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North America

U.S. Economics Market and Policy Comments

GDP 4 Point 0 Reassures Fed Is On Track

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- The economy rebounded sharply in the second quarter, but there was an unmistakable loss of output in the first half as a whole. Since fundamentals remain supportive of growth, we expect that the economy will achieve 3 percent growth or higher in the second half and in 2015.

- The pattern of growth in the first half had clear markings of a large one-time shock to the economy, in this case the weather. The transitory nature of the shock became evident as every major sector that showed weakness in the first quarter rebounded in the second. This widespread "V" pattern suggested that the economy did not exhibit lasting weakness. This same pattern of US growth occurred after the March 2011 Fukushima disasters in Japan disrupted supply chains temporarily.

- Labor market indicators confirm robust economic growth. The acceleration in payrolls and the rapid drop in the unemployment rate are consistent with above-trend GDP growth. While July employment growth (209 thousand) was not as strong as June's blistering pace, when the US added 298 thousand jobs, July's figure matches the average employment gain for the last twelve months.

- The Federal Open Market Committee policy statement acknowledged the improved economic conditions and concluded that downside inflation risks have diminished. All committee members voted for the monetary policy action except for one. Philadelphia Fed President Charles Plosser dissented.

- President Plosser objected to the "guidance indicating that it likely will be appropriate to maintain the current target range for the federal funds rate for a 'considerable time after the asset purchase program ends,' because such language is time dependent and does not reflect the considerable economic progress that has been made toward the Committee's goals."

- Apparently President Plosser wanted to remove any hint of a calendar-based policy stance, and wanted to be ready to shift policy if conditions warranted—regardless of the timing.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

GDP 4 Point 0

Peter D'Antonio

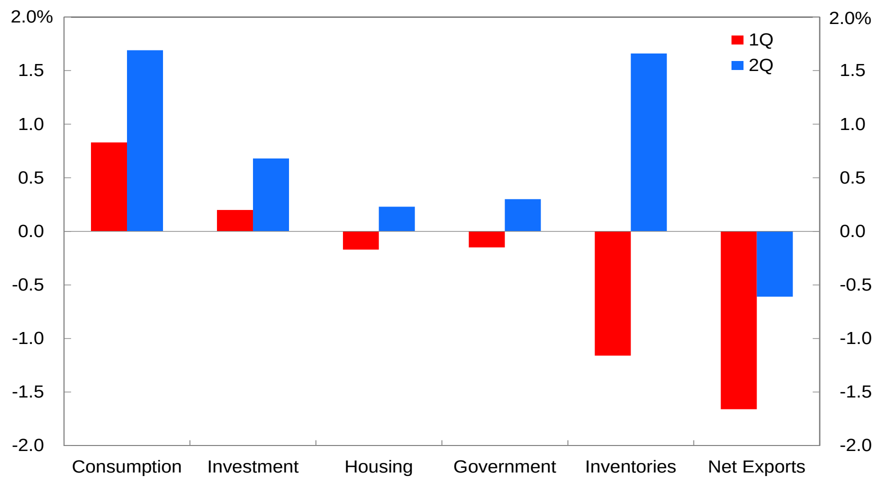
The economy bounced back after the dismal first quarter.

The 4.0 percent rebound in second quarter real GDP growth reversed much of the dismal performance in the first quarter, but for the first half as a whole GDP increased by just 0.9 percent annualized. Will that be enough to dispel doubts about the robustness and sustainability of the recovery? Although the second quarter rebound was stronger than expected, many market participants believe that the economy has lost steam and is unlikely to carry solid growth into the second half of the year. They discount the bounce back in growth because about three points of the swing in growth from first to second quarter was in inventories, which will not be repeated. We disagree with this view of a fragile economy. Even though events such as the harsh winter always involve some permanently lost output, current fundamentals are signaling that the better economic news will continue.

Growth formed a classic "V" around the weather disruption.

The rebound in the second quarter was broad based, with every major spending and production category that showed weakness in the first quarter bouncing back (**Figure 1**). That pattern of widespread reversals is typical of events such as weather disruptions that affect all sectors at the same time and then dissipate. This was also evident in the monthly data across sectors. For instance, manufacturing production nearly stalled in the first quarter, then jumped by 6.7 percent in the second. The same pattern occurred in retail sales, with the second quarter total up 9.6 percent, after edging up just 0.9 percent in the first. Business and consumer surveys indicated solid rebounds as well.

