City National Rochdale®
INVESTMENT MANAGEMENT

Economic Perspectives

WHOEVER WINS, STRONGER GROWTH WILL LIKELY REMAIN ELUSIVE

NOVEMBER 2016

Paul Single
Managing Director
Paul.Single@cnr.com
(415) 576-2531

Steven Denike
Portfolio Strategy Analyst
Steven.Denike@cnr.com
(212) 702-3500

IN THIS ISSUE

- U.S. economic growth has modestly picked up after several disappointing quarters
- Labor market conditions remain healthy
- Inflation pressures firming on higher energy prices and shelter costs
- Fed appears on track for a December rate hike

By most measures, this has been an unusual presidential election year. What has not changed are the bold promises made by political candidates to fix the economy. Ever since the financial crisis, the U.S. economy has grown at a stubbornly slow rate—far less than the 3.0% or more that is widely considered a sign of good health. However, the factors holding back economic growth are more complex than what politicians would have you believe and are not subject to easy fixes.

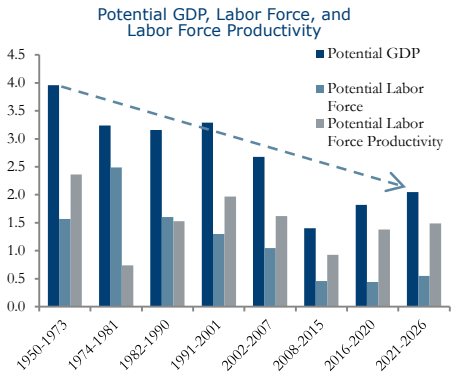
A nation's economic potential is ultimately a product of its labor force's growth and productivity. The math is simple: More workers plus higher output per worker equals stronger economic growth. Unfortunately, over the last five years, labor productivity has fallen to an annual rate of just 0.5%, the lowest level since the early 1980s. Why productivity growth has stalled is a source of some debate, but a big part of the recent slowdown is likely due to the fading impact of the IT revolution. Output per worker has been trending lower since it peaked at more than 3.0% in the early 2000s.

The U.S. economy will likely see a resurgence in productivity growth at some point in the future, but it is very hard to know exactly when that might be or what might spark it. Historically, productivity advances in fits and starts, and while innovation certainly has something to do with it, the ability to stimulate innovation is something over which governments have very little control. In the meantime, the problem can become self-reinforcing. Lower output per worker drives labor costs up and profits down, limiting businesses' ability to invest in the capital equipment needed to make workers more efficient or in the research necessary for the next technological breakthrough.

The far bigger problem for the economy is shifting labor dynamics (*Figure 1*). With the birth of the baby boomer generation, the U.S. enjoyed a substantial post-war demographic dividend as the number of workers relative to the total population reached a historic high. When boomers reached working age in the 1960s and 1970s, they significantly drove up the supply of labor, and that in turn boosted economic growth. The effect was especially strong because boomer women joined the workforce in much greater numbers than their mothers did.

But the boomer generation also ended up having fewer children than their parents did. And as they age and retire, they are leaving fewer people in the American workforce, reducing the country's economic output. Recent research from the Fed has shown that these demographic changes account for about a 1.25 percentage point decrease in annualized GDP growth since 1980, which according to some estimates is essentially most of the decline we've seen in that metric. Since America's working population is not set to grow much in coming decades, the effect of these trends will likely grow more pronounced.

Figure 1



Source: CBO Forecasts.
As of January 2016.

All of this means that the economy is likely operating close to its economic potential even with GDP growth around 2.0%. The U.S. is not alone in facing these challenges. Countries in Europe and East Asia are undergoing similar transitions, with rapidly aging populations and declining productivity growth. In fact, given this trend and the current political environment, it is ironic that the only way to sustain a meaningful acceleration in economic growth over the foreseeable future would be to attract a massive wave of new immigrants.

The 2008 financial crisis, fiscal fights in Washington, Europe's repeated debt crises, China's slowdown, and more have all undoubtedly contributed to the current malaise. In this context, it is tempting to think what ails the economy can be solved if only the right policy mixes were in place. However, the simple fact is that the "golden age" of 3.0% plus growth of the post-war era was driven by a unique but fading combination of technological advancements and a demographic boon. There is not much that policymakers can do to change that. Voters will need to reset their expectations for more modest economic growth no matter which candidate wins the election next week.

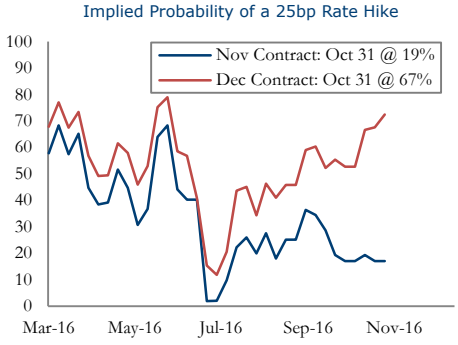
THE FED

The final Fed meeting will be mid-December; the general expectation is that the Fed will raise rates then.

2016 started off with the Fed forecasting a hike of 100 basis points in the federal funds rate. Presumably, this would have been implemented through four separate quarterly hikes of 25 basis points each. As the year progressed, however, the Fed downgraded its expectations. The expected first quarter rate hike was negated after plummeting oil prices caused the global economic outlook to fall. During the second quarter, uncertainty surrounding the U.K. referendum (commonly referred to as "Brexit") prompted the Fed to further reduce its outlook to just two increases this year. Last month, the Fed changed its forecast again—this time to one rate hike this year.

