THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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June 9, 2015

This Could Be A Long Hot Summer For The Fed, Especially If The Economy Continues To Pick Up Speed

The health pendulum of the US economy has swung from “dismal” to “mixed,” to now “unambiguously vibrant” --- all in just the last three months! This rapid transition was perhaps best captured by two recent business confidence surveys.

On Monday, the Business Roundtable released its latest CEO confidence report on the economy and it wasn’t pretty. Corporate leaders were so sour about the next six months they were planning to ***scale back*** hiring and investment. Their CEO Economic Outlook Index plummeted to 81.3 this quarter, the lowest in nearly two years! (The Business Roundtable consists of corporate leaders who represent the nation’s largest companies, with $7.2 trillion in annual sales and employ nearly 16 million people.)

But a day later, another major trade group representing small businesses looked into the future and came to a radically different conclusion. The National Federation of Independent Business’ released their Small Business Optimism Index and it actually jumped in May to 98.1, its highest level of the year! Moreover, these firms were planning to ***accelerate*** hiring in the coming months given this improved outlook.

Which group has a better sense on the path of the economy?

Before we answer that question, we have to make clear that the Business Roundtable survey was conducted between April 22 and May 13, a time when we were getting conflicting reports on the economy’s health. We also have to acknowledge that large companies with global customers have suffered more than smaller firms because the dollar’s strength made exports more costly. And certainly the major energy producers took a beating by the plunge in oil prices. So clearly, the bigger S&P 500 firms faced some significant headwinds this past year and many of its CEOs chose to remain cautious about the second half of 2015.

Having said all that, when it comes to actual employment trends, small businesses have historically played a more important role; they account for 7 out to 10 new hires in the economy.

So, which of the two business groups has a better sense on where the economy is headed?

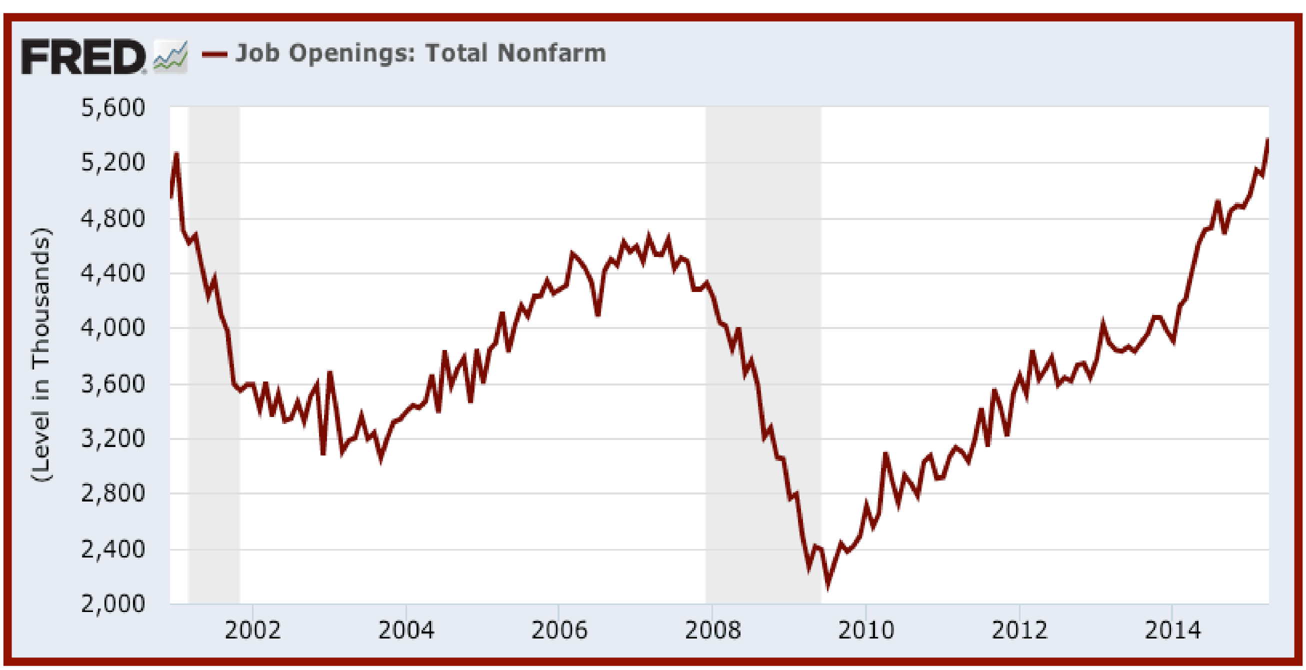
We believe that small businesses are more sensitive to changing trends in economic activity. Their optimism on the economy now appears to be justified given the latest data points. In the last several days, the government released a cascade of reports and they uniformly show an economy that has successfully re-energized following the contraction in the first quarter.

Certainly May's employment report turned out to be better than anyone expected. Payrolls jumped by 280,000, the most this year. A few hours after that release, the Federal Reserve's monthly publication on consumer credit outstanding showed Americans were actively shopping again. Credit card debt soared by $20.54 billion, the biggest increase in a year and, again, far higher than consensus forecasts.

