



# The Improved Economic Outlook for 2011

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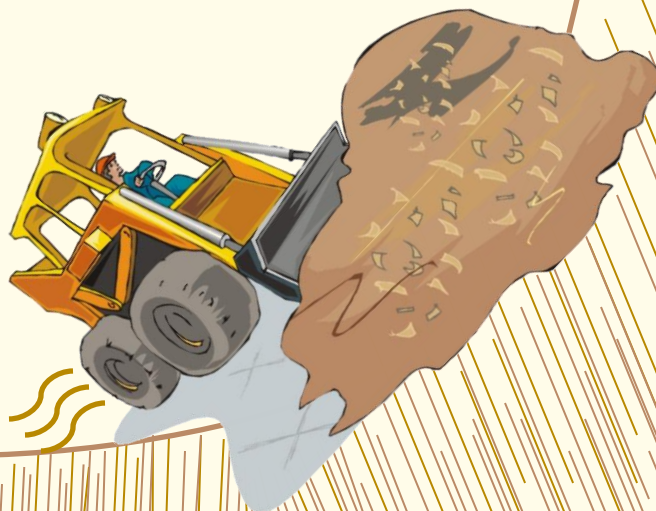
Federal Reserve Bank of Dallas

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It's time to talk UP the  
economy and stop  
talking it down.

# Time to Cast Aside





# Dominant Macro Themes for 2011

- U.S. expansion gains traction
- European sovereign debt primarily a European problem
- Reduced headwinds from deleveraging
- Interest rates can only go UP from here
- Federal, state and local governments seeking austerity



# Over-Arching Theme

- Positive Momentum Dominates Negative Momentum
- Corollary: Beginnings of Positive Feedback Loops



# Bottom Line

- 4% real output growth
- Steady, low inflation
- Falling unemployment



# Most Likely Scenario

	2009 (%)	*2010 (%)	2011 (%)
Real GDP	0.3	2.7	4.0+
<b>Inflation (eop)</b>			
Headline PCE			
Trimmed Mean PCE			
<b>Employment</b>			
Unemployment (eop)			
Monthly Payroll Growth (thous)			

\*using latest release



# Most Likely Scenario

	2009 (%)	* 2010 (%)	2011 (%)
Real GDP	0.3	2.7	4.0+
<b>Inflation (eop)</b>			
Headline PCE	2.4	1.0	1.5
Trimmed Mean PCE	1.8	0.8	1.0
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Trimmed Mean PCE	1.8	0.8	1.0
<b>Employment</b>			
Unemployment (eop)	10.0	9.4	8.9
Monthly Payroll Growth (thous)	-395	94	200

\*using latest release



# Where will GDP growth come from?

- Drivers of growth:
  - Consumption
  - Business investment
  - Net exports
- Neutral/Drag:
  - Housing
  - Government

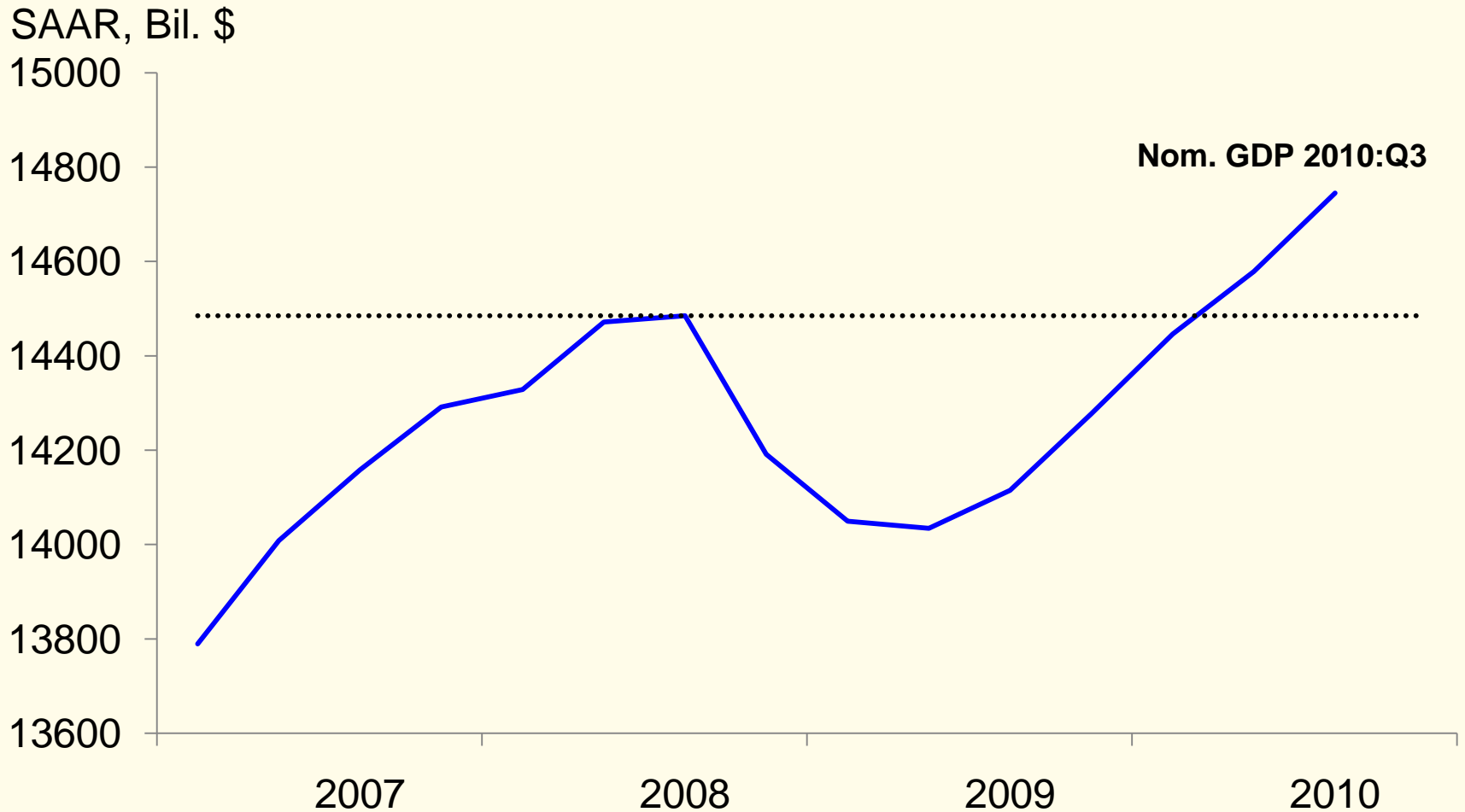


# Momentum Changes

Perhaps some confirmatory bias:

- Money income now in expansion, not recovery
  - But real output below pre-recession level
- Pent-up demand; Comeback in autos
- Sales tax revenues turning corner in some states
- Companies begin hiring, though gradual
- Risk assets seem less risky
- Lending markets more competitive

