Northern Trust

WEEKLY ECONOMIC COMMENTARY

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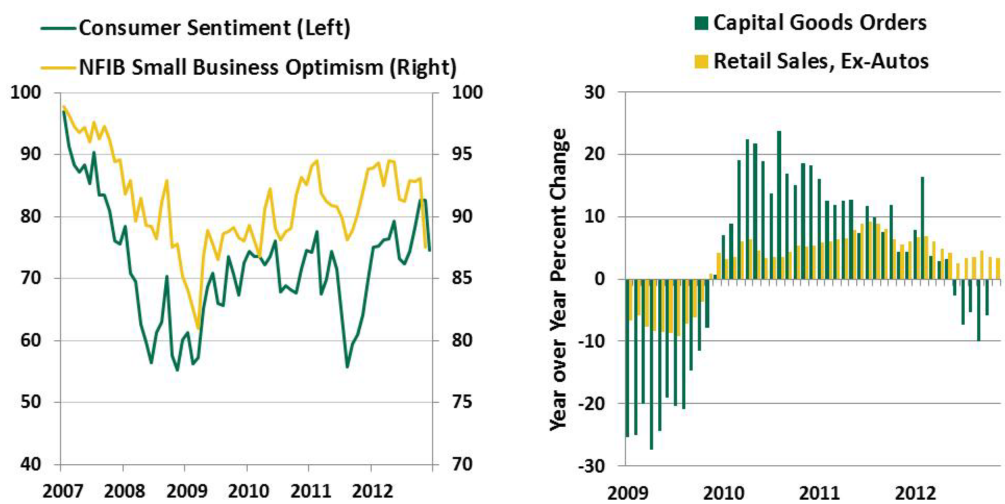
- **Fiscal friction is taking a toll on confidence in Washington and Rome**
- **What inflation rate should be used to index entitlements?**
- **Our updated US forecast assumes a budget resolution before year end**

I am usually pretty calm, but being late and being lost can get me agitated. So imagine the escalation in my blood pressure during a recent family outing, when a wrong turn took me into an unfamiliar neighborhood. To make matters worse, my mother, my wife, and my children were all heckling me as I sought to get back on course. I was tempted to drop them off and proceed on my own.

The path to prosperity often runs through some unfamiliar territory. Along the way, there will be those who question whether policy is on the right course. The key to success is maintaining confidence that the ultimate destination is the right one. At the moment, this challenge is particularly acute in the US and Italy.

As we approach the end of the year, the uncertainty surrounding the US fiscal cliff discussions has hindered America's confidence in the future. Worried consumers spend conservatively. Worried businesses don't expand. Worried investors are more risk averse. None of these is especially helpful to market and economic performance.



Sources: University of Michigan, NFIB, Census Bureau, Bloomberg

The last time the US government came close to the fiscal brink was in the summer of 2011. In that case, confidence took a dive amid the inability of policy makers to reach a resolution. Fortunately, economic fundamentals were little affected, and a positive outlook was restored in short order.

Economic literature has found only the softest of links between confidence measures and consumer spending; the mind and the wallet are not as closely linked as one might think. But present circumstances may be different, since the source of concern is a potential reduction in spending power and wealth.

As we wrote last week, the debate over the fiscal cliff may be awakening consumers to the likelihood that after-tax income for almost all households will be lower next year. (While much of the revenue discussion centers on those with the highest incomes, the expiration of this year's payroll tax holiday will take about $1,000 out of take-home pay for working families.) And the equity markets may be vulnerable if stock prices reflect the expectation that the cliff will not hit with full force.

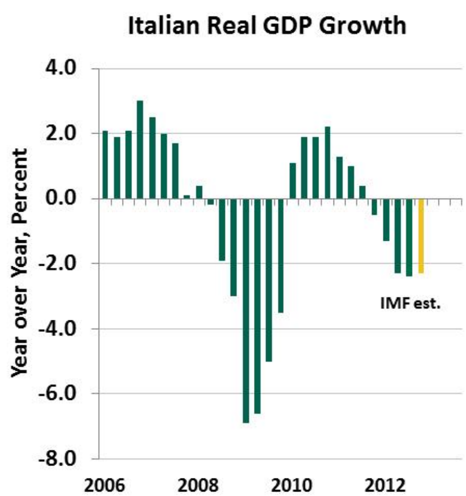
Today's concerns may be self-fulfilling, if businesses and consumers pull back in anticipation of tough times.

