

CHRONICALLY WEAK INVESTMENT SPENDING REINFORCES OTHER SECULAR FORCES RESTRAINING GROWTH, INFLATION, MONETARY POLICY AND INTEREST RATES

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The Federal Reserve had second thoughts about its plans for interest rates that it proposed in December. At the policy meeting held that month, the central bank raised its benchmark short-term interest rate by .25 percent, the first increase in nearly a decade, and indicated that it would raise it four more times in equal quarter-point increments, most likely starting in March. But as they say, the best-laid plans often go astray. Instead of following up with the second installment, the Fed punted at its March meeting, opting instead to keep rates unchanged for a while longer.

This is not the first time the central bank altered its plans, nor will it be the last. Between December and March, the financial markets were hit with a wave of turbulence that saw stock prices plunge and then recover, the dollar soar and then sink and oil prices swing between \$30 and \$40 a barrel. Meanwhile, global headwinds gathered force: the International Monetary Fund lowered its forecast for global growth, with a major drag coming from the ongoing slowdown in China and a deepening recession in Brazil, and central banks in Japan and Europe continued to grapple with deflationary forces, sending interest rates deeper into negative territory. Fed officials understandably felt it is best to wait a month or two to see how well the economy holds up before deciding on its next move.

The wait will probably be longer than the Fed anticipates. The much-ballyhooed rebound from the fourth quarter's slowdown is looking ever more like a pipe dream. The latest data on consumer spending – the economy's main growth driver—are dismal. Personal consumption expenditures increased by a tepid 0.1 percent in February and the January increase was revised down to 0.1 percent from the previously reported 0.5 percent. Simply put, there may not even be a

'dead-cat' bounce on the horizon. Following the latest PCE numbers the Federal Reserve Bank of Atlanta – which has been spot-on with its GDP Now tracking model – lowered its first-quarter growth rate from 1.4 percent to 0.6 percent, which would be the weakest quarter in two years. Nor does the future look promising. While the erratic behavior of households throughout the recovery renders any forecast dubious at best, one growth-retarding constant has been the reluctance of businesses to step up capital spending. This misfiring cylinder in the economy's growth engine, which shows no sign of righting itself, will continue to impede the Fed's efforts to normalize policy.

Businesses Still Holding Back

Seven years into a recovery, the economy should be operating on all cylinders. Sadly, that's still not the case. Forget for the moment that none of the main growth drivers have been running at speeds normally seen during upturns. Housing activity has finally picked up over the past year or so, but its contribution is coming much later than it normally does during recoveries. What's more, this sector has shrunk so much during the housing bust that its influence on overall growth is greatly reduced. The economy's primary motor, consumer spending, has been on a persistent, if erratic, forward glide path; but it too has been cruising at speeds well below past recovery yardsticks. The government, of course, has been an absentee tailwind for some time, only recently emerging from an austerity mindset that has hobbled growth.

But a critical outlier throughout the recovery has been the business sector. Despite racking up hefty profits until recently, companies spent a much smaller proportion of their cash flow on investments than in past cycles, opting instead to use the funds to repurchase stocks, boost dividends or acquire other companies. Indeed, this has been the only upturn since at least as far back as 1960 that nonfinancial corporations plowed less than 100 percent of their internal cash flow into spending on plant and equipment. On average capital spending equaled 93 percent of cash flow from the start of the recovery in mid-2009 to the end of 2015. The average share over the previous seven upturns was 111 percent.

To be sure, the balance reversed in 2015, with capital spending finally surpassing internal funds. But that was mainly because profits slumped during the year, with a particularly big drag coming from the energy sector. That drag affected the other side of the ledger as well, as investment in oil drilling and exploration also ground to a halt. Still, the resistance to spend was broadly based in both dollars and real terms and the profit squeeze intensified over the last two quarters. Even worse is that the recovery received less of a boost from capital spending over the past year than in the previous one. In 2015, real nonresidential outlays increased by just 2.8 percent, less than half the 6.2 percent gain in 2014. In the fourth quarter, such spending actually declined for the first time since the second quarter of 2012.

Still Too Much Spare Capacity

The weak contribution of business spending to the recovery has been bad enough. But the sputtering out so late in the upturn is even worse, as that is when capital spending usually steps in as the key driver of growth. Underscoring this time-honored role is that late in a recovery, companies tend to be operating at or near full capacity, spurring the need for expansion. Additionally, aging equipment needs to be replaced and software needs to be upgraded with the latest technology to maintain productivity.

But these spurs to spending have not kicked in this time. One reason: the unprecedented plunge in production during the Great Recession left industry with a huge amount of excess capacity. Compounding the problem, the vigorous rebound in activity that usually follows a severe downturn never materialized. Instead, the recovery progressed in fits and starts, with growth averaging about half the pace of previous postwar upturns.

