U.S. Economics Weekly: Market and Policy Comments

Interest Rate Déjà Vu

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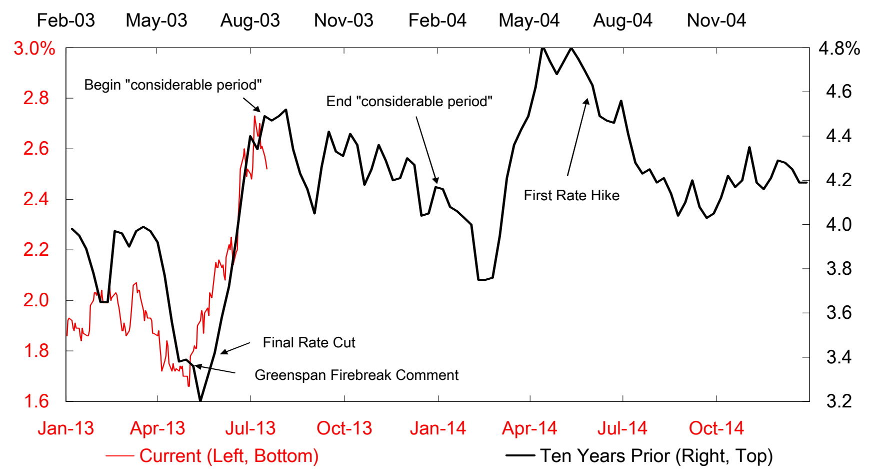
- The recent spike in interest rates has shown some hints of leveling off in July. Retail sales, housing starts and jobless benefits have given off mixed signals this month and Fed officials have not let up in their effort to cap rate expectations. We draw parallels to the 2003-04 experience when policy initially resisted rising rates amid rebounding confidence and improved fundamentals in a similar cyclical setting.
- Contractionary fiscal policy remains a last headwind of sorts to a more compelling growth story and the end of Fed easing. Budget data indicate that discretionary spending has slowed sharply since sequester began but thus far signs of spillover to private activity are scant. With financial conditions still highly accommodating, we continue to see growth picking up to north of 2½% following a very weak Q2.
- The housing recovery remains on track with one of the more reliable leads in buyer traffic now in a dramatic uptrend through July. A plunge in multi-family construction is typical of this volatile segment but the much larger value-added single-family sector continues to gain. Despite a letdown in core retailing, overall real consumption likely posted a healthy 0.3% in June, suggesting renewed momentum heading into Q3.

Ten-Year Treasury Yield, Feb 03-Dec 04, Jan 13-17 Jul 13



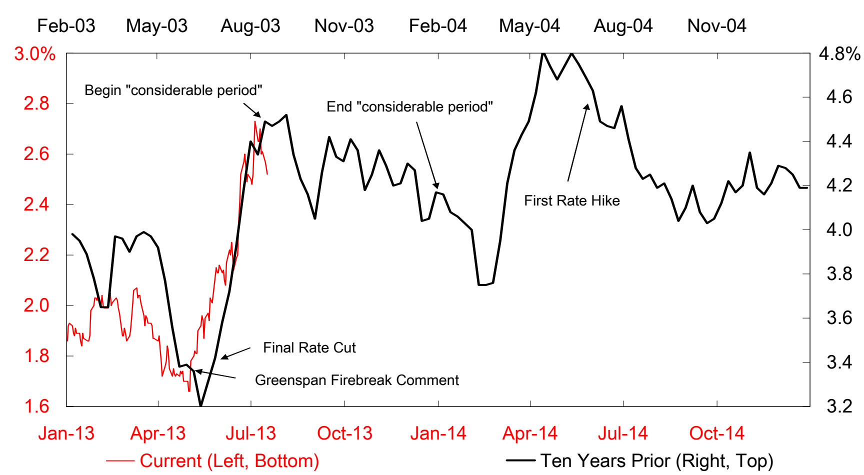
Note: The black line and axes refer to the 2003-04 period. Red line and axes refer to the current episode.
Source: Federal Reserve Board.

Interest Rate Déjà Vu

Rates seem to be plateauing, but with fundamentals improving, it may be hard to keep them super low.

