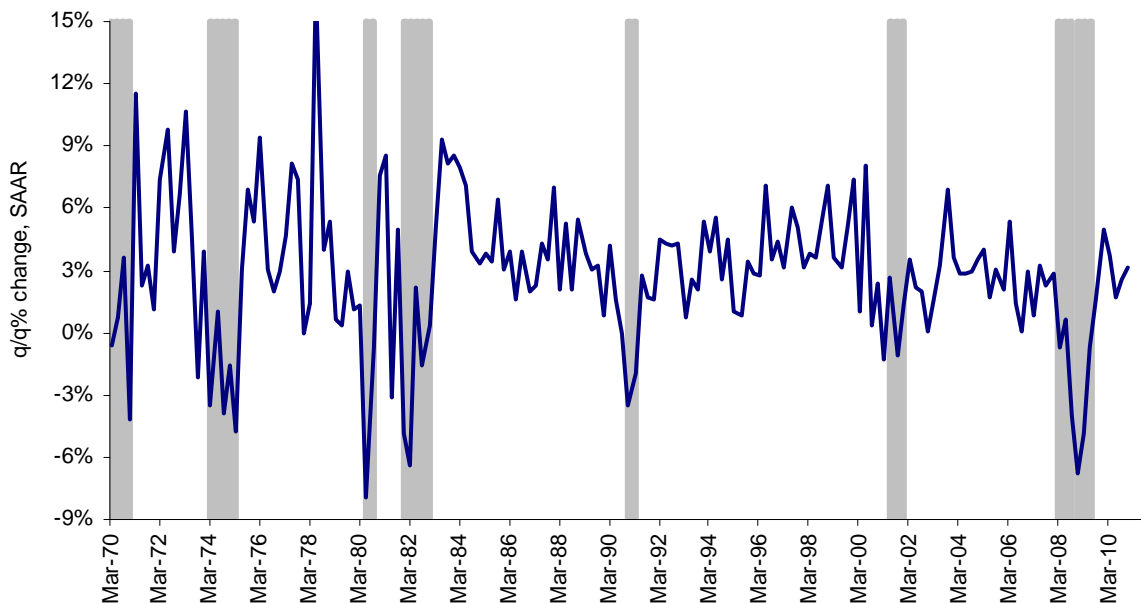


## Another 'Soft Patch'?

We expect a substantial letdown in real growth from the fourth quarter's 3.1% rate, but not to the extent of the 2010 'soft patch'. Growth then fell from 5% in the fourth quarter of 2009 to 3.7% in the first quarter of 2010 and 1.7% in the second quarter before picking up to 2.6% in the third quarter. The S&P fell 16% -- from 1217 in late April 2010 to 1023 in early July 2010.

- The Japan disaster and the spike in oil prices are clear near-term negatives for U.S. growth. Also, Irish and Portuguese bond yields are rising fast, signaling more debt reschedulings (joining Greece) -- we expect continued growth problems in the weaker countries as debt reduction packages are negotiated and the ECB begins rate hikes.
- More than offsetting these drags, however, we note strength in U.S. manufacturing, corporate profits, exports, and auto sales (and soon in U.S. auto production). Wage and salary income is growing faster as is disposable income.
- We expect GDP growth to slow to 2.2% in the first quarter (was 3%) and then recover to 3% – still too slow for solid job creation, but above the feared 2% 'new norm'.

