Dutta's Weekly Economic Digest

RENMAC
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A tale of two cities

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Review: At the mercy of incoming data

The recent period has been challenging for economists. There have been a series of positive and negative shocks, complicating the outlook. As a result, forecasters are at the mercy of incoming data. And, the latest add-up points to just 1% GDP growth.

Macro Mantra: A tale of two cities

We recently argued that 2013 would be a tale of two cities with growth weak in the first half, but significantly stronger in the second. We've spilled enough ink on the former. So, here we will focus on the latter.

Data Preview: Sandy shaves payrolls

November's employment report is released tomorrow. The aftermath of Hurricane Sandy has kept workers from their jobs, putting downward pressure on the payroll number. For a worker to be counted, they must be on the job. An early Thanksgiving may provide some positive offset. Still, we expect payrolls to advance by just 50,000 with the jobless rate rising to 8.0%. Next week, we expect the Fed to announce a continuation of long-dated Treasury purchases totaling $85bn per month as Operation Twist winds down.

The week ahead: December 7 to 14

Date	Time	Event	Period	Survey	RM Estimate	Prior
12/07/2012	**08:30**	**Change in Nonfarm Payrolls**	**Nov**	**86K**	**50K**	**171K**
12/07/2012	08:30	Change in Private Payrolls	Nov	90K	60K	184K
12/07/2012	08:30	Unemployment Rate	Nov	7.9%	8.0%	7.9%
12/07/2012	08:30	Avg Hourly Earning MOM All Emp	Nov	0.2%	0.2%	0.0%
12/07/2012	08:30	Avg Weekly Hours All Employees	Nov	34.4	34.4	34.4
12/07/2012	09:55	U. of Michigan Confidence	Dec P	82	81.5	82.7
12/07/2012	15:00	Consumer Credit	Oct	$10B	--	$11.365B
12/11/2012	08:30	Trade Balance	Oct	-$42.0B	--	-$41.5B
12/11/2012	10:00	Wholesale Inventories	Oct	0.4%	--	1.1%
12/12/2012	08:30	Import Price Index (MoM)	Nov	-0.5%	-0.6%	0.5%
12/12/2012	**12:30**	**FOMC Rate Decision**	**12-Dec**			
12/13/2012	**08:30**	**Advance Retail Sales**	**Nov**	**0.3%**	**0.4%**	**-0.3%**
12/13/2012	08:30	Retail Sales Less Autos	Nov	0.0%	-0.1%	0.0%
12/13/2012	08:30	Producer Price Index (MoM)	Nov	-0.5%	-0.5%	-0.2%
12/13/2012	08:30	PPI Ex Food & Energy (MoM)	Nov	0.2%	0.2%	-0.2%
12/13/2012	08:30	Initial Jobless Claims	8-Dec		365K	370K
12/14/2012	08:30	Consumer Price Index (MoM)	Nov	-0.2%	-0.2%	0.1%
12/14/2012	08:30	CPI Ex Food & Energy (MoM)	Nov	0.2%	0.1%	0.2%
12/14/2012	09:15	Industrial Production	Nov	0.3%	0.2%	-0.4%
12/14/2012	09:15	Capacity Utilization	Nov	78.0%	77.8%	77.8%

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Macro Mantra

A tale of two cities

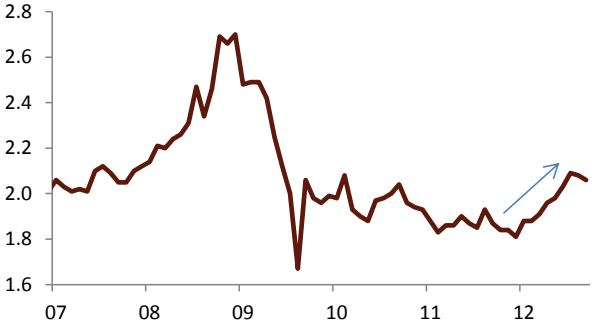
- **Review:** The recent period has been challenging for economists. There have been a series of positive and negative shocks, complicating the outlook. As a result, forecasters are at the mercy of incoming data. And, the latest add-up points to just 1% GDP growth.

- **Macro Mantra:** We recently argued that 2013 would be a tale of two cities with growth weak in the first half, but significantly stronger in the second. We've spilled enough ink on the former. So, here we will focus on the latter.

