RCF
ECONOMIC & FINANCIAL CONSULTING, INC.

# ECONOMIC UPDATE AND FORECAST SUMMARY

**(*Prepared under contract for Prudential Capital Group)***

## OCTOBER 2013

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## QUICK LOOKS:

- Economy is hamstrung by a host of policy uncertainties – government shutdown, debt ceiling, and timing of Fed tapering.
- After rising sharply from May through August, interest rates fell in September; however, we expect rates to resume upward trend once budget issues are resolved.
- We believe the current weakness in the economy is a short-term problem; thus, there is a window of opportunity to take advantage of what we expect to also be a short-term dip in interest rates.

One consequence of the government shutdown is the delay in the jobs and unemployment report which was scheduled to be released October 4, 2013. Another impact of the budget standoff is that it has given the Federal Reserve one more reason to delay the tapering of its asset purchases. We say one more reason because beyond the Beltway battle, the bottom line is that economic growth remains slow. True, second quarter real GDP grew at a 2.5 percent rate, better than the 1.1 percent rate in the first quarter and the minimal 0.1 percent growth in 2012Q4. But 2.5 percent growth is still not enough to produce much improvement in the job situation. Based on data from ADP, which is for the time being the private sector stand-in for the Labor Department's employment report, job gains are running at about two million per year indicating that while the labor market recovery continues to grind along, there is no evidence that the economy is shifting into a higher gear.

Our sense of what is holding back the economy is a pervasive feeling of uncertainty about the future consequences of the fiscal and monetary actions that have been taken since the Great Recession. We believe the budget and debt ceiling issues will eventually be resolved, but the political conflict does not inspire confidence that Washington will be able to address the nation's long-term fiscal imbalance. Similarly, the future effects of the Fed's massive injection of monetary stimulus remain unclear. The slow economy has kept the lid on inflation and interest rates, but what happens when the Fed does taper and, following that, when it starts to raise interest rates? Will that crush the stock and housing markets, reversing the gains in net worth, thereby depressing consumer spending and sinking the economy? Will the Fed find itself too far behind the curve, resulting in a spike in inflation? Given these unknowns, it is not surprising that households and businesses have kept their spending in check.

We will try to provide our readers some comfort. First, we do not think either the stock market or the housing markets are "bubbles," at least not in the sense that their rises are unjustified by economic fundamentals. We believe the primary factor behind the increase in stock prices is not Fed policy – it's the near tripling of corporate profits over the past five years. The recent spike in housing prices is mostly due to a temporary mismatch between demand (high because recent increases in mortgage rates have pushed people into the market) and supply (still low because many potential home sellers remain underwater and new construction is far below its normal pace). Even so, adjusted for inflation, home prices today are about where they were in 1998, and well below their peak level of 2006.

A second reason to take comfort is found in the sustained drop in new claims for unemployment insurance, which have returned to pre-recession levels, excluding any short-term negative increase from the government shutdown. Thus, while job creation has not picked up, job losses have greatly diminished, giving households some degree of job security. That should provide a foundation that will keep consumer spending rising even if it does not accelerate as we had hoped.

We are assuming that a budget and debt ceiling agreement will be made by the time you read this report. Nonetheless, given the aforementioned uncertainties, we have downgraded our near-term outlook for the economy somewhat, predicting slower growth and a more gradual decline in unemployment than we had projected in our last report. Our forecasts of inflation and interest rates are also a bit lower, the latter being because the Fed's tapering plan is currently on hold. We still expect the economy to pick up in 2014 and should that happen, the Fed will curtail its asset purchases and interest rates will move higher. But any rise in rates would therefore be accompanied by improvements in the economy, meaning that businesses and consumers should both be able to handle the increase in borrowing costs.

