Janet Yellen's Surprising Warning Of "Secular Stagnation"

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FORECASTS & TRENDS E-LETTER
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April 14, 2015

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Overview

Speaking at a monetary conference hosted by the Federal Reserve Bank of San Francisco on March 27, Fed Chair Janet Yellen warned that the US economy might be facing ***"secular stagnation,"*** a prolonged period of below-trend economic growth or no growth at all.

While emphasizing that secular stagnation is not the Fed's most likely scenario, Ms. Yellen nonetheless believes that it is a risk important enough to warn her colleagues about. Secular stagnation is where Japan has been for most of the last 20 years. Given that, we should spend some time today and subsequently discussing this phenomenon and what it means for the economy should it rear its ugly head.

Following that discussion, we will take a look at the minutes from the March 17-18 Fed Open Market Committee (FOMC) meeting that were released last Wednesday. Those minutes described how the Committee decided to drop the word ***"patient"*** in its forward guidance as to when the central bank might decide to raise the Fed Funds rate this year.

The minutes are abundantly clear that there is widespread disagreement among the Committee members as to when the key lending rate should be increased. Some members still believe that ***"liftoff"*** should occur at the June meeting, while others prefer waiting until the September meeting, and still others think the Fed should wait until next year. I continue to believe the first rate hike will not occur prior to September of this year, if at all.

Finally, President Obama and Congress have an opportunity to help the US economy significantly in the weeks ahead. Two very important international trade agreements are on the table, and both should be passed in my opinion. The **Trans-Atlantic Trade and Investment Partnership** and the **Trans-Pacific Partnership** could create hundreds of thousands of new full-time jobs and over **$100 billion in new exports** each year. Let's hope Congress passes both and Obama doesn't veto them!

Fed Chair Janet Yellen Warns of ***“Secular Stagnation”***

In her speech on March 27 at the Federal Reserve Bank in San Francisco, Ms. Yellen repeated her usual points about the Fed needing to begin normalizing the Fed Funds rate this year. She noted that the economy continues to recover; however, she did acknowledge that growth in the 1Q slowed somewhat, mainly due to the severe winter. Still, she maintained her general view of ***“cautious optimism.”***

Yet later on in her lengthy speech in a section subtitled ***“Special Risks and Other Considerations”*** is where things got very interesting. The first of her special concerns about hiking interest rates began as follows:

> ***Some recent studies have raised the prospect that the economies of the United States and other countries will grow more slowly in the future as a result of both demographic factors and a slower pace of productivity gains from technological advances.***
>
> ***At an extreme, such developments could even amount to a type of 'secular stagnation,' in which monetary policy would need to keep real interest rates persistently quite low relative to historical norms to promote full employment and price stability, absent a highly expansive fiscal policy."*** [Emphasis mine.]

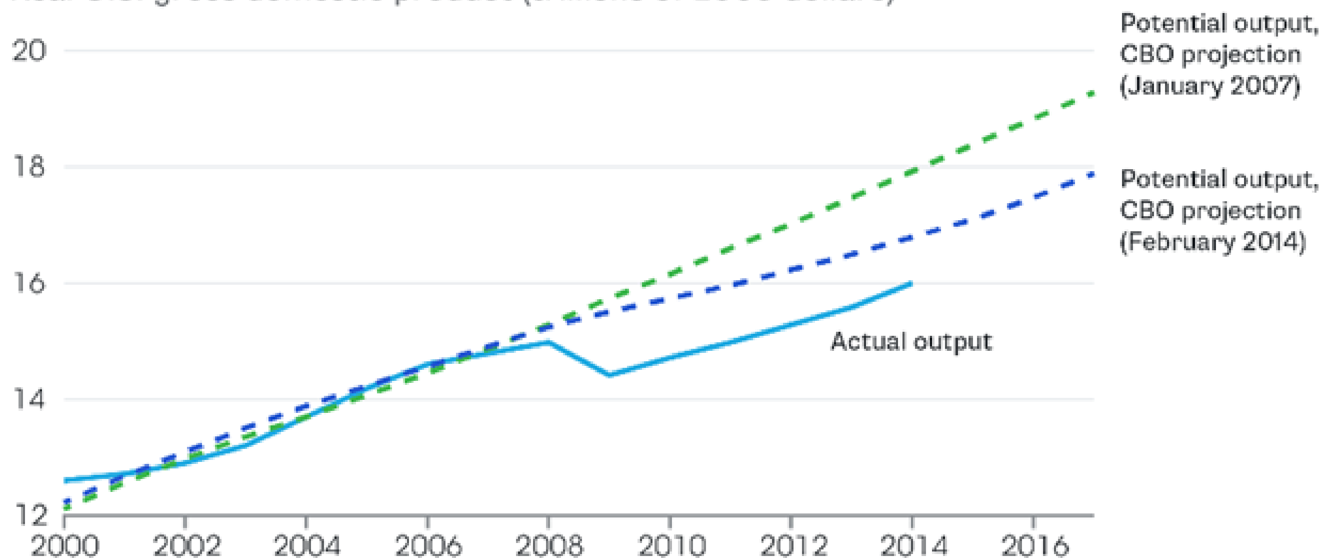
To take a step back, the term ***“secular stagnation”*** is not new. It was originally coined in the late 1930s in the Great Depression era and refers to the theory that an economy may become stuck in a long-term period of slow growth, low productivity and low interest rates, due to certain external factors.

