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ECONOMIC TALKING POINTS

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Starbucks Needed At The Fed:

The Danger of Being Lulled To Sleep By Low Inflation

Enough already with this wacky fixation over the Federal Reserve's use of "patience." It has become a silly distraction.

The real issue now is this: If Janet Yellen and her FOMC colleagues are to be believed when they says the timing for a lift off of the fed funds rate is dependent on economic data, then mark June on your calendar as the month it all begins. Period.

Should the Fed fail to act then, you have to wonder if policymakers have become so deeply anesthetized by the persistent low level of inflation, their heavy eyelids are missing the fact that forces are already at work to drive the cost of living higher.

What forces are we talking about?

Let's begin with wages. Just about every meaningful indicator on employee pay shows it is now marching higher. I'll present the evidence for that in moment. The point here is that wages are steadily rising --- but they are doing so in the absence of any productivity growth! And that can spell trouble down road.

Higher wages combined with falling productivity can produce one of two unpleasant outcomes: Either companies will have to absorb the higher cost of labor and be

resigned to smaller profit margins. If so, stock prices will soon take a bath. Or, firms will try to offset these expenses by raising prices, actions that can heat up inflation

and catch the Fed off guard. Since most CEOs will fight hard to avoid sacrificing margins, the odds are more companies will soon move to raise prices, especially as confidence grows that the economic expansion is sustainable.

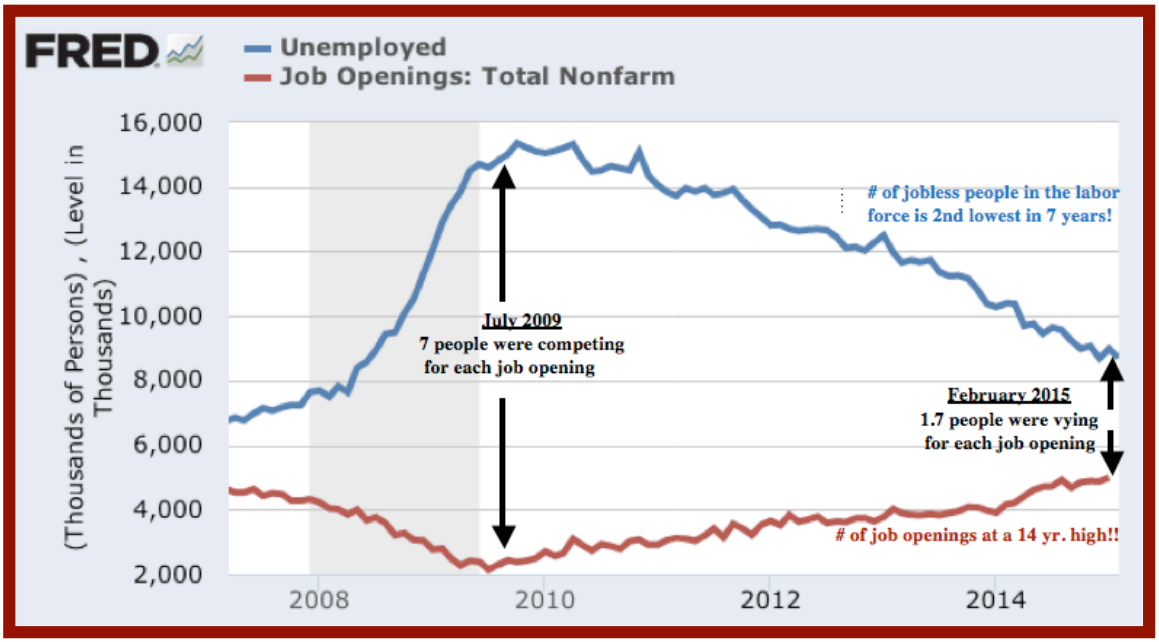
But let me be clear. The prospect of seeing high levels of inflation anytime soon is still remote. Both the CPI and PCE price index are running way below the Fed's 2% target, and have been for some time. However, monetary policy is not based on how prices behave now or even in 6 months. The Fed has to take precautionary steps to prevent an outbreak of inflation 18 to 24 months from now. And given the data we have seen lately on the precursors of inflation, the case gets stronger that June is the proper time to begin --- emphasis is on "begin" --- normalizing rates.

