Liftoff Less Likely With Loss of Thrust

While hope springs eternal, U.S. economic growth is not about to take off just yet.

Failure to Launch For the fifth straight year, expectations are running high that this time around the U.S. economy will take off and reach "escape velocity." The need for a self-sustaining expansion is increasingly urgent, with the quantitative easing (QE) booster rockets expected to drop off by year-end. Yet, it is far from clear whether the "forward guidance" thrusters favored by the incoming Fed Chairman, Janet Yellen, can make up for the loss of QE.

Key to the upbeat expectations is a sharp reduction in the fiscal drag assumed in most economists' models, which therefore predict a significant pickup in growth. We find this rationale to be reasonable, and understand the general logic.

However, as students of the business cycle, we consider ourselves "monitorists," who objectively monitor cyclical economic indicators. Viewing the economy from this perspective, which is not driven by model-specific assumptions, we see things differently from the more comfortable consensus, because the cyclical indicators do not show an economy on the verge of "taking off."

Monitoring cyclical interrelationships from that distinct standpoint, we pointed out two months ago *(↗USCO, November 2013)* that, while year-over-year (yoy) "growth in nonfarm payroll jobs [had] firmed a little in recent months... yoy job growth as measured by the household survey [was] in a steep downswing, [essentially] at its worst reading in over two years..." We went on to note that, "when household employment growth is in a cyclical downturn, it is virtually unprecedented for payroll job growth not to follow suit."

Because cyclical turns in household job growth typically exhibit a short lead over payroll job growth, we wrote the following month *(↗USCO, December 2013)* that the latter "may well be in a nascent downturn and decline further in the near term." Sure enough, contrary to soaring expectations, that is what happened, with yoy payroll job growth dropping in December to a seven-month low.

Shocked by the drop in the monthly number to just 74,000 jobs, some prominent analysts urged people to ignore the data, while seizing upon the cold weather to explain the apparent aberration. While the frigid December weather could not have been a surprise by the second week in January, when the employment data was reported, it is curious that women were

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seemingly more resilient to the weather, gaining 75,000 jobs in December, while men lost 1,000 jobs.

Nevertheless, it is possible that the December number will be revised, but that would not impact our downbeat assessment of the labor market. Placing the December data aside, it is notable that job growth over the *preceding* 12 months had averaged 194,000 per month according to the establishment survey, but only 101,000 according to the household survey. As we wrote recently *(↗EWU, January 17, 2014)*, "[o]ver the past decade, the mean revision to the 12-month moving average of household job growth was only 1/25th that for payroll jobs. Since their longer-term patterns are similar, the payroll jobs data are more likely to be revised down. Separately, when adjusted to the payroll concept, the household survey actually shows a decline in employment since the summer. Thus, even ignoring December's data, the job growth trends have become noticeably worse."

The steepening cyclical downturn in labor force participation growth does not support expectations of a quick revival in U.S. economic growth.

Plainly, the December payroll jobs number is not as much of an anomaly as most would prefer to believe. That said, a bit of an uptick in job growth from here would be no surprise, since near-term job growth prospects have improved a little, with U.S. Leading Employment Index growth rising recently *(↗Chart 8, page 14)*.

This does not change the bigger picture for the U.S. labor market, which has behaved atypically in the period following the Great Recession, with cyclical turns in job growth exhibiting unusually long lags against those in other key coincident indicator growth rates. In particular, the employment growth rate cycle crested at the end of 2012, almost two years after the growth peak in a version of the U.S. Coincident Index excluding job-related indicators (not shown). Historically, the two growth rates have been roughly coincident.

Another example of such a long lag was in the years following the previous recession, which was also associated with massive structural job losses – in that case, of manufacturing jobs. Specifically, the corresponding lag was almost a year and a half, with the employment growth rate cycle peaking in the summer of 2005.

Evidently, following the hemorrhaging of 2.7 million payroll jobs during and in the wake of the 2001 recession, employers were relatively slow to hire workers. As a result, the pace of hiring could keep climbing long after growth in other key coincident indicators had peaked.

Similarly, panicked employers in survival mode slashed jobs during and in the months following the Great Recession. They were then slow to hire, resulting in an extended upswing in job growth that peaked long after growth in production, income and sales had already done so.

Because employment growth rate cycles can be distinct in timing from overall growth rate cycles, we maintain separate leading and coincident indexes for employment. But this reality also underscores a vital fact that most analysts fail to appreciate: even if job growth ticks up from here, growth in the other key coincident indicators can still stay in cyclical downswings.