The sharp run up in long-term interest rates of the past couple of months has shown some hints of flattening out in July. Although there have been indications of strength in forward-looking data on balance in recent weeks, some of the latest readings in retail sales, homebuilding and jobless claims have given off more mixed signals. For their part, Fed officials have not let up trying to persuade markets that a possible near-term tapering of QE has no bearing on the medium-term outlook for policy rates. The period immediately ahead will present a key test for all as we wait on benchmark GDP revisions and what if any spillovers surface from fiscal cutbacks that are increasingly visible in budget data. Nonetheless, it is getting harder to keep interest rates down near extreme lows when fundamentals and confidence in the recovery continue to gain traction.

Figure 1. Ten-Year Treasury Yield, Feb 03-Dec 04, Jan 13-17 Jul 13



Note: The black line and axes refer to the 2003-04 period. Red line and axes refer to the current episode.
Source: Federal Reserve Board.

Fed over-sharing is intended to avoid even greater dislocations later.

The accepted view in markets seems to be that the Fed has either mis-communicated or even misfired its policy signals since May with the Chairman in the dual roles of Dr. Jekyll and Mr. Hyde. If the Fed is guilty of over-sharing, it has been in the spirit of transparency and intended to avoid even greater dislocations in markets at some later date, particularly in light of complacency in markets at the lows in rates earlier this year. The Chairman highlighted a similar point in testimony this week. At the same time, he attempted to clarify that laying out a possible tapering scenario consistent with an improving economy was not intended as a policy change; nor was it meant to suggest that the path for QE has been preset.

The rate backup started with better news on the economy.

In fairness to policymakers, the backup in rates was under way weeks before Bernanke's May 22 comment about tapering later this year. In some respects, the bond rally that preceded this selloff represented an exaggerated response to sequestration and another springtime swoon in economic data that hasn't truly played to the script, given the acceleration in hiring and key demand-side data toward the end of Q2. Looking back now, the rally had run its course by the time the FOMC issued its two-way guidance on prospects for asset purchases on May 1. Two days later, job growth trumped the consensus and huge upward revisions upended speculation that labor markets were faltering. An 88,000 March gain in employment is now 142,000 and the three subsequent readings all have been in a tight range near 195,000.

Fed attempts to push back on rates can only go so far.

From this perspective, discussions about whether tapering is tightening may be secondary. By now, it's clear policymakers aren't going to encourage higher rates anytime soon. But when most indications suggest recovery is weathering strong fiscal headwinds and in some areas actually accelerating through them, it's highly unlikely Fed rhetoric will reverse very much of the recent reset. We can see a meeting of minds at some point soon: Market participants need to adjust to the idea that the Fed intends no harm by tapering and is willing, according to Bernanke's latest testimony, to consider more aggressive steps if higher long-term rates do too much to erode financial supports for growth. Fed officials need to take into account that markets will struggle to separate QE decisions from the eventual path of policy rates. However, both sides need to accept that improving fundamentals will force rates higher and the more compelling the evidence, the greater the chance that adjustments will happen abruptly, as some recent jobs reports have shown.

Figure 2. Average Monthly Federal Budget Outlays (Billions of Dollars), Fiscal 2013

			Estimated Change	
Major Program or Category	**October-February**	**March-June**	**Billions of Dollars**	**Percent**
Defense – Military	52.2	49.2	-3.0	-5.8
Social Security Benefits	66.3	69.1	2.7	4.1
Medicare[a]	40.9	40.9	0.0	0.0
Medicaid	21.7	22.5	0.8	3.7
Unemp., Food, Farm Subsidies, Net Interest	40.0	37.0	-3.0	-7.4
Other Activities	81.4	77.5	-4.0	-4.9
Total[1]	302.5	296.1	-6.4	-2.1

[a]Medicare outlays are net of offsetting receipts.
[1]Totals exclude certain offsetting receipts such as GSE dividend payments to Treasury.
Sources: Congressional Budget Office; Department of the Treasury and Citi Research calculations.

The current rise in rates is reminiscent of the 2003 episode…

There are aspects to the recent patterns in rates that are reminiscent of developments in 2003, a not too different stage in the previous business cycle. Although there are sharp differences in the fiscal thrust between the two periods, in other ways the current episode may be retracing cyclical history **(Figure 1)**. By the summer of 2003, the unemployment rate was coming down but employment was lagging and inflation was already low and declining. Corporate profits were surging again after a severe credit downturn and financial conditions were becoming increasingly accommodative as Fed easing efforts had reached an advanced stage. Amid concern that inflation was slowing by more than could be explained, Chairman Greenspan used a forceful analogy that policy needed a "much wider firebreak" against deflation and that officials should be prepared to "lean over backwards" to underpin the economy.[1]

…when Greenspan used his "firewall" analogy to underpin inflation expectations.

