August 19, 2013

GLOBAL MACRO

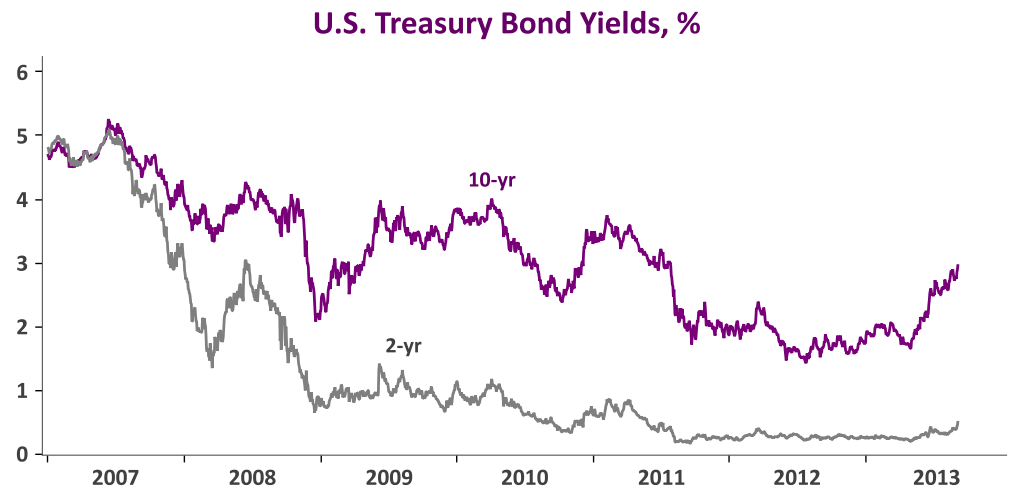
The Upcoming Fed Meeting: Playing for Time

Most pundits agree that the question isn't *if* the Fed will taper off its liquidity injections, but *by how much*. And they hope to find answers in the minutes of the next FOMC meeting a month from now. It's unlikely the Fed will backtrack from previous guidance; even that was enough to steer markets back in the right direction. Long-term interest rates are returning to more normal levels, and capital is starting to flow back into money-market funds. An about-face by the Fed at this point would be more likely to wreak havoc than anything else. However, a closer look reveals that the economic indicators predicating investors' newfound optimism don't actually point to a U.S. recovery (see below). Many of these indicators remain weak, signaling that the world's largest economy isn't strong enough yet for a return to regular interest rate levels. It typically takes around nine months to see the effects of an interest rate hike on the country's economy. The lag is probably shorter in today's economic climate, but—despite investors' renewed enthusiasm—we cannot yet say whether this summer's rate hikes have gone down without some indigestion.

The Fed should therefore tone down its rhetoric and quash any expectations of an untimely further rise in interest rates. It will have to walk a fine line at its September 17–18 meeting and in its ensuing statement to play for time—without undoing the progress made since June. There are several ways the Fed could strike this balance:

- By setting a fixed date, e.g., in November, for when it will start tapering its securities purchases;
- By setting a minimum amount by which it will taper its securities purchases, such as by $10 billion (i.e., scaling back from $85 billion to $75 billion)—instead of the $20 billion currently expected by the market;
- By setting a conditional long-term target for securities purchases instead of specifying monthly amounts.

So the Fed has a great deal of scope for influencing interest rates and mitigating the risks related to a rise in borrowing costs, which shot up too steeply this summer. We still see interest rates returning to the 2.30 percent—2.50 percent range just after the September FOMC meeting and easing up more gradually in 2014 (see our articles "The U.S. Economy: Don't Count Your Chickens Before They Hatch," dated June 5, 2013, and "Outlook 2013–2014," dated June 21, 2013. We also expect to see a corresponding flattening of the 2-year and 10-year T-bond yield curves.



Sources: RichesFlores Research, Macrobond

U.S. Economy Not as Rosy as it Seems

The markets' summer love affair with the U.S. economy appears gratuitous, as the latest economic data do not corroborate investors' ardor. Below is a review of the U.S. economic highlights this summer.

