Economics from Washington

SECOND THOUGHTS

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- *The March employment report showed solid improvement across a large segment of the economy. Other indicators point to continued growth. This is the most persuasive evidence the expansion has become self sustaining.*

- *Q1 GDP growth is currently tracking at a 2 - 2 ½ % pace, but this appears to be a temporary lull. Both consumer spending and manufacturing output will be stronger in Q2.*

- *The 2011 budget agreement will exert little fiscal drag on the economy. Commonly advertised budget cut numbers are roughly three times the size of actual spending cuts.*

February's employment report showed good growth, but it was not entirely satisfying. A good portion of the increase was a result of weather depressed activity in January. The March report was the real deal. Very solid employment growth, combined with modest upward revisions to past estimates, confirms labor markets continue to improve. The household survey has been running well ahead of the payroll estimates, indicating reality may be somewhat better than shown in the most commonly used data. With each of these reports, the case grows stronger for believing the economy has moved into the self-sustaining part of an economic expansion.

In many ways, the March employment report validates other indicators of labor market improvement which have been apparent for some time. The good news is these other indicators remain positive, suggesting solid job growth ahead. These indicators include a falling trend in new claims for unemployment insurance and a rising trend for new job postings. Almost half of the job vacancies tracked by the Conference Board were first-time ads in March, the highest share since 2007. The Business Roundtable, representing large businesses, just reported healthy increases in hiring and capital spending plans. The Human Resource Managers' LINE index suggests the hiring pipeline at large businesses is growing larger. The NFIB also reports modest increases in small business' plans. Both survey data and diffusion indexes show labor market strength is broad based and improving.

Despite job improvements, wage rates have been stagnant. From the perspective of the average worker, living standards are not rising. Nevertheless, total wages are rising because there are more employed workers. In the aggregate, wages are rising at about a 4% nominal rate, and about a 2 ½ % rate after inflation. As labor markets continue to improve, the average worker is likely to benefit from an increase in hours worked, but it will be some time before the market is strong enough to generate pressure on private sector rates of pay.

As the first quarter unfolded, analysts lowered expectations for current quarter growth. Tracking estimates of

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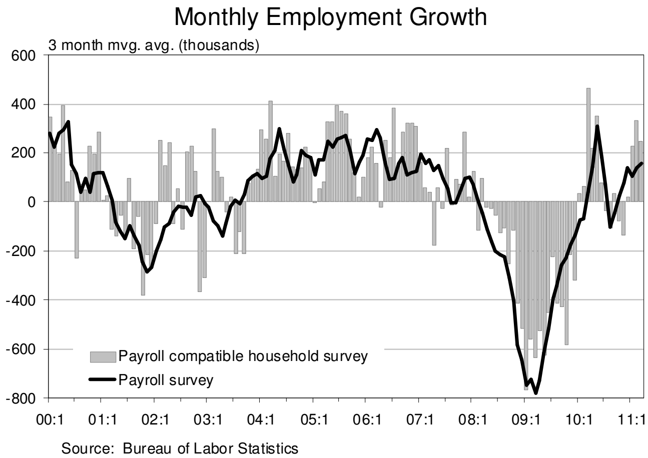

GDP growth are currently running in the 2 - 2 ½ % range. However, this does not seem to represent a fundamental slowing in economic activity. While consumer spending has slowed to about a 1 ½ % pace, auto sales are still running well above the Q4 pace. Autos and other durable goods are typically the first to soften when spending slows, because these purchases are the most discretionary. If futures markets are correct in indicating food and fuel prices are leveling out, this will soon be reflected in top line inflation measures, which means less erosion of nominal income growth. Manufacturing orders have slowed, but production remains very strong, and the ISM survey data is quite strong. Part of the ISM orders slowdown is due to export orders, which is probably a reaction to the Japanese disaster in Asian markets. Interestingly, while economic analysts have lowered expectations for 2011 GDP growth, business executives have raised their expectations. Both groups seem to be converging on about 3%. This is the low end of the 3 - 4 % range we expect.

Nonfarm business productivity grew at a very strong 3.7% pace in 2009 and 3.9% in 2010. Strong labor productivity growth was an important factor in allowing businesses to maintain profit margins in the face of rising commodity prices. With labor markets strengthening and GDP growth appearing to slow in the first quarter, productivity growth could report a sharp slowdown. This is consistent with a growing number of reports that businesses plan to increase prices to offset rising costs. Of course, sustaining price increases under current economic conditions will be difficult and some attempts will fail. Nevertheless, sources of cost pressure are spreading, and this will translate into pressure on both prices and profits.

Nothing in recent reports has changed the likely path of Fed policy. Clearly, the amount of public discussion has increased, with FOMC members expressing a range of opinions about the appropriate exit strategy. Still, as long as the economy remains on track for above trend growth, something quite unexpected must happen to alter the plan to complete the asset purchase program in June. Once the program ends, the Fed would prefer to allow markets to adjust before initiating new action. Absent some unexpected development in the economy, the next policy change is unlikely before Q4, and that change remains the subject of very active discussions. While no decisions have been made, we expect the Fed to begin shrinking its balance sheet before it begins to increase short term interest rates.

As expected, budget negotiators have moved closer to a final agreement on the 2011 Federal budget, and the probability of a Government shutdown has declined. It is clear avoiding a shutdown has become a widely shared goal. The numbers commonly used in Congressional debate and press articles refer to budget authority rather than outlays, and are somewhat bloated to make the cuts appear larger than reality. From a macroeconomic perspective, the fiscal drag in 2011 will be less than one-third the amount mentioned in news articles. If the final package is advertised as a $33 billion cut, the fiscal drag in 2011 will be about $10 billion, which is quite small. The next critical budget period will occur as the debt limit nears – probably sometime in May or June. The Treasury will begin altering its normal debt management practices as it approaches the limit, so market distortions are likely. The timing of this critical budget period could coincide with a decision by investors to pull back from markets in anticipation of the end of the Fed's asset purchase program.

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