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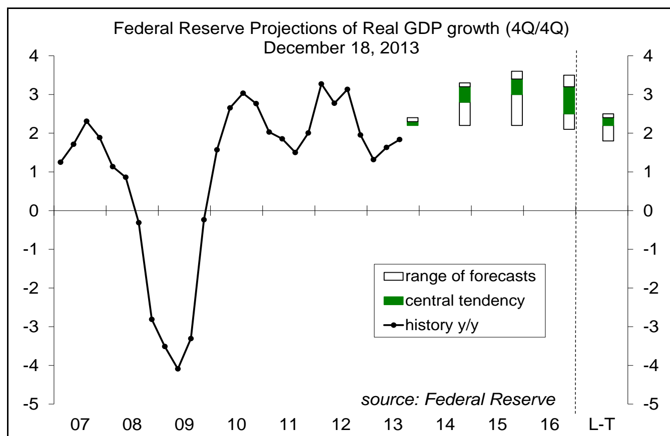
Monthly Economic Outlook

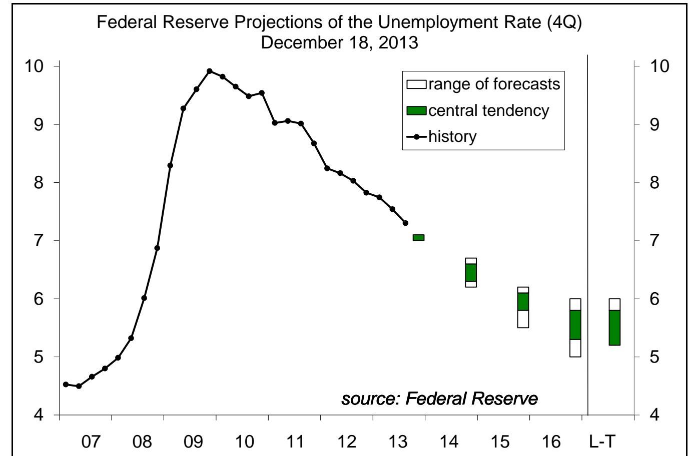
The Economy in 2014

- With headwinds fading, U.S. economic growth is expected to pick up over the course of 2014 and into 2015. Federal fiscal policy, the major economic headwind in 2013, will be much less of a drag in 2014, while state and local government should make a moderate contribution to growth.
- While the economy has continued to rebound from a severe recession, it's far from fully recovered. The large degree of slack should allow the economy to expand more rapidly, without a significant threat of higher inflation.
- The Federal Reserve will taper its monthly asset purchases in "measured steps" in 2014, with the pace to be dictated by the economic data. The Fed will continue to support growth through its forward guidance on short-term interest rates. Long-term interest rates should trend gradually higher as the economy recovers, but expect some volatility along the way.

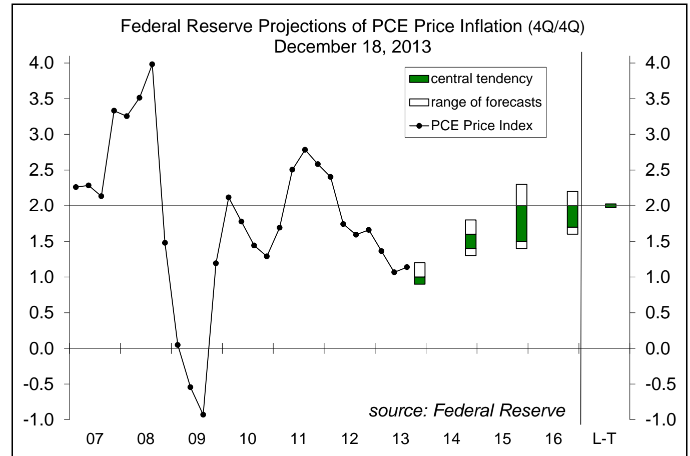
The economy has faced a number of headwinds in the last few years. The housing collapse left households poorer. Tax revenues sank, leading to a sharp contraction in state and local government. Both of these headwinds had faded by the start of 2013. However, tighter fiscal policy at the federal level (the payroll tax increase and sequester cuts) shaved 1.5 percentage points from 2013 GDP growth. Instead of growing at around 2.3%, real GDP would likely have advanced 3.8% if not for that restraint. Further sequester cuts are set for mid-January, but the recent budget deal will reduce their impact. Tighter federal fiscal policy may shave 0.2 to 0.3 percentage point from GDP in 2014, much less of a drag, which should be more than offset by an expansion in state and local government (which reflects a partial unwinding of the drastic cuts of a few years ago).



Investors want to know specifically what will drive the recovery. However, rebounds from recessions are usually a lot of things getting better at the same time. Job growth picks up, consumer spending improves, banks are willing to lend a little more, and the good news feeds on itself. This recovery has been restrained by the housing sector and by tighter fiscal policy (first at the state and local level, then at the federal level). Those headwinds are fading and positive feedback loops (increased consumer spending leading to better job growth, which leads to more spending, etc.) are likely to take hold.



The unemployment rate fell from 10% four years ago to 7% in November, but that decline overstates the degree of improvement in the job market. Labor force participation has declined, although about a quarter of that is demographics (reflecting an aging population). We still have a long way to go for a full recovery in the labor market. Fortunately, job growth has remained moderately strong in recent months.



Continued slack in the labor market, sluggish global growth, and a decline in energy costs have contributed to a low trend in inflation. Persistently low inflation could create some risks for the economy. Indeed, inflation can be too low as well as too high. Inflation trends typically do not change rapidly, but should pick up gradually over time. If not, the Fed would be likely to slow the tapering of asset purchases.

