Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Longbrake Letter
2013 Forecast Assessment and 2014 Outlook*

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I. Outlook — 2013 and Beyond — Final Asessment

Observations about the 2013 U.S. and global economic outlook and risks to the outlook were contained in the ***December Longbrake Letter*** and are included below without any changes. Current assessments follow each item with the following identifiers: "+" tracking forecast; "-"not tracking forecast; "?" too soon to know.

1. **U.S.**

   - ***Q4 2012 real GDP*** growth projections range from 0.5% to 1.8%; tracking estimates based on October and November data are consistent with growth of approximately 1.0%.
     - ✓ ***- "Final Estimate" was +0.14%; much weaker than expected.***
   - ***2013 real GDP*** growth projections range from 1.5% to 3.0% but with a preponderance of the forecasts falling in the lower end of the range. The drag from tighter fiscal policy will offset gradual improvement in the household and business sectors. Growth should improve gradually over the course of the year. The balance of risks, particularly U.S. fiscal policy but also global growth, is weighted toward slower GDP growth.
     - ✓ ***+ First quarter GDP growth was a much weaker than expected 1.14%; the "Final Estimate" of second***

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quarter growth was 2.47%; the "Preliminary Estimate" of third quarter growth was 3.60%; forecasts for all of 2013 Q4/Q4 are approximately 2.2%; the Federal Reserve reduced its projection during the year and the final number looks like it will fall within its expected Q4/Q4 central tendency range of 2.0% to 2.3%.

- ***Real GDP output gap*** will remain very high and close little, if at all, during 2013.
  - ✓ ***+ The output gap was 5.80% in the first quarter, a little higher than the level in the first quarter of 2012. (Because of substantial GDP data revisions, CBO will need to revise its estimates of the output gap; this has not occurred yet.) Because expected 2013 real GDP growth of 2.2% should exceed CBO's February 2013 estimate of 1.9% potential growth in 2013, the output gap will shrink just a little bit.***
- ***Employment*** should grow about 125,000 per month, somewhat more slowly than in 2012.
  - ✓ ***- Data revisions indicate that employment grew 183,000 monthly in 2012; employment growth has been much stronger than 125,000 monthly in 2013; over the first eleven months of 2013 payroll growth has averaged 189,000 per month.***
- ***Unemployment rate*** should edge down to about 7.5%. A lower rate is not very likely unless more discouraged workers exit the labor force.
  - ✓ ***- The unemployment rate has edged down from 7.85% in December to 7.02% in November.***
  - ✓ ***+ But, a substantial number of additional discouraged workers has dropped out of the labor force, bringing the labor force participation rate to 62.98%, the lowest level since March 1978; 23 basis points of this decline of 63 basis points are due to demographic trends, leaving 40 basis points due to additional temporarily or permanently discouraged workers.***
- ***Consumer disposable income and spending growth*** will remain weak and could decline from 2012 growth rates if employ-

ment growth slows and wage and salary increases remain under pressure. Growth will be a lot weaker if Congress permits the payroll tax cut and extended unemployment benefits to expire.

✓ ***+ Through October both disposable income (7.52% in 2012; 2.58% in 2013) and consumer spending growth (3.73% in 2012; 2.80% in 2013) have been much weaker than in 2012.***

- ***Household personal saving rate*** will probably continue to decline gradually; however, it could rise if employment and income prospects worsen materially.

✓ ***+ The saving rate rose at the end of 2012 primarily because of acceleration in capital gains realization to avoid higher tax rates in 2013, but the saving rate has been lower over the first nine months of 2013 (4.99% in 2013 vs. 5.61% for all of 2012).***

- ***Export and import*** growth will probably continue to slow gradually due both to slower U.S. growth but also due to deepening recession in Europe.

✓ ***+ The 12-month moving average measure of the trade deficit fell from 3.26% of GDP in December to 2.87% in October; export growth is slightly higher and import growth is slightly slower.***

- ***Manufacturing*** growth will be subdued reflecting recession in Europe and slower growth in the U.S. The order backlog index was a very low 41.0 in November.