GDP revised upwards by $560 billion, but the economic backdrop remains the same

In late July, the Bureau of Economic Analysis—the organization responsible for compiling the country's main economic data—changed its method for calculating the national income and product accounts. Spending on intellectual property, which includes things like R&D and artistic creation, is now treated as a *capital investment* and included in the calculation of value added. This brings the BEA's method closer in line with international guidelines. The new method will be applied retroactively to national accounts dating back all the way to 1929, and has led to significant revisions in the BEA's figures for GDP, capital investment, and personal income. The Bureau also changed the way it accounts for commercial banking services, transactions related to defined-benefit pension plans, and the ownership transfer costs for residential housing (which are now considered a residential fixed investment). The reference year has also been updated from 2005 to 2009. As a result of these changes:

- Real GDP was revised upwards by $300 billion for 2002 and $560 billion—or 3.5 percent—for 2012.

Detail of inflation-adjusted revisions to 2012 national accounts (in billion $)

Total GDP revision	559.8
Methodological changes	526.0
- Capitalization of R&D expenditures	396.7
- Capitalization of entertainment, literary, and artistic originals	74.3
- Ownership transfer costs for residential housing included under fixed investment	42.3
- Accrual-based accounting for defined-benefit pension plans	12.6
Statistical changes	33.8

Source: U.S. Bureau of Economic Analysis, July 31, 2013

- 2012 personal income was revised upwards by $300 billion—or 2.3 percent—after taking into account the discounted amounts owed to employees under defined-benefit plans, which also increased the personal savings rate by 1.5 percentage points that year.

These changes in the BEA's calculation method couldn't have come at a better time, since they automatically lower both public- and private-sector debt ratios and give a hefty boost to GDP growth figures, which for 2012 rose from 2.2 percent to 2.8 percent.

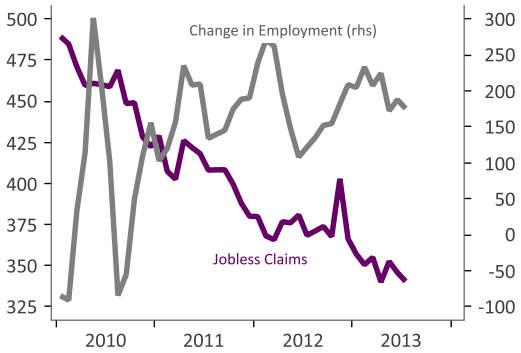
But such "improvements" in the national accounts are merely cosmetic and mask the U.S. economy's persistent underlying woes. Even though the higher GDP number indicates that the U.S. has a lower output gap than previously thought, and the higher household savings rate indicates that consumers are better poised to absorb January's round of fiscal belt-tightening than previously thought, the country remains stuck in an economic quagmire. First-quarter GDP growth came in at 1.1 percent on an annualized basis (versus 1.8 percent using the former calculation method); the second quarter should be little better at 1.7 percent. These new figures have prompted us to lower our 2013 GDP growth forecast from 1.6 percent to 1.4 percent, all other things being equal.

Economic indicators point to choppy waters ahead

Although the financial markets have been waxing lyrical about a rebound in the U.S. economy, the latest economic data leave us unimpressed. We do not intend to raise our H2 growth forecasts. Our reading of the data is much more nuanced, as explained below.

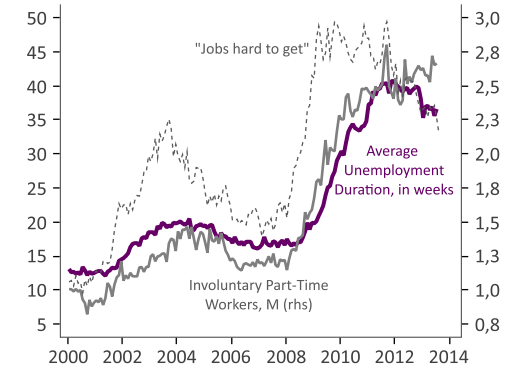
- **Weekly jobless claims have eased**, but this indicator has been completely uncorrelated with job creation for over a year. Jobless claims have shrunk by more than 100,000 since early 2011—but nonfarm payroll employment has barely moved. We believe the most likely explanation is that long-term job-seekers are getting discouraged; a conclusion based on:
  - The persistently high number of Conference Board survey respondents stating they find "Jobs hard to get;"
  - The average duration of unemployment, which remains stuck near record highs; and
  - The labor force participation rate, which is hovering at record lows.

