

CURRENT VIEWS | SEPTEMBER 2015

EQUITY MARKET ANXIETY AND OTHER RISKS TO U.S. ECONOMIC GROWTH



Ross DeVol



MILKEN INSTITUTE

About the Milken Institute

The Milken Institute is a nonprofit, nonpartisan think tank determined to increase global prosperity by advancing collaborative solutions that widen access to capital, create jobs and improve health. We do this through independent, data-driven research, action-oriented meetings and meaningful policy initiatives.

©2015 Milken Institute

This work is made available under the terms of the Creative Commons Attribution-NonCommercial-NoDerivs 3.0 Unported License, available at <http://creativecommons.org/licenses/by-nc-nd/3.0/>

CURRENT VIEWS | SEPTEMBER 2015

EQUITY MARKET ANXIETY AND OTHER RISKS TO U.S. ECONOMIC GROWTH

Ross DeVol

Equity Market Anxiety and Other Risks to U.S. Economic Growth

Ross DeVol, chief research officer, Milken Institute

If we required a reminder that the United States is more fully integrated into global economic and financial markets than ever, we received it by way of the latest turmoil in U.S. equity markets. By many measures, valuations had become stretched, so in some respects the markets were looking for a reason to correct. However, there is no doubt that the recent market anxiety was at least “assembled” in China, with components from the global supply chain, before being imported into the U.S.

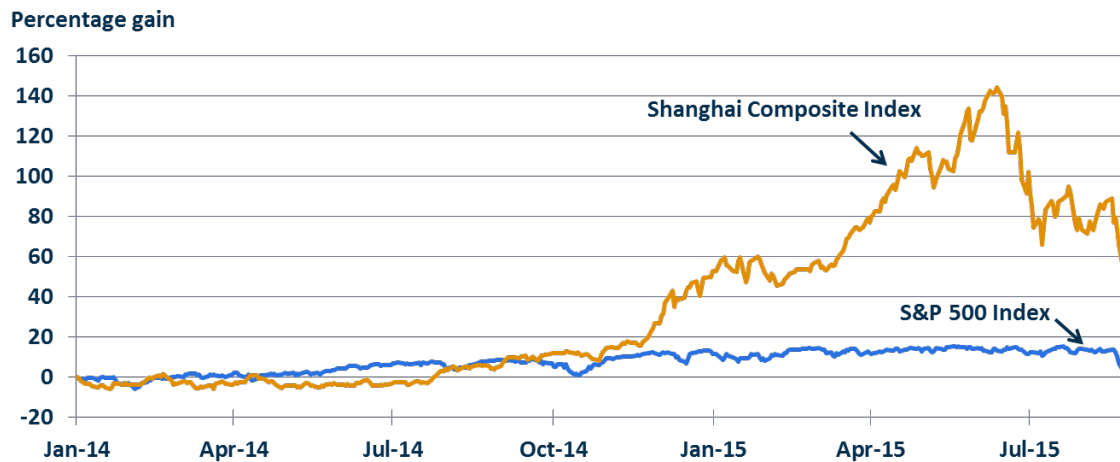
Nevertheless, recent data on housing, consumer confidence, auto sales, capital goods orders and PMIs all point to underlying strength in the U.S. economy. Even the second quarter was stronger than previously thought with GDP growth being revised up to an annual rate of 3.7 percent. More impressively, final sales to domestic private purchasers rose at an annual rate of 3.3 percent, an upward revision from the first estimate of 2.5 percent.

So, where does this leave us? On balance, the U.S. economy is expanding at a 2.5 percent to 3.0 percent pace, but downside risks to the outlook have risen due to the correction in U.S. equities and financial sector stress. Equity market anxieties will knock just 0.2 to 0.3 percentage point off of U.S. GDP growth over the next four quarters.

China Origins

Chinese authorities had made concerted efforts to boost the value of equities in China markets and implemented a number of policies such as allowing greater use of margin lending in equity purchases. Through May, these policy maneuvers appeared successful in propelling valuations. Subsequent data releases showed that the Chinese economy was slowing more abruptly than envisioned. Chinese exports witnessed the weakest performance since the 2008-2009 financial crisis. Export and infrastructure led growth were no longer driving the economy.

