THE CHARTBOOK

Economics from Washington

November 5, 2010

- The economy grew near its long term trend in the first three quarters of 2010, and this will continue. The outlook for growth in 2011 is improving.
- Manufacturing and business investment continue to lead the expansion. Inventory rebuilding has ended, but export demand remains strong.
- Employment is rising, but at a sluggish pace, and will not improve quickly. The combination of modest job growth and a small increase in hours worked will keep income rising.
- Consumers have been spending increased earnings, and this will continue. A significant rise in savings is unlikely.
- Housing construction has stabilized at a low level, but the inventory of vacant units has changed very little. This will keep pressure on both home prices and new building activity for some time.
- Bad debt held by banks has begun to decline, and will be fully reserved against by early 2011. In 2011, banks will be in a position to expand assets for the first time in three years.
- The Fed's planned asset purchases are large enough to have a material impact on interest rates and risk markets.
- Congress is likely to extend all expiring tax cuts in the upcoming lame duck session, along with some of the expiring spending programs. The result will be more fiscal stimulus in 2011 than many have expected.

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ECONOMIC OUTLOOK

	2008A	2009A	2010F	10:2 A	10:3 A	10:4 F	11:1 F	11:2 F	11:3 F
	(% change, Q4 - Q4)				(seasonally adjusted annual rates)				
GDP	-3.0	0.2	2.3	1.7	2.0	2.1	3.3	3.7	3.6
Final Sales to Domestic Purchasers	-2.7	-1.4	2.9	4.3	2.5	3.4	2.8	3.2	3.3
Consumption	-2.1	0.2	2.3	2.2	2.6	2.5	2.5	2.7	2.7
Fixed Investment	-12.2	-12.9	7.5	18.9	0.8	7.9	7.2	9.0	10.1
Business Structures	-2.8	-26.5	-4.1	-0.5	3.4	0.0	1.0	6.0	8.0
Equipment & Software	-10.8	-4.9	16.7	24.8	12.0	10.0	9.0	8.0	10.0
Residential	-24.8	-13.4	-4.6	25.6	-29.1	6.0	7.0	15.0	12.0
Change in Private Inventories*	-37.6	-113.1	68.4	68.8	115.5	50.0	47.0	50.0	50.0
Government Purchases	2.5	0.8	1.9	3.9	3.3	2.2	1.1	1.1	1.1
Net Exports*	-504.1	-363.0	-444.8	-449.0	-514.9	-476.9	-465.3	-454.5	-449.7
Exports	-3.0	-0.1	8.3	9.1	5.0	8.0	8.0	9.0	10.0
Imports	-6.2	-7.2	14.6	33.5	17.4	-1.0	4.0	5.0	7.0
Interest Rates									
3 Month T Bill	1.3	0.1	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Fed Funds Rate	1.8	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10 Year Bond	3.7	3.2	2.9	2.7	2.8	2.5	2.3	2.4	2.3
Inflation									
PCE Deflator ex Food & Energy	2.0	1.7	1.0	1.0	0.8	0.8	0.6	0.6	0.7
CPI ex Food & Energy	1.8	2.1	0.7	1.3	0.7	0.8	0.9	1.0	1.0

* Billions of chained 2005 dollars

KEY CONCLUSIONS

ECONOMIC ACTIVITY

GDP grew at a 2% rate in Q3 and final demand increased at a 2.5% rate. In the first three quarters of 2010, both have averaged about 2 ½% – near the economy's trend rate. This will continue, although the outlook is improving.

Consumer spending rose at a 2.6% rate in Q3 and has grown stronger in each quarter. Given the prospects for income growth, we expect spending to remain near its current pace. Labor markets are improving, but the pace is very slow. Our forecast assumes tax cuts are extended through 2011.

Business investment remains on a solid growth path. While our forecast shows this continuing, there is upside potential if Congress approves Obama's proposal to allow expensing for new investment.

Inventory accumulation added to growth in Q3 and will likely subtract in Q4, but the underlying trend is for small accumulation to keep I/S ratios fairly constant.

Government spending declined early in 2010 due to large cuts by state and local jurisdictions. These budgets have returned to balance, with revenues rising slightly faster than spending. Spending at the state and local level will be fairly flat, with modest growth from the Federal government.

The **trade deficit** has been a mild drag over the past six months, but import growth is now slowing rapidly and the outlook for exports is very favorable. Net exports will be neutral or modestly positive over the next year.

KEY CONCLUSIONS

OUTLOOK IMPROVES

The range of economic forecasts at present is unusually wide. While few anticipate a return to recession, some expect growth at a very low 1 ½ - 2% rate, and others expect 3+%. One forecast points to below trend growth and rising unemployment while the other suggests slightly above trend growth and a slow decline in unemployment. Plus or minus 1 percentage point is considered a normal error range for growth forecasts one year ahead, but with growth rates so low, the implications of a 'normal' error are huge.

Our expectation for 3 - 3 ½ % growth in 2011 is clearly at the top of the current range of expectations. There are several reasons we are optimistic.

First, financial conditions are improving dramatically. We expect the Fed to hold short term interest rates near zero throughout 2011, and believe asset purchases will keep long rates at or below current levels. This will allow ongoing debt restructuring, and will support other risk markets. It will have a positive impact on wealth, while allowing the Treasury to finance a large deficit with no increase in rates. It will put some downward pressure on the value of the dollar and encourage foreign central banks to consider more accommodative policies.

The banking sector is on the cusp of a change which will amplify the Fed's policy. In 2008 and 2009, bad debt increased faster than banks could write off or set aside reserves. This put enormous pressure on banks to reduce assets, and forced them to contract credit. This changed in 2010. In Q2 (and apparently in Q3), bad debt declined and the gap between bad debt and reserves narrowed. We expect this gap to close by early 2011, putting the banking sector in a position to expand assets for the first time in three years. Bank lending standards have already begun to ease. While credit demand remains weak, when bankers begin marketing loans more aggressively, we expect they will find borrowers.

Second, the global outlook is positive for US exports. Over the past decade, the share of US exports destined for emerging market economies has grown from about 35% to just over 50%; the outlook for these markets is generally quite positive. In the developed world, the outlook for our most important trading partner, Canada, is also favorable. On a real trade weighted basis, the dollar declined about 7% between early 2009 and the summer of 2010. Given the lags between currency depreciation and trade impacts, this will be helpful for 2011 exports. There were crop failures in Russia and parts of Europe which are also increasing demand for US agriculture exports.

Third (discussed in Fiscal Policy Issues on page 7), the possibility of a small increase in fiscal stimulus is growing stronger. We expect the Bush tax cuts and those contained in American Recovery and Reinvestment Act (ARRA) of 2009 to be extended, and believe there is a good chance the Obama proposal to expense new investment will be approved. There are also some spending programs, such as the Buy America Bonds subsidy, which are likely to be extended. Those forecasting low growth in 2011 expect fiscal policy to become quite restrictive next year – we disagree.

OUTLOOK IMPROVES CONT'D

Fourth, businesses have been operating in an unusually uncertain environment in 2010, but this is changing. Election results provide assurance that regulatory decisions implementing healthcare and financial reform will be made in an environment where both political parties participate. Tax policy uncertainty will be resolved in the lame duck session. The Fed has provided substantial guidance on the monetary policies they expect to maintain in 2011. As these uncertainties decline, businesses will be able to move forward with decisions that have been on hold.

Finally, some negative factors that were a drag on growth in 2009 and the first half of 2010 are absent from the future. The housing sector has already collapsed and cannot do so again. State and local governments were forced to cut spending when revenues plunged, but revenues are now rising slightly faster than spending and budgets are back in balance. Government spending cuts are largely behind us. Business construction also plunged in the 2009 recession, but now looks stable. Even if none of these areas contribute to growth in 2010, the absence of these drags will be positive.

KEY CONCLUSIONS

FED POLICY

In announcing its new large scale asset purchase program – commonly called QE2 – the Fed provided a very detailed outline of what it plans to do. New purchases will total roughly $110 billion per month (an increase of about $75 billion over current reinvestment purchases), they will last through June, 2011 subject to ongoing review, the average duration will be 5 - 6 years with purchases in all maturities over 1.5 years, the self imposed 35% per issue limit on purchases will be relaxed subject to certain constraints, etc. While plans are always subject to change if economic conditions change, the Fed has provided as much certainty as possible about monetary policy for the next eight months.

To put the Fed's plan in perspective, translate it into annualized rates. If the Fed buys $110 billion/month of Treasury securities, this amounts to an annual rate of $1.32 trillion. This is roughly the entire amount of new Treasury debt that will be issued during the next year. Since the Fed intends to make these purchases by auction, paying whatever price the market commands, other potential Treasury buyers will be forced to pay higher prices or purchase something else. As prices rise, something else will become increasingly attractive. With the Fed purchasing virtually all of the net new issuance of Treasury securities, net new purchases by everyone else must be close to zero.

Normal purchasers of Treasury debt cover a wide range, but several sectors have been dependable buyers. The household sector usually purchases several hundred billion per year and pension funds generally purchase a few hundred billion. The current account deficit (roughly $400 billion) ensures a steady inflow of foreign investments, much of which goes into Treasury securities. In fact, foreigners hold about one-half of outstanding Treasury securities. The unique characteristics of Treasury securities will be important enough that some buyers will pay higher prices to acquire them, but with the Fed absorbing the entire new issuance, existing bondholders must sell to allow others to buy.

Eventually, bonds will be re-priced and a substantial portion of the Fed's purchase will flow into alternative investments. Of course, those alternatives will not necessarily be US based. Foreign Treasury owners who sell part of their existing portfolios are especially likely to consider non-US alternatives. To the extent commercial banks sell Treasury securities from existing portfolios, they can simply hold reserves without buying anything else. In this case, excess reserves will increase until banks begin increasing loans or the Fed withdraws them. By absorbing all new Treasuries issued, the Fed can force investments into other assets, but it cannot determine exactly which assets.

Even in the context of a very large US economy and capital market, annualized purchases of $1.3 trillion are quite significant. This represents roughly 9% of the annual GDP or just under 10% of the combined capitalization of the NYSE and NASDAQ equity markets or 2 ½ - 3% of the annual trading volume in those markets. After making allowance for leakage into international markets and bank reserves, we still expect the Fed's asset purchases to have a significant impact in US markets.

FISCAL POLICY ISSUES

With the elections behind us, Congress is about to begin its lame duck session. While many issues are sure to be raised, tax policy is at the top of the agenda. As we moved from the summer (when European sovereign debt issues were paramount) to the fall (when concern about continued economic growth became dominant), the odds rose that all expiring tax provisions would be extended. As it became more clear Republicans were likely to dominate at the polls, the Obama administration quietly began to indicate the president would compromise on his proposal to extend only those tax cuts which applied to those earning below $250,000. With the elections over, the Republicans will insist their priorities be reflected in any legislation approved by the lame duck session – otherwise it will not be approved. The bottom line is all expiring provisions will be extended for at least one or perhaps two years.

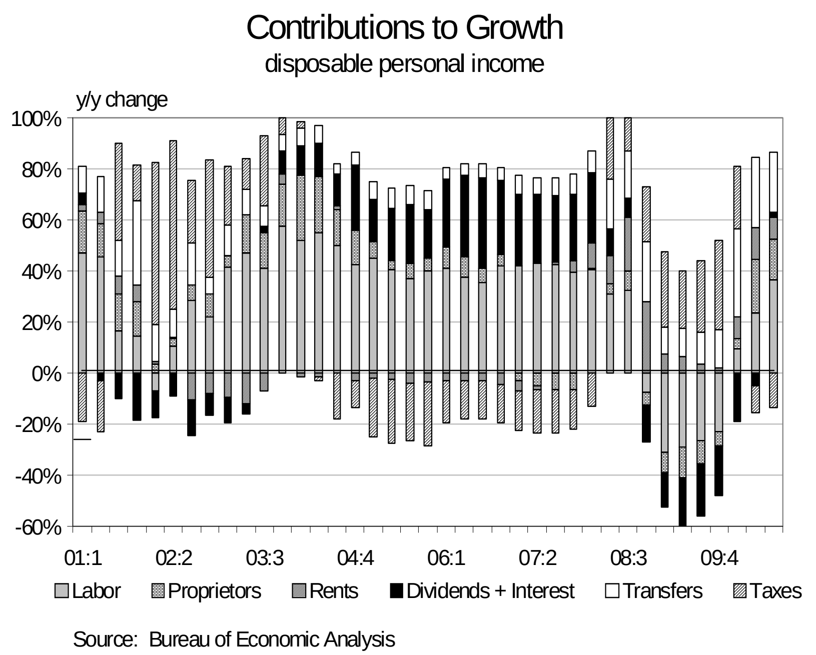
Extending all expiring provisions provides more fiscal stimulus than most forecasters anticipated last summer, and the prospect of additional stimulus is good. Pres. Obama has recommended expensing instead of depreciating new investment during the next year. Some think this idea would be helpful, while others are indifferent – no one seems to believe it would be a big mistake. With no one fighting hard against it, this proposal will be easy to attach to a larger tax bill as it makes its way through the legislature. The long term impact on the deficit is quite small, but concentrating the deduction in 2011 provides a tax cut of roughly $200 billion that has not been incorporated in most forecasters' expectations for next year. The tax element in fiscal policy will likely remain mildly stimulative in 2011.

