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An Arduous Anabasis to the November Election

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Weak Productivity, Slowing Labor Force Growth Underpins Secular Stagnation, Rendering Central Bank Policies Impotent to Deal with Deflationary Headwinds and Looming Financial Crisis.

With the economy struggling to grow at a measly 1 percent pace over the past three quarters – the weakest for such a stretch since the end of the Great Recession – it may be appropriate to ask if the seven-year old recovery is running on fumes. Economists are notorious for not being able to forecast a recession and, true to form, very few see any on the horizon this time. But the disappointments are piling up, including, most recently, the unexpected weakness revealed in the second-quarter GDP report. Most forecasters were looking for a solid rebound from the previous two quarters, each of which posted growth rates of less than 1%. Instead, the second quarter turned out to be not much better, as GDP increased by a 1.4% annual rate, far less than the 2.5% consensus estimate.

Nor was it just the headline growth rate that provided grim news. Some of the underlying details of the report were just as disappointing. Business investment in capital equipment contracted for the third consecutive quarter, something that hasn't happened since the recession. Just as disconcerting, residential outlays declined for the first time in over two years. It's rare for both capital spending and residential outlays to fall together outside of a recession; indeed, a contraction in residential activity is, by itself, a time-honored leading indicator of a recession. That said, the consensus of economists as well as policy makers are nothing if not consistent in their conviction that this time it will be different. Once again, the prevailing view is that the economy is poised for a meaningful rebound, setting the stage for higher inflation, interest rates and stock prices, fueled by rebounding profits.

From our perspective, the current quarter will prove to be another head fake that will force the perennial optimists to kick their encouraging forecasts down the road again. Indeed, respected economists are already backtracking somewhat. The Atlanta Federal Reserve Bank's widely followed GDP Now model just lowered its third quarter growth estimate for GDP to 2.2%. That's the sixth downward adjustment in less than a month; on September 2nd, the model was tracking a growth rate of 3.5%. The lowered estimate, of course, follows a string of disappointing economic reports on retail sales, industrial production and residential construction for August. We suspect that September will not turn out to be much better, if only because of the growth dampening impact of election uncertainty. To be sure, presidential elections always bring with them heightened uncertainty, but the degree of angst this time is particularly high, reflecting elevated ex-ante uncertainty (who will win) and ex-post uncertainty (what policies will be proposed).

Producing Less With More

When the economy emerged from the 2001 recession and, to a lesser extent, the 1990-91 downturn, economists were fretting that the nation was mired in a "jobless recovery". For a while, it appeared that a similar trend was unfolding over the first year or so of the current upturn, as it took a while for the economy's jobs engine to kick in. All three episodes had one thing in common – a burst of productivity early in the recovery that enabled companies to increase output without hiring new workers.

This "dark side" of productivity growth is usually tolerated because it occurs alongside of strengthening economic activity. Now, however, the virtuous circle is spinning much more slowly than in past recoveries. Jobs have been created at a decent clip in recent years, but output growth has been the weakest of the postwar recoveries. As a result, the amount of goods and services produced by each worker has been growing much more slowly than in past upturns. Indeed, the slowdown in worker productivity has occurred

earlier and has been much more dramatic than in past recoveries. Since mid-2009, productivity has increased at an annual rate of 0.9% compared to 2.6% in the 2001-2007 recovery and an average of 2.4% over the previous five recoveries dating back to 1960. And it's getting worse. In the second quarter, labor productivity declined by 0.5%, marking the third consecutive quarterly decline. That's the longest stretch of declining productivity since the late 1970's.

Businesses Retrench

Fed Chairwomen Janet Yellen recently said the extended weakness in productivity was one of the greatest puzzles in the economic picture. To be sure, productivity growth tends to slow at the mature stage of a recovery, when it becomes harder to find qualified workers in a tight labor market and operating capacity is stretched to the limit. At that point, companies usually ramp up investment spending, both to expand capacity and to enhance productivity by giving workers more efficient tools to work with. Not so this time. Instead of spending more, businesses have cut back on capital outlays for three consecutive quarters, the steepest and longest retrenchment since the recession. While most of the decline can be attributed to the energy patch, other industries have not stepped up to the plate. In fact, nonresidential investment spending outside of the energy sector has declined in two of the past three quarters. Hence, instead of the boost to growth typical of a recovery in its later stage, the pullback in investment outlays has been a major drag on GDP, reducing the overall growth rate by about one-third over the past three quarters.

