Economics *from* **Washington**

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T 301.365.6395 • F 301.365.2686
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THE CHARTBOOK

- **Economic growth was very weak in Q1 due to a combination of seasonal adjustment issues, weak global demand, a strong dollar, and the decline in oil prices. These factors will be much less important for the remainder of the year. Growth near its 2% trend is likely.**
- **Consumers are still in excellent shape. Income is rising, balance sheets are strong, and confidence is high. Consumption remains the driving force behind economic growth.**
- **Labor markets have tightened enough for employment growth to slow, and wages to rise faster. At present, wages are putting more pressure on profits than inflation.**
- **Inflation is beginning to move higher and could reach the Fed's 2% target by the end of the year. Higher oil prices are one factor, but this could be offset by slower increases in other areas. Inflation is a long way from becoming a problem.**
- **Housing construction is shifting toward a larger share of single family units. Single units have a larger impact on economic growth than multifamily units.**
- **Fiscal policy will be modestly stimulative this year. Congress may have a budget crisis before the end of September, but this will likely be resolved without a major disruption of Government services.**
- **Profit margins are under growing pressure from rising costs. It is not clear how long this will continue, but it will contribute to weak investment for the remainder of the year.**
- **The Fed is not likely to increase the funds rate at the June meeting, but increases later in the year are still probable.**

Economic Outlook

	2014A	2015A	2016F	15:4 A	16:1 A	16:2 F	16:3 F	16:4 F	17:1 F
	(% change, Q4 - Q4)								
GDP	2.5	2.0	1.6	1.4	0.5	1.9	1.9	1.9	2.0
Private Sector Final Demand	3.6	2.8	2.4	2.0	1.2	2.8	2.8	2.7	2.7
Consumption	3.2	2.7	2.4	2.4	1.9	2.8	2.5	2.3	2.3
Fixed Investment	5.5	3.1	2.4	0.4	-1.6	2.3	4.4	4.6	4.4
Business Structures	5.0	-3.5	-1.8	-5.1	-10.6	-2.0	2.0	4.0	5.0
Equipment	5.1	2.5	0.8	-2.1	-8.6	2.5	5.0	5.0	4.0
Intellectual Property	6.5	3.6	3.4	-0.1	1.7	4.0	4.0	4.0	4.0
Residential	5.1	9.4	7.8	10.1	14.9	6.0	5.5	5.0	5.0
Change in Inventories*	68.0	97.5	57.2	78.3	60.9	58.0	55.0	55.0	50.0
Government Purchases	0.4	1.3	1.4	0.7	0.5	1.7	1.5	1.7	1.7
Net Exports*	-442.5	-543.5	-605.3	-551.9	-566.6	-588.9	-618.0	-647.6	-668.5
Exports	2.4	-0.6	0.8	-2.0	-2.6	2.0	2.0	2.0	2.5
Imports	5.4	2.9	4.3	-0.7	0.2	5.0	6.0	6.0	5.0
Interest Rates									
3 Month T Bill	0.0	0.1	0.4	0.1	0.3	0.3	0.5	0.5	0.9
Fed Funds Rate	0.1	0.1	0.4	0.2	0.3	0.3	0.5	0.6	0.8
10 Year Bond	2.5	2.2	2.0	2.2	1.9	2.0	2.1	2.1	2.2
Inflation									
PCE Deflator ex Food & Energy	1.5	1.4	1.8	1.3	2.1	1.5	1.7	1.9	1.9
CPI ex Food & Energy	1.6	2.1	2.1	2.1	2.0	2.0	2.0	2.2	2.2

* Billions of chained 2009 dollars

KEY CONCLUSIONS

ECONOMIC ACTIVITY

GDP increased at a 0.5% annualized rate in the first quarter. Final demand was stronger with a 1.2% increase. While seasonal adjustment problems account for some of the reported weakness, those parts of the economy affected by trade and oil prices are clearly struggling.

Consumer spending rose at a 1.9% pace in Q1. Auto sales have flattened. While consumption is likely to rebound, annual growth will not exceed about 2 ½ % this year.

Business investment continues to be restrained by a decline in the energy sector, but this is reaching its end. Rising costs have begun to squeeze profits, which will be a constraint on other areas. Investment will remain weak.

Residential investment remains quite strong, but the gap between supply and demand for housing is narrowing and the inventory of unsold new homes is creeping higher. Solid growth will continue, but the pace will slow.

Inventory accumulation has declined for three consecutive quarters, and the correction appears to be almost complete. This drag on growth is becoming neutral.

Government spending increased slightly in Q1 and will be stronger for the remainder of the year. Both the Federal and state and local sectors are expected to make small contributions to growth.

The **trade deficit** has become a reliable drag on growth. Although the dollar is below its peak, it remains a very strong currency and global demand is weak.

KEY CONCLUSIONS

GROWTH PROFILE

GDP growth was very slow in 1Q, which was widely expected. Part of this was due to the usual problems of seasonally adjusting first quarter data, but the more important part was because some parts of the economy are struggling. The good news is there has been marginal improvement in some factors that have been a drag on growth.

The goods producing part of the economy has been undergoing an inventory correction. While this may not be totally complete, most of this adjustment is now behind us. In addition, the sharp decline in oil prices early this year caused an additional decline in energy related investment. Energy markets have moved into a much better supply/demand balance and oil prices are well above their bottom. With energy related investment now very low, there is little risk of additional declines. Finally, weak global demand combined with a strong dollar has been a significant drag on exports. While global demand remains weak, the dollar is 5 - 6% below its highs which will be moderately helpful for trade. Reducing and/or eliminating these drags on growth will be helpful for the remainder of the year.

Service related parts of the economy and those dependent primarily on consumer demand have been doing well. Consumers remain in excellent financial condition, employment and income are rising, and savings are relatively high. These parts of the economy will continue to do well, but there is not much upside potential. The current rate of job growth is not sustainable, so it will slow. Whether wage rates will increase enough to compensate is unclear. Nominal income growth may slow.

Residential construction has also been strong and will continue to rise, and the composition is shifting. In the rental market, supply has caught up with demand which is slowing the growth of multifamily units. Single unit construction will continue to edge higher. Single unit construction has a larger impact on GDP and a larger multiplier, so this change in composition is positive for growth.

Business investment has generally been weak, and we expect this to continue. It is helpful that the energy related drag is rapidly diminishing, but profit margins are under pressure from rising costs. With top line growth very moderate, costs rising, and profits and cash flow declining, business will remain very cautious about initiating new investment.

Government fiscal policy has become more stimulative, and this will continue. This is true at both the Federal and state and local levels. There may be a confrontation over the Federal budget before the end of September, but we expect this to be resolved without a major disruption to Government services.

Trade has become a reliable drag on growth and this will continue. Although the dollar is below its peak, it remains a very strong currency and export markets are weak. While the decline in petroleum imports helps to offset weakness in exports, the net deficit has not improved and will remain large.

KEY CONCLUSIONS

THE GREAT AMERICAN SAVER

For many years, there was one thing economic analysts could count on – American consumers spent most of what they earned. While that remains true, consumers have changed since the 2007 - 08 recession – they are saving more. This is true for any given level of wealth, and it does not appear it will revert to the previous pattern any time soon. Since consumer spending is the engine that drives most economic growth, recognizing and adjusting to this change is quite important.

A variety of theories have been put forth to explain why behavior may have shifted, but two are especially plausible in our view. The first, articulated by Bank of England economist Andy Haldane*, has roots in the classic Friedman and Schwartz study of the Great Depression – psychologists call it 'dread risk'. This results when large numbers of people incur large losses at the same time. Catastrophic events cause people to overestimate the probability of these events recurring. There are many illustrations of this, but the most prominent example of an economic dread event was the Great Depression. According to Friedman and Schwartz, "expectations of great instability enhanced the importance attached to accumulating money and other liquid assets." The Asian financial crisis of the late 1990s is another example of an event that caused catastrophic losses for many people at about the same time, and caused a precautionary shift to safe assets. In 2008, US households and companies were running a combined deficit of 2.4% of GDP, but this switched to a 7.2% surplus by 2010 – strong evidence the recession was a dread event which caused a change in behavior.

Dread risk affects demand in two ways. First, it makes consumers cautious about making big ticket spending decisions. They adopt a 'glass half empty' mind set. Second, the response to news is asymmetric. Good news is banked and used to bolster balance sheets; bad news causes an immediate defensive reaction. That savings remains high despite wealth having almost returned to previous peaks, suggests the 'glass half empty' frame of mind continues to dominate.

A second theory relates to a change in expectations about returns on investment. It is well known that long term interest rates have been declining for a very long time. While this trend was in place well before the 2007 - 08 recession, events since have cemented the idea it is not turning around any time soon. Most central banks have continued easing policy, with many pushing rates into negative territory. The Fed projects very low rates for an extended period and they have been forced to continuously extend that period, because forecasts have consistently been overly optimistic.

As a result of this experience, many have lowered expectations about what they may earn on their savings. Those expecting to earn 4 - 6% returns before the recession may be looking at 2 - 4% today. Financial advisors are telling their clients they need to incorporate lower rates of return in their long term planning assumptions. The implications of this shift in expectations are quite clear – more savings are necessary to reach any goal.

* *Stuck* – a speech by Andy Haldane, June 30, 2015.

Key Conclusions

The Great American Saver

The second theory does not contradict the dread risk theory – both may be at work and both point to a long term change in behavior. However, the dread risk effect diminishes over time as the event fades from memory, with more serious events fading more slowly. Low interest rate expectations will only change if interest rates themselves change. It is now seven years since the end of the last recession and saving rates are edging higher rather than lower. The longer this continues, the more it appears expectations of continued low interest rates are outweighing any dread risk effect.

Unfortunately, it may be some time before we will have a high degree of confidence in the reasons for a change in saving behavior, and small revisions in either income or consumption could cause large changes in estimated savings. Nevertheless, savings since the recession have consistently been higher than before and there appears to have been some upward drift in the rate. Interest rates will likely remain low by historical standards for an indefinite period, which will encourage higher savings. In addition, saving rates seem to have become somewhat less sensitive to rising wealth. These facts suggest saving rates will not revert to significantly lower levels in the foreseeable future. The great American consumer is likely to continue saving more than before the last recession.

KEY CONCLUSIONS

MONETARY POLICY

As discussed before, there are important reasons to believe higher interest rates are (in the longer run) in the best interests of the US economy. These reasons have not changed. The issue is the pace at which the Fed moves to reach this goal.

There are two major constraints the Fed must consider in determining monetary policy. The first is financial markets themselves. The market's reaction to the initial 25 bp increase in the funds rate tightened financial conditions more than such a small increase justified. This was probably a reaction to the Fed's stated expectation of four additional increases in 2016. As the Fed backed away from this plan, financial conditions eased significantly. This is an important illustration of how markets can constrain policy.

The other important constraint is the behavior of other central banks. Divergence in interest rate policy has a direct impact on the exchange value of the dollar. As exports have grown in importance for our manufacturing sector and as global financial markets have become more closely linked, the value of dollar has been given a much heavier weight in monetary policy decisions. When other central banks move to ease policy, this puts upward pressure on the dollar, limiting the Fed's ability to tighten policy.

There also continues to be a great deal of uncertainty about the use of relatively new monetary policy tools. The Fed has only recently been managing rates by paying interest on deposits, instead of restricting the supply of reserves. While this has worked as planned so far, experience is still quite limited and the rate increase has been very small. Other central banks are exploring the use of negative rates which has provoked some unexpected responses. Again, experience is limited and they have not pushed very far into negative territory. Central bankers everywhere are cautious about the longer term reliability of these new tools.

In the near term, Fed policy decisions will be influenced more by inflation than by labor markets. Officials believe they have largely met their mandate to achieve maximum employment and expect the unemployment rate to move below their sustainable target rate. Inflation is likely to move higher as recent increases in energy prices work their way into the index numbers, but there are other factors at work. Wage increases have been very moderate, despite tight labor markets and are putting more pressure on profit margins than on prices. At this point, tight labor markets do not pose an inflation threat. In addition, the changing supply/demand balance in rental markets suggests shelter related inflation may slow later this year. This has a very large weight in the price indexes, so smaller increases will offset pressure from other sources. On balance, inflation is edging higher, but not aggressively. There is nothing the Fed needs to rush to get ahead of.

We continue to believe one or two rate increases is the best bet for 2016. Decisions can be made at any meeting – meetings followed by press conferences have no special significance. Because the Fed will need to be opportunistic in choosing when to raise rates, they may not be able to provide much advance notice to markets. We give a slightly better than 50% probability to a rate increase at the July FOMC meeting.

KEY CONCLUSIONS

FISCAL POLICY

Congress has never been very enthusiastic about making fiscal policy in the sense economists use this term, but prior to the mid-1970s, it generally followed the lead of the President. Congress made marginal changes in budget proposals constructed with a great deal of fiscal policy awareness provided by the President's Council of Economic Advisors. This changed when Richard Nixon became president and began proposing a series of spending cuts which Congress would not accept. Each year, Pres. Nixon proposed cuts and Congress boosted the proposed spending level. This disagreement came to a head in 1973 when Pres. Nixon presented a proposed budget containing a multi-page table listing the Government agencies for which he would impound or refuse to spend funds. Congress was infuriated. This set off a fight to wrest control of the budget from the President.

The culmination of this fight was the Budget and Impoundment Control Act of 1974. This law established new budget committees in the House and Senate, created the Congressional Budget Office, established a process for Congress to follow in setting each year's fiscal policy, and prohibited the President from unilaterally refusing to spend funds that had been duly approved and signed into law. This landmark legislation successfully moved budget and fiscal policy determination back into the hands of Congress.

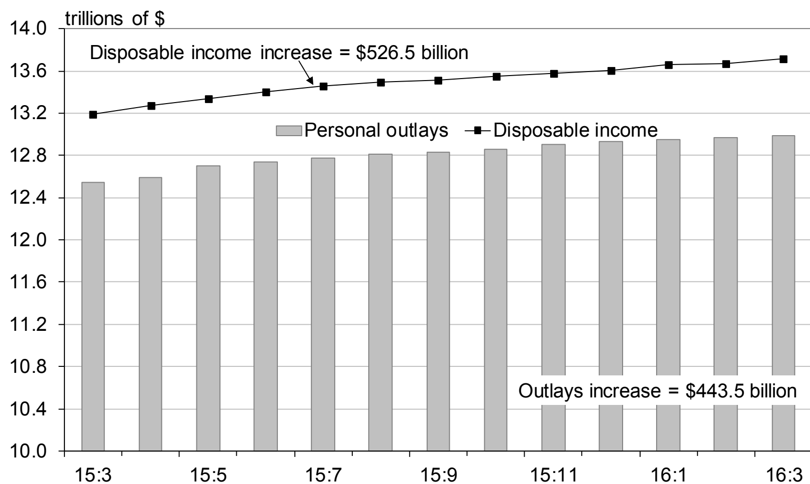
When the budget process was fresh and new, Congress tried it a few times but quickly decided they did not really like following it. Congress is fine making decisions about individual spending programs or making incremental changes in provisions of the tax law, but fiscal policy in the broader context does not interest most members. The procedures set up under the new law quickly fell into disuse.

