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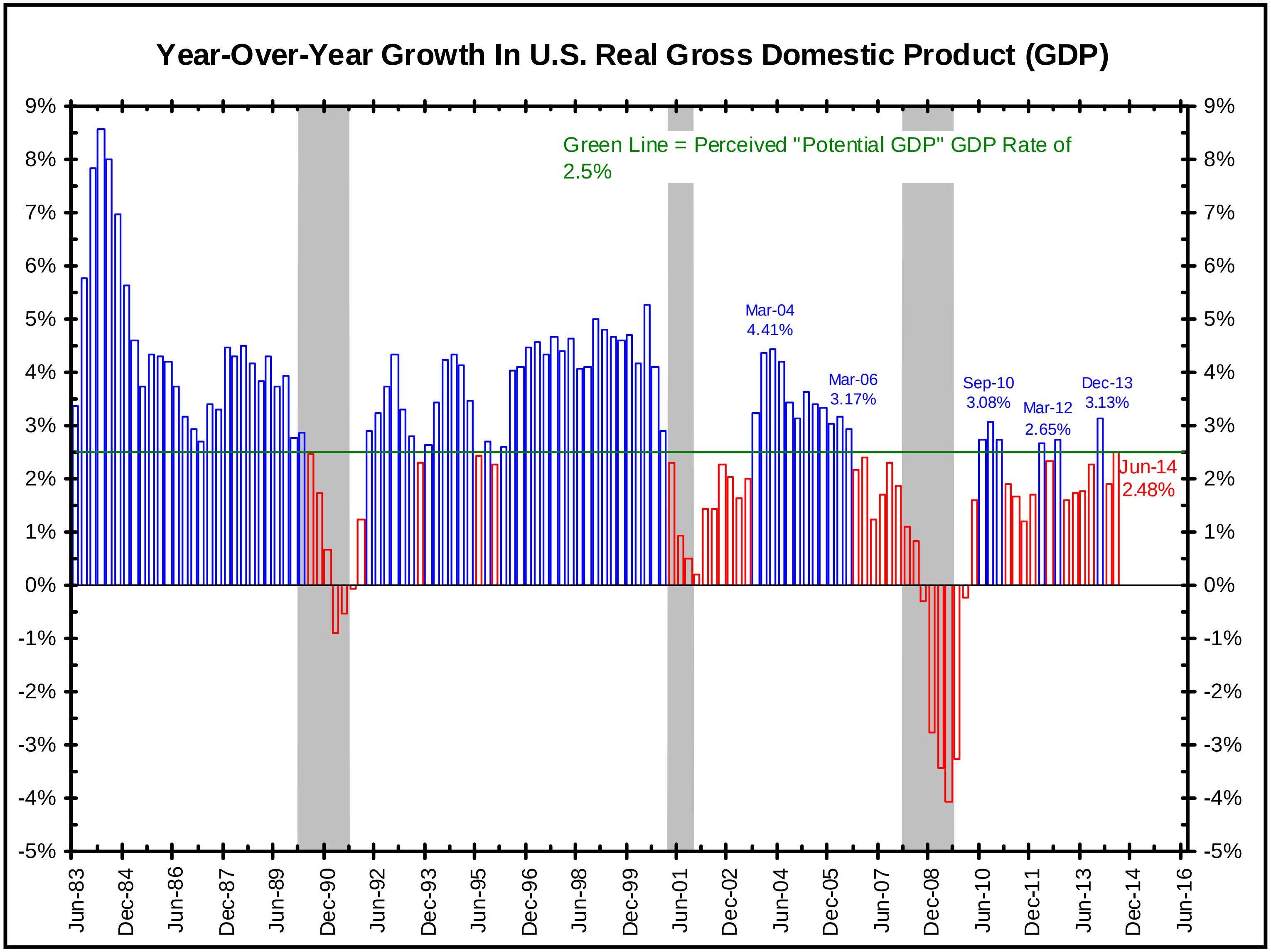
Is The Economy About To Break Out?

Milwaukee Presentation Package

September 16, 2014

Long-Term Interest Rates - 1900 to 2013

Struggling To Hit Potential GDP



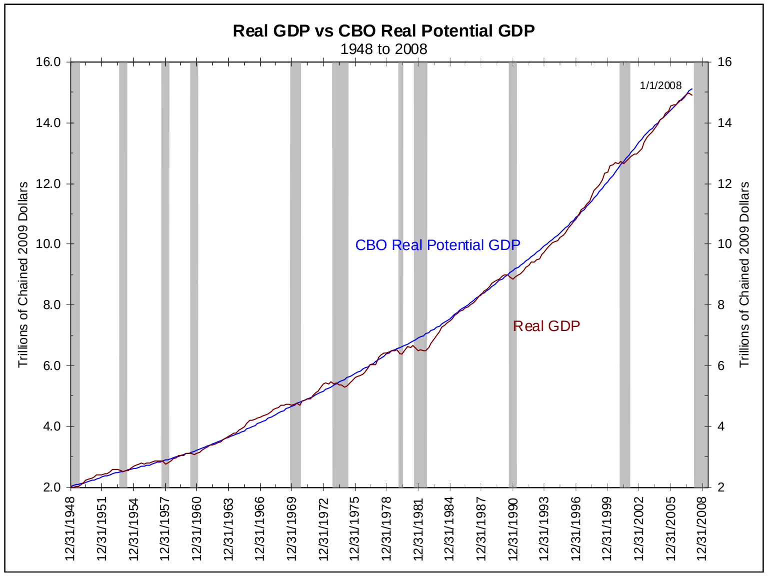
Potential GDP

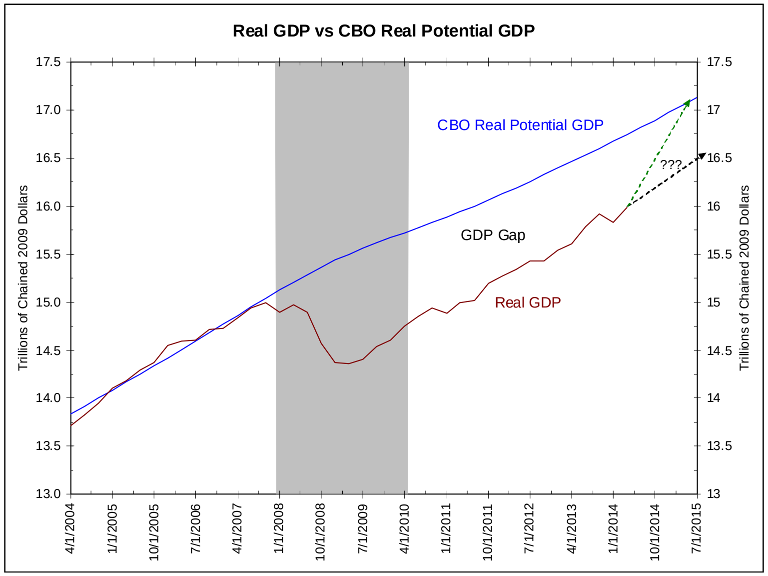
Potential GDP estimates the output the economy would produce with a high rate of use of its capital and labor resources. The data is adjusted to remove the effects of inflation. Restated, potential GDP shows how fast the economy should grow without excess stimulus (easy money) or restraint (hike rates) influencing it. It is a guess by economists and is expressed as a math equation, not something that is actually observed.

The first chart to the right is from the St. Louis Federal Reserve's "FRED" data service. It shows real potential GDP in blue as calculated by the Congressional Budget Office and actual real GDP in red. The chart starts in 1949 and ends in 2008. For 50 years, until 2008, potential GDP did an excellent job of predicting the long-term path of the US economy. When the economy slumped below potential, a recession was often underway. Then, coming out of a recession, faster-than-average growth enabled the economy to catch up to long-term potential.

