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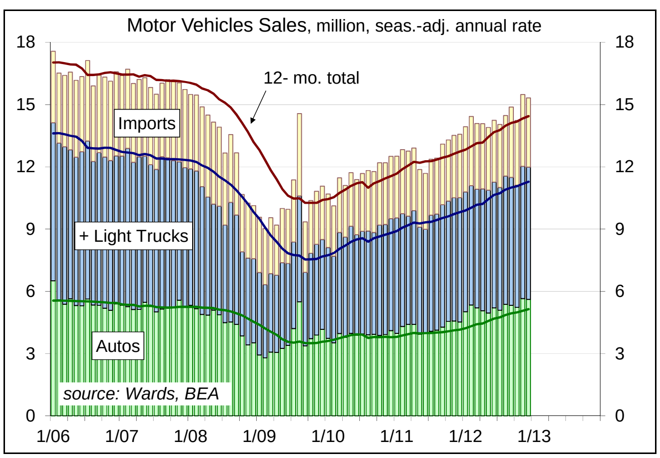
Monthly Economic Outlook

Beyond the Cliff and Through the Ceiling

- *Congress avoided most of the fiscal policy restraint in the fiscal cliff, but failed to prevent a rise in the payroll tax, did little to reduce the long-term federal budget deficit, and did not address the federal debt ceiling.*
- *One way or another, the debt ceiling will be raised, leaving investors to focus on the fundamentals of the economic recovery.*
- *The rise in payroll taxes will dampen consumer spending growth to some extent and cuts in federal spending should restrain overall output in the first half of the year. However, headwinds are expected to continue to fade and tailwinds should pick up in the second half of the year and into 2014.*

Congress reached a budget agreement in the early hours of the new year. The American Taxpayer Relief Act (ATRA) raised tax rates for upper-income households, but made most of the Bush-era tax cuts permanent. However, ATRA did not prevent a two percentage point increase in the portion of payroll taxes paid by individuals (the rate went from 4.2% to 6.2%). For an individual making $60,000 per year, that amounts to $100 per month less in take-home pay. Most consumers were unaware that payroll taxes had been cut over the last two years (it was not well advertised). However, they will miss the tax cut when it's gone. Average hourly earnings rose 2.1% over the 12 months ending in December. Inflation was a little less than 2%. Hence, the payroll tax increase will lower inflation-adjusted wages in the near term, dampening the pace of consumer spending growth. However, once consumer spending adjusts to the drop in disposable income, it should return to a relatively robust pace of growth in the second half of the year.



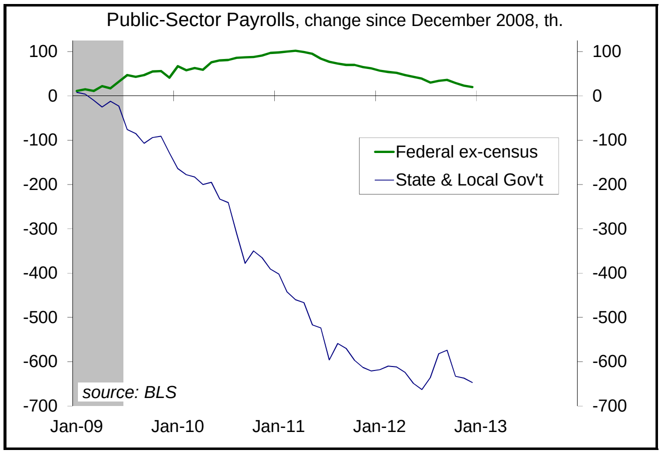
The economic outlook is often judged as an assessment of the various forces acting on it. The economy has faced a number of headwinds over the last few years, most of which have been fading. Most notably, the drop in housing wealth was a major restraint on consumer spending. During the housing boom, many homeowners used their houses as ATMs. The extraction of home equity went largely toward home improvements, but also helped fuel vacations, sales of motor vehicles, and other types of consumer spending. Amid the housing collapse, much of this spending evaporated. The household sector shifted from extracting home equity to paying down housing debt. In a typically recession, consumers postpone buying new homes and motor vehicles, and these areas typically recovery quickly once the recession ends. However, following the housing collapse, repairs to household balance sheets were expected to take some time. Housing and autos were not going to recover quickly. At present, balance sheet repair still appears to be undergoing, but most of the adjustments are behind us.