## Comparison of Economic Forecasts: RCF and Consensus

| | | What We Said | What We Saw | What We See | |
|---|---|---|---|---|---|
| | | 2013 2nd Half | 2013 Q3 | 2013 2nd Half | 2014 1st Half |
| **Real GDP** | **RCF** | **+2.4%** | +2.5% | **+2.2%** | **+3.0%** |
| | *Consensus* | *+2.5%* | (2013Q2) | *+2.1%* | *+2.7%* |
| **Inflation** | **RCF** | **1.7%** | 1.5% | **1.7%** | **1.9%** |
| | *Consensus* | *1.7%* | | *1.7%* | *2.0%* |
| **Core Inflation#** | **RCF** | **1.8%** | 1.5% | **1.7%** | **1.9%** |
| | *Consensus* | *2.0%* | | *1.9%* | *2.0%* |
| **Unemployment** | **RCF** | **7.2%** | 7.3% | **7.2%** | **6.8%** |
| | *Consensus* | *7.3%* | | *7.2%* | *6.9%* |
| **Fed Funds Rate** | **RCF** | **0.125%** | 0.125% | **0.125%** | **0.125%** |
| | *Consensus* | *0.125%* | | *0.125%* | *0.125%* |
| **2-year Treasury Rate** | **RCF** | **0.55%** | 0.33% | **0.55%** | **0.75%** |
| | *Consensus* | *n.a.* | | *n.a.* | *n.a.* |
| **10-year Treasury Rate** | **RCF** | **2.85%** | 2.62% | **2.80%** | **3.15%** |
| | *Consensus* | *2.70%* | | *2.88%* | *3.19%* |

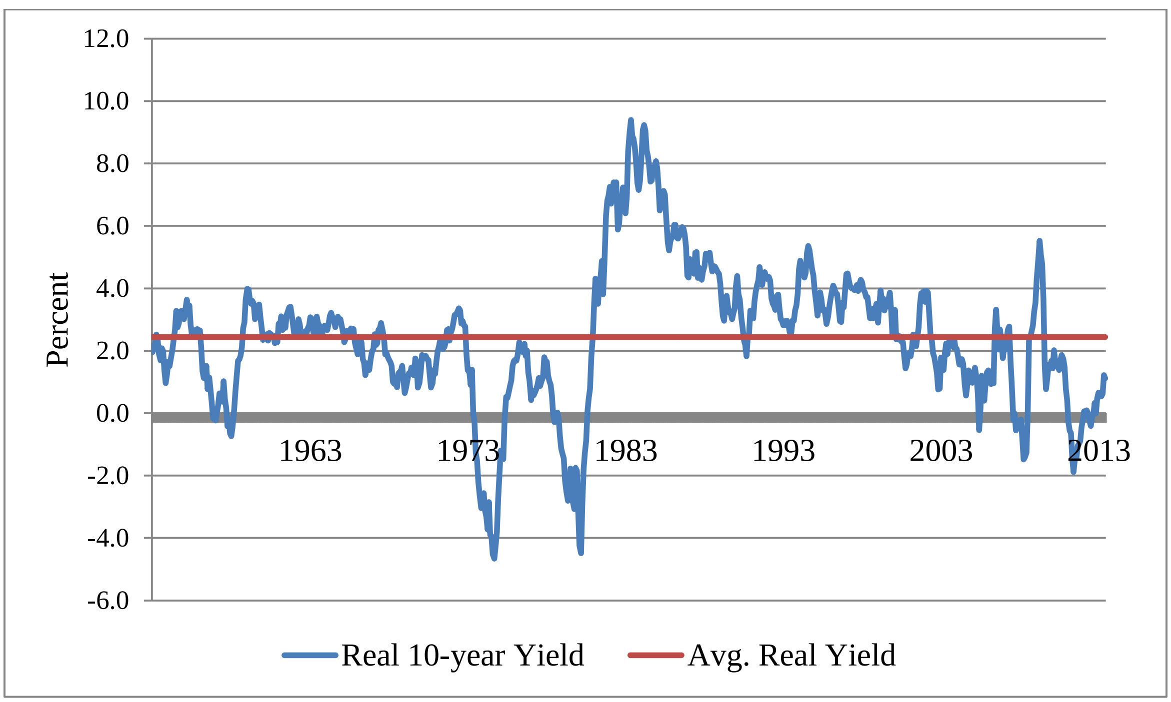
RCF: RCF Economic & Financial Consulting, Inc. Consensus (except for core inflation): Wall Street Journal October Survey of Economists. # Core Inflation (excludes food and energy prices); consensus forecast is from the Philadelphia Federal Reserve's Survey of Professional Forecasters. Actual economic data as of October 7, 2013.

