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Domestic Economy Begins 2014 Strong; Rest of Year Depends on Rest of World

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Balance Sheet Re-expansion Gains Traction, So Where Is It Leading? Several Possibilities

Speculative activity and private balance sheet expansion both picked up significantly in the United States during the fourth quarter. There were positive consequences for profits during the period and, more importantly, positive implications for profits in at least early 2014. Consequently, Treasury yields have become more likely to push still higher, at least briefly, and create further strains in housing and global markets. Meanwhile, developments abroad during the fourth quarter were mixed: some economies appear to have slowed while others gained momentum; some suffered increasing financial vulnerability while others enjoyed improved financial stability; international capital flows became more risk-tolerant; and speculative investment increased in some markets. These circumstances together most likely constitute a recipe for economic crosscurrents and high market volatility, and it is wise to prepare for more than one economic scenario for 2014. I will discuss our latest outlook and then come back to our thoughts for investment and business management.

While our forecast has not changed drastically, the domestic economy now appears likely to stick to the upper boundary of our previous forecast range or even push through it until rising yields, major problems abroad, or both intervene to weaken it. The most positive case for profits for the entire year 2014 is now somewhat higher than before. The first half—especially the first quarter—will probably bring generally positive business conditions and a pace of expansion above average for this business cycle, although not without some underperforming sectors, most notably housing. The second half could bring anything from a continuation of the first half firmness to a serious weakening, with events around the world during the first half doing much to shape the domestic outlook for the second half.

Increasing balance sheet expansion and speculative behavior, while cheering for the short term, actually have disturbing implications for the next several years. We have previously explained that lasting stability can come only from further correcting the economy's financial imbalances, not from making them more extreme. But for now, I want to focus on (1) what is presently taking place, (2) the economic environment investors and executives should expect in 2014, and (3) some suggestions on how they should position themselves.

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The Jerome Levy Forecasting Center LLC
69 South Moger Avenue, #202
Mount Kisco, New York 10549-2217
914-666-0641
www.levyforecast.com

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How Did an Expansion Go So Far within the Contained Depression?

Through much of the recovery we thought the likelihood that the economy would expand for several more years was small, yet it will reach its fifth birthday this year. What surprised us? Throughout the 2009-2013 cyclical expansion, we correctly anticipated the prolonged weakness ahead for the domestic private profit sources and therefore that any one of a number of potential setbacks could end the recovery. We did not anticipate that serendipity would enable the economy to dodge so many bullets, especially a half dozen threats of policy outcomes here or abroad that could have been enough to break the expansion; in fact, sometimes the economy not only avoided a negative policy threat but at the last minute actually received a boost. Finally, even though we had been watching for secular improvement in the U.S. balance of trade, we were surprised by the speed with which domestic petroleum production replaced imports and by the strength of import substitution in other goods categories.

Here are six occasions when the economy avoided bullets in the form of policy outcomes:

1. *Eve of 2011*: Congress reached an eleventh-hour budget deal that avoided sharp deficit cuts and, instead provided further stimulus from a large payroll tax cut
2. *Fall of 2011*: Steps taken by European policymakers and longer-term refinancing operations (LTRO) by the ECB steer European financial markets away from disaster
3. *End of 2011*: Congress again reached an eleventh-hour deal, abstaining from tough spending cuts and extending the payroll tax cut through 2012
4. *Mid 2012*: Mario Draghi's "whatever it takes" speech and commensurate actions contained another wave of euro area financial crisis
5. *Start of 2013*: Congress veered away from the severe fiscal cliff, instead merely sending the economy through a fiscal pothole
6. *First half of 2013*: With the Chinese and euro area economies dangerously deteriorating and widespread fear about the emerging market (EM) sector, the Chinese hit the gas and the Europeans' efforts to cut government deficits lapsed, allowing their economies to firm and check the deceleration in the global economy that otherwise would have threatened the U.S. expansion

The persistence of the expansion has helped private balance sheets to increasingly expand. The accelerating growth in balance sheets is most evident on the asset side as prices of corporate equities, real estate, risky debt securities, and other assets have risen smartly. The debt picture is more mixed as household mortgage debt and financial sector debt have continued declining, but now several categories of debt are expanding. Most notably, the debt of nonfinancial corporations has been surging, and the ratio of this debt to the sector's value added has eclipsed the all-time record set in 2009 (chart 1).

