Smith Affiliated Capital

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DEFLATION PRESSURES CREATING A BRICK WALL FOR MONETARY POLICY

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Market participants retain an unhealthy fixation on the timing of the Fed's presumed rate liftoff and the speed with which rates are expected to rise next year. However, they are obsessing over a forest that has no trees. They have either lost sight or choose to willfully ignore Chairwoman Yellen's repeated assertion that any policy moves will be data dependent. Any sensible observer that has a grasp of recent history as well as a realistic perception of incoming data will view this herd-like obsession with a jaundiced eye.

The economy delivered a solid growth performance in the second quarter, surging by an upwardly revised 4.6 percent annual rate. However, that followed a sizeable first-quarter contraction, resulting in an average growth rate of just over 1 percent over the first half of the year. It also appears that the third quarter's performance will not be too shabby, registering a growth rate of approximately 3 percent. It would be premature to wax ebullient over this performance or to believe that decent back-to-back quarterly growth rates bring the economy anywhere near its output potential. On three occasions since the Great Recession ended, the economy delivered an average growth rate of at least 3 percent over two consecutive quarters, only to lose momentum in subsequent quarters. Given the erratic pattern that has been the hallmark of this lackluster recovery – and the array of headwinds still buffeting the economy – it would take a leap of faith to presume that the spring/summer rebound in activity will be sustained later this year and into 2015.

For the past several years, Fed critics have been warning that the central bank's easy policy is sowing the seeds of disaster, foreshadowing an inflationary outbreak and surging interest rates. Time and again, they have been wrong on all counts, although they continue to cry wolf. While the venerable Milton Friedman and his followers firmly believe that inflation is "always and everywhere a monetary phenomenon", there is little evidence that such is the case now. Most of the massive volume of liquidity pumped into the banking system by the Fed over the past five years resides on bank balance sheets as excess reserves, not morphing into the loans that would spur inflationary spending. It remains to be seen if the Fed has the will and ability to sop up these reserves without disrupting the markets when the time is appropriate. But the pressure to tighten policy is far from evident now and we suspect that neither the economy nor inflation will justify such a move between now and 3Q2015.

Wide Output Gap

The 4.6 percent growth rate during the second quarter boosted real GDP by $180 billion and generated 800 thousand jobs. Normally, increases of that magnitude five years into a recovery would put pressure on the labor and product markets, driving up wages and prices. However, the economy is in a much different place than it would normally be at such an advanced stage of a recovery. Thanks to the deep losses in output, jobs during the Great Recession and lackluster recovery that has since unfolded; the economy is still well behind where it should be if it were operating up to its full potential. Indeed, at no other time since the 1930s has there been so much of an output gap as there has been over the past five years.

At the end of the second quarter, the economy was still producing approximately $750 billion less than what the Congressional Budget Office (CBO) estimates it is capable of turning out, a shortfall of 4.5 percent. That's a tad narrower than the shortfall five years ago when the recovery first got underway. The narrowing has occurred not because the economy's growth engine revved up, but because its growth potential slowed down. According to the CBO, the potential annual growth rate downshifted to 1.8 percent over the past five years from nearly 3.0 percent in the 10 years prior to the onset of the recession in 2007. Although the economy has increased by a subpar annual rate of 2.2 percent since the end of the recession – about half the average rate of postwar upturns – that is still faster than its diminished growth potential. Simply put, whatever inroads have been made in reducing slack in the product market has occurred primarily because the economy's output capacity is shrinking, reflecting slower productivity and labor force growth.

While the output gap has narrowed for dubious reasons, the $750 billion shortfall is still painfully high. One reason for the persistent gap is that the Great Recession caused a historic plunge in industrial output that left the nation's producers with a huge amount of spare capacity. After running over 80 percent of capacity in the three years prior to the recession, the massive drop in global demand in 2008 reduced the industrial utilization rate to 69.3 percent, the lowest on record. With so much unused plant and equipment, companies had little incentive to add to capacity, resulting in five years of underinvestment. That incentive is still missing, as the utilization rate for all industry in August remained more than 1 percentage point below its long-run average. In good part, the secular productivity slowdown now underway is linked to the weak recovery in capital spending.

Labor Force Slack Holding Back Wages

The modest reduction in labor force slack in recent years is as much an artifact of slowing labor force growth as to the increase in employment. True, a good part of the slowdown – perhaps as much as one-half – can be attributed to demographic factors, such as a natural increase in retirements associated with an aging population, but millions of workers dropped out of the labor force because they were dismayed by persistently dismal job prospects. Many, if not most, of these discouraged workers would have resumed their job search if the demand for workers were stronger.