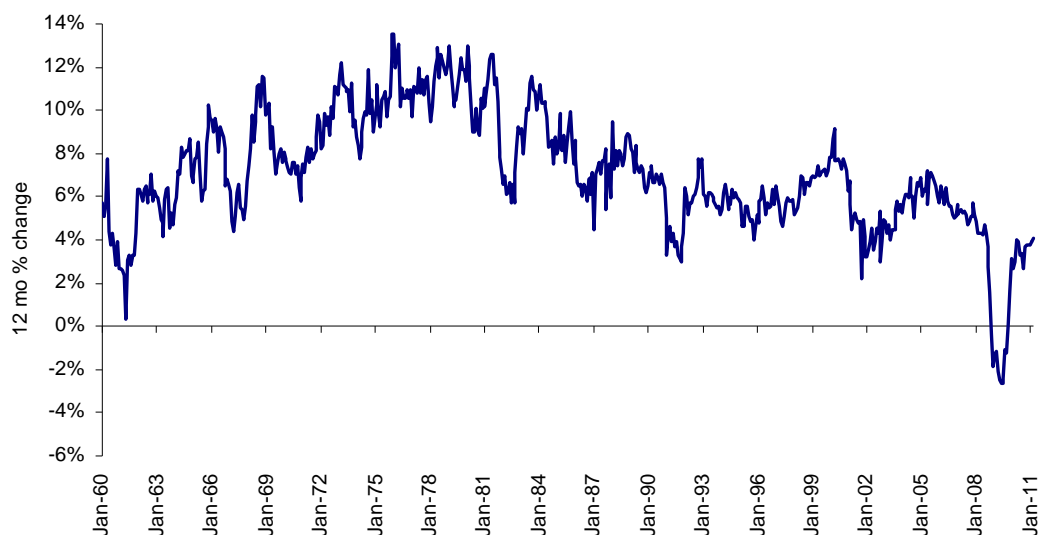
### Real GDP q/q (last obs. Q4 2010)



Source: Bureau of Economic Analysis; Encima Global

- Personal consumption expenditures rose 0.7% in February from January, bringing the year-over-year rate to 4.1% and the three-month annualized rate to 5.4% (both in nominal terms). Real consumption (adjusting for inflation) rose 0.3% in February, but is up at only a 1.4% annualized rate over the three months through February, suggesting a substantial letdown in real GDP growth from the fourth quarter.

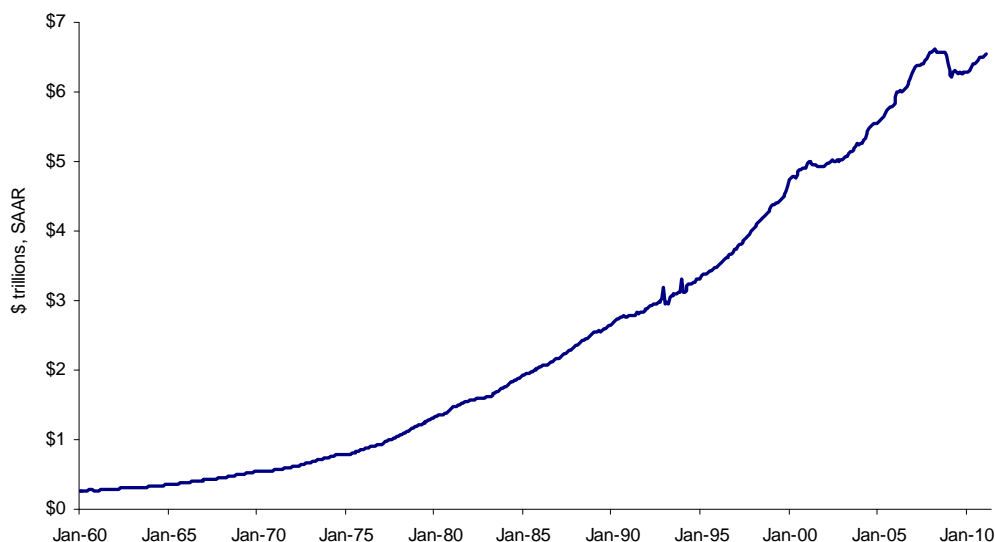
### Personal Consumption Expenditures y/y (last obs. February 2011)



Source: Bureau of Economic Analysis; Encima Global

- Wages and salaries have finally been recovering from the 2008 crash. They were up 4.1% year-over-year in February – though with year-over-year CPI inflation at 2.1% in February and likely to rise well above 3% in coming months, there’s no fluff.

