ISAKOV PLANNING GROUP®

Economic Research

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Monthly Economic Outlook

Near-Term Outlook

- *The economy seems to have entered 2011 with a good amount of momentum. There are still a few variables restraining economic growth, but the recovery is still moving up stream.*
- *Unemployment is beginning to slowly trend downwards, which signals that the job hiring situation should improve in Q3.*
- *The Federal Reserve is set to complete its $600 billion asset purchase program by the end of June. An increase in short-term interest rates is not expected until next year 2012.*

Real GDP rose at a 2.8% annual rate which is at a smaller rate then estimated initially by the advance estimate of 3.2% in the fourth quarter of 2010 (4Q10). There were some unusual swings in changes of private inventories and in net exports. It seems that many businesses slowed or held production of goods fearing that slow economic growth would hamper consumer demand for goods. From 2Q10 and 3Q10, the pace of inventory accumulation in 4Q10 sharply slowed and, as a result, subtracted 3.7 percentage points from the total real GDP figure. Net exports added percentage points to economic growth as we witnessed a sharp downturn in imports and acceleration in exports. Lower imports can further corroborate the lean business inventory story. However, lean inventories typically lead to a pickup in production, which seems to be the trend unfolding from early ISM manufacturing data for the beginning of 2011. So far, this year January and February have consecutively shown a PMI above 60 which, if maintained over the next couple of month, could indicate strong continued growth.

Domestic Final Sales (GDP less change in inventories), an excellent barometer of measuring demand for U.S. products, has increased substantially in 4Q10 to 6.7% in great contrast from a meager third quarter increase of 0.9%. However, we must look at this figure with a grain of salt, because Final Sales of domestic product include sales to foreigners and U.S. consumers. To get a better sense of demand just in the U.S., we have to take a look at Gross Domestic Purchases, which includes purchases solely by U.S. residents of goods and services wherever they were produced, which is clocked in at a decrease of 0.6% for the fourth quarter in contrast to an increase of 4.2% in the third. The difference between Domestic Final Sales and Gross Domestic Purchases is indicative that U.S. demand is still somewhat restrained and U.S consumers are cautiously optimistic about the future expectations of U.S. economic growth; however, foreign and global demand seem to be strengthening for U.S. goods and services. The increased global demand for U.S. products can be attributed to recent declines of the US dollar relative to other major currencies and accelerated economic growth in countries overseas.

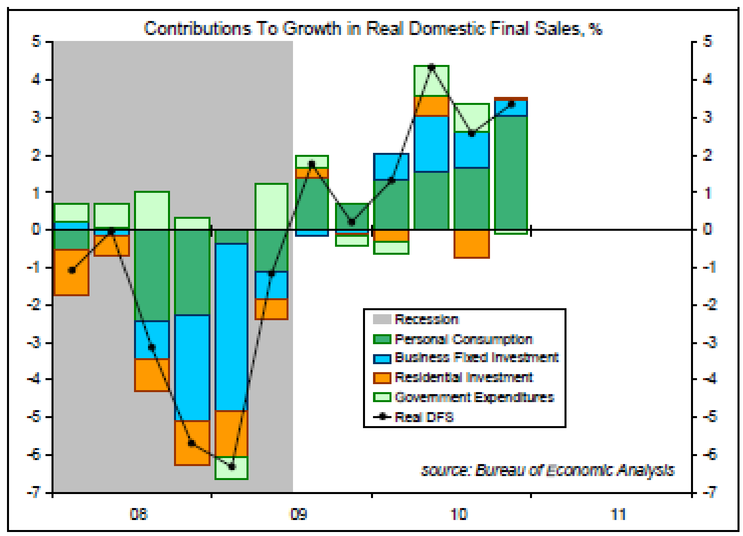

Figure 1: *Contributions to GDP in Real Domestic Final Sales*

As depicted in Figure 1, personal consumption is steadily growing with an upswing in the fourth quarter of 2010. Consumers are cautiously continuing to spend with inflation-adjusted consumer spending increasing at a 4.4% annual rate in 4Q10. This spending increase is largely fueled by a drop in the savings rate which dropped from 5.9% to 5.4%.

