

Overview and Outlook

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Chart 1 Enhanced Aggregate Spread

“The future ain’t what it used to be.”

-- Yogi Berra

In the last edition of the Employment Situation Report I mentioned that I was going to direct the emphasis of the analytical part of this report to the sources and uses of growth. That decision was prompted by some of the factors that emerged in the employment statistics as they relate to the progress we have made since the start of this expansion as well as to the conditions we would expect to prevail as we go forward. After putting together the chart sequence that you will see shortly, it occurred to me that I also needed to make some changes in the configuration of the base package of charts with which we open these missives. So, let’s start with those modifications.

We began by removing the chart with the Aggregate Spread. I will continue to compute that statistic, and will on occasion refer to it. But since our main forecasting tool is the Enhanced Aggregate Spread I think it best to make it the primary focus of the reporting process. The other change you will note here is the addition of the Phase Forecast section. This segment of the chart will always be nine months wide. But, as we go from one phase of the cycle to the next, the bars will change colors. As of today, we expect to see readings from the coincident indicators that confirm the forecast of the EAS that says we should be staying in Expansion Phase through June of 2016.

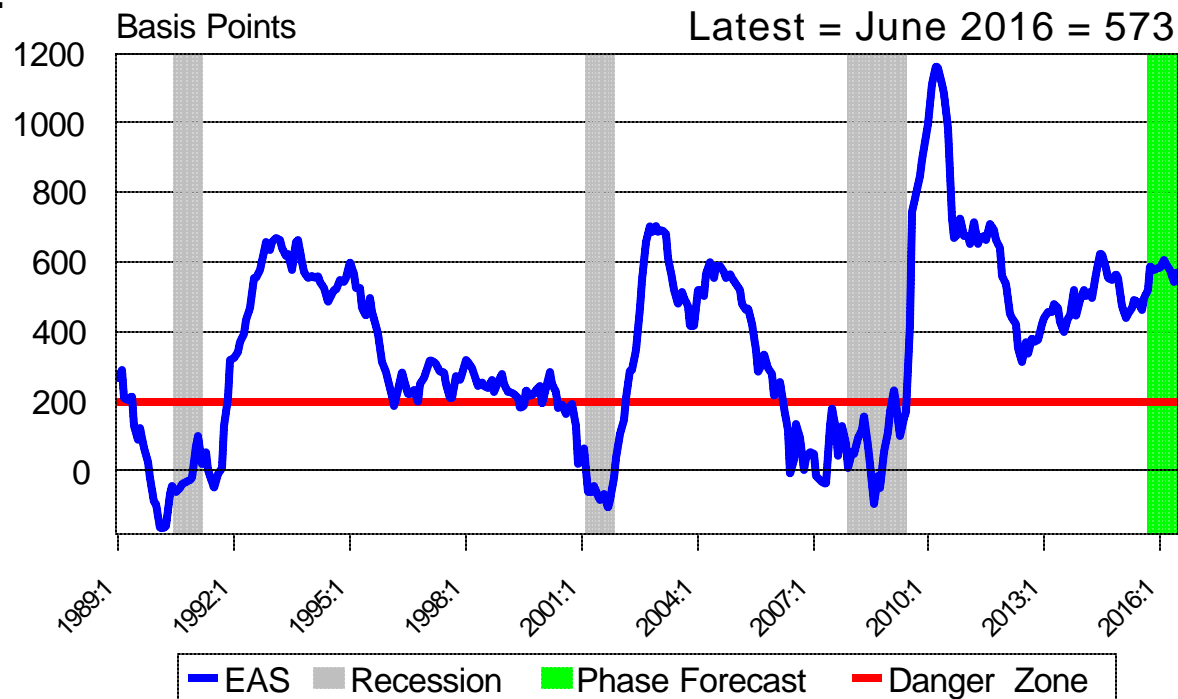


Chart 2 Aggregate Spreads -- Forecast Summary

In order to further tighten our focus on the results provided by the EAS, I have made it the sole occupant of this chart. The green bars on this chart are the same green bars in the forecast phase of Chart 1. We will color code the numbers on the chart according to whether or not they meet their recession associated levels. I also added a small version of the phases chart as reminder of what drives the color scheme. I am not entirely happy with the layout of this page, so I will be glad to hear any suggestions you might have. The goal of this cluster of charts is to provide a composite visual record of the forecast. But, as we know there is a point where information displays can become cluttered. I am not sure if we have passed that point.

By the way, I expect that there will be a lot fewer words on this page going forward.

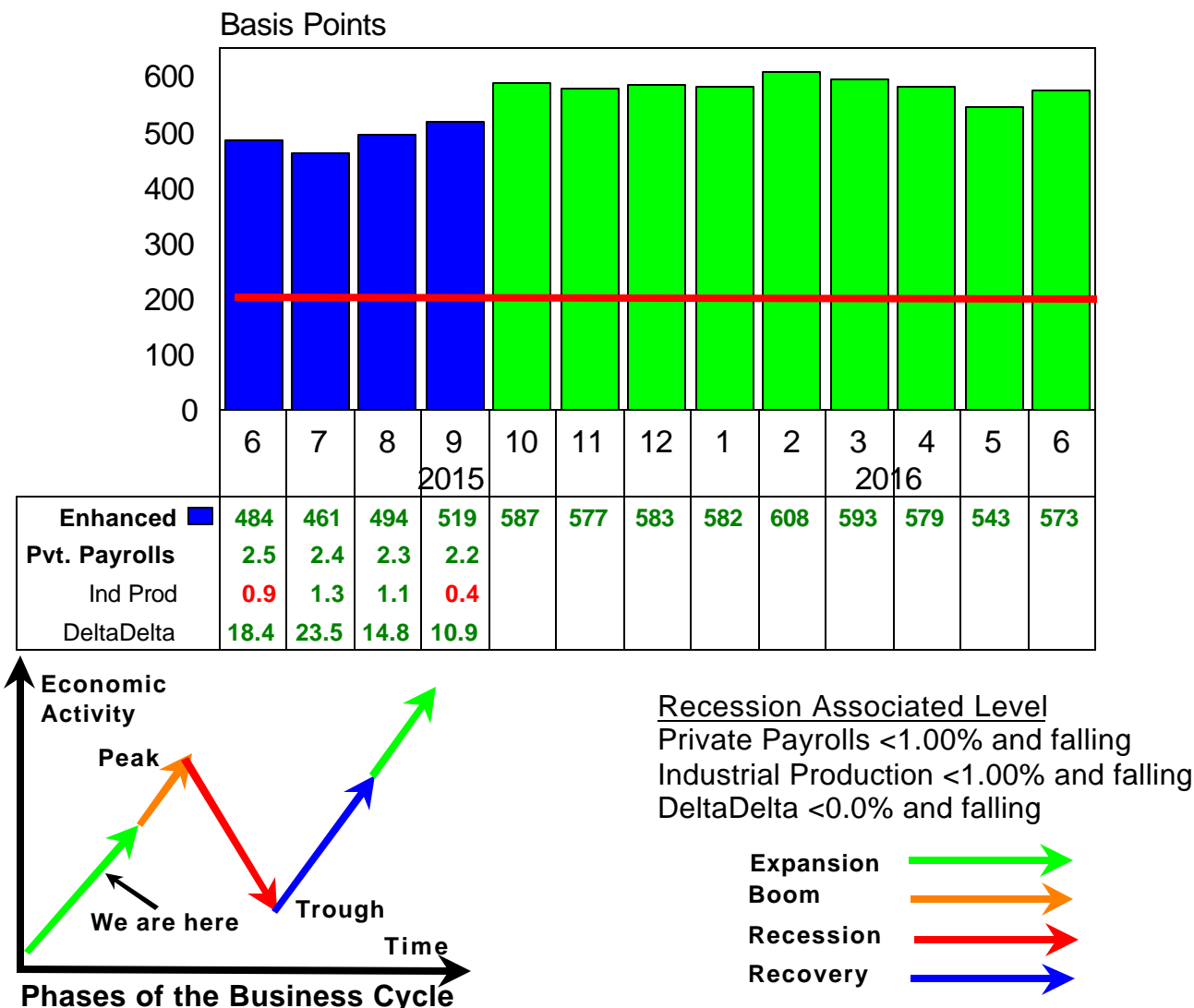
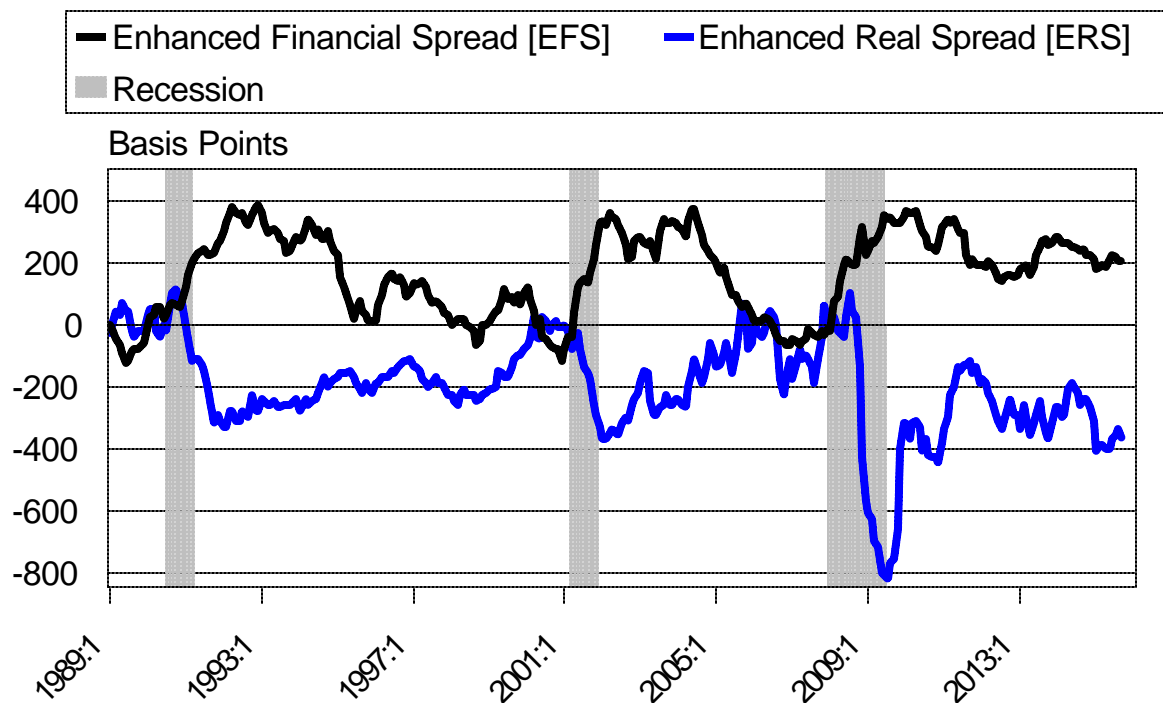


