Economic Outlook for 2012

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The views expressed are those of the speaker and should not necessarily be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.
It is better to remain silent and be thought a fool than to open one’s mouth and remove all doubt.

— Abraham Lincoln
2012 Outlook

The chart illustrates the probability distribution of real GDP growth for 2012, with the following breakdown:

- **Muddle Through**: 45%
- **Worse**: 35%
- **Better**: 20%

GDP growth is measured on a scale from -2 to 4, with the probabilities shown for each range.
## 2012 Outlook

<table>
<thead>
<tr>
<th></th>
<th><strong>MUDDLE THROUGH</strong></th>
<th><strong>WORSE</strong></th>
<th><strong>BETTER</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP GROWTH</strong></td>
<td>2%</td>
<td>0 OR –</td>
<td>3%+</td>
</tr>
<tr>
<td><strong>INFLATION (TREND)</strong></td>
<td>2%</td>
<td>1%</td>
<td>2.5%</td>
</tr>
<tr>
<td><strong>PAYROLL GROWTH (AVG. MO.)</strong></td>
<td>175K</td>
<td>75K</td>
<td>225K</td>
</tr>
</tbody>
</table>

*Under WORSE scenario: globally, as many as 20 TBTF banks might need extraordinary government assistance (i.e.– failure)*
Muddle Through

To manage to get through something awkwardly; to continue despite confusion and difficulties.

Ann. Real GDP growth, %

- '05: 3.1
- '06: 2.7
- '07: 1.9
- '08: -0.3
- '09: -3.5
- '10: 3.0
- '11: 1.4
- '12: 2.0

YTD Avg. Forecast
Forward Momentum

- GDP growth – fits and starts, but positive since Q3 ‘09
- Employment growth – sluggish, but essentially positive since March ‘10 (private payrolls)
- Inflation – somewhat higher than desired, but no deflation since Fall ‘09

U.S. economy flirted with “stall speed” during 2nd half of 2011, but did not stall

A sustainable positive feedback loop developing?
Impediments to Stronger Growth

U.S. Headwinds

- Weak income growth
- Underemployed workforce
- Large overhang of unsold/foreclosed homes
- Vacant CRE
- Still tight credit standards
- Gov’t austerity measures
- Household deleveraging
- Monetary policy constrained by zero lower bound
Impediments to Stronger Growth

Global Headwinds

- Slowing global economy
- European sovereign debt problems with soaring gov’t and private sector borrowing costs
- Spillover into banking sector
Impediments to Stronger Growth

Uncertainties

- U.S. Presidential election cycle adds to already abundant tax/ regulatory uncertainties
- All the usual geopolitical risks and concerns

**BOTTOM LINE: NOTHING NEW, NOTHING DIFFERENT**
U.S. ISM’s Show Modest Growth

Diffusion Index, 50+=Increasing

- ISM Nonmanufacturing
- ISM Manufacturing

Dec 52.6 53.9

Danger Zone!!

Expanding
Declining
- Slowing manufacturing activity and a Eurozone recession could quickly impact global export growth.
Side-bar: Dubious Distinction of TX

- Texas is the leading U.S. exporter
  - Texas is a “high beta” state with a lot to lose from a decline in global trade

% change, year-over-year

Texas Real Exports

Texas GDP

'05 '06 '07 '08 '09 '10 '11 '12

-20 -10 0 10 20 30

Texas is the leading U.S. exporter
- Texas is a “high beta” state with a lot to lose from a decline in global trade

Texas Real Exports

Texas GDP

'05 '06 '07 '08 '09 '10 '11 '12

-20 -10 0 10 20 30

The bond market has differentiated between U.S., Germany, U.K, France... and the rest.

10-year Gov’t Benchmark Yields

German 6-mo. bill auction, Jan. 9, saw strong demand and -0.012 avg. yield

<table>
<thead>
<tr>
<th>Nation</th>
<th>Yield</th>
</tr>
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<tbody>
<tr>
<td>U.S.</td>
<td>1.98</td>
</tr>
<tr>
<td>Germany</td>
<td>2.11</td>
</tr>
<tr>
<td>U.K.</td>
<td>3.35</td>
</tr>
<tr>
<td>France</td>
<td>5.69</td>
</tr>
<tr>
<td>Spain</td>
<td>7.16</td>
</tr>
<tr>
<td>Portugal</td>
<td>13.29</td>
</tr>
<tr>
<td>Greece</td>
<td>37.99</td>
</tr>
</tbody>
</table>
Spending Outpaces Earning

Percent, yr/yr

Real Disposable Income

Real Durable Goods Expenditure

Real PCE

'02 '03 '04 '05 '06 '07 '08 '09 '10 '11
Housing sector has stopped exerting drag

Now, potentially, a source of growth?
Improving Employment Picture

- 22 months of steady private sector job gains; ~3.2M jobs gained
- Unemployment rate at 8.5%, lowest since Feb. 2009
- Initial jobless claims lowest level in the past 3 ½ years
Evolution of the Treasury Yield Curve

January 2007

January 2012

Percent

1 yr 2 yr 3 yr 5 yr 7 yr 10 yr 20 yr
Money Growth

Ann. M2 growth, %

M2 growth

<table>
<thead>
<tr>
<th>Year</th>
<th>M2 Growth</th>
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<tbody>
<tr>
<td>2004-2006 Avg</td>
<td>4.8%</td>
</tr>
<tr>
<td>2007</td>
<td>6.3%</td>
</tr>
<tr>
<td>2008</td>
<td>7.1%</td>
</tr>
<tr>
<td>2009</td>
<td>7.9%</td>
</tr>
<tr>
<td>2010</td>
<td>2.3%</td>
</tr>
<tr>
<td>2011*</td>
<td>9.8%</td>
</tr>
</tbody>
</table>

*Nov. '11 YoY
Money Growth

Ann. M2 growth, %

<table>
<thead>
<tr>
<th>Time Period</th>
<th>M2 Growth</th>
</tr>
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<tbody>
<tr>
<td>50 months prior to crisis</td>
<td>5.0</td>
</tr>
<tr>
<td>50 months after crisis</td>
<td>6.6</td>
</tr>
</tbody>
</table>

Note: The diagram illustrates the annual M2 growth rates before and after a crisis.

50 months prior to crisis: 5.0%

50 months after crisis: 6.6%
Will Price Pressures Remain “Modest”? 

Percent, yr/yr

- Headline CPI: 3.4
- Core CPI: 2.2
- Trimmed Mean PCE: 1.8
Takeaways

- **2012**: MUDDLE THROUGH most likely scenario
- U.S. growth is OK, but looming and large downside risks necessitate humility in making forecasts
A pre-requisite for being a good economist is an *ample dose of humility*

Forecasting Folly

Murphy’s Fourth Corollary:

If you perceive that there are four possible ways in which a forecast can be wrong, and circumvent these, then a fifth way will promptly develop

**BUT...**

Harvey & David’s Corollary:

**Things often turn out better than anticipated**