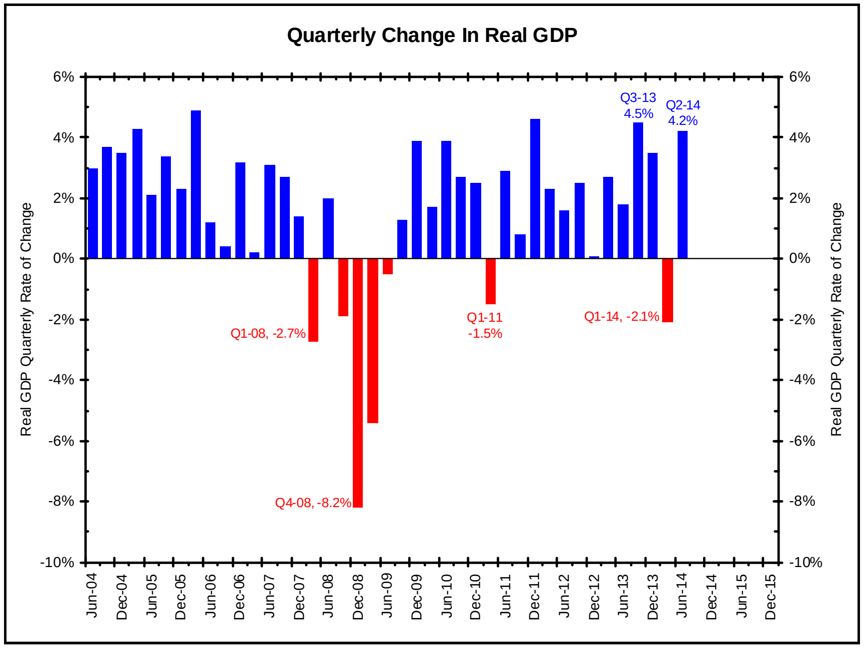
Then something happened during the Great Recession of 2007 to 2009. As the lower chart to the right shows (same as above, shorter time frame), the economy slumped badly through 2009, opening up an output gap between real and potential GDP. Normally economists would have expected a sharp rebound following the recession to bring real GDP (red line) back to its long-term potential (blue). This is one of the assumptions behind the now annual prediction that the economy will reach "escape velocity." But, as the output gap persists, this is not happening and the economy remains below its perceived potential.

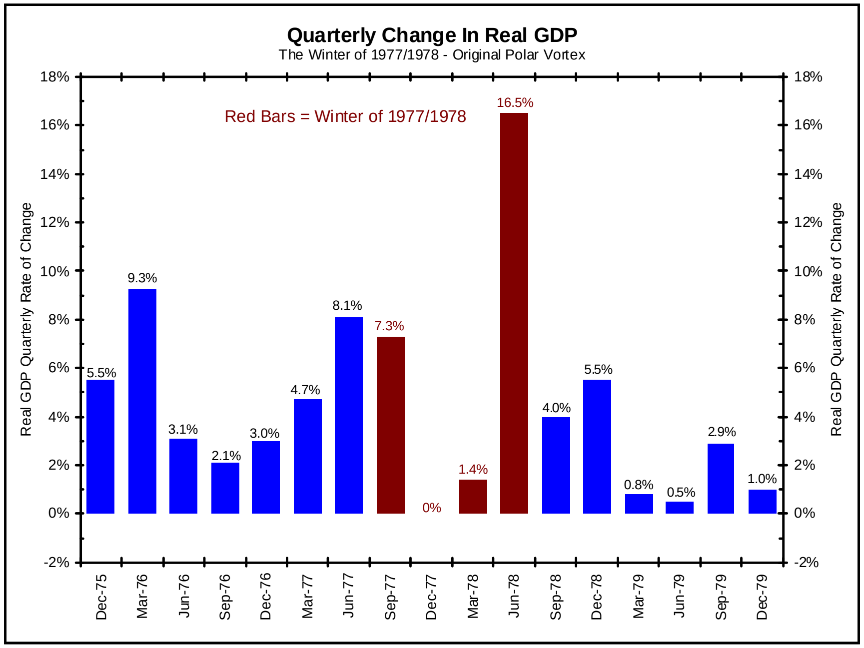
This has led economists to question if this GDP gap is temporary (cyclical) in which case real GDP may follow closer to the green dashed line and close the gap or if the gap is permanent (secular) and real GDP will follow closer to the black dashed line and keep the gap open. For the record, we have argued (here and here) this gap is temporary or cyclical as its primary cause is heavy central bank and government intervention into markets. This has depressed risk taking as asset prices are perceived as temporary. Should central banks/governments exit markets, risk taking would return and this gap would close.





Quarterly GDP



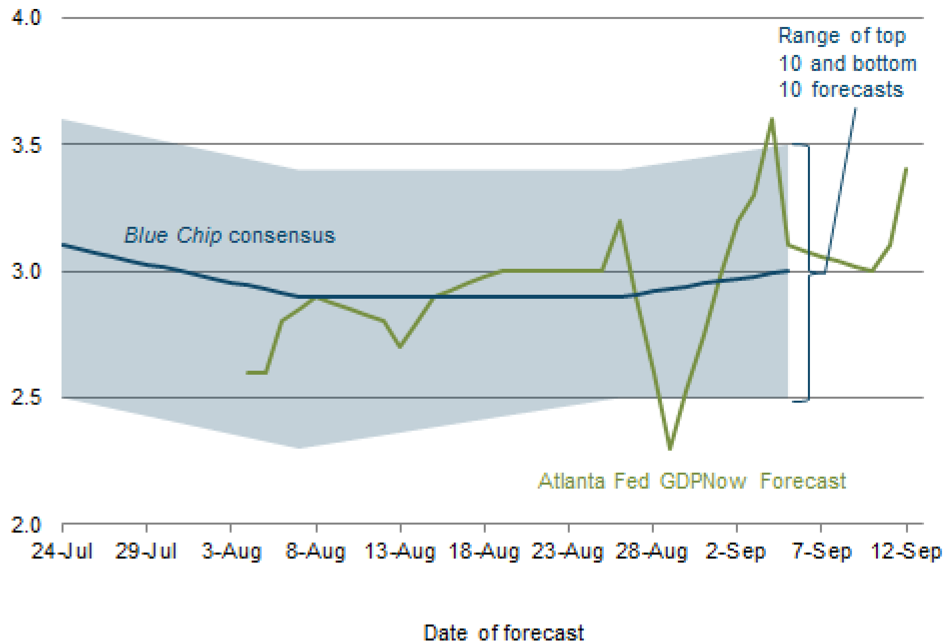


Q3 GDP Tracking

Latest forecast

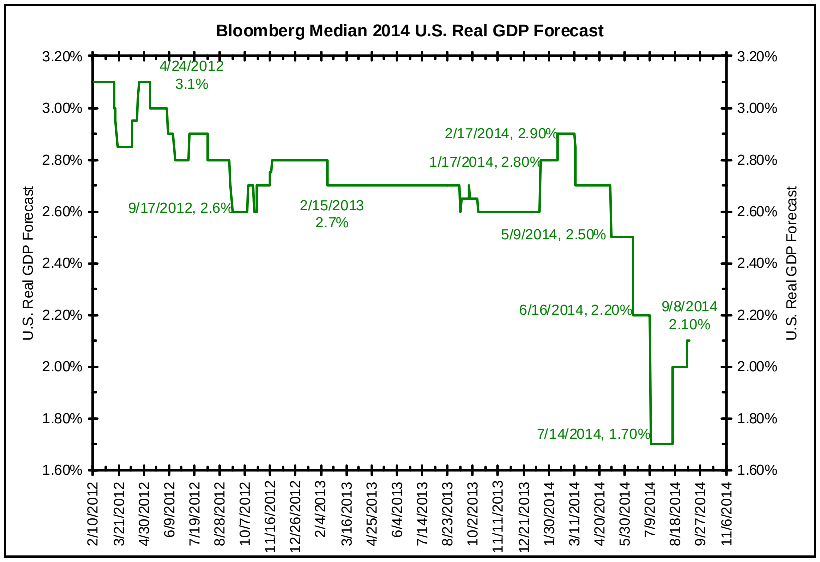
The GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the third quarter of 2014 was 3.4 percent on September 12, down from 3.6 percent on September 4. On September 5, the nowcast for real GDP growth fell from 3.6 percent to 3.1 percent following the employment situation release from the U.S. Bureau of Labor Statistics. The GDP growth nowcast increased from 3.1 percent to 3.4 percent and the nowcast for real consumer spending growth increased from 1.3 percent to 1.8 percent following this morning's retail sales release from the U.S. Census Bureau.

