City National Rochdale
INVESTMENT MANAGEMENT

Economic Perspectives

U.S. DOMESTIC STRENGTH COUNTERS EXTERNAL WEAKNESS OCTOBER 2015

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

- Fed hesitates, but rate hike still likely this year
- Fears of a hard landing in China are overdone
- Advanced economies looking resilient
- U.S. labor market continues to gain momentum and reduce its slack

In recent weeks, markets were rattled over concerns about a hard landing in China and the risk that the developed world would in turn falter. Now, with a full-blown growth scare already underway, the Fed has further fueled worries by highlighting global economic risks in its recent decision to delay tightening. Meanwhile, signs of stability and even some improved economic data are generally being ignored by investors.

Recent turmoil notwithstanding, we find these fears largely overblown, and continue to expect global growth led by the United States and Europe to regain its slow upward momentum in the quarters ahead. Neither of these economies is robust, but both are getting healthier and should slowly strengthen in the absence of a shock. Indeed, the latest business surveys suggest that the pace of global growth, particularly in advanced economies, has held up fairly well, despite further weakness in China.

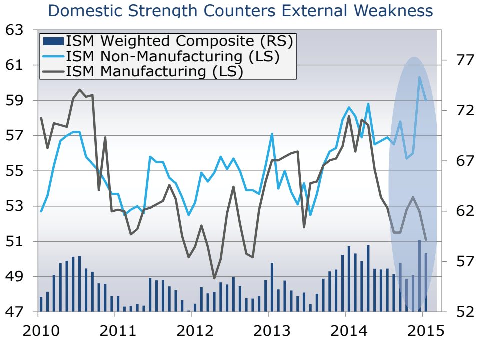
China's current weakness is focused on its "old" economy, where the large decline in fixed asset investment has kept overall growth under pressure. However, after a sharp slowdown at the start of the year, recent activity measures indicate growth has begun to stabilize and even appears to be on an upward trajectory. While it is likely that China's economy will continue to expand at a markedly slower pace than the official figures show, with policy support gathering force, the upshot is that there is no sign in the recent data of a deepening economic crisis.

Pessimism has generally dominated the landscape in the U.S. throughout the current economic expansion. However, despite the many headwinds that weighed on growth since the recovery began and the persistence of dire warnings, the economy has steadily continued its gradual recovery, creating 12.4 million net new jobs since the trough. This great improvement in fundamentals has resulted in relatively strong domestic demand and has left the U.S. economy more than able to offset any external weakness.

The divergence between the export-orientated manufacturing sector and the rest of the U.S. economy is rather striking. The most recent ISM surveys show manufacturing at a two-year low, while non-manufacturing activity remains close to a decade high *(Figure 1)*. The continuing weakness in exports and manufacturing is unfortunate, but both account for only about 13% of GDP. Meanwhile, the vast majority of sectors and domestic demand are doing well.

The environment today, of course, is not as rosy as during the period between 1980 and 2000 when credit was on a structural upswing. More people now live within their means than they did in the past. Still, the consumer sector is in better shape than is widely perceived and should endure yet another round of equity market turmoil. The key, as always, is the trend in net employment and, to a much lesser extent, housing activity; the outlook for both remains upbeat.

Figure 1



Source: Federal Reserve, September 2015

At 5.1%, the unemployment rate is now roughly in line with most estimates of the long-run natural rate. Others would argue that, since wage growth has not taken off yet, there must still be slack in the labor market, presumably because disillusioned job seekers could be coaxed back into the labor force. But the surge in job openings and the net proportion of households saying that jobs are plentiful are very strong signals that any remaining slack really is pretty limited.

The Fed is expected to remain ultra-accommodative.

Meanwhile, the housing recovery continues to roll on, driven by the improving trend in employment, ongoing affordability, and reduced debt burdens. It would take a marked deterioration in employment conditions to halt the uptrend, which is not the current message from leading indicators. While a small part of the overall economy, better housing activity and prices should provide support to further consumption and credit demand.

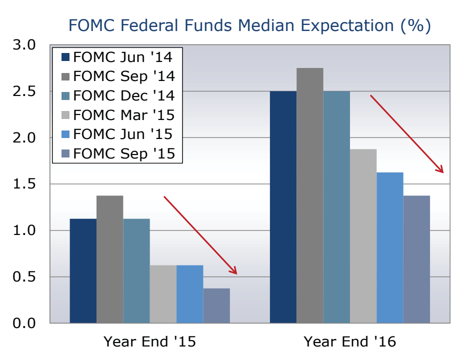
The Fed does not have any special insight into the state of the global, or even the U.S., economy. What is clear is that the Fed is expected to remain ultra-accommodative by moving slowly relative to the pace of the economic expansion even after it starts to hike rates. The start of a Fed rate cycle typically signals that the liquidity boom is cresting, but it also confirms that a self-reinforcing expansion is underway. This is a unique cycle, and it will take some more time for investors and the Fed to be convinced that the recovery is durable.

THE FED

With a vote of 9-1, the FOMC decided to keep interest rates unchanged.

