Economic Update, April 2017

Where is the Economy Headed?

By Richard Morey

According to the official figures, the U.S. economy grew 1.6% in 2016 and was projected to have grown at an annualized rate of .9% in the first quarter of this year. For many decades, when the economy grew at less than 2%, recession followed immediately thereafter. For example, in 1990 the economy slowed to a 1.9% growth rate, and the following year we had a recession. In 2001 it slowed to 1%, followed by a recession, and in 2007 it fell to 1.8% and then recession.

This has been the regular pattern since before World War II – until 2012. In 2011 the economy slowed to a 1.6% growth rate, but in 2012 we went back up to 2.2%. Then in 2013 it fell back to 1.7% only to rebound to 2.4% in 2014. Something appears to have changed in which we can grow below the 2% "stall speed" without either going into recession or attaining the average 3% growth rate or above.

Before attempting to explain this phenomenon, let's first take a snapshot of where the economy stands today. Since the election, business and consumer confidence have both soared. Businesses and individuals are expressing near record optimism about our economic future, a fact we can see playing out in the stock market. I expect this is simply hope that, with a new administration in charge, surely the economy will finally begin to grow at least at the average 3% annual rate. For the last seven years the economy grew 1.6%-1.7% for three years and 2.2%-2.6% the other four. Perhaps a new President can get us over the hump into at least "normal" growth?

Despite all the "hopium," the real economic data is pointing in the opposite direction. Here are a few of the actual numbers: 1) Business investment has been falling since the beginning of this year. In January, core capital goods and orders fell .4%, with unfilled orders having had its worst 8 months since 2009. 2) Personal spending has only increased slightly but has fallen when adjusted for inflation this year. 3) In February industrial production did not grow at all (a trend that has been going on since 2014). 4) Retail sales remain flat (up a miniscule .1% in February), with department store sales crashing 15% year-over-year.

After looking at all the current hard data and the Atlanta Fed's report showing the economy expanded at less than a 1% rate in the first quarter, I did a search to try to find news supporting the opposing view that the economy is going in the right direction. The <u>only</u> positive news I could find involved employment. For several years we have looked at the employment reports with disdain, noting the majority of the new jobs being created were part-time and low-paying. As a result, the most recent employment report showed, once again, a disappointing .1% monthly gain in wages.

What Determines Economic Growth?

Unlike many topics in economics, we know precisely what numbers equate to economic growth. There are two variables that fully determine growth: GDP growth = growth in the number of hours worked in the economy + growth in productivity.

Due to the aging of our population, the growth rate in the number of hours worked is projected to average only .3% a year over the next 7 years. This then just leaves us with increases in productivity to get growth. Productivity has averaged 2% since World War II, but over the last five years has plummeted to only .5%. If you add these two numbers together, you find the U.S. economy is on pace to grow at only eight-tenths of one percent over the next 7 years!

This is what our economy will do unless something very substantial changes. However, perhaps the only way to increase the number of hours worked in our nation is to increase the number of immigrants entering our country. We can probably all agree this is not going to occur in the next 4 years.

Increasing productivity is much more complicated. Productivity growth is determined by something called "gross domestic investment." And just like economic growth, gross domestic investment can be calculated to the penny by adding up three numbers: 1) Total savings of U.S. citizens, 2) Savings by the U.S. government, and 3) Foreign investments. Unfortunately, our citizens do not and cannot save very much, as their wages are not keeping up with inflation. The government not only is not saving money but accumulating massive deficits every year. This just leaves us with foreign investment as the source of new investment. Unfortunately, foreign investment comes from trade deficits. When we import more than we export, we pay the foreign companies with U.S. dollars which then go towards gross domestic investment. So unless our citizens start saving a lot more money and the government actually not only stops deficits but starts reducing debt, the only way domestic investment can increase is with larger trade deficits. Once again, this is (understandably) the exact opposite of what our new administration intends to achieve.

When Will We Return to Recession?

Thus far I have simply been presenting data reported by the government and discussing "accounting identities" that define economic growth. Arithmetic tells us we have a challenging economic future ahead. We are far past-due for another recession, but predicting the exact timing of recessions is quite difficult. That being said, all of the data currently points towards upcoming recession. In fact, the only supposedly positive economic news, employment growth, suggests an upcoming recession as much or more than the negative news. This is due to the fact the economy almost always goes into recession shortly after the unemployment rate hits a low-point. This actually does make sense, as when most of those who want a job have a job, there aren't many workers left to employ to increase the total number of hours worked.

On the productivity or business investment side of the growth equation, investors have been filled with hope that the recent surge in business optimism would lead to an increase in businesses investing money into their companies. This optimism has not yet led to increased business investment. Regardless of how much hope they may express, business owners do not invest large amounts to attempt to grow their business when they are uncertain about the future. Looking at the political landscape, the only thing we can say for sure at this point is that uncertainty is at or near an all-time high.

Since historically we go into recession whenever growth falls below 2%, we "should" have had recessions in 2012 and then 2014. What happened? Clearly there is one multi-trillion-dollar difference called the Fed's quantitative easing programs. We have never before seen the Federal Reserve Board print trillions of dollars and engage in a wide variety of other programs to prop up banks and encourage the creation of another mountain of new debt. And given the explosion of new debt – particularly corporate debt – it isn't too surprising the economy has managed to, just barely, keep its head above water far longer than would normally be warranted.

There is a very good chance the next recession will be caused by an "external shock," i.e. something traumatic and unexpected which occurs. Given the global geopolitical and macroeconomic uncertainties present in the world today it would be near impossible to catalog all the potential shocks we might experience.

Then we have the most accurate predictor of recessions known as the Federal Reserve Board. The Fed is now raising interest rates and seems quite intent on continuing. Over the last 30 years only one major event has preceded every recession. Every time the Federal Reserve Board has started to raise interest rates, the economy has fallen into recession shortly thereafter. In other words, they *always* get the timing completely wrong. We see nothing which leads us to expect anything different this time around.