



US Economy: MEF Fall Bulletin 2015  
Surfing the Waves of Recovery



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## United States Economic Overview - 2015

### Marin Economic Forum

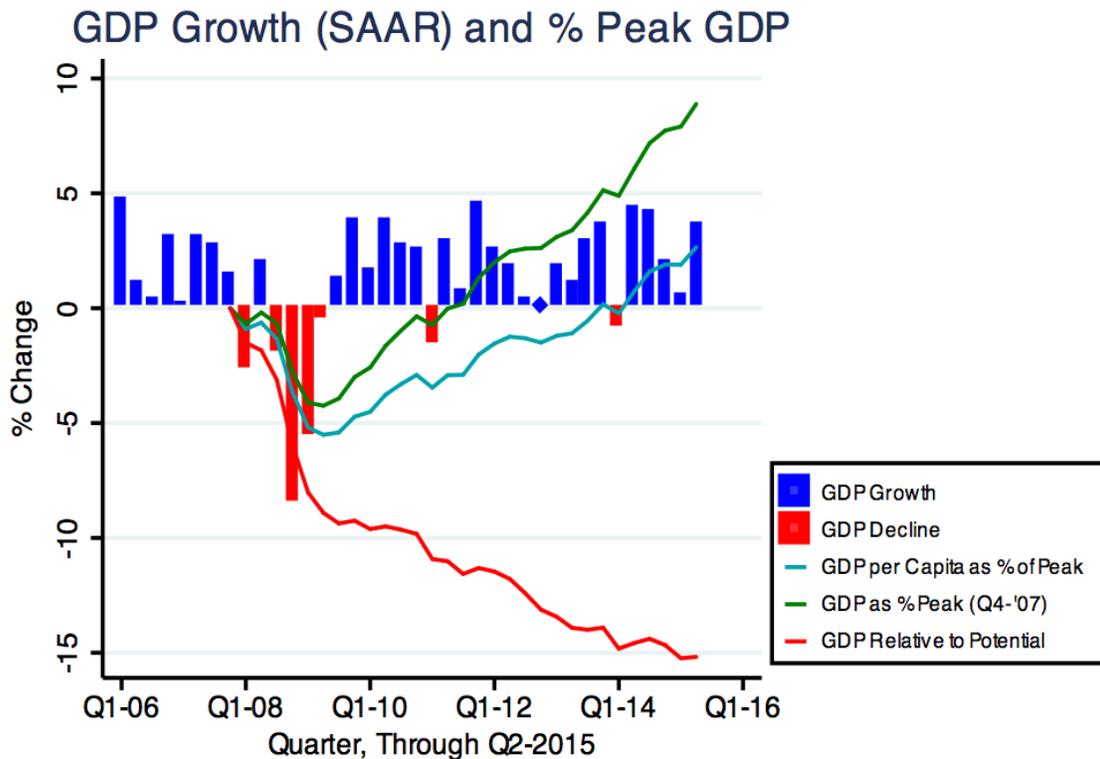
#### Key Observations

- The national economy continues to emerge from the Great Recession, though forecasts have been revised downward due to global growth worries.
- GDP per person and personal income per capita continue to grow.
- Employment levels continue to increase and headline unemployment is now 5.1 percent. However, the U-6 unemployment rate, which includes the marginally employed, has been over 10 percent since 2009.
- Equity markets, along with corporate profits, continue to rise. The connection to central banking decisions about interest rates and global growth to 2015's shaky markets will likely continue into 2016.
- Federal Reserve policy remains hawkish, now both supporting continued economic growth domestically, while also playing a part in global economic support.
- The flight of investment from other countries toward the United States, as well as slow-moving inflation will likely keep the Federal Reserve from being overly aggressive on moving interest rates up.
- Income and wealth inequality continue to grow in the United States. Extreme levels of inequality reduce savings and investment.
- The U.S. is among the countries with the highest levels of inequality.
- Despite strong forecasts coming into 2015, both Asia and Europe have shown signs of weariness, which has caused a commodities glut in the short-term.
- Forecasted gains in American GDP through 2019 suggest that good credit conditions, slow-moving inflation, and continued recovery in the US economy will outweigh global growth concerns.

## U.S. Economic Overview

The US economy has experienced another rocky start in 2015. While the second quarter showed growth of 3.9 percent after 0.7 in the first quarter of 2015, a global slowdown (both perceived and real) will likely act as a bit of a drag on the US economy for the rest of 2015. The outlook for 2016 remains positive, but likely slower than original forecasts 12 months ago and perhaps 0.5 percent lower than expected. Nonetheless, recovery continues into its seventh year and is projected to continue for the next three years. Forecasts suggest no recession before 2018 at least (as we will see below); that would make the current recovery and expansion since 2010 the longest economic expansion (in terms of quarters) for the US economy (and California) since World War II. It is also likely to be the slowest expansion since 1945, as very few quarters showed economic growth above the long term trend.

Figure 1: U.S. GDP Growth and Other Measures of Recovery



Source: Bureau of Economic Analysis

The first quarter of 2015, after initial estimates suggested the US economy contracted, showed positive, but very slow growth. The second quarter grew more robustly (3.9 percent positive growth). In contrast to 2014, where output declined in the first quarter, the second and third quarters grew faster than any six month period since 2005. This was followed by a disappointing fourth quarter. The third