Figure 1. Contributions to GDP Growth Bounced Back Across Sectors in 2Q



Source: Bureau of Economic Analysis.

Much of the swing was in inventories.

***Figure* 1** shows that the bulk (nearly half) of the swing from the 2.1 percent decline in the first quarter to the 4.0 percent rise in the second was caused by inventories. We actually view the jump in inventories as necessary to maintain a normal relationship with sales. Inventories had not kept up with demand last year, driving the inventory-to-sales ratio down sharply (**Figure 2**). The pullback in demand in the first quarter righted this ratio and the restocking in the second quarter kept pace with the rebound in demand.

The weather hit entailed permanent loss of output.

But why didn't the second quarter rebound completely offset the decline and reestablish the former trend? There is inevitably some loss of output whenever a significant event disrupts the normal course of business activity and consumers' lives. In the case of the bad weather in the first quarter, for example, people across the entire eastern seaboard were repeatedly blanketed with snow, which kept them

from going to work and to shopping centers and restaurants. These types of activities are never fully made up in subsequent quarters.

Figure 2. The Ratio of Inventories to Goods Sales Rebounded to Recent Low Norms

Note: Shaded regions denote recessions.
Source: Bureau of Economic Analysis.

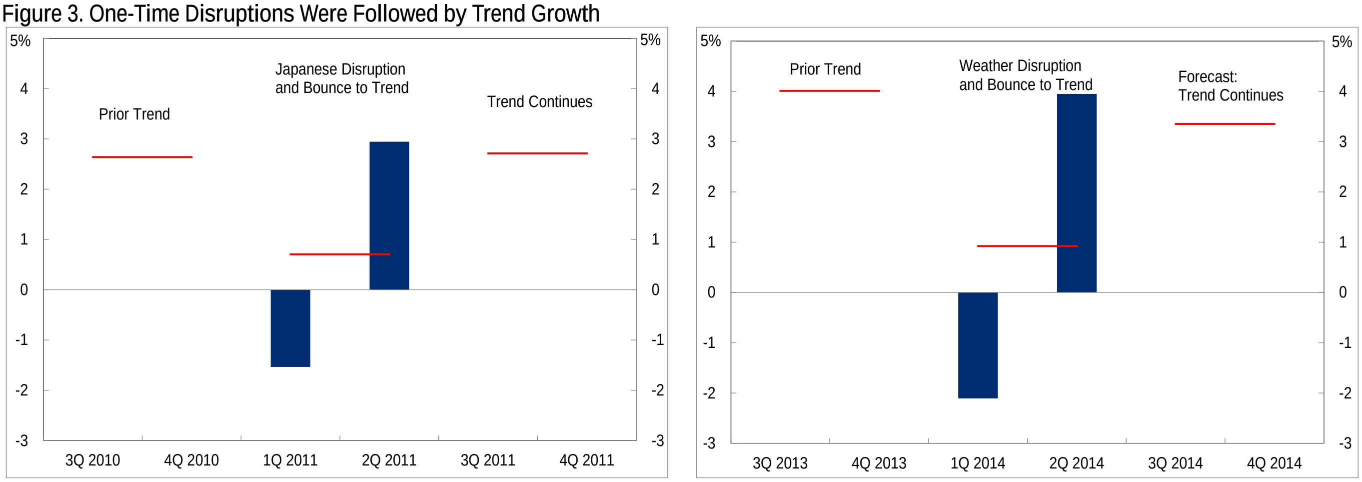
The 2011 Japanese disasters had a similar impact…

This same pattern occurred in the first quarter of 2011 in the aftermath of the Fukushima tsunami and nuclear disasters in Japan. The details were a little different, however. Japanese firms provide important inputs for US companies' products, so the catastrophe in Japan created a sudden supply chain disruption in the US. Shipments were delayed, causing a chain reaction that rippled through the US manufacturing base. The result was that the US economy, which had been growing at a 2.8 percent pace in 2010, suddenly contracted by 1.2 percent. In the following quarter, the economy returned roughly to the growth rate that prevailed prior to the disaster (but not to the previous path of real GDP). The net effect was US growth of less than 1 percent in the first half of 2011.

…on U.S. growth.

