US Economy: Improving Outlook, Long-Term Policy Risks

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US Economy Themes for 2013 and Beyond

- **Housing rebound is for real.**
- **Unemployment rate headed below the 6.5% Fed threshold during 2014.**
- **Energy growth dividend could add 1% to US annual real GDP growth over next ten years.**
- **International headwinds remain, but diminishing in force.**
- **Long-term fiscal policy compromise likely to remain out of reach of a polarized Congress.**
- **Fed to delay, delay, delay exit from zero-rate policies until inflation appears – none in sight.**

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US Economic Resilience

Housing

- Robust housing starts suggest net new construction jobs in 2013 sector -- good news

Labor Markets

- Solid private sector net job creation
- Government jobs contraction diminishing
- Overall labor force growth is slowing

Energy

- Growth dividend on the way

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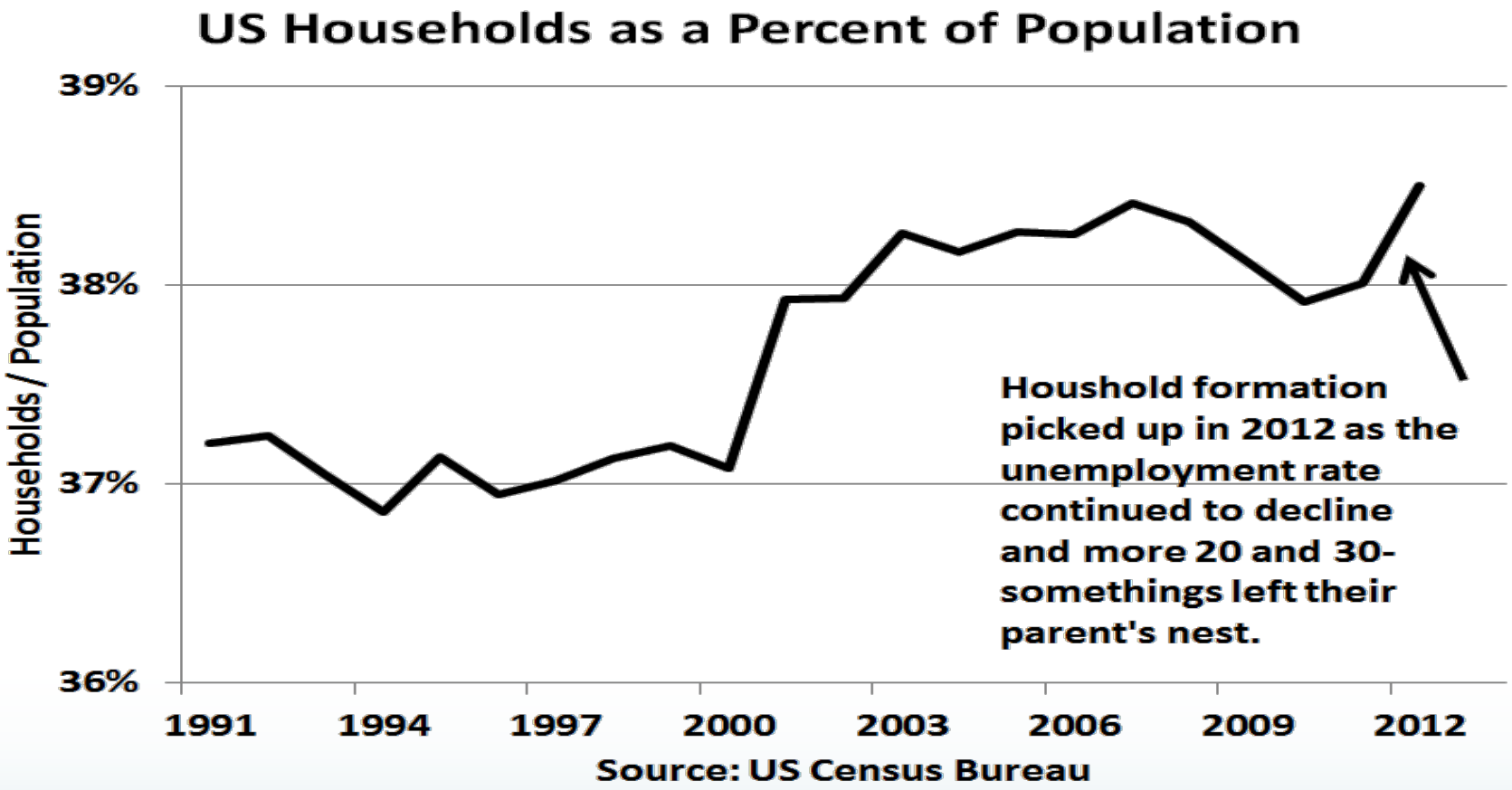
US Homes are affordable, but Household Formation has been Depressed until 2012



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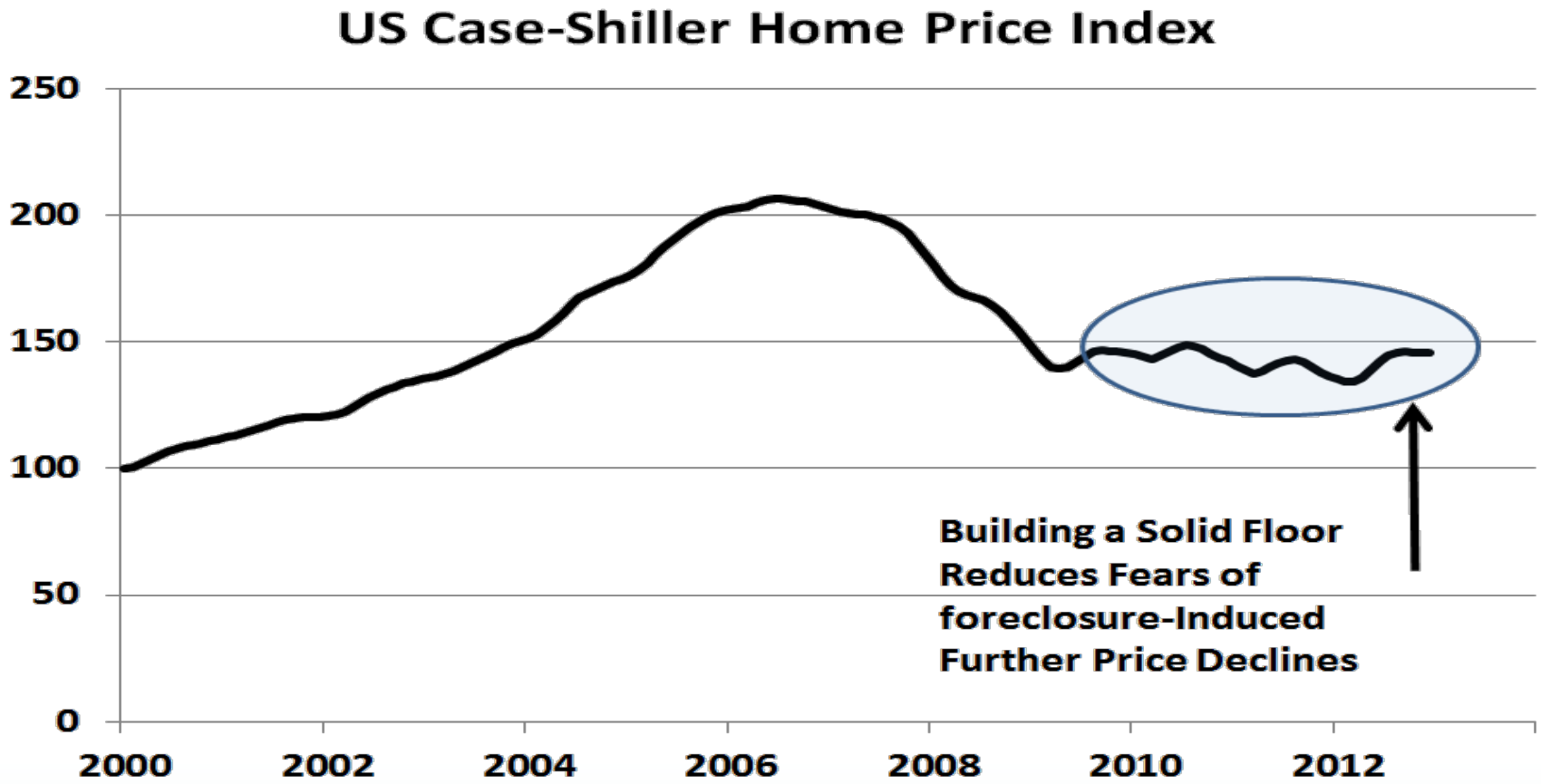
US Home Prices Finally Stabilized ….