As a result, it has taken longer than usual to whittle down spare capacity. Even now, the capacity utilization rate, at 76.7 percent, is 3.3 percentage points below its long-run average, and even further below the 83-85 percent typical of late-stage expansions, when supply bottlenecks force companies to rev up expansion plans. The shortfall is even more striking considering that private companies are adding to their capital stock at a historically low rate. According to the Commerce Department, net additions to the stock of buildings, equipment and software of private companies have averaged 3.9 percent a year between 2010 and 2014 compared to a 7 percent average since 1960.

CEO's Have a Bleak Outlook

The reluctance of companies to invest in structures, equipment and software has not just deprived the economy of a much-needed cyclical boost. It also deprives workers of more efficient tools of production and, hence, contributes to weaker productivity, the indispensable condition leading to rising living standards over the longer-run. After all, when companies can squeeze more output from the labor force they can afford to give larger pay raises to workers without hurting profits or raising prices. That's a win-win situation for both workers and consumers, who ultimately are the very workers with more cash to spend.

It may be no accident that the historically low additions to capital stock since the Great Recession have coincided with a significant slowdown in productivity. Nor is the stagnant growth in worker pay unrelated to the productivity slowdown. Companies alter the mix of capital and labor to generate output according to the relative costs of these inputs. When labor is cheap, as has been the case during the recovery, it is more cost effective for employers to substitute labor for capital. As the ratio of workers per unit of output increases, productivity suffers. Indeed, the productivity slowdown in recent years helps explain why job growth has been so much stronger than economic growth. More workers were needed to generate each unit of output.

To be sure, the decision of companies to increase capital spending is not just based on relative input costs. If corporate CEOs believe that demand for their products would justify the additional spending, they would gladly open their budgets to avoid losing future sales either through lack of capacity or because of costly and inefficient production methods, which diminishes their ability to compete with rivals. That, of course, is where the rubber meets the road. According to the latest Business Roundtable Survey of leading CEOs, the economy is expected to perform below its potential again this year, suggesting little trouble in meeting demand.

Simply put, companies are not particularly optimistic, and their mood is being backed up by deeds. Just as consumer spending is on track to slow in the first quarter, capital spending is poised to fall even more steeply than it did in last year's fourth quarter. According to the latest report on durable goods, shipments of nondefense capital goods excluding aircraft - a proxy for equipment spending in the GDP accounts - declined by 1.1 percent during the month

following 1.3 percent decline in January. Nor do things look ripe for a turnaround anytime soon. New orders for these same capital goods fell in February for the third time in the past four months. Indeed, new orders and shipments are tracking a path that is more indicative of the onset of a recession than the late stages of an expansion. We doubt the economy is close to such a turning point in the cycle, but the drag from capital spending is clearly an impediment that is clogging the growth engine.

Bull Case for Bonds Firmly Intact

Without the important contribution from capital spending and little help from consumers, it is hard to see the economy's growth engine kicking into a higher gear. It may well be that the cautious mindset of businesses and households echoes the widespread notion that the nation is mired in secular stagnation, a persistent period of subpar growth. While the Fed does not explicitly subscribe to this notion, it has nonetheless downgraded its growth forecast and lowered the path of future interest rate increases it expects over the next few years. Instead of the four rate increases projected in December, Fed officials now expect to raise the federal funds rate only twice this year; what's more, they lowered the longer-run rate expected when the economy returns to normal from 3.5 percent to about 3.25 percent. That's a full percentage point lower than the longer-run rate the Fed expected a few years ago.

The downward adjustment in the policy rate is consistent with the new realities facing policy makers. In past cycles, particularly one as advanced as this one, the Fed would be poised to take wind out of the economy's sails and lean against rising inflationary pressures. Nothing could be further from that confluence happening today. Thanks to domestic structural impediments—including weak productivity and slower labor force growth — persistent global headwinds, including a prospective Grexit, Brexit and a chronic deflation threat, and the existential geopolitical menace associated with repeated terrorist attacks, policymakers are far more concerned about looming downside risks to the economy than upside pressures.

That point was clearly reiterated by Fed Chair Yellen in a recent speech before the Economic Club in which she sounded a much more dovish tone than was conveyed by the FOMC statement following the March 15th-16th policy meeting.

We suspect that even if another step towards policy normalization takes place at the June meeting — which is not a sure thing by any means — the impact on bond yields will be minimal at best. Some are comparing the prospective policy stance with the so-called conundrum that faced Alan Greenspan during the 2004-2006 tightening episode, when long-term interest rates hardly budged in response to a series of federal funds rate hikes. Indeed, the forces that held down bond yields a decade ago are even stronger now. True, the so-called global savings glut, highlighted by China's voracious appetite for Treasury issues, is no longer an issue. But the slowdown in China is pulling down growth throughout the emerging markets as well as in many advanced economies; as well, it is amplifying the deflation in commodities that is contributing to low — even negative — bond yields on a broad array of sovereign debt.

