

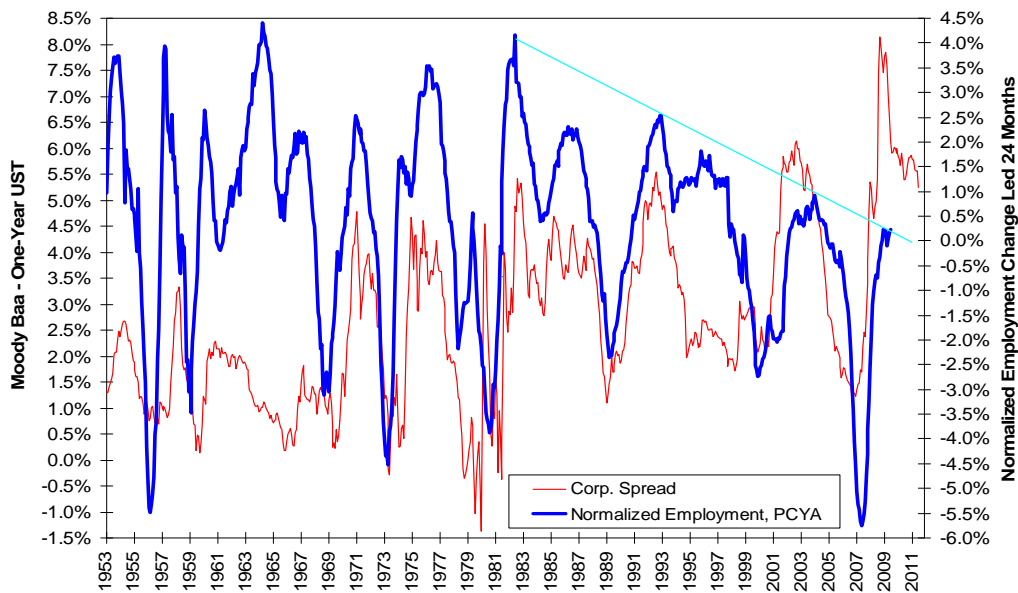
## Cost of Capital Investment and Employment

As we noted last month, nearly all economic data and by extension many of the movements in financial markets begin with employment (see “Productivity and Employment”). One of the surprising conclusions we reached was policies designed to stimulate the economy via low interest rates often have the counterproductive effect of making capital cheaper relative to labor and therefore reduce domestic employment growth. Overall, we concluded rising productivity as the result of cheaper capital and improved technology provided a strong headwind for employment growth and explains a three decade-long secular decline in normalized employment growth, highlighted with a turquoise trendline in the first two charts below; this is the year-over-year changes in employment adjusted for growth in the civilian population.

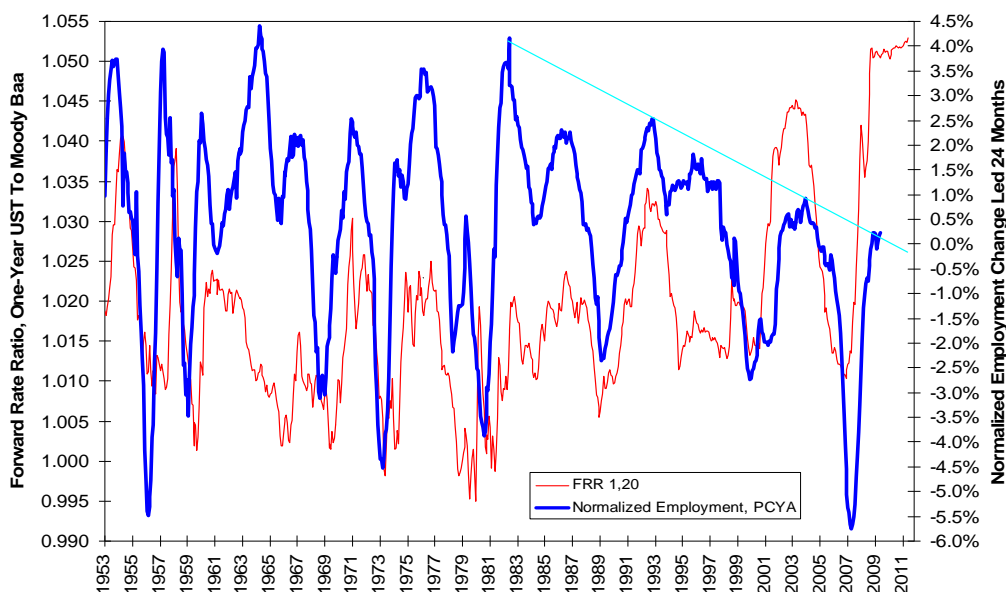
Let’s shift the driving independent variable from nonfarm productivity to the relative cost of corporate debt capital as measured by either the forward rate ratio or the absolute yield spread between one-year Treasuries and Moody’s Baa-rated yields as reported by the Federal Reserve. As the bonds in this Moody’s index have maturities ranging between twenty and thirty years, we will use a forward rate ratio between one and twenty years; this is the rate at which we can lock in borrowing for nineteen years starting one year from now divided by the twenty-year rate. The more this  $FRR_{1,20}$ , the steeper the yield curve is.

