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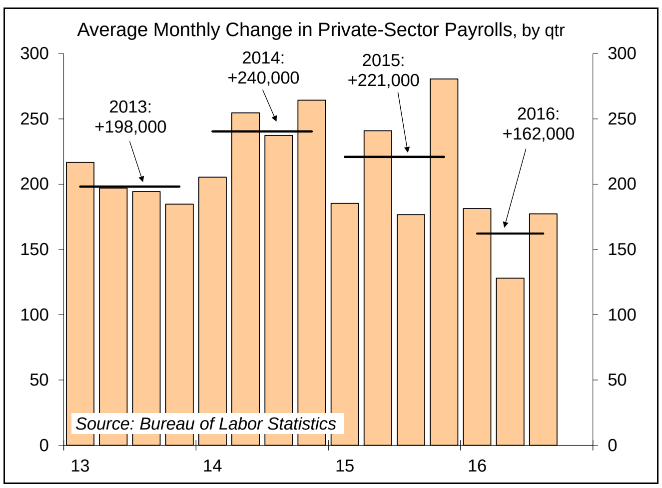
Economic Trends

The New Normal

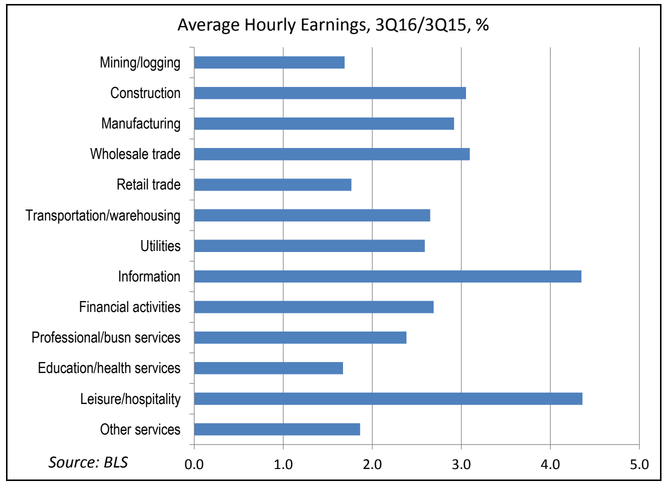
- *The near-term economic outlook is "more of the same" – mixed but moderate growth, with moderate inflation.*
- *While the presidential race appears to be less uncertain, attention has turned to down ballot contests, which could alter the composition of the House and Senate.*
- *The underlying trend of economic growth in the U.S. and around the world is slowing, creating a number of challenges for policymakers and investors.*

Real GDP rose 1.3% over the four quarters ending 2Q16, but the headline figure was restrained by slower inventory growth and a wider trade deficit. Adjusted for inflation, Private Domestic Final Purchases (consumer spending + business fixed investment + residential homebuilding), a measure of underlying domestic demand, rose 2.3%. While that may not be strong by historical standards, it's relatively robust given the changing demographics. The unemployment rate has flattened in recent months (at 4.9-5.0%), but that reflects a pickup in labor force participation. As the job market tightens, many of those on the sidelines (not officially counted as "unemployed" but willing to take a good job) are lured back into employment by a greater availability of jobs and higher wages.

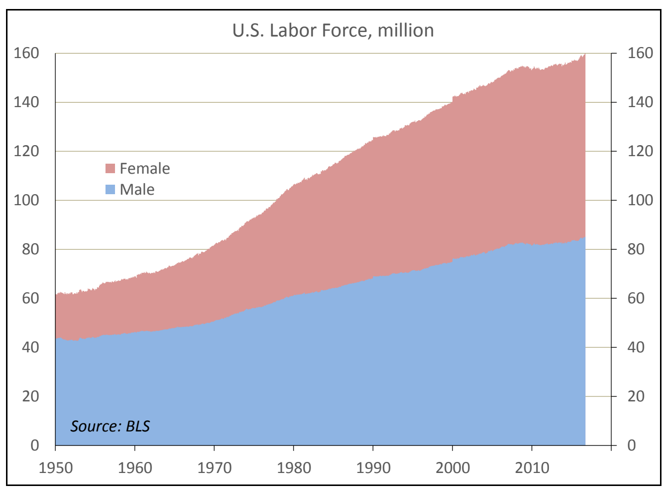


Nonfarm payrolls rose by 156,000 in the initial estimate for September, but one shouldn't get too worked up about the data for any given month. There's a fair amount of statistical noise in the data and seasonal adjustment is large in September (due to the start of the school year and the end of the summer travel season). The trend over the last several months suggests a slower pace relative to the last few years. That may reflect greater business caution ahead of the election, but anecdotal evidence suggests that firms are finding it more difficult to find qualified workers (willing to work for the wage that the firm wants to offer).

