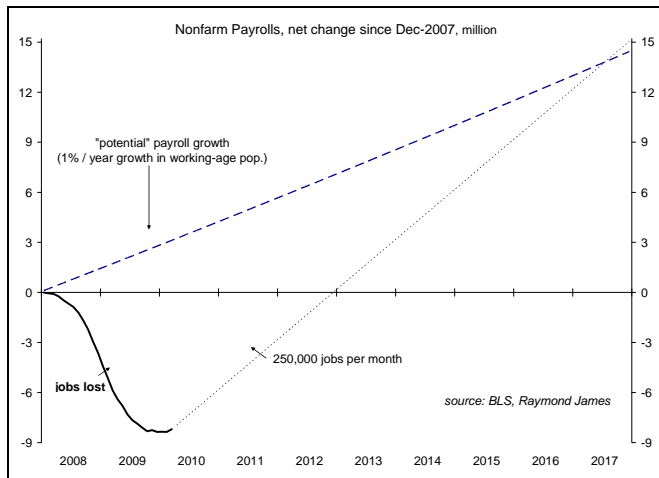


Monthly Economic Outlook

**A Moderate Path, With Continued Headwinds**

- *The U.S. economy continued to expand in the first quarter. The job market appears to have finally turned the corner. Still, the recovery will likely be relatively moderate.*
- *In contrast to fears of higher inflation, core inflation measures have actually been trending lower. The Federal Reserve is unlikely to raise the overnight lending rate this year.*
- *Long-term interest rates normally creep higher in an economic recovery. However, they should not rise so much that they threaten the recovery.*

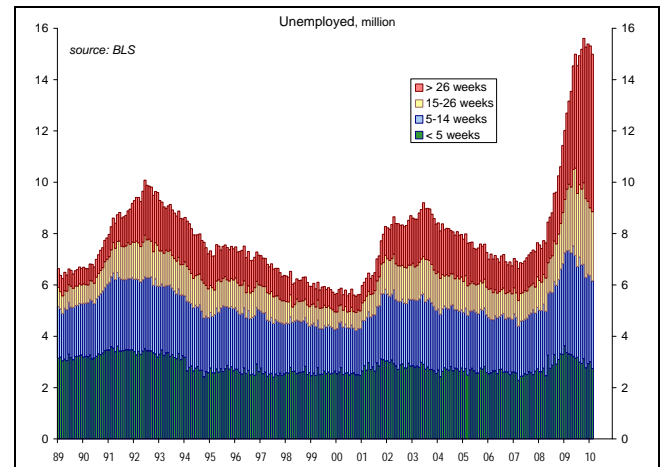
Real GDP rose at a 5.6% annual rate in the government’s third estimate of 4Q09 growth. Two-thirds of that increase was due to a slower pace of inventory reduction (the *change* in inventories contributes to the *level* of GDP, the *change in the change* in inventories contributes to GDP *growth*). The inventory correction is nearly complete, but is expected to have contributed further to GDP growth in 1Q10 (the advance GDP estimate will be reported on April 30). However, as Fed Chairman Bernanke put it in his recent congressional testimony, “with inventories now much better aligned with final sales and with the support from fiscal policy set to diminish in the coming year, further economic expansion will depend on continued growth in private final demand.” It looks likely that private demand will be strong enough to carry the expansion forward, but the pace is likely to remain disappointing given the magnitude of the economic downturn.



Nonfarm payrolls rose by 162,000 in the advance estimate for March. Hiring for the 2010 census accounted for 48,000 and temp-help agencies added 40,000. Temporary census jobs will boost the payroll figures further in April and May, with most of those jobs being shed between June and September. Firms are still generally reluctant to hire new workers. Credit conditions remain tight for small businesses (which normally account for about a third of net job growth in an expansion).

