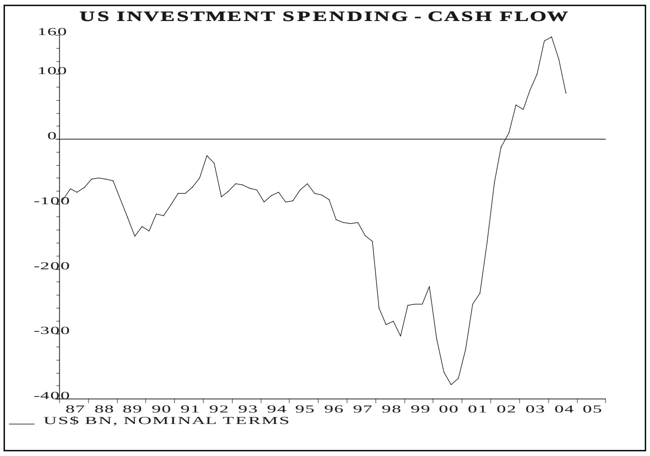
GFC ECONOMICS

DAILY COMMENTARY

LABOUR MARKET THREATENS BOND SELL-OFF

The pressure on longer-dated Treasuries is mounting, after two-year yields hit a new high of 3.52% on Friday. The curve has started to flatten again, and ultimately, there is every chance it will invert. But increasingly, this may take place in the context of rising long-term rates too. The immediate threat to the bond market is unquestionably stronger labour market reports. The jobless claims data and a bounce in the help wanted index are both warnings that we may see a decisive upswing in the payroll numbers, starting this week. Many of the longer-term structural forces that have precipitated an unusually sluggish period of hiring have not gone away. However, the US is facing a significant rise in short-term inflation pressures as a result of its housing boom, and the associated failure to bring down its current account deficit to manageable levels. That is the driving force behind the rise in bond yields, not the labour market *per se*. Indeed, it was quite instructive to see from last week’s CPI report that core service sector inflation remains remarkably well behaved. But as ever with asset bubbles of this magnitude, there will come a point when the labour market data will start to improve, persuading the Fed to act even more decisively. That could leave its mark on the long-end too.



Payrolls May Bounce

After such a long period of disappointing labour market numbers, punctuated by the occasional strong month, it has been customary to assume the US has undergone a structural shift that is inherently bullish for bonds. That still remains the case, and provides an important secular argument why yields will eventually fall again, once the housing bubble starts to deflate in earnest. Last week's GDP revisions and durable goods report provided confirmation that the US is in the midst of another overinvestment cycle. The real capital spending to GDP ratio fell from a high of 12.7% in Q3 2000 to a 'low' of 10.4% in Q1 2003. But since then, it has crept up to 11.7%, and is threatening to head higher. Orders for non-defence capital goods - excluding aircraft - have accelerated in recent months, even though the enhanced tax break on depreciation allowances has ended. A rise of 2.9% m/m in January, followed another strong increase of 3.3% m/m in the previous month. On a 3m/3m annualised basis, orders jumped 14.3%.

In some areas, the overinvestment cycle is already more pronounced than in the dotcom bubble. Investment on information technology as a percentage of GDP has risen to an all-time high of 5.4%. Spending was up 16.1% last year compared with 2003. Critically, the rate of development in new computer chips shows no sign of abating, with a number of companies announcing significant technological break-throughs of late. Structurally, there is every reason to believe a rapid pace of technological progress will underpin the strong underlying trend in productivity that has emerged in recent years. Since the corporate sector's cash flow in aggregate remains considerably in excess of spending on capital goods (see chart), companies certainly possess the requisite funding to push through strong efficiency gains.

But the parallels with the late-1990s can be taken one step further. These 'structural' forces may have precipitated a step-change in the potential growth path of the economy. Based on Federal Reserve estimates, there is a good case for suggesting the non-inflationary growth rate has risen to over 4.0%. But the very suppression of long-term inflation expectations has spawned another asset bubble, arguably one that is even bigger than the first. The level of pri-

GFC Economics
Coborn House, 3 Coborn Road, London E3 2DA
Tel. 020 8981 8085 Fax. 0870 056 1693
graham.turner@gfceconomics.com - rupert.thompson@gfceconomics.com - ben.combes@gfceconomics.com

vate sector debt has certainly risen since the end of 1990s, despite the dramatic recovery in the corporate sector's finances over the past two years or so. And as with all bubbles, there will come a point when the short-term inflation dynamics cannot be ignored. This time, the risks are all the more acute in one sense, given the deterioration in the external finances. It does seem that the US$ has seen its high-point for the year. The recent strength of consumer spending could be enough to push the current account deficit up towards 7.0% of GDP by the summer. At that point, one can only assume the temptation for central banks worldwide to cut and run, diversifying their reserves out of Treasuries, will be intense, threatening further US$ selling.

Intriguingly, last week's CPI report did confirm the secular case for low inflation, once the housing market has been tamed. Core service sector inflation outside of shelter fell again to 2.2%. While part of this was admittedly down to the financial services component, most components remain very subdued. Low or falling price increases in recreation, telecommunications and transportation continue to underpin the trend, while the high rate of inflation in school fees is showing signs of turning down too. But of course, the flipside to these benign numbers is the acceleration in goods prices, and durables inflation rose to 0.8% last month. Given that durable prices are rising 5.9% y/y at the PPI level and import prices for consumer goods are accelerating, the risks of a further spike in the CPI numbers must be high.

Of course, if the underlying inflation fundamentals remain so favourable, it is only right to ponder why the Fed is still tightening. Once again, there is a clear parallel with the late-1990s. At the time, Mr Greenspan was quite enthusiastic about the productivity benefits that flowed from heavy investment in information technology. But even the eternal optimists were forced to concede that cost pressures had started to rise during the final stages of the boom. The Fed belatedly started to raise rates, and combined with the inevitable profit warnings on certain leaders within the tech-sector - notably Amazon - the bubble started to deflate. One might reasonably suggest it would have been more prudent if the authorities had pre-empted the bubble. But on the contrary, Mr Greenspan adheres very much to the Keynesian view, which implies it is still better to have the bubble than not at all. That way, one could still ascertain the upper limits to the economy's potential growth path.

The precise source of the build-up in cost pressures during the late-1990s was the opposite of today. The economy was approaching full employment, and wage pressures were starting to surface. By contrast, the most recent household survey shows that the ratio of employment to working-aged population has hardly improved, rising from a low of 62.1% in September 2003 to just 62.4% last month. Persistent overinvestment may have wrought significant productivity gains, but it has also spawned a whole new problem of long-term joblessness. The average duration of unemployment has barely fallen from its high-point last February, and has actually risen in recent months. The growth in average hourly earnings has come under pressure again, with the 6-month growth rate turning down from 1.5% last September to 1.1% in January.

Nevertheless, it is a fact that cyclically, the labour market indicators have improved of late. The drop in jobless claims could be dismissed as an aberration, since the data can be volatile. But these numbers have proved quite a reliable guide to the underlying trend in the payroll numbers, and the drop in the 4-week moving average to 308,000 corroborates other labour market reports. The help-wanted index has started to bounce too, rising by 5 percentage points during December and January combined. That was the biggest two monthly gain since early 1999. It is quite possible that we have reached a point where the economic data will force a market reaction that will eventually start to deflate the housing bubble, and in turn set the stage for a fall in the current account deficit. But the adjustment is unlikely to be smooth.