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ECONOMIC TALKING POINTS

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September Jobs and Pay: Back on Track and Likely to Remain So

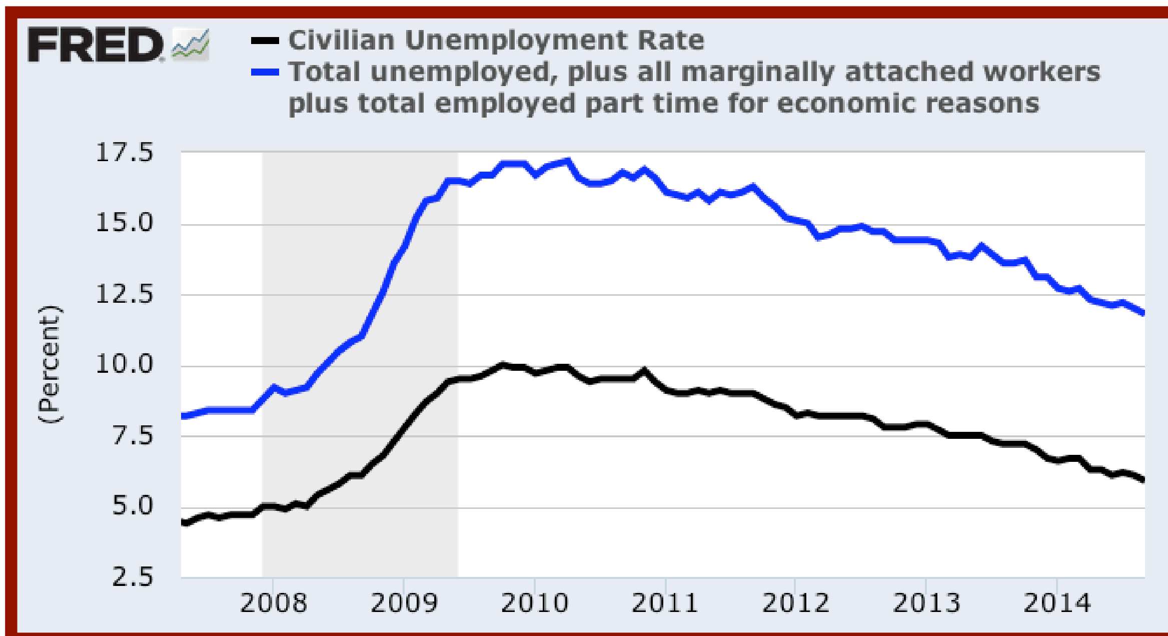
After a major statistical misstep by the government last month when it significantly undercounted August job numbers, we now get a more accurate picture of labor market conditions. The strong 248,000 increase in total payrolls during September, along with substantial upward revisions for August and July, is consistent with an economy that is growing at a pace above 3%.

Let's go even further. There is now mounting evidence that ---barring any major geopolitical blow-up --- this recovery has a life span that could last another three years, and even a reasonable chance it may stretch on to become the longest economic expansion in U.S. history.

This is not hyperbole. The combination of healthy job growth, gradually rising wages and very low inflation suggests that interest rates and the cost of capital overall will remain low. Secondly, we are *finally* in the midst of a much-needed upturn in business capital spending and that should fuel even greater hiring in the coming months and years. More on this last point in a moment.

Let's first drill down a bit on the latest jobs report.

The headline unemployment rate has now fallen to 5.9%, the lowest since July 2008. Even the more broadly defined underemployment rate slid to 11.8%. The last time underemployment was less was in September 2008.

