The U.S. Economic Outlook

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What Has Happened to the Recovery?

The Bad News

• Growth very weak; usual pattern after a severe financial crisis
• Commodity price surge and Japan disaster hit H1 growth
• Confidence in U.S. policy-making has hit new lows
• The debt-ceiling outcome offered neither short-term fiscal support nor long-term fiscal reforms; huge uncertainty remains
• Fed running out of options
• Global growth slowing; Eurozone recession likely
• Financial fall-out from Eurozone sovereign debt crisis could be severe if policy-makers cannot act more decisively
What Has Happened to The Recovery?
The Good News

- Leading indicators don’t yet point to U.S. recession
- Stock market is down but financial stress indicators are nothing like 2008, or even 2007
- Japan shock effects receding, commodity price pressures easing
- The downside to battered sectors like housing is limited
- Pent-up demand is building
- Consumer sentiment is at recession levels, but spending hasn’t followed sentiment down
- It would probably take more shocks to make a recession (rather than just weak growth) the most likely outcome
Key Leading Indicators Have Slipped, but ISM Indexes Still Above Breakeven

(ISM Diffusion Indexes, 50 = breakeven) (NFIB Index, 1986=100)

2007 2008 2009 2010 2011

ISM = Institute for Supply Management; NFIB = National Federation of Independent Business
No Surge in Initial Claims

(Initial unemployment insurance claims, thousands)

Jan-10 Apr-10 Jul-10 Oct-10 Jan-11 Apr-11 Jul-11 Oct-11

4-Week Moving Average
• Actual
Deep Recession, Slow Recovery

(Annualized real rate of growth, Q/Q, percent)
Summary Outlook Tables
# U.S. Economic Growth by Sector

(Percent change unless otherwise noted)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>3.0</td>
<td>1.7</td>
<td>1.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Final Sales</td>
<td>1.4</td>
<td>1.9</td>
<td>1.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Consumption</td>
<td>2.0</td>
<td>2.1</td>
<td>1.9</td>
<td>1.8</td>
</tr>
<tr>
<td>Light Vehicle Sales (Millions)</td>
<td>11.6</td>
<td>12.5</td>
<td>13.2</td>
<td>14.7</td>
</tr>
<tr>
<td>Residential Investment</td>
<td>-4.3</td>
<td>-2.1</td>
<td>4.3</td>
<td>17.9</td>
</tr>
<tr>
<td>Housing Starts (Millions)</td>
<td>0.58</td>
<td>0.59</td>
<td>0.67</td>
<td>0.94</td>
</tr>
<tr>
<td>Business Fixed Investment</td>
<td>4.4</td>
<td>8.7</td>
<td>4.3</td>
<td>5.8</td>
</tr>
<tr>
<td>Federal Government</td>
<td>4.5</td>
<td>-1.9</td>
<td>-2.7</td>
<td>-3.6</td>
</tr>
<tr>
<td>State and Local Government</td>
<td>-1.8</td>
<td>-2.4</td>
<td>-2.7</td>
<td>-0.9</td>
</tr>
<tr>
<td>Exports</td>
<td>11.3</td>
<td>6.7</td>
<td>3.4</td>
<td>7.5</td>
</tr>
<tr>
<td>Imports</td>
<td>12.5</td>
<td>4.6</td>
<td>2.4</td>
<td>3.8</td>
</tr>
</tbody>
</table>
### Other Key Indicators

(Percent unless otherwise noted)

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial Production (% growth)</td>
<td>5.3</td>
<td>3.6</td>
<td>1.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Employment (% growth)</td>
<td>-0.7</td>
<td>0.9</td>
<td>0.6</td>
<td>1.3</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>9.6</td>
<td>9.1</td>
<td>9.3</td>
<td>9.1</td>
</tr>
<tr>
<td>CPI Inflation</td>
<td>1.6</td>
<td>3.0</td>
<td>1.3</td>
<td>1.9</td>
</tr>
<tr>
<td>Oil Prices (WTI, $/bbl)</td>
<td>79</td>
<td>91</td>
<td>89</td>
<td>98</td>
</tr>
<tr>
<td>Core PCE Price Inflation</td>
<td>1.4</td>
<td>1.5</td>
<td>1.4</td>
<td>1.6</td>
</tr>
<tr>
<td>Federal Funds Rate</td>
<td>0.18</td>
<td>0.11</td>
<td>0.10</td>
<td>0.11</td>
</tr>
<tr>
<td>10-year Government Bond Yield</td>
<td>3.21</td>
<td>2.76</td>
<td>2.32</td>
<td>2.84</td>
</tr>
<tr>
<td>Dollar (Major Currencies, 2005=1)</td>
<td>0.90</td>
<td>0.85</td>
<td>0.88</td>
<td>0.86</td>
</tr>
</tbody>
</table>
The Housing Cycle: Still At The Bottom
The Homeowner Vacancy Rate Is Little Changed

