The Outlook for the U.S. Economy

Presented by Daniel North, Euler Hermes ACI, October, 2011

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The Outlook, October, 2011

- It’s getting harder to be an optimist
- Odds of a double-dip >35%   <50%
- Debt uncertainty in Europe & U.S.
- U.S. in more detail
  - Forces and measures
  - Government responses
- The Future
- Conclusions

European Debt Uncertainty

- What happens if:
  - Italy’s / France’s fiscal positions need bailouts?
  - Greece defaults, Greek bonds held by European banks lose value, banks can’t lend, economy crushed, banks need bailout?
  - Two sources of money – could need 1.5T-2T €
  - European Central Bank (ECB) already buying Italian and Spanish debt – how much more?
  - European Financial Stability Fund (EFSF) only has 440B € - France & Germany can’t decide how much more to put in it – technically not ratified yet
  - If things get really bad… IMF, EU, U.S. Fed, U.S. taxpayers?
  - Problem is it is UNCERTAIN

U.S. Debt Uncertainty

- U.S. debt problem is different. In contrast to Europe, U.S. will never have to default because it can do what no one else can – print U.S. dollars.

- U.S. problem is government has no plan to reduce debt that's so high it hurts the economy - not defaulting.

- Congress just made pathetic attempt to fix it – BCA 2011. Spending "cuts" of only 5% from a fantasy budget, not current level. Deficits continue and debt/GDP at 100% for next 10 years. No attempt to reform entitlements.

- UNCERTAIN how debt can be managed if just blew that chance… new stimulus programs… 2012 elections

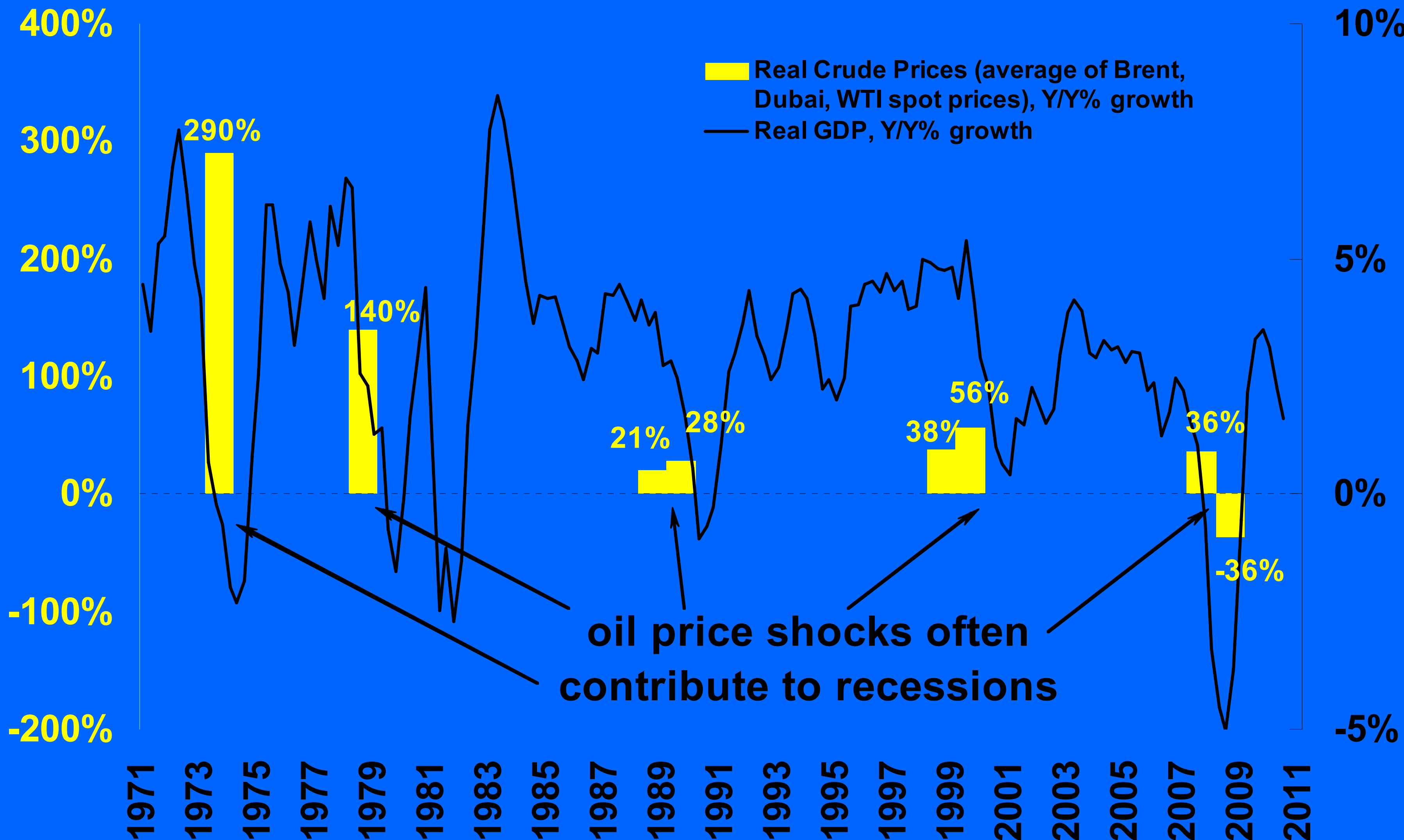
- Uncertainty over taxes, regulation hurting growth. …Let's look at the details….

The four forces which started and ended the recession can help forecast the outlook:

- Oil
- Housing
- Fed policies
- Fear

(GDP: $15T, 3.3% ave. growth. It's the "size" of the economy. Use it to measure the "size" of other big numbers like budget deficit/debt)

Oil Price Shocks and the Economy



Source: Dept. of Commerce, Dept. of Labor, World Bank, EHACI

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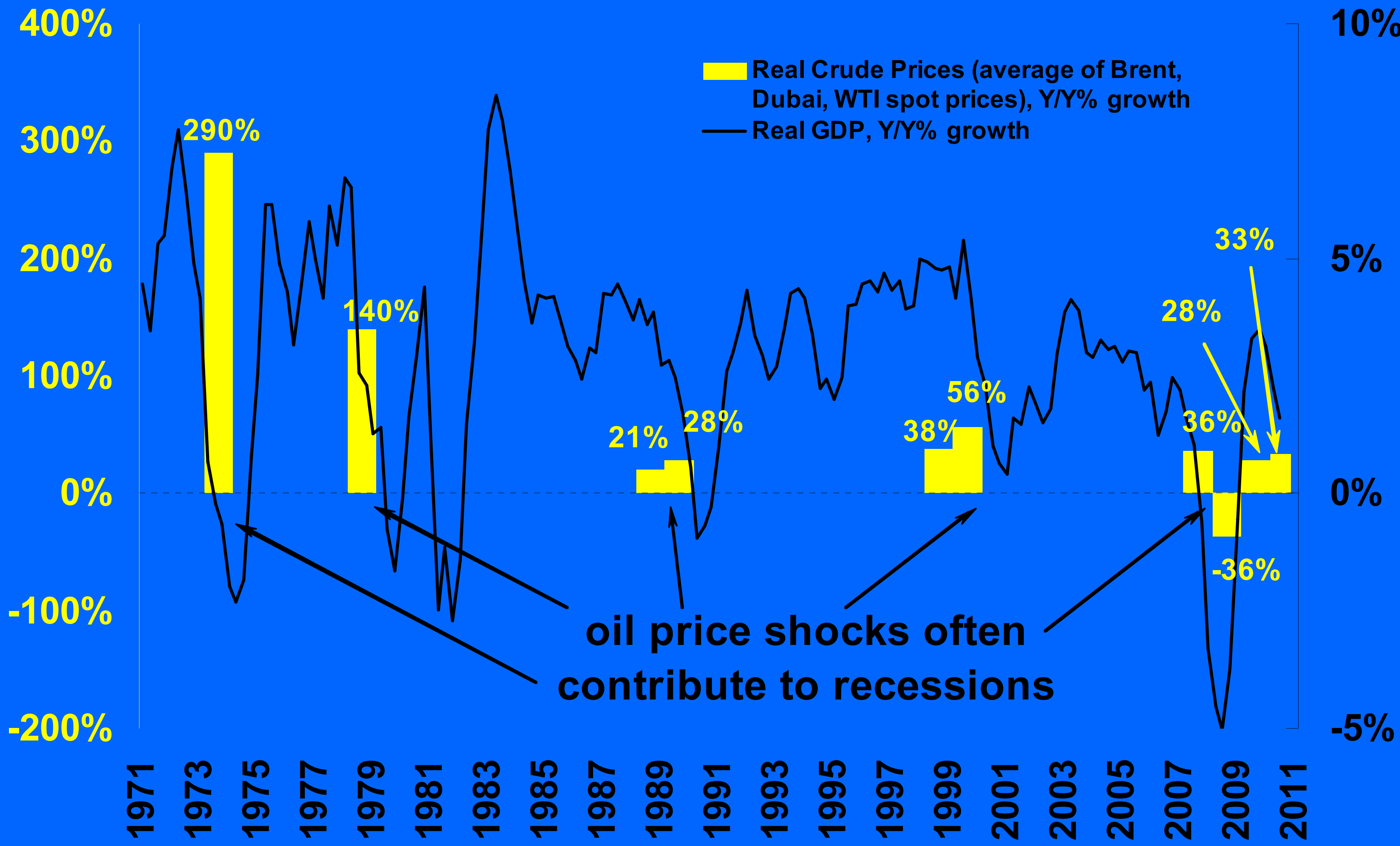

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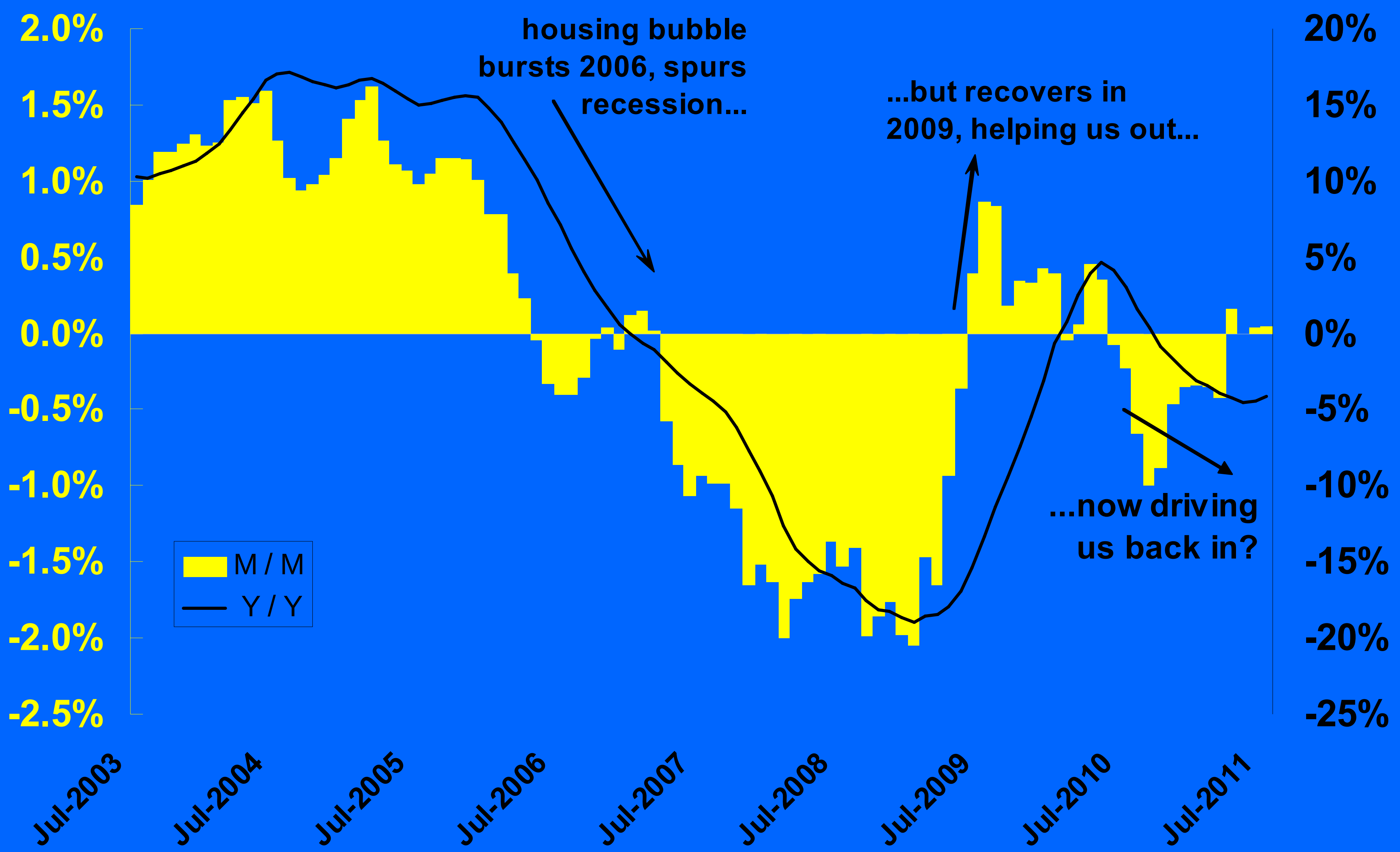
Housing

Case - Shiller Home Price Index, % Change



S&P/Case-Shiller

Housing

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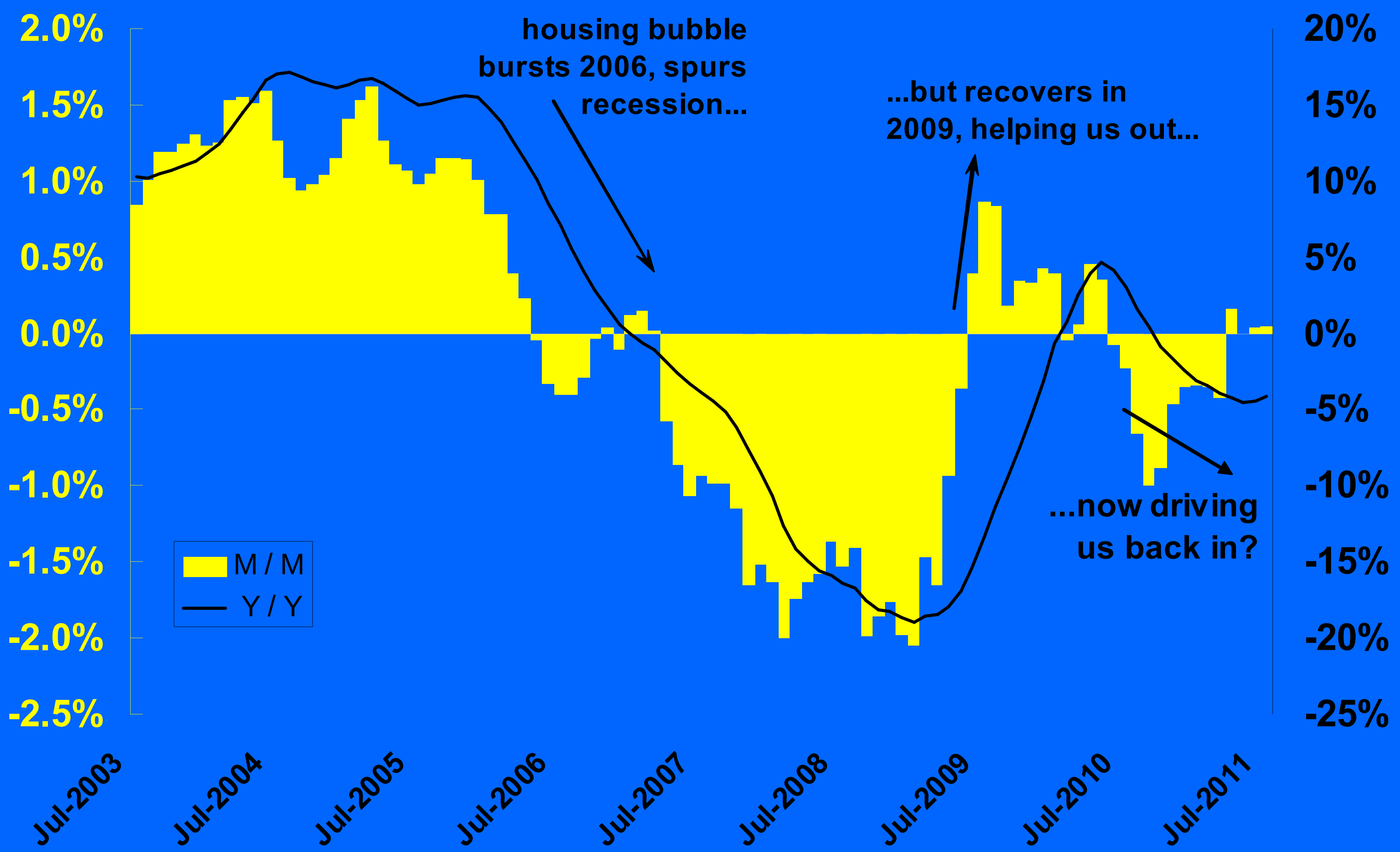
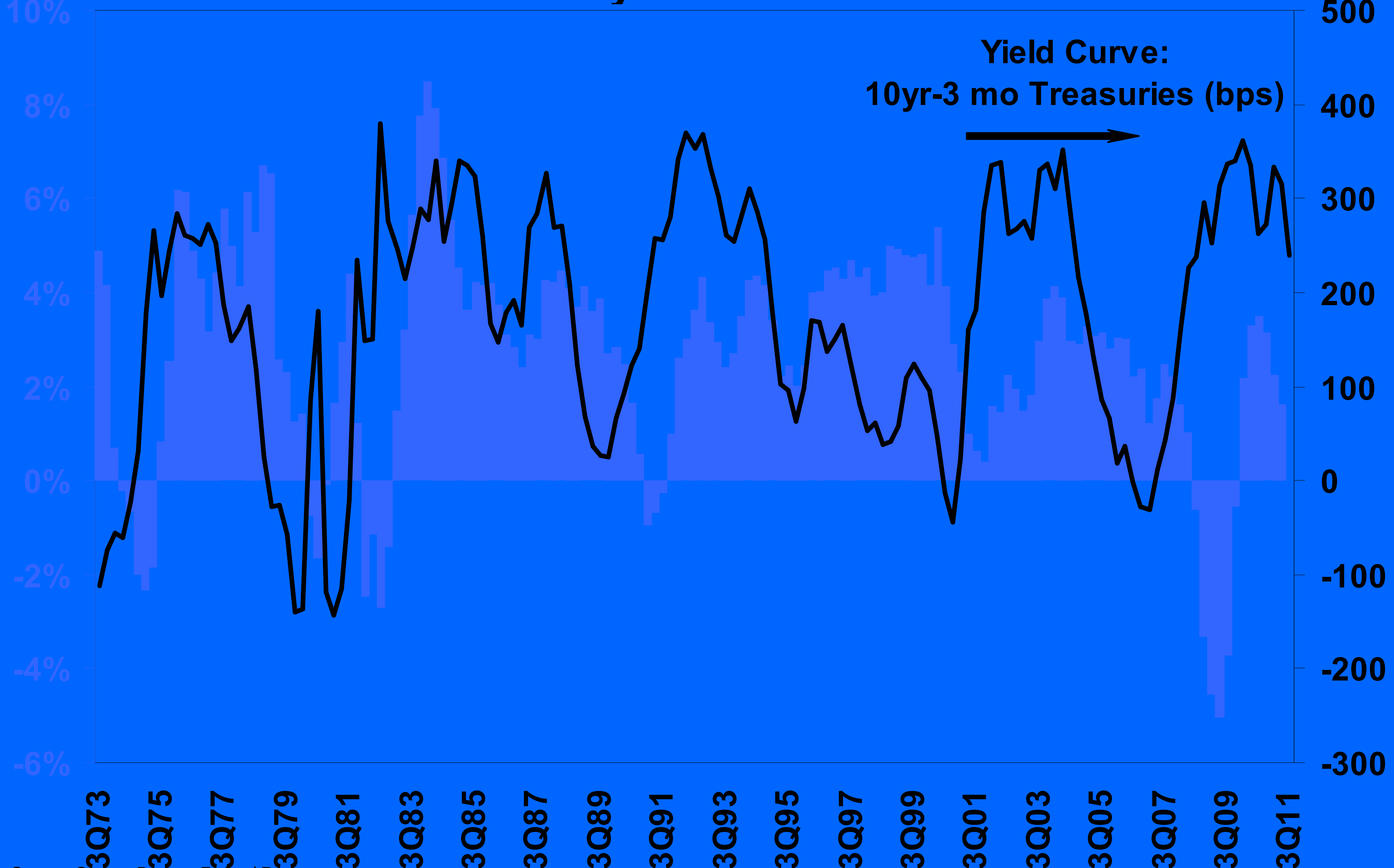


S&P/Case-Shiller

This month sales, permits & inventory good, prices & starts bad.
Volatile! Change every month!