## I. Interest Rate Overview

Expectations that the Federal Reserve would begin to reduce its bond buying in September sent the 10-year Treasury yield up to almost 3.00 percent. When the Fed announced instead that its bond buying would continue, rates fell back down, ending the third quarter at 2.62 percent. That is still almost a full percent higher than it was in April, but nonetheless a catalyst for an extremely strong September for corporate bond sales. We had felt that the Fed would end its bond buying before the end of the year. That may still happen, but it will require stronger performance from the economy than we are currently seeing. Given the added negatives from the budget standoff and the debt ceiling debate, we expect 10-year yields to remain close to where they are now for the time being.

Longer term, however, we think the factors contributing to higher rates outweigh those that would keep rates low. The most important factor is that the current real interest rate on 10-year Treasuries is notably below its long-term historical average. Bond-buyers have been sacrificing yield for security for a long time now, but eventually, the fundamentals will take over and interest rates will rise to more reasonable levels. In fact, as Chart 1 shows, real yields – which were negative not so long ago – are gradually returning to their historical average. Thus, even if inflation remains at its current level of 1.5 percent, a return to the historical real rate of 2.25 percent would push 10-Year Treasury yields to 3.75 percent, about one percent higher than today.

**Chart 1: Real (inflation-adjusted) Yield on 10-Year Treasury (1953 – 2013)**




Sources: Federal Reserve, Bureau of Labor Statistics, and RCF Calculations

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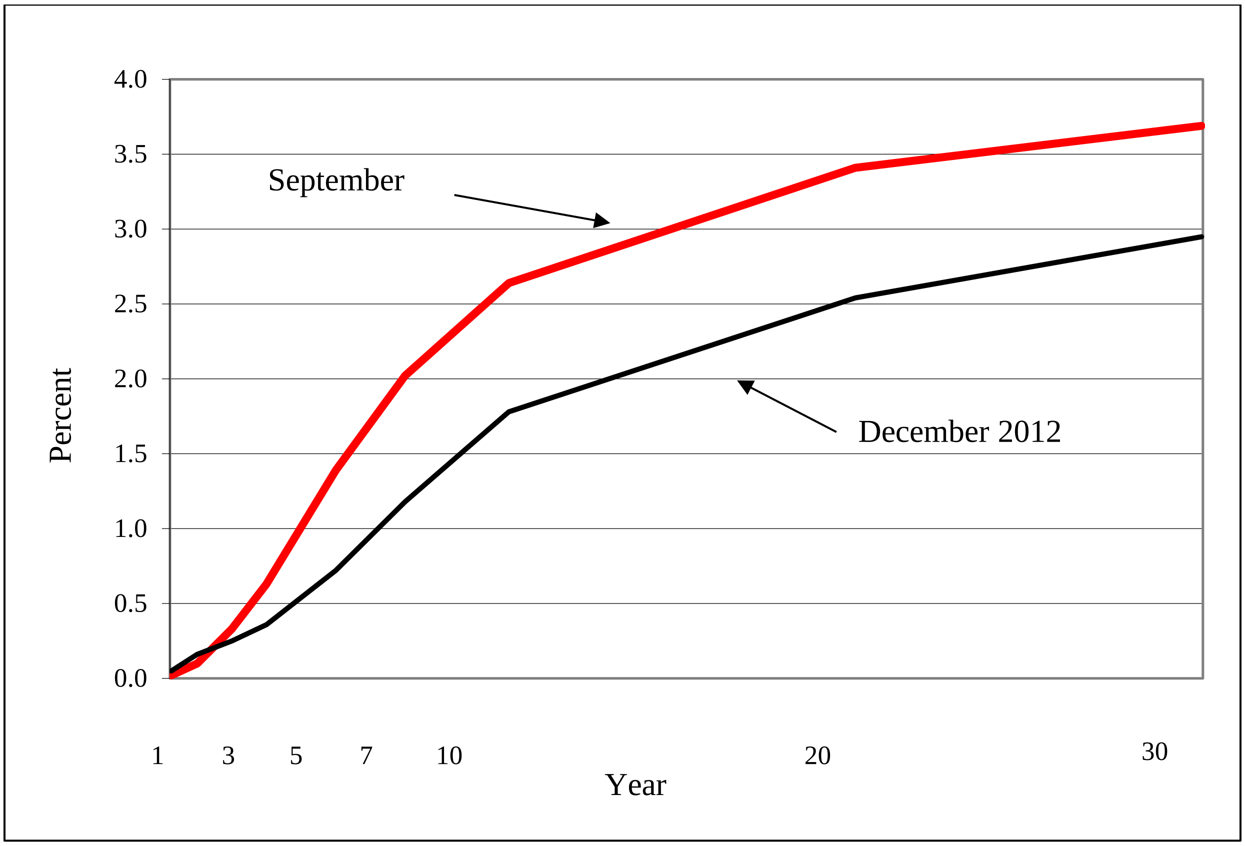
The Fed's near zero federal funds rate will keep short-term Treasury yields low, creating a fairly steep yield curve as shown in Chart 2. Normally, a steep yield curve is a bullish sign for the economy but in this case it is mainly because the Fed has greater ability to influence short-term interest rates than long-term rates. We do not believe that the Fed will raise the fed funds rate for at least another 12 months. However, as Chart 2 shows, even with a near-zero funds rate, the yield on 3-year Treasuries has increased. As we get closer to the time when the Fed does raise rates, we can expect short-term Treasury rates to rise even further.

