



The Longbrake Letter\*  
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**I. 2011 Ends on Upbeat Note; Optimism Builds for a Better 2012; But, Significant Downside Risks Remain In Play**

In the *December Longbrake Letter* I attempted to peer forward into 2012. This is always a high risk venture for any economic forecaster, because surprises, either favorable or unfavorable, which drive economic activity in unexpected directions, always lurk in the shadows.

People tend to focus on key economic indicators, such as growth in real GDP, the unemployment rate, and the inflation rate, to name a few of the more important ones. There is also a tendency to extrapolate recent trends in these key variables. This results in large oscillations between optimism and pessimism. At the moment optimism is in ascendancy. That sentiment may be merited if the economic recovery has reached the stage at long last where positive developments become self-reinforcing. Or, it may turn out with the passage of time that a self-reinforcing sustained recovery has not yet taken hold and once again the current burst in optimism will turn out to be premature just as been the case several times before over the last two years.

It is easy to get caught up in the predominant mood of the moment. To avoid this kind of capture one must examine critically details of evolving economic activity. Such examination may confirm the prevailing mood but more often it will reveal probable overshoots in optimism or pessimism and identify significant risks to simple trend extrapolation. Forecasts of key economic indicators depend upon a plethora of forecasts of components

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which affect them. Without an understanding and critical examination of those components and an appreciation for trends in them and risks to those trends, point estimates for the key economic indicators can turn out to be very misleading.

### **1. Four Significant Negative Shocks Derailed 2011 Forecasts**

At the outset of 2011 most forecasters expected strong real GDP growth and moderate inflation. In fact, the opposite occurred in both cases . . . and the differences weren't small. Four shocks, all negative, intervened — an explosion in commodity prices driven mainly by Chinese economic policy, but also by the “Arab Spring” in the Middle East; the tsunami in Japan and floods in Southeast Asia, which disrupted important global supply chains; substantial deterioration in European sovereign debt and bank liquidity/solvency; and heightened fiscal policy uncertainty in the U.S.

Because the U.S. economy was still in the early stages of recovery from the 2007-09 Great Recession, its fragility made it especially vulnerable to these negative shocks.

### **2. Shocks Dissipate or Moderate Toward the End of 2011**

As 2011 came to a close, commodity prices were in retreat and supply chains had returned to normal. While fiscal uncertainty remains the order of the day in the U.S., Congress did back away from confrontation by passing a two-month extension of the payroll tax cut and unemployment benefits. While this fiscal policy issue will re-emerge over the next month, markets are sanguine that Congress will end up extending most of these benefits for the remainder of 2012. The situation in Europe remains fraught. But, the holiday lull and the overlay of improving confidence in the U.S. appear to have diminished temporarily anxieties about European prospects.

### **3. 2011 Q4 Tracking 3.5% Real GDP Growth**

Nearly all recent survey and data reports have exceeded expectations. This string of good news was punctuated by a strong December employment

report, including the creation of 200,000 jobs and a further decline in the unemployment rate to 8.5%. The good news has continued into the new year with rising consumer and business confidence, expanding business activity, robust growth in consumer credit and rising stock prices.

#### **4. Sentiment Brightening for a Better 2012**

As I have discussed in previous letters, good and bad sentiment tend to be extrapolated uncritically. Thus, with the recent spate of good news it is understandable that sentiment has shifted in the direction of expecting positive momentum to continue to build. But history has taught us that economic activity usually does not move in a straight line.

While there is plenty of evidence that the healing process is underway in the U.S. economy, that does not necessarily imply that the economy is at the threshold of a more rapid robust recovery. The economy remains fragile. Key components, such as housing and mortgage finance, are still badly broken. And, while job creation is accelerating, total payroll employment remains 6.1 million or 4.4% below the pre-Great Recession peak.

We have a long ways to go. The economy is still fragile and remains vulnerable to setbacks.

As I described in the ***December Longbrake Letter***, it will be hard to sustain recent momentum in economic activity in some sectors as 2012 unfolds. In addition, risks of a slowdown in global growth and an outright recession in Europe, will impact the U.S. and that impact will probably be greater than the consensus expects. In recent days I have heard the word “decouple” cropping up once again. This word implies that the linkages between the U.S. economy and the global economy — think “Europe” in particular — are sufficiently limited that negative shocks in Europe or elsewhere will have limited impact on derailing building momentum in the U.S. economy. In today’s highly integrated global economy there is no substantive basis for the decoupling theory, yet discussion of it seems to crop up every time the U.S. economy is improving or doing well as an explanation for why difficulties elsewhere are unlikely to have much impact.

In this month’s letter, I begin with a summary of the 2012 outlook, which I described in detail in the ***December Longbrake Letter***. While not much

has changed over the last month, where it seems pertinent, I have incorporated recent developments in the 2012 outlook summary. Then, I comment on prospects for GDP growth, progress in employment and developments in monetary policy. I conclude with a status report on developments over the last month for the three significant risks — China, Europe and U.S. fiscal policy — which I identified in the December Letter as the key risks to monitor during 2012.

## II. 2012 Outlook — Summary

*While disappointing growth is probable during 2012, healing is occurring gradually and eventually stronger growth will take hold. It just won't happen in 2012. And, if the European sovereign debt crisis worsens appreciably, the U.S. could experience a recession.*

### 1. Consumers

Consumer spending accounts for 70% of GDP which means that the most important determinant of GDP growth during 2012 will turn on what consumers do. Spending is directly impacted by employment and income growth and indirectly impacted by consumer confidence.

**Confidence.** Consumer confidence plummeted during mid-2011 from already low levels sparking speculation about the possibility of return to recession. But, as third quarter data and more recent monthly reports confirm, this plunge in confidence did not lead to a pullback in consumer spending. Indeed, consumers reduced saving in the face of stagnation in income growth to maintain consumption growth. This outcome is a reminder that surveys of sentiment are not necessarily very good predictors of what people will do. Recently measures of consumer confidence have been rising and have erased last summer's plunge. Just as last year's plunge in consumer confidence had no apparent effect on spending one should not blithely assume that improving confidence will lead to increased consumer spending.