Source: St. Louis Federal Reserve Bank FRED Database (SPCS20RSA)

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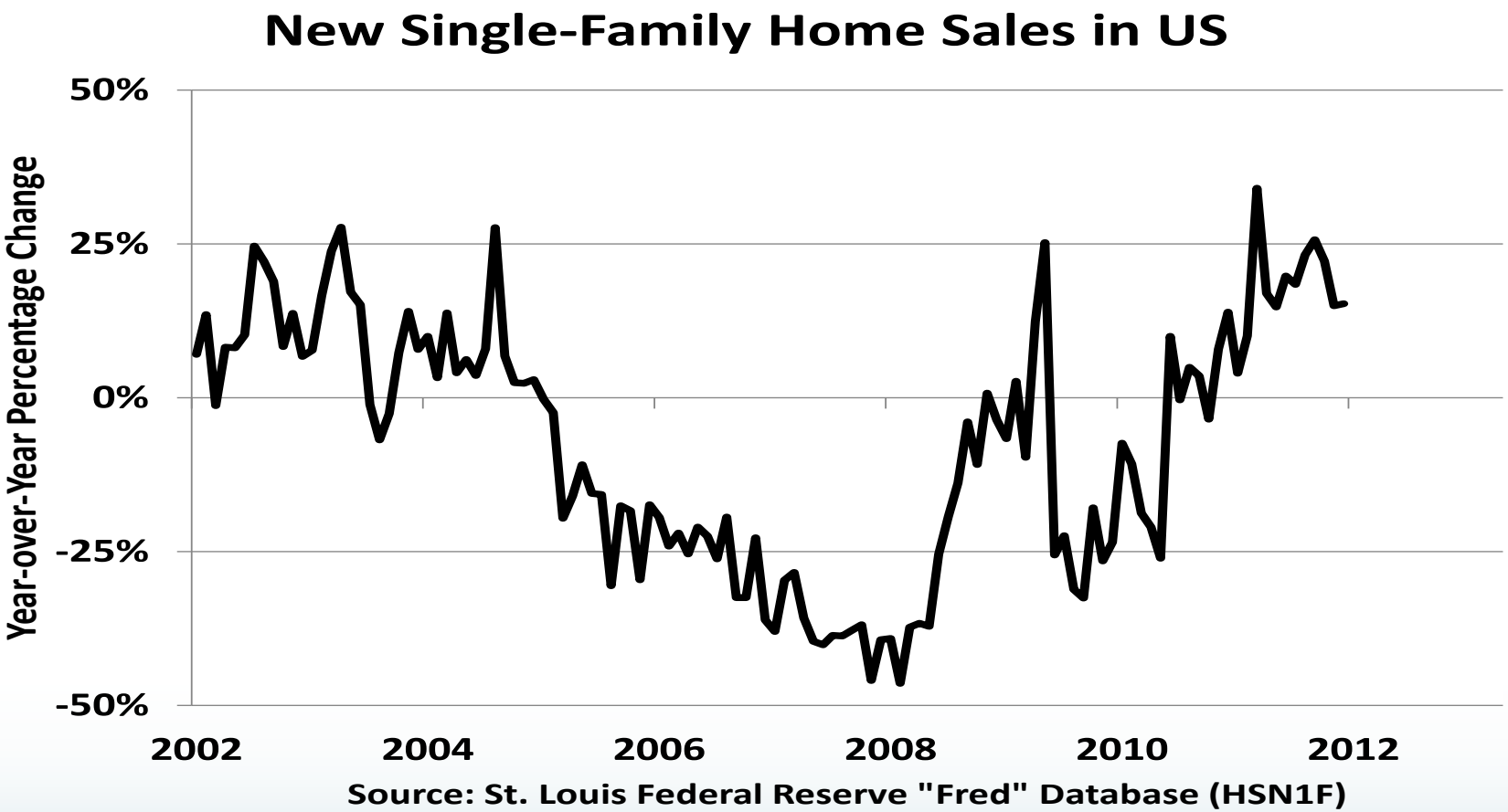
Leading to a Recovery in Single-Family New Home Sales …



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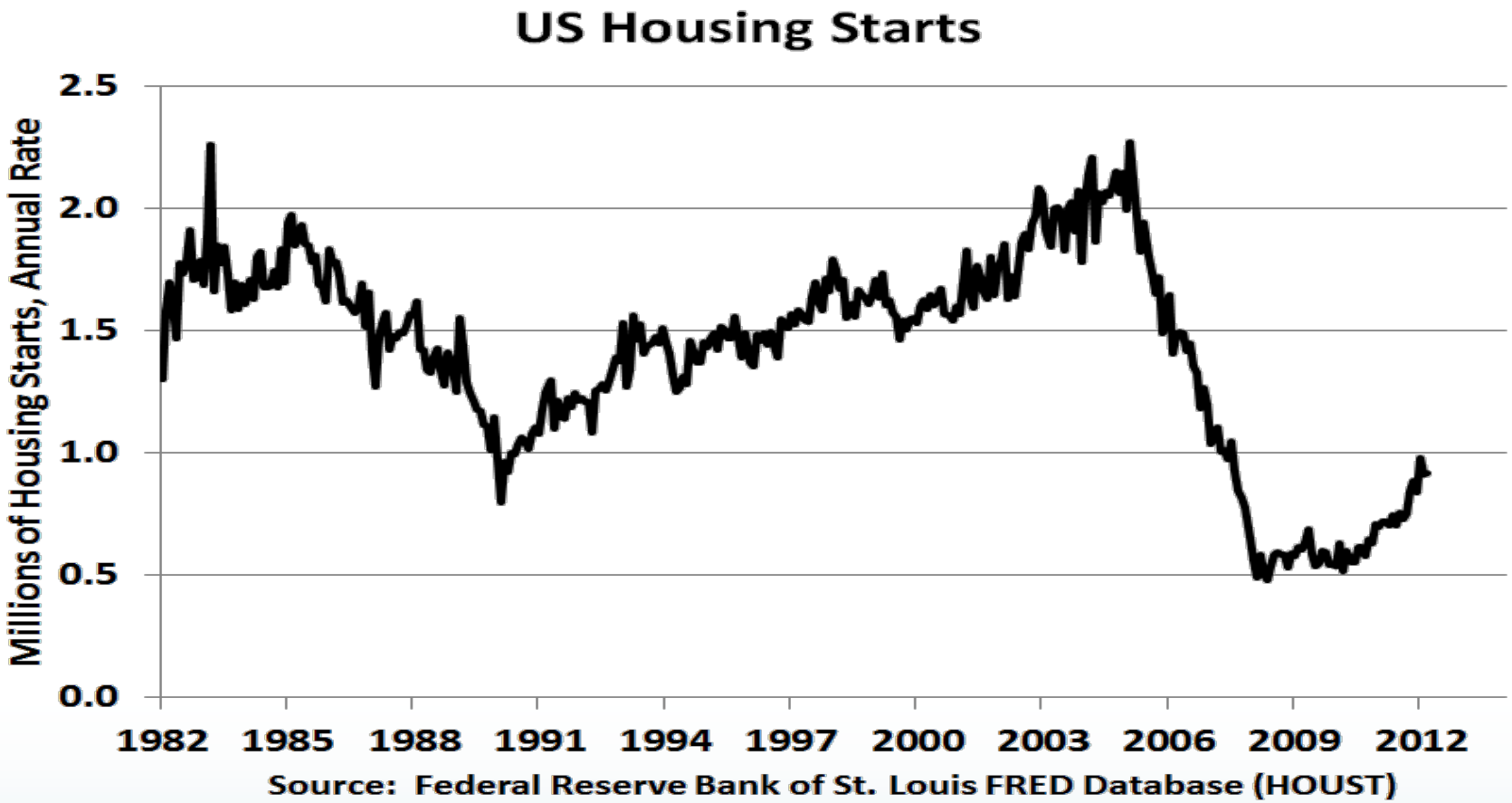
Rising Housing Starts Mean New Construction Jobs



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Private sector job creation has been strong

Source: Federsal Reserve Bank of St. Louis FRED Database (USPRIV)

