Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Longbrake Letter*

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I. Economic Recovery Is Progressing But Remains Fragile

1. Abundant Policy Stimulus Has Not Fostered Strong Economic Recovery

Extraordinarily accommodative monetary and fiscal policies in the U.S. and elsewhere, combined with strong growth in emerging markets, have underpinned a modest economic recovery in the U.S. In another era these factors would have lead to much stronger growth than has occurred over the last 21 months. But it takes time and a lot of stimulus to climb out of the deep economic hole that the financial meltdown and Great Recession created.

2. Comparing Recoveries Following the 1981-82 and 2008-09 Recessions

At the end of the 1981-82 recession in July 1982 the unemployment rate stood at 9.8% compared to 9.6% in June 2009. But over the ensuing 21 months, the unemployment rate fell to 7.8%, while it has come down only to 8.8% in this cycle. Actually, comparing the improvement in unemployment rates for the two periods paints a rosier picture than looking at the growth in jobs, which was a robust 4.8% after the 1981-82 recession but has barely eked out 0.2% growth in the current recovery. Based on changes in labor force participation rates, this difference is due to 3.5 million workers leaving the labor force "voluntarily" during this recovery compared to an increase

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in labor force participation of more than 400,000 after the 1981-82 recession. Some economists have tried to argue that demographic factors and structural unemployment account for recent declining labor force participation. While such arguments might have an element of validity, it is hard to imagine that these factors alone explain the significant contrast in the behavior of employment participation between the two recoveries.

The contrast between the two recoveries is even starker when the Congressional Budget Office's estimate of the output gap is compared. Over the seven quarters following the end of the 1981-82 recession the output gap fell from 6.9% to 1.1%. The output gap peaked at a slightly higher level of 7.7% during the recent recession, but has fallen in the subsequent seven quarters to only 6.3%.

Thus, by these measures, in comparison to previous recoveries, this economic recovery is demonstrably weak. What seems to be forgotten or given little credence is that aggressive monetary and fiscal policies and the fortuity of rapid growth in emerging markets avoided what might easily have turned out to be a replay of the Great Depression of the 1930s. What also seems to be little understood is that the grievous damage that flawed policies, which spawned overconsumption, easy credit, housing speculation and excessive leverage, wreaked upon the economy cannot be undone quickly and painlessly through the application of massive amounts of monetary and fiscal stimulus. Indeed, these policy responses risk setting in motion new imbalances, such as excessive national indebtedness, which could lead to painful, and perhaps disastrous, consequences, if not addressed, in a few years time.

3. Optimism Dominates Financial Markets, But Pessimism Abounds Elsewhere

Nonetheless, for the time being economic data reports confirm that recovery is underway. Optimism dominates financial markets. Federal Reserve officials publish optimistic economic outlooks and some fret about the risk of inflation. If one looked no further than this it would seem as though the economy is strengthening rapidly so that underperformance will soon be a worry of the past to be replaced by concerns of overheating and inflation. But ask the average American. There is little optimism. Sentiment and confidence surveys remain mired near recession lows and, courtesy of soaring gasoline prices, have been deteriorating over the last couple of months.

How does one explain the optimism of financial markets and the pessimism of most Americans? Company earnings results support stock market optimism. But, a great deal of economic data describing employment and income growth, residential housing prices and consumer spending are more in sync with consumer pessimism.

An objective of the Federal Reserve's non-traditional monetary policy of quantitative easing has been to provide sufficient liquidity to drive up prices of financial assets. And, this is exactly what has happened. This creates additional wealth, part of which is spent on current consumption, thus accelerating economic recovery. Were we to probe no further, we would conclude that the Federal Reserve's monetary policy has accomplished what was intended, which is to create a strong enough economic base for a self-sustaining expansion to take hold. What is missing, when we probe a bit deeper, is that the benefit of the Federal Reserve's policy in creating financial asset wealth is limited to a small fraction of the American populace. In other words, quantitative easing mostly benefits the wealthy in the short-run and relies on "trickle down" to have broader favorable impacts on the economy over time.

Strong company earnings growth has benefited not so much from economic recovery in the U.S. as it has from strong international growth and cost containment, including falling unit labor costs, which result from productivity increasing at a faster rate than nominal wage growth. While strong productivity growth is good for earnings, it weighs against job creation. While domestic sales revenues are recovering the level of real consumer spending is up only 0.5% since December 2007 and it would actually be down were it not for the significant increase in government transfer payments such as unemployment insurance. Moreover, consumer spending growth is still well below the long-term average as consumers struggle with unemployment, underemployment and high debt burdens.

Strong international growth, lead by emerging markets, and a decline in the value of the dollar have combined to fuel a strong recovery in manufacturing and trade. Unfortunately, manufacturing and trade account for a very small portion of economic activity in the U.S. and productivity has been particularly robust in the manufacturing sector. So, again, this development has been an engine driving profit growth but not much employment growth.

