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Economic Outlook

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September 2012

Recovery: Playing a Double Header

- The three year-old recovery has two clear characteristics
  - Data displays two clear phases: 1st half weak and 2nd half weaker
  - Driven by two normal leading sectors
  - Absence of other traditional leaders limits acceleration

- Monetary Policy much less accommodative than monetary liquidity implies

- Fiscal Policy poorly designed and poorly implemented

- Major economic issues submitted to political resolution
  - Euro Zone sovereign debt crisis
  - US Fiscal Cliff

- Labor market faces cyclical and structural pressure

- Corporate profits prevail while Personal income declines

- There’s a recession out there somewhere

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Weak Recovery: Missing Some Starting Pitchers

- Weak recovery began with some typical foundation drivers…
- Near-record Business Cap Spending
  - and Inventory Accumulation
  - Strong corporate profits

- Consumer: bought durable goods and ***repaired household debt***

- …but lacked other typical early cycle leaders:
  - Credit transmission: regulatory uncertainty
  - Housing: sales returning but foreclosure overhang retards pricing
  - Government: Failure

- Labor market ***does not lead***
- Inflation: generating ***deflation angst***
- Monetary Policy: ZIRP; QE 1 and 2 and Operation Twist
- ***Global re-recession*** (x-US) led by Euro Zone finance and China policy

- US election year: ***the decision is already made***
- Fiscal Cliff: ***Disaster***… IF…

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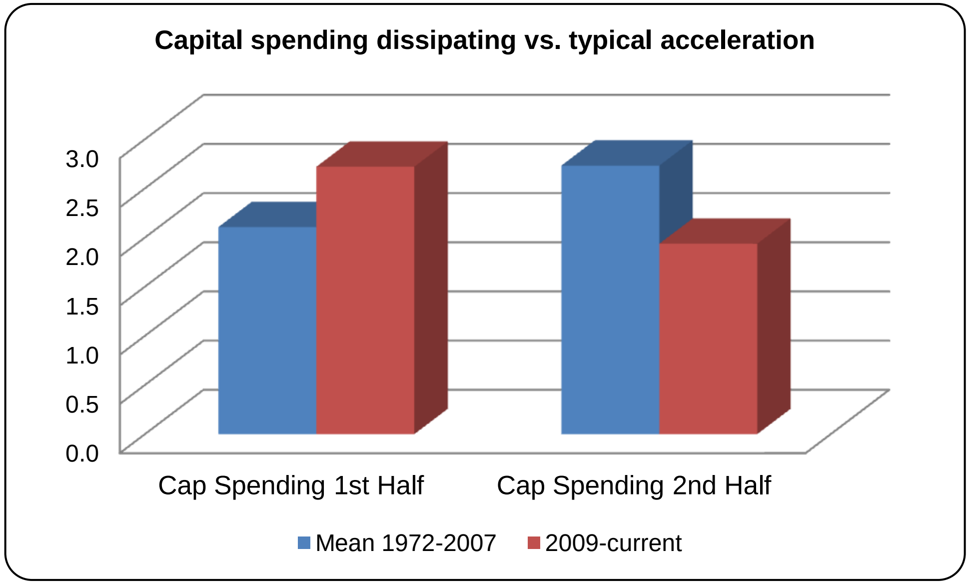
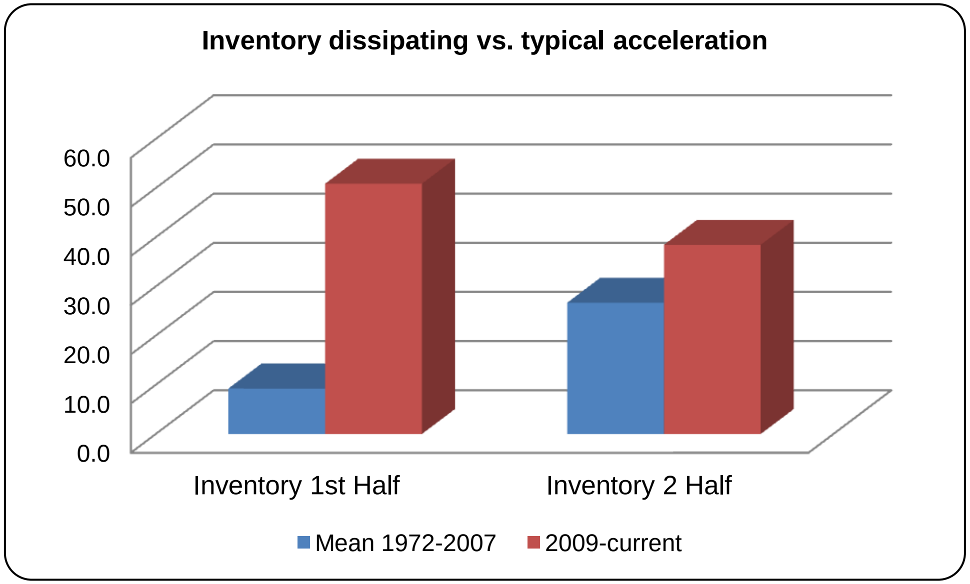
Weak Recovery: Missing Some Starting Pitchers





