No Economy is an Island

Challenging the United States Economic Decoupling Meme

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No Economy is an Island:
A More Rigorous Look Under the Hood of the U.S. Economy

Is it possible, in a global economy in which the United States' principal competitors are experiencing slow growth, disinflation or deflation, wage stagnation or slowing of wage growth, and slumping currencies relative to the US$, that the U.S. economy can be an island of relative prosperity unto itself?

Can the level of global market interest rates, in the aggregate at historically low levels (some short term rates being, in fact, negative) be ignored? Or is something more serious amiss?

Is the U.S. economy – so heavily dependent on consumption and exhibiting similar characteristics as its competitors (disinflation and anemic growth/reversals in many data points) – really as healthy as equity markets seem to believe it is?

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This slide deck contains data on, and "mostly-new" analysis of, what is really going on under the hood of what appears to many to be a U.S. economy moving out of idle and into sustainable traction forward. What you see here may explain many of the inconsistencies highlighted by the above questions and, if nothing else, should provide surprising insight.

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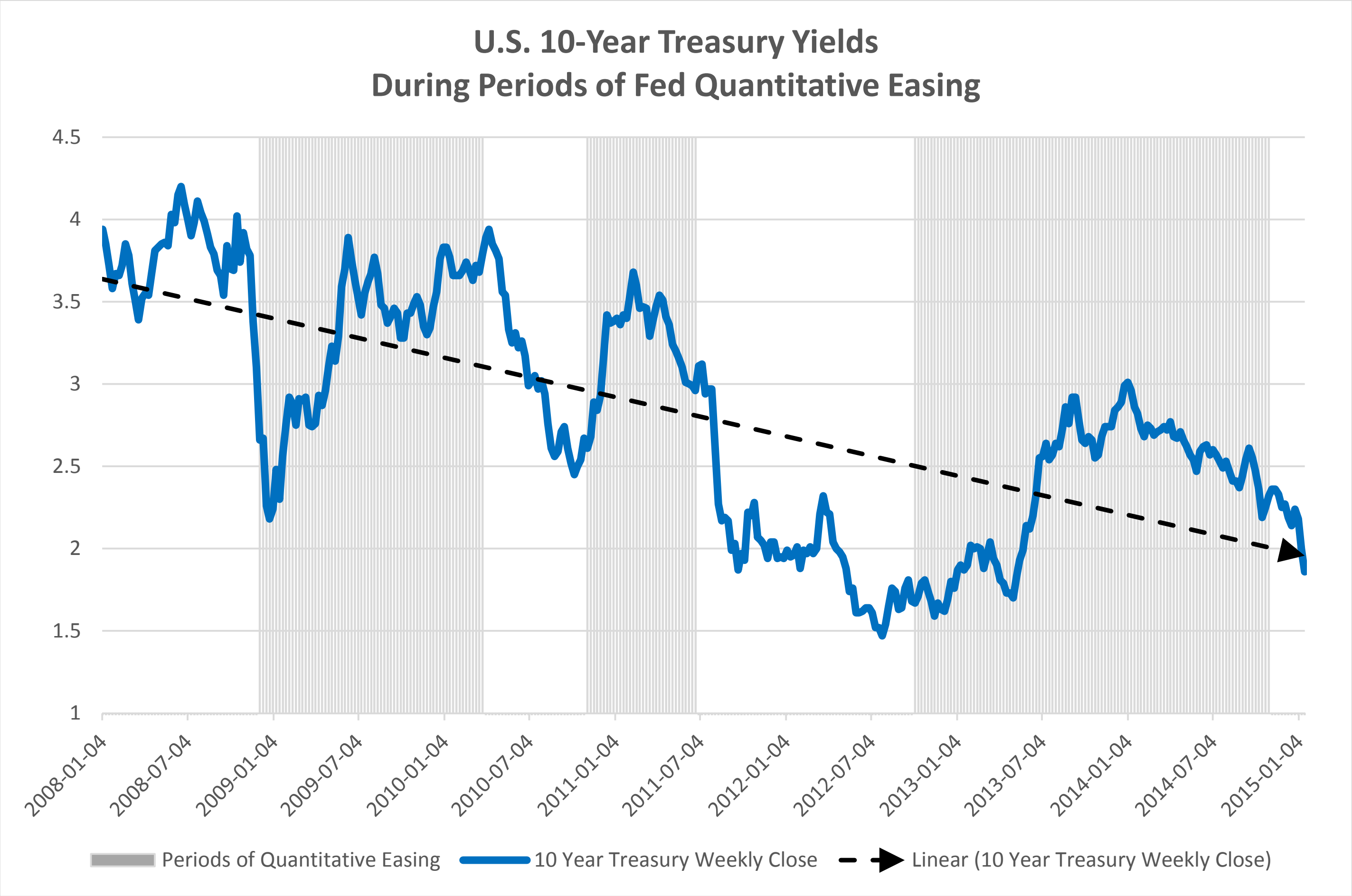
Topics Covered in this Presentation

- Extraordinary monetary intervention by the Federal Reserve, while initially necessary, actually masked the true magnitude of the global capital glut (*i.e.* interest rates were destined to fall anyway), and has distorted price discovery in financial/real assets with insufficient "bang for the buck" in the real economy.
- The U.S. employment situation is poorly understood and will not guide the economy to escape velocity in 2015.
- U.S. households are still deeply in debt on a nominal basis.
- Deflation is not just a problem for Japan and Europe – but will shortly challenge the U.S. and is being seen in the form of unexpected disinflation in China.
- Deflation is being imported to the U.S. via the strong dollar as well as global oversupply relative to weak demand.
- Inflation expectations are already significantly unanchored.
- The closed-economy hypothesis – the source of the notion that the U.S. economic health can decouple from its slumping competitors – generally proceeds from the fact that exports are a relatively low 13% of U.S. GDP. This hypothesis is incorrect as it ignores the actual mechanics of transmission of global oversupply relative to the U.S. economy.

The Fed's Zero Interest Rate and Quantitative Easing Policies may have had Less Impact on Long Term Interest Rates than is Commonly Believed

- Interest rates have fallen through-out the three periods of Quantitative Easing, as indicated by the trend line at right. But have they fallen as the result of QE policy itself?
- It is somewhat difficult to conclude that Fed policy has been the principal cause of declining long term interest rates in that in no instance have interest fallen (net) during the three periods of Large Scale Asset Purchases (LSAP), as QE is formally known. And long rates have fallen dramatically AFTER LSAP periods. ***It is reasonable to conclude that something else is going on.***



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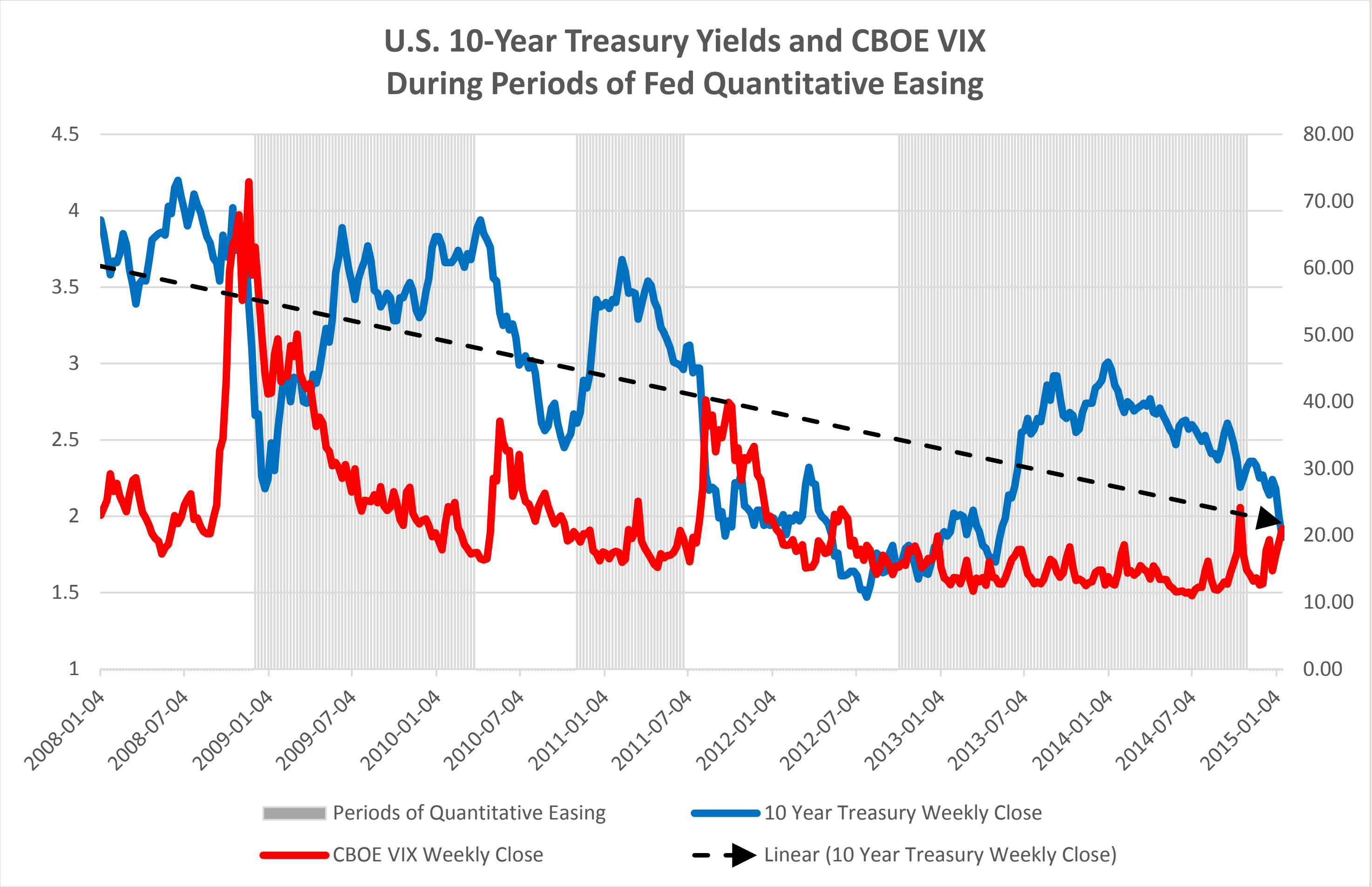
The Fed's Zero Interest Rate and Quantitative Easing Policies may have had Less Impact on Long Term Interest Rates than is Commonly Believed

