RSQE FORECASTS

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The U.S. Economic Outlook for 2011–2012
Executive Summary: June 2011

Another Soft Patch

The U.S. economic recovery, which has been moving ahead in fits and starts, appears to have hit another soft patch this year. After growing by 2.8 percent during 2010 (4th qtr to 4th qtr), output rose at only a 1.8 percent pace in the first quarter, and it appears to be headed toward another quarter of about 2 percent growth this spring.

Two negative shocks have dampened recent economic growth. First, the price of oil (w. Texas int. crude) rose dramatically from about $76/barrel last summer to $110 in April. This drove up consumer prices, which then slowed the growth of real consumption spending.

Second, the earthquake and tsunami in Japan disrupted supply chains in many industries, curbing production until these linkages can be reestablished. In the U.S. this problem has perhaps been most notable among the Japanese nameplate automakers.

Fortunately, these problems appear to be temporary. As expectations of world growth were ratcheted down in early May, the price of oil fell back to about $100/barrel. Going forward, a steady-to-slowly-rising oil price will relieve some of the pressure on consumer prices. As the recovery in Japan proceeds, and alternate suppliers are identified, production in the affected industries can return to normal, and indeed, lost production can be made up, temporarily boosting growth. Recent announcements by the Japanese automakers suggest that they will resume normal production levels at home and abroad sooner than previously expected.

Labor Market Woes

Earlier this year it looked as though the labor market was improving. Monthly payroll job additions averaged 182,000 workers for the four months ending in April, up from average monthly gains of 139,000 in the final three months of 2010. In addition, the 4-week moving average of initial claims for unemployment insurance fell below 400,000 claims for March and the first half of April.

More recent labor market data have been less promising. Since mid-April, the average initial claims series has rebounded to levels seen in late 2010, suggesting renewed weakness in the labor market; and job gains in May, at 54,000, were only about 30 percent of the recent monthly average.

The Second Half of 2011

We expect the economy to regain some momentum in the second half of the year, with output growing at a 3.4 percent pace. Production levels for those firms impacted by the Japanese disasters will be returning to near normal levels over the next several months. Light vehicle sales should improve as inventories are replenished. In addition, the retreat in gasoline prices supports stronger consumption growth for the balance of the year.

With the acceleration in economic activity, employment gains pick up again later in the year, and the unemployment rate drifts down from its current reading of 9.1 percent to 8.9 percent by year's end.

Brinkmanship and the Debt Ceiling

Both political parties have agreed that it's time to get serious about the budget deficit; it's the "how" they can't agree on. Some want to use debt limit legislation as the vehicle to force deficit reduction. With the art of compromise seemingly dead in Washington, it could be a long summer as negotiations continue while the list of available accounting tricks to forestall default grows short. While we don't anticipate a government default, neither do we expect a comprehensive plan that deals with entitlement programs and the tax structure to be in place over our forecast horizon.

Existing budget provisions imply some fiscal drag in the coming year as stimulus spending continues to wind down, the payroll tax holiday ends at the end of 2011, and investment incentives for businesses are reduced for 2012.

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Monetary Policy: The Next Phase

The Federal Reserve's current program of quantitative easing (QE2) is drawing to a close. With the latest round of weak economic news, discussion of further monetary easing has surfaced. Since we believe the slowdown in growth is temporary, we view a QE3 as a long shot. Given the unusual nature of present-day policy, however, we expect the Fed will prefer to tighten policy early and gradually. We have assumed that at the start of 2012 the Fed will begin to let its balance sheet shrink, with hikes in the policy rate delayed at least another year.

We expect interest rates to be fairly steady through 2012, with the 3-month T-bill rate at or below 0.2 percent, the 10-year T-note rate in the 3.3–3.4 percent range, and the 30-year conventional mortgage rate below 5 percent.

The Outlook for 2012

The economy loses a little steam the first quarter of 2012, growing at a 2.6 percent pace as the temporary tax cuts are reduced, but growth then picks up to 3.2 percent during the balance of the year. Consumption and business fixed investment are the major sources of growth; a recovery in housing also plays a role. Government purchases, at the federal as well as the state and local level, continue to be a drag on growth.

Housing starts improve from 614 thousand units in 2011 to 873 thousand in 2012.

Light vehicle sales, which totaled 11.5 million units in 2010, reach 12.9 million units this year and 14.8 million the following year as some sales are deferred in 2011 by a lack of inventory.

Employment and Inflation

Nonfarm payroll employment hit bottom on a calendar-year basis in 2010 at 129.8 million jobs. We are projecting an increase of 1.5 million jobs for 2011 and an additional 2.6 million for 2012. Even so, that would leave the job count well below the 137.4 million average of 2007. In a recovery, discouraged workers reenter the labor market as job prospects become more promising, slowing the improvement in the unemployment rate. We expect the jobless rate to inch down from 9.6 percent in 2010 to average 9 percent this year and 8.7 percent in 2012.

Core CPI inflation, which registered a very low one percent in 2010, picks up to a more comfortable 1½ percent in 2011 and 2012. With the recent run-up in food and oil prices, the all-items CPI rises by 3.1 percent this year, but a subsequent moderation in oil prices slows headline inflation to 1.9 percent in 2012.

	Actual		**RSQE Forecast**	
	2009	2010	2011	2012
GDP (billions of current $)	14119.0	14660.4	15274.9	16005.9
Real GDP (billions of chained 2005 $)	12880.6	13248.2	13583.6	13999.1
% change: year-over-year	–2.6	2.9	2.5	3.1
% change: 4th-qtr-to-4th-qtr	0.2	2.8	2.7	3.0
Nonfarm payroll employment (millions)	130.8	129.8	131.3	134.0
Civilian unemployment rate (%)	9.3	9.6	9.0	8.7
Capacity utilization, total industry (%)	69.2	74.5	77.1	78.9
Inflation (private nonfarm GDP deflator, % change)	0.8	0.8	1.2	1.9
Inflation (CPI-U, % change)	–0.4	1.6	3.1	1.9
Inflation (core CPI, % change)	1.7	1.0	1.4	1.5
Light vehicle sales (millions)	10.4	11.5	12.9	14.8
Private housing starts (thousands)	554	585	614	873
3-month Treasury bill rate (%)	0.2	0.1	0.1	0.2
10-year Treasury note rate (%)	3.3	3.2	3.4	3.3
Conventional mortgage rate (%)	5.0	4.7	4.7	4.7
Real disposable income (billions of chained 2005 $)	1099.8	10236.6	10390.8	10530.2
% change	0.6	1.4	1.5	1.3
Corporate profits after tax (billions of current $)	1061.8	1384.5	1441.4	1358.0
Value of U.S. $ (FRB broad index), % appreciation	5.8	–3.4	–6.3	–2.6
Current account balance (NIPA basis, billions of current $)	–379.7	–481.2	–540.8	–573.9
Federal surplus (FY, NIPA basis, billions of current $)	–1094.2	–1326.1	–1281.0	–1086.5