Many forecasts for 2011 have assumed tax stimulus will be partially withdrawn and spending stimulus will be entirely withdrawn. We question the second part of this assumption as well as the first. While there is no prospect of another stimulus package like the American Recovery and Reinvestment Act (ARRA) of 2009, Congress routinely extended expiring pieces of spending legislation throughout 2010. Repeated extensions of unemployment insurance benefits are the most visible example, but not the only one. We expect a similar pattern in 2011. State and local governments are likely to receive Federal assistance for a variety of expenditures. The 35% subsidy for Build America Bonds expires at the end of the year and is likely to be extended in the lame duck session. While the size of the subsidy may be reduced, retaining the program is not controversial. ARRA also expanded a number of tax credits and allowed partial exemption of unemployment compensation – tax items worth about $80 billion per year scheduled to expire at the end of this year. We expect these to be extended. When everything is added together at the end of 2011, we expect a billion here and a billion there will have provided substantially more stimulus than forecasters now anticipate.

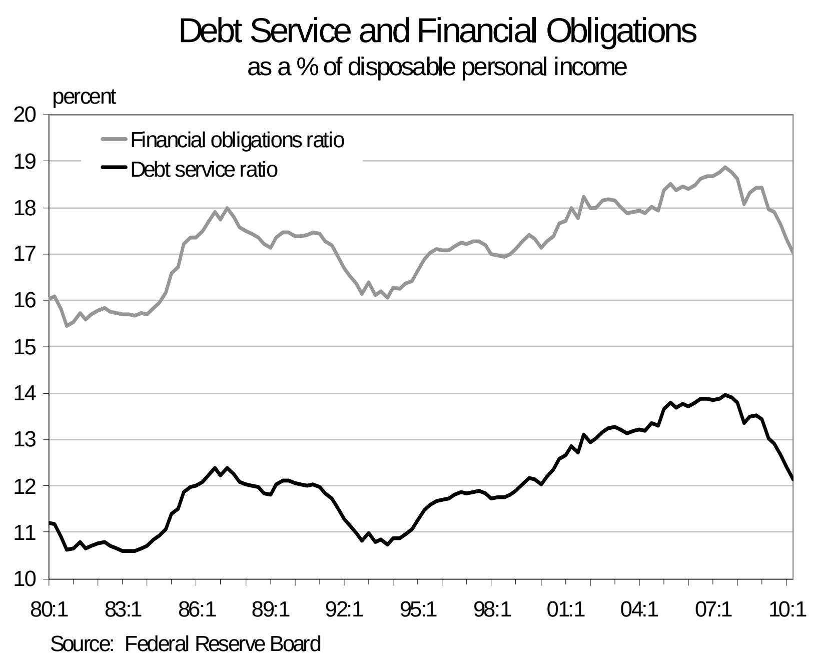
Our fiscal policy expectations implicitly assume the long term deficit issue will not be addressed in the near term. With no impending crisis to force politicians to deal with these issues, we expect them to be ignored. Although concern about the budget deficit has been increasing and it does play a role in budget debates, this is outweighed by the need to reduce a very high rate of unemployment. Until a crisis forces the issue or the economy becomes substantially healthier, Federal deficit issues will remain a topic of discussion rather than action.

CONSUMER ACTIVITY

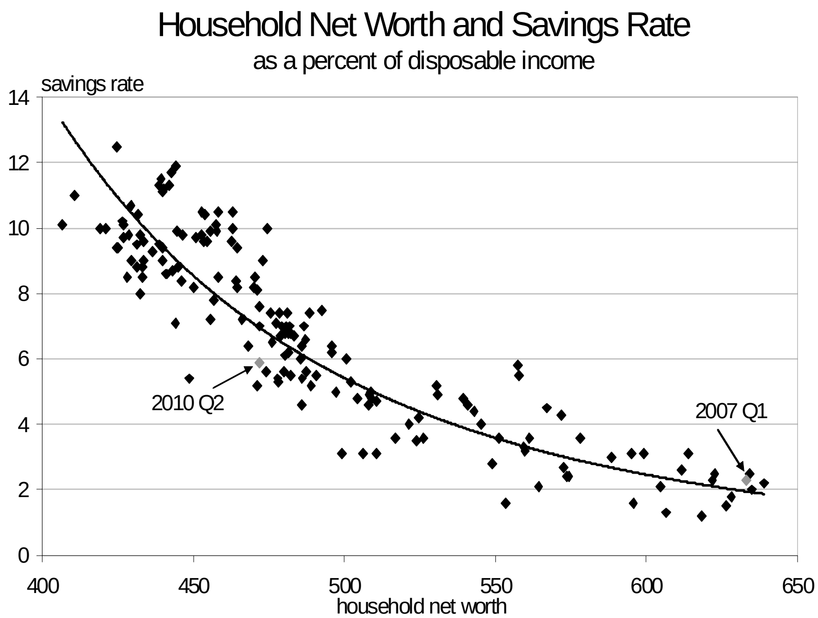
The consumer sector continues to grow steadily healthier. Income and its composition is improving, debt and debt service are declining, and wealth is growing. There is no rapid rebound in spending in sight, but continued moderate improvement remains likely.



Income growth has become steadily healthier, with more from private sources and less from the Government.

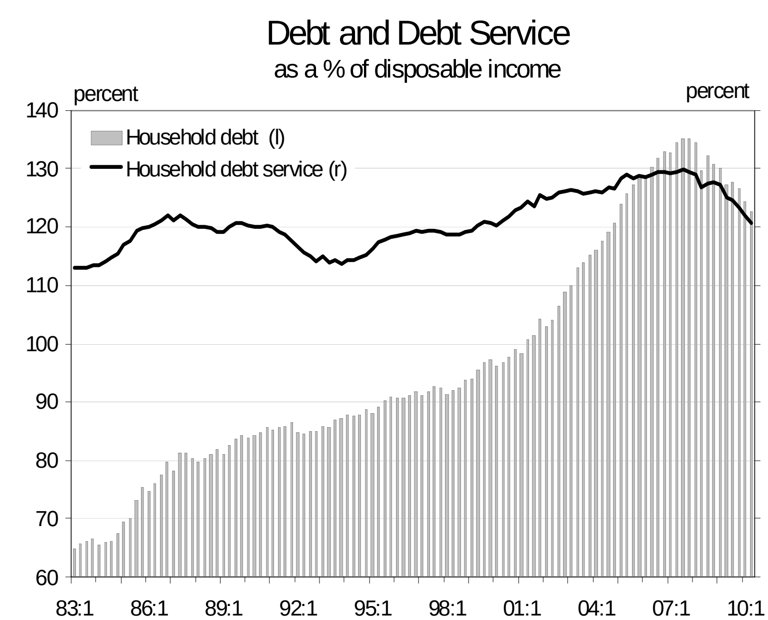


The decline in debt service costs has allowed consumers to shift about 2% of income to other uses. This has helped support an increase in savings with only a small impact on consumption.



Source: Bureau of Economic Analysis, Federal Reserve Board

The savings rate is now very close to its normal relationship with wealth. Our estimate of Q3 wealth places this relationship almost exactly on the fitted line. This suggests the savings rate will remain fairly stable at current levels.

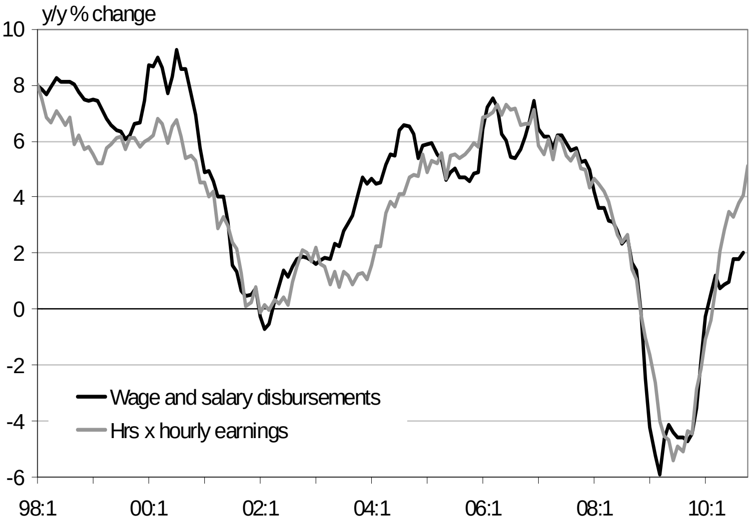


Source: Federal Reserve Board

Although debt service is lower than in the past decade, debt levels remain high. This causes some concern that an increase in interest rates could drive debt service sharply higher. However, debt is heavily dominated by mortgages, which are mostly at fixed rates. Even credit card debt adjusts more slowly than in the past due to recent legislation. If interest rates increase, there will be a substantial lag before this has a significant impact on total debt service.