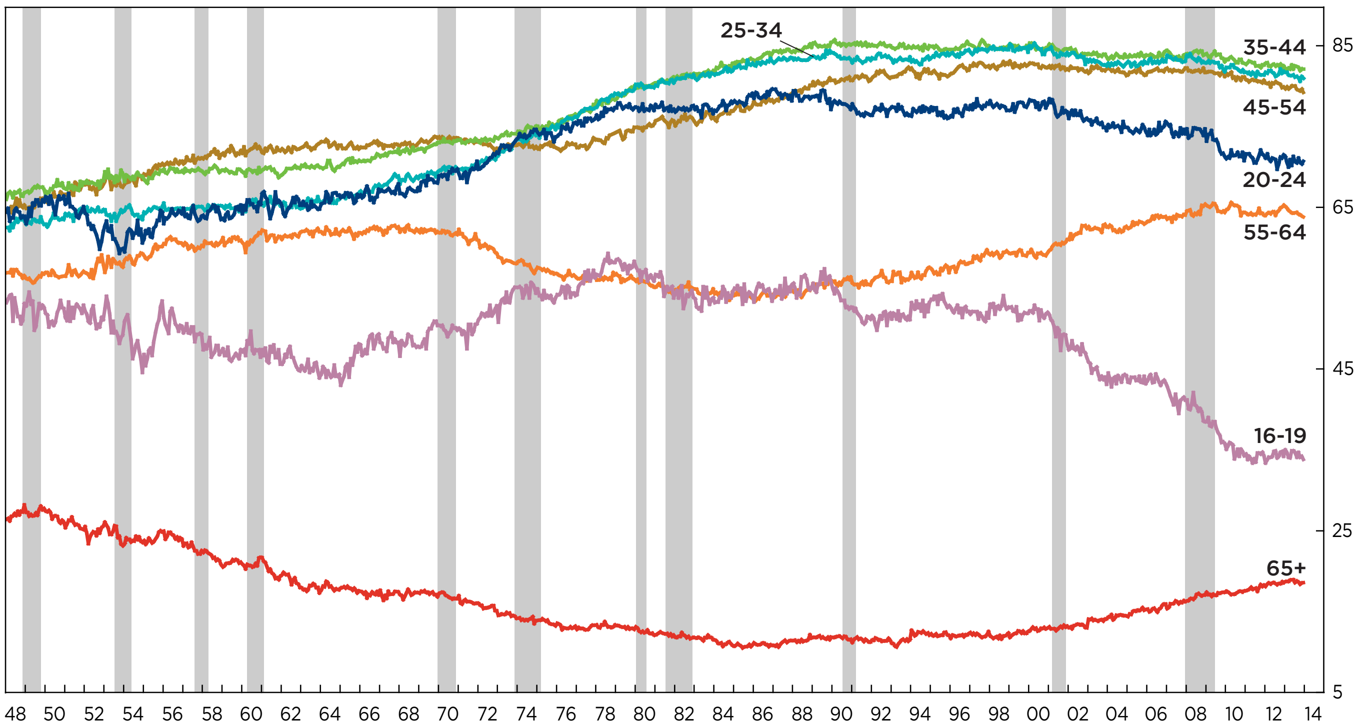
Another unusual feature of the current cycle is the relative rapidity of the decline in the jobless rate in recent years, despite lackluster job growth. The well-known explanation is the plunge in the labor force participation rate, much of which is routinely ascribed to "demographics," and then dismissed. After all, it makes sense that the baby boom generation should be starting to retire faster than a smaller cohort of young people is entering the labor force.

As Chart 1a shows, the reality is more complicated and largely at odds with that explanation. The youngest baby boomers will turn 50 this year, while the oldest of them will turn 68. What we find is that the labor force participation rate (LFPR) for those in the 65+ age group, while relatively low, had risen steadily since the 1990s, but began to decline in mid-2013. Meanwhile, for those in the 55-64 age group – all baby boomers – the LFPR, while substantially higher, had been rising since the 1980s, and especially since the turn of the century, but stalled out soon after the Great Recession and began to decline quite noticeably a year or so ago.

Incidentally, during confirmation hearings before the Senate two months ago, Ms. Yellen in effect said that the Fed's zero interest rate policy would help "retirees who are hoping to get part-time work in order to supplement their income," being among the savers "hurt by this policy." Apart from the irony, it is also unfortunate that even those older adults needing to supplement their low interest incomes now seem to be dropping out of the labor force in greater numbers.