Chart 3 Components of the Enhanced Aggregate Spread

This chart remains in the regular rotation as it helps to visualize the process of convergence between the two components of the EAS. But more than that, it is also the place where we will be looking in the event that we start to get multiple recession-associated readings from the coincident indicators on the prior chart. Remember, the process of making a call on changes in the phases of the cycle is based on the combined information from the EAS and all three of the coincident indicators. And, I should add, any additional insight Saint Offset might provide.



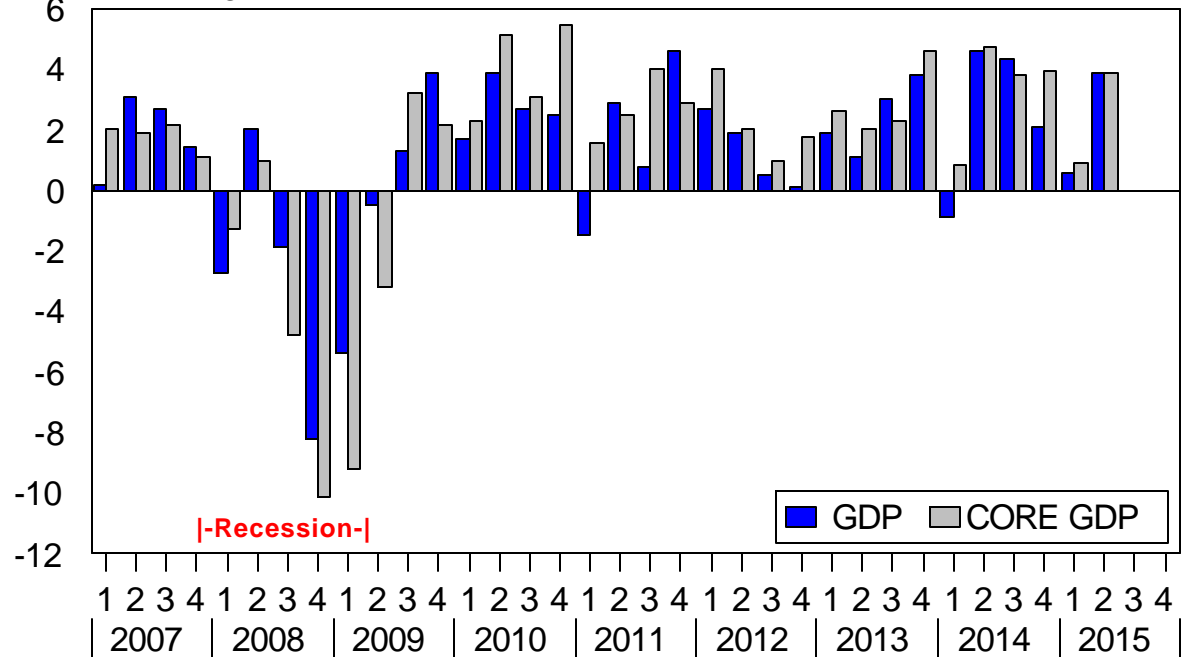
<u>Date</u>	<u>EAS</u>	<u>DATE</u>	<u>EFS</u>	<u>ERS</u>
2016:3	593	2015:6	223	-370
2016:4	579	2015:7	219	-360
2016:5	543	2015:8	203	-340
2016:6	573	2015:9	203	-370

Chart 4

Selected Measures of Aggregate Economic Activity

Core GDP = PCE+BFI+Exports

Percentage Points At Annual Rates



We are going to spend more time with this series a bit later in the report. But I wanted to take advantage of the space we have on this chart to reintroduce the concept that this chart conveys.

Several years ago I heard someone claim, on the electric teevee, that the entirety of the gains made in economic activity since the end of the recession were because of government spending. I found the claim a bit extreme and decided to investigate further. What resulted was the series you see plotted here. The three components of Core GDP are all from the private sector of the economy. And, the contributions that each of them makes to total GDP are available in each and every GDP press release. I don't do anything more than add up the numbers as they are reported. If you would like the link to the table let me know.

What this variable tells us is how much of total GDP is being generated by the private sector. Since, in most cases the gray bar is taller than the blue bar, it means that the private sector is accounting for all of the growth, and then some. Hence the claim that government spending was the engine of growth was completely debunked. By the way, this person was later seen on the electric teevee telling us that falling gasoline prices were bad.

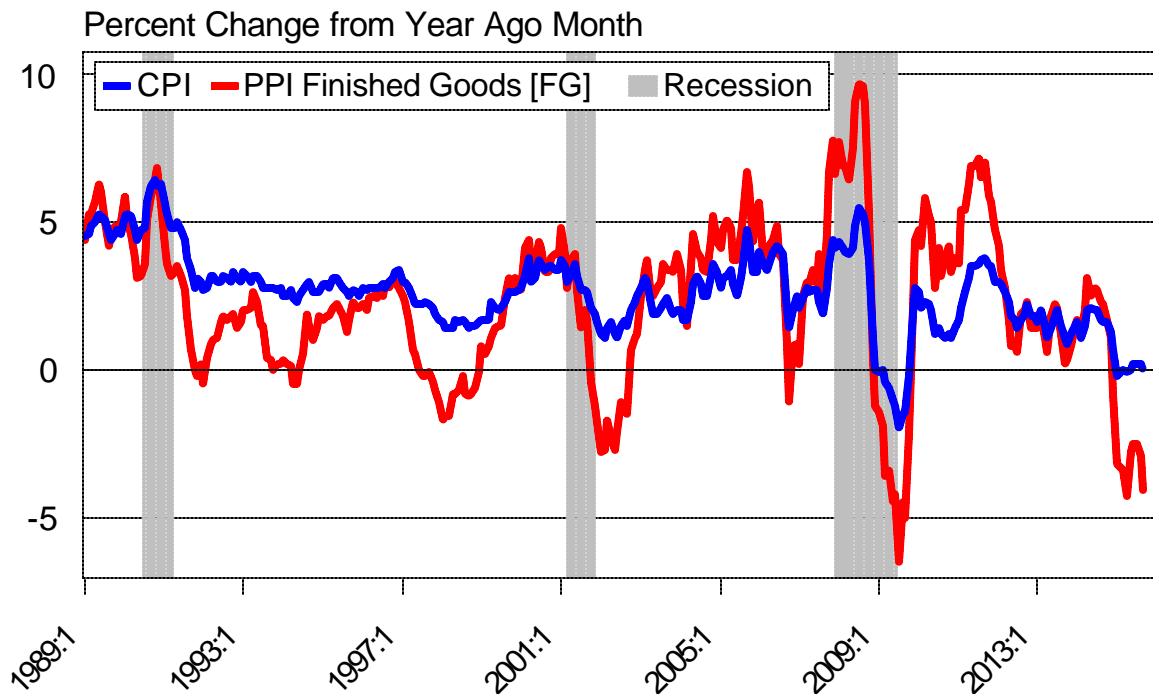
PCE = Personal Consumption Expenditures
BFI = Business Fixed Investment

Date	GDP	Core
2014:3	4.3	3.81
2014:4	2.1	3.96
2015:1	0.6	0.90
2015:2	3.9	3.89

Chart 5 Selected Measures of Inflation

After reading in both the PPI and CPI reports that the negative headlines were caused by falling energy prices, in particular gasoline prices, I considered redoing this chart using the indexes that exclude energy. But, since we have a chart where we already do that, I decided to leave this chart alone.

