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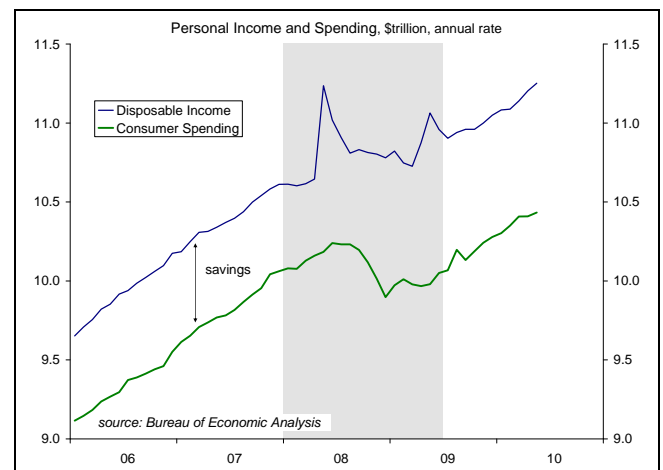
Monthly Economic Outlook

A Moderate Outlook, But Downside Risks

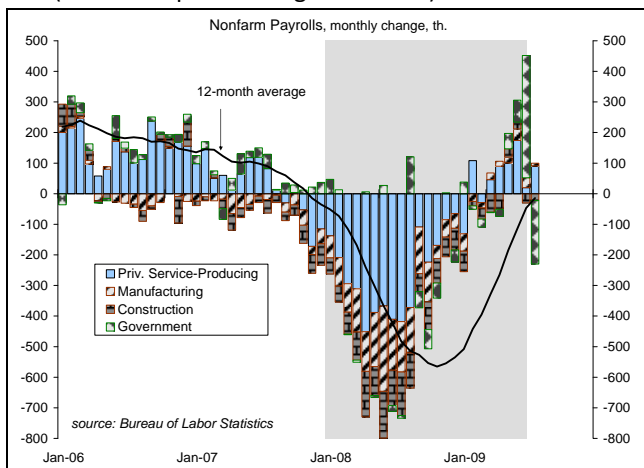
- Recent economic data reports have generally been on the soft side of expectations, consistent with moderate growth.
- The outlook for 2H10 economic growth has softened over the last few months. A double-dip recession appears unlikely, but the risks to the growth outlook are tilted to the downside.
- If needed (the recovery falters more significantly), there is limited scope for further monetary and fiscal policy stimulus.

Real Gross Domestic Product rose at a 2.7% annual rate in the 3rd estimate for 1Q10 (down from 3.2% in the advance estimate and 3.0% in the 2nd estimate). The advance estimate of 2Q10 GDP growth will be reported (along with annual benchmark revisions) on July 30. Recent data suggest about a 2.0% to 3.0% annual rate of growth in underlying demand in 2Q10. That's not enough to push the unemployment rate down by much. The outlook for the second half of the year is moderate, but somewhat softer than was expected a couple of months ago. The economy continues to face a number of headwinds: lingering problems in residential and commercial real estate, contractionary fiscal policy at the state and local level, tight credit for small firms (and a reluctance to borrow). Uncertainty about tax policy also appears to be a dampening factor (or at least provides a good excuse).

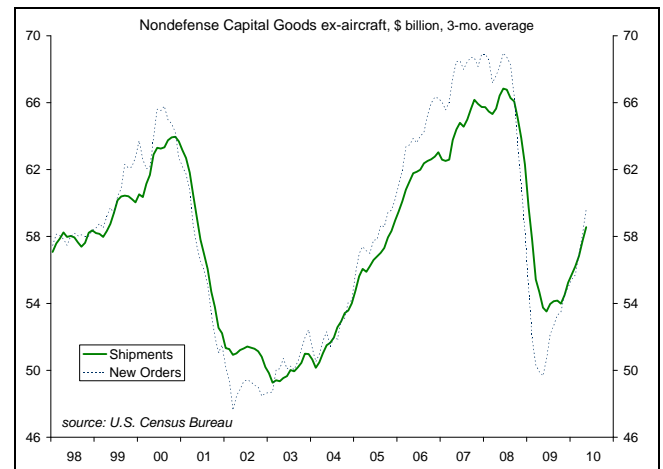
The June Employment Report indicated some softness in aggregate wage income last month, but the trend has been higher this year (private-sector wage and salary income rose 2.1% in the first five months of the year). The savings rate dipped to 3.3% in March, but rose to 4.0% in May, which may account for some of the more recent softening in consumer spending growth (note: these figures will undergo annual benchmark revisions on August 3). Savings could continue to creep higher in the near term, dampening the pace of spending growth. Consumer confidence fell sharply in June, apparently reflecting an impact from the Gulf oil spill (figures were down sharpest in the Gulf region). Unit sales of motor vehicles slowed in June (still up 2Q10-over-1Q10).