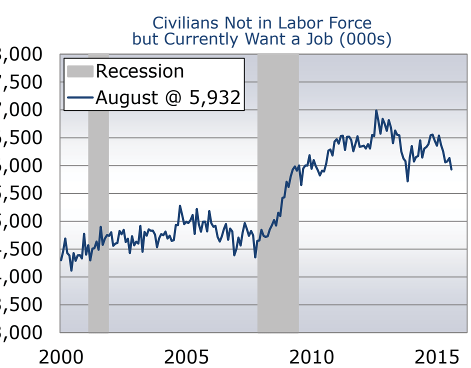
There was some expectation that the Federal Open Market Committee (FOMC), the Fed's committee that sets monetary policy, would raise the federal funds rate at its mid-September meeting. The interest rate has been at near-zero percent for almost seven years. But, with a vote of 9-1, the FOMC decided to keep interest rates unchanged. The Fed justified the postponement of the start of the tightening cycle by noting concerns about the rest of the world: "Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." Furthermore, the Fed's forecast of future levels of the federal funds rate have all been revised downward *(Figure 2)*. That said, 13 of the 17 members believe that

Figure 2



Source: Federal Reserve, September 17, 2015

Figure 3



Source: Bureau of Labor Statistics, August 31, 2015 rates will be increased by the end of the year; of the remaining four members, three believe that rates will be unchanged, and one believes that rates will fall into the negative territory.

The FOMC remains optimistic about the domestic economy.

Overall, the FOMC remains optimistic about the domestic economy. The economy is growing faster than what the Fed had previously forecasted. Business investment has been upgraded, and household consumption is expected to continue to grow. The labor market is strong, with solid monthly gains in payrolls, and the unemployment rate at just 5.1%. The inflation rate (1.2%) remains below the target rate of 2%.

LABOR

The labor force continues to gain momentum and reduce its slack. The unemployment rate fell to 5.1%, the lowest level in more than seven years. However, as we have learned, this is not the only gauge to determine the health of the labor market. The monthly change in payrolls, which was not as exciting, is more in line with the current trend. It came in at a gain of 173,000, which is below the six-month trend level of 205,000 but above a post-recession average of 153,000. The labor force participation rate fell to 62.55%, a multi-decade low.

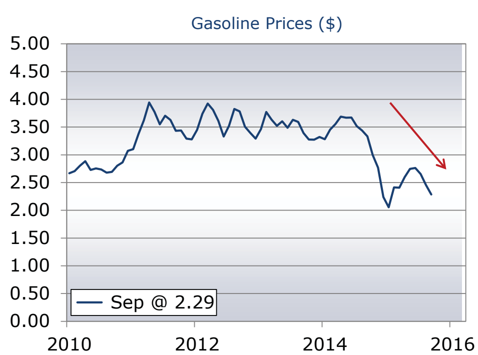
The labor force continues to gain momentum.

As we move further from the end of the economic crisis, economists are feeling that the drop in the labor force participation rate is related to structural and demographic factors, rather than cyclical factors. The evidence for this is the number of workers who want a job but are not in the labor force, which fell below six million for the first time in five years *(Figure 3)*.

INFLATION

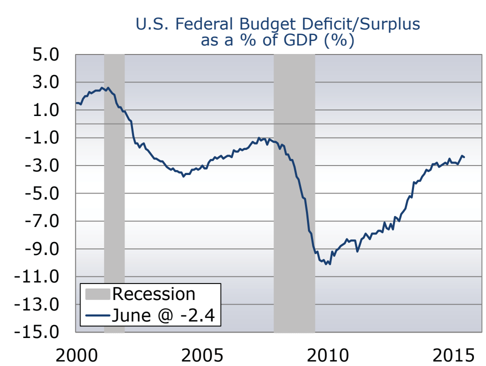
Consumer prices, which continue to remain tame, are expected to persist in the same fashion due to the drag from lower energy prices and the surge in the value of the dollar. The Consumer Price Index (CPI) is up just 0.2% over the past year, while the Personal Consumption Expenditure Core Price Index (core-PCE)—the Fed's preferred proxy for inflation—is up just 1.2%. This benchmark has been below the Fed's 2% target inflation rate for all but five months over the past five years.

Figure 4



Source: American Automobile Association, September 30, 2015

Figure 5



Source: U.S. Treasury, June 30, 2015

Gasoline prices are down 31.4% in the past year.

The Fed is neither overly concerned with the current low level of inflation, nor with where it has been for the past year. Instead, the FOMC is concerned as to where it will be one to two years from now. The current Fed leadership, the Keynesians that they are, believe that inflation is heavily driven by the slack in the labor market. Even the recent drop in global commodity prices—most notably with gasoline prices down 31.4% in the past year—is viewed as transitory *(Figure 4)*. Eventually, prices should stabilize or increase and the yearly change in the price is expected to move back up.

FEDERAL DEBT

The U.S. Treasury's fiscal year ended on September 30. Although we will not know the actual yearly deficit for several more weeks, based upon recent history, it should come in around the Congressional Budget Office's (CBO's) estimate of $426 billion—which will be an improvement over 2014's deficit of $485 billion. The 2015 shortfall will be the smallest since 2007, representing just 2.4% of GDP *(Figure 5)*.

The 2015 shortfall will be the smallest since 2007.

The falling deficit is benefiting from increasing revenues, which should continue to increase by 8% this year. Outlays are projected to rise 5%. The outlays, in particular, are benefiting from lower interest payments (low interest rates) and discretionary outlays.

Despite this marked improvement, which should continue into 2016 with a deficit of just $414 billion (2.2% of GDP), the CBO's outlook beyond that is more bleak. The CBO sees the deficit increasing to 3.7% of GDP in 2025. This will be caused by increased spending on healthcare (because of the aging population) and on higher interest rates.