# Money Income in Expansion Mode



Source: Bureau of Economic Analysis

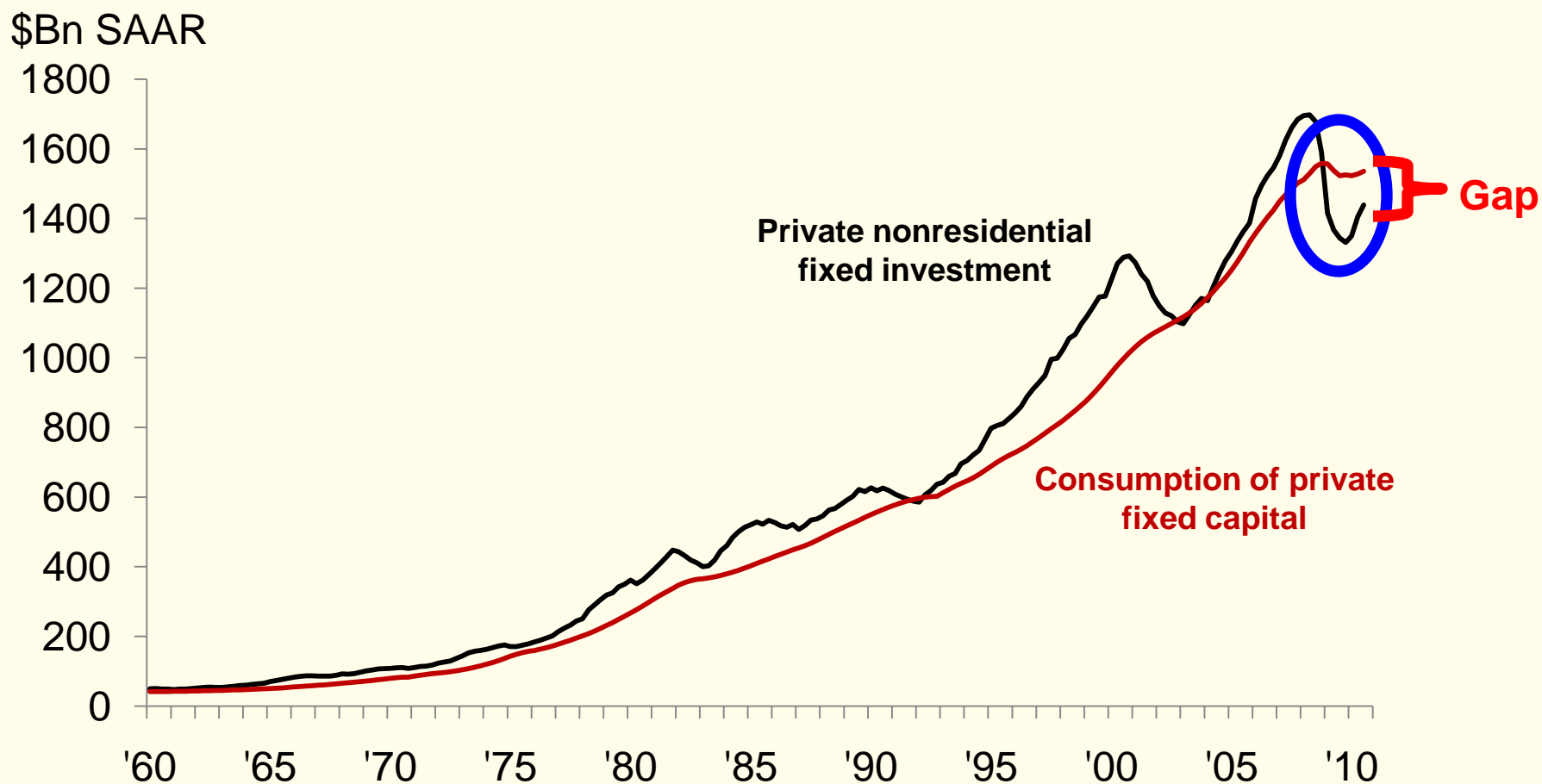


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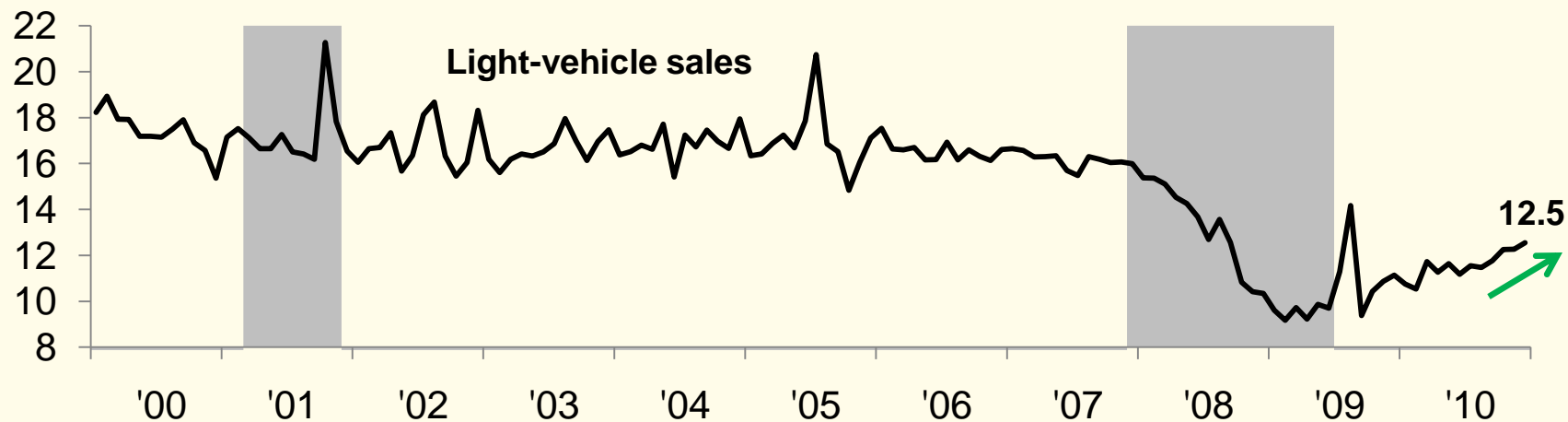
# Pent-Up Demand



Source: Bureau of Economic Analysis

# U.S. Auto Sales Making a Comeback

SAAR, Mil. Units



Change from 2009

**GM**

**Ford**

**Toyota**

**Honda**

**Chrysler**

**Nissan**

**Hyundai**

7%

20%

0.4%

7%

17%

18%

24%

***“Ford plans to hire 7,000 new workers”***

Source: Autodata Corporation, WSJ Jan. 5, 2011 B1



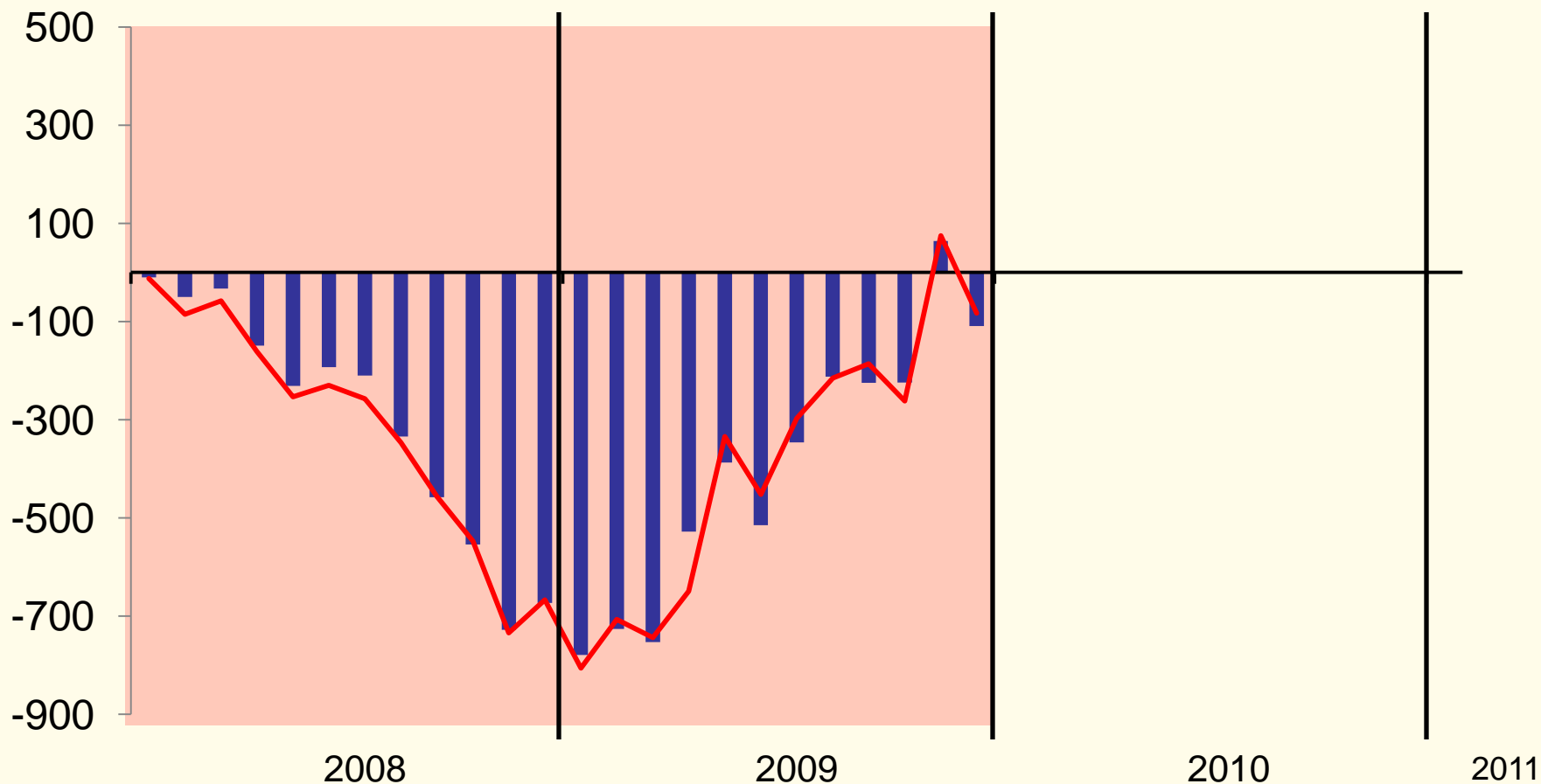
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# Employment Outlook Improving, Finally

