Current Economic Conditions

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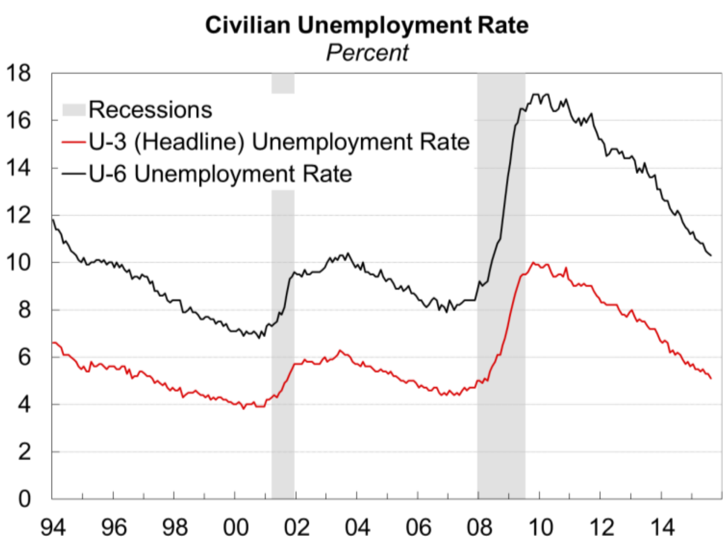
FOREIGN WEAKNESS SLOWING U.S. MANUFACTURING; KEEPS FED ON HOLD

The U.S. Federal Reserve's Federal Open Market Committee announced on September 17 that it would leave its target federal funds rate unchanged at 0-0.25%. In explaining its decision, that FOMC cited "recent global economic and financial developments [that] may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term," making it difficult for the Fed to get inflation up to its 2% target.

Before the announcement, economists and stock market analysts were split over whether the FOMC **would** raise the funds rate. Afterwards, they were split about whether they **should have** raised it. One's opinion on whether or not the Fed made the "right" call depends on what data one focuses on. If one looks only at U.S. economic data, it would seem that the Fed should have hiked rates. Real Gross Domestic Product rose at an upwardly revised 3.7% annualized rate in the second quarter, and that estimate is likely to be revised up further. Motor vehicle sales rose in August to their highest seasonally adjusted annual rate since 2005. Housing starts slipped in August, but single-family housing permits, a better measure of underlying housing market conditions that is less affected by weather, rose to their highest level since 2008. Headline retail sales were soft, but underlying details were stronger, and July data were revised up. New claims for unemployment insurance fell to an eight-week low of 264,000 last week, suggesting that the unemployment rate, already down to the Fed's estimate of "full employment," could fall further from August's 5.1% rate.



Data from the rest of the world paint a much less positive picture. Global manufacturing has stagnated. Aside from Central Europe, where production is up strongly, and Brazil, where production has collapsed, industrial production in manufacturing is essentially flat everywhere. Year-over-year growth rates are in the 0-1% range in both the European Union and Japan. Of the countries for which I could find industrial production data for manufacturing, only four (the Czech and Slovak Republics, Hungary, and Turkey) reached new record highs in the most recent month of data. (That doesn't include China, where official data for growth in Value Added of Industry imply that industrial production is at a record high, but where more detailed data and purchasing managers' indexes suggest that that production is declining.)

