Deutsche Bank

US Outlook for 2014
Higher wages and a shrinking fiscal drag: Rates, dollar, stocks moving higher

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Torsten Slok, Ph.D.
Chief International Economist
Managing Director
60 Wall Street
New York, New York 10005
Tel: 212 250 2155
Torsten.Slok@db.com

Significant upside risks to the US economic outlook

1. **With rising home prices we now have an accelerating virtuous cycle between the housing sector, banking sector, and consumers**.
2. **Smaller fiscal drag** going forward will boost growth as we go through 2014.
3. **Declining oil prices** and a coming bear market in oil will boost growth in 2014.
4. **Wages are rising** so we are finally seeing income growth.

Are we in a period of secular stagnation? No, this is wrong for a number of reasons:

1. The reason there was no inflation problem in 2004-2006 was because the Fed was hiking rates during that period.
2. Wealth in the economy continues to increase, that will at some point spur an acceleration in growth.
3. One important reason growth has been weak following the crisis has been the fiscal drag and that drag is big in 2013 and is much smaller in 2014 and 2015.
4. If there is so much slack in the labor market why are wages then rising across all industries (except construction) and why are unit labor costs then trending up?
5. Yes, demographics will weigh on growth for a while but there are other production factors/growth sources (namely capital and productivity). Do we really believe the US has lost its ability to invent IPads and IPhones in the future?

Secular stagnation is a nice academic concept but unfortunately it doesn't fit with the data. The conclusion in Reinhart and Rogoff was that it takes time (7 years) to get over a banking and a housing crisis but after that period the economy starts to grow again. Add 7 years to 2007 and we may be closer to growth than many people think.

US Economic Outlook

The ongoing housing recovery is healing household and banking sector balance sheets

Household sector balance sheet

Banking sector balance sheet

Government sector balance sheet

Corporate sector balance sheet

Rising home prices

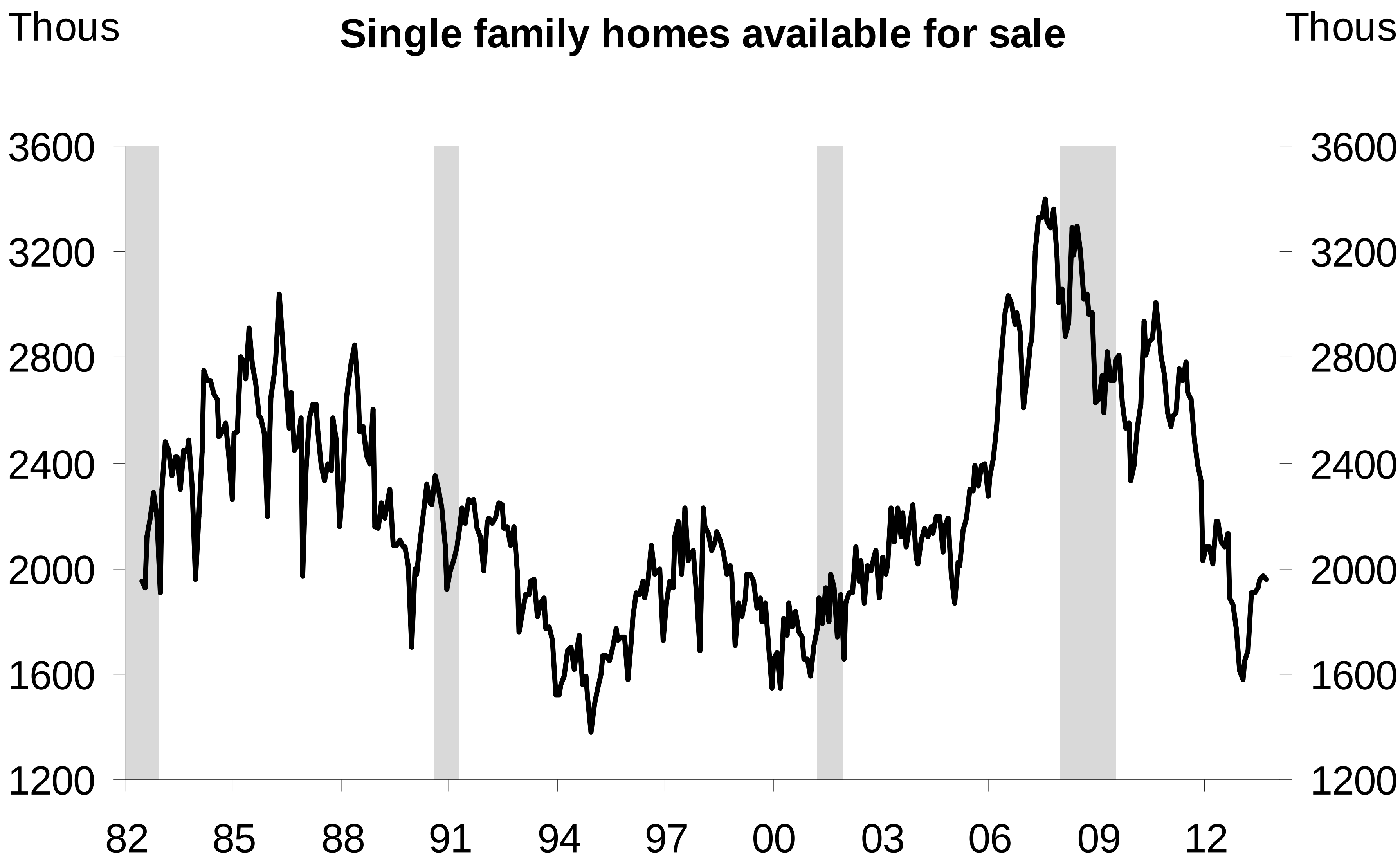
Sequester will have modest impact on 2013 GDP growth (-0.5%)

In stellar shape

Source: DB Global Markets Research

Housing recovery continues

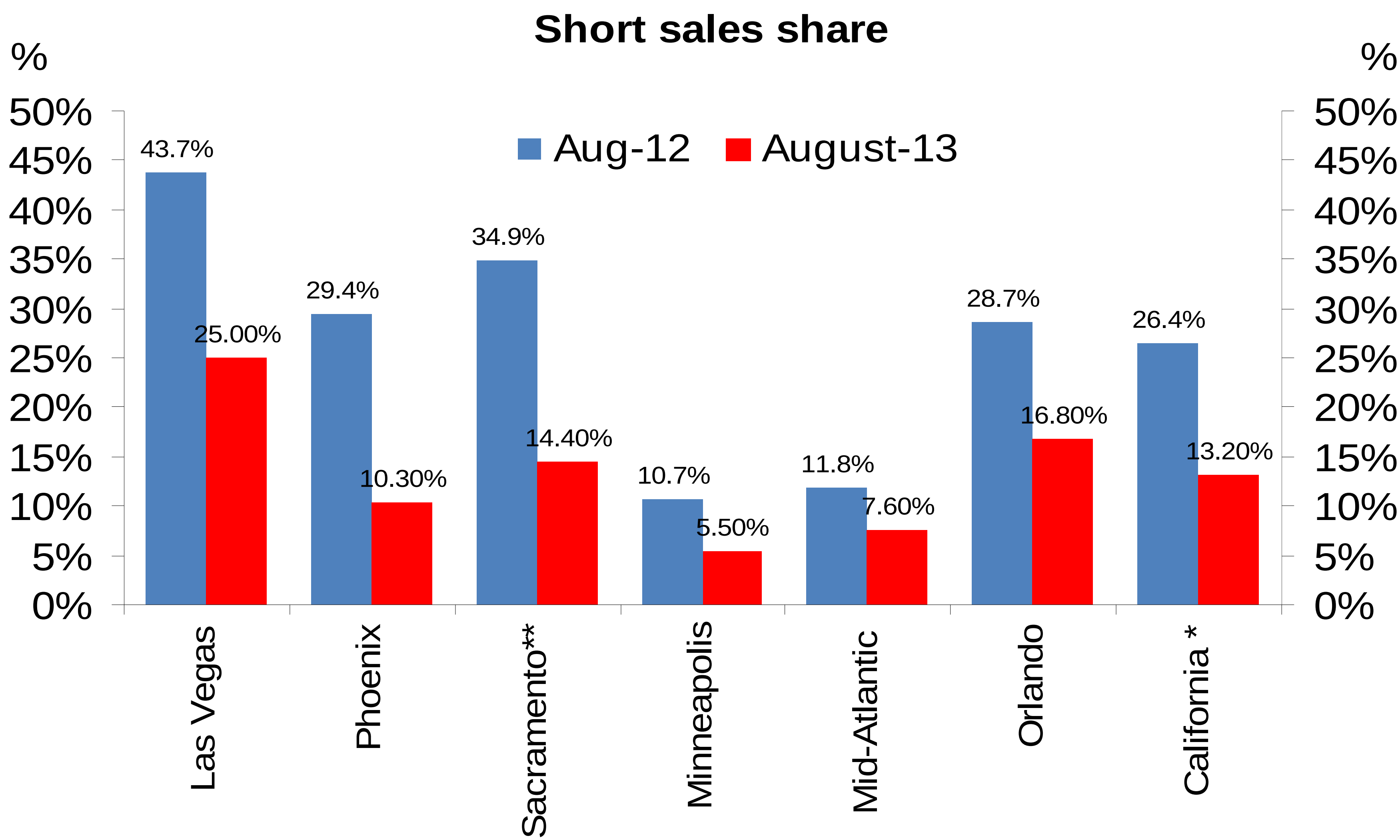
The number of homes for sale is very low…



Source: NAR, Haver Analytics, DB Global Markets Research

Torsten Slok, torsten.slok@db.com +1 212 250-2155

…share of short sales falling across the country…

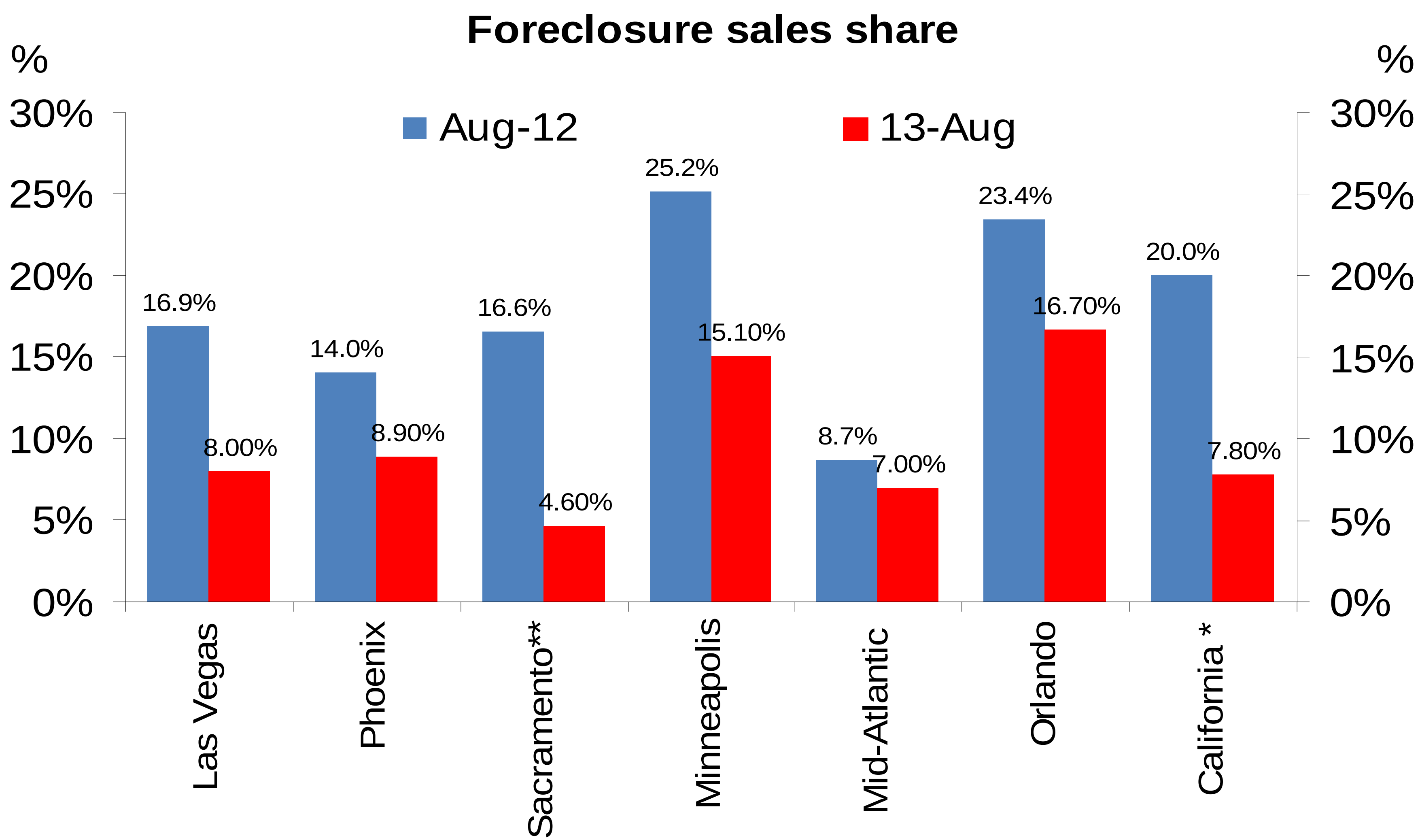


*share of existing home sales, based on property records

**Single Family Only

Source: Tom Lawler , DB Global Markets Research

…foreclosure share of existing home sales falling…

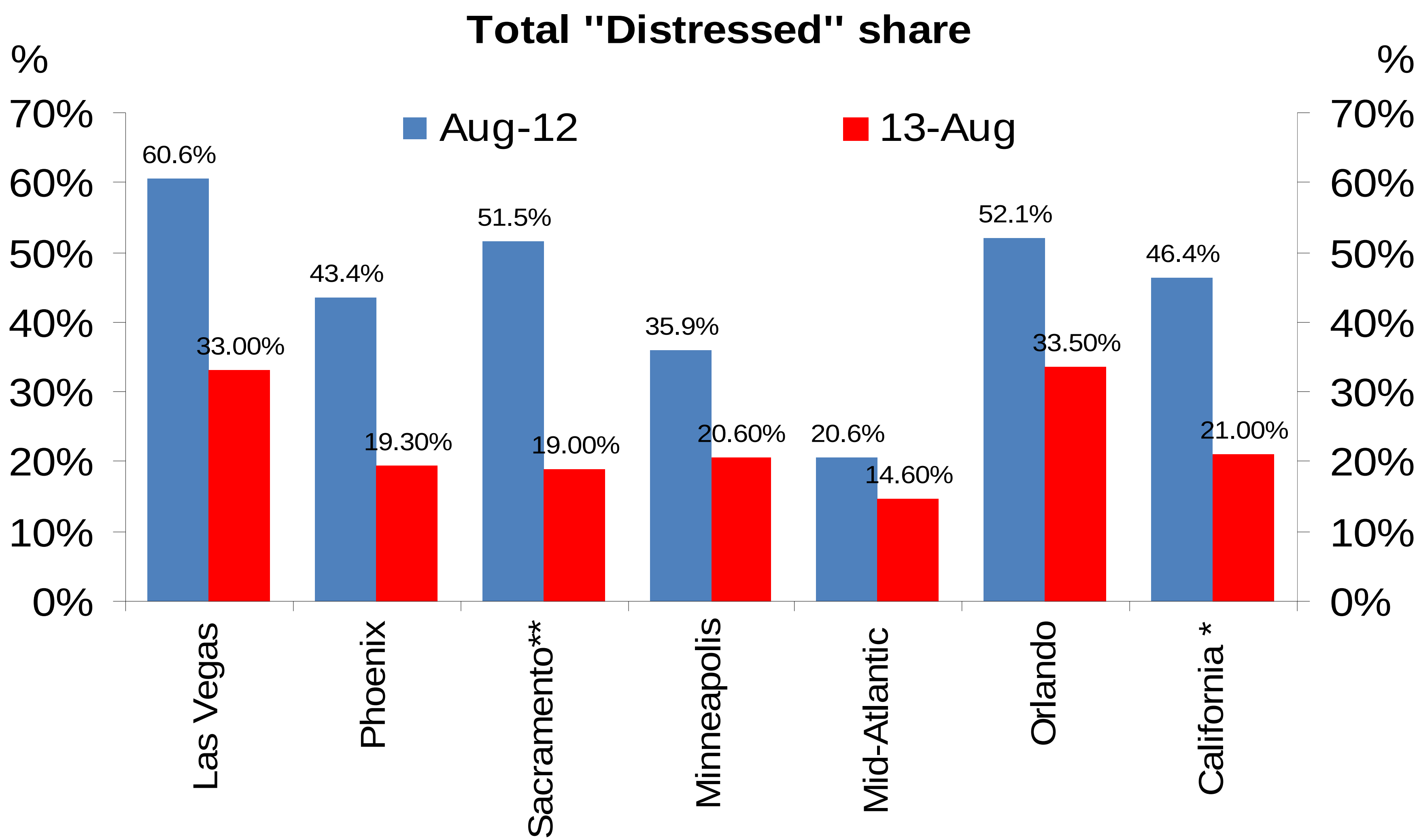


*share of existing home sales, based on property records

**Single Family Only

Source: Tom Lawler, DB Global Markets Research

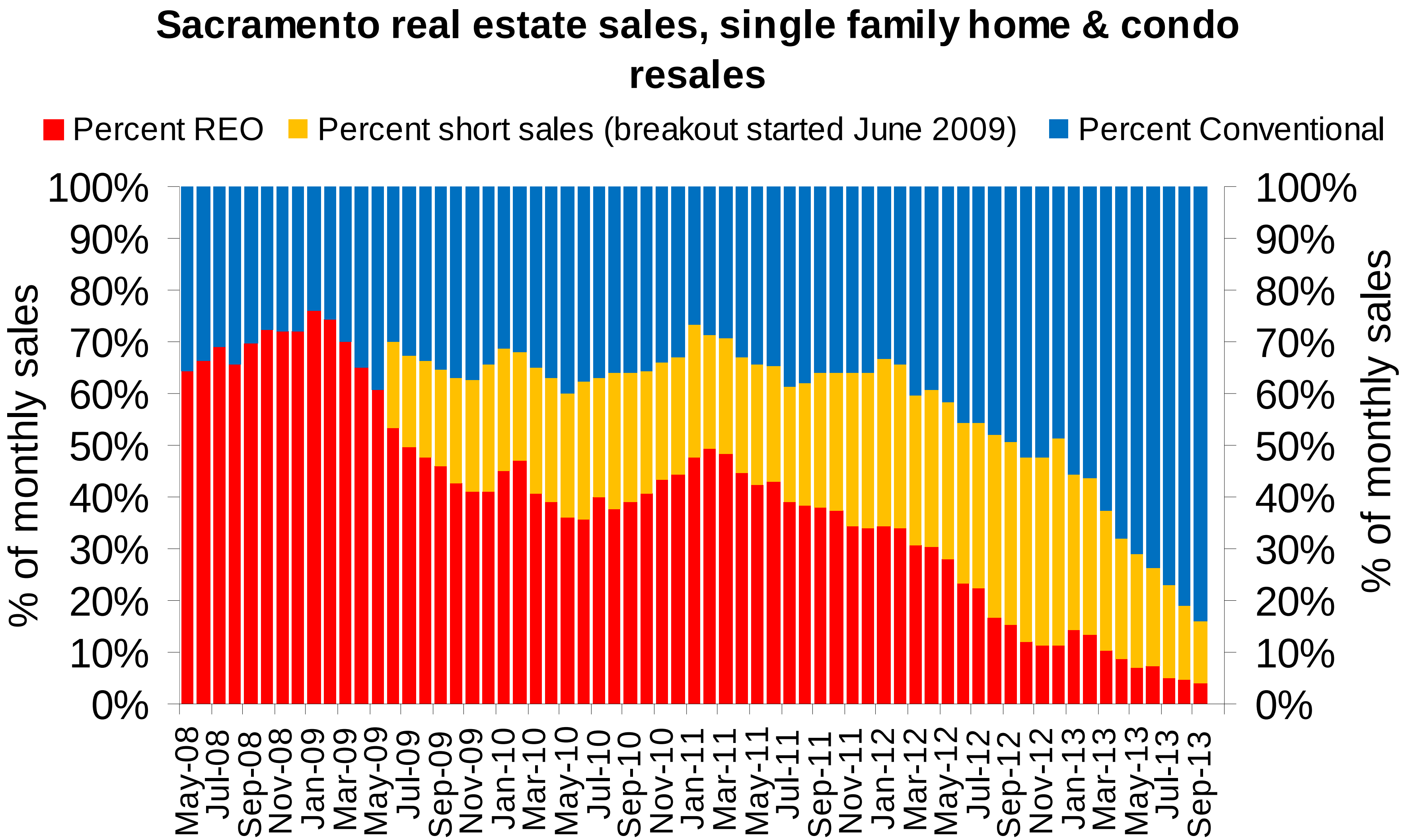
…and distressed share falling



*share of existing home sales, based on property records
**Single Family Only

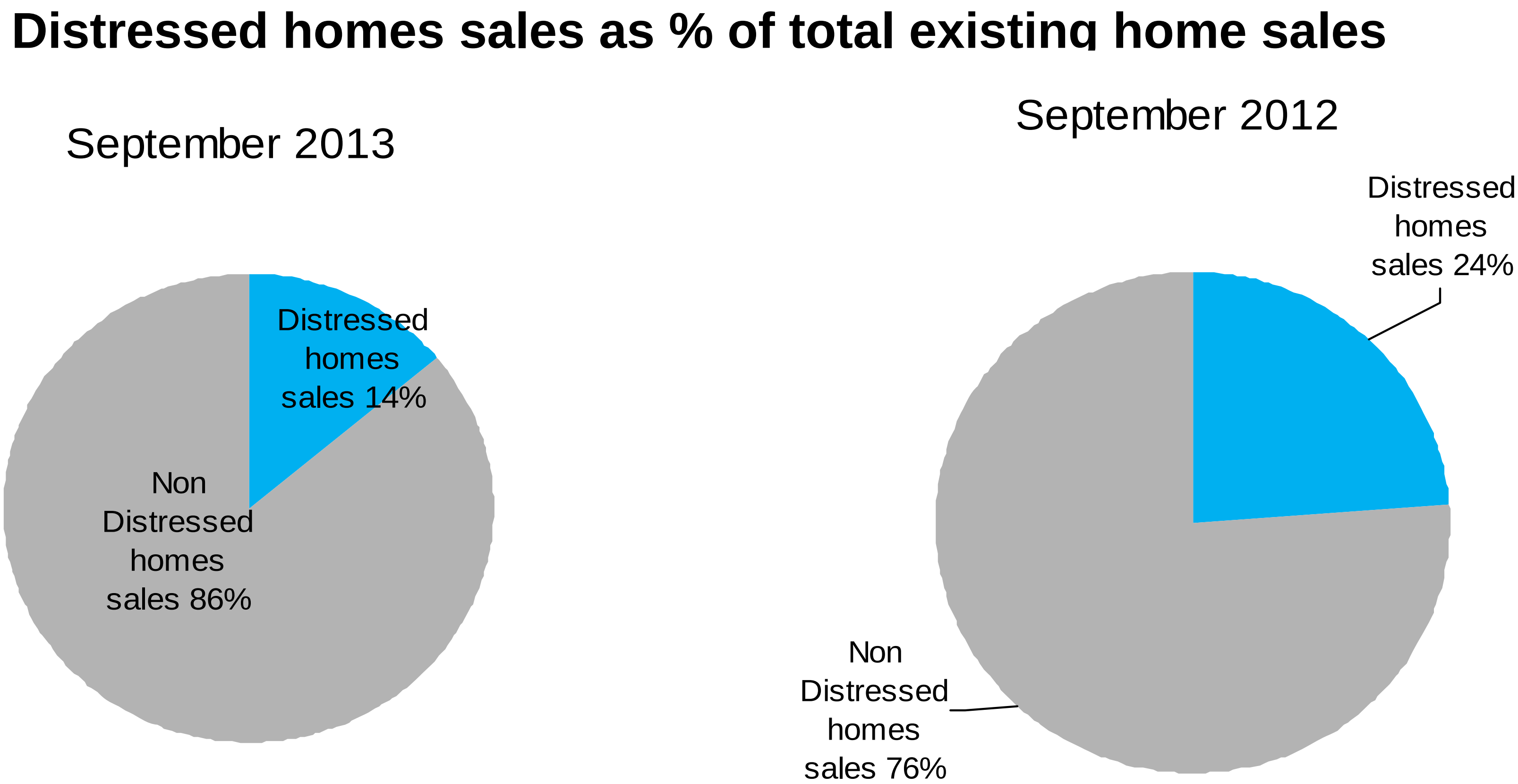
Source: Tom Lawler, DB Global Markets Research