With the IMF repeatedly downgrading global growth and central banks in Japan and Europe struggling to combat recession and deflationary forces, the appeal of the U.S. as the best destination in a deteriorating neighborhood is as strong as ever. Hence, even as China unloads U.S. Treasuries as its reserves plunge, investors in other nations are more than taking up the slack. Not only does a 1.5 to 2.0 percent yield on a 10-year bond look attractive relative to the even slimmer returns abroad, the promise of safety and liquidity is also facilitating the flow of capital to the U.S. markets, reinforcing the flattening yield curve already underway. And with domestic corporate profits plunging 11.5 percent in the fourth quarter from the same period the year earlier — the steepest drop since the fourth quarter of 2008 — and analysts revising down first-quarter estimates for the S&P 500 companies at the fastest pace since 2009, the stock market does not look like a promising alternative to quality bonds.

In short, the U.S. growth engine is still not firing on all cylinders and will be severely constrained by global headwinds for some time to come. While the labor market is cranking out a decent amount of jobs, its impact on growth is being diluted by the ongoing productivity slowdown. Inflationary pressures are nonexistent. Even Fed chair Yellen acknowledges that the recent uptick in key inflation gauges is not likely to be sustained, spurred mainly by transitory spurts in apparel and medical costs. The large pool of available workers outside of the labor force is continuing to put a lid on wage increases, thus capping pressure on prices coming from labor costs. With a sizeable gap between the nation's actual and potential output, demand-pull pressures are not an issue. Simply put, the secular bullish case for bonds remains firmly intact.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	3/31/2015	12/31/2015	3/31/2016	Last Quarter ⁽¹⁾	Last Year ⁽²⁾
6-Mo. Bill	0.11	0.48	0.39	0.08	0.14
2-Yr. Note	0.56	1.05	0.74	0.82	0.72
5-Yr. Note	1.38	1.76	1.22	2.96	2.53
10-Yr. Note	1.93	2.27	1.78	4.79	3.06
30-Yr. Note	2.54	3.02	2.62	8.93	0.40

Municipal Bonds	Yields (%)			Total Return (%)	
	3/31/2015	12/31/2015	3/31/2016	Last Quarter ⁽¹⁾	Last Year ⁽²⁾
ML Rev 22+ Index	2.81	2.85	2.67	2.04	5.20
ML G.O. 22+ Index	2.60	2.66	2.52	2.24	5.37

Equities	Levels			US \$ Terms (%)	
	3/31/2015	12/31/2015	3/31/2016	Last Quarter ⁽¹⁾	Last Year ⁽²⁾
S&P 500	2,067.89	2,043.94	2,059.74	1.34	1.77
DJIA	17,776.12	17,425.00	17,658.00	2.18	2.09
NIKKEI (Tokyo)	19,206.99	19,034.00	16,759.00	-11.23	-11.15

Commodities	US \$			Percent Change (%)	
	3/31/2015	12/31/2015	3/31/2016	Last Quarter ⁽¹⁾	Last Year ⁽²⁾
COMEX Gold Active Monthly	1,183.68	1,060.20	1,234.00	16.39	4.25
CRB Future Com. Pr. Index*	211.86	176.14	170.52	-3.19	-19.51
West Texas Intermediate Crude (\$ per bbl)	47.60	37.04	38.34	3.51	-19.45

Currencies	Levels			Percent Change (%)	
	3/31/2015	12/31/2015	3/31/2016	Last Quarter ⁽¹⁾	Last Year ⁽²⁾
Yen	120.13	120.22	112.57	6.36	6.29
Sterling	1.48	1.47	1.43	-2.55	-3.09
Euro	1.07	1.09	1.13	4.77	6.05

Foreign Bond Markets	Levels			US \$ Total Return (%)	
	3/31/2015	12/31/2015	3/31/2016	Last Quarter ⁽¹⁾	Last Year ⁽²⁾
3-Mo. LIBOR DEM Fixing ⁽³⁾	0.01	-0.09	-0.28	N/A	N/A
ML German 10-Yr.+ Bond Index	0.47	1.20	0.58	9.98	-1.23
3-Mo. LIBOR Yen Fixing ⁽³⁾	0.10	0.08	-0.01	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.89	0.78	0.29	9.85	13.62

Source: Bloomberg Financial Data

Notes: ¹⁾ 3/31/2015 thru 12/31/2015 ²⁾ 3/31/2015 thru 3/31/2016

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

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