Weekly Economic Commentary

September 22, 2014

Mind the Gap

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Highlights

The key now for the Fed, as it deliberates when to begin to raise rates, is to gauge how quickly the output gap is likely to close.

The pace at which the U.S. economy takes up slack is likely to command a great deal of attention from the Fed and market participants in the coming months.

We believe the first Fed rate hike is likely to occur in about a year's time, assuming the economy tracks the FOMC's forecast.

On September 17, 2014, the Federal Reserve's (Fed) policymaking arm, the Federal Open Market Committee (FOMC), met for the sixth time this year. On the one hand, the FOMC surprised markets by announcing "how" it would exit from quantitative easing (QE) and reduce the size of its balance sheet in the coming years. On the other hand, the FOMC calmed markets by not making any substantive changes to its forward guidance to the public and financial markets on when it would begin raising rates.

The statement released after the meeting once again said that the FOMC would keep rates low for a "considerable time" after QE ends. However, the new set of economic and rate forecasts by FOMC members indicated an earlier start to rate hikes than the forecasts made at the conclusion of the June 2014 FOMC meeting and a slightly steeper path for the fed funds rate once rate hikes commenced. Some market participants — ourselves included — thought that perhaps the FOMC would switch to a more explicitly data-dependent approach (how quickly the economy is growing, where the unemployment rate is, what the inflation rate is, etc.). The FOMC, however, decided to strike a more balanced tone, and Fed Chair Janet Yellen repeatedly stressed in her post-FOMC meeting press conference that the timing of the first Fed rate hike would be data dependent. On balance, it appears that the financial markets had it about right, and the first Fed rate hike is likely to occur in about a year's time — assuming the economy tracks the FOMC's forecast.

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As noted above, last week the FOMC released a new set of forecasts for economic growth (as measured by inflation-adjusted [or real] gross domestic product [GDP]), the unemployment rate, and inflation. The FOMC updates its forecasts four times per year: in March, June, September, and December. Fed Chair Yellen stressed that the decision to raise rates will be based on two factors:

1. The gaps between where inflation and the unemployment rate are now (1.7% and 6.1%, respectively) and the rate associated with the Fed's dual mandate (2.0% and 5.4%)
2. How quickly those gaps change

This is the data-dependence part of the Fed's message.

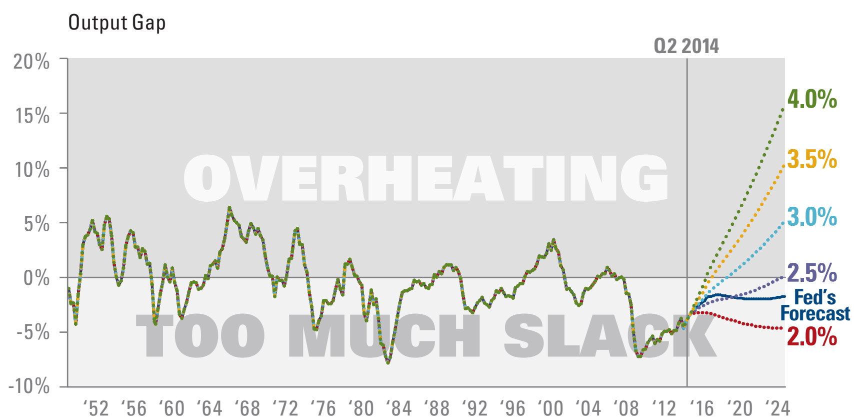
Output Gap

What Yellen did not specifically mention last week was the output gap — the difference between the actual output of the economy and what the economy would produce at full capacity, or what economists call the long-term potential growth rate of the economy. The nonpartisan Congressional Budget Office publishes a history of and provides projections for potential GDP. We adopt these projections for the analysis in the remainder of this commentary, but acknowledge that projections of potential GDP contain a wide range of potential outcomes.

The Great Recession widened the output gap to its widest since the wrenching early 1980s recession.

Since 1982, the output gap has averaged around 1.5%. As shown in Figure 1, the gap tends to narrow during economic expansions and in some periods (mid-1960s, mid-1970s, late 1970s, late 1980s, late 1990s, and briefly in the mid-2000s) the economy grows faster than its long-term potential. When this occurs, inflation is usually rising, and in the past 30 or so years, the Fed has typically responded by raising rates to cool the economy. The Fed didn't act quickly and decisively enough to cool the economy in the mid-1960s and early 1970s, and one of the results was the runaway inflation that gripped the U.S. economy in the 1970s and early 1980s.

1 Output Gap Forecasts Under Different Growth Scenarios



Real GDP Growth Runs At:	Output Gap First Reaches '82–'14 Average (-1.5%)
4.0%	Q4 2015
3.5%	Q2 2016
3.0%	Q4 2016
2.5%	Q1 2020
Fed's Forecast	Q3 2017
2.0%	Never

Source: LPL Financial Research, Congressional Budget Office; Federal Reserve 09/19/14

On the other hand, when the economy persistently runs at a slower pace than its long-term potential — usually during economic recessions — depression and deflation can ensue. Since 2001 (the past 13 years) the economy has consistently run below its long-term potential growth rate. The Great Recession widened the output gap to its widest since the wrenching early 1980s recession. Unlike the robust recovery that followed the 1981–82 recession, when the output gap narrowed within a few years of the end of the recession, the recovery since the Great Recession, which ended in mid-2009, has been lackluster. The output gap remains the widest it has been outside of a recession. The nature of the

Great Recession, a recession caused and exacerbated by a financial crisis, is mostly to blame for the sluggish recovery and still wide output gap. We have devoted many pages in these *Weekly Economic Commentaries* to detailing the other reasons for the sluggish recovery.

For more information about the Fed's labor market indicators, please see the *Weekly Economic Commentary* "Reconnected?" (August 4, 2014).

The key now for the Fed, however, as it deliberates when to begin to raise rates, is to gauge how quickly the output gap is likely to close. In the past, the Fed has not waited until the output gap has completely closed. Instead, the Fed has usually acted to hike rates around a year or so before the gap closed to around 1.5% — its 1982–2014 average. Figure 1 provides the history of the output gap along with GDP growth scenarios and how quickly the output gap would close under those scenarios.

For example, under the FOMC's forecast for GDP — published last week — the output gap would reach 1.5% in the third quarter of 2017. In that scenario, the Fed would likely have to begin raising rates sometime in early to mid-2016. If the economy maintains its current 4.0% growth rate in the coming quarters, the output gap would narrow to its 1982–2014 average by the end of 2015, suggesting the first rate hike would be likely in the next few months. Were the economy to slow to its 2011–13 average growth rate of around 2.0%, the output gap would never get close to 1.6%, and the Fed may need to do more QE. If real GDP growth in 2015 and 2016 is 3%, in line with our 2014 forecast, the output gap would reach its long-term average by Q4 2016, putting the first Fed rate hike sometime in the latter half of 2015, which is just about what the market has priced in today.

As noted in the *Outlook 2014: The Investor's Almanac*, LPL Financial Research expects GDP to accelerate from the 2% pace of recent years to 3% in 2014. Since 2011, government spending subtracted about 0.5% each year from GDP growth. Government spending should be less of a drag on growth, which when combined with better global growth and business spending would result in +1% increase for 2014.

Although projecting the economy's growth rate relative to its long-term potential growth rate is not the only metric on the Fed's radar as it prepares to normalize rates, the pace at which the economy takes up slack is likely to command a great deal of attention in the coming months among the members of the FOMC, investment professionals, and the public. LPL Financial Research will continue to monitor the Fed as it begins its transition away from six years of monetary policy easing and toward a more normal policy. ■

RES 4830 0914
Tracking #1-310200 (Exp. 09/15)