**Spending.** Stronger consumer spending during 2011 was not based on growing incomes but stemmed from consumers reducing their saving rate. Unless incomes begin growing more strongly soon, spending growth

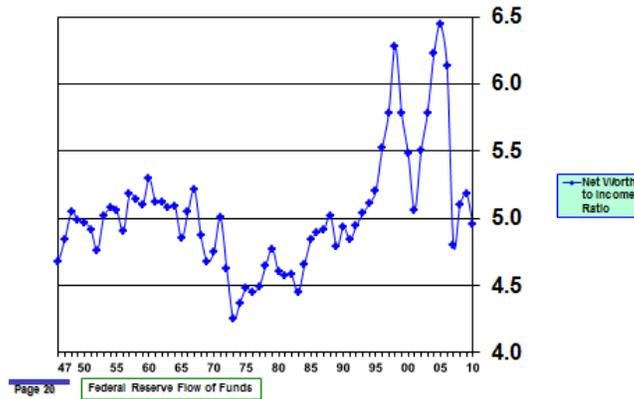
will fall back to a level which can be supported by income growth and the contribution of consumer spending to GDP growth will decline. Somewhat slower spending growth will tend to slow employment growth.

**Employment.** While the recent uptick in payroll employment growth appears solid, the decline in the unemployment rate over 2011 from 9.4% to 8.5% masked a more troublesome trend. In the last year, while household employment increased 1.6 million, the number willing to work, which includes both employed and unemployed workers, rose only 274,000 rather than the 1.1 million it should have. The difference of 816,000 is people who became discouraged and dropped out of the labor force. Had this not occurred the unemployment rate at the end of 2011 would have been 9.0% rather than the reported 8.5%. Employment should rise about the same amount during 2012 and the unemployment rate should drop slightly, but remain above 8.0%, provided more discouraged workers don't drop out of the labor force.

**Income.** Disposable income growth depends primarily upon the number employed, the hourly wage rate, the number of hours worked and government transfer payments. Employment grew 1.3% during 2011. The hourly wage rate rose 2.1% and a slight expansion in the number of hours worked pushed wage growth up to 2.7%. However, government transfer payments, particularly at the state and local level, shrank during 2011. Aggregate disposable income grew 2.4% during 2011 and growth was close to zero during the second half of the year. Because wage growth is likely to remain depressed and further expansion in hours worked is doubtful, wage growth should be about 2% or slightly greater during 2012. Aggregate disposable income growth will continue to be depressed by declining government transfer payments. Thus, substantial obstacles stand in the way of a meaningful acceleration in disposable income. Self-sustaining and accelerating economic activity requires the consumer virtuous circle — rising income begets rising spending begets rising employment begets rising income, etc. — to become firmly entrenched. While such an outcome is possible in 2012, as I said, the obstacles are formidable.

**Wealth.** Consumer net worth fell \$105 billion in the second and \$2.4 trillion in the third quarter of 2011, but should rise in the fourth quarter as the rebound in the stock market should more than offset the decline in residential home equity. The ratio of consumer net worth to disposable income (**Chart 1**) fell to 4.96 consistent with the long-term average. Given the like-

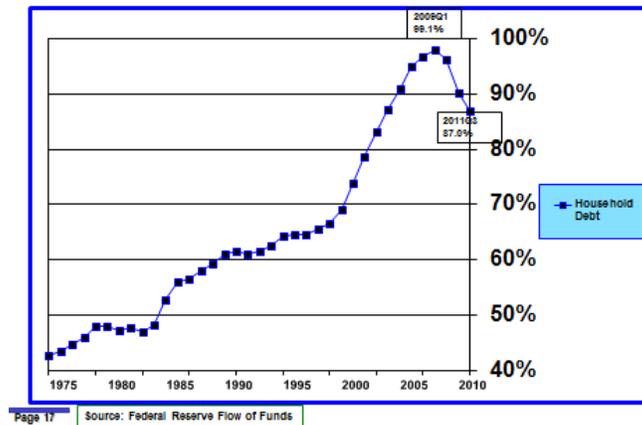
**CHART 1 – Consumer Net Worth to Disposable Income**



likelihood of slow growth in disposable income in 2012 and further decreases in home prices, changes in consumer wealth probably won't have much impact on spending during 2012 for better or worse.

Debt. Since consumer debt leverage peaked at 99.1% in the first quarter of 2008 (see **Chart 2**), deleveraging has been the order of the day. However,

**CHART 2 – Household Debt to GDP – 1975-2010**



at 87.0% in the third quarter of 2011 the leverage ratio is still considerably

above the pre-housing bubble range of 60% to 70%. While consumer credit conditions have eased considerably, the same cannot be said for mortgage credit. Deleveraging, declining home prices and impaired access to mortgage credit will continue to be a drag on consumer spending growth.

## 2. Investment

**Single Family Residential Housing.** Construction has bottomed but no appreciable increase seems likely in 2012. Single family housing starts declined about 8% from 471,000 in 2010 to 433,000 in 2011. This compares to a level which exceeded 1.5 million annually during the housing bubble.

**Multi-family Housing.** Construction starts expanded approximately 50% in 2011 from 114,000 units in 2010 to 167,000 units. Construction should increase at least 25% in 2012 to 210,000 units as declining homeownership rates favor rental properties. However, even with a further increase in construction in 2012, multi-family housing starts are likely to remain considerably below a long-term average of about 350,000 units annually.

Overall, housing construction should be a small positive contributor to GDP growth in 2012.

**Nonresidential Construction and Investment.** Equipment and software investment was a major contributor to GDP growth during much of 2011. However, data on recent shipments imply that business equipment and software spending probably slowed to an annual growth of zero or less in the fourth quarter.

## 3. Manufacturing

According to the Institute of Supply Management's (ISM) manufacturing diffusion index, manufacturing activity rose to a six-month high of 53.9 in December. The new orders index rose to 57.6. This apparent improvement is not corroborated by Goldman Sachs Analyst Index which fell to 48.3 in December. (Note: a value in a diffusion index above 50 indicates expansion, while a value below 50 indicates contraction.) Goldman Sachs has put together persuasive analysis which shows that the seasonal adjustment procedure results in overstating the ISM manufacturing index by 2 to 3 points

from November through March; correspondingly, the index is understated during the summer months. Thus, the apparent recent strengthening in manufacturing may be illusory.

What is more important is whether manufacturing will remain strong in 2012. Slowing global growth and recession in Europe will be negative as will the recent modest appreciation in the value of the dollar. Catch up and inventory restocking in response to supply chain challenges during 2011 should largely have been completed during the fourth quarter.

All of this suggests that the balance of risks during 2012 is weighted in the direction that manufacturing's contribution to GDP growth will be more subdued.

#### **4. Fiscal Policy**

Just before Christmas Congress agreed to a two-month extension of the payroll tax cut and unemployment benefits. It now seems likely that both will be extended for all of 2012, although extended unemployment benefits might be scaled back and some of the cost may be offset through other fiscal actions. On balance, however, it now appears that the impact of federal fiscal policy will be somewhat less negative than seemed likely in early December. But, the key forecast is "somewhat less negative".

