ECONOMIC AND FINANCIAL DIGEST

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Lower Ceiling

With the heat of the summer fading from memory, let's hope that the sizzling and overwrought debate over monetary policy will also cool down. For the better part of the past few months, nothing has been more of a lightning rod than speculation over when or even should the Federal Reserve start to taper off its bond-purchase program. Since last December, the central bank has been purchasing $85 billion a month of Treasury and mortgage-related securities in an effort to hold down long-term interest rates and juice up the lackluster economic recovery. Many believe that the Fed will start reducing the volume of purchases following the September 18 policy-setting meeting, which would be earlier than expected a few months ago.

Not surprisingly, that prospect has sent shock waves through the financial markets, where fear is running rampant over what a less supportive Fed would bring about. The fear is taking many forms— that it will choke off the recovery, kill the four-year old stock-market rally, stifle the housing revival, destabilize financial markets and send borrowing costs sky-high, among other worries. From our lens, all of these variations can be summed up simply: fear of the unknown. To some extent that's understandable, as policy changes often produce unintended consequences. Uncertainty, in turn, is a time-honored breeding ground for volatility, which has clearly reared its ugly head whenever it seemed the tapering process was getting closer to the starting gate.

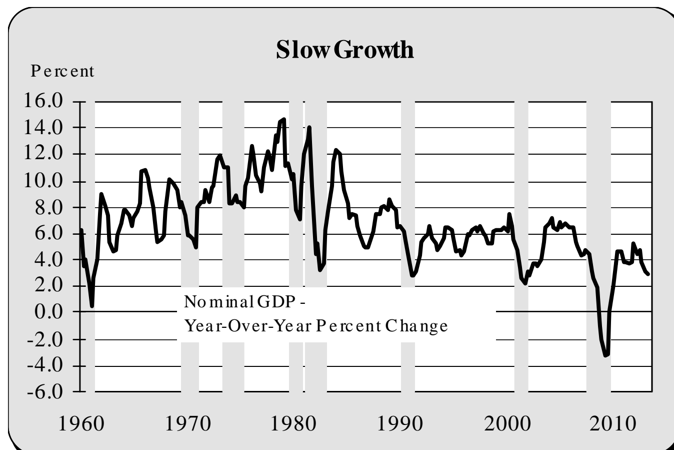
Whether the timetable is for a start at the September 18 meeting or later in the year, at some point the Fed will need to wind down its asset-purchase program. The program, which was originally designed to combat an economic and financial crisis, is now on the verge of overstaying its welcome. Although the recovery has been very disappointing, the nation is no longer in a crisis mode that requires heroic remedies. The economy is healing, however slowly, which means that the Fed can begin moving towards a normalization of policy. The challenge is to convince investors – as well as businesses and households –that this is not the end of the world. An overreaction to unfounded fears could set the healing process back and complicate future policy decisions, leading to even more confusion and uncertainty.

Tepid Growth

At first blush, it might seem like folly for the Fed to even consider scaling back its bond-buying program. After all, the recovery is hardly gaining traction, at least according to some basic broad measures of activity. For example, real GDP increased by only 1.4 percent in the second quarter compared to a year ago, a tad better than the 1.3 percent annual gain in the first quarter but much weaker than the 3.3 percent cycle peak reached in the first quarter of 2012. In current dollars, the performance is even more downbeat. Nominal GDP registered a 2. 9 percent year-over-year increase in the second quarter; that's not only weaker than the first quarter's 3.1 percent gain, it is the slimmest 12-month increase outside of a recession in the postwar period.

To be sure, the historically slow growth rate in nominal GDP reflects in part the unusual decline in inflation, something that normally does not occur four years after the end of a recession. As much as the weakness in real growth, the periodic threats of deflation during the recovery have prompted the Fed to retain its turbocharged easy policy longer than it otherwise would. Indeed, the GDP deflator – the broadest measure of prices in the economy – increased by only a 0.7 percent annual rate in the second quarter, the slimmest gain since the third quarter of 2009 and less than half the 1.7 percent average increase over the 14 quarters of the recovery.

No doubt, Fed officials see the continued ebbing of inflation this year as a cautionary sign. At least one — St. Louis Fed President Bullard — still believes that inflation is too low and the economic data too inconclusive to justify a change in policy. But Fed chairman Bernanke as well as others believe that transitory forces have been primarily responsible for holding down inflation, and expect it to move up towards its 2 percent target over the second half of the year. There will clearly be a spirited discussion of this issue at the September 17-18 policy meeting, but there are compelling reasons to expect higher rather than lower inflation in the period ahead.



