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U.S. Outlook: Good News from the Economy, Bad News on Policy

The future performance of the economy of the United States can be characterized as having a "good news, bad news" plot line with certain critical acts to be played out in 2013 and beyond which will determine whether we are witnessing a theatrical tragedy or an uplifting comeback tale. The good news is that the U.S. private sector economy is building a solid base for future growth, even if the path has been difficult, the international headwinds severe, and the time taken much longer than policy makers and many analysts had hoped. The bad news is that the U.S. still has a very large overhang of federal government debt, faces a political rift that has the potential, if not the likelihood, to push the economy off the "fiscal cliff" and back into recession, and has seen an unprecedented expansion of the Federal Reserve's balance sheet which has the seeds to the threaten the stability of the economy over the long-term if and when the record stimulus is unwound.

In this report, we turn first to the good news from the economy, before describing the massive and unprecedented fiscal and monetary policy risks which the economy faces. The conflicts in this plot line leave us with an extremely uncertain economic projection for 2013 and beyond. Essentially, if the worst case fiscal cliff is avoided, 2014 and beyond look quite promising, assuming the Fed can manage its way out of its massive balance sheet without short-circuiting the expansion.

- *20% Probability: Fall off the "Fiscal Cliff" and back into recession – 2013 Real GDP Growth of -2%.*
- *60% Probability: Muddle Through, No Long-Term Fiscal Compromise – 2013 Real GDP Growth of +1.5% to +2.5%.*
- *20% Probability: Unexpected Long-Term Fiscal Compromise – 2013 Real GDP Growth of +3% to +4%.*

A. Good News: Sustainable Bright Spots in the Economy

There are many bright spots. Once severely depressed, the U.S. housing sector has shown concrete signs of life and sustainable improvement in 2012. The automobile sector is back and has been for a few years now. By 2010, the banking sector had recovered from its recession. Banks are now profitable, relatively well capitalized, and prepared for Basel III requirements (unlike many European banks). Layoff activity in the private sector has stabilized. On an incremental basis, the private sector labor market continues to create net new jobs, allowing for a grudgingly slow decline in the reported unemployment rate. All this has been achieved by the U.S. economy in the face of some very tough headwinds, including European recession and financial turmoil as well as sharply decelerating economic activity across the emerging market countries, especially China, India, and Brazil.

The data paint a picture of a very solid, if not rapid, economic recovery. The U.S. has grown modestly, yet consistently starting in mid-2009 and continuing through 2012. For the 12 quarters from Q3/2009 through Q2/2012, real Gross Domestic Product growth averaged 2.2% on an annual basis. (See Figure 1.) During 2010 through 2012 year to date, 4.69 million private sector jobs have been created, helping to offset the 478,000 government jobs lost over that same time period. Even with just modest economic and job growth, the unemployment rate seems set to continue its path deeper into the 7% territory from its 10% peak in 2009.

Figure 1.

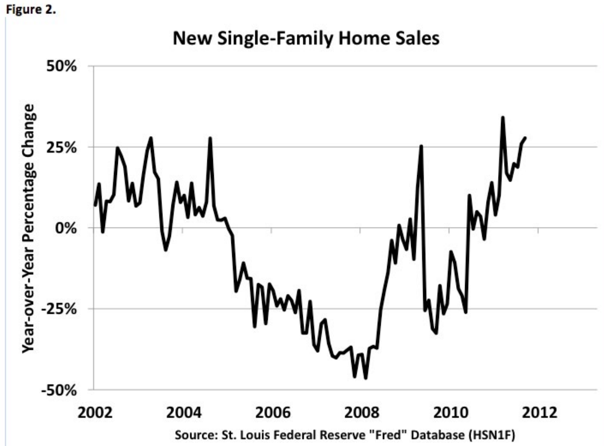
While we could work our way through a myriad of economic sectors, we would like to focus on the housing market and the labor market. The overheated state of the housing market helped cause the recession, and the recovery in the labor market has been essential to the improving picture in housing.

1. Housing Market

The 2012 recovery in the U.S. housing market was not widely projected, even during the first half of the year. For many analysts, the sector was too depressed and the foreclosure supply too large to anticipate that a recovery might take hold in 2012. We do note, however, that CME Economics staked out a much more optimistic view than the consensus for U.S. housing back in March 2012, when we published our report, "US Housing Market: Looking Brighter for 2012", reflecting in more detail our analysis developed back in late 2011 for a relatively more optimistic view of the U.S. economy and a sustained improvement in the labor markets.

