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Peaks and Valleys

July 16, 2012

Summary:

- **Second quarter economic activity disappointed on many fronts. The drama in Europe has taken its toll on exports, markets, and confidence.**
- **The 2012 election is starting to take shape, amid the approach of a huge fiscal "cliff" at the national and local level. The negativity and uncertainty which often surround Presidential campaigns may hinder economic and market performance.**
- **This month's special focus is on the Fed's recent Survey of Consumer Finances, and what it means for our economy.**

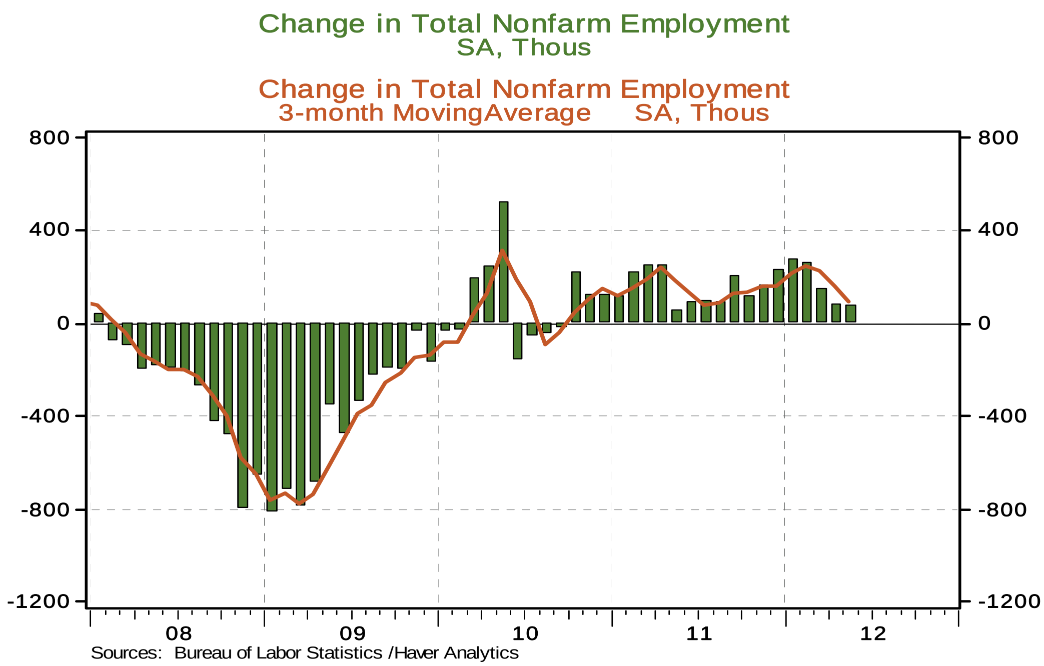
With three of our four major sports in recess during the peak summer months, those armchair spectators wanting a little diversity from baseball have slim pickings. The Canadians are playing football already, but most Americans can't get used to 12 players, three downs, and round end zones. The European soccer championships are done; here's hoping that Spanish success on the pitch provides momentum to their economy. There are golf tournaments each week, but they often don't get interesting until the back nine on Sunday.

One candidate to fill the gap is the Tour de France. Now telecast each day in its entirety, the Tour has a lot to offer viewers: spectacular vistas, fierce competition, and the occasional multi-rider pileup. As I watched a recent mountain stage, it struck me that the course traversed by the *peloton* and the one traced recently by our economy have a lot in common.

U.S. Fundamentals

After making a promising ascent during the first quarter, many key indicators have moved to a lower altitude. Chief among them is job creation, which averaged just 75,000 per month in the second quarter. This is well below the trend of the prior year (162,000 per month), and well below what most economists think is needed to make a meaningful dent in the unemployment rate.