- It seems clear, from the behavior of global interest rates and disinflationary trends since the Great Recession, that the global capital glut/weak demand for capital (accompanied by insufficient demand for production), not monetary policy, was exerting downward pressure on interest rates all along.
- In contrast, Fed policy had a demonstrably positive impact on <u>equity markets</u> which proved unnerved at the end of each period of QE, but re-stabilized as rates fell in between QE rounds and during them. One might therefore contemplate the question of what policy was principally being responsive to.



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The U.S. Employment Situation Indicates Serious Secular Problems

Labor Force Participation Rate (LFPR): We are, by now, all familiar with the below graph:

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Some suggest that demographic forces are the principal culprit behind the decline of the LFPR. But this argument ignores the enormous impact of the collapse of the debt driven economy and the Great Recession on the LFPR, which declined far more precipitously thereafter.

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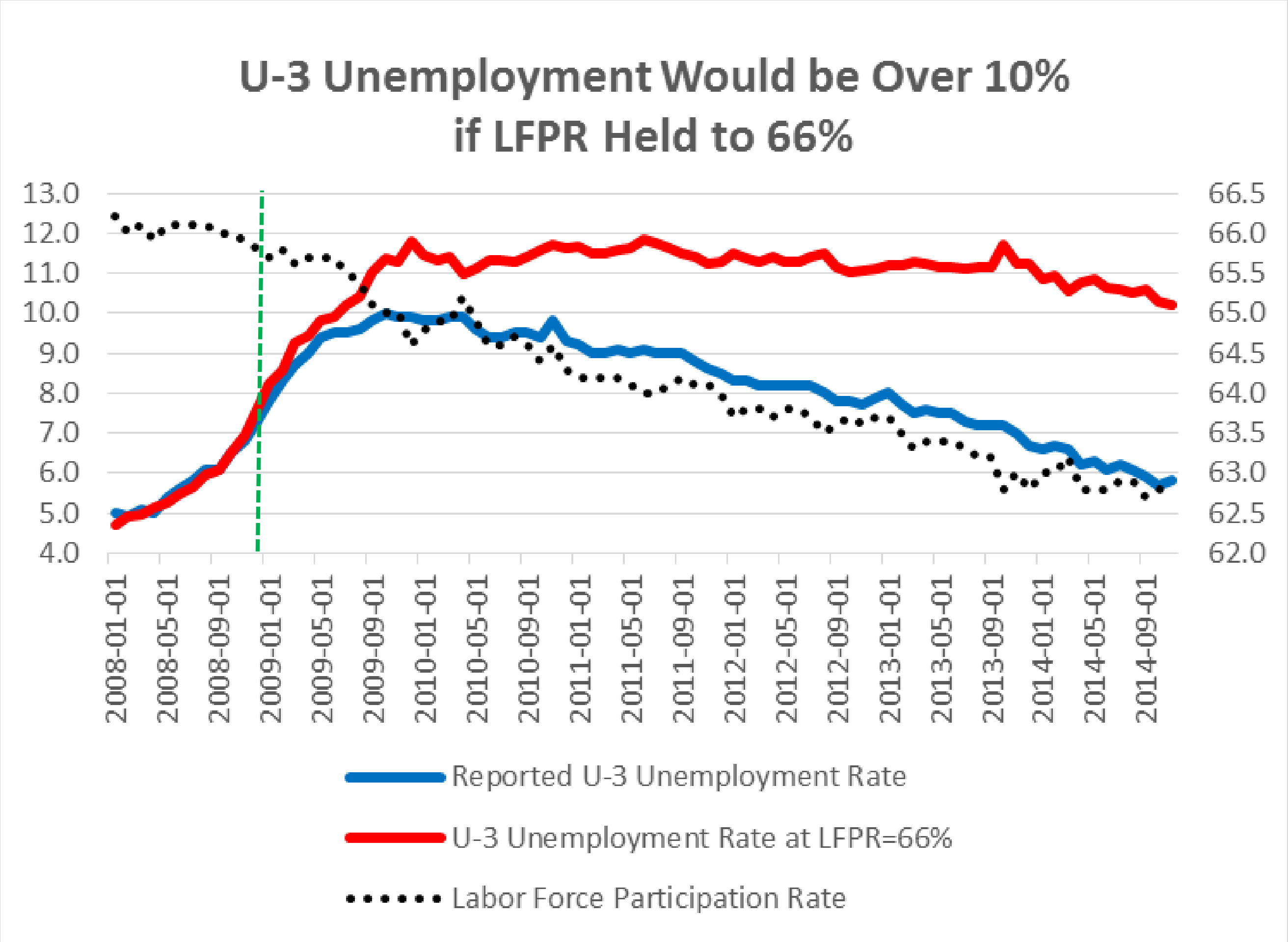
As a consequence of the substantial post-2008 decline in the Labor Force Participation Rate, the U-3 headline unemployment rate is of diminished relevance in analysis and policy-setting:



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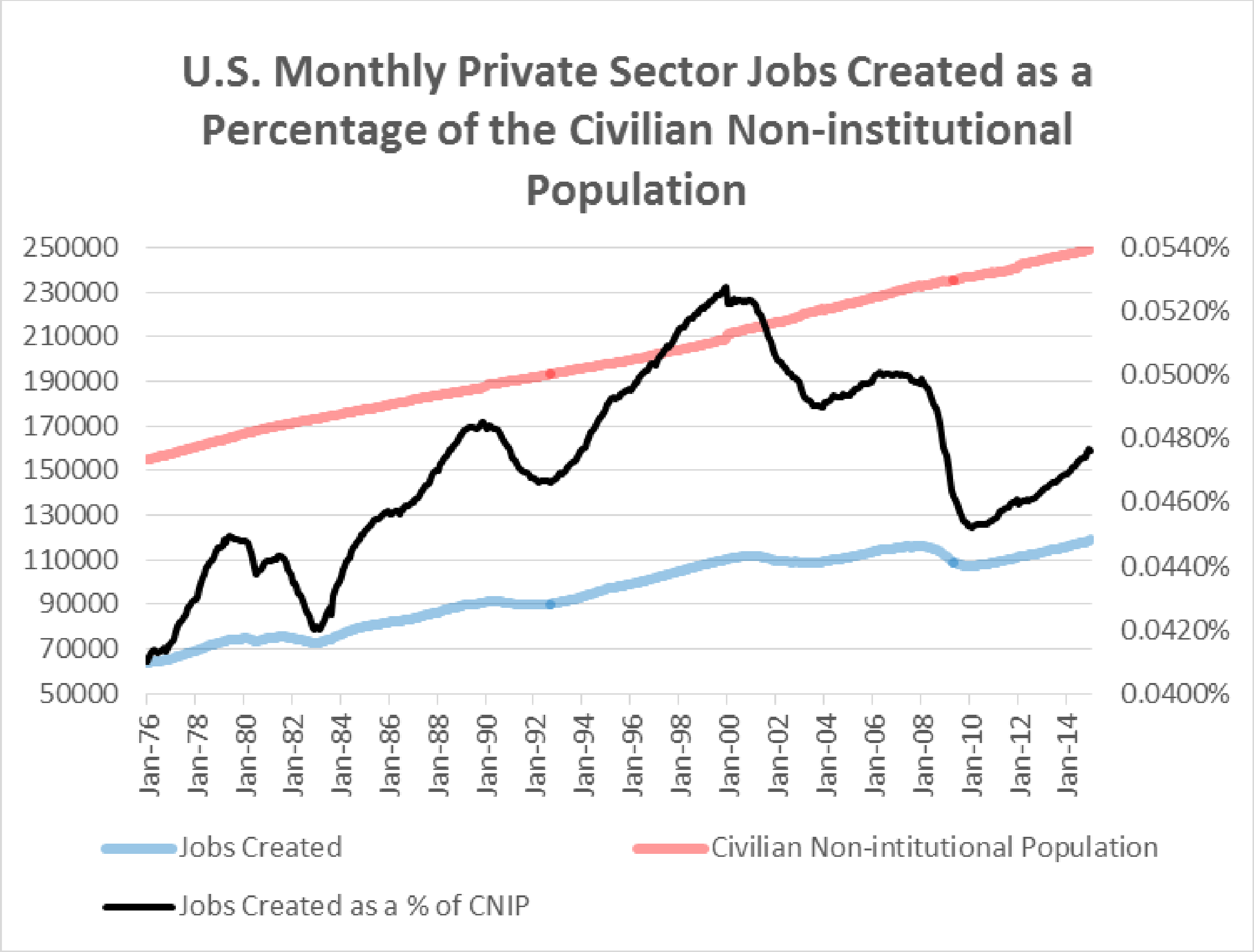
The monthly rate of job formation, as a percentage of the employable population, has strengthened since 2010. But it is still nowhere near the pace prior to the recession (even that of the so-called "jobless recovery" of the early 2000's) and is below any monthly percentage recorded from then end of 1994 through the end of 2008 (and, with the exception of the recession of the early 1990's, since early 1988). Prior to the 1980's women's participation in the labor force was at far lower levels, hence the lower rates in the graph at right.



