Economic Outlook

— The economy still seems to be stuck in the moderate growth mode that has characterized this recovery from the start, neither showing definitive signs of broad-based improvement nor clear indications of downshifting.

— Hurricane Sandy has begun to impact the high-frequency economic data, and will likely continue to make it tougher to discern underlying trends for a while. Ultimately, the hurricane will impart a bit of a drag on aggregate growth in Q4, and then provide a modest lift in H1 2013 as delayed activity is rekindled and rebuilding kicks in.

— Before the storm, readings on housing, consumer confidence and spending, and even the labor market were slightly more encouraging, but had to be set against weaker data on capital spending, and still tepid business confidence. Also, this recovery has been replete with “false dawns” -- times when it seemed activity was gathering momentum only to falter as the economy proved unable to shift persistently into higher gear.

— The forces restraining activity have been known for some time, if perhaps underestimated. The economy has been laboring under a “post-bubble hangover;” efforts by households to strengthen balance sheets and reduce debt, a housing overhang, credit restraint, and retrenchment at state and local governments have hampered the recovery, diluting the economy’s normal recuperative forces. For example, housing is usually in the vanguard of recoveries, but this time has been largely absent (at least until recently) as massive excesses have had to be worked off. Similarly, some of monetary policy’s normal impact has been blunted because the housing and related consumer spending channels have been impaired. And pent-up demands -- which normally fuel recoveries -- have been vented more slowly than usual, in part because of household deleveraging and credit restraint.

— As if these drags weren’t enough, policy uncertainty in Washington has also taken a toll. That was evident during last summer’s debt-ceiling debacle, and may be building again now as the fiscal cliff looms at the start of 2013. If those tax increases and spending cuts go into effect as scheduled, they could turn a lackluster recovery back into recession.

— The global situation isn’t helping either. Growth in emerging markets has clearly downshifted (though recent data out of China have been more encouraging), and though Europe has taken some positive measures to deal with its crisis, a full resolution there remains elusive, and its economy is in recession.

— These global woes, coupled with the looming fiscal cliff, may be reinforcing the hesitancy of US firms to expand, as evidenced by the recent weakening of new orders for capital goods.

— But there’s hope amid the gloom. For one, we continue to believe that the worst landmines will be averted. That Europe will “muddle through,” thus mitigating the adverse effect on the US, and that US policymakers will sidestep the fiscal cliff (albeit probably not until the 11th hour).

— Perhaps the most important reason we see grounds for guarded optimism is that progress has been made in repairing the excesses of the bubble era. For example, home prices have been brought into better alignment with fundamentals, while new building activity has run so low for so long that it has reduced the housing overhang. As a result, housing is showing signs of

Economic & Financial Market Projections

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<th>Year</th>
<th>Real GDP (Q to Q % chg, ann rate)</th>
<th>Core PCE prices (4-qtr % chg)</th>
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F—Forecast
FR—Forecasted revision

Josh Feinman is a Managing Director and Chief Global Economist of DB Advisors in the Americas. In this position, he provides portfolio managers and clients around the world with timely analysis of global macroeconomic trends and their implications for financial markets. Josh is also responsible for authoring and editing a series of publications on global economic and financial market issues for distribution among the Bank’s offices and clients. A frequent guest lecturer and commentator, Josh delivers speeches around the world and is a frequent guest on financial television programs and is often quoted in major print and electronic media.

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improving, perhaps presaging a broader-based upturn in economic activity (the way housing’s peak in 2006 portended the ensuing economic crisis). Households have improved their financial positions, trimming debt (and especially debt service), while benefiting from some recovery in asset prices and easing of credit conditions, while the retrenchment at state and local governments appears to be abating. In sum, though the headwinds aren’t all gone, they are diminishing.

— In this sense, time is on the economy’s side. As the bubble fades further into the past, and more progress is made in repairing its excesses, the pace of recovery is apt to pick up — provided the US doesn’t go off the fiscal cliff. We expect growth to claw back to an above-trend pace within a year or so, though still well below the rates typical of past recoveries from deep recessions, restrained in part by a gradual fiscal drag at the federal level.

— But the climb back will be long. And there may be lingering scars, including a hit to the level of potential output and slightly higher structural unemployment - all the more likely the longer it takes to recover, increasing the chances some of the long-term unemployed or disillusioned become permanently detached from the labor market.

Inflation is likely to remain low, near to slightly below the Fed’s objective, restrained by tame inflation expectations, still-ample spare capacity, modest growth in demand, and dormant labor costs.

Monetary Policy Outlook

— With the economy showing only modest and unconvincing signs of improving, and inflation in check, policymakers remain clearly tilted toward accommodation. Indeed, the Fed is likely to step up the pace of outright asset purchases at the end of the year, in order to offset the impact of the expiration of “Operation Twist.”

— Looking beyond that, we expect the Fed to maintain the asset purchase program until the labor market shows much more convincing signs of healing. That’s unlikely before late 2013, at least. And the Fed is apt to maintain the expanded balance sheet even longer.

— As for the funds rate, Fed policymakers are considering shifting from a calendar-based forward guidance -- currently, they expect to hold the funds rate at zero at least through mid-2015 -- to an outcome-based guidance. Under that approach, the Fed would provide ranges for, say, the unemployment rate and the inflation rate, that would act not as automatic triggers for raising the funds rate, but as thresholds that would prompt policymakers to begin considering hiking rates. Relative to a calendar-based approach, outcome-based forward guidance more clearly links monetary policy to the central bank’s dual mandate. But finding a consensus on suitable threshold ranges that don’t limit policymakers’ flexibility may be difficult. The Fed will probably not make such a shift until early next year.

Financial Market Outlook

— Continuing the see-saw pattern evident over the past few years, sentiment in financial markets has shifted back toward “risk off” mode in recent weeks, weighed down by increasing anxiety about the looming fiscal cliff in the US, deteriorating economic activity in Europe, and heightened geopolitical tension in the Middle East. In response, equity markets have retreated, risk spreads have widened a bit, and Treasuries have rallied.

— We think these market moves may be getting a bit overdone (much as we worried that the shift toward “risk on” in the late summer and early fall was going too far). Ultimately, if the fiscal cliff is averted, Europe holds together, and the US economy gradually improves later next year, as we expect, it should be supportive for risk assets and a slight weight on Treasuries.

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