Sacramento as an example: More conventional home sales



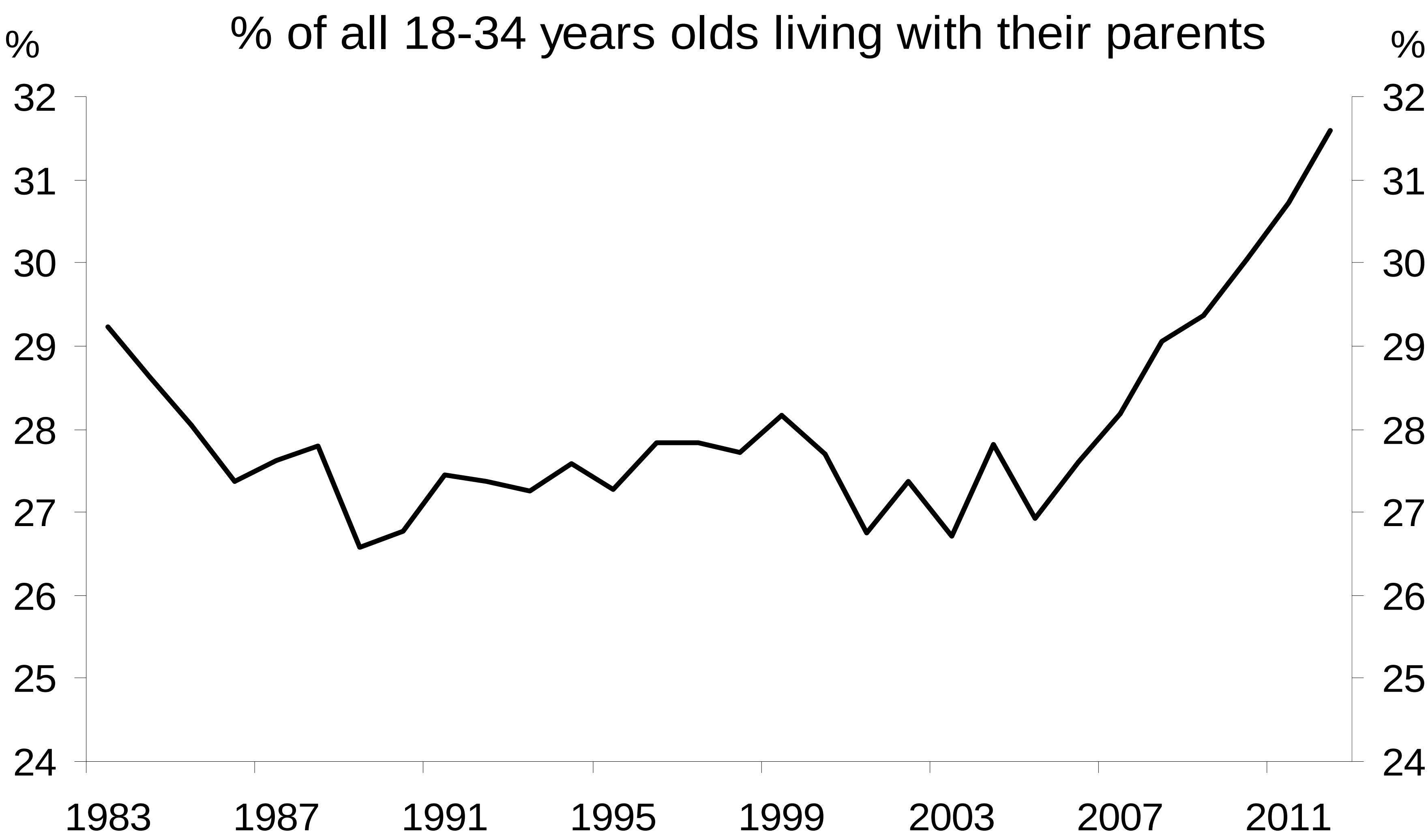
Source: Sacrealtor.org, DB Global Markets Research

Share of distressed sales has lowered significantly



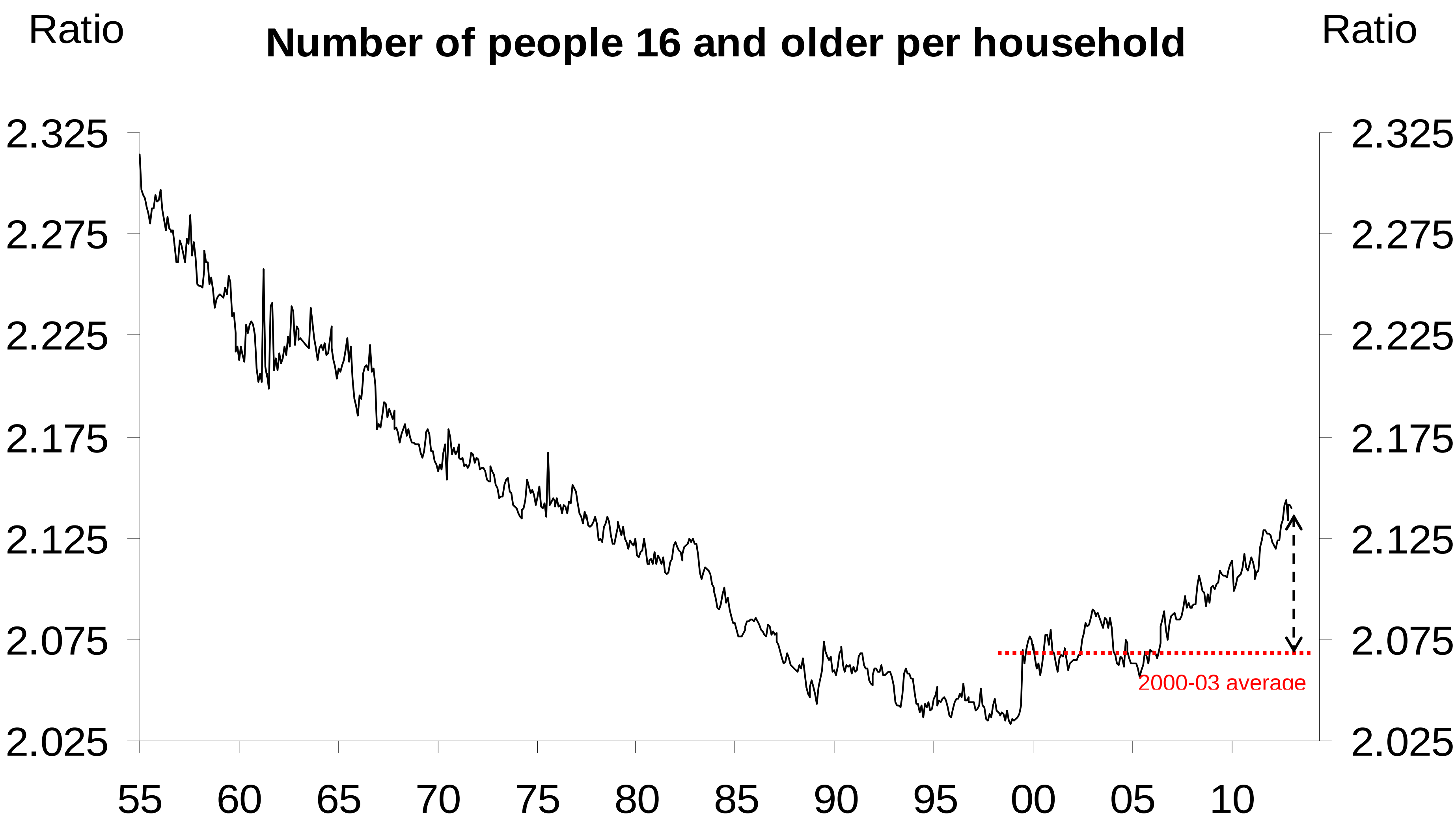
Source: NAR, DB Global Markets Research

Substantial pent-up demand for housing: Almost 1/3 of 18-34 year olds now living with their parents



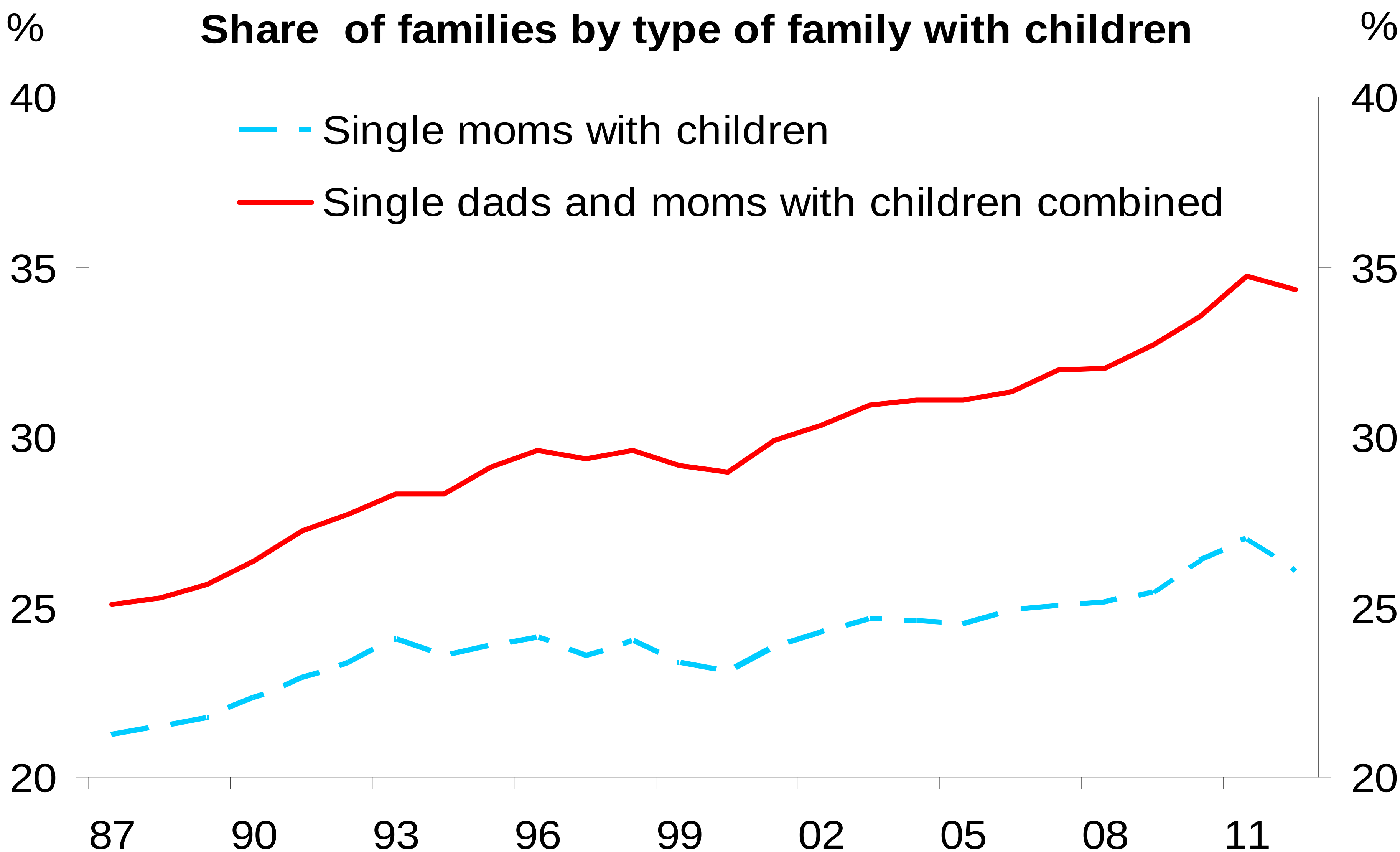
Source: Census, DB Global Markets Research

Significant pent-up demand:
If the number of people per household returns to the 2000-2003 level it would add up to 3mn new households



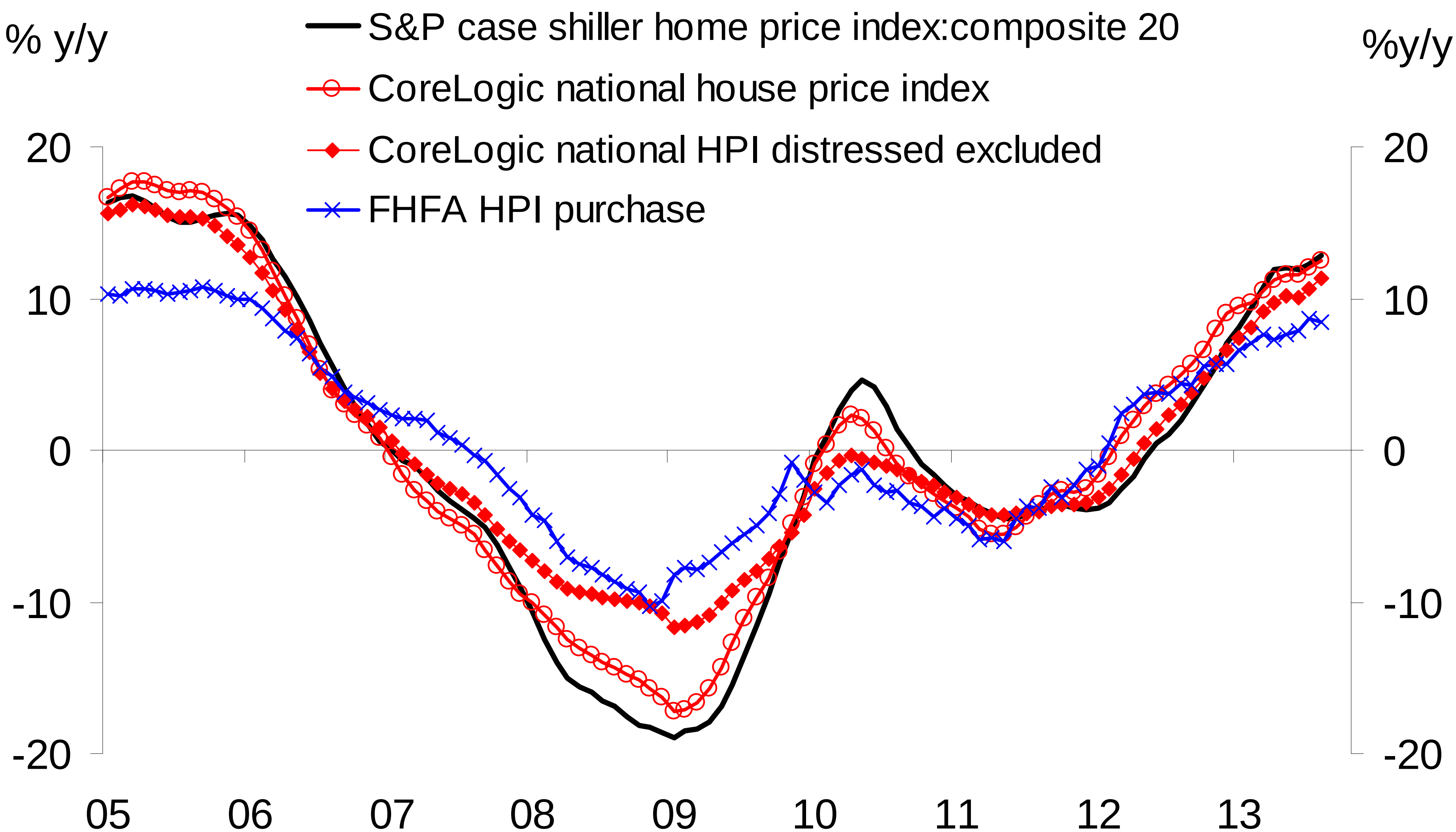
Source: Census, BLS, Haver Analytics, DB Global Markets Research

The share of single mother and single father households has risen dramatically



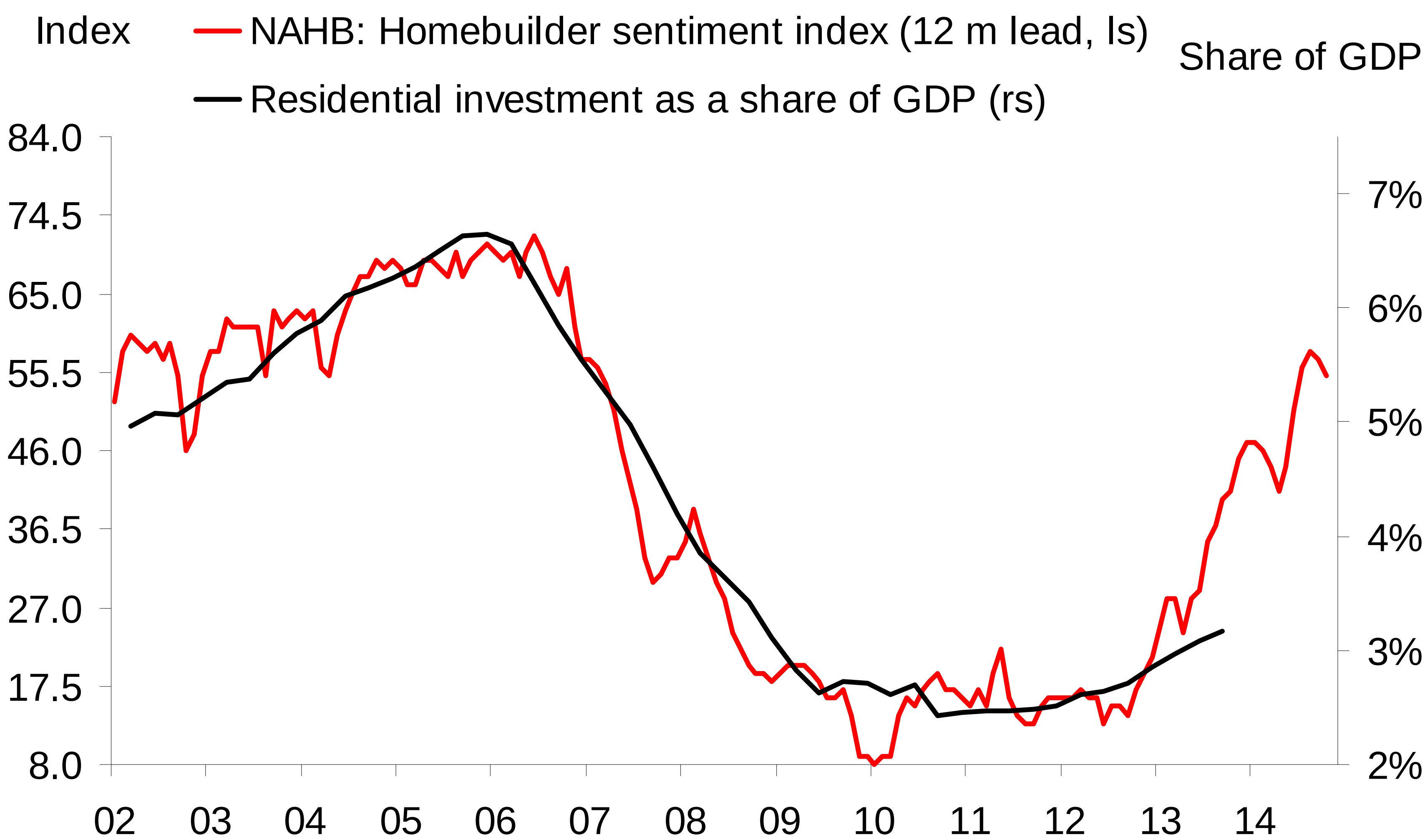
Source: US Census, DB Global Markets Research