Labor market weakness has been a centerpiece of the economic downturn. Nonfarm payrolls are now down 8.2 million from when the recession began. The economy needs about 125,000 additional payroll jobs per month to keep the unemployment rate steady over time. If the economy were to add 250,000 jobs per month, it would take nearly three years to regain the jobs lost over the last two years. However, over that time (since the recession began), over 7 million people would have been added to the workforce. If we continued to add 250,000 jobs per month, the unemployment rate would not return to its pre-recession level until 2017. Clearly, the challenges for the labor market are monumental.

Long-term unemployment has increased substantially. In March, more than 6 million had been out of work for more than half a year. Workers lose valuable job skills the longer they are unemployed. In addition, new entrants to the workforce have had a harder time finding jobs – many are not getting the skills they would have gotten if the economy were closer to full employment. The unemployment rate for college graduates was 4.9% in March, up from 2.1% before the recession began.



The large degree of slack in the labor market implies that wage pressures are unlikely to build anytime soon. Productivity growth has been extremely strong, pushing unit labor costs down (unit labor costs, the labor expense per unit of output, are the key measure of inflation pressure in the labor market). In contrast to the Great Inflation of the 1970s and early 1980s, higher oil prices have not fed through to the labor market. The labor market is the widest channel for inflation pressures and an elevated unemployment rate implies that overall inflation is likely to remain low.

Manufacturing output has been increasing, but there is still a considerable amount of slack in production. There are no bottleneck constraints. Firms are not going to be struggling to keep up with demand. Commodity prices may be up, but firms generally have little ability to raise prices of finished goods.

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It takes a huge increase in commodity prices to have much of an impact by the time you get to the consumer. There are more important factors in inflation, such as labor costs, transportation, processing, and advertising. The exception is the price of oil, which has a broad impact across the economy. However, the oil price increases of the last several years have been more associated with weaker economic growth than with a higher underlying trend in inflation.

More recently, measures of core inflation have been trending lower. Ex-food & energy, the Consumer Price Index rose just 1.1% over the 12 months ending in March – a 0.6% annual rate over the last six months. The Cleveland Fed’s Median CPI, which has half of weighted price increases above it and half below it, rose 0.6% for the 12 months ending in March. Much of the disinflation (a decline in the inflation rate) has been due to weakness in rents (a consequence of housing sector problems). Remember, the Bureau of Labor Statistics does not consider the price of the home or mortgage payments in calculating inflation in housing. The BLS seeks to capture the price of the service provided by a home, rather than its asset value. Owners’ equivalent rent, which makes up a quarter of the overall CPI and nearly a third of the core CPI, was unchanged over the 12 months ending in March – down at a 0.6% annual rate over the last six months. However, the decline in the core inflation rate is more than just housing. Nearly half of the weighted components of the CPI exhibited flat or declining inflation over the last 12 months.

Deflation, a decline in the general price level, is something that the Federal Reserve takes very seriously. Falling prices can paralyze consumer spending and business fixed investment, leading to lower prices and even weaker growth. Deflation appears to be much less of a threat than it did a year ago, and still is not likely, but the odds have increased.

The Fed has the tools to fight deflation. In fact, it employed these tools last year (buying \$1.25 trillion in mortgage-back securities and \$300 billion in long-term Treasury securities). The Fed’s asset purchase programs have ended (the Fed stopped buying Treasuries in October and mortgage-backed securities in March). However, officials reserve the right to resume purchases if conditions warrant. Most likely, the U.S. economy will avoid a prolonged deflationary episode, but it’s not out of the realm of possibility.

The Fed has continued to indicate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for “an extended period.” That view is conditional on three things: low rates of resource utilization (an elevated unemployment rate and low capacity utilization in manufacturing), subdued inflation trends (low core inflation), and well-anchored inflation expectations. These conditions are unlikely to shift enough to force the Fed to raise short-term interest rates anytime soon. Credit is still generally contracting – so there’s no need to tighten policy to cool the economy off.