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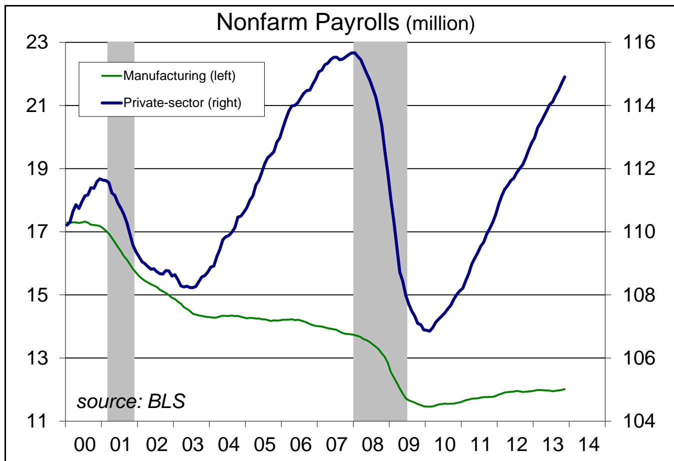
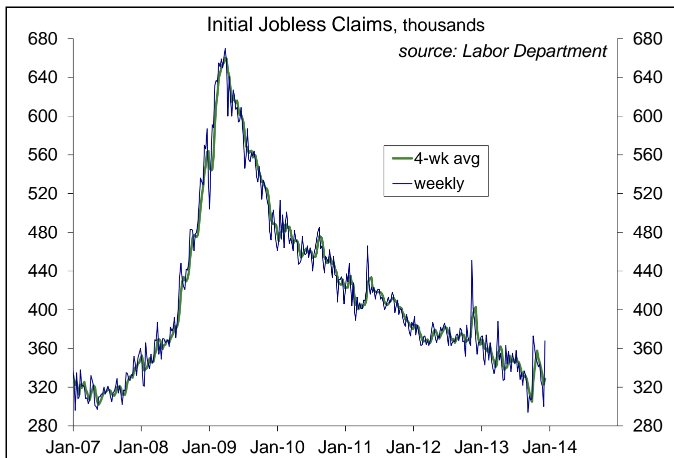
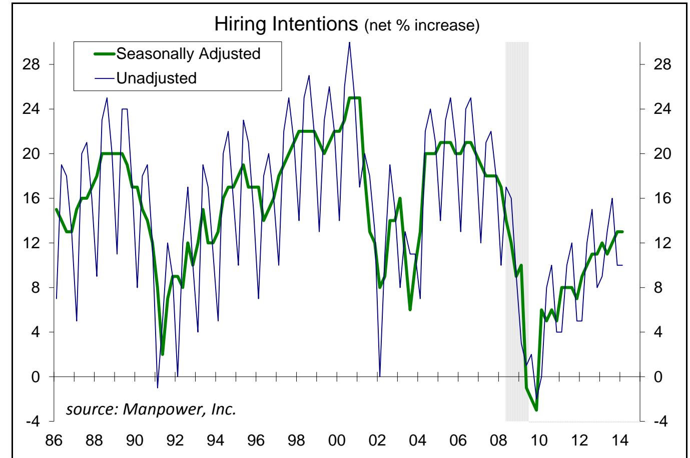
Employment and the Consumer

Job growth was moderately strong in 2013 and should strengthen somewhat in 2014. Private sector payrolls are expected to have risen by about 2.3 million, when the December figures are reported, an increase of about 1.7% (in comparison, the working-age population is growing about 1% per year). This is a slightly stronger pace of job growth than in 2012. While the strong pace of job growth is encouraging, we're still below where we were when the recession began. Long-term unemployment remains very high. Unemployment rates for teen-agers and young adults have been trending down, but are still relatively high by historical standards.

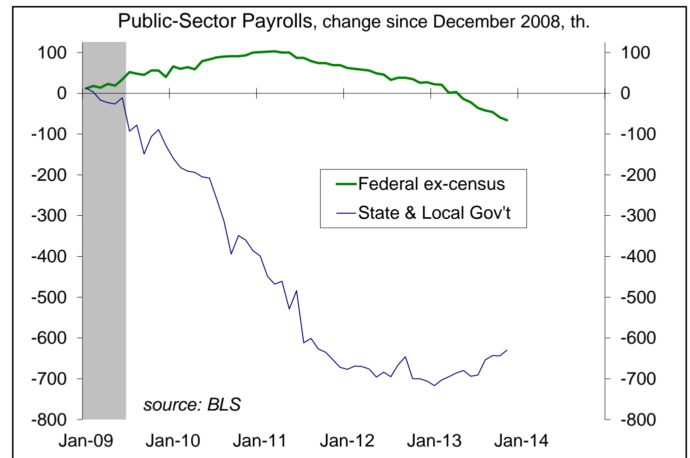


In the last few years, job destruction has remained relatively low. One still reads of corporate layoff announcements in the newspapers, but when you add them up, the trend is remarkably low by historical standards. The key issue for the labor market in the last few years has been a weak trend in job creation. Normally, we look to small, newer firms to account for a lot of the job growth in an economic expansion. Bank credit available to these smaller firms is still relatively tight, but is gradually getting easier. The Affordable Care Act may have had an impact, but probably more due to the negative press and the uncertainty that has caused. Recent data do not suggest any significant slowing in job growth at smaller firms. Surveys of hiring intentions, while still relatively low, have been trending higher over the last few years.

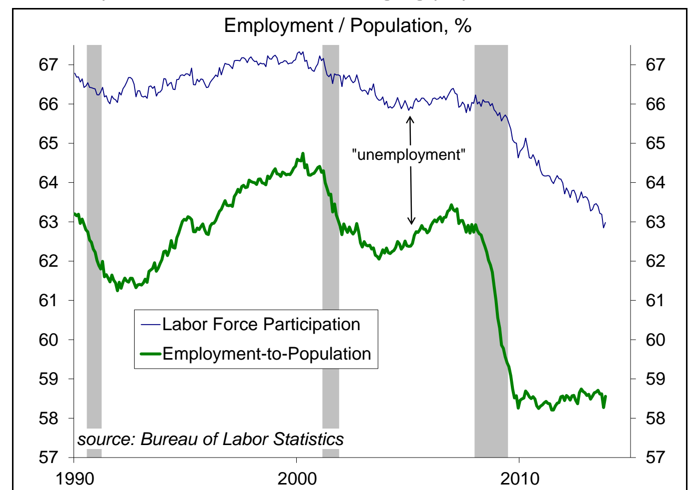




In the public sector, federal payrolls began to trend lower in 2011, reflecting a contraction in the U.S. Postal Service. In 2013, cuts to spending accelerated the decline in federal payrolls (which is now at the lowest level since 1966). However, employment in state and local government, which fell sharply in the early years of the recovery, has begun to trend higher (reflecting improvement in tax revenues).



While the unemployment rate has fallen from 10% to 7% over the last four years, the employment/population ratio has barely budged. Labor force participation has declined, with about a quarter of that due to an aging population.