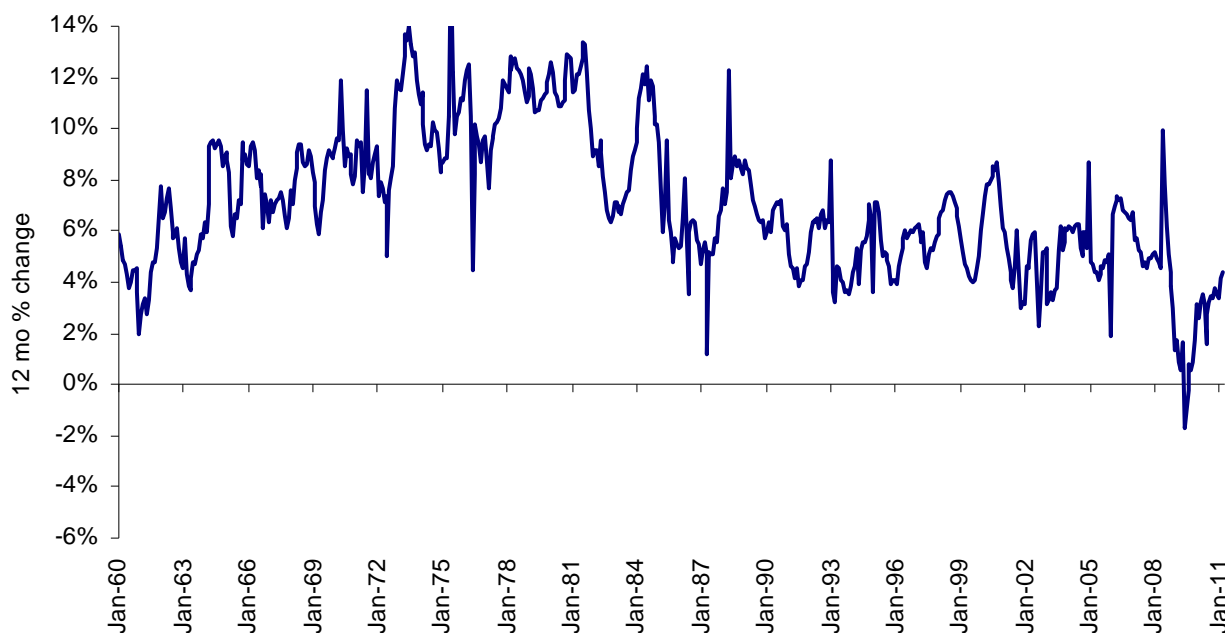
### Wages and Salaries (last obs. February 2011)



Source: Bureau of Economic Analysis; Encima Global

- Disposable personal income (income after taxes) was 4.4% higher in February 2011 than February 2010. It was boosted by transfer payments (up 4.8% y/y) and the social security tax cut in January (though the impact of the tax cut was largely offset by the expiration of the Making Work Pay tax credit from the 2009 stimulus bill.)
- In the graph below, note the spike in DPI in May 2008 caused by the Bush tax rebate checks, but, in the graph above, the negligible impact on consumption.
- In anticipating consumption growth in 2011, we put more emphasis on the labor environment and rising wage and salary income than on the wealth effect, housing or the slowdown in transfer payments as unemployment insurance runs out. We think consumption may be growing at a 1.7% real rate in the first quarter, with an improvement likely in the second quarter.

