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ECONOMIC TALKING POINTS

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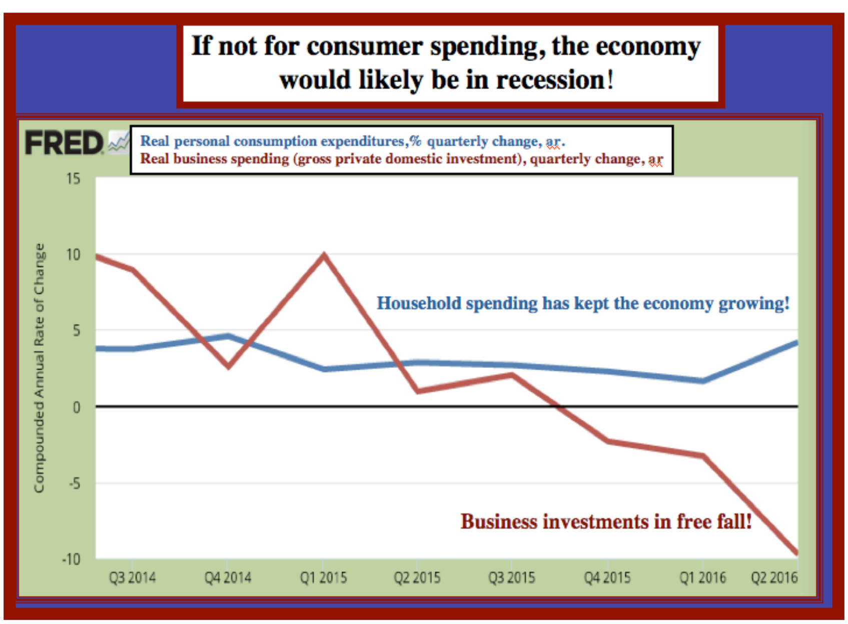
July Employment Report: With the Economic Outlook Still So Murky, Companies Choose Labor Over Capital

Try this thought experiment. Imagine two consecutive months of unambiguously robust job growth --- and that they are occurring at a time when the economy is hovering close to recession. How can that be, you wonder? Why would employers aggressively hire workers when US GDP shows so few signs of life?

Yet that is precisely what has been happening and the explanation is quite fascinating.

Business hiring these last two months have been the strongest of the year. The surge in employment July and June is a vivid reminder of the powerful impact household spending has on the economy. Indeed, were it not for the active participation of the consumer, we would now be facing recession, since no other major sector of the economy is currently contributing to growth: Business capital spending is in free fall, government outlays have declined, and you might need a a jeweler's loupe to detect a minute uptick in net exports.



The dichotomy between hiring trends and overall economic output raises some interesting issues. GDP growth has averaged LESS than 1% the last three quarters, yet companies found sufficient cause to increase payrolls by an average of 210,000 during those months. (To better appreciate this paradox, keep in mind the economy grew *more than twice as fast* in the first nine months of 2015 --- and added the same number of people.)

So how do we explain this bizarre trend? Simple. There are two forces at work here. First, we have see a strong recovery in consumer expenditures the last several months, and companies have to satisfy that demand. They can do so by ramping up hiring and/or by investing in additional production capacity to boost output and productivity. It seems CEOs have chosen for now to rely solely on beefing up their labor force. Total payrolls climbed by 255,000 in July, with the private sector accounting for 85% of that increase.

In addition the amount of time Americans spent at work in July increased as well. Average weekly hours on the job in the private sector rose to 34.5, the most since January.

We also saw manufacturing overtime climb for the first time in four months, as did average hourly earnings in the private sector, which was up 2.6% from a year ago, suggesting labor markets are getting tighter.

Chart 1. Unemployment rate, seasonally adjusted, July 2014 – July 2016

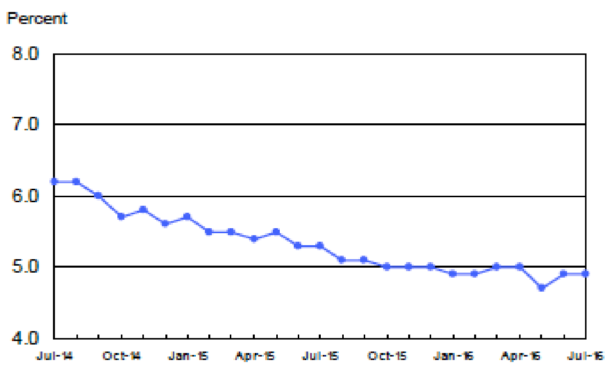
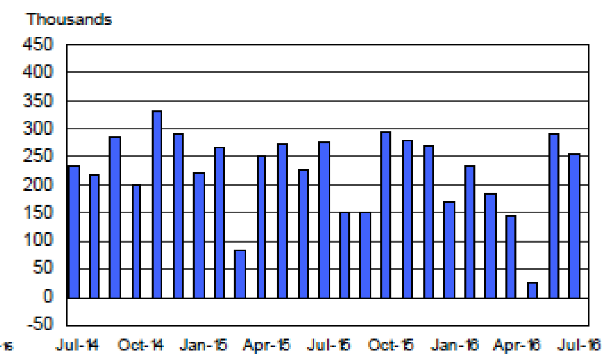


Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, July 2014 – July 2016



Looking at specific sectors, we see more clearly how consumer spending has influenced hiring.

• The recovery in housing demand contributed to a 14,000 jump in construction workers, the first upturn since last March.

• Manufacturing employment rose 9,000 last month, which followed a 15,000 gain in June. These are the best two-month numbers since 2014.

• Retailers hired another 14,700 workers, which while less than June's 25,700, nevertheless lifted total retail employment to a record 15.96 million --- this even as brick and mortar retail stores are struggling to compete with online sellers!

• The leisure and hospitality industry employed another 48,800 last month, following 52,000 in June. Both represent the fastest pace of hiring this year, as a record number of Americans take advantage of lower gasoline prices and hit the roads this summer.

• The last two months have also seen a surge in temporary hiring, with July and June showing a 17,000 and 21,700, respectively. This represents the most aggressive hiring in two years.

Let's probe even deeper. One key part of the economy we regularly track is the US supply chain network. It serves not only as a barometer on the current heath of the economy but also as a useful leading indicator of economic activity. Specifically we track activity in the trucking industry, which has struggled this past year as weaker foreign economies, the strong dollar, and

falling US oil production reduced the need for drivers. But the worst may now be over thanks to stronger than expected demand from US consumers and some early signs of a pick up in exports. The result: After five straight months of layoffs, trucking companies are calling back workers. The industry hired 1,700 people in July and we expect this rebound to continue in the coming months.

Hiring vs. business capital spending.

Strong consumer spending is thus one force at play here. But there is a second factor that led to greater employment even with GDP fundamentally weak. Firms have shown no inclination to ramp up capital spending. In fact, gross private domestic investment collapsed the last nine months. It plummeted by a 10% rate in the last quarter, the worst downturn in more than a year!

This willingness to absorb the high cost of labor and completely shut down business capital spending illustrates how cautious CEOs remain. Given the uncertainties about the US election, the fallout from Brexit, and the health of the global economy, companies appear content for now to satisfy consumer demand by adding on more workers to boost production, rather than invest in capital equipment to enable productivity growth.

In other words, with so many economic, political and geopolitical variables in flux at the same time, employers perceive labor more as "inventory" (i.e., people can be hired when needed…and let go when business sours). In contrast, an investment to expand facilities and purchase more equipment involves a costlier, longer-term commitment of capital, a commitment firms are still reluctant to make with the economic outlook still terribly murky. When it is so difficult to assess rate of return on invested capital, the only choice employers have to boost output is to hire more people. We may be in that cycle for the balance of the year: stronger hiring to offset a freeze on capital expenditures.

What implications does all this have for the Federal Reserve?

The odds of a rate hike in September remains less than 25%, precisely because it is so difficult to determine how the economy will perform in 2017. Hillary Clinton and Donald Trump have presented radically different tax, trade and foreign policy proposals, with polar opposite results to GDP growth next year by our assessment. (Our forecast calls for the economy in 2017 to expand by 2.8% with a Clinton victory, versus 0.5% under a Trump presidency).

Second, the Fed wants to wait and see how the US economy will be affected by the Brexit vote, the wobbly banking system in Europe, and the deepening financial crisis in China. A rate increase at this juncture would punch the dollar's value higher and further harm US exporters.

If the US economy keeps improving the rest of the year, as we expect, the Fed will likely proceed to raise rates in December. Their most difficult task will be to explain why, in the face of such strong numbers on employment and consumer spending, they will refrain from taking any action between now and then.

Key Economic Forecasts

- Actual
- Forecast

United States

	I 2015	II 2015	III 2015	IV 2015	I 2016	II 2016	III 2016	IV 2016	I 2017	II 2017	III 2017	IV 2017
Real Gross Domestic Product (GDP):												
%	2.0	2.6	2.0	0.9	0.8	1.2	2.1	2.5	2.4	3.3	2.8	2.4
Personal Consumption Expenditures:												
PCE	2.4	2.9	2.7	2.3	1.6	4.2	3.0	2.7	2.4	3.0	2.7	2.8
Inflation, end of period, year-over-year:												
CPI %	-0.1	0.1	0.0	0.7	0.9	1.0	1.3	1.4	1.8	1.9	2.2	2.3
Unemployment Rate (end of period):												
%	5.5	5.3	5.1	5.0	5.0	4.9	4.7	4.5	4.5	4.5	4.5	4.9
Non-farm Payrolls, monthly avg. thousand:												
	195	231	174	282	196	147	140	165	210	220	220	210
Treasury 10-yr Note Yield % (end of period)												
	1.93	2.38	2.06	2.27	1.78	1.49	1.58	1.78	2.10	2.30	2.55	2.90
Federal funds rate % (end of period)												
	0.13	0.13	0.13	0.38	0.38	0.38	0.38	0.63	0.88	1.13	1.38	1.63

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
US	1.8	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.7	2.8
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.6	-0.4	0.9	1.5	1.3	1.6
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.5	0.2
Japan	2.1	-0.7	-5.4	4.6	-0.4	1.6	1.5	-0.1	0.5	0.6	0.8
Canada	2.7	0.7	-2.8	3.1	3.1	1.7	2.2	2.5	1.2	1.6	2.5
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	7.4	7.8	7.5	7.8
China	14.2	9.6	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.2	6.0
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-4.1	-0.8
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.4	2.3	2.5	2.2	2.6
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.6	2.5	2.5	3.0
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	0.6	-3.7	-2.0	0.3
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	3.0	2.6	2.4	2.9