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DIFFERING OPINIONS

In December of 2015, the Federal Reserve raised its policy rate – the federal funds rate – for the first time in almost ten years. Furthermore, the quarter-point increase represented the end of a seven-year period in which the rate was held at near zero. And since the Fed evidently viewed the 2016 economic outlook with considerable optimism, it was widely expected that the Fed would raise the rate by quarterly increments of a quarter percentage point this year. Therefore, the federal funds rate would be in the vicinity of 1½ % by the end of the year 2016. Since that time, however, evidence of a palpable slowdown in global economic growth, notably in China, along with the rise in the dollar – which has curbed the growth of U.S. exports – and a declining trend of equity prices, have raised doubts about the expectation that the four quarter-point hikes in the federal funds rate are likely in 2016. At the same time, moreover, the inflation rate, as measured by the deflator for personal consumption expenditures, has continued to run well below the Fed's target of 2%. Last year, for example, the increase was just 0.3%. And considering the recent slump in oil prices and other commodities, as well as the dollar's continued strength, the inflation rate could well remain below the Fed's target for some months to come.

For the most part, however, the Fed has continued to take a generally upbeat view of prospects for the U.S. economy in 2016. True, Ms. Yellen observed in recent testimony before the House Committee on Financial Services, “Financial conditions in the United States have recently become less supportive of growth, with declines in broad measures of equity prices, higher borrowing rates for riskier borrowers and a further appreciation of the dollar. These developments, if they prove persistent, could weigh on the outlook for economic activity and the labor market, although declines in long-term interest rates and oil prices provide some offset.” Notwithstanding this note of caution, however, the Fed has remained optimistic that, recent advances in employment, along with the steady growth of disposable personal incomes, point to a moderately rising trend of consumer spending – and overall economic activity. In January of this year, nonfarm payroll employment posted an increase of 151,000, down from the average of 231,000 recorded during the preceding three months. But the number was still substantial, especially in the context of an unemployment rate of 4.9%, which corresponded to most definitions of “full employment.” Indeed, since the low point of February 2010, nonfarm payroll employment has recorded an impressive gain of over 13.5 million. At issue is whether these gains in employment, along with a strengthening of wage growth, will generate further significant increases in incomes and spending.

From our perspective, however, there is a less optimistic interpretation of recent economic statistics. Despite reports of a tightening labor market, there has been very little increase in wage growth that is needed to support a steadily rising trend of consumer outlays. In January of this year, weekly earnings of all employees in the private sector posted a year-over-year rise of 2.5%, representing very little change from the modest gains reported in recent months. And after allowing for price increases, the year-on-year real improvement is little more than 1%. One partial explanation for the lack of wage growth is that most of the recent gains in employment were in what are generally regarded as low-wage industries. Thus, in January of this year, some 60% of the overall rise in private payroll employment was in such industries as retail sales, health care, social assistance and the like.

As might be expected, there are marked disparities in income growth between different sectors of the economy. In January 2016, the largest year-over-year increases in earnings were in the service-producing industries, notably, utilities, information and financial activities, all of which reported year-over-year increases in average weekly earnings of between 3.5% and 5.3%. In contrast, earnings of workers in the goods-producing sector of the economy posted a meager year-over-year increase of 1.8%, which, after adjusting for price increase, implies little or no improvement in real earnings. What we find troubling is that more significant wage increases are unlikely in light of the dismal performance of productivity, which is the key to long-term economic growth. Last year, for instance, productivity in the nonfarm business sector of the economy posted a miniscule increase of 0.6%, well below the post-World War II average of 2.8%.

Meantime, the marked slowdown in business investment is also becoming something of a drag on overall economic activity. There is no doubt that some part of the recent weakness in business fixed investment can be attributed to the decline in oil prices, which has led companies in the energy sector to announce sizable cutbacks in employment and capital outlays. As one example, the number of U.S. Rotary Rigs in Operation has fallen from a peak of more than 1,600 in October 2014 to the latest reading of 439. And more generally, the fact that new orders for capital goods (nondefense ex aircraft) has declined almost steadily from a yearly rate of $888 billion in late 2014 to less than $792 billion at the end of last year does not bode well for an early strengthening of outlays for business equipment.

Turning to prospects for consumer expenditures, which, as we regularly point out, represent close to 70% of GDP, we believe that the outlook for household earnings is one which suggests very subdued gains over the coming months. However, others clearly disagree as indicated by the front page article of the Wall Street Journal on February 13 headed “Consumers Power Past Headwinds.” True, in January retail sales (ex motor vehicles) and gasoline stations were up a moderate 3.3% from a year earlier. Likewise, the closely watched core retail sales (retail sales ex food services, motor vehicles, building materials and gasoline stations) also posted a similar year-over-year gain of 3.1%, which, in terms of real volume, points to a rise in the neighborhood of 1.5%. On a much less positive note, the GAF category of retail sales, which is a reliable indicator of discretionary spending, registered a barely positive gain of 1.5% above January a year ago. For 2015 as a whole, the year-over-year increase was just 1.6%, which, with the exception of years 2008 and 2009, was the lowest for any year since at least 1992. And over the past 12 months the increase was an even smaller 1.4%. The lack of significant growth in real earnings, combined with a high degree of uncertainty about future prospects for employment and incomes and a reluctance to take on additional debt, are likely to dampen the demand for nonessential goods and services over the immediate months ahead.

At the same time, inventory investment is likely to make a negative contribution to real GDP in 2016. In the third and fourth quarters of last year, inventory investment posted a significant decline from the annualized rate of $113 billion recorded in the second quarter of the year. One can speculate that the cutbacks were needed in light of weaker-than-expected sales activity. Since inventory/sales ratios in many industries still seem high by historic standards, some further realignment between sales and inventories could well lie ahead, especially in view of a generally unsettled outlook for sales and earnings.

For now, our forecast for real GDP growth in 2016 calls for a modest gain of close to 2%. But since we believe that economic activity is losing rather than gaining forward momentum, we believe that the risks to this forecast are on the downside. In our view, moreover, the political climate could be contributing to the uncertainty and uneasiness about prospects for 2016 – and beyond. Arguably, the current popularity of those candidates for the presidency who are advocating radical economic policies that seem out of touch with reality could inhibit business and consumer spending over the coming months. Another concern is that the nervousness in financial markets, if continued, might also have a negative effect on confidence – and spending. Needless to say, it would be folly to predict the impact of this economic scenario on the equity markets. This much, however, can and should be said. While the 10% decline in the S&P 500 Index since the end of last year is undoubtedly worrying to many investors, it needs to be viewed against the background of a 200% advance in the Index during a six-year period ending in May 2015. Quite simply, neither bull nor bear markets last for an indefinite period of time.

Norman Robertson