

# NATIONAL ECONOMIC OUTLOOK

## Executive Summary

June 2010

### Extending the “Extended Period”

We have pushed back our expected timing for the start of the Federal Reserve’s interest rate tightening cycle. We now expect the Fed to wait to raise short-term interest rates until January 2011. May’s soft jobs report showing only 41,000 new private-sector jobs, very benign inflation aided by lower energy prices, fiscal crises in the euro-zone and the ongoing rise in the value of the dollar relative to the euro and the pound all point to no tightening by the Federal Reserve until early 2011.

### 10 Themes for the 2010s

The beginning of the new decade of the 2010s marks a turning point in the global economy as we move beyond the “Great Recession” of 2008-09. Now, with the most destructive part of the cycle behind us, it is a good time to look ahead to ponder the major themes that will shape the coming expansion.

**1. Financial Market Regulation.** The theoretical underpinning for much of the financial deregulation movement of the 1980s and 1990s came from the efficient market hypothesis. Which said, in a nutshell, that financial markets were best left to function free of government interference. However, scholarly research and real-world experience has repeatedly shown that markets are not always efficient and are prone to distortion. New financial regulation coming in the aftermath of the global financial crisis marks the demise of the efficient market hypothesis in the real world.

**2. Coupling versus Decoupling in International Markets.** Synergies between trading partners are a source of economic prosperity, but these synergies depend on relatively stable currency regimes. A collapsing euro is a threat to both the U.S. and to China. Japan remains in the doldrums. Europe may stall. The linkages between global economies remain in flux. China passes Japan as the world’s second largest economy. At some point China will mismanage their economy and fall into recession. Why? Because that is what happens to economies and China is no different from every other economy in that sense. What is unique about the Chinese economy is that their hybrid system has not yet been stress-tested in a domestic down-cycle.

**3. Political Crises.** We have already seen a global financial crisis morph into an economic crisis. Now we are witnessing a global economic crisis morph into a series of political crises. Greece, Germany, the U.K., Thailand, Japan have already seen or are experiencing political upheaval. The U.S. mid-term elections this fall will be interesting.

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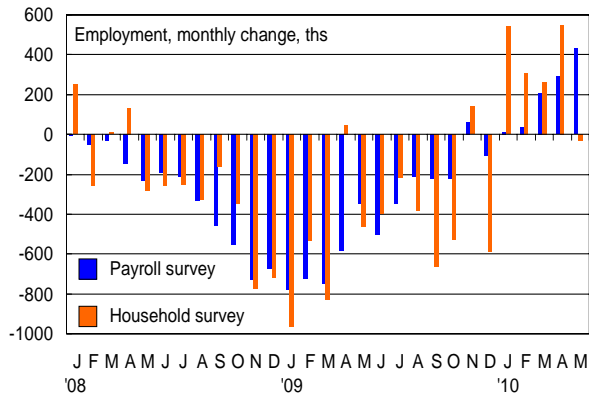
## Baseline U.S. Economic Outlook, Summary Table\*

	1Q'10a	2Q'10f	3Q'10f	4Q'10f	1Q'11f	2Q'11f	3Q'11f	4Q'11f	2009a	2010f	2011f
<b>Output &amp; Prices</b>											
Real GDP (Chained 2005 Billions \$)	13248	13334	13435	13542	13648	13749	13852	13961	12987	13390	13803
Percent Change Annualized	3.0	2.6	3.1	3.2	3.2	3.0	3.0	3.2	-2.4	3.1	3.1
CPI (1982-1984=100)	217.6	217.6	218.1	219.0	220.2	221.4	222.7	223.9	214.5	218.1	222.0
Percent Change Annualized	1.5	-0.1	1.0	1.7	2.1	2.1	2.4	2.3	-0.3	1.7	1.8
<b>Labor Markets</b>											
Payroll Jobs (Millions)	129.70	130.61	131.23	131.89	132.53	133.12	133.72	134.34	130.91	130.86	133.43
Percent Change Annualized	0.2	2.8	1.9	2.0	2.0	1.8	1.8	1.9	-4.3	0.0	2.0
Unemployment Rate (Percent)	9.7	9.8	9.6	9.4	9.1	8.9	8.6	8.4	9.3	9.6	8.7
<b>Interest Rates (percent)</b>											
Federal Funds	0.1	0.2	0.2	0.2	0.5	1.3	1.9	2.3	0.2	0.2	1.5
Treasury Note, 10-year	3.7	3.6	3.7	3.7	3.9	4.2	4.3	4.5	3.3	3.7	4.2
a = actual    f = forecast    p = preliminary    * Please see the Expanded Table for more forecast series.											