US home prices rising…



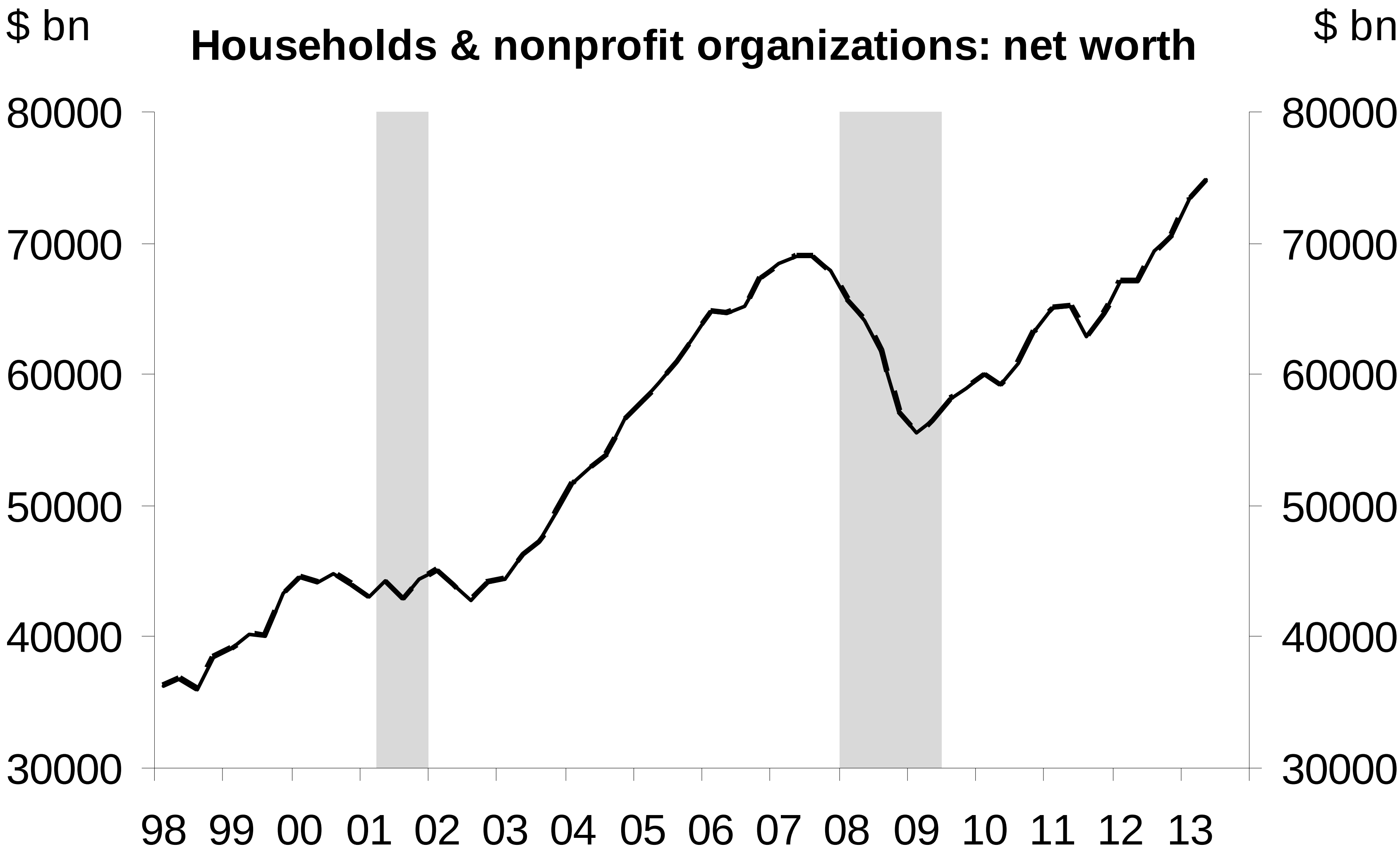
Source: S&P, CoreLogic, FHFA, Haver Analytics, DB Global Markets Research

...and we are still in the early phase of the housing recovery



Sources: NAHB, BEA, Haver Analytics, DB Global Markets Research

Household net worth at all-time high. This wealth effect dominates the negative impact of higher interest rates.

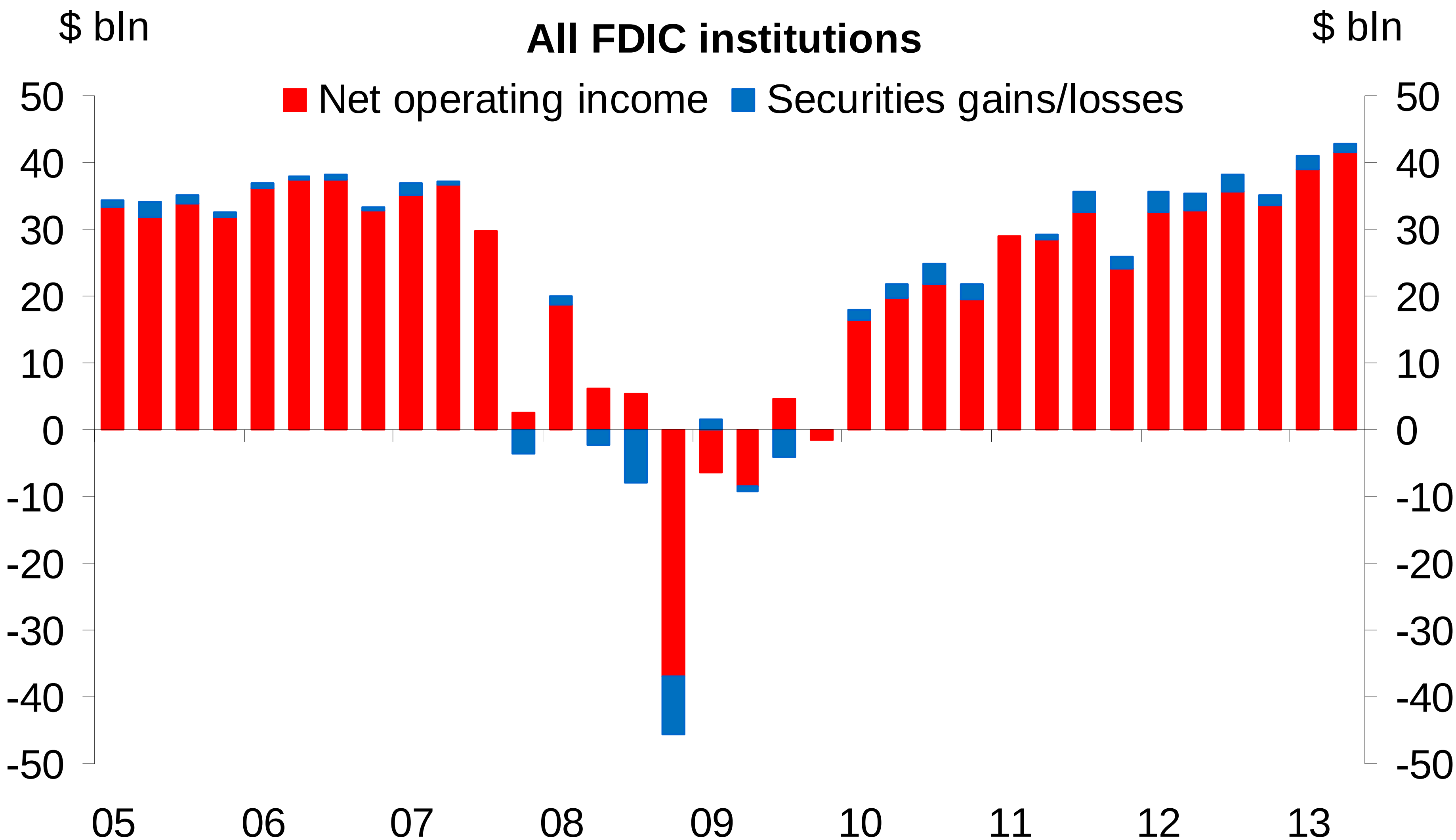


Source: BEA, Haver Analytics, DB Global Markets Research

Banks:

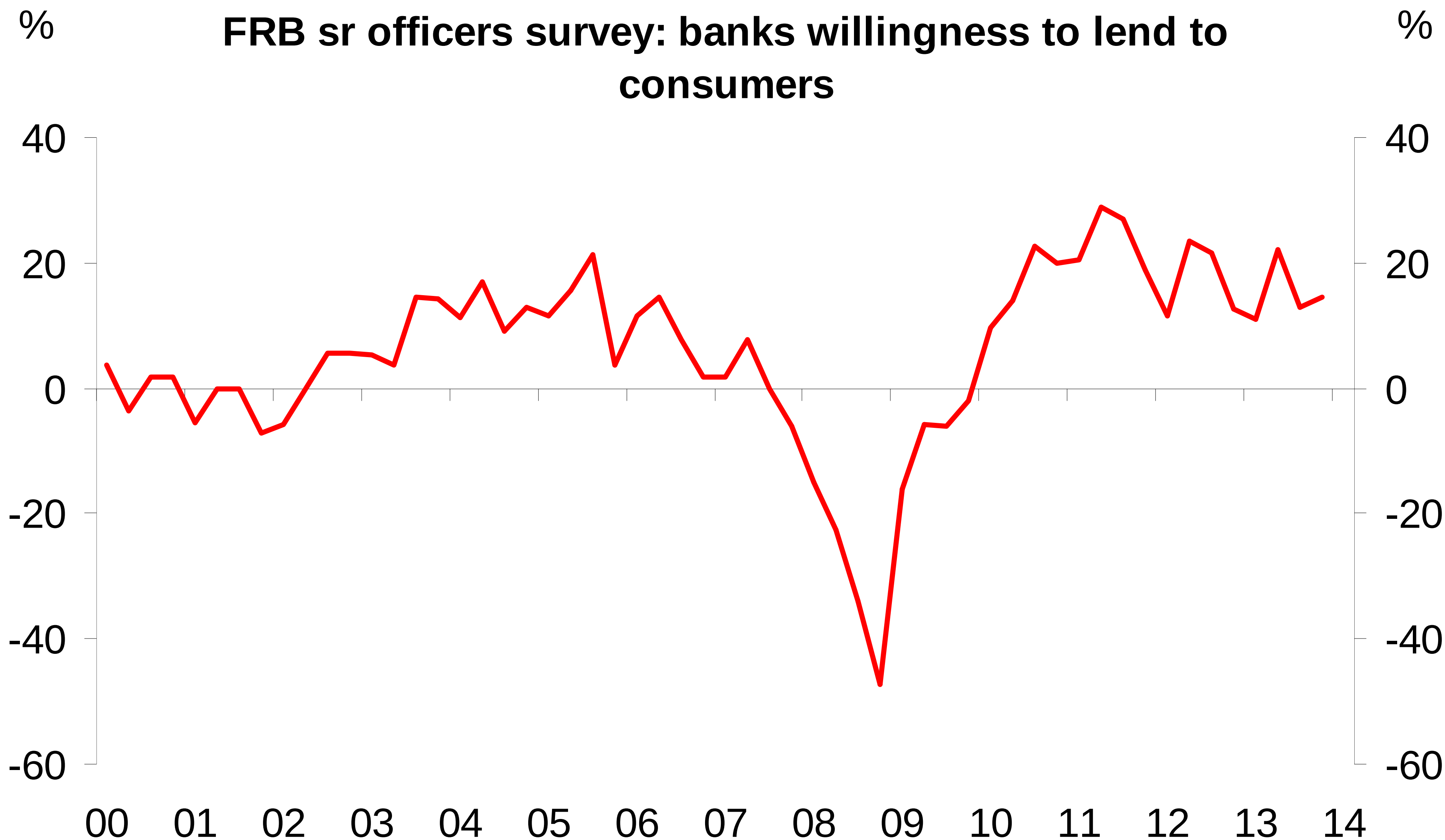
Balance sheet repair coming to an end

Banking sector quarterly net income currently at the same level as in 2005 and 2006



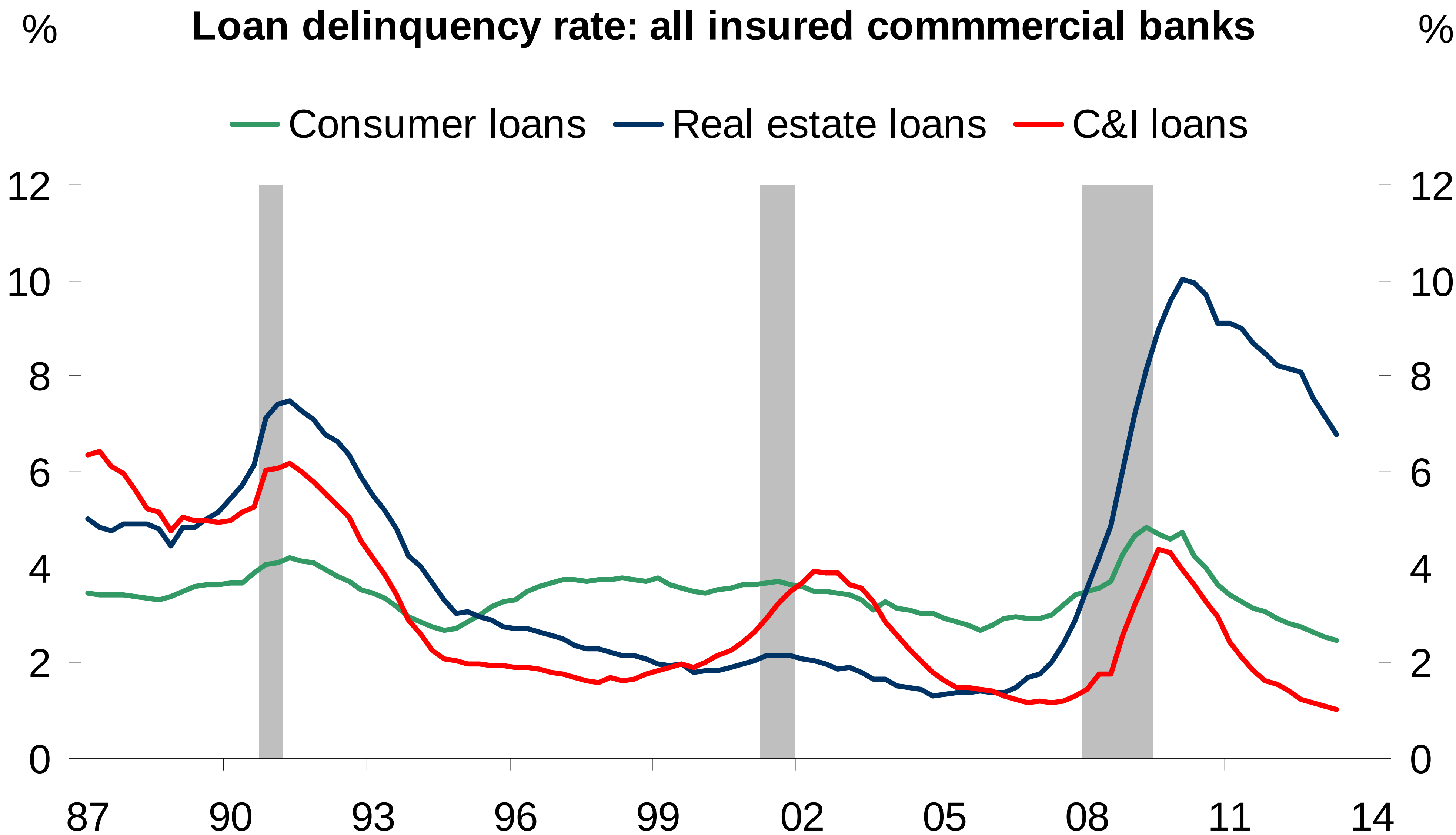
Source: FDIC, Haver Analytics, DB Global Markets Research

Banks' still more and more willing to lend



Source: FRB, Haver Analytics, DB Global Markets Research

Delinquency rates coming down

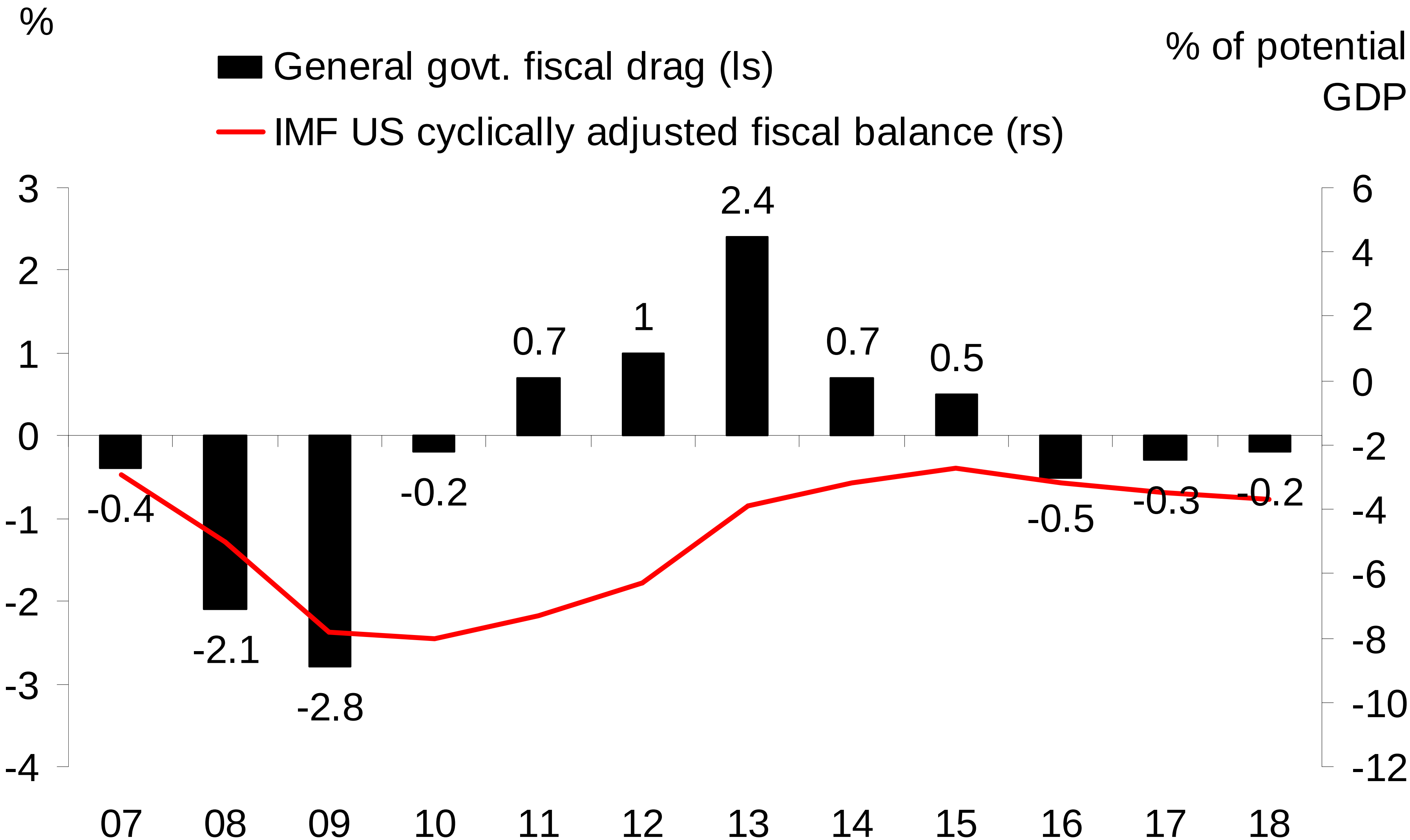


Source: FRB, Haver Analytics, DB Global Markets Research

Fiscal drag fading

Source: DB Global Markets Research

If we didn't have a fiscal drag in 2013 then monthly nonfarm payrolls in 2013 would have been +400k (instead of currently 186k). And in 2014 the fiscal drag on the economy is much smaller.



Source: IMF Fiscal Monitor, October 2013, Haver Analytics, DB Global Markets Research

Torsten Slok, torsten.slok@db.com +1 212 250-2155

The shrinking fiscal drag is a big deal in 2014

The chart on the previous page with IMF data from October shows that the fiscal drag in 2013 is 2.4%, ie **if GDP growth in 2013 ends up being 1.7% then if we had not had the fiscal drag then GDP growth would instead have been 4.1%** (=1.7% + 2.4%). **Translated into nonfarm payrolls this means that instead of having nonfarm payrolls at 186k - the average monthly number so far for this year - then nonfarm payrolls would have been more than 400k** (=if growth in the economy would have more than doubled then employment growth would also have more than doubled).