Prior to Yellen’s March 27 speech, the last time the term secular stagnation was referred to was by former White House economic adviser Larry Summers, who in late 2013 suggested that the US might be mired in secular stagnation. So what exactly is secular stagnation?

In secular stagnation, people become so concerned about the economy that they obsess on saving money, rather than spending it and making longer-term capital investments in such things as infrastructure, education, etc. that are necessary to sustain future economic growth.

Over time, the absence of such capital investments, and consequently of economic growth, leads to declining levels of per capita income and eventually per capita savings. Once set in place, secular stagnation can become a self-fulfilling prophecy.

In April 2014, Brown University economists Gauti Eggertsson and Neil Mehrotra published a comprehensive model of secular stagnation, showing how income inequality and a drop in population growth, both of which we have now, could lead the economy into a period of slow growth as we have seen since the current recovery began.



Essentially, the economists' point is that a surplus of individuals looking to save their money, combined with a lack of individuals looking to borrow and spend money, can lead interest rates to fall to unusually low levels. That can cause an economy to become mired in slow growth for longer than the historical economic models would predict – consequently making the stagnation secular (longer-lasting) rather than merely cyclical.

It is interesting that Chair Yellen chose to bring up secular stagnation in her latest public policy speech. The policy implications are clear: If the Fed is indeed worried about secular stagnation, this suggests that **short-term interest rates will be kept lower for longer** than is currently anticipated.

My guess is that Ms. Yellen does not want to raise interest rates this year, and that she raised the possibility of secular stagnation to give the Fed "cover" for not raising rates. She basically admitted as much in her latest speech in which she said that the mere possibility that the US could slip into economic quicksand "***has important monetary policy implications for the near-term."***

I am very surprised that her concern about secular stagnation has not received more attention in the media. In any event, I will leave our discussion of secular stagnation there for today. I'm sure I will have more to say about it in the weeks and months to come.

Bottom Line: The Fed Doesn't Know When to Raise Rates

As noted above, there is no consensus within the FOMC as to when to enact the first Fed Funds rate hike, or ***liftoff***, as the Fed refers to it. The minutes from the March 17-18 policy meeting reveal a widespread disagreement among the Committee members regarding when the Fed should make its first move toward normalization. Take this excerpt:

> ***Several participants judged that the economic data and outlook were likely to warrant beginning normalization [rate hike] at the June meeting. However, others anticipated that the effects of energy price declines and the dollar's appreciation would continue to weigh on inflation in the near term, suggesting that conditions likely would not be appropriate to begin raising rates until later in the year, and a couple of participants suggested that the economic outlook likely would not call for liftoff until 2016.***

The point is, there is **no consensus** among the Committee members. In addition, there is disagreement among the members as to how much the Committee should communicate with the public about the timing of the first rate hike, whenever such a decision is reached.

> ***With regard to communications about the timing of the first increase in the target range for the federal funds rate, two participants thought that the Committee should seek to signal its policy intentions at the [FOMC] meeting before liftoff appeared likely, but two others judged that doing so would be inconsistent with a meeting-by-meeting approach.***
>
> ***Finally, many participants commented that it would be desirable to provide additional information to the public about the Committee's strategy for policy after the beginning of normalization.***

The minutes also suggest that, going forward, the Committee will simply consider the subject of a rate hike on a ***"meeting-by-meeting"*** basis, and that any decision would be ***"data-dependent"*** (ie: subject to further improvement in the economy and labor markets). Given the disagreement over timing and how much advance notice should be provided, I continue to believe that we will not see a rate hike until September at the earliest.

As Fed Contemplates Liftoff, Investors Head for the Exits

For reasons that are not entirely clear, investors are sensing trouble ahead for the US equity markets. A combination of a possible Fed rate hike, the stronger US dollar, weakness in the economy of late and falling earnings for US corporations finally has investors spooked.

Outflows from equity-based mutual funds and ETFs have reached their highest level since the darkest days of 2009, just as the recession was ending and the Fed was kicking its zero interest rate policy and quantitative easing into high gear.