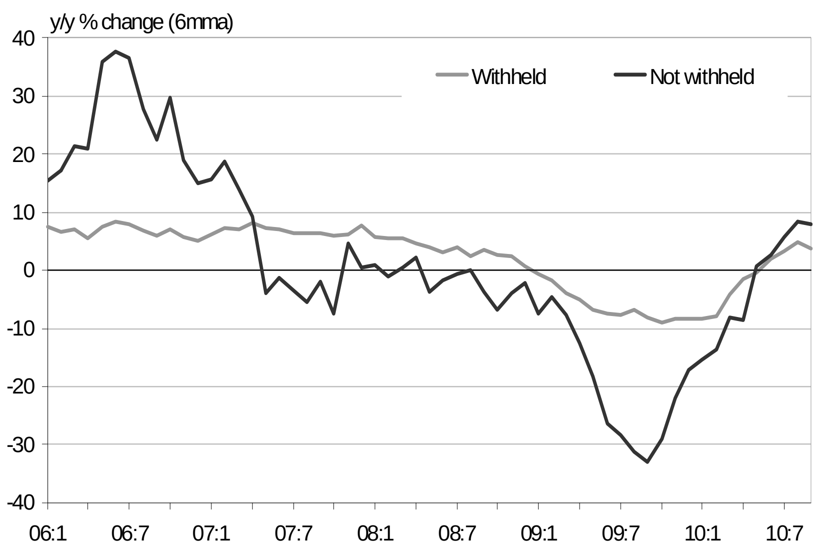
CONSUMER ACTIVITY

Wage and Salary Disbursements
vs. Hours and Earnings



Source: Bureau of Labor Statistics, Bureau of Economic Analysis

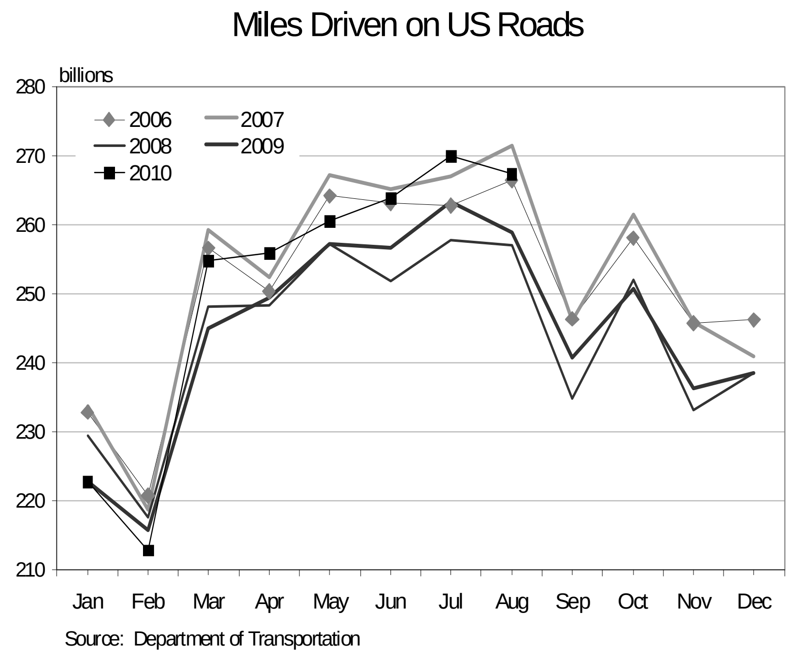
Taxes Withheld and Not Withheld



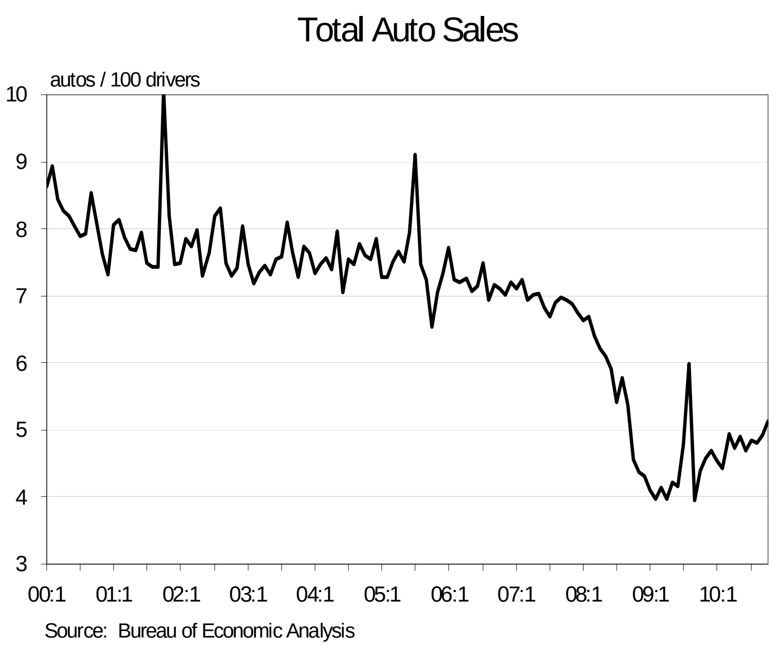
Source: Department of Treasury

There are reasons to believe wage growth may have been underestimated. Labor market data suggest earnings are rising faster than wage and salary data.

Tax payments not withheld suggest increases in capital gains and in the income of those who make estimated payments. When this part of income changes, there can be a lag before it is captured in the statistics.

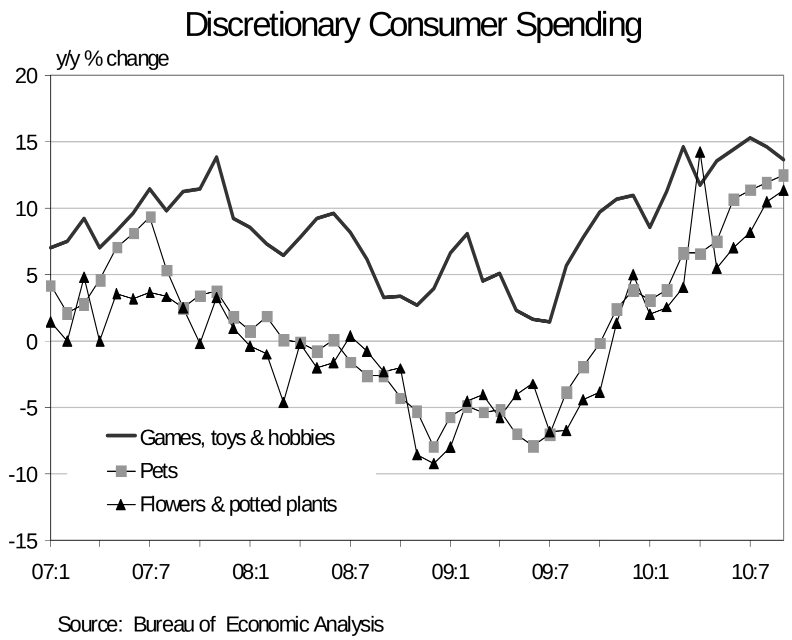


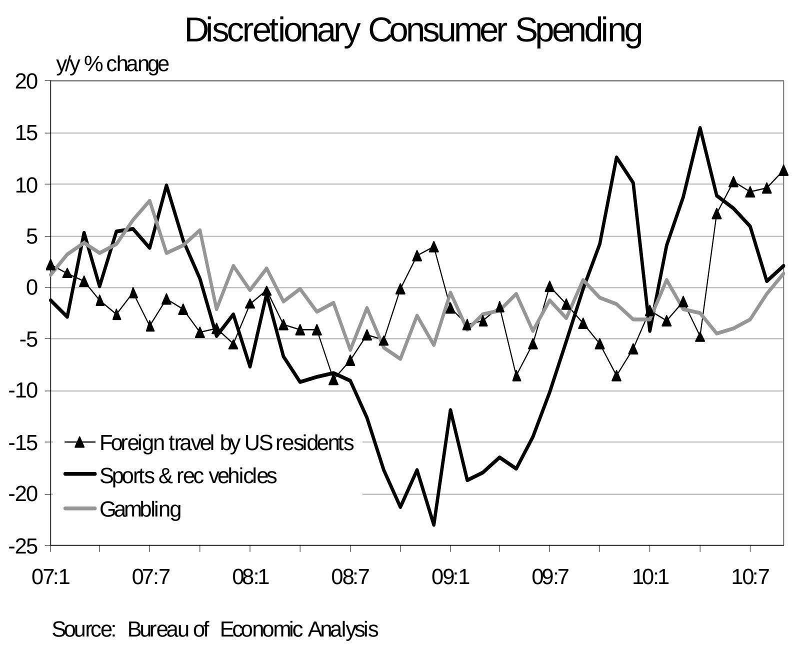
Miles driven were temporarily reduced during 2008 - 09, but have returned to pre-recession levels. Of course, this increases auto depreciation. At the same time, the driving age population has continued to rise.



Yet, auto sales remain well below pre-recession levels. We expect auto sales to improve steadily over the next year.

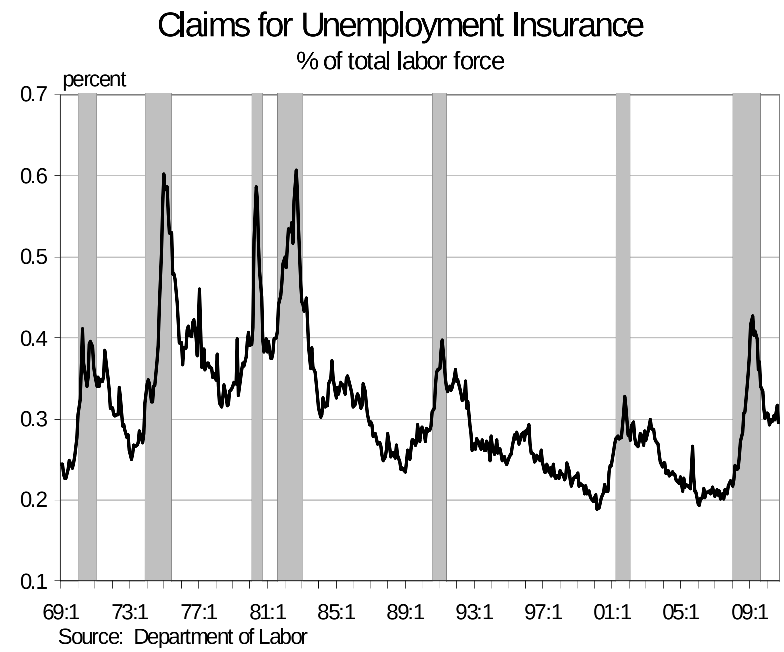
CONSUMER ACTIVITY



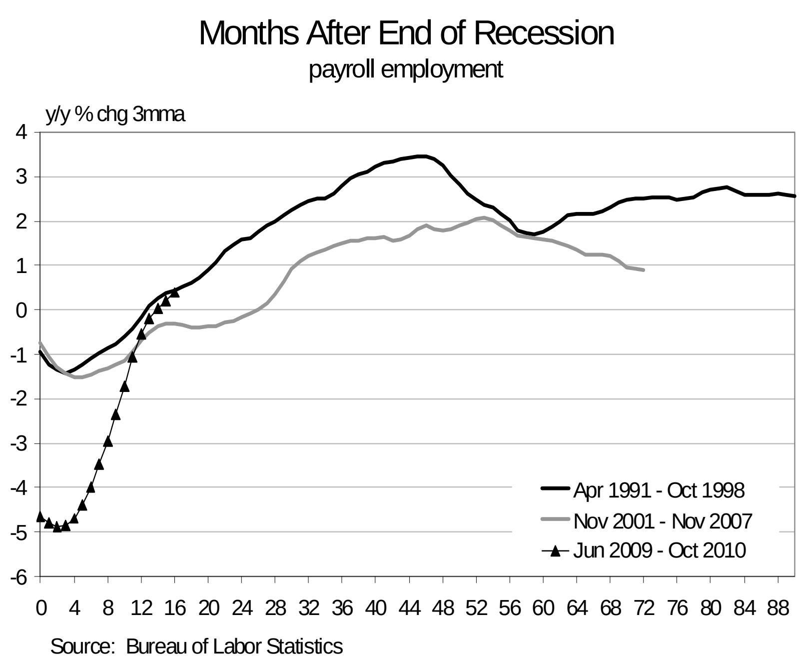


Spending for items that are clearly discretionary is also improving. Although this is not true in all discretionary categories, there has been a clear change in spending patterns as labor markets have stabilized. Although the unemployment rate remains stuck at a high level, modest job growth has relieved anxiety among the 90+% of the labor force that remain employed.

Labor markets are slowly improving with a pattern similar to the aftermath of the 91 and 01 recessions. Still, the structural element in current unemployment is unusually high, suggesting unemployment will be slow to decline. Nevertheless, modest job growth and small increases in hours worked promise to keep income rising. The slowdown in firing also bolsters confidence of the 90+% of the work force that are employed.

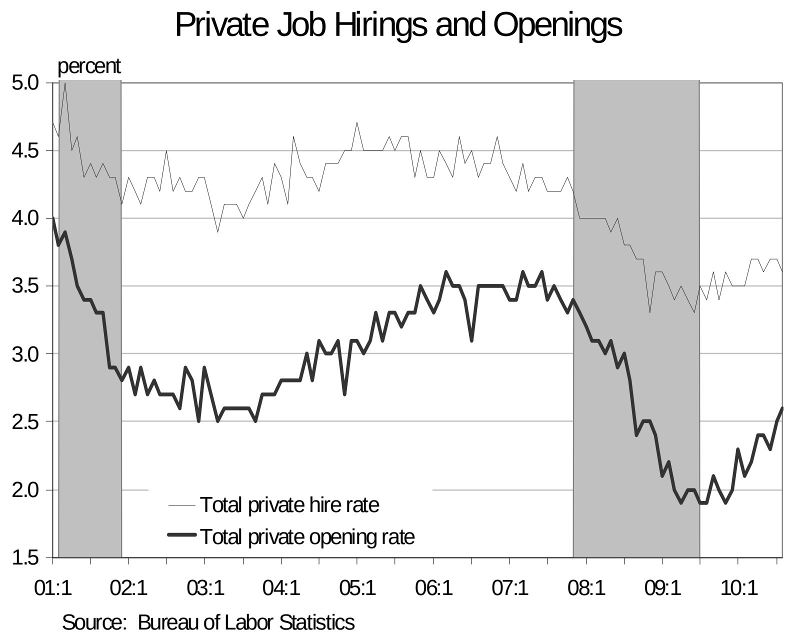


If unemployment insurance claims follow the pattern set by the last two recessions, they will remain elevated until about 11Q2.