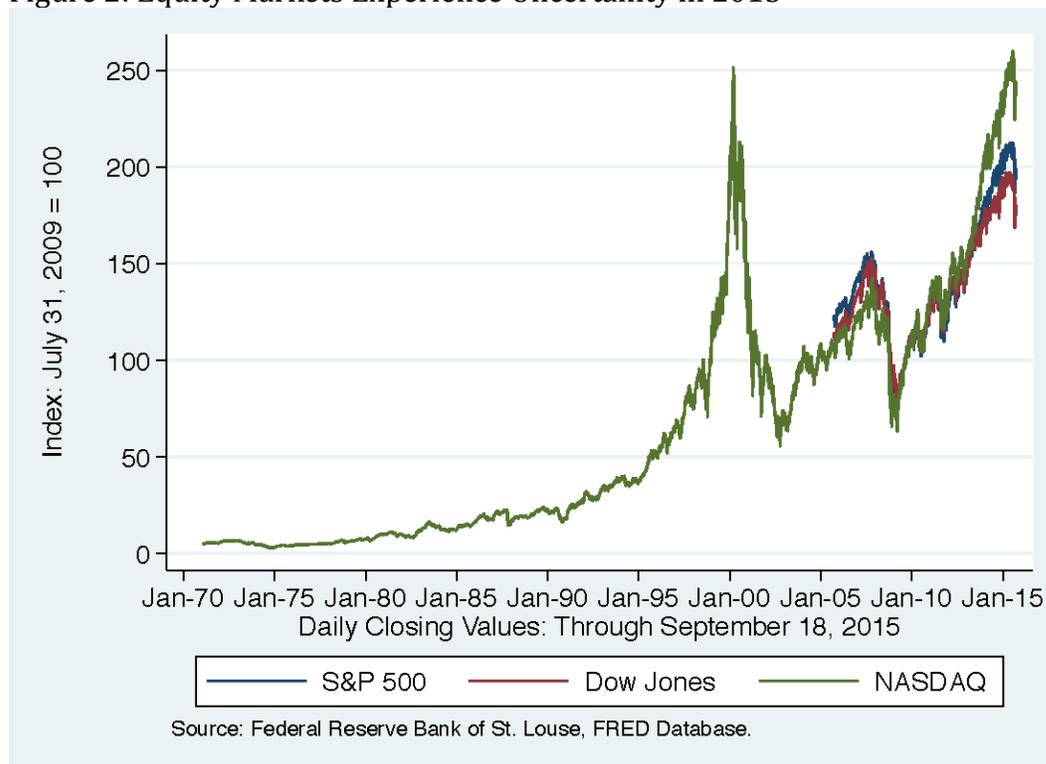
and fourth quarters of 2015 may well provide insight into expectations about global growth and the likelihood that the Federal Reserve will raise interest rates after 2016 begins.

Financial and labor markets continues to watch the Federal Reserve. Business and consumer confidence seem to be slowly moving forward, betting that interest rates will remain at the lowest possible levels toward 2016, and then rise very slowly thereafter. The Federal Reserve has all but stated it will decide to increase interest rates in 2015 for the first time since 2006. The Federal Reserve did not raise rates in September 2015 due to concerns over the global economy.

We do need to prepare for rising rates. As interest rates rise, we will see some slowdown in areas that are sensitive to interest rates (construction and manufacturing, and finance) but may also see some upward movement in real estate and business services as households and businesses that have been sitting on cash put that cash in motion and use financial leverage while interest rates are still very low.

The trend is favorable in equity markets, but there are warning signs. Starting in summer 2015 (and similar to 2011), markets have had some ups and downs; a note of uncertainty has crept back into financial markets. Fears in equity markets have ranged from instability in the European economy, driven primarily by Greece and its financial woes and the outlook for China's economy.

Figure 2: Equity Markets Experience Uncertainty in 2015

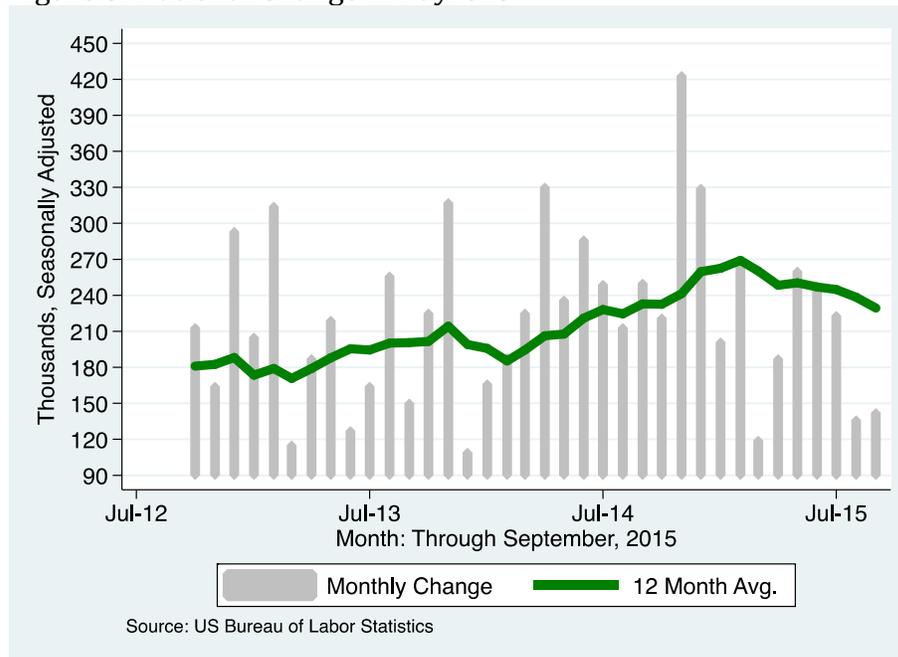


Job growth in the United States acts as an indicator of equity values in many circles, and job growth continues in the United States through 2015 and is forecast through at least 2018.

## EMPLOYMENT GROWTH

Economic recovery is now in its seventh year, with employment growth and prospects continuing to look good toward 2016. At the same time, the rate of job creation has slowed a bit. Notice in Figure 3 the 12-month average has flattened after growth year-on-year in 2014 steadily. August and September, 2015, provided the slowest two-month growth in employment in the last three years. It is too soon to be concerned about employment growth looking like recession, but this trend does bear watching. Although growing more slowly, month to month job gains continue to be significant.