Let's look at the relevant data.

We begin with Chart 1, which contains two important figures -- job openings (from the JOLTS report) and the number of unemployed in the labor force (based on the employment release). The month after the great recession ended there was a paucity of job openings, but lots of people seeking work. The chart shows that 7 people were competing for each available position in July 2009. Given the large pool of idle workers at that time, employers had little incentive to increases wages.

However, this slack in the labor force has been steadily shrinking and history shows that once the ratio dwindles to 2 job seekers for each post, wages rebound within six months. Well, we are now even below that level, with a ratio of 1.7 people vying for each available job.

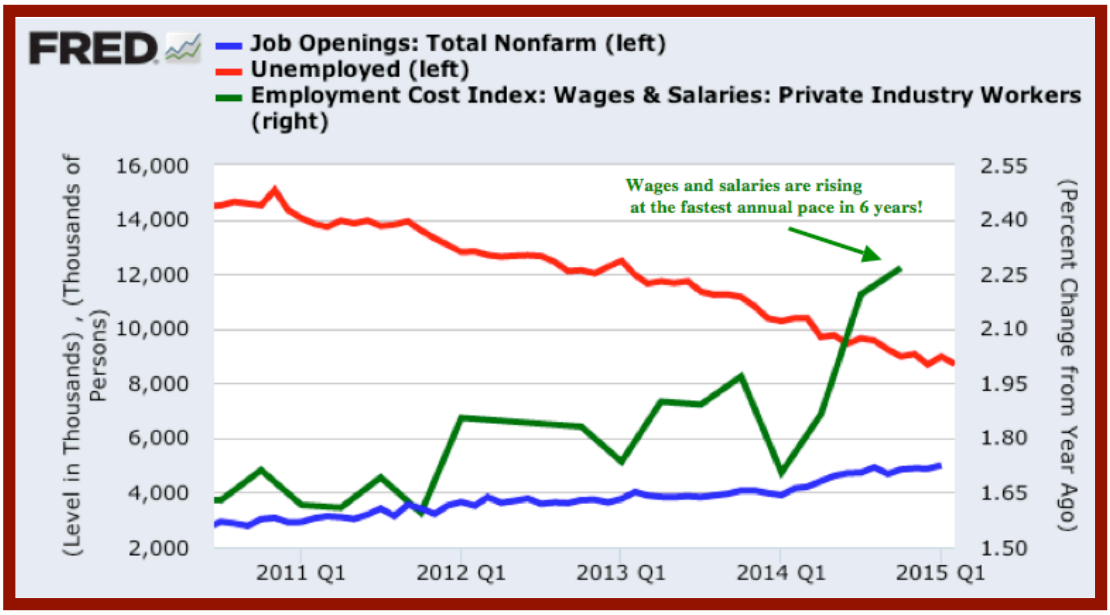
Chart 1.



A tightening of the labor market usually sets the stage for employee pay to turn higher –– and that precisely what we're seeing now. Chart 2 combines data shown on Chart 1 and overlays the trend in wages and salaries based on the Employment Cost Index, a measure that looks at compensation based on responses from businesses.

