



# Inflation and the Outlook for the U.S. Economy

Presented by Daniel North, Euler Hermes ACI, June 7<sup>th</sup>, 2011

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# The Outlook, June, 2011

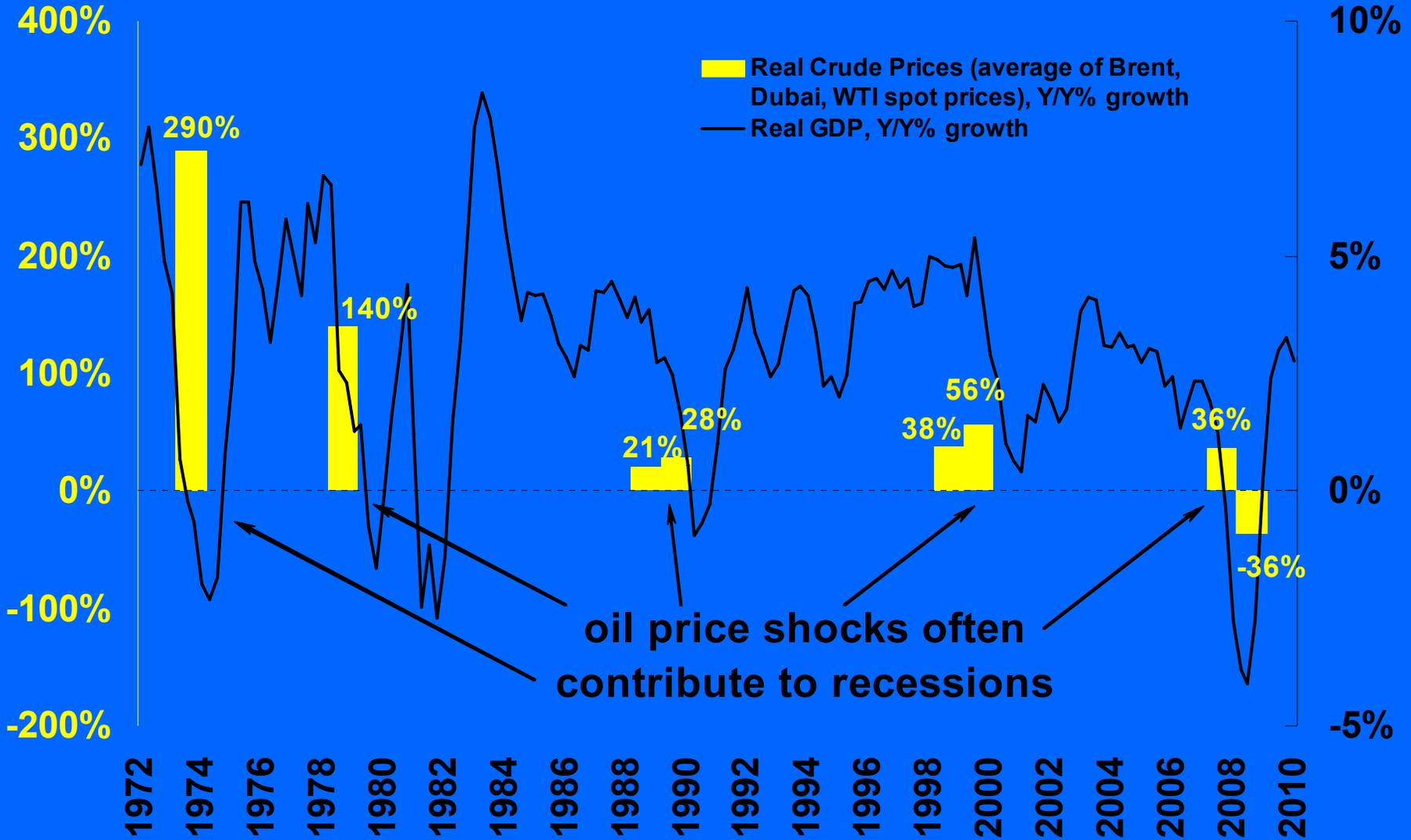
- **Actually pretty positive but with risks**
- **Forces and measures**
- **Government responses**
- **Inflation**
- **Conclusions**

# The four forces which started and ended the recession can help forecast the outlook:

- Oil
- Housing
- Fed policies
- Fear

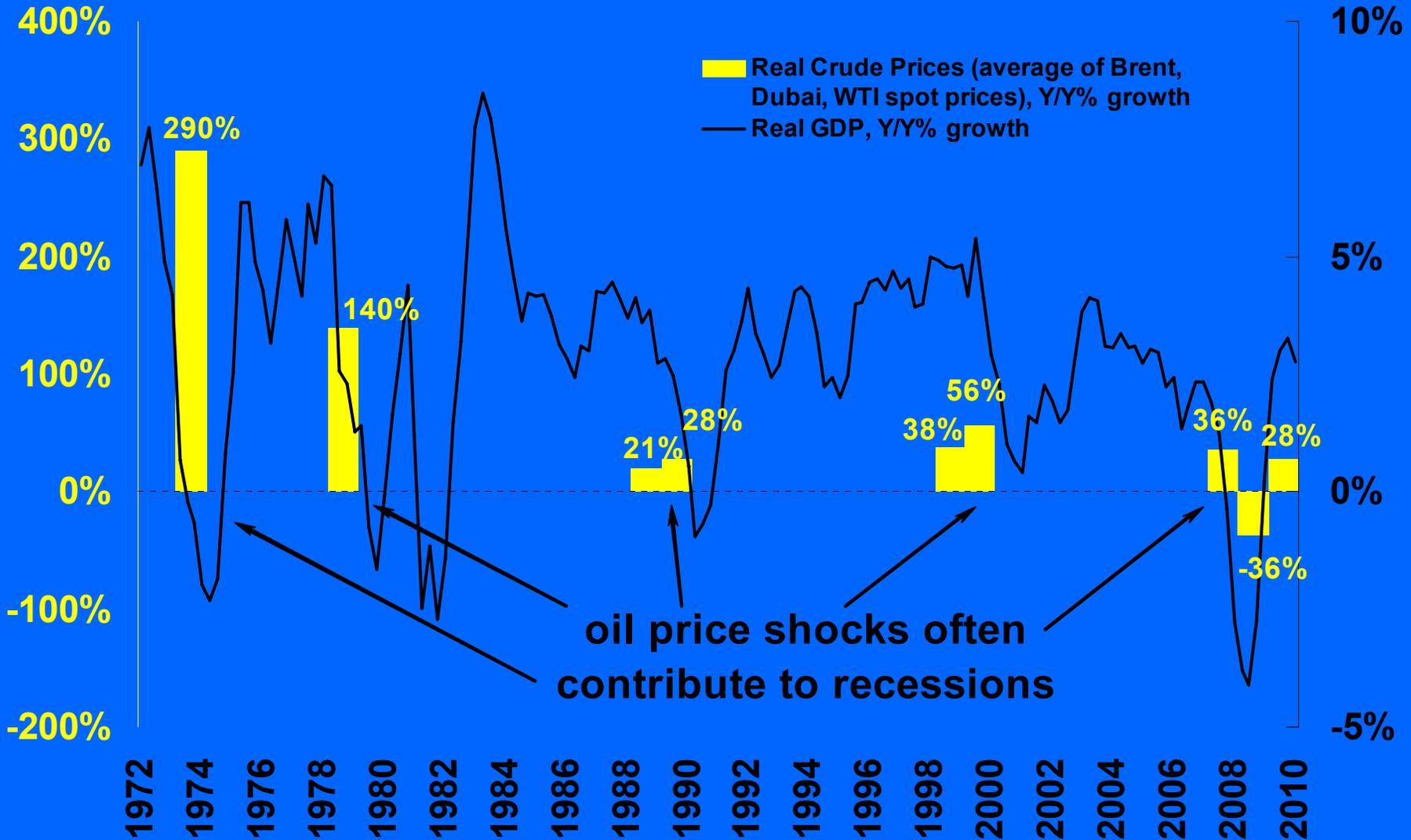
(GDP: \$14T, 3.3% ave. growth. It's the "size" of the economy. Use it to measure the "size" of other big numbers like budget deficit/debt)

# Oil Price Shocks and the Economy



Source: Dept. of Commerce, Dept. of Labor, World Bank, EHACI

# Oil Price Shocks and the Economy



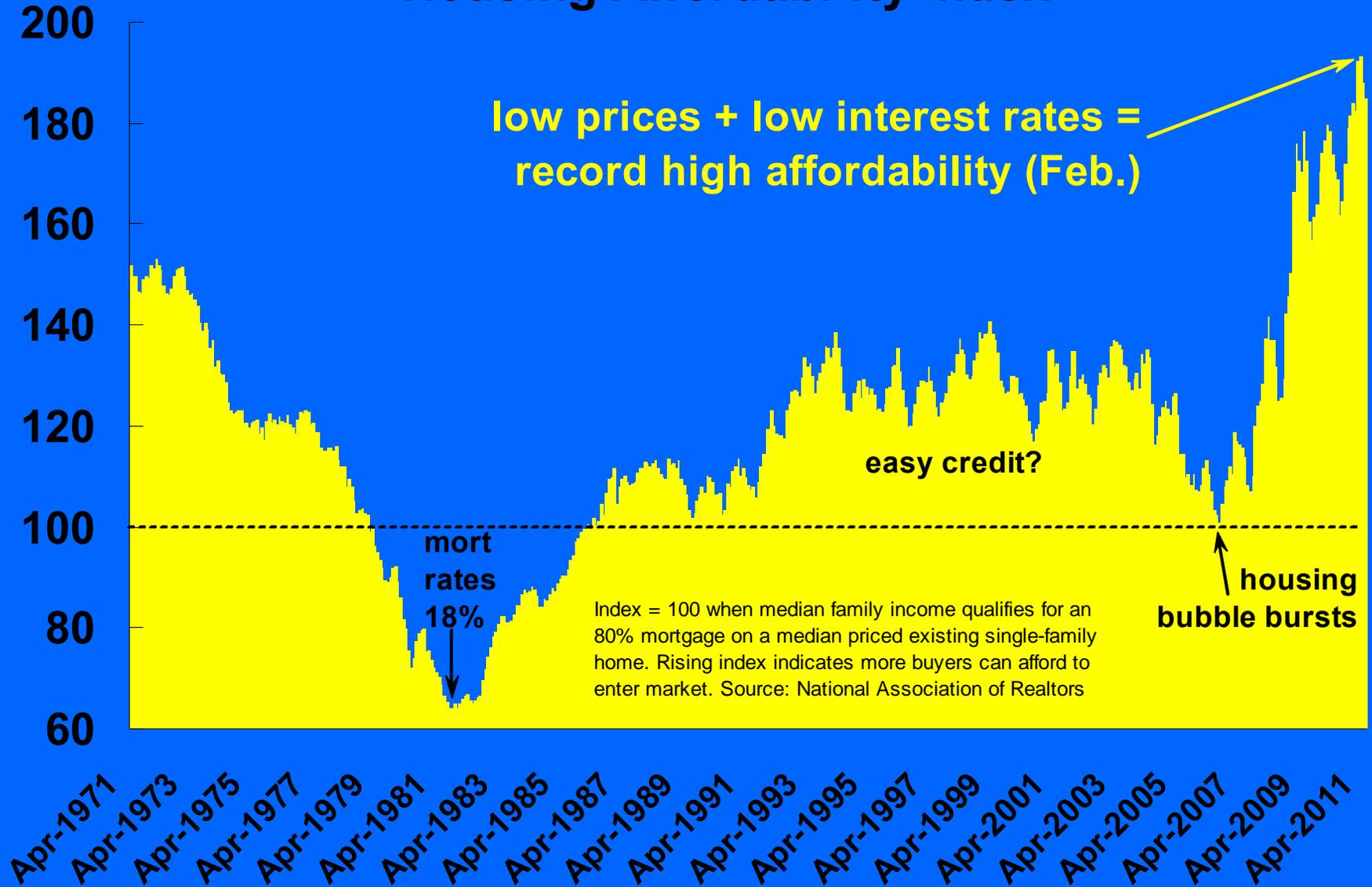
Source: Dept. of Commerce, Dept. of Labor, World Bank, EHACI

# Housing

Not much good to say at all, but...

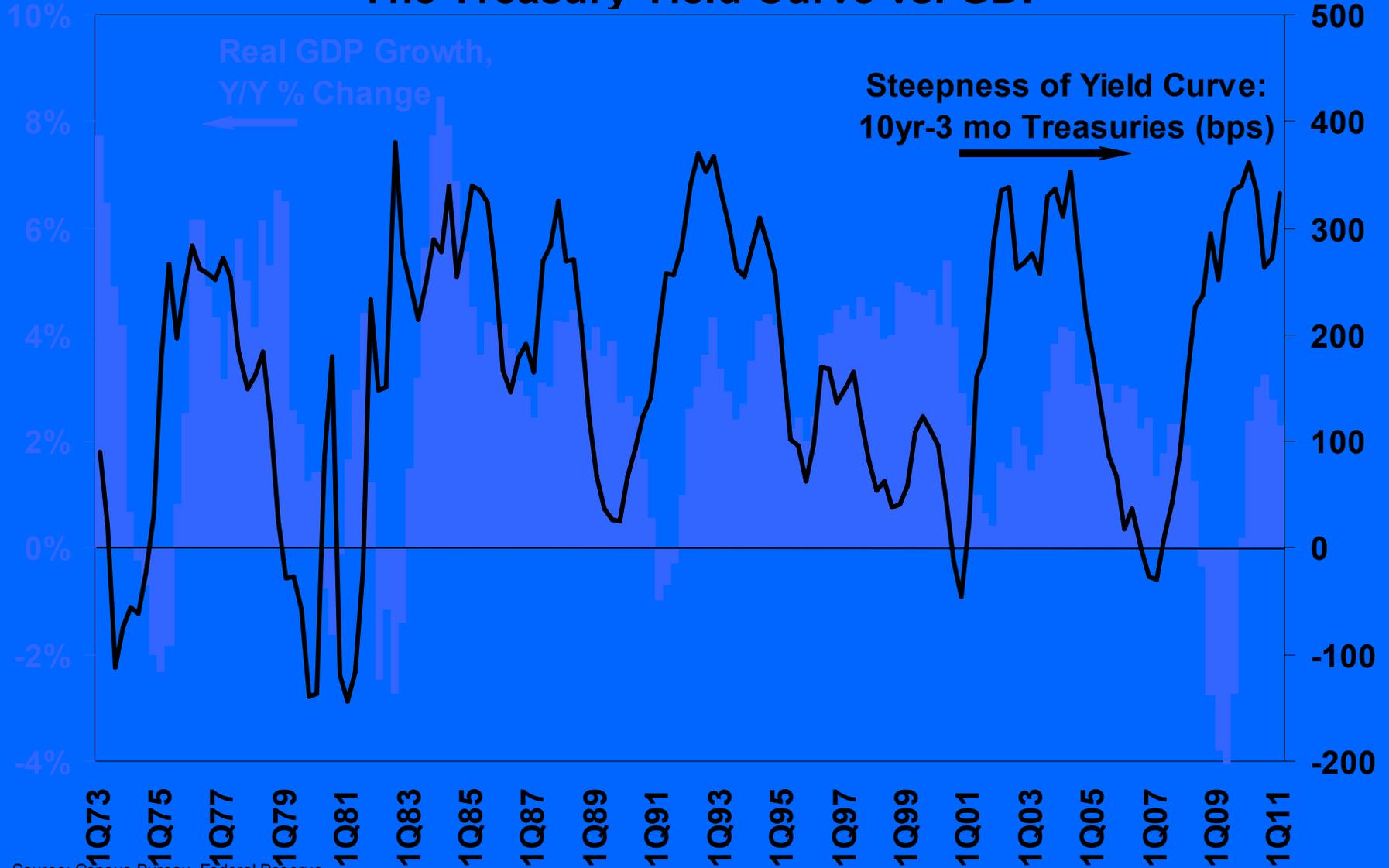
1. We have recovered without it.  
When it returns it'll be great.
2. An incredible buyer's market

# Housing Affordability Index



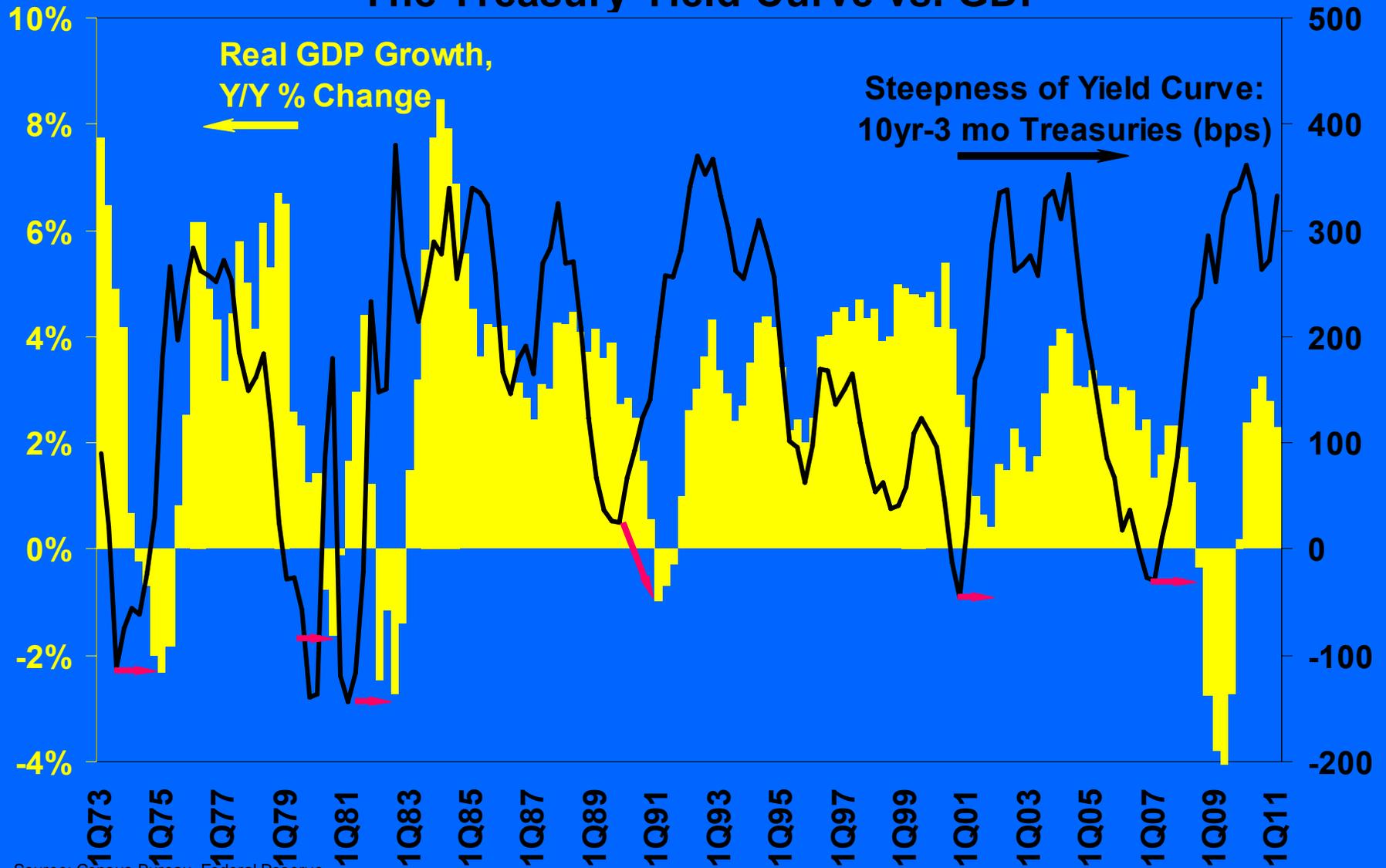
Index = 100 when median family income qualifies for an 80% mortgage on a median priced existing single-family home. Rising index indicates more buyers can afford to enter market. Source: National Association of Realtors