Figure 1: S&P 500 and Shanghai Composite Returns (Jan 2014 – Aug 2015)



Source: Bloomberg.

Chinese monetary authorities had effectively been pegging the Yuan against the dollar. As the dollar appreciated by over 15 percent, and many other emerging market currencies had fallen against the dollar, the Yuan had risen by nearly 20 percent on a trade-weighted basis. This harmed China's competitiveness in export markets. Additionally, the corruption crackdown in China had weakened growth in consumption as purchases of luxury goods and services were no longer embraced. In the midst of these financial shocks, it is reassuring that China's July retail sales managed to rise 10.5 percent from twelve months earlier.

The latest plunge in Chinese stock markets was precipitated by monetary authorities' decision to allow the Yuan trading band to widen, effectively allowing a 3-4 percent depreciation. After repeated failed attempts by Chinese officials to stabilize equity markets, Chinese investors and international players lost confidence that these efforts could be effective. The question is, "Has China lost control of events?"

The potential fallout of the slump in Chinese equities is a bit overblown. It is important to keep in perspective that Chinese equity valuations are back to where they started the year. Secondly, the majority of equities traded in the market are owned by a small segment of the population which limits the broader economic exposure to the stock market. Lastly, foreign ownership of Chinese equities is low due to a lack of an open capital account.

The question that has really spooked financial markets is this: What does a Chinese growth of about 5.5 percent mean for the global economy and the implications for diminished U.S. growth? Here again, perspective is necessary. China's economy was growing at a 14 percent rate as recently as 2007 and the

rate of expansion has been cut at least by half in 2015. Nevertheless, due to the compounding effect of rapid Chinese expansion in the interim, today's seemingly mediocre growth contributes the same absolute global demand gains as in 2007.

Global Ripple Effects

As China's economy rebalances away from growth that was heavily commodity-dependent, the nations that relied on commodity exports to China are being harmed. Two of the former infamous BRICs, Russia and Brazil, became mired in recession as commodity demand and prices plunged, exposing structural weaknesses. Only India appears still to be growing at a BRIC-like pace. Southeastern Asia nations such as Malaysia and Indonesia have been harmed due to their commodity exposure.

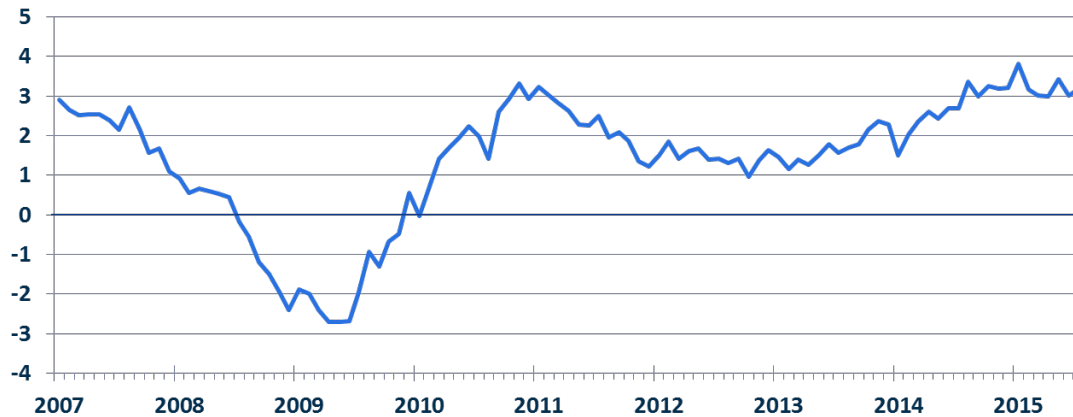
There are some similarities to the 1997-1998 Asian Crisis where currencies plummeted causing recessions throughout the region. A critical difference is that an appreciably smaller amount of short-term loans are denominated in foreign currency today relative to the previous currency crisis, easing the burden of servicing those loans in domestic currency terms. Nevertheless, there is more exposure to corporate bonds that were issued in U.S. dollars than during the Asian Crisis which could prove problematic. According to the Institute for International Finance, total corporate bonds outstanding in emerging markets are almost twice as large as in 2008; reaching \$6.8 trillion today. During the first five months of 2015, the share of debt issued in dollars rose to 40 percent, up from only 15 percent in 2008. Mitigating this potential impact is Emerging Asian economies hold far higher foreign currency reserves today than in 1998.

