A. National Economic Review and Forecast

Training Wheels Coming Off?

The news on the domestic economy, especially on employment, has been good enough that the Federal Reserve has indicated that it is less likely to launch any more quantitative easing (QE). Although financial markets do not like that message, it is good news since it implies that the Fed thinks the economy is healthy enough to keep improving without emergency assistance. It is still the case, however, that the GDP picture is not as robust as the news from the labor market. There's probably a number of factors behind the disconnect – GDP growth may be understated, employment is probably in a "catch-up" phase after the severe cuts during and immediately after the recession, and the exceptionally mild winter weather has probably helped employment more than GDP. As long as there is doubt over how strong and durable the economy's "take-off" will be, the Fed will keep further easing as a possibility. Our own view remains cautious. We have edged up our growth rate projections slightly to 2.2% for 2012 (from 2.1%) and 2.4% for 2013 (from 2.3%), an outlook that keeps open the possibility of some form of Fed action in the second half of the year. But a full QE III would likely arrive now only in the event of the recovery being derailed by a shock – the most likely sources being higher oil prices or a reignited Eurozone crisis. So QE III is not something to hope for.

Slower GDP Growth in the First Quarter. Growth remains on track to slow by about one percentage point in the first quarter from the inventory-fueled 3.0% pace in the fourth. Our first-quarter GDP growth rate projection is now 2.1% up from 1.9% last month. Consumer spending growth picked up smartly in February leaving real consumption on track to rise by 2.1%, the same as in the fourth quarter. Residential construction was a big plus (probably helped by the warm weather) and business capital spending probably rose in the mid-single digits, similar to the fourth quarter. Foreign trade appears to have been a drag – export growth improved a little but faster domestic spending growth seems to have pulled in imports at a faster clip.

Beyond the First Quarter? Over the rest of the year we expect GDP growth to hold at or just above the 2% mark. The key factors preventing an acceleration are rising gasoline prices (that will pinch most sharply in the second quarter), the absence of a strong rebound in housing activity and huge uncertainty about the path of fiscal policy in 2013 as key tax and spending deadlines loom on January 1, 2013. Even if politicians just "kick the can" further down the road we are unlikely to know exactly what they will do until the very last minute – a recipe for delay in private-sector decisions to spend and hire.

Oil Remains the Key Immediate Risk. Oil prices have not moved much over the past month but gasoline prices have risen further as the usual seasonal premium is added into the price. The national all-grades average was a fraction of a cent below $4.00 in the latest week and we expect it to average $4.04 in the second quarter. This would be the highest quarterly average on record but would not wreck as much damage as last year's price hike. It's the size of the hike, not the level of prices, that determines the growth impact. Last year second-quarter prices were 34.8% above year-earlier prices; this year we expect the hike to be just 4.5%. The time to worry would be if a disruption of supplies drives the Brent oil price up a further $30-40/barrel, meaning gasoline prices hitting $5 per gallon rather than $4.

The Fed: More Quantitative Easing Less Likely. The Federal Reserve has signaled that it is now less likely to launch a further round of QE. We have removed QE III from our forecast (i.e., we now assume no further expansion of the Fed's balance sheet). However, our outlook for growth remains softer than the Fed's, so we still assume some further action in the second half of the year via sterilized purchases of mortgage-backed securities – closer to "Operation Twist" than QE.

Figure N.1*

	Quarterly				Annual				
	4Q 11	**1Q 12**	**2Q 12**	**3Q12**	**2011**	**2012**	**2013**	**2014**	**2015**
Real GDP (%, AR)	3.0	2.1	2.0	2.1	1.7	2.2	2.4	3.4	3.2
Federal Funds Rate	0.07	0.10	0.10	0.10	0.10	0.10	0.10	0.11	1.23
10 Year T-Bill	2.05	2.04	2.20	2.36	2.79	2.24	2.66	2.91	3.56
Oil Prices, Refiner Acquisition Cost ($)	105	110	117	113	102	113	113	111	109
Consumer Price Index (Y/Y %)	3.3	2.8	2.2	1.9	3.1	2.2	1.7	1.9	1.9
Housing Starts (millions)	0.67	0.70	0.71	0.75	0.61	0.74	1.01	1.40	1.69
Consumer Sentiment (Univ. of Michigan)	65	76	77	79	67	78	81	84	85
Unemployment Rate (Percent)	8.7	8.3	8.3	8.2	9.0	8.2	7.9	7.3	6.6