We see Business Fixed Income (BFI), a measure of business spending on residential and nonresidential expenditures, rising to 4.4%, which is a pace much lower than recent quarters. This slowdown may be reflective of the business inventory story as well. However, we see this area contributing a greater percentage to GDP in 2Q11-4Q11 as business activity begins to pick up.

The 4Q10 GDP figures will be revised again on March 25, but the story in unlikely to change much from the February 25 revision. Following a very strong build up in inventories in 3Q10, certainly some correction was anticipated. However, it appears that the correction occurred over one quarter. It looks like inventory will rebuild in subsequent quarters, which will add to GDP growth in the first half of this year.

December's tax extension and expansion agreement included a 2% reduction in the employee paid portion of payroll taxes. Although some of this consumer gain will be offset by the rising prices of gasoline and the expiration of the Making Work Pay tax credit (which was one part of the stimulus package), we should still see an increase in disposable income in the first quarter of 2011, which should help foster consumer spending growth.

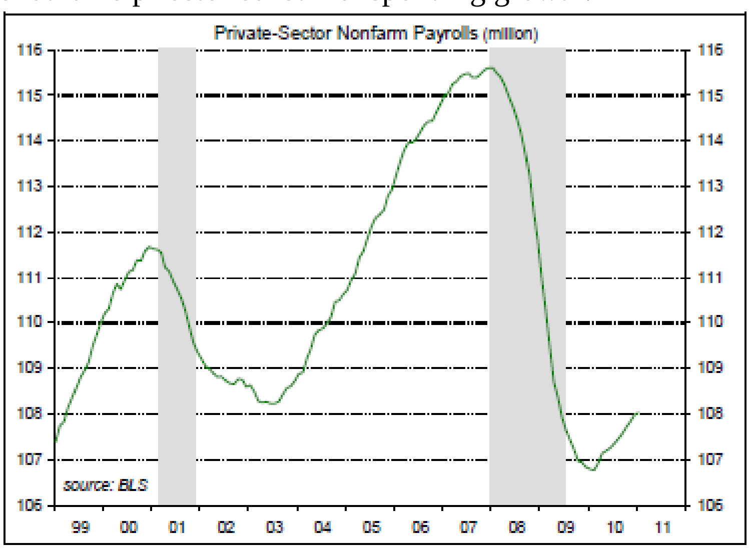

Figure 2: *Private Sector Nonfarm Payrolls*

Private-sector payrolls(less government payrolls) rose in February's preliminary estimates by 222,000, which is a substantially better figure from a disappointing low in January. However, one should not put too much emphasis on any one month's figure. Needless to say, the labor market in the country is still a major concern. It will take several years before we get to the level of jobs that we saw before the economic downturn. As the population grows every year, the workforce will continue to expand at about 1.3 million workers per year, so the economy will need to correct itself to account for the growing population by creating new jobs overtime.

The good news is that job layoffs remain low at the current level of unemployment. Announced corporate layoff intentions for the 2010 were the lowest since 1997. While that is a good sign for the labor market, the main concern is a lack of job creation. Even though corporate profits appear to be improving, business expansion has slowed pace as illustrated in Figure 1. Higher profits are not always a sign for new business expansion and job creation. In fact, a major reason why corporate profits are high is because firms are holding off costs on labor, which is typically the largest expense for businesses. Normally, we look to small firms for most of the new job creation; however, they are facing quite a few problems, specifically tight credit, which is making it more difficult for them to expand and create jobs. On a positive note, many standards and terms for providing bank loans to businesses have begun to ease. Still firms both large and small will hire at a much slower pace until they see a sustained strengthening in demand for their goods and services.

