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US Economy: Solid Momentum Entering 2014

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The US economy appears poised for its best performance since the depths of the financial recession in 2008 and 2009. After four years of modest recovery, the economy has largely mended from the debilitating injuries received during the financial panic. And given the healthiest foundation for growth in more than five years, there are positive signs from the Federal Reserve and the energy sector that underscore the potential for superlative economic performance in 2014, although not without a few risks.

Here we present our top five reasons why the US in 2014 may post 3.5% real GDP growth (Figure 1), with core inflation (excluding food and energy) remaining under 2%. Looking a little further ahead, though, we see core inflation gaining traction in late 2014 and 2015, rising toward 3.5% by end 2015 (Figure 2). While the base case growth outlook is healthy, there are a few mixed signs with potentially volatile implications for bond and equity markets. Housing prices may rise a little less rapidly, and automobile sales may begin to stall. With little inflation pressure until 2015, corporations may lose some momentum in earnings growth, lacking the pricing power to increase top-line growth. And in the Treasury markets, as quantitative easing winds down, the debate will naturally shift to when the target federal funds rate might be raised – especially if our base case 3.5% core inflation projection for 2015 is borne out. Gold is especially vulnerable if the Fed's rate-rise debate comes sooner than generally expected, while crude oil may feel some downward pressure from increased North American supply as well as from additional US production of less expensive natural gas.

Figure 1.

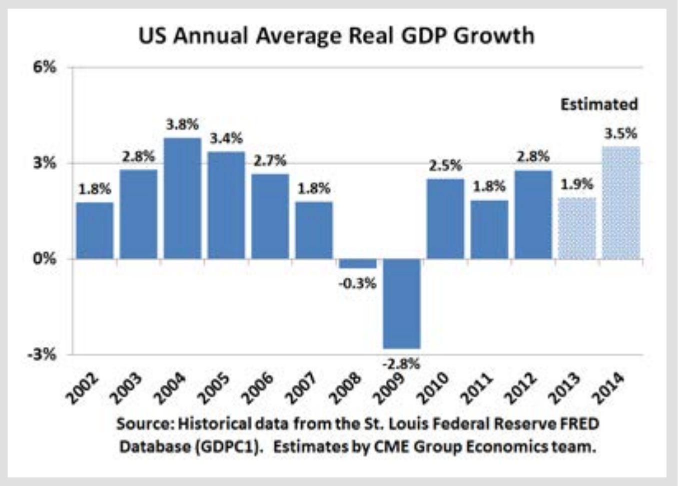
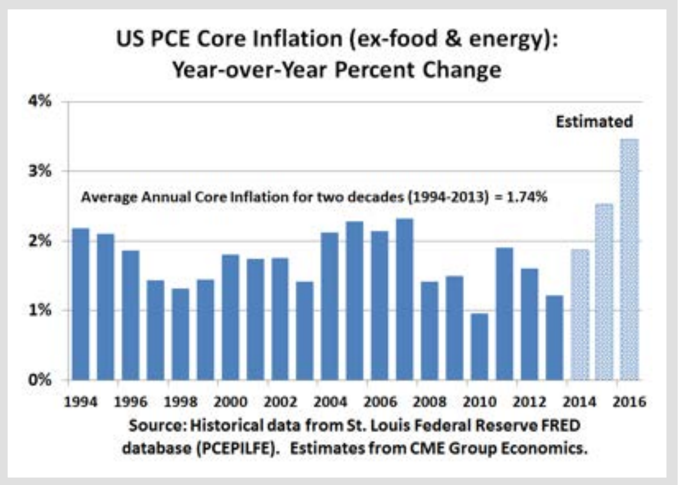


Figure 2.



I. The private sector and the consumer are relatively healthy

Recoveries from financial disasters generally are more difficult and take much longer than cyclical economic corrections. This is because financial disasters expose fundamental and structural weaknesses in the over-extended balance sheets and spending habits of nearly every sector of an economy, from corporations to consumers to state and local governments. During the multi-year period of financial rebalancing after the crisis, otherwise known as the deleveraging phase, monetary policy is powerless to encourage more rapid growth since each sector of the economy, in its own way, is almost myopically focused on getting its debt reduced and its spending in line with a more realistic assessment of its future income. For the US economy, this process has taken nearly four years from the bankruptcy of Lehman Brothers and very messy bailout of AIG in September 2008 that set-off the financial panic. Now that the deleveraging process is largely complete, the US economy is finally ready to grow at a very healthy pace.

US corporations generally had restored profitability by 2011 (Figure 3), although they continued to feel the necessity to build cash hoards due to the perceived fragility of the US recovery. US consumers required a little longer to rebalance their debt and spending. For the most part, consumers appear to have completed their deleveraging in 2012, as evidenced by a willingness to take on more consumer credit (Figure 4) and buy big-ticket items, such as automobiles (Figure 5). From the perspective of the private sector, the US enters 2014 in the best shape since the recovery began. This supports more **private sector job creation**, which already had been creating new jobs at a healthy clip since 2010 (Figure 6).

Figure 3.