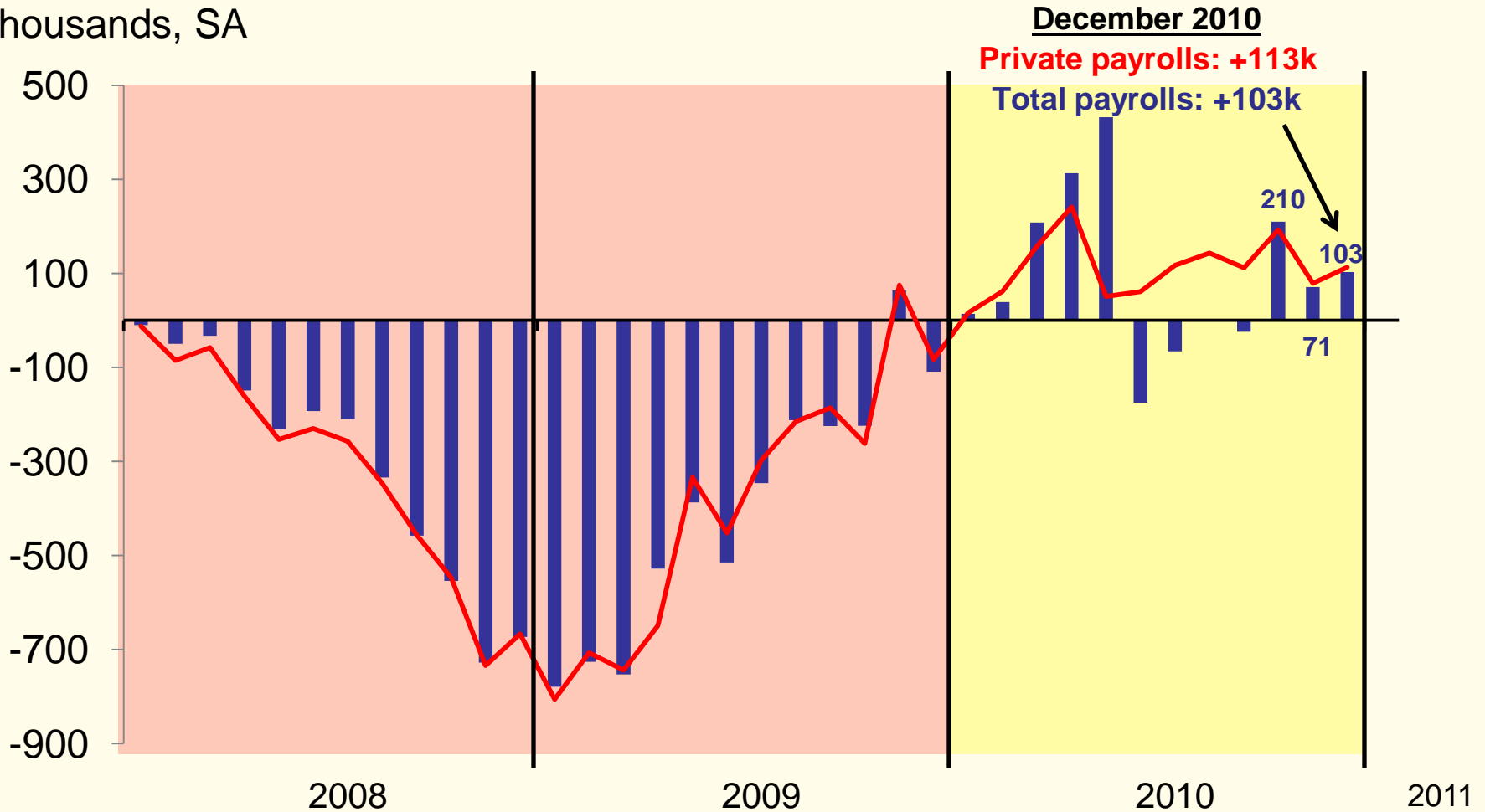
Thousands, SA



Source: Bureau of Labor Statistics

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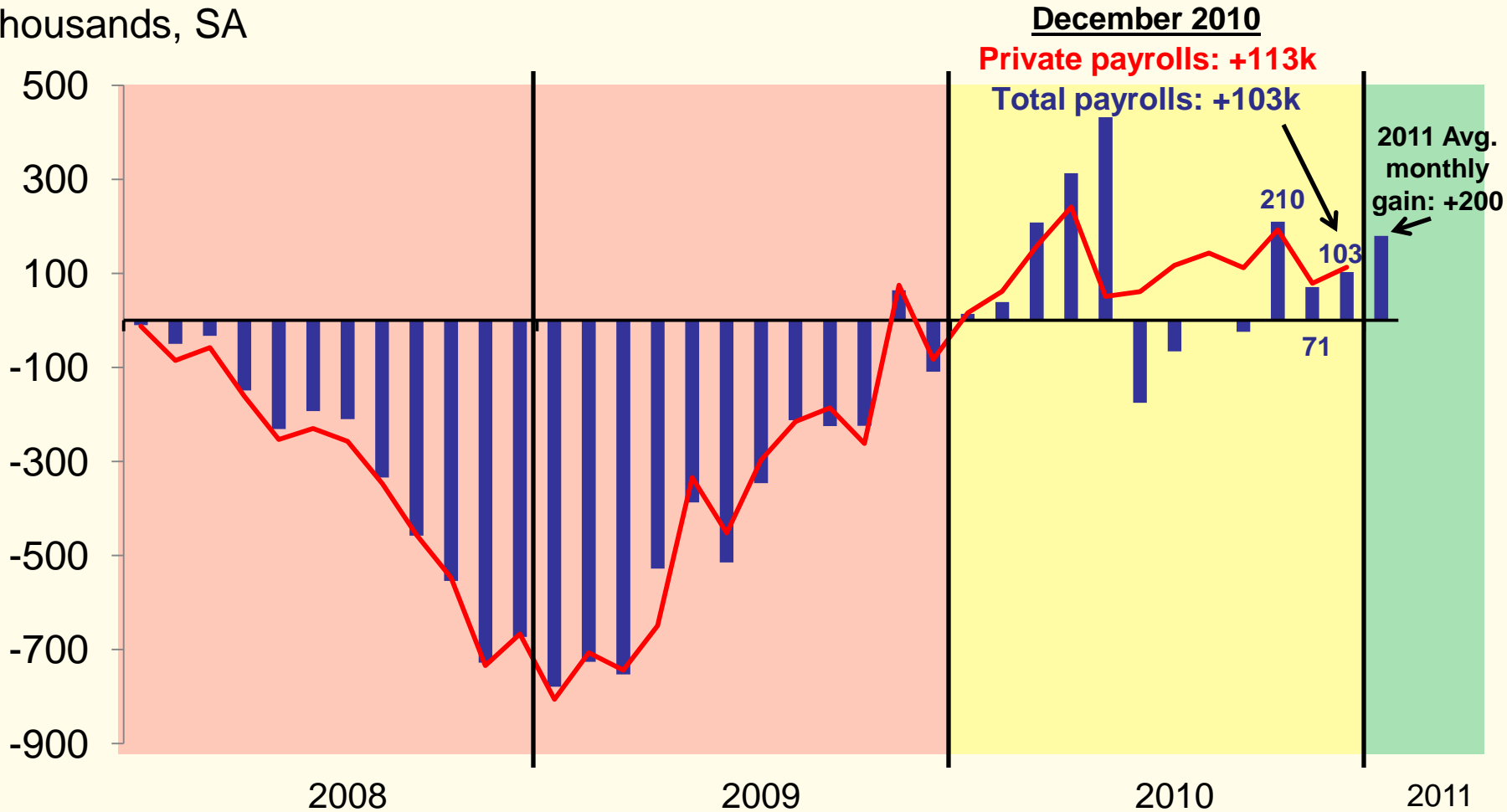
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Source: Bureau of Labor Statistics

# Employment Outlook Improving, Finally

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Source: Bureau of Labor Statistics



BUT...

