day, rather than simply an offshoot, that equity markets eventually may swoon later in 2011. We are staying with our forecasted trading range of 1400-to-1125 for the S&P 500 index.



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