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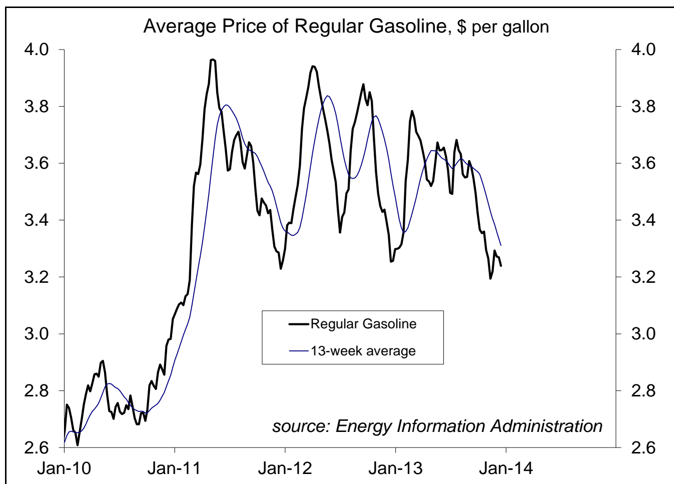
Broader gauges of unemployment have declined, but remain relatively high. Measures of underemployment suggest that the labor market is still a long way from a full recovery. There has been no noticeable surge in part-time employment over the last year. Most part-time workers are student and others with time constraints. Still, the percentage of those working part-time due to economic weakness remains high.

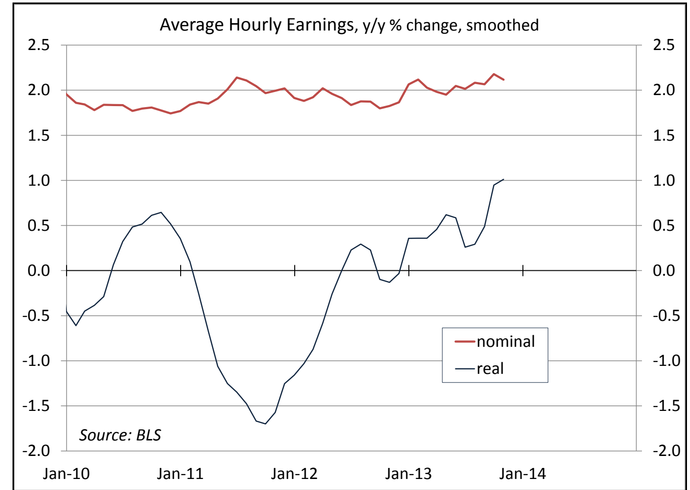
Consumer attitude measures fluctuated over the course of 2013. While the general trend is higher, levels have remained relatively low by historical standards. However, consumers don't spend confidence. The key drivers of spending are income, wealth, and the ability to borrow.

Consumer spending was a mixed bag in 2013. As a rule of thumb, the top 20% of income earnings account for a little over half of aggregate personal income and about half of consumer spending. The distribution of wealth is even more skewed. The stock market gains of the last few years and rising home prices have boosted wealth considerably, which is concentrated at the high end of the income scale. However, for middle class households, the spending story in 2013 was more muted.

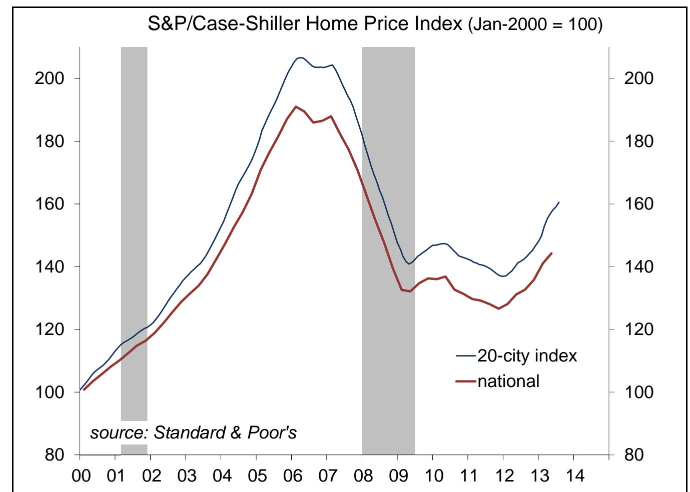
The two percentage point rise in payroll taxes took a bite out of disposable income in early 2013. For a typical household making $75,000 per year, the payroll tax reduced take-home pay by about $100 per month – enough to be missed. Yet, consumer spending initially held up relatively well. Surveys have suggested that most workers were unaware that the payroll tax had gone up (just as they were unaware that it had been lowered over the two previous years). However, consumers appeared to figure it out eventually, and consumer spending growth slowed in the spring and early summer. By now, households have adjusted to the payroll tax increase and consumer spending growth is expected to be more or less in line with income growth into early 2014.

Real average weekly wages trended flat for most of 2013. Consumer spending was fueled largely by job growth (which adds to aggregate personal income). Real wages have begun to pick up recently. Lower gasoline prices have helped boost consumer purchasing power – and a further downtrend would be helpful for consumers in 2014.

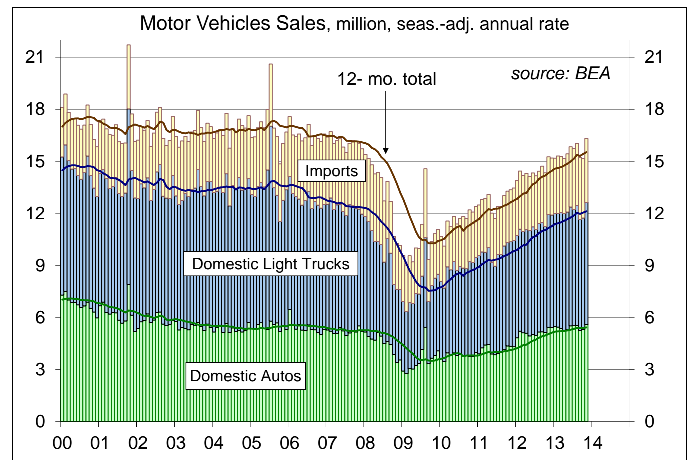




The rise in home prices has helped lower the percentage of homeowners who are underwater on their mortgages (about 13% of mortgaged homes had negative equity in 3Q13, according to CoreLogic, vs. about 22% in 3Q12).



The pace of motor vehicle sales continued to improve in 2013, supported by two key factors. The first is that cars get old and eventually need to be replaced. The second is that banks are willing to make auto loans. These two factors should continue to support gains in vehicle sales through 2014, but the pace may begin to stabilize later in the year or in early 2015.



