The State of the U.S. Economy

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Credit Risk
1. Default Risk – borrowers’ willingness and ability to repay debt
   (unemployment rate)
2. Collateral Risk – market value decline of the asset securing the loan.
   (home price changes)
Wisconsin’s unemployment rate was 6.7% in August versus 7.0% one year earlier. Minnesota’s unemployment rate was 5.1% in August versus 5.7% one year earlier. Illinois’s unemployment rate was 9.2% in August versus 8.9% one year earlier.

Madison’s unemployment rate was 4.9% in August versus 5.3% one year earlier. Milwaukee’s unemployment rate was 7.6% in August versus 7.9% one year earlier. Greenbay’s unemployment rate was 6.2% in August versus 6.7% one year earlier.
Wisconsin’s home prices rose 3.7% over the last year.
Minnesota’s home prices rose 7.93% over the last year.
Iowa’s home prices rose 3.5% over the last year.

Madison’s home prices rose 1.55% over the last year.
Milwaukee’s home prices rose 1.07% over the last year.
Greenbay’s home prices rose 0.98% over the last year.
Wisconsin’s production of goods and services rose 2.65% over the last year. Minnesota’s production of goods and services rose 2.29% over the last year.

Source: CBO & Federal Reserve.
2013 Economic Growth = 2.5%
2014 Economic Growth = 3.0%

1. Housing market recovery (25% growth)
2. Rising home prices (7-9%)
3. Rising auto manufacturing (16 million units)
4. Rising business investment spending
5. Strong energy sector
6. Strong medical care sector
7. Easing credit conditions
8. Rising consumer confidence
9. End of deleveraging
10. Less imported oil will reduce current-account deficit

Is there a recession in our future?

Are there excesses or imbalances in any sector?

1. Farm land prices?
2. Stock prices?
3. Bond prices?
4. Political?

Fiscal Policy Uncertainty

- Debt Ceiling (mid-October)
- Continuing resolution to fund federal government (Sept. 30)
- Republicans attempting to defund ‘Obama-care’ (Sept./Oct.)
The output of goods and services produced by labor and property located in the U.S rose 3.6% in Q3. Positive contributions came from personal consumption expenditures, private inventory investment, exports, nonresidential fixed investment and residential fixed investment. Negative contributions came from rising imports and lower federal government spending.

Final sales of domestic product – GDP minus change in inventories – grew 1.9% annualized. Inventories added 1.7% to growth as firms increased the pace of inventory accumulation. Stronger aggregate demand will lead to job growth, rising confidence and further spending (a self-sustaining expansion).

A “balance sheet recession” is the process whereby households and companies pay down debts rather than embark on new spending. The lack of demand for loans is due to the debt-strapped private sector.

Economic growth during 2002-08 relied too much on consumption spending and house buying, both financed by foreign savings channeled through an undercapitalized financial system. Today’s sluggishness stems from pre-crisis excesses and the misshaped economy it created. Recoveries from debt-driven busts always take years as households repair balance sheets.

### 3rd Quarter 2013 GDP

**Spending** = C + I + G + X - M  
% of total = (70.6) (14.0) (18.5) (13.4) (-16.4)  
**Growth rate** = (1.4) (16.7) (0.4) (4.5) (2.7)  
**Contribution** = (1.0) + (2.5) + (0.1) + (0.4) + (-0.4) = 3.6%  

\[(1+0.036)^{1/4} - 1 = 0.0089 = 0.89\% \quad \text{(non-annualized quarter growth rate)}\]
Payroll employment grew 203,000 in November, above the 150,000 long-run target and above the 200,000 needed to meaningfully lower the unemployment rate (private payrolls rose 196,000, government payrolls rose 7,000). Housing-related employment, directly and indirectly, will account for 2/3 of all private sector job gains during the next few years. Improved consumer balance sheets will also stimulate job creation in 2014. But higher payroll and income tax rates will dampen consumer spending and job creation. Government spending cuts will affect employment through furloughs, hiring freezes and delayed expansion plans.