The Japanese event caused a similar disruption to US growth as the inclement weather this year. The cause was an isolated event that impacted the economy all at once and then dissipated. Importantly, the US weakness at the start of the year did not carry over to the rest of the year, as second quarter and second half 2011 growth jumped back to the 3 percent range. Note that the one-time loss in output in the first half was never recovered (**Figure 3**). The economy did not bounce back enough to offset the immediate lost output from the original disruption.

Figure 3. One-Time Disruptions Were Followed by Trend Growth



Note: Red lines represent two quarter average annualized percent changes.
Sources: Bureau of Economic Analysis and Citi Research.

Solid employment gains were completely at odds with the 1Q drop in output.

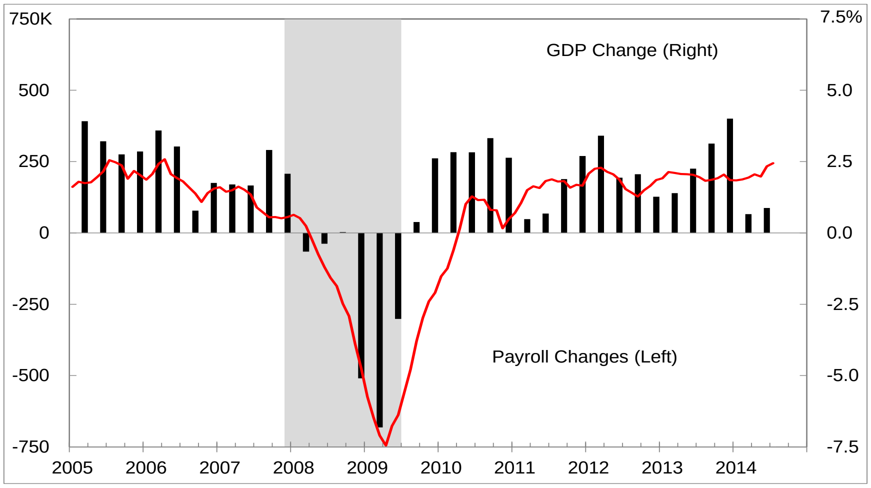
We also try to make inferences about future GDP growth by tracking developments in the labor market, which are not as influenced by weather as output or demand. It would be hard to make the case that many workers were fired permanently due to the storms that raged from December to March. We do not think there was any lasting impact on employment levels. In fact, payrolls accelerated thus far this year, with monthly gains averaging 230K. In other words, businesses have not restrained hiring at all, which is completely at odds with the pullback in GDP growth in the first half (**Figure 4**). These employment figures are telling us that the sudden weakness in output (GDP) was not a fundamental change in the trajectory of growth, but rather a short term reaction to the disruptions from weather, compounded by measurement errors.

Labor market indicators were consistent with no let-up in growth.

We can carry this line of reasoning a step further, by using Okun's law — a relationship between changes in the unemployment rate and growth in GDP — to determine what growth rate would be implied by the change in the unemployment rate. We estimated an Okun factor of 1.5, which says that for each point the unemployment rate falls in a year, real GDP growth will be about a point and a half above potential growth.[1] With potential growth currently at 1.7 percent and the unemployment rate down 0.6 percentage point in a half year, the implied growth rate in the first half would be about 3.5 percent annualized. In other words, the labor market was signaling sharply higher growth in the first half, consistent with our expectations for the second half and beyond. The disruptions from weather that plagued the GDP statistics, causing a series of huge revisions, barely registered in the labor market data.

[1] See William Lee "Boosting Employment with GDP Growth: Accentuating the Cyclical" in "Fed's Employment Mandate: Cyclical and Structural Forces Clash" for a further discussion of the variability of Okun's law and the asymmetric relationship between employment gains and GDP growth; it is stronger on the downswing than during recoveries. In addition, we found that the unemployment rate became less sensitive to changes in growth due to structural shifts associated with the tech boom. This trend reversed following the financial crisis and Great Recession. Currently, the unemployment rate is more sensitive to growth than the period prior to the Great Financial Crisis.

Figure 4. Six-Month Average Change in Payrolls Does Not Mirror the Disruption in the Two-Quarter Annualized Change in Real GDP



Note: Shaded region denotes recession.
Sources: Bureau of Labor Statistics and Bureau of Economic Analysis.