**Chart 2: Treasury Yield Curve: September 2013 vs. December 2012**




Source: Federal Reserve

Basically, we have pushed back our interest rate forecasts a couple of months, meaning that while we still project rates to rise, the increase will come somewhat later than we had earlier anticipated. It is still the case that U.S. Treasuries are viewed as the safe-haven in times of uncertainty and as long as the fiscal and monetary policies remain in flux, demand for government debt will be strong. Eventually, the policy clouds will clear, and the upward trend in interest rates, which began at the end of April, will return. As such, we expect 10-year Treasury yields to top 3.0 percent during the first quarter of 2014, ending the first half of that year at 3.15 percent.

## II. Inside GDP

The Commerce Department's final 2013Q2 GDP report showed that the economy grew at a 2.5 percent rate in the second quarter, up from 1.1 percent in the first quarter and 0.1 percent in the fourth quarter of 2012. Although growth is improving, it remains sluggish due to the general weakness in consumer spending which rose at a real rate of only 1.8 percent. Preliminary data for July and August suggest a similar growth pace for consumer spending in the third quarter as well.

**Chart 3: 2013Q2 GDP vs. 2013Q1 and 2012Q2**

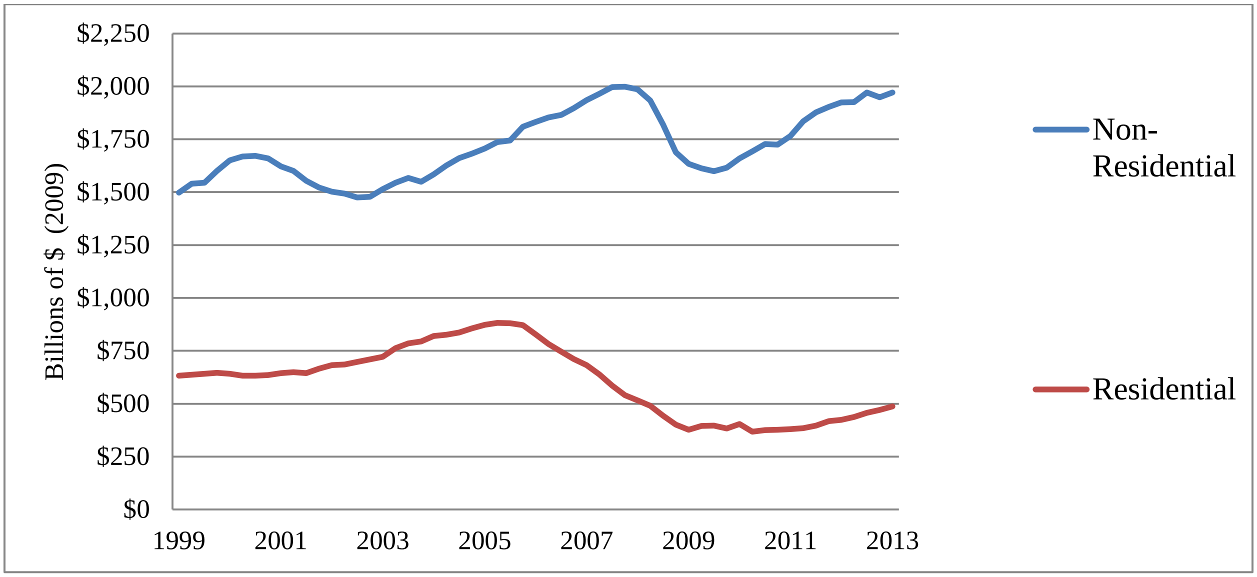
| | 2013Q2 | vs. 2013Q1 (Annualized) | vs. 2012Q2 |
|---|---|---|---|
| **Nominal GDP** | **$16,661** | **+3.1%** | **+3.1%** |
| **Real GDP ($2009)** | **$15,680** | **+2.5%** | **+1.6%** |
| **Consumer Spending** | $10,692 | +1.8% | +1.9% |
| **Business Investment** | $2,525 | +9.2% | +4.4% |
| **Government Purchases** | $2,905 | -0.5% | -2.0% |
| **Exports** | $1,998 | +8.0% | +2.0% |
| **Imports** | $2,443 | +6.9% | +1.2% |