4. Forecast Risk

Put this all together and what it tells us is that the economic recovery is not broad-based. There are pockets of strength, but considerable weakness prevails in many sectors. Given time and the absence of unexpected negative shocks it would be reasonable to expect the economy to strengthen gradually and for the weak sectors to improve. GDP growth would be sufficient to reduce the output gap slowly and the unemployment rate would fall as hiring picks up. However, the pace of improvement would be sufficiently gradual that a sharp and sustained increase in inflation would not threaten for a long time. This outlook forms the base case for most forecasters. I count myself among them, but my conviction is not strong. That is because a fragile economy is particularly vulnerable to negative shocks.

In recent weeks several risks, some new, have escalated. Yet, it is too early to opine whether any of these risks or a combination of them will prove sufficient to slow economic recovery significantly or even derail it. The new risks include yet another oil price shock resulting from political turbulence in the Middle East and the multiple disasters in Japan triggered by the recent earthquake, which has had a devastating impact on the Japanese economy. Several other risks have been in place for a while. Some, such as the problems of peripheral countries in the European Union, and housing in the U.S. are worsening. Others, such as federal fiscal policy and monetary policy are transitioning from positive to negative impacts. There are other risks, such as overheating of emerging market economies, particularly China, which could lead to cyclical reversal. While this particular risk and others I have not mentioned bear watching, I believe they constitute lesser concern at this time than the others which I have mentioned.

II. Significant Risks Threaten Economic Recovery

1. Global Oil Price Shock

Political turmoil continues to roil the Middle East. However, so far the only serious interruption of oil supplies stems from the civil war in Libya, which currently appears to be stalemated. This has reduced oil supply by 1.5 million barrels per day, which equals about 30% of OPEC's spare capacity of 5.2 million barrels per day. This and accentuated uncertainty about what might happen in other oil-producing Middle Eastern countries has been sufficient to push the price of oil up by more than 20% in a few weeks time. While prices appear to have stabilized at the new higher level, prospects for them to decline in the near term seem remote. Libya's production appears to be lost for a very long time. The political risk premium now embedded in the price of oil will remain until tensions ease in the Middle East and that prospect seems a long ways off. Further interruptions in oil supply appear to be unlikely, but as long as political instability remains the order of the day the balance of risks tilts in the negative direction.

An offsetting factor to this risk is a drop in the demand for oil. If the drop is significant enough, it would bring the price of oil down. There is already evidence in the U.S. of demand destruction. According to MasterCard, the quantity of gasoline purchases has been less than a year ago for five consecutive weeks. Purchases were 3.6% below the year ago level during the week of April 1.

Econometric models indicate that a sustained 10% increase in the price of oil will reduce economic growth in the U.S. by about 0.2% in each of the two following years, for a total reduction of about 0.4%. This would mean that the 20% to 30% increase in the price of oil, if sustained, which increasingly seems likely, will depress U.S. GDP growth over the next two years by about 1%.

The models also indicate that the adverse effect on GDP growth is not linear but escalates as the sustained percentage increase in the price of oil rises. Should prices stabilize near the current level, which seems to be the most likely scenario at the moment, some damage to growth will occur but it would be insufficient to tip the economy back into recession. Oil prices in the range of $125 to $135 per barrel (West Texas Intermediate), or another

20% to 30% increase, however, would put economic recovery under severe strain and could result in negative GDP growth for a quarter or two.

Europe appears likely to be affected adversely to a much greater degree than the U.S. for several reasons. First, the lost Libyan oil is predominantly low-sulfur "sweet" crude, which goes mostly to Europe. While Saudi Arabia has the capacity to increase oil production to close the shortfall created by the loss of Libyan oil, it is "sour", high-sulfur content crude. Unlike the U.S., Europe has little capacity to refine high sulfur content crude, so the replacement of lost supply is far from perfect. That is one of the reasons that a large price gap has opened up between the Brent and West Texas Intermediate (WTI) oil prices. As of April 13, 2011 WTI was about $107 per barrel while Brent was $123 per barrel. Prior to the crisis Brent averaged about $1 more per barrel than WTI. Another reason that the price of WTI has not escalated to the same extent is that the current ample supply of natural gas in the U.S. is an effective energy substitute and it is currently cheap and abundant. Europe does not have access to cheap U.S. natural gas. The impact of the Libyan situation will be the greatest for Italy, which is not a happy prospect because Italy is not totally immune from possible sovereign debt issues.

Second, commodity prices have a greater impact on measured inflation in Europe. For a variety of reasons unrelated to oil prices, inflation had already been rising in Europe, so the run up in oil prices simply exacerbates matters. Unlike in the U.S. where the Federal Reserve has a dual policy mandate covering both inflation and employment, the European Central Bank (ECB) is only responsible for limiting inflation. In response to this new threat to inflation, the ECB recently raised rates by 25 basis points. Most believe the ECB's policy action was taken to contain inflationary expectations and was not the first of a series of rate increases.

Third, the increase in interest rates in Europe will have two consequences, both negative, for the peripheral European members of the European Union (EU) that are struggling with sovereign debt problems. First, higher oil prices and interest rates will depress economic growth and second, higher interest rates will increase the cost of sovereign debt. The first will depress tax revenues, the second will increase expenditures. Already, in anticipation of the next round in the on-going sovereign debt crisis, interest rates have risen on sovereign debt to levels that are simply not sustainable without intervention of some sort.