Expansion: Game 1

- GDP = 2.2% vs typical recession recovery = 4.7%
- Consumer durable goods = 6.5%
- Inflation: -2.5% to 4.4%

- Drivers: Business Cap Spending and Inventory Accumulation

- "Absent without leave"
  - Credit transmission: ***C&I loans = -15.2%***
  - Housing: ***-4.1%***
  - Government: ***-0.8%***
  - Labor Market: ***-40K payroll jobs per month***

- Monetary Policy: ZIRP; QE 1 and 2 and Operation Twist
  - Bernanke all in.
    - Fed funds – effective zero and interest paid for excess reserves
    - Bond purchases supply cash and lower mortgage rates but weak monetary multiplier
    - Twist lowers public sector interest cost

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Expansion: Game 2

- GDP 1.9% and ***sliding***
- Consumer: Refi and more ***autos***
- Inflation: 4.4% to ***1.3%***

- Drivers: ***Shifting and not all for the better***
  - Credit transmission: 7.3% (should be 12% to 14% by now)
    - Access remains balkanized
  - Housing begins late rebound: 7.6%
  - Labor Market: ***143K jobs per month***

- Critical Slowing:
  - Business Cap Spending and Inventory Accumulation
  - Government: ***accelerating downward*** = ***-2.8%***
  - Labor Market: ***Productivity dissipates***
    - Inevitable result of ***fatigued work force***