Figure 3: National Change in Payrolls

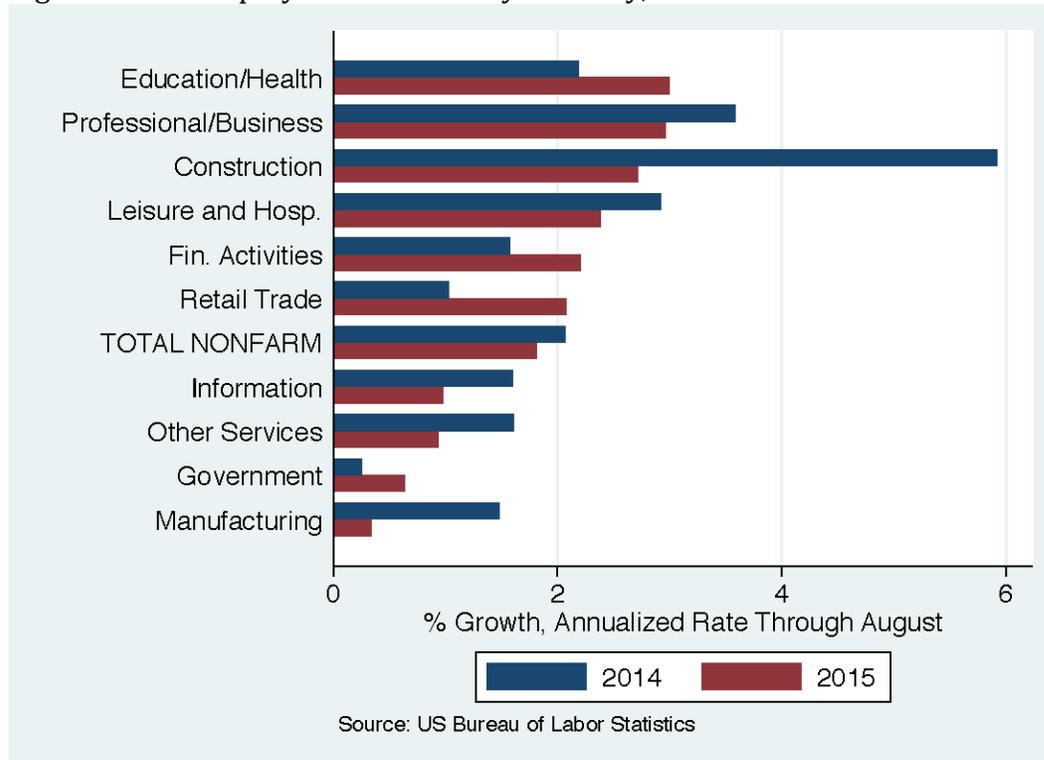


In July 2015, payroll employment in the United States was over 144 million, well above the pre-recession peaks. However, labor force participation (the percentage of the working-age population that is working) continues to slowdown. Part of this phenomenon is due to people making a change to self-employment or contractual employment (multiple temporary positions) versus classic payroll employment.

Employment growth by sector has been focused on education, finance and retail, with a small expansion of government since 2014. Other sectors, while growing, have slowed since last year. Sectoral growth is a major factor in understanding why the American economy continues to expand and also how shifts have taken place.

Construction employment continues to recover, and there is also strong growth in professional and business services employment.

Figure 4: U.S. Employment Growth by Industry, 2014 and 2015

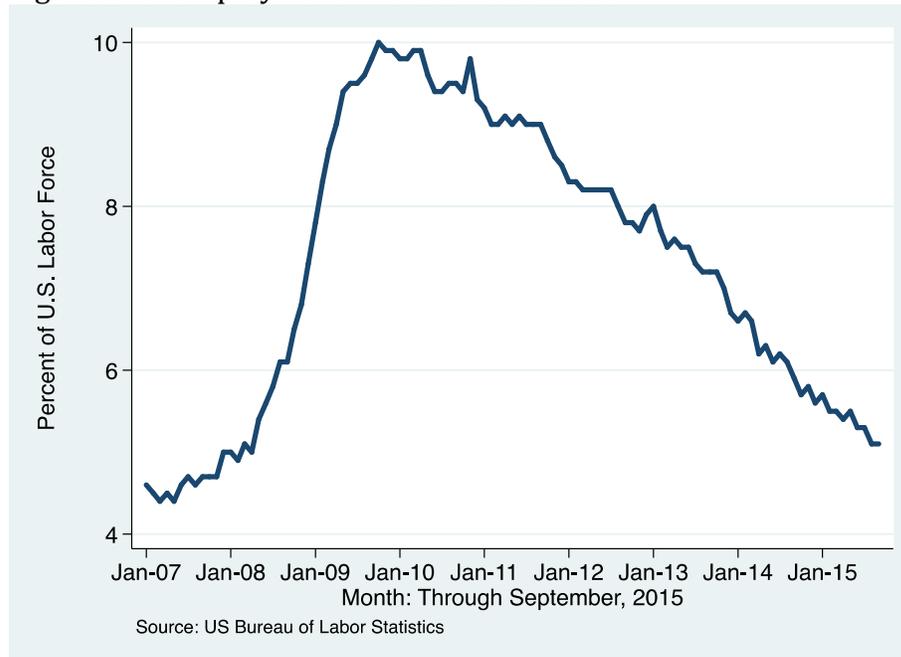


Nationwide, manufacturing is especially troubling, and mirrors the slowdown in California (see the California Update 2015 for more). Faster growth in manufacturing is certainly important, but it may not indicate a renaissance in the sector; American manufacturing depends on global growth and demand rather than domestic. Because 2015 has seen a slowdown in energy and commodities markets, costs have fallen for American manufacturers at the same time that incomes have declined in economies where commodities and energy are major exports to fuel demand for American produced goods.

Manufacturing employment peaked in June of 1979 and has been in decline for nearly all those 35 years. The decline started in earnest in 1998, with year over year employment losses experienced through early 2010. The rise of eastern Asia as a manufacturing center and shifts toward services propelled these changes. Since that time, manufacturing employment growth has been largely positive, as the sector recovers from year over year declines in excess of 15% during the Great Recession. These declines were faster than would have been experienced in the absence of the recession. Recent job growth is therefore a recovery and not renewed vigor in the sector.

The unemployment rate continues to fall and be a focus of monetary policy in the United States. One of the largest questions in the recovery and expansion period that followed the recent recession is how tied job growth and reducing the number of unemployed workers is to wage and inflation growth. Having peaked at 10%, the overall unemployment rate is now (September 2015) just 5.4% (Figure 5).