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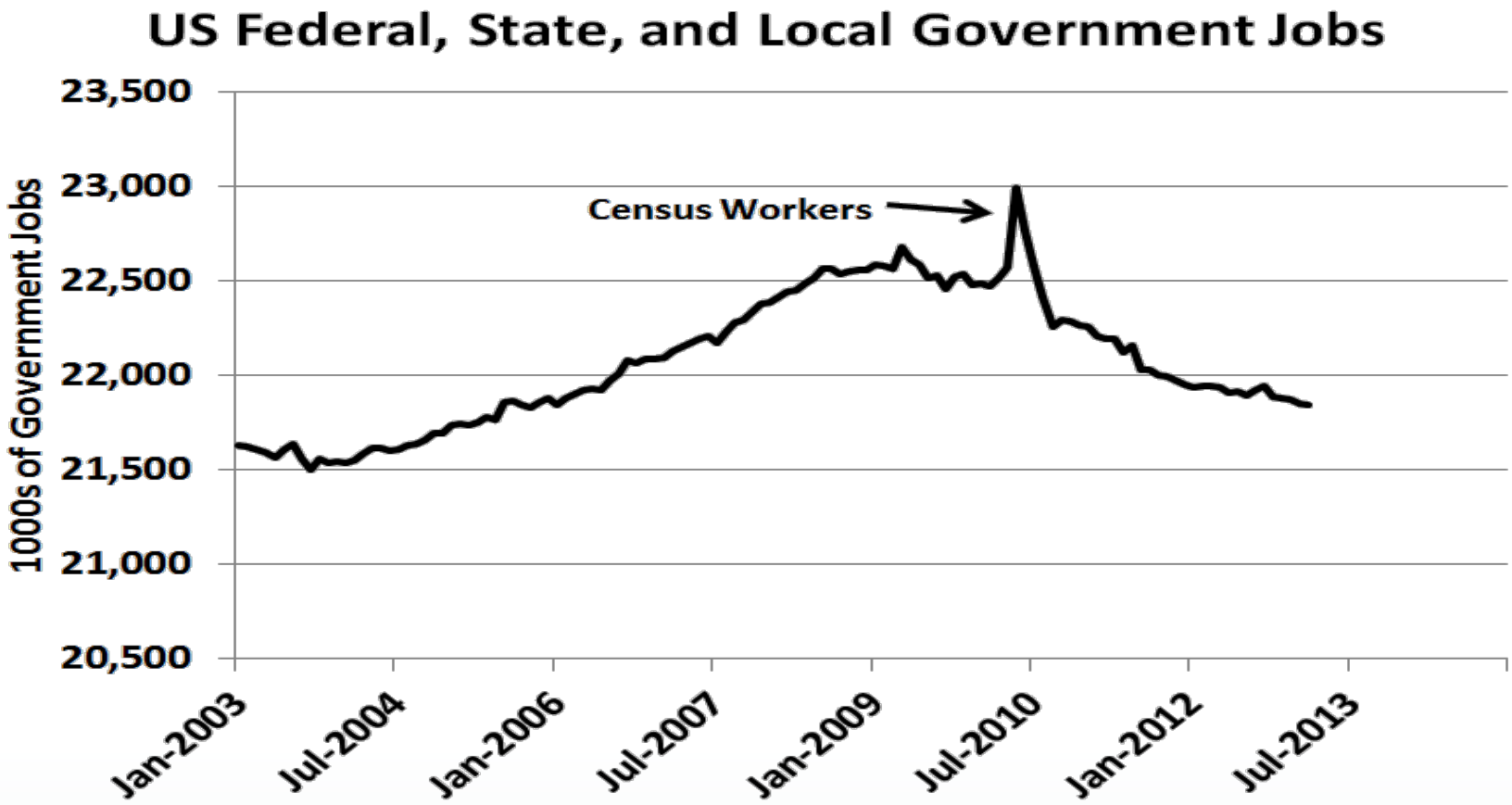
Government jobs have been contracting



Source: Federal Reserve Bank of St. Louis FRED Database (USGOVT)

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Implications for effectiveness of Federal Reserve quantitative easing

There is little likelihood that any amount of balance sheet expansion by the Federal Reserve has had or is going to have any impact on government job creation.

Federal, state, and local jobs were cut after the financial crisis in 2008, because government revenues were not sufficient to support expenses.

The good news is that state and local governments have reached a point where they now have their finances more or less in balance. Of course, the same thing cannot be said for the Federal government.

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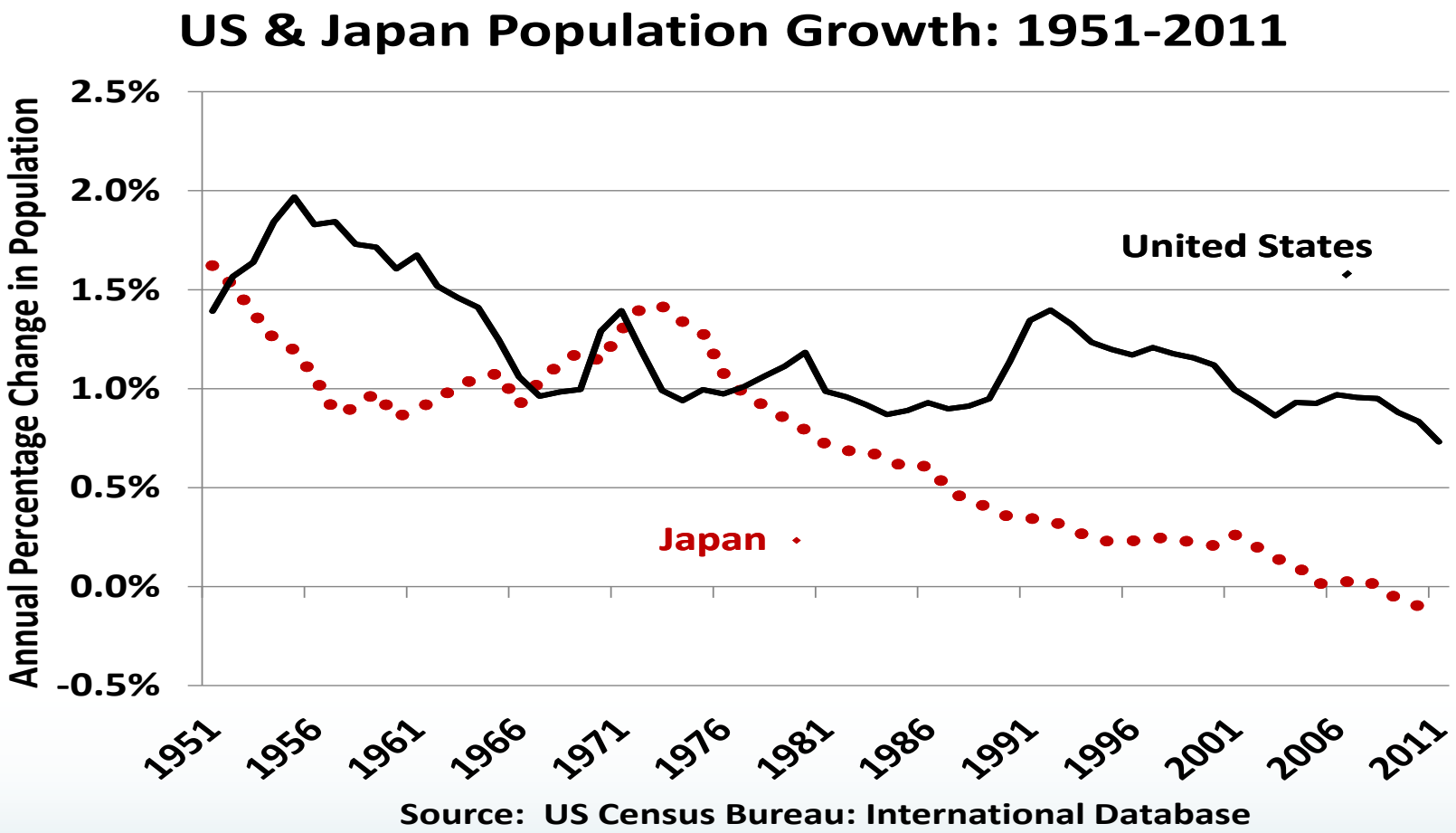
US Population Growth is Slowing – US is 20 years ahead of Japan



