Weekly Commentary **September 25, 2015**

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Yellen Ready to Hike; GDP Up but Productivity Still Lags

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It is very rare when equities respond favorably to a tightening by the central bank, but that is exactly what happened today after yesterday's speech by Fed Chair Janet Yellen at U Mass Amherst indicating that is almost assured that the Fed will hike rates this year. Generally, stocks love the liquidity provided by the central bank, even if the bank errs on the side of providing too much. But the negative reaction of the stock market to the Fed "no hike" last week gave the signal that the market is indeed prepared for a hike, particularly if it is wrapped in dovish language about the future path of the Fed Funds target. Although the financial press is billing today's bull move as a reaction to Yellen's brighter outlook for the world economy, one cannot dismiss the fact that finally the waiting for "The Event" will finally be over.

Yellen also presented a decomposition of the factors that have caused the Fed to undershoot the 2% target inflation since the Financial Crisis. This year, almost the entire shortfall (1.4 % of the 1.6% undershoot) has been due to the drop in energy prices and import prices, the latter caused by the strong rise in the dollar. Only 2 tenths are due to slackness in the labor and product markets and other factors. It is unlikely that the first two factors will be operative in the next year or two, unless oil prices fall into the 20s and the dollar soars another 20% (bringing the Euro down to 90 cents). In fact, it is also possible that energy prices will rise and the dollar fall, pushing inflation above the 2% target. For this reason, Yellen seems comfortable in projecting that inflation is very likely move towards the Fed's 2% target in coming months, removing the last barrier to the Fed raising rates.

Rarely does the second revision (3rd estimate) of quarterly GDP warrant attention, but this morning's upward revision of Q2 GDP to 3.9% from 3.7% merits comment. Not only was consumption revised upward by 5 tenths (from 3.1% to a healthy 3.6%), but inventories were revised downward by $8b. This means that final sales were revised upward by 4 tenths and projections for Q3 have also been revised upward, which now are just under 2 ½%. GDP has been increasing at 2% to 2 ½% through the first three quarters of this year, a level that is slightly above the long-run growth rate of GDP which is now estimated between 1 ½ and 2%. One should point out that this is still an extremely poor performance given that 2 ½ million workers will be added to payrolls this year, representing a 1.7% increase in workers. This leaves productivity growth at a measly ½% annual rate and this computation ignores the slight increase in the number of hours worked, which reduces productivity even further. We are either understating GDP growth due the new digital economy and/or increased regulations and other factors are restraining the growth of aggregate output.