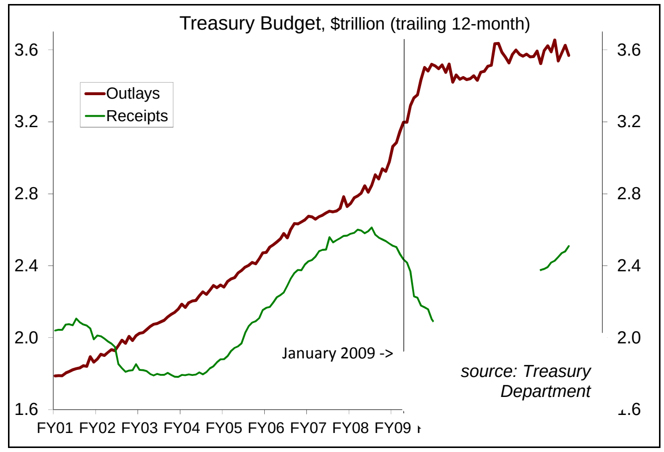
Autos have a limited lifespan. Households can delay the purchase of a motor vehicle, a phenomenon apparent during the recession, but they'll eventually need a replacement. Replacement needs have been a key factor behind the improving trend in vehicle sales over the last couple of years and should continue to provide support for several quarters.

The housing sector has improved over the last several quarters. Home sales have picked up in most areas of the country. Prices have firmed. Many homeowners remain underwater on their mortgages, but further price increases will help relieve some of the strains. Residential construction activity is not a large portion of the overall economy, normally accounting for about 4% of Gross Domestic Product, but homebuilding is likely to add a few tenths of a percentage point to GDP growth – not much of a game-changer by itself, but a welcome development nonetheless.

The increase in payroll taxes will limit the ability of some households to put together a down payment for a car or home. We may see some restraint in these areas in the first half of the year, but momentum should pick up again in the second half.

The contraction in state and local government was another prominent (but under-reported) headwind in the last few years. During the economic downturn, budget pressures intensified as revenues fell. About a third of stimulus in the $800 billion American Recovery and Reinvestment Act of 2009 was aid to the states, which helped offset some of the budget pressures, but not entirely. Severe budget strains remained as the fiscal stimulus faded in late 2010 and government job losses accelerated sharply in 2011. Tax receipts have been slow to recover, but are improving in most states. State and local government should no longer be a drag on the overall economy and may add slightly in coming quarters.





More than 600,000 state and local government jobs were lost in the last few years. Annual benchmark revisions (due in a few weeks) are likely to boost that figure somewhat. Data over the last several months may have been distorted due to the seasonal adjustment (that is, difficulties in adjusting for job gains and losses associated with the school year), but the underlying trend appears to have slowed in 2012.

Much of the focus on government spending is on federal spending, but it's worth noting that employment in state and local government is about seven times the size of employment at the federal level. Federal government payrolls have been trending gradually lower over the last couple of years (largely reflecting a contraction in the U.S. Postal Service) and are up only 20,000 since Obama took office.

The recent budget agreement pushed the sequestration out to March 1. Recall that the sequester (large spending cuts) was a result of the failure of lawmakers to agree to a long-term plan to reduce the deficit. About half of the scheduled spending cuts will be in defense.

The federal government faces three major issues over the next few months. Spending cuts ($1.2 trillion over nine years) are set to begin on March 1, cutting $85 billion from spending in the final six months of FY13. The debt ceiling will have to be raised (Treasury reported that the ceiling was hit on December 31, but the "drop dead" date is expected some time between February 15 and March 1). The current Continuing Resolution to authorize government spending ends March 31.

Large spending cuts would have a negative impact on economic growth this year. However, it's unclear whether Congress will act to further delay the cuts. It's easy to talk about cutting spending in general, but difficult to specify what to cut. As part of an agreement to raise the debt ceiling, Republicans want reductions in entitlement spending. The White House says it will not negotiate.

Political bickering is likely to have some day-to-day impact on the financial markets, but the upcoming mini-cliff will be resolved one way or another. The economy will face restraints in the first half, but growth should pick up in the second half.