*Figure N.1 was taken from Nigel Gault, *U.S. Economy: Current Situation: Forecast Flash,* IHS Global Insight, April 2012

Graph N.1

U.S. Economic History and Forecast

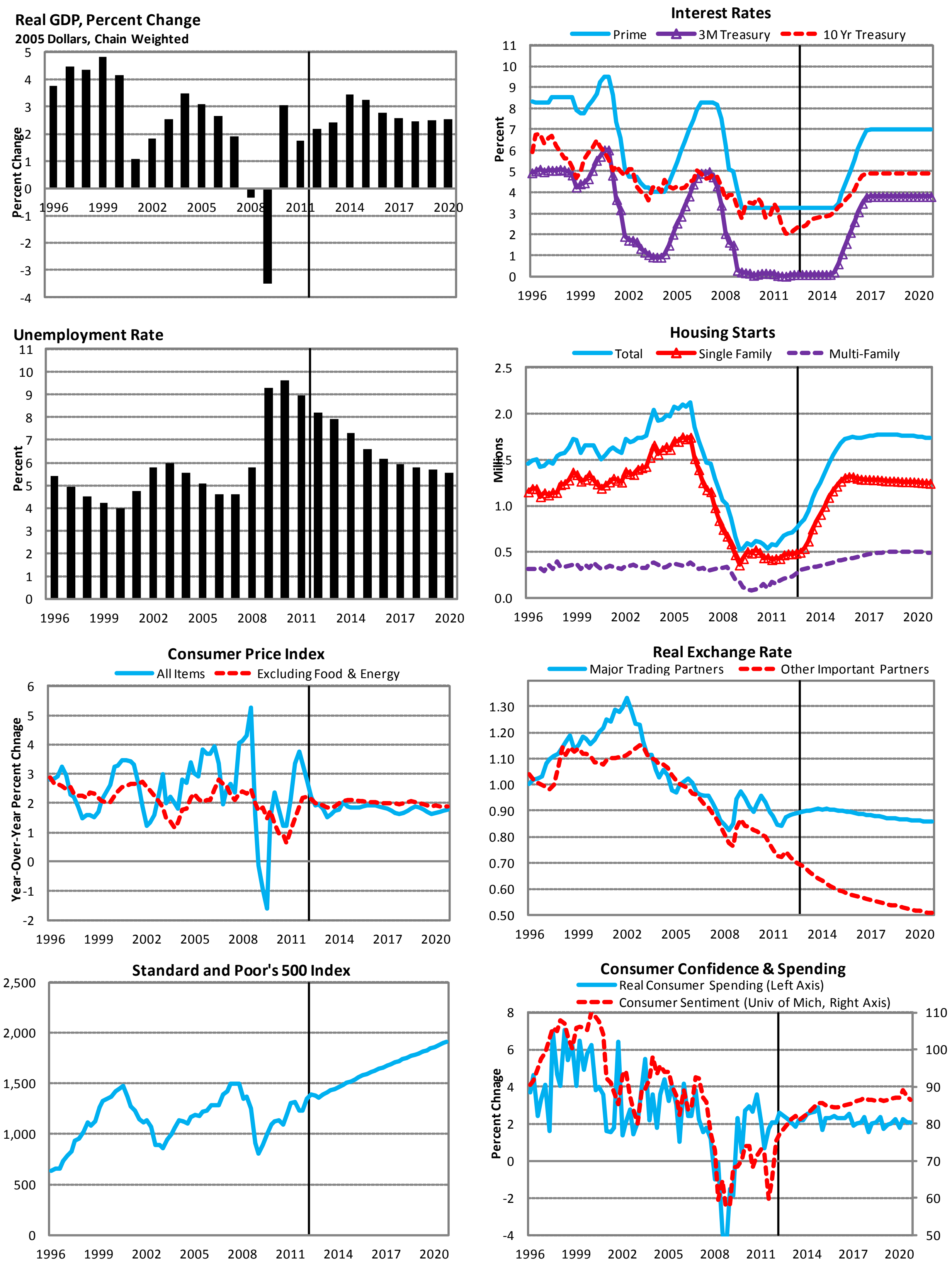

TABLE N. 1

U.S. Forecast Summary 2009-2017 (Apr 2012 U.S. Forecast, IHS Global Insight)