**Very Roughly...**

- 10% unemployed

AND

- 10% underemployed

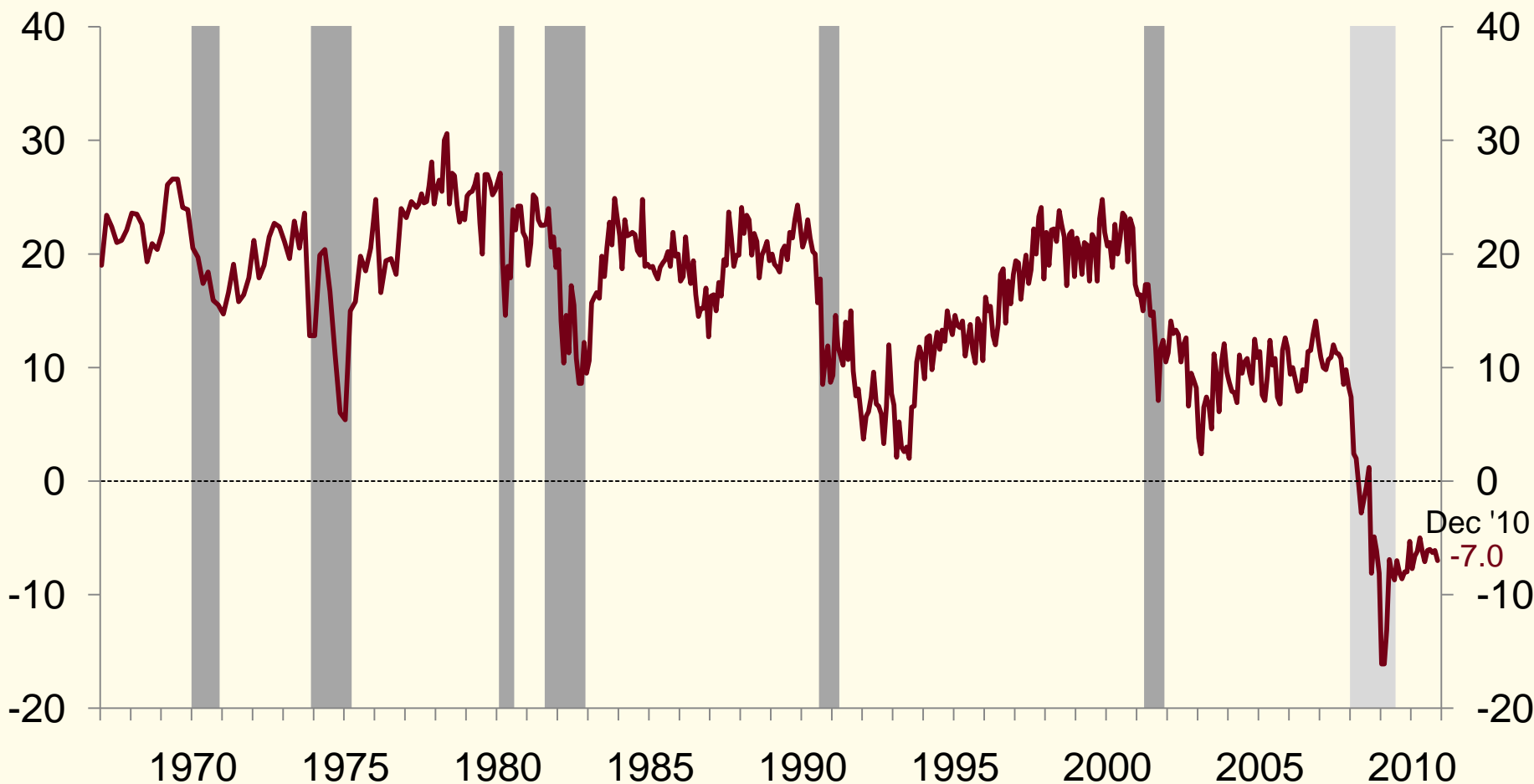
AND

- 10% believe they'll become unemployed or underemployed within the next 6 months

# Pessimism Regarding Income Growth

(Conference Board 6-month income expectations)

