The macro economic statistics released in the course of the past two months have painted an increasingly less optimistic outlook. One year ago I argued in these monthly reports that the real GDP growth in the first half of 2011 will fall one percentage point below the growth of the second half of 2010, but that outlook proved to be too optimistic. The average growth in the second half of 2010 was 2.4%, while the average growth in the first half of this year was only 0.7%, 1.7% lower. This more rapid than expected deterioration appears to be expedited by the ongoing monetary and fiscal policies. As argued in the October report of last year, the monetary policy would help turn 2011 into a resemblance of 2008, and unfortunately this appears to be true. The economic performance is still expected to get some momentum in the end of the summer and the start of the fall, but that momentum will dissipate completely by the start of 2012. At this point, the probability of a mild recession developing towards the start of 2012 is now over 50% and therefore should be seriously considered.

Any further expansionary policy of the FED will continue to help the stock market but will produce no effect on the real economy. However, as argued earlier in the Spring, the FED will continue further monetary expansion at this time. This is a necessary response to the Fiscal situation, but it will produce nothing but a stock market effect and inflation in commodities, which is already at very unusual for the US levels and causes major negative effects on investment, consumption and trade balance.

However, these negative effects are expected to materialize at the start of 2012, so, for now, the current expansion of the US economy is intact.

The seasonally adjusted regional PMI dropped below the 50 point mark in August again. Following the July jump, the index declined to 48.8 in August, indicating incrementally small contraction in the region's manufacturing, but that needs to be interpreted from the moving average point of view. The three month moving average remains a little above 50 points, at 50.7.

The commodity price index continued to advance for the second month, and is now at 82.2. 64.3% of our survey participants indicated higher commodity prices and NONE of the survey participants stated that they observed lower commodity prices. Commodity price inflation is a clear by-product of the current fiscal and monetary policies and presents a great danger to our firms. The US economy is a net importer of many commodities and our demand for those is highly inelastic. Rising commodity prices clearly have a negative effect on business costs, but most importantly, in light of the high unemployment, they have a clear negative effect on the profits too as our firms find it difficult to pass these cost increases onto consumers. The FED's actions cause a wave of liquidity that seeks shelter from inflation. The most popular form of shelter among investors appears to be a run into commodities. In this way, 2011, following the latest round of monetary printing that started in October of 2010, completely resembles 2008, just on a lower level. As was argued in the October report of 2010, inflation cannot be controlled and directed and therefore releasing this uncontrollable force is a dangerous policy.

Our production index declined from 53.4 in July to 45.1 in August indicating a mild decline in the region's manufacturing activity. 42.9% of our survey participants indicated lower production levels. This is in sharp contrast with the 31.3% response in July.

We also saw a significant deterioration in the new orders index. The seasonally adjusted index declined to 43.9, with only 28.6% of responders indicating higher levels of new orders activity.

The region's employment index also pulled back below 50 to 45. Higher levels of employment were only reported by 14.3% of participants. However, it is worth noting that we did not see a large jump in negative responses, but rather a significant rise in the number of responders indicating unchanged employment levels (64.3%). This suggests that the manufacturing sector's employment remains flat, being consistent with the ongoing jobless recovery process we are in.

Quarterly Averages for Seasonally Adjusted Measures

	2010:QIII	2010:QIV	2011:QI	2011:QII	2011: July - August
PMI	54.0	56.4	53.3	52.7	52.3
Production	53.6	59.5	55.7	54.6	49.3
New Orders	53.8	56.6	47.4	46.2	49.3
Employment	57.2	52.0	49.5	47.1	48.1

The outlook for the future is alarming. The probability of a national recession is already above 50%. Our economic weaknesses have already helped push the economies of our trading partners into a decline. This is particularly alarming for the greater Buffalo region as the economy of Canada has already sunk into a recession in the second quarter of this year. Commodity price inflation is negatively impacting consumer's purchasing power and the costs of production. The unemployment rate is around 9%. The National government's fiscal situation is to say the least problematic, and the interest rates are at all time lows. If we do indeed slide into a recession at the start of 2012, even a mild one, what policy tools do we have to get out of it? This is a very painful question. It appears that we need to adjust to the reality of a new equilibrium for the US economy, that of lower average growth (around 2%), higher natural unemployment (around 6.5 – 7%) and higher overall inflation (around 5 – 6%).

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