

U.S. Economics Weekly: Market and Policy Comments

Outlook Update: From Tail Risks to Tailwinds

- The updated economic forecast continues to show a modest firming in growth over the next year and a half from near 2% closer to 3%. Near-term growth appears to be slowing to 1½%, reflecting in part continued declines in government spending. But the drag from earlier tax hikes may be easing up on schedule as stronger employment and more supportive financial conditions buoy demand.
- We have lowered the projected path for unemployment and now show it straddling 7% around the turn of the year. That is a quarter- to a half-point lower than current Fed forecasts but reflects the likelihood that labor force participation may continue to fall faster than demographic trends suggest. Participation appears to be keying off the elevated level of joblessness more than improving employment trends.
- Signs that the expansion is overcoming the threat from fiscal tightening are expected to prompt an initial pullback in the pace of Fed QE by September with an anticipated end date by next spring. Both retail sales and housing market indicators have buoyed the case that a durable recovery has significant support from key sectors. Nonetheless, the bigger test for policy and interest rates likely awaits renewed improvement in a range of employment leads this summer.

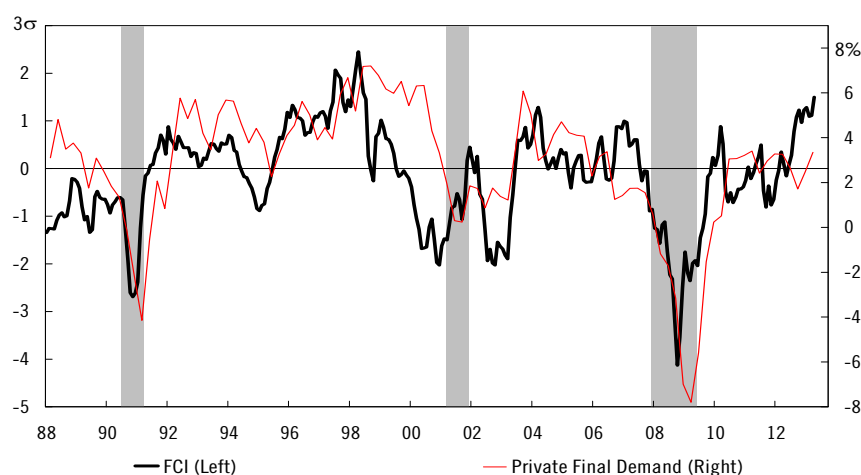
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Citi Financial Conditions Index (Standard Dev.) and Private Final Demand (Two-Qtr. Smoothed, Ann. Pct. Chg.), 1988-Apr 2013



Sources: Bureau of Economic Analysis and Citi Research.

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Outlook Update: From Tail Risks to Tailwinds

The updated forecast still sees slight firming in growth later this year and next.

Strengthening financial tailwinds present some upside potential for growth, countering the chance that fiscal drag might prove more sizable.

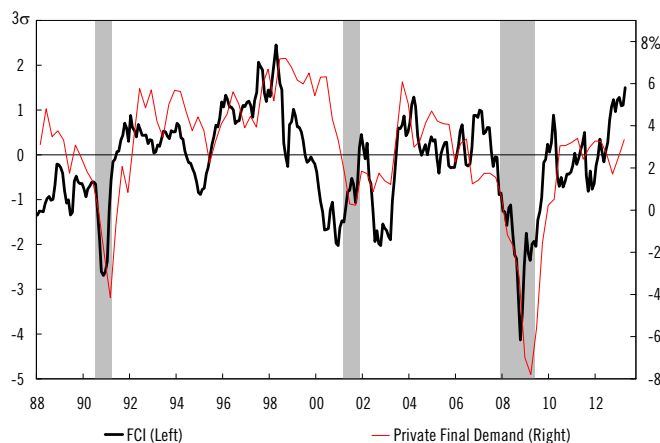
Our growth forecasts fall somewhere in the middle of Fed officials' projections.