Business fixed investment appears to have remained mixed. Orders and shipments of nondefense capital goods ex-aircraft have continued to trend higher. Spending on business structures has declined further, but the pace of retreat seems to be less steep. The inventory correction has run its course. Industrial production has continued to improve (except for offshore drilling activity). Credit remains tight for small businesses and there is some reluctance to take on added debt.

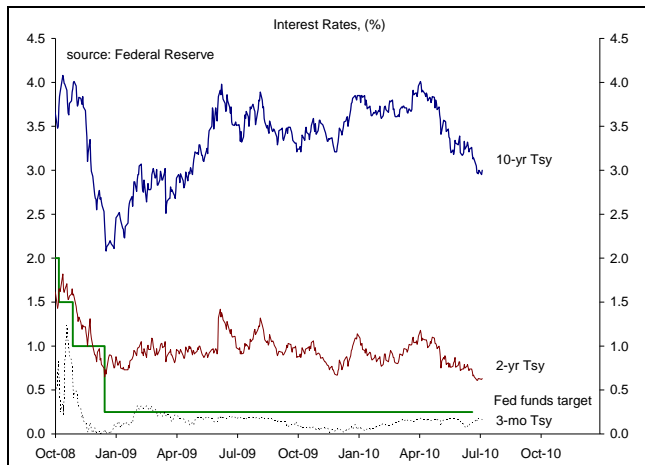


Nonfarm payrolls fell by 125,000 in June, reflecting a 225,000 decrease in temporary census jobs (that leaves 339,000 census jobs to be shed mostly in the next few months). Private-sector payrolls advanced by 85,000, up by 593,000 since December – not horrible, but disappointing. We lost 8.4 million jobs from December 2007 to December 2009 and we need about 130,000 to 150,000 jobs per month just to absorb the growth in the working-age population. Government normally provides some stability in tough economic times. However, facing severe budget strains, state and local governments have shed 154,000 jobs (-0.8%) over the last 12 months and the U.S. postal service has lost 54,000 (-7.2%).



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The European debt crisis and downward revisions of near-term growth expectations have put a Fed rate increase further out in the future, most likely not until the second half of 2011. Having exhausted conventional policy stimulus more than a year and a half ago, the Fed could resume its program of quantitative easing (buying mortgage-backed securities or long-term Treasuries). However, long-term interest rates are already extremely low, so it's not clear what that would accomplish. Reportedly, Fed officials are considering other options, which would likely meet some opposition from the more hawkish FOMC members. The first volley would be verbal. The Fed could promise to keep rates low for a longer period. It could also lower the interest rate that the Fed pays on bank reserves held at the Fed (currently 0.25%).



Long-term interest rates have dropped significantly in a flight to safety following the European debt crisis and reduced expectations for U.S. economic growth. Importantly, low long-term interest rates should aid the recovery. Mortgage rates are at a record (39-year) low.

With conventional monetary policy at its limit, the economy would benefit from a further dose of fiscal stimulus. Unfortunately, the public mood and the sentiment in Congress are set against it. Near-term worries about the federal budget deficit are misguided. The bigger problems lie 10 to 20 years out, as Medicare costs are projected to rise sharply. It's important that lawmakers come up with a credible plan to reduce the budget deficit (as a percentage of GDP) over time. However, acting too soon, or failing to come up with further stimulus if it's needed, puts the recovery at risk. There's no sign that large government deficits are crowding out private borrowing and government borrowing costs are very low. Austerity measures in Europe are likely to dampen the pace of the global economic recovery to some extent in 2011.