✓ ***- The purchasing managers' index moved from weak to strong expansion in July, August, September, October, and November.***

- ***Business investment*** spending has slowed sharply because of fiscal cliff concerns and could rebound if there is a satisfactory resolution of major fiscal issues. Capital expenditure plans are cautious based both on concerns about growth and political uncertainty.

✓ ***+ Business investment growth was very strong in the fourth quarter of 2012, growth is projected to rise 2.5% during 2013; as the year comes to a close most fiscal issues have been resolved and policy uncertainty***

is declining, but that was not the case for much of the year, which contributed to slow business investment growth.

- ***Housing investment*** is one of the brighter prospects. However, increased activity is likely to be concentrated in multi-family rather than single family. Housing starts are likely to increase 25% in 2013 to approximately one million. Housing prices should rise between 2% and 3%.
  - ✓ ***- Total housing starts averaged 906,500 over the first eight months of 2013, which was up a disappointing 15.7% from 783,170 in 2012.***
  - ✓ ***+ Multi-family starts account for 60.6% of the increase in housing starts, but only 32.6% of total starts (the Census Bureau has not yet published data for September and October).***
  - ✓ ***- Housing prices are rising much, much faster than anticipated in part due to strong investment demand and in part due to declining inventories, but the sharp rise in mortgage rates since mid-year is slowing the rate of increase.***
- ***Monetary policy*** — the Federal Reserve has committed to purchase \$85 billion in securities every month including \$40 billion in mortgage backed securities and \$45 billion in U.S. Treasury securities.
  - ✓ ***+ Monthly purchases of \$85 billion will continue through December; tapering will begin either in January or March 2014.***
- ***Inflation*** will remain below the Federal Reserve's 2% objective at least through 2015. Concerns about increases in inflation in the long-term are misplaced.
  - ✓ ***+ October PCE inflation was 0.74% and core PCE inflation was 1.11%.***
- ***Federal Funds rate*** is not likely to increase before mid-2015 and might not increase until late 2016 or early 2017.
  - ✓ ***+ My models suggest the federal funds rate will not be raised until late 2016 or sometime during 2017; the market expects the fed funds rate to increase in mid-2015.***

- ***Fiscal policy*** will be contractionary in 2013, but will become less of a factor in ensuing years.
  - ✓ ***+ Fiscal policy has been more contractionary during 2013 than most had expected because Congress permitted automatic spending cuts to take effect as scheduled on March 1st; fiscal policy is now expected to subtract at least -2.0% from GDP in 2013 and -0.4% in 2014; the deficit is shrinking more rapidly than expected and was 4.0% for fiscal 2013 and is expected to decrease to 3.2% or less in fiscal 2014.***
- ***Potential structural rate of real GDP growth*** has declined significantly and could decline further in coming years unless a concerted public initiative is undertaken to invest in education, research and public infrastructure.
  - ✓ ***+ Too early to tell, but this increasingly appears to be a correct call; productivity growth is up 0.5% through the first nine months of 2013.***

2. **Rest of the World**

- ***European financial markets*** are likely to remain relatively calm thanks to the activist role of the European Central Bank.
  - ✓ ***+ To date calm has prevailed but political uncertainty is rising in Italy and Spain; the Cyprus bailout/bail-in was a significant negative development early in the year; however, that crisis passed without any lasting consequences.***
- ***European recession*** is spreading to stronger countries and worsening in peripheral countries.
  - ✓ ***- Eurozone countries collectively eked out small positive quarterly GDP growth of 0.3% in the second quarter and 0.1% in the third quarter.***
  - ✓ ***+ Peripheral countries, Italy, and France remain in recession; fundamental structural problems have not been addressed — Europe's crisis is quiescent for the moment but far from over.***
- ***European banking union*** will do little to solve deep-seated European and Eurozone structural problems.