Developments over the past month have not changed our views about a modest firming in economic growth over the next year. The recovery/expansion is approaching its fourth anniversary next month and yet it still hasn't achieved a pattern of really dynamic, self-feeding momentum. Nonetheless, financial markets sense that such a transition may not be that far off now. Growth has remained stuck in a range either slightly above or a little below 2% in the first half of the year but that belies some powerful crosscurrents working in opposite directions in the very short run. The optimistic case rests on the notion that the downward pull from fiscal tightening will fade and absent new shocks, the improved fundamentals and the remaining lift from monetary accommodation will promote a stronger finish to this year and beyond.

For the latest forecast round, we have bumped up our current quarter growth estimate from 1.1% to 1.5% based on a combination of better early tracking data and the persistent trend toward more accommodating financial tailwinds in recent months. Financial conditions have outrun earlier assumptions and the most recent readings would suggest a possibility of above-trend private sector demand (**Figure 1**). We think that leaves some upside to the base case that counters whatever downside risk there might be in the event that demand multipliers from budget cuts prove larger than expected. Not only are financial conditions looser, but the usual tradeoff in which rallies in economically-sensitive assets come at the expense of higher benchmark Treasury yields has been especially muted so far as global yields have remained mostly pinned down in this period (**Figure 2**).

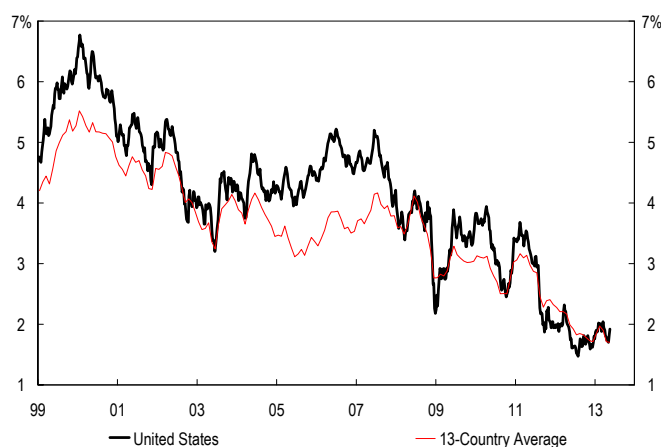
The slightly better near-term outcome has not altered our full-year estimates for growth in part because we incorporated slightly greater fiscal drag via larger declines in discretionary federal spending (almost 10% over this year and next) than we previously anticipated (**Figure 3**). Our growth estimate is still near the middle of central tendency forecasts among Fed officials. At their March meeting, the central view was that GDP would rise somewhere between 2.3% and 2.8% this year and then accelerate further to 3% or better in 2014. That view recognized that fiscal policy would likely be more restrictive this year as post-meeting statements have acknowledged. Implicitly, officials are anticipating — like us — that the drag

Figure 1. Citi Financial Conditions Index (Standard Dev.) and Private Final Demand (Two-Qtr. Smoothed, Ann. Pct. Chg.), 1988-Apr 2013



Sources: Bureau of Economic Analysis and Citi Research.

Figure 2. U.S. Ten-Year Treasury Yield and 12-Country Average, 1999-17 May 13



Note: 13-Country Average includes Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Singapore, Spain, Sweden, Switzerland, Taiwan and UK.
Sources: Federal Reserve Board and Citi Research.

Figure 3. U.S. Economic Outlook Highlights (Annualized Percent Change Unless Noted), 2012-14F