Funds that invest in stocks have seen **$44 billion** in outflows, or redemptions, year-to-date, according to Bank of America Merrill Lynch. Equity funds have seen outflows in six of the last seven weeks, including $6.1 billion in the last full week of March.

The biggest outflows, by far, have come from the most popular ETF, the $193 billion SPDR S&P 500, the fund that tracks the index of the same name. The ***"Spider"*** as it is called has seen

redemptions of **$26.1 billion** as of the end of March this year, more than eight times the second-biggest outflow victim, the iShares MSCI Emerging Markets Fund, which has given up $3.2 billion, according to ETF.com.

Apparently, many investors share my recent concerns about the elevated risks in the market and are moving to reduce exposure to stocks. But rather than sitting on the sidelines, I advise that you consider the actively managed programs such as those I recommend that can move to the safety of cash, or hedge long positions as warranted.

Free Trade Deals: Obama's Big Chance to Help the US Economy

Two very important international trade agreements will be on the table for Congress and President Obama just ahead, and both should be passed in my opinion. The ***Transatlantic Trade and Investment Partnership*** and the ***Trans-Pacific Partnership*** could create hundreds of thousands of good new jobs and over **$100 billion in new exports** each year. Let's hope Congress passes both and Obama doesn't veto them!

I have been planning to write about these two important trade deals, but **Forbes Editor In-Chief, Steve Forbes,** beat me to it, and I couldn't address it any better. So here is his April 8 column in ***Investors.com***:

> ***Obama's Big Chance to Help the US Economy: Free Trade***
>
> ***American businesses of all sizes increasingly depend on access to international markets for buying and selling goods and services that will expand our economy, create jobs and increase economic efficiency in nearly every sector of the economy.***
>
> ***In today's globalized 21st-century economy, it's critical to strengthen relationships with our global trading partners, and Congress and the White House have an opportunity to do just that by finalizing both the Transatlantic Trade and Investment Partnership and the Trans-Pacific Partnership.***
>
> ***Adopting TTIP and TPP will strengthen our economy by removing barriers to new markets and increasing exports as well as foreign direct-investment in America.***
>
> ***For example, TPP — a trade pact that includes the United States, Japan and 10 other Pacific Rim countries — is a historic opportunity to expand our trade relationships in the Pacific Rim. Consider: With the inclusion of Japan, the world's third-largest economy, TPP nations will account for 40% of global gross domestic product.***
>
> ***Historically, free trade agreements (FTAs) provide a boon to the American economy. In 2014, nearly 50% of U.S. exports went to FTA partner countries. Since 2009, America's total exports have grown by roughly the same percent, contributing almost one-third of U.S. economic growth.***

FTAs like TTIP and TPP benefit American workers by directly and indirectly creating millions of high-paying jobs.

The White House projects that TPP would boost American exports by over $120 billion a year by 2025 while creating 650,000 additional jobs in the U.S. For the U.S. economy, which is starving for high-paying jobs, this trade agreement is a no-brainer.

In addition to promoting U.S. commercial interests, FTAs have advanced key policy and societal goals by exporting the higher U.S. standards concerning labor, working conditions, the environment, corruption, drug trafficking and democratic reform.

TPP also has the potential to deliver significant global strategic advantages beyond extending policy best practices and economic benefits.

An FTA with Japan solidifies our alliance and fosters in a new era of cooperation and partnership. Some trade unions and other anti-free-trade elements have taken very self-serving positions and opposed Japan's inclusion in TPP.

But Japan's inclusion creates a historic opportunity for the U.S. to do more business in critical sectors including financial services, automotive industries, agriculture and the Internet economy.

Deepening our relationship with Japan is critical at this time as China becomes more aggressive militarily in the Pacific region and allies are worried about U.S. resolve.

Economically, Japan's inclusion in TPP puts pressure on China, the United States' largest economic rival, to conform to modern labor standards and alter its unfair trade policies and its assault on American intellectual property. Solidifying the U.S.-Japan relationship through TPP will create a check and balance on China's expanding influence in the Pacific Rim.

President Obama and I do not agree on much, but he was correct to note that if the U.S. doesn't write the rules of international trade, China will. If we don't seize this opportunity, China is waiting with a competing 16-country trade deal that would exclude the U.S. in the same way that TPP excludes China.

In other words, the Chinese will write the rules — rules that would lessen global trade standards and make it even harder for U.S. businesses to compete.

TPP's inclusion of Japan would cement a critical partnership in a strategically vital region of the world. It would bring significant benefits to American industries of all sizes and stripes while strengthening America's geopolitical influence in the world's most critical region.

> ***Congress and the administration must work together to ensure that TPP is completed. Letting this once-in-a-generation opportunity pass would hurt American workers, our economic output and our long-term ability to compete in the global marketplace.*** **END QUOTE.**

I'll leave it there for today.

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Best regards,

Gary D. Halbert

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