- ✓ + ***The EU has issued a policy paper but no action is expected anytime soon.***
- ✓ + ***Germany has persuaded other EU members to eventually amend treaties to require a separation of the ECB's monetary and supervisory responsibilities — this move is seen by some as a delaying tactic on the part of Germany; insurance protocols have been recommended, but no action is likely any time soon.***
- ✓ ***The ECB is preparing to conduct rigorous bank stress tests.***
- ✓ ***Net new bank credit extension is nil.***

- European political dysfunction, populism and nationalism will continue to worsen gradually.
  - ✓ + ***Coalition governments in Italy and Greece appear increasingly fragile, but have managed to hold together.***
  - ✓ + ***Portugal, may need another bailout, Greece definitely will need one, and Ireland looks like it will not need one.***
  - ✓ + ***Nontraditional euro-skeptic parties are gaining strength in several European countries.***
- ***China*** appears to have achieved a ***soft landing*** and economic activity will strengthen modestly.
  - ✓ + ***Soft landing achieved early in the year, slowing occurred in mid-year, but recent data suggest growth on track to meet lower end of China's target range.***
  - ✓ + ***Third quarter year-over-year growth edged up to 7.8% from 7.5% in the second quarter.***
- ***China's new leadership*** understands the need to design and implement ***economic reforms*** and avoid repeating a massive infrastructure spending program.
  - ✓ + ***Transition toward a more consumer-focused economy has begun.***
  - ✓ + ***As expected, the Third Plenum of the 18th Central Committee adopted policies that will lead eventually to significant reforms; implementation has begun.***
- ***Global growth*** is likely to be fairly steady in 2013 but will depend on developments in the U.S. and Europe.

- ✓ ***+ Global growth is down slightly from 3.2% in 2012 to 2.9% in 2013; slower growth in emerging countries has been offset by modestly better growth in developed economies.***
- ✓ ***The IMF expects global growth to rise to 3.6% in 2014.***

3. **Risks** — stated in the negative, but each risk could go in a positive direction

   - ***U.S. fiscal policy*** tightens more than expected.
     - ✓ ***+ Automatic spending cuts kicked in on March 1 and were not modified during fiscal year 2013; they have been modified for fiscal year 2014.***
     - ✓ ***+ The federal budget deficit is falling much more quickly than expected.***
     - ✓ ***+ A fiscal year 2014 budget resolution was adopted in mid-December, which restores some spending cuts and provides for more discretion in allocating other spending cuts.***
   - ***Europe's recession*** deepens more than expected; financial market turmoil reemerges; political instability and social unrest rises more than expected threatening survival of the Eurozone.
     - ✓ ***+ Economic data indicated in the first quarter that the recession was worse than expected, however Eurozone countries collectively posted a small positive increase in GDP during the second quarter and an even smaller increase in the third quarter.***
     - ✓ ***- Structural problems largely remain unaddressed; Eurozone countries are likely to muddle along for a while, but strong recovery seems unlikely and resumption of crisis is still a distinct possibility.***
     - ✓ ***+ Financial markets have remained calm and the Cyprus crisis passed without creating lasting damage.***
     - ✓ ***- Bank credit is difficult to obtain.***
     - ✓ ***- Renewed political instability and/or additional bailouts in 2014 could reignite a financial markets crisis.***
     - ✓ ***- Political instability is not yet serious, but trends are unfavorable in several countries — Italy, Greece, Spain, Cyprus, and Portugal.***

- ✓ ***- Incidents of social unrest have occurred in a few countries and political parties on the left or right are gaining adherents.***