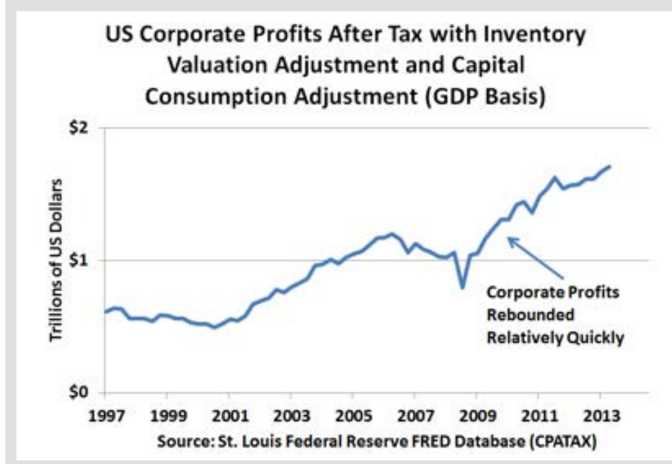


Figure 4.

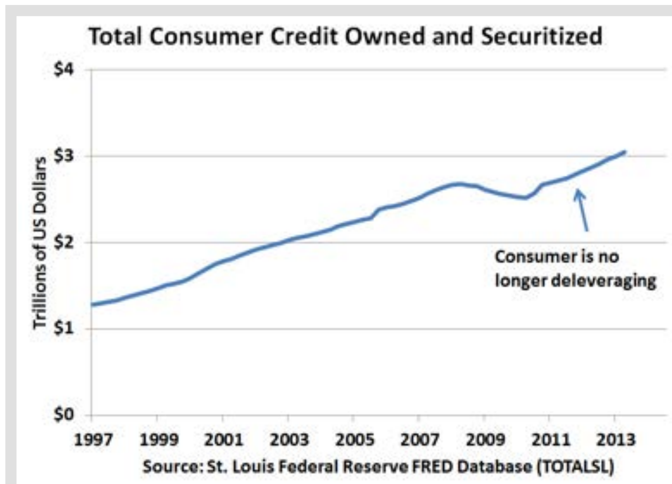


Figure 5.

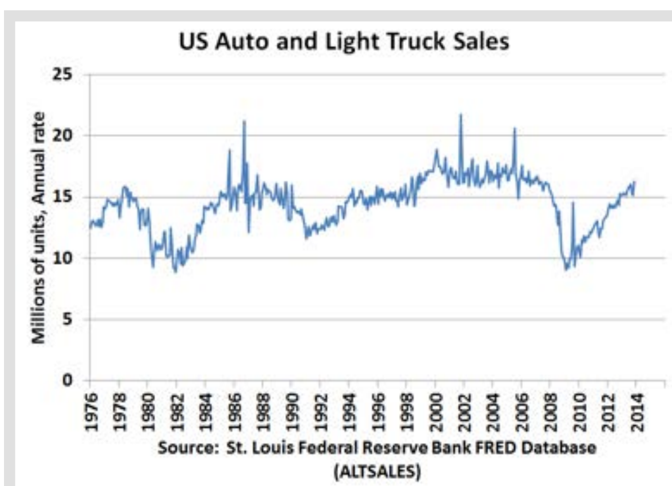
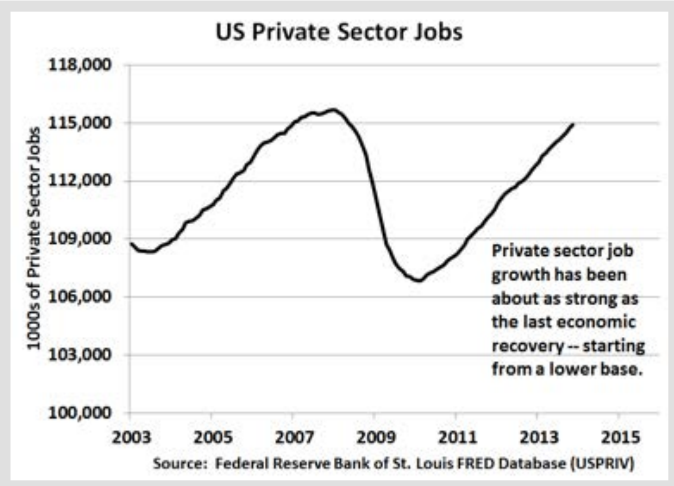


Figure 6.