Average hourly earnings rose 2.6% over the 12 months ending in September, up from the 2.0% pace that we saw in recent years. Wage growth has been mixed across sectors.

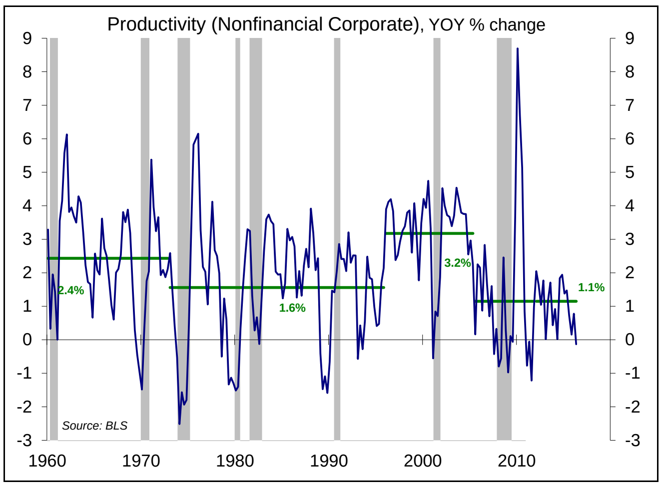


In the final four decades of the 1900s, economic growth was fueled by two significant trends. One was the arrival of the baby-boom generation. The second was a rising trend in female labor force participation. Together, these two trends lead to 1.8% average annual growth in the labor force from 1960-2000. Since 2000, labor force growth has averaged 0.6% per year (partly reflecting slack generated in the Great Recession). The Bureau of Labor Statistics expects about 0.5% per year over the next 10 years as the baby-boom generation moves into retirement. Job growth is still positive, but will be slower than we experienced in previous decades.



Other countries are experiencing similar demographic changes. Europe is aging. Japan's population is declining. One consequence of China's one-child policy is that the country's labor force peaked in 2011. Unless we get a large increase in productivity, the trend in economic growth will be a lot lower.

Economic output can be thought of as the amount of labor input times the productivity of that labor. Equivalently, economic growth is labor growth plus productivity growth. Nonfarm business productivity has slowed to about 0.5% per year in recent years. Productivity growth for the nonfinancial corporate sector is better (1.1% per year since 2006, +0.9% over the last five years), but still low by historical standards. The slowdown in productivity growth does not appear to be a measurement issue, and the slowdown is worldwide. Most likely, it is related to the slower pace of (productivity-boosting) capital investment. If so, then we should see a pickup once business fixed investment improves. There's no guarantee of that; in fact, business fixed investment needs a stronger growth outlook and stronger growth depends on business fixed investment. So, it's a chicken and egg question.



Fed officials peg the economy's long-term growth rate at 1.7%. That's consistent with policy normalization (higher short-term interest rates), but the path should be gradual. At the September FOMC meeting, most officials expected to hike once by the end of this year, twice in 2017, and three times in 2018.

Slower trend growth creates a number of challenges. At any particular growth rate, some sectors of the economy will do better than others. In a slower growth trend, some sectors are likely to contract while others expand. Slow growth leaves the economy susceptible to negative shocks, and policymakers have limited scope to deal with a downturn. Slow growth also strains government budgets (making it harder to meet retirement and healthcare obligations for aging populations).

Corporate earnings seem to face an uphill battle; top line growth is expected to slow, while labor costs are set to rise. Results will vary. Some industries may decline while others improve. Over the years, the great success of the U.S. economy has been the ability to reinvent ourselves. Advances in artificial intelligence, robotics, medicine, and other fields hold a lot of promise for the future. In the years to come, labor-saving technologies can help to offset much of the slowdown in labor force growth. It's not necessarily a bleak outlook. However, there will be winners and losers over time.

