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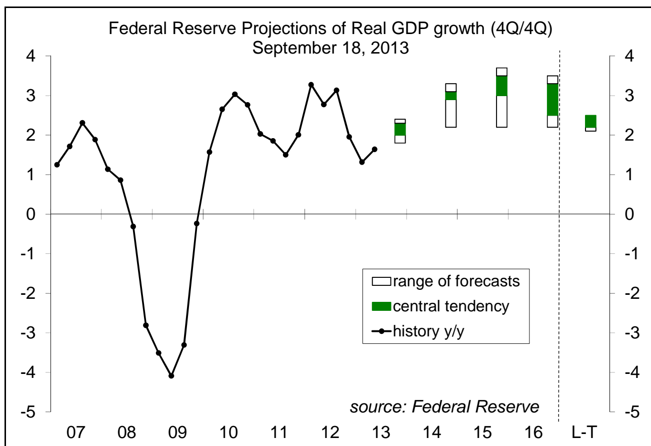
**Monthly Economic Outlook**

## The Fed Buys Itself Some Time

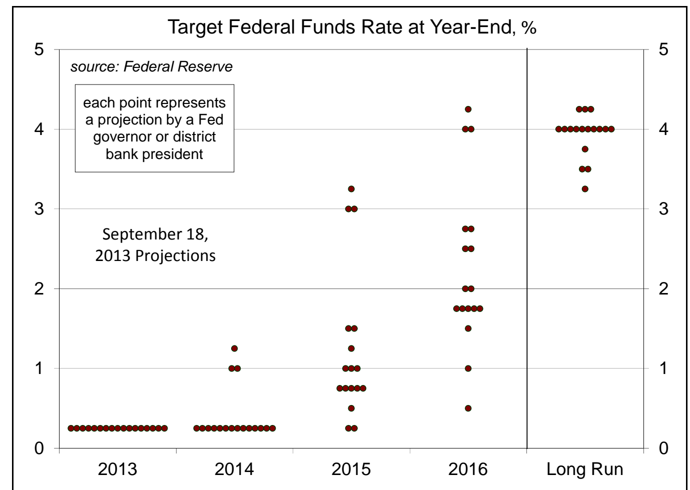
- Recent economic data reports have remained mixed, but have been consistent with moderate growth in 2H13.
- While the economic outlook has evolved broadly in line with earlier expectations, Federal Reserve policymakers *"decided to await more evidence that progress will be sustained before adjusting the pace of its asset purchases."*
- Fed officials were concerned about *"the rapid tightening"* in financial conditions in recent months and saw upcoming fiscal policy debates as a downside risk to growth.

In its September 18 monetary policy statement, the Federal Open Market Committee noted that *"economic activity has been expanding at a moderate pace."* The improvement in economic activity and labor market conditions since it began its asset purchase program a year ago was viewed as *"consistent with growing underlying strength in the broader economy."* However, the FOMC decided to delay the start of tapering. In his press briefing after the policy meeting, Fed Chairman Bernanke cited worry that the rapid tightening of financial conditions could slow growth, *"a concern that would be exacerbated if conditions tightened further."* Bernanke noted the uncertain impact of tighter fiscal policy and indicated that upcoming fiscal debates *"may involve additional risks to financial markets and the broader economy."*




The reaction in the financial markets to the Fed's talk of tapering, as well as the decision to delay, is puzzling. The Fed's view had been that it is the total size of assets purchased that matters, not the monthly pace. It should make little difference if it begins to reduce the pace of asset purchases in September, or December, or in early 2014. The Fed's forward guidance on short-term interest rates would prevent long-term interest rates from rising too rapidly and provide important support to the economic recovery. However, the markets believe that tapering matters, therefore it *does* matter.

It was widely anticipated that the Fed would decide to begin tapering at the September policy meeting. However, that was not a universal expectation. The FOMC likely saw a risk of a further increase in long-term rates if it chose to taper. Delay allows policymakers to better judge the impact of the run-up in long-term interest rates and to see how negotiations over the federal budget and debt ceiling will turn out.




The Fed's asset purchase program (QE3) was never meant to be indefinite. The goal was to impart the economy with some momentum, with a focus on improving labor market conditions. Once the labor market picked up sufficiently, asset purchases would be scaled back and eventually completed, at which point the forward guidance on the federal funds target rate would continue to provide support for the economy. Most Fed officials do not expect the overnight lending rate to be raised until sometime in 2015 – and most expect that this rate will still be well below normal levels at the end of 2016.