Source: U.S. Department of Commerce

The weakness in consumer spending is being driven by weakness in consumer income which, after inflation, was only 1.0 percent higher than it was a year ago. Spending is getting some boost from the increase in household wealth that has come from the increase in stock and home prices. In fact, household net worth has surpassed its pre-recession peak. In real terms, net worth has increased 23.2 percent since it hit bottom in 2009 while real consumer spending has gained only 8.6 percent over this same four-year period. Although there is no rule that wealth and spending growth should track each other exactly, it does appear that households are somewhat less willing to spend their recent asset gains than they have been in the past. As we noted in our overview, many people suspect that the recent run-ups in stock and housing values may not last and are therefore understandably less willing to use these recent wealth gains as a basis for increased spending.

Thus, with consumer spending seemingly stuck in a slow growth mode, we turn our attention to business investment spending as a possible source of stronger growth in overall GDP. Real Investment spending increased at an annual rate of 9.2 percent in the second quarter, and is 4.4 percent higher than it was during the second quarter of 2012. However, most of that increase came from the 15 percent rise in residential investment. Non-residential investment was up only 2.4 percent compared with a year earlier. (Although investment has been redefined in the most recent GDP calculations, historical numbers have been re-estimated to allow for an apples-to-apples comparison.)

Chart 4: Real Non-Residential and Residential Investment Spending




Source: U.S. Department of Commerce

The distinction matters. While residential investment (mainly construction of new housing) has a number of positive impacts on the economy, non-residential investments include the additions of technology, machinery and – yes – intellectual property that drive increases in productivity. And one of the overlooked stories of the U.S. economy has been the weakness in productivity growth, which has averaged just 1.5 percent per year over the past 6 years. That is notably weaker than the 2.5 percent annual growth in productivity we saw from the late 1990s until onset of the Great Recession.

Optimistically, one can hope that the rebound in non-residential investment (up 30 percent compared to four years ago) will yield an improvement in worker productivity. It has not happened yet (output per hour is up only 0.8 percent over the past year), but historically business investment has been a key driver of gains in productivity, though it may take several years for these investments to pay-off. Realistically, with the job market seemingly stuck in slow growth mode, we will have to see improvements in productivity if we are going to see any acceleration in the growth rate of real GDP.

