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ECONOMIC COMMENT – OCTOBER 21, 2015
BE PREPARED . . .

While we do not see a recession in 2016, we believe that the chances of a downturn have climbed to the vicinity of 35%. As matters now stand, our forecast of real GDP growth in 2016 calls for an increase of about 2%, which would be less than the expected gain of 2.4% in 2015. And the risks to this forecast are, in our view, mainly on the downside.

One reason for our cautious assessment of prospects for the coming year is that there has been a sharp and unexpected slowdown in job growth. During the first seven months of this year, gains in nonfarm payroll employment averaged a robust 214,000 per month. In August, however, the increase fell to 136,000, which was followed by a similar number – 142,000 – in September. To be sure, the monthly statistics on employment are often very volatile and it would be premature to conclude that a continued decline in job growth is likely over the coming months. That said, a number of other economic statistics are signaling a significant growth slowdown from the annualized rate of 3.9% reported in the second quarter of this year.

To start with, manufacturing output has been essentially flat since the fourth quarter of 2014. In September of this year, output was only 1.4% ahead of a year earlier. One consequence of this near stagnant pattern of production has been a lack of new jobs in the manufacturing sector. As a matter of fact, employment in manufacturing fell by 18,000 and 9,000 in August and September, respectively. Moreover, according to recent surveys of manufacturing firms in different parts of the country, the near-term outlook for output and employment is one of continued weakness rather than renewed strength.

In addition to the slowdown in manufacturing activity, the latest statistics on retail sales are, in our judgment, indicative of a generally lackluster pace of consumer spending, which, of course, accounts for about 67% of real GDP. During the third quarter of this year, for example, retail sales – excluding automobiles and gasoline – were up a less-than-impressive 3.2% from a year earlier. And in real terms, moreover – after adjusting for price increases – the year-over-year gain is reduced to little more than 1½%. At the same time, discretionary spending – as measured by the GAF[1] category of retail trade – was up less than 2% during this same period of time. In real terms, this gain is estimated at a weak 1% or less. These numbers imply that the widely anticipated boost to consumer spending from falling oil prices has failed to materialize.

One plausible explanation for the sluggish trend of retail trade (ex autos) is the lack of income growth in the private sector of the economy. Thus, in the first nine months of this year, the average weekly earnings of all workers on private nonfarm payrolls were up only 2.4% from the comparable period of 2014. The fact that in real terms earnings are barely ahead of a year ago will, in our view, continue to limit what most consumers are willing – or able – to spend.

Many forecasters, including those at the Federal Reserve, have tended to regard these and other statistics as little more than evidence of a brief pause, which, in their view, is likely to be followed by a significant rebound in overall economic activity. We take a contrary view and see the current expansion, which is now entering its seventh year, as very unlikely to pick up strength and momentum at this relatively late stage of a business cycle expansion.

Bear in mind that the current expansion has already lasted for 75 months, considerably longer than the post-World War II average of 58.4 months. While this is not to suggest that the current expansion will shortly come to an end, it does send a warning signal that slower economic growth might lie ahead in 2016.

Unfortunately, recessions give little, if any, advance notice of their impending arrival. Certainly the record of forecasting economic downturns is not one to generate much in the way of confidence in our ability to predict the next one. Consider, for instance, that in October 2007, just weeks before the worst recession to hit the United States in

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[1] Furniture, home furnishings, electronics and appliances, clothing and accessories, sporting goods, hobby, books and music, general merchandise and office supply, stationery and gift stores.

more than 50 years, the Federal Open Market Committee predicted continued, albeit modest, growth in 2008 and 2009. Thus, the economic projections of Federal Reserve Governors and Reserve Presidents anticipated real GDP growth of between 1.8% and 2.5% in 2008 and a larger gain of between 2.3% and 2.7% in 2009. As we now know, real GDP in 2008 declined 0.3% and fell nearly 3% in 2009. So much for the ability of economists to predict the timing and magnitude of the next recession!

What, if anything, will the Federal Reserve do next? Of late, the Fed has taken the position that an increase in its policy rate – the federal funds rate – can be expected before year end. Perhaps so. But chances are that the economic situation and outlook will look less favorable than it was in September or even earlier. From the standpoint of the Federal Reserve, will the time ever be right to increase interest rates? It often seems as though the Fed will find some reason to avoid moving to a less accommodative policy stance. We agree that an increase in interest rates will not be well received by either the public or the Congress. Nonetheless, we are concerned that the Fed's continuing vacillation and indecisiveness on when to boost interest rates does not bode well for the future stability and smooth functioning of financial markets. One can speculate that the recent rally on Wall Street – which although welcome news to investors – can be attributed, at least in part, to what seems to be the consensus view that the long-awaited increase in interest rates is likely to be delayed until some unspecified date in the future. We shall see!

Norman Robertson