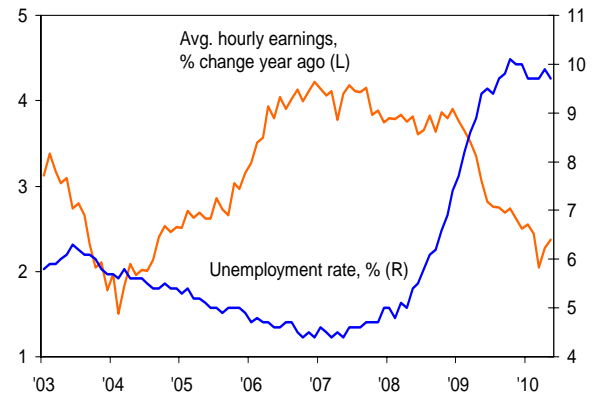
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**May Jobs, All Frosting no Cupcake**



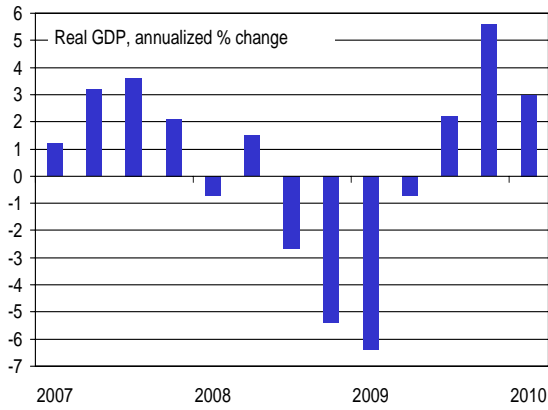
**U Rate Resumes Slow Descent**



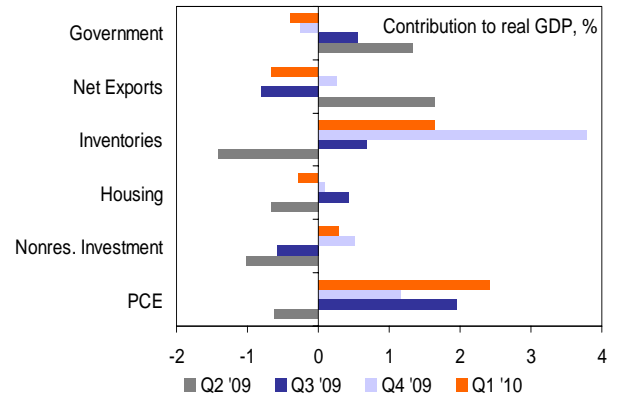
**10 Themes for the 2010s, continued**

4. **Bond Defaults.** The massive \$1 trillion bailout package for Europe, cobbled together by the European Central Bank and the International Monetary Funds, has kicked the can down the road for Greece. Expect an eventual debt restructuring by Greece and possibly others including Hungary. The state and local government fiscal crisis in the U.S. is far from over. Fiscal stimulus was a band aid but will not prevent defaults on municipal bonds.
5. **Lower Potential GDP Growth.** The rate of population and labor force growth in the U.S. is slowing down. Lower labor force growth accompanied by no changes in the long term trend for productivity growth means lower potential GDP growth for the U.S. Think of nearly 3 percent GDP growth as a normally function economy. We expect growth spurts above 3-3.5 percent, but they will not be sustainable. Now, working backwards, lower potential GDP growth accompanied by no changes in the long-term trend for productivity growth means weaker job creation over the coming decade. The productivity assumption is not set in stone and could be changed by a new wave of technical innovation.
6. **Post-Keynesianism.** British economist John Maynard Keynes developed the theory that governments should increase spending in times of recession to stimulate economic growth. His ideas shaped global economic policy following the Great Depression and remain influential today, evident in President Obama’s nearly \$800 billion fiscal stimulus plan. But there has been no complete test of the long-term consequences of Keynesian economics following a global recession. The trajectory of the global economy following the Great Depression was changed by World War II. Hopefully, we will avoid such an economic game changer this decade while we enter a new economic era.
