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INVESTMENT MANAGEMENT

Economic Perspectives

MAKING AMERICA PRODUCTIVE AGAIN MARCH 2017

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Figure 1

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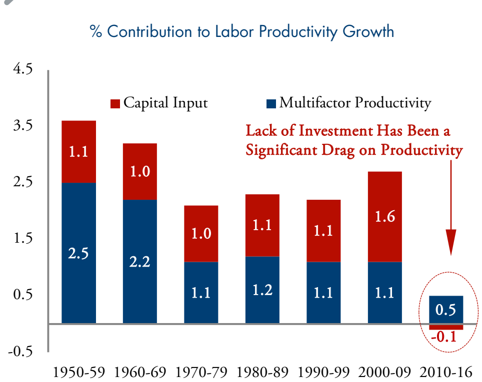

Source: Bureau of Labor Statistics
February 2017

The U.S. economy appears to be off to a good start this year. Following a batch of stronger-than-forecasted economic reports, the Citi U.S. Economic Surprise Index recently hit a three-year high, and the Atlanta Fed's GDP tracker is forecasting first-quarter growth to come in at a solid 2.4%, a bit better than the 2.1% average since 2010. But judging from the stock market and a number of business and consumer surveys, many Americans are now expecting more out of the economy. Whether those expectations can be met will likely depend on the ability of policy changes to spark a recovery in business investment and a revival in productivity growth.

Lack of productivity gains has been a key reason why economic trend growth has been so lackluster during this expansion. Typically, productivity growth accelerates during an economic expansion as labor and capital utilization rates recover. But with the economy now operating close to full capacity, that clearly hasn't happened. Last year marked the sixth consecutive year that productivity growth has been less than 1%. In fact, if anything, the performance of productivity is getting even worse.

While the slump in productivity can be traced back to a number of different causes, a big contributing factor has been the pullback in business investment. Despite high levels of corporate cash, low interest rates, and widely accessible capital market funding, business investment has been one of the more disappointing elements of the economic recovery, as it has failed to keep pace with other measures of growth. Since the Great Recession, the level of capital relative to labor and output has been declining or flat. In other words, instead of adding to productivity growth, it has subtracted from it (*Figure 1*).

Encouragingly, several policy proposals of the new administration and Congress could provide the key to unlocking pent-up demand among American businesses. The first is reducing government regulation to provide a more favorable climate for investment. Ever-increasing regulation, however well-intentioned, has been detrimental to the formation of capital, especially for the little guy. Small businesses surveyed by the National Federation of Independent Business (NFIB) have increasingly cited government requirements as the single most important problem facing their businesses. Overall, the Competitive Research Institute estimates that nearly 10% of GDP is associated with the cost of federal regulation and intervention.

Likewise, for some time, there has been bipartisan agreement that the current corporate tax code is overly complex and even contains some perverse incentives. Capital is mobile, and America's relatively higher tax rate hurts its competitive position globally as a place for businesses to invest. Research by the OECD has found that corporate tax rates have the most adverse impact on investment and productivity, with one study finding that a 10% reduction in the current rate could lift annual growth in GDP per capita between one to two percentage points.

Already, several measures of business confidence and investment intentions have picked up meaningfully since the election, suggesting that business' "animal spirits" have indeed been reignited. Most notably, the NFIB's Index of Small Business Optimism has skyrocketed, with the percentage of businesses saying that "now is a good time to expand" rising to its highest level since 2005. Of course, expectations are volatile, and a great deal of uncertainty remains regarding the timing and composition of changes coming out of Washington.

Critically, the ultimate impact will depend on how these plans are paid for, since an increase in the federal debt burden raises interest rates and can crowd out private investment over the long run. In the nearer term, with the U.S. economy already close to full employment, there is also the risk that stimulative policy changes could place upward pressure on inflation and lead to a faster pace of Fed rate hikes. Nevertheless, if reforms are focused on removing impediments to business investment, they may hold the answer to finally reviving productivity and lifting potential economic growth towards more historic norms.

THE FED

Fed policymakers are likely to hike the federal funds rate several times this year.

Federal Reserve Board Chair Janet Yellen gave her semiannual talk on monetary policy to Congress this past month (what used to be called the "Humphrey-Hawkins testimony"). She suggested that policymakers are likely to hike the federal funds rate several times this year. While she did not specify when that would happen, the Fed has plans for three rate increases of 25 basis points in 2017. The general belief is that the Fed is itching to raise interest rates. Economic data is strong enough for the planned rate increases, and the current level of the federal funds rate is highly stimulative. Adjusted for inflation, it is negative (*Figure 2*). In which months the Fed chooses to raise rates is not the important issue. What matters is that the Fed will follow through with its forecast of three hikes this year. Last year, the Fed expected to increase rates four times but ended up raising rates just once, and that was at the end of the year.

