Two-Speed Economy to Result in Easing Growth

As a pickup in non-manufacturing growth partly offsets slower manufacturing growth, the upshot is likely to be a mild slowdown.

If Not Now, When? Given half a chance, the Fed would like to raise rates this year – and sooner rather than later. Indeed, a number of Fed governors have recently reiterated their expectations of a mid-year rate hike. The sixty-four thousand dollar question is whether they will get that opportunity.

Consider the latest headline numbers, showing 5% GDP growth in Q3 2014, almost 3 million payroll jobs added in 2014, and the jobless rate dropping in December to 5.6%, approaching the Fed's estimate of "full employment." Taking these statistics at face value, more than six years after rates hit the zero lower bound (ZLB), the question has to be, "if not now, when?"

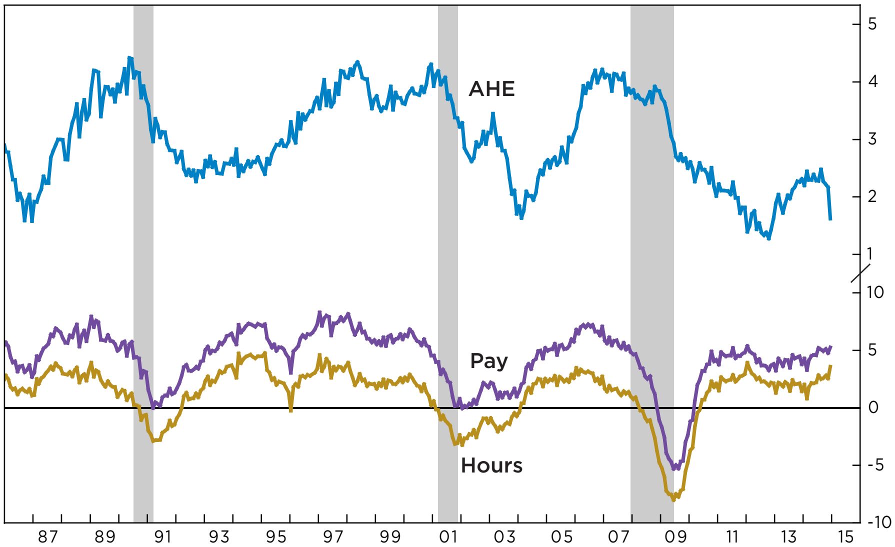
The Fed's real motivation to hike rates soon is not so much the fear of inflation, but their concern that rates will not be high enough for them to cut without promptly encountering the ZLB when the next recessionary shock hits the economy. In other words, they are worried about their own longer-term relevance.

While the Fed does not appear to be overly concerned about the near-term fragility of the U.S. economy, our analysis shows that economic growth will get worse in the coming months. In contrast, the consensus view on the economy is that things will get even better, justifying a wait-and-see attitude. Therefore, the current market consensus is that rate hikes can be pushed back, since inflation is falling and wage growth, highlighted by Chairman Yellen, is unexpectedly in retreat.

In essence, wage growth is even more "non-existent" than before, with average

GDP growth around 3% is unsustainable unless productivity growth reverts to its decades-old historical average, essentially quadrupling its pace since the start of this decade.

Chart 1: Growth in Average Hourly Earnings, Total Pay and Total Hours (%)



Shaded areas represent U.S. business cycle recessions.

hourly earnings (AHE) of production and nonsupervisory employees actually dropping in December, and year-over-year (yoy) AHE growth falling to a two-year low (Chart 1, upper panel). With the economy apparently revving up, this data so blindsided most economists that they dismissed it as a statistical anomaly.

Nine months ago, when many analysts were prematurely celebrating the increase in earnings growth, we pointed out that it "has risen for an unwelcome reason – because growth in hours has fallen faster than pay growth" *(↗USCO, April 2014)*. Today we have the flip side of that illusory strength.

As Chart 1 (lower panel) shows, yoy growth in aggregate hours (gold line) has been climbing faster than growth in aggregate pay (purple line). Naturally, growth in the ratio of the two has been plunging. In essence, the weakness in wage growth is the result of total hours growth outstripping total pay growth.

Investigating the upturn in aggregate hours growth, we found that the latest spike was driven by construction, education and health services, leisure and hospitality, and other services, but the upswing since last winter has also been supported by upswings in finance, trade, transportation, and utilities (not shown). This is a broadbased cyclical upturn in the growth of total hours, not a narrow or temporary anomaly. It is just that it rose too fast in 2014 for aggregate pay growth to keep pace.

Indeed, this labor market strength is consistent with the upswing in U.S. Leading Employment Index (USLEI) growth, which rose in December to a 13-month high *(↗U.S. Indexes, January 2015)*. Unfortunately, multiple jobholders, who typically obtain low-paying jobs, have accounted for a disproportionate number of the jobs added lately *(↗USCO Essentials, December 2014)*.

