Deutsche Bank
Research

Global | Economics

Date
24 January 2014

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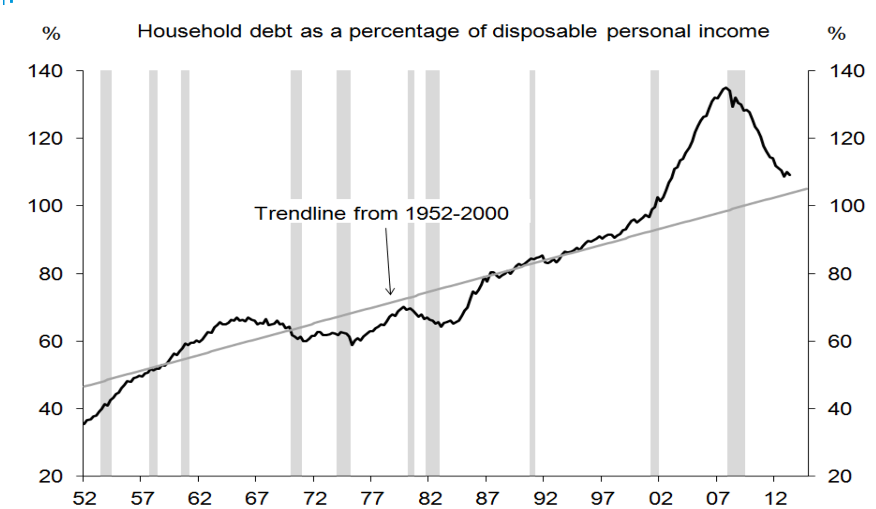
US Economics Weekly

Private and public balance sheets on the mend

Overview: Since last month's release of the Federal Reserve's Flow of Funds data, we have taken an extensive look at the financial health of US households. The latest readings on household buying power and the ratio of household liquid assets to liabilities both show tremendous improvement in the underlying financial health of US consumers. This week we complete our analysis of the household sector by looking at the ratio of total household debt to disposable income. This series has declined dramatically over the past six years, providing us with further evidence of a dramatic improvement in consumer finances that should be supportive of above-trend growth in the quarters ahead. Indeed, we are projecting the fastest annual growth in real GDP this year since 2003.

Budget outlook 2014: Despite dilution of sequester, deficit still on track to shrink Due to both stronger revenues and spending restrictions, the fiscal year 2013 budget deficit was markedly smaller than that of previous years. This improvement in the national fiscal position is poised to carry over into 2014, as well—even despite the recent bipartisan congressional agreement to reduce the severity of the sequester-mandated spending cuts. In fact, the 2014 budget deficit is on track to be even smaller than that of 2013—our current estimate is -$530 billion. This has implications for net Treasury issuance and in turn the level of interest rates, because less issuance should help to mitigate the potential for a damaging backup in rates as the Fed continues to curtail the pace of asset purchases. While we do anticipate higher rates this year, reduced issuance should help to moderate the pace of the backup.

The household debt-to-income ratio has declined sharply from its 2007 peak



Source: FRB, Haver Analytics & DB Global Markets Research

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Forecasts

	2013		2014			
	Q3	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP (% q/q)	4.1	4.0	3.1	3.2	3.5	3.7
Core CPI (% y/y)	1.7	1.8	1.9	2.0	2.1	2.2
Unemployment rate	7.3	7.0	6.5	6.4	6.3	6.1
Fed funds	0.09	0.07	0.06	0.10	0.10	0.10
10 Yr Treasury*	2.61	3.03	3.25	3.50	3.75	4.00

*Compiled by DB US Economics team; may differ from official 10Yr yield forecasts from DB Fixed Income Strategy team

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For the latest from Deutsche Bank's Chief US Economist Joseph LaVorgna and team

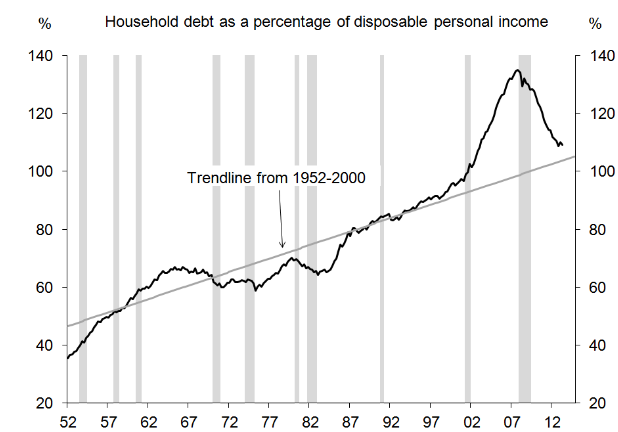
Overview

Summary: Since last month's release of the Federal Reserve's Flow of Funds data, we have taken an extensive look at the financial health of US households. The latest readings on household buying power and the ratio of household liquid assets to liabilities both show tremendous improvement in the underlying financial health of US consumers. This week we complete our analysis of the household sector by looking at the ratio of total household debt to disposable income. This series has declined dramatically over the past six years, providing us with further evidence of a dramatic improvement in consumer finances that should be supportive of above-trend growth in the quarters ahead. Indeed, we are projecting the fastest annual growth in real GDP this year since 2003.

Debt to income has tended to rise over time. As shown in the nearby chart, the ratio of household debt to disposable income rose consistently from 1952, the first year for which the Flow of Funds data exist, until 1962. It was then essentially flat until 1983 at which point the ratio steadily rose until 2000. This is evident in the chart in the next column from the stable upward slope of the trend line. However, following the 2001 recession, the level of debt to income accelerated sharply from 2002 to 2007. We can see the slope of the ratio is much steeper than it had been prior to 2000. This is also apparent from the underlying trend line of the series, which we discuss in more detail below. It is clear that the ratio of household debt to disposable income went well above this line from 2000 to 2007. After topping out at an all-time high of 135% in Q4 2007, the ratio has declined markedly, down to 109% as of Q3 2013, which is where it had been over the previous few quarters. The last time this ratio was below 109% was in Q1 2003 (108%). Conceivably, the ratio of household debt to disposable income is in the midst of bottoming as our analysis suggests that the ratio is close to its longer-term equilibrium value.

How do we define equilibrium debt-to-income? Since the ratio of household debt-to-disposable income has had a long-term, upward-sloping trajectory, reflecting financial deregulation, innovation, and a shift in households' attitudes toward debt, we assume the optimal level of debt-to-income is higher than where it was in 2000—albeit much lower than where it peaked in 2007 at the height of the credit bubble. Therefore, we fit a trend line from 1952 to 2000 and then extrapolate that trend forward as a way to proxy the equilibrium level of debt-to-income in the absence of the credit boom. Importantly, this assumes that debt-to-income has a natural upward slope. In practice, there is an upper limit of debt relative to income growth. In the last business cycle, a ratio of 135% debt to income proved to be the tipping point. What about the floor? Since the ratio of debt to disposable income has exceeded 90% for every quarter since Q3 1996, we do not see any reason why we would breach that level. Consequently, we are comfortable that a linear extrapolation of the 1952 to 2000 trend is a good underlying proxy for the present day equilibrium. The current 109% reading on household debt to income compares to a trend-based equilibrium estimate of 104%. When will we get there? Given the trend over the past few years, we could be at the 104% threshold by Q4 of this year. Based on this simple approach, the household deleveraging cycle then is almost complete. Consequently, to the extent that deleveraging has been a headwind to growth, the improvement in consumer balance sheets is a meaningful positive development for the medium-term economic outlook.