This year (2016) provides yet another illustration of the dysfunctional budget process. Last December, Congress reached an agreement on spending caps for the 2016 and 2017 budgets. This was an attempt to eliminate budget controversy prior to the 2016 elections. It has failed. First the Senate, then the House, was unable to pass a budget resolution implementing the agreement. On the surface, things look normal. Spending committees are going about the business of hammering out deals on the hundreds of individual items that keep Government functioning. Behind the scenes, leaders are quietly discussing the '1070 number'.

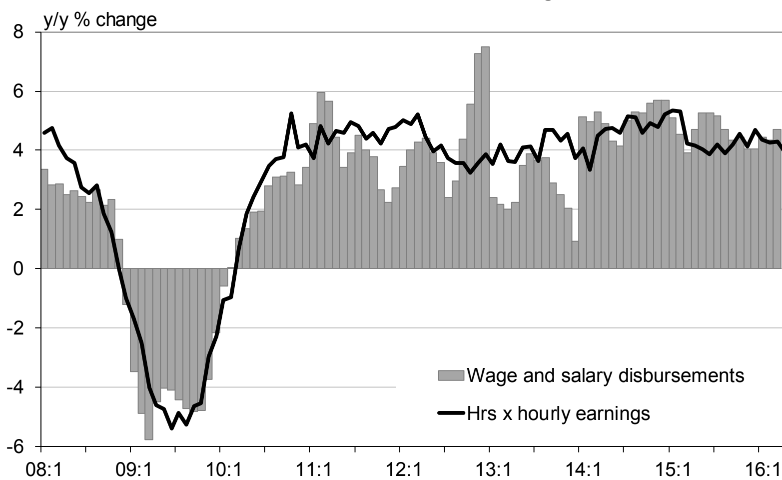
The '1070 number' is the $1070 billion spending cap for the 2017 budget agreed to last year. About three dozen conservatives oppose this spending cap, because it includes an increase of about $30 billion. Of course, Democrats say they cannot accept a penny less, and conservative Republicans who have had to abandon plans to slash spending are now focused on preventing an increase. Without their support, the Republican leadership does not have the votes to pass a budget.

This means the budget train is progressing down a track that dead ends on October 1 when current funding expires. We do not expect Congress to allow this to happen, but there is no alternative in sight at present. The most likely outcome is an extension of the current budget until after the elections when they will try again to reach an agreement. Markets may have become insensitive to threatened Government shutdowns, but caution is appropriate as we move through the summer and this issue comes into sharper focus.

Consumer spending continues to chug along at a reasonable pace. Wages are rising in line with employment indicators and tax collections, so the data is in balance. The changes are in the composition of spending. Auto sales are flat, flowers are out of fashion, and there is a lot of foreign travel.

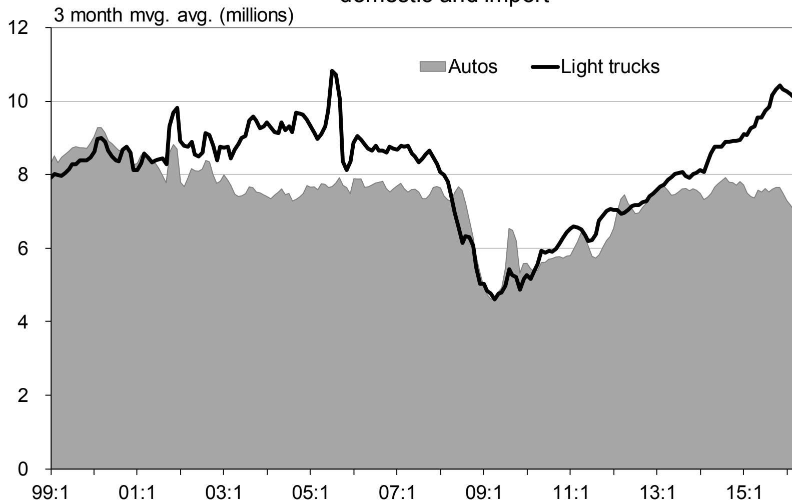


After tax income is consistently rising faster than spending.

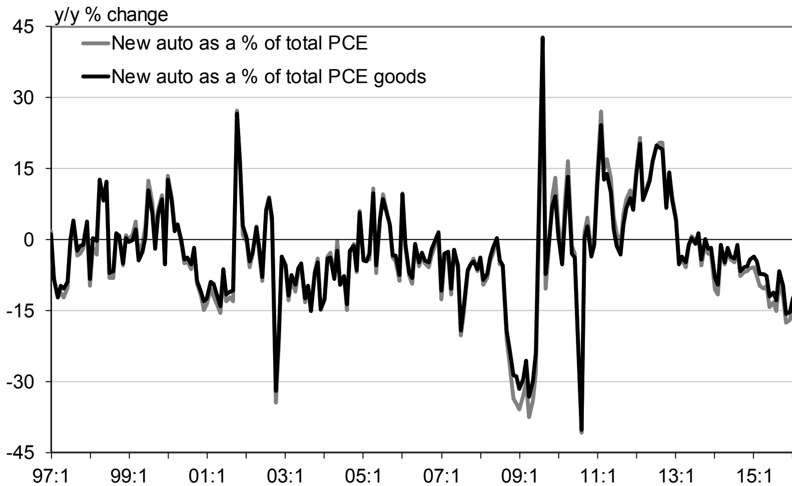


There are no clear anamolies in current data reports. Wages are in line with employment and tax collections.

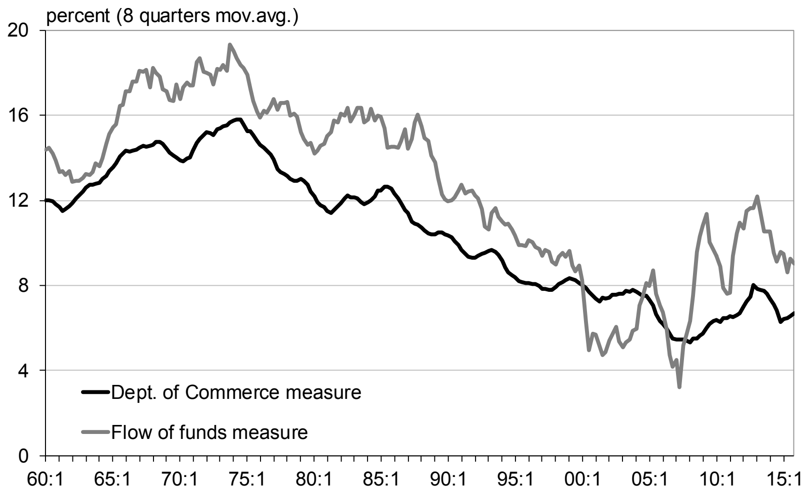
CONSUMER ACTIVITY



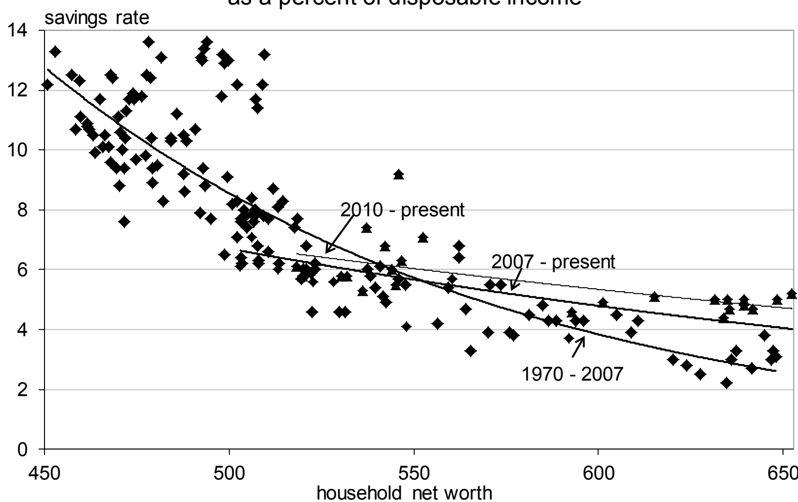
Auto sales remain strong, but they are slightly below the recent peak.



Growth in consumer spending has shifted to other goods and services.

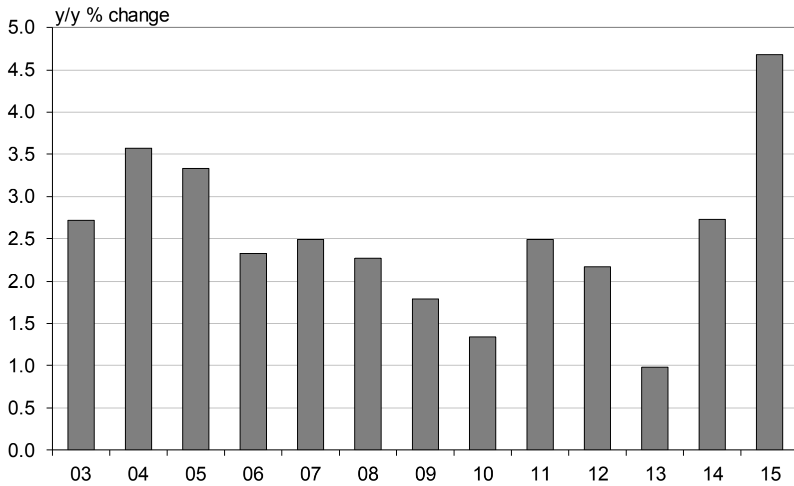


Savings has moved higher since the recession. The BEA measure is very close to the Fed's when adjusted for definitional differences.

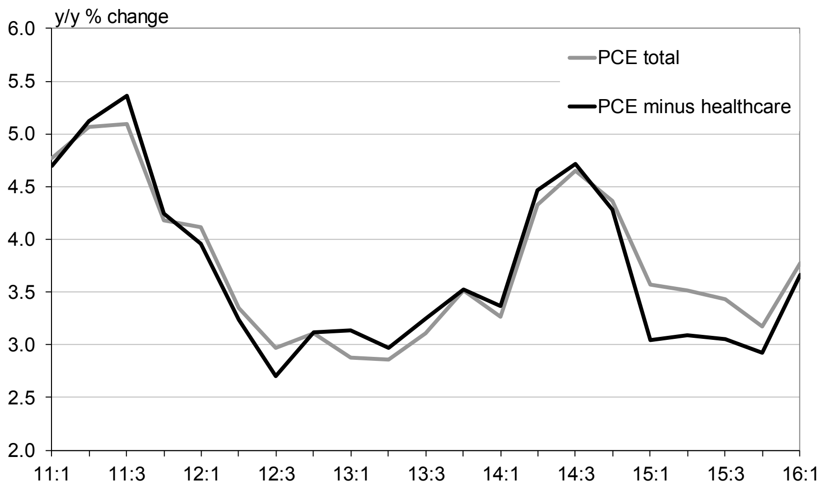


Savings has also become less sensitive to rising wealth. We believe this upward shift will continue.

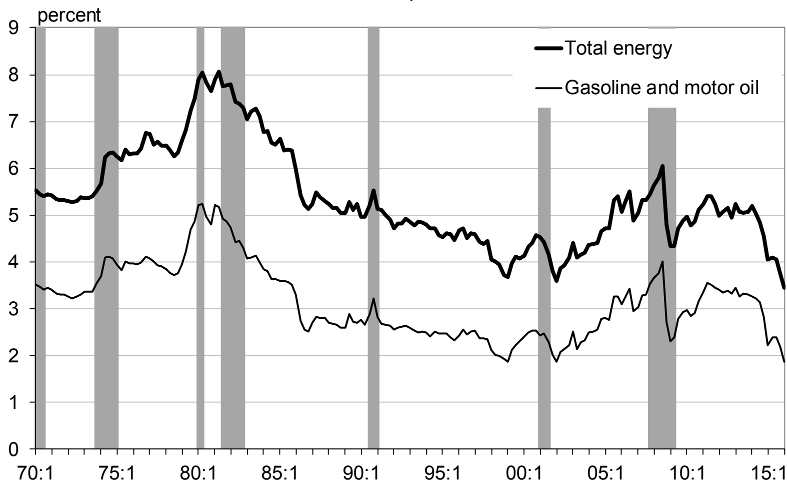
CONSUMER ACTIVITY



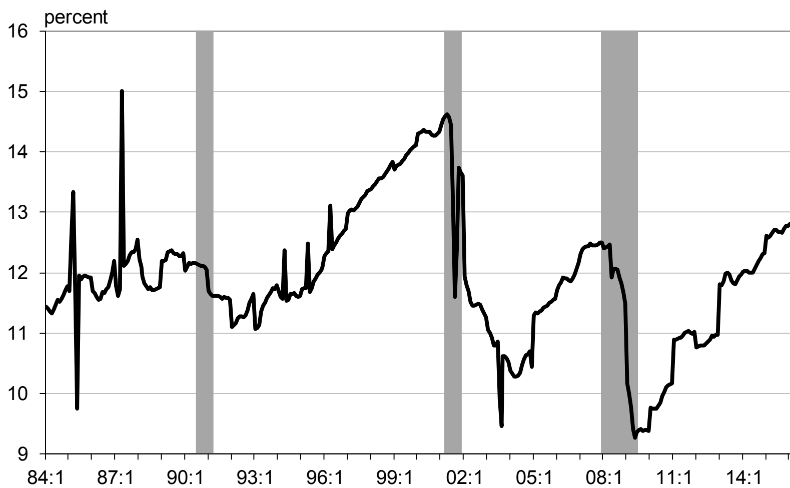
Healthcare spending has grown rapidly for the past two years, due to the expansion in coverage.



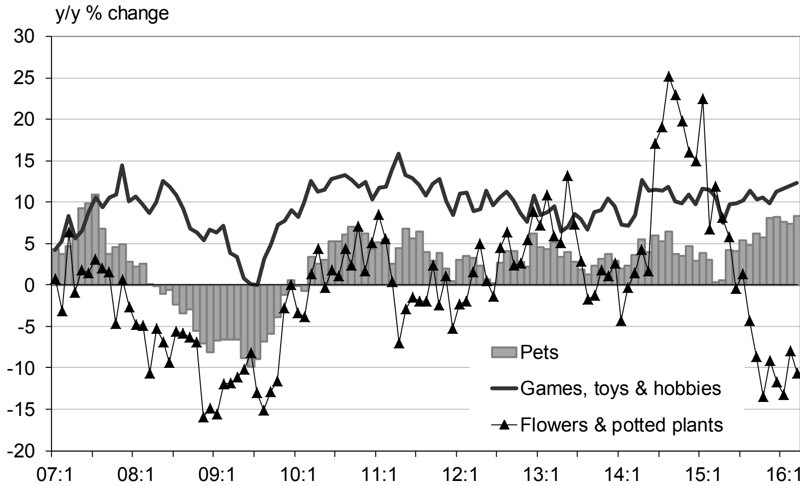
This boosted personal consumption. Additional increases in coverage will be small, so this impact will fade in 2016. Of course, very little of this spending is directly paid for by consumers.