The Treasury Yield Curve vs. GDP



Source: Census Bureau, Federal Reserve

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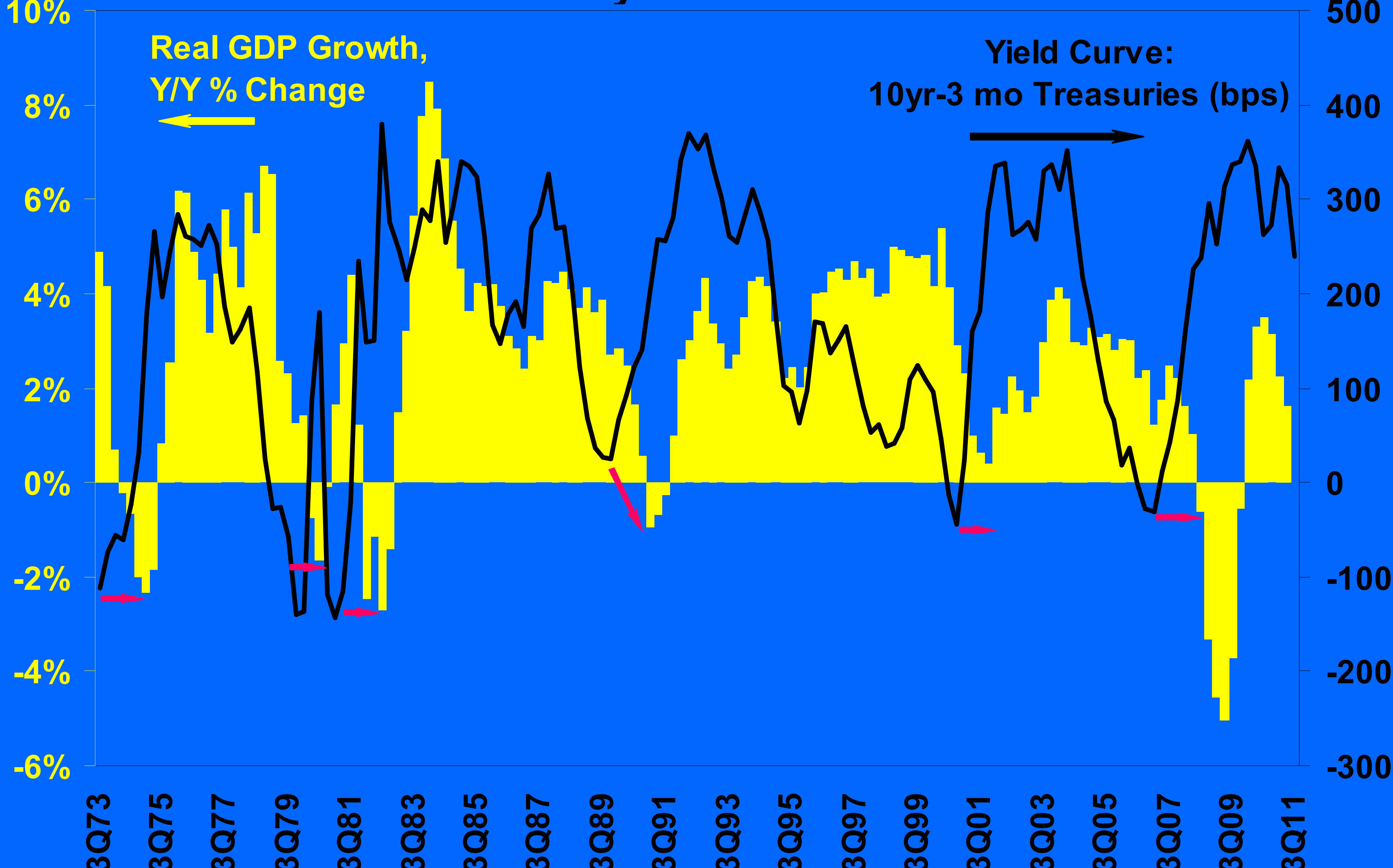

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Yield curve had been looking good…

Yield Curve Steepness: 10 yr-3 mo. yield (bps), was good, now going the wrong way

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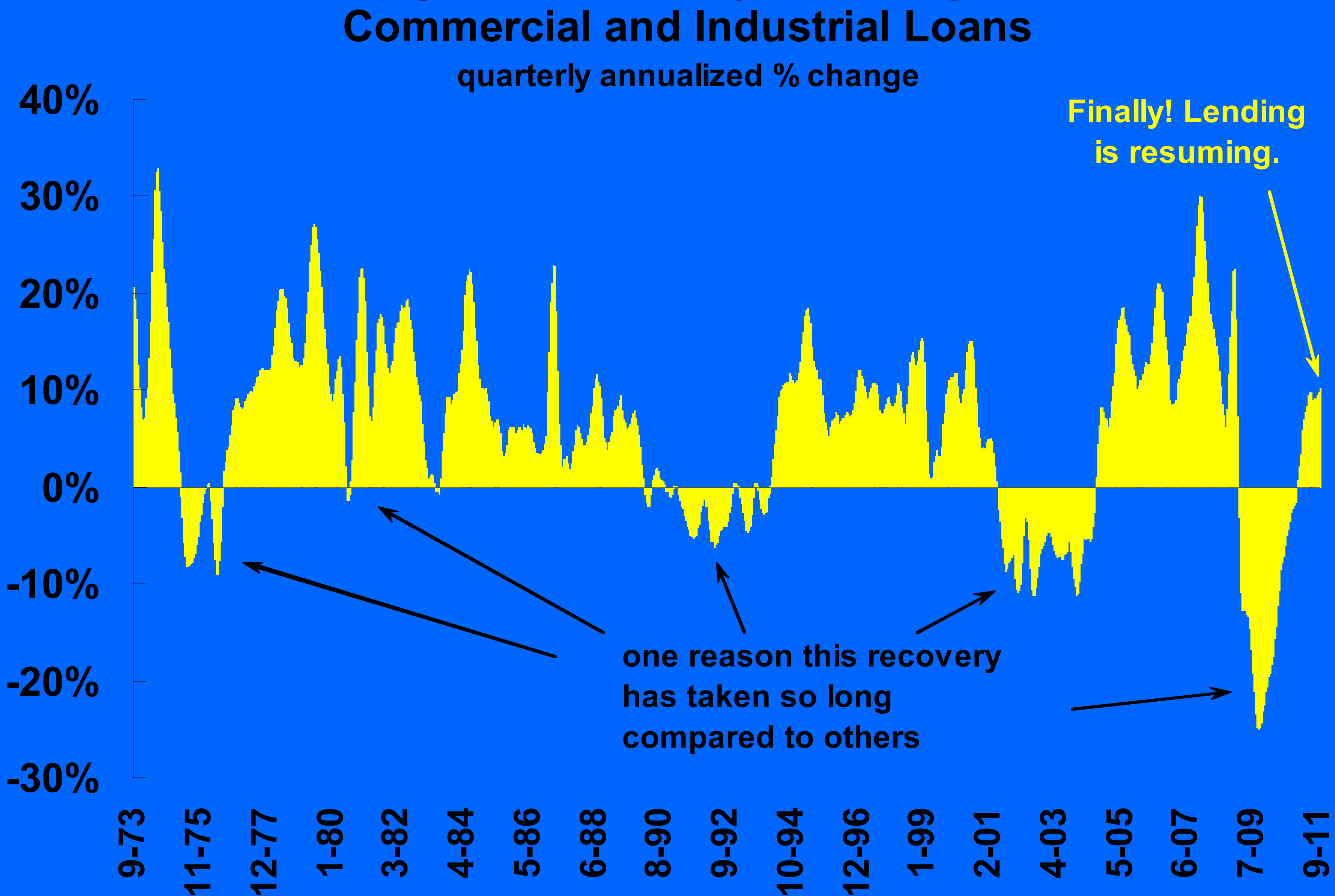
Yield Curve Steepness: 10 yr-3 mo. yield (bps), was good, now going the wrong way

Banks are lending, fear slowly leaving



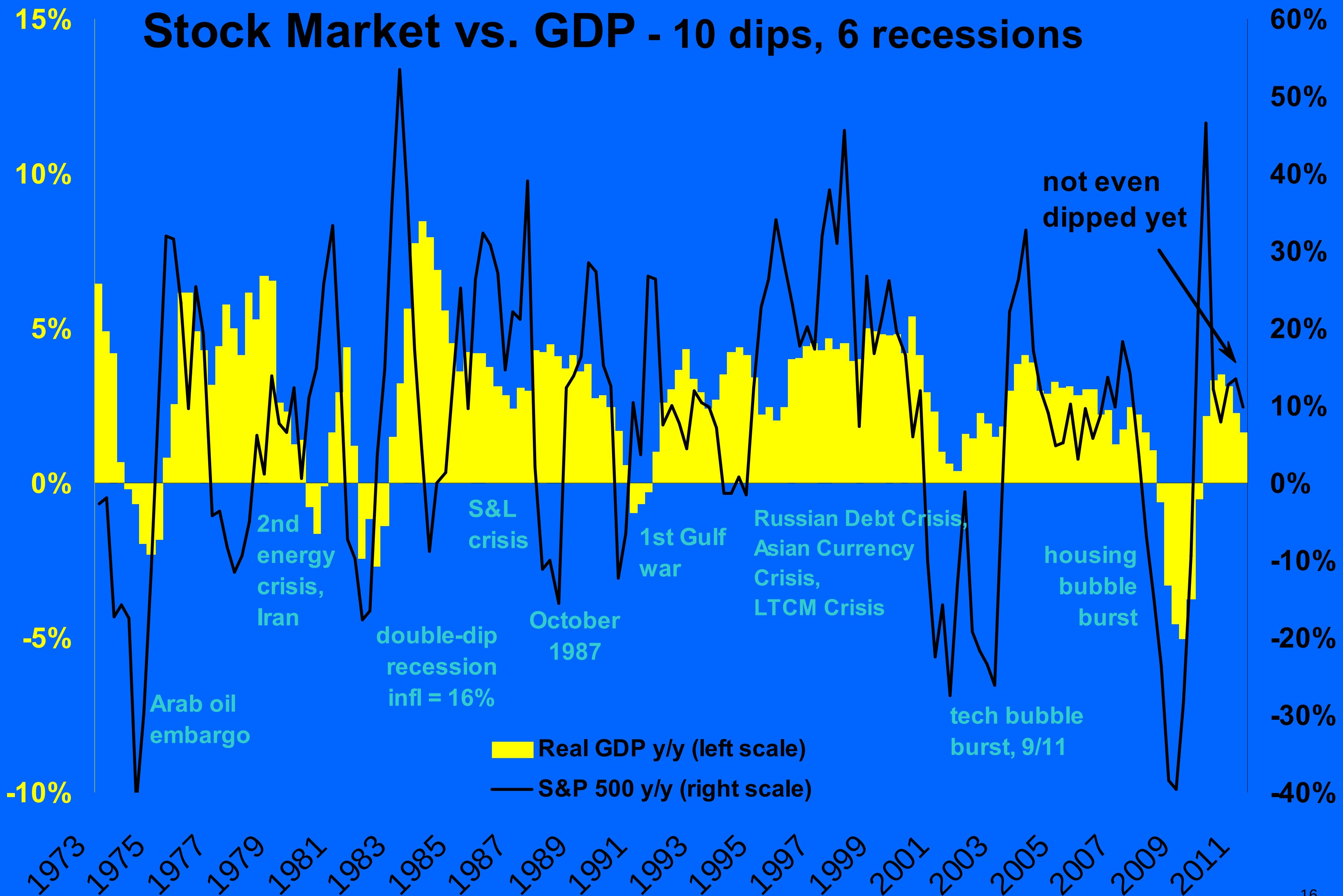
source: Federal Reserve

So the 4 forces:

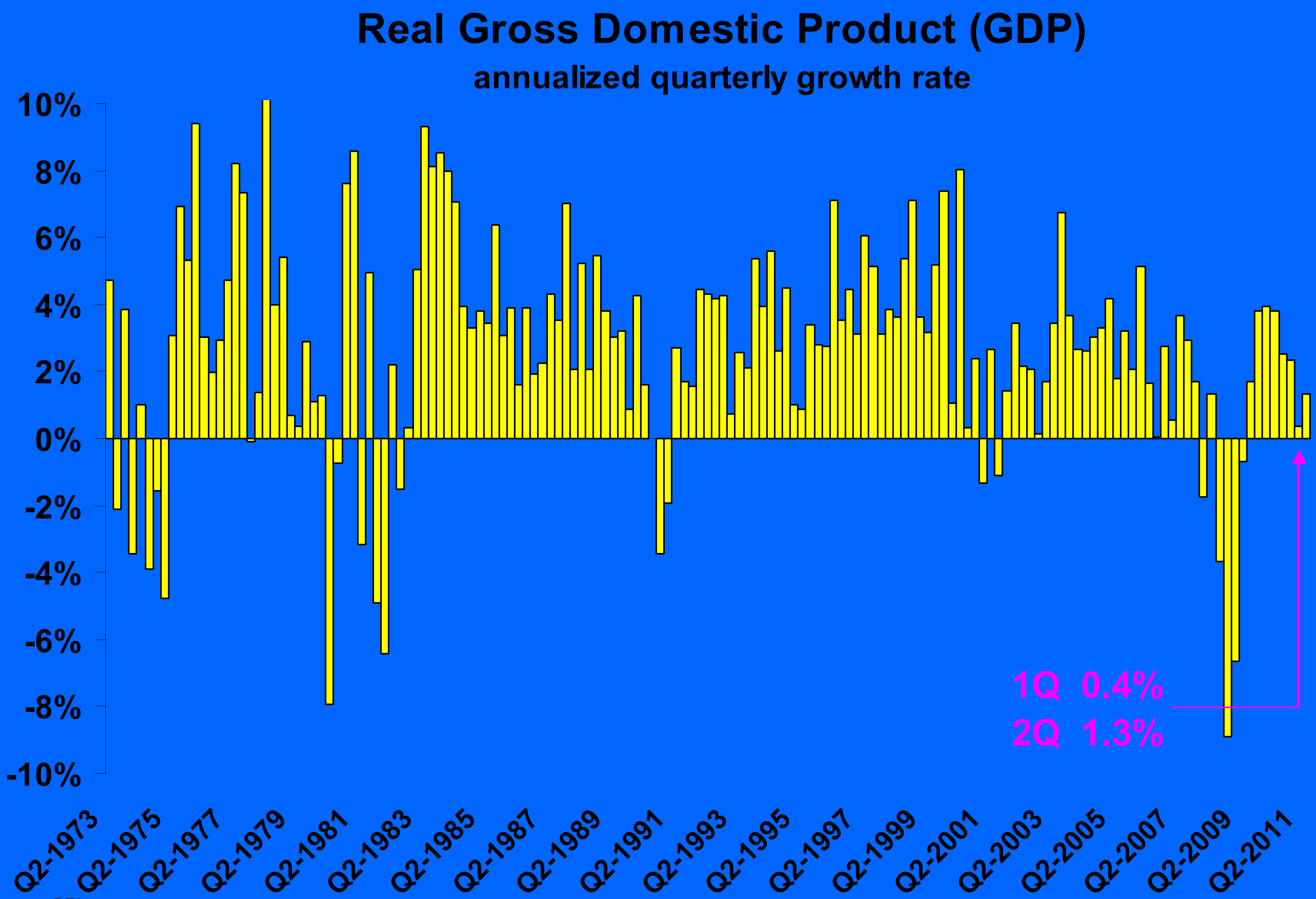
- Got us into recession
- Got us out of recession
- Now: oil, housing bad, yield curve worsening, lending OK

So what do the measures of the economy say?

What the stock market says isn't reliable

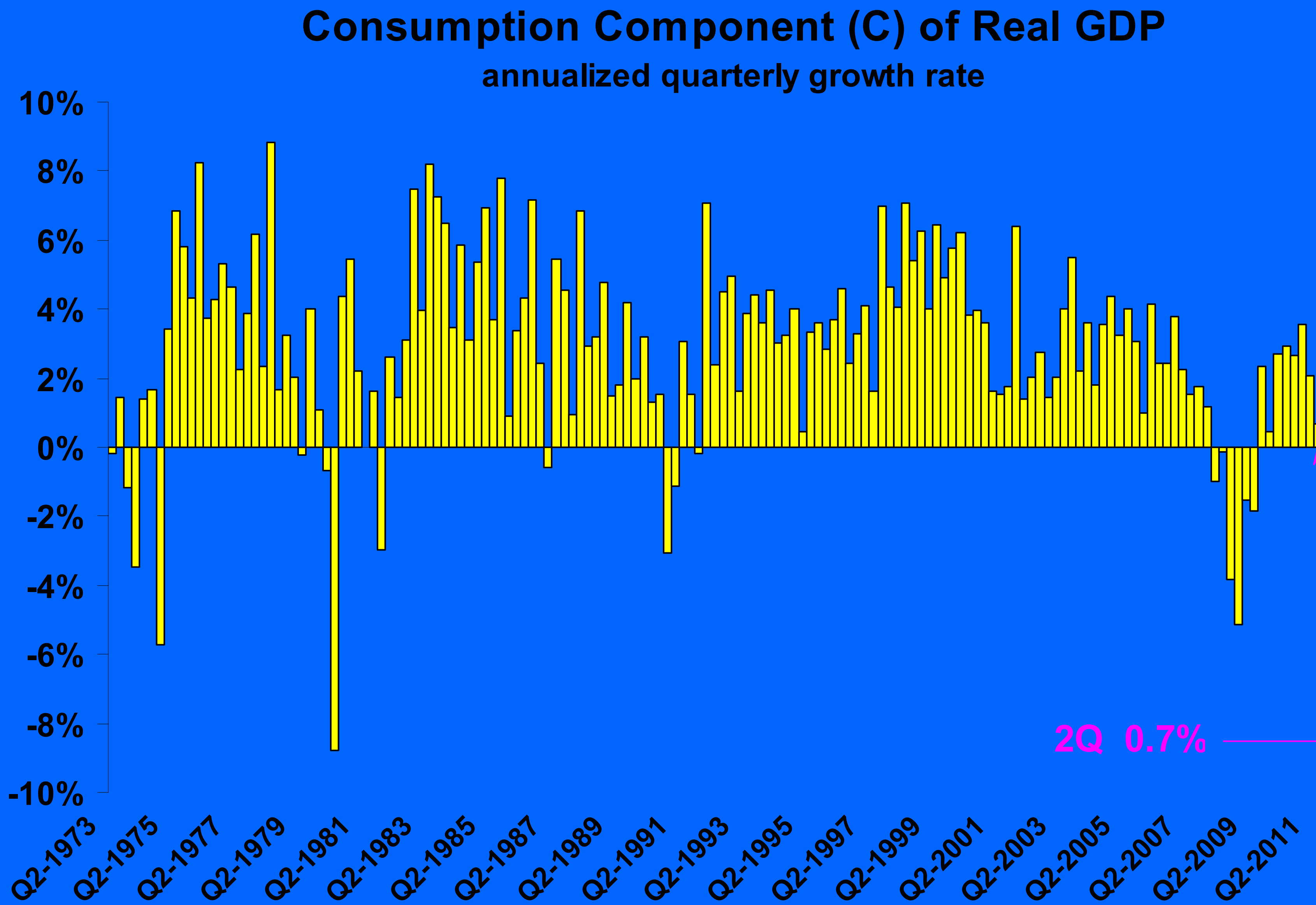


GDP had been recovering



source: BEA

Consumer had been recovering



source: BEA

ISM was recovering

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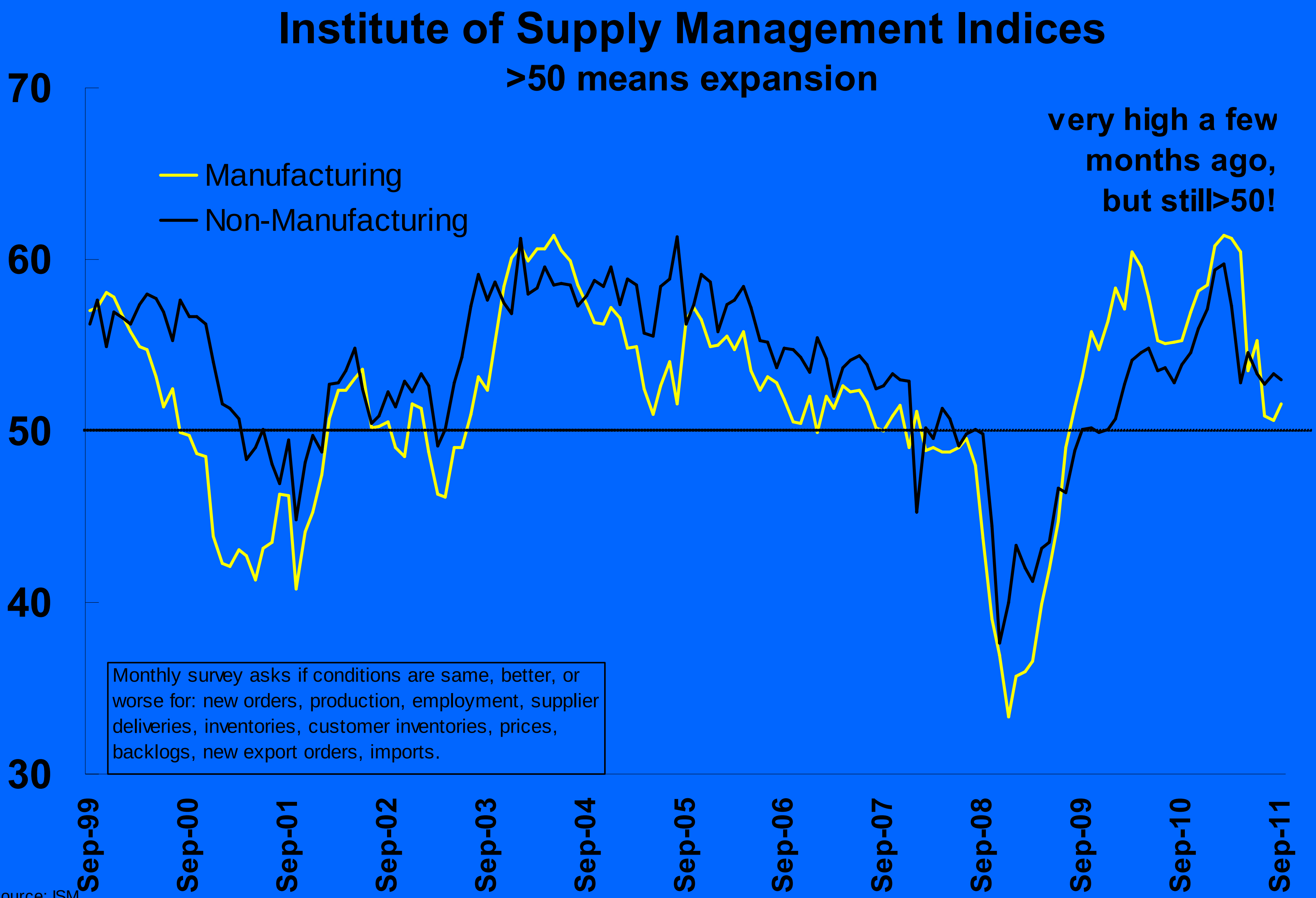


