Centre for Asset Management Research & Investments
NUS Business School

CAMRI Global Perspectives

Monthly digest of market research & views

Issue 61, May 2019

The Fed at the Brink

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The Fed under fire

For the second time in less than six months the President of the US called upon the Federal Reserve Board and specifically his appointed Chairman to follow his preferred decisions. First, late last year the President admonished the Fed for deciding to raise its official rate for a third time in 2018. Recently, the President advised the Fed Chairman to lower interest rates in order to stimulate the economy further, in spite of its presently healthy rate of growth. The Fed did stop raising official rates in early 2019, and in May 2019 they made clear their intent to remain on pause until the high frequency economic data coerces them to change rates in either direction.

Inflation has been stubbornly stable

While economic growth in the US has thus far proved highly resilient to all of the political headwinds in its path, inflation has been remarkably constant. The Fed used stable rates of inflation to justify its decision in February 2019 to stop raising its official interest rate in spite of the interest rate projections made by Board members and its past hawkish rhetoric.

Chart 1

In May 2019, the relatively well-behaved inflation rate was again used to vindicate their decision to keep rates constant. However, how long can the Fed remain complacent about the future path of inflation while the labor market pushes deep through estimated full employment? Moreover, can they also ignore repeated and heated warnings from the President now that the Presidential election cycle is drawing closer?

Wages are finally beginning to rise

Throughout most of the present economic expansion, wages have remained stagnant. There are many factors that have probably contributed to this atypical shift in income distribution from labor to capital: globalization, immigration expanding the labor force (whether officially recognized, or not), loss of union bargaining power, corporate zeal in maximizing profits and dispersing them immediately to equity owners.

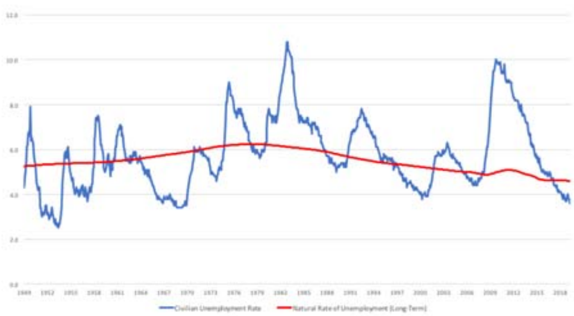

Chart 2

Recently wage growth has begun to accelerate; slowly, but steadily. One factor behind the sudden and welcome increase in wage growth has been the plunge in the unemployment rate. As the following chart demonstrates, the national unemployment rate has pieced the estimated full employment unemployment level 28 months ago. Wage growth had begun to pick up depressingly slowly several months thereafter from an exceedingly low pace. Wage growth had troughed at the end of 2012 three years after the end of the past 'great recession' at the disastrously low rate of 1.43%.

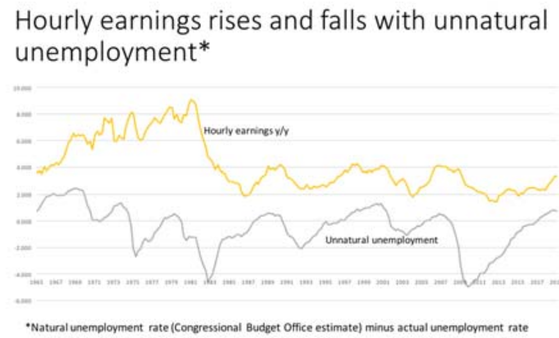

Chart 3

This modest pickup in wage growth, after a fairly lengthy period following the absorption of excess labor, suggests that the past estimates of full employment may have been too optimistic. It could be that full employment is significantly lower and therefore more consistent with a more meager estimated natural rate of economic growth. It may also reflect that there are more unaccounted workers presently employed in the labor force than official data reports. And, it may reflect that so much more production of goods and services have been offshored.

Wage growth leads to higher inflation

There is little controversy among economic savants that when wage growth accelerates it usually begins to push inflation higher. There is some controversy, however, over how long the lags are before a rise in wages does cause a pickup in inflation and how much of the acceleration in wage growth leaks into inflation.