Sub-Saharan Africa commodity-dependent nations are seeing a slowdown. Oil-dependent Middle East nations are feeling the fallout as well. Within North America, Canada and Mexico are experiencing the effects of exposure to weakness in global oil markets. Other data from the euro-zone and Japan, on balance, have been generally good. Nevertheless, we are talking about 1.5 to 2.0 percent growth, at best.

U.S. Consumption and Housing Activity

Figure 2: Real Consumer Spending Fluctuating Around 3 Percent Growth

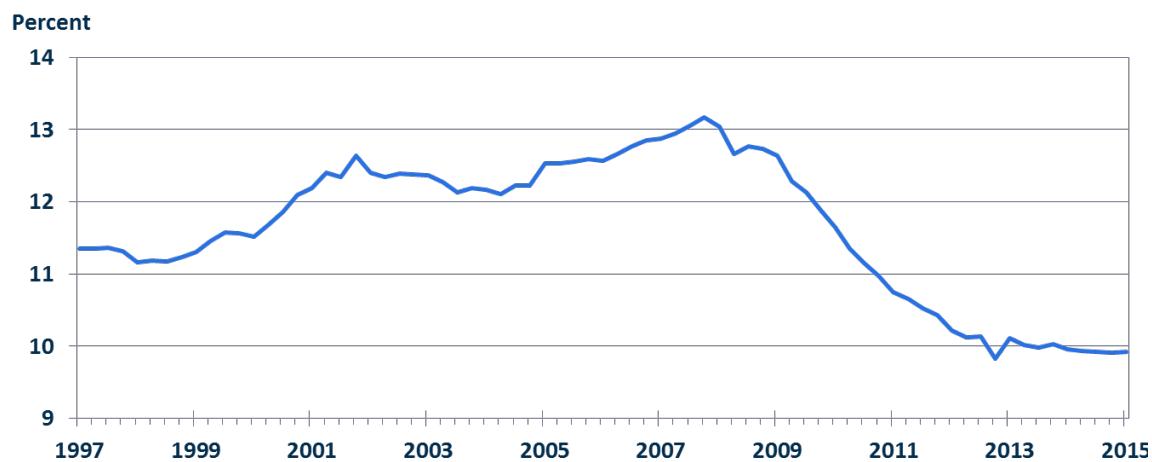
Percent change, year ago



Source: Federal Reserve Bank of St. Louis.

Consumption and housing are underpinning growth in the U.S economy. Consumer spending is witnessing renewed vigor growing at an annual rate of 3.1 percent in the second quarter, and early data on the third quarter suggest an advance of roughly 3.0 percent. Jobs gains came in at a solid 215,000 in July and gains over the latest three months averaged 235,000. Although wages are still growing about 2.0 percent year-over-year, real income growth is performing better due to the decline in gasoline prices. Real disposable income is up 3.5 percent from twelve months ago. Consumer durables is leading the advance. July light vehicle sales came in at a robust annual rate of 17.4 million units at an annual rate. Retail sales in July rose 0.8 percent indicating solid momentum as the economy moved into the third quarter. The household balance sheet has improved as the debt-servicing burden has been cut since 2008. The Conference Board's Consumer Confidence Index rebounded in August to 101.5, up a huge 10.5 points from July and hitting the highest level since January.