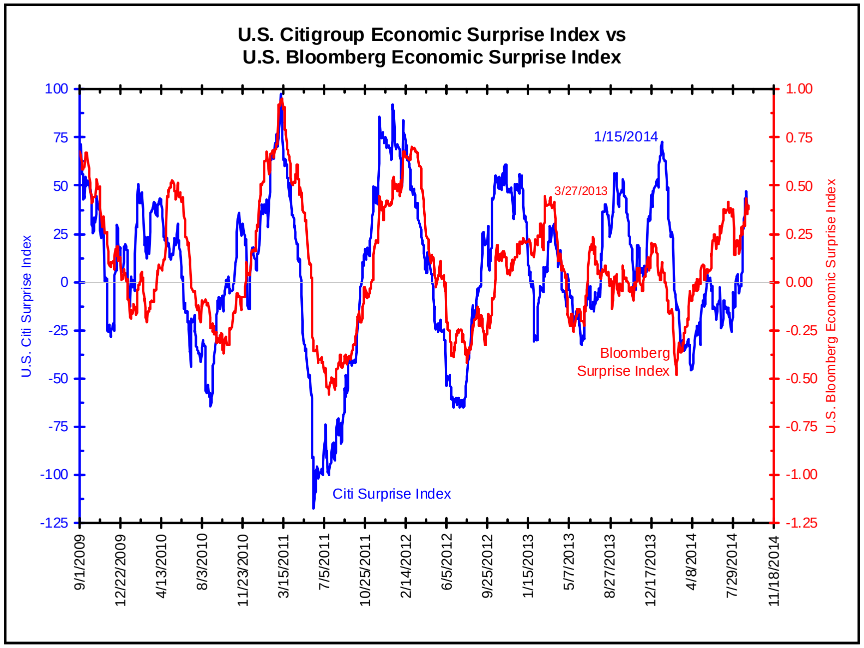
Evolution of Atlanta Fed GDPNow real GDP forecast for 2014:Q3
Quarterly percent change (SAAR)



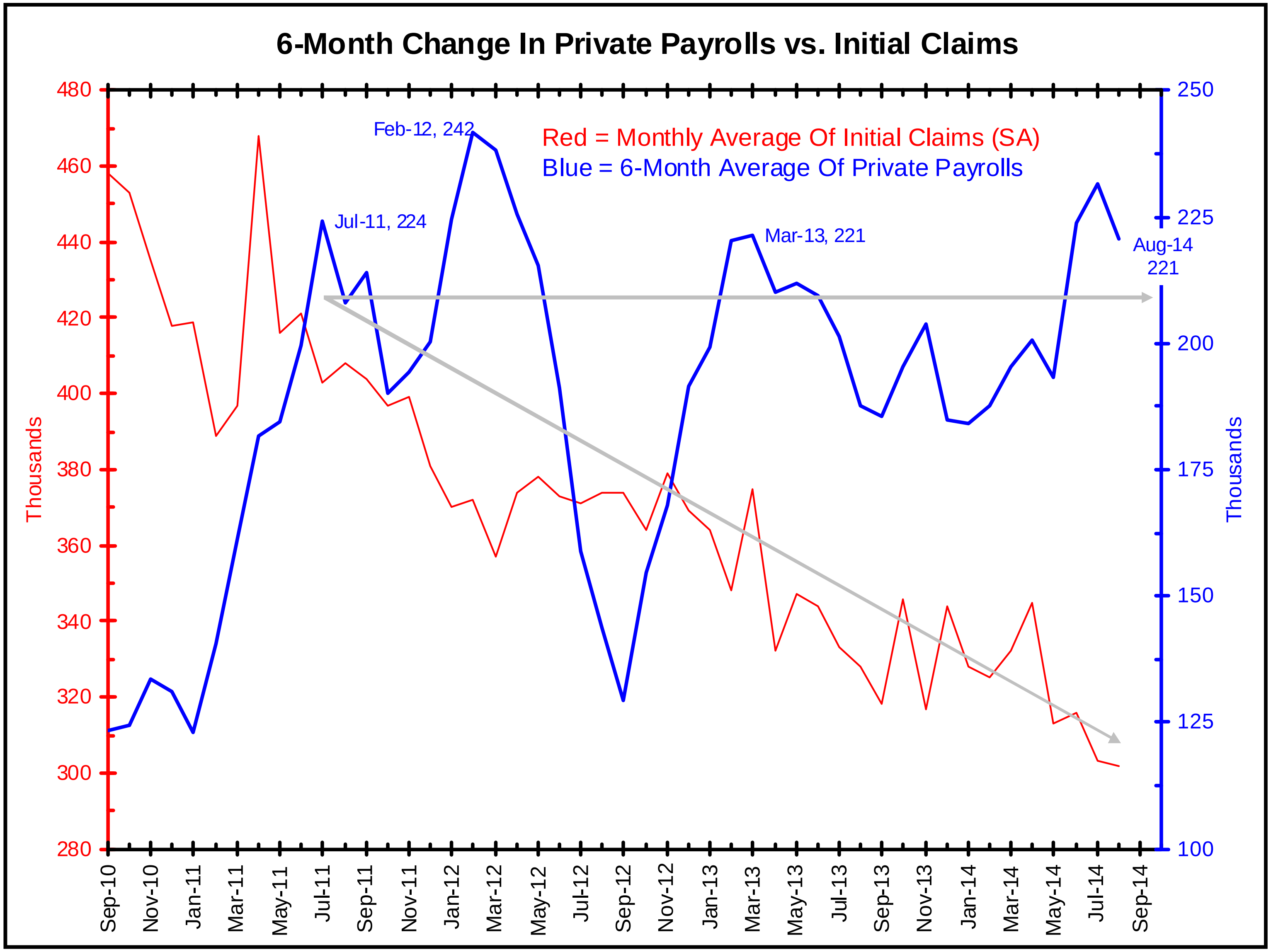
Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

