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MIDYEAR OUTLOOK 2016
BELIEVING IN THE POTENTIAL OF THE U.S. ECONOMY

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KEY TAKEAWAYS

Looking out into the second half of the year, we expect the U.S. economy may grow between 2.0% and 2.5%.

Given both the direct and indirect impacts of Brexit on the U.S. economy and financial system, we are now expecting the Fed to raise rates just once this year.

We continue to keep a close eye on the progression of labor market growth and inflation.

This week's commentary features content from our Midyear Outlook 2016: A Vote of Confidence, *published on July 12, 2016.*

For the first half of 2016, the U.S. economy—as measured by real gross domestic product (GDP)—is on track to grow at around 2.0%. Looking out into the second half of the year, aided by a dollar tailwind, stable oil prices, steady consumer spending, record high household net worth, and a slowing, but still solid labor market, the U.S. economy may grow between 2.0% and 2.5%. But even at just over 2%, actual GDP is growing faster than potential GDP (the maximum pace the economy can grow without causing inflation), taking up slack and slowly pushing up wages and inflation. If this persists, the Federal Reserve (Fed) is likely on a path of one rate hike this year. Although the Brexit vote in late June 2016 may slightly lower U.S. GDP growth in the second half of 2016, we do not expect the U.S. to enter a recession this year.

This economic recovery, now seven full years in, has been marked by a slower pace of growth than some would expect or hope for, and in some cases this pace has varied greatly across sectors of the economy and even regions in the U.S. Depending on the source, headlines range from "solid economic recovery moves forward" to "stagnant, below-trend growth persists." So, which is it? Digging into the data shows that it's probably a little bit of both, and likely lands somewhere in the middle. Although this pace of growth may be below trend, we maintain our confidence in the potential for continued U.S. economic growth in 2016.

THE BAR HAS BEEN LOWERED FOR GDP

To understand why GDP growth has recently been below the historical trend of 3%, it's important to look at its core components. The maximum rate at which the economy can grow without causing inflation (formally known as "potential GDP") is shown in Figure 1. The "building blocks" for potential GDP are

Please see our *Midyear Outlook 2016: A Vote of Confidence* for in-depth insights on the economy, stock and bond markets, and investments for the second half of the year.

productivity growth and labor force growth. The figure clearly illustrates that potential GDP and both of its building blocks have slowed since the onset of the Great Recession, relative to the decade and a half prior to it.

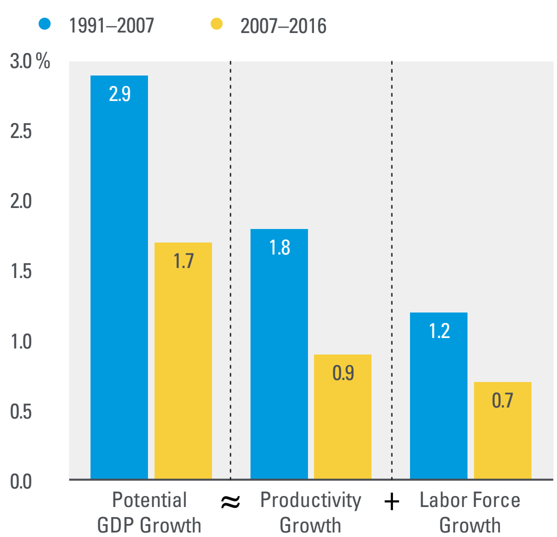
Since the end of the Great Recession, the causes of — and potential remedies for — the anemic pace of economic growth have been hotly debated by investors, business leaders, and policymakers alike. Productivity (as measured by output per hour worked) is slowing, not only here in the U.S., but around the world. The debate is whether the slowdown in productivity is cyclical (largely due to the nature and severity of the Great Recession), structural, or something else. That something else usually being a "measurement problem"; in a global economy that has become more service oriented and technology driven, it is more difficult to measure productivity the old-fashioned way, i.e., measuring the amount of hours of labor required to put out a particular amount of goods.

Labor force growth is the less flexible building block of potential GDP; demographics and long-term secular labor trends are difficult to reverse in the short term. There is some reason for optimism on the productivity side of the equation.

Still, improvement from the recent tepid pace of productivity will likely require, at minimum, better coordination between businesses, labor, and governments at all levels, and almost certainly more monetary and fiscal policy coordination among policymakers worldwide. Governments in the U.S. (federal, state, and local) and around the globe should be encouraging more spending on public and private infrastructure, training more existing and potential workers to be more productive in the 21st century economy, and keeping regulatory burdens low to allow businesses to thrive.

The Great Recession still looms large for many, but ultimately, businesses, governments, and individuals need to look forward and think about how to invest wisely in the future to drive renewed productivity growth. We have vast reserves of know-how. Future productivity gains will depend on how well we put them to work.

1 THE BUILDING BLOCKS OF POTENTIAL GDP, PRIOR TO AND SINCE THE GREAT RECESSION



Source: LPL Research, Organization of Economic Cooperation and Development 06/30/16

Past performance is not indicative of future results.

OUR GOOD FRIEND, THE FED

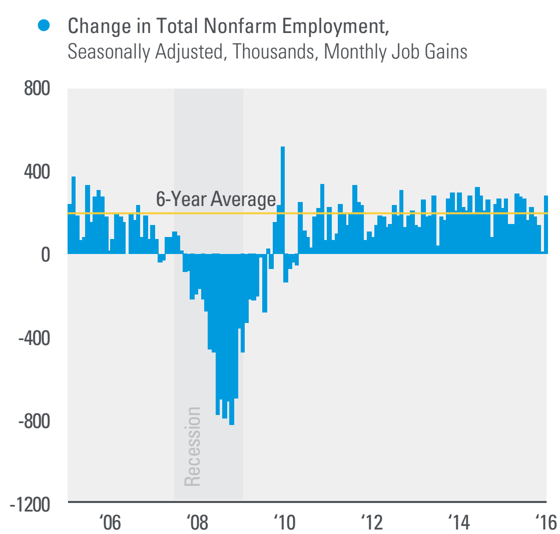
Much like the views on the pace of economic growth, there has been a consistent disconnect between the market's expectation of Fed rate hikes and the Fed's guidance on future hikes. At the start of 2016, the federal funds futures market was pricing in two 25 basis point (0.25%) rate hikes for the year, versus the Fed's December 2015 guidance that it planned four hikes in 2016. In late February 2016, the fed funds futures market didn't see a rate hike until the end of 2017. Since then, the Fed has guided markets to expect just two hikes this year. The Fed had remained adamant that these hikes will happen, until just after the Brexit vote in late June 2016, when the Fed signaled a more cautious approach for this year.

Given both the direct and indirect impacts of Brexit on the U.S. economy and financial system, we are now expecting the Fed to raise rates just once this year, potentially in December 2016. If Brexit uncertainty lingers, putting more downward pressure on the U.S. economy and inflation—and more pressure on financial conditions than we now expect—it is possible that the Fed could choose to stay on the sidelines all year. Similarly, if the impact of uncertainty around Brexit is short-lived, it is still possible that the Fed may hike rates twice this year, matching the forecast we made in November 2015. Three rate hikes by the Fed this year, which was a small possibility prior to the Brexit vote, now seems very unlikely. Brexit vote aside, fundamentally it comes down to the labor market and inflation. So what do we expect to see over the remainder of 2016?

THE LABOR MARKET: IT ALL COMES DOWN TO TURNOUT

The labor market could be on the cusp of a slowdown in job creation. Even after surprisingly weak job growth in April and May 2016 (averaging just 80,000 per month), over the past six years, the U.S. economy has created more than 13.6 million net new jobs, an average of between 175,000 and 200,000 per month. Over that span, the unemployment rate has dropped from nearly 10% to 4.9%, and wage inflation (as measured by the year-over-year gain in average hourly earnings) has moved from a low of near 1.5% to over 2.6%. History suggests that given where we are in the business cycle, and how far the labor market has come, a routine downshift in the labor market may be at hand. "Temporary help" jobs, a key leading indicator of future job growth, have fallen by more than 40,000 jobs in the first six months of 2016. If sustained, this suggests a slowdown in overall job creation later this year.

2 **FED SAYS JOBS TARGET IS 125,000–150,000; MARKET LIKELY EXPECTS MUCH HIGHER**



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 07/08/16

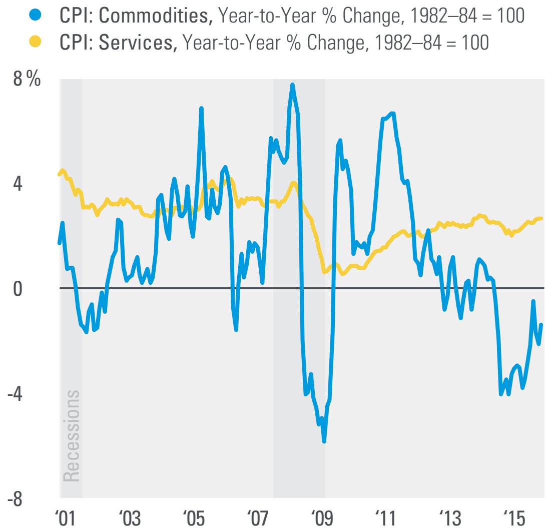
Market participants may view this downshift as a sign that the economy is slowing, and may even begin preparing for the next recession and next set of rate cuts from the Fed. But here's where the market and the Fed may be at odds. In a series of public appearances over the past few years, Fed officials noted that monthly job gains as low as 120,000 would still be enough to tighten the labor market, take up slack in the economy, and push up wages and ultimately inflation. Whereas the market would likely view a downshift to job creation of 120,000 jobs per month—or even 160,000 per month—as a sign of a slowing economy, and begin to worry about global growth and the onset of a recession [Figure 2]. Yet another disconnect between the Fed and the market to worry about.

INFLATION: BATTLEGROUND STATE

The aftershocks of the Great Recession, plenty of global spare capacity, slower global GDP growth, and the globalization of product and labor markets have acted as restraints on inflation in recent years. However, at least in the U.S., the factors pushing inflation higher may begin to win the battle over the second half of 2016 and beyond.

The recent rise in commodity prices off the early 2016 lows increases the odds that inflation will continue to move toward the Fed's longer-run 2% target by year-end. The overall reading on the Consumer Price Index (CPI) at midyear is running at just 1.1% year over year; but beneath the surface, CPI for services (two-thirds of CPI) has recorded a 2.7% year-over-year gain—placing it in the middle of its recent range. Meanwhile,

3 IN THE U.S., FACTORS PUSHING INFLATION HIGHER MAY BEGIN TO WIN THE BATTLE OVER H2 2016 AND BEYOND



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 06/30/16

Data for CPI are as of May 31, 2016, the most recent data available.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services, and is a commonly used measure of inflation.

CPI for commodities (one-third of CPI) was down 1.4% year over year in May, but for much of 2015 and early 2016 that figure was closer to down 4% [Figure 3]. If oil and gasoline prices stay in their recent ranges, CPI for commodities will turn positive in the second half of 2016 and push overall CPI close to 2%. By then, the Fed may have already raised rates again.

While headline inflation remains low, most consumers would say that there is plenty of inflation, and they have the grocery and gasoline bills to prove it. In the 1960s, 1970s, and early 1980s, soaring inflation was a big concern in the voting booth; but today, low inflation—and the low wage increases that have accompanied it lately—are the big issues. The latest survey of consumer inflation expectations (via the University of Michigan's Survey of Consumers) revealed that consumers expected 2.3% inflation over the next 5–10 years, the lowest on record. But these days, consumers equate low inflation to slow wage growth. The good news is that those grocery prices are down nearly 1% and have been roughly unchanged for the past 18 months or so. The bad news (for politicians, at least) is that gasoline prices are up by nearly 75 cents per gallon since early this year—and if that trend continues into the summer and early fall, rising inflation could still become a key issue in the 2016 race. ■