7. **Taxes and Spending.** Fiscal stimulus and wars cost money and have driven the federal budget deficit into the danger zone at more than 10 percent of U.S. GDP for 2010. We assume higher taxes in our macroeconomic model beginning in 2011Q1. The other side of the fiscal equation needs to be brought into balance. One of the lasting legacies of the “Great Recession” may be trimmed entitlements both in the U.S. and in Europe. Cuts in state and local government spending are ongoing and will likely be a drag to GDP for the remainder of this year.
8. **Houses and Cars.** The rate of house construction in the U.S. remains well below the long-term rate of household formation. Housing markets will tighten up and house construction will recover, eventually. Cars are being built better, but they still wear out and need to be replaced. Strong sales in China help U.S. automakers.
9. **Baby-Boomer Demographics.** This issue has not received much media attention lately, but it has not gone away. Some boomers will delay retirements due to the wealth-depleting effects of the recession, but the tidal wave of retirements will hit this decade.
10. **Urbanization.** For the first time in history more people live in urban areas than in rural areas worldwide. Urban quality of life becomes increasingly important globally. Transportation and communication infrastructure is expanding in developing economies. Cultural trends spread ever more rapidly.

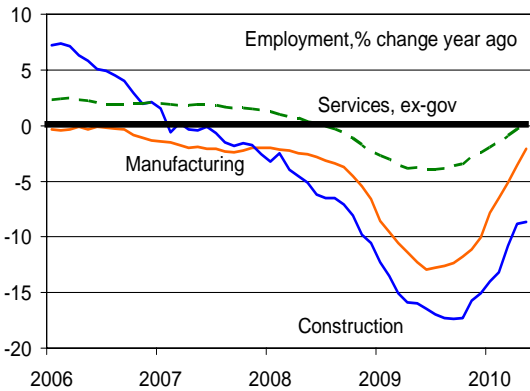
### Ongoing Drags Keep Recovery at Half Speed



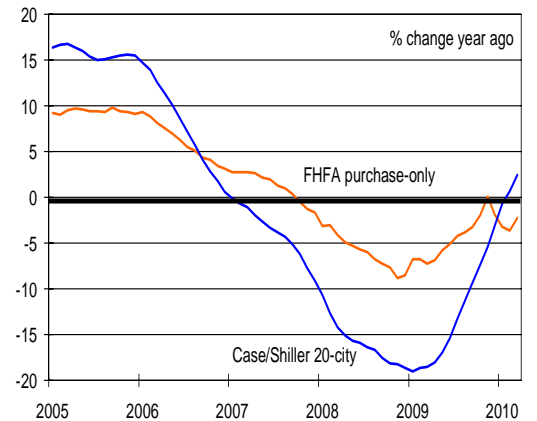
### More From Consumers and Less from Inventories in 2010Q1



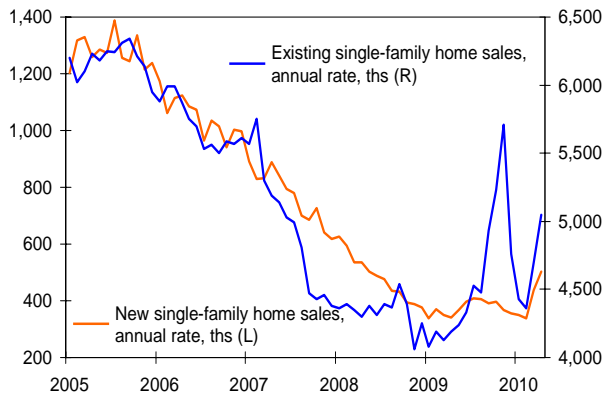
### Construction Employment Remains a Laggard