No further fiscal policy action is likely during 2012 as the two major political parties take their widely divergent policy agendas to the public as part of the 2012 national and presidential elections. Sequestration mandated by the Budget Control Act will not kick in until 2013.

A plethora of spending cuts and tax increases is currently scheduled to kick in automatically on January 1, 2013 unless Congress takes action prior to that date. It is hard to see how in an election year Congress will act prior to the general election in November and it is difficult to conceive that a divided lame-duck Congress will be able to do much after the election. This sets the stage for mounting uncertainty as 2012 comes to a close. Uncertainty usually has negative impacts on financial markets and consumer sentiment. This is the downside risk to watch and it could have substantial negative consequences as 2012 comes to a close.

Needless to say, if Congress does nothing, the economy would suffer an enormous shock at the beginning of 2013. It is a virtual certainty that Congress will not let this occur, but it is highly uncertain what Congress will do and it is unlikely there will be much sense of what might happen until after the November general election.

## **5. Residential Housing**

Housing prices are likely to decline in 2012 because of acceleration in the disposition of foreclosed homes. The risk is that the decline in home prices will be much greater than expected. That could occur if the economy slows more than expected and unemployment increases. The probability that this risk materializes on its own accord is low, but if other negative economic shocks occur, they could lead to a much worse decline in housing prices and that, in turn, would negatively impact sentiment and consumer spending, setting in motion a series of negative feedbacks that would reinforce downward momentum. If such risks materialize, some U.S. financial institutions would incur additional financial losses and solvency issues could reemerge. Multiple pending mortgage litigation lawsuits already pose the potential for much greater losses than market participants currently expect and, needless to say, a greater than expected decline in housing prices would only serve to exacerbate that risk.

One area in which government policy could make a difference for the better during 2012 is in residential housing. Foreclosures and disposition of foreclosed properties are set to increase and if permitted to take their natural course without policy intervention will depress housing prices and reinforce negative feedback loops affecting consumer sentiment and spending. To date the impact of government housing policies in facilitating the unwinding of housing bubble excesses has been underwhelming. Thus, even though by most accounts housing prices on average are fairly valued or even undervalued, further price declines are likely in 2012.

These risks are well understood, as witnessed by a recent housing white paper released by the Federal Reserve. There is considerable speculation about bulk sales of foreclosed residential properties to investors who would rent them. Such a program would help stabilize housing prices by removing selling pressure and limit increases in rent by increasing the supply of rental properties. While such a policy intervention seems likely, it is difficult to see

how a program could be designed to be a meaningful game changer.

## 6. Monetary Policy

While monetary policy in the aftermath of the Great Recession appears to have been successful in preventing deflation, its ability to stimulate economic activity has been limited and perhaps non-existent. The impact of monetary policy seems likely to continue to have limited impact on the economy during 2012.

**Federal Funds Rate Forecasts.** The Federal Open Market Committee has signaled its intent to start publishing forecasts of the federal funds rate beginning with its January meeting. The consensus of speculation is that this will result in pushing out the date for the first increase in this rate from mid-2013 to sometime during 2014. If that turns out to be the case, it could help flatten the longer end of the yield curve somewhat.

**Quantitative Easing.** In addition, many believe that the Federal Reserve will approve the third iteration of quantitative easing by authorizing the purchase of mortgage backed securities. If this occurs, it would likely take place during the summer of 2012 after Operation Twist has been completed. Also, economic performance and inflation would need to slow during the first half of 2012, both likely prospects. A meltdown in Europe would assure implementation of more quantitative easing. That said, with interest rates already at extraordinarily low levels, it's difficult to see what good another round of quantitative easing would do for the economy other than to prevent strengthening in deflationary pressures.

**Inflation.** Higher inflation, both total and core, was the major surprise in 2011. A principal cause, however, was greater than expected pass through of higher commodity and import prices. Another cause was rising rental rates prompted by ongoing housing market dysfunction and the fall in home ownership which increased the demand for rental housing.

High inflation was not due to economic reacceleration more generally and it was not due to wage growth. And, without inflationary wage growth, any burst in price inflation cannot be sustained. In fact, measured price inflation is already slowing and this trend will continue into 2012. If anything, forecasters, having been very wrong in 2011, are probably being too

cautious about potential slowing in the inflation rate during 2012.

**Interest Rates.** High unemployment, a large output gap, feeble growth in GDP and monetary policy actions have combined to push interest rates to extremely low levels. Given the current rate of inflation, interest rates should be higher. But, slowing growth and inflation during 2012 will keep interest rates near recent levels. There is not much risk, aside from periodic transitory growth scares, that long-term interest rates will rise during 2012. But, if matters deteriorate in Europe and growth slows even further in the U.S. or turns into recession, long-term interest rates would decline below current levels. Another round of quantitative easing by the Federal Reserve would probably assure such an outcome.

## 7. Europe

While the markets seem to be optimistic that the European authorities are putting together policies that will resolve the sovereign debt crisis, the reality is that Europe is already in the grip of a severe credit crunch, several countries are already in recession and indicators strongly imply that growth in the stronger nations will slow appreciably and perhaps even morph into recession. In short, the damage has already been done and will become increasingly evident as 2012 unfolds.

With as much as a two to three quarter lag the consequences of European recession will spill over to the rest of the world through trade and financial linkages. The negative risk is that efforts to resolve the crisis prove to be inadequate or, worse, end in abject failure. A collapse of the euro would have extremely severe consequences for the global economy. Let us hope that this outcome does not come to pass, but the possibility of such an outcome should not be dismissed lightly.

## 8. China

Imbalances in the Chinese economy continue to grow. An increasing share of Chinese GDP comes from investment in infrastructure. And a massive property bubble continues to build. In time these imbalances will trigger corrections. The question is whether the necessary transition will be man-

aged and orderly or whether it will be disorderly and disruptive. What we know from past experience is that the longer these imbalances continue to build, the greater will be the correction whenever it eventually occurs. But China's day of reckoning is not likely to happen in 2012. And, there is evidence that China is in the early stages of attempting to manage an orderly transition. But an ugly outcome in Europe could change all of this and precipitate a Chinese correction. China's economy is very dependent on the health of global trade.

