# INVESTMENT COMMENTARY: Q3 2016

October | 2016

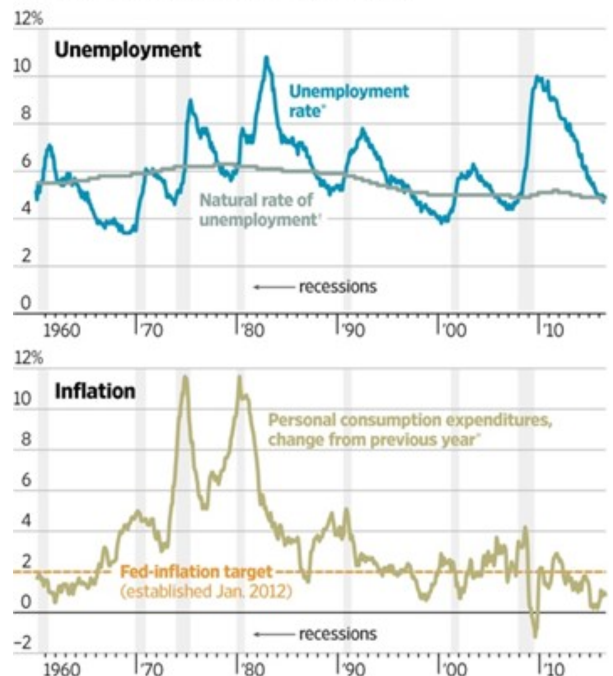
## Full Employment Economy Changes Little

The third quarter of 2016 had something for everyone. In July, the S&P 500 soared to record highs after Brexit concerns quickly faded. In August, stocks traded in a very tight range, moving sideways as market volatility seemingly disappeared. Then in early September, the market declined sharply and reminded everyone that prices often fall more quickly than they rise when volatility spikes. As September wore on, stocks recovered much of the early drop and finished flat for the month. In the end, the market showed itself to be resilient.

The resiliency comes from favorable market fundamentals and accommodative central bank policies around the globe. Low short and long-term interest rates continue to support the prices of riskier assets. With interest rates at generational lows, investment is being diverted into riskier assets to achieve a reasonable return. In addition to low interest rates, the economy is grinding out slow and steady growth. Employment numbers and consumer confidence are both improving. The low interest rate environment is perhaps the most important underpinning to this market, so the near-term direction of interest rate policy deserves detailed discussion.

The US Federal Reserve is keeping interest rates low in support of its dual mandate to achieve full employment with low inflation. Reading the many public speeches by Federal Reserve governors over the past few months, most Fed officials agree that the economy is at or getting very close to what economists consider full employment, the rate below which inflation is expected to rise. What they can't agree on is what should happen next. As the unemployment rate hovers below 5% and job gains moderate, one of the key debates at the Fed meetings is how much farther the Fed can let unemployment fall without risking runaway inflation.

There are essentially two sides in this debate – "Hawks" who believe inflation should be fought pre-emptively and aggressively, and "Doves" who support more accommodative policies to foster broader economic growth. On one side are dovish officials, including governors Lael Brainard and Daniel Tarullo, who say there's still room for improvement in the labor market. Allowing unemployment to fall further below its current 4.9% level would give more Americans—especially minorities—a chance to come back to the labor force and share in the gains of the expansion, they say. The counterargument from more hawkish officials such as San Francisco Fed President John Williams is that letting the jobless rate get too low could cause prices to surge, forcing the Fed to ratchet up short-term interest rates faster than they'd like. In their view, that could trigger a downturn that would hurt minorities most. "I understand the desire to try to help everybody in the economy," Mr. Williams said Sept. 6 in Reno, Nev. "But I think that just running an overly hot economy for too long does risk creating the conditions that then could lead to a recession that undoes all of that."




When faced with inflation spikes in the past, the Fed doesn't have a great track record of combating rising prices without causing a sharp upturn in the unemployment rate. In the 1960s and early '70s, the Fed let the jobless rate fall below estimates of full employment.

Several bouts of runaway inflation and the severe recessions that followed have made officials wary of testing that boundary today, despite little evidence of inflationary pressures.

Fed Chairwoman Janet Yellen has expressed sympathy for both camps, and stated earlier this year that the Fed could be wrong in its estimate of the full-employment level. The Fed's official median estimate of full employment is 4.8%, and she said the true level was likely lower. If so, "a lower level of unemployment might be needed to fully eliminate slack in the labor market, drive faster wage growth, and return inflation to our 2% objective."