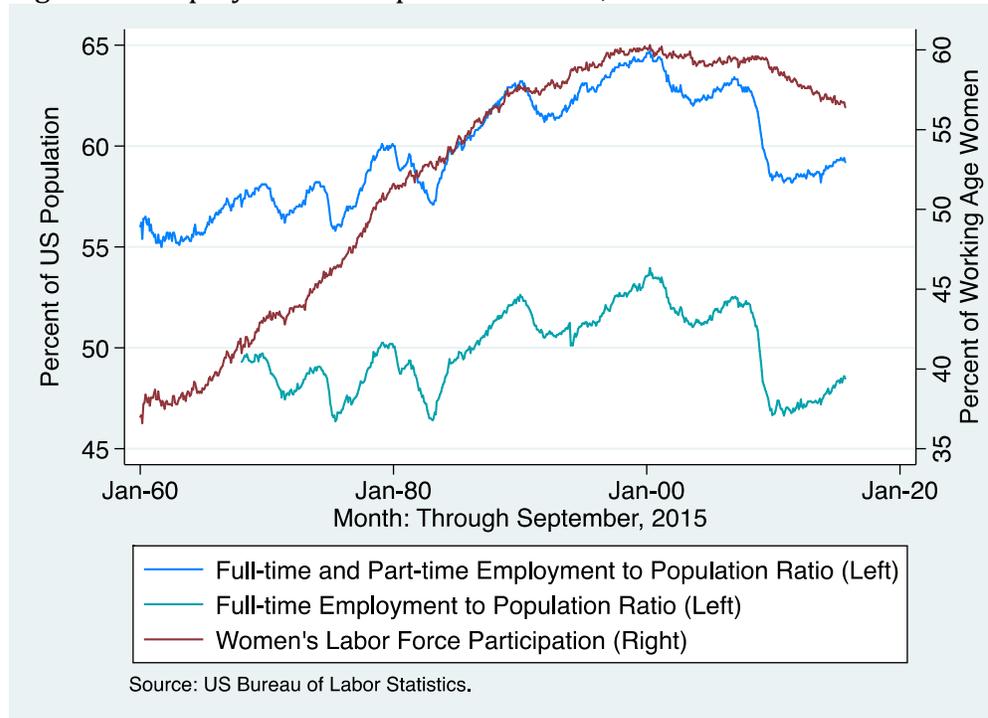
Figure 5: Unemployment in the United States



While employment has gone beyond pre-recession levels and the unemployment rate has crept closer to what economists consider “full employment”, labor force participation among women has been in rapid decline since the onset of recession and the composition of jobs has shifted toward more services and less construction and manufacturing. These trends may continue toward 2020.

First, the unemployment rate remains elevated even with recent growth. Figure 6 shows the participation rates and other measures of the labor force. These rates remain well below what we estimate would be achieved if current labor demand was more akin to expansion periods from the past. The beauty of such a reduction is that wages remain in check and keep inflation from rising rapidly; the curse is that worker incomes are moving slowly and domestic demand remains tenuous; fixed investment depends on long-term forecasts of growth which then become return on such investment.

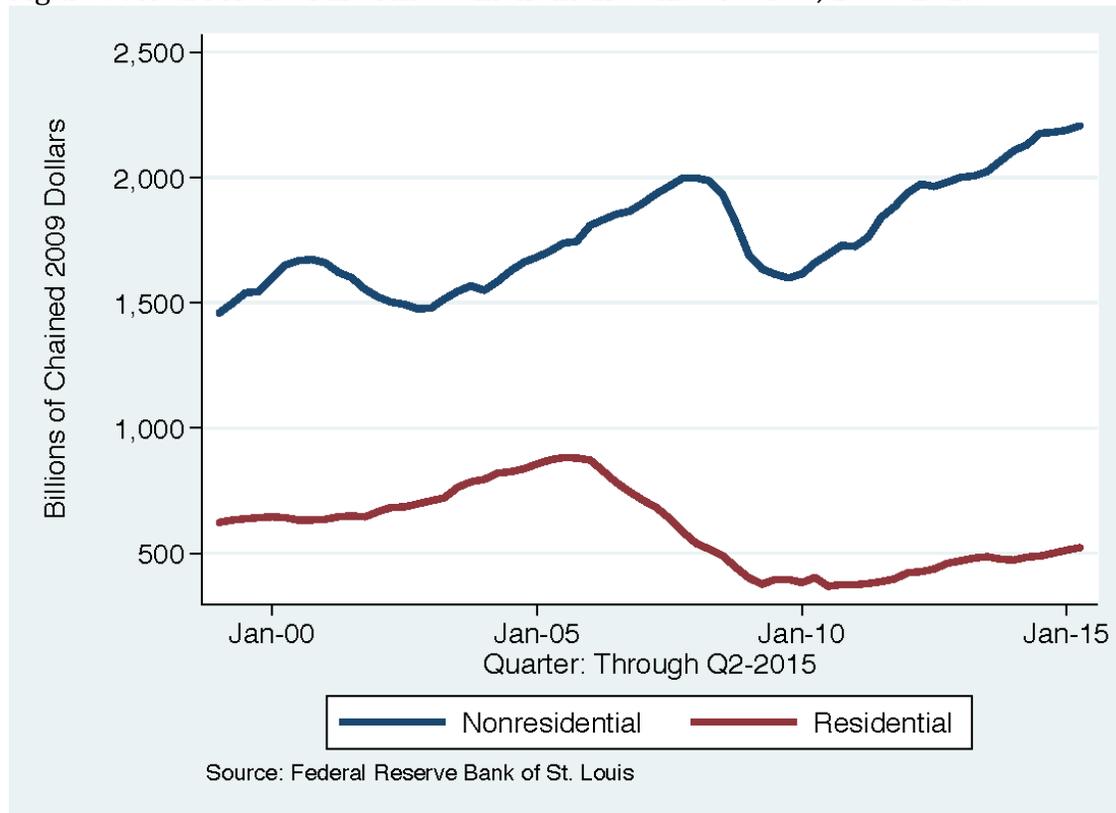
Figure 6: Employment to Population Ratios, 1960 - 2015



## FIXED INVESTMENT

Fixed investment expands productive capacity. New factory spaces and equipment, military hardware, tools for auto body shops, new commercial spaces and homes, all provide infrastructure and returns on that investment for years to come. Investment is divided into residential and nonresidential categories; nonresidential accounting for roughly 70% of fixed investment in the United States. The recent recession took a toll on both categories, and recovery came first into non-residential and then in residential by way of new homes. Such investment is important for future growth; importantly, new housing units prepare a local economy for population growth and for employment. Figure 7 provides data on both of these categories through the second quarter of 2015.