While the consequences in the U.S. are likely to be lesser in scope, they are not trivial. Already, consumer optimism has plummeted, although this has yet to show up in reduced consumer spending.

There will also be consequences for emerging economies because most are net importers of oil. The increase in oil prices that has already occurred is expected to have a modest negative effect on global growth over the next two years. But, further escalation in oil prices would result in much greater damage to global growth.

What to watch for is that when shocks occur, if they persist for any length of time, consequences will emerge and those consequences will set in motion responses that could have further adverse impacts on the global economy.

2. Japanese Economy Severely Wounded — Negative Supply Chain Impacts

Usually disasters have a short-lived negative effect on an economy which is quickly followed by a growth spurt as reconstruction activity moves into high gear. However, as additional information about the consequences of the Japanese earthquake, tsunami and nuclear catastrophe come to light, the customary pattern may stretch out over a much longer period of time. Electrical power generation capacity has been severely impaired and will take an exceptionally long time to restore. Manufacturing plants that were damaged by the earthquake and tsunami can be repaired relatively quickly but without sufficient electrical power they will not be able to operate at full capacity.

Japan is a key exporter of critical component parts for electronics, autos, cameras and other manufactured goods. Given time, those who rely on those parts will be able to find acceptable substitutes elsewhere. It is difficult to assess the extent to which these supply chain interruptions will harm global and U.S. manufacturing. What we do know is that these interruptions are likely to be sustained for longer than initially was thought. It is that fact that increases the risk.

3. European Sovereign Debt Crisis

Greece and Ireland have already received financial bailouts and now Portugal has acknowledged that it will be unable to roll over government debt at a reasonable cost without a bailout. It is estimated that Portugal will need approximately 75 billion euros in assistance.

In the meantime, both the Greek and Irish economies are faring more poorly than economic projections that were made at the time financial assistance was provided. It is not surprising that the austerity measures that were required as a condition of financial assistance have depressed economic activity. Neither is it surprising that the outcome is worse than the original projections. If the original projections had been honest ones, they would have indicated that a debt restructuring for Greece and perhaps for Ireland as well was inevitable. That is because measures to reduce government expenditures and increase taxes would be more than offset shortfalls in tax revenues caused by declining economic activity. Moreover, the original terms of financial assistance involved fairly high interest rates and interest rates have moved higher as time has passed and as rating agency debt downgrades have occurred.

There were strong reasons for playing this game of "pretend and extend" or less charitably known as "kick the can down the road". First, because much of the sovereign debt is held by European banks, a debt restructuring involving principal forgiveness would deplete bank capital and perhaps even threaten insolvency for a few. This most certainly would trigger a liquidity crisis for European banks as investors seek to move funds to safer climes. European authorities did not relish the prospect of dealing with contagion. This remains a problem and because restructuring appears to be inevitable, European authorities will have to figure out how to handle the consequences. There is not yet any plan for how to do so. It is likely that a plan will emerge in a crisis atmosphere when time has run out and this will raise the risk of a significant policy mistake.

Second, as I mentioned in last month's letter, France and particularly Germany want other member countries of the European Union to agree to fiscal policy constraints — the so-called competitiveness pact. By agreeing to such a policy regime, member countries would give up a large measure of sovereignty over taxing and spending. Economists point out that this is a necessary component to make a monetary union actually work. Indeed, this imperative has always been recognized in the treaty that formed the foundation for the European Union. But it is a policy of words with no enforcement mechanism and obviously the lack of an effective enforcement mechanism permitted individual country behaviors which have lead to the current sovereign debt problem.

Bailing out Portugal will buy some more time, but time is running out and it will be necessary for Europe in a few months time to deal directly rather than indirectly with the sovereign debt crisis. The situation is worsening and delay will only make the ultimate necessary resolution more difficult and risky. Because of the interconnectedness of the global financial system and Europe's importance in the system, the manner in which Europe's sovereign debt crisis is ultimately resolved will have repercussions for U.S. financial markets . . . and they will not be positive ones.

4. Declining Housing Prices

In a typical economic cycle housing is a key sector that contributes to recovery. Low interest rates spur housing demand and stimulate new construction. That is not the case now. Interest rates are at all time lows and measures of residential housing affordability are at record highs, conditions which in other cycles were sufficient to launch a strong housing recovery. And now, when a turnaround ought to be underway, home prices are declining once again and housing construction and sales activity is plumbing new lows.

The causes of this malaise are many — a substantial inventory of excess homes due to overbuilding in the bubble years; declining new household formation; a gradual shift from ownership to rental; and stringent credit qualification requirements — all of which have and will continue to depress housing demand. On the supply side, foreclosures continue unabated, dumping houses into a resale market already burdened by excess inventory.