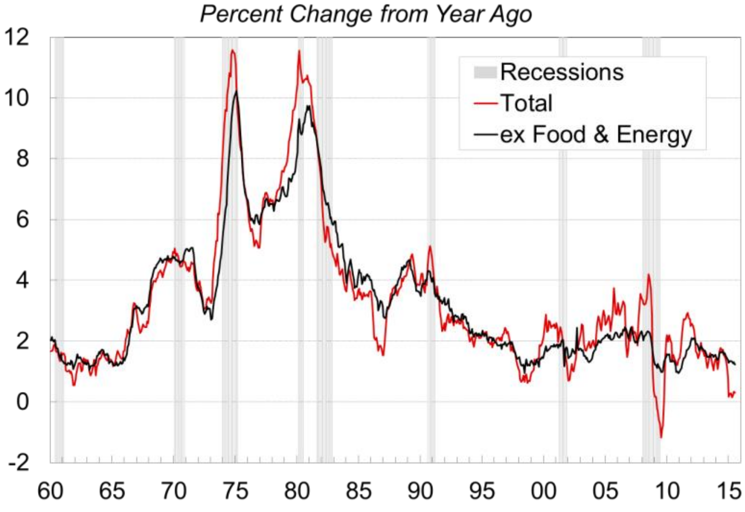
Some argue that the FOMC should pay no attention to foreign data in setting the course of monetary policy in the United States. However, weakness abroad and the associated strengthening of the dollar and declines in U.S. import prices and global commodity prices make it hard for the Fed to get inflation up to its 2% target. Furthermore, there are signs that weakness abroad and the strong dollar are holding down growth in U.S. manufacturing. Despite strength in housing starts, vehicles sales, and retail sales more generally, industrial production in U.S. manufacturing slipped in August, leaving it up just 0.2% since November 2014. The Institute of Supply Management's New Orders index for manufacturing fell from an above average 56.5 in July to just 51.7 in August. This level suggests growth will be just barely positive in coming months. The ISM new export orders index fell to 46.5 in August, indicating that weakness abroad and the strong dollar will cause exports of U.S. manufactured goods to decline. Indexes from the New York and Philadelphia Federal Reserve Banks suggest declining manufacturing activity in September. A further significant strengthening of the dollar – a possible result from a hike in the federal funds rate – could further weaken the outlook for U.S. manufacturing. Although the FOMC seemed more concerned about inflation, the potential hit to manufacturing might also have played a role in the Fed's decision.

Because exports account for just 13% of U.S. GDP, weakness abroad generally has little impact on the **overall** U.S. economy, unless it triggers a global financial crisis. However, the limited impact on broad measures of economic activity obscures bigger impacts at the sectoral level. Tradable goods sectors – manufacturing, mining, and agriculture – can be hit hard by weakness in the rest of the world, while services and construction are largely unaffected. Weakness abroad can also have a significant impact on the profits of large U.S. companies. S&P Dow Jones Indices, a division of McGraw Hill Financial, estimates that sales from foreign countries accounted for nearly 48% of the sales of S&P500 companies in 2014. That explains why stock prices have underperformed the overall U.S. economy over the last several months.

One's opinion of whether or not the FOMC should have raised rates also depends on whether one focuses on the level of interest rates or on changes in interest rates. If asked, "Given the pace of economic growth, the rate of inflation, and the level of unemployment, what should the federal funds rate be?" most economists would suggest a rate higher than 0.25%. This is the approach taken by those who adhere to the Taylor Rule, named for Stanford economist John Taylor. But if asked, "Given the pace of economic growth, the rate of inflation, and the level of unemployment, should the Fed raise or lower the federal funds rate?", many might say "lower it," especially if they focus on the U-6 unemployment rate, which is at 10.3%, far above its "full employment" level of 8-9%. The answer depends on how the question is posed.

The FOMC may be boxing itself in by holding too rigidly to its 2% target for the PCE price index. It isn't clear that the Fed **can** get inflation up to that level anytime soon, for several reasons. I'm reluctant to disagree with Milton Friedman, but his oft-cited statement that "inflation is always and everywhere a monetary phenomenon" is wrong. Inflation is largely a demographic phenomenon; inflation is high when a large birth cohort (e.g., the Baby Boom) reaches adulthood, boosting demand for housing and motor vehicles and causing the labor force to swell. Given the aging of populations and slowing in population growth, it will be difficult for central banks to achieve their inflation goals in developed economies and in China, where the working-age population has already peaked. Measured inflation is also being held down by a cyclical decline in the prices of food, energy, and other commodities. Finally, there is so much inertia in official measures of inflation that they might not show a rise in inflation until it is well underway.

US Personal Consumption Expenditures Price Index
Percent Change from Year Ago



The initial negative reaction of stock markets notwithstanding, the Fed's failure to raise rates in September is not going to set off an inflationary spiral (and a quarter-point hike in rates would not have triggered a global recession). However, if the Fed waits for conclusive evidence that inflation is on its way to reaching the 2% target, it risks inflating asset bubbles, the bursting of which could cause a global recession that the U.S. economy could not escape.