HOW CAN THE U.S. ECONOMY START LIVING UP TO ITS POTENTIAL?
Are Americans optimistic and confident?
Or are they cautious, and maybe losing hope that a better future may lie ahead? Based on some surveys, the results are not encouraging. For example, in a recent poll, 48% of young Americans said that they believe the American Dream is dead.¹ A whopping 76% of those polled were not confident that life will be better for their children,² and only 28% said they believed America is the best country in the world.³

Results like this raise the question: Why is the world’s greatest economy struggling to live up to its potential? And, perhaps more importantly, how do we fix it?

The U.S. Economy Is Performing Below Potential

Many Americans have a negative outlook on the future state of the U.S. economy, as demonstrated by the poll results noted above. Although we are more than seven full years into the current economic expansion, many still feel a sense of disappointment in its progress. In fact, although the economy has seen continued growth, the pace of that growth— as measured by gross domestic product (GDP)— has been sluggish at times, and overall, below trend.

Historically, there has been a correlation between the depth of a recession and the strength of the recovery that followed. Figure 1 shows that deeper recessions (vertical axis) have typically led to stronger rates of growth during the recovery (horizontal axis). However, this has not been the case in the current recovery. The 2008 recession was the largest since the Great Depression, but the recovery rate has also been the slowest since that time.

Another way to quantify the current growth gap is known as potential GDP [Figure 2]. Broadly, potential GDP is the rate at which an economy can grow at a constant rate of inflation. When an economy exceeds this growth rate, excesses start to appear, which can lead to inflation and eventual recession. (LPL Research’s Over Index⁴ is an indicator that can help to track potential excesses before they become a problem.) However, when an economy is growing below potential GDP, as has been the case the past several years, it indicates that the economy is not living up to its potential. The current gap stands at $365 billion. To put this number in perspective, this is like removing the entire state of Minnesota from the U.S. economy.

¹ Harvard University Institute of Politics, Survey of Young Americans’ Attitudes toward Politics and Public Service, 2015.
² Wall Street Journal/NBC poll, August 2014.
⁴ The LPL Research Over Index measures trends in three broad economic drivers: spending, borrowing, and confidence. A sophisticated statistical process is used to measure the likelihood that the economy is showing signs of overactivity and that we may be approaching a cyclical peak.
Although the economy has seen continued growth, the pace of that growth — as measured by gross domestic product (GDP) — has been sluggish at times, and overall, below trend.

**Economic Growth in the Current Recovery Is Well Below Trend**

**U.S. Economic Growth Is Not Living Up to Its Potential**
INSTITUTIONAL INSIGHTS  HOW CAN THE U.S. ECONOMY START LIVING UP TO ITS POTENTIAL?

WHAT IS KEEPING US FROM OUR POTENTIAL?

We believe two major forces are keeping the U.S. economy from reaching its potential: monetary policy and income/debt dynamics.

**Monetary Policy**

The Federal Reserve (Fed) uses monetary policy to help smooth out economic cycles. At a high level, this works as follows:

1. The economy enters recession, and the Fed decreases rates to spur growth.
2. The economy recovers, and the Fed normalizes rates to prevent runaway growth and inflation.

Previous recoveries have seen the Fed raise rates an average of 18 times during each recovery [Figure 3]. However, more than seven years into the current recovery, the Fed has only raised rates once so far. Although another may be coming before 2016 ends, this is far below average; one, or even two, rate hikes clearly doesn’t equate to rate normalization. To put it another way, the Fed may have taken the economy off life support, but it hasn’t released it from the hospital.

Low rates are a good thing when borrowing to buy a car, a house, or financing the expansion of a business. However, according to data from the U.S. Bureau of Economic Analysis (BEA), economy-wide, Americans receive two times more interest than we pay. Because rates don’t discriminate, this means that low rates hurt the typical consumer twice as much as they help.

Historically, lower rates have led to lower levels of savings. When consumers could receive 10% interest on a savings account (such as during the 1980s), it made more sense to save than spend. But as interest rates fell, so did the rate of savings. The Fed pushed rates to zero following the Great Recession, but instead of leading to higher rates of spending, this move actually led investors to save more [Figure 4].

The reason for this change in behavior is easy enough to explain. Investors looking to save for retirement or other purposes can’t count on interest to push them to their goals. For example, if investors wanted to generate $100,000 in income from a portfolio of 2-year Treasury bonds in 1980, they would need just $763,395 to meet the goal. By the year 2000, that number had grown to nearly $2 million, and given today’s ultra-low rate environment, an investor would need a staggering $14 million of 2-year Treasury notes to generate that same $100,000 in income.

