



**QUICK MARKET UPDATE**

# Fed to the Rescue Again?

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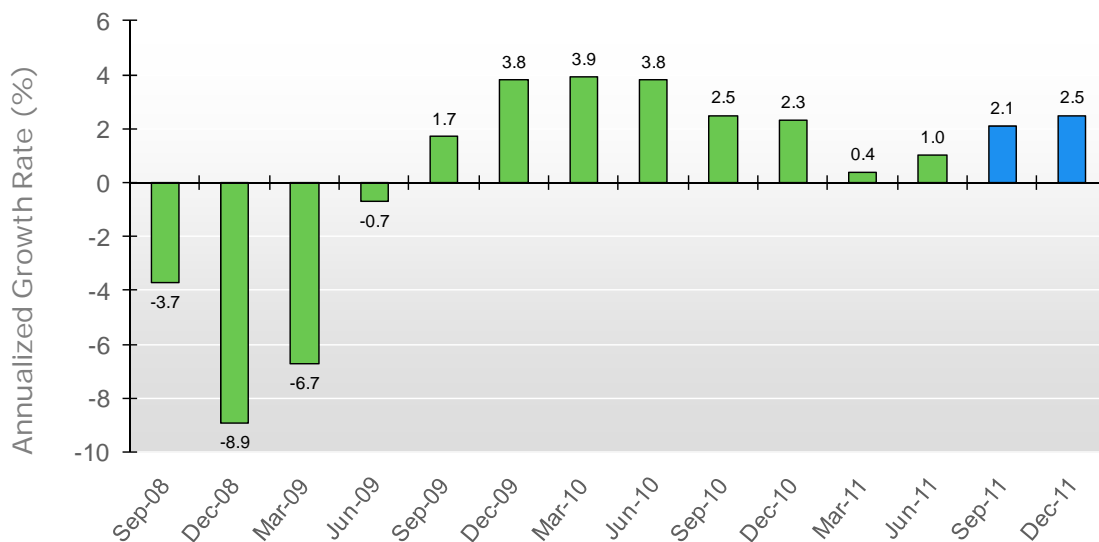
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Second quarter U.S. Gross Domestic Product (GDP) growth was revised downward today to a sluggish 1.0 percent. The reduction reflected a smaller increase in inventories and fewer exports and follows a sizeable adjustment to first quarter growth, which rose a modest 0.4 percent. Despite the weakness, there were a few bright spots with higher corporate profits and upward revisions to wages and consumer spending.

Although the U.S. economy is clearly in a soft patch, there were several temporary factors that influenced output early in the year. The consumer, which supplies the largest piece of the U.S. economic pie, has dealt with higher prices for much of the year, which has put a strain on real income and spending. Meanwhile, the Japanese earthquake hindered automobile production in the second quarter and we are just now beginning to see a rebound in the sector. Political gridlock and the debt ceiling debate also weighed on confidence and likely postponed some consumer, business and government spending.

The economic recovery that began in 2009 appears to be losing steam as fiscal stimulus is replaced with fiscal austerity and monetary stimulus becomes less effective. In fact, government spending was down more than three percent in the first and second quarter, while actions from an extremely accommodative Fed failed to spur economic growth and had minimal impact on the employment situation.

**U.S Real Gross Domestic Product Growth**



Source: Bloomberg

## Can we expect a rebound?

Recent economic reports have been mixed at best, but do not, at this point, signal a recession. Our view is that economic growth will show modest improvement in the second half of 2011 and 2012, however, likely will remain below levels needed to meaningfully improve the employment situation. While some of the headwinds faced early in the year will subside in the coming quarters, there are still structural issues (housing, consumer/government deleveraging) that may suppress growth to levels that are below potential. Nonetheless, we are encouraged that our Economic Points of Data Index is indicating a possible turn in the data over the last month with many reports refuting the likelihood of another recession. Specifically:

- Retail sales started the third quarter on a high note, rising 0.5 percent in July—the strongest monthly gain since March. Even excluding a resurgent auto sector, sales rose 0.5 percent, showing remarkable consumer resiliency.
- Although national manufacturing activity has decelerated and several regional surveys have shown contraction, industrial production and durable goods orders both surged in July. Industrial production, a key recession indicator, jumped 0.9 percent in July with most categories showing improvement. Capacity utilization increased to 77.5 percent, which is the highest reading since 2008. Meanwhile, durable goods orders rose 4.0 percent in July (double consensus expectations), led by the transportation sector.
- Inflation came in hotter than expected in July; however, we believe it likely will peak in the near-term with slower growth pushing commodity prices lower. This should be a positive for consumer confidence and spending.
- The employment situation remains a problem, but the economy continues to add jobs each month and unemployment claims have stabilized around the key 400,000 level. Payroll growth at current levels will do little to help the unemployment rate, but should support modest economic growth.
- The Leading Economic Index rose 0.5 percent in July, the 26<sup>th</sup> gain in 28 months of the recovery. The index can be a good barometer of economic activity for the coming months and continues to point to expansion. The money supply and an upward sloping yield curve have been key contributors, while deteriorating consumer sentiment has detracted from the reading lately.

Despite several potential catalysts for optimism in the coming quarters, we acknowledge the tightrope the U.S. economy is straddling at the moment. The confluence of negative events throughout the year was significant and has taken a toll both economically and psychologically. Although growing, the U.S. economy is in a fragile state and highly susceptible to an unexpected shock. Without an appropriate policy response to reduce unemployment and support economic activity, we likely will experience subpar growth through 2012.

### Can the Fed save the economy?

It was just a year ago at the Federal Reserve's annual conference in Jackson Hole, Wyoming, when Fed Chairman Bernanke hinted at the prospect of a new quantitative easing program (QE2). At the time, economic indicators were beginning to slow, and there was fear of a deflationary spiral taking hold and sinking the economy into another recession. Once again, we are seeing slowing economic indicators and the fear of another recession has gripped markets, so investors have been anxiously awaiting the opening speech of this year's conference for hints of another Fed rescue.

The results of last year's program were mixed. The Fed was able to engineer inflation and prevent deflation, but the higher prices had the unfortunate effect of choking off economic growth. The Fed's latest move was to state that rates likely will remain exceptionally low through mid-2013; however, three members of the committee dissented, making a policy changing announcement today unlikely. Setting a target date had an immediate impact on Treasury rates with the 10-year Treasury yield recently falling below 2.00 percent. With interest rates near historic lows for some time now, it is unclear whether even lower rates would have much economic impact. Furthermore, with core consumer inflation now running at an annual rate of 1.8 percent, much closer to the unofficial Fed target rate of between 1.5 and 2.0 percent, it would be difficult to argue that deflation is a current threat.

### Then and Now

	August 2010	July/August 2011
GDP (2Q)	3.8	1.0
CPI	1.1	3.6
Core CPI	0.9	1.8
Leading Indicators	0.1	0.5
Unemployment	9.6	9.1
Consumer Confidence	53.2	52.0*
S&P 500	1,055.33	1,159.27
10 Year Treasury Yield	2.49	2.23

*\*Bloomberg Estimate, to be released 8/30/2011*

### Wait and See Approach

Investors were watching today's speech closely for any signs of new monetary stimulus, however, the Fed chairman gave no signal for QE3, but instead reiterated that the FOMC is prepared to use appropriate tools if necessary. *"The Committee will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools as appropriate to promote a stronger economic recovery in a context of price stability."*

He went on to stress that monetary policy cannot work alone. A combination of monetary policy here and abroad is needed to maintain the recovery. *"Although the issue of fiscal sustainability must urgently be addressed, fiscal policymakers should not, as a consequence, disregard the fragility of the current economic recovery....Acting now to put in place a credible plan for reducing future deficits over the longer term, while being attentive to the implications of fiscal choices for the recovery in the near term, can help serve both objectives."*

The weak recovery is a problem, and has been held back by temporary and permanent factors. However, the Fed's longer term outlook for the economy is for continued moderate growth and lower inflation as commodity prices are expected to decline.

### **Initial Market Reaction**

It appeared earlier in the week that traders were expecting Dr. Bernanke to come to the rescue again. Although he did not rule it out, there was no hint of QE3 in today's speech. Most likely the Fed will reassess the data at its September meeting (which has been extended to two days) before it considers further moves. Equity markets initially sold off, but are now slightly positive for the day and higher for the week. Safe haven areas, such as Treasuries and gold rallied shortly after the speech, but are now well off their highs. Meanwhile, the dollar is virtually flat on the news. After time to digest the text, the markets may be interpreting Fed inaction as a reason not to panic and a sign that the U.S. is less likely to fall into recession despite the lower GDP numbers released earlier today.

*Data for this QMU sourced from Bloomberg unless otherwise noted.*

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