Economic Outlook For 2014

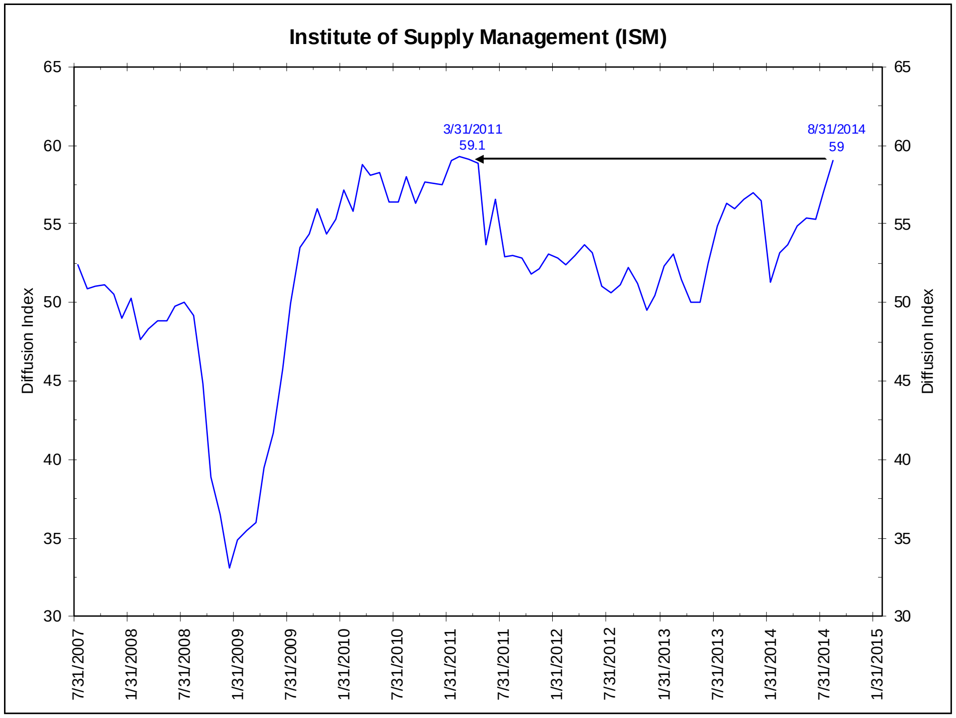


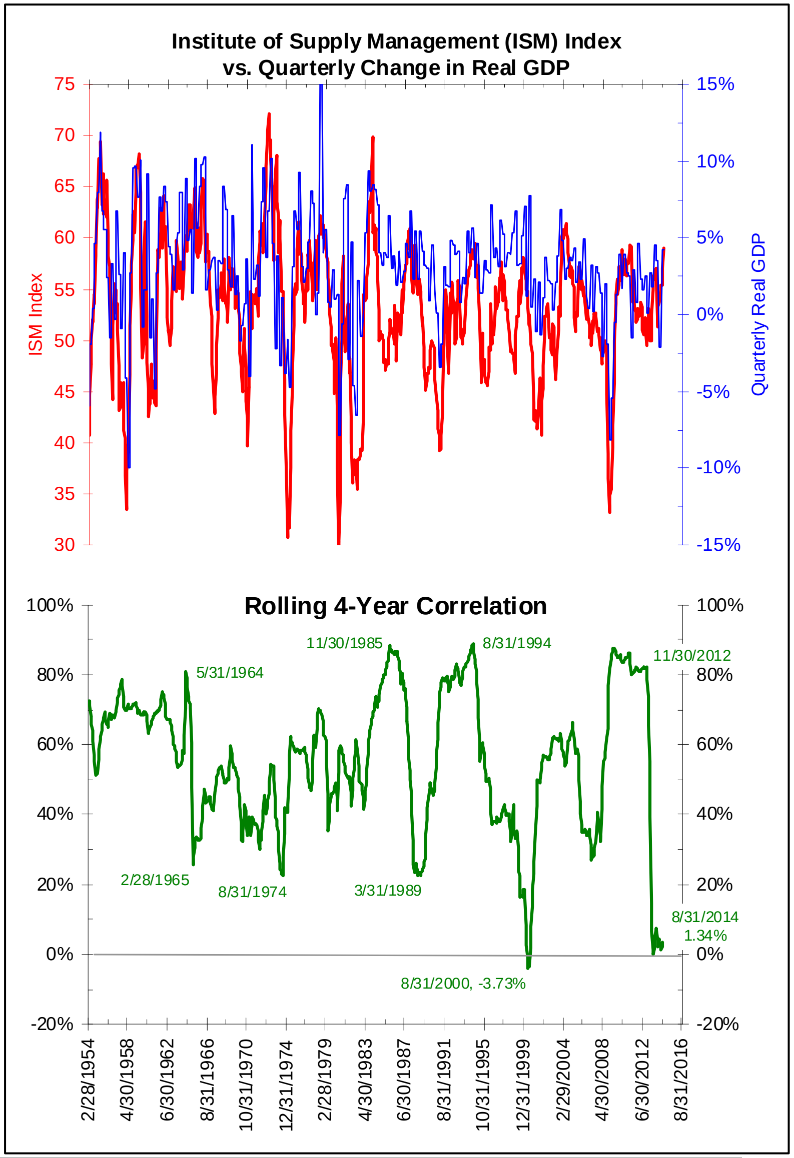


Claims vs. Jobs

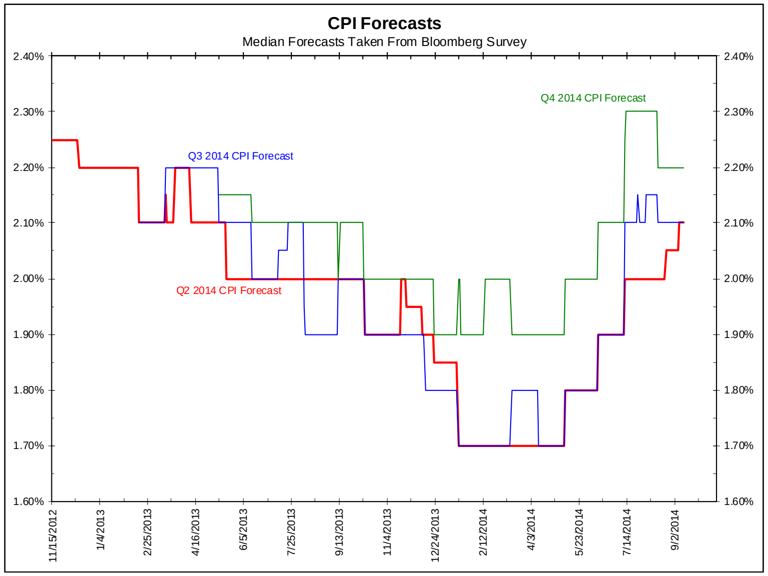


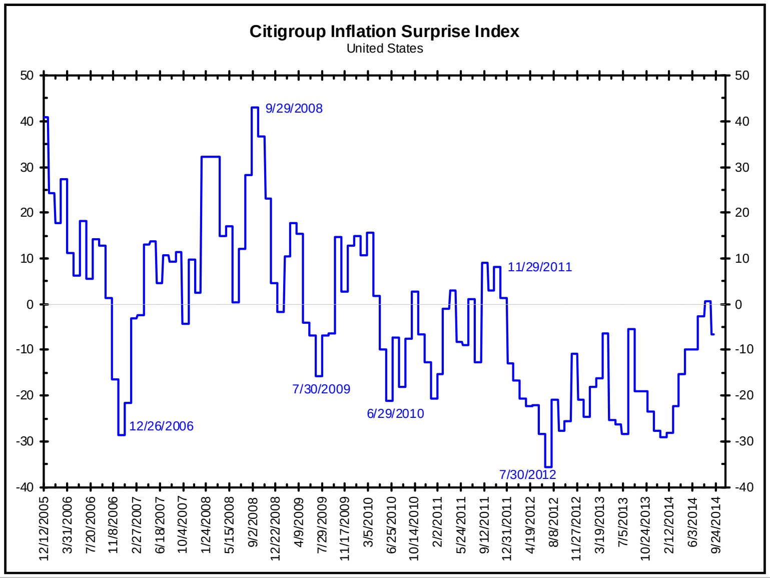
Does The Purchasing Managers' Report Still "Work?"

