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Economy is beating expectations despite sequester

The economy likely will dip this spring as it has the past couple of years this time because of Washington deficit-cutting. But the housing rebound and less-debt-laden consumers should ease the pain.

Paul Davidson, March 19, 2013

After sputtering for several years, the U.S. economic engine finally seems poised to fire on all cylinders.

If only the federal government can patch up that unsightly pothole it created about a mile up the road.

For the third consecutive year, solid first-quarter job growth and budding hopes for a stronger recovery are tempered by the specter of a midyear swoon. In the past, Europe's financial crisis, Japan's earthquake and the debt-ceiling showdown in Congress have slowed early-year economic surges.

This year, private-sector momentum is threatened by January's payroll tax increase and across-the-board federal spending cuts that will likely affect the economy in a couple of months unless the White House and Congress reach a deal to delay most of them.

Yet this time is different, experts say, because the underpinnings of the economy are sturdier.

Both households and businesses have shed much of the debt they amassed before the recession, leaving them freer to spend and invest. The housing market is finally turning around and stocks have rallied to all-time highs. Consumers and corporations seem inured to Washington's dysfunction after the biggest potential tax increases were averted by the New Year's fiscal cliff deal between Congress and President Obama.

"The private sector is kicking into a higher gear," says Mark Zandi, chief economist of Moody's Analytics.

Reports last week showed February retail sales and manufacturing output beating estimates and business confidence growing. After strengthening in February, though, a measure of consumer sentiment slipped in mid-March amid the looming budget cuts, the payroll tax hike and rising gasoline prices.

There are other risks. The eurozone economy could contract again in 2013, hindering U.S. exports. And some economists say the housing upturn could be gradual.

The economic crosscurrents pose a dilemma for the Fed, which begins a two-day meeting Tuesday. The Fed is buying $85 billion a month in government bonds to keep long-term interest rates low and spur more borrowing by consumers and businesses, and to encourage bond investors to buy stocks.

Several Fed policymakers, such as Kansas City Fed chief Esther George, have voiced concerns about the program's costs and growing risks, including eventual higher inflation. Some have suggested the Fed could reduce or end the bond purchases well before the end of the year, according to Fed meeting minutes.

But in testimony before Congress this month, Fed Chairman Ben Bernanke reiterated that the Fed intends to keep the stimulus going until the job market improves substantially. Some Fed officials, such as Chicago Fed chief Charles Evans, have suggested that could mean at least six months of 200,000-plus job additions or a 7.2% unemployment rate.

Job growth has averaged 205,000 the past four months, up from a pace of 154,000 in July through October. In February, job gains surged to 236,000 and the unemployment rate fell to 7.7% from 7.9%.

Economists will be scouring the Fed's post-meeting statement on Wednesday for signals that it may rein in the purchases later this year. In a report last week titled "Are the Good Times Back?" UBS economist Drew Matus said he expects the Fed to delete its reference to the need for the labor market to improve substantially before it scales back the bond purchases.

Nigel Gault, chief U.S. economist of IHS Global Insight, expects no changes, noting policymakers don't want to spook investors and dampen the economy with the tax hike and budget cuts already poised to hamper growth.

The tax increase, which took effect Jan. 1, will shave about a percentage point off growth this year and the spending cuts will trim another half percentage point if they're not postponed or reduced, Zandi says. The upshot would be a modest expansion of about 2% in 2013 — in line with the nearly 4-year-old recovery thus far — and about 500,000 fewer job gains.

Bernanke told Congress the "additional near-term burden on the recovery is significant."

Here's the good news: Zandi and many other economists say the effects will largely be temporary, with growth rising to a 3% annual clip toward the end of the year and surging even higher in 2014. And some economists say the private sector could strengthen even more this year, turning the federal government's tax and spending pothole into a speed bump.

Bernard Baumohl, chief global economist of the Economic Outlook Group, expects growth of 2.8% even if all the federal spending cuts occur. While the reductions will crimp the recovery, they won't sap consumer and business confidence, Baumohl and other economists say. "Washington has become essentially a distraction," **Baumohl** says.

