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ECONOMIC TALKING POINTS

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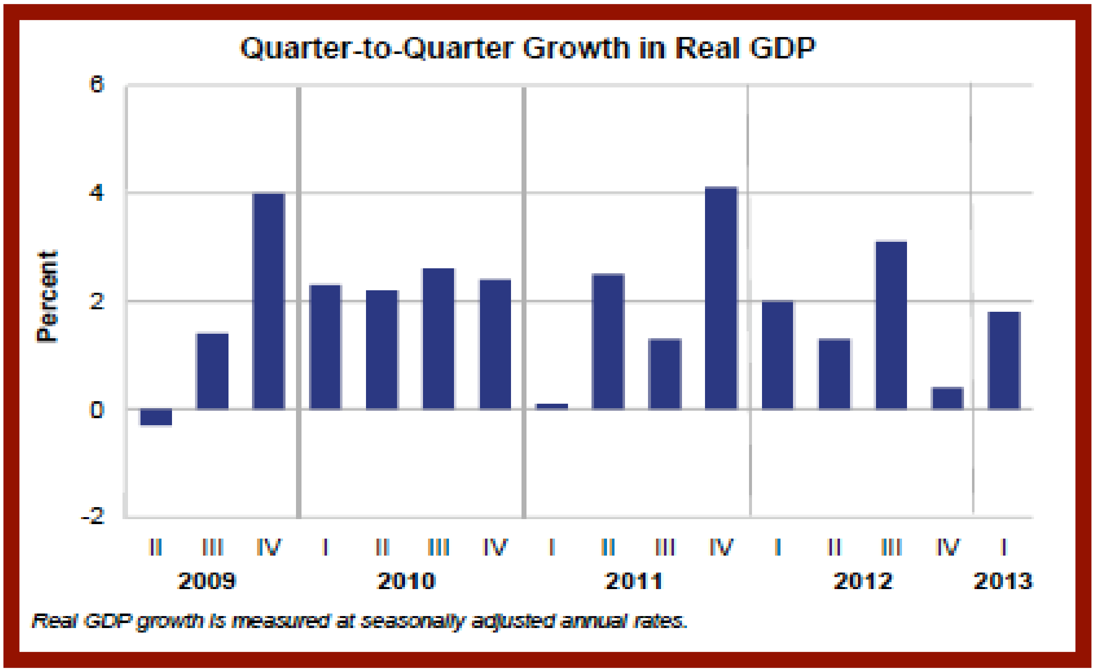
Final GDP 1Q: So much liquidity, yet so little to show for it. What about the rest of the year?

The all-consuming debate lately on when and how much the Federal Reserve will scale back on quantitative easing has given way to a different question. How is it the US economy just cannot seem to gain any real traction?

After all, the fed funds rate has been nearly zero for more than four years and nearly $3 trillion of additional liquidity has been pumped into the banking system by the Fed during this time as well. *And what does the economy have to show for it?* Growth in the first three months turned out to be a miserly 1.8% annual rate. In the last six months, the economy squeaked by an average 1.1% pace, and over the past four quarters it managed just 1.6% growth. That's it!

When an economy remains that lethargic ---even after being force fed massive monetary stimulus for nearly half a decade --- then all the ubiquitous speculation about whether or not the central bank will reduce quantitative easing this year really seems misplaced. We suspect even Fed policymakers have been scratching their heads about why the economy has so far failed to perform better.

At last week's press conference, Bernanke told reporters that "if the incoming data support the view that the economy is able to sustain a reasonable cruising speed, we will ease the pressure on the accelerator by gradually reducing the pace of purchases." It's fair to say that the pace of GDP growth so far hardly fits the definition of "cruising speed."



Certainly one big surprise was the sharp downward revision in consumer spending. Personal consumption expenditures rose at a 2.6% rate, and not 3.4%. It turns out that household outlays for durable goods rose less than what was originally thought (up 7.6%, instead of 8.2%). There was an even greater reduction in spending for services, which was slashed by nearly half, to show a 1.7% increase, not. 3.1%.

There were also marked downward revisions in business investments. For example, spending on non-residential structures contracted by 8.3%, not 3.5%). The latest revisions also reversed the course of exports; It actually declined by 1.1%, rather than increased 0.8%. The decline in federal government spending remained unchanged at 8.7%.