Consumer fundamentals are supportive of 3% plus growth…

We expect the economy to expand at a 3 percent plus rate through 2015, largely driven by consumers (**Figure 5**). Consumer fundamentals have improved greatly in recent years, reflecting continued gains in employment, a stunning rise in net worth due to sharply higher equity values and home prices, and the drive to work down debt. Consumer debt service payments are now below 10 percent of disposable income (a 35 year low – albeit aided by extraordinarily low policy-induced interest rates) and delinquency rates are falling. This is not to say that all forces that were dampening growth earlier in the expansion have become supportive. It is still difficult to obtain credit, especially for first time home buyers, and wage growth has been lackluster. However, these factors, which have been evident throughout, moderate the implied upswing in spending but do not squash it.

…which should spur investment growth.

We also look for an additional boost from investment spending. Firms have the means to expand investment, with profits near 30 year highs, but they have been reluctant to do so.[2] Although the latest durable goods report was weaker than expected, there has been an unmistakable rebound in demand for core capital goods. In the second quarter, new orders for these products increased at a 6.7 percent annual rate, shipments rose by 4.1 percent, and unfilled orders expanded by 10.5 percent. These data imply that firms are beginning to sense a sustainable pickup in demand for their products and that capacity needs to be expanded. As a result, we anticipate faster growth in investment.

Laggard sectors have improved.

Meanwhile, some important drags on growth have either ceased (state and local government spending) or even have begun to make small positive contributions (residential investment). Real state and local expenditures increased by 4.2 percent in the second quarter and the number of municipal jobs has been increasing for the past year. Because of lower broker fees, housing investment snapped back in the second quarter after two quarters of decline. Gains in housing construction, especially multifamily dwellings, are likely to continue adding modestly to growth.

[2] For an analysis of how economic policy uncertainty has produced headwinds holding back investment, see William Lee Global Economics View - Policy Uncertainty and Investment—How Much Lower Must Real Interest Rates Go? Fortunately such headwinds have dissipated.

Payrolls are averaging above 200 thousand.

Today's employment report supported our view of continued solid growth into the second half. Nonfarm payrolls slowed to 209 thousand in July after rising by an average of 245 thousand in the preceding three months. Nonetheless, employment gains have shifted up into a higher pace with the average gain in payrolls over the last 12 months at 209 thousand.

Other measures of slack are improving.

The unemployment rate ticked up by 0.1 percentage point to 6.2 percent in July compared to June, largely because of a 0.1 percentage point rise in the participation rate (to 62.9). However, the unemployment rate has declined by 0.5 percentage points since the first quarter of this year, consistent with robust underlying growth. Labor market slack persists, but assorted measures of underutilization are improving. Notably, the percent of persons experiencing extended unemployment durations has fallen by about 5.0 percentage points this year to 32.9 percent in July.

Figure 5. U.S. Economic Outlook Highlights (Annualized Percent Change Unless Noted), 2013-15F

	2013	2014	2015F	2014				2015			
	4Q/4 E	4Q/4	4Q/4	1Q	2Q	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	2.2	2.1	3.2	-2.1	4.0	3.5	3.2	3.2	3.0	2.9	3.3
Domestic Demand	1.9	2.2	3.2	0.7	2.8	3.4	3.1	3.2	3.2	3.1	3.3
Consumer Spending	2.4	2.4	3.0	1.2	2.5	3.2	3.0	3.1	3.1	2.9	3.1
Housing	11.9	2.6	8.2	-5.3	7.5	10.0	9.6	7.5	6.9	8.1	8.8
Investment	3.0	5.5	6.8	1.6	5.5	7.1	7.2	6.8	6.8	6.6	7.3
Exports	3.0	3.2	6.2	-9.2	9.5	5.5	6.2	6.1	6.0	6.0	5.8
Imports	1.1	4.3	4.8	2.2	11.7	3.6	4.4	3.6	5.0	5.2	5.0
Government	-2.0	-0.5	0.4	-0.8	1.6	0.7	-0.1	0.3	0.3	0.3	0.2
Inventory (Contrib.)	0.5	0.0	-0.2	-1.2	1.7	-0.2	-0.1	-0.2	-0.2	-0.1	0.0
Net Exports (Contrib.)	0.3	-0.5	0.0	-1.7	-0.6	0.1	0.1	0.2	0.0	0.0	0.0
Unemployment Rate (Pct.)	7.4	6.2	5.7	6.7	6.2	6.1	5.9	5.9	5.7	5.6	5.5
PCE Deflator (Yr-to-Yr)	1.2	1.6	1.8	1.1	1.6	1.7	1.8	1.9	1.8	1.7	1.8
Core PCE Deflator (Yr-to-Yr)	1.3	1.5	1.8	1.2	1.5	1.6	1.7	1.9	1.8	1.8	1.8

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

Dana M. Peterson

Fed Displays Cautious Optimism Without Altering Policy Guidance

The FOMC displayed cautious optimism this week, without altering its guidance.