Net percentage expecting increase



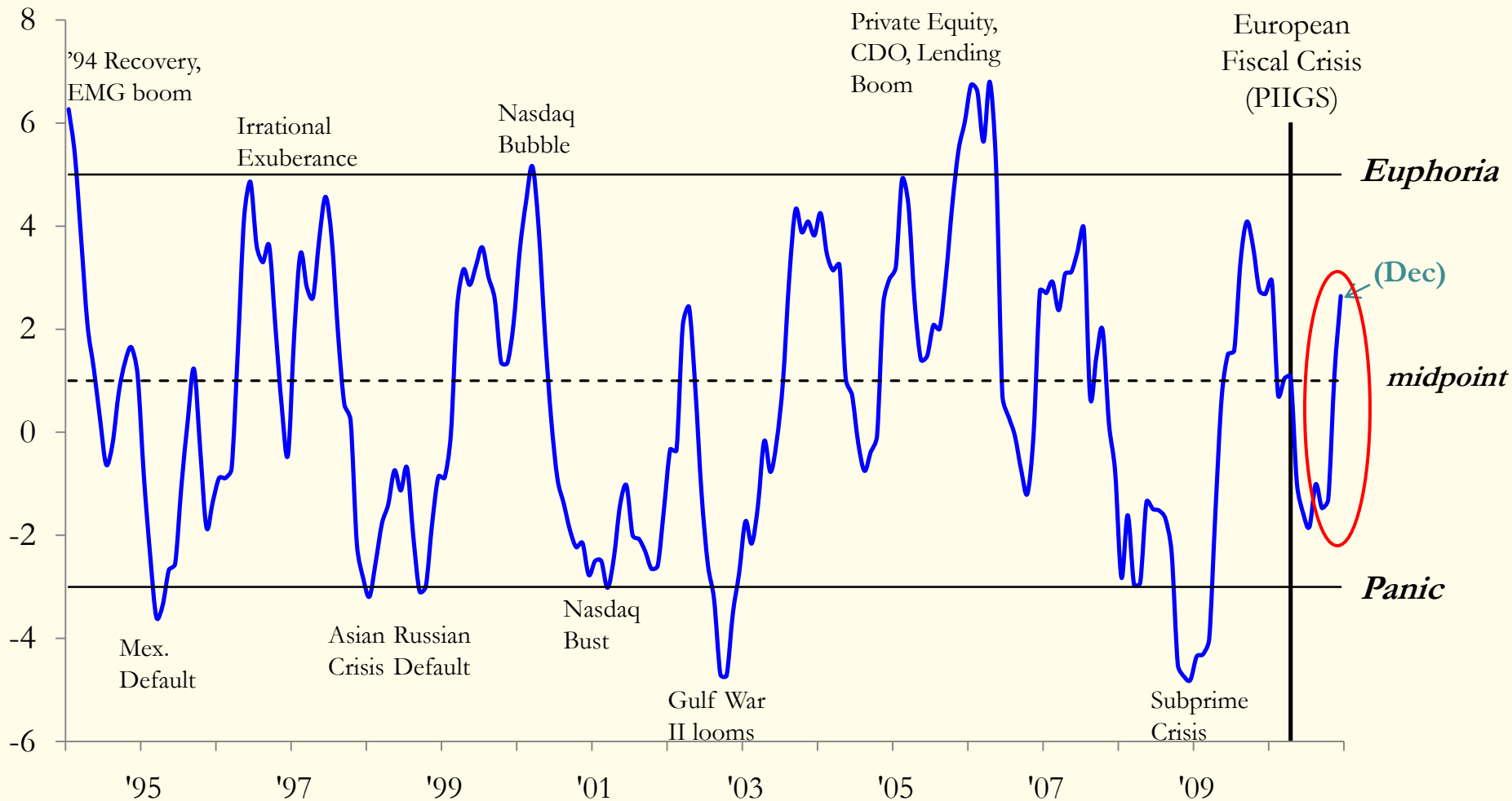


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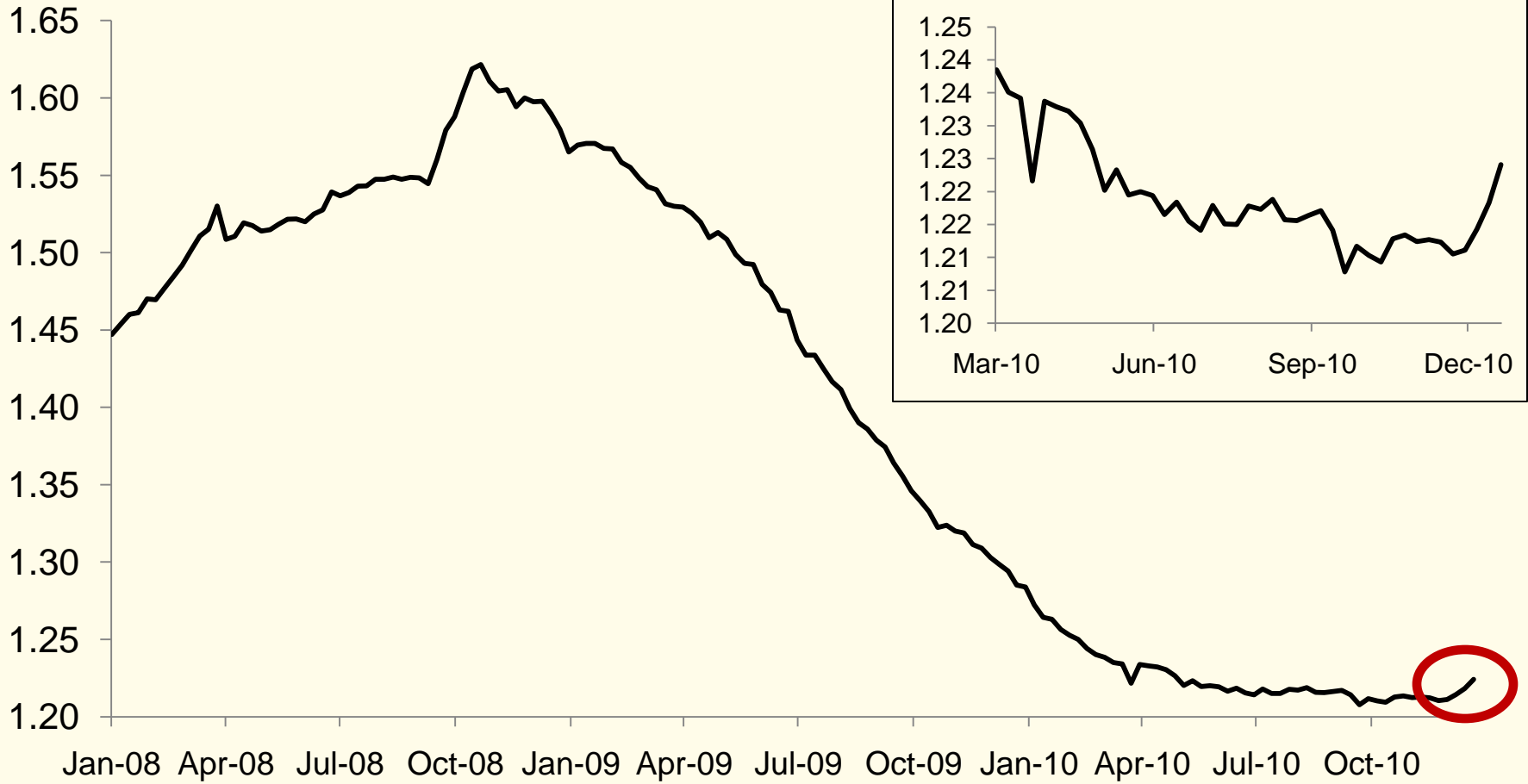
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# CS Global Risk Appetite Index: December 2010

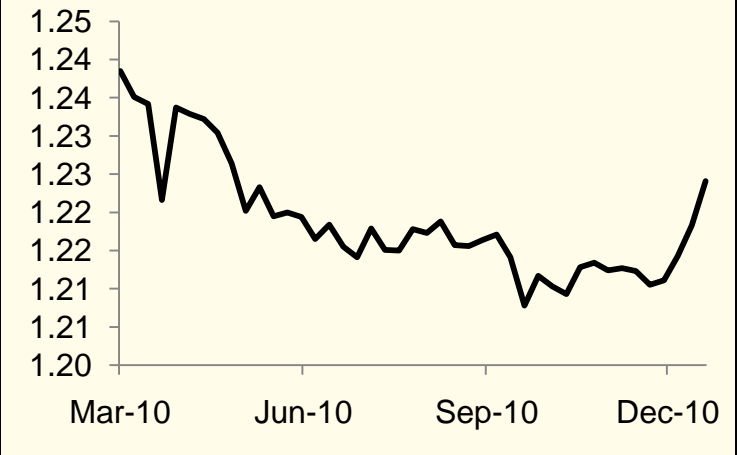


# C&I Bank Credit Outstanding Starting to Expand

SA, \$ Trillions



SA, \$ Trillions



Source: Federal Reserve Board



# Fears of “Crowding Out”

Sooner than we think:

- Change in psychology regarding low rates could push a potential new wave of debt financing
  - Junk bond issuer vs. junk bond issuer

Gov’t & European banks’ heavy borrowing needs:

- Could crowd out other issuers → must offer higher rates to attract investors



# Other Momentum Shifts



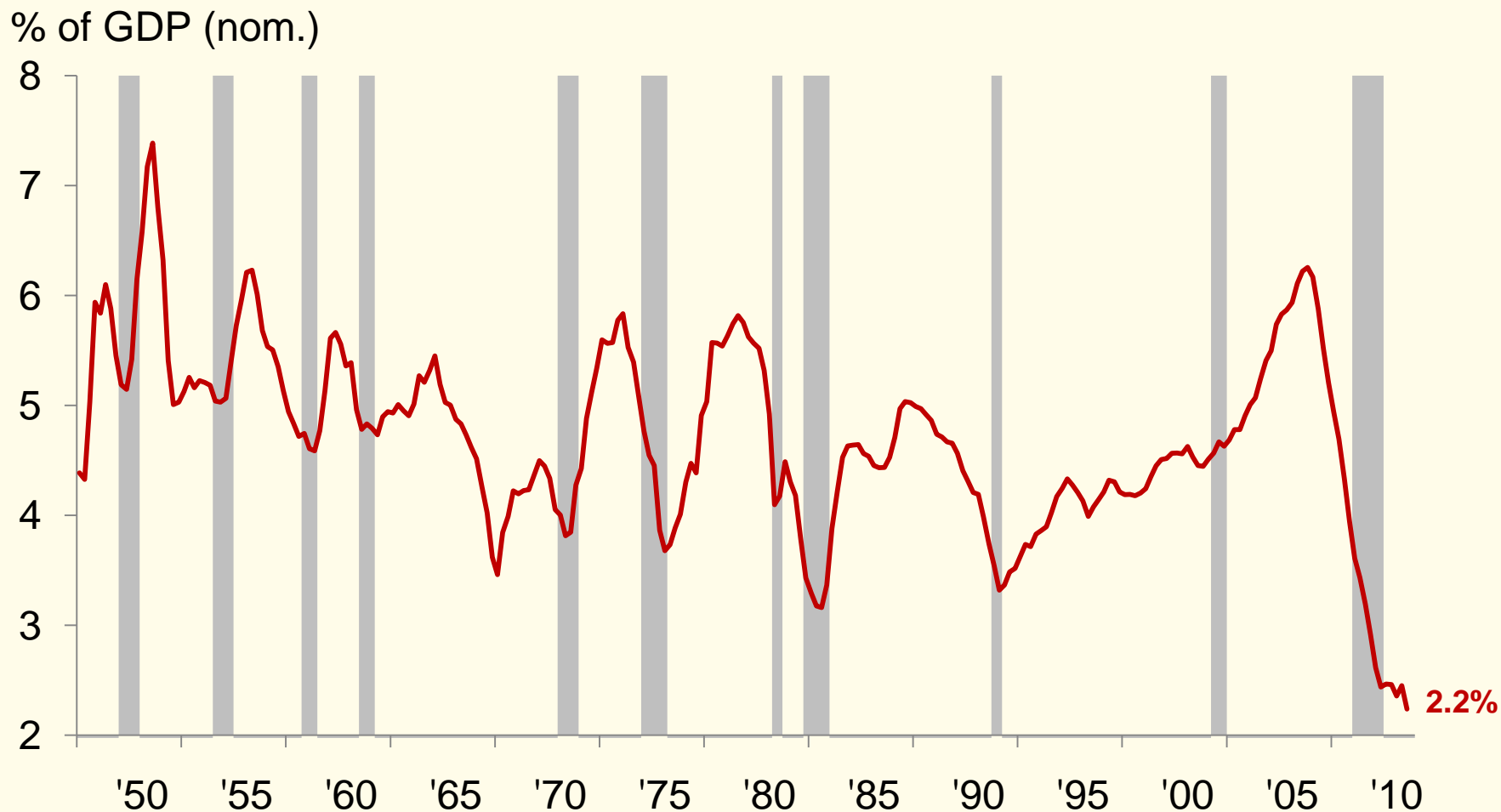
# Negative to (roughly) Neutral is Still a Momentum Change