As we discussed recently *(↗USCO Focus, January 2015)*, the correlation between wage growth and the jobless rate moves in cycles, typically switching signs every year and a half or so. Indeed, from November 2012 through September 2013, an increase in wage growth accompanied a decline in the jobless rate. "However, in the most recent period, from October 2013 through December 2014 ... declines in the jobless rate have been accompanied by hardly any change in wage growth, and more recently by declining wage growth ...This suggests that, if this current relationship holds, a further decline in the jobless rate would not be a harbinger of rising wage growth." While this is normal behavior, not a conundrum, the question is whether the weakness in wages or the recent drop in inflation will restrain the Fed from raising rates.

Ebbing Expectations With yoy CPI inflation dropping closer to zero, and inflation expectations continuing to plummet, some analysts doubt that the Fed would raise rates by mid-year when it is so far from fulfilling its inflation mandate. Yet, in its latest statement, the Federal Open Market Committee said that it "expects inflation to rise gradually toward 2 percent as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate."

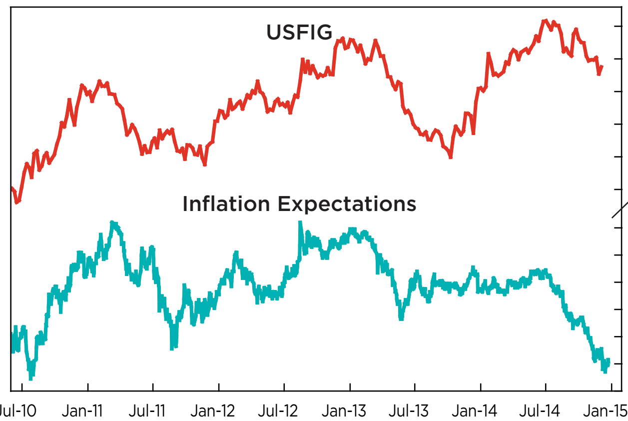
Recall that both the U.S. Future Inflation Gauge (USFIG) and the U.S. inflation cycle bottomed in late 2013 and increased through mid-2014. After CPI inflation hit a one-and-a-half-year high, it staged a rapid retreat as oil prices plunged, while the USFIG also began to ease (Chart 2, upper panel).

Although the USFIG has declined somewhat, it is not in a pronounced, pervasive and persistent (three P's) downturn. In particular, its decline has not been driven by pervasive downturns in its components. Therefore, it is premature to recognize this as a cyclical downswing in the USFIG.

While headline CPI inflation has clearly dropped, CPI inflation ex-energy, after rising from 1.5% at the beginning of 2014 to 2.0% in May, has since been essentially flat, staying in a tight band between 1.9% and 2.0% (not shown). This means that the current decline in U.S. inflation is concentrated in energy prices, and does not represent a broadbased cyclical downswing in inflation. Notably, yoy growth in CPI for food rose to a 34-month high of 3.4% in December from 1.0% a year earlier (not shown), while rental inflation has also stayed in a sustained cyclical upswing.

In other words, the U.S. inflation cycle bottomed in the fall of 2013 and then entered a cyclical upswing – in line with the upturn in the USFIG – that continued at least through mid-2014. The subsequent decline in inflation has been driven

Chart 2: Forward-Looking Measures of Inflation



by a narrow drop in energy prices, and thus cannot be said to constitute a broadbased cyclical downturn in inflation. The USFIG has also eased in recent months – though not as much as headline CPI inflation – but is not yet in a three P's downturn indicative of a downswing in the U.S. inflation cycle.

While the USFIG has slipped since the summer, 10-year inflation expectations have nosedived to their lowest readings since the summer of 2010 (Chart 2, lower panel). The cyclical swings in inflation expectations do still correspond to those in the USFIG, albeit biased to the downside since late 2013, perhaps due to the growing realization of structural lowflation, which should keep inflation relatively low for several years.

Meanwhile, inflation expectations have been in free fall, as we pointed out last October *(↗USCO Essentials, October 2014)*. Those derived from the prices of 5-year, 5-year forward inflation swaps, which we highlighted two months ago *(↗USCO Essentials, November 2014)*, have since plunged to their lowest reading since November 2008 (not shown). At the same time, 5-to-10-year-ahead consumer inflation expectations, after touching a five-and-a-half-year low in November, have ticked up but remain near that low (not shown), suggesting that the decline in longer-term inflation expectations cannot be dismissed as just market-driven distortions. After all, even if oil prices stay low, that hardly assures low inflation for the first half of the 2020s.

The consensus forecast of U.S. economic growth in 2015 has turned more optimistic of late. Once again, it seems to many, the economy has attained "escape velocity." As such, yoy real GDP growth is generally expected to rise from about 2.5% in Q4 2014 to around 3% a year later.