(Proportion of homeowner inventory vacant and for sale, percent)

Source: Census Bureau
A Prolonged Trough for Housing Starts: Prices Not At Bottom Yet

- Housing Starts (LS, millions of units)
- FHFA House Price Index (RS, purchase-only index, 1991Q1 = 100)
The Consumer: Too Many Negatives
Consumer Sentiment Is In Recession Territory

(Reuters/University of Michigan Index, 1966=100)
Consumer Finances: Too Many Negatives

**Negative Forces**
- High Unemployment
- Heavy Wealth Loss
- Tight Credit Conditions
- High Debt Burdens
- High Prices – esp. Gasoline, Food
- Future Tax Increases Likely

**Positive Forces**
- Fiscal Stimulus (temporary)
- Pent-Up Demand
- Gasoline Prices Should Fall, Food Inflation Should Ease
Consumer Spending Is Not A Strong Driver of Recovery, But It’s Doing Better Than Sentiment

(Annualized rate of growth)
Business Investment: Are Structures Joining The Recovery?
Business Capital Spending Cycle: Construction Dawn Premature?

(Percent change annualized rate, real spending)

2007 2008 2009 2010 2011 2012 2013

Software & Equipment - Buildings

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Foreign Trade:
Still A Plus For Growth,
Though Export Prospects Have Dimmed
Exports Expected to Outpace Imports

(Percent change annualized rate, volumes)

Real U.S. Exports
Real U.S. Imports
Fiscal Policy
Our Fiscal Policy Assumptions

• Discretionary spending caps implemented, as agreed under debt-ceiling deal

• Supercommittee fails...

• ...but sequester is replaced by entitlement savings and tax increases to be determined after the 2012 elections

• 2% payroll tax cut and emergency UI benefits extended into 2012, and later phased out, not suddenly removed

• But nothing on top of that from the President’s jobs plan

• These assumptions stabilize (but do not cut) the debt-to-GDP ratio
The Federal Budget Gap: We Expect Action On Both Sides of the Ledger...

(Percent of GDP)


Revenues
Expenditures
Big Squeeze on Discretionary Spending – Defense and Non-Defense
Recession Risks
<table>
<thead>
<tr>
<th>Why?</th>
<th>Why Not?</th>
</tr>
</thead>
<tbody>
<tr>
<td>• An economy near stall speed is vulnerable to shocks</td>
<td>• U.S. banks in better shape than 2008</td>
</tr>
<tr>
<td>• Fed can’t help much</td>
<td>• Nonfinancial corporations balance sheets are strong</td>
</tr>
</tbody>
</table>
| • Risks of policy mistakes  
  – Premature fiscal tightening  
  – Policy paralysis | • Exposures to Eurozone sovereign debt are better understood than exposures to sub-prime debt were |
| • Eurozone is the immediate risk | • Europe unlikely to allow a major institution to collapse |
| • Oil shocks a perennial threat |  |
GDP Growth Outlook

(Annualized rate of growth)

Baseline (50%)  Pessimistic Scenario (40%)  Optimistic Scenario (10%)
Unemployment Outlook

(Percent)

2007 2008 2009 2010 2011 2012 2013

Baseline (50%)  Pessimistic Scenario (40%)  Optimistic Scenario (10%)
Implications and Bottom Line

- Most likely outcome is anemic growth, not recession
- Recovery very muted; growth doesn’t beat 3% until 2014 (helped, at last, by a housing revival)
- Fed powers are limited; no panaceas
- Fiscal stimulus; the question is how fast it’s withdrawn, not whether it will be ramped up
- Still huge fiscal uncertainty; supercommittee task looks impossible
- January 1, 2013 could be another crisis deadline
- Growth at around “stall speed” leaves the economy highly vulnerable to recession risks (40% odds)
Thank you!

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