Admittedly, the extent of slack in the labor market is subject to wide disagreements as various measures provide differing results. But even with the respectable increase in nonfarm payrolls this year – including the 248 thousand increase in September -- it is hard to refute the notion that a huge oversupply of labor relative to the demand for workers still persists. If that were not so, the pace of job growth and decline in the official unemployment rate would have translated into bigger paychecks for workers. But that has hardly been the case. The year-over-year increase in average hourly earnings has been stuck at around 2 percent in each of the past five years and shows no sign of picking up. Indeed, buried in the otherwise headline-positive September jobs report was the fact that hourly earnings were flat during the month. It may well be that this seemingly intractable trend is the result of "pent-up wage deflation" as Fed Chairwoman Yellen alluded to in her recent Jackson Hole presentation. Simply put, companies are slow to increase wages because they did not cut them as much as they should have during the Great Recession. But until this stickiness comes to an end, workers will lack the earnings firepower that would propel consumption onto a much faster growth track.

The feeble increase in worker pay has underscored a decline in real household income over the past five years. Not only has inflation-adjusted median income for all households on average fallen by $4.5 thousand since 2007, all income and demographic segments except the very wealthiest have suffered declines. Nor does the increase in net worth to record highs change that dynamic. As documented by the Federal Reserve's latest Survey of Consumer Finances, virtually all of the increase has accrued to the top 1 percent of households, which have been the prime beneficiaries of the five-year stock and bond market rally. So the vast majority of consumers are still struggling to maintain living standards, hardly a recipe for a sustained improvement in spending.

Deflationary Forces Still Powerful

Notwithstanding the generally upbeat data on the U.S. economy over the spring and summer months, the deflationary forces seeded by the Great Recession continues to flourish on a global scale. New reports confirm that an expanding list of countries are having a rough time staying afloat. The Euro Zone, already stuck in the mud during the second quarter, seems to be sinking further. Even the region's powerhouse, Germany, is feeling the pain, as manufacturing activity contracted in August. Deflation is not just a threat, but a reality in many parts of the currency bloc. While the annual inflation rate for the entire region slipped to a five-year low of 0.3 percent in August, several members are experiencing outright price declines. Likewise, Japan, which has never really emerged from a decades-long deflationary grip, is once again suffering a setback in activity, partly in response to an ill-advised tax increase put into effect in April. The looming collapse of a property bubble in China threatens to amplify an already slowing economy, even as that nation copes with a public-relations disaster emanating from street protests in Hong Kong.

Time will tell if the headwinds from abroad eventually inflict meaningful damage on the U.S. economy. Thus far, the main impact has been on the dollar, as the relative strength of the U.S. economy versus the rest of the world has caused the greenback to soar on the foreign exchange markets. That trend poses a threat to U.S. exports and lowers prices on imports, reinforcing disinflationary pressures that are already well entrenched. The personal consumption deflator was unchanged in August and stood only 1.5 percent above its year-earlier level, the 28th consecutive month that the Fed's preferred inflation gauge came in under its 2 percent target. With labor costs stagnant, it is hard to see where upward pressure on inflation will come from.

The hawks continue to maintain that with job growth picking up this year, it is only a matter of time before wages pick up and spark higher inflation. But most of the employment gains have been in lower-paying industries, such as leisure and hospitality and retail, where a large fraction of employees work for hourly wages and receive little or no benefits. In manufacturing, the traditional source of middle-income wages, payroll growth has slowed dramatically in recent months, which might be an early indication of the surging dollar's impact. What's more, despite the hoopla over how total employment has surpassed pre-recession levels, the fact is that in 29 of 50 states payrolls are still below where they were in 2007. Simply put, labor mobility has been reduced not just because millions of households are stuck in place with underwater mortgages, but because jobs are lousy everywhere, so there is little incentive for workers to travel in search of a better paycheck.

Gravitational Pull of U.S. Markets and Fed Patience will Limit Rate Increase

Just as the hawks have been wrong in their inflation forecasts, so too are their dire predictions that interest rates are poised to surge. Recall the erroneous claims made when QE2 ended in June 2011; instead of spiking, the 10-year Treasury yield plunged from 3.2 percent to 1.50 percent over the next year. It's doubtful that a similar move will occur following the end of the bond-purchase program this month. But fears that the absence of Fed purchases will send bond yields higher are misplaced. For one, the void will easily be filled by foreign and domestic sources. Not only is the U.S. Treasury market the prime safe haven for funds in a global market buffeted by geopolitical and economic turmoil; it also offers a higher interest rate than the sovereign debt of any developed nation including Italy and Spain. What's more, the demand for safe assets is increasing exponentially, especially among developing nations. According to the IMF, developing countries account for 39 percent of world output, up from 21 percent a decade ago. However, their financial markets are far too immature to accommodate the increase in savings associated with that growth, making U.S. Treasuries a natural destination for these funds.

