Economics from Washington

SECOND THOUGHTS

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- *The initial report on Q1 GDP growth will be very weak – a negative number is within the normal error range. This is a misleading indicator of current activity and any negative market reaction will be temporary.*

- *The recent rise in labor market participation is not because tight conditions are bringing dropouts back into the labor market, it is due to a sharp decline in those exiting the market. This is probably temporary.*

- *The Federal budget is progressing down a track that dead ends on October 1. There is no resolution in sight.*

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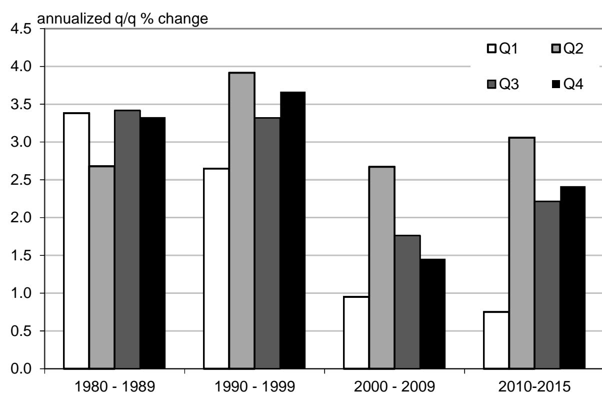
The majority of source data for estimating Q1 GDP has now been reported, and it points to a very low growth number. All tracking estimates are under 1% and many are close to zero. Last week's reports were almost uniformly below expectations. This included March reports for industrial production and capacity utilization, retail sales, and small business sentiment. Consumer sentiment also fell in early April and all price reports were slightly below expectations. There was little in the latest round of reports to fuel much optimism, but this is not unusual in the early part of a year.

The Fed's Beige Book (compiled in March and early April) suggested growth remains "modest to moderate" in most districts. This is Fedspeak for about 2%. We believe this is a reasonable view, despite the fact tracking estimates are well below this rate. The New York Fed has introduced a new GDP nowcast model which estimates 0.8% GDP growth in 1Q16 vs. the Atlanta Fed's nowcast of 0.3%. While the press characterized this as Fed banks sparring, in fact the two models are close cousins and one New York Fed economist made important contributions to both. Two additional indicators, the Chicago Fed's National Activity Index and the Philadelphia Fed's ADS Business Conditions Index, are in the same class of models and point to similarly low growth. All nowcast model forecasts improve as data become available and are incorporated into the projection, but the improvement stops about a month before the initial GDP estimate is published – all of the details have been reported. Still, the average error of these models never falls below 1 percentage point. Statistically speaking, the range for current estimates of Q1 GDP growth is about - ½ to 1 ½ %. While these models are a handy way to incorporate incoming data into a forecast, their track record is no better than the judgmental forecasts produced by professional forecasters. It is also important to remember Q1 GDP growth is typically the lowest of the year and Q2 is typically the highest, as illustrated in this week's chart. This is a seasonal adjustment problem, not a problem of economic activity.

The Fed's judgmental notion that growth is expanding at about 2% seems to correlate with other indicators aligned with real activity. For example, new claims for unemployment insurance have been extremely low and have declined over the past two months. Applications



for mortgages to purchase houses have shown steady improvement. While production has been weak, all surveys show impressive gains in new orders in March, and the New York manufacturing survey showed an additional advance in April. The February inventory/sales ratio was quite high, but the Fed survey conducted in March and early April suggested there had been material improvement and inventory levels had become satisfactory. Although the March retail report was weaker than expected, February was revised higher and many categories with big ticket, discretionary items increased. An early Easter undoubtedly punished the seasonally adjusted March data. The most recent price reports showed a small rise in the purchasing power of wages, which means the engine of consumer spending is doing just fine. If markets react poorly to a low or even negative Q1 GDP report, this will be a temporary adjustment – the economy is still bumping along.

As labor markets have grown tighter, participation has increased. This is a positive development, especially for prime age workers whose participation decline had been something of a mystery. The story is tighter labor markets and a large number of job openings are enticing workers who dropped out of the labor force to return. This would be a welcome development if accurate, but it is not what the data show. Since mid-2015, the number of workers moving into the labor force has been fairly steady, while the number moving out has declined sharply. Inflows in 2015 and 2016 have been smaller than in 2010 – 2012, when labor markets were significantly weaker. The decline in workers leaving the labor force has been much more important in pushing participation higher than new entrants. The reason for this decline in dropouts is just as mysterious as the earlier decline in participation itself. This leaves us uncomfortable assuming participation will remain near current levels or continue to increase. What we know is the labor force continues to grow older and the past few years of rising wealth have repaired much of the financial damage done by the 2007 - 08 recession – damage which presumably forced many to continue working past planned retirement. As a recent blogpost from the Atlanta Fed points out, participation rates are influenced by many factors which are extremely difficult to forecast, but aging of the population is the most important and the easiest to foresee. We will not be surprised if recent increases in participation prove to be temporary. If so, the unemployment rate has further to fall.

Budget update. Several weeks ago, we reported the Senate had failed to pass a budget resolution for the year that begins October 1, and speculated the House would also be unable to pass this resolution. Our speculation was correct, and the budget resolution has been given a quiet burial. 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 the Government functioning. Behind the scenes, leaders are quietly discussing what they refer to as the '1070 number'.

The '1070 number' is the $1070 billion spending cap for the 2017 budget which Congress approved last year. This deal was cut by Speaker Boehner and approved with plenty of help from Democrats. That was then. Now there is a different Speaker and politicians are in the midst of an election campaign – Democrats have no interest in helping Republicans pass the budget. Without help, Republicans have a problem. About three dozen conservatives oppose the 1070 number – it includes a spending 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 expect something will happen to avoid a Government shutdown, but there is nothing in sight at present. 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.

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