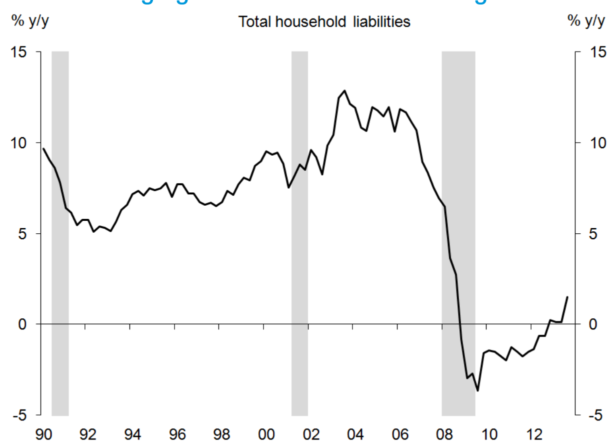
The household debt-to-income ratio has declined sharply from its 2007 peak



Source: FRB, Haver Analytics & DB Global Markets Research

If we are wrong, the deleveraging cycle could already be over. From its Q4 2007 peak, the ratio of debt-to-income has fallen 26% through a combination of rising disposable income and declining household debt. Over this timeframe, disposable income has grown 2.9% at an annualized rate while household debt has declined at a -0.9% annualized rate. While the growth in income has been remarkably soft compared to history, the decline in debt is equally unusual, as we had never seen an annual decline in household debt before the last recession. This is shown in the chart on the following page. Recently, however, the downtrend in household liabilities has reversed, as they rose 1.5% over the four quarters ending Q3 2013. This represents the largest increase since Q3 2008 and suggests to us that households are becoming more confident in the economic and financial outlook, as they are no longer paying down debt. The slight rise in household debt is also consistent with a loosening in commercial bank lending standards. Anecdotally, the fact that liabilities are rising provides further evidence that deleveraging has largely run its course. The upshot is that an eventual re-leveraging of household balance sheets will be constructive for aggregate demand.

Households are starting to take on more debt, a sign that releveraging of balance sheets has begun



Source: FRB, Haver Analytics & DB Global Markets Research

What if we are wrong and further household deleveraging is necessary? For argument's sake, what if the equilibrium is closer to 90%, which is basically what the ratio averaged during the 1990s? Based on our estimate of disposable income and an assumption that liabilities revert back to roughly their -1% annualized decline that has persisted to this point in the business cycle, we would arrive at a 90% debt-to-income ratio sometime in 2018. In this case, we are only slightly more than halfway through the deleveraging process. Of course, we believe this scenario is much too extreme, because as we highlighted above, household debt is no longer shrinking. Furthermore, an improving housing market should lead to more access to mortgage credit. Mortgages account for approximately 70% of total household liabilities. A continuation of robust residential construction activity and sturdy home price appreciation should add to builders', lenders', and prospective buyers' confidence that the housing recovery is gaining further traction. In point of fact, the latest Federal Reserve Senior Loan Officer Survey showed a further easing of commercial bank lending standards across the board, especially for prime mortgage borrowers. Therefore, we expect household debt, led by an expansion of mortgage credit, to rise modestly over time. A healthier job market should also eventually lead to an even faster pace of disposable income growth.

What is the bottom line? The debt-to-income ratio has declined dramatically from a peak of 135% in 2007 to 109% at present, which is a 10-year low. Clearly, households have made great strides in repairing their balance sheets. Based on a simple linear extrapolation from history, we believe that a reasonable proxy for equilibrium debt to income is around 104%, which we could see by the end of this year. However, the lack of any meaningful further reduction in debt to income over the past several quarters points to an impending end to the household credit deleveraging cycle. To the extent that deleveraging has been a factor weighing on the economy to this point in the business cycle, a conclusion of this process should be constructive for economic growth prospects—all else being equal. The next step of the broad financial recovery is a further thawing in mortgage finance. Double-digit gains in home prices should spur lenders to further ease credit standards for mortgages, thus allowing for larger gains in home construction and a faster pace of home sales. In conclusion, a releveraging of household balance sheets will be reflected in a rising debt-to-income ratio—and the prevailing evidence suggests we are much closer to that point than at any other time in recent history.