With the benefit of hindsight, the apparent bottoming out of the housing market and small rise in home prices a year ago stemmed from the housing purchase tax credit program, which artificially inflated demand for several months. According to the Federal Housing Finance Agency's (FHFA-HPI) home price index, prices rose 2.5% in the first quarter of 2010, but declined 4.0% during the remainder of the year. The FHFA-HPI is released quarterly, so the next update for the first quarter of 2011 will not be available until May. However, monthly FHFA and Case-Shiller home price data both indicate that housing prices are continuing to decline. B of A forecasts that home prices will decline 4.6% during 2011.

Falling home prices obviously will continue to depress housing demand. Who wants to buy a home when its value is likely to fall. But, there are two other risks that bear close watching. First, falling home prices will reduce consumer wealth. Because perceptions of wealth affect consumer confidence and spending, declining housing wealth will have a negative impact on economic activity. Whether this impact will be significant will depend upon the extent of housing price declines during 2011. A worst case scenario entails a combination of stagnant or declining stock prices and decreases in home prices that exceed the widely forecast 5.0% decline.

Second, holders of mortgages are not required to mark the value down to reflect realizable value upon foreclosure as long as the borrower makes payments. What this means is that there are substantial embedded unrealized losses in the home mortgage portfolios of financial institutions because most borrowers remain current on loans, even when the value of their home is less than the loan amount. If housing prices recover, these "paper" losses will diminish or disappear altogether. The risk is that further declines in housing prices will induce additional voluntary foreclosures and increase the realized losses on involuntary foreclosures. Such activity would deplete capital and force new lending retrenchment for many financial institutions.

The risk of potentially substantial additional losses by holders of defaulting mortgages is not yet a significant issue, but developments are moving in the wrong direction and could turn the financial consequences of further declines in housing prices into a significant problem later on in 2011. Financial institutions can slow down realization of financial losses by delaying foreclosure activity. This is exactly what has been occurring. Unfortunately, delaying foreclosures is a solution that will also postpone housing market stabilization. In that respect the financial handling of the housing problem is the same as the "kick the can down the road" approach to dealing with the European sovereign debt problems. Ultimately, losses must be realized and debt restructured before the housing market will return to health. But the interim consequences of doing so are enormous and no policy has been crafted yet to contain the potential for contagion. Residential housing continues to be an unhealthy situation with risks tilted decidedly to the downside.

There is one bright spot in the housing market and that involves multi-family rental units. Rental vacancies are now shrinking rapidly thanks to a falling homeownership rate and extremely limited new construction. While excess multi-family inventory remains, it has fallen from a peak of 1.4 million units in the third quarter of 2009 to about 700,000 units in the fourth quarter of 2010. This market tightening is already putting very moderate upward pressure on rental rates. Rising rental rates have contributed to stabilizing the core rate of consumer price inflation and will probably contribute to small increases in core inflation in coming months. But, more importantly, rising rental rates improve the financial economics of new multi-family construction and will surely lead to an increase in economic activity in this sector later on during 2011.

5. Monetary Policy

Monetary policy is currently extraordinarily accommodative thanks both to the Federal Reserve's zero-interest-rate policy and its large scale asset purchase (LSAP) program, better known as quantitative easing (QE) II. QE II involves purchase of an additional $600 billion in U.S. Treasury securities and maintenance of mortgage backed securities balances through replacement purchases.

QE II will be completed by June and as matters currently stand, further quantitative easing is unlikely. By simply completing the purchase program and doing nothing else, monetary policy will become somewhat less accommodative after June.

The longer term issue is when the Federal Reserve will begin to take action to tighten policy. One's answer to that question depends upon one's forecast of economic activity. Optimists, who expect GDP growth to accelerate, the unemployment rate to continue falling and inflation expectations to edge up, forecast that the Federal Reserve will begin to tighten policy as soon as the fourth quarter of 2011. However, forecasters who expect recovery to proceed gradually, which includes myself, believe the Federal Reserve will not begin tightening monetary policy until late 2012 or early 2013.

Criticism of the Fed's QE II program late last year was extremely intense and to a certain extent politically motivated. What this means to me is that the bar is very high for the Fed to engage in another round of quantitative easing. Thus, if other risk factors escalate and interfere with and slow economic recovery, I believe the Federal Reserve will remain on hold until there is convincing evidence that the damage is not simply transitory but also consequential. Unfortunately, if that scenario unfolds, because monetary policy takes time to work, QE III, outside of a positive announcement effect, would be of little immediate help in reversing negative momentum in economic activity.

There is also a risk that the Federal Reserve might choose to pursue tightening sooner than later to forestall an escalation in inflation expectations stemming from rising commodity prices, particularly the price of oil. This is the action that the European Central Bank (ECB) recently took. While there is considerable debate among members of the Federal Open Market Committee (FOMC), the most credible guidance comes from Chairman Bernanke, Vice Chairman Yellen and New York Fed President and FOMC Vice Chairman Dudley, all of whom are permanent members of the FOMC. It is clear from their statements that the FOMC is unlikely to follow the ECB's lead. Also, these members are less concerned about inflation prospects than some other FOMC members and have voiced concern about the weakness of the economic recovery and the risks that could derail or slow recovery.