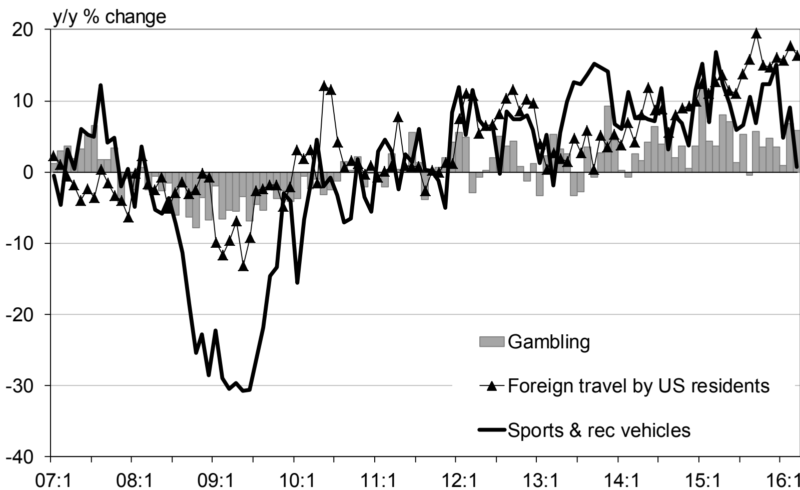
Energy costs are absorbing the least amount of income in decades.



Taxes are now above pre-recession levels.



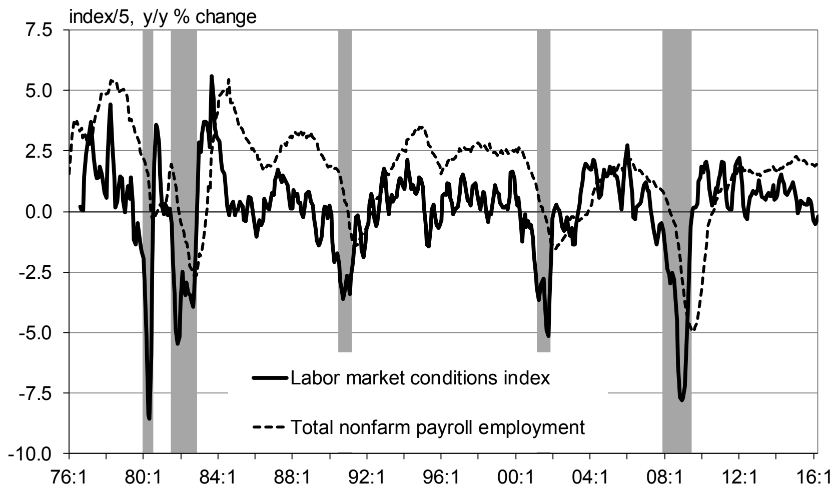
Source: Bureau of Economic Analysis



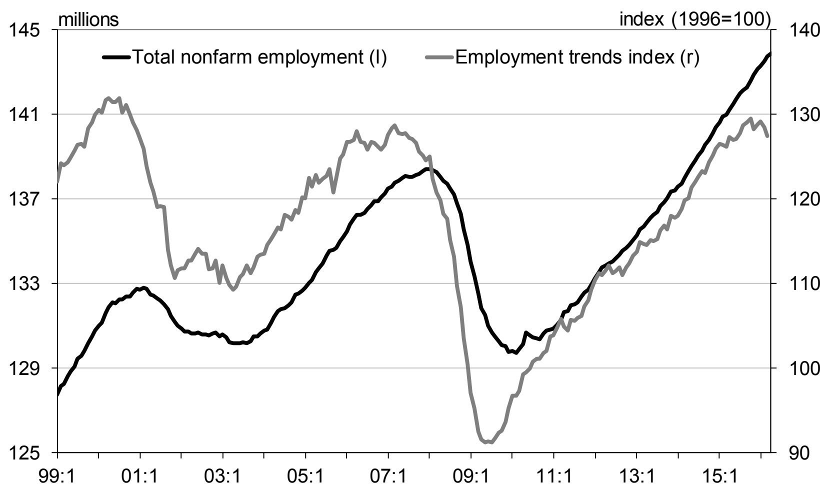
Source: Bureau of Economic Analysis

Discretionary spending has shifted. Games, pets, and foreign travel are strong, but sports and recreational vehicles are flat. Flowers and plants are out of favor.

Employment growth remains strong, but there are more signs it is starting to slow. This is consistent with the economic cycle moving into a mature phase. Unemployment is likely to decline further, causing wage pressure to increase. Markets are tightening at a slower pace.

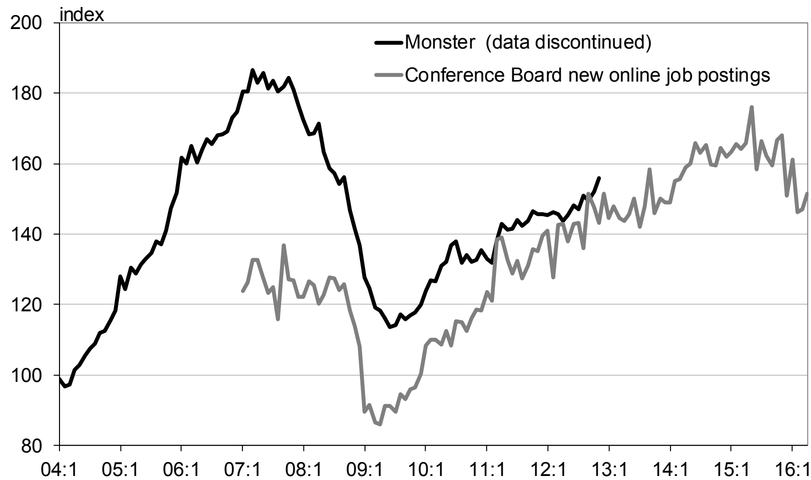


The Fed's Labor Market conditions index is predicting slower job growth in the near future.

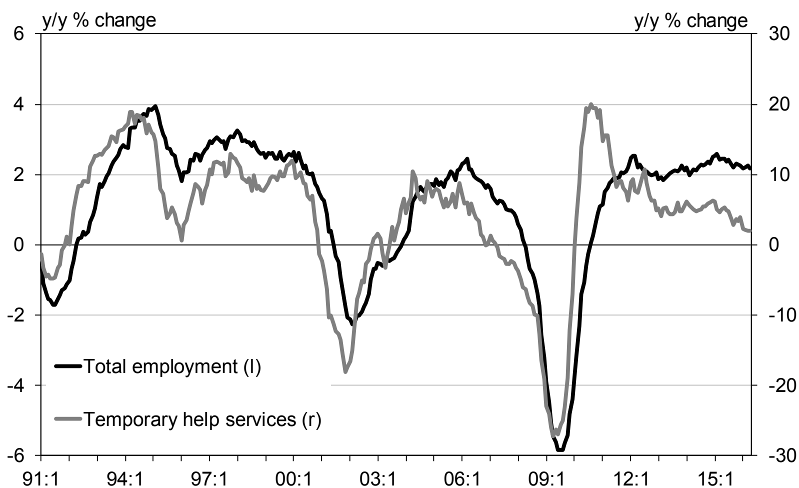


The trends index appears to have reached a peak.

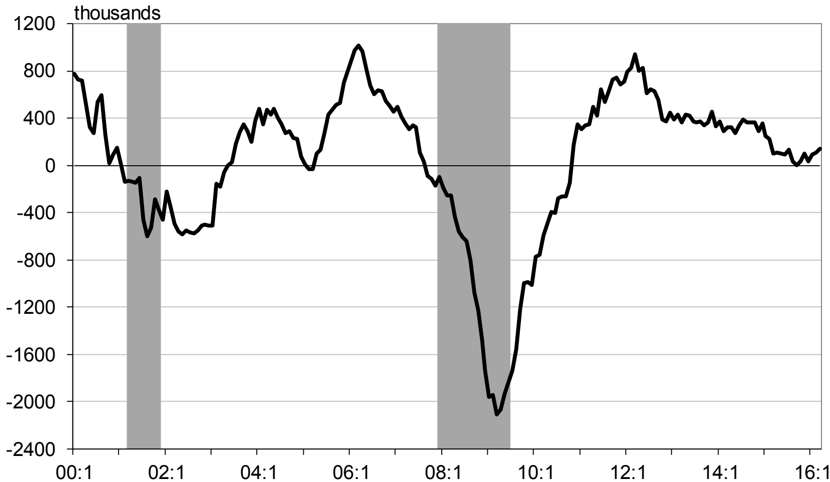
LABOR MARKETS



New online job postings have been declining erratically.

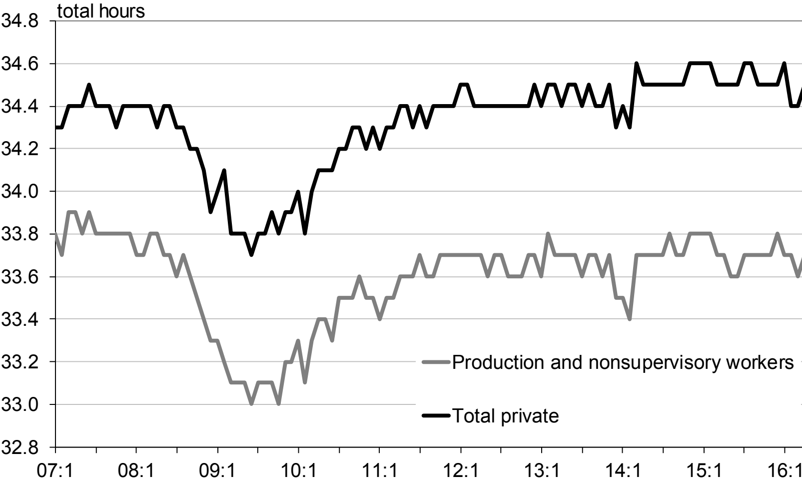


Slower growth in help supply services is another indication of a mature cycle.



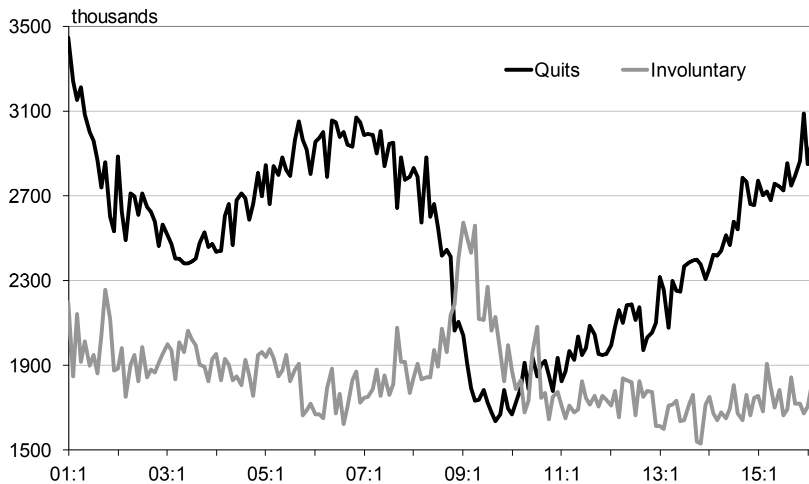
Source: Bureau of Labor Statistics

Ever smaller upward revisions to initial employment estimates are also consistent with slower job growth.

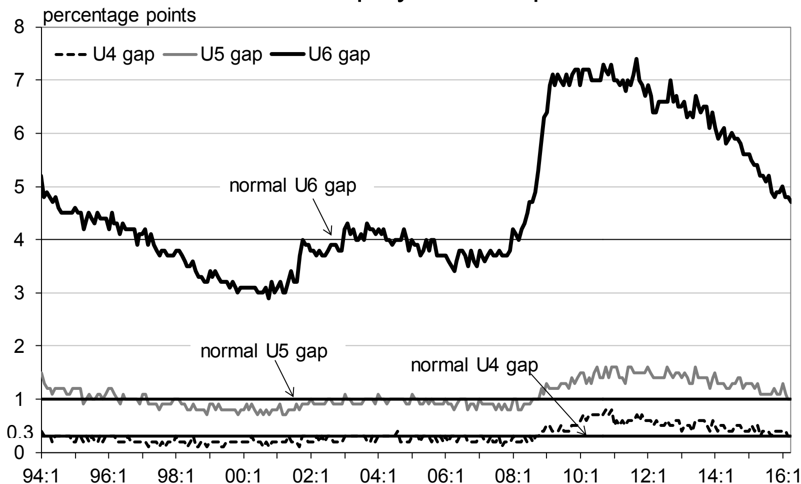


Source: Bureau of Labor Statistics

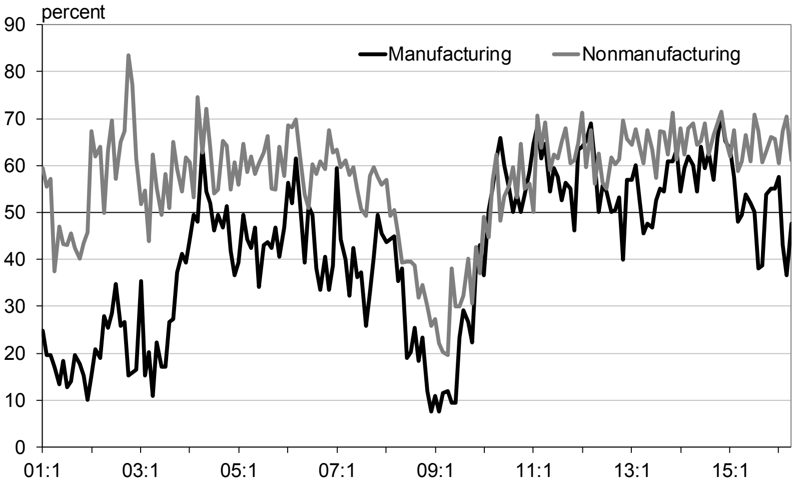
Hours worked continue to fluctuate in a small range. There is no rising trend.



The rising number of quits (and the low number of firings) shows growing confidence in the strength of the labor market.