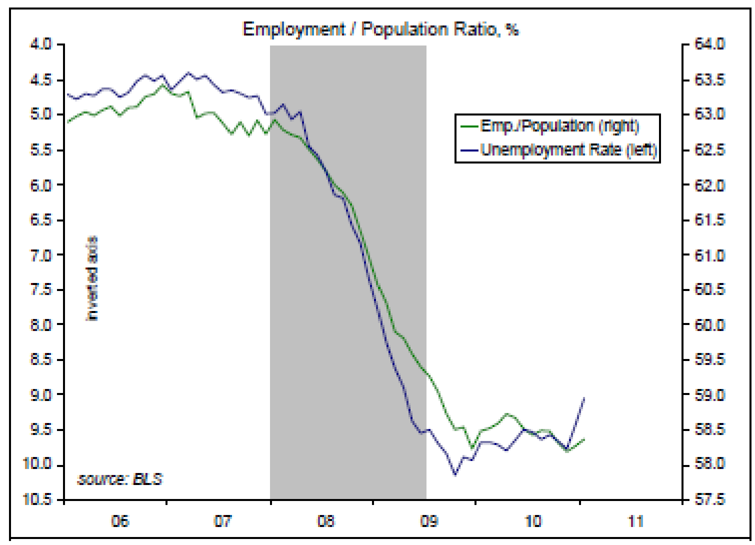

Figure 3: *Employment / Population Ratio (%)*

The unemployment rate has fallen to 8.9% in February, which is better and better from December (9.4%) and November (9.8%). But the above figure seems to be slightly misleading, because the employment-to-population ratio, a good measure of the slack in the labor market, changed only a little and remains mostly flat.

The job situation is getting better. As economic growth rises, this will lead to more jobs, and more jobs will generate more economic growth. Surely, expansion is working its way at a much more restrained pace, but that's because there are still a few headwinds in the near term that need to be corrected. Firstly, the housing market is still dismal and state and local governments are facing budgetary issues, but there is positive momentum building in consumer spending and production which will add to growth in subsequent quarters. Strong job growth should alleviate some of the problems in state and local government budgets, while at the same time strengthen the demand for home purchases. We can expect continued improvements in the job market in the following quarters of 2011.

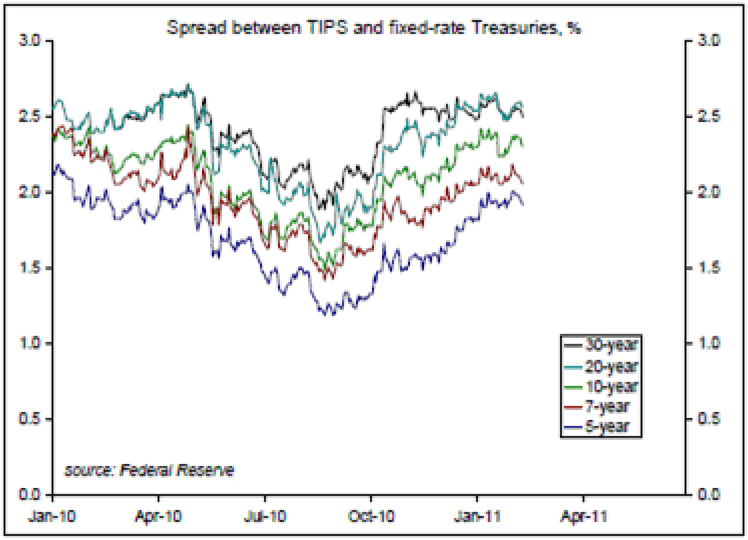

Figure 4: *Spread between TIPS and fixed-rate Treasuries, %*

Many investors are concerned with increased commodity prices in 1Q211. However, based on the spread between inflation-adjusted Treasury securities and fixed-rate Treasuries, inflation seems to be at bay and holding that way at similar levels from a year ago.

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