- ***Chinese*** leaders have difficulty implementing ***economic reforms***; growth slows more than expected.
  - ✓ ***+ It is too early to tell about implementation of reforms, but potentially significant reforms were approved in November.***
  - ✓ ***- Growth forecasts are being revised lower; growth is likely to decelerate very gradually as economic reforms are implemented.***
- ***Global growth*** slows more than expected.
  - ✓ ***- The trend in global growth is slightly slower than last year.***
  - ✓ ***- Brazil's economy slowed earlier this year and India and Indonesia are experiencing capital outflows and slower growth.***
- Severe and, of course, unexpected ***natural disaster*** occurs.
  - ✓ ***? A devastating typhoon killed thousands in the Philippines; however negative global economic impact is likely to be immaterial.***
- ***Disruption of Middle East oil supply***, stemming from hostile actions involving Iran and Israel, occurs.
  - ✓ ***+ Political turmoil in Egypt and civil war in Syria have not had any material impact on global oil prices.***
  - ✓ ***+ The recent accord with Iran has reduced the level of risk considerably.***
- ***<u>New</u> North Korea attacks South Korea***, which spokes global financial markets.
  - ✓ ***- There was a lot of saber rattling early in 2013, but this potential crisis has disappeared from view; political instability may be developing in North Korea with the recent execution of the leader's uncle.***

II. Outlook — 2014 and Beyond — Forecast Summary for the U.S. and the Rest of the World, Highlights of Key Issues, and Identification of Risks

Observations about the 2014 U.S. and global economic outlook and risks to the outlook are listed below. As events unfold during 2014, this will enable the reader to track my analytical prowess.

1. U.S.

   - ***2014 real GDP Q4/Q4*** growth projections range from 2.9% to 3.4%; the FOMC's projection range is 2.9% to 3.1%. 2014 real GDP Y/Y growth projections range from 2.5% to 3.1%. (Q4/Q4 projections are highly dependent upon potential anomalies in Q4 data; therefore, Y/Y estimates, which average all four quarters, are more stable estimates.) Growth should improve gradually over the course of the year. I expect real GDP growth to track the lower end of the Y/Y range in 2014.
   - ***Real GDP output gap*** will remain very high, but will close a little faster during 2014 (I intend to supply numerical estimates once CBO updates its GDP gap analysis).
   - ***Potential structural rate of real GDP growth*** has declined significantly in recent years. I expect potential growth to be about 1.5% in 2014, which means the output gap could close by approximately 1.0%. Potential GDP growth is likely to rise slowly in coming years to between 2.1% and 2.4%.
   - ***Productivity*** should rise as growth improves and investment increases, but should still fall well short of the historical 2.1% average.
   - ***Employment*** should grow about 190,000 per month in 2014, about the same as in 2013.
   - ***Employment participation*** will not rebound in 2014, which will contribute to a more rapid decline in the unemployment rate; the secular demographic decline will be offset by a small reduction in discouraged workers.

- ***Unemployment rate*** should edge down to about 6.5%. A lower rate is not very likely unless discouraged workers do not re-enter the labor force or more exit the labor force.
- ***Nominal consumer disposable income***, measured on a Y/Y basis will rise about 2.0% with employment growth and a small increase in the nominal wage rate. Because of the depressing effect of increased taxes in 2013 on disposable income growth, the Q4/Q4 growth rate should be a much higher 2.9%.
- ***Nominal consumer spending growth*** on the Y/Y basis will grow at a faster rate of approximately 3.3% (Q4/Q4 growth rate would also be about 3.3%, as spending was not affected materially by increased tax rates in 2013).
- ***Household personal saving rate*** will decline slightly as growth in spending exceeds growth in disposable income.
- ***Stock prices***, as measured by the S&P 500 average, should rise about 5%.
- ***Manufacturing*** growth will continue to be relatively strong and the PMI index will exceed 50.
- ***Business investment*** spending growth should improve to about 5 to 6% as employment and consumer spending growth gathers momentum.
- ***Residential housing investment*** should rise about 10% and contribute 30 to 40 basis points to real 2014 GDP growth; residential housing starts should rise 20 to 25%.
- ***Residential housing prices*** should rise about 5% in 2014, more slowly than 2013's 10% increase.
- ***Trade deficit*** should rise slightly as economic growth improves because imports should grow more quickly than exports. The dollar's value should decline modestly on a trade-weighted basis.
- ***Monetary policy*** — the Federal Reserve will end quantitative easing by mid-year and will clarify forward guidance.
- ***Inflation*** will rise slightly in 2014 but will remain well below the FOMC's 2% objective at least through 2016.
- ***Federal funds rate*** is not likely to increase before mid-2015 and might not increase until late 2016 or early 2017. The 10-year Treasury rate is likely to fluctuate in a range between 2.5% and 3.5% in 2014.

- ***Fiscal policy*** will be significantly less contractionary in 2014, decreasing real GDP growth by about -0.4%; the federal budget deficit will decline to 3.0% by the end of 2014.

2. **Rest of the World**

   - ***Global growth*** is likely to improve to 3.5% in 2014 from 2.9% in 2013.
   - ***European growth*** will be positive but will fall short of the ECB's forecast of 1.1%.
   - ***European financial markets*** are likely to remain relatively calm thanks to the activist role of the European Central Bank, the May European parliamentary elections could lead to a new round of turmoil.
   - ***European banking union*** will do little to solve deep-seated European and Eurozone structural problems; ECB stress tests will contribute to slow credit expansion.
   - ***European political dysfunction, populism and nationalism*** will continue to worsen gradually.
   - ***U.K. growth*** will continue to be robust as the housing and debt bubble continue to build.
   - ***China's GDP growth*** will slow below 7% as economic reforms are implemented.
   - ***China's leadership*** will focus on implementing ***economic reforms*** and will overcome resistance and maintain stability.
   - ***Japan's*** economic resurgence is likely to falter by the end of 2014, as Abenomics' third arrow of economic reforms fails to raise the level of potential growth sufficiently to overcome negative population growth.
   - ***Emerging market countries*** on balance will experience greater growth, as long as the U.S. and European economies do better in 2014; countries heavily dependent upon commodities exports for growth will do less well as will also be the case for countries with large balance of payments deficits.

3. **Risks** — stated in the negative, but each risk could go in a positive direction

   - ***U.S. potential real GDP growth*** falls short of expectations

- ***U.S. employment growth*** is slower than expected; the ***participation rate*** continues to decline
- ***US. Unemployment rate*** falls less than expected
- ***U.S. productivity*** does not improve
- ***Real U.S. consumer income and spending*** increase less than expected
- ***U.S. financial asset prices*** rise more than expected posing increased bubble risks
- ***Growth in U.S. residential housing investment and housing starts*** is less than expected
- ***U.S. residential housing price increases*** slow more than expected
- ***U.S. private business investment*** does not improve as much as expected
- ***U.S. manufacturing growth*** slows
- ***U.S. trade deficit*** widens and the ***value of the dollar*** falls
- ***U.S. monetary policy*** spawns financial market uncertainty and contributes to financial instability
- ***U.S. inflation*** *falls, rather than rising, and threatens deflation*
- ***U.S. interest rates*** rise more than expected
- ***U.S. fiscal policy*** is more restrictive than expected and the ***budget deficit*** falls more than expected
- ***U.S. state and local spending*** does not rise as fast as expected
- ***Global GDP growth*** does not rise as fast as expected
- ***Europe*** slips back into recession
- ***Europe*** — financial market turmoil reemerges
- ***Europe*** — political instability and social unrest rises more than expected threatening survival of the Eurozone and the European Union
- ***U.K. growth*** falters as housing bubble collapses
- ***Chinese*** leaders have difficulty implementing ***economic reforms***
- ***China's growth*** slows more than expected
- ***Japan*** — markets lose faith in Abenomics

- Severe and, of course, unexpected ***natural disasters*** occur, which negatively impact global growth
- ***Middle East oil supply*** is disrupted and oil prices rise sharply

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