Table 1: Assumptions and conclusions

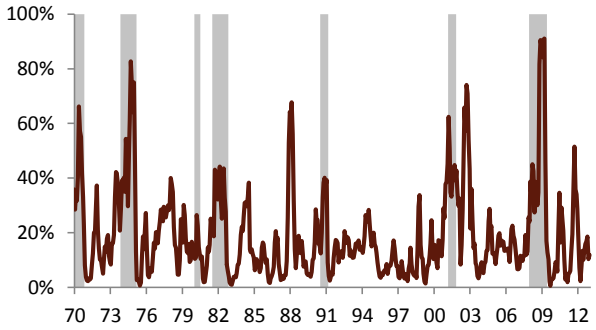
Real Economic Activity (SAAR %)	Baseline	Tracking
Real GDP	1.5	**1.0**
% Change, Year Ago	1.8	**1.7**
Consumption	1.6	**1.2**
Structures	-1.0	**1.5**
Equipment and Software	-0.5	**3.0**
Residential Investment	13.5	**18.0**
Inventory Accumulation ($)	65.3	**46.3**
Net Exports ($)	-394.9	**-392.6**
Exports	3.0	**3.5**
Imports	1.0	**1.0**
Government	-1.5	**-1.5**

Chart 1: Auto industry losing steam
I/S ratio: Retail motor vehicle and parts dealers



Source: Census Bureau, Renaissance Macro Research

Chart 2: Equities underestimating the downside
Recession probability: Six-month change in S&P 500



Shaded region represents period of US recession
Source: Renaissance Macro Research

Review: At the mercy of incoming data

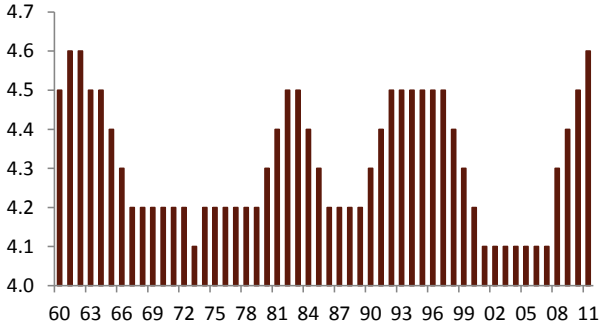
The recent period has been a challenging one for economists. Drought conditions were thought to shave growth through a decline in farm inventories and hit to incomes from higher food prices. Sales of Apple's iPhone 5 were initially thought to boost growth by up to half a percentage point in Q4. The Call of Duty II video game, as another example, is estimated to have registered $1 billion in sales within two weeks of its November release date. Hurricane Sandy tossed another wrench into the engine, recently prompting some forecasters to slice estimates anywhere from 0.3 to 0.5ppt. Finally, it is difficult to precisely quantify the early impact of the fiscal cliff. Which businesses will pull back investment? Which consumers will cut back in anticipation of higher taxes?

As a result, forecasters are at the mercy of incoming data. Most of us have a baseline view and a tracking estimate, an expenditure add-up model of GDP. Current tracking estimates point to anemic growth, near-1% annualized in Q4 against a baseline of 1.5%. Some institutions see growth even weaker than 1%. Table 1 summarizes our results. Residential and business investment has been somewhat stronger. But, the principal cause of the weakness is a slowing in consumer spending. We suspect the holiday season will not be nearly as strong as indicated by initial press reports. In addition, inventories may shave as much as 1ppt off growth as they are drawn down. Auto inventories look particularly bloated, potentially weighing on industry profitability next year (Chart 1).

Stock market underestimating near-term downside risks

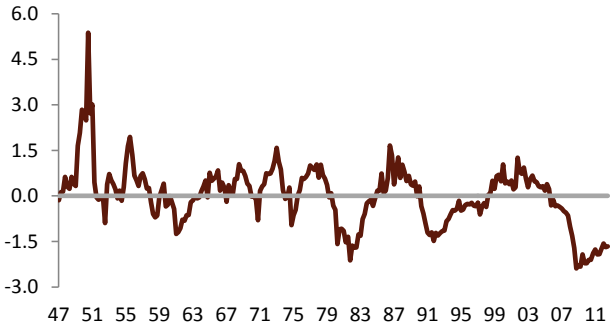
This leaves us scratching our heads at the current equity market price action. The S&P 500 is up just under 1% over the last three months and up 11% over the last six months. Our probit model indicates that the equity market is discounting just a 12% chance of recession (Chart 2). That is below the longer-term historical average, which seems too upbeat relative to the recent trajectory in the economy.

