

BUSINESS CONDITIONS MONTHLY

November 2016 Vol. 3 Issue 11

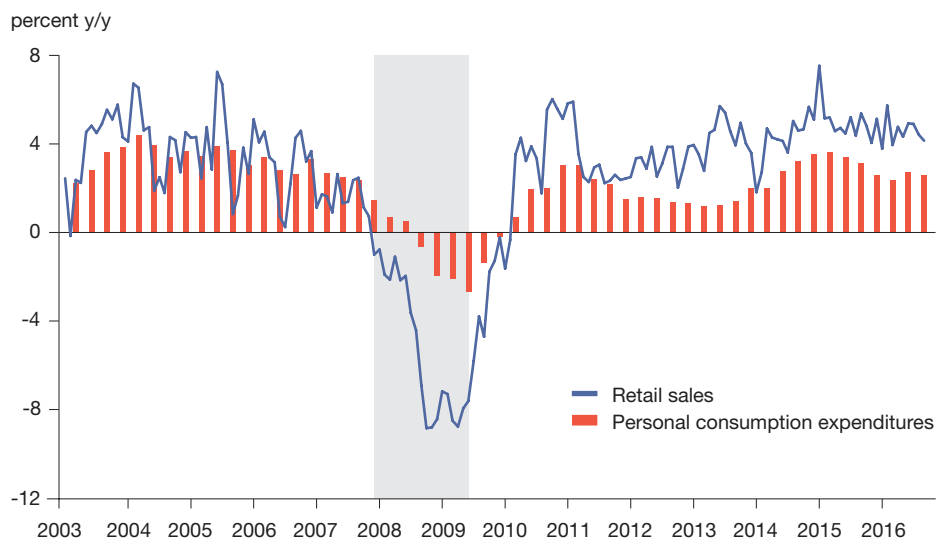


Retail sales stay solid heading into the holidays

Consumer spending slowed to a 2.1 percent annual rate in the third quarter from a strong 4.3 percent pace in the second quarter, according to the latest data on real gross domestic product from the Bureau of Economic Analysis. On a year-over-year basis, personal consumption expenditures, a measure of real consumer spending, grew at a 2.6 percent rate, down slightly from a 2.7 percent pace in the second quarter (Chart 1).

Growth in real retail sales (a subset of total PCE) has been much stronger (Chart 1), climbing into the 4-to-6 percent range for much of the past four years. This strong performance is consistent with the continued gains in jobs (the unemployment rate is now 4.9 percent) and slowly accelerating gains in hourly earnings (up 2.8 percent over the 12 months through October). As the always-important holiday spending season approaches, healthy gains in real retail sales and generally strong consumer fundamentals provide solid ground for optimism.

Chart 1. Steady growth in retail sales for much of the past four years supports an optimistic outlook on holiday spending.



Note: Shaded area denotes recession.
Source: Bureau of Economic Analysis (FactSet).

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Market-capitalization-weighted indexes change over time, reflecting a changing economy.

Consumers are buying and shopping differently than they used to, but their spending remains the driver of the U.S. economy.

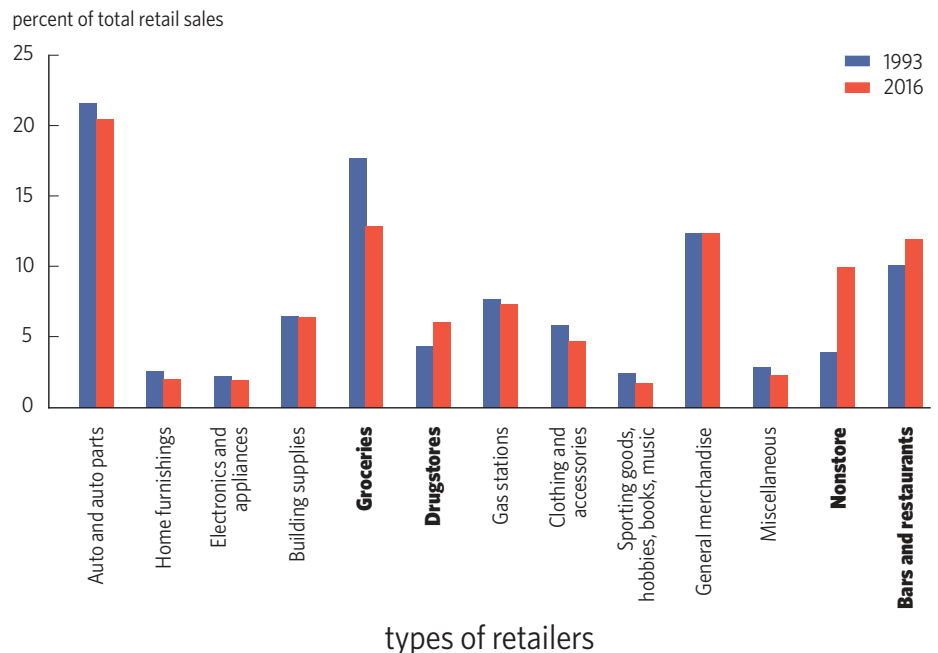
Change is apparent in nearly all aspects of the economy. Economic agents are constantly adapting, innovating, and attempting to improve. As we focus on U.S. consumers as the engine of growth for the current economic expansion, it's interesting to note changes in their spending patterns.

