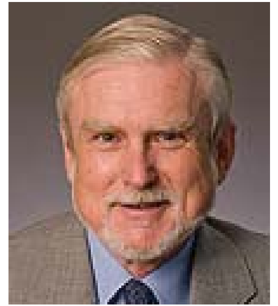
ECONOMIC UPDATE:

Inflection Point to Faster Growth



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Economic forecasts for 2014 are being marked down just as the pace of global and U.S. economic growth is at a positive inflection point to faster growth, in our opinion. Estimates of 2014 global growth are being lowered somewhat to a third year of global real GDP growth near 3% (IMF measure). Due to the decline in first-quarter 2014 real GDP, estimates of U.S. real GDP growth are being lowered to close to 2% for 2014. The downward forecast revisions for 2014 reflect the mark-to-market of economic weakness which already occurred in the early months of this year. We believe that these mark-to-market economic revisions are occurring just as both global growth and U.S. growth are at an inflection point to a somewhat faster pace of growth than has prevailed over the last several years. It is crucial to distinguish between the mark-to-market of what has already occurred and the prospects for growth over the next four to eight quarters, which should run at 3.5% to 4% for the global economy and close to 3% for the U.S. economy, in our opinion.

Our expectation for the European economy has been for a moderate but sustained economic expansion over the next several years. Faced with low current inflation and declining inflation expectations, the ECB adopted a variety of easing moves. We regard the combination of these moves as a successful defensive policy which substantially lowered the risk of a confidence collapse in Europe. It should foster both moderate expansion and a gradual bottoming of inflation in Europe. We continue to expect European economic growth in the 1% to 1.5% range in 2014.

Early indications are that the large value-added tax increase in Japan did not break down confidence in the Japanese economy, with the Economy Watch Survey rising in both April and May 2014. While the Bank of Japan might adopt an additional easing in the fall of 2014 if required, it is now plausible that it may be patient as Abenomics unfolds and stand pat on monetary policy.

While China's economy has decelerated and the property sector is weakening, an orderly deceleration of trend growth rather than a major financial crisis and hard landing remains the most likely case. We expect that weak construction in China is likely to mute commodity inflation even as the pace of global expansion improves. As a result, the cyclical rise in industrial country inflation is likely to be gradual, permitting developed country monetary policy to retain a stimulative stance.

In the U.S., both the fiscal drag and the deleveraging drag are fading, although much of the drag from growth-hostile regulation persists. Recent evidence of an acceleration in economic growth includes (1) four months of strong payroll gains, (2) a strong improvement in job openings in the JOLTS (Job Openings and Labor Turnover Survey) data, with the ratio of job seekers to job openings improving to the best level since June 2008, (3) high manufacturing ISM, (4) high non-manufacturing ISM, (5) high auto sales, (6) rising readings on small business and other private sector business surveys, (7) an acceleration in business credit growth, (8) a rebound in housing starts, and (9) a continued rise in U.S. household net worth to all-time highs. This strengthening of U.S. economic indicators has occurred after U.S. real GDP was roughly flat in the half-year period of the last quarter of 2013 and the first quarter of 2014, including an absolute decline in the first quarter.

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While we expect an even deeper decline in real GDP for the first quarter of 2014 when the estimate is revised, the quarterly declines in residential construction, capital spending, exports, defense spending and inventory accumulation are likely to prove temporary.

Federal Reserve policy remains stimulative, which is likely to contribute to some shift higher in both real growth and inflation. We believe that U.S. real growth is at an inflection point from real growth averaging close to 2% over the past five years to real growth averaging about 3% over the next several years. We also believe that most major measures of inflation are bottoming, but in a shallow, saucer-shaped bottom rather than a sharp acceleration. With both real growth and inflation shifting higher, we expect that the result will be an acceleration of nominal GDP growth towards 5%. We believe that a near-zero Federal funds rate in an economy we expect to record a nominal GDP growth rate of 5% with accelerating growth and an upward drift in inflation will represent aggressively easy monetary policy. That is especially true since there are finally growing signs of an acceleration of credit growth.

We believe that both consumer price inflation and wage inflation are bottoming and should drift higher over the next several years. There is still excess labor supply among the long-term unemployed, younger job-seekers and the underemployed, including those who are working fewer hours than desired. However, we agree with the view that the short-term unemployment rate, which has normalized, is a more relevant indicator for future wage inflation. Wage inflation has started to rise for production and supervisory workers, job openings are rising and the surveys of the NFIB (National Federation of Independent Business) of compensation expectations have been moving up.

We expect U.S. monetary policy to remain easy, since the core of the Federal Reserve appears to have a dovish perspective on a variety of issues: (1) the state of the labor market, (2) the risk of future inflation, (3) potential tolerance of a period of core inflation above 2%, (4) the risk of asset bubbles and the Fed's role in preventing them, and (5) the prospect of a terminal Fed funds rate below historic norms. The result should be a prolonged eight-year economic expansion (2009 to 2017), with a gradual rise in the Fed funds rate in late 2015 and 2016 followed by a more aggressive monetary tightening in 2017 or 2018 after the 2016 Presidential election. In the meantime, monetary policy supports a prolonged economic expansion.

When the U.S. unemployment rate dropped through the Fed's old economic threshold of 6.5%, rather than guiding to an earlier start to interest rate hikes, there was an easing of Fed balance sheet guidance, in our interpretation. This occurred in the May 20, 2014 speech by William C. Dudley, President of the Federal Reserve Bank of New York. Because he is at the core of Fed decision-making, we interpret it as modifying the Fed's guidance on its balance sheet, although it is not yet an official Fed decision. He argued that the Fed should not halt the reinvestment of maturing bonds in its portfolio prior to the first hike in the Fed funds rate. The result would be an even greater artificial scarcity of Treasury bonds available to the free market than would have otherwise occurred. We also interpret this as a signal that the Fed is unlikely to significantly reduce its large bond portfolio any time soon.

There are three distinct explanations for the decline in bond yields which occurred in the early months of 2014: (1) anticipation of substantial economic weakness, (2) anticipation of easier monetary policy and (3) supply/demand dynamics. We do not concur with the interpretation that the bond market was discounting major future economic weakness, as other markets (including the stock market) were not consistent with that interpretation. Under conditions of managed Treasury bond scarcity, we regard Treasury prices and yields as "unreliable guides" as economic indicators and market benchmarks. In the case of Europe, we believe that anticipation of easier monetary policy from the ECB was a major factor in the decline in European interest rates. Overall, however, we lean towards the view that a bout of short covering under conditions of a tightening supply/demand balance for high-grade long duration bonds was a major explanation. Quantitative easing was designed to create a scarcity of sovereign bonds and drive their yields below free-market levels. We believe that the expanded central bank balance sheets are likely to be retained for many years, rather than quickly sold back to the free markets. With budget deficits improving and a substantial portion of safe sovereign assets diverted to central bank balance sheets, reserve holdings and corporate liability-driven investment, the scarcity is likely to ease only gradually. However, cyclical forces are likely to drive first the Bank of England and then the Fed to begin hikes in policy rates over the next several years, even as policy rates are locked down in Europe and Japan. As a result, we expect the resumption of a cyclical and secular uptrend in bond yields in most industrial countries, led by Treasuries and gilts.

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