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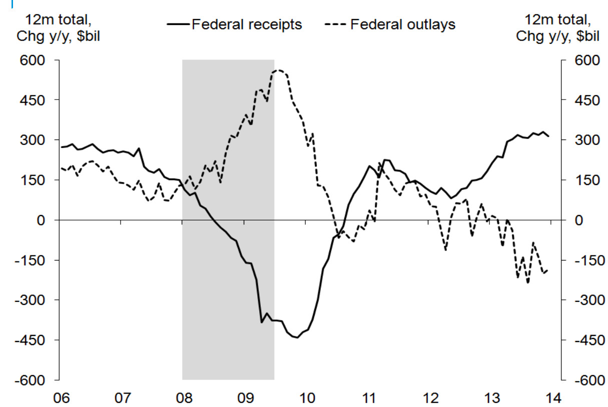
Budget outlook 2014: Despite dilution of sequester, deficit still on track to shrink

Summary: Due to both stronger revenues and spending restrictions, the fiscal year 2013 budget deficit was markedly smaller than that of previous years. This improvement in the national fiscal position is poised to carry over into 2014, as well—even despite the recent bipartisan congressional agreement to reduce the severity of the sequester-mandated spending cuts. In fact, the 2014 budget deficit is on track to be even smaller than that of 2013—our current estimate is -$530 billion. This has implications for net Treasury issuance and in turn the level of interest rates, because less issuance should help to mitigate the potential for a damaging backup in rates as the Fed continues to curtail the pace of asset purchases. While we do anticipate higher rates this year, reduced issuance should help to moderate the pace of the backup.

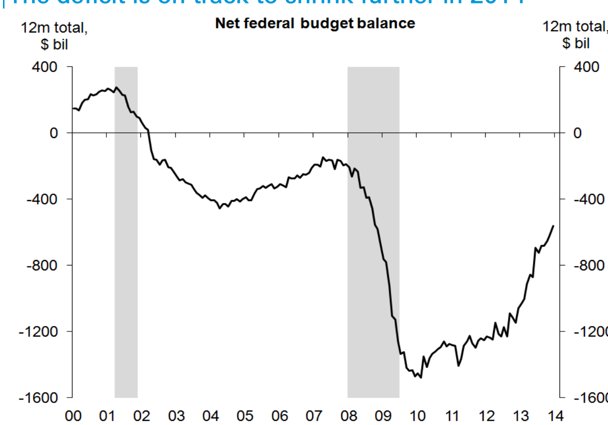
Plenty more deficit reduction is in store. Following four years of budget deficits in excess of -$1 trillion, in 2013 the annual deficit shrank to -$680 billion (compared to -$1.1 trillion in 2012). There is little doubt that fiscal austerity helped to drive the narrowing of the gap between receipts and outlays—however, the contributions are not equally weighted. Federal outlays, which were restricted by sequester-mandated spending caps, declined by -2.4% in fiscal year 2013; whereas federal receipts, which are dominated by tax revenue, increased by +13.3%. As such, of the $409 billion reduction in the deficit last year, approximately $325 billion (or roughly 79%) was due to stronger revenues, while $84 billon was due to reduced expenditures. The revenue increase is attributable to two factors—higher tax rates and sturdier income growth in a stronger economy. We estimate that a little over half (55%) of the revenue gain was the result of higher taxes, while the rest was due to a more robust economy. Therefore, fiscal austerity made a meaningful contribution to deficit reduction, but the contribution was significantly skewed toward higher taxes rather than spending cuts. For this reason, we expect the recent, moderate relaxing of sequester spending levels to only modestly alter the deficit outlook in either 2014 or 2015.[1] As of last May (prior to the recent bipartisan agreement), the CBO was projecting the 2014 budget deficit at -$560 billion and the 2015 deficit at -$378 billion. The CBO is scheduled to release updated projections on February 4.