- Monetary Policy -- a promise or a warning?: ZIRP to 2014

- Global recession deepens; ***policy promise but scant implementation***

- Fiscal Cliff: ***No Change*** -- not even a campaign issue

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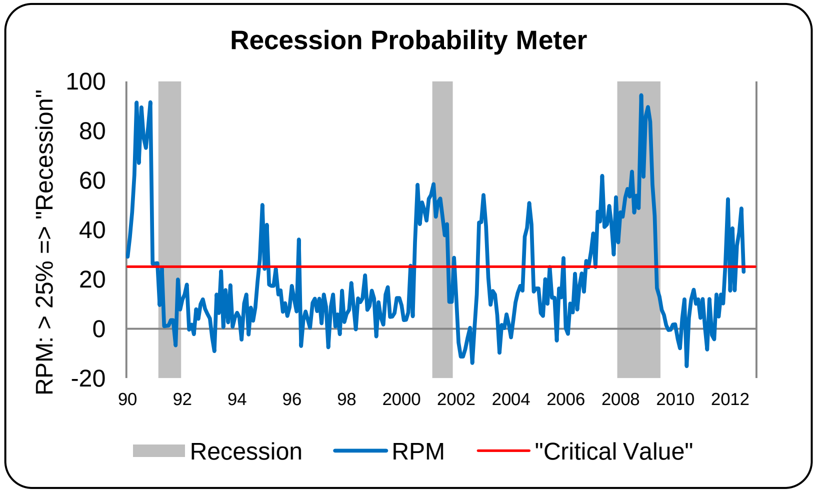
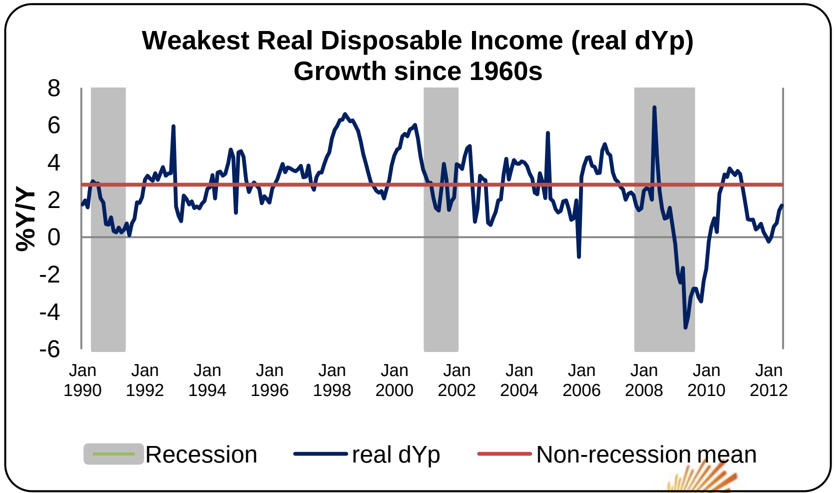
There is a recession out there somewhere

When you come to a fork in the road, take it …
-- Yogi Berra

- Recovery is three-years long; the economy enters recession every five years

- What could push recession forward
  - Recession Probability Meter
  - Fiscal Cliff = -$600 billion – A sure thing??
    - Expansions since 1982 average $300 billion per year
  - Greatest fundamental risk: Stagnant real disposable personal income
    - Household resources stretched to the limit
    - Oil = $150; gasoline = $5.50
  - Monetary transmission remains balkanized
  - Business capital spending has dissipated





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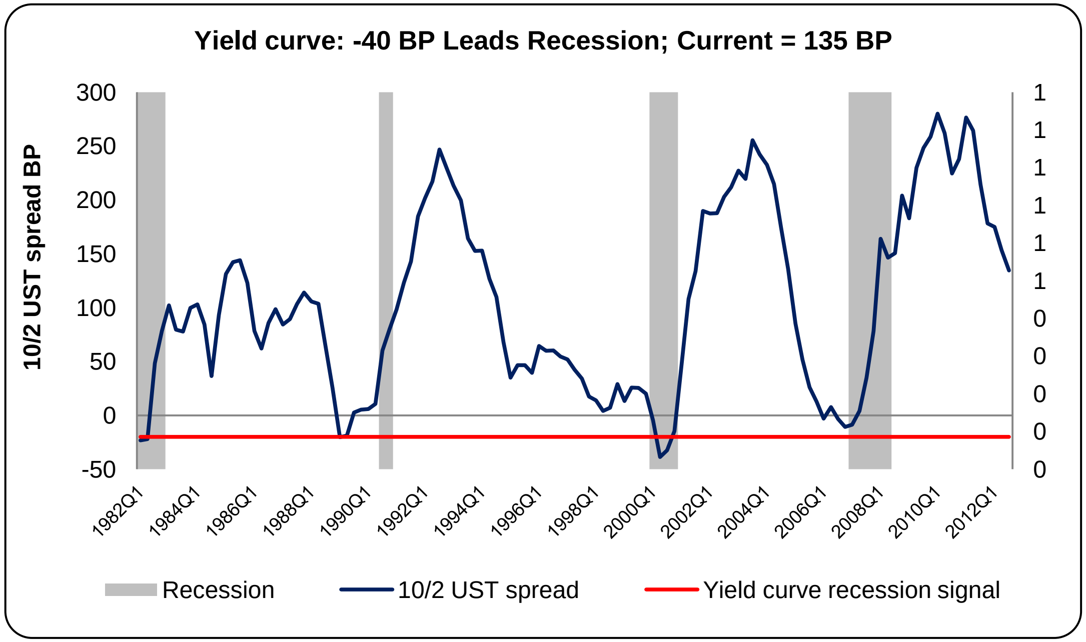
There a recession out there somewhere