## The Treasury Yield Curve vs. GDP



Source: Census Bureau, Federal Reserve

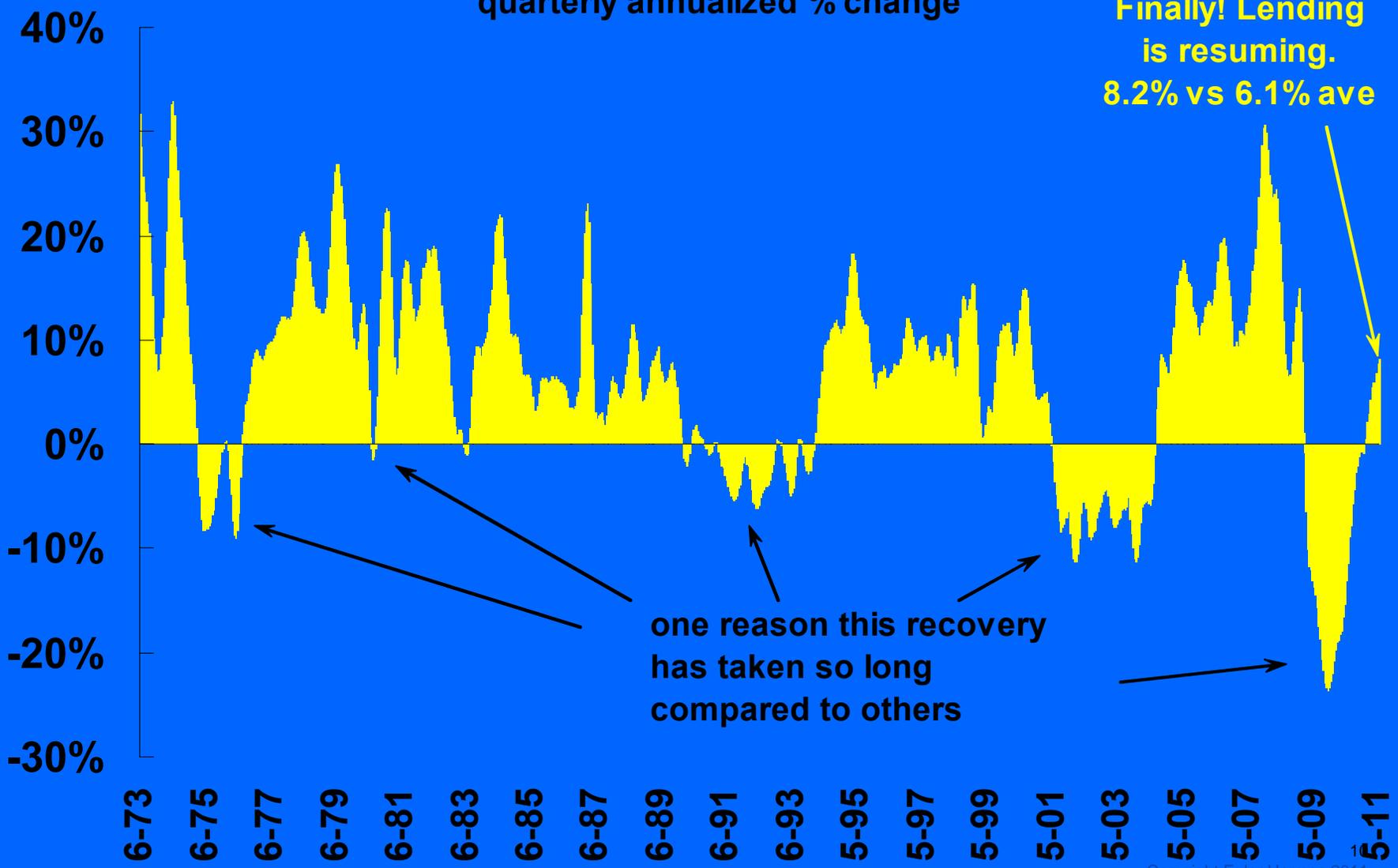
# The Treasury Yield Curve vs. GDP



Source: Census Bureau, Federal Reserve

# Fear of lending receding...

## Commercial and Industrial Loans quarterly annualized % change



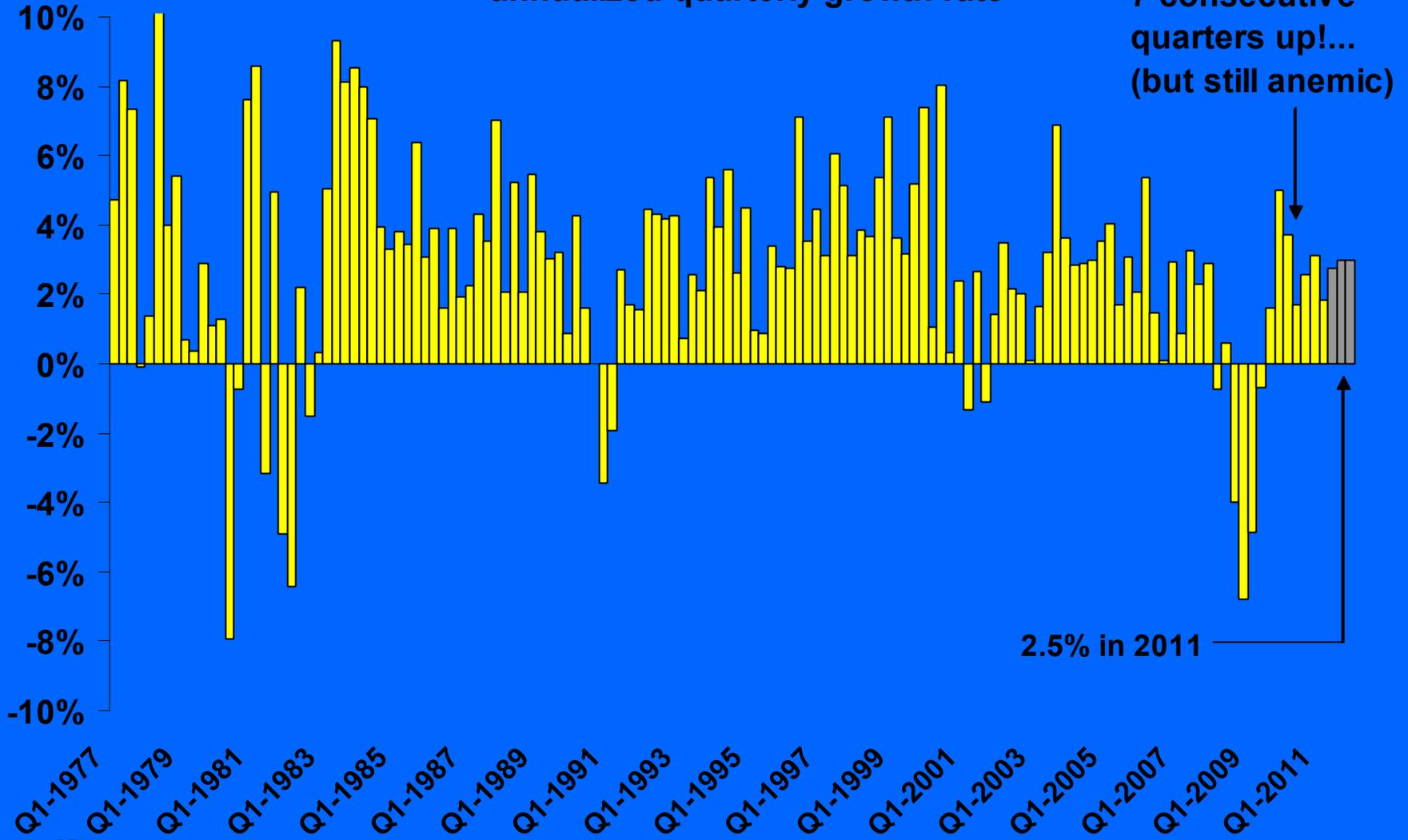
source: Federal Reserve

# Recap

- **Four forces caused/ended recession**
  - **Oil bad, housing a negative**
  - **Yield curve great and lending good**
- 
- **So what do the measures, the dashboard, say?**