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- The U.S. has experienced increasing polarization and a changing rates of formation of high wage jobs (currently 64% of total private sector; average hourly wage $28.36) and low wage jobs (currently 36% of total private sector; average hourly wage $16.25).

- **In 2013, only 46% of job creation were in the high wage sectors**. In 2014, we did better with 58% created in high wage sectors. But fewer than 18.5% of jobs created in 2014 were in the goods producing sectors.

High Wage and Low Wage Jobs

	Number of Jobs	Hourly Wages
HIGH WAGE JOBS		
Goods Producing	19,336	25.81
Wholesale Trade	5,908	28.17
Transportation and Warehousing	4,686	22.92
Utilities	558	35.86
Information	2,689	34.34
Financial Activities	8,022	31.02
Educational Services*	3,421	24.38
Healthcare*	14,916	27.26
Professional and Tech*	8,490	37.79
Management of Companies*	2,150	37.24
Other services	5,538	22.09
Totals and Weighted Averages	75,714	28.36
LOW WAGE JOBS	-	-
Retail Trade	15,511	17.04
Social Assitance*	3,387	15.48
Administrative and Waste Services*	8,934	18.79
Leisure and Hospitality	14,856	14.08
Totals and Weighted Averages	42,688	16.25
Total	118,402	

* All data is as of December 2014, escept for wage data in the starred sectors, which is from November 2014.

Source: Bureau of Labor Statistics

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Headline job creation in 2014 was much better than in 2013, with less dependence on low wage jobs. But headline job creation numbers, as with the unemployment rate, are not telling the entire story…

2014 U.S. Private Sector Jobs Creation

	December-13	December-14	Y/Y Variance	Percent of Private Sector Jobs
HIGH WAGE JOBS				
Goods Producing	18,811	19,336	525	18.35%
Wholesale Trade	5,797	5,908	111	3.87%
Transportation and Warehousing	4,547	4,686	139	4.87%
Utilities	551	558	7	0.24%
Information	2,674	2,689	15	0.52%
Financial Activities	7,901	8,022	121	4.23%
Educational Services*	3,365	3,421	56	1.97%
Healthcare*	14,605	14,916	311	10.87%
Professional and Tech*	8,201	8,490	289	10.10%
Management of Companies*	2,109	2,150	41	1.43%
Other services	5,480	5,538	58	2.03%
Totals and Weighted Averages	**74,040**	**75,714**	**1,673**	**58.48%**
LOW WAGE JOBS				
Retail Trade	15,262	15,511	250	8.72%
Social Assitance*	3,272	3,387	115	4.02%
Administrative and Waste Services*	8,532	8,934	402	14.06%
Leisure and Hospitality	14,435	14,856	421	14.71%
Totals and Weighted Averages	**41,500**	**42,688**	**1,188**	**41.52%**
Total	**115,541**	**118,402**	**2,861**	

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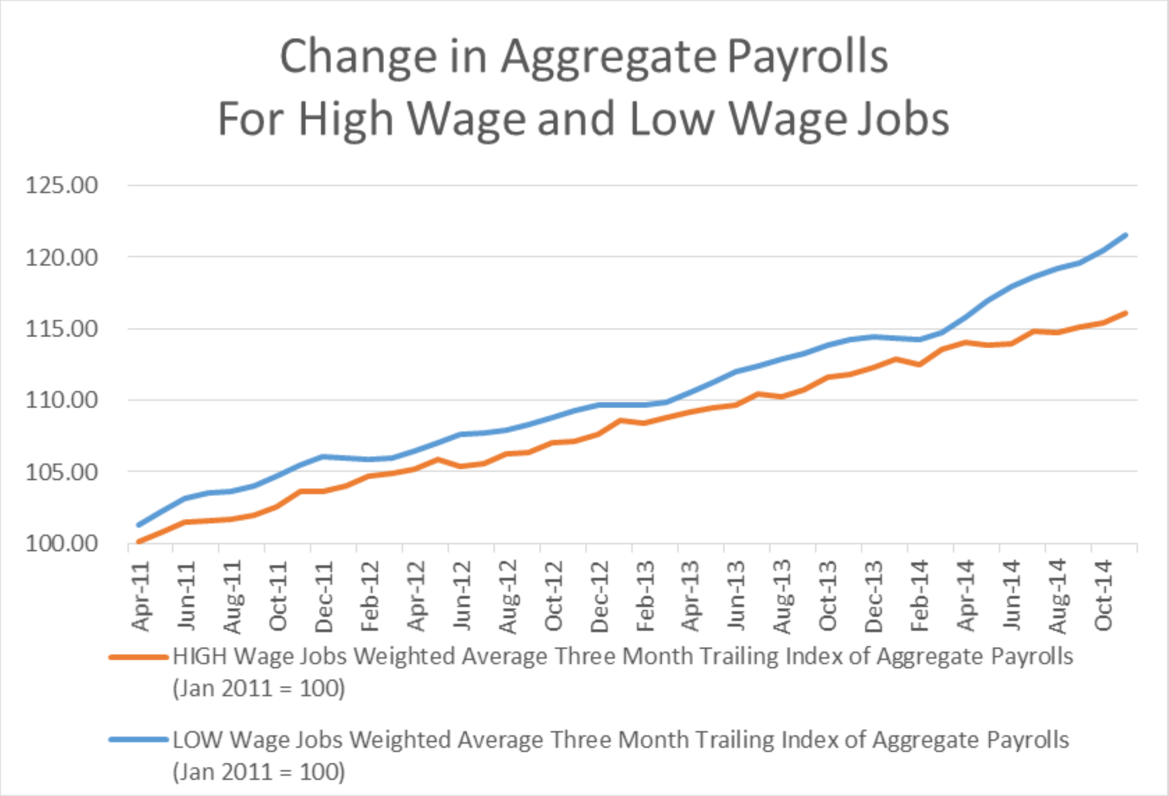
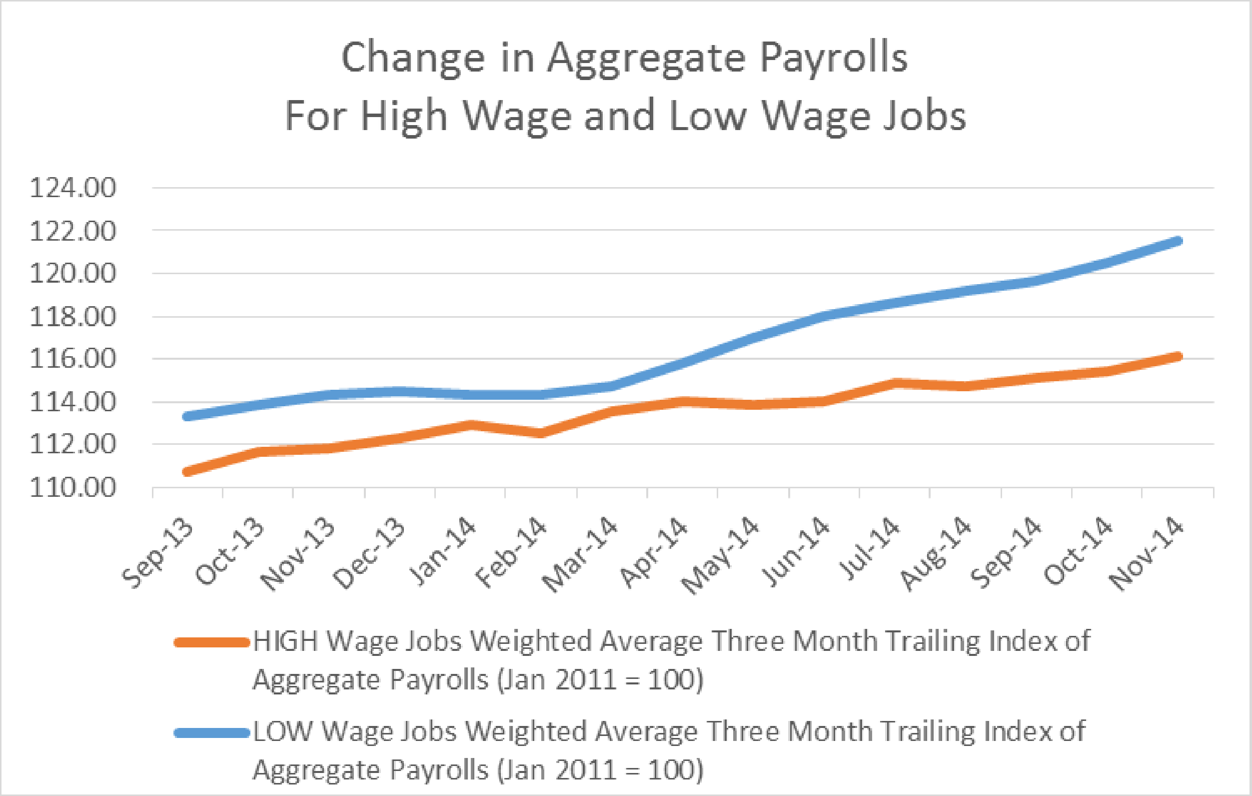
…Headline job creation counts are not telling the entire story because (i) beginning in Q2 of 2014, aggregate payroll growth in high income sectors began to flatten while that of low wage jobs accelerated (Aggregate Payrolls = jobs x hours x wages/hour); and in December 2014 all aggregate payroll growth stalled…