I would also note that as fiscal policy becomes restrictive and the political will to attack huge deficits firms, it will become easier and also desirable for the Federal Reserve to maintain an easier, even accommodative, monetary policy. The historical record indicates that easy monetary policy often accompanies restrictive fiscal policy. My sense is that it will be no different this time around unless politicians fail to pursue fiscal consolidation aggressively. Of course, there will always be the risk that monetary policy will be tightened independently of what is happening on the fiscal front, but I think this risk is a small one.

6. Fiscal Policy

There is little doubt that political momentum has swung in the direction of reducing federal budget deficits. The questions now are ones of how much and how soon.

As of this writing the House of Representatives has passed a fiscal year 2011 budget resolution that includes $38.5 billion in spending reductions. It is likely that the Senate will follow suit. This action ends the cat and mouse game of temporary continuing resolution extensions but shifts the gamesmanship to the debt ceiling and fiscal year 2012 budget.

In addition, payroll tax cuts and extension of unemployment insurance benefits, which were enacted last December, and which have contributed significantly and favorably to economic activity during the first quarter of 2011, are scheduled to expire at the end of the year. It is too early to forecast whether any or all of these measures will be renewed for 2012. Extension will probably depend on the strength of the economy later this year, the mood of the public, and presidential electioneering. If economic recovery is grinding along, odds tilt in the direction of letting these measures expire as scheduled, given the current mood of Congress.

So, on balance, fiscal policy is already in the process of shifting from stimulus to restriction. The risk going forward is tilted in the direction of even greater fiscal restrictiveness rather than less.

With the battle over the continuing resolution for fiscal 2011 now resolved, attention is shifting to the need to raise the federal debt ceiling and to adopt a continuing budget resolution for fiscal 2012, which begins on October 1, 2011.

Republicans remain focused on spending cuts, but significantly Representative Paul Ryan's 10-year budget proposal begins the necessary process of downsizing entitlement programs by focusing on restructuring Medicare and Medicaid. Importantly, Ryan's proposal does not touch Social Security. As is well known by all, the developing U.S. sovereign debt problem cannot be brought under long-term control without dealing with entitlements.

President Obama at last long has entered the budget debate with his own proposal. After studiously ignoring the work and recommendations of his own fiscal commission after it submitted its report last December and then subsequently submitting a budget proposal to Congress that in essence denied the severity of the long-term debt problem, the president has finally joined the debate. Of course, the president's proposal differs considerably from Paul Ryan's, reflecting differing imperatives of each one's political constituency. Importantly, the president's proposal also addresses the need to restructure entitlement programs, but the projected deficit reduction over ten years is much smaller than the number targeted by Ryan.

What is important is that the political debate is no longer a matter of whether but a matter of what and when. Although Ryan's proposal would begin the fiscal consolidation process in fiscal 2012, most of its firepower would not take effect until after the presidential election, which means fiscal 2013. My best sense is that there will be a lot of political posturing and debate over the next two years but little significant action until after the 2012 election. However, that will depend upon how hard Republicans choose to press their agenda for spending cuts and longer-term budget reforms. Both the debt ceiling and the fiscal year 2012 continuing budget resolution are in play and could lead to more restrictive fiscal policy sooner than later.

While reducing budget deficits is essential to restoration of long-term fiscal health of the United States, and the sooner this process is commenced the better, let there be no doubt that fiscal consolidation will have short-term negative consequences for economic recovery and growth. This fact is not reason for engaging in further delay because as long as the U.S. federal debt problem remains unaddressed imbalances will continue to grow and when fiscal consolidation is ultimately addressed, as it will have to be, the cure will be even more painful. One has only to consider what is happening to Greece, Ireland and Portugal to appreciate the risks of delay.

Thus, it would be better to address the budget problem now, and perhaps it will be. But, it seems more likely that serious action will be delayed for another two years. This will not be fatal by any means, but, as I have said, the problem doesn't get any easier with the passage of time — it gets worse.

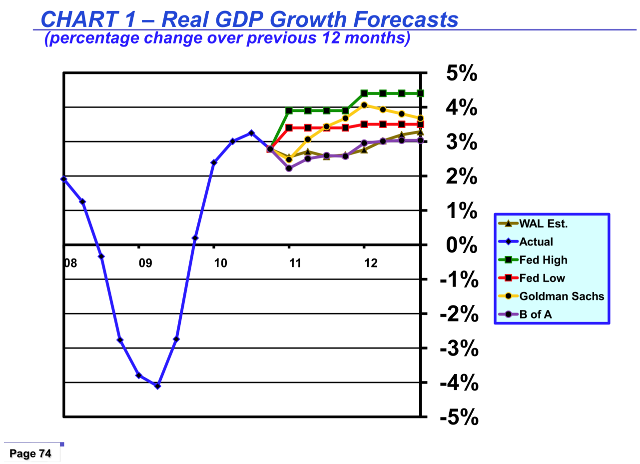
7. Summary

Each of these risks on an individual basis will likely have a moderate restraining impact on acceleration in the economic recovery that is underway. What is uncertain and worrisome is the possibility that several of these risks will impact the economy in the same time frame and trigger reinforcing and negative feedback loops that slow or even derail economic recovery. I remain optimistic that recovery will proceed slowly but I believe the recovery will continue to be much weaker than previous recoveries. In that regard I am not worried about near-term inflation risks. However, as I have discussed above, there are several significant risks, which if realized, could have negative consequences given the frailty of the economic recovery.