	2012	2013F	2014F	2013				2014	
	4Q/4Q	4Q/4Q	4Q/4Q	1Q	2QF	3QF	4QF	1QF	2QF
Real GDP	1.7 %	2.4 %	3.2 %	2.5 %	1.5 %	2.4 %	3.1 %	3.2 %	3.1 %
Domestic Demand	1.8	2.2	3.2	1.9	1.4	2.4	2.9	3.2	3.1
Consumer Spending	1.8	2.7	3.2	3.2	1.7	2.8	3.0	3.2	3.2
Housing	14.9	14.5	17.9	12.6	13.2	14.1	18.2	20.2	16.9
Investment	5.5	4.1	5.7	2.1	3.8	4.6	5.8	5.4	5.3
Exports	2.1	4.3	7.5	2.9	2.7	4.5	7.2	7.6	7.4
Imports	0.2	4.3	6.8	5.4	2.5	4.0	5.4	6.8	7.2
Government	-1.8	-2.5	-0.7	-4.1	-2.5	-2.2	-1.2	-0.9	-0.7
Inventory Change	-0.5	0.3	0.0	1.2	0.0	0.0	0.1	0.0	0.1
Net Exports (Contrib.)	0.3	-0.1	-0.1	-0.5	-0.1	-0.1	0.1	-0.1	-0.2
Unemployment Rate (Pct, Q4)	7.8	7.1	6.7	7.7	7.5	7.4	7.1	7.0	6.9
PCE Deflator	1.6	1.3	2.1	0.9	-0.1	2.2	2.2	2.1	2.2
Core PCE Deflator	1.5	1.6	2.1	1.2	1.0	2.0	2.0	2.0	2.2
Fed Funds Target				0.25	0.25	0.25	0.25	0.25	0.25
Ten-Year Treas. Yld. (Avg.)				1.95	1.85	2.10	2.35	2.60	2.80

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, and Citi Research.

from fiscal policy would likely be concentrated in the first half but that underlying cyclical forces and the Fed's own easing efforts would overcome or outlast that restraint.

The outlook is consistent with initial tapering of Fed QE later this year.

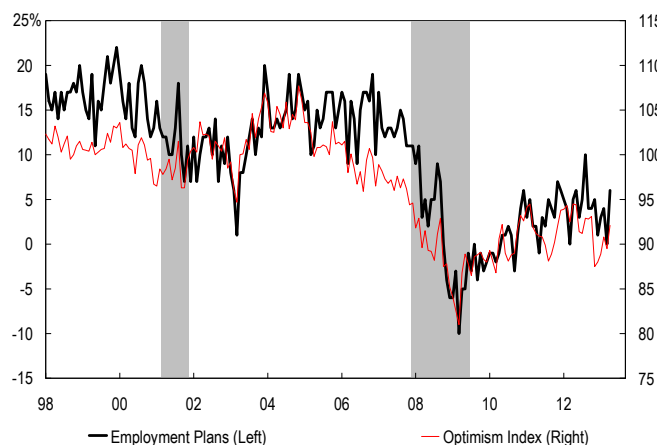
For monetary policy, we think the centrist view among Fed officials is reasonably close to the game plan outlined by San Francisco President John Williams in a speech this week:

"Consistent with the payroll and unemployment data I mentioned earlier, most of these indicators look healthier than they did in September. What's more, nearly all of them are signaling that the labor market will continue to improve over the next six months. This is good news. But it will take further gains to convince me that the "substantial improvement" test for ending our asset purchases has been met. However, assuming my economic forecast holds true and various labor market indicators continue to register appreciable improvement in coming months, we could reduce somewhat the pace of our securities purchases, perhaps as early as this summer. Then, if all goes as hoped, we could end the purchase program sometime late this year. Of course, my forecast could be wrong, and we will adjust our purchases as appropriate depending on how the economy performs."

We expect cutbacks in asset purchases to begin around September, conditioned on further encouraging signs in labor markets.