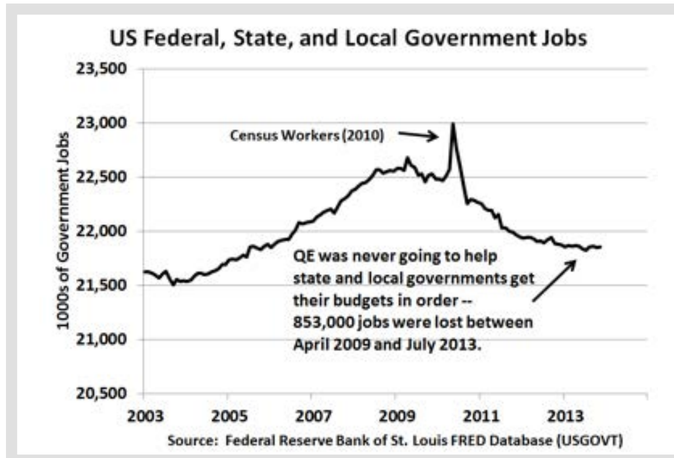


II. Fiscal and regulatory drag is greatly diminished for 2014

Government influence on economic performance has been and will remain crucial in at least three ways. First, the most under-appreciated drag on the economy and the labor markets over the past several years has been the cutbacks in the state and local government sector. Second, the federal government has made impressive strides toward achieving fiscal stability, reducing the drag from this sector. And finally, the massive regulatory changes enacted in the finance and health care sectors in 2010 are still creating uncertainty, but not nearly as much as in 2011-2013.

State and local governments, for the most part, did not get their operating expenses lined up with their revenues until mid-2013. Most analysts, and especially the Fed, have ignored the huge fiscal drag on labor markets coming predominately from state and local governments as well as the postal service. State and local governments' main tool for getting their expenses in line with their reduced revenue flows has been to cut services, meaning to cut jobs. Most states and local authorities thought the recession would be V-shaped, with a faster recovery than occurred, and they did not start their job cutting until mid-2009, well behind the more rapid reactions in the private sector. About 840,000 jobs were lost in this sector between mid-2009 and mid-2013 (Figure 7), when the job cutting finally ceased. Job cutting by state and local governments over the past three years is far and away the main reason why the US unemployment rate remains above 6.0%. Were it not for the jobs lost in this sector, the unemployment rate would more than likely have already declined below 6.0% by the end of 2013, given the strong and robust growth in private sector employment that started in 2010 and has kept going apace since then. Our perspective is that the Fed's QE program did absolutely nothing to help state and local governments, which were at the heart of the perceived sluggishness in labor markets.

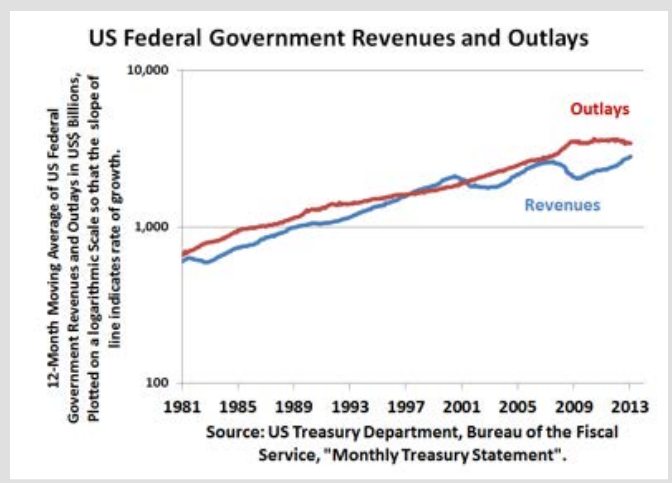
Figure 7.



The US federal budget deficit was vastly expanded at the end of President Bush's second term with then Treasury Secretary Paulson's trillion dollar emergency spending request to combat the financial crisis. After a short debate, prior to the November 2008 Presidential election, this spending was approved by the US Congress, although it was largely distributed in the ensuing year. The federal budget deficit peaked in FY2009 at $1.4 trillion (approaching 10% of GDP). Since then, substantial progress in deficit reduction has been made. For FY2013, the federal deficit was $680 billion (4% of GDP). For FY2014 we are projecting a federal deficit of "only" $500 billion (3% of GDP). By FY2015, we expect the US government to have achieved a fully balanced operating budget, which excludes interest expense (about 2% of GDP). More importantly, US federal budget deficit reduction is being accomplished with much higher tax revenues, up 8% FY2013 over FY2012, and expense stability, essentially flat FY2013 over FY2012 (Figure 8). The higher tax revenues are a surprise to many analysts, but they reflect the healthy recovery of the private sector that has been obscured in the employment data due to the lost jobs in the state and local government sector that did not come to an end until mid-2013.

On the regulatory front, there has also been an economic drag from important, yet complex, new legislative initiatives

Figure 8.



undertaken in 2010. Specifically, financial regulatory policy in the US was vastly complicated by the Dodd-Frank Wall Street Reform and Consumer Protection Act with almost 1000 pages of legal code leading to 14,000 pages of new rules and regulations, and still counting. And the Affordable Health Care Act of 2010 (aka ObamaCare) is proving exceedingly difficult to implement. The regulatory drag from new rules and regulations were most active in 2011-2013, and are expected to be less constraining in 2014.