In 1993, automobile and auto parts retailers and grocery stores held the two largest shares of retail sales (based on the trailing 12 months of data through September 1993). They accounted for 21.6 percent and 17.7 percent of total retail sales, respectively (Chart 2). Along with general merchandise stores (a 12.3 percent share), these top three retail categories accounted for over 50 percent of retail sales.

Twenty-three years later, retail shopping habits have changed, in some cases significantly. While auto and auto parts retailers still account for the largest share of retail spending, their share has dipped about 1 percentage point to 20.5 percent. Grocery stores have seen their share fall to 12.9 percent, almost 5 percentage points below 1993. In fact, nine of the 13 retail categories have seen their market share drop between 1993 and 2016. The general merchandise category has managed to hold about steady.

The big gainers over the past two decades have been nonstore retailers (up to 9.9 percent from a 3.9 percent share), restaurants and bars (up to 12 percent from 10.1 percent), and drugstores (up to 6.1 percent from 4.3 percent). Nonstore retailers includes the fast-growing online segment, while 20 years ago, when online shopping was in its infancy, the category was predominantly catalog and direct sales. Those top three market-share gainers now account for about 28 percent of retail sales, a full 10 percentage-point gain over 1993. Their gains may reflect changes in merchandising or customer demographics, but whatever the reason, their growing market share shows that consumers have altered their spending patterns.

Chart 2. Nonstore retailers, restaurants, and drugstores have gained the most market share among retailers, while grocery stores have lost out.



Source: U.S. Census Bureau (FactSet).

ECONOMIC OUTLOOK

Our Business-Cycle Conditions Leaders Index improved again in the latest month, rising to 58 in October from 54 in September (Chart 3). October marks the second month in a row above the neutral 50 level following seven consecutive months in the 38-to-50 range. As we cautioned last month, we do not believe there is enough evidence to suggest the economy is on a significantly different path. Consequently, we still believe the results over the past nine months are consistent with overall slow growth and continued economic expansion. However, this second month of improvement and readings above 50 provides marginal optimism that the risk of recession in the months ahead has diminished.