Figure 3: Household Debt Service Falls

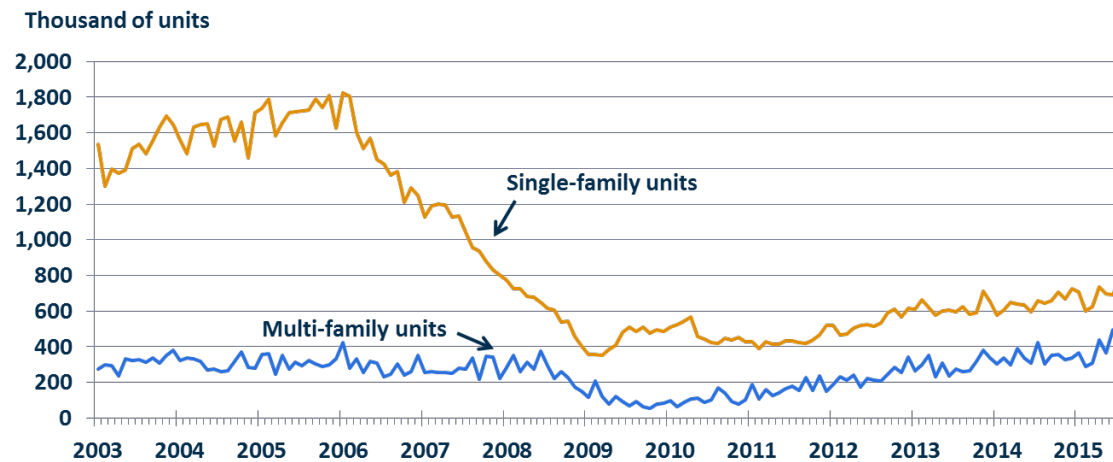


Sources: Bloomberg, Federal Reserve.

Nevertheless, one of the biggest risks from the plunge in U.S. equity markets is likely to be a substantial hit to measures of consumer confidence. As my paper, *Consumer Sentiment and Spending: Watch What I Do, Not What I Say*, illustrates, the decline in U.S. equities in August suggests a 10 point fall in consumer confidence next month. Offsetting some of the negative equity market impact on consumer confidence is falling gasoline prices. My analytical work demonstrates that declining gasoline prices directly feed into better readings on consumer confidence. Additional mitigating support stems from the fact that during this recovery, each \$1 dollar change in equity wealth affects consumption spending by less than 2 cents. Historically, these wealth-effect estimates have been around 5 cents out of every dollar. Combined, the net effect should be somewhere between 5 to 7 points off of the next reading on consumer confidence. If equity valuations stay at current levels through the end of 2015, it will reduce consumption growth by 0.2-0.3 percentage point.

Housing market activity has experienced the most pronounced improvement thus far in 2015. Stronger job and wage gains, continued low mortgage rates and slower home price appreciation are aiding affordability. Housing starts in July hit the highest level, 1.206 million at an annual rate, since October, 2007 just prior to the financial crisis. Even better news was that single-family starts jumped to an annual rate of 782,000, a 12.8 percent gain from June. The multifamily market has experienced a stronger rate of recovery during this cycle overall, but doesn't add as much economic growth as the single-family market. Existing home sales rose to a 5.59 million annual rate in July, a 2.0 percent increase from June. Single-family existing sales were at the highest level since February, 2007. New home sales rose in July and were up 25.8 percent from July, 2014.

Figure 4: Housing Starts Finally Accelerate



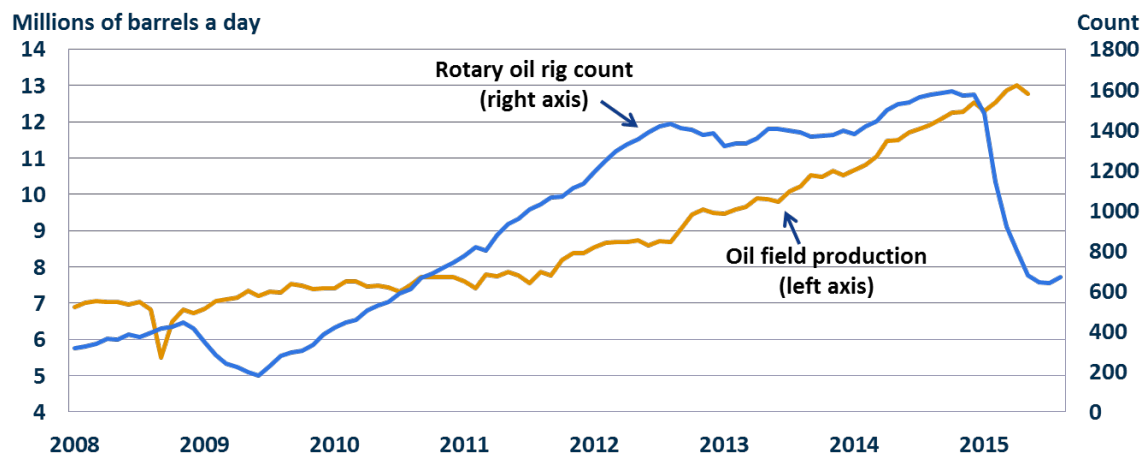
Source: Datastream.