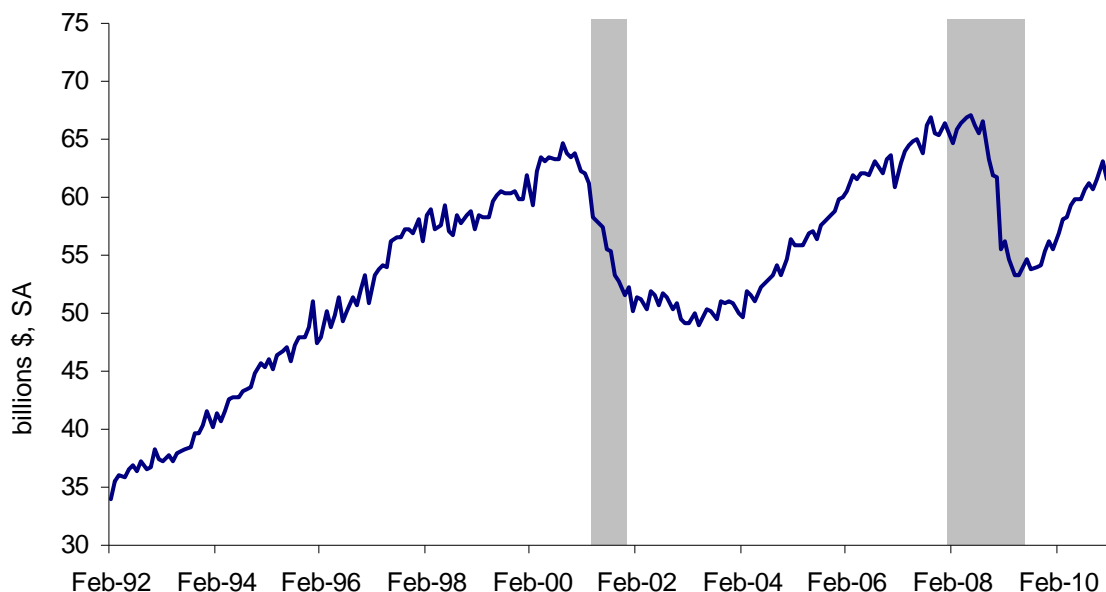
### Disposable Personal Income y/y (last obs. February 2011)



Source: Bureau of Economic Analysis; Encima Global

- Capital goods shipments were up 9.3% year-over-year in February, versus the peak rebound of 13.5% in September 2010. The three month annualized growth rate in shipments is 3.7%, suggesting a modest contribution to first quarter GDP.

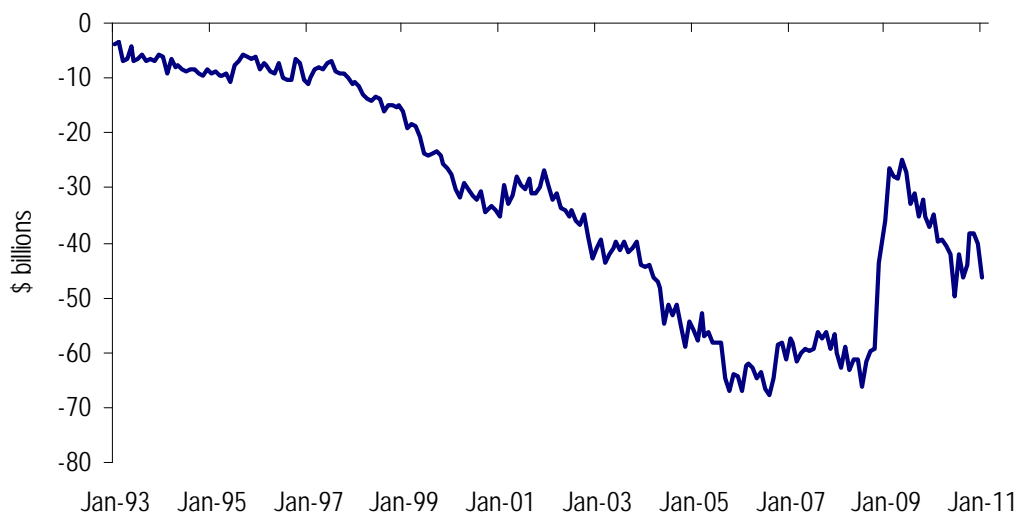
## Shipments of Nondefense Capital Goods ex Aircraft (last obs. February 2011)



Source: Census Bureau; Encima Global

- We expect the trade deficit to continue widening in dollar terms as the global expansion broadens. The 2008-2009 recession narrowed the U.S. trade deficit by reducing imports more than exports. The one-month trade deficit narrowed from \$66 billion in July 2008 to \$25 billion in May 2009. With the U.S. recovery, the trade deficit has been widening back out. Oil prices have more than doubled since early 2009, boosting imports more than exports, while consumption has exceeded the pre-recession peak drawing in imports.