Moreover, the expansion has revived faith in economic stability, and investors have gradually become impatient with defensive holdings earning little or no yield. Although the U.S. financial situation remains well short of a macro bubble like the late 1990s stock market or the mid-2000s housing mania, it is becoming frothier in some markets even as caution persists elsewhere. For example, hunger for yield has been rapidly beating back caution in fixed income markets. High-yield bond spreads have been narrowing despite increasing corporate leverage, accelerating corporate downgrades, and more covenant-lite issuance. Spreads on dollar-denominated foreign debt have also fallen despite the dubious condition of many foreign economies.

Investor attitudes are still largely cautious, yet generous valuations suggest they are not being as cautious as they think. The recent strength of both stock and home prices is largely attributed by some commentators to "attractively cheap" assets, yet these assets are not cheap. Home prices are claimed to be low because of the size of their 2006-2010 decline and

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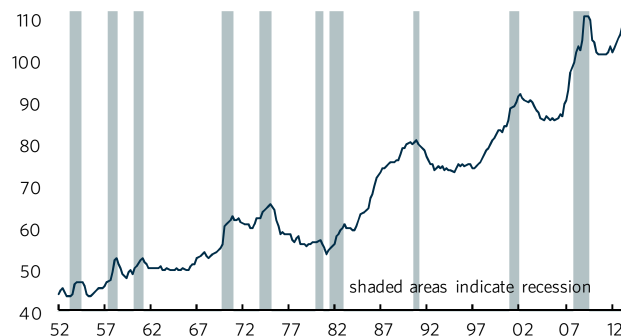
NF Corporate Leverage Breaches New High CHART 1

Credit Market Debt of Private Nonfinancial Corporations as % of Gross Value Added, seasonally adjusted, last data point Q3 2013



the relatively small progress undoing it, but real home prices remain at their highest level ever except for 2001 to 2008. As for stock valuations, they are not only not low, but actually high (see "Equity Valuations: Stocks Hardly Cheap, But Could Become More Expensive," *The Levy Forecast*, December 2013). Moreover, even if one relies on the commonly followed (and generally flawed) metrics suggesting that equities are attractively priced, one should note that the attractiveness would fade rapidly without both strong earnings and zero interest rates.

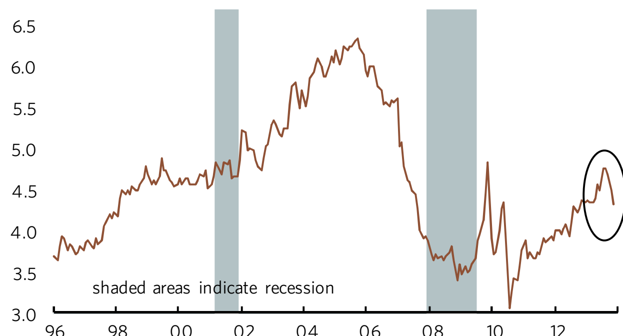
Speculative Attitudes Are Softening Some of the Effects of Rising Yields

Shifting speculative attitudes are probably providing some short-term help for the expansion by softening some of the effects of rising long-term interest rates. We have continually stressed that rising yields are a threat to the domestic housing market, to financial stability in economically challenged emerging market countries, and ultimately—indirectly if not directly—to equity and other asset markets. The negative effects of higher yields on housing and EMs are certainly real; indeed, with Treasury yields back up near 2013 highs, mortgage lending activity and existing home sales have been deteriorating and EM stock markets and currencies have generally been sliding again. However, these negative effects are probably somewhat less than they would have been if not for the rapid change in financial attitudes.

Consider housing for a moment. The sharp decline in housing affordability brought on by 2013 price increases and the surge in mortgage rates has undermined the overall market for homes, and this is reflected in declining existing home sales

Existing Home Sales Reflecting Higher Rates CHART 2

National Association of Realtors: Existing Single-Family Home Sales
millions, seasonally adjusted, annual rate, last data point November 2013



(chart 2). New home demand would also likely be sagging were affluent buyers not playing a disproportionate role in the new home market and were they not encouraged by their recent wealth gains, improved job security, and confidence. Improving confidence and attitudes cannot cancel the effects of rising mortgage rates, but they are probably offsetting some of the effects, particularly in the new home market, which is of course critical to residential fixed investment, a profit source.

Meanwhile, soaring stock markets and rising optimism about the U.S., Japanese, and European economies have raised expectations for a global economic revival that will buoy emerging market economies. This sentiment has not been enough, at least so far, to completely offset the pressures from rising U.S. Treasury yields on EM currencies, financial markets, and economies, but undoubtedly financial conditions would be weaker with a less optimistic outlook.