# Real Gross Domestic Product (GDP)

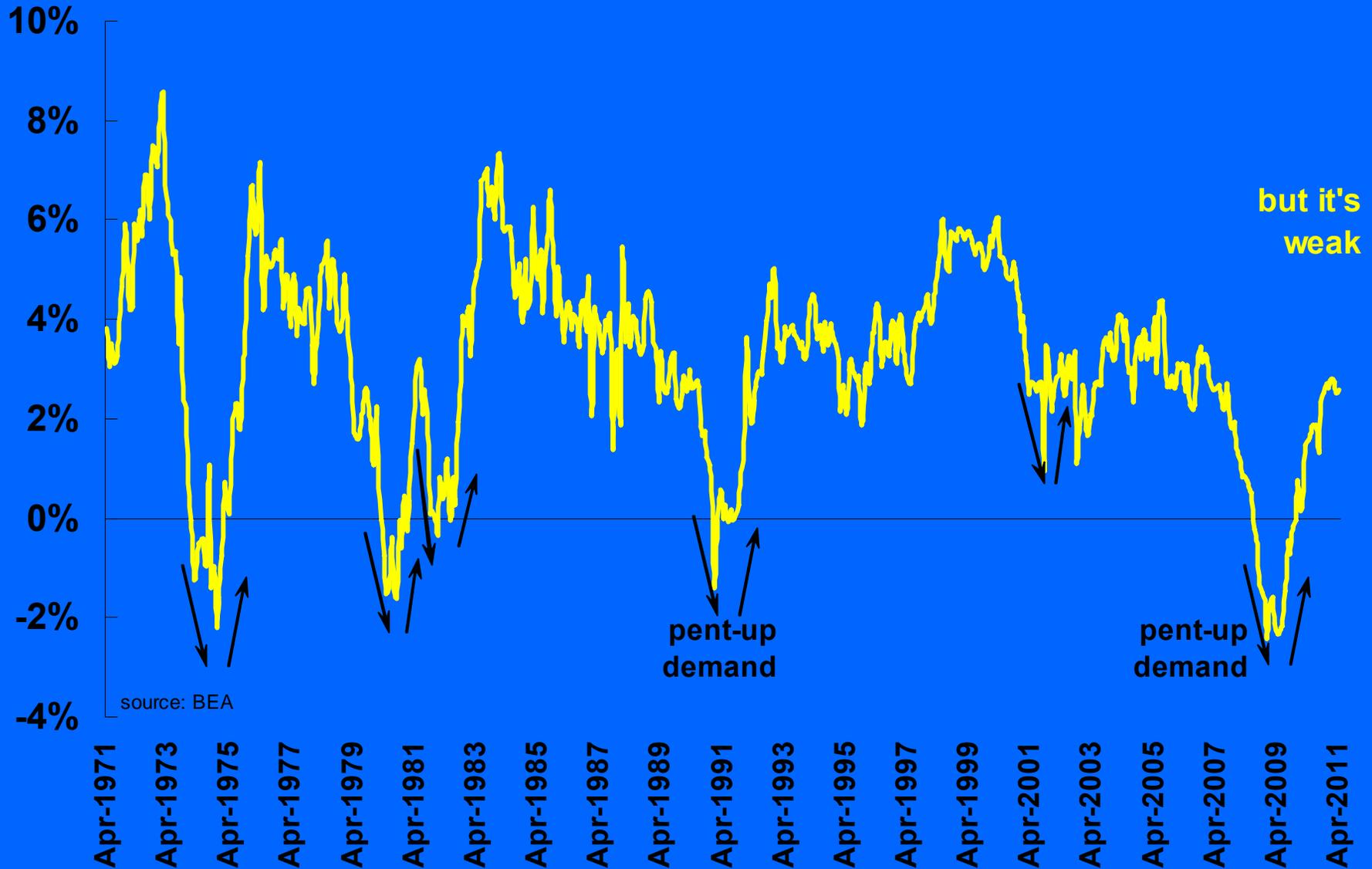
## annualized quarterly growth rate



source: BEA

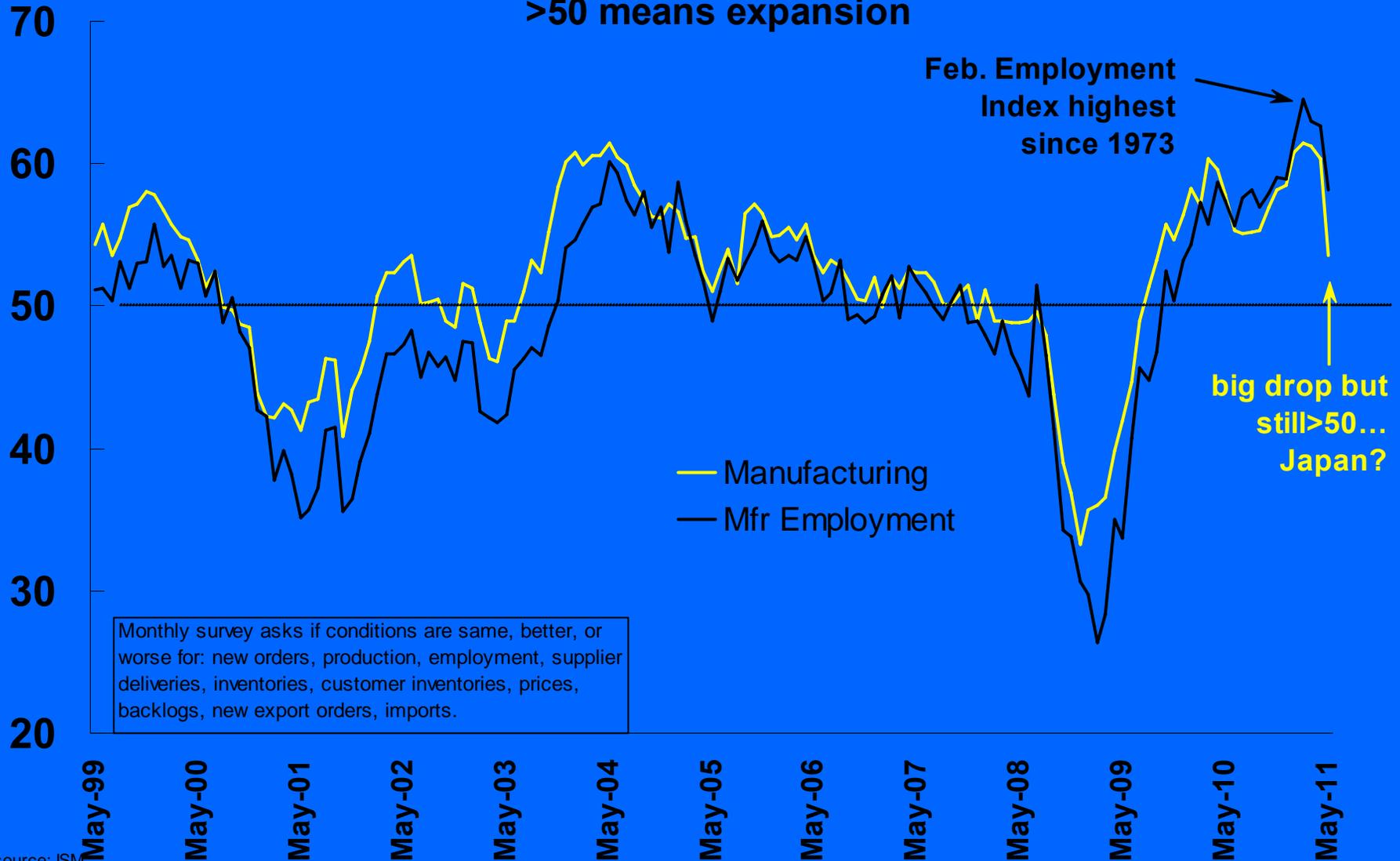
# Consumer recovering

## Real Personal Consumption Expenditures, y/y% Growth Rate



# Manufacturing recovering

## Institute of Supply Management Manufacturing Indices >50 means expansion

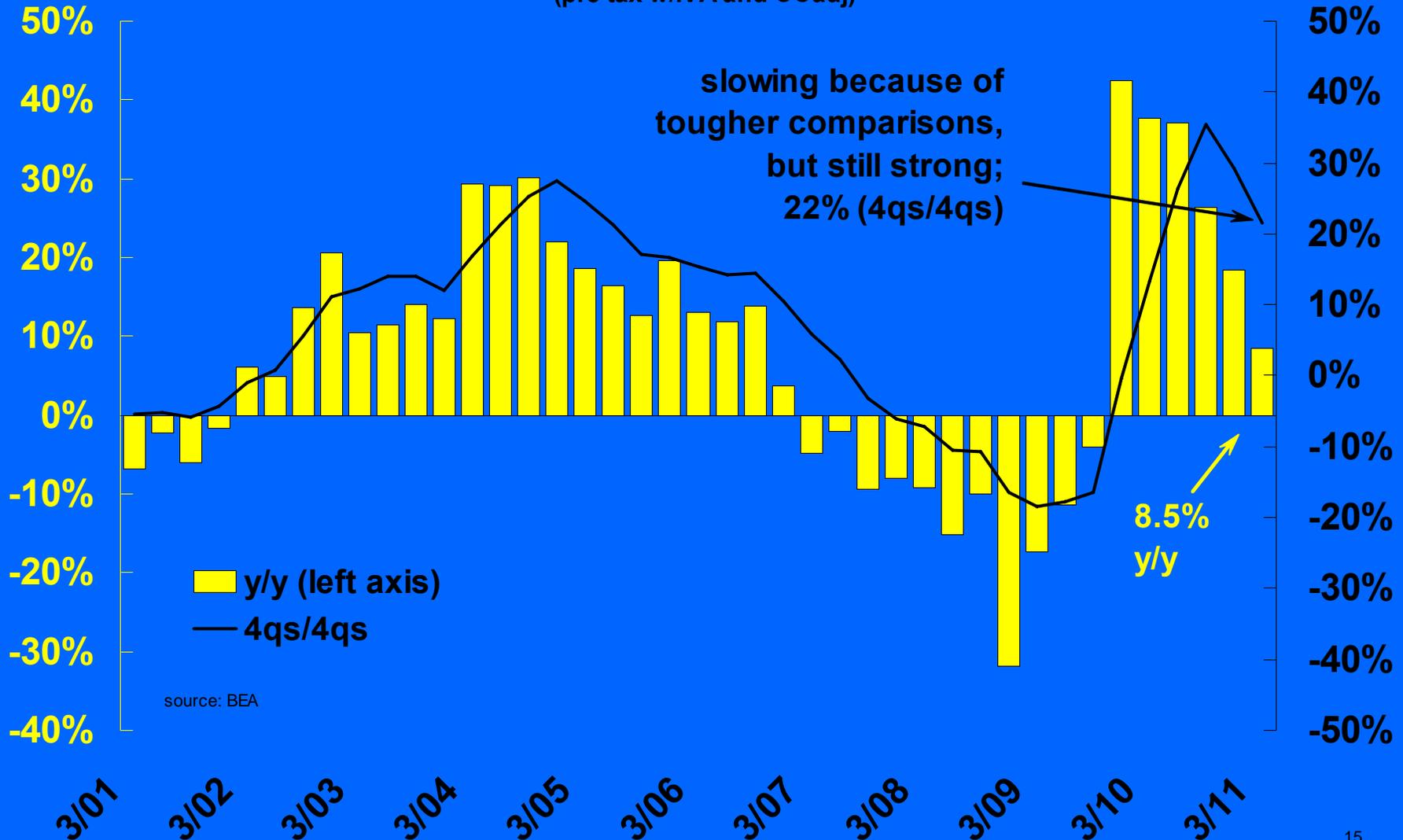


source: ISM

# Business conditions good: low interest rates, inflation, labor; 67% S&P beat, strong outlook

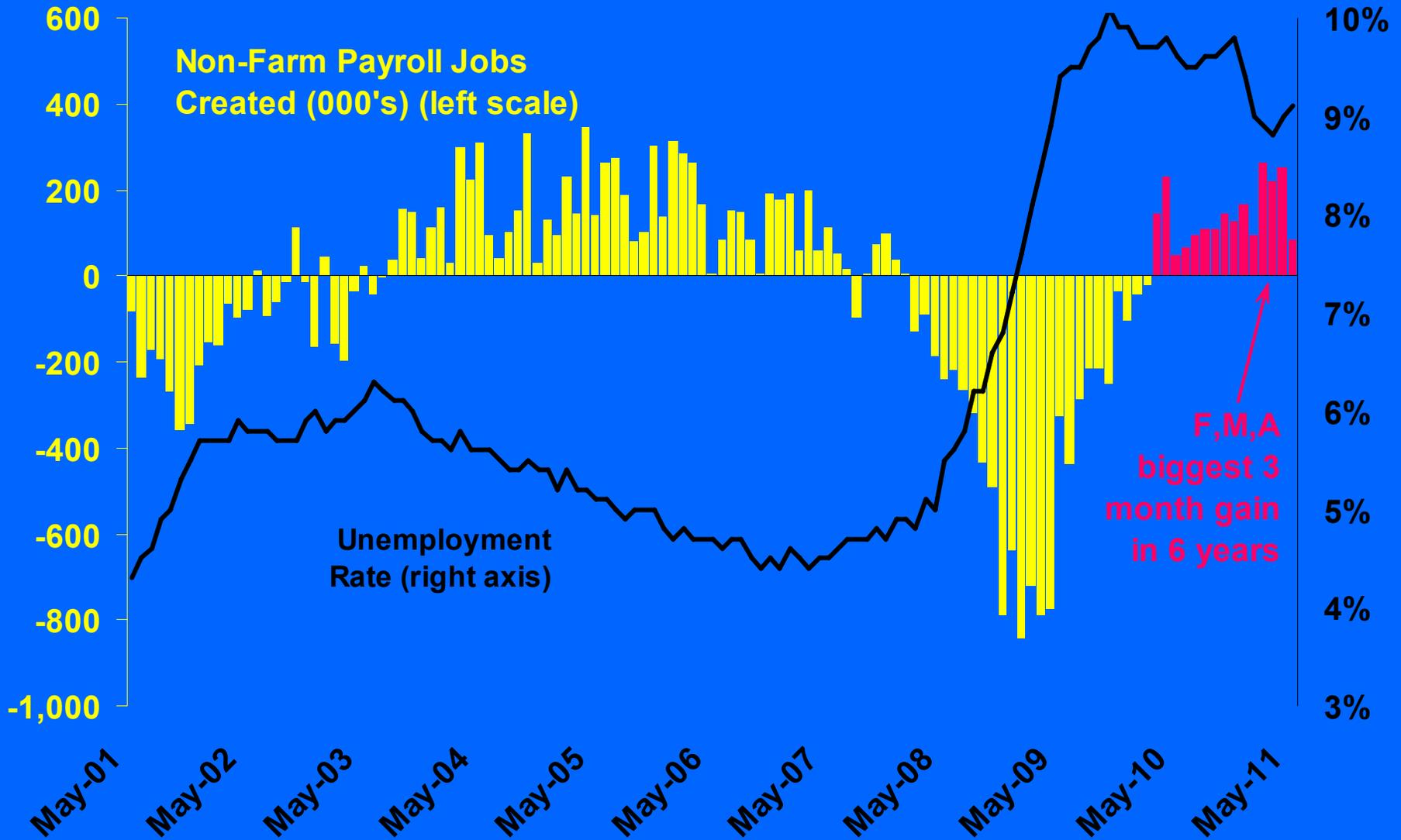
## Corporate Profits

(pre tax w/IVA and CCadj)



# Employment: May weak, but prior 3 months best in 6 years...

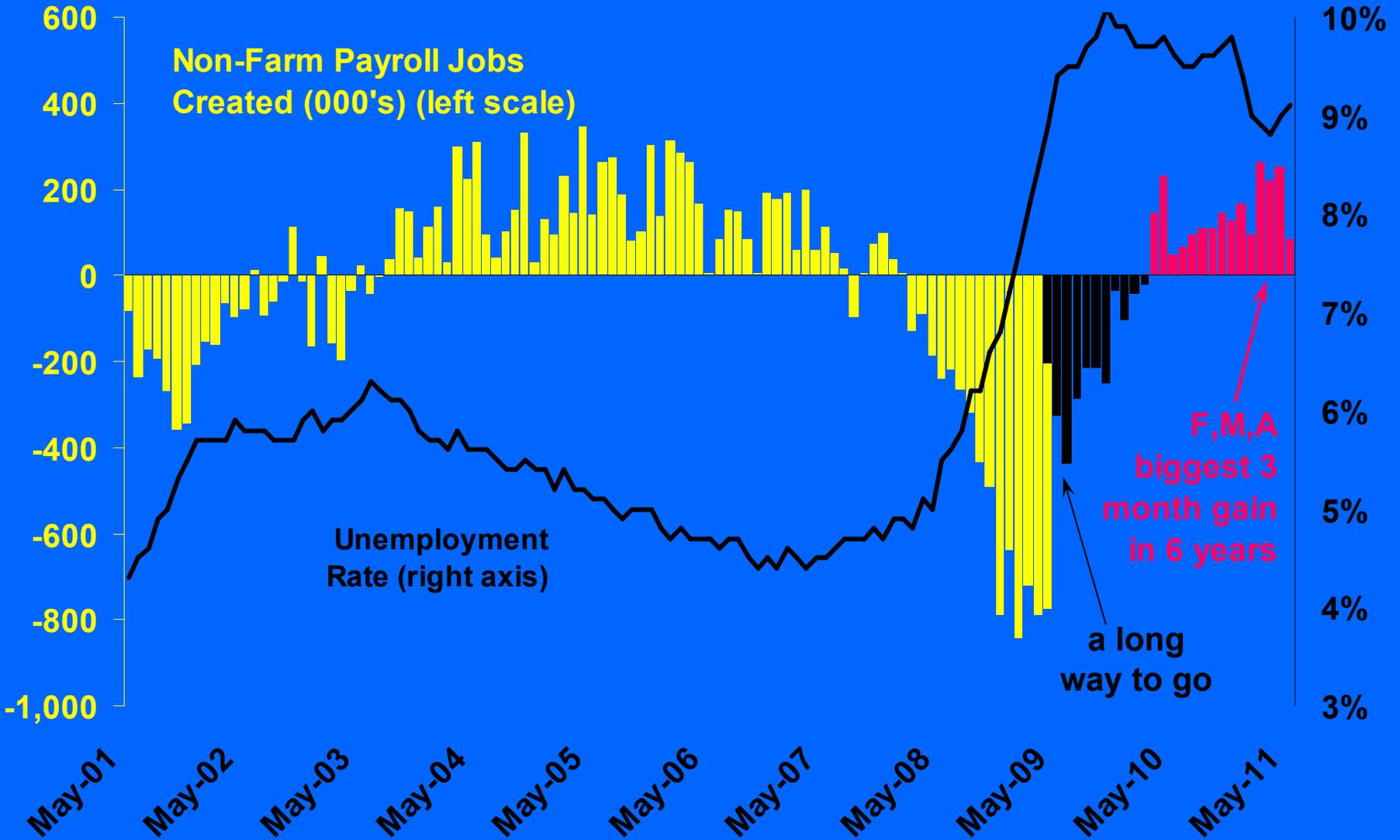
## Private Sector Jobs Created and the Unemployment Rate



source: Labor Department

...need to go faster

# Private Sector Jobs Created and the Unemployment Rate



source: Labor Department

# Recap

- Four forces caused/ended recession
- Oil bad, housing a negative
- Yield curve great and lending good
- GDP OK
- Consumer, mfrg, corp profits good
- Employment is catching
- But the unemployment rate is still high
- To fix it, the government is causing two big problems:

**Debt & Inflation**

# FISCAL POLICY

**Congress, Administration  
Spending, taxing, borrowing  
deficits/debt, budgets...**

# Budget Proposals Anyone?

- **Fiscal Deficit Reduction Commission**
- **Obama 2012**
- **Continuing Resolution** (substitute for FY2011)  
Debt ceiling
- **Ryan (House Republican) 2012**
- **Obama 2012, Part 2**
- **Senate Gang of Six**
- **Biden commission**
- **18% budget**

# Budget Proposals Anyone?

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- **Biden commission**
- ~~18% budget~~

# Budget Math in Washington

- Year 1: spent \$80
- Original budget for year 2: spend \$110
- Final budget for year 2: spend \$90
  
- In Washington, even though they're spending \$10 more in year 2, this is actually a \$20 "cut".
  
- Both sides do this

# Spending, Deficits and Debt

**Gov't spends** **\$120**

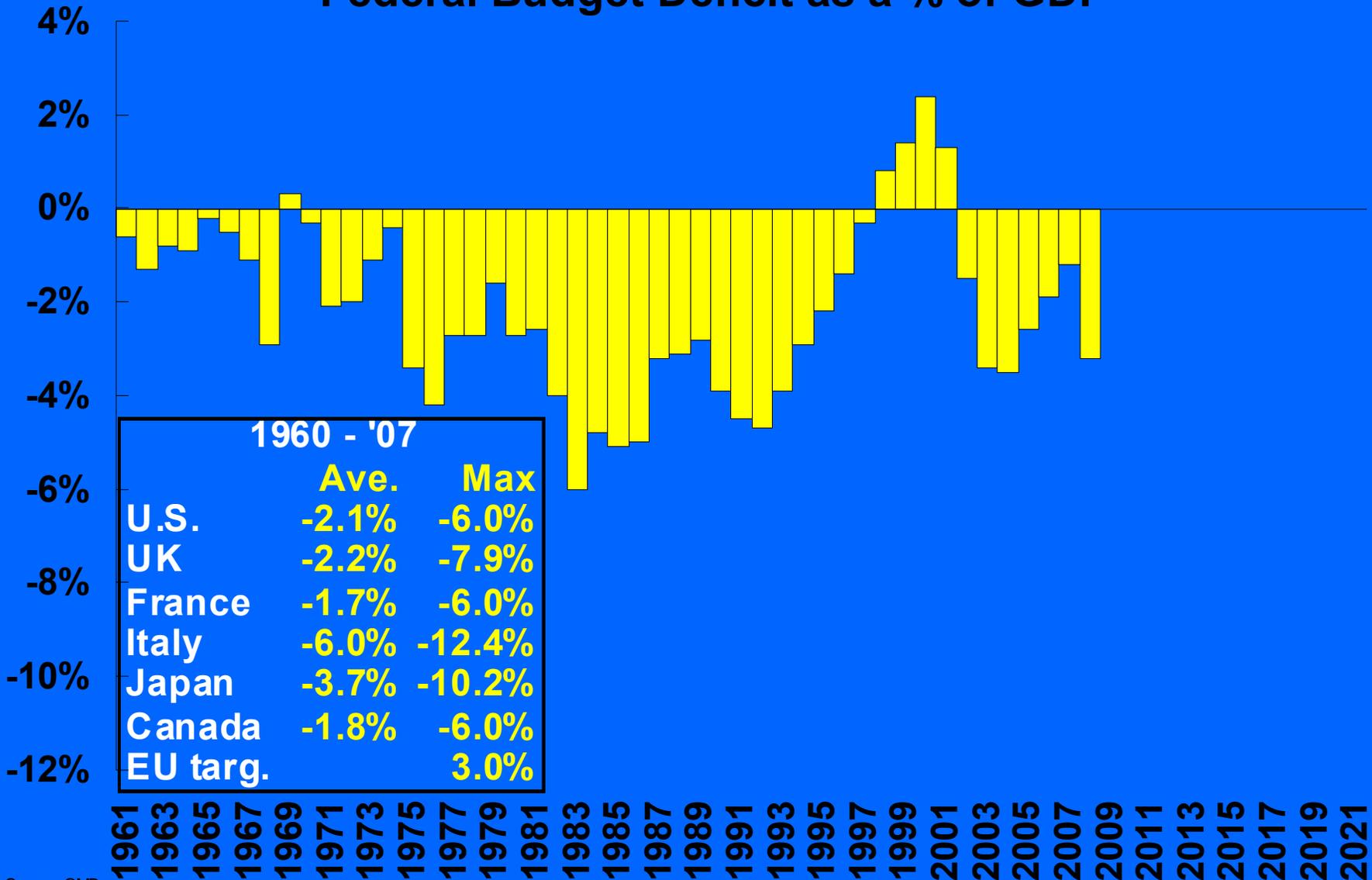
**Gov't gets tax revenue** **\$100**

**Deficit** **\$20**

**Treas. gets loan, issues \$20 notes/bonds**

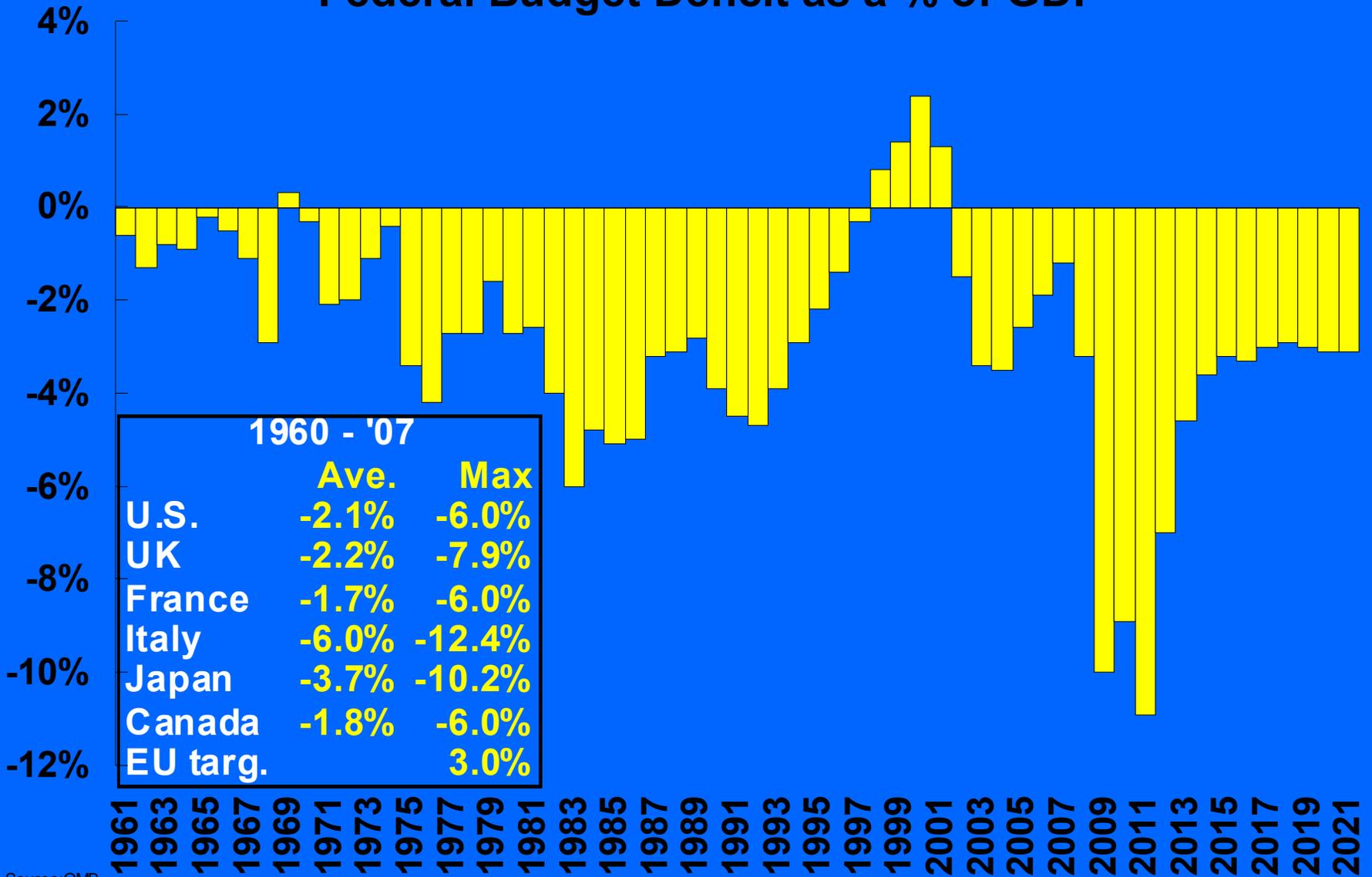
**How big is \$20T? Don't know - measure  
against size of the economy - GDP**