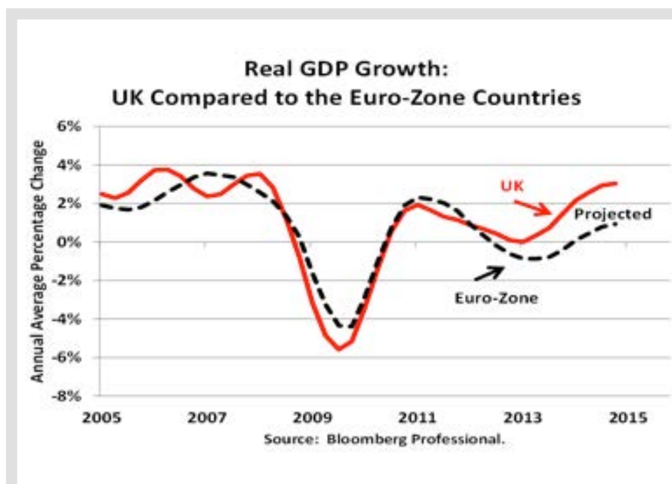
The last fiscal issue is the debt ceiling. The budget compromise agreed in December 2013 did not include a debt ceiling deal. We expect the debt ceiling to be reached in February or March 2014. Congress most likely will continue to play an economically damaging game of brinkmanship with debt ceiling legislation. Nevertheless, we see the debt ceiling debate as an uncertainty that gets resolved by the end of Q1/2014 and does not reappear until at least Q1/2015, conveniently (for the US Congress at least) after the November 2014 elections.

III. International Headwinds Subside

Our next observation concerns the diminishing headwinds from the global context in which the US economy operates. Global factors have weighed heavily on economic growth in the US over the past few years, and even more heavily on emerging market countries. The prime culprits have been Europe and China, and their stories are inter-related. The economies of the Euro-Zone are a critical leg for global growth. Europe is China's largest trading partner, and represents important sources of demand for goods from every other region from North and South America to Asia and Africa.

Europe had an extremely severe reaction to the 2008 financial panic because the sovereign debt of some of the weaker economies in the Euro-Zone had grown so large and destabilized their banking systems. The initial reaction to the sovereign debt crisis was to add a large dose of fiscal austerity on top of the normal private sector deleveraging that was in progress. This fiscal correction in many of the Euro-zone nations can been seen as essentially a parallel reaction to what states and local authorities were experiencing in the US. Like US states and municipalities, Euro-zone nations have no power to print money for massive asset purchases or even to meet regular expenses. Hence, the fiscal drag was deeper and has lasted longer than in the US, although the worst is clearly over from this perspective. For example, Italy now has an operating budget balance (not including interest expense). Greece is approaching stability at a much lower level of economic activity, and there was a smooth transition in the European Union, as Greece just took their six-month term as President of the EU.

Figure 9.



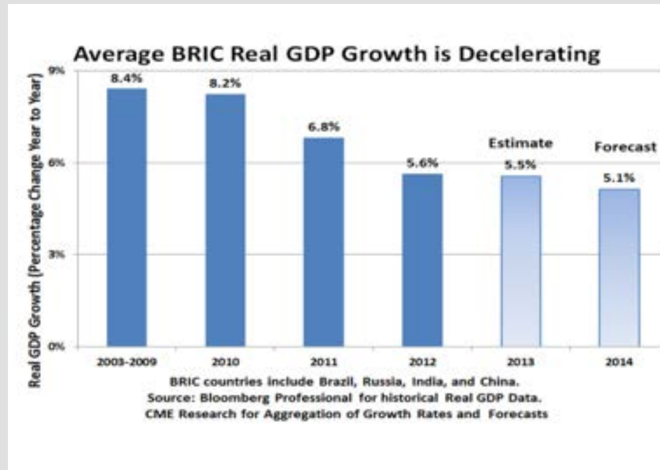
Adding to Europe's woes were the large sovereign debt holdings of the banking system. For Europe to grow at a healthy pace, its banking system needs more capital and EU-wide reforms that will actually encourage bank lending. The process of EU-wide banking reform is underway, but it is going to be painfully slow. The focus remains on how to cope with failed banks and not how to get the system back on its feet. Thus, the bad news for Europe is that it faces several more years of potentially substandard economic growth. But the good news for the US, China, and other emerging market nations is that the economies of the Euro-Zone nations are no longer shrinking and that at least some incremental economic growth is likely in 2014.

In contrast to the Euro-zone nations, economic activity is picking up speed in the UK (Figure 9). There is a housing boom, and some inflation pressures are appearing on the horizon. The Bank of England is currently committed to low rates for an extended period of time, but that guidance could shift in 2014 as economic activity out-performs the central bank's conservative expectations.

Around the world in China, many in the market had feared a hard landing, but that has not been the case. China's new leadership is making important reforms, including relaxing the one-child policy and making it easier for rural migrants to urban centers to acquire residency permits. In addition, China has committed itself to a greater role for markets, as it shifts toward a more domestic-demand growth model and away from the state-led infrastructure spending approach of the last three decades. China looks to post real GDP growth of around 7.5% to 7.7% for 2013, and with some incremental further deceleration in 2014, possibly to 6.5% to 7.0% real GDP growth. We view this modest deceleration as the natural and healthy process of a maturing modern economy. The infra-structure spending growth model had hit the point of diminishing returns and change was coming. China's new leaders have embraced this change and we may even see a much more rapid pace of financial reforms than many westerners expect, including currency normalization, over the next few years.