### III. U.S. GDP

#### 1. Final Estimate of 2011 Q3 GDP

The "Final Estimate" of third quarter GDP growth was 1.82% compared to the "Second Estimate" of 2.00%. **Table 1** provides details. The only

**Table 1**  
**2011 Third Quarter GDP Estimates**

	Advance	Second	Final
	Estimate	Estimate	Estimate
Personal Consumption	1.72%	1.63%	1.24%
Private Investment			
Nonresidential	1.54%	1.41%	1.49%
Residential	.05%	.04%	.03%
Inventories	-1.08%	-1.55%	-1.35%
Net Exports	.22%	.49%	.43%
Government	.00%	-.02%	-.02%
<b>Total</b>	<b>2.46%</b>	<b>2.00%</b>	<b>1.82%</b>

meaningful revisions occurred for consumer spending and inventories.

**Consumer Spending.** Consumer spending, which was surprisingly

strong in the “Advance Estimate”, was revised down substantially in the “Final Estimate” and is now somewhat more in line with lackluster consumer disposable income growth.

While the saving rate was revised upwards in the “Final Estimate”, the consumer saving rate still declined from 4.8% in the second quarter to 4.0% in the third quarter. Put somewhat differently, disposable income (at an annual amount) rose only \$9.5 billion in the third quarter; personal consumption increased \$179.9 billion and personal saving fell \$170.4 billion.

***This is not sustainable.*** Either disposable income must grow faster or personal consumption growth will slow in coming quarters. Slow employment growth and stagnant wage growth do not bode well for acceleration in disposable income growth.

**Inventories.** The adjustment to inventories in the “Final Estimate” offset about half of the reduction in consumer spending. Nonetheless, the decline in inventories was substantial during the third quarter and leaves plenty of room for reversal and a higher GDP growth rate in the fourth quarter.

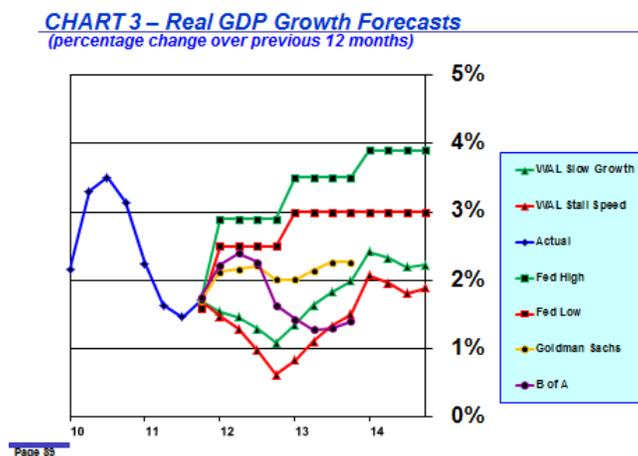
## **2. 2011 Q4 GDP Growth**

Monthly data reports during the fourth quarter consistently have been better than expected. Consumer spending appears to be holding up. Manufacturing has strengthened a little, perhaps due to some restocking to offset the decline in inventories during the third quarter. Goldman Sachs (GS) is currently estimating a 3.3% annual rate of growth and Bank of America/Merrill Lynch (B of A) expects 3.5%.

Goldman Sachs has another measure, which it calls the ***Current Activity Indicator (CAI)***, which estimates the trend rate of growth in GDP based on both reported data and surveys. Over time this indicator appears to track trends in GDP growth reasonably well. However, it is not as useful for estimating GDP growth over short time periods. The CAI indicates that growth was slower during the fourth quarter. The disparity may be connected to inventory restocking.

### 3. GDP Forecasts for 2012 and Beyond

Chart 3 shows several GDP forecasts — the Federal Reserve’s high and



low; B of A; GS and my “Slow Growth” and “Stall Speed” scenarios. My “Stall Speed” scenario assumes that payroll employment growth rises only enough to absorb new labor force entrants so that the unemployment rate and the GDP output gap remain unchanged.

Both GS and B of A have upgraded their forecasts for the first half of 2012 modestly. The upward revisions reflect the stronger recent data flow and a more optimistic conclusion about extension of the payroll tax cut and unemployment benefits. Nonetheless, both forecasts remain on the pessimistic end of the spectrum and are well below the Federal Reserve’s low forecast. That is particularly true for the B of A forecast, which still has embedded in it a 40% probability of recession occurring in the U.S. during 2012.

GDP growth averages 2.2% for the next eight quarters in GS’s forecast and 1.7% over the next eight quarters in B of A’s forecast. Both forecasts expect the unemployment rate to remain stuck at 8.5% for the next two years.

The Federal Reserve’s forecast is on the optimistic end of the spectrum. However, the minutes of the December FOMC meeting indicated that the

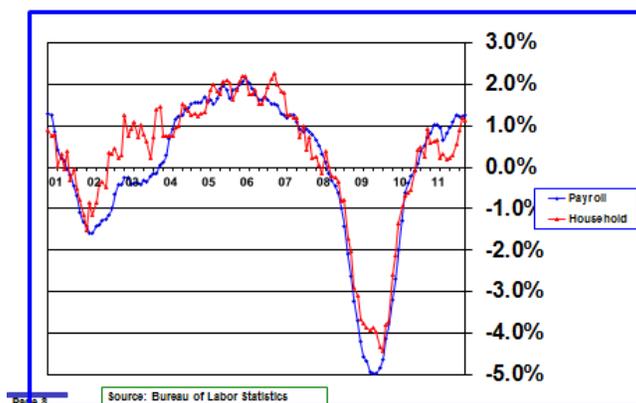
staff downgraded its forecast primarily because of deteriorating conditions in Europe. It will be interesting to see the next set of Fed forecasts which will be released at the end of January. The recent more upbeat data could offset the more downbeat staff assessment in December.

Both my “Slow Growth” and “Stall Speed” scenarios project lower GDP growth in 2012 than the GS and B of A forecasts. The “Slow Growth” forecast is slightly better than the B of A forecast in 2013. Average GDP growth over the next eight quarters for the “Slow Growth” forecast is 1.5% and is 1.2% for the “Stall Speed” scenario.

## IV. Employment

Employment growth and wage growth are primary determinants of consumer spending power. The good news is that payroll employment has risen 2.7 million from the low reached in February 2010. An uncritical examination of **Chart 4**, which shows both payroll and household employment growth,

**CHART 4 – Employment Growth** (annual rate of change)

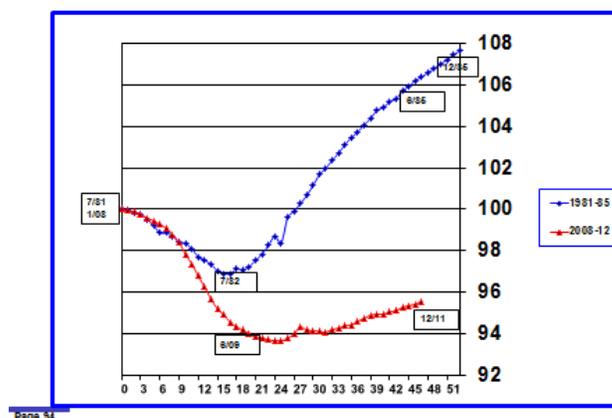


suggests that employment growth appears to be following a relatively typical recovery track.