# Federal Budget Deficit as a % of GDP



Source:OMB

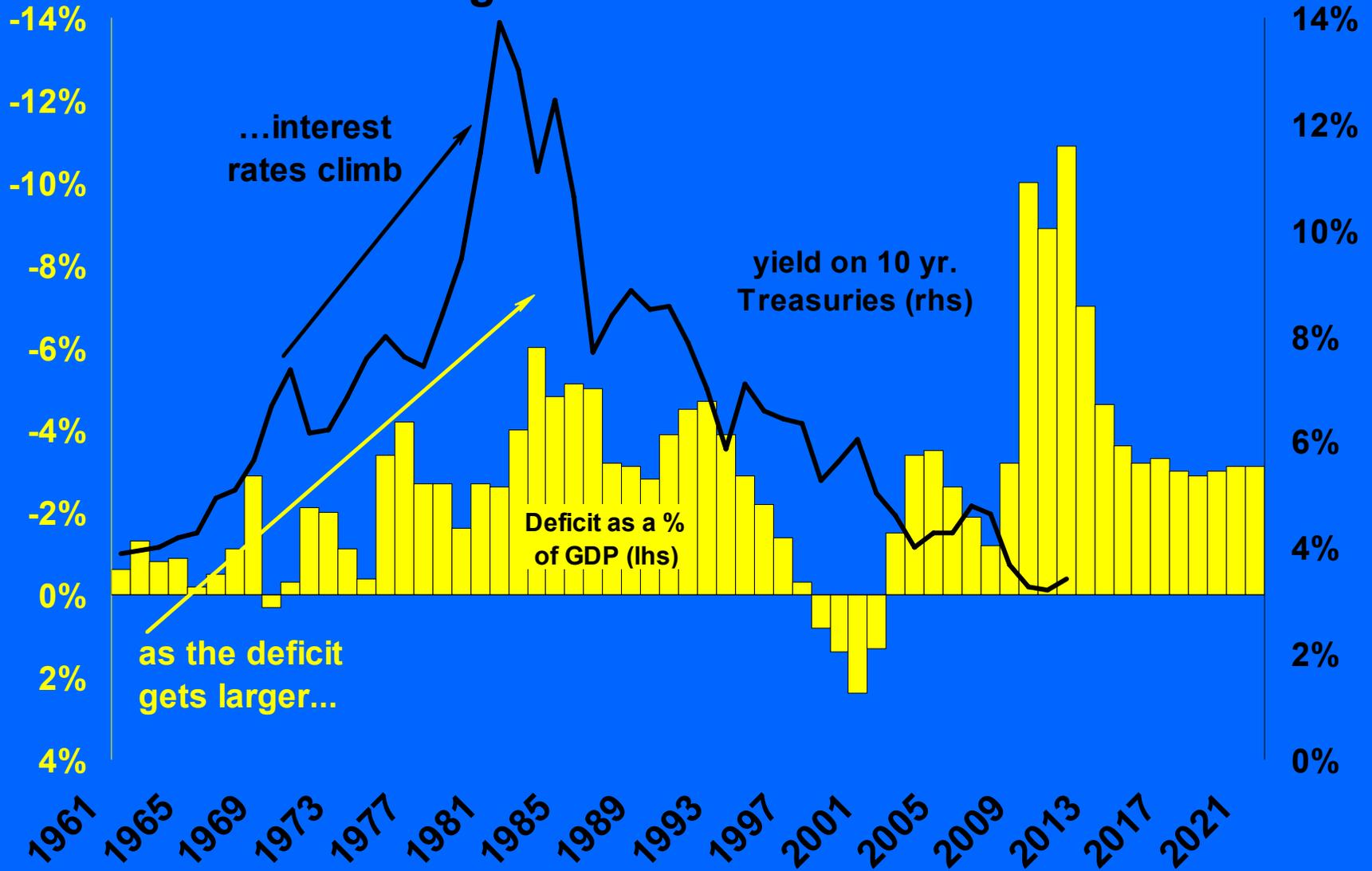
# Federal Budget Deficit as a % of GDP



1960 - '07		
	Ave.	Max
U.S.	-2.1%	-6.0%
UK	-2.2%	-7.9%
France	-1.7%	-6.0%
Italy	-6.0%	-12.4%
Japan	-3.7%	-10.2%
Canada	-1.8%	-6.0%
EU targ.		3.0%

Source: OMB

# The Budget Deficit vs. Interest Rates

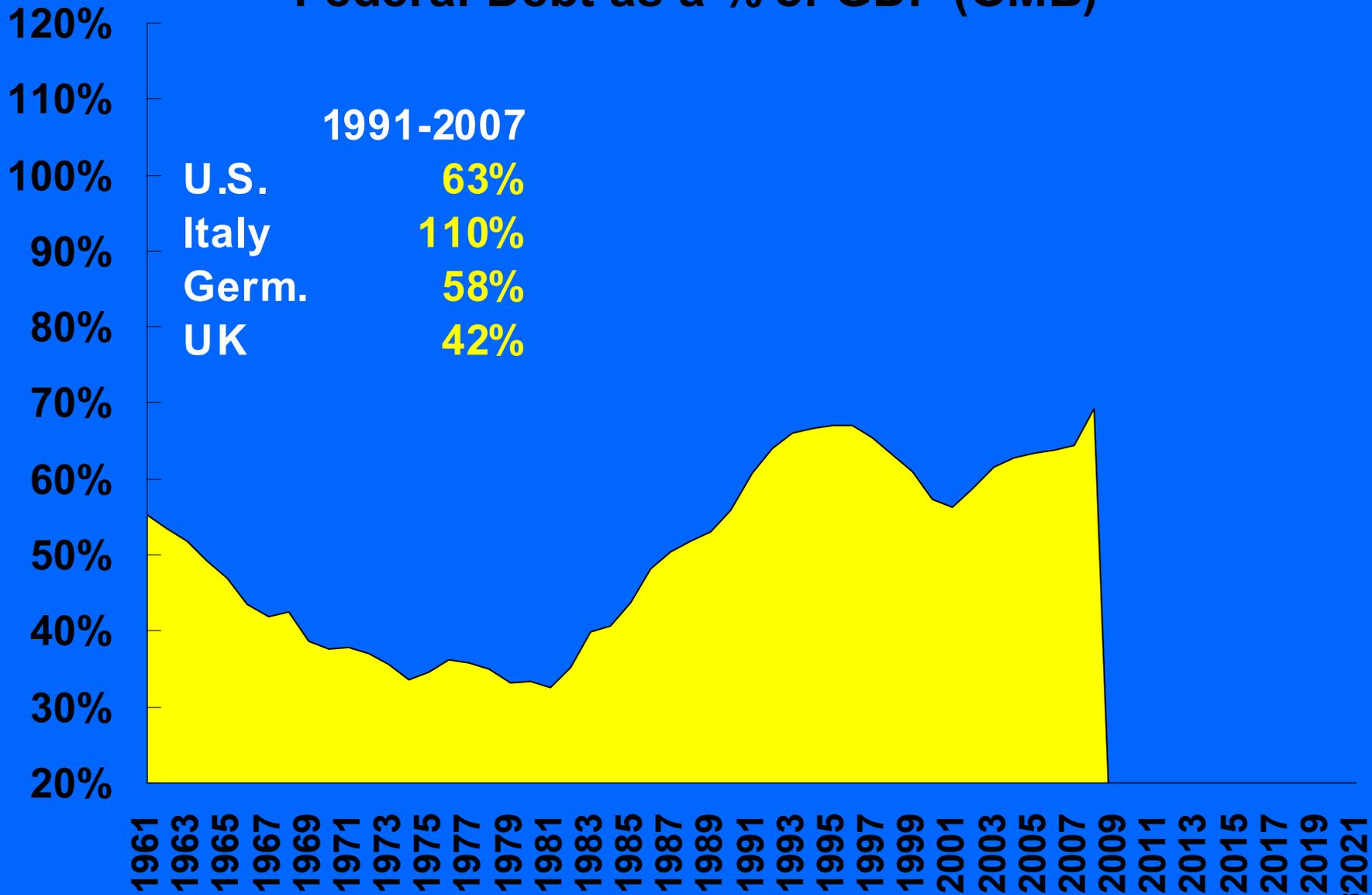


Sources: The Federal Reserve. Congressional Budget Office

Accumulated deficits become debt. <sup>26</sup>

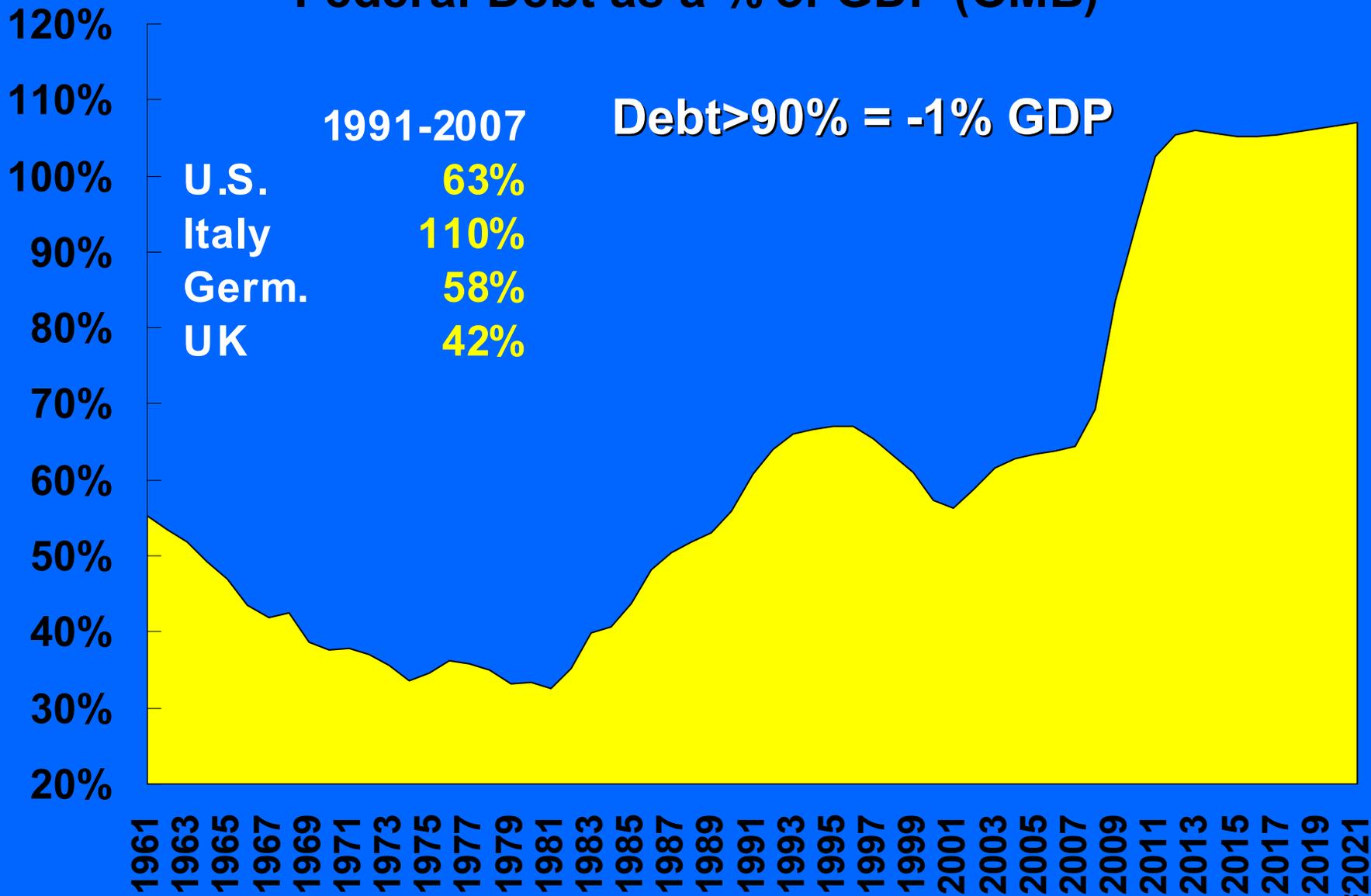
# Accumulated deficits become debt...

## Federal Debt as a % of GDP (OMB)



# Accumulated deficits become debt...

## Federal Debt as a % of GDP (OMB)



# The Deficit Reduction Committee is finally saying it out loud:

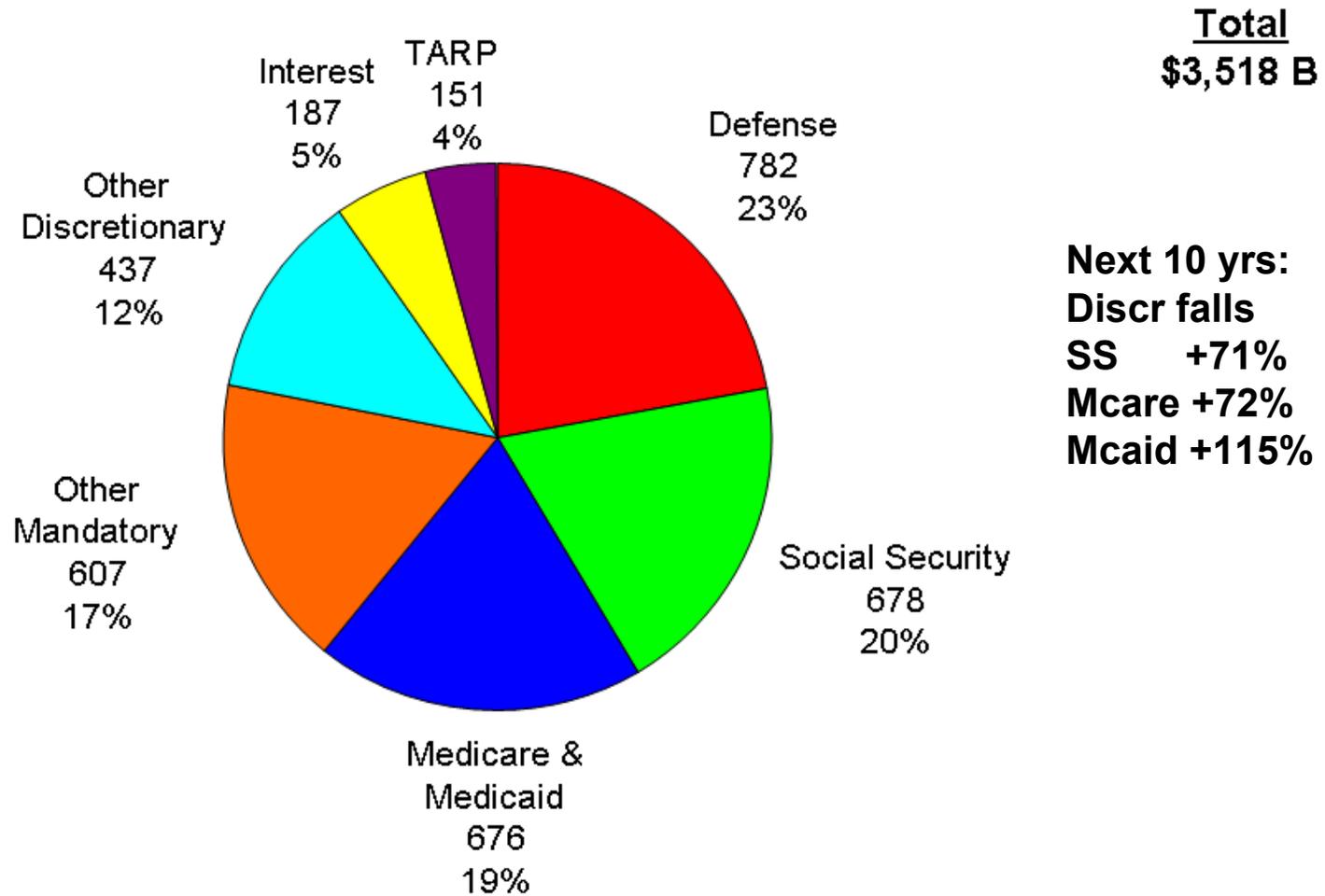
We must touch the “third rails” of

- Social Security
- Medicare

If we don't we will never be able to balance the budget - entitlements will become the entire budget