Chart 3: Getting old
Average age: consumer durable goods (years)



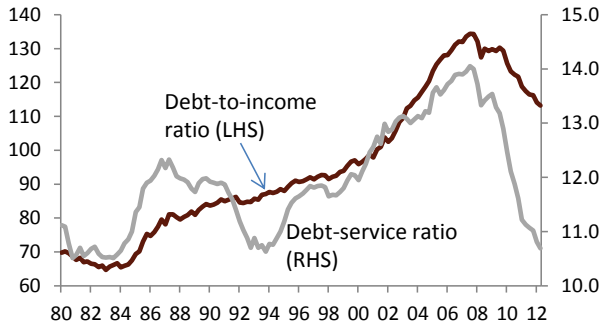
Source: Bureau of Economic Analysis, Renaissance Macro Research

Chart 4: Cyclical consumer upside
Durable goods consumption as a share of GDP (z-score)



Source: Renaissance Macro Research, Bureau of Economic Analysis

Chart 5: Household balance sheets improving
(percent)



Source: Haver Analytics, Renaissance Macro Research

One explanation is that the global economy is showing signs of stabilizing. While Europe's economy remains in recession, the ECB has been successful in arresting the negative feedback loop from the financial markets to the economy. Bond spreads across peripheral nations have dropped relative to benchmark German bunds. In Asia, trade momentum has accelerated across key nations. The other explanation, which we find more compelling, is that equity investors are paying less attention to present fundamentals and more on the prospects for a deal around the year-end fiscal cliff.

Back and forth gyrations on the prospect for a deal miss the broader story over what the deal actually entails. We are confident that disaster is averted before year-end, but skeptical that pain will be averted next year. That is, even under a benign scenario, there is a possibility that policymakers agree to some fiscal tightening. Thus, the risk to the equity market builds as investors pivot from the binary outcome, deal or no deal, to the details. The soft growth in the economy implies that even modest fiscal tightening will present challenges to the economy and corporate revenues early next year.

Macro Mantra: A tale of two cities

Now is the time of year when research outfits across the major sell-side institutions unveil their year-ahead publications. Globally, the political dysfunction in the US has usurped Europe as the principal macro concern. In the US specifically, we recently argued that 2013 would be a tale of two cities with growth weak in the first half, but significantly stronger in the second. We've spilled enough ink on the former. So, here we will focus on the latter, starting with the cyclical dynamics.

Nothing but cyclical upside to the US economy

By a normal business cycle framework, there is nothing but cyclical upside to the US economy. This extends beyond residential investment (housing), which has been already well documented. Cyclical components of GDP including durable goods consumption and business investment remain well below long-run averages. Businesses have put off investment and consumers have pared down debt, delaying spending. Profits are running well ahead of investment, indicating the capacity to expand. The average age of consumer durable goods is running close to five years, the highest since the 1960s (Chart 3). Sure, consumer durables are of higher quality today, but durable goods consumption remains roughly 1.5 standard deviations below normal (Chart 4). With household finances improving, consumers are increasingly likely to commit to big ticket purchases.

The importance of the US deleveraging story lies in the sequence and timing. As interest rates have been lowered and debt removed from household balance sheets, debt burdens have declined (Chart 5). Debt-service burdens are likely to continue their descent. Current mortgage rates remain below the rate of mortgages outstanding, indicating future

refinancing activity. Still, with the corporate sector cautious and unwilling to draw down its high rate of saving – taking on the other end of the household deleveraging trade – the federal government stepped up to the plate, running a budget deficit. None of this is to say that household deleveraging is over, consumers still have more work to do in rebuilding assets, but the deleveraging process is unlikely to accelerate. With the private economy healing, the US economy is better positioned to absorb a modest fiscal drag in coming years. By contrast, in Europe, the public and private sectors delevered simultaneously.

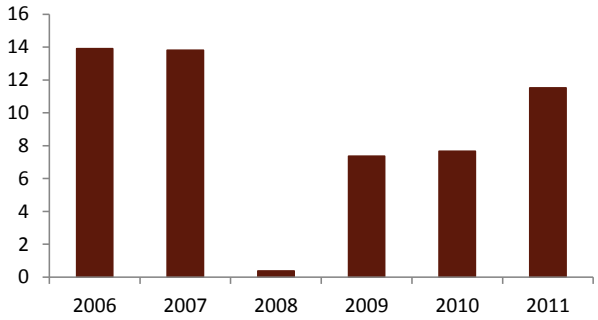
Chart 6: The dollar is more competitive
Trade-weighted US dollar (March 73 = 100)

Source: Renaissance Macro Research, Federal Reserve Board

In addition to Europe's ongoing recession, we believe an important factor holding back economic activity is a lack of corporate confidence. The first paragraph of the latest Beige Book report, an anecdotal survey of firms across the 12 Fed Districts concluded, "Contacts in a number of Districts expressed concern and uncertainty about the federal budget, especially the fiscal cliff." Once the cliff is resolved, we would some of pent-up investment demand to be released. Our second-half optimism rests of the assumption that policymakers are able to forge a credible multi-year deficit reduction deal. Thus, the shock from fiscal policy begins to dissipate and business confidence begins to improve.