- Housing...
  - High apartment rental demand kicking off construction in some areas (10-yr high in N. TX)
  - Home building begins slowly where inventory already low, not overbuilt areas
  - Market for vacation homes beginning to improve

## BUT:

- Home price declines likely to continue in many markets
- As much as a 2.5-year supply yet to work through

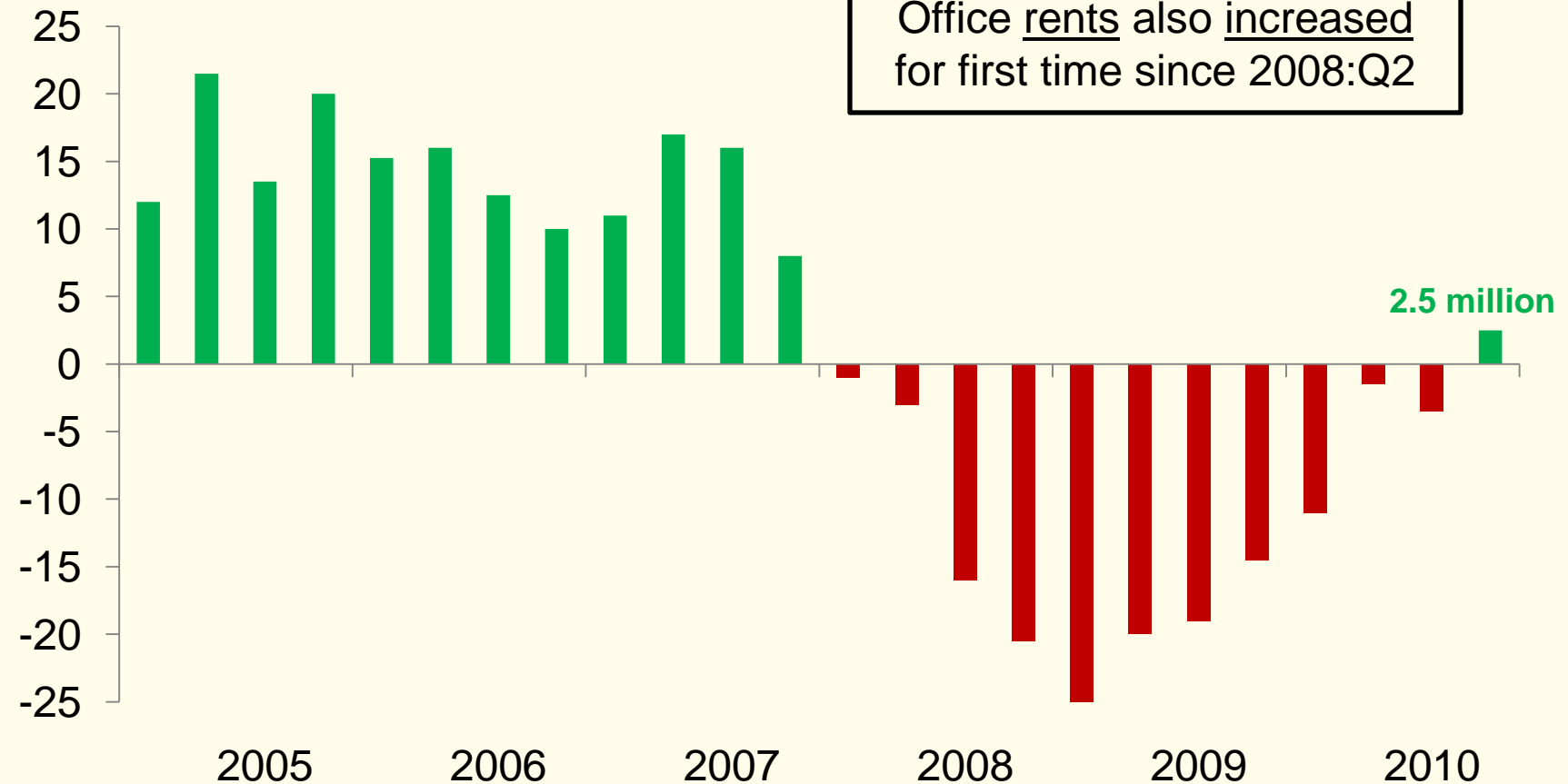
# Housing: The New Neutral



Source: Bureau of Economic Analysis

# Fresh Signs of Life in the Office Market

Change in occupied US office space, sq. ft. (million)



Source: Reis Inc. (WSJ, Jan. 4, 2011)



# Europe's Problem

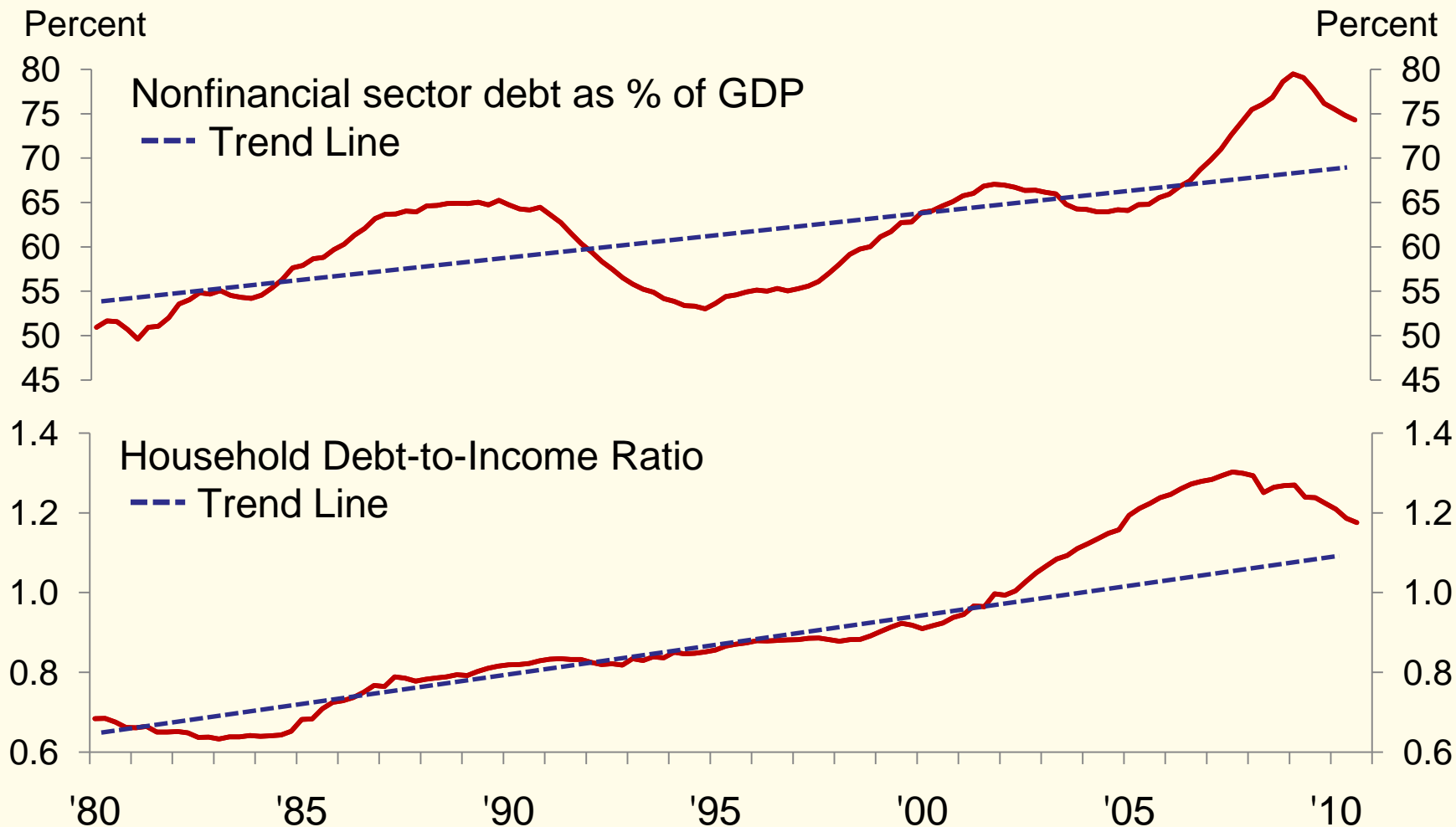
- European sovereign debt primarily a European problem
  - U.S. banks' exposure to European debt a “known unknown” with some spillover
  - Unlikely to derail U.S. expansion