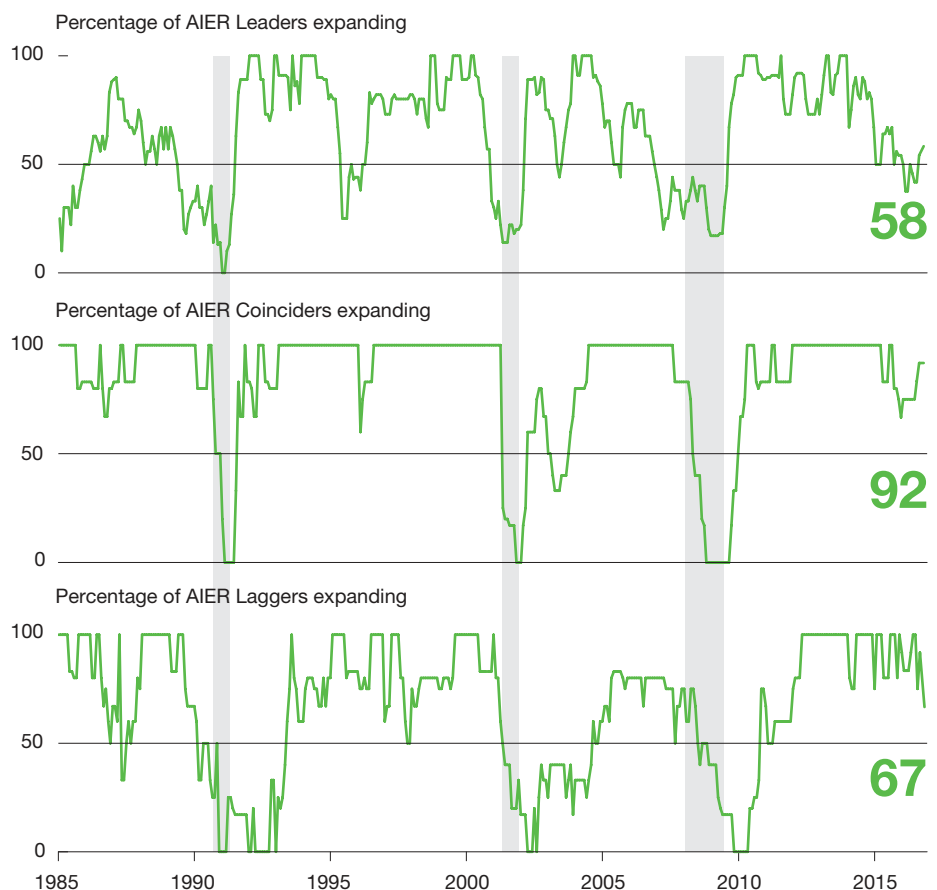
The improvement is a result of two indicators turning up, from a neutral to a positive reading, while one fell from positive to neutral. Housing permits and debit balances in margin accounts both showed positive trends in the latest readings, while the average workweek in manufacturing flattened after rising for two months.

For the remaining Leaders, initial claims stayed favorable, as did real retail sales. However, consumer expectations are weak. Real stock prices and the yield curve have been positive, while real new orders for core capital goods and heavy truck unit sales remained down.

Among our other indexes, the Coinciders were unchanged at 92 in October, while the Lagggers fell sharply, to 67 in October from 92 in September. That drop was a result of three indicators turning neutral from positive (real manufacturing and trade inventories, commercial and industrial loans, and core CPI). The sharp decline reflects the period of weakness in the economy in the first half of 2016.

Chart 3. Indicators at a glance

Shaded areas denote recessions.
A score above 50 indicates expansion.



Source: AIER.

Monetary policy and financial stability: rules vs. discretion**The Fed's dual mandates and financial stability**

It has been eight years since the U.S. economy went through the worst economic crisis since the Great Depression. During what became known as the Great Recession (December 2007–June 2009), the economy lost nearly 800,000 jobs monthly. Unemployment soared to 10 percent, and households' equity in real estate declined by 55.6 percent, to nearly \$6 billion by the second quarter of 2009 from its peak of \$13.5 billion in the first quarter of 2006. From 2007 to 2009, 146 U.S. banks failed. This domino effect in the financial system did not even end after the recession was officially declared over. In its aftermath, another 157 and 92 banks failed in 2010 and 2011, respectively.

But what did we learn from the financial crisis? Could the Federal Reserve have done something to avoid it?

According to the Federal Reserve Reform Act of 1977 (<https://www.gpo.gov/fdsys/pkg/STATUTE-91/pdf/STATUTE-91-Pg1387.pdf>), the Fed's monetary policy objectives are to achieve the goals of maximum employment, stable prices, and moderate long-term interest rates by maintaining long-run growth of the monetary and credit aggregates that ensure the economy's potential to increase production. This act has clearly bestowed the Fed with two important dual mandates: maximum employment and stable prices. However, due to the inherent trade-offs that exist between inflation and unemployment, achieving these two objectives simultaneously is one of the key challenges of monetary policy.

For example, under former Chairman Paul Volcker, the Fed committed to combat the double-digit inflation of the late 1970s. Monetary policy was tight (the effective federal-funds rate, by January 1981, was 19.08 percent), which put a heavy burden on borrowers and immediately led the economy into a recession (the unemployment rate rose to 10.8 percent by December 1982).

On the other hand, keeping interest rates too low for too long with the objectives of promoting growth and ensuring maximum employment has its own risks. It builds inflationary pressure and encourages excessive risk-taking behavior leading to asset price rallies. It is evident from the financial crisis of 2007 and 2008 that such excessive risk-taking behavior in a highly interconnected financial system poses systemic risk and financial instability.