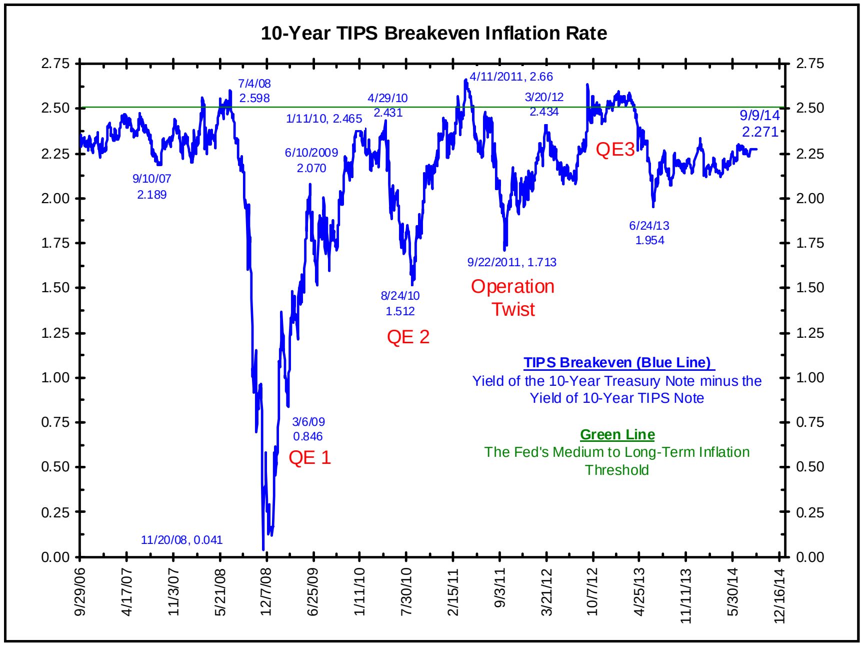




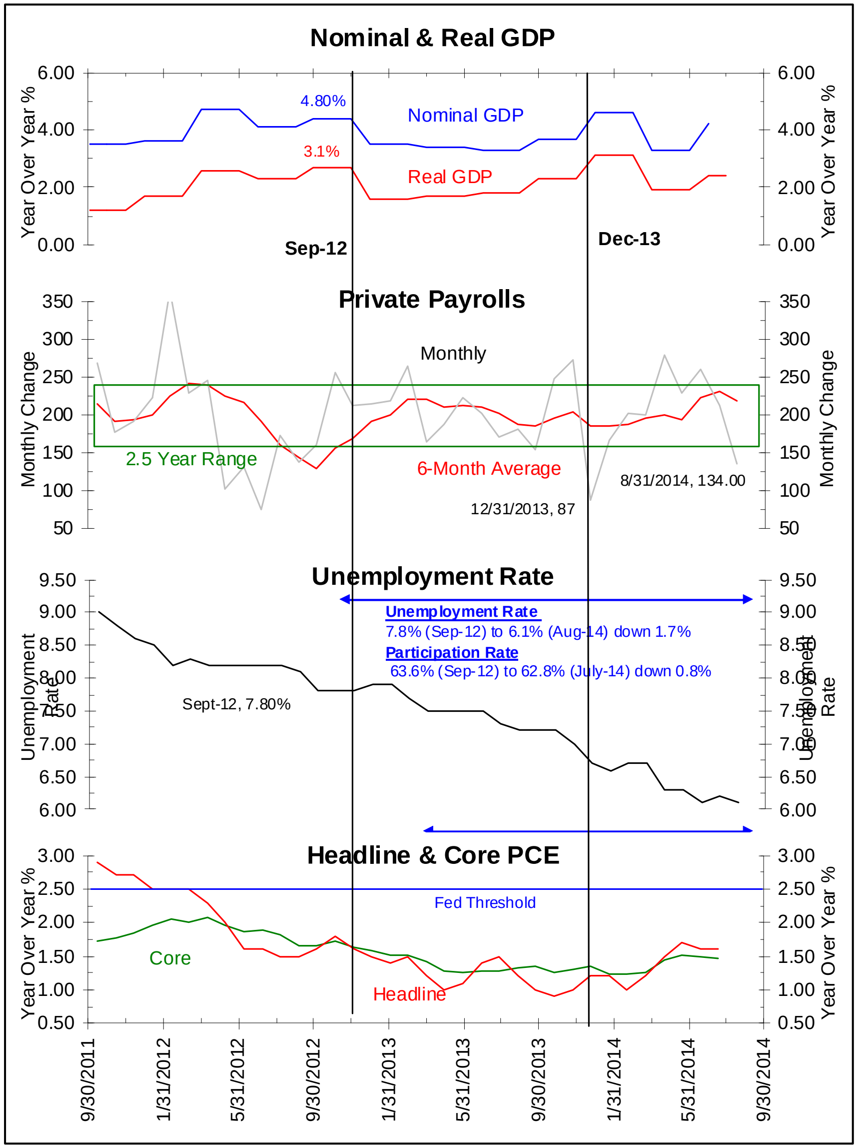
Inflation Expectations Are Rising



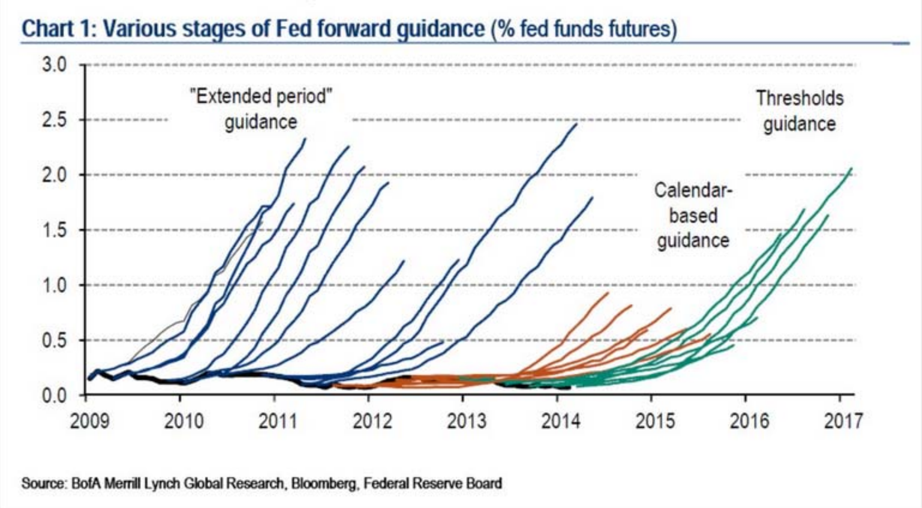


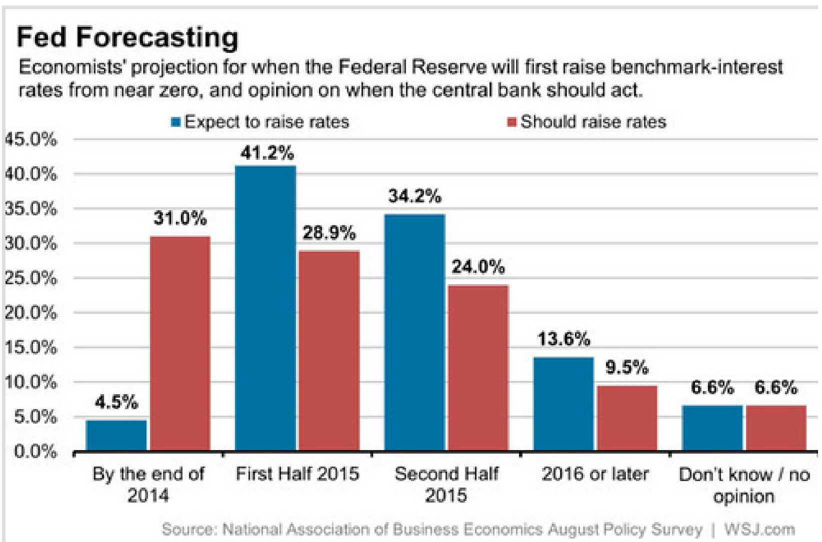


Why Did The Fed Taper?



End Of Forward Guidance And On To The "It Depends" Era





The Wall Street Journal* – *Jon Hilsenrath: Fed Frets About Market Rate Expectations

A San Francisco Fed study on market expectations for short-term interest rates is notable because it underscores a concern that has become prevalent among many Federal Reserve officials: … There are two explanations for this disconnect. The first is that investors expect a weaker economy and lower inflation than Fed officials expect. Thus they might be betting the Fed won't follow through on its own rate projections because the economy won't justify rates at higher levels in the next two years. The alternative explanation is that investors are complacent about Fed rate increases. Fed officials see the job market improving and inflation returning to normal, but investors don't think the central bank will respond to it. Fed officials worry about this explanation, because if they do follow through on these rate plans, the market could get caught off guard.

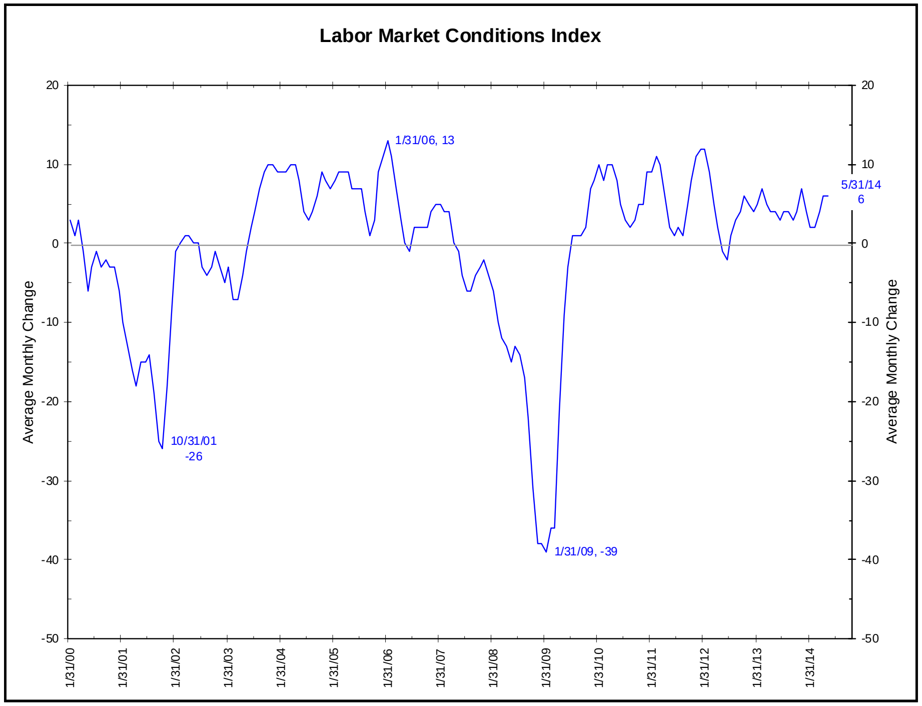
Comment

Despite some talk of raising rates sooner than anticipated, the markets know by now to ignore this type of conjecture. In each of the instances below the Fed said one thing only to act in another manner when push came to shove:

- As QE1 came to a close, they claimed there would be no more QE
- As QE2 came to a close, they claimed there would be no more QE
- They claimed Operation Twist would end on September 30, 2012 only to extend it
- Calendar guidance was offered and abandoned
- Forward guidance was offered and largely abandoned
- Economic thresholds (6.5% unemployment and 2% inflation) were offered as guideposts and largely abandoned

In each of these instances the market correctly ignored the Fed and priced in a more accommodating policy. Why should this episode of "The Boy Who Cried Wolf" be any different?

Why The Fed Will Never Raise Rates!



Bloomberg.com – Yellen's Dials Defy Truman Plea for One-Handed Economist

Janet Yellen is adding more dials to her labor-market dashboard, and that's making it harder for investors to tell where she will be steering monetary policy as Federal Reserve chair. …, Yellen also cited a gauge from the Kansas City Fed that distills 24 numbers and depicts an improving job market. Jacobsen counts himself among fans of the Fed Board's labor-market conditions index. He said he agrees that the main jobless rate "isn't a perfect indicator" as it can mask problems, such as high involuntary part-time employment, that signal broader weakness. … Measuring how much slack is left in the labor market is growing more difficult as the jobless rate falls, Yellen said in her speech last month..

Comment

The Fed first first unveiled the Labor Market Conditions Index (LMCI) in a May 2014 blog post. They also referenced it back in July.

As a new indicator to assess the labor market, the LMCI is an interesting idea. However, the Fed has adopted this as a major part of its dashboard and touted it as a more comprehensive measure than the unemployment rate. Conveniently the LMCI indicates the labor market is much weaker than does the unemployment rate.

This smacks of starting with a conclusion and searching for data to support it. When Bernanke first started noting 6.5% unemployment as his threshold, just 18 months ago, the Fed was thinking that rate would be reached around 2016. When the falling participation rate forced the unemployment rate to this level much sooner than anticipated, the Fed abandoned the unemployment rate and invented a new series out of thin air to support their timeline for raising rates further in the future.