Emerging market countries from Mexico, to Brazil, to India and Indonesia, have also seen growth slowdowns in the last few years. This trend for emerging market (and BRIC nations) growth deceleration is now stabilizing (Figure 10). Again, one of the under-appreciated reasons for the growth deceleration was the recession in Europe. Some analysts in the go-go growth years of emerging markets had put forth the idea that these countries could disconnect from the mature industrial countries and be their own engines of growth. This idea has been retired. Importantly though, better prospects for the US and economic stabilization in Europe are likely to provide strong support for emerging market growth at around the 5% level for 2014 and beyond.

Figure 10.



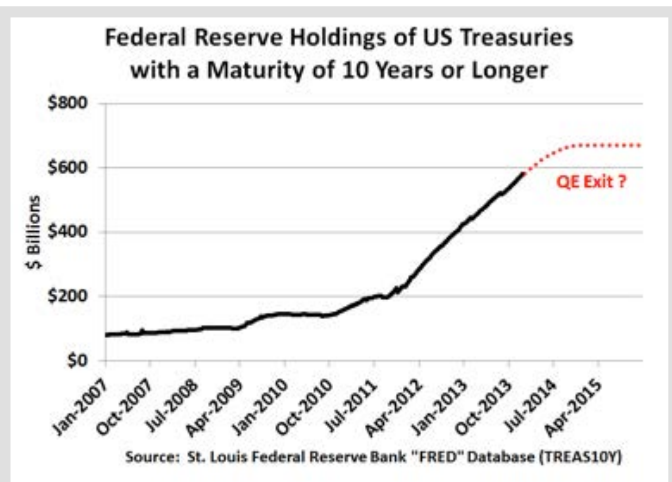
IV. Fed signaling has turned positive

The hugely positive monetary policy event that occurred at the end 2013 was the Federal Reserve's (Fed's) decision to abandon its increasingly indefensible view that the US economy needed life support and emergency measures. Technically, what the Fed decided at its December 2013 Federal Open Market Committee (FOMC) meeting was to begin to taper its emergency asset purchase program known as quantitative easing or QE. The tapering will be incremental and last most of 2014, economic conditions permitting. What matters most is the diminishing purchases of long-dated US Treasuries (Figure 11), since the near-zero target federal funds already anchors the short-end of the yield curve and mortgage-backed security purchases mainly add liquidity for housing loans, taking some of the burden off Freddie Mac and Fannie Mae yet not having much of any impact on Treasury yields.

What the equity markets heard, however, was the strikingly different tone of analysis from the Fed. The Fed had finally become positive on the economic future. Since the economic recovery began in 2010, and continuing through 2013 with strong private sector job growth, the Fed had focused on the less than robust economic growth of around 2% annualized real GDP, caused mostly by job losses at the state and local government level and fiscal cutbacks at the federal level. The Fed had been pounding away at the message that the economy was so fragile that it could easily slip back into recession and that emergency (i.e., never tried and highly experimental) monetary policy measures were justified to encourage stronger job creation – never mind that the private sector was recovering nicely and that lower bond yields were not likely to have any impact on the required rebalancing of federal, state, and local finances.

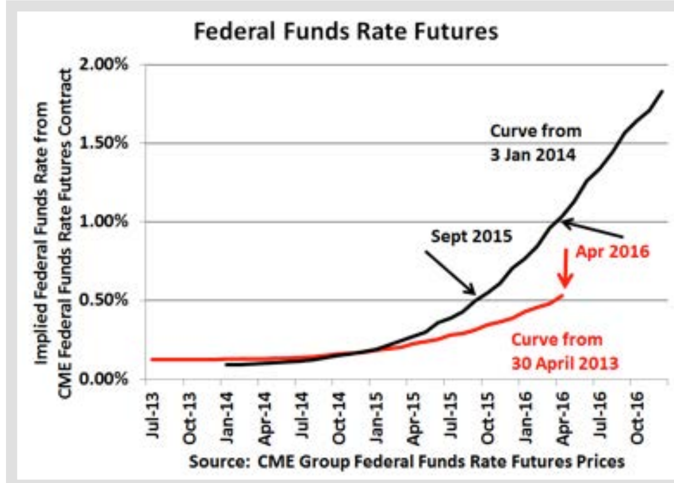
Our perspective is that the negativity of the Fed in terms of the country's potential economic performance was sorely misplaced and did considerable damage – that is, much more damage was done to expectations than any good was done by quantitative easing. Our analysis suggests QE lowered bond yields in 2012 and early 2013 by about 100 basis points, which was quickly reversed as soon as Fed Chair Bernanke initiated the QE exit debate in May 2013. We do not think QE created one net new job because (as we have previously argued) the jobs problem was with state and local governments. So, the absence of QE makes little difference for US labor markets. What really matters is that such an important and respected institution as the Fed now believes that the US economy is strong enough to stand on its own and to grow without emergency measures and life support. That is a well-deserved and overdue vote of confidence that many consumers and companies may well factor into their own longer-term decisions.