Looking ahead, bank lending should become looser over time. However, credit is likely to remain tight for small businesses for some time, keeping the overall expansion at a moderate pace. The hangover from the residential housing collapse will continue, although problems should decrease gradually over time (and job growth will be a necessary condition for recovery). Commercial real estate will be a problem for many small banks around the country. State and local government budgets remain under severe strain, leading to higher taxes and cuts in services, although tax revenues have begun to increase. The fiscal stimulus will ramp down into 2011 and the Bush tax cuts are set to sunset at the end of the year. However, while these negatives are expected to dampen growth into early 2011, they should not cause a double dip.

	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	2009	2010	2011
GDP (↓ contributions)	-6.4	-0.7	2.2	5.6	4.5	3.4	3.0	3.0	2.6	3.0	-2.4	3.6	3.0
<i>consumer durables</i>	0.3	-0.4	1.4	0.0	0.4	0.3	0.3	0.3	0.1	0.3	-0.3	0.4	0.3
<i>nondurables &amp; services</i>	0.2	-0.2	0.6	1.1	1.9	1.5	1.6	1.7	1.5	1.6	-0.1	1.4	1.6
<i>bus. fixed investment</i>	-5.3	-1.0	-0.6	0.5	0.6	0.5	0.5	0.5	0.5	0.6	-2.2	0.3	0.5
<i>residential investment</i>	-1.3	-0.7	0.4	0.1	0.3	0.3	0.3	0.4	0.3	0.4	-0.7	0.2	0.4
<i>government</i>	-0.5	1.3	0.6	-0.3	0.3	0.3	0.1	-0.1	-0.1	-0.1	0.4	0.3	0.0
Domestic Final Sales	-6.4	-0.9	2.3	1.4	3.5	3.0	2.9	2.7	2.3	2.8	-2.8	2.5	2.8
<i>exports</i>	-4.0	-0.5	1.8	2.4	1.1	0.9	0.7	0.8	0.8	0.8	-1.2	1.2	0.8
<i>imports</i>	6.6	2.1	-2.6	-2.1	-1.4	-1.1	-0.9	-0.9	-0.7	-0.8	2.2	-1.3	-0.8
Final Sales	-4.1	0.7	1.5	1.7	3.2	2.8	2.7	2.7	2.4	2.9	-1.7	3.3	3.0
<i>ch. in bus. inventories</i>	-2.4	-1.4	0.7	3.8	1.2	0.5	0.3	0.3	0.2	0.1	-0.7	1.2	0.2
Unemployment, %	8.2	9.3	9.7	10.0	9.7	9.5	9.5	9.4	9.4	9.4	9.3	9.5	9.2
NF Payrolls, monthly, th.	-753	-477	-261	-90	54	175	50	105	95	135	-395	96	144
Cons. Price Index (3 mo)	2.5	3.7	2.5	2.5	1.5	1.8	1.8	1.9	2.0	2.0	2.8	1.8	2.0
<i>excl. food &amp; energy</i>	2.3	2.2	1.4	1.3	0.1	1.4	1.5	1.5	1.6	1.6	1.8	1.1	1.6
PCE Price Index (q/q)	-1.5	1.4	2.6	2.5	1.6	1.7	1.8	1.8	1.9	1.9	0.2	1.9	1.9
<i>excl. food &amp; energy</i>	1.1	2.0	1.2	1.8	0.6	1.3	1.4	1.5	1.5	1.6	1.5	1.3	1.5
Fed Funds Rate, %	0.19	0.18	0.15	0.12	0.14	0.21	0.24	0.25	0.29	0.70	0.16	0.21	0.97
3-month T-Bill, (bond- <i>eq.</i> )	0.2	0.2	0.2	0.1	0.1	0.2	0.3	0.3	0.4	0.8	0.2	0.2	1.0
2-year Treasury Note	0.9	1.0	1.0	0.9	0.9	1.0	1.7	2.2	2.4	2.5	1.0	1.5	2.6
10-year Treasury Note	2.7	3.3	3.5	3.5	3.7	3.8	3.8	3.9	4.0	4.1	3.3	3.8	4.1