III. U.S. GDP Growth

1. Forecasts

Various GDP forecasts are shown in **Chart 1**. The Federal Reserve's most



recent forecast increased the expected range of GDP growth in 2011 from 3.0% to 3.6% to 3.4% to 3.9%. This upward adjustment reflected stimulative monetary and fiscal policies initiated in December. However, the Fed reduced the 2012 GDP forecast range moderately from 3.6% to 4.5% to 3.5% to 4.4%, most likely because of impacts stemming from the withdrawal of monetary and fiscal stimulus by the end of 2011.

Following a fairly consistent pattern, the Fed's forecast is at the optimistic end of the forecast range. Both the Bank of America (B of A) forecast and my forecast, labeled "WAL Est.", fall below the lower end of the Fed's forecast range. There is very little difference between my forecast and B of A's.

Goldman Sachs (GS's) forecast falls in the middle of the Fed's forecast range for 2011 but approaches the bottom end of the Fed's forecast range in 2012. However, GS projects that if the current 20% oil price shock persists, GDP growth in 2011 could slow as much as 0.4% and 0.5% in 2012, which would be similar to my and B of A's forecasts and below the lower bound of the Fed's forecast range. GS has not yet revised its forecast, which means it is not yet convinced that the rise in oil prices will be sustained.

GS presents a second forecast in which the oil price shock doubles to 40% and persists. That would mean a sustained Brent oil price of about $125 per barrel, not much different than the Brent spot price of $122.50 on April 13. In that scenario, GS expects GDP growth to slow to between 0.5% and 2.0% by the first quarter of 2012 and then rebound to about 3.0% by the end of 2012.

2. Output Gap

Even the GS forecast, although it is at the optimistic end of the current forecast range, isn't really all that optimistic. Its real GDP forecast still puts the output gap at a still very sizable 3.25% by the end of 2012 compared to 6.27% at the end of 2010. By comparison, I expect the output gap to fall to 4.60% by the end of 2012 and B of A's forecast is slightly more pessimistic with an output gap of 4.86% at the end of 2012.

3. 2010 Q4 GDP

The "final estimate" of fourth quarter GDP growth was 3.1% compared to the "advance estimate" of 3.2% and the "second estimate" of 2.8% (see **Table 1**).

Between the advance and final estimates the downward revision in personal consumption was almost entirely offset by a reduction in inventory de-accumulation. Private investment in nonresidential structures was considerably stronger than the advance estimate, while net exports added less. All in all Q4 real GDP growth, according to the Congressional Budget Office was just sufficient only to keep the output gap from expanding — it did not reduce it.

Table 1
2010 Fourth Quarter GDP Estimates

	Advance Estimate	Second Estimate	Final Estimate
Personal Consumption	3.04%	2.88%	2.79%
Private Investment			
Nonresidential	.43%	.51%	.73%
Residential	.08%	.06%	.07%
Inventories	-3.70%	-3.70%	-3.42%
Net Exports	3.44%	3.35%	3.27%
Government	-.11%	-.31%	-.34%
Total	**3.18%**	**2.79%**	**3.10%**

4. Prospects for Q1 2011 GDP

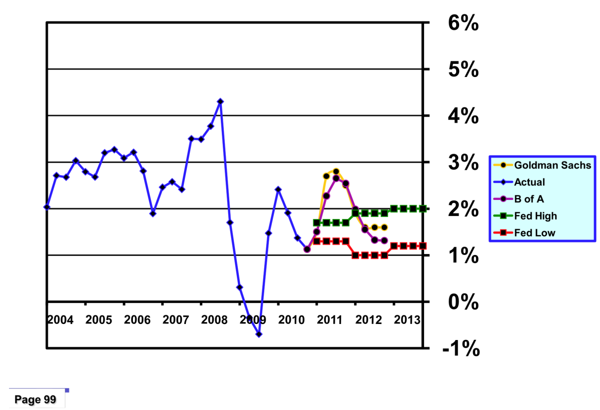
The "advance estimate" for 2011 Q1 real GDP will be reported on April 28th. Based upon available data most forecasters have reduced their estimates. B of A has penciled in 1.5% and GS is at 2.5%. Both expect growth to pick up later in the year, but that will depend upon the impacts of various risks and, as I have outlined above, risks are asymmetric with a greater chance of less growth rather than more.

IV. Inflation

Thanks to energy and food prices, total inflation is headed higher. Total CPE (personal consumer expenditures) inflation bottomed at an annual rate of 1.0% in November 2010 and rose to 1.6% in February. In coming months, unless oil prices rise further, total CPE inflation should peak toward the end of the third quarter at 2.6% to 2.8% before receding to a level of about 1.3% to 1.5% during the second half of 2012.

