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Monthly Economic Outlook

2013 Outlook: Life Beyond The Fiscal Cliff

- *The fiscal cliff is a major uncertainty in the economic outlook. However, we're likely to see some resolution one way or another, if not by the end of 2012, then in early 2013.*
- *With at least some fiscal tightening expected, economic growth should be slower in the first half of the year, but more robust in the second half and into 2014.*
- *Economic headwinds should ease somewhat in 2013, while tailwinds are likely pick up over time.*

The common question in recessions is "what will drive us out of the mess?" The answer is that it's rarely one particular thing. Economies recover through small improvements in a lot of things. Job growth picks up a little, fueling more spending, which, in turn, helps generate more jobs. Autos and housing, depressed in the downturn, gradually return to more normal levels. Bank lending gets easier and credit quality improves. Essentially, it's about positive feedback loops.

The 2007-09 downturn was not a typical recession. The decline in output was much deeper than usual, the worst since the Great Depression. Studies of past recessions show that recoveries from financial crises tend to be a lot more gradual. The lackluster pace of improvement over the last few years should not have been much of a surprise.

The collapse of the housing bubble was a significant loss of wealth for the household sector. During the boom, many households used their homes as ATMs. With prices moving higher, home equity expanded, fueling consumer spending. The housing correction imposed a major constraint on consumer spending growth. Many homeowners remain underwater on their mortgages, but rising home prices help lessen the drag on spending growth. Home sales and residential construction have posted double-digit percentage gains year-over-year (although such improvement is not a real stretch given the low levels of activity a year or so ago). Residential construction is a relatively small portion of Gross Domestic Product. Homebuilding should add a few tenths of a percentage point to the pace of GDP growth over the next several quarters – not a game-changer, but positive.

Motor vehicle sales fell sharply during the recession, but have gradually picked up over the last couple of years. The age of the fleet has increased. Replacement needs should continue to support vehicle sales in 2013 and beyond.

State and local government has been a major drag on the job market and GDP growth in the last few years. Normally, government provides some base level of support for the economy in a recession and early recovery. The contraction of the last few years was unusual. Recall that a third of the $800 billion fiscal stimulus package (put forth largely in the first two years of the Obama administration) was aid to the states. These funds were meant to relieve budget pressures in state and local government. As the stimulus faded into 2011, job losses in state and local government picked up. However, state and local government employment appeared to stabilize in 2012 and may turn into a mild positive contribution for growth in 2013. However, any gain from state and local government may be offset by tighter fiscal policy at the federal level.

Job destruction was massive in the recession. However, job destruction has been trending relatively low for the last few years (a cynic might argue that companies quickly ran out of people to fire). Announced layoff intentions still make headlines, but the total has continued to trend at low levels in recent months. The real issue for the labor market has been the relatively muted pace of job creation.

The lackluster pace of hiring is partly a credit story. Bank credit to small businesses was tightened sharply in late 2008. Credit to large firms recovered relatively quickly. These firms were more able to borrow from the large banks and could easily raise funds in the bond market. Credit for smaller firms has improved only gradually, and those with good credit have not necessarily wanted to take on additional financial obligations (not until they see more significant improvement in the demand for the goods and services they produce). The Affordable Care Act ("Obamacare") should not be much of a factor for very small firms and large firms, but will be a concern for many of small to mid-sized firms heading into 2014.

As it is, the pace of job growth over the last few years would not have been bad if we were at full employment. The economy has added about 150,000 jobs per month in 2011 and in 2012. With the aging of the population, the pace of payroll growth consistent with a steady unemployment rate has dropped to perhaps 110,000 per month. However, we've not made up much of the ground lost in the labor market during the downturn. Long-term unemployment levels and underemployment remain very high. New entrants to the workforce are not acquiring the skills they would normally and these individuals will tend to see lower wage incomes for decades. The long-term unemployed typically find it more difficult to find a job even as the labor market picks up.