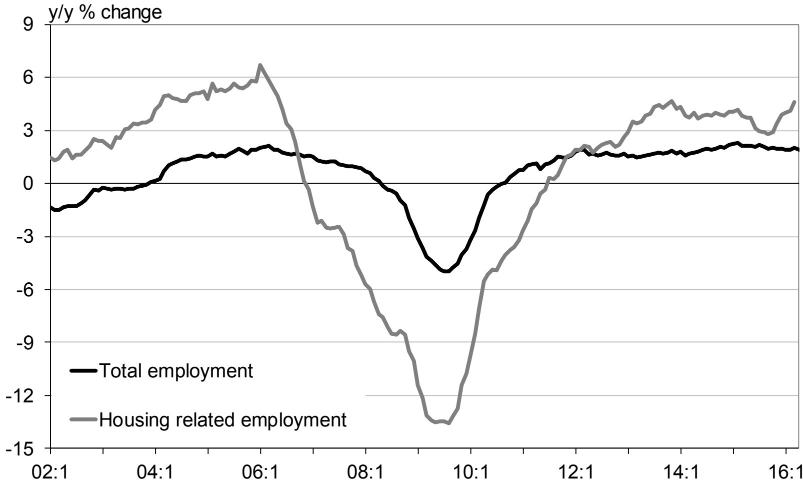


The gap between the official rate of unemployment and broader measures has returned to normal, except for the U6 gap. This may indicate a permanent upward shift in the number of part-time workers.



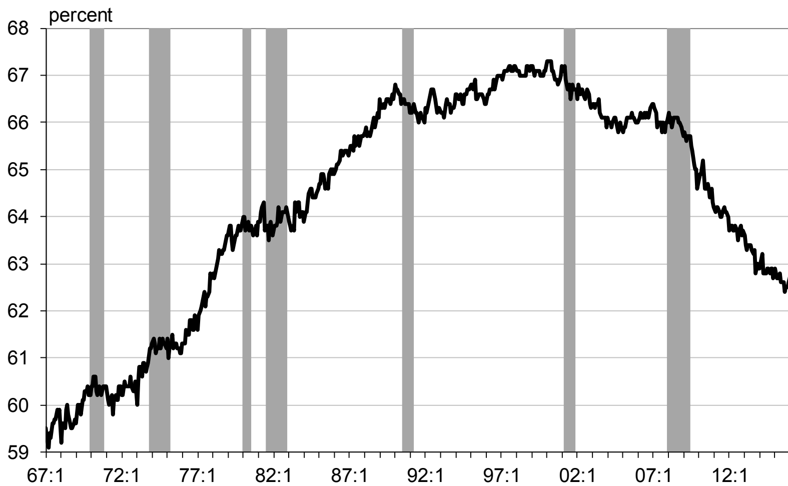
Source: Bureau of Labor Statistics, EfW

Diffusion indexes point to solid job growth in nonmanufacturing industries, but continuing weakness in manufacturing.

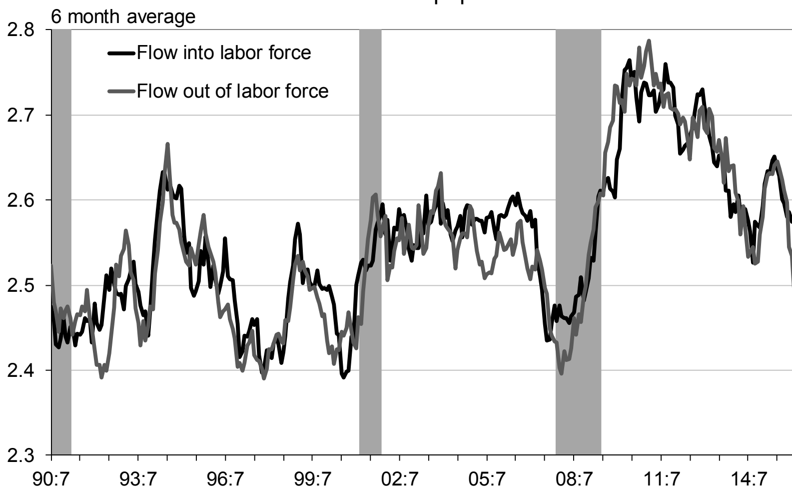


Source: Bureau of Labor Statistics

House construction is supporting strong job growth in that sector.



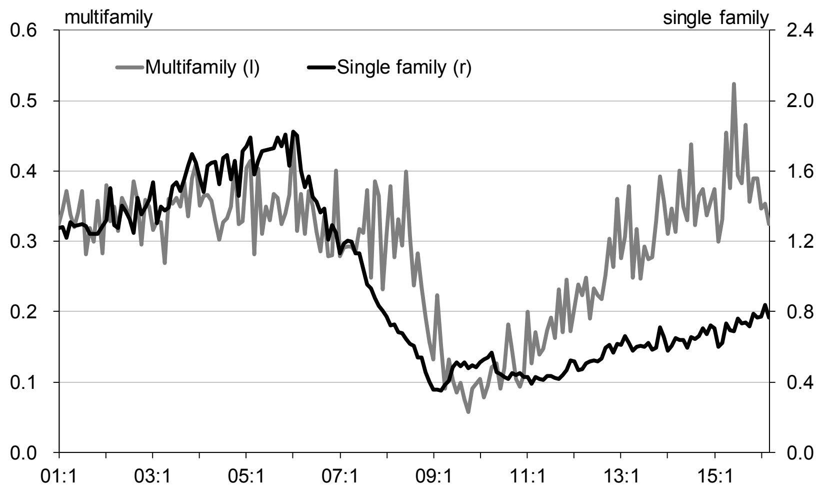
The recent uptick in labor force participation is not likely the start of a trend.



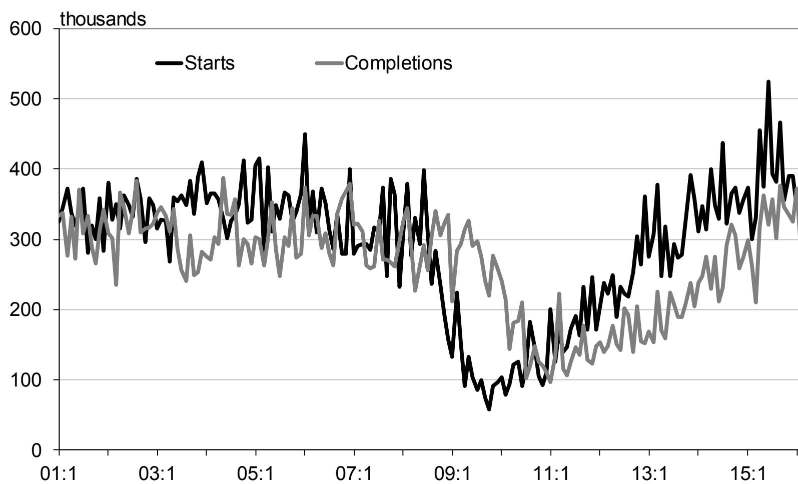
Fewer people dropping out of the labor force recently is the predominant reason. Still, the major cause for dropping out is age and retirement. Over time, this will again dominate.

Housing Indicators

Residential construction will continue contributing to economic growth, although its share of GDP is small. The supply of multifamily units is catching up with demand, which will slow rent increases later this year. Both turnover and the share of single unit construction are edging higher, which bode well for this sector of the economy.

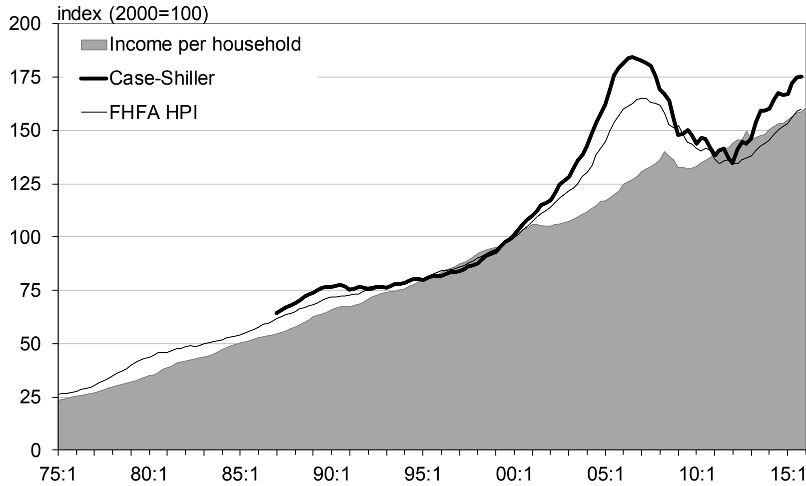


Although single unit construction typically is about four times multi units, multis led the housing recovery. Rental vacancy rates have leveled out and are starting to decline, which is already reflected in the decline of multi unit starts

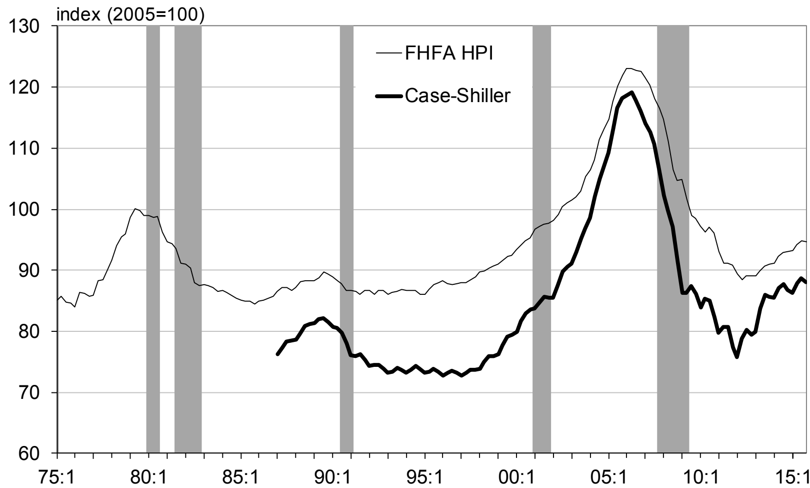


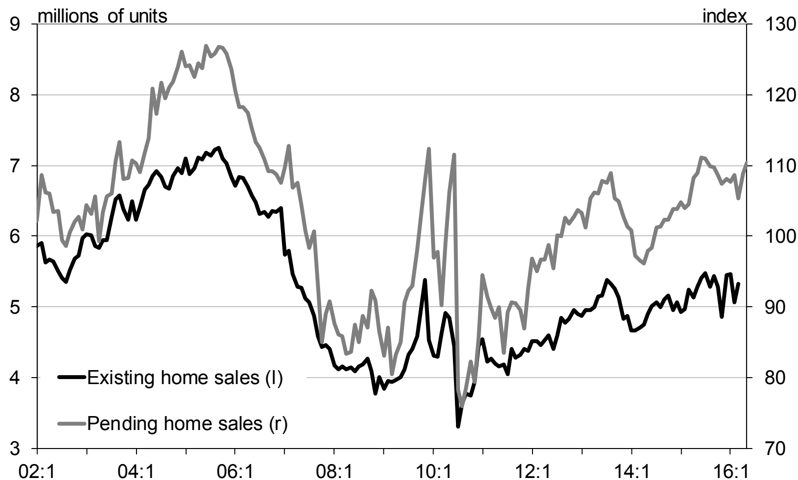
However, completions lag behind starts about one year, so they will remain high into the second half of 2016. This will reduce rental inflation pressure.

HOUSING INDICATORS

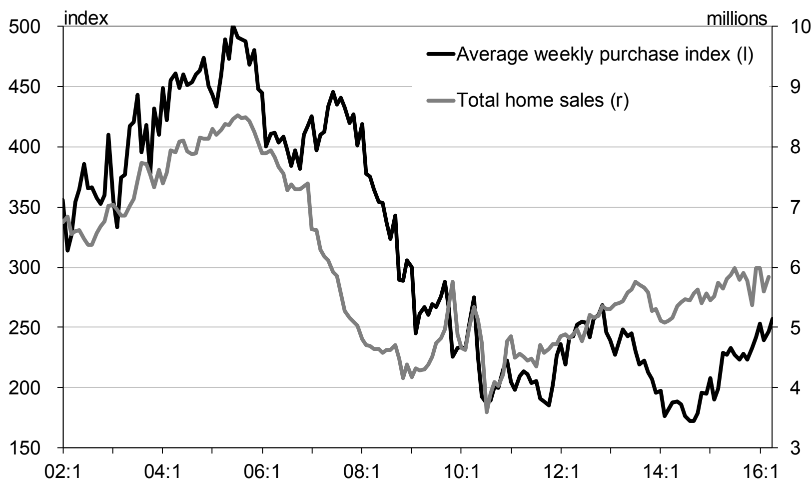


Both price to rent and price to income ratios remain high. Eventually, this will also put pressure on prices, but at present low mortgage rates help offset relatively high prices.



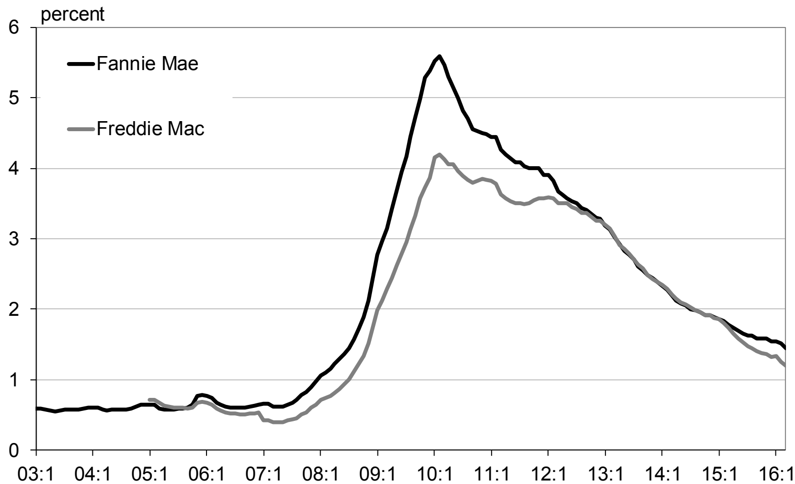


The market for existing home sales is also doing well, and pending sales reports suggest this will continue.



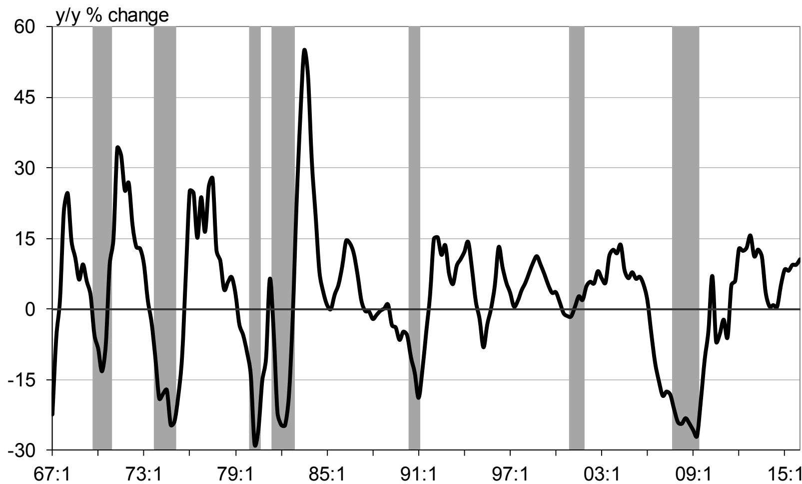
Rising mortgage applications are also consistent with rising sales.

