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2013 ECONOMIC OUTLOOK: *THE RECOVERY CONTINUES BUT QUESTIONS LINGER*

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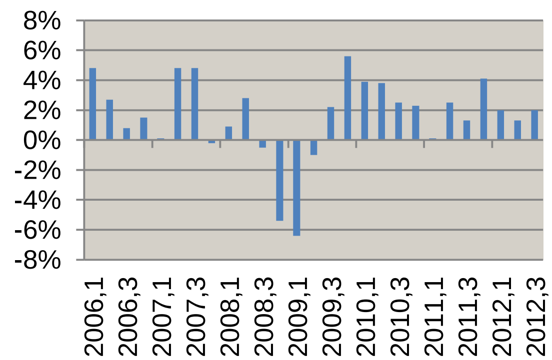
The National Economy: Still Gaining at a Snail's Pace

In June, 2012, the economy completed its third consecutive year of economic growth. After hitting a recessionary bottom in June 2009, the economy's broadest measure of output – Real Gross Domestic Product – has completed three straight years of growth (Figure 1). Indeed, by the middle of 2012, this measure of aggregate economy-wide production had exceeded the pre-recessionary high.

Other economic indicators confirmed the improvement in 2012. Factory production (Figure 2) has almost returned to pre-recessionary levels, and exports have continued to grow and set new records. Bank loans have also been steadily rising from 2009's low numbers. But perhaps the most important indicator of all to most people – employment – although well above its early 2010 low, is still only half-way back to the previous high set in early 2008 (Figure 3).

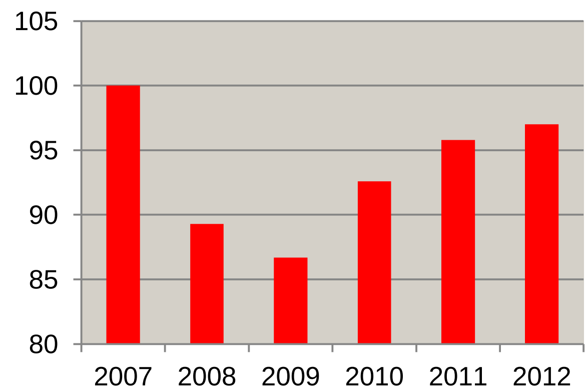
In short, the economic recovery from the "Great Recession" continues, but it has been an extremely sluggish recovery compared to earlier ones. For example, three years after the low points of both the 1990-91 and 2001 recessions, employment had fully recovered to it pre-recessionary job levels.

Figure 1. U.S. Real Gross Domestic Product Growth Rates



Source: U.S. Department of Commerce

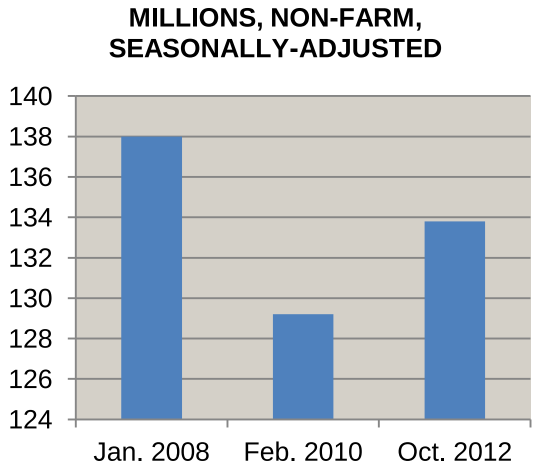
Figure 2. Industrial Production Index (2007=100)



Note: 2012 value is for September

Source: Federal Reserve System

Figure 3. National Employment



Source: U.S. Department of Commerce

So what's behind the slow rebound this time? Economists give two answers – a decimated housing market and household deleveraging. The unprecedented decline in the residential housing market left several casualties – collapsed construction and real estate industries, struggling local governments who rely on residential property taxes, and multi-trillion dollar loses in wealth to homeowners. The combined shocks were unparalleled in the post-World War II economy.

Households had built-up record debt levels during the housing boom of 1997-2005. With the housing market crash and accompanying recession, households found themselves over-extended and forced to moderate spending, increase saving, and reduce debt. Some have dubbed this the "Great Deleveraging". Since household spending accounts for 70% of total economy activity, frugal households have led to a slow-moving economy.

Fortunately, both of these conditions – the struggling housing market and financially constrained households – showed noticeable improvement in 2012. Through October, housing prices – as measured by the Case-Shiller national housing price index – did not suffer a single month of decline in 2012.

Housing inventories during the year fell to pre-recessionary levels, both housing starts (construction) and housing sales trended upward in 2012, and mortgage delinquencies also dropped. Likewise, the average household's financial balance sheet improved: Both financial wealth and – importantly – real estate wealth gained, while liabilities dropped. Debt-to-income ratios were down almost 25% from their high, and by the end of the year households were increasing credit use as their confidence and financial condition strengthened. Gains in both household spending and household income were on track to be significantly stronger in 2012 than in 2011.