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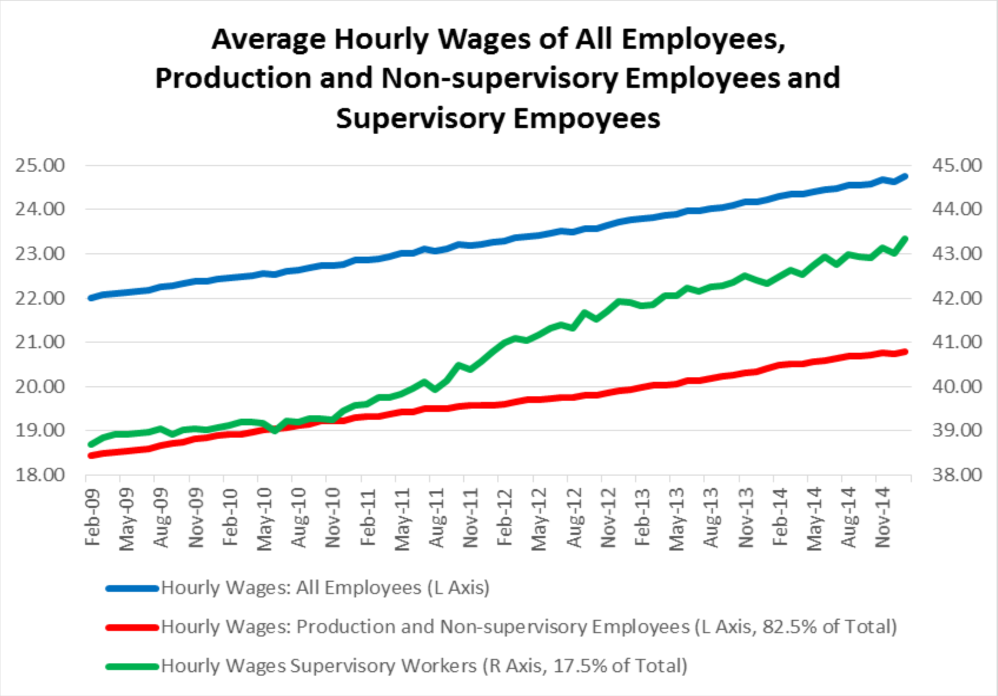
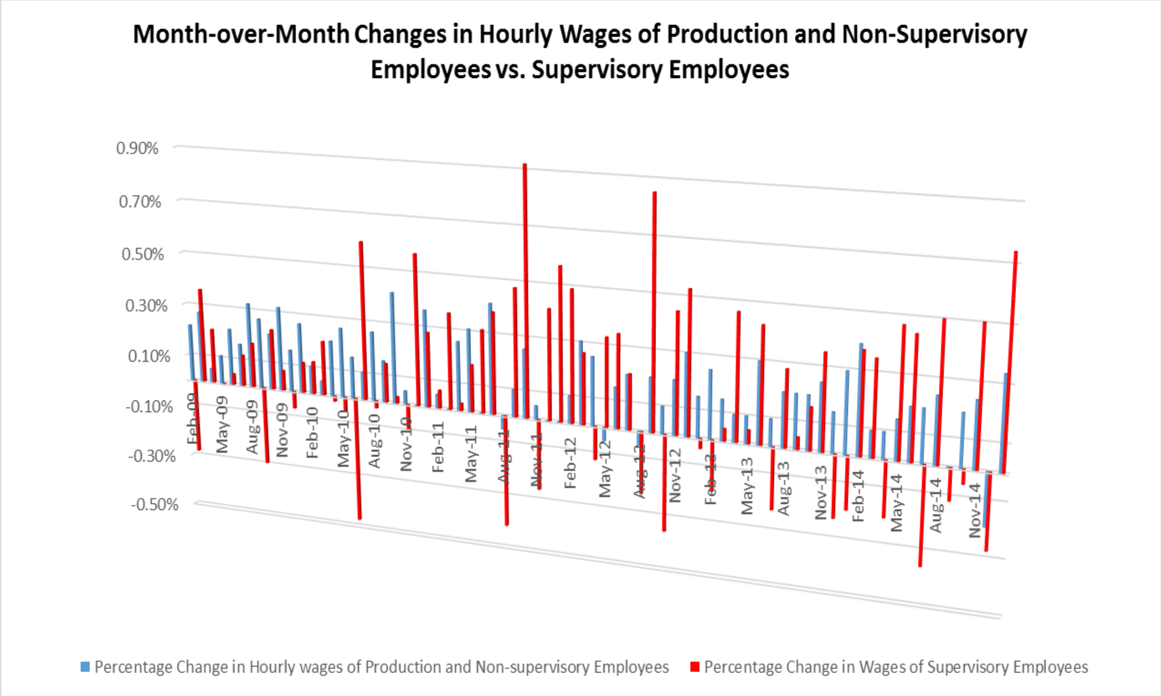
…and (ii) worse yet, a majority of the reported inter-month change in the rate of hourly wage growth is not broad based but, rather, reflects dramatic fluctuations in the wages of the top 17.5% of employees. ***Since November 2010, hourly wages of such supervisory employees grew at a rate 28% higher (up $4.09/hour cumulatively) than the wages of the lower 82.5% of all employees (up $1.57/hour).*** The sluggish growth in cumulative labor productivity from 2011 through 2014 is likely related to this trend, among other things.





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The U.S. Employment Situation Indicates Serious Secular Problems

Low-wage jobs tend to also be low-hours jobs (and, from a job-creation-count perspective, it should be noted that many are jobs held by multiple job holders). The resulting annual incomes in low wage sectors are very weak. In the leisure and hospitality sector, annual incomes are not much more (after taxes) than the total of unemployment benefits plus food stamps that long-term unemployed workers previously received before those benefits were withdrawn in 2014. As a result, the impact of the creation of such jobs on consumer spending and GDP is minimal.