HOUSING INDICATORS

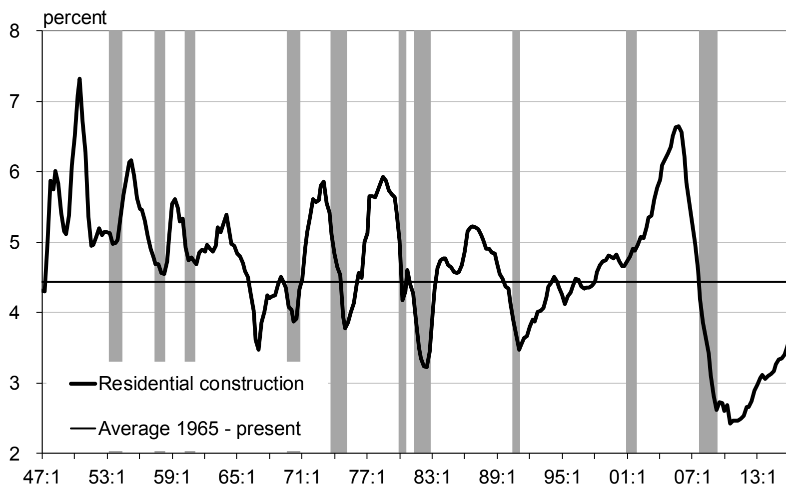


The delinquency rate continues to drift lower. There are few new delinquencies – these are old.

Gradually rising turnover helps the impact of housing in the overall economy, because changing houses always entails an increase in consumer spending.



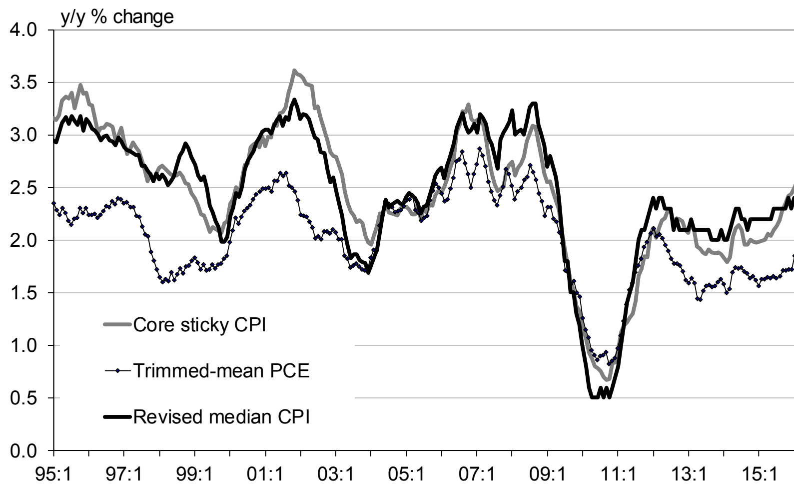
Residential investment is growing at a reasonable rate which will continue.



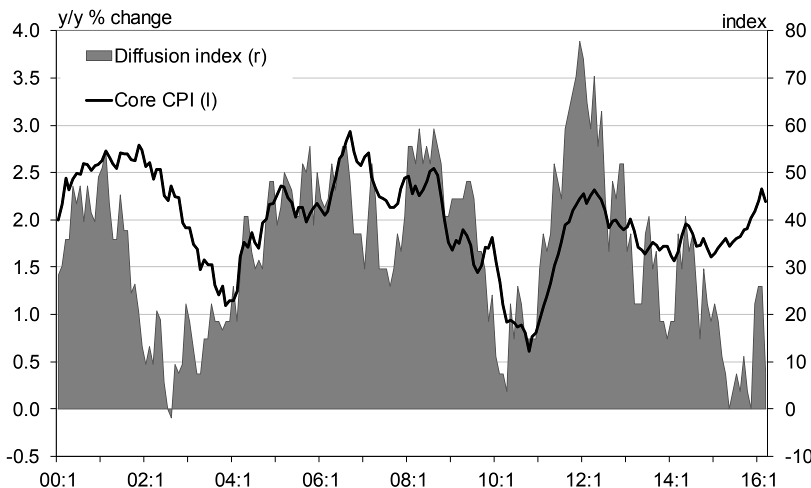
Still, its overall share of GDP remains well below the historical average.

INFLATION INDICATORS

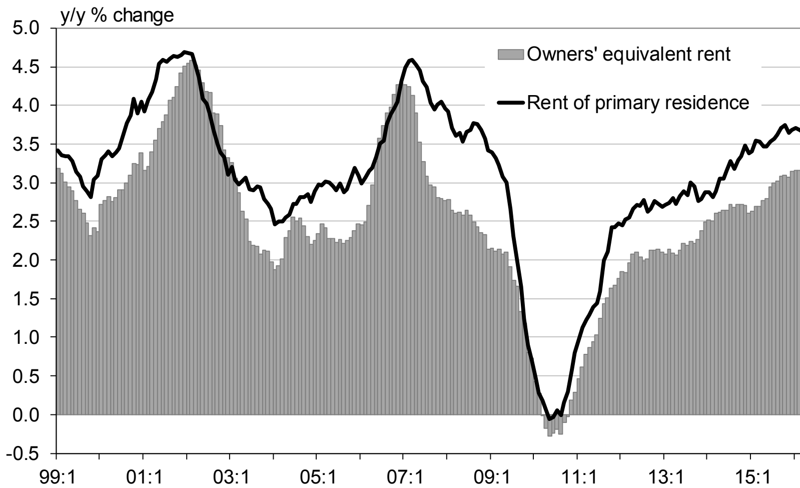
Inflation has begun to edge higher and might reach the Fed's 2% target by the end of the year. However, housing market conditions suggest shelter inflation will slow before the end of the year. On balance, inflation pressures remain very mild.



A small increase in inflation is evident in a variety of measures.

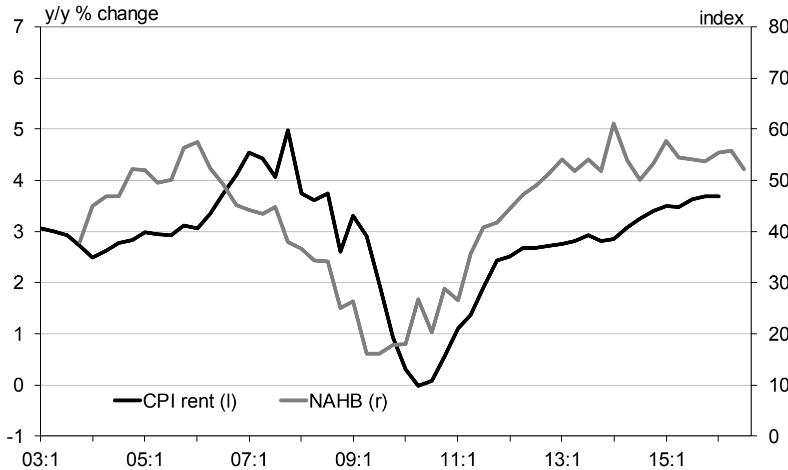


Still, price increases are narrowly based. The diffusion index is well below 50%.



Source: Bureau of Labor Statistics

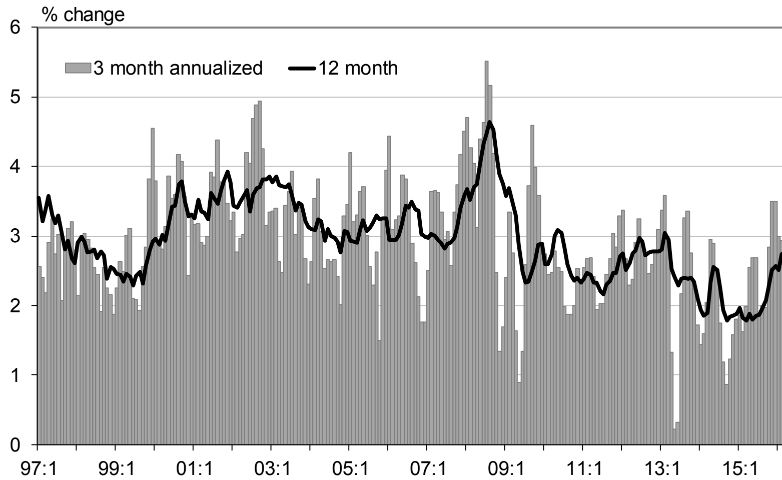
Shelter inflation has kept upward pressure on price measures, but this is no longer rising.



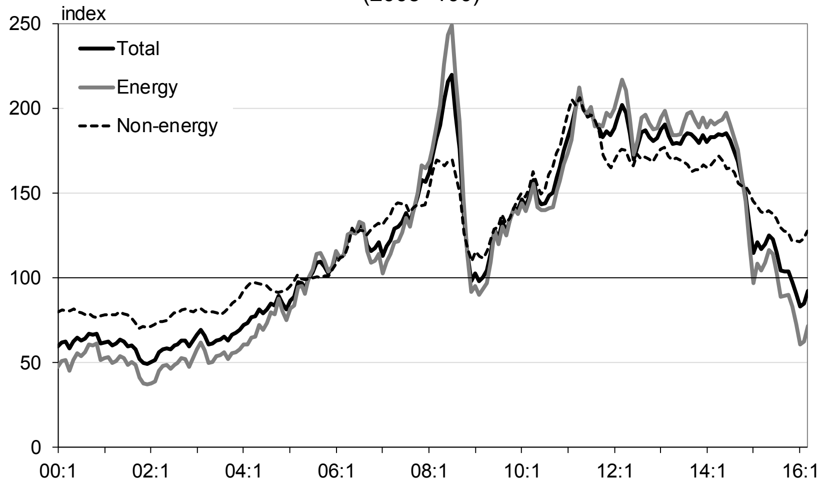
Note: NAHB index forwarded 3 quarters
Source: Bureau of Labor Statistics, National Association of Home Builders

Housing indicators suggest the supply of rental property has caught up with demand. This source of pressure may ease late this year or next.

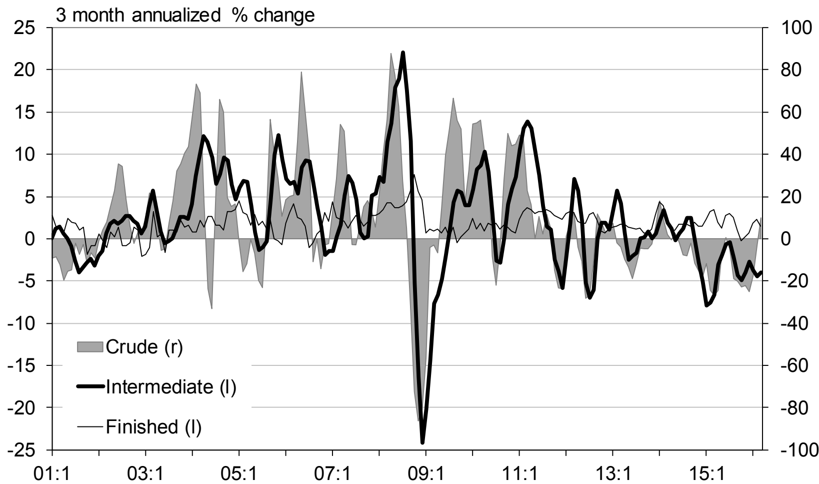
INFLATION INDICATORS



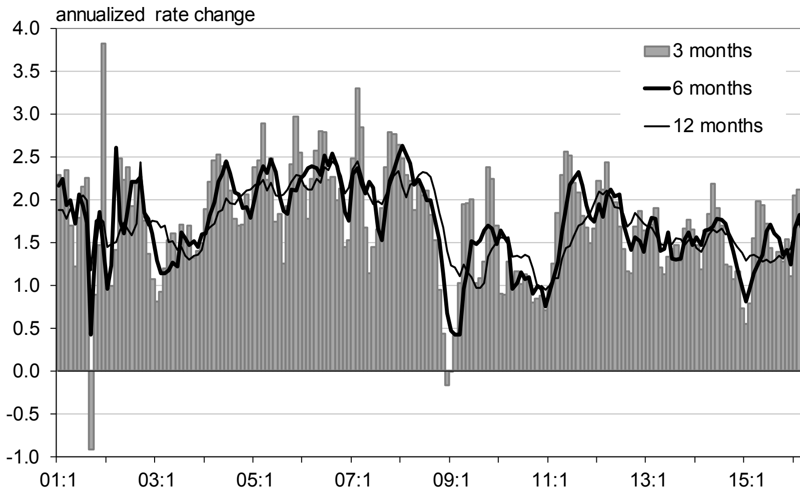
Excluding shelter, other service price increases have accelerated.



Although commodity prices have stopped falling, there is no inflation in goods prices.

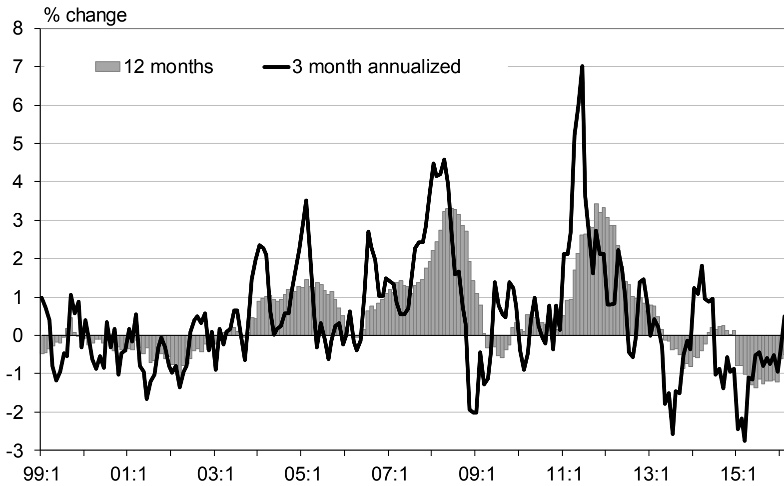


Producer price data show nothing in the pipeline.

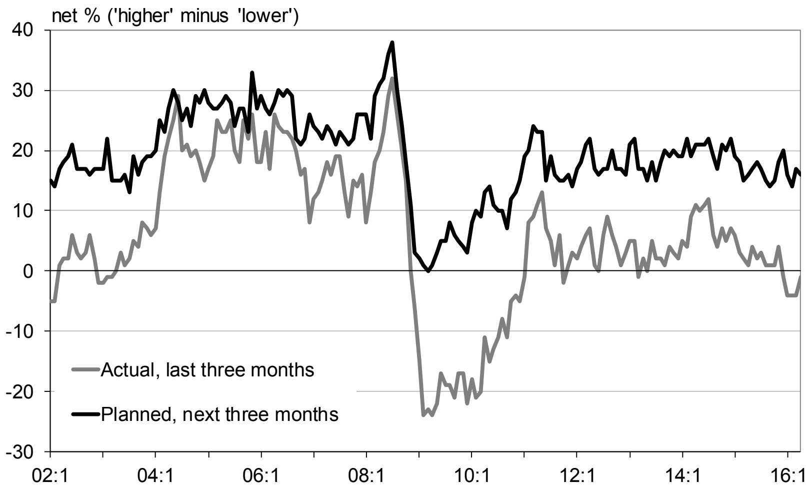


The PCE index is drifting up slowly.

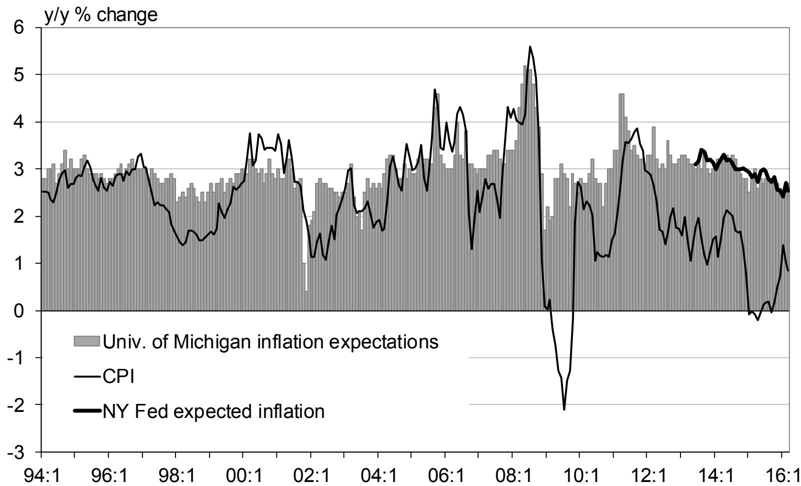
INFLATION INDICATORS



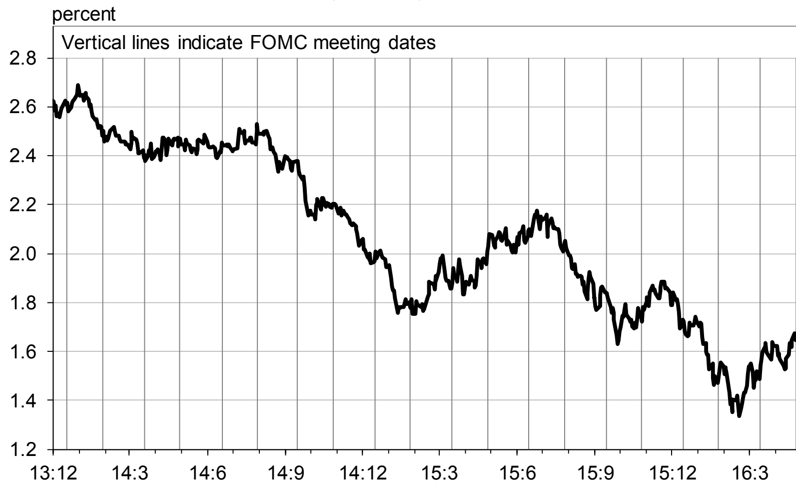
Consumer import prices have stopped falling and non-auto imports have moved higher.



Although rising unit costs are putting pressure on margins, there is no evidence business' pricing power is getting stronger.



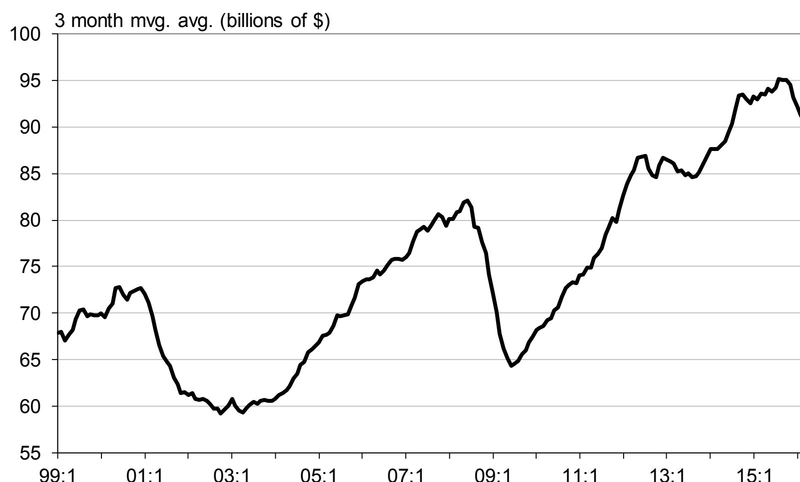
Consumer inflation expectations are drifting lower, although changes are quite small.



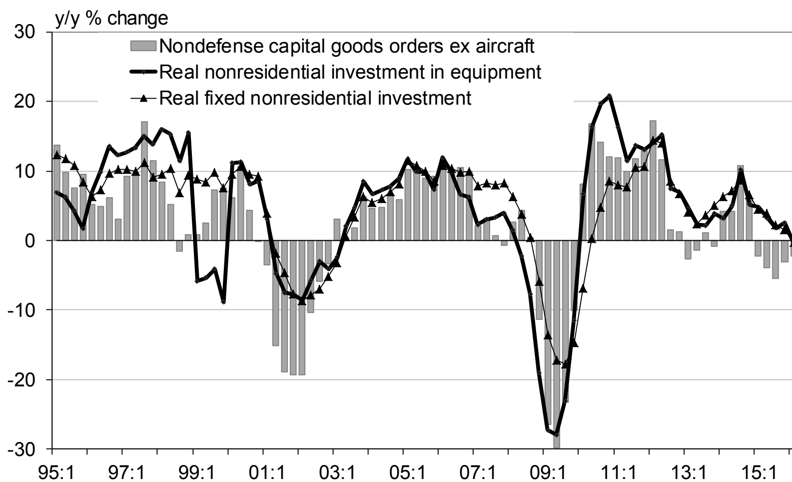
Market measures of expectations have moved higher (along with oil prices), but the changes are small and the level remains low.

PRODUCTION AND INVESTMENT INDICATORS

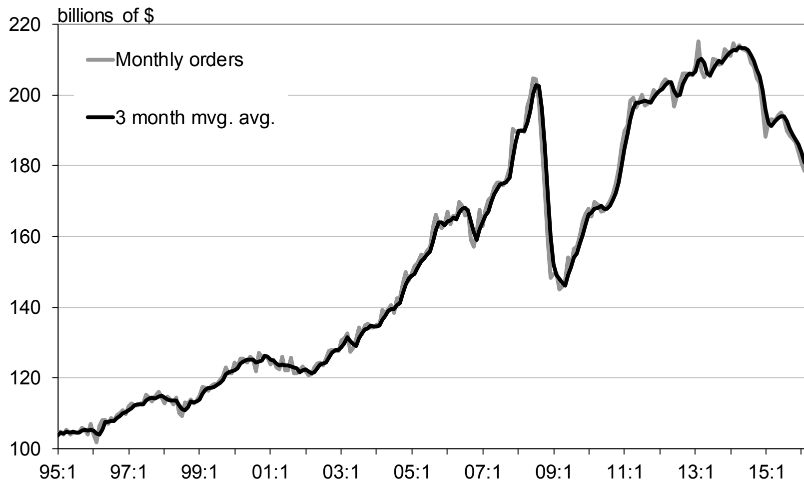
Production remained weak in early 2016 with energy extraction still a large drag. Still, weakness is not limited to energy related sectors. While capital spending will remain weak, a modest decline in the dollar and slightly higher oil prices will improve this picture in the second half of 2016.



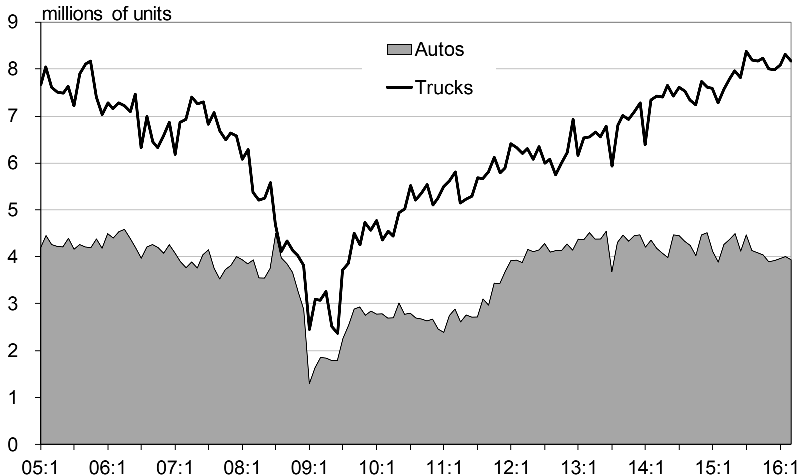
Capital goods demand is weak in the early part of the current quarter.



Orders do not yet point to a turn - around.

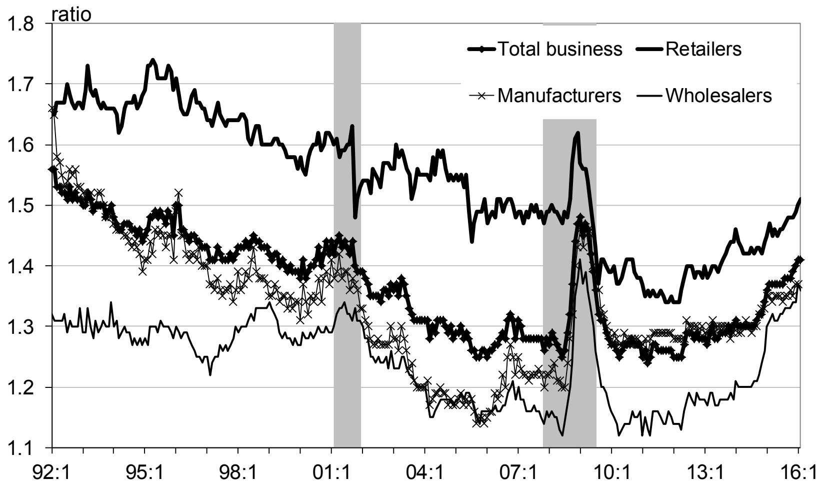


Consumer goods orders have also been declining.

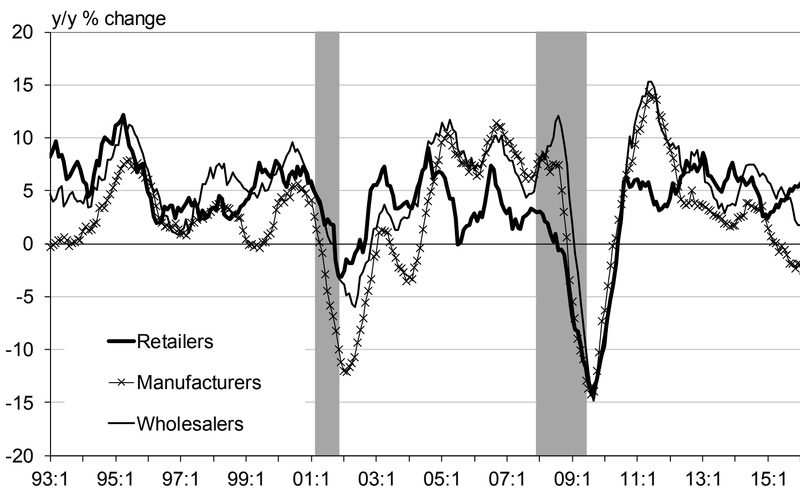


Auto sales have been strong, but they are not rising. This is also reflected in a flattening in auto assemblies.

PRODUCTION AND INVESTMENT INDICATORS

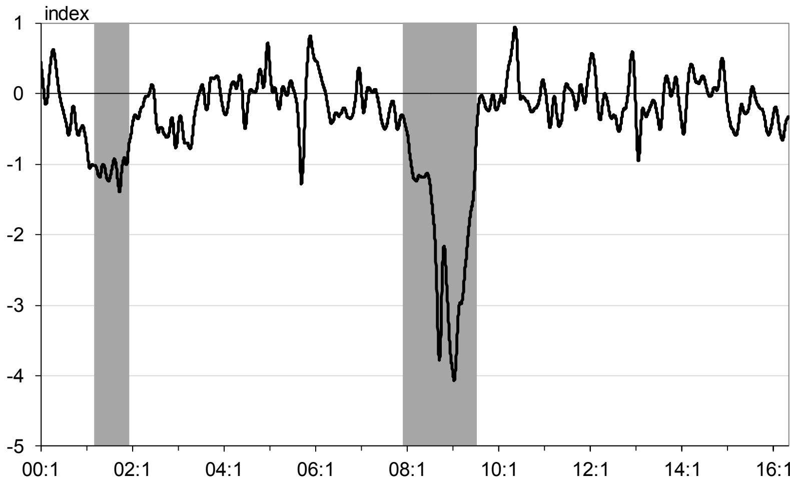


Inventory/sales ratios remain very high...

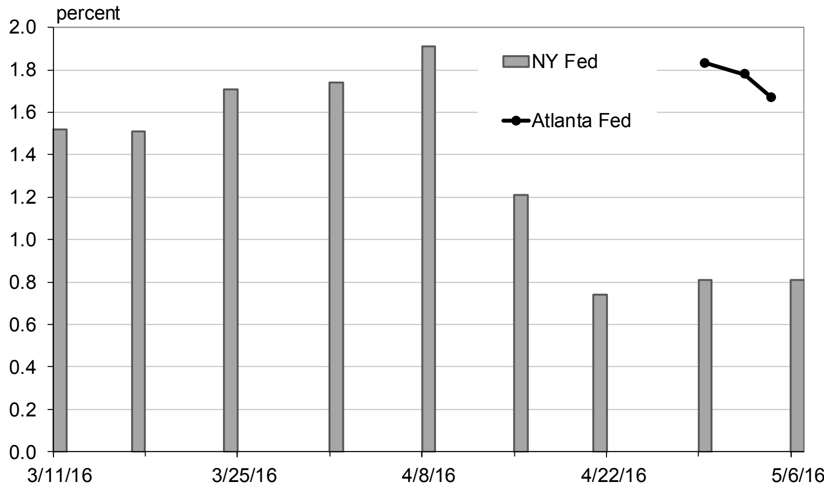


… although inventory levels have fallen at the manufacturing and wholesale levels. This correction appears to be reaching its end.

Production and Investment Indicators



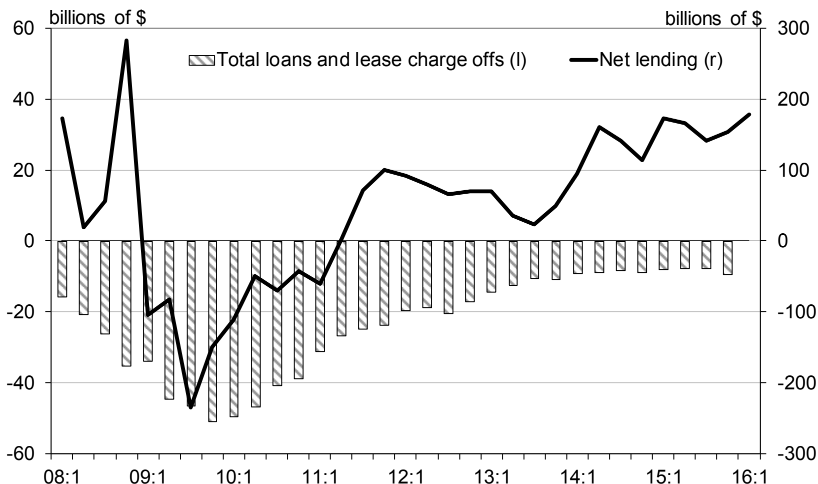
High frequency indicators show below average performance in 4Q15 and early 2016.