Average workweek remained at 34.5 hours. A stable workweek but more payrolls lead to 0.2% rise in total hours worked. Average hourly earnings ($23.82) rose by 0.2% m/m and 2.2% y/y, indicating little evidence of wage pressures and slightly above the 1.7 inflation rate. Forward looking indicators (temp hiring and average weekly hours) suggests additional hiring in coming months.

The unemployment rate fell to 7.0% in September, which corresponds to 11.7 million unemployed workers of which 4.6 million have been unemployed for more than 26 weeks. Underemployment fell to 13.7%. The labor force participation rate remained at 63.2%. Employment-to-population ratio remained at 58.6%.

The labor force rose 455,000: employed roe 818,000, unemployed fell -363,000.

Structural Unemployment Disease: Joblessness is becoming chronic with the average unemployment at 40 weeks. Long-term unemployment is harder to cure because workers’ skills atrophy (human capital degradation) and they become detached from the work force. High long-term unemployment decreases future economic growth, raises future deficits and decreases social order. the theory of hysteresis argues that a recession can permanently affect the labor force, leading to an increase in long-term unemployment.
Fed’s “Financial Repression”

3 Step Process:
1. Fed pushes S.T. rates to zero
2. Fed pushes L.T. rates very low
3. Fed lets inflation increase to 2.5%

- Facilitate wage and price adjustments
- Erode real value of household and government debt
- With short-term nominal rates close to zero, higher inflation means lower real rates
- Negative long-term real rates
- Lower real interest rates benefit young borrowers at the expense of old savers
- Political implications of aging population

Source: Federal Reserve
The debt-to-income ratio fell over the last 5 years because a lot of mortgage debt has been written off and new debt is hard to get. Consumers are also deleveraging to work off this mountain of debt. The debt-to-income ratio reached 1.04% in Q2, 2013, down from 1.29% in Q3 2007. Economists believe a ratio of 100% is sustainable in the long run.

**Rising debt ratios:** Households using future income to fund current consumption.

**Falling debt ratios:** Households using current income to pay for past consumption.

**QE:** Continued QE will lower interest rates, encourage additional borrowing and spending, and therefore increase economic growth and job creation.

**Not QE:** American households’ debt levels are still excessive and therefore must continue to deleverage their balance sheets. The Fed’s QE policy of encouraging more debt will just postpone the day of reckoning of the U.S. economy. QE and low interest rates has caused a redistribution of wealth from the old (savers) to the young (borrowers).

Source: Flow of Funds, D.3 Debt Outstanding By Sector, Total Household .
BEA, Disposable Personal Income, $ billions.
Quantitative Easing
(Print money to buy bonds)

The Fed’s large scale asset purchase program.
(Monthly purchases of $45 billion Treasuries and $40 billion MBS)

Should the Fed Continue QE or End it Today?

The Fed policy is to hold down long-term interest rates and encourage investors to take more risk. This should revive demand and economic growth.

In normal times the Fed moves short-term interest rates via “open-market operations”: by buying and selling securities, they supply or subtract reserves from the banking system. The quantity of reserves that banks hold is a secondary consideration; the real target is the interest rate. A lower rate, for example, encourages spending and investment, boosting the economy.

In times of severe economic distress, however, short-term interest rates may fall to zero. That is when QE comes into play. One type of QE is called “credit easing” with the aim to support the economy by boosting liquidity and reducing interest rates when credit channels are clogged, for example the mortgage backed security market. Another type of QE works through “portfolio rebalancing”. Investors who sell securities to the Fed then take the proceeds and buy other assets, raising their prices. Lower bond yields encourage borrowing; higher equity prices raise consumption; both help investment and boost demand. If investors buy foreign assets, portfolio rebalancing also weakens the domestic currency, fueling exports.