	Quarterly						Annual								
	2011:3	**2011:4**	**2012:1**	**2012:2**	**2012:3**	**2012:4**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
GDP (Bil of 2005 $) Chain Weight	13,332	13,429	13,498	13,565	13,636	13,714	12,703	13,088	13,315	13,603	13,935	14,415	14,880	15,289	15,684
% Ch	1.8	3.0	2.1	2.0	2.1	2.3	(3.5)	3.0	1.7	2.2	2.4	3.4	3.2	2.8	2.6
Personal Income (Bil of $)	13,057	13,162	13,259	13,398	13,563	13,719	11,930	12,374	13,005	13,485	14,054	14,757	15,471	16,223	16,943
% Ch	3.2	3.3	3.0	4.3	5.0	4.7	(4.3)	3.7	5.1	3.7	4.2	5.0	4.8	4.9	4.4
Nonagricultural Employment (Millions)	131.5	132.0	132.7	133.2	133.7	134.4	130.8	129.9	131.4	133.5	135.7	138.1	140.6	142.7	144.2
% Ch	0.9	1.4	2.2	1.6	1.6	1.9	(4.4)	(0.7)	1.2	1.6	1.7	1.8	1.8	1.5	1.1
Unemployment Rate	9.1	8.7	8.3	8.3	8.2	8.1	9.3	9.6	8.9	8.2	7.9	7.3	6.6	6.2	5.9
Point Change	1.5	(15.2)	(18.5)	0.2	(5.1)	(5.1)	59.9	3.8	(7.0)	(8.5)	(3.5)	(7.7)	(9.6)	(6.4)	(3.8)
Industrial Production Index (2007=100)	94.2	95.2	96.3	97.7	98.6	99.3	85.4	90.1	93.7	98.0	101.0	104.5	107.8	110.6	113.3
% Ch	5.6	4.3	5.0	5.9	3.8	2.6	(11.4)	5.4	4.0	4.6	3.1	3.5	3.2	2.6	2.4
Corporate Profits (Bil of $)	1,913	1,905	2,019	1,982	1,963	1,964	1,456	1,819	1,896	1,982	2,151	2,261	2,190	2,123	2,064
% Ch	4.8	(1.7)	26.4	(7.3)	(3.6)	0.1	7.0	25.0	4.2	4.5	8.5	5.1	(3.1)	(3.1)	(2.8)
Money Supply (M2) (Bil of $)	9,426	9,595	9,782	9,857	9,961	10,060	8,492	8,760	9,595	10,060	10,491	11,041	11,515	11,889	12,252
% Ch	17.5	7.4	8.0	3.1	4.3	4.0	5.0	3.1	9.5	4.8	4.3	5.2	4.3	3.3	3.1
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	4.23	6.27	7.00
% Ch	0.0	0.0	0.0	0.0	0.0	0.0	(36.1)	0.0	0.0	0.0	(0.0)	0.0	30.3	48.1	11.6
Consumer Price Index (1982-84=100)	226.2	227.0	228.3	229.4	230.6	231.4	214.6	218.1	224.9	229.9	233.7	238.2	242.6	247.2	251.4
% Ch	3.1	1.3	2.4	2.0	1.9	1.5	(0.3)	1.6	3.1	2.2	1.7	1.9	1.9	1.9	1.7
Federal Budget (unified) (Bil of $, Fed FY	(326.3)	(321.7)	(413.2)	(97.6)	(241.9)	(272.3)	(1,471.3)	(1,275.1)	(1,249.6)	(1,025.0)	(726.9)	(598.3)	(501.7)	(515.6)	(529.3)
Current Account Balance (Bil of $)	(430.5)	(496.4)	(547.6)	(574.3)	(566.2)	(546.8)	(376.6)	(470.9)	(473.4)	(558.7)	(511.7)	(500.6)	(531.3)	(566.4)	(556.1)
% Ch	(42.19)	76.80	48.09	20.95	(5.52)	(13.01)	(44.4)	25.1	0.5	18.0	(8.4)	(2.2)	6.1	6.6	(1.8)
Population (Millions)	313.81	314.56	315.32	316.09	316.85	317.61	307.80	310.46	313.43	316.47	319.54	322.63	325.75	328.89	332.05
% Ch	1.0	1.0	1.0	1.0	1.0	1.0	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0

TABLE N. 2

U.S. Forecast Change - (Current Forecast Apr 2012 vs. Last Forecast Jan 2012)