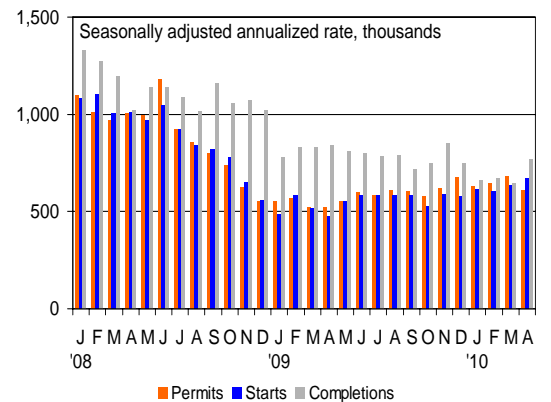
### Case/Shiller House Prices Ahead of Year Ago



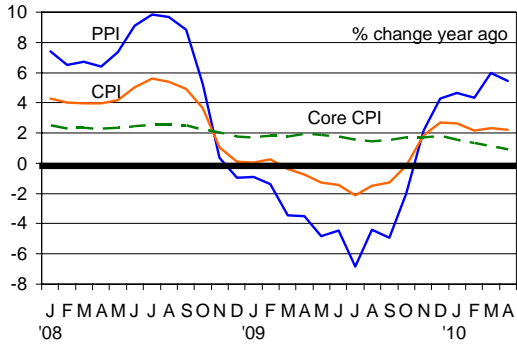
### The Government-Aided Tailwind in Housing is Ending



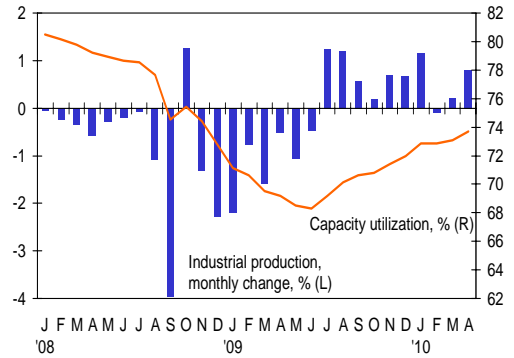
### Completions Improve Ahead of Expiring Tax Credit