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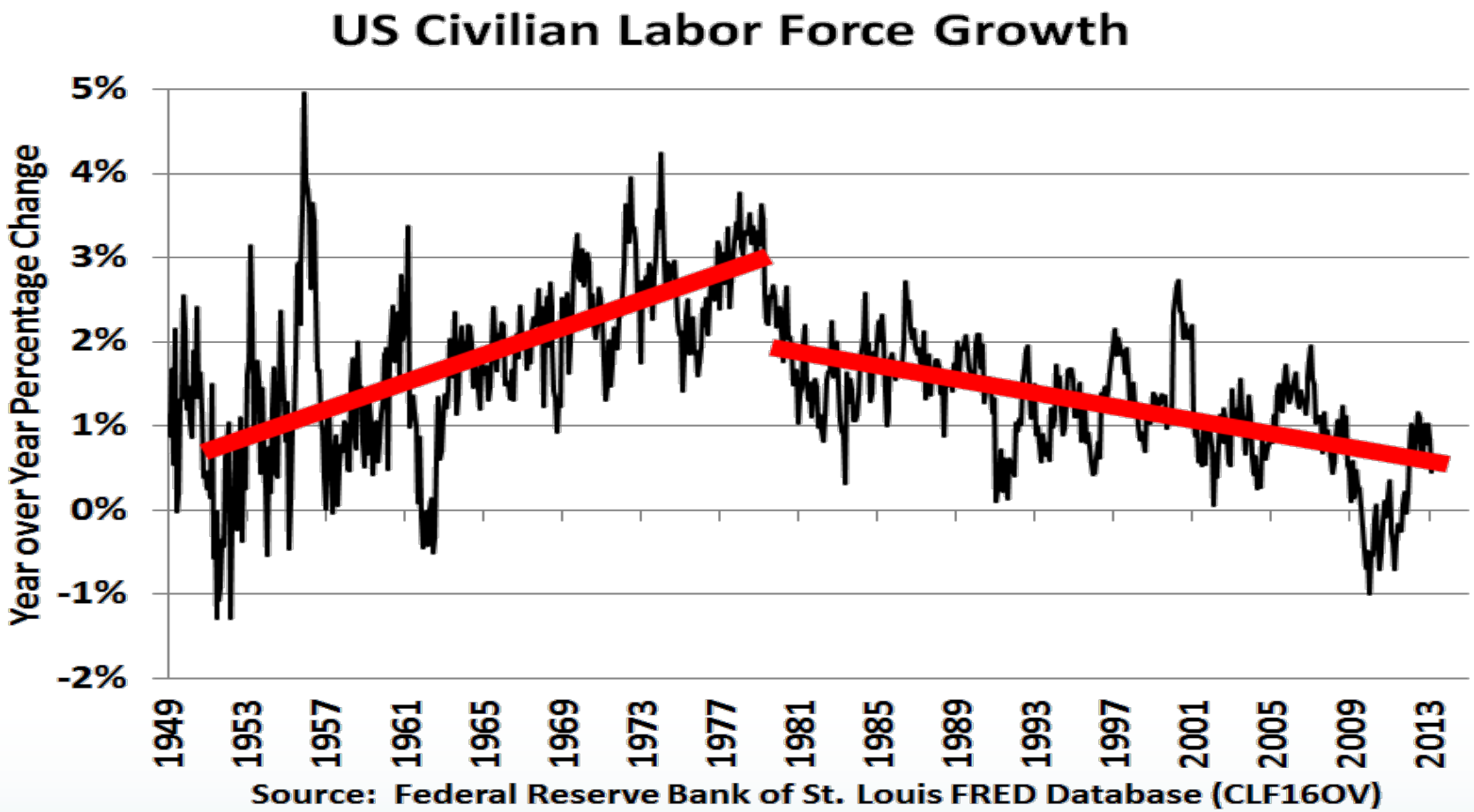
US Labor Force Growth – less than 1%/year



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Slower Labor Force Growth Implies

For a given amount of real GDP growth and net monthly job creation, the unemployment rate can fall more rapidly than otherwise.

That is, the denominator of the unemployment rate is not growing as fast while the numerator is shrinking.

Slower real GDP growth unless there are special factors (energy growth dividend).

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Increased Supply of Energy in the US Implies a Growth Dividend

Growth dividend depends on infrastructure development and industry adjustments to the new supply.

The pace of infrastructure develop is uncertain, but it is clearly underway.

The energy growth might reach 1% or more per year over the next ten years.

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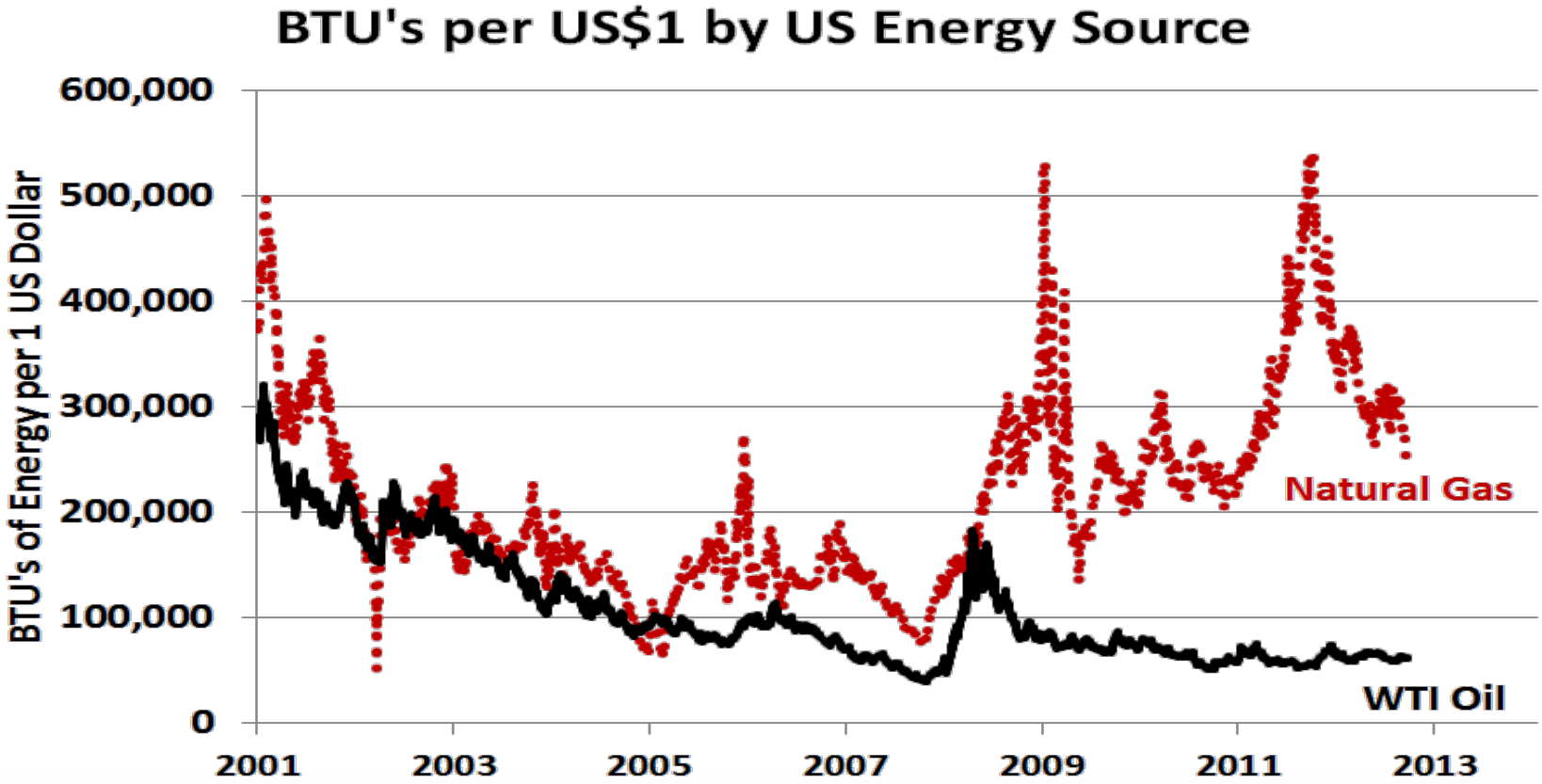
Energy Transformation is Underway in the US



Source: Bloomberg Professional for prices (USCRWTIC, NGUSHHUB), CME Economics Research for BTU conversion.

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Infrastructure Development is Happening

New pipelines are in the planning phase and some old pipelines have been reversed to move crude oil to refineries more efficiently.

More transit systems are using buses powered by natural gas.

Where feasible, electrical power generation has been switched to natural gas.

Fertilizer plants have been built near sources of natural gas.

The US steel industry is rebounding on the back of less expensive energy.

The list goes on.