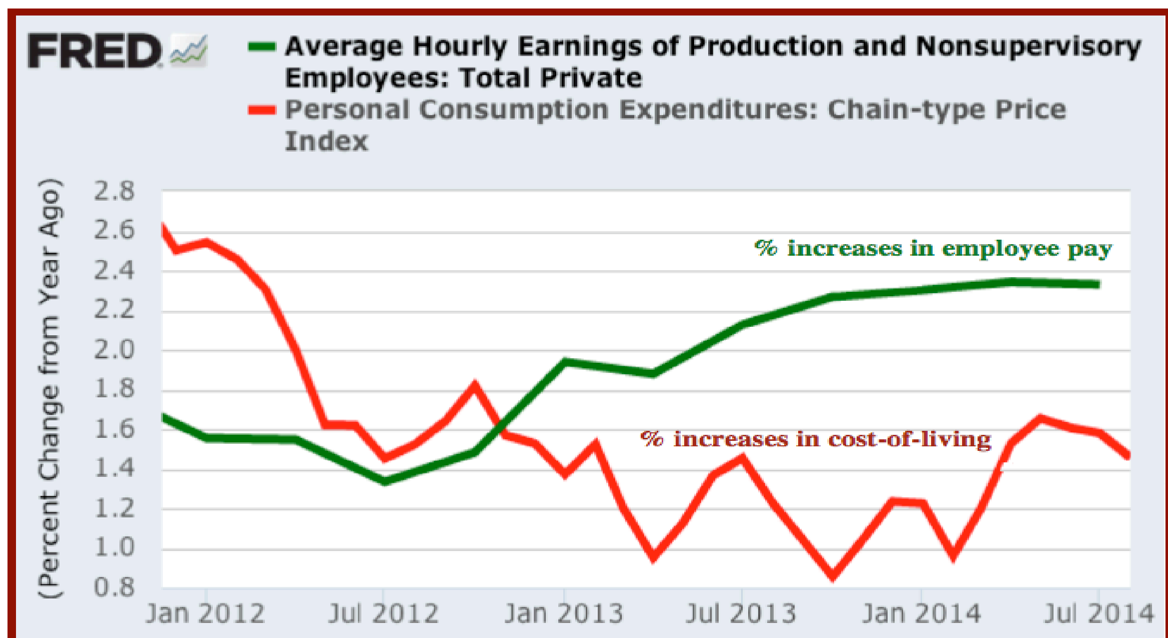


But what really stands out for us is the "short–term unemployment rate," people who have been out of work for six months or less. This is where we get a better sense of what's happening among the cyclically unemployed. By this definition, the short-term jobless rate just dropped to 4.0%, from 4.2% from August and 4.5% in September of 2013. It now stands even below the 4.1% level when economic activity last peaked (December 2007).

If we make progress reversing cyclical unemployment, then one would hope to see a decline in structural unemployment too, those marginally attached to the labor force. (This group is defined as people wanting to work but stopped "actively" seeking employment and thus not counted in the labor force.) Unfortunately, for this group the numbers haven't changed much. The marginally attached population stood at 2.2 million in September, essentially unchanged from the year ago level (down just 76,000).

This actually sets up an interesting reality check for the Federal Reserve. The Yellen-led institution is getting close to the limits of what monetary policy can do to reduce cyclical unemployment. As for reducing structural unemployment (that is, Americans who have lost skills or never had them, or have been out of work so long they look unattractive to employers), the process is not only much more difficult to correct --- but, frankly, out of the purview of the Federal Reserve. To cut the number of the structurally unemployed requires more action on the fiscal front, but not monetary policy. Government-funded retraining programs and greater spending on modernizing the nation's infrastructure will accomplish a lot more than what the Fed can do to shrink the long-term unemployed. Indeed, any effort by the Fed to keep interest rates low for a longer period ***just*** to deal with structural unemployment risks firing up inflation to levels not seen in three decades.

Along with the decline in cyclical unemployment, we have also seen companies post the most job vacancies in seven years! The difficulty in finding suitable workers has started to put some upward pressure on wages. While September's employment report shows only a modest 2.3% rise in average hourly earnings for production and non-supervisory workers over the past year (it was 2.5% in August), there has been a clear transition toward higher pay over the last 18 months. This has been confirmed in the latest monthly personal income & spending report too, which showed wages and salaries rose 5.1% in the last 12 months to August, and that followed a 5.3% annual rise in July. They represent the fastest back-to-back jumps since the end of 2012! ***These increases significantly exceed the rise in the cost of living, which means Americans are gaining more purchasing power.***



Why do we expect to see both hiring and pay continue to climb?

The main reason is that companies are ***finally*** gearing up their capital spending programs. Such expenditures typically lead to more employment and higher incomes. There are numerous factors behind the rebound in capex spending.

1. CEOs appear more upbeat about the economic outlook.

2. Consumer demand has clearly picked with the rise in household income and net worth.

3. Chance of a government shutdown or debt default looks much more remote.

4. The Federal Reserve is in no rush to "tighten" monetary policy. **Here we have to make a distinction between the normalization of rates --- that is ending the zero-bound rate policy and returning to a level where they should be given the**

improvement in the economy --- and a policy directive that lifts rates explicitly to cool business activity. Even if the Fed starts to push rates higher rates next Spring, the "real" fed funds rate will remain negative in 2015, and thus still highly stimulative. It will only begin to bite once the "real" benchmark rate climbs to at least a positive 2.5%, a level we do not expect to see until 2017 at the earliest.)