Figure 7: Real Private Fixed Investment in the United States, 1999-2015

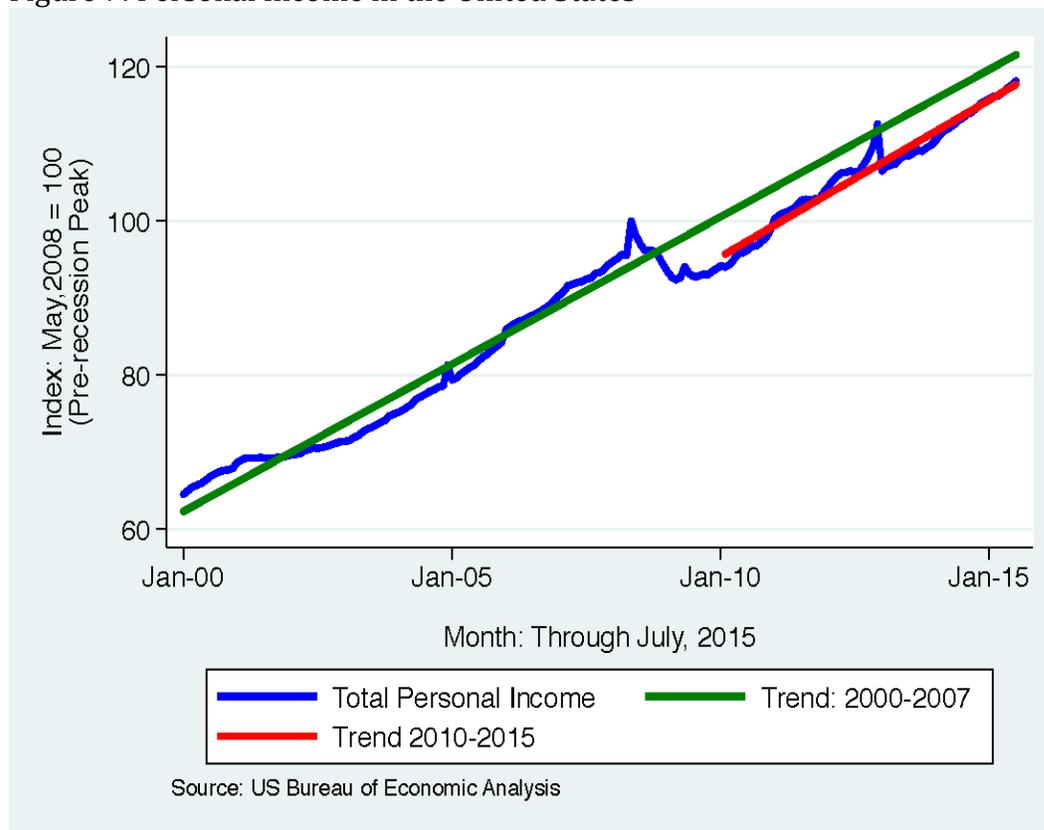


Residential investment has also been tilted toward multi-family units and urban areas. Much like other, historic recovery periods, population movements toward job centers from suburban and rural areas provide builders with more return on investment in populated areas rather than mass home building in all areas. The slow pace of residential investment is likely to continue with enhanced regulatory filters on lending for homes, slow wealth recovery in the 25-34 year age range, and land-use restrictions outside urban areas. The growth in nonresidential investment has flattened in the last five to six quarters; slow economic growth globally may continue to reduce growth and ultimately affect overall income growth as a result.

## INCOME GROWTH

Personal income is the genesis of consumer spending, derived mainly from wages and salaries and investment income. The United States passed its pre-recession levels of aggregate personal income, even in real terms, but the per-capita personal income levels fell during the recession and passed the 2008 level of inflation-adjusted personal income per person in 2014. Figure 8 shows recent trends, both before and after the recent recession, and also aggregate income levels.

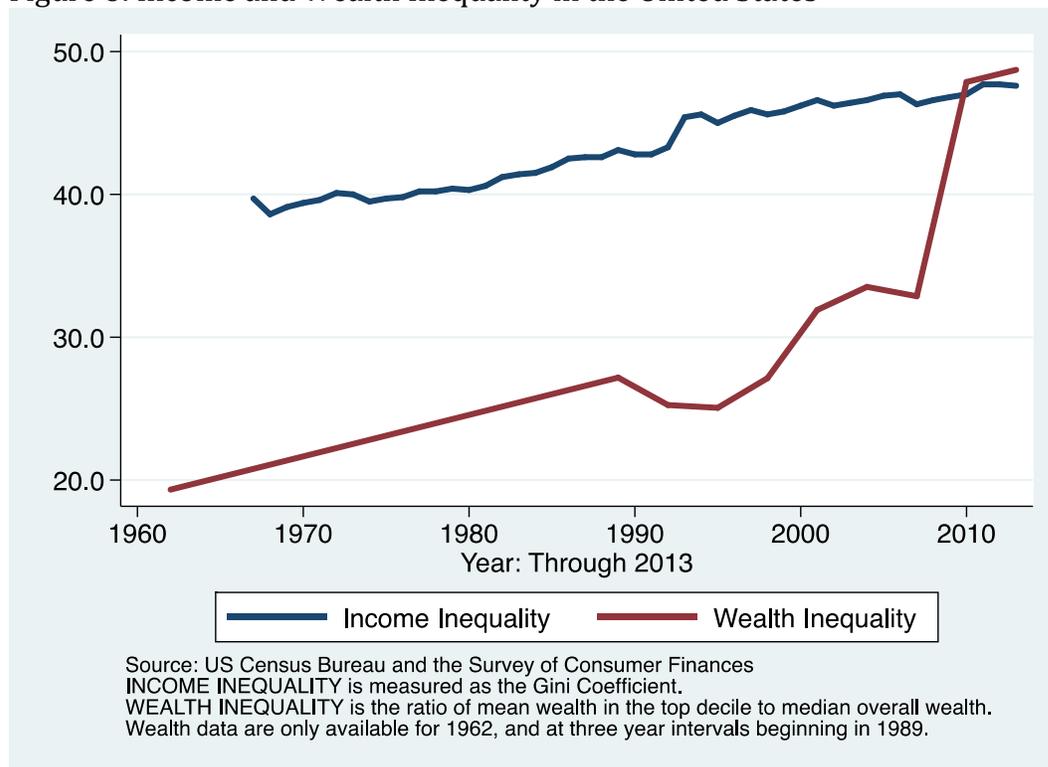
Figure 7: Personal Income in the United States



Although trend growth is slightly faster than long term trend (the red line is steeper than the green line) it will be several years yet before income is where it might have been without the Great Recession. Current employment remains 2.8% below trend employment, but was down 7.3% in early 2010. A return to trend levels of employment continues, but it is and will likely continue to be slow.

Inequality remains a prevalent issue as the American economy continues its growth (Figure 9). Higher incomes are generated through market forces, creating incentives for investing in education and time where financial gains are most obvious. Education is a tool to reduce income inequality. The public education system in the United States continues to struggle globally. Investments in education can revitalize potential labor resources and support continued economic growth. Decreasing unionization and stagnating wages among middle-income workers have also contributed significantly to increases in inequality.

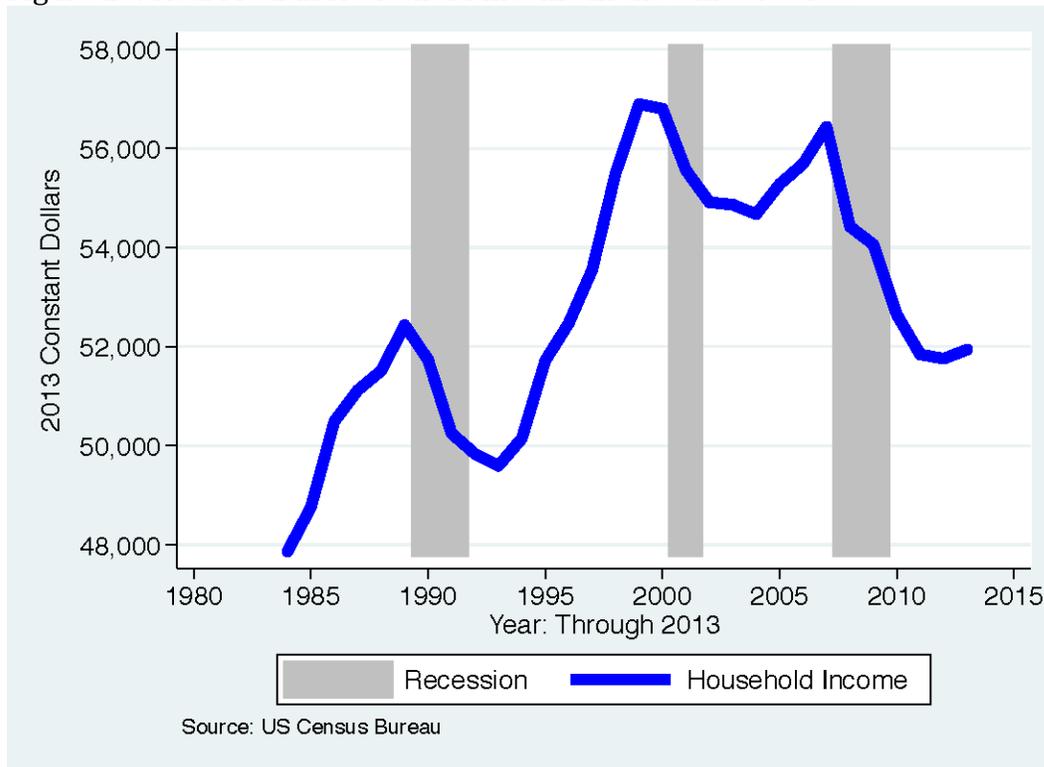
Figure 8: Income and Wealth Inequality in the United States



Wealth inequality has increased even more dramatically than has income inequality. This is a long term trend that was greatly exacerbated by the Great Recession. During the recession, many families lost their homes, and with them much of their savings, or accumulated wealth. The ratio of mean wealth among the richest 10% of households to the overall median level of wealth grew from just over 30 to nearly 50 in three short years.

Real median household income has struggled to get back to levels before 2008 (Figure 10). Between 2010 and 2013, median incomes fell for all groups other than the wealthiest 10% of households. Figure 9 shows how households, rather than individuals (per capita), have struggled to recover from the recession, even with rising personal income growth.

Figure 10: Real Median Household Income in the United States



Corporate profits continue an upward trajectory, but may dampen if the global economy continues to show weakness (Figure 11). This growth in corporate profits contributes to growing income and wealth inequality in that it accrues generally to higher income individuals and is partly a reflection of labor taking home a smaller share of income generated by businesses in the United States. As corporate profits rise, so does the income and wealth among those at the top of the distribution.

Figure 11: Corporate Profits

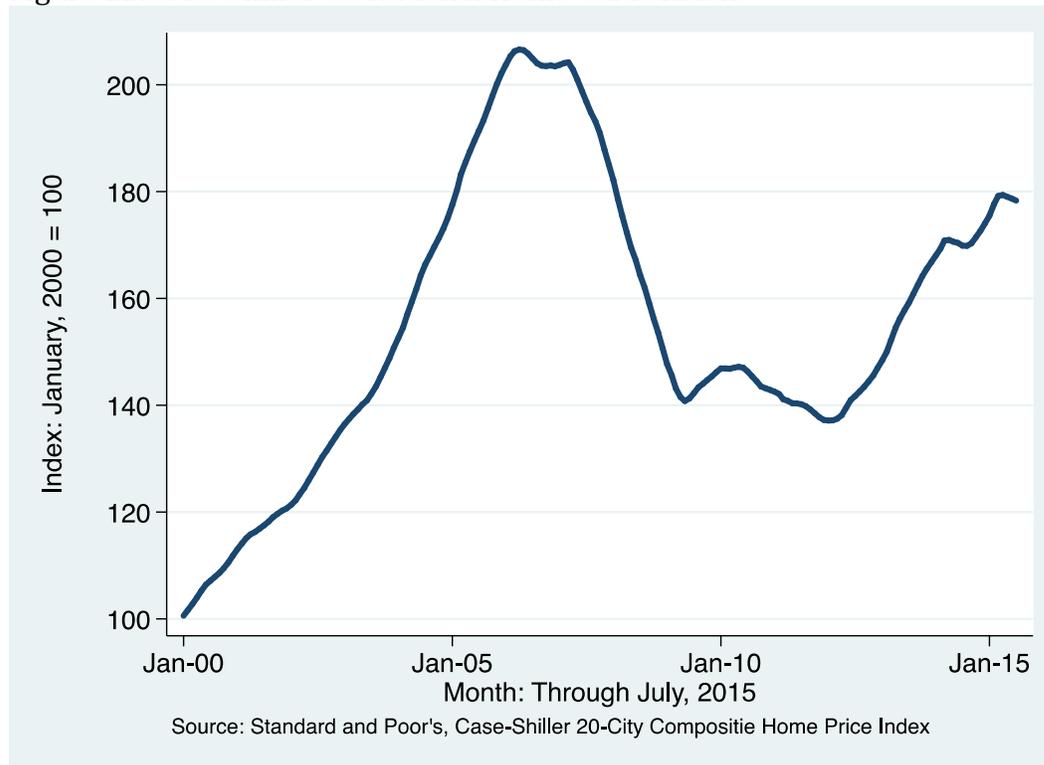


Investments are not made in the face of weak demand for the ultimate product. It is likely that increased inequality has weakened domestic demand in the United States. Concentrating wealth and income in the hands of fewer and fewer people will have this effect. The wealthy simply spend a smaller proportion of their income than do the poor. Give \$1,000 to an impoverished individual and they will likely spend it all. Give \$1,000 to the top 1% and it will likely be saved rather than spent. That this savings drives investment and hence overall economic growth remains a red herring that justifies ambivalence over growing income inequality.

## HOUSING

Between 2006 and 2011, homes in the United States lost an average of 28% of their value instead of the previous estimate of 34%. Regardless, home values are rebounding and have been since 2012. During the middle of 2014, national home prices flattened a bit (Figure 12). The same is happening in 2015, with the expectation that home price appreciation will resume later this year.

Figure 12: Case-Shiller US National Home Value Index

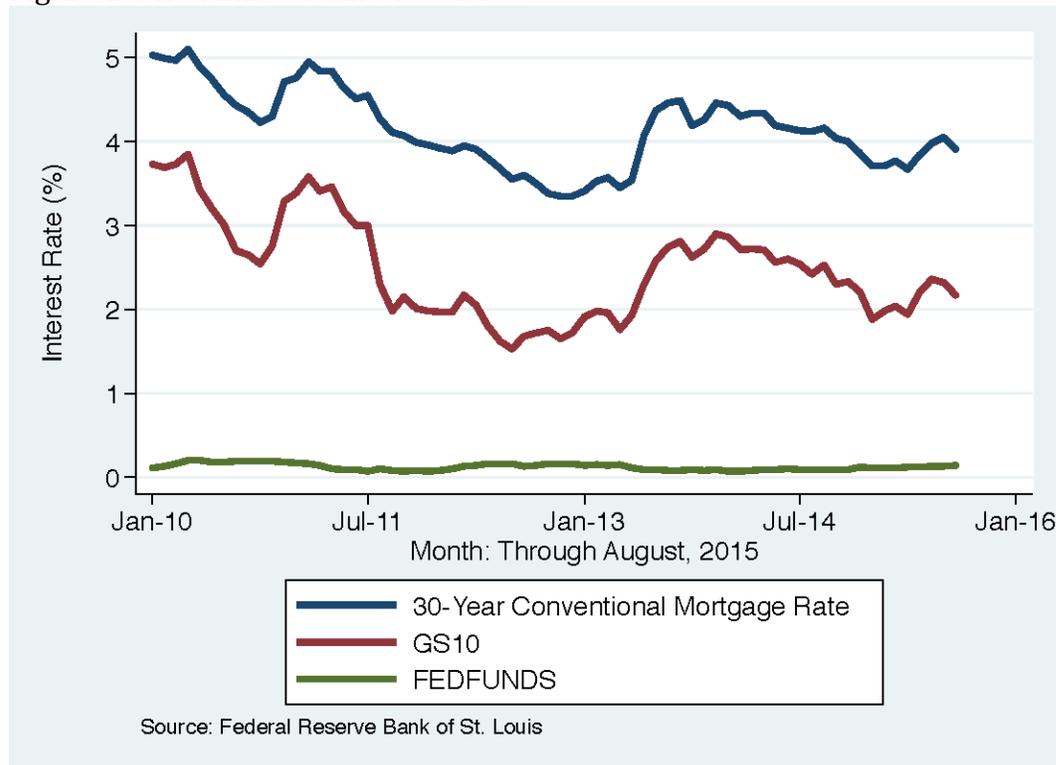


Income and job projections fuel both home building and sales, which makes this index (like the stock market counterpart from which this index originates) a potential way to predict economic cycle fluctuations. The trajectories of interest rates, inflation and consumer spending will also affect housing demand.

### **INTEREST RATES, INFLATION, AND CONSUMER SPENDING**

For yet another year, interest rates remain at low levels. Conventional mortgage rates remain around 4.125% (Figure 13). Notice that early 2015 showed some increase in market interest rates and then both European and Chinese aggression toward interest rates triggered bond buying and yield reductions in the United States. Through these policies, and the Federal Reserve not changing its policy rate (the Federal Funds Rate target, which is currently between 0 and 0.25 percent and has been since December 2008), low interest rates remain the norm for private-sector borrowers, the U.S. Government, and global businesses.

Figure 13: Headline U.S. Interest Rates



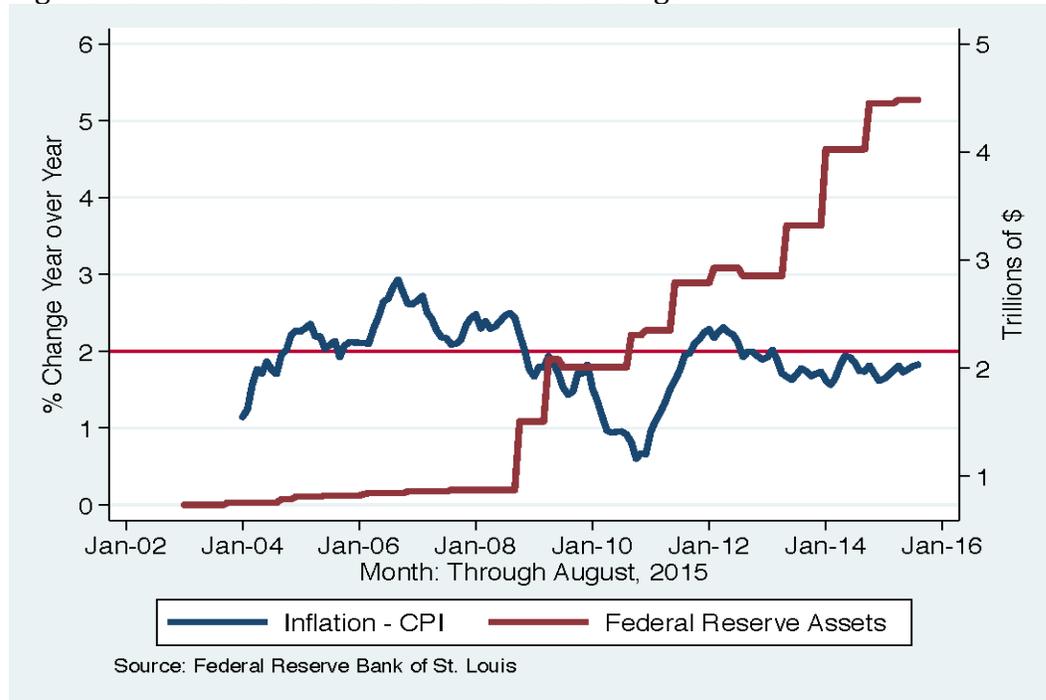
Interest of foreign borrowers in holding U.S. treasuries continues and has accelerated from Asia as the dollar's value has risen and interest rates in other currency areas (mainly the Chinese Yuan and the Euro) continue to fall. A significant development, especially in terms of market perceptions of the Chinese economy, is the flight over summer 2015 of Chinese foreign reserves toward the United States as investments. This pattern seems unlikely to change in the near future, especially if the Federal Reserve raises interest rates quickly.

Despite monetary policy aggression toward low interest rates, inflation remains low (Figure 14). Wage growth has not driven goods prices to rise quickly, and a global commodities glut (connected to global slowdowns in Asia and South America) has stabilized inflation. As a consequence, consumer demand continues to rebound well from the recession, without causing inflation as it might have were the Federal Reserve printing money. For most of the post-recession period, inflation has been at or below 2%, the oft-cited target rate of inflation of the Federal Reserve.

In 2008, the Federal Reserve started paying interest on excess reserves held by banks at the Fed. The excess reserves have correspondingly increased from just under \$2 billion to nearly \$2.4 trillion (Figure 15). So, lending money to consumers has increased, banks have been holding the increased supply of money as excess reserves, thereby avoiding the inflation problem. This is a mix of new regulation concerning how banks hold cash and risk aversion, specifically in business lending. Fiscal policy otherwise, specifically the use of debt to fund federal government

spending, has continued to use low interest rates and worldwide demand for American securities to increase debt. However, the expanding economy and recent austerity measures have reduced the rate of growth in US debt.

Figure 15: Inflation and Federal Reserve Holdings



## GOVERNMENT POLICY

Federal government debt held by the public as a percent of GDP has more than doubled from 35% at the end of 2007 to 75% in 2015 (Figure 16). In 2009, the Federal debt reached a peak of \$1.4 trillion. It fell to less than half of that in 2013 and projections suggest that it will fall by another \$150 billion in 2014.

Recent government spending patterns have slowed down (2011-2014) and then increased again due to defense spending rising. The Federal Government has recently avoided yet another showdown over the debt ceiling and whether to raise it or not, where politics and economics collide. The issue will likely be raised again in December 2015. With a new Speaker of the House of Representatives, uncertainty looms.

Figure 16: U.S. Federal Government Debt



The United States continues to have a debt problem. It is not the primary concern facing policymakers, but we have yet to implement a long term solution. Borrowing today to fund infrastructure and to make other investments in our economic future makes good sense, with interest rates this low. Government borrowing has the potential to crowd out private-sector borrowing and concerns about the long-term sustainability of current fiscal policies remains. In time, though the United States is never likely to default on its debt, markets may come to fear such an outcome, making continued borrowing more expensive.

## **Into 2016**

As 2016 approaches, global forces are providing some headwinds on the US economy. The US economy has grown for seven years, though some quarters and years have been negative or slower than trend as exceptions. 2015 is ending on a curious note; financial markets are volatile due to multiple forces (Federal Reserve indecision, China's questionable economic growth, and European issues that have persisted since 2010), but job and income growth continue forward.

Forecasts in the 3 percent range of real, annualized growth of gross domestic product (GDP) trigger other, sanguine forecasts. Employment will continue to grow, and unemployment to fall. Financial markets, assuming interest rates do not rise outside expectations – which would have a detrimental effect on current GDP forecasts also – are predicted to remain at historically high levels. Wealth and income growth are also expected to rise, which may affect income inequality and poverty levels if wages and salary growth are not balanced across industries and jobs categories.

Expectations for labor markets likely include some flattening of employment growth, with wage pressures remaining weak; slack labor persists and the unemployed may be hidden in short-term contracts and other work not counted easily in payroll employment data.

Presidential elections in the United States may provide another headwind over the next year, even if Europe and Asia provide more global growth after larger fiscal and monetary stimulation. Uncertainty over fiscal policy will grow with a new administration coming into the White House in early 2017. Businesses and workers may keep an eye on Washington and on their pocket books if no obvious frontrunner emerges. This adds to financial and job uncertainty, but in a low interest rate environment as compared to 2008 and 2000.