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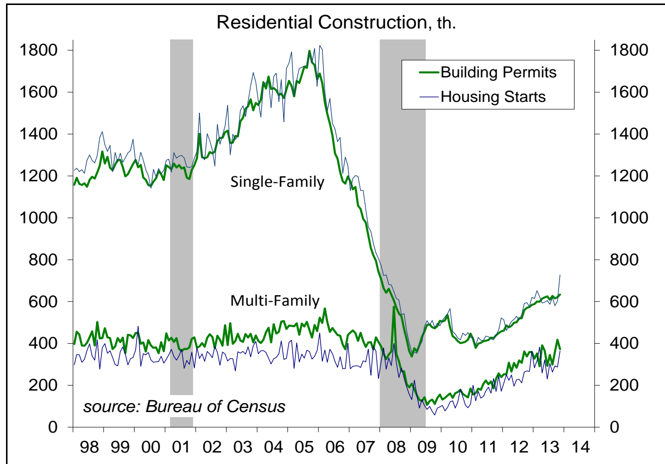
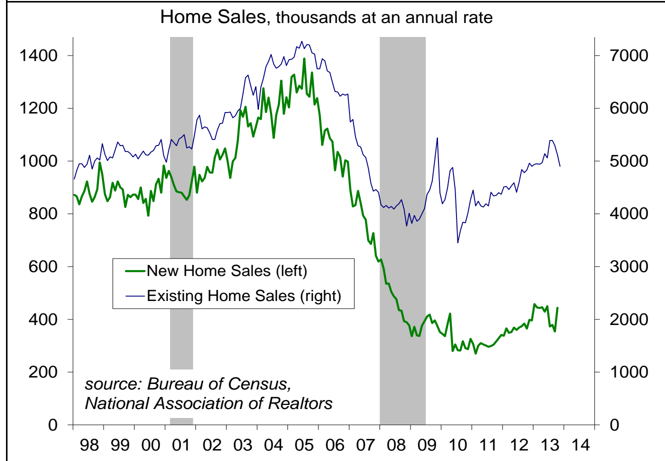
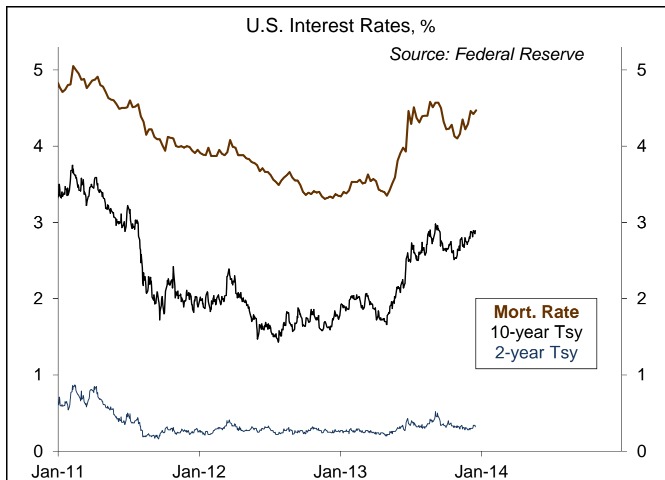
Residential Fixed Investment

Housing has improved over the last year, with strong gains in home prices and a pickup in homebuilding. However, supply constraints have been an issue. The homebuilding supply chain was badly damaged during the downturn and it will still be some time before the industry fully recovers.



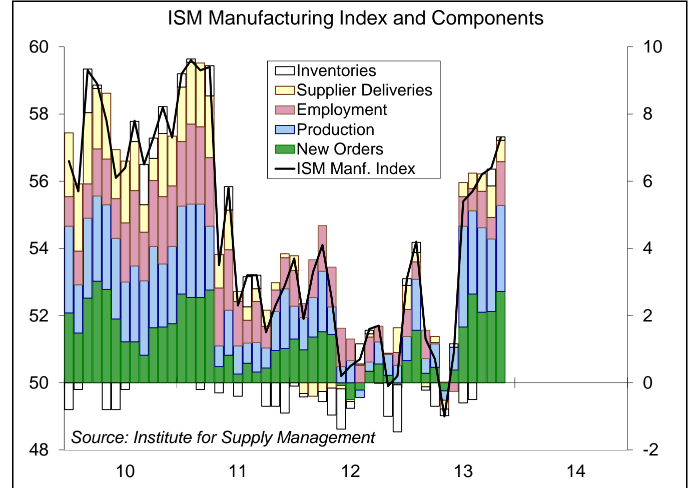


Rising home prices and higher mortgage rates reduce housing affordability. The Fed will face a tough task in tapering the rate of asset purchases, while keeping the housing market recovery on track. Note that data for the fall and winter are often distorted. The bigger test will come this spring.

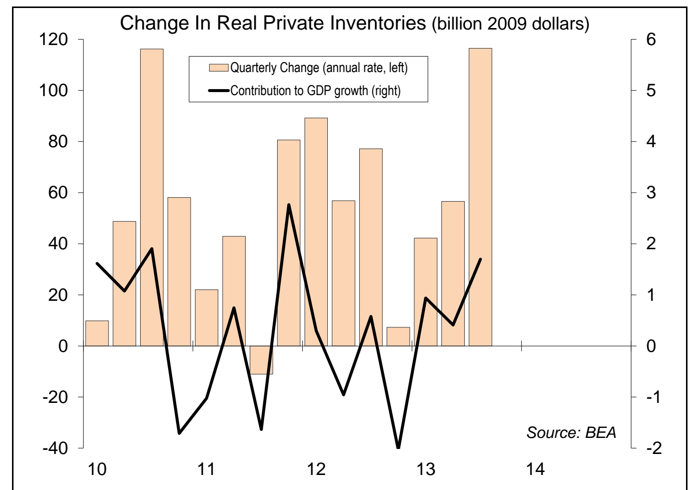


Manufacturing

The ISM Manufacturing Index improved significantly in the second half of 2013, but relatively little strength was seen in manufacturing orders, production, and employment. That's likely to change in early 2014. However, the global economy is expected to remain a bit soft, which may limit export growth.



Inventories rose rapidly in 3Q13. The pace is almost surely to have slowed in the fourth quarter, which will subtract significantly from 4Q13 GDP growth (in contrast, figures on domestic demand are likely to pick up). However, we may see some of the inventory correction pushed into 1Q14.



Much has been written about a "manufacturing renaissance" in the U.S. However, it's not been observed in the data. Manufacturing payrolls rose just 0.6% over the 12 months ending in November (vs. +2.1% for the overall private sector), one of the weakest areas of the job market. The government does not keep track of jobs returning from overseas, although there is some anecdotal evidence. Yet, there's also a lot of hype. Factory output should pick up as demand increases at home and abroad. Manufacturing gains are more likely to be capital-intensive than labor-intensive. Advances in robotics should add to manufacturing productivity, meaning we can see more output with fewer added workers. That's good news for firms, but not necessarily for workers.