But, the bad news is that payroll employment in December 2011 was 6.1 million less than peak employment of 138.0 million in December 2007.

Indeed, when the level of employment is scaled to the starting month of the recession, **Chart 5** clearly shows how feeble the employment recovery has

**CHART 5 – Monthly Employment Growth Following 1981-82 and 2008-09 Recessions (Index = 100: January 2008 and July 1981)**

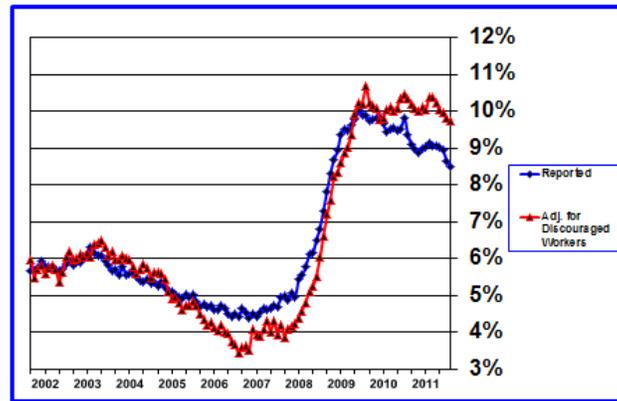


been. So before getting too excited about a 200,000 gain in employment in December, do the numbers. It would take another 30 months of similar gains simply to get back to 138.0 million. That would mean it would take 6½ years just to get aggregate employment back to the pre-Great Recession peak.

December's decline in the unemployment rate to 8.5%, as was the decline in November, is also deceptive. Unfortunately, much of the improvement in the unemployment rate had to do with discouraged workers dropping out of the labor force rather than finding a paying job. The labor force participation rate declined to the lowest level since January 1984. While participation in the labor force has been shrinking in recent years for demographic and other reasons, these factors cannot explain the full extent of the decline.

**Chart 6** compares the reported unemployment rate and the unemployment rate adjusted for demographic trends and the exit of discouraged workers. There is a cyclical pattern to the relationship between the two data series. The reported unemployment rate is higher than the adjusted rate when unemployment is low and the reverse is true when unemployment is high. This occurs because marginal workers enter the labor force when jobs are plentiful and exit when jobs are hard to get. However, the gap between the two measures is unusually large currently and this reflects the ongoing

**CHART 6 – Reported Unemployment Rate & Adjusted for Discouraged Workers**

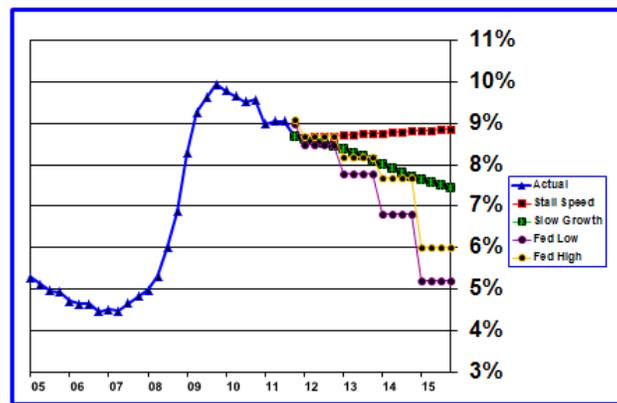


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weakness of the labor market in the current economic expansion.

**Chart 7** shows projections for the unemployment rate for my “Slow

**CHART 7 – Unemployment Rate**



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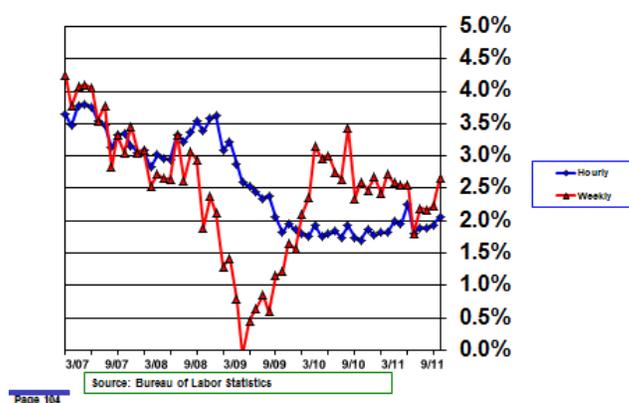
Growth” and “Stall Speed” scenarios and the Fed’s high and low projections. The high and low Fed unemployment numbers for 2015 are not forecasts; rather they are the Fed’s upper and lower bounds for the long-run noninflationary rate of unemployment. While not shown, the GS and B of

A unemployment forecasts both remain at 8.5% through the end of 2013; the unemployment rate in my “Slow Growth” scenario declines to 8.1% by the end of 2013.

Notice in **Chart 7** that the Fed’s long-run noninflationary unemployment rate ranges between 5.2% and 6.0%. The lower bound of 5.2% is the unemployment rate the Congressional Budget Office (CBO) assumes is consistent in the long run with full employment. CBO raised this rate a few months ago from 5.0%. However, many believe that structural unemployment has risen and that the long-run full employment unemployment rate has risen to approximately 6.0%, which is the Fed’s upper bound. Structural unemployment occurs when workers who would like to work and thus are counted in the labor force are unable to find jobs because their skills do not match available jobs. Structural unemployment tends to rise during and following recessions and also tends to worsen the longer workers are unemployed. Persistent unemployment has been much worse following the Great Recession than after other recessions over the last 60 years.

Weak employment translates into slow disposable income growth. This trend is exacerbated by limited improvement in wage rates and the length of the work week. **Chart 8** shows that from 2007 to the end of 2009 the

**CHART 8 – Hourly and Weekly Wages**  
(annual rate of change)



annual rate of growth in hourly wages decelerated from about 3.5% to less than 2.0% and has remained near 2.0% ever since. The 12-month rate of hourly wage growth was 2.06% in December. The good news is that the

rate of growth has stabilized. As long as the unemployment rate remains unusually high, labor will have very little bargaining power and this is likely to limit increases in hourly wages.