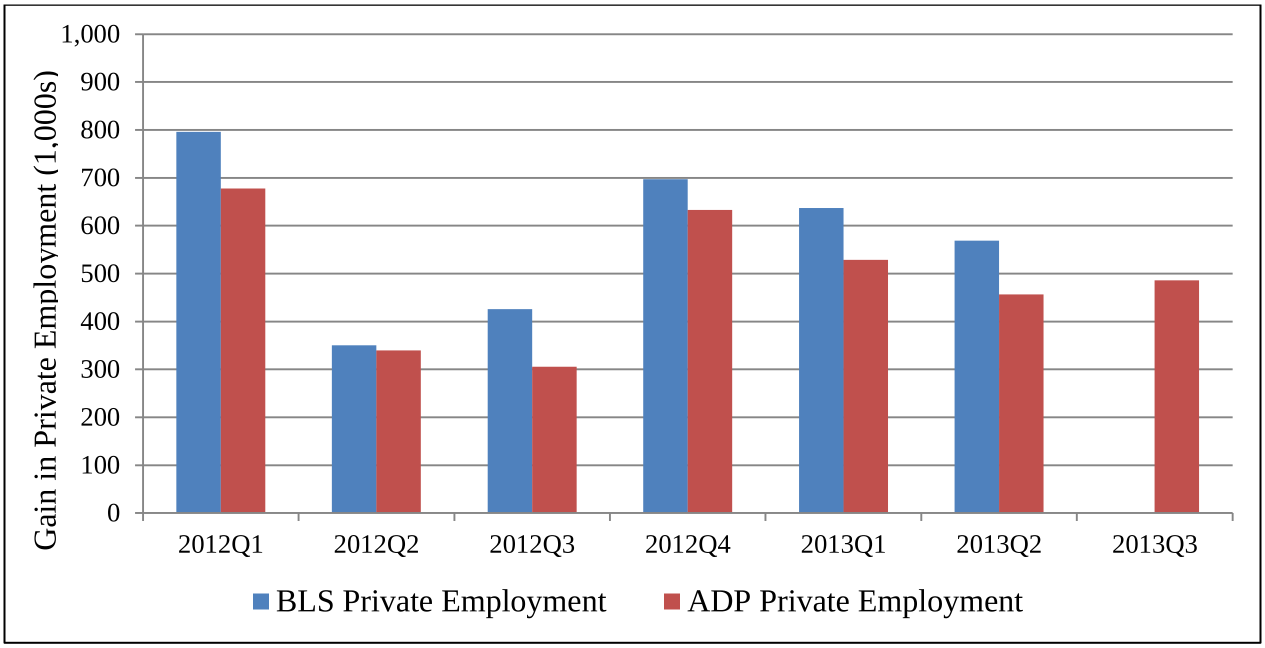
For the time being, however, we expect the economy to grow at only a 2.2 percent pace in the second-half of the year, slower than the second quarter pace, due to the negatives from the government shutdown. For the first-half of 2014, we expect the economy to grow at a 3.0 percent rate, assuming that the budget and debt ceiling issues can be resolved fairly soon and some of the policy uncertainty is removed from the economy. With less uncertainty and still low borrowing costs, businesses might pick up the slack caused by slow growth in consumer spending.

## III. Jobs Picture

The federal government shutdown delayed the September jobs report, originally due in early October. It may even prevent a reliable report for jobs in October as the Labor Department is not even conducting its surveys as of this writing. As such, we will have to rely on non-government sources of employment information.

ADP provides an estimate of private sector employment based on analysis of their payroll processing data. According to ADP, the private sector added 486,000 jobs in the third quarter of 2013 and 2.1 million over the prior 12 months. Those figures are somewhat lower than the Labor Department's estimate of private sector (2.3 million additional jobs over the 12 months ending in August). In either case, the evidence is that the private sector is continuing to slowly but surely add jobs to the U.S. economy.

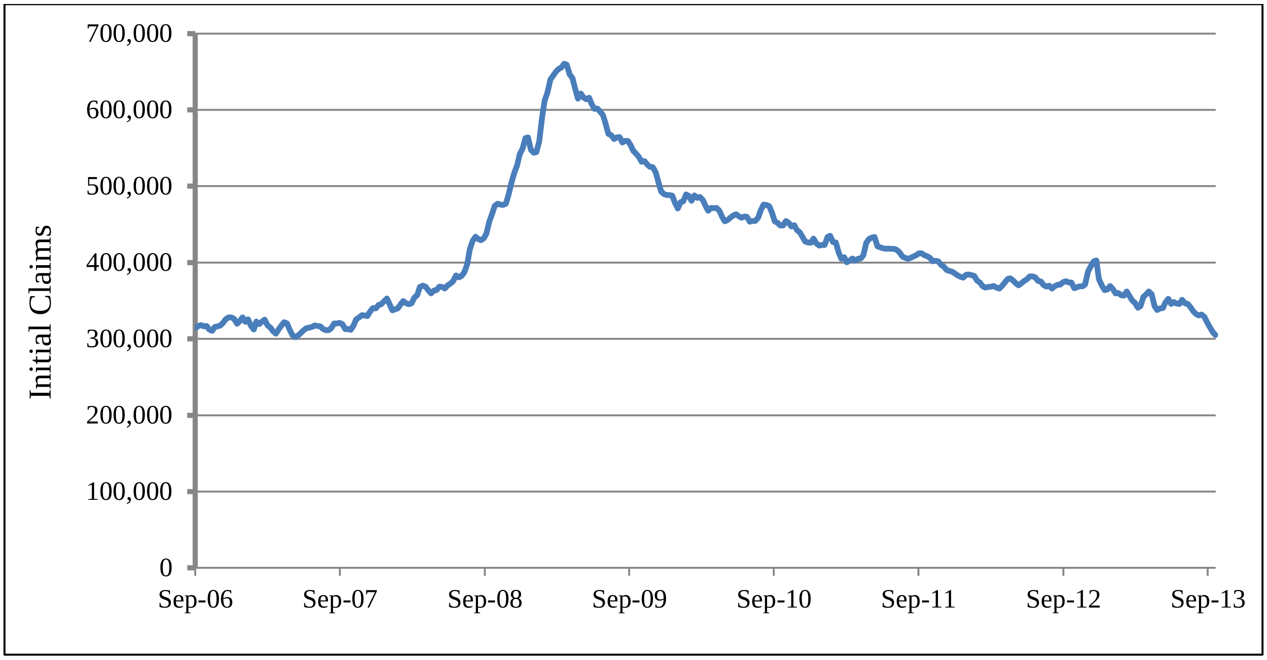
**Chart 5: Quarterly Gain in Private Employment (BLS vs. ADP)**