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International Headwinds

Europe – Political uncertainties may destabilize Euro

China – No hard-landing from growth deceleration, but China is a on a glide path to industrial maturity

Japan – Monetary policy expansion to achieve 2% inflation target is likely to promote further yen weakening

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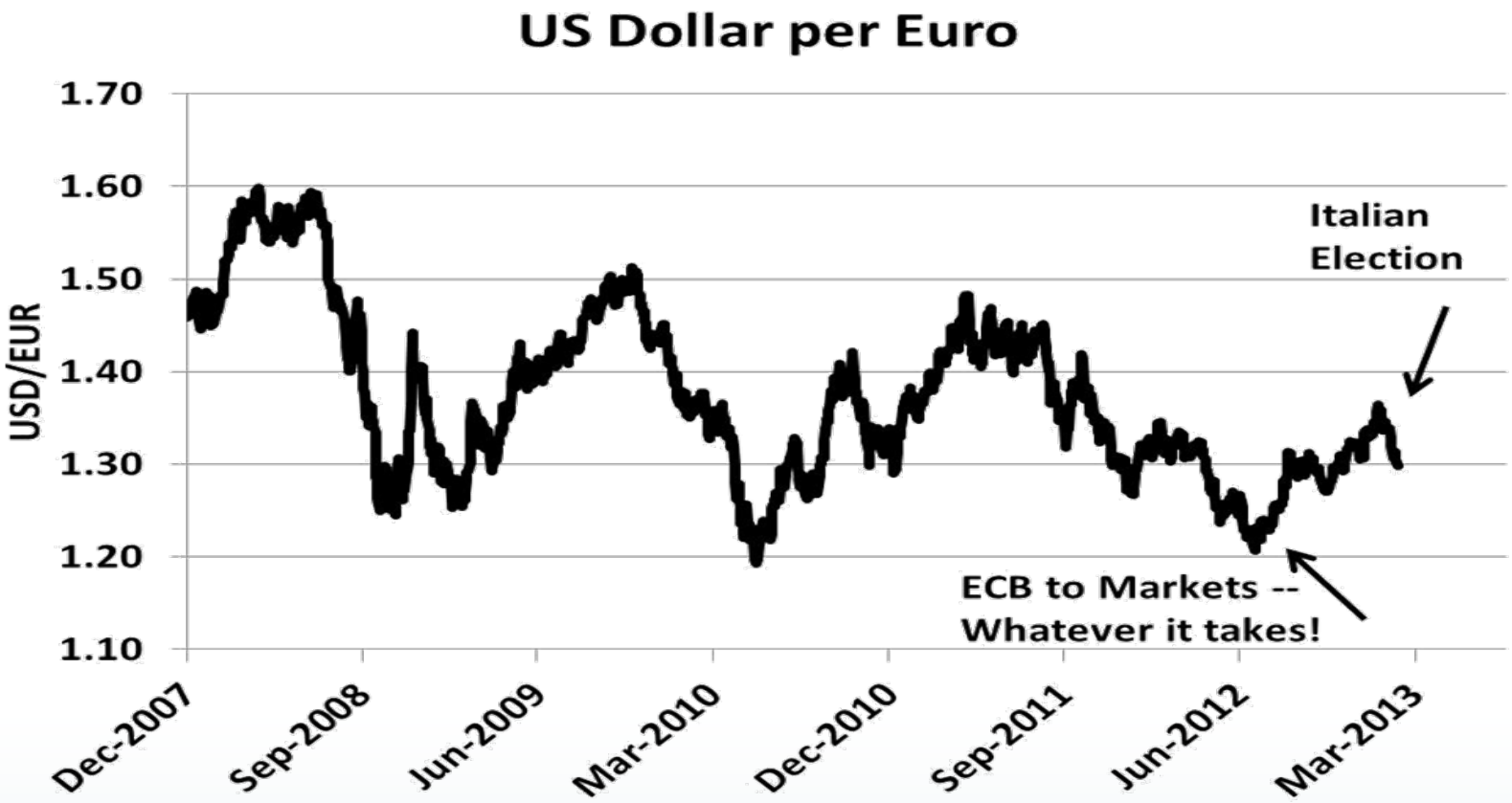
Euro Has Recovered from Worst of Break-up Fears, but Politics Matter Now



Source: Bloomberg Professional (EUR)

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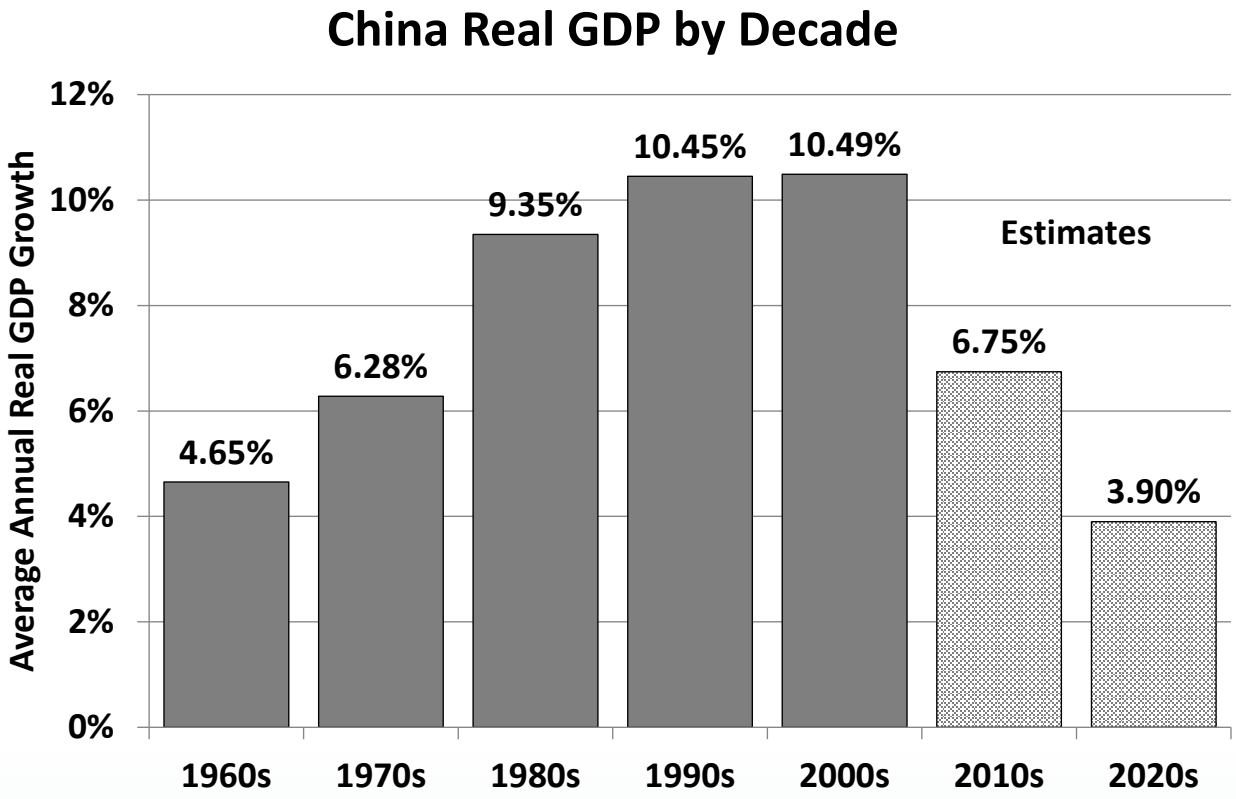
China stabilizing in the 7% real GDP range for 2013, then slowing into the 2020s



Source: World Bank Data through the Bloomberg Professional, CME Economics Estimates for 2012-2030.