That strong guidance from Greenspan telegraphed a final rate cut three weeks later and with economic fundamentals improving steadily, his words helped put a floor under declining inflation expectations. As **Figure 1** highlights, two months later the Fed's obsession with deflation risk prompted new rate guidance that accommodation could be sustained for a "considerable period." That language helped to moderate emerging pressures on long-term rates temporarily but by early 2004 job growth was accelerating, deflation fears subsided and the Fed dropped its rate commitment in favor of guidance that accommodation could be removed gradually, By mid-2004, the next policy cycle began with the first rate hike.

[1] See "Decoupling Rates From Recovery," *Comments on Credit*, Citi Research, June 6, 2003,.

The 2003 experience may serve as a blueprint for the current path of rates.

That episode demonstrates that policy efforts at super-accommodation in the face of improving fundamentals may have only partial success and may leave markets more vulnerable to sudden setbacks. It's easier to see in hindsight and there is no certainty that our judgment is correct that fundamentals and cyclical forces ultimately will support modestly higher rates in time. But for our base case, it is quite plausible that the 2003-2004 experience could serve as a template of sorts. As mentioned, a key difference is that a major fiscal expansion was under way in that earlier period as the structural balance shifted from a small surplus of a half percent in 2001 to a deficit of 3% by 2004. This calendar year, policy changes have imparted a fiscal headwind of more than 1½% of potential GDP.

Contractionary fiscal policy is a wild card to ending easing.

The role of fiscal policy in this period has been a major uncertainty and one of the main risks Fed officials are waiting out before moving ahead with the "end of easing." Tax hikes in January seemed to make a visible difference in slowing discretionary consumer spending early on, but that drag has dissipated somewhat. The more pressing concern of late is the sequester, in which an estimated $65 billion in discretionary spending cuts over the calendar year beginning last March unfold. The two main questions have been: Are the cuts in fact taking place and what is the spillover effect on private economic activity?

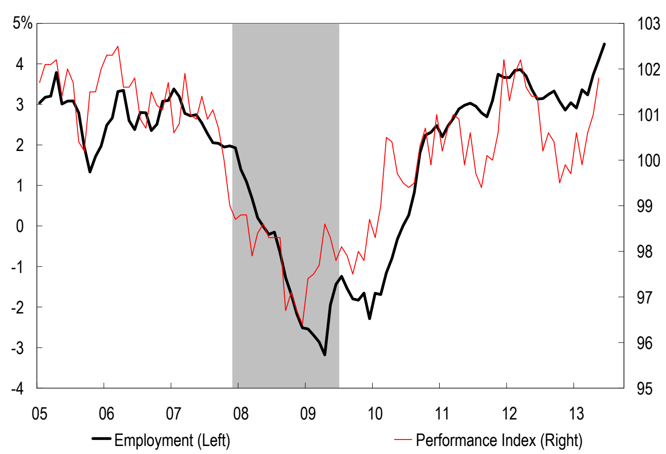
Government spending has slowed…

A close look at monthly budget data leaves little doubt that despite some delays, spending in the affected areas has slowed significantly in recent months. **Figure 2** breaks out spending so that we can isolate the most vulnerable discretionary areas. Note these are raw data that are not adjusted for seasonality or timing quirks in disbursements and in some cases it is difficult to extract areas off limits from the sequester from those most affected.

…broadly in line with earlier estimates of the sequester effects.