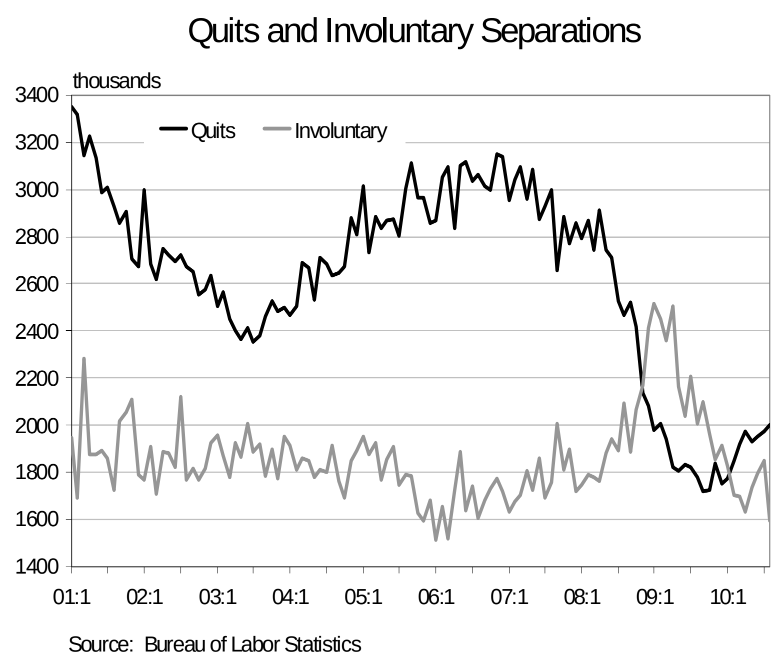


Job growth is also likely to remain sluggish.

LABOR MARKETS

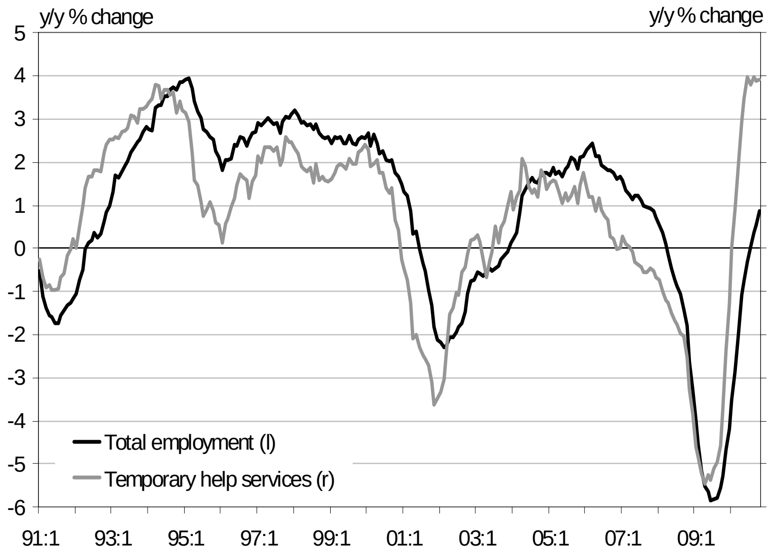


Job openings are improving more rapidly than hirings – a strong indication of structural mismatch.



Still, firings are down and quits are up. This is important in bolstering confidence of those who remain employed.

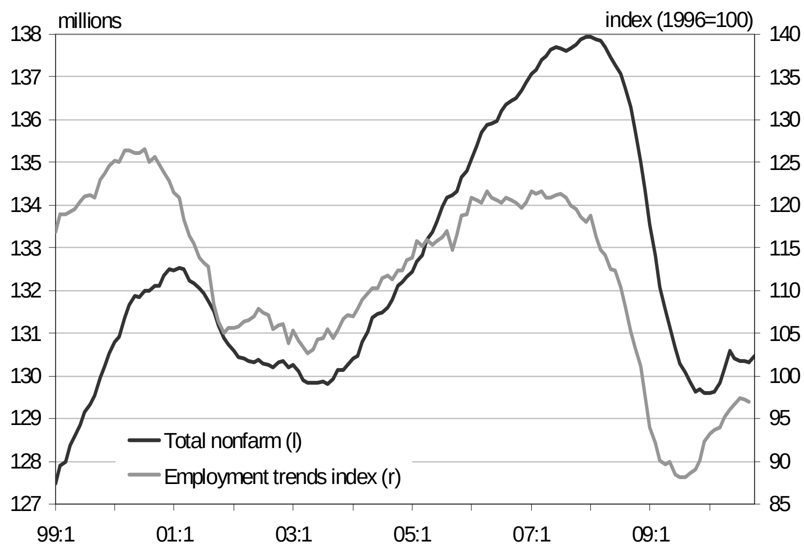
Help Supply Services vs. Total Employment



Source: Bureau of Labor Statistics

Temporary job growth has been quite strong, and surveys of help supply agencies show this is continuing. However, temporary jobs are not becoming permanent to the same degree as in the past.

Employment Trends Index

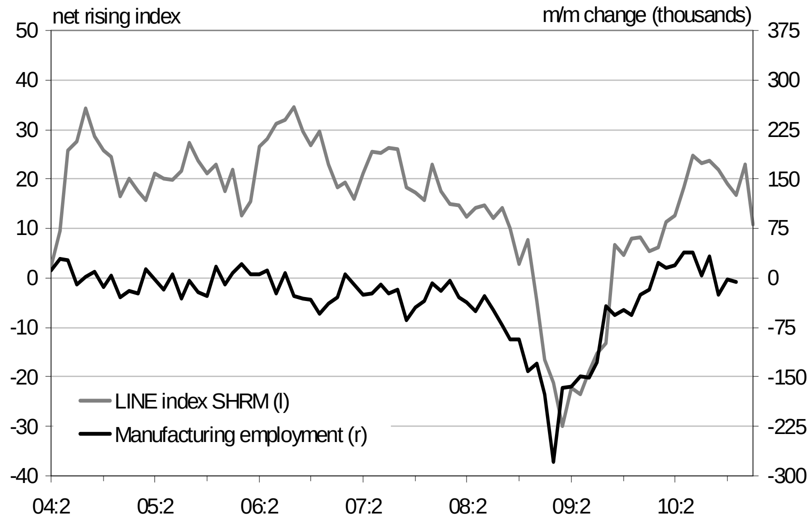


Source: Bureau of Labor Statistics, Conference Board

The trends index suggests weak payroll growth in Q4.

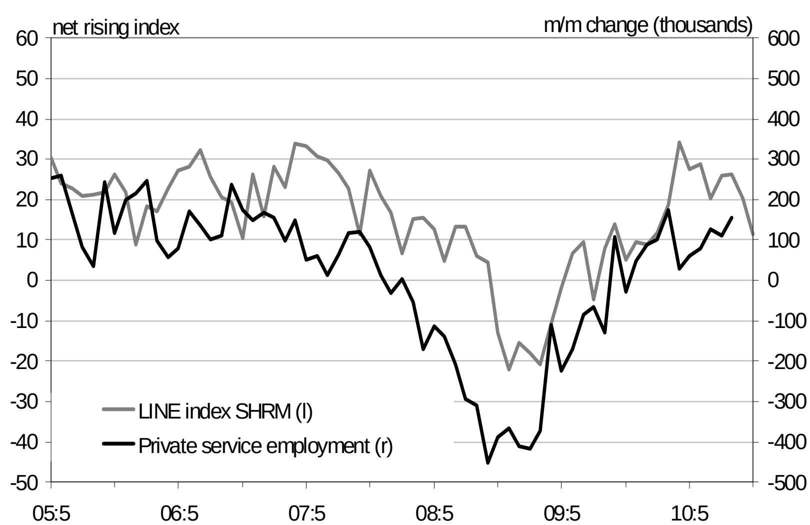
LABOR MARKETS

Manufacturing Employment



Note: SHRM data moved ahead one month.
Source: Society for Human Resource Management, Bureau of Labor Statistics

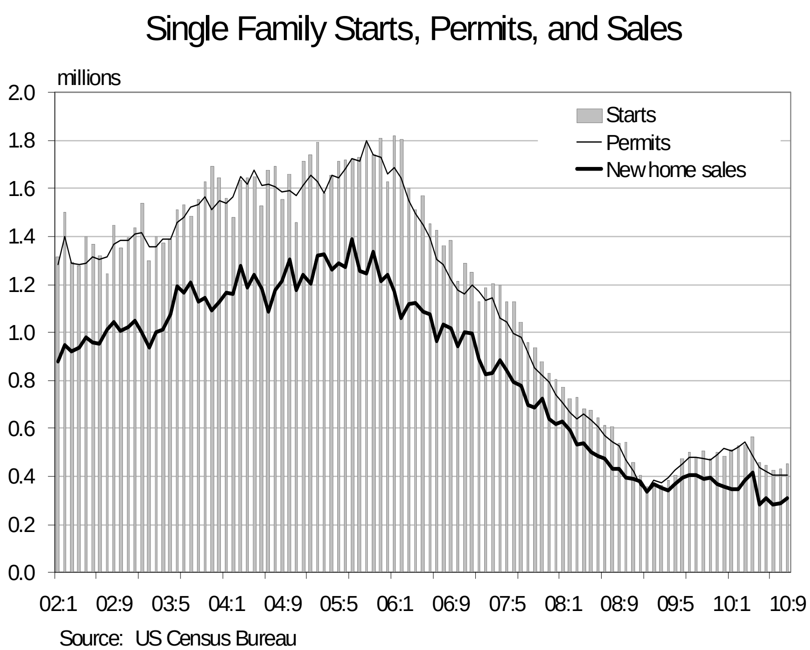
Service Employment



Note: SHRM data moved ahead one month.
Source: Society for Human Resource Management, Bureau of Labor Statistics

Resource managers' surveys also point to weak hiring in Q4. The diffusion index for both manufacturing and nonmanufacturing has slipped back after being higher for several months. Conditions are right for hiring to improve, but labor market indicators suggest there will be little improvement in Q4.

Housing construction and sales remain moribund, and this will continue until improving labor markets revive household formation. However, homeowners are putting money back into their houses which is a strong vote of confidence in house values. Financial conditions will support stronger activity when labor markets improve.

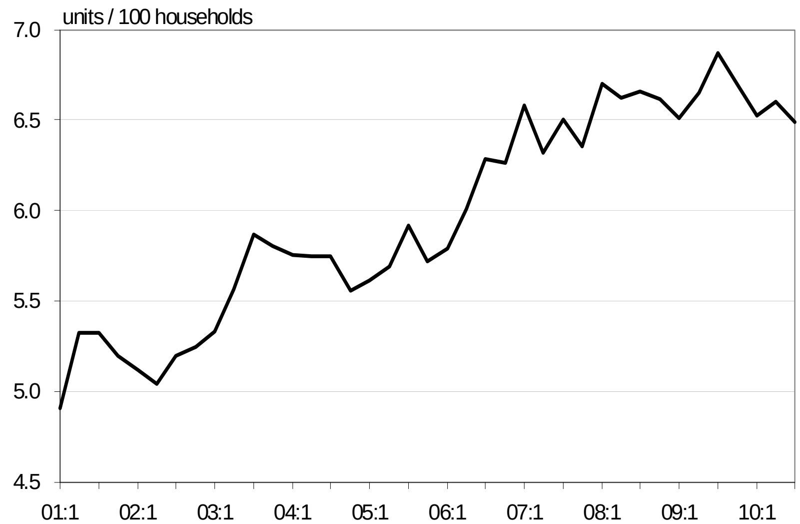


Conditions have changed little in housing construction or sales.

Existing home sales have been more volatile than new sales, but both remain quite low. Volatility will decline now that temporary tax credits have expired.

