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ECONOMIC TALKING POINTS

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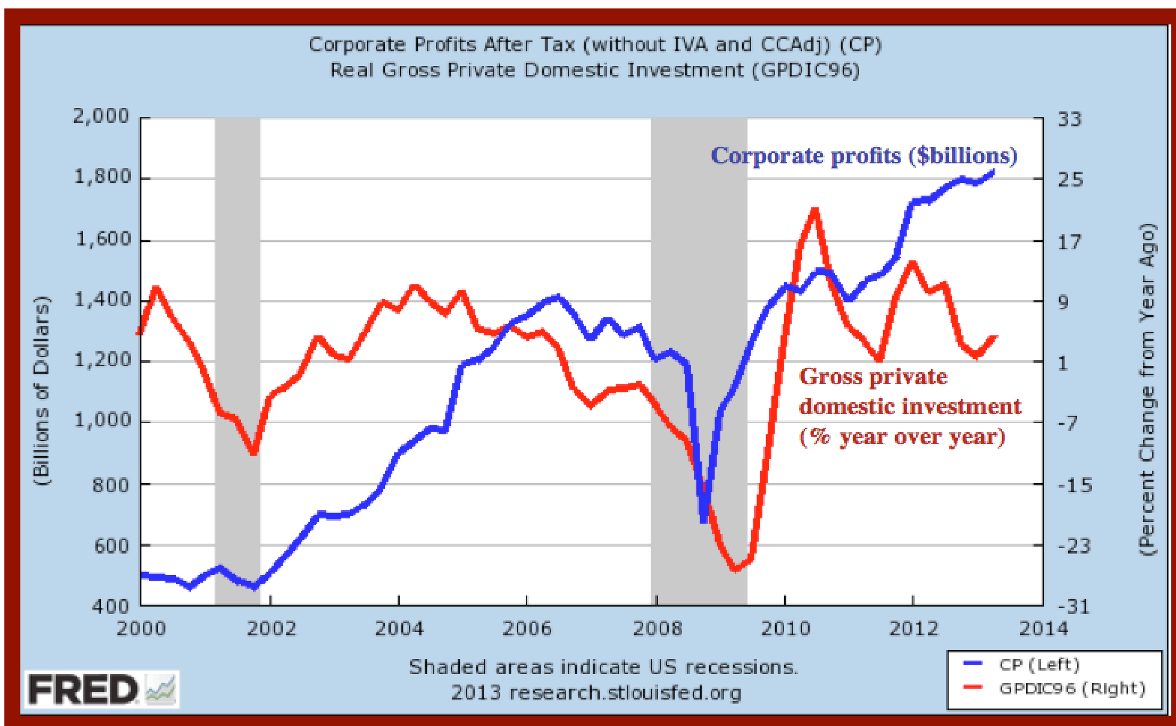
The Fed Stays The Course…But The Economic Outlook Is About to Brighten

Today's decision by the Federal Reserve to stay the course on monetary policy could hardly come as a surprise. Those on the FOMC really had no other choice--- not when the 16-day government shutdown and threat of debt default temporarily froze consumer and business confidence and halted spending plans. Nor could the Fed have acted with any conviction when so many key economic indicators lacked their usual statistical integrity after data collectors were forced to drop all work during the shutdown.

Indeed, we have advised clients to dismiss most of the government's economic releases that cover September and October because they will not present an accurate picture of the underlying health of the current economy---which is actually pretty good.

Let me drill deeper on that last point. Instead of looking at the official economic indicators the next few weeks, focus more on some of the glaring disconnects in the economy currently, disconnects that I believe show promise of faster growth in 2014.

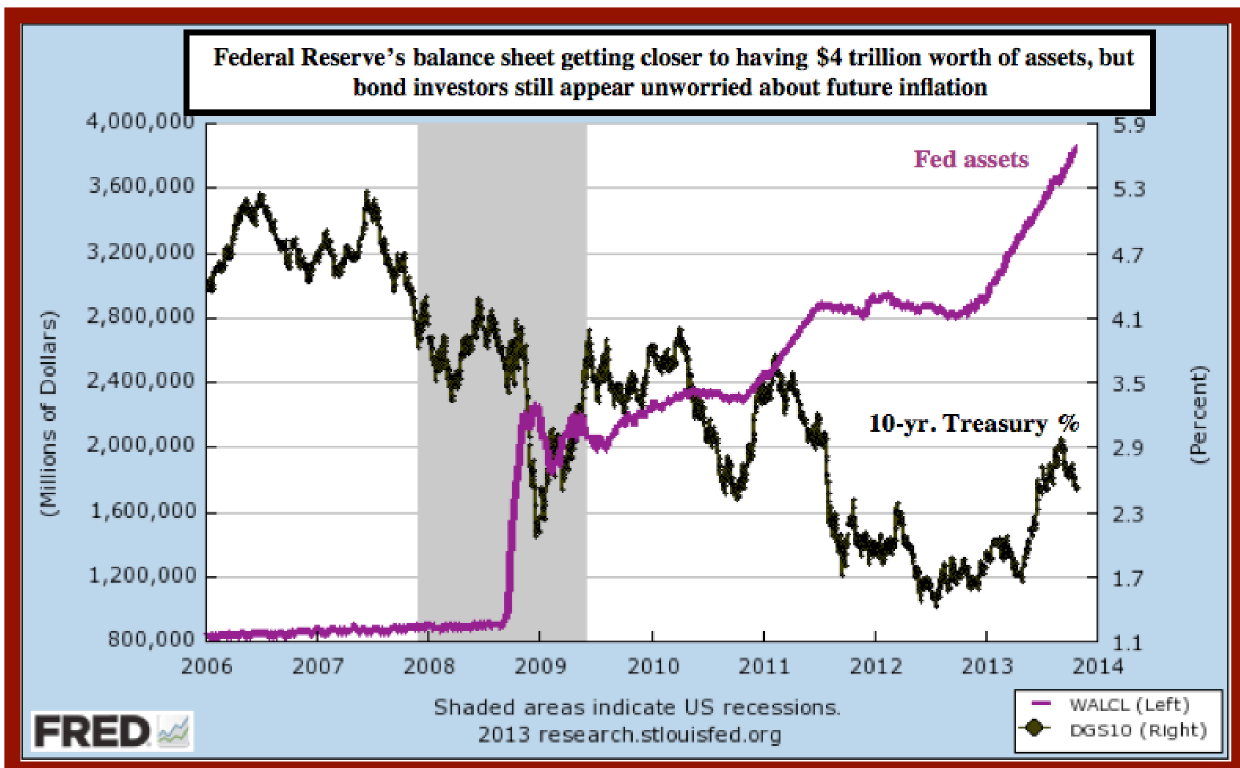
For example, history has long shown that sustained growth in corporate profits is a prerequisite for greater capital spending and hiring. But that relationship has completely broken down lately. Instead, we have a dichotomy where companies keep winning strong profits, yet still resist plans to ramp up business investment and accelerate employment. This morning's ADP employment report underscores that point; it noted that firms added fewer workers than expected this month. The 130,000 increase in private sector jobs in October turned out to be the smallest in six months! At the same time, corporate profits are coming in better than projected. Of the 313 companies in the S&P 500 that have reported third quarter earnings so far, nearly 7 out of 10 have topped Wall Street expectations.