The rest is whistling past the graveyard

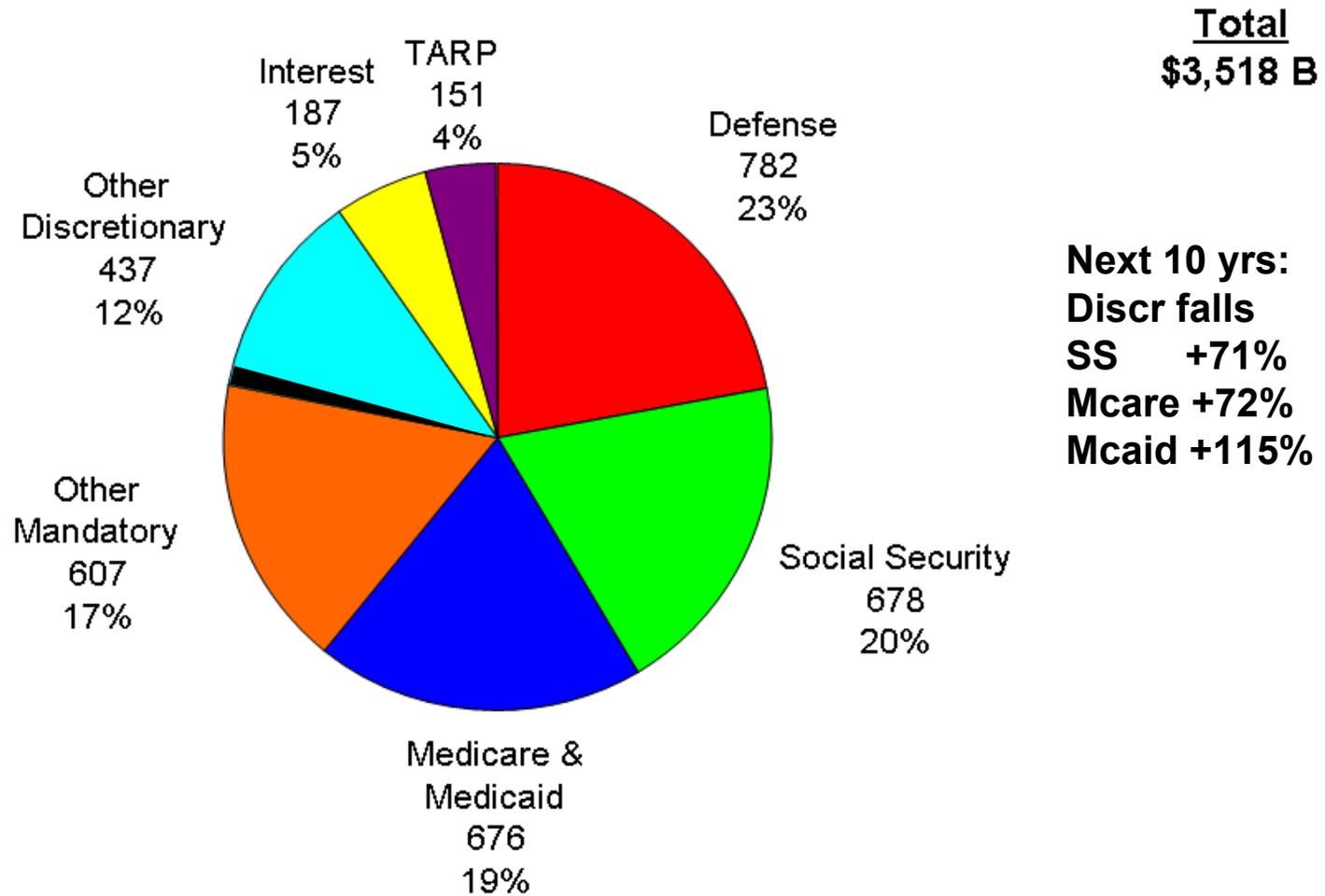
# U.S. Federal Spending – Fiscal Year 2009 (\$ Billion)



Source: OMB - 2011 Budget - Summary Table S-3

**heroic efforts...**

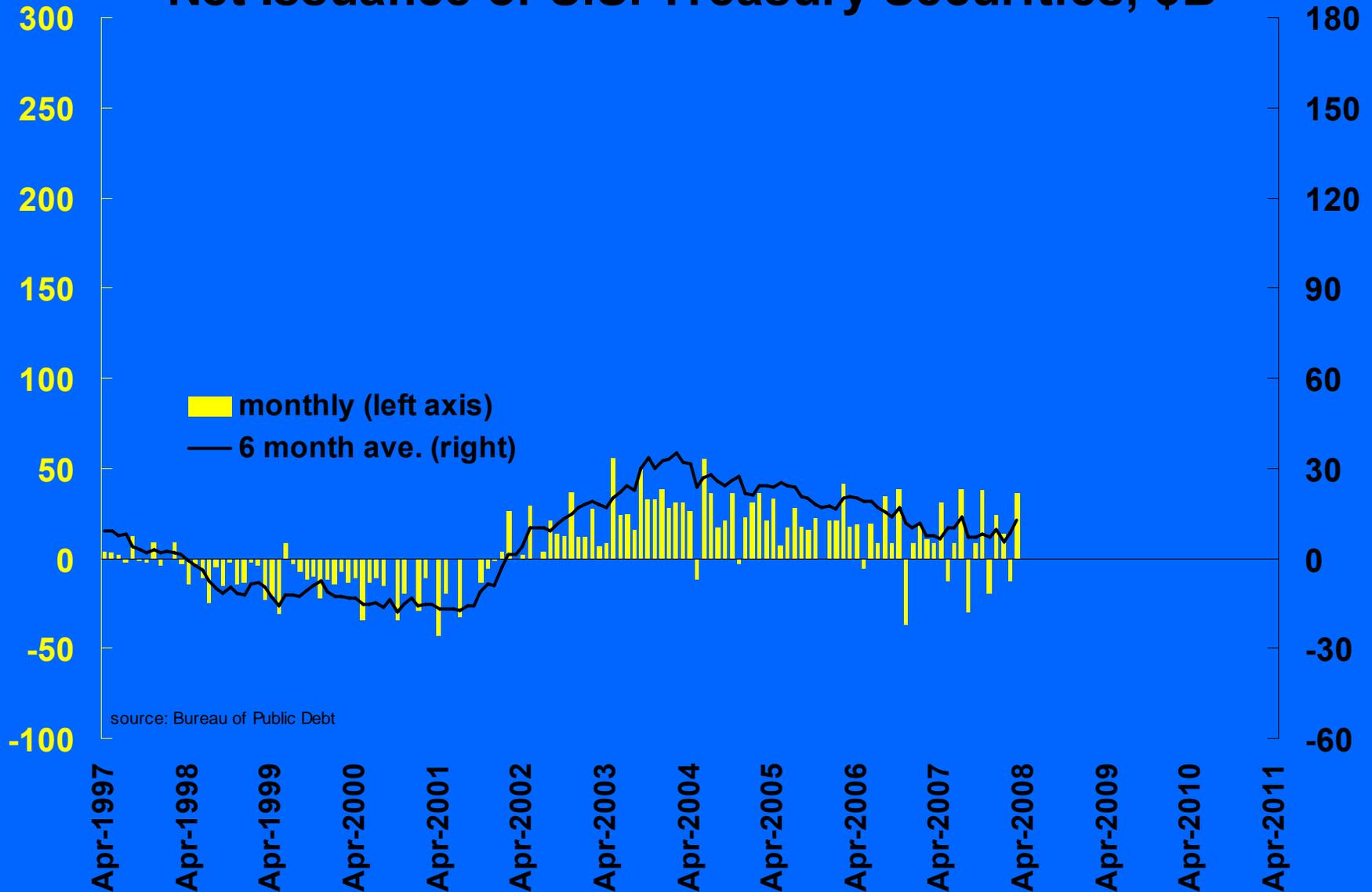
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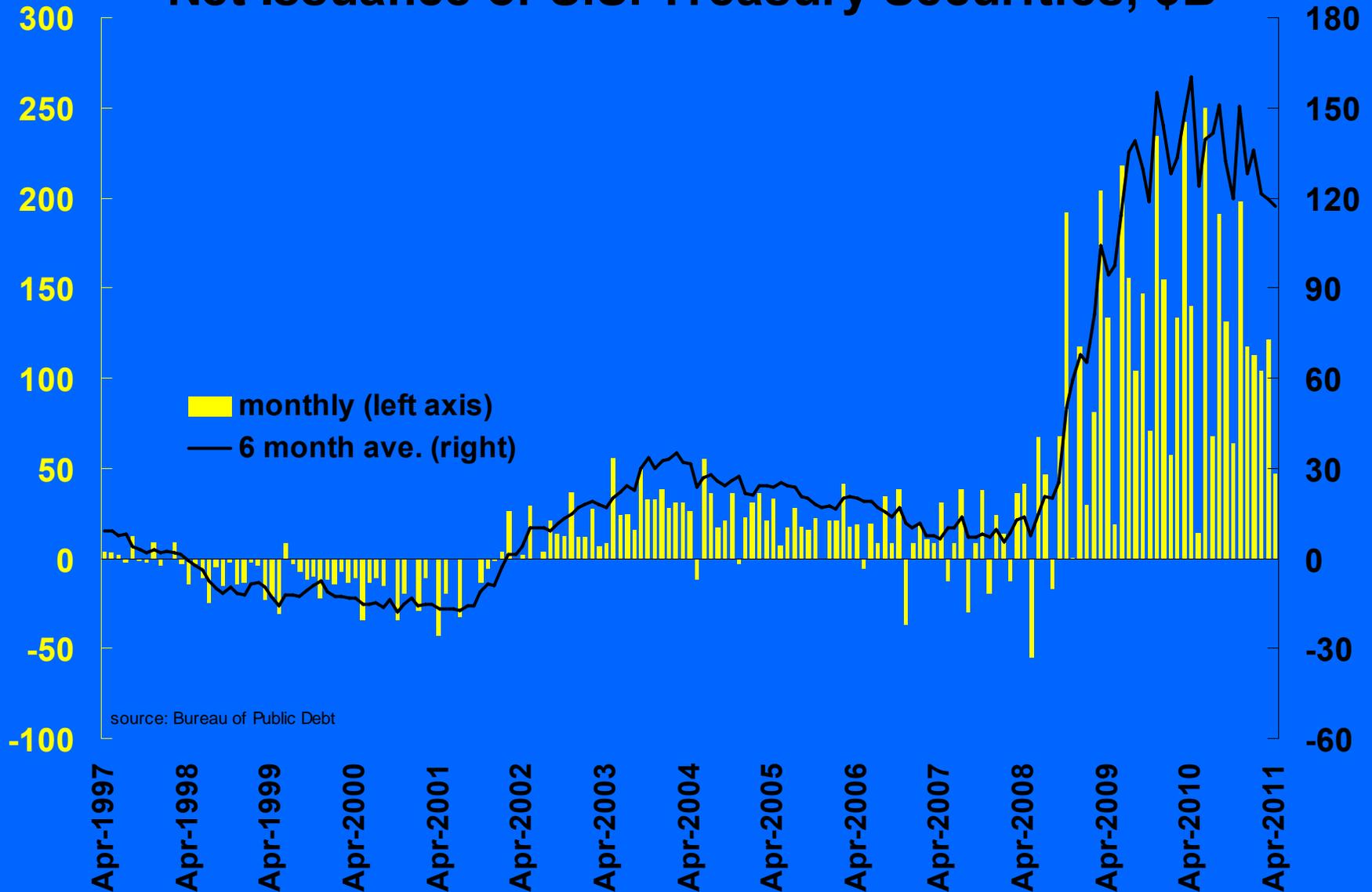
Source: OMB - 2011 Budget - Summary Table S-3

**In the meantime...**

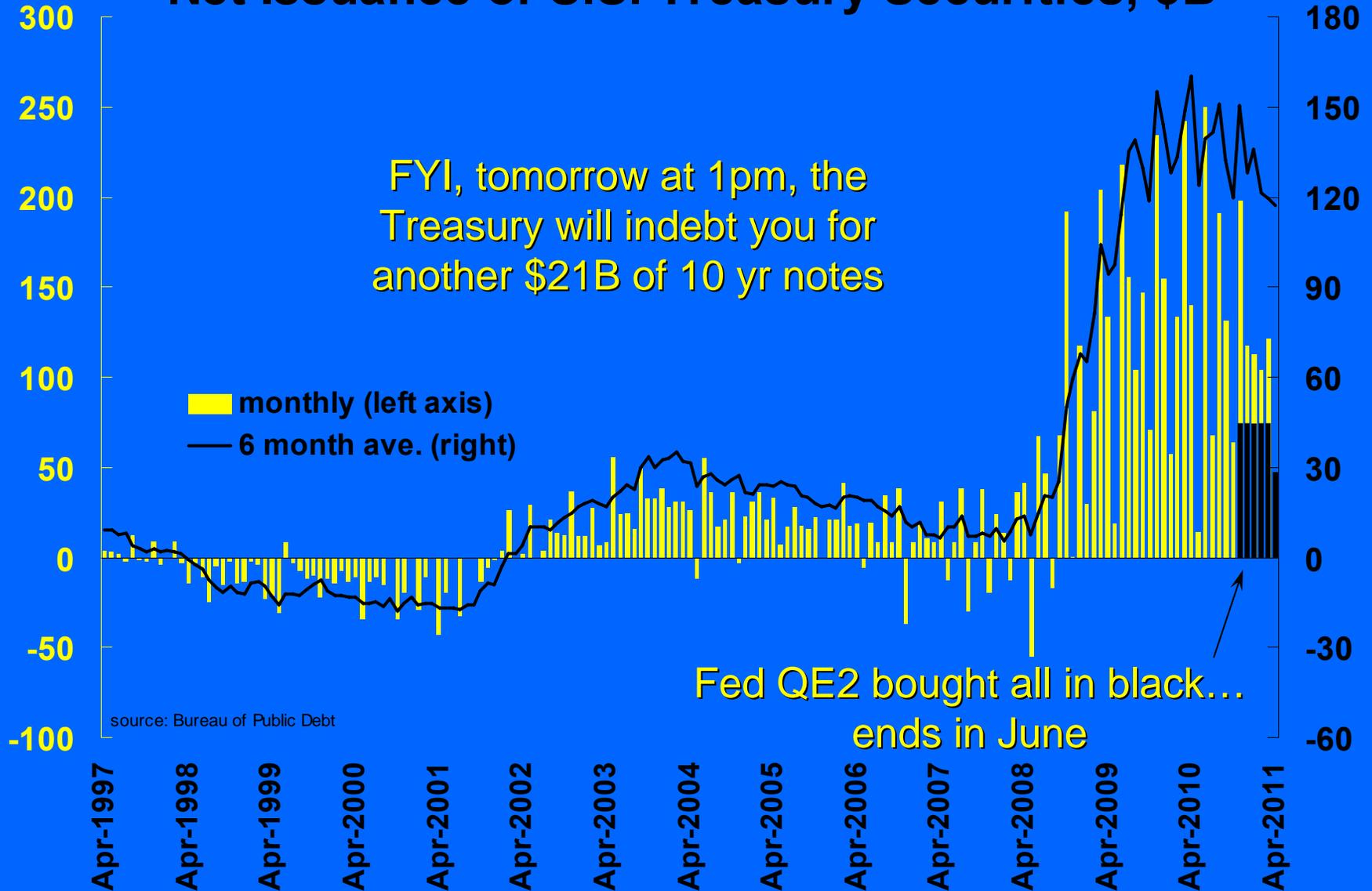
# Net Issuance of U.S. Treasury Securities, \$B



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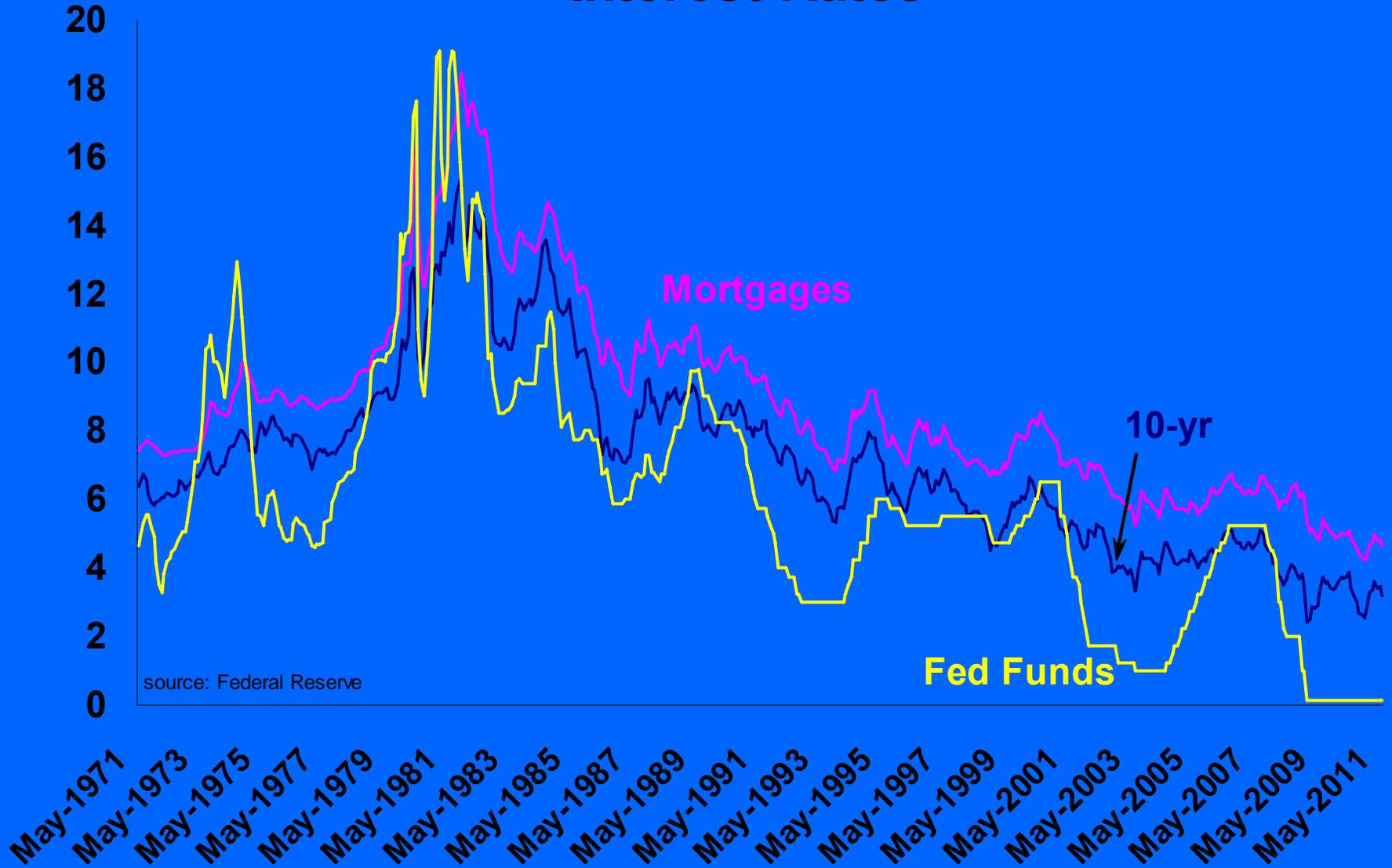
# Net Issuance of U.S. Treasury Securities, \$B