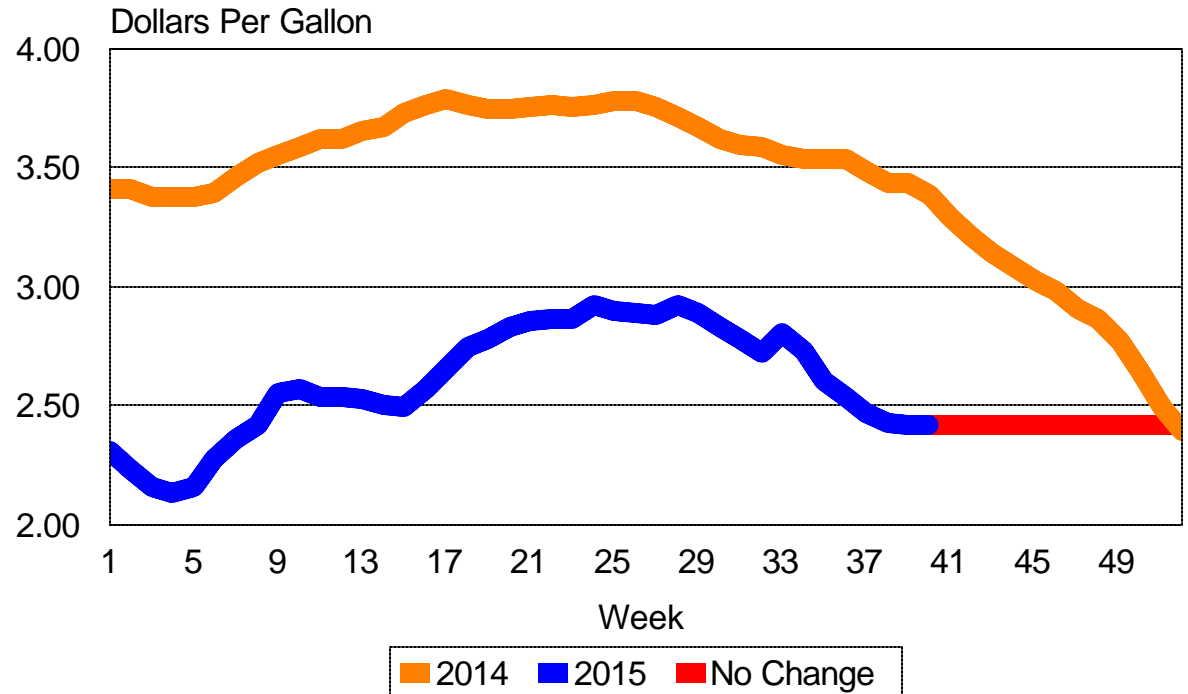
And I am glad that I did. While we caption this chart Selected Measures of Inflation, this is a good time to bring up the fact that the CPI was originally known as the Cost of Living Index, and the PPI used to be known as the Wholesale Price Index. They only became measures of inflation in the 1970s when we needed something to describe the episodes of double-digit gains in prices. So, while we might be concerned about what low prices mean for the level of aggregate economic activity, we should not forget what they mean for the cost of living and the costs of production.



Date	CPI	PPI
2015:6	0.2	-2.5
2015:7	0.2	-2.5
2015:8	0.2	-2.9
2015:9	0.0	-4.1

Chart 6 Weekly Average Gasoline Prices

And now a little fun with numbers. As we noted earlier, energy prices are the main reason why the headline rate of consumer inflation is as low as it is. Furthermore, in one of the news stories commenting on the current and prospective level of the CPI I saw a note that the inflation rate was not likely to rise because fuel prices were not likely to rise. To which I said, “you don’t read the weekly gasoline price report, do you?” “You know, the one the BLS uses in the calculation of the CPI?” If they had, they would see what’s on this chart and the one that follows.



The red line on this chart makes the assumption that prices do not change from the level they are now, which is a national average of \$2.41, for the rest of the year. Now, turn the page and watch what happens to the percent change from the same week of 2014.

Chart 7 Weekly Average Gasoline Prices

With no change in the current price, the percent change goes from -30% to zero. In other words gasoline prices stop making a negative contribution to the headline rate of inflation. What does that mean? Turn the page and find out.

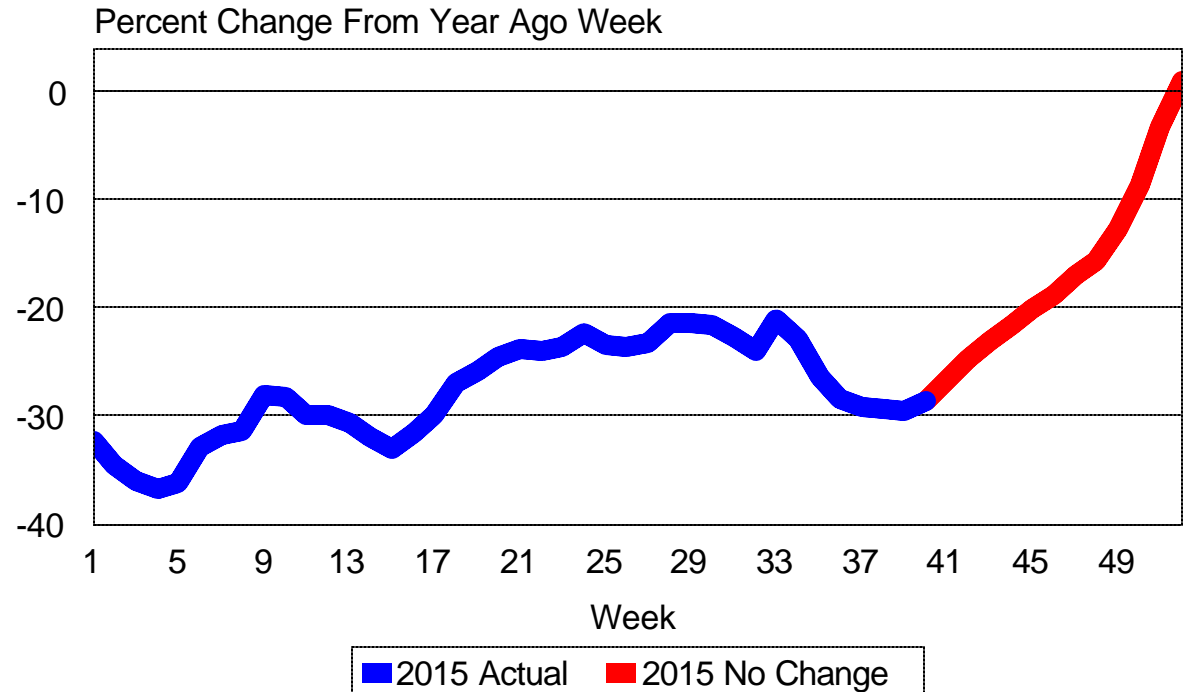
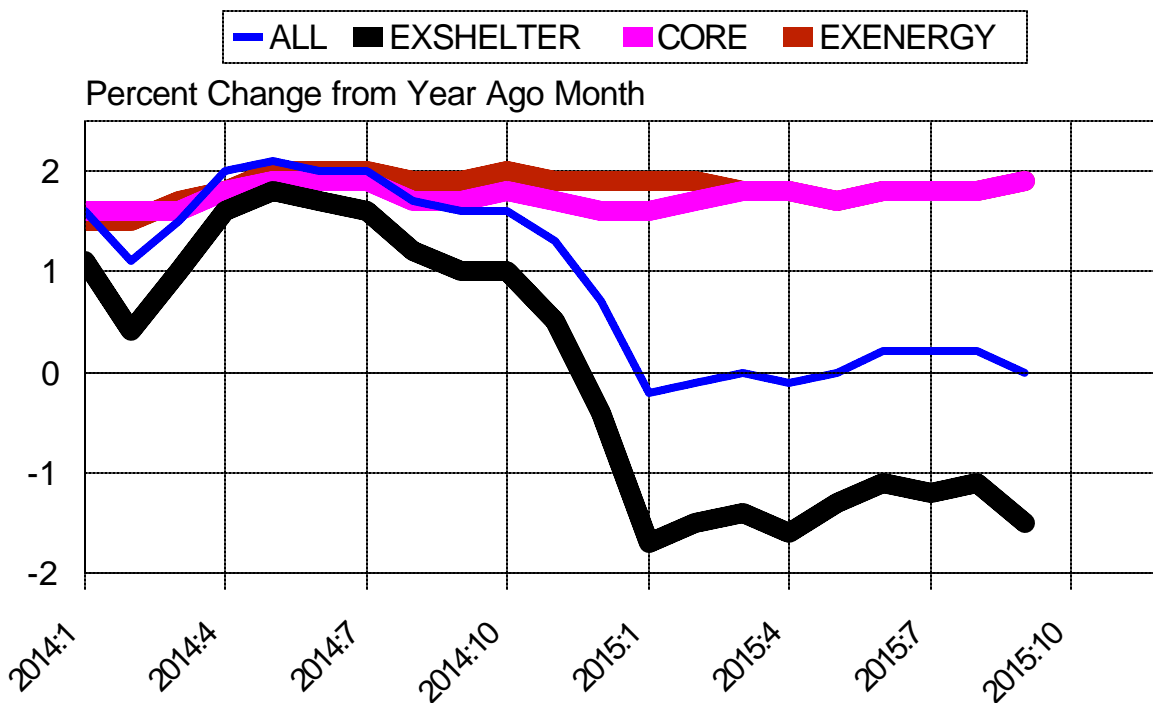


Chart 8 CPI -- Selected Measures of Inflation

It means that the All Items Index, a.k.a. the headline rate of inflation, and the All Items Excluding Energy will be identical. And so we would have a case of the rate of inflation rising without the price of gasoline going up.