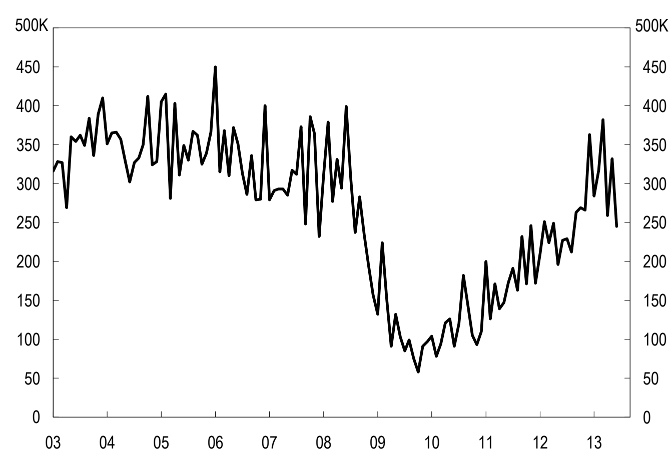
But we focus on three broad groups: entitlements, cyclically sensitive outlays, and military and other activities that would capture the bulk of sequestration hits. As the table shows, entitlements continue to expand in the period since March relative to the first five months of FY13. Medicare has been flat, but this includes some cuts in physician reimbursements due to sequester. Military and other activities together have fallen by an average of $7 billion per month. Although some of the slowing in defense reflects ongoing effects of drawing down troops and operational support in Afghanistan, these cuts are broadly in line with earlier sequestration estimates. But

Figure 3. Restaurant Employment (Six-Month Smoothed, Annualized Percent Change) and Restaurant Performance Index, 2005-Jun 13



Note: Shaded region denotes recession.
Sources: Bureau of Labor Statistics and National Restaurant Association.

Figure 4. MultiFamily Housing Starts, 2003-Jun 13



Source: Census Bureau.

this is a direct step down in aggregate demand largely centered in Q2 and will likely have steadily diminishing effects beyond that, particularly if Congress backtracks on elements of sequester — notably defense — in the FY14 budget. .

It is still an open question how much these cuts will ripple through to the private sector.

The harder question surrounds the ripple effects on private economic activity from these cutbacks. This is probably the bigger source of differences among forecasters with respect to fiscal drag. Moreover, there is probably no bigger source of uncertainty in near-term Fed policy. On this score, the evidence is encouraging but still leaves room for doubt. As discussed last week, running estimates of Q2 GDP have sunk to around 0.5% but that belies widespread indications that job growth and key segments of private demand have been gaining strength heading into the second half with still very accommodative financial conditions.

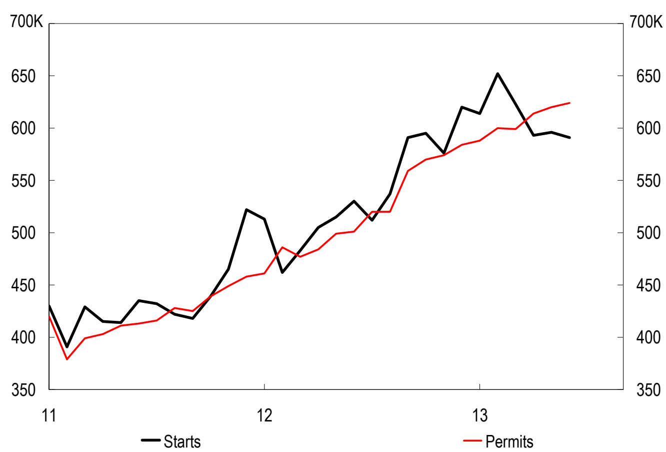
Despite mixed data lately, forward looking indicators suggest a consumer rebound.

Despite a few negative surprises, data this week had no effect on our thinking that growth will rebound to 2½%-3% in the next few quarters. Some of the numbers raised more questions than they answered. Core retail sales in June were up by only 0.1% from a level that was revised lower for May and that left our tracking estimate of Q2 real PCE at a subpar 1½%. However, with unit sales of light vehicles up more than 4%, that will likely boost overall monthly consumption for June by an estimated 0.3% and position PCE already 1% annualized above its Q2 level. With auto sales making new highs and car loan rates virtually untouched by the recent back up in long rates, we don't see the consumer faltering.

Survey and hard data have run counter to the soft retail sales report.

Moreover, the June retail numbers included some puzzling results sharply at odds with other readings, suggesting either the possibility of upward revisions or a significant bounce back ahead. For example, core retail was held down by a 1.2% plunge in restaurant sales. But this outcome is very different from survey readings from restaurants as well as hard data on payroll employment for the sector, where both have been accelerating to the upside **(Figure 3)**. The Restaurant Performance Index is rising on across the board improvements in capex, hiring, same store sales, and traffic. It is worth noting that the standard error (between first and final prints) on monthly retail sales in this category is a very high 0.9%, suggesting a high degree of caution in interpreting the initial softness in June.