Spending cuts have helped, but most of the deficit reduction has come from stronger revenues



Source: Treasury, Haver Analytics & DB Global Markets Research

The deficit is on track to shrink further in 2014



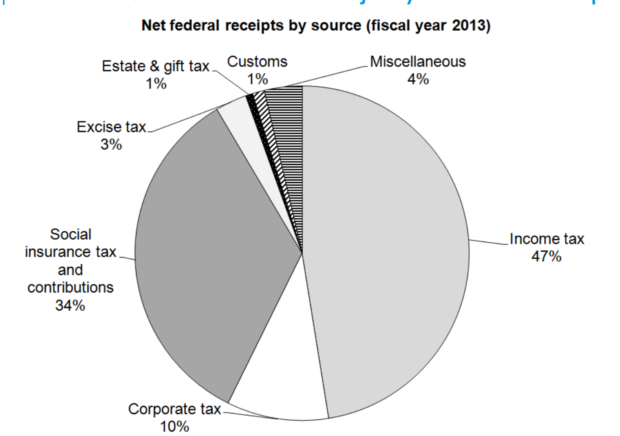
Source: Treasury, Haver Analytics & DB Global Markets Research

We are one quarter into the fiscal year and our rolling estimate of the deficit is already approaching the CBO's 2014 target. As of December, the Monthly Treasury Statement (MTS) showed ongoing improvement in the federal fiscal position. We tabulate a rolling estimate of the deficit (shown in the above figure) by taking the difference between a 12-month rolling sum of receipts versus a similar tally of outlays. Currently, this rolling estimate is running at -$561 billion—which is effectively in line with the CBO's 2014 estimate. However, as the figure above illustrates, the rolling estimate is not exhibiting a stable trajectory; rather, it is shrinking at a pace of about -$22 billion per month (six month average). Case in point, the rolling deficit was -$615 billion in November and -$652 billion in October. Clearly, if this pace continues, the deficit in the current fiscal year will be much smaller.

[1] The Bipartisan Budget Act of 2013 increases the cap on discretionary spending in fiscal year 2014 by $45B and in 2015 by $18B. The increases are split evenly between defense and non-defense categories.

However, we expect the pace to moderate in the coming months for a number of reasons, including the following: One, as previously highlighted, the caps on 2014 discretionary spending have been moderately lifted; two, special payments from Fannie Mae and Freddie Mac to the Treasury, if repeated in 2014 are not likely to be as large; and three, income tax rates are more stable between 2013 and 2014, which was not the case between 2012 and 2013 when higher tax rates significantly lifted revenue. For fiscal year 2013, the CBO projected outlays at -2.3% year-on-year, and the MTS showed actual outlays at -2.4%. The corresponding revenue projection anticipated an increase of +14.8%, while the MTS showed total receipts up +13.3% over the same period. For 2014, the CBO anticipates receipt growth to decelerate to +8.1% and outlays to rise +4.3%—although the net effect of the recent sequester ease/expiration of extended unemployment benefits will probably boost outlays slightly above +5.0%. We expect the budget deficit to shrink to -$530 billion in 2014.

