



Daily Notes on the **United States**

November 22, 2011. Worldwide Edition

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More Downgrades Likely; Do They Matter?

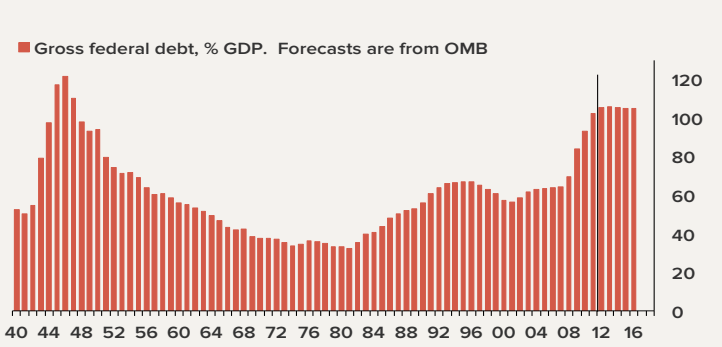
So, they failed. The Supercommittee announced yesterday, amid the expected recriminations, that it did not reach a deal to cut the deficit by \$1.2 trillion over the next decade. We thought a last minute rabbit-out-of-the-hat was a decent bet, based on the experience of the debt ceiling fiasco in the summer, but the politics proved insurmountable. *Republicans were unwilling to raise taxes on the affluent, and Democrats were unwilling to cut entitlements without such tax increases.* Whatever you might think about the business of American politics, you'd have to say that both parties know who pays their bills.

Now what? Well, nothing much. The sequestering process does not start to cut spending until 2013, so it is subject to the whims of the next Congress. What one Congress has made, another can unmake. *We would be quite surprised if the full \$1.2T automatic cuts—half from defense and half from non-defense, excluding social security, medicare and medicaid—were ever to be implemented, especially if our relatively optimistic view of the economy in 2012 proves correct, and federal tax revenues are rebounding.* That would spark downward revisions to projections for the future deficit and, hence, allow politicians to put off the hard decisions.

The markets will not seek revenge for the failure of the Supercommittee beyond, perhaps, an initial knee-jerk reaction. ***If we have learned anything from eons of watching government bond markets, it is that they don't care about deficits unless investors decide they are intractable.*** At that point, markets flee. The U.S. budget deficit is not intractable: The country is growing, it will grow in the future and the exchange rate floats. None of these things apply to Greece, or Italy, or other European countries facing funding crises.

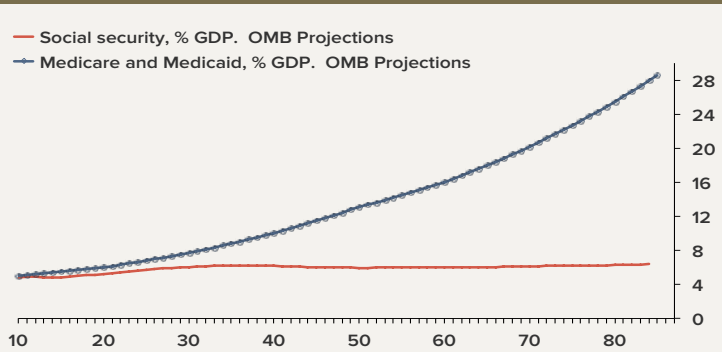
The U.S. does face a large current deficit, but that is largely the result of the depth and duration of the Great Recession, not out-of-control discretionary spending. The stock of debt has risen markedly too, but it remains well below the post-war peak of 121.7%, which was reduced to just 32.5% by 1981. The big difference between now and the post-

Debt Stock Is High, But It Has Been Higher



war period is that entitlement spending was small in 1946, whereas now it accounts for about 55% of all spending. That number will rise massively over the next half-century, but the big hit is still about 20 years away, as our second chart shows. Eventually, if left unreformed, spending on health will shred the U.S. public finances, but eventually is a long time off. *We have never seen markets punish a country for failing to take preventive action to deal with a problem that is 20 years away, and we don't expect that to change anytime soon.*

Health Spending Is The Key Long-Term Fiscal Threat



HFE's Economic Forecasts

GDP	Q4 third est.	2.3%	2009 year:	-3.5%
	Q1 third est.	0.4%	2010 year:	3.0%
	Q2 third est.	1.3%	2011 year:	1.9%
	Q3 first est.	2.5%	2012 year:	3%
	Q4 forecast	>3%		

CPI	October:	-0.1% (3.5% y/y); core 0.1% (2.1% y/y)
	Mar. 2012 forecast:	2.5% y/y; core 2.4% y/y
	Sep. 2012 forecast:	2.3% y/y; core 2.5% y/y

Unemployment: December 2011, 9.0%; June 2012, 8.7%
Federal budget FY 2012 forecast: -\$1.4T (9.5% of GDP)

HFE's Financial Forecasts

	End-month:				
	4:30pm Monday	Dec	Mar	Jun	Sep
Fed funds actual	0.08	0.13	0.13	0.13	0.20
2-yr	0.27	0.30	0.30	0.35	0.40
10-yr	1.97	2.25	2.50	2.60	2.75
30-yr	2.95	3.25	3.50	3.60	4.00
Curve 10-2	170	195	220	225	235
Curve 30-2	268	295	320	325	360
Dow Jones IA	11547	12000	12250	12500	12500

Dollar: EU crisis drives safe-haven cash to U.S. Loonie and Ozzie to recover on safety. Yen strong despite domestic mess.