It ain't over 'till it's over …
-- Yogi Berra

- Recovery is three-years long; the economy enters recession every five years
- What supports re-acceleration?
  - UST 2-Yr and UST 10-Yr Yield curve spread
  - Housing replaces Cap spending
  - Weak global production helps consumer prices
  - Deflation fear supports ZIRP and QE$^{\infty}$



There is a recession out there somewhere

You've got to be careful if you don't know where you going, because you might not get there
-- Yogi Berra

- Note that there are no Fiscal Policy prescriptions listed among either positives or negatives. Short-sighted policy over this and prior administrations ham string policy tools with potential to boost economy quickly.

- Issues are large and increasing, but the size of the issues is the fault of both parties at different times and in different ways.

- The high profile issues are Federal but …
  - The biggest dollar issues exist at the state and local level.

- Republican policy cuts deficit. Spending and deficits cuts in 2017. No help for now.

- Democratic policy requires cultural shift. Spending and deficits cuts in 2017.

- Both virtually assure Congressional log jam and "kick the can" alternatives that don't solve big ticket problems

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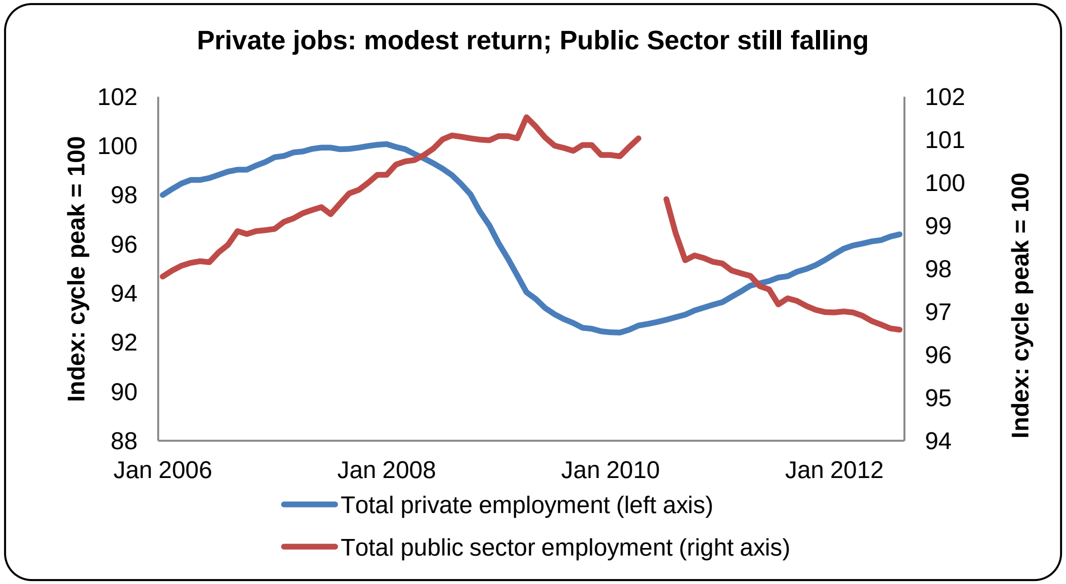
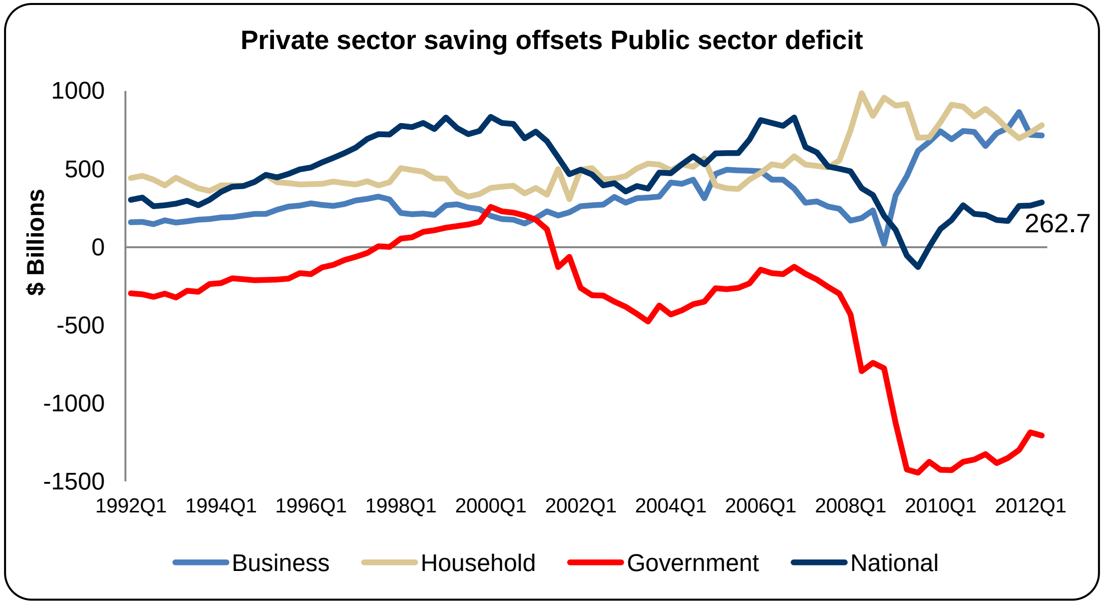
There a recession out there somewhere