So Is the Contained Depression Over? No

How does all this jive with our venerable forecast (a forecast that dates from well before the recession and contained depression even began) of a multi-business cycle era with secular weakness in investment, economic performance, asset markets, goods and services prices, and lending? We have predicted that this era's overcapacity, poor growth, disinflation, secular wealth losses, and resulting long-term pessimism and conservative financial attitudes would discourage spending and investing and perpetuate the secular correction of balance sheets. Are we altering this view?

Not really. We always maintained that some cyclical reversal in balance sheet trends—some rise in asset and debt ratios—is consistent with the secular trend of balance sheet contraction, although the current trends have gone on longer than we expected. Even during the Great Depression, there were business cycles with periods of rapid expansion and market recovery.

Despite the strength thus far in markets and the expansion, the economy is unlikely to escape the contained depression, that is, to start another episode of rapid balance sheet expansion—such as the tech and stock market boom of 1993-2000 or the housing bubble of 2003-2007—before turning down again. There remain obstacles to sustaining present trends; one of them is the dependence of markets and the economy on both strong earnings and zero interest rates, which are likely to

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become increasingly incompatible. A strong expansion would tend to sow the seeds of its own destruction by driving up yields, which will fall back only after weakening financial stability, asset markets, profits, or a combination.

Our view remains that a sustained strengthening of the expansion is unlikely, although not impossible; however, it is somewhat more likely than a year ago. What *is* virtually impossible is for the economy to return to a long-term path of stability and normalcy without first experiencing further private sector balance sheet correction. Even if a period of strong expansion were to occur, the necessary re-expansion of balance sheets would create greater instability and make the eventual resumption of balance sheet contraction that much worse. The excesses in both asset values and liabilities relative to income are a problem that cannot just fade away; there is no path (short of fantastic government actions) back to lasting prosperity without first completing the balance sheet retrenchment associated with the contained depression.

U.S. Economic Risks Become Still More Tied to Global Developments

The domestic economy has enough positive influences going for it in early 2014 that it is unlikely that U.S. profits will be significantly reduced before yearend unless serious economic and financial problems develop in the international economy. These positive domestic influences include a break from fiscal tightening, growing wealth effects that will tend to lower personal saving, and domestic production increasingly supplanting imports. Even if these positives moderate over the course of the year, profits will hold up fairly well as long as foreign demand does not plunge and U.S. financial markets are spared severe shocks from overseas.

Therefore, to gain insight into the outlook for domestic economic performance, focus on the condition of the rest of the world. It may foretell more about the U.S. economy in the second half than anything happening at home.

Some Possible Scenarios for 2014

For the purposes of investment strategy and business planning, we can summarize the outlook as follows. The first quarter will probably bring strong overall domestic business conditions with rising profits, solid output gains, and somewhat stronger employment growth. The second quarter will be at least respectable and quite possibly strong as well, but there may be some portentous crosscurrents. Housing will likely be the most notably weakening part of the economy early in the year. The dichotomy within consumer spending will continue, with strong high-end sales and soft low-end sales. As for the second half, the range of potential economic scenarios widens considerably, from remaining fairly strong to rapidly decelerating. However, the uncertainty surrounding the second-half outlook will probably diminish considerably as the next few months pass.

There is one big upside constraint on the economy's behavior, and that is the need to maintain Goldilocks conditions; that is, too much strength would in all probability mean yields moving higher and the expected timing of actual Fed tightening moving closer, and higher yields would undermine the expansion's vigor if not the expansion itself. To a degree, the yield curve and the economy are locked in a negative feedback loop: the economy speeds up, so yields go up, so the economy slows down, so yields fall down, so the economy speeds up.

However, the rhythm of this dance could be slow, since it would take time for all the effects of rising yields to occur, and it would take time for changes in the economy to be reflected in economic data and company reports on business conditions. One relatively benign scenario would be that the strong first quarter pushes the 10-year Treasury yield well over 3% even as the housing market softens and EM markets weaken; then, in the spring, alarmingly weak housing market indications, falling export orders, and rising fears of developing EM recessions drive yields down sharply, with the 10-year yield falling perhaps back near 2%, nipping the damage in the bud and setting up a reaccelerating second half.