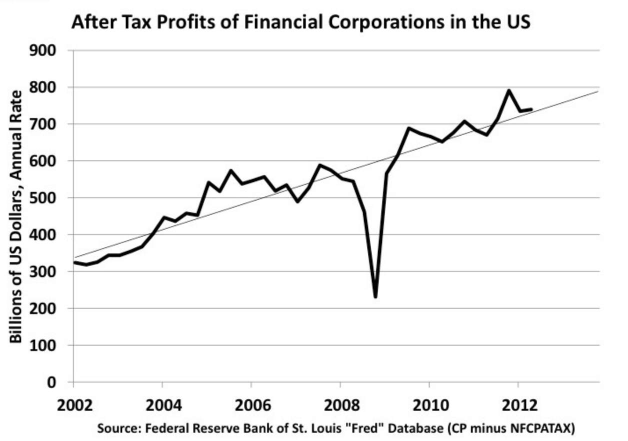
The data now support the view that housing has entered a recovery phase. The S&P Case-Shiller Housing Price index shows a very small increase over the same period a year ago. With housing prices now rising slowly across the nation, a bottom has been built that allows for growth in transactions. New single-family home sales are up 27% over a year ago. (See Figure 2.)

Figure 2.



The improvement we have witnessed in the housing market in 2012 is the result of a combination of factors reflecting the return of the U.S. economy to better health. First, housing cannot be purchased without a well-functioning financial system. And the U.S. financial system returned to profitability in 2010 and has been able to recapitalize and adapt to the new and changing regulatory environment. (See Figure 3.)

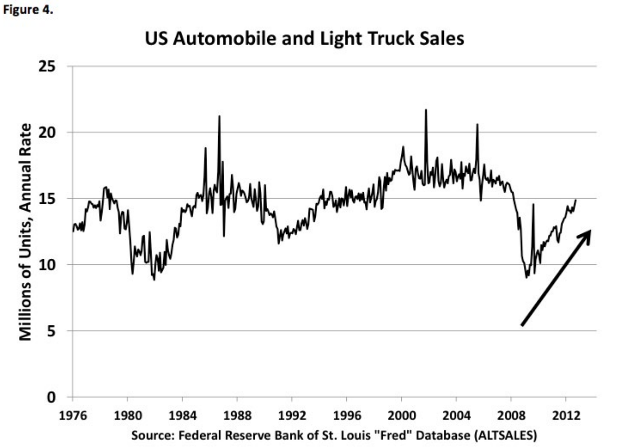
Figure 3.



Second, home purchasers have to have the confidence that they will have a steady income, and that means a dependable job. Hence, the recovery of the labor market has been essential to under-pinning the housing market. While not as impressive as some might prefer, the U.S. economy has been creating jobs on a monthly basis for almost three years and that has brought the unemployment rate down slowly. An improving labor market has given consumers the confidence to expand purchases of durable goods, such as automobiles. Increased auto sales and purchases of durable goods are generally a precursor to the willingness to make the long-term investment in a new home. (See figure 4.)

Also, aiding the housing market has been an increase in the affordability of housing. House prices crashed during the consumer deleveraging phase right after the financial panic of 2008. The depressed level of housing prices coupled with very low interest rates made housing considerably more affordable than in the period prior to the recession. Moreover, there has been an upswing in net household formation. That is, the depth of the recession sent many 20-somethings and some 30-somethings back home to live with mom and dad, effectively putting a stop to net household formation in the US. With the increase in private sector jobs over the last few years, the trend in household formation also has reversed, which is undoubtedly a win-win for parents and their offspring.

Figure 4.



The last item necessary for housing to recover was the need to reduce the inventory of foreclosed homes. While foreclosure sales are still an important component of the housing market, they are no longer holding back non-foreclosure sales. There is also the perception that there is a large "shadow" market of houses waiting to go on the market if prices rise. There is likely some truth to this, but the impact is more to prevent a rapid recovery in prices rather than to prevent sales from increasing. Taken together, house prices appear to have developed a bottom, even if they are not ready to surge upward. Home purchasers are much more realistic now. The perception that housing prices will only go up has been well and thoroughly debunked. This means that new home purchasers are cautious about their expectations for capital gains and are focused on the quality of life improvements they hope to receive from a new home.