Weekly wage growth is more volatile than hourly wage growth because it incorporates the length of the workweek. When the length of the workweek is stable, the two measures will track each other closely. Divergences occur during and following recessions. During recessions employers tend to cut the length of the workweek before shedding workers. The opposite happens in recoveries — employers increase hours before adding workers. The recent convergence of the two measures implies that there is little further room for expansion of the workweek and that employers will need to hire additional workers as economic activity picks up. The uptick in weekly wages in December implies that hiring should be relatively strong in January.

*Consumer spending growth will continue to be very weak until employment growth accelerates substantially and increases in wages occur. Neither is very likely to occur in 2012.*

## V. Monetary Policy

### 1. The Federal Reserve Is Currently in a Monitoring Mode

There is little further the Federal Reserve can do to stimulate the economy at this time. Its program to extend maturities of Treasury securities it holds is underway and will not be completed until June 2012. This action, called “Operation Twist” by some, is intended to flatten the yield curve by driving down longer term rates.

There have been hints that the Federal Open Market Committee (FOMC) might consider a third round of large scale asset purchases, which the market would quickly dub “QE III”. But given the very low level of interest rates that already exists, it is hard to perceive how effective such an action would be and there is the potential for the liquidity effect to stimulate financial asset speculation. This pretty much relegates the FOMC to a monitoring mode. If deflation once again threatens and/or the economy slows significantly — the two usually go together — the Federal Reserve will probably implement QE III, but this is not likely to occur until after Operation Twist

has been completed in June.

## **2. Monetary Policy Guidance**

In the past consistently better than expected economic data reports, which recently have been reported, would have been accompanied by a steepening yield curve. This has not occurred. The yield curve has barely budged since last July when the FOMC first announced that “economic conditions . . . are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.” Thus, it is increasingly apparent that the Fed’s guidance has been taken seriously and has been successful in driving down longer term interest rates and dampening volatility.

During the FOMC’s recent meetings members spent time discussing options for further increasing the transparency of monetary policy. Many believe that the Federal Reserve can help anchor inflation expectations by communicating in advance its long-term inflation target and its expected path for interest rates. There has been debate about whether to focus on establishing an inflation target or provide projections for the federal funds rate, or both. The FOMC has resolved the debate for the time being by announcing that it will begin publishing projections of the federal funds rate at its January meeting. It will also publish the range of estimates for the date of the first increase in the federal funds rate. The issue of whether to provide an inflation target continues to be debated.

**Publishing a Long-Term Inflation Objective.** It can be argued that the FOMC has already defined its long-term inflation policy objective in the quarterly Summary of Economic Projections of real GDP growth, the unemployment rate, total CPE inflation and core CPE inflation. The last column in its Summary of Economic Projections shows the long-term projection for inflation, which is a range of 1.5% to 2.0%. Presumably, this is the target. The only change, then, would be making this projection an explicit, rather than an implicit, objective.

**Projecting the Federal Funds Rate and the Date of the First Rate Increase.** The FOMC’s announcement that it intends to publish projections for the federal funds rate and the range of dates for the first rate increase following its January 24-25 meeting has prompted speculation about how this might be done and how the market could react.

**Federal Funds Rate Projections.** For starters it seems likely that the FOMC will add another row to the table it releases quarterly, which currently includes projections for real GDP, the unemployment rate, total PCE inflation and core PCE inflation. The columns currently cover the current and next two years and there is a fourth column for long-term projections. The long-term projection is important for real GDP as it reflects the FOMC's expectation for the long-run full employment potential rate of growth. Similarly, as mentioned above, the long-term total PCE inflation rate presumably is the FOMC's inflation target.

Overall there are 19 potential participants in the FOMC (7 governors and 12 regional Reserve Bank presidents), although only 12 are voting members (7 governors, the New York Federal Reserve Bank president, who serves as Vice Chair, and 4 other regional reserve bank presidents) at any one time. All 19 (17 currently because there are two vacancies on the Board of Governors) make independent projections. The FOMC publishes the full range (highest and lowest projections), but it focuses attention on a second table which shows the central tendency of the projections. The central tendency narrows the range of projections by dropping the three highest and three lowest.

**Table 2** shows the full range and central tendency projections for real GDP growth, unemployment rate, PCE inflation, and core PCE inflation. Courtesy of Goldman Sachs (GS), another line is added for the federal funds rate projections. GS estimates for the federal funds rate appear reasonable but, of course, they represent GS judgments and are not those of FOMC members.

Assuming that the GS estimates for federal funds rate projections are reasonable, the question becomes one of how might the market interpret this information. Will it focus on the upper bound, will it focus on the mid-point of the range or will it try to ascertain from other information sources the median of the distribution? GS observes that the median of the distribution is likely to be less than the midpoint. Assuming that is a correct surmise, the FOMC could improve transparency by also publishing the median, or it could go even further, as GS recommends, and publish the individual FOMC member estimates in rank order without attribution. The importance of increasing transparency can be understood by comparing the GS end of 2014 median federal funds rate estimate of 0.75% with the range of 0.0% to 2.75%. GS believes the market would focus on the median

**Table 2**  
**FOMC Summary of Economic Projections**

Variable	Central Tendency			
	2012	2013	2014	Long-Run
Real GDP Growth	2.5 to 2.9%	3.0 to 3.5%	3.0 to 3.9%	2.4 to 2.7%
Unemployment Rate	8.5 to 8.7%	7.8 to 8.2%	6.8 to 7.7%	5.2 to 6.0%
PCE Inflation	1.4 to 2.0%	1.5 to 2.0%	1.5 to 2.0%	1.7 to 2.0%
Core PCE Inflation	1.5 to 2.0%	1.4 to 1.9%	1.5 to 2.0%	
Federal Funds Rate <sup>a</sup>	0.0 to 0.0%	0.0 to 1.0%	0.0 to 2.75%	3.75 to 4.25%
Median <sup>a</sup>	0.0%	0.0%	0.75%	

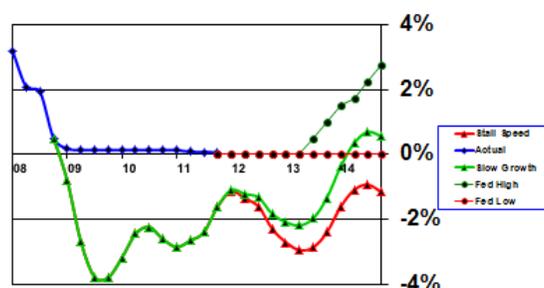
  

Variable	Full Range			
	2012	2013	2014	Long-Run
Real GDP Growth	2.3 to 3.5%	2.7 to 4.0%	2.7 to 4.5%	2.2 to 3.0%
Unemployment Rate	8.1 to 8.9%	7.5 to 8.4%	6.5 to 8.0%	5.0 to 6.0%
PCE Inflation	1.4 to 2.8%	1.4 to 2.5%	1.5 to 2.4%	1.5 to 2.0%
Core PCE Inflation	1.3 to 2.1%	1.4 to 2.1%	1.4 to 2.2%	
Federal Funds Rate <sup>a</sup>	0.0 to .75%	0.0 to 1.75%	0.0 to 3.75%	3.50 to 4.25%

<sup>a</sup>Goldman Sachs estimates

projection rather than the range and, assuming that to be the case, the yield curve would flatten further because it would add up to another year before the first increase in the federal funds rate occurs.

