Monthly Commentary

June 2015

The advice surplus

This Thursday, June 18, is the 200th anniversary of the Battle of Waterloo. Far more significantly it is the 27th Birthday of our older son, Andy.

Andy and his younger brother Josh are making their own way in the world now, far beyond the reach of parental control. Long gone are the days when we could threaten them with time out or cut off their allowance. Now all we can do is offer advice – great flourishing torrents of unsolicited counsel on how they should run their lives. They bear up under the flood pretty well but with much the same attitude we had at the same age – that is to say, they regard the advice as being neither informed nor disinterested. Consequently, they largely ignore it, and try to make the best decisions they can on their own.

The Federal Reserve (Fed), which meets this week, has also been the recipient of unsolicited advice, first from the IMF and then from the World Bank. The advice is to delay any rate hike until 2016. However, as in the case of much parental advice, it is not clear that the economists from either institution understand the real position of the American economy. Moreover, as they make clear, their advice is offered because they think it might help emerging markets (EM) just as much as they think it is right for the U.S.

The advice is not sound under either rationale. First, while the pace of U.S. economic growth is slower than in prior expansions, numerous indicators suggest that the economy has accelerated from its first-quarter slump and that it is rapidly absorbing excess slack in the economy. Retail sales numbers for May, including upward revisions to prior months, suggest that real consumer spending is rising at about a 2.5% annualized pace.

While manufacturing numbers are still a little soft, both home sales and home-building continue to improve and light-vehicle sales in May hit their highest level since 2005. In addition, recent inflation reports suggest that the temporary impacts of lower oil prices and a higher dollar are beginning to wane. All of this suggests better demand growth in the economy, with the potential for first quarter economic growth to be revised to a positive, and for growth to rebound to roughly 3% for the second quarter and about 2.5% for the rest of the year.

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However, the critical issue, really ignored by the IMF and World Bank, is how much the potential growth rate of the U.S. economy has slowed down. Look at three quarters in modern American history – the first quarters of 1955, 2005 and 2015. The average unemployment rate in these quarters was 4.7%, 5.3% and 5.5% respectively - not significantly different from a cyclical perspective. However, from the first quarter of 1955 to the first quarter of 2005, real GDP grew at an annual rate of 3.4%. From the first quarter of 2005 to the first quarter of 2015, it grew by a truly miserable 1.4% per year. This huge slide in output growth reflects a collapse in productivity growth and labor force growth.

Nothing in today's numbers on capital spending suggests a surge in productivity is just around the corner, while labor force growth is likely to slow down further due to the retirement of the baby boom. The reality is that the potential growth rate of the U.S. economy may be no more that 1.5% today, in which case, rebounding actual GDP growth will continue to eat up the diminished remaining slack in the economy.

The second rationale cited by the IMF and World Bank for delaying rate hikes until 2016, is higher short-term rates could cause a further surge in the dollar and destabilize global capital flows in a way that could particularly hurt emerging markets. However, history over the past 20 years has shown an unreliable relationship between the dollar and short-term interest rate differentials, so that it is by no means certain that higher short-term rates in the U.S. would, in fact, boost the dollar.

Moreover, from an economic logic perspective, it hardly seems reasonable that a 0.25% increase in short-term rates in the United States would cause long-term investors to abandon EM investing. If, due to the activities of short-term traders, EM currencies were to fall sharply, the fault would lie not with the policy change in Washington but the lack of cooperation among major central banks in intervening to stabilize currency markets. It is true that many major emerging market economies are weaker than normal. Russia, Brazil and Venezuela are all in recession while China has been experiencing slower growth. However, in each case, the economic weakness is due to home-grown mistakes and can not be fixed by an easier Fed.

Meanwhile, there are growing costs involved in waiting. The most obvious is that inflation takes time to build but also takes time to control and too much tightening, too late in the cycle is the classic monetary policy mistake that has frequently led to recessions in the past. However, there are a multitude of other potential distortions and bubbles that are being created across asset markets and asset bubbles are just as dangerous as inflation to the longevity of expansions.

Historians generally agree that Napoleon's fatal mistake on June 18, 1815 was that he thought the ground was too soft and he thus waited too long before launching an attack on the forces of the Duke of Wellington. This allowed the Prussian army the opportunity to regroup and attack him from the side.

The Fed appears to be gradually getting more comfortable with the pace of demand growth and, barring some macroeconomic shock, we believe that they will finally raise interest rates by September. As was the case two centuries ago, waiting for firmer ground would be a mistake.

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