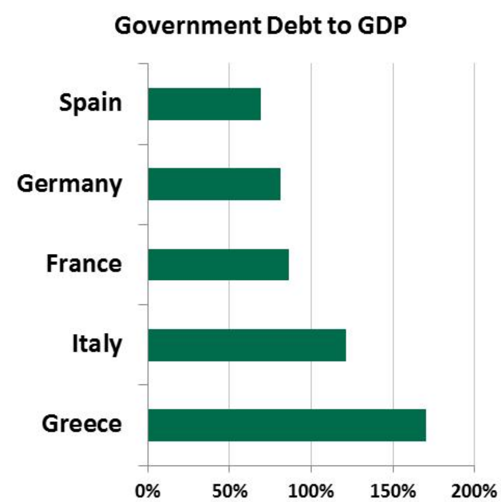
On the business side, the cloudiness over general business prospects and the tax status of certain activities has diminished optimism. Many small businesses are structured in a manner that makes personal tax rates relevant for corporate profits, so their proprietors are vulnerable on both fronts.

We have already seen a significant moderation in US spending and investment. Capital goods orders have fallen by almost 6% over the past twelve months, and the growth rate of retail sales (excluding autos) is about half of what it had been in the first quarter of 2012. If fiscal discussions fail, these trends could deepen.

Talks are continuing, but time is running short. Some lawmakers have suggested passing a measure to tide over operations for a couple of months, and then engaging more seriously as we approach the US Federal debt ceiling next March. Those kinds of statements are not going to add holiday cheer to a vulnerable national mood.

In Italy, we have seen how the stress of fiscal change can cause a loss of confidence in a leading European government. After passing an austerity-laden budget, Prime Minister Mario Monti announced that he would resign, triggering elections early next year. Monti had been shepherding the country through a series of measures aimed at reducing Italy's government debt, which is the second-highest in the Eurozone (as a fraction of GDP).





Source: Bloomberg, International Monetary Fund

A change in Italian government is not uncommon; there have been 39 leadership changes since World War II. The concern is that Italy's next government might not press forward with fiscal reform. Still in the political picture is former Prime Minister Silvio Berlusconi, who has expressed displeasure with the concessions the country has made to its EU partners.

Short election cycles are at odds with long-term reform.

Monti's resignation sets the stage for a potentially volatile couple of months in Italian markets. Italy's financial ties to institutions in the US and the UK are far deeper than other challenged Mediterranean nations, so a worst-case outcome carries a high risk of contagion.

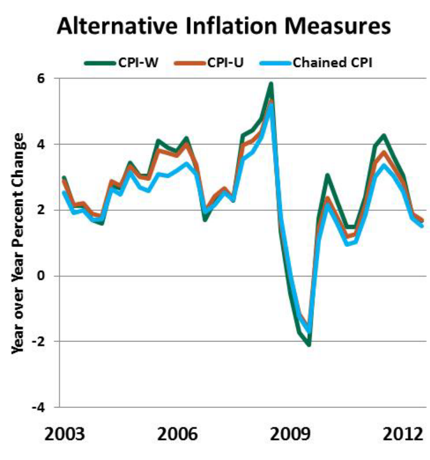
On a structural level, one might ask whether frequent government turnover is conducive to the implementation of important reforms. Calls for sacrifice inevitably create short-term discontent, which can undermine the long-term discipline needed to enforce change. Some have wondered whether the two-year election cycle for US Representatives is too short. What about countries where coalitions can dissolve at any time?

