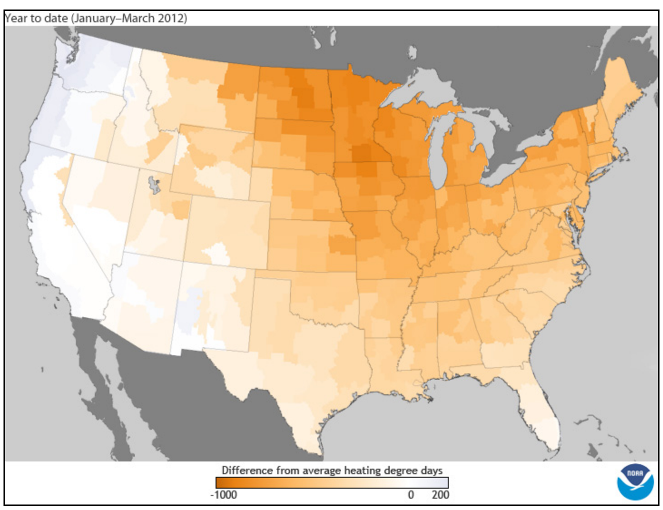
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **April 16, 2012**

Monthly Economic Outlook

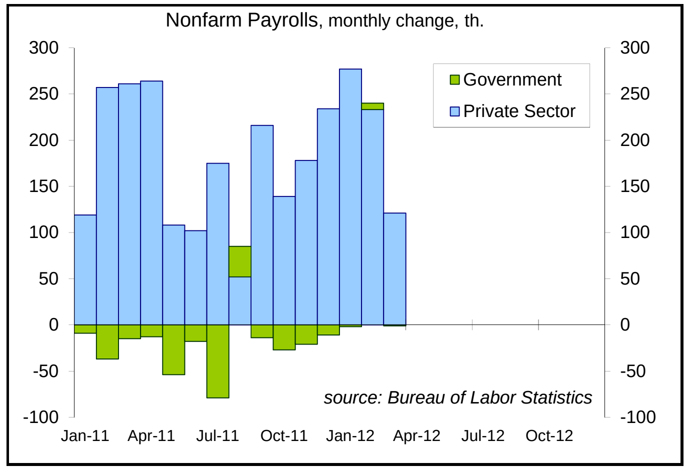
The Fed, Europe, and Bond Yields

- *Recent data, while mixed, continue to suggest moderate economic growth in the near term.*
- *The economy continues to face a number of headwinds, including higher gasoline prices, although the drag from these headwinds should decrease over time.*
- *Monetary policy will be conditional on how the economy evolves. Short-term interest rates are expected to remain exceptionally low for a long time. Further asset purchases (QE3) would depend on a faltering of the economic recovery.*

Real GDP rose at a 3.0% annual rate in the 3rd estimate for 4Q11 (vs. +3.0% in the 2nd estimate and +2.8% in the advance estimate). The advance estimate of 1Q12 GDP growth will be released later this month. There's always a lot of uncertainty in the advance estimate. The government will make assumptions about foreign trade, inventories, and a few other categories for March. First quarter growth is likely to have been around 2.6%, but history has shown that the advance estimate can easily be more than a full percentage point above or below the third estimate. The financial markets typically react to the headline figure, but the story behind the numbers is what's important.



Winter was unusually mild. It was the warmest first quarter on record. Unusual weather often has a significant impact on the economy. Mild weather appears to have pulled forward seasonal job gains that would have normally occurred in March and April into January and February. Investors were disappointed by a reported 120,000 gain in nonfarm payrolls for March. However, at +212,000, the average monthly gain for the first quarter was relatively strong – beyond what's needed to absorb the growth in the working-age population. The Household Survey data showed that the numbers of individuals who could not work due to adverse weather in January and in February were a lot lower than average. While these figures are not directly comparable to the payroll data, which come from the establishment survey, they suggest that weather was a key factor.