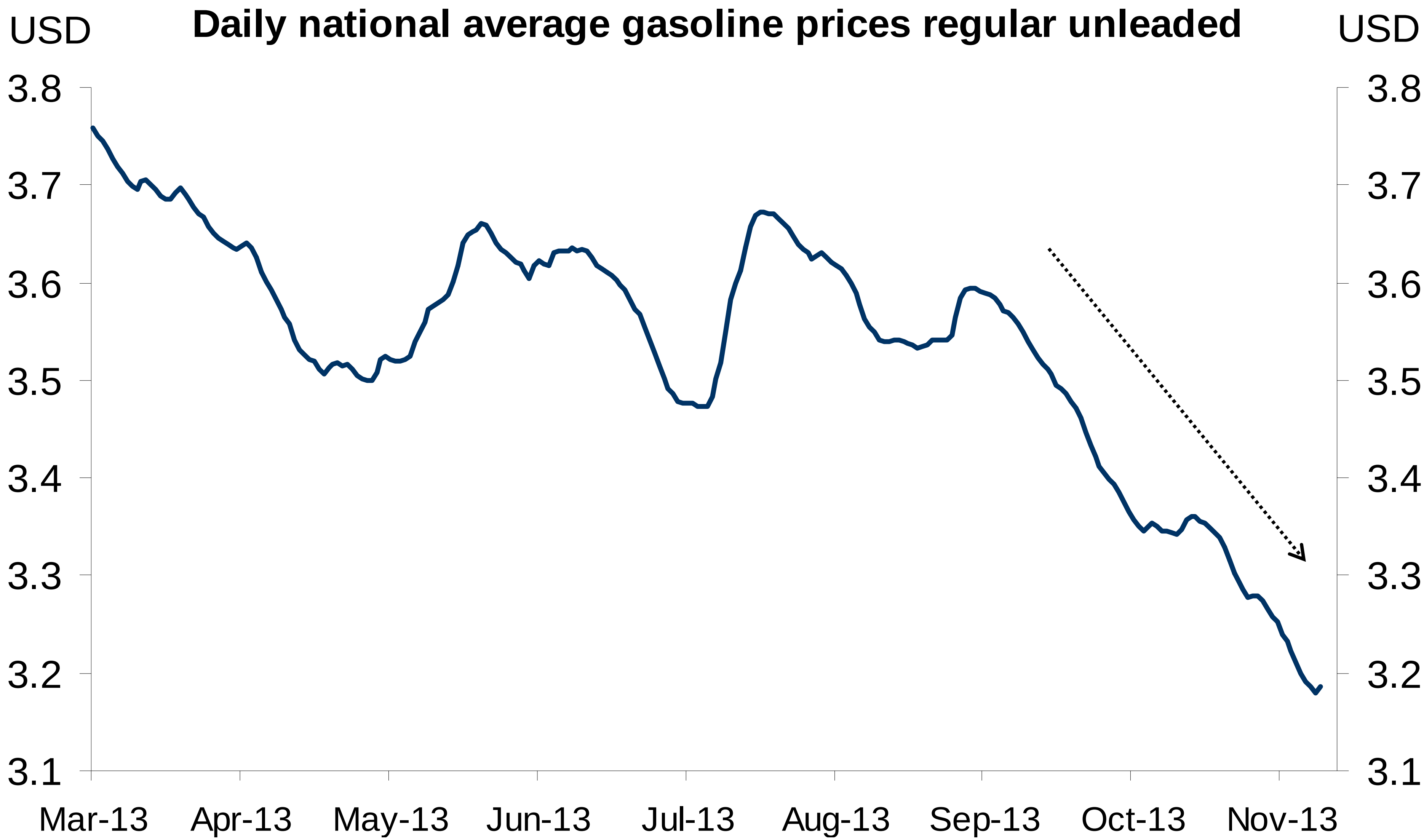
Looking to 2014 the fiscal drag is going to shrink from 2.4% to 0.7%, see again the chart on the previous page. If private sector economic performance in 2014 is the same as in 2013 – ie if GDP growth without a fiscal drag in 2014 is 4.1% like it was in 2013 - then **the shrinking fiscal drag in 2014 will alone lift nonfarm payrolls from its current level of 186k to instead +300k.**

Note: The conventional fiscal multiplier is 1, which is also what we use here; some of the fiscal drag is sequestration, ie spending cuts, which have a multiplier of 1.5 and some of the fiscal drag is tax changes which have a multiplier of 0.5.

Source: DB Global Markets Research

Gas prices falling

Gas prices trending down



Sources: American Automobile Association, Bloomberg Finance LP, DB Global Markets Research

Impact on GDP growth due to fall in oil prices by $10 per barrel

	OECD-Interlink model (2004-05)	FRB/US (1999)	IMF-Mulitmod Model (2000)	DB VAR (2011)	Consensus
US	0.3	0.2	0.6	0.4	0.35
Euro Area	0.5		0.4		0.5
Japan	0.4		0.2		0.3
Total Developing countries			0.2		0.2
Asia ex Japan			0.8		0.8
World			0.4		0.4

Sources: OECD, FRB, DB Global Markets Research

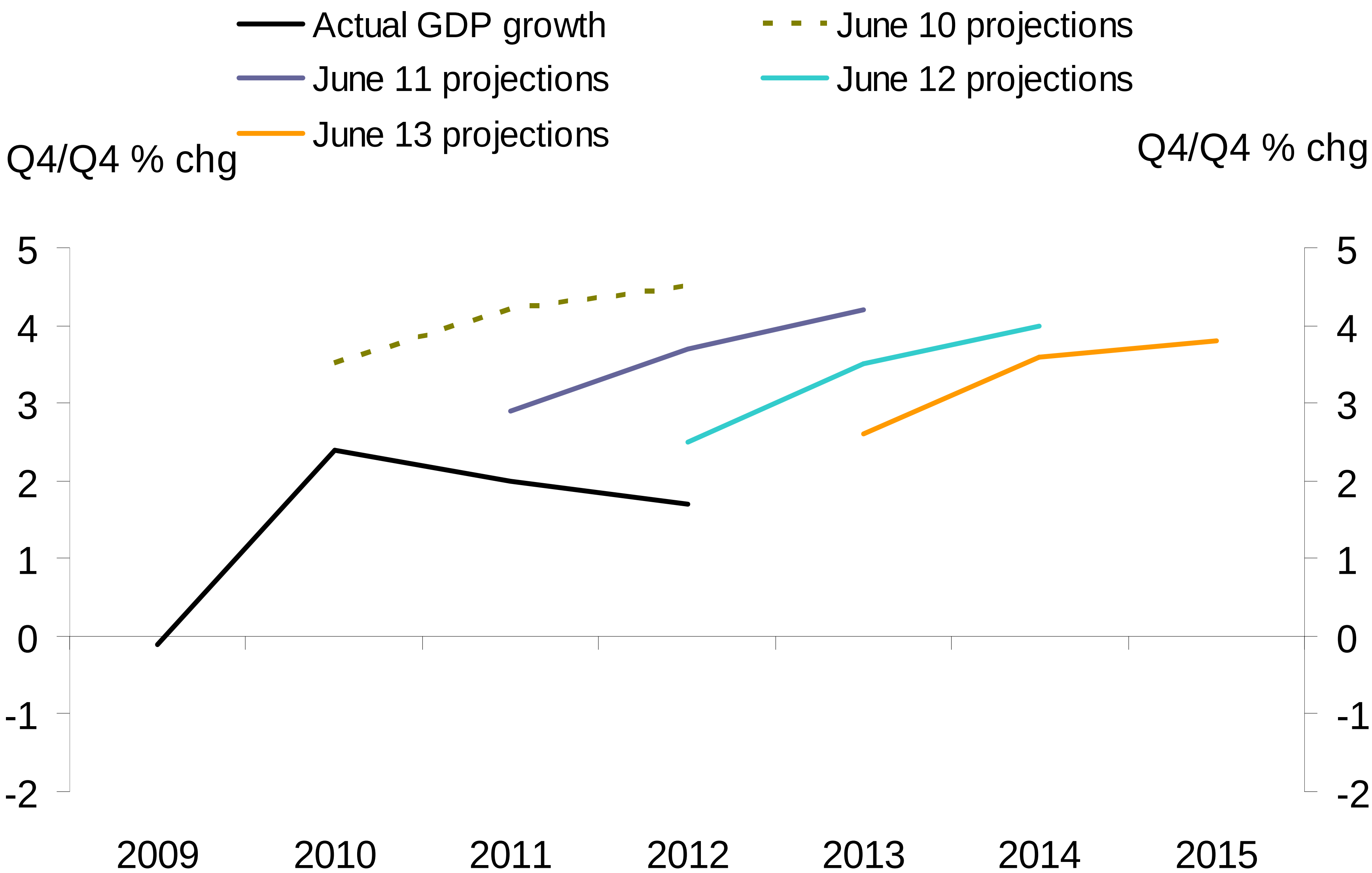
Impact on inflation due to fall in oil prices by $10 per barrel

	OECD-Interlink model (2004-05)	FRB/US (1999)	IMF-Mulitmod Model (2000)	DB VAR (2011)	Consensus
US	-0.5	-0.5	-0.6	-0.5	-0.5
Euro Area	-0.5		-0.2		-0.4
Japan	-0.3				-0.3
Total Developing countries					
Asia ex Japan			-0.7		-0.7
World					

Sources: OECD, FRB, DB Global Markets Research

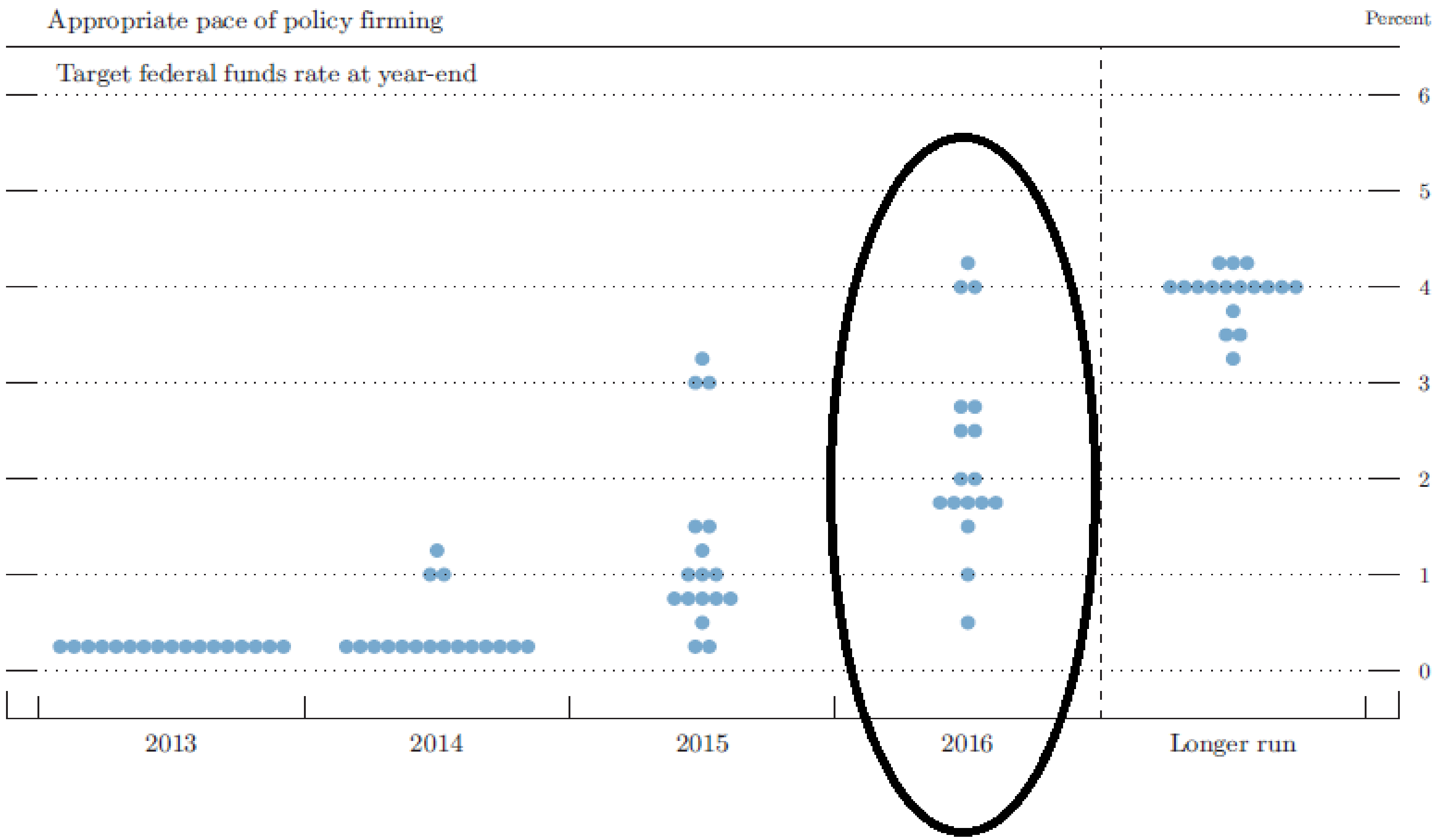
Fed outlook

Since 2010 the Fed has been too optimistic about the recovery



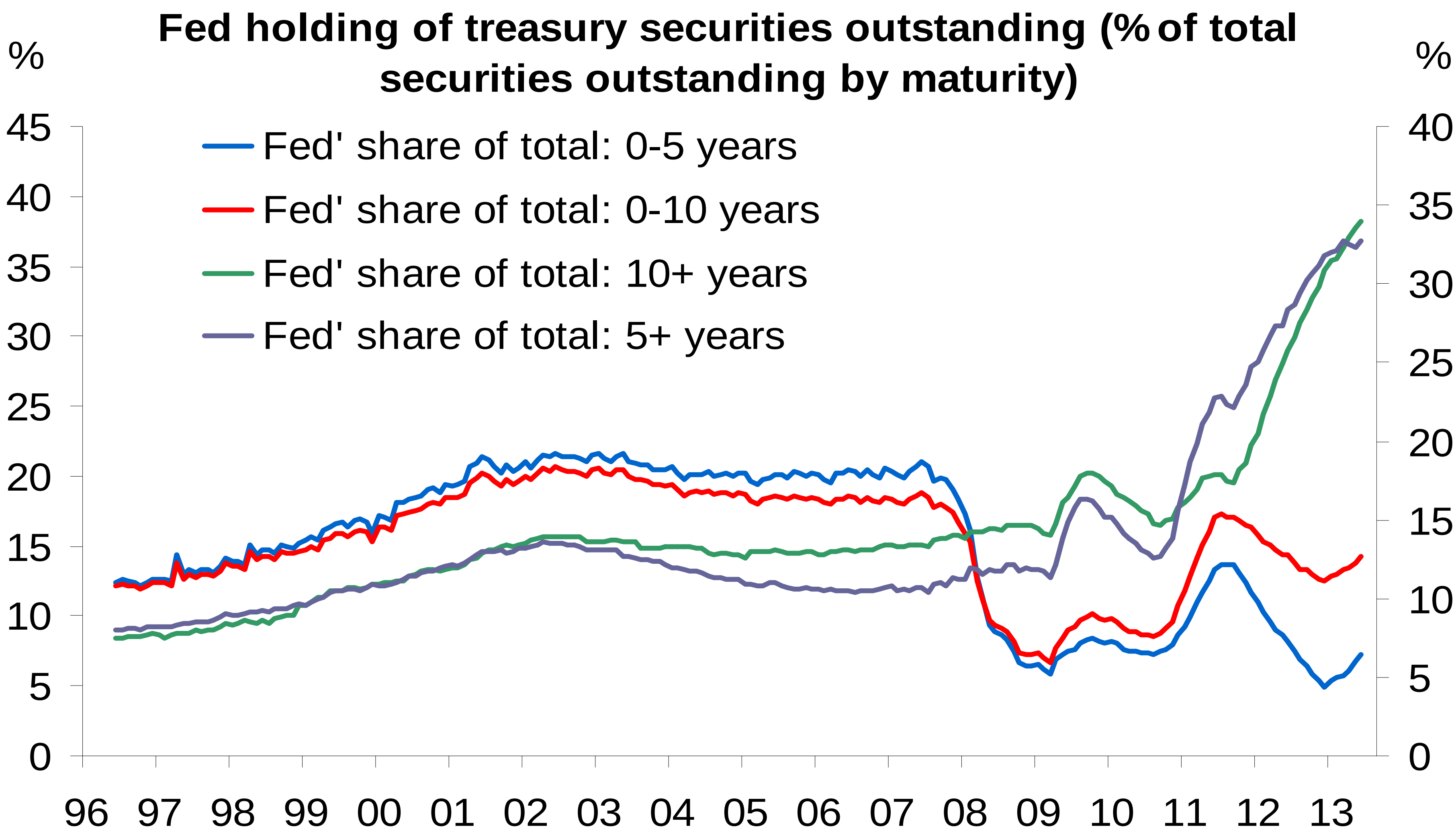
Source: Washington Post, FRB, DB Global Markets Research

Some FOMC members believe the fed funds rate in 2016 will be 4.25%. Others it will be 0.5%.



Source: Federal Reserve, DB Global Markets Research

This chart suggests tapering will begin sooner rather than later: The Fed now holds more than 1/3 of long Treasuries



Sources: FRB, Treasury, Haver Analytics and DB Global Market Research

Fed taper in December or March?

Arguments for December taper

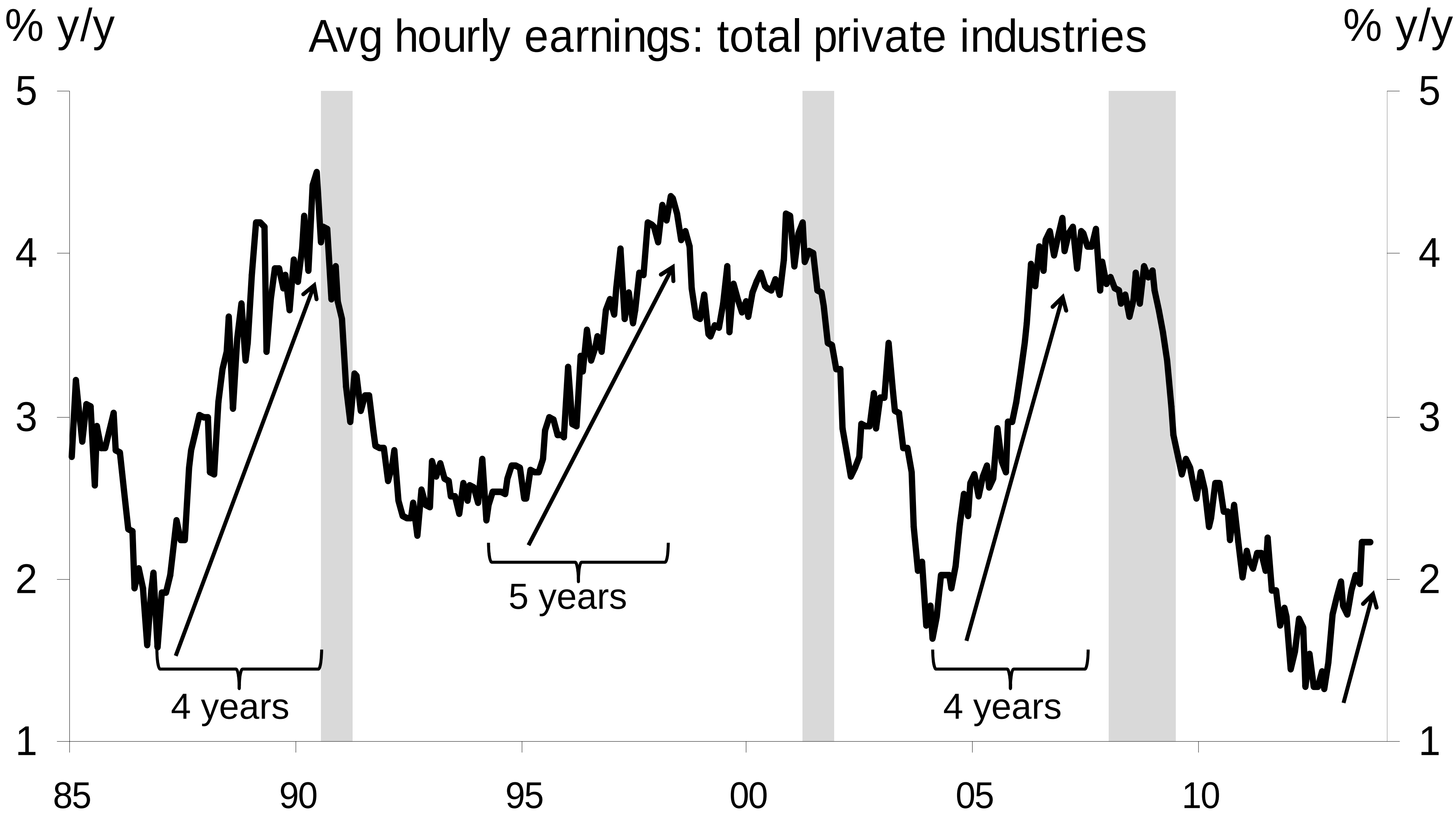
1. In September and October a large majority of the FOMC participants said they expected the initial taper to take place in coming months
2. The shutdown uncertainty is behind us (the economy grew 4.9% in 2011Q4 after the 2011 debt ceiling debate)
3. Fiscal drag is waning and economy will accelerate in coming months, oil prices are trending down
4. Since September rates are lower, stocks higher, and credit spreads narrower, all supporting the economy in the near term
5. Wages are trending higher
6. Costs of Fed balance sheet expansion (financial stability costs, market functioning costs, fiscal costs, confidence costs, and potential inflation costs). The Fed holds 1/3 of all +5yr Treasury bonds – limits to how much Fed can buy

