Dutta's Weekly Economic Digest

RENMAC
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Shocks subside

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Review: Near-term risks skewed to downside

When coupled with our expectation for weaker underlying growth in the near-term, the threat of tighter fiscal policy may weigh on risk appetite in the first half.

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Macro Mantra: Shocks subside

We are often asked, "What is the catalyst for growth?" Whether it is housing or technology, investors often search for a growth narrative. In our view, the answer is straightforward: shocks subside.

Data Preview: Starting off 2013 with a thud

A bevy of economic indicators are released next week, informing market participants of how the year began. We are cautious on the near-term economic data flow and our high-frequency forecasts reflect this. Nonfarm payrolls are expected to rise by just 135,000 with the unemployment rate holding steady at 7.8%. We also see January's ISM Manufacturing Index dipping below 50 to 49.5.

The week ahead: January 25 to February 1

Date	Time	Event	Period	Survey	RM Estimate	Prior
01/25/2013	10:00	New Home Sales	Dec	385K	375K	377K
01/28/2013	08:30	Durable Goods Orders	Dec	1.9%	1.5%	0.8%
01/28/2013	08:30	Durables Ex Transportation	Dec	1.0%	1.0%	1.6%
01/28/2013	10:00	Pending Home Sales MoM	Dec	0.5%	0.0%	1.7%
01/29/2013	09:00	S&P/CS 20 City MoM% SA	Nov	0.7%	0.7%	0.7%
01/29/2013	10:00	Consumer Confidence	Jan	64.0	63.5	65.1
01/30/2013	08:15	ADP Employment Change	Jan	165K	150K	215K
01/30/2013	08:30	GDP QoQ (Annualized)	4Q A	1.3%	0.7%	3.1%
01/30/2013	08:30	Personal Consumption	4Q A	1.5%	2.3%	1.6%
01/30/2013	**14:15**	**FOMC Rate Decision**	**30-Jan**			
01/31/2013	08:30	Personal Income	Dec	0.8%	0.8%	0.6%
01/31/2013	08:30	Personal Spending	Dec	0.3%	0.3%	0.4%
01/31/2013	08:30	PCE Core (MoM)	Dec	0.1%	0.1%	0.0%
01/31/2013	08:30	Initial Jobless Claims	26-Jan	--	340K	330K
01/31/2013	09:45	Chicago Purchasing Manager	Jan	51.0	50	48.9
02/01/2013	08:30	Change in Nonfarm Payrolls	Jan	160K	135K	155K
02/01/2013	08:30	Change in Private Payrolls	Jan	164K	135K	168K
02/01/2013	08:30	Unemployment Rate	Jan	7.8%	7.8%	7.8%
02/01/2013	08:30	Avg Hourly Earning MOM All Emp	Jan	0.2%	0.2%	0.3%
02/01/2013	08:30	Avg Weekly Hours All Employees	Jan	34.5	34.4	34.5
02/01/2013	09:55	U. of Michigan Confidence	Jan F	71.3	71.5	71.3
02/01/2013	10:00	Construction Spending MoM	Dec	0.6%	0.5%	-0.3%
02/01/2013	10:00	ISM Manufacturing	Jan	50.5	49.5	50.7
02/01/2013	17:00	Total Vehicle Sales	Jan	15.20M	15.20M	15.30M

Macro Mantra
Shocks subside

- **Review:** When coupled with our expectation for weaker underlying growth in the near-term, the threat of tighter fiscal policy may weigh on risk appetite in the first half.

- **Macro Mantra:** We are often asked, "What is the catalyst for growth?" In our view, the answer is straightforward: shocks subside.

Review: Near-term risks skewed to downside

Table 1: Q4, weak headline, decent details

Real Economic Activity (SAAR %)	Q3 12	Q4 12
Real GDP	3.1	0.7
% Change, Year Ago	2.6	1.8
Consumption	1.6	2.3
Structures	0.0	0.5
Equipment and Software	-2.6	10
Residential Investment	13.6	18
Inventory Accumulation ($)	60.3	25.3
Net Exports ($)	-395.2	-407.9
Exports	1.9	-4.5
Imports	-0.6	-1.5
Government	3.9	-2.5

Shaded region represents tracking estimate
Source: Renaissance Macro Research

US Q4 GDP, released next week, is tracking slightly below 1.0% annualized. However, the weak headline will mask stronger underlying momentum. Absent a sharp drawdown in inventories, Q4 growth would be slightly above 2.0%, indicating a pick-up in consumption, business and residential investment relative to Q3 (Table 1). In the current quarter, we expect final sales and GDP to trade places. Inventories will boost headline growth but mask a softening in consumer spending.

