

2nd Quarter 2011 Economic Commentary

The second quarter of 2011 proved to be a difficult one both in the U.S. and abroad. Concerns over a Greek default and possible Eurozone contagion dominated the headlines during the quarter. At the same time, incoming economic data showed that the U.S. recovery was once again hitting a soft patch. Sound familiar? It should. Substitute disruptions from the earthquake and tsunami in Japan with the BP oil spill disaster, and we're reliving the second quarter of 2010. And just like then, uncertainty over what happens next abounds.

The European sovereign debt crisis resurfaced during the quarter as Greece faced a potential default if it was unable to pass new austerity measures and ensure further funding under its aid package. After much public outcry, the austerity measures passed and default was avoided – at least for the short term. While EU leaders work on a second bailout package for Greece that could involve some form of debt restructuring, the focus has now shifted to the periphery Eurozone countries. Recent downgrades of Ireland's and Portugal's debt to below investment grade have led to renewed fears of a Eurozone contagion and pushed the 5 year credit default swaps of the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) to record highs. Uncertainty over the European fiscal situation has resulted in increased market volatility as investors decrease risk and flee to the relative safety and soundness of U.S. Treasuries.

Europe, however, does not have the market cornered on sovereign debt uncertainty. Moody's and S&P recently placed the U.S. government's debt ratings on credit watch negative due to Congress's inability to come to an agreement on raising the debt ceiling. Although a default is highly unlikely, political posturing and lack of compromise on deficit reduction could eventually lead the U.S. to lose its coveted AAA debt rating.

Although bond market reaction to a potential U.S. downgrade has been muted, it comes at a time when the U.S. economic recovery is taking a turn for the worse. After a few months of decent job growth, the labor market recovery has stagnated. Employers cite economic uncertainty as a key reason for the decline in hiring. In addition, the housing market remains depressed. Home sales remain weak as high unemployment and the glut of foreclosed properties on the market constrain demand. Consumer spending, which accounts for the majority of GDP, has also begun to slow as confidence in the recovery wanes.

At the June FOMC meeting, the Fed stated that temporary factors were partly responsible for the slowdown in growth. Supply disruptions from the earthquake in Japan hurt manufacturing and consumer spending was constrained by higher gas prices. While Fed members expect growth to pick up in the second half of the year, they did reduce their outlook for economic growth over the medium term. Members saw the outlook for both employment and inflation as "unusually uncertain." Some members stated that if growth continued to slow, additional monetary stimulus may be necessary. Other members believed that the increase in inflation risks could warrant the removal of policy accommodation sooner rather than later. Given the high degree of uncertainty about the economic outlook, the Fed will likely be on the sidelines until the case for either more or less policy accommodation becomes clearer.

Thus far, uncertainty appears to be the key theme for 2011. Will the EU resolve its debt crisis? Will the political game of chicken end in time to save the U.S. AAA rating? Will growth pick up in the second half of the year? Will we need another round of stimulus? Will rising inflation levels prove to be transitory? Uncertainty does not bode well for growth, so hopefully we will get some definitive answers to these questions sooner rather than later. For now it appears the only certainty during these uncertain times is that we are in for a bumpy ride. Hold tight...