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Modest Pickup Expected

Clearly, the best case for higher inflation would be a faster-growing economy. That, in turn, would generate more job creation and strengthen worker ability to bargain for higher wages, which, in turn, would put more purchasing power in the hands of consumers. The combination of higher labor costs and stronger demand would provide both the incentive and justification for businesses to raise prices. Indeed, failure to do so would lead to lower profits, something that would likely punish a company's stock price.

While the consensus view is that growth will pick up in coming months, the acceleration is expected to be modest at best. The Fed itself is projecting a growth rate of 2 ½ - 3 percent over the second half of the year compared to a 1 ½ pace over the first half. While that's a meaningful, if doubtful, step up, it would still be below the long-term trend rate of about 3.5 percent. It would certainly not be strong enough to sop up the considerable slack in the labor and product markets created during the Great Recession, keeping the bottlenecks at bay that typically ignite inflationary pressures.

But the economy may not have to grow as rapidly as once perceived to close the gap. The nation's potential growth rate – the fastest long-term rate that can be sustained in a noninflationary environment – is the product of two trends: the growth in the nation's labor force and growth in labor productivity. These determinants have slowed considerably in recent years, partly in response to the economy's subpar performance. However, both seem destined to grow at a slower pace in the foreseeable future.

Slowing Workforce and Productivity Growth

Over the past decade, the labor force has grown at a 0.7 percent annual rate, less than half the 1.5 percent average annual increase over the previous fifty years. Some of that slowdown is cyclical, reflecting the impact of the Great Recession and weak recovery that caused millions of workers to drop out of the job market. Since the start of the recession in late 2007, the labor force has increased at a measly 0.3 percent annual rate.

However, the slowdown is also the product of longer-term demographic forces. For example, the labor force grew by a 2.5 pace during the 1970s and early 1980s -- bloating the long-term trend -- due largely to the mass entrance of women in the workplace; that trend reached a saturation point in the mid 1980s. For another, the working-age population is aging, with an ever-increasing number of baby boomers exiting the labor force for retirement. Finally, immigration laws have toughened significantly since 9/11, resulting in a sharp reduction in net migration to the U.S. Taking all these factors into account, the Congressional Budget Office projects the labor force to grow at a 0.6 pace over the next five years, far slower than the 1.5 percent long-term trend.

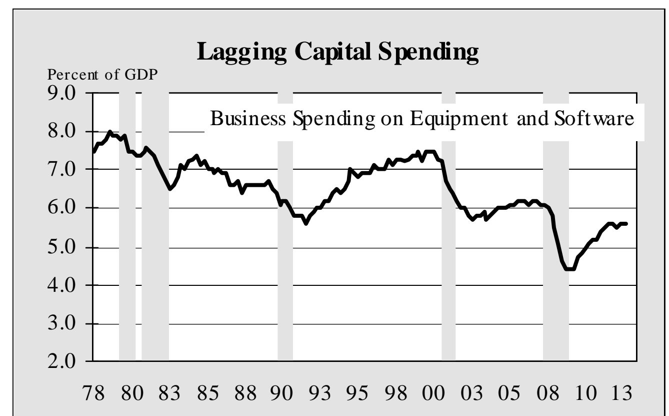
Meanwhile, the other variable in the growth equation, productivity, is also undergoing a fundamental slowdown. No doubt, the drop-off over the past year or so is typical of an aging recovery. After surging by nearly 4 percent in 2009 and 2010, labor productivity has since slowed considerably and showed no gain over the first two quarters of 2013 compared to a year ago. But the downshift in productivity growth started well before the last recession – averaging 1.5 percent a year since 2005 compared to 2.5 percent over the previous sixty years – that may reflect more fundamental forces. For example, business investment spending – particularly on productivity-enhancing high-tech equipment and software – has taken the smallest share of GDP over the past five years than any comparable period since the 1960s.

Lower Growth Potential.

At some point, labor productivity may well revert to its long-term mean of 2.5 percent growth, as businesses accelerate outlays on capital equipment and research and development, leading to new innovations and technological advances. However, the recent slump in capital spending together with the normal cyclical pattern as a recovery matures suggest that productivity growth will stay in the 1 –1 ½ percent range over the next several years. Combine that with the CBO's projection for the labor force puts the potential growth rate of the U.S. economy at about 2 percent, well under the 3.5 percent long-term trend.

Simply put, the economy may not have to grow as rapidly as in the past to generate inflationary pressures. True, given the apparent excess slack in the labor and product markets, there is considerable room for growth before labor costs come under pressure and/or supply bottlenecks emerge. But the slack in the labor market may contain a sizeable structural component, reflecting a shortage of workers with skills that companies need. Indeed, there are signs that employees are becoming more confident in their ability to find better-paying jobs elsewhere. One striking example is the 35 percent increase in voluntary quits since September 2009 to a four-and-a-half year high. This may be one indication that the unemployment rate need not fall as far as in the past before workers can gain more bargaining power.