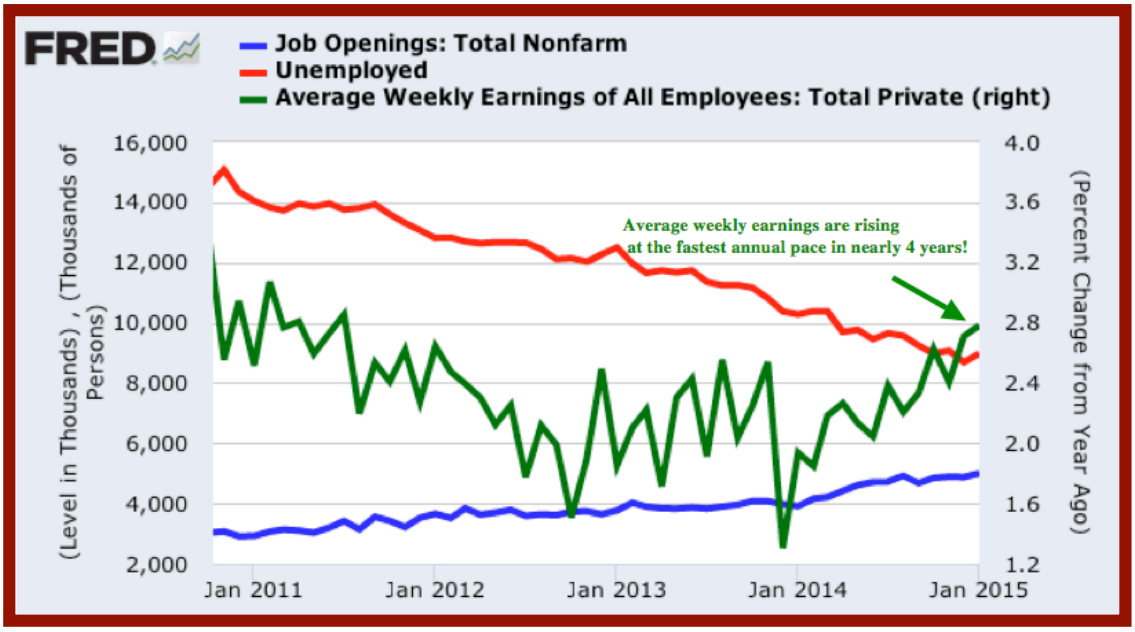
Not surprisingly, wages and salaries are now climbing at the fastest pace in 6 years. Moreover, expect pay hikes to continue as firms compete to attract new workers and seek to retain their existing employees.

Chart 2.



We also looked at other measures of worker income to see if they confirm this uptrend in wages. Chart 3 examines average weekly earnings, which combines average hourly pay with the average numbers of hours worked in a week.

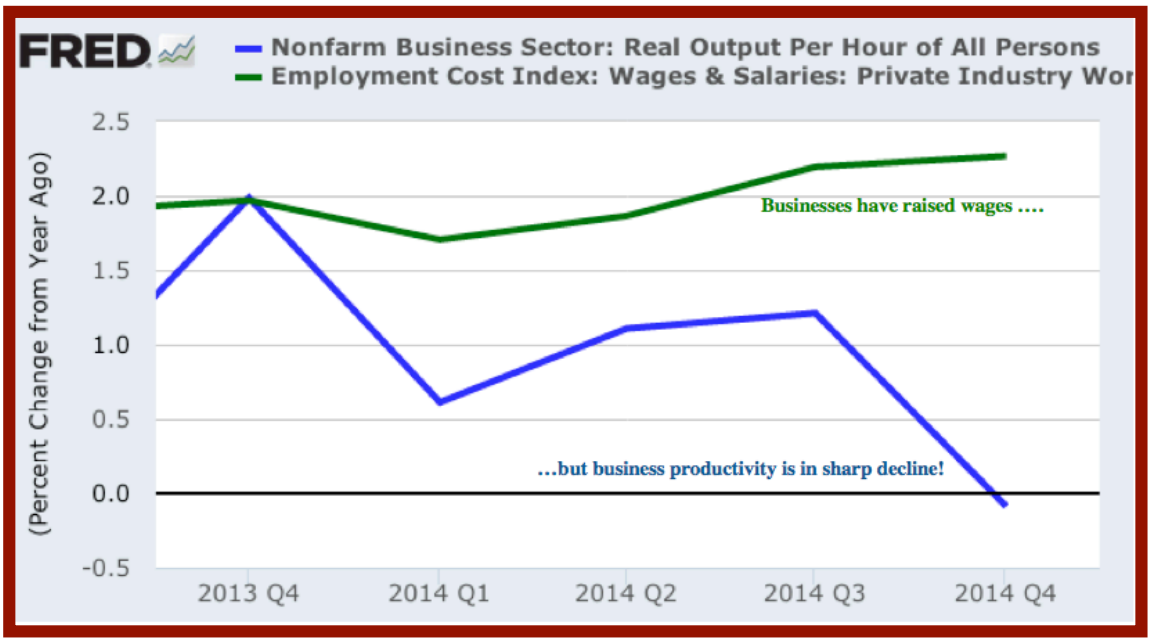
Chart 3.