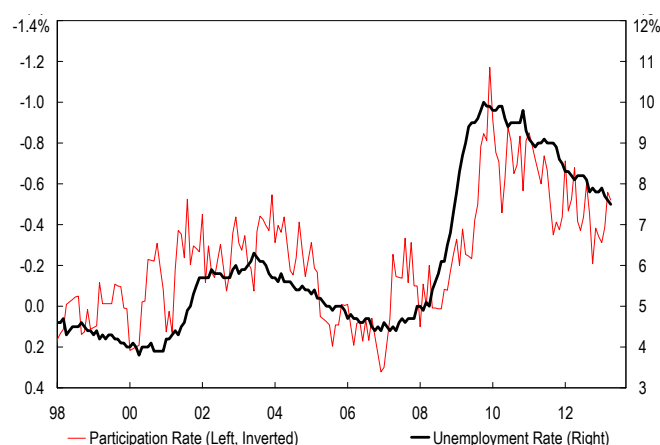
That quote is notable for too many caveats and hedges. Still, it is a clear enough indication that curtailing the pace of QE is data-dependent and not pre-ordained but likely to happen in the next several months if recent labor market trends continue. We have penciled September for the initial step down from the \$85 billion pace to a \$50-\$60 billion range, with an end to purchases by the start of the second quarter of next year. That reflects the expectation that very near-term job growth will fall short of its six-month 200,000-plus pace and firm up again later, while the unemployment rate continues to edge down. As discussed before, we would like to see some further improvement in hiring surveys from Manpower or small firms in the NFIB canvass among others. The latest NFIB survey showed a bounce in hiring intentions as well as stronger readings on sales and the general outlook. However, hiring plans and overall optimism in the sector are still below norms, and hiring especially has given off similar false starts (**Figure 4**).

Figure 4. Small Business Optimism Index and Net Planning to Increase Employment, 1998-Apr 13



Note: Shaded regions denote recessions.
Source: National Federation of Independent Business.

Figure 5. Labor Force Participation (Difference from Two-Year Moving Average) and Unemployment Rate, 1998-Apr 13



Source: Bureau of Labor Statistics and Citi Research.

The new forecast shows a lower unemployment rate at or near 7% heading into next year.

Further declines in the unemployment rate should also support the Fed's decision to scale back QE this year even if that trend is exaggerating the rate of improvement in labor markets. We have lowered our forecast for unemployment for this round and now show it straddling 7% around the turn of the year. Fed officials' last go-round anticipated a fourth quarter average between 7.3% and 7.5%, consistent with the argument that the cyclical portion of the decline in labor force participation might level off with better hiring trends. That judgment has been repeatedly frustrated and our forecasts for the jobless rate have been missing to the high side as well. In particular, we had thought that a revival in housing markets and construction would bring back discouraged prime-age workers whose disappearance couldn't be explained by structural factors. But with housing in a solid recovery and job growth in the sector up by 150,000 in the past six months, there are scant signs of a response among potential jobseekers.

The elevated unemployment rate may be driving participation rates lower despite better hiring.

As a result, for this forecast, we have assumed that participation will continue to decline but at a slowing rate. This reflects the judgment that high unemployment is still signaling a psychological roadblock of sorts to labor market reentrants and that participation is being driven more by the elevated *level* of unemployment than either job growth or the decline in unemployment. **Figure 5** illustrates this relationship, implying that participation could continue to decline relative to demographic trends — at a decelerating rate — until the unemployment rate itself is closer to more normal levels. In this scenario, even a temporary dip in job growth may not prevent further declines the unemployment rate in the next few months.

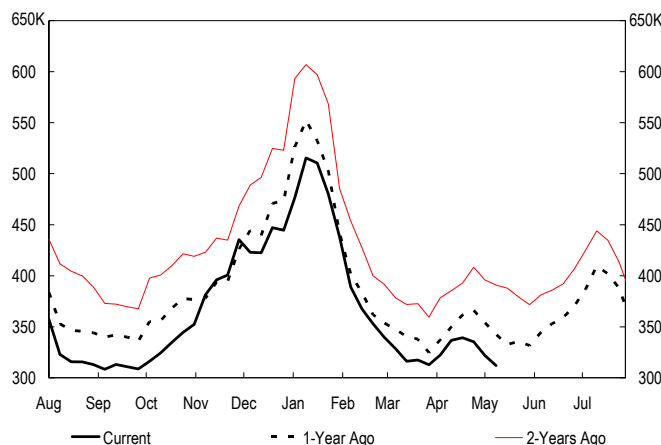
Volatile initial claims data probably are consistent with an improving trend in layoffs.

