Dutta's Weekly Economic Digest

RENMAC
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On a path to stronger growth

Thursday, October 10, 2013

Forecast adjustment: Cutting Q3 and Q4 2013

We are cutting our Q3 GDP estimate to 2.3% bringing it in-line to our tracking model. The momentum heading into Q4 has been weak and as a result, we are shaving 0.5ppt off our Q4 GDP forecast, taking it to 3.0%.

Review: Battle of the brink

Financial markets are beginning to price in more adverse outcomes in Washington as the current stalemate shows few signs of abating. The longer the shutdown lasts, the bigger the hit to the economy will be.

Macro Mantra: On a path to stronger growth

Our optimistic forecast for 2014 is predicated on two factors. First, we see a fading of government fiscal drag relative to 2013. Second, as the fiscal shock begins to dissipate, the normal business cycle dynamics of recovery should assert themselves.

Data Preview: Beige Book and confidence due up

The calendar will be light so long as the government shutdown persists. There are two things we will be keeping an eye on. The first will be the U of M consumer sentiment index, released tomorrow. We expect a downside surprise given the squabbling in Washington and jitters in financial markets. The second will be the Fed's Beige Book, released next Wednesday. Given the dearth of data, the anecdotes from the regional Fed banks will take on greater importance.

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Macro Mantra

On a path to stronger growth

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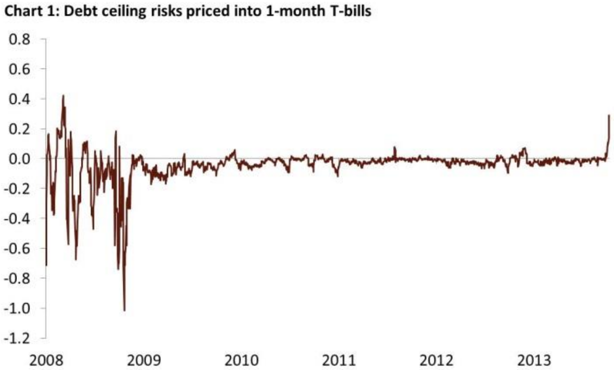
Forecast adjustment

We've cut our near-term GDP forecast (which probably means we are near the bottom in the S&P 500). While Q2 surprised on the upside, Q3 is shaping up to be weaker than expected. With slightly over half the data in, we are cutting our Q3 GDP estimate to 2.3% bringing it closer in-line to our tracking model. The momentum heading into Q4 has been weak and as a result, we are shaving 0.5ppt off our Q4 GDP forecast, taking it to 3.0%. Our 2013 Q4/Q4 forecast was cut 0.3ppt to 2.2%. The shutdown is a secondary consideration in this adjustment. That said, we remain above consensus on Q4 2013, and as we discuss in our *Macro Mantra,* 2014.

Review: Battle to the brink

Chart 1: Debt ceiling risks priced into 1-month T-bills

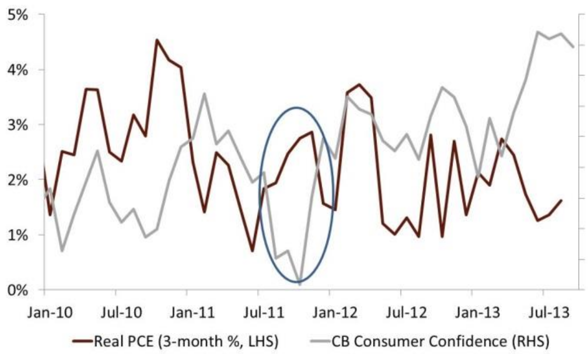


Source: Renaissance Macro Research, Haver Analytics

Financial markets are beginning to price in more adverse outcomes in Washington as the current stalemate continues. This week, a four-week Treasury bill auction ended with the lowest bid-to-cover ratio since 2006, significantly worse than expected. Chart 1 illustrates that the rates on one-month Treasury bills, which may not be repaid on their due date, have moved up above three-month bills. Assuming the debt limit is not raised, the government will not have enough cash on hand to finance the payments on these auctioned T-bills.

Equities, for their part, have been under pressure, but are still far from signaling significant angst, down just 2% since the shutdown began. Equity markets seem to treat the risk of unlikely events as binary; it either happens or it does not. In the US, investors have seen this movie before both in the summer of 2011 and late 2012. Hedging tail risks only bears fruit under a rare set of circumstances. Thus, market disruptions were relatively short-lived, but were also sharp and came near the end of the political drama. Legislators may take this latest battle to the brink, but we are not anticipating a severe 2011-like market disruption for two reasons: (1) improving growth in Europe and (2) less hard-landing risk in China.