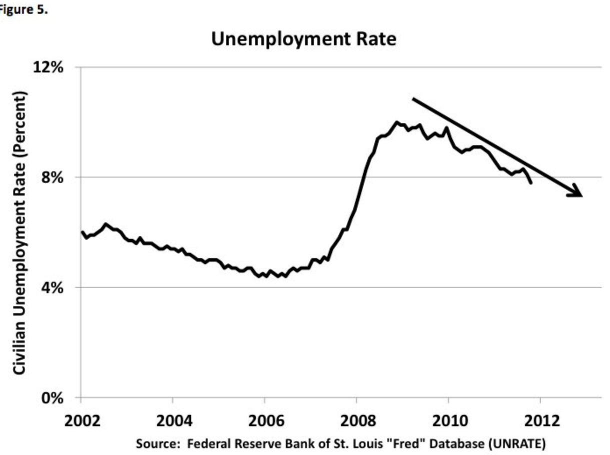
Finally, while an improving housing sector is certainly encouraging, we have to emphasize that housing is a much smaller part of the U.S. economy than in the

Greenspan-led Fed-engineered boom of the mid-2000s. Typically, in a post-World War II recession, a housing construction recovery helped to lead the economy back to good health. This time around, the housing market was at the epicenter of the recession. While consumers deleveraged, housing prices fell off a steep cliff. Thus, the housing recovery is both real and robust, but (1) we are not going back to the over-exuberant and heady days of the past and (2) the contribution of housing to real GDP gains will remain quite small and no longer a key driver of economic activity.

2. Labor Market

The decline in the U.S. unemployment rate, to just below 8% toward the end of 2012 from 10% in 2009 (See Figure 5), has occurred with a relatively modest economic recovery and only an average of 127,000 net new jobs per month since January 2010. Many analysts and policy makers have been surprised that the unemployment rate could decline as much as it has with such modest net job growth. To better understand why the unemployment rate has been able to decline steadily with only modest economic growth, one must gain an appreciation of both secular and cyclical trends.

Figure 5.

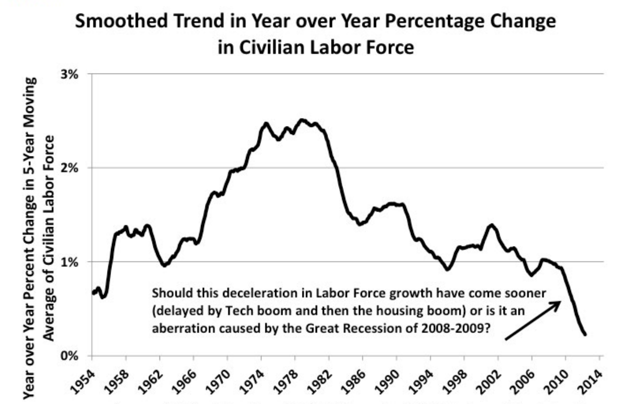


From a secular perspective, the U.S. labor force reflects the demographic patterns of the country, and like it or not, the average age in the U.S. is increasing. Unlike India, which is still a late 20-something in terms of average age, the U.S. has moved into the upper 30s, and will turn 40 early in the decade of the 2020s. [By the way, China will also turn 40 in the next decade.]

An aging population is merely the reflection of a sustained low birth rate, assuming that immigration is not so large as to reverse the inevitable. And with the rise of the middle class in the emerging markets, while still a favored destination of immigrants, the U.S. is not nearly the magnet for immigration that it once was. All of this translates into a much more slowly growing labor force. The U.S. has not hit the point, as Japan has, where there are more workers retiring than new entrants into the labor force, but long-term labor force growth is more likely to be around 0.5% to 1% annually rather than the 2%-plus of the late 1960s and 1970s when the baby boomers came into the labor force. This has important implications for long-run real GDP gains, since the arithmetic suggests that real GDP growth potential depends on the sum of labor force growth and labor productivity growth. Unless one expects a sharp and sustained rise in labor productivity, then the long-term trend rate of growth for the U.S. economy is much lower than it once was when the labor force was growing more rapidly.

There is also a cyclical component to labor force growth that was distorted over the last decade. Typically, an extended economic expansion draws marginal or non-permanent workers into the labor force. Then a recession, with its job cuts and high unemployment, pushes many workers out of the active labor force – many go back to school or just stop looking for work. The cyclicality of the measured labor force raises some doubts as to the real size of the permanent labor force. Our contention is that the housing boom of the mid-2000s effectively drew many marginal and non-permanent workers into the measured labor force. Put another way, the measured growth of the labor force prior to the 2007-08 financial crisis was elevated by the extended period of easy money and increased leverage provided by the Greenspan Fed than help to produce the housing and construction boom. Many of these marginal and non-permanent workers lost their jobs in the recession, but they are not likely to ever return to the labor force. (See Figure 6.) There are two important implications from this analysis.

