Northern Trust

WEEKLY ECONOMIC COMMENTARY

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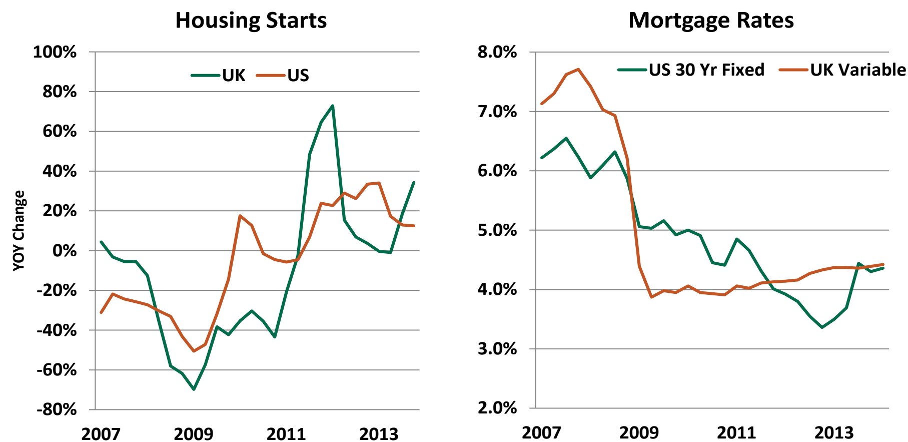
- **Housing may be returning to a bad neighborhood**
- **Hiring gathers pace in the United States**
- **A new look at "Das Kapital"**

I've always tried to combine rigorous study of the data with more-informal methods to arrive at a sense of how the economy is performing. I ask cab drivers about traffic, restaurateurs about bookings and merchants about markdowns. I usually get interesting answers, but some respondents mistake me for a tax agent and end the conversation abruptly.

One of my favorite signs of the times is the number of cranes visible on the horizon. By that metric, business is booming in many places. Toronto, Miami, Atlanta and Austin are just a few of the places I've been lately where building seems especially active. Next month, I'll make my annual swing through Asia, which must have more cranes per square mile than anywhere in the world.

Prior to 2008, I viewed active crane fields as very positive signs. Today, my feelings are considerably more mixed. Real estate can lift an economy but can also drag it down. Hence, the strong readings that we are seeing on housing from many world markets should be viewed somewhat cautiously.

Policy-makers love housing. Construction is a very tangible sign of economic activity, and it employs an egalitarian mix of workers. The inhabitants of new space indenture themselves to an annuity of spending to furnish and maintain their surroundings, creating revenue for local businesses. For owners, rising property values serve as a source of wealth and a basis for leverage that can support consumption.



Sources: Bloomberg, Haver Analytics

To promote housing, governments across the globe provide a mix of incentives. Tax preferences, housing agencies and financing assistance are commonly employed for this purpose. Housing also responds very powerfully to low long-term interest rates, so the dedication of the world's central banks to price stability has improved affordability over time.

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With short-term rates reduced to near zero and quantitative easing programs in place in many nations, the cost of financing new property has rarely been lower. As a consequence, housing activity has picked up nicely across a number of markets, albeit from modest post-crisis starting points. Residential investment has been a key contributor to recovery from the Great Recession.

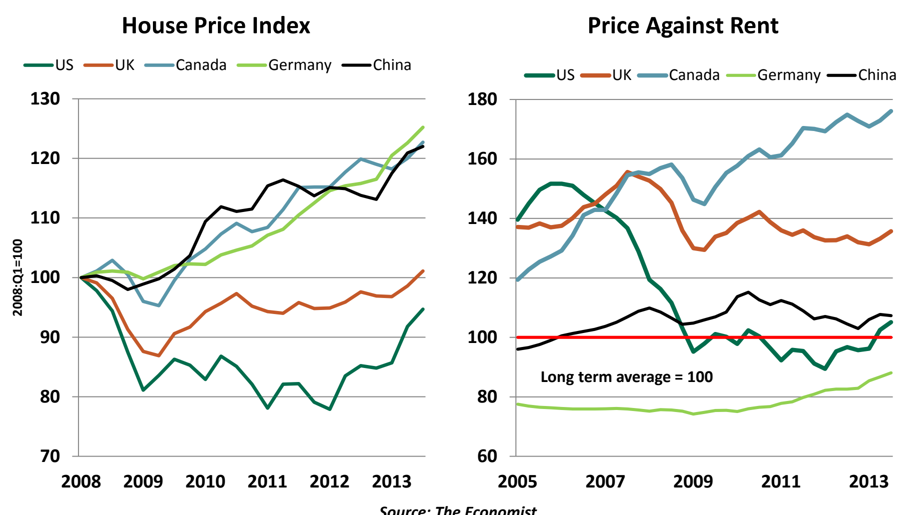
Much of the recent momentum in residential construction seems centered on multifamily units. This has been fueled in many places by a scarcity of land for development and by the desire of residents to be closer to city centers. In particular, retired persons are leaving the sprawl of the suburbs for the attractions of an urban setting.

