Weekly Economic Commentary

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A Look at Double-Dip Risks in the Economy

Highlights

- Few, if any, of the traditional harbingers of recession are in place today.
- Although this week's economic calendar in the United States is chock full of data for May and June, investors are likely to be looking for more as the week draws to a close ahead of the long holiday weekend in the United States.

As the second quarter of 2011 draws to a close, financial market participants are once again asking the question: are we headed for a double-dip recession? This week's busy economic calendar in the United States is likely to leave investors wanting more, but they will have to wait until next week (July 4–8) for news on the debt limit and the employment situation in June.

Even as the economic expansion in the United States (which began when the Great Recession ended in June 2009) reaches its second birthday this week, market participants are once again posing the question: is the U.S. (and global) economy headed for a double-dip? Our view remains that the U.S. economy remains in a soft spot that may show signs of ending in another few weeks, and that the economy will reaccelerate back to a modest pace of growth in the second half of 2011. Lower gasoline and consumer energy prices, a rebound in auto production, a return to more "normal" weather across the United States and the onset of rebuilding in Japan are the likely catalysts for the pickup in growth.

Risks to growth remain, however, and we will continue to track them closely. Although very few, if any, of the traditional harbingers of recession are present. These include, but are not limited to:

- The Fed raising interest rates to slow growth or restrain inflation
- An inverted yield curve, where short-term lending rates are higher than long-term rates
- A freeze up of intra-bank lending
- Widespread imbalances in the economy (i.e. too much lending, overbuilding or overspending in one segment of the economy, widespread asset bubbles)
- A spike in consumer energy prices
- High and rising inflation
- High and rising consumer interest rates (mortgages, cars and trucks, credit cards, etc.)
- Sluggish money supply growth

The potential exists for some of these to begin to materialize in the coming weeks, and that might cause us to revisit our view. However, our base case remains that the economy will reaccelerate and post solid, but not spectacular growth in the second half of the year. This growth will likely be accompanied by moderate inflation and a modest decline in the unemployment rate.

Economic Calendar

Monday, June 27
Personal Spending
May

Personal Income
May

Tuesday, June 28
Consumer Confidence
Jun

Wednesday, June 29
Pending Home Sales
May

Thursday, June 30
Initial Claims
wk 06/25

Chicago Area Purchasing Managers Index
Jun

Friday, July 1
U of Mich Consumer Sentiment
Jun

ISM Manufacturing
Jun

Construction Spending
May

Domestic Light Vehicle Sales
Jun

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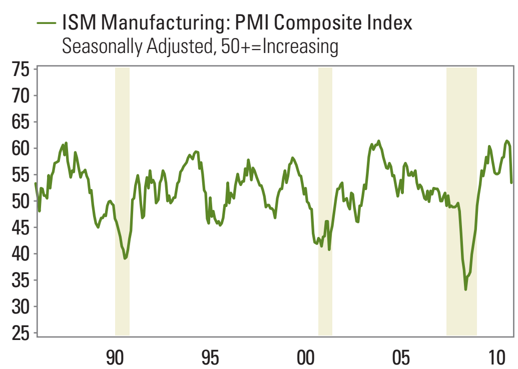
1 Robust Money Supply Growth Suggests Double-Dip Not Likely

Source: Federal Reserve Board/Haver Analytics 06/26/11

2 The Deceleration in the ISM Index is Typical for This Point in the Business Cycle, But Bears Watching



Source: Institute for Supply Management/Haver Analytics 06/26/11

(Shaded areas indicate recession)

Near term, some of the key risks to our economic outlook include the following:

- The latest flare-up of the European fiscal saga
- The ongoing debt ceiling debate in the United States
- The end of QE2 (the second round of quantitative easing)
- The second quarter earnings reporting (and more importantly, earnings guidance season) for corporate America

These risks stand as potential threats to the recovery. The Greek parliament votes this week on a package of spending cuts and tax increases needed to ensure that Greece gets the next round of aid from the Eurozone and the International Monetary Fund (IMF). If Greece fails to enact the necessary cuts to spending and increases to revenues, the interbank lending market which is crucial to the global economy may begin dry up, and that would raise the odds of a return to recession. Similarly, if the ongoing negotiations in Washington over the state of the U.S. federal budget fail to produce an agreement in the next few weeks that would at least extend the nation's debt ceiling beyond August 2, interest rates may rise in the United States, which could lead to higher consumer interest rates and lower consumer confidence and spending.

We have discussed the end of QE2 at length in this publication and its companion publications, the *Weekly Market Commentary* and the *Bond Market Perspectives*. Our view is that markets are likely to take the end of QE2 in stride, but if they do not, there is a risk that rates could rise sharply, which could put downward pressure on bank lending to both businesses and consumers, and threaten the recovery. Finally, earnings season is just a few weeks away, and thus far corporations have been relatively sanguine about the outlook for the economy and profits over the second half of 2011. If company managements begin to pull in the reins on spending and hiring, it may lead to a sharp slowdown in the economy, and even a return to recession in the second half of the year. Business spending, and in particular business spending on hiring new workers, remains a key driver of the health of the economy in the second half of 2011.

Always Leave Them Wanting More

We continue to expect that business spending, which helped to lead the economy out of recession in 2009 (thanks to booming exports and booming emerging markets) will continue to outpace consumer spending this year.

Although this week's economic calendar in the United States is chock full of data for May and June, investors are likely to be looking for more as the week draws to a close ahead of the long holiday weekend in the United States. Why? The discussions on the debt ceiling may linger into the weekend of July 2–3 and the key June jobs report is not due out until Friday, July 8. Until then, the health of the consumer and the manufacturing sectors are likely to dominate this week's reports. We continue to expect that business spending, which helped to lead the economy out of recession in 2009 (thanks to booming exports and booming emerging markets) will continue to outpace consumer spending this year.

On the consumer side, reports on personal income and personal spending for May kick off the week and it concludes with the nation's vehicle manufacturers reporting their sales for June. In between, the University of

Michigan will report its latest data point on consumer sentiment for June. In recent months, consumers have been buffeted by sharply higher gasoline prices, poor weather and most recently, a sluggish labor market (in May). But some relief for the consumer may be in the pipeline. Gasoline prices have declined sharply (by nearly 18%) in the past eight weeks, and some of the recent weakness in hiring may be temporary. Still, the consumer is weighed down by a sluggish housing and labor market, and although consumer debt burdens have improved, they too are keeping consumers on the sidelines. We continue to expect the consumer to merely "hang in there" over the remainder of 2011.

Over on the manufacturing side, the earthquake in Japan, the slowdown in Europe, rate hike-induced slowdowns in emerging market nations in the first half of 2011 and severe weather in the United States have led to a deceleration in manufacturing. This slowdown is fairly typical for this point in the business cycle, but when the sector that led the economy out of the recession in the first place slows, it is certain to attract the attention of market participants and the financial media. This week's reports on the manufacturing sector for June—Richmond Fed, Dallas Fed, Milwaukee Area Purchasing Managers, Chicago Area Purchasing Managers, and the key Institute for Supply Management (ISM) report on manufacturing—are likely to continue the theme of deceleration. The question is: how much further (and faster) will the manufacturing sector decelerate and when will the deceleration end? The answers could be found in this week's reports, but more likely, the reports for July (released in mid-July through early August) may provide the ultimate answer on the debate over the manufacturing sector, and the overall economy.