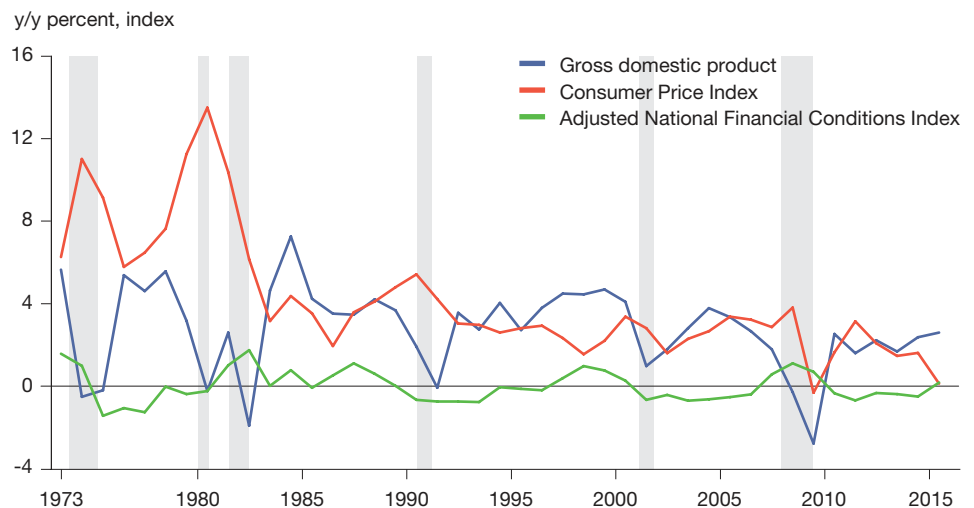
Chart 4 illustrates the close relationship between the financial sector and the economy and the challenges of achieving the dual mandates. The Chicago Fed's Adjusted National Financial Conditions Index, or ANFCI, reflects the underlying risk, credit, and leverage conditions in financial markets. Positive values indicate a tighter financial market, and negative values show relatively stable conditions. In two of the most severe recessions since the late 1970s—July 1981–November 1982 and December 2007–June 2009—gross domestic product declined 2 percent or more and financial markets were tighter than average, indicating elevated risk, tight credit conditions, and declining leverage.

Rules vs. discretion

Discussion about the role of the Fed and particularly the role of monetary policy in promoting financial stability received greater attention after the 2007–2008 financial crisis, in part because of the loss of confidence in then-existing regulations to protect the economy from such unprecedented episodes. Economists such as Michael Woodford of Columbia University argued that monetary policy, by embracing the added objective of financial stability, could achieve its dual mandates. On the other hand, Swedish economist and ex-deputy governor of the Sveriges Riksbank (Sweden’s central bank), Lars Svensson, preferred to leave the task of financial stability to macro-prudential regulation—that is, rules intended to reduce instability across an entire financial system. The debate is still unresolved.

If we assume that the Fed adds the role of financial stability to its monetary policy objectives, it is faced with two options to communicate its actions to the public and execute its policy. One is to announce its commitment to a set of policy rules, such as keeping interest rates within a certain band to achieve a target level of inflation, unemployment, and financial stability (this could be measured by a composite index such as the ANFCI or the interest-rate spread between a risky asset, i.e., a BAA corporate bond, and a safe asset, i.e., a Treasury bond) and stick to this policy indefinitely. This type of policy resembles a parent who promises to punish a child for misbehavior and fulfills it no matter what. It is called a rule-based monetary policy. With this type of policy, the Federal Reserve loses flexibility but gains credibility with the public and minimizes trade-offs between inflation and unemployment while maintaining financial stability.

Chart 4. Short-term fluctuations in the financial sector are closely related to economic conditions.



Note: Shaded areas denote recessions. The Adjusted National Financial Conditions Index (ANFCI) measures risk, liquidity, and leverage in money markets and debt and equity markets as well as in the traditional and shadow banking systems. Positive values of the ANFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve Bank of Chicago (FRED).

The other possibility is for the Fed to periodically update its policy based on the available information. For example, after announcing a lower interest rate, the Fed could change its policy in the middle of the course if there are signs of movement in the opposite direction in key macroeconomic indicators. This type of policy is similar to a parent who promises to punish a child for misbehavior but forgives the child after the incident happens. This is called a discretionary monetary policy. Its advantage is flexibility, but the Fed loses credibility and faces bigger trade-offs in inflation and unemployment as it stabilizes the financial system.

Considering the two options, research based on modern macroeconomic models suggests that a rule-based policy results in superior outcomes in terms of achieving target inflation, lower unemployment, and a stable financial system.