The changes to the July FOMC monetary policy statement reflected mainly the Committee's assessment of new evidence that the economic recovery is moving at a robust pace. Importantly, the Committee's policy guidance for continued monetary accommodation remained unchanged. It appears that the Committee is becoming more encouraged by the progress of the economic recovery, citing improving output and labor market developments. Moreover, the FOMC upgraded slightly its views on inflation and the likelihood of achieving the 2 percent inflation objective, stating that the risk of inflation running persistently below 2 percent had diminished somewhat.

The rebound in economic activity in 2Q pleased policymakers. 2014 GDP tracking is back in line with Fed projections.

The FOMC noted the rebound in 2Q economic activity, and stated that household spending appears to be rising moderately and that business investment is advancing. Just ahead of the release of the policy statement, the BEA reported that real GDP in the second quarter rose by an above-forecast 4.0 percent annualized pace. Output in 2014 is now tracking at 2.1 percent 4Q/4Q, which is well within the FOMC's projected 1.9 to 2.4 percent 4Q/4Q range for this year. The FOMC said that labor market conditions had improved, with the further decline in the unemployment rate. Possibly to appease the less hawkish members of the Committee, the statement added a new sentence: "However, a range of labor market indicators suggest that there remains significant underutilization of labor resources."

The FOMC judged that the risk of inflation running persistently below 2 percent has diminished somewhat.

The most significant change in the FOMC's review of economic conditions was that "inflation has moved somewhat closer to the FOMC's longer-run objective," and is no longer "running below" the objective. The FOMC now judges that the likelihood of inflation running persistently below 2 percent has diminished somewhat. This contrasts with the June statement, which said "The Committee recognized that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term."

Better growth, unemployment and inflation prints were not sufficient to alter the policy guidance.

The Committee's more sanguine growth and labor market assessments, and brightening inflation sentiment were notable, but not sufficient to prompt alteration of the Fed's policy stance. The FOMC left policy guidance unchanged and trimmed QE, as expected: interest rates remained fixed, and the Committee tapered agency MBS (from $15 to $10 billion per month) and long-term Treasury securities (from $20 to $15 billion per month) purchases by $10 billion combined. The Committee also retained the prevailing forward guidance: (1) further taper of QE as economic and financial market conditions warrant; (2) "lower for longer" interest rates; and (3) data dependency regarding timing and extent of policy accommodation removal.

FOMC dissent alludes to fears that the FOMC may fall behind the curve…

All committee members voted for the monetary policy action except for one. Philadelphia Fed President Charles Plosser dissented. He objected to the "guidance indicating that it likely will be appropriate to maintain the current target range for the federal funds rate for a 'considerable time after the asset purchase program ends,' because such language is time dependent and does not reflect the considerable economic progress that has been made toward the Committee's goals." Apparently President Plosser wanted to remove any hint of a calendar-based policy stance, and wanted to be ready to shift policy if conditions warranted—regardless of the timing.

The dissention reinforces the growing tension among committee members — evident in the June meeting minutes — with regards to balancing multiple objectives: satisfying the dual mandate of maximum employment and price stability; effective use of Forward Guidance as a policy tool; and supporting financial stability in a shifting economic and financial market environment. The more hawkish members believe that the Fed runs the risk of falling behind the curve as inflation risks and financial imbalances grow. Indeed, we have noted that Chair Yellen's passive structural approach to managing financial stability risk should be supported more actively with interest rate policy.[3]

…but Chair Yellen continues to contend that below-target inflation and slack warrant extreme accommodation.

But Chair Yellen continues to contend that better output and unemployment prints notwithstanding, below-target inflation and excess supply continue to warrant a significant degree of monetary policy accommodation. Perhaps Chair Yellen will use the Jackson Hole Economic Symposium to elaborate further on the Committee's stance on these key issues.