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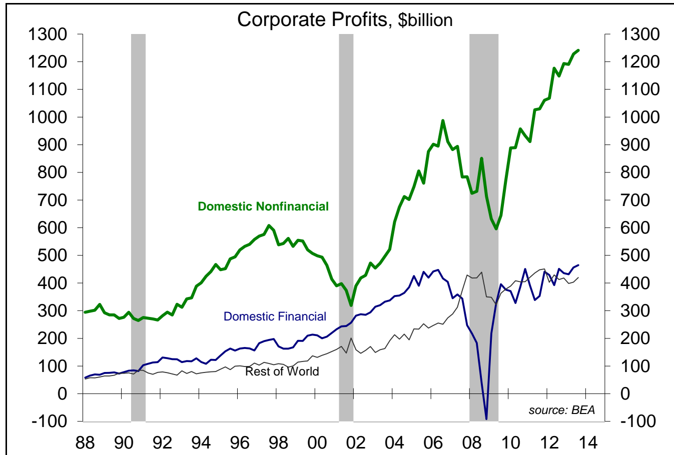
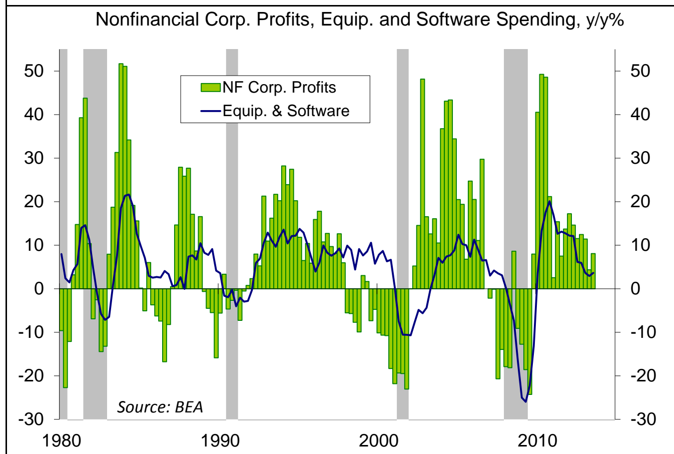
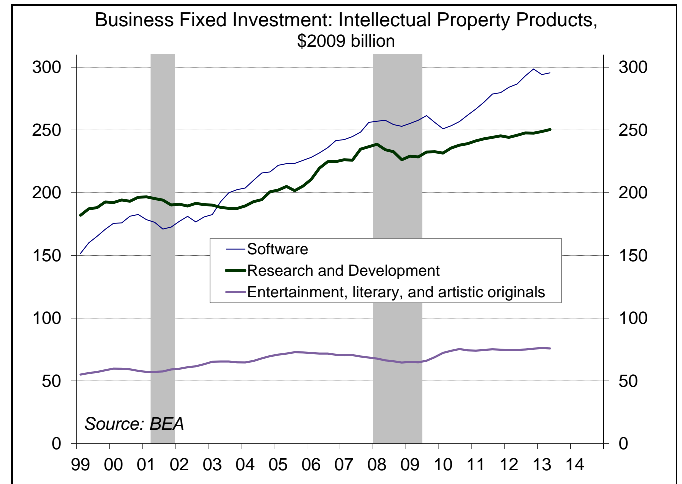
Business Fixed Investment

The biggest driver of business fixed investment is corporate profits, and profits have been strong. Companies are generally cash rich. However, business fixed investment has not been especially strong over the last year. Some may cite the political environment, but the lackluster pace of growth in 2013 was likely the chief restraint. Firms are not going to expand (that is, hire new workers and make capital expenditures) unless they anticipate an increase in demand. That will likely change in 2014. Stronger demand at home and abroad should lead to an increase in capital expenditures, which will, in turn, add to overall domestic growth.

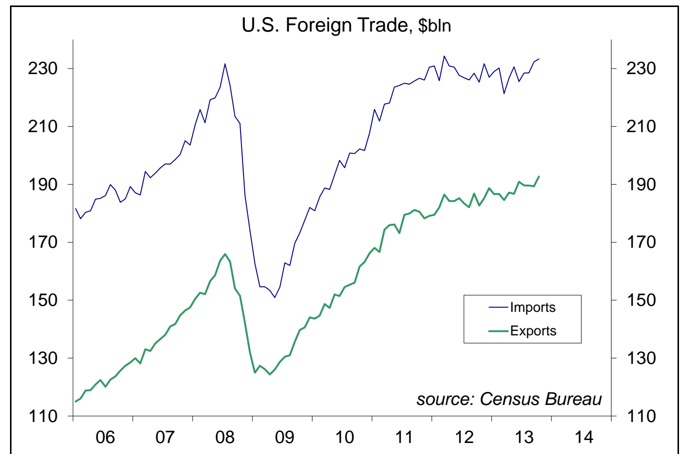




In its comprehensive revision to the National Income and Product Accounts, the Bureau of Economic Analysis expanded its definition of business fixed investment in 2013. The new category, Intellectual Property Products, is made of business investments in software, research and development, and in artistic endeavors (movies, theatre, music, books, etc.). Business software was introduced into the NIPA accounts in 1995. The introduction of the two new categories, along with other changes to the methodology, boosted the 2012 level of Gross Domestic Product by 3.6%, but had a relatively minor impact on estimates of historical GDP growth. Note that investment in intellectual property products is much less cyclically sensitive than the two other major categories of fixed investment (structures and equipment and software).



The soft global economy was also a restraining factor for business fixed investment in 2013. The rebound in exports was an important factor in the early stages of the economic recovery, but the pace slowed to a crawl in 2013 (although appears to have picked up somewhat in the early autumn).



An expansion of trade capacity (the Panama Canal, East Coast port improvements and increased distribution systems), along with new trade agreements and low energy costs, will be important factors in foreign trade over the next few years. The impact on exports could be substantial, but the effect on imports will likely be less significant than the expansion of West Coast trade in the two previous decades.