	1Q12	2Q12	3Q12	4Q12	**1Q13**	**2Q13**	**3Q13**	**4Q13**	**1Q14**	**2Q14**	2012	**2013**	**2013**
GDP (↓ *contributions*)	2.0	1.3	3.1	**1.4**	**1.4**	**1.6**	**2.8**	**2.9**	**2.9**	**3.0**	**2.3**	**1.9**	**2.8**
consumer durables	*0.9*	*0.0*	*0.7*	***0.8***	***0.2***	***0.2***	***0.3***	***0.3***	***0.3***	***0.3***	***0.6***	***0.4***	***0.3***
nondurables & services	*0.9*	*1.1*	*0.5*	***0.8***	***0.6***	***0.6***	***1.4***	***1.5***	***1.5***	***1.5***	***0.8***	***0.8***	***1.4***
bus. fixed investment	*0.7*	*0.4*	*-0.2*	***0.4***	***0.6***	***0.5***	***0.7***	***0.9***	***0.9***	***0.9***	***0.7***	***0.5***	***0.8***
residential investment	*0.4*	*0.2*	*0.3*	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***
government	*-0.6*	*-0.1*	*0.8*	***-0.3***	***0.1***	***-0.4***	***-0.2***	***-0.1***	***0.0***	***0.0***	***-0.3***	***0.0***	***0.0***
Domestic Final Sales	2.2	1.4	1.9	**2.0**	**1.7**	**1.2**	**2.6**	**2.9**	**3.0**	**3.0**	**2.0**	**1.9**	**2.8**
exports	*0.6*	*0.7*	*0.3*	***-0.4***	***-0.2***	***0.2***	***0.4***	***0.4***	***0.5***	***0.6***	***0.5***	***0.1***	***0.5***
imports	*-0.5*	*-0.5*	*0.1*	***0.2***	***0.2***	***0.4***	***-0.2***	***-0.5***	***-0.6***	***-0.6***	***-0.5***	***0.1***	***-0.5***
Final Sales	2.4	1.7	2.4	**1.8**	**1.7**	**1.8**	**2.7**	**2.8**	**2.9**	**2.9**	**2.0**	**1.7**	**2.7**
ch. in bus. inventories	*-0.4*	*-0.5*	*0.7*	***-0.4***	***-0.3***	***-0.2***	***0.0***	***0.0***	***0.0***	***0.1***	***0.2***	***-0.1***	***0.0***
Unemployment, %	8.2	8.2	8.0	7.8	**7.9**	**7.8**	**7.6**	**7.5**	**7.3**	**7.2**	8.1	**7.7**	**7.2**
NF Payrolls, monthly, th.	226	67	168	151	**100**	**115**	**150**	**175**	**185**	**190**	153	**135**	**190**
Cons. Price Index (q/q)	2.5	0.8	2.3	**2.1**	**0.9**	**1.9**	**1.9**	**2.0**	**2.0**	**2.0**	**2.1**	**1.7**	**2.0**
excl. food & energy	2.1	2.6	1.5	**1.7**	**1.6**	**1.8**	**1.9**	**2.0**	**2.0**	**2.0**	**2.1**	**1.8**	**2.0**
PCE Price Index (q/q)	2.5	0.7	1.6	**1.4**	**1.1**	**1.8**	**1.8**	**1.9**	**1.9**	**1.9**	**1.7**	**1.5**	**1.9**
excl. food & energy	2.2	1.7	1.1	**1.0**	**1.5**	**1.7**	**1.8**	**1.8**	**1.9**	**1.9**	**1.7**	**1.5**	**1.8**
Fed Funds Rate, %	0.10	0.16	0.15	0.16	**0.15**	**0.15**	**0.16**	**0.17**	**0.18**	**0.19**	0.14	**0.16**	**0.20**
3-month T-Bill, (bond-eq.)	0.1	0.1	0.1	0.1	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	0.1	**0.1**	**0.2**
2-year Treasury Note	0.3	0.3	0.3	0.3	**0.3**	**0.3**	**0.4**	**0.5**	**0.7**	**0.8**	0.3	**0.4**	**0.9**
10-year Treasury Note	2.0	1.8	1.6	1.7	**1.7**	**1.7**	**1.8**	**2.0**	**2.1**	**2.2**	1.8	**1.8**	**2.2**

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