What’s Up With the Economy?

- A few words about the fiscal cliff
- A brief assessment of our current economic situation
- Some (hopefully) rational observations on equity valuations
- An intrepid foray into macroeconomic forecasting
What’s this I hear about a fiscal cliff?

- Shorthand for a group of policy changes that will come together around Jan. 1 – expiration of Bush-era tax cuts, automatic spending cuts (“Sequestration”), alternative minimum tax starts kicking in ...

- Conventional wisdom assumes that Congress will do something constructive in a lame-duck session.

- In September, a Goldman Sachs research note said there was a 1 in 3 chance that Congress would fail to pass even short-term measures to avoid a cliff.
Or Is It More of a Slope?

Key Elements of the “Fiscal Slope”:

- Failure to enact a retroactive inflation adjustment for the Alternative Minimum Tax.
- Reversion to 2000 Estate Tax levels.
- Reinstitution of original payroll tax deductions (End of payroll tax “holiday”).
- New taxes associated with the Patient Protection and Affordable Care Act of (a.k.a., “Obamacare”) of 2010.
- “Sequestration” – automatic spending cuts.

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<th>2011</th>
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<th>2000 (Adjusted for Inflation)</th>
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<tr>
<td></td>
<td>Married Filing Jointly</td>
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<td>Tax Rate</td>
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Not All Slopes Are the Same,
... And Sometimes We Get to Choose Our Way Down

And there is a way back up!
The Long Road Back (From the 2008 – 2009 Recession)

The Long Road Back

Graph showing the personal saving rate from 1960 to 2012. The graph includes a line for the smoothed personal saving rate, which is smoother and less volatile than the raw data. The saving rate fluctuates over time, with a noticeable decline in the 1980s and early 1990s, followed by a recovery in the late 1990s and early 2000s. The saving rate stabilizes around 3% to 4% in recent years.
The Long Road Back

- We’re experiencing a very slow recovery from a “balance sheet recession”

- The “fiscal cliff” would amount to a shift to austerity by having the public sector deleverage while the private sector continue its own deleveraging. This could be detrimental to economic performance. Luckily, it’s more of a “slope” than a “cliff”

- “… in a depressed economy like the present, if a long deep recession casts even a small shadow on future potential output, with interest rates in the range at which the U.S. has been able to borrow, there is a substantial likelihood that expansionary fiscal policy right now would be self-financing, and an overwhelming likelihood that it would pass a benefit-cost test.”
Aggregate consumer debt fell again in the third quarter, by $74 billion, continuing the nearly four-year downward trend in household debt. As of September 30, 2012, total consumer indebtedness was $11.31 trillion, 0.7% lower than its level in the second quarter of 2012 and down $1.37 trillion from the 2008Q3 peak.
"This is a major, major, empirical win for Campbell and Shiller. This is why only fools say today that movements in market-wide price-earnings ratios are best interpreted as shifts in rational expectations of future earnings and dividend growth. Instead, they are best interpreted as due to fads and fashions in how much people are willing to nerve themselves to pay for a dollar of earnings today ..."
A Very Brief Look at Equity Markets

Shiller P/E10

http://www.multpl.com/shiller-pe/
Forecasting is not a strength of any economist, but that never stops us from trying ...
James Bullard, president of the St. Louis Federal Reserve Bank, told them he thinks the U.S. gross domestic product will grow 3.5 percent next year. While that’s above average, it might not sound exceptional to an uninformed listener.

Bullard’s forecast puts him at odds with most private-sector economists. Three other forecasters who joined Bullard at Monday’s program said the economy remains stuck at a growth rate of just over 2 percent.

Bullard was, he admitted, too optimistic heading into 2011 and 2012. “We expected a faster re-bound” from the recession, he said. “There have been drag factors, primarily housing and the situation in Europe.”

Now, housing is showing signs of recovery, and the European Central Bank seems committed to keeping the continent’s banks afloat, no matter how many bail-outs the Spanish and Greek governments need.
U.S. Economic Growth Over Time

Various recent forecasts for 2013:
- FOMC September 13  2.5% to 3.0%
- NABE October 15    2.4%
- Phil. Fed November 9 2.0%

Source: Bureau of Economic Analysis data. Smoothed series generated using a Hodrick-Prescott filter.
Forecasting probabilities of recessions

Historical U.S. Recession Probabilities
June 1967 – August 2012

Notes: These probabilities were generated using monthly data on non-farm payroll employment, industrial production, real personal income excluding transfer payments, and real manufacturing and trade sales. All data was obtained on October 29, 2012.


October 2011: ~ 19.6%
Forecasting probabilities of recessions

Historical U.S. Recession Probabilities
January 1960 – October 2012

Probability of Recession

Jan-60  Jan-64  Jan-68  Jan-72  Jan-76  Jan-80  Jan-84  Jan-88  Jan-92  Jan-96  Jan-00  Jan-04  Jan-08  Jan-12

November 2011:
~ 5.7%

Going out on a (fairly sturdy) limb...

Various recent forecasts for 2013:
- FOMC September 13: 2.5% to 3.0%
- NABE October 15: 2.4%
- Phil. Fed November 9: 2.0%

10% probability of recession.
10% probability of "robust" growth.
Going out on a (fairly sturdy) limb...
Downside risks are more pronounced than are upside opportunities

Various recent forecasts for 2013:
- FOMC: September 13, 2.5% to 3.0%
- NABE: October 15, 2.4%
- Phil. Fed: November 9, 2.0%
Downside risks are more pronounced than are upside opportunities

1. **Europe:** There are some signs that the required political will is emerging and that some “structural adjustment” is underway.

2. **China:** The greatest threat to the U.S. economy of a slowdown in China is via rising geopolitical tension.

3. **Failure to choose the right line down the fiscal slope:** … especially when the housing and labor markets finally seem to be showing signs of recovery.