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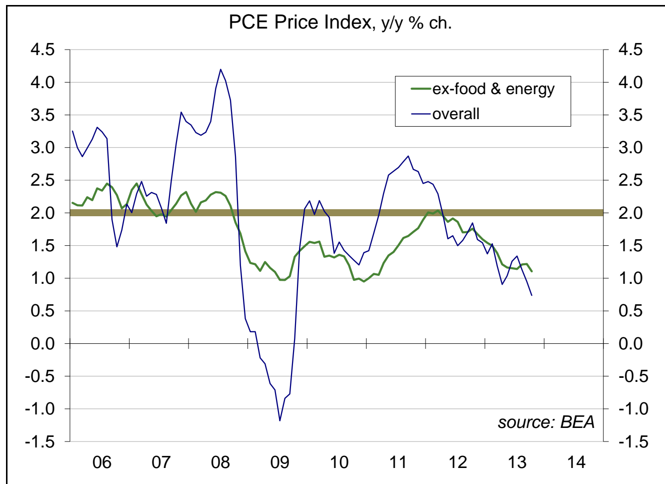
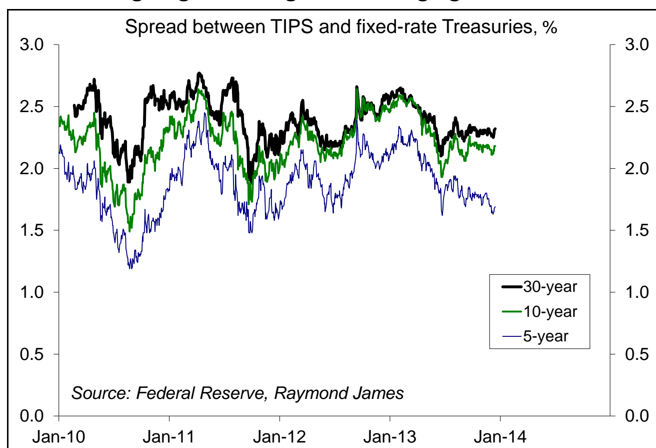
Inflation and Federal Reserve Policy

Inflation moved lower over the last year. The decline in energy prices was a key factor, but core inflation also fell far below the Fed's 2% goal (for the PCE Price Index). Short-term deviations from the 2% goal are usually nothing to worry about, but a persistent low trend in inflation could result in some risks for the economic outlook. Real (that is, inflation-adjusted) interest rates are what matters for the economy. So, all else equal, lower inflation means higher real interest rates, and economic growth will be slower than it would be otherwise.

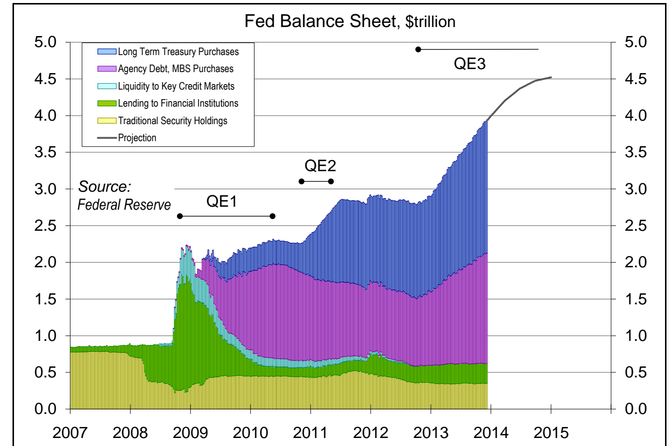


Inflation is always a monetary phenomenon, but it's observed largely through pressures in resource markets. The soft global economy and increased energy production in the U.S. have put downward pressure on commodity prices. There's plenty of excess capacity in production. You're not going to see bottleneck production pressures as firms struggle to keep up with demand (at least in most industries). The labor market is the widest channel for inflation pressure. While job market conditions have improved, they're far from the point where we're going to see significant wage gains.

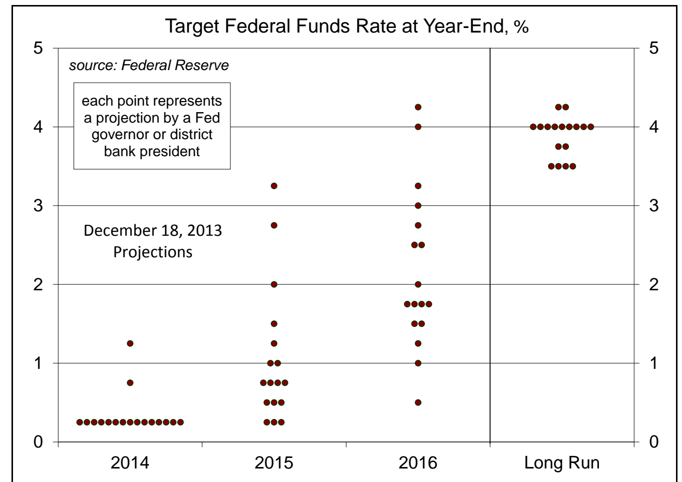


Expectations play an important role in the inflation process. Inflation expectations have remained moderate over the last few years, reinforced by the Fed's formal announcement of its 2% inflation goal. Note that well-anchored inflation expectations reduce the threat of deflation as well as the risk of substantially higher inflation.

At the December 17-18 policy meeting the Federal Open Market Committee decided to reduce the monthly pace of asset purchases from $85 billion to $75 billion in January. The FOMC indicated that it expects to reduce the pace of asset purchases further in measured steps, depending on the economic data. The Fed will still be adding policy accommodation as it slows the rate of asset purchases.



In its policy statement, the FOMC emphasized that the federal funds target rate would remain in its current low range well after the unemployment rate falls below 6.5%. Chairman Bernanke and other Fed officials have stressed this idea before, but it was the first inclusion of that sentiment in the policy statement. Most Fed officials do not expect to begin raising the overnight lending rate until 2015, and most anticipate that the target rate will be well below normal at the end of 2016.



Janet Yellen (pending final approval by the Senate) is set to be sworn in as Federal Reserve chair on February 1. We aren't likely to see much of a change in how monetary policy is conducted. Yellen has beliefs that are very similar to Bernanke's and she has had a strong hand in the Fed's policies (including the move to an official 2% inflation goal). President Obama will have an opportunity to nominate individuals to assume the two vacant seats on the Fed's Board of Governors. However, monetary policy and regulation aren't going to be much affected. Yellen's challenge will be to taper judiciously in 2014 and normalize monetary policy over the next few years.