Source: Bureau of Labor Statistics (BLS) and Automated Data Processing (ADP)

Job growth is slow, not just because employment remains below its pre-recession peak, but because employment gains are low given the substantial reduction in new claims for unemployment insurance. The 4-week moving average of new claims fell to its lowest level since before the recession, a figure which is consistent with job growth in excess of 2.5 million per year. Our interpretation of the jobs and claims data is that while the big layoffs from the recession have ended, businesses are still cautious about adding new employees. Thus, the claims data give us some confidence that the economy can continue to grow at its current pace, but the jobs data do not provide a basis for assuming that growth will pick up any time soon.

**Chart 6: 4-Week Moving Average of Initial Claims for Unemployment Insurance**




Source: U.S. Department of Labor

The failure of the job market to kick into a higher gear has meant that the unemployment rate remains elevated (7.3 percent in August), workers' earnings growth has stayed slow (up 2.2 percent in August vs. a year earlier), and the labor force participation rate remains low. The government shutdown (still ongoing as of this writing) will have negative effects on the job market due mainly to the furlough of some 800,000 federal employees as well as temporary layoffs of private sector workers on federal contracts. Our assumption, however, is that this will prove to be only a temporary disruption and before the end of October, these workers are expected to be back at their jobs. Therefore, we believe that the gradual increase in employment will continue and the unemployment rate will drop to 6.8 percent by the middle of 2014.

## IV. Fiscal and Monetary Policy

The federal government shutdown will have a modest negative impact on the economy. The far larger issue is the raising of the debt ceiling, without which the government cannot continue to borrow. Being unable to borrow means not only being unable to fund various government programs but also being unable to pay interest on the debt. In other words, default.

Of course, we do not think this will happen. Just as was the case with the debt ceiling debate back in 2011, we expect some agreement to raise the government's borrowing limit will be reached before the clock strikes midnight. What is unfortunate though is that both the President and Congress are likely to miss the important lessons from the 2011 budget agreement. The first lesson is that deficit reduction need not destroy the economy. Since 2011, taxes were raised, spending was cut, and the economy continued to grow. The second lesson is that continued economic growth is a key ingredient to reducing both the deficit and the debt-to-GDP ratio. But government shutdowns and stalemates only cause the economy to slow, worsening the budget situation.

The third lesson is that the near-term budget outlook is actually not that bad and, as a result, attention should be paid to the longer-term fiscal issues. The Congressional Budget Office (CBO) estimates that the FY 2013 budget deficit will be 4 percent of GDP, down from 10 percent of GDP in 2009. Moreover, the CBO projects that by 2015, the deficit will fall to 2 percent of GDP, not much more than what it was before the recession blew apart the government's finances. Because of, or in spite of, Washington's efforts, the budget deficit is not the biggest problem facing the U.S. economy today.

