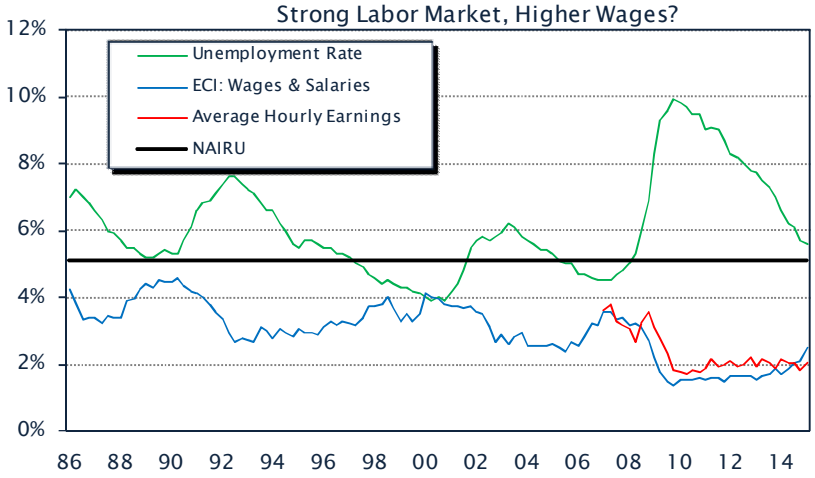
JUNE 2015

INVESTMENT UPDATE

The head of the International Monetary Fund (IMF), Christine Lagarde, suggested in a speech this month that the Fed should hold off raising short term interest rates for all of 2015. Not only was the advice unusual (there's no real policy coordination between the two bodies) but it will certainly be ignored; it's hard to think of a policy-making institution that's more fiercely independent than the Federal Reserve. You can almost imagine the chuckling that resounded through the halls of the Fed's Washington and New York offices. If anything, this might make the Fed even more determined to raise rates sooner rather than later, so that there's no doubt about who calls the shots on US monetary policy.

But, on the face of it, Ms. Lagarde's advice might not be so off-key. The Fed is clearly anxious to begin pushing up its official rate, the overnight interbank lending rate known as the Fed funds rate, from the zero-point-zero yield that's been in place for more than six years. The ZIRP (zero interest rate policy), along with the Fed's bloated balance sheet, are the last remaining vestiges of the extraordinarily unorthodox tools that the Fed pulled out of its toolkit in order to prop up both the global banking system and the US economy during the financial crisis. By definition, tools that are "extraordinary" should be used only during very unusual periods. And by many conventional measures, the US economy has recovered to the point that policies can and should return to normal.



The main argument in favor of the Fed delaying the "liftoff" in short-term rates is that the economy in the US is fragile (and economies outside the US may be even more fragile), and raising rates will slow growth down to a crawl, raising the risk of sending us back into a recession. Here again, there's some truth to this notion. First quarter 2015 GDP growth in the US was negative compared to the previous quarter, mostly due to certain one-time factors (port closures on the West coast and severe weather in the Eastern half of the country). Forecasts for current quarter GDP and the rest of 2015 are looking up, but practically nobody—not even the Fed—is looking for the economy to take off in the next few quarters. Delaying the increase in short rates will help the US economy continue to build momentum over the next few years without the volatility and uncertainty associated with an increase in rates.

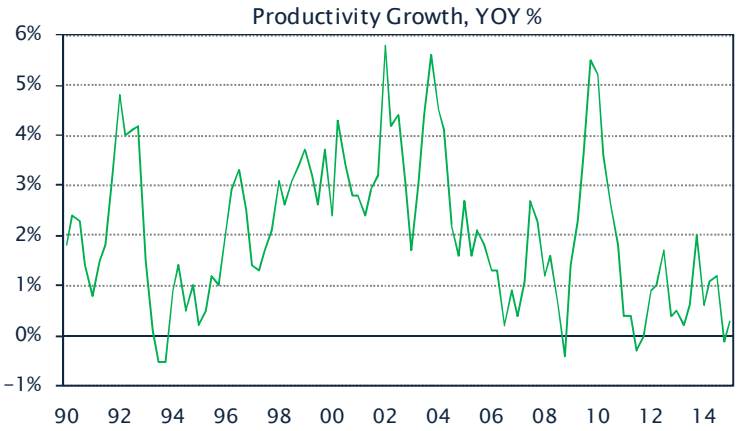
Supporting this argument is the idea that the Fed can always raise rates more aggressively later; by waiting to boost rates, the worst that could happen is that the economy overheats and spurs inflation. But there's little risk of that happening any time soon, as this recovery has been marked by the near-complete absence of consumer price inflation, as a worldwide glut in both the raw materials and the capacity to produce goods has kept prices down. Meanwhile, consumerism in general has taken a back seat to thriftiness, as households de-levered their balance sheets, further restraining demand for goods and services.