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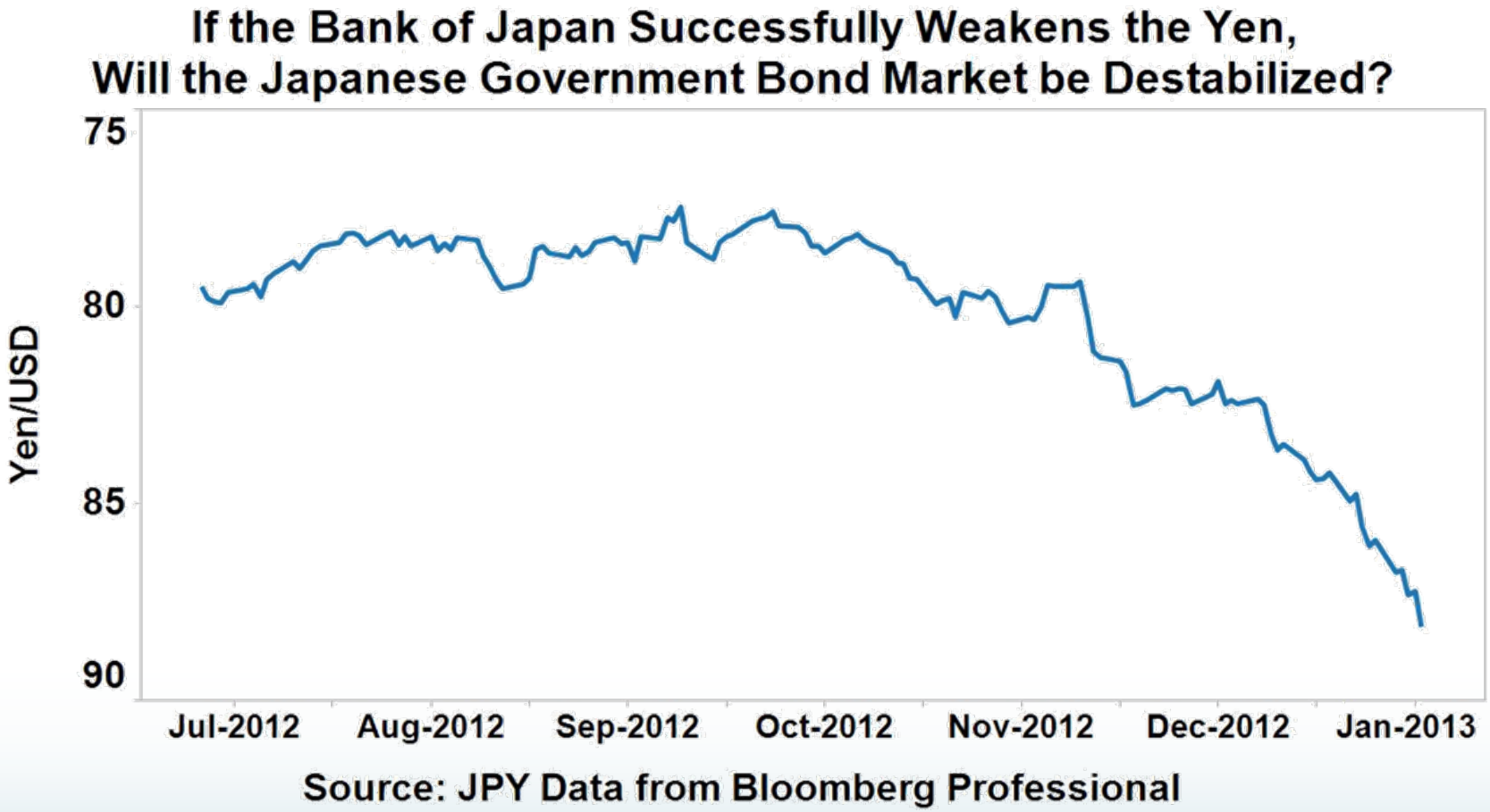
Japan Embarks on Currency Depreciation Policy and Expanded Quantitative Easing



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Long-Term Policy Risks

Fiscal Policy

- **Congress is polarized.**
- **No grand fiscal compromise likely.**

Monetary Policy

- **Fed may cease asset purchases by the end of 2013, assuming economic growth continues apace.**
- **Fed may delay commencing the process of raising the federal funds rate target until inflation pressures emerge, which could be one or two years after the unemployment rate declines below the Fed's 6.5% threshold.**
- **The Fed may never sell assets, holding them until maturity to avoid causing a severe steepening of the yield curve.**

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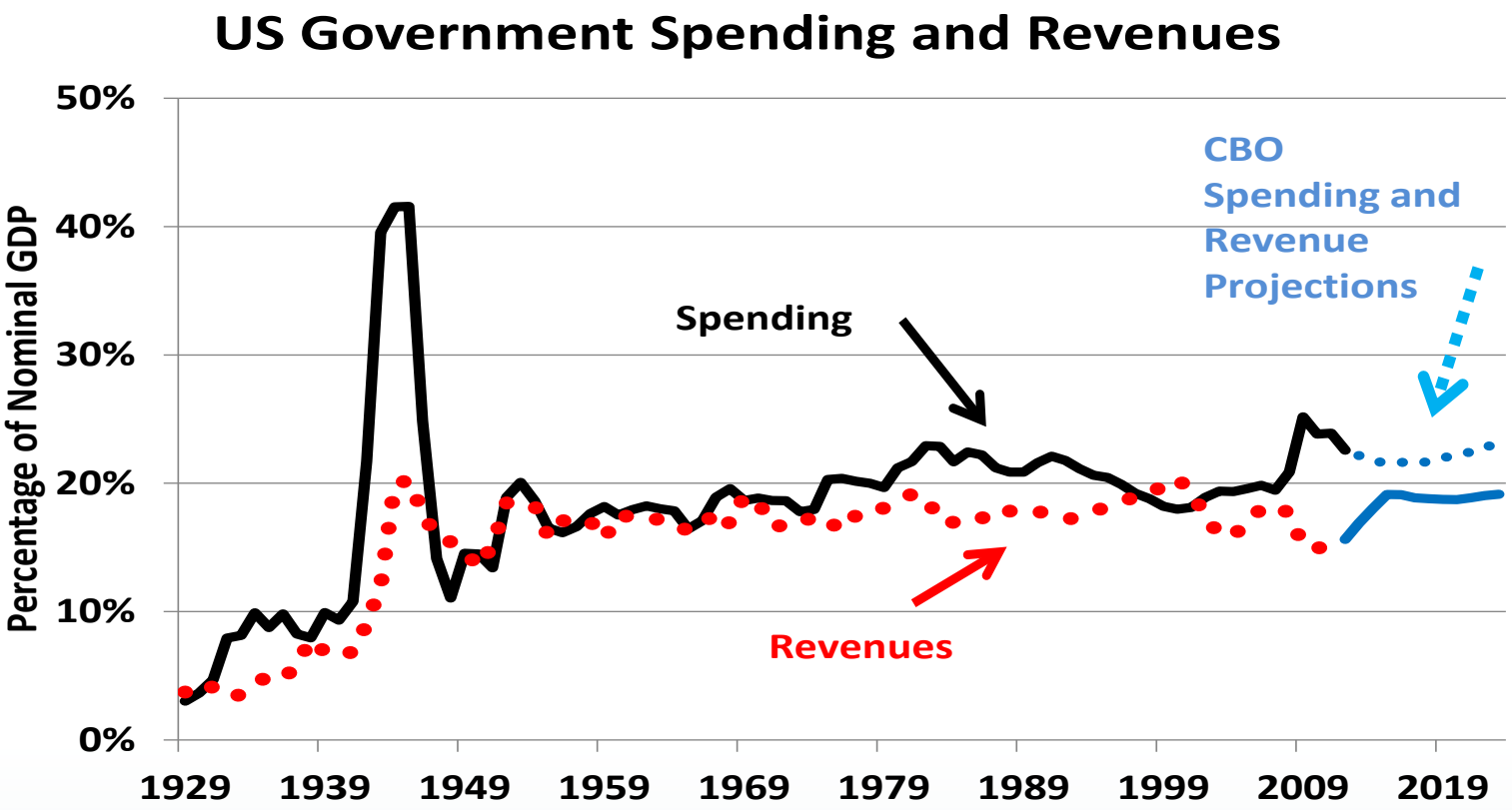
The Spending Debate in the US Congress



Source: Historical Data from the St. Louis Federal Reserve FRED Database (FYONET, FYFR), and Projections from the Congressional Budget Office

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2013 -- Back to the Quantitative Easing Debate

Evaluating Why QE Did Not Help Create Jobs: "Essential concepts necessary to consider when evaluating the efficacy of quantitative easing," *Review of Financial Economics*, 2013, (Bluford H. Putnam)

Unintended Consequences of QE: "Ultra easy monetary policy and the law of unintended consequences," Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, 2012, Working Paper no. 126 (William R. White).