Here's another bizarre divergence: The S&P 500 and the Dow keep marching to record highs, a trend that suggest expectation of more robust economic growth and greater corporate earnings in the coming quarters. Investors thus appear bullish on the outlook. But if you look at private sector surveys that gauge business confidence, they appear they have utterly failed to capture the optimism reflected in the stock market.

A third disconnect is the realization the Federal Reserve will keep on adding massive amounts of liquidity into the economy, perhaps well into the first half of 2014. That is far longer than most analysts thought they would this summer. You would think that with a Fed balance sheet swelling to $4

trillion in assets --- and expanding another $85 billion a month --- would begin at some point begin to unnerve fixed income investors who would ordinarily worry about future inflation. But there's no evidence of that whatsoever. The yield on the benchmark 10-year Treasury note has just fallen to a three-month low of 2.48%. Moreover, the BLS reported (for whatever the release is worth this time around) that consumer prices rose 1.2% in September, from the same month a year ago. That's the smallest annual increase since April. Even wholesale prices remain remarkably well behaved. The September producer price index inched up a sleepy 0.3% the past 12 months.



Why do all these disparities hint of stronger economic growth in 2014?

Clearly strong corporate profits, along with the massive cash assets firms have accumulated (a record $1.7 trillion in liquid assets), tell you they have the financial resources to increase capital spending and hiring once they choose to do so. Up to now they haven't done so because of the uncertain economic outlook (thank you, Washington!) and the fact the US economy has managed to grow a paltry 1% a year on average since 2009.

But that is about to change for three reasons.

(1) Expect a rebound in consumer spending. Households have been deleveraging the last five years, reducing outstanding debt by some $1.5 trillion. That process is now over. Household balance sheets are now the healthiest in nearly a decade. In fact, the financial burden of consumers to service their remaining debt is currently the lowest in nearly 30 years. In addition, when you add to that the fact household wealth has touched a record high for the second quarter in a row, along with the recent improvement in household purchasing power, I expect this holiday shopping season to be one of the best in years. That should also foreshadow stronger outlays in 2014!

(2) For years the international economic backdrop had been dismal, with Europe in chronic recession, Japan suffering from slow growth and deflation, and there were widespread fears that China might suffer a hard landing.

Fortunately, conditions among all three have improved. Europe is now on the mend. Eurozone unemployment has begun to come down. Business and consumer sentiment in the region keeps improving. Even Spain received a psychological boost when it emerged from a two-year recession in the third quarter.

Japan is implementing a multi-prong strategy to lift economic growth and allow for more inflation. Those policies seem to be working. Japan's economy grew at a 3.8% pace in the second quarter and 4.1% in the previous period. That's more than twice as fast as the US grew in the first half.

And China recently demonstrated that even as policymakers work to reform the second largest economy, growth still accelerated in the third quarter to a 7.8% annual pace. Worries of a hard landing have since been greatly diminished.

(3) More central bankers around the world (including those in the US, Canada, Eurozone, UK, Philippines, Norway, Sweden, Chile, Australia, Israel, Mexico) have shown an inclination to maintain their course of easy monetary policy for a longer period of time. At the same time, other countries, who were prepared to lift rates, are now much less likely to do so because such a step would then risk causing their currencies to surge and that would hurt exports. Thus, with more central bankers committed to keeping the cost of capital down for a longer period of time, global economic activity should speed up.

Bottom line:

Look, the Federal Reserve has been flying blind lately by the lack of reliable data on the health of the economy. Moreover, fresh questions may surface again on how the economy might react early next year as Washington braces for new budgetary deadlines. It's why the Fed reiterated in today's statement "it will closely monitor incoming information on economic and financial developments *in coming months* and will continue its purchases of Treasury and agency mortgage-backed securities…" (The italics are mine.)

At the same time, we feel quite confident the US economy is poised to show faster growth next year. While Congress is unlikely to demonstrate much bi-partisanship between now and the 2016 elections, chances of another destructive government shutdown and threat of a debt default have faded to the point where corporate leaders will shift focus away from the follies in Washington and look more to satisfying growing demand from a re-energized global economy in 2014.

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