Election-year uncertainty is often cited as a negative for business investment. A lot can happen in the next few weeks, but the Electoral College map has been looking much better for Hillary Clinton (she leads in most of the key battleground states, which Donald Trump would have to sweep). In the Senate, the Republicans are playing defense this year (defending 24 seats, vs. 10 for the Democrats). A pickup of four or more seats would give Democrats a majority, but it's very unlikely that they would achieve a 60-seat super majority (hence, the Republicans can put up roadblocks). The Democrats appear poised to gain seats in the House, but getting even close to a majority is a long shot. During Bill Clinton's administration, gridlock had some benefits (we ended up with a budget surplus), but in the current environment, the two sharply divided parties will need to come together. As they say, despair is easy, hope is hard.

	4Q15	1Q16	2Q16	**3Q16**	**4Q16**	**1Q17**	**2Q17**	**3Q17**	**4Q17**	2015	**2016**	**2017**	**2018**
GDP (↓ *contributions*)	0.9	0.8	1.4	***2.6***	***2.3***	***2.0***	***2.0***	***2.0***	***2.0***	2.6	***1.5***	***2.1***	***1.9***
consumer durables	0.3	-0.1	0.7	***0.6***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.5	***0.4***	***0.3***	***0.2***
nondurables & services	1.2	1.2	2.2	***1.1***	***1.1***	***1.1***	***1.2***	***1.2***	***1.2***	1.6	***1.6***	***1.2***	***1.2***
bus. fixed investment	-0.4	-0.4	0.1	***0.1***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.3	***-0.1***	***0.2***	***0.2***
residential investment	0.4	0.3	-0.3	***0.1***	***0.2***	***0.2***	***0.2***	***0.2***	***0.1***	0.4	***0.2***	***0.1***	***0.1***
Priv Dom Final Purchases	1.8	1.1	3.2	***2.2***	***2.0***	***2.0***	***2.0***	***2.0***	***2.0***	3.3	***2.2***	***2.1***	***2.0***
government	0.2	0.3	-0.3	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.3	***0.2***	***0.2***	***0.2***
exports	-0.3	-0.1	0.2	***0.6***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.0	***0.0***	***0.3***	***0.2***
imports	-0.1	0.1	0.0	***-0.2***	***-0.3***	***-0.2***	***-0.2***	***-0.2***	***-0.2***	-0.7	***-0.1***	***-0.2***	***-0.2***
Final Sales	1.2	1.2	2.6	***2.4***	***1.8***	***1.9***	***1.9***	***2.0***	***2.0***	2.4	***2.0***	***2.0***	***1.9***
ch. in bus. inventories	-0.4	-0.4	-1.2	***0.2***	***0.5***	***0.1***	***0.0***	***0.0***	***0.0***	0.2	***-0.4***	***0.1***	***0.0***
Unemployment, %	5.0	4.9	4.9	4.9	***4.9***	***4.8***	***4.8***	***4.8***	***4.8***	5.3	***4.9***	***4.8***	***4.9***
NF Payrolls, monthly, th.	282	196	146	192	***150***	***135***	***140***	***135***	***130***	229	***171***	***135***	***118***
Cons. Price Index (q/q)	0.8	-0.3	2.5	***1.6***	***3.3***	***2.2***	***2.1***	***2.0***	***1.9***	0.1	***1.3***	***2.3***	***2.0***
excl. food & energy	2.2	2.7	2.1	***2.0***	***2.0***	***1.9***	***1.9***	***1.9***	***1.9***	1.8	***2.2***	***1.9***	***1.9***
PCE Price Index (q/q)	0.3	0.2	2.0	***1.3***	***2.7***	***2.1***	***1.9***	***1.9***	***1.8***	0.3	***1.1***	***2.0***	***1.9***
excl. food & energy	1.3	2.0	1.8	***1.6***	***1.8***	***1.7***	***1.7***	***1.7***	***1.7***	1.4	***1.7***	***1.7***	***1.7***
Fed Funds Rate, %	0.16	0.36	0.37	0.40	***0.44***	***0.63***	***0.65***	***0.88***	***1.13***	0.13	***0.39***	***0.77***	***1.27***
3-month T-Bill, (bond-eq.)	0.1	0.2	0.3	0.3	***0.4***	***0.6***	***0.7***	***0.9***	***1.2***	0.1	***0.3***	***0.8***	***1.3***
2-year Treasury Note	0.8	0.8	0.8	0.7	***1.0***	***1.1***	***1.3***	***1.4***	***1.5***	0.7	***0.8***	***1.3***	***1.8***
10-year Treasury Note	2.2	1.9	1.8	1.6	***1.8***	***2.1***	***2.2***	***2.5***	***2.6***	2.1	***1.8***	***2.4***	***3.0***