Low Wage Jobs

	Hourly Wages	Hours per Week	Imputed Annual Income	Number of Jobs
Retail Trade	17.04	31.50	27,911.52	15,503.60
Social Assistance	15.48	29.80	23,987.81	3,377.60
Administrative and Waste Services	18.79	35.10	34,295.51	8,898.50
Leisure and Hospitality	14.08	26.30	19,255.81	14,820.00
Weighted Averages and Totals	**16.25**	**30.31**	**25,613.73**	**42,599.70**

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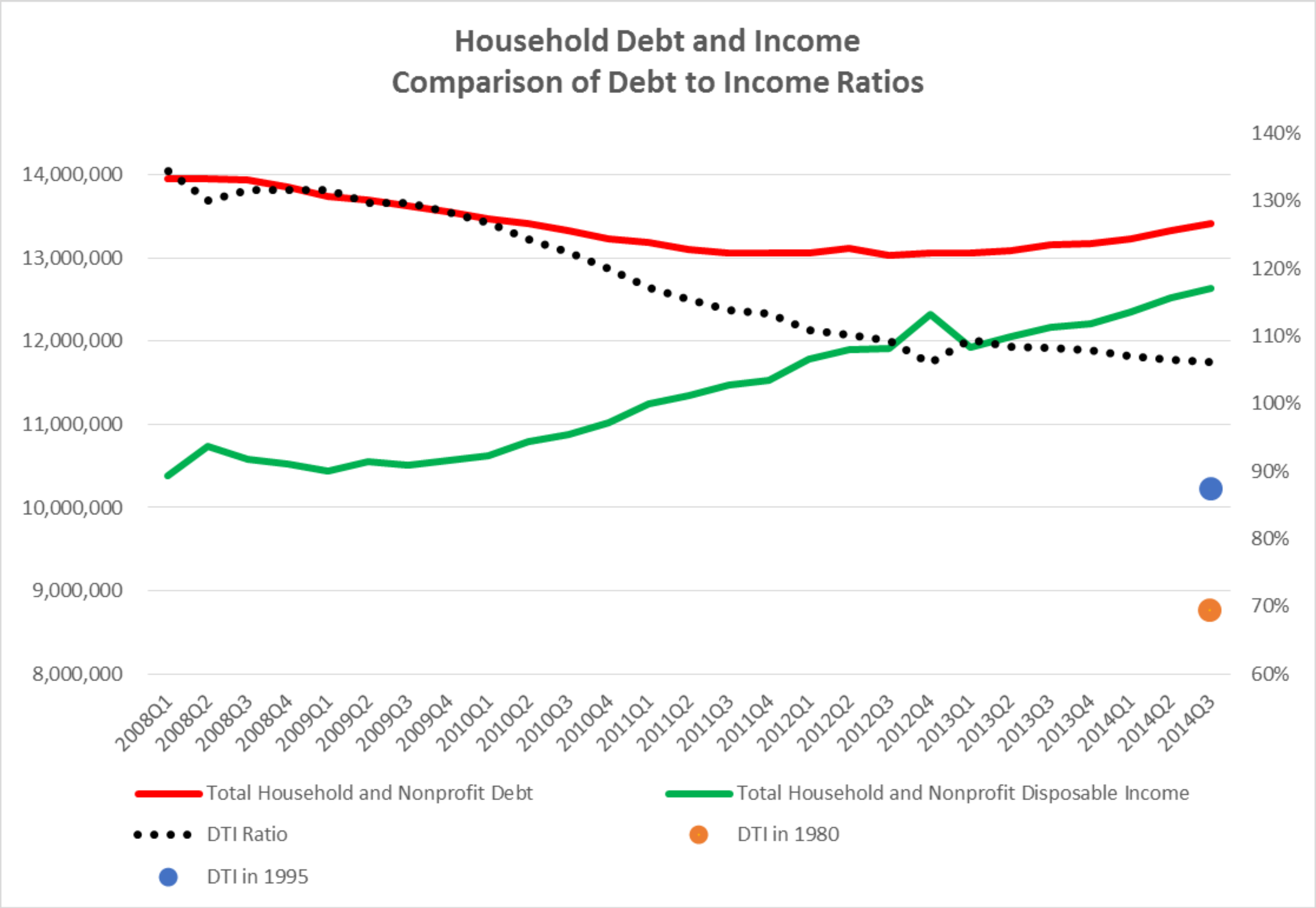
Household Debt is Still a Problem – Just Well Masked

- In nominal terms, household debt has only fallen by 4% since the peak of the credit bubble.
- Comparisons of debt to GDP are misleading, given how little of increased GDP is flowing to household sector (labor).
- Equally misleading are debt service ratios, which are lower today only because of zero interest rate policy and the global capital glut.
- The best we can do is to analyze debt to disposable income (imperfect because the income gains have not necessarily gone to those most indebted – see slide 13).
- DTDI has fallen to 106% from 134% - yet is still far from earlier norms (see 1980 and 1995 levels on graph).



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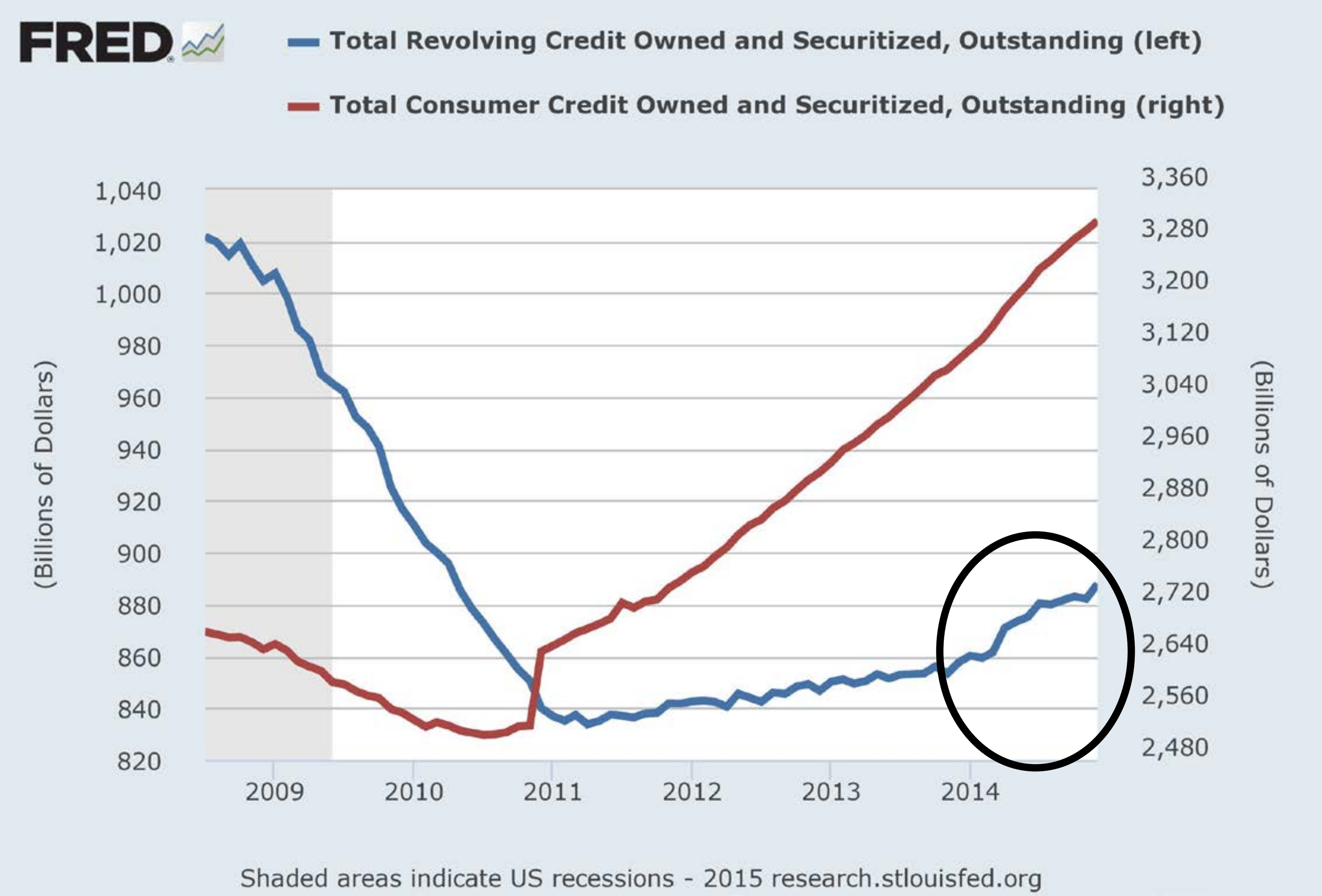
Household Debt is Still a Problem – 2014 and Revolving Consumer Credit



- After falling from its mid-2008 bubble-era peak, **consumer credit has skyrocketed past its former high by about 22% through Q3 2014**.
- The increase in aggregate consumer credit since its Q3 2010 low equals about 24% of the increase in GDP during the same period.
- Most of that increase was in auto and student loan balances.
- But **in 2014, the U.S. saw a spike in credit card balances which had previously remained fairly flat**. This could be confidence induced spending, of course, but it could also be banks loosening credit to households that have seen no real improvement in wages and are trying to make ends meet.