That does not mean the rating agencies will necessarily feel the same way, and the failure of the Supercommittee greatly increases the odds that Fitch and Moody's will join S&P in downgrading U.S. long-term debt. S&P's move on August 5 sparked a 6% drop in the stock market, but we would be hugely surprised by a repeat performance now. *Even the scariest movie is less frightening the second—and third—time around.*

We see no possibility that the U.S. will renege on its debts in the foreseeable future, and the markets seem to think the same way: Since the S&P downgrade, yields on 10-year notes have dropped by 60 basis points. *If the deficit is not intractable, government bond markets care about the prospects for future short-term interest rates. Their rate expectations are framed by the pace of economic growth, the outlook for inflation and, in the short term, the pronouncements of the Fed.* The rating agencies don't matter except in the few minutes after their press releases hit the screens.

Small Revision To Q3 GDP; Puzzling Redbook

Today brings the first revision to third quarter GDP growth, which was originally estimated to have been 2.5%. We don't expect the headline number to change much, if at all, but a couple of the components will be revised significantly. Following the release of the September data, we can be sure the net foreign trade numbers will be significantly better than initially assumed, but wholesale inventory-building will be revised sharply downwards. That means total inventories likely fell outright, for the first time since Q4 2009. *That cannot be sustained in an economy where business sales are still rising strongly, and we expect a rebound in inventory-building to make a substantial positive contribution to fourth quarter growth.*

Elsewhere today, we hope to see a rebound in chain store sales after two weeks of year-over-year growth about one percentage point below the prior trend. *We pointed out a few weeks ago that unfavorable basis effects will depress the year-over-year rate of growth of chain store sales in due course, but we did not expect to see the hit until the end of this month at the soonest.* That said, we have been surprised by the strength of the Redbook in recent months, so perhaps we are now seeing a correction. In short, the latest numbers are puzzling, and we will be watching the next few reports with interest.

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Notice To Readers

High Frequency Economics Ltd. will not publish *Notes on the United States* on Thursday, November 24, and Friday, November 25, in observance of the Thanksgiving holiday in the U.S. Our regular publication schedule will resume on Monday, November 28.

This Week's Funding

Mon	Announcement—4-week bills (Nov. 22) Auction—\$29B 3-month, \$27B 6-month bills
	Auction—\$35B 2-year notes (settles Nov. 30)
Tue	Auction—4-week bills Auction—\$35B 5-year notes (settles Nov. 30)
Wed	Auction—\$29B 7-year notes (settles Nov. 30) Announcement—3-month, 6-month bills (Nov. 21)

This Week In Brief

Note: "**SS**" prefix denotes Snapshot for these data.

Monday, November 21

- **SS: Existing Home Sales (10)/10:00 EST**

Sales rose 1.6% to **4.97M**, despite the sharp drop in the pending sales index. The trend is more or less flat.

Tuesday, November 22

- **GDP (Q3 second estimate)/8:30 EST**

Growth will likely be revised down trivially to about **2.3%** from 2.5%, with weaker inventories, mostly in the wholesale sector, largely offset by better-than-assumed foreign trade numbers.

Consensus: 2.5%.

- **Redbook Chain Store Sales (11/19)/9:00 EST**

We look for a rebound after two soft weeks; last week, sales were up **3.3%** year-over-year. For the previous six months, the trend rate of growth of sales was a steady 4-to-4.5%. We have been expecting a slowdown because of unfavorable basis effects, but not yet.

- **FOMC Minutes (11/2)/14:00 EST**

The Fed made no changes in policy at this meeting; Chicago Fed President Evans dissented, wanting more easing.

Wednesday, November 23

- **MBA Mortgage Applications (11/18)/7:00 EST**

The purchase index has recovered its summer losses but remains very low indeed. Last week it stood at **183.1**.

- **SS: Personal Income (10)/8:30 EST**

Nominal incomes should rise **0.4%**. Nominal spending likely rose **0.6%**, so with the deflator likely unchanged, real spending should climb **0.6%** too. Spending on goods, especially non-auto durables and autos, looks to have been strong, with a more sedate performance in services. The core deflator should be **unchanged**. **Consensus: Income 0.3%, nominal spending 0.3%, core PCE deflator 0.1%.**

- **SS: Initial Jobless Claims (11/19)/8:30 EST**

Claims have fallen in four of the past five weeks, reaching their lowest level since early April. We expect a pause in the downshift this week, with claims nudging back to **395K** from 388K. **Consensus: 390K.**

- **SS: Durable Goods (10)/8:30 EST**

A steep drop in the wildly volatile aircraft orders component means total orders should drop about **2.0%**. Orders ex-transport should be more or less **unchanged**. **Consensus: Orders -1.0%, ex-transport 0.0%.**

- **Univ. of Michigan Consumer Sentiment (11f)/9:55 EST**

We expect no significant revision from the preliminary **64.2**, which was up from 60.9 in October. **Consensus: 64.5.**

Thursday, November 24

- **Thanksgiving Holiday**

Friday, November 25

- **No significant data released.**