The U.S. Economic Outlook, Fiscal Issues and European Crisis

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Troy Davig
Director of Research
Outlook themes

• The US remains in a moderate growth environment

• The unemployment rate is 8.1%, close to its value in January

• The recovery in the housing sector is gaining traction

• Core measures of inflation remain in line with 2% goal, with upside risk to headline measures due to food and energy

• Major risk factors: Europe and the fiscal cliff
Since the end of the recession, growth has been moderate.
The unemployment rate is little changed since January

Source: Haver Analytics, Bureau of Labor Statistics
Gains in job openings continue to outpace gains in hiring

Source: Bureau of Labor Statistics, Haver Analytics
Long-term unemployment remains elevated

Share of Long-term Unemployed (27+ weeks)

Source: Bureau of Labor Statistics, Haver Analytics
Consumers still remain heavily indebted, but have made substantial progress in deleveraging the past few years.

![Graph showing household debt as a percentage of disposable personal income from 1976 to 2011. The graph indicates a rising trend from 1976 to a peak in 2006, followed by a decline to 2011.](source: Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics)
Household wealth has fluctuated over the past 15 years, but remains above its level from 1985-1995.

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Source: Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics
Companies appear cautious about their capital spending, as orders for new capital equipment have been declining.
Manufacturing activity has slowed according to the ISM, but nonmanufacturing activity continues to expand.
House prices are showing convincing signs of increasing
Construction of multi-family housing units continues to trend higher

Source: Census Bureau, Haver Analytics
Inflation is running a bit below 2%

Source: Bureau of Economic Analysis
Retail gasoline prices have moved up sharply over the past month.
Retail food prices are likely to move higher in coming months

Index: Jan 2, 1970 = 100

q/q % chg (saar)

S&P GSCI Agricultural & LiveStock Index (left)
CPI-U: Food (right)

Source: Standard & Poor’s, Bureau of Labor Statistics, Haver Analytics
Risk Factor #1: The European trilemma

Sovereign debt crisis – Poor fiscal management and rising bond yields in some countries threaten fiscal sustainability.

Banking crisis – A property bust in some markets and a decline in sovereign debt values have impaired the balance sheets of some Euro zone banks.

Slow growth and recession – Tighter fiscal policy and financial conditions, plus the uncertain climate, is weighing on European growth.
Sovereign yields have diverged

10 Year Sovereign Yields

Source: Bloomberg
The rise in sovereign yields reflects concerns over fiscal sustainability

Source: Bloomberg, Eurostat
Euro area and US growth looked similar during the recession, though Euro area growth has now stalled.

Source: Bureau of Economic Analysis, Statistical Office of the European Communities, Haver Analytics
A challenging negative feedback cycle...

- **Government balance sheet**
  - Future tax revenue
  - Sovereign debt
    - Decline in market value
    - Fiscal tightening
  - Real economy
    - Weak tax revenue

- **Banking sector balance sheet**
  - Sovereign debt
    - Loans
  - Equity
    - Deleveraging pressure
  - Debt
    - Solvency concerns
    - Higher funding costs
  - Slow loan growth
U.S. trade growth has been steadily slowing

Source: Haver Analytics, Census Bureau
The slowing in trade activity is likely reflecting the Eurozone crisis

Trade Flows of Goods as a Share of US GDP

Source: IMF
Risk Factor #2: US fiscal policy

• According to the Congressional Budget Office, realizing the full impact of the “fiscal cliff” will cause a recession in the first half of 2013

• Fiscal deficits are likely to improve in the next few years, but will also remain large by historical standards

• Debt accumulation will continue at an unsustainable pace and without fiscal reform, will likely accelerate later this decade
Without Congressional action, US federal fiscal policy will tighten by about $560bn in 2013

- $399 bn Expiring tax provisions and new taxes
- $105 bn Other
- $103 bn sequestration, extended UI benefits, “doc fix”

Source: Congressional Budget Office
The “cliff” is nearly 4% of GDP and would be one of the sharpest fiscal contractions in over 50 years.

Source: International Monetary Fund, Haver Analytics, Author’s calculations
The Congressional Budget Office is forecasting a recession under current law (i.e. the fiscal cliff is fully realized)

![Bar graph showing real GDP growth under CBO fiscal cliff scenario from Q3 2012 to Q4 2013.]

Source: Congressional Budget Office, Haver Analytics
Private forecasters project continued growth and presumably, that the fiscal cliff will be avoided.

% chg q/q (saar)

12 Q3 12 Q4 13 Q1 13 Q2 13 Q3 13 Q4

-5 -4 -3 -2 -1 0 1 2 3 4

Real GDP, under CBO fiscal cliff scenario
Real GDP, Blue Chip forecasts

Source: Blue Chip Economic Indicators, Congressional Budget Office, Haver Analytics
Hitting the cliff may be undesirable in terms of growth, but would notably decrease deficits in the coming years.

Source: Congressional Budget Office, Haver Analytics
Extending existing policies will cause deficits to widen dramatically
Deficits could begin persistently widening sooner than 2015 if growth disappoints.

Source: Congressional Budget Office, Office of Management and Budget, Haver Analytics
Extending existing policies will create a mountain of debt

![Graph showing debt projections over time.](source: Congressional Budget Office, Haver Analytics)
Despite forecasts of rapidly rising debt levels, yields continue to decline

Source: Financial Times, Haver Analytics
Forecasts of large fiscal deficits have not caused inflation expectations to rise

Source: Federal Reserve Board, Haver Analytics
The debt ceiling is again on the horizon

![Graph showing the debt ceiling and public debt]

Source: U.S. Treasury, Haver Analytics
The debt ceiling debate in August 2011 pushed consumer confidence to its lowest non-recessionary reading in history.

Source: The Conference Board, Haver Analytics
Final points

• The Congressional Budget Office forecasts that the US will experience a recession if the fiscal cliff is fully realized

• A fiscal tightening, however, will notably improve medium- and longer-term deficit projections

• A “grand bargain” before Dec 31, 2012 that smoothes out the timing of the fiscal tightening is the best option