Early readings from nowcast models put current quarter growth below its long term trend.

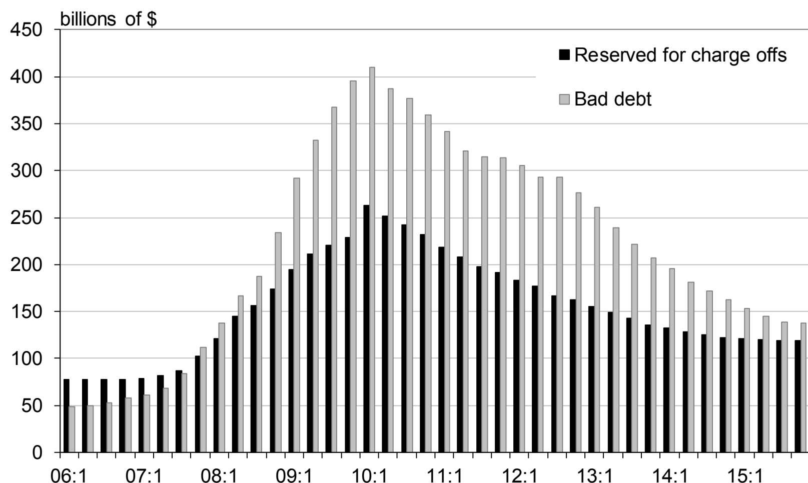
MONETARY AND CREDIT INDICATORS

The banking sector has been quick to respond to energy related loan problems by increasing reserves. Credit remains widely available, but bankers are tightening some standards. Overall financial sector health improved last quarter.



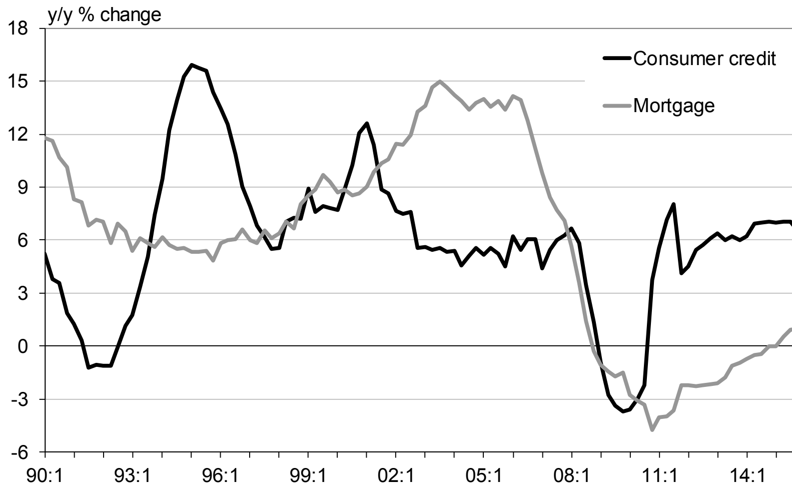
Note: Data adjusted in 10Q1 for assets consolidated on bank balance sheets.
Source: Federal Reserve Board

Net lending has continued to rise at a moderate pace, even though bad debt charge offs have also increased recently.

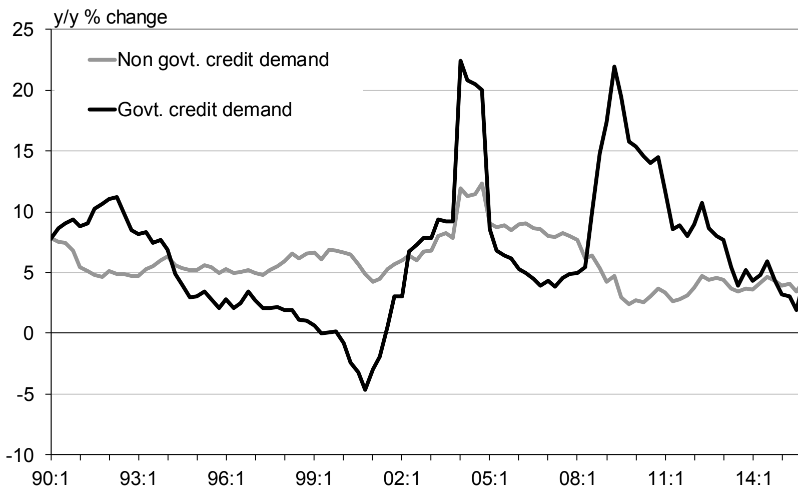


Source: Federal Deposit Insurance Corp.

Based on individual bank reports, reserves set aside for bad debt have also increased. Bankers remain very cautious.

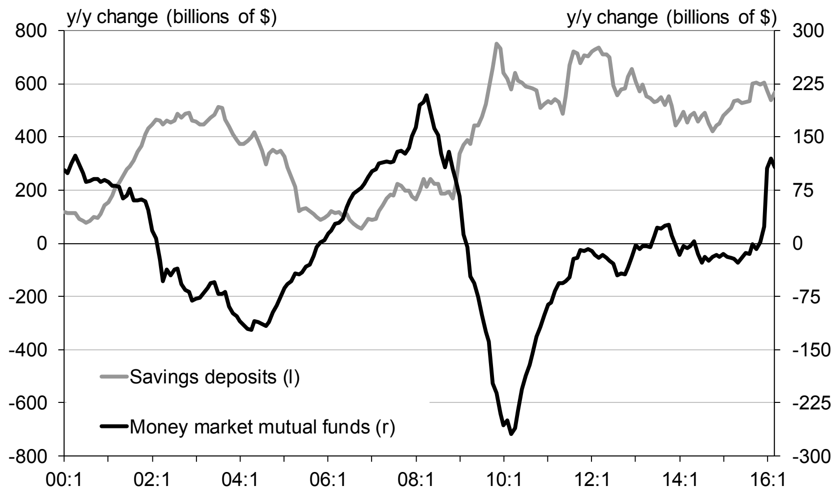


Credit demands have been reasonably stable. Mortgage growth has moved from negative to positive.

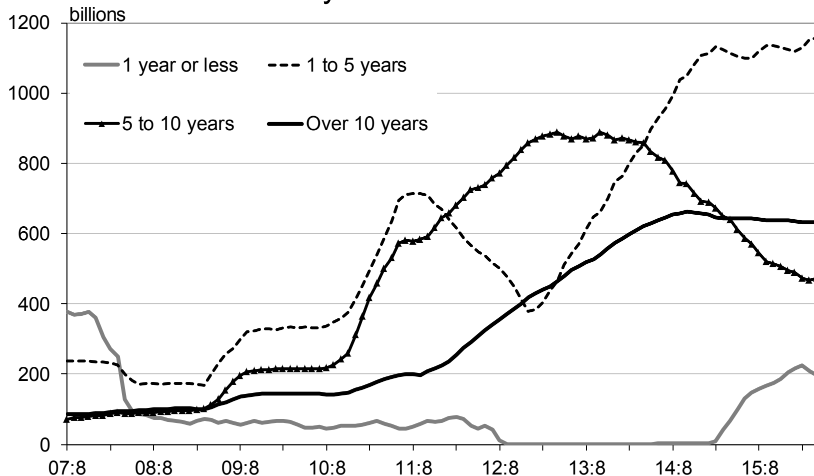


Both government and nongovernment business credit demand are growing at a moderate pace.

MONETARY AND CREDIT INDICATORS

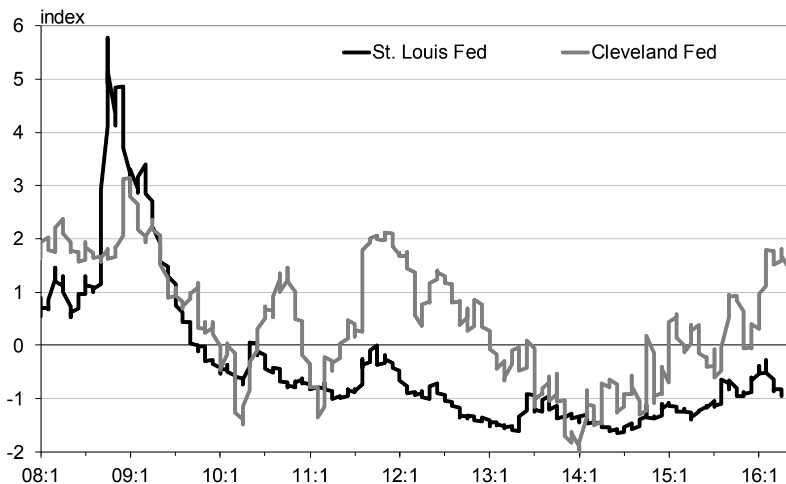


Consumers responded quickly to the 1/4 point increase in short term interest rates by moving out of savings accounts into money market mutual funds.

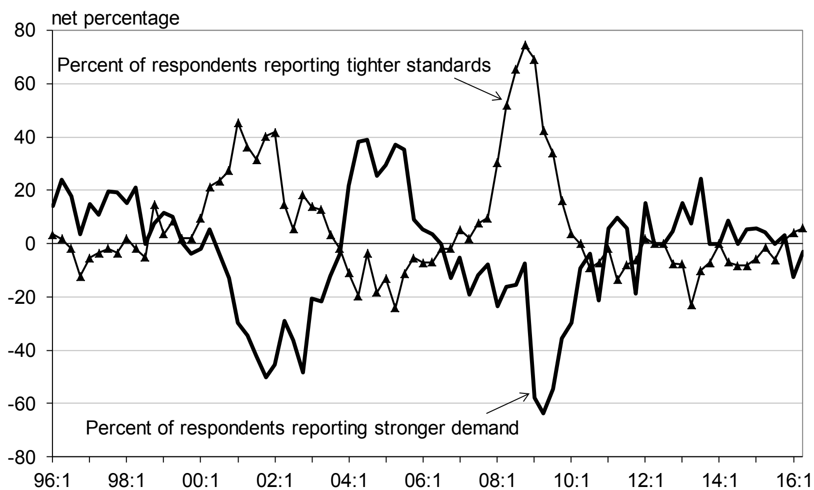


Although the Fed's balance sheet size has not changed materially since 2014, the composition continues to shift toward shorter assets.

MONETARY AND CREDIT INDICATORS



Stress indexes moved significantly higher early in the first quarter, but declined late in the quarter and declined further over the past month.

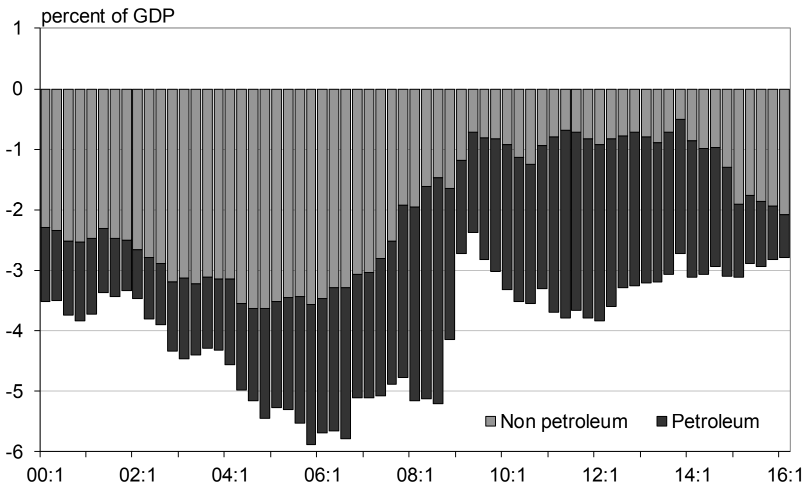


While banks remain very willing to make consumer loans, they have materially tightened standards for small firms.

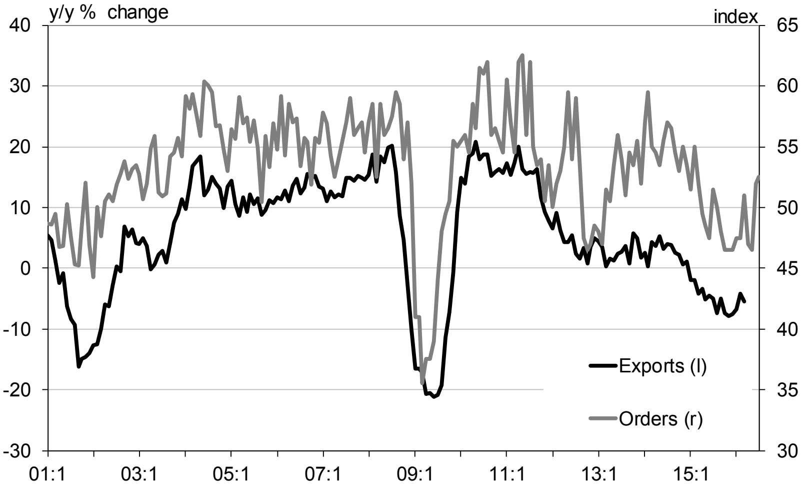
INTERNATIONAL

If the dollar remains near current levels, this will help exports by the end of the year, but additional divergence between central bank policies remains a threat. Trade will continue to be a small drag on growth.

The dollar is now about 5% below its recent peak, but it remains sensitive to diverging central bank policies.

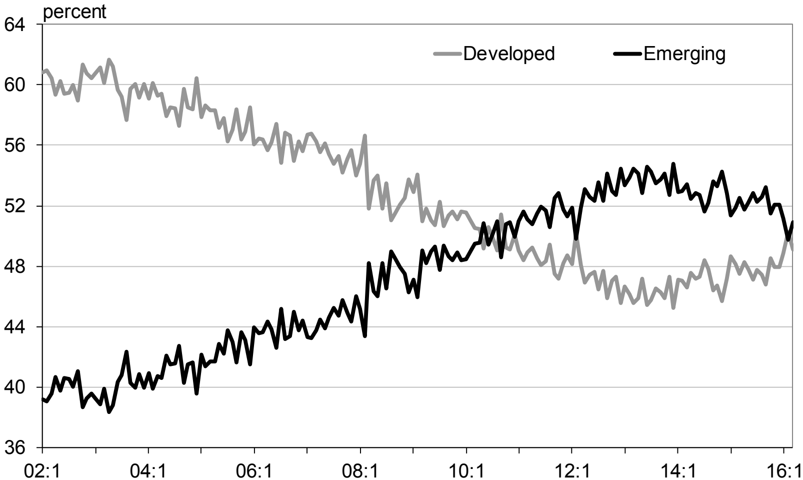


Although petroleum imports are significantly smaller, the overall trade deficit has changed little.