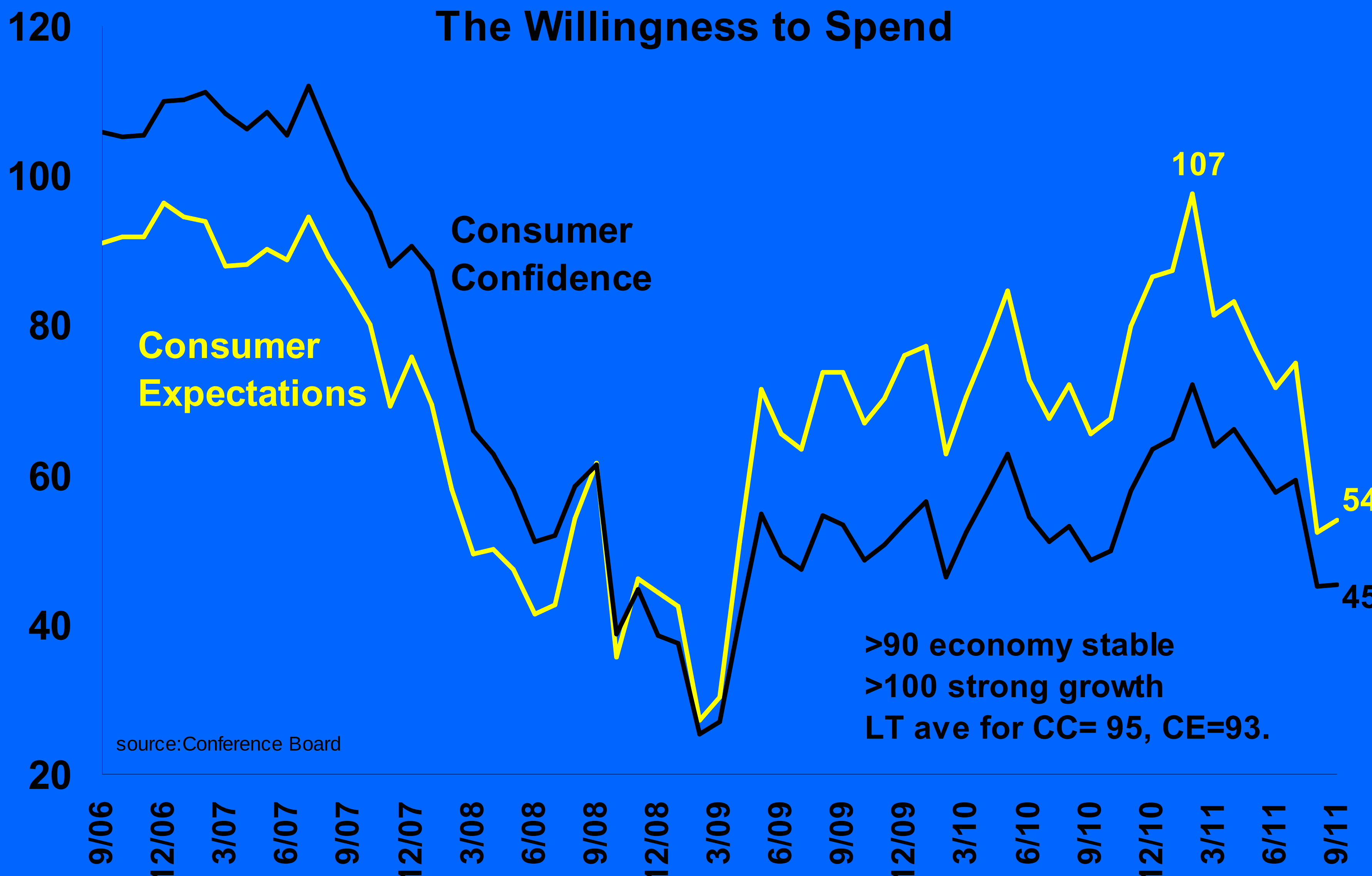
source: ISM

Another Measure: Retail Sales

Consumer must have:

- Willingness to Spend
  - Consumer confidence & expectations
- Ability to spend
  - Debt load
  - Income and employment

Consumer Confidence and Expectations
The Willingness to Spend



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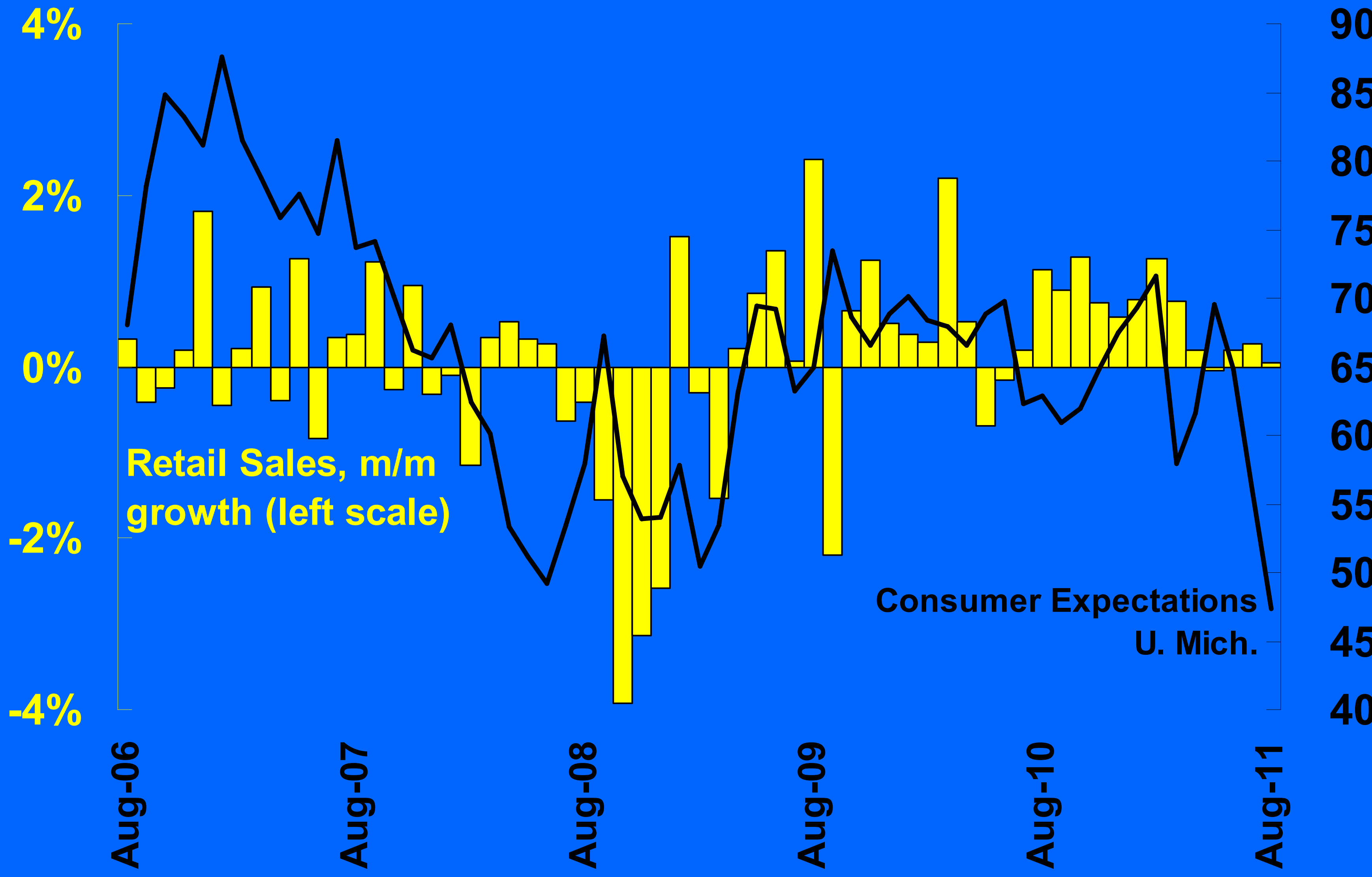
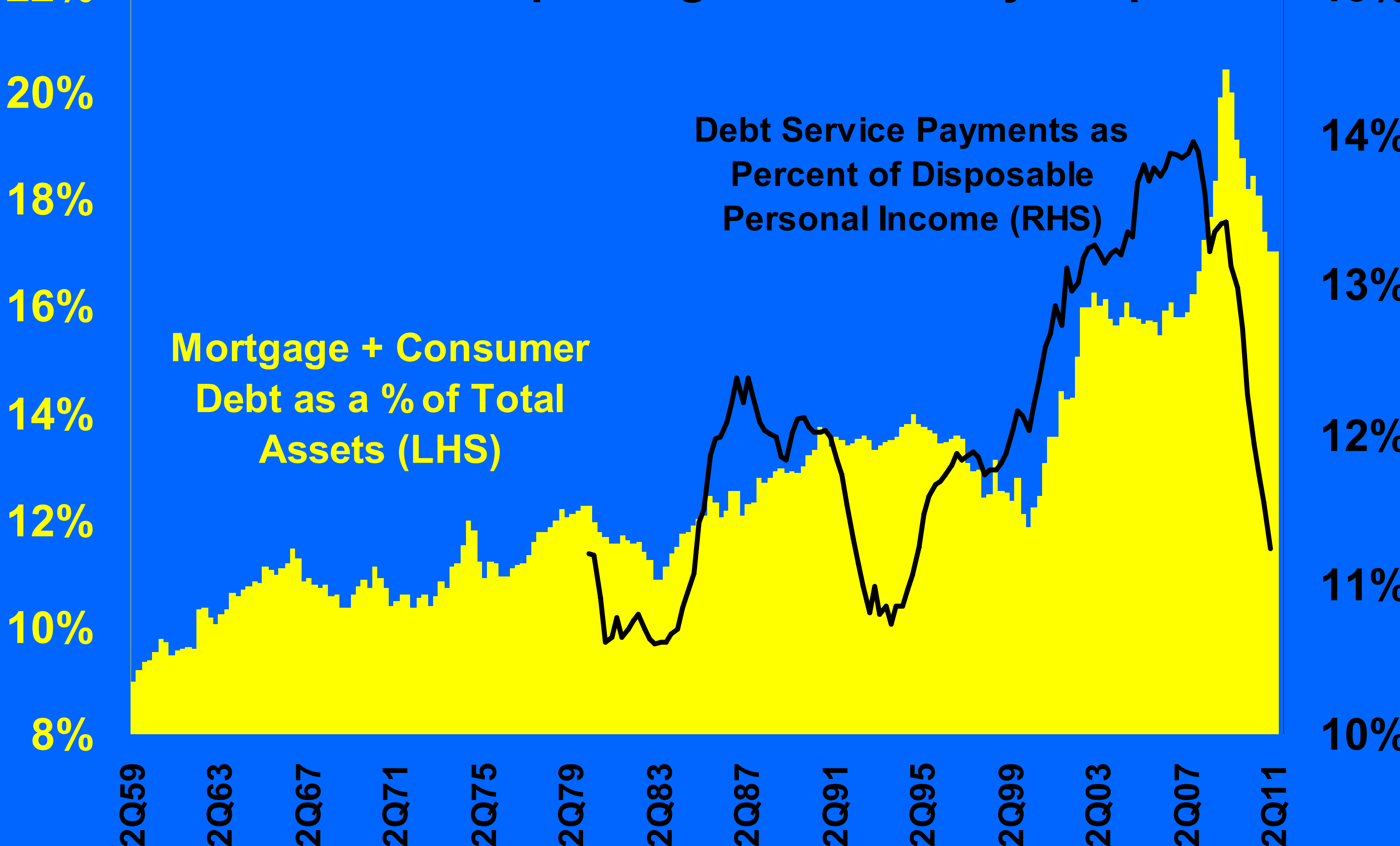
The Willingness to Spend: Consumer Expectations & Retail Sales



The Consumer Debt Burden
two measures improving = more ability to spend?



Source: Federal Reserve

Since recession revolving credit down 14%, nonrevolving up 6%

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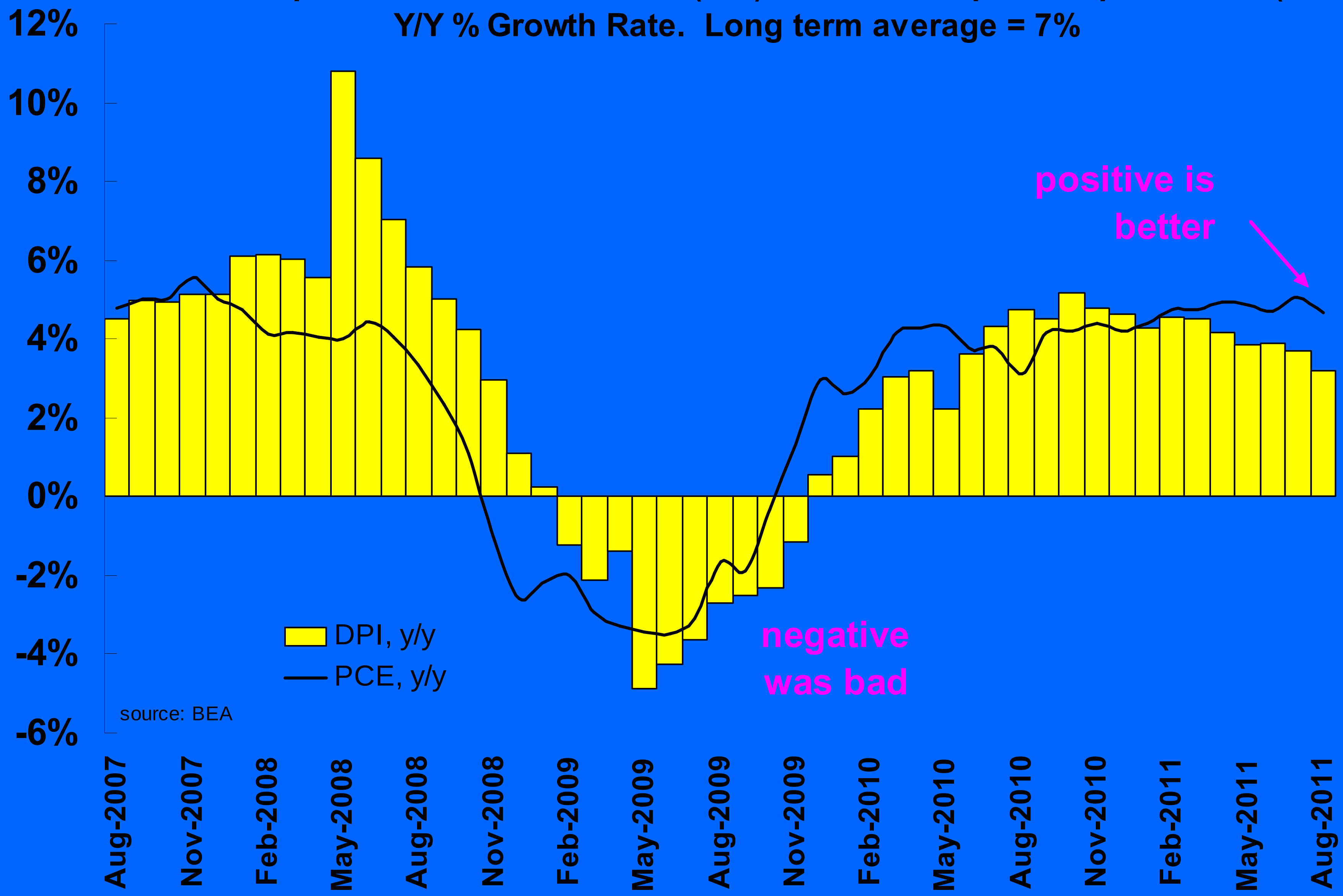
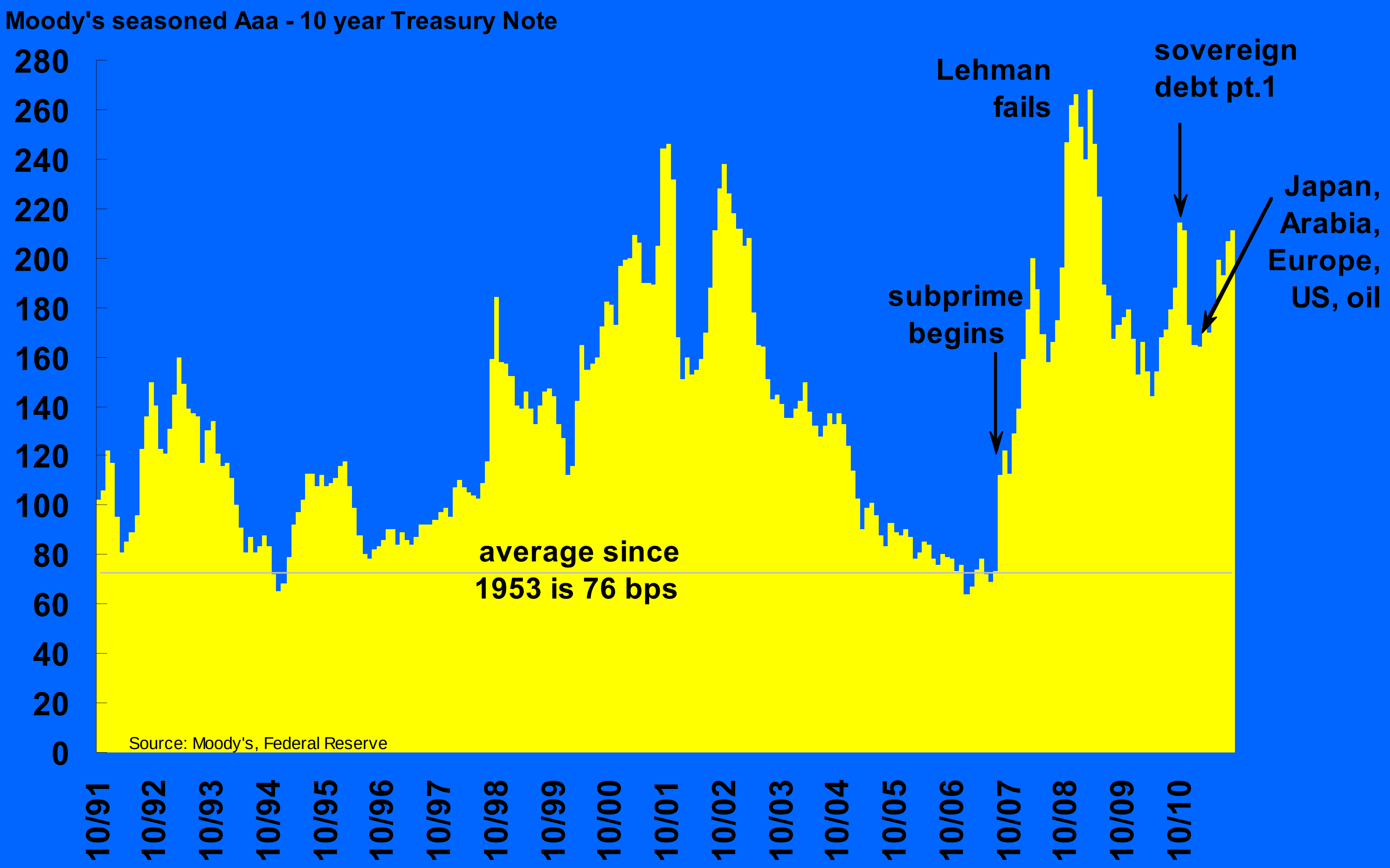
Nominal Disposable Personal Income (DPI) and Consumption Expenditures (PCE)
Y/Y % Growth Rate. Long term average = 7%

