First Trust
Monday Morning OUTLOOK
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What if "Potential" is Just 1.5%?

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A key ingredient of monetary policy is the estimate of "potential real GDP growth" – how fast the economy should expand. The Federal Reserve thinks potential is about 2¼% per year. Using this, the Fed estimates GDP is about 8.5% below potential and monetary policy should remain easy.

But what if the Fed is wrong? What if bad policy (tax hikes, spending, and regulation), which started even before the Panic of 2008, but got worse afterward, cut potential to 1.5%?

To clarify, we're not using the word "potential" as a true, inviolable, speed limit. Like a rusty old Corvette, we believe that if it were fixed up (with pro-growth policies), the economy could grow a lot faster.

We reject the theory of the "new normal." Slow growth isn't a natural aftermath of a financial crisis. If anything, it's the "new ab-normal." Anti-growth government policies have hurt the economy and caused higher unemployment.

Looking back at historical data suggests potential GDP growth may have slowed to about 1.5% around a decade ago (see chart here).

At first no one noticed. Excessively accommodative Fed policy and other government stimulus created a bubble in housing – which pushed the economy above its potential back in 2007. Then the Panic of 2008 took it back below its potential, but not as far as most thought.

Since then, real GDP has grown faster than 1.5%. So, instead of being 8.5% below potential as many at the Fed think, the economy may very well be operating at a level close to its true potential given current policies.

We are not yet 100% convinced by this argument, but it explains some perplexing things. First, it helps explain why the "Plow Horse Economy" hasn't moved faster. It doesn't matter how many steroids the Fed feeds the horse, it just isn't going to run like a thoroughbred.

Second, it doesn't mean growth won't accelerate. For example, we may see 3% real GDP growth later this year, but any move to 4% growth, or above, is highly unlikely.

Third, the CPI is up at a 2.6% annual rate in the first five months of 2014 versus 1.1% in the same period in 2013, even though real GDP fell in Q1.

Fourth, with growth slow, and the Fed holding short-term rates down artificially, longer-term rates have been held down. If real GDP growth averages 1.5% in the long run and markets expect that to continue, the 10-year Treasury yield should hold at a lower level than would have been the case in an economy with higher potential – say, during the 1994-2004 period. So, as long as the Fed keeps inflation at 2-2.5%, a 10-year of 3.75% is a better long-term forecast than 4.5%.

A lower potential growth rate slows increases in standards of living, but doesn't curtail new innovation and the profits that come from that. So, if you're wondering what happened to the middle class or why wages aren't growing rapidly while stocks are, look no further than slower potential growth.

And, there is only one way to improve it. Get better fiscal policies and stop counting on the Fed.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-15 / 7:30 pm	Retail Sales – Jun	+0.6%	**+0.7%**		+0.3%
7:30 am	Retail Sales Ex-Auto – Jun	+0.5%	**+0.6%**		+0.1%
7:30 am	Empire State Mfg Survey – Jul	17.0	**18.6**		19.3
7:30 am	Import Prices – Jun	+0.4%	**+0.5%**		+0.1%
7:30 am	Export Prices – Jun	+0.2%	**+0.2%**		+0.1%
9:00 am	Business Inventories – May	+0.6%	**+0.6%**		+0.6%
7-16 / 7:30 am	PPI – Jun	+0.2%	**+0.2%**		-0.2%
7:30 am	"Core" PPI – Jun	+0.2%	**+0.1%**		-0.1%
8:15 am	Industrial Production – Jun	+0.3%	**+0.2%**		+0.6%
8:15 am	Capacity Utilization – Jun	79.3%	**79.2%**		79.1%
7-17 / 7:30 am	Initial Claims – July 12	310K	**310K**		304K
7:30 am	Housing Starts – Jun	1.025 Mil	**1.002 Mil**		1.001 Mil
9:00 am	Philly Fed Survey – Jul	16.0	**16.9**		17.8
7-18 / 8:55 am	U. Mich Consumer Sentiment- Jul	83.0	**83.0**		82.5