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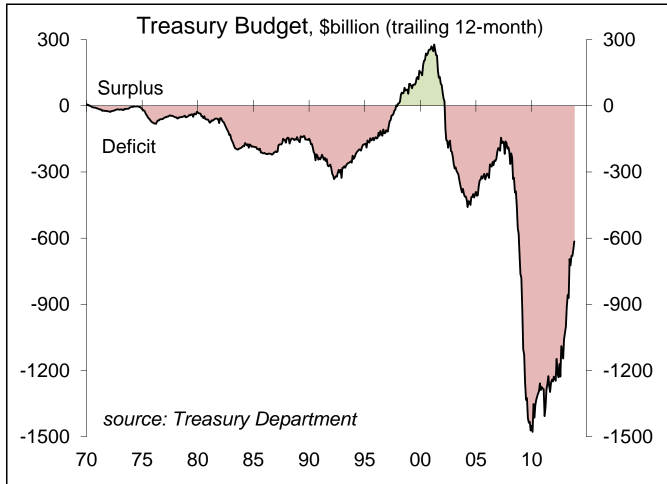
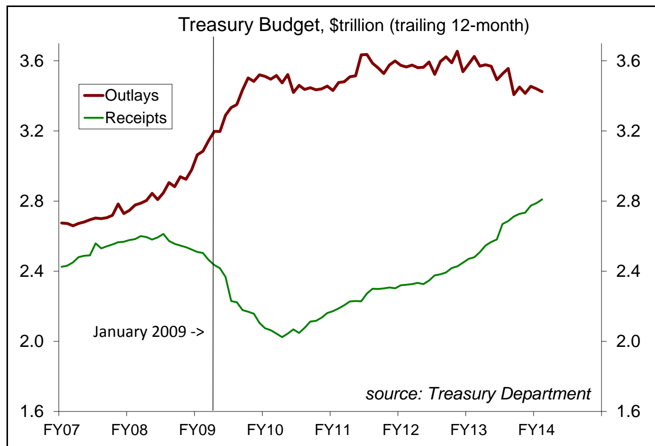
Fiscal Policy

Federal fiscal policy has been misguided. Lawmakers worked to reduce the budget deficit in the short term, which slowed the recovery significantly in 2013, while also making the long-term budget problems a little worse. The budget deficit fell to about 4% of GDP in FY13, is set to decline to about 3% of GDP in FY14 and about 2% of GDP in FY15. The U.S., like most nations, faces serious long-term issues regarding the funding of healthcare and retirement for the elderly.



As expected, the economic recovery has played an important role in reducing the budget deficit. Revenues have improved significantly, but are far from normal (as is the level of overall economic activity). Spending has fallen for two years in a row and is below where it was projected to be in 2008.



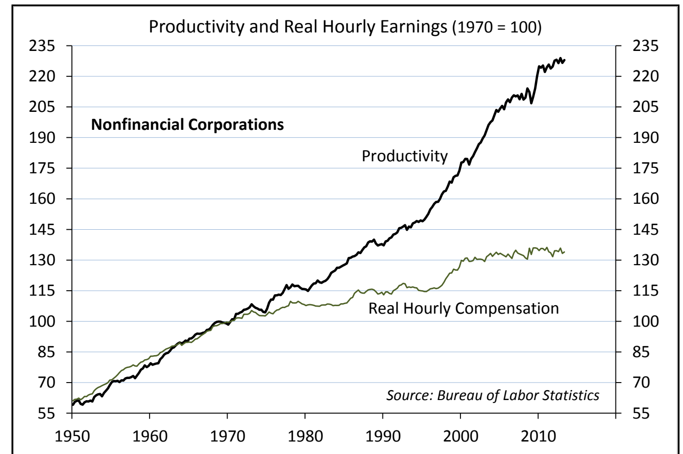
Sequester cuts to spending are set for mid-January. The recent budget agreement reduces, but does not eliminate, the impact of those cuts on the economy. More importantly, the budget deal means that we aren't going to see another government shutdown in January. However, the budget deal did not raise the debt ceiling, which is set to go back into effect on February 7. Through creative accounting, Treasury should be able to borrow for weeks, and perhaps months, after that deadline – but the debt ceiling will have to be raised at some point. As minor as the budget deal was, it may just be the last major accomplishment of the current Congress, as the two sides square off ahead of November's midterm elections.

Income Inequality

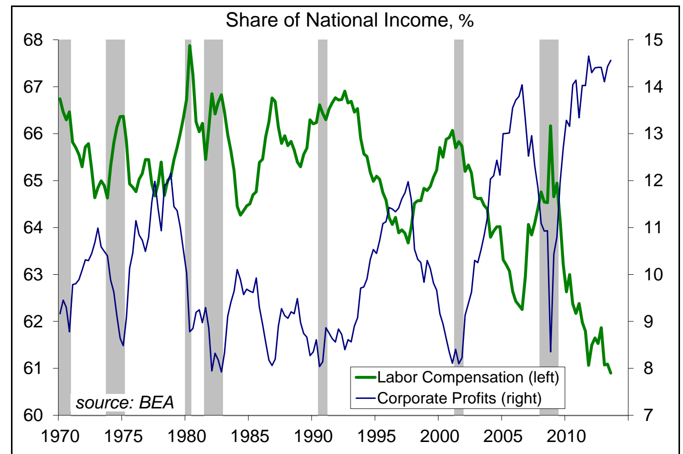
"Just as the commandment 'Thou shalt not kill' sets a clear limit in order to safeguard the value of human life, today we also have to say 'thou shalt not' to an economy of exclusion and inequality. Such an economy kills."

– Pope Francis, Apostolic Exhortation, November 24, 2013

The two previous popes cautioned against the excesses of capitalism. However, the new pope's comments were sharply more critical. I point this out not to debate what the pope said, but to highlight the issue of income inequality, which you're going to hear a lot about over the course of 2014.



At this point, there should be little doubt that income inequality has increased. Despite strong growth in productivity over the last few decades, real incomes have grown meagerly. The key questions are whether income inequality has a significant impact on overall economic growth (and there's growing evidence that it does) and if so, what to do about it.



As the discussion of income inequality heats up, investors may become concerned about proposed efforts to reduce it. Democrats are likely to push for an increase in the minimum wage and call for higher taxes on the wealthy. However, with a Republican majority in the House, we aren't going to see action in 2014. Income inequality could become an important issue in the midterm elections. In the Senate, Democrats will defend 21 seats, while the Republicans will defend 14. Republicans will need to pick up 6 seats for a majority, but that may difficult.