There is a chicken-and-egg quality to the atypical resistance of businesses to increase investment spending. By holding back, it is depriving the recovery of much-needed fuel to grow faster. But the slower growth, in turn, is discouraging businesses from investing more. That's because, despite seven years of recovery, the revival in output has been far too slow to soak up the huge excess capacity created during the Great Recession. In August, for example, the capacity utilization rate for industrial companies stood at 75.5%, fully 4.5 percentage points below the long-term average. To be sure, the capital spending slump is only one of several possible factors contributing to the persistent productivity slowdown. There is also the argument that productivity is not benefiting as much from current technology as in the past. Some experts believe that the latest most important Innovation – the Internet – is less transformative than earlier inventions, such as indoor plumbing, electricity and the internal combustion engine.

In all likelihood, the productivity weakness reflects some combination of the above as well as others that are not easily identified. But one thing is certain: the economy has little chance of pulling out of the slow-growth syndrome unless productivity picks up. Keep in mind that the economy's growth potential is determined by the increase in the labor force combined with productivity growth. Both have slowed dramatically over the past decade, spurring policy makers to lower their long-run growth expectations for the economy. The diminished growth potential, in turn, underpins the notion that the U.S. is stuck in the quicksand of secular stagnation, a stubbornly slow-growth economy that underpins the sustained disinflationary forces and handicaps the Federal Reserve from normalizing monetary policy.

The Economy's Not Ready for a Rate Hike

At its latest meeting on September 20-21 the FOMC, as expected, kept interest rates unchanged. The primary reason the Fed stood pat was the conviction as expressed by Yellen "that the economy has a little more room to run than might have been previously thought." The slower growth in the labor force is central to that assessment. At a low 4.9%, the unemployment rate is currently close to what has historically been viewed as consistent with a fully employed economy. But the swift decline in the rate from an elevated 10% peak in 2009 reflects in good part the decline in the labor force participation rate, which, in turn, has contributed importantly to the slowdown in the growth of the labor force.

While Yellen is pleased with the current pace of job growth, she is implicitly refuting the notion that it will spark an upsurge in wage-price inflation that some of the Fed hawks believe is an imminent threat. In her view, the job market still has "room to run" by luring some of the army of workers, that have dropped out of the labor force, off of the sidelines. In other words, there is still slack in the labor force, notwithstanding the low unemployment rate, which is putting a lid on wage pressures. Indeed, wage increases, as measured by average hourly earnings for all workers, have been generally steady since late last year. What's more, the broader underemployment rate, which includes part time

workers who would prefer full time jobs as well as unemployed workers who have not searched for a job but would like one, still stands at a relatively high 9.7%, more than a full percentage point above the pre-recession level.

In our view, Yellen still seems more concerned about a premature rate increase that would curb growth than in falling behind the curve in combating inflation. It is hard to believe that the economy is strong enough to withstand higher rates. The profit recession underway for the past four quarters is already squeezing corporate debt-servicing capacity and banks, which have less tolerance for risk, are already tightening lending standards on C&I loans according to the Fed's latest bank lending survey. Auto financing rates would be the first to respond to higher short-term rates, which would sap sales of cars and trucks, the biggest driver of consumer spending in recent years. If consumer spending falters, the recovery's end game would be sight as sagging demand would almost certainly push business investment further into a deep hole.

The more interesting development at the latest FOMC meeting was the downward adjustment in the longer-run rate forecast adopted by the committee. Simply put, the central bank now expects that future rate increases will be even more gradual than previously thought, slicing a half-percent from the projected federal funds rate in both 2017 and 2018 from the forecast made in June. The downward adjustment, in turn, was taken in response to the lowered long-run growth potential of the U.S. economy, reflecting the aforementioned slower growth in productivity and the labor force. But it is also emblematic of the Fed's persistent tendency to overstate growth prospects, which is increasingly undercutting its credibility.

The Fed is in a Straitjacket

While the Fed still hopes to pull the rate trigger before the end of the year, if only to redeem some of its lost credibility, it can only hope that a quarter-point hike in the fed funds rate won't derail the recovery. Its bigger challenge though is to provide convincing evidence that the years long ultra-easy policy, including several rounds of QE, has done anything to stimulate growth. The dismal track record not only of the Fed but also of its central bank colleagues overseas, clearly proves otherwise. The only visible accomplishment of the massive volume of global liquidity created is that it has artificially inflated asset prices, setting the stage for another severe crisis when the first steps towards normalizing policies are taken.