Once again we see wages picking up as a result of tighter labor market conditions. In addition, pay is now rising faster than prices, which is a good thing because it boosts purchasing power and that will help fuel more consumer spending in the coming quarters.

Now for the spoiler. A sustained rise in labor costs that is accompanied by declining productivity (See Chart 4) is an inherently unstable mix. Something has to give. Over the next year or so, firms will be under pressure either to raise prices, or lay off workers, or accept shrinking profits.

Chart 4.



Why has productivity growth lagged so badly? That's no mystery. Firms have long neglected to reinvest profits back into their company. In the last decade, more than half the earnings of S&P 500 firms were spent not on replacing or modernizing their business, but to buy back stocks in order to jazz up their earnings per share. That may have cracked a smile on investors, but the result is that a growing number of firms are now left with equipment, machinery and buildings that are showing lots of wear and tear. Take a look at the current age of some of these corporate assets, as measured by the Commerce Department (Chart 5)!

Chart 5.

AGE OF U.S. CAPITAL STOCK GETTING OLD

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

Thus our first argument is that the Fed appears much too complacent about the toxic consequences of rising wages and declining productivity. It is a combination that in the past has led to a more problematic inflation.

Divergence in global monetary policies

Here's our second major concern. The Fed believes it must tread more carefully when considering a rate increase because of the vast divergence in global monetary policies. Lifting the US benchmark rate now when other major central banks have been pounding their rates down, the Fed fears, could push the dollar sharply higher, hurt exports, corporate earnings, and result in less GDP growth.

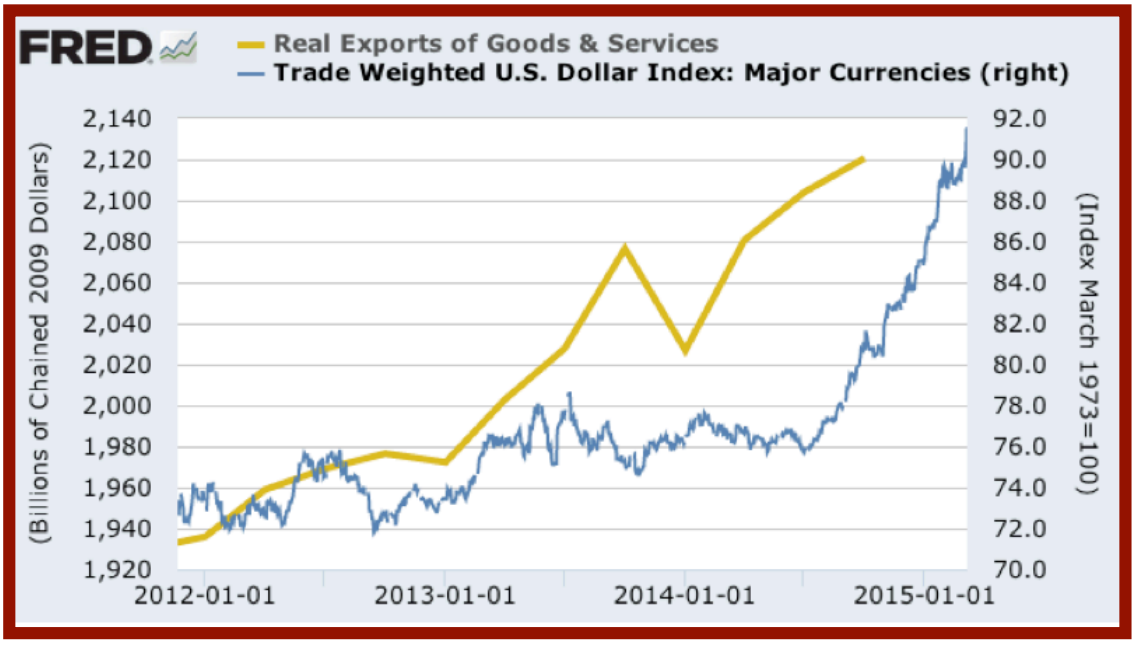
But this worry, while logical, lacks any sense of proportion and should not be the basis for a delay a rate increase. Here's why.

The dollar's value has been on a tear all right, climbing more than 26% against its major trading partners over the past 12 months. That includes an 18% jump versus the yen and more than 30% against the euro. These are major moves, to be sure.