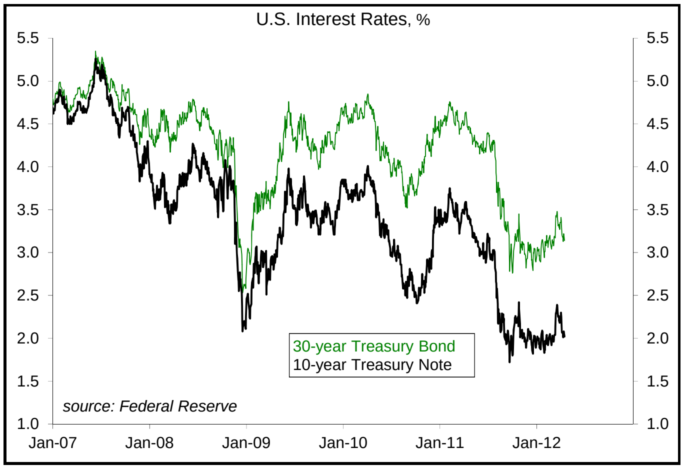


A bigger concern in the near term is the impact of higher gasoline prices. Last year, higher gasoline prices dampened the pace of consumer spending growth and appeared to restrain new hiring by small businesses. We could be in for a repeat. Note that the impact of higher gasoline prices depends on how high prices go and how long they stay high. It also shows up with a lag, which means that we haven't seen the full effect yet. Gasoline is viewed as having a transitory impact on inflation. Real average weekly wages were flat over the last 12 months – no added purchasing power for the typical worker.

Last year, a contraction in state and local government subtracted significantly for GDP growth (about 0.3 percentage points from overall growth, roughly matched by a similar-sized drag from the federal government). Government job losses were the result of continued weakness in tax revenues. We averaged a 20,000 monthly decline in state and local government payrolls in 2011 – not a lot, but we would normally be adding about 20,000 of these jobs per month (consistent with overall population growth) – that's a -40,000 switch relative to normal. However, tax receipts are picking up as the economy gradually recovers. State and local government jobs stopped falling in 1Q12. Yet, while state and local government job losses have waned, we're unlikely to see them reverse higher anytime soon. Moreover, the federal government is likely to shed jobs more rapidly over the next few quarters.

Corporate profits have continued to improve, which should help support business fixed investment in the near term. Business expectations have improved, but are still relatively cautious. Corporate borrowing costs are low and bank credit to smaller firms is getting easier.

To QE3 or not to QE3? The markets have reacted to variations in the perceived odds of additional asset purchases by the Fed (Quantitative Easing 3) – rallying if perceived as more likely, selling off if viewed as less likely. Fed officials suggest that QE3 is still on the table, but the odds are relatively low. Additional asset purchases, likely centered on mortgage-backed securities, would depend on a significant deterioration in the economic outlook. The goal of QE3 would be to push long-term interest rates down, but long-term interest rates are already low. So why would the Fed take action now?



Investors may be concerned about what will happen to long-term interest rates when the Federal Reserve ends Operation Twist in June. Probably very little. Fed officials view Operation Twist a lot like they viewed QE2. That is, it's the stock of bonds purchased that matters, not the flow. There was no significant rise in long-term rates when QE2 ended. There is unlikely to be much of a difference when Operation Twist ends. However, the bond market will be sensitive to whether the Fed will undertake QE3 – and some small positive probability of additional asset purchases is now factored in.

Long-term interest rates normally rise as the economy recovers, but long-term interest rates can be viewed as a combination of current and future short-term interest rates. The current 10-year Treasury yield is consistent with the expected path of short-term interest rates. That assumes that the Fed will maintain its current target range for the federal funds rate into late 2014 and then begin to raise rates. However, Fed officials are not entirely committed to that path. The Fed could raise short-term interest rates sooner, or later, depending on how the economy evolves. Indeed, back in January, Fed officials were divided on when they thought short-term interest rates should begin to rise (3 saw the first increase in 2012, 3 in 2013, 5 in 2014, 4 in 2015, and 2 in 2016).

Long-term Treasuries have also been influenced by a recurring flight to quality. The European Central Bank dodged a near-term banking crisis with its long-term refinancing operations. However, the region's economic problems are still there. The region needs growth, but austerity measures have further weakened the economies of the peripheral countries, making financial difficulties even worse. The problems in Europe seem (to many) to be insurmountable, but European leaders have a strong commitment to keep the euro area intact. That may mean repeatedly stumbling to the point of crisis and then doing just enough to postpone a collapse. For U.S. investors, the European crisis is not going to go away anytime soon, but its importance will vary over time.

Real GDP growth for 1Q12 appears stronger than was expected a month ago. The main reason for that is that personal spending figures were revised higher. Weather was a positive factor. However, high gasoline prices are expected to dampen consumer spending strength into the second quarter. Tighter fiscal policy will restrain GDP growth in early 2013, but lawmakers are likely to postpone most of the pain.