Figure 6.

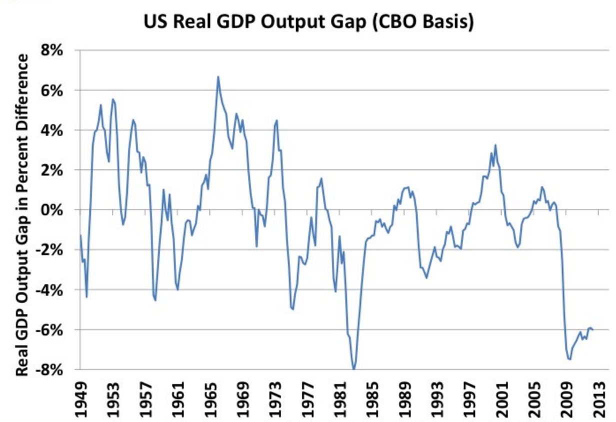


Source: Civilian Labor Force (CLF160V) from the FRED Database of the Federal Reserve Bank of St. Louis

First, in the recovery phase from the recession of 2008-09, we are not likely to see nearly as much cyclical increase in the measured labor force as is the average in previous post-WWII economic recoveries. A slower growing cyclical labor force means the unemployment rate can decline with fewer net new jobs being created each month than was the statistical relationship in previous recessions.

Second, the long-term permanent labor force may not have been as large in the first decade of the 2000s as is often assumed and its long-term average growth rate may be slower than commonly assumed. This has huge implications for how the Congressional Budget Office (CBO) calculates potential output and the output gap. That is, if the permanent labor force is a little smaller than assumed and growing a little more slowly, then the CBO is over-estimating potential output. This might not sound like a big deal, except that the Fed uses the output gap, the difference between actual real GDP and potential real GDP as a measure of under-utilized resources in the economy. Currently, the measured output gap, using CBO data, is about 6% (See figure 7), but there is the possibility the output gap is actually smaller, around 3% to 4%. If one believes the latter, then the economy is not in nearly as bad shape as many Fed policy makers assume, in that it is closer to its more realistic potential output.

Figure 7.



Source: Federal Reserve Bank of St. Louis "Fred" Database (GDPC1, GDPPOT)

To review, the U.S. economy is doing modestly well. Housing is now recovering, the unemployment rate is declining, and real GDP growth is hanging around 2% per year even in the face of severe headwinds from overseas and the homemade uncertainty surrounding the fiscal cliff. Unfortunately, before jumping to the conclusion that the economy has the capability to enter a more robust phase of economic expansion, we have to consider some key policy risks.

B. Bad News: Extremely Large Risks to Overcome in Fiscal and Monetary Policy

We will spend more time on the fiscal policy issues here, since they are staring the economy in the face. We will, however, discuss briefly the longer-term risks inherent in the Fed's extensive use of its balance sheet, known collectively as QE2, operation twist, and now QE3, which have been employed aggressively since 2010.

1. Fiscal Policy Risks

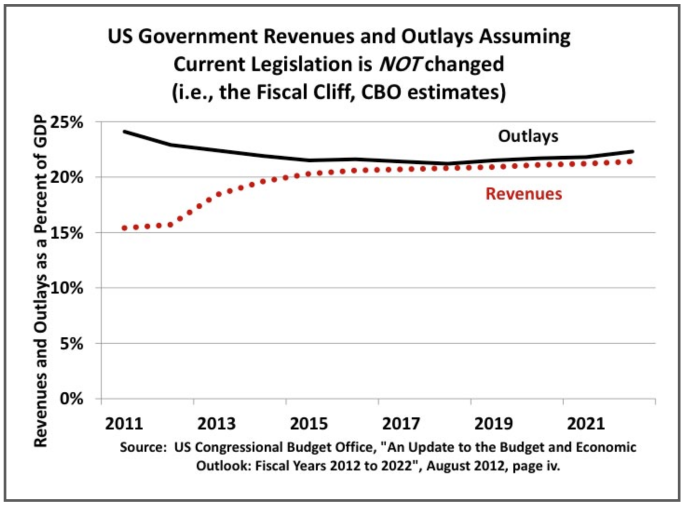
The looming political issue in the United States that will likely determine the direction of the economy in 2013 and beyond is what is known as the "fiscal cliff." The terminology embodies a rather heady mixture of automatic provisions in previously enacted legislation that will end certain programs, rollback taxes to the higher rates of the 1990s, and automatically restrain certain federal government expenditures in both discretionary and non-discretionary programs. That is, unless the new Congress takes legislative action to the contrary, the following will occur in 2013:

- *Bush-era tax cuts expire and rates return to Clinton-era levels;*
- *Automatic enforcement of the procedures in the Budget Control Act of 2011 will constrain both mandatory and discretionary spending;*
- *Sharp reductions in Medicare payment rates to physicians will take effect;*
- *Extension of emergency unemployment benefits will expire;*
- *2% reduction in the social security payroll tax will expire; and just to complicate matters,*
- *The debt ceiling will be breached around mid-year or sooner.*

Every one of these items comes with a heavy burden of controversy, meaning that action by Congress is by no means certain. In the worst-case scenario (20% probability), the U.S. falls off the fiscal cliff. If current U.S. law is not changed, the CBO estimates the combination of legislated tax increases and spending decreases by the government are likely to reduce the budget deficit in fiscal 2013 to around $641 billion or 4% of GDP. This would imply fiscal tightening in just one year of an estimated $487 billion, compared to the $1.128 trillion deficit estimated for FY 2012. The CBO estimates this degree of austerity would result in a 0.5% decline in real GDP between Q4/2012 and Q4/2013 with the rate of unemployment rising back over 9%. Our own view is that if the U.S. economy goes over the fiscal cliff, the recession in the U.S. will be more severe than CBO estimates, perhaps a 2% decline in real GDP, and that the unemployment rate could head back over 10%, due in no small part to the major blow to global confidence in the ability of the U.S. government to manage its affairs that a failure by Congress to act would cause.

Moreover, the Fed will be powerless to offset a recession caused by a half trillion dollars of rapidly implemented austerity. Consumers and corporations will be retrenching in an effort to realign their expenditures and future plans to accommodate higher taxes and reduced government expenditures. Another round of quantitative easing will make no difference, since the issue for the economy will not be about interest rates.

Action between now and the end of 2012 by a lame duck Congress is not particularly likely. Bi-partisan efforts to "kick the can down the road" in the European tradition of their debt crisis may include enacting multiple delays in the automatic enforcement of the restraints of discretionary and mandatory expenses and agreeing to temporary increases in the debt ceiling. It is highly likely that partisan political splits within both parties mean that the Bush-era tax cuts will be allowed to expire at the end of 2012, along with the emergency unemployment benefits and the payroll tax cut. In cases like this, political brinkmanship is usually the order of the day, so there is very little likelihood of pre-emptive action.



Our base case projection for the U.S. economy for 2013 (60% probability) makes the following assumptions:

- *A return to Clinton-era tax rates,*
- *Expiration of the 2% reduction in the social security payroll tax,*
- *Expiration of the emergency unemployment benefits, and importantly*
- *Postponement through temporary resolutions of the automatic spending cuts mandated by the Budget Control Act of 2011,*
- *Postponement of the cuts in Medicare payments to physicians, and*
- *The debt ceiling is temporarily raised, although only at the last minute.*

Subject to revisions after our analysis of the results of the November elections, we do not think the economy will be allowed to go off the fiscal cliff. However, we are not willing to assume that a long-term fiscal policy compromise will be forthcoming in 2013. Given this rather heavy burden of political assumptions, continued brinksmanship in Congress feeding uncertainty, and no long-term fiscal compromise, our projection for the U.S. economy in 2013 is that it can bump along at the current real GDP growth rate of 1.5% to 2.5%, creating around 100,000 net new jobs per month, and ever so slowly lowering the unemployment rate.

There is the potential for rather large upside surprises in the economic outlook (20% probability) should a bi-partisan spirit take hold of the Congress in 2013 and a long-term tax and expenditure compromise be enacted into law. While the details of any tax and spending compromise will matter for long-term economic activity, the main driver in the short-run of the economic optimism that could result would come mostly from the massive reduction in uncertainty over tax and expenditure policies. Please note, though, that only a long-term fiscal compromise without sunset clauses will generate the maximum benefit to economic growth over the coming years.

All of this means that we are less confident in the economic projections associated with our base scenario for the U.S. economy in 2013 than would normally be the case. We recognize the potential for large surprises in either direction if the economy is driven off the fiscal cliff or powered upward in a burst of confidence on the foundation of an unexpected long-term fiscal compromise.