With officials divided over whether to raise rates, the Fed has held their benchmark short-term rate since December in a range between 0.25% and 0.5%. The debate among Fed officials is occurring against a backdrop of growing pressure from liberal lawmakers and labor activists, who urge the central bank not to raise rates right as low-income workers are finally starting to see economic progress. They say some measures of labor market slack suggest there are still gaps to be closed. The share of prime-age workers participating in the labor force—those 25 to 54 years old—is still below where it was before the crisis, at 81.3% in August, compared with 82.9% in August 2007.

The median U.S. household income rose 5.2% last year to $56,516, the biggest annual gain recorded since the survey began in 1967, the Census Bureau said last week. Still, it remained 1.6% below the 2007 level and 2.4% below the all-time recorded high reached in 1999. At the same time, the Fed's preferred inflation gauge continues to run below its 2% objective, and inflation expectations have softened. Lael Brainard, one of the most influential dovish Fed governors, said in a speech last month: "In the presence of uncertainty and the absence of accelerating inflationary pressures, it would be unwise for policy to foreclose on the possibility of making further gains in the labor market."

Part of the challenge for both sides is that nobody knows where that sweet spot is: How low can the jobless rate go, and for how long, before inflation starts to rise too much? The Congressional Budget Office estimates that full employment—also known as the nonaccelerating inflation rate of unemployment, or Nairu—is 4.8%, the same as the Fed's estimates in March and June and a hair below the current jobless rate. That's enough for some officials to worry that hotter inflation could be right around the corner, based on the long-held belief that falling unemployment eventually generates higher wages, which in turn will push up prices and generate stronger inflation. But that relationship hasn't been working the way many Fed officials have come to expect. No one can disprove these employment and inflation models, except for the fact that we keep driving unemployment lower and still there's no inflation. That's the pesky reality we have today.

Taking into account all the Federal Reserve speeches and press releases, it does appear that they want to raise rates when given the opportunity, and may do so again at their December meeting. Low inflation is one reason why they have been reluctant to hike; negative interest rate monetary policies in Europe and Japan are another reason. Both Europe and Japanese central bankers have recently taken more extreme actions to stimulate growth and inflation, forcing their interest rates into negative territory. These policies, coupled with the December 2015 US rate hike, caused the US dollar to spike and commodity prices to crash late last year and early this year. The US Federal Reserve does not want to see a replay of that, and has likely been waiting and hoping that European and Japanese central bankers would end their negative interest rate experiments. We discussed this phenomenon in our 2016 Q1 Commentary, and this was central to our case that we were likely in a "Lower for Longer" interest rate environment.

Recent developments indicate that central banks in Japan and Europe could be ending their negative interest rate policies. Last month Japan modified its policy, stating that it is targeting zero-bound short and long-term rates until it exceeds its 2% inflation target; this caused interest rates there to rise out of negative territory, and the Yen strengthened against the US dollar. The Japanese central bank acknowledged constraints on its ability to push rates deeply into negative territory, noting that an excessive decline in rates can hurt the economy by raising doubts about the financial system's long-term health. As for Europe, the ECB's bond buying program that has pushed its rates into negative territory is set to expire in March 2017, and there is growing consensus that they will begin a "tapering" process when they decide to end the program.

While it appears that rates are set to rise worldwide, they will likely remain at lower levels from a historical perspective. The low inflation conundrum has structural components that will persist. Economic growth forecasts have come down; US Federal Reserve officials last month revised the U.S.'s long-term growth rate at 1.8%, down from 2% in June and 2.5% in 2011. The forces behind this combination of low growth and low rates go well beyond areas central banks can influence. One is demographics. Aging populations are shrinking the global workforce and customer bases, which saps incentives for capital expansion. Japan's shift from elderly to younger workers, from manufacturing to less-productive services, and from permanent to temporary employment are all depressing wages. Second, productivity growth is stagnant, for reasons that aren't clear.
A third reason is fiscal tightening efforts by governments to cut their deficits that ballooned after the recession.

In summary, while we expect rates to rise over the next year, the forces conspiring to suppress yields will persist and likely limit any significant backup in yields. It will continue to frustrate investors searching for yields, and require caution, patience, and a resetting of expectations.

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