I am happy to report that my family's detour was short-lived. We found our way back home safely, and my blood pressure returned to normal. Afterwards, I reminded everyone that their protestations were misplaced and counterproductive. And if they didn't like my driving…they are welcome to walk.

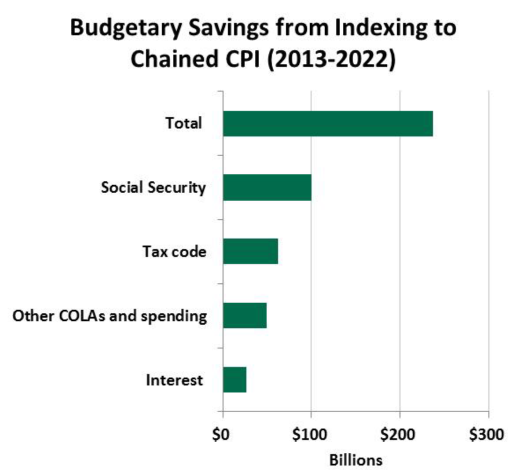
Using Chains to Restrain Entitlement Costs

A number of deficit-reduction outlines have included proposals to modify the current method of indexing federal benefits and elements of the tax code to inflation. While this might seem to be a minor and technical matter, big dollars are at stake.

The objective of indexing benefits is to allow beneficiaries to maintain purchasing power. Indexing tax brackets shields filers from owing higher taxes simply because of inflation. At the moment, benefits are increased annually based on the consumer price index (CPI) of Urban Wage Earners and Clerical Workers (CPI-W). Tax brackets and standard deductions are adjusted using the CPI for All Urban Consumers (CPI-U). As shown in the left hand chart below, these measures move closely, but not exactly.



Source: Bureau of Labor Statistics/Haver Analytics



Source: The Moment of Truth Project

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The different CPI measures all start with the monthly collection of prices on 8,108 items, but differ in the way they are aggregated to form an overall index. The weights for the CPI-U and CPI-W are updated every two years, so they are often thought of as referring to a reasonably stable basket of goods. (The baskets differ slightly between urban consumers and wage-earners.)

By contrast, the chain-weighted CPI reacts much more quickly to changes in consumption patterns. The weight assigned to the cost of a given item can change monthly, if people are buying more or less of that item. For example, consumers will tend to purchase less beef and more chicken if the price of beef shoots up. The overall grocery bill is lower than it would be if households always bought the same basket of goods.

The choice of an inflation index may seem like an arcane issue, but it drives billions of dollars.

The Bureau of Labor Statistics began computing the chained CPI in 2000, following the Boskin Commission's conclusion that the traditional CPI was overstating inflation. The CPI's inability to account for substitution was identified as a weakness. Some in Congress are now proposing that the chained CPI be adopted as the driver of annual increases in Federal benefits and alterations in the tax tables.

Over the past ten years, average inflation based on the CPI-W is 2.5% compared with 2.2% for the chained CPI. This may seem like a small difference, but applied over a broad base and over a long time frame, it can produce a substantial difference in results. Currently, 62 million Americans are recipients of Social Security and Supplemental Security Income. The trajectory of baby boomers retiring in the years ahead suggests that the benefit from a switch to chained CPI is a notable sum.

From a tax filing perspective, several parameters in the tax code would experience a smaller adjustment if the chained CPI is used. The immediate benefit to the federal government is that a larger share of income would be subject to taxes. Pulling the two sides together, the Moment of Truth Project estimates that the total budgetary savings from switching to the chained CPI is close to $240 billion over a ten year period.

Taxpayers will certainly see this as a stealthy way to increase revenue. But it can certainly be argued that the chained CPI is a more accurate reflection of the cost of living, and should be considered on its merits. And as opposed to other options for reducing the deficit, this may be among the most palatable.

Year-End Forecast: Looking Beyond the Fiscal Cliff

Forecasts are always challenging. This time around, the fiscal cliff is a special short-term unknown which makes it difficult to predict the near term course of the economy.

