Economics from Washington

SECOND THOUGHTS

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- *Source data point to very slow growth in Q1 and a plunge in productivity. This does not represent what we see happening in the real economy.*
- *The Fed will likely clarify its plans for ending the current asset purchase program. It is likely to maintain its portfolio for several months by reinvesting maturing assets in Treasuries.*
- *Politicians need a way to increase the debt limit while verbally opposing it. This may require an opportunity to vote no before finally voting yes.*

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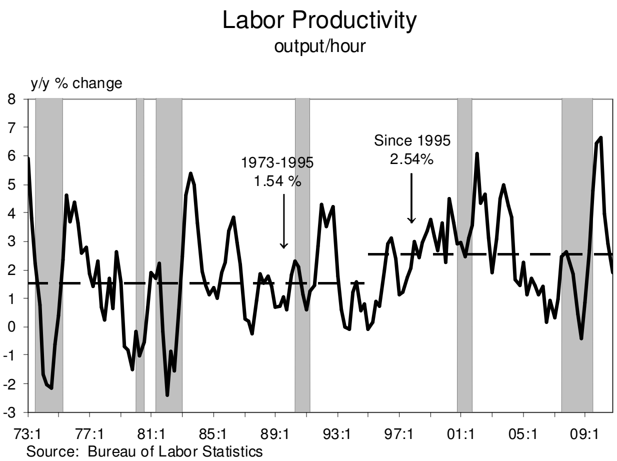
In many respects, the economy has gradually climbed out of a very large hole created by the past recession. Yet the expansion continues to be characterized as fragile. This will be emphasized by the Q1 GDP report which could show growth of only 1 ½ %. While we believe this is only a temporary slowdown, markets may adopt a wait and see attitude. Investors will be monitoring the upcoming FOMC meeting to see how the Fed views this slowdown.

Estimates of GDP are not tied to various measures of economic output. Instead, BEA uses data like retail sales, construction spending, capital spending, change in inventories, and net exports. Most of these bits and pieces are reported on a monthly basis, allowing analysts to add them up to reach a GDP estimate just as BEA does. Of course, there are no data for inventories or net exports for the third month of the quarter when the initial GDP estimate is released, so everyone has to make a guess. This explains a good deal of variation in analysts' estimates and often explains why the BEA estimate differs from expectations. These bits and pieces are currently pointing to 1 ½ - 2% growth in Q1.

The problem with the upcoming GDP report is first quarter output indicators showed robust growth. Employment gains measured by the payroll survey showed almost 500,000 new jobs, which translates into a 2% increase in hours worked in Q1. The household survey reported over twice as many new jobs and tax withholding data looks more consistent with the household numbers than the payroll reports. In addition, manufacturing output rose at almost a 10% pace in Q1 and the ISM survey suggests nonmanufacturing output was also very strong.

A good way to estimate GDP growth is to combine the growth in hours worked with growth in productivity. If hours rose at a 2% pace and GDP grew more slowly, productivity must have plunged. Productivity growth has averaged 2 ½ % since 1995, and experienced only one negative quarter at the bottom of the 08 - 09 recession when it fell 0.4%. Productivity growth was unusually strong in 2010 and will certainly slow in 2011, but



there is no evidence it has suddenly plunged into negative territory.

Occasionally, economic reports do not reflect what we see happening in the real world. When this happens, we go with the eyes. This is the reason we will view a weak GDP report as likely to be only temporary. Too many output indicators tell us the economy is expanding at a rate modestly above trend. Growth in Q2 will also be a challenge, because the disruption in parts supply caused by the Japanese disasters is expected to reduce auto output enough to subtract ½ point or more from GDP growth. Some of the recent uptick in unemployment insurance claims may have been caused by this problem. Auto companies expect to make up this lost output in the second half of the year.

Financial reporters are very excited about the upcoming FOMC meeting because Ch. Bernanke plans to hold a press conference after the meeting. This is a new policy, and promises to give reporters an opportunity to directly question the Fed chairman on a regular basis. In terms of substance, it will be surprising if Ch. Bernanke says anything not already reflected in the written statement. There is a good chance the committee will clarify its plans for ending the current asset purchase program and managing its portfolio over the following months. Some estimates suggest the Fed could reach its targeted $600 billion before the end of June. Once the purchase program is complete, we expect the Fed to maintain its portfolio for several months by reinvesting the maturing assets in Treasuries. As core inflation creeps higher, the case for tightening policy will grow stronger, but we are not likely to see the next policy change until late in the year.

Budget related problems continue to be the most important policy issues working in the background. The committee headed by VP Biden is scheduled to begin meeting May 5, but it has not gotten off to an auspicious start. Republicans decided the Obama proposal included too many negotiators so they decided to send only two representatives from each house instead of four. Washington observers rate this committee as the least likely way to reach a new agreement on increasing the debt limit.

The major political problem with increasing the debt limit is many Americans do not believe it should be raised. Political polls are showing a large number of constituents (in both Democratic and Republican dominated districts) are opposed to an increase. Some moderates, who believe raising the limit is necessary, are very worried they will be punished at the polls if they vote contrary to constituent wishes. The usual way around this problem is to provide some type of political cover. In this situation, it probably means giving politicians an opportunity to vote no on increasing the limit before they finally vote yes. They can then point to their initial no vote and argue they only voted yes to avoid a terrible catastrophe.

Politicians will argue about the debt limit as long as they think they can, and there is no date certain to force a decision. The questions are how long markets will remain patient with this political process and how markets will react if the politicians decide they need to vote no on raising the limit before they can vote yes. Although the reaction to the S&P downgrade of US Government debt was very short, it suggests this is very risky business.

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