Figure 11.



We also want to point out that market participants in the federal funds futures market are generating the view that the Fed might start raising the target federal funds rate in 2015, ahead of current guidance from FOMC members. As of early in January 2014, federal funds futures showed the 0.50% (50 basis point) rate being achieved by September

Figure 12.



2015, compared to April 2016 back in early 2013 before the QE debate began (Figure 12). To get to 50 basis points for the federal funds rate, however, the Fed would have to institute open market operations (i.e., tightening procedures) to get the federal funds rate to the upper end of the current range, that is to 25 basis points. And, as we have learned from the QE decision to taper, the debate may last through several FOMC meetings, implying that the market discussion may start in the second half of 2014 if the economy stays on a positive track.

V. Energy boom continues

The US energy production boom began in 2005-2006. As of 2014, both US crude oil production and natural gas production were some 40% higher than 2005-2006 levels. Our estimates are that this energy boom has been assisting the US economy to the tune of 0.5% real GDP growth per year in the post-financial crisis period, and that this energy growth dividend will continue for 3-7 years into the future as energy infrastructure investment continues, production increases further, and US industrial companies gain a global competitive advantage from their locations close to less expensive natural gas.

The impact on US trade flows has been interesting. We have seen increased oil production lower crude oil imports (Figure 13). Increased natural gas production has been displacing coal as fuel for electrical power, and this has resulted in a doubling of coal exports since 2006 (Figure 14).

Figure 13.

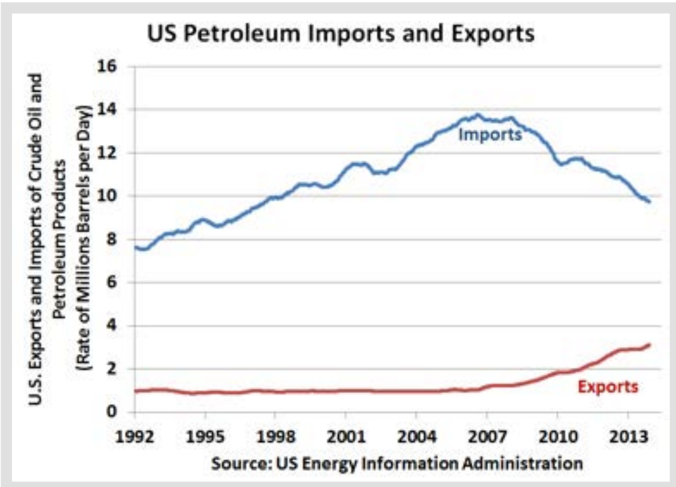
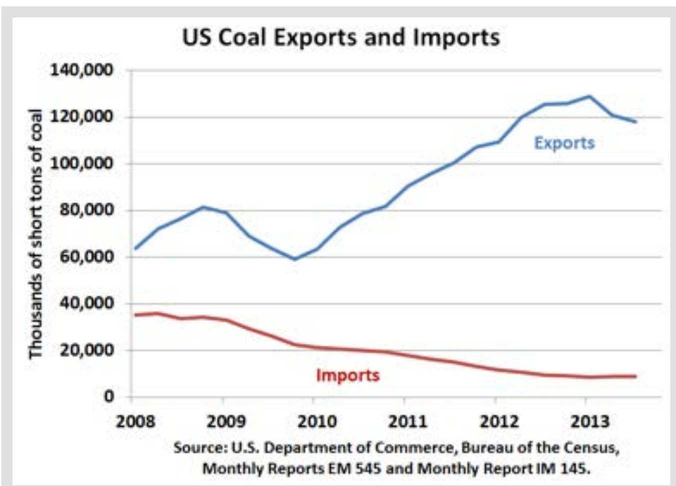


Figure 14.



VI. Risks to Robust Growth for 2014 & Market Implications

As we look back a year ago to December 2012, markets were justifiably worried the US might go off the proverbial fiscal cliff, Europe might implode, and China might face a hard landing. At the time, we disagreed with all these dire outcomes[1]. In fact, the US did not go off the fiscal cliff and the federal budget deficit now is well on the way to an operating balance by FY2015. Europe has not imploded, and instead of the euro breaking up, a new member (Latvia) just joined. The European economy has stabilized, even if stronger economic growth remains out of reach for now. And China has had a smooth transition to new leadership, achieved a soft landing, and is poised to implement meaningful market reforms. The removal of these critical drags on economic growth, a sense that the necessary and multi-year financial rebalancing after the disaster of 2008 has been largely accomplished, the fact the US federal government is on the road to fiscal stability, the more positive messaging from the Fed, and the energy revolution in the US, all point toward a strong year of economic growth.