HOUSING INDICATORS

Housing Vacancies for Rent or Sale



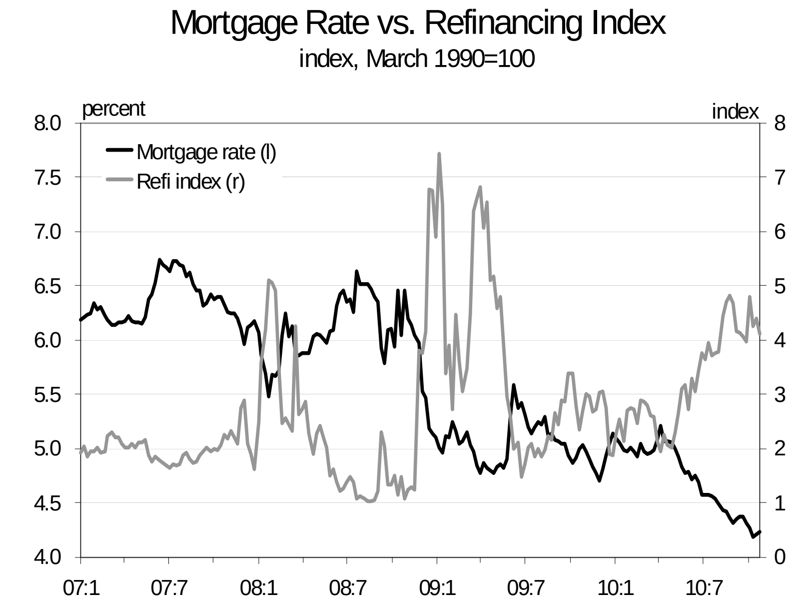
Source: US Census Bureau

As long as vacancies remain near current levels, there is no reason for construction activity to increase.

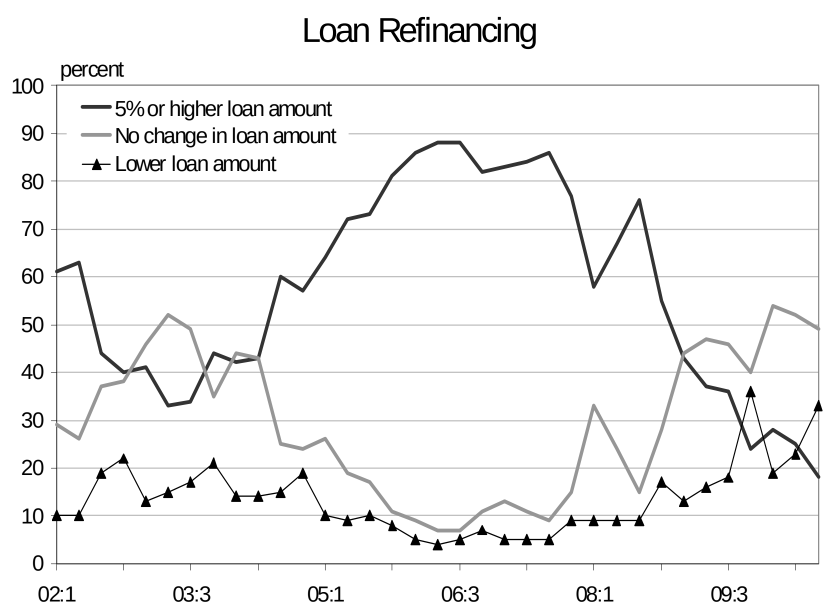
Housing Turnover
share of housing stock sold

Source: US Census Bureau, National Association of Realtors, National Association of Home Builders

Turnover appears to be stabilizing, which indicates a modest improvement in conditions.



Source: Mortgage Bankers Association, Federal Reserve Board



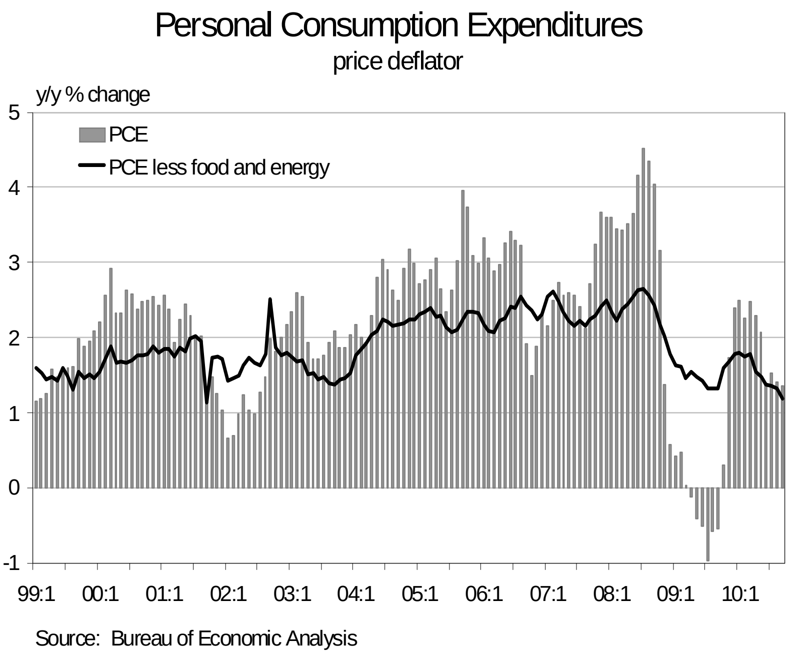
Source: Freddie Mac

Finance conditions have changed. As rates have declined, refinancing has surged. The decline in home values means new mortgages are smaller than old ones, requiring many to make cash payments in order to refinance (about 1/3 in 10Q3). This represents a strong vote of confidence by homeowners that house values have stabilized.

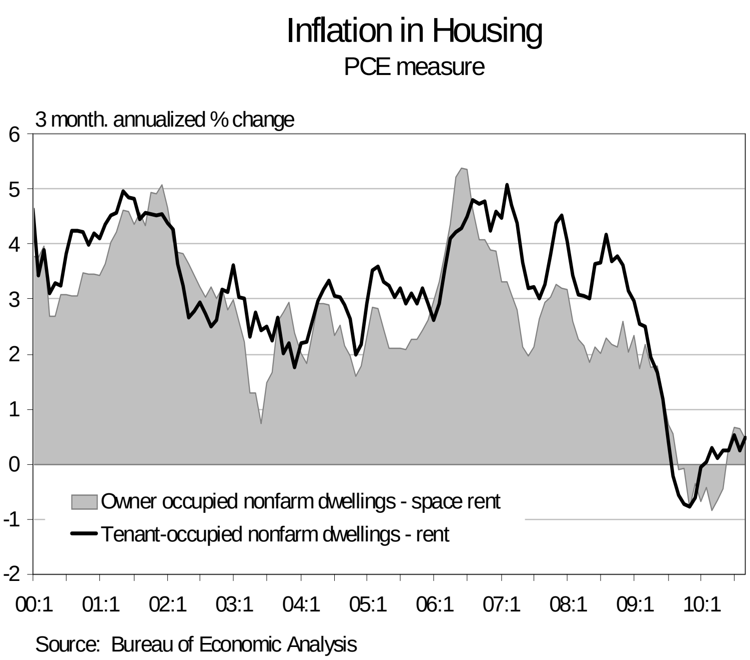
An increase in household formation awaits better labor market conditions; when this begins, financial conditions will support higher sales.

INFLATION INDICATORS

The Fed has made extremely low inflation a central part of its justification for QE2, but deflation risk has clearly declined. Disinflationary pressure from housing has stabilized, and some markets show inflation pressure. On balance, low but stable inflation is likely for late 2010 and early 2011.

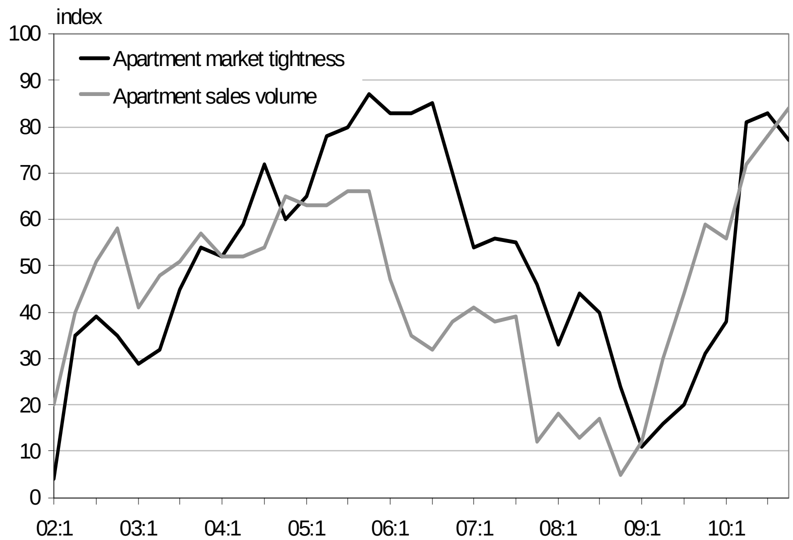


While still trending lower on a yearly change basis, the more recent trend for both core and total inflation is fairly flat.



Housing inflation has been the most important factor pushing the trend lower, and this has stabilized.

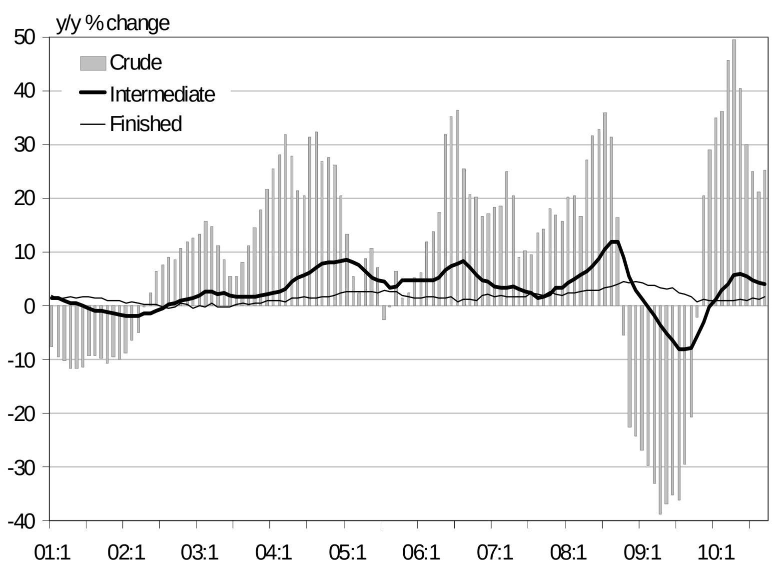
Apartment Market Conditions



Source: National Association of Realtors, National Multi Housing Council

Rental prices drive housing inflation data and market conditions point to increases rather than decreases.

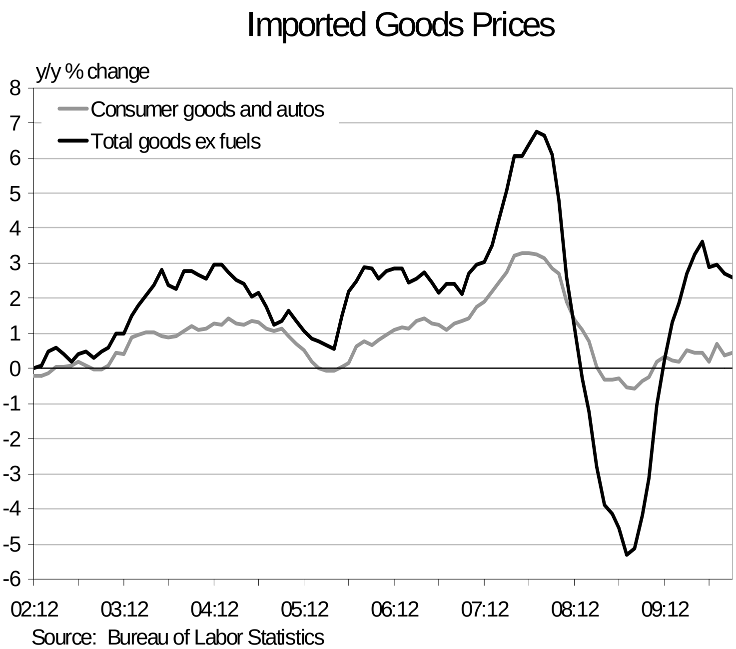
PPI Core Inflation



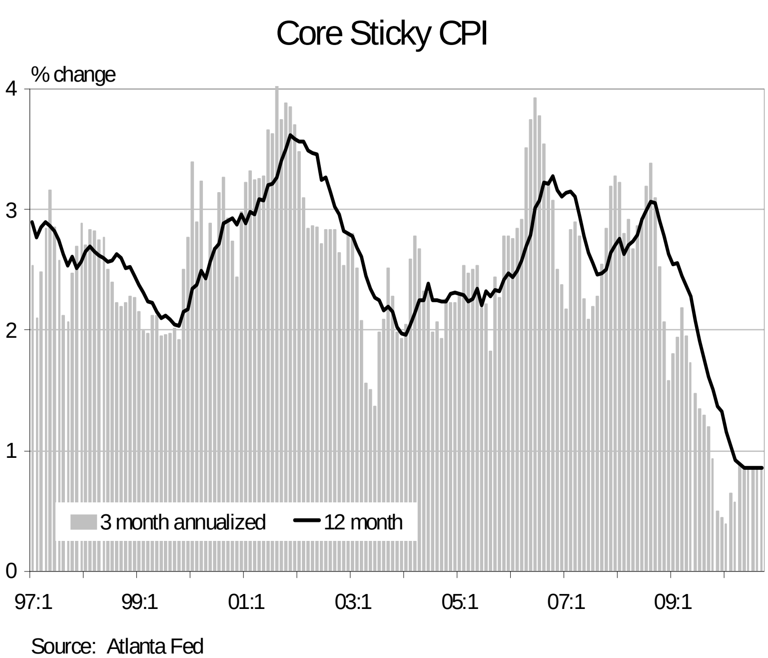
Source: Bureau of Labor Statistics

Producer price trends are stable with a little pressure in the 'pipeline'.