With inventories down to a 4.8 months' supply, and permits moving higher, housing seems poised for an outsized contribution to economic growth in 2015 and into 2016. Consumer confidence will decline somewhat due to the equity market correction and sap some strength from housing; nevertheless, residential construction should rise 8.4 percent in 2015 and 9.5 percent in 2016. New home construction will add 0.3 percent to real GDP growth in 2015 and 2016.

Business Investment

Capital spending has been a source of weakness in 2015. Much of this soft patch is attributable to deleterious impacts of low oil prices on petroleum exploration activity. The oil rig count has been cut in half over the past twelve months and investment in oil equipment and structures fell at annual rate of nearly 50 percent in the first half of the year. With the boom in tight oil production, the U.S. doesn't purchase as much foreign oil. This translates into less net benefit from lower oil prices as less purchasing power is transferred to U.S. consumers from foreign producers. Additionally, investment in oil and gas exploration represents a larger share of U.S. GDP and a falloff harms activity more than in previous periods of declining oil prices.

Figure 5: Oil Rig Count Falls but U.S. Production Increases



Sources: Datastream, Energy Information Administration.

The good news is that the drilling rig count has been inching up in recent weeks as significant technology gains in exploration efficiency have increased discovery rates and lowered costs. The restraining effect from declining exploration has pretty much worked its way through the industrial complex. Business investment in the year's second half should be a bit peppier.

The rise in the value of the dollar has harmed U.S. exports competitiveness and reduced the need to expand investment in plant and equipment. Members of the S&P 500 receive nearly 50 percent of their earnings abroad. Spending on non-defense, non-aircraft capital goods was essentially flat in the first half of 2015. As capacity utilization fell, new capacity additions were curtailed. Even investment in information and communications equipment contracted in the second quarter. This sector seems poised to recover.

A source of strength in business investment has been in nonresidential construction. Much of this is driven by a recovery in commercial markets as vacancy rates decline and rents rise. The latest figures from June show that seven out of 11 non-residential construction categories rose at double-digit rates year-over-year. This should elevate growth as we close 2015 and move into 2016.

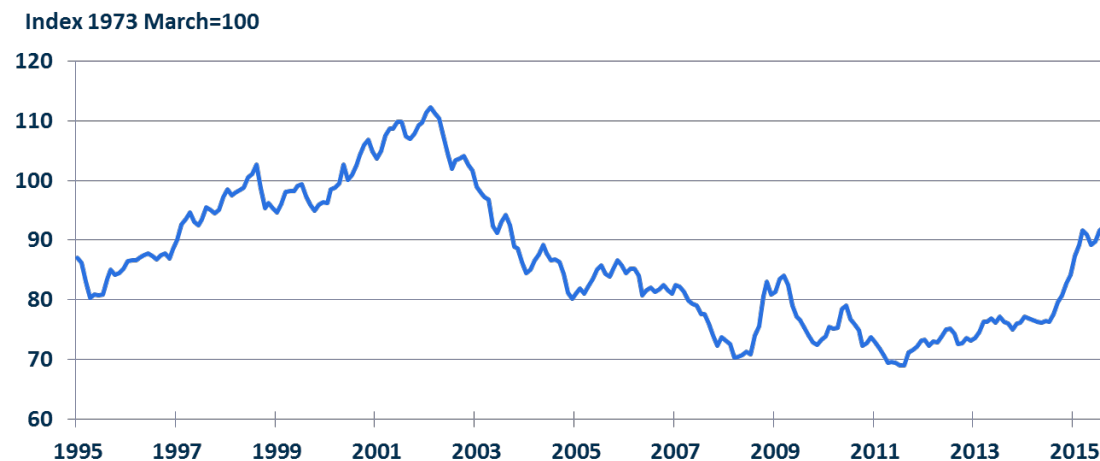
The July durable goods report provides another reason for cautious optimism in the outlook for business investment. New orders for durable goods rose \$4.6 billion, or 2.0 percent, in July. The bulk of the growth was from aircraft and vehicles, both volatile categories. But a better gauge of investment plans is orders for nondefense, non-aircraft capital goods. These core capital goods jumped 2.2 percent and June's gain was revised upwards to a 1.1 percent advance. The rate of inventory investment will fall