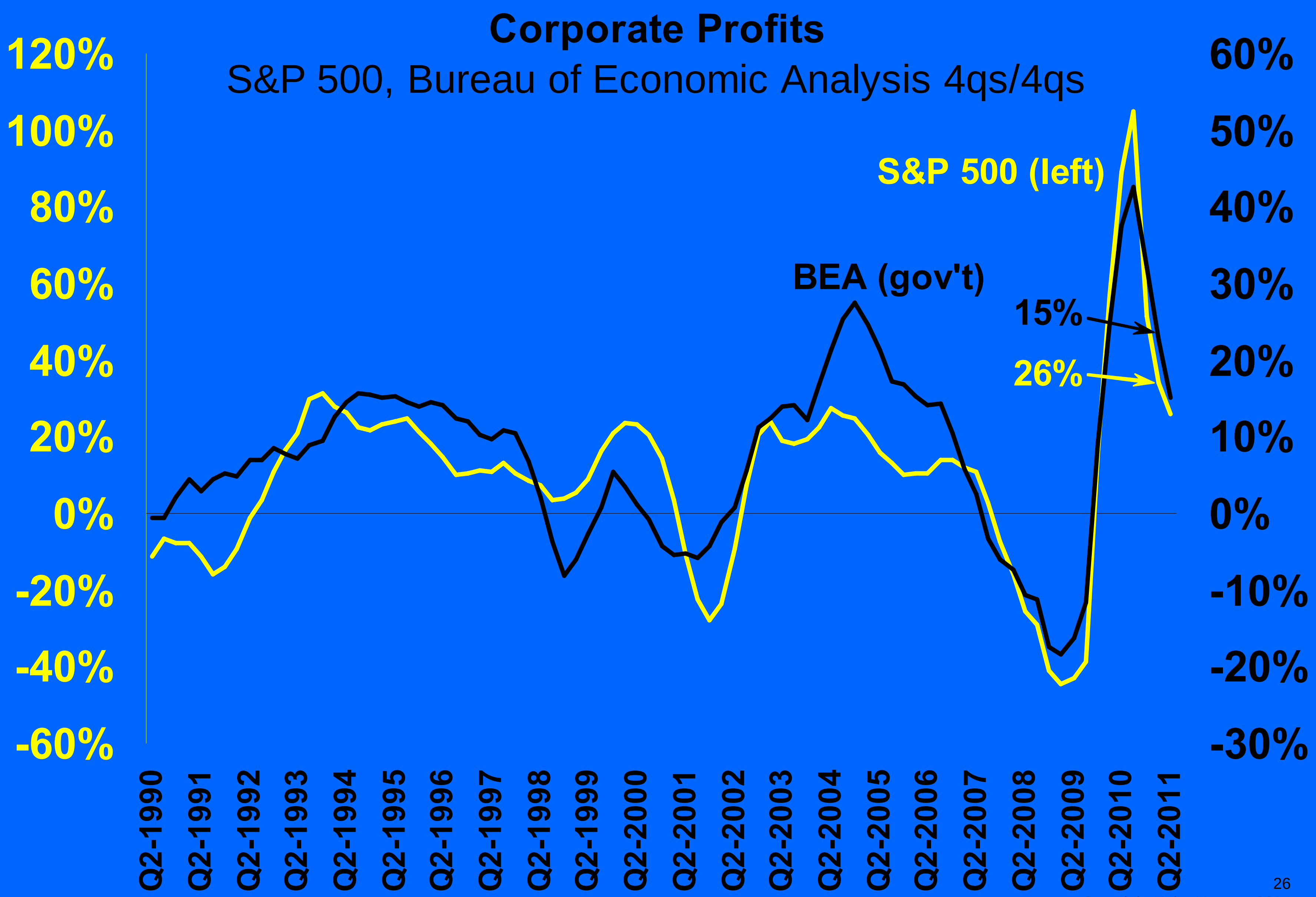


NFR holiday sales forecast 2.8%

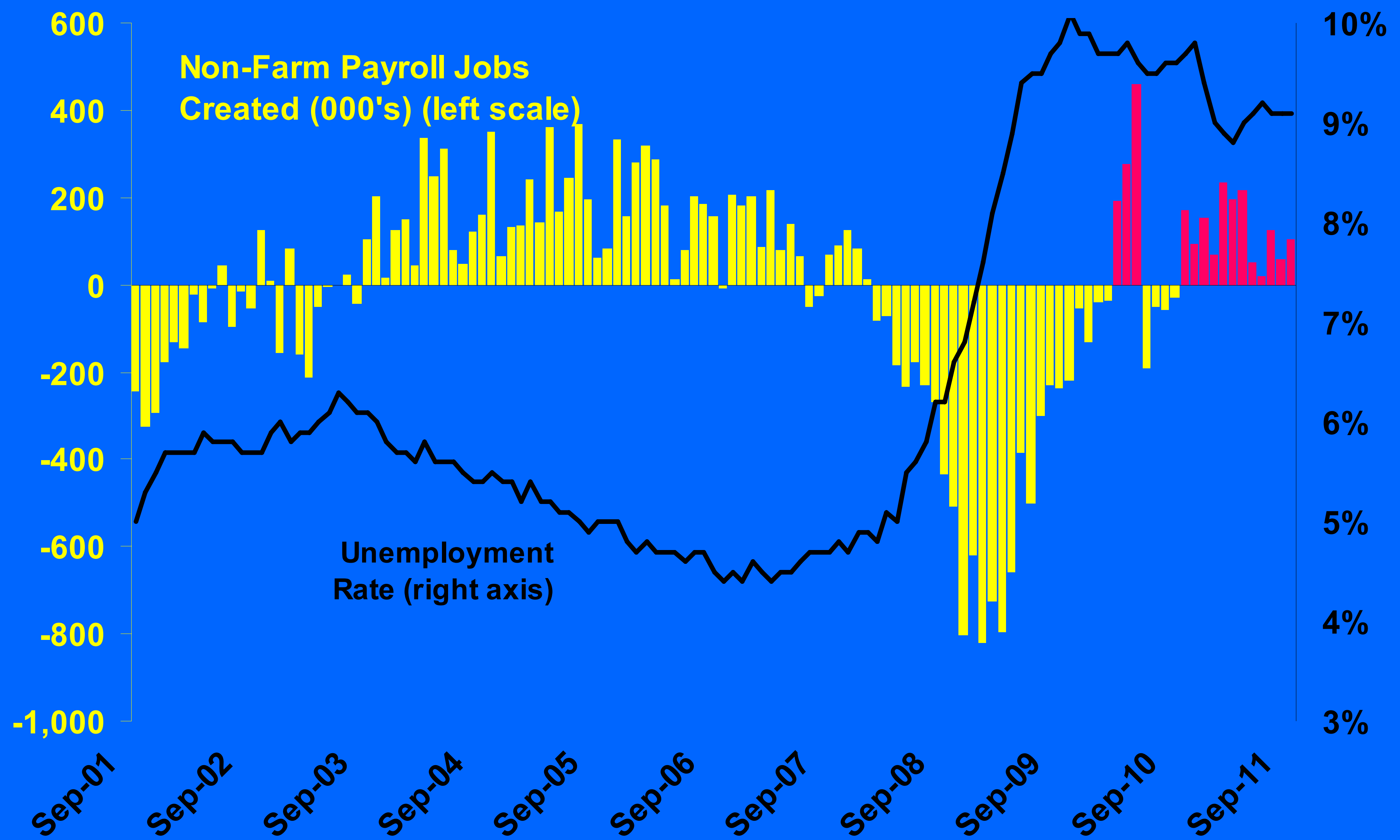
Default Risk: Corporate Bond Spread Over Treasuries



Business conditions good: low labor rates, interest rates, inflation. But profits made overseas.



Jobs Created and the Unemployment Rate



source: Labor Department

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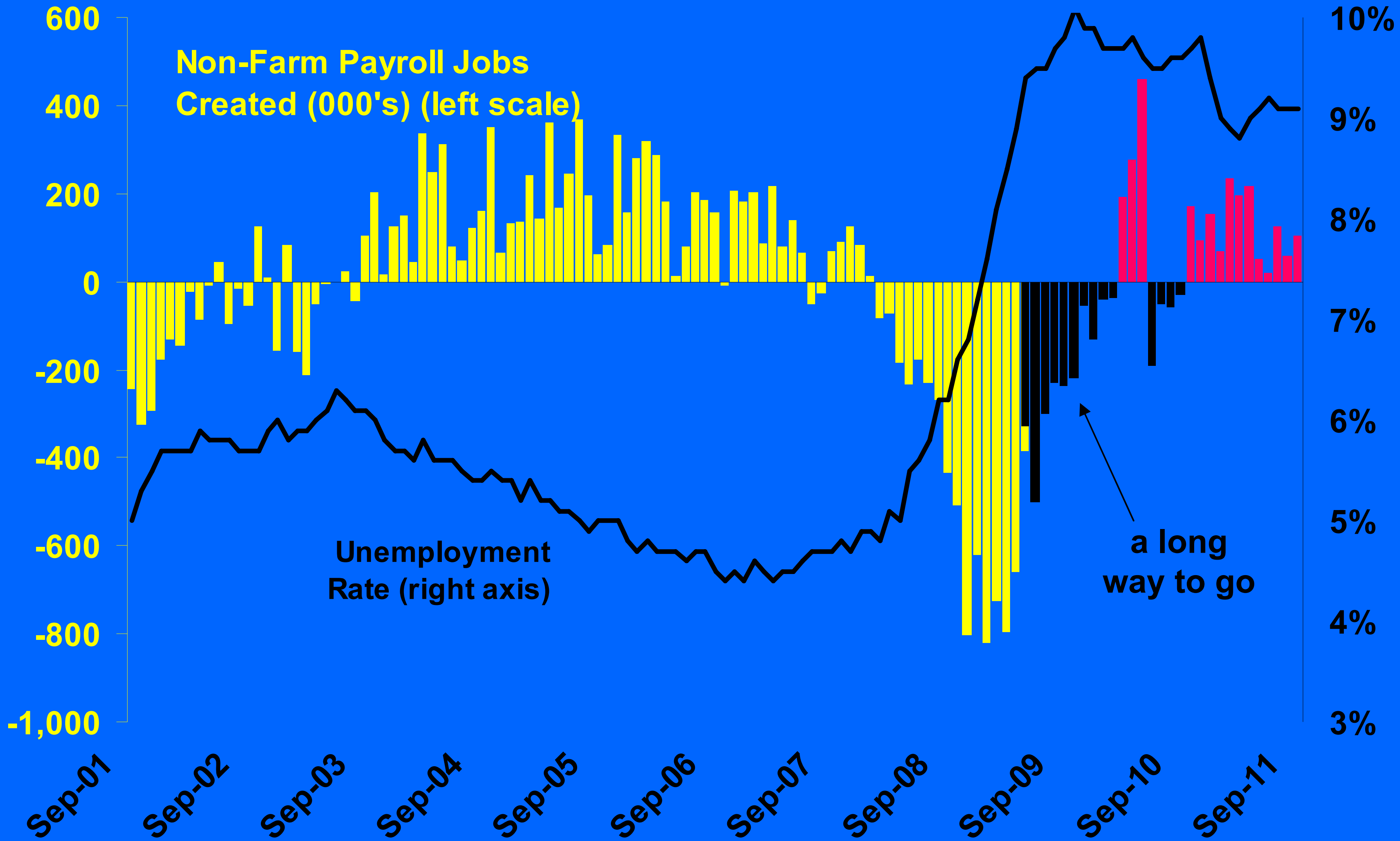

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Recap

- Four forces caused/ended recession
- Oil, housing bad
- Yield curve deteriorating but positive
- Lending started
- GDP,ISM's weak
- Consumer mixed
- Employment alarming
- To fix it, the government is causing two big problems:

Debt & Potential Inflation

FISCAL POLICY

Congress, Administration
Spending, taxing, borrowing
deficits/debt, budgets…

Budget Math in Washington

- Year 1: spent $80
- Original budget for year 2: spend $110
- Final budget for year 2: spend $90

- In Washington, even though they're spending $10 more in year 2, this is what they call a $20 "cut".

- Both sides do this

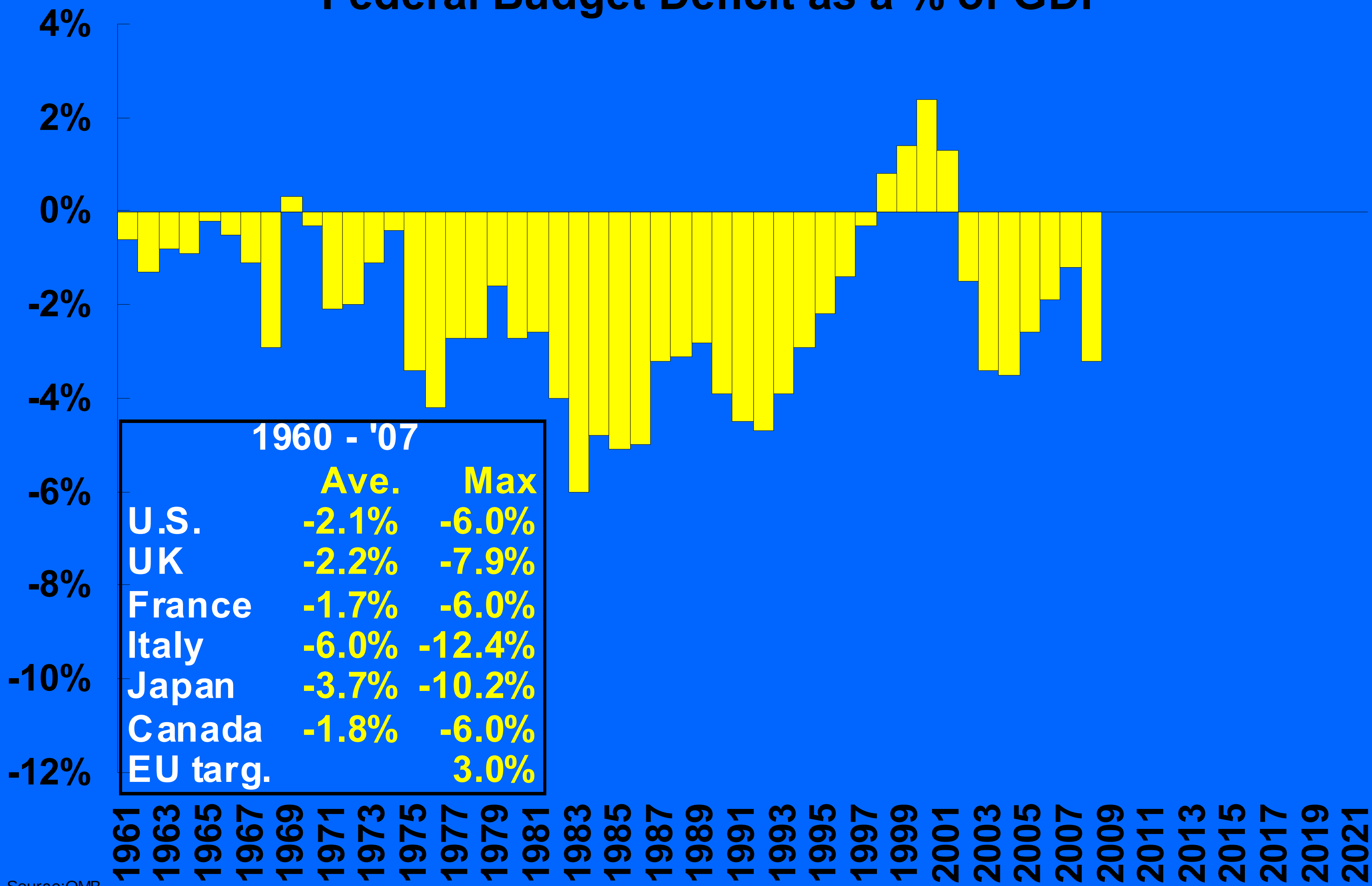
Spending, Deficits and Debt

Gov't spends	$120
Gov't gets tax revenue	$100
Deficit	$20

Treas. gets loan, issues $20 notes/bonds

How big is $20T? Don't know - measure against size of the economy - GDP

Federal Budget Deficit as a % of GDP



1960 - '07	Ave.	Max
U.S.	-2.1%	-6.0%
UK	-2.2%	-7.9%
France	-1.7%	-6.0%
Italy	-6.0%	-12.4%
Japan	-3.7%	-10.2%
Canada	-1.8%	-6.0%
EU targ.		3.0%

Source:OMB

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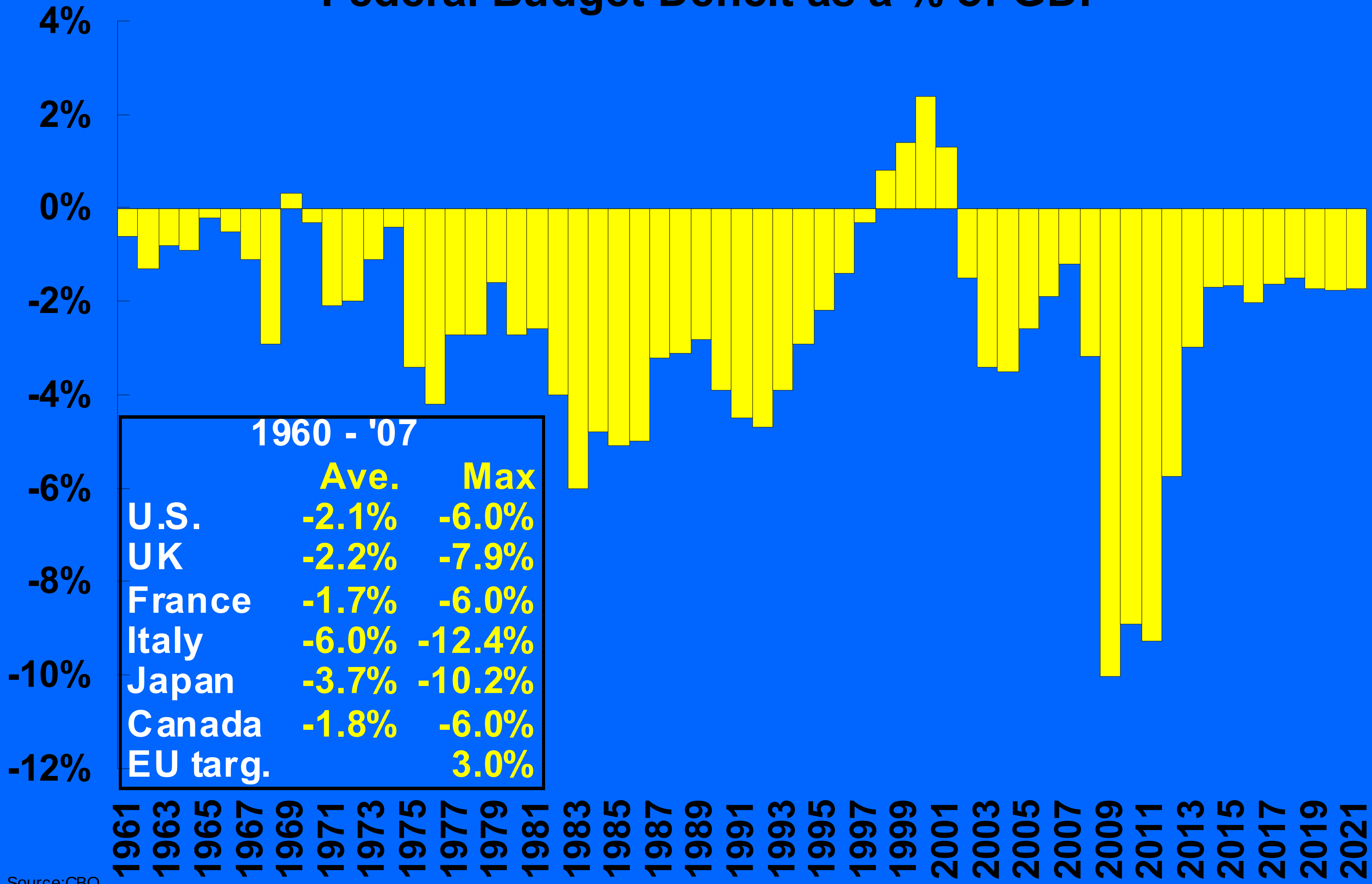