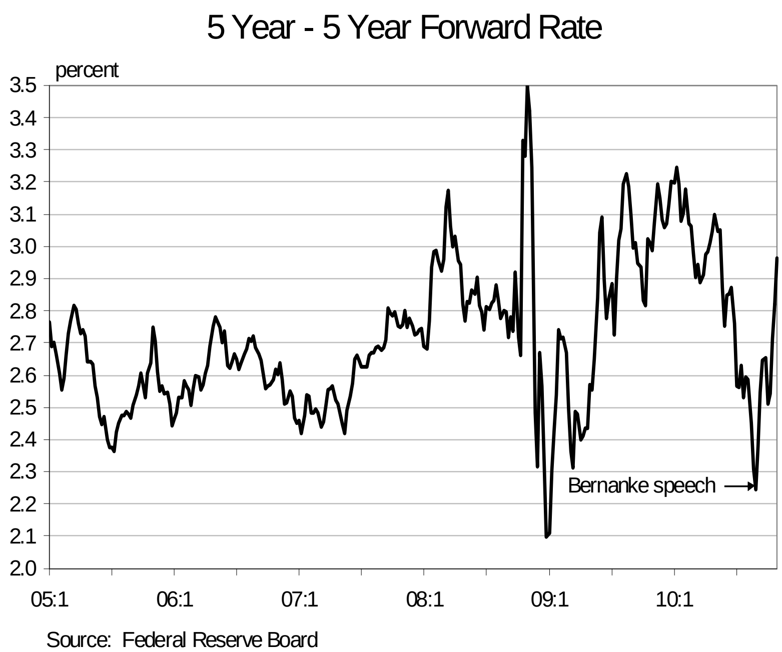
INFLATION INDICATORS



Imported goods prices have also been increasing at a low and steady pace. Recent currency moves suggest potential for a small rise.



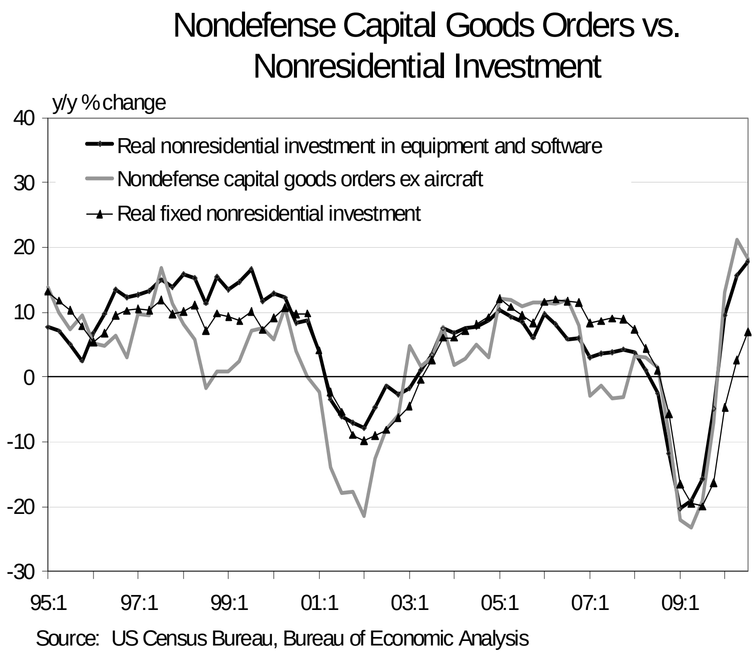
'Sticky' prices account for about 70% of the CPI. They strongly suggest disinflation has ended.



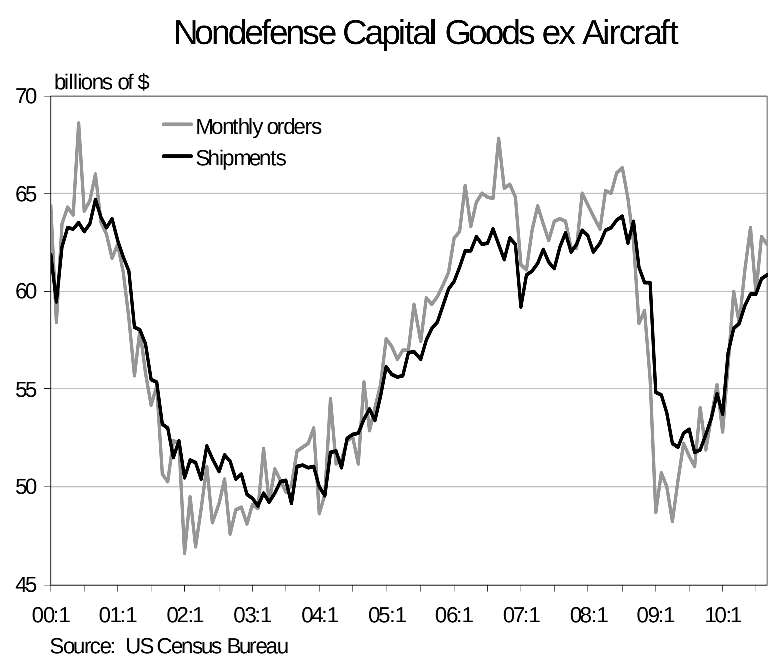
Since Ch. Bernanke's speech on Aug. 27, market inflation expectations have moved about ½ percentage points higher. In one sense, this is a vote of confidence the Fed will be successful in increasing inflation. However, it also indicates markets expect inflation to exceed the Fed's desired target.

PRODUCTION AND INVESTMENT INDICATORS

Manufacturing output continues to lead the current expansion, but the boost provided by inventory rebuilding is now behind us. Foreign demand remains strong, and nonresidential construction has stabilized.

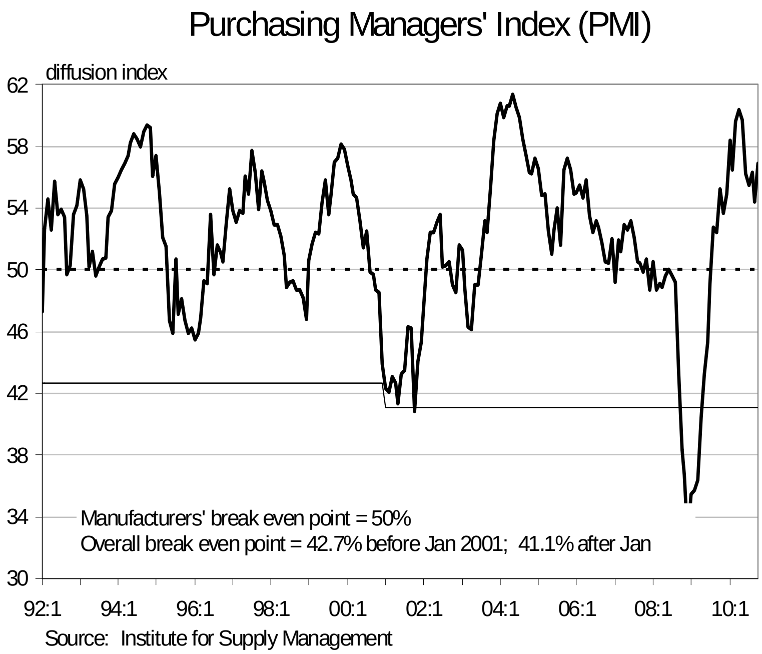


Capital goods demand and nonresidential investment have been quite strong.

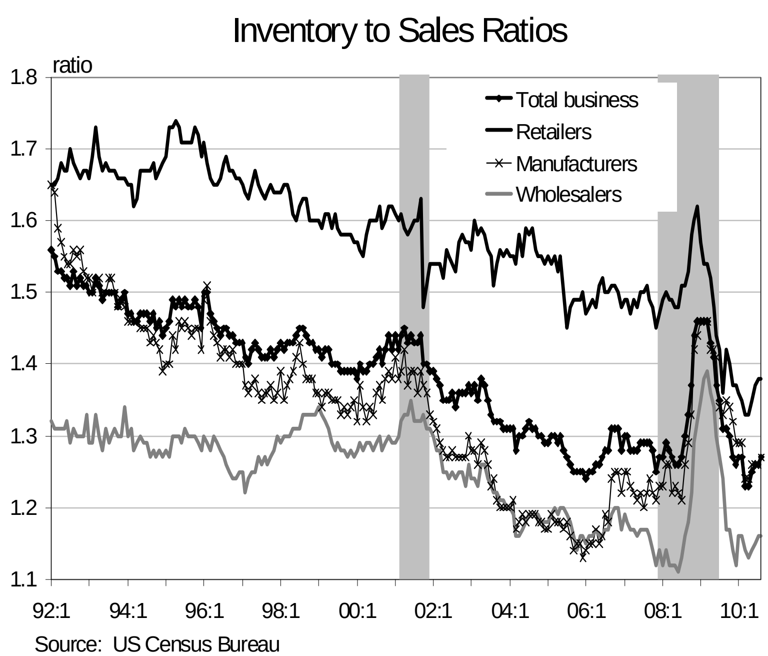


Orders suggest this will continue.

PRODUCTION AND INVESTMENT INDICATORS



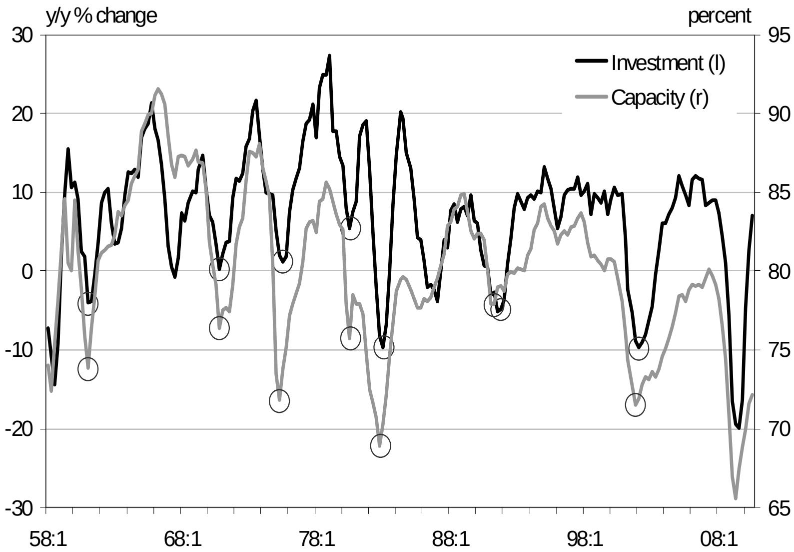
Survey data are also consistent with continued growth in the manufacturing sector.



While part of the recent increase was due to inventory rebuilding, I/S ratios are still relatively low.