after a first-half buildup, placing downward pressure on second-half GDP growth. Business confidence could be harmed by the recent stock market fallout and negatively affect investment plans, but underlying conditions are improving, which should limit the downside risks.

International Trade

Dollar strength is sapping export growth and allowing imports to capture a larger share of final demand. The dollar has climbed back to levels last witnessed in 2003. Net exports slashed first quarter GDP growth by 1.9 percentage points and recovered to add a minor contribution of 0.1 percentage point in the second quarter. In addition to a strengthening dollar, weaker rest-of-world GDP growth is taking its toll on U.S. export growth. June's merchandise trade deficit widened to \$43.8 billion, with imports rising and exports falling. Some good news can be found that service exports are still increasing despite the stronger dollar.

Figure 6: Value of the U.S. Dollar

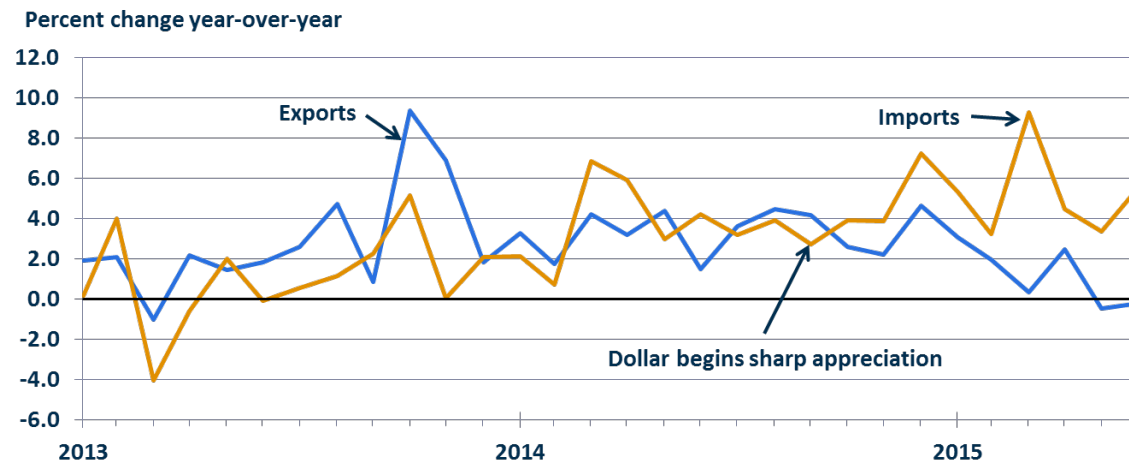


Source: Bloomberg.

Softer demand growth in China and throughout most of emerging Asia, combined with Yuan devaluation against the dollar, will dampen export growth to China and boost imports from China. Further, other Asian nations may feel compelled to engineer competitive devaluations in response to the fall in the Yuan. This could cause a small decline in U.S. exports. The impacts of Yuan devaluation should be contained due to the small reduction in its value and the effects being spread out over 16-24 months. Additionally, U.S. exports to China represented 7 percent of total exports (just 1.0 percent of GDP) and imports from China accounted for 17 percent of total imports. The trade effects stemming from Yuan devaluation should restrict U.S. GDP growth by 0.1 percent over the medium term.