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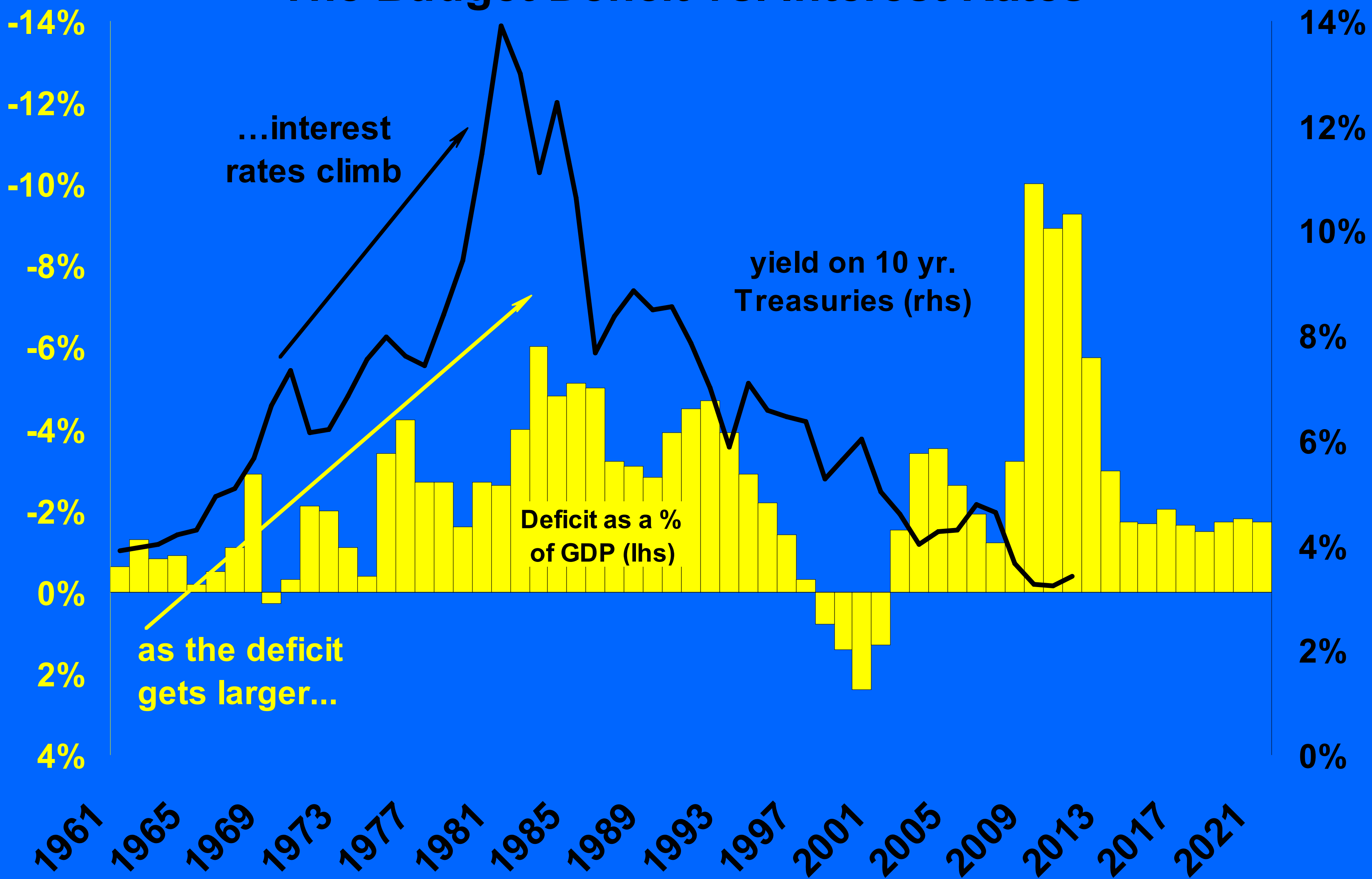
Source:CBO

The Budget Deficit vs. Interest Rates



Sources: The Federal Reserve. Congressional Budget Office

Accumulated deficits become debt…

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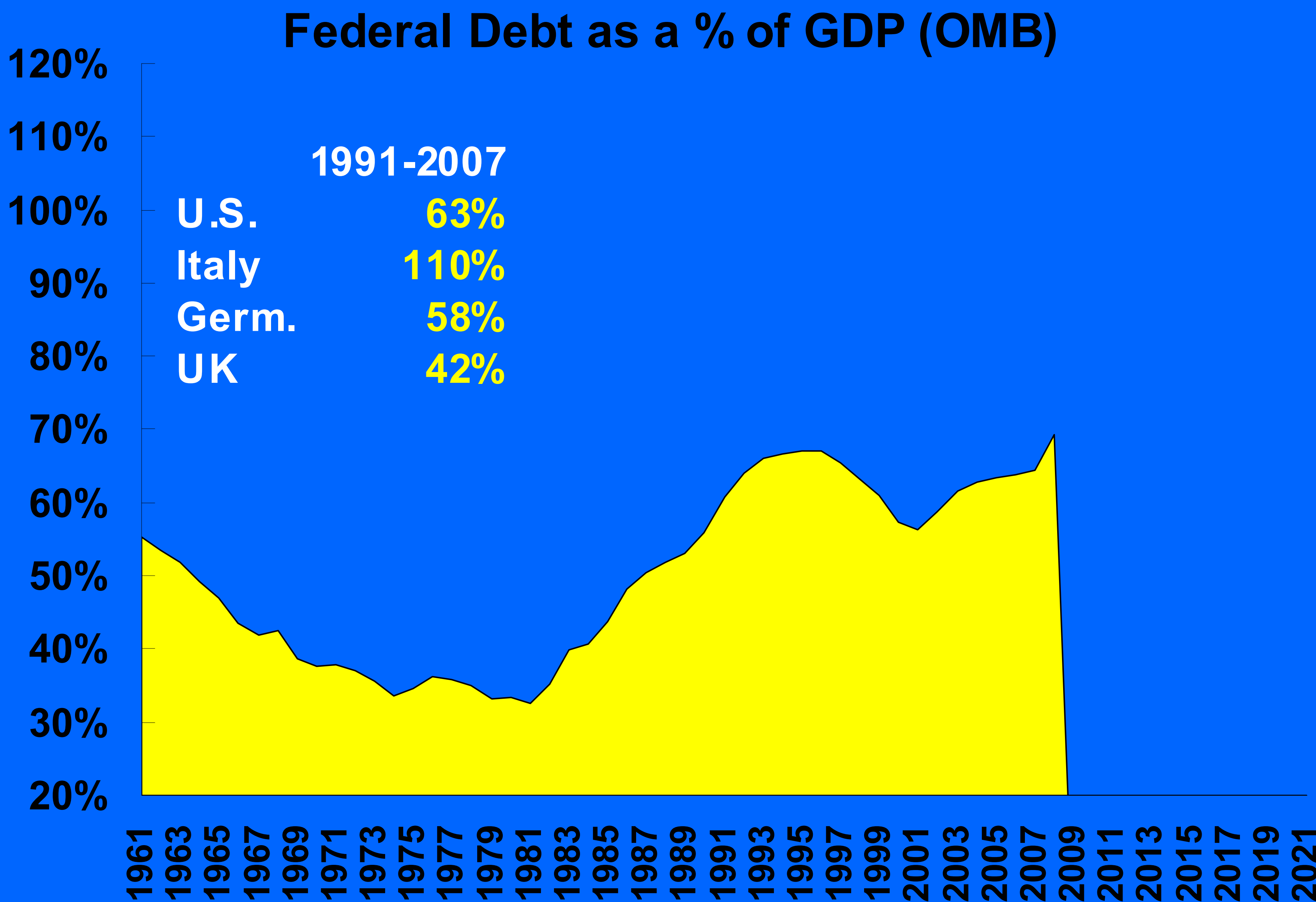

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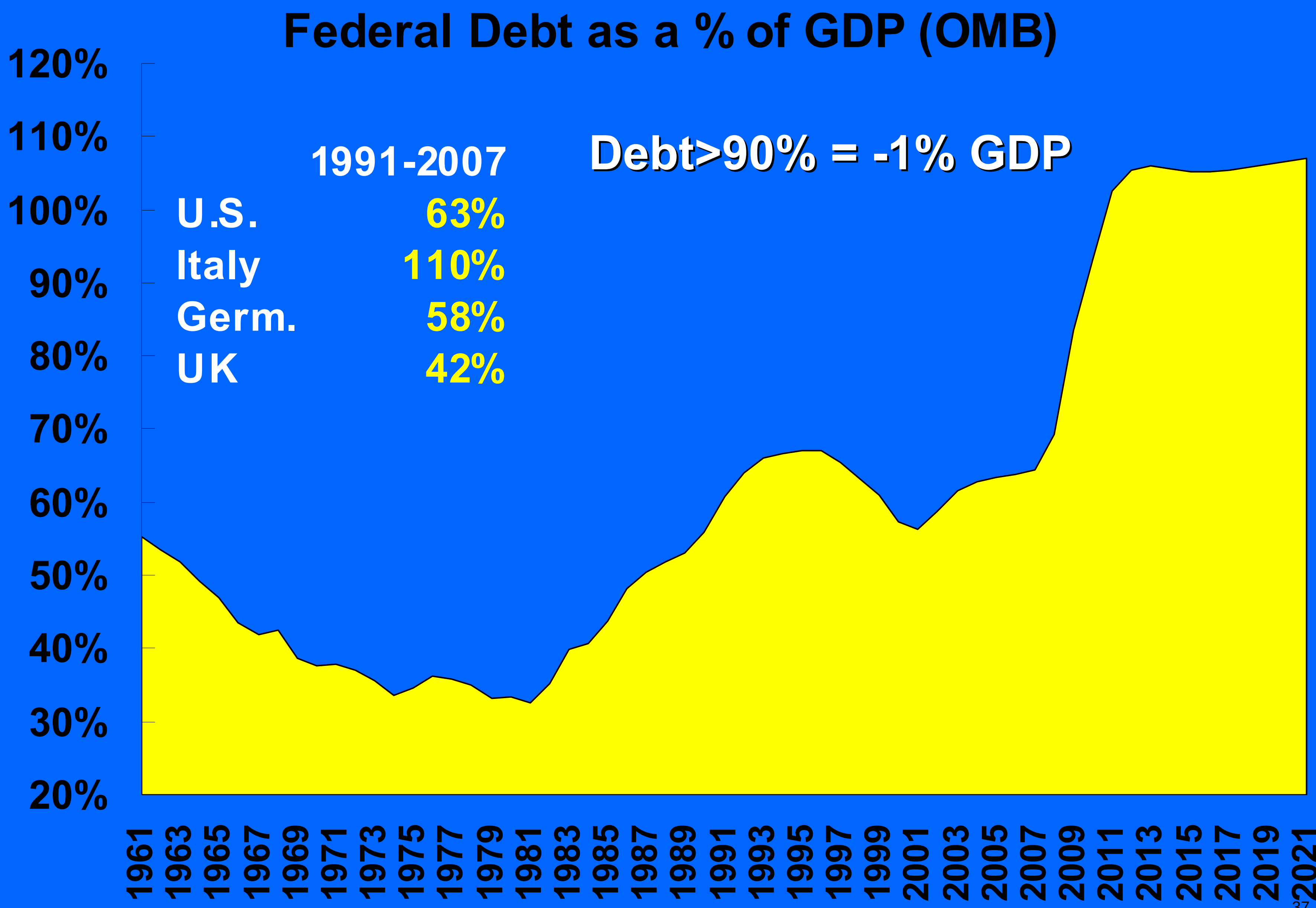

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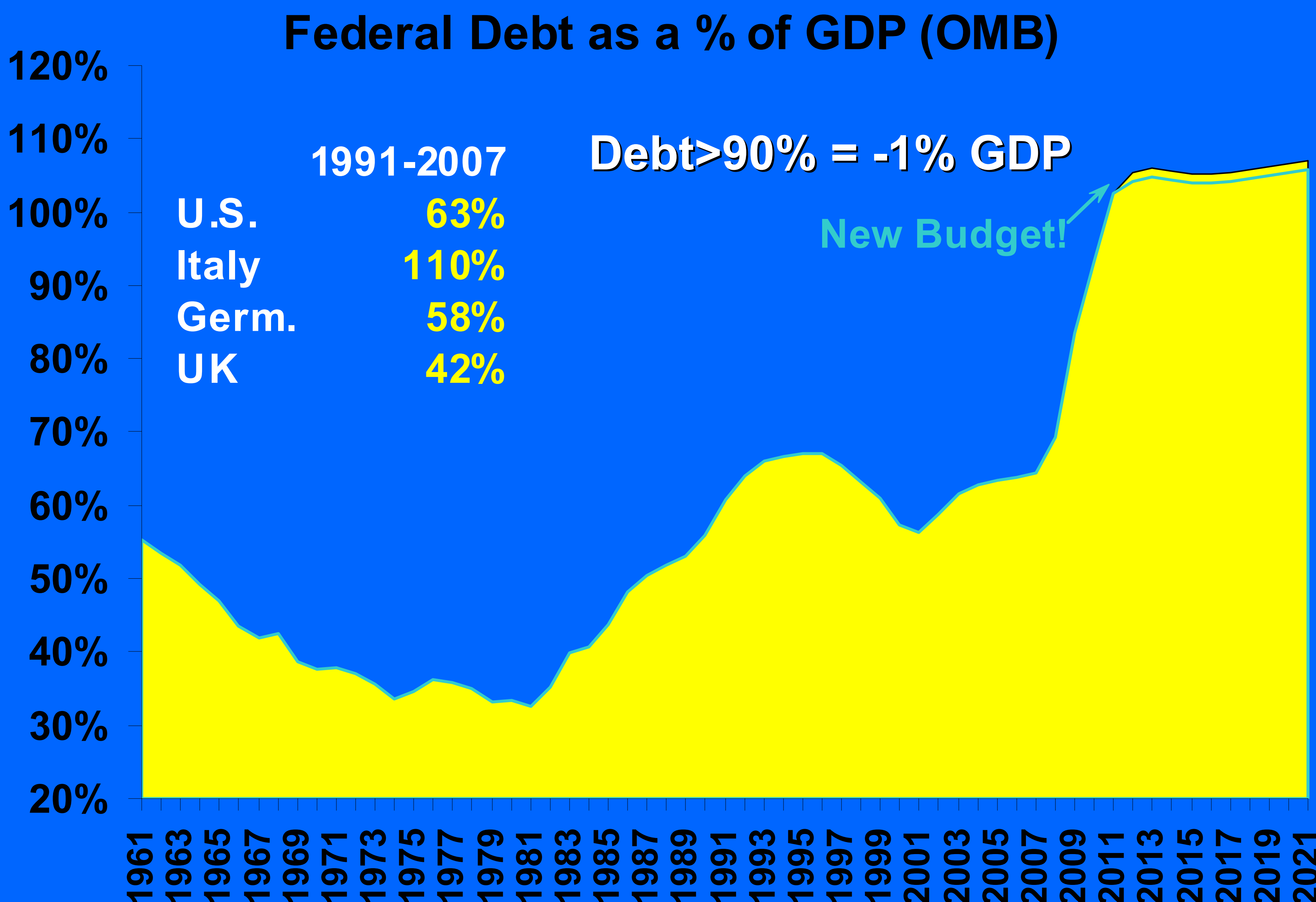


The Deficit Reduction Committee finally said it out loud:

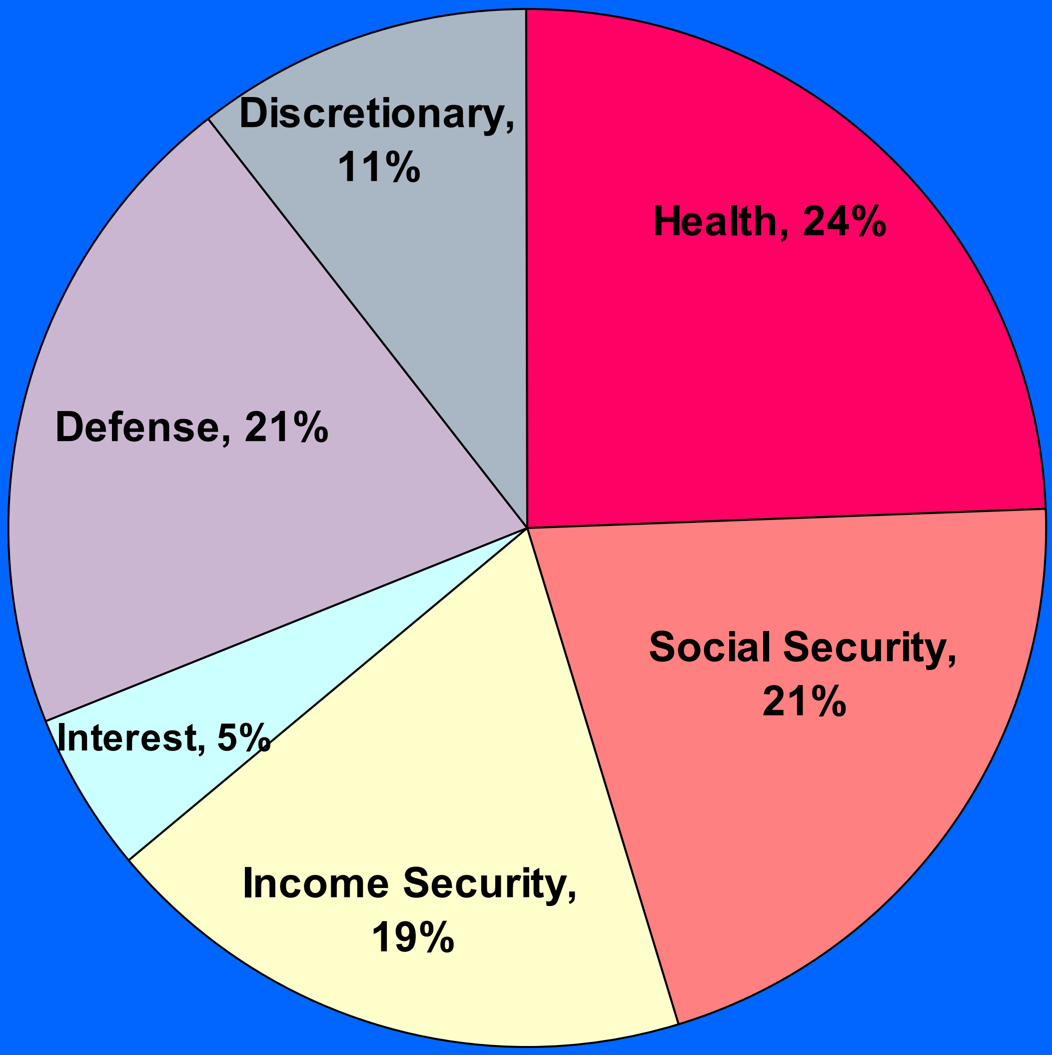
We must touch the "third rails" of

- Social Security
- Medicare

If we don't we will never be able to balance the budget - entitlements will become the entire budget