Arguments for March taper

1. The labor market will not improve enough in Nov
2. Decline in unemployment rate has been driven by decline in the labor force participation rate.
3. Inflation remains low
4. The debt ceiling problem hasn't really been solved and the fiscal uncertainty will weigh on the economy
5. The Fed is scared about the May/June experience and want to wait with tapering
6. Housing data has softened a bit recently
7. The FOMC wants to wait until Yellen sits in the chair at the end of the table
8. There is less excessive risk-taking following the May/June experience and as a result tapering can be delayed

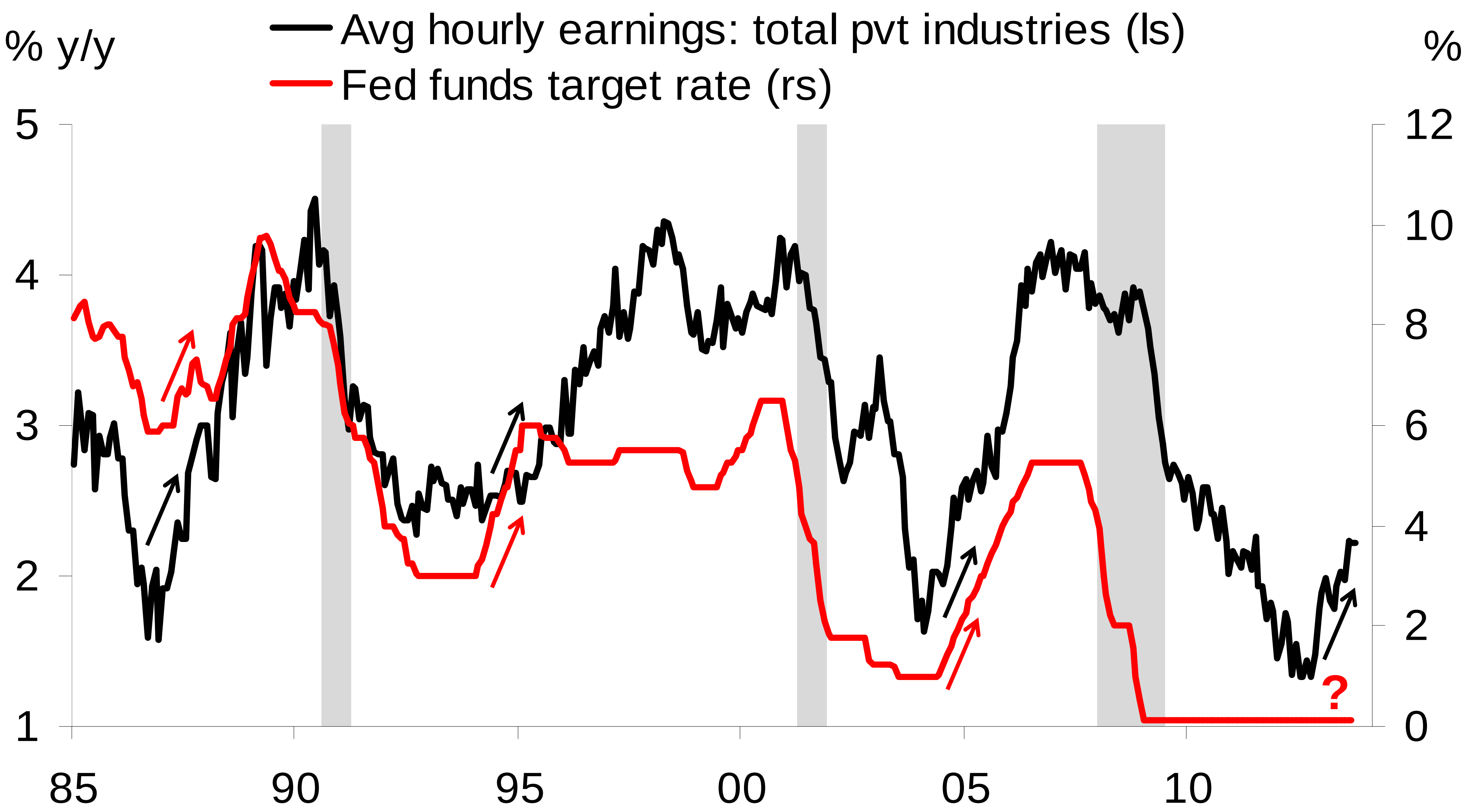
Is the Fed behind the curve?

Wages are clearly trending up, and once wage inflation takes hold it continues for 4-5 years



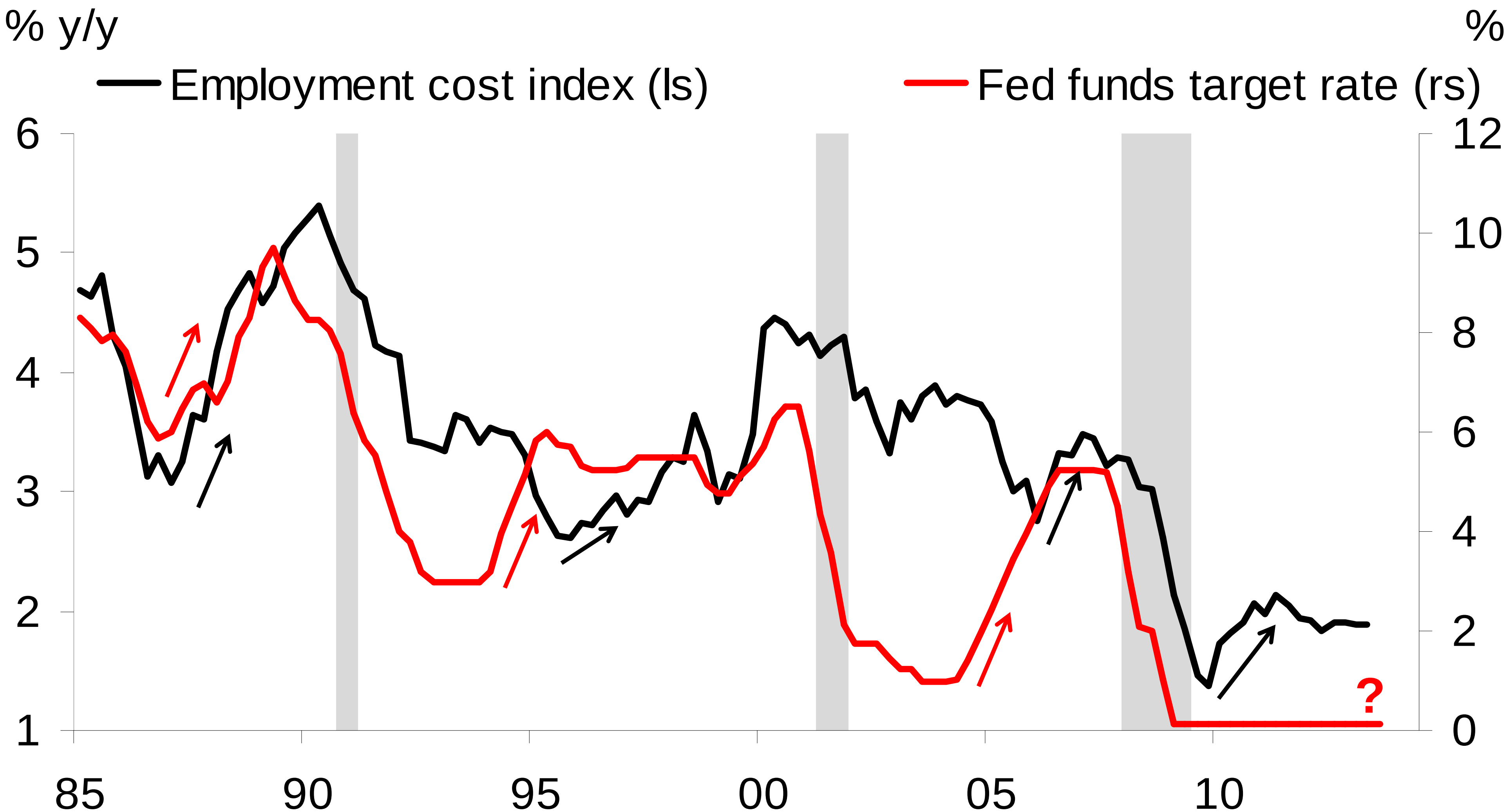
Source: BLS, Haver Analytics, DB Global Markets Research

Historically the Fed has hiked when wages started rising – but not this time around



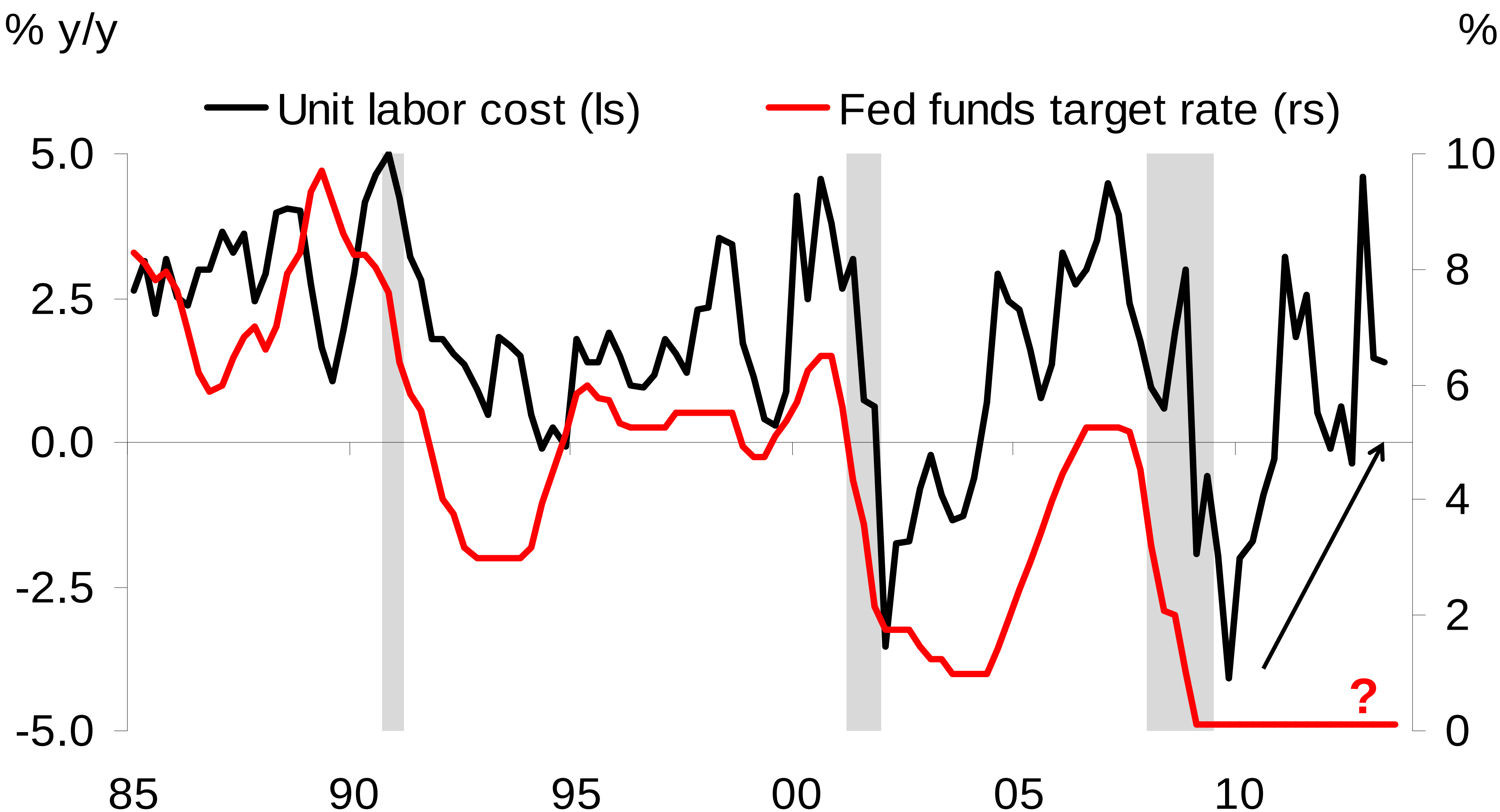
Source: BLS, FRB, Haver Analytics, DB Global Markets Research

Historically a rising employment cost index (ECI) has been associated with Fed hikes – in the 1990s and 2000s the Fed even hiked before we had seen a rise in the ECI



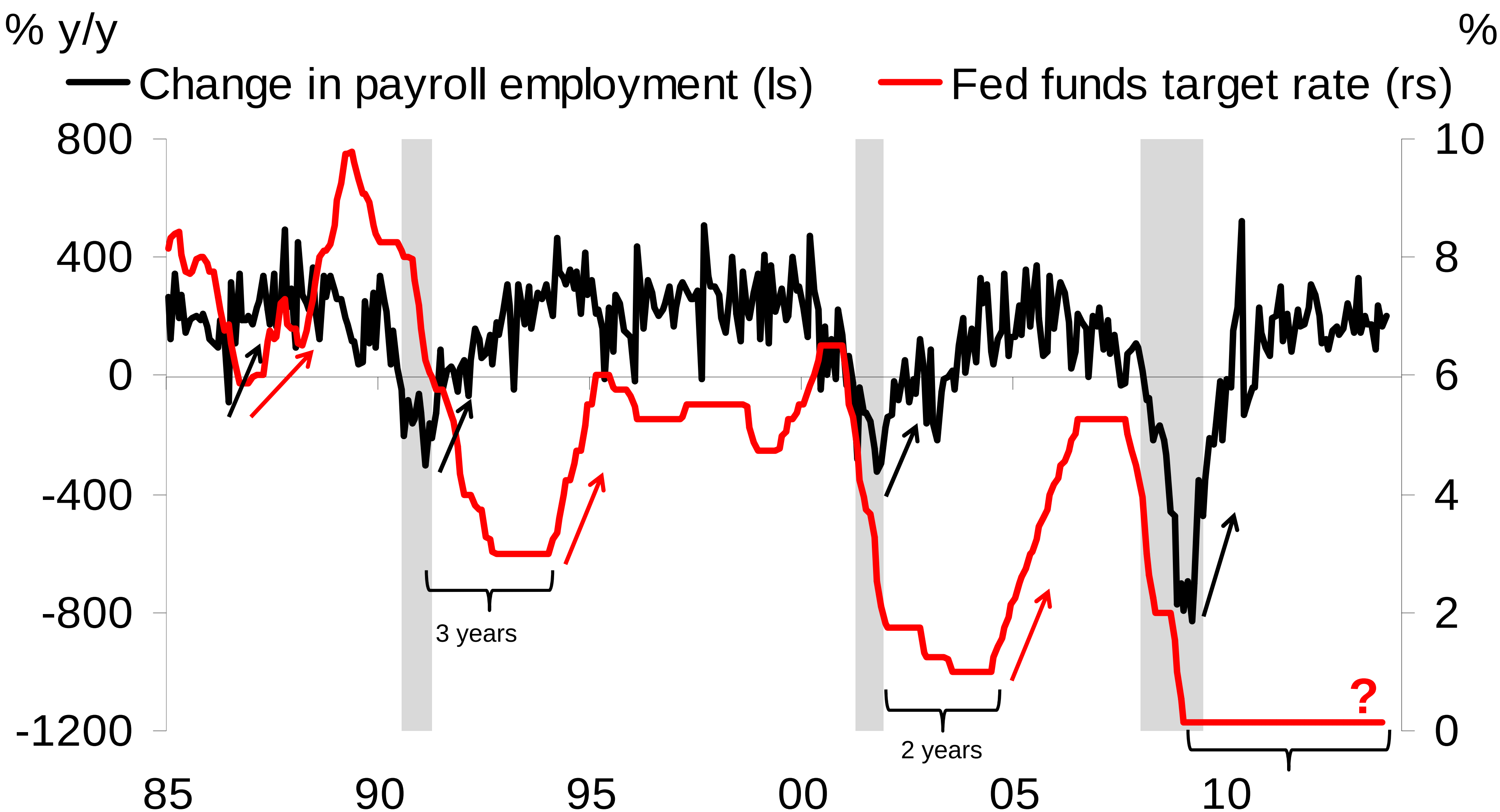
Source: BLS, FRB, Haver Analytics, DB Global Markets Research

The cycle in unit labor costs has historically been correlated with the cycle in the Fed funds rate – but not this time around



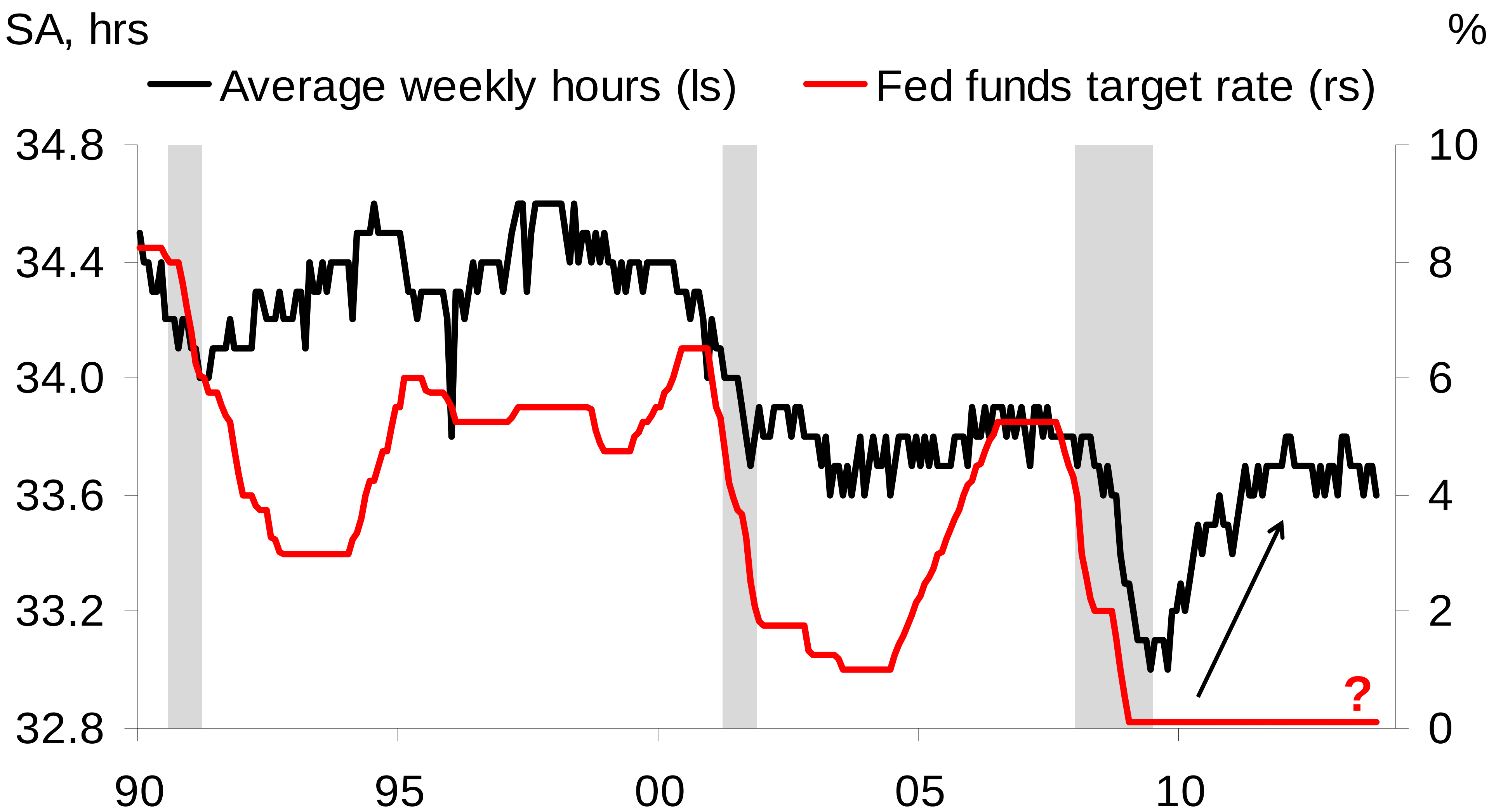
Source: BLS, FRB, Haver Analytics, DB Global Markets Research

The Fed has historically hiked rates 2-3 years after the trough in employment growth