Milken Institute

Figure 7: Imports Outpacing Exports as Dollar Appreciates



Sources: Bloomberg, U.S. Census Bureau.

Government Spending

Federal spending on consumption and investment has been declining on a steady path for over three years. Much of this is due to the unwinding of fiscal stimulus and reduced need for transfer programs as labor markets improve. The impact of the budget sequester on discretionary government purchases is playing a role as well. Additionally, reductions in defense spending after the troop withdraw from Iraq and the diminished presence in Afghanistan are assisting. The federal budget is improving as receipts are up 8.0 percent through July from the comparable fiscal period last year. Most of this is attributable to rising corporate and personal income tax receipts.

Given the devastating blow to state budgets from the Great Recession, state and local spending has been a source of weakness during the recovery as officials restored fiscal soundness. Based upon spending in this category in the second quarter, it appears that process has worked its way through the system. State and local spending rose a remarkable 4.3 percent at an annual rate in the second quarter. The bottom line: not as much fiscal drag is present.

Financial Conditions

The main story has been the reverberations from Chinese developments, but there are other signs of financial stress in the U.S. Credit markets have seen this manifested in the widening spreads between high-yield corporate debt relative to investment grade. Much of the wider spreads have been caused by the large amount of non-investment grade debt being issued to firms engaging in tight-oil exploration and concerns that they will be unable to service this debt given the collapse in oil prices. This is forcing

SMEs to pay a higher cost of capital and may be an additional reason why capital investment has been restrained.

Figure 8: High-Yield Corporate Bond Spreads Widening



Source: Bloomberg.

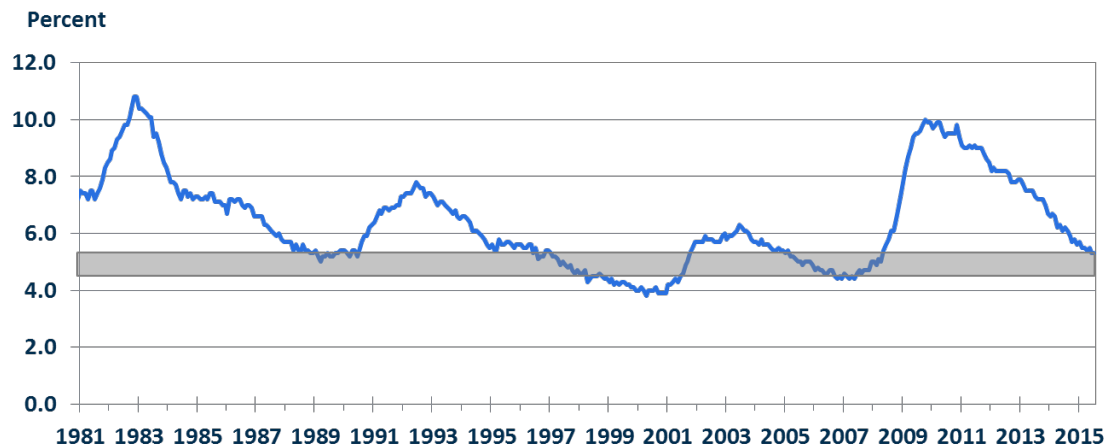
Another source of concern emanating from China in recent weeks has been the reported selling of U.S. Treasuries by the People's Bank of China. Yields on Treasuries didn't fall as much as normal during a period of equity-market volatility in a safe-haven flight to quality. It does appear that China has been selling, but not for nefarious reasons, as some are speculating. China is principally selling Treasuries in an attempt to keep the Yuan from depreciating too much against the dollar. Recent domestic banking regulatory changes have been playing a role. Chinese bank deposits can be held in dollars and many depositors are converting from renminbi-based holding to dollars. The domestic renminbi exchange rate against the dollar is lower than the external exchange rate. This seems to be playing a role in why the Central Bank is selling Treasuries. This process may be keeping bond yields 10-15 basis points above where they might be in the absence of such selling, potentially dampening U.S. growth at the margin.