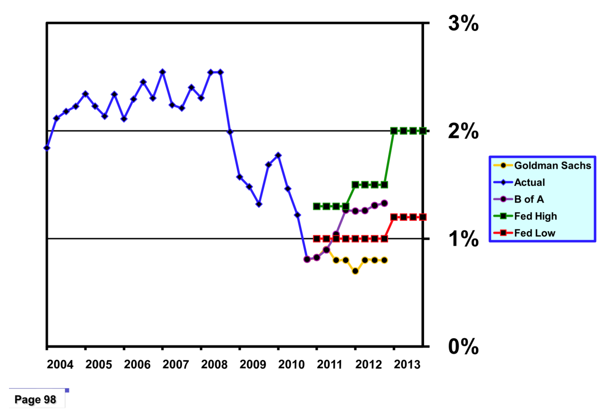
Chart 2 shows inflation forecasts for total PCE inflation and **Chart 3**

CHART 2 – PCE Inflation Forecasts
(percentage change over previous 12 months)



shows inflation forecasts for core PCE inflation, which excludes volatile food

CHART 3 – Core PCE Inflation Forecasts
(percentage change over previous 12 months)



and energy prices. The GS and B of A forecasts for 2011 reflect the expected impact on total inflation of oil price increases that have already occurred. If oil prices rise further, these total inflation forecasts will need to be raised further. If that were to occur, the pattern in total inflation could end up looking more like the pattern that occurred in 2008-09. Generally, both GS and B of A expect core inflation to remain relatively low and unaffected by oil price increases. However, an important aspect of these forecasts is that deflation is no longer a real possibility. Either core inflation will remain at a low level (GS forecast) or move up gradually (B of A forecast).

Changes in oil prices impact inflation measures. Prior to the mid-1980's research shows that oil price increases impacted both core and total inflation measures, but since then only the total, not the core, measure has been affected. This change in behavior has to do with increased credibility of the Fed's inflation-fighting credentials and structural changes that virtually have eliminated automatic inflation adjustments in union wage contracts and other kinds of legal agreements.

Nonetheless, the rise in oil prices has stoked inflation anxieties. According to the March University of Michigan consumer survey, 5-10 year inflation expectations rose from 2.9% in February to 3.2% in March, which is near the top end of the range over the last several years. However, if the expected one-year change in inflation is factored out, long-term inflation expectations rose only a small amount in March. This indicates that consumers' concern about higher inflation is focused on the short-term due to oil and food prices and that consumers remain relatively sanguine about longer-term inflation prospects.

In the Treasury Inflation Protected Securities market the 5-year, 5-year forward inflation yield has risen recently to about 3.0%. While this yield is high by historical standards it is lower than levels that prevailed during late 2009 and early 2010 and during the summer of 2010. Also, it is important to note that both of these measures of expected inflation spiked to high levels when oil prices peaked at more than $140 per barrel in mid-2008. What this means is that the recent rise in inflation expectations probably means little in terms of prospects for core inflation.

V. U.S. Employment

1. March Data

Payroll employment rose a solid 216,000 in March following an equally strong advance of 194,000 in February. The one statistic which usually receives the greatest amount of attention, the unemployment rate, fell to 8.8% in March and has now fallen sharply from its recent peak of 9.8% in November in just five months time.

On the surface this paints a rosier picture of labor market than a detailed examination of the data supports. During this same five month period, the labor force, those working or willing to work, has shrunk by 544,000. However, those employed increased 955,000, while the number unemployed fell by 1.5 million. The story these data tell is one in which at least one-third of the decline in unemployed workers probably were people who dropped out of the labor force altogether. This means that they are neither counted in the eligible labor force nor the ranks of the unemployed.

2. Shrinking Labor Force Participation Rate

Falling labor force participation is responsible for the simultaneous shrinkage in the labor force and the falling rate of unemployment. Labor force participation was 66.2% in January 2008 at the start of the Great Recession. Since then it has fallen precipitously to 64.2% in March 2011. Participation changes over time because of demographic changes and cultural considerations, such as greater entry of women into the labor force. Over shorter periods of time labor participation is also influenced by workers who exit the labor force during difficult times only to re-enter the labor force during good times.

As mentioned above and as can be seen in **Chart 4**, demographic factors have driven a slow decline in labor force participation since it peaked just prior to the 2001 recession. There was a bit of a rebound in the late part of the cyclical expansion prior to the start of the Great Recession in December 2007. However, the decline in participation over the last three years is much greater than can be explained by demographic factors alone.

The primary demographic reasons for declining participation are an aging workforce with a lower participation rate in the oldest cohorts and a declining participation rate among young workers, probably reflecting a larger proportion going to college. Demographic considerations have accounted for about a 0.5% decline in the participation rate since the start of the Great Recession. Other factors have contributed to the remaining 1.5% decline. See **Chart 5**. These would include discouraged workers who have given