Chart 1



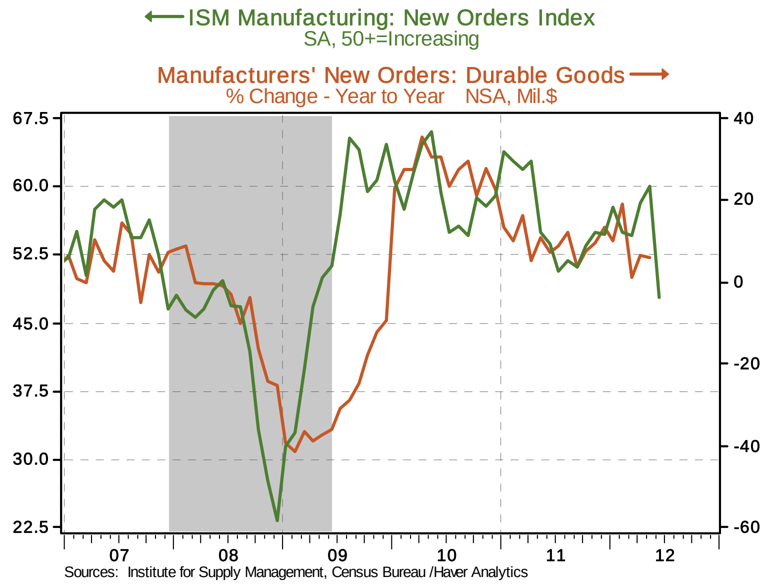
Unfortunately, the employment situation is likely worse than it appears on the surface:

a) The official unemployment rate, which stands at 8.2%, is being "helped" by the lowest labor force participation rate in about 30 years. Broader measures of joblessness, which include discouraged workers and those working part-time because full-time roles are unavailable, actually rose during the second quarter. This "shadow inventory" of workers will ultimately need to be absorbed back into the labor force.

b) The average duration of joblessness remains close to 40 weeks, and has not shown any signs of diminishing. These longer search times may result in much more important levels of income loss once workers are re-hired.

The outlook for hiring may also be affected by somewhat less encouraging data on sales and production. Retailers reported a third straight monthly decline in June, and inventories are rising. Readings on orders stepped back in the second quarter, and the June ISM surveys of heavy industry showed the largest single month decline since 2001.

Chart 2



Analysts observe that we've seen this kind of pattern in the data for the past three years, and suggest that seasonal adjustments may be accentuating both the ups and the downs. But even if one looks at trends over longer time intervals (which limits the influence of seasonality), levels of activity are still below potential, and well below what we've observed in past recovery/expansion cycles.

On the heels of this, our expectation is for second quarter growth of only 2.0%, and 2.1% for the full year. Our first formal look at 2013 shows only modest improvement from this pace, with real GDP projected to increase by 2.5% on a fourth quarter to fourth quarter basis.

Full details on the forecast can be found at the back of this piece.

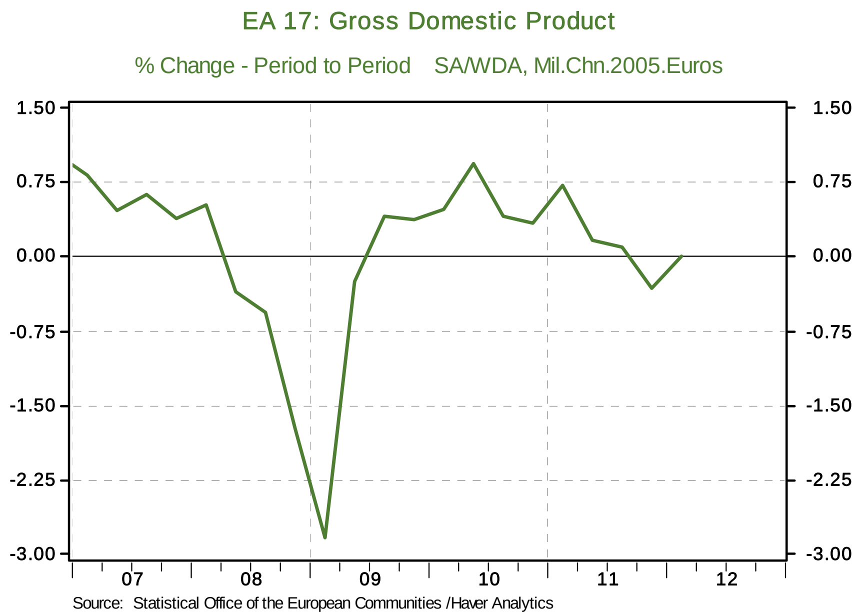
For now, this looks like a gentle deceleration from a category 2 climb, not a crash. But the possibility of a steeper and less orderly descent among overseas economies could make the trail ahead much more hazardous.