Actually, the current optimism was foreshadowed four months ago *(↗USCO, September 2014)* by the three P's upturn we recognized in the U.S. Leading Nonfinancial Services Index (USLNFSI) growth. Furthermore, with growth in the broader service sector "likely to hold up, and possibly pick up a bit in the short term" *(↗USCO Essentials, November 2014)*, we recognized a two-speed economy in view of the simultaneous deterioration in manufacturing growth prospects.

The growth rates of both the USLNFSI and the U.S. Leading Services Index have now climbed to 33-month highs *(↗U.S. Indexes, January 2015)*, underscoring further brightening in service sector growth prospects, and consistent with the favorable job growth outlook suggested by the USLEI. Construction sector growth prospects are also fairly positive.

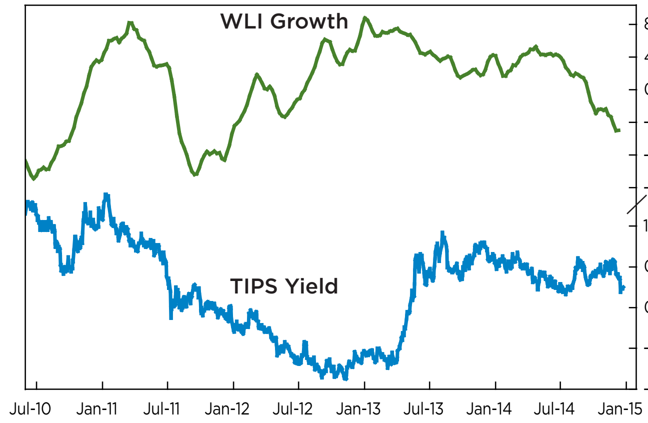
At the same time, however, growth in the U.S. Leading Manufacturing Index has dropped to a 30-month low *(↗U.S. Indexes, January 2015)*. In that context, yoy growth in U.S. industrial production – which has already slipped from November's four-year high – is likely to decline further in the near term.

The upshot is a two-speed economy but, because manufacturing is much more cyclically sensitive than the larger service sector, we are near the cusp of a new growth rate cycle downturn. That is also the clear conclusion from the three P's downturn in Weekly Leading Index (WLI) growth that we highlighted last week *(↗EWU, January 16, 2015)*, as well as the downturn in U.S. Short Leading Index growth. It is also consistent with our earlier analysis *(↗ICO Focus, November 2014)*, concluding that, with Japan and the Eurozone in simultaneous growth rate cycle downturns, "the U.S. is highly unlikely to avoid a growth rate cycle downturn."

To be clear, the U.S. economy registered its most recent growth rate cycle trough in early 2013. At the time, the economy was mired in a period of weakness that – based on the U.S. Coincident Index growth rate – looks to be the worst non-recession in over half a century, and may eventually be classified as a recession following future data revisions. By the second half of 2013, however, the economy was almost surely out of that cyclical episode, and in a growth rate cycle upturn, albeit with a clear stumble early last year. It is an end to that growth rate cycle upturn that is at hand today.

To complete our roundup of the relevant evidence, please note that U.S. Long Leading Index growth slipped in December, sliding further below July's 26-month high. Under the circumstances, a growth rate cycle downturn is highly probable but, given the improving prospects for non-manufacturing

Chart 3: WLI Growth and Real Interest Rates (%)



growth, which are bolstered by falling energy prices, this is unlikely to become a sharp downturn at this time.

The decline in real interest rates, as measured by the yield on 10-Year Treasury Inflation-Protected Securities (TIPS), shown in Chart 3 (lower panel) is consistent with the downturn in WLI growth (upper panel). Indeed, while international forces may be playing a role here, the TIPS yield approaching lows not seen since the 2013 "taper tantrum" is consistent with less optimistic longer-term expectations of U.S. economic growth, i.e., the structural decline in trend growth at the heart of our "yo-yo years" thesis *(↗ICO, March 2012)*.

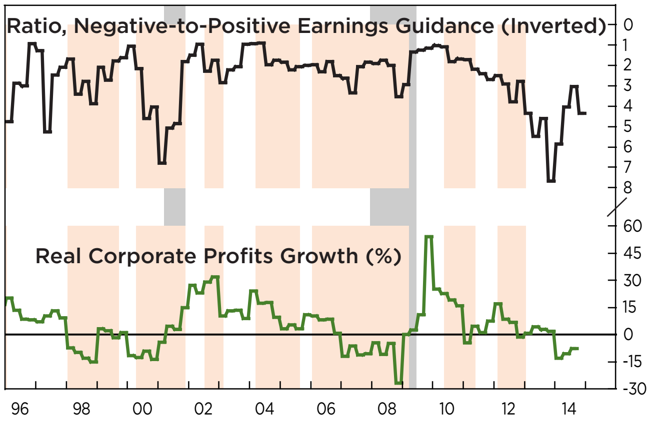
Falling Profits Cyclical downturns in corporate profits growth often go hand-in-hand with growth rate cycle downturns (Chart 4, orange-shaded areas). In that context, the chart shows yoy growth in real corporate profits including inventory valuation adjustments and capital consumption adjustments (lower panel), which tends to have a slight lead at growth rate cycle turning points. As we show, since the beginning of 2014 this measure has stayed deep in negative territory through Q3 2014 – something that typically happens around recessions (gray-shaded areas).