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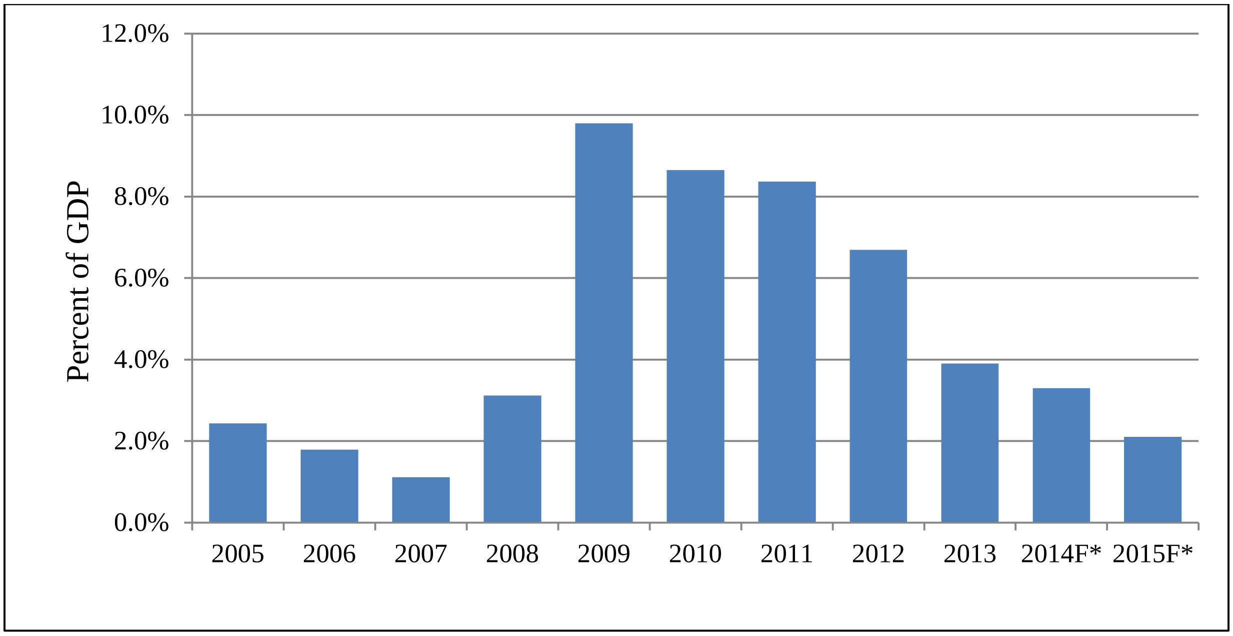
**Chart 7: Federal Budget Deficit as Percent of GDP**




Source: U.S. Department of Treasury and CBO Forecasts for 2014 and 2015

More important than the government's budget is the future of monetary policy. The appointment of Janet Yellen to succeed Ben Bernanke as Federal Reserve Chairman is not likely to produce any major changes. The Federal Reserve has announced its *intention* to curtail its purchases of long-term U.S. debt and mortgage backed securities. But the Fed has also said that the timing of this decision will depend on "incoming economic data." Here the fiscal and monetary worlds intersect, with the budget stalemate being one of the reasons why the Fed announced recently that it would continue its $85 billion of monthly bond purchases.

We still believe the Fed will begin to taper before the end of the year. One reason again has to do with the link between fiscal and monetary policy. The Fed is currently on pace to buy $540 billion of Treasury debt on an annual basis. However, if the CBO's deficit projections are correct, the budget deficit may be less than $540 billion in 2014. In other words, the Fed may have to taper simply because the new supply of government debt is not keeping up with the Fed's current pace of purchases.

If so, the reduction in the Fed's demand for debt will coincide with a reduction in the Treasury's new supply of debt, meaning that interest rates are not likely to rise too much as a result of Fed tapering. (We are assuming the Fed will for some time continue its $40 billion monthly purchases of mortgage backed securities.) Yet, until Congress and the President can agree on a budget and an increase in the debt ceiling, the Fed will likely continue its policy of buying whatever government debt it can.

And so, we come full circle. A budget stalemate about a deficit that is not really that big is causing the Fed to buy bonds that do not really need to be bought, at least not by the Fed. As such, it is our view that it is time for the Federal Reserve to phase out its purchases of government debt. It has been five years since the financial crash. Stock prices and corporate profits have returned to new highs. Housing prices, home sales, and new construction are heading upward. New car sales have rebounded. Household debt has shrunk and household net worth now exceeds its pre-recession level. In short, the problems that can be fixed by low interest rates have mostly been fixed. The problems that still plague the economy – weak consumer spending, slow job creation -- are in part a result of the many fiscal and monetary policy uncertainties that remain. Ending five years of fiscal and monetary stimulus will not be without some negative consequences. But we think those negatives will eventually be more than offset by the positives that come from households and businesses having a clearer picture of the future path of government policies.