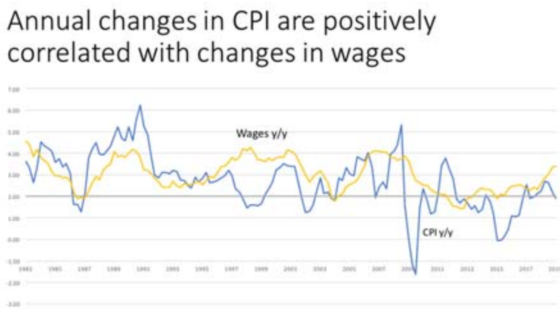

Chart 4

Chart 5

Consequently, while economic activity in the US continues to expand, as enthusiastically predicted by the Federal Reserve Board members last week, the demand for labor needed to accommodate this economic expansion will increase employment. Higher employment will eat into the small surplus that remains in the unemployed labor pool and induce wages to continue accelerating. Therefore, some of this advancing labor cost will drive the national inflation rate higher.

From another perspective: profits share of national income rose

The share of national income being absorbed by corporate profits soared to unhealthy proportions in the years immediately following the ‘great recession’. It is natural to expect capital’s share to escalate in the immediate aftermath of a recession because corporations had peeled away unnecessary costs, inefficient operations, and excess labor during the recession, and when demand finally improved their profit margins sizzled. Consequently, the growth in output per worker surged, as seen in the next chart.

What was significantly different in this cycle was the extended plateau of surplus profits compared with the relatively quick peaking and subsequent plunge in profits’ share of past cycles. This contributed greatly, or at least accompanied the relative slow progress of wage appreciation in the current expansion.

The causes of this prolonged period of unusually high absorption of national income going to corporate profits are not readily known, but what is known is that, although it is still high and above its long-term average share of national income, profits share is finally falling down toward that average.

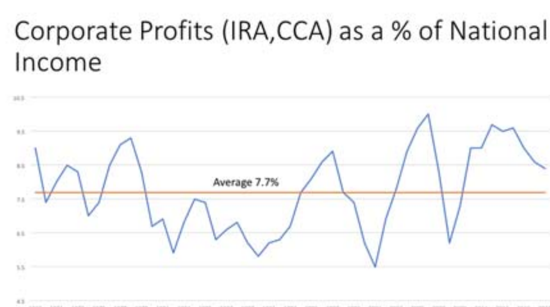

Chart 6

Corporate's share is projected to decline

The share of national income absorbed by corporate profits is expected to continue to decline because more workers will be added to the nation's total employment from a shrinking excess labor pool. This inevitably will propel wage growth higher and lead to more inflation.

Recently there has been a noticeable increase in output per employee, as seen in Chart 5. Consequently, some of the expected increase in future labor cost may be mitigated by increased productivity. However, productivity is not increasing as rapidly as final demand. Thus, profit margins will decrease and businesses will begin to raise the prices of their products and services in order to decelerate the rate of decline in their share of income distribution.

The Fed missed its inflation target; barely

The Federal Reserve Board stated several years ago that they would specifically target a 2% rate of inflation similar to other advanced economy central banks. That was at a time when the economy was advancing at a lackluster rate of growth and there was widespread unemployment. Economic growth accelerated slightly since then, propelled by sizeable tax reductions. However, inflation only modestly picked up speed and it is now rising at a rate slightly below the Fed's 2% target, albeit, core inflation (CPI less food and energy prices) through March 2019 is increasing at the Fed's 2% year-over -year target.

Chart 7

The members of the Federal Reserve Board have recently fallen under a mountain of criticism, mainly from the president and his advisors and almost all for political reasons. The President wants to ensure that economic growth will be robust through next year to assure support from his political base for the general election in 2020. He is pressing the Fed Chairman to commit to lowering the official Fed interest rate this year under the guise that the inflation rate is slightly below their announced target.

The Fed has shifted its economic view and guidance several times in the past year. In 2018, the Fed wanted to lift the official rate up to an estimated equilibrium level that was several percentage points above the prevailing official rate. They did raise the official rate three times in 2018 and provided guidance that they would continue increasing it in 2019. At the end of last year several significant threats to global economic growth were mobilizing, and in response the Fed altered its view of the economic outlook for 2019 and decided to pause before raising rates again.