In September, the energy component took 1.7% off the headline rate, offsetting the 1.7% gain from the rest of the items in the CPI. Since it is unlikely that the rest of the CPI will stop rising, once we no longer get the benefit of gasoline prices being lower than they were a year ago, we stop getting the reduction in the headline rate from that source. And, just like that, three of the numbers in our table will be the same. And none of those numbers will be zero.

And, we will also take almost 200 Basis Points off the EAS.



<u>Date</u>	<u>All</u>	<u>ExShelt</u>	<u>Core</u>	<u>Ex Eng</u>
2014:7	2.0	1.6	1.9	2.0
2015:6	0.2	-1.1	1.8	1.8
2015:7	0.2	-1.2	1.8	1.8
2015:8	0.2	-1.1	1.8	1.8
2015:9	0.0	-1.5	1.9	1.9

Chart 9 Expansion Periods as Defined by the National Bureau of Economic Research

I thought it might be helpful, for two reasons, to begin our inquiry into the sources and uses of growth with a brief stop at our expansion counter. The first reason is as a reminder that it matters where we are and how we got here. Some of what we have recorded as growth is the recovery of the ground we lost in the recession. This counts as progress and we should not be apologizing for it.

The second reason is that I continue to see “forecasts” that are based on the average length of expansions. Please disregard any comments you see about the likelihood of the expansion ending based on how long it has lasted. Not only is that idea silly on its face, it ignores the conditions that made each of these expansions last as long as they did.

And, for the record, as of right now and including the current episode, the average expansion has lasted 66 months, which is 5.5 years. However, the standard deviation of the data set is 37 months, or slightly more than 3 years. So, if you are going to base your forecast on the average you also have to mention the standard deviation. So, you have an average length of 5.5 years plus or minus 3 years. Quite the forecast range. Yet, people are actually allowed to say that a recession is at hand because we have exceeded the average.

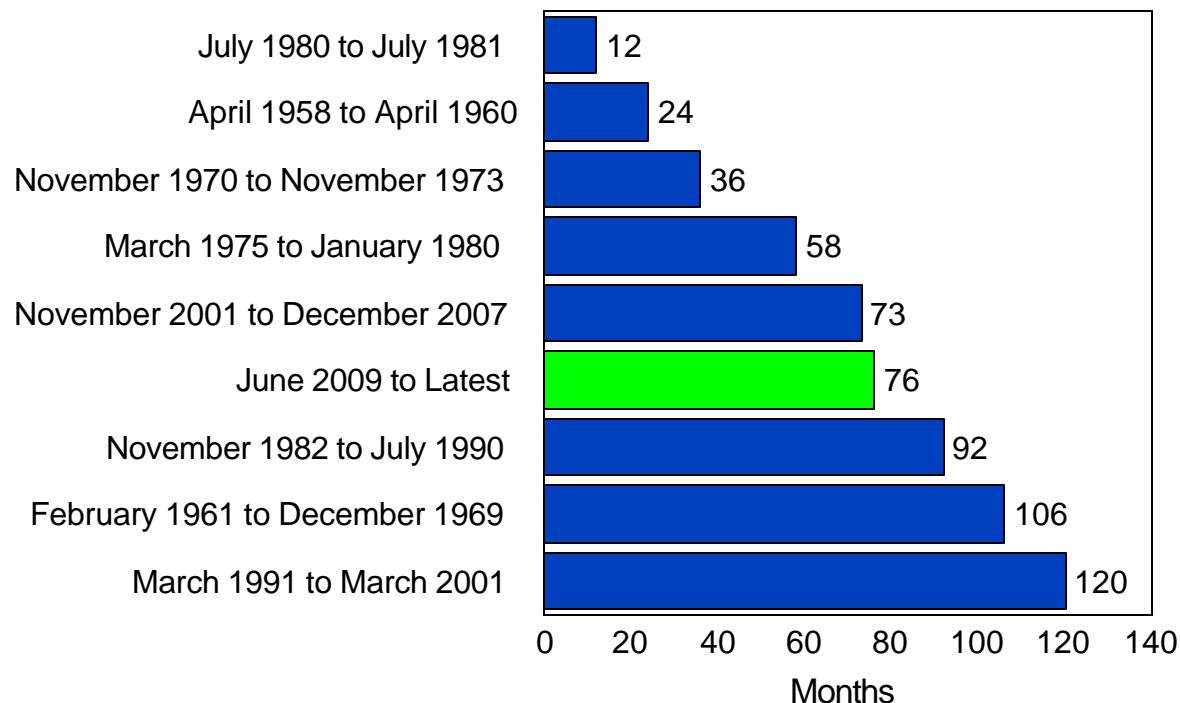


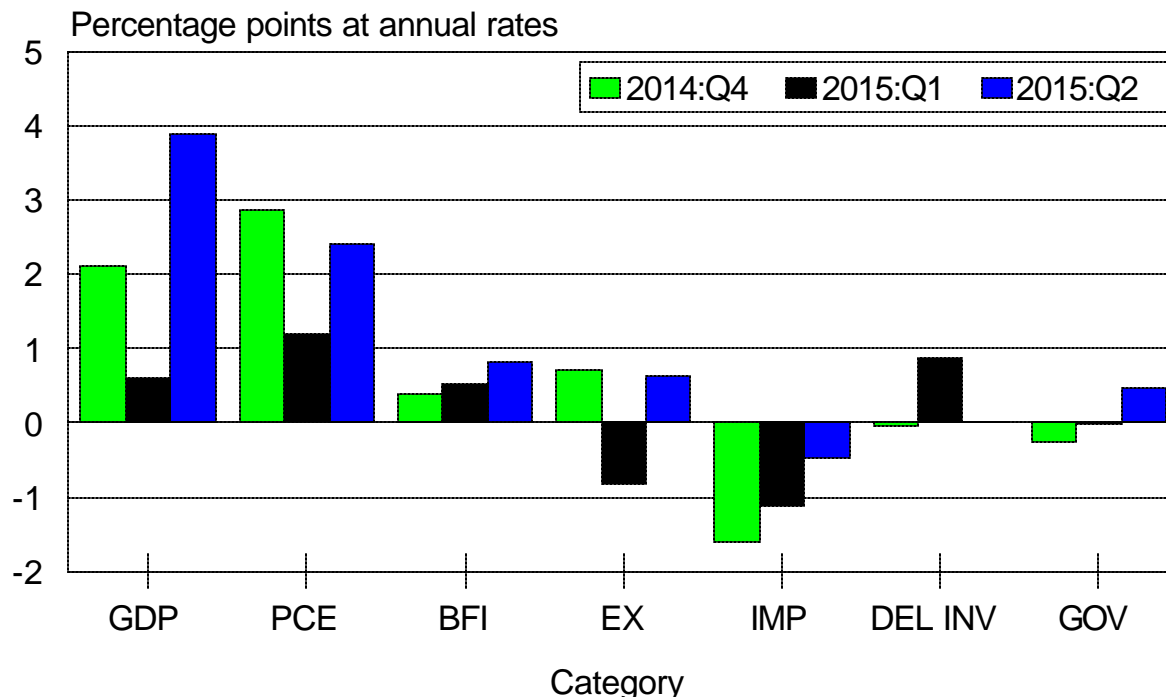
Chart 10

Components of Real Gross Domestic Product (GDP)

We have made it this far into the expansion because of what we are going to see on the charts that follow, which are based on the data that appear here. Thanks to the good folks at the Bureau of Economic Analysis, we can access a table that shows the weighted contribution of each and every component of GDP to the headline rate of change.

In the table below the chart you see both the expanded labels and the values of each of the blue bars on the chart. As you can also see there the six major components add up to the headline number. These are the same figures we use when we compute the Core GDP statistic that regularly runs in the reports. And, a series we shall be looking at in just a moment.