Nobody goes there anymore. It's too crowded
-- Yogi Berra

- Labor market confront two issues: cyclical and structural
- Cyclical: 30% of all job losses during recession accrued to Construction, Mortgage finance, and government.
  - X-housing and government losses, current unemployment rate of 8.1% would be 6.8%
- Structural: More complex issue. Housing/construction and finance are already slowly recovering
  - Construction up 60,000 jobs from trough
  - Mortgage finance up 35,000
  - Government continues 45 straight months of losses totaling 1,300,000 jobs



Three Pools of National Saving



National Saving illustrates one of the private/public dichotomies that fee bias toward angst over potential economic weakness

- The public debate agonizes over the public sector's $1.2 trillion deficit …
  - … indeed it is bad, but …
- Total National Saving is still positive -- $263 billion …
- Business saving is $714 bill
- Household saving is $780 bill

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Economic Summary

- **2012 US economy at uncertain "fork"**
  - We are guardedly optimistic that 2012 growth can stabilize, but requires reversal of some fundamentals
  - Housing is now **non-negative** and banks lending has reappeared – both need to accelerate
  - Consumer resources are stretched to the limit
  - Absent fundamental strengthening, expect GDP to continue in a range between 0.5% with a downside risk
  - 8% Unemployment should be 7%+'s by year end 2012 and 6.5% by 2013

- **Inflation risk rising, as growth risk declines**
  - Cost pass-through remains primary inflation risk
  - As jobs grow, productivity sags and wage cost becomes a greater profit constraint
  - Upward trading pressure on crude oil prices in spite of global slowdown and increased refinery activity
    - Risk is Crude at $150

- **Credit improvement is essential, but remains hindered by moral hazard and new regulation**

- **Interest rates and monetary policy**
  - Fed remains committed to accommodation until mid-2013
  - Interest rates rise and yield structure flattens

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