# Deleveraging Slowing

- Reduced headwinds from deleveraging
  - Business sector: mostly done
  - Households: more to go, but slower pace
  - Implication: improved traction for monetary policy

# More Deleveraging to Go, But Slower

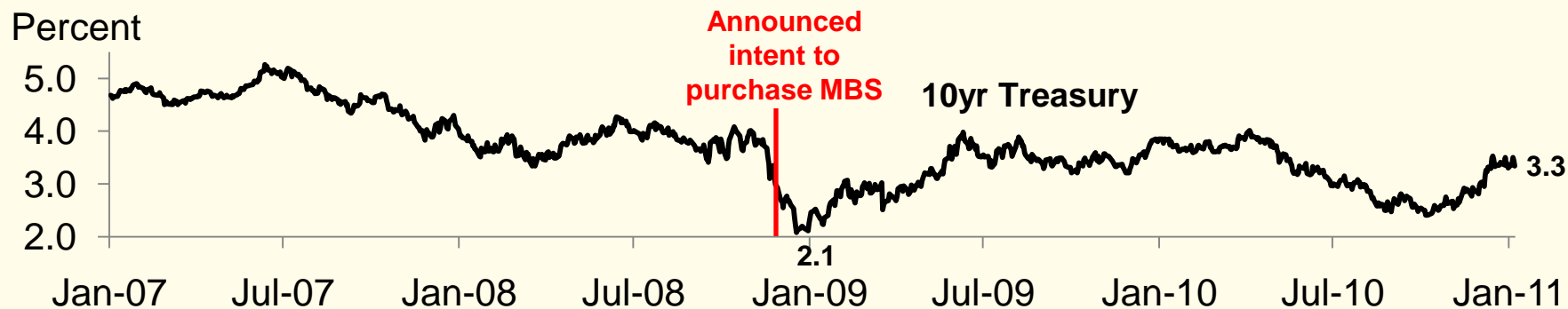


Source: BCA Research 2010 (Martin Barnes), Federal Reserve Board, BEA

\*Some securitizations moved onto balance sheets

# Financial Markets

	2008 (%)	2009 (%)	2010 (%)
<b>Stock Market</b>			
S&P 500 (% change)	-38.5	23.5	12.8
<b>Bond Market</b>			
10-yr Treasury (eop)	2.3	3.9	3.4
BAA Corporate (eop)	8.0	6.4	6.0
Junk (eop)	19.5	9.1	7.8