Another scenario would begin in a similar fashion, but by the time yields come down again, more severe damage would have occurred. EM economies would increasingly be falling into recession, and some would experience currency crises. Global equity markets would fall sharply, confidence would be damaged, wealth effects would turn negative, and so forth. A prerequisite for this scenario is that the rest of the world is having serious problems on its own so that high U.S. long-term rates are fanning flames, not igniting them.

The most optimistic scenario for 2014 would involve something other than falling housing or international recession pushing yields back down. Examples of what could push yields back down include extremely low inflation data, geopolitical tensions, or Americans flooding back into the labor force so that solid job growth is not accompanied by declines in the unemployment rate and indications of a tightening market.

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Some Business and Investment Implications

Most businesses will fare well in at least early 2014 and possibly through the year. Ignoring sharp distinctions from industry to industry, in general we would advocate planning for continuing strong trends but to the extent possible maintaining flexibility. Executives should be extremely careful when considering major financial commitments that are based on reasonably stable and prosperous conditions over the next five years, whether major capital investments to expand capacity aggressively or committing to major shareholder payouts that will leave their balance sheets vulnerable should another severe recession and liquidity crisis arrive one of these years. Indeed, we would favor using the relatively strong business conditions to address balance sheet weaknesses. At the same time, for very long-term strategic planning, the next quarter century of U.S. economic history—after some difficult years as balance sheets correct—has enormous potential unlike anything witnessed in this country since the post-World War II boom.

Investors should be prepared for greater stock market volatility this year than in 2013. The negative feedback loop between the yield curve and the economy is likely to mean that regardless of the U.S. stock market's overall trend in 2014, it will probably cover a lot of ground up and down along the way.

Treasury yields are now more likely than not to spurt above 2013 highs and cause stress before coming back down. We remain extremely confident that the next round of private sector balance sheet retrenchment, which will almost surely accompany a global recession and financial mess, will send the yield on the 10-year note below 1% and the 30-year yield below 2%, and we expect that to occur in the next few years. But, whether the major bond rally begins this year, next year, or even later is unclear at the moment. If starting a bond portfolio today to hold through the next downturn, we would begin buying now but stay no more than half invested until yields shoot well above 3% or until we see signs that the economy is likely to weaken, especially signs of trouble in the rest of the world.

Europe has some momentum, but its outlook six months out is highly uncertain. Falling interest rates and overly optimistic expectations of recovery are fueling the market for now, but we expect signs of business improvement to fade at some point this year, perhaps late in the year, perhaps sooner. For now, with overall European equity markets running, we have temporarily taken off our long-U.S.-equities-short-European-equities positions, but we expect to reinstate the position at some point in 2014.

Given the uncertainties, we have no conviction about commodities for now, but if the world does tend toward the strong side in the first half with inventory building that lifts prices of industrial commodities, some attractive shorting opportunities may emerge.

Many are now turning bearish on emerging markets—a position that we have held since mid 2012. We maintain EM equities as a short against our U.S. and Japanese equity longs. We continue to expect Japan to outperform expectations as its vast potential fixed investment demand has barely begun to emerge.

While the biggest questions concerning the outlook, particularly in the second half, revolve around potential developments overseas, there are, of course, important issues concerning domestic profit sources. One of the biggest is inventory building, which has been strong but not necessarily unsustainable, but it could get ahead of itself. Two others are personal saving and residential investment. The behavior of all three will be interconnected along with financial market behavior—long-term interest rates, stock market and real estate wealth effects—and all three could have abrupt direction changes over the course of the year. The downside risk clearly involves problems in the global economy, but assuming global stability, these domestic issues will have much to do with the strength and consistency of expansion.

David A. Levy

January 22, 2014

The next issue of *The Levy Forecast®* will be mailed the week of February 17, 2014

OUTLOOK: *Key Issues*

Economic Growth

The domestic economy now appears likely to stick to the upper boundary of our previous forecast range or even push through it until rising yields, major problems abroad, or both intervene to weaken it.

Prices

Both headline and core consumer price inflation remain in a narrow range between 1% and 2% annual growth. Inflation will remain subdued in 2014 and beyond.

Employment

Payrolls will likely continue to grow at roughly the same average pace as they have over the past three years. As unemployment falls, labor force participation will increase and slow or reverse declines in the unemployment rate.

Corporate Profits

NIPA profits likely rose strongly in the fourth quarter, possibly by as much as 5% quarter-over-quarter. Profits will probably rise through mid 2014. As the year progresses, this trend could persist, but downside risks will rise.

