CHINA VOLATILITY RAISES THE QUESTION: DID THE FED MAKE A MISTAKE?

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Recently, Professor Jeremy Siegel and I chatted with Don Kohn, former vice chair of the Federal Reserve (Fed), and Leland Miller, president of the China Beige Book, about their outlook for 2016 and implications of the Fed policy decision. **Based on Recent Volatility, Was the Fed's First Rate Hike a Mistake?** Kohn says no. He believes the increase was warranted based on progress in the labor markets and how close we are getting to full employment. The job-creation rate of 284,000 jobs over the last three months is amazing but unsustainable. In order to hold unemployment steady, Kohn believes that we need a job-creation rate of only 100,000 jobs, and we are currently growing at about 200,000 jobs more than needed. While there is still some slack in the labor markets, given the U-6 unemployment rate of 9.9%, Kohn believes it was ultimately the right decision to hike interest rates in December. **What Is the Natural Rate of Employment (NAIRU)?** While many criticize the reliability of the Phillips curve to appropriately forecast inflation based on labor markets, there is hardly a viable alternative. Currently, the Fed believes the natural rate of unemployment—the rate that determines inflation pressures—is close to 5%, which is one reason the Fed hiked rates in December. Kohn believes it is unlikely that NAIRU, or nonaccelerating inflation rate of unemployment, is close to 3% given the recent slowdown in productivity. With sluggish productivity, wages cannot grow that significantly. However, real wages have been growing close to 1.75%—partly due to low inflation. **Is a Recession Likely?** Fiscal policy in the U.S. has been a headwind over the past few years, but today, governments, households and businesses have been expanding spending as energy prices fall. Kohn also points to relatively robust domestic demand and says the odds of a recession are low. While consumers have been the backbone of U.S. economic growth, exports have been a drag on the economy, and consequently, manufacturers have been hurt. While a recession is unlikely, Kohn thinks that the multinational nature of American corporations is likely to result in weaker corporate earnings. An appreciating dollar can put a squeeze on profit margins. Further, if wages go up and there is no productivity growth, corporate earnings might take a harder hit. Professor Siegel notes that a stronger dollar and weaker commodity prices resulted in S&P 500 earnings contracting more than 7% in 2015—an unlikely outcome outside of a recession. **China's Policy Missteps** Kohn believes that China-related concerns are twofold. First, investors find it difficult to measure China's progression from an industrial-driven economy to a consumer-oriented one. Second, China has been inefficient in communicating this transition to the rest of the world. Additionally, Leland Miller found that both the manufacturing and services sectors faltered in Q4 2015. He saw a two-tiered Chinese economy, with the services industry bolstering the slide in manufacturing. Unfortunately, he also saw Q4 data as notably weak on both the services and manufacturing fronts. **How Much Can China's Currency Depreciate?** According to Kohn, two forces will drive China's currency valuation. First is the large and growing trade surplus, which is likely to be supportive of the currency. Second is an opposing force of capital outflows that can lead to yuan weakness. A large amount of capital has been trapped in China over the years and is searching for a way out. It will be important to see how China sequences its reforms—and what it decides to free up first. In managing its currency, Kohn believes, China likely will follow the Singapore model of BBC (basket, band and crawl), which is a semi-controlled currency regime, within a band of allowable movement, that crawls over time, depending on economic conditions. Miller believes the currency is likely to depreciate 8% if allowed to float freely. This may, in turn, result in competitive devaluations across currencies in Asia, triggering currency wars. However, he also believes that a large devaluation is unlikely. First, he does not see the same type of benefit in currency devaluations boosting exports—as China is not seeing exports as a prime driver of growth, and it is not the export powerhouse it used to be. Further, the risk of political backlash from the U.S. and the rest of the world would be great. Rather, China may need to keep its currency strong to keep up its reform plan of moving from manufacturing to services and to prevent further outflows. **Bottom Line for Investors** Miller's data shows a dramatic slowdown in China that has both short- and long-term repercussions. He expects a lot more volatility in the markets, and this will affect the way the Fed views stability. For those who have a universe that is affected by Chinese stock markets, he expects significant volatility, and this will have changes in central bank attitudes. Read the Conversations with Professor Siegel Series.

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DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Natural Rate of Employment (NAIRU) : Economic concept that in the long run, there will be a typical rate of employment determined by market forces which the government can increase only by causing high rate of inflation. In some industrialized countries, however, this rate is seen to move upwards over time due to gains in productivity.

Phillips curve : An economic concept developed by A. W. Phillips stating that inflation and unemployment have a stable and inverse relationship. According to the Phillips curve, the lower an economy's rate of unemployment, the more rapidly wages paid to labor increase in that economy.

Inflation : Characterized by rising price levels.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Profit margins : Net income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Trade Surplus : occurs when the value of exports exceeds that of its imports of any one country.