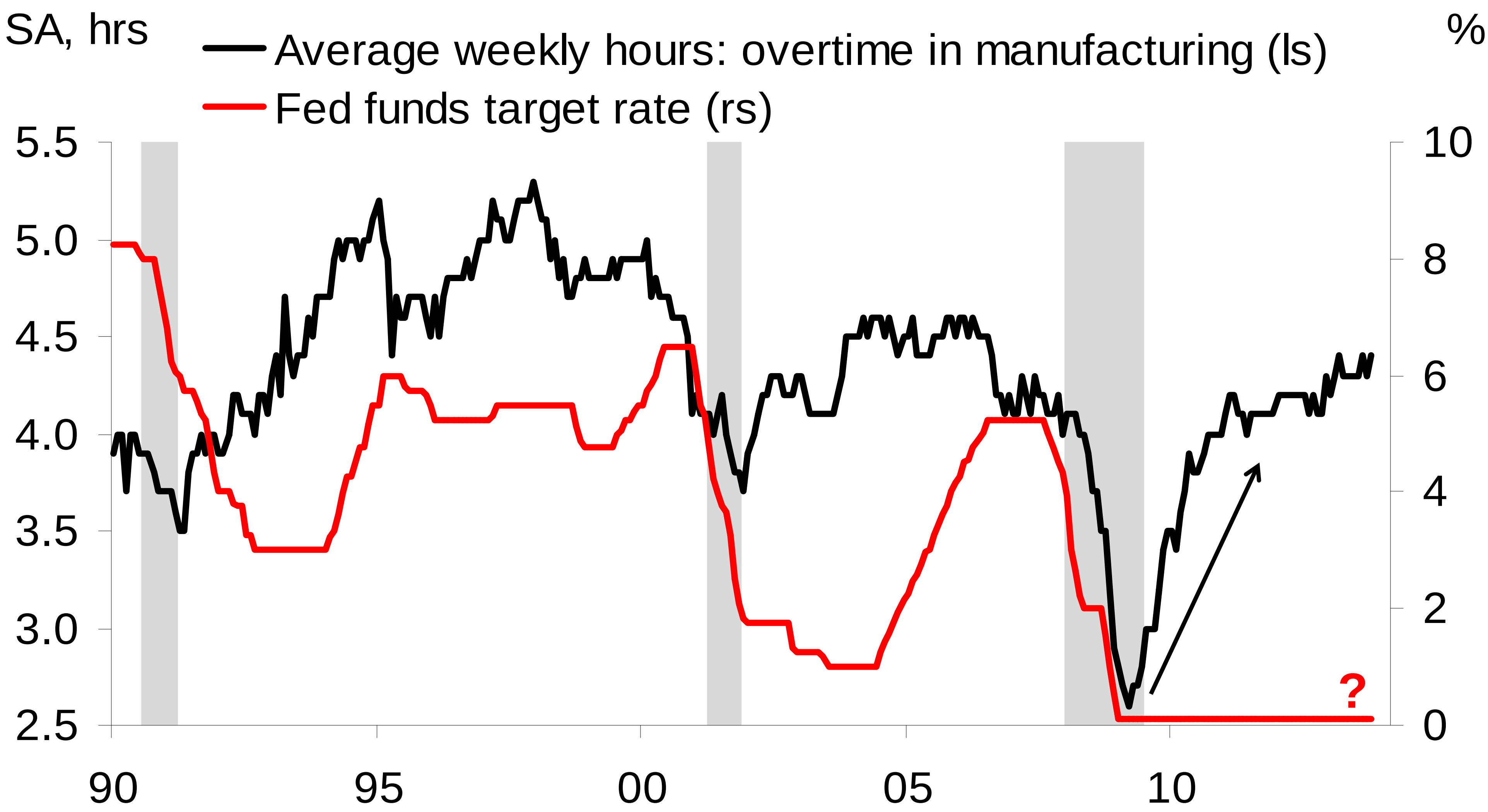
Source: BLS, FRB, Haver Analytics, DB Global Markets Research

The cycle in average weekly hours has historically been associated with the cycle in the Fed funds rate – but not this time around



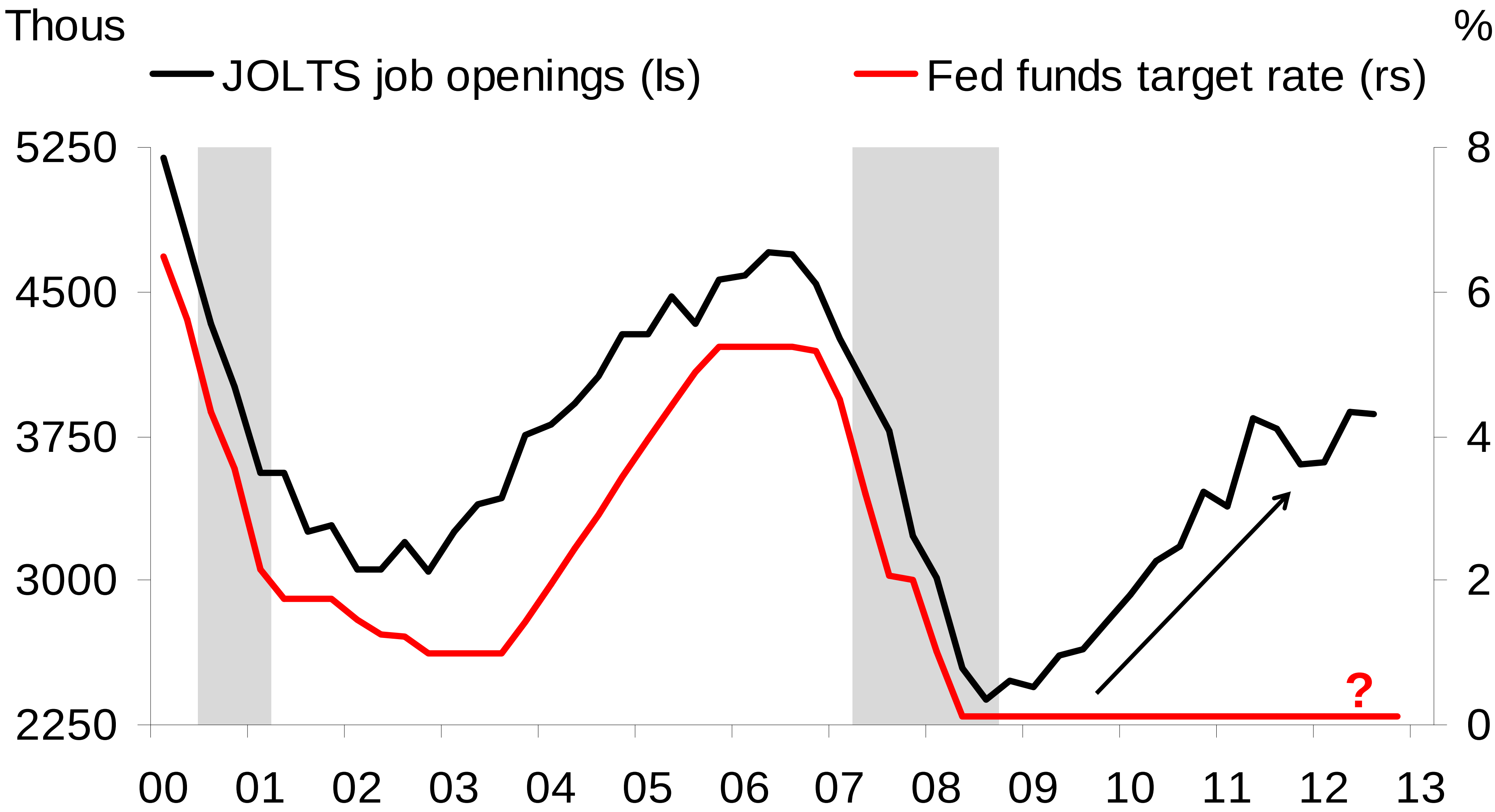
Source: BLS, FRB, Haver Analytics, DB Global Markets Research

The cycle in overtime hours has historically been associated with the cycle in the Fed funds rate – but not this time around



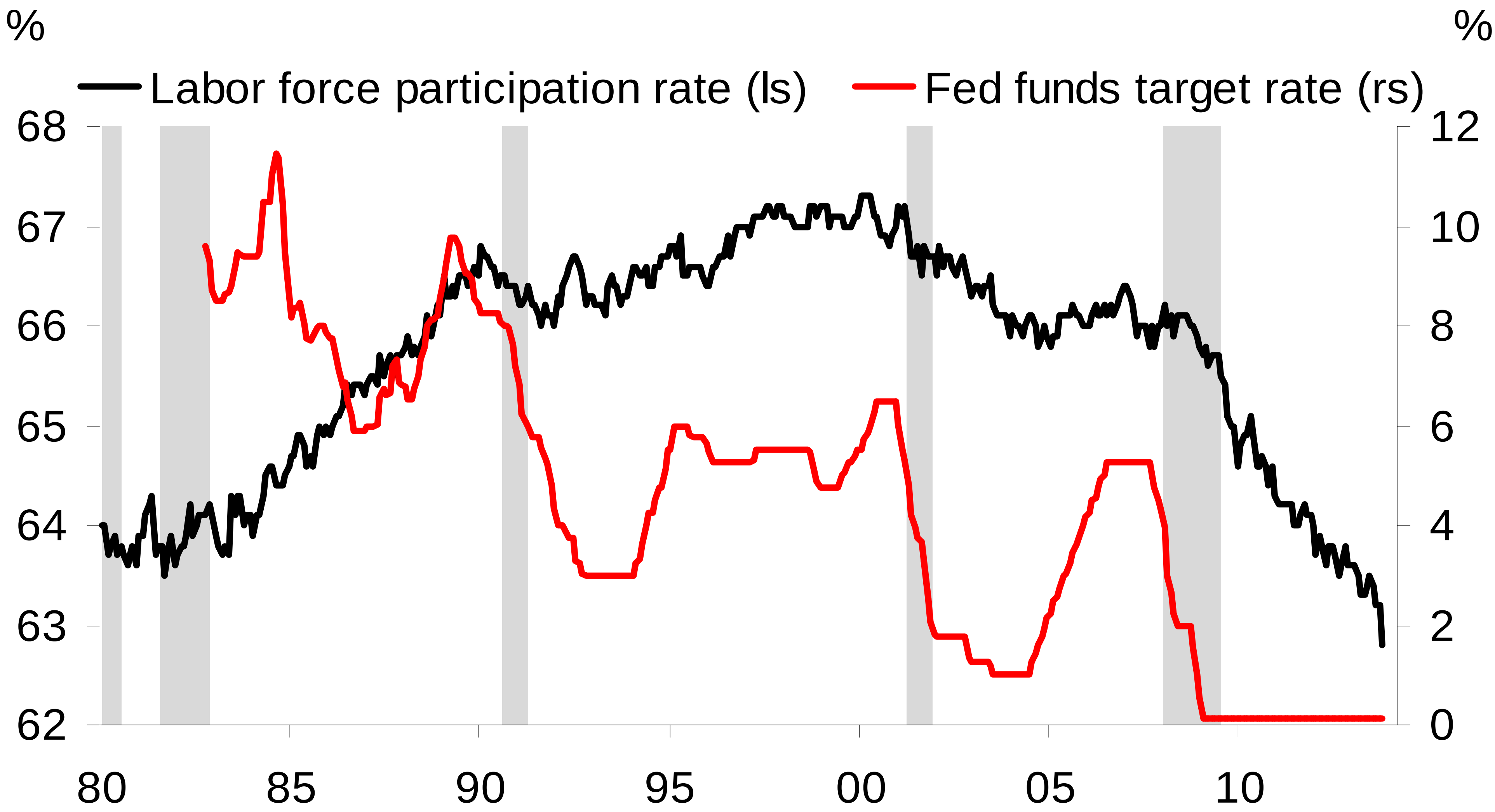
Source: BLS, FRB, Haver Analytics, DB Global Markets Research

The cycle in job openings has historically been associated with the cycle in the Fed funds rate – but not this time around



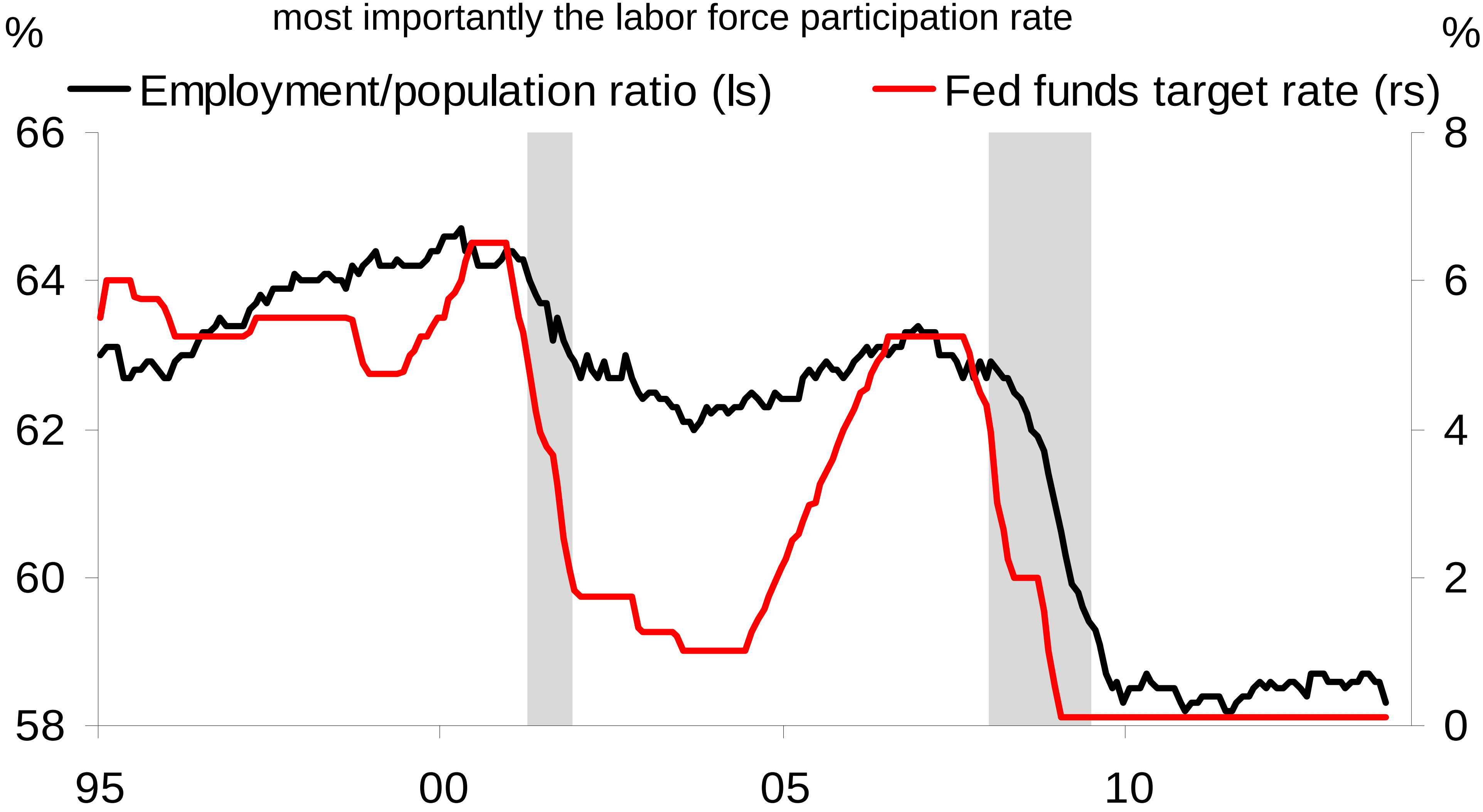
Source: BLS, FRB, Haver Analytics, DB Global Markets Research

The labor force participation rate has never been correlated with the fed funds rate



Source: BLS, FRB, Haver Analytics, DB Global Markets Research

The employment to population ratio has historically had a lose relationship with the fed funds rate but this ratio seems to be the main driver of policy at the moment. But this ratio is driven importantly by factors that are outside the control of the Fed, most importantly the labor force participation rate