The range of labor market data suggests improvement. Nonfarm payrolls were reported to have risen by 169,000 in the initial estimate for August, a bit slower trend in recent months than was seen over the last year or two, but still moderately strong. The unemployment rate fell to 7.3% last month (vs. 8.1% in August 2012), due mostly to lower labor force participation. However, most of the decline in the unemployment rate over the last year has been due to job growth. The drop in labor force participation over the last year appears to be consistent with the longer-term demographic trend (related to the aging of the population). Initial claims for unemployment benefits, while recently distorted by a computer system change in California, have been trending lower. Surveys of hiring intentions have gradually picked up. The sequester spending cuts appear to have had some impact on the pace of job growth over the last few months.

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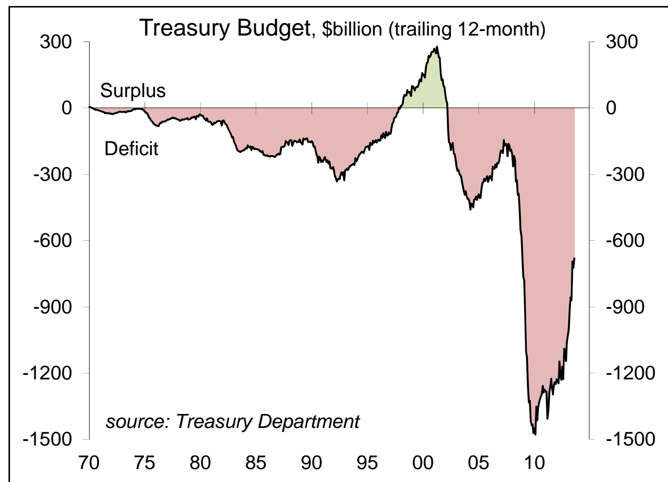
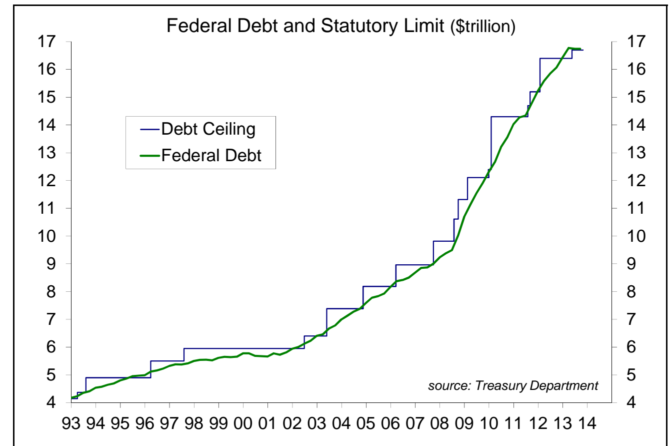
The government's spending authority will expire at the end of this month. Most likely, Congress will come up with a series of short-term Continuing Resolutions to fund the government, while lawmakers continue to work out their differences on spending priorities. There is some risk of a government shutdown, as some lawmakers don't want to fund the Affordable Care Act ("Obamacare"). Note that the federal budget deficit is falling rapidly as recession-related spending slows and tax revenues continue to recover. The deficit for the full fiscal year (ending September) should be less than 4% of GDP (vs. 9.8% in FY09). This will be the second year in a row that federal spending has declined. In fact, spending is now lower than it was projected to be in mid-2008.




The bigger fiscal hurdle, and the greater risk for the financial markets, is the debt ceiling. Treasury has indicated that it will not be able to borrow beyond mid-October. A failure in negotiations to raise the debt ceiling would lead to a default on government debt and a potential financial crisis.




In the last couple of years, Washington has focused on reducing the budget deficit in the short term, which has restrained the pace of economic growth. However, the problem with the deficit is long term, and lawmakers have actually worsened that outlook. As a percentage of GDP, the federal budget deficit is expected to fall further in the next few years, but will start rising again toward the end of the decade. Nondefense discretionary spending should continue to shrink. Interest expenses will rise as interest rates normalize over the next several years, accounting for most of the federal budget deficit in the years ahead. Entitlements are the biggest concern, with most of the strain coming from Medicare (which faces a combination of demographic pressures and healthcare cost inflation). There's plenty of time to work things out, but nobody gets re-elected on what they do for the long term.

Economic growth should pick in the remainder of the year and into 2014, as headwinds continue to fade. However, it's still going to be a long way to a full recovery and growth may be subject to downside risks – especially from Washington.