Jobless Claims and Change in Total Nonfarm Payroll Employment, thousands of people, 3MMA



Sources: RichesFlores Research, Macrobond

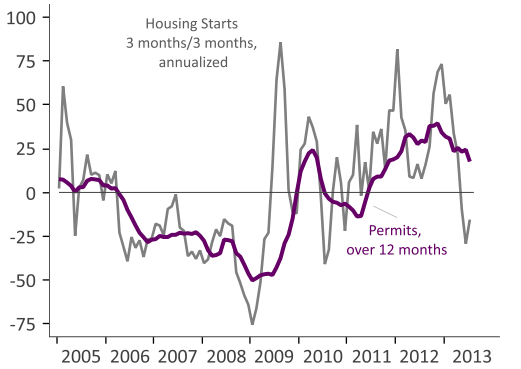
Job Market Indicators



Sources: RichesFlores Research, Macrobond

- **July's uptick in new housing starts** didn't fully offset the declines in May and June. Over the past three months, new housing starts have fallen by an average of 15.5 percent on an annualized basis, and the 12-month trend for both housing starts and building permits points to a near-term slowdown in residential construction.

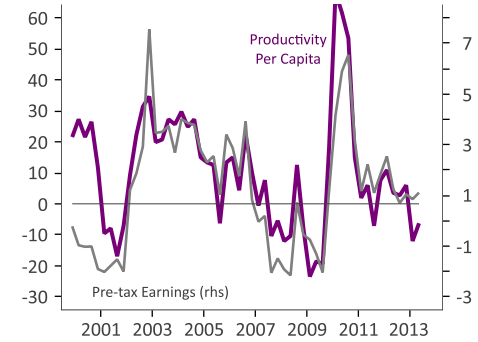
Change in Housing Starts, 3MMA in %



Sources: RichesFlores Research, Macrobond

- **Although productivity per capita rose in Q2 2013,** edging up 0.9 percent on an annualized basis relative to Q1, this was an extremely modest gain. Moreover, productivity has actually declined over the past 12 months—holding down pre-tax earnings growth at non-financial companies.

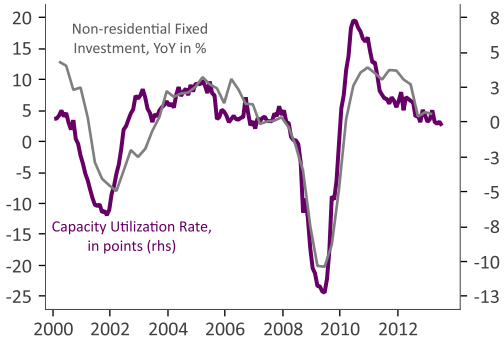
Change in Productivity Per Capita and in Real Earnings at Non-Financials, YoY in %



Sources: RichesFlores Research, Macrobond

Against these headwinds, any pickup in the job market or capital spending seems unlikely—especially since stagnant capacity utilization rates at U.S. companies are keeping a lid on capital investment.

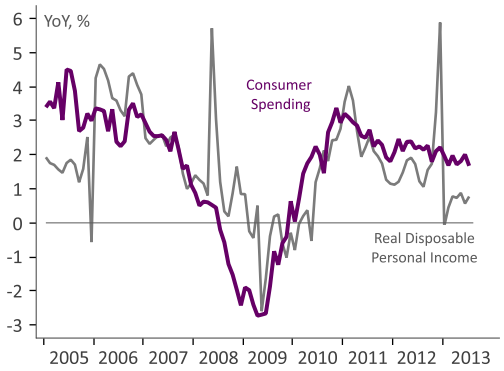
Change in Capacity Utilization and Non-residential Fixed Investment



Sources: RichesFlores Research, Macrobond

- **Consumer spending rose for the third consecutive month in July,** a sharp improvement from the first few months of the year. However we don't expect to see much of a rebound in consumer spending in the near-term, due to the meager gains in real disposable personal income.

Change in Disposable Income and Consumer Spending



Sources: RichesFlores Research, Macrobond

In light of the above, we feel the U.S. recovery is still too fragile to withstand a material rise in interest rates. The Fed would be wise to use its upcoming meeting to play for time, stalling the return to more normal long-term interest rates.

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