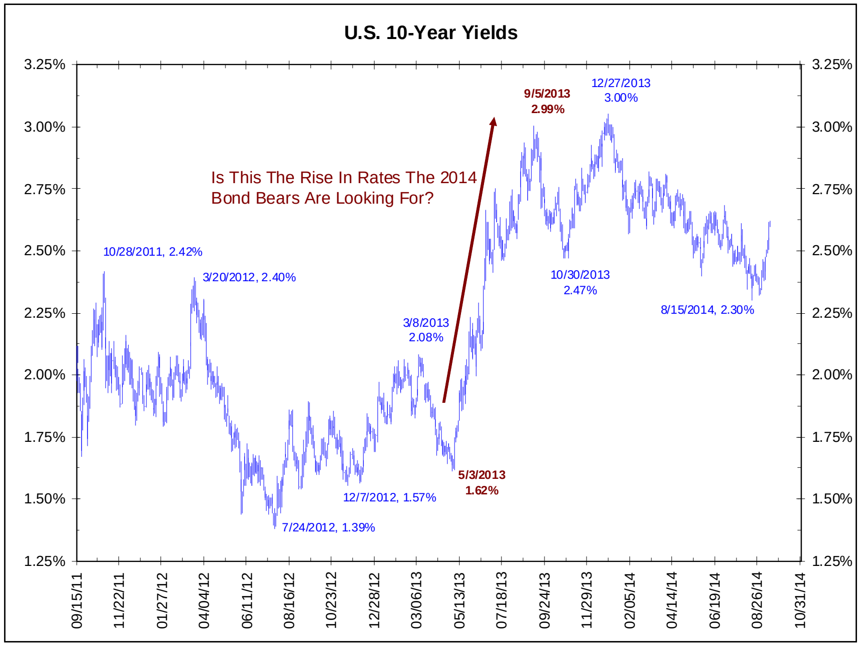
We believe the Fed is going to drag their feet on hiking rates a lot longer than everyone thinks. As they did with the LMCI, the Fed will invent data to justify their stance if necessary.

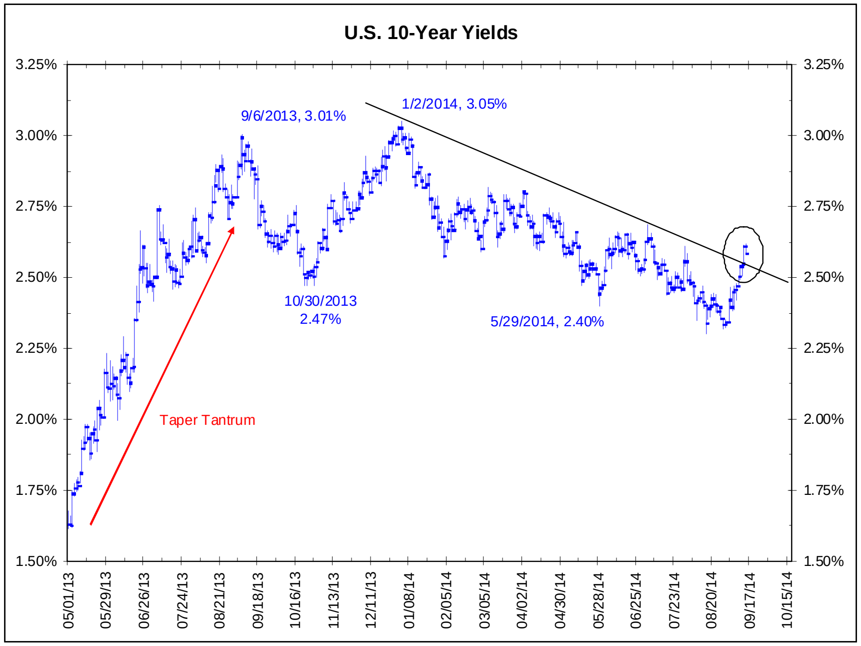
The Fed And The Markets

Propublica - Jesse Eisinger: The Fed Hates To Burst Your Bubble

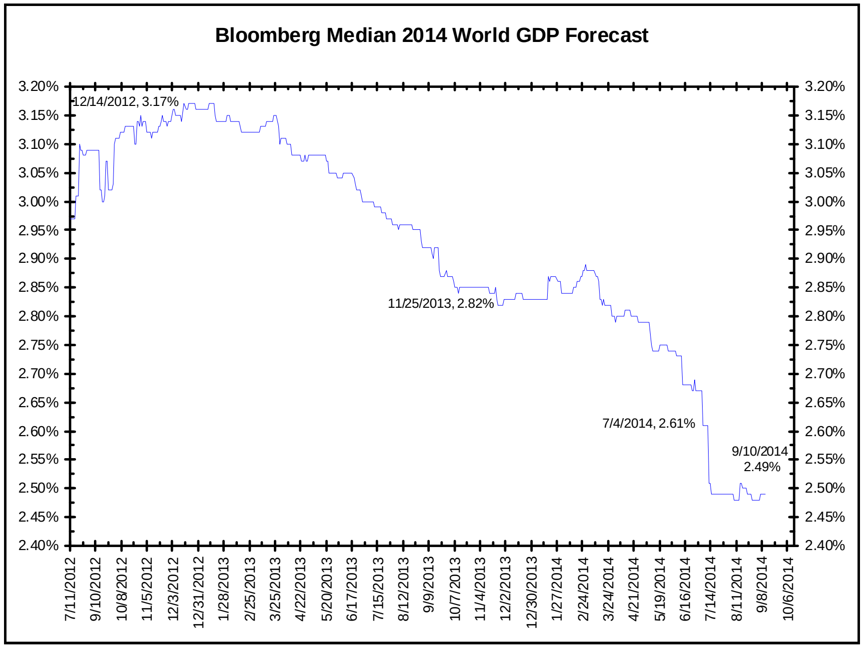
Is the Fed cautiousness an effort to protect the investing class? Mr. Stein says no. "It's not because the F.O.M.C. cares about people in the market and is trying to backstop them," he said, referring to theFederal Open Market Committee. "It's because they care about their mandate," which is to help the labor markets and preserve price stability. Sudden market movements tighten credit, which hurts the economy. A solution, in Mr. Stein's words, is that "over the longer run, it might be helpful to try to build some institutional resolve and reputational capital around the proposition that policy should not be overly reactive to asset-price declines." Translation: The Fed needs to set a tightening course it cannot deviate from even if markets freak out. Unfortunately, the Fed has made it pretty clear over the past few decadesthat it lacks the nerve to do this. More recently, this long bull market has been one of the smoothest and steadiest in history. The Fed has reinforced investor complacency and recklessness. The lack of volatility creates a volatile mix. If there's a price to be paid, and many think there will be, it will be borne less by the wealthy than by the rest of us.

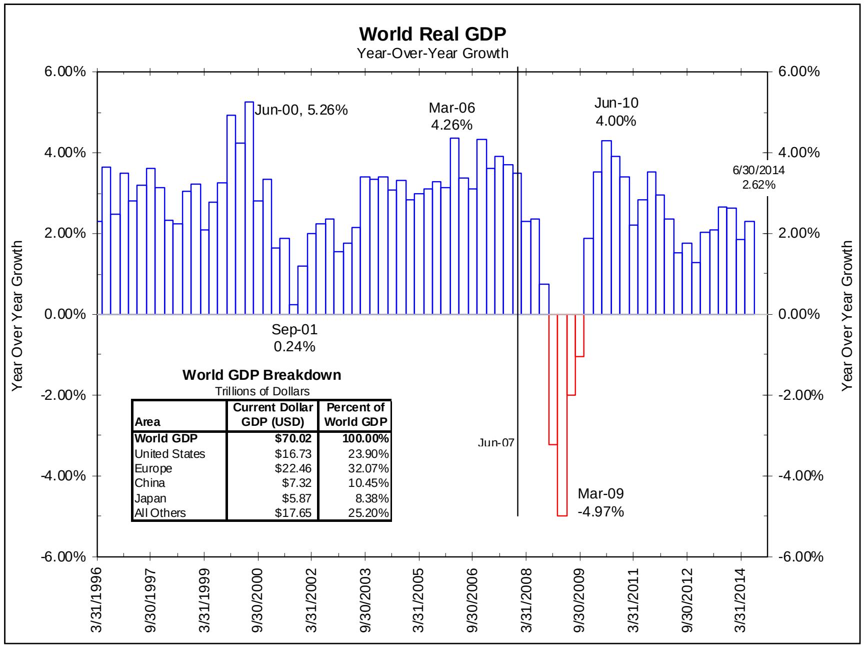
Are They Forecasting Last Year's Rally?