What's next?

Attention now shifts to how the economy performed this quarter and what the outlook is for the second half. We are revising our second quarter forecast down to 2.3% from 2.7%. However, we do expect the second half of the year to be more robust, with growth averaging above 3%.

That optimism is based on several factors.

• We do not see yields on Treasury 10 yr notes exceeding 4% this year, which means conventional 30-yr. mortgage rates will not rise above 6%. The housing recovery will thus remain on track, as will auto sales.

• Furthermore, household finances are still in the best shape they have been in decades. While their debt service burden did bounce up slightly in the first quarter (debt service as a percentage of disposable personal income inched up to 10.49% from 10.32% in the fourth quarter of 2012), it was still the second lowest in more than 30 years.

• The job market continues to improve, albeit slowly.

• Household wealth climbed to a record high in the first quarter --- and we expect it will do so again this quarter.

• Moreover, June consumer confidence remains at a five year high and this should foster more spending in the second half.

• As for business capital spending, we believe the softness in the first half was temporary as CEOs took a cautious approach to see how the sequester-mandated cuts in federal spending and the payroll tax hike would affect demand for goods and services. It now appears that business leaders are expressing more confidence about the economic outlook. (U.S. small business optimism rose to a one year-high in May, according to the National Federation of Independent Business. And in separate surveys, both the Conference Board and Chief Executive magazine reported similar optimism emerge among CEOs of large firms.)

• Furthermore, in the absence of a major geopolitical eruption in the Middle East, oil and gasoline prices should continue to slide. The average retail price of gasoline is $3.54, down a dime from a month ago. Gas this season is expected to be the cheapest in three summers--- ad that translates into greater discretionary spending. Prices will face even more downward pressure later this year and next as domestic oil production continues to surge and refineries operate at greater capacity.

• On the international economic front, we do expect the Eurozone to come out of recession this summer and register positive growth the second half of the year. That bodes well for US exports to the region. In addition, the riots in Brazil, where people expressed their outrage over the country's dismal infrastructure, prompted President Dilma Rousseff to ramp up spending by an additional $25 billion to improve public roadways and other transportation systems. These projects are likely to increase purchases of capital goods from the US as well. As for China, concerns about a severe financial crisis have many worried that economy will come dangerously close to a hard landing, an event that would have grave repercussions throughout the global economy. However, we believe such a dark scenario is highly unlikely. Over the last 30 years, Chinese policymakers have adroitly steered the country away from any severe economic storms. What we are now seeing is a ***managed slowdown*** by its new leaders as part of an effort to deal with the country's highly inefficient financial system. It's a delicate process that will force state banks to better manage lending risks, encourage capital to flow to areas where it is really needed, and allow the private sector to play a greater role in shaping the economy. Yes, the days of double-digit annual growth rates are over. But the government ***will not allow growth to fall below 6%.*** In other words, a hard landing is not an option for the Communist Party leadership, not after seeing the recent riots in Turkey and Brazil. Our expectation is China will be successful at navigating growth toward a more efficient and sustainable pace of 7% to 8% year.

So what should we be looking at from this point on? These seven key indicators will shed light on how the economy will perform the rest of the year.

1. How high and how fast will yields climb on 10 yr government notes?

2. Will new and existing home sales stay on course, or suddenly lose momentum?

3. Are employers ready to accelerate hiring so that private payrolls average above 200,000?

4. Will manufacturing activity rebound in the US? The main gauge here is the ISM index for new orders, which ominously contracted last month.

5. Are we going to see consumer and business confidence remain at high levels?

6. The performances in China of both the Purchasing Manager's manufacturing Index (PMI) and industrial production will tell us whether the second largest economy in the world will contribute to global growth, or endanger it.

7. Finally, if the Eurozone is to emerge from recession, it will show up in stronger data on the region's PMI for both manufacturing and services.

Bottom line:

While the final read on first quarter GDP was a clear disappointment, we believe the fundamentals of the US economy are healthy and should set the stage for faster growth in the second half. That recovery will be further supported by the improved outlook in the economies of Europe and China later this year and in 2014.

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