The critical question is whether the uncertain risks of uncertain magnitude outweigh the benefits of doing more QE.

Stipulated: The FRB of San Francisco estimates that $600 billion of QE reduces long-term interest rates by 15-20 basis points, equivalent to a 75 basis point cut in the federal-funds rate. QE helps the real economy. QE1 and QE2 increased output 3%, employment is 3 million higher, and the unemployment rate is 1.5 percentage points lower than otherwise.

Quantitative Easing Timeline
QE-1 = November 2008…$ 600 b MBS
QE-2 = November 2010…$ 600 b Treasury
QE-3 = September 2012…$40b/m of MBS
QE-4 = December 2012…$85b/m of MBS & Treasury
Quantitative Easing

Spending = HH + Bus./Res. + Gov. + Exports – Imports

Con. Invest.
The size of the Fed’s balance sheet is what matters for monetary policy. If the size of the balance sheet continues to grow then policy is getting looser. So if the Fed cuts in half its monthly purchases, that would be like reducing the fed funds rate by 5 basis points instead of 10.

**QE:** The Fed has indicated it would hold the bonds on its balance sheet to maturity to address fears that dumping bonds will lead to a rapid rise in borrowing costs. This will also allow the Fed to avoid realizing losses on its bond holdings (and therefore capital levels) as interest rates rise to normal levels when QE ends.

**Not QE:** The level of the monetary base has now reached dangerous levels. Unwinding of such a massive program will prove to be very difficult. So the longer the Fed continues QE the harder it will be. The Fed’s asset purchases and growing market presence could increase the chance of price distortions because QE makes the markets less liquid. QE is distorting pricing signals in the MBS market. The greatest risk is a mishandled QE exit: inflation and interest rate could spike, and the Fed could lose credibility with financial markets and lawmakers.
Inequality of foresight produces overinvestment during rising prices and relative stagnation during falling prices.

In the former case, society is trapped into devoting too much investment of productive energies for future return, while in the contrary case, underinvestment is the rule.

Irving Fisher, 1930
**ECONOMIC FORECAST**

- **The U.S. economy is expected to grow 2.00% in 2013 and 3% in 2014.** The U.S. economy will grow 2% in 2013 due to surging housing construction, rising home prices, rising auto sales, stronger business investment spending and a robust energy sector. Fiscal headwinds coming from higher payroll and income tax rates and lower government spending due to the sequestration will be a modest drag on overall economic growth but not enough to derail the recovery.

- **Inflation will fall below the Federal Reserve’s inflation target of 2% in 2013.** Core inflation (excluding food and energy prices) will also remain around 1.75% in 2013 due to a modest recovery and falling commodity prices. Low core inflation will keep inflation expectations low and therefore also keep long-term interest rates low.

- **The unemployment rate will fall below 6.5% by the end of 2014.** The 6.5% is the new threshold the Federal Reserve has adopted as to when it will begin raising the fed funds interest rate target. The higher than normal unemployment rate over the next two years will keep CU loan delinquency rates slightly above historical averages.

- **The fed funds interest rate will stay in the 0-0.25% range through 2014 due to the economy operating below potential.** The U.S. economy is currently producing a level of output of goods and services 6% below its potential level of output. The Federal Reserve will wait until the economy closes that gap before exiting its extraordinarily easy monetary policy.

- **The 10-year Treasury interest rate will move in the 2.75% to 3.25% range through 2014.** The Federal Reserve’s QE-3 program (monthly purchases of $85 billion of Treasury bonds and MBSs) will continue through 2013 to keep downward pressure on long term interest rates. The quantity of purchases will decrease in 2014 as economic growth reaches 3%. This will raise long-term interest rates to over 3.25% by year-end 2014.

- **The Treasury yield curve will steepen in 2013 and 2014 as long-term interest rates rise faster than short-term interest rates.** This may increase credit union’s net interest margins as borrowing short term and lending long term becomes more lucrative; but only if loan demand is there.