Figure 5. Single Family Housing Starts and Permits, 2011-Jun 13



Source: Census Bureau.

Figure 6. Traffic of Prospective Home Buyers and Total Single Family Home Sales, 2002-Jul 13

Sources: National Association of Realtors, Census Bureau and National Association of Home Builders.

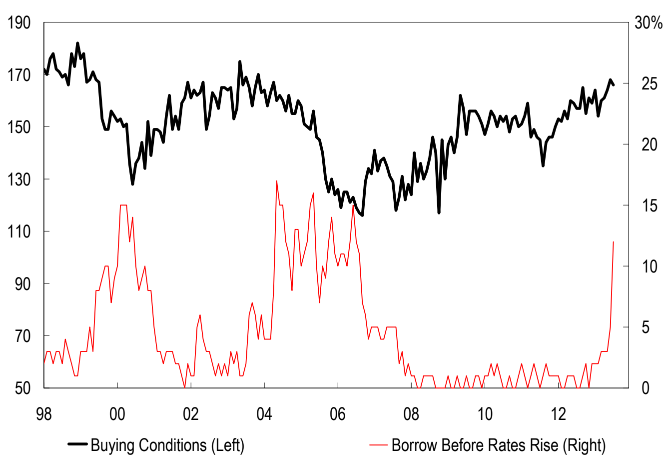
The housing recovery remains on track.

Housing data this week also sent mixed signals but on balance suggested the recovery there is proceeding apace. Housing starts fell well below expectations largely on a 26% plunge in multi-family activity. Rental markets led the housing upturn and multi-family construction has rebounded all the way back to previous cyclical highs and could be plateauing temporarily **(Figure 4)**. However, the data are exceptionally volatile and in any event carry much less weight in value-added contributions to GDP than single-family housing where permit activity continues to trend higher **(Figure 5)**. Meanwhile, buyer traffic **(Figure 6)** has surged in the past few months, including the most recent period since mortgage rates have rebounded. It is possible that higher rates have panicked some fence-sitters but as discussed last week, recent sentiment surveys indicate that consumers have been relatively unfazed in their assessments of home buying conditions **(Figure 7)**.

Unemployment benefit rolls have risen sharply in early July, raising uncertainty about hiring this month.

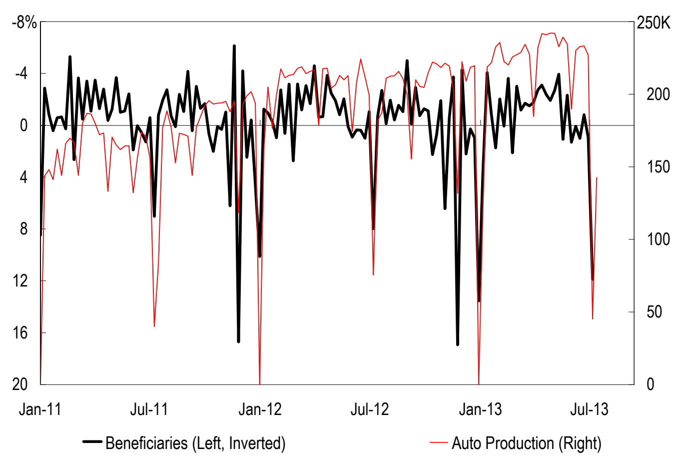
Finally, the last bit of mixed news on early July activity with possible links to fiscal drag is the latest report on unemployment insurance activity. Initial jobless claims fell back in the second week of July correcting for an exaggerated increase the prior week. This probably reflects the difficulty of dealing with seasonal shutdowns in the auto industry at this time of year. Auto and truck output in the U.S. plunged 80% in the holiday week and was still not quite back to scheduled run rates at mid-month. The number of people collecting benefits surged by almost 12% **(Figure 8)** in the first week of the month, probably reflecting those factory shutdowns. But the increase is unusually large even after accounting for the seasonal influence and we will need to monitor the next couple of weeks for reassurance that this is not the leading edge of a slowing in hiring.