CHART 4 – Labor Force Participation Rate

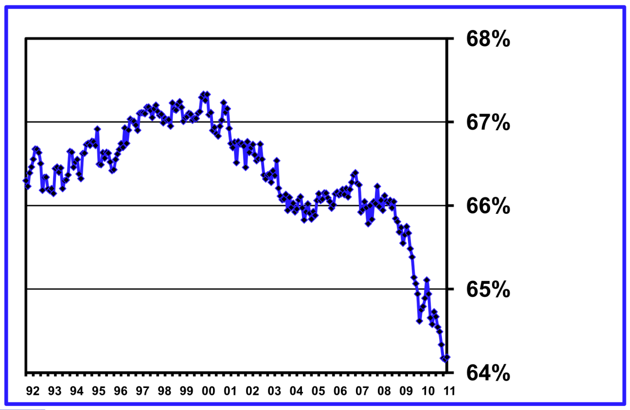


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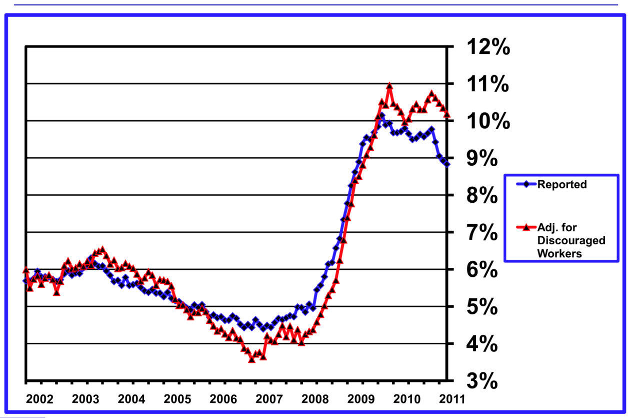
CHART 5 – Reported Unemployment Rate & Adjusted for Discouraged Workers



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up and dropped out of the work force. Such workers could well re-enter the labor force when job prospects improve and the labor market tightens. However, some of the decline could also stem from structural unemployment for workers that are simply unemployable because they do not have skill sets any employer needs.

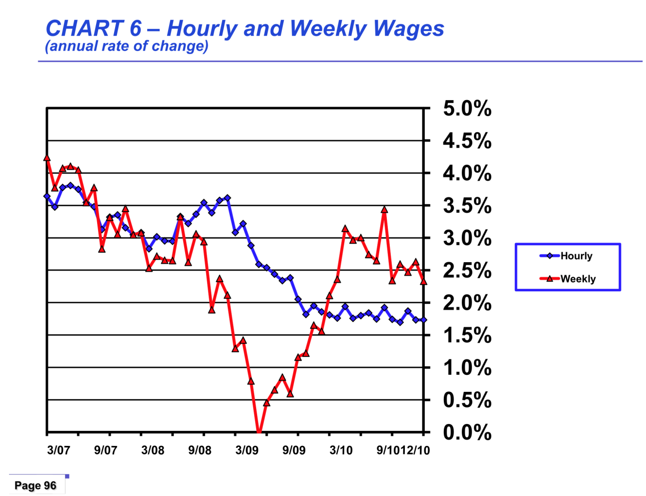
There are currently approximately 2.1 million workers who have dropped out of the labor force for reasons unrelated to demographic considerations.

If all of these workers are discouraged and plan to re-enter the labor force as the labor market improves the March unemployment rate would have been 10.2%. Again, reflecting the drop-out phenomenon of the last five months, this adjusted unemployment rate has improved from 10.7% to 10.2%, while the official unemployment rate has improved from 9.8% to 8.8%.

A steady, but gradual, decline in the labor force participation rate means that employment will grow more slowly in the future, but it will probably not affect the unemployment rate or, for that matter, other growth rates to any material extent. What it will affect, however, is the level of personal income, the level of retail sales and any other aggregate measures of household income and spending. This trend will matter in the following way. A 2% to 3% permanent decline in the labor participation rate means that household income, and probably spending as well, will be approximately 2% to 3% lower for the same population base. This is not good news for nominal tax collections that are geared to income or sales taxes.

3. Wage Growth

Average hourly wage growth, which is an indicator of the intensity of excess labor supply relative to demand, has stabilized over the last year. **Chart 6** shows the annual rate of change in the hourly average employee wage rate



and the annual rate of change in weekly wages. The growth rate in average weekly wages adjusts for the average number of hours worked. The growth rate in weekly wage earnings is a measure of spending power of consumers. Weekly wages had grown since mid-2009 as average hours worked slowly increased, but now appear to be converging downward toward the growth rate in average hourly wages. Overall **Chart 6** tells a story of a very weak labor market that is in the process of stabilizing.

In the long run, the more important of the two measures is growth in the average hourly wage rate. Average weekly hours fluctuate with the strength of the business cycle, fallings during recessions and rising when the economy is expanding. Early in the recovery phase of the business cycle, employers increase the number of hours worked by employees. But, as employers gain confidence in the sustainability of the expansion, they begin to hire additional workers. We appear to be at the transition point. What that means is that the number of people hired will increase at a more rapid rate, which is what most, including myself, expect. It also means that the expansion in the number of hours worked per week will begin to flatten out and that is what has happened over the last several months. That means that growth in the average hourly wage rate is once again the better indicator of the tightness of labor supply relative to demand.

The rate of growth in the average hourly wage rate is also a leading indicator of inflationary pressures. As long as it remains at a very low and stable level there will be little to no upward pressure on inflation.

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