

April 18, 2011

L. Douglas Lee
dlee@econfromwashington.com

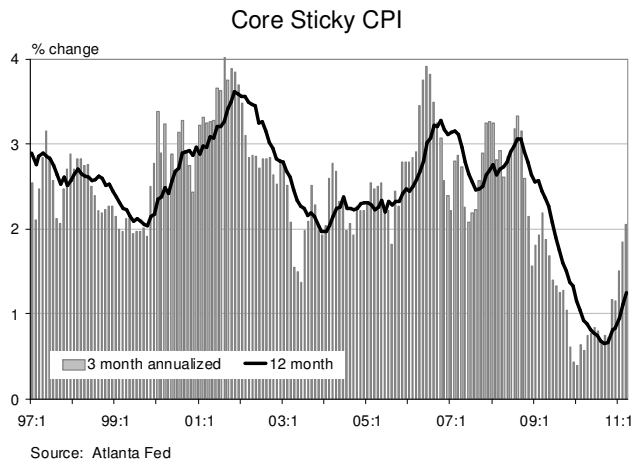
- *Economic growth slowed significantly in Q1, but there are a variety of reasons this will be temporary. Above trend growth continues to be the most likely outcome for 2011.*
- *While core inflation remains benign, underlying trends point to a gradual increase. This will begin putting pressure on the Fed before the end of the year.*
- *Increasing the debt limit debate is a serious problem which politicians will not resolve until something forces action. That something is likely to be a negative market reaction.*

Last week, economic forecasters again lowered expectations for first quarter growth, with rates of 1 ½ - 2% becoming common. For investors, the issue is whether this represents a temporary or longer lasting slowdown. Our view is the slowdown will prove temporary.

The most recent reasons for lowering expectations for Q1 GDP growth were weaker than expected exports and inventory investment. The broader theme, however, is the data used by BEA to estimate GDP have been lower than other signals indicated. For example, export orders surged to a new high in Q1, which normally indicates strong exports will follow. Yet export volumes fell in February, almost reversing the gains from the two previous months. It would take an enormous gain in March for trade to have a positive impact on GDP growth. Production of business equipment is normally a good indicator of capital goods shipments; in the first quarter, one shows a double digit increase while the other slowed sharply. Employment rose at a rising rate in Q1, something that normally accompanies faster, not slower growth.

These contradictory signals cause us to rely on what common sense tells us is happening. The increase in jobs is hard to argue with, and the February JOLTS data just reported a large increase in private sector job openings. Real consumer spending has slowed due to a surge in food and energy inflation, but absent another surge in prices, it will rebound fairly quickly. Steady increases in durable goods spending do not suggest a consumer retrenchment is at hand. There were some weather related problems in Q1, but the weather has improved. Production has been strong across a broad range of manufacturers, and while auto output will slow in Q2, other areas are holding up well. The recent Empire State survey was very strong. Undoubtedly, there will be some supply disruptions from the series of disasters in Japan, but those will be temporary. In short, there are too many indicators the economy is moving ahead at about a trend or slightly better pace to change our view. Until we can point to data showing the slowdown was temporary, markets will still worry.

Inflation data (excluding food and energy) have been



fairly benign, but the underlying story points to gradual acceleration. The core rate is up only 1.2% over the past 12 months, but the annualized increase was 1.4% over the past 6 months and 2% over the past 3 months. The acceleration has occurred mostly in goods prices excluding food and fuel. This suggests some spillover from earlier commodity price increases and some impact of the weaker dollar. While this portion of the index may now slow, there is good reason to expect service prices to rise faster. Private sector surveys show rents are rising more quickly, and vacancy rates are falling. Builders see a stronger market for rental property and have increased multifamily construction, but it will take a year before new units expand supply. Given the large weight of shelter in the index, this will be a source of

rising inflation pressure for the remainder of the year. Wages have also begun to edge slightly higher, and productivity growth appears to have slowed sharply. Low unit labor costs have been important in helping business absorb other cost increases without increasing prices, but that is changing. Numerous surveys (including last week's NFIB report) show more businesses planning to increase prices. Inflation has not yet reached the point of putting pressure on the Fed to tighten policy, but it is moving in that direction.

Washington's debate over increasing the debt limit is also providing a source for market concern. Markets could ignore the threat to close the Government, because this has happened before and we have a fairly good idea of the consequences – the world does not come to an end. The failure to increase the debt limit is something different. It has never happened before, and debt is directly tied to markets. Even if you believe the Government will not default on its debt if it loses the ability to borrow, the idea of meeting only about two-thirds of its obligations is very disturbing.

Thus far, the debate has not inspired confidence in our politicians' ability to address budget problems. The President has presented a new plan which he claims will reduce the deficit \$4 trillion in 12 years. Careful evaluation shows this plan relies almost exclusively on tax increases and the CBO just announced his earlier budget (which forms the baseline for the new plan) would produce cumulative deficits over the 2012 - 2021 period \$2.3 trillion greater than the Administration claimed. Alternately, the Republicans have passed a plan they claim will reduce the deficit \$4 trillion in 10 years without any tax increases. According to this plan, fiscal contraction will cause economic growth to accelerate and the unemployment rate will fall about 20 times more than a historical Okun's law relationship would predict. Clearly, the politicians' favorite forecaster, Miss Rosy Scenario, is back in town and she is working for both parties.

Still, the budget debate has moved beyond the numbers to underlying political philosophy. The President's goal is to raise taxes and defend current social welfare programs. Republicans oppose both. Resolving this disagreement is far more difficult than winning or losing a few dollars in a spending dispute and this is the reason it will not be resolved any time soon. The Treasury never knows exactly how much money will flow into or out of their accounts in a particular period, and Congress does not know exactly how much wiggle room the Treasury has to juggle those accounts to avoid the limit. The current estimate is the debt will reach its limit sometime between early May and early July, but that estimate can change very easily. With no date certain for the debt to reach its limit, politicians will continue to argue until something forces action. Unfortunately, that something is most likely to be a negative market reaction.

Economics from Washington, Inc. ■ T 301.365.6395 ■ F 301.365.2686

Economics from Washington, Inc.TM is a private consulting firm. This report is for private circulation and distribution in its entirety. Although the information herein has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness, or fairness. Opinions and estimates may be changed or withdrawn without notice. The information contained in this report should under no circumstances be considered or relied upon as investment advice or recommendations for the buying or selling of any security or commodity. Forward-looking statements are inherently subject to multiple risks and uncertainties that could cause actual circumstances to differ from those that are expected.

©2011 Economics from Washington, Inc. All rights reserved.