**Chart 9** shows my projections for the federal funds rate for the “Slow Growth” and “Stall Speed” scenarios along with the GS estimates of the FOMC’s high and low central tendency projections. The first federal funds rate increase in my “Slow Growth” scenario occurs in the second quarter of 2014 and rises to 0.75% by the end of 2014, which, coincidentally, is the same as GS’s median FOMC end of 2014 projection. My “Strong Growth” scenario (not shown in **Chart 9**) projects the federal funds rate to be 3.0%

**CHART 9 – Federal Funds Rate Forecast**

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at the end of 2014 which is similar to the 2.75% high end of the central tendency range at the end of 2014.

**Date of First Federal Funds Rate Increase.** Whether the markets conclude that the federal funds rate will remain at zero beyond mid-2013 depends upon the FOMC's projected date for the first rate increase. GS believes that less than half of FOMC participants will project the first rate increase to occur before the middle of 2014 but a majority will project the first increase by the end of 2014. If the FOMC provides information in this way, it would prompt the market to expect no change in the federal funds rate until mid-2014 and an increase to 0.75% by the end of 2014. Needless to say, the FOMC may not provide the kind of information detail which GS is suggesting. Less detail would result in greater uncertainty and less flattening of the yield curve. Another way of putting this is that if the FOMC really wants to signal further easing of monetary policy, it must provide detailed information.

**Qualitative Balance Sheet Guidance.** In addition to all of this, the FOMC will begin to provide "qualitative" balance sheet guidance at the January 24-25 meeting. This would provide information about the possibility of further large scale asset purchases (quantitative easing). It seems likely that the FOMC will publish this information by indicating that "a few", "some", "several", "most" expect an increase (or decrease) in the balance sheet during a specified time period. GS thinks that the operative language

for 2012 might be that “several” expect the balance sheet to increase. This translates into about “half” and keeps QE III in play but does not assure it. “Most” might state that the balance sheet will remain unchanged in 2013 and “several” might indicate that the balance sheet would shrink in 2014.

It should be apparent that the market will have a lot of new information to digest following the January 24-25 FOMC meeting. Chairman Bernanke will hold a press conference and that might help clarify ambiguities that remain from whatever new information the FOMC chooses to publish.

## VI. Significant Risks — Status

In the *December Longbrake Letter* I described in detail three significant risks which, if realized, would depress U.S. economic growth and might even lead to recession. The three risks include: significant slowing in Chinese economic growth; European recession and attendant sovereign debt and financial system distress; and tighter U.S. fiscal policy and negative impacts of increased policy uncertainty.

Notwithstanding recent stronger data reports and increasing optimism little has occurred in the last month for better or worse to clarify the extent of the threat these risks pose to the U.S. economy. An update follows.

### 1. China

Recent economic news from China is mixed. On the positive side reported inflation is declining and monetary policy has become moderately accommodative. The official Chinese purchasing managers index rose into expansion territory in December.

But, on the negative side there is increasing evidence that the air might be going out of the Chinese property bubble. For example, there has been a sharp decline in steel production. ISI’s China sales index, which is dominated by capital expenditures, has been declining gradually for several months and has been in negative territory for the last month. Growth in imports slowed in December.

These developments are more indicative of slowing global growth than they are of an investment top-heavy Chinese economy poised for significant setback. While an eventual correction of China's economic imbalances and financial excesses is probable, the timing appears to be a long ways off.

As I discussed in last month's letter, China has chosen to emphasize infrastructure investment. Construction of buildings, railroads and the like, which is financed by state controlled financial institutions, provides plenty of jobs and can continue for a very long time, even when the projects themselves result in insufficient revenues to cover the cost of construction and operation. This is simply another version of the policy the U.S. and Europe pursued of stoking economic growth with gobs of debt leverage. When debt leverage outruns the ability to service the debt out of income as it did for U.S. mortgage loans and European sovereign debt, the game is up and the collapse quickly follows. That is the game that China is also playing. But China appears to have plenty of room to continue to play the game. Certainly, nothing has happened over the last month which would indicate that the risk of a significant Chinese setback is likely or even possible during 2013.

## **2. Europe**

While the headlines emanating from Europe in the early days of 2012 appear to be favorable, a bit of probing indicates that the situation continues to deteriorate. A European meltdown remains the biggest and most imminent risk for the global economy during 2012.

**Greece.** Did you think that all would be well after Lucas Papademos became prime minister? You might have that impression because there has been little about Greece in the news media recently. However, what has been in the media is absolutely chilling.

French President Sarkozy said in a recent news conference that "The situation is very tense, very tense." And, Prime Minister Papademos warned that a disorderly default is a possibility which could result in Greece leaving the Euro.

The odds of a disorderly default occurring are increasing. Greece has made virtually no progress in implementing fiscal and structural reforms. In the meantime the Greek economy continues to deteriorate rapidly. And

depositors continue to flee Greek banks.

Three things have to happen for Greece to avoid disorderly default: Greece has to make good on its fiscal consolidation commitments; European countries and the International Monetary Fund must continue to provide funds to finance debt payments; and private investors must agree to rollover Greek debt at substantial discounts. Greece has made no meaningful progress on fiscal consolidation. And, there is now a great deal of evidence that private investors will not be willing to do what is expected.

European authorities in their zeal to avoid an event of default put together a proposed debt restructuring program that was technically voluntary but which all investors were expected to accept. That fiction seemed somewhat plausible as long as most of Greek sovereign debt was held by banks. But, lo and behold, an increasing amount of Greek sovereign debt, perhaps as much as €80 billion which matures in March 2012, is now held by private investors (hedge funds). Investors have been buying short-term Greek debt, much of it at a substantial discount to par from European banks, betting that authorities will not be able to enforce the 50% haircut and will be forced to redeem the bonds at par when they mature.

