January | 2013

Monthly Economic Outlook

The recovery of the U.S. economy and the risks of the fiscal cliff

The Business Confidence indexes measured by the ISM, for both the industrial sector and the service sector are signaling continued recovery over thenext few quarters

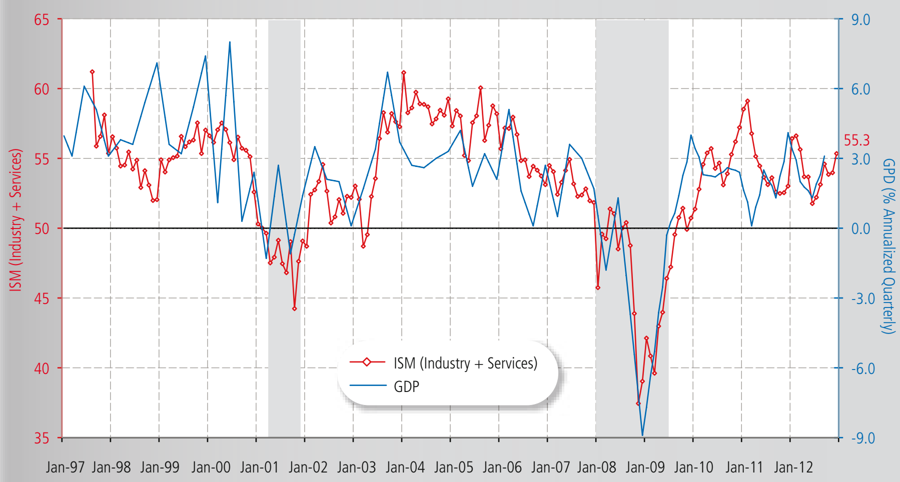
The graphs on this page illustrate the U.S. economic recovery which has taken place at a moderate pace of around 2.0% per year since the Great Recession of 2008 and 2009. The Business Confidence indexes measured by the ISM, for both the industrial sector and the service sector are signaling continued recovery over the next few quarters. Nevertheless, even with the partial agreement reached in Washington at the outset of 2013 to postpone the risks of the so-called "fiscal cliff" (raising taxes and cutting government spending), the risky environment of recessionary shocks still points to a cautionary outlook for the pace of economic growth in the U.S.

Let's not forget that the U.S. Federal Reserve Chairman, himself, coined the term "fiscal cliff," in order to illustrate the monetary authority's concern about the impact that Congressional policy decisions could have on U.S. economic activity. After prolonged negotiations that ran up to, and a bit beyond the New Year's Day deadline, Republican and Democratic politicians finally managed to reach an agreement on the most highly disputed issue: i.e. the income bracket that would receive the income tax rate hike. That agreement restricted said rate hike to people making over US$ 400,000.00 per year, and left the great majority of the nation's population unaffected, thereby limiting any reduction in the consumption capacity of the American middle class. Yet, in light of this tax increase which has now defused a good part of the risk related to the fiscal cliff, there will certainly still be forceful political debate surrounding the cost cutting measures that Congress has technically just postponed by for another two months. This issue is exacerbated by the fact that the new target date for the negotiation of spending cuts will now coincide with the deadline for the elevation of the debt ceiling which needs to be agreed to by Congress in order to cover total U.S. public debt. One must not forget that this same heated discussion during the last debt ceiling elevation in August of 2011 caused Standard & Poor's to strip the United States of its AAA credit rating and provoked considerable volatility in the global financial markets.

It was this fear of the potential recessionary effects of the fiscal cliff that was one of the great motivators for the U.S. Federal Reserve to initiate its current round of unconventional monetary policy (QE3).

USA: GDP vs ISM Index

(evolution of the Gross Domestic Product and the Institute for Supply Management index)



Note: The shaded areas denote periods of recession in the U.S. economy (defined by the NBER). Sources BLS and ISM. Preparation VAM.

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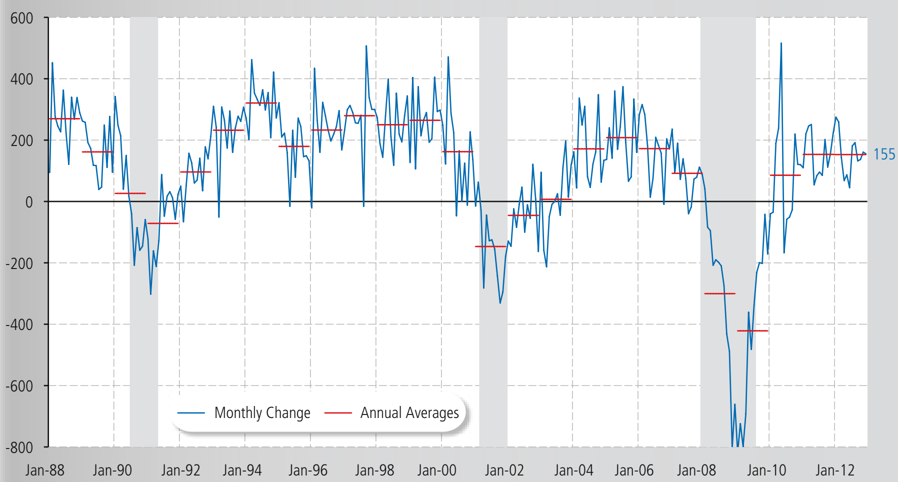
Communiques from the Fed have shown its concern about a prolonged period of economic weakness, in which even with GDP growth in the range of 2.0% per annum, the sluggishness of the labor market would not return to acceptable levels before 2015. Therefore, the Fed has made a conditional pledge to leave its benchmark interest rate near zero at least until then. Moreover, as additional risks of economic slowdown appear, the Fed will likely continue adding unconventional economic stimulus, like its QE3 asset purchases. It is no wonder then that most of the Fed officials signaled in the minutes of their last meeting that they understand that the asset purchase program is likely to continue throughout the next few quarters. Regarding the pace of economic recovery and its impact on the labor market (the main variable pointed to by the Fed for determining the end of the period of zero interest rates in the U.S.), the downward trend in the unemployment rate still seems to be occurring slowly. In 2012 the U.S. economy generated an average of 153,000 net new jobs per month. Coincidentally this pace was identical to 2011 and nearly double that of 2010. Nevertheless, even with these three years of recovery in the labor market, this period has accounted for the creation of only 4.7 million net new jobs. This is equivalent to just over half the number of jobs lost during the crisis of 2008 and 2009, and it has resulted in only a modest decline in the unemployment rate from the high of 10% in October of 2009 to its current level of 7.8%. If all goes well with no recessionary risks coming out of Washington, and no resurgence of the European crisis, it is still likely to take at least another two years for the unemployment rate to reach the target level of 6.5% and finally trigger a halt to the Fed's emergency zero interest rate policy.

USA: Net change in new jobs

(US Change in Nonfarm Payrolls)



Note: The shaded areas denote periods of recession in the U.S. economy.

Sources: BLS and NBER.