Households account for the majority of federal receipts

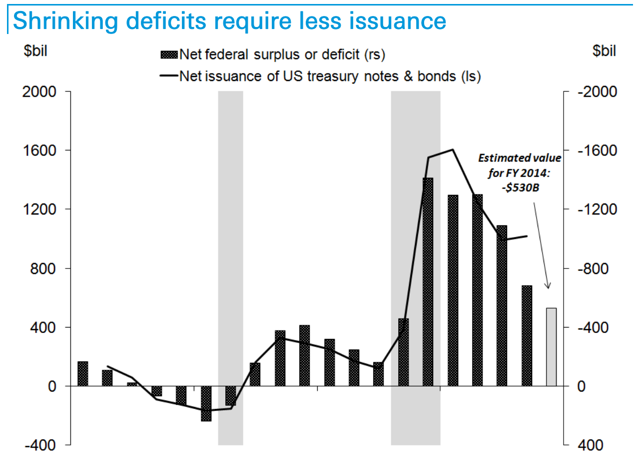


Source: Treasury, Haver Analytics & DB Global Markets Research

How will economic performance impact budget projections? Barring an official mandate to alter outlays, such as a fiscal stimulus package or unexpected spending related to defense or natural disaster relief, federal spending should hew closely to the CBO's projections for the remaining fiscal year. This is because much of the budget is predetermined at the start of the period, and so it is not economically sensitive. In other words, most budget provisions are immune to deviations in economic output. (Obviously, some components, such as nutrition assistance and jobless benefits, are highly sensitive to economic conditions.) On the other hand, revenue trends will be far more responsive to changing economic trends. The preceding figure shows the composition of federal receipts in fiscal year 2013. (The ten-year average shows similar results.) The top three contributors—individual income taxes, corporate income taxes and contributions to social insurance programs, such as social security and unemployment benefits—account for a combined 91% of revenue; and all of these categories are highly sensitive to economic activity. Since 2000, the respective correlations between nominal GDP growth and the aforementioned revenue streams have been 72%, 80% and 55%. As a result, the overall receipt trend is also closely correlated with GDP—the correlation has been 87% over the past two decades.

Herein lies the main risk to the 2014 budget deficit estimates, because a deviation from projected economic output will significantly alter the revenue trend. For example, in February of last year, the CBO assumed full year real GDP growth of 1.4% in 2013 and 2.6% in 2014 when they constructed their revenue projections. Both of these estimates are likely to be too conservative. We will not have an official read on 2013 until next week, but if our Q4 forecast of 4.0% is correct, then full year growth should be closer to 2.0%; and we are projecting 2014 at 3.5%. Hence, stronger growth than what the CBO anticipated should result in larger-than-expected revenues, and therefore a smaller deficit is possible. In a similar vein, the CBO projected payroll gains of +182k per month in 2014; if the pace of hiring is faster, this will directly translate into stronger income tax revenue. As such, if the CBO incorporates more bullish economic forecasts into their upcoming budget update, their 2014 (and possibly 2015) deficit estimates could be smaller. Based on recent economic performance, our preliminary estimate is that the CBO's 2014 budget deficit projection, previously pegged at -$560 billion last May, could be reduced by about $10-$20 billion.

Shrinking deficits require less issuance



Source: Treasury, Haver Analytics & DB Global Markets Research

In conclusion, the upcoming budget projections from the CBO bear watching. Given that the economy is on a somewhat stronger footing than the CBO previously assumed, their revenue projections may prove to be too conservative. While stronger revenues point to a smaller deficit, some of the improvement will be mitigated by less restrictive sequester-mandated spending caps. However, whether the 2014 budget deficit estimate remains near previously projected levels or marginally shrinks is less important than the fact that the broader trajectory of the deficit is dramatically improved relative to the experience from 2009 to 2012. Effectively, the budget deficit has been cut in half; and as the preceding figure illustrates, this should have significant implications for net treasury issuance—although we will refrain from making a more formal assessment until the official budget projections are released on February 4. Even so, one fact is clear—the government's fiscal position is dramatically improving as the economy continues to mend.

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Data and Events Calendar

Calendar (Jan 20 – Feb 14)

Jan-20
Martin Luther King Jr Holiday
All markets closed

Jan-21

Jan-22

Jan-23

Initial Claims (wk-end)

8:30 AM	Jan 4:	330k	-15k
	Jan 11:	325	-5
	Jan 18:	326	+1

Existing Home Sales

10:00 AM	Oct:	5.12M
	Nov:	4.90
	Dec:	4.95

Leading Economic Indicators

10:00AM	Oct:	+0.1%
	Nov:	+1.0
	Dec:	+0.1

Jan-24
2 Yr FRN Announcement
$15B
2 Yr Note Announcement
$32B
5 Yr Note Announcement
$35B
7Yr Note Announcement
$29B
10Yr TIPS Auction
$15B

FORECASTS

Jan-27

New Home Sales

10:00 AM	Oct:	474k
	Nov:	464
	Dec:	*465*

Jan-28

Durable Goods Orders			ExTrans
8:30 AM	Oct:	-0.7%	+0.7%
	Nov:	+3.4	+1.2
	Dec:	*+6.0*	*-1.0*