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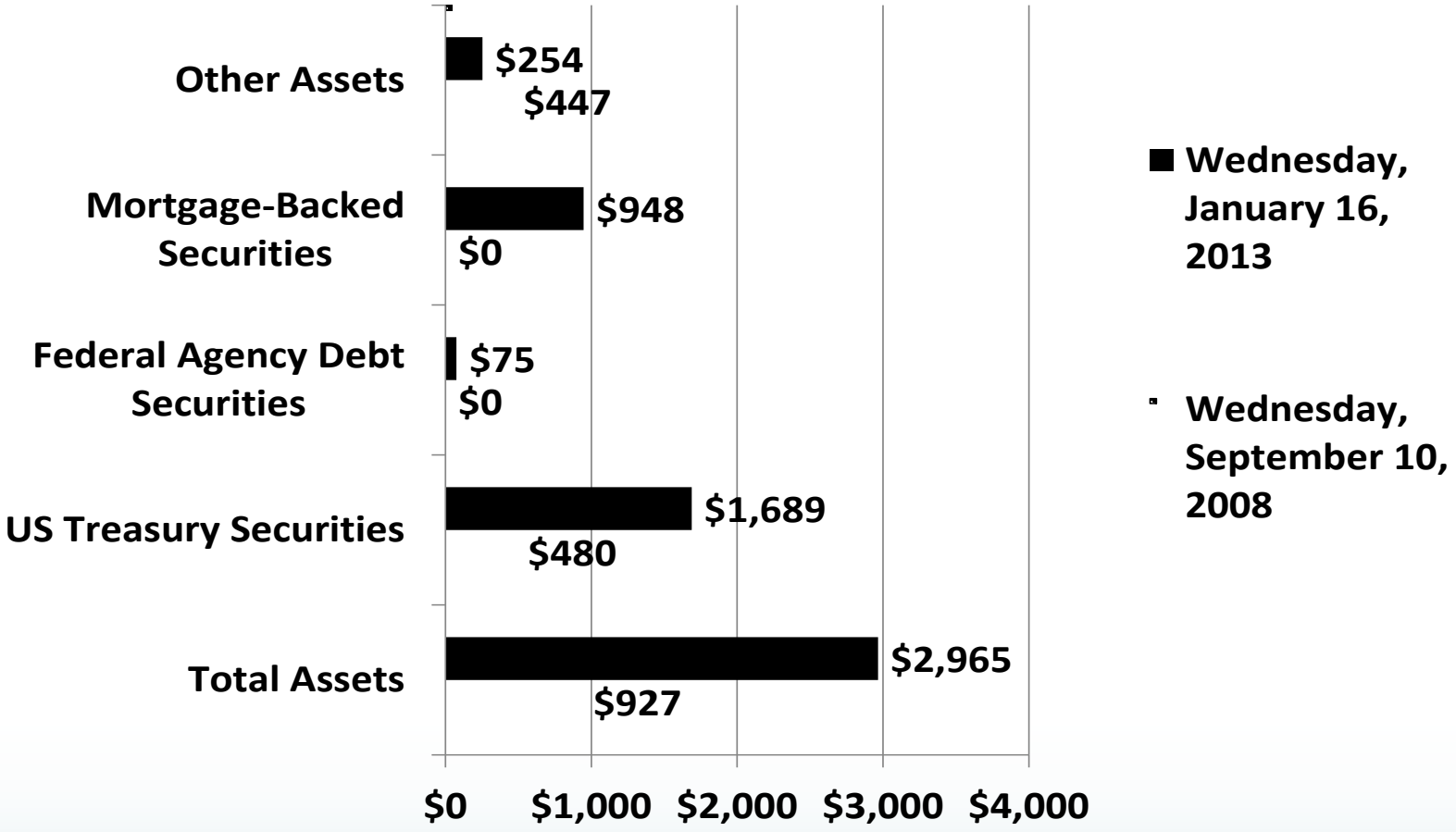
US Federal Balance Sheet Expansion

Assets of the US Federal Reserve ($Billions)



Source: Federal Reserve Release H.4.1, Table 8.

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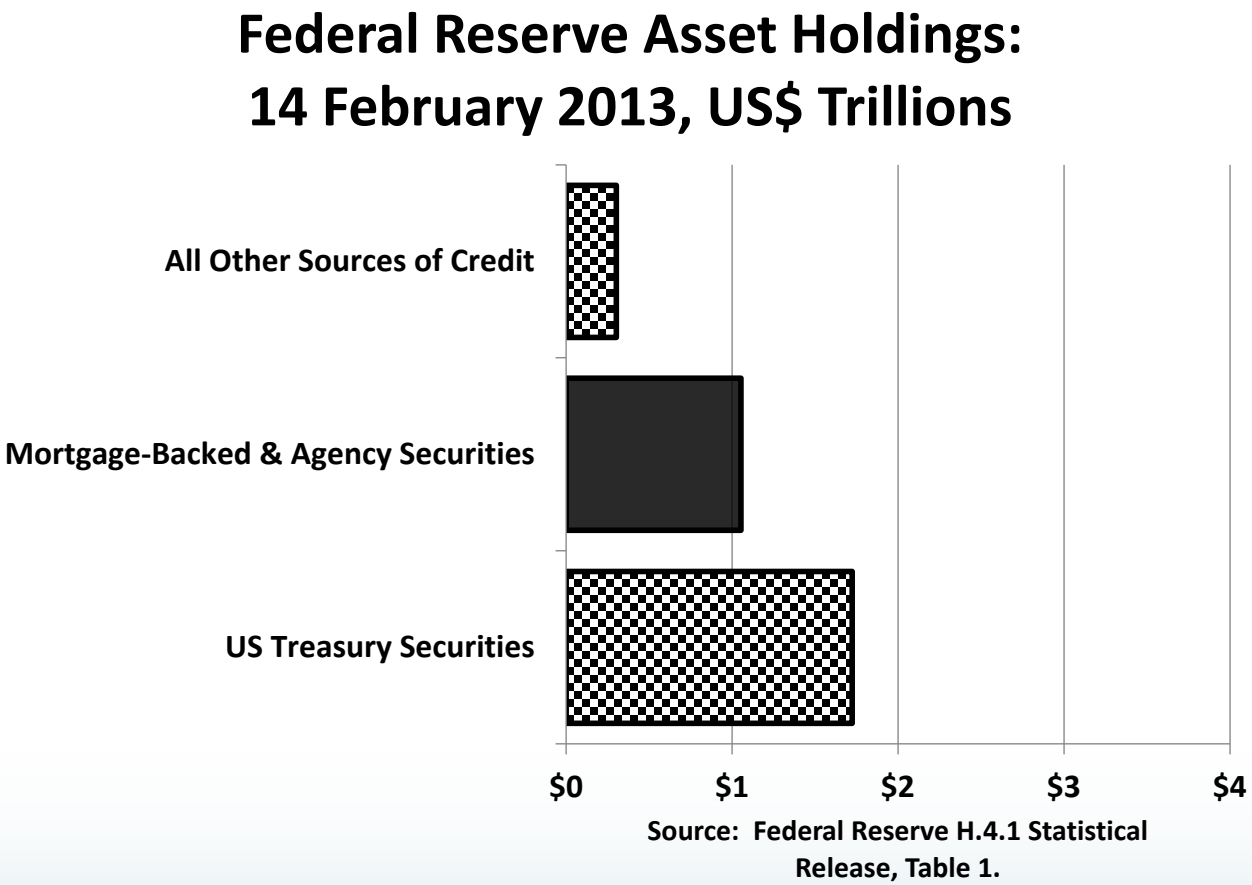
What the Fed Owns



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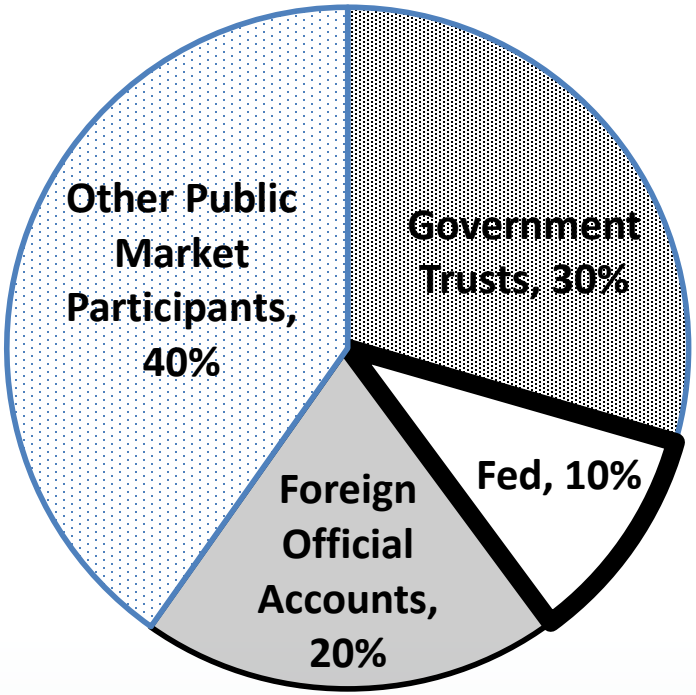
Ownership of US Treasury Debt

Percent of US Government Debt Held by Various Types of Entities



Source: US Treasury for Gross Government Debt and Intergovernmental Trust Holdings, Federal Reserve H.4.1 release for Fedearal Reserve Treasury Security Holdings and Foreign Official Acocunt Holdings.

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Too Many Assets to Sell

The Federal Reserve may choose to hold its assets until maturity.

The Fed will not want to destabilize a perceived fragile housing recovery by selling mortgages.

The Fed will not want to push bond yields higher and raise US Treasury interest expense by selling US Treasuries.

The Fed just may decide to never sell.