It is important to note there are dissenters to this positive view for housing and household spending. Some analysts worry there is a "shadow inventory" of homes for sale that will eventually hit the market, swell supply, and cause housing price declines to resume. This occurrence would then reverse the gains in household real estate wealth, stifle the household's financial re-set, and curtail gains in household spending.

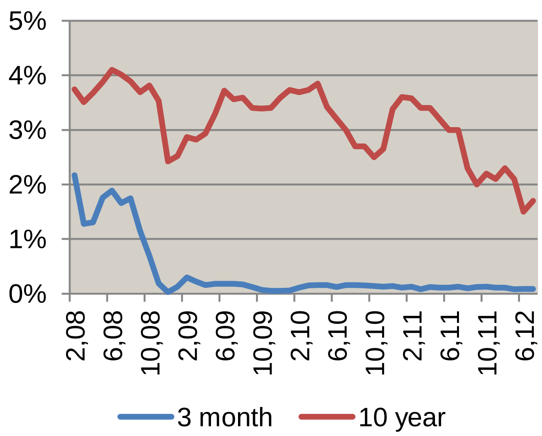
There are also some warning signals from the other two sectors (in addition to household spending) in the economy – business spending and government spending. While spending by businesses on equipment, software, and structures rose in 2012, the rate of increase slowed as the year progressed. Total government (federal, state, and local combined) spending also became tighter during the year. Government receipts grew faster than government spending, and government non-transfer spending fell.

The trends in business spending are worrisome. However, business managers may have paused in their expansion plans until they saw the election outcome and the resolution of the federal budget debate. With the former completed, there is hope that settlement of a long-term federal budget path will give businesses the confidence to resume investments. However, the tightening of government budgets will likely not end. A federal “grand budget deal” will involve additional tax revenues and reductions in planned spending. And while state public revenues are improving, requirements for balanced budgets will limit states’ abilities to provide fiscal stimulus.

Financial market conditions in 2012 continued to be historically unique. The retail level inflation rate (as measured by changes in the Consumer Price Index) will come in near 2.5% in 2012. This is below 2011’s rate, but near the average for the past twenty-five years. Real short-term interest rates have been almost zero for four years, while long-term interest rate (represented by the 10-year Treasury note rate) continued to fall in 2012, setting an all-time historic low for the country (Figure 4).

These outcomes represent several financial conditions in the country. While loan demand strengthened in 2012, it is still under levels existing prior to the recession. Cautious household spending and still-struggling labor markets are moderating cost increases for businesses. Also, the Federal Reserve continues to be aggressive in its monetary policy, facilitating an increase in the money supply of 7% in 2012 after a 10% jump in 2011.

Figure 4. Real Interest Rate Trends (Treasury securities)



Source: Federal Reserve System

National Outlook

The key phrase for 2013’s national economic outlook is “cautious optimism.” The year could have begun in rocky fashion if the federal government had plunged over the “fiscal cliff.” Had that happened, the combination of federal tax increases and spending reductions would likely have shocked the economy into negative growth for the first quarter of the year.

Now that the fiscal cliff has been avoided, real Gross Domestic Product will likely grow at an annualized rate of 2.25% to 2.5%. Although modest, this will be a stronger growth rate than in 2012 and will generate a monthly average of 167,000 net additional payroll jobs (or 2 million jobs for the year). The national unemployment rate will fall to near 7% by year’s end.

This outlook is based on continued improvement in three areas: the housing market, household wealth, and household spending. As discussed above, these positive trends are already underway, and the forecast is they will continue. However, any disruption that derails gains in any of the three factors would cause economic growth to be downgraded. In particular, if the housing market sputters, or resumes a retreat, then the growth forecasts will not be met. In contrast, if the housing market accelerates its recent climb, then the economic numbers will be better than forecasted. The collapse of the housing market is what put the “great” in the “Great Recession,” and the return of the housing market will dictate the pace of the broader economic recovery.

Spending by businesses and government (excluding transfers) account for 30% of total spending in the economy, so household spending ultimately “calls the shots” in the economy. Buoyed by gains in real estate wealth, an improved household balance sheet, and job gains, household spending is forecast to increase at a slightly faster rate (between 2.5% and 3%) in 2013 than in 2012. Business spending will take its cues from household spending. So although business spending decelerated at the end of 2012, more household buying will ultimately drive business spending higher in 2013.

However, the government sector will likely move toward greater "austerity" in 2013. There is strong political pressure to reduce the long-run relative size of the national debt. The major question is how this will be done – that is, through what combination of tax revenue increases and planned spending reductions. This situation means little likelihood of additional government fiscal "stimulus" for the economy in 2013. Yet, it should be noted there is a great debate over whether stimulus or austerity is the best prescription for long-run economic growth. Some argue a long-run federal fiscal plan resulting in a steady decline in the federal debt-to-GDP ratio would increase business and investor confidence and promote growth. Others worry about the likely public revenue increases associated with such a plan and their impacts on investor incentives and growth.

With a modest inflation rate and higher-than-desired unemployment, the Federal Reserve's activities will continue to be "accommodative" in 2013. The Fed is providing strong support to the housing market through its mortgage purchase program, and it has used its power over the money supply to keep short-term interest rates low and to put downward pressure on long-term interest rates. Each of these activities will be on-going in 2013.

Still, at some point the Fed will have to reverse course. The signal for a switch will be a sustained acceleration in inflation to beyond the Fed's preferred peak rate of 2.5% and a trend to noticeably higher interest rates generated by higher inflationary expectations. Then the challenge for the Fed will be to reduce its stimulus without hampering the economic recovery. This challenge will likely not occur in 2013, but discussions about it may begin at the close of the year.

Finally, two foreign concerns face the economy in 2013. One is the potential for slower economic growth in the European Community (EC) and in China. Growth rates in those two regions fell in 2012, and the economic issues facing the regions have not been solved. Together the EC and China account for 20% of U.S. exports, and export growth has been a big plus for the U.S. economy. Economic stagnation in the EC and/or China could derail U.S. export gains and adversely impact domestic economic growth.

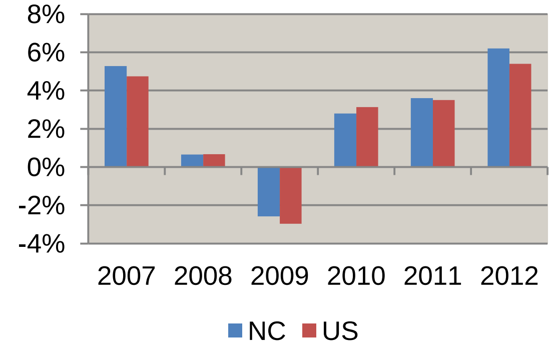
The other foreign challenge is geopolitical, centering on the Middle East. Tensions between Iran, Iran's allies, and Israel continue to simmer, periodically boiling over as happened at the end of 2012 in Gaza. Of course, the economic concern is what a military conflict in the region could do to oil supplies and oil prices. Any direct action between Iran and Israel would likely interrupt regional oil supplies, create a spike in oil prices, and disrupt economic growth in the U.S. and worldwide.

North Carolina: Will 2013 be the "Break-out" Year?

Using total labor compensation as a proxy for the state's Gross Domestic Product, economic growth in North Carolina actually out-performed national growth in 2012 (Figure 5). Also, since the low point in the job market in early 2010, North Carolina has gained jobs at a rate only slightly less than the national economy (3% versus 3.5%). Yet despite this job growth North Carolina's unemployment rate continues to linger at a higher rate than in the nation, with a 2012 year-end rate near 9% compared to almost 8% for the nation. This comes after both North Carolina and the nation began the recession with similar jobless rates near 4.5%.

An analysis by the author of state unemployment rates during the "Great Recession" suggests two key reasons for North Carolina's greater jump in unemployment: the importance of manufacturing in the state's economy, and

Figure 5. Annual Change in Total Labor Compensation



These are changes in nominal values; 2012 is annualized based on first and second quarters

Source: U.S. Dept. of Commerce

high rates of in-migration (movement from other states) into North Carolina during the recession. Almost 22% of North Carolina's economy (measured by output of businesses) is based on manufacturing, compared to the national average of 13%. Since the purchase of manufactured products is more easily postponable, manufacturers always suffer more during economic downturns (indeed, the manfacturing sector fell twice as much during the "Great Recession" as the overall economy). Also, between 2008 and 2010, the net movement of households from other states to North Carolina was five times higher than the average for all states. Certainly some percentage of these individuals registered as unemployed.

Nonetheless, the state unemployment rate has dropped by over 2 percentage points in the last two years. Historically, North Carolina's employment recovery from a recession has begun more slowly than in the rest of the nation but then has accelerated. The state enjoys a level of labor productivity much higher than the national average, which is an attractive "selling point" for the state in attracting and generating economic growth.

Therefore, it is logical to expect North Carolina's economy to outpace national growth in 2013. Gross State Product is forecast expand between 2.45% and 2.65%, and payroll job gains will be just shy of 70,000 for the year. The headline unemployment rate will fall to 8.3% by the end of 2013. The metropolitan areas of Raleigh-Cary, Durham-Chapel-Hill, Charlotte, and Asheville will lead the growth. The gains will be headed by a state housing market rebound which, like the nation, enjoyed improvements in prices, new construction, and sales in 2012. These trends that are expected to continue in 2013.