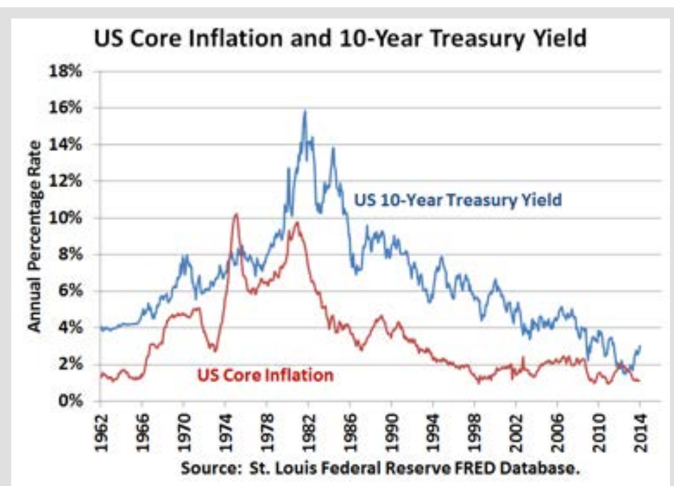
For the record, our base case projections are for 3.5% growth in US real GDP in 2014, the unemployment rate to drop to around 6.0% by year end, and core inflation to remain tame and below 2% year-on-year growth. Not a bad year, if it can be achieved. There are, however, some downside risks. Automobile sales and the housing market were both decimated in the financial panic, and more recently they have posted strong recoveries. For 2014, we expect a slowing of the growth rate for automobile sales as well as slower increases in national housing prices. These assumptions are included in our 2014 base case, but if the slowdown in auto sales growth or house prices is more dramatic, then our growth estimates could prove too high.

In addition, several risks for financial markets are embedded in this optimistic base case scenario. Most important for US bond markets are when inflation pressures might emerge. The Fed's maturity extension program of 2012, when it sold short-term securities and bought long-term US Treasuries, and the expansion of QE in 2013, which included $45 billion of US Treasury purchases a month, created a temporary period in which 10-year US Treasury yields fell slightly below observed year-over-year core inflation (Figure 15). Once the QE tapering debate began in May 2013, though, the 10-year Treasury yield to core inflation jumped back to its more typical positive spread (Figure 16). Any persistent trend toward higher bond yields will probably require the support of rising core inflation pressures. So far, core inflation pressures are completely absent.

[1] See "China: Slower Export Growth, End of the Infrastructure Boom Years" (December 2011); "US Unemployment May Dip Below 7% Before End of 2013" (February 2012); and "Euro Saved for Now; Europe Still in Recession and Debt Denial" (October 2012), all available at www.CMEGROUP.com/Putnam.

Figure 15.

Figure 16.



Our research suggests that inflation pressures from accommodative monetary policy have been delayed by the financial recession, but not denied[2]. As noted earlier in Section I's discussion of the deleveraging brought on by a financial recession, monetary policy is relatively ineffective in stimulating growth in the first stages of the recovery. This does not mean that monetary policy was not helpful in the fourth quarter of 2008 in preventing a depression; it was. But for monetary policy to gain traction, the economy must be interest-rate sensitive, and this linkage is missing during a deleveraging period. We believe the US was largely over the deleveraging phase by the end 2012 or early 2013, so as the US economy becomes more interest-rate sensitive, monetary policy with near-zero short-term rates will gain traction. If economist Milton Friedman was right about the long and variable lags in monetary policy, then it is probably appropriate to start the clock at the beginning of 2013, and thus, to expect some inflation pressures 18-24 months later – late 2014 or early 2015.

When it comes, even modest inflation pressures may trigger a change in the debate at the Fed about when to raise the target federal funds rate. This has a spillover effect into currency markets and equity markets. The US dollar (Figure 17) could come under pressure should the joint scenario of rising inflation pressures late in 2014 be coupled with a sense that the Fed will wait to see the eyes of 2.5% core inflation or higher before making a move on raising rates. For equity markets (Figure 18) there are two issues – narrowing margins and the Fed's potential removal of stimulus. A lack of inflation pressure coincides with an equally difficult time for corporations to grow top-line revenues. Without pricing power, earnings growth is driven in no small way by expense control and maintaining margins. We expect margins to come under pressure in early 2014, and for earnings growth to decelerate. Then, once inflation pressures emerge, some pricing power is regained, but this can be countered by worries over how the removal of low-rate monetary accommodation will impact the economy. These observations suggest that both equities and the US dollar are in for a much more volatile ride than one might assume from our base case scenario of healthy economic growth. The link between economic activity and equity and currency markets is quite loose, or as the old English saying goes: *"There is many a slip betwixt the cup and the lip."*

[2] "U.S. Inflation: Delayed, Not Denied" (May 2013), available at www.CMEGROUP.com/Putnam.

Figure 17.

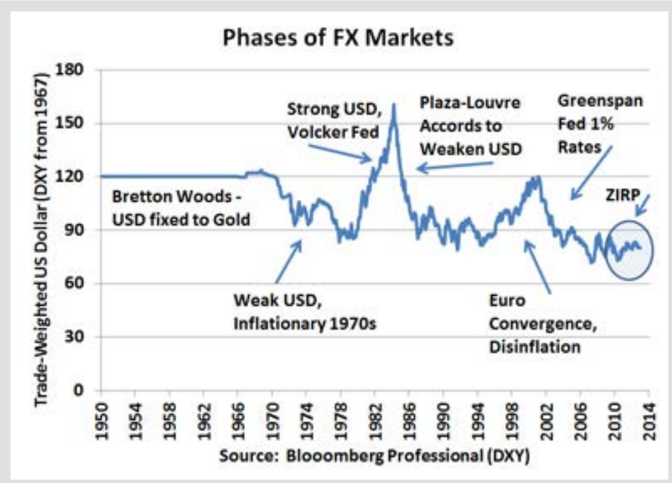


Figure 18.