# **MONETARY POLICY**

## **The Federal Reserve Bank, Ben Bernanke**

# Interest Rates

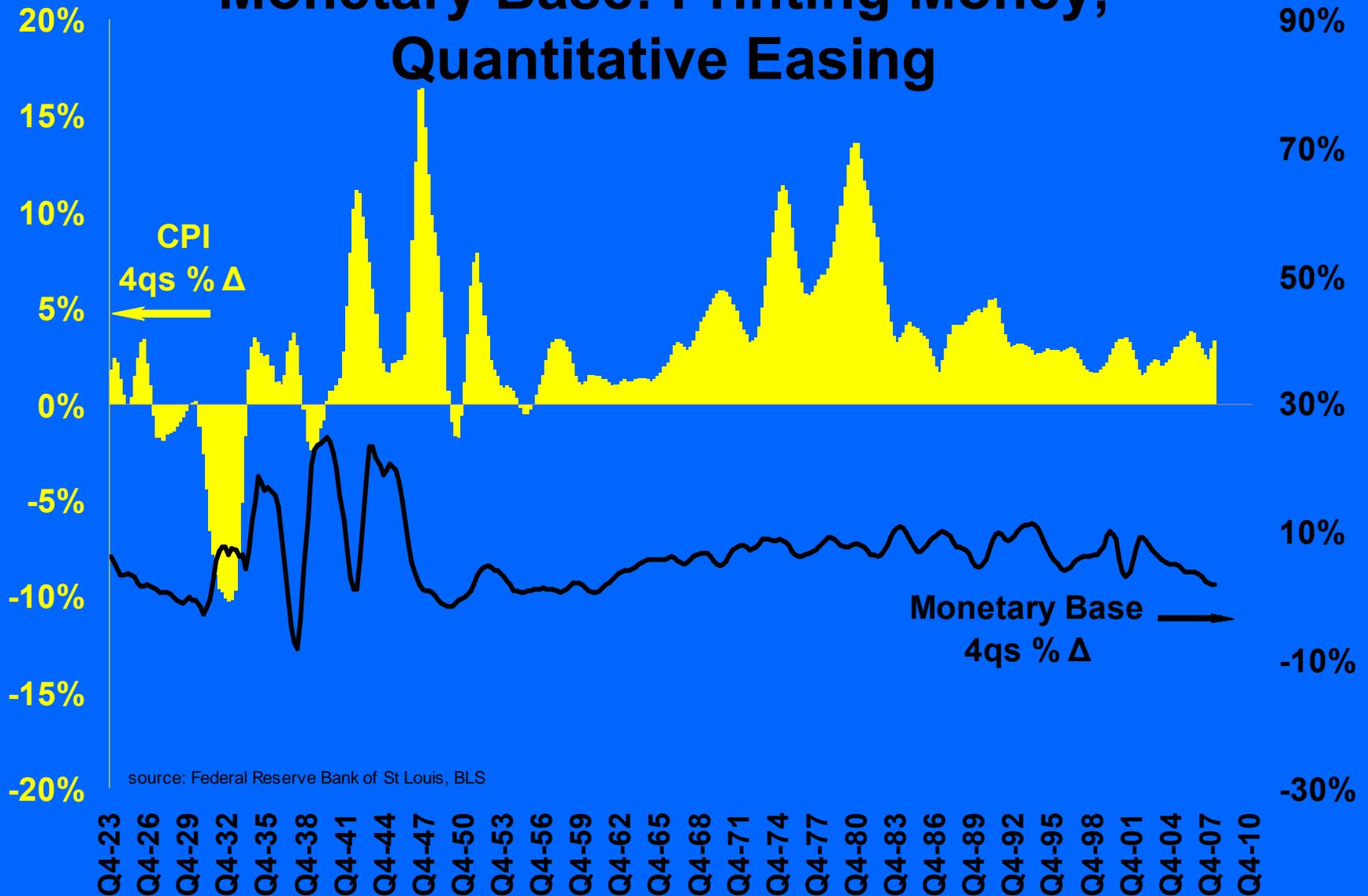


source: Federal Reserve

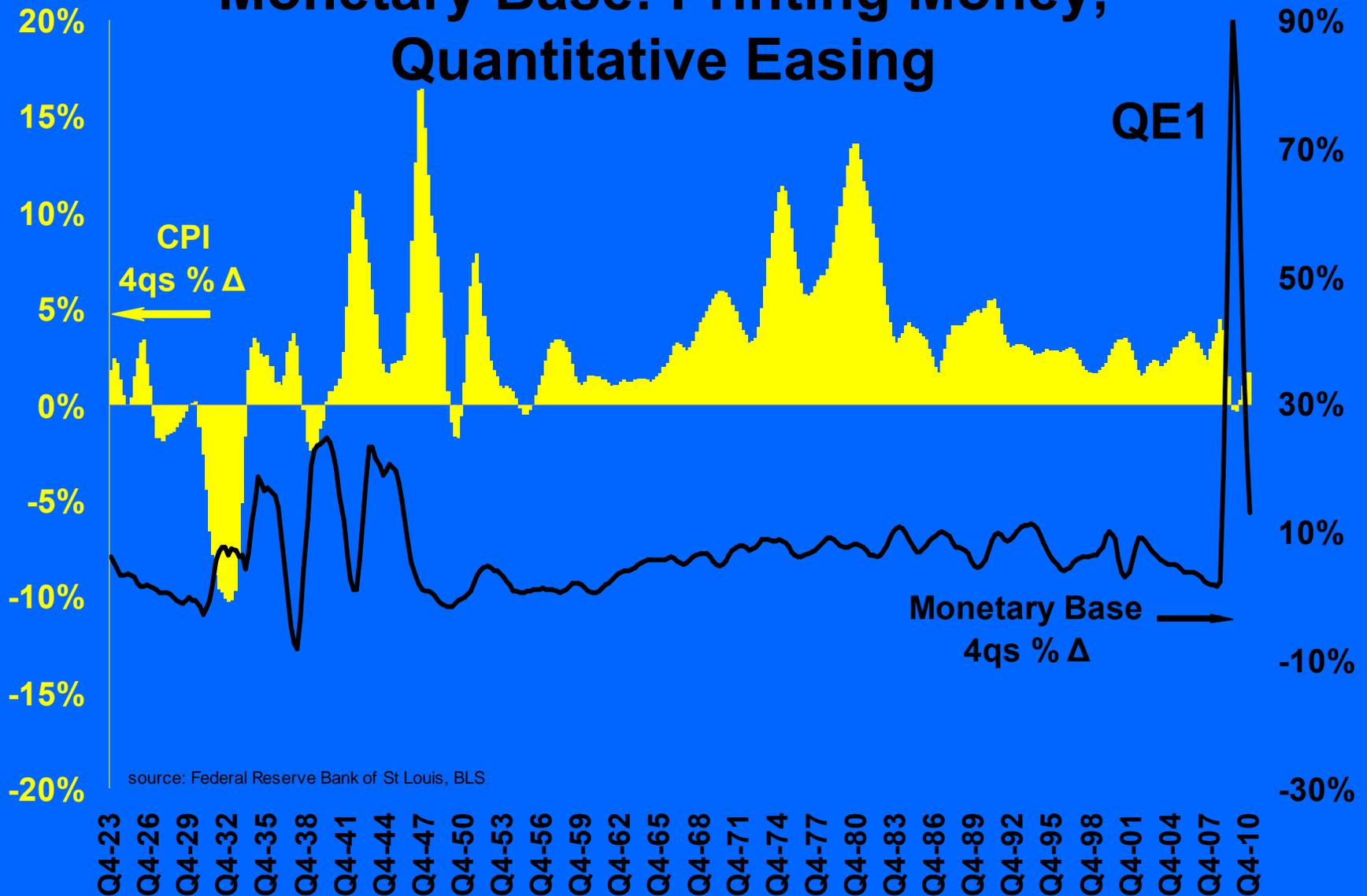
# MONETARY POLICY

- Lowering the short term Fed Funds interest rate works, but need an extra boost, lowering long term interest rates.
- Quantitative easing:
- Fed prints new \$ bills
- Buys Treasury bonds in open market
- Raises bond prices, lowering interest rates (they move in opposite directions)
- Puts \$ into financial system
- And creates inflationary pressures...

# Monetary Base: Printing Money, Quantitative Easing



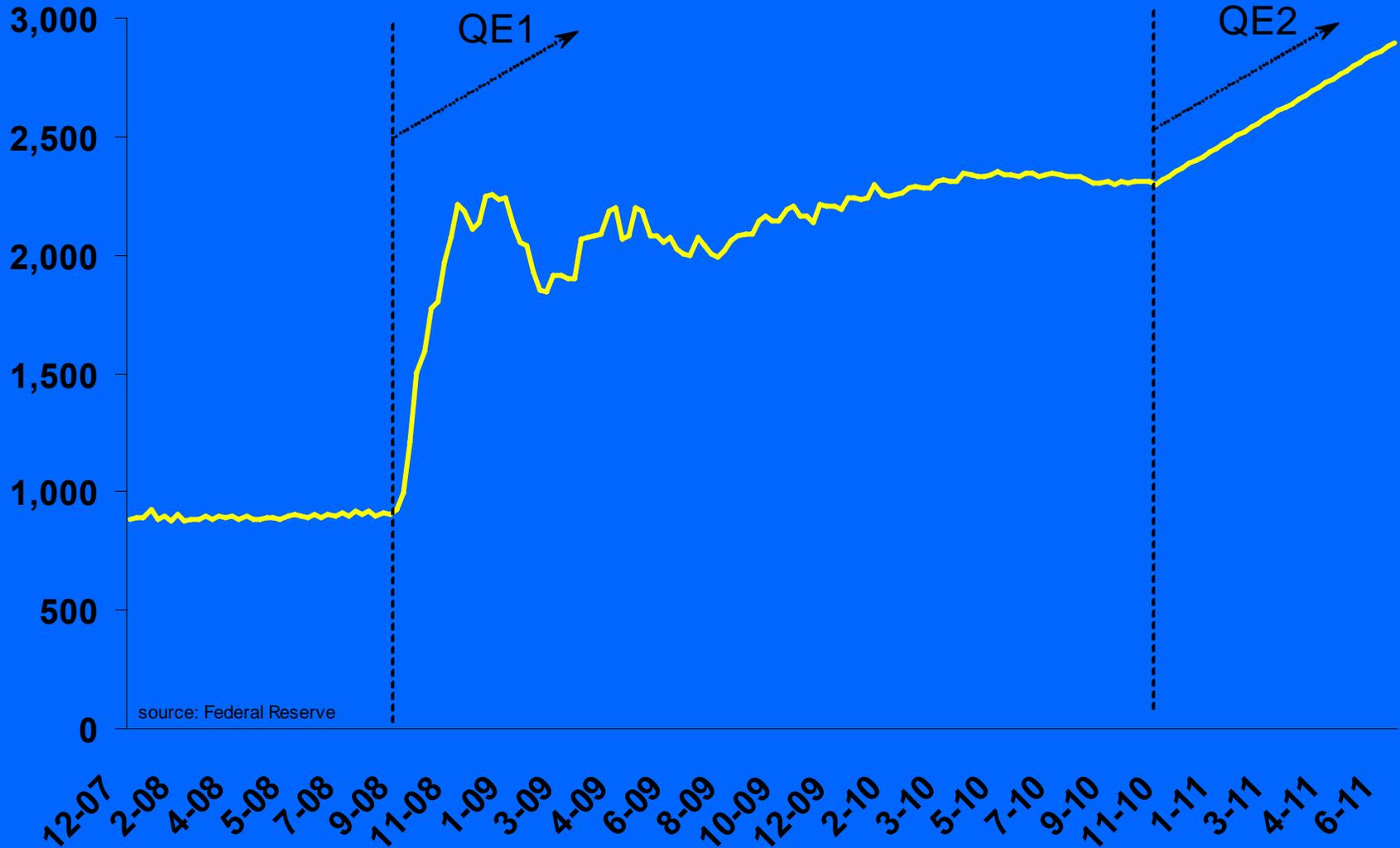
# Monetary Base: Printing Money, Quantitative Easing