	1Q11	2Q11	3Q11	4Q11	**1Q12**	**2Q12**	**3Q12**	**4Q12**	**1Q13**	**2Q13**	2011	**2012**	**2013**
GDP (↓ *contributions*)	0.4	1.3	1.8	3.0	**2.6**	**2.0**	**2.6**	**3.0**	**2.2**	**2.6**	1.7	**2.4**	**2.6**
consumer durables	*0.9*	*-0.4*	*0.4*	*1.2*	***1.0***	***0.3***	***0.3***	***0.3***	***0.2***	***0.3***	*0.6*	***0.6***	***0.3***
nondurables & services	*0.6*	*0.9*	*0.8*	*0.3*	***0.7***	***1.3***	***1.5***	***1.6***	***1.2***	***1.4***	*0.9*	***0.9***	***1.4***
bus. fixed investment	*0.2*	*0.9*	*1.4*	*0.5*	***0.8***	***0.8***	***0.9***	***0.9***	***0.6***	***0.7***	*0.8*	***0.9***	***0.8***
residential investment	*-0.1*	*0.1*	*0.0*	*0.3*	***0.3***	***0.1***	***0.1***	***0.2***	***0.0***	***0.2***	*0.0*	***0.2***	***0.1***
government	*-1.2*	*-0.2*	*0.0*	*-0.8*	***-0.2***	***-0.2***	***-0.2***	***0.0***	***0.0***	***0.0***	*-0.4*	***-0.3***	***0.0***
Domestic Final Sales	0.4	1.3	2.7	1.3	**2.6**	**2.4**	**2.6**	**3.0**	**2.0**	**2.5**	1.9	**2.3**	**2.6**
exports	*1.0*	*0.5*	*0.6*	*0.4*	***0.4***	***0.4***	***0.4***	***0.5***	***0.5***	***0.6***	*0.9*	***0.4***	***0.5***
imports	*-1.4*	*-0.2*	*-0.2*	*-0.6*	***-0.2***	***-0.5***	***-0.6***	***-0.5***	***-0.4***	***-0.5***	*-0.8*	***-0.4***	***-0.5***
Final Sales	0.0	1.6	3.2	1.1	**2.8**	**2.3**	**2.6**	**2.9**	**2.1**	**2.5**	1.9	**2.2**	**2.4**
ch. in bus. inventories	*0.3*	*-0.3*	*-1.4*	*1.8*	***-0.2***	***-0.2***	***0.0***	***0.0***	***0.0***	***0.0***	*-0.2*	***0.1***	***0.0***
Unemployment, %	9.0	9.1	9.1	8.7	8.2	**8.1**	**7.9**	**7.8**	**7.7**	**7.6**	9.0	**8.0**	**7.5**
NF Payrolls, monthly, th.	192	130	128	164	212	**150**	**160**	**165**	**160**	**170**	153	**172**	**176**
Cons. Price Index (q/q)	4.5	4.4	3.1	1.3	2.5	**2.5**	**1.5**	**2.0**	**2.1**	**2.1**	3.0	**2.3**	**2.1**
excl. food & energy	1.8	2.4	2.5	1.9	2.1	**2.1**	**2.0**	**2.0**	**2.0**	**2.0**	2.2	**2.1**	**2.0**
PCE Price Index (q/q)	3.9	3.3	2.3	1.2	**2.4**	**2.2**	**1.6**	**1.9**	**2.0**	**2.0**	2.5	**2.1**	**2.0**
excl. food & energy	1.6	2.3	2.1	1.3	**2.1**	**1.9**	**1.9**	**1.9**	**1.9**	**1.9**	1.4	**1.9**	**1.9**
Fed Funds Rate, %	0.16	0.09	0.08	0.08	0.10	**0.12**	**0.18**	**0.20**	**0.21**	**0.23**	0.10	**0.15**	**0.23**
3-month T-Bill, (bond-eq.)	0.1	0.0	0.0	0.0	0.1	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	0.1	**0.1**	**0.3**
2-year Treasury Note	0.7	0.6	0.3	0.3	0.3	**0.3**	**0.5**	**0.6**	**0.8**	**1.0**	0.5	**0.4**	**1.1**
10-year Treasury Note	3.5	3.2	2.4	2.0	2.0	**2.1**	**2.3**	**2.4**	**2.6**	**2.6**	2.8	**2.2**	**2.6**

International Headquarters:
The Raymond James Financial Center | 880 Carillon Parkway | St. Petersburg, Florida 33716 | 800-248-8863
RAYMOND JAMES