And while the termination of QE3 is set in stone, the timing of the first rate increase is very much up in the air. The consensus among Fed officials at the September FOMC meeting was that lift-off will probably occur around the middle of 2015. More recently, the hawks on the Fed have become more vocal in calling for an earlier lift-off date, drawing encouragement from the headline strength in some key economic indicators. Leaving aside the likelihood of another setback that has been the hallmark of the recovery, the Federal Open Market Committee will be less receptive to a tightening move next year than now. That's because the roster of voting members is set to undergo some substantial changes. Three of the hawks on the current committee – Charles Plosser (Philadelphia), Loretta Mester (Cleveland) and Richard Fisher (Dallas) will be nonvoters or retiring by the spring, which is the earliest that a rate hike is anticipated. They will be replaced by three doves: Charles Evans (Chicago), Dennis Lockhart (Atlanta) and John Williams (San Francisco). The only die-hard hawk in the group will be Jeffrey Lacker (Richmond), who will be greatly outnumbered.

Fed Chairwoman Yellen, of course, is the reigning dove on the FOMC, and she has steadfastly preached patience regarding a tightening move, recalling the "false dawns" that have misguided policy decisions in recent years. Time will tell if the recent strength in some key indicators is another such episode. But even if the modest pick-up in activity is sustained, it will take a while before the slack in the product and labor markets is used up. It's worth noting that the inflation hawks are not seeing confirmation in the financial markets, as the 10-year TIPS expected inflation rate has dropped 36 basis points since July 31 to 1.93%, the lowest since June 24, 2013. Simply put, global deflationary forces combined with surging demand for a dwindling supply of safe assets that offer relatively high real returns will keep a firm underpinning in the bond market over the foreseeable future.

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	9/30/2013	6/30/2014	9/30/2014	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.03	0.06	0.04	0.01	0.06
2-Yr. Note	0.32	0.46	0.59	0.04	0.56
5-Yr. Note	1.38	1.63	1.78	-1.19	0.81
10-Yr. Note	2.61	2.53	2.51	0.75	4.32
30-Yr. Note	3.69	3.36	3.21	3.33	13.37

Municipal Bonds	Yields (%)			Total Return (%)	
	9/30/2013	6/30/2014	9/30/2014	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	4.80	3.57	3.14	2.47	12.98
ML G.O. 22+ Index	4.66	3.25	2.94	2.56	15.13

Equities	Levels			US $ Terms (%)	
	9/30/2013	6/30/2014	9/30/2014	Last Quarter (1)	Last Year (2)
S&P 500	1,681.55	1,960.23	1,972.29	1.13	19.96
DJIA	15,129.67	16,826.60	17,042.90	1.87	15.25
NIKKEI (Tokyo)	14,455.80	15,162.10	16,173.52	7.27	13.65

Commodities	US $			Percent Change (%)	
	9/30/2013	6/30/2014	9/30/2014	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,328.94	1,327.33	1,210.50	-8.80	-8.91
CRB Future Com. Pr. Index*	285.54	308.22	278.55	-9.63	-2.45
West Texas Intermediate Crude ($ per bbl)	102.33	105.37	91.16	-13.49	-10.92

Currencies	Levels			Percent Change (%)	
	9/30/2013	6/30/2014	9/30/2014	Last Quarter (1)	Last Year (2)
Yen	98.27	101.33	109.65	-8.21	-11.58
Sterling	1.62	1.71	1.62	5.14	-0.25
Euro	1.35	1.37	1.26	7.75	6.62

Foreign Bond Markets	Levels			US $ Total Return (%)	
	9/30/2013	6/30/2014	9/30/2014	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	0.16	0.18	0.16	N/A	N/A
ML German 10-Yr.+ Bond Index	2.41	1.97	1.61	5.81	15.28
3-Mo. LIBOR Yen Fixing (3)	0.15	0.13	0.12	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	1.29	1.16	1.10	1.43	5.16

Source: Bloomberg Financial Data

Notes: 1) 6/30/2014 thru 09/30/2014 2) 9/30/2013 thru 9/30/2014

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

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