

Will the U.S. economy finally lift off in 2015?

by **Bruce McCain**, Chief Investment Strategist, Key Private Bank

Monetary authorities influence economic growth by raising or lowering the cost of borrowed funds. And worldwide monetary authorities have flooded the global economy with money over the last few years in an effort to stimulate economic growth by pushing interest rates lower. The beneficial effects of lower rates on growth, however, are not as effective when consumers and businesses cannot or will not spend, regardless of the cost of borrowed funds. Put simply, when businesses do not see the potential for more sales, they tend not to care how cheap borrowed money becomes. And while consumers may always desire to spend more, their financial circumstances do not always allow them to borrow. Throughout the current economic cycle, businesses have remained extremely cautious about expanding their productive capacity and consumers have lacked the financial wherewithal to spend much more.

Much of the weakness in U.S. economic growth over the course of this cycle can be traced to weak consumer demand. Statistics suggest that a shortage of spendable income accounts for more of that shortfall than the desire to spend. If the economy was creating more new jobs, consumers as a whole would certainly have more money to spend. Yet as important as jobs growth is to increased consumer spending, wage growth is even more important. Since most people are already employed, strong wage gains affect a much broader portion of the workforce.

Typically, however, income growth does not accelerate until after the labor markets have tightened. While the unemployment rate has declined significantly, other labor measures suggest most markets may not yet be tight enough to produce sustainably stronger wage growth. Measures such as the number of people who have been unemployed for 27 weeks or longer and the number of people who are working part-time for economic reasons tell us that there remains a large number of people who are either still seeking jobs or are seeking better jobs. Note, too, that the unemployment rate has improved in part because many potential workers say they are no longer looking for a job. Thus, when labor markets tighten, some of the people who have stopped looking for work will re-enter the labor force, and the expanded number of job seekers will extend the time it takes for the markets to tighten.

Wage rates have recently shown signs of rising more rapidly, encouraging many economists about the prospects for rising incomes. Wage growth, however, is still weak by historical standards, and the acceleration of wage rates may not be sustained. The economy may be nearing the point where incomes will rise more rapidly, but the indications of employment slack suggest that incomes are more likely to improve gradually over the coming year.

Overseas markets also suggest that slack resources in the global economy pose an overhang for growth both abroad and in the United States. Earlier in this recovery, we hoped that the world's emerging economies would grow fast enough to help



About Bruce McCain

Bruce McCain is the Chief Investment Strategist for Key Private Bank, where he monitors the economy and the financial markets and serves as part of the team that formulates investment strategies for clients.

He supplies frequent insights to media throughout the region and around the country. His comments and interviews have been featured in such publications as *The New York Times*, *The Wall Street Journal*, *Investor's Business Daily*, and *Business Week*, as well as on television outlets such as CNBC and Bloomberg TV. He is also a regular source for wire services such as the Associated Press and Reuters and is a Contributor on Forbes.com. Bruce joined a predecessor of Key in 1987, after spending six years on the business faculty of the University of Iowa's Henry B. Tippie College of Business. Bruce earned a PhD in Business Administration from the University of California at Berkeley, and undergraduate degrees in Psychology and Accounting from Boise State University.

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the United States and other developed economies accelerate. Instead, growth in the emerging economies dropped sharply. Those economies had achieved much of their growth not just from exporting to the developed countries of the world, but from building productive capacity to export even more. It appears that global supply may have outgrown global demand by a wide enough margin to make broad expansion of capacity unattractive pretty much across the world.

Once oversupply develops, it takes time for economies to absorb excess capacity. While economic growth in many emerging economies seems to be stabilizing, the rates of growth are much lower than they were in the last cycle. Excess global capacity is also a headwind for export-oriented developed economies. Certainly, Germany and Japan are both fighting to avoid being mired in recession. As difficult as the conditions in the United States have been, the U.S. economy is still in much better shape than most overseas economies. Sluggish growth overseas suggests the stiff global competition that has prevailed over recent years will continue. Intense global competition can only weaken the positive effects that improving U.S. consumer demand might otherwise have on U.S. GDP growth.

While the analysis of global supply and demand suggests the United States will not accelerate quite as sharply as the optimists forecast, there are still a number of reasons to be positive about U.S. growth. Energy prices, for example, have dropped markedly, and that will leave consumers and businesses considerably more money to spend on other things if the lower prices are sustained. And while the economic growth rate has not been strong, continued growth will eat into surplus capacity. Some industries have already exhausted their surplus. In those industries, firms have been expanding as the potential for future sales justifies new capacity. The longer this expansion continues, the more business investment will contribute to domestic economic growth. If the U.S. economy can sustainably grow closer to 3%, rather than averaging roughly 2.5% as it has over the last two years, expansion will become necessary for a much broader range of industries and firms.

Modest growth also has another advantage: inflation should remain more subdued than it would if economic growth were stronger. That, in turn, should allow the Federal Reserve to avoid raising rates for a longer period of time. As long as inflation remains contained, the Fed will likely not be quick to raise rates. The consensus expects the Fed to begin raising rates around the middle of 2015. Subdued growth and inflation would likely extend the start of rate hikes until later in 2015.

The level of economic growth the United States has experienced the last few years is well below what most people had hoped would be achieved. The evidence of continuing slack in the global economy suggests that optimists on 2015 growth may again be disappointed. Still, economic growth is improving and productive slack is gradually being absorbed. Over the last two years, the U.S. economy has grown at an annualized rate of approximately 2.4%. Even if the domestic economy simply moves closer to the 3.0% growth it achieved from 1980 through 2007, people should feel significantly better. While many people would like to see stronger growth, an outlook that involves low inflation, low interest rates and steady economic growth for a longer period of time is not all that bad.

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