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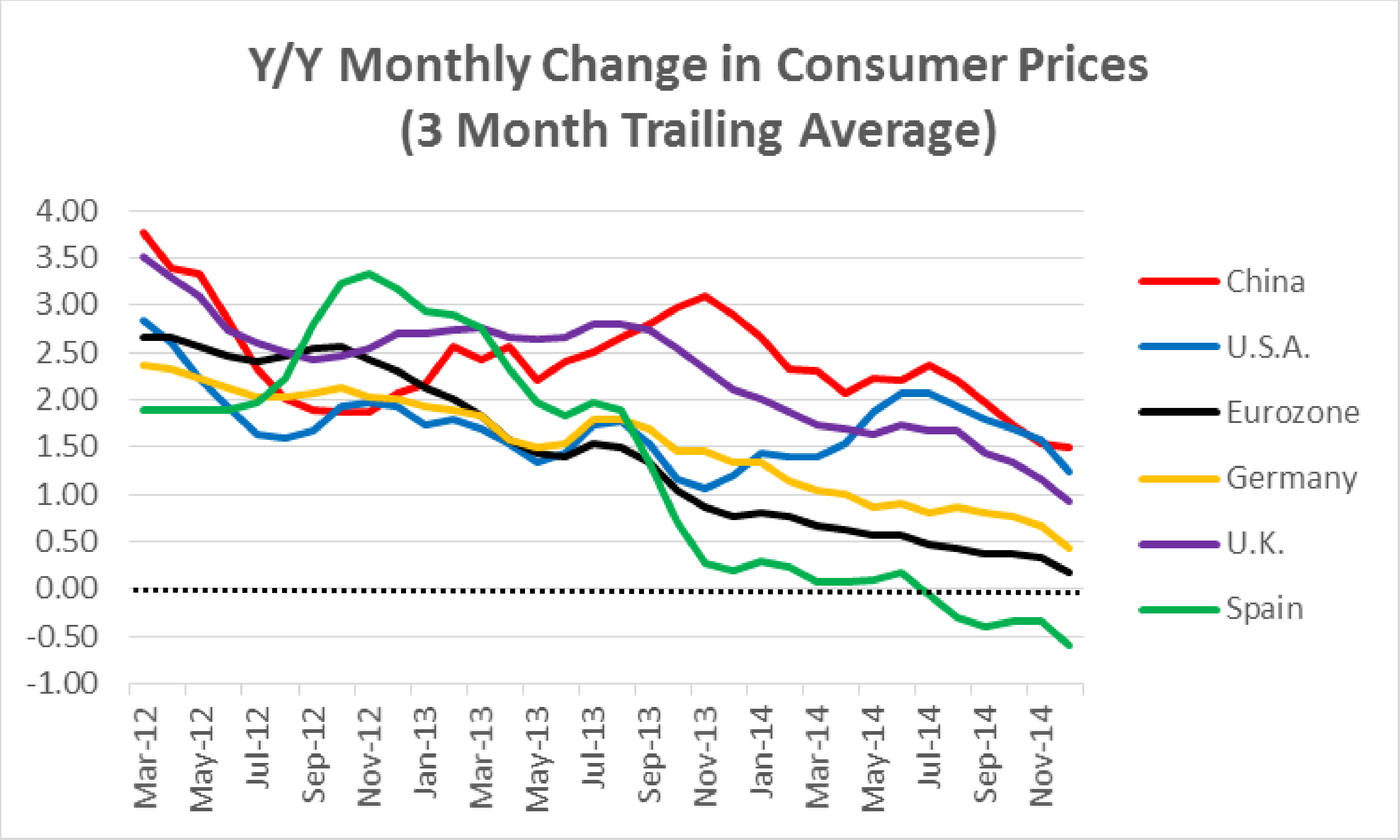
Disinflation/Deflation is a Global Phenomenon Effecting all the Developed Economies as well as China and some other Emerging Nations

- Much has been made of late regarding the collapse of the price of crude oil and other input commodities. But the fact remains that price trends in final production, and many services, have been negative for some time – aggregate consumer prices as well.

- **Japan** – deflation's canary in the coal mine – experienced short lived reflation connected with its massive devaluation of the yen under Abenomics. But, with apparent failure of Abenomics, and especially with the fall in oil prices, Japan is expected to back into deflation.



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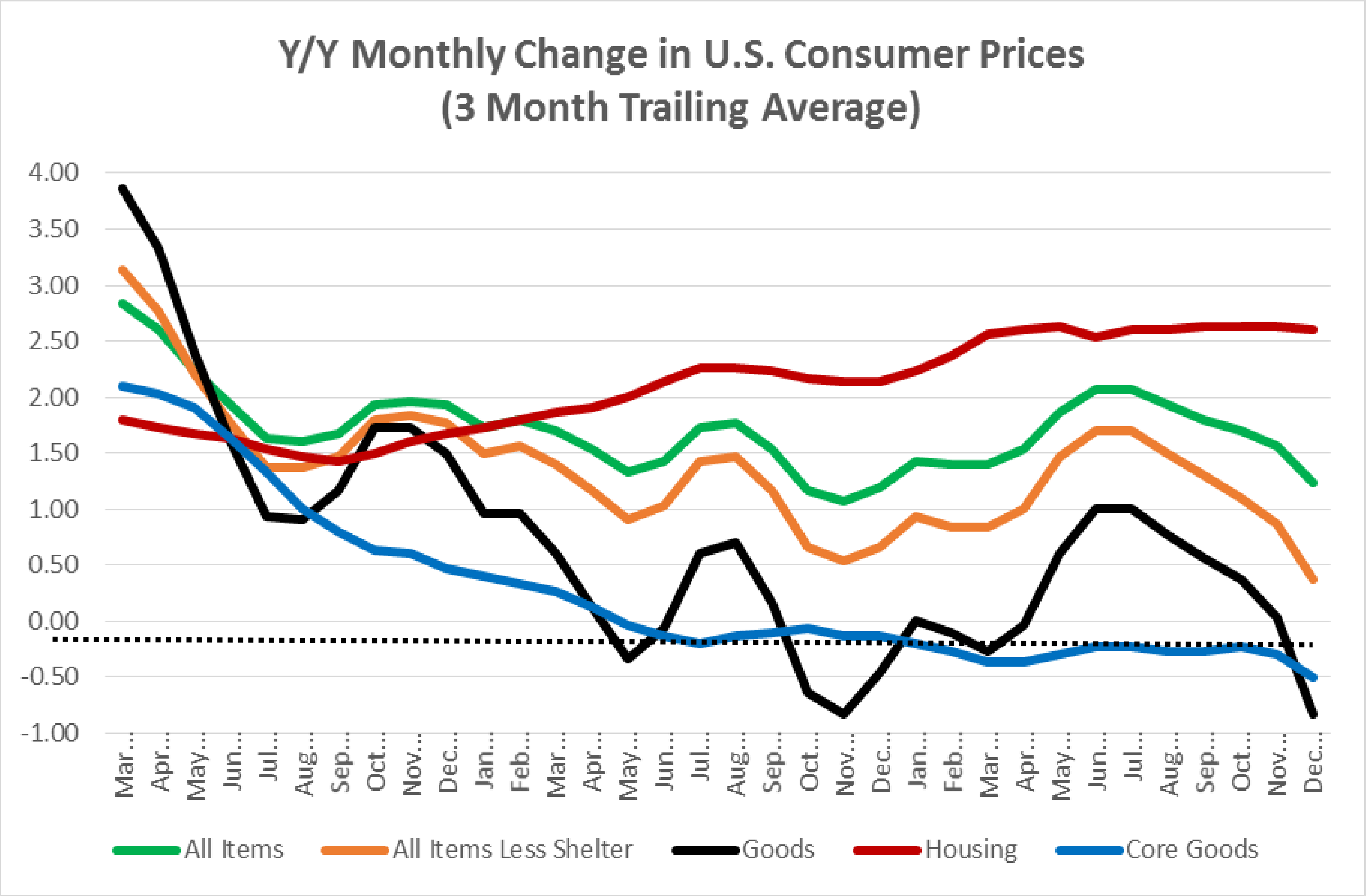
U.S. Disinflation is Accelerating – Limited Chiefly by Housing

- The U.S. has seen inflation at rates below the FOMC's target 2% rate for two years. ***The core goods portion of the CPI has been negative for a year and a half.*** Inflation in all items other than shelter deteriorated markedly in the second half of 2014, well before the oil collapse.
- In the U.S., the housing sector rents (and owners' equivalent rents) – ***disproportionately impacted by the rising price of owner-occupied homes due to ZIRP and post-housing crisis mortgage market dislocations, both forcing households to into the rental market*** – have for nearly two years been the only thing keeping U.S. inflation above other developed economy averages.