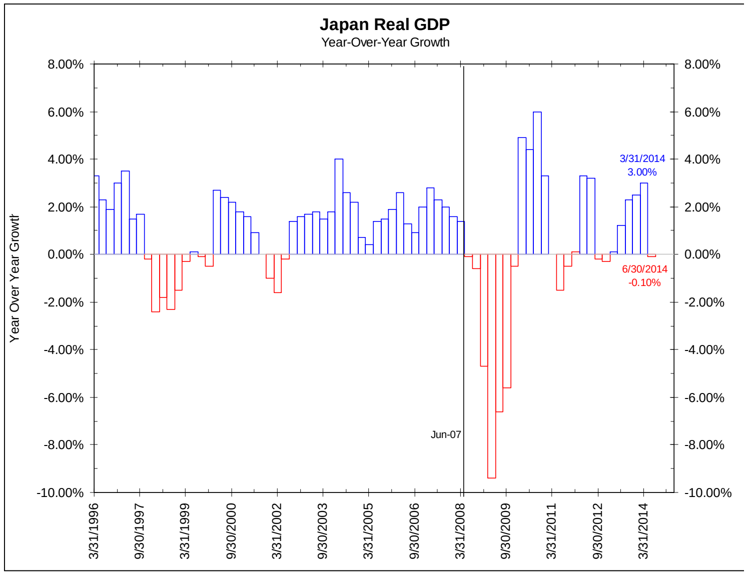
World Growth Slowing

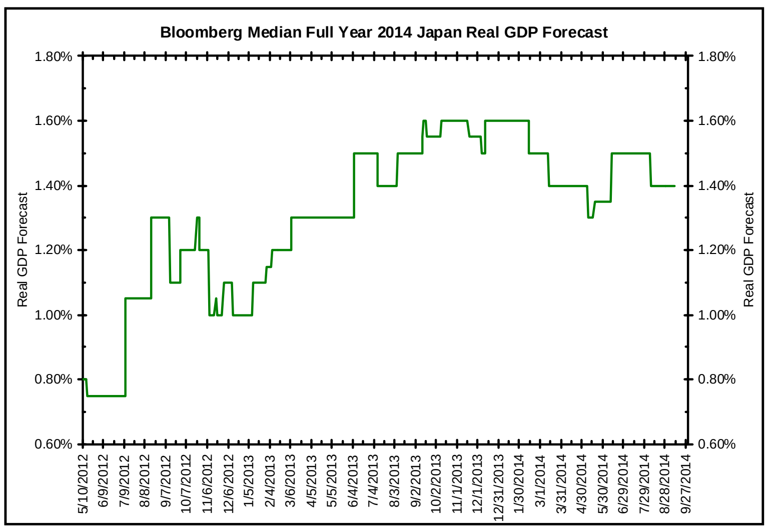


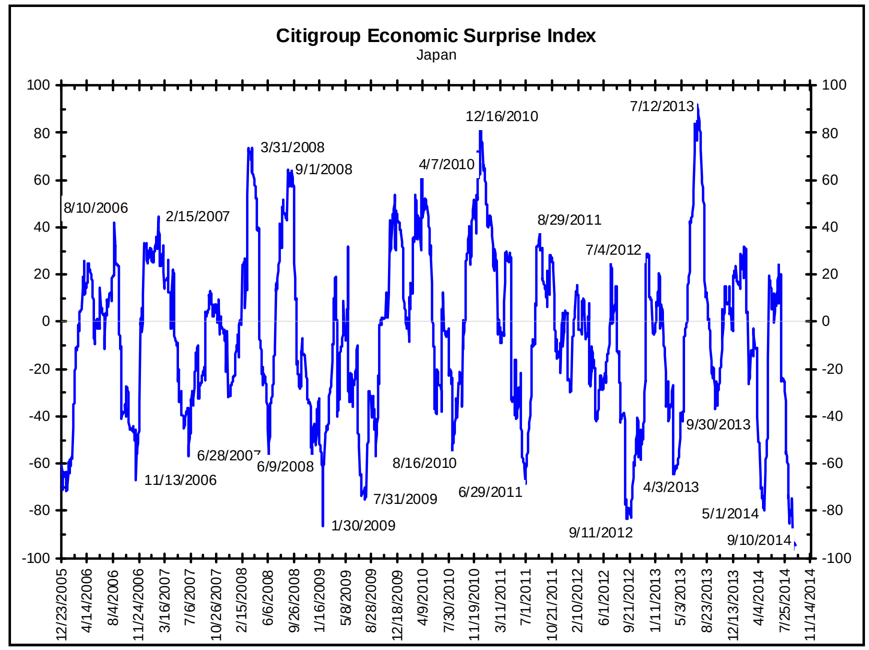


Area	Current Dollar GDP (USD)	Percent of World GDP
World GDP	**$70.02**	**100.00%**
United States	$16.73	23.90%
Europe	$22.46	32.07%
China	$7.32	10.45%
Japan	$5.87	8.38%
All Others	$17.65	25.20%

