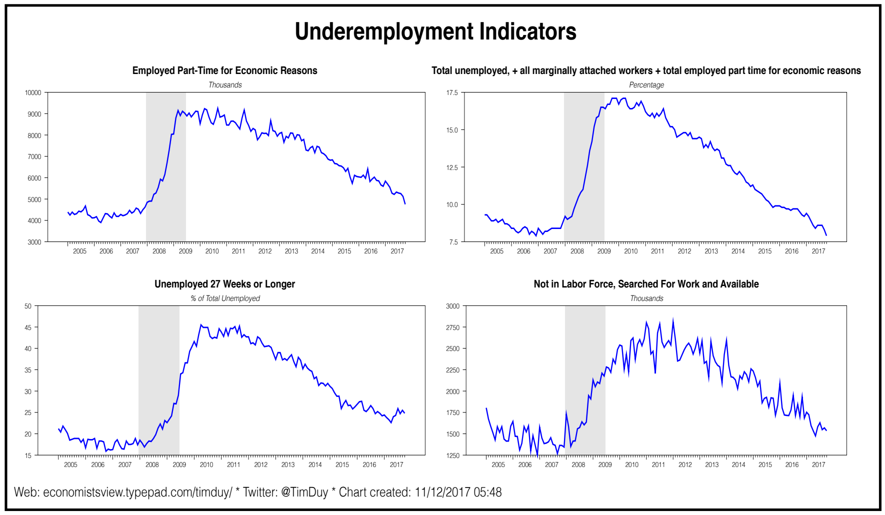
Tim Duy's Fed Watch

NOVEMBER 13, 2017

Taking Stock



At some point every year I sense a need to reset and clarify my baseline views on the economy and monetary policy. This is that time.

The US economy clearly gathered some steam this past year. This was not unexpected. The first quarter data came in on the weak side, but this was widely attributed to a failure to fully adjust the data for seasonal factors (there is debate on this issue). Hence, the first quarter did not reflect the underlying trend of the economy and data would rebound.

The seasonal adjustment issues were likely relevant, but more important was the revival of business investment spending, which had dropped in the wake of the oil price crash of 2015, and stronger global growth. The impact of these factors was particularly evident in the manufacturing data, with stronger industrial production, capital goods orders, and survey data from the Institute of Supply Management.

The rebound of activity pulled the economy up to an underlying rate of growth that exceeds the Federal Reserve's estimate of potential output (FOMC participants median estimate of longer-run growth is currently 1.8%). Compared to a year ago, output gained 2.3% while real final sales, which exclude inventories, gained 2.2%.

In my view, the potential for supply side constraints and, perhaps, easing of those constraints will shape patterns of economic activity in 2018. The Federal Reserve believes the economy currently operates close to if not a little beyond full employment. The unemployment rate fell to 4.1% in October, well below the Fed's longer run estimate and the 4.4% low of the last cycle. And note the broader U-6 unemployment rate, which includes measures of underemployment, fell to 7.9%, the low of the last cycle.

By these metrics, conditions are fast approaching those the late-90's. I believe the economy will sustain enough momentum to hit that point within the next six months. Job growth continues at a pace that exceeds labor force growth, while low initial unemployment claims and gains in temporary help employment suggest that pace is not likely to diminish in the near future. This would also be consistent with an economy growing faster than the growth of potential output.

We do not have much experience with an economy operating near full employment. This sounds odd, but generally the Fed kills the economy soon after reaching that point. Moreover, we do not have much recent experience with a full employment, low inflation economy. The tops of the last two cycles were fairly shot-lived. Beyond that, I think you need to look at the late-60's for a similar dynamic.

The unemployment rate fell below 4% in February 1966, and stayed below 4% for four years. It fell as low as 3.4%.

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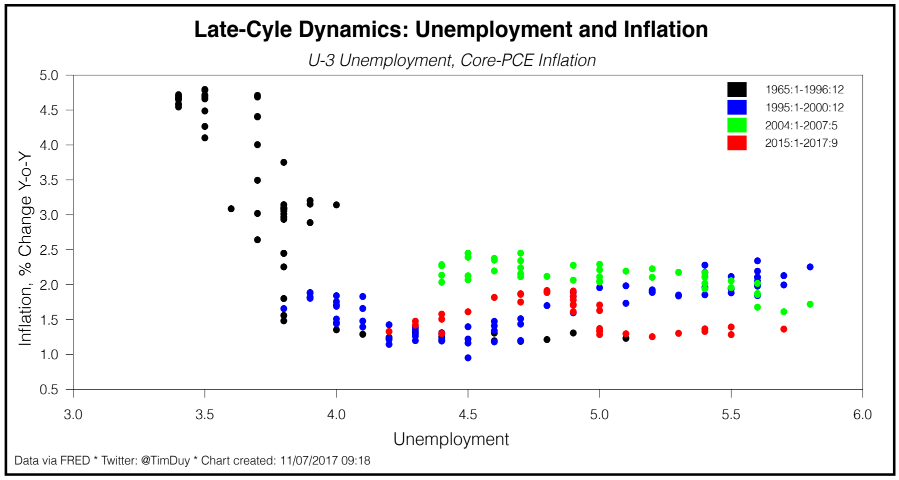
During that time, inflation accelerated from 1.5% to 4.8%. Supply-side constraints bit hard, and thus began the great inflation of the 1970's.



Now, as is well known, inflation has not been a problem, at least since 1995. The Phillips curve is reported to be very flat, a dead fish floating on the surface of the lake of discarded economic theories. Thus it is said the Fed should dismiss any concerns that low unemployment will create excessive inflationary pressures.