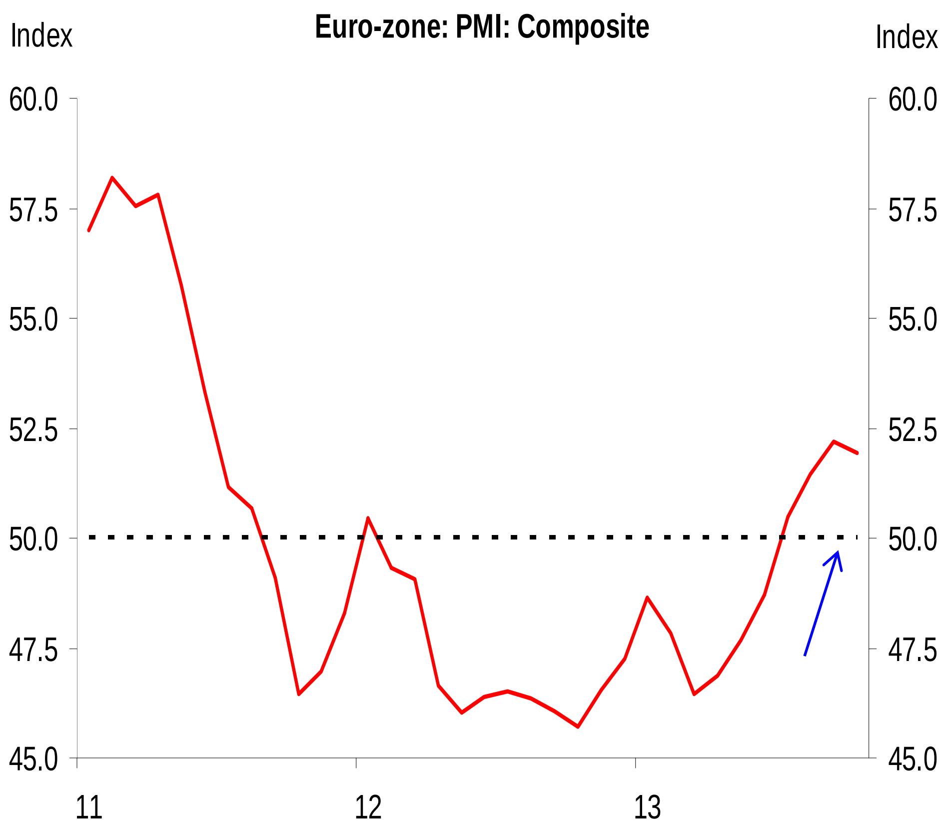


Source: BLS, FRB, Haver Analytics, DB Global Markets Research

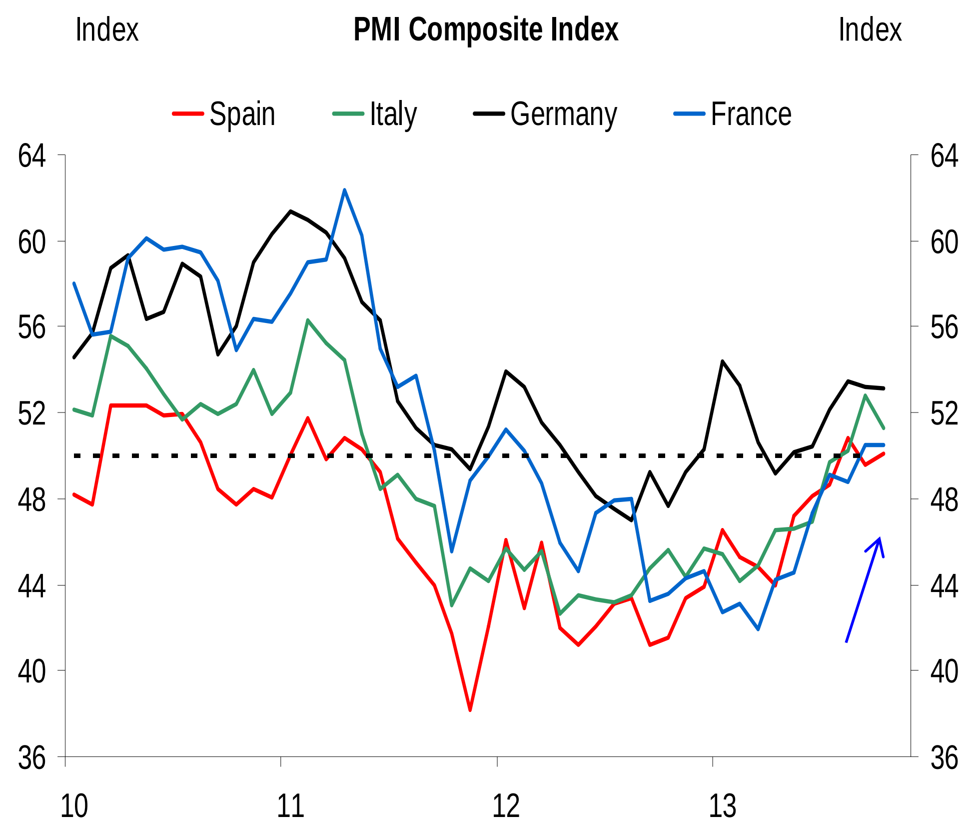
Outlook for Europe, Japan, and Canada

Europe coming back

Europeean PMIs have turned up recently…

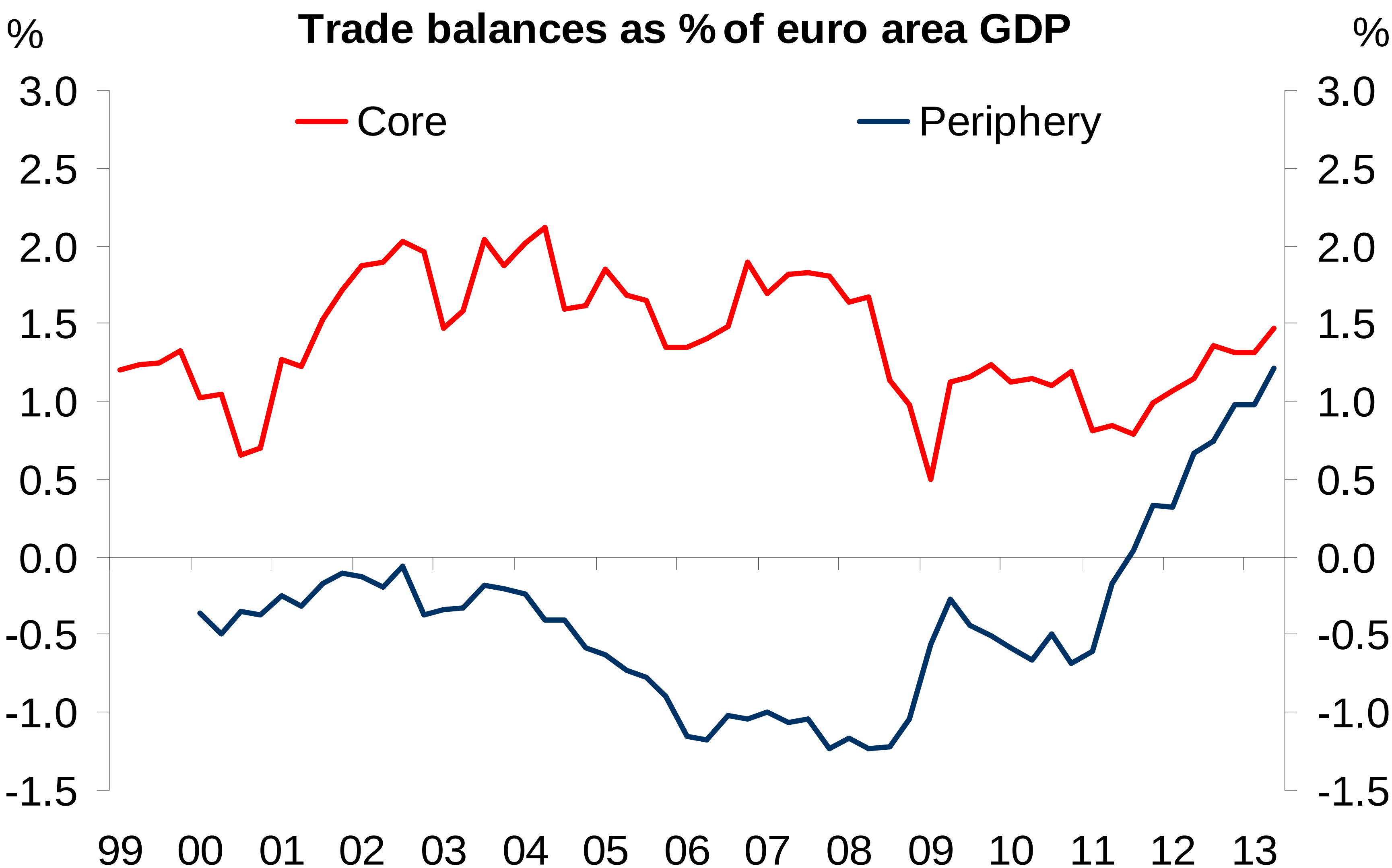


…and improvements have been broad-based



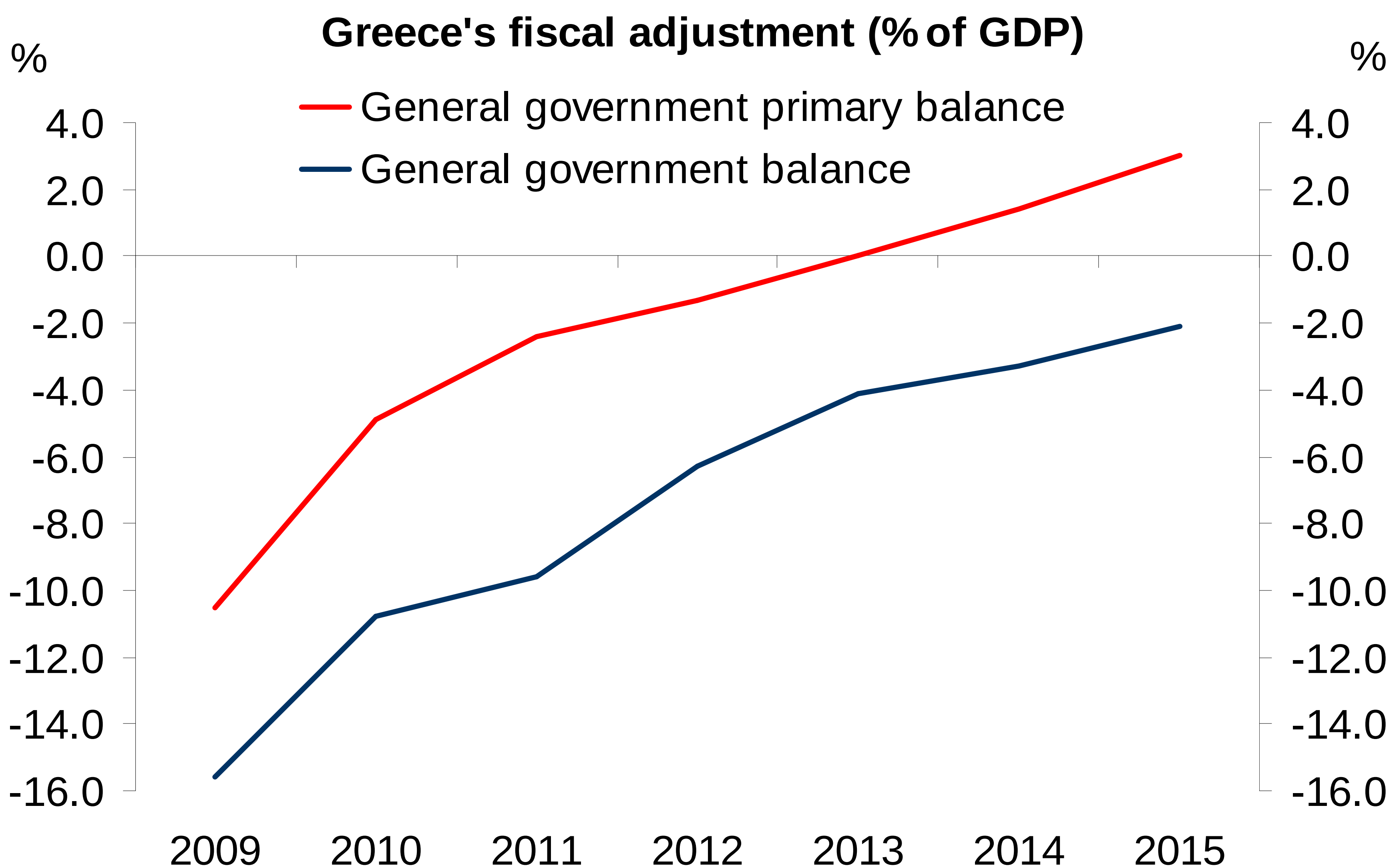
Sources: Markit, Haver Analytics, DB Global Markets Research

Trade balances improving in Europe



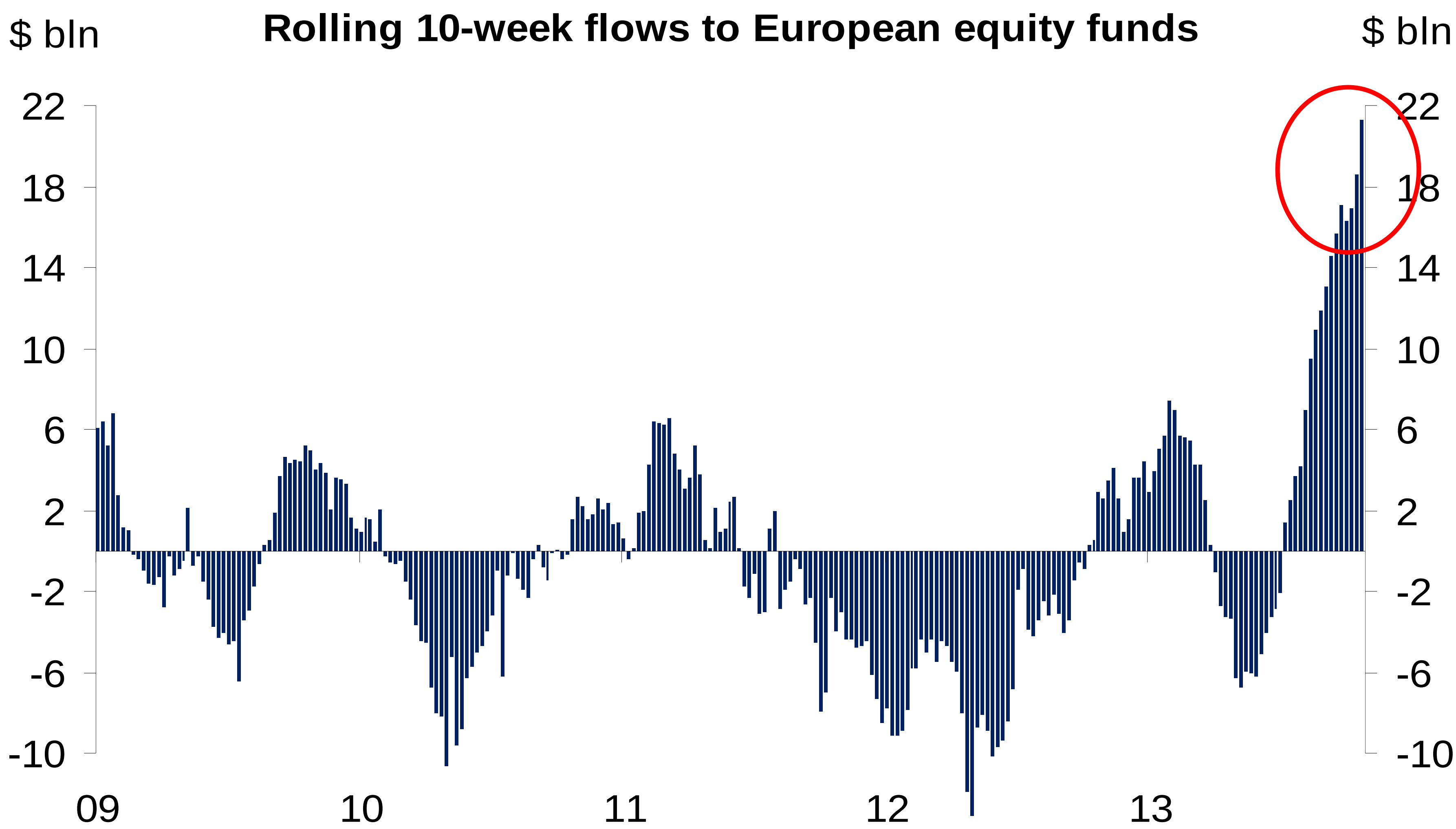
Source: EUDATA, Haver Analytics, DB Global Markets Research

Fiscal balance improving in Greece



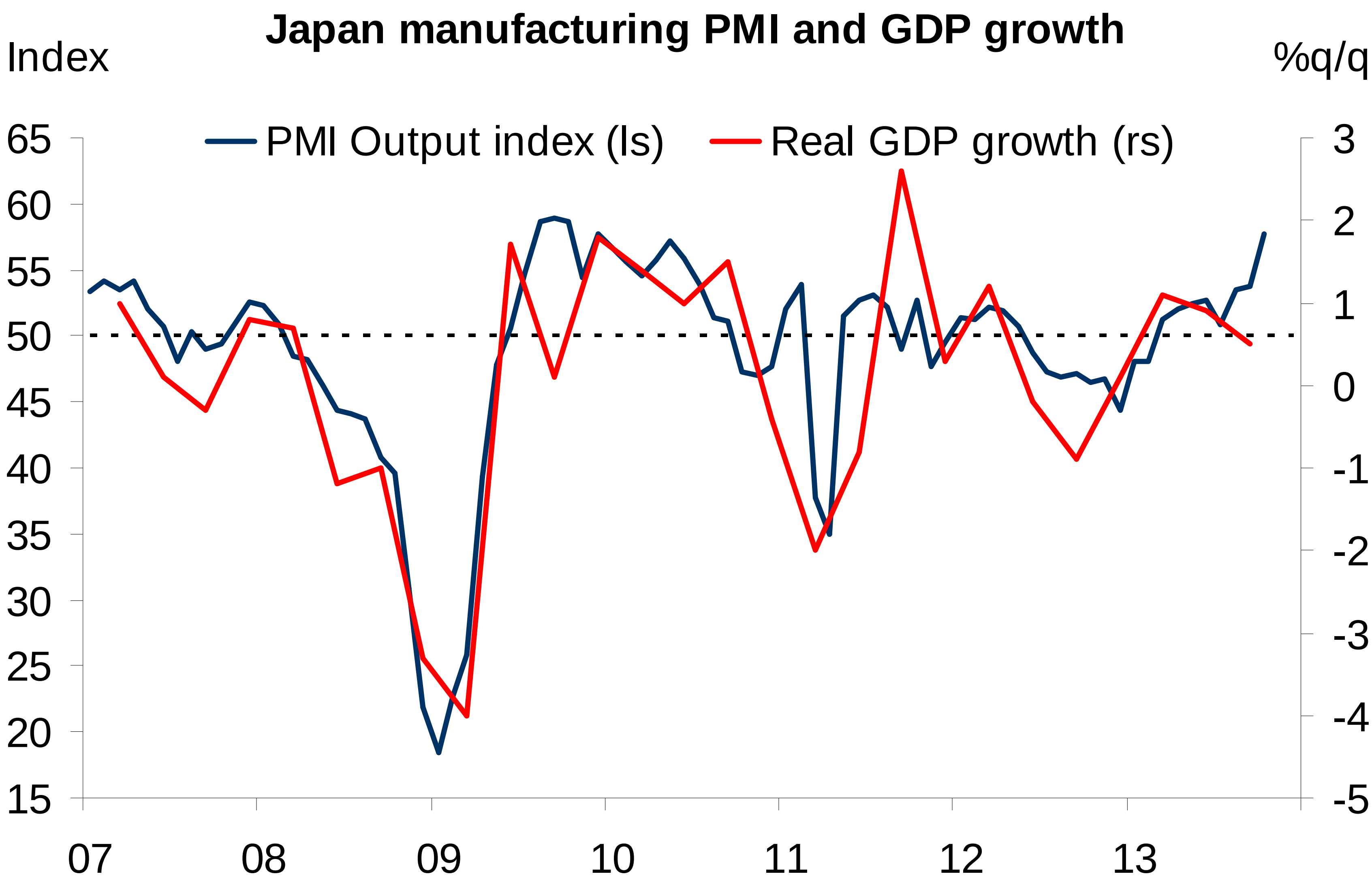
Source: IMF, Haver Analytics, DB Global Markets Research

A lot of money flowing into European equities at the moment



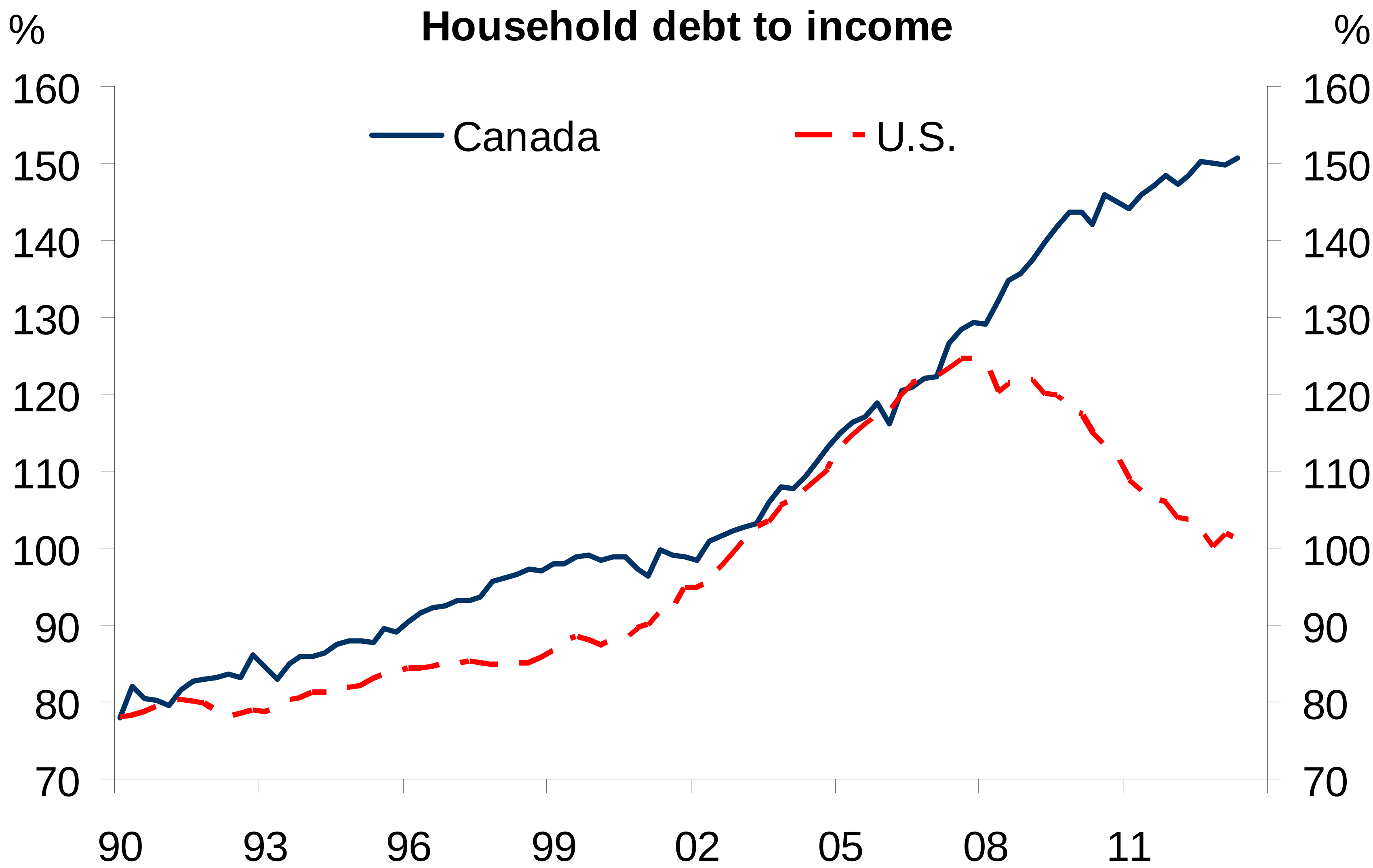
Source: EPFR, Haver Analytics, DB Global Markets Research

