ECONOMIC FORECAST 2016

The Tortoise Or The Hare?

We all know of Aesop's fable The Tortoise and the Hare — a story of two unequal opponents who agree to a race. The outcome appears to be obvious, but in a surprising twist the ever-so-diligent tortoise perseveres and wins the race. The moral of the story is slow and steady wins the race.

UMB's economic theme for 2016 is The Tortoise OR the Hare. We think the U.S. economy, which has grown over the past few years at a tortoise-like pace, will continue to produce mediocre growth in 2016. Given the stimulus that abounds, one might think the economy should grow at a faster pace, more "hare-like;" however, we think slow and steady will win out once again. We anticipate the U.S. economy will once again grow in the 2 percent to 2.2 percent range in 2016. Relative to other economies, tortoise-like growth will be a winner.

THE HARE

Historically the U.S. economy has been more hare-like. So what has changed? When did our economy go from consistently growing more than 3 percent annually, to a tortoise-like economy, with growth less than 2.5 percent? For example, from 1955 to 2005, the U.S. average real GDP was 3.4 percent. Fast-forward to the period from 2005 to 2015 and real GDP averaged a paltry 1.5 percent, leaving economists wondering what happened.

To answer this question we investigated two economic variables that drive potential GDP: labor force growth and productivity gains. In economics, potential output refers to the highest level of real GDP (output) that can be sustained over the long term. Year-to-year actual GDP may vary from potential GDP; this is called the output gap. Forecasting potential GDP should be relatively easy, as the formula is simply labor force growth plus productivity gains.

Labor force growth has changed over the years and is influenced by several factors. In the 1960s and '70s labor force growth changed due to population growth, the baby-boomer generation reached working age and more women were working outside the home and entering the labor force. However, the significant labor force growth rate increase of the '70s will not be repeated anytime soon. One reason is that most baby-boomers have more siblings than children and labor force growth is partly a function of population growth.

One might think the economy should grow at a faster pace; however, we think slow and steady will win out once again.

The second variable is productivity, or the efficiency of production. According to the Bureau of Labor Statistics, productivity change in the non-farm business sector from 2007 – 2014 was only 1.3 percent. There is an ongoing debate among economists over the drivers of productivity gains. One theory argues that capital accumulation drives growth. Another suggests that a combination of accelerating technical progress in high-tech industries and the resulting investment in information technology drives productivity.

One common theme between both theories is that investment is critical to any growth theory. Therefore monitoring measures of human capital and research and development expenditures is necessary. We believe we will continue to see exciting new technologies developed in the future, but caution that even though new technology is introduced, the lack of adoption to these new technologies can be limiting to productivity. Therefore, we don't see productivity gains spiking higher in the near future.

THE TORTOISE

So as the fable goes, the tortoise never gives up – it is patient and persistent, and wins the race. I think this is a great parallel to the U.S. economy in 2016 and perhaps even over a longer timeframe. Our economy has been slow growing since the

Great Recession in 2009 and has continued on that path to real GDP of 1.5 percent in 2013, 2.4 percent in 2014, and 2.4 percent last year.

I expect our economy to continue to grow at a slow and steady pace in 2016 with real GDP in the range of 2 percent to 2.2 percent. This is in part due to several tailwinds and a few headwinds.

TAILWINDS

The labor market, consumer confidence and low interest rates are a few of the positive variables that support our expectation for steady, ongoing economic expansion.

The robust labor market gives us confidence that the U.S. economy will continue to grow at a steady pace. In 2015, total non-farm payrolls increased 2.65 million or 221,000 avg/month, down from 3.12 million in 2014. By the end of 2015, the number of full-time workers rose to a record high of 122.6 million. The Federal Reserve Chairperson, Janet Yellen, suggested in her recent testimony that payroll growth of 100,000 per month can absorb all of the new entrants into the labor market.

For additional perspective, historically payroll growth of 200,000 per month supports economic growth of 2.5 percent or better. Falling in line with our forecast, we expect 200,000 new jobs will be created on average per month in 2016.

Additional data supports a solid labor market. The median duration for the unemployed fell to 10.5 weeks, the lowest in seven years. Finding part-time workers is becoming more difficult and as the job market improves, we think more people will be encouraged to consider seeking employment. As the labor market tightens, wages will be on the rise as well. Average hourly earnings in December were up 2.4 percent year-over-year, the highest in 2015, and we think that trend will continue. A tightening labor market should support continued wage inflation and given very little inflation elsewhere, another bonus for consumers.

This dovetails into consumer confidence. When consumers feel good, they will support the economy by spending. Consumer confidence has been relatively flat throughout 2015, but remains at a level that supports economic growth. Confidence is primarily driven by the labor market, stock prices and home prices.

