Cliff, Carols, or Coal

DKW, November 28, 2012

The elections are over and TV commercials are back to pharmaceuticals, beer, and automobiles. Maybe your side won on November 6th, maybe it didn't, but the economic situation has changed little and the "fiscal cliff" is staring everybody in the face. (The "fiscal cliff" is the name given to the pending tax increases and spending cut deadlines that are to take effect January 2, 2013. The combination takes some $580 billion out of the economy from a previous congressional agreement (Budget Control Act of 2011) as a condition of increasing the federal debt limit last time around.)

Note: this rendering is abbreviated due to the ongoing negotiations around the cliff. The ramifications of the cliff are ominous and onerous, and difficult to quantify. I will update the situation after the first of the year when hopefully clearer heads have prevailed.

The cliff is high and short. The end of the Bush tax cuts, the Obama payroll tax cuts, and extended unemployment benefits (higher revenue), coupled with cuts to the defense budget, Medicare, and another thousand programs (lower spending) amounts to over three percent of GDP. Pulling three percentage points out of current GDP ($15.1 T), would probably push the economy, which is growing at about two percent, into a recession. So the stakes are large.

As this is being written, most of the talk out of Washington D.C. about the cliff is mutually conciliatory. Everyday, good/bad news about the budget talks will push market confidence higher/lower and economic stability up/down in the corresponding direction. Politics are not my strong suit, but the economic ramifications of policy decisions are. We cannot continue to spend more than we have. Suffice it to say, here exists a crisis from which to draw opportunity.

Moreover, failure to address the cliff in a conciliatory manner provides a contentious preamble to the debt ceiling negotiations in early 2013. You may remember the country came within hours of defaulting on its debt the last time around and had its credit rating cut. So, successfully and cooperatively dealing with the cliff will determine whether the holidays bring choruses or carbon.

Change in my outlook

Over the last couple months I have changed my outlook on the prospects for economic growth in the medium term. The shift has been subtle, but significant.

Formerly, I was looking for East Asian economic growth and exports thereto to keep pulling the U.S. economy slowly along. Wisconsin manufacturing was benefitting from Asian infrastructure development. But there was nothing I could see that would give a real jumpstart to the growth cycle and widen and deepen its roots. Now, the fiscal and economic desperations in Europe have slowed Asian exports and, in turn, U.S. exports to Europe and Asia.

In the meantime, however, the U.S. economy has stabilized to the point of convincing the consumer that the worst is over. While jobs aren't being created in sufficient quantities to propel workforce growth, enough are being created to set a base of momentum. Initial U.S. unemployment claims are moving sideways at about 370,000 per week, levels higher than we want (250,000), but not increasing. Retail sales are steadily higher and the projections for holiday sales are in the four percent range. Those indicators are relatively superficial and subject to volatility.

Where I see the strength, finally, is in the housing markets. Housing sales and prices are moving steadily higher off their bottoms. Existing home sales are up 11% year-over-year. Housing starts and permits have an annual run rate of over 800,000 units. Residential construction investment has increased 14% y/y, up every quarter.   Bankers are seeing more original mortgage applications. Housing has a large multiplier, generating demand for a lot of related goods, such as lumber, carpeting, appliances, lighting, and décor, so the gains will help broaden activity across a number of sectors.

So, while I don't see rapid growth on the horizon, I am more confident that the recovery will pick up steam over the next couple of years.

The major caveat to this heightened optimism is the cliff. The uncertainty surrounding solving the fiscal problems in the short- and long-runs has had a dampening affect on business investment. One of the measures we had going for us was non-residential fixed investment. That growth rate has turned lower and even investment in software and equipment has flattened. We are no means out of the woods or near Grandmother's house.

Decisions about the cliff will make or break economic festivities. I hope to be singing.

Happy Holidays to you and yours.

P.S. I once got a holiday card that on the outside said, "You get <u>two</u> pieces of coal." On the inside the snowman cried with glee, "I can see!" I thought it was a nice turn of perspective.