But there has to be a limit to how far unemployment can fall. Eventually, a supply-side constraint will bite. But when? Former Federal Reserve Chair Alan Greenspan pondered this question in 2000:

> ***However one views the operational relevance of a Phillips curve or the associated NAIRU (the nonaccelerating inflation rate of unemployment)--and I am personally decidedly doubtful about it--there has to be a limit to how far the pool of available labor can be drawn down without pressing wage levels beyond productivity. The existence or nonexistence of an empirically identifiable NAIRU has no bearing on the existence of the venerable law of supply and demand.***

I am not convinced that the Phillips curve is dead. **I am convinced that the Fed has repeatedly killed expansions in recent years before inflationary pressures emerge.** In other words, the Fed has not allowed the economy to hold in a full employment situation for a length of time sufficient to allow inflation to become an issue.

At this point, I don't see any reason to believe that the Fed to deviate from this recent history. If the Fed believes the economy is hitting supply side constraints, and that the pace of growth is likely to further strain those constraints, the Fed will act to slow the pace of growth. This means tightening monetary policy.

Hence, I take the Fed at its word when policymakers tell us that rates are likely rising 75bp in 2018. But note that forecast is wrapped into a forecast in which growth decelerates as well. If growth does not decelerate, then Fed will be inclined to hike rates at a faster pace. At this point, I would have to say the risk is on the latter.

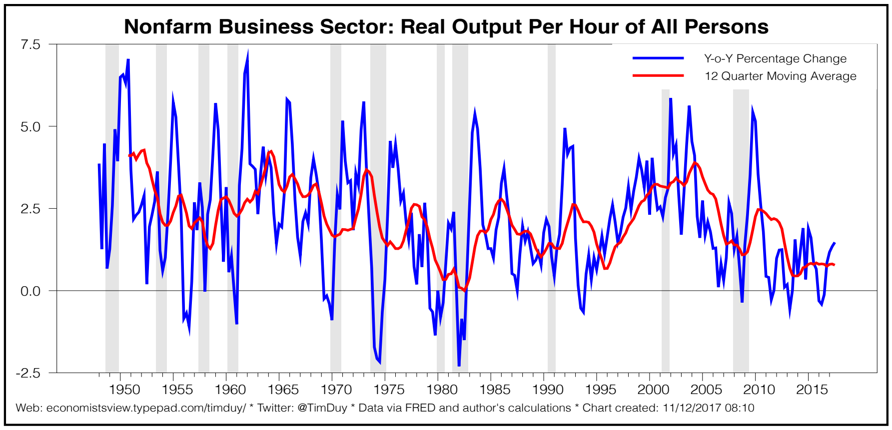
To sum at this point, if the economy is hitting supply side constraints, we should see a slowing pace of job growth due to labor shortfalls and, finally, greater upward pressure on wages and inflation. The perception of reaching those constraints will trigger a reaction on the part of the Fed, hence we are not likely to see a substantial acceleration in wage growth and inflation. The Fed will continue to suppress the Phillips curve.

The tricky part for the Fed will be managing the slowdown of activity. **Policymakers have had limited success at holding the economy near full employment for a sustained period of time.** The risk is that the Fed forgets about policy lags and believing that the economy is not slowing quickly enough, tightens too much. This sets the stage for recession in late 2019 or 2020. That would still leave this as a record-breaking expansion.

The above is essentially a baseline view for the next year. Reality and forecast often differ. Growth may be a little slower or faster than the Fed anticipates. They will adjust accordingly. I will not offer a litany of potential black swan events that generally fall under the umbrellas of "financial crisis" or "geopolitical risk." I don't find those discussions particular helpful, and I think they tend to excessively emphasize left-hand side risk versus right-hand side risk. If you think that only bad things can happen when you go outside, you should just stay home.

More of an issue is the Fed's pessimistic outlook for longer-run growth, driven not just by demographically-induced slowing of labor force growth but also by slow productivity growth. Yet productivity growth accelerated in recent quarters. This may be just volatility in the data; the 3-year moving average of productivity growth remains stable at an anemic 0.8%. Still, even a small sustained boost would allow growth to exceed the Fed's current forecast.

It may be that stress on the supply-side of the economy encourages firms to substitute capital for labor (again, notice the acceleration of investment activity this year). In practice, this means the Fed holding unemployment just below full employment for a sustained period of time, finding a sweet spot that allows for productivity growth to accelerate while boosting real wages and keeping a lid on inflation. Such a scenario would allow the economy to maintain its current speed; it would ease those supply-side constraints that would induce the Fed to slow growth next year.



That said, such a scenario does not in any way eliminate rate hikes for next year. The Fed will still feel compelled to raise rates sufficient to stabilize unemployment. Job growth needs to slow even if this slowing is offset in overall economic activity with faster productivity growth. Moreover, the Fed will believe that accelerating productivity growth reduces the downward pressure on the neutral interest rate. They would want to raise short term rates accordingly. This, along with some rise of the term-premium, is I think the path to an upward shift in the yield curve (although maybe not a parallel shift as tightening cycles tend to produce flatter yield curves).

Bottom Line: The acceleration of activity in 2017 sets the stage for more interesting monetary policy decisions in 2018 as the Fed manages an economy closing in on supply-side constraints. The Fed expects they will manage to guide the economy into a slow growth equilibrium characterized by stable yet low unemployment and target inflation. They will accept faster growth than forecast if that growth is delivered by productivity gains and does not drive unemployment too much toward 3.5%. I think we are closing in on limits to their patience regarding the unemployment rate. If recent history is a guide, the Fed will continue to behave in a way that effectively suppresses the Phillips curve.

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Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index.

Tim has published in the *Journal of Economics and Business* and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog as "influential." The Huffington Post identified him has one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

Notice: This newsletter is commentary, not investment advice.

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