Euro Travails

The situation in the Eurozone has vacillated over the past several years from seemingly manageable to intractable. Unfortunately, we may be closer to that latter extreme at the moment.

Some analysts attempt to separate the financial from the fundamental issues in Europe, but they are inextricably intertwined. As of this writing, all of the major economies in Eurozone are in recession. This will not be helpful for countries and companies that rely on sales to the region for growth; reports from China indicate that economic activity has stepped back, partly because of weaker demand in the West.

Chart 3

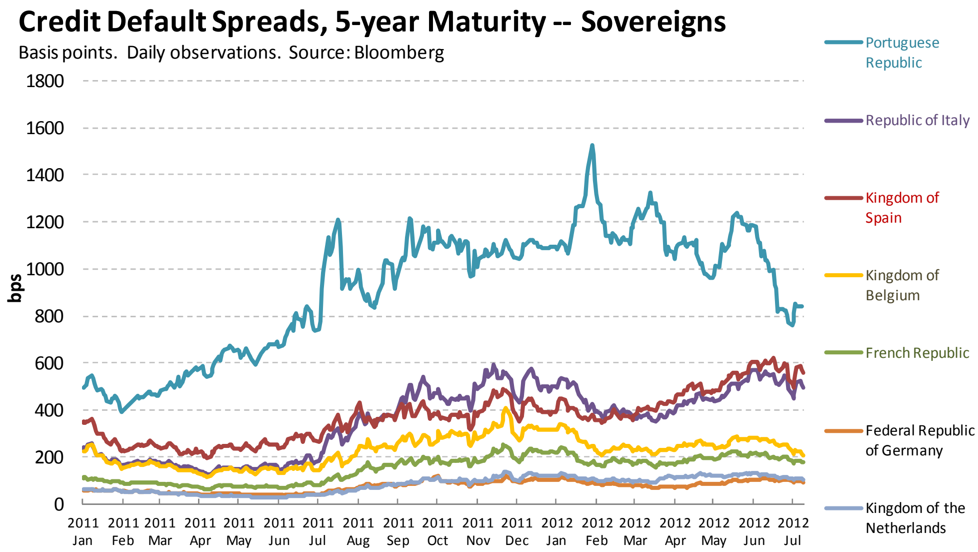


Ordinarily, such a development would call for important amounts of policy stimulus. Central banks in the Old World have certainly been doing their part; the ECB cut interest rates to the lowest level in its history in early July, and the Bank of England extended on its nascent program of quantitative easing.

Unfortunately, this may only serve to offset the drag from restrictive fiscal policy. Governments across the continent, but especially in its periphery, are facing large prospective shortfalls. Shrinking tax receipts and growing costs for bank support (among other things) serve to push revenues and expenses further apart. Still, the solution to budget problems may lie as much in stronger growth than belt-tightening, leading some to call for deferring austerity measures.

Here, the interests of debtholders and equity holders diverge. In this tableau, the international investment community is cast in the subordinated role, anxious to protect the value of their claims from the dilution that might result from additional deficit spending. National governments have more of an equity stake in the proceedings, hoping to stoke growth and pacify voters by delaying austerity. These two have been on a collision course for some time, with polls taken every day in the market for sovereign debt.