Instead of stimulating growth, rock bottom rates– including the proliferation of negative rates – are generating huge losses at financial institutions – pension funds, insurance companies and banks – sowing the seeds of another wave of bailouts that will shatter trust in the institutional framework and choke off credit availability. The Deutsche Bank fiasco now unfolding is only the most visible of the prospective disasters that loom ahead. Meanwhile, strenuous efforts to combat a global deflationary spiral – including Japan's latest strategy of pegging 10 year rates at zero – are having just the opposite effect. Households and businesses view these policies as a sign of desperation that will ultimately fail, prompting them to hold back spending until prices fall further.

We suspect that even a modest rebound in growth will spur the Fed to lift rates by a quarter-point in December in deference to the three hawks on the FOMC who dissented at the September meeting as well to justify the persistent – if misguided – claims by Chair Yellen that the "case for a rate increase has strengthened." If so, it would be another one and done affair, as the global headwinds – secular stagnation, deflation and financial turmoil – will push policy makers to the sidelines again. What's more, the case for policy inaction next year becomes even more evident because of the changing composition of the FOMC. All three of the hawkish dissenters at the September meeting will be replaced by regional bank presidents that are on average more dovish than their predecessors.

But as noted, it will take more than sustained dovish monetary policies to stimulate growth. While the presidential candidates are talking the good game about how their plans would invigorate the American economy, the likelihood is the elections will produce another split verdict on Capitol Hill that will lead to at least another year of gridlock. What's more, both candidates are espousing restrictive trade legislation, which in the view of most economists, would do more to curb than stimulate growth. Given this domestic and global backdrop, we suspect that investors will increasingly turn to defensive safe assets, gold and high-quality bonds, over the next year, and central banks will once again be forced to follow the markets in policy decisions instead of leading the way.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	9/30/2015	6/30/2016	9/30/2016	Last Quarter [1]	Last Year [2]
6-Mo. Bill	0.07	0.35	0.43	0.13	0.29
2-Yr. Note	0.63	0.58	0.76	-0.13	0.72
5-Yr. Note	1.36	1.00	1.15	-0.38	2.52
10-Yr. Note	2.04	1.47	1.59	-0.75	5.60
30-Yr. Note	2.85	2.29	2.32	0.13	14.53

Municipal Bonds	Yields (%)			Total Return (%)	
	9/30/2015	6/30/2016	9/30/2016	Last Quarter [1]	Last Year [2]
ML Rev 22+ Index	3.12	2.10	2.35	-0.61	8.55
ML G.O. 22+ Index	2.90	2.08	2.20	-1.13	9.39

Equities	Levels			US $ Terms (%)	
	9/30/2015	6/30/2016	9/30/2016	Last Quarter [1]	Last Year [2]
S&P 500	1,920.03	2,098.86	2,168.27	3.85	15.39
DJIA	1,628.47	17,929.99	18,308.15	2.78	15.44
NIKKEI (Tokyo)	17,388.15	15,575.92	16,449.84	6.33	-3.65

Commodities	US $			Percent Change (%)	
	9/30/2015	6/30/2016	9/30/2016	Last Quarter [1]	Last Year [2]
COMEX Gold Active Monthly	1,115.07	1,322.20	1,315.75	-0.49	18.00
CRB Future Com. Pr. Index*	193.76	193.43	186.32	-3.68	-3.84
West Texas Intermediate Crude ($ per bbl)	45.09	48.33	48.24	-0.19	6.99

Currencies	Levels			Percent Change (%)	
	9/30/2015	6/30/2016	9/30/2016	Last Quarter [1]	Last Year [2]
Yen	119.88	103.20	101.35	1.79	15.46
Sterling	1.51	1.33	1.30	-2.55	-14.25
Euro	1.11	1.11	1.12	1.16	0.52

Foreign Bond Markets	Levels			US $ Total Return (%)	
	6/30/2015	3/31/2016	6/30/2016	Last Quarter [1]	Last Year [2]
3-Mo. LIBOR DEM Fixing [3]	-0.08	-0.32	-0.35	N/A	N/A
ML German 10-Yr.+ Bond Index	1.07	0.14	0.18	-0.67	15.60
3-Mo. LIBOR Yen Fixing [3]	0.08	-0.02	-0.02	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	0.90	0.00	0.22	-4.39	14.48

Source: Bloomberg Financial Data

Notes: 1) 6/30/2015 thru 3/31/2016 2)6/30/2015 thru 6/30/2016

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

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