Where are We in this Business Cycle?

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August, 2014

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Major Policy Risks Facing Investors Fading

- Systemic debt-ceiling risk
- Government shutdown
- Fiscal drag

- The behavior of the private sector, rather than the government, is becoming more important at this stage of the business cycle
- Government can still affect certain industries, companies that lobby, etc.
U.S. Past the Mid-Cycle Slowdown, in the Second Half of the Cycle

U.S. Real Gross Domestic Product

% Change - Year to Year SAAR, Bil.Chn.2009$

Source: Bureau of Economic Analysis

More volatile past.
U.S. Past the Mid-Cycle Slowdown, in the Second Half of the Cycle

U.S. Real Gross Domestic Product

% Change - Year to Year  SAAR, Bil.Chn.2009$

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More volatile past.
In the Second Half of a Business Cycle, Labor’s Share of GDP Accelerates.
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Source: Haver Analytics
In the Second Half of a Business Cycle, Labor’s Share of GDP Accelerates.

* PRODUCTIVITY BECOMES MORE IMPORTANT *
In the Second Half of a Business Cycle, Labor’s Share of GDP Accelerates.

Globalization + Technology
U.S. Wage Growth Now Headed Higher

Avg Hourly Earnings: Prod & Nonsupervisory: Total Private Industries

% Change - Year to Year  SA, $/Hour

Source: Bureau of Labor Statistics
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U.S. Wage Growth Now Headed Higher

Debate on the measure of wages: looking at hourly wages of hourly earners.
Debate on the Measure of Wages/Slack

Unemployment Margin Attachment + Part Time Economic Reasons/CLF + Margin Attachment

SA, %

“U-6”

Source: Bureau of Labor Statistics
Debate on the Measure of Wages

• 3 Views on the Labor Market
  – Extreme Slack
  – “Headline” Unemployment
  – Short-vs-Long Term Unemployment
Debate on the Measure of Wages

• 3 Views on the Labor Market
  – Extreme Slack (eg, U-6)
  – Headline Unemployment
  – Short-Long Term Unemployment Tightness

If the “Extreme Slack” arguments are correct, why are wages going up?

If Short-Term Unemployment is correct, why isn’t wage growth “fast”, eg, 4%?
Headline Unemployment: Maturing in the Business Cycle

- Headline unemployment suggests we are maturing in the business cycle

![Civilian Unemployment Rate: 16 yr +](chart)

Source: Bureau of Labor Statistics
Bottom Line: 2H of the Cycle

• The U.S. appears to be maturing in the business cycle.
• Labor market tightening, but probably not “tight”.
Second Half of a Business Cycle: Not a Complete Explanation

• Some items are getting more normal:
  – Unemployment rate headed toward 6%.
  – U.S. Inflation headed higher.

• Some items do not look normal:
  1) 1Q GDP: expected bounce?
  2) 10-year Treasury yields well under 3%.
  3) Expectations of Fed tightening in 2015?
What Else? A Bandwidth Problem?

• *Scarcity*, Mullainathan & Shafir, 2013
• People react to scarcity of things the same way.
  – Money
  – Time
  – Bandwidth

• Getting more debt is now too complicated (not too expensive)?
A Bandwidth Problem?

U.S. Nonfinancial Debt % GDP

Source: Haver Analytics
A Bandwidth Problem?

U.S. Nonfinancial Debt % GDP

Source: Haver Analytics
A Bandwidth Problem?

U.S. Nonfinancial Debt % GDP

Source: Haver Analytics
Normalization? Central Banks Have Been Stuck at the Zero Bound

- Normalization from where?
- After a shock, many central banks have been at or close to the “zero bound” on interest rates.
- This has happened around the world.
- It has attracted significant interest in the academic community.
Who Is Patient Zero?

The International Monetary Fund's top economist, Olivier Blanchard, says central bankers should consider aiming for a higher inflation rate.

*WSJ, 2/12/10*

Now “we’re in this situation where many of the central banks of the world need to convince the public of their tolerance for inflation, not their intolerance.” Kenneth Rogoff said.

*Bloomberg, 8/12/13*

“But why is the inflation target only 2 percent?”
- Paul Krugman

*NYT, 1/26/12*

Princeton professor Alan Blinder said balance sheet policies such as QE might be needed permanently if average inflation stays low and interest rates hit the zero lower bound (ZLB) more often.

*Reuters, 10/9/13*
Who Is Patient Zero?

• Bandwidth?
• Inflation targeting (target too low)?
• Very large shock?
• Other policies?
  – Monetary policy
  – Fiscal policy
  – Trade policy
  – Regulatory policy
• Interaction between various policies?
NO KICK: Zero-Bound Interest Rates

Federal Funds [effective] Rate

% p.a.

Source: Federal Reserve Board
Both the “X” and “Y” Axis are Odd
“Time” Versus “Magnitude”

- Monetary policy cannot give the economy a big enough kick.
- Can central banks make up in time (at zero) what they cannot do in magnitude?
- Problem is the reinforcement of “low for long”.
- Is “forward guidance” credible – “we’ll see”
  - Reaction function vs. measured pace vs. hard rule.
- “Three Steps and a Stumble”
Why Does This Matter?

Definition of an Equilibrium:

• The Fed behaving the way the market expects.
• The market behaving the way the Fed expects.

• Hyper-sensitivity on both sides now.
3 Main Central Bank Tools

• Are central banks tasked with too much?
• 3 tools exhausted?
  – Interest rates
  – Balance sheet
  – Forward guidance
• Add in regulatory responsibility/bubble watch.
Uncertainty = A Hyper-Sensitivity to Financial Developments

• “Financial conditions” matter.
• How much central bank tightening vs. market tightening?
  – Market tightens first.
• Less inflation, but more frequent “inflation scares” (since policy is so easy)
A Hyper-Sensitivity to Financial Developments

• “Financial conditions” matter.
• How much central bank tightening vs. market tightening?
• Less inflation, more frequent “inflation scares”
  – Wage growth now headed higher.
  – Very smooth data series.
  – Consistent with the second half of a business cycle.
Market Implications

• Volatility has been low, but for how long?
• Changing market dynamics
  – Point of the capital markets: money vs. ideas.
  – Why do companies ever spend money?
  – Activist shareholders
Thought Experiment

• The longest U.S. business cycle is 10 years (time from one recession to the next)
• We are 5 years into this cycle.
• Sometime in the next 5 years there’s likely another downturn.
• What will the policy response be?
• Monetary policy exhausted?