What all this means is that come March Europe will not be able to kick the can down the road any longer. Either investors' bluff will be called, which probably would require actual default, or stronger European nations will have to step up and pay off investors. Bailing out Greece is political anathema in Germany. But, that may be the only remaining viable solution other than disorderly default.

Most market practitioners believe that disorderly default will result in widespread insolvency of Greek banks and trigger significant contagion elsewhere in Europe.

**European Recession Unfolding.** Consensus thinking is that Europe will encounter a brief shallow recession during the first half of 2012. This might be a reasonable expectation if governments were already engaging in fiscal stimulus, but exactly the opposite is occurring. For example, Spain reported that its deficit was 8% of GDP in 2011, which was 2% above its target. The Spanish government responded to this miss by taking additional measures to reduce the deficit.

Inflation remains elevated across Europe even as it recedes in the U.S.

There are two contributing factors. First, increases in taxes, such as the value added tax, feed directly into higher inflation. Second, the decline in the value of the euro relative to the dollar means that oil prices are rising in Europe. Inflation shocks tend to depress consumer spending which contributes in turn to recessionary pressures.

Recent data reports indicate that recession is probably already underway. Germany reported that real GDP grew 3.0% in 2011, but contracted at an annual rate of approximately 0.9% in the fourth quarter.

Credit conditions remain tight and this is slowly but surely strangling spending and investment. One must understand that once a course of events is set in motion, such as a credit crunch, it reverberates throughout an economy and gathers momentum for a period of time through feedback loops. Eventually, but not always, a negative shock and its ramifications will exhaust themselves, but not before considerable damage occurs. The problem in Europe is that as recession unfolds and gathers momentum little is likely to be done from a policy standpoint to limit the interplay of negative feedbacks. In this kind of environment, a disorderly unraveling of the Greek banking system and economy has the potential to become a “Lehman” moment.

**European Sovereign Debt.** There is much excitement about the highly successful auctions of Italian and Spanish debt in the early days of 2012 at greatly reduced interest rates. Does this mean that the fiscal compact agreed to in principle by the European Council in early December has been a gameeurosym changer? If that were the case, then why has Italian 10-year debt been trading above 7%, somewhat above the level that prevailed prior to the European Council meeting? Now to be totally fair, the yield on 10-year Italian debt did fall to 6.5% in the wake of the successful auction of 12-month bills on January 12th. While this may signal a change in market sentiment, I remain doubtful. The more likely reasons for the successful auctions have to do with two policies. The first involves the extension of copious amounts of liquidity from the European Central Bank (ECB) to Italian banks. Even at greatly reduced spreads, investing in short-term Italian sovereign debt is a lucrative arbitrage opportunity. The second involves the stipulation in the fiscal compact that effectively provides a guarantee of all European sovereign debt except the debt of Greece. The ability and willingness to honor this guarantee appears relatively solid in the near term, but ten years is a long time and a lot could happen, including

breakup of the euro zone. With that in mind it seems more likely than not that yields will remain very high on long-term Italian and Spanish bonds.

Fitch doesn't seem to have been too impressed. David Riley, head of global sovereign ratings at Fitch, recently commented that Italy is the single biggest threat to the Euro area's future. He telegraphed that it is likely that Fitch will downgrade Italian debt at the end of January. Italy's rating is currently A+ and was put on credit watch with a negative outlook in December.

**Implementation of the European Stability Mechanism (ESM) and Additional Contributions to the International Monetary Fund.**

There hasn't been much talk lately about how the plan to accelerate the implementation of the ESM is faring. Presumably this will be a topic at the upcoming meeting of European leaders in Brussels on January 30<sup>th</sup>. Another fact that quickly faded from attention was the call in the fiscal compact for members of the European Union to contribute €200 billion to the IMF. When the trail went cold the more likely amount seemed to have fallen to €150 billion. Moreover, non-European nations have expressed no interest in helping out.

**3. U.S. Fiscal Policy**

Two issues will dominate fiscal policy early in 2012 — extension of the payroll tax cut and unemployment benefits and a \$1.2 trillion increase in the federal debt ceiling. Expect a lot of political noise over the next two months and Democrats and Republicans jockey for political advantage. It is highly probable, although not absolutely certain, that both issues will be resolved favorably by the end of February. Certainly that is the current market expectation.

Fiscal policy will not pose a meaningful risk until toward the end of 2012. Assuming that Congress acts favorably on the payroll tax cut and unemployment benefits, which is likely but not absolutely certain, fiscal policy is set to tighten by as much as \$586 billion or 3.5% of GDP on January 1, 2013:

\$109 billion in spending cuts mandated by the sequestration provision of the Budget Control Act;

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\$255 billion from the expiration of the Bush tax cuts;

\$21 billion in Medicare tax increases mandated by the Obama health care legislation;

\$112 billion from the expiration of the payroll tax reduction, assuming Congress renews a 2% reduction in 2012;

\$51 billion from the expiration of extended unemployment benefits, and

\$38 billion from the alternative minimum tax temporary fix.

The estimate of \$586 billion is high because some offsets will accompany extension to the payroll tax cut and unemployment benefits.

There are three general categories of outcomes:

**Do nothing.** Worst case — Congress and the president reach a complete impasse and all tax increases and spending cuts go into effect as scheduled. Negative impact on GDP of 3% in 2013.

**Extend everything.** Almost as bad and perhaps worse in the long run — All tax cuts are extended and the spending sequester is repealed. No long-term deficit reduction plan is adopted. While this would maintain plenty of economic stimulus, rating agencies would downgrade U.S. debt. Financial markets could riot.

**Grand Bargain** — Congress and the president agree to a short-term/long-term deficit reduction plan similar to that proposed by the Simpson/Bowles Commission.

Financial markets would prefer a “Grand Bargain” outcome but will worry about some of the short-run consequences for economic activity if deficit cutting kicks in too quickly.

As the year progresses anxiety will build. Because it is a presidential election year and because the parties have staked out extremely divergent positions and have locked into inflexible hardline positions it is difficult to see how there can be much certainty about how this whole mess might be resolved. The election might clear the air or it might not if the outcome

leaves neither party with a strong mandate. Unfortunately, the dysfunctional partisan antics of 2011 are fresh in everyone's memory. This and ongoing politically heated rhetoric will only serve to fuel anxiety. Uncertainty is not the friend of growth.

For now the risk of a fiscal disaster in 2013 is far away and there is plenty of hope that reason will prevail. But in several months' time this sanguine attitude will deteriorate if sincere dialogue about meaningful and shared solutions has not commenced in earnest.

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