With these data we can identify precisely where GDP growth is coming from. And, as we shall see in a moment that can help tell us where we might expect the strengths and weakness in the economy to be found.

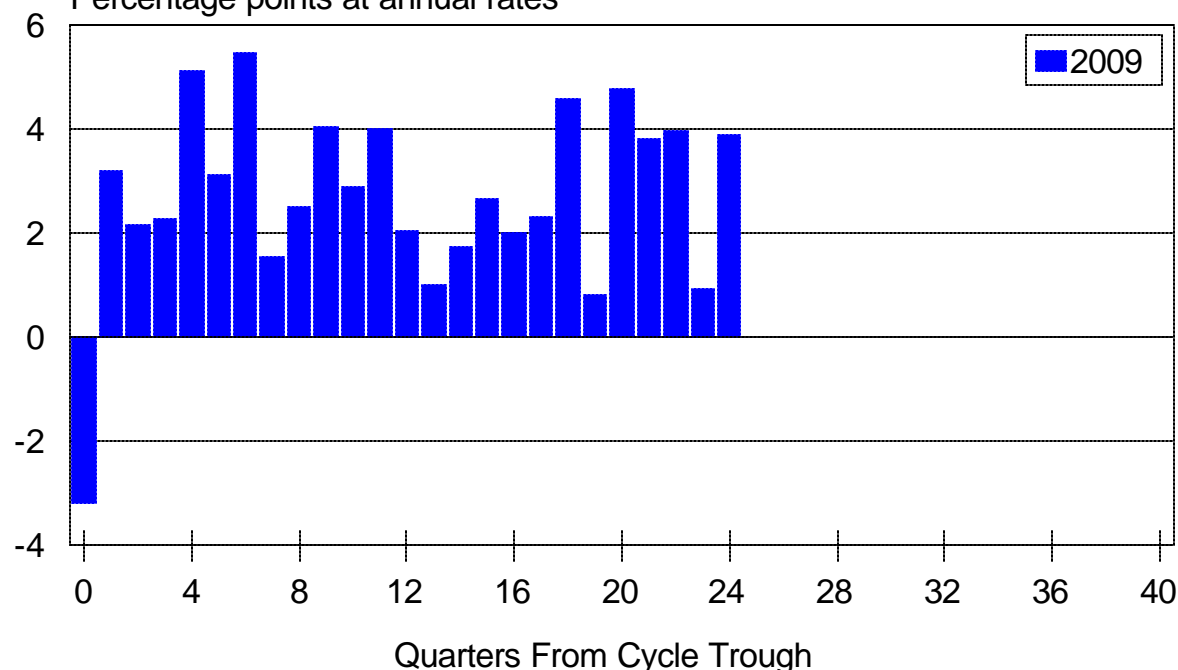


Category	2015:Q2
GDP=Real Gross Domestic Product	3.9
PCE=Personal Consumption Expenditures	2.42
BFI=Business Fixed Investment	0.83
EX=Exports	0.64
IMP=Imports	-0.46
DEL INV=Change in Business Inventories	0.02
GOV=Government	0.46
SUM	3.91

Chart 11 Core GDP

Core GDP = PCE+BFI+Exports

Percentage points at annual rates



I thought I would start the discussion on the sources and uses of growth by looking at two charts. This one which covers activity in the private sector, and the next one which will cover activity in the public sector. We will then take a look at how each of those measured performed in the longest expansion on record. I have, as you might suspect, made up a chart package that compares the current expansion against all of the long expansions. But I am not going to show all of those because I can only risk a 90 chart presentation when I have an escort.

As you see here, once the recovery got under way, the private sector has made a positive contribution to GDP growth in every quarter since the second half of 2009. And, as you saw when we lined up Core GDP against headline GDP earlier in this report, the contributions of the private sector often exceeded the headline rate. This has been our primary source of growth.

Category	2015:Q2
GDP=Real Gross Domestic Product	3.9
PCE=Personal Consumption Expenditures	2.42
BFI=Business Fixed Investment	0.83
EX=Exports	0.64
SUM	3.89

Chart 12 Government GDP

This chart shows the combined contribution of the Federal and State and Local government components of GDP. As you see, for most of the expansion we have had negative contributions. You should also note that the vertical scale on this chart goes from -2% to plus 2%. On the previous chart the scale went from -4% to +6%. And that is the reason why the two series are not shown on the same chart.

You should also keep in mind that all of the numbers that we are using on these charts are the weighted contributions of each of the components.

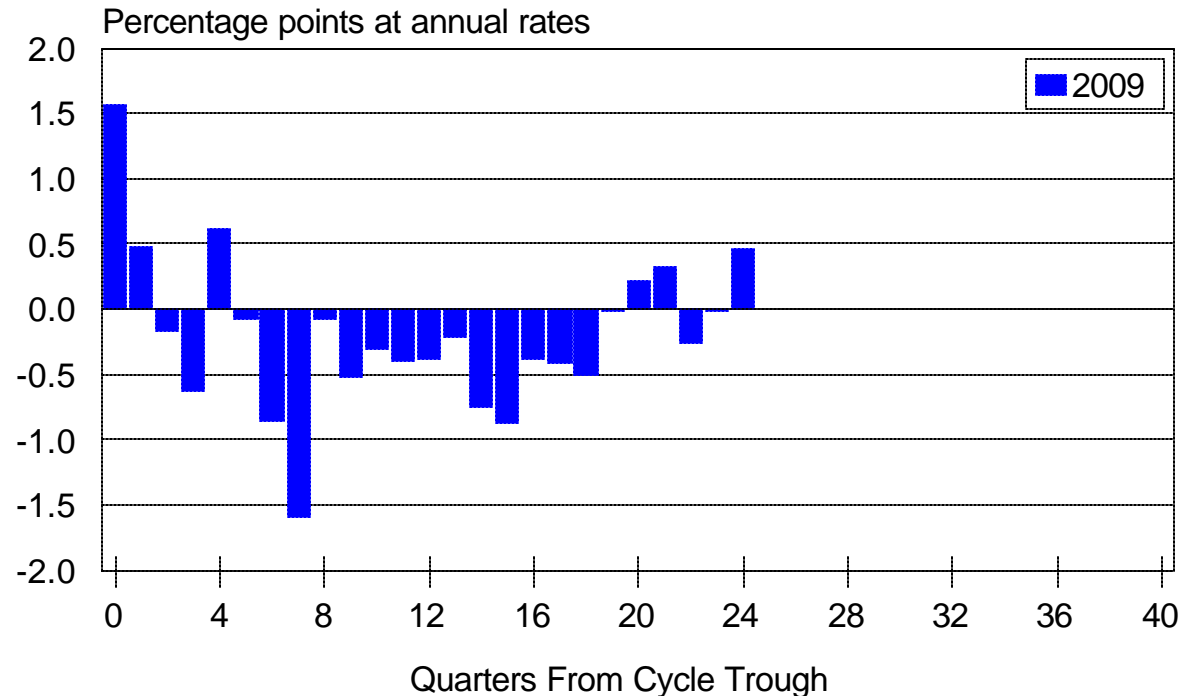
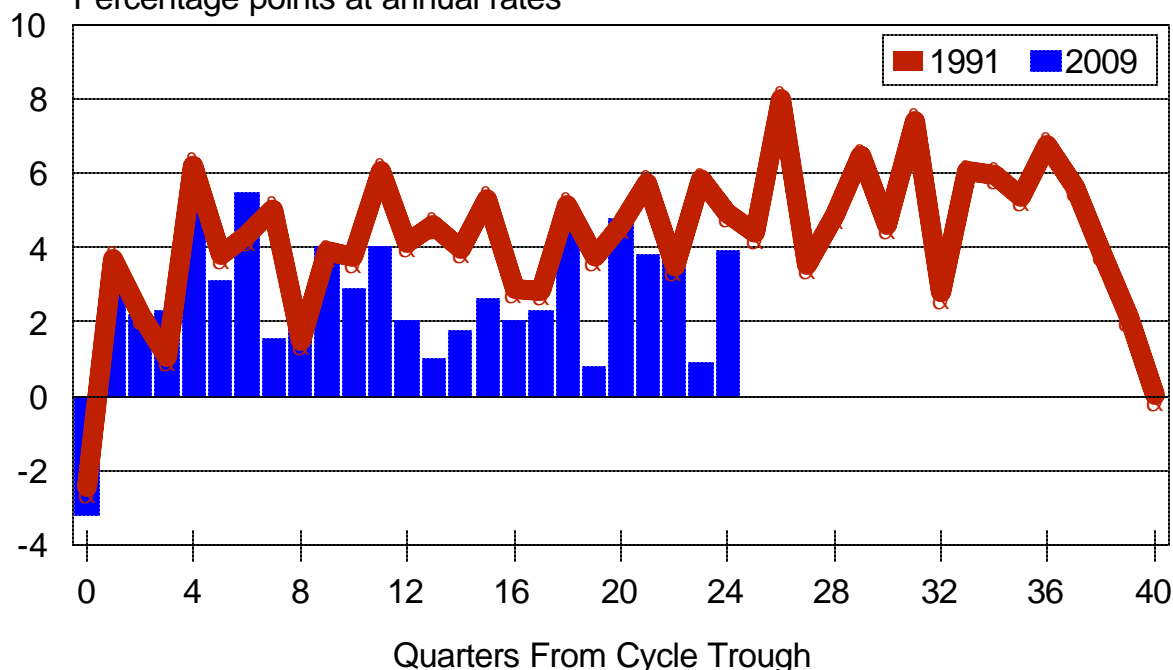


Chart 13 Core GDP

Core GDP = PCE+BFI+Exports

Percentage points at annual rates



On this chart we compare the performance of Core GDP so far in this expansion to that of Core GDP in the 1991-2001 episode. I am doing this for the purposes of comparison and not to make a forecast. And as you shall see on the next chart, my reason for using the 1991 episode was because of the way it compares to what has gone on so far this time.

