RSQE FORECASTS

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The U.S. Economic Outlook for 2013–2014
Executive Summary: June 2013

The Seesaw Ride

Since the beginning of 2011, the U.S. economy has not been able to string together two consecutive quarters of GDP growth in excess of 2 percent. In the first quarter of 2013, GDP expanded at a 2.4 percent pace, up two full percentage points from its pace in the closing quarter of 2012. A rebound in inventory investment explains much of the difference. The available monthly data for the spring quarter suggest that we are likely to see growth drop to a sub-2 percent pace yet again.

Behind the large fluctuations in headline growth there is a much smoother underlying trend in final sales to domestic purchasers, which posted 1.9 percent growth in the first quarter of 2013, matching its calendar-year 2011–12 average. Lately, government spending has been the largest consistent drag on growth. Reductions in real government purchases subtracted an average of 0.5 percentage points from growth for 2011–12.

On balance, the available monthly data for the spring quarter are tilted slightly to the downside. Both the manufacturing and nonmanufacturing indices from the Institute for Supply Management weakened in the April–May period relative to January–March, with the manufacturing index slipping into contractionary territory in May. The Fed's index of industrial production so far this quarter has averaged just below its first-quarter level. Average payroll gains in the past two months decelerated by almost 40,000 jobs per month relative to the first-quarter monthly average of 207,000. The unemployment rate, which had been falling, stalled at about 7.5 percent for March through May.

Consumer Resilience

Consumer-related monthly data brighten the picture. After a slight dip in April, light vehicle sales quickly rebounded the following month. In May, nominal retail and food service sales rose 4.3 percent relative to a year ago, an improvement over March–April readings. The Thomson Reuters/University of Michigan Survey of Consumers registered a dramatic rise in May in its index of consumer sentiment, to 84.5, a level that had not been reached since 2007. Coupled with the preliminary June reading, the index is up 6.4 percent over its 2012q2 average, yet another reason to expect solid consumption growth.

Housing Prices Sizzle

Increasing home values certainly do not hurt consumer optimism either. Home prices registered remarkable gains nationally; in the first quarter, the seasonally-adjusted S&P/Case-Shiller index posted a 16.7 percent annual rate of growth. Apart from making consumers happier and wealthier, higher prices are likely to stimulate more new home building. Residential construction, notwithstanding a hiccup in preliminary data for April, has shown strength and may even be accelerating as housing starts exceeded 1 million units in March for the first time since June 2008.

Fiscal Policy Brake

The significant increase in the federal tax take since the beginning of the year reflects not just rising personal and corporate incomes, but also the expiration of several tax cuts at the end of 2012. Real government purchases have continued to fall at a rapid rate in the first quarter as a result of harsh federal spending limits and the implementation of the sequester. Going forward, the House and Senate must reconcile the differences between the Ryan budget and the Senate alternative, two documents miles apart. Any passable budget will involve some considerable compromise in both spending and taxes.

The federal government deficit is projected to improve rapidly, decreasing from 7.1 percent of GDP (on a NIPA basis) in fiscal 2012 to 4.6 percent in 2013. Somewhat paradoxically, the better state of fiscal affairs is only expected to complicate future budget negotiations.

No Monetary Tightening on our Horizon

Despite the latest market reaction, our read on the expected path of monetary policy has not changed much. Broadly speaking, the details of the past few FOMC meetings paint a picture of a steady medium-term economic outlook. We expect the Fed to start tapering off its asset purchases by the end of 2013. Throughout our forecast horizon, our projections for *the unemployment rate and core inflation stay well clear of the triggers that could prompt the Fed to tighten the policy rate. We expect the fed funds rate to stay under 20 basis points through the end of 2014, with the 3-month T-bill closely following the fed funds rate. The 10-year Treasury yield rises to 2.2 percent by the end of 2013, and reaches 2.3 by the end of 2014. The mortgage rate is projected to rise to 3.8 percent in the final quarter of 2013 and to edge higher, reaching 4 percent by the end of 2014.*

The 2013–2014 Outlook

We forecast that the U.S. economy will grow more slowly in the second quarter of 2013 as consumption growth moderates to a more sustainable pace and the federal sequester impacts government spending. Real GDP then accelerates throughout the rest of 2013 and into 2014. This translates into real GDP growth of 1.9 percent for calendar 2013 and 2.7 percent the following year.

Starting in mid-2013, consumption picks up, and the drag from a contracting public sector lessens. Business fixed investment accelerates in the second half of 2013 and through 2014, as both nonresidential construction and investment in equipment and software contribute to faster GDP growth.

The recovery in home construction is finally a robust contributor to the pickup in growth. Single-family housing starts almost double from 2012 to 2014, growing to nearly 1 million units.

Pent-up demand, and easing credit conditions for auto loans, are helping to support light vehicle sales, which continue to improve. The annual gains moderate over the next two years, with the 1.3-million-unit gain from 2012 to 2014 less than the 1.7-million-unit increase for 2012.

Employment and Inflation

Employment growth does not exceed 200,000 jobs per month until output growth ratchets up to a sustained 3 percent pace during the second half of 2014. Payroll job gains improve from 2.2 million during 2012 to 2.4 million during 2014. With this moderate pace of job growth, employment will finally exceed its January 2008 peak in mid-2014, a six-and-a-half-year span.

Sluggish labor force growth has contributed to the drop in the unemployment rate during the recovery. As job prospects improve, workers return more quickly to the labor pool, slowing the improvement in the jobless rate. The unemployment rate edges down over the forecast horizon from 7.5 percent this quarter to 6.8 percent by the close of 2014.

Core consumer price inflation returns to 1¾ percent in 2013–14, following an uptick to 2.1 percent in 2012. With oil prices inching down, and food price inflation moderating, the all-items CPI rises by 1.4 percent per year for the next two years.

	Actual		**RSQE Forecast**	
	2011	2012	2013	2014
GDP (billions of current $)	15075.7	15684.8	16192.0	16887.4
Real GDP (billions of chained 2005 $)	13299.1	13593.2	13846.6	14223.6
% change: year-over-year	1.8	2.2	1.9	2.7
% change: 4th-qtr-to-4th-qtr	2.0	1.7	2.2	3.0
Nonfarm payroll employment (millions)	131.5	133.7	135.9	138.2
Civilian unemployment rate (%)	8.9	8.1	7.5	7.0
Capacity utilization, total industry (%)	76.5	77.6	78.0	79.1
Inflation (private nonfarm GDP deflator, % change)	1.9	1.7	1.1	1.6
Inflation (CPI-U, % change)	3.2	2.1	1.4	1.4
Inflation (core CPI, % change)	1.7	2.1	1.7	1.8
Light vehicle sales (millions)	12.7	14.4	15.3	15.7
Private housing starts (thousands)	611.8	783.0	1015.2	1305.0
3-month Treasury bill rate (%)	0.1	0.1	0.1	0.2
10-year Treasury note rate (%)	2.8	1.8	2.0	2.2
Conventional mortgage rate (%)	4.5	3.7	3.6	3.9
Real disposable income (billions of chained 2005 $)	10149.7	10321.2	10400.7	10686.7
% change	1.3	1.7	0.8	2.8
Corporate profits after tax (billions of current $)	1475.1	1712.9	1738.9	1916.2
Value of U.S. $ (FRB broad index), % appreciation	–4.6	2.8	0.8	0.1
Current account balance (NIPA basis, billions of current $)	–465.8	–474.1	–445.5	–456.4
Federal surplus (FY, NIPA basis, billions of current $)	–1265.4	–1111.0	–733.1	–597.6