PRODUCTION AND INVESTMENT INDICATORS

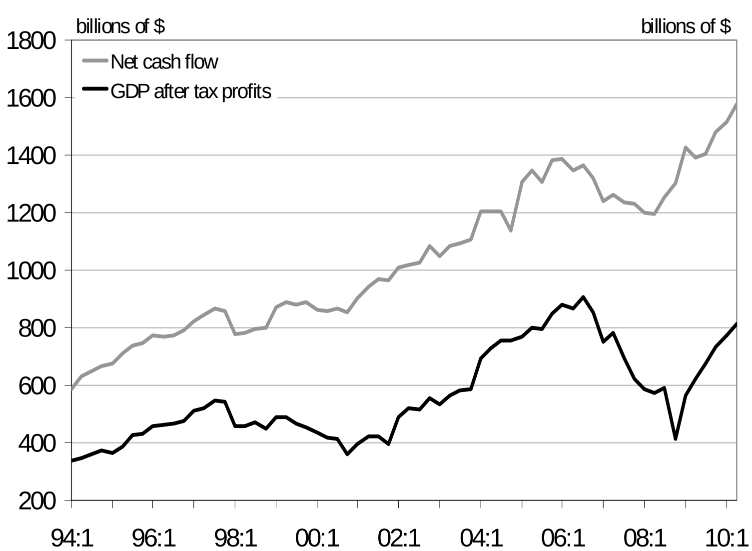
Business Investment and Capacity Utilization



Source: Bureau of Economic Analysis, Federal Reserve Board

The cyclical rebound in investment looks quite typical, but capacity utilization levels appear low. Capacity measures are sometimes slow to reflect the speed up in depreciation, which occurs during recessions.

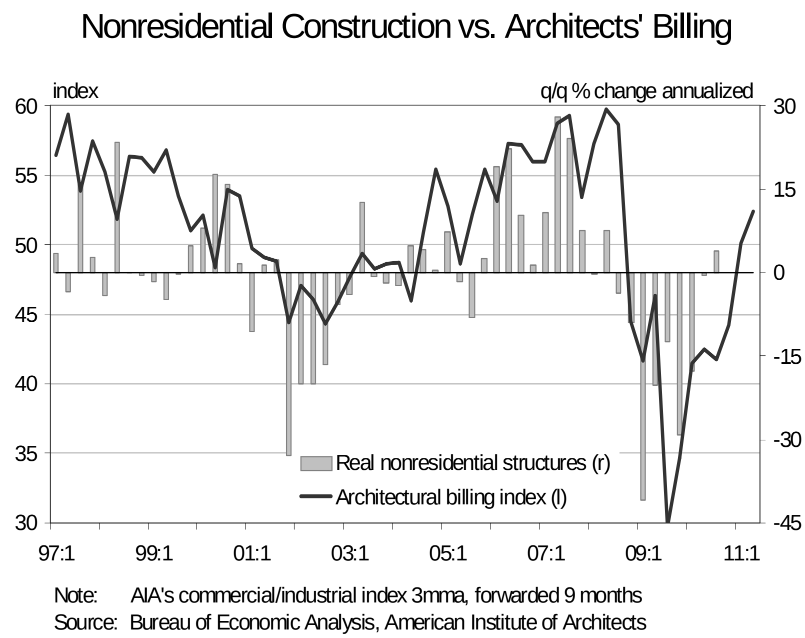
Domestic Profits and Cash Flow



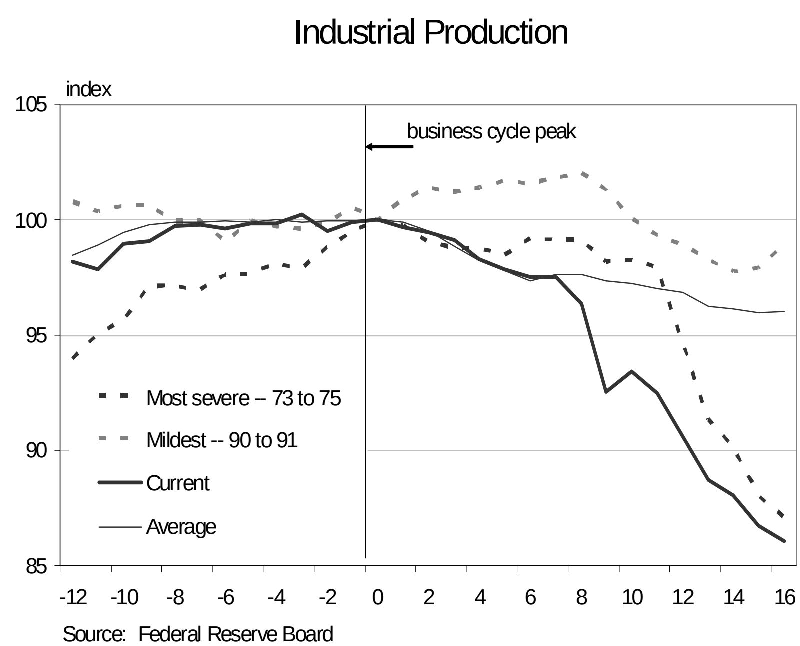
Source: Bureau of Economic Analysis

The strong rebound in profits and cash flow will support continued investment growth.

PRODUCTION AND INVESTMENT INDICATORS



The construction portion of business investment has stabilized, and the architects' index points to continued stability.

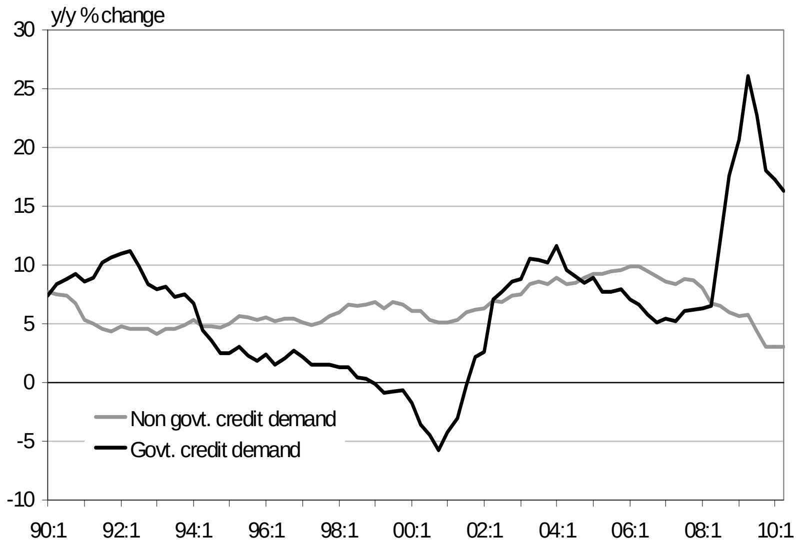


Although the 2009 - 10 expansion has been led by the manufacturing sector, production is still low relative to other business cycles.

MONETARY AND CREDIT INDICATORS

The Fed's new QE2 purchases represent a significant increase in the demand for Treasury securities without a corresponding rise in the supply. The Fed effectively plans to purchase all newly issued Treasury securities through the middle of 2011. With the household sector still deleveraging and minimal corporate borrowing needs, this will cause further declines in long term interest rates and support other risk markets.

Growth in Nonfinancial Credit Demand

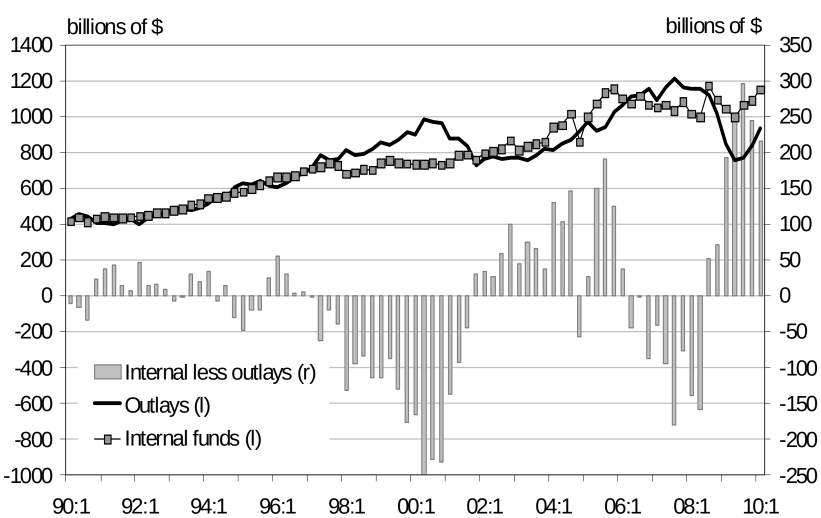


Source: Federal Reserve Board

Credit demand remains quite modest outside the Federal government, and this will likely continue.

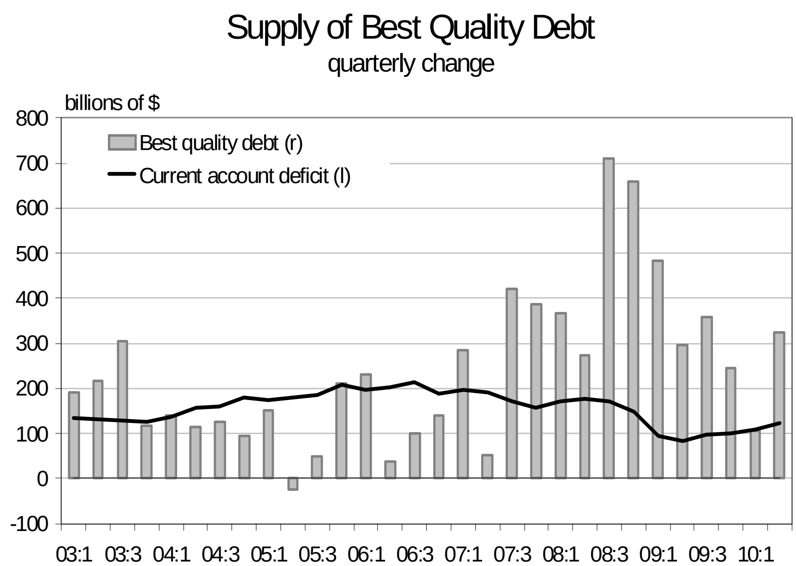
Outlays and Internal Funds

nonfinancial corporations

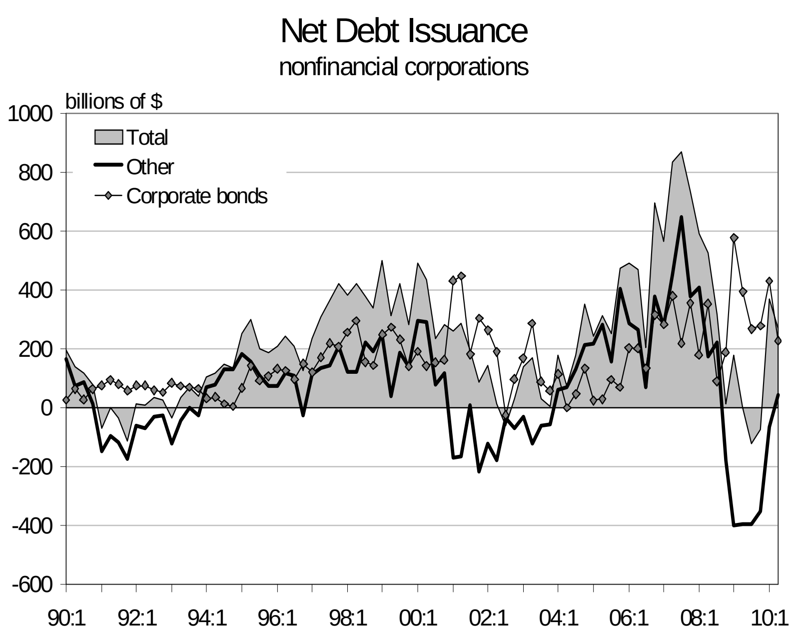


Source: Federal Reserve Board

The corporate sector has increased borrowing to restructure, and investment has increased. Still, strong profits and cash flows suggest net borrowing needs are minimal. The household sector is still deleveraging.