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The U.S. equity market has shifted to reflect changes in the economy.

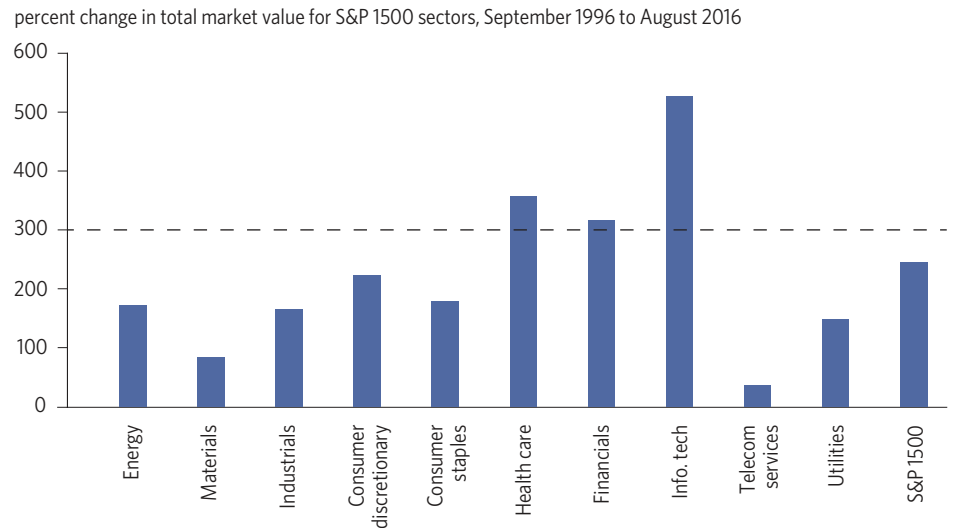
The U.S. economy is constantly changing to reflect the behavior patterns of its participants, the changing global economy and regulatory structure, and shifts in demographics and technological innovation. Just as the composition of the economy and retail sales have changed over time, so has the composition of the U.S. equity market.

Over the two decades from September 1996 through August 2016, the total market value of the Standard & Poor's Composite 1500 Index increased 243 percent, an annualized gain of 6.4 percent. Over the same period, nominal gross domestic product increased at a 4.2 percent rate, while real GDP posted 2.3 percent annualized gains.

Among the ten sectors of the index, information technology, health care, and financial stocks posted the largest gains, increasing in total market value by 526 percent, 356 percent, and 315 percent, respectively (Chart 5). The weakest performers were telecommunication services, up just 36 percent, and materials, up 83 percent.

The strong outperformance of the information technology, health care, and financials sectors reflects the growing importance and stronger underlying growth of the companies in these sectors. In each, the companies have generally benefited from strong sales and earnings growth as a result of increased demand. That increased demand has often been supported by some combination of technological innovation and demographic trends.

Chart 5. Total market values of the health care, financial, and information technology stock sectors have gained more than 300 percent over the past two decades, far outpacing other sectors.



Source: Standard & Poor's (FactSet).

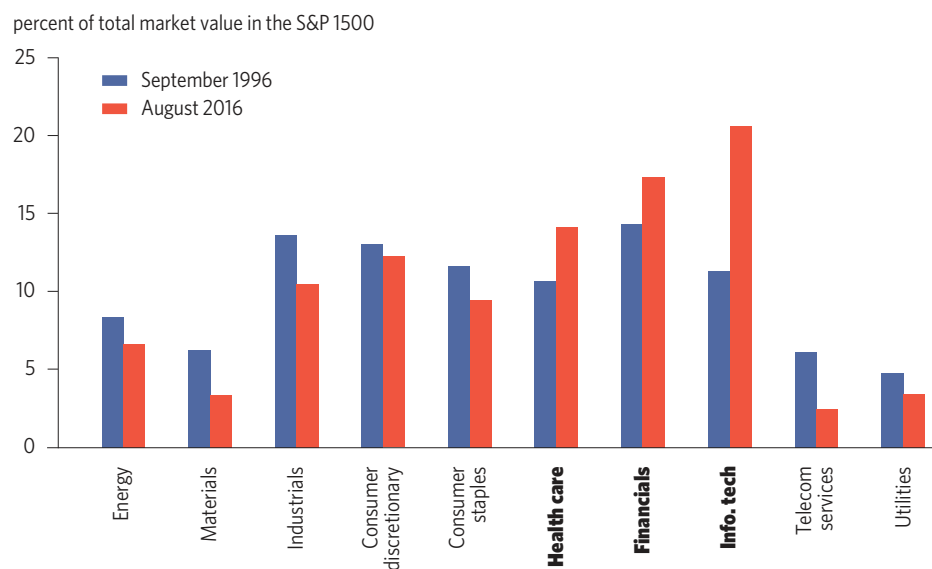
Indexes constructed with market-capitalization weightings rely on the collective wisdom of investors to determine sector allocations. As capital is allocated to some sectors rather than others, the total market value of sectors changes. Market-cap-weighted indexes reflect those changes over time.