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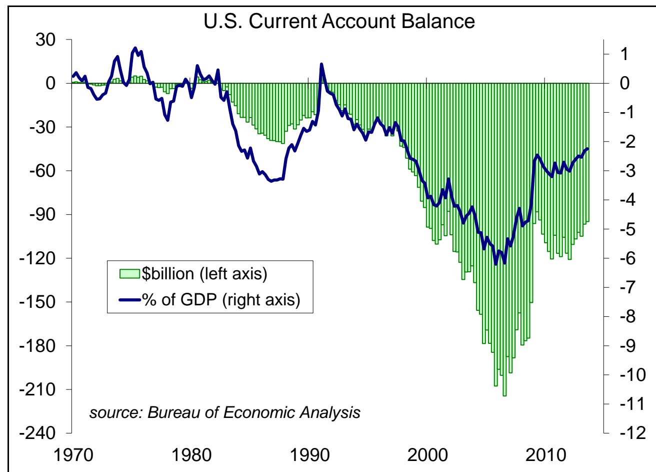
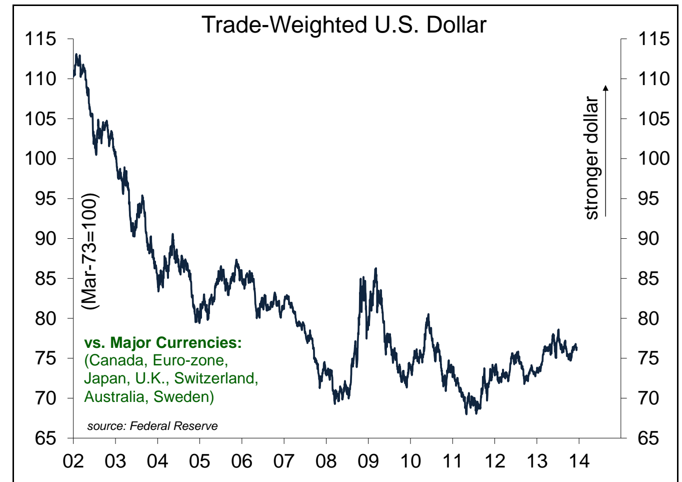
Foreign Trade and the Dollar

The global economy was weak in 2013, but showed some signs of improvement in the second half. Global growth should continue to pick up, but will likely be a bit disappointing relative to historical norms. Europe still faces challenges, but appears to have turned the corner. The long-term outlooks for China and other emerging market economies remain strong, but conditions could be spotty in the near term. China remains dependent on exports and it banking system will face a number of challenges over the course of 2014.



U.S. export growth should pick up moderately in 2014, with better prospects beyond that (reflecting an improved global outlook and capacity expansions for East Coast ports). Increased energy production should extend the downtrend in oil imports, keeping overall growth in imports largely in check. As a consequence, the current account deficit is likely to decline further as a percentage of GDP. In turn, the U.S. would need fewer net capital inflows to keep the dollar stable.



The exchange rate of the dollar is a price, reflecting supply and demand. The U.S. has a net trade outflow and a net capital inflow (the dollar moves to equate the two). A smaller deficit implies limited downward pressure on the dollar over the long term. In the medium term, U.S. growth prospects are brighter than for most other developed economies – a positive factor for the dollar. Short term, it's mostly central bank policy that matters. The dollar is poised to strengthen as the Federal Reserve begins to normalize monetary policy.

Projections

The pace of inventory growth should slow significantly, but it's unclear whether that will show up more in 4Q13 or in 1Q14. Domestic Final Sales are expected to pick up moderately. The unemployment rate should continue to trend lower, while job growth is expected to strengthen. Inflation should remain low, but trend gradually back toward the 2% target. Long-term interest rates should trend gradually higher, but the path is likely to be more uneven than what is suggested by the table.

	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	2012	2013	2014	2015
GDP (↓ *contributions*)	0.1	1.1	2.5	4.1	1.4	2.4	2.9	3.0	3.1	2.8	1.8	2.6	3.1
consumer durables	0.7	0.4	0.5	0.6	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.4	0.4
nondurables & services	0.4	1.1	0.8	0.8	1.2	1.4	1.4	1.5	1.5	1.0	0.8	1.3	1.5
bus. fixed investment	1.1	-0.6	0.6	0.6	0.4	0.5	0.6	0.7	0.7	0.8	0.3	0.6	0.7
residential investment	0.5	0.3	0.4	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.4	0.4	0.3
government	-1.3	-0.8	-0.1	0.1	-0.1	0.1	0.1	0.1	0.1	-0.2	-0.4	0.1	0.1
Domestic Final Sales	1.4	0.5	2.1	2.3	2.5	2.7	2.8	2.9	3.0	2.5	1.6	2.6	3.0
exports	0.2	-0.2	1.0	0.5	0.4	0.5	0.6	0.6	0.6	0.5	0.3	0.6	0.6
imports	0.5	-0.1	-1.1	-0.4	-0.2	-0.4	-0.5	-0.5	-0.6	-0.4	-0.2	-0.4	-0.6
Final Sales	2.2	0.2	2.1	2.5	2.7	2.8	2.9	3.0	3.1	2.4	1.5	2.6	3.0
ch. in bus. inventories	-2.0	0.9	0.4	1.7	-1.4	-0.5	0.0	0.0	0.0	0.2	0.1	-0.1	0.0
Unemployment, %	7.8	7.7	7.5	7.3	7.1	6.8	6.7	6.4	6.3	8.1	7.4	6.6	6.0
NF Payrolls, monthly, th.	209	207	182	167	203	195	205	205	210	183	190	204	196
Cons. Price Index (q/q)	2.2	1.4	0.0	2.6	0.6	1.4	1.6	1.7	1.8	2.1	1.5	1.4	1.9
excl. food & energy	1.7	2.1	1.4	1.8	1.6	1.6	1.7	1.8	1.9	2.1	1.8	1.7	1.9
PCE Price Index (q/q)	1.6	1.1	-0.1	2.0	0.7	1.3	1.5	1.6	1.7	1.8	1.1	1.3	1.7
excl. food & energy	1.3	1.4	0.6	1.5	1.2	1.5	1.5	1.6	1.7	1.8	1.3	1.4	1.8
Fed Funds Rate, %	0.16	0.14	0.12	0.09	0.10	0.12	0.16	0.20	0.22	0.14	0.11	0.18	0.93
3-month T-Bill, (bond-eq.)	0.1	0.1	0.1	0.0	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.9
2-year Treasury Note	0.3	0.3	0.3	0.4	0.3	0.4	0.6	0.8	1.0	0.3	0.3	0.7	1.6
10-year Treasury Note	1.7	2.0	2.0	2.7	2.7	2.9	3.0	3.2	3.4	1.8	2.3	3.2	4.1

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