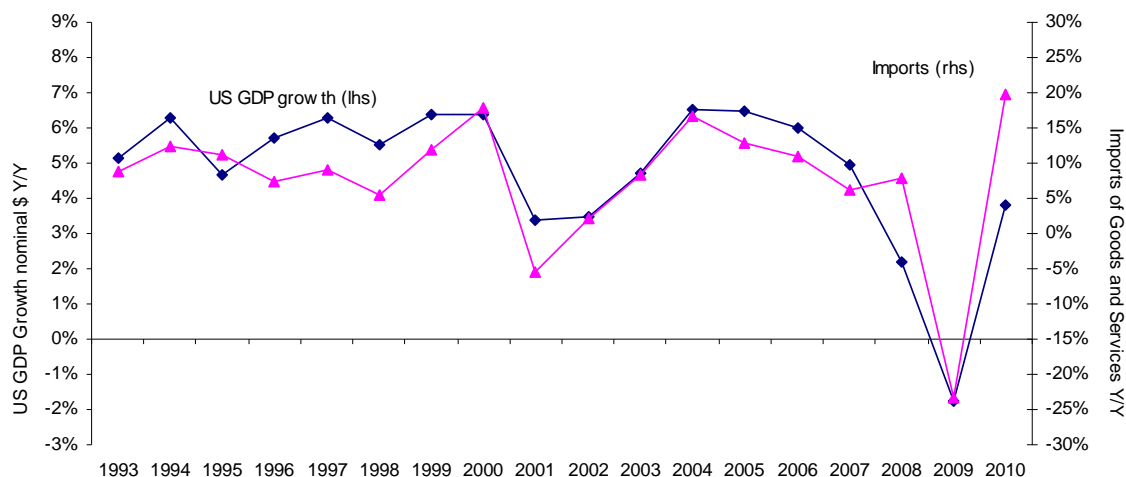
## Trade Deficit (last obs. January 2011)



Source: Census Bureau; Encima Global

- We think it is misleading to look at the widening trade deficit as a subtractor from growth. In general, imports are coincident with GDP growth, picking up with growth in the domestic economy.

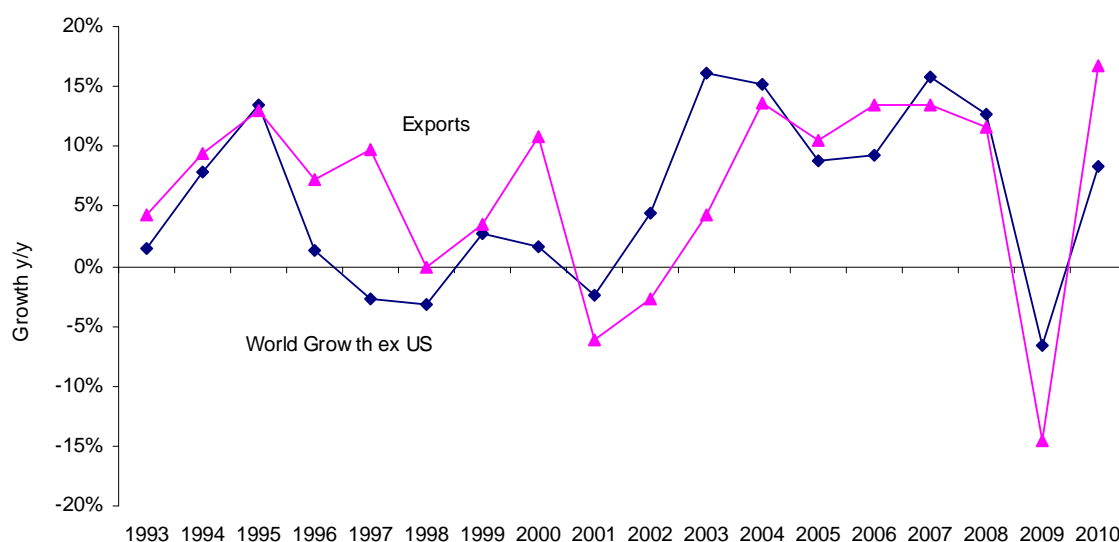
### U.S. Imports of Goods and Services and US Nominal GDP (last obs. 2010)