The trend toward high-rises also reflects the rotation toward rental that has been an important feature in the United States, among other places. Here, home lending standards have been tightened in response to lessons learned from the financial crisis; down-payment requirements and controls over the ratio of mortgage payments to income have become much more restrictive. Young workers, having seen their parents damaged by the financial risk of property ownership and anxious to remain geographically flexible, would rather lease.

Easy monetary policy might overstimulate housing.

But one has to be amazed by the sheer number and size of some of the developments underway. Real estate has historically had a nasty habit of swinging from depression to euphoria in relatively short spans of time. It seems like we've gone from a strong preference for pre-leasing back to the mind set of "if you build it, they will come."

A powerful recovery of real estate values has aided the recent strength of construction. As individual properties begin to appreciate, higher prices get transmitted through the industry via benchmarking and appraisal. On this basis, lenders may find themselves more comfortable extending credit. As they do, values rise even further, creating a very cyclical pattern that can be difficult to control.



Source: The Economist

In some markets, it appears that house prices are once again stretching valuation boundaries. Skeptics wonder whether officials are allowing housing to reflate because other sectors of the economy have been very slow to recover.

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The head of financial stability at the Bank of England recently called rising property prices "the very brightest [hazard] light on its dashboard." But he may have a difficult time getting his colleagues who are charged with promoting full employment to agree with him. And if they do, it is far from clear what they might do about the issue. Some favor supervisory curbs; others prefer the more-traditional method of raising rates.

The recovery in global real estate has been pronounced. While it beats the alternative, one wonders whether the hard lessons learned in recent corrections have been sufficiently internalized. We can only hope that all those cranes aren't building the superstructure of a future financial collapse.

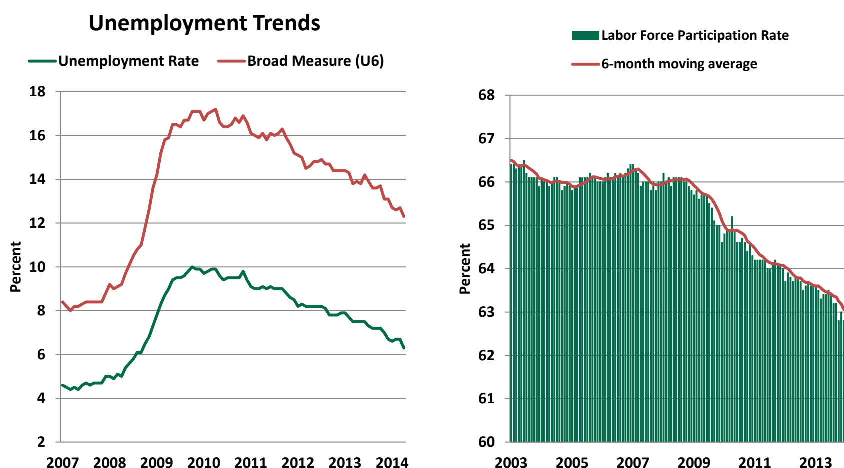
April Employment Situation: Good but Certainly Not Great

The headline numbers of the April U.S. employment report are impressive – 288,000 new jobs and a 6.3% unemployment rate. But underneath the headlines are some reasons for pause.

The unemployment rate is derived from the household survey. Although April employment declined 73,000 in this reading, the jobless rate fell because the labor force dropped 806,000. As a result, the participation rate fell four-tenths to 62.8%, a discouraging outcome that reversed four months of improvement.

The decline of labor force participation was a discouraging outcome.

The participation rate is likely to move up only over an extended period as the economy gathers more steam. As the chart indicates, the participation rate in the last expansion held at 66% for several quarters in a row, with the strength in hiring offsetting the setback from demography. Going forward, it will be meaningful to look at the participation rate on a moving-average basis rather than on a month-to-month basis. Based on this recommendation, the participation rate held at 63% during the entire January – April period.



Source: BLS, Haver Analytics

Looking through the jobless rate by age, the teenage unemployment rate fell 1.8 percentage points in April, probably an aberration that will be reversed soon. Long-term unemployment shows a small improvement, with the share of those unemployed for over 27 weeks edging

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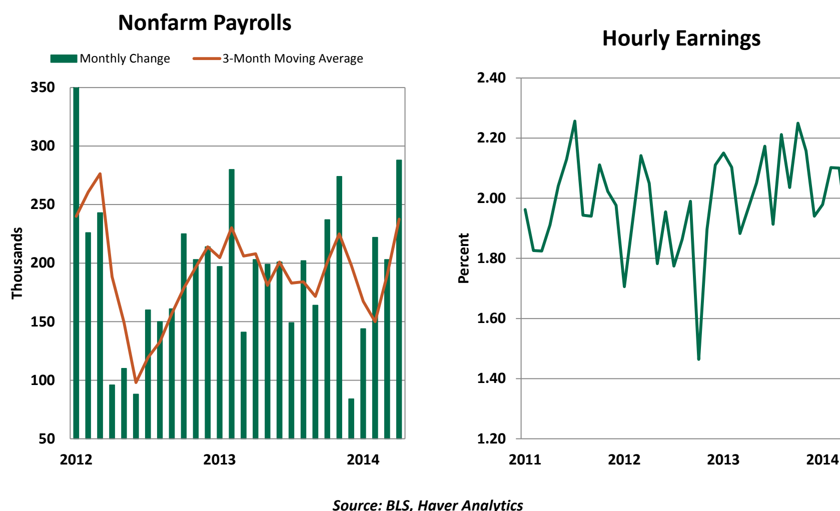
down to 35.3% from 35.8% in March. The unemployment rate is projected to be lower at the end of the year, but we need to winnow through data trends with care.