The Federal Reserve put a greater emphasis on the labor market in 2012. Earlier in the year, the Fed announced dual policy targets: 2% inflation in the PCE Price Index and an unemployment rate of 5.2% to 6.0%. Citing concern about the labor market, the Fed launched a third asset purchase program.

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At the December policy meeting, Fed officials clarified their forward guidance on short-term interest rates. Previously, the Fed had specified a date through which exceptionally low levels of the federal funds rate would be maintained. The date was based on expectations of economic conditions and changed when the economic outlook changed. The Fed has jettisoned the date guidance in favor of economic thresholds. Short-term rates will be kept low as long as the unemployment rate remains above 6.5%, PCE Price inflation one to two years out is expected to be less than 2.5%, and inflation expectations remain well anchored. The 6.5% figure is a threshold, not a target, a guidepost, not a trigger. The Fed *"could"* begin to tighten monetary policy if the unemployment rate falls below 6.5%, according to Chairman Bernanke, but not necessarily. The 2.5% inflation threshold does not signal a change in the Fed's tolerance of inflation. Senior Fed officials expect the PCE Price Index to trend at or below the 2% target for the next few years. With its one- to two-year inflation outlook, the Fed will not respond to higher current inflation (if, for example, inflation were to be boosted temporarily by increases in food or energy prices). Bernanke noted that the threshold guidance is currently equivalent to the "mid-2015" date guidance, so this change does not signal any shift in the expected path of monetary policy. Rather, the threshold guidance should allow market participants to adjust to changes in the economic outlook. This could include factoring in a rate hike sooner if job growth is much stronger, or pushing out the potential date of tightening if the economy stumbles (and long-term interest rates would fall accordingly, helping to support growth). Very accommodative Fed policy is a key tailwind for 2013.

Corporate profits, an important driver of capital spending, remained strong in 2012. However, business fixed investment trended lower in the second half of the year.

Business investment has been pressured on two fronts. One is the slowdown in global growth. While domestic profits have continued to improve, U.S. corporate profits from the rest of the world have turned down. Exports, an important factor in the early part of the economic recovery, are no longer helping. Europe and Japan have been in what appear to be mild recessions. Austerity measures in Europe have not been helpful. While smaller deficits are a laudable long-term goal, tightening budgets in struggling recoveries is bad economic policy. Contractionary policy is contractionary. Proponents of austerity have argued that reduced budget deficits will lead to improved confidence, but it hasn't worked out that way. Confidence should return, however, once the tightening stops. Stronger economic growth would better help reduce budget deficits. That may be the case in 2013.

The U.S. faces its own issues with austerity. However, the fiscal cliff is not about the need to move to a sustainable long-term budget path. Rather, it's about doing too much too soon to reduce the deficit and the impact that would have on economic growth. The two parties appear to be far apart on issues of tax rates and entitlement reforms. However, both sides favor keeping taxes low for the middle class. A budget deal may not happen by the end of the year, but could be reached after the new Congress arrives in January. If it looks like there is some progress, Treasury Secretary Geithner could order tax withholding rates to stay low in January, so workers would not see a decrease in take-home pay. There are still some uncertainties about raising the debt ceiling, but we should get some resolution on the fiscal cliff, good or bad.

Most of the fiscal cliff is expected to be postponed, leading to a moderate drag on growth in the first half of the year. Further budget tightening will be required in the years ahead, which means it may be more of a fiscal staircase than a cliff.