	Quarterly						Annual								
	2011:3	**2011:4**	**2012:1**	**2012:2**	**2012:3**	**2012:4**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
GDP (Bil of 2005 $) Chain Weight	13,332	13,429	13,498	13,565	13,636	13,714	12,703	13,088	13,315	13,603	13,935	14,415	14,880	15,289	15,684
% Change From Last Forecast	0.0	(0.1)	(0.1)	0.1	0.3	0.4	0.0	0.0	(0.0)	0.2	0.2	0.2	0.1	0.0	(0.0)
Personal Income (Bil of $)	13,057	13,162	13,259	13,398	13,563	13,719	11,930	12,374	13,005	13,485	14,054	14,757	15,471	16,223	16,943
% Change From Last Forecast	0.6	0.8	0.3	0.4	0.8	1.0	0.0	0.0	0.4	0.6	1.1	1.0	0.6	0.4	0.2
Nonagricultural Employment (Millions)	131.5	132.0	132.7	133.2	133.7	134.4	130.8	129.9	131.4	133.5	135.7	138.1	140.6	142.7	144.2
% Change From Last Forecast	0.2	0.2	0.4	0.5	0.6	0.7	(0.0)	0.0	0.2	0.6	0.6	0.5	0.2	0.1	(0.1)
Unemployment Rate	9.1	8.7	8.3	8.3	8.2	8.1	9.3	9.6	8.9	8.2	7.9	7.3	6.6	6.2	5.9
Point Change From Last Forecast	(0.0)	(0.1)	(0.5)	(0.5)	(0.6)	(0.7)	0.0	(0.0)	(0.0)	(0.6)	(0.7)	(0.6)	(0.5)	(0.5)	(0.4)
Industrial Production Index (2007=100)	94.2	95.2	96.3	97.7	98.6	99.3	85.4	90.1	93.7	98.0	101.0	104.5	107.8	110.6	113.3
% Change From Last Forecast	(0.2)	0.3	0.8	1.7	2.1	2.3	(0.1)	(0.0)	(0.0)	1.7	1.9	1.3	1.0	0.8	0.9
Corporate Profits (Bil of $)	1,913	1,905	2,019	1,982	1,963	1,964	1,456	1,819	1,896	1,982	2,151	2,261	2,190	2,123	2,064
% Change From Last Forecast	0.0	(4.4)	(1.4)	1.1	(0.8)	(0.8)	0.0	0.0	(1.1)	(0.5)	(1.3)	0.1	(0.3)	(3.4)	(5.1)
Money Supply (M2) (Bil of $)	9,426	9,595	9,782	9,857	9,961	10,060	8,492	8,760	9,595	10,060	10,491	11,041	11,515	11,889	12,252
% Change From Last Forecast	(0.5)	(0.5)	0.3	0.7	0.9	1.0	(0.2)	(0.2)	(0.5)	1.0	0.7	1.2	1.9	1.3	0.8
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	4.23	6.27	7.00
% Change From Last Forecast	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(0.0)	(23.3)	(32.5)	(10.4)	0.0
Consumer Price Index (1982-84=100)	226.2	227.0	228.3	229.4	230.6	231.4	214.6	218.1	224.9	229.9	233.7	238.2	242.6	247.2	251.4
% Change From Last Forecast	0.0	0.1	0.4	0.9	0.8	0.8	0.0	0.0	(0.0)	0.7	0.6	0.4	0.3	0.3	0.2
Federal Budget (unified) (Bil of $, Fed FY	(326.3)	(321.7)	(413.2)	(97.6)	(241.9)	(272.3)	(1,471.3)	(1,275.1)	(1,249.6)	(1,025.0)	(726.9)	(598.3)	(501.7)	(515.6)	(529.3)
Current Account Balance (Bil of $)	(430.5)	(496.4)	(547.6)	(574.3)	(566.2)	(546.8)	(376.6)	(470.9)	(473.4)	(558.7)	(511.7)	(500.6)	(531.3)	(566.4)	(556.1)
% Change From Last Forecast	(2.41)	9.86	17.54	12.02	9.36	7.85	0.0	0.0	1.3	11.6	5.1	(0.0)	(0.8)	9.4	17.7
Population (Millions)	313.81	314.56	315.32	316.09	316.85	317.61	307.80	310.46	313.43	316.47	319.54	322.63	325.75	328.89	332.05
% Change From Last Forecast	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0