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HOW HIGH CAN WE FLY?

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The above title does not refer to the stock market as many readers might prefer, but to the US economy. Since springtime, real GDP has been growing at about a 3% rate, substantially faster than trend, which is estimated at 2% or slower. In most months, nonfarm payrolls have increased by 200,000 or more, twice the number needed to absorb newcomers (including immigrants) into the labor force. The unemployment rate has shrunk to 4.1%. Profits are growing near a double-digit pace, prices of equities and some other assets are soaring; yet, inflation in wages and prices remains below the Fed's target. Credit is ample and interest rates are low. Legislation to reduce taxes is close to being enacted.

It feels like never-never land, especially when contrasted with the ugly domestic and international political divisiveness that has developed concurrently with the economic boom.

For some time now, the principal source of rising demand has been expanding household discretionary spending, mirroring the growth in payrolls. Indeed, spending has increased more than earnings, so that the household saving rate has retreated to the low that preceded the Great Recession. Eventually, however, employment growth must slacken, as the supply of employable persons is exhausted, after which the growth in discretionary spending will stall. In turn, businesses will retrench their purchases, inventories, and production. Whether bouncing off the employment ceiling leads to a recession depends partly on the responses of monetary and fiscal policymakers, but mainly on the extent of resulting business bankruptcies and defaults. Were this to happen today, the slowdown would probably be mild. But the longer the boom lasts, the more speculative excesses and financial repercussions will develop (hello: bitcoin!), amplifying the downturn.

What about interest rates? So long as the economy rises smoothly, and the stock market holds its own, the Federal Reserve, under Chairman-to-be Jerome Powell, is likely to raise the short-term interest rate by ¼% every three months, with the chief purpose of lifting the rate high enough that it can be lowered sharply if necessary, without running into the problem of the zero lower bound. My guess is that such increases will be discontinued by next autumn because of a weakening business outlook. What then? The most recent appointee to the Board, Marvin Goodfriend, is currently a "hawk" who tends to favor higher rates and, more importantly, wishes to revamp the playbook to make rate-setting more formula-driven. The recently appointed Vice Chairman for Supervision, Randal Quarles, also leans in that direction. In addition, three other board vacancies remain to be filled, as well as the presidency of the New York Federal Reserve, which holds the vice-chairmanship of the Federal Open Market Committee, the body that sets the federal funds rate. The views and personalities of future designees and, therefore, the Fed's response if the economy diverges from its smooth forecast, are unpredictable.

The outlook for long rates is even more of a conundrum. When the Fed announced, sooner than expected, its intent to reduce its security holdings, bond yields actually declined. Not long ago, such a surprise would have sent them soaring. When the Treasury recently announced that it would finance the budget deficit by issuing only short rather than long-term obligations--effectively countervailing the effects of the Fed's portfolio reduction--bond prices, rather than rallying, barely took notice.

If we take the textbook view that the long rate should in the long run approximate 4% (2% economic growth plus 2% inflation), how do we rationalize the fact that it has been much lower for many years? There is a huge safety and liquidity demand for US Treasury securities, from individuals, institutions, and governments worldwide, which helps to explain why the yield on the 10-year note is below 4%--but *not* why it is as high as the current 2.4%. After all, rates are much lower in Europe and Japan, although the US is obviously more creditworthy. Weighing these imponderables, and postulating a plausible weakening in the business-cycle outlook next year, suggests that long-term Treasury yields, while volatile, may not be much different in 2018.

So far, these conjectures have ignored the impact of any change in tax structure. Indeed, many households will be unaware, until they file their 2018 returns in April 2019, that the method of calculating their liability has been altered, in many cases with trivial dollar impact. Because of obscure and ill-advised legislation, the publicized tax reductions are guesstimated totals for the 10-year period ahead, although budget experts differ widely even in their one-year-ahead forecasts. Multinational corporations and their executives and accounting staffs have surely laid plans to optimize their positions in the event of likely tax changes. Thus the macroeconomic impact of tax restructuring will likely be minimal, even if sectoral redistribution turns out to be sizable.

Except for one caveat. In important respects, the corporate profits tax resembles a sales or value-added tax. When an article is sold, the price and the sales tax are clearly itemized on the bill of sale. But both buyer and seller know that, in the absence of tax, the bill would be lower. How much lower would depend on the competitive realities of the marketplace. Similarly, the proceeds of a reduced tax on corporate profits will, in principle, be shared among suppliers (including labor), owners and managers (through dividends and bonuses), and customers. Most companies have profit targets (which higher prices make easier to achieve), but also volume targets (which benefit from lower prices). In the present profitable environment, price competition for sales dollars is said to be intense, as seems to be confirmed by the tepid behavior of the price indexes for goods and services.

In this scenario the reduction in business taxes might be disinflationary, as some of the tax reductions are passed on to customers. What might be the repercussions on the Fed's and other economic policies--and the economy--if reducing the corporate tax rate were to nudge the cost-of-living index just a bit lower than it would be otherwise?

As 2018 unfolds the economy seems likely to continue to grow, but with slowing forward momentum.

A MERRY CHRISTMAS AND HAPPY NEW YEAR TO ALL