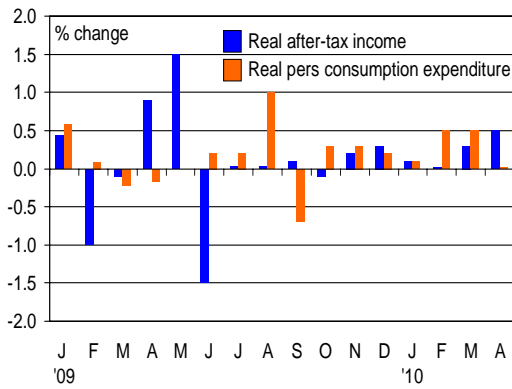
### Disinflation Continues



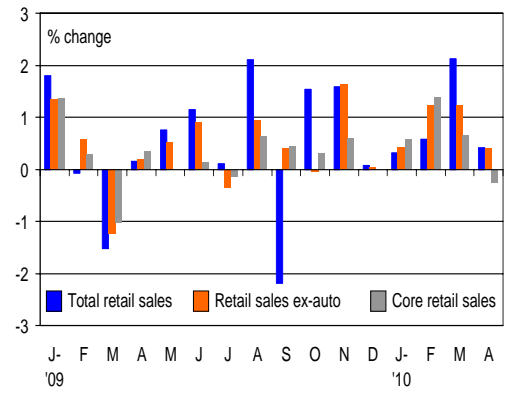
### Production Expanded in April



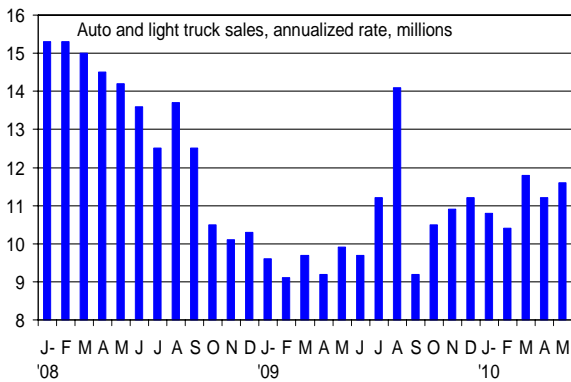
### Consumer Spending Stalled in April



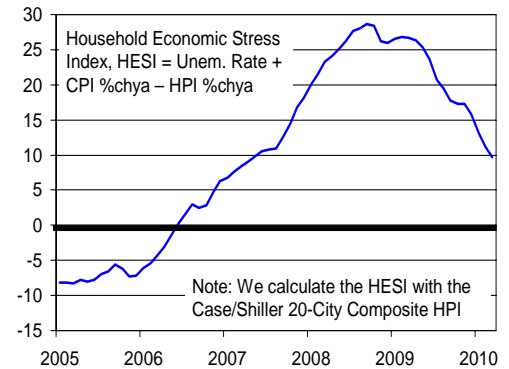
### Smaller April Sales Gains Follow Stronger March