Over the 20 years from 1996 through 2016 the value of each of the 10 economic sectors has grown at different rates. As a result, the composition of these indexes has changed. In 1996, financial stocks accounted for the largest market-value share in the S&P 1500, at 14.3 percent. Second was industrials at 13.6 percent, and rounding out the top three was the consumer discretionary sector at 13 percent. Combined, the top three sectors accounted for 41 percent of the market value of the index. By contrast, the bottom three sectors—utilities, telecommunication services, and materials—accounted for 17.1 percent (Chart 6).

As of August 2016, the largest market-value share within the S&P 1500 belonged to information technology, at 20.6 percent. Financials and health care were the next two largest sectors, with market shares of 17.3 percent and 14.2 percent, respectively. Combined, the top three sectors accounted for 52.1 percent of the total index, up 11 percentage points from 1996. By contrast, the bottom three, which were still telecommunication services, materials, and utilities, accounted for just 9.1 percent of the total index, a drop of eight percentage points. The net effect is that the S&P 1500 is now more heavily concentrated in the top three sectors than it was 20 years ago.

Market-capitalization-weighted indexes like the S&P 1500 are a popular and efficient tool for investing. However, investors still need to be aware of shifts in the composition of the indexes within their portfolios. Changes in index composition, even when driven by market performance, can alter the investment characteristics of an index over time.

Chart 6. The gains in market value for the health care, financial, and information technology sectors have given these stocks greater significance in the S&P 1500 index.



Source: Standard & Poor's (FactSet).

CAPITAL MARKET PERFORMANCE

(Percent change)

	Oct. 2016	Latest 3M	Latest 12M	Calendar Year			3-year	Annualized 5-year	10-year
				2015	2014	2013			
Equity Markets									
S&P 1500	-2.1	-2.3	2.5	-1.0	10.9	30.1	6.3	11.2	4.7
S&P 500 - total return	-1.8	-1.7	4.5	1.4	13.7	32.4	8.7	13.6	6.7
S&P 500 - price only	-1.9	-2.2	2.3	-0.7	11.4	29.6	6.5	11.1	4.4
S&P 400	-2.8	-3.2	4.5	-3.7	8.2	31.6	5.3	11.2	6.8
Russell 2000	-4.8	-2.3	2.5	-5.7	3.5	37.0	2.7	10.0	4.5
Dow Jones Global Index	-1.9	-1.2	0.3	-4.0	2.1	20.8	1.3	6.0	1.8
Dow Jones Global ex. U.S. Index	-1.6	-0.2	-1.6	-6.6	-5.5	13.3	-3.1	1.6	-0.6
STOXX Europe 600 Index	-1.1	-0.9	-9.7	6.8	4.4	17.4	1.7	6.8	-0.4
Bond Markets									
iShares 20+ year Treasury bond	-4.6	-7.3	6.9	-4.2	23.6	-15.9	21.9	2.5	3.9
Dow Jones corporate bond index total return	-1.0	-1.3	7.3	-0.2	7.7	-1.5	15.8	4.9	6.6
Commodity Markets									
Gold	-3.8	-5.2	8.0	-12.1	0.1	-27.3	-1.3	-5.6	7.7
Silver	-8.2	-11.4	12.0	-13.5	-18.1	-34.9	-7.2	-11.6	3.9
CRB all commodities	-0.4	-2.6	0.9	-14.4	-3.8	-5.7	-4.2	-4.6	1.4