source: Federal Reserve Bank of St Louis, BLS

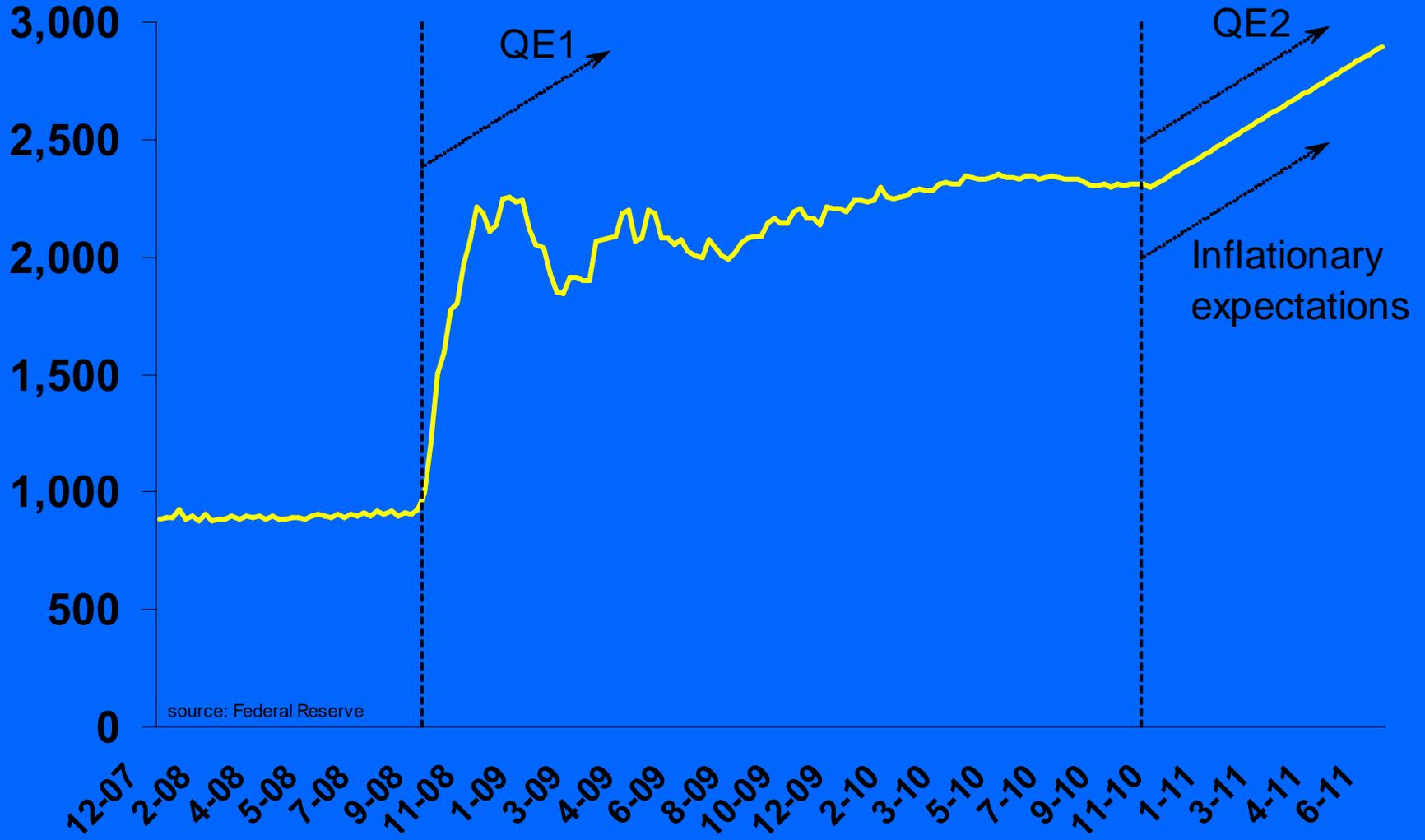
**S&P +8% in 2 days**

# Federal Reserve Balance Sheet, \$B



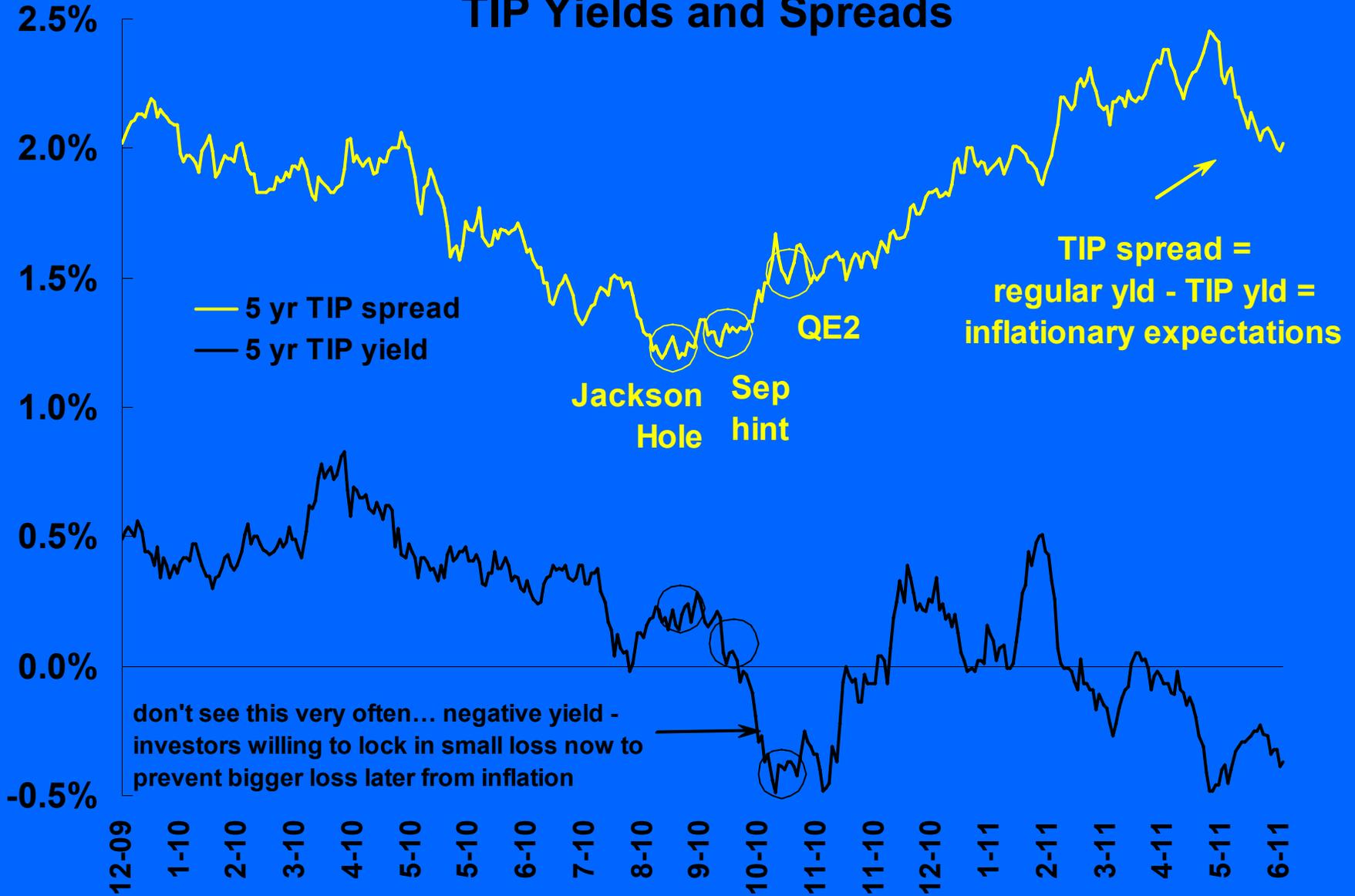
source: Federal Reserve

# Federal Reserve Balance Sheet, \$B



source: Federal Reserve

# TIP Yields and Spreads



The Fed will eventually have to mop up, because, here's what happens if you print a bit too much money:

# German Hyperinflation

## Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4

# German Hyperinflation

## Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
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Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3

# German Hyperinflation

## Wholesale Price Index

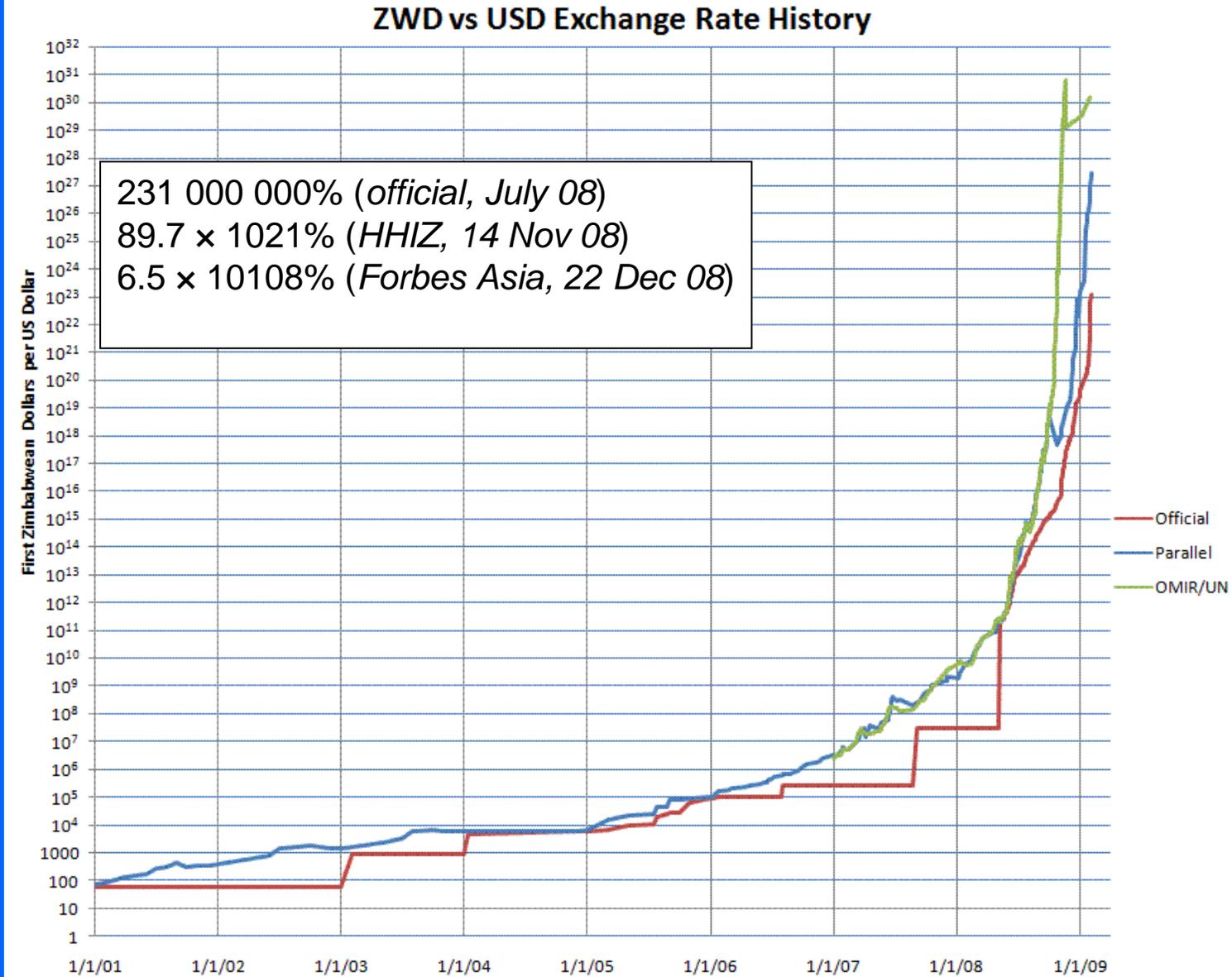
July 1914	1.0
Jan 1919	2.6
July 1919	3.4
Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3
Jan 1922	36.7
July 1922	100.6

# German Hyperinflation

## Wholesale Price Index

July 1914	1.0
Jan 1919	2.6
July 1919	3.4
Jan 1920	12.6
Jan 1921	14.4
July 1921	14.3
Jan 1922	36.7
July 1922	100.6
Jan 1923	2,785
July 1923	194,000
Nov 1923	726,000,000,000

# Zimbabwean Hyperinflation



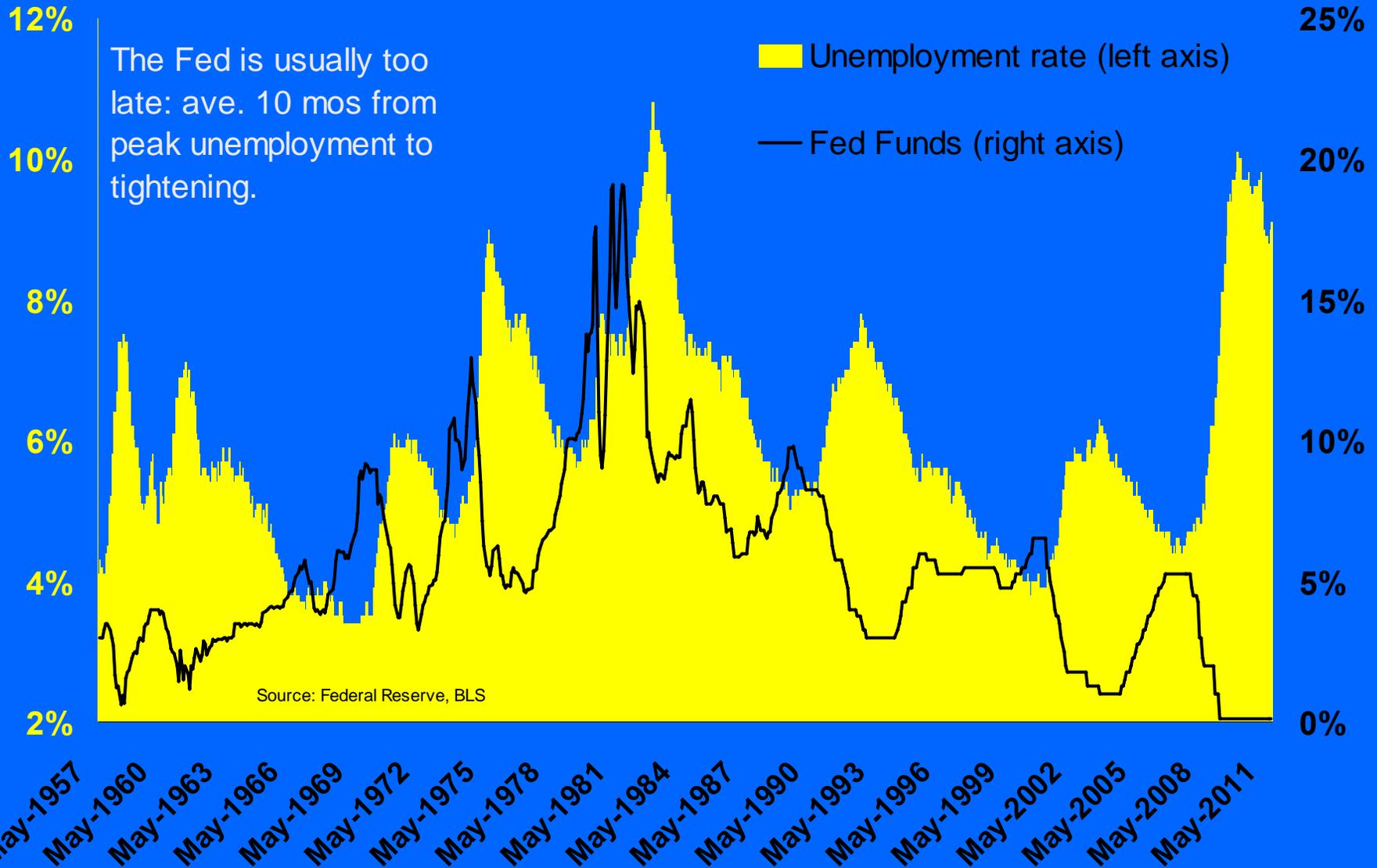
**\$250,000,000**

**The Fed is unlikely to let that happen.**

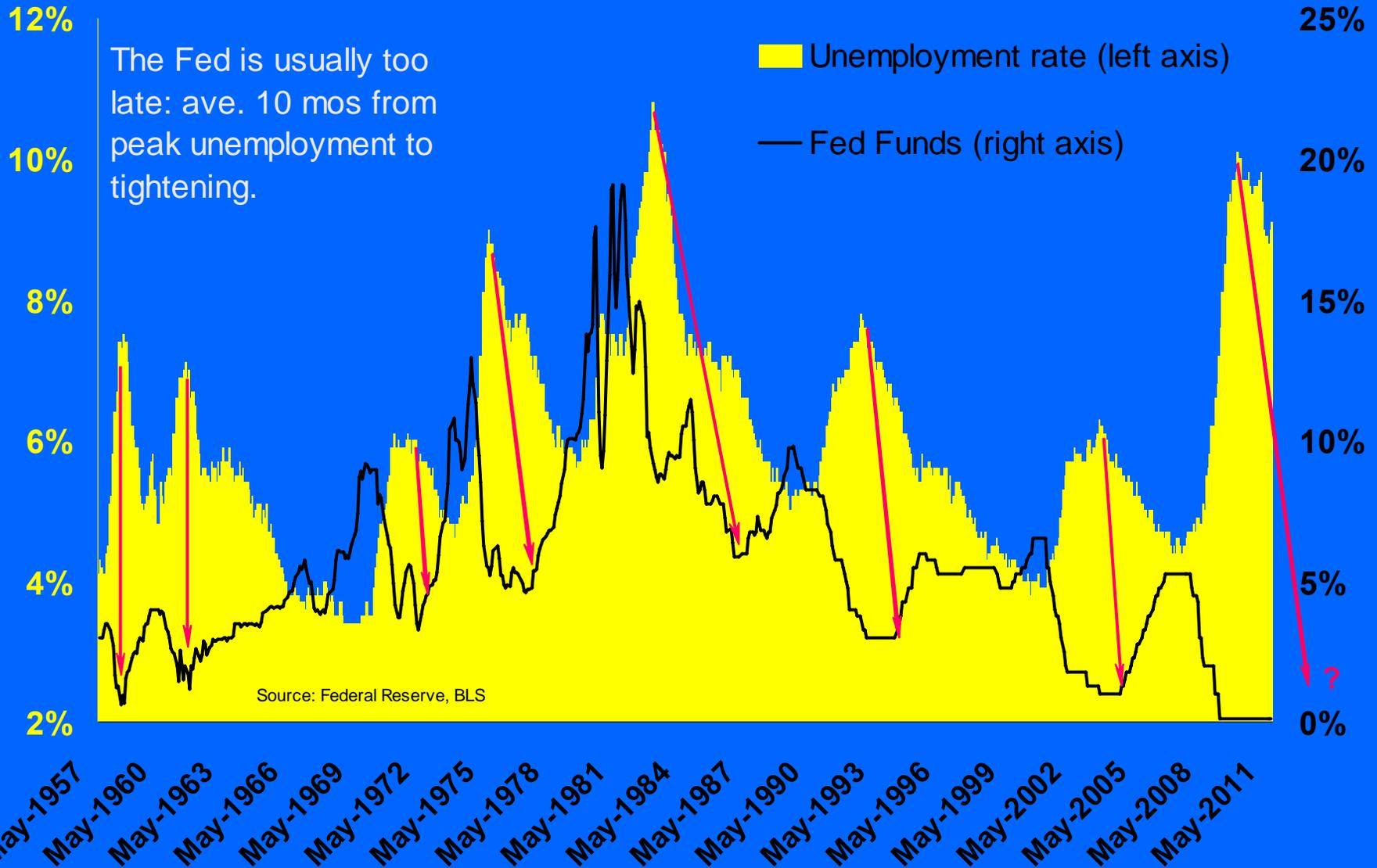
**But the Fed waits to tighten until it's sure that unemployment has peaked.**