Note: Debt issued or backed by Federal government and government sponsored enterprises.
Source: Federal Reserve Board, Bureau of Economic Analysis

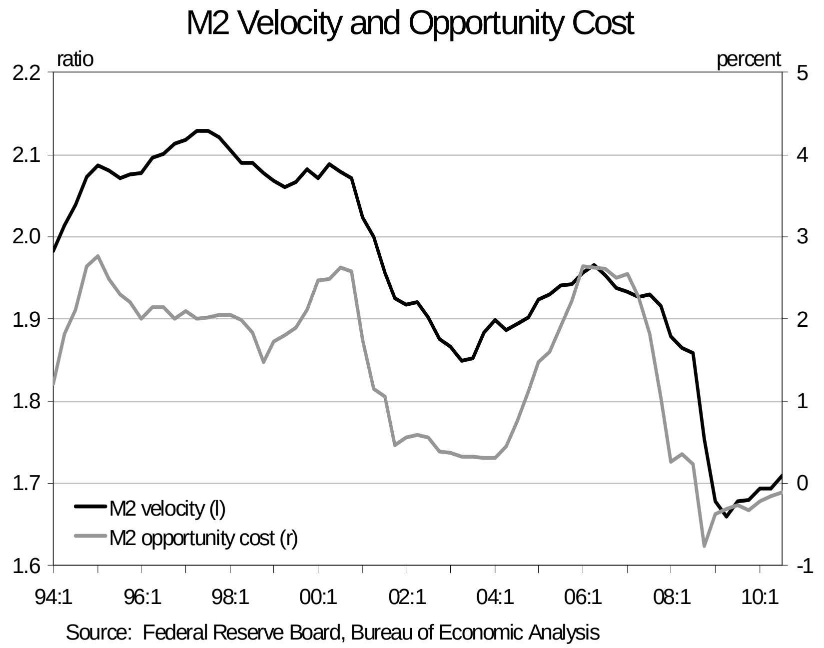


Source: Federal Reserve Board

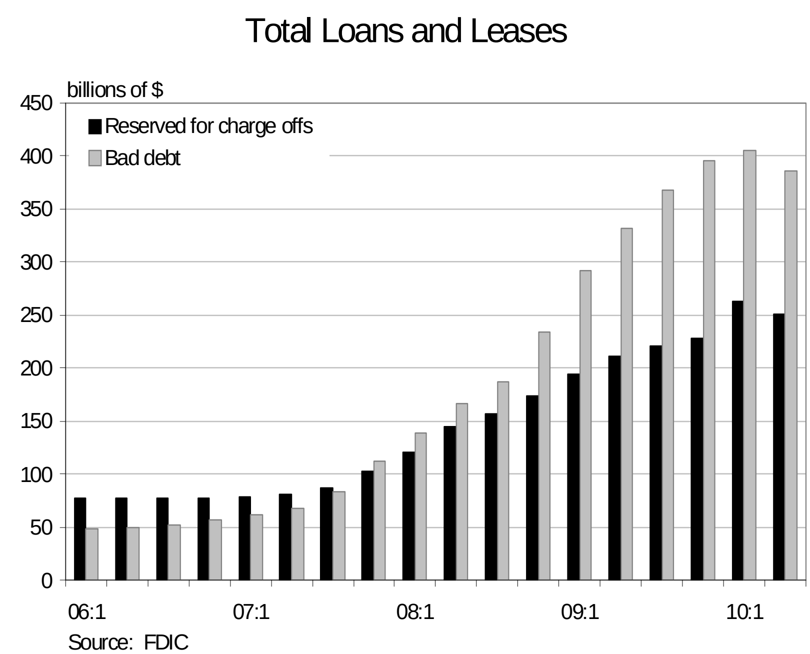
Government backed debt is the primary source of new debt and roughly ⅓ has been absorbed by the current account deficit. Now the Fed's new QE2 purchases promise to absorb virtually all newly issued Treasury debt.

This will push current Treasury buyers into other markets. Corporate debt may absorb some of this demand, but foreign governments will be reluctant buyers. This supply/demand balance suggests substantial downward pressure on rates.

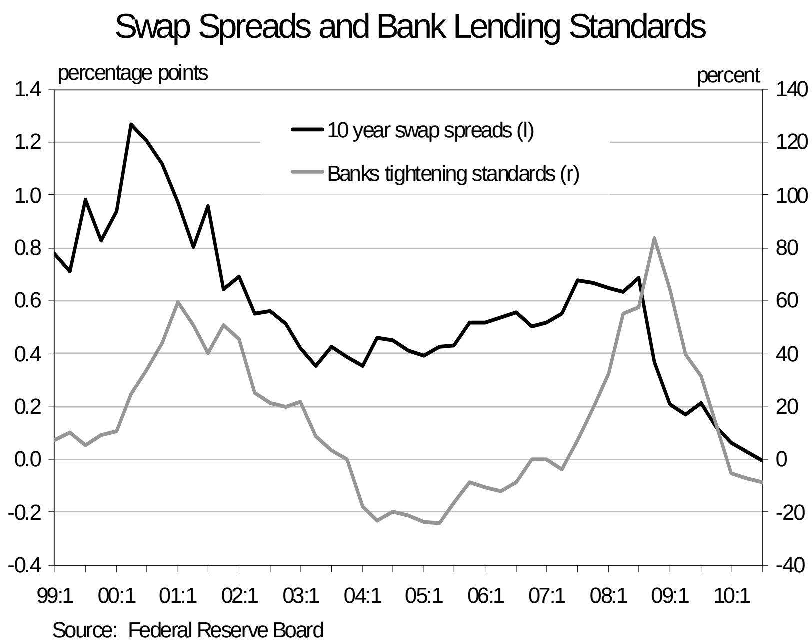
MONETARY AND CREDIT INDICATORS



The slight increase in M2 velocity suggests a small increase in the impact of monetary policy on the economy.



The banking sector is moving closer to the point of expanding assets again. Preliminary Q3 data show the gap between bad debt and reserves has grown smaller.



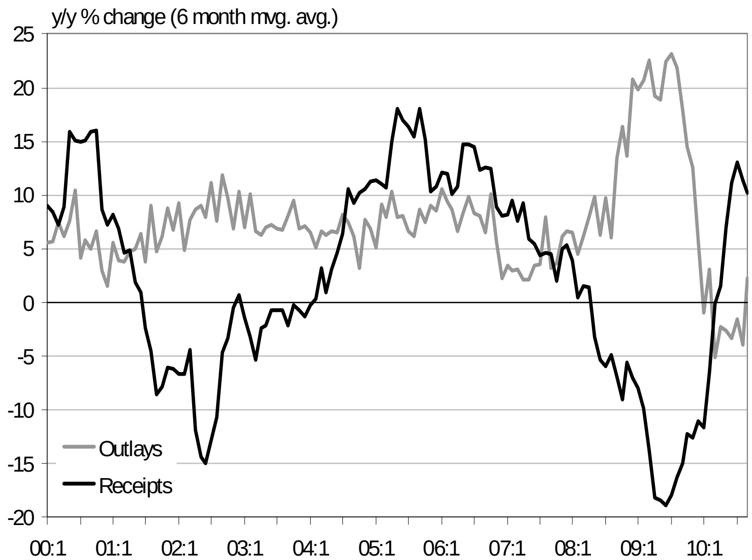
Swap spreads point to continued easing in bank lending standards.

If the gap between Treasury and mortgage rates continues to widen, the Fed will reconsider purchasing mortgage backed securities in addition to Treasuries.

GOVERNMENT

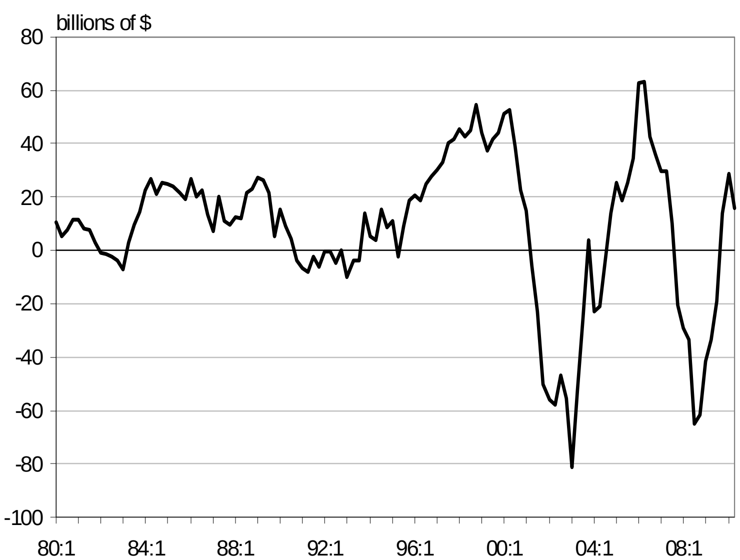
Most current projections show fiscal policy turning restrictive in 2011. However, this does not allow for changes made in the upcoming lame duck session. We expect old tax cuts to be extended and new ones to be added. We also expect new spending stimulus in 2011. On balance, policy will be neutral or slightly stimulative next year.

Federal Outlays vs. Receipts



Source: Department of Treasury

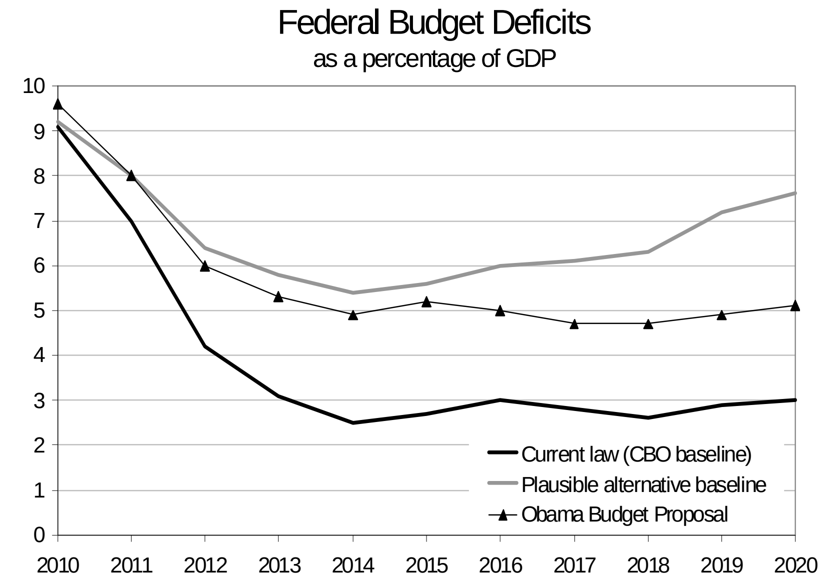
State and Local Surplus/Deficit



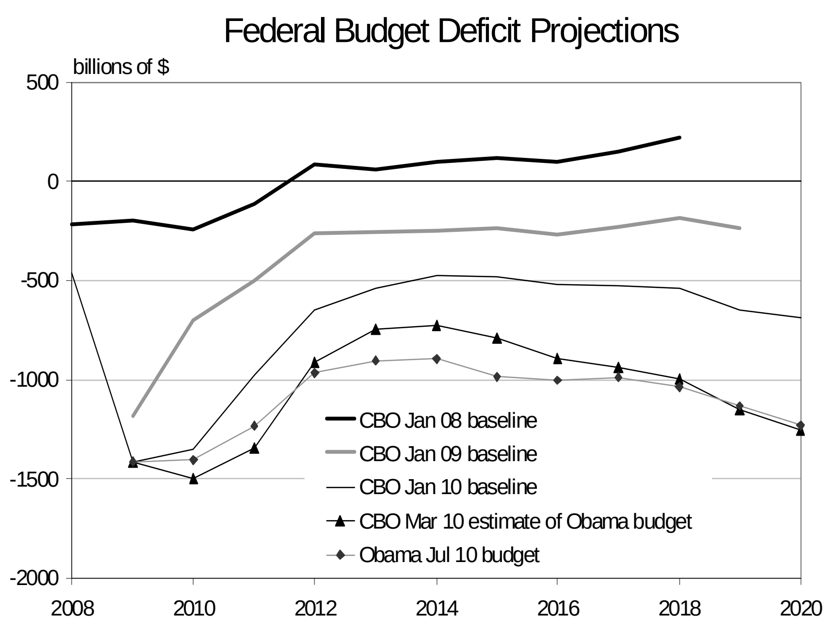
Source: Bureau of Economic Analysis

At present, Federal receipts are rising faster than outlays, but this will not continue. The 2011 deficit is expected to be only slightly smaller than the 2010 deficit.

State and local budgets have moved from a large deficit to a small surplus. This suggests spending cuts will not be necessary in 2011.



Source: Congressional Budget Office (Aug 2010), Office of Budget and Management (Jul 2010), EfW (plausible alternative)



Source: Congressional Budget Office, Office of Management and Budget

Current estimates show the Federal deficit falling to 5 - 6 % of GDP.

However, deficit estimates generally get larger as time passes and more realistic policy assumptions are incorporated.

Economics from Washington

The next issue of *The Chartbook* will
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