Additionally, Yellen gave an upbeat view on the economy, noting that it "has continued to make progress toward our dual-mandate objectives of maximum employment and price stability," and that Fed policymakers "expect the economy to continue to expand

Figure 2

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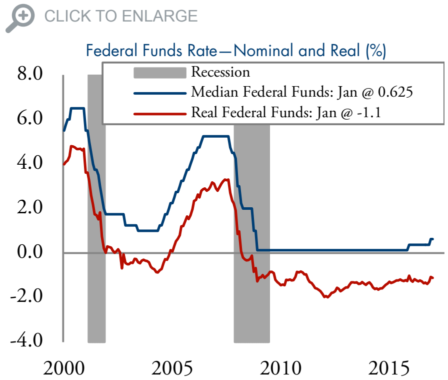

Note: "Real Federal Funds" is defined at nominal federal funds minus Core-PCE (12-months trailing)
Source: Federal Reserve Bank, Bureau of Labor Statistics
Feburary 2017

Figure 3

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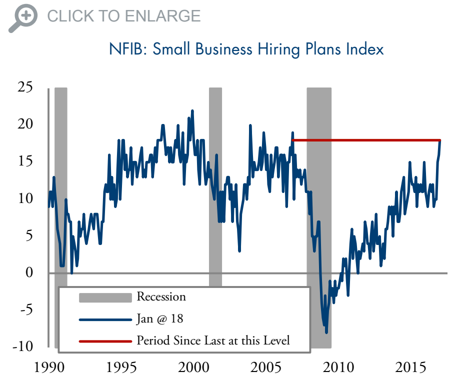

Source: National Federation of Independent Business
February 2017

at a moderate pace, with the job market strengthening somewhat further and inflation gradually rising to 2.0%."

EMPLOYMENT

The new year got off to a strong start, with January nonfarm payrolls leaping 227,000.

The new year got off to a strong start, with January nonfarm payrolls leaping by 227,000— well above the 148,000 average of the previous three months. This is a pattern that has been seen before in this expansion. During periods of uncertainty (in this case, the general election), employers delay hiring but later reaccelerate once the uncertainty passes. Another cause behind the growth is businesses' increasing optimism about the economy. The National Small Business Association survey for January reported that hiring plans are the strongest in more than a decade (*Figure 3*). Combine that with expectations for a looser regulatory environment and some analysts are getting excited about stronger gains in labor. But at this late in the expansion, to attract qualified workers, business will need to pay up.

The unemployment rate popped up from 4.7% to 4.8%, reflecting an increase in the labor force participation rate from 62.7% to 62.9%. Also, the number of workers working part time increased, probably due to strong hiring in such part-time industries as retail and leisure & hospitality.

INFLATION

CPI is now at 2.5%, the highest level in almost five years.

Prices took a big jump in January, with the monthly change in the Consumer Price Index (CPI) jumping 0.6%—the biggest monthly increase in almost four years. Nearly half of the increase came from a surge of 7.8% in gasoline prices for the month. These prices now stand 17.5% higher than they were a year ago (*Figure 4*) and have been on an upward trajectory since hitting a cycle low last February, when oil prices also hit the cycle low of $26.61 per barrel. CPI is now at 2.5%, the highest level in almost five years. It has been on a swift and steep trajectory for the past two years, moving 2.7 percentage points from -0.2% in March 2015. Most of that upward movement is due to energy and other commodity prices, which fall into the "Goods" category that makes up roughly 36% of CPI.

The remaining roughly 64% of CPI is "Services." Here, inflation has been far more steady. In that same period of time, the service component of CPI has moved up just 1.4%.

Figure 4

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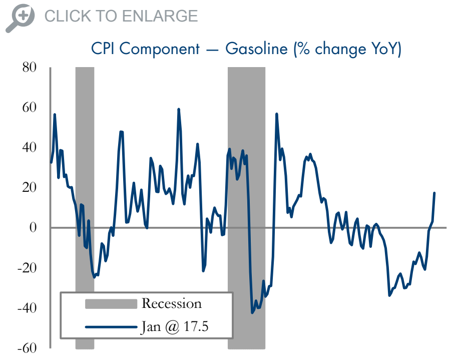

Source: Bureau of Labor Statistics, Bureau of Economic Analysis
February 2017

Figure 5

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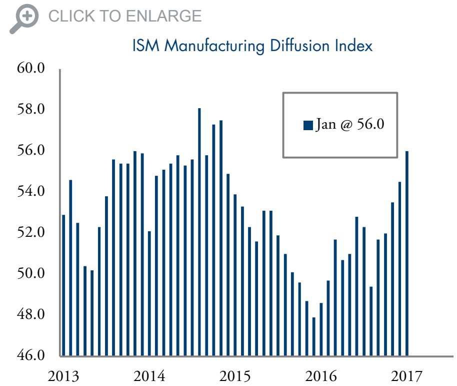

Source: Institute of Supply Management
February 2017

Economists refer to service prices as being "sticky," since they tend not to move as much as goods prices. That said, service prices have been driven up by housing and medical costs, and are currently at 3.5% YOY, which is well above the expansion average of 2.0%.

This is the healthiest the manufacturing sector has looked in quite some time.

MANUFACTURING

The January ISM Factory Composite Index increased 1.5 points, marking the fifth consecutive monthly advance. It now stands at 56.0, which is the highest reading since November 2014. This is the healthiest the manufacturing sector has looked in quite some time. This index has been on an upward trend since hitting a cycle low back in December 2015. At that time, oil prices were near their lows. Since then, they have experienced a gradual rebound, which has helped the mining portion of the index. In addition, many of the headwinds facing the factory sector have eased, and manufacturers are benefiting. Most notably, the surge in the dollar back in 2014 and 2015 has stabilized and is no longer causing a drag. Finally, global growth has inched up a tad in recent months.

However, uncertainties remain. On one side, the administration has been vocal about reducing corporate tax rates and providing regulatory relief. This could be highly beneficial to the manufacturing sector and may be the catalyst for more investment in this sector. But talk of trade wars is something that could be detrimental to the entire economy. Time will give us those answers.

Index Definitions

The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median).

The small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of 10 seasonally adjusted components based on the following questions: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job openings, expected credit conditions, now a good time to expand, and earnings trend.

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 ISM Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. A composite diffusion index monitors conditions in national manufacturing and is based on the data from these surveys.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.