Deutsche Asset
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Economic Outlook

- Incoming information has been mixed, reflecting the crosscurrents buffeting the economy.
- On the plus side, the labor market continues to improve at a solid pace, and although there is still a long way to go to repair the damage from the Great Recession, clear progress is being made. Similarly, housing continues to recover, both in terms of activity and prices.
- But other areas are considerably less perky. Consumer spending hit a bit of a lull this spring, business investment remains sluggish, government spending is in retreat under the weight of the federal sequester, and exports and manufacturing remain tepid, partly reflecting weak growth abroad. All told, real GDP is likely to have advanced at a meager rate of only 1% or so in Q2, the third consecutive quarter below the already-underwhelming 2% pace that has been characterizing the recovery up until now.
- Clearly, the fiscal drag is taking a toll. Federal spending restraint (which began even before the sequester, but has intensified since), coupled with the tax hikes enacted at the start of the year, are weighing heavily on activity, trimming perhaps 1% to 1-1/2% off GDP growth.
- Against that backdrop, the economy's recent performance is actually not bad. What's helping is the progress that has been made in repairing the excesses of the bubble era. That progress has reduced some of the headwinds that had been holding back the recovery, such as household efforts to repair balance sheets, credit restraint, a housing overhang, and state and local government retrenchment.
- Home prices have been brought into better alignment with fundamentals, while new building activity has run so low for so long that it has markedly reduced the housing overhang.

Economic & Financial Market Projections

	Real GDP (Q to Q % chg, ann rate)	Core PCE prices (4-qtr % chg)	10-year Treasury yield (%, last mth of qtr)	S&P 500 (last mth of qtr)
2011				
3Q	1.3	1.6	1.98	1174
4Q	4.1	1.7	1.98	1243
2012				
1Q	2.0	1.9	2.17	1389
2Q	1.3	1.8	1.62	1323
3Q	3.1	1.6	1.72	1443
4Q	0.4	1.5	1.72	1422
2013				
1Q	1.8	1.3	1.96	1551
2Q	1.0[F]	1.1	2.30	1619
3Q(F)	2.4	1.3	2.55	1660
4Q(F)	2.8	1.4	2.80	1675
2014				
1Q(F)	3.0	1.5	2.90	1700
2Q(F)	3.2	1.6	3.00	1725

F – Forecast

Josh Feinman is a Managing Director and Chief Global Economist of Deutsche Asset & Wealth Management. In this position, he provides portfolio managers and clients around the world with timely analysis of global macroeconomic trends and their implications for financial markets. Josh is also responsible for authoring and editing a series of publications on global economic and financial market issues for distribution among the Bank's offices and clients. A frequent guest lecturer and commentator, Josh delivers speeches around the world and is a frequent guest on financial television programs and is often quoted in major print and electronic media.

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Consequently, housing is showing clear signs of improving, and we expect that to continue.

- Meanwhile, households have improved their financial positions, trimming debt (and especially debt service), while benefitting from a firming of both home prices and equity prices. In fact, household net worth/income ratios have recovered a lot of lost ground. Also, credit conditions continue to improve, and the retrenchment at state and local governments is abating.
- In sum, though the headwinds aren't all gone – uncertainty about fiscal and regulatory policies, for example, persists -- they are ebbing. And as they do, some of the clogged arteries through which monetary policy normally provides support (e.g., housing, interest-sensitive spending) should open. Moreover, pent-up demands – from delayed household formation, to deferred durable goods purchases, to postponed capital investment by firms – are increasingly likely to be vented as private balance sheets heal.
- So as the fiscal drag diminishes later this year and virtually disappears in 2014 (the push for additional fiscal restraint is apt to fade in light of shrinking budget deficits), the pace of recovery should pick up. Our base case remains that the economy will finally "get over the hump," shifting out of the mediocre growth rut that has characterized this recovery so far and transitioning into a higher, more self-sustaining gear, slowly later this year and especially in 2014.
- Still, growth will likely remain well below the rates typical of past recoveries from deep recessions. Part of the reason is that potential output may have taken a hit. Productivity growth has been meager over the past few years (which is why there hasn't been much GDP growth, despite solid job gains), and though some of this may be transitory – a makeup for super-strong productivity earlier in the cycle, when firms may have fired too aggressively, and a normal reaction to sluggish output growth – some of the persistent weakness in productivity may be more enduring, reflecting among other things less capital investment by firms. Although productivity is likely to re-accelerate as the economy gathers pace, a complete restoration of pre-crisis trends seems unlikely (this is not unusual following a severe economic shock). Together with some lingering damage to labor supply (due to long bouts of idleness and the erosion of skills for some), plus slower growth in the working-age population, it all adds up to less robust potential output (certainly the level, if not the growth rate, at least for awhile).
- This doesn't mean the economy is about to run up against capacity constraints. There is still plenty of slack, especially in the labor market, that will take years to absorb, just a bit less than if potential output were completely unscathed.
- All that spare capacity is part of the reason inflation has remained so tame. In fact, inflation has moved even lower of late, though we see that as due at least partly to temporary factors that are likely to recede. Still, with ample slack, tame inflation expectations, only a modest pickup in demand, and dormant labor costs, inflation is likely to remain well in check, near to slightly below the Fed's objective at least over the next couple of years.

Monetary Policy Outlook

- The Fed is on track to begin gradually scaling back the pace of asset purchases, most likely in September, largely because the labor market has continued its steady, healthy improvement.
- But Fed policymakers are likely to move only incrementally, and push back hard against expectations that small reductions in the pace of asset purchases necessarily imply a smooth, inevitable progression toward policy tightening. Instead, they've apt to stress that any tapering of asset purchases is merely a slowing in the pace of easing – and a conditional and potentially reversible one at that – and that an actual tightening of policy is likely still years away.
- After all, the Fed continues to fall short of both sides of the dual mandate, and policymakers, chastened by repeated "false dawns" in this recovery – times when activity seemed to be improving, only to peter out – will likely be wary of removing stimulus prematurely.
- In short, we don't see the Fed rushing for the exits. On the contrary, we continue to expect that the process of returning monetary policy to a neutral setting – and even defining what neutral is in terms of combinations of the funds rate and the size of the Fed's balance sheet – will be a long and winding road that could take the better part of this decade.

Financial Market Outlook

- Financial markets have become increasingly focused on the prospects of Fed tapering. Initially, those prospects caused some indigestion, with increased volatility in risk assets and a backup in Treasury yields. More recently, things have calmed down, in part because the Fed had pushed back against overly aggressive market expectations about monetary policy.
- We have long viewed our base-case economic scenario as supportive of risk assets and a slight weight on Treasuries. A concern, though, is that risk assets seem to have priced in much of this brighter outlook already, making them potentially vulnerable to disappointment. Also, Fed tapering could still cause some market anxiety. But the Fed will likely take great pains to move slowly, and only in the context of an improving economy, which should mitigate any hit to risk assets. And while Treasury rates may drift higher as the economy improves later this year and in 2014, they'll likely do so modestly, restrained by a still-far-from exuberant recovery, tame inflation, and a still-accommodative Fed.

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