[3] Our critique of the inadequacy of Chair Yellen's approach to managing financial stability risks is in two parts: William Lee U.S. Economics Market and Policy Comments - Fed Chiefs Debate Monetary Normalization While Yellen Passes Off Financial Stability; and Willem Buiter, William Lee, and Joe Seydl U.S. Economics Market and Policy Comments - Fed Creates Maginot Line to Defend Against Financial Instability

U.S. Economics Weekly: Market and Policy Comments — Previous Essays

	Publication Date
Fed Creates Maginot Line to Defend Against Financial Instability	25 July 2014
Potential Growth Slump Is Likely Temporary	18 July 2014
Fed Chiefs Debate Monetary Normalization While Yellen Passes Off Financial Stability	11 July 2014
Bright Outlook Leaves Fed On Schedule Despite Dark Q1	27 June 2014
Gradual Fed Exit Discounted By Markets	20 June 2014
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Fed's Employment Mandate: Cyclical and Structural Forces Clash	9 May 2014
Shifting Focus to Rebounding Growth	2 May 2014
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Forward Guidance: More than Old Wine in New Bottles and Cheap Talk?	25 September 2013
Some Guidance on Forward Guidance: Not Ready to Solo	10 September 2013

July-August 2014

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4 Auction 3 & 6 Mth. Bills: $53.0B(E)	5 ISM Non-Manufacturing PMI: Jun 56.0, Jul(E) 57.0 Prices: Jun 61.2, Jul(E) Factory Orders Ord: May -0.6%, Jun(E) 0.5% Inv: May 0.9%, Jun(E) 0.5% Auction 1 Mth. Bill: $45.0B(E)	6 Mortgage Applications International Trade Balance May -$44.4B, Jun(E) -$43.0B Ann. 3-Yr. Note: $26.0B(E) Ann. 10-Yr. Note(r): $24.0B(E) Ann. 30-Yr. Bond(r): $16.0B(E)	7 Jobless Claims 8/2 290 Thous(E) Consumer Credit May $19.6B, Jun(E)	8 Nonfarm Productivity Prod: 1QP -4.5%, 2QP(E) 2.2% ULC: 1QP 7.1%, 2QP(E) 0.7% Wholesale Inventories May 0.5%, Jun(E)
11 Auction 3 & 6 Mth. Bills: $53.0B(E)	12 Small Business (Jul) Federal Budget Balance Jul 13 -$97.6B, Jul 14(E) Auction 3-Yr. Note: $26.0B(E) Auction 1 Mth. Bill: $45.0B(E)	13 Mortgage Applications Retail Sales Total: Jun 0.2%, Jul(E) ExAuto: Jun 0.4%, Jul(E) Business Inventories May 0.5%, Jun(E) Auction 10-Yr. Note: $24.0B(E)	14 Jobless Claims 8/9 Import Price Index Total: Jun 0.1%, Jul(E) ExPetro; Jun -0.2%, Jul(E) Ann. 5-Yr. TIPS(r): $16.0B(E) Auction 30-Yr. Bond: $16.0B(E)	15 Empire State Manufacturing Jul 25.6, Aug(E) Producer Price Index Final Demand: Jun 0.4%, Jul(E) ExF&E: Jun 0.2%, Jul(E) Industrial Production Jun 0.2%, Jul(E) Capacity Utilization Jun 79.1%, Jul(E) Reuters/Michigan Sentiment Jul F(E) 81.8, AugP(E)
18 Housing Market Index (Aug) Auction 3 & 6 Mth. Bills: $53.0B(E)	19 Consumer Price Index Total: Jun 0.3%, Jul(E) ExF&E: Jun 0.1%, Jul(E) Real Earnings (Jul) Housing Starts Jun 893K, Jul(E) Permits Jun 973K, Jul(E) Auction 1 Mth. Bill: $45.0B(E)	20 Mortgage Applications FOMC Minutes Released	21 Jobless Claims 8/16 Leading Indicators Jun 0.3%, Jul(E) Existing Home Sales Jun 5.04M, Jul(E) Philly Outlook Survey Jul 23.9%, Aug(E) Ann. 2-Yr. FRN: $13.0B(E) Ann. 2-Yr. Note: $28.0B(E) Ann. 5-Yr. Note: $35.0B(E) Ann. 7-Yr. Note: $29.0B(E) Auction 5-Yr. TIPS: $16.0B(E)	22

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

Appendix A-1

Analyst Certification

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