Source: Census Bureau; IMF; Encima Global

- Rather than thinking of GDP in terms of consumption plus investment minus the trade deficit, we think in terms of the consumption of and investment in domestically-produced goods (excludes the imported component) plus exports. Imports subtract from reported consumption figures (but not GDP growth) while exports are part of output. With global growth continuing, U.S. exports are adding to GDP while imports are responding to GDP, arguing for moderate GDP growth in 2011.

### U.S. Exports of Goods and Services and World GDP Growth ex US (last obs. 2010)

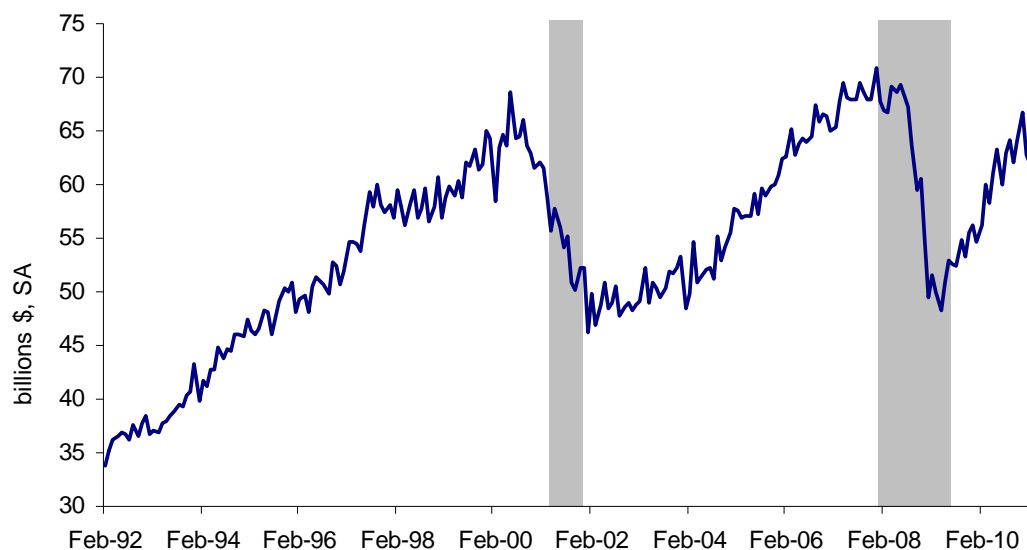


Source: Census Bureau; IMF; Encima Global

**We're shifting our data focus a bit.** In 2010, we emphasized jobless claims and auto sales as indicators of the recovery. They were good at picking up the soft patch and then the cyclical upturn in the second half on a timely basis.

- We think the next leg of the expansion needs to come from actual job growth (not the reduction in job losses measured in jobless claims). For this, the household employment survey and ADP (due later this week) will be more useful indicators than jobless claims.
- Stronger business investment is also a necessary step in the expansion. Orders for capital goods are a key indicator of future growth. In February, new orders for nondefense capital goods excluding aircraft were up 10.2% from February 2010, versus the peak rebound growth rate of 21% in April 2010. However, the three-month annualized rate shows a 13.4% decline in orders, in part weather-related. An improvement in capital goods orders in March and subsequent months will be a key signal of whether the letdown turns into a 'soft patch' like 2010.

### **New Orders of Nondefense Capital Goods ex Aircraft (last obs. February 2011)**



Source: Census Bureau; Encima Global

**Notes:** This email and attachment are confidential and intended solely for the use of the individual to whom they are addressed. Encima Global LLC does not accept liability for the content, or for the consequences of any actions taken on the basis of the information provided. The information is not necessarily complete, and we make no warranty as to its accuracy.