Figure 19.

Figure 20.

Complications for metals markets also lie beneath the surface of our optimistic case for US growth. Gold (Figure 19) may also find itself in the crosshairs of the Fed interest rate debate. Gold typically sees price rises when inflation fears appear, but these can be negated if they are accompanied by perceptions of tighter monetary policies to come. By contrast, copper is a more pure industrial metal. As such, copper relies heavily on demand from emerging markets, especially China. The shift in China from an infrastructure building growth model to a more consumer-driven economy has not been kind to copper. Under our US and global economic scenario, though, the copper-gold relative price spread could be impacted by any debate at the Fed over inflation pressure. Since stronger US growth will support global growth, and the growth will be the trigger for worries about inflation, this logic raises the possibility of copper outperforming gold in our optimistic scenario (Figure 20).

On the energy front, infrastructure bottlenecks have led to two interesting pricing spreads. The Brent-WTI spread represents the disconnect between US and Canadian crude oil and North Sea oil pricing. The WTI-Natural Gas spread in BTU terms (natural gas is much cheaper in pure energy terms) represents a BTU gap (Figure 19) that will continue to encourage more uses for natural gas, from municipal transit systems to fertilizer plants to electrical power and more. The capital investment and building of the infrastructure may well chip away at these long-term price gaps, even as it provides meaningful benefits to the US economy.

Figure 21.

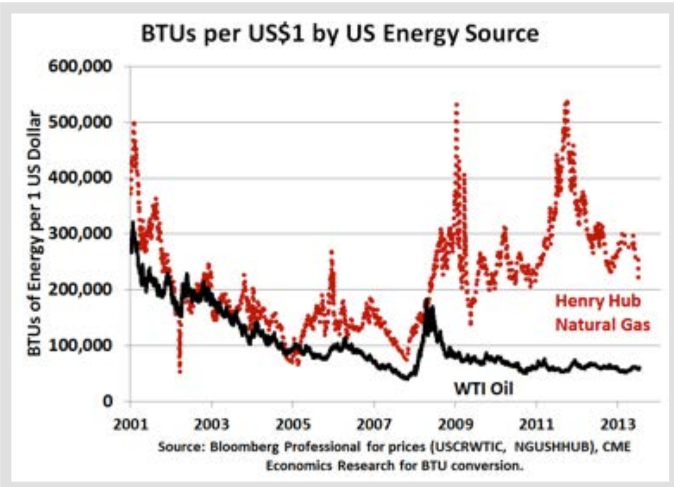
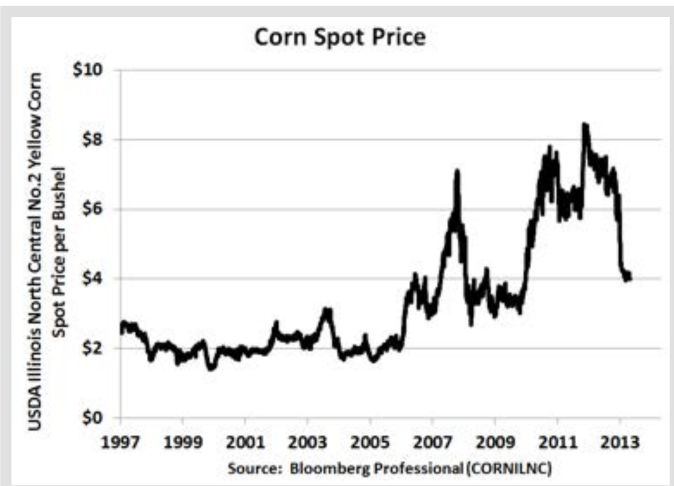


Figure 22.



The one sector not overly influenced by the US economy is the agricultural sector, where weather volatility and drought probabilities in bread-basket regions rule the markets. If there is no weather disturbance in the US or in a major growing region around the world, then even at current levels, corn prices may come under more pressure. This underscores a more general global trend that agricultural commodities, in most cases, are in reasonably good supply. This comes at a time when global crude oil prices have not materially reacted to the additional supply from North America and the downward pull of less expensive US natural gas. And in the industrial metals sector, the growth deceleration of emerging markets removed demand pressures several years ago. Thus, for now, global commodity price pressures are relatively benign.

We will be watching all these commodity prices in 2014 – not for their impact on inflation – but for signs of demand that suggest global growth may be turning stronger, supported in no small way by more robust economic activity in the US. What has been missing from the world economy is the energizing effect of synchronized growth, and with European stability and improved prospects for the US, that possibility may be on the horizon again.

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