The first thing I am sure that you noticed is that the red runs above the blue bars in almost each pair of observations. This is a reminder that this expansion is less robust than that of 1991-2001.

The other thing you notice is that the line goes to zero as we approach the end of the 1991-2001 expansion. Which is as it should be. Right now Core GDP is well above zero.

Chart 14 Government GDP

It is only fair to tell you that my eyebrows went up when I saw this chart. In fact, I went back and checked to be sure that I had the correct numbers. Yes, I had forgotten that back in the mid-1990s we had the first version of the current gridlock. The White House in the hands of a Democrat and the House and Senate in the hands of the Republicans. The results being quite similar to those we have experienced in the current recovery and expansion.

As you also see, for reasons that are similar to what is going on now, the contribution to overall growth from the government sector became greater in the later stages of the expansion. And that was because the state and local component of government shifted the austerity imposed by the 1990-1991 recession to improved fiscal conditions that allowed more spending. The same process is underway now, and has lately been reflected in the pace of hiring at the state and local sector.

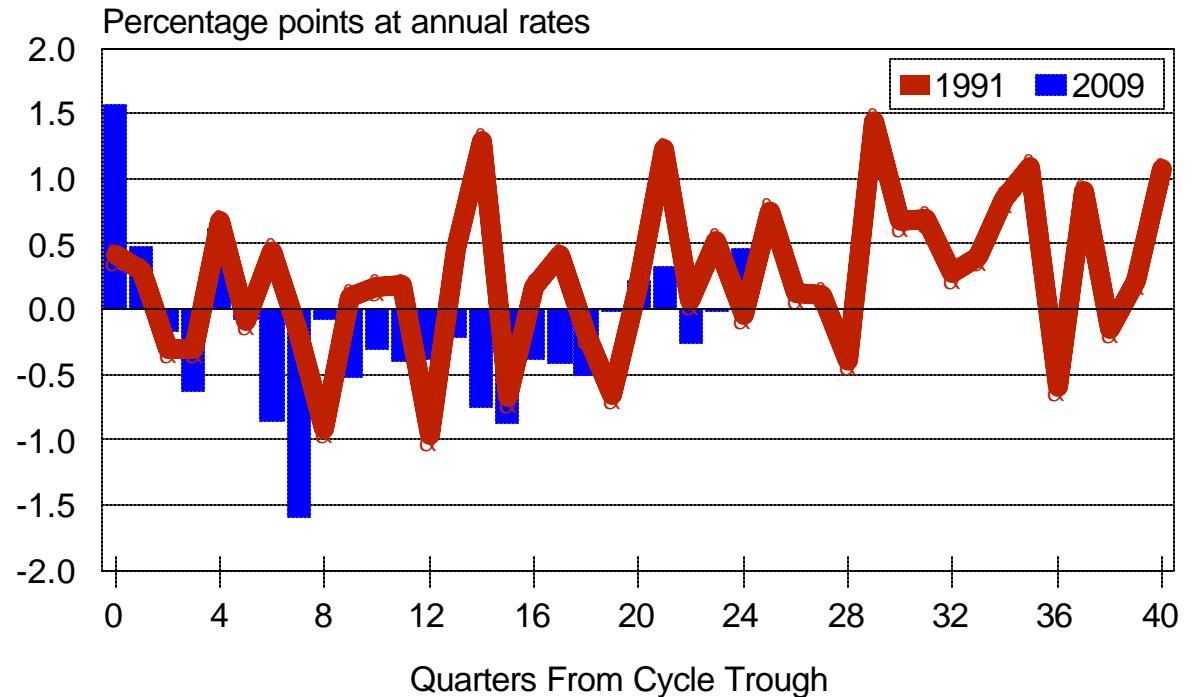


Chart 15 Real GDP

Let's end this installment of our review of the sources and uses of growth with a look at headline GDP in this expansion and that of 1991-2001. We had several choices for the comparison of what is going on now and what happened earlier. I thought it might be best to start with a comparison of the current episode with the longest and strongest of the expansions.

This chart tells several useful and important things. First, even in a long and strong expansion, the volatility of GDP growth is quite high. There is a tendency to forget that and think that the process of expansion is a smooth upward rise of economic activity.

Second, even in long expansions we find periods where the GDP growth rate slows markedly. How and why matters more than how much.

Third, as we approach the cycle peak it behooves us to identify the sources of instability. That is why we call the boom phase the boom phase, instability is its signature characteristic. We will be looking at the major components of GDP in the months ahead.

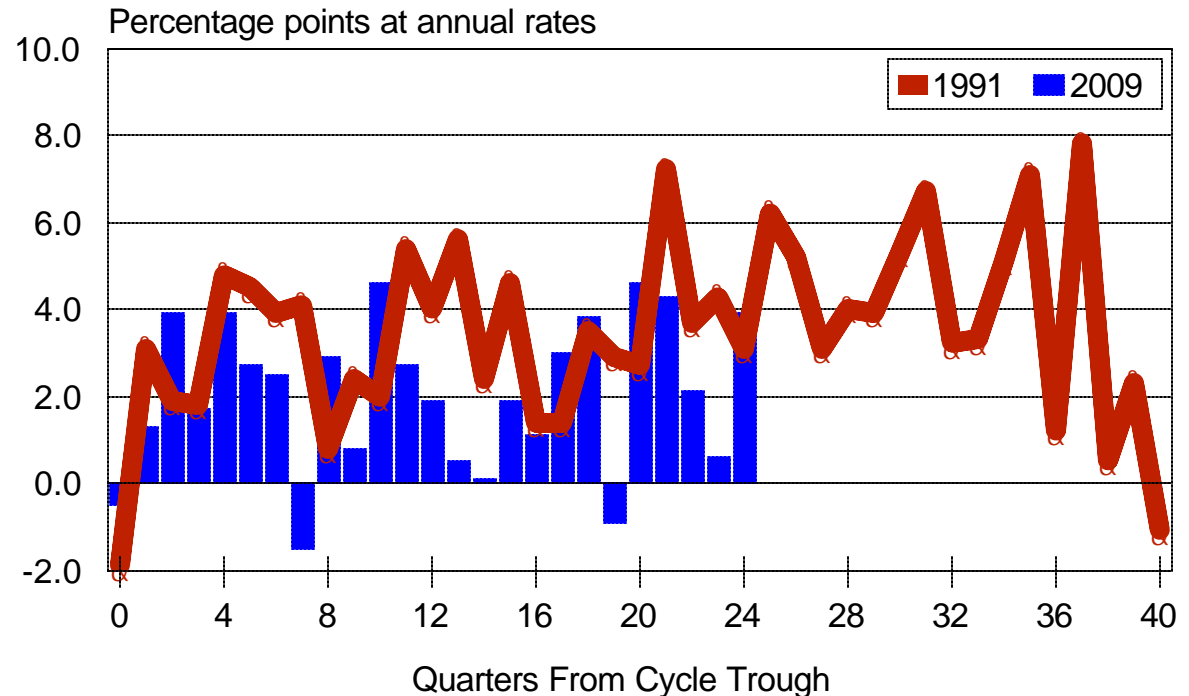


Chart 16 10-Year Treasury Note Percent

Given the range of items that the Federal Open Market Committee [FOMC] says it is considering in its policy deliberations, I will not conduct another survey of your outlook for rates. I get the urge to do this every time the 10-Year gets to 2%. It was hard enough when all we had to consider were the domestic usual suspects. When the FOMC added international concerns to the list, the list got too long. So, I plan on just watching for the next couple of months.

Perhaps by then the FOMC will have made up its mind so that we can go back to trying to figure out what the connection is between low inflation and low interest rates in an era of moderate nominal GDP growth.