| | 3Q12 | 4Q12 | 1Q13 | 2Q13 | **3Q13** | **4Q13** | **1Q14** | ***2Q14*** | ***3Q14*** | ***4Q14*** | 2012 | **2013** | **2014** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP (↓ *contributions*) | 2.8 | 0.1 | 1.1 | 2.5 | **2.0** | **2.6** | **2.7** | ***2.8*** | ***2.9*** | ***2.9*** | 2.8 | **1.6** | **2.7** |
| *consumer durables* | *0.6* | *0.7* | *0.4* | *0.5* | ***0.4*** | ***0.3*** | ***0.3*** | ***0.3*** | ***0.3*** | ***0.3*** | *0.5* | ***0.5*** | ***0.3*** |
| *nondurables & services* | *0.6* | *0.4* | *1.1* | *0.8* | ***1.3*** | ***1.4*** | ***1.5*** | ***1.5*** | ***1.5*** | ***1.5*** | *1.0* | ***0.9*** | ***1.4*** |
| *bus. fixed investment* | *0.0* | *1.1* | *-0.6* | *0.5* | ***0.4*** | ***0.7*** | ***0.8*** | ***0.8*** | ***0.8*** | ***0.8*** | *0.8* | ***0.3*** | ***0.7*** |
| *residential investment* | *0.4* | *0.5* | *0.3* | *0.4* | ***0.4*** | ***0.4*** | ***0.3*** | ***0.3*** | ***0.3*** | ***0.3*** | *0.3* | ***0.4*** | ***0.3*** |
| *government* | *0.7* | *-1.3* | *-0.8* | *-0.2* | ***-0.1*** | ***-0.1*** | ***-0.1*** | ***0.0*** | ***0.0*** | ***0.1*** | *-0.2* | ***-0.4*** | ***-0.1*** |
| Domestic Final Sales | 2.2 | 1.4 | 0.5 | 1.9 | **2.4** | **2.7** | **2.8** | ***2.9*** | ***3.0*** | ***3.0*** | 2.5 | **1.6** | **2.7** |
| *exports* | *0.1* | *0.2* | *-0.2* | *1.1* | ***0.2*** | ***0.4*** | ***0.5*** | ***0.5*** | ***0.6*** | ***0.6*** | *0.5* | ***0.3*** | ***0.5*** |
| *imports* | *-0.1* | *0.5* | *-0.1* | *-1.1* | ***-0.3*** | ***-0.5*** | ***-0.6*** | ***-0.6*** | ***-0.7*** | ***-0.7*** | *-0.4* | ***-0.2*** | ***-0.6*** |
| Final Sales | 2.2 | 2.2 | 0.2 | 1.9 | **2.3** | **2.6** | **2.7** | ***2.8*** | ***2.9*** | ***2.9*** | 2.4 | **1.5** | **2.6** |
| *ch. in bus. inventories* | *0.6* | *-2.0* | *0.9* | *0.6* | ***-0.3*** | ***0.1*** | ***0.0*** | ***0.0*** | ***0.0*** | ***0.0*** | *0.2* | ***-0.1*** | ***0.0*** |
| Unemployment, % | 8.0 | 7.8 | 7.7 | 7.5 | **7.3** | **7.2** | **7.0** | ***6.9*** | ***6.8*** | ***6.7*** | 8.1 | **7.4** | **6.9** |
| NF Payrolls, monthly, th. | 152 | 209 | 207 | 182 | **155** | **180** | **190** | ***200*** | ***200*** | ***210*** | 183 | **181** | **200** |
| Cons. Price Index (q/q) | 2.1 | 2.2 | 1.4 | 0.0 | **2.6** | **1.8** | **1.9** | ***1.9*** | ***1.9*** | ***2.0*** | 2.1 | **1.5** | **1.9** |
| excl. food & energy | 1.6 | 1.7 | 2.1 | 1.4 | **1.8** | **1.7** | **1.8** | ***1.8*** | ***1.8*** | ***1.9*** | 2.1 | **1.8** | **1.8** |
| PCE Price Index (q/q) | 1.7 | 1.6 | 1.1 | 0.0 | **2.0** | **1.6** | **1.8** | ***1.8*** | ***1.8*** | ***1.9*** | 1.8 | **1.2** | **1.7** |
| excl. food & energy | 1.4 | 1.3 | 1.4 | 0.8 | **1.6** | **1.6** | **1.6** | ***1.7*** | ***1.7*** | ***1.7*** | 1.8 | **1.3** | **1.6** |
| Fed Funds Rate, % | 0.15 | 0.16 | 0.14 | 0.12 | **0.09** | **0.10** | **0.12** | ***0.16*** | ***0.20*** | ***0.22*** | 0.14 | **0.11** | **0.18** |
| 3-month T-Bill, (bond-eq.) | 0.1 | 0.1 | 0.1 | 0.1 | **0.0** | **0.1** | **0.1** | ***0.1*** | ***0.2*** | ***0.2*** | 0.1 | **0.1** | **0.1** |
| 2-year Treasury Note | 0.3 | 0.3 | 0.3 | 0.3 | **0.4** | **0.4** | **0.5** | ***0.7*** | ***0.9*** | ***1.1*** | 0.3 | **0.3** | **0.8** |
| 10-year Treasury Note | 1.6 | 1.7 | 2.0 | 2.0 | **2.7** | **2.8** | **3.0** | ***3.1*** | ***3.2*** | ***3.5*** | 1.8 | **2.4** | **3.2** |

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