

# Macro Trends

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## Monthly Analysis on the U.S. Economy

### Summary

*The U.S. economy is continuing to expand, although recent reports suggest growth may not be quite as strong as it was late last year. Nevertheless, job growth is improving. Consequently, the economy is approaching the point where the expansion is more self sustaining. This means that the Federal Reserve may not need to pump as much liquidity into the financial system and could end its quantitative easing program at the end of June as currently scheduled.*

### Record output

The latest inflation-adjusted gross domestic product (GDP) data show that the economy expanded at a 3.1% seasonally adjusted annual rate in the fourth quarter. This is slightly above the 2.8% average quarterly growth rate during the past 30 years. Moreover, fourth quarter output was at a new record high, surpassing the peak just prior in activity three before the recession started three years earlier. However, recent data suggest the economy may have expanded at a slower 2.0%-2.5% annual rate during the first quarter of this year. Looking ahead, we continue to expect inflation-adjusted GDP to expand at an average 3.0% rate in 2011, with manufacturing and exports leading the way.

### Employment expands

Companies are hiring more workers this year as the economy strengthens. Specifically, nonfarm payrolls increased a net 216,000 in March, following a net 194,000 increase in February. This is an encouraging sign that the economy is on a firmer footing as the Federal Reserve says. More important, as job growth increases, household income increases, giving consumers more money to spend. This boosts business sales and reinforces the expansion, eventually making the economy self sustaining.

### Firmer footing

The Federal Reserve has been holding interest rates at an exceptionally low level for an extended period, according to their own language. We believe that the Fed will begin to remove this very easy money policy once the economy no longer needs help. The Fed has not yet declared that the recovery is self sustaining, although one official recently said that the recovery is more sustainable and that policy may need to be reversed in the not-too-distant future. If other officials adopt a similar view, the Fed may drop its reference to holding rates low for an extended period of time when it releases its policy statement after the next Federal Open Market Committee meeting on April 27. If the Fed changes its characterization of the economy, it may not be long before the Fed ends its exceptionally easy policy.

### Rising gasoline prices

Retail gasoline prices have jumped sharply during the past few months in response to the improving economy and concerns about supply disruptions linked to Middle-East turmoil. If gasoline prices remain high this summer, consumers are likely to curtail purchases of discretionary goods and services in order to afford necessities like food and energy. At this point, the increase in energy prices is only likely to dampen economic growth, not derail the expansion and cause another recession. However, if energy prices jump substantially more and gasoline goes to nearly \$5.00 per gallon across the country, the economy could slow significantly. Fortunately, the quantity of energy

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demanded appears to be declining in reaction to the higher prices. As a result, oil prices may not rise substantially further unless the turmoil in the Middle East spreads to Saudi Arabia, causing global oil supplies to decline.

### **Inflation concerns increase**

Investors are becoming increasingly concerned about the potential for rising inflation. However, Federal Reserve policymakers believe that the recent increase in inflation is transitory. That's because there is still a lot of excess capacity in the economy and unemployment is high. As a result, there are no shortages of goods or labor that would tend to drive prices or wages significantly upward. Nevertheless, inflation expectations are higher and that means that the Federal Reserve needs to be careful and not throw more fuel on the fire by maintaining its easy monetary policy longer than necessary.

### **Deficit battle looms**

The compromise tax cuts passed last December and the increased federal spending are causing the deficit to increase again this year. As a result, this year's budget deficit could be near its previous record high of \$1.4 trillion in the fiscal year ended in September 2009. On the positive side, Congress and the Administration finally reached an agreement on funding government programs for this year but may still fight over future spending during the next few months when the debt ceiling needs to be raised. It is somewhat encouraging that both sides recognize that the deficit needs to be cut. Unfortunately, there is still a significant difference of opinion on how to do it. Consequently, the battle to reduce the deficit is likely to persist for quite some time, although the debt ceiling is likely to be raised in the end.

### **Japanese production cuts could hurt U.S. too**

The devastating earthquake and tsunami in Japan will probably send that country into a recession this year before rebuilding boosts growth next year. In the meantime, supply chains of manufactured products to other countries could be disrupted. This means that many U.S. producers may not get the components that they need to make their products in the United States. Consequently, the global economy is likely to grow at a more subdued rate this year.

### **Housing remains depressed**

Unfortunately, the housing market has not recovered from the steep decline during the recession. Housing is very affordable but buyers are reluctant to purchase homes because of concerns that prices could decline further. There is still a large supply of unsold homes on the market, keeping home prices depressed. As a result, the housing market may not recover until next year.

### **Leading indicators point to further growth**

The index of leading economic indicators continues to point towards further economic growth. This is an important sign that the economic expansion is on a firmer footing as the Federal Reserve has said. Rising food and energy prices may slow economic growth, but commodity prices have not increased enough to derail the economic expansion. However, if the turmoil in the Middle East were to spread to Saudi Arabia and global oil supplies were reduced, oil prices could increase significantly further, and this could derail the expansion. In other words, economic conditions continue to point toward growth but if geopolitical events take a turn for the worse, the economy could suffer more than economic conditions would otherwise suggest.

### **Profit expectations continue to increase**

Rising food and energy prices may increase the cost of production for many firms. However, at this point, the consensus estimate of future expected corporate earnings continues to increase. The last time food and energy prices were above current levels, in 2007 and early 2008, corporate profits were weaker and the economy was more vulnerable to the price increases. Companies are leaner today and are better able to deal with rising costs. Therefore, the recent increase in commodity prices is only likely to reduce profit margins and slow profit growth not cause profits to decline.

### **Conclusion**

The U.S. economy is still on track for further growth. However, the recent increase in food and energy prices will probably slow economic growth this summer as consumers temper discretionary spending in order to afford other necessities. Commodity prices would probably need to rise substantially more in order to derail the current recovery. This could happen, but is not the most likely scenario at this time.

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