For the younger cohorts, the LFPR has been falling even longer. Indeed, it has been declining for about a quarter of a century or more for the two youngest

Chart 1a: Labor Force Participation Rates (%) **by Age Group**



Shaded areas represent U.S. business cycle recessions.

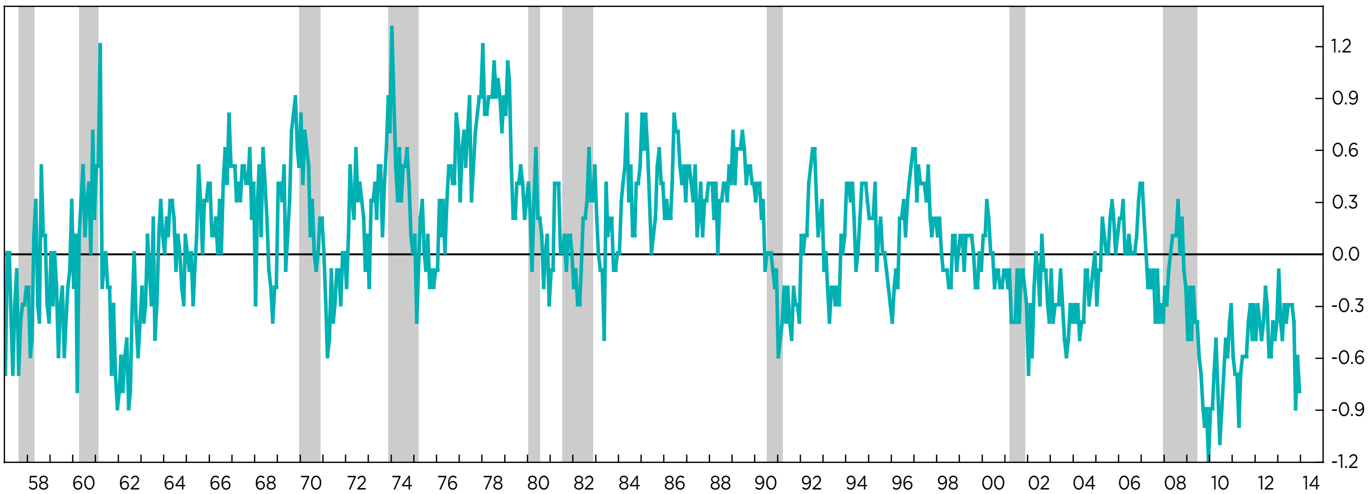
cohorts – the 16-19 and 20-24 age groups. What is striking is the rapidity of the plunge for the 16-19 cohort and, to a lesser extent, for the 20-24 age group, partly because a larger proportion of younger people are now choosing to attend college.

Separately, a close look at the chart shows that the LFPR for each cohort is at least mildly pro-cyclical, tending to decline around business cycle recessions. In fact, they lead business cycle peaks more often than they lag them, but lag business cycle troughs more often than they lead them. So it is notable that all of them have now been falling for some time, resulting in a plunge in the overall LFPR to its lowest reading since 1978.

In fact, the yoy change in the overall LFPR is highly cyclical (Chart 1b), anticipating the clear majority of business cycle downturns, while lagging business cycle upturns more often than not. It is worth noting, in that context, that it peaked a year ago, in January 2013, and remains in a decisive downturn.

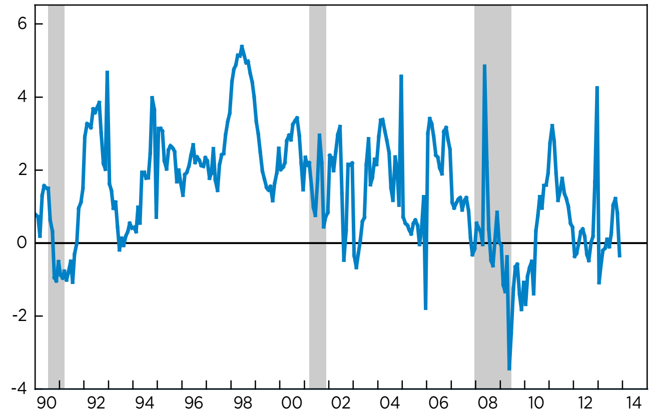
Also, this indicator tends to lead the U.S. growth rate cycle, typically turning up a couple of months before upturns in economic growth. So it is interesting that, by late 2013, it had not only plummeted to

