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Subpar data slow Fed's march to interest-rate increase

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Each week Fed leaders take to the luncheon circuit to speak in favor of higher interest rates. Each time they seem ready to raise rates something gets in the way. If it is not China, it is Brexit, or it is employment data. The one time the Fed did raise rates, the market corrected sharply.

Ever determined, the Fed speakers are again calling for rate increases. After Chairwoman Janet Yellen opened the door just a crack at the Jackson Hole economic conference, it seemed very likely that the Fed would raise rates in September. This contrasts with previous Fed expectations not to raise rates before December and maybe not at all this year. But a subpar jobs report showing hiring of 151,000 workers in August stunned the markets, again reflecting the weak economy. With 24,000 fewer jobs than expected, the jobless rate held steady at 4.9 percent.

The labor participation rate remained at a meager 62 percent. The report is likely to keep the Federal Reserve on hold when it meets on Sept. 21.

Furthermore, the Institute for Supply Management Non-Manufacturing Business Activity Index showed a surprise massive slowdown in growth in August, raising new warnings about the economy. This service-sector index represents a large portion of the economy. Coming on the heels of the recent decline in the manufacturing index, these gauges represent a twin blow. Expectations of a rate increase in the futures markets showed a sharp drop, with expectation of a September rate increase dropping to 13 percent.

There is a strong case for raising rates. Except for the single raise in December 2015, rates have been extremely low for many years. These low rates have punished savers and distorted the economy in many ways. One obvious way is that the equity market is trading near all-time highs, with the price-earnings ratio historically high. That raises the question: Is the market properly valued? But with interest rates low, there is a rush to find yield, driving investors into such things as emerging market debt, high yield instruments and perhaps setting up a bubble. Investors have snapped up equities in an effort to get some return on their otherwise moribund investments. This distortion has been good for equity investors and investments in real estate, but not good for savers or lenders.

The purpose of the low interest rates and quantitative easing was to get the economy moving again, creating jobs and profits. It worked to an extent, but clearly not enough. The theory was correct, but the execution was not good enough, as the executive and legislative branches of government piled on more and more deterrents to economic growth.

The result has been a sluggish economy. The Fed has been wrestling with these problems for years, but the result has been like the sound of one hand clapping. Economic growth has remained slow, wage growth has been slow, productivity growth has been slow, and employment growth has been slow. In many cases increased profits have been generated by financial engineering, layoffs, and moving companies to more

favorable tax environments. And now profit margins are under pressure because of rising employment costs, largely coming from government mandates.

So far in 2016, gross domestic product has grown a meager 1.1 percent. Business investment has shrunk 9.7 percent. Even government spending has been reduced by 1.5 percent. Only consumer spending has supported the economy, growing 4.4 percent. Consumer spending has increased for the fourth straight month. But now consumer confidence has dropped to its lowest level since April, according to the University of Michigan consumer confidence survey. Forty-one percent of Americans say the economy is in a recession, up from 37 percent last month. In the face of all these negatives, the Fed has to make a decision regarding rates: sit tight or raise them?

The Fed has a dual mandate: control inflation and grow the economy at its natural rate. There is not much inflation, and growth is meager, so it would seem the Fed should do nothing for now. However, there are those annoying distortions that will lead to bigger problems if not dealt with. Our belief is that the Fed will raise rates this year, probably by a quarter point, and then wait and see how the economy and markets react.

In the meantime, continue to count on little or no returns from non-risk assets such as cash or Treasurys. Expect equities to be the preferred investment vehicle.

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