Consumer Confidence

10:00 AM	Nov:	72.0
	Dec:	78.1
	Jan:	*75.0*

2 Yr Note Auction
$32B
FOMC Meeting
1st day

Jan-29
FOMC Meeting
2nd day
2 Yr FRN Auction
$15B

Jan-30

Real GDP			Deflator
8:30 AM	Q213:	+2.5%	+0.6%
	Q313:	+4.1	+2.0
Adv:	*Q413:*	*+4.0*	*+1.3*

Pending Home Sales Index

10:00 AM	Oct:	-1.2%
	Nov:	+0.2
	Dec:	*+0.5*

5 Yr Note Auction
$35B
7 Yr Note Auction
$29B

Jan-31

Personal Income

8:30 AM	Oct:	Nov:	*Dec:*
Income	-0.1%	+0.2	*Unch*
Consump.	+0.4%	+0.5	*+0.3*
Core PCE	+0.1%	+0.1	*+0.1*

Employment Cost Index

8:30AM	Q213:	+0.5%
	Q313:	+0.4
	Q413:	*+0.5*

Chicago PMI

9:45 AM	Nov:	62.5
	Dec:	60.8
	Jan:	*61.0*

Consumer Sentiment

9:55 AM	Nov:	75.1
	Dec:	82.5
Final	*Jan:*	*80.4*

Feb-03

ISM Index

10:00 AM	Nov:	57.3
	Dec:	57.0
	Jan:	*57.0*

Construction Spending

10:00 AM	Oct:	+0.9%
	Nov:	+1.0
	Dec:	*-0.5*

Unit motor vehicle sales

Sales:	Cars	Trucks	Total
Nov:	5.6	7.0	16.3M
Dec:	5.1	6.5	15.3
Jan:	*5.3*	*6.7*	*15.5*

Feb-04

Factory Orders

10:00 AM	Oct:	-0.5%
	Nov:	+1.8
	Dec:	*+3.5*

Feb-05

ADP Employment Report

8:15 AM	Nov:	+229k
	Dec:	+238
	Jan:	*+200*

Nonmfg. ISM

10:00 AM	Nov:	53.9
	Dec:	53.0
	Jan:	*53.5*

3 Yr Note Announcement
$30B
10 Yr Note Announcement
$24B
30 Yr Bond Announcement
$16B

Feb-06

International Trade Balance

8:30 AM	Oct:	-$39.3B
	Nov:	-34.3
	Dec:	*-37.0*

Productivity			Unit Labor Costs
8:30AM	2Q13	+1.8%	+2.0%
	3Q13	+3.0	-1.4
Prelim:	*4Q13*	*+2.5*	*+1.5*

Feb-07

Employment

8:30 AM	Nov:	Dec:	*Jan:*
Payrolls	+241k	+74	*+200*
Private	+226k	+87	*+200*
UnRate	7.0%	6.7	*6.5*
Hrly Erngs	+0.2%	+0.1	*+0.2*
Workwk	34.5hrs	34.4	*34.5*

Consumer Credit

3:00 PM	Oct:	+$17.9B
	Nov:	+12.3
	Dec:	*+10.0*

Feb-10

Feb-11

Wholesale Inventories

10:00 AM	Oct:	+1.3%
	Nov:	+0.5
	Dec:	*+0.3*

3 Yr Note Auction
$30B

Feb-12
10 Yr Note Auction
$24B

Feb-13

Retail Sales		Total	Ex Autos
8:30AM	Nov:	+0.4%	+0.1%
	Dec:	+0.2	+0.7
	Jan:	*-0.2*	*-0.3*

Business Inventories

10:00 AM	Oct:	+0.8%
	Nov:	+0.4
	Dec:	*+0.3*

30 Yr TIPS Announcement
$9B
30 Yr Note Auction
$16B

Feb-14

Industrial Production			Cap. Util.
9:15AM	Nov:	+1.0%	79.1%
	Dec:	+0.3	79.2
	Jan:	*+0.5*	*79.4*

Consumer Sentiment

9:55 AM	Dec:	82.5
	Jan:	*80.4*
Prelim	*Feb:*	*82.0*

Source: Deutsche Bank

Appendix 1

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GRCM2014PROD031265