Global Trade is plunging

One of the most convincing statistics supporting the belief that world economic growth would be slowing in 2019, partly as a result of the trade tensions among major trading economies and the tariffs on trade already imposed, is the rapid descent of world trade. As seen in the accompanying chart, the growth in global trade has declined significantly in the past year. It is a stark reflection of the negative effects from political disruptions to global trade.

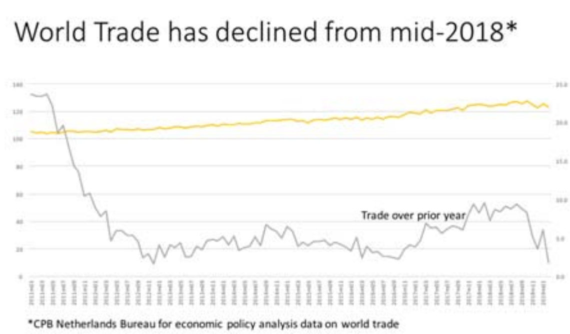

Chart 8

Economic growth in early 2019 proved more resilient to these threats, and US economic growth persisted at a robust rate and core inflation was stable. Perhaps opportunistically in light of the President's pressure, the Fed Chairman decided that the economy was operating in a sweet spot and didn't need accommodation or restraint. Therefore, the Fed's guidance indicated that they would keep rates at their present level and await future economic data.

Conclusion: What will move the Fed next?

The tussle between desired monetary policy in an uncertain world of economics and circumnavigating around a president's directives will leave the FOMC very little space to maneuver.

The latest development, the imposition of 25% tariffs on $200 billion of imported goods from China and similar retaliatory tariffs on $60 billion of US goods exported to China, may eventually push the FOMC into new action. The tariffs on Chinese goods will increase prices of those goods to US consumers. Estimates of the inflation consequences from these increased tariffs indicate that core inflation in the US will rise by 0.5 percentage points above its present rate.

Higher tariffs on Chinese exports to the US and greater tariffs on US exports to China will also reduce global trade further because the ultimate consumers of those products will cut back on their purchases of the higher priced, tariffed goods in both countries. Normal trade will also suffer when companies affected by increased costs adjust their supply chain operations. This disruption and reorganization to the system of global supply chains cannot be accomplished quickly and probably will not be frictionless. Consequently, the concerns and risks to global growth that were present at the end of 2018 and were initially dismissed, as this year progressed, will reemerge with more virulence and credibility.

Higher inflation from rising labor costs and supplemented by greater tariffs on imported goods will push the inflation rate in the US above the FOMC's 2% target this year. Because the FOMC is caught between a rock and a hard place the most likely solution will be to shift their inflation target of 2% to a symmetric target around 2%, which could be attained after several years, or more likely over a business cycle. Thus, they remove inflation from being a trigger to raise interest rates as soon as inflation climbs above 2%.

The consequent shock to financial markets emanating from the latest round of tariff increases will send unambiguous signals to the FOMC that their previously held belief that the US economy had entered a sweet spot is seriously misguided. Now, the FOMC will be confronted with ascending inflation and diminishing economic growth, and a quick tempered, loose thinking President who may realize his economic plan for succession is in jeopardy.

For more information, please contact
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	KEY INDICATORS TABLE (AS OF 30 APRIL 2019)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2945.83	4.05%	4.05%	13.48%	13.48%	3MO LIBOR	2.58	9.00
FTSE	7418.22	2.28%	2.67%	3.09%	-2.32%	10YR UST	2.50	-15.28
NIKKEI	22258.73	4.97%	4.20%	1.19%	-1.07%	10YR BUND	0.01	-97.60
HANG SENG	29699.11	2.25%	2.31%	-0.27%	-0.23%	10YR SPG	1.00	-21.83
STI	3400.20	6.10%	5.71%	-2.60%	-5.22%	10YR SGS	2.17	-14.14
EUR	1.12	-0.03%		-7.15%		US ISM	52.80	-8.81
YEN	111.42	0.51%		1.90%		EU PMI	47.90	-14.77
CMCI	1241.59	-0.10%		-4.83%		JP TANKAN	12.00	-29.41
Oil	63.91	6.27%		-6.80%		CHINA IP	5.40	-22.86

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency