U.S. ECONOMIC GROWTH
Be Careful What You Wish For
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As 2014 begins to unfold, there remains a sense that it is difficult for the United States and the world at large to extricate itself from the remnants of the global financial crisis and accompanying Great Recession. Despite extraordinary monetary and fiscal measures, world economic growth still has not reached “escape velocity,” although the United States seems closer than many other developed countries.¹

Many prognosticators have upbeat views on the U.S. economy in 2014, but similar pronouncements have been made before, only to be disproved. Because the Milken Institute’s GDP forecast of 3.2 percent is on the positive side of the distribution, it is worth exploring what impact unanticipated growth in combination with other factors might mean for inflation, interest rates, and financial markets in the coming year. While some of the items discussed may seem like low-probability events, history and a more in-depth look at the data might suggest otherwise.

**Upside Trends**

Certain high-profile data like recent slow employment growth have raised concerns about the health of the U.S. economy. Severe weather in parts of the country explains some of the downside, and when looked at more broadly, economic indicators have tended to outperform consensus estimates rather than underperform them. Longer-term trends are even more encouraging for the outlook. In particular, the following could push economic growth higher than the current consensus forecast:

- Sharply reduced fiscal drag
- Progress in household deleveraging
- Impact of wealth effect
- Rising energy production

It is difficult to estimate what impact these items could have on growth this year, as numerous measurement issues are associated with each. Fiscal drag is generally believed to have squeezed about 1.5 percent out of GDP last year, although recent estimates have gone higher, reflecting larger multiplier effects in line with those cited in IMF research on fiscal austerity.

¹. The governor of the Bank of England, Mark Carney, used the term “escape velocity” at the 2013 World Economic Forum in Davos to describe the point where the major economies begin to grow sustainably again, without being pulled back into stagnation by low confidence and high debt levels, among other travails. This is the “green shoots” de nos jours.
This year’s budget agreement should result in a significant reduction, if not near-elimination, of fiscal drag.

The United States, in contrast to other developed countries, has been reasonably successful in reducing household debt. In aggregate, households have pared their debt/GDP ratio by 18 percentage points in the last five years. This has provided room for households to begin borrowing and banks to lend again. Although deleveraging so far has had little impact on revolving credit (e.g., credit cards), this could change soon. The latest University of Michigan Consumer Sentiment poll shows household expectations for real incomes jumping from 65 to 75—the highest level since January 2008. Installment credit is set to increase further as consumers continue to purchase new cars to replace a fleet with a record median age of 11 years.

The wealth effect has often been discussed in the context of how the Federal Reserve’s nontraditional policy of quantitative easing might influence it, but estimations of this effect have appeared less frequently. According to the Credit Suisse Research Institute, household net worth in North America rose nearly 12 percent in the year through mid-2013. More detailed data from the U.S. flow of funds indicate that the net worth of U.S. households increased significantly to reach a record $77.3 trillion in the third quarter of last year, a gain of about $20 trillion since the end of 2008. While it seems unlikely that asset prices will continue to rise at last year’s pace, there is a reasonable expectation that the wealth effect will have a positive impact on real GDP growth this year, especially if there is no discernible drop in housing prices.

The impact of fracking technology in transforming America’s prospects as a hydrocarbons producer has generally been underappreciated by economists. Natural gas output rose by more than one-third from its most recent trough in 2005 through 2013, and oil production has risen similarly since 2008. According to IHS CERA, the energy boom contributed $283 billion to gross domestic product and lifted average household income by more than $1,200 in 2012. It foresees a further boost to the economy, with the impact on households reaching $2,000 by 2015.

Possible Surprises for Investors and Policymakers

A stronger than anticipated pick-up in growth, combined with other events that may be wrongly viewed as unlikely, could push investors and policymakers to reassess their positions. These key factors, taken together, could alter the notion that accelerated growth will create a virtuous circle, enabling the economy to reach that hoped-for escape velocity without nasty consequences. Possibilities worth considering include:
A further fall in labor force participation and unemployment
Rising wages
Price pressures reflecting capacity constraints

Despite the noticeable fall in unemployment in the final months of 2013, the Federal Open Market Committee (FOMC) decided “that it likely will be appropriate to maintain the current target range (0 to ¼ percent) for the federal funds rate well past the time that the unemployment rate declines below 6½ percent.” This has been widely interpreted as providing a further cause for inaction by the FOMC in raising the federal funds rate. Reinforcing this view is this text in the FAQ section of the Federal Reserve website: “Most policymakers estimate the longer-run normal rate of unemployment is between 5.2 and 5.8 percent.” That range is appreciably below the year-end 2013 level of 6.7 percent.

However, this gap could narrow much quicker than expected, especially if the labor force participation rate continues to decline beyond its current 36-year low of 62.8 percent. While there has been much debate about the reasons for the drop, it seems increasingly clear that it is tied to baby boomers retiring. Indeed, nearly 80 percent of those who left the workforce in 2013 were over the age of 55, and demographics support a continuation of this large-scale exit.

The new chair of the Federal Reserve, Janet Yellen, has indicated that she will look at a variety of data in determining how close the U.S. economy is to full employment. She may be surprised to find that among prime working-age males (25 to 54 years old) the unemployment rate is 5.8 percent—the lowest it has been since October 2008. The latest Job Openings and Labor Turnover Survey (JOLTS) shows job openings rising by 70,000 from November to December and 193,000 in the past four months. The total number of jobs that companies are looking to fill
exceeds 4 million for the first time since March 2008. In addition, the number of voluntary quits increased 46,000 to stand at its highest level (2.4 million) since September 2008. This measure, a supposed Yellen favorite, is considered a bellwether of worker confidence and an indicator of future wage growth.

Data from the nonfarm payroll report gives little support to rising wages. However, both the Gross Domestic Income report and the National Federation of Independent Business Small Business index suggest more movement. In particular, the NFIB worker compensation sub-index jumped from 14 to 19, a 5½-year high with plans to raise them further remaining elevated. This is significant because the small business sector employs about two-thirds of the U.S. workforce. Information from this survey is backed up anecdotally by the latest Federal Reserve Beige Book, which contains no less than two dozen references to labor shortages and strong wage gains in a variety of sectors that employ about 40 million workers.

Although wage gains are unlikely to be a source of rising prices, other factors might be at work. Despite the fact that current overall industrial capacity utilization is 79.2 percent and remains below its 40-year average of 80 percent, it’s much higher at the earlier, “crude” stage—88.7 percent, a rate 2.4 percentage points above the long-run average. In the semiconductor equipment sector, the book-to-bill ratio, which compares the number of units ordered for the last quarter to the number shipped and billed, now exceeds 1, indicating the possibility of capacity issues.

The managing director of the IMF, Christine Lagarde, warned recently of the “deflation ogre” in advanced economies, including the United States. While inflation is indeed low in this country, there are certainly signs that the ogre is in retreat. In December, the headline producer price
index rose 0.4 percent on a monthly basis, the strongest print in six months. The fourth quarter also witnessed an average 0.8 percent monthly increase in rent prices as the apartment vacancy rate fell to a 12-year low of 4.1 percent. A further acceleration seems likely as projected demand outstrips new units coming on the market.

With the rent/imputed rent component accounting for nearly 30 percent of the consumer price index (CPI) and almost 40 percent of the core measure, inflation expectations could be poised to move upward, no doubt grabbing the attention of Federal Reserve officials. According to the latest University of Michigan Consumer Sentiment survey, 26 percent of respondents see inflation between 3-4 percent before the end of this year and 14 percent expect inflation to reach 5 percent. At the moment, Treasury Inflation-Protected Securities, also known as TIPS, imply consumer price inflation of only 1.4 percent during the year, which may make them attractive to investors.

**Implications for Fixed-Income and Equity Assets**

Although it is often difficult to pin down the factors that influence asset price moves, it is not unreasonable to suggest that a positive shift in expectations for GDP growth combined with the factors mentioned above could push market interest rates higher than the current consensus estimates for later this year and 2015. The likely acceleration of Federal Reserve tapering as the year progresses reinforces this view. When the possibility of tapering was first alluded to by then-Chairman Ben Bernanke last spring, the 10-year Treasury yield jumped more than 100 basis points in two months.
An argument can be made that with tapering underway, market participants have incorporated the expectation that asset purchases will end this year. However, the term premium in bonds is still lower than in much of the pre-2007 period. Goldman Sachs’ models of term premium and the federal funds rate suggest that some upside risk remains for market interest rates even in a more subdued monetary policy and inflation environment.

In regard to equities, their prices tend to be hurt when bond yields gain momentum, even with strong economic growth as a backdrop. If this is accompanied by expectations of tighter monetary policy, it becomes even more unambiguously negative for stock markets. Notwithstanding the softness in equity prices so far this year, metrics like price-to-sales ratios and market capitalization as a share of gross domestic product remain at levels not seen since the dot-com boom of the late 1990s. The Shiller cyclically adjusted price/earnings multiple for the S&P 500 stands at about 25, which is higher than 29 of the past 35 bull mark peaks since 1900. However, based on relative measures of valuation, including equity risk premium and equity credit premium, stocks are generally not considered to be overvalued from a historical perspective. Given the uncertain conditions that seem to prevail, even a seemingly benign uptick in wages could raise concerns about corporate margins that translate into downward pressure on equity prices.

**Is This a Red Herring?**

Although it is easy to be complacent and believe that the economy won’t deviate far from its general performance of the past two years, thus rendering the above scenario a red herring, certain lessons of history suggest a need for more diligence. At the time, it seemed premature that the Federal Reserve would tighten policy in early 1988 on the heels of the October 1987 stock market crash. The same was true in late 1998 following the Long-Term Capital Management debacle several months earlier. In late 2003, the central bank tightened once again, notwithstanding the July speech titled “An Unwelcome Fall in Inflation?” by Fed Gov. Ben Bernanke. Those comforted by the “dovish” label attached to Yellen should know there has not been one instance during her 12-year tenure on the FOMC in which she has dissented from a majority decision to hike the federal funds rate.

Even if the Federal Reserve does not tighten policy sooner than expected under its current forward guidance, the equity market could suffer a significant correction despite a pick-up in economic growth. The massive setback in October 1987 took place while real GDP was advancing at a 6.8 percent annual rate. In 1994, equities were turbulent as the growth trend stood at 4 percent. Moreover, the sizable market correction of 1998 came about at a time of 5 percent growth in the real economy.
This article is not intended to dismiss the many positive attributes of economic growth. However, it does raise the possibility that managing its effects will be a more daunting task than policy officials would have us believe. While a juxtaposition of growth and risk might seem odd in the aftermath of a global crisis and deep recession, a broader review of history reminds us that it is not.
About the Author

Keith Savard is senior managing economist at the Milken Institute. He has extensive executive management experience with expertise in evaluating the interrelationship between economic fundamentals and activity in global financial and commodity markets. He also has a background in sovereign risk analysis and applying a disciplined economic approach to investment-portfolio decision-making. Prior to joining the Milken Institute, Savard was director of economic research and chief economist at Samba Financial Group (formerly Saudi American Bank) in London. He also held positions at Zurich Investments, the Institute of International Finance, the U.S. Department of State and the Board of Governors of the Federal Reserve System.