	4Q11	1Q12	2Q12	3Q12	**4Q12**	**1Q13**	**2Q13**	**3Q13**	**4Q13**	2011	**2012**	**2013**	**2014**
GDP (↓ *contributions*)	4.1	2.0	1.3	2.7	**0.8**	**1.1**	**1.8**	**2.8**	**2.9**	1.8	**2.2**	**1.7**	**2.9**
consumer durables	*1.0*	*0.9*	*0.0*	*0.6*	***0.4***	***0.2***	***0.2***	***0.3***	***0.3***	*0.5*	***0.5***	***0.3***	***0.3***
nondurables & services	*0.5*	*0.9*	*1.1*	*0.3*	***0.8***	***1.1***	***1.2***	***1.4***	***1.5***	*1.3*	***0.8***	***1.0***	***1.4***
bus. fixed investment	*0.9*	*0.7*	*0.4*	*-0.2*	***0.2***	***0.4***	***0.5***	***0.8***	***0.9***	*0.8*	***0.7***	***0.4***	***0.8***
residential investment	*0.3*	*0.4*	*0.2*	*0.3*	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	*0.0*	***0.3***	***0.3***	***0.3***
government	*-0.4*	*-0.6*	*-0.1*	*0.7*	***-0.3***	***-0.3***	***-0.2***	***0.0***	***0.0***	*-0.7*	***-0.3***	***-0.1***	***0.0***
Domestic Final Sales	2.1	2.2	1.4	1.7	**1.5**	**1.7**	**2.0**	**2.8**	**2.9**	1.9	**2.0**	**1.9**	**2.9**
exports	*0.2*	*0.6*	*0.7*	*0.2*	***-0.4***	***-0.2***	***0.3***	***0.4***	***0.5***	*0.9*	***0.5***	***0.1***	***0.5***
imports	*-0.9*	*-0.5*	*-0.5*	*0.0*	***0.2***	***0.0***	***-0.4***	***-0.5***	***-0.6***	*-0.8*	***-0.5***	***-0.2***	***-0.6***
Final Sales	1.5	2.4	1.7	1.9	**1.3**	**1.4**	**1.9**	**2.7**	**2.9**	1.9	**1.9**	**1.8**	**2.8**
ch. in bus. inventories	*2.5*	*-0.4*	*-0.5*	*0.8*	***-0.5***	***-0.3***	***-0.1***	***0.0***	***0.0***	*-0.2*	***0.2***	***-0.0***	***0.0***
Unemployment, %	8.7	8.2	8.2	8.1	**7.8**	**7.7**	**7.6**	**7.4**	**7.3**	9.0	**8.1**	**7.5**	**7.0**
NF Payrolls, monthly, th.	164	226	67	168	**145**	**110**	**135**	**170**	**175**	153	**151**	**148**	**188**
Cons. Price Index (q/q)	1.3	2.5	0.8	2.3	**2.6**	**1.3**	**1.9**	**1.9**	**2.0**	3.1	**2.1**	**1.9**	**2.0**
excl. food & energy	1.9	2.1	2.6	1.5	**1.8**	**1.8**	**1.8**	**1.9**	**2.0**	1.7	**2.1**	**1.8**	**2.0**
PCE Price Index (q/q)	1.1	2.5	0.7	1.7	**2.4**	**1.6**	**1.8**	**1.8**	**1.9**	2.4	**1.8**	**1.6**	**1.9**
excl. food & energy	1.3	2.2	1.7	1.3	**1.6**	**1.7**	**1.8**	**1.8**	**1.8**	1.4	**1.7**	**1.6**	**1.9**
Fed Funds Rate, %	0.08	0.10	0.16	0.15	**0.15**	**0.15**	**0.15**	**0.16**	**0.17**	0.10	**0.14**	**0.16**	**0.20**
3-month T-Bill, (bond-eq.)	0.0	0.1	0.1	0.1	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	0.1	**0.1**	**0.1**	**0.2**
2-year Treasury Note	0.3	0.3	0.3	0.3	**0.3**	**0.3**	**0.3**	**0.4**	**0.5**	0.5	**0.3**	**0.4**	**0.9**
10-year Treasury Note	2.0	2.0	1.8	1.6	**1.7**	**1.6**	**1.7**	**1.8**	**2.0**	2.8	**1.8**	**1.8**	**2.2**

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