Our baseline case is that a compromise of sorts between the two parties will be struck at the eleventh hour. Even in this event, a mild fiscal slope will occur, with some parts of current law permitted to become effective as a new year unfolds.

The final months of this year and the early part of next year will go down as a period of soft economic conditions, with real GDP growth barely above 1.0%, partly due to inclement weather and partly due to political gridlock. We have lowered our estimates of real GDP for the fourth quarter to 1.1% from 1.3%, largely due to the weakness in consumer spending in October and an expected reduction in inventories. Elements of the fiscal cliff set back the first quarter forecast a tad, compared with the estimate last month.

US Economic Outlook

	2011		2012				2013				Q4 to Q4 change			Annual change		
	11:3a	11:4a	12:1a	12:2a	12:3a	12:4f	13:1f	13:2f	13:3f	13:4f	2011a	2012f	2013f	2011a	2012f	2013f
Real Gross Domestic Product (% change, SAAR)	1.3	4.1	2.0	1.3	2.7	1.1	1.2	1.9	2.1	2.2	2.0	1.7	1.8	1.8	2.2	1.7
Consumer Price Index (% change, annualised rate)	3.1	1.3	2.5	0.8	2.3	3.3	1.7	1.7	1.7	2.0	3.3	2.2	1.8	3.1	2.2	2.1
Civilian Unemployment Rate (%, average)	9.1	8.7	8.3	8.2	8.1	7.8	7.7	7.6	7.5	7.3				9.0*	8.1*	7.5*
Federal Funds rate	0.08	0.07	0.10	0.15	0.14	0.15	0.15	0.15	0.15	0.15				0.10*	0.14*	0.15*
2-yr. Treasury Note	0.28	0.26	0.29	0.29	0.26	0.30	0.30	0.30	0.30	0.45				0.45*	0.29*	0.34*
10-yr. Treasury Note	2.43	2.05	2.04	1.82	1.64	1.65	1.70	1.80	1.80	2.00				2.79*	1.79*	1.83*

a=actual
f=forecast
* =annual average

Key elements of the current forecast include:

Even an agreement to avert the fiscal cliff will diminish spending power.

- Consumer spending in the fourth quarter will be marked with strength in auto sales and soft non-auto retail sales, based on data available thus far. It is not entirely clear if Hurricane Sandy has played a role in holding back retail sales; additional data should offer more insights. All in, real consumer spending growth should average a little below 1-1/2% in the final three months of 2012 and first quarter of 2013. The reinstatement of payroll tax cuts should account for a big part of the deceleration in consumer spending in the first three months of next year.
- The housing sector is a bright spot in the overcast short-term landscape. Incoming household sector data on home sales, starts, and prices point to improvements that will make a positive contribution to fourth quarter real GDP growth. Residential investment expenditures should post an annual increase in 2012 (assuming a fourth quarter gain), which will be the first since 2005.
- Business spending is estimated to have advanced at a tepid pace, following the first decline since the recovery began in June 2009, as firms continue to hold back amid uncertain fiscal policy discussions. High vacancy rates and tight credit conditions are curtailing the growth of non-residential construction spending. Inventory accumulation is expected to subtract from GDP growth in the fourth quarter following a sharp increase in the third quarter.
- A widening of the trade gap is nearly certain given the poor-to-soft growth prospects of America's trading partners in the near term. The recent European Central Bank downgrade of the economic outlook for the Eurozone supports expectations of a tepid contribution from exports to GDP growth. China's exports and imports slowed in November and have diminished the optimism associated with other recent economic indicators.

- The sub-par growth forecast in the near term combined with moderate momentum from spring of 2013 suggests only a slow improvement in the unemployment rate. Lack of robust demand conditions is consistent with a non-threatening trend of inflation during the forecast period.
- Risks are tilted to the downside, given the political and economic situation in Europe and estimates of growth in Asia pointing to subdued growth. Turmoil in the Middle East is a source of economic risk that could have adverse consequences on not only the US but also the global economy.

We are tracking negotiations about the fiscal cliff very closely. Stay tuned for the updates about the impact of these talks on the economy.