Monetary Policy and the Fed

Based upon minutes from the July Federal Reserve Open Market Committee meeting, most voting members were leaning towards raising interest rates in September if the incoming data continued to show gathering economic strength. Speculation on the timing of the Fed rate increase was playing a role in capital fleeing emerging markets, driving down their currencies, boosting the dollar and adding to global growth concerns. Monetary officials must now monitor the volatility in the U.S. and Chinese equity markets to determine whether to delay raising interest rates. As New York Federal Reserve Bank

President Bill Dudley stated, the case for a rate increase is less “compelling” than before the correction in equity markets. It is possible that equity markets will stabilize before the September meeting, allowing them to proceed to end extraordinary monetary policy.

Figure 9: Unemployment Approaching Fed-Set NAIRU



Source: Moody's Analytics.

Recent data on the U.S. economy have been unambiguously positive since the July Fed meeting, suggesting that the incoming data are sufficiently strong to warrant a lift-off. Most pre-conditions for raising rates are in place with the exception of inflation accelerating to 2.0 percent. Core-price inflation has edged up to roughly 1.5 percent and there are some signs of wage and compensation gains moving higher, but not by much. However, with the unemployment rate hitting 5.3 percent and many other labor market indicators strengthening, a strong case can be made that the pre-conditions for the first rate increase since 2006 are in place. Janet Yellen and her colleagues at the Fed face a difficult choice. If they go ahead and tighten, they risk being blamed for any further volatility in equity markets. However, if they postpone a rate increase into 2016, emerging markets may go through the same turmoil as was just experienced over the past few months in anticipation of a Fed rate increase. Unless the equity markets dive again over the next few weeks, the Fed should move rates up by 25 basis and evaluate its effect on economic activity. Will they? To this question, not even the Fed has an answer!

Post-Equity Correction U.S. Economic Outlook

While the Greek drama isn't over, it has been removed as a near-term threat. We are now more fully aware of the weight that China's economy and financial markets carry in the world economy. The potential contagion effects of the euro-zone losing a member could have been highly disruptive, but

China is an 800-pound gorilla. Additional sources of worries emanate from a further slump in growth in non-China emerging markets. Brazil and Russia could get much worse, and if India's growth doesn't accelerate, other emerging markets could suffer. Another risk to the outlook is ongoing corporate caution in making commitments to capital investments. Risk aversion in corporate C-suites and boardrooms is pervasive in the post-financial crisis world. The U.S. is being affected by this caution as capital spending relative to GDP has remained below the average since 1980. Without the return of "animal spirits," productivity growth could remain at its lethargic pace and diminish the potential growth of the U.S. economy over the long term and restrict gains in the standard of living.

Nevertheless, the U.S. economy remains on track for modest growth despite the recent turmoil in equity markets. Overall, forecasts in key sectors remain positive. Real consumption spending will rise 3.2 percent and 3.1 percent in 2015 and 2016, respectively. Residential construction will be growing in excess of 8.0 percent over the next two years. Capital spending seems poised to advance 3.8 percent this year and 5.9 percent in 2016. Export growth falls to 1.5 percent in 2015 before a modest recovery in 2016 to 4.3 percent. Imports will advance 5.9 percent this year and 5.0 percent in 2016. Real GDP is projected to increase 2.6 percent in 2015 and 2.8 percent in 2016. U.S. GDP growth rates were reduced by 0.2 percent and 0.3 percent in 2015 and 2016, respectively, because of the events in China and their impacts on the rest of the world.

Although the United States isn't completely immune to China's market turmoil, the ripples that it helped create on Wall Street don't appear to be strong enough to make a serious dent in the U.S. growth trajectory.



MILKEN INSTITUTE

1250 Fourth Street
Santa Monica, CA 90401
Phone: 310-570-4600

1101 New York Avenue NW, Suite 620
Washington, DC 20005
Phone: 202-336-8930

137 Market Street #10-02
Singapore 048943
Phone: 65-9457-0212

E-mail: info@milkeninstitute.org • www.milkeninstitute.org