**By then it's too late... it takes a really long time for changes in monetary policy to have full effect... 3-5 Qs.**

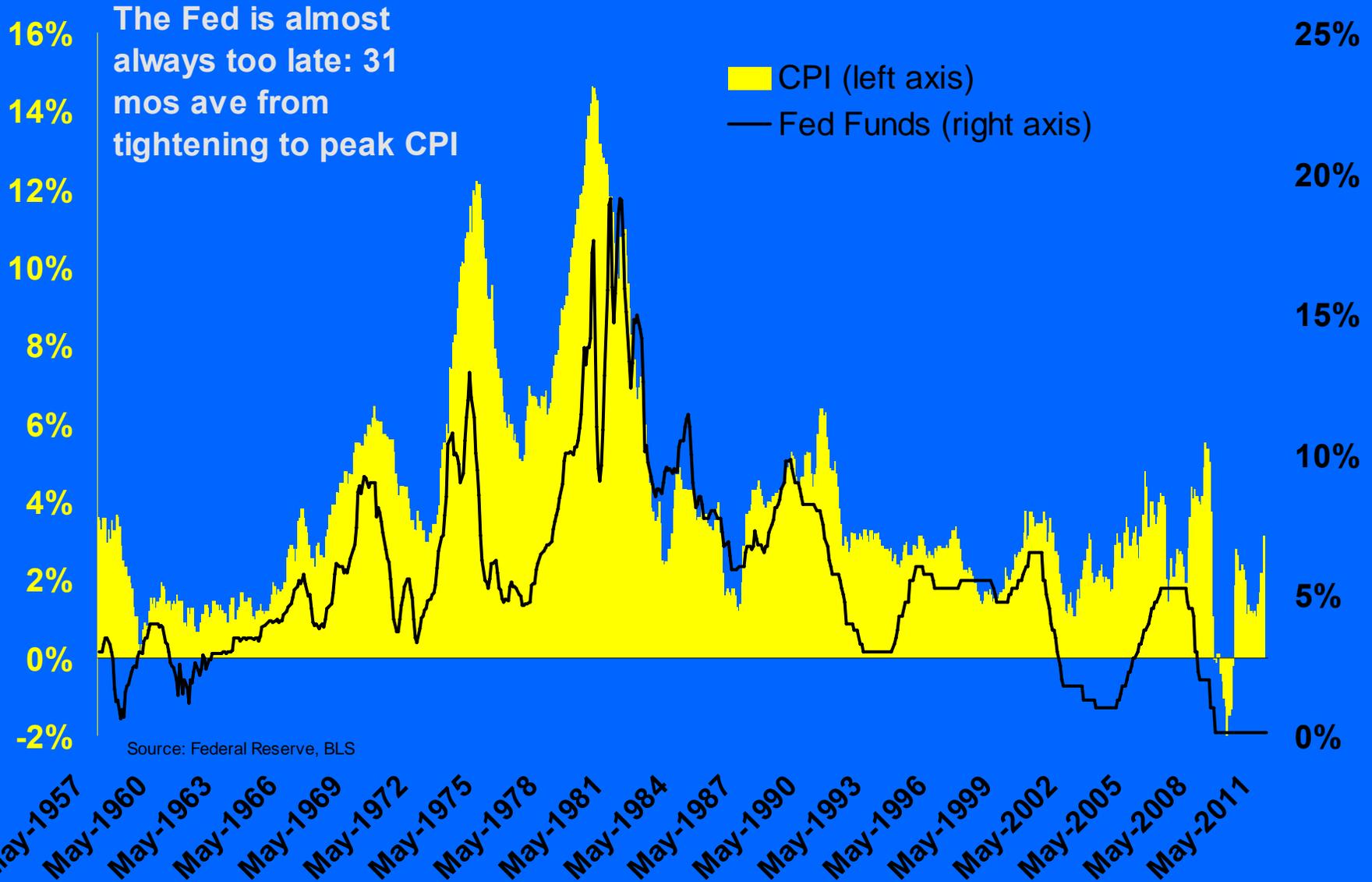
# Federal Funds Rate vs Unemployment



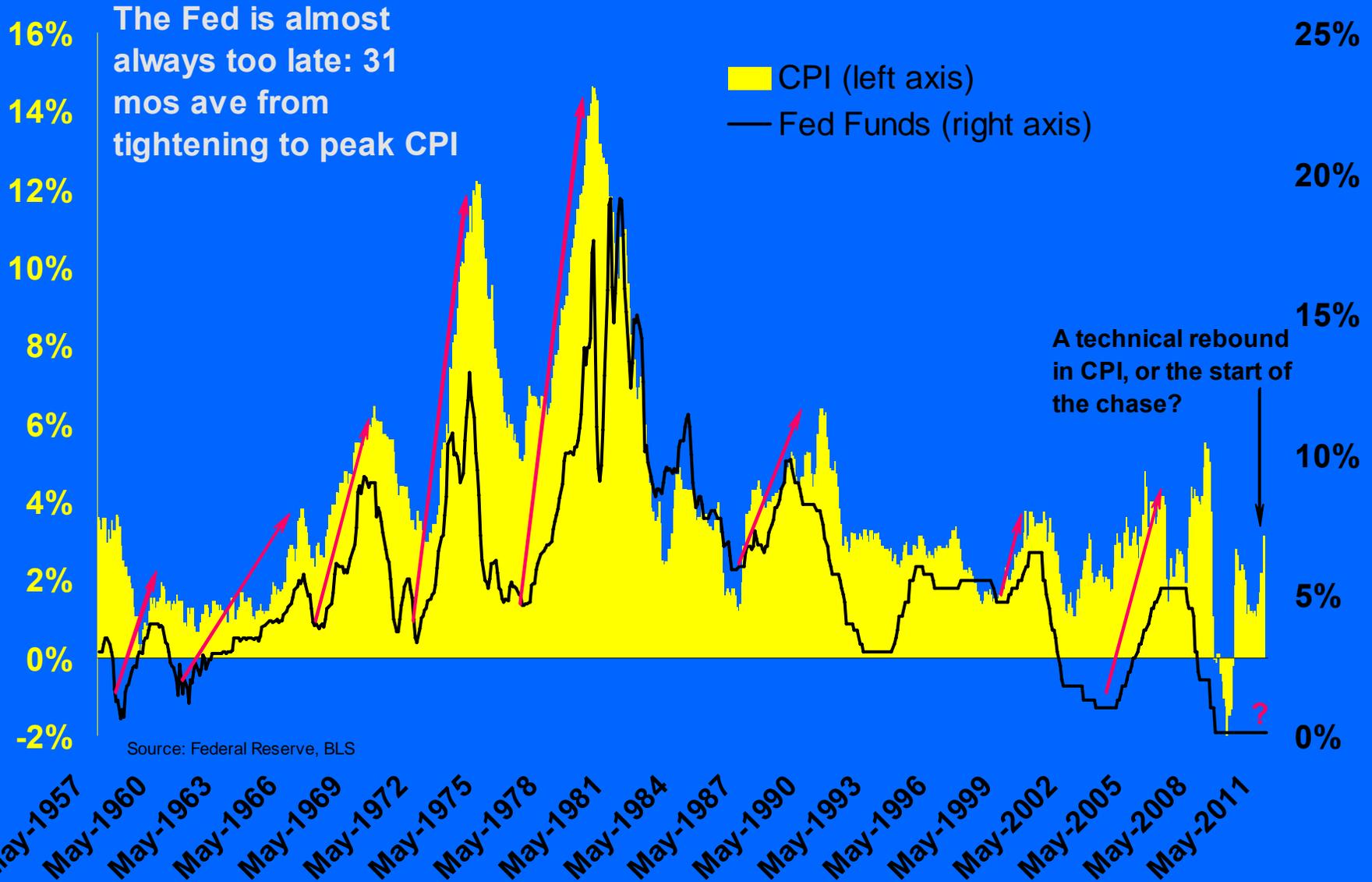
# Federal Funds Rate vs Unemployment



# Federal Funds Rate vs Inflation



# Federal Funds Rate vs Inflation



# Inflation

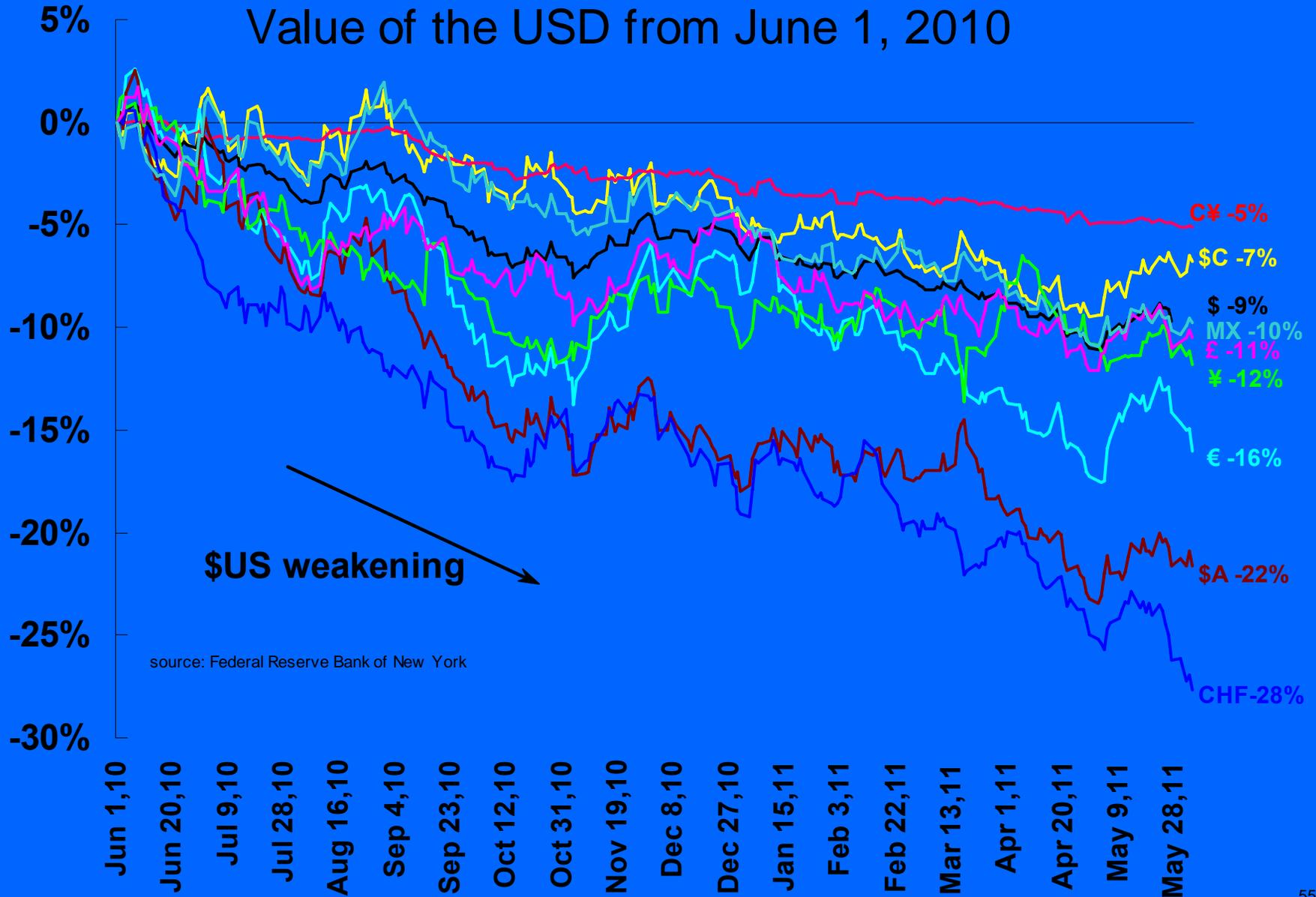
**Inflation = QE 2 = Printing money = Dollar devaluation**

- All the same thing
- QE 2, printing money, meant to stimulate the economy by lowering interest rates

**But can also:**

- Devalue the \$ and debt we owe (\$4T to foreigners)
- Raise commodity prices (inflation)
- Lower the trade deficit (\$500B/yr)
- Create asset bubbles

# \$ devalued, QE at work



# Debt Devaluation

## Simple example

Today: Lend \$1 @10%. Loaf of Bread costs \$1  
Inflation goes to 20%

A Year later:

Creditor gets \$1.10 back.

But now loaf of bread costs \$1.20.

Creditors lose with inflation / dollar devaluation.

Debtors, like the U.S. government, win.

The U.S. government is ok with inflation.

The U.S. government is ok with a weaker dollar.

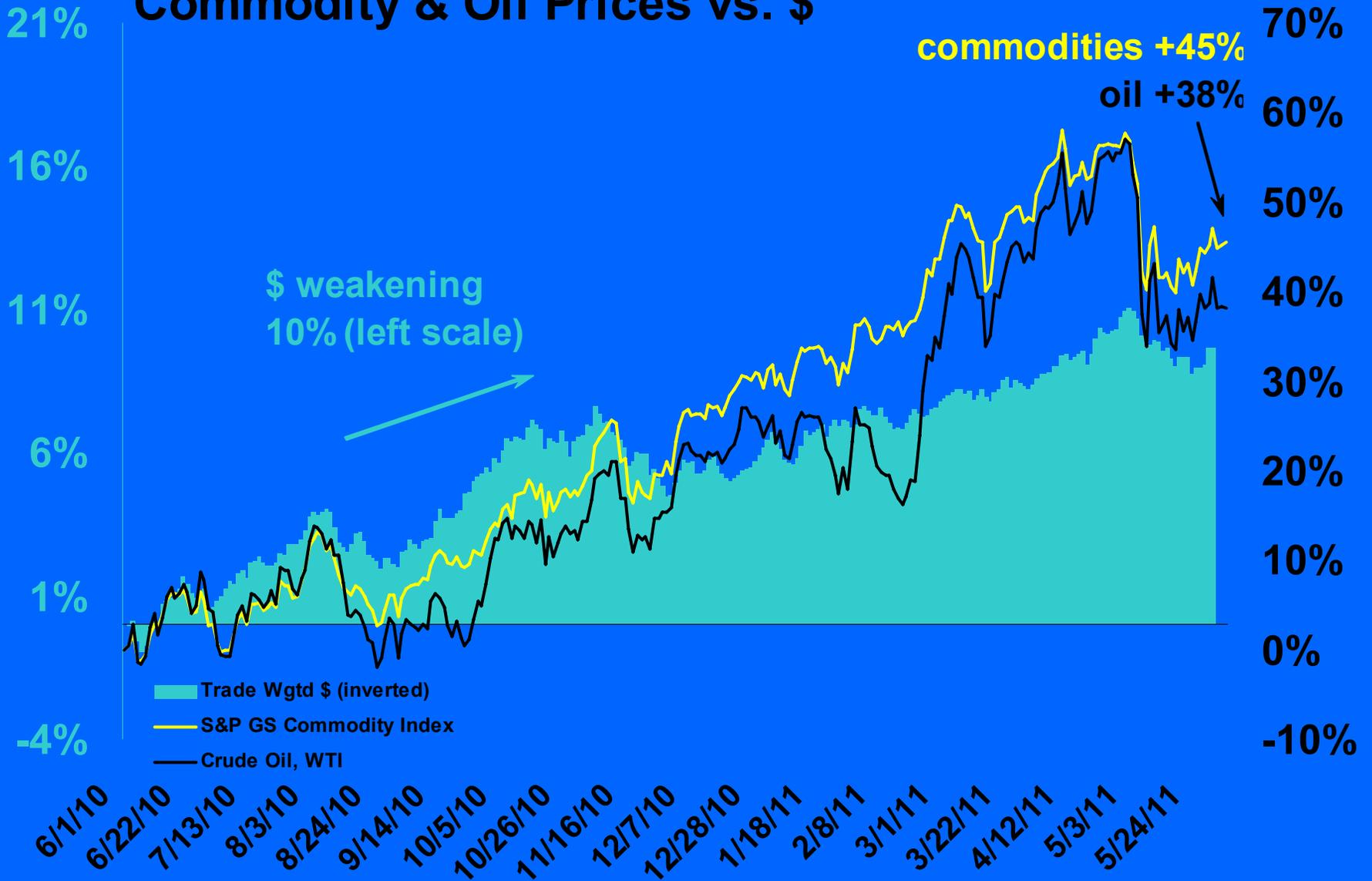
Maybe the only way out of massive debt obligations.

Dollar devaluation may be going on for years.

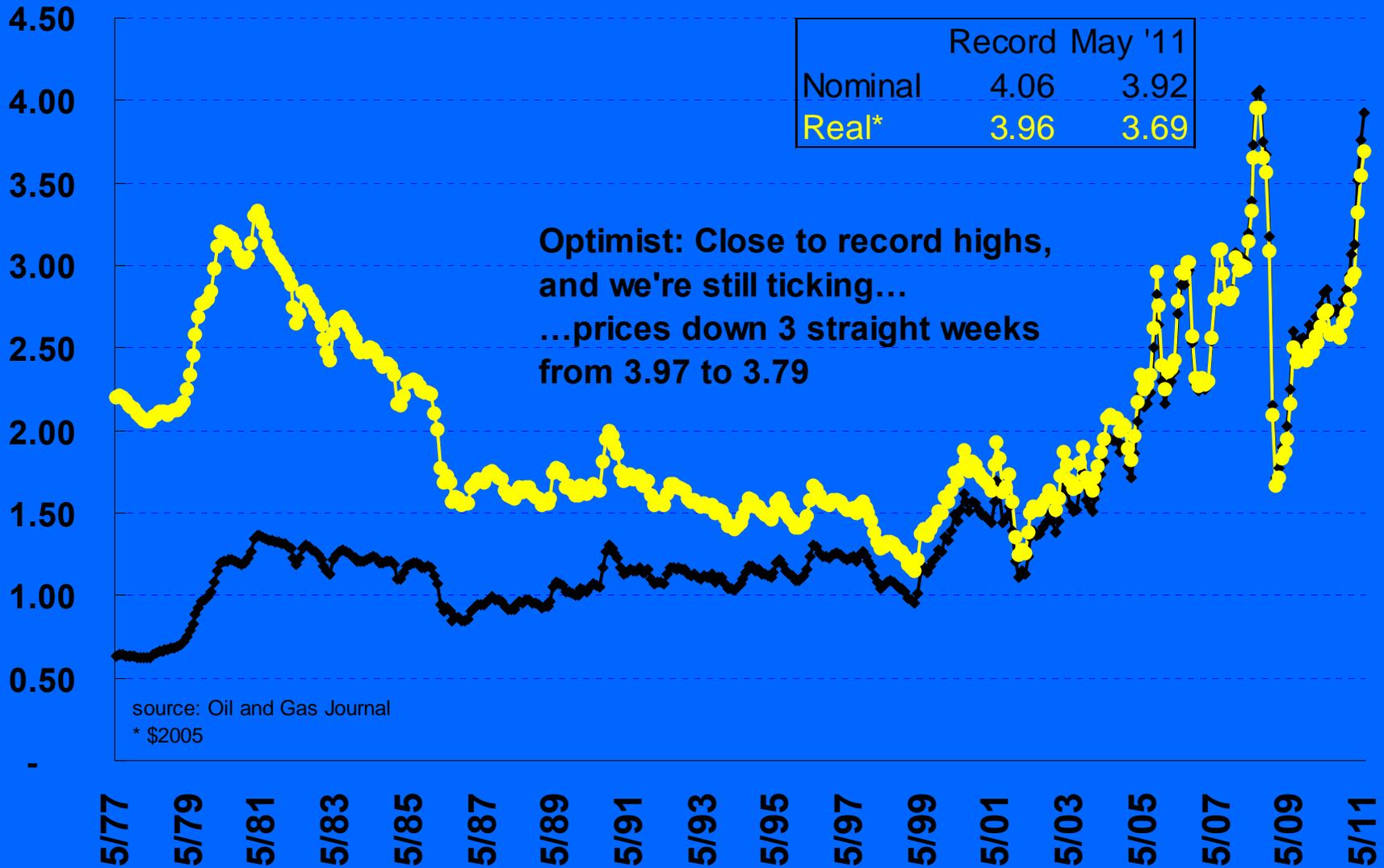
...also affects commodities...

# ... and \$ deval = inflation

## Commodity & Oil Prices vs. \$



## Gasoline Prices, U.S. Average



# Conclusions

## Positives

- Good consumer
- Gas prices falling
- Strong manufacturing
- Employment; May hiccup
- Strong corp profits, outlook
- Tax package good
- Monetary policy will take off
- Banks starting to lend
- Falling dollar
- Yield Curve positive

## Risks

- Oil prices
- Weak housing market
- High unemployment
- Inflation (strong arg.)
- Fiscal policy damaging
- State budgets
- PIIGS

Thank you  
for your attention.

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