The rest is whistling past the graveyard…

Outlays, 2010 Budget, $3.5T



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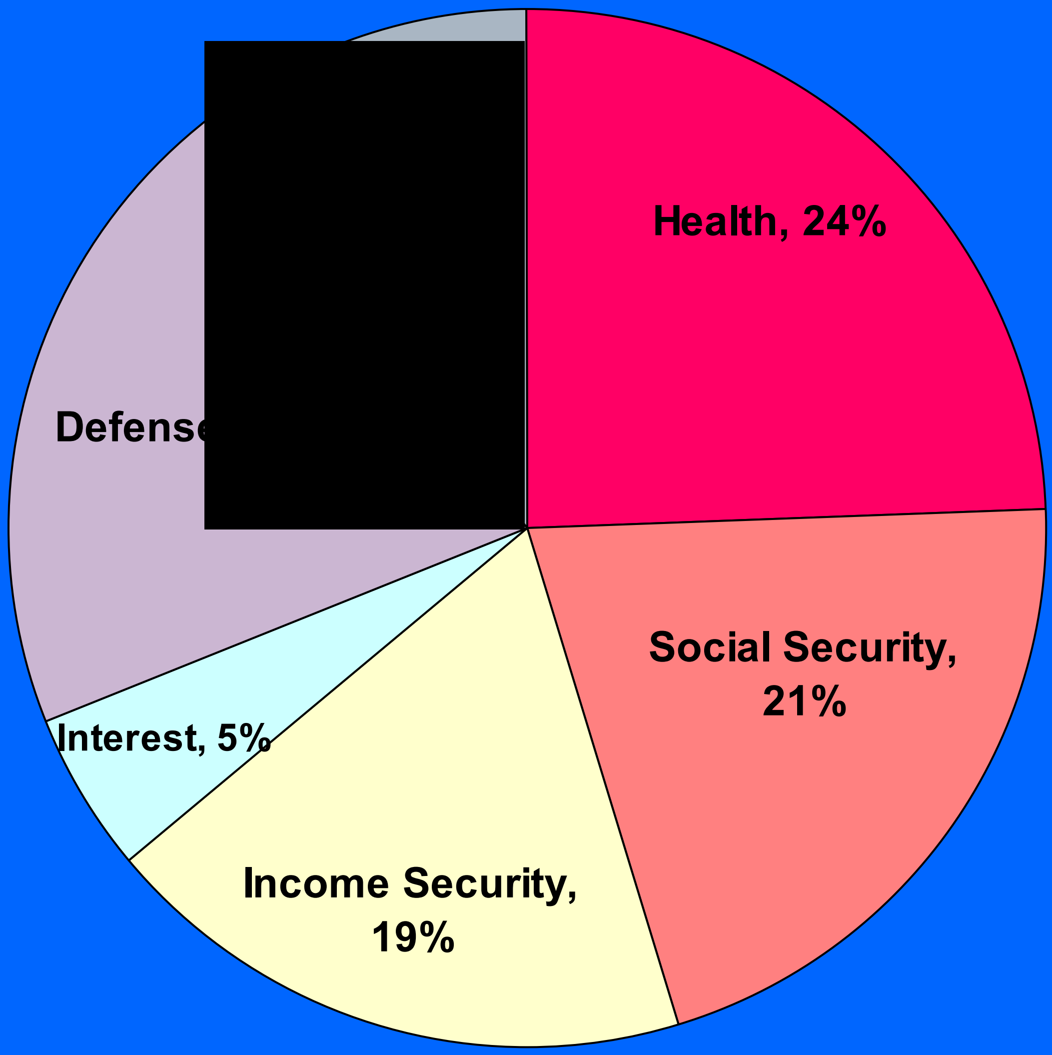
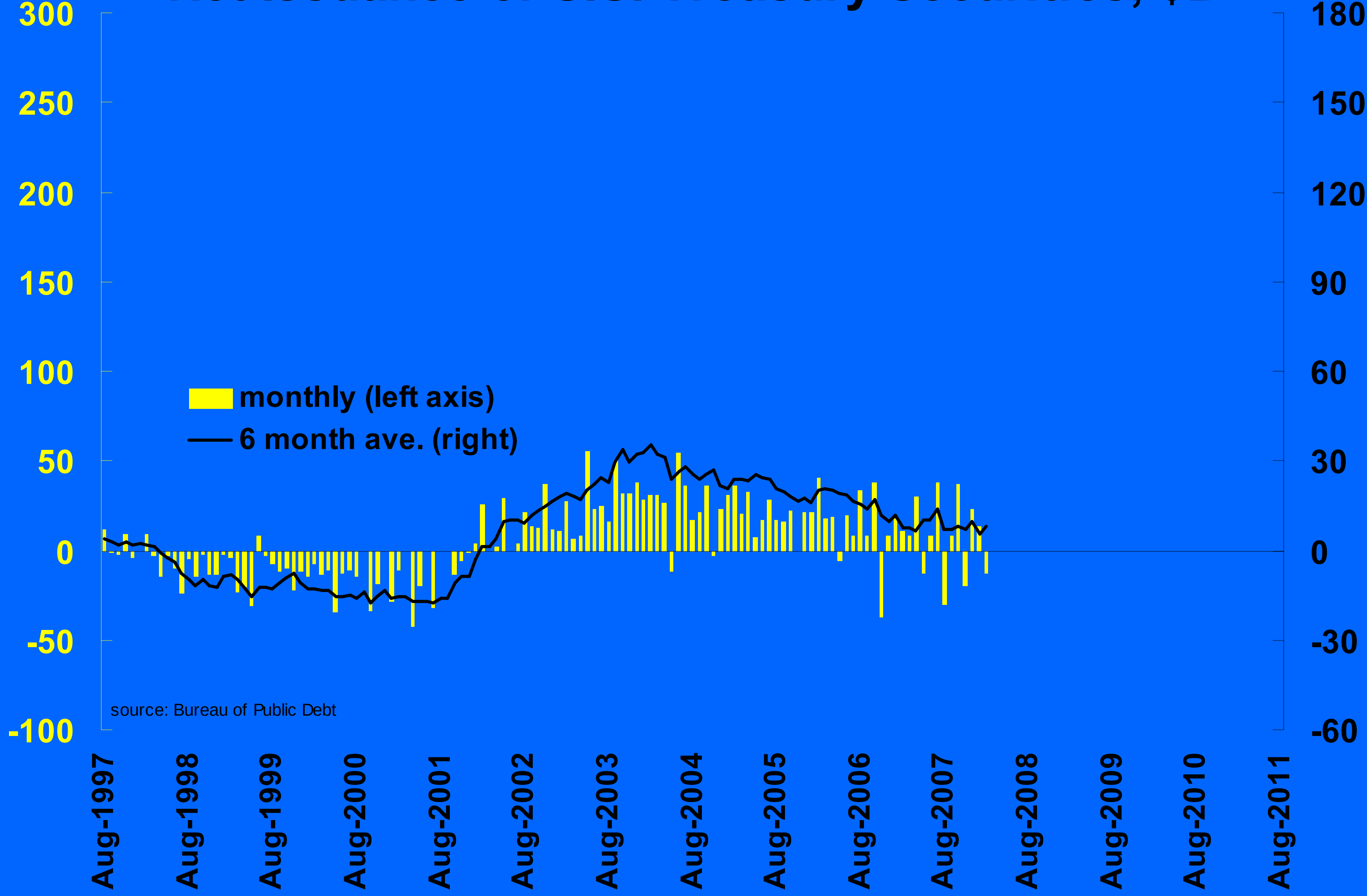


We need clarity, and a plan, instead we have:

- Budget Control Act of 2011 (BCA) and its Super Committee to come up with $1.5T cuts by Thanksgiving
- A few weeks ago, another $447B stimulus proposal…
  - To be paid for by more taxes over the next 10 years…
  - Built in to the Super Committee plan
- Days later, another proposal, cut deficit by $3T over 10 yrs,
  - Built in to the Super Committee plan
  - Does reform Medicare
  - $1.5T in new taxes
  - $3T? In ten years. Around 20%+ How about 100%?
  - Doesn't eliminate deficit – debt continues
- Fourth administration deficit reduction plan this year
- Many others this year from Congress and 2 other Commissions

Net Issuance of U.S. Treasury Securities, $B



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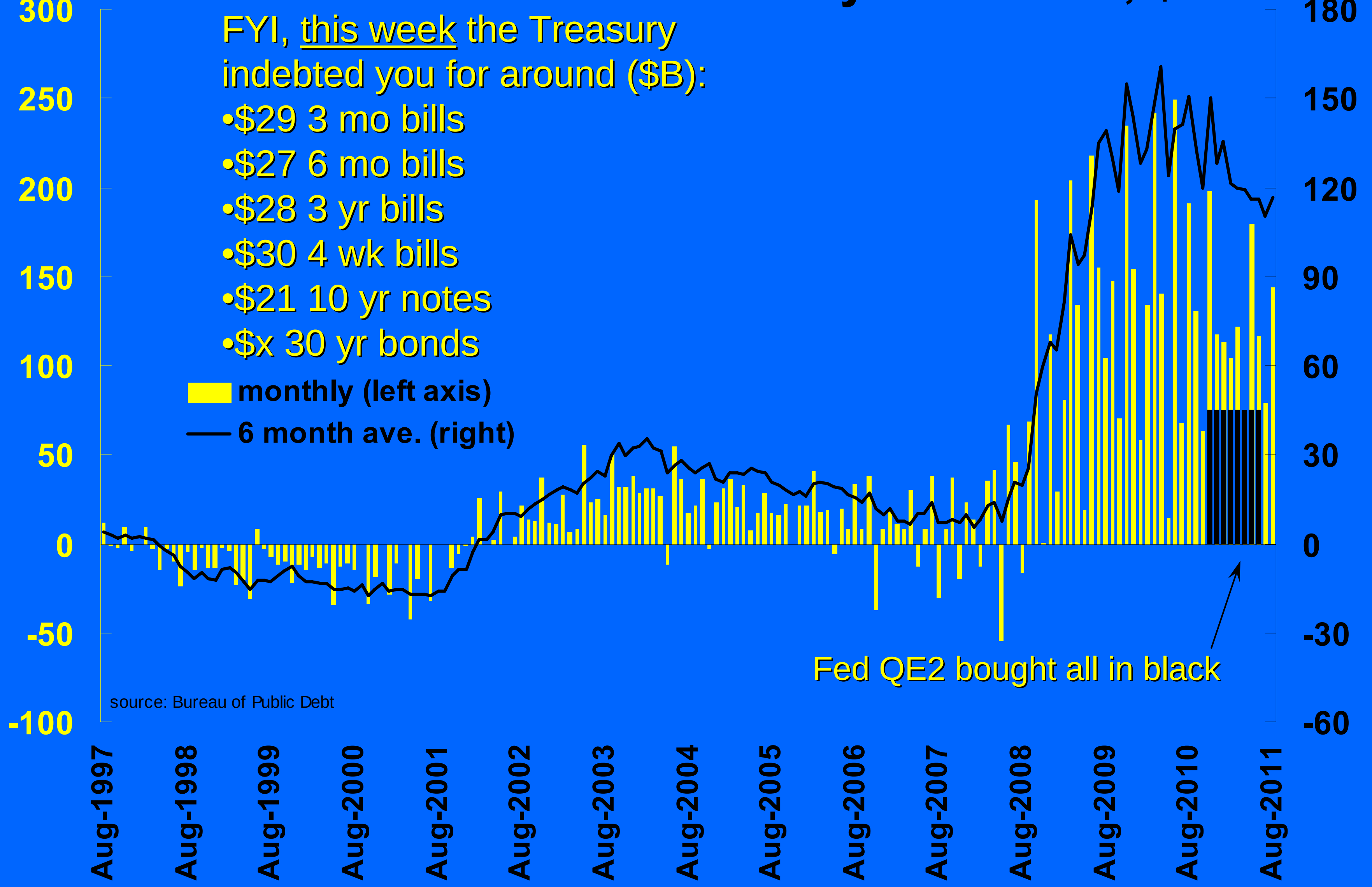


FISCAL POLICY REVIEW

- Recent plan, BCA 2011 cuts nothing
- Recent plan does nothing to reduce debt
- Recent plan does nothing to reform Medicare and Social Security (the first one did)
- Super Committee a waste of time
- $477B stimulus, another $3T def red plan
- No clarity; 4 admin plans and many other plans this year
- Borrowing more every day

FISCAL POLICY REVIEW

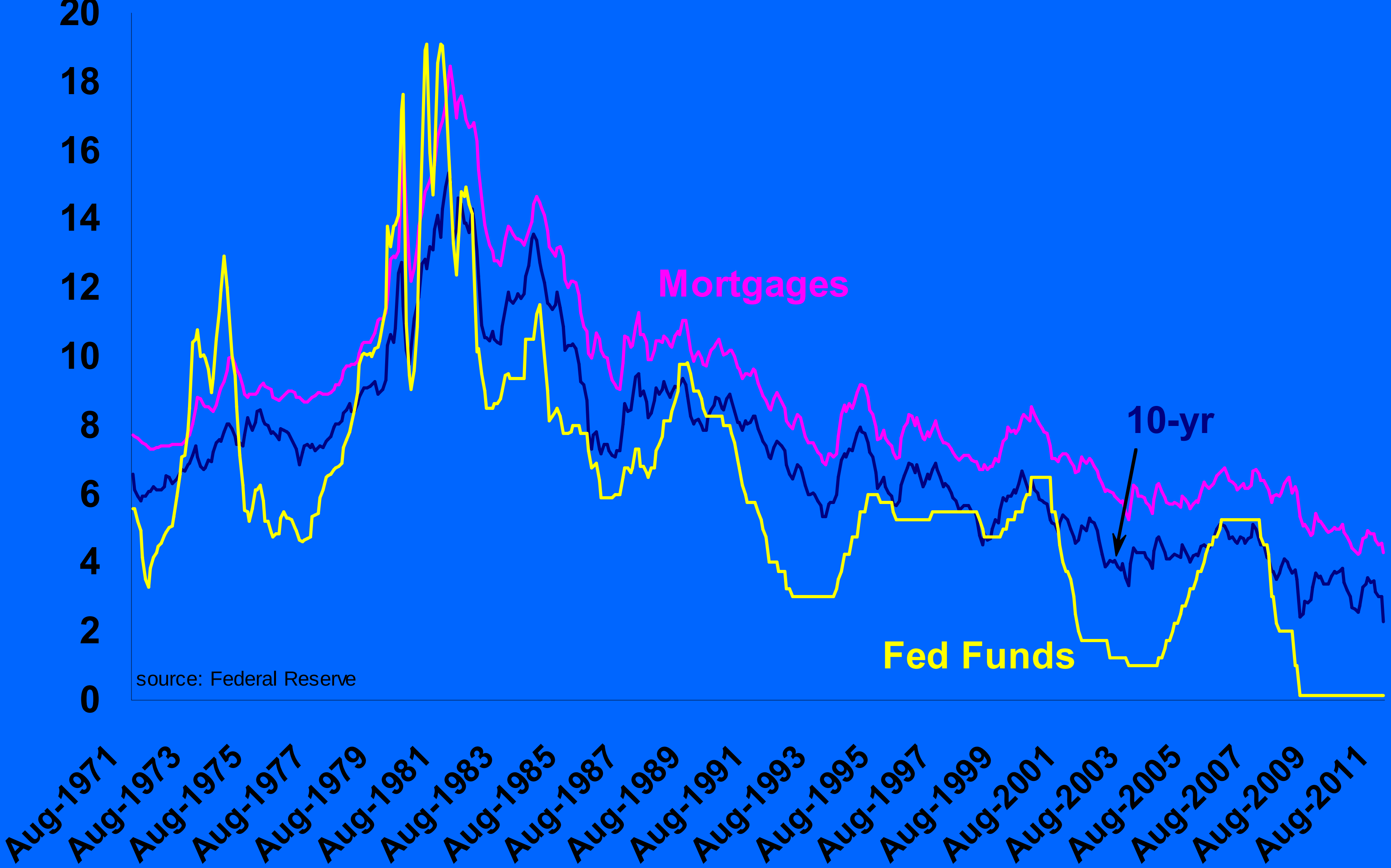
What now?
Things could change at:

- New stimulus plan vote
- 2012 elections
- 2024 Medicare goes insolvent
- 2050 Social Security goes insolvent

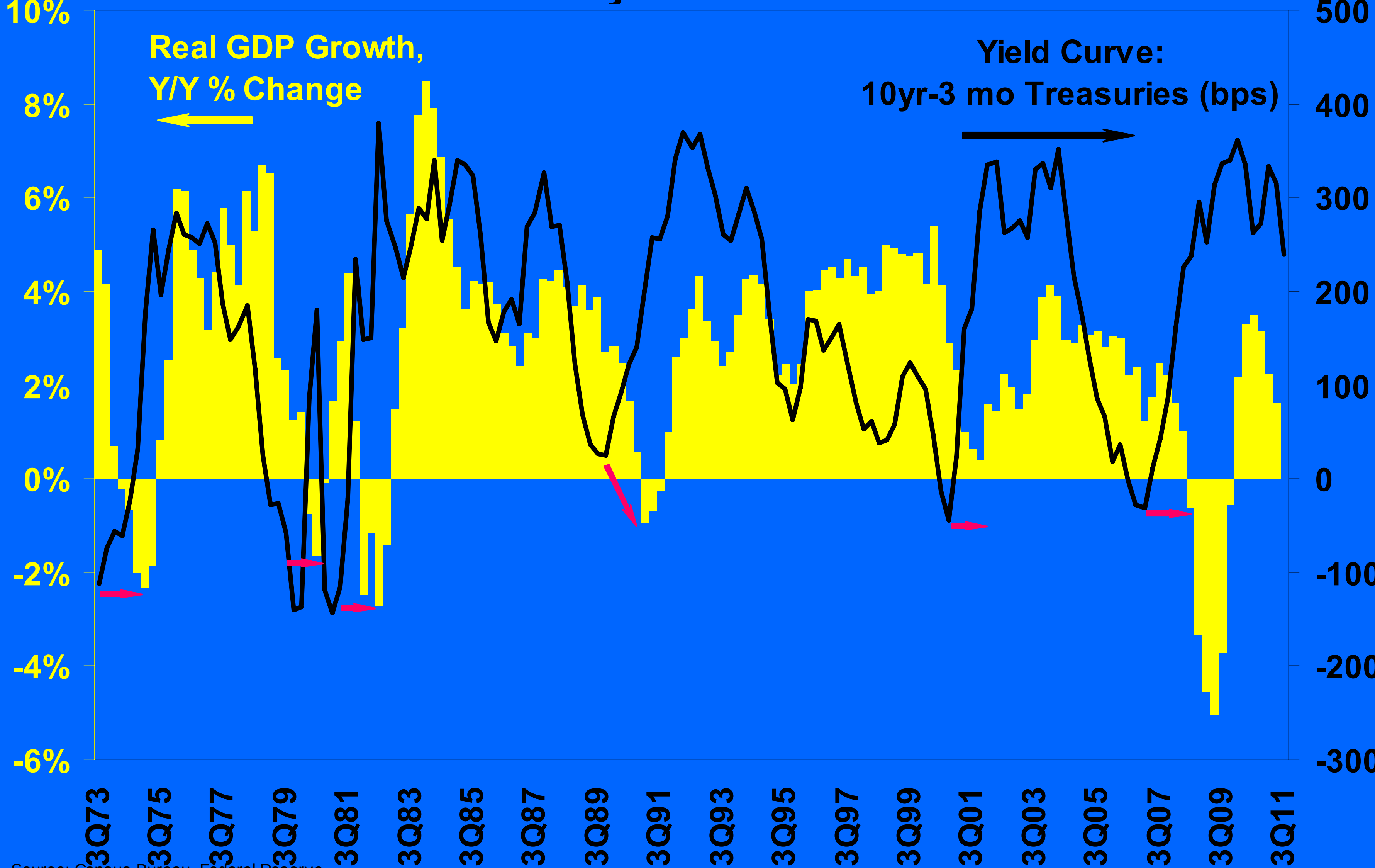
MONETARY POLICY

The Federal Reserve Bank, Ben Bernanke

Interest Rates



The Treasury Yield Curve vs. GDP



Source: Census Bureau, Federal Reserve

MONETARY POLICY

- **Lowering the short term Fed Funds interest rate works**
- **A few months ago, said they would keep it 0% into mid-2013 – bad sign**

MONETARY POLICY

- Lowering the short term Fed Funds interest rate works
- A few months ago, said they would keep it 0% into mid-2013 – bad sign
- But need an extra boost, lowering long term interest rates.
- Quantitative easing:
- Fed prints new $ bills
- Buys Treasury bonds in open market
- Raises bond prices, lowering interest rates (they move in opposite directions)
- Puts $ into financial system
- And creates inflationary pressures…

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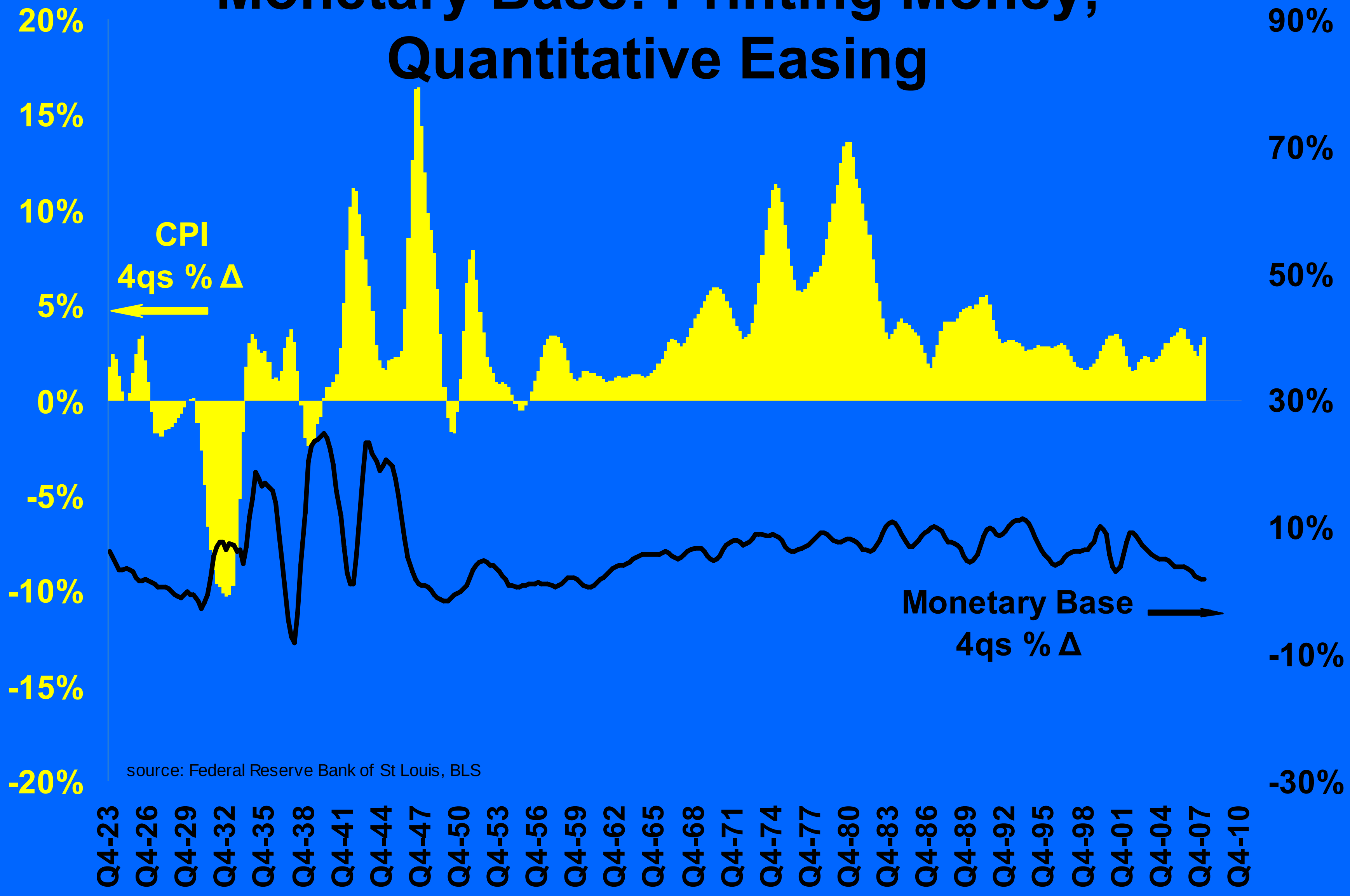
Monetary Base: Printing Money, Quantitative Easing