Chart 4



It does not help things that policy makers in some parts of Europe are not seen as credible. The failure of Spanish leadership to acknowledge and size their banking problems did not help their standing among those whose support they'll desperately need. As of this writing, the € 100 billion bailout program for Spanish banks is still not fully defined, and its terms could still create a jolt for world markets. Candor, even when painful, is the best communication strategy in a crisis.

And then there is the tricky business of gaining consensus among the member nations. Experts agree that the way forward will have to include further pooling of interest and vulnerability; naturally, those absorbing the risk are hesitant to do so without important behavioral modifications from those being covered. (The analog to simpler insurance pools is actually telling here.)

Yet structural change takes time, and the loss of national sovereignty over some aspects of policy will not go down easily in some national capitols. The EU took an important step late last month, moving to allow the ECB to serve as a primary regulator over institutions in all member countries. This could clear the way for more direct support for banks and a program of quantitative easing for the region's economies. If this sounds like the Federal Reserve's mandate, it is no coincidence.

The situation in Europe remains the chief risk to our outlook. Either through diminished exports or the importing of financial distress, a bad outcome from across the Atlantic could cause us to veer off the road of recovery.

The US Fiscal Outlook

In fairness, though, we have our own budget issues to deal with.

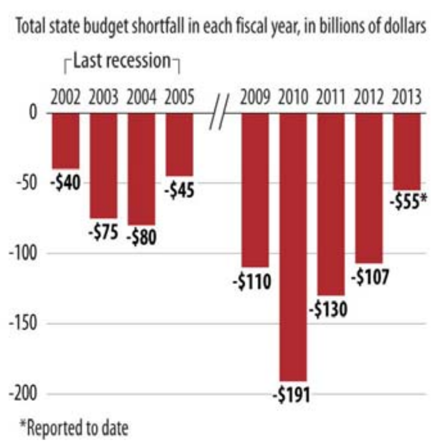
As Asha described in her [May 23 commentary](), the Congressional Budget Office has registered its concern over has become widely known as our "fiscal cliff." The approaching chasm is formed from (among other things) the expiration of payroll tax relief, the expiration of the 2001 Bush tax cuts (which Congress extended for two years in 2010) and the approach of automatic spending cuts (sequestration) which are mandated by the budget accord reached last summer. The automatic cuts became a possibility when the bipartisan "super committee" appointed last summer lacked the sufficient super powers to reach a negotiated solution.

Under the CBO's model, the combination of these factors could throw the U.S. economy back into recession during the first half of next year. It seems unlikely that even a divided Congress would allow this to occur.

Nonetheless, there could be a great deal of public dissonance on the topic as Election Day approaches. This will not play well with the markets or ratings agencies, which may be forced to consider another downgrade of Treasury debt if negotiations stall. Projections suggest that we will reach our new debt limit early next year, setting the stage for another potential round of fiscal brinksmanship.

As challenging as our Federal fiscal picture is, the situation at lower levels may be even more challenging. The Center on Budget and Policy Priorities (CBPP) recently reported that states are wrestling with $55 billion of fiscal shortfalls, which represents almost 10% of their annual budgets. While down from recent years, this gap is still substantial.

Chart 5



Source: CBPP

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These totals don't include budget deficits faced by local governments; in some cases, state budgets are being balanced by reducing support to counties and townships. Further, these aggregates do not reflect huge shortfalls in public pension plans, which will become more apparent under recently-enacted accounting rules.

States, counties, and towns don't have a great deal of flexibility in dealing with these challenges. Most have balanced budget requirements, caps on tax escalation, and much more limited access to debt markets than the US Treasury.

In extreme cases, local governments have considered bankruptcy as a way out of trouble. But the bankruptcy rules for public bodies are different than they are for businesses or consumers, and often require debt service to continue.

Many don't realize that spending by state and local governments contributes roughly 40% more to real GDP than Federal spending; cumulative cutbacks in our backyards have been a significant drag on economic growth.

We'll certainly discuss this topic at greater length in the months ahead.

