Rebalancing the U.S. Economy

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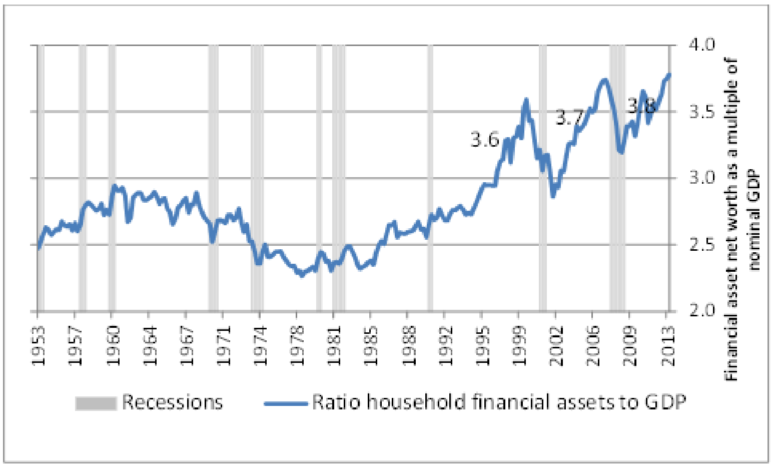
It’s happening again—a fourth quarter bounce in economic activity that extends into the first quarter and supports the view that growth really, finally, has started to accelerate. Such bounces have disappointed so far, although it does appear to be more than just hope this time. But the pick-up will be moderate—up to 2% to 3% possibly more with scattered inventory gains. In offering up my more pleasant, but not robust, forecast, I am banking on a number of favorable trends. Some are already in the pipeline and some are just starting to gain modest traction. All involve some rebalance in the economy toward normalization. The first is policy normalization—both fiscal and monetary. The economy has been weighed down to varying degrees by a huge fiscal drag from earlier year tax hikes that hit households and from spending cuts by federal and state governments. While painful, these cuts have rebalanced budget deficits. A year ago, the U.S. budget deficit was 6.5% of gross domestic product (GDP). It will likely fall to less than 4% of GDP in last year’s fourth quarter and looks to decline to something near 3% this year. Receipts are up 13% and outlays are down 5.5% in the last year—this is admirable progress. The easing fiscal drag will add to GDP via less subtraction. Indeed, private sector real GDP growth (GDP less government expenditures) is up 3% in the last 12 months versus overall real GDP at 1.7%. With the fiscal drag receding, monetary policy will also begin to normalize, providing less accommodation as large scale asset purchases wind down. This is important as the effects seem to have pushed up markets more than the economic growth. Many ratios relating stock and financial assets to GDP appear extended on a historical basis. For instance, looking at data from the Federal Reserve’s (the Fed) quarterly Flow of Funds report, the total worth of financial assets owned by households is at its highest ratio ever compared to GDP (see chart 1). Most of the gains in financial assets have been from equities, mutual funds and pension reserves. They appear about 12% higher than their average over the last 20 years relative to GDP. The economy, of course, could grow faster to normalize the ratio, but would require an unlikely 7.5% growth for two years straight. Nevertheless, the economy’s performance is an important metric for markets in the coming year, as growth needs to catch up.

Ratio of household worth in financial assets to nominal GDP



Sources: Federal Reserve, Bureau of Economic Analysis and National Bureau of Economic Research, September 2013

Two additional sectors where rebalancing is likely to add to domestic production are trade and capital spending. As to trade, the catalyst here is incremental domestic energy production and the diminishing dependency on oil imports which materially narrow trade deficits. Petroleum imports fell 6% (the lowest level since 1996), and petroleum exports rose 4% (to record highs) adjusted for inflation. The shale revolution together with increased energy efficiency has put the U.S. on the path toward energy independence, which can lower domestic energy costs and boost production onshore. Finally, one area that has failed to lift in recent years is capital spending. I do not expect a vigorous recovery here, but some firming should be expected in the coming year enough to raise capital investment growth from near 2% to

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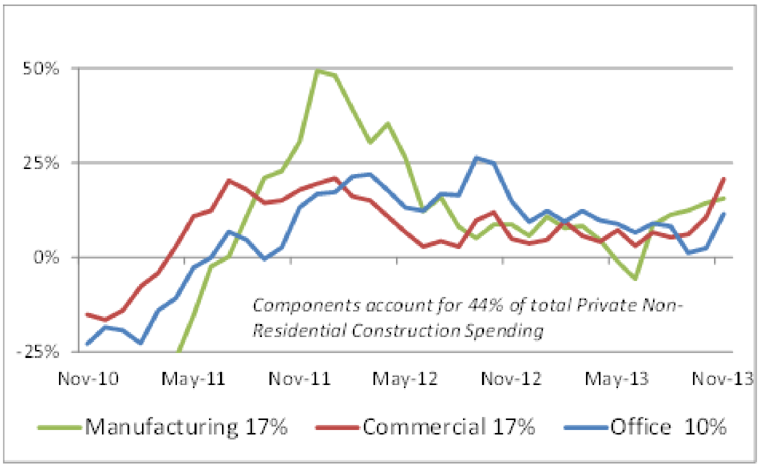
about 8% this year. The key to getting growth to accelerate beyond 2% is for business to borrow to improve and expand their productive capital, not return it to shareholders in the form of dividends. This capital deepening can begin to close the output gap and is probably what the markets are counting on. We are beginning to see some lift in private sector construction spending on offices, commercial space and manufacturing plants (see chart 2).

Private sector construction



Source: Census Bureau, November 2013

Consumers (70% of growth) appear a bit hamstrung. Spending has picked up slightly in the last six months, but the credit goes to falling inflation and another dig into savings—neither is sustainable. A pickup in income and wages is required which will be keyed off stronger labor markets. But gains remain only near trend, even forgiving the weather-related weakness in December. Personal income is rising only 2.3% year over year and is barely changed (essentially no growth) after adjusting for inflation and taxes. This area has failed to rebalance and remains challenged, particularly as businesses assess staffing and planned costs of the ACA (Obamacare). The global growth story as well appears a mix—capital flows are rebalancing and demand drivers are few with lots of excess supply putting downward pressure on inflation. Investors should note that this rebalance to better growth may also require some squaring by markets, particularly in light of policy shifts.

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