Data this week on initial jobless claims along with soft regional manufacturing surveys reenergized debate about the economy's underlying health, especially in light of ongoing fiscal restraint. Claims jumped by a surprising 32,000 in mid-May after an impressive run to new cycle lows. It's difficult to trace the source of movements like this in weekly data and it is possible that seasonal factors may be overstating some recent moves in both directions. A smoothed series of not seasonally adjusted claims is more reassuring that the improving trend in this area is probably continuing (**Figure 6**).

Stronger demand should stop out the weaker pattern in factory surveys.

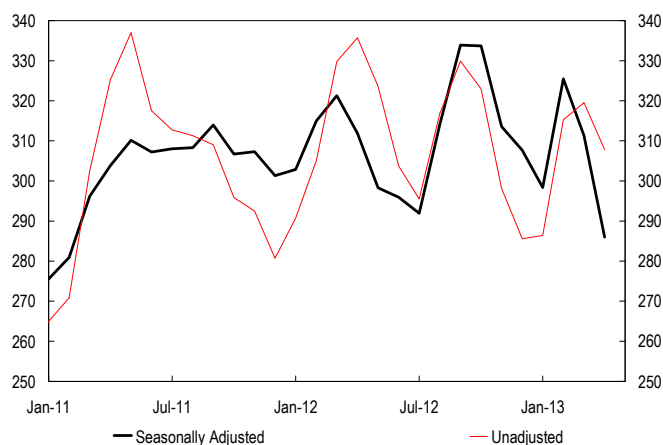
Similarly, we do not view the softness in factory readings as significant beyond the very immediate horizon because a pickup in final demand from consumers as well as a recovering housing sector ought to stop out any weakening in goods

Figure 6. Unadjusted Weekly Jobless Claims (Four-Week Moving Average), 2010-11 May 13



Source: Department of Labor.

Figure 7. CPI Gasoline Index (Seasonally Adjusted and Unadjusted), 2011-Apr 13



Source: Bureau of Labor Statistics.

production. The drop in industrial production in April was dominated by a sharp fall in utility output and that's a reminder that there is payback ahead from the superficially strong 3.2% jump in Q1 consumption. Real overall consumer spending likely fell in April or was perhaps flat at best because energy use fell back to normal levels after a cold winter. Those somewhat passive swings in spending mask some more encouraging signs that slowing in discretionary areas prompted by tax increases at the start of the year may be nearing an end.

Both retail sales and housing indicators suggest the recovery has good support in key areas.

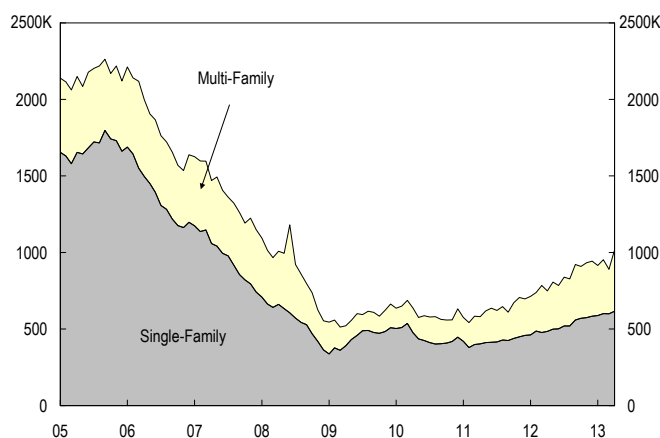
On that score, the current forecast reflects the healthy gains reported this week in retailing and housing activity.