In Washington, worst case outcomes continue to be avoided. With the GOP signaling a short-term extension of the debt ceiling, the threat of default and running the government on a cash-basis has been removed. That Republicans removed the debt ceiling as a bargaining chip implies that sequestration will be used to extract additional fiscal policy concessions from the White House.

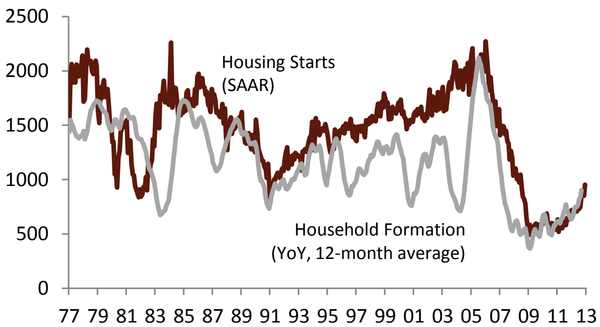
As our colleagues Kim Wallace and Tom Gallagher have intimated, if the GOP finds a modicum of success, there is a higher risk of tighter fiscal policy in calendar year 2013 than is presently assumed in most baseline expectations. Most forecasters, we included, expect roughly 1.5ppts of fiscal drag this year; however, the upper-end of what is now plausible has risen to 2.0ppts.

When coupled with our expectation for weaker underlying growth in the near-term, the threat of tighter fiscal policy may weigh on risk appetite in the first half. However, given our relative optimism over the medium-term economic outlook, with growth at or above 3.0% in H2, we suspect any risk pullbacks will ultimately be opportunities to build on positions.

Macro Mantra: Shocks subside

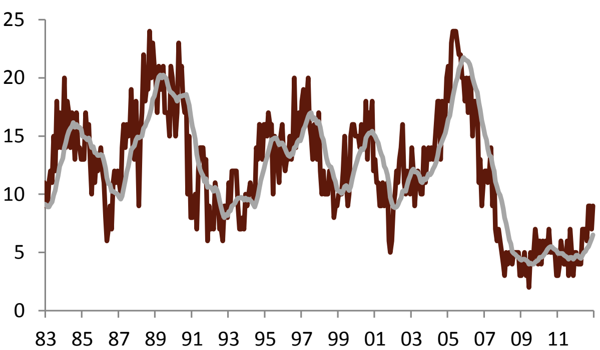
In client meetings, we are often asked, "What is the catalyst for growth?" Investors often search for a narrative. During the 2000s, it was housing. Before that, the technology sector was all the rage. In the 1980s, no doubt the defense industry was thought to be a major growth catalyst. In our

Chart 1: Demography helps housing



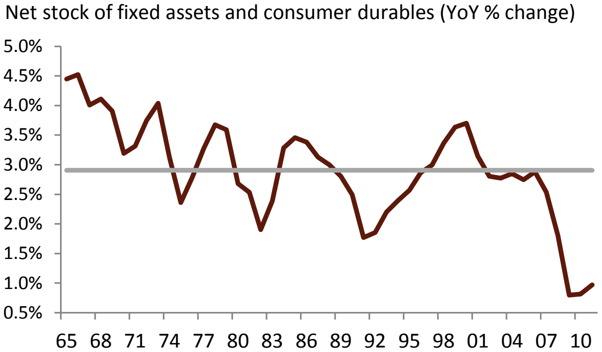
Source: Haver Analytics, Renaissance Macro Research

Chart 2: Housing viewed more favorably
U of M: % saying housing a good investment or prices will go higher



Source: University of Michigan, Renaissance Macro Research

Chart 3: No growth in capital stock
Net stock of fixed assets and consumer durables (YoY % change)



Source: Bureau of Economic Analysis, Renaissance Macro Research

view, long-run growth dynamics are driven by supply-side considerations such as the growth in the labor force and productivity. However, in the near-term, the growth catalyst is simple: shocks subside. Sectors that were persistent drags on recovery are now poised to contribute more meaningfully. Let us tally up the ways.