Figure 7. Home Buying Conditions and Consumers Reporting It is a Good Time to Buy Ahead of Rising Mortgage Rates, 1998-Jul 13



Source: University of Michigan.

Figure 8. Unemployment Beneficiaries (Percent Change) and Auto Production (Not Seasonally Adjusted), 2011-13 Jul 13



Sources: Department of Labor and Automotive News.

July-August 2013

Monday	Tuesday	Wednesday	Thursday	Friday
15 Retail Sales Total ExAuto May 0.5% 0.3% Jun 0.4% 0.0% Empire State Manufacturing Jun 7.84% Jul 9.46% Business Inventories Apr 0.2% May 0.1% Auction 3 & 6 Mth. Bills $55.0B	**16** Consumer Price Index Total ExF&E May 0.1% 0.2% Jun 0.5% 0.2% Industrial Prod. & Cap. Util. May 0.0% 77.7% Jun 0.3% 77.8% Real Earnings (Jun) Housing Market Index Jun 51 Jul 57 Auction 1 Mth. Bill: $35.0B	**17** Mortgage Applications Housing Starts and Permits May 928K 985K Jun 836K 911K **Beige Book**	**18** Jobless Claims 7/13 334 Thous Philly Outlook Survey Jun 12.5% Jul 19.8% Leading Indicators May 0.2% Jun 0.0% Ann. 2-Yr. Note: $35.0B Ann. 5-Yr. Note: $35.0B Ann. 7-Yr. Note: $29.0B Auc 10-Yr. TIPS: $15.0B	**19**
22 Existing Home Sales May 5.18M Jun(E) 5.35M Auction 3 & 6 Mth. Bills $55.0B(E)	**23** FHFA Ann. 2-Yr. Note: $35.0B(E) Auction 1 Mth. Bill: $40.0B(E)	**24** Mortgage Applications New Home Sales May 476K Jun(E) 470K Auction 5-Yr. Note: $35.0B(E)	**25** Jobless Claims 7/20 340 Thous(E) Durable Goods Orders Total ExTrans May 3.7% 0.5% Jun(E) 3.6% 0.6% Auction 7-Yr. Note: $29.0B(E)	**26** Reuters/Michigan Sentiment JulP 83.9 JulF(E) 84.0
29 Pending Home Sales (May) Auction 3 & 6 Mth. Bills: $55.0B(E)	**30** Consumer Confidence Jun 81.4 Jul(E) S&P/CaseShiller (May) **FOMC Meeting** Auction 1 Mth. Bill: $45.0B(E)	**31** Mortgage Applications ADP Employment Jun 188K Jul Employment Cost Index Q/Q Y/Y 1Q13 0.5% 1.9% 2Q13(E) GDP & Chain Price Index 1Q 13F 1.8% 1.2% 2Q 13A(E) Chicago Barometer PMI Prices Jun 51.6 59.9 Jul(E) **FOMC Meeting** Ann. 3-Yr. Note: $32.0B(E) Ann. 10-Yr. Note: $24.0B(E) Ann. 30-Yr. Note: $16.0B(E)	**Aug 1** Jobless Claims 7/27 ISM Manufacturing PMI Prices Jun 50.9 52.5 Jul(E) Construction PIP May 0.5% Jun(E) Total Vehicle Sales Jun 15.9M Jul(E)	**2** Employment Jun Jul(E) Payrolls 195K Unemp. Rate 7.6% Avg. Hrly. Earn. 0.4% Priv. Wrkwk 34.5H Personal Income & Consumption May 0.5% 0.3% Jun(E) Factory Orders Ord. Inv. May 2.1% 0.0% Jun(E) Strips Data (Jul)
5 ISM Non-Manufacturing PMI Prices Jun 52.2 52.5 Jul(E) Delinquencies (2Q) (TBA) Auction 3 & 6 Mth. Bills $55.0B(E)	**6** International Trade Balance May -$45.0B Jun(E) Auction 3-Yr. Note: $32.0B(E) Auction 1 Mth. Bill: $45.0B(E)	**7** Mortgage Applications Consumer Credit May $19.6B Jun(E) Auction 10-Yr. Note: $24.0B(E)	**8** Jobless Claims 8/3	**9** Wholesale Inventories May -0.5% Jun(E) Auction 30-Yr. Bond: $16.0B(E)

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

Notes

Appendix A-1

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