

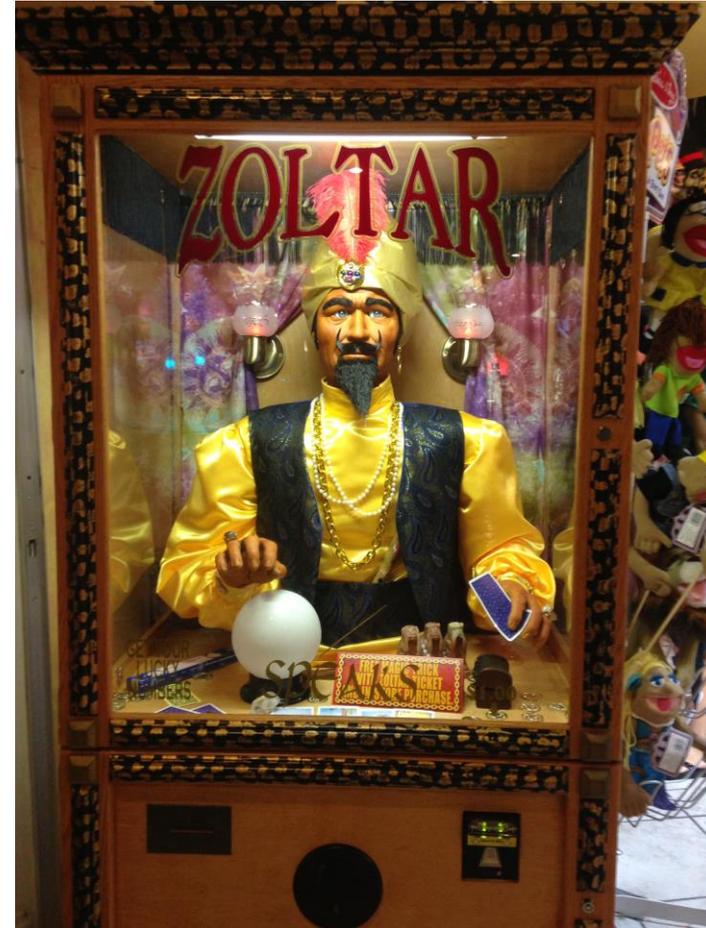
Dallas Association  
for Business Economics

## US economic outlook

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**June 16, 2016**



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The US forecast:

Where's the party?

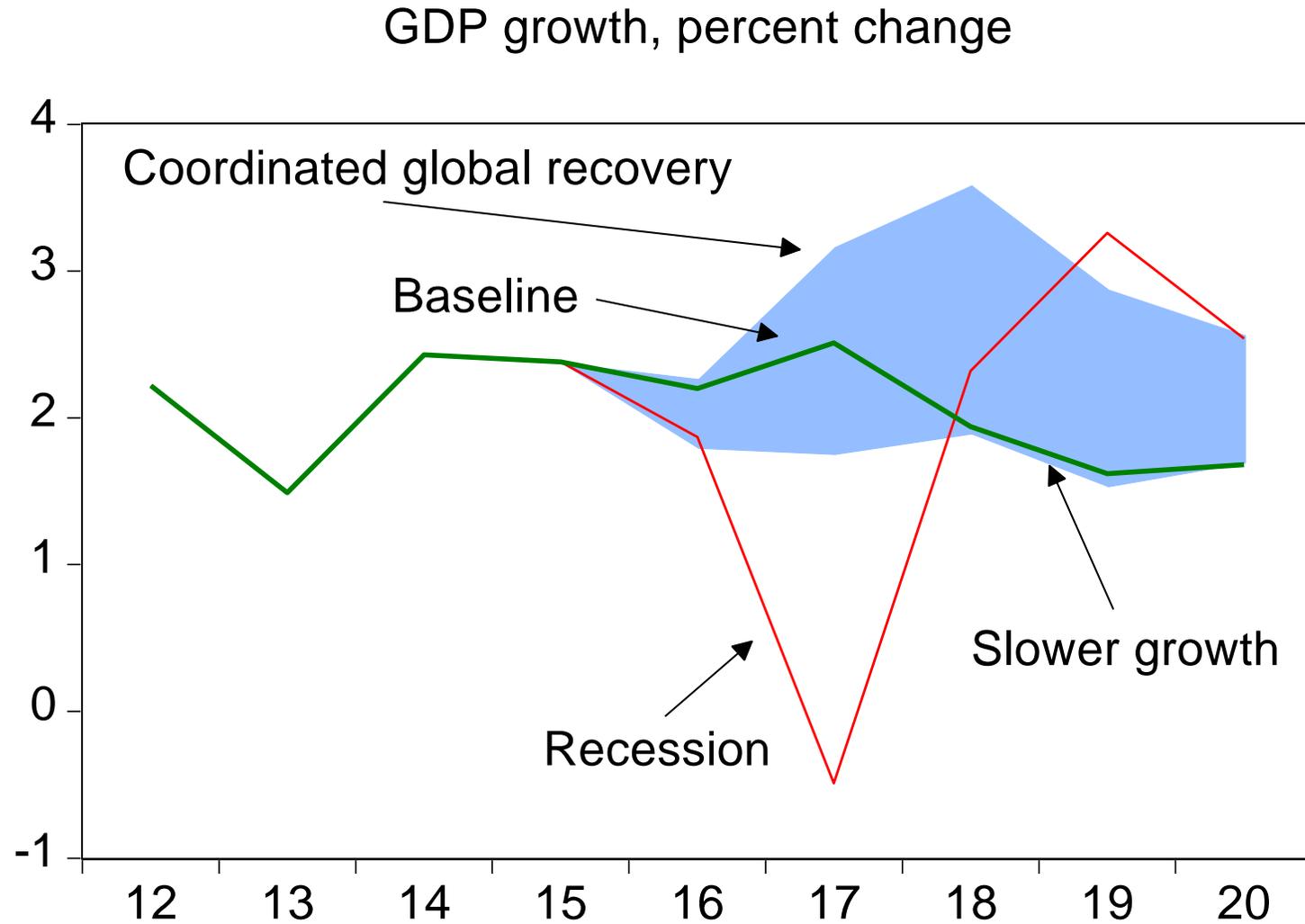
# William McChesney Martin, Fed Chairman, 1950-1971

“The Fed’s job is to take away the punch bowl just as the party gets going”



But somebody forgot to spike the punch.

# The key to understanding forecasts is thinking in probabilities.



Source: Deloitte/Oxford Economics

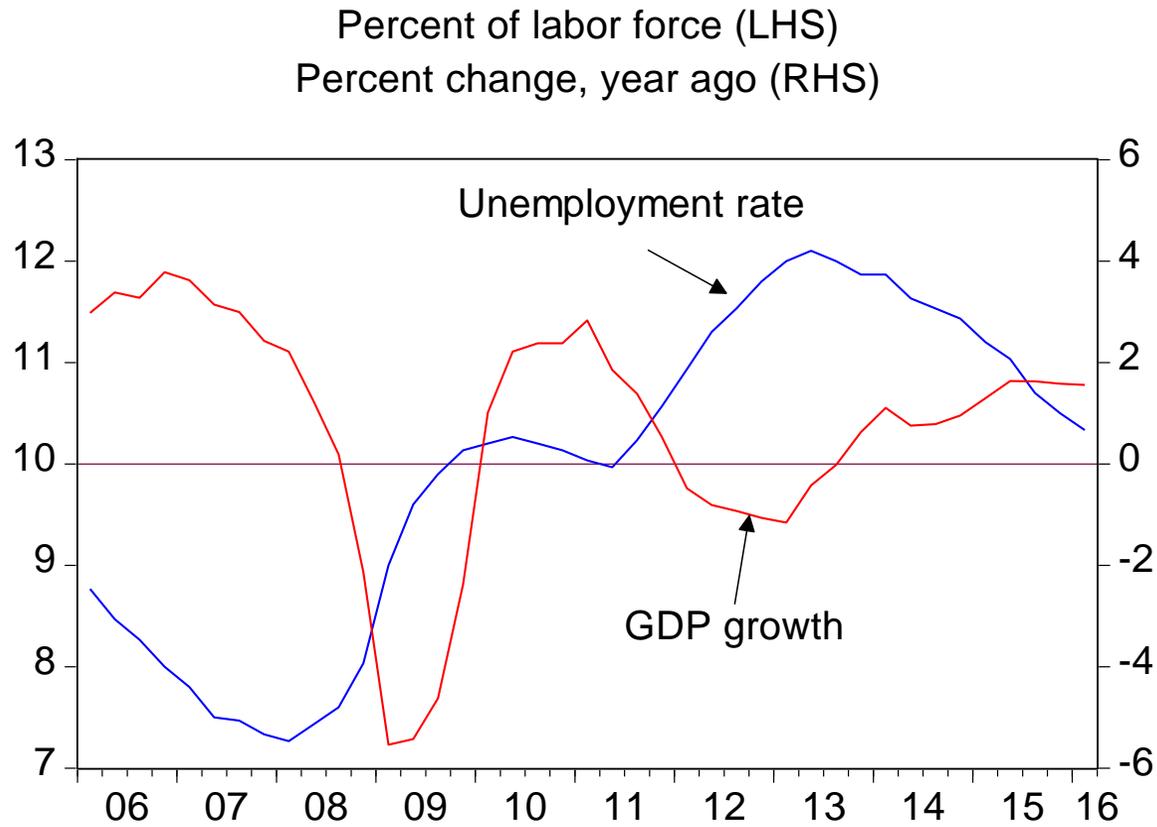
# Four alternatives

1. **The baseline:** Growth will remain at the 2.5% level before slowing to below 2.0% by 2018. 55%
2. **Slower growth:** Headwinds start pushing unemployment up. Growth remains below 2.0% 25%
3. **Recession:** Chance of a financial shock in Europe or China. How do we know banks aren't exposed to risk? How do they know? 5%
4. **Coordinated global boom:** Europe and China are on their way to fixing their problems. So is the U.S. 15%



Headwinds

# Headwind #1: European growth



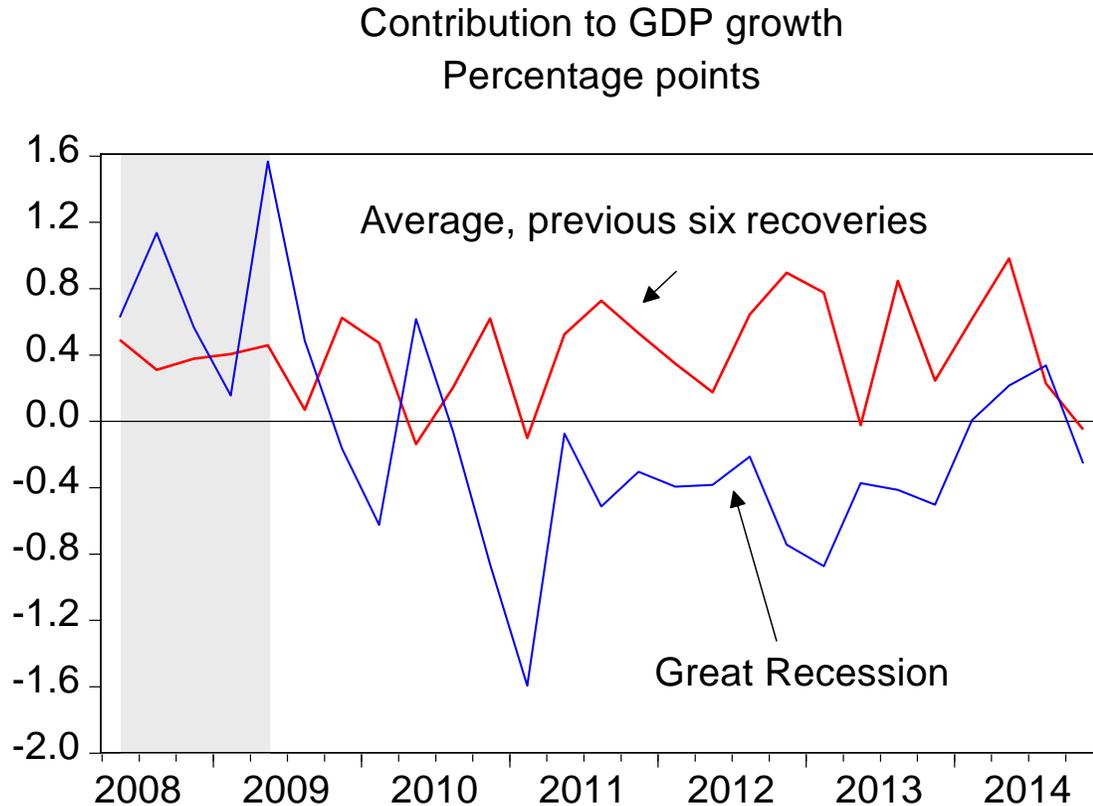
Source: Eurostat/Haver Analytics



Europe's unemployment rate is still substantially above the level before the Great Recession.

- **Headwind #2: Government spending has been subtracting from growth.**

- On average, government spending subtracted 0.7 percentage points from GDP growth each year from 2010 to 2014.
- Had government spending grown at a rate similar to that of previous recessions, we would have seen +3% growth for several years.

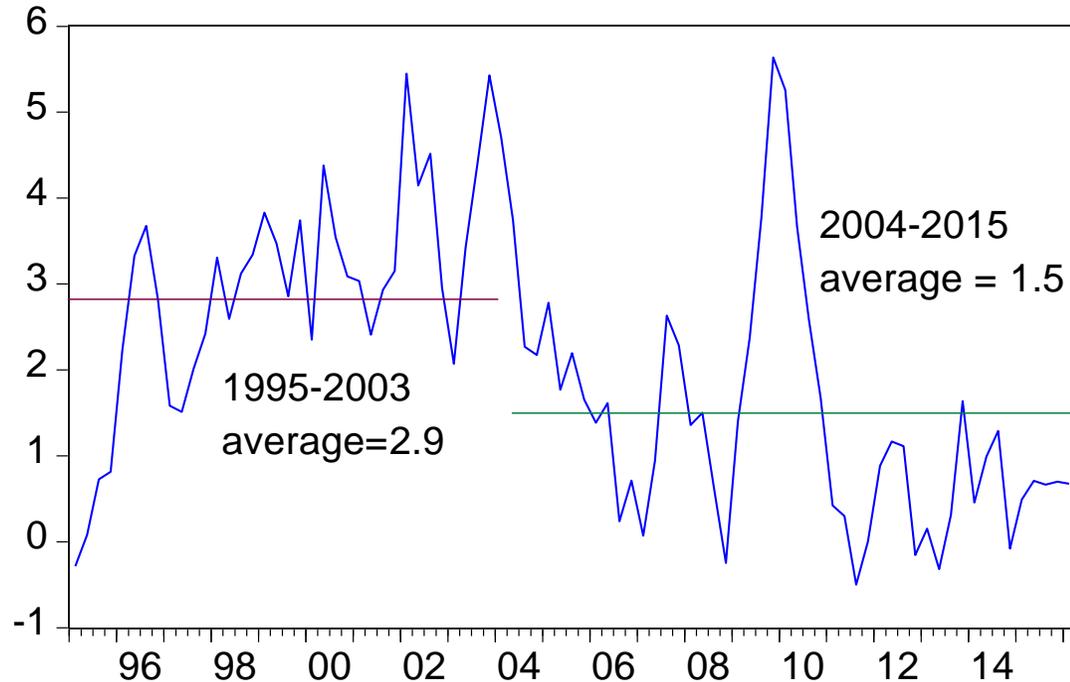


Source: BEA/Haver Analytics



# Headwind #3: Productivity growth has slowed.

Output per hour, business sector  
Percent change, year ago



Source: BLS/Haver Analytics

Researchers date the slowdown to 2003. And since 2009, average productivity has been below 1.0%.

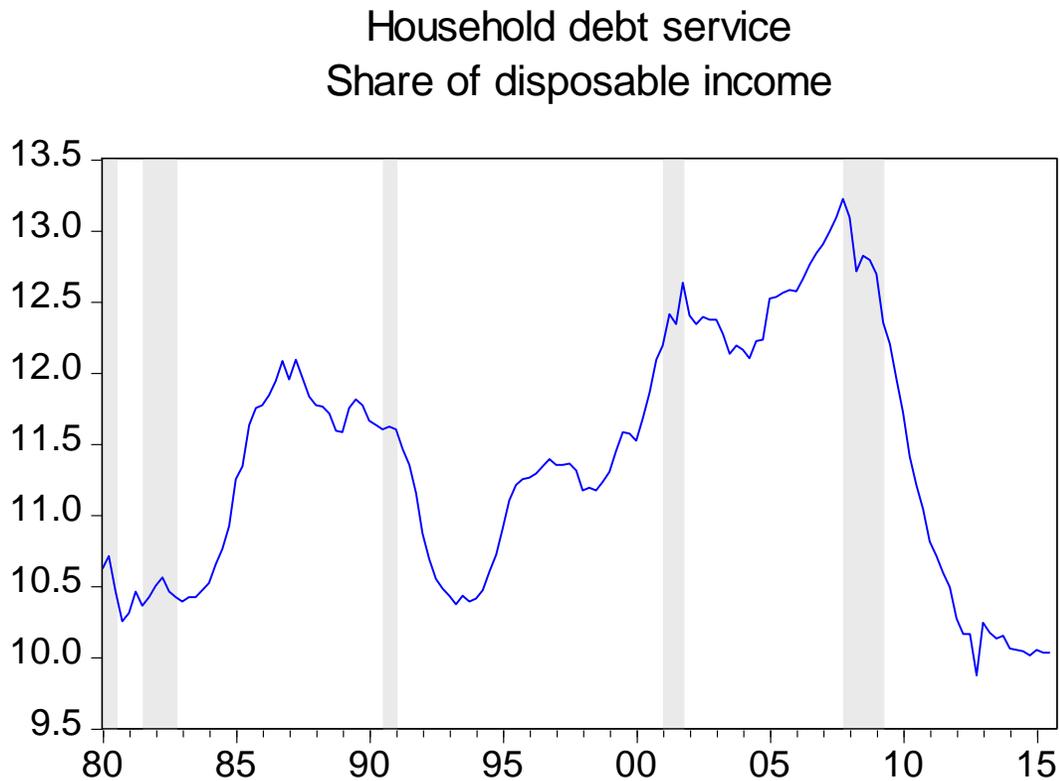
That has kept potential GDP much lower than if productivity growth had continued at the 1995-2003 rate.



Now for some good news

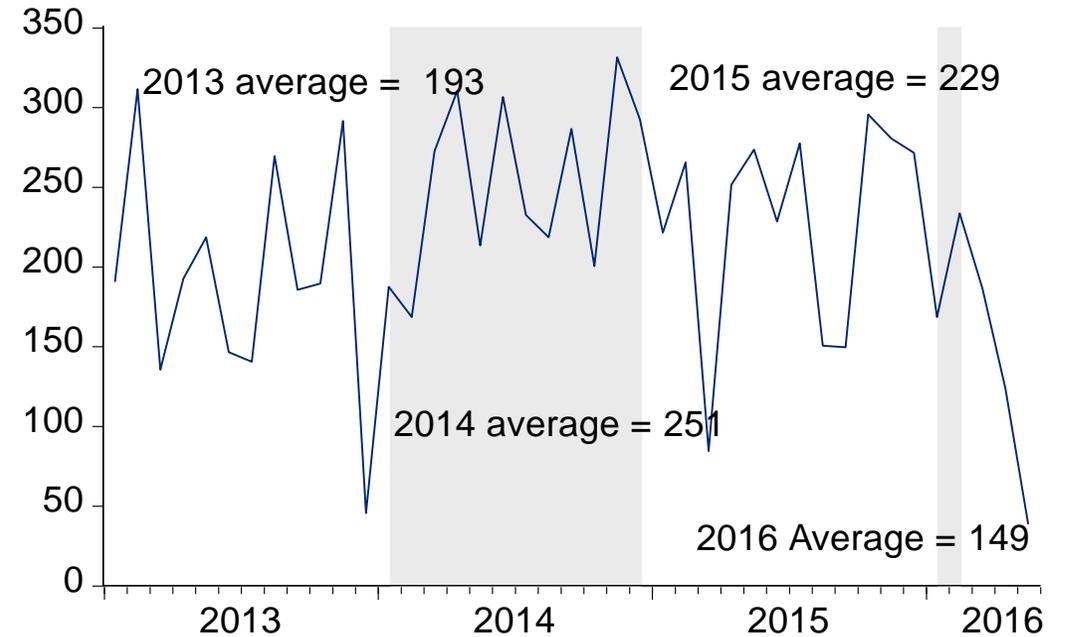
# Households are in better shape than they've been in a long time.

The household debt burden is at its lowest point ever.



Source: Federal Reserve/Haver Analytics

Change in establishment employment  
Thousands of jobs



Source: BLS/Haver Analytics

But there might be signs of  
weakness in the labor market.

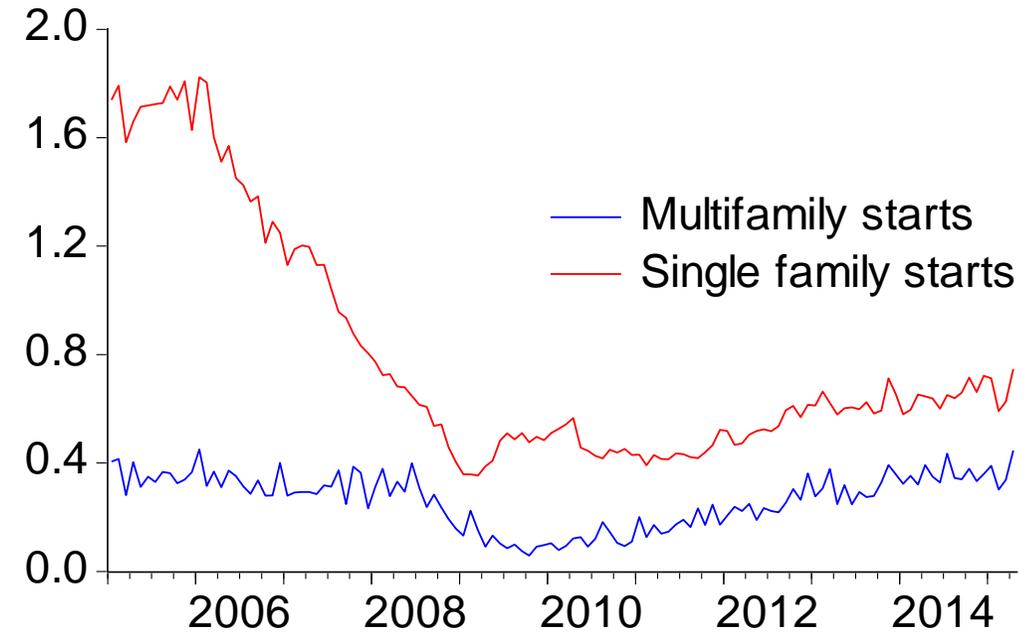
# Housing is picking up, but still not that strong.

Lots of unanswered questions here.

- How much housing do we need? And what type?
- How important are credit restrictions—and how should policymakers react?
- Why would anybody invest in a 30-year mortgage? Do we need a new housing finance paradigm?



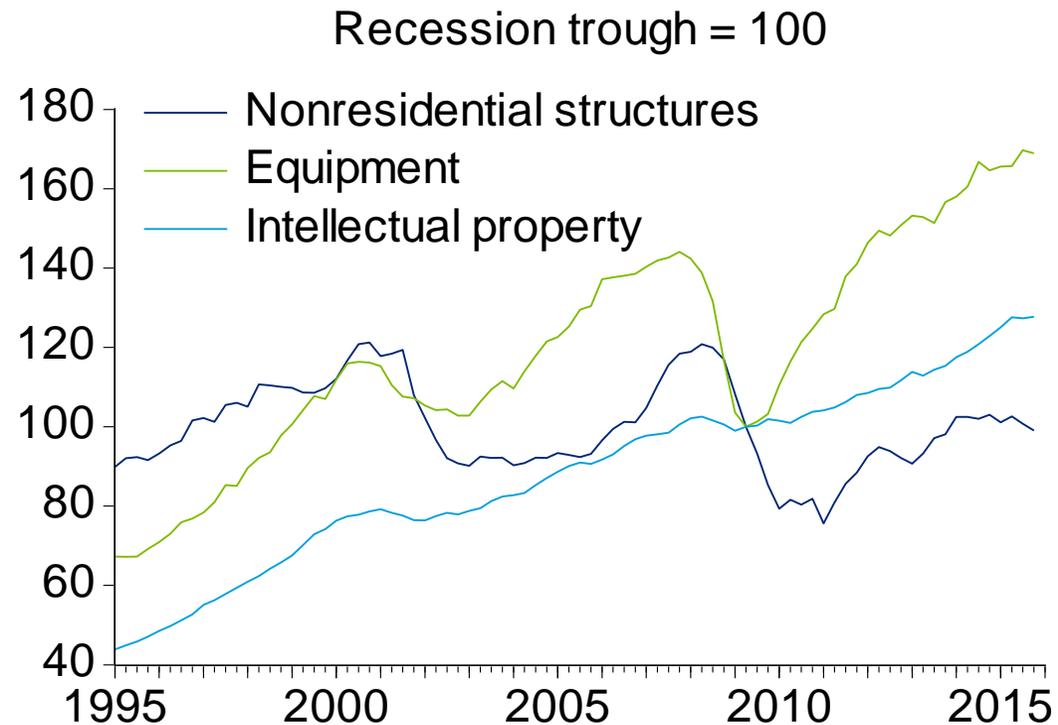
Housing starts by type  
Millions (annual rate)



Source: Census/Haver Analytics

# Equipment and intellectual property investment above pre-recession levels

Structures are a special case—the sector haven't really grown since 1980.



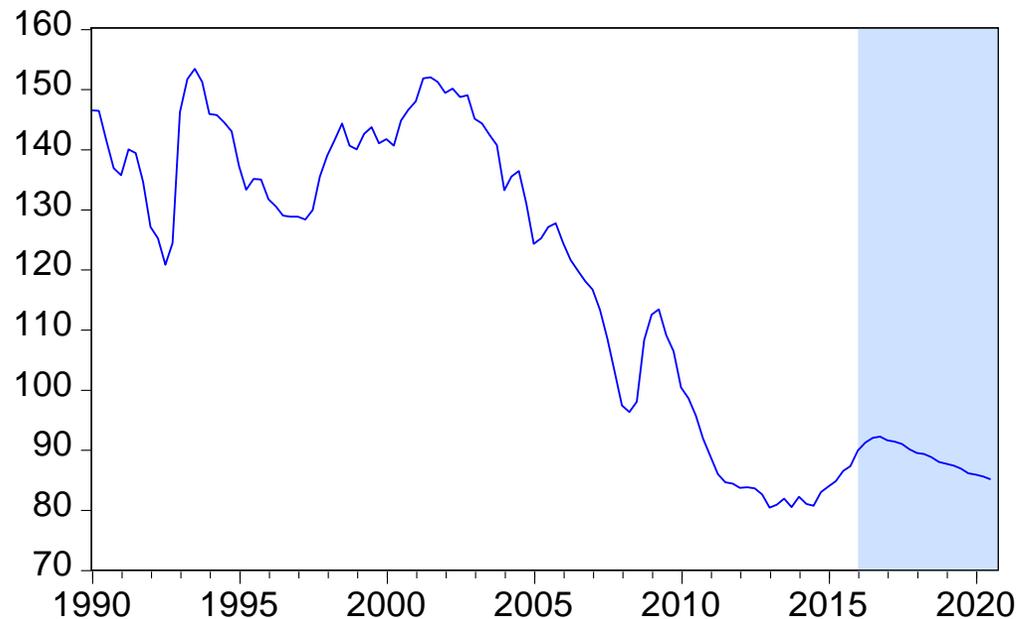
Source: BEA/Haver Analytics

Equipment and software investment is most likely to embody new technology and indicate future productivity growth.



# US competitiveness presents a short-term problem, but a long-term opportunity.

US labor costs relative to foreign labor costs  
2008 = 100



Source: Deloitte/Oxford Economics

## Why a problem?

- Dollar's role as the global safe currency.

## Why an opportunity?

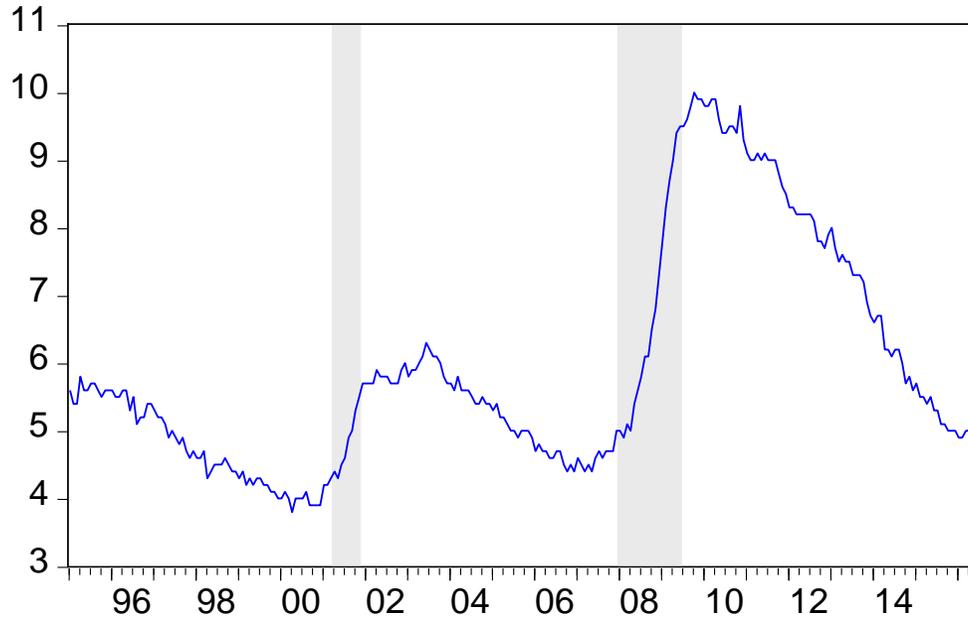
- High productivity.
- Cheap energy.
- Recovery abroad (we hope).

But...weakness in China and especially in Europe is pushing up the dollar.

# Labor markets

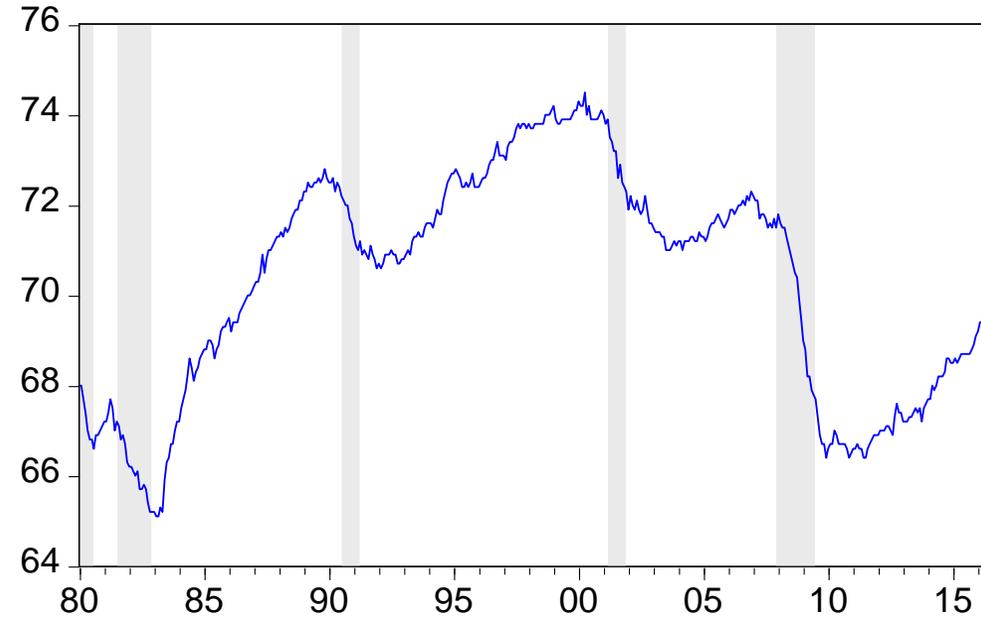
# The low unemployment rate hides labor market slack.

Unemployment rate  
Percent



Source: BLS/Haver Analytics

Employment rate, 16 to 64 years  
Percent

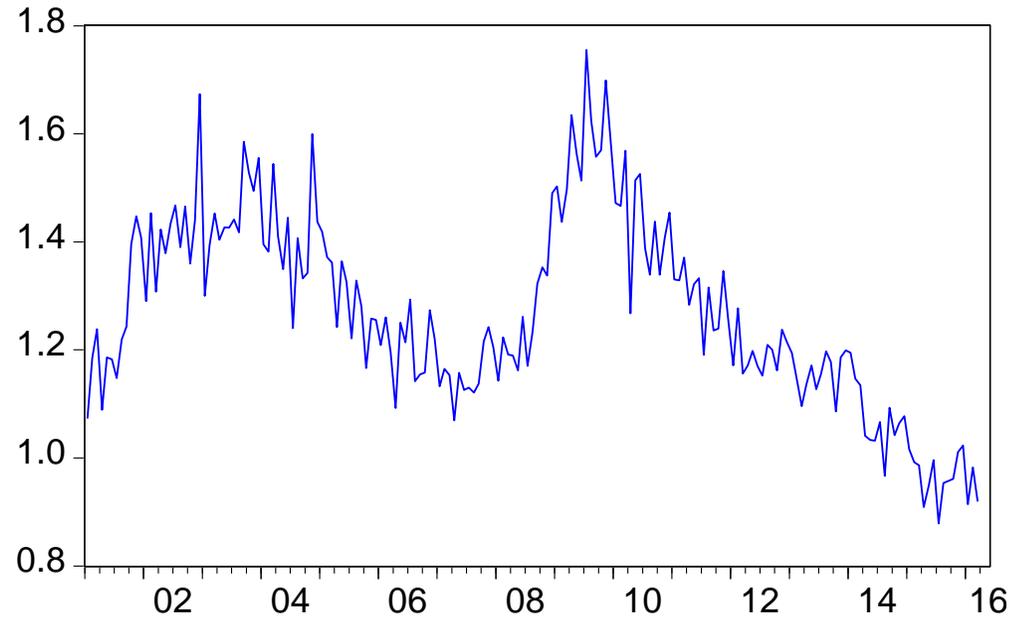


Source: BLS/Haver Analytics

Although the unemployment rate suggests that labor market conditions are tight, the low participation rate points to considerable potential excess labor.

# Are there signs of a skills mismatch?

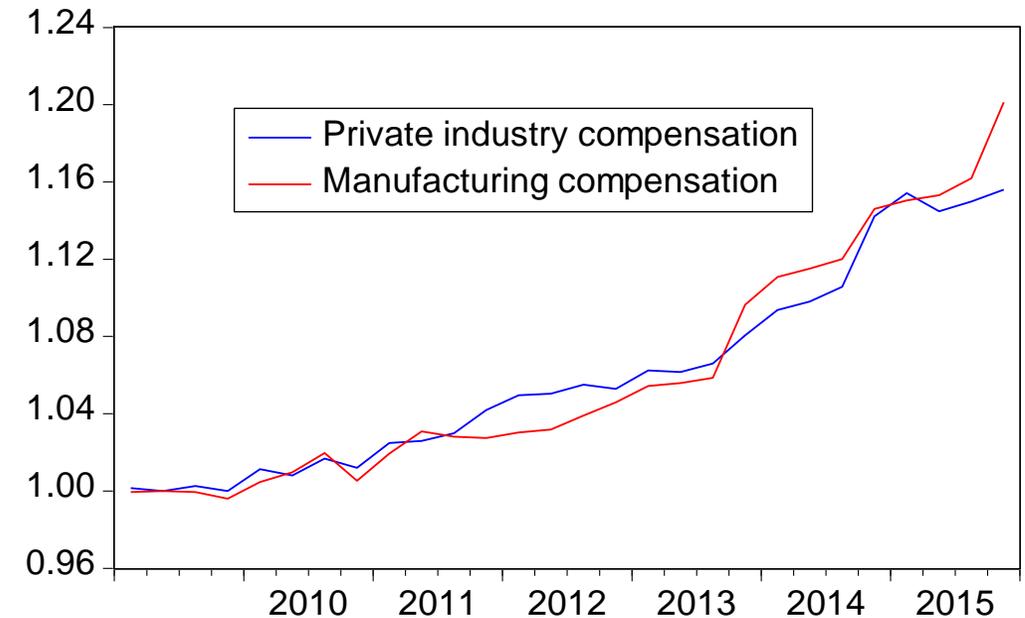
Hirings to openings ratio



Source: BLS/Haver analytics

Until recently, not a lot of evidence.  
But if the recent rise in  
manufacturing labor costs  
continues...

Employer costs for employee compensation  
2009q2 = 1

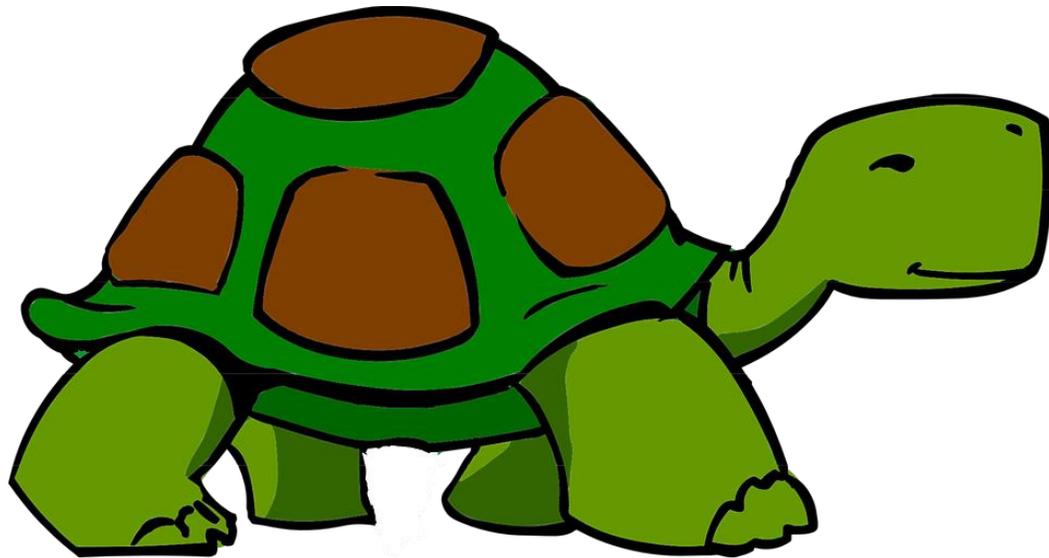


Source: BLS/Haver Analytics

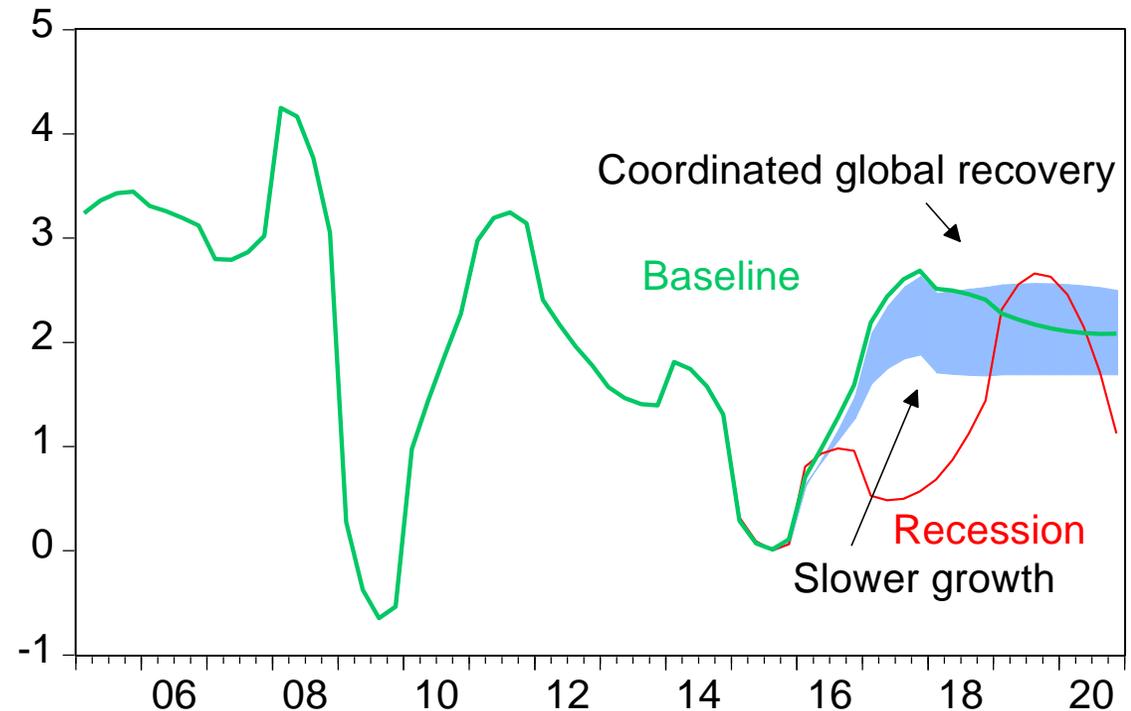
Inflation?

# Not much to worry about here.

The range is 1.7% to 2.4% over the next few years.

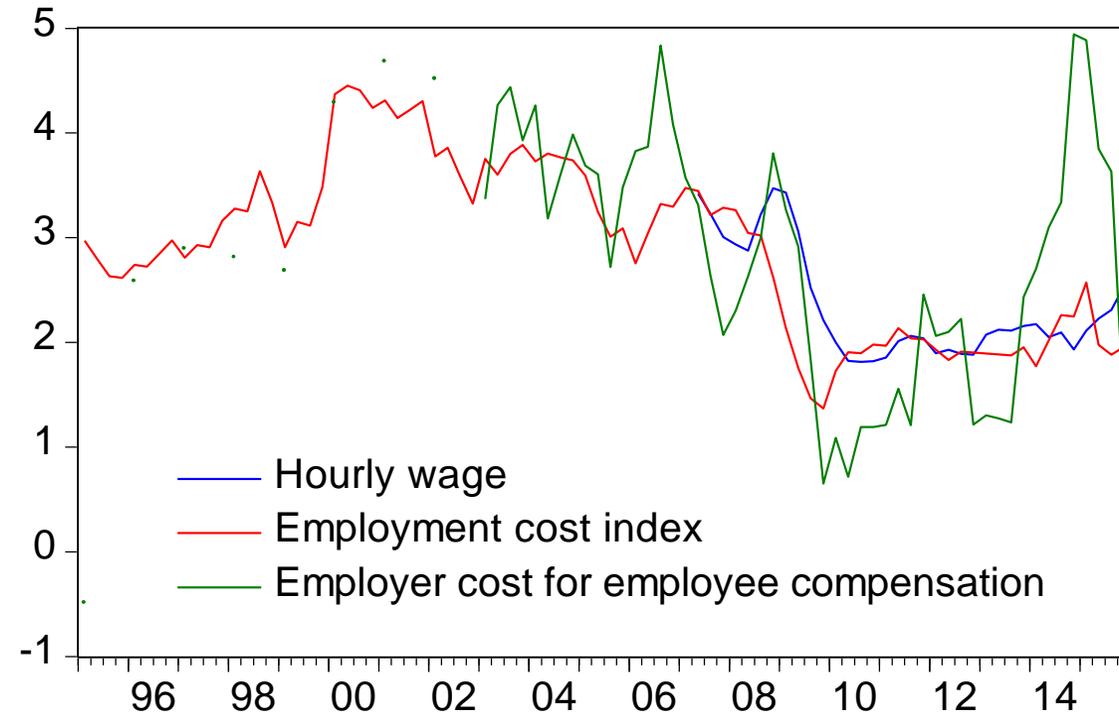


CPI growth in four scenarios  
Percent change



Source: Deloitte/Oxford Economics

## Labor costs are still flat.



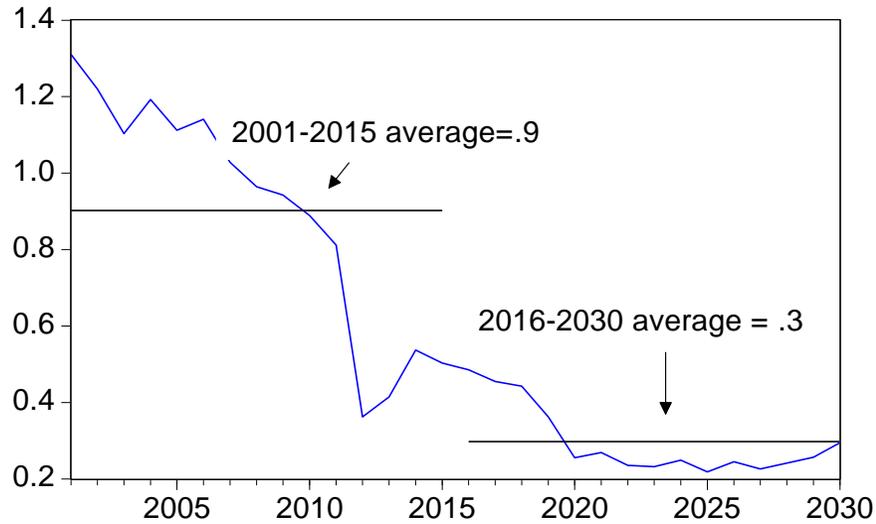
Source: BLS/Haver Analytics

Why the big jump in employer cost? The difference between this measure and the others seems to be bonuses...possibly in the financial sector.

The long run

# Long run growth is a matter of population and productivity.

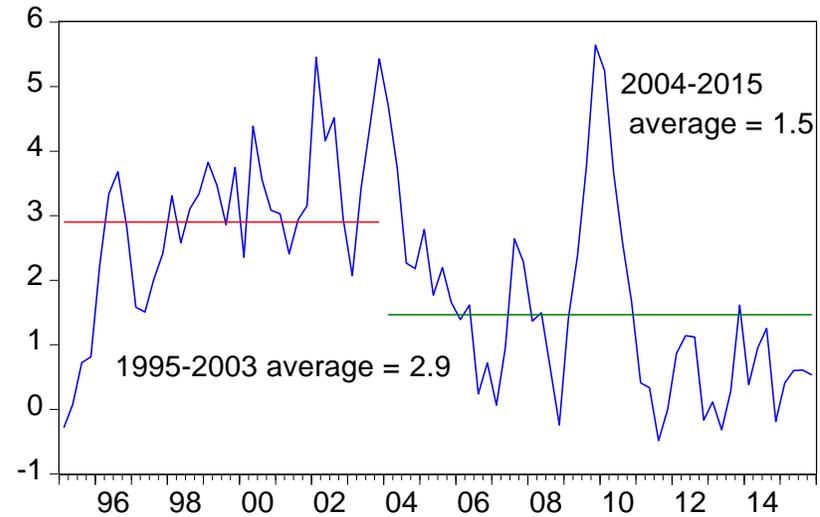
US working age population growth rate  
Percent



Source: Census/Haver Analytics

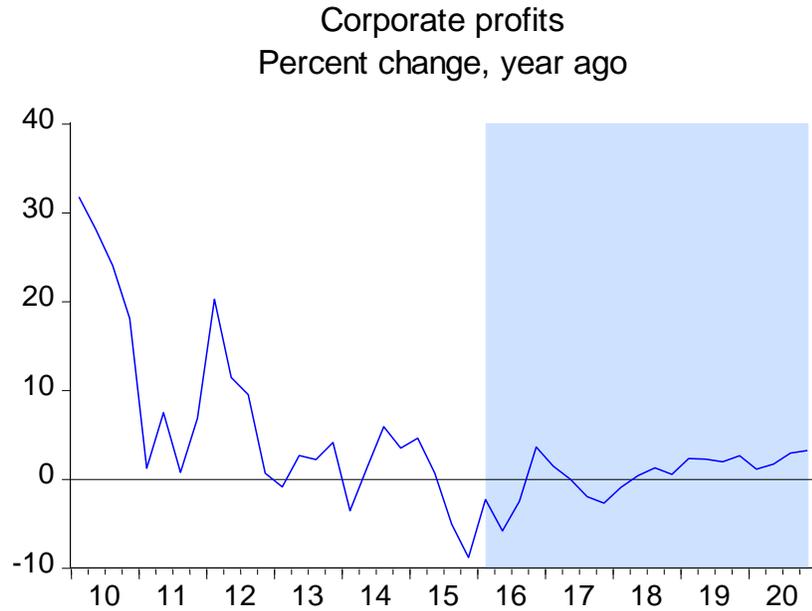


Output per hour, business sector  
Percent change, year ago

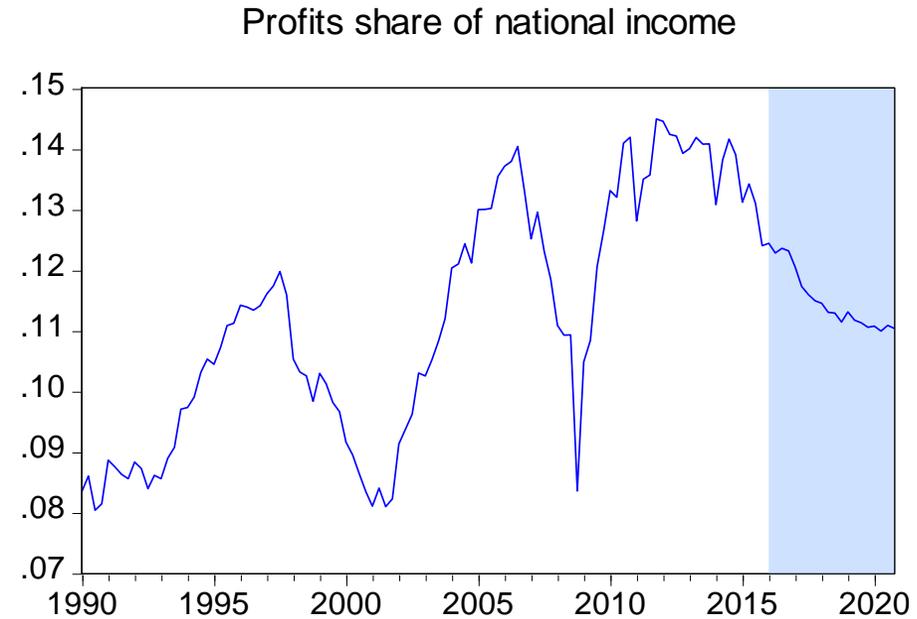


Source: BLS/Haver Analytics

# There are limits to profit growth.



Source: Deloitte/Oxford Economics



Source: Deloitte/Oxford Economics

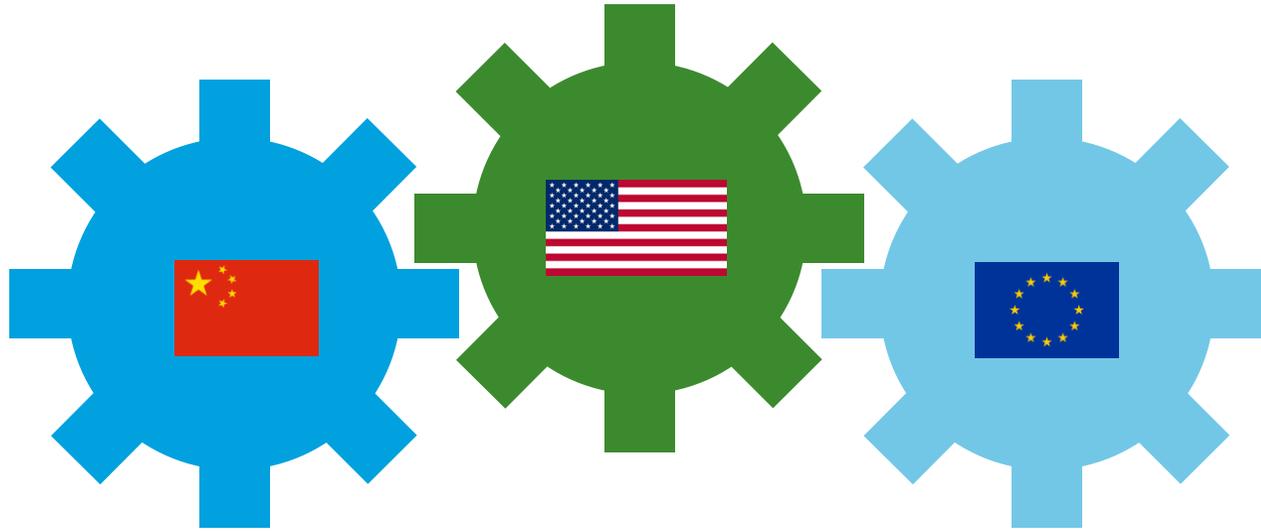
Profits should be set to grow at a satisfactory rate for the next few years. But don't be surprised if labor begins to regain its share of national income in a healthy economy.



The global economy: Can't anybody here play this game?



# Drivers of the global economy.



# To grow or not to grow? Europe is experiencing a Hamlet recovery.

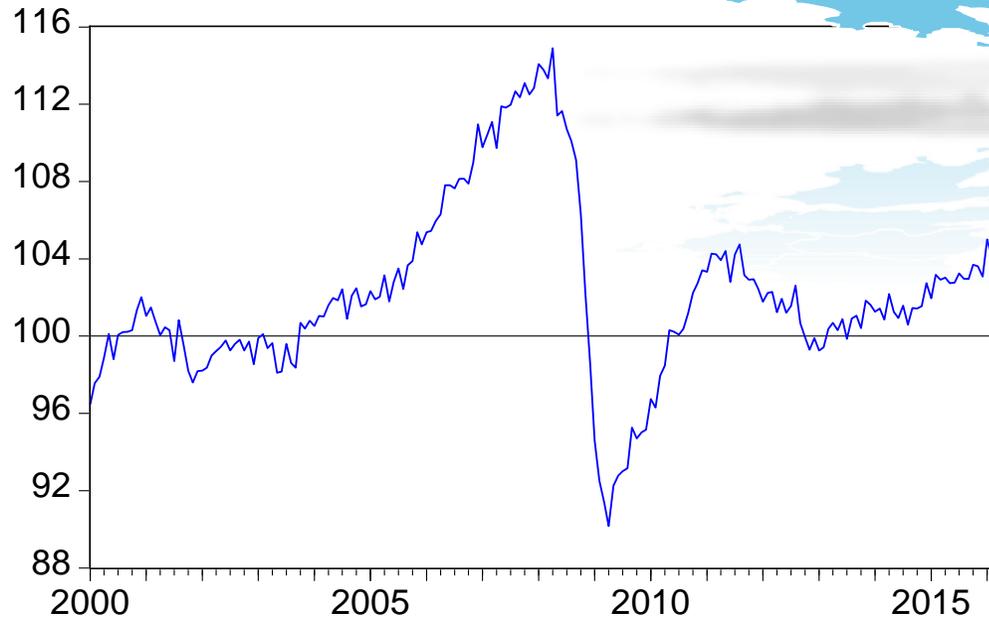


Source: Esri, DeLorme Publishing Company, Inc.  
Projection: World Gall Stereographic



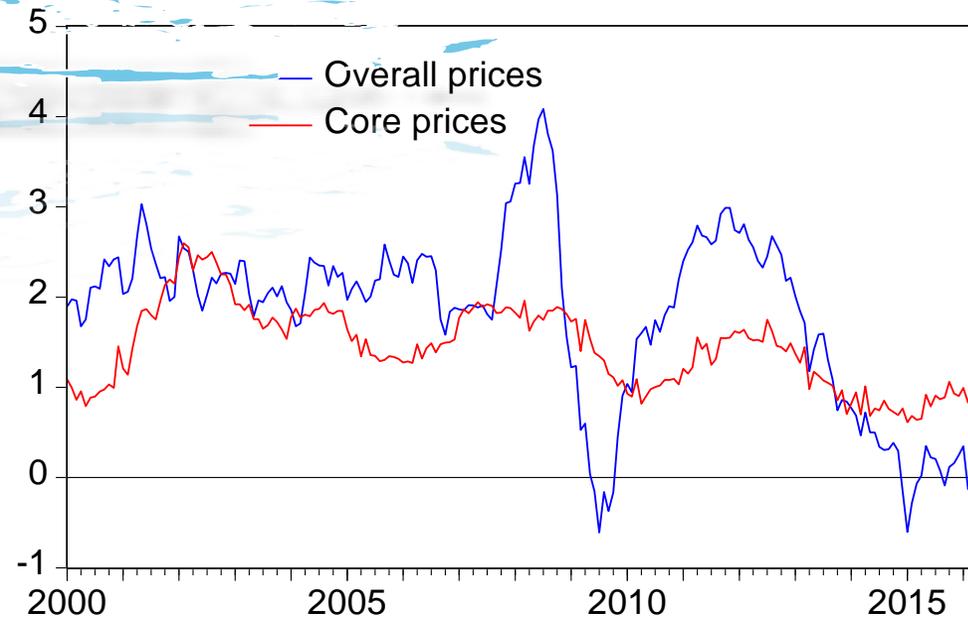
# Something's casting a shadow over Europe.

Eurozone industrial production  
2010=100



Source: Eurostat/Haver Analytics

Eurozone inflation  
Percent change, year ago

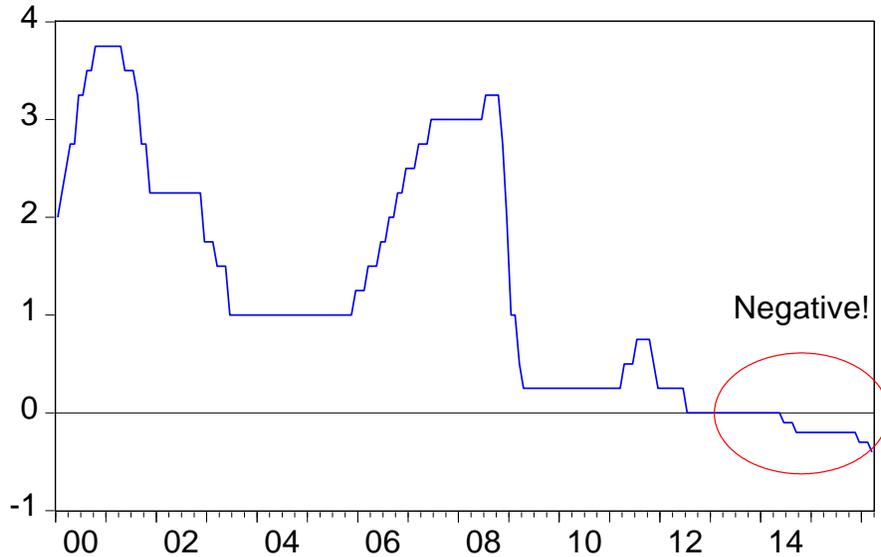


Source: ECB/Haver Analytics

# The ECB brought out the big bazooka...

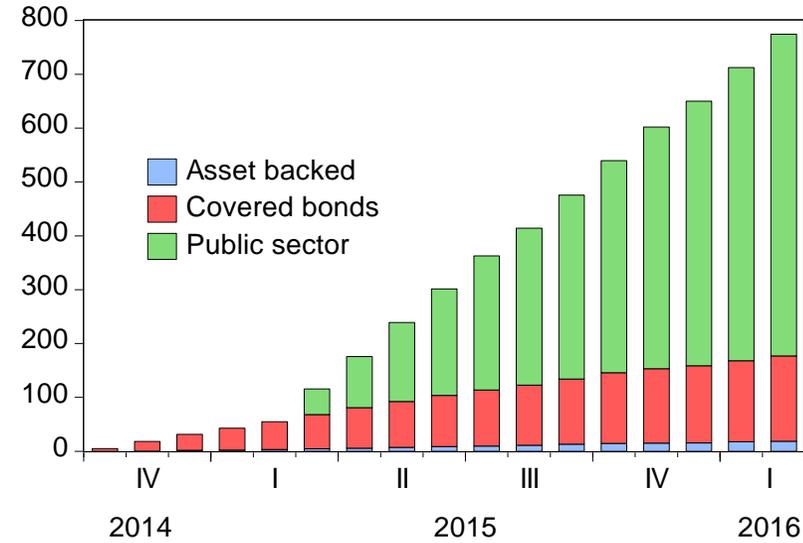
Or the “hail Mary pass.”

ECB deposit rate  
Percent



Source: ECB/Haver Analytics

ECB Asset Holdings  
Billions of euros



Source: ECB/Haver Analytics

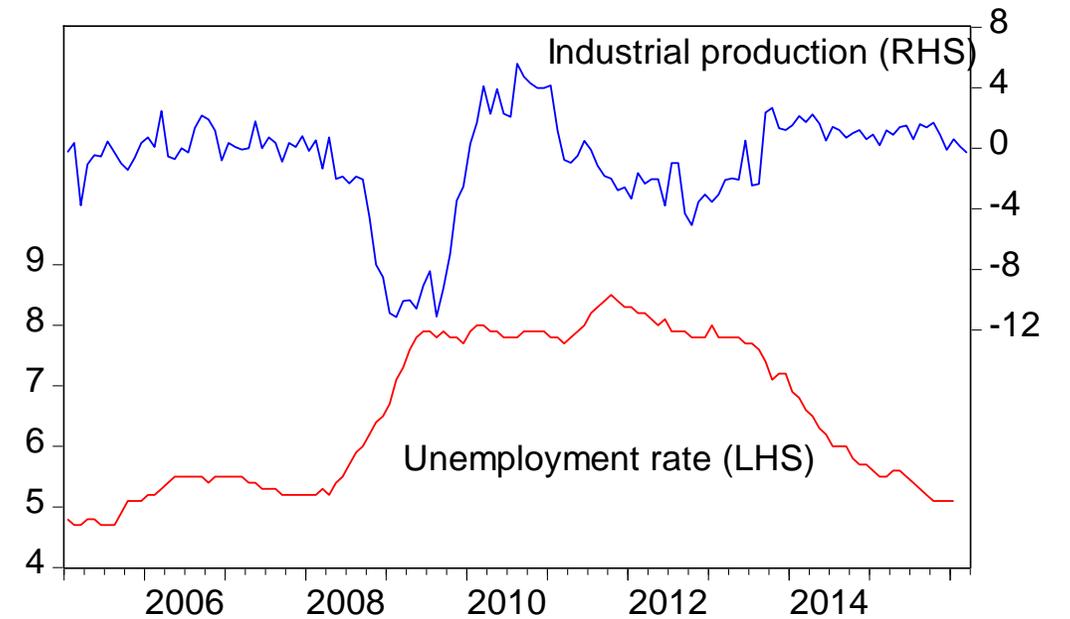


Or maybe they need a European metaphor?

# Another source of European risk (as if there wasn't enough).



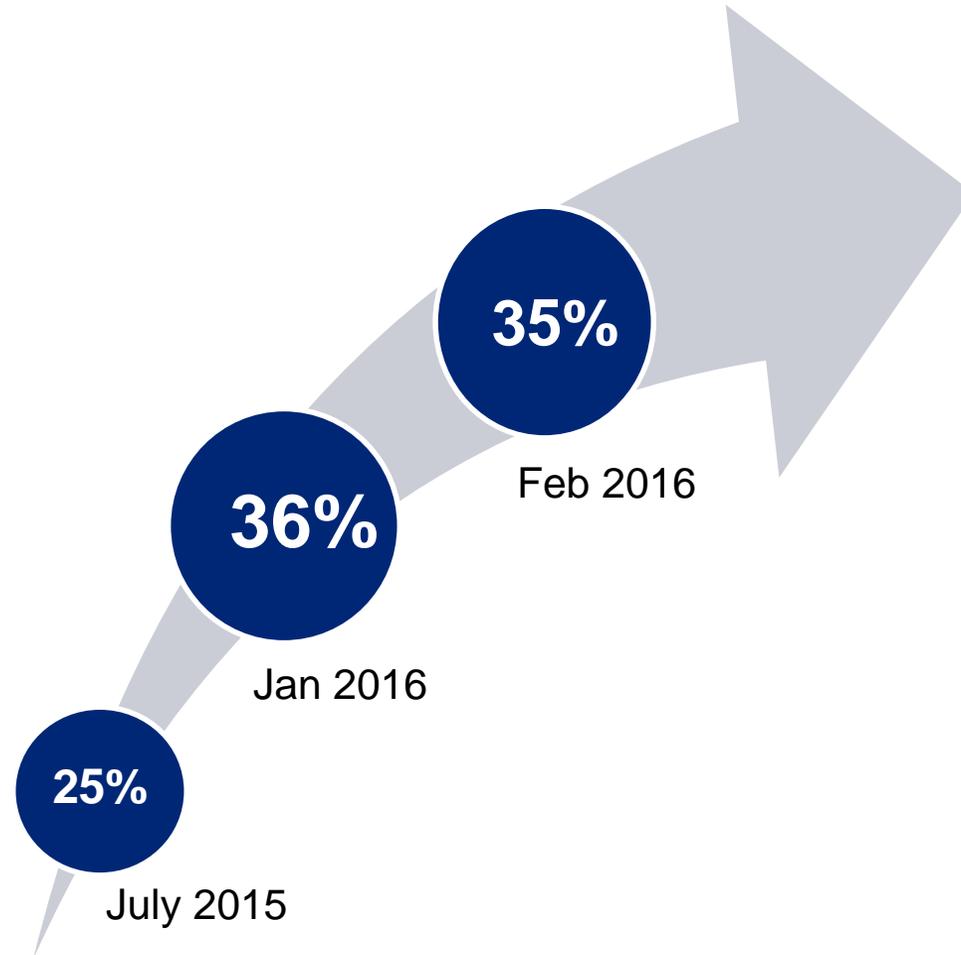
UK Economy  
Percent of labor force (LHS) and percent change year ago (RHS)



Source: Office of National Statistics/Haver Analytics

# Odds of Brexit are non trivial.

Implied probability of Brexit, based on PaddyPower political betting odds.



**Boris Johnson signs up for Leave**

**PM's renegotiation; date set for 23<sup>rd</sup> June**

**European migration crisis: EU support falls**

**May General Election: confirms referendum will take place**

# Are China's problems finally showing up the country's economic performance?

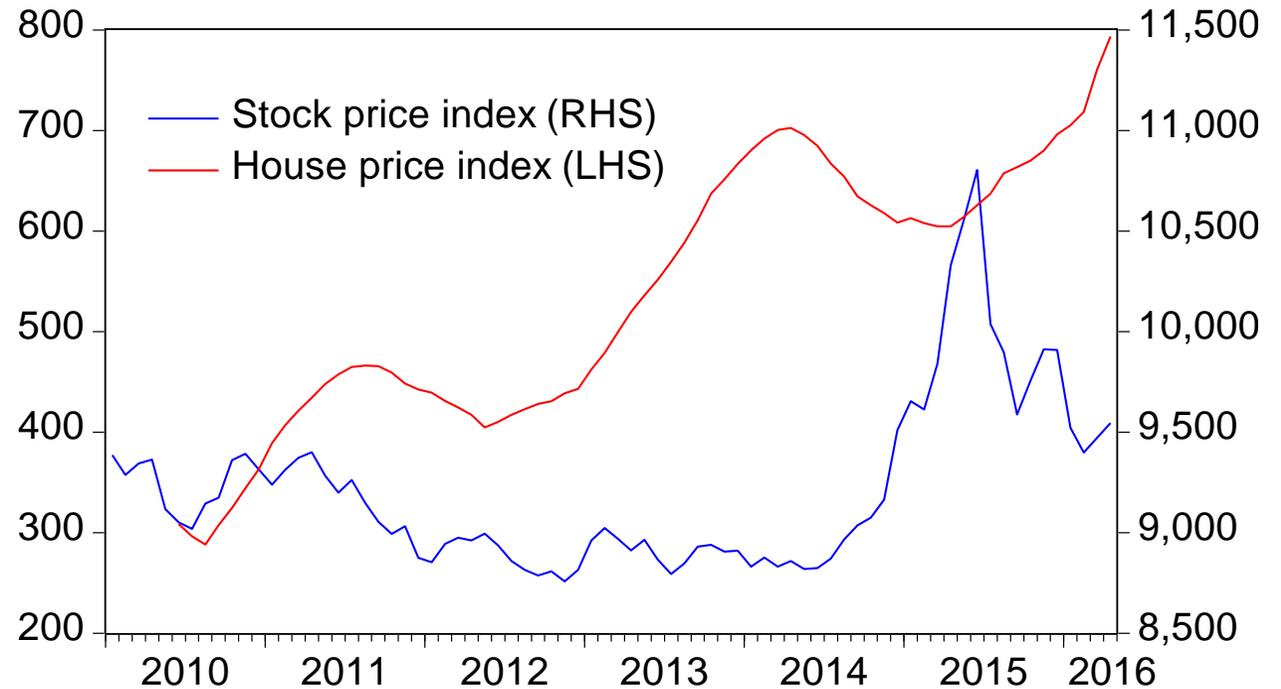


As the real estate bubble subsided, the stock market bubble took its place.

Bubbles do what bubbles gotta do...burst!



Chinese asset price indexes  
Dec 31 1993 = 100 (LHS) and Yuan/Sq. Meter (RHS)

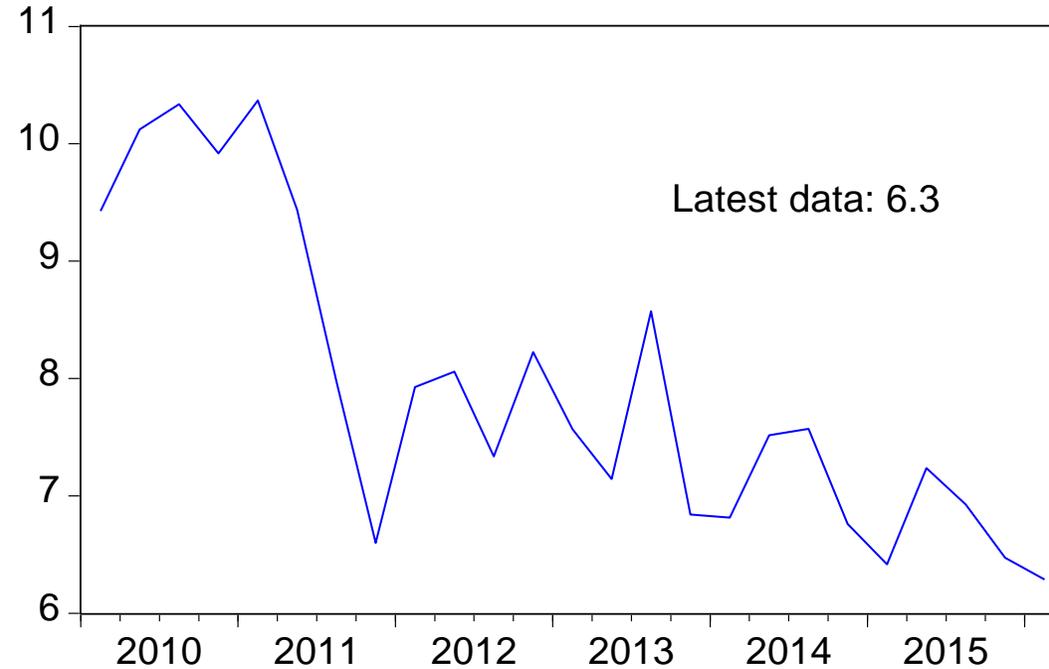


Source: Wall Street Journal and China Index Academy/Haver Analytics

# Growth looks to be slowing.



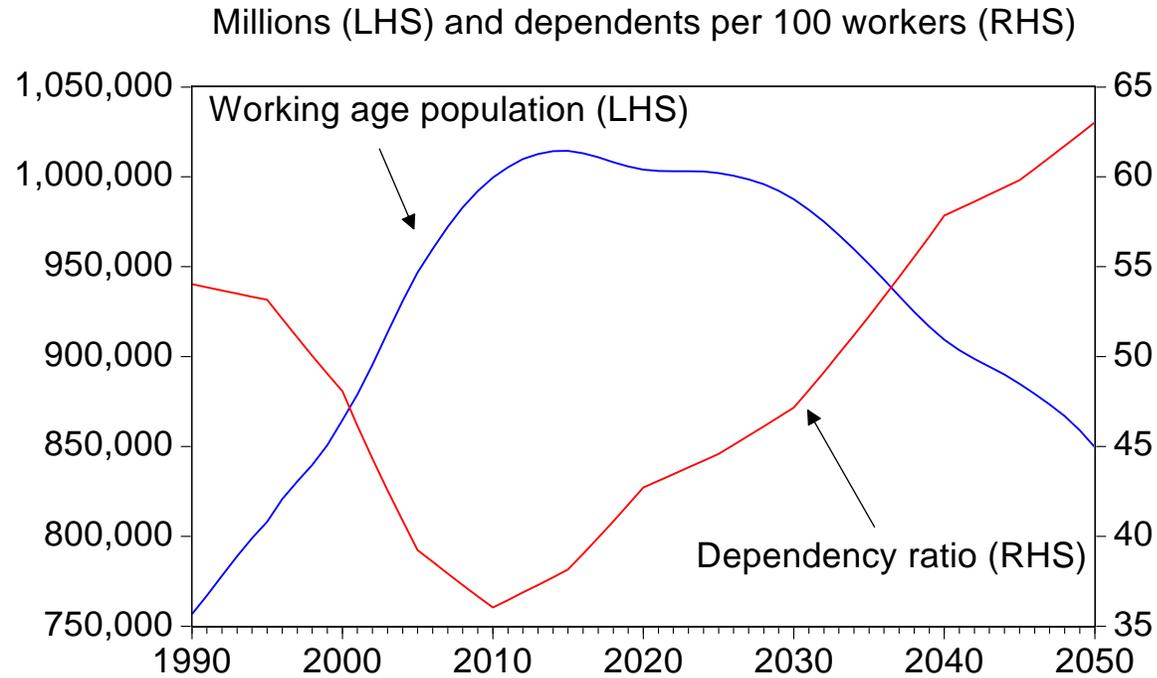
Chinese GDP  
Percent change, annual rate



Source: China National Bureau of Statistics/Haver Analytics

Chinese authorities are caught between keeping growth up and preventing more overinvestment.

# China's Long-Term Demographic Problem

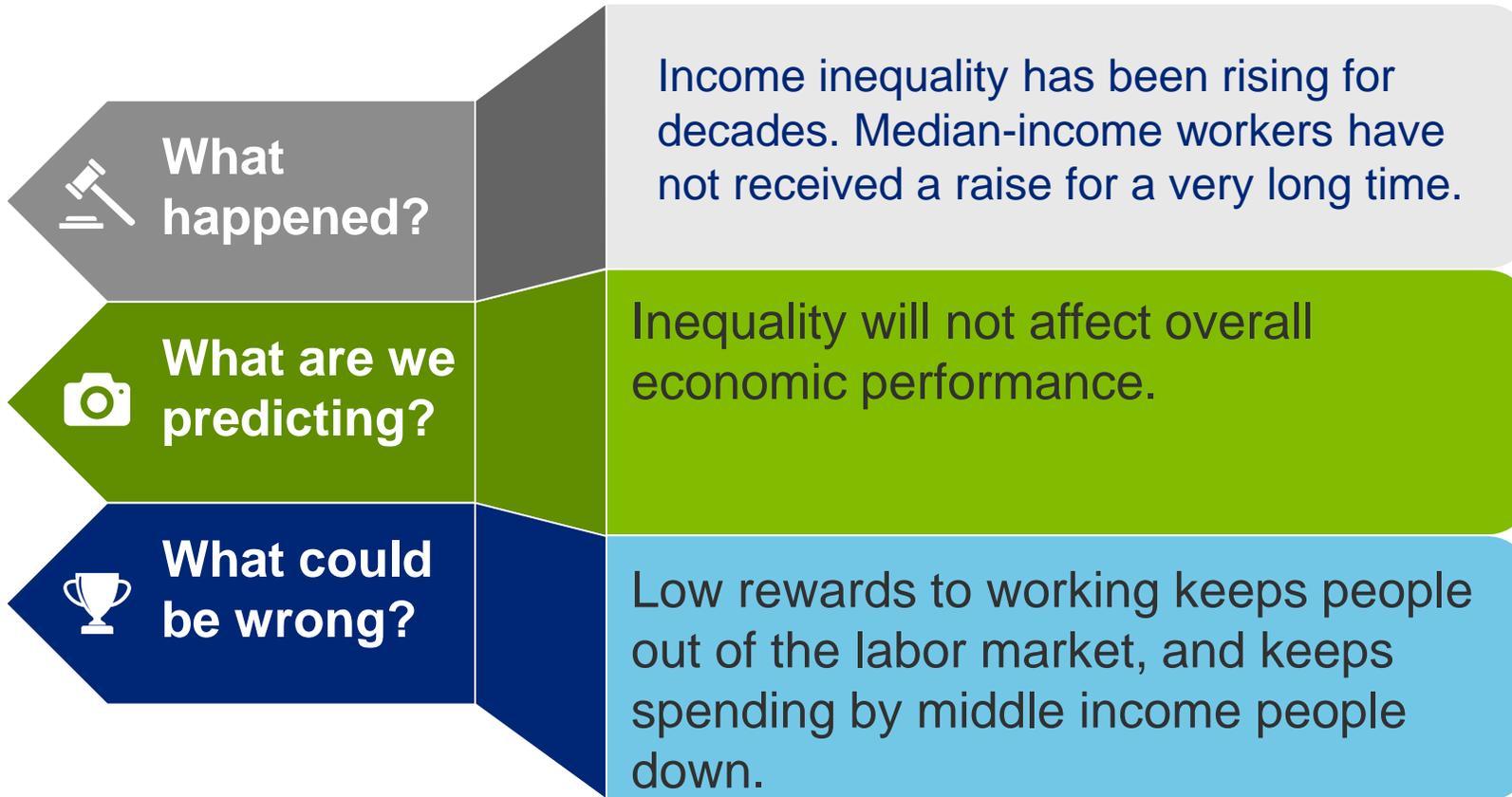


Source: United Nations/Haver Analytics

Within ten years, the prospect of supporting large numbers of retirees will create a substantial challenge for the Chinese economy.

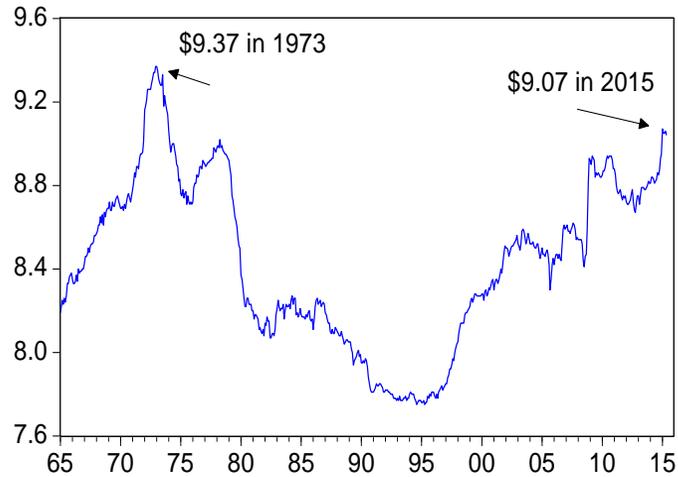
# Three big problems

# #1: Income inequality: could it drag down the economy?



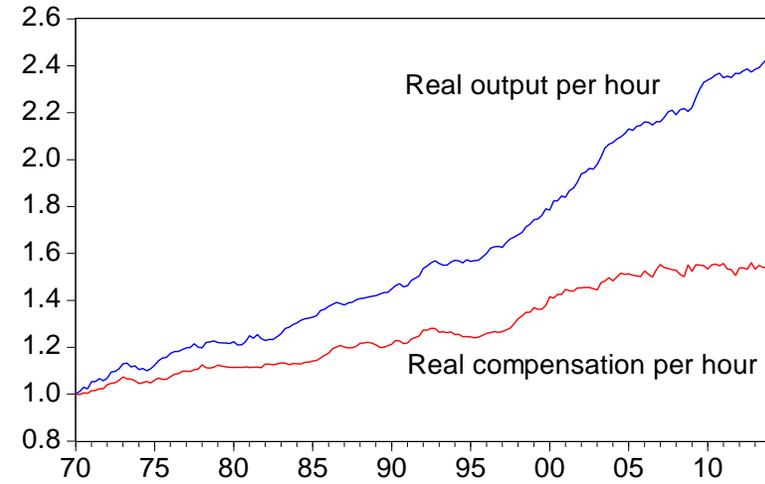
# The real hourly wage for nonsupervisory workers is still below its peak...in the early 1970s!

Average hourly earnings, production and nonsupervisory workers  
1982-84 dollars



Source: BLS/Haver Analytics

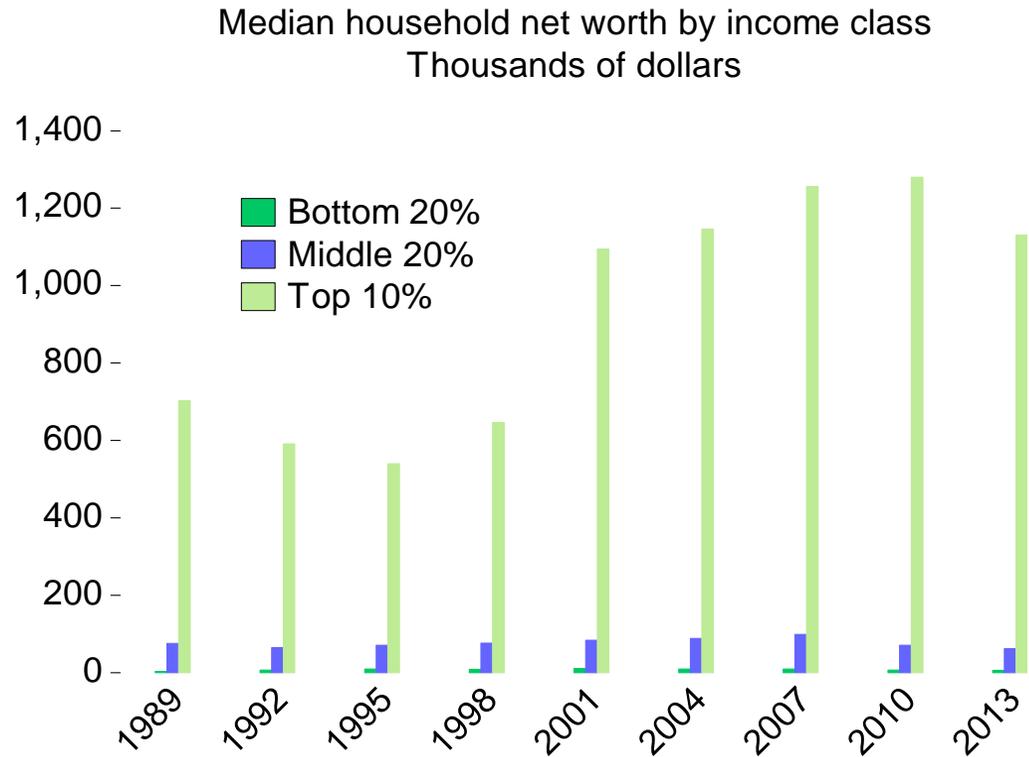
Productivity and compensation  
1970Q1 = 1



Source: BLS/Haver Analytics

It adds up to this—the average worker doesn't really feel the benefits of economic growth.

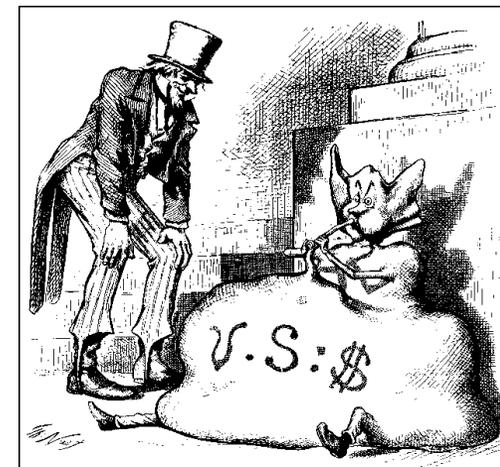
# Only the top part of the income distribution has significant wealth.



Source: Haver Analytics/Federal Reserve Survey of Consumer Finances

Median net worth of households at the low end of the income distribution was just \$6,100 in 2013. Even for the middle of the distribution, household net worth was \$61,000.

For the top 10%, household net worth was over \$1.1 million.



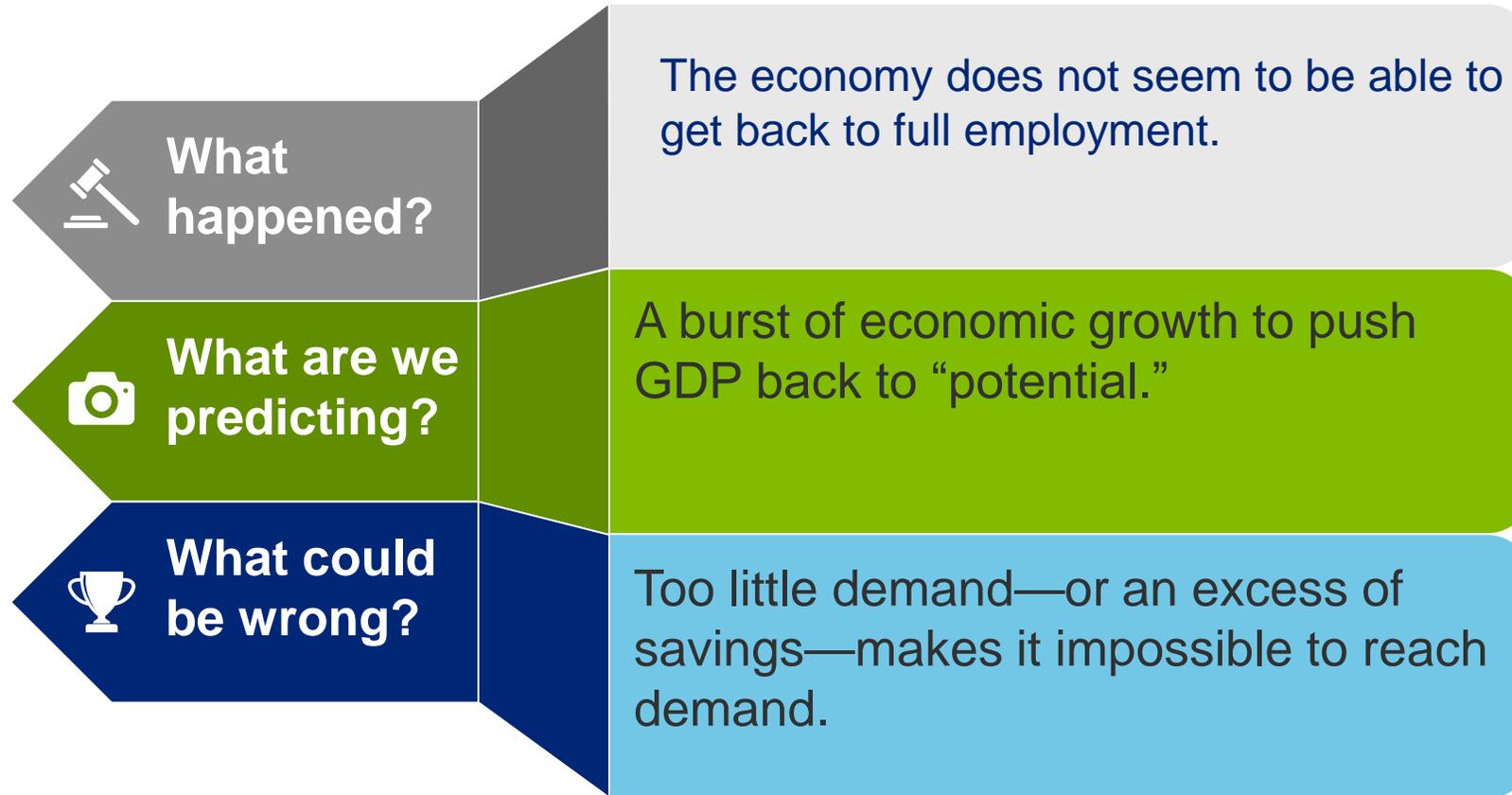
## #2: Financial institutions are still vulnerable.



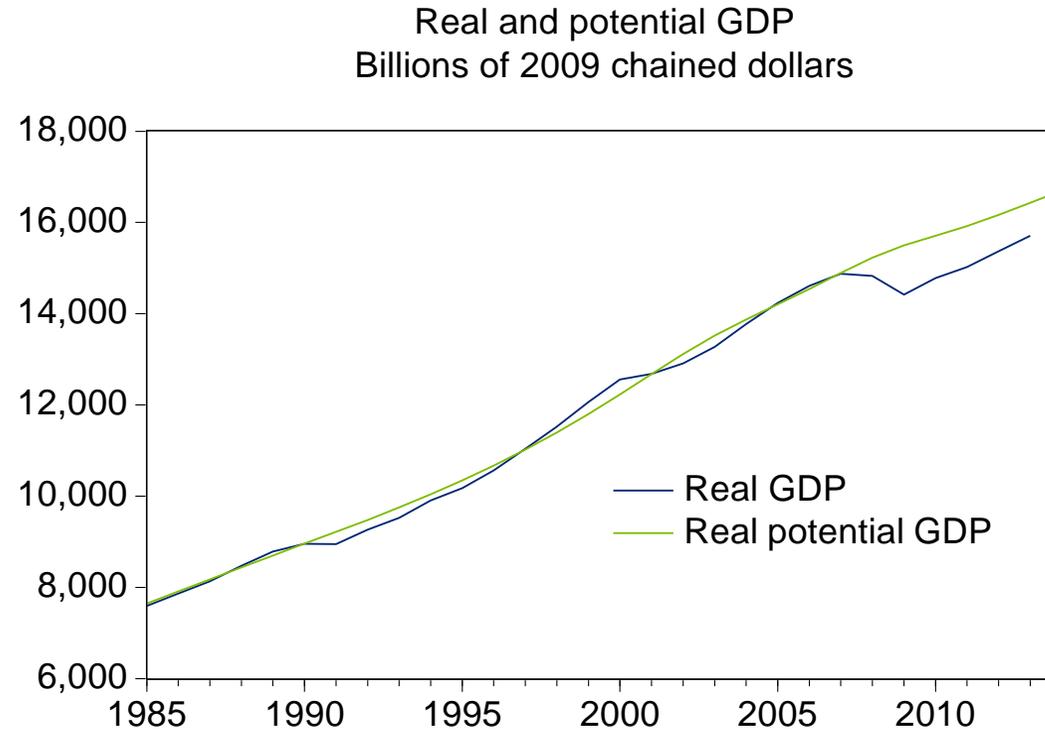
# Some information about the riskiness of holdings of major financial institutions.

The lack of a chart is no accident. Major financial institutions continue to have opaque balance sheets. Derivatives (and the way they change the risk profile of an institution) are a particular problem.

# #3: Secular stagnation



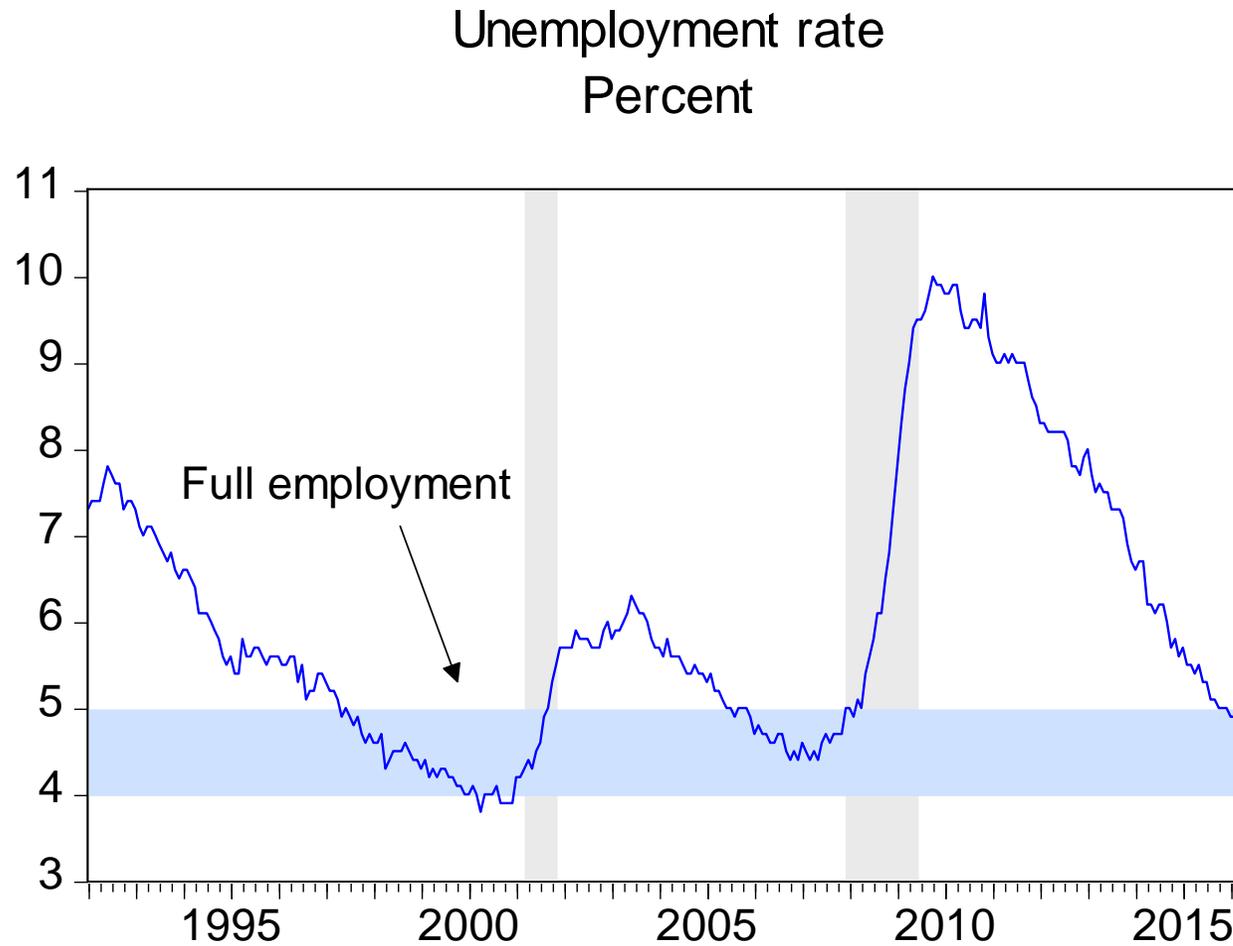
# Is the difference between potential and actual GDP permanent?



Source: Congressional Budget Office

During past recessions, GDP might have been a bit below potential—but eventually it returned to potential. Now, however, GDP remains far below potential without signs that it will soon return.

# Does it take a bubble to reach full employment?



Source: BLS/Haver Analytics

# What are some possible causes?

Low population growth may reduce the need for new capital—leaving investment demand below savings.

Low inflation means low nominal interest rates means no room to cut interest rates enough to create demand.

Low rate of technical change reduces demand for new investments and lengthens the effective life of capital goods.

The falling demand for nonresidential structures has cut the amount of investment companies need for a given level of production.

## And how to fix the problem?

Monetary policy can only have a limited impact.



Fiscal policy has huge multipliers—and government debt provides the private sector with the savings vehicles it is searching for.



But...it leaves the country with a large debt.

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