Last week, for example, the government said February retail sales — excluding gasoline, cars and building materials — rose 0.4%. The report surprised many economists who expected a bigger negative impact from higher gasoline prices and the tax increase, which is slated to slice take-home pay for a $50,000-a-year worker by about $1,000 in 2013.

Gault notes that sales of discretionary items such as furniture and electronics dipped last month, likely reflecting the tax hit. And Zandi says it often takes workers a few months to adjust their spending to match lower paychecks.

Others are less concerned. "If we haven't seen the effects (of the tax increase) in January and February, I think what consumers are telling us is the rise in household wealth and improvement in the job market" are more than offsetting it, **Baumohl** says.

A recent Fed report showed that climbing home and stock prices have helped households recover virtually all of the wealth they lost in the recession and housing crash through last year. Meanwhile, the share of income that Americans are using to pay off debt has fallen to a 29-year low of 10.6%, leaving many with more spending money.

The recovery of household net worth is important in part because wealthier consumers have an outsize impact on the economy. The top 20% of households based on income account for nearly half of consumer spending, says Dean Maki, chief U.S. economist for Barclays Capital. Maki expects the tax increase and higher gas prices to have a delayed effect on consumer purchases over the next couple of months. But the wealth effects and rising wages should fuel stronger consumption in the second half of 2013, he says.

For many low- and moderate-income Americans, the tax hike is already curtailing spending. Pamela Carr, 48, of West Dundee, Ill., lost her job as a marketing specialist in 2009. After going back to school to learn website development, she landed a job as a marketing coordinator for a newspaper in 2011, but at a 30% lower salary.

Carr already had stopped shopping for clothes and strictly limits how much she spends at restaurants. After noticing the further drop in pay from the January tax increase, she has put off doctor visits and canceled housekeeping services.

"I'm always on edge," Carr says. "I just have to figure out a different way."

Others are opening their wallets. Oren Spiegler of Upper St. Clair, Pa., says he feels more secure lately in his job as an administrative hearing officer for unemployment benefits now that the state's finances are in better shape. And his stock and other investments have recouped the tens of thousands of dollars lost in the downturn.

Spiegler, 56, who earns an upper-middle-class income, says he and his wife, Colleen, an administrative assistant, spend more when they eat out and they bought a new $33,000 Buick LaCrosse last year, trading in a 10-year-old car. "I felt comfortable getting into monthly payments," he says.

Although he noticed his somewhat smaller paycheck in January, "It's notsomething that impacts our lifestyle," he says.

The housing upturn, meanwhile, has lifted the economy in myriad ways. Zandi expects 1.1 million housing starts this year, up from 781,000 in 2012. The industry's recovery is also boosting sales and payrolls in sectors such as wood manufacturing and architectural services. Zandi predicts housing will contribute about seven-tenths of a percentage point to economic growth — including construction and wealth effects of higher home prices — helping cushion the blow from Washington.

The lower interest rates produced by Fed policies allowed Atul Laddu to recently refinance his four-bedroom house in Suwanee, Ga., saving him thousands of dollars a month. Meantime, his investments are benefiting from a swelling stock market.

He and his wife, Jayashree, are buying more clothing and jewelry, giving their children gifts and visiting them — in Orlando and St. Louis — more often. They also upgraded their car leases to two new Toyota minivans for an additional $400 a month.

"Because I have the extra cash, I feel very confident," says Laddu, 73, a retired pharmaceutical researcher.

The nation's top CEOs are also more bullish about the economy despite the federal budget cutbacks and tax hike, according to a Business Roundtable survey out last week. Large non-financial companies are sitting on nearly $2 trillion in cash.

Doug Weich, CEO of Sophelle, an information technology consultant for big retailers, says revenue has grown 20% to 35% each of the past two years, and he plans to add 10 workers to his staff of 50 this year. After the recession, high-end and low-end retailers made up most of the firm's sales, but recently middle-market companies have contributed significantly as well.

Retailers "are not seeing the headwinds (to sales growth) they thought they would see," he says.

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