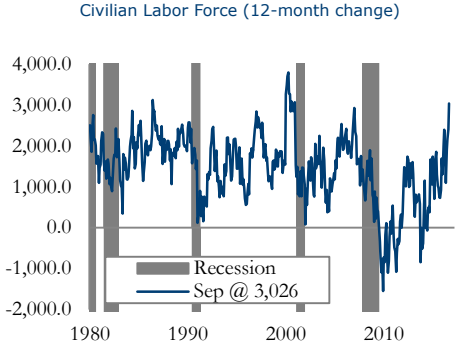
There are only two Fed meetings left in 2016. The next one will end on November 2, and expectations are very low that any Fed action will occur so close to the general election (which will take place on November 8). The final meeting will be in mid-December; the general expectation is that the Fed will raise rates then (*Figure 2*). That is our expectation as well.

Figure 2



Source: Chicago Board of Trade, Bloomberg
October 28, 2016

Figure 3



Source: Bureau of Labor Statistics
September 30, 2016

LABOR

Based on the September report from the Bureau of Labor Statistics, employment remains on solid footing with a 156,000 gain in payrolls.

Based on the September report from the Bureau of Labor Statistics, employment remains on solid footing with a 156,000 gain in payrolls. This marked the 72nd consecutive monthly increase—the longest uninterrupted stretch of job growth on record. In a separate survey, the unemployment rate popped up to 5.0% from 4.9% in August. Here, the rise in employment (354,000) was more than offset by a large increase in the labor force (444,000), which resulted in the Labor Force Participation Rate moving up to 62.9%. While this report can be volatile on a monthly basis, the yearly change in the participation rate is up 0.5%, marking the largest annual increase since the recession ended—a clear reversal from more than a decade of falling. Average hourly earnings are at $25.79, which is up 2.6% from this same time last year.

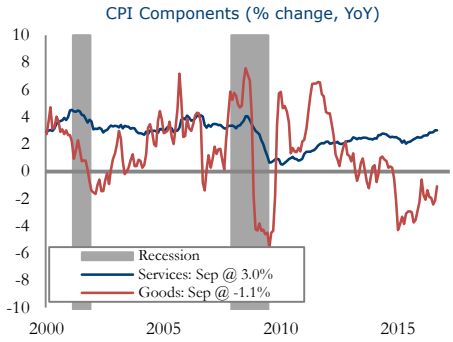
The increase in the labor force is the main reason why the unemployment rate has been relatively stable in the past year. Since September 2015, the unemployment rate has fallen just 0.1%. This is a notable slowdown from the 5.0 percentage point drop over the previous six years (which averaged an annual drop of 0.8 percentage points per year). The labor force has increased by 3.0 million individuals in the past year—the largest such increase since 2000, which was near the peak of the tech boom (*Figure 3*). These continued improvements will help to set the stage for a tightening of Fed policy this coming December.

INFLATION

The price pressures of goods and services continue to work their way up to the Fed's target level of 2.0%.

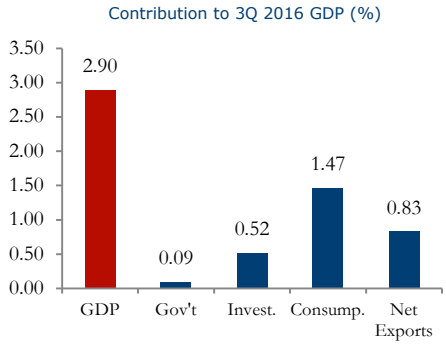
The price pressures of goods and services continue to work their way up toward the Fed's target level of 2.0%. The Consumer Price Index (CPI) is up 1.5% year-over-year, a jump from the previous month's reading of 1.1% (*Figure 4*). The core reading, which excludes the volatile food and energy component, is up 2.2% in the past year. This core reading has been above the target level of 2.0% since October of last year. The main reason for the low level of inflation has been the plunge in energy and commodity prices over the past several years. This year, however, energy prices have been rising. Oil has more than doubled in price since hitting a nadir this past February, and most other commodity prices have stabilized. This combination has put upward pressure on the yearly change in some inflation components. Importantly, inflation is also getting a boost from the tight supply in housing and medical costs.

Figure 4



Source: Bureau of Labor Statistics
September 30, 2016

Figure 5



Source: Bureau of Economic Analysis
September 30, 2016

The service component, which makes up 62.0% of CPI, has increased 3.0% in the past year. The goods component, which makes up the remaining 38.0%, has decreased 2.1% in the past year.

GDP

Two areas of growth were key in helping the GDP regain its footing in the third quarter: exports and inventories.

Economic growth in the third quarter surged to 2.9%, the strongest level in two years. Importantly, this showed the economy bouncing back from the previous three quarters' sluggish rates of growth, which were each below 1.5%. The third quarter's growth helped lift the yearly change in GDP from 1.3% to 1.5%. Since the recession ended, the economy has averaged 2.1% growth per quarter.

Two areas were key in helping the GDP regain its footing (*Figure 5*). Due to a bad harvest season in Brazil, U.S. sales of soy beans to China increased significantly in the last quarter, causing exports to rise 10.0%—the largest quarterly increase since 2013. This is not expected to be replicated next quarter. The other area of growth was inventories, which posted its first positive contribution to GDP following five consistent quarters being a drag on GDP.

Consumption, which makes up more than two thirds of GDP, increased 2.1%. Lately, this has been a volatile number on a quarterly basis, but the yearly change has been relatively stable: up 2.7% for the past year.

Index Definitions

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, including transportation, food, and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

The Core Personal Consumption Expenditures Price Index (Core PCE) measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

Important Disclosures