Chart 1b: Labor Force Participation Rate, Change (Percentage Points)



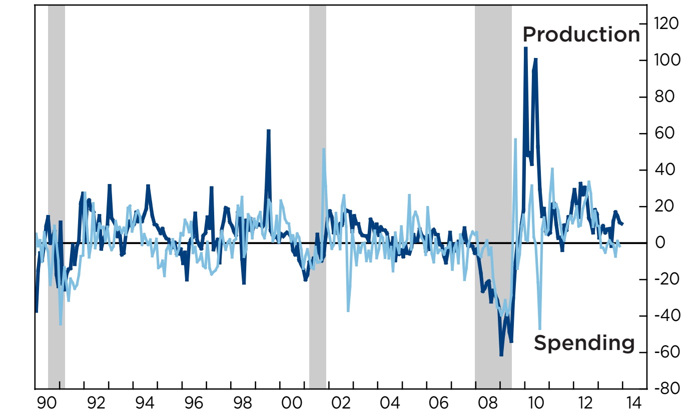
Shaded areas represent U.S. business cycle recessions.

Chart 1c: U.S. Real Personal Disposable Income Per Capita, Growth Rate (%)



Shaded areas represent U.S. business cycle recessions.

Chart 1d: Industrial Production and Spending on Autos, Growth Rates (%)



Shaded areas represent U.S. business cycle recessions.

readings not seen in over half a century, except in the immediate wake of the Great Recession, but had also entered a pronounced, pervasive and persistent cyclical downturn for the first time since 2008-09. The steepening plunge in the LFPR is not an encouraging sign for those expecting a quick revival in U.S. economic growth.

Losing Altitude The reality is that, for all the upbeat rhetoric, the proportion of people in the labor force is falling. As such, it is instructive to examine the yoy growth rate of real per capita personal disposable income (Chart 1c), a quarterly version of which we had examined recently *(ICO, November 2013)*.

As the chart shows, this indicator of income has once again plunged below zero, having spent about half of the months since the beginning of 2012 mired in negative territory. Indeed – except for a brief period in late 2013 and a couple of months at the end of 2012 when it spiked up as a result of advance bonus and dividend payments and tax planning in anticipation of higher tax rates – it has been below 0.5% for the last two years. It is clear from the chart that since 1990, we have hardly ever seen such an extended period of weakness in income growth except around recessions.

Of course, this dearth of income growth does not bode well for purchasing power. However, the Fed has encouraged borrowing, especially in interest-rate-sensitive areas of the economy like automobiles and housing, both of which have recovered notably from their recessionary lows. As with home loans in the previous cycle, we now have a rising proportion of subprime car loans driving the revival in car sales, and thereby higher auto production.

Indeed, as Chart 1d shows, yoy growth in industrial production for autos (dark blue line), after peaking at over 30% in mid-2012, fell below zero last summer, but has since recovered to double-digit readings. Is this sustainable?

As the chart shows, yoy growth in personal consumption expenditures for new domestic autos (light blue line) peaked at over 30% in the summer of 2012. It then plunged into negative territory by early 2013, and remains there, staying negative for eight of the last ten months. In other words, consumer spending on cars has clearly lagged auto production in recent months, resulting in a buildup in inventories. Therefore, despite all the hope, auto production is not likely to remain a driver of industrial production growth or overall U.S. economic growth.

How about housing, the other major driver of economic growth in recent years? In fact, yoy growth in building permits and housing starts have both plunged to their worst readings since 2011 (not shown). This does not bode well for employment in residential construction, the only category of construction where yoy job growth has been on the rise. As we show later *(pages 7 to 10)*, yoy job growth rates in the other areas – non-residential building construction, heavy and civil engineering construction, and specialty trade contractors – have all dropped to their lowest readings in about a year or two.

The picture is not encouraging, either, for non-residential construction spending, including the largest sector, power, where yoy growth is sliding deep into negative territory, and the educational sector, where spending has shown hardly any recovery following a serious decline in the wake of the Great Recession. The only real recovery is in construction spending for manufacturing, largely driven by the shale oil and gas boom, and the auto recovery. As we have noted, growth prospects for the latter appear to be fading.

Under the circumstances, it is not surprising that growth in the U.S. Leading Non-Residential Construction Index is in a decisive downturn, suggesting that growth in the sector, which began to worsen two years ago, will dim further. All of this is consistent with the plunge in U.S. Leading Construction Index growth – which remains in a three P's downturn – to a 26-month low *(↗Chart 22, page 21)*.