### May Auto Sales Maintain Upward Trend



### Firmer House Prices and Low Inflation Drop HESI



### Baseline U.S. Economic Outlook, Expanded Table

	1Q'10a	2Q'10f	3Q'10f	4Q'10f	1Q'11f	2Q'11f	3Q'11f	4Q'11f	2009a	2010f	2011f
<b>Output</b>											
Nominal GDP (Billions \$)	14601	14695	14828	14985	15159	15337	15528	15728	14256	14778	15438
Percent Change Annualized	4.1	2.6	3.7	4.3	4.7	4.8	5.1	5.2	-1.3	3.7	4.5
Real GDP (2005 Billions \$)	13248	13334	13435	13542	13648	13749	13852	13961	12987	13390	13803
Percent Change Annualized	3.0	2.6	3.1	3.2	3.2	3.0	3.0	3.2	-2.4	3.1	3.1
Pers. Consumption Expenditures	9369	9432	9517	9598	9673	9734	9797	9859	9235	9479	9766
Percent Change Annualized	3.5	2.7	3.7	3.5	3.1	2.6	2.6	2.6	-0.6	2.6	3.0
Nonresidential Fixed Investment	1310	1331	1361	1392	1430	1472	1510	1543	1297	1349	1489
Percent Change Annualized	4.2	6.7	9.1	9.6	11.1	12.4	10.7	9.2	-17.4	4.0	10.4
Residential Investment	353	362	360	364	369	376	384	391	359	360	380
Percent Change Annualized	-10.7	10.9	-2.4	4.5	6.2	7.8	7.9	7.7	-20.5	0.3	5.7
Change in Private Inventories	34	43	42	44	44	42	39	40	-108	41	41
Net Exports	-368	-383	-391	-402	-416	-432	-443	-449	-356	-386	-435
Government Expenditures	2564	2563	2560	2560	2564	2572	2583	2594	2565	2562	2578
Percent Change Annualized	-1.9	-0.3	-0.4	0.0	0.6	1.3	1.6	1.7	1.8	-0.1	0.6
Industrial Prod. Index (2002=100)	101.4	103.3	105.0	106.7	108.3	110.0	111.6	113.3	98.2	104.1	110.8
Percent Change Annualized	7.5	8.0	6.6	6.6	6.3	6.3	6.2	6.1	-9.7	6.0	6.5
Capacity Utilization (Percent)	72.9	74.5	75.6	76.6	77.8	78.7	79.6	80.5	70.1	74.9	79.2
<b>Prices</b>											
CPI (1982-1984=100)	217.6	217.6	218.1	219.0	220.2	221.4	222.7	223.9	214.5	218.1	222.0
Percent Change Annualized	1.5	-0.1	1.0	1.7	2.1	2.1	2.4	2.3	-0.3	1.7	1.8
PPI, Finished Goods (1982=100)	179.5	179.4	179.7	180.0	180.5	181.3	182.2	183.3	172.7	179.7	181.8
Percent Change Annualized	9.2	-0.3	0.7	0.8	0.9	1.8	2.1	2.3	-2.5	4.0	1.2
GDP Price Index (2005=100)	110.2	110.2	110.3	110.6	111.1	111.6	112.1	112.7	109.7	110.3	111.9
Percent Change Annualized	1.0	0.0	0.6	1.1	1.5	1.8	2.1	2.1	1.2	0.5	1.4
Crude Oil, WTI (\$/Barrel)	78.6	78.0	82.0	85.0	85.0	90.0	90.0	90.0	61.7	80.9	88.8
<b>Labor Markets</b>											
Payroll Jobs (Millions)	129.7	130.6	131.2	131.9	132.5	133.1	133.7	134.3	130.91	130.86	133.43
Percent Change Annualized	0.2	2.8	1.9	2.0	2.0	1.8	1.8	1.9	-4.3	0.0	2.0
Unemployment Rate (Percent)	9.7	9.8	9.6	9.4	9.1	8.9	8.6	8.4	9.3	9.6	8.7
Average Weekly Hours	33.3	33.4	33.5	33.7	33.8	33.9	34.0	34.2	33.1	33.5	34.0
Population (Millions)	308.5	309.3	310.0	310.8	311.5	312.3	313.0	313.8	306.7	309.6	312.7
Percent Change Annualized	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.9	1.0	1.0
<b>Personal Income</b>											
Average Hourly Earnings (\$)	18.9	19.0	19.1	19.3	19.4	19.6	19.8	19.9	18.6	19.1	19.7
Percent Change Annualized	2.1	2.1	2.8	2.8	3.1	3.4	3.7	3.8	3.0	2.4	3.1
Total Personal Income (Billions \$)	12179	12277	12406	12554	12698	12852	13016	13185	12019	12354	12938
Percent Change Annualized	3.7	3.3	4.3	4.9	4.7	4.9	5.2	5.3	-1.8	2.8	4.7
Real Disp. Income (2005 Billions \$)	10032	10110	10183	10259	10286	10361	10437	10517	9994	10146	10400
Percent Change Annualized	1.9	3.1	2.9	3.0	1.1	2.9	3.0	3.1	0.8	1.5	2.5
Median Family Income (\$)	62134	62441	62827	63262	63687	64135	64610	65091	61753	62666	64381
Percent Change Annualized	2.2	2.0	2.5	2.8	2.7	2.8	3.0	3.0	-2.5	1.5	2.7
<b>Housing</b>											
Housing Starts (Ths, Ann Rate)	617	642	613	685	759	821	852	879	554	639	828
Ext. SF Home Sales (Ths, Ann Rate)	4497	5179	4732	4895	4991	5060	5123	5219	4567	4825	5098
New SF Home Sales (Ths, Ann Rate)	375	425	395	421	430	436	441	449	374	404	439
Case/Shiller HPI (Jan. 2000 = 100)	134.3	135.9	134.7	136.3	137.3	138.4	139.2	140.4	134.1	135.3	138.8
Percent Change Year Ago	2.1	2.2	-0.7	0.2	2.2	1.8	3.4	3.0	-11.4	0.9	2.6
<b>Consumer</b>											
Household Economic Stress Index	10.0	9.5	11.6	10.2	8.0	8.8	7.3	7.6	20.0	10.3	7.9
Auto Sales (Millions)	11.0	11.5	11.9	12.4	12.7	12.9	13.1	13.3	10.3	11.7	13.0
Consumer Credit (Billions \$)	2451	2451	2452	2457	2460	2467	2482	2503	2495	2453	2478
Percent Change Annualized	0.4	-0.1	0.2	0.8	0.5	1.2	2.5	3.4	-2.8	-1.7	1.0
<b>Interest Rates (percent)</b>											
Prime Rate	3.3	3.3	3.3	3.3	3.5	4.3	4.9	5.3	3.3	3.3	4.8
Federal Funds	0.1	0.2	0.2	0.2	0.5	1.3	1.9	2.3	0.2	0.2	1.5
3-Month LIBOR	0.3	0.4	0.5	0.5	0.8	1.7	2.2	2.7	0.7	0.4	2.2
3-Month Treasury Bill	0.1	0.2	0.3	0.3	0.6	1.2	1.7	2.2	0.2	0.2	1.4
10-Year Treasury Note	3.7	3.6	3.7	3.7	3.9	4.2	4.3	4.5	3.3	3.7	4.2
30-year Fixed Mortgage	5.0	5.0	5.2	5.2	5.4	5.7	6.1	6.3	5.0	5.1	5.9

a = actual f = forecast p = preliminary

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