Note: Orders shifted ahead three months
Source: Institute for Supply Management, Census Bureau

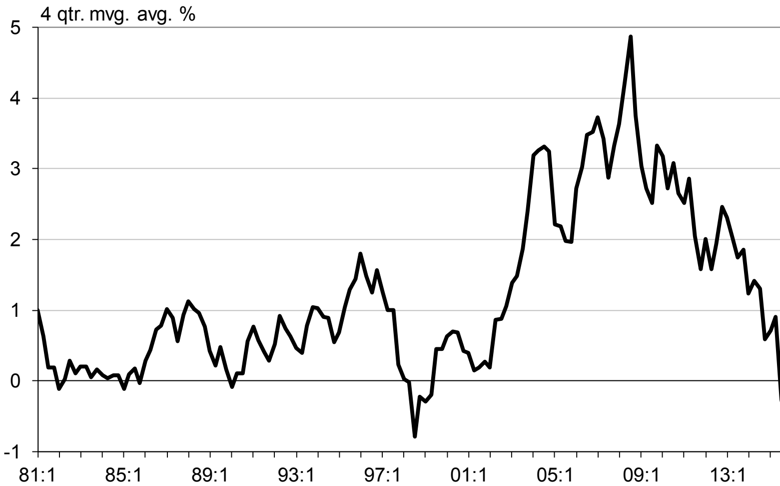
Export orders do not promise much improvement in the near term.



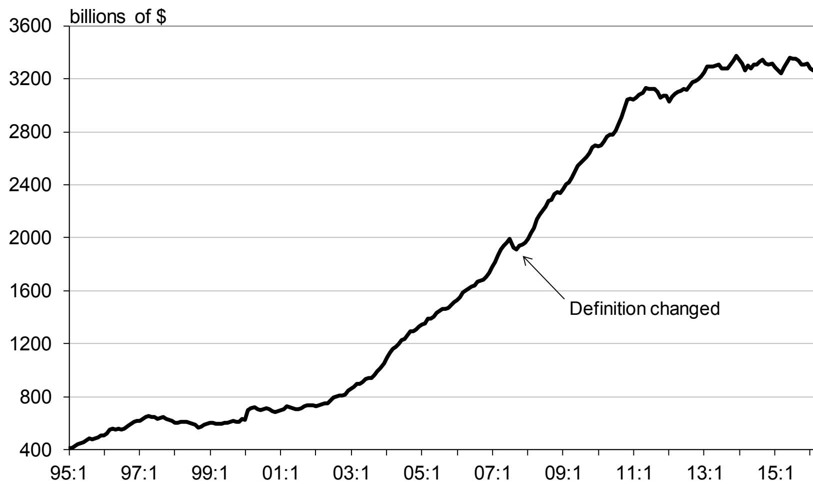
Developed countries: Australia, Canada, the European Union, Israel, Japan, South Korea, Taiwan
Source: Census Bureau

Problems in emerging market economies have reduced the importance of this market.

INTERNATIONAL

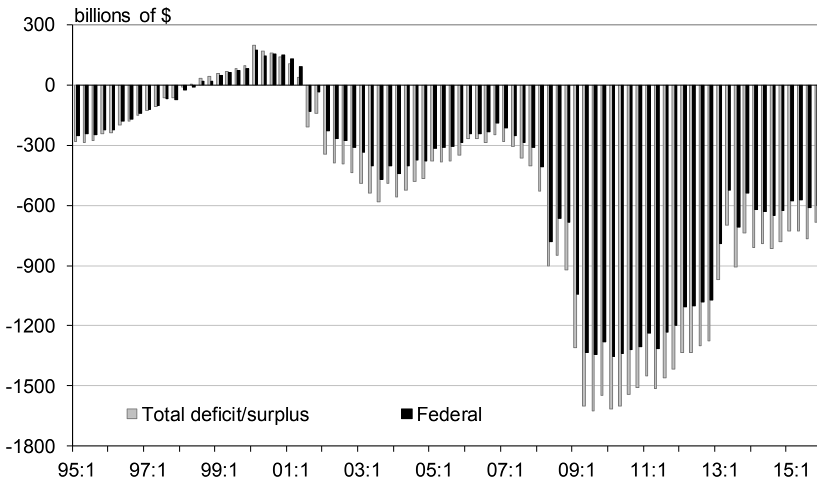


As commodity producers' surpluses have shrunk, so have official inflows into the US. There has also been a shift in China, with more private outflows supplanting official outflows.

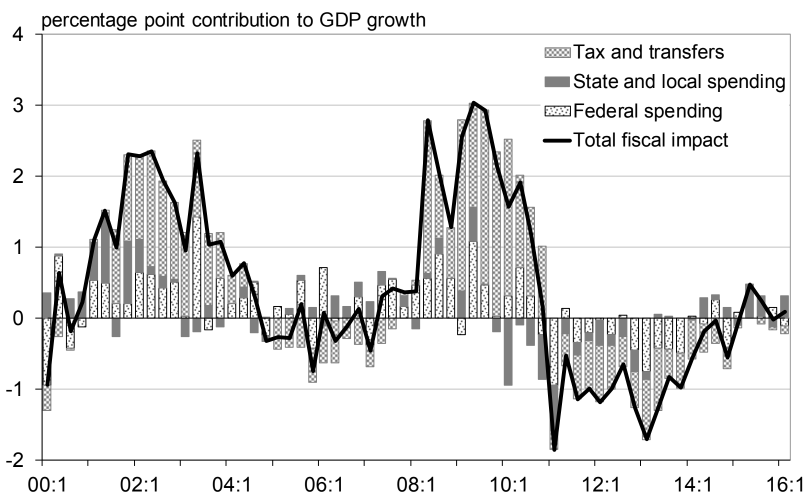


With no increase in foreign official inflows, most new Treasury issuance is being purchased domestically.

Congress is back on track for another Government shutdown scare at the end of September. The budget for 2017, agreed to last year, cannot be approved without the support of 30 - 35 conservative House Republicans who have refused to approved it. Getting a new agreement before the election is unlikely. An extension of the current budget until after the November elections is the most likely solution.

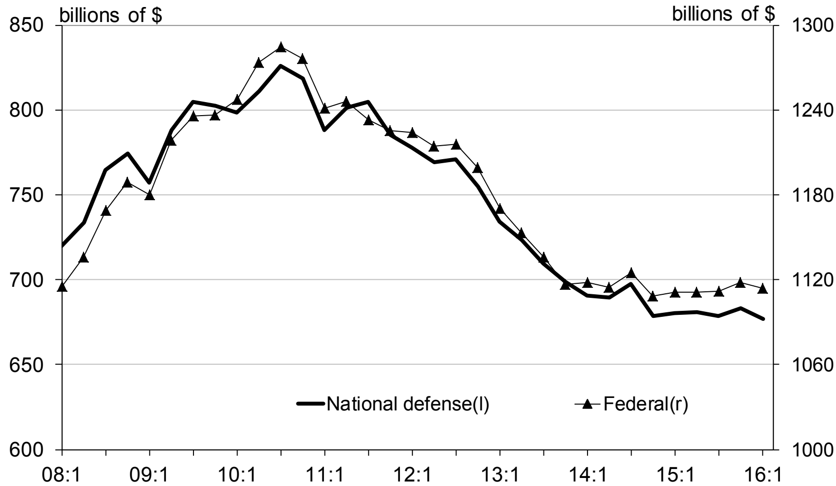


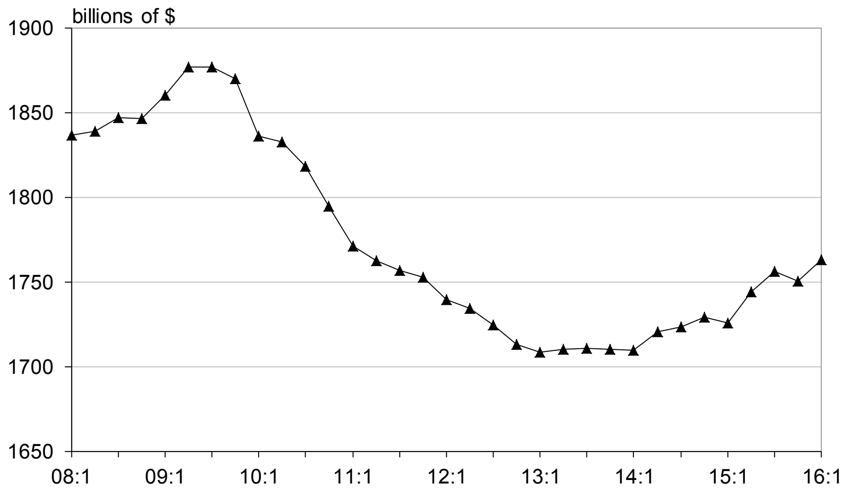
Budget deficits have been fairly stable for the past two years. They are projected to begin rising soon.



Fiscal policy has shifted from restrictive to neutral where it will stay this year and next.

GOVERNMENT

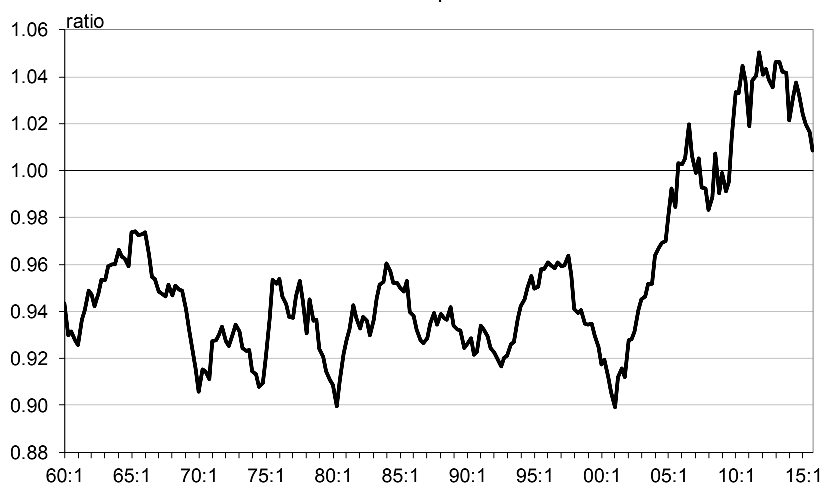




Federal spending has been roughly flat, while state and local spending is edging higher. If the Federal budget is held flat in dollar terms, this will cause a small decline after inflation adjustments.

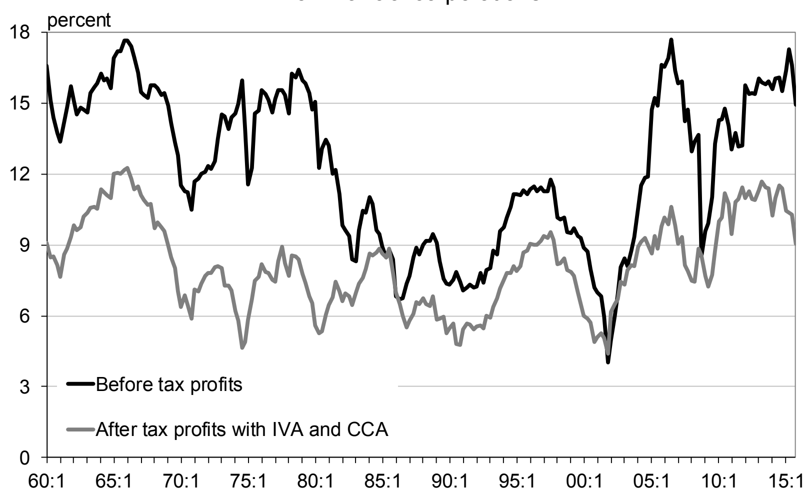
PROFITS

Poor productivity growth has pushed unit labor costs up almost as fast as prices in recent quarters. This means pressure on margins is rising. With both domestic and foreign earnings weak, the outlook for capital spending is poor.



Source: Bureau of Labor Statistics

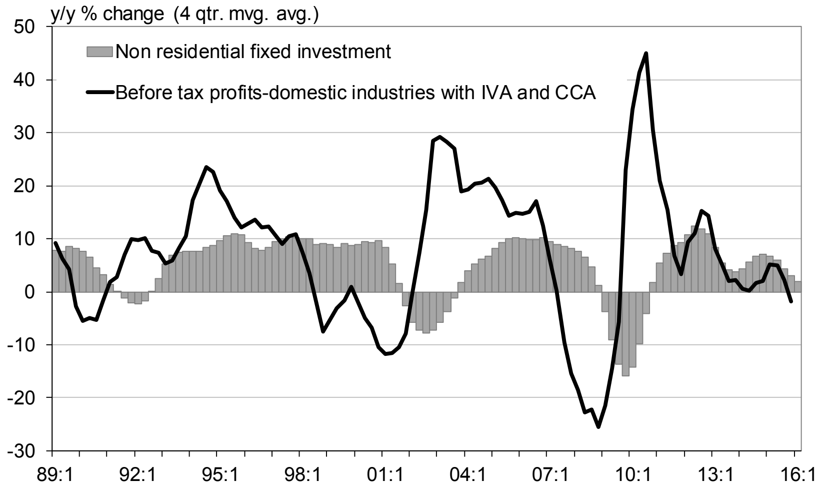
The long period of slow productivity growth has pushed unit cost increases close to price increases.

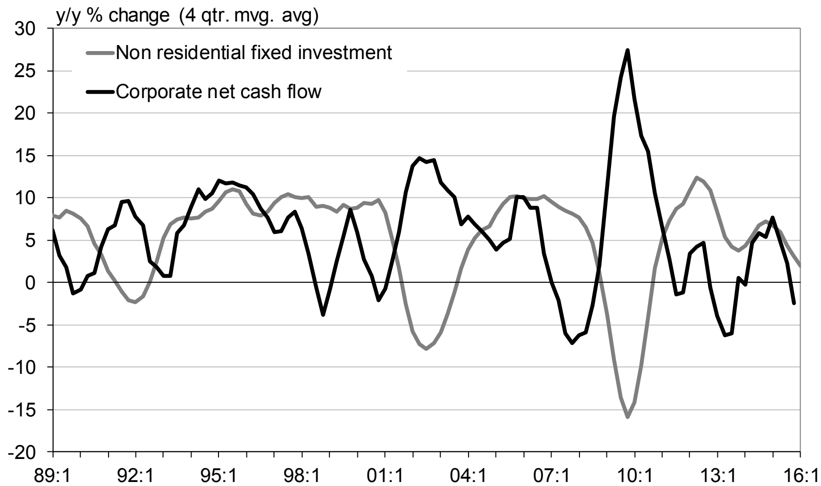


Source: Bureau of Economic Analysis

While margins remain high, pressure is growing stronger.

PROFITS





With both profit growth and cash flow likely to remain weak on even negative, the outlook for capital spending will also remain weak.

Economics

from Washington

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T 301.365.6395 • F 301.365.2686
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