Housing not a hindrance

Residential real estate was the epicenter of the last recession. For years, the weakness in household formation restrained housing demand. The declines in home prices restrained mobility within the country. With less home equity, homeowners were prevented from moving because they would have to sell at a price that would not be enough to repay an existing mortgage and put a down-payment on a new home.

Today, these sources of weakness are transitioning to sources of growth. The healing in the labor market is leading to a decline in multi-generational households. These youngsters are forming households of their own. Chart 1 illustrates the improvement in formation and how it underpins new residential construction. Second, home prices are now rising, and more importantly, consumers expect the gains to continue (Chart 2). This supports a positive feedback loop in which higher prices prompts looser financial conditions, additional demand for homes, and more construction.

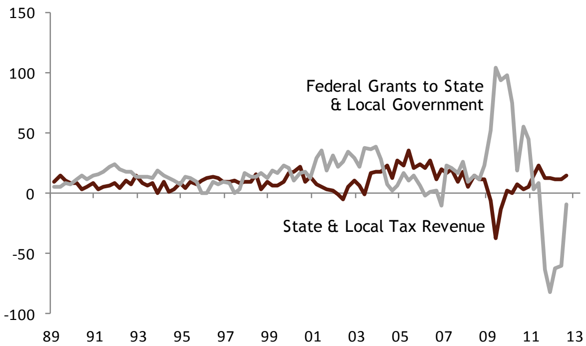
Consumers more willing to borrow

With home prices rising, consumer appetite to borrow is improving. And, because consumers are more willing to take on debt, it is increasingly likely that household deleveraging is nearing an end. Moreover, consumers are able to stretch their incomes further through smaller interest payments. The drop in the debt-service ratio has been dramatic, falling steadily from a peak of 14.1% to 10.6% as of Q3 2013, the lowest in decades. Because current mortgage rates remain below the rate of mortgages outstanding, indicating future refinancing activity, debt-service ratios are likely to continue their descent. This is an important offset to higher taxes.

Corporate finances in good shape

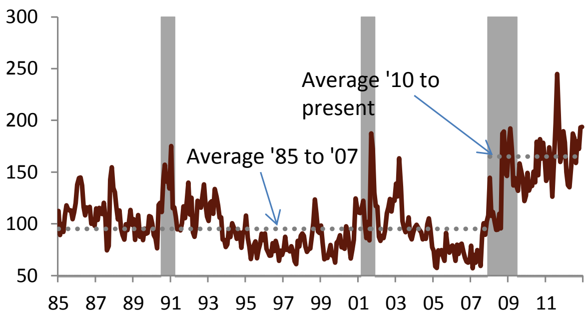
In our earlier work, we noted that consumers have delayed spending on important durable goods. Corporations have delayed spending too. The growth in the capital stock has been anemic (Chart 3). In an economy that is expected to grow, companies have not kept up their productive capacity to meet a modest pick-up in demand. Companies are hoarding profits, which implies they are posed for more investment.

Chart 4: Easing pressure at state and local level
(billions $, YoY change)



Source: Census Bureau, Renaissance Macro Research

Chart 5: Policy uncertainty is not new
Economic Policy uncertainty index



Source: Haver Analytics, Renaissance Macro Research

State and local finances improve

The budget concerns across state and local governments (S&Ls) have been well advertised. What has been largely ignored, however, is the extent to which finances across lower level governments has improved. The stabilization in home prices and pick-up in the economy has helped generate an increase in state and local tax receipts. Chart 4 tells the tale. During the recession, lower level governments were able to offset the sharp drop in revenues with federal stimulus dollars. Governments tend to exhaust the easy budget options first. As federal stimulus dried up, S&Ls were forced on an austerity diet. Today, there is less need for austerity. Over the past year, tax revenues are up by $15.2bn, fully offsetting the declines in federal grants to state and local government.

Policy uncertainty bubble deflates

Perhaps the most controversial shock that we see dissipating is "policy uncertainty." We have been skeptical of the uncertainty shock literature. The evidence that political brinksmanship in Washington has a meaningful impact on private economic decision-making remains ambiguous. Still, if policy uncertainty has been a drag on growth, it has been a persistent one. The most popular measure of policy uncertainty, developed by economists at Stanford, has been consistently high since the recession ended in 2009 (Chart 5).

Investors may not get the "grand bargain" on deficit reduction they were hoping for. However, with the cyclical deficit taking care of itself and the ratio of debt to GDP only modestly higher through 2022 there may be no need for a bargain at the moment. With 2011's deal to cut spending by $1.5 trillion over ten years and last year's deal to raise revenues by $600 billion, another $1.4 trillion over ten years will likely finish the job, completely stabilizing the debt-to-GDP ratio over the next ten years. [1] In other words, the ten-year budget outlook is not particularly worrisome.

Because fiscal decisions are less urgent, government should be a more neutral factor in second-half growth backdrop. If anything, legislators may surprise on the upside. Our policy analyst, Kim Wallace, has noted that 2013 will be a constructive year for sector policy as the government reinforces recoveries already underway, particularly in housing and energy production.

[1] Kogan, Richard, "To Stabilize Debt, Policymakers Should Seek Another $1.4 Trillion in Deficit Savings," *Center on Budget and Policy Priorities*, 9 January 2013 .

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	3.1	1.0	1.0	1.5	3.0	3.5	1.8	2.2	1.8
% Change, Year Ago	2.4	2.1	2.6	1.8	1.6	1.6	1.6	2.2			
Consumption	2.4	1.5	1.6	1.6	1.0	1.5	2.0	2.5	2.5	1.8	1.5
Structures	12.8	0.6	0.0	1.0	0.0	5.0	8.0	10.0	2.8	9.7	2.8
Equipment and Software	5.4	4.8	-2.6	3.5	2.5	3.0	7.0	9.0	11.0	6.4	3.2
Residential Investment	20.6	8.4	13.6	18.0	15.0	15.0	20.0	20.0	-1.4	12.1	15.9
Inventory Accumulation ($)	56.9	41.4	60.3	40.3	42.3	47.3	57.3	64.3	31.0	49.7	52.8
Net Exports ($)	-415.5	-407.4	-395.2	-385.4	-390.5	-398.8	-394.8	-390.6	-408.0	-400.9	-393.7
Exports	4.4	5.2	1.9	-4.0	2.5	3.0	7.0	7.0	6.7	3.3	2.3
Imports	3.1	2.8	-0.6	-5.0	3.0	4.0	5.0	5.0	4.8	2.4	1.5
Government	-3.0	-0.7	3.9	-2.5	-1.0	-1.0	-0.5	-0.5	-3.1	-1.4	-0.6
Key Indicators											
Nonfarm Payrolls (MoM, 000s)	226	67	168	151	95	125	185	225	153	153	158
Private Payrolls (MoM, 000s)	226	88	140	181	100	130	185	220	175	159	159
Unemployment Rate	8.3	8.2	8.0	7.8	7.8	7.7	7.6	7.5	8.9	8.1	7.7
Housing Starts (000s)	715	736	774	898	914	949	996	1054	612	781	978
Light Vehicle Sales (SAAR)	14.2	14.1	14.5	15.1	15.0	15.0	15.3	15.6	12.8	14.5	15.2
Industrial Production (% SAAR)	6.2	2.4	0.3	0.8	3.9	2.8	3.9	4.5	4.1	3.7	2.6
Capacity Utilization	78.7	78.9	78.6	78.5	78.9	79.1	79.5	80.1	76.8	78.7	79.4
Inflation											
Consumer Price Index	2.5	0.8	2.3	2.1	0.5	1.8	2.0	2.2	3.1	2.1	1.6
% Change, Year Ago	2.8	1.9	1.7	1.9	1.4	1.7	1.6	1.6			
Core CPI	2.1	2.6	1.5	1.6	1.6	1.8	2.1	2.2	1.7	2.1	1.8
% Change, Year Ago	2.2	2.3	2.0	1.9	1.8	1.6	1.8	1.9			
Core PCE Chain Price Index	2.2	1.7	1.1	0.9	1.3	1.7	2.0	2.1	1.4	1.7	1.5
% Change, Year Ago	1.9	1.8	1.6	1.5	1.3	1.3	1.5	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	0.25	0.20	0.25	0.25	0.30	0.24	0.25	0.30
10-Year Treasury Note	2.21	1.64	1.63	1.76	1.65	1.75	1.95	2.15	1.88	1.76	2.15
30-Year Treasury Bond	3.33	2.75	2.85	2.95	2.95	3.05	3.15	3.35	2.90	2.95	3.35
10s/2s Treasury Curve (bps)	188	134	140	151	145	150	170	185	164	151	185

Shaded region represents baseline forecast

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