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THE **UNITED STATES** IN 2015

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Don't be Swayed by the Weak Q1; Labor Data Matter More than GDP

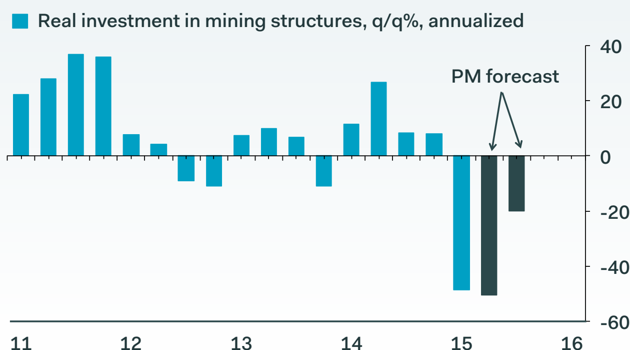
* **Growth in the early part of this year was depressed by a bewildering, unprecedented array of temporary factors.** The severe winter, the post dispute on the west coast, the plunge in oil companies' capital spending, distortions to the real import numbers and, apparently, substantial seasonal adjustment problems in the GDP numbers all worked in the same direction, squeezing reported GDP growth. With the exception of the oil capex hit, all of these factors will reverse, at least in part, in the second quarter, and the GDP numbers will be free of them completely by the third quarter.

* Market disappointment at the sluggishness of growth in the first few months of the year was exacerbated by unrealistic expectations of the speed of the pass-through from falling gas prices into consumers' spending. But the lag is always long, typically six or seven months, and the big drops in retail gas prices didn't start until November. **We expect consumption to accelerate markedly in the late spring and summer;** consumption will be much stronger in the third quarter than the second.

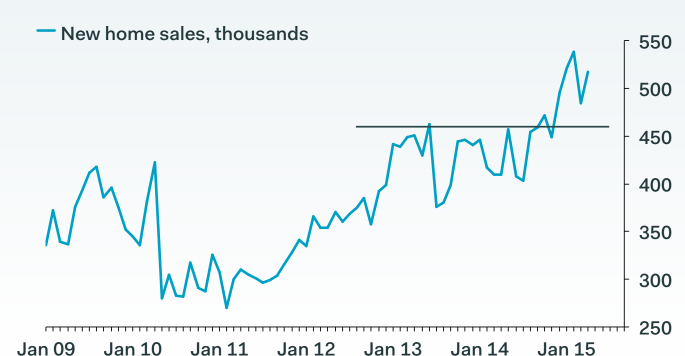
* The key point to remember here is that the oil business is extremely capital-intensive—spending per employee per year is more than forty times greater than in manufacturing—but the sector employs very few people. A crunch in the business can make a material difference to the aggregate capital spending numbers but it is very unlikely visibly to depress payroll growth or slow the rate of decline of unemployment. **Oil producers, capital equipment makers and oil servicing businesses are being hit very hard, but their losses will be much smaller than consumers' gains.** Job growth in consumer-facing sectors like retailing, leisure and recreation will accelerate once consumption gains traction.

* **The housing market meanwhile, is finally strengthening.** New home sales rose through the winter, despite usually being sensitive to severe weather, and have broken decisively up through the top of the range in place for the past two years. The strength of mortgage applications points to further gains in the summer and, with inventory tight, new construction will follow. Mortgage lending standards are still very tight but the sustained acceleration faster payroll growth is boosting the pool of qualified potential buyers, while fear of job loss is fading for people already in work. Housing construction now accounts for less than 3% of GDP, but it could easily be rising at a 15%-plus rate by the fall.

THE OIL HIT IS REAL, AND DEEP, BUT TEMPORARY



HOUSING IS RECOVERING, AT LAST



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* The Fed takes much more notice of the trends in the labor market data, which have remained very strong, than the GDP numbers, which are unreliable at the best of times and are revised endlessly. Jobless claims are at their lowest level ever, adjusted for the size of the workforce in employment, and **business surveys are consistent with very rapid payroll growth through the summer and into the early fall, at least.**

* The pace of payroll growth implied by the surveys and jobless claims is fast enough to continue driving down the unemployment rate down by about 0.1% every month, implying a sub-5% rate by the fall—below the Fed's 5.0-to5.2% Nairu estimate—and, critically, pushing up the rate of increase of wages.

* Businesses can't find the skilled people they need even at the current unemployment rate, and they appear uninterested in hiring people who have not worked for some time or have dropped out of the labor force. That means they will have to **pay more to attract people** currently working for other employers. This matters, because the Fed's view of the inflation process is primarily cost-push.

