The Outlook for the U.S. Economy

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

Real Crude Prices (average of Brent, Dubai, WTI spot prices), Y/Y% growth
Real GDP, Y/Y% growth

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

Oil price shocks often contribute to recessions
Oil Price Shocks and the Economy

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Housing
Case - Shiller Home Price Index, % Change

housing bubble bursts 2006, spurs recession...

...but recovers in 2009, helping us out...

...now driving us back in?

S&P/Case-Shiller
This month sales, permits & inventory good, prices & starts bad. Volatile! Change every month!

housing bubble bursts 2006, spurs recession...

...but recovers in 2009, helping us out...

...now driving us back in?
The Treasury Yield Curve vs. GDP

Source: Census Bureau, Federal Reserve
Yield curve had been looking good...

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

sovereign debt worries
weak economic data
Jck Hole
Sep '11 mtg hint
Nov mtg go QE2!

Source: Federal Reserve
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sovereign debt worries
weak economic data
Arab Spring
Japan
euro worries
euro/US debt worries
oil prices

Source: Federal Reserve

Jck Hole
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go QE2!
mtg hint
Finally! Lending is resuming.

Commercial and Industrial Loans
quarterly annualized % change

one reason this recovery has taken so long compared to others

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

Stock Market vs. GDP - 10 dips, 6 recessions

- Arab oil embargo
- 2nd energy crisis, Iran
- double-dip recession, infl = 16%
- S&L crisis
- October 1987
- 1st Gulf war
- Russian Debt Crisis, Asian Currency Crisis, LTCM Crisis
- tech bubble burst, 9/11
- housing bubble burst
- not even dipped yet

Real GDP y/y (left scale)
S&P 500 y/y (right scale)
GDP had been recovering

Real Gross Domestic Product (GDP)
annualized quarterly growth rate

source: BEA

1Q  0.4%
2Q  1.3%
Consumer had been recovering

Consumption Component (C) of Real GDP

annualized quarterly growth rate

source: BEA

2Q 0.7%
ISM was recovering

Institute of Supply Management Indices
>50 means expansion

very high a few months ago, but still >50!

source: ISM

Monthly survey asks if conditions are same, better, or worse for: new orders, production, employment, supplier deliveries, inventories, customer inventories, prices, backlogs, new export orders, imports.
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

>90 economy stable
>100 strong growth
LT ave for CC= 95, CE=93.

source: Conference Board
The Willingness to Spend: Consumer Expectations & Retail Sales

Retail Sales, m/m growth (left scale)

Consumer Expectations
The Consumer Debt Burden

two measures improving = more ability to spend?

Debt Service Payments as Percent of Disposable Personal Income (RHS)

Mortgage + Consumer Debt as a % of Total Assets (LHS)

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

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

- DPI, y/y
- PCE, y/y

source: BEA

NFR holiday sales forecast 2.8%

positive is better

negative was bad
Default Risk: Corporate Bond Spread Over Treasuries
Moody’s seasoned Aaa - 10 year Treasury Note

Average since 1953 is 76 bps

Source: Moody’s, Federal Reserve

- Lehman fails
- Subprime begins
- Sovereign debt pt.1
- Japan, Arabia, Europe, US, oil

- 10/91
- 10/92
- 10/93
- 10/94
- 10/95
- 10/96
- 10/97
- 10/98
- 10/99
- 10/00
- 10/01
- 10/02
- 10/03
- 10/04
- 10/05
- 10/06
- 10/07
- 10/08
- 10/09
- 10/10
Business conditions good: low labor rates, interest rates, inflation. But profits made overseas.

Corporate Profits
S&P 500, Bureau of Economic Analysis 4qs/4qs

Q2-1990 to Q2-2011

S&P 500 (left)
BEA (gov't)
Jobs Created and the Unemployment Rate

Non-Farm Payroll Jobs Created (000's) (left scale)

Unemployment Rate (right axis)

a long way to go

source: Labor Department
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
A New Era of Responsibility!

Accumulated deficits become debt...

The Budget Deficit vs. Interest Rates

...interest rates climb

yield on 10 yr. Treasuries (rhs)

as the deficit gets larger...

Deficit as a % of GDP (lhs)

Sources: The Federal Reserve. Congressional Budget Office

Accumulated deficits become debt...
Accumulated deficits become debt...

Federal Debt as a % of GDP (OMB)

1991-2007

- U.S.: 63%
- Italy: 110%
- Germ.: 58%
- UK: 42%

2001

Accumulated deficits become debt
Accumulated deficits become debt...

Federal Debt as a % of GDP (OMB)

1991-2007 Debt>90% = -1% GDP

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Debt>90% = -1% GDP

New Budget!
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

- Discretionary, 11%
- Defense, 21%
- Interest, 5%
- Income Security, 19%
- Social Security, 21%
- Health, 24%

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- Social Security, 21%
- Income Security, 19%
- Interest, 5%
- Defense, 11%
- Outlays, 2010 Budget, $3.5T
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**
- **$3T? In ten years. Around 20%+ How about 100%?**
- **Doesn’t eliminate deficit – debt continues**
- **Fourth administration deficit reduction plan this year**
- **Many others this year from Congress and 2 other Commissions**
FYI, this week the Treasury indebted you for around ($B):
- $29 3 mo bills
- $27 6 mo bills
- $28 3 yr bills
- $30 4 wk bills
- $21 10 yr notes
- $x 30 yr bonds

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

Fed QE2 bought all in black

source: Bureau of Public Debt
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

Fed Funds

Mortgages

source: Federal Reserve
The Treasury Yield Curve vs. GDP

Real GDP Growth, Y/Y % Change

Yield Curve: 10yr-3 mo Treasuries (bps)

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...
Monetary Base: Printing Money, Quantitative Easing

source: Federal Reserve Bank of St Louis, BLS
Monetary Base: Printing Money, Quantitative Easing

source: Federal Reserve Bank of St Louis, BLS
Federal Reserve Balance Sheet, $B

source: Federal Reserve

QE1

QE2

QE3?

Inflationary expectations

source: Federal Reserve
Did QE2 work?

Yield on 10 year Treasury Note

source: Federal Reserve

hoped for this:

Jackson Hole

Sep hint

QE2

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Did QE2 work?

Yield on 10 year Treasury Note

but got this: record rate of increase, inflationary expectations

source: Federal Reserve
Did QE2 work?

Yield on 10 year Treasury Note

Arab Spring

Japan

euro worries

QE2 ends... did it work?

Record low, 1.77%

but got this: record rate of increase, inflationary expectations

source: Federal Reserve

 QE2

Jackson Hole

Sep hint

3/31/11

5/25/11

7/19/11

9/12/11

2/4/11

5/5/10

6/29/10

8/23/10

10/17/10

3.5%

3.0%

2.5%

2.0%

1.5%

5/5/10

6/29/10

8/23/10

10/17/10

12/11/10

2/4/11

3/31/11

5/25/11

7/19/11

9/12/11

2.0% 2.5%

3.0% 3.5% 4.0%
Inflation

QE = Printing money = Dollar devaluation = Inflation

They are all the same thing.
Inflation

QE = Printing money = Dollar devaluation = Inflation
They are all the same thing.

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

QE = Printing money = Dollar devaluation = Inflation
They are all the same thing.

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
• **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

Value of the USD from June 1, 2010

$US weakening

source: Federal Reserve Bank of New York
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

Growth in U.S. Exports vs $US, 12mo/12mo Change

source: Federal Reserve, Census

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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 is ok with inflation.
The U.S. government is ok with 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
At some point, these will become the new markets for exports.
Conclusions

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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