Both the yield spread and the  $FRR_{1,20}$  lead changes in normalized employment by 24 months on average. The two measures of the corporate yield curve have a different relationship to normalized employment growth. Both a wider spread and a steeper  $FRR_{1,20}$  are associated with rising normalized employment growth, but for different reasons. In the former case, higher corporate credit demands are associated with prospective hiring as business conditions improve. In the latter case, the Federal Reserve drives short-term financing costs lower in an attempt to maintain operating margins. Restated, the spread is driven by corporate actions at the long end of the yield curve while the  $FRR_{1,20}$  is driven by Federal Reserve actions at the short end of the yield curve.

Corporate Bond Spread Leads Normalized Employment Changes



### Steeper Carry To Corporate Bonds Leads Normalized Employment Changes

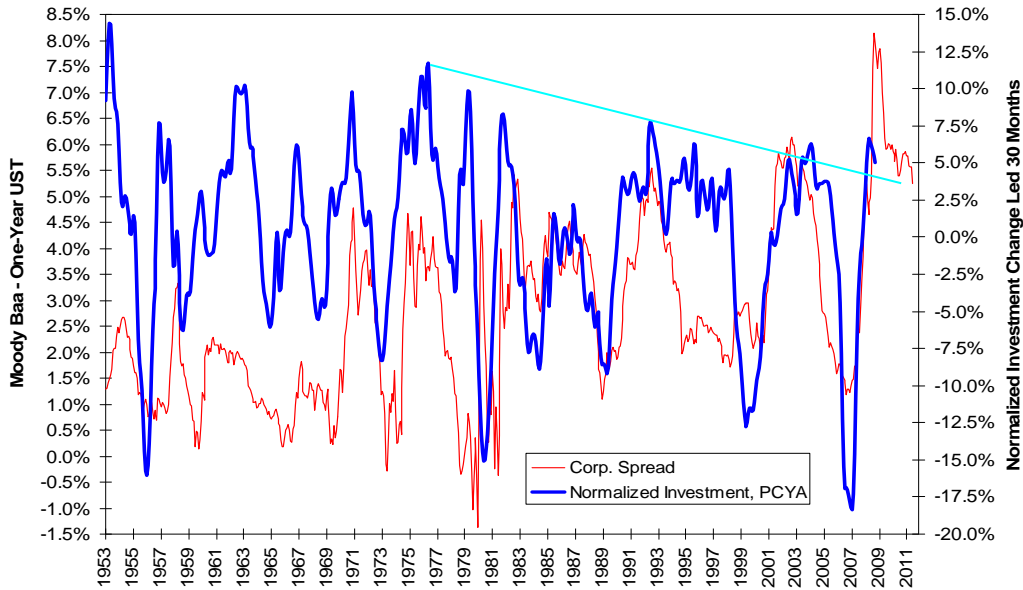


### Investment And Employment

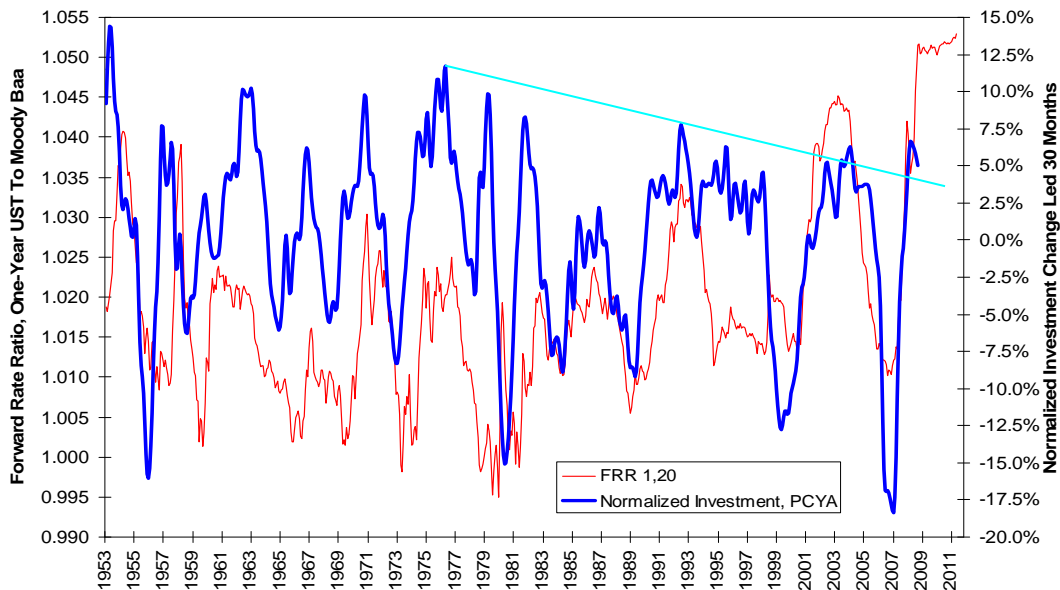
Now let's look at a second variable, year-over-year changes in non-residential fixed investment normalized to GDP as a function of both the yield spread and the  $FRR_{1,20}$ . Here the relationship changes in two important ways. First, the lead time between changes in the yield curve variables and investment flows expands from 24 months to 30 months. Second, the secular downtrend in normalized non-residential fixed investment growth year-over-year began not in the early 1980s with the Reagan-era tax cuts, accelerated depreciation schedules and elimination of Regulation Q interest rate ceilings that favored capital over labor, but rather in the mid-1970s exit from the 1974-1975 recession. This was the era of the first energy shock, the transition to floating exchange rates, rising inflation, high marginal tax rates, declining productivity growth and the final surge in both long- and short-term interest rates to their highs of the twentieth century. Declining investment growth was born in the Disco Era: We should have known.

Once again, this secular decline is marked with a turquoise trendline on both charts. The general effect of both measures of the yield curve is the same with a similar fundamental differentiation seen in the employment case: A wider spread and a steeper  $FRR_{1,20}$  both lead normalized year-over-year changes in non-residential fixed investment. Higher interest rates attract capital in the case of the spreads and cheaper short-term funding leads to carry trades in the case of a steeper  $FRR_{1,20}$ .