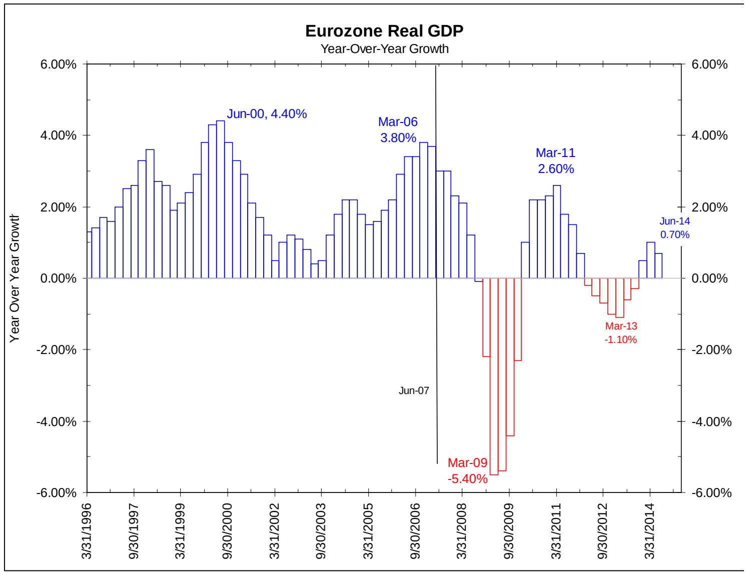
Japan’s Economic Outlook

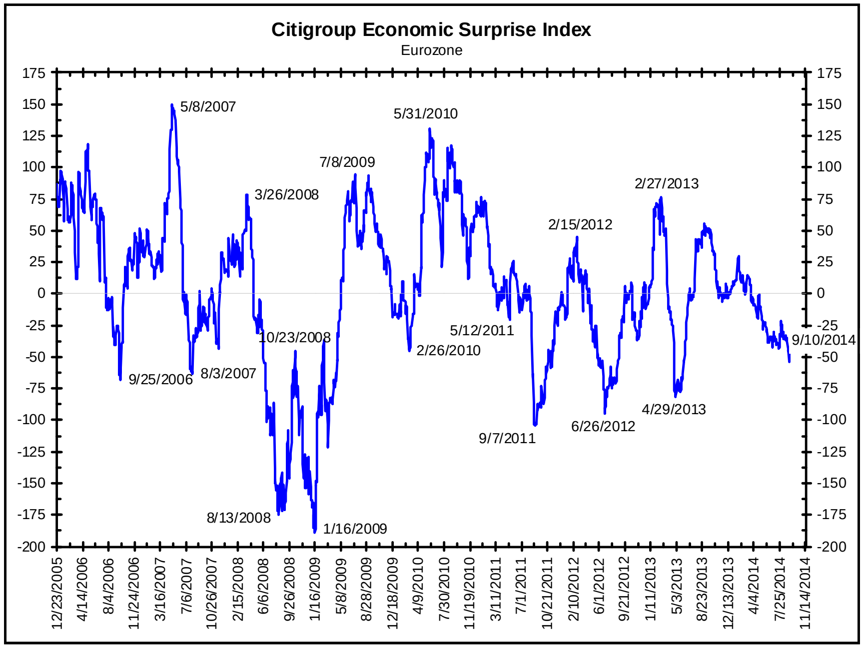


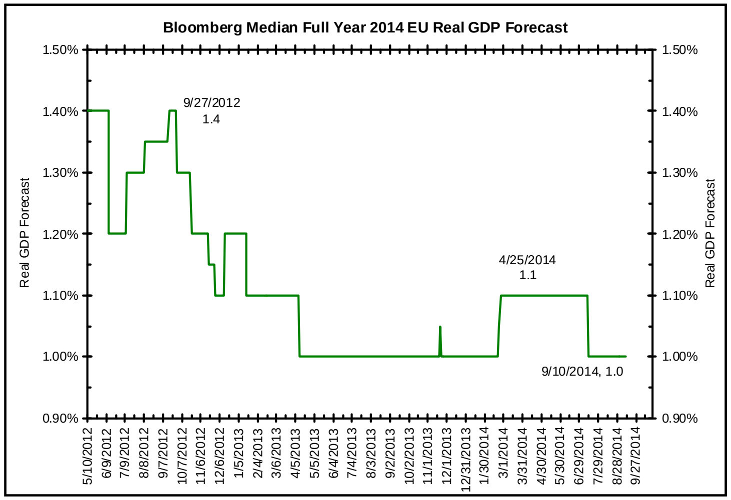




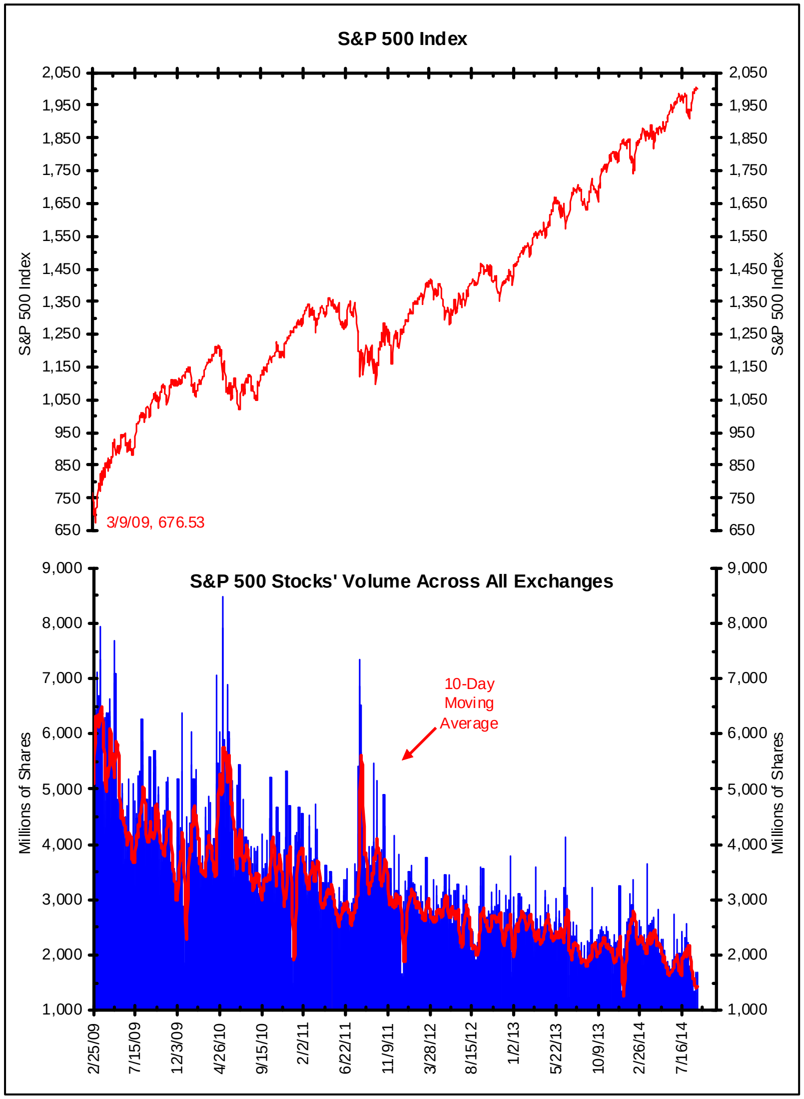
Europe's Economic Outlook

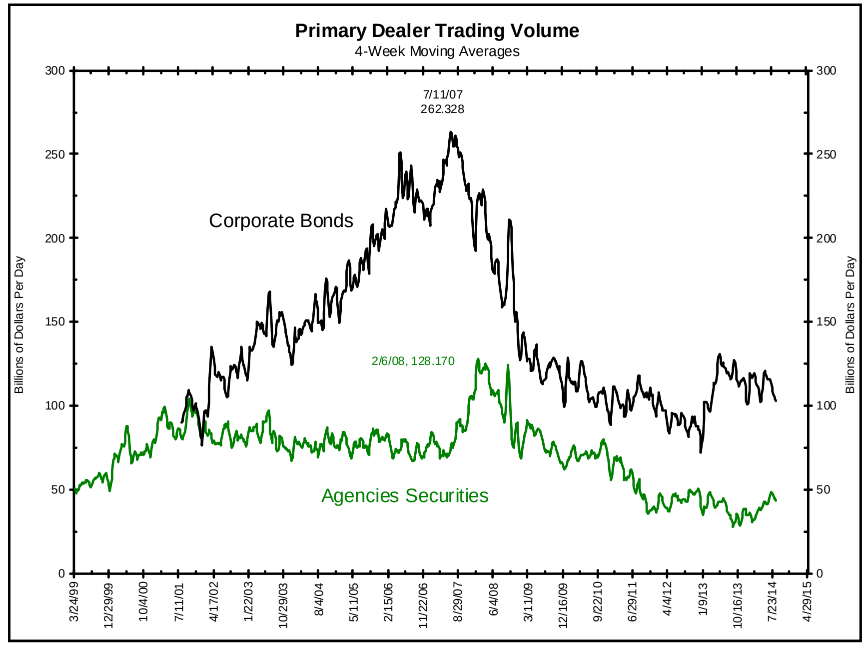




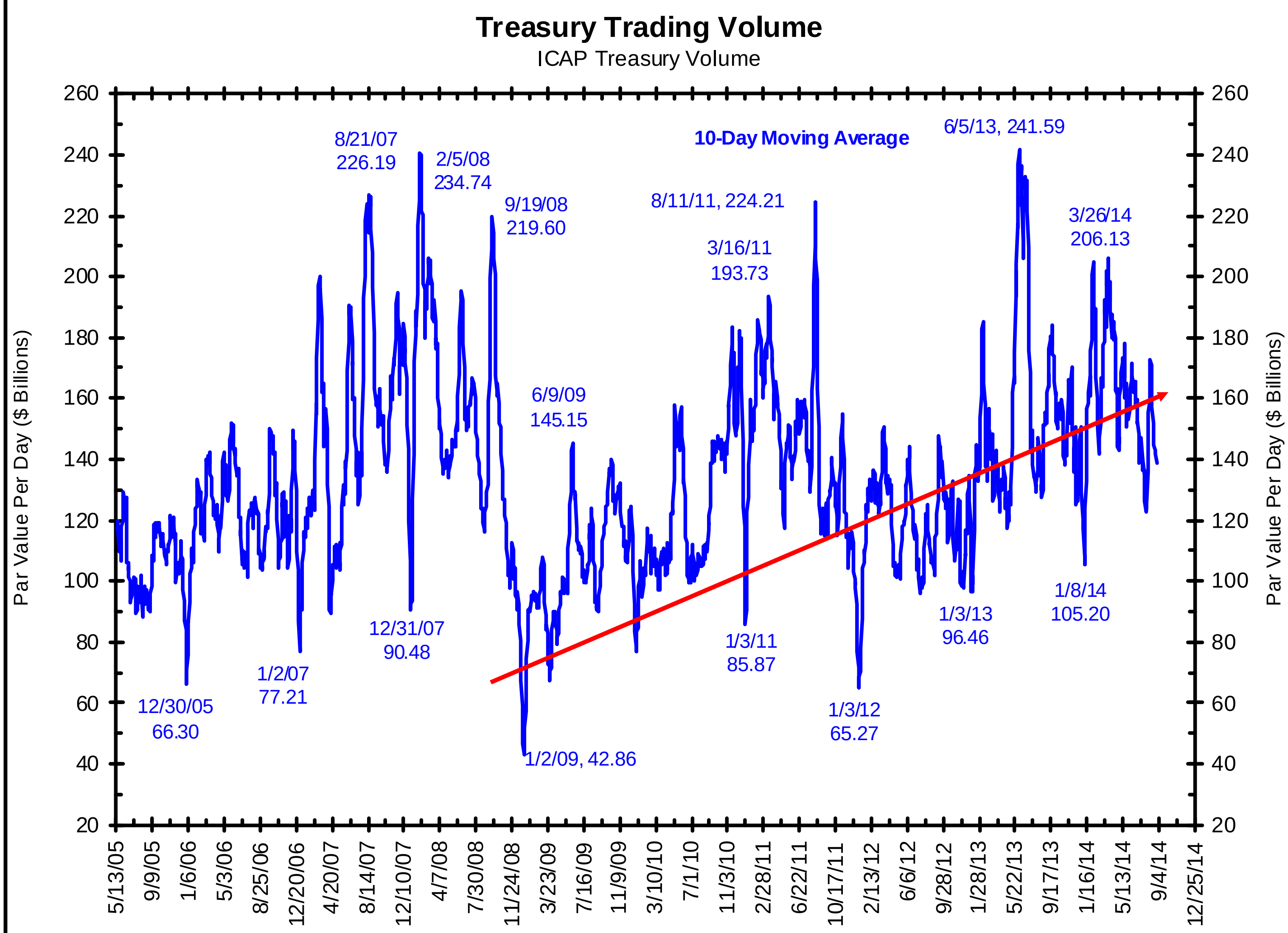


Poor Liquidity





Treasury Market Liquidity



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