Household Finances

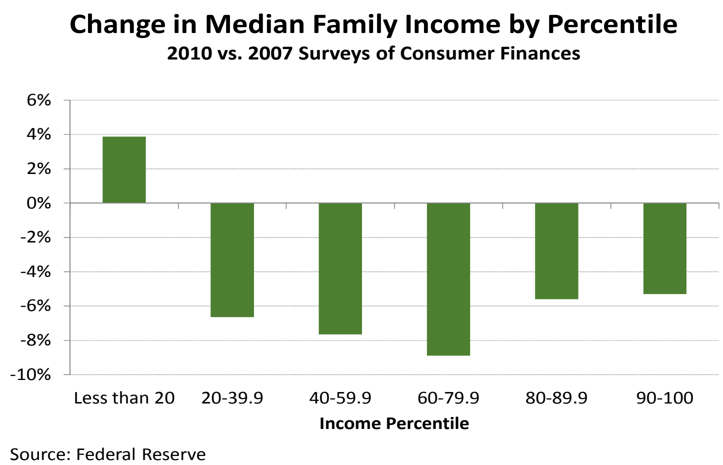
Our lingering economic sluggishness can be blamed on many things. Kenneth Rogoff and Carmen Reinhart (authors of the book This Time Is Different) observe that economic corrections combined with financial crisis take an especially long time to recover from. Others observers blame policy uncertainty surrounding taxation and regulation as a hindrance. But the most important headwind to economic progress may be found closer to home.

Every three years, the Federal Reserve Board publishes its Survey of Consumer Finances. It is a rare glimpse of how consumers are doing beneath the aggregates on income, spending, and saving that we see each month from the Commerce Department. With personal consumption making up almost 71% of real GDP, insight into household balance sheets is particularly important.

Some highlights:

1. Median income levels dropped for all households between 2007 and 2010, but more sharply for those in the middle percentiles of the distribution. Periods of joblessness and the wage adjustments that follow account for some of this, but the diminished contribution of capital gains is a major theme.

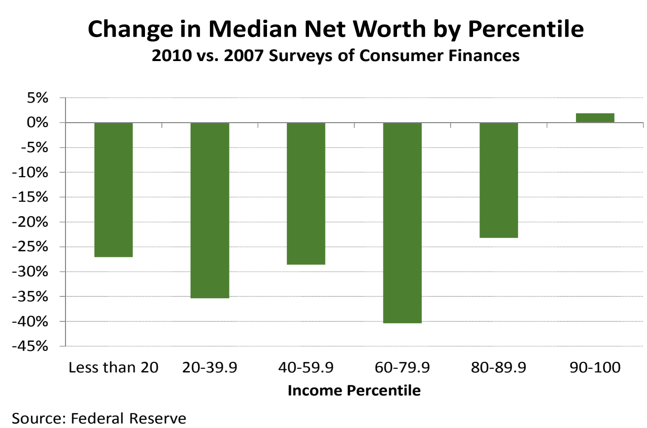
Chart 6



Those in the top 10% of households were impacted most, but the democratization of stock ownership over the past generation left many others vulnerable to the market correction that occurred in 2008-9.

2. Wealth destruction since the 2007 survey has been most pronounced among households who were most reliant on real assets (such as their home) as opposed to financial assets.

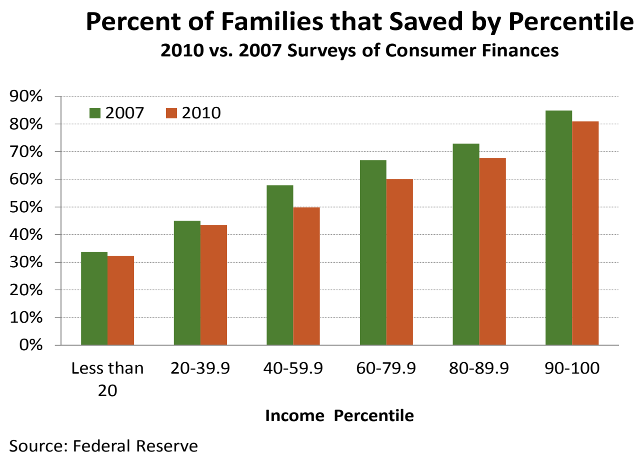
Chart 7



Estimates of the negative "wealth effect" vary, but 5% is a figure often cited as the impact on spending when net worth declines. When multiplied across a broad spectrum, you're talking a significant loss of consumption.