The strength in the aforementioned labor market, paired with home prices up 5.5 percent last year, should continue to support confidence. Lower oil prices also gave most consumers a good feeling as their transportation costs were reduced. The wild card here is the stock market. Investors saw mediocre returns last year, (only 1.4 percent return from the S&P 500), along with higher volatility. Weak markets and an increase in volatility may shake consumer confidence this year.

The Fed has kept interest rates low for seven years. In December 2015 the Fed started the process of normalizing rates by moving short-term rates up 0.25 percent. We think interest rates will be on rise throughout 2016, ending the year at 1 percent. However, from a historical perspective, the Fed policy remains extremely expansionary, affording consumers and businesses access to inexpensive capital.

Perhaps China is getting a bad rap; it seems to be blamed for any problem ranging from stock market volatility to global warming. However from our point of view, it's not all bad. The U.S. imports more goods from China than from any other country. As China devaluates its currency, the yuan, those everyday goods we import become cheaper, which is good for consumers. As their economy slows to a more sustainable level, the demand for energy and commodities wanes and prices are reduced. Again, this is good for the U.S. consumer. Only 7.6 percent of total U.S. exports head to China. Even if its economy slows and demand weakens for our exports, the damage China could potentially do to the U.S. economy appears relatively small. Lastly, when the yuan is devalued, fixed direct investment, or capital, heads for the doors. As this capital leaves China, it just may end up in the U.S. — which would be a good thing.

Not everything outside of the U.S. is necessarily a negative story, as some would lead consumers to believe. The Eurozone is sprouting green shoots of growth. Europe possesses a very stimulative environment. With low interest rates and a quantitative easing program, Europe could experience economic growth in the 1.5 to 2.0 percent range. This may not sound like much, but remember in 2014 they grew at a 0.8 percent pace and last year at 1.5 percent.

HEADWINDS

It's not all rosy. Some headwinds lead to slower growth and some may not have a significant impact on our economy directly, but rather they may spook risk markets. Stocks are included in this category.

The recent U.S. manufacturing data is suggesting an oncoming economic contraction. For two quarters now, the ISM Purchasing Managers Index has been below 50, indicating a contraction. The good news is the non-manufacturing data is solidly in growth territory, albeit trending south. Back to the bad news, historically the manufacturing data leads the non-manufacturing data. Once again, we think the current data supports a tortoise-like economy in the U.S.

The Fed has a tough job: maximize employment, stabilize prices, support global markets, normalize interest rates. Oh, and don't send us into a recession. Many recessions have been blamed on the Fed for creating a policy error, which is typically viewed as moving too fast or too soon. This time, did they move too late? Or is a policy error on its way? At this time we don't see a policy error at hand. The Fed plans to move at a measured pace and it doesn't look like it will threaten a tortoise-like expansion.

Issues in the global economy will constrain growth in the U.S.; and as we mentioned, China is slowing. It will have an impact on other emerging markets as well as the U.S. to a lesser extent. We don't believe the Chinese stock market gives us any indication of economic fundamentals due to the speculation in their markets and government intervention. However the massive volatility of their stock markets sends a violent reaction to markets around the globe. If downward pressure continues, it could negatively impact consumer confidence in the U.S.

Energy is also an important variable. Even though low energy prices are good for the consumer's wallet; tension in the Middle East may create an uneasy global economy. No one likes uncertainty, especially the markets. The collapse in Saudi relations with Iran, North Korea testing a hydrogen bomb, Russia and Brazil in recessions, and a Presidential election in the U.S. all sound like uncertainty. And while much of this won't significantly affect the U.S. economy, it may affect our markets in the short run.

A SLOW AND STEADY 2016

For all of the variables discussed above, slow and steady is a great metaphor for the economy this year.

- In 2016 we anticipate GDP growth between 2 percent and 2.2 percent. We think this will be supported by the labor market once again as businesses create new jobs.
- Domestic equity returns may once again be challenged, profits are in question and valuations may contract. We expect 3 percent earnings growth which should lead to total returns in the 4 to 6 percent range.
- We also think interest rates will be on the move this year, expecting both short-term and long-term rates to increase. Fed Funds should end the year at 1 percent.

The moral of Aesop's fable is slow and steady wins the race. The moral to our economic story is slow and steady won't be all bad on a relative basis. Our economy expanding at an approximate 2.1 percent pace will allow the Fed to normalize interest rates and companies will find a way to be profitable and continue to hire workers, supporting consumption.

KC Mathews, CFA, is executive vice president and chief investment officer at UMB Bank.