Unfortunately, the ratio of negative-to-positive earnings guidance for S&P 500 companies (shown inverted in upper panel) worsened in Q4 2014 after improving for the prior three quarters, and is now at a reading not often seen away from recessions. Once again, this does not necessarily point to an imminent recession, and could, for instance, reflect the impact of the strong dollar. However, this is scarcely a harbinger of better corporate earnings growth this year.

Furthermore, after years of multiple expansion, there is a general perception that further stock price advances would have to be driven by earnings growth. To the extent that this is true, the discouraging earnings picture suggested by Chart 4 may impede a further advance in equity prices this year.

This is not to suggest that stock prices will be driven largely by cyclical fundamentals in the near term. As we first noted three years ago *(↗USCO, January 2012)*, "[t]his does not mean that equity prices must soon tumble. After all, the world's major central banks are flooding the financial system with liquidity, and monetary easing is often greeted with bullish moves in risk assets." We have reiterated this observation in the months and years since, and it remains relevant, with the Bank of Japan recently ramping up its quantitative easing (QE) efforts and the European Central Bank launching its own version of QE in 2015.

Chart 4: Earnings Guidance and Corporate Profits



Gray-shaded areas represent U.S. business cycle recessions. Orange-shaded areas represent U.S. growth rate cycle downturns.

Meanwhile, the Fed has become rather sensitive to significant stock market declines, which could potentially persuade them to push off rate hikes. This is because the Fed apparently watches market reactions quite closely as an indicator of the potential vulnerability of the economy to negative shocks delivered by the Fed. In that context, the earnings outlook indicated by Chart 4 suggests that some caution may be in order.

Barring a significant slide in equity prices, however, the Fed is determined to achieve "lift-off" for interest rates, if possible by around mid-2015. In this regard, neither the dive in inflation expectations nor the lack of wage growth is likely to ultimately stand in the way of rate hikes.

Above all, the Fed wants to remain relevant in case the economy is hit by recessionary shocks, requiring a return to the ZLB. The September Fed minutes noted that "the recent Survey of Primary Dealers placed considerable odds on the federal funds rate returning to the [ZLB] during the two years following the initial increase in that rate." Indeed, as implied by our "yo-yo years" thesis resulting from the decline in trend growth, and as Fed Chairman Janet Yellen acknowledged last July, "we will have to worry about these episodes more often."

The key reasons for falling trend growth include demographics and productivity growth. These factors, which are hardly transitory, drive potential GDP growth, which depends on the number of hours worked and output per hour of work, i.e., labor productivity. Regarding the former, the Congressional Budget Office (CBO) projects a slowing in potential non-farm business hours by 2024 to 0.64% per year from 1.4% per year from 1949 through 2007, with labor quality exacerbating this demographic slowdown, since new labor market cohorts are no more educated than retiring cohorts.

Separately, as Alan Blinder recently wrote, while labor productivity growth plummeted to 1.4% in 1973-95 – "the worst in recent history" – after popping up to 2.6% in 1995-2010, "so far in this decade [since 2010], productivity has grown at only half its rate during the productivity slowdown period – our previous standard of poor performance." Moreover, "if productivity crawls along at just 0.7% a year ... potential GDP will grow less than 1% a year," i.e., about the pace of GDP growth seen during Japan's "lost decades" starting in the early 1990s.

Thanks to demographics that are essentially set in stone for many years to come, the sharply slower growth in the potential number of hours worked, as projected by the CBO, is pretty much a given. Meanwhile, as Fed Vice Chairman Stanley Fischer said last month, labor productivity growth is "way, way down," and the U.S. needs to "face the problem." Unless productivity growth reverts to its decades-old historical pace – essentially tripling or quadrupling its pace since the beginning of this decade, it is hard to see how the economy could see sustained GDP growth near 3% in the years ahead.

This implies repeated returns to the ZLB, which is why the Fed badly needs to get back as soon as possible to "business as usual," i.e., regain the ability to cut rates to stimulate the economy, having essentially exhausted the potential of QE to pull forward growth. In order to do so, of course, they must first raise rates, which they fully intend to do by mid-year, barring unforeseen circumstances including stock market downturns. ■