The structural dynamics for stronger US growth have already been well established. The US dollar is becoming increasingly competitive; the trade-weighted dollar has declined roughly 30% since its peak in 2002 (Chart 6). A weaker dollar makes US companies more competitive, boosts exports, and stimulates import substitution industries. Foreigners see the US as low-cost production center and tourists see the US as a cheap vacation destination. Foreign direct investment in the US manufacturing rose 11.5% in 2011 (Chart 7). Oil and gas production continues to develop, which will keep US energy prices lower relative to the rest of the world, stimulating our industrial base.

Chart 7: A low-cost production base
Foreign direct investment in US: Manufacturing (% Change)



Source: Bureau of Economic Analysis, Renaissance Macro Research

A tactical strategy of defensives now and cyclicals later

2013's split personality presents investors with a more tactical trading strategy. In the near-term, we expect conditions to be largely the same as today and would favor a defensive strategy, overweighting bond substitutes such as utilities, healthcare, and consumer staples. On the assumption that the economy accelerates in the second-half, it stands to reason to favor sectors tied to the early stages of the business cycle, including energy and industrials. We expect the long-end of the Treasury curve to sell off modestly as the short-end remains anchored, facilitating margins on bank lending, stimulating the financial sector.

Economic projections

Real Economic Activity (SAAR %)	Q1 12	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13	Q3 13	Q4 13	2011	2012	2013
Real GDP	2.0	1.3	2.7	1.5	1.0	1.5	3.0	3.5	1.8	2.2	1.8
% Change, Year Ago	2.4	2.1	2.5	1.8	1.6	1.6	1.7	2.2			
Consumption	2.4	1.5	1.4	1.6	1.0	1.5	2.0	2.5	2.5	1.8	1.5
Structures	12.8	0.6	-1.0	-1.0	0.0	5.0	10.0	10.0	2.8	9.5	2.5
Equipment and Software	5.4	4.8	-2.7	-0.5	2.5	3.0	7.0	9.0	11.0	6.1	2.5
Residential Investment	20.6	8.4	14.3	13.5	15.0	15.0	20.0	20.0	-1.4	11.9	15.2
Inventory Accumulation ($)	56.9	41.4	61.3	65.3	67.3	72.3	84.3	97.3	31.0	56.2	80.3
Net Exports ($)	-415.5	-407.4	-403.0	-394.9	-400.1	-408.6	-409.1	-409.5	-408.0	-405.2	-406.8
Exports	4.4	5.2	1.1	3.0	2.5	3.0	6.0	6.0	6.7	3.7	3.3
Imports	3.1	2.8	0.1	1.0	3.0	4.0	5.0	5.0	4.8	2.9	2.8
Government	-3.0	-0.7	3.5	-1.5	-1.0	-1.0	-0.5	-0.5	-3.1	-1.4	-0.4
Key Indicators											
Nonfarm Payrolls (MoM, 000s)	226	67	174	119	85	120	185	225	153	146	154
Private Payrolls (MoM, 000s)	226	88	142	133	90	125	185	220	175	147	155
Unemployment Rate	8.3	8.2	8.1	7.9	7.9	7.9	7.8	7.7	9.0	8.1	7.8
Housing Starts (000s)	715	736	780	887	896	924	956	997	612	780	943
Light Vehicle Sales (SAAR)	14.2	14.1	14.5	14.9	14.5	14.6	15.0	15.5	12.8	14.4	14.9
Industrial Production (% SAAR)	6.2	2.4	-0.3	-1.8	3.2	2.8	3.5	4.5	4.1	3.5	1.8
Capacity Utilization	78.7	78.9	78.5	77.8	78.1	78.3	78.6	79.2	76.8	78.5	78.5
Inflation											
Consumer Price Index	2.5	0.8	2.3	3.4	1.3	1.8	2.0	2.2	3.1	2.2	2.0
% Change, Year Ago	2.8	1.9	1.7	2.2	1.9	2.2	2.1	1.8			
Core CPI	2.1	2.6	1.5	1.8	1.8	1.8	2.1	2.2	1.7	2.1	1.9
% Change, Year Ago	2.2	2.3	2.0	2.0	1.9	1.7	1.9	2.0			
Core PCE Chain Price Index	2.2	1.7	1.1	1.2	1.4	1.7	2.0	2.1	1.4	1.7	1.5
% Change, Year Ago	1.9	1.8	1.6	1.6	1.4	1.4	1.6	1.8			
Interest Rate Forecasts											
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
2-Year Treasury Note	0.33	0.30	0.23	0.20	0.20	0.20	0.25	0.30	0.24	0.20	0.30
10-Year Treasury Note	2.21	1.64	1.63	1.65	1.65	1.70	1.85	2.05	1.88	1.65	2.05
30-Year Treasury Bond	3.33	2.75	2.85	2.85	2.85	2.90	3.05	3.35	2.90	2.85	3.35
10s/2s Treasury Curve (bps)	188	134	140	145	145	150	160	175	164	145	175

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