Despite the combination of weak demand and global slack, this month marks the sixth anniversary of the "official" end of the Great Recession (according to the eggheads at the National Bureau of Economic Research, who decide these things), a point in the economic cycle where that slack begins to get used up. Perhaps the most important indicators of US economic health, those measuring the strength of the labor markets, are starting to show that they're running out of slack. As the chart on this page shows, the unemployment rate, which currently stands at 5.4%, has been falling steadily during this economic expansion after hitting a cyclical high of 10.0% in late 2009. Somewhere around the 5% mark (and this number varies over time and is open to interpretation), the unemployment rate falls to the point where companies are forced to begin raising wages in order to attract qualified new workers; this level of unemployment is known by economists as the NAIRU—the non-accelerating inflation rate of unemployment.

The chart shows this strong negative correlation between unemployment and wage inflation—as the business cycle enters into a more mature stage, labor shortages begin to put upward

pressure on wages. Again, NAIRU can move higher or lower over time, and it appears that it's been falling over the past couple of decades (we're using 5.1% in this chart, the mid-point of the Fed's current estimate). The chart also shows that as unemployment hit a multi-cycle peak in '09, wages troughed well below previous cyclical lows at the same time, and have remained at or below the 2% year-over-year level throughout this recovery. It was only in the most recent quarter's reading of the Employment Cost Index (ECI) that we've seen the first blip above 2% in the cost of labor during this cycle.

Now, we don't want to read too much into a single data point, but at the same time, the laws of supply and demand were not repealed during the financial crisis. Now that most of the excess supply of labor has been absorbed, we should expect upward pressure on the costs of labor; that's axiomatic. The bigger questions are "how much" wages might rise and to what extent those increases can and will be passed on in the form of higher prices for goods and services.



Or maybe those questions don't need to be answered. Fed Chair Janet Yellen, earlier this year, stated "*[history] suggests that inflation will eventually begin to rise as resource utilization continues to tighten. It is largely for this reason that a significant pickup in incoming readings on core inflation will not be a precondition for me to judge that an initial increase in the federal funds rate would be warranted.*" In other words, the Fed will tighten when it sees fit, and that might come even before there's a "significant pickup…in core inflation." Why the hurry?

Again, one reason may be that they simply want to "normalize" policy. The overnight Fed funds rate is the US central bank's primary tool for achieving its dual mandates of "full employment" and "price stability." But if the funds rate is permanently set to zero, the Fed gives up its best method to stimulate the economy when economic growth sputters in the future, and will have to once again resort to extraordinary measures (QE Five, anyone?). For this reason alone, the Fed should be anxious to begin pushing the funds rate higher.

But there's one more critical factor that must be concerning to Yellen and company, and that's the slowdown in productivity that has been a feature of the US economy for the past decade. As the chart on this page shows, productivity growth—the year-over-year change in economic output per unit of labor—was strong throughout the late 1990's and early 2000's, spurred by heavy investment in technology and corporate downsizing. By definition, GDP growth can only come from a combination of productivity growth and an increase in the labor pool; as a result of the improvement in productivity, the US economy grew steadily during this period.

But over the past decade, productivity has averaged just 1.4% year-over-year, the worst ten-year period in more than six decades (excluding a quick productivity trough in the early 80's). At this point in the cycle, productivity should be approximately 20% above the pre-recession level, but has only grown about 10%, despite the typical early-cycle jump in productivity in 2009-10.

The reasons for this anemic performance are beyond the scope of this *Update*, but according to researchers at the Federal Reserve Bank of San Francisco boil down to a lack of "innovative growth" (creative new technologies that increase productivity) and a slowdown in capital investment. Innovative growth is unpredictable, waxing and waning over longer periods, but capital investment is far more predictable and therefore easier to forecast and model. And the forecast for capital investment is for continued slow growth over the next few years, which douses any hope for a quick turnaround in US productivity.

Slow productivity has big implications for the labor market, and therefore, inflation and interest rates. If more workers have to be hired to pick up the shortfall in productivity, that puts more pressure in the short-term on wages and salaries. But for the longer term, low productivity means slow GDP growth, which would reduce the outlook for inflation in the coming years.

Taken together, this means that we should expect a fairly rapid rise in short rates over the near-term—helping to explain the Fed's anxiousness to raise rates. But it also implies that the so-called "terminal" Fed funds rate, once we get down the road after a couple of years of tightening, is very likely to be well below that of previous cycles.