**Income and Debt Dynamics**

Another factor holding back economic potential in the U.S. has been income growth. The U.S. has the 4th highest average income in the world. But U.S. median income, which removes the impact of disproportionate gains among the very wealthy, ranks 19th. In fact, according to U.S. Census data, median income has only increased by $3,149 since 1989, when adjusted for inflation (in 2015 dollars), with most of this increase coming in 2015 (the increase from 1989 to 2014 was an even smaller total of $351, or $13 per year). That equates to approximately $121 per year for a family that makes the median income. This lack of income growth for a large segment of the economy is holding back economic growth.

In addition to the lack of substantial income growth, based on inflation rates, necessities are becoming more expensive, while luxuries are becoming cheaper [Figure 5].
3. The Fed Has Yet to Normalize Rates, 8 Years into the Economic Recovery

4. Low Interest Rates Led Investors to Save More Following the Great Recession

5. Luxuries Are Becoming Cheaper, While Necessities Are Costing More
HOW CAN WE REACH OUR POTENTIAL?

Real GDP growth needs to increase in order for the U.S. economy to meet its potential. As Figure 6 shows, at a 2.1% growth rate, we won’t close the gap very fast. But increasing real GDP even slightly to 2.5% shows a significant improvement, and a larger increase to 3.5% would help close the gap even faster. Of course, this growth has to come from somewhere, and we believe that potential areas of improvement include business spending and wage growth.

Growth in business spending has been slow during this recovery. Companies have not been afraid to borrow given historically low interest rates, but spending in recent years has been more focused on stock buybacks than on expanding capacity. Part of the reason for this is that existing capacity has been sufficient, given slow wage growth at home and slow economic growth abroad, limiting demand for U.S. exports.

Wage growth, which has been showing signs of life recently, obviously helps growth by giving consumers the means to spend more. But it also helps by improving consumer confidence, which allows consumers to save less or even take on additional debt. Debt, up to a certain point, can be a positive for an economy, if it spurs needed growth or is an investment in future growth, but as we have learned time and time again, too much debt (driven in many cases by too much confidence) can end up being a problem; so there is a delicate balance on this front that the Fed will need to watch closely.

The fact that wage growth is also one of the best predictors of Fed rate hikes is another testament to its impact. Figure 7 shows that the fed funds rate has historically had a strong correlation with wage growth, meaning that stronger wage growth may lead to rate normalization. Or, it might be just the medicine the economy needs for the Fed to decide it’s time to release a now healthy patient from the around-the-clock care of the hospital.

Growth has to come from somewhere, and we believe that potential areas of improvement include business spending and wage growth.
HOW TO INVEST IN A POTENTIAL RESURGENCE

As we work toward closing the gap and improving GDP growth, it’s important to look ahead to possible investment opportunities and how to make the most of a potential resurgence. As we discussed in our Midyear Outlook 2016: A Vote of Confidence, we expect the stock market to continue to see volatility through year-end, but still expect stocks to see mid-single-digit returns for the full year.* Stock ownership rates in the U.S. are currently low by historical standards, with only 52% of adults investing, according to a recent Gallup poll (compared to 65% in 2007). This indicates that additional money may be on the sidelines that could help stocks move higher. We continue to favor growth sectors (specifically technology and healthcare), and are watching for opportunities to add exposure to emerging markets (EM) and energy.

Year-end stock returns have been positive 70% of the time, going back to 1980. And though it hasn’t worked well in recent years, we continue to believe a diversified portfolio can help investors over the long run (see our recent Thought Leadership publication, “Diversification May Be Poised for a Comeback”). Diversification, as measured by whether a diversified equity portfolio outperforms large cap equity holdings, has only worked in 1 of the past 5 years, but has also worked in 10 out of the last 16. We continue to believe a diversified portfolio may benefit investors once again, as they seek to achieve a better risk-adjusted return and reach their long-term goals.

CONCLUSION

We continue to believe there are reasons to be optimistic about our economic future. While the U.S. economy is not currently living up to its potential, we believe in the prospect of stronger growth and continued global leadership. Additional economic growth, driven by wage growth and business spending, can help us close the GDP gap quickly, helping the country again reach its economic potential.
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IMPORTANT DISCLOSURES
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Any economic forecasts set forth in the presentation may not develop as predicted and there can be guarantee that strategies promoted will be successful.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

INDEX DESCRIPTIONS
The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.