- Core retail sales rose by 0.5% in April, well above our estimates, and more surprising because the March level was revised upward by an additional 0.5%. The boost accounts for slightly stronger PCE estimates for Q2 this month and is reminiscent of recent significant restatements of job growth. Some observers believe that the better news was deceiving because gasoline sales fell nearly 5% in April, a larger decline in dollars than the rise in core sales. But it's very unlikely that consumers spent any savings on gasoline in the same month. Just two months ago, gasoline sales spiked by 5% when core sales were up by 0.5%. Recent gyrations in gasoline prices net out to only a tiny "windfall" (Figure 7) that traditionally would show up in spending with a lag. In fact, savings to date are too small to count on. It's more likely that rising confidence led by employment and household wealth gains are beginning to overpower fiscal drag.
- In housing, buyer traffic rebounded this month along with overall builder optimism about prospective sales. Extreme swings in reported housing starts in recent months reflect the inherent volatility in multi-family building activity that has played a much larger role in this recovery. We don't think the steep fall in overall starts will have any lasting effect in part because the latest drop was dominated by lower value-added apartment building but also because the pipeline of permits continues to post new highs (Figure 8). Permits in the multi-family sector were up 37% in April and are already approaching the highs of the previous economic expansion. Similarly, the more stable, larger single-family sector also reached a new cyclical high and should help keep residential investment on a solid double-digit growth track.

A rapidly improving fiscal picture reflects the improving outlook and will ease one source of market unease in coming months.

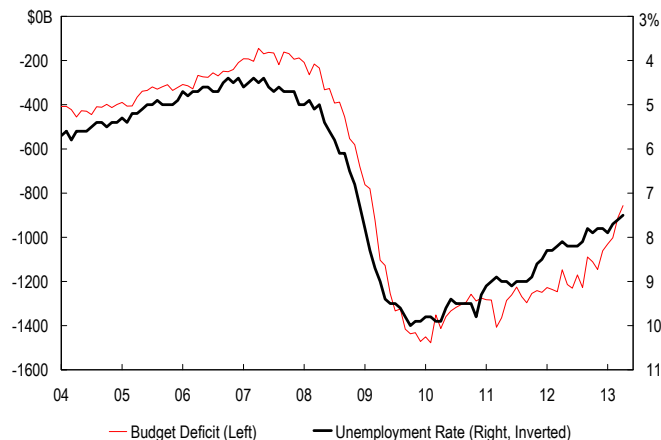
Against this backdrop, updated fiscal projections from the Congressional Budget Office show more convincing evidence that the economic recovery is driving deficits down quickly (**Figure 9**). While the latest figures incorporate nearly \$100 billion in one-time dividend payments from Freddie Mac and Fannie Mae to Treasury, the story apart from that is just as impressive for the medium term. Tax revenues are surging at a 15% rate while the combination of spending caps, the unwinding war and sequestration has literally flattened spending. We will have a full discussion of fiscal policy and the updated budget outlook next week. While the unfortunate side effect of near-term deficits dropping below 3½% will probably stall any progress on long-term fiscal consolidation, the improving trend also diminishes one source of investor unease and a recurring headache for monetary policymakers.

Figure 8. Single and Multi-Family Home Permits (Thousands), 2005-Apr 13



Source: Census Bureau.

Figure 9. Budget Deficit (Twelve-Month Cumulative Sum) and Unemployment Rate, 2004-Apr 2013



Sources: U.S. Treasury and Bureau of Labor Statistics.