But has it actually damaged shipments of US exports?

Actually not! In fact, this country is selling ***more goods*** to foreign buyers now than it did a year ago! Real exports, that is the actual volume of products sold (such as industrial supplies, capital goods, automobiles, and consumer goods) was up nearly 3% this January compared to a year ago. In fact, real exports were higher every month in 2014 than it was for the same month the prior year (Chart 6.)

Chart 6.



It is certainly true that export earnings in nominal dollars have fallen, with a decline of 1.7% from a year ago. And yes, the dollar's appreciation has been a factor in that. But this primarily affects corporate income statements, not the real economy.

Even on the income statement side, we have to main a certain perspective.

First, with just about all of S&P 500 companies reporting Q4 earnings, we find 75% recorded earnings that were ***above*** the mean estimate and 58% have reported sales ***above*** the mean estimate.

Second, many multinationals typically protect themselves from currency fluctuations by utilizing hedging strategies, or they sign long term sales contracts at fixed FX rates, which explains the rather small decline in nominal dollars received so far.

Third, there is a widely held assumption that the dollar is predestined to climb much higher once the Fed begins to notch up rates. We disagree. It is more likely that the dollar will stabilize, if not slide back in the second half of the year. Remember, we have already begun to see fresh signs of growth in Europe, especially in Germany. Cheaper fuel prices and the massive QE policy just started by the ECB should spur more economic activity there. If that is the case, this increases the likelihood of greater exports to that region and also encourages investors to rotate out of richly valued dollar denominated financial assets in favor of other cheaper markets that are showing fresh economic momentum.

One final point here to add here. The Fed stated on several occasions that once rates begin to move up, don't expect a hike to follow after each subsequent FOMC meeting. The target rate is more likely to creep up so gradually, it could be more interesting watching grass grow. In practical terms, the *real fed funds rate* will therefore remain negative the rest of this year and most of 2016 too.

Higher rates and the trade deficit.

Will higher rates cause the trade deficit to widen and hurt GDP growth? Perhaps, but we have to make an important distinction between slower economic growth due to a fundamental weakness in the US economy --- which is clearly not the case today, and how the math of a larger deficit in net exports can drag down GDP.

A larger trade deficit does make aggregate GDP numbers look softer. After all, US consumers and businesses are importing more goods and services as economic growth here outpaces every other major world economy. For example, the widening trade deficit in the fourth quarter of 2014 slashed more than a full percentage off GDP, resulting in weaker than expected 2.2% growth. But that is no reason for the Fed should shy away from raising rates in June, since the true the vitality of the domestic economy is not captured by GDP in this instance.

The indicator that best gauges the strength of US economic activity is "gross domestic purchases," which looks at total spending for goods and services only among US consumers and businesses. What we see is that pure domestic demand has soared an average of 3.6% the last three quarters, the strongest pace in more than a decade!

When you factor in that kind of US growth, plus:

- An unemployment rate of 5.5%, lowest since 2008,
- Payrolls surging at the fastest pace in 15 years,
- Job openings at 5 million, most in 14 years,
- The quit rate at the highest level in more than 6 years.
- Consumer spending in 4Q up the most since 2010.
- Bank lending to businesses rising at double digit rates in 2014 and continuing so far this year.
- S&P 500 entering is 7th year of a bull market, with valuations at five -year highs.
- A Dow that has climbed more than 10,000 points since the Fed brought rates down to near zero in late 2008.

…then I think it is fair to say that all the vestiges of the Great Recession have largely disappeared.

Yes, we would like to see more vibrancy in the housing market. And, yes, we want to reduce the number of structurally unemployed Americans so they can join the workforce. But these two objectives fall more into the domain of fiscal policy, where the White House and Congress can work to ease some of the stringent mortgage regulations to homebuyers, and to set up training programs that help jobseekers acquire new skills.

The issue for Fed monetary policy is much simpler at this juncture. The economic crisis is essentially over and the zero-interest policy is no longer necessary. Indeed, prolonging it can do more harm than good, we argue. So, the Yellen Fed should prepare a reset. The time has come to delete "patience," and end the smoky verbiage from future FOMC statements. A June lift off of the fed funds rate is appropriate and Yellen should not shy away from raising that prospect.