A separate three P's analysis *(↗pages 22-23)* shows the growth rates of both the U.S. Leading Home Price Index and the U.S. Real Home Price Index to be in decisive cyclical downturns, the latter having peaked shortly after our forecast of a downturn in real home price growth *(↗USCO, March 2013)*, *prior to* the taper tantrum. With home price gains ebbing, there should be even less hope of a wealth effect from housing this year.

The reality is that yoy growth in the U.S. Coincident Construction Index has already dropped to a 28-month low (not shown), and is poised to fall further. Meanwhile, yoy growth in the U.S. Coincident Manufacturing Index has also dipped to a three-month low, and will be hard for auto production to prop up much longer. Finally, yoy growth in the U.S. Coincident Services Index has plunged to a 41-month low, and is likely to stay in a cyclical downswing. Thus, broad economic growth has slowed, and is not about to pick up.

Looking back, the epicenter of the recession appears to be the half-year spanning Q4 2012 and Q1 2013, which saw just 0.6% annualized GDP growth, mostly from a freak jump in agricultural inventories, without which annualized real GDP growth would have been just a quarter of a percent. Given that GDP growth for the early quarters of the last few recessions saw massive gyrations of two to four percentage points as a result of very belated revisions, generally downward, GDP growth for that half-year period could easily end up negative after revisions. That is less likely for subsequent quarters, since the initial prints were stronger to start with, and the revisions tend to be somewhat smaller beyond the early recession quarters.

In any case, starting in Q4 2012, yoy real GDP growth has stayed under 2% for four straight quarters. Such a long stretch of sub-2% GDP growth has been seen before only around recessions, and has never begun outside recession, though it has occasionally extended somewhat after the end of recession.

Actually, given our view that a mild recession began in the second half of 2012, possibly that summer, we would have expected a sustained upturn in economic growth to have begun by the second half of 2013 as the economy pulled out of recession. While we need to wait for revised data to determine whether the recession ended at some point last year, we do not yet see clear evidence of a three P's upturn in the coincident data to support such a thesis. Indeed, economic growth appears to be relapsing to lower and lower readings in recent months, not getting better.

In this connection, it is worth recalling a recent presentation made by St. Louis Fed President James Bullard, making the point that, "as of early August 2008, the growth picture for the U.S. economy according to available real-time data was relatively good. In particular, estimates of real GDP growth were modest but positive for 2007 Q4, 2008 Q1, and 2008 Q2." Basically, "[t]here was no recession according to the conventional definition of two consecutive quarters of negative GDP growth."

Yet, as of August 2008, the U.S. economy had already been in recession for eight months, and remained in a cyclical window of vulnerability. As we now know, it was on the cusp of a much deeper downturn.

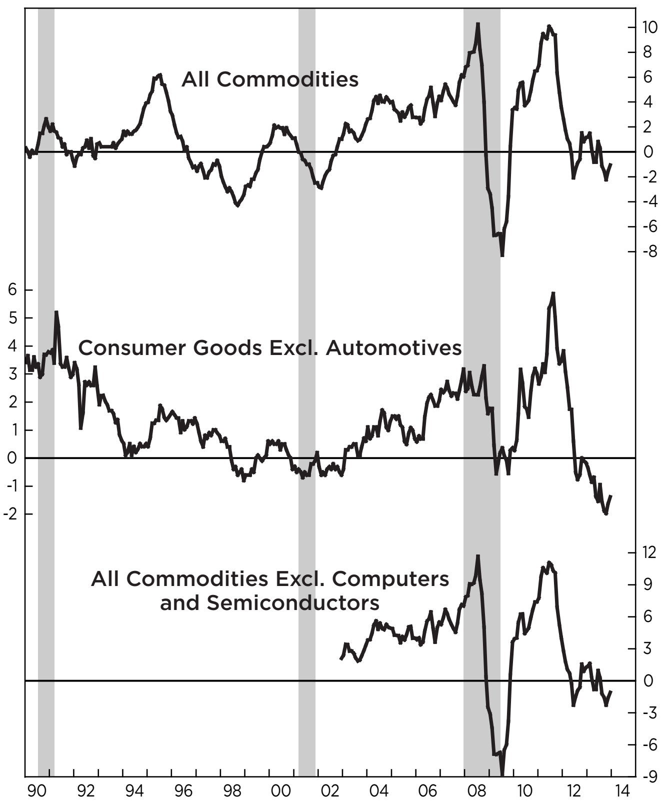
We cannot rule out a brighter growth outlook for late 2014, but today, near-term economic growth prospects are once again dimming. The biggest immediate issue facing the economy is a strapped consumer, whose changing shopping habits are not helping retailers, either. With foot traffic dropping by double-digit percentages in each of the last three years, retailers received only about half the holiday traffic in 2013 as they did in 2010. While online sales surged, they accounted for less than 6% of overall retail sales as of Q3 2013.

Also, shoppers visited an average of just three stores per mall trip in 2013, down from five stores in 2007. Not only are retailers losing out on impulse purchases as a result, but, with customers often looking up the best deals in advance online and then making targeted trips, retailers' pricing power is being eviscerated.

All of this fits with a soft economy and low inflation. In a "highly promotional" holiday season, retailers were able to "pull demand forward" by heavy discounting, but only at the cost of profits.

At least some Fed officials appear to be taking note. In a recent speech, Atlanta Fed President Dennis Lockhart observed that "we have been on a disinflationary trend for about two years," and that "[c]ontinued disinflation could pose risks to economic performance." Moreover, the "inflation situation ... seems disconnected from the recent growth momentum and the outlook that it will continue... So I'm interpreting the soft inflation numbers as a risk

Chart 1e: Export Price Indexes, Growth Rates (%)



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signal. Through the lens of prices, the economy could be weaker than we currently believe."

Of course, the Fed intends to keep tapering this year, but, as Dallas Fed President Richard Fisher noted, he would favor it "as long as the real economy is growing, cyclical unemployment is declining and demand-driven deflation remains a small tail risk." Unfortunately, underlying inflation pressures remain in a cyclical downswing, according to the U.S. Future Inflation Gauge *(↗Chart 3, page 12)*.

Economists looking for stronger GDP growth have been cheered by the trade balance data. Yet, part of the reason for the reduced trade deficit has been a plunge back into negative territory in yoy U.S. imports growth, whose weakness was not due just to smaller energy imports. Moreover, to the extent that U.S. exports have increased, it is notable that exporters needed to cut prices, with the merchandise having to be effectively "on sale" in order to secure orders.

As Chart 1e (top line) shows, yoy growth in export prices for all commodities, having dipped again into negative territory last spring, has stayed there for seven of the last nine months. Excluding autos, the picture is even more startling, with yoy growth in export prices remaining at or below zero for the past year and a half, and still staying near October's record low (middle line). This is export price deflation of unprecedented magnitude.

Some claim that deflation is not necessarily a bad thing, and point to computers and semiconductors as examples. While there is certainly such "good deflation," yoy growth in U.S. export prices for all commodities excluding those items is negative anyway, and has been so for most of the time since the spring of 2012 (bottom line). Again, the U.S. is able to boost exports only by cutting prices, because exporters simply lack pricing power.

American Exceptionalism The prevailing belief is that, while the Eurozone may be flirting with chronically weak growth and deflation danger, America faces no such threats. And even if most other major developed economies may be "becoming Japan," that cannot possibly hold for the U.S.

But is it really "different" for the U.S.? After all, inflation remains well below the central banks' 2% targets in both the Eurozone and the U.S. Indeed, in both cases, inflation is below 1%. So why is the U.S. uniquely poised to reach escape velocity?

Many are eager to declare victory, trumpeting 2014 GDP growth forecasts of 3% or better, as if that would prove that the U.S. was not "becoming Japan." Perhaps they do not know that, in its lost decades, starting in 1990, Japan experienced six recessions and recoveries, in the course of which quarter-over-quarter annualized GDP growth registered at least 3% more than 30% of the time.

There is a pressing need today for an adult conversation, taking a long view of what is going on with U.S. economic growth, instead of refusing to acknowledge the problem. The reality is that major structural changes are occurring in developed countries around the world – including the U.S. – resulting in more frequent recessions in such economies, as is already obvious in Europe and Japan.

In this context, we are pleased that Larry Summers is beginning to focus mainstream attention on a condition of the U.S. economy that he calls "secular stagnation" – in essence the pattern of falling trend growth we first highlighted more than five years ago *(↗USCO, August 2008)*. If he and ECRI are right, this condition will bedevil the U.S. for many years to come, yet the scope of the problem is hardly yet appreciated. Rather, there seems to be a persistent hope, as voiced by Ms. Yellen, that if we do more of what we have been doing, things will eventually return to business as usual. ■