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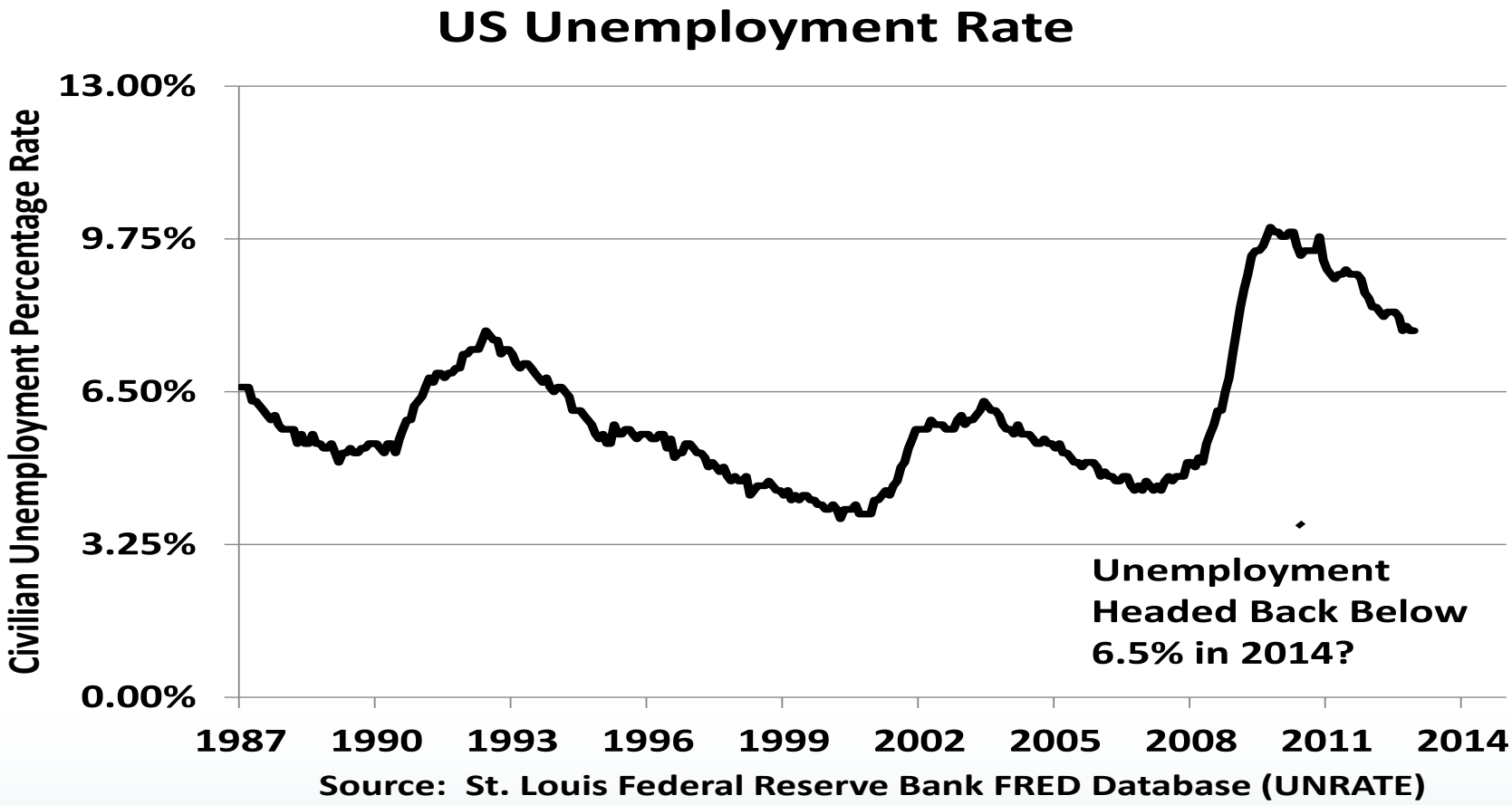
The Fed has 6.5% Unemployment as a "Threshold" for reconsidering its rate policy



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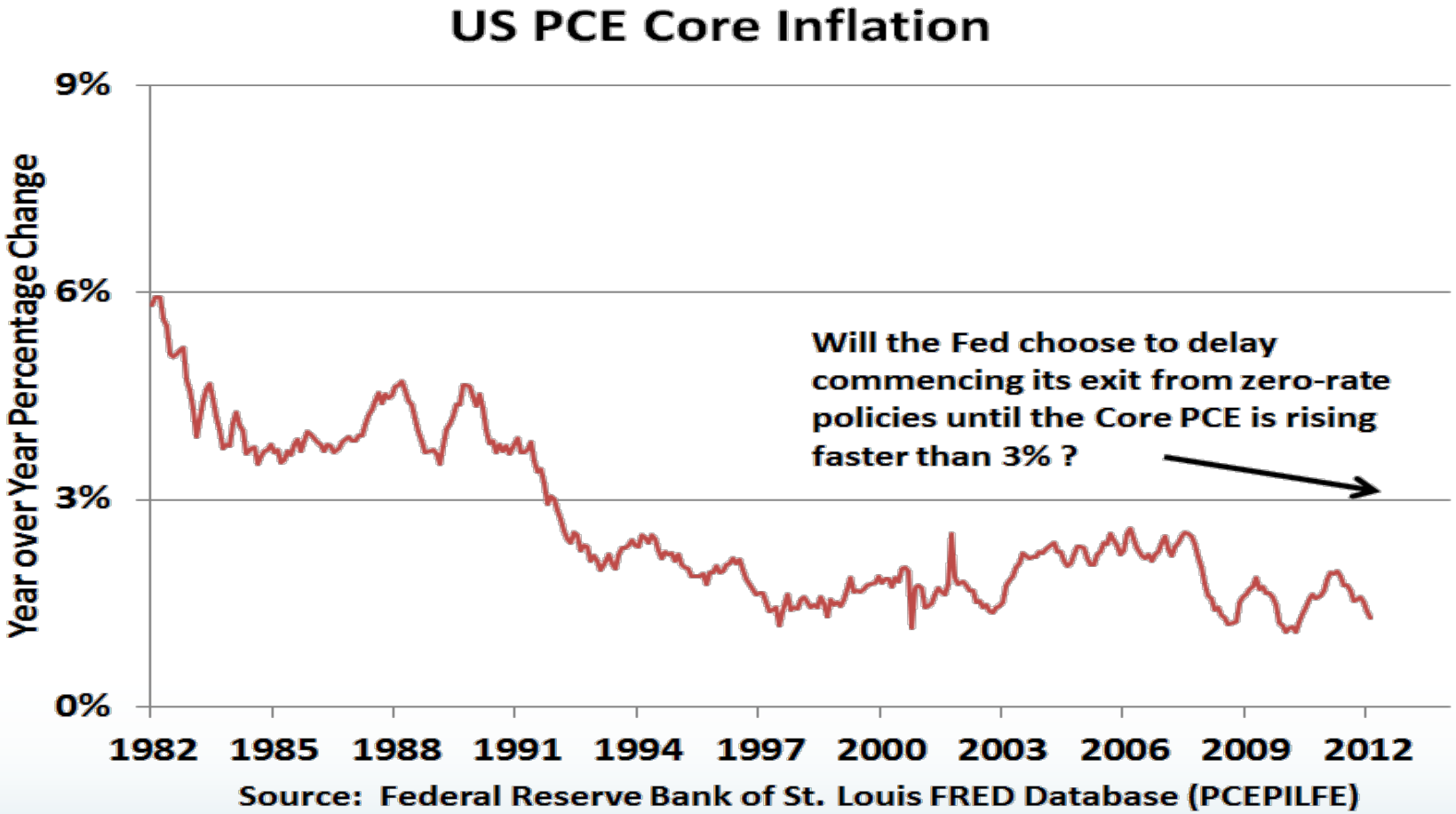
But, the Fed may delay zero-rate exit until inflation pressure emerges, regardless …



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Summary of Key Points: US Economy

US Housing is on the rebound, and rising housing starts will lead to net new construction jobs in 2013.

The US labor force is on a secular trend toward much slower growth, which implies that the unemployment rate can fall faster for a given number of net new jobs each month than typical historical rules of thumbs might suggest.

Expanded energy supply in the US is likely to lead to an energy growth dividend, which could be 1% or higher in added annual real GDP growth over the coming decade.

International headwinds from a stagnating Europe and slowing China represent modest drags on the US economy, but their influence is diminishing from previous years.

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Summary of Key Points: Long-Term Policy

Congressional political incentives for compromise are not sufficient to suggest the likelihood of any long-term budget compromise, now or after the 2014 elections.

The Federal Reserve is likely to focus as much or more on its inflation mandate as its unemployment concerns, which means that the trigger for exiting its zero-rate policies may be the inflation rate, not the unemployment rate.

Since there are no signs whatsoever of inflation pressures, this means the Federal Reserve may delay commencing to raise the federal funds rate target to long after the unemployment rate has declined below the threshold level of 6.5%.

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