### Corporate Bond Spread Leads Normalized Investment Changes



### Steeper Carry To Corporate Bonds Leads Normalized Investment Changes

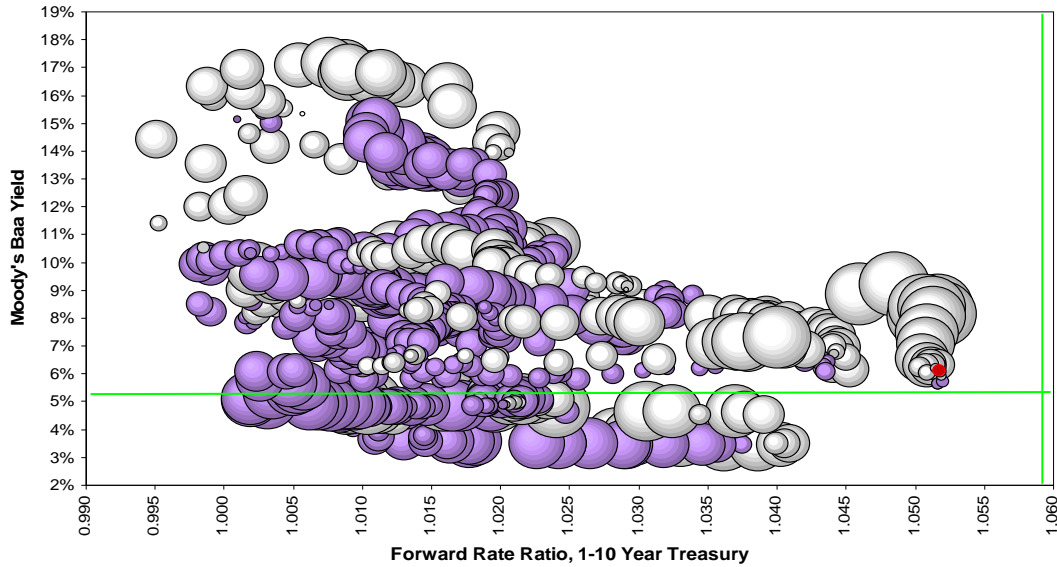


### Looking Ahead

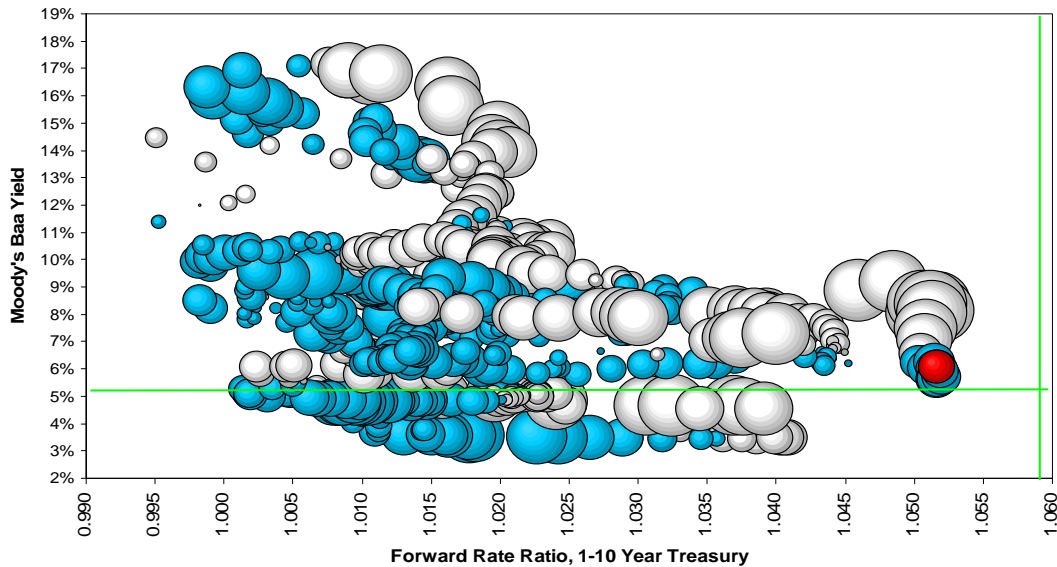
As the entire point of policy changes is or should be to affect changes, let's see how both year-over-year changes in normalized employment and in normalized investment are a function of six month-ago conditions in both the  $FRR_{1,20}$  and in absolute Baa corporate bond yields. In both charts below colored bubbles depict positive changes; negative changes are depicted in white bubbles with the diameter of the bubbles corresponding to the absolute magnitude of the change. The most recent environment is depicted in the green bombsight and the six month-ago datum is highlighted in magenta.

In the case of normalized year-over-year employment changes, it is quite easy to see how driving a yield curve steeper, the Federal Reserve's favorite and perhaps only trick, is astonishingly ineffective at producing a positive employment response in the near-term. The conclusion is only slightly less definitive in the case of normalized investment gains. Yes, we can argue the lags may center around 24 and 30 months, respectively, but we do live in a world with short-attention spans. To paraphrase Keynes, in the long-term, all politicians are dead. The only thing they care about is the next election cycle.

**Six Month-Ahead Normalized Change In Employment  
As Function of Corporate Yields And Treasury Yield Curve**



**Six Month-Ahead Normalized Change In Non-Residential Fixed Investment  
As Function of Corporate Yields And Treasury Yield Curve**



**Conclusion**

Before we go off excoriating politicians, look around the literal or proverbial room at your fellow traders. Long-term investors are a rare breed, and even short-term position traders are giving way to day traders and high-frequency traders. If politicians have a quick trigger, traders have an even quicker one and have a nasty habit of linking bad market conditions with incumbents. We cannot know for certain if the outcomes of presidential elections in years such as 1932, 1980 or 2008 would have been different if they were held during bull markets, but the conversation itself has to be considered reasonable.

The demand to “do something” often results – and this may surprise you – in something being done. As the tools available to policymakers are limited, they tend to focus on more borrowing, more spending, more printing of money and more (eventual) taxes and inflation to pay for today’s shot of Dr. Feelgood. What we have seen both last month and here is the desired outcomes of higher employment and investment are difficult to achieve even as the momentary buzz of financial bubbles is easy to create.

If you ask someone, anyone, to do something they cannot do and then demand to see immediate results, they eventually will show you some immediate results; shamans, sorcerers and witch-doctors through the ages have understood this mechanic well. If the results are poor for the long-run; well, that is the long-run's problem, is it not? It is not: As conditions in municipal pensions and federal entitlements have shown, the future shows up eventually and demands the bills be paid.