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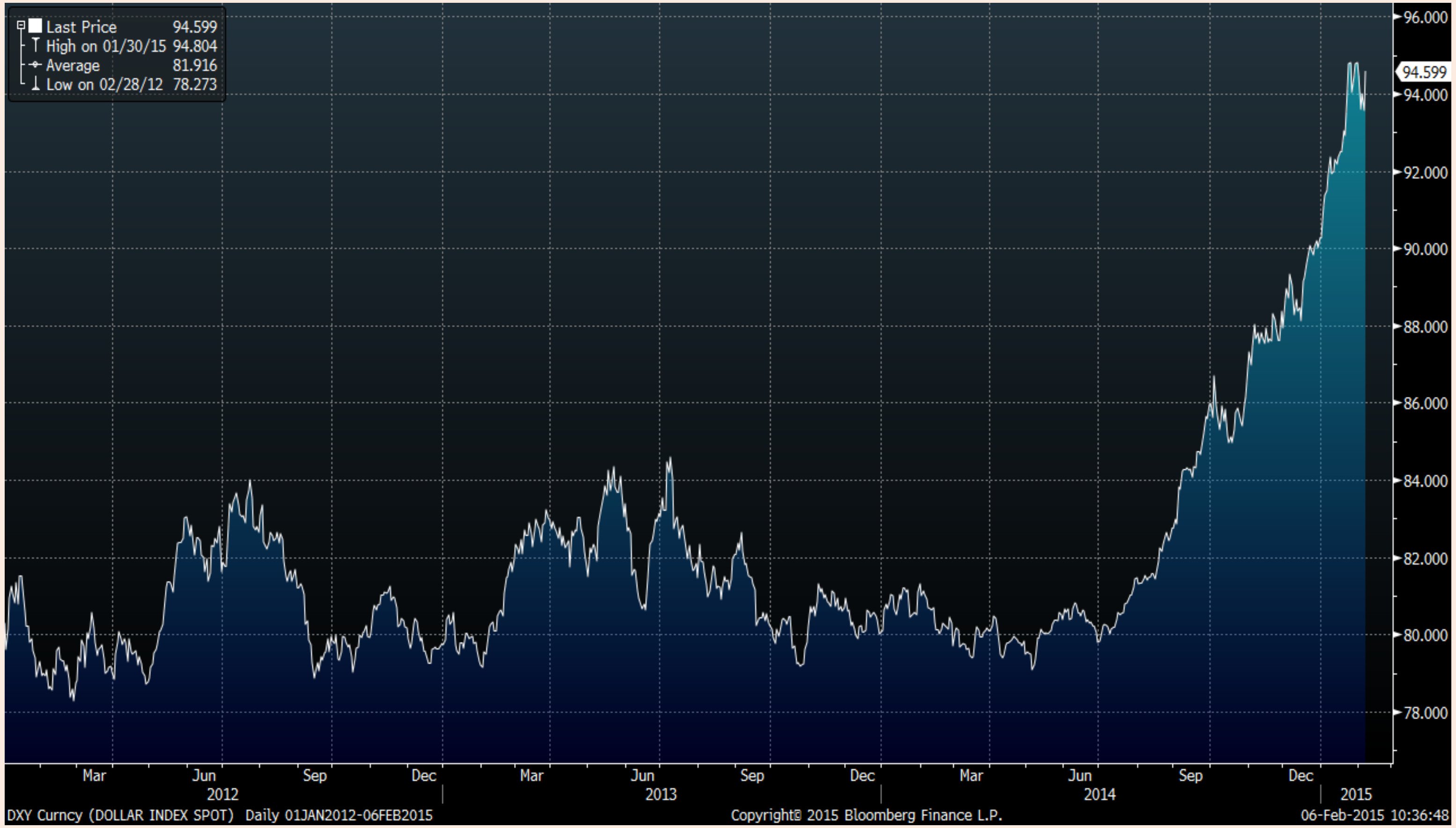
The Strong U.S. Dollar will Import Further Deflation and Limit Growth

- Weak global aggregate demand in an age of oversupply of labor, capacity and capital, has been the problem all along. But it was only in H2 2014 that competitor nations began to scramble aggressively for more of a share of the inadequate demand by pursuing policies that have the effect of tanking their currencies against the US$.
- Japan and the Eurozone are pursuing extensive QE, while China is pursuing stimulative policies, widening the trading range of the RMB, and is not unlikely to become more aggressive in its policies that impact RMB/US$ valuation.



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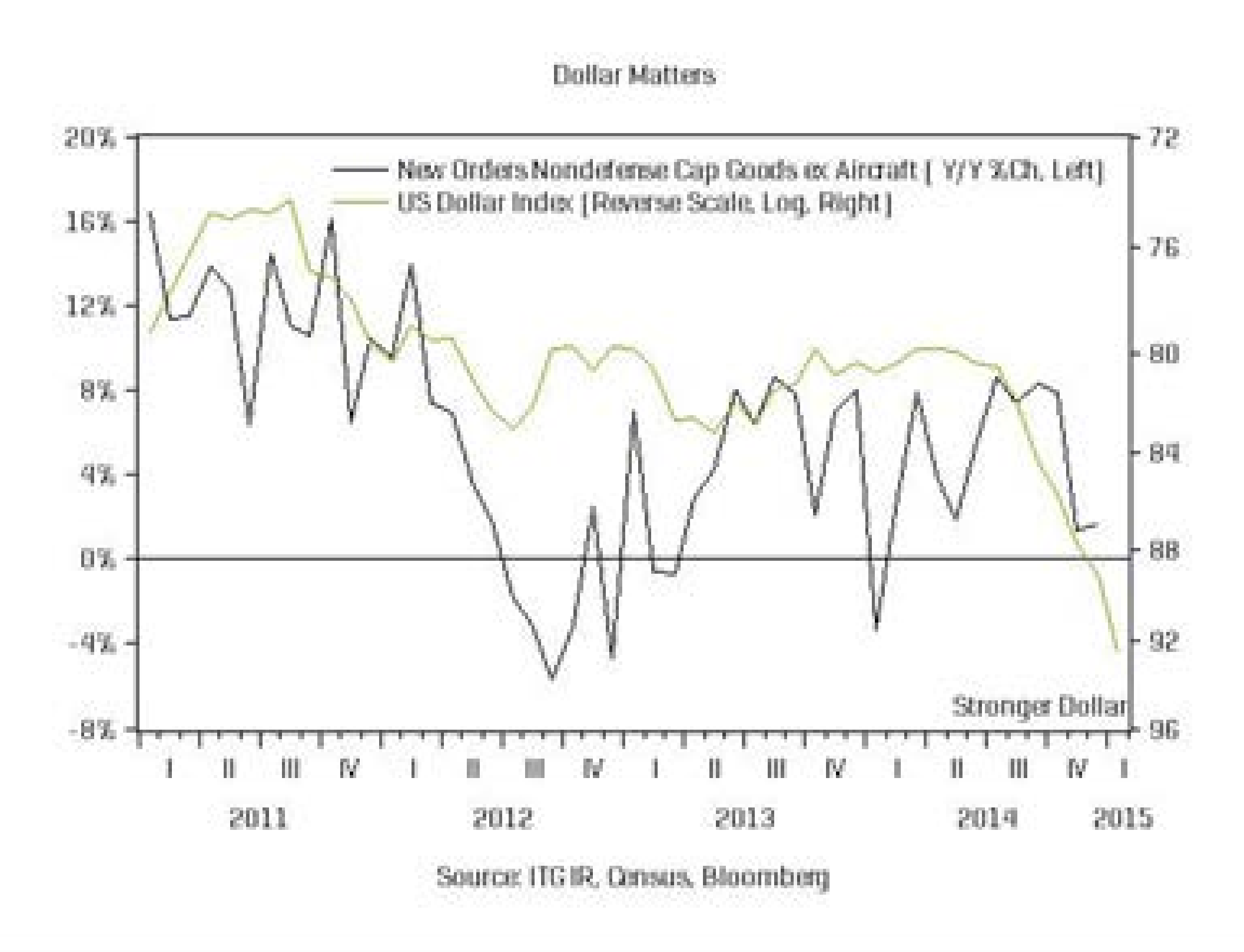
The Strong U.S. Dollar will Import Further Deflation and Limit Growth

And, yes, the strength of the dollar does matter, as demonstrated by recent trends in U.S. Durable Goods Orders…..