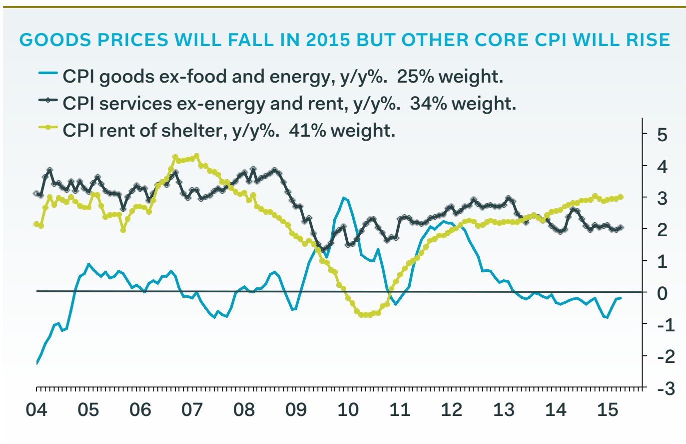
* In this context, the Fed is now on the alert after the data showing that the wage component of the mix-adjusted employment costs has accelerated markedly, despite the continued flat trend in the rate of growth of the raw hourly earnings data. Over the past 30 years, **movements in the fed funds rate have been linked more closely to the rate of growth of wages** than any other variable.

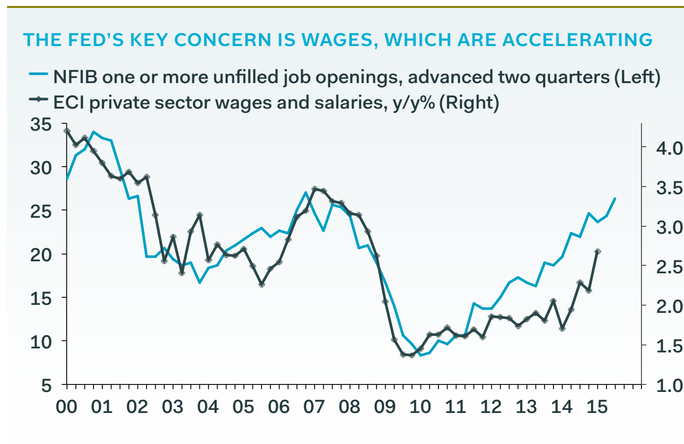
* Core inflation, at least as measured by the core CPI, has picked up a bit in recent months, largely reflecting faster increases in rents, which account for 41% of the index. So far, this has not been reflected in the Fed's target measures, the core PCE deflator, where the weight of rents is less than half that in the core CPI, but the divergence between the indexes cannot widen indefinitely. **With rental property vacancy rates at a 20-year low and still falling, the upside risk is considerable.**

* If wages continue to accelerate, as the low and falling unemployment rate suggests, the rate of increase of core non-rent services prices is likely to pick up too, leaving only falling goods prices to prevent a sustained—though likely modest—increase in core inflation.

* The Fed has been willing to experiment with maintaining ultra-easy monetary policy as unemployment has falling. But as wage gains pick up, it will prove impossible for the Fed to maintain its current policy stance. **We expect the first rate increase by September—earlier action is entirely possible—and we then expect rates to rises faster than either the Fed or the markets expect.**

* The Treasury curve will flatten, with excess global liquidity—thanks to QE from the ECB and the BoJ—limiting the damage from Fed action at the longer end. But rates still have some way to rise, threatening the equity market, where valuations are now looking stretched.





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Economic Activity (year-over-year, %)	**2012**	**2013**	**2014**	**2015**	**2016**
Consumers' spending	**1.8**	**2.4**	**2.5**	**3.4**	**4.0**
Fixed investment	**8.3**	**4.7**	**5.3**	**2.0**	**4.0**
of which:					
residential	*13.5*	*11.9*	*1.6*	*4*	*6*
equipment	*6.8*	*4.6*	*6.4*	*2*	*3*
IP	*3.9*	*3.4*	*4.8*	*7*	*5*
non-res. structures	*13.1*	*-0.5*	*8.2*	*-10*	*-4*
Government spending	**-1.4**	**-2.0**	**-0.2**	**1.0**	**1.0**
Inventories, change $B	**58**	**66**	**71**	**110**	**110**
Domestic demand	**2.2**	**2.0**	**2.5**	**3.0**	**3.5**
Exports	**3.5**	**3.0**	**3.2**	**3.0**	**4.0**
Imports	**2.3**	**1.1**	**4.0**	**4.0**	**4.0**
GDP	**2.3**	**2.2**	**2.4**	**2.8**	**3.5**

Labor Market, Costs and Prices (year-over-year)					
Productivity growth	1.0	0.9	0.7	1.5	2.0
Payrolls, monthly average, thousands	188	199	260	275	250
Unemployment rate (Q4 average)	8.1	7.4	5.7	4.8	4.2
Hourly earnings (Q4 average)	1.8	2.0	2.1	2.8	4.0
CPI (Q4 average)	2.1	1.5	1.2	0.9	2.0
Core CPI (Q4 average)	2.1	1.8	1.7	1.8	2.0
Core PCE deflator (Q4 average)	1.8	1.3	1.5	1.5	1.7

Other					
Current account, % GDP	-2.9	-2.4	-2.2	-2.5	-2.8
Budget deficit, $B FY	1,089	683	483	425	300
Budget deficit, % GDP, FY	-7.0	-3.9	-2.9	-2.1	-1.3
Fed funds, December	0.16	0.09	0.13	0.75	2.50
10-year notes, Q4 average	1.71	2.75	2.28	2.75	4.00
30-year bonds, Q4 average	2.86	3.79	2.97	3.25	4.25
S&P 500, Q4 average	1,408	1,796	2,014	2,125	2,175

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