Chart 2: Fiscal issues only weigh in temporarily



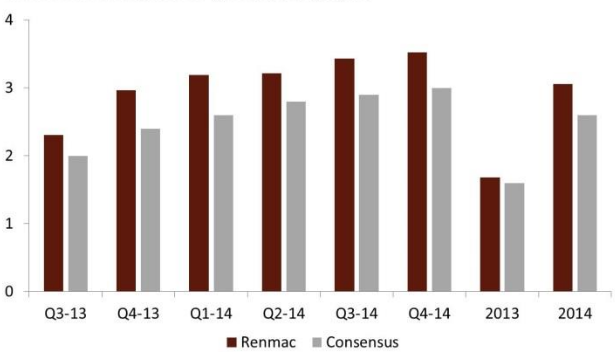
Source: Renaissance Macro Research, Haver Analytics

The good and the bad of the shutdown impact

Turning to the real economy, let's start with the good news first. Recall that the direct mechanism through which the shutdown was to affect the economy was reduced income for federal workers. However, the civilian employees at the Pentagon are now back to work while legislation has been passed to give back-pay to furloughed federal workers. Assuming the government shutdown ends by November, there will be no direct impact to quarterly GDP. A weak start will be offset by a stronger finish.

The bad news? The direct hit to federal employees says very little about the spillovers to private economic activity. Consumer sentiment has already started to crack. While the direction of the impact is clearly negative, the magnitude of the impact on the economy is difficult to quantify. As Chart 2 illustrates, consumer confidence was quite weak in the aftermath of the August 2011 debt ceiling drama, and yet, consumer spending accelerated into year-end. The longer the shutdown lasts, the bigger the hit to the economy will be. If the government manages to stay out of the headlines for an extended period of time, three months from now, the shutdown will be an afterthought.

Chart 3: Growth expected to gradually change gears



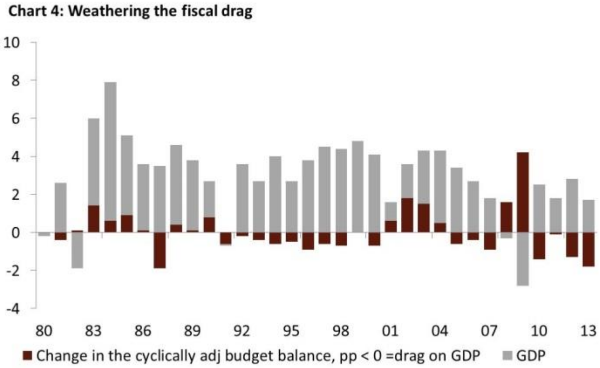
Source: Renaissance Macro Research, Bloomberg

Macro Mantra: On a path to stronger growth

Our 2014 economic outlook (full table on page 6) is above consensus; we see growth roughly 50bps stronger than the median forecast (Chart 3). We see 3.1% annual growth. The bigger story, in our view, is that even the most pessimistic forecasters see between 2.0 to 2.3% growth.

Our optimistic forecast for 2014 is predicated on two factors. First, we see a fading of government fiscal drag relative to 2013. Second, as the fiscal shock begins to dissipate, the normal business cycle dynamics of recovery should assert themselves. By a normal business cycle framework, there is plenty of upside to the US economy; we remain in the early stages of a cyclical recovery.

Chart 4: Weathering the fiscal drag

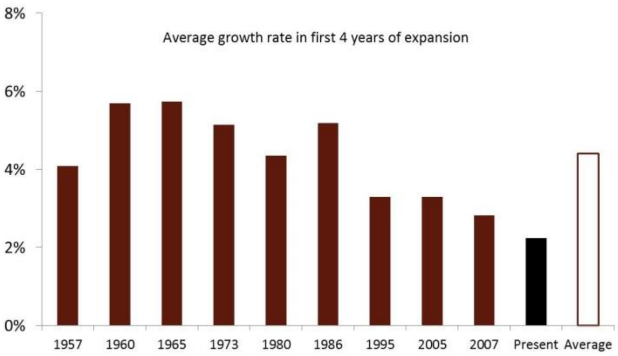


Source: Renaissance Macro Research, CBO

Fiscal drag dissipates

To gauge the outlook for next year, it's important to understand the state of underlying economic conditions. At present, the economy is managing through a 1.8ppt fiscal drag in 2013, defined as the annual change in the cyclical adjusted deficit relative to GDP. This is arguably the sharpest drag in nearly three decades (Chart 4). Despite this, the economy is on pace to expand roughly 2.0% this year, roughly in-line with the average growth rate during the first three years of recovery. Similarly, payrolls are averaging monthly gains of 165,000 thus far in 2013, the same pace as 2012. That the economy is steady in the face of a significant shock, implies a firmer foundation to future growth.

Chart 5: Sub-par performance



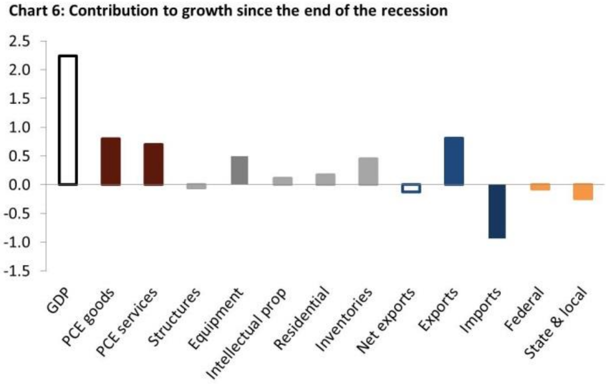
Source: Renaissance Macro Research, Haver Analytics

Business cycle dynamics kick-in

The recovery since mid-2009 has admittedly been disappointing. This below average economic performance is largely the result of a deep housing recession and banking crisis. This goes well beyond construction activity. For example, a sharp drop in home prices prompted a tightening of lending standards, forcing most households to cut back on mortgage and consumer debt, boost saving and slow consumer spending. Because local governments rely on property tax receipts, a drop in home values dried up funding for local governments, forcing budget consolidation.

Typically, four years into recovery the economy is expanding 4.4%. By contrast, four years into this recovery, the economy is averaging an annual growth rate of just 2.2%, or 2.2ppts below normal (Chart 5).Today, however, these shocks have abated. Chart 6 illustrates the average growth contribution by sector. Think of this as an accounting identity. The economy managed to expand 2.2% despite a drag from structures investment, trade, and government. Assuming structures investment and state and local governments return to a normal, we can see a path to 3% growth under a fairly conservative set of assumptions.

Chart 6: Contribution to growth since the end of the recession



Source: Renaissance Macro Research, Haver Analytics

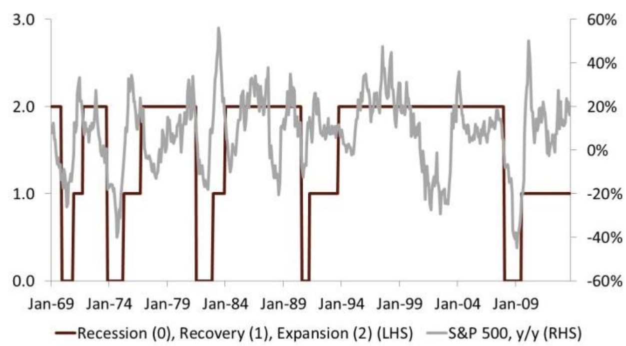
Inflation still a non-issue

We remain of the view that in developed economies, inflation is a slowly evolving process, especially outside of commodities, and picks up only when strong economic growth puts pressure on spare capacity. Sustained increase in inflation requires a feedback between wages, prices and expectations. While aggregate wages and salaries are expanding, household inflation expectations remain well anchored. With expectations anchored, inflation is somewhat less sensitive to swings in the business cycle. We expect core PCE inflation to rise next year closer to the Fed's flexible target, to 1.7% from 1.2% now.

Equities driven by earnings not multiple

Our optimistic outlook for the economy has important implications for capital market. In general terms this implies moving into riskier asset classes such as credit and equities and away from safer investments like Treasury bonds. For the equity market, in particular, we expect gains next year to be more dependent on corporate earnings as opposed to an

Chart 7: Stocks and the Business Cycle



expansion of the market multiple. Our assumptions for nominal GDP and productivity point to an acceleration in corporate profits.

However, we do expect equity gains to moderate next year despite the stronger economy. Chart 7 builds on the work of economists from INSEAD. We assign values for recession (0), recoveries (1) and expansion (2). Our work implies that we are still in the recovery phase of the business cycle – a standard deviation below normal.

That we are still in recovery – as opposed to expansion – is a sign of just how slow economic growth has been since 2009. That said, the stock market has mounted a fairly dramatic run despite this. Indeed, we're on track to see double-digit gains in four of the last five years. Our guess is that we've likely pulled forward some equity gains. So, we're still upbeat on stocks just looking for modest gains relative to the last few years.

Economic projections

Real Economic Activity (SAAR %)	Q1-13	Q2-13	Q3-13	Q4-13	Q1-14	Q2-14	Q3-14	Q4-14	2012	2013	2014
Real GDP	**1.1**	**2.5**	**2.3**	**3.0**	**3.2**	**3.2**	**3.4**	**3.5**	**2.8**	**1.7**	**3.1**
% Change, Year Ago	**1.3**	**1.6**	**1.5**	**2.2**	**2.7**	**2.9**	**3.2**	**3.3**			
Final Sales	**0.2**	**1.9**	**2.1**	**2.7**	**3.1**	**3.1**	**3.4**	**3.4**	**2.6**	**1.7**	**2.9**
Consumption	2.3	1.8	2.0	2.3	2.5	2.5	2.7	2.7	2.2	1.9	2.4
Nonresidential Fixed Invest	-4.6	4.4	3.2	6.1	6.8	7.0	7.4	7.8	7.3	2.5	6.3
Structures	-25.7	16.2	2.0	5.0	5.0	5.0	5.0	5.0	12.7	0.1	5.3
Equipment and Software	1.6	2.9	3.5	8.0	8.5	9.0	9.0	10.0	7.6	3.3	-13.6
Intellectual Property	3.8	-0.9	2.5	4.0	5.5	5.5	6.5	6.5	3.4	2.8	4.6
Residential Investment	12.5	12.9	7.0	12.5	17.5	17.5	15.0	15.0	12.9	12.9	14.5
Inventory Accumulation ($)	42.2	62.6	69.6	77.6	79.6	82.6	85.6	90.6	57.6	63.0	84.6
Contribution to GDP	*0.9*	*0.6*	*0.2*	*0.2*	*0.0*	*0.1*	*0.1*	*0.1*	*0.2*	*0.0*	*0.1*
Net Exports ($)	-422.3	-422.0	-411.7	-406.0	-403.0	-403.4	-403.8	-407.1	-430.8	-415.5	-408.2
Exports	-1.3	8.6	7.0	6.0	6.0	6.5	6.5	6.5	3.5	3.0	6.5
Imports	0.6	7.0	4.0	4.0	4.5	5.5	5.5	6.0	2.2	1.8	4.9
NX Contribution to GDP	*-0.3*	*0.0*	*0.3*	*0.2*	*0.1*	*0.0*	*0.0*	*-0.1*	*0.1*	*0.1*	*0.1*
Government	-4.2	-0.9	-0.5	-0.5	0.0	0.3	0.8	1.0	-1.0	-2.1	0.0
Key Indicators											
Nonfarm Payrolls (MoM, 000s)	207	182	158	188	197	208	212	215	183	184	208
Private Payrolls (MoM, 000s)	212	190	158	183	192	203	207	210	189	186	203
Unemployment Rate	7.7	7.6	7.3	7.2	7.2	7.1	7.1	7.0	8.1	7.5	7.1
Housing Starts (000s)	957	869	897	964	1011	1041	1071	1101	783	922	1056
Light Vehicle Sales (SAAR)	15.3	15.5	15.7	15.4	15.7	16.0	16.1	16.3	14.5	15.5	16.0
Industrial Production (% SAAR)	4.2	0.7	2.0	4.2	5.2	5.3	5.4	5.8	3.6	2.4	4.4
Capacity Utilization	78.0	77.8	77.9	78.4	79.0	79.7	80.4	81.2	77.6	78.0	80.1
Inflation											
Consumer Price Index	1.4	0.0	2.6	1.7	1.3	2.0	2.4	2.4	2.1	1.5	1.8
% Change, Year Ago	1.7	1.4	1.5	1.4	1.4	1.9	1.8	2.0			
Core CPI	2.1	1.4	1.8	1.9	1.9	1.9	1.9	1.9	2.1	1.8	1.3
% Change, Year Ago	1.9	1.7	1.7	1.8	1.8	1.9	1.9	2.0			
Core PCE Chain Price Index	1.4	0.6	1.6	1.7	1.7	1.4	1.7	2.1	1.8	1.3	1.6
% Change, Year Ago	1.5	1.2	1.2	1.3	1.4	1.6	1.6	1.7			
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	0.24	0.35	0.32	0.40	0.50	0.70	0.90	1.10	0.25	0.40	1.10
10-Year Treasury Note	1.85	2.49	2.61	2.85	3.1	3.2	3.3	3.45	1.76	2.85	3.45
30-Year Treasury Bond	3.10	3.50	3.68	3.8	3.9	3.95	4	4.05	2.95	3.8	4.05
10s/2s Treasury Curve (bps)	161	214	229	245	260	250	240	235	151	245	235

Shaded region represents baseline forecast

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