FORECAST FLASH

MAY 2011

Conflicting Signals

The economy slowed in the first quarter, in GDP terms, at the same time that job creation accelerated, the unemployment rate fell sharply, and survey evidence was buoyant, especially from manufacturing. We believe that the economy had more momentum in the first quarter than the GDP figures showed, so GDP should do better in the second quarter. But underlying momentum is moving in the opposite direction to GDP—labor market evidence and business surveys are now weakening. Our forecast anticipates that the current soft patch represents another bump in the road on a prolonged and subdued recovery, rather than a more serious breakdown. But downside risks have become more troubling. Overall, our growth forecasts remain in the high-2% range for this year and next, at 2.7% in 2011 (down from 2.8% last month) and 2.9% in 2012 (as before).

The First-Quarter GDP Slowdown. Fortunately, the first-quarter GDP report showing just 1.8% growth was not as bad as it looked on the surface. There were a number of temporary factors restraining growth, including unusually bad weather (which hurt construction) and a plunge in defense spending that will likely prove temporary. Indeed, defense spending and private structures spending combined took 1.4 percentage points off the GDP growth rate. We think that manufacturing production (up 9.1% in the first quarter, compared with 3.5% in the fourth quarter) was a better guide to momentum.

Second Quarter Has Less Momentum, But Will Probably Show Faster GDP Growth. Underlying momentum has slowed, as surging commodity prices have taken their toll on consumer spending power, and possibly now on business hiring intentions. But we still expect second-quarter GDP growth to beat first-quarter growth (3.3% versus 1.8%), as the unusual factors that held down the first quarter unwind. Construction spending should increase along with the arrival of more-normal weather, and we expect much of the plunge in defense spending to be reversed. The GDP bounce would be bigger still but for the supply-chain problems that will temporarily disrupt domestic vehicle production.

The Second Half Is the Big Question Mark. Our growth forecast for the year remains heavily back-loaded, with 3.5% growth (on average) expected for the second half of the year, after 2.5% growth in the first half. That improvement rests on several factors, including a return to normal levels of production in the vehicles sector by year-end, the beginnings of upturns in both residential and nonresidential construction, and a temporary acceleration of business equipment spending to lock in full expensing before depreciation allowances become less generous next year.

Oil and Commodity Prices Crucial. The second-half improvement is also conditional on an easing in oil prices back to around the $100/barrel mark (West Texas Intermediate), from recent levels of $110-115/barrel. We also anticipate some easing for food and other commodity prices. At the time of writing (late afternoon on May 5), we have effectively seen that oil price fall occur in just one day. Fears over growth generated by signs of a slowing labor market, plus a surge in the dollar generated by a less-hawkish-than-anticipated European Central Bank, drove that price adjustment. To the extent that surging commodity prices were threatening to throttle the expansion, it's good news to see them lower. The primary downside risk to our forecast is if commodity prices have fallen so sharply because the economy has lost more momentum than it appeared.

Fed to Stay the Course on QE II; No QE III. Chairman Bernanke has made clear that the Federal Reserve will stay the course on the QE II program, but that the Fed has no plan to launch a QE III. During the second half of this year, we assume that the Fed will make gradual preparations for the first interest rate hike sometime in the first half of 2012. But we see no reason for haste, especially with the latest news softer for both growth and commodity prices.

A Quick Look at the Numbers
(Annual rates)

	Quarterly				Annual				
	11:1	11:2	11:3	11:4	2010	2011	2012	2013	2014
Real GDP (Percent change)	1.8	3.3	3.2	3.8	2.9	2.7	2.9	2.8	3.3
Federal Funds Rate (Percent)	0.16	0.13	0.16	0.20	0.18	0.16	1.28	3.43	3.62
Ten-Year Treasury Yield (Percent)	3.46	3.43	3.58	3.63	3.21	3.53	3.86	4.66	4.79
Oil Prices, WTI (Dollars/barrel)	94	110	102	100	79	102	104	108	111
Consumer Price Index (% change y/y)	2.2	3.4	3.5	3.1	1.6	3.0	1.8	2.0	2.1
Housing Starts (Millions)	0.56	0.58	0.65	0.72	0.59	0.63	1.02	1.42	1.66
Consumer Sentiment (Univ. of Michigan)	73	70	74	78	72	74	79	80	85
Unemployment Rate (Percent)	8.9	8.9	8.7	8.5	9.6	8.8	8.3	7.8	7.2

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