Make no mistake. The economy is not on the cusp of an inflationary outbreak that would prompt the Federal Reserve to tighten credit conditions. By most measures, the inflation rate remains well below the Fed's comfort zone of 2 percent, and the risk that it recedes further is not trivial if the economy continues to underperform. But if growth picks up, as the Fed expects, the threat of deflation – and the need for a crisis-combating monetary policy – would clearly ebb. What's more, it may not take much of a growth pickup to revive inflation, and there is something to be said about staying ahead of the curve. It's important to remember, however, that a tapering off of the bond purchase program is a far cry from a tightening of policy. The Fed would simply be purchasing fewer bonds each month than before, but still expanding its holdings and providing additional support for growth. The economy may not be ready to stand on its own two feet, but baby steps towards a normalization of policy should be welcomed, not feared.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	July	June	May	April	March	February	January	12-Month Range High	Low
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
3-Month CD Rate	0.19	0.19	0.20	0.20	0.21	0.22	0.23	0.26	0.19
3-Month Treasury Bill Rate	0.04	0.05	0.04	0.06	0.09	0.10	0.07	0.11	0.04
5-Year Treasury Note Rate	1.40	1.20	0.84	0.71	0.82	0.85	0.81	1.40	0.67
10-Year Treasury Note Rate	2.58	2.30	1.93	1.76	1.96	1.98	1.91	2.58	1.65
20-Year Treasury Bond Rate	3.31	3.07	2.73	2.55	2.78	2.78	2.68	3.31	2.39
Tax-Exempt Bond Yield	4.56	4.27	3.72	3.92	3.96	3.72	3.60	4.56	3.46
Corporate Bond Yield (AAA)	4.34	4.27	3.89	3.73	3.93	3.90	3.80	4.34	3.47
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Dow Jones Industrial average	15390	15036	15172	14676	14418	13967	13615	15390	12896
S&P 500 Index	1669	1619	1640	1571	1551	1512	1480	1669	1395
Dividend Yield (S&P)	2.10	2.18	2.17	2.17	2.14	2.21	2.20	2.28	2.10
P/E Ratio (S&P)	16.2	15.6	15.9	15.5	15.4	14.9	14.8	16.2	14.2
Dollar Exchange Rate (vs. Major Currencies)	77.2	76.2	76.9	76.2	76.2	74.6	73.5	77.2	72.6

* Monthly Averages

ECONOMIC INDICATORS

	July	June	May	April	March	February	January	12-Month Range High	Low
Housing Starts (In Thousands)	896	846	919	852	1005	969	898	1005	749
New Home Sales (Thousands of Units)		497	459	453	443	445	458	497	365
New Home Prices (Thousands of Dollars)		250	263	282	258	265	252	282	245
Retail Sales (% Change Year Ago)	5.4	5.9	4.3	3.7	3.2	4.3	4.5	5.9	3.2
Industrial Production (% Change Year Ago)	1.4	1.8	1.7	1.9	3.0	2.2	2.1	3.3	1.4
Operating Rate (% of Capacity)	77.6	77.7	77.7	77.8	78.2	78.1	77.7	78.2	77.0
Inventory Sales Ratio (Months)		1.29	1.29	1.30	1.30	1.29	1.30	1.30	1.29
Real Gross Domestic Product (Annual % Change)		1.7			1.1			2.8	0.1
Unemployment Rate (Percent)	7.4	7.6	7.6	7.5	7.6	7.7	7.9	8.1	7.4
Payroll Employment (Change in Thousands)	162	188	176	199	142	332	148	332	138
Personal Income (% Change Year Ago)		3.1	3.1	2.7	2.9	2.9	2.3	7.9	2.3
Savings Rate (Percent of Disposable Income)		4.4	4.6	4.4	4.3	4.2	3.6	8.7	3.6
Hourly Earnings (% Change Year Ago)	1.9	2.1	2.0	2.0	1.8	2.1	2.1	2.1	1.6
Consumer Credit (Change in Mil. Of Dollars)		13818	17541	9766	4691	20235	13759	20235	4691
Consumer Prices (% Change Year Ago)	2.0	1.8	1.4	1.1	1.5	2.0	1.6	2.2	1.1
CPI Less Food & Energy (% Change Year Ago)	1.7	1.6	1.7	1.7	1.9	2.0	1.9	2.0	1.6
Wholesale Prices (% Change Year Ago)	2.1	2.5	1.7	0.6	1.1	1.7	1.4	2.5	0.6