Abenomics is working



Source: Markit/JMMA, CAO, Haver Analytics, DB Global Markets Research

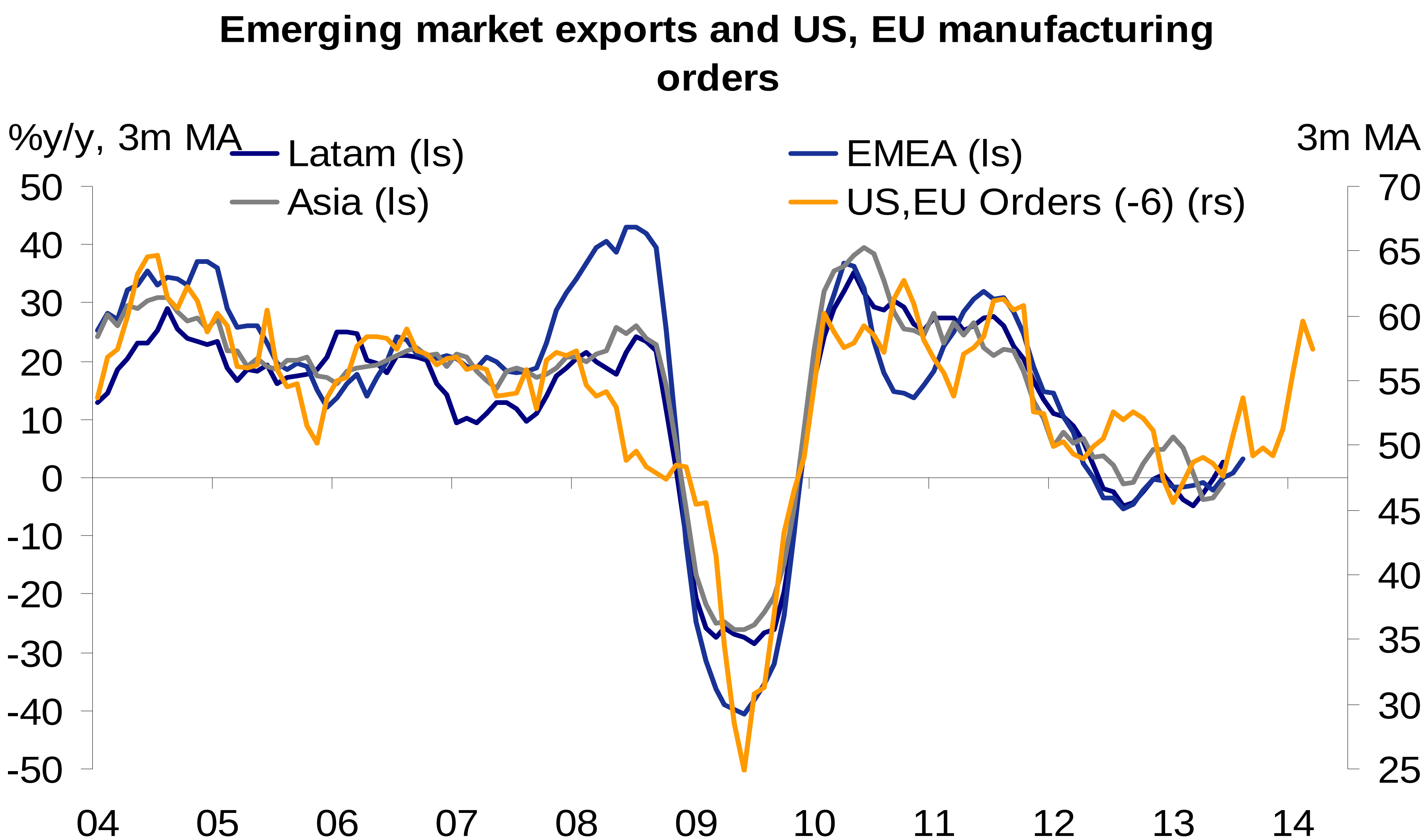
Canada is in trouble



Source: StaCan, FRB, Haver Analytics, DB Global Markets Research

Outlook for Emerging Markets

EM coming back with a 12 month delay

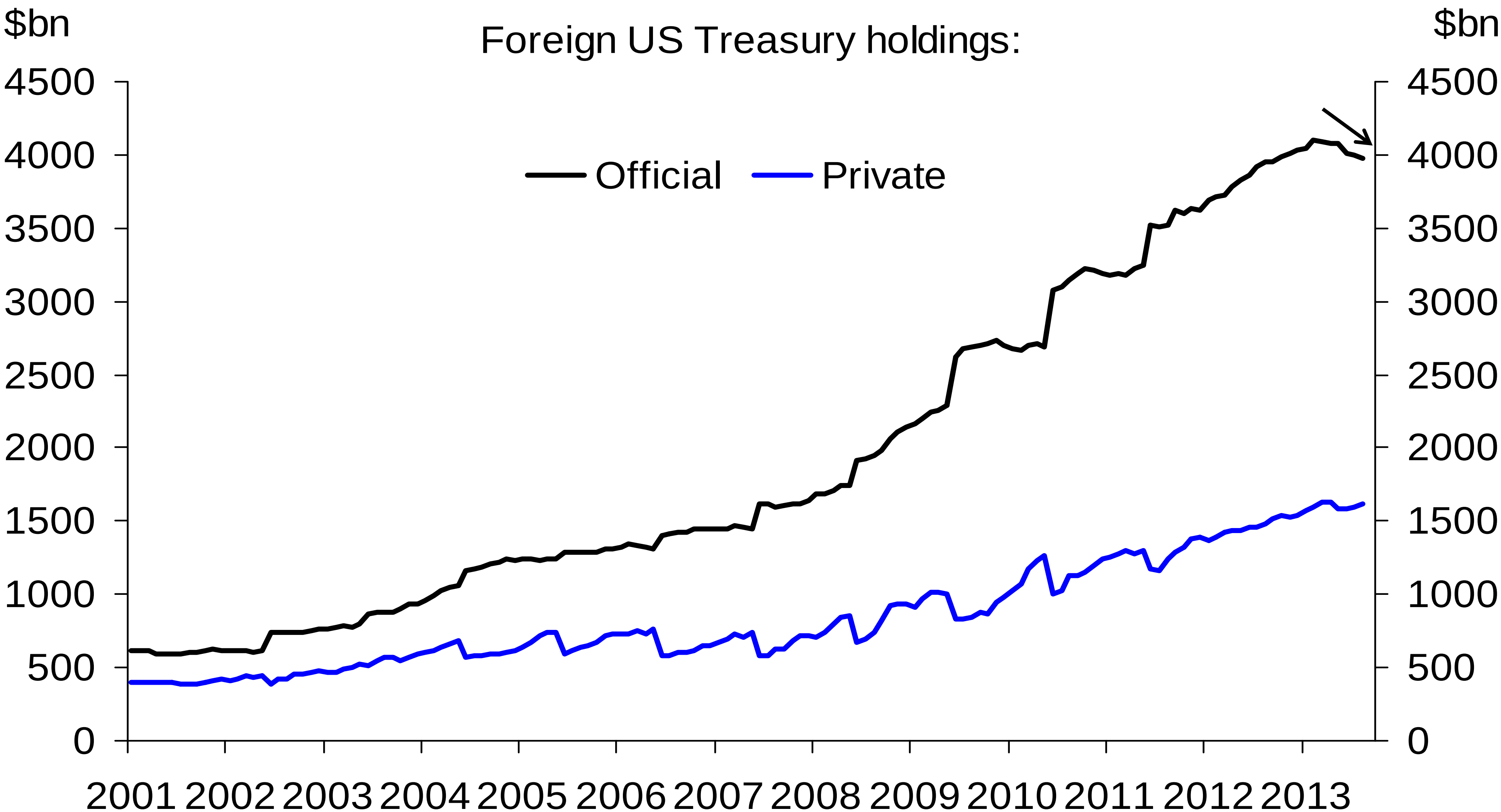


Source: National Sources, Haver Analytics, DB Global Markets Research

Foreign central banks losing appetite for US Treasuries

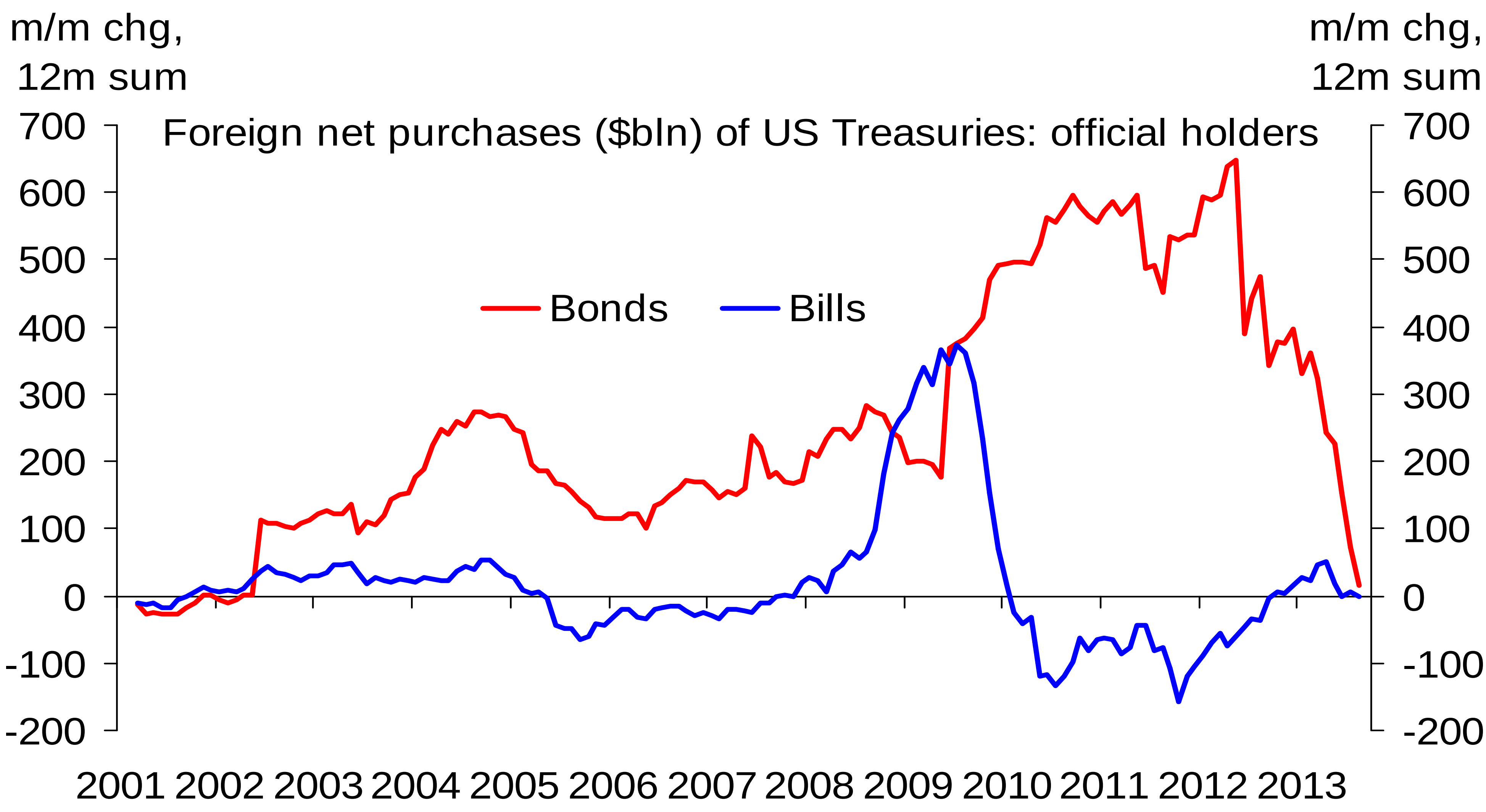
Torsten Slok, torsten.slok@db.com +1 212 250-2155

Foreign official holdings of Treasuries starting to roll over…



Source: Treasury, Haver Analytics, DB Global Markets Research

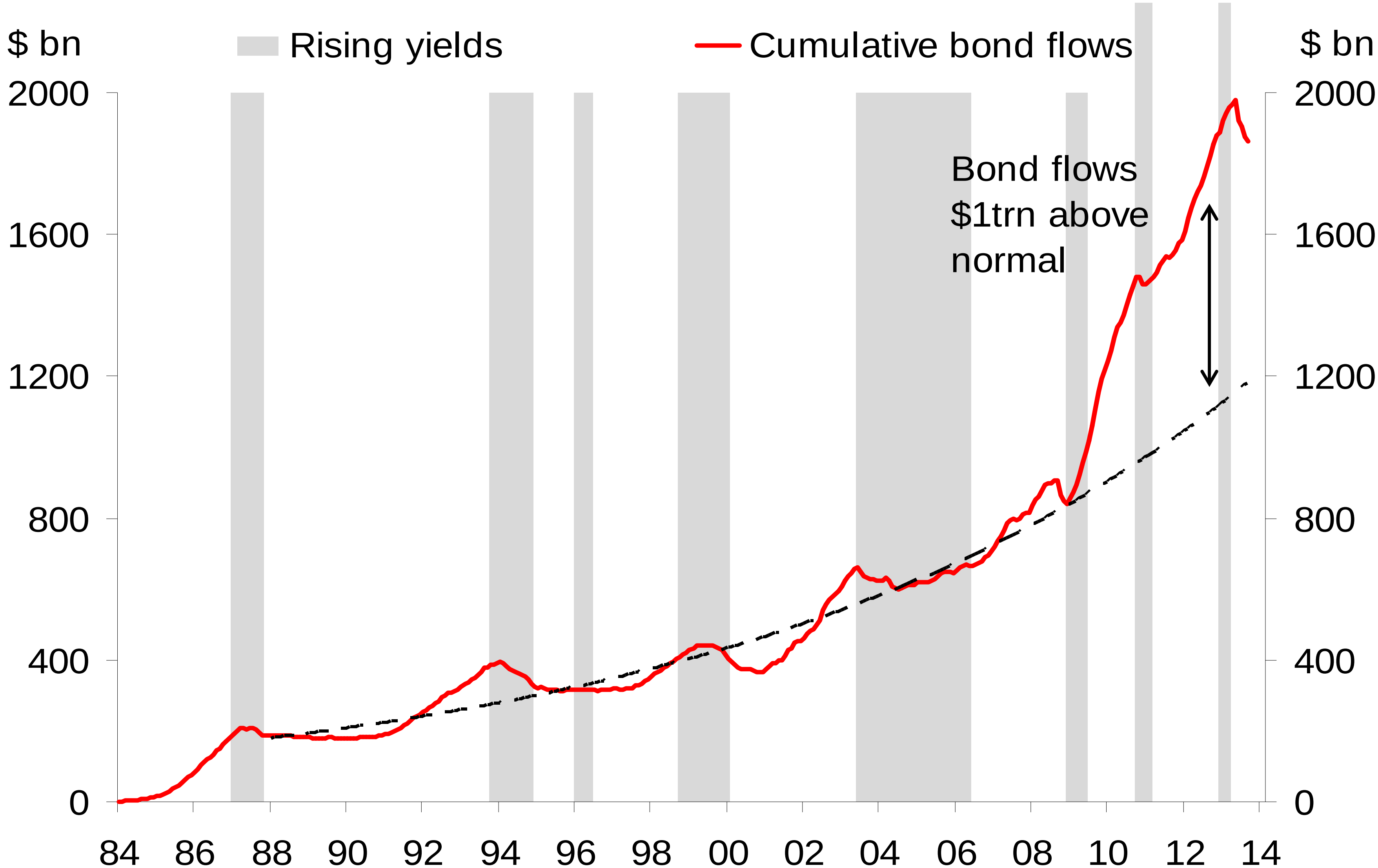
…and foreign central banks are losing appetite for both bonds and bills…



Source: Treasury, Haver Analytics, DB Global Markets Research

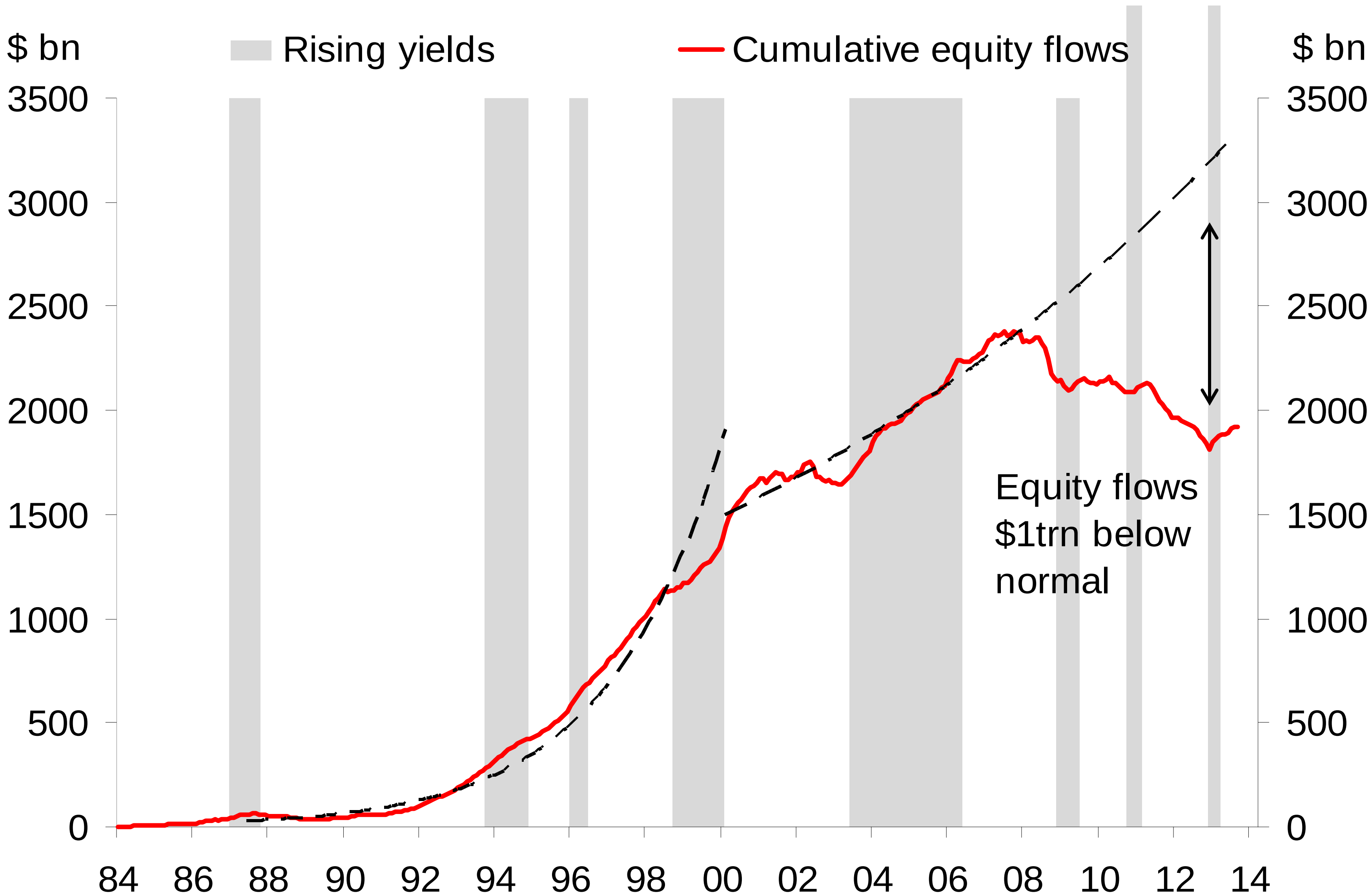
Investment Implications

In recent years investors have bought too much fixed income…



Source: Bankim Chadha & team, ICI, Haver Analytics, DB Global Markets Research

…and they are now underinvested in equities



Source: Bankim Chadha & team, ICI, Haver Analytics, DB Global Markets Research

Investment implications summarized

Fed outlook **– Fed to start tapering in the next six months**	Fed will taper in December or March
Bond markets **- Rates higher next year**	Fundamentals suggest 10y rates are at fair value. As growth accelerates going into 2014 rates will move higher.
Stock markets **- Better private sector balance sheets**	Corporate, household, and banking sector balance sheets continue to heal. This bodes well for equities.
FX **- USD up**	Stronger US recovery will mean Fed hiking sooner, which will mean higher USD
Commodities - **Downside risks**	Slowing Chinese construction growth likely to continue to put downward pressure on commodity prices. If commodity prices fall, Australia, Latam, and Canada likely to be hit.
Emerging markets **- Will benefit from US and EU recovery**	Structural problems starting to surface in a number of emerging markets, including China. Social unrest also a problem in several countries.

Source: DB Global Markets Research

Rules of thumb for the US economy

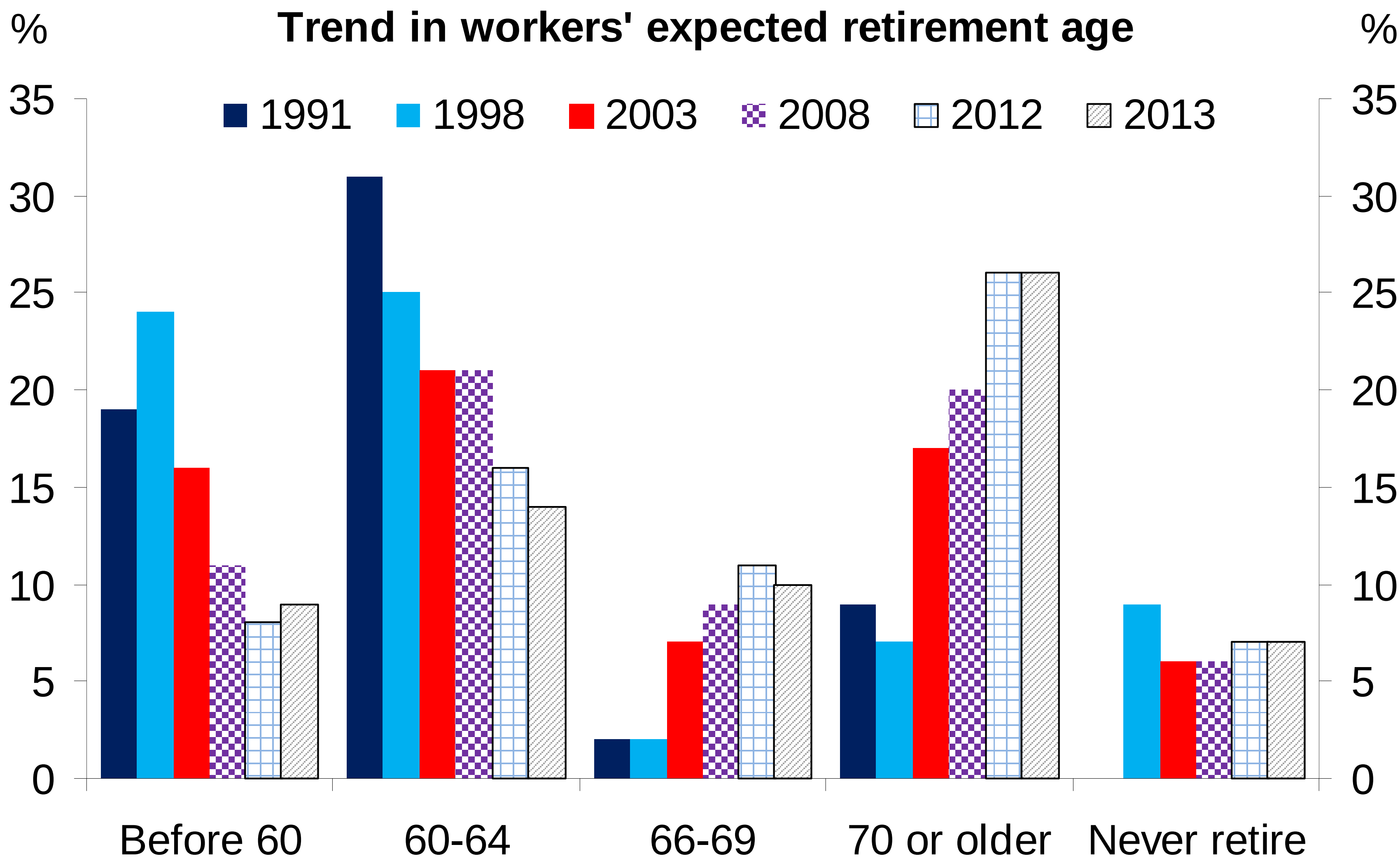
Cumulative impact on GDP growth and unemployment rate after 1, 2, and 3 years

Experiment	**Year 1**	**Year 2**	**Year 3**
10% decline in the dollar			
GDP	0.4	1.6	2.5
Unemployment rate	-0.1	-0.4	-1.0
$10 increase in oil prices			
GDP	-0.2	-0.4	-0.2
Unemployment rate	0.1	0.2	0.1
20% increase in stock market			
GDP	0.4	0.8	1.0
Unemployment rate	-0.1	-0.3	-0.4

Note: Percent change from baseline. All experiments assuming constant real funds rate

Source: Federal Reserve FRB/US Model, DB Global Markets Research

Workers expect to retire later



Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 1991-2013 Retirement Confidence Surveys, DB Global Markets Research

Torsten Slok, Ph.D.

- **Chief International Economist, Managing Director**
- **Deutsche Bank Securities, Inc.**

- Torsten Slok joined Deutsche Bank Securities in the fall of 2005.
- Mr. Slok's Economics team has been top-ranked by Institutional Investor for the past four years. Slok currently serves as a member of the Economic Club of New York
- Prior to joining the firm, Mr. Slok worked at the OECD in Paris in the Money and Finance Division and the Structural Policy Analysis Division. Before joining the OECD he worked for four years at the IMF in the Division responsible for writing the World Economic Outlook and the Division responsible for China, Hong Kong, and Mongolia.
- Mr. Slok studied at University of Copenhagen and Princeton University. He has published numerous journal articles and reviews on economics and policy analysis, including in Journal of International Economics, Journal of International Money and Finance, and The Econometric Journal.

Appendix 1

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