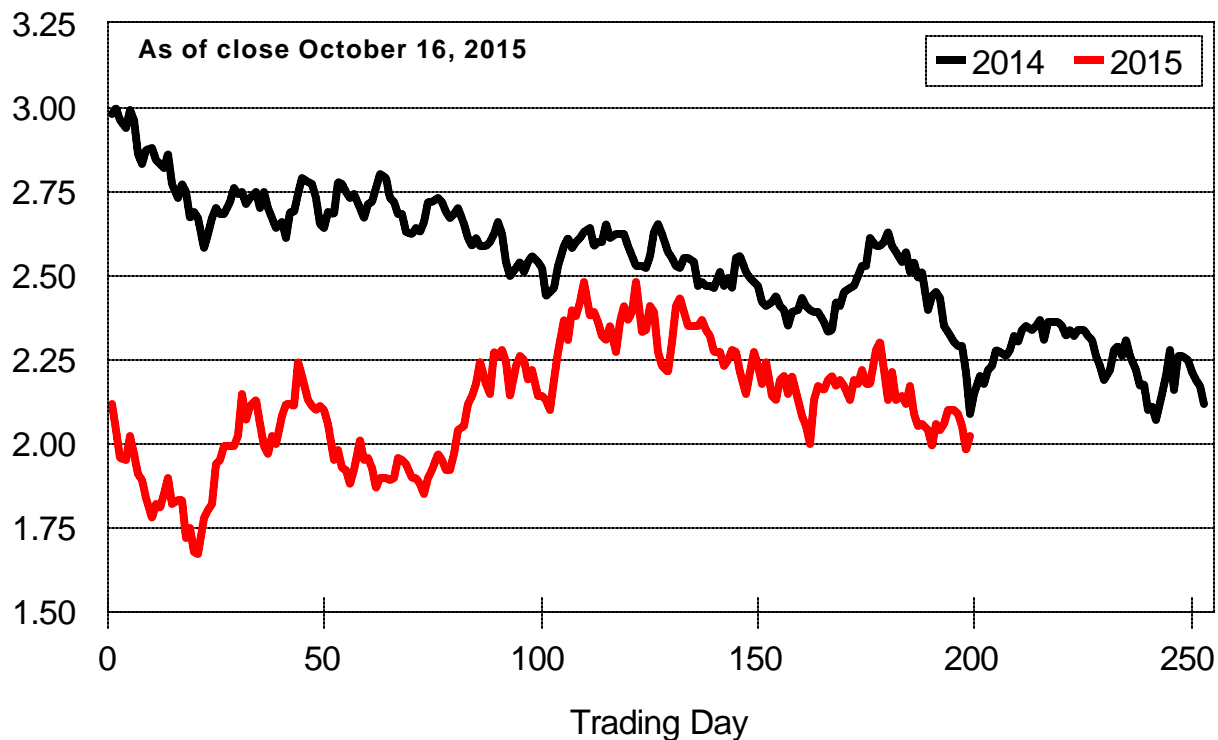
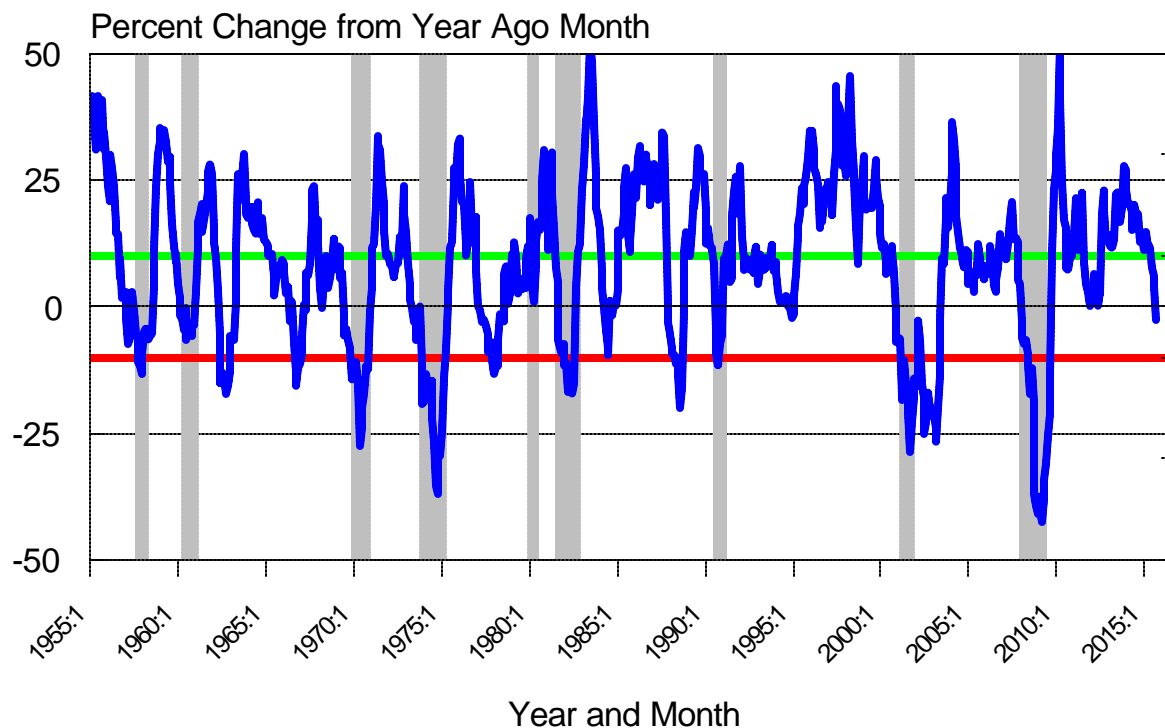


Chart 17

Standard and Poor's 500 Stock Index

With the full effects of the latest correction now clearly visible on our Zone of Death [ZOD] chart, the question will become whether this turns out to be another one of the many instances where a major move in equity prices is not associated with a recession. Observers of long expansions will note that in both the 1960-1969 and 1991-2001 episodes the blue line went into the ZOD more than once.



Date	S&P500
2015:6	7.82
2015:7	6.13
2015:8	3.99
2015:9	-2.42

Chart 18

Standard and Poor's 500 Stock Index

S&P500 2015 Daily Close with Zone of Death Limits (Index Points)

Based on what we see here, it is entirely possible that the next observation we put on the ZOD chart will be at or above the zero line, since we are about to traverse a range where the black line is moving down. But after that it will be more difficult to stay above zero unless we get a new spark in the stock market.

And, while I am at it, this is a good time to remind you that the blue line on this chart will become the black line on the chart we will be looking at in 2016. In other words, it will take readings above 2000 on the SPX next year to be above the zero line on the ZOD chart.

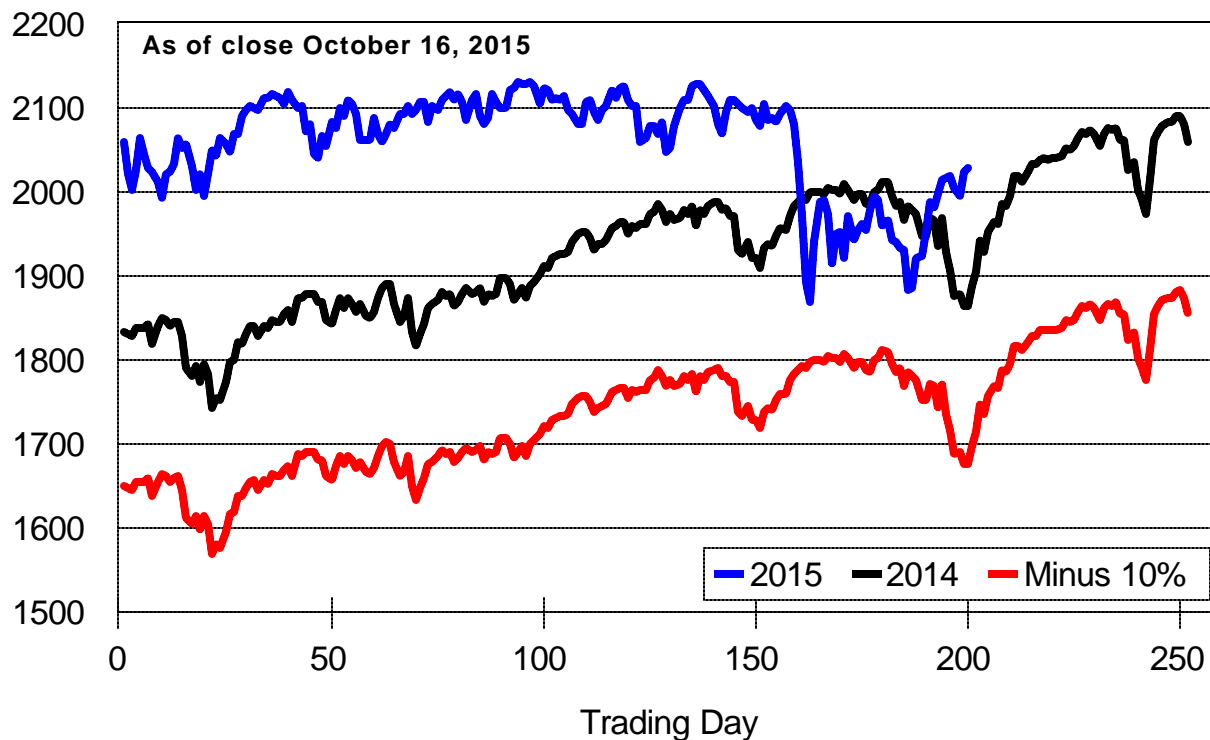


Chart 19

Standard and Poor's 500 Stock Index

S&P500 2015 Daily Close with Correction Indicators

While we are running near the zero level on ZOD charts, we are now running at about the -5% level on the correction chart. By the way, I have used this chart at a couple of client meetings over the past month. All the attendees liked the chart because it finally allowed them to see what the terms “correction” and “bear market” meant. They were particularly glad to learn that those events are defined by the prior high. Several admitted not knowing that. So, thanks to the several of you who suggested adding this to the mix.