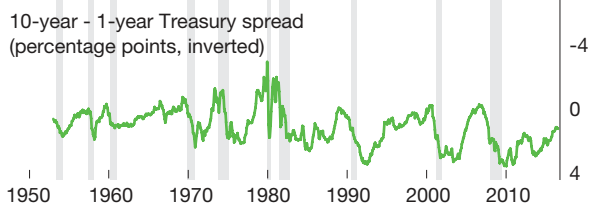
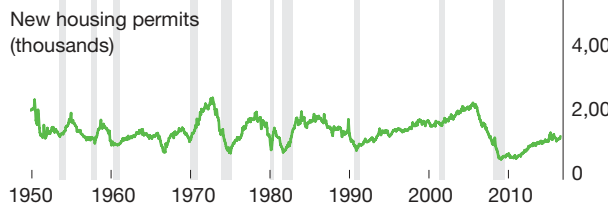
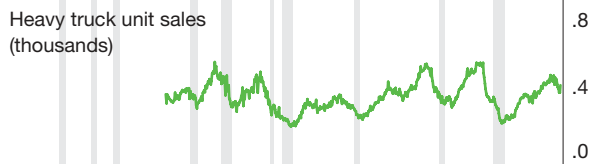
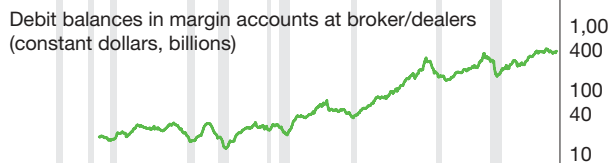
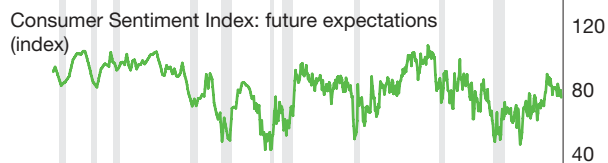
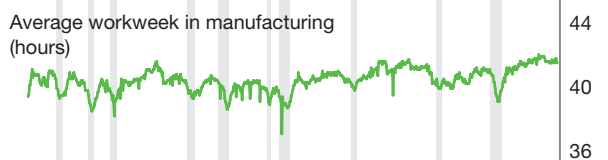
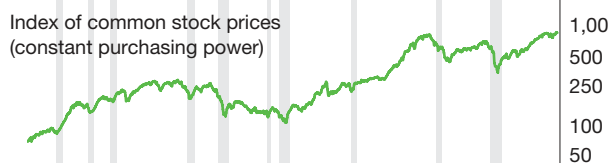
CONSUMER FINANCE RATES

(Percent)

	Oct. 2016	Latest 3M	Latest 12M	Average For Year			Average Over Period		
				2015	2014	2013	3-year	5-year	10-year
30-yr. fixed mortgage	3.9	3.9	3.9	3.9	4.2	4.1	4.1	4.2	4.2
15-yr. fixed mortgage	3.0	3.0	3.0	3.0	3.2	3.2	3.1	3.3	3.3
5-yr. adjustable mortgage	3.2	3.2	3.2	3.2	3.4	3.2	3.3	3.2	3.2
Home-equity loan	4.8	4.8	4.8	4.8	5.4	6.1	5.4	5.7	5.7
48-month new car loan	4.2	4.2	4.2	4.2	4.2	4.4	4.3	4.7	5.9

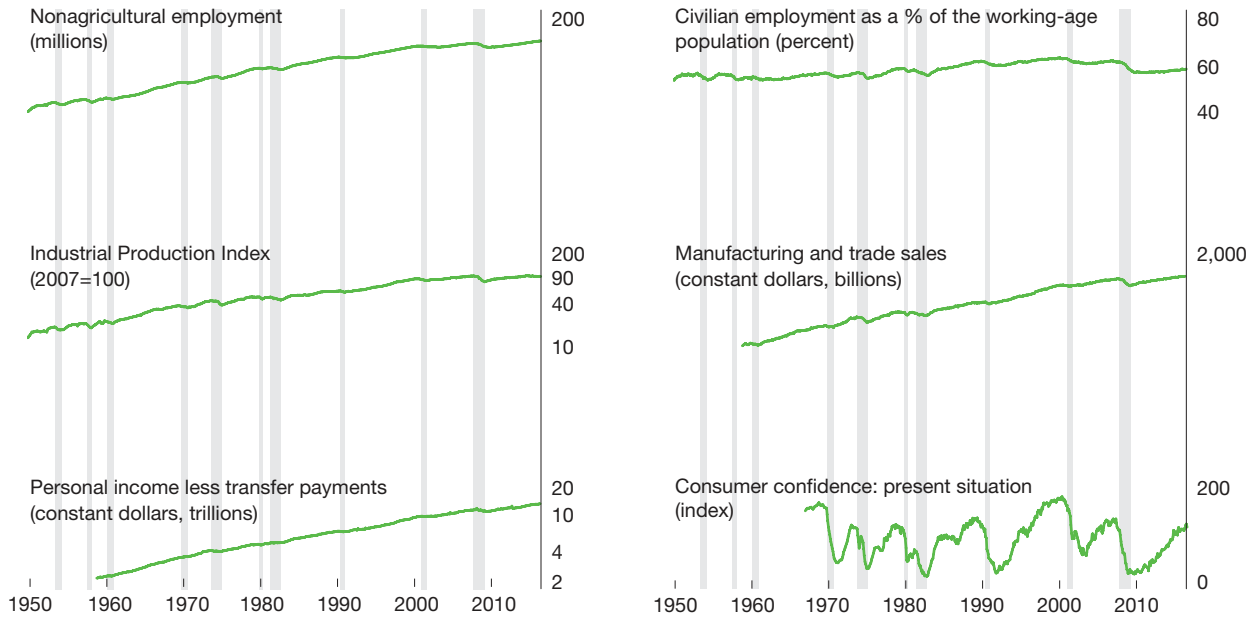
Sources for tables on this page: Bankrate, Barron's, Commodity Research Bureau, Dow Jones, Federal Reserve, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, FactSet.

LEADERS (1950–2016)

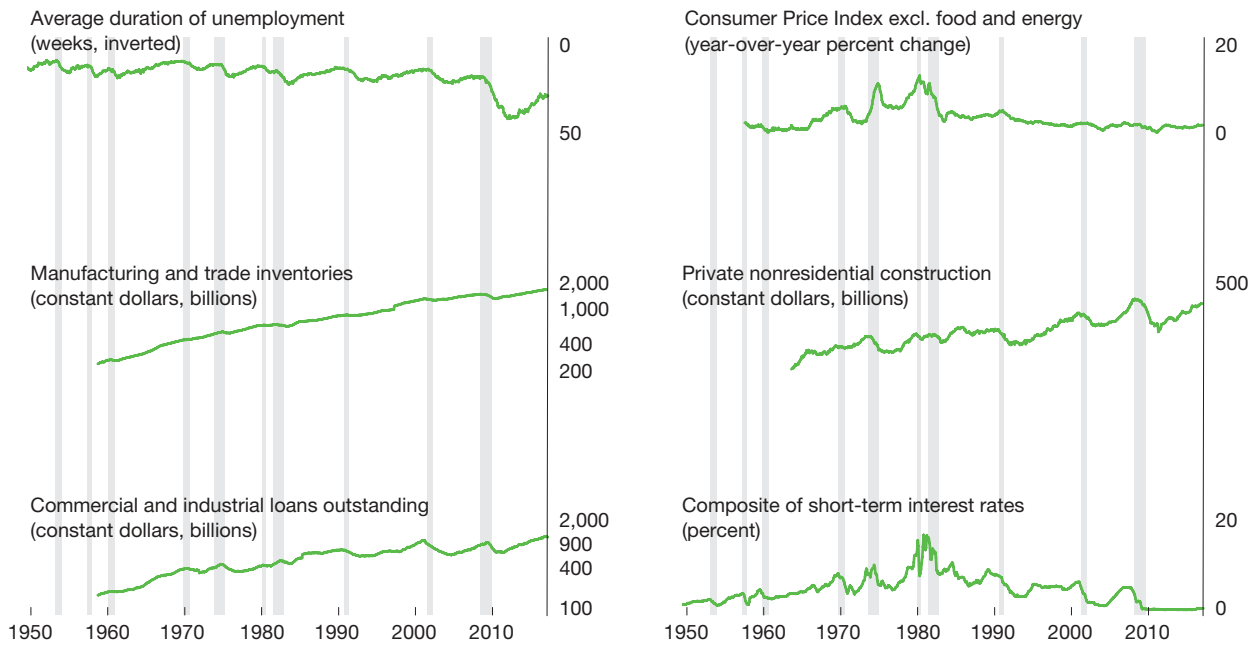


Sources for Appendix: Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Labor, Federal Reserve, New York Stock Exchange, Standard & Poor's, The Conference Board, University of Michigan, U.S. Census Bureau.
 Note: Shaded areas denote recessions (FactSet).

COINCIDERS (1950–2016)



LAGGERS (1950–2016)



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