2. Long-Term Monetary Policy Risks

We turn now to monetary policy. In the last quarter of 2008 and in early 2009, the Fed expanded its balance sheet by roughly $1 trillion in what became known as QE1, the first round of quantitative easing. There is little doubt that this action prevented a recession from turning into a depression and saved millions of jobs from being lost.

More controversial, however, are the long-term and potentially unintended consequences of the additional $1 trillion (and growing) of quantitative easing since 2010, as well as the maturity extension program known as "Operation Twist." We recommend that the interested reader see our detailed analysis, published in September – "Quantifying QE", as well as the recently posted working paper by William White, "Ultra Easy Monetary Policy and the Law of Unintended Consequences," from the Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute, Working Paper No. 126.

Assuming that the U.S. economy gets by the fiscal cliff and the unemployment rate continues to decline in 2013 toward the 6% to 7% range, at some point, in 2014 or beyond, the Fed is going to have to decide how to manage its exit from quantitative easing. It is possible that the exit will be exceedingly difficult, complex, and probably induce considerable Treasury market volatility. A normal, yet still accommodative, monetary policy would probably have the federal funds rate equal to or slightly above the measured core inflation rate. That means that at the same time that the Fed has to manage its exit from QE, it will be incrementally raising the Fed funds rate from near zero to 3% or so. Put another way, increases in the Fed funds rate may occur at the same time as massive asset sales, which could put upward pressure on longer maturity Treasury yields.

There are some alternatives. The Fed could choose to raise the interest rate it pays on excess reserves, essentially to fund its mammoth portfolio and then hold the portfolio until it runs off in 10, 15, 20 years or so. Or, the Fed could slow the increase in the federal funds rate, take extra time to get back to normal, and try to time its asset sales to have less impact on the markets and the economy. The problem is that once the economy is growing a little more strongly and is closer to its potential output, delays in returning to a normal monetary policy have huge inflation risks (including risks of a weaker dollar) that are not apparent when the unemployment rate is still as elevated as it is now. Fed Chairman Ben Bernanke states that these problems are manageable, and we do not doubt this. We remain concerned, however, that the solution will involve delays in returning to a normal policy and that even a well-managed exit from QE may involve considerable Treasury market volatility and the potential for elevated long-term yields that could slow a recovering economy.

C. Summary of U.S. Real GDP Projections

We have an economy that is growing, but not as fast as policy makers would like. The primary reasons are the headwinds from Europe and emerging market countries and the uncertainty over the U.S. fiscal cliff. The fact that the U.S. economy has done as well as it has in the face of these headwinds and policy uncertainties is quite impressive. The peer group of mature industrial economies – in the UK, Europe and Japan – have not done nearly so well. In the spirit of the glass-is-half-full, if the U.S. can get by the fiscal cliff, then economic growth has the potential to be quite robust over the next few years. Unfortunately, if the economy goes off the fiscal cliff, the ensuing recession could be much worse than standard predictions due to the lack of global confidence in the U.S. and its ability to manage its economy. The longer-term monetary policy risks are no less real to us, but it is hard to worry about how the Fed will manage its exit from quantitative easing when the fiscal cliff is looming just around the corner.

- *We come down to the view that the U.S. is roughly a 2% real GDP growth rate economy until the fiscal cliff is resolved, and we give this scenario a 60% probability because we see a divided country and a Congress that reflects those deep divisions, making long-term fiscal compromise difficult even if the cliff scenario is avoided.*
- *We put the recession scenario and going off the fiscal cliff at a 20% probability.*
- *Equally, there is a 20% chance of an unexpected long-term fiscal compromise giving the economy newfound confidence to take risks and grow much more strongly.*

Essentially, the 2013 U.S. real GDP projection is of unusually high risk. There are international risks coming from Europe, China, and the potential for geopolitical disruptions. On the home front, though, the risks are much more political than market based and exceedingly hard to handicap. We may get some news on election night in November that clarifies this picture. Unfortunately, in terms of the potential for a long-term fiscal compromise, so much depends on the make-up of the House of Representatives and the Senate, including intra-party divisions, that the election may not provide nearly as much clarity as one might hope. The fiscal cliff has all the attributes of a brinksmanship debate, probably crystalized by the debt ceiling being breached during the spring of 2013. Thus, a resolution and clarity are more likely to come in the second half of 2013, even if much of the legislation, especially tax legislation, may be retroactive to January.

Additional Resources

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