As was the case with the 10-Year, I am not going to take survey of how many of you think we will touch the green line before we touch the red line. But the urge to do so is strong. My call? Not a clue.

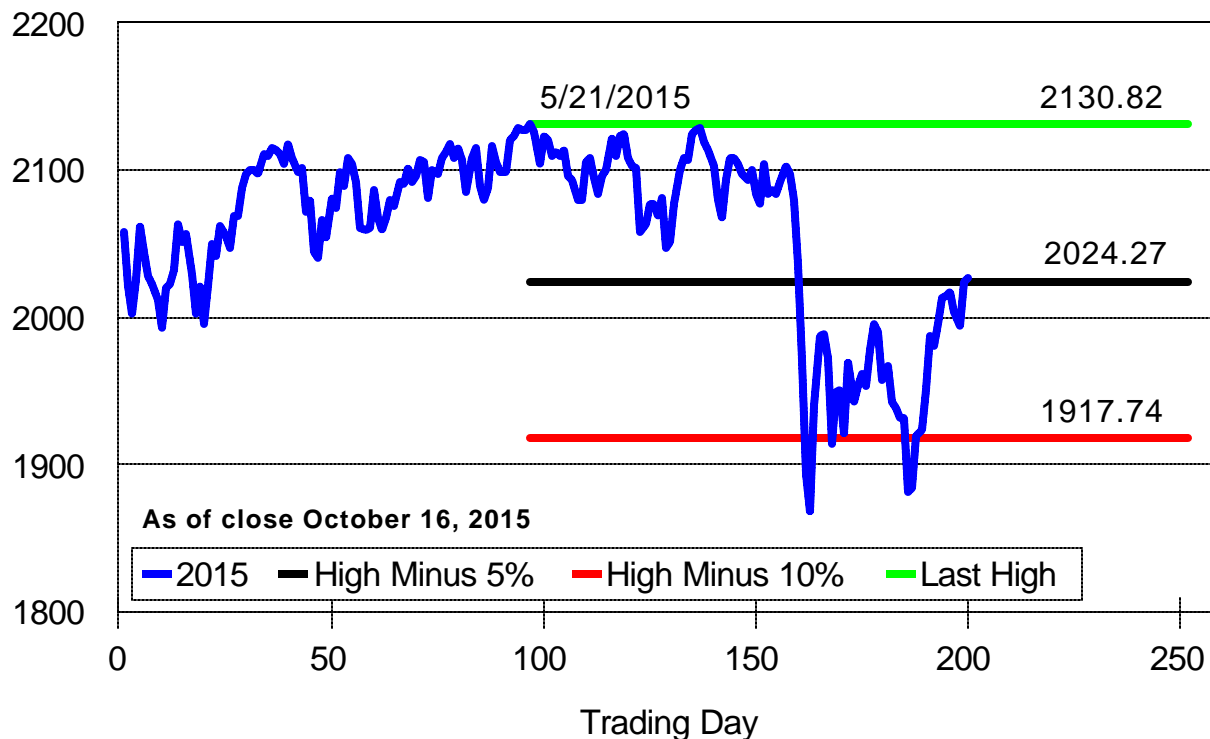
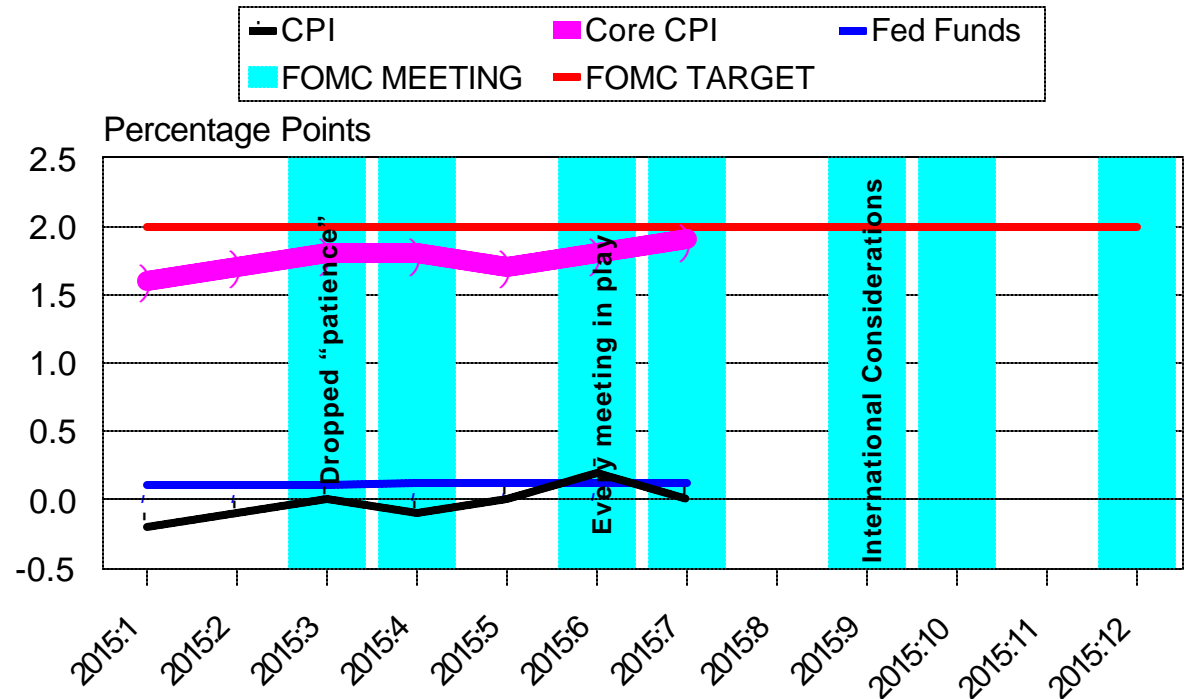


Chart 20 Monetary Policy Scoreboard

Both because there is no press conference scheduled after the October 27-28 FOMC meeting and because they really will not have learned much more about the current pace of economic activity, the expectation is that no announcement of a policy change will come this month. But, until such time as we find out whether or not they are going to do anything, we will continue to run this chart.

If they say something of interest in the press release, I will add it to the comments that you see in the blue bars.



Note: For CPI and Core CPI the figures plotted are the percent change from prior year. For Fed Funds the figure plotted is the monthly average level.

	<u>CPI</u>	<u>Core CPI</u>	<u>Fed Funds</u>
2015:4	-0.1	1.8	0.12
2015:5	0.0	1.7	0.12
2015:6	0.2	1.8	0.13
2015:7	0.0	1.9	0.13



Chart 21 Summary and Conclusions



“The future ain't what it used to be.”

Once again, I rely on my main man Yogi to come up with a way of converting jargon into plain English. I have used, and probably abused, the term structural change in these missives for quite some time. Structural change is the hallmark of this expansion. And, in an effort to convey what that means, let me trot out an analogy I used when teaching microeconomics. Yes, there was a time when they let me talk, with minimal supervision, to the youth of America.

Consider this: You have a bowl and there is a marble sitting in the bottom of the bowl. You shake the bowl. The marble rolls around in the bowl and comes back to rest in the bottom of the bowl. This is a stable equilibrium in that you return to the condition that prevailed before you shook the bowl. Now, consider this: You have a bowl and there is a marble sitting in the bottom of the bowl. You drop the bowl and it shatters when it hits the floor. You then chase the marble as it rolls across the room. This is an unstable equilibrium in that when the ball finally comes to rest it will not be under the same conditions that prevailed before you dropped the bowl.

In the 2007-2009 recession we dropped the bowl, and when it shattered we had no reason to think that the marble was going to come to rest in the bottom of the bowl. So it should not surprise you that most of what you have been reading in these pages for the past several years is nothing more than the tale of our chase of the marble across the floor. In other words, we had structural change, the totality of which we are still trying to comprehend.

What I have tried to do in this month's report is to lay out some of the things we have learned in our pursuit of the marble and where I think it might be headed in the months ahead. How and why we got here is crucial to knowing where we are headed next. That is what the sources and uses of growth is about, and we have only just begun to examine all the evidence.

We know that every expansion phase transitions into a boom phase. And after that, we have a cycle peak. The main focus of our efforts is to see whether a set of indicators, heretofore quite reliable, will provide the same information about the transition into the boom phase and beyond.

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