Courtesy of Steve Blitz, ITG

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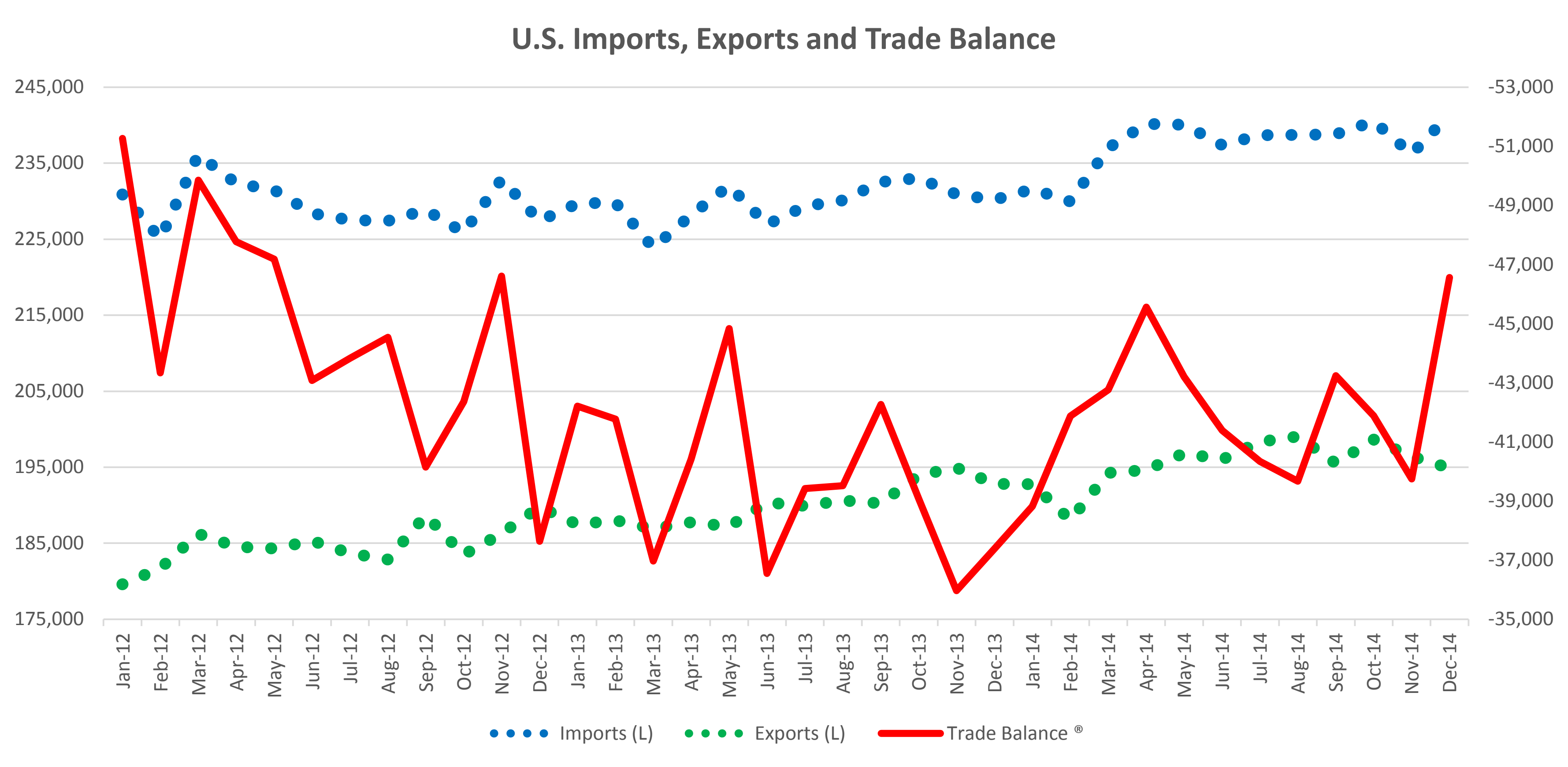
...and by a widening of the U.S. trade deficit and increasing lower cost import demand.



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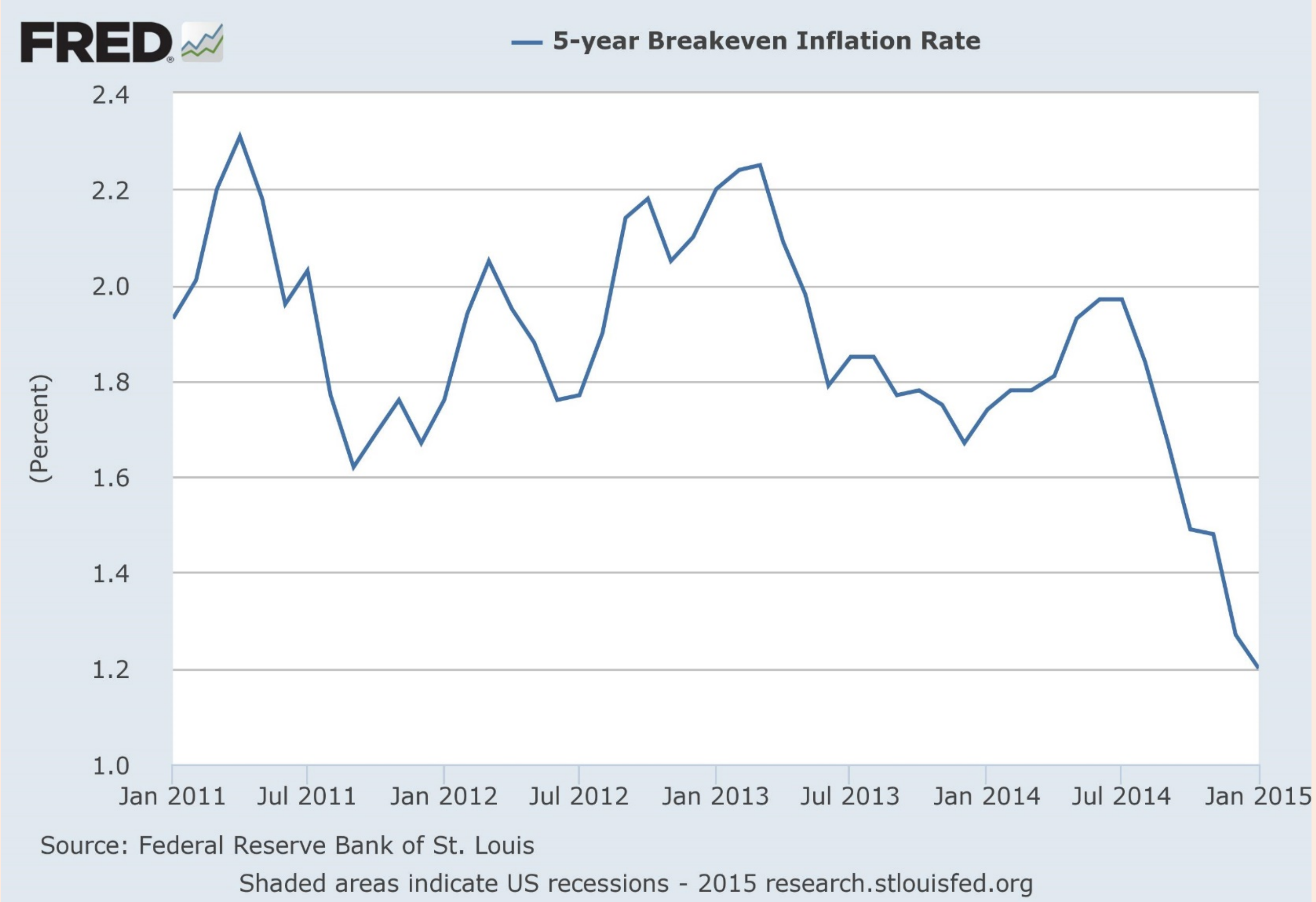
Inflation Expectations have Already Become Unanchored…

...Notwithstanding Fed statements to the contrary:



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The U.S. Economy is Very Much Affected by Trade and other Global Phenomena – it is Not an Island of Unilateral Prosperity

- Those who disagree with the above statement frequently point to the fact that exports currently comprise only about **13% of U.S. GDP**.
- But U.S. imports are in an amount **equal to 17% of GDP** (and oil is a decreasing factor because of domestic production).
- A substantial share of goods consumed in the U.S. are imported and, thus, increases in U.S. consumption tend to "leak" abroad.
- Global deflation and the strong dollar therefore impacts the U.S. economy in two ways:
    - Increasing the volume of imports as non-domestic goods become cheaper; and
    - Placing downward price pressure on producers in the U.S.

A possible mechanism for the effect of the foregoing on the broader service economy is described on the following page:

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The U.S. Economy is Very Much Affected by Trade and other Global Phenomena – it is Not an Island of Unilateral Prosperity (continued)

How deflation in tradable goods sectors impacts the services sectors:

Declines in unit pricing (or potentially declining sales volumes, if pricing proves inelastic) produce downward pressure on wages (labor) and the prices of other inputs into production.

Much of the services sector is supported by the distribution, marketing and sale of goods of one sort or another (the exception, of course, being "guild"-type services such as education and medical care – especially invulnerable when such services involve third-party payment systems).

Those providing services in connection with the distribution, marketing and sales of goods are therefore impacted by negative unit pricing pressures in a manner similar to that of manufacturers – albeit with a time lag and offset to an extent by potential increases in volumes at such lower prices – and adjust hiring and wages accordingly.

The elimination of excess labor in the tradable goods and goods-related services sectors or – as we have been experiencing – the reduction of wage pressures in otherwise high wage sectors, can then transmit to those sectors otherwise considered less vulnerable (guild sectors and non-product related consumer services such as maintenance and repairs).

Conclusion

- In the most fundamental sense, understanding the present condition of the U.S. economy – as well as its future prospects – comes down to whether one examines the present situation from a ***cyclical*** versus a ***secular*** perspective.
  - To a not insubstantial extent, "cyclicalists" have tended to interpret post-Great Recession economic behavior and results with interpretive tools that have worn well with economists since business-cycle theories were first refined during the mid-19th century and through the 20th century. Business cycle theory squares well with the decoupling meme (as well as, in the U.S., the notion of "American exceptionalism") in that, historically, nations' business cycles have not necessarily temporally coordinated.
  - In contrast, those (including the author) who believe that the business cycle itself is liable to very long term disruption emanating from both endogenous secular changes and exogenous alterations in the supply of, and demand for, labor, productive capacity and capital tend to be less satisfied ignoring systemic and global inconsistencies that are not compatible with the cyclical interpretation of certain headline economic data.
- As to the economic (un)health of the rest of the world, there can be little serious debate. That the U.S. is able to be an island apart in a world so thoroughly globalized and mired in oversupply as that of the present day, is sheer folly. Policy based on such a view should be more assiduously avoided than has been the case in recent years.

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