May-June 2013

Monday	Tuesday	Wednesday	Thursday	Friday
13 Retail Sales <u>Total</u> <u>ExAuto</u> Mar -0.5% -0.4% Apr 0.1% -0.1% Business Inventories Feb 0.0% Mar 0.0% Auction 3 & 6 Mth. Bills \$53.0B	14 Small Business Import Price Index <u>Total</u> <u>ExPetro</u> Mar -0.2% -0.1% Apr -0.5% -0.1% Auction 1 Mth. Bill: \$20.0B	15 Mortgage Applications Producer Price Index <u>Total</u> <u>ExF&E</u> Mar -0.6% 0.2% Apr -0.7% 0.1% Empire State Manufacturing Apr 3.05% May -1.43% Industrial Prod. & Cap. Util. Mar 0.3% 78.3% Apr -0.5% 77.8% Housing Market Index Apr 41 May 44	16 Jobless Claims 5/11 360 Thous Consumer Price Index <u>Total</u> <u>ExF&E</u> Mar -0.2% 0.1% Apr -0.4% 0.1% Housing Starts and Permits Mar 1021K 890K Apr 853K 1017K Philly Outlook Survey Apr 1.3% May -5.2% Real Earnings (Apr) Ann 10-Yr. TIPS: \$13.0B	17 Reuters/Michigan Sentiment AprF 76.4 MayP 83.7 Leading Indicators Mar(R) -0.2% Apr 0.6%
20 Auction 3 & 6 Mth. Bills \$55.0B(E)	21 Auction 1 Mth. Bill: \$30.0B(E)	22 Mortgage Applications Existing Home Sales Mar 4.92M Apr(E) 4.98M FHFA FOMC Minutes Released	23 Jobless Claims 5/18 345 Thous(E) New Home Sales Mar 417K Apr(E) 420K FHFA Auction 10-Yr. Tips: \$13.0B(E) Ann. 2-Yr. Note: \$35.0B(E) Ann. 5-Yr. Note: \$35.0B(E) Ann. 7-Yr. Note: \$29.0B(E)	24 Durable Goods Orders <u>Total</u> <u>ExTrans</u> Mar -5.8% -1.5% Apr(E) 0.1% 0.3%
27 Memorial Day NYSE Holiday Federal Gov't Holiday	28 S&P/CaseShiller (Mar) Consumer Confidence Apr 68.1 May(E) Auction 2-Yr. Note: \$35.0B(E) Auction 3 & 6 Mth. Bills \$55.0B(E)	29 Mortgage Applications Auction 5-Yr. Note: \$35.0B(E) Auction 1 Mth. Bill: \$30.0B(E)	30 Jobless Claims 5/25 GDP & Chain Price Index 1Q 13A 2.5% 1.2% 1Q 13P(E) Corporate Profits (1QP) Pending Home Sales (May) Farm Prices (May) Auction 7-Yr. Note: \$29.0B(E)	31 Personal Income & Consumption Mar 0.2% 0.2% Apr(E) Chicago Barometer PMI Prices Apr 49.0 51.0 May(E) Reuters/Michigan Sentiment MayP 83.7 MayF(E)
Jun 3 ISM Manufacturing <u>PMI</u> <u>Prices</u> Apr 50.7 50.0 May(E) Construction PIP Mar -1.7% Apr(E) Total Vehicle Sales Apr 14.9M May(E) Auction 3 & 6 Mth. Bills \$55.0B(E)	4 International Trade Balance Mar -\$38.8B Apr(E) Flow of Funds (1Q) Auction 1 Mth. Bill: \$30.0B(E)	5 Mortgage Applications ADP Employment Apr 119K May(E) Nonfarm Productivity <u>Prod.</u> <u>ULC</u> 1QP 0.7% 0.5% 1QR(E) Factory Orders Ord. Inv. Mar -4.0% 0.0% Apr(E) ISM Non-Manufacturing PMI Prices Apr 53.1 51.2 May(E) Beige Book	6 Jobless Claims 6/1 Ann. 3-Yr. Note: \$32.0B(E) Ann. 10-Yr. Note: \$21.0B(E) Ann. 30-Yr. Bond: \$13.0B(E)	7 Employment <u>Apr</u> <u>May(E)</u> Payrolls 165K Unemp. Rate 7.5% Avg. Hrlly. Earn. 0.2% Priv. Wrkwwk 34.4H Consumer Credit Mar \$8.0B Apr(E) Strips Data (May)

(E) Indicates Citigroup estimates. (A) Advance. (P) Preliminary. (F) Final. (UNCH) Unchanged. (R) Revised. Contributors: Martha Berasain and Cathy Gaeta.

Appendix A-1

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