3. As a result of the two observations above, families report saving at a somewhat lower rate as a means of buffering variations in income and wealth.

Chart 8



Of course, some of these changes were especially pronounced for households in certain parts of the country, and those headed by persons in the middle age ranges. Funds drained will eventually have to be replenished.

What does all of this mean?

- For many families, the process of balance sheet repair is only beginning. Median household net worth in the 2010 survey was only $77,000, which is scarcely sufficient to support a level standard of living during a long retirement. Having endured an interruption in income and having lost their main source of saving (home equity), many households are not in a position to spend as robustly.

  This can't help but limit GDP growth. Past recoveries did not occur in the wake of record levels of home ownership and mortgage debt, that caused a broad swath of Americans to feel the sting of our steep house price correction. Comparing the current expansion to its past analogs may therefore be unfair.

- The types of products that people buy, and the type of financial services they use, vary quite a bit across age and income cohorts. Households in the upper percentiles appear to have come through the recession in relatively better condition, and so aggregate consumption may be tilted toward their preferences.

- With more traditional sources of income flagging somewhat, households are becoming more reliant on retirement plans and transfer payments (more than 15% of income in the 2010 survey, versus 11.5% in the 2007 survey). This will make it even more politically difficult to have a reasonable discussion about entitlement reforms at the national and local levels.

Professional cyclists fall more often than you might think. Whether taking a turn too quickly, running through a pothole, or being sideswiped by a support vehicle or spectator, riders go down with surprising regularity.

Some bounce back up fairly quickly, tending to a few scrapes. Others suffer more extensive damage to themselves and their gear, and take longer to rejoin the *peloton*. Our economy seems to be in the latter category at the moment, with increasing grades just ahead. Let's hope that we can mend in time to steer away from the many cliffs that dot the road in front of us.

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ECONOMIC RESEARCH DEPARTMENT
July 2012

SELECTED BUSINESS INDICATORS

Table 1 US GDP, Inflation, and Unemployment Rate

	2011		2012				2013				Q4 to Q4 change			Annual change		
	11:3a	11:4a	12:1a	12:2f	12:3f	12:4f	13:1f	13:2f	13:3f	13:4f	2011a	2012f	2013f	2011a	2012f	2013f
REAL GROSS DOMESTIC PRODUCT (% change, SAAR)	1.8	3.0	1.9	2.0	2.0	2.5	2.5	2.4	2.6	2.7	3.1	2.1	2.5	1.7	2.1	2.4
CONSUMER PRICE INDEX (% change, ann. rate)	3.1	1.3	2.5	0.6	0.2	1.3	2.0	1.8	1.8	2.0	3.3	1.1	1.9	3.1	1.7	1.5
CIVILIAN UNEMPLOYMENT RATE (avg.)	9.1	8.7	8.3	8.2	8.1	7.9	7.8	7.7	7.6	7.5				9.0*	8.1*	7.6*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

	Quarterly Average								Annual Average		
	12:1a	12:2a	12:3f	12:4f	13:1f	13:2f	13:3f	13:4f	2011a	2012a	2013f
Federal Funds Jul-2012	0.10	0.15	0.15	0.15	0.10	0.15	0.15	0.15	0.10	0.14	0.14
2-yr. Treasury Note Jul-2012	0.29	0.25	0.25	0.25	0.29	0.25	0.25	0.25	0.45	0.26	0.26
10-yr. Treasury Note Jul-2012	2.04	1.82	1.65	1.70	1.80	1.95	2.00	2.15	2.79	1.80	1.98

a = actual
f = forecast