Today came more good news with the release of wholesale inventories and sales. While the amount of goods held in stockrooms and lots of these rose by 0.4%, sales shot up by 1.6% in April, the largest jump in more than a year! That brought the inventory/sales ratio back down to 1.29 months worth of goods. Should this trend continue, and we expect it will, wholesalers will be under pressure to replenish their diminishing supplies and that should keep factories busy in the months ahead, lead to more hiring and stimulate fresh spending by households and businesses.

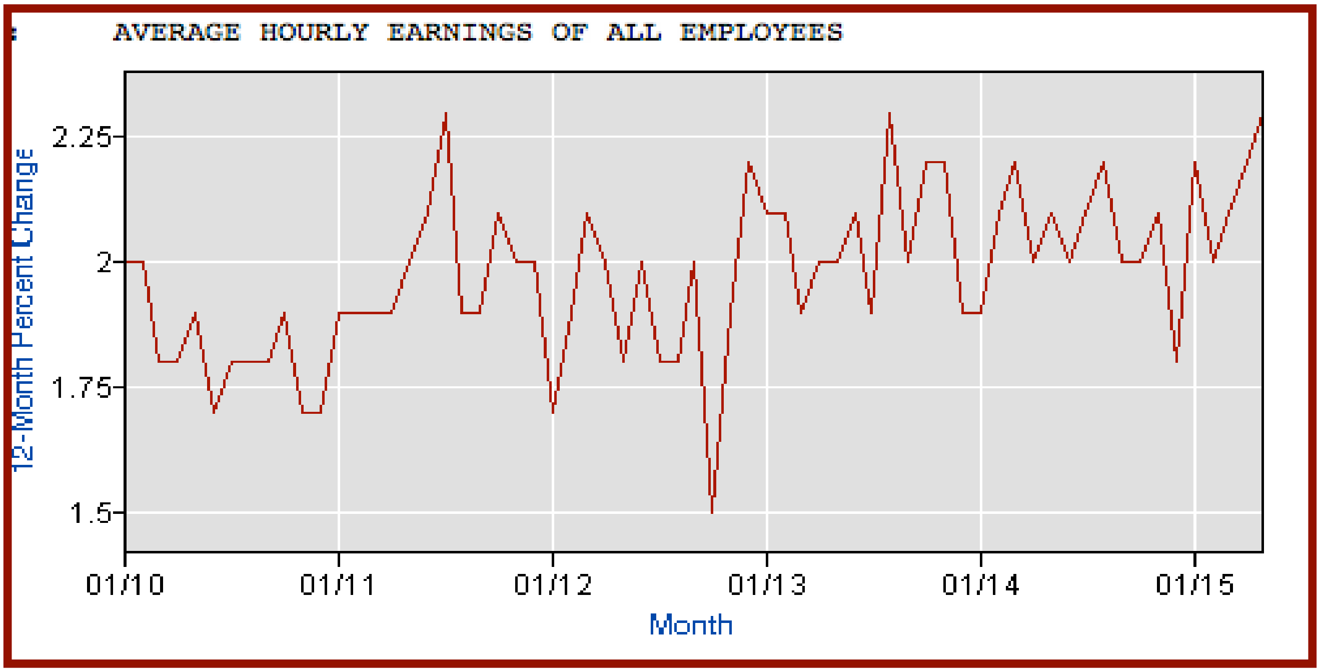
But the brightest news today came from the Job Openings and Labor Turnover report (JOLT). Total job openings surged to 5.4 million in April, the largest number of vacancies ever recorded by this series, which began in 2000 (Chart 1). Firms ramp up hiring when they are believe demand for their products will remain strong. After all, labor is the biggest cost of production so companies have to be fairly confident they will earn a return on that investment.

Chart 1.



The prospects for bigger wage gains also improved with the JOLT report. There are now 1.6 people competing for each available job. It was as high as 7 vying for each position during the low point of the last recession. Typically, the threshold that leads to an acceleration in pay begins once the jobless slack shrinks to where 2 people are available for each job. With the ratio now well below that, it is not surprising that average hourly earnings last month jumped by 2.3%, the largest annual increase since August 2013 and only the third time in five years. (Chart 2.)

Chart 2.



Does all this good news on the economy put additional pressure on the Fed to finally lift rates --- perhaps as early as next week?

With a strong retail sales report expected on Thursday, questions will arise on whether the Fed should once again consider raising interest rates at next week's meeting, rather than wait until September. This poses a real dilemma for Fed policymakers. If they choose to keep rates near zero through the summer and the economy, employment and wages keeps climbing in the interim, investors may grow more anxious that monetary policy is trailing the rest of the economy. In that case, we could soon see a more rapid sell-off in the bond market this summer. If yields on the 10 yr benchmark Treasury climbs too quickly, it can hurt the housing recovery and possibly derail the economic expansion itself.

At this juncture, we believe each additional strong economic report raises the urgency for the central bank to act if it wants to keep its credibility intact. This could be one long hot summer for the Fed.

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