Interest Rates

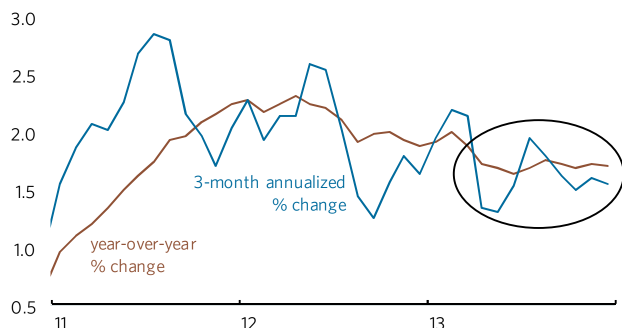
U.S. Treasury yields have become more likely to push still higher, at least briefly, and create more strains in housing and global markets. Economic and financial conditions will drive Treasury yields to new lows during the next recession. The federal funds rate will generally remain trifling for years.

Labor Costs/Earnings

Overall, compensation inflation remains subdued and is unlikely to pick up unless the unemployment rate falls well below 6%.

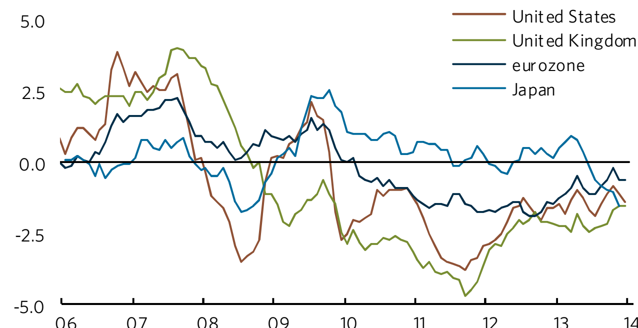
Core Inflation Holding Steady around 1.7% CHART 3

BLS: Consumer Price Index less Food and Energy
seasonally adjusted, last data point December 2013



Developed World Real Policy Rates Converging CHART 4

Effective Policy Rates, Deflated by Year-over-Year % Change in Consumer Price Index, through December 2013 (Japan through November)



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PROFITS FORECAST

Profits probably rose significantly from the third quarter to the fourth. Profits are likely to remain near or above current levels, but risks will increase as the year progresses.

The U.S. trade deficit will probably continue to narrow—assuming the global economy holds up. Also, personal saving will likely trend lower as the wealth effect increasingly boosts household spending. As a result, the chances are increasing that the economy will show enough firmness in the near term to keep upward pressure on bond yields, thus destabilizing housing demand, emerging markets, and ultimately several of the private profit sources. Even without higher yields, global instability holds the potential to reduce U.S. corporate profits in mid-to-late 2014.

The profit sources listed in the table are the terms in the aggregate profits equation, or profits identity. For an explanation of the profits equation and the sources of profits, see *Where Profits Come From*, available on request or at www.levyforecast.com.

	Past 4 Quarters (Q3 2012–Q3 2013)	Next 4 Quarters (Q3 2013–Q3 2014)	
Profit Sources	**Direction of Change**	**Direction of Change**	**Effect on Profits**
Investment			
Equipment	Rose	Rising	Positive
Intellectual Property	Rose	Rising	Positive
Nonresidential Structures	Rose	Rising	Positive
Residential Structures	Rose	Flat-to-declining	Neutral-to-Negative
Inventory Investment	Rose	Flat-to-declining	Neutral-to-Negative
Capital Consumption	Rose	Rising	Negative
Nonbusiness Saving			
Personal Saving	Flat	Falling	Positive
Government Saving	Deficit narrowed	Deficit flat-to-narrowing	Neutral-to-Negative
Foreign Saving	Deficit narrowed	Deficit flat-to-narrowing	Neutral-to-Positive
Dividends	Rose	Rising	Positive
Corporate Profits after Taxes	Rose Slowly	Flat to Rising Slowly	

There are technical and coverage differences between NIPA profits and S&P operating earnings, and there is substantial scope for divergence from quarter to quarter. Nonetheless, large moves in one are mirrored in the other, except in cases that can be explained by identifiable differences in accounting treatments.

S&P 500 Operating Earnings vs. NIPA After-Tax Profits

NIPA Profits after Tax, seasonally adjusted and adjusted for tax law distortions to depreciation
S&P 500 Total Operating Earnings, with Consensus Bottom-Up Projections
$ billions, seasonally adjusted, annual rate, forecasts through Q4 2014