As it stands now, the federal fiscal stimulus will ramp down in 2011 and the Bush tax cuts are set to expire at the end of this year. Congress doesn't have to do anything to raise taxes. It will take a bipartisan effort *not* to raise taxes. The Obama administration wants higher taxes only at the high end of the income scale (the top marginal tax rate and the capital gains tax rate for upper income households), but would likely be willing to extend the Bush taxes or phase them out over time. Nobody likes paying taxes, and the specter of higher tax rates is widely cited by businesses large and small as *the* key concern in the economic outlook. However, taxes haven't gone up yet, and it's hard to imagine how a return to the tax rates of the late 1990s would be that detrimental to economic growth (as one recalls, growth in the 1990s was pretty strong).

It's difficult to gauge the impact of psychology on the economy. A few months ago, it appeared that positive feedback loops were beginning. That's still possible, but negative business and consumer attitudes could dampen the pace of the economic recovery in the second half of the year.

	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	2009	2010	2011
GDP (↓ contributions)	-0.7	2.2	5.6	2.7	2.2	2.3	2.3	2.4	2.7	3.3	-2.4	2.8	2.6
<i>consumer durables</i>	-0.4	1.4	0.0	0.8	0.9	0.2	0.3	0.3	0.3	0.4	-0.3	0.6	0.3
<i>nondurables & services</i>	-0.2	0.6	1.1	1.3	1.1	1.7	1.7	1.6	1.6	1.8	-0.1	1.1	1.6
<i>bus. fixed investment</i>	-1.0	-0.6	0.5	0.2	0.5	0.5	0.5	0.5	0.6	0.7	-2.2	0.2	0.5
<i>residential investment</i>	-0.7	0.4	0.1	-0.3	0.3	0.4	0.3	0.3	0.4	0.4	-0.7	0.1	0.3
<i>government</i>	1.3	0.6	-0.3	-0.4	-0.3	-0.3	-0.2	-0.2	-0.1	0.1	0.4	-0.1	-0.1
Domestic Final Sales	-0.9	2.3	1.4	1.6	2.4	2.6	2.6	2.4	2.7	3.4	-2.8	1.9	2.7
<i>exports</i>	-0.5	1.8	2.4	1.3	0.7	0.7	0.7	0.7	0.7	0.7	-1.2	1.2	0.7
<i>imports</i>	2.1	-2.6	-2.1	-2.1	-1.1	-0.9	-0.9	-0.7	-0.8	-0.8	2.2	-1.5	-0.8
Final Sales	0.7	1.5	1.7	0.8	2.1	2.3	2.4	2.4	2.7	3.3	-1.7	2.6	2.7
<i>ch. in bus. inventories</i>	-1.4	0.7	3.8	1.9	0.1	0.0	0.0	0.0	0.0	0.0	-0.7	1.2	0.0
Unemployment, %	9.3	9.7	10.0	9.7	9.7	9.7	9.7	9.6	9.5	9.3	9.3	9.7	9.4
NF Payrolls, monthly, th.	-477	-261	-90	87	207	14	116	100	135	170	-395	106	148
Cons. Price Index (3 mo)	3.7	2.5	2.5	0.9	-0.8	1.7	1.7	1.7	1.7	1.8	2.8	0.9	1.8
<i>excl. food & energy</i>	2.2	1.4	1.3	-0.2	1.1	1.2	1.3	1.4	1.4	1.5	1.8	0.9	1.5
PCE Price Index (q/q)	1.4	2.6	2.5	1.6	0.6	1.4	1.6	1.6	1.6	1.6	0.2	1.6	1.5
<i>excl. food & energy</i>	2.0	1.2	1.8	0.7	1.0	1.2	1.2	1.3	1.3	1.4	1.5	1.2	1.3
Fed Funds Rate, %	0.18	0.15	0.12	0.13	0.19	0.21	0.23	0.24	0.25	0.58	0.16	0.19	0.55
3-month T-Bill, (bond- <i>eq.</i>)	0.2	0.2	0.1	0.1	0.1	0.2	0.3	0.3	0.4	0.7	0.2	0.2	0.7
2-year Treasury Note	1.0	1.0	0.9	0.9	0.9	0.7	1.2	1.8	2.2	2.4	1.0	0.9	2.2
10-year Treasury Note	3.3	3.5	3.5	3.7	3.5	3.2	3.5	3.7	3.9	4.1	3.3	3.5	4.0