5. Last, but not least is the fact that after years of neglect, the age of the capital stock in the U.S. business sector has gotten much older. That ***has*** to be redressed if the US is to successfully compete in the world economy. How old is the capital stock currently?

- Equipment - average age is now 7.4 years, oldest since 1994.
- Aircraft - 10.3 years old, highest ever!
- Communication structures, a record 19.3 years old.
- Manufacturing facilities - 23.2 years old, beating the 1946 peak!
- Lodging structures - 17.7 years, oldest since 1963.

The main question we keep returning to is what could go wrong with our optimistic forecast for the US economy?

The biggest risk is not a misstep by the Fed, or the outcome of mid-term elections, or the sharp political rhetoric sure to be with us during the 2016 presidential campaign.

In our view, there are three prominent threats to the US and world economy--- and all stem from potential events overseas.

Threat 1: Russia's makes a grab for the rest of the Ukraine and then follows up eyeing other eastern European countries, effectively challenging NATO's principle of collective defense.

Threat 2: China. Here we confront three high-risk scenarios; (1) A much sharper slowdown in China's economy that leads to domestic social unrest; (2) A Tiananmen Square-like assault by Chinese forces against Hong Kong's protestors who seek more democratic elections; and (3) A shooting war in the western Pacific between China and Japan over disputed islands in the East and South China Seas.

Threat 3. Islamic militants move to take over Baghdad and/or destroy Saudi Arabia's oil facilities and threaten the Kingdom's monarchy.

From our perspective, it is the eruption of one or more foreign geopolitical events that pose the greatest risk to knocking the US economy off the healthy path it is on right now.

Key Economic Forecasts

- Actual
- Forecast

United States

	I 2013	II 2013	III 2013	IV 2013	I 2014	II 2014	III 2014	IV 2014	I 2015	II 2015	III 2015	IV 2015
Real Gross Domestic Product (GDP):												
%	2.7	1.8	4.5	3.5	-2.1	4.6	3.2	3.3	2.7	3.4	3.1	3.0
Personal Consumption Expenditures:												
PCE	3.6	1.8	2.0	3.7	1.2	2.5	3.1	4.0	2.7	3.1	2.9	2.9
Inflation, end of period, year-over-year:												
CPI %	1.5	1.8	1.2	1.5	1.5	2.1	2.0	2.3	2.3	2.4	2.5	2.8
Unemployment Rate (end of period):												
%	7.6	7.6	7.2	6.7	6.7	6.1	5.9	5.9	5.8	5.7	5.7	5.5
Non-farm Payrolls, monthly avg. thousand:												
	206	201	172	198	189	267	224	235	210	265	250	250
Treasury 10-yr Note Yield % (end of period)												
	1.9	2.5	2.6	3.0	2.7	2.5	2.5	2.8	3.0	3.1	3.6	3.8
Federal funds rate % (end of period)												
	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.5	1.0	1.5

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
US	1.8	-0.3	-2.8	2.5	1.6	2.3	2.2	2.4	3.1	3.3
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.4	0.5	1.1	1.7
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	3.0	2.6	2.9
Japan	2.1	-0.7	-5.4	4.6	-0.7	1.6	1.5	1.2	1.4	1.0
Canada	2.7	0.7	-2.8	3.2	2.5	1.7	2.0	2.3	2.7	2.9
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	5.5	6.5	7.0
China	14.2	9.6	9.2	10.5	9.3	7.8	7.7	7.1	7.3	7.1
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.6	1.6	2.3
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.1	2.4	3.5	4.1
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.8	2.7	3.0
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	-1.8	-.06	1.1
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	2.9	3.4	3.8

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015
USD/Yen	91	93	81	77	87	105	112	116
Euro/USD	1.40	1.43	1.34	1.29	1.32	1.37	1.25	1.20

Oil (Brent spot) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015
Crude oil per barrel	46	78	95	107	111	111	98	110
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	3.30	3.25

Major Stock Indexes

	End 2011	End 2012	End 2013	% Change '13	End 2014	% Change '14
DJIA	12,218	13,104	16.577	27	17,200	3.8
S&P 500	1,258	1,426	1,848	30	1,910	3.4
NASDAQ	2,605	3,019	4,177	38	4,400	5.3
RUSSELL 2000	741	849	1,164	37	1,210	4.0

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