Nonfarm payrolls rose 288,000, with revisions of the prior two months adding 36,000 more jobs. The three-month moving average of payroll gains stands in excess of 200,000 jobs.



Source: BLS, Haver Analytics

From the details, construction jobs advanced 32,000, and factory employment rose 12,000. Private-service sector jobs advanced 220,000, the strongest performance in the last three months. Widespread gains in employment were reported, with retail (+34,500), health care (+19,000) and professional and business services (+75,000) posting relatively large improvements. Government hiring rose in April after a lull in the prior two months.

April's job readings will not change Fed policy.

The workweek was mostly unchanged in April. Hourly earnings slipped slightly in April; for the most part it is holding around the 2% range in the last few months. This is not indicative of wage pressures that can stoke inflation. In fact, it is far lower than what would be consistent with the current jobless rate. Employment gains bode positively for personal income and spending in April, a noteworthy aspect following on the heels of a noticeable increase in income and spending in March.

Employment data of the last three months validate that bad weather held back hiring in December and January. The Federal Open Market Committee will view the decline in the jobless rate within the context of the decline in the participation rate and bear in mind that the level of the unemployment rate is not a true reflection of the status of the current labor market.

The current forward guidance and Fed rhetoric continue to stress that the Fed will consider the evidence from a broad set of labor market indicators to take the temperature of the labor market. Long-term unemployment, the magnitude of part-time employment, quit rate, hiring rate and wage trends signal a different message compared with the latest jobless rate. The mixed messages are likely to leave the Fed set on its course to wind down the asset purchase program by October.

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A new book ignites an old debate.

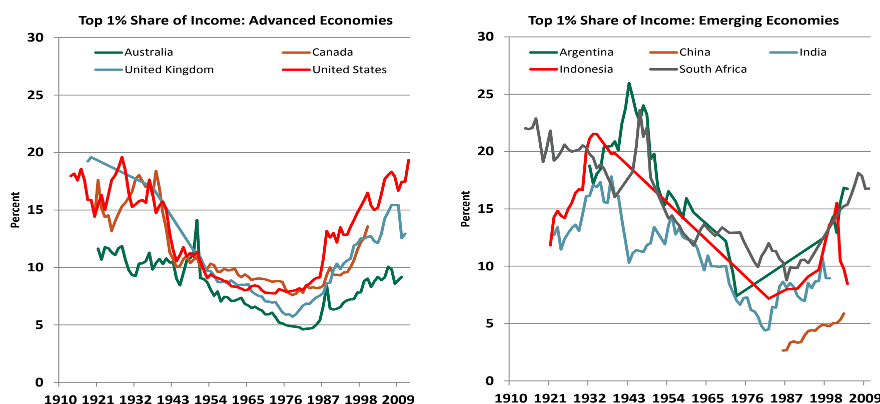
"Capital in the 21st Century" – The Premise

Thomas Piketty's book, "**Capital in the 21st Century**," initiated an intellectual storm after the English translation was published last month. The title of the book is a play on Karl Marx's well-known work "**Das Kapital.**" The content is a contemporary discussion of income distribution, which was prominent in the writings of Karl Marx and others more than 150 years ago.

Economic data, which 19th century political economists lacked, support Piketty's thesis. He uses the share of income as a measure of income distribution to make his case.

Based on this measure, the charts below indicate **three** phases of income inequality. A high level of income inequality prevailed in the early part of the 20th century in both advanced and emerging economies. A sharp reduction of income inequality was associated with the onset of WWII, and inequality re-emerged after the 1970s. Advanced economies experienced a flat trend of top income shares in the aftermath of WWII.

Piketty's main concern is the recent upward trend of inequality, visible in the charts below. The share of the top 1% of wage earners in the United States in 2012 stood at nearly 20%, up from 9.1% in 1986.



Source:http://topincomes.g-mond.parisschoolofeconomics.eu/

He introduces the concept "capital" to develop his analysis. Capital is any non-labor asset that yields a "rate of return." It ranges from stocks and bonds, to physical assets, to intellectual property.

He attributes the rise in inequality to the divergence between the rate of return on capital and rate of growth of the economy. (This is another way of noting that asset returns have often been well in excess of real growth.) As long as the return on capital is higher than the rate of growth of the economy, the share of capital in total income grows over time at the expense of the share of labor income. This systematic long-term development, inherent in an untethered free-market economy, can lead to fairly substantial growth in income inequality over the span of a few generations.

Piketty's conclusions have certainly created a buzz, but they have not gone unchallenged. We'll be back next week with a critique.

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