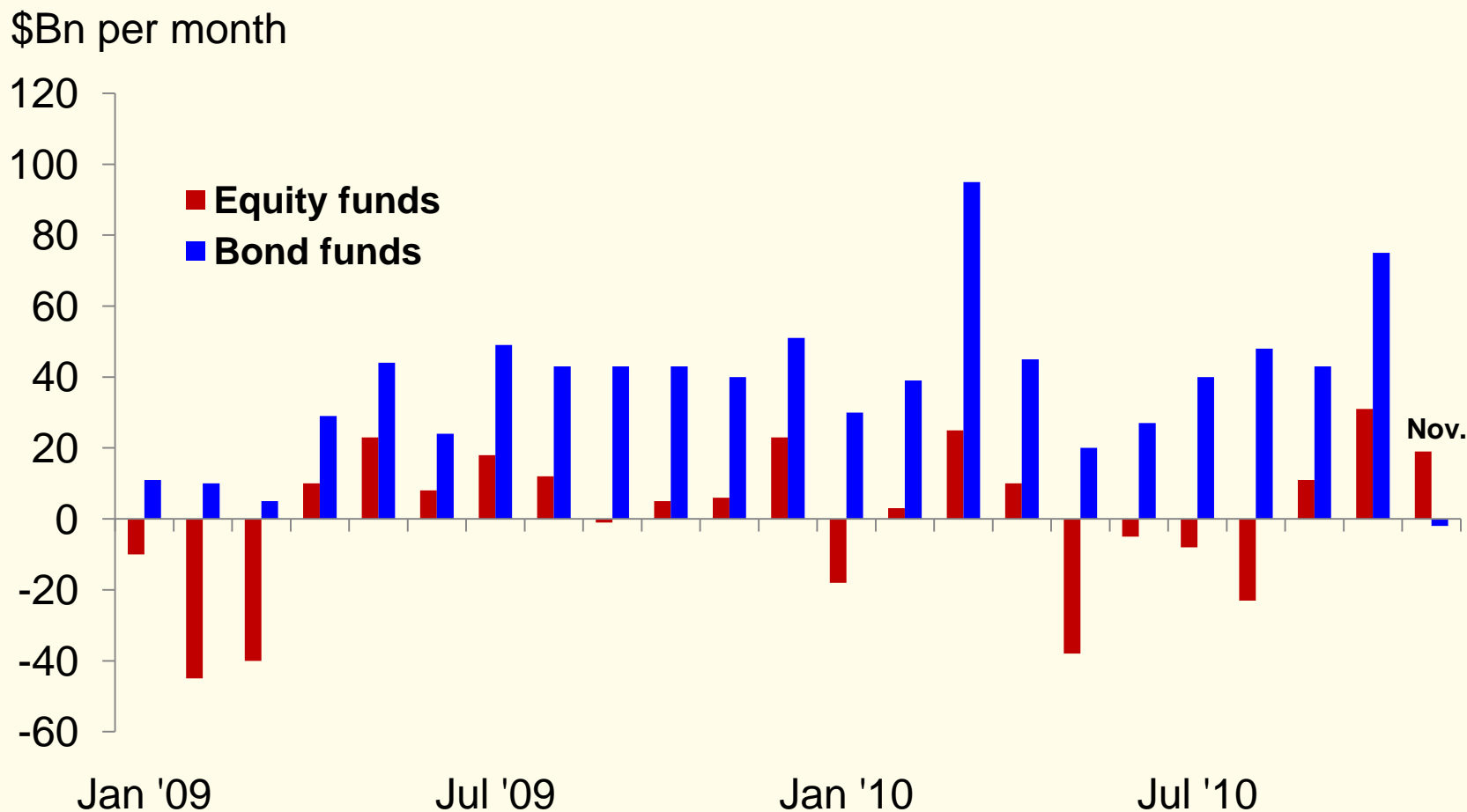


# Interest Rates

Interest rates can only go UP from here

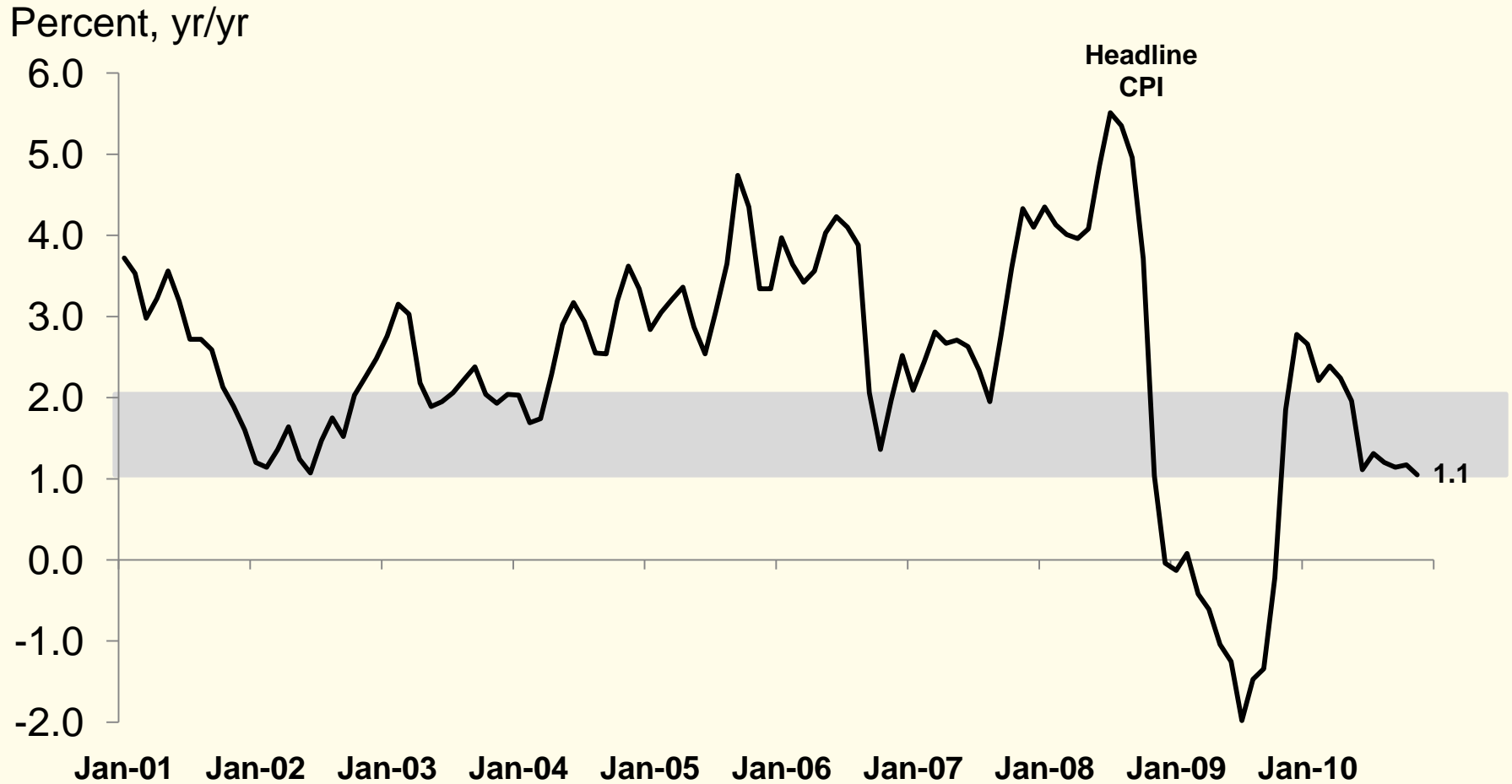
- Near-record lows
  - Stronger growth
  - Bonds must compete with equities
- 
- Upward interest-rate pressures limited by U.S. being “best horse in the glue factory” (low credit risk)
  - Limited upside inflation potential

# Monthly Global Equity and Bond Fund Flows



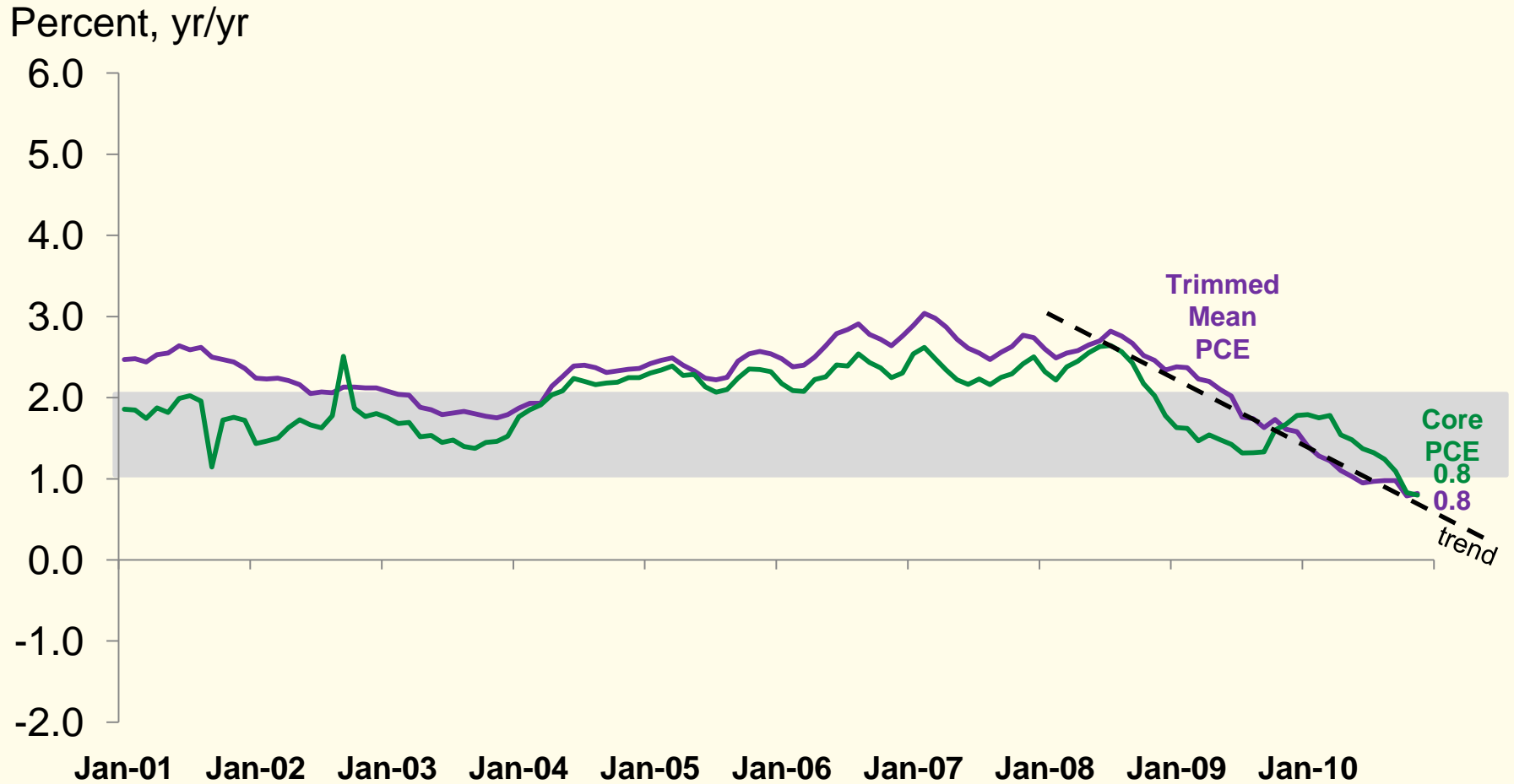
Source: EPFR, J.P. Morgan (*Flows & Liquidity*, Dec. 3, 2010)

# Inflation Trending Down, But Likely Stabilizing



Source: Federal Reserve Board, Dallas Fed, BEA, BLS

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Source: Federal Reserve Board, Dallas Fed, BEA, BLS

# S&P/GS Commodity Price Index Trends Up with Global Economy



Source: Standard & Poor's, Goldman Sachs



# Ben's Year to Reap the Benefits

- GDP growth revving up
- Labor market recovering
- Slowly gaining confidence
- Inflation stabilizing
- Risks less likely to derail U.S. expansion

Source: "Meet the Supporting Cast," *WSJ*, Jan. 3, 2011



# Reminder, However, of the Risks

- European sovereign debt
- China over-tightening
- Oil price surge
- US home price declines
- US state & local budget problems
- Politics before appropriate fiscal policy



# Monetary Policy

As long as unemployment remains near 9% and inflation near 1%, the Fed will be under pressure to maintain or increase monetary policy accommodation.



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