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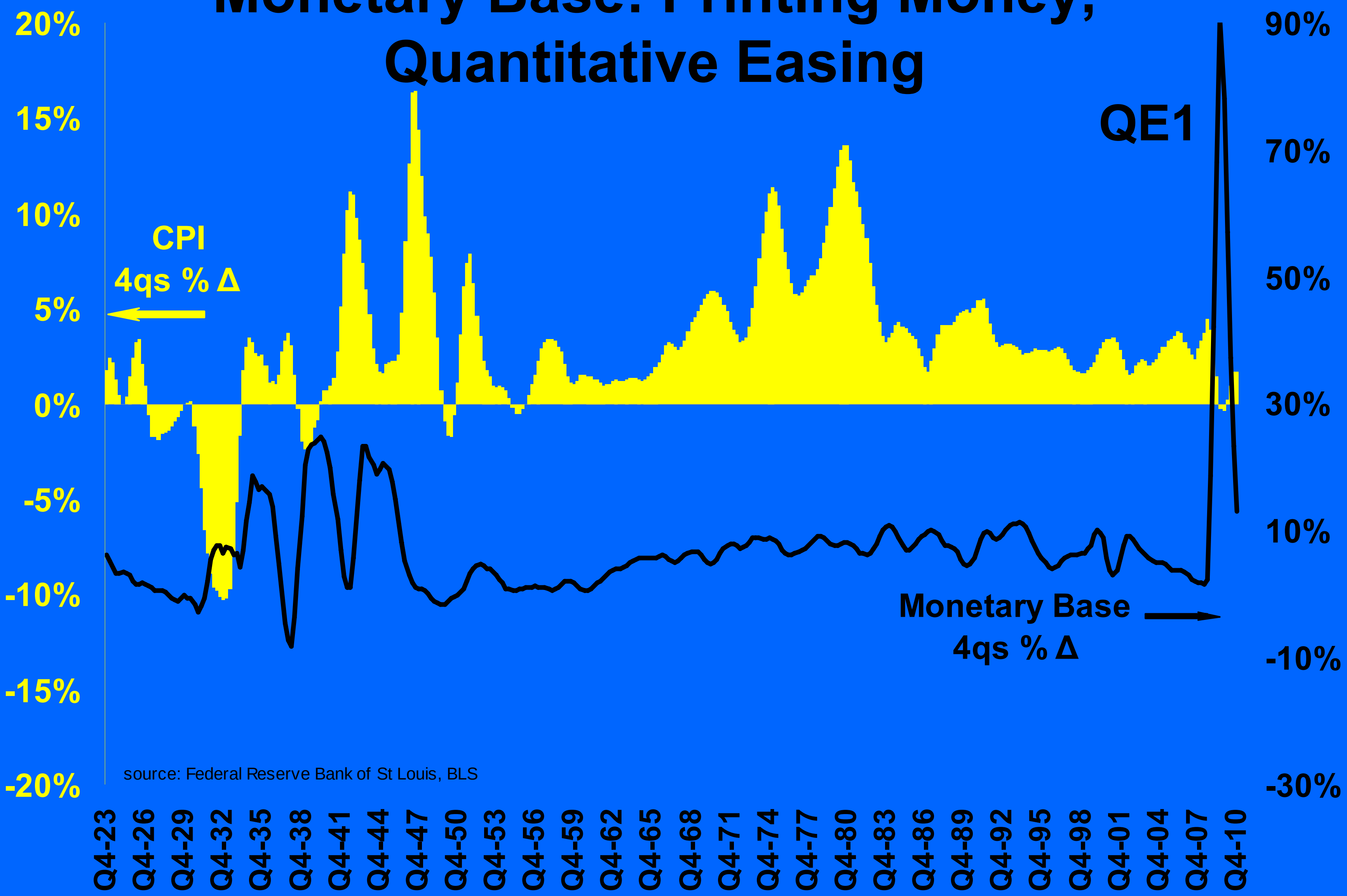
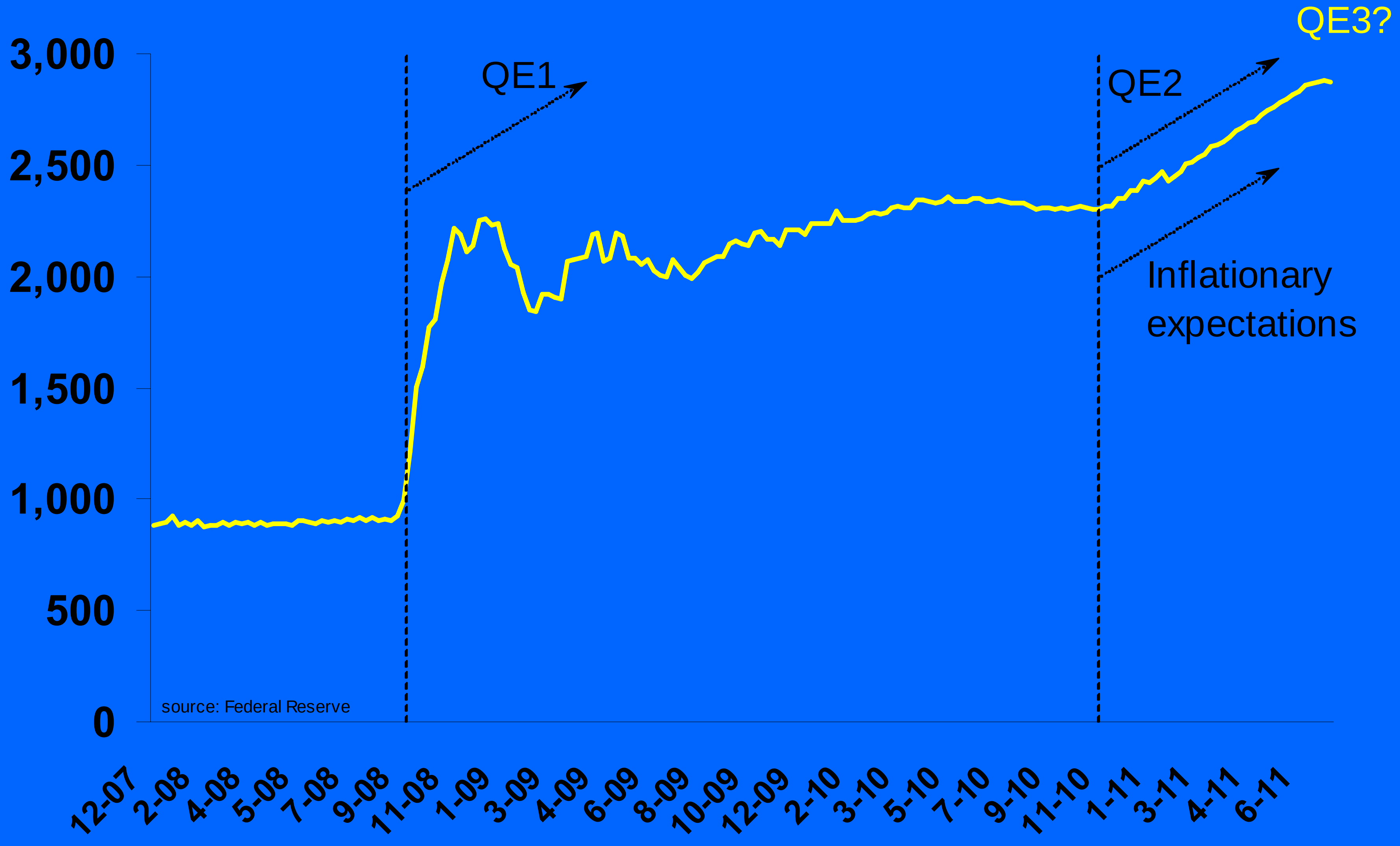
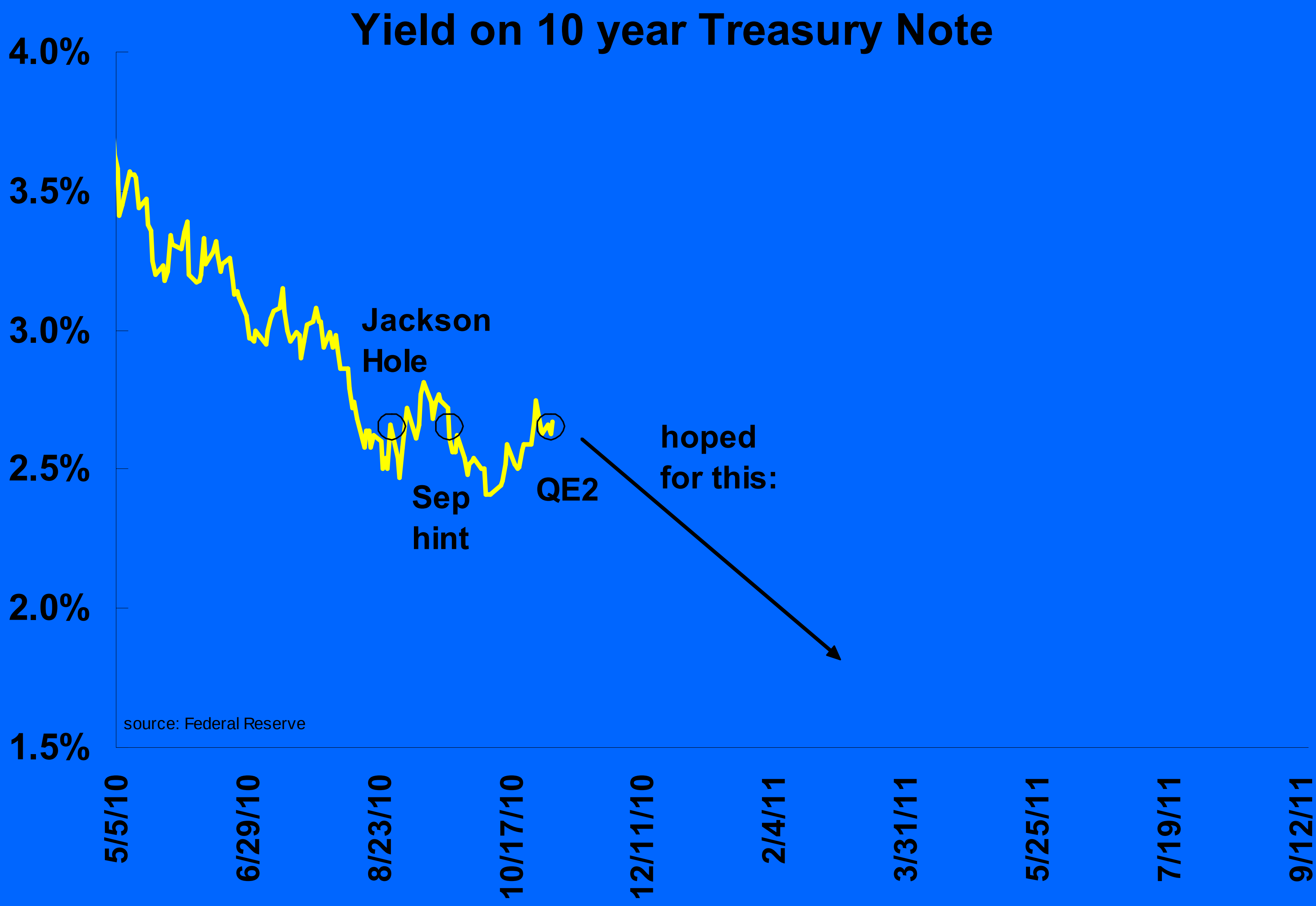


Federal Reserve Balance Sheet, $B



Did QE2 work?



Yield on 10 year Treasury Note
4.0%
3.5%
3.0%
2.5%
2.0%
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Jackson Hole
Sep hint
QE2
hoped for this:
source: Federal Reserve
5/5/10
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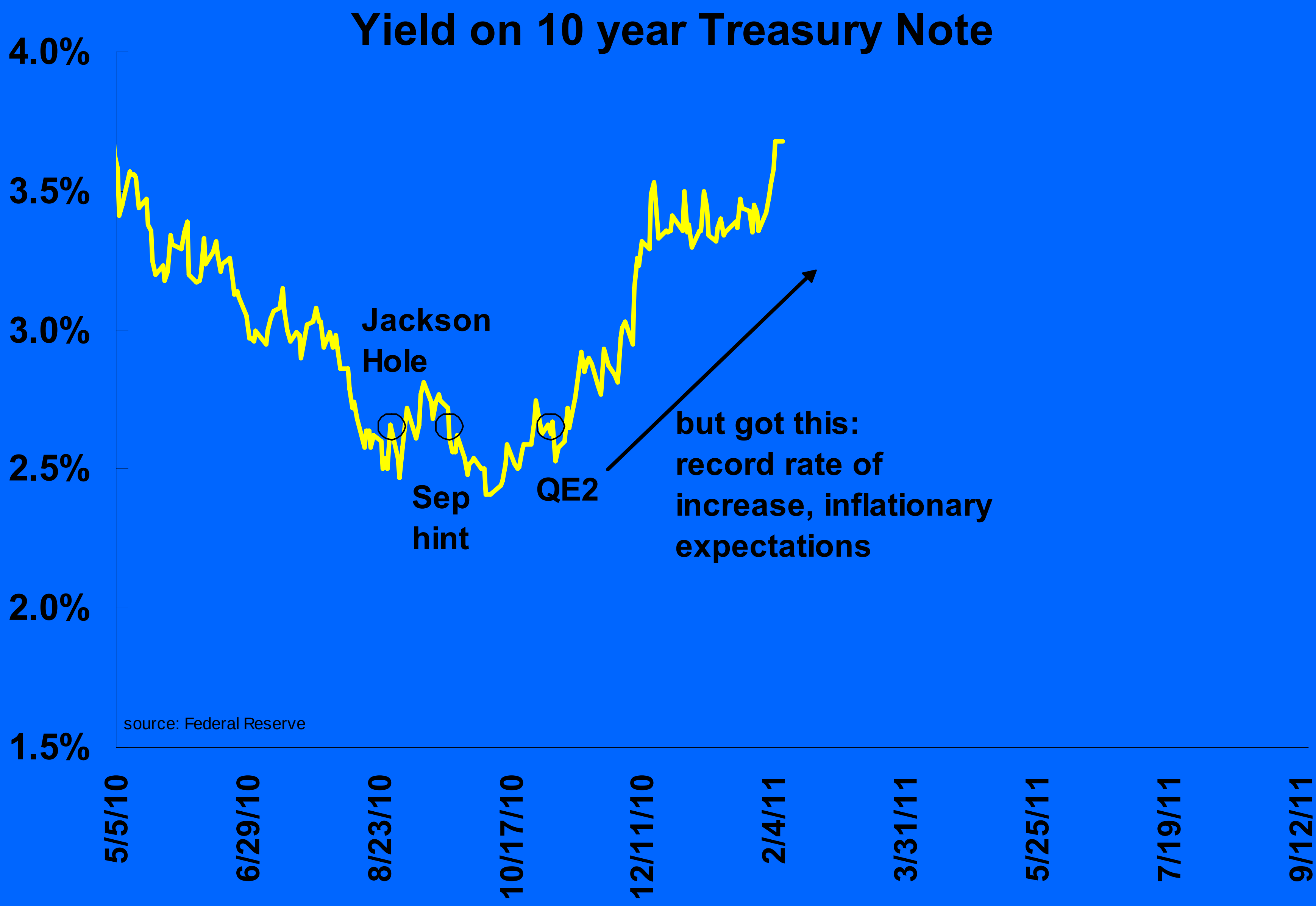
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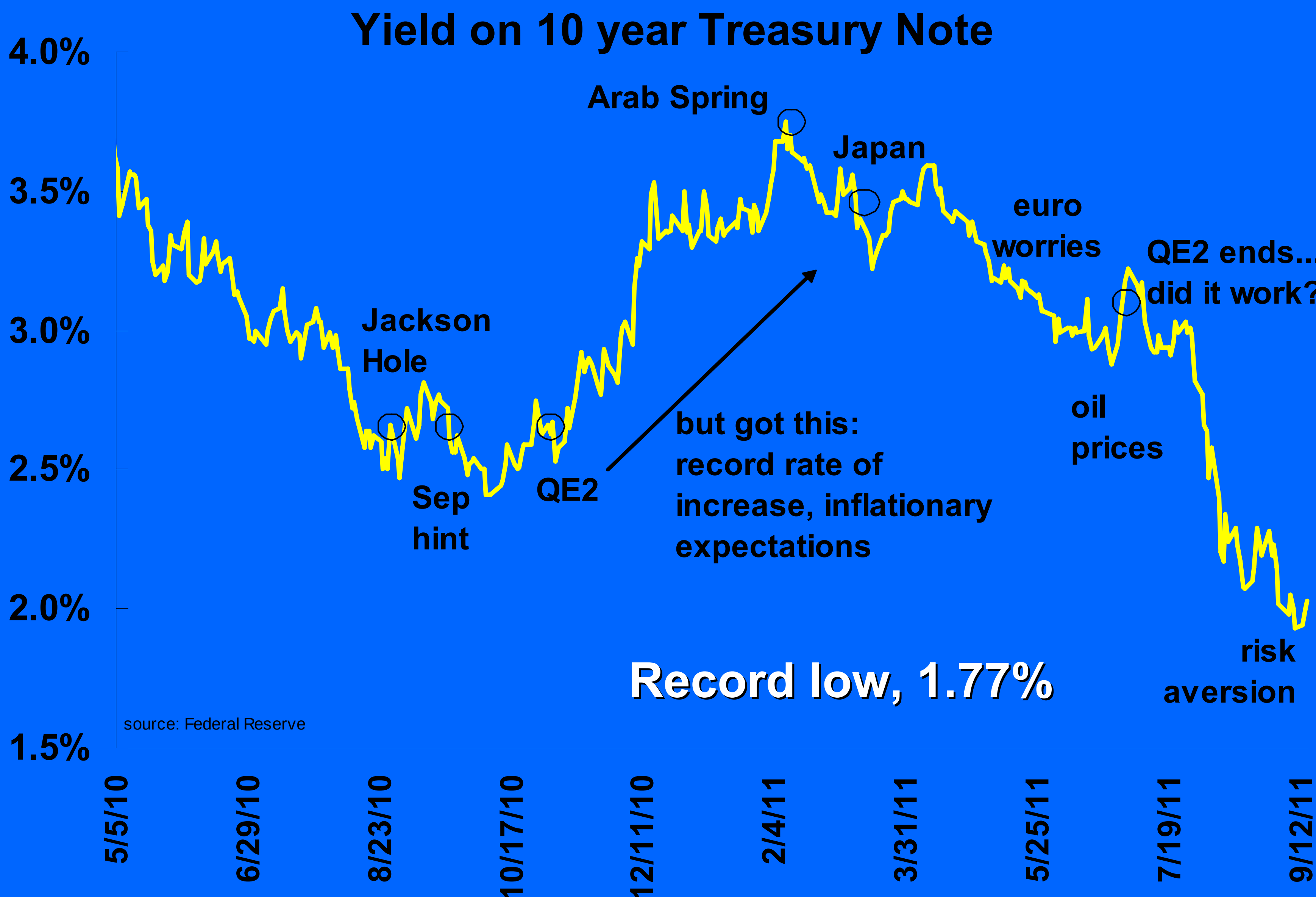

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Arab Spring
Japan
euro worries
QE2 ends... did it work?
Jackson Hole
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QE2
but got this: record rate of increase, inflationary expectations
oil prices
Record low, 1.77%
risk aversion
source: Federal Reserve
5/5/10
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Inflation

QE = Printing money = Dollar devaluation = Inflation

They are all the same thing.

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Example; suppose today there is

- **one loaf of bread priced at $1, up for auction**
- **two hungry people, each with a printing press**
- **to out-bid the other, each runs his press as fast as possible until one breaks**
- **by then, the price of the bread is $1M**

Inflation

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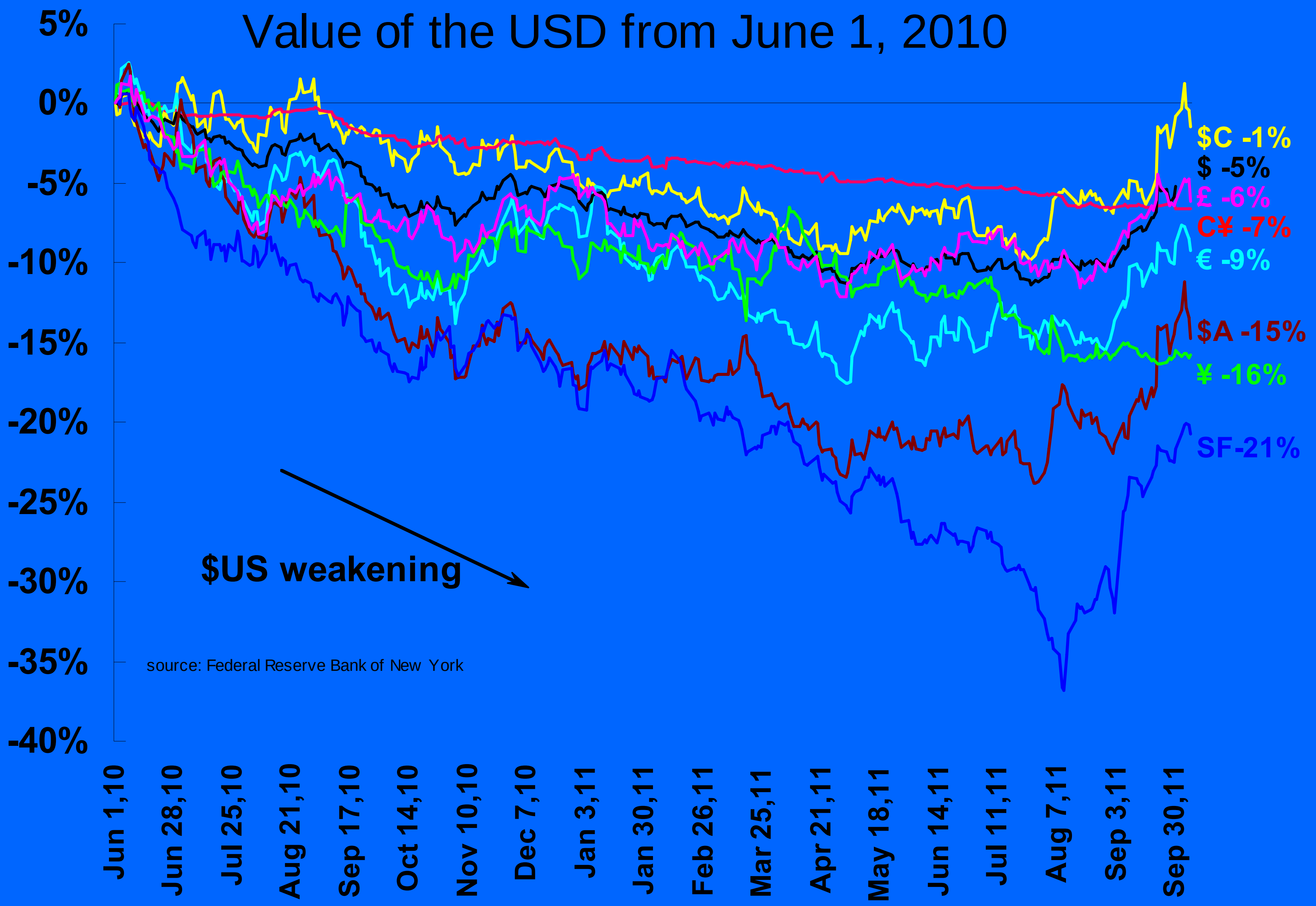
- **one loaf of bread priced at $1, up for auction**
- **two hungry people, each with a printing press**
- **to out-bid the other, each runs his press as fast as possible until one breaks**
- **by then, the price of the bread is $1M**
- **printing money created inflation; price from $1 to $1M**
- **printing money devalued each $1 bill; each $1 bill used to be worth one loaf of bread, but now is worth 1 millionth of a loaf of bread**

- **Money was printed (QE)**
- **Inflation was created**
- **The dollar was devalued**

$ devalued, QE at work



QE = Printing money = Dollar devaluation = inflation meant to stimulate the economy by lowering interest rates

But dollar devaluation can also:

- Boost exports
- Devalue the $4T in debt U.S. owes foreigners
- Raise commodity prices - oil
- Create asset bubbles - real estate

$ devalued, growing exports, QE at work

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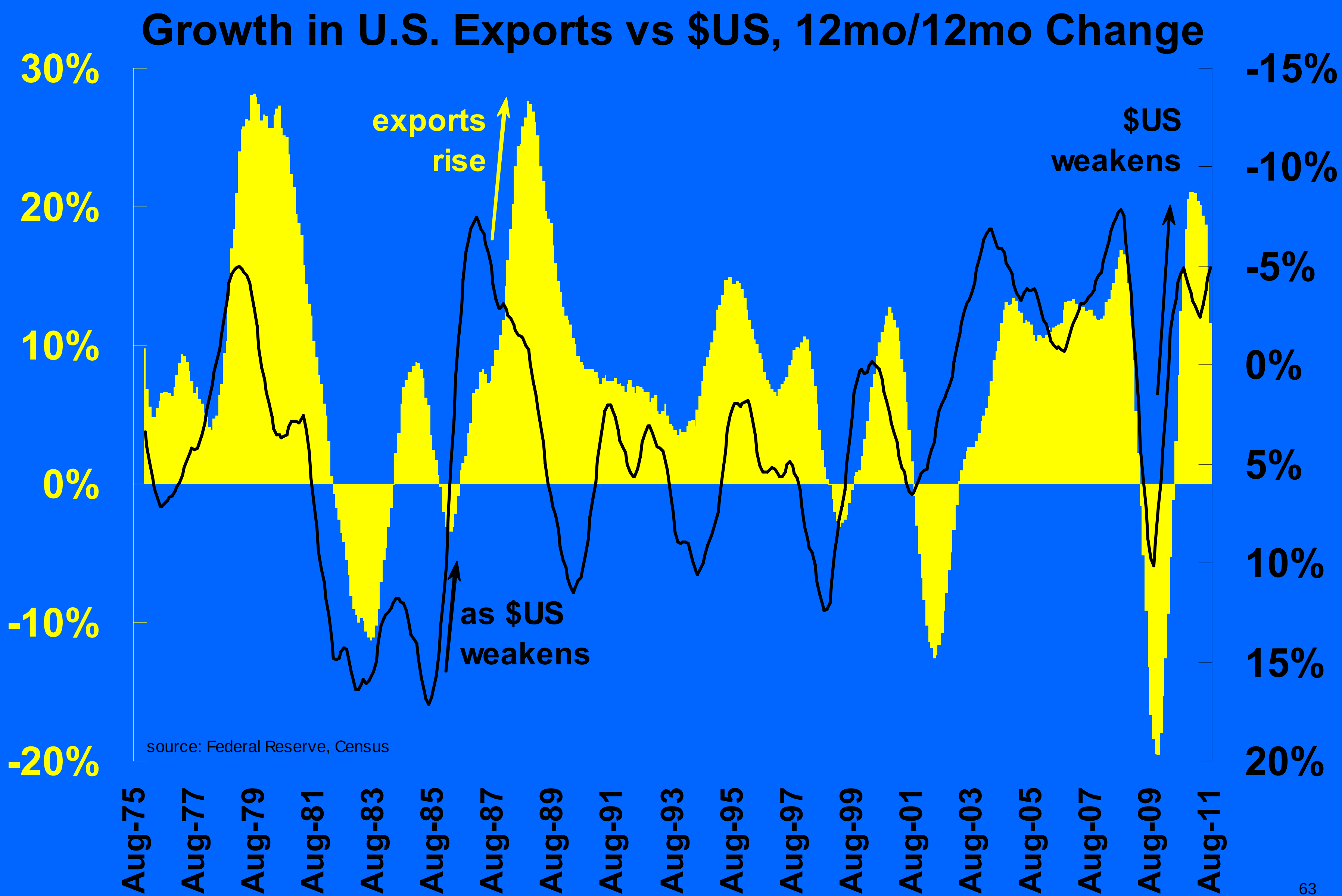


Debt Devaluation

Simple example
Today: Lend $1 @10%. Loaf of Bread costs $1
Inflation goes to 20%

A Year later:
Creditor gets $1.10 back.
But now loaf of bread costs $1.20.

Creditors lose with inflation.
Debtors, like the U.S. government, win.
The U.S. government <u>is ok with</u> inflation.
The U.S. government <u>is ok with</u> a weaker dollar.

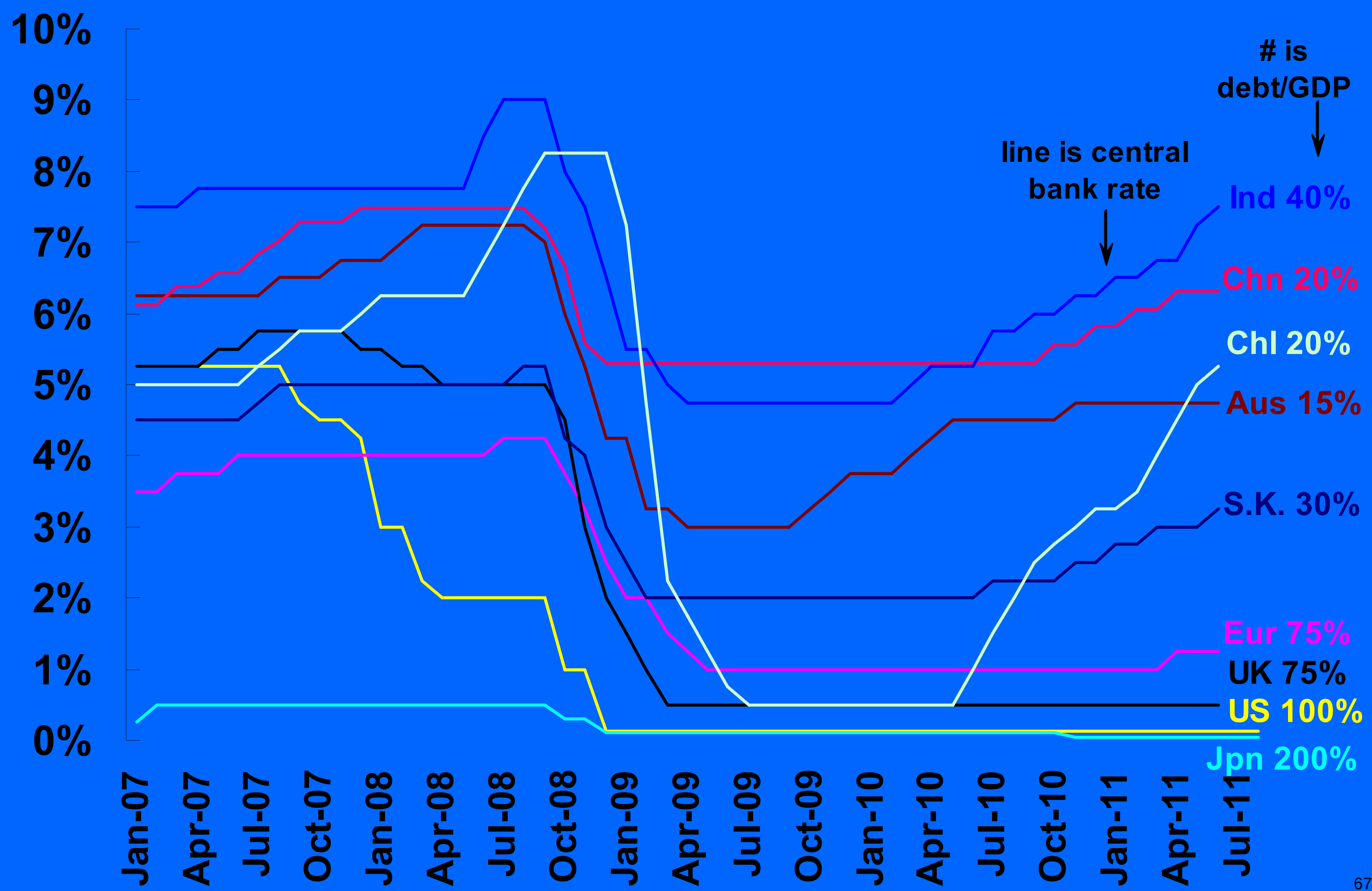
MONETARY POLICY REVIEW

- Controls short term Fed Funds rate
- Prints new money, pumps it into global financial system = QE
- Meant to lower long-term interest rates
- Also causes $ devaluation
- Boost exports, devalue debt

MONETARY POLICY REVIEW
WHAT NOW?

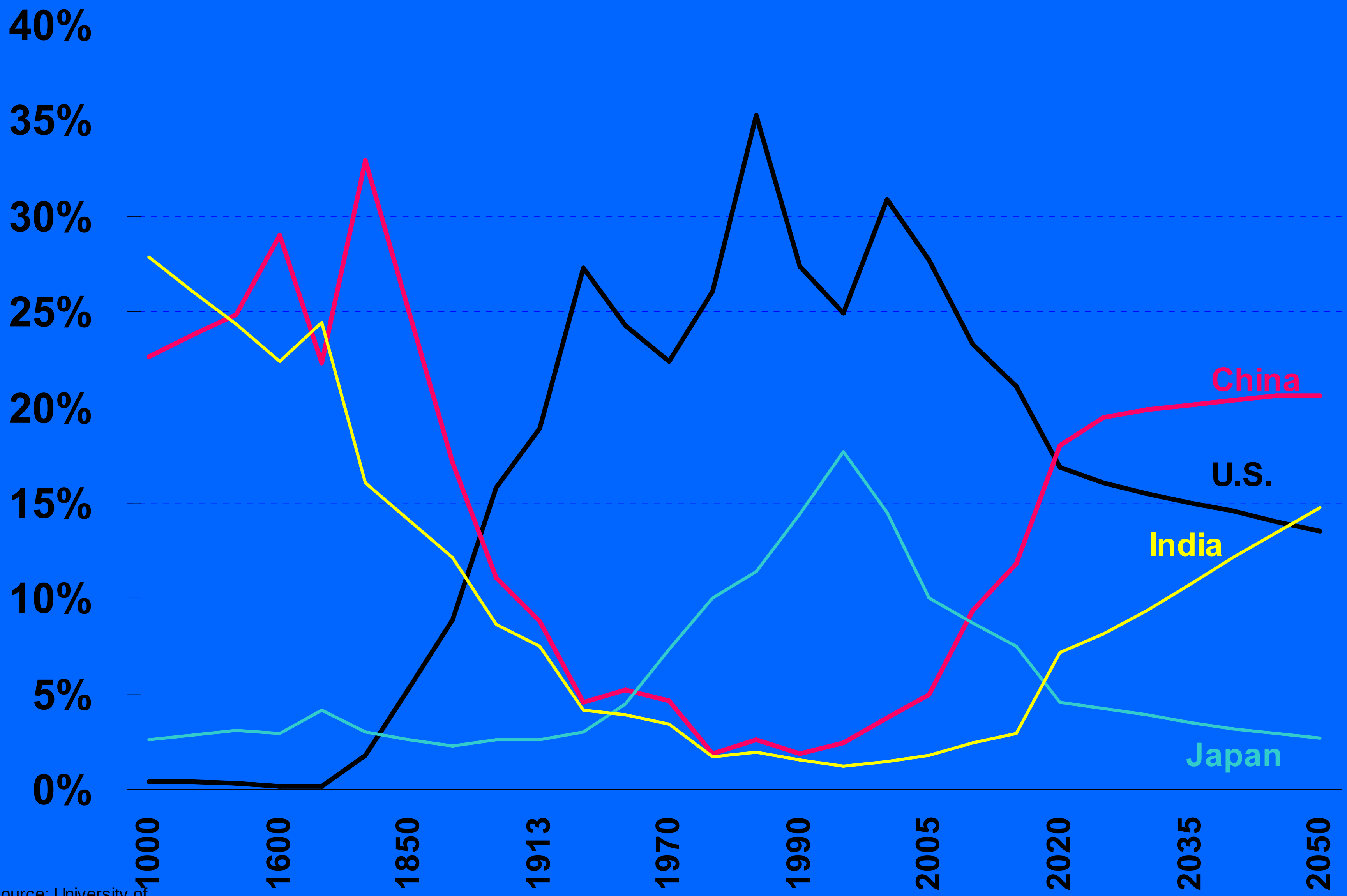
- A few weeks ago:
  - Operation twist - move maturity out – likely to have little effect
  - Reinvest in MBS
- Lower interest paid on reserves to 0%
- Jawbone (not “faltering”!!)
- QE3
- Buy more MBS and Fanny/Freddy debt
- Set inflation or unemployment targets
- Create small business lending facility

Monetary & Fiscal Policy
Less debt, faster recovery. Debt kills.



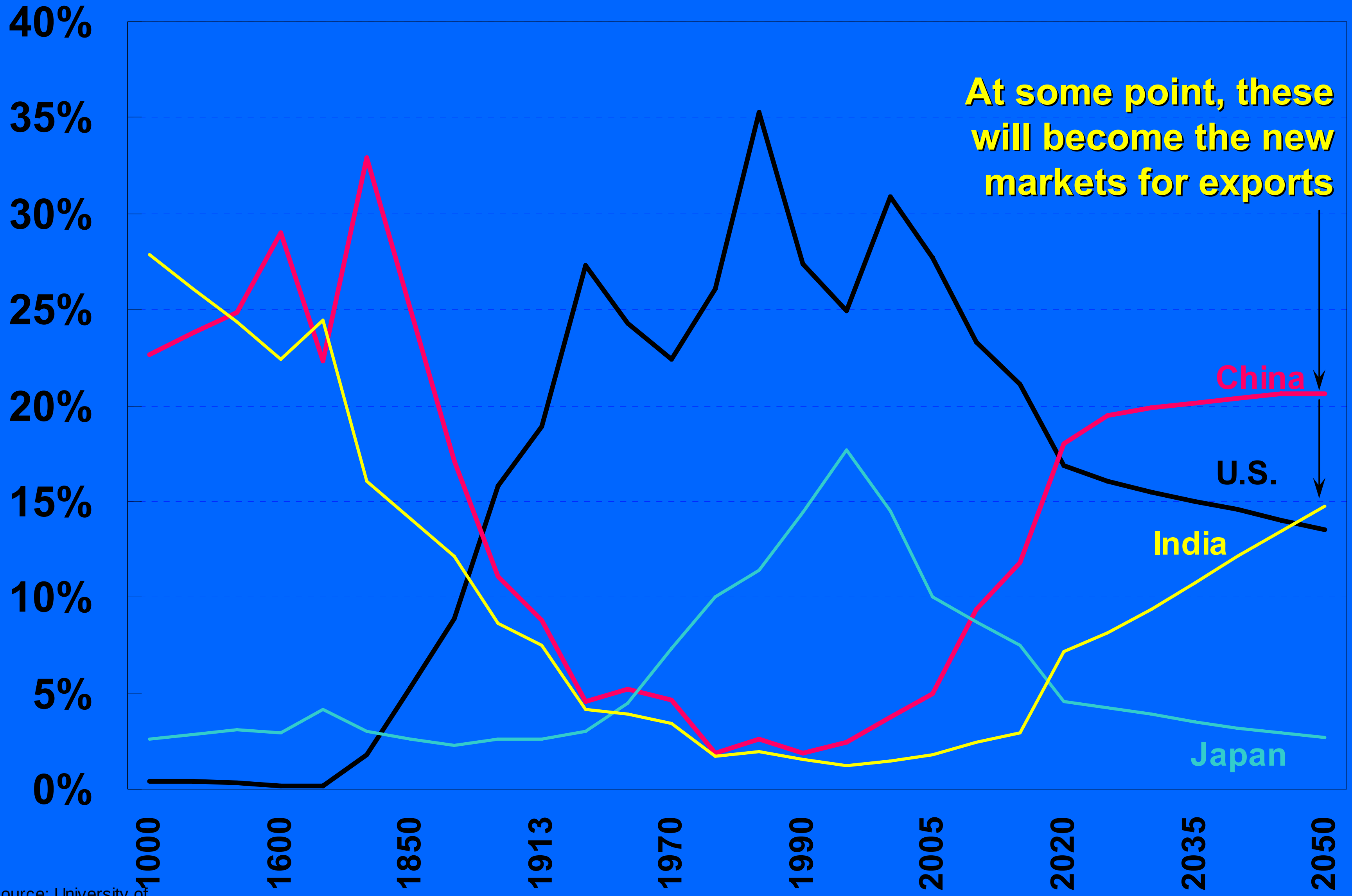
source: central banks, national stat. offices

Global Share of GDP



source: University of Groningen, IMF, PWC

Global Share of GDP



source: University of Groningen, IMF, PWC

Conclusions

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Business insured. Success ensured.

Positives

- Arab spring, Japan, weather, oil, might be “transitory”
- Super stimulative monetary policy will eventually help
- Banks starting to lend
- Consumer mixed
- Strong corp profits
- Stocks OK
- Falling oil and gas prices
- Falling dollar
- Yield curve positive
- Global economy growing

Negatives

- Uncertainty from Europe
- Uncertainty from WDC